M&A Market Review
Information Technology

Q4 2014

Content Summary:

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Key Observations	Significant levels of funding remain available within the IT sector from both private equity and acquisitive corporates. US leverage multiples have increased significantly, which allied with the current strength of the dollar, makes the UK attractive to US acquirers. UK businesses contemplating an exit should consider the current market as providing significant opportunities. Private equity's ability to fund software companies' transition from licence model to SaaS represents a significant market opportunity.
Industry Overview	Global equity markets experienced significant volatility in Q4 as a result of continued concern on certain European economies, albeit that the US economy finished the year strongly. Amongst the global macroeconomic uncertainty, IT companies were generally resilient. Transaction data also reveals an upward trajectory of valuation multiples for the technology sector, reaching their highest levels in over a decade.
Feature Article	1) 2015 – A pivotal year for Private Equity? 2) "Web-scale" cloud - the next phase of Cloud adoption? *Justin Lewis, Founder Director at Skybrid* 3) Cyber Security: "It's An IT Issue": Don't Blame Them. Train Them. Grasp the Market Advantage. *Brian Lord, Managing Director at PGI Cyber*
UK Cross-border M&A	We identify key countries participating in UK incoming and outgoing IT cross-border M&A activity.
Public Comparables	Companies tracked by Gambit outperformed the FTSE All-Share by 6.1%. Greater volatility in UK equities due to falling oil prices explain the limited growth (+0.1%) in the FTSE-All Share over 2014.

Key Observations From Q4 2014:

- Global Tech M&A closed an impressive 2014, with transaction values 34% ahead of 2013 ($63 billion).
- Improved US leverage multiples and an appreciating US dollar provide a significant opportunity for acquisitive US corporates. US buyers accounted for 58% of incoming cross-border transactions in 2014 confirming this trend.
- Stock market volatility for small-cap companies and the reduction in the number of IPO's has created an opportunity for private equity to back public-to-private (P2P) transactions. Private equity have also identified a means of gaining exposure to SaaS companies at lower entry multiples through funding the working capital requirements of a licence-to-SaaS transition.
- UK IT Software: EV/EBITDA levels in the sector have continued to rise. Valuations are likely to remain buoyant as large corporates seek to strategically acquire software developers rather than develop capabilities in-house.
- UK IT Services: Transaction volumes in Q4 matched those observed in Q3, signalling a continuing momentum within the IT services M&A market. A doubling in average deal values between Q3 and Q4 in conjunction with steady EV/EBITDA multiples also indicate an increasing number of larger corporates are coming to market.
- Strategic buyers are taking advantage of improved liquidity to acquire quality assets, whilst a number of high profile exits from financial buyers are giving investors the confidence to reinvest further in the IT markets.
- Despite a sluggish European and French economy, French IT companies were the most active European cross-border acquirers and sellers of UK IT investments.
- Well-positioned and scalable companies will achieve high valuations as a result of increased risk appetite and ongoing flight-to-quality. This is supported by the growing competition between PE and cash rich corporates for quality assets as sellers are increasingly moving to a dual track process in order to ensure the best value for their business.

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

- ***To sell:*** With valuations at their highest level in a decade and volumes stabilised, combined with a greater level of funding currently available than in recent years, those considering a sale should act now.
- ***Private equity:*** Private equity investors remain focused on the IT sector, given the potential consolidation opportunities in fragmented sub-sectors, with intense competition for quality assets.
- ***Financing:*** The search for yield in a low interest rate environment is driving investors to provide liquidity to mid-market companies. As a result, we can expect strategic and financial acquirers to use improving liquidity for M&A or LBO purposes.

Information Technology Industry Overview

Simon Williams
Director,
Information Technology

Global tech M&A closed an impressive 2014, with transaction values 34% ahead of 2013 ($63 billion). Global equity markets experienced significant volatility in Q4 as a result of continued concern on certain European economies, albeit that the US economy finished the year strongly. In amongst the global macroeconomic uncertainty, IT companies were generally resilient.

