Tech and private equity

PE's role in tech businesses

HSBC UK

Introduction

In a world where gilt yields are persistently low, pension funds are focused on alternative asset classes that are providing reliable growth. Private equity (PE) is one of them. In turn, PE firms are looking to invest in businesses that are growing today, as well as showing strong future growth prospects. The general rise of the tech sector in recent years, and its role in providing much of the answer to the COVID-19 challenge, puts high-growth tech companies firmly in the sights of PE investors.

Fundamentally, PE looks to invest in a business and its management team, helping the business to grow and prosper, and then selling. The tech sector PE playbook has some unique aspects.

We know PE is an area many owner-managed tech firms are interested in, and keen to learn more about. With that in mind, our latest webinar brought together a partner in one of the UK's leading mid-market PE firms, and a tech entrepreneur who has been backed by multiple PE firms. Roland Emmans, Head of Tech Sector at HSBC UK, joined them to unpick tech and PE in the UK today.

1 › Hungry to invest in UK tech

Why private equity can't get enough of tech

Tech deals are coming thick and fast. In the first quarter of 2021, a record-breaking 268 M&A transactions were completed in the UK, according to one analysis[1]. Others report Q2 2021 being the busiest quarter ever for UK tech M&A. But why?

There are many drivers for the increased level of tech M&A activity we are seeing today. They include pent-up M&A activity from Q3/Q4 2020 that was delayed due to COVID-19, and the shift of the economy to tech over the last 18 months due to the effect of the COVID-19 pandemic: the wholesale switch to remote working and services underlined the indispensable value of technology.

PE seems particularly keen to get more involved in the tech sector action. The sector's strong market growth and innovation dynamics mark it out as a great place to invest, leading to strong returns upon exit.

PE investment now makes up roughly 40% of the total value of tech deals[2]. "In 2021 so far, there have been over 50 UK management buyouts of over £100m in value, compared to 40 for the whole of 2020[3] ," notes Roland Emmans.

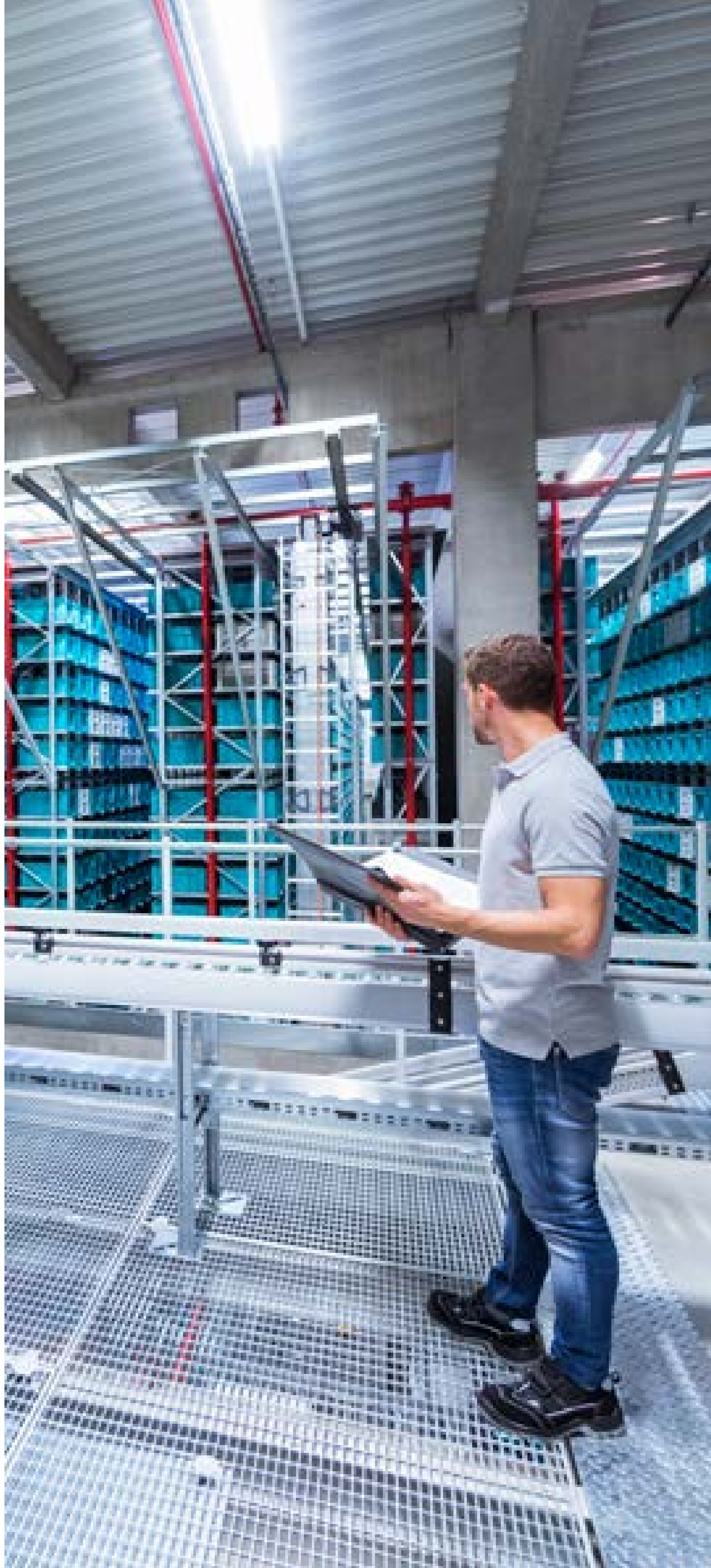
"Tech is definitely in vogue," agrees Tom Wrenn, a managing partner at PE firm ECI, which has been investing in mid-market UK firms for 45 years. With tech software and automation tools growing rapidly and new tech tools emerging at fast pace, he's convinced this is more than a passing trend: "Tech is on a great, macro long-term run, and it's still got a long way to go. Tech businesses that can show good growth, and reasons why they will get bigger and better, are attractive."

