M&A Market Review

Information Technology

gambIT CORPORATE FINANCE

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Content Summary:

Key Observations	UK businesses contemplating an exit should consider the current market as providing significant opportunities, arising from both corporate and private equity acquirers focused on consolidation with significant funding currently available. Transaction valuations have stabilised and have increased within the IT sector supported by more robust macro-economic fundamentals.
Industry Overview	The IT sector enters 2014 with an optimism buoyed by improved corporate confidence, and building on increased M&A activity in 2013 (both for private companies and a resurgent IPO market) and improved valuation metrics for software and IT services.
Feature Article	This edition: Simon Hitchcock, Partner at Lyceum Capital and non-executive director at Adapt Group, discusses private equity's attraction to the IT sector and the development of market leading businesses in the sector.
Public Comparables	The 21 public companies tracked by Gambit outperformed the FTSE All-Share Index by 5.1% in 2013, although the Software and Consultants / Infrastructure companies significantly outperformed, whilst certain Data Centre / Managed Hosting companies experienced a high level of volatility and downward pressure on share price.

Key Observations From 2013:

Global stock markets reflected a significant improvement in investor sentiment during 2013, as demonstrated by the FTSE 100 Index, achieving an all-time high early in January 2014. This resurgence was underpinned by improving macro economic conditions, with the IMF upgrading global growth forecasts further in January 2014.

In the IT sector large deals regained prominence, including Silver Lake-Dell, Liberty Global-Virgin Media and Vodafone-Verizon Wireless (representing an aggregate value of $178bn) resulting in increased M&A global transaction values. Transaction multiples improved during 2013 with UK Software and Services transactions having median EV / EBITDA multiples for 2013 of 15.1 and 11.5 respectively.

UK private equity activity in the lower mid-market (EV of £10m-£100m) was buoyant in the second half of 2013 with key mid-market private equity investors very active with a number of new platform investments and bolt-on acquisitions by existing portfolio companies. Acquisitive UK corporates such as Iomart, Telecity and Daisy continued their consolidation strategies.

Our view is that the favourable underlying market conditions and corporate confidence, supported by improved access to capital, will act as a catalyst for strategically significant M&A activity across the sector.

UK businesses contemplating an exit should consider the current market as providing a significant opportunity. Well-positioned and scalable companies will achieve good valuations as a result of increased risk appetite and ongoing flight-to-quality. This is supported by a significant number of public and private companies with access to capital and ambitious growth plans to deliver against.

Summary: Favourable M&A conditions in place for mid-market IT companies

- ***To sell:*** With valuations having stabilised and increased, combined with a greater level of funding available currently than in recent years, those considering a sale should act now.
- ***Private equity:*** IT remains attractive to private equity as consolidation opportunities exist in fragmented sub-sectors. Significant exits have been achieved from both corporate acquirers and via secondary buy-outs, with intense competition for quality assets. A number of existing private equity platforms in the sector are anticipated to seek an exit in the next 18 months.
- ***Financing:*** Whilst raising debt capital remains challenging in many sectors, the underlying fundamentals of mid-market IT companies are more attractive to banks, resulting in increased availability, albeit that maturities have reduced and cost increased.

Information Technology Industry Overview

Simon Williams
Director, Gambit Corporate Finance LLP

The IT sector ended 2013 in robust health, both globally and in the UK. There was a return of landmark transactions within IT and the wider Technology sector. These contributed towards a 31% increase in global technology M&A value in 2013 versus 2012. Economic growth rates in key economies are increasing and equity market volatility is decreasing. This is resulting in a marked improvement in corporate confidence, highlighted by a recent survey of UK CFOs.

We forecast that this improvement in corporate confidence, coupled with unprecedented levels of cash held on the balance sheets of technology corporates and uninvested funds held by private equity firms, will underpin a continued improvement in M&A within the IT sector in 2014. The IT sector demonstrates fundamental characteristics which make it attractive to financial buyers and banks, aside from product/geographic extension, cross-sell and consolidation opportunities available to corporate acquirers. Financial buyers and banks are attracted to the availability of long-term contracts, recurring revenues, business critical nature of products and services and cash generation of mid-market and larger companies in the sector. This allows relatively high levels of debt leverage within transactions relative to other sectors, underpinning high, and sometimes eye-watering, sectoral valuations. Debt availability for early stage and smaller companies remains challenging.

