2014

PCPI Q1

Private Company Price Index

Spotlight on Software & IT Services

PCPI/PEPI – IS IT ALL BAD NEWS?

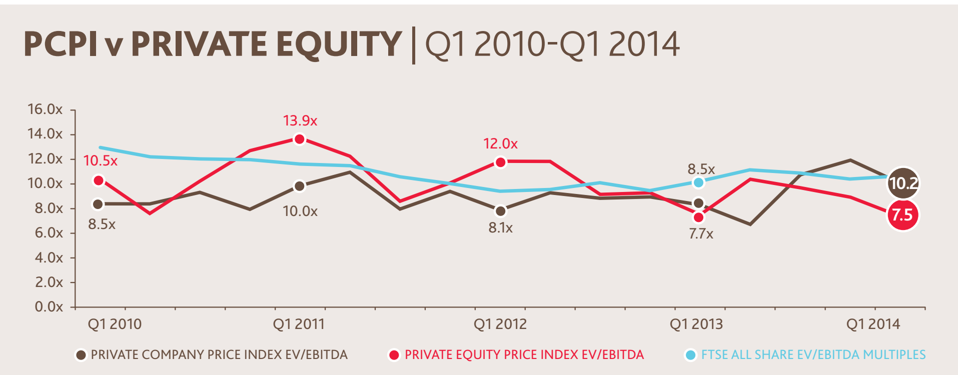
2013 ended on a high: deals in Q4 2013 were up by 5.4% year-on-year, and the Private Company Price Index (PCPI) rose to a five year high of 12.1 times. The Office for National Statistics announced last week that the economy grew by 0.8% in Q1 2014, and everything pointed to a strong performance in the capital markets.

Whilst confidence may be up, deal volumes and valuations are down with only 429 transactions in Q1 2014 – a drop of 22.0%. Although deal volumes are traditionally down in Q1, the performance in Q1 is down by -14.4% compared to Q1 2013, indicating there is more to this decline than mere seasonal fluctuation. Trade deals are suffering the most with private equity deal volumes rising by 3% year-on-year, whereas trade slumped by 27.7%. Furthermore, the deal multiples are also in decline as the PCPI slumped to 10.2 times this quarter, whilst the Private Equity Price Index (PEPI) slipped further to 7.5 times, indicating the market still remains repressed. But is it all bad news?

Whilst the threat of the Ukraine crisis may have dented confidence, the lack of deal volume masks a number of healthy trends. Firstly, the IPO market is experiencing its best quarterly performance for 20 years, and dealmakers are finding it impossible to match IPO valuations. Due to this, PE companies are opting to offload assets via IPO's where they can get a premium on a sale, which in turn is stagnating the M&A market.

Secondly, many companies turned to their 'war-chests' of cash and made tactical, bolt-on acquisitions in the period immediately post-recession. Businesses are now taking a more strategic view to M&A with overseas acquisitions being in favour (outbound deal volumes rose by 10.3% to £21.08 billion in Q1 2014 according to Dealogic) and companies are paying more for the right acquisition (deal values rose by 15% to £32.5 billion in Q1 2014). The pharmaceuticals sector is already seeing hints of a return to the era of the megamerger with Eli Lilly buying Novartis' animal healthcare business and Pfizer currently embroiled in hostile takeover talks with UK rival AstraZeneca.

PCPI v PRIVATE EQUITY | Q1 2010-Q1 2014



VOLUME OF DEALS COMPLETED | Q1 2012-Q1 2014

Source: Corpfin

SPOTLIGHT ON SOFTWARE AND IT SERVICES

Within the software and IT services sector we are seeing increased levels of activity as well as rising deal multiples. The two bubble graphs help to illustrate this by showing enterprise value/EBITDA multiples for selected software and IT transactions over the past five years. The size of the bubble depicts the transaction value (although any deals over £100 million are represented by a bubble size of £100 million).

From these graphs, it is clear that the average EV/EBITDA multiple has been on an upward trend since the dark days of the credit crunch and the post-apocalyptic world of the Lehman Brothers debacle. Furthermore, there is a clear drop-off in the number of deals immediately subsequent to the crisis, but activity has now reverted to levels in line with the long term trend.

