"Better to invest in a company facing growth problems than ageing problems"

There were some massive software deals recently.

Some were predictable, most weren't.

While we have recently focused on hardware, it's time to shift the spotlight back to software. In this edition, we will delve into a few of these deals, explore their underlying motivations, and offer insights.

Previous Newsletters, including this one, are available on our site in pdf HERE

Software M&A is Making a Comeback

According to LSEG data, activity in the technology sector saw a 61 percent drop year-to-date in the first eight months of 2023, totalling US$231.5 billion. LINK

One of the most well-known recent software deals was Microsoft's US$10 billion investment in OpenAI, which we discussed in our Issue #15 newsletter LINK. However, other recent deals indicate that investment is returning, and this increased interest is worth reviewing as it reveals important industry trends.

Cisco – Splunk | Acquisition US$28B (Sept 2023)

Background: One of the largest deals was Cisco's announcement of its intention to acquire Splunk for US$28 billion. The financials are compelling, with Cisco's CEO, Chuck Robbins, emphasising the US$4 billion in annual recurring revenue from Splunk's subscriptions as a key driver. Splunk, with 8,000 employees and 230,000 users, had seen its shares rise 39 percent in 2023 before the deal's announcement, despite being down 44 percent from their October 2020 high due to increased IT spending during the COVID-19 pandemic LINK.

Analysts consider Cisco's deal to value Splunk reasonably at 7 times projected 12-month revenue.

Insight: Let's now consider the strategic value of the deal. Splunk is a leader in observability and security analytics, complementing Cisco's existing security offerings. It provides Cisco access to Splunk's expertise in data analytics, particularly in collecting, indexing, and searching large volumes of data.

"Customers will be able to go from detecting and responding to predicting and preventing",
Scott Herren, Cisco CFO

Cisco is known for its frequent acquisitions, but this one is the largest in the company's history. While the financials appear sound, from a technological perspective, the question arises whether this is a high price to pay for a company that may have fallen behind industry leaders. While SIEM/SOAR functions are important, others are already leading with AI to address increasingly complex cybersecurity challenges. The key question is whether Cisco and Splunk can bring a relevant AI capability to market quickly enough to compete with others who are already doing so.

Francisco Partners/TPG (PE) - New Relic | Acquisition US$6.5B (July 2023)

Background: New Relic, a competitor to Splunk and Application Dynamics (both now owned by Cisco), was founded in 2008. It provides software for real-time monitoring of web and mobile apps, supporting custom-built plugins for collecting telemetry and performance data, often referred to as "observability." The company partners with industry giants like IBM, AWS, Azure, and Rackspace LINK.

Insight: New Relic's move to private equity comes as the observability market gains momentum. Enterprises increasingly invest in data-driven decision-making and streamlining their data infrastructure. Observability companies have raised nearly $2 billion in capital over the past two years. As organisations shift to as-a-Service models owning less infrastructure, understanding where the problems are and who is responsible, is becoming a more important issue.

Silver Lake – Qualtrics | Acquisition: US$12.5 billion (Mar 2023)

Background: Founded in 2002, Qualtrics offers software that helps companies gather data and measure their customers' product experiences. SAP acquired Qualtrics in 2018 for $8 billion and subsequently spun it off in an IPO in 2020, retaining a majority stake. Earlier this year, SAP sold its Qualtrics shares to Silver Lake for US$7.7 billion LINK.

Insight: Qualtrics, once valued at $28 billion in early 2021, saw its market value decline to around $5 billion in late 2022, where it has roughly remained since. SAP's decision to divest its stake in Qualtrics aligns with its strategy to focus on core offerings, primarily S/4HANA. Questions arose about why SAP needed to purchase Qualtrics rather than maintain it as an ecosystem partner alongside other popular CX products. Likewise, Qualtrics' ability to partner with SAP's competitors became in jeopardy once they were part of SAP. It took about three years to figure this out LINK.

IBM – Apptio | Acquisition US$4.6B (June 2023)

Background: Founded in 2007, Apptio provides a spend-management platform that combines public or hybrid cloud spend management tools with investment planning capabilities. These capabilities allow users to align development resources with prospective business outcomes LINK.

Insight: IBM's acquisition of Apptio aims to accelerate the advancement of IBM's IT automation capabilities, benefiting both sides.