Within software, cloud computing, SaaS and big data analytics are anticipated to remain key areas of focus, and therefore drive premium valuations, for the foreseeable future. The managed IT services sub-sector has undergone large scale consolidation in recent years by both corporates and private equity backed buy-and-build platforms. This is anticipated to continue an extension to both service offering and geographic footprint are sought, whilst the incremental adoption of cloud services by larger corporates will increase demand for managed services capacity. Although some data centre operators experienced pressure on rack rates and margins in 2013, IBM's recent announcement of a $1.2 billion investment in its data centre footprint to improve its cloud capabilities demonstrate that data centre requirements remain intense.

The managed services sector in the UK witnessed sizeable private equity activity in 2013, with significant new or bolt-on (via their portfolio companies) transactions completed. Private equity funds are demonstrating a voracious appetite to invest in managed services platforms as part of buy-and-build strategies. Iomart, Telecity and Daisy continued to spearhead corporate acquisition activity in the UK in 2013.

I hope you find this market review interesting. If you would like to discuss any of the issues raised or wider trends within the sector, please contact either myself or a member of the Gambit team.

IT Public Company Comparables

			Share Price Changes		
	Enterprise Value ($m)	**EV/EBITDA**	**1 month**	**3 months**	**12 months**
FTSE All-Share			**3.4%**	**3.5%**	**13.2%**
S&P Global 1200 IT Index			**2.0%**	**7.6%**	**22.8%**
Datacentre/Managed Hosting					
Equinix	11,336	10.1	4.1%	4.7%	(19.5%)
Iomart	507	10.6	15.1%	9.4%	28.9%
Rackspace	5,176	8.9	2.9%	(21.8%)	(50.6%)
Telecity	2,942	10.2	4.1%	4.7%	(19.5%)
Sub-sector (weighted average)		***10.0***	***4.1%***	***(2.1%)***	***(26.3%)***
Consultants/Infrastructure					
Accenture	62,583	12.7	14.1%	15.9%	20.4%
Computacenter	1,303	6.6	3.5%	18.5%	51.3%
Cap Gemini	10,057	6.7	11.3%	12.5%	51.7%
CGI Group	13,964	8.4	5.9%	12.9%	23.2%
CSC	8,840	4.2	(6.9%)	(10.5%)	28.1%
Cognizant	27,186	13.0	5.4%	15.6%	26.5%
Hewlett Packard	67,305	4.8	8.6%	27.4%	74.2%
IBM	228,550	8.0	8.2%	8.7%	(1.8%)
Infosys	30,784	11.8	8.7%	13.2%	17.7%
Phoenix IT	252	5.1	(8.0%)	(24.0%)	(28.7%)
Tietoenator	1,708	5.6	6.3%	7.3%	4.6%
Sub-sector (weighted average)		***7.9***	**8.6%**	**13.0%**	**18.3%**
Software					
Dassault	13,233	13.0	(0.3%)	1.6%	6.0%
Microfocus	1,867	9.5	(4.9%)	(5.4%)	24.3%
Microsoft	242,277	7.4	(0.4%)	4.2%	33.8%
Oracle	158,123	7.7	13.6%	16.2%	10.4%
Red Hat	10,225	19.7	21.5%	34.6%	6.8%
SAP	104,996	11.2	1.4%	13.2%	5.9%
Sub sector (weighted average)		***11.4***	**4.5%**	**10.0%**	**20.1%**

Source: Infinancials, Capiq. Prices at 20/01/2014.

Macro Outlook

With global GDP growth of 3.7% forecast by the IMF for 2014, credit spreads in debt markets reflecting low global default risk, and cash stockpiles at all time highs, the global environment for corporate investment/M&A appears to be well set for 2014. UK CFO's recently affirmed this with a record 57% maintaining it was a good time to take risk onto their balance sheets with uncertainty at three and a half year lows.

