ClearBridge Investments

Private Equity Placing Floor Under Tech Valuations

February 19, 2019

Key Takeaways

- Private equity (PE) investors are evolving from the buyers of last resort for smaller public companies in high-growth verticals into strategic acquirers of key technology capabilities.
- The enhanced role of PE buyers should keep M&A activity within the technology and health care technology areas robust and push takeout multiples higher, effectively placing a floor on valuations in certain segments like software-as-a-service.
- Reasonable interest rates and the continued availability of affordable financing are keys to keeping the new PE model operating effectively.

PE Buyers Consolidating Key Technology Segments

In recent periods, the role of private equity (PE) investors in the life cycle of smaller and newly public companies has evolved. Certain PE participants have transitioned from being the buyer of last resort for companies to engaging in strategic deals to roll up key industry segments. In this way, PE buyers are creating strongholds within certain technology verticals and becoming the "go to" source for certain key functionalities, which they will be able to either take public through IPOs or sell to strategic acquirers down the road.

With this new positioning comes pricing power, in our view. In other words, PE is no longer just the "buy cheap, lever up and hope to limit business deterioration over that time" type of model it once was. Instead, PE investors are becoming more strategic and have the balance sheets, expertise and foresight to do so. Vista Equity Partners, for example, specializes in software-as-a-service (SaaS) and has a keen sense of industry trends. Thoma Bravo and activist PE firm Elliott Management, meanwhile, have taken information security providers private as part of their portfolios.

PE firms are often nimbler than publicly-traded strategic acquirers in making bids and recent transactions illustrate this new paradigm. On February 12, Thoma Bravo beat the strategics to the punch by announcing plans to acquire SaaS mortgage loan provider Ellie Mae at $99/share or about 6x forward revenues, a 21% premium to its prior close and a 31% jump since a Jan. 31 report that the company was shopping itself. The ability to put together an offer in less than two weeks is what separates today's PE investors from publicly-traded strategic acquirers that must research the opportunity and then hire investment bankers to help plan an offer.

The Ellie Mae deal follows recent similar actions by other PE firms. On the morning of the sharp Christmas Eve selloff, Vista Equity announced plans to acquire small cap SaaS vendor MindBody for about 6x forward 12-month revenues. While down from higher absolute stock price levels earlier in the year, the purchase price represented a 68% premium to the prior day's closing price, and further confirmed the "new PE model" for SaaS of "buy at 5x (revenues) and seek to sell at 10x." On February 4, SaaS payroll provider Ultimate Software (ULTI) agreed to a

