We could be past the top of the cycle already; we just don't know it yet

Ian Spence CEO of Megabuyte shares his views on the current valuations in the technology sector

As the quoted tech sector continues to trade near its all-time high and private equity and M&A deal valuations push on historic peak levels, all seems well in corporate-land. However, if we dig a little deeper, the evidence that the market is near, or possibly even passed its peak, is becoming increasingly clear. Share prices and valuations have been on a relentless upwards track for nearly a decade, driven by a handful of key macro-economic factors, and have all but trebled over that period. However, many of these drivers now seem to be running out of steam, suggesting that the good times may soon be over.

Let's examine first where we are in terms of public company valuations. As Megabuyte subscribers will know, we track closely the valuations of UK list tech companies, and publish a number of proprietary share price indices. When we look at the performance of these indices, and the valuations thereon over the long run, the extent of the bull run in which we find ourselves becomes clear.

The Megabuyte All-Share Index, which is a weighted index of around 100 London-listed tech stocks, is up nearly 30% from its 12 months low in November 2016. Perhaps more tellingly, the index is up fivefold from its cyclical low at the end of 2008. And the story is even more clear when we look at software sector share prices, which are up over 35% in the last year.

The story is replicated when we look at tech sector valuations. Looking at the Megabuyte All-Share average EV/EBITDA, it has risen from just under 11x in November, to nearly 14x today. Again, more significantly when we consider where we are in the longer term cycle, the rise in tech sector valuations since the bottom of the cycle is striking. Average current year EV/EBITDA valuations reached their nadir in November 2008 at just 5.4x but are currently at 13.8x. Once again, the comparison is even more stark when we focus on the software sector, where valuations reached a low of 6x on 2008 and are now at just under 17x. And remember, that's an average; there are a significant number of quoted tech companies trading on current year EV/EBITDA multiples of well over 20x.

Unsurprisingly, this valuation inflation has been carried through to private equity and M&A transactions. The fact that there are fewer data points in private company valuations means that establishing an average is more challenging, but a couple of transactions over the summer struck us as particularly indicative of 'top of the market' stuff. The first and most prominent was the acquisition of Civica by Partners Group. To be clear, Civica is a decent company; it scores 59 on the Megabuyte Scorecard, slightly above average, and has a strong presence in its market. However, the valuation at which the deal was struck, in my opinion, was totally out of kilter with its underlying value. Partners paid an enterprise value for Civica of just over £1bn, representing a trailing valuation of 19x EV/EBITDA. Even with help from acquisitions and a strong year of trading, that valuation must still be high-teens on a current year basis.

Compare this to the last two PE transactions for Civica. Back on 2008, just before the bottom fell out of the market, 3i paid 9.6x trailing EV/EBITDA and, more recently, OMERS Private Equity paid 10.2x, in May 2013. Bear in mind that Civica has done nothing transformational under OMERS' ownership; some in-fill M&A and that's about it.


Ian Spence CEO of Megabuyte

The other deal that was notable both for its size and valuation was the investment by Singaporean investor Temasek into Francisco Partners-backed Blujay Solutions, formerly Kewill Systems. Here again, this deal was struck at over 19x trailing EV/EBITDA compared to the 7.6x at which the company was taken private in 2012. For further context, we can see that BluJay scores 49 on the Megabuyte Scorecard, well below the peer group average.

As well as the eye-catching valuations of these two deals, the other important aspect they have in common is that both incoming investors – Partners and Temasek – have very limited direct experience of investing in the UK tech sector.

So what is driving this valuation inflation? Well I can pick out four main factors. First, is the underlying economic environment. While ongoing government austerity has meant that it has not felt like a good time for the economy for many people, the reality is that the last five years have seen pretty decent macro-economic conditions. And, for many tech companies, these solid underlying conditions have been augmented by increasingly strong secular growth trends in the tech sector, which we can broadly categorise as resulting from the digital transformation agenda (I have a full dissertation on that subject for another time!).