Source: CBOE

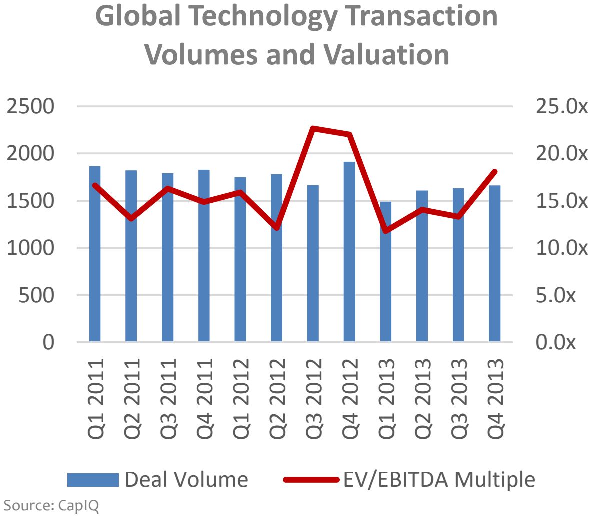
The VIX Volatility Index is a measure of volatility in global equity markets and as such is reflective of the perceived risk in the market. This in turn provides the backdrop for lending conditions. 2013 has seen a return to the benign volatility of the early 2000's suggesting a positive economic backdrop for corporate activity. Volatility has decreased 21% during 2013 as global default risk has subsided.

As CEOs and CFOs become increasingly willing to augment their risk appetite, the release of excess capital and the desire to penetrate new markets will serve to drive the dynamics that underpin momentum in the technology M&A markets. In the UK, the Bank of England recently upgraded its 2014 growth forecast from 2.8% to 3.4%. Q4 2014 GDP growth is forecast at close to pre-recession levels.

From a technology perspective, we would argue that investment in an open ended or disruptive technology will always be considered irrespective of the macro environment. While true, we are entering 2014 on the back of positive deal momentum in the fourth quarter of 2013 with accelerating economic growth. Vertical and horizontal integration, lifecycle management solutions, migration to cloud services, smart mobility, security solutions, Software Defined Anything (SDx) all underpin the relentless drive for efficiency and return on investment (ROI). Additionally, differential growth rates between the UK and mainland Europe, where high unemployment and structural deficits in the latter continue to act as a drag on economic growth, may make the UK a more attractive proposition for inward technology investment.

Transaction Activity

Globally, technology M&A by value increased 31% to $238bn in 2013, whilst average deal sizes rose 73% to $270m *(Source: 451 Group, Gambit Corporate Finance)*. To some extent this number is flattered by several large transactions, with the absolute number of transactions actually decreasing 11%. However, increasing confidence, cash rich corporates and an increased appetite for risk provide a healthy backdrop for activity in 2014. While quoted company valuations are towards the upper end of their cyclical range, technology companies with competitive advantage, scalable business models and strong management will continue to see strong interest.



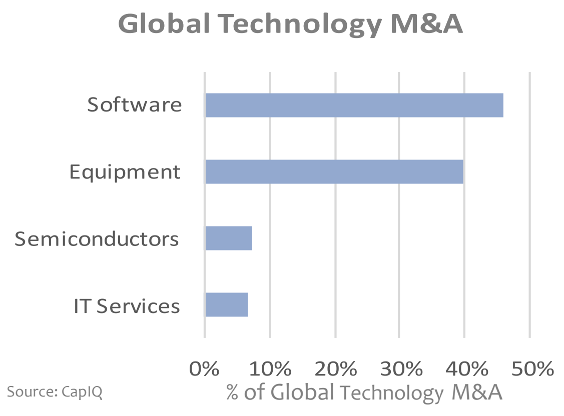
Source: CapIQ

Global technology transaction valuation multiples displayed a significant improvement during the last three quarters of 2013, increasing from 13.3 to 18.1, with stable transaction volumes.

In 2013, more than 85% of global transactions took place in the sub-$100m space, whilst cross border transactions represented 48% of all UK M&A. The UK remains the main European country in terms of buy-side activity accounting for 26% of deals announced in 2013. US buyers into Europe were relatively cautious in H1 2013 but accelerated activities in H2 2013 representing 12% of transactions for the full year.

Underpinned by a positive macro economic background, decreasing volatility and conducive global capital markets, the outlook for 2014 remains extremely positive. A sizeable element of M&A activity over the course of the last three years has related to the acquisition of under-value assets or divesting non-core business. We expect 2014 to be a year where strategic transactions dominate.