The current strength of the M&A market in the US is underpinned by an improved US economy, strong corporate earnings, accessible credit markets with high leverage multiples and record levels of uninvested funds held by both corporates and private equity funds. The availability of credit in the US is providing US corporates with a significant advantage in cross-border acquisitions versus their non-US competitors. This is of specific relevance to the UK economy, as US acquirers accounted for 58% of inbound M&A in the UK over the last 12 months.

Transaction data also reveals an upward trajectory of valuation multiples for the technology sector, reaching their highest levels in over a decade. Buyers have taken advantage of a rapid increase in available credit, with debt leverage multiples in the US having increased nearly 70 percent over the last two years to return to pre-2008 levels. This rapid improvement in US credit conditions has not yet been experienced in Europe.

Whilst the IT sector remains attractive to both private equity and corporates in the mid-market, the latter appeared to hold the advantage for the majority of 2014. However, two specific themes emerged in the latter part of 2014 which provided an advantage to private equity, and we expect to see this continue in 2015.

Firstly, stock market volatility for small-cap companies and the reduction in the number of IPO's has created an opportunity for private equity to back public-to-private (P2P) transactions. This includes HgCapital bidding to acquire Allocate Software, and Vista Equity acquiring ACS. A number of software transactions have been undertaken by private equity investors in recent months at low teens multiples for quality assets, and there are a number of listed software companies trading at similar levels (EV/EBITDA 10-11x).

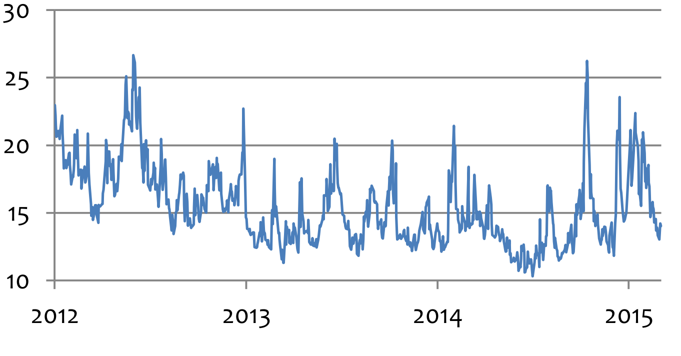
Secondly, private equity has identified a means of gaining exposure to SaaS companies without having to pay stratospheric entry multiples, especially as SaaS adoption accelerates. Private equity can back established software companies to transition from a traditional licence to a SaaS model, funding the working capital requirement, and allowing them to buy into a SaaS model at a lower valuation. This SaaS strategy can be combined with a P2P, whereby the transition can be undertaken in a flexible way without having the reporting exposure inherent in a listed company. This is another aspect of the rationale for Vista acquisition of ACS.

Gambit's view is that the M&A transaction activity and robust valuations in the IT sector will continue during 2015. Whilst strategic opportunities will always remain key, whether that is to create a new platform, consolidate a fragmented segment or support disruptive technology, availability of funding remains robust. Improved US leverage multiples provide a significant opportunity for acquisitive US corporates, mid-market private equity appears to have gained recent momentum and lower mid-market private equity remains a very active investor in the IT sector, supporting high growth and innovative companies.

Macro Outlook

After a number of years of sluggish performance, the UK economy appears to be heading in the right direction. Economic growth remained strong in the fourth quarter with real GDP rising by 0.5% following 0.8% in Q3, whilst the Q4 year-on-year growth rate was 2.7%. However, inflation fell dramatically in Q4 reaching 0.5%, (and has decreased to zero in February 2015) a consequence of the sudden slump in energy and raw material prices combined with sterling strengthening versus the euro. Furthermore, the VIX index – a measure of market equity volatility – reached a high of 26.25 in October as markets reacted against falling oil prices, the rapid spread of Ebola and the IMF's third revised forecast for world economic growth.

