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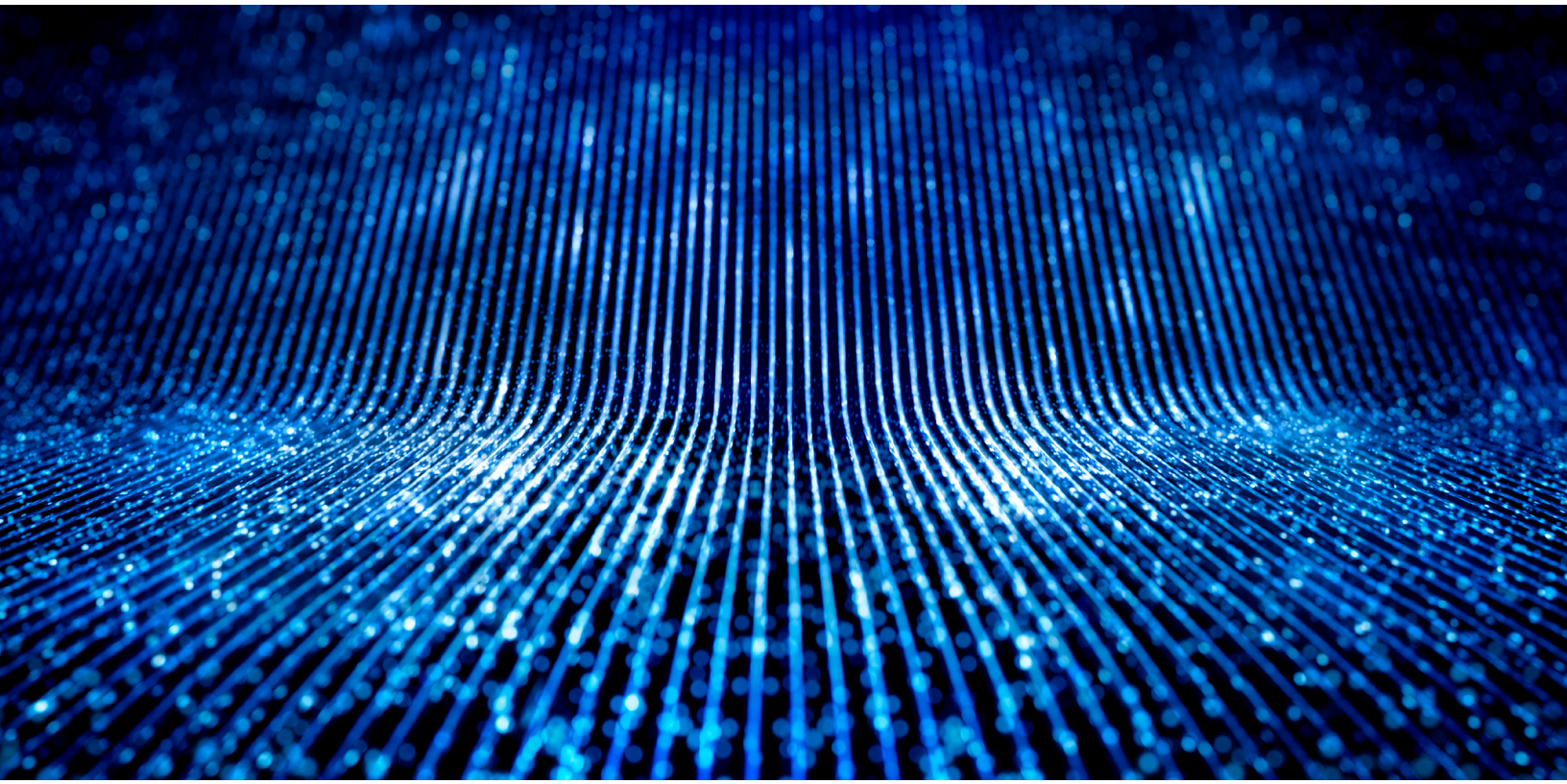
Private Equity & Principal Investors Practice

Private equity investments in tech services: Three considerations

While they can generate significant returns, tech services companies have a different business model than software and software-as-a-service assets.

by Marco Carpineti, Vish Narayanan, and Gaurav Sharma



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The global tech sector attracted $675 billion from private equity (PE) in 2022, up from $100 billion in 2012.[1] Within this world, software and the software-as-a-service (SaaS) sector have long been preeminent thanks to a combination of growth, profitability, and sectorwide multiple expansion. But our analysis found that recent market corrections have depressed valuations in the space by more than 40 percent.

Recent marquee exits by PE firms in the tech services segment have also brought tech services into the spotlight for investors that were traditionally more focused on software.[2] We estimate that tech services currently accounts for 25 to 30 percent of the total assets under management in tech. This represents a ten-percentage-point increase over the past decade.

Disruptive technological innovations have created opportunities across a range of assets. However, understanding the structural differences between software and SaaS and tech services—particularly between their business models—is important. Stakeholders, especially PE investors, may consider carefully evaluating these differences when assessing the segment. Here are a few key insights.

