Headroom in Tech Budgets Offers Long-term Upside for Private Capital

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KEY TAKEAWAYS

- Current valuations for tech providers may seem high, but the headroom for increases in corporate tech expenditures suggests that this is a long-term trend to stay invested in.
- Financial companies are leading corporate spending on technology, but investment from other sectors is surprisingly low. Taking finance as a benchmark and looking at upward trends in business IT budgets suggests there is the potential for sustained upside.
- As tech budgets increasingly focus on digital transformation, budgets for innovation are likely to continue to rise. Private capital is best placed to provide funding for these innovative sectors and to take advantage of the opportunity that these investments offer.

Corporate IT spending is predicted to reach $4.5 trillion globally in 2022, and will be a primary driver of growth for many existing and emerging tech players.[1] The digital transformation taking place across the business world strongly supports the long-term investment thesis for tech.

The accelerating integration of technological solutions into all aspects of business models is demanding fundamental cultural changes, requiring organizations to continually experiment with new technologies. As MIT Sloan Management Review puts it, "Digital transformation is better thought of as continual adaptation to a constantly changing environment."[2] This process cannot, by definition, ever be complete.

This paper will first examine data showing the relatively low levels of tech spending by companies in several sectors, highlighting the headroom for increases in tech budgets. Second, we will analyze how the shifting shape of that investment – in terms of target sectors and the balance between internal and external spending – will provide opportunities for emerging tech. Finally, we will show how private capital is best placed to support and benefit from this long-term growth in technology investment.

THINKING LONGER TERM FOR PRIVATE MARKET TECH INVESTMENTS

Before we dive into our analysis, it is important to place this discussion in the context of the gyrations in tech stock prices over recent months.

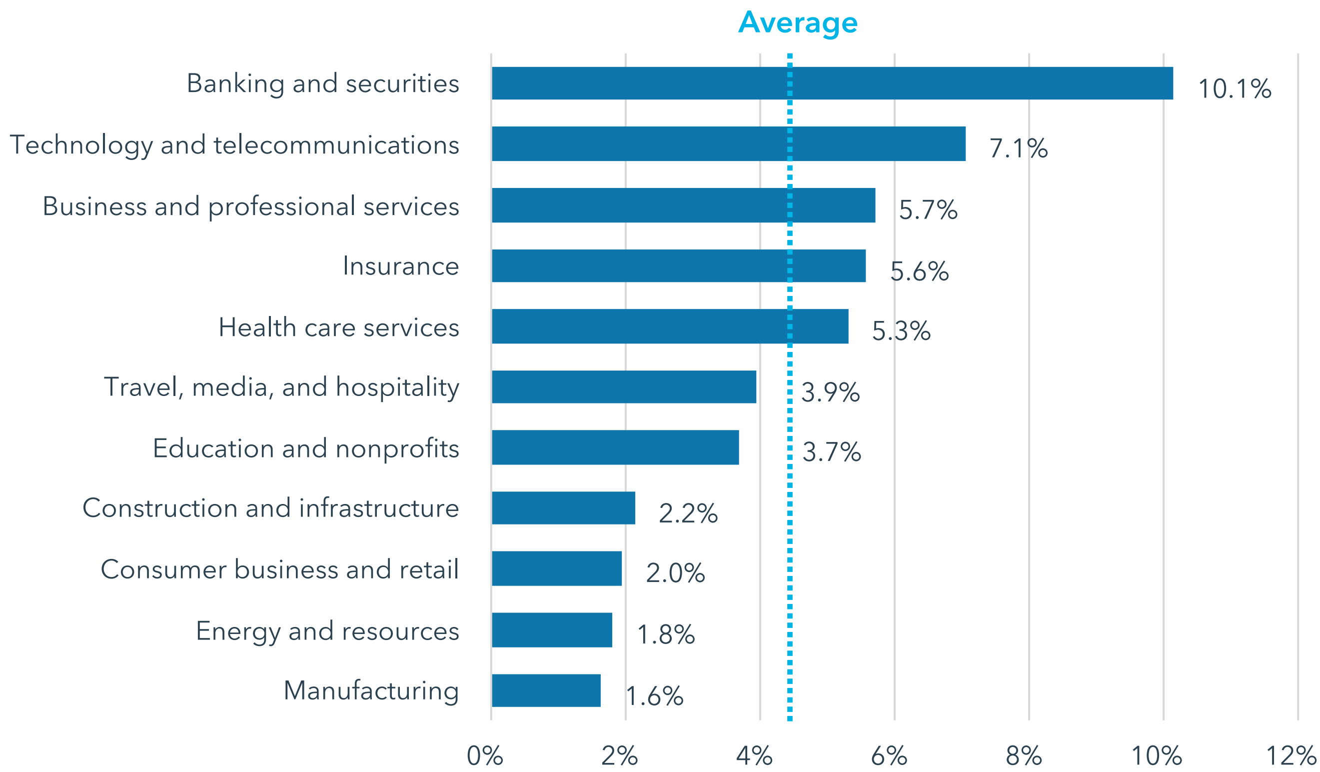
The short-term movements of stock markets are obviously important for private market investors to monitor. As public tech company valuations have inflated, so has the perceived value of their private counterparts. The median price-to-sales ratio of tech companies going public in 2021 rose to 15.2, its highest reading since the dot-com bubble in 2000.[3] Elevated IPO multiples inevitably ripple down across the company growth life cycle. Many private companies have recently doubled in value from one private financing round to the next, sometimes in just six months.[4] Now, as public tech valuations reset lower, private ones are likely to follow.

