Tech Services: Pivotal Strategies Amid Tariff Disruptions in 2025

After two years of relative softness for tech services firms, investor optimism was building as 2025 began. Corporates and financial sponsors projected a more consistent growth trajectory for the technology sector, supported by Gartner's initial forecast of 7.1% industry growth (excluding Infrastructure as a Service [IaaS]). However, unexpected U.S. tariff announcements have introduced widespread macroeconomic uncertainty, impacting sectors globally.

Lincoln International's technology services team—having closed over 75 deals since 2020—has a proven track record of navigating turbulent markets. With deep sector expertise and global reach, the team remains committed to guiding clients through these challenging times. This article explores the immediate tariff impacts on technology services firms and the outlook for mergers and acquisitions (M&A) in 2025.

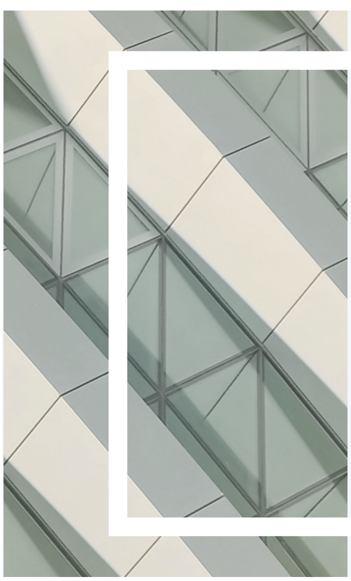
Indirect Impacts Loom Large

Thus far, technology services have been spared from direct tariff impacts in the U.S., as these firms primarily rely on human capital and software-based supply chains. However, companies engaged in hardware resale need to deal with added cost and pricing complexity and could experience direct cost increases that customers may resist absorbing.

A broader concern stems from the ripple effects of tariff-induced inflation and policy uncertainty. Sponsors and operators alike fear that these factors could restrain consumption and investment, paralyzing the economy. Even as stock markets reacted favorably to May headlines, volatility in policy direction challenges firms' ability to project confidence. Gartner has since revised its 2025 forecast down to 2.7%, a sharp 62% reduction from initial expectations, as "wait and see" sentiment continues to weigh on performance across the sector.

Many technology services firms depend on discretionary IT spending, which becomes less urgent during periods of uncertainty. Growth-oriented initiatives, particularly those requiring discrete projects led by outside consultants and systems integrators, are commonly deprioritized when budgets tighten. System modernizations, upgrades and experimentation in new technologies, which often feel more like capital expenses than operating necessities, are easy targets for deferral. Notably, consulting and application implementation, the two largest segments in technology services (accounting for 60% of the non-IaaS IT market), have seen their growth expectations slashed from 7.7% to 3.6% and 8.0% to 3.0%, respectively.

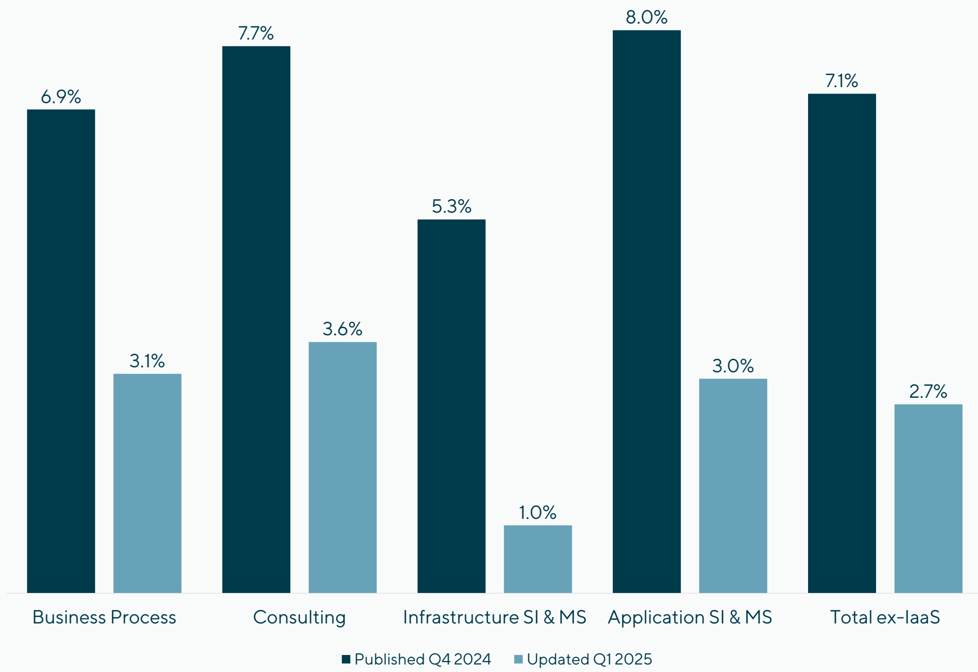
Gartner's revised viewpoint demonstrates near-term caution but longer-term optimism. While growth rates for 2025 have been revised downwards, the 2023-2028 5-year CAGRs remain relatively stable—6.2% before the revision and 5.3% currently. Indeed, the three years following this one suggest an acceleration in technology services spending consistent with the viewpoint that 2025 is a deferral of discretionary spend rather than an entirely new trajectory.



