Privcap/ Report

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The 'New Normal' for **Mid-Cap Technology Companies**

Dropping valuations, 5G rollout and the rise of cybersecurity

Featured Experts:

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David Van Wert, RSM US LLP

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This report is based on an edited transcript of a recent Privcap podcast.

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The Experts

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Privcap: When people think about technology and software, they often think of the mega companies—Google, Amazon. But you're thinking about the influence of technology in the middle market, correct?

Richard Lawson, HGGC: Traditional industries are transitioning from the traditional economy to the digital economy. We see two trends: One, medium-sized software businesses that are growing and are looking for investment. But we're also seeing companies that are more tech-enabled in nature and they're serving end-markets – whether they be insurance, media, retail – that are using technology to become far more competitive. Almost every company in the middle market that we're involved in is tech-enabled. Marc Andreessen said, "Software is eating the world." We see that in the middle market, much like we see it in the large-cap market.

Privcap: David Van Wert, as someone who works extensively with middle-market companies and with the private equity firms that invest in them, what are you seeing with regard to the rollout of tech across traditional industries in the middle market?

David Van Wert, RSM: There are significant technology-driven initiatives providing growth for traditional companies. What's driving growth in the middle market is really dependent on access to capital. Recently, that's been provided by private equity groups focusing on the technology industry.

Privcap: Rich, can you give an example of a traditional industry getting impacted by technology and how that might make an investment theme for your firm?

Lawson: We've obviously seen the Amazon effect have a tremendous impact on retail. We helped a business that was traditionally on-prem move to subscription services and grow sales forces in multiple countries. We provided tools that allow retailers to be more effective. As you fast forward from a few years ago to today, a buy-and-build strategy in the middle market around software technology is a way to drive real alpha.

Privcap: As we speak, Coronavirus is rolling across the U.S. What do you think the impact is going to be?

Lawson: Valuations across the board, both in the middle market as well as in large-cap technology, have declined irrespective of company fundamentals. I think that, again, you are going to see a tremendous buying opportunity that's going to emerge from this environment. Think about where we were just last month, talking about the expansion of valuation multiples over three years in big cap, middle market, SaaS, applications, infrastructure.

Van Wert: The fundamentals of those businesses really haven't shifted much. There may be some earning delays, there really hasn't been a structural change in those companies. I think [this crisis] definitely will impact how we approach deals. People will be much more flexible. We'll be able to use a WebEx or a virtual platform more readily. People will still want to look into the whites of someone's eyes and shake hands, or bump elbows, as the cultural norm may become. There are probably a lot of ed-tech businesses that will do quite well through this COVID-19 scare. Five years ago, I think schools probably would've just shut down. Now there are so many virtual learning platforms and ways to actually deliver content from teachers to students. I think things like this will continue to drive innovation and if something like this happens again, we'll be even more prepared for it.

Lawson: As we tracked our companies, we saw valuation on revenue and EBITDA expand dramatically. Let's just use EBITDA as an example: seven or eight turns of expansion in the past two or three years for a typical SaaS business. A big-cap like Salesforce used to trade in the high 20s, and was then trading in the mid-30s. In the last three weeks, it's now trading back in the mid-20s. But what's really interesting is that a lot of the medium-sized businesses that are not as large, that don't have as large a cash balance or may not

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have as much of a competitive moat, are off 50%, 40%. And I think this is going to have a fundamental impact. The acquisition pipeline of strategics in the market probably will be getting more active. And one would argue that this is not a temporary blip, that when the P/E fundamentally changes, we might be in a new normal.

Privcap: On the one hand, valuations have dropped precipitously, but on the other hand, will owners of companies be in the mood to transact in this kind of a market?

Van Wert: Yes, definitely. We've been hearing from our clients that a lot of them signed engagements letters, were already started on sell-side due diligence, and they're pulling the plug or pressing the "pause" button. We hear the same thing from investment banks, many of which are shutting down processes, waiting to see how this plays out. The question is, given the divot in a company's earnings as the result of oil shock and COVID reverberations, how is the market supposed to view that? The bankers are going to be saying, "We'll value it based on the pre-COVID earnings." What's actually going to happen is probably somewhere in between.

