GUIDE FOR SOFTWARE COMPANIES BEING ACQUIRED BY PRIVATE EQUITY

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BDO

CONTENT

INTRODUCTION

Software company founders and CEOs continually see messages from private equity (PE) firms land in their inbox. Hidden amongst the many emails may be the perfect opportunity to take your company to the next level or achieve an optimal exit – but how can you know which message it is? The answer to that question is, in part, what this guide aims to provide.

The reason for the many messages is partly that PE firms have high expectations for software companies. In BDO's ninth annual Private Equity Perspective Survey, 92% of private equity firm fund managers focusing on technology said they expect the value of their portfolios to increase in the coming years.

PE managers also expect valuations to increase. 67% of all respondents pointed to technology as an industry that could see valuations increase over the next 12 months - more than any other sector.

This is good news for software companies, many of whom have already received investment from PE firms, with more deals undoubtedly on the way. Technology company CFOs overwhelmingly point to software (including cloud computing) as likely to generate most deals in the coming years. Technology companies are also more likely to be acquired by PE investors than anyone else. In 2017, around 43% of all technology M&A deals were funded by PE. For technology M&A deals worth between $50 million and $1 billion, the figure was 52%.

Deal flow will likely continue to be high, as PE firms across the globe are sitting on stores of dry powder. BDO's PE survey shows that 58% of private equity fund managers intend to continue seeking acquisition opportunities over the next 12 months.

Receiving investment from - and thereby potentially being acquired by - PE investors can be great news for a software company. It often boosts revenue. Analysis from BDO UK shows that private equity-owned companies on average increased revenue by 12% between 2016 and 2017. The same companies grew their combined workforce by 8.5% to 311,833 employees.

However, PE can also be a risky path to more capital. PE firms often have goals and focus that differ from other investors, such as VC firms.

Knowing how to prepare for a potential PE acquisition, what PE firms are looking for, how to negotiate the optimal deal and collaborate with the PE firm post-investment is crucial. In this guide, BDO experts give their advice on how you can achieve the best results.

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Preparing for a deal

1. WHAT ARE YOU LOOKING FOR?

The starting point for deciding whether to pursue a PE deal is looking inward. Your current situation, your strengths, weaknesses and opportunities - and near, medium and long-term goals - can help you identify if, when and how much external capital you may need.

The short answer to whether you need external capital to achieve your goals will most often be yes. Software companies tend to be rapid-growth enterprises and access to funds will almost invariably be a key driver for growth phases. Depending on your company's specific situation, you may be looking for capital to grow sales, expand into new markets, invest in R&D, make strategic acquisitions of competitors, a combination of all of the above - or something else entirely. For example, you may be looking to exit the company within a given timeframe.

When considering PE investment, or identifying strategic and business goals, the starting point is finding answers to questions such as:

- Are you looking for personal, monetary success (an exit) or to take your company to the next level?
- What are your core strengths and weaknesses?
- Why should you choose PE investment over other kinds of funding?
- How will you use the raised capital?
- How can you work with a PE firm to achieve the best possible results?

The list of questions goes on, and each needs a detailed answer to help you decide whether PE is the best option for raising capital.

Many of the answers – and definitions of goals – can likely be found in mission statements, three-to-five-year targets, SMART goals, SWOT analysis and other, similar strategy documents. If the busy day-to-day running of your company means that these documents have not recently been updated, the starting point should be doing so.

PE is far from the only way to raise capital. There are other options that each have advantages and drawbacks. They include loans, venture capital and public markets. Depending on your specific situation, these may be better suited to your business strategy and goals.

When considering potential PE deals, it is advisable to consult with your business advisor and discuss the potential opportunities and challenges each investment avenue presents. A positive side-effect of the process – whether or not it leads to negotiations with a PE firm and potentially a deal – is that it will teach you valuable lessons about the current state of your business and its future potential.