When represented by a line of best fit, the ascension in pricing is notable. For IT Services the average EBITDA transaction multiple has risen from just under 7 times to 8.75 times today. For software, the transaction multiple has risen from 7.5 times to 9.75 times. Indeed, average deal sizes have also increased, both as a consequence of UK tech market evolution and the realisation from vendors that there is an undoubted premium for scale or 'highly scalable' assets.

A number of notable recent deals have helped to drive valuations such as Alternative Networks acquisition of cloud infrastructure services provider Control Circle for a reported current year EBITDA multiple of close to 20 times (albeit the valuation based on significant synergy potential and long term revenue visibility) and on the software side: SaaS deals such as HgCapital's buyout of IFA solutions provider, Intelliflo; and Accel KKR's minority investment in pharmaceuticals risk and compliance solutions provider Zinc Ahead with both deals attracting double digit profit multiples.

We are also seeing a healthy mix of trade and PE buyers on transactions. Deliverability is key and with debt liquidity continuing to improve, PE are able to compete more aggressively with their trade counterparts. However, for the most hotly contested, high–end assets and without a platform portfolio company, PE does sometimes struggle to match synergistic trade pricing.

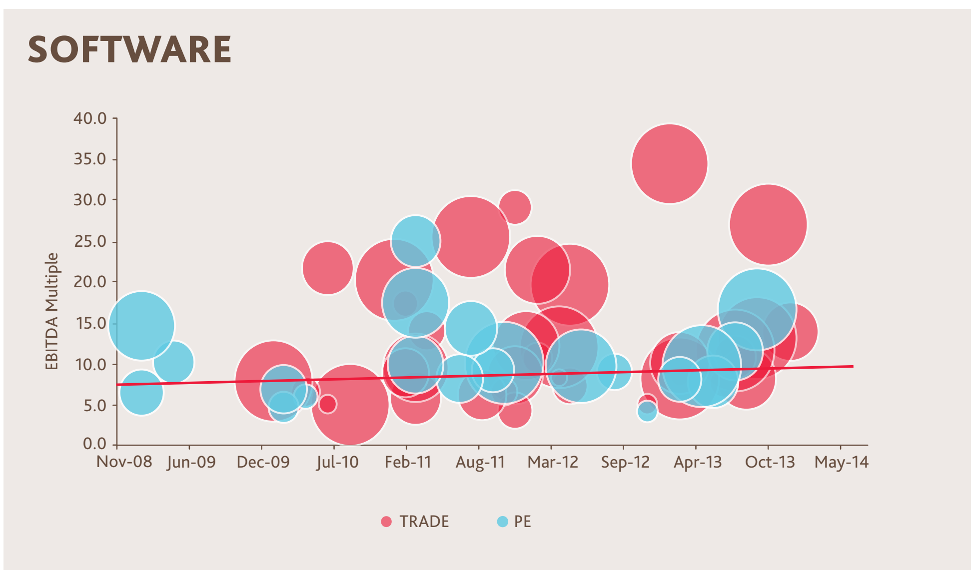
Evidence suggests pricing is levelling out at current levels, a consequence of both synchronised buyer and seller expectations and hype around 'cloud' based deals softening.

We fully expect deal volumes in the IT Services space to continue the healthy upward trend seen in 2012 and 2013 in to 2014, whilst the rise was less pronounced for software businesses, a recent survey of 100 US technology CFOs by InfoWorld put software – which includes cloud computing – as the area where CFOs believe there will be the most activity in 2014 (60% of respondents believed this would be the most active sector). Given that cloud computing is often categorised as IT services, it is perhaps this change in definition which is causing the perceived slowdown in software transactions.

