Expert Discussion

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Dealmaker Roundup Q1 2020

Why Private Equity Loves Software Deals

Privcap curated a conversation with three experts who have worked extensively on software transactions. As software has grown exponentially as an industry and omnipresence in society, private capital has flowed into the sector in greater and greater amounts. Why are private equity investors so eager to own software businesses? What can they bring to the table besides capital? This wide-ranging discussion delivered these insights and more.

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The Experts

Michael Pantilione
LLR Partners

David Van Wert
RSM US LLP

Kurt Shenk
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Privcap: Why has private equity become such a force within the software business today?

Michael Pantilione, LLR Partners: The software business model exemplifies a few of the attributes that private equity firms tend to find most valuable. Specifically, they usually provide a great degree of revenue visibility by virtue of either a recurring subscription license or a large pool of recurring maintenance revenue. The other side of the business model that I think drives a lot of attraction is scalability. Most software firms operate with very strong gross margins, meaning they don't have a very high cost of goods sold. And once you get down into the operating expenses, you find a lot of operating leverage. The mix of revenue visibility and operating leverage can create strong cash flows that ultimately can yield very high valuations.

Privcap: David, as someone who works on the sale of many software businesses to private equity firms, would you describe the market as crowded?

David Van Wert, RSM: I don't know if I would describe it as crowded, but it's certainly well-attended. There have been the legacy-focused private equity groups that continue to focus on software, and then there are other funds that are dabbling or creating a vertical in software investing. And then you also see a lot of offshoots - people that have come up the ranks in a private equity group, and then they go out and hang their own shingle and start their own private equity investing groups.

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Kurt Shenk, RSM: Software businesses are fantastic targets for private equity. They are asset light, require less to capital to scale, and can achieve rapid growth, even in the later stages of an economic cycle. Software companies have the opportunity to sign up lifetime customers with a click of a button and can achieve rapid growth. It is a competitive market, as the amount of dry powder continues to grow. Last week, I was talking with a company that was up for sale and speaking with 25 different private equity groups. Even though it's competitive, the tech industry is rewarding private equity investors. Over the last 10 years, PE groups investing in tech have received annual returns of approximately 19%, which is about 5% higher than PE groups investing in non-tech investments. In the coming decade, we believe tech will continue to provide above-average returns.

Pantilione: I do feel like it's a crowded market. I've been reaching out to software companies over the last 15 years. When I was first getting started, it was somewhat novel for an entrepreneur to hear from a private equity firm, to have a bit of flattery that someone was interested. Now when I reach out or when I'm in a meeting, it's not unusual to hear that I'm the 10th email they got that day, or I'm one of 20 VCs or private equity professionals that they're keeping up with. Private equity firms are just really bombarding these companies with outreach. I try to get there before the investment bankers, and try to create a relationship that gives us an edge when the company does choose to raise money. So it does feel competitive, and more so than ever.

Privcap: What can private equity firms do to stand out in such a competitive market?

Van Wert: There are a lot of different ways that investors and buyers are attempting to differentiate themselves. The obvious one is just paying a higher purchase price or a higher multiple. Also, increasing the speed to close. You see a lot of banked processes where buyers are attempting to preempt the process and get to the finish line before anyone else. But when you peel back the onion, you start talking about what's really going to make the investment successful post-close. The groups that really have a plan and have seasoned operators in the ranks are the ones that tend to differentiate themselves, especially when they already have a proven track record.

Privcap: What are some important operating tools that private equity buyers can bring to a software business?

Van Wert: Being able to understand the sales channels could be one. Understanding how to optimize profitability is another one. And lastly, being able to work with management teams. I think a lot of management teams want to have an advisor and a partner, but the level of prescriptiveness can vary among investors. In some cases, a highly prescriptive model with specific KPIs works really well.

Shenk: More and more, I'm hearing about KPIs. They are helping our clients think about key metrics like customer renewals or cash burn by having a line of sight into industry norms. We are finding that investors are looking for a combination of revenue growth with profitability. Investors are no longer rewarding top line revenue growth at all cost. As a result, KPIs over expense categories are received increased focus.

PRIVATE EQUITY-BACKED BUYOUT DEALS IN SOFTWARE, 2010 - 2020 YTD

Source: preqin

YEAR	NO. OF DEALS	AGGREGATE DEAL VALUE ($BN)
2010	246	15.1
2011	362	27.1
2012	348	17.5
2013	415	28.6
2014	594	57.6
2015	634	133.6
2016	763	94.0
2017	867	70.2
2018	1140	106.8
2019	877	101.9
2020 YTD	32	1.3

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Pantilione: It's good to hear David and Kurt somewhat validating the approach that LLR has taken. They're basically describing the pitch that we make to executives, which is that we have a bench of operators in functional areas like sales, strategy, strategic finance, corporate development. These can be deployed on a non-prescriptive basis. We sell against the notion that we're going to come in as an operator. We try to be less threatening and scary. There can be perceptions that the private equity boss is going to come in and change the way that they operate their business as entrepreneurs. We try to bring a user-friendly model, where you can deploy the resources in a collaborative way. We're going to discuss what the business' needs are, what our capabilities are, and how you can optimize them to get to the best outcome.

