

Where is the smart money going in ICT?



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Methodology

In September and October 2009, Remark, the research and publications arm of The Mergermarket Group, canvassed the opinion of 40 private equity practitioners with experience of investing in the UK's ICT sector. In terms of the respondent breakdown, 35 were drawn from UK private equity firms with five respondents coming from US-based funds with a history of making investments in the UK's ICT sector. Respondents were asked to give their opinion on a number of extant issues, including the key opportunities and challenges that businesses in the space face in the current trading environment as well as their own firm's likely investment strategy over the coming months. All answers were confidential and results have been reported in aggregate.

Introduction

Despite the travails of the UK economy over the last year, most ICT businesses have continued to perform robustly, responding swiftly to any need to downsize their teams or evolving their business models in order to deal with a changing environment. The experiences of the dot com crash at the turn of this century had given many of them valuable precedents for dealing with sudden change.

In recent months we have seen an upsurge of corporate activity in the ICT space, not yet completed but well underway, much of which has been driven by private equity interest in the sector. The focus has been on businesses with reasonable scale, clearly differentiated product or service streams, diversified client bases and clear evidence of sustained profitability over a prolonged period as well as the ability to clearly articulate a plan for further growth.

Where these factors exist, competition between trade and private equity houses has made it possible to attain some sensible multiples – not perhaps the heady levels of 2007 – but very respectable nonetheless, with 7–8 x current year EBITDA being a defensible average.

With far less leverage in the market than we are used to and with the capital markets not currently a viable exit route, private equity and trade buyers are the two clear options left for shareholders seeking an exit. We felt it would be helpful to explore quantitatively, the criteria which private equity apply when evaluating a potential ICT investment or acquisition and the factors they take into account when determining how much appetite they have for it. We examine our findings in more detail in this report.

The message for UK technology companies is that investment in their sector is expected to increase over the next 12–18 months. If you are an ICT company looking to grow aggressively and needing external funding to deliver

that growth, or you are considering exiting in the short to medium term, then this report will assist you to evaluate whether private equity is likely to be an option for you. For those without this short-term agenda, this will also be a useful guide on how to evolve your strategy so that when the time comes, your business is an attractive target for private equity.



Wendy Hart
Corporate Finance Advisory Partner,
Grant Thornton UK LLP

What private equity looks for

Drawing on the findings of the survey, combined with our day-to-day experiences in the market, the following elements need to come together to make an ICT business an attractive investment proposition for private equity players.

The focus of private equity houses is on mature IT services and software businesses with established revenues, sustainable profits and a clearly differentiated product or service set. This might be focus on a particular vertical market, or expertise in a particular technology or solution.

With the banks typically providing leverage only to businesses with EBITDA comfortably in excess of £1m, businesses which don't meet this criterion are likely to find private equity more difficult to attract. Although new investment models have been evolving in recent months in response to the challenges of the banking environment, private equity houses still generally find it **more attractive to transact when there is debt in the transaction.**

There needs to be a clear future strategy which will deliver growth and/or the opportunity for multiple arbitrage. Software companies evolving to a SaaS model or IT services companies evolving to a managed services offering where there is evidence of customer traction and the opportunity to deliver an increasing recurring revenue base might well meet this criterion. Equally, businesses focusing on “hot” sub-sectors such as virtualisation, cloud computing and anything which reduces the need for infrastructure spend or makes current infrastructure more efficient, are likely to appeal.

Buy and build opportunities are attractive, particularly where specific acquisition targets are already identified and known to be willing participants in a roll-up. Lower valuations, especially for smaller businesses where 4–5 times

