Central Intelligence

Information Technology Runaway

By Marc Raybin, Editor in Chief

When it comes to deal-making this year for alternative investment vehicles like private equity funds, there has not been a whole lot to cheer about. The numbers have not exactly blown anyone away, as the credit crunch continues to tighten its grip on the necks of bankers. Perhaps the only sector to show any real chutzpah in the early start to the year is information technology. Thus far, that industry has lapped the rest of the sectors when it comes to private equity deals. According to numbers provided by Capital IQ, a division of Standard & Poor's, there have been 464 deals in information technology in 2008. The next closest industry is healthcare, which comes in at only 175 deals.

"There has been a pickup in the sector in the last year or two," says Steve McCormack, a cofounder and general partner of IT-fcoused Commonwealth Capital Ventures. "Maybe it was because it was so desperately in decline at the beginning of the century that it just feels that way."

According to McCormack, a ton of software and hardware was purchased in the late 1990s and when the early 2000s came around people were simply digesting what they had bought. As a result, people were not buying much technology in 2001, 2002 and 2003. Nowadays, however, that technology is old and the same people are looking to upgrade what they've got. That includes software and hardware for more Internet-related technologies.

There could be other forces at work, however. Dave Fishman, a partner at Vector Capital, says he is seeing a lot of deal-flow in the IT sector because the fundamentals remain strong. Leverage has not completely dried up, and deals that are getting done or are in the works are not seeking tremendous sums of borrowed money to capitalize their transactions. Based on what Fishman has seen and the part of the sector that his firm invests in, these deals do not compare to the types of mega-deals that the asset class has become known for in the last few years.

"We are a value-focused investment firm," explains Fishman. "We buy third quartile companies and make them into second or first quartile companies."
To be sure, however, there are some types of companies within the IT sector that do require a lot of startup capital. Microchips and the like come to mind.

Although there does seem to be an up-tick in the sector, not everyone is convinced private equity is going to jump in all at once. The overall U.S. economy is still weak and federal agencies continue to inch toward saying the country is in a recession, with a full-fledged declaration seemingly around the corner.

"The prospects for investments in new technologies are relatively good," says William Venema, a managing partner in the Dallas office of law firm Epstein Becker Green Wickliff & Hall. "On the demand side, however, questions about the economy will make corporate purchasers of information technology cautious."

As the economy continues to slip and the dollar continues its dramatic fall against other currencies, like the British pound and the euro, that is bad news for most IT companies, according to Venema. He predicts that customer spending within the sector will slow and the margins will thin.

The key, Venema says, is that U.S. IT companies will have to broaden their footprint to include overseas markets. He says these companies will have to sell into markets where there are much more favorable exchange rates, enticing customers to buy their products since they will be so much cheaper to acquire.

“Hewlett-Packard, for example, has been successful in part because 65% of its sales are in non-U.S. markets,” says Venema. “The average for other IT companies is 40%.”

Still, even if IT were to slow down a bit there are sure to be some deals that will get done. Investors will most likely look to get more involved in security this year, McCormack predicts. He is not alone in that thought. Venema agrees.

“There are hackers who, for reasons known only to them, spend considerable amounts of time and energy hacking into computer systems,” Venema says. “There are [also] modern-day spies and saboteurs who are hired to give companies a competitive advantage through the use of electronic espionage tactics. All of this suggests the need for more automated and sophisticated record-retention programs.”

This year could prove to be a difficult one. Private equity investors may wind up sitting on their money for awhile until the smoke clears, but they will have to put their money to work somewhere when limited partners become restless. Managers however, are paid to know where the smart money goes and IT could be the beneficiary.