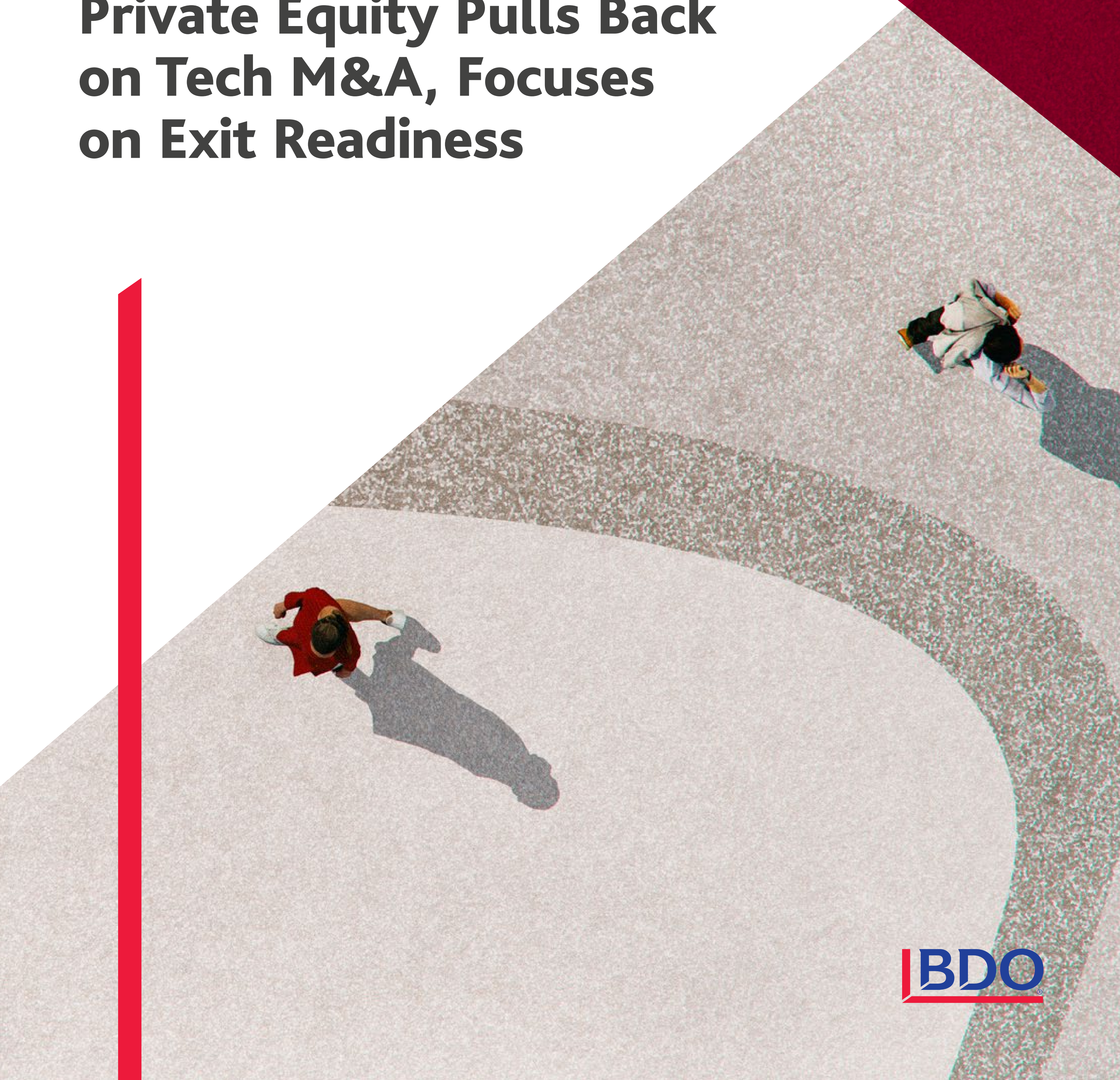
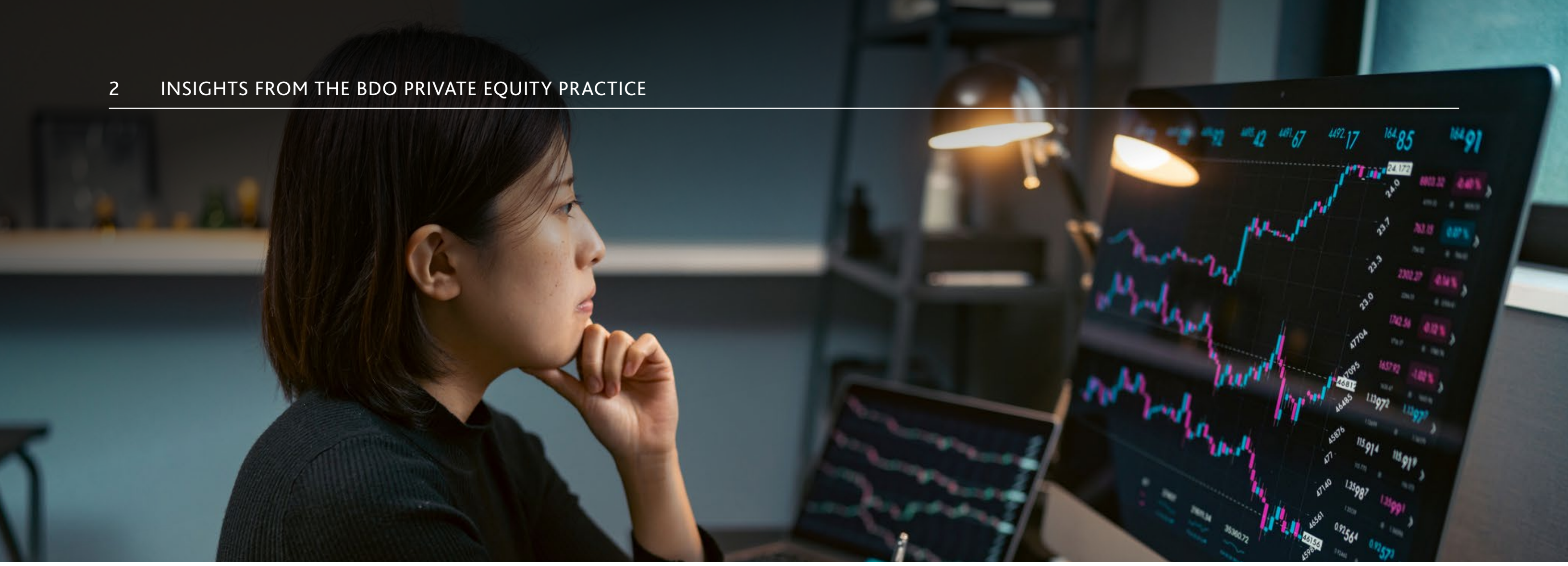
INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