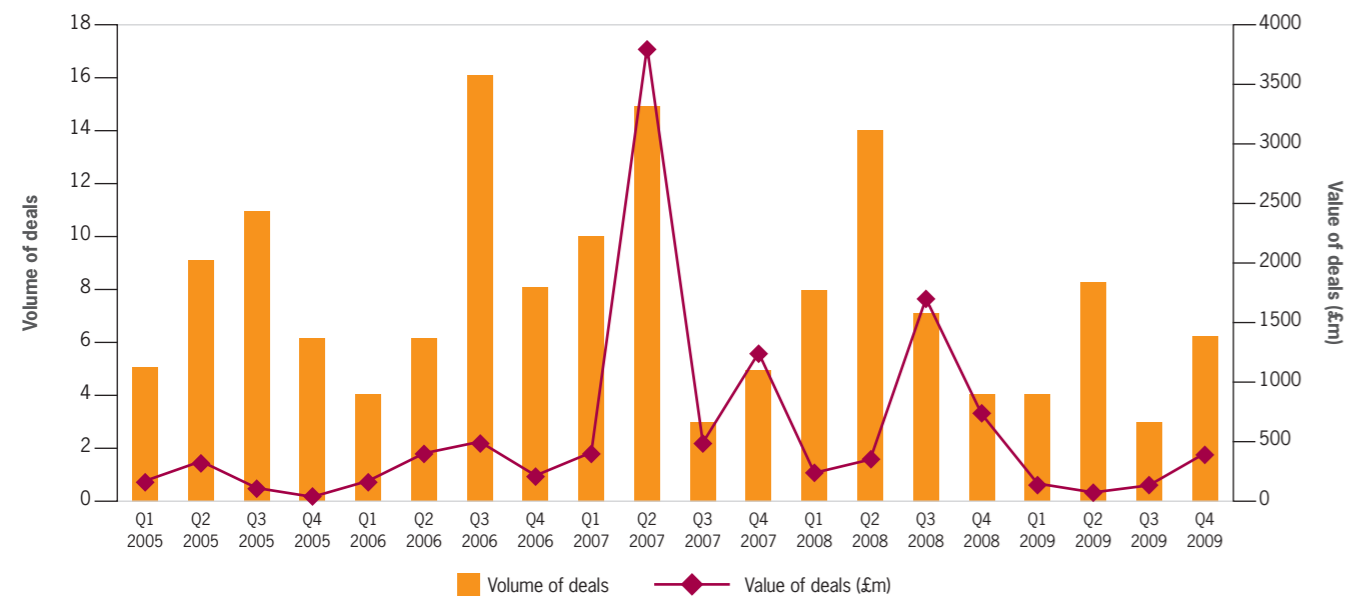
EBITDA would be a fair price, create a real opportunity to grow critical mass and leverage multiples in the medium term. As ever, buy and build strategies will only be deliverable in the context of a strong “platform” business for which the investment logic stands alone.

As with any private equity investment, there needs to be a **strong management solution**, whether this is the incumbent management team, an incoming team or a combination of the two. Would-be vendors who “own” customer relationships need to beware of making themselves indispensable, since this will make a long-term lock-in inevitable and reduce the capacity for short-term cashing out.

A realistic expectation on valuation. For the right proposition respectable multiples can be achieved, but only through creating competitive tension among acquirers or investors, and EBITDA multiples north of 10 are likely to be a rarity for the foreseeable future.

UK ICT in review

Overall private equity activity in the UK ICT sector



The ICT sector in the UK has seen significant investment from private equity players in recent years. Since the first quarter of 2007, 82 transactions worth a combined £9.15bn have come to the market, confirming that the niche is now an established space for financial investors. Given the scale and scope of the financial crisis, it is unsurprising that 2009 numbers are down in both volume and value terms, although a number of significant deals have been brokered by private equity houses in recent months.

Top five private equity-related deals in the UK ICT sector, 2009

Announced date	Status	Target company	Bidder company	Bidder description	Bidder dominant country	Seller company	Seller dominant country	Deal type	Deal value (£m)
9/11/2009	C	Playfish Ltd	Electronic Arts Nederland BV	Netherlands based interactive entertainment software company and gaming software developer	Netherlands	Accel Partners & Co Inc; Index Ventures; Stanhope Capital LLP	USA	Exit	239
26/8/2009	C	1st – The Exchange Ltd (majority stake)	Lloyds TSB Development Capital Ltd	UK-based mid-market private equity firm	UK	Vertex Group Ltd	UK	MBO	115
21/12/2009	C	Synetrix (Holdings) Ltd	The Capita Group plc	UK-based provider of business process outsourcing services	UK	Apax Partners LLP	UK	Exit	75
6/3/2009	C	Snell & Wilcox Ltd	Snell Group	UK-based company providing routing, control, signal processing and automation equipment for the broadcast market	UK			Buy & build; Exit	72
30/12/2009	C	SpinVox Ltd	Nuance Communications Inc	US-based company providing speech and imaging solutions for businesses and consumers	USA	BlueMountain Capital Managment LLC; GLG Partners Ltd; Goldman Sachs; Toscafund Asset Management LLP	UK	Exit	64

