



## Market View

### Westchester's UK Experience in 2006

**January 2007:** This is a Westchester-centric view of the small and mid-size Mergers and Acquisition (“M&A”) activity involving UK companies during the last year. It is based on our team’s specific experience and involvement with the market and hence we hope it will resonate with the clients, potential clients, advisors and partners that form the backbone of the community that we serve and with whom we work.

**What’s our weight?** Firstly who are our clients? On the buy-side they are predominantly AIM-listed companies and ambitious private companies. On the sell-side they are for the most part privately owned companies run by a majority shareholder or a team of shareholders. Secondly what have they and we experienced? During 2006 we closed eight transactions and performed two advisory projects. We currently have a dozen or so open mandates at various stages of which two are so new that we are only just beginning them. Taken together, the sell-side forms slightly over two thirds of our projects with a fairly even split between software product and services businesses. Nine have a significant international dimension.

**Quality will tell.** This has been a busy year for us and that suggests that the private company end of the IT software and services sector is doing reasonably well. We found sellers for our buyers and buyers for all our sellers. Companies have the confidence and the motivation to buy or sell, the market is in equilibrium; that is buyers and sellers are agreeing price levels and key terms without too much of a struggle. We note too that for businesses without a “special” factor the advantage is tipped with the buyers but for businesses that do have that quality, for example contracted forward revenues, growing top line, good quality customers, an effective management team or a well developed product on a modern technical platform, the reverse is true.

**Where’s the beef?** The first area we highlight is our robust Financial Technology practice which involves both buy-side and sell-side mandates. We have completed four deals in this sector – three acquisitions and one sale and we are currently engaged on six more, mostly sales. The sector commands strong multiples and both buy and sell sides transactions completed in 2006 showed prices in the range of 2.7-4 times revenues and 10-17 times pre-tax profit. That the latest mandates are all sell-side probably indicates that owners see this is a good time to exit but trade buyers are still recognizing value even at these price levels because of opportunities to improve their product range and generate cross-selling opportunities.

We also observe that service companies are not as highly valued as the product businesses in the Financial Technology sector and we see that as being the probable reason for less M&A activity involving service businesses. We are though noting the increasingly higher values achieved by some service companies from overseas buyers with strong delivery capability (particularly Indian firms) looking to acquire local and vertical domain knowledge combined with access to the market. There is a high level of activity amongst product companies in growth segments as sellers seek access to customers, and buyers look to fill out their product portfolios as a way to grow revenues. Valuations are typically for multiples of revenues and often reflect the opportunity to the buyer.



Another strong area is the Managed Services sector. Here we have been working both with buy-side and sell-side clients (obviously with differing attributes) and as a result engaging with many of the leading mid-market players. There is a very strong demand throughout the sector and prices are genuinely full valued. The main strength of such businesses is that they have a very high percentage of secured revenues which makes them a relatively financially safe acquisition but the down side can be a long lead time to winning new orders and hence only modest growth. Those that are commanding the best prices are those which show top line growth, have a good quality client base and at least one other service – perhaps a development capability in a strong vertical market or two with good domain knowledge – which gives the company a competitive advantage in driving such businesses forward and delivering top line growth.

Security software is also a key area for M&A activity partly because software vendors wish to incorporate more security into their products rather than leave this important and lucrative area to third parties. It is also being driven by businesses appreciating the importance of protecting sensitive customer data. This is good news for security product companies with appropriate products and a good customer base. We are finding it not such good news, however, for some of the ordinary smaller and mid-sized security integrators that are overly reliant on providing third-party vendor software as they are finding their margins are under attack. Of these companies, those that have adapted by expanding into related areas such as VoIP, technical consultancy and implementation around the networks themselves or are offering solutions as an outsourced managed service, are faring better.