Private Equity Pulls Back on Tech M&A, Focuses on Exit Readiness





With declining valuations creating a gap between seller and buyer expectations and volatile debt markets creating financing uncertainty, deals may encounter more challenges to execute as firms turn their attention to readying their portfolios for exit.

After soaring throughout the previous decade, valuations for public market technology companies have retreated to lower levels in recent months due to a **marked deterioration in macroeconomic conditions**. Tech M&A, which set records for value and volume in 2021, **reversed course this year** as companies in the sector adjust to the perilous financial climate and rethink their growth plans. Even when sellers (target companies) are willing to meet buyer (private equity fund) prices, private equity funds investing in tech no longer have certainty of financing, with rising interest rates increasing the cost of the debt that typically fuels their deals.

Still, gaps in valuation expectations between target companies and private equity buyers remain a crucial roadblock for M&A activity in the sector. In this shifting landscape, private equity investors should focus on readying existing companies in their tech portfolios to capitalize on exit opportunities once market conditions improve.

PRICE DISLOCATION IMPACTING PRIVATE EQUITY DEAL ACTIVITY

Following a year in which deal volume steadily increased to record levels, private equity M&A activity in the tech industry has decreased each quarter in 2022, according to PitchBook's Q3 2022 US Private Equity Breakdown.

