Grant Thornton's technology practice
A Reality Check report
Who is buying UK software companies and why?

LIBRARY HOUSE

What makes UK software companies attractive to potential acquirers?

What impact does the US have on UK M&A activity?

When will the hangover from the tech boom end?

Is the US paying top-dollar?

Is the UK a player in European software M&A activity?

The Reality Check series of reports has been commissioned by Grant Thornton's technology practice, to cover a range of topics of importance to UK technology companies. Each report will focus on a single issue and help to provide a thorough understanding of the current situation and any important emerging trends which will impact upon technology businesses.

This first report in the series focuses on the emerging patterns of acquisition of UK software companies over the past four years and assesses the impact that recent improvements in the US market have had on mergers and acquisitions (M&A) activity in the UK.

If you would like to discuss any of the matters contained within this report please contact Grant Thornton's technology practice, using the details given at the back of this publication.

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Part of the Grant Thornton **thinking** series

Introduction

Mergers and acquisitions (M&A) form a key part of expansion and development strategies in the software sector, particularly as sources of development funding, such as private investment or public offering, have been limited in recent years.

However, even M&A activity suffered following the end of the technology "boom" in 2000 and overall deal values have fallen annually. 2004 was the first year in which the trend reversed and total deal value increased significantly. This report examines the causes of this recent increase in M&A deal activity in the sector and highlights the increasing optimism and appetite for expansion in the US as a key factor driving deal values up.

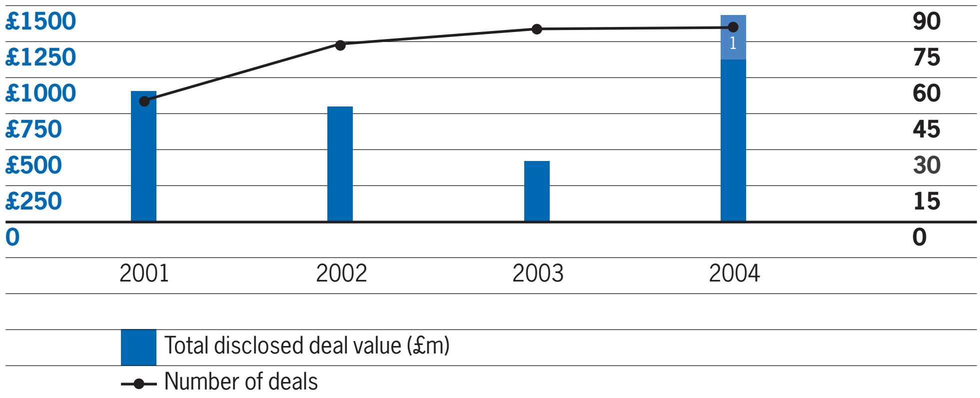
In this first report of the Reality Check series we highlight some of the key drivers for acquirers and suggest how UK companies might effectively position themselves as potential M&A targets.

The software sector is a core focus area for Grant Thornton's technology practice and we hope this report demonstrates our understanding of, and commitment to, a sector which we believe will see increasing levels of deal activity in the coming years.

Wendy Hart
Head of Grant Thornton's technology practice

Light at the end of the tunnel?

Figure 1: UK software M&A activity



Source: Bureau van Dijk (Zephyr)

1 Indicates the £340m acquisition of Torex by iSoft

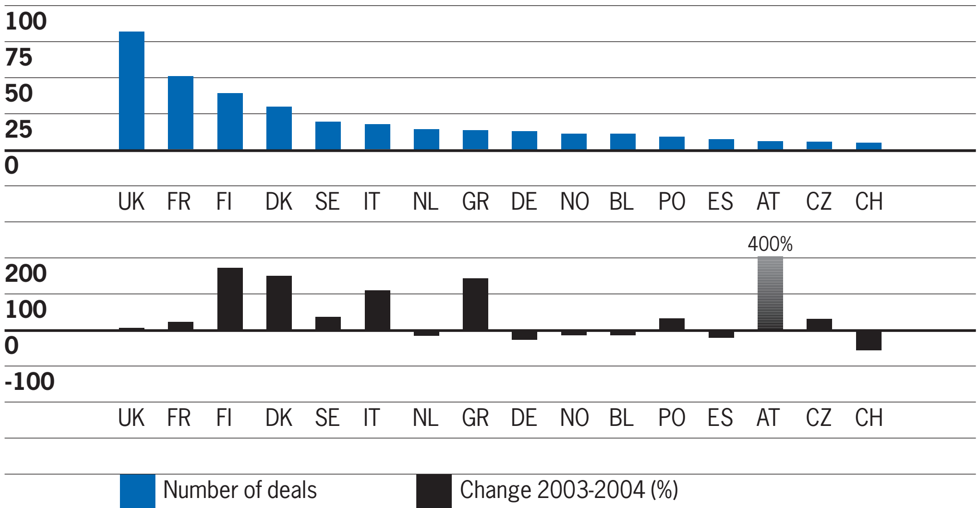
The total value of software M&A activity in the UK shot up in 2004 to levels not seen since the end of the technology boom.