Another lure of the sector is that business models have improved in recent years. Rather than simply providing software licences and maintenance, many firms now offer SaaS (Software as a Service) in some form, a recurring income and embedded into their end customers' business model. This offers more predictable growth opportunities, says Tom.

As Tom explains, PE firms look to take the risks and rewards of being a shareholder of the business, though without a daily or weekly interest: "It's about making the most of the business that we've invested in and backing the management team." The fact that the companies involved are not publicly listed means the management team and their investors can pursue their ambitions out of the glare of the public eye.

> **"Tech businesses that can show good growth, and reasons why they will get bigger and better, are attractive."**
>
> Tom Wrenn, Managing Partner, ECI

1 https://www.privateequitywire.co.uk/2021/05/07/299871/tech-sector-ma-activity-hit-record-high-q1
2 https://www.ey.com/en_uk/private-equity/how-2021-is-unfolding-for-private-equity
3 https://cortex.dealogic.com/



2 › More than just fresh capital

The benefits of private equity to tech firms

Cyber security specialist Deep Secure, based in Malvern, has benefited from PE backing since its launch in 2009. YFM Equity Partners backed a management buy-in then, and followed up with further investment in 2017. This enabled the firm to launch its proprietary cyber threat identification and removal technology, while scaling up sales and operations. For the funds advised by YFM, the payback was a return of 6.5 times their investment[4].

These are among the PE experiences that have left Dan Turner, CEO of Deep Secure, with a positive view of the process. “It’s a trusted mechanism for people like me, who want the chance to be a bit entrepreneurial, with the discipline of a proven model behind the business,” he says.