VIX Volatility Index



The ECB's decision to conduct quantitative easing, a programme instigating the monthly purchase of 60 billion euros worth of European sovereign bonds, should provide a much needed economic stimulus to the UK's largest trading partner resulting in increasing domestic demand, inflation and credit growth. However, with government bonds delivering a negative yield there is a potential danger that investors believe the Eurozone is entering a "lost decade", as deflation remains a key threat to the region.

Transaction Activity

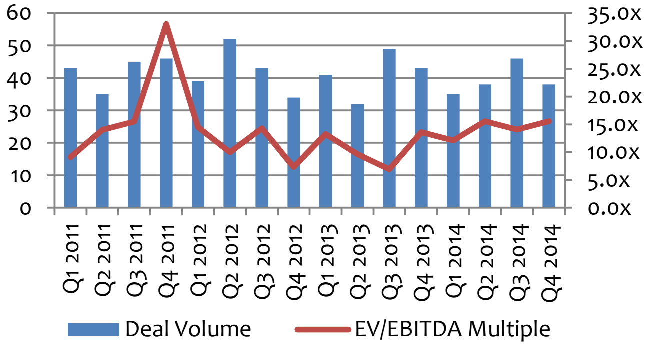
As ever the UK tech sector has been a key driver of global M&A activity. Q4 2014 saw 983 global deals, a 22.2% increase since June 2014. With rising business confidence and the continuing strength of the debt market we have confidence that M&A activity will strengthen into 2015 across the Information Technology sector. Potential sellers may find that now is a very good time to consider going to market. Innovation continues to drive the deal market with companies willing to pay high premiums in order to access areas they perceive as high growth.

Software

UK Software deal activity decreased by 16% between Q3 and Q4 to similar levels of deal activity in Q2 (38 deals).

Valuations continue to climb steadily upwards, increasing by 9.6% since Q3 and 12.7% year-on-year.

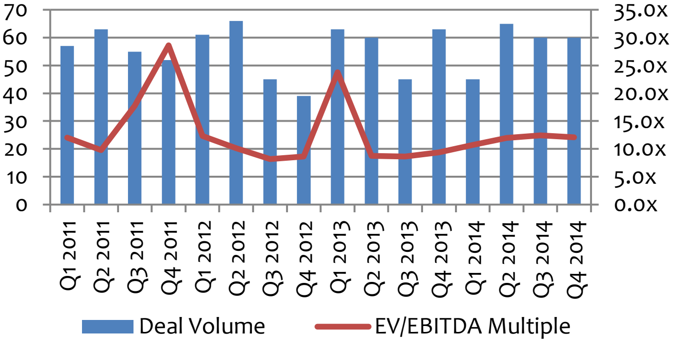
Valuations are likely to remain buoyant as large corporates seek to strategically acquire software developers rather than develop capabilities in-house in order to remain competitive, as seen with SS&C Technologies Holdings' (NYSE) acquisition of DST Global Solutions.



Services

IT Services transaction volumes in Q4 matched those observed in Q3 (60 deals), signalling a continuing momentum within the IT services M&A market. A doubling in average deal values between Q3 and Q4 to £130m in conjunction with steady EV/EBITDA multiples also indicate an increasing number of larger corporates are coming to market.

Strategic buyers are taking advantage of improved liquidity to acquire quality assets, whilst a number of high profile exits from financial buyers such as YFM Equity Partners' sale of Aconite Technology ($101.9m), are giving investors the confidence to reinvest further in the IT services market.



2015 – A pivotal year for Private Equity?

The fourth quarter marked a standout period for Private Equity (PE) activity, with seven deals completed by companies valued at an aggregate £3.2bn – the highest since 2009. This mixed with the re-awakening in Public-to-Private activity has made PE a key focus point for commentators and industry players operating in the software space. We therefore outline five key drivers of UK private equity M&A activity in this sector:

1. **SaaS Transition** – The SaaS market is rapidly expanding as increasing numbers of individuals move to "the cloud", generating high multiples for companies operating in the space. However, the SaaS business model has been a major barrier to software companies adopting this model due to its significant negative impact on working capital initially. This scenario presents PE with a lucrative opportunity as they agree to fund the working capital requirements for established firms transitioning to a SaaS model yet do so at a much lower entry multiple. With improved certainty of the SaaS business model (high long-term profitability) and superior exit valuations of SaaS companies, this is likely to drive further PE backed/ P2P SaaS investments in the coming months.