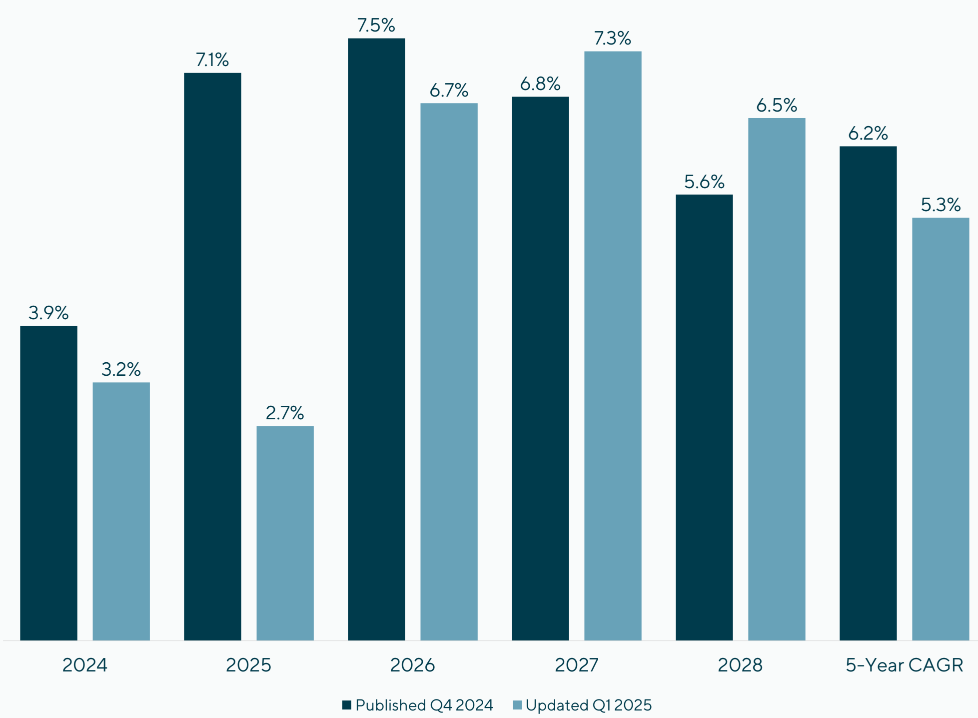
Notably, consulting and application implementation, the two largest segments in technology services, have seen their growth expectations slashed from 7.7% to 3.6% and 8.0% to 3.0%, respectively.

2025 Gartner Forecasts

By Subsector



Total (excluding IaaS)



Non-Discretionary IT Spend Increasingly Attractive

In contrast, non-discretionary IT spending remains attractive. Critical systems ranging from e-commerce platforms to servers are essential for keeping businesses operational, making them more akin to operating expenses than capital expenditures. While uncertainty leaves firms cautious about growth-driven IT investments, certain milestones and mission-critical upgrades cannot be ignored.

Companies that can prove their indispensable role, such as IT managed service providers (MSPs) specializing in cybersecurity, full IT outsourcing or ERP system management, are well-positioned to resist the pressures on discretionary IT spending. Nonetheless, even for core and essential services, pricing pressures remain. While such MSPs may be spared from deep discretionary cuts, we observe pricing pressure on even the best-positioned MSPs as organizations seek to streamline costs and resist price increases. To maintain and grow margins, investing in AI and automation throughout their own cost structures is imperative. However, despite these frictions, mission-critical IT services are increasingly viewed as safe-haven assets in today's volatile market.