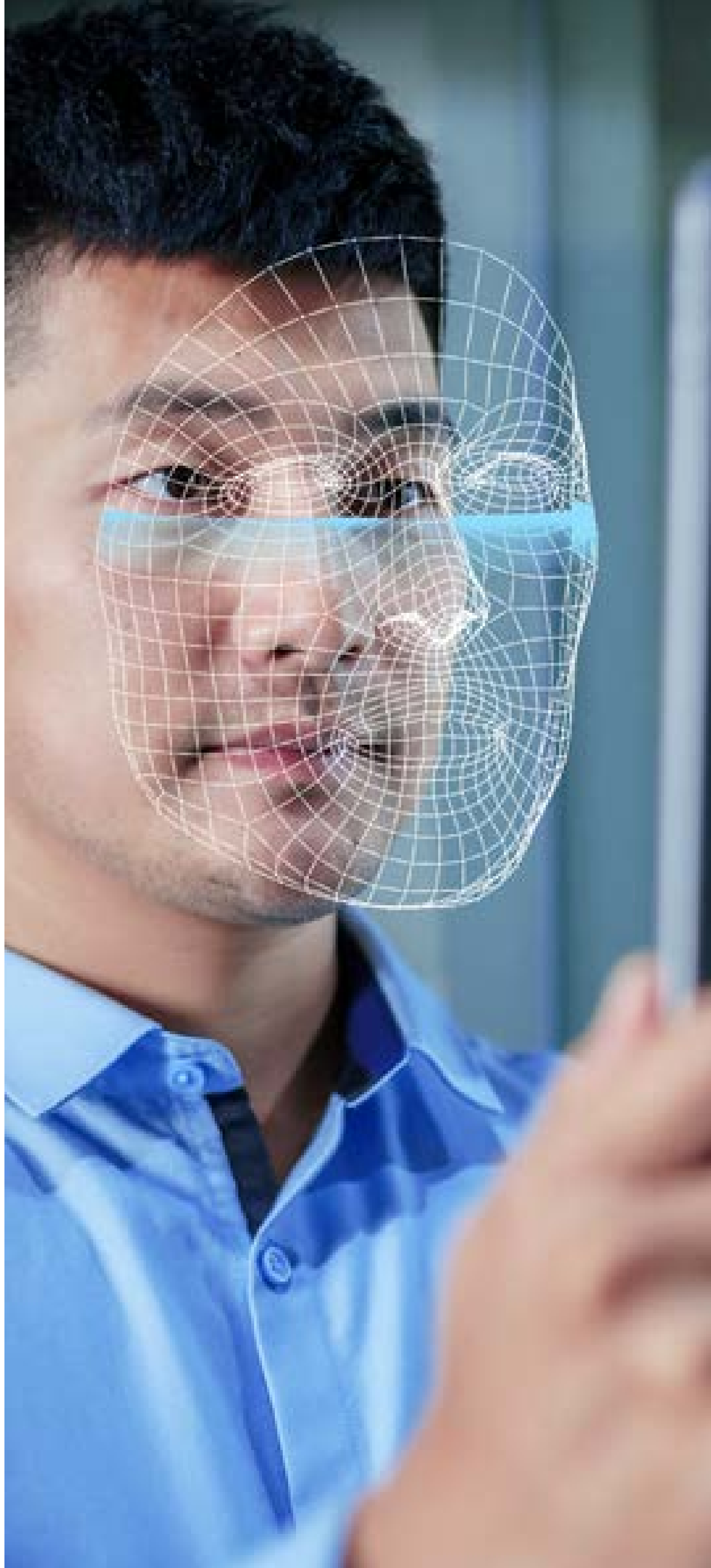
The potential benefits include capital to help fund business growth initiatives, or to fund acquisitions, and perhaps an opportunity to de-risk the position of a shareholder who has all their wealth tied up in the business. But beyond that, PE can bring external expertise to bear on strategic issues, such as international expansion or growing into new areas.

This is where the power of the network bears fruit. While seeking to move from an SME-focused investor to one more suited to his firm’s emerging mid-market position, Dan was introduced to many potential candidates by the Big Four accountancy firm that advised him. He was struck by the power of the PE firms’ networks: “They have contacts you could only dream of. As a business person trying to get on with operations, I couldn’t imagine how you would source that expertise.”

The PE profession also brings a long track record of handling challenges faced by multiple businesses. It understands that the road to success is not a straight line, says Dan: “What I’ve experienced time and time again is that PE investors don’t panic. They have seen it all before and understand that a business doesn’t grow in a straight line. They might lean in with a bit more advice, but they are in the boat with us, not just shouting instructions from the quay.”