2. **Substantial cash reserves** – Years of conservative investment during the recession and recent quantitative easing programmes in North America and Europe have resulted in record levels of PE cash reserves globally ($1.19tn). With a number of PE funds nearing maturity and investors applying increasing pressure on fund managers to invest, greater availability of capital combined with inflating asset prices are only likely to force private equity to invest more in 2015 in a period of historically high multiples.

3. **Foreign buyers** – Gambit's analysis in Q4 shows that 50% of PE backed IT transactions came from overseas buyers illustrating that UK businesses are an increasingly attractive option for foreign investors. An appreciating US dollar will continue to fuel this trend as North American buyers look to take advantage of currency tailwinds to pursue cross-border M&A, competing strongly on valuations. With US acquirers accounting for 58% of inbound M&A in the UK in 2014, this trend is likely to continue in 2015.

4. **Clear Exit Strategy** – Whilst stock market volatility due to large macro events has reduced the potential for an IPO exit, the strong fundamentals of IT companies have meant that private equity investors are able to realise solid returns via a sale to trade buyers, these often being cash rich traditional software companies seeking an entry to the SaaS market.

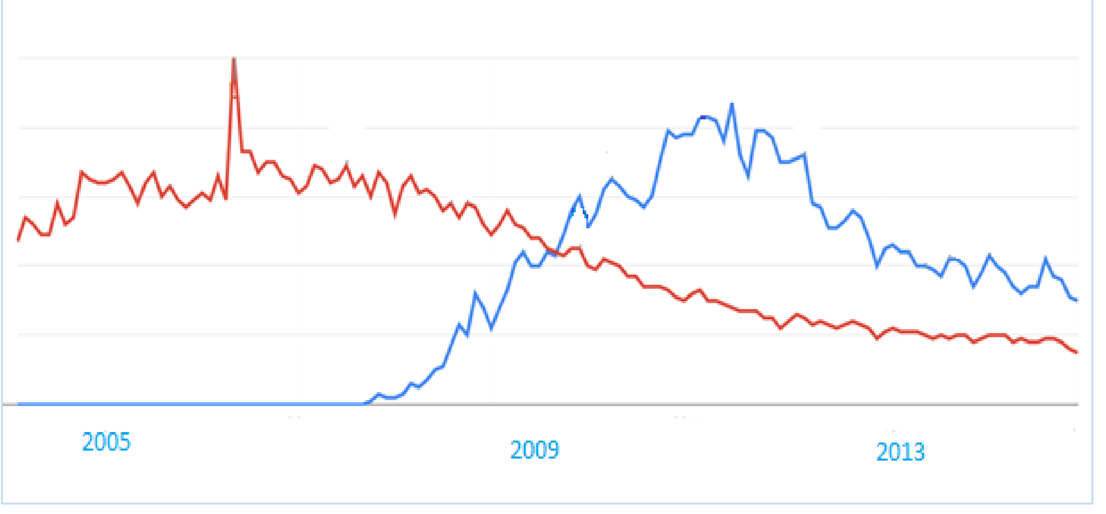
5. **Increasing leverage** – The search for yield in a low interest rate environment is driving investors to provide liquidity to mid-market companies. As a result, we can expect PE to optimise investor returns via M&A or LBO in 2015.

"Web-scale" cloud - the next phase of Cloud adoption

Justin Lewis
Founder Director, Skybrid

"Cloud" is no longer an IT buzzword, as the various forms of "Cloud Services" are increasingly well understood. The graph shows when the search term "Cloud Computing" (the blue line) started getting queried via Google, hitting a peak around 2011. The red line of the graph shows the profile of search for an earlier technology "Virtual Server".