Investors should remember, however, that private investments are made with much longer hold periods, while capital committed today will not necessarily be invested immediately, as private fund managers generally deploy capital over a two- to four-year period. At the other end of the investment life cycle, private companies closer to potential IPOs may be impacted by public valuation declines. However, many will simply delay a planned exit via a listing or strategic sale until market conditions improve, and use that time to grow revenue and earnings, providing some level of insulation from the slide in valuations.

Short-term market fluctuations should not, therefore, be allowed to obscure the bigger picture. Technology is a growth theme with significant upside potential over the longer term, supported by robust demand from both consumers and businesses. This paper focuses on the latter.

Exhibit 1: Wide variance in tech budgets between industries

Average technology budget as a % of revenue



Source: Deloitte, "2020 Global Technology Leadership Study." N=374. For illustrative purposes only.

FINANCE LEADING THE CHARGE IN TECH INVESTMENT

Companies' technology budgets can be a valuable gauge for comparing the spending propensity of various sectors as part of the ongoing technological transformation of business.

As Exhibit 1 shows, the variance between sectors can be quite dramatic.[5] Financial firms have clearly moved quickly to integrate technology solutions into their business models, devoting more than 10% of their company budgets to technology investment. This likely reflects the extent to which their various business models are consumer facing, and the growing level of competition from emerging online-only challengers.

EXPECT TECH BUDGETS TO GROW ACROSS THE BOARD

Tech budgets rarely, if ever, shrink. Even during 2020, under the weight of the COVID-19 pandemic, worldwide corporate IT spending rose 0.9%.[6] We believe that banking and securities firms are leading a trend rather than permanent outliers. Tech budgets should continue to rise across a broad array of sectors, as the ongoing digital transformation spreads from early adopters to other business models.

The implications are significant. For example, health care tech budgets were just 5.3% of revenue in the Deloitte survey.[7] In the United States, overall health care spending was $4.1 trillion in 2020, or 19.7% of GDP.[8] If health care tech budgets rise even slightly in coming years, that would result in hundreds of billions of dollars per year in incremental tech spending. Given that spending on just a single vertical within health care – artificial intelligence – is expected to rise by nearly $200 billion globally from 2021 to 2030 (from $10.4 billion to $208.2 billion), substantial tech spending growth seems probable in the sector.[9]

The Deloitte survey cited in Exhibit 1 predicted that average tech budgets would rise from 4.25% of revenue in 2020 to 5.11% in 2022.[10] Other surveys tell a similar tale.

