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Outlook for IT Channel Leveraged Buyout Valuations Looking Up

By Marty Wolf, Global M&A Advisor

Conditions for leveraged buyouts in the IT channel have improved, but it would be a mistake to think we are on the brink of another heyday for debt-financed acquisitions. Private equity firms seem to be taking a far more conservative today approach than they have in previous boom times, mostly recently 2005 to 2007 -- for obvious reasons. Many of the investments made just prior to the recession have resulted in huge losses for private equity firms, with more to come.

Even Dell (NSDQ:Dell)'s leveraged buyout is not a bellwether. At $24.8 billion, it is the largest IT leveraged buyout ever and has the unique circumstance of a billionaire founder willing to put a large chunk of his own money into the deal to buy back the company that bears his name.

Still, as Milton Friedman once said, "No one spends other people's money as carefully as they spend their own."

That could explain why, according to new data from S&P Capital IQ, leveraged buyout valuations hit their highest levels in more than a year in June 2013.
There were a total of 79 U.S. LBO deals tracked by Capital IQ in June and purchasers valued the targets at an average 21.4 times trailing 12-month EBITDA. That was more than double the valuations in May and the highest average multiple since April 2012.
(In the interest of full disclosure, Capital IQ data for July showed that U.S. leveraged buyout activity was at its lowest point of the year -- although this is probably more a result of summertime vacations than a harbinger of the future.)

Even more encouraging, there have been a handful of significant solution provider leveraged buyouts at premium valuations so far this year. In April, Birch Hill Equity Partners acquired Canadian IT services company Softchoice for $420 million, a 24 percent cash-adjusted premium to the stock's closing price on the day of the announcement.

Also in April, Thomas H. Lee Partners acquired IT services company CompuCom. Financial details were not disclosed, but a sale price of $1.1 billion was reported. As a side note, this was the third acquisition of CompuCom by a private equity firm since 2004 -- each time at a higher valuation.

Then in late June, Thoma Bravo said it would acquire Keynote Systems, an Internet and mobile cloud testing and monitoring company, for approximately $395 million. The firm followed up a few days later with an announcement that it would acquire Intuit (NSDQ:INTU)'s Financial Services Division, a provider of online and mobile banking software to financial institutions, for $1.025 billion. Both acquisitions closed in August.

These higher valuations are being driven by the availability of inexpensive debt, which partly accounts for private equity firms' willingness to pay higher prices. And even though interest rates are rising now, they are still low and debt is still easier to get than at any time in the past five years.

So one question for IT channel companies and solution providers considering a sale is what can they do to increase their appeal to private equity investors or, for that matter, any potential buyer?

One answer is this: The value of a company to a potential buyer is based on its future value, not on its past performance. Therefore, every company considering a sale should engage in a deep and thoughtful exercise of forecasting its performance after an acquisition or investment, rather than basing it solely on current conditions and what is known now.

This may seem like an obvious thing to do, but in our experience as M&A advisors to midmarket IT companies, it is something that is rarely done.

That's because it's difficult. It requires starting with the expected infusion of new capital, deciding how it might be invested in the business and then modeling the company's future.

For example, one company might use new capital to buy more capital equipment that would enable it to deliver new services. Another might use it to open new markets or hire more salespeople. Another might use to make a series of acquisitions that would enable the company to change its revenue mix to include higher-margin services.

The rewards for this type of exercise can be substantial. We recently advised an IT company in a sale where its expected valuation began at four times last 12 months (LTM) revenue. After working with the company to build a solid two-year forecast based on the revenue it might achieve with an infusion of capital, it was acquired at six times LTM revenue.

The message is this: Sellers should not force potential buyers to "do the math" on future value themselves. From the outset and throughout the process a seller should do everything possible to put its best foot forward -- and that takes work.

Marty Wolf is founder and president of martinwolf | *M&A Advisors. Marty has been directly involved in the divestiture of six Fortune 500 divisions and has completed more than 115 transactions in the IT services sector. A frequent commentator and guest blogger for leading business and IT media outlets, Marty also acts as a counselor and trusted adviser to CEOs of select IT firms.*