Both search profiles are now similar, as you would expect, as "Virtual Servers" underpinned the initial implementation of "Cloud"-like infrastructure services. Only a few years ago internal IT departments adopted virtual servers to gain the benefit of increased utilisation of hardware and some additional capabilities, in some cases coining the term "Internal Cloud". Hosting and Managed services companies began providing commercial versions usually called "Private Cloud", using a similar approach.



The next major shift is underway to "Web-scale" Public Cloud infrastructure providers – "true cloud" computing offering almost unlimited capacity, charge by the hour (or less) and instant availability. Amazon Web Services (AWS) and Microsoft Azure are the two leading players. The acceptance of virtualisation was rapid - the shift to these platforms is happening just as quickly. In larger organisations the shift is in full flight. Start up businesses already implement "cloud first" strategies for their email, file sharing, and applications. In the mid-market and government, uptake has been slower but this is changing as pressure intensifies for cost reduction and increased agility, and awareness has generally increased.

"[Enterprise customers are] skipping the years of early getting-their-feet-wet, and immediately jumping in with more significant projects, with more ambitious goals…" (Gartner).

Amazon Web Services, the market leader in Public Cloud (with 7 times the capacity of their fourteen nearest competitors combined), has a scale that has already turned IT infrastructure into a commodity. Their initial offering was a storage platform, launched in 2006. By 2012 this service held over 2 trillion objects. Their compute capacity can scale from a few servers to thousands of servers within hours, paid for by the hour used. No "Private Cloud" could provide this level of scalability and agility with the same cost profile. The vision in the future is infrastructure as code, with no servers to actively manage. It is already possible to run code directly in the Cloud and to scale capacity up and down as demand changes, and to automatically deal with failures – this is the standard approach for companies in the web/mobile apps business.

How do companies with more traditional business requirements and organically grown IT estates begin to benefit from these new models? A clear strategy, agreed at business level, is key – with rapid proof of concept work a priority to clarify the strategic objectives and business case. Time has to be set-aside for both IT and business leaders to immerse themselves in the range of Cloud services available, to gain a better understanding of the huge advantages the Cloud will provide, and to understand "the Cloud" is far from marketing hype.

There is no silver bullet to adoption as a Cloud Strategy leads to business change – whether a business is moving to a Cloud infrastructure or taking Software as a Service solutions (or more likely doing both). In the next few years the standard will be for companies to take a rich hybrid range of cloud services, from multiple providers, to gain the maximum benefit. They will also need to maintain legacy infrastructures as transitions take place, potentially putting more strain on the IT departments in the interim. There are complexities in moving to and managing this new service delivery approach, many IT processes will be challenged, and "old style" managed service providers will no longer be able to gain rich fees for offering little value-add on fixed infrastructures. But adoption of web-scale cloud within a business will be validated when events like "Black Friday" occur – for the first time the CEO will be confident the web site and ordering systems will be able to keep up, whatever the demand.

"It's An IT Issue": Don't Blame Them. Train Them. Grasp the Market Advantage

Brian Lord
Managing Director, PGI Cyber

When hostile activity leads to a data breach or affects data processing systems, where do roads lead and fingers point when explanations and even accountability is sought? Most IT managers or systems engineers or IT outsourcers or IT providers can answer that question. And as Boards, training departments and general users continue to wrestle with the challenge of understanding the breadth of the digital security threat - and their own role and accountabilities in managing the risk - the default position of "it's an IT issue" will remain prevalent. As long as "it's an IT issue" remains a convenient (albeit unsustainable) comfort blanket, the natural assumption is that your IT provider, supplier or workforce actually understands IT Security to the extent necessary to protect data and systems against most threats.

When an analysis is undertaken amongst IT workforces, or IT outsourcers, or even IT systems providers and developers and engineers to find out how many of them have recent recognised training in relevant aspects of IT Security, our clients are horrified; not just at the scarcity of such knowledge and skills but also at the dawning realisation that they are unreasonably holding people accountable for something they are not trained to counter, or encouraged to learn, or have ever been contractually stipulated to provide.