A Spiceworks Ziff Davis survey of corporate tech buyers in North America and Europe found that 53% of businesses planned to increase tech spending year-over-year in 2022, with just 7% expecting a decrease.[11] Research from International Data Corporation predicts that spending on technologies and services aimed at facilitating digital transformation will rise to $2.8 trillion by 2025, up from just $1.5 trillion in 2021 – representing a compound annual growth rate of 16.9%.[12]

Broader economic trends should also accelerate this process. Higher input costs, including higher wages, raw material prices, and transportation costs, are likely to put pressure on margins in many sectors. While costs can (and will wherever possible) be passed along to customers, businesses will also seek efficiencies by investing in technological solutions, such as automation and artificial intelligence, with the goal of improving productivity and reducing costs.[13]

FROM PHYSICAL TO INTANGIBLE, INTERNAL TO EXTERNAL

Rising corporate spending on tech presents opportunities for a wide variety of emerging innovators, as technology budgets shift toward new and innovative technologies, and from internal to external spending—from capital to operating expenditures.[14]

Investment in business innovation is predicted to account for a rising share of IT budgets – from 15% in 2020 to 23% in 2023.[15] For those businesses leading the charge on tech investment, this figure could be around 30%.[16]

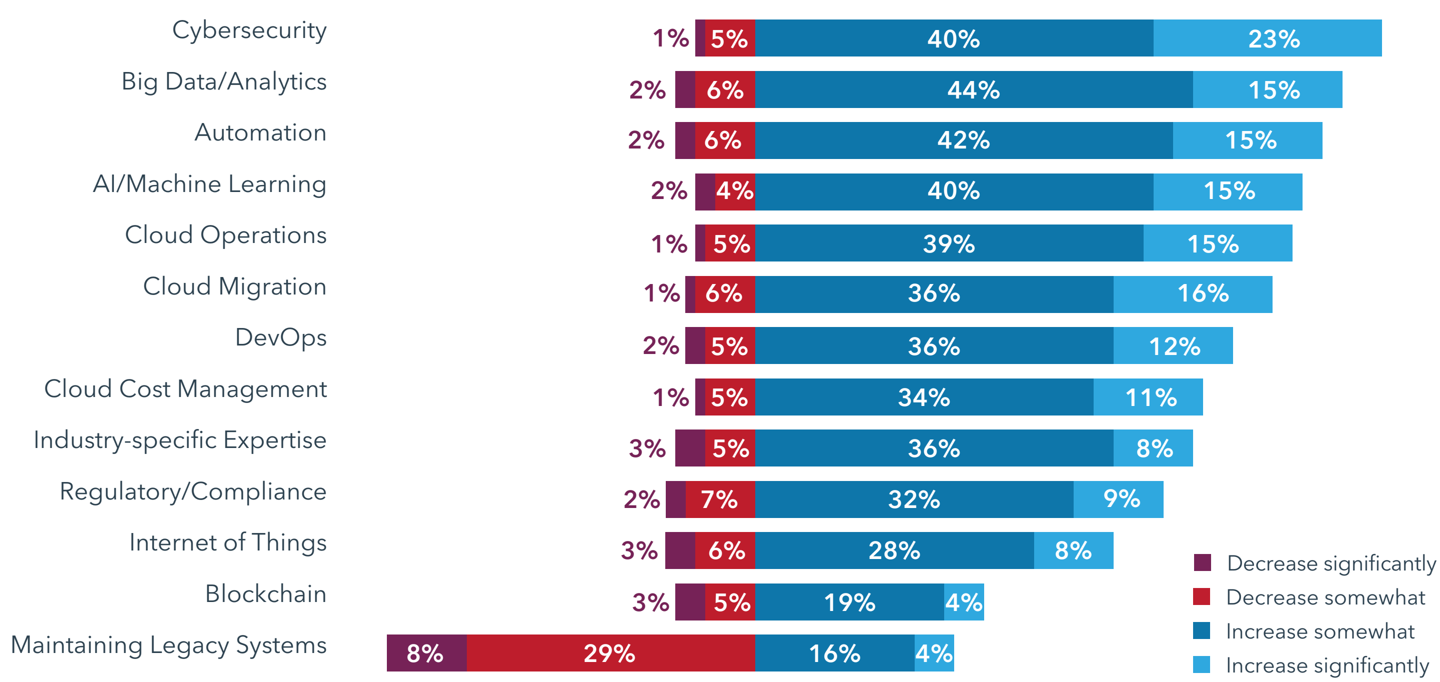
Priority areas for business tech spending are increasingly innovative and external (see Exhibit 2).

