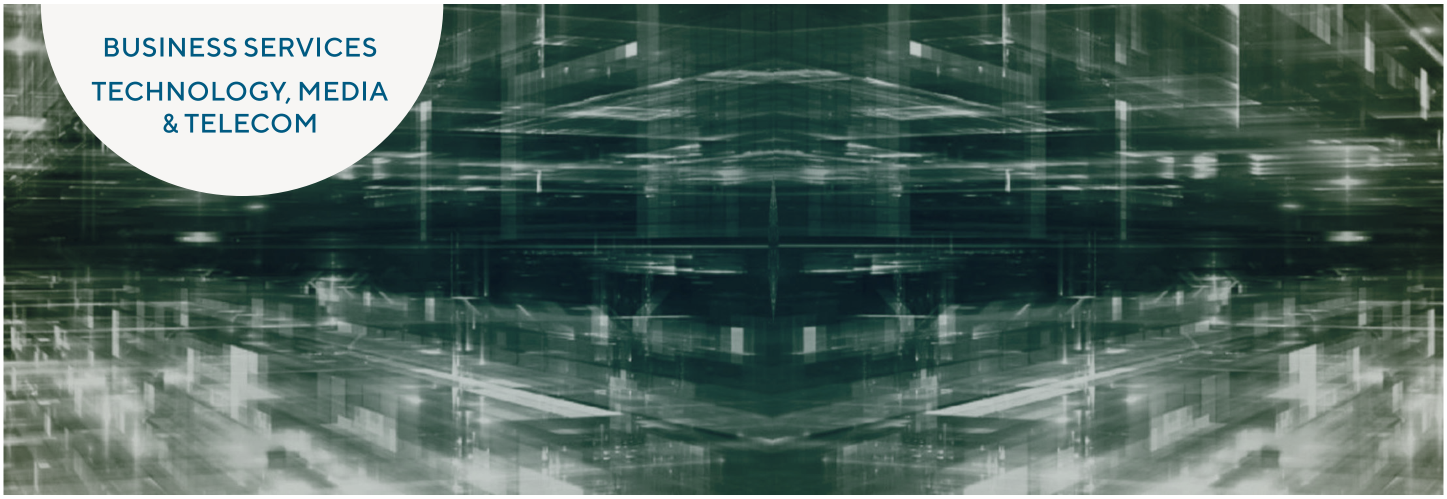

Filtering the Noise: a Deep Dive into IT Services' Key Valuation Drivers

This article was first published by TMT Finance on 9 July 2024: Filtering the noise: a deep dive into IT services' key valuation drivers | TMT Finance

The information technology (IT) services sector continues to see robust mergers and acquisitions (M&A) activity fueled by strong market growth, ongoing technological advancements and industry fragmentation. However, to capitalize on emerging opportunities and maximize valuation, stakeholders must remain aware of the key value drivers. Not doing so increases the risk of an incomplete sale process; a common feature in this sector in Europe.

European Private equity (PE) firms remain enthusiastic participants, driving a significant and increasing proportion of volumes, and demonstrating a keen interest in new platforms as well as bolt-on acquisitions to existing ones. As PE-backed assets grow, we are seeing increasing interest from the larger PE funds in Europe, with more secondary and tertiary buy-out transactions taking place.

Non-PE-backed trade entities are also exhibiting renewed interest, particularly in Europe, where sentiments have improved in H1 this year. This is being bolstered by growing interest from international players in the U.S., India and Asia-Pacific region.

The sector's resilience is further underscored by the emergence of domestic champions in Europe, driving an appetite for cross-border expansion and the establishment of pan-European platforms.

Although transaction volumes are not at peak, there is sustained activity. Lincoln International advised on 16 IT services transactions in Europe in the last two years, including Pictet's new investment in Technology Services Group (TSG), Bridgepoint Development Capital (BDC)'s investment in Kerv Group and KLAR Partners' investment in hallo.

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An elevated backlog of assets poised for market entry suggests a potential uptick in M&A activity to come towards the end of this year and into the next. TMT Finance data records that H1 2024 has already seen the announcement of 145 European cloud, IT and managed services deals, 55% of those announced in 2023, suggesting stronger growth for the rest of this year if the trend continues.

Key value drivers

The IT services industry is multifaceted, comprising various sub-sectors characterized by distinct key performance indicators (KPIs) and valuations. These include value-added resellers, managed services providers (MSPs) with varying levels of recurring revenues, systems integrators, professional services (PS) firms (including outsourced software developers) and cybersecurity service providers.