Prolonged Uncertainty Establishes MSPs as a Safe Haven Asset

For investors deploying capital, IT MSPs offer strong downside protection through recurring revenues, non-discretionary services, multiyear contracts, low capital expenditures, high switching costs and access to a fragmented marketplace. These dynamics have driven rich valuations for MSP deals, with multiples in the high teens for the best quality assets over the past year. Yet such pricing introduces risks, as achieving strong returns requires a careful balance of strategies:

Organic growth: Often challenging for MSPs and frequently observed as single-digit growth rates

Accretive acquisitions: Subscale targets are plentiful, but the market for such is increasingly competitive, pushing prices higher. Successful integrations demand substantial human capital resources

Cross-sell / upsell: Larger customers with complex needs present upselling opportunities, particularly in cybersecurity—a high-demand area that is costly and challenging to develop internally

Within the infrastructure MSP space, there are two prevailing models: regionally focused providers and vertically oriented providers. Regional focus is most closely associated with an SMB customer base that prioritizes outsourcing of core IT functions including server management, network monitoring and management, backup and disaster recovery, etc. Vertical orientation most often aligns with middle market and small- and medium-sized enterprise customers in regulated industries with core IT needs and additional, more complex needs such as sensitive data management, regulatory compliance and specific technical products. This is particularly prevalent in the large U.S. market, with other smaller markets such as in Europe often requiring plural vertical specializations. Cybersecurity is an increasingly important capability to both segments. Representative end markets for vertically oriented MSPs include financial services, life sciences, healthcare, legal, education and the public sector. This segment of the MSP landscape is especially popular among private equity investors due to the greater regulatory compliance drivers, consistency in technology stack and greater wallet potential in serving a more complex set of requirements.

Note: Many providers of application services will also offer a managed services capability, but the market treats these differently as they are most often associated with a single technology vendor such as SAP, Oracle or Microsoft. Unlike infrastructure MSPs, sentiment and growth prospects for the technology vendor itself can drive interest and valuation more so than the nature of the business model itself.

While individual investors will pursue unique strategies, we consider the current pricing environment in the segment a sign that an increasing numbers of private equity firms are prioritizing downside protection over return potential in light of the uncertain market outlook. Multiples of EBITDA for quality MSPs currently exceed those for higher-growth segments, when the opposite has been true in the past. The high-visibility, recurring revenue model of IT MSPs offers a comforting predictability during a time when macro volatility fosters a cautionary mindset. The market indicates peace of mind is worth the premium.

However, with a more uncertain and challenging macroeconomic environment and interest rates perhaps reducing more slowly than expected only a few months ago, there is a need for greater focus on operational excellence. Buy and build strategies can still create significant value, but there is greater scrutiny from strategic buyers and investors on integration strategies, customer experience and sales performance. Investors attach greater importance on companies with a differentiated proposition, whether vertical or vendor specialization, or own IP tools or products – that provide a “right to win”. This should then manifest itself in stronger organic growth.

Urgency in Certain Pockets Creates Opportunity

While the market at large craves clarity and prizes non-discretionary investment themes, the technology frontier is market-agnostic. Technology consultancies specializing in AI and cybersecurity continue to attract investors as advances in these segments are moving too fast and are too transformative. Deferral risks falling behind. Strong interest and valuations remain for companies positioned alongside the most impactful technology trends.

However, the market does not trade on potential alone, and companies are heavily scrutinized on demonstrated growth and traction with enterprise customers. A barbell market has emerged as both strategic and financial buyers demand strong proof points for current and future growth. High growth assets within these themes are rewarded handsomely with revenue multiples. Others may be penalized for lack of growth and see EBITDA-based valuation interest.

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AI Remains Large on the Horizon

AI looms large as both an opportunity and a threat. While rapid advancements make long-term implications difficult to predict, the clearest risk lies with firms providing software development services. Many such companies rely on labor arbitrage, leveraging lower-cost geographies to design, develop and maintain cloud-based software. This revenue model, based on rates and hours, faces disruption as generative AI displaces lower-level development work and enhances productivity for higher-level tasks—reducing billable hours (and revenue).