This is a huge opportunity for emerging tech vendors as new technologies, such as cybersecurity, automation and robotics, blockchain, and data analytics, become increasingly ubiquitous among businesses. For example, cloud spending, at an average 30% of IT budgets, has already surpassed on-premises software spend (24%).[17] That gap looks set to grow.

Growth in external spending across multiple categories should support revenue growth for private product and service providers – with most emerging tech sectors dominated by private companies. For example, as of February 2, there were 184 unicorns (private tech

Exhibit 2: Corporate IT spending is increasingly shifting to external vendors

Planned changes to use of external IT resources (% of respondents)



Source: Flexera, "2021 State of Tech Spend Report," January 2021. N=474. For illustrative purposes only.

companies valued at $1 billion or more) in the internet software and services space, 77 in artificial intelligence, and 43 in cybersecurity.[18] There are many more that do not (yet) meet the unicorn classification.

This growth should also open up exit opportunities within the tech ecosystem. Innovation among larger tech companies has in recent years effectively been outsourced to smaller companies, which the giants then acquire as they look to integrate these technologies to gain a competitive edge. Google's growth, for example, was supported by 250 acquisitions in the decade to November 2019.[19]

PRIVATE CAPITAL'S ADVANTAGEOUS POSITIONING

Private capital is best positioned to support the growth of emerging innovators and help investors gain exposure to rising business spending in tech.

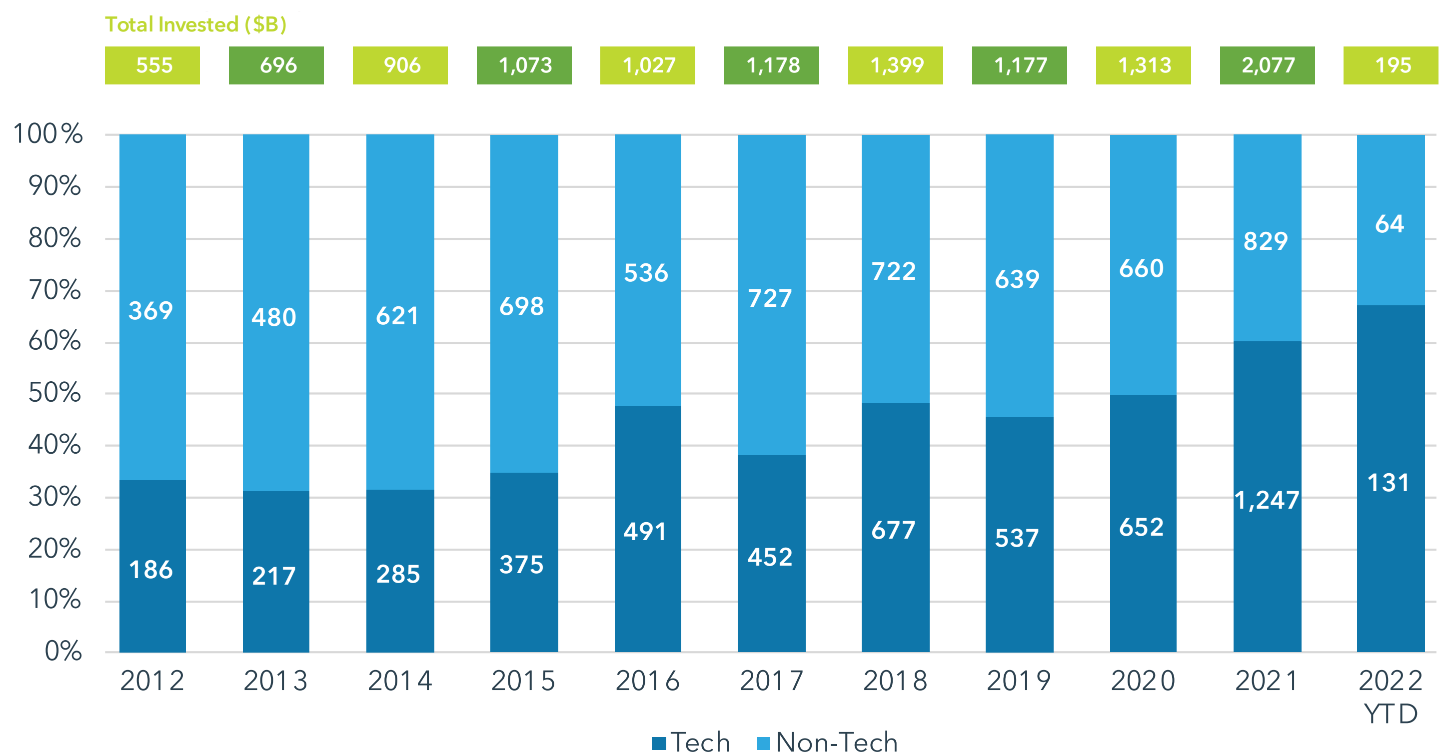
Private markets have become the dominant funding source for the innovation economy, with tech companies accounting for an ever-rising share of private investment (See Exhibit 3). In 2021, private equity and venture capital funds invested $1.25 trillion in tech companies, accounting for more than 60% of total completed deal value across the industry.[20] So far in 2022, tech has accounted for more than two-thirds of deal value.