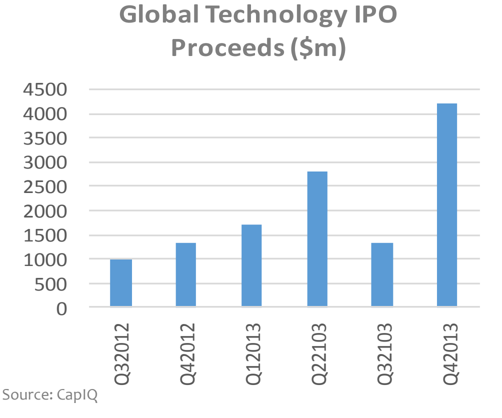
Technology M&A continues to be driven by convergence, smart mobility, wireless, cloud, social networking and business intelligence/analytics. Open ended and scalable technologies, whether as an application platform, service offering or disruptive new technology will continue to govern the mindset of the acquisitive landscape. The ubiquity of the cloud is now an embedded technology theme. Low cost of ownership, high ROI and faster time to market are compelling themes .



Sub-sector M&A trends demonstrate that software, with 46% of reported global transactions, remains the area of highest activity. Equipment is boosted by the inclusion of the Silver Lake-Dell LBO, without which software would constitute >70% of all M&A in 2013. Within software, cloud computing/SaaS and healthcare technologies have remained areas of focus, whilst other underlying trends such as big data analytics continue to drive premium valuations. IT Services has seen large scale global consolidation in recent years, the extension of managed services and territorial footprint will continue to drive activity in the data centre and hosted markets, particularly as SaaS, PaaS and IaaS moves towards mainstream adoption.

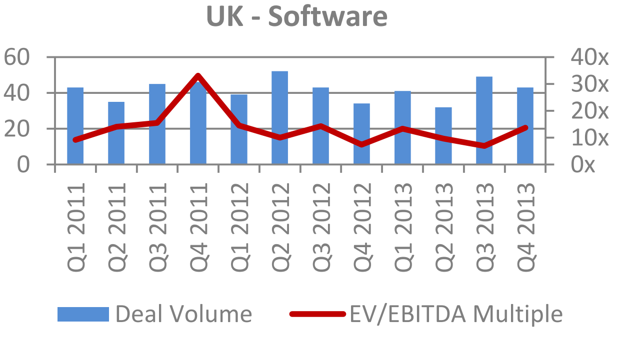
The appetite for IPOs increased considerably as the year progressed with the EMEA region accounting for 267 of the global total. A recovery in consumer confidence, conducive global monetary conditions, a reduction in volatility and easing political uncertainty led to a strong Q4 2013 for the IPO market.

Q4 2013 saw a substantial uplift in technology IPO's in the UK with the likes of Servelec, Arria and JQW all enjoying successful listings. Indications for Q1 2014 remain positive with a range of forecasters anticipating around 300 IPO's globally representing a year-on-year increase of >90%.



Software

Uninvested funds at global private equity houses and cash held by corporates remains at historic highs. It is estimated that at the end of 2013 the Top 25 global technology firms were sitting on approximately $780bn of cash and equivalents with private equity at around $715 billion. Worldwide PE investments in 2013 were $636bn, an increase of 13% on 2012, reflecting their focus on deploying this capital as economic conditions have improved. Deal activity in Europe gathered substantial momentum with deal activity and capital invested up 18% and 52% respectively. The technology/IT component of private equity investment was 18% of the total representing global PE investment in the sector of $114bn in 2013. The UK lower mid-market (enterprise values between £10 million to £100 million) was resurgent in H2 2013, with deal values at their highest half year level since 2008.



In the UK Software sub-sector deal volumes increased 43% year-on-year in H2 2013. Cross border acquisitions represented 38% in H2 2013. Q4 2013 saw 43 transactions in UK software with a mean EV/EBITDA of 13.6x for disclosed deals. Across Europe internet services, principally e-retailing, has seen the greatest increase in M&A volumes over the course of the year with a 23% increase continuing the trend of 2012.

Globally reported software transaction valuations rose 12% during 2013, with median EV/EBITDA multiples in the sector averaging 17.0x during the period. The positive market backdrop in Q4 2013 provided further momentum to valuations with Q4 2013 EV/EBITDA valuations for the 482 software transactions being 19.1x.

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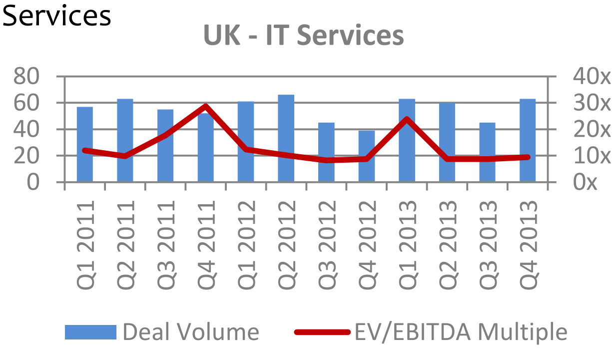
Services



In the services sub-sector, median global EBITDA valuations increased marginally ahead of software, by 14% to 14.8x in 2013 with the UK on average achieving median multiples of 11.5x during the period.