The near term looks promising, as AI has become the next technological frontier requiring expertise and development from outside vendors. However, in the medium and long term, the outlook appears more precarious. Valuation trends for digital engineering assets reflect this caution, among other dynamics. In the ebullient M&A market circa 2021, digital engineering assets were prized for rapid market growth, seemingly recurring revenue profiles and strong tailwinds for digital modernization across all industries and functions. No transaction better embodied this market than Hitachi's acquisition of GlobalLogic for $9.6 billion at a staggering 37.8x EBITDA. Private markets were similarly frothy, with many assets trading at valuations into the mid-twenties.

In the interim, market growth has slowed and exposed the business model as more discretionary than presumed. Public valuations have traded off significantly—in 2021 Apax Partners brought industry darling Thoughtworks public at a ~$9.0 billion market capitalization, only to reacquire the company in 2024 when the market cap had dropped to ~$1.4 billion. Private markets have since settled into the low- to mid-teens—still attractive but nearly 10x EBITDA lower than during the peak.

Modernization tailwinds remain strong, but the environment has shifted to reward true differentiation from players offering a commoditized or capacity-based value proposition. The emergence of generative AI in coding further stresses this dynamic as headcount becomes less of a competitive moat and more of a liability in a rapidly shifting environment.

To navigate these shifts, firms must differentiate themselves through intellectual property, vertical-specific solutions and value-based pricing. Labor arbitrage alone offers little enduring value in a rapidly evolving technological landscape. There are many reasons to be bullish about digital engineering, but AI changes what winners may ultimately look like as firms establish a new balance among specialization, labor productivity and use of AI in their operational processes. Tomorrow's leaders may be nascent today as new firms emerge with AI-centric business models that leverage human capital differently, scaling without the same headcount requirements as today's competitors. We will be watching whether the massive headcount and delivery center networks that exist today ultimately prove a strength or a drag on agility as business models adapt in transformative ways.

Not all Doom and Gloom

Despite these challenges, tech services remain a compelling investment opportunity. Key reasons for optimism include:

> Technology increasingly permeates every sector of the economy, and future enterprises will buy more technology, not less.

> Labor dynamics do not change overnight, and few companies outside of Big Tech have the ability to attract and retain technology talent with skills at the edge of the innovation frontier. Pandemic-era dynamics proved an accelerator for remote work, and tech services has been a clear beneficiary. Collaboration with third-party teams located in nearshore or offshore locations has proven critical in overcoming labor market tension and filling technology roles. Immigration restriction or reluctance further exacerbates the skills gaps impacting many companies who have relied on highly skilled immigrants in technology roles. Acceptance of remote teams in technology roles is now a permanent market feature, accelerated by the COVID-19 pandemic and inadequate local labor markets. As champions of remote work and global talent, tech services firms remain beneficiaries and essential partners. It is hard to imagine that the complexity and difficulty of attracting and retaining technology talent will dissipate in the coming years, offering a long-term place for such firms as an essential partner in the adoption and optimization of technology products across the economy.

> Technology debt is real, and many companies (large and small) run on decades-old systems never designed for a cloud environment. AI can help ease tech debt, but critical and highly unique pieces of technology on which businesses depends will be high-value systems that require skilled human oversight.

> As a sector, technology and its services subsectors project to grow much faster than the economy at large, presenting a compelling opportunity for investors.
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> - Given the fragmentation and pace of change, few winners are truly enduring, and the industry overall resists oligopoly dynamics.
> - Regulatory and antitrust oversight of Big Tech, combined with deep pockets of capital chasing technology, provides ample opportunity for new competitors.
> - Software has not disintermediated services, as complex implementation, customization and change management benefit from supporting human capital. Tech leaders continue to invest in cultivating a flourishing ecosystem of third-party services partners that can produce many winners.
> - Tech services in the private capital markets are especially open to competition, where new business formation is abundant, capital requirements are low and human capital talent is mobile.

Despite macroeconomic uncertainty, tariffs and regulatory risks, the technology services market offers resilient pockets of growth. Lincoln International's team of bankers is ready to help investors uncover opportunities and navigate challenges in 2025. Contact us today to discuss your growth strategy.

Ready to discuss the opportunities ahead for you?
Connect with a senior professional at connect@lincolninternational.com