DEMYSTIFYING TECH M&A VALUATION

Understanding the Most Important—But Least Understood—Part of Every Tech M&A Process

By Ben Boissevain, Managing Partner, Ascento Capital

Valuation is the most important part of every tech transaction, the key component in determining the net proceeds to shareholders when a transaction closes. Yet the actual process of valuation is not well understood. Here we'll examine the following four subjects to better understand tech valuation and how it can be maximized.

- **POSITIONING:** How positioning a company in a sector affects the valuation
- **MACROECONOMICS:** How the macroeconomic environment plays a role in valuation
- **WALL STREET VALUATION METRICS:** A review of Wall Street valuation methodologies
- **PRACTICAL TIPS:** How to maximize the valuation of private tech companies on the sell side

POSITIONING

Positioning is critical for M&A valuation. WeWork is an excellent example. Adam Neumann, the former CEO of WeWork, effectively positioned the company as an "on demand" technology company, rather than a real estate company. To emphasize the technology sector positioning, WeWork acquired 20 small tech companies in preparation for its IPO, including Euclid, an operator of an analytics platform. However, when WeWork filed its S-1 to go public, **Wall Street analysts didn't buy that WeWork belonged in the tech sector** and instead placed WeWork in the real estate sector where valuation multiples are much lower. As a result, **WeWork's valuation, which was $47B in a private round in January 2019, decreased dramatically to $8B** in the Softbank bailout in October 2019. That valuation, when compared to other companies in the sector, such as Regis, is much more reasonable.

To further emphasize that WeWork belongs in the real estate sector, not the tech sector, WeWork subsequently named Sandeep Mathrani as their new CEO. Mathrani was formerly the senior executive at Brookfield Properties, a massive real estate company in New York. **WeWork is now solidly positioned in the real estate sector, as it should be, with a much lower valuation.**

On the flip side, positioning can obviously work to a seller's advantage. Take the example of a US-based public wireless antenna company that acquired a private Scandinavian sensor company. That acquisition changed their positioning from the antenna sector to the Internet of Things (IoT) sector which has a much higher revenue multiple. That repositioning by acquisition improved the company's valuation significantly, because **the company went from a domestic antenna company to an international Internet of Things company**.

Which leads to another point. A company that has 10 offices domestically in the US has a decision to make about opening another office. **Should they open that office in Kansas City or London? From a positioning perspective the answer is London** because that means they are now an international company. That demonstrates to acquirers and investors that the company has international reach and distribution and that the management team is internationally ambitious.

Takeaways:

1. **How a company is positioned has a significant effect on valuation.**
2. **Acquisitions can be an effective way to reposition a company.**
3. **Pay careful attention to how you position your company because you're going to be put in a bucket and you want to ensure you're put in the right bucket.**