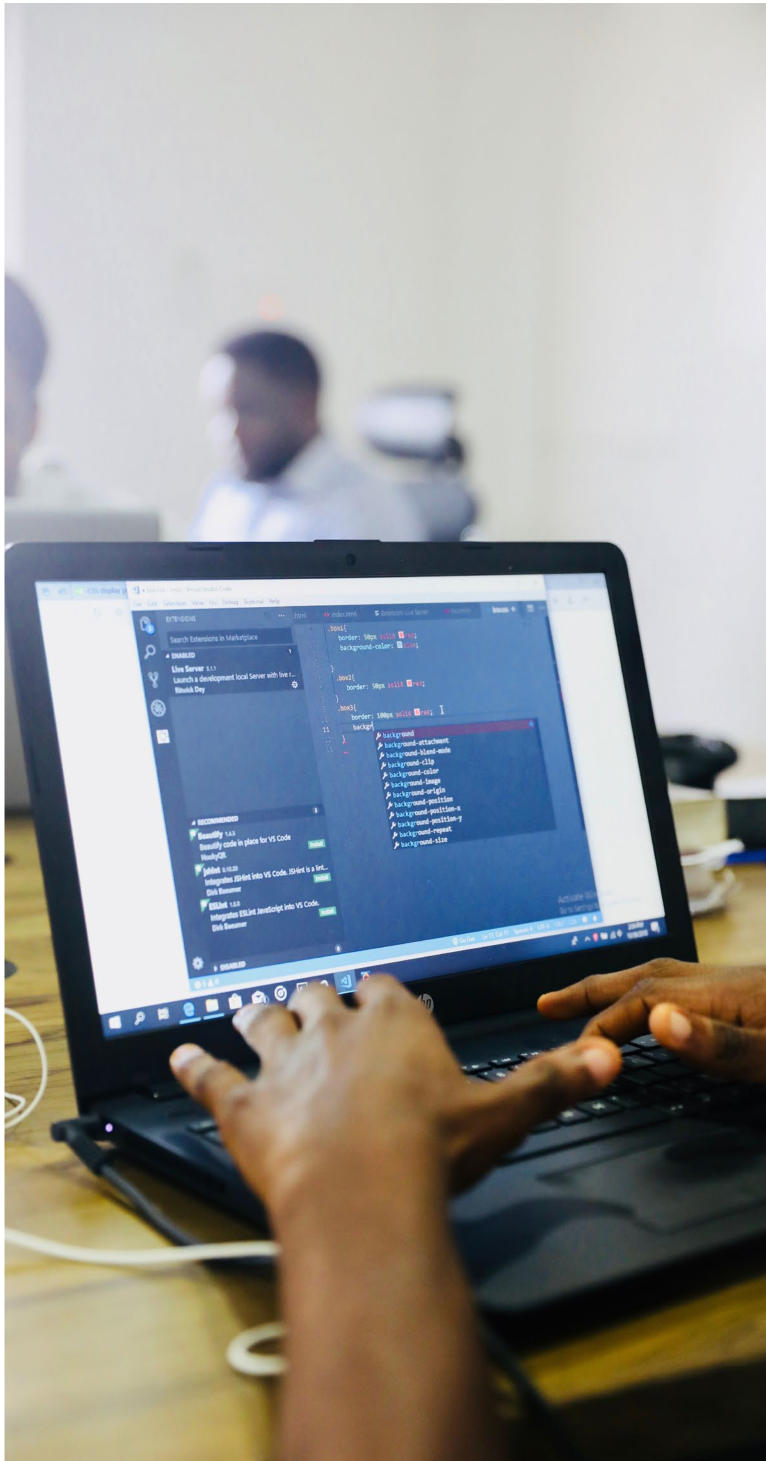
2. KNOW WHAT A PE CAN OFFER

There are many good reasons why almost half of all investments in technology companies come from PE firms - and why those technology companies, including many in the software space, say yes to the investments.