Private IT services valuations show significant divergence between sub-sectors and companies of the same category. Lincoln's eight key value drivers show the underlying reasons.

1 Quality of earnings

- Quality of earnings serves as a pivotal factor in determining valuations, with recurring revenues emerging as a primary indicator. MSPs, which have higher levels of recurring revenues, command superior valuation multiples compared to value-added resellers, whose recurring revenues typically hover under 20%; largely sourced from third-party product sales.
- While conventional notions stipulate 80%+ recurring revenues for top-tier valuations, things are changing. PS, particularly those catering to mid-market or enterprise clients, are increasingly valued, while PS-centric organizations that specialize in digital transformation and software engineering, especially artificial intelligence (AI), data science and cybersecurity, can also see high valuations.
- Cloud and software-based infrastructure is altering dynamics, with software subscriptions driving a significant share of recurring revenues. This model, with service providers operating as strategic partners and providing professional or managed services, garners substantial value and resilience.
- In addition to true recurring revenues, repeated or contracted revenues enhance visibility and valuation. Each company warrants a meticulous case-by-case analysis to optimize positioning and credibility.
- EBITDA and gross margins are benchmarks of both efficiency and quality of solutions. EBITDA margins of 15% or more show value and complexity, while those exceeding 20% attract a premium.
- Asset-light businesses dominate this analysis, marking expectations of high cash generation. However, recognizing the value of internal IP development or infrastructure can be pivotal to achieving successful transactions.

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2 Scale

- Scale is a barometer of a business' maturity and resilience and influences both investor interest and corporate partnerships. Achieving a €10 million EBITDA milestone is a significant threshold, with multiples generally increasing thereafter, buoyed by more accessible leverage structures.
- Pan-European PE investors are targeting platform deals in the €10-25 million EBITDA range, utilizing a substantial pool of European and U.S. investors seeking market consolidation opportunities.
- As companies surpass this threshold, investors increasingly look for proof of scalability beyond local markets. Both PE-backed and independent trade buyers are exhibiting interest across transaction sizes, albeit requiring a certain scale and maturity for entries into new markets.
- For a majority of recurring revenue MSPs or high-quality PS businesses, achieving an EV / EBITDA multiple above 10x is feasible. Scale, maturity and management capability dictate the extent to which multiples can reach the mid-teens and beyond. This underscores the importance of strategic positioning and alignment with key value drivers.

3 Growth

- Growth within the IT services sector shows the strength of a company's business model, with organic growth the ultimate validation. Exceptional solutions, technology offerings and customer service foster client loyalty, reducing churn and stimulating increased purchases while also attracting new clientele.
- Despite favorable industry conditions, there are varying growth rates that distinguish winners from losers. Organic revenue rates exceeding 10% are considered robust, with 15-20% or higher particularly commendable; often achieved by businesses with a strong foothold in professional services or cybersecurity services.
- In an inflationary climate, investor attention is on both price and non-price, volume-based growth strategies such as up-selling, cross-selling and new customer acquisition. Demonstrating growth sources via metrics is crucial, though many companies lack adequate data systems.
- While growth through acquisition is valuable for a buy-and-build strategy, organic growth remains paramount, influencing revenue levels and margins. Companies must prioritize organic growth capability to enhance their value.

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4 Integration

- A buy-and-build strategy has long been esteemed as a value accretive approach for scaling IT services businesses, often spearheaded by PE-backed platforms. However, recent years have seen a significant shift in investor sentiment, with a higher scrutiny on companies pursuing inorganic growth.
- In Europe particularly, several ventures faltered because of inadequate integration, resulting in declining growth rates and failed transactions. Consequently, investors and trade buyers prioritize well-integrated and clean businesses and are willing to pay premium valuations for entities that have a robust platform for strategic advancement.
- Effective integration methods vary, with front- and back-end integration serving distinct purposes.
  - Front-end integration, fostering brand scalability and cultural cohesion, facilitates cross-selling, yet can look superficial if the service offerings and technology focus lack cohesion.
  - Conversely, back-end integration drives cost efficiencies, consolidates data management and streamlines internal processes, enhancing profitability tracking and sales strategies.
- Integration needn't involve amalgamating brands into a single entity, particularly if they possess niche value. An effective strategy can focus both on a center of excellence and a group model, preserving brand identity while optimizing alliances.
- Success hinges on well-defined integration and transformation, complemented by a proven record of earlier acquisitions and momentum in both up-selling and cross-selling solutions. By meticulously executing the integration, businesses can command premium valuations, ready for sustained growth and market leadership, as shown by the mid-teen EBITDA multiple paid for the MSP hallo.

