

## **2004: The year of Consolidation and Transformation in the UK Internet Services Provider ("ISP") sector**

**January 2005:** It is very apparent to us that the last year for the UK's ISP sector has been one not only of major consolidation but also one of major transformation. After a slow start to the year, we soon observed a considerable increase in overall M&A activity in this industry. However, there is no doubt the end result of this significant increase in M&A activity is a major shift in the shape of the industry. The domestic, mid-sized, especially privately owned, ISP has now become virtually extinct as many of the well known, successful and respected companies in this category have been absorbed and are now part of much larger, typically listed businesses. Other ISPs in this category have chosen to be floated on AIM.

Since the mid-1990's analysts have been predicting this as a part of the ongoing consolidation of the sector and that we shall be left with a very small number of industry players but even now in the mid-2000's the situation is not as straightforward as it may seem.

**A year of Activity:** For the first significant news of the year we had to wait until February and that was the AIM float of *Business Serve plc* valuing the company at £17.5 million. *Business Serve* itself was founded via a series of mergers beginning two years earlier culminating with its last pre-float acquisition, *Legend Internet*, near the end of 2003. This company went on to be the active acquirer of 2004 although most of its appetite was satisfied by relative morsels.

The first truly noteworthy deal involving a UK company was transacted in March, but even this was not a domestic transaction. *Easynet Group plc* announced the acquisition of *Novaxess Beheer BV*, a leading Dutch business broadband local loop company and its subsidiaries, for aggregate consideration of £26.2million (€38.4m), including assumed debt.

Towards the end of March, *NetBenefit*, a listed internet business solutions provider specialising in domain name registration companies as well as web site hosting acquired *Easily Ltd*, a provider of domain name and hosting services, for total consideration of £2.5 million in cash and shares. *Easily's* business consisted mainly of domain name, hosting and email services and produced revenues of £2.5 million in the year ending 31st December 2003. *Easily plc* is now called *Group NBT plc* following a name change in October.

April brought us *PIPEX Communications plc* cash offer for *Host Europe plc* worth approximately £33 million. *Host Europe*, also an ISP, had revenues of £17.1 million for the year ending 31<sup>st</sup> December 2003 and sold primarily to small and medium sized enterprises in both the UK and Germany. The month also saw a significant name change announcement, *Freeserve* to *Wanadoo*, to pursue the French owner's goal of being an internationally recognised leader in broadband.

In May we saw the first significant all domestic ISP transactions when *Cable and Wireless plc* acquired *Bulldog Communications Limited* for £18.6 million. *Bulldog*, as well as offering broadband services using DSL technology on the basis of BT wholesale tariffs, had also installed its own equipment in 38 BT exchanges in central London under "Local Loop Unbundling" ("LLU").

Sheffield based *PlusNet Plc* joined AIM in July with a market capitalisation of £25.1 million. Until then the company was a wholly owned subsidiary of NASDAQ-quoted *Insight Enterprises Inc*. For the year ended 31 December 2003 *PlusNet* produced revenues of £17.4 million. In December *Insight* sold all its remaining shareholding raising £15.8 million gross.

In August, *PIPEX* announced another significant purchase when it acquired privately held *AccentUK Limited*, which trades as *Nildram*, and was at the time one of the UK's leading independent broadband ISPs. The total consideration paid for *Nildram* in cash by *PIPEX* was £12.9 million. During the year ending 31st March 2004, *Nildram's* turnover was £14.1 million. *Westchester Associates* acted on behalf of *AccentUK/Nildram* in this transaction. Later in the month, *Telstra Europe Limited* announced the acquisition of the UK businesses of *PSINet Europe* for £50 million from the parent company, *Israel Corporation Limited*. This was *Telstra's* third UK acquisition in nine months, the others being *Powergen's* telecoms network infrastructure in October 2003, and *Cable Telecom* in February of this year. And to prove August is not entirely a holiday month, another significant acquisition was completed by *Invox Plc*. They paid £25 million – equity plus the settlement of loans – for *Brightview Group Ltd*, an independent ISP in the UK consumer and small business market with approximately 310,000 customers and turnover to April 30<sup>th</sup> (54 weeks) of £12.4 million.