To decide whether a PE deal is right for you and your company, you need to know what PEs can bring to the table. What their key strengths are and how they can help your business. The list of potential benefits from collaborating with a PE firm includes:

- Market expertise: PE firms often have extensive market expertise and can help you identify new business opportunities, guide sales growth, help define marketing strategies and find new possibilities for upselling your solutions. Through working with other companies to grow their revenue and profitability, they also have practical experience of what does and what does not work.
- Access to new markets: Many businesses are looking for growth capital to expand into new markets. Having a growth-focus, PE firms have keen insights and expertise relating to entering new markets. Furthermore, they can leverage existing, extensive business networks to identify and engage new potential customers.
- Funding: A deal with a PE firm often enables your company to raise more capital than would be the case for deals with most other types of investors.
- Business acumen: PE firms are often experts in the organisational and financial sides of running a business. Their skills and experience may complement those of your current employees as well as the leadership team. This includes in relation to areas such as process optimisation, accounting practices, formulating business strategy and daily management.
- Objective insight: Software companies often start as companies run by individuals – for individuals. Said differently, the leadership and employees of a software company have built it from the ground up through passion and innovation. PE firms can offer an objective and data-driven evaluation of your business and help identify areas for improvement.
- Efficiencies: PE firms will be able to help you identify best practices, make you more efficient and maximise your growth and value. They can also help you execute to reach your full potential.
- Higher profitability: The likely result is that your business will grow and become more profitable.

When considering PE investment, and what a PE Firm can offer, it is also important to consider where PE firm and management interests align – and where they may differ. Many potential collaboration challenges (described in detail later in the guide) arise due to interests not being aligned early in the negotiation process. In fact, initiating the alignment process can begin already before negotiations take place.



3. KNOW THE PE ECOSYSTEM

The PE landscape has changed a lot over the last ten to 15 years. A situation that meant some software companies, especially early-stage enterprises, were not necessarily of interest to PE firms.

Today, most technology companies, including those in the software space, that are post-series A funding round will be of interest to some PE firms – and in some cases companies even earlier in their life-span can find interested PE investors.

Some PE firms are generalists, whereas others have a specific regional focus. Some are sector specialists; others focus on turnaround or transformational acquisitions. Each PE is different and has different focus points and strengths. Other factors, such as risk-willingness and how closely involved they wish to be in the running of their portfolio companies also vary substantially. Some PE firms prefer a hands-off approach, while others will want to be very hands-on. Both approaches have merit, and it is important for the leadership team of your company to look objectively at what kind of PE partner your company needs.

Their investment preferences also differ. Some prefer taking minority stakes in companies, including enterprises that are in pre-profit stages of growth, while others target more mature companies, sometimes looking to make multi-billion-dollar investments.

When considering PE investment, it is advisable to find at least three or four interested parties. This promotes healthy competition between the PE firms and thereby increases the chances of getting the deal you are hoping to achieve.

Company leadership should pay extra attention to identifying why you want to work with a specific PE firm. For example, if you are a software company, you may prefer to work with a PE firm focused on your industry. In some cases, it can be advantageous to collaborate with industry experts, but if, for example, your core ambition is to grow international sales and optimise internal business processes and optimise business processes, industry expertise becomes a somewhat less important quality to pursue.

Insight and understanding of the focus of specific PE firms help you identify which PE email inquiries to reply to or which PE firms you should contact. It may take much time to sift through the many options and identify potential buyers, as well as define your core needs, which makes working with consultancies a good option. Thanks to extensive networks and contacts, consultancies can help you identify the optimal PE firms to engage with, and often much quicker than you would necessarily be able to do on your own.

4. KNOW YOUR WORTH

Before sitting down at the negotiation table opposite the PE firms you wish to discuss a deal with, you need to evaluate your company's worth. Such a valuation forms part of the foundation for establishing realistic negotiation targets.

A valuation should include appraising your material and immaterial assets, your current situation and future potential. It should also include an analysis of deal values and deal structures in your industry. Generally, revenue or EBITDA multiples are used as a yardstick for the former. The multiple is currently high in the technology sphere. For example, average EBITDA multiples for Software-as-a-Service (SaaS) deals in the first half of 2018 was north of 10x. While high valuations may cause some investors to pause, unsure if they will be able to make a profit, the current amount of available capital is working as a counterbalance, incentivising investors to seek new deals.

