

Technology: a high conviction private equity playbook

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Executive Summary

- ◆ **Market context:** There has been significant valuation volatility in the public markets, with accelerating valuations in 2020-21 (due to a pull-forward in demand) and decline in H1 2022 (due to slowing demand and increasing interest rates). Valuations have stabilised in H2 2022 and 2023, offering a potentially attractive entry point.
- ◆ **Deal flow:** The technology sector has received the lion's share of private equity investment in recent years. In 2018-22, technology accounted for 25-30% of total private equity deployment. Although private equity deployment slowed in 2023, software technology maintained its share of deal flow.
- ◆ **Market outlook:** The software market has grown at a 16% compound annual growth rate ("CAGR") between 2018-2024E and given the root causes of this growth, HSBC Asset Management believes it will continue going forward.
- ◆ **Performance:** In the period 2005-20, software and services investments have consistently outperformed the other technology sub-sectors by 500-600bps and generated strong absolute returns averaging ~26% gross IRR.
- ◆ **Conviction in software:** HSBC Asset Management's conviction in the software technology sub-sector is derived from the secular and structural tailwinds, the value proposition and high return on investment for software customers, the defensive characteristics of software companies, the proven and repeatable private equity playbook and the fundamentally attractive financial profiles of software companies.

This paper outlines HSBC Asset Management's conviction of investing in the technology private equity space and is structured to provide an overview of the market context, descriptions of some of the key sub-sectors within the technology industry, market trends and outlook, and HSBC Asset Management's high-conviction manager selection approach.

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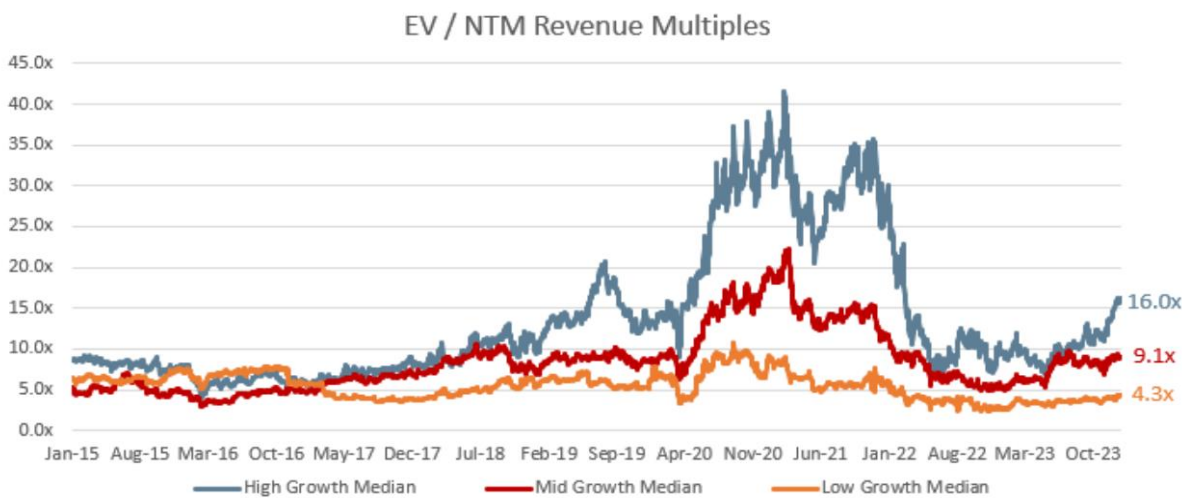
Market context: valuation volatility

Recent years have brought about significant changes in the investing landscape: Distortions caused by COVID-19 followed by subsequent lockdowns and government stimulus packages; and more recently a confluence of factors including heightened inflation, hawkish central bank policies, geopolitical tensions, and supply chain disruptions. These macroeconomic forces have induced volatility and oscillations in investor sentiment across various asset classes.