Technology advancements are the greatest business enablers of our age. Business models rightly demand it, our ability to operate is wholly dependent upon it and it is a pre-requisite of commercial advantage and modern customer service. Inevitably, priority lies in speed of IT delivery, system availability, data accessibility/usability and operational cost-efficiency. Since company commercial reputation depends upon it, those are the considerations on which the supporting IT community is routinely judged.

When data security breaches happen, or when digital security is raised; then often IT Security salesmen or consultants proceed to pull apart the design, integration, configuration, administration and maintenance of the systems concerned. Systems were built not only with the primary considerations of usability, accessibility, cost-efficiency and speed in mind, but also with no demand, or contractual stipulation, of meaningful security measures. They were built by professionals who had no recognised training in these areas. These consultants make recommendations that involve retrofitting procedural or technical security into a system for which it was never designed, often with disregard for the effect it will have on the subsequent accessibility, usability, maintenance or efficiency on the system upon which the company relies. The result; unhelpful tension, opprobrium and defensiveness leading to a sub-optimal solution all round.

Whilst a more empathetic relationship between the IT community and the IT Security consultants always helps; the gap is not a sustainable one. Reliance upon technology is a way of life and demands for security of digital data and operational processes are growing daily and rapidly becoming market differentiators. Therefore, normalising both the threat and the risk mitigation must happen quickly.

"...consultants make recommendations that involve retrofitting procedural or technical security into a system for which it was never designed, often with disregard for the effect it will have on the subsequent accessibility, usability, maintenance or efficiency on the system upon which the company relies".

Demonstrable security measures are becoming compulsory in the public sector supply chain. Large organisations are starting to demand it in their supply chain too. Consumers and clients are increasingly demanding assurances around their data held by third parties. Regulatory bodies, legislation and insurance policies are setting minimum security criteria. This trend is increasing.

An IT product provider or outsourced IT service provider has an increasingly significant market advantage if they can demonstrate recognised, accredited training of their staff in basic contemporary IT security. Moreover, mainstream company clients and consumers are looking for such assurances before buying services or awarding contracts.

"Insurance premiums and risks of regulatory fines can be reduced and, most importantly the likelihood of a company incurring the large end-to-end costs of data breaches can be slashed. The gain to the company massively outweighs the training costs incurred".

Continued Next Page

Managing digital security risk is reliant on people, procedures and technology. Boards and workforce users increasingly understanding their roles and responsibilities in mitigating this risk. Therefore training IT staff is not the sole solution to the digital security challenge, it is a non-discretionary component.

"Managing digital security risk is reliant on people, procedures and technology".

The IT community needs to integrate a deeper understanding of contemporary IT security within their day-to-day work. A system that is designed, built, maintained, upgraded and administered with inbuilt seamless security considerations will be more commercially efficient than one with retrofitted security solutions imposed by others. A complete collective of boards, IT staff and users trained to, and operating to, appropriate levels reduces a company's risk by around 80%. And for many companies, particularly SMEs, the risk is reduced by more than that.

UK Cross-Border Activity 2014 IT Services & Software

	Outgoing cross-border transactions	
1	United States	42.1%
2	France	7.5%
3	Netherlands	6.5%
4	Germany	6.5%
5	Denmark	4.7%
	Total No. Transactions	**107**

	Incoming cross-border transactions	
1	United States	57.7%
2	France	12.4%
3	Canada	7.2%
4	Ireland	5.2%
5	Germany	3.1%
	Total No. Transactions	**97**

