



Deal or No Deal

2007 saw mergers and acquisitions (M&A) in the ICT channel hit record numbers. We saw global players like BT make one purchase after another in an effort to capture new customers, and at the same time an enormous number of mid-market companies set about expanding their portfolios through the acquisition of complementary companies and competitors. Christine Horton looks at the reasons behind the trend, and what all this M&A activity means for the channel.

M&A activity in the UK ICT channel is on the rise. This statement will hardly come as a surprise to anyone, as barely a week seems to pass at the moment without news of yet another strategic acquisition unfolding. So what are the reasons behind this growing market trend? Well, of course, motives differ with each buyer. But in general, solution providers use acquisition to increase their existing market share (by acquiring customers, a brand, distribution), or provide a new complementary product to sell into their core user base, or to springboard entrance into a new geographic market or adjacent market sector.

Traditionally, however, technology companies acquired new capabilities through partnerships and alliances with complementary businesses, rather than businesses pulling out their wallets and buying up technologies and customers.

Industry experts believe there are a number of explanations for the shift.

"There continues to be great consolidation and convergence in the IT industry which has made the old adage of 'get niche, get big, or get out' never more true," says Claire Barclay, director of partner marketing at Microsoft. "A growing number of businesses have realised the additional profit that is up for grabs, and companies that have the means

to merge and acquire stand to benefit from significant market advantages – from economies of scale to an increased customer base."

"Moreover, the commoditisation of IT has put limits on the success of niche businesses. The widespread popularity of standardised technologies has led to a decreasing demand for specialised, industry-specific products. No longer able to make the same level of profit from niche demand, those companies that do not have the financial strength to

“There continues to be great consolidation and convergence in the IT industry which has made the old adage of 'get niche, get big, or get out' never more true

merge or acquire may choose to move out of the market," she adds.

Ward Carter is president of US firm, Corum Group, which provides M&A services to the ICT industry. He points out that a company can only achieve a limited amount of growth organically: "As such, acquisitions provide a means to supplement internal development, and quickly enter new markets with the advantage of immediate presence through the customers, employees of the acquired companies, and take advantage of existing brand, technology,

distribution, domain expertise, business model, etc.," he says.

Equiteq, meanwhile, is a UK-based M&A advisory firm for consultants, which helps investors find and acquire companies, and also helps SME consulting businesses to gain investment or sell their company. The company handled last year's sale of Catalyst Development Ltd to Abeam Consulting, as well as Detica Group's acquisition of MA Partners at the beginning of 2007.

The firm's managing partner, Paul Collins agrees there are difficulties associated with growing organically in the mid-market: "In addition to board level access, it is actually very difficult for a public company to meet shareholder growth requirements, particularly in people businesses, by growing just organically.

"If you do the math, the recruitment and induction task becomes a real constraint if you have even modest growth requirements. Acquiring is one way of instantly adding value to shareholders without the potential downside of running with underutilised expensive staff for a period."

With all the M&A activity in the ICT industry, it is easy to imagine that smaller businesses will struggle to survive against the big boys in the playground. Smaller firms with high levels of innovation and service grow well

as a result of strong client demand and then usually get bought by bigger firms when they start to either be a threat, or an opportunity to add value to their business.

"Many managers who are very capable of managing a technology start-up are ill-suited to managing a larger company, even if they have adequate financial resources," says Carter.

"Many markets have already witnessed significant consolidation and are now dominated by a few large players, leaving little room for the smaller companies."



Clare Barclay

Nick Grossman, business development director at solution provider 2e2 says that the company's history of acquisitions has significantly shaped the business: "We started 2e2 from scratch with very low revenues; hence acquisition was an important tool in our armoury. We deliberately selected businesses with strong management teams and a track record of growth and success, particularly through the tougher economic times; we felt this was very important as these businesses would (and did) bring strong specialisation, track record and technical excellence in their areas of specialisation whereas we added the corporate gravitas and the cross-selling glue which meant that the businesses could leverage each other and win increasingly larger deals," he explains.

"This model worked very well for us and allowed us to generate up to 22 per cent organic growth in some years due to strong synergistic working and cross selling. One can only purchase what's available, but that said, we have been careful to only buy companies for the right reasons and not to get carried away with deal momentum. We've completed 14 acquisitions since we started 2e2 and all have added good value."

Grossman says the strategy of acquisition over, say, technology

partnerships with other companies as "a case of horses for courses."

He explains: "Sometimes one needs the in-house skills and specialism, and in these instances, acquisition is often preferable over growing a team organically which can take a long time. However, one must have the right alliances and the appropriate high-level accreditations from those vendors. With a strong skill set, appropriate accreditations and a good relationship with the vendors one can build an exceptionally powerful organisation."

So is this trend set to continue? You can't ignore the bombardment of bleak news about the economy, and for most of us there's no escaping the effects of the 'credit crunch', professionally or in our personal lives. But does this mean that companies will rein in their spending on acquisitions?

It hasn't so far, says Equiteq's Paul Collins, who reckons it's not a simple case of the economy hampering M&A activity – there is still a huge demand globally for IT businesses; the credit crunch has merely shifted the balance of power between the dealmakers.