QoQ PE Tech Deal Volume

	2021				2022		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Materials & Resources	46	37	51	88	23	32	31
IT	**380**	**406**	**416**	**464**	**338**	**317**	**254**
Healthcare	311	347	315	461	297	268	188
Financial Services	163	149	182	245	168	165	126
Energy	57	74	58	68	54	50	48
B2C	292	303	360	447	332	310	243
B2B	706	703	793	1063	741	666	592

Source: PitchBook Data, Inc
*As of 9/30/2022

Concerned about the quality of assets in the market, private equity investors are no longer willing to accept risks in deals that earlier appeared tolerable. In 2021, competition for tech deals was intense and the prospects for returns were more optimistic. Now, an unfavorable financing market significantly impacting the economics of potential buyouts has negatively affected deal activity by reducing competition and creating uncertainty around returns.

One might expect that private equity would capitalize on better prices to acquire targets, given the decline in valuations of public tech companies. That hasn't been the case, however. While there have been some notable recent examples of take-private transactions of public tech companies (e.g., Vista Equity's proposed acquisitions of Avalara and KnowBe4), the valuation gap between buyer and seller expectations in the private markets hasn't closed enough for private equity to make opportunistic deals at attractive prices. According to PitchBook's Q3 2022 US Private Equity Breakdown, YTD deal value [in IT technology] is higher than the average values seen in the three years before the pandemic. This dynamic suggests that private market valuations have remained higher than those in the public market.

These conditions raise the bar significantly for companies hoping to receive private equity investment. Firms are placing much more scrutiny on the quality of their target's customers, increasing their attention on concentration risk and ability to withstand recession, particularly with the possibility of an economic downturn over the next few months. Rather than take more risk on higher growth/lower margin companies with the goal that they'll generate returns consistent with the last decade's, private equity investors are now placing a renewed emphasis on ensuring their targets are cash flow positive.

Ultimately, the transactions private equity firms make while the economy falters will potentially bear the most fruit when macroeconomic conditions improve. This reality places even more pressure on conducting comprehensive due diligence processes that address the current risk in the market.

Learn more about BDO's holistic Quality of Business™ approach to due diligence

EXIT READINESS FOR WHEN THE DEAL PIPELINE RE-EMERGES

In the absence of the robust deal pipeline that was in place at the beginning of the year, the broader private equity space has **prioritized exit planning in the softening market** as sellers wait to maximize their value once conditions improve.

This trend has been acutely felt in the private equity-backed tech sector. After a robust 2021 that culminated in an impressive fourth quarter, exit activity in 2022 has been anemic. The rate of exits among private equity-owned tech companies in 2022 is less than half that of 2021 on a quarter-over-quarter basis.

QoQ PE Tech Exit Volume

	2021				2022		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Materials & Resources	9	13	13	20	9	7	15
IT	**75**	**78**	**83**	**97**	**40**	**54**	**34**
Healthcare	57	66	64	75	47	27	22
Financial Services	21	21	23	35	13	18	5
Energy	29	23	14	29	18	14	18
B2C	54	65	79	101	48	30	37
B2B	118	116	145	231	114	87	92

Source: PitchBook Data, Inc
*As of 9/30/2022

Private equity investors with tech portfolios can still take action. With activity low, they can use the time afforded by the lackluster deal market to develop an unassailable case for potential investors that will be more fully formed as soon as the pipeline of deals resumes.

PRIORITIES SHOULD INCLUDE:

- **Modernize the finance team:** Evolve the office of the CFO to develop the financial experience and expertise expected by prospective investors. Assess current strengths and gaps of the staff and develop a plan that enables the finance function to drive value for the broader business after an IPO or sale.
- **Solidify the value proposition:** Further strengthen the portfolio company's value proposition within its target market. Begin by gaining a clear understanding of the portfolio company's vertical and the industry's perception of the company and the market's expectation for value.
- **Prioritize metrics that matter:** Prospective buyers and investors will heavily scrutinize financial metrics prior to a deal. Concentrate on improving metrics that will resonate most with them.

The gap between buyer and sellers of private tech companies will eventually close and dealmaking will resume — and could happen sooner than expected. For a recent article in PitchBook, a tech M&A attorney said "Merger talks were nearly non-existent in the summer, but it all changed around Labor Day." However, given that the Federal Reserve has given no indication of lowering interest rates as it continues to fight inflation, executing deals may continue to be challenging.

In the interim, private equity should prepare their tech companies for an exit when market conditions improve.

Learn how BDO can help ready your tech investments for exit ▶

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