Many factors can affect your valuation, both positively and negatively. Below is an inexhaustive list of areas that affect your company's value:

- Technology: Including your products, services, technology, intellectual property and R&D.
- Management: A proven track record of overcoming challenges will likely increase your valuation.
- Industry trends: Macro- and micro-trends that directly and indirectly affect your industry will be something that PE firms are acutely aware of during negotiations.
- Revenue: Your current revenue, historical growth and projected future revenue. Important factors include whether your revenue is recurring, project-based and if it comes from a broad customer base or few, large customers.
- Turning revenue to cash flow: Your ability to turn revenue into positive cash flow. This is a key metric for PE firms, as it indicates that you are able to grow your liquid assets.
- Growth potential: Your future potential for growing revenue and profitability; includes potential untapped markets or customer bases, as well as the diversity of your growth strategy.
- Sales: Includes customer stickiness, your historical sales growth and the organisation and performance of your sales team.
- Potential future buyers: Who might be interested in acquiring you in the future, or your potential to IPO within a set timeframe.

The valuation of each part is not based solely on a picture of current and past performance but will include an analysis of what your material and immaterial assets (especially IP) will be worth over time.

In many cases, it is beneficial to carry out your own due diligence process ahead of negotiations. The process will help form a clear idea of what your company is worth, as well as what opportunities and challenges an interested PE firm likely sees for the future of your company – and therefore will focus on during deal negotiations.

Negotiating with a PE Firm

5. KNOW WHAT PE FIRMS ARE LOOKING FOR – AND AT

Traditionally, PE firms have a set goal for an investment, which is that it should deliver a substantial return in three to five years. Often, the goal is to either double an investment in three years or see it treble within five years.

A time-constrained, returns-based approach to M&A means that PE firms are interested in identifying if your company, for example, has high growth potential or if efficiencies or bolt-on acquisitions can markedly increase your short to medium term profitability.

Software companies need to be aware of the focus on growth and create detailed plans and strategies for how such short to medium-term goals can be realised without jeopardising long-term growth and the future vision for the company. Reaching a constructive agreement with the PE firm on such plans is crucial.

During negotiations, PE firms will, amongst other areas, be focused on:

- Technology: Including your products, services, technology, intellectual property and R&D. IP rights and future potential in a rapidly changing market will be two key areas that PE firms will pay extra attention to during negotiations.
- Management/employees: The PE firm is focused on management and employees' ability to deliver on business strategy, overcome challenges, create new solutions and grow the business. Documenting your track record of reaching set targets will also be crucial.
- Succession planning: Whether your company have a pipeline of talent and a complimentary strategy in place for replacing key employees if they retire or leave the company.
- Contingency plans: Every industry and individual business goes through ups and downs. Specific clauses regulating what happens in case of market changes, and govern the decision process in such cases, will be mapped out by the PE firm.
- Market trends: Where the market and sub-industry you are part of is headed – both on a macro and micro level. Changing customer demands, new technological developments and similar trends all have the potential to benefit or threaten your market position and service portfolio.
- Cash flow: Documenting recurring cash flow and ability to expand sales to both new and existing customers can go a long way towards securing a PE deal.
- Investments: What you are going to be using the money from the deal for and how it helps you achieve growth.
- Exit strategy: What happens with the company, and funds raised, through a future sale or IPO.

Prior to negotiations, PE firms will have mapped out their take on various aspects of your company and used it to form an outline of deal terms. Carrying out a similar process and preparing your own arguments – based on detailed data and documents to support them - will give you a much stronger starting position for negotiations and help speed up the negotiation process.

6. KNOW PE'S SITUATION

Another important factor in negotiations is knowing what the situation is like on the other side of the table. It helps make it easier to discern your position and whether different tactics will be effective. BDO's annual PE Equity Survey provides good insight into the current situation for PE firms, which can stand you in good stead during negotiations. Amongst its findings are:

- Healthy competition: The market for PE firms is very competitive – and becoming more so. 32% of international fund managers responding to the survey point to increased competition from private equity peers.
- Dry powder: PE firms currently have access to a lot of capital to spend on new deals. A robust fundraising environment and easy access to leveraged loans with relatively loose covenants is a driving force for increased competition.
- High valuations: Available capital and competition are driving up valuations for software companies, which are considered attractive deal targets. To use European M&A as an example, buyout firms paid an average of 11.6 times EBITDA for targets in the first half of 2017, up from an average of 10 times EBITDA seen the previous year. Both are higher than the 5-year average EBITDA.
- Strong investment appetite: Although rising valuations and deal multiples would often make PE firms more reticent towards new investment, the favourable investment environment and access to capital seem to outweigh those concerns. 79% of respondents in the PE Equity Survey said that they were already directing most of their capital toward new deals. About 82% said that they were planning to make between one and four new platform deals in the next 12 months.
- Longer investment periods: PE firms' rule of thumb of keeping an acquired company on the books for between three and five years seems to be eroding. PE firms are generally favouring extending investment periods. 58% of international respondents to the BDO PE Equity Survey said that they expected investment periods to increase.