With a total disclosed deal value of almost £1.5 billion, the value of M&A activity in the UK software sector as a whole grew for the first time last year since the end of the dotcom era.

This rise has been driven by a shift upwards of average deal value, rather than by either a change in deal activity, which was essentially static compared with the previous year, or a small number of very large deals affecting the overall value. Even without the inclusion of the £340 million acquisition of Torex by iSOFT, the single largest deal of 2004 by some degree, the total value is still significantly larger than any year since 2000.

UK still leads the pack in Europe

Figure 2: European software M&A activity in 2004



Source: Bureau van Dijk (Zephyr)

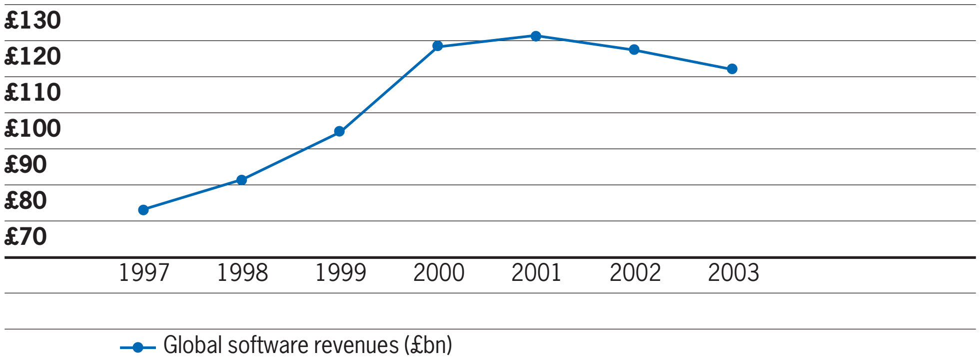
The UK still dominates activity in Europe despite slow growth of activity last year.

The UK has historically been the most active European market for software M&A activity and, despite the absence of any real growth in activity over the last year, it remains the leading country in Europe in terms of both value and activity.

Of the 360 software mergers and acquisitions during 2004 which involved a European company as the target of an acquisition or either party of a merger, the UK featured in 23% of deals. However, the lack of growth of activity has caused the UK to fall back slightly from the average of 29% over the previous three years.

Growing to survive

Figure 3: Global software market



Source: DTI

In order to prosper in the current environment, companies are finding that they have to expand in order to remain profitable.

The fast growth in the software industry during the late 1990s was fuelled by the rapid uptake of new technologies, both by newly formed start-ups and also established companies not wanting to be left behind. In addition, concerns over the Y2K bug caused many companies to instigate complete overhauls of their IT infrastructure.

When growth was rapid, it was sufficient for many companies to grow at the rate of the market. However, the drop in global software spending, which currently shows little signs of easing, has heightened competition within the sector and forced companies to adapt to the new environment in order to survive.

While the overall market has seen a decline since 2001, there have continually been small pockets of high growth within defined "hot" areas. Recently, these have included security software and location

Table 1: Top ranking global software companies, 2004

Forbes 2000 Rank	Name	Country	Sales ($bn)	Profits ($bn)	Assets ($bn)	Market Cap ($bn)
47	Microsoft	US	38.5	10.0	64.9	273.8
220	First Data	US	10.0	1.9	32.7	33.0
267	Oracle	US	10.6	3.0	13.1	67.7
335	SAP	Germany	10.2	1.8	10.0	50.7
450	Computer Sciences	US	14.3	0.6	13.1	8.8
584	Yahoo	US	3.6	0.8	9.1	44.4
832	Electronic Arts	US	3.2	0.6	4.4	19.9
867	Fiserv	US	3.7	0.4	8.4	7.4
902	Symantec	US	2.4	0.5	5.4	15.6
904	Google	US	3.2	0.4	3.3	51.4

Source: Forbes 2000 Global

awareness technology. It is within these niche growth markets that the highest levels of activity have been seen.

