PRIVATE EQUITY SERVICES

How the Coronavirus is Changing Software & Technology Deals

The Software & Technology (S&T) sector has been somewhat insulated from the negative financial and operational impact of COVID-19, however, the virus has brought about certain risks and altered the way we perform due diligence for most S&T deals. At Alvarez & Marsal (A&M) we have a dedicated financial, tax, and operational team that focus exclusively on the due diligence of S&T companies. Since March, we have encountered several transactions with COVID-19-related risks or issues. Whether you are an experienced S&T investor or just starting to look at the space, you will want to be aware of these risks and understand how to best mitigate them through diligence and structuring of the purchase agreement.

During the COVID-19 pandemic, software sales have slowed overall, but not evenly across different industry verticals and software types. As one might expect, heavily impacted verticals (e.g., hospitality, travel, retail) have declined more than less-impacted verticals (e.g., finance, insurance). Likewise, we have seen sales impacted unevenly based on the type of software — sales of marketing and sales software has decreased, whereas sales on video conferencing, remote learning, and collaboration solutions have increased. With lower costs and barriers to entry, adoption of software as a service (SaaS) has also increased with the growth of remote work.

Cost cutting initiatives - evaluating reductions in force (RIFs)

Software companies experiencing declining, flat, or low growth have generally responded to the crisis by shoring up cash reserves through executing cost-cutting initiatives. Prudent investors must evaluate the mid- to long-term impact of these cuts during due diligence. The process is simple, but the execution can be nuanced. At its core, investors must compare current and historical spend (labor and non-labor) and evaluate management's rationale for and the impact of any material changes.

RIFs are the primary way software companies reduce costs. For companies that have recently performed a RIF, here is what to look for:

- **Over cuts** – Companies that over cut can face issues supporting slower demand and may struggle scaling back up when higher demand returns. We recommend reviewing key productivity metrics for the functions the RIF impacts to determine if the cuts were too deep. On a recent diligence a company cut the number of customer support agents in response to decreased ticket volume. It was clear the decreased support capacity was creating delays and the ticket backlog was growing when looking at operating statistics overtime. This led to a number of issues including poor service, a decline in existing employee morale, and the inability to quickly respond when demand returned.

- **Under cuts** – Under cuts can be equally problematic. Companies that have not cut enough are likely to have tough decisions on the horizon. Expecting a quick return to normal, one software company decided to retain their implementation consultants to protect their knowledge base. After evaluating the company's implementation pipeline, resource capacity, and utilization, it was clear the company did not have enough work to cover the cost of the team. If demand remains low longer than anticipated, deeper cuts will be required in the future to sustain cash flows. This may result in incremental one-time costs associated with severance.

- **Research & development cuts** – While many of the companies we reviewed have not made R&D cuts, when evaluating companies that have reduced R&D headcount, we consider the long-term impact. In these cases, we recommend reviewing the product roadmap, pipeline opportunities linked to delayed or eliminated features, knowledge loss, and potential changes in the level of technical debt.

- **Sales & marketing cuts** – For many companies, COVID-19 has not impacted the existing customer base as much as it has impacted new sales. This has led to a drop in new bookings and companies pulling back on sales and marketing headcount. Companies that chose to furlough (vs. terminate) employees will likely be able to get new bookings back on track more quickly once the impact of COVID-19 ebbs.

- **Normalizing costs** – In order to best assess the go forward cost structure of the business, we recommend looking at headcount and margin levels prior to COVID-19 (e.g., February 2020 last twelve month or run-rate) and the target's fiscal year 2021 budget to corelate the true structure and help assess any fiscal year 2020 adjustments to historical earnings or budget. Also, we advise being skeptical of any claims that current cuts or changes in terms are sustainable when the economy goes back to normal, with the exception of potential rent savings. From our experience internally and in speaking with various companies, we are seeing a significant shift to a work from home structure. This may lead to sustainable rent savings.