Once the business and the investor are aligned in their ambitions, progress can be swift. Tom recalls ECI’s experience after buying out a division of a FTSE100 business. Having presented a soundly reasoned paper on a big investment plan, the management team were surprised when the investors simply encouraged them to get on with implementing it. In their old plc corporate environment, they had been accustomed to a four-month decision-making process. “With the PE investor round the board table, the key people are there in the room when you want to make things happen,” Tom says.

> **“It’s a trusted mechanism for people like me, who want the chance to be a bit entrepreneurial, with the discipline of a proven model behind the business.”**
>
> Dan Turner, CEO, Deep Secure



4 https://yfmep.com/investments/deep-secure/

3 › The right bedfellow

How to pick the perfect PE match for your business

There's a huge diversity of players in the PE profession, so it's important to find the right match. Inevitably, not every PE investment gets the desired result. In many cases, says Tom, this is because the expectations of the investor and the management team were mismatched from the start.

Tom makes the analogy of a homeowner deciding to rent out a room, and realising only after the renter takes up residence that their interests and personalities are incompatible. Having looked forward to a companion to watch and discuss the football, the householder finds their new tenant only wants to listen to music.

How to avoid such a clash? The first step is for business owners to consider their objectives before entering PE discussions. Whether the ultimate goal is to expand the business, to take it overseas or even to step back from it altogether, it's best to think ahead without immediate pressure to act.

Having decided to seek out PE, businesses should aim to select a firm that aligns with their own market position and ambitions. Most PE firms have their own preferred niche, whether it's investing in high-growth SMEs, turning around underperforming businesses, or supporting those with potential for international expansion. They also focus on different sizes of business: for ECI, the sweet spot is firms valued up to £300m.

Ask yourself what you need from your investor. "For some people, the priority is deep sub-sector experience," says Tom. "Others want an investor they can get on with personally, and chat about the issues in a way that's not too formal."

In that vein, Dan emphasises the importance of spending time with the potential investors, to ensure a good personal rapport. While the pandemic has pushed much M&A activity online, Deep Secure also made time for "eyeballing" PE representatives in person in the run-up to its latest transaction.

That helps to ensure a common vision. "You have to be aligned on the plan," Dan says. And even if the plan is derailed, transparency is key to trust: the management team shouldn't wait until the next board meeting before reporting a major issue to the investor. "You can always alter a plan, but you need to get it out in the open if things are not going quite in the way you hoped."

Increasing competition means that tech businesses can afford to be picky in making their choice. Often more than one PE firm is jostling with strategic buyers in any transaction, says Tom. Businesses should be asking what each investor can offer, besides funds: "Everyone has capital, but how is this partner going to make it worth more?"

"Everyone has capital, but how is this partner going to make it worth more?"

