BMI Mergers & Acquisitions

Software M&A Market Update

Q4 2022

Opportunities for sellers in a 'softening' market

Executive Summary

After a record-breaking performance in 2020 and 2021, the software M&A market is leveling off. Top of market valuation multiples of 10x to 12x ARR have all but faded, while deal volume in the tech sector appears to have softened by roughly 30%.

Thank the economic slowdown. The rise of inflation has lowered prospects of nearer term ROI and higher interest rates make debt financing more expensive and more difficult to obtain. Bottom line: Compared to the last two years, there are fewer options for sellers in the software M&A and capital markets.

Software M&A is alive and well

Yet there are still plenty of great opportunities for sellers in the current market. To see them requires some perspective.

Compared to the historic, nose-bleed highs of 2020 and 2021, the drop in performance *appears* unpalatable. Yet while valuations, for example, have softened, they remain significantly higher than they were before the software M&A boom of the last few years.

> **The current market is still a great time for companies that are ready to sell or raise growth capital, provided they can adjust their expectations and strategy for savvy buyers.**

Savvy buyers know that economic dips are prime opportunities to find strategic acquisitions that generate above-average returns. They are also typically well capitalized, so that if they are convinced an acquisition can give them a strategic advantage, they have the resources to meet current average multiples, which are still well above those of 2019 and earlier.

How Sellers Can Best Navigate The Current Environment

In order to land a favorable deal with a savvy buyer in this market, sellers must be prepared for levels of scrutiny significantly higher than the past two years. The fundamentals still apply, yet companies performing below industry KPI benchmarks will have an even more challenging time finding interested buyers.

Therefore, sellers should make sure their houses are in order. Demonstrated performance in growth rate, low churn rate, and strong gross and net revenue retention numbers will be critical.

State of the Software M&A Market

Deal opportunities are not as abundant as they were the past two years.

The software M&A market isn't what it used to be.

After a record-shattering performance in 2020 and 2021, the numbers appear to be returning to Earth.

> **Since the beginning of Q2 2022, deal volume has softened by roughly 30%.**

Public company valuations have also dipped well below the 15x+ multiples of 2021. In fact, the total value of deal making globally is estimated to hit $4.7 trillion in 2022–a 20% decline from the year before.

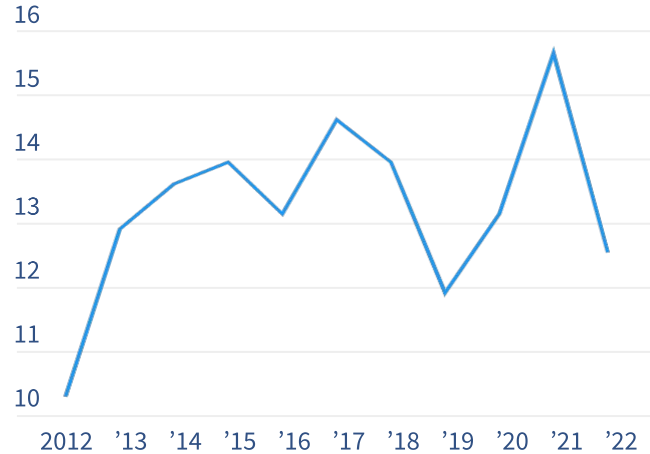
Of course, the stock market has been experiencing similar shifts.

On the heels of what was expected to be the last of a bear market, the benchmark index ended the month of August down 4.2%, leaving analysts to expect continued stock price volatility the rest of the year.

Getting Cheaper

Valuations on strategic transactions have dipped so far in 2022 after peaking last year.

Deal valuation multiples



Note: 2022 data is through June 1.
Source: Bain & Co.

Tech stocks in particular have not fared much better. Early September saw investors shedding tech-focused funds at the fastest rate since Meta's profit shock sparked a selloff in February.

Yes, it's the economic slowdown

For M&A specifically, blame the double whammy of inflation and rising interest rates. At the time of writing this report, the U.S. inflation rate is 8.26%, five percentage points higher than the long-term average. This level of inflation makes it especially difficult for both would-be sellers and investors to generate a real return.

Unfortunately, efforts to curb inflation aren't helping. On September 21st, the Federal Reserve hiked interest rates for the fifth time in 2022, bringing the benchmark to between 3% and 3.25%. Financing acquisitions with debt is currently more expensive than it's been since 2008.

BMI Mergers' Outlook

There are still plenty of opportunities for sellers in the current market.

The news is not all bad. Far from it.

> **The current market holds favorable deals for sellers ready to exit or recapitalize, though finding them requires some perspective.**

A few steps down from historic valuations is still very high.

Consider the dizzying heights the market experienced over the last two years. In 2020, the pandemic forced digital transformation across industries, which accelerated the adoption of SaaS solutions to facilitate new ways of doing business.