Furthermore, as private capital funds have scaled up, armed with ever-greater resources, newly emerging tech leaders are able to remain private and thrive without needing to tap public markets. Take leading business payment tech provider Stripe, for example, which rose to a valuation of over $150 billion in June 2021, supported by a cumulative $2.23 billion of private funding (See Exhibit 4).[21]

Dry powder (funds available for investment) among late-stage venture and growth equity funds targeting information technology investments rose to an all-time high of $85 billion at the end of 2021, up from $47 billion a year earlier.[22] Private capital is poised to continue to support emerging tech leaders as they reach unprecedented scale in private markets.

Exhibit 3: Tech accounting for increasing share of private investment

Share of global private equity and venture capital deal value in $B accounted for by tech



Source: PitchBook, as of February 28, 2022. For illustrative purposes only.

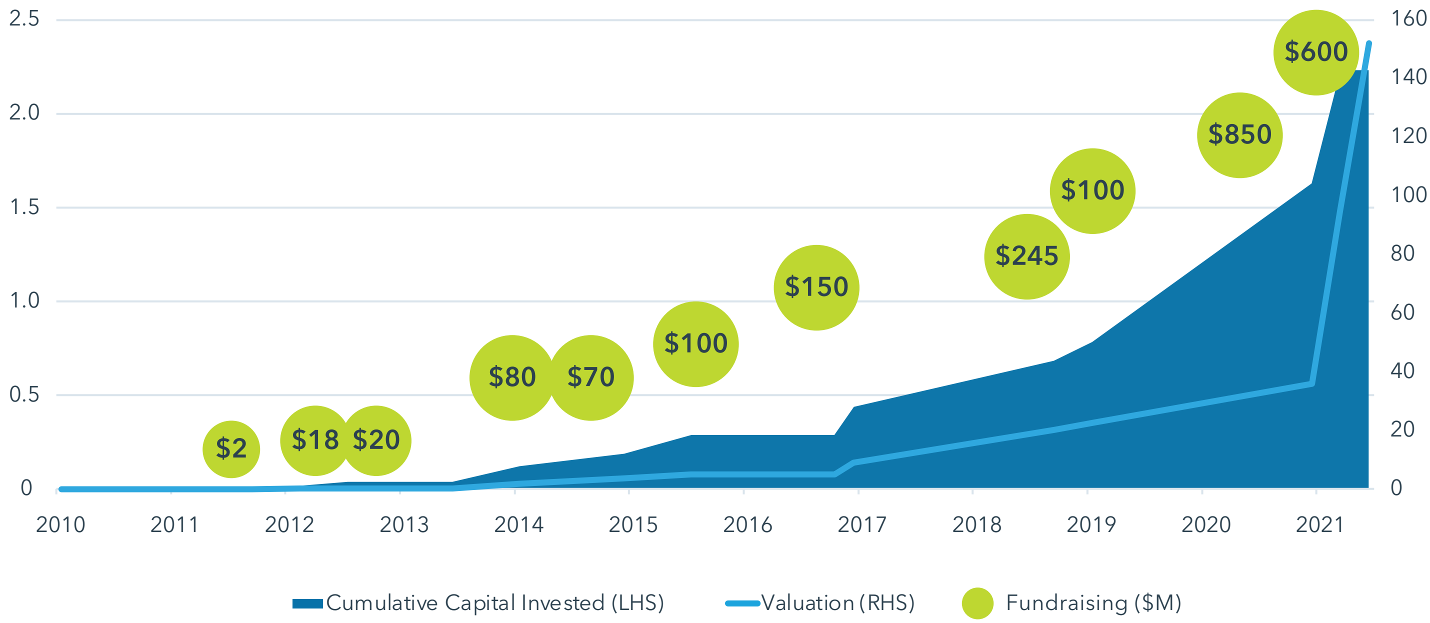
STAY THE COURSE IN TECH

For investors, it can be difficult to maintain perspective given the daily noise around swings in tech valuations. This paper hopefully serves as a reminder of the potential scale of the long-term opportunity in technology, one worth staying the course for and best accessed via private markets.

Corporate spending is just one part of the tech growth story, though an important and expanding one: Global IT spending by businesses is expected to increase by almost half a trillion dollars in just two years to reach nearly $4.7 trillion in 2023.[23] While finance companies have taken the lead in tech investment, we expect other sectors to catch up as technology continues to reshape business models across the spectrum. This investment is likely to be disproportionately directed toward innovation, presenting significant and ongoing opportunities for young, high-tech, private companies and the funds that support them.

Exhibit 4: Privately held Stripe, a FinTech, has grown and thrived

Cumulative private capital invested and company valuation ($B)