During this time of wider market volatility, the technology sector has experienced a valuation roller-coaster. In 2020-21, high-quality, high-growth technology companies experienced a demand pull-forward phenomenon as companies invested heavily into software, which resulted in above average growth and ballooning valuations. Subsequently, amidst the slowdown in demand and increase in interest rates in 2022, software valuations fell materially, with the highest growth, lowest profitability companies being the most susceptible.

Figure 1 shows long-term EV / NTM revenue multiples of a group of Software as a Service (“SaaS”) public companies, illustrating the aforementioned valuation peak and subsequent decline. The SaaS peer group has been categorised into three groups, namely (i) a high-growth group of greater than 30% NTM revenue growth, (ii) a mid-growth group of 15%-30% and (iii) a low-growth group of less than 15%. The recent return of valuation multiples to pre-pandemic levels has created a potentially attractive opportunity to acquire SaaS companies.

Figure 1: Correction of software multiples to a pre-pandemic level



Source: Clouded Judgement, Altimeter, 29 December 2023. EV/NTM Revenue Multiple is a financial metric that compares a company's Enterprise Value (EV) to its projected revenue for the Next Twelve Months (NTM).

Throughout this period, private equity has demonstrated its resilience as a nimble and dynamic asset class capable of adapting to evolving market conditions. At HSBC Asset Management, we actively seek out General Partners (GPs) that are positioned to thrive in this dynamic macro environment, generating potentially attractive returns with underlying revenue growth and margin expansion through strategic and operational improvements, with low dependency on multiple expansion or leverage.

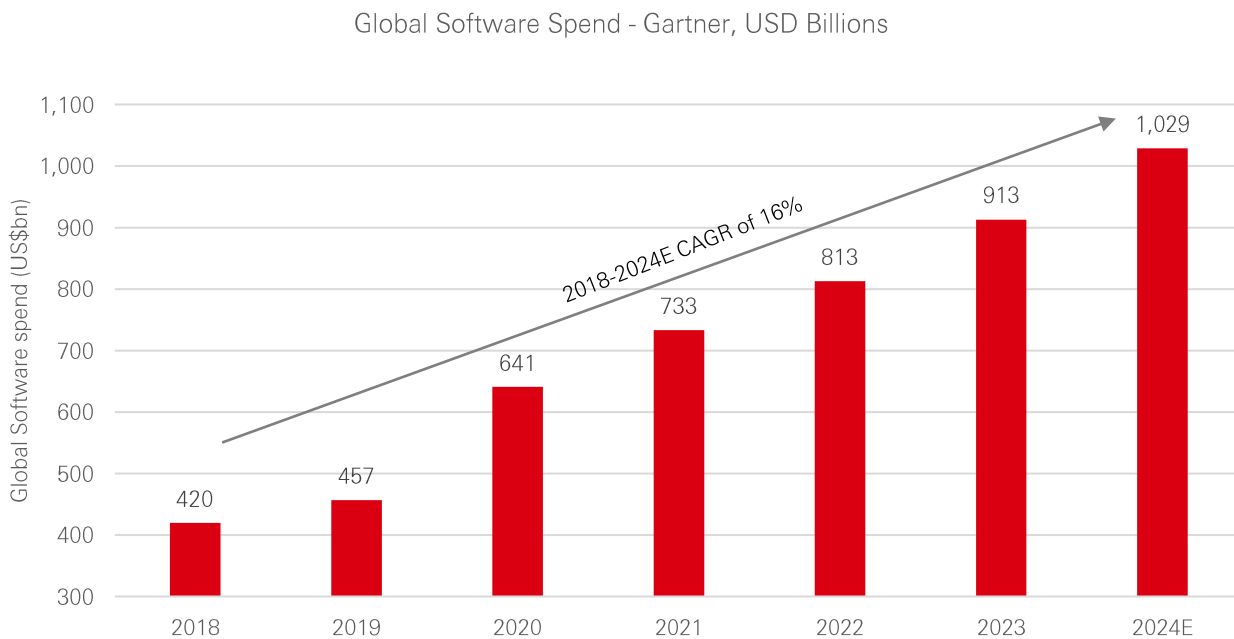
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Market outlook on the technology sector

For many years, the technology sector has benefited from robust global demand and an ongoing increase in software spending. Figure 2 indicates that global software spending has grown at a 16% CAGR between 2018-2024E.