And this positive underlying trading environment has been turbo charged by the availability of cheap (almost free) debt. I see two key elements to the impact of this; leverage multiple inflation and the attractiveness of risk assets. Looking at these in turn, with the memories of the global economic crash still fresh in investors' minds, the impact of the availability of this cheap debt was quite slow to materialise. However, as memories of the crash recede, leverage multiples have started to climb once again, fuelling the boom in valuations described above. As a result, we have seen Debt to EV/EBITDA multiple back at 6x–7x, broadly where they were in 2007.

And rather more worrying is that some banks and private equity firms are applying these multiples to EBITDA numbers that are calculated in ways that the more rational investor might consider optimistic, to say the least. We hear lots of talk of run-rate EBITDA, adjusted for all manner of supposedly one-off items. Some of the more interesting 'one-offs' we have seen recently include 'new product launch costs' and 'exceptional R&D costs'. As we used to say back in the dotcom days, EBITDAbBS (EBITDA before Bad Stuff).

The second consequence of historically low interest rates has been a somewhat manic dash for growth as investors seek a decent return on their money. With bank accounts effectively paying nil interest, private and professional investors alike have sought out risk assets wherever they may be. As this pursuit has got gradually more desperate over the last few years, there has been a concomitant and worrying reduction in investors' quality threshold. As a result, we have seen relatively poor quality businesses trade at silly multiples, while some of the highest quality businesses are now off-the-chart expensive.

In addition to these two long running macro factors, I see two other specific issues which have been contributing factors to the recent bull-run. The first is the huge sums of money on the balance sheets of US tech gorillas that is trapped outside of the US for tax reasons. Without the ability to repatriate this cash, US corporates have been directing a meaningful amount of it to M&A strategies outside of the US, thereby fuelling M&A activity and valuations. Lastly, and more recently, the sharp fall in Sterling since the Brexit vote has made UK assets look relatively inexpensive, despite underlying valuation inflation.

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These four factors have combined to create what increasingly looks like a valuation bubble. But, as we know, bubbles usually last longer than many investors think – it's an intrinsic part of a bubble – so why should it stop now? Well, if we examine the current state of the four driving factors outlined above, we can see that the tide is turning.

While valuations have been rising consistently since 2008, GDP growth in the UK has actually been falling since 2014. It hit a peak of 3.1% in 2014 and dropped to 1.8% in 2016. While we have certainly not seen the dire effects of the Brexit vote that the Remainers predicted, there is no doubt that the uncertainty surrounding our exit from the EU has caused a further weakening of the economy, with GDP growth now firmly below 1%.

More recently, after nearly a decade of almost nil interest rates, the direction of travel is now finally changing. The Fed has already raised rates modestly, and has sent clear indications that it will continue to do so, and the MPC is turning significantly more hawkish on interest rates, with a rise now predicted in the new year.

Turning to my last two factors, while Sterling remains well below its pre-Brexit vote levels, it has recovered about half of the ground it lost against the dollar, thereby moderating the valuation deflation effect for US buyers of UK assets. And, last but not least, while there is nothing active right now, Trump is openly talking about changes to the US tax regime to make it easier for US corporations to repatriate cash trapped overseas, which would materially reduce the international M&A war chests of large US corporates.

So, where does all of this leave us? Well, I learned long ago that trying to make short term calls on the market is a mug's game so I won't even try. And I am certainly not predicting some kind of year 2000-style dotcom crash, although the possibility of that happening does increase if valuations continue to rise. What is important, for investors and entrepreneurs alike, is to understand that, in my view at least, we are at or near, or even perhaps already passed, the top of the valuation cycle.

Whether valuations will continue to rise for some time yet before they fall, and when they fall, how far and how fast it will happen is impossible to predict with any accuracy. However, I do know that those investing today should take account of the clear evidence about valuations and, all but those with the shortest of investment horizons should plan to exit their investments at a lower valuation than their entry price. Under these circumstance, the only way in which the investor can still make a return is by growing profits faster than the decline in valuations, so only the very best businesses are likely to deliver any return for their investors over the coming few years.