Privcap: With regard to due diligence before a deal is completed, what are the tires you need to kick hardest that are specific to software businesses?

Pantilione: Where we generally start, and tend to spend most of the time, is in the customer base, and understanding the relationships with customers - the selling dynamics, the length of the relationships, the upsell possibilities in terms of getting more dollars into those channels, and the ultimate retention. We want to see a database of your customers over time and study how they behave. When you get into the customer file, you may find a disturbing trend in retention, or one or two outsized events that have carried that growth.

Van Wert: I would agree with that wholeheartedly in terms of customer retention analysis - gross retention, net retention - all the different ways you can slice and dice it. It really has become the paramount analysis in terms of a go/no-go decision. In terms of other areas to diligence, taking it down to brass tacks, you need to make sure the company's actually collecting the cash related to the revenue they're recording. This is especially important if it's a smaller business.

Privcap: Let's move on to post-transaction value-add strategies. One of private equity's most important tools for creating growth is the buy-and-build strategy: combining several similar companies together in hopes of realizing all kinds of value. Does buy-and-build work in the software industry?

Pantilione: You need to start with the market and the product, and how those two things come together. When you're thinking about a buy-and-build strategy, it's all about maintaining consistency, making sure that you're not diluting that fit or trying to be too many things to too many potential buyers. One of the ways that we'll start our ownership process is with a strategic planning session that goes through a mapping exercise, to try to understand not only who the customer is, but what they're trying to achieve with the product that we're currently offering, and what other adjacencies exist. I think where you see buy-and-builds go awry is when you deviate too far from that initial process and you don't get the cross-selling opportunities that you may be underwriting to. You end up underwater from a cost-structure and lack-of-growth standpoint.

Shenk: The quote-to-cash process is critically important. The outcome, if done properly, will result in improved controls, better customer relationships and retention, improved utilization of talent, higher valuations, reduced diligence risk, and better collection rates. We can help companies build out their digital strategy by helping them think about people, process and technology. We take a business-first approach. To effectively transform an organization, it is important to consider how innovation can enhance customer relationships, operational effectiveness, and culture among a workforce. SaaS businesses really need to focus on keeping their base (recurring revenue) and layering on new sales. Most of their revenue typically comes from that base so they need a strong process and good clarity around the renewal process (whether it is annual, monthly or other). If it fits the business model, we are also seeing clients focus on locking longer terms and bundling products.

Privcap: Where is software as an industry going next? Can these small and medium-sized companies continue to have sticky relationships with their customers, or is there a danger that the mega-software companies, like Google and Microsoft, can flood free software into these niche industries and hurt the legacy players?

Pantilione: I think there's always going to be a spot for the small player. And the current environment supports this thesis. There's a demand from business software buyers right now, a consumer-like expectation that exact needs have to be addressed by the product. So, if you are Microsoft, if you are Google, you've got products and services that appeal to the masses. But if I'm a small software startup, I can get very zeroed in on a pain point that is relevant to a smaller universe where I can succeed. And as long as those opportunities present themselves, the small companies that are delivering those pain-point solutions are going to have a chance to build valuable businesses and create exit opportunities for themselves by selling to those large consolidators.

Shenk: I would agree with that. Big tech companies have been highly acquisitive in the past decade. Google has been the most active in the M&A market this past decade, completing 146 deals. Corporate balance sheet remain flush with cash and it is expected that this trend will continue into the new decade. There is approximately $342 billion of cash on public company tech company balance sheets, which is near record highs. That said, there are big opportunities for middle-market technology companies. Here at RSM, that is our focus. The middle market is defined as 200,000 companies, which generate 40% of GDP and one-third of jobs. The middle market is really the heart and soul of the U.S. economy. These middle-market companies can be nimble. They're willing to take risks with innovative and disruptive ideas. Private equity is increasingly a buyer of VC-backed tech companies. In 2019, private equity accounts for a record high 30% of venture capital-backed technology company exits.

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Van Wert: Mike and Kurt both mentioned the word "nimble." That's the key point. I think small technology businesses and their ability to be nimble is really what keeps them relevant compared to the big behemoths out there. The mass conversion from on-premise software to SAAS a few years ago. . . AWS or Google Cloud are getting in on the play without trying to buy up the whole store and every single little item in the store. These smaller technology companies have a role to play in terms of disruption.

Privcap: What makes you continue to be excited about being an investor in the software space?

Pantilione: It's really just the amount of opportunity that still somehow exists. Even though the field is as competitive as ever, it's still exciting to find a company that hasn't taken on much capital, that has a unique product, that's addressing a big market. It still feels like winning a prize somehow.

Van Wert: We've talked about the smaller companies and their ability to innovate and bring new things to bear. I think as different companies focus on different verticals, you're seeing the traditionally non-technology-driven verticals now becoming tech-driven. I think that's one area where you're going to see continued expansion and innovation. That creates a lot of additional opportunity.

Shenk: Working with software companies is really my passion. These companies are highly innovative. There's lots of energy at these companies, and they're always doing something exciting. I enjoy all aspects of the natural progression for high-growth software companies. ■