Google, Amazon, Salesforce, Nvidia - Hugging Face | Invest US$235m | Valuation US$4.5B (Aug 2023)

Background: Founded in 2016, Hugging Face hosts hundreds of thousands of AI models from major tech players like Amazon, Google, Meta, Microsoft, and others. It serves as a GitHub-like hub for AI code repositories, models, datasets, and web apps. Hugging Face provides libraries for tasks such as dataset processing and model evaluation, along with an enterprise version that supports both software-as-a-service and on-premises deployments LINK.

Insights: Hugging Face operates at the intersection of two significant trends — AI and open-source. It enables users to share resources, models, and research, reducing model training time, resource consumption, and the environmental impact of AI development. Lots of hugs for this one.

Google, then Amazon ($4B) .. then Google ($2B) days later – Anthropic | Valuation est US$20-30B (Sept 2023)

Background: Amazon announced a $4 billion investment and a minority stake in Anthropic, the San Francisco-based AI company known for its cutting-edge AI research. Just two days later, news circulated that Google led another round of funding, valuing Anthropic at US$20-30 billion LINK.

Founded by siblings Dario Amodei and Daniela Amodei, who previously led OpenAI's engineering and policy/safety teams, Anthropic specialises in creating large-scale AI models and a chatbot called Claude. The founders split from OpenAI due to concerns about its commercial direction LINK.

Insights: Microsoft's investment in OpenAI has clearly highlighted the new battleground. The following are some of the larger, recent AI moves and partnerships:

- Microsoft - OpenAI
- Google – DeepMind
- Tesla – xAI
- Meta – Meta AI
- Nvidia – Nvidia AI hardware, CUDA software

In the case of Anthropic, it appears that two industry giants are engaged in a competitive battle. The situation can be summarised as follows:

- *Google*: Anthropic is upholding an agreement it previously announced with Google in February. Anthropic utilises Google's custom chips and has plans to make its technology accessible through Google Cloud and other platforms.

- *Amazon*: With its recent deal, Anthropic is significantly bolstering Amazon Bedrock, a service that has already attracted thousands of users keen on developing AI applications. Anthropic has chosen Amazon's AWS as its primary cloud provider for essential tasks, including safety research and the development of future foundational models. Moreover, Anthropic will harness AWS Trainium and Inferentia chips for building, training, and deploying these advanced models. (It's worth noting that Anthropic has been an AWS customer since 2021.)

Insights from the Software M&A Landscape

These software deals offer valuable insights:

- **Software** remains highly attractive, driven by improved hardware performance and the accelerating proliferation and benefits of cloud computing.

- **Recurring Revenue**: Equity markets prioritise deals with predictable revenue streams.

- **AI** is entering a new phase where models can generate new content (text, images, videos, sounds etc) with minimal training, presenting significant new opportunities. See graph below.

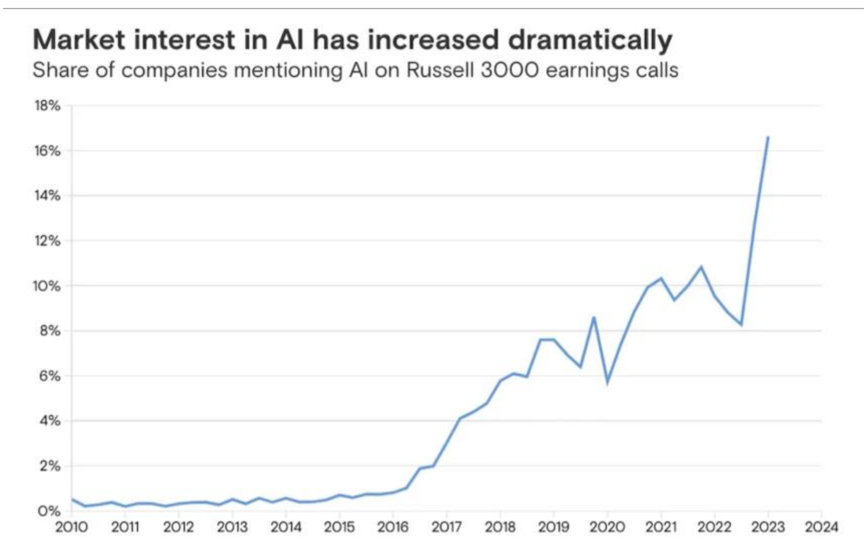

Image and Data: Goldman Sachs

- **New markets**: Sectors such as telecommunications, private networking, and private data centres are facing challenges in terms of profitability and growth. As a result, vendors are actively exploring other markets to sustain growth.

Expect more surprises, and by 2025, AI will have permeated nearly every aspect of our lives.

Stay connected.

Kevin