Opinion Why "technology investor" has become synonymous with "investor"

By

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Tech is once again the darling of the M&A world. Recent deals that demonstrate how rife the sector is with activity include the initial public offering of Snapchat developer **Snap Inc.**(NYSE: SNAP), which soared 44 percent on its first day of trading, and the announced purchase of Whole Foods by Amazon.com Inc. (Nasdaq: AMZN). Many observers are citing tech as the sector that will power M&A activity this year and beyond.

These expectations have brought new attention to what it means to be a private equity investor in technology businesses today, and how that has changed for both general partners (GPs) and limited partners (LPs). Many firms that are not considered ”tech shops” in the usual sense are making significant investments in later-stage technology companies; however, these are seen as technology-enabled businesses serving traditional markets, rather than pure-play technology companies.

Finding value in technology does not have to mean extremely disruptive, cutting edge technologies that radically alter the way world operates, the way standouts of the dot-com era and the Snapchats of the world did. The reliable and—this is important—profitable businesses delivering value to investors are companies that use information technology to help traditional industries become more competitive and efficient.

The biggest difference between dot-com era tech and tech today may be that companies that formerly would have been considered part of a “technology sector” are now much more part of the end-user sectors that they serve. They may be technology-based, but that doesn’t mean that their fortunes all move together in lockstep. For example, the growth of a healthcare technology solution provider will correlate much more to the healthcare sector than to information technology businesses serving different sectors—and that is where the GP’s experience is most valuable.

Back in 2000, the vast majority of investors in traditional businesses—rightfully—were wary of investing in the wave of new tech businesses because they did not understand it. Those concerns were overcome by soaring (and sometimes unjustified) valuations. Today, understanding the customer base, the sector dynamics and the business problem being solved is much more relevant to investment success than pure-play technology expertise.

Technology solutions must be understood, analyzed and valued much like an advanced production line, continuous improvement initiatives or any other

business tool. New and exciting technologies often fail because of lack of understanding of the business problem being solved, rather than for functional reasons.

There are some common dynamics that these businesses share that make them very attractive for private equity:

- Customer retention rates of 99 percent are not uncommon for these businesses because the solutions take time to implement, solve complex problems and are harder to rip out. They are also slower to experience disruptive change.
- Recurring revenue from maintenance and subscription models mean good cash flow and high Ebitda margins.
- Scalable business models that are not reliant on adding manpower. Once you've invested in the intellectual property, you can add customers without a lot of additional costs. You can also often apply the intellectual property to other industries.
- Macro growth trends. There is an enormous market opportunity because traditional industries worldwide are not as penetrated as they could be. You have a lot of companies that 10-15 years ago were immature, but now they have increased technology needs. You also have industries being served by technology that hadn't been fundamentally changed in decades, and the technology is evolving now.
- Exit opportunities abound. Because of the characteristics above, the prospects for investments in technology-enabled businesses are very bright indeed. Strategic buyers are interested for both market growth and defensive reasons, and financial investors know that they will be able to generate income on the investment. In contrast to the "unicorns" of the dot-com era, there are no concerns about being locked into a long holding period.

A great example is configure-price-quote (CPQ). This is fundamentally bringing the simplicity and elegance of the consumer e-commerce experience—epitomized by Amazon—to the business-to-business (B2B) sector. B2B e-commerce sales are expected to grow from $780 billion in 2015 to $1.13 trillion in 2020. However, the B2B process is a highly complex one, still mired in a world of product catalogs, faxes and phone calls with myriad suppliers. Rather than a consumer's choosing a shoe size and color, B2B purchases must navigate through thousands of stock keeping units (SKUs) and all the compatibility and build-to-order issues that go with them. A successful CPQ implementation can shorten this process from weeks to days, and often to a few clicks. From the outside, it's not a new paradigm, but it can mean millions of dollars in sales to a business.

What does this mean for LPs who didn’t set out to build a tech-heavy portfolio? First, LPs need to think differently about their technology exposure because the meaning of “technology business” has truly changed. These companies are no longer part of a monolithic sector, but are integral parts of a vast number of traditional business sectors.

Second, most technology investments are not the immature, non-critical, volatile and trend-driven consumer businesses of 10-15 years ago. They are low-risk, stable businesses that don’t need to transform an industry to be hugely successful.

Finally, “technology investor” has become synonymous with “investor.” Technology continues to grow as a percentage of business overall and, especially in the middle market, that’s where the opportunity is for great investments.

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