Economies of scale are of critical importance in the software sector, more so than in many other industries. This is owing to the low costs of goods sold and the opportunities to increase client revenues through broader product offerings or new global markets. Success under the current adverse market conditions has become highly dependent on both the scale and scope of companies.

The US, the largest global player in the software market, has the distinct advantage of having the majority of the world's biggest software companies, including 16 of the 20 highest ranked Forbes 2000 software companies and nine of the top ten. The presence of a significant number of large and highly profitable IT companies in the US has greatly aided the development of the

industry as a whole, as they have provided a major source of funding for smaller companies through corporate venture capital and acquisitions and they also act as a major purchaser of developed products.

One of the key issues that has faced the UK software sector for some time is the lack of a significant number of large multinational companies capable of delivering the high productivity and profitability seen in the US. Sage, the largest UK-based software company, with an annual turnover of around £560 million, is one of the few companies in the UK of this scale.

Software-developing companies have found that they must expand in order to be able to compete on a global scale. The importance of M&A in expansion strategy has increased in recent years as the main alternatives for expansion, capital investment or organic growth, have shown a downturn.

Routes to growth

Limited alternative sources of funding are leaving companies little alternative to M&A in order to fuel growth.

Capital investment

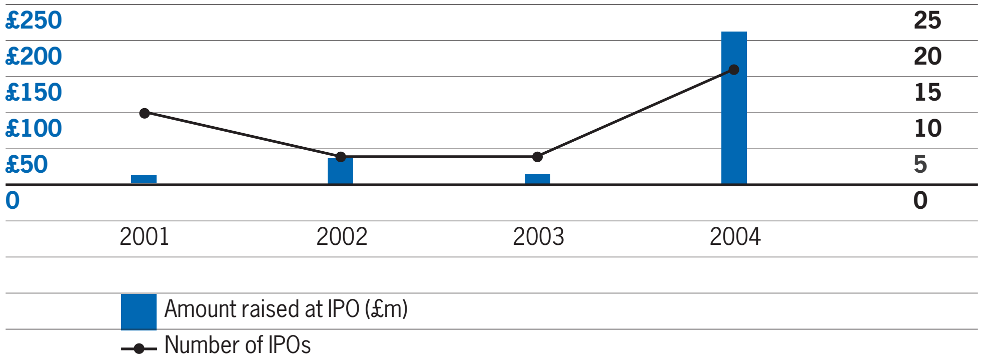
Although not as capital intensive as some high-tech industries, the software sector as a whole is highly dependent on capital inflow to fund expansion. Since the end of the 1990s, the amount of capital available to software companies through private equity investment and public markets has been significantly reduced. During the boom, companies could more easily tap both the public and private markets for expansion capital. However, recent years have seen both markets largely withdraw from the sector.

Public markets

The access to public market capital for expansion through initial public offering (IPO) for private software companies has become extremely limited over recent years, with only a handful of completed IPOs each year.

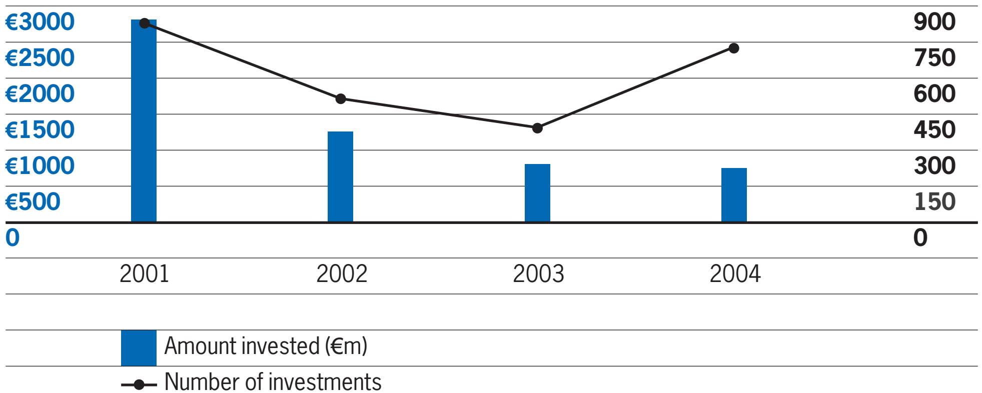
Although the IPO market appears to have recovered significantly during 2004 from the lows of the previous two years, the overall amount of capital raised remains small. The total amount raised through IPO for UK software companies in 2004 was a little over £200 million, with an average deal size of just £13 million. The general lack of significant capital inflow from IPOs over the past few years has forced many companies to seek alternative sources of funding and has also prevented many of the private investors in these companies from exiting their investments, leading to pressure in the private equity markets.

