MORRISON FOERSTER

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LEADERS SURVEY

M&A Leaders Survey

Morrison & Foerster / 451 Research

MoFo and 451 Research See Bullish Sentiment Return for Tech Industry Dealmakers

In the wake of an explosive first quarter for deal activity, in which M&A spending was triple the average quarterly rate over the past five years, tech industry insiders participating in the latest MoFo/451 M&A Leaders Survey were more bullish than they've been in four previous biannual surveys going back to 2012.

The twice-yearly survey, issued by MoFo in partnership with technology research firm 451 Research, gathers data and comment from tech M&A insiders, including C-suite and business development executives, in-house counsel, investment bankers, venture capitalists, and financial advisers within the tech sector. Respondents in the latest survey, conducted in mid-April, were queried about:

- expectations of M&A activity for 2014, as compared to 2013;
- expectations of M&A activity over the remainder of this year, as compared to the torrid first quarter;
- expectations regarding valuations and IPO activity;
- thoughts regarding the effects of the maturation of the tech industry; and
- thoughts and expectations with regard to aspects of deal structure, including the use of stock consideration and the function and efficacy of earnout clauses and various earnout metrics.

I. Market Analysis + Outlook

Responding after a first quarter in which M&A spending was triple the average quarterly rate of the past five years, 72 percent of participants said they planned to step up their M&A activity through the end of the year, up from 50 percent last November. Only 4 percent expect activity to decrease.

More strikingly, 72 percent said they expect the torrid first-quarter pace to either accelerate or continue on its current surge. If maintained, the first quarter pace implies a level of activity not seen since the pre-recession boom in 2006–07 — approximately $450 billion in total value for the sector.

M&A spending outlook for the next six months

Survey date	Increase	Stay the same	Decrease
April 2014	72%	24%	4%
October 2013	50%	43%	7%
April 2013	54%	27%	19%
October 2012	49%	34%	17%
April 2012	59%	33%	8%

Source: M&A Leaders Survey from 451 Research / Morrison & Foerster

Those expectations represent a sea change from six months ago, when participants expected at best a long, tough slog before activity levels reached their pre-recession peak. In October, only 40 percent of participants felt confident that M&A spending would reach 2006–07 levels within five years, by 2018. Now, almost three quarters of participants effectively anticipate that mark being cleared this year.

What is the likelihood that M&A spending will recover to prerecession levels by 2018?

Response	Percent
Absolutely will not recover	2%
Probably will not recover	27%
50/50 chance it will	31%
Probably will recover	35%
Absolutely will recover	5%

Source: M&A Leaders Survey from 451 Research / Morrison & Foerster

Hot industry segments include cyber-security and defense, cloud enabling technologies, and health care IT. "Defense and homeland security are set to explode," predicted one dealmaker. Many noted that cable consolidation continues and that "cable operators need to add mobile Internet to their portfolio as quickly as they can." Another common thread: "Regulations will continue to drive IT spending in select industries."

II. Valuation + Maturation

Most respondents expect target company valuations to remain elevated (42 percent) or actually climb to loftier levels (42 percent) in the near term. One commentator captured the general tenor of expectations: "Prices are already quite high, but there will be some increase as new players enter the market. Traditional players will be careful not to overbid, but new players will challenge them."

Buyers are entering the market well-armed. "Valuations are strong, lots of dry powder — healthy cash positions among private equity and corporate buyers," said one. Conditions are ripe on both the buy and sell sides, or as another respondent explains: "Sellers will seek to lock in high sales prices, while buyers seek to lock in cheap financing."

Not everyone saw limitless expansion. One participant quipped that valuations will stay high "until the bubble bursts." Another warned that "ridiculous valuations being paid for private companies with no/limited revenue and large losses drive up expectations." One more potential drag: "The tech correction in the equity markets should filter through, bringing prices down and slowing the pace of deals."