Leading indicators to identify customer issues

Many companies have seen deterioration in the existing customer base, however, because of the recurring nature of the software business model and calendar year renewals coming before the crisis began, the impact of the deterioration may not be reflected in revenue yet. There are leading indicators to look at and diligence procedures that can be implemented to identify these issues. A few of them are:

- **Bookings momentum** – New bookings, either through new logos or existing customer upgrades, are often the first thing to go when the business environment changes. A decline in new bookings will lead to lower growth and potential declines in future revenue. In order to identify trends in bookings we recommend a bookings-to-invoicing-to-revenue analysis be done for at least the prior two years to understand trends. This involves reviewing contracts, obtaining invoices, and often digging into the company's CRM system.

- **Accounts Receivable (AR) deterioration** – Revenue is at risk even if a customer hasn't canceled their service yet. A majority of maintenance and SaaS arrangements are now evergreen (automatically renewing), therefore we often run into instances where revenue continues to be recognized despite the customer not explicitly renewing or even paying their bill. This will manifest into deterioration in AR and ultimately write offs or revenue reversals. In order to protect against this we recommend i) analyzing DSO and DBO (days billing outstanding) trends, ii) digging into all aged balances, and iii) protecting yourself in the purchase agreement by extending the net working capital true-up period and requiring all AR not collected in the last 90 or 120 days not be included in final AR. This will prevent you from paying sellers for uncollectible AR.

- **Price concessions** – In order to get customers to renew, companies will often provide price concessions on renewals on either a permanent or temporary basis. To identify type of price concessions, we recommend an annual recurring revenue ("ARR") retention analysis using the most recent revenue information, which should be impacted by the concessions.

- **Extended pilot programs** – Companies may try to win new customers by offering free or inexpensive extended pilot programs. These programs often carry lower margins because of the direct cost to support them. When these programs come to an end, they may increase cancelation rates or lower renewal prices.

Increase liquidity through working capital management

Many companies stretched liabilities to increase liquidity this spring. Some have unwound the increase in liabilities, however, many have not. The stretch liabilities can relate to vendors, employees, and government payments. Investors should ensure these are adjusted as part of the net working capital or indebtedness in the purchase agreement to avoid assuming excess liabilities. Below are the most common instances of this:

- **Accounts Payable (AP)** – Companies will stretch payments to vendors by 5 to 10 days, often significantly increasing AP over its normal balance.
- **Payroll taxes** – As part of the US CARES Act passed in April, companies can defer payroll tax payments until July 15, causing a non-recurring increase in accruals.
- **Vacation accruals** – The primary expense at most S&T companies are headcount costs. As part of the stay at home orders most of this workforce is now working from home and forgoing vacation, causing vacation accruals to balloon.

Payroll Protection Program (PPP) loans

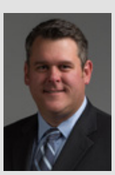
In addition to payroll tax deferrals, the US CARES Act provided many founder-owned businesses, and some sponsor-owned businesses, PPP loans to fund payroll for April through July, and potentially extended to be longer. The loan will be forgiven at the end of the period if headcount levels remain the same but will need to be repaid if headcount levels decrease. Investors should ensure any PPP loans that need to be repaid are treated as indebtedness in the purchase agreement. Also, investors will need to verify the gain associated with the loan forgiveness is excluded from EBITDA calculations.

Expanding diligence procedures

Lastly, as part of uncertain economic times and financial strains that may impact companies, such as Wirecard AG, management teams may be pressured, and frauds can occur. In order to mitigate these risks, we recommend performing a cash proof on last twelve months (LTM) periods and other substantive procedures, such as a detailed contract review and order to cash walkthrough. A proof of cash involves reconciling revenue to cash receipt per the source bank statements and expenses to cash disbursements per the bank statements. In addition, a proof of cash reconciles cash balances at the beginning and ending of the LTM period to cash on the balance sheet. Although this is not a replacement for an audit, it is a detailed procedure we can perform as part of diligence that can identify significant issues that a typical diligence project would not.

Many of the issues discussed above have always existed, however, COVID-19 has brought them to the forefront. If investors do not protect themselves, it could be costly when making acquisitions. This is why it is more important than ever to expand your diligence procedures and ensure you are evaluating these issues.

Contacts:



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