The driving force behind this structural growth trend is the combination of demand-side pressures and supply-side acceleration. Rising labour costs have heightened the need for automation and productivity gains, while SaaS delivery models are streamlining software access and maintenance for end-users. At the same time, information technology (“IT”) spending is accelerating due to increased technology adoption and innovative digital transformation, expanding the addressable markets of software companies.

Figure 2: Global software spending



Source: Gartner Market Databook, January 2024.

HSBC Asset Management believes that we remain midway through the adoption cycle of SaaS software since a longer-term projection of the SaaS market size growth from 2022 to 2030 exhibits a CAGR of 18.7%¹, and therefore feels confident that such growth will continue going forward. Furthermore, we are in the early stages of some revolutionary changes in technology, such as generative artificial intelligence (“AI”), which will drive incremental growth for many years to come.

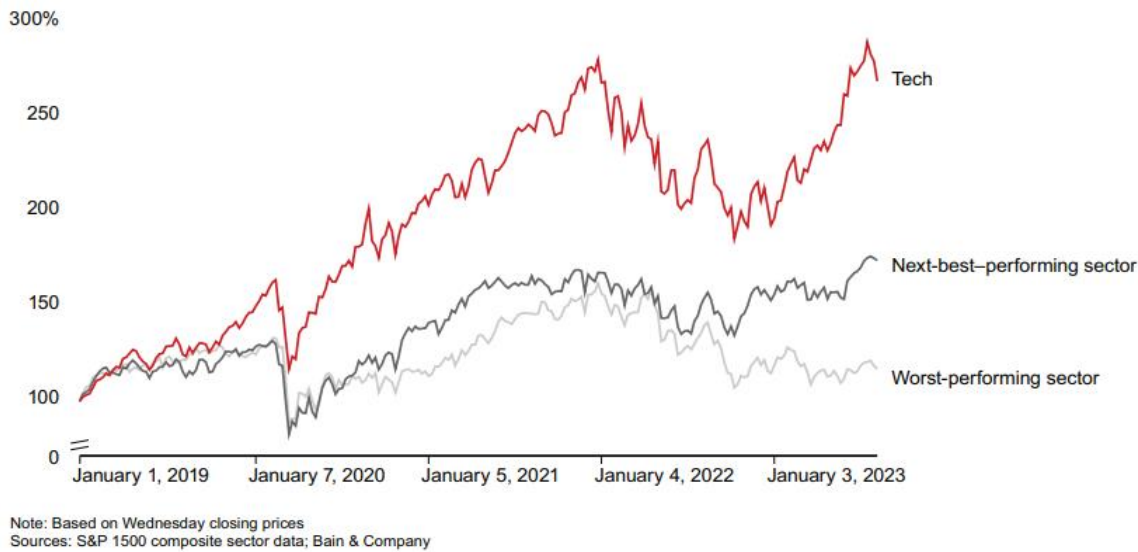
Following the exuberant demand cycle of 2020-21, company profitability and cash generation have regained prominence. In response, the sector has pivoted from “growth at all cost” to “profitable growth”, often achieved by rationalising operating expenses, such as sales & marketing (“S&M”) and research & development (“R&D”) spending, as well as by workforce restructuring.

This combination of continued growth and improved profitability has meant that despite valuation volatility, the Technology sector has outperformed all other sectors, as demonstrated in Figure 3.

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1. Fortune Business Insights as of December 2023.