Asked about the impact of the much-discussed "maturation" of the tech industry, 55 percent of respondents said that such maturation was putting upward pressure on overall M&A activity, versus just 9 percent who saw downward pressure, and 52 percent saw this factor putting upward pressure on valuations, with 15 percent anticipating the reverse. Respondents noted that the industry's established leaders are under pressure to grow revenue and "buy innovation." One participant commented "The Street is not differentiating between organic and organic growth; they just need growth." That's a fair description of the year's biggest deal: Facebook's $19 billion acquisition of WhatsApp. Another asserted: "No other way than buying into those (newer) businesses, impossible to build." Many look primarily to next-gen giants such as Google and Facebook to be the primary drivers.

Private company valuation outlook for next six months

Survey date	Increase	Stay the same	Decrease
April 2014 forecast	48%	41%	11%
October 2013 forecast	36%	43%	21%
April 2013 forecast	53%	33%	14%
October 2012 forecast	25%	47%	28%
April 2012 forecast	43%	47%	10%

Source: M&A Leaders Survey from 451 Research / Morrison & Foerster

III. IPOs: A High Threshold

As global equity markets awaited the initial public offering of Chinese web bazaar Alibaba, survey participants were split on how the IPO market would impact M&A activity. A narrow majority (46 percent) expect minimal competition, with 44 percent projecting the market impact would be "somewhat high." As one respondent put it: "As long as there's an active IPO market, private companies and investors are going to be tempted." But the majority view accepts that going public is an option reserved for only a handful of players. "The IPO market is healthier than in many years but will still only accommodate a very small number of companies because the threshold is still quite high," said one.

Brenon Daly, research director for M&A at 451 Research, notes in his analysis that responses to this question — whether the IPO market would pose significant competition to M&A — are unchanged from results last October, notwithstanding very different equity market conditions. As of October 2013, the Nasdaq had been climbing steadily all year on its way to a 30-plus percent annual gain. When the latest survey was being conducted in April, the market was down for the year. Against that backdrop, Daly points out, most of participants' written comments on this question were bearish on the market for new issues.

Projected competitiveness from IPOs for deals over the next year

Survey date	Increase	Decrease
April 2014 forecast	48%	52%
October 2013 forecast	48%	52%

Source: M&A Leaders Survey from 451 Research / Morrison & Foerster

IV. Valuation + Competition

With equity markets still close to record highs, approximately half of buy-side participants expected to increase their use of stock as acquisition currency for the remainder of 2014, versus just 11 percent expecting a decrease in the use of equity. The sell side is cooler to the use of stock, dividing almost evenly between those who expect decreased demand (26 percent) and who project greater deployment of stock deals (24 percent). The difference in sentiment is no mystery; as one respondent stated: "Buyers will want to use an overpriced currency, but sellers will continue to want cash instead."

Respondents showed a marked ambivalence about the role of earnouts in completing M&A deals. Most respondents use these time-released incentives (88 percent deployed earnouts at least once in the past two years), and most (63 percent) also agree they're "effective tools for bridging valuation gaps between buyers and sellers." Still, many feel that earnout provisions often create problems among the parties, or as one respondent said, "They are likely to trigger post-closing disputes." Among various metrics for structuring earnouts, achievement of revenue targets were held in highest regard, with 71 percent deeming them effective, followed by achievement of specific product development and profitability targets.

V. Survey Composition

The M&A Leaders Survey draws from a wide range of technology influencers. Of the 157 participants, 21 percent are C-level executives, and another 20 percent are in corporate or business development. Ten percent are general counsel. Forty-two percent work on the deal side, either in investment banking or financial advisory roles (37 percent) or in venture capital or private equity (5 percent). Almost half are based in California, and more than a quarter from the East Coast, with others spread throughout the United States, Asia-Pacific, Canada, the UK, and continental Europe.

Participants work across all sectors of the industry, the greatest portion in IT, including application and infrastructure software, semiconductors, mobile applications, systems/hardware, IT, and hosting services. Other sectors represented included life sciences/biotech, and clean technology.

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