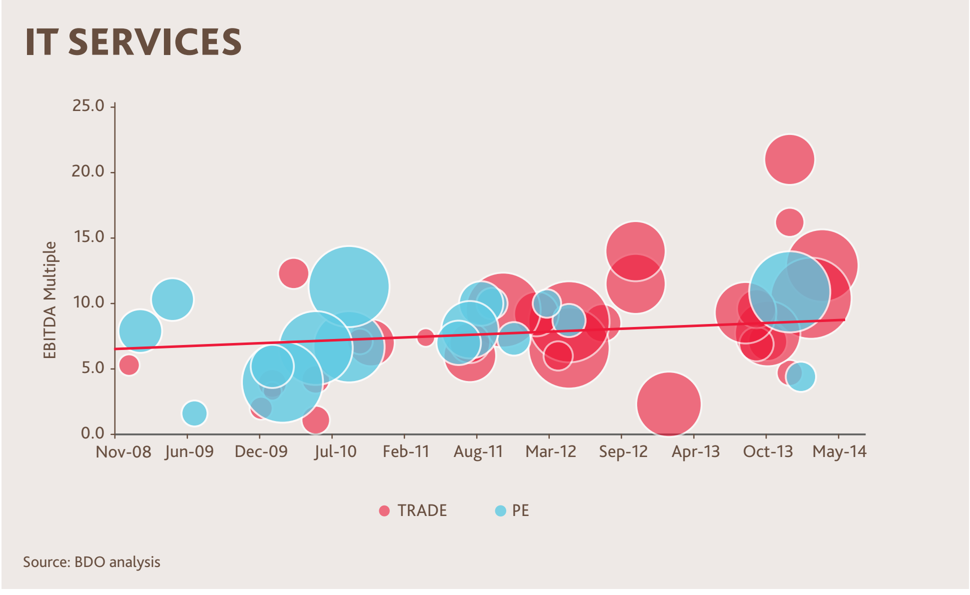
There are particular areas which are seeing accelerated activity. For example, the public sector market is seeing renewed interest at present. A number of businesses within this sub-sector are performing particularly well at present and are being eyed as possible takeover targets as a consequence. A good example of this is that public sector Updata recently announced that it grew both revenues and EBITDA by around 40% through purely organic growth and was immediately snapped up by Capita. Capita paid 11 times EBITDA for the deal: expensive, but it expects the margin gain through its work on the Scottish Wide Area Network (SWAN) project with Updata and the opportunity for Updata to leverage Capita's scale and resources to more than justify the cost. The acquisition is further demonstration of Capita's interest in increasing its coverage of the public sector market after its £65 million acquisition of Northgate Managed Services from Northgate Information Systems last year. That acquisition allowed Capita to access NMS' education-sector focused cloud based, infrastructure solutions and specialised managed services. Capita is not the only company which is helping to buoy interest in the public sector arena. Advanced Computer Software, which has significant interest in the UK education market, used the £44 million raised via share placing's on the AIM market to finance part of the acquisition of Computer Software Holdings from HgCapital LP.

These deals help exemplify the current trend and although M&A volumes may be down, values are on the up with companies willing to pay higher premiums for businesses in sub-sectors that are offering opportunities for growth. Deal volumes are likely to increase in Q2 and not only due to the historical trend of deal volumes rising in the second quarter of the year. Sub-sectors, such as IT services and software continue to attract high multiples from trade buyers who are seeking transformational deals and the PCPI index should see a healthier performance in the next quarter. Furthermore, the recent trend for private equity to offload assets via IPO's could be drawing to a close with the huge sell off in technology stocks impacting the performance of London listings in recent weeks. According to Dealogic, five out of this year's 12 main market IPOs fell below their offer price on the first day of trading, compared to just four out of 32 in the same period last year. The poor performance could trigger a resurgence in private equity related M&A and reignite the falling PEPI index.

SOFTWARE



IT SERVICES



Source: BDO analysis

The two bubble graphs illustrate enterprise value/ EBITDA multiples for selected software and IT transactions over the past five years.
The size of the bubble represents the transaction value although bubble sizes have been capped at £100 million for any deals over £100 million.

MAKING THE MOST OF THE PCPI/PEPI

The PCPI has been updated for 2014 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 10.2 times historic EBITDA. The PEPI indicates that, on average, private companies are being sold to private equity buyers for 7.5 times 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 last four years, the included deals for the PCPI have had a mean Enterprise Value of £42.4 million and a median Enterprise Value of £13.5 million. The included deals for the PEPI have a mean Enterprise Value of £89.5 million and median Enterprise Value of £35.0 million.

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.

IF YOU WOULD LIKE TO KNOW MORE ABOUT HOW TO USE THE PCPI/PEPI TO VALUE YOUR COMPANY, PLEASE CONTACT YOUR LOCAL BDO REPRESENTATIVE.

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