Figure 3: S&P 1500 aggregate market cap, data based on weekly percentage changes



Source: Bain & Company, Technology Report 2023

With these opportunities in the technology sector, we anticipate that (i) an expanding set of opportunities will continue to receive private equity investment, (ii) companies will stay private for longer, with extended holding periods, and (iii) the rate of realisations will increase, following the recently depressed levels. Nevertheless, HSBC Asset Management believes that vigilance and prudence in investment selection are paramount in the private markets. With disciplined and rigorous manager selection, managers are expected to consistently deliver above-average returns with low loss rates in general.

Key sub-sectors in technology

It should be noted that technology is not a monolith, but an umbrella of various underlying sub-sectors. The diverse spectrum of technology sub-sectors encompasses: telecommunications, hardware, semiconductor, B2C software, B2B software etc. Our sectoral analysis and investment experience have honed our focus on three key verticals: (i) B2B software, (ii) Cybersecurity, and (iii) IT services. Although Generative AI is not currently investable within the private equity space, HSBC Asset Management will continue paying attention to its developments.

Business-to-Business (“B2B”) software – B2B software companies are those that sell to commercial clients rather than consumer clients. They may be “enterprises” selling to larger businesses or selling to small- and medium-sized businesses (“SMB”).

Some of these companies offer software that provides client facing tools to optimise specific business operations. This is called **Application Software**, and some examples include Enterprise Resource Planning, Human Capital Management, Customer Relationship Management, Field Service Management, etc. It was estimated that the global enterprise Application Software market reached approximately \$336.3 billion in 2023, with a year-over-year growth of 12.0%. Projections indicate that the market will expand to \$580 billion by 2027, with a CAGR of 13.4% from 2022 to 2027¹.

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1. Gartner Research, 3Q2023 Update - Forecast: Enterprise Application Software, Worldwide. Growth rates in constancy currency terms.

Some other companies develop software that interacts with middle- or back-office functions. This is called **Infrastructure Software**, and some examples include Business Process Management, Data or Database Management, and IT Operation Management. Enterprise Infrastructure Software spending is expected to reach \$457 billion in 2023, registering an annual growth rate of 14.2%. By 2027, infrastructure software spending is forecast to grow to \$761 billion, with a CAGR of 12.9% between 2022 and 2027¹.

In 2022, total private equity B2B software deal value amounted to \$138.8 billion². Driven by macroeconomic factors, the mismatch in expectations between buyers and sellers as reflected in the widened bid-ask spread has led to a decline in such deal value to \$58.3 billion in the year to date as of October 2023. Nevertheless, we have started seeing positive signals with GPs generally expecting a likely recovery in deal activity².

Cybersecurity – Cybersecurity software is employed by an enterprise to protect its cyber assets, and encompasses information technology (“IT”) security, Internet of Things (“IoT”) security, information security, and operational technology (“OT”) security. This sub-sector has witnessed remarkable growth driven by the escalating threat and sophistication of cybercrime. With the current market penetration rate estimated to be approximately 10%, the total market opportunity of the industry ranges from \$1.5 to \$2.0 trillion, representing a substantial expansion compared to the currently vended market. According to McKinsey’s report’s data point, current vended market is only \$0.14T-0.15T compared to the \$1.5T-2.0T³. This significant gap underscores the imperative for cybersecurity providers and investors to address the needs of underserved segments and unlock untapped potential.

IT services – IT services are non-software products where a company provides business or technical support to enable customers to create, manage or optimise IT systems or processes. It may include hardware maintenance, applications services, infrastructure services or business process services. Software support services often provide long-term technical-support contracts or “pay-as-you-go”, incident-based support.

It is forecast that IT services will continue to see an increase in growth, with the spending on IT services expected to grow by 8.7% in 2024, reaching \$1.5 trillion⁴.

Generative AI – Although not immediately investable, the HSBC Asset Management team continues to monitor developments and remains vigilant for opportunities, given the rapid advancement of generative AI, deep learning, and neural network technologies. The generative AI market is estimated to grow to \$1.3 trillion over the next decade from a market size of just \$40 billion in 2022. In addition, the rising demand for generative AI products brings positive externalities of \$280 billion in new software revenue⁵.

