Buyouts

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FIRMS & FUNDS

Tech investing reboots amid market dislocation

After a four-year rollercoaster ride, private equity investing in software and tech companies seems due for a rebound. But post-2021 dislocation has not gone away

Technology investing, long the darling of private equity funds, has endured a turbulent series of highs and lows from which it is only now emerging.

As activity normalizes, opportunities are opening up, GPs tell Buyouts – among them senior representatives of some of the industry's leading investors in software and tech, such as Thoma Bravo, Insight Partners, TPG and Blackstone. Dislocation, originating with the post-2021 market correction and revaluation, is generating a wealth of new dealflow, they say.

The vintage opportunities include access to once unavailable high-quality software and tech assets. Large-cap buyout funds are also undertaking more take-privates and carve-outs as large public tech companies adjust to a changed environment.

And perhaps most compelling of all is the vast expanse of software and tech companies added to private equity portfolios at premium values over 2021-22. Most of these assets, GPs tell Buyouts, remain unrealized but must ultimately come to market.

Influencing the flow of opportunities is a slow fundraising market and LPs facing overallocation and illiquidity, factors that are applying pressure on GPs to realize their tech investments and make distributions. In addition, with vintage opportunities on offer, the ability to raise and deploy capital has taken on greater significance.

How did we get here?

Until recently, investing in high-growth software and tech businesses had experienced almost two decades of continued multiples expansion, powered by increasing digitalization of the economy. In the process, GPs racked up superior returns.

Activity hit its first wall in 2020, as the pandemic caused near-total demand destruction, though ever-resilient tech soon found opportunity in the crisis.

"The covid period was unique in many ways," Nehal Raj, co-managing partner of TPG's TPG Capital, says. "Even while things were disrupted, no company was turning off its software. It also proved the innovation capabilities of software and tech, with new solutions created to manage remote work and productivity."

This led to the red-hot market of 2021, when a record $308 billion was poured into 1,842 tech transactions in North America, PitchBook reports, as premium valuations fueled a "growth-at-any-cost" mentality. Dealmaking the following year was only slightly less robust, with $283 billion invested.

"This was the time when multiples were way up, and yet volumes were also up, even though businesses were more expensive," Martin Brand, global co-head of technology investing at Blackstone, says.

Then, in 2022, the bubble burst. Inflation, rising interest rates and supply-chain disruptions, along with geopolitical conflict, brought uncertainty and volatility. Public tech stocks, widely regarded as over-priced, met with a reckoning as the N index fell 33.1 percent.

The correction found its way into private markets. A resulting drop in tech dollar and deal volumes in 2023 was sharper than for private equity industry activity as a whole, with $148 billion invested, down 48 percent from a year earlier.

This perhaps owed to a market reaction to the euphoric over-deployment and peak values of 2021. "When you get into a toppy environment, that's where investors, for better or worse, pull back on some of the higher-priced sectors and segments – and that typically is always the technology space," Drew Schardt, vice-chairman of Hamilton Lane, says.

Tech investing was now in dislocation, with valuations forced to reset. One measure was a reversal in 2022 of the historical outperformance of sector-focused private equity funds vis-à-vis the diversified benchmark, according to PitchBook data.

However, after a four-year rollercoaster ride, ending in painful correction, investing in software and tech companies – together with fund returns – seems due for a rebound. A key influence is a better macroeconomic picture spurred by the Federal Reserve's promise of rate cuts.

"I am hoping we come to look at this year as the first normal year since 2019," Ryan Hinkle, managing director at Insight Partners, says, "with an absence of

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downward pressure and nothing radically better or worse."

"We're in an environment that I would describe as stable," Holden Spaht, managing partner at Thoma Bravo, adds. "It looks neither like an incredible buyers' market nor an incredible sellers' market."

