2016

PCPIQ4

PRIVATE COMPANY PRICE INDEX

Spotlight on Technology

BDO

ACTIVITY REACHES HIGHEST LEVEL SINCE 2008

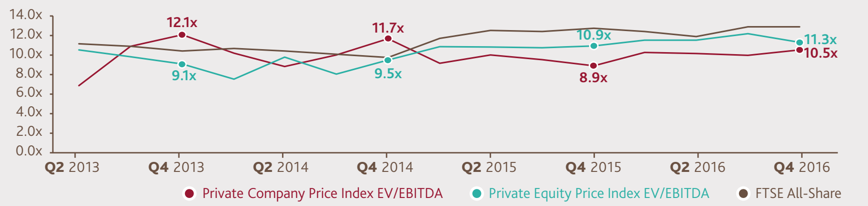
2016 finished with a flurry of deals with a total of 771 deals completed in the fourth quarter.

Deal activity showed a huge jump from last quarter's 578 deals and a record for quarterly Mergers and Acquisitions (M&A) activity since 2008 Q2. In the final quarter of 2016, trade buyers completed 672 deals and showed no signs of reducing their appetite for M&A.

The PCPI/PEPI index, which tracks the multiples paid by trade and private equity buyers for private companies, found that the level of private equity activity has slightly dropped over the quarter, with 99 deals (down from 106) completed in Q4.

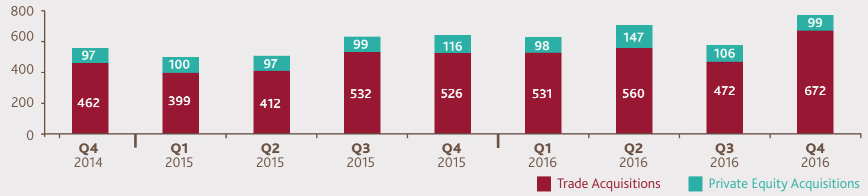
The growth in M&A activity has not been at the expense of deal values. The trade (10.5x) and private equity (11.3x) multiples have both remained at high levels throughout the last quarter of 2016. Indeed BDO has seen spending power increase with considerable deal appetite amongst both trade buyers and private equity houses which raised a further £25bn of firepower during 2016. Whilst demand for deals continues to outweigh supply and economic indicators remain positive, we expect deal values to remain strong.

PCPI V PEPI | Q2 2013 - Q4 2016



Source: Capital Q, Fame and BDO Research

VOLUME OF DEALS COMPLETED | Q4 2014 - Q4 2016



Source: Corpfin

BDO UK

18 Offices

250 Partners

3,500 Staff

FOR THE **THIRD YEAR RUNNING** MORE OF OUR CLIENTS WOULD RECOMMEND US THAN **ANY OTHER** FIRM[1] **86%**

2015/2016 RESULTS: REVENUES UP **3.8%** TO **£405m**

BDO INTERNATIONAL

US$7.6 billion 2016 REVENUE

158 Countries

1,400 Offices

68,000 Staff

1. Independent research (Mid Market Monitor 2013-2016) undertaken by Meridian West shows that BDO, for the third year running, have the highest proportion of clients who would recommend their advisers among its peer group

IF YOU WOULD LIKE TO KNOW MORE ABOUT HOW TO VALUE OR UNDERSTAND M&A MARKET DYNAMICS FOR YOUR COMPANY, PLEASE CONTACT A BDO REPRESENTATIVE (SHOWN ON THE BACK)

MAKING THE MOST OF THE PCPI/PEPI

The PCPI has been updated to incorporate Enterprise Value to EBITDA multiples as the method of valuation, replacing the previously used Price to Earnings ratio. These changes have been made to incorporate the level of debt in deals and to use a less subjective measure of profitability. Historical data has been incorporated to ensure comparability and to identify trends.

The PCPI/PEPI tracks the relationship between the Enterprise Value (EV) to Earnings Before Interest Tax Depreciation and Amortisation (EBITDA) multiple (EV/EBITDA) paid by trade and private equity buyers when purchasing UK private companies.

The private company EV/EBITDA is calculated from publicly available financial information on deals that complete in the quarter. At present, the Private Company Price Index (PCPI) indicates that, on average, private companies are being sold to trade buyers for 10.5x historic EBITDA. The PEPI indicates that, on average, private companies are being sold to private equity buyers for 11.3x historic EBITDA.

As private companies are generally owner-managed, reported or disclosed profits tend to be suppressed by various expenses that may be non-recurring under a new owner. This will have been factored into the price the purchaser paid, but may not be reflected in the profits declared to the public. The effect of this is that the EV/EBITDA paid as calculated from the publicly available information may be overstated.

