

2005: Seismic shift in the UK ISP sector: “the ISP is dead, long live the ISP”

A look back at Mergers and Acquisitions (“M&A”) in a most peculiar year and a look forward to 2006

January 2006: Following on a relatively uncomplicated 2004, ISPs – i.e. companies primarily offering relatively straightforward internet connectivity – grew, merged, sold out or went public. Of the top thirty UK ISPs, seven were acquired by competitors in the year. One would have anticipated that 2005 would be expected to show more of the same but even early in the year, one business driver – the ability to offer surf and talk packages – was already setting the tone for the developments and competition to come. The Carphone Warehouse owned *TalkTalk*, which was only established in 2003, opened the year as probably the fastest growing business in the ISP sector thanks to its talk and surf package and strong general market position. It has just ended the year as the fastest growing alternative to *BT* and the third largest provider of fixed-line telephony (the cable companies being in second place) in the country.

In last year's review we reported that the UK's ISP sector was in major transformation but we had no idea of the seismic shifts to come. These shifts were produced by natural consolidation, triple and quadruple plays, major tier two telecommunication businesses put up for sale, and the continued evolutionary expansion of the sector further into hosting services. Seismic change indeed! As 2006 begins, the days of the large ISP offering solely internet connectivity are already gone. What might happen in 2006? We provide our outlook later in this review.

Quarter one: smallcos eaten by slightly bigger companies: From an M&A perspective January followed the pattern of 2004 although none of the larger players made any acquisitions in the first quarter. *Mistral Internet*, one of the few mid-size independent non-quoted ISPs, bought two businesses. Firstly it acquired *Astra Associates* and then they acquired the assets and customer base of managed services company *Keybridge*, a subsidiary of *Global Switch*. No financial details of these deals were released but these additions increased the Buyer's staff to around 90 people. Also in January the national press speculated that public companies, *Easynet* and *Pipex* would announce a tie-up but this proved to be well off the mark. February opened with *Mistral Internet* again announcing another acquisition. This time it was Basingstoke-based *NetKonec*, a business founded 1994 and described as supplying a number of telecoms and internet services and working closely with a network of resellers. *NetKonec* claimed around 3,000 business partners and reached a turnover of around £3.5 million in 2004. As with *Mistral's* two earlier deals while no financial details were published it was stated that the enlarged group was expecting revenues of £18-20 million for the year. Soon after *186k*, a Leeds based ISP business, bought another northern-based small business, *Elite Internet Services*. *Elite* was primarily a business-focused ISP and operated other brands including *ISPISP*, *Freedom Names* and *VISPWEB* which have a claimed combined user base of around 500,000 including dial-up and hosting customers. And, as with most small acquisitions by private companies, no financial details were released. Later, *186K* announced that it had acquired 200 VISP's from the UK operation of *Tiscali*.

Quarter two: bigger names enter the fray but no large deals completed: *One.Tel*, (then part of *Centrica*, was the first larger company to make an acquisition and for this we had to wait for April when it paid £5 million cash for *RedNet Ltd*, a privately owned business-to-business ISP mainly serving the SME market. Later that month another well known name, *Pipex Communications*, acquired *Donhost*, a hosting and domain name business, to expand its hosting capabilities and provide a reseller-based solution. *Donhost* had 92,000 end customers for hosting services and 120,000 domain names which took the total number of domain name registrations for the *Pipex* group to over one million. Late in May we saw *Telefónica UK* sold to *Netservices*. No financial details were disclosed but the company stated the transaction would increase turnover at *Netservices* by £20 million over the next fifteen months. The quarter's activities ended in late June when another small transaction was completed when *Namesco Limited* bought *NDO Limited*.

Quarter three: sector goes on vacation but someone has to stay at home: July and August proved to be an M&A summer holiday for most of the sector, however, *Cable and Wireless* proved the exception by announcing a £600 million acquisition of *Energis* then claiming the combined business to be the second largest fixed line provider after *BT*. At the other end of the scale, *186k* made another acquisition by buying *Mailbox Internet*. Not surprisingly financial details were not disclosed, yet many reports indicated the price was close to £2 million. *Mailbox Internet* claimed 10,000 broadband business users in London and the South East. Also in July *Claranet* completed its purchase from *VIA NET.WORKS* of the *Amen Group* and *VIA* operations in the Netherlands, Portugal and the USA for \$9.3 million in cash. *Claranet* announced it now had 180,000 business customers and €120m in revenues, making it the largest private B2B ISP in Europe.

Quarter four: seismic change coming and hanging threads: The sector obviously needed its summer rest so that the larger companies, particularly the second tier telecommunications companies who all have interests in ISP sector, had the energy to enter centre stage. After rumours of approaches and talks throughout the year, in September *Centrica* confirmed its plans to sell of *One.Tel*. With around 1,500,000 fixed line customers, this would be a worthwhile acquisition for the right buyer and strengthen the buyer's position in a number of competitive telecommunications battles including internet connectivity, VoIP and the triple and quadruple plays. Also in September, *Namesco Limited* bought *Simply.com Limited* for £2.15 million in an all cash deal.