Supporting these perspectives are green shoots in 2024's deal market. As of September 30, $134 billion had been invested in 1,044 tech transactions, PitchBook reports, backing companies like Alteryx, Everbridge, Instructure, PowerSchool, Smartsheet and Vantage Data Centers. This suggests activity is on course to exceed 2023 outcomes.

"The question of what the right valuation is given a company's growth rate and path to profitability all have become more challenged," Lawton says. The exceptions are top-performing businesses able to "grow into their valuations."

Dealmaking this year is likely favoring some in this latter category. It definitely favors the starriest companies, which in many instances still command lofty valuations.

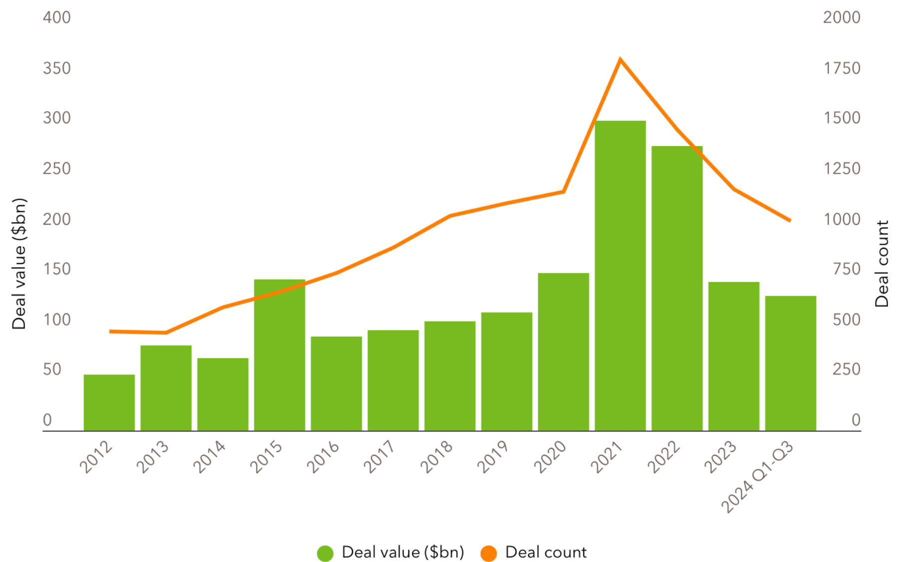
"Any time people are tiptoeing back into a market, the focus tends to be on the highest-quality assets," Deven Parekh, managing director at Insight Partners, says. "The assets you're seeing transacting tend to be the tier-one assets and they're still transacting at very attractive prices."

This leaves a large population of businesses, many of which have been transitioning from the growth-at-any-cost mindset of 2021, often by increasing efficiency, reducing costs and deleveraging balance sheets. In the mix, Thoma Bravo's Spaht says, "are a significant number of high-growth, high-gross-margin but low-profit-margin software and tech companies."

Such companies are appealing to investors, so long as the price is right. GPs interviewed by Buyouts say tech investing's bid-ask spread has narrowed somewhat since last year. However, anecdotal evidence indicates buyers and sellers are

FALLOUT FROM THE CORRECTION

North American private equity tech deal value and number of deals, 2012-Q3 2024



Source: Pitchbook

FUNDRAISING RISE AND FALL

North American specialty tech funds closed and capital raised, 2012-H1 2024

Source: Buyouts

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still failing to match in formal and informal processes as many sellers refrain from adjusting their expectations.

"We only read about the deals that got done," TPG's Raj says. "We don't see the prices or data on the deals that were discussed but didn't trade. The shadow market of deals that didn't happen may actually be bigger in 2024 than the deals that did. In the shadow market," he says, "there may be a two- or three-turn EBITDA multiple gap between buyers and sellers."

Blackstone's Brand agrees, saying: "I've seen a number of processes fail in the last six months because the sellers had high price expectations and they'd rather walk than transact at the lower price."