Looking at the top deals of 2009, it is notable that sell-side activity dominates. The largest deal was announced in the application software space and saw a consortium of investors comprising Accel Partners, Index Ventures and Stanhope Capital exit their investment in Playfish, the provider of social network games. In a transaction valued at £239m, the financial investors sold out to Electronic Arts Nederland, the Netherlands-based subsidiary of US entertainment company Electronic Arts. On the buy-side of the asset class,

the top deal of 2009 was the £115m management buyout of 1st – The Exchange, a software provider to the financial services sector, backed by Lloyds TSB Development Capital. Despite market conditions restricting private equity deal making at the top end of the market, the UK ICT sector has witnessed several large-cap transactions in recent times. The largest such deal was announced at the height of the buyout boom in April 2007 where Macquarie UK Broadcast Holdings, the investment vehicle created by Australian

financial services group Macquarie Bank, agreed to acquire the UK wireless business of National Grid for a cash consideration of £2.5bn. Other notable transactions include the August 2008 £1.5bn acquisition of NDS Group by Permira and KKR's £970m secondary buyout of Northgate Information Solutions from General Atlantic in the fourth quarter of 2007.

Impact of the financial crisis on the UK's ICT sector

Top five private equity-related deals in the UK ICT sector, 2005-2009

Announced date	Status	Target company	Bidder company	Bidder description	Bidder dominant country	Seller company	Seller dominant country	Deal type	Deal value (£m)
3/4/2007	C	National Grid Wireless	Macquarie UK Broadcast Holdings Ltd	Australia based investment vehicle representing the Macquarie Communications Infrastructure Group led consortium	Australia	National Grid plc	UK	IBO	2500
14/8/2008	C	NDS Group plc (76.2% stake)	Permira	UK-based private equity firm	UK	News Corporation	USA	IBI	1496
21/12/2007	C	Northgate Information Solutions plc	Kohlberg Kravis Roberts & Co	US-based private equity firm	USA	General Atlantic LLC	USA	SBO; Take Private	970
11/6/2007	C	Computer Software Group plc IRIS Software Group Ltd	Hellman & Friedman LLC	US-based private equity firm	USA	HgCapital	UK	SBO	500
8/10/2008	C	MessageLabs Ltd	Symantec Corporation	US-based company providing content and network security software	USA	Madison Dearborn Partners LLC	USA	Exit	402

The market has been depressed for most of 2009 and although there are a number of potential transactions currently in the pipeline, these tend to take a long time to complete, reflecting the fragility of trading and the nervousness of investors and debt providers alike. It is not surprising that the deals in 2009 were limited and focused on disposal activity. With the market completely flat until at least the end of the second quarter, and given the timescales needed to conclude a transaction in the current environment, we expect to see reported transactions start to increase in the first quarter of 2010.

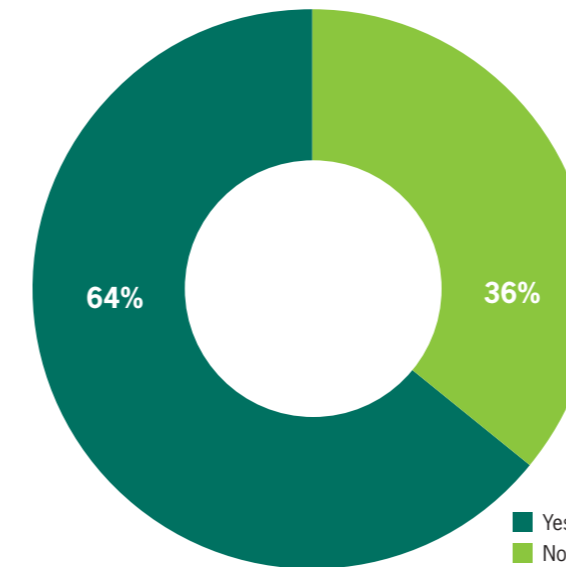
Based on what we are seeing with our clients, there will be an increasing number of private equity backed ICT transactions coming to market in 2010. With a concentration of available funds within the mid-market buyout houses, we would expect the majority of these deals to be neither very large nor very small, featuring equity cheques of £5m to £30m. There is likely to be an increasingly active market for secondary buyouts.

We would also expect to see private equity portfolio companies taking advantage of the reduced market valuations for ICT assets to make bolt-on acquisitions which will typically drive activity at the lower end of the market, offering an exit route to vendors with niche offerings of more limited scale provided they are realistic about price and deal structures.