As a result, the value of M&A deals rebounded to an all-time high in 2021. Amid soaring valuations, dealmakers could not get their hands on the transformative capabilities fast enough. By year end, total M&A deal values weighed in at $5.9 trillion, smashing previous records.

Across the board, valuation multiples hit record highs of 15.4 times enterprise value/EBITDA. SaaS assets went even higher, some reaching multiples as high as 25 times ARR.

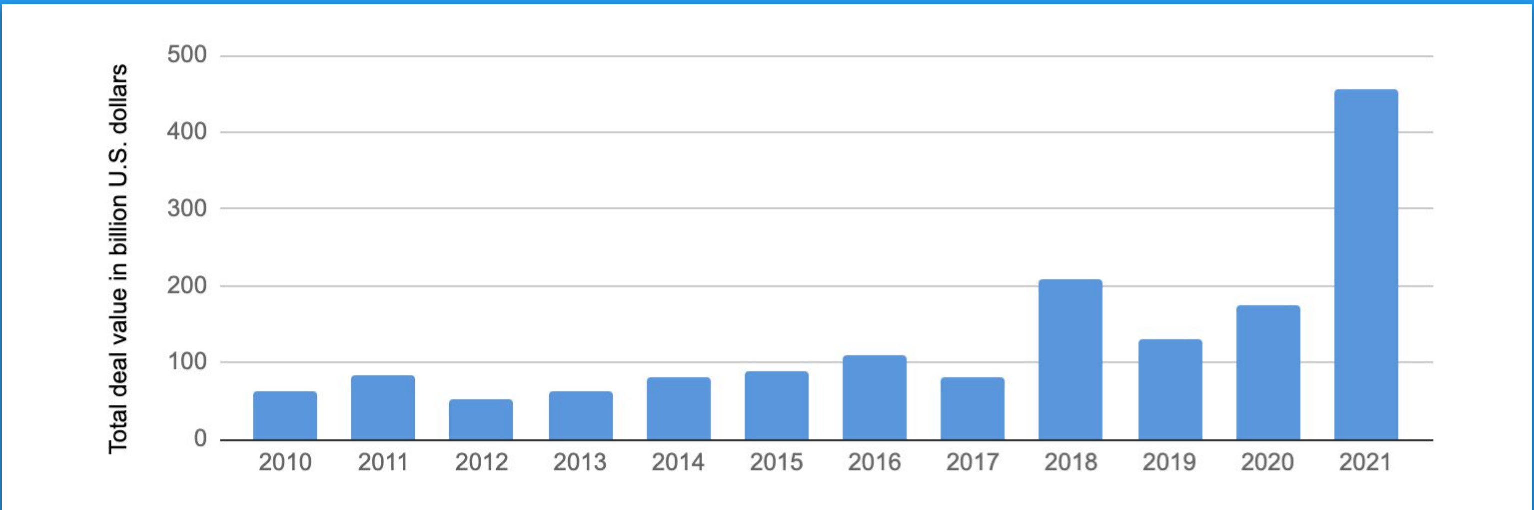
Next to 2021, any previous year of M&A performance pales by comparison, no matter how exceptional. Those historic highs were the result of a massive response to a once-in-a-century event. We are unlikely to see them replicated any time soon.

For sellers who want to exit or recapitalize, writing off the current market because it doesn't offer the record-shattering opportunities of 2021 would be a tragic failure of perspective.

Even as inflationary and interest rate pressures have pushed tech M&A performance to plateau in 2022, tech valuations are still unusually high.

That's why we contend there are still plenty of highly favorable opportunities for sellers that adjust to current expectations.

Savvy buyers are hunting for strategic acquisitions.



Source: Statista

Deals are still getting done

Enter the savvy buyer. They know, historically, companies that made significant acquisitions during past ebbs in the economy outperformed those that did not. They also know that depressed valuations are likely to bounce back relatively fast as the economy improves.

In our experience, these buyers are looking to make acquisitions that promise a long-term strategic advantage. And should they find one, they typically have the capital to pay a fair market value.

That’s good news for tech sellers ready to divest soon. Keeping in mind, the current “fair market range of valuation” is still highly favorable in this sector. (The rates we are currently seeing range from 4x - 8x ARR).

Private equity is flush with cash

What’s more, private equity is still sitting on a mountain of capital. Spurred by pent up demand fueled by the pandemic, fundraising in 2021 reached a record high of almost $1.2 trillion. Private equity buyers have no choice but to deploy that capital, and they will view the current market as a great opportunity to do so.