"It's not that there is no effect but the end result – i.e. the number of deals completed is still at the same levels as earlier in 2007 before the credit crunch," he explains. "The reasons for this are all to do with increasing demand globally for mid-market IT consulting firms coming from new geographies and new types of buyers.

The Middle East, Indian sub-continent and the Far-East, including China, are all entering the buyer market for consulting firms generally, but in particular IT consulting firms that can provide them access to the board rooms of European Plcs and government," he says.

"Buyers are trying to use the current economic climate to buy at lower prices but because for every good seller there are five qualified keen buyers, price competition is countering the natural effect of a depressed economy. Also, other than some IT consulting firms that serve some sections of the financial service sector like investment banking, there is still a healthy demand for the services of most consulting firms. Recruitment in the sector for example is at an all-time high. So really what has changed is that in 2006 and 2007 there were many firms proactively putting their businesses on the market to sell, now in 2008 the transaction initiative is coming more from the buyer community who still need to expand to meet global shareholder growth requirements."

"There certainly doesn't appear to be any shortage of activity in the market," says 2e2's Grossman. "In times such as these, pricing is often more realistic than aspirational which helps to maintain activity levels. Very large deals or highly leveraged deals will clearly be more difficult to bank. However, if the potential acquirer has



Paul Collins

a sound business and a clear vision for how an acquisition would be accretive to their company then I see no reason why they wouldn't continue with M&A activities."

Freedom Communications is another channel company that keeps a close eye on any businesses looking to sell. Tom Perry, the firm's head of marketing, says he has seen an increase in the number of businesses coming onto the market, including many data businesses that are currently looking to sell.

"Many businesses are looking for a quick sale; some believe that we are starting to face a recession and are seeing a downturn in sales," says Perry. "It is hard to get agreement on the value of companies that are looking to sell, many have high multiple values that in the current climate seem unrealistic."

"We are certainly seeing a reduction in the multiples available that were around nine to twelve months ago, which in turn is now making more companies attractive to an acquisitive reseller like Freedom."

A word of warning comes, however, from across the pond, where companies' experiences of credit woes are arguably further down the line than in the UK.

“Buyers are trying to use the current economic climate to buy at lower prices but because for every good seller there are five qualified keen buyers, price competition is countering the natural effect of a depressed economy”

"The credit crunch has had the greatest negative impact on private equity firms that rely on leverage (adding debt to their equity investment) in order to complete acquisitions," says US-based Corum Group's Ward Carter. "With tightening credit markets, the cost of borrowing is higher and the covenants are

tighter, resulting in overall tougher terms which impact deal economics. Strategic buyers are less apt to employ leverage [take on debt], preferring to use cash and stock as transaction consideration, so they are less impacted by the credit crunch."

He adds: "The credit markets overall have not impacted the technology sector compared to financial services and housing. If the credit crunch causes further deterioration of overall economic conditions and leads to a broader recession, then technology will eventually be impacted."

Regardless of the economy, there are clearly a number of 'hot' technology areas that forward-thinking channel players will look to snap up through the purchase of specialist firms.

"The current technology hot topic would be Business Intelligence (BI)," reckons Collins. "We know of many buyers who are looking to acquire in this area."

"Software as a Service (SaaS) is getting a lot of press, and good SaaS companies are being sought by buyers," says Carter. "The delivery model is very efficient, and at scale, the economics are spectacular. Overall, [it's] the preferred business model for ISVs and end-users alike in many cases.

"Security is still a very active market and the threat of intrusion, data/identity theft, malware, etc grows daily and impacts more people when left unchallenged," he adds.

Other attractive sectors include internet (commerce, advertising, content, social sites, communications, speech, search, and new business models), wireless & mobile, vertical markets (especially healthcare, transportation, government and engineering), and IT services.

In terms of how these acquisitions are funded, private equity and other financial investment vehicles had become the biggest single buyer category by the end of 2006. However, analysts believe this year will see a return to trade buyers becoming the biggest buyer category as access to cheap debt hinders the ability of private equity investors to deliver competitive prices.



Ward Carter

So despite the economic downturn, there appears to be no slowdown in the industry's thirst for acquiring new businesses. However, these companies will have to deal with a new set of challenges if they are to embark on the M&A trail.

One of the biggest tests will be finding good quality firms to acquire – followed closely by the 'perceptual gap' that now exists in value in the minds of buyers and sellers.

"Sellers still believe their firms are worth what they were at the peak of this economic cycle towards the end of 2006 and buyers are looking for 'cheap' deals because of the current economic uncertainties. This perceptual gap will probably exist through 2008 until the market settles down to the reality of new prices, which will be 20 per cent or so down on the peak of the cycle," believes Equiteq's Collins.

It appears that mergers and acquisitions in the channel will carry on regardless of the economy. However, there will probably be a more pragmatic approach to deal making in terms of pricing and how the deals are structured, reflecting the increasing unavailability of credit. To achieve this companies will increasingly look at more imaginative deal structures such as equity-based considerations rather than hard cash. Whether this bodes well for smaller businesses remain to be seen. But the deals will continue, and just as nature finds a way to adapt, so will the dealmakers.

Look out for the second part of the M&A series in September CBS