Tom Wrenn, Managing Partner, ECI

Summary

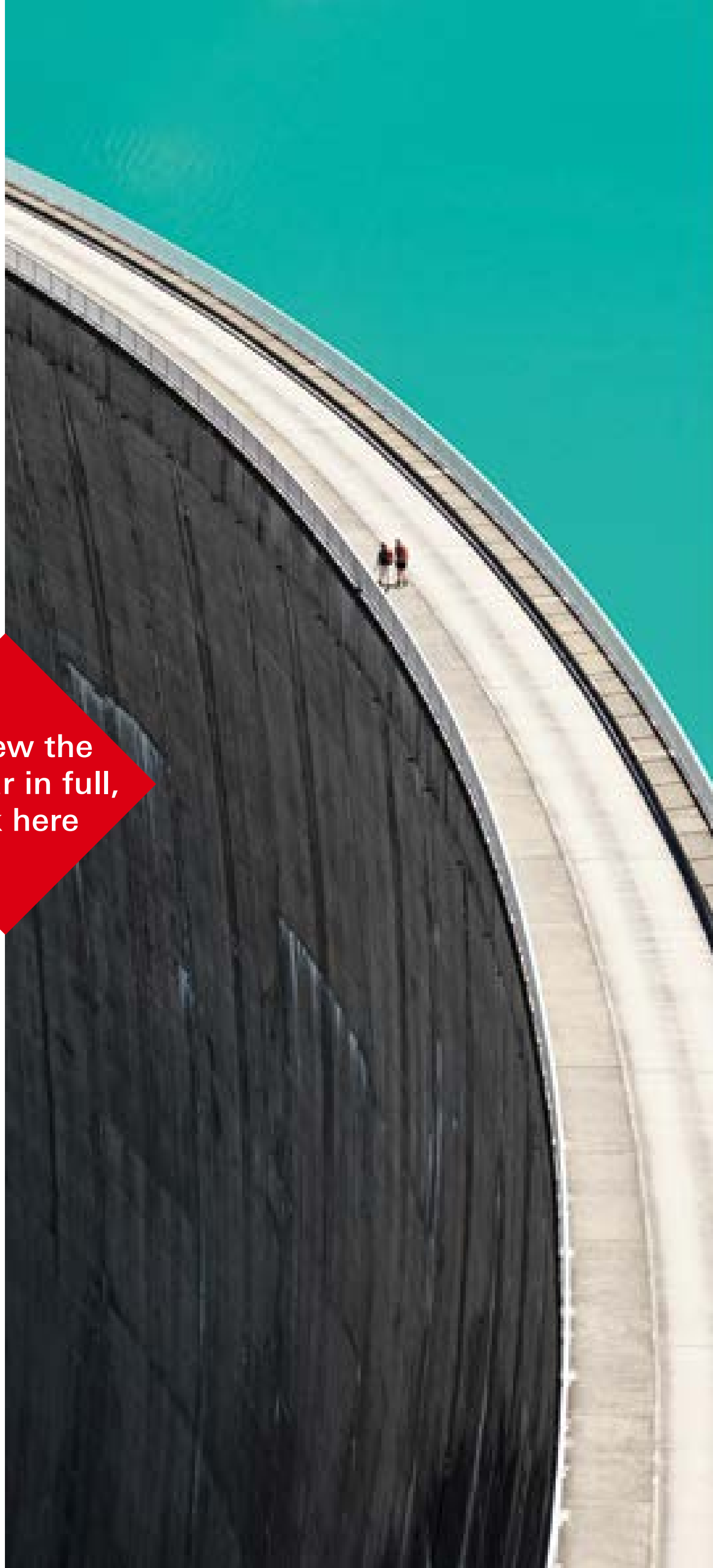
"Tech has been one of the key areas of interest for PE investment in recent years," Roland Emmans concludes. "At HSBC we're excited to be using the power of our networks to support that trend, both by bringing together our tech clients with PE specialists, and by sharing insights from those who have been through the process with their peers in the sector."

Key lessons from the webinar for tech firms considering PE involvement included:

- **Think about what you want from a PE investor,** besides the capital itself. Seek out an investor that could fill critical gaps in the expertise you'll need as your business grows.
- **Take market soundings.** Speak to businesses that have attracted PE investment and that now enjoy an enviable position. Ask them about their experiences, including how the partnership handled unexpected challenges.
- **Understand what's on offer.** In particular, will the person who's pitching to you from a PE house be the one who takes up a place on your board?
- **Be prepared to offer transparency.** Ensure your management team knows that any attempt to hide a major issue, or resolve it before it needs to be reported, could damage trust.
- **Get to know potential investors as individuals.** Be sure you can get on personally, as well as having a common vision for the business.

> "Tech has been one of the key areas of interest for PE investment in recent years."
>
> Roland Emmans, Head of Tech Sector, HSBC UK

To view the webinar in full, click here



If you would like to discuss any of the topics raised here, please contact the Tech Sector team directly:

https://www.business.hsbc.uk/corporate/technology

Roland Emmans,
Technology Sector Head
UK Corporate Banking
HSBC UK Bank
Email: roland.j.emmans@hsbc.com
Tel: +44 (0) 7387 245 202

Or speak to your local Relationship Director.