Figure 4: UK software IPO activity



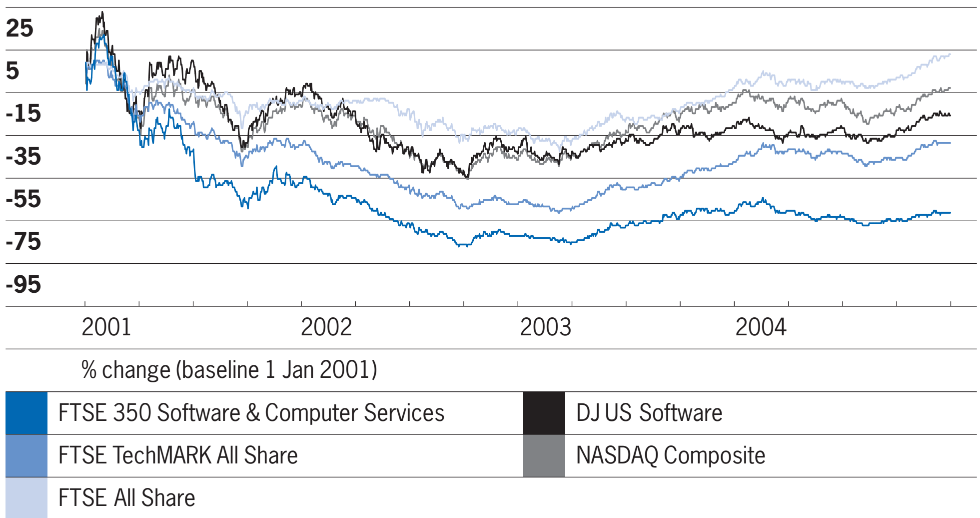
Source: Bureau van Dijk (Zephyr)

Figure 5: Private equity investment into European software companies



Source: VentureOne

Figure 6: Stock market index performance



Source: Bloomberg

Private equity

Private equity investment across European software companies has been falling since 2000 to the current levels of investment – under €750 million (around £500 million) invested in the sector across the whole of Europe in 2004. This drop in investment has left a number of companies founded during the growth period unable to gain subsequent expansion or development capital to fund further growth. Although the decline in private equity investment has slowed, there are currently no signs of a reversal. However, if the observed increases in IPO and M&A deal value continue, this will start to feed capital back to the private investors which will become available for reinvestment.

Organic growth

In the UK, the IT software industry grew rapidly throughout the late 1990s and despite falling continually since then, revenues from the sector were over £7 billion in 2003 and now appear to be levelling out. This is leading to the expectation that the market will once again start to expand over the coming years.

Many of the companies that have survived until this point have done so through improving internal processes, sales channels and becoming more capital-efficient. As a result, when capital flows back into the sector through public markets they should then find their valuations rise. However, the opportunity to fund expansion through organic growth will remain limited when faced with high levels of global competition, especially from markets which have recovered more quickly.

Over the past four years, stock market performance for software stocks fell to lower levels and has been slower to recover than for many other market areas. The general technology market, as represented by the Techmark index, has shown significant recovery from the low levels during 2003, as has the general UK stock market which returned to 2001 levels during 2004. A comparison with the US for software stocks shows that recovery in the US has also been slow. However, particularly towards the end of 2004, the gap between UK and US markets continued to grow.