TOP 10

Biggest technology funds closed in 2023-Q3 2024

Fund	Manager	Amount raised ($bn)
Silver Lake Partners VII	Silver Lake	20.50
Vista Equity Partners VIII	Vista Equity Partners	20.00
TA XV	TA Associates	16.50
Iconiq Strategic Partners VII	Iconiq Capital	5.75
Alpine Investors IX	Alpine Investors	4.50
Accel-KKR Capital Partners VII	Accel-KKR	4.40
STG VII	STG	4.20
Thrive Capital Partners IX Growth	Thrive Capital	4.00
TPG Tech Adjacencies II	TPG	3.40
KKR Next Generation Technology Growth Fund III	KKR	3.00

Source: PEI data

Vintage opportunities

Revaluation of software and tech companies since 2022 appears to be an important source of vintage opportunities for investors. For some sector-focused private equity funds, these can include access to highly prized, long-sought-after assets.

One example is Thoma Bravo, "because we like to buy revenue streams and turn those into cashflow streams through our operating approach," Spaht says. "Before this valuation correction, we would not have been able to buy Coupa, Ping and SailPoint – those types of companies."

In addition, TPG last year acquired New Relic, Raj says, a company "we've been eyeing for a decade."

Among the main beneficiaries of the correction are funds with strategies emphasizing control or significant minority investments. Large-cap buyout funds, for example, are currently targeting listed tech businesses struggling to address challenges like elevated interest rates.

"Public companies are improving profitability, but some of them just don't have the operational capability," Spaht says. "They don't know exactly how to turn negative margins into 20 percent or 25 percent margins expeditiously." This, of course, creates the pretext for take-private acquisitions.

Similarly, opportunity exists with the return of corporate carve-outs to the deal pipeline. "It's been a time when large tech companies have been reassessing what is core and non-core, which can often lead to divesting," Raj says, "as in the case of Aareon."

Along with public businesses, opportunities include the vast expanse of private businesses added to private equity portfolios during the past few years. "Supply from the original dislocation has not worked its way through the system," Blackstone's Brand says.

Many of these software and tech companies have been held, or are likely to be held, beyond the traditional private equity horizon of three to five years because they and GPs are reluctant to write down valuations.

"People have to make a tough decision," Insight's Parekh says, "which is: do I hold the asset longer, take longer to execute my strategy, but it's going to take me five, six, seven years to get to my original underwriting? Or maybe I just have to bite the bullet and sell a piece of the asset or sell the asset for a price that's not what I thought."

The decision may be further complicated, he says, for investors who "paid a 2021 price for a not necessarily tier-one asset. That's a harder place to get yourself out of."

In the same bucket are companies that have not yet made the post-2021 move from growth-at-any-cost to growth with profitability via an internal overhaul. They are "the zombies," John Ruffolo, managing partner at Maverix Private Equity, says, as "they've never fixed anything."

Some of the more problematic assets perhaps reside in venture capital and growth equity portfolios. "There are many high-quality but low-profit-margin software companies in those portfolios," Spaht says. "As their businesses mature and growth decelerates, these are companies that just don't have an exit."

Such businesses are strong candidates for M&A opportunities led by Thoma Bravo's portfolio companies, he says. "Now we are starting to play offense."

For those 2021-vintage businesses still "hanging on," Brand says, the clock is ticking. "Maybe they won't come back in 2025, but they will come. My prediction is the sellers will cave because supply and demand is simply in the buyer's favor and there's pressure to show returns."

Capital as a 'strategic weapon'

Like tech investing, capital raising by

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sector-focused private equity funds has plunged with the correction. As with the industry as a whole, the primary obstacle to closing these funds has been supply challenges owing to overallocated and illiquid LPs.

Today's broad community of pure-play investors in software and tech companies was built in North America over the last two decades – and especially in the period since 2012, when fundraising routinely sped up. The record was reached not in 2021 but in 2022, when 420 funds raised $165 billion, up 38 percent from $119 billion secured a year earlier.

The number of tech fund closings, however, began to fall off after 2021. With respect to capital inflows, the decline was sharper than the market average, with $72 billion raised in 2023, less than half of the peak level attained the year before.

