

## **The mergers and acquisition (M&A) market for small and medium sized software & IT service businesses**

**December 2003:** Our current view of the M&A market for small & medium Software and IT Service companies is that we are starting to see an increase in overall activity. This is a welcome change from the past two years when M&A activity in this sector was significantly lower than the preceding “boom period” of 1998 – 2001. Since early 2001, many companies were not in a position to buy or sell due to the overall IT market malaise.

### **Sell Side Story**

Over the past two years, valuations were considered too low by Sellers and often still too high by the few potential Buyers in the market. Attempts to actively market a business for sale were often viewed as a sign of weakness by prospective Buyers, as many of the businesses for sale were usually in a distressed condition. As the IT sector has begun to recover in the second half of 2003, valuations have improved somewhat, although nowhere near the level of the boom period. Sellers have also adjusted to the more realistic valuations in the market and it is thus becoming respectable to sell a business once again.

IT market conditions over the past several years, however have had a severe affect on many companies in the sector, which makes it difficult for them to be active as Buyers or as Sellers, until they demonstrate sustained improvement in their financial performance.

In our recent experience this sector can be segmented into four types of companies when viewing them from a potential Sale perspective:

1. **Troubled:** those businesses that are performing poorly and are seeking an exit as the best way out of a distressed situation; there are few enthusiastic Buyers for these businesses today, and if there are potential Buyers they are normally “bottom feeders”
2. **Recovering:** those companies concentrating on improving their performance, and are therefore, not yet ready for a Sale in the near-term
3. **Contented:** those businesses performing well and not actively seeking an exit, but are sometimes approached by a potential Buyer. These Contented companies are unlikely to be interested in a sale, unless the Buyer is willing to offer a valuation that is a significant premium to the current market. Most Buyers today are unwilling to pay such a premium
4. **Cast Off:** a subsidiary or business unit of a parent or larger group where the owners are most likely selling this business to raise cash, or to improve management bandwidth, or to simply dispose of a non-core asset. Many of these types of transactions are the result of the Seller’s becoming more realistic with regard to terms and valuation

### **Buy Side Story**

From the potential Buyer’s perspective, many companies are still cautious about acquisitions and about the valuations they are willing to pay. Thus, even when a very complementary opportunity is presented, it can still be difficult to actually complete a transaction. Buyers are not keen to value businesses on soft or intangible rationale such as strategic fit or complementary technology; instead they wish to focus on tangible benefits such as sustainable profits and positive cash generation. Assets such as long-term customer contracts, a substantial list of customers, and strength of the management team are important, but even these attributes are not valued as highly, unless the financial performance of the business (good gross margins, positive cash generation and consistent profitability) is also strong.

As small and medium Software & IT Service businesses adapt to changing market conditions and position themselves to become Buyers or Sellers, we expect to see more M&A activity as a primary means of faster growth than the comparable rate of the overall market in which they operate. M&A is also now being viewed as a means of creating competitive advantage and reducing risk through increased business scale. This includes covering a wider range of market segments and offering a broader portfolio of products and services.

Finally, we anticipate another increase in M&A activity as owner/operators, especially those close to retirement, accept the reality that valuations are not going to suddenly improve in the near-term and decide to exit their businesses at current market valuations.

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