IT Public Company Comparables			Share Price Changes		
	Enterprise Value (£m)	EV/EBITDA	3 months	6 months	12 months
FTSE All-Share			**0.1%**	**(1.8%)**	**(2.1%)**
S&P Global 1200 IT Index			**4.1%**	**6.7%**	**14.2%**
Gambit IT Index			**6.2%**	**10.3%**	**16.1%**
Datacentre/Managed Hosting					
Equinix	10,321	14.5	6.7%	7.9%	31.0%
Iomart	201	8.6	(22.8%)	(23.7%)	(33.1%)
Rackspace	4,190	11.0	43.8%	39.1%	22.4%
Telecity	1,913	11.6	7.6%	6.7%	9.8%
Sub-sector (weighted average)		**13.0**	**17.8%**	**16.9%**	**25.1%**
Consultants/Infrastructure					
Accenture	33,804	11.4	9.8%	10.5%	8.6%
Computacenter	774	6.5	(6.9%)	(2.1%)	(8.1%)
Cap Gemini	7,442	8.3	4.7%	14.2%	21.1%
CGI Group	8,236	8.3	0.8%	7.6%	14.0%
CSC	6,378	5.2	3.1%	(0.2%)	12.8%
Cognizant	17,792	12.9	17.6%	7.7%	4.3%
Hewlett Packard	50,968	5.9	13.1%	19.2%	43.4%
IBM	125,344	8.2	(1.4%)	3.2%	(0.3%)
Infosys	20,505	15.2	5.2%	21.0%	13.0%
Phoenix IT	167	5.6	17.2%	50.7%	(0.2%)
Tietoenator	1,269	9.1	8.2%	(0.9%)	28.8%
Sub-sector (weighted average)		**8.3**	**5.5%**	**9.6%**	**12.3%**
Software					
Dassault	9,362	15.3	0.2%	8.4%	12.9%
Micro Focus	2,515	22.4	1.9%	24.4%	40.6%
Microsoft	206,274	10.9	0.2%	11.4%	24.6%
Oracle	88,704	7.7	17.5%	11.0%	18.4%
Red Hat	7,854	29.1	23.1%	25.1%	23.4%
SAP	56,942	11.8	1.6%	3.3%	(6.5%)
Sub-sector (weighted average)		**10.3**	**6.2%**	**10.4%**	**18.2%**

Source: CapIQ

"Gambit's Global IT Index outperformed the S&P Global IT 1200 Index by 2.1% in Q4"

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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Our team would be delighted to meet with you to discuss our experiences in the sector and to answer any questions you may have on the current M&A market.

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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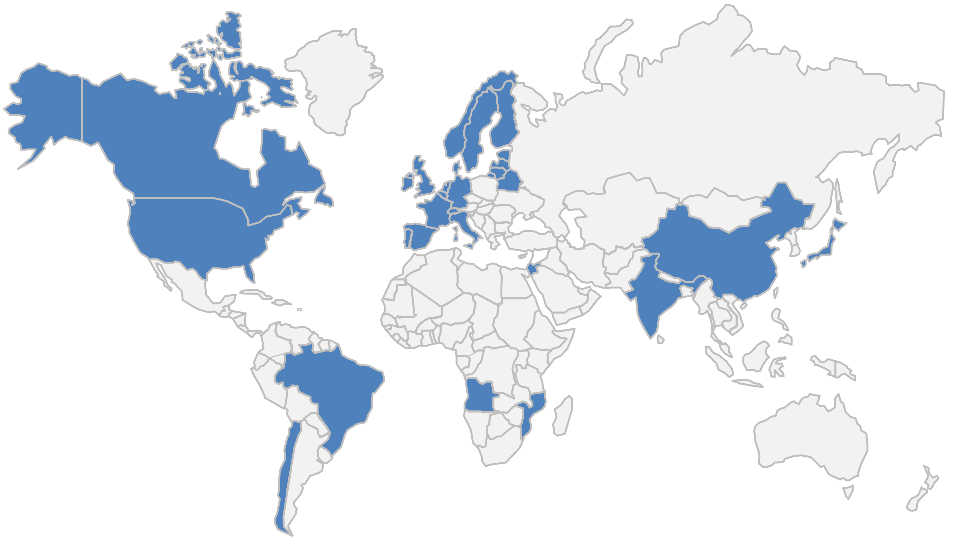

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