September was a very busy month. Firstly, AIM listed *Iomart Group plc* completed its first significant acquisition buying the domain name and web hosting company, *Easyspace Ltd*, for net consideration of £10.5 million. For the six months ended 30 June 2004, *Easyspace* recorded revenues of £2.8 million. Earlier, in February of the year, *Iomart* had also acquired *Internetters Limited*, an ICANN accredited registrar of domain names, for a total maximum cash consideration of £250,000. Very late in September *Claranet Limited* bought the UK operations of *Via net.works Inc.* for £7.3 million in cash. And on the last day of the month, *Kingston Communications (HULL) PLC* acquired *Eclipse Networking Limited* for initial consideration of £12.5 million. In the year ended 31 May 2004 *Eclipse Networking* reported turnover of £9.9 million. The month also saw *Virgin.net* come under the full control of *NTL* after the latter bought the remaining 51% of its joint venture ISP. *NTL* and *Virgin.net* created this joint venture company in 1996, which currently claims 590,000 customers. No financial details of this transaction were disclosed and the business will continue to use the *Virgin* brand.

October commenced as briskly as September ended. *Business Serve* announced two small transactions a week apart. It first paid £200,000 in cash and shares for the assets of the ISP division of business-focused *Vital Online Ltd*; with a potential maximum Earnout of £150,000. *Business Serve* then acquired *Pipemedia*, a company offering Voice Over Internet Protocol (VoIP) and broadband telephone services. The initial consideration paid was £300,000 together with 692,841 ordinary shares. Deferred consideration of up to a maximum of £1.5 million, settled equally between cash and shares, may become payable over the next two years should *Pipemedia* achieve certain performance requirements. *Pipemedia* is believed to have achieved revenues of £2.64 million for the year ending 31st May 2004. This was *Business Serve's* sixth acquisition of the year, which also included the assets and customer base of *KB Media Limited* completed in July for £404,000 in cash and shares. *KB Media Limited* was a specialist in selling broadband targeted at the reseller market. In May, *Business Serve* paid £1.87 million for *DSVR*, which for the year to 30 April 2004 had an unaudited turnover of £1.58 million. It was only in March of the year that *Business Serve* completed its first acquisitions. It bought the assets and customer base of an automated online company, *Domain Names GB.com Ltd* for cash consideration of £400,000, and also acquired the assets and customer base of *RealTouch Internet Ltd* for £60,000 in cash.

**Commentary:** No doubt it has been an eventful year in the domestic ISP sector, but how significant has it really been?

We have seen the demise of *Eclipse*, *AccentUK/Nildram* and *Bulldog* as independent ISPs. *Business Serve* and *PlusNet* are now AIM listed. Perhaps only *Zen Internet*, *Mistral Internet* and the much larger *Claranet* remain as mid-sized, privately held ISPs. Other independent companies in the sector appear small, all with turnover less than £5 million and most £2 million or less. The ADSL Guide [www.adslguide.org.uk](http://www.adslguide.org.uk) lists about 100 names and the UK trade body, ISPA, <http://www.ispa.org.uk> claims more than 120 members. So is the domestic ISP sector heading for total consolidation, as some believe, ultimately leaving only a few major players?

Whilst some ISPs are acquired and others go out of business new ones will still be created. The continuous changes in technology means new opportunities will be created for new entrants with new technology opportunities - currently including VoIP for example – but the traditional small ISP offering simple connection to the Internet is doomed. These traditional services can be offered more efficiently and often with considerable added-valued services as well by the larger players. Some small ISPs with offerings focused on SME's will try to develop special expertise in areas such as high-technology services or high-quality anti-spam and anti-virus solutions not available from the larger providers. But ultimately the smaller ISPs will too have to sell possibly expecting a premium price based on the unique products and services they have developed.

We expect in 2005 to see a continued exit of the smaller players from the sector. The first and second tier suppliers will continue their market grabbing which will further reduce margins for all and particularly place added pressure on the smaller ISPs. The development and further implementation of LLU will begin to be a significant driver providing the opportunity to compete more effectively without commercial dependence on BT. This too will mean both white label and virtual ISP's will be at a significant disadvantage, dependent on their suppliers own ability and desire to take advantage of the lower costs that will undoubtedly be available to the larger players in the market.

*Westchester* has significant experience with and has worked extensively in the ISP sector. We see an increase in our activity in the future from assisting tier two ISPs seeking smaller acquisitions, overseas ISPs and Telcos seeking market entry into the UK, and possibly some exit too, and acting for small ISPs wishing to exit successfully. There will certainly be excellent opportunities for buyers and sellers alike.

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