Return of the major players into M&A

Table 2: Average UK software M&A deal values

Year	Number of deals with known value	Median (£m)	Mean (£m)
2001	33	5.5	27.3
2002	39	4.4	21.4
2003	37	3.1	12.7
2004	40	8.9	36.4
Change 2003-2004 (%)		**186%**	**187%**

Source: Bureau van Dijk (Zephyr)

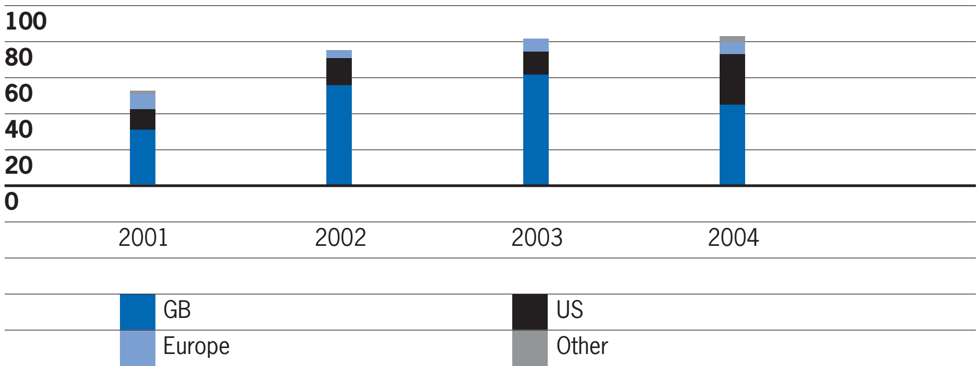
2004 saw the return of the US into the UK M&A market, forcing up deal value significantly.

The number of deals in 2004 was similar to 2003, but the overall deal value increased significantly. This increase was driven by a general growth in deal value rather than a few major deals with a large value, as shown by a similar increase in both the mean and median of the deal values.

2004 was the first year since the turn of the century in which the number of national deals fell. However, an increase in the number of cross-border deals compensated to leave top-line deal activity static. The increase in cross-border deals comes mainly as a result of a significant upturn in acquisitions from US-based acquirers. In 2004 there were 29 completed deals in which a UK-based software company was acquired by a US company. This is up from 14 in 2003 and is the highest value since the boom period of the late 1990s.

The observed growth in acquisitions by US companies in 2004 is particularly remarkable when taken against the backdrop of the low dollar value throughout that year, making many of these deals between 10-15% more expensive in relative terms when compared with 2003. However, there are two factors which will tend to offset the relative decrease in the value of the dollar over this period: stock price rises and revenue locality.

Figure 7: Number of UK software M&A deals by acquirer location



Source: Bureau van Dijk (Zephyr)

Stock price

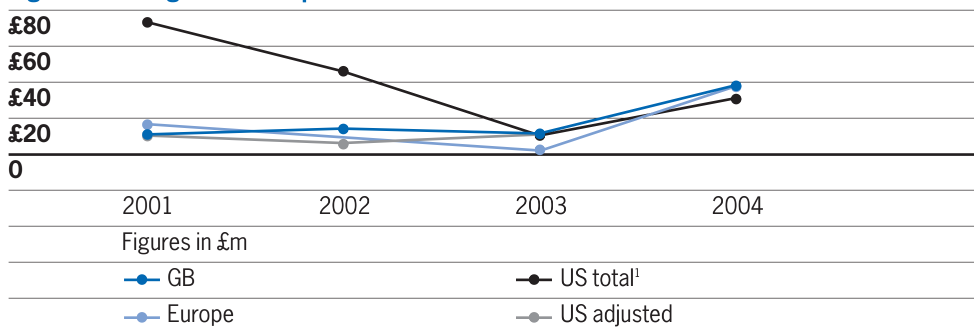
Stock prices for US software companies did not fall as far following the end of the technology boom and have risen since 2003 by more than those in the UK market. This has helped offset some of the decrease in the value of the dollar, and made the US stock more valuable for equity swap acquisitions of UK companies.

Revenue locality

If US acquirers are successful in utilising existing UK sales channels to expand current products rapidly into the UK market, they can hedge any falls in the dollar value with the increased relative value of revenues received in sterling. This can help to insulate the company from adverse currency swings.

Is the US paying top-dollar?

