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Technology Focus

Expert Insight

Investors will be ready to do deals with midmarket tech companies

By George M. Shea

On Jan. 18, Kodachrome officially died. This happened when Dwayne's Photo, the last developer of the once popular, mass-marketed color film manufactured by Eastman Kodak Co., ceased processing Kodachrome film.

That is but one example of a once-booming industry that simply ran its course. Be it buggy whips, typewriters or VCRs, this is simply a case of natural selection playing out in the business world.

There are several sectors that may not recover from the recession, according to the Bureau of Labor Statistics. Technology, however, is not one of them. Many economists suggest technology deal-making, particularly in the lower-middle-market, has provided a silver lining in the recovery.

D.C.-based LivingSocial, for example, received a $175 million investment from Amazon.com Inc. in December, and the social commerce company is projecting $500 million revenue in 2011. Our company even witnessed an increase in technology deal-making in 2010, with half of Focus' deals taking place in the information technology services sector, including the recent recapitalization financing for FutureTech Holding Co. and Tribridge Inc.

The recession ended in June 2009, according to the National Bureau of Economic Research, and the U.S. economy appears to be recovering. However, organic growth remains weak, and companies are considering alternative growth options.

Why this is a good time for tech firms?

Private equity firms are bulging with cash. They're dedicating more money to lower-middle-market businesses as platform companies and "tuck-ins" to existing investments. At the same time, tech startups and small to midsized businesses are looking to scale up. Finally, after running lean the last few years, larger corporations with strong balance sheets can now execute acquisition strategies that had been put on hold.


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Following the surge in life sciences and clean tech growth during recent years, the National Venture Capital Association (NVCA) expects the IT sector to show the biggest investment increases in 2011. A major reason is the emergence of business models built around technology trends — software-as-a-service, cloud computing, managed services — that are very attractive to investors.

In addition, improved debt markets should allow buyers to borrow more, and in this environment buyers and sellers should be more realistic about valuations. We see an increasing trend of sellers who are tired of sitting on the sidelines, and buyers who must step up valuations to be competitive.

What kind of deals are ahead?

Deal activity is increasing with corporate strategic buyers (particularly in North America), private equity buyers (particularly transactions to take majority control) and foreign buyers (particularly from Europe and India).

In 2011, typical deal activity should revolve around recapitalizing existing financing. This will help provide an exit for outside shareholders who have been in the deal well beyond their usual investment period and help companies find the long-awaited financing to execute growth strategies.

Last year capital remained expensive and in short supply, but now private equity firms have $400 billion to invest, according to Deloitte Corporate Finance. They have raised more cash from limited partners and have more leverage now that debt requirements have eased. And many have raised less debt-intensive funds for specialty investments.

Rather than vying aggressively for new acquisitions, private equity firms are more inclined to improve the operational efficiency of IT companies in their portfolios, in part by working out debt conundrums.

Who is ripe for the picking?

Recently, there have been several parallels between private equity and overseas buyers in deals where existing U.S. management is retained with a large equity stake. With majority control, both buyers financially invigorate the organization without overtaking the current business model or management. Existing management keeps a substantial minority equity position and has the opportunity for a "second bite of the apple" when the company is sold or goes public.

In the U.S., software was the dominant sector in the IT deal arena last year. In the year ahead, private equity interest in IT services and consulting should increase, along with interest in payment-systems companies and cloud-based solutions. (In fact, 80 percent of investors surveyed by the NVCA predicted growth in cloud-computing investment.)

Most of the IT deal activity will be focused on the low-hanging fruit — lower-middle-market players valued at less than $100 million.

Perhaps drawing on experience from the tech downturn a decade ago, the IT sector is faring far better than other industries today. Overall, IT is recovering faster because it is not as capital-intensive and companies' IT budgets have loosened up considerably.

The ever-increasing dependence on technology — and the velocity of its evolution and adoption — is a genie that has been uncorked. To a great extent, that ensures many years of healthy deal-making in the IT sector.

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