5 Management, talent and culture

- Effective management teams play a pivotal role; disparities in performance often hinge on execution.
- PE investors prioritize the backing of strong management teams; fostering partnerships that have alignment of interests, strategic vision and timelines.

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- Despite the increase in tech-enablement, human capital and organizational culture remain paramount, influencing both employee and client engagement.
- The challenge of sourcing and retaining top IT talent persists; low employee attrition indicates a positive organizational culture; crucial for scaling operations.
- Cultural and language disparities are significant considerations for near-shore and on-shore models. The preference is shifting towards on- or near-shore setups complemented by advanced AI and other technologies, rather than off-shore human resources, despite cost differences.

6 Business mix

- Quality of earnings is a pivotal factor in buyer perception, with a balanced business mix being highly prized. This typically includes recurring revenues, professional services and reselling; each plays a distinct role in valuation.
- Buyers scrutinize the revenue composition within these categories, favoring next-gen cloud-based IT infrastructure, connectivity, software technologies and associated services over legacy systems.
- For PS firms, advanced technical capability, accreditation and involvement in intricate projects raise valuation. The strong interest from PE and trade buyers in the recent UK MSP TSG transaction showed that expertise in cybersecurity, public cloud migration and Microsoft technologies commands significant attention. SD-WAN, SASE security solutions, AI and data science capabilities are also in high demand.
- Another emerging trend among MSPs is the shift towards application migration and management, particularly targeting mid-market and enterprise clientele. This includes the use of platforms such as Microsoft Dynamics, ServiceNow, Workday, Salesforce and SAP.
- Given the intense competition for IT talent and the imperative of earnings quality, a well-crafted business mix gives a scarcity value. This translates into higher margins and ultimately drives higher valuations.

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7 Customer focus

- Customer focus is also gaining prominence, prompting a shift towards disciplined acquisitions that are tailored to the needs of different customer segments. For SMEs, success hinges on reducing costs via automation, portals and streamlined purchasing. Conversely, mid-market and enterprise clients demand a consultative, outcome-oriented approach.
- Serving multiple customer segments efficiently poses considerable challenges – from SMEs to enterprise and public sector clients. Nevertheless, highly successful models can excel by focusing on specific segments. Investors increasingly recognize the value of customer-centric strategies, as shown by BDC's investment in UK MSP Kerv Group.
- Trade buyers exhibit discipline in their acquisitions, aligning with existing customer segments while larger, international, groups tend to prioritize enterprise-sized clients.
- Lincoln anticipates growth in the SME and mid-market sectors that drives cross-border expansion and acquisitions, enabled by cloud-based infrastructure and software solutions. This is likely to spur the emergence of pan-European champions capable of navigating cross-border markets.

8 Differentiators

- Differentiation in IT services is evolving as investors look for attributes that enhance client loyalty, bolster margins and establish a competitive edge. While meeting key value drivers remains crucial, investors demand tangible differentiators that affirm a "right to win".
- Various avenues exist to achieve differentiation. Industry focus (not exclusive specialization) can show a company's expertise and depth of capability. Differentiation can also stem from the development of IP tools. Whether monetized products or internal enhancers, these not only improve efficiency but also bolster margins.
- In essence, differentiation is becoming pivotal in securing a competitive advantage. By showcasing unique attributes, companies can strengthen client relationships, improve profits and position themselves as leaders.

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These key value drivers should be interpreted in the context of disparate business models and customer segmentation. Investors consistently prioritize similar KPIs across different models, although preferences vary between PE and strategic investors.

Both investor types emphasize organic growth and differentiation that attract interest at premium valuations. There's been a recent shift towards integration by both investor categories, indicating a recognition of the importance of establishing a robust platform for future growth, whether by organic expansion or strategic acquisition.

Lincoln Perspective

In today's market, substantiating key value drivers and showcasing differentiation through data is essential for achieving favorable sale outcomes and maximizing valuations. Lincoln advocates for proactive engagement with clients long before a sales process begins. Early and thorough preparation is critical to ensuring successful transactions.

This entails conducting a comprehensive review of KPIs and devising an action plan early. By integrating data requirements into existing systems and implementing regular reporting, companies can effectively demonstrate their value proposition.

Connect with a Lincoln IT services professional below to learn more about how we can take your business to its next success.

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