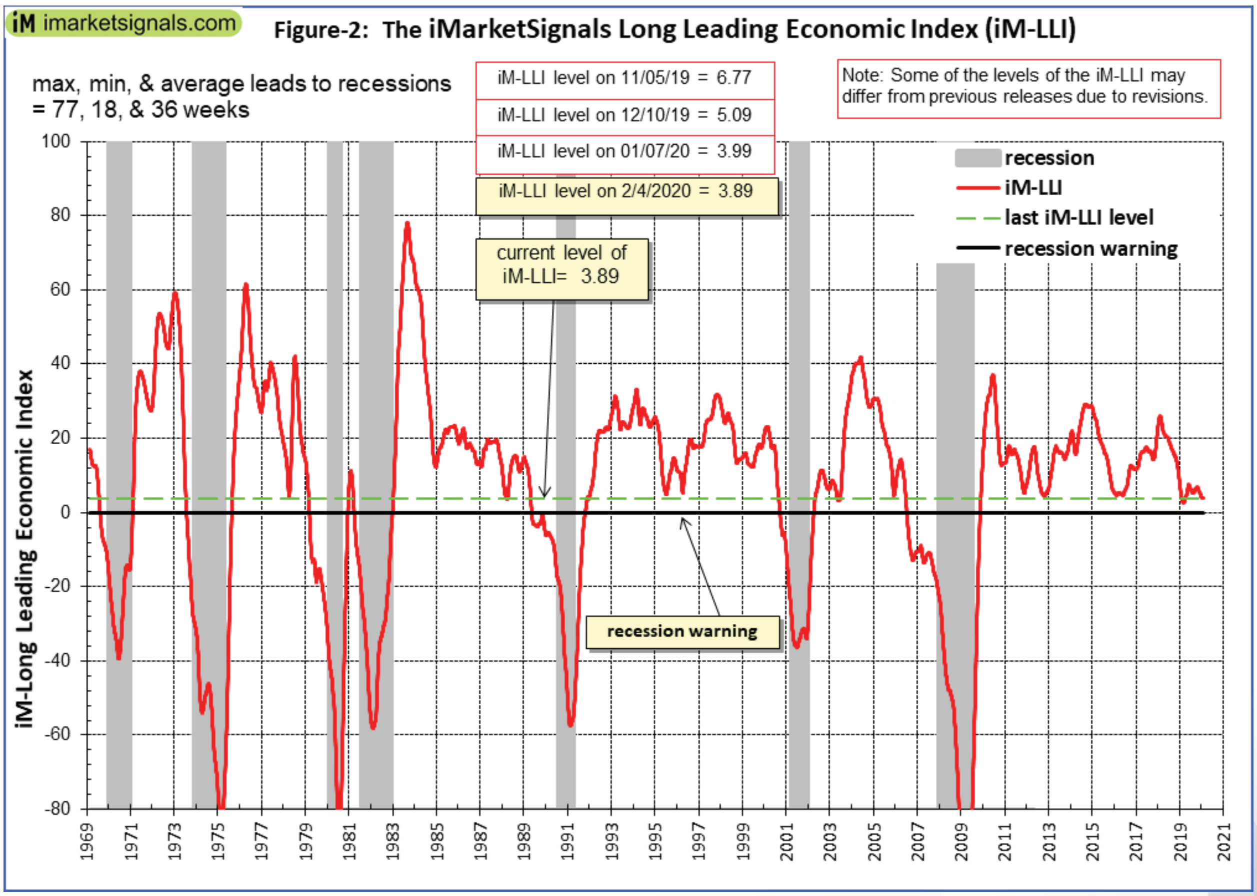
MACROECONOMICS

Macroeconomics is essentially the state of the economy. Because M&A is driven by supply and demand like any other market, the state of the economy has a critical influence on M&A valuation.

Selling a company in a robust and active M&A environment will garner higher valuations just as selling during an economic downturn will dampen valuations. If there is a global recession or black swan event like a global pandemic that affects the economy, that will result in fewer buyers since companies will be conserving cash and be much more risk adverse. So, ask yourself: What is the state of the M&A environment when I prepare to sell my company?

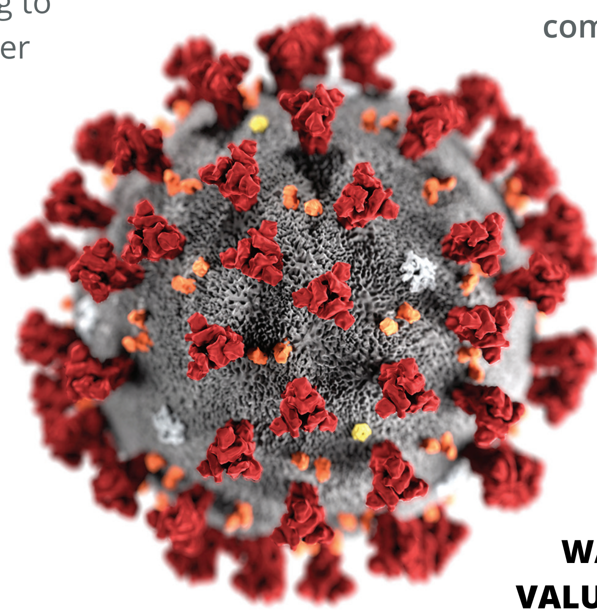
During a downturn:

- Venture capital and private equity firms will be using their cash primarily to ensure their current portfolio of companies survive the downturn. They will look at new opportunities but expect the process to take longer and for due diligence to be more intense.



- There will be many more sellers since it will be more challenging to raise capital and companies with a burn rate will have no choice but to sell.
- A healthy company selling in this environment will be competing with desperate companies running out of cash willing to sell for much lower valuations in asset sales and acquirers.
- If you need a new round of financing during a downturn, start early and reach out to a lot of targets.

It's important to note that private companies are valued compared to public companies and their trading multiples. If a black swan event hits, trading multiples can decrease dramatically. As an example, during the recent coronavirus crisis, technology shares in the S&P 500 information technology sector declined 10% in just four trading days.



Take aways:

1. **When thinking of selling, monitor the macroeconomic environment closely.**
2. **If a company expects to increase revenue by 25% in the coming year, but the macroeconomic environment is poor, then the company could sell for 50% less even though it's healthy.**
3. **Look at your competition, especially the public markets, and evaluate how they are trading.**

WALL STREET VALUATION METRICS/ METHODOLOGIES

Wall Street typically uses three main methodologies for M&A valuation:

1. **Comparable Company Analysis (CCA)**
2. **Precedent Transaction Analysis**
3. **Discounted Cash Flow Analysis (DCF)**

COMPARABLE COMPANY ANALYSIS (CCA)

A comparable company analysis is a process used to evaluate the value of a company using the metrics of other businesses of similar size in the same industry. Comparable company analysis operates under the assumption that similar companies will have similar valuation multiples, such as EV/EBITDA. Analysts compile a list of available statistics for the companies being reviewed and calculate the valuation multiples in order to compare them. The most common valuation measures used in comparable company analysis are enterprise value to sales (EV/S), price to earnings (P/E), price to book (P/B), and price to sales (P/S).

