One-on-One With

Giles McNamee of McNamee Lawrence & Co.

M&A, Not IPOs, the Best Deal for Software Exits

GILES MCNAMEE

Despite an Ivy League diploma, Giles McNamee says that he's probably not very bright. After all, he and his partner Glover Lawrence opened a boutique investment bank for software firms in 2002, the "nuclear winter" of technology M&A. Yet despite the timing, **McNamee Lawrence & Co** has grown to 21 employees in Boston, San Francisco, and London. His firm has advised sellers in deals with buyers like **Liberty Media**, **IBM**, and the **Carlyle Group**. A former investment banker at **Hambrecht & Quist**, Giles has a BA in history from Yale University.

Q: While tech spending is growing again, it's still not where it once was. What effect is that having on the companies you work with?

A: Tech spending is like unemployment data. It's interesting in the aggregate, but it may not necessarily apply to you since you have a job. The same is true with tech spending. Business spending is not the best way to figure what's going on in the technology market place. Many of the fastest-growing areas are not enterprise-driven, but consumer-driven like wireless.

If you look at enterprise, there are some areas growing rapidly whatever the trends have been overall. Storage, for instance, is driven by both enterprise and consumer spending. On the consumer side, you have digital photos and thousands of songs in your digital library, so you need better storage software. Same is true at work. People are storing massive amounts of data. Storage software is needed for archiving and complying with regulations for keeping e-mail and other internal communications.

Q: What about interest in security software companies?

A: There's less interest in perimeter stuff like firewalls, but increasingly much more application security, database security, and stuff inside the firewall. We're seeing more interest in 'Big Brother'-type applications that watch behavior, particularly in banks and financial institutions. Imagine that you work at a broker-dealer. You are required by law to monitor any communications sent outside the firm. Most financial crimes have some internal component because there's an inside guy. Such applications also have use in defense and government institutions.

Q: How has the sluggish IPO market or Sarbanes-Oxley affected the decision of companies to go public?

A: In the second quarter, you had about 16 venture-backed companies go public. To go public now, companies need a minimum of $50 million to $70 million in revenue. If you think about the thousands of companies have been funded, having 16 go public is a drop in the bucket. Total IT IPOs were only four in the second quarter. There are about six transactions a week in M&A. So if you want liquidity, M&A is likely to be your exit.

There are some interesting trends in M&A. There was never a technology leverage buyout back in 2000. Subsequently there have been quite a few. When we were selling (former **Siebel** division) **OnTarget** for **Oracle**, we had a little over 30 private equity firms take a look. There weren't that many private equity firms interested several years ago.

Q: Why is private equity so interested in technology?
A: They figured out there are opportunities at scale. Public markets assign much different valuations for companies in the same business based on scale. Bigger companies get a higher multiple in general. Private equity guys look at buying a bunch of smaller companies and putting them together to get the arbitrage on the increasing scale. You have an example of that with **Oak Investment Partners** doing a rollup in the call-center software world with a company called **Aspect Software**. Another big one was **SSA Global** where **General Atlantic Partners** aggregated a billion dollars worth of software companies, took it public and recently sold it.

Q: So there are opportunities to consolidate the software industry?
A: In the case of SSA, **Microsoft** and **Oracle** dominate much of the market SSA sold into. But there are about 50 smaller software companies, many that are just single country or single language. SSA consolidated a bunch of those. There are spaces like it, where people consolidate geographies, where they buy things in different countries, or you see them consolidating in vertical industries, or they will consolidate across industries, whether financial, healthcare, or government. Surprisingly, private equity firms are often the highest bidders. A year ago, we sold a virtual call center company. We had three different strategic buyers in three different countries and we eventually sold it to a private equity firm in New York. They paid 40% higher than the highest strategic bid.

Q: What kinds of trends are you seeing in regards to multiples?
A: Multiples for customer relationship and business intelligence software have compressed over the past year. Multiples for companies which offer hosted software have stayed steady and are at least 2 times higher than a comparable companies that sell installed software. **Salesforce.com**, the largest of the hosted CRM software companies, has a multiple 3 times to 4 times higher. Wall Street likes recurring and predictable revenue streams of hosted companies.

Q: So is hosted model the way for every software company to go?
A: It depends on the sector. If you're the Defense Department, the CIA, the NSA, JP Morgan, or Citibank, you are not going to buy hosted software. Your customer data secrets are going to stay behind your firewall. There are some things that can be hosted and some not. We're a small firm. We'd like to use hosted software, but by law we can't. The SEC, NASD and the FSA in the UK require us to keep all our data and e-mail on-site.

Q: How has the concentration of software in relatively few companies like Microsoft, Oracle, **SAP**, and **IBM** affected M&A?
A: You have about a dozen big strategic buyers including Oracle, **Symantec**, IBM, **EMC**, and **Sungard**. You have that group of basic buyers, but there is also a lot consolidation among mid-size and small-size companies. One of the trends we see a lot of are private-to-private mergers because two companies that have $10 million in revenue aren't going to get bigger on their own. But they can potentially grow to a $50 million company if you put them together. We also see a lot of

non-US companies buying companies in the US. The company that bought the Oracle unit we sold was an UK software firm (**TAS Group**) backed by an Irish private equity firm (**Trinity Venture Capital**).

You are going to see a lot more cross-border activity. It's a lot easier to buy somebody who is already in the country and has customer traction rather than set up an office overseas. I think you will see more non-US companies buying US companies to get customers and to get people. A cheap dollar is helping make things look cheap in the US.

Q: Does the concentration of software in a few companies make it more difficult for smaller companies to get a toehold in the market?

A: That's always been true. You never got fired for buying IBM. But if you're a small company and you sell something really good to American Express, then American Express is going to tell IBM to buy you. You can be a small guy. As long as you have some customer traction, you can find a good exit.

Q: And IPOs don't provide that exit?

A: I think being a public company CEO or CFO is a difficult place to be in right now. We did an analysis of the costs of going public and being public. If you are doing an IPO to raise $30 million, it would cost you 15% to go through the IPO process. So you are looking at $4.5 million just to go public, plus another $1.5 million to $2 million annually just to stay public. You have to be a pretty big company to have enough income to support that additional expense. Why be public?

Q: Are you seeing an equal level of interest among strategic and private equity buyers in technology?

A: It depends. For next-generation technology, especially in mobile and wireless, the strategics are much more interested. For more mature technologies, like call center software, that's where private equity is going to be more active. They want something with no technology risk, no product risk, and no customer risk. That's the stuff they are less well-equipped to deal with. But they can figure out how to take out the SG&A costs in three like businesses, what's the scale benefit, and what's the multiplier effect of going up in size.

Q: As one of the many smaller, boutique investment banks out there, how has business been?

A: We are a little over four years old. Eight of us worked at **Hambrecht & Quist**. We are now 21 people in three locations. The big bank thing was not what we liked to do. So we started this firm. We started in the nuclear winter of the software industry because we're not very bright. It taught us fiscal discipline and managing our expenses. We are strict at sticking to our knitting. We are getting into some new energy businesses, but they are intellectual property businesses which we understand. We know what we don't know, so we don't do healthcare or medical technology, which is another not-so bright move on our part seeing how many of those firms are around Boston. The bulge brackets don't do what we do. The closest might be **Jefferies Broadview**. But they like to position themselves a little more upmarket than what we do. There is a firm a block away from us in Boston called **Revolution Partners**. They opened a year ago and we have only competed with them on one deal. Maybe they are doing something different, but there seems to be enough deals going around that we don't run into them. Everyone seems to be doing OK.

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