Tech services: Three considerations

We observe three considerations that PE firms could keep in mind when venturing into the tech services space.

The Rule of 40 applies. Tech services companies have lower valuations compared to software and SaaS companies with analogous performance as measured by the Rule of 40 (that the sum of a software company's growth rate and profit margin should be greater than 40 percent). However, tech services companies that exceed the threshold of the Rule of 40 see a disproportionate jump in their valuation multiples (Exhibit 1).[3] Our analysis

[1] McKinsey analysis based on reported PE deals in tech.
[2] Tech services include IT professional services, managed service providers, communications service providers, business process outsourcing, and outsourced product development.
[3] PitchBook and S&P Global revenue, EBITDA, and free cash flow data for software and tech services companies, January 2018 through April 2023, accessed May 10, 2023.

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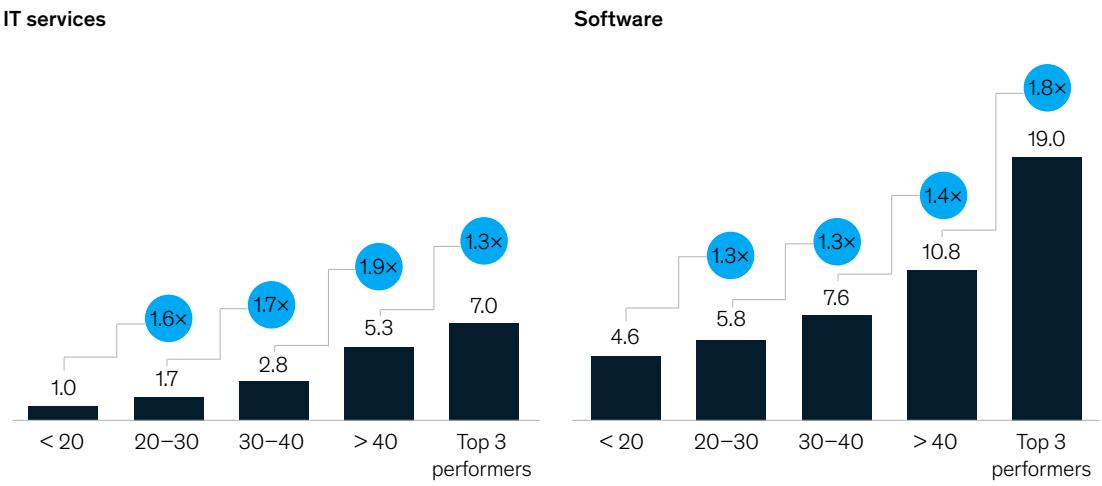
Exhibit 1

Tech services companies' multiples jump when the companies exceed the Rule of 40 threshold.

Average enterprise-value-to-revenue multiple, 2018–23

● Change in multiple compared with the lower band of revenue growth and margin %



Average revenue growth plus EBITDA, 2018–23, %

Average revenue growth plus free cash flow, 2018–23, %

Note: Rule of 40 for software is calculated as revenue growth + free cash flow margin; for services, it is calculated as revenue growth + EBITDA margin. Represents data for 84 IT services companies and 435 for software companies. Figures are rounded.
Source: PitchBook and S&P Global revenue, EBITDA, and free cash flow data for software and tech services companies, Jan 2018–Apr 2023

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shows that the enterprise-value-to-revenue ratio almost doubles when companies cross the Rule of 40 threshold compared to their counterparts with annual earnings growth of 30 to 40 percent. The difference between these two cohorts is explained by the difference in their revenue growth profiles. In short, investors are willing to pay a premium for tech services companies that can deliver industry-leading revenue growth with high efficiency.

Investors value revenue growth more highly than margin growth. A company's service portfolio mix is critical for revenue and returns (Exhibit 2). Specialization and exposure to new digital technologies—such as the cloud, data and analytics, cybersecurity, the Internet of Things, and blockchain—are essential for higher performance and valuation.

We've observed that system integrators with a mix of digital and traditional technologies and providers focused on infrastructure services tend to trade at a discount and struggle to significantly boost their earnings. In contrast, companies that specialize in digital and new technologies have shown that they could produce higher revenue, margins, and returns. This suggests that it is important for tech services companies to have a well-defined service portfolio mix.

Exhibit 2

A mixed portfolio of services is critical to revenue growth and valuations.

Portfolio mix, approximate share by archetype

~75%

Tech services company archetypes	Average of earnings growth, 2018–22,[1] %	Historical median EV/EBITDA multiple[2]	% of digital	% of system integrators mix[3]	% of infrastructure
Digital specialists	~40	~25x			
Large system integrators	~25	~13x			
Midtier system integrators	~30	~15x			
Infrastructure-focused players	~15	~5x			

Note: Represents data for 84 tech services companies. Sample includes global system integrators, tier-1 and tier-2 system integrators in India, and digital specialists.
[1]Revenue growth % plus margin %.
[2]Enterprise-value-to-EBITDA multiple. Only public companies included.
[3]Range of services from application data management, enterprise app implementation, and business process management.
Source: S&P Global earnings and multiples data for tech services companies, 2018–22

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Sustaining or elevating performance is a bigger factor in returns than multiple expansion. Multiple expansion in software and SaaS has been a prime driver of the sector's high returns, particularly when PE investors invested in assets that were about to breach the Rule of 40 threshold and when they've exited through IPOs.