Figure 8: Average M&A deal price



Source: Bureau van Dijk (Zephyr)

1 "US total" value includes the 2001 acquisition of Geneva Technology by Convergys (£496m) and the 2002 acquisition of Rare Ltd by Microsoft (£241m). During those years there were no other deals of comparable size made by other regions. The average value excluding these large deals is shown as "US adjusted".

The return of M&A activity from the US has accompanied a rise in average deal value. However, contrary to common opinion, US purchasers don't pay over the odds.

The average deal value rose significantly in 2004, but this was not driven by US acquirers willing to buy at any price and ending up paying significantly more. Instead, the increased number of bidders at the table drove prices up. The top-line average deal values since 2001 indicate that the US had a higher deal value, however this is owing to the fact that the US has participated in many of the largest deals. Excluding very large deals, the average deal price paid by acquirers has been remarkably consistent across all acquirer locations in recent years.

What drives the US to look to Europe?

The recent spate of US acquisitions in Europe has been driven by the desire to acquire core technology to allow the development of new product lines, rather than to acquire revenue streams.

In the current climate of declining IT spending, the industry has become increasingly dominated by the larger companies, particularly those with revenues of $1 billion plus. However, these companies have found it harder to maintain growth. They have had to devise growth plans based either on extending their own customer base by introducing new product lines alongside existing ones, or by capturing large installed customer bases through acquisition.

These strategies have driven many of the large megadeals seen over the past few years, culminating in the recent acquisition of PeopleSoft by Oracle for $10 billion. This deal has allowed Oracle both to capture the PeopleSoft installed base and to broaden its offering in the lucrative enterprise application space.

Owing to the high concentration of the world's largest software companies in the US, deals focused on capturing market share tend to be contained largely within the US. It is when companies are seeking to expand their product offering or accelerate the development of current projects that they are prepared to look overseas for acquisitions.

The acquisition of Trigenix by Qualcomm is a typical example of such an acquisition – a major US company willing to look outside the US for the technology necessary to accelerate ongoing internal projects to make it to market more rapidly in a currently hot area.

Trigenix – a case in point

The deal

In October 2004 Qualcomm acquired Trigenix for £20 million in cash. This deal was typical of the new breed of US acquisitions during 2004, where major US players looking for strategic in-fill technology were willing to acquire leading technology, regardless of location. Trigenix did not file accounts in the year before the deal, but based on the latest filed figures (December 2002), this deal valued the company at almost seven times revenue.

The acquirer

Qualcomm had historically not used acquisitions for expansion, either within the US or overseas, preferring to broaden product lines through internal R&D projects. However, since 2003 Qualcomm has made two acquisitions in Europe: Alcatel Mobicom (a French satellite communications provider) and Trigenix. Prior to that, the last acquisition was in the US in 2001. Both of these recent cross-border deals were chosen for their ability to add value rapidly to in-house development programmes already underway.

The target

Trigenix was involved in the development of a range of mobile user interface (UI) technologies, in particular "skinnable" UIs which can be customised by the mobile operator or vendor to raise brand awareness. The technology had significant synergies with Qualcomm's own in-house mobile UI programme, BREW. Trigenix had previously been collaborating with Qualcomm in development of BREW prior to the acquisition. Trigenix had been consistently unprofitable in the years prior to the deal with pre-tax losses in the region of £1-1.5 million per annum.

The vendor

Trigenix was founded in 2000 with £2 million private equity backing from 3i; the company had subsequently received a total of £5.6 million in two further rounds from 3i, in 2001 and 2003. The deal valued the company at approximately 2.5 times the total amount of private equity investment; at the time of the sale 3i owned approximately 40% of the company.

What does this mean for you?

If the current increase in acquisitions by US companies continues, many companies could benefit from improved valuations, but are there defined strategies that make companies attractive to US acquirers?

Early indications seem to predict that the rise in activity from the US seen in 2004 looks set to continue into 2005 and possibly beyond. Both Yahoo and eBay have recently made acquisitions in Europe and Google has recently announced it is likely to make a number of acquisitions over the coming year, with Europe seen as one of the likely sources of targets. If this expansion of the US into European M&A continues, it will become necessary for UK companies to consider acquisition by a major US company as one of the likely outcomes of their business.