Slow fundraising is likely to play a role in helping to clear tech portfolio backlogs. That is because LP liquidity issues are mostly a function of tepid distributions caused by weak exit markets. LPs pressing GPs to run up their DPI, Hamilton Lane's Schardt says, will be "a positive driver of momentum on the deal front."

GPs, of course, are motivated to realize investments if they aim to raise capital. Where traditional exit channels are unavailable or gummed up, Schardt says, secondaries might "come to the rescue."

For example, secondaries could be instrumental to investors looking to grow software and tech companies into their valuations.

"The secondary market has been a great tool to facilitate this dynamic," Schardt says, "both in terms of GPs searching for liquidity for existing or older LPs and with the advent of continuation vehicles." The latter would allow GPs "to continue to manage their best, highest-quality assets living through the storm."

But the secondary option may not work "if the asset quality is not there, he says. "And that is what LP's scrutinize most of all when they look at portfolios."

For GPs, a downside to using secondaries to move assets is "secondary investors want discounts on marks, meaningful discounts on marks," Insight's Hinkle says. "Most private equity funds are seeking premiums to marks as the value they have aspirationally. It will expose a new value gap."

Slow fundraising is also relevant to investors wishing to pursue vintage opportunities. While some sponsors have residual dry powder due to the quieter deal market, others are trying to raise capital at a moment when timelines are longer and outcomes less of a sure thing. This suggests not everyone will have money on hand as attractive transactions materialize.

"It's not an easy fundraising environment – it's tough," Thoma Bravo's Spaht says. "And it's creating opportunity. Capital is as big of a strategic weapon now as I can remember."

Digitalization's long runway

At this story's outset, it was noted that tech investing's popularity in the private equity industry is a result of the disruptive power of digitalization, penetrating an increasing range of businesses and sectors.

Despite the challenging market conditions of late, this secular force has continued and will probably only gain in intensity going forward.

"What we're witnessing is the transformation of the world from an industrial economy to a digital economy," Maverix's Ruffolo says. "We're only at the front end of this."

Tech investing accelerated after the financial crisis, led by ground-breaking advances like cloud migration and SaaS models. While enterprise adoption of these innovations has skyrocketed, GPs interviewed by Buyouts say the opportunity ahead is much larger.

"SaaS is growing far faster than GDP because it's ROI-generating and it's productivity-enhancing," Spaht says. "Despite its scale, SaaS is still only about 30-40 percent of total software revenue. It has a long way to go before it matures."

Cybersecurity, he says, provides another example of tech's fast-expanding scope. "Before, companies didn't really need a chief information security officer. Now it's become one of the most important personas in corporate America."

For sector-focused private equity funds, these examples indicate demand for software and tech companies remains durable. "The universe of buyers is still infinite," Spaht says, "because every company in the world realizes it has to be somewhere in the digital transformation journey."

Frontier tech promises even more opportunities down the line. Generative AI "has been a standout trend since 2022," McKinsey and Company's Technology Trends Outlook 2024 says, with an uptick in interest and investment unlocking potential across "interconnected trends, such as robotics and immersive reality."

"Like SaaS and mobile coming before it, what we have now with AI is another step change," TPG's Raj says. "It's another 15-year innovation loop that's just starting and will be net additive to the market's size."

At the same time, Raj anticipates "a bit more of a bifurcation of winners and losers at the deal level. There is a host of companies that will be hard to exit since they are no longer relevant for an AI-centric world."

Tech's track record, together with long-term forecasts, argues its sturdiness as an investment theme. An improving macroeconomic picture – above all, in the expected reduction of interest rates – also suggests the market will eventually begin another full-blown growth trajectory.

"Investment in new innovation is only going one way – which is up," Insight's Parekh says. "We'll have fits and starts, as you always do. But there's no other market I'd rather wake up to tomorrow morning and be investing in." ■

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