These selected sub-sectors offer compelling investment prospects within the technology landscape, each characterised by unique growth catalysts, market dynamics, and risk profiles. At HSBC Asset Management, we leverage our expertise and strategic insights to capitalise on these opportunities and deliver sustainable potential returns for our investors.

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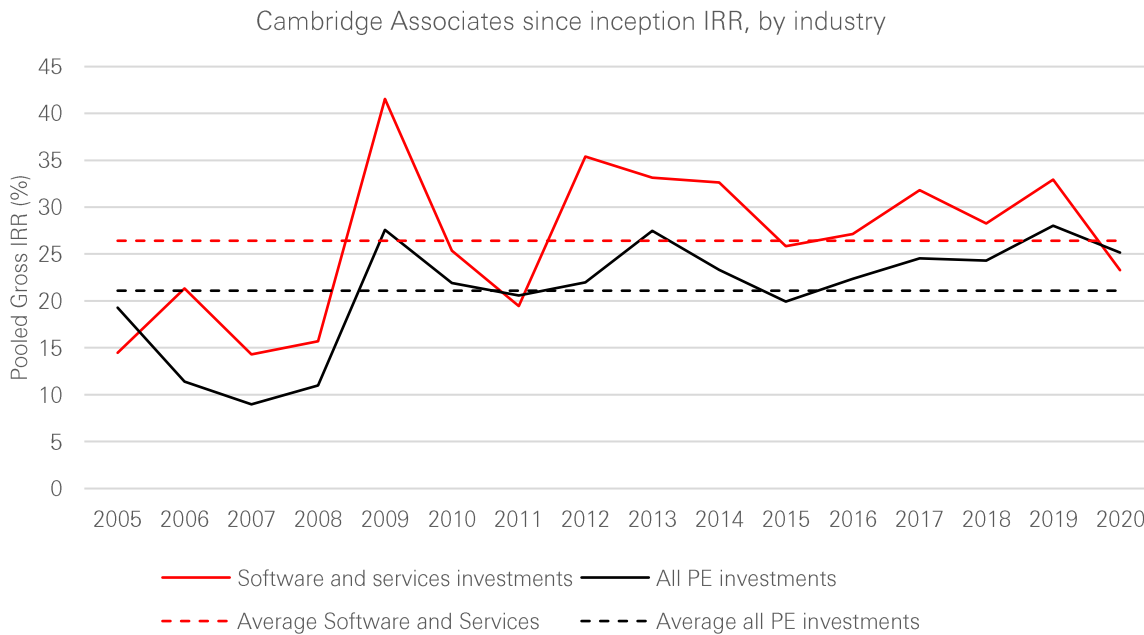
1. Gartner Research 3Q2023 Update - Enterprise Infrastructure Software, Worldwide, 2021-2027, 3Q23 Update.
2. Pitchbook - Take-privates dominate top PE-backed enterprise software deals, 26 October 2023.
3. McKinsey & Company as of October 2022.
4. Gartner Press release 17-Jan-2024 - Forecasts Worldwide IT Spending to Grow 6.8% in 2024.
5. Bloomberg Intelligence, as of June 2023.
6. Bain & Company 2023 Private Equity Report, Figure 9 page 11.

Strong returns and outperformance of software technology

The private equity industry has increasingly favoured technology companies, shifting towards an overweight position compared to public equity markets. In the period 2018-23, technology has dominated private equity investments, representing 25-30% of the global deal count⁶.

Figure 4 shows that between 2005 and 2020, software and services investments in the US outperformed the average US private equity returns fairly consistently by approximately 500-600 bps. Furthermore, software and services generated strong absolute returns averaging 26% gross IRR.

Figure 4: Since Inception IRR based on company initial investment year, by industry



Source: Cambridge Associates, private equity index and benchmark statistics, Q3 2023.