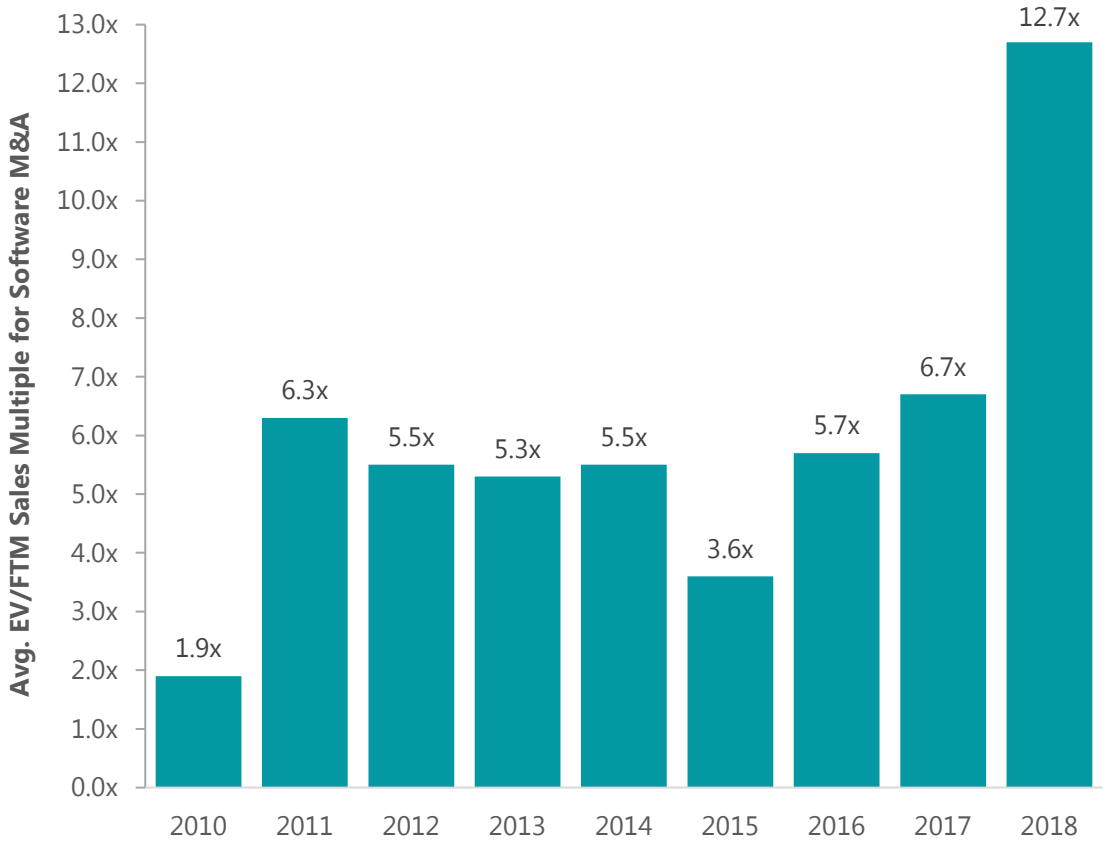
takeover by PE firm Hellman & Friedman. Ultimate is going private at $331.50/share or about 7.5x 2019 forward consensus revenues, a 19% premium to its previous close.

Strategic acquisitions, by comparison tend to entail higher valuations, in many cases, much higher. Vista Equity sold SaaS marketing automation vendor Marketo, which it purchased in mid-2016 for $1.8 billion, to Adobe for $4.75 billion just two years later for about 9x forward revenues.

With consistent 20% plus revenue growth, Ultimate represents an attractive franchise in SaaS payroll and its takeout valuation is consistent with peers. Investors had speculated a potential strategic takeout of the company given its well-established and well-regarded franchise and the lack of a succession plan for a founder/CEO in his 70s. The transaction is further confirmation that PE buyers are getting more strategic, and still see the potential to sell targets at 7x-10x+ forward revenues. Hellman & Friedman could use ULTI as a foundation for creating a mid-market, payroll and enterprise back office enterprise that it could eventually take public by revisiting the IPO market or more likely selling to a public buyer down the road.

M&A purchase prices effectively doubled in 2018 vs. 2017, reflecting growing strategic interest and unprecedented levels of PE funding (Exhibit 1). If rising interest rates don't completely interfere with the PE model, we see a robust M&A environment continuing within technology in general and SaaS in particular, fueled by both PE and strategic acquirers. Publicly-traded strategics are likely to take over where PE falls off should rates and deal multiples increase as they're the ones PE is ultimately selling to. Such a setup should mean short-lived selloffs in the software industry will be followed by potentially sharp rallies. We expect most SaaS providers should continue to enjoy support and potential long-term interest similar to that shown for Ultimate Software.

Exhibit 1: Software M&A Multiples Surged in 2018, Reflecting PE Participation



Data as of Dec. 2018. Source: J.P. Morgan Chase & Co.

About the Author

Hilary Frisch, CFA
Director, Senior Research Analyst for Information Technology

- 25 years of investment industry experience
- Joined ClearBridge Investments in 2013
- Member of the CFA Institute
- BA in Economics/International Studies from University of North Carolina, Chapel Hill