Small-to-mid market is strong

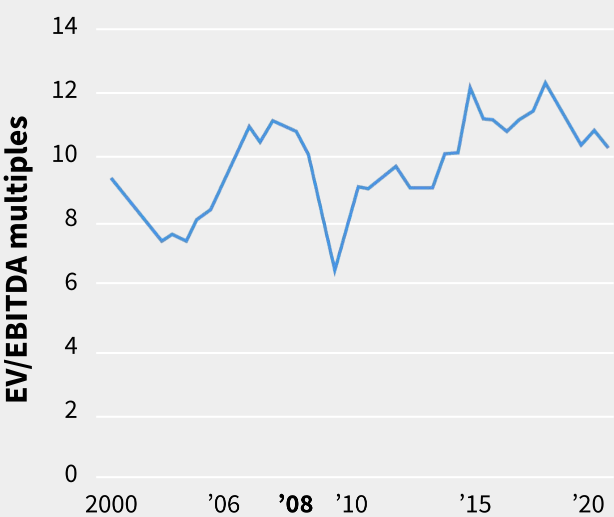
Historically, the small-to-mid market generally experiences lower volatility during economic disruptions, which is what we’ve seen in Q2 and Q3. Mega-deals may grab headlines, yet it's “middle-of-the-bell-curve” deals that continue to be most common.

Time is limited

Buyers are also aware that their window to find and secure strategic deals is somewhat short. History suggests the best acquisitions are won by those with the liquidity and risk tolerance to move fast, and who have done their homework in advance.

Deal Multiples, 2000-2020

An examination of deal multiples - the ratio of enterprise value divided by EBITDA that is used to determine a company’s value - during the 2008 financial crisis suggests that valuations that have or will decline during the current downturn are likely to bounce back somewhat quickly.



Note: EBITDA- short for “earnings before interest, taxes, depreciation, and amortization” - is a measure of a company’s financial performance.
Source: EY and Dealogic

BMI Recommendations

Sellers who want to exit or recapitalize now should prepare to pass higher scrutiny.

The current market has raised the stakes for buyers.

Today's inflation rate will suppress their future returns on investment. Higher interest rates have made debt more expensive and harder to secure. In fact, underwriters are now showing up at the negotiating table to ensure their capital is being deployed responsibly.

Bottom line: Sellers can expect a level of scrutiny greater than they may have experienced over the past two years.

Therefore, to sellers who want to sell soon, we offer the following recommendation:

Get your financial house in order

The fundamental KPIs still apply. Yet, in the current market, potential acquisitions are expected to perform at least on par with industry benchmarks.

KPIs we've seen to be most critical to buyers are:

1. **ARR Run Rate:**

   The higher your rate, the more attractive the potential acquisition. A meaningful ARR Run Rate shows product-market fit and long-term viability.

2. **Growth Rate:**

   No growth or negative growth usually indicates a declining market, lack of strong product-market fit, high churn, or an inability to scale the business.

3. **Gross Revenue Retention:**

   GRR tracks a company's ability to retain its contracted revene. An ideal benchmark is 90%.

4. **Net Revenue Retention:**

   NRR represents a company's ability to not only retain customers but also drive expansion revenue across those customers. Buyers want to see an NRR of at least 100%.

5. **Rule of 40:**

   The target's growth rate and profit margin should equal 40% or more.

6. **Churn Rate:**

   An acceptable churn rate for buyers and investors is between 5% and 7%.

Conclusion

Good deals are waiting in the current market for the right sellers.

We expect the slowdown in the software sector to continue as long as the economic downturn continues––how long and/or severe that will be remains to be seen.

Regardless, we also expect favorable deals will continue to get done. Sellers who have built a good company will be able to sell. And despite the slowdown, we are still seeing strong valuations occur.

Does that mean *you* should sell now? Not necessarily. Here is what we recommend:

Sell now if…

- You are simply ready to exit or recapitalize.

Consider selling if…

- You are uncertain you can achieve meaningful growth.
- You are concerned about the competitive environment.
- Your acquisition window of opportunity is closing.

Wait to sell if…

- You are very confident you can realize meaningful revenue growth over the next 12-18 months without the need to raise additional capital.

About

About BMI Mergers

For over twenty-five years, we have been successfully engaged in the practice of buying, selling and managing the business acquisition process. Our professionals have been engaged in transactions in a multitude of industries. They have completed multi-million dollar deals, and they have also successfully integrated businesses post-merger. Whether your business is worth $5 million or $100 million, this experience is put to work to achieve your desired result.

About The Author

Matt Tortora brings over seventeen years of business ownership, sales leadership, and consulting experience in the software and technology services sectors. He has founded three companies and held strategic leadership positions at growth stage B2B software companies. Most notably, Matt was the co-founder and CEO of a Chicago based software company which he successfully grew and sold to a strategic acquirer.

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