HSBC Asset Management's conviction in software technology and criteria for manager selection

HSBC Asset Management has a strong conviction in the technology sector, in particular B2B software, driven by the following considerations:

- ◆ **Secular and structural tailwinds:** Growth potential of the software sub-sector remains significant, and the market is generally only partially along the adoption curve. Although maturity differs, the opportunities that HSBC Asset Management focus on often enjoy low market penetration and substantial white space, especially among the SMB segments.
- ◆ **High return on investment ("ROI") for customers:** Software technology has demonstrated significant potential to increase productivity for its clients and to generate a high ROI for them.

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- ◆ **Defensive characteristics:** B2B software has exhibited defensive characteristics, as mission critical software is an indispensable product for its users and is often embedded into key functions. This is illustrated by its high level of recurring revenues and retention rates of often over 90%, as well as its recession resilience: B2B customers tend to generate stickier revenues when the economy slows, whereas B2C consumer-driven revenues can decline sharply. Software expenses are often a small component of a client's cost base, which gives advantageous customer dynamics when combined with a highly diversified customer base.
- ◆ **The private equity playbook:** Private equity has an established set of successful valuation levers that have been repeatedly used to generate value in software investments, for instance, driving inorganic growth through mergers and acquisitions ("M&A"), accelerating organic growth through improving routes to market, improving sales efficacy or introducing price rises (given aforementioned customer stickiness), strengthening management team capabilities, and enhancing profitability (such as offshoring of back-office functions to reduce operating expenses, especially in R&D centres), and many more.
- ◆ **Potentially attractive financials:** High quality software business often combines rapid revenue growth with the potential for attractive profitability. HSBC Asset Management seeks exposure to high quality software businesses that have attractive unit economics, generally generating gross profit margins of over 80%, with discretionary operating expenses and asset light characteristics, which result in the potential for very high cash flow conversion.

Conclusion

HSBC Asset Management does not seek to "time the market". Instead, we focus on selecting high-quality managers and companies that are capable of enhancing risk-adjusted returns and reducing correlations within our private equity portfolio.

Private companies are staying private for longer, and we believe there is a larger opportunity set of software companies in the private markets than in public markets. We believe B2B software, cybersecurity, and IT services offer a rich selection of private equity investment opportunities.

Our portfolio construction seeks to gain an advantage from investing with what we believe are best-in-class technology private equity managers across a variety of specialist strategies (such as hyper-growth, buy and build, buyout, turnaround, etc.). We also seek exposure to the best large-cap, mid-market, lower mid-market and growth businesses. We will continue to seek software specialist GPs that are poised to benefit from high ROI, mission critical products with sticky, recurring revenues, low customer concentration, good unit economics, and a combination of growth and profitability potential. We also favour managers with strong recent realisations and good distribution to paid-in capital ("DPI").

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Key Risks

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested. Past performance does not predict future returns. The return and costs may increase or decrease as a result of currency fluctuations.

- ◆ **Liquidity Risk** - Investors may be unable to dispose of an investment quickly and at a price that's closely related to recent similar transactions. There is no guarantee of distributions and no established secondary market
- ◆ **Event Risk** - A significant event may cause a substantial decline in the market value of all securities
- ◆ **Long-term Horizon** - Investors should expect to be locked-in for the full term of the investment, which is subject to extensions
- ◆ **No Capital Protection** - Investors may lose the entirety of invested capital
- ◆ **Unpredictable Cashflows** - Capital may be called and distributed at short notice
- ◆ **Economic Conditions** - Ability to realise/divest from existing investments depends on market conditions and the regulatory environment
- ◆ **Risk of Forfeiture** - Failure to make call payments could result in forfeiture of commitment, including invested capital, without compensation
- ◆ **Default Risk** - in the event of default investors risk losing their entire remaining interest in the vehicle and may be subject to legal proceedings to recover unfunded commitments
- ◆ **Reliance on Third-party Management Teams** - Underlying investments will be managed by various third-party management teams that will in aggregate determine the eventual returns for the investor

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