In addition, small independent developers and suppliers have seen their markets squeezed as larger players attempt to broaden their product offerings. Furthermore, the continuing decline in sales has seen many smaller suppliers go to the wall, leaving end-users less inclined to purchase from smaller outfits in the future. This provides additional impetus to smaller privately-held software developers to consider partnering with, and ultimately even sale to, a US company.

In light of these factors it is worth noting that there are a number of similarities between many of the US acquired UK companies, which marks them out as attractive to US companies willing to pay the right price for the right technology.

Technology leading

Companies in the UK which were acquired had, almost without exception, at least one core development technology that was highly advanced and tended to be the leading solution in the field. When acquiring for technology, the US companies have tended to look beyond current revenue streams and are willing to consider valuations based solely upon the technology benefits achievable.

Growth market

Many recent deals have occurred between companies where the target is operating in an area that has seen rapid growth and is perceived to have high future potential. This growth has been so rapid that the larger organisations have not had time to develop solutions internally. They are then left looking to implement a step change in their abilities rapidly within the sector and hence they consider acquisition.

Visibility

The majority of UK software developing companies are privately-held, and as a result have little apparent visibility to potential US acquirers. Many of the recent acquisitions by US companies have arisen after a previous period of partnering, which has raised the profile of the target company in advance of any deal. This was seen in the case of the Qualcomm-Trigenix deal, where Trigenix had been in partnership with Qualcomm before the acquisition deal was struck.

This pre-deal partnering also allows both companies to gain a more complete understanding of what each party can offer before cementing a deal. Although this is often seen as a try-before-you-buy approach, where a possible acquirer can pull out after sampling the technology, this can often lead to higher deal values for completed sales. This is because the acquirer has a full understanding of how the technology can be integrated with any concerns over the viability of the technology being addressed to a much greater degree than in any standard pre-deal due diligence.

For further information about the
Reality Check series please contact:

Wendy Hart
Head of technology practice
T 01865 799899
E wendy.e.hart@gtuk.com

or
Alex Adendorff
National technology marketing
T 01865 799899
E alex.adendorff@gtuk.com

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Contact

Mark Littlewood
Business Development Director
E mark.littlewood@libraryhouse.net

Library House, Kett House,
Cambridge, CB1 2JX, UK
T +44 1223 500 550
www.libraryhouse.net

For more information on any of the issues covered, or to discuss how our technology practice can assist your business, please contact one of our partners listed below. Alternatively, visit our website at www.grant-thornton.co.uk

Banbury
T 01865 799899
Tracey James

Bedford
T 01234 211521
Gary Markham

Belfast
T 028 9031 5500
Trevor Blayney

Birmingham
T 0121 212 4000
David White

Brighton
T 0870 381 7000
Ellen Walsh

Bristol
T 0117 926 8901
Peter Gourd

Bury St. Edmunds
T 01284 701271
Graham Shorter

Cambridge
T 01223 225600
James Brown

Cardiff
T 029 2023 5591
Geraint Davies

Cheltenham
T 0845 026 1250
Patrick Brooke

Edinburgh
T 0141 223 0000
Robert Hannah

Fareham
T 01202 683406
Julian Sheppard

Farnham
T 01252 734 345
Robin Rowe

Gatwick
T 0870 381 7000
Trevor Lewin

Glasgow
T 0141 223 0000
Graeme Forbes

Ipswich
T 01473 221491
Graham Shorter

Kettering
T 01536 310000
John Corbishley

Leeds
T 0113 245 5514
Will Lifford

Leicester
T 0116 247 1234
Mark Vyner

Liverpool
T 0151 224 7200
John Shinnick/Neil Sturmey

London
T 020 7383 5100
David Miller

London Thames Valley
T 0870 733 6700
Jim Rogers

Manchester
T 0161 834 5414
Alistair Nuttall

Milton Keynes
T 01908 660666
Simon Jones

Newcastle
T 0113 245 5514
Andrew Moore

Northampton
T 01604 623800
James Brown

Norwich
T 01603 620481
Mike Burrows

Nottingham
T 0115 948 3483
Bruce Thornton

Oxford
T 01865 799899
George Siemieniuch

Petersfield
T 01730 266711
Robin Rowe

Poole
T 01202 683406
Mike Bevis

Sheffield
T 0114 255 3371
Garry Meakin

Southampton
T 01202 683406
Stephen Mills

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