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Tech Valuation Trends for the 2nd Half of 2024

The technology industry is facing another year of inflated interest rates, which generally results in a higher cost of capital. The hopes that interest rates would begin to decline in the second quarter have proven untrue as inflation proves to be stubborn. Despite healthy cash flows, current market conditions have taken a toll on tech valuations.

For the first half of 2024, the total number of M&A deals has fallen 25 percent year over year to a four year low. We have seen a recent uptick in global mega-mergers, which offsets the declining number of acquisitions, but pressures remain. Goodwill impairment continues to be a focus for many companies in the tech industry due to continued higher discount rates. Changes in market conditions, interest rates, or the perceived risk of an investment can lead to changes in the discount rate. In short, a higher discount rate will reduce the present value of future cash flows, while a lower discount rate will increase it.

This confluence of factors can leave a tech company in an uncertain position, with competing forces stranding it in a valuation limbo. Companies are generating revenue, but many are unable to escape the **weight of interest rates** and the high cost of capital.

Despite these less-than-ideal conditions, there are still ways for tech companies to weather the uncertainty and set themselves up for success when the market reopens.

The Risk of Goodwill Impairment

High interest rates increase borrowing costs, which can reduce cash flows and dampen earnings potential, making it challenging for companies to take on or pay off debt. This, in turn, impacts earnings forecasts and negatively affects fair value, which may cause an impairment (or write-down) of goodwill.

The specific risks and effects of goodwill impairment can vary from business to business, but the impact can be substantial — significantly reducing share prices or causing companies to second-guess a potential deal. While the current environment is less than ideal, tech companies should know that they are not alone, as many of their peers are also struggling with goodwill impairment.

Even if an impairment does not exist in the current period, companies should adequately disclose the risk of a potential impairment in the future, as well as the assumptions and estimates used by management in its most recent analysis.

The AI Variable

Artificial intelligence (AI) is generating more investor interest than other sectors within the tech industry. Fueled by the promise of varied and numerous applications — from financial forecasting and cybersecurity to marketing personalization and supply chain management — AI startups continue to draw funding despite the cooler market conditions.

But the staying power of many AI companies has not been tested. Organizations are acknowledging AI's potential while remaining cautious about the associated risks and costs. Rather than diving in headfirst, they are carefully developing strategies to minimize risks and ensure ROI. For AI companies, generating investor returns will be the key to securing new funding. Uncertainty around their ability to do so makes AI company valuations complex, despite the present boom.

Silver Linings

Even though the previously anticipated surge in M&A activity has yet to arrive in 2024, that does not mean dealmaking is at a standstill. Many private equity (PE) firms have been sitting on capital for years — through the COVID-19 pandemic and the record inflation and rising interest rates of the subsequent years. They are now eager to put that money to good use, even if conditions are not yet perfect. Tech companies interested in exploring divestment or in carving out specific areas of their business may find willing partners in PE firms. At present, this activity is more of a trickle than a flood, but combined with **slower inflation in May** it could be a precursor to growing tech valuations, lowered interest rates, and more active dealmaking later in the year.