Comparable company analysis starts with establishing a peer group of companies (normally at least 20) in the same sector that are similar in size. Investors are then able to compare a particular company to its competitors on a relative basis. This information can be used to determine a company's enterprise value (EV) and to calculate other ratios used to compare a company to those in its peer group.

The selection of the appropriate comparable companies is critical because if companies are selected that are not similar the valuation will be challenged by the buyer. The number of comps is also important as the sample size should be large enough to be meaningful.

Finally, there are subtle differences. For example, European public companies generally trade at lower valuations, so if you're using European comps your valuation will be lower. Also, private companies are typically given a 20% liquidity discount because they are not liquid.

PRECEDENT TRANSACTION ANALYSIS

Precedent transaction analysis is a valuation method in which the price paid for similar companies in the past is considered an indicator of a company's value. Precedent transaction analysis creates an estimate of what a share of stock would be worth in the case of an acquisition. Precedent transaction analysis is sometimes referred to an "M&A comps."

It's important to note, however, that precedent transaction analysis has a dynamic component to it and will be affected by the macroeconomic environment. For example, if your next door neighbor's house is very similar to yours and sold yesterday for $1M you could assume your house was worth in the neighborhood of $1M. However, if tomorrow there is a global pandemic that crashes the economy you will have to come to the painful realization that you home is no longer worth anywhere near $1M.

DISCOUNTED CASH FLOW

Discounted cash flow is a valuation method used to estimate the value of an investment based on future cash flows. DCF analysis finds the present value of expected future cash flows using a discount rate. A present value estimate is then used to evaluate a potential investment. The DCF methodology has limitations, primarily that it relies on estimations on future cash flows, which could prove to be inaccurate.

PRACTICAL TIPS

The technology hype cycle is an important consideration when selling a business. Valuations are higher for an early stage business at the peak of "inflated expectations." One can also wait until the "plateau of productivity" but there are execution risks to reach that stage.

Consider selling your company whey your competitors are selling. If Microsoft buys your closest competitor then competition just got more intense and the number of buyers for your company just went down. That changes the M&A supply and demand curve and that's not in your favor.

For early stage valuations, the first 6

months of revenue forecast should be conservative. One of the first questions a buyer will inevitably ask is whether the company is on track to achieve its forecast. Hitting your targets looks good. Falling short of forecasts looks bad and sends the buyer a signal that you are not good at forecasting. If a seller is 5% below its revenue forecast, expect the price to be cut by 10%.

On the other hand, if the seller has aggressive forecasts beyond the six months this can send a signal to the buyer that the seller is confidant that aggressive growth is possible. Longer-term revenue forecast should still be reasonable, but it's okay if they're on the aggressive side.

OTHER TRICKS OF THE TRADE TO MAXIMIZE VALUE

- Use a forward revenue multiple to increase valuation. If it's July then use the full calendar year revenue estimate in the valuation with the justification that the bookings for the full calendar year are very visible.
- Establish the valuation early in the negotiating process. Don't spend a lot of time negotiating terms and conditions if the valuation is not locked down.
- If the parties are far apart on valuation, consider structuring the deal with an earnout in order to bridge the valuation gap. For more information on earnouts, read Ben Boissevain's article on the subject here: **https://www.linkedin.com/pulse/bois-capital-smart-ma-series-3-structuring-effective-ben-boissevain/**

Tech M&A valuation can be an uncertain process, but following the principles outlined above can demystify the process and help sellers maximize the value of their company.

About Ben Boissevain

Managing Director, Ascento Capital

Ben Boissevain has 30 years of cross border M&A experience and has senior-level global connections in the technology sector. He graduated from NYU Law School and started his career at White & Case. His legal training enables him to handle any aspect of contractual negotiations in M&A and capital raising. He garnered investment banking experience at Erste Bank in Vienna and Barclays Bank in New York.

Mr. Boissevain regularly speaks on panels on the technology sector and corporate finance and has appeared on TV at Fox News and Bloomberg.

About Ascento Capital

ASCENTO CAPITAL

Ascento Capital was founded in 2017 by Ben Boissevain, a seasoned investment banker. Ascento provides individual attention to each client regardless of size. Ben speaks frequently on panels in New York City and has appeared on Fox Business News and Bloomberg TV. Ascento Capital has extensive senior-level contacts at private and public tech companies, private equity firms, venture capital funds and family offices. Ben Boissevain leads each transaction and leverages a large network of sector experts. The team at Ascento Capital has extensive corporate finance experience at firms such as White & Case, Barclays Bank, Advocate Re, Tiger Risk, Philips and Samsung.

To learn more visit, https://www.ascentocapital.com/about.

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dba ShareVault**

Headquarters
16795 Lark Avenue, Suite 210
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Toll-free USA 800.380.7652 | Worldwide 1.408.717.4955
sharevault.com