In short, PE firms see increased competition for attractive acquisition targets, which has driven up valuations. While this would often lead them to wait with making further investments, the readily available capital and beneficial market conditions seem to outweigh valuation concerns. Simultaneously, PE firms are generally looking to grow their acquisitions for longer periods before potentially selling them on, leading to longer periods of collaboration.

While difficult to generalise, the current investment environment means that software companies currently have a strong negotiation position – if they know how to employ the right strategies to leverage it.

7. KNOW PE FIRMS' CONCERNS

Software companies are attractive targets for PE firms. However, their interest can be tempered by some of the challenges PE firms see in relation to the technology industry in general – including in the software space.

Respondents in the BDO Private equity study point to identifying growth opportunities (42%) and finding and retaining management teams (33%) as some of the biggest challenges when acquiring target companies. Something that also applies to the software industry.

A consensus amongst PE firms is that diversifying products and services (identified by 96% of respondents), evaluating cybersecurity risks (95%) and implementing digital transformation strategies (91%) are effective tactics to combat some of the challenges. While the latter may not be predominantly relevant to software companies per se, it is important to be aware of the areas that a PE firm see as potentially challenging in relation to your company and find ways to address these worries during a deal negotiation process.

For example, your company should have a clear, well-documented IT security policy that should include prioritised technical and strategic risk mitigation strategies – both for your current and future situation.

PE firms may be concerned that your current product portfolio is too narrow or worried that your company has limited opportunities to enter new markets or engage with new customer segments. There may also be concerns regarding your intellectual property (IP) and solutions. For example, if your IP is reliant on third-party systems and solutions, or if you only have partial ownership of the IP in question. Cases of software company deals that became unprofitable because of IP issues have led more PE firms to hire technical and IP experts to help them during the negotiation of a deal. Your company should be prepared to document every part of your IP and IP rights during a negotiation process. Potential financial and compliance issues are other areas that PE firms will often want to focus on during negotiations.

The speed of change in the software industry is another area that could concern PE firms. Disruptive technologies open new markets, but shorter life-cycle and intense competition can lead to uncertainties regarding medium to long-term profitability. Given the fact that many PE firms are looking for a time-limited exit in three to five years, such uncertainties can lead to lower valuations and a less advantageous deal if they are not addressed appropriately.

8. HAVE ALL YOUR DOCUMENTATION IN ORDER

Documenting your strengths in the areas that PE investors – and other types of investors – will likely focus on during a deal negotiation process should be a continuous effort. One that starts very early in your company's lifetime.

One of the things that often comes as a surprise to software companies when entering into negotiations with a PE firm is the level of granularity of their questions. These questions can cover areas such as financial, legal and tax issues, as well as existing business processes, future earning perspectives, risks and much more. The maxim on preparing for tomorrow, today most definitely applies to getting documentation ready ahead of time. The same applies to the preparation of the data that PE firms will request and how to safely present it to them in data rooms, business summaries, legacy tax documentation and other formats.

PE investors will be focused on how your company will make use of the capital they provide in connection with a deal. Key focus areas include how the funds will help you grow revenue, boost your R&D and give you access to new markets. Their focus comes from wanting – and needing – to know what steps you will take to grow your business and thereby enable them to make a good return on investment.

Questions and focus points can include areas that your company may not have considered. For example, you may face very detailed questions regarding the potential value created through non-financial activities such as corporate responsibility and sustainability programmes. Your business' debt capacity is another area that you may not have previously explored in the level of detail that PE firms are likely to do during negotiations.

