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Insights for Technology Companies Being Acquired by Private Equity

Advice on achieving the best results with PE firms

If you're a technology company founder or CEO, chances are good that you receive a number of messages from private equity (PE) firms interested in acquiring your business on a regular basis. Among 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 what this article aims to provide.

According to the *BDO 2022 Technology CFO Outlook Survey*, 1 in 4 tech firms are pursuing PE or venture capital (VC) investment, a likely reason for the frequent PE outreach. PE managers have also watched valuations increase and expect them to continue that path, with recent estimates claiming an industry overall value of more than $35 trillion.

This is good news for tech companies, and most tech execs are looking to capitalize on that strong position. 65% of company CFOs polled for the 2021 BDO Technology CFO survey planned to pursue some form of deal activity in 2022. Technology companies are also more likely to be acquired by PE investors than anyone else.

Deal flow will likely continue to be high, as PE firms across the globe invested in tech are seeing record returns and are sitting on stores of dry powder. Receiving investment from PE investors can be great news for a technology company. It often boosts revenue, among other benefits, but there are many things to consider before entering into an agreement. PE firms often have goals and focuses that differ from other investors, such as VC firms.

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 goals (both near-term and long) 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. Technology 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 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 were not recently updated, now is the time to update them.

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 wise to consult with your business advisor and discuss the potential opportunities and challenges each investment avenue presents. A positive side-effect of the process is that it will teach you valuable lessons about the current state of your business and its potential, regardless of a deal being struck.

2. Know What a PE Firm 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 PE firms 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, PE firms 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 organizational and financial sides of running a business. Their skills and experience may complement those of your current employees as well as the leadership team. It might be helpful to apply PE insight to areas such as process optimization, accounting practices, formulating business strategy and daily management.

- **Objective insight:** Technology companies often start as companies run by individuals — for individuals. Said differently, the leadership and employees of a technology 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 maximize 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 article) arise due to interests not being aligned early in the negotiation process. In fact, initiating the alignment process can begin even before negotiations take place.

3. Know the PE Ecosystem

The PE landscape has changed significantly over the last 10 to 15 years. In the past, early-stage enterprises were not necessarily of interest to PE firms. Today, most technology companies, including those in the software space, which are post 'Series A' funding round will be of interest to some PE firms. in some cases, companies even earlier in their lifespan can find interested PE investors.

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 securing 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 optimize internal business processes, industry expertise becomes a less important quality to prioritize.

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. 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 thus incentivizing 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 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 can 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 longevity, your historical sales growth and the organization, and performance of your sales team.
- **Potential future buyers:** Determine 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 you 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.

Negotiating with a PE Firm

5. Know What PE Firms are Looking for, and at

Traditionally, PE firms set a goal for each investment to deliver a substantial return in three to five years. Often, the goal is to either double an investment in three years or see it triple within five years. A time-constrained, returns-based approach to M&A means that PE firms are interested in identifying whether your company, for example, has high growth potential or if efficiencies or bolt-on acquisitions can markedly increase your short- to medium-term profitability.

Technology 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 realized without jeopardizing 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 focus on the following, among other areas:

- **Technology:** The firm will assess 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 pay extra attention to during negotiations.

- **Management/employees:** The PE firm will focus on the ability of management and employees 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:** Your company should have a pipeline of talent and a complementary 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 that address 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:** The firm will evaluate 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 the ability to expand sales to both new and existing customers can go a long way towards securing a PE deal.
- **Investments:** The firm will want to know what you are going to use the money from the deal for and how it helps you achieve growth.
- **Exit strategy:** Every PE deal needs an exit strategy. What happens with the company, and funds raised, through a future sale or IPO?
- **Areas of exposure:** The firm will assess risks, such as tax liabilities, quality of earnings, revenue recognition policies, sales and international tax exposure, and other areas that could potentially expose the business to legal threats. Often, PE funds will engage established accounting firms to perform this due diligence.

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 the 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 bi-annual Private Capital Pulse Survey provides good insight into the current situation for PE firms.

Among the survey’s findings are:

- **Healthy competition:** The market for PE firms is very competitive and becoming more so.
- **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 technology companies, which are considered attractive deal targets.
- **Strong investment appetite:** Although rising valuations and deal multiples would often make PE firms more reticent towards new investment, the favorable investment environment and access to capital seem to outweigh those concerns.

- **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 favoring extending investment periods.

In short, PE firms see increased competition for attractive acquisition targets, which has driven up valuations. While this would often lead them to wait on making further investments, the readily available capital and beneficial market conditions have counterbalanced those concerns for now. 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 generalize, the current investment environment means that technology companies have a strong negotiation position if they know how to employ the right strategies to leverage it.

7. Have All Your Documentation in Order

Documenting your strengths in the areas that 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 technology companies when entering 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 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 programs. 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, as 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, minimizing 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

8. 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, IPO or SPAC. 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.

Aligning expectations regarding communication forms and regularity is essential to ensure smooth collaboration. Selecting the right chairperson for 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, 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 they can also help both parties arrive at mutually beneficial compromises.

It is advisable to include clear guidelines for communication in the memorandum of understanding (MOU). While the MOU 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.

9. 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, which 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. 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 efforts start 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 optimize collaboration. Identifying how to maintain strong communication channels between you and your new collaborator should be a core focus in the days and weeks 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.

Conclusion

By keeping these tips in mind, your company can more effectively negotiate with a PE firm to reach a deal that benefits both sides and sets the company up for continuing success.

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