In terms of exits for private equity houses, the sterling/dollar exchange rate and the relative speed with which the US appears to be coming out of recession suggest that there will be continued appetite from the US for UK acquisitions. As larger UK corporates start to feel more confident, one would also expect them to seek to take advantage of lower multiples to explore acquisitions during 2010.

Wendy Hart
Corporate Finance Advisory Partner

Is the ICT sector more insulated from the current downturn, given the lessons previously learnt when the dot com bubble burst in 2001?



To an extent, the impact of the economic crisis on some UK ICT firms seems to have been tempered by previous lessons learnt. 64% of respondents noted that firms which experienced the downturn in the sector in 2001 are now better placed to weather current market conditions.

One respondent rather intuitively explained that due to past experiences, firms in the space are “better prepared to deal with problems and fundamentally more robust”. One of their peers had a similar explanation and noted that companies are “better prepared in all of the key aspects”.

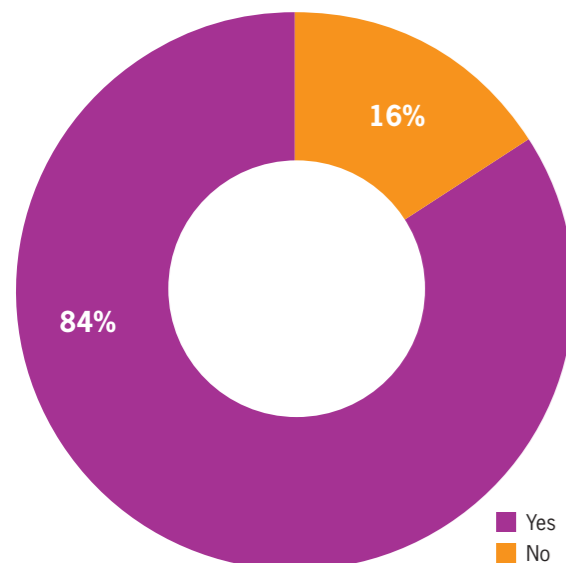
However, it needs to be pointed out that a number of respondents caveat their view by saying that the level of insulation is dependent on the life cycle of the business and how long the current management team have been in place. One respondent also said, “The start of the supply chain has been hit just as hard although businesses are definitely better proofed further along the chain. There has been a move into subscription based models and as a result revenues are more locked in.”

Back in 2000/2001 everyone jumped on the dot com bandwagon, and realistically a large proportion of those businesses were going to fail. There were no really new business models around, and the ICT developments making it all possible were in their infancy. Now, people have learnt what works and what doesn't, and it's the wider availability of new ICT solutions that makes much of it possible. The recent shift to a more service-based approach has to be helpful for the sector, and you only have to look at the development of iPhone apps to see how money can be made with clever ideas.

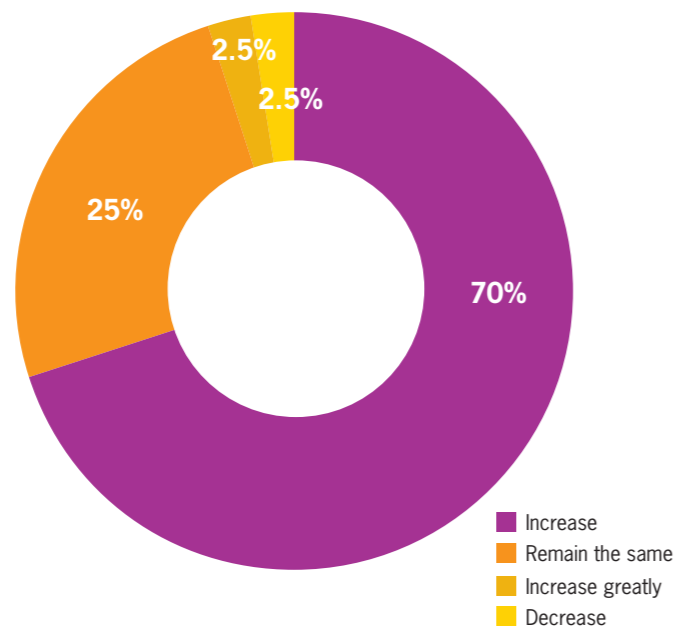
Philip Keown
Partner, Head of Technology Risk Services

Buying into the space – private equity activity in the UK's ICT sector

Does your firm plan to make an investment in the UK ICT sector in the next 12 months?



What do you expect to happen to the level of private equity investment in the UK ICT sector over the next 12 months?