Preparing documentation for all the areas mentioned above can be a simultaneously arduous and novel task, in that most companies will not have experience with it, nor know what level of documentation PE firms are likely to request. An almost unavoidable fact is that your documentation will not have the required detail level in all areas at the start of negotiations. However, minimising the number of areas where documentation needs to be updated has many positive side-effects, including ensuring minimum disruption to the day-to-day running of your company during negotiations, as well as heightening PE firms' confidence in your management team.

At the very minimum, most companies will need several months to prepare everything from scratch. If your company undertakes the task on its own, the required time will likely be longer.

Collaborating post-deal

9. PLAN FOR THE POST-ACQUISITION

It is crucial to establish the fundamentals of how you envision the collaboration between yourself and the PE firm to work post-deal ahead of sitting down at the negotiation table.

Anticipating and planning for creating effective collaboration starts with both you and the PE firm explicitly stating what you expect to get out of the partnership - and how it should work in practice. Such plans and statements of intent should include everything from day-to-day collaboration and how both parties can work together towards a potential exit down the road.

It is sometimes said that PE firms spend 50% of their time studying a given company and the other half looking at how and when they will divest. The exit can take various shapes, including repurchase, secondary sale, trade sale and an IPO. Working proactively with the PE firm towards a defined exit goal is a core aspect of your collaboration.

PE firms vary in the level of involvement in the day-to-day running of your company they wish to have. Some prefer to be very hands-on; others are more hands-off. Some might want you to consider hiring specific people to work within the company – or they may leave hiring decisions entirely up to you.

That said, private equity firms often prefer to be more hands-on than other investors, like a VC firm for example.

Compared to VCs, PE firms tend to invest larger sums in fewer companies. If one investment fails to achieve growth, the financial consequences are therefore higher. A fact that leads PE companies to be active members of your company's board and want to stay more closely informed about your business decisions.

Aligning expectations regarding communication forms and regularity is essential to ensure smooth collaboration. Selecting the right chairperson to your board is an often-overlooked part of this process. If you have chosen the right deal partner, both you and the PE firm will be passionate about your company, which can, at times, lead to discussions and even confrontations regarding business decisions. The chairperson can not only function as a go-between and mediator between you if disagreements arise, but can also help both parties arrive at mutual beneficial compromises.

It is advisable to include clear guidelines for communication in the so-called memorandum of understanding. While the memorandum is not legally binding it provides an excellent opportunity to agree on general terms for the communication and collaboration between your company and the PE firm.

10. SET CLEAR TARGETS

Communication and collaboration issues often arise from a misalignment between expectations and goals.

A core part of the analysis is keeping your targets realistic. Unrealistic plans for sales growth, cost cuts, and lack of foresight regarding future challenges can be a red flag for PE firms during a negotiation process that can create doubts about your management team's business acumen. If unrealistic targets become the basis of setting future goals for your business during negotiations, they can lead to collaboration issues when they are missed.

The same issues can affect communication and collaboration itself. Few company leaders and founders will have experience with setting targets and outlines for communication and collaboration, which in turn can hamper the efficiency of running your company, post-deal.

Shaping the conversation and collaboration starts during the negotiation process, but it should be a continuous effort. Not everything will be put into the final contract, which could also stifle an open dialogue and both parties' ability to optimise collaboration. Identifying how to maintain strong communication channels between you and your new collaborator should be a core focus in the days and week after a deal is reached.

While the exact structure, form and regularity of communication between you and the PE firm will vary, there are guidelines which apply to almost any situation, including:

- Be proactive instead of reactive: Communicate ahead of making important business decisions, including when unforeseen challenges arise. Be clear about what the problem is and how you are planning to remedy it.
- Define the decision-making process: Establish clear guidelines for what business decisions are the remit of your company and which decisions ought to be discussed with the PE firm before making a final call.
- Ask for help when you need it: PE firms can offer valuable insight and assistance. Inform them of business issues and ask for guidance or a second opinion.
- Set and update communication schedules: Agree on a format and timetable for communication that keeps your collaborator continually updated without hindering the efficient day-to-day running of your business.
- Avoid surprises. There are various ways of avoiding frustrations arising from a PE firm feeling like you are 'springing' new information on them. For example, it is a good idea to arrange a call with representatives of the PE firm a couple of days ahead of board meetings to lay out what you hope to discuss during the meeting.

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