Mid-October saw *Pipex Communications* announce the acquisition of *Freedom to Surf plc*, the internet service provider, and *Freedom to Surf Consumer Services Ltd* (collectively "F2S") for a cash consideration of £10 million. *F2S* had 40,000 broadband customers at the end of September 2005 and with that *Pipex Communications* became the fifth largest broadband DSL provider in the UK. *F2S* was reported as profitable and cash generative with unaudited, turnover of £7.2 million for the year ended December 2004. A week later, the seismic theme continued with the surprising announcement that *BSkyB* has agreed to spend £211 million to acquire *Easynet* in a deal that would take the satellite broadcaster into the UK's telecommunications sector; a significant triple play – television, telephone and internet – proposition. With *Easynet* being a leading local loop unbundling ("LLU") ISP at over 230 exchanges already, *BskyB* became a rival to both the cable companies – the currently merging *NTL* and *Telewest* – and *BT*.

Into November and *Kingston Communications* confirmed it had been approached with a bid valuing the group in excess of £400 million and press reports suggested the potential buyer was the US private-equity firm *Carlyle*. *Carlyle* had previously bought a business from *Kingston Communications* – buying its satellite unit in 2004. Acquisition talks are reported to be at an early stage so this is one to look out for in the coming months. Last year, *Kingston Communications* themselves bought the west country-based ISP, *Eclipse Networking Limited*, for an initial consideration of £12.5 million.

Back at the smaller end of the market, *Parbin Limited*, better known by its trading name of *Metronet*, was acquired by *PlusNet*, the well performing AIM listed company since its float in July 2004. This was *Plusnet's* first acquisition and added 16,000 broadband customers to its base. As of March 2005, *Parbin* reported turnover of £2.1m and operating profit of £40,000 for the year.

Still in November *Legend Communications* (formerly *Business Serve*), confirmed "it had entered into preliminary talks which may or may not lead to an offer for the company" and most bets are on the buyer being *Thus* (most likely) or *Pipex communications*. *Thus*, the Glasgow-based telecoms company is reported to be looking for acquisitions after its last-minute attempt to buy *Energis* (see earlier) failed in the summer. *Thus* is also reported to be interested in buying *Your Communications*, a business that has been on the market some time now, from the parent, *United Utilities*. This is another situation to follow during the year.

Moving back to surf and talk brings us to *Homecall*, the *Caldwell Group* business which offers such services. The sale of *Caldwell Communications*, the fixed line telephony

subsidiary, which had been on the market for some time was halted when, in November, *The Cauldwell Group* announced the results of its strategic review which said it was inviting offers for the whole of the business which has a combined turnover of over £2 billion. Yet another situation to monitor as 2006 unfolds.

Could much more happen? It certainly did when, in early December, *Virgin Mobile* confirmed it was in bid talks with *NTL*. This, if it happens, would create a multimedia business to compete directly with *BskyB* and *BT* and be strong in the quadruple play: television, fixed line telephone, broadband and mobile. If successfully achieved, the new business would use the better known brand, *Virgin*.

As if all that wasn't enough action for one year, anyone watching was in for a surprise as the week before Christmas, *Carphone Warehouse* strengthened its position in the residential calls and broadband markets with two acquisitions totaling up to £164.5 million. It bought *One.Tel*, the telecommunications arm of *Centrica* and the British and Irish businesses of Swedish company, *Tele2*. Both of these companies acquired by *Carphone Warehouse* are to be rebranded as *TalkTalk*. Under the terms of the deal, *Carphone Warehouse* will pay £105 million for *One.Tel* plus up to an extra £49 million dependent on *Centrica* recruiting around 700,000 new customers in the next few years through its British Gas operations. It is paying £8.5 million plus £2 million in restructuring costs for *Tele2's* businesses.

Outlook for 2006: Can it possibly be more seismic than what we saw in 2005?

We already know that the *Wanadoo* name, once *Freeserve*, is to be re-branded as *Orange* sometime this year. This will provide the *France Telecom* mobile telephone business a single brand for all mobile, broadband and other converged telecoms services. The re-branding exercise will include *Equant's* fixed line business too. *Orange* should then be neatly positioned for its pre-announced ambitious plans for mobile, broadband, video-on-demand and fixed line services.

There will be much to keep an eye on as the year progresses. Will *Kingston Communications* be bought and will the buyer be *Carlyle*? Will *Legend Internet* go to *Thus* or *Pipex* or neither? And will *Thus* be the buyer of *Your Communications*? *The Cauldwell Group* is a massive opportunity but our guess, if it is sold it will most likely be bought by a financial rather than a strategic buyer. And then there's *Virgin Mobile* and here we believe Richard Branson will eventually agree a deal with *NTL*. One consumer brand not mentioned so far is *IDT's Toucan*? Will they find it a challenging time not being active in this seismic upheaval or will we soon be hearing from them?

And what will be the drivers for 2006? Consolidation is a given and so is convergence especially between voice and telephone in the consumer market. Market opportunity will be there for ISPs and Telcos offering one combined bill and the savings to be had from this for both the customer and supplier. VoIP will become more common as it becomes transparent to the user; we are not far away from the user being unaware whether they are using VoIP or a fixed line connection.

LLU roll out is accelerating and those left behind will find it hard to compete on both pricing and service. Look out for 24 Mb service at prices close to the 2Mb services offered today. Businesses will particularly wish to take advantage of the faster upload speeds becoming available so expect significant competition in that area. And, of course, the higher speeds will make television via the internet accessible which will produce opportunity in its own space and in the wider triple and quadruple plays.

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