Industry Perspectives

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Technology M&A: Can This Buying Frenzy Continue?

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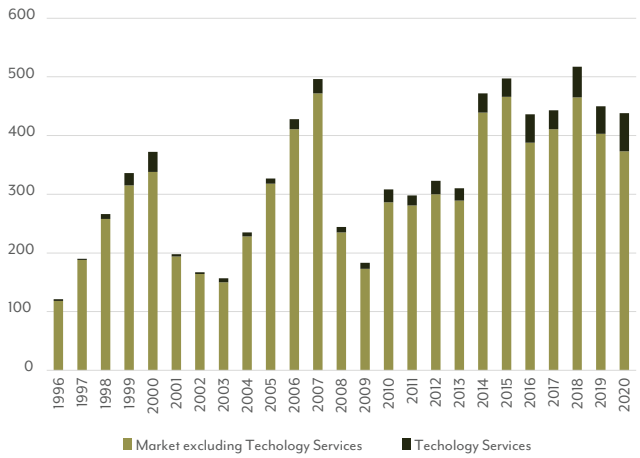
Merger and acquisition (M&A) activity within the technology services sector—what we define as software, information technology services and data processing businesses—has been particularly prominent the past five years. Multiple mega-cap software businesses, including Microsoft, Oracle, Salesforce, IBM and SAP, have made headlines with acquisition activity, the most recent being Salesforce's December 2020 announcement that it will acquire messaging and collaboration platform Slack Technologies for $26 billion. Additionally, IBM purchased Red Hat, a leading open-source software vendor, for $33 billion in mid-2019, and Microsoft acquired LinkedIn for $25 billion in 2016. These deals make headlines because of their price tags, but there have been several other notable deals in technology services during the past few years. In 2020 alone, there were over 60 acquisitions either completed or pending valued at $1 billion or greater, the most in the last 25 years.

It makes sense why many of these businesses would be coveted M&A targets — revenue is usually predictable, switching costs are consequential and customer purchase decisions are typically less affected by economic conditions. However, outsized M&A activity seemingly points to additional considerations worth exploring. Here, we will dive into the numbers and examine select M&A activity among mega-cap software businesses.

Technology Services M&A by the Numbers

There were 244 acquisitions of technology service businesses valued at $1 billion or greater between 2016 and 2020, compared to 305 the previous 20 years. This elevated M&A activity is disproportionately high relative to the market overall. A partial explanation is the relative youth of the sector during the late-1990s and early-2000s. However, we suggest that strategic buyers, including larger competitors and tangential businesses, have played a leading role in the recent disparity. Strategic acquisitions accounted for nearly 60% of technology services M&A in the last five years; financial buyers, like private equity firms, were involved in the balance but are also represented in the broader market. It is difficult to generalize, but we believe common motives contributing to the industry's M&A activity outpacing the broader market include the pursuit of new and diverse offerings by market leaders, competitive responses to disruptive challengers and the heavy emphasis on growth within technology services. During the pandemic, technology services M&A activity has been further fueled by accelerated digital transformation timelines and buoyant stock prices of many acquirers.

MEGA DEALS: ACQUISITIONS GREATER THAN $1 BILLION



Source: FactSet. 2020 data includes pending acquisitions.

Mega-Cap Software M&A

From 1996 to 2015, M&A programs of mega-cap software companies were fairly deliberate and diversified. Purchase prices were normally below $5 billion, and targets mostly consisted of smaller, cash-generative businesses with meaningful market shares in their respective niches. Additionally, while there were several hundred acquisitions completed, few were particularly large. In retrospect, the risk of squandered capital on M&A was relatively low when considering these factors.

Since 2015, M&A activity by software mega-caps has been strategically more varied and bolder when considering the prices paid relative to acquisition target fundamentals. From 2016 to 2020, over $155 billion has been spent on M&A by software mega-caps for roughly $15 billion in revenue, or a little over 5% of the group's aggregate revenue base in 2015. The investment case is that these acquired companies will grow to be more significant over time, as they access a broader pool of resources and benefit from the robust distribution channels of the world's largest software companies. Maintaining mind share with customers as the market evolves is an important additional consideration. It is exceedingly difficult for very large software companies to develop material new products organically as they wrestle with incumbency dilemmas in a dynamic market and as smaller, more nimble firms gain momentum. So, passing up unique acquisition opportunities in favor of other capital uses could potentially be detrimental to long-term competitive positioning. This particular risk seems more pronounced now than it was historically, which is likely a contributing factor to larger, more eclectic M&A activity by mega-cap software companies.

Salesforce has been among the most active acquirers over the past five years, with M&A activity the centerpiece of its capital allocation strategy to broaden its offering set beyond CRM software. The company has spent over $50 billion on M&A since 2015 (inclusive of the pending Slack Technologies acquisition) compared to $8 billion on research and development (R&D). Salesforce's three largest acquisitions, Slack, Tableau Software and MuleSoft, address different use cases but commonly give the company turnkey access to attractive areas within technology services—workforce collaboration, data proliferation and simplifying connectivity across systems. Neutrality and independence are strengths of all three businesses, as their respective software interacts with a wide array of third-party applications and databases. However, Salesforce is seemingly planning a more integrated approach for its business once the Slack deal is finalized in hopes of unlocking additional growth opportunities and competing more directly with Microsoft. An M&A-dominant strategy involving several large deals is, in our view, higher risk, but if Salesforce continues to execute and can successfully integrate Slack then it will be even more formidable.

For Microsoft, acquisitions have been a tertiary use of capital in recent years behind investments in the business and returning capital to shareholders. Microsoft boasts a nearly $20 billion annual R&D budget that, along with its superior distribution advantages, has distinctively allowed it to rely less on M&A when pursuing new products and markets. For example, Microsoft organically developed Teams and Power BI, two offerings that compete head-to-head with Slack and Tableau Software, respectively. Nonetheless, Microsoft's acquisitions over the last five years have been noteworthy. Its three largest acquisitions since 2015—LinkedIn in 2016, GitHub in 2018 and the still-pending ZeniMax Media deal—have an aggregate purchase price of $39 billion. LinkedIn and GitHub are inimitable network businesses with domain-specific ubiquity, and ZeniMax Media strengthens Microsoft's gaming franchise within that secularly growing market. All three businesses differ widely from Microsoft's traditional strength in enterprise and consumer software, but we believe they will positively influence Microsoft's intrinsic value over time.

Conclusion

While M&A activity in the technology services sector has been elevated over the past five years, it will likely take at least another five years to evaluate the success of many of these acquisitions. We do acknowledge that measuring success over time will likely be nuanced, as large strategic acquirers have to balance the risk of M&A inaction and its potential competitive consequences against the risk of paying too much, particularly as acquisition multiples have continued to rise. Ultimately though, price is still important to us as intrinsic value investors and we fear returns may fall below acquirer and shareholder expectations on a meaningful portion of these deals absent unique integration skill or established competitive advantages.

As of February 28, 2021, Diamond Hill owned equity shares of Microsoft, Inc. and was short equity shares of Oracle Corp.