Although they enjoy a valuation premium, high-performing tech services companies above the 40 percent threshold from the Rule of 40 have still delivered unlevered returns (assuming that 100 percent of investments are equity, with no leverage) of 20 to 25 percent.[4] If these were typical tech services deals, which use leverage for 50 to 60 percent of the funding, the levered returns would be 40 to 45 percent (Exhibit 3).

Our experience suggests that, unlike in software and SaaS, returns in tech services are mostly the result of performance rather than multiple expansion. However, our assessments of recent exits show that PE investors that significantly boost a tech services company's performance have also received an additional 25 to 30 percent in returns from multiple expansion in the sector.

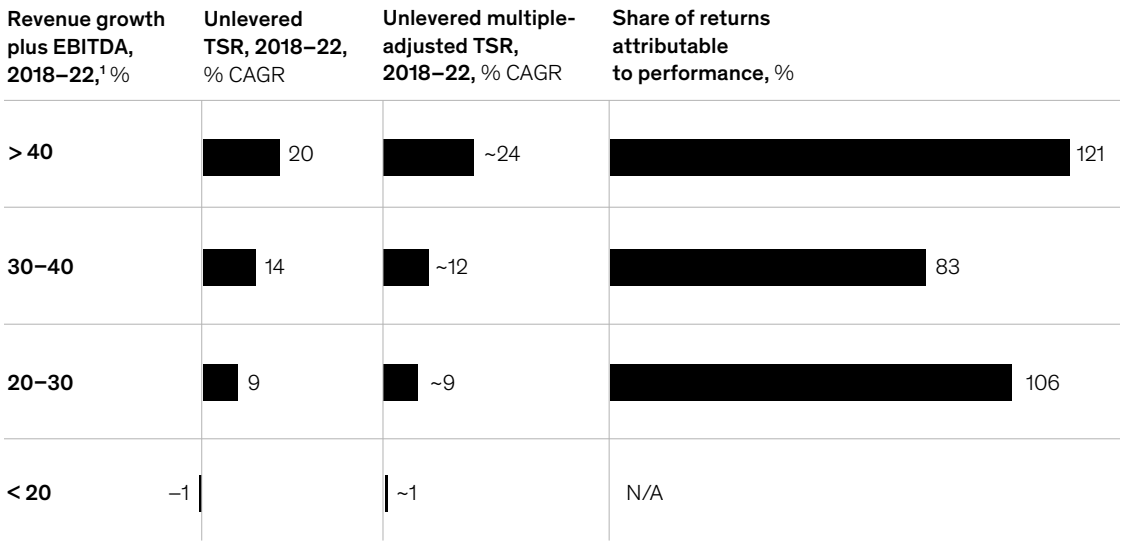
These findings underscore the importance of a thorough evaluation of tech services targets' business models. Investors would ideally account for factors such as targets' service portfolio mix, specialization, and exposure to emerging technologies.

[4] S&P Global revenue, EBITDA, TSR, and multiples data for tech services companies, 2018–22, accessed May 10, 2023.

Exhibit 3

Tech services companies that exceed the Rule of 40 deliver returns based on performance more than margin expansion.

Sum of revenue growth and EBITDA compared to returns.



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It's also important to assess the potential for using operational improvements to achieve higher multiples. However, evidence from the recent past suggests that this is the exception rather than the rule, and PE investors would ideally avoid relying on multiple expansion to generate returns in tech services.

A proven value-creation playbook for stable returns

Our analysis of past PE deals in tech services found many successful exits and a few that generated outsize returns of more than 25 percent. We found almost no failed exits. A close examination of those deals revealed that the companies had five things in common:

1. They scaled or differentiated their competencies. Those companies focused on two to four competencies in either vertical offerings, such as the cloud, or analytics or digital service lines.
2. They shifted their portfolios to serve tech-native customers and customers who continuously reinvest in digital capabilities, who we project will drive about 75 percent of incremental tech spending over the next seven to ten years.
3. They increased their sales efficiency by increasing the share of large deal wins to their largest accounts.

4. They boosted their capital efficiency by optimizing platform costs and deriving more synergies from M&A.

5. They had entrepreneurial, customer-focused leaders who delivered consistent performance even in uncertain times.

The playbook for these outcomes is fairly straightforward, and a few PE investors use this as their go-to approach for achieving stable and satisfying returns in tech services.

Less glamorous than software or SaaS, tech services companies create value through performance. Decision makers attuned to the dynamics specific to the sector may uncover insights and returns.

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