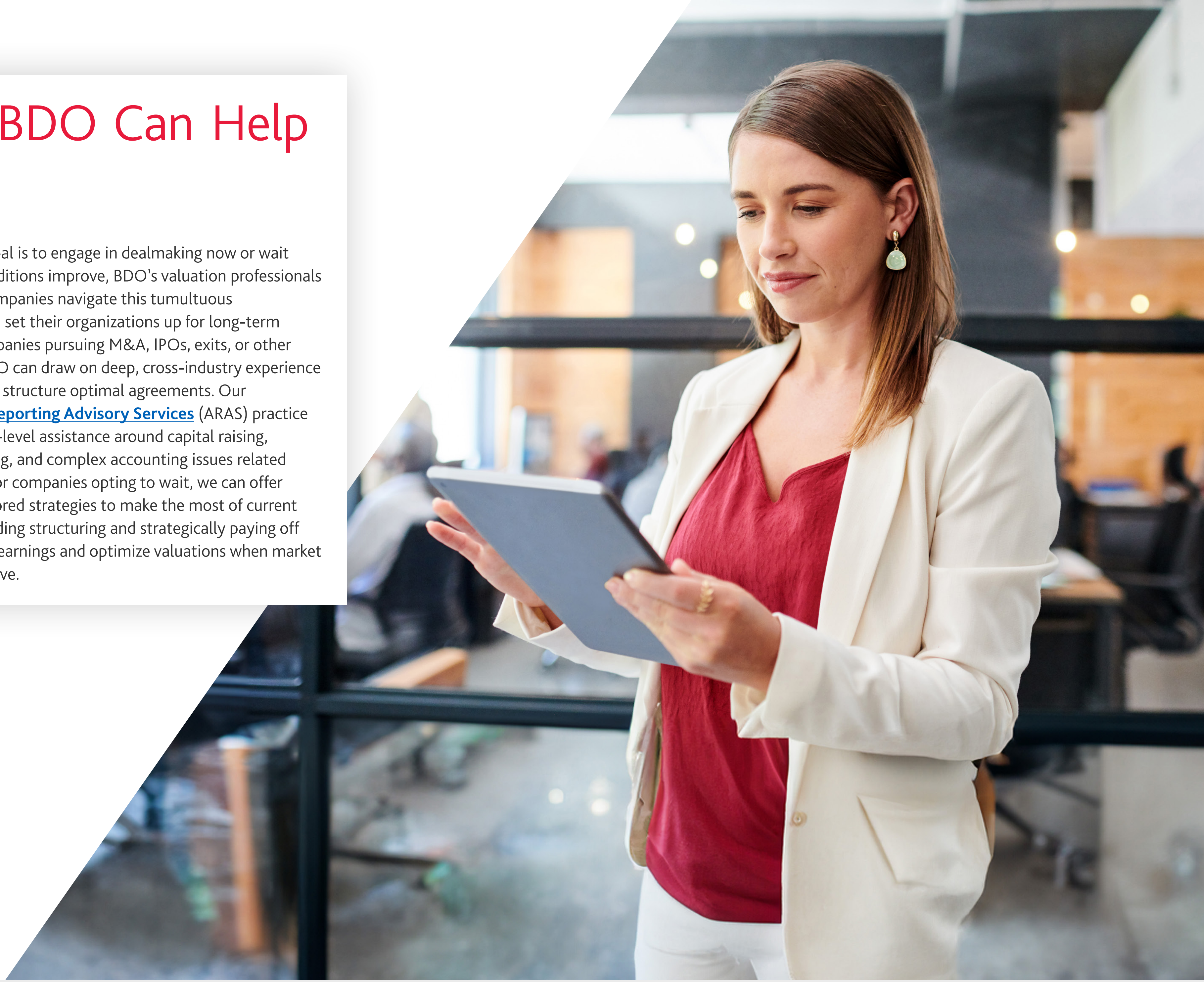
Even tech companies that are waiting for a more active dealmaking environment are not remaining idle. Many companies are putting cash flows to use by paying off debts as a means of safeguarding their valuations. This is a conservative move that can improve the health of the business. Paying off debt is a sound strategy during uncertain conditions, particularly as outstanding debt is emerging as a primary driver of goodwill impairments.

In other cases, tech companies may continue focusing on enhancements to the business, such as product or service expansions or pricing strategy adjustments — strategies which about half of tech CFOs cite as priorities in ***BDO's 2024 Tech CFO Outlook Survey***. These approaches, along with paying down debt, can help increase resilience and ultimately bolster valuations by growing revenues and creating a healthier business.

AI can also help tech companies **optimize costs**, which can improve valuations over the long term by creating new efficiencies and reducing expenses. More than half (55%) of tech CFOs say they plan to leverage AI for this purpose.

How BDO Can Help

Whether their goal is to engage in dealmaking now or wait until market conditions improve, BDO's valuation professionals can help tech companies navigate this tumultuous environment and set their organizations up for long-term growth. For companies pursuing M&A, IPOs, exits, or other transactions, BDO can draw on deep, cross-industry experience to help price and structure optimal agreements. Our Accounting & Reporting Advisory Services (ARAS) practice can provide high-level assistance around capital raising, financial reporting, and complex accounting issues related to these deals. For companies opting to wait, we can offer scalable and tailored strategies to make the most of current cash flows, including structuring and strategically paying off debt to improve earnings and optimize valuations when market conditions improve.



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