The PCPI/PEPI is calculated as the arithmetic mean of EV/EBITDA for deals where sufficient information has been disclosed. Over the four years to end of 2016, the included deals for the PCPI have had a mean Enterprise Value of £83.3m and a median Enterprise Value of £17m. The included deals for the PEPI have a mean Enterprise Value of £100m and median Enterprise Value of £32.5m.

The PCPI/PEPI is an average measure and a guide, not an absolute measure of value, as there are many other factors that can have an impact on value.

TECHNOLOGY

RAPID CHANGE IN THE SECTOR DRIVES INCREASED LEVELS OF M&A ACTIVITY

Technology M&A is experiencing a very interesting phase right now as shareholders become increasingly concerned with whether or not their investments are secure when there is so much change and disruption across the industry. Business owners with product niches that are under increased competition from flexible contracts and (x)aaS product lines are looking for ways to pivot into new and faster growth services.

Traditional, increasingly transactional, products that are experiencing decreased pricing and competition from virtualisation and the cloud need to be reviewed and owners and investors need to understand whether their business strategy aligns with technology change.

Enterprise valuation tracks trends in technology with specialists attracting attention from investors. In 2016 our UK Corporate Finance Technology & Media team has completed 49 transactions with a total value of £969m and 50% of our deals involving private equity. This experience gives us the perspective required to ensure business owners and investors are advised by experts. Our successful sale process for ITC Secure networking (£24m sale to C5 Capital) is a clear example of the attention and valuation strength the cyber security market is receiving. Valuations for IT Managed Service providers continue to show strong growth and attract a wide group of potential suiters. BDO Corporate Finance's sale of Selection Services (£34.8m sale to Castle Street Investments) being a good example of strong activity in the sector.

One clear trend is evidenced in virtualisation of hardware; from traditional PBX's to networking hardware. Businesses still focused on capex sales, and rewarding their teams based on these one off sales, need to focus on how they increase their recurring revenues to drive shareholder value. This might mean significant change; not only in product but in the skill sets needed across the business as well as reviewing how they adapt to the demands of customers for increased digital transformation.

Long term value can be generated through careful evaluation of how best to adapt to this changing market. Large amounts of enterprise value are being left on the table by business owners that fail to adapt or to articulate their company's strategy to take advantage of these changes.

The speed at which technology has changed our lives is incredible. Ten years ago, it would have been hard to believe how widespread the use of it would become. For example, 72% of the UK population now has a smartphone with over 2.87bn in use worldwide; up from 122m in 2007. The rapid pace of technology innovation has completely transformed the way we work. Though many of these advances have been for the better, some are also keeping IT decision-makers up at night. After all, there are various external and internal forces impacting decision makers, in particular, the issue of cyber security is of growing concern.

Regulatory pressures abroad are also a major issue, as uncertainties legislation as well as over global trading agreements can make it harder for businesses to feel confident in expanding operations abroad. Cloud growth is fuelling strong uptake in the IT Managed Services and Data Centre industry – not just from the shared public cloud providers such as Microsoft Azure and Amazon Web Services but from an increasing trust in outsourcing critical enterprise infrastructure to specialist businesses such as Rackspace, Host Europe, Century Link or Equinix.

The challenge cloud growth delivers is that, if not carefully managed, long term Enterprise Value can be reduced. Chasing short term growth opportunities may result in client side opportunism around vendor pricing. Many owners want the market to be brave and for supply side pressure to result in firmer pricing expectations from buyers. Service providers need to ensure they evaluate their specific local market before offering discounts that drive down investor returns – especially if the contracts are long term.

Enteprise IT Managers are aware that their infrastructure needs to evolve, but the concerns around being able to make changes could be holding them back. What can be done to alleviate concern? We expect more companies to partner with or acquire specialists to adapt their offerings to take advantage of increased automation ensuring that their security is capable of dealing with an increasingly complex level of threats; both internal and external. The investment perspective relating to this favours businesses that look to future market dynamics rather than adapting present technologies.

Artificial Intelligence (AI) is very interesting as an example. We have not yet come close to understanding its value or the risks. This is clear when looking at the valuation placed on Deep Mind by Google. Google believes that Deep Mind will generate significant savings in their Data Centre energy efficiency. The price paid for Deep Mind will be recovered through these cost savings alone, indicating tremendous value for the investor. Future AI valuations may be affected positively by this one point alone. Organisations should focus on their core business, partnering with those who can help mitigate their business risk, whilst ensuring flexibility in their offerings and keeping a focus on valuation drivers as they evolve. As M&A specialists, BDO knows that it is our deep understanding of the value to be derived by strategic buyers that drives the true value of a Technology focused business.

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