Capita plc utilised its £290m 2012 fund-raising to further enable its expansion into managed services through the acquisition of Northgate Managed Services and iQoR in the BPO space. CEOs are increasingly placing cloud services and virtualisation towards the top of their agendas. The build out of infrastructure to provide cloud services will continue in 2014, with smaller players increasing capacity whilst large software vendors and telcos increasingly enter this market to extend their service offering.

Creating specialist market leaders in UK IT

Simon Hitchcock
Partner, Lyceum Capital

The pace of technological advancement and the corporate flight to efficiency in leaner times have seen the UK software and IT infrastructure industries change dramatically over the past 4 years. The days of simply selling licences and delivering high volumes of hardware, with little emphasis on service development and cost of ownership, ended prior to the downturn. Providers are being challenged to deliver more value than ever before, in terms of technology, integration, true consultancy and, most importantly, identifiable efficiencies. One size no longer fits all.

Significant organic growth in sales is increasingly hard to achieve for IT businesses without a clear focus on innovation and delivery. This naturally creates an opportunity for smaller independent players to punch above their weight in specific vertical markets or new technology segments – particularly when selling in to the UK mid-market, where a large amount of IT investment is being made as corporates in all sectors seek to give themselves a competitive edge and reduce costs.

Both the software and managed services sectors continue to deliver strong growth and expansion expectations at technology companies are well above the UK private sector average, according to most market observers. Many lucrative and growing sub-sectors of software and managed services also remain highly fragmented, with firms operating in these markets developing their own valuable intellectual property. In many cases, the ingredients these high-growth, mid-sized businesses need are growth finance – which could be for acquisitions, investment in R&D, geographical expansion or the development of technologies in adjacent markets – and additional strategic guidance to realise their full potential and shareholder value.

Private equity firms active in the technology market continue to provide the sector knowledge and buy-and-build expertise to create market leaders in fragmented subsectors of UK IT. Lyceum has been particularly active in recent years, backing business management and accounting software provider Access Technology Group, global digital security software company Clearswift, Infrastructure-as-a-Service supplier Adapt and most recently Isotrak an enterprise fleet management solution provider. Continued organic investment in development and selected acquisitions are both important pillars in each company's growth strategy. In a buy-and-build investment strategy, private equity investors work with management to target strategic bolt-ons that will deliver long-term value through complementary technology and skills, with additional benefits such as the transfer and acquisition of new client contracts, and geographical and service line growth.

Business valuations are gradually rising in the UK IT sector, especially for larger assets that have critical mass. This is a result of improving economic conditions and the premium placed on protected, innovative new technology. Buy-and-build strategies create larger assets that become strategic acquisition targets. Strategic purchasers are also impacting company valuations; trade buyers are competing with private equity-backed buy-and-build businesses, which both commonly have compelling reasons to outbid rivals for assets. This will be a growing theme during 2014 as large corporates increase investment during the recovery.

The enduring characteristic of private equity houses in the UK software and managed services industries will be their focus on backing companies to make bolt-on acquisitions which primarily reinforce existing specialisms, broaden their technological capabilities or apply applications or services in high growth sectors. Scale remains important, but it is a secondary consideration to a clear strategic focus and commercial rationale. Lessons learnt during the recession have made for a healthier, more considered approach to investment in the sector which is creating sustainable market leaders which deliver value to benefit shareholders, customers, employees and the economy as a whole.

Simon Hitchcock is a Partner at Lyceum Capital and Non-Executive Director of Adapt

Contact us:

Gambit has a dedicated IT team with a significant track record in the sector. We have deep relationships with investors, vendors and acquirers in the sector. We understand the key issues and trends that drive M&A activity in the sector and how our clients' businesses are affected.

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Gambit Corporate Finance LLP

Established in 1992, Gambit is an independent corporate finance advisory firm specialising in advising private and public companies on mid-market transactions in the UK and overseas. Gambit is widely recognised as a market leader in M&A advice in the IT industry having built up detailed industry knowledge and an enviable track record in deal origination and execution.

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