

Westchester's Experience in 2004

February 2005: In the early period of a new year a number of companies and business magazines publish their view of the previous year. These usually contain a broad view of the market as they see it including providing statistics on the number of deals completed and their size. Instead we thought we would write a much narrower view based on our specific experience. This is a note on what we at Westchester have seen in the market during 2004 in the UK and USA. It is not a definitive statement or comprehensive review but our experience and what we make of it.

By and large, software and IT services companies have now adjusted to the market and have produced at least one and often two years of profit. But the issue most of these companies now face is "how to grow at anything above a single digit rate?" There are some segments of the market such as; security, industry specific ERP and storage management that are growing rapidly, but not every business can easily shift into the growth segments. Consolidation could be an answer, however there are usually issues to be overcome for that to work as well.

For example, we have been in contact with a number of companies in the UK Infrastructure Sector who are uncertain what to do next. The market cries out for consolidation but there does not appear to be a management team with the resources or the inclination to do it. There is also the issue that the current value of these businesses is at a level that shareholders are not inclined to sell now. We feel that there is an opportunity to create significant value in this sector, however it requires both a management team with vision and resources to achieve it. It also requires innovative deal structures, so that current shareholders can share in some of the future upside, to get things moving. We will continue to be on the lookout for that management team during 2005.

We have also seen a real surge in the number of buyers entering the market in 2004, including private companies looking for growth and expansion. This has been especially true in the IT services arena.

We completed five sales in 2004, three of which involved non- UK buyers of UK businesses, one from the USA, and two from Europe, which reflects the high level of interest in the UK market. One of the buyers was looking to enter the UK market and the other two were looking to strengthen existing operations. All three situations have opened up interesting opportunities for the management of selling business within the acquiring company. Of the other two, one was a UK buyer looking to strengthen their market position, and the other was motivated by a complex corporate reorganisation. We also completed two buy side acquisitions in the US during 2004, one for a NASDAQ company in the IT services sector, and one for a private company in the web services sector.

The renewed interest in UK companies by non-UK buyers who have been absent from the market in recent years has increased the pool of buyers and helped to improve valuations. The valuations in our deals supported that view with EBIT multiples ranging from 7 to 11X, levels that were not being achieved in 2002 and 2003. In three of our transactions there were performance related payments which required the sellers to maintain profits or modest growth for the next one or two years, which indicates that buyers are still more concerned that profits will decline rather than having expectations of hi-growth.

Our experience indicates that the market is improving for businesses looking to sell, as there is a larger pool of buyers willing to pay more realistic valuations. Similarly for buyers there are an increasing number of sellers coming onto the market with a realistic view on valuations. This is illustrated by one of our current buy side engagements in which virtually all the companies contacted have indicated a willingness to have acquisition discussions with our client.

So what does this suggest for the year ahead: on a like-for-like basis we anticipate that we will do more deals than in the previous years and, particularly in the UK, to be working on more buy mandates. We expect to be more involved with overseas buyers and have the expectation that more of the transactions involving them will be between UK and USA companies. In addition and specifically for our business in the UK where we welcomed a new director at the beginning of 2005, we see greater involvement with the Financial Technology sector. With American companies so strong in banking and finance software and services, that too should add to the number of transactions between American and British companies.

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