**Home and away.** In the late '90s much of our business had a cross-border dimension. The IT sector was growing rapidly and companies large and small wanted to be international. Then there was a downturn prompted initially by Y2K, then the dotcom collapse followed by recession in France and Germany and a very tough time in the UK. Hopes for improvements collapsed as 9/11 changed the world and business generally and particularly the USA, the driver for the technology world, became more inward facing. International mandates became rare but in the last two years we have noticed a change and in 2006 five of our transactions were cross-border. Four of these, the sale of TLC to a Swiss company, Statpro's acquisition of companies in Australia and North America, and Quadrant's acquisition of a US company were not only Buy-side mandates but also were Financial Technology clients. All of our current financial technology sale mandates have potential buyers in the USA and Europe. Not surprisingly if you serve the global banking and asset management community you are more likely to do cross-border acquisitions. Indeed all our product company sale mandates have interest from overseas buyers.

**Timing is everything?** We won most of our new mandates in the second half of the year, particularly in the final quarter. Why should that be? It might be statistically untypical of current activity in the wider market but we usually find that our experience is not too dissimilar from that of the market in general. In early 2006 many analysts predicted a difficult year for the IT sector and that may have held back owners' decisions to sell as they might have thought prices would not be strong. However, having had a solid or even good trading year and seeing prices firm up, more have decided to take advantage of current conditions.



**What's it worth?** For service businesses valuations are being based on multiples of EBIT, at similar levels to last year, ranging from 7 to 11x but the average has moved up. Product business valuations are being based on revenue and EBIT multiples, at higher levels, with 2-4 x revenues frequently being achieved. A number of the deals that we completed have involved performance related payments because the parties are expecting significant growth rather than seeing that element of the structure as a defensive measure to protect the downside for the buyer. What we are observing is that the pricing for the better private companies is narrowing the valuation gap compared to the average valuations of quoted companies.

But that is not the case for everyone.

**The sun's not out for all.** The top end of the market has seen some good prices obtained for mid-sized and larger Internet Service Providers ("ISPs") but the consolidation of the last couple of years has left a large number of small i.e. below £5 million turnover and especially those below £3 million of revenue without premium value. They cannot compete in promotion, they cannot compete on price and they don't offer the added-value service lines that the larger providers do.

Infrastructure companies, those with the majority of revenues obtained from the sale of hardware and associated system software, are also finding it difficult to exit for a premium or even a satisfactory value. Indeed those that have gone to market this year have found it a slow arduous process. Broadly the larger players – the natural buyers of such businesses - are themselves implementing strategies to move to more profitable added-value offerings. They are not too interested in acquiring further revenues in the sector but will if the price is right, and that can mean paying as little as twenty percent of turnover even for a profitable enterprise.

The conclusion is that companies without a special ingredient can regard themselves as a commodity and the market does not value commodity items too highly.

**And the outlook is...** We have particularly noted the strong performance of Financial Technology companies and see very brisk M&A activity in this sector during 2007. We expect more companies coming to market and buyers paying good prices as banks and financial institutions rapidly move from internal development to vendor-packaged products. Furthermore, the global nature of the customers will ensure international M&A activity will grow in the sector thus increasing demand for good quality Financial Technology businesses. Certainly Westchester expects to continue to complete transactions in this sector throughout the year.

Managed Services will continue to be a very active sector and we expect to see many small and mid-size companies finding new owners in 2007 as price levels are maintained and possibly increase. Apart from the attributes of these companies mentioned earlier, the customer desire to outsource continues to grow and there are opportunities for suppliers to obtain increased profitability from consolidation and scale. Mid-size to larger companies may also see interest from the Private Equity sector too.



We do not see a surge in cross-border deals but we do expect a steady increase on last year both for ourselves and the industry as a whole. Certainly Indian companies will be among the buyers but cultural differences, among other factors, will ensure the number of them will be close to the current level.

And what about the IT market generally? M&A activity in our microcosm will reflect the wider environment. There is a global trend for consolidation; buyers are seeking to widen their distribution capabilities and software product companies are on the lookout to broaden their product range. Put this together with public companies having strong cash balances and the cash-rich Private Equity sector needing to invest, we see a busy year ahead and sellers, if they have the quality, doing very well indeed.