Lawson: Our philosophy at HGGC is never to acquire 100% of a business. It's more of a partner-oriented model. So, what's been counter-intuitive for us is that we've actually seen over the past month an increase in the inbound calls from the folks we cover, saying, "I'm not sure if this is going to get better or worse. I'm not interested at all in selling 100% of my business. But what I am interested in doing is thinking about how I focus on getting to raise my next fund if I'm a sponsor, and focusing on my family and setting up my estate plan." Folks are interested in selling a good portion of their business, but will they take the capital they made in exiting in their business and put it in the markets? Absolutely not. They'd rather reinvest it in their own business. In many cases, we've had our partners sell us 51% of their business and reinvest for 49% on a leveraged basis. So, in a very strange counter-intuitive way, this is providing more dialogue for us, from people that want to do something [with their assets], but certainly don't want to exit in the middle of what could be a prolonged, environment around COVID.

Privcap: Let's move on to what hopefully is a longer-term trend. Talk about the importance of the rollout of the 5G network.

Lawson: We're a global firm in the middle market. The opportunity for people to have more connectivity globally is only going to increase. A decade ago, you had a technology market that even the financing market didn't understand. They didn't understand the software model that we were employing. The ability to build a business service that might provide connectivity like 5G. Ten years ago, institutions didn't understand that businesses that would service this market could have lasting models, would have customer retention rates in the 99% range, would have recurring revenue from maintenance and subscription models or would have cash flow that you could finance against. They didn't understand they could have scalable business models that weren't reliant on adding manpower.

So now, you have a new generation of infrastructure that's been built to work within a landscape of infrastructure – a lending community, an intermediary community and a seller community that understand how these models work. It allows us to scale and build businesses far more dramatically to service what we believe is going to be a huge demand created by global connectivity.

Van Wert: I think we're so early on the curve for 5G. Right now, the investments are really coming from telecoms. There will be job growth to provide the rollout of 5G. I think the innovations in the tech sectors and the investments from VC and PE will come thereafter. But it's definitely going to be a game-changer – the download speeds, the improved latency. There will be many technology use-cases that will come out of this that no one's even thinking of today.

Privcap: Data security has been very much in the headlines the past several years. Can you talk about what you believe will be the most interesting investment opportunities around cybersecurity and data security?

Lawson: Cybersecurity has obviously been an ever-increasing issue, not only in terms of businesses that can serve as a target, but also in the type of diligence that we do. So, what has been fascinating is that five to seven years ago, we thought very differently about compliance and technical diligence, about bringing in third parties to do cybersecurity audits on our own portfolio companies, or prospective companies. Then, on the other side, the opportunity in security is very interesting as well. You have just a whole host of businesses in that security space that are sponsor-owned, or that are public, that have grown and become very successful and very needed. There are Okta, QualiCES, SalePoint, Symantecs, Proofpoint. What you're also seeing is quite a bit of consolidation.

Van Wert: It used to be that everyone was reactive, and this was all very new. Now, it's known that there are hackers out there that are going to try to get into your environment. And the question is, how do you respond? We're seeing a lot of focus on assessing the data, training your people. There's been a boom in cybersecurity insurance. From an RSM standpoint, cybersecurity has been one of the fastest-growing forms of due diligence. Understanding what the risks are going in, with eyes wide open, has become part of the deal thesis.

Privcap: If you buy a company with poor cyber hygiene, so to speak, I would imagine that elevates the risk of value destruction.

Lawson: Yes, it absolutely can. When you're buying traditionally on-prem software companies, those are different from SaaS businesses. One might argue that it would be harder to acquire a SaaS business. I think it's the other way around. The holes in that are just less than they would be if you were buying a big organization with multiple touch points. ■