Source: PitchBook, as of February 8, 2022. Valuation data is post-valuation metric for each financing round. For illustrative purposes only.

END NOTES

1. Source: Gartner, "Gartner Forecasts Worldwide IT Spending to Grow 5.1% in 2022," January 18, 2022.
2. Source: MIT Sloan Management Review, "'Digital Transformation' Is a Misnomer," August 7, 2017.
3. Source: Jay Ritter, University of Florida, "Initial Public Offerings: Technology Stock IPOs," December 30, 2021. Refers to opening price at listing.
4. Source: Reuters, "Klarna funding round makes it Europe's most valuable startup at $31 billion," March 1, 2021; Print21, "Canva valuation doubles in six months," September 24, 2021; TechCrunch, "Instacart raises $265M at a $39B valuation," March 2, 2021; CNBC, "Bolt valued at $4.75 billion as Uber rival aims to push into on-demand grocery delivery," August 2, 2021.
5. Source: Deloitte, "2020 Global Technology Leadership Study."
6. Source: Gartner, "Gartner Forecasts Worldwide IT Spending to Grow 9% in 2021," July 14, 2021.
7. Source: Deloitte, "2020 Global Technology Leadership Study."
8. Source: Centers for Medicare and Medicaid Services.
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11. Source: Spiceworks Ziff Davis, "The 2022 State of IT," from July 2021 survey.
12. Source: IDC, "Worldwide Digital Transformation Spending Guide," November 9, 2021.
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14. Source: Chief Investment Officer, "Tech Companies, Not Factories, Are Getting the Capital Spending Dollars Now," February 24, 2022.
15. Source: Deloitte, "2020 Global Technology Leadership Study."
16. Ibid.
17. Source: Flexera, "2021 State of Tech Spend Report," January 2021.
18. Source: CBInsights, "The Complete List Of Unicorn Companies," as of February 9, 2022.
19. Source: CBInsights, "Infographic: Google's Biggest Acquisitions," November 2019.
20. Source: PitchBook, as of February 28, 2022.
21. Source: PitchBook, as of February 8, 2022.
22. Source: PitchBook, as of January 31, 2022.
23. Source: Gartner, "Gartner Forecasts Worldwide IT Spending to Grow 5.1% in 2022," January 18, 2022.

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