The survey results suggest that private equity deal making in the UK ICT sector will increase, with an overwhelming 84% of respondents noting that their firm plans to undertake an acquisition in the space over the next 12 months.

One respondent explained his firm's continued commitment to the sector by saying "technology has become extremely important and valuable in the marketplace", while another was even more explicit and remarked that "shifts in digital platforms [offer] an attractive opportunity". Interestingly, one respondent also noted that valuations are attractive in the current market, suggesting that depressed corporate valuations will continue to create additional opportunities for private equity investors.

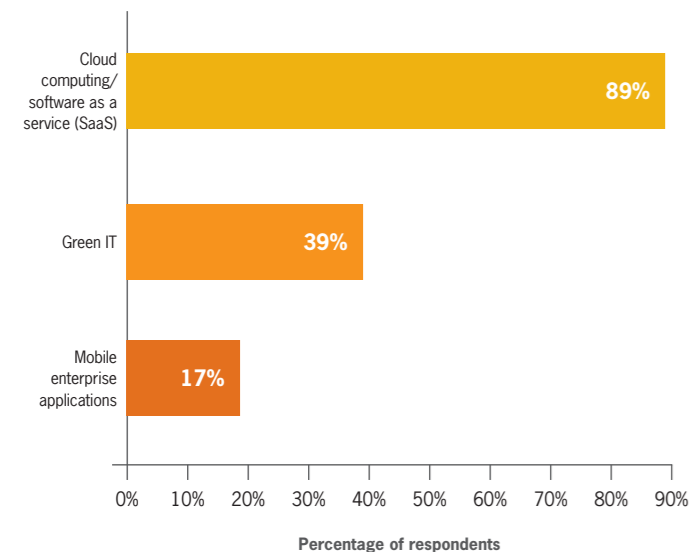
More generally, it is remarkable that a combined 73% of respondents expect the overall level of private equity investment in the niche to increase over the coming 12 months. One respondent explained this trend by saying that there is "scope for [additional] deals [as] technological innovations create impetus." Another said that "it is a good time to commit capital. I believe we will see an increase in the number of growth stories going forward."

Despite the fundamental optimism private equity investors have towards the UK ICT sector, it should be noted that one respondent tempered this slightly by suggesting that while an increase on 2009 numbers is very likely, activity is still expected to be lower than 24 months ago.

Tellingly, bullish sentiment from private equity investors in the ICT sector is reinforced by market data from mergermarket intelligence which indicates that a number of private equity-related transactions are in the pipeline. Online retailer The Book Depository is one such UK-based firm which could be acquired by a private equity buyer in 2010. Indeed, the wider ecommerce space remains attractive for the asset class, especially where the upside can be maximised through international expansion. A related area which could see significant activity is the e-wallet sub-niche where deal flow is expected to accelerate as sale conditions improve. Companies such as Moneybookers and Neovia

Financial will likely be targeted as e-wallet functionality becomes increasingly central to company competitiveness. All e-wallets in the UK are regulated by the Financial Services Authority (FSA), and such firms are particularly attractive to acquirers as obtaining the requisite licence can be protracted and costly.

Which niche within the UK ICT sector do you expect to represent an attractive investment location for private equity buyers over the next 12 months?



Elsewhere, 89% of survey respondents believe that private equity houses will actively look to acquire targets in the Software as a Service (SaaS) space. This niche is characterised by recent impressive growth, although smaller SaaS companies fully involved in hosted email could be ripe for acquisition next year with Microsoft moving into this space. Nevertheless, despite large corporates such as Microsoft, Oracle and Adobe embracing SaaS, pure vendors have largely dominated with new companies continuing to enter the market, leading to a relative abundance of potential targets for financial investors. A significant minority of respondents (39%) also cited the green IT niche, with government initiatives helping to encourage private equity investment in this area.

It is clear to me that geography is becoming less and less important within the ICT sector, particularly in respect of SaaS and other service-based developments. ICT providers will need to recognise this in the competition they face and the solutions they provide, if they are to be successful.

Philip Keown
Partner, Head of Technology Risk Services

As a part of the whole green agenda government investment support has tended to focus upon the development of low carbon energy generation and the associated infrastructure projects, rather than specific support for emerging technologies that have the potential to reduce energy usage.

As computing capacity and the use of mobile devices increase, so does energy consumption. Emerging technologies such as optical computing, the development of solid state drive technologies and a broad range of solutions to improve operational efficiency look likely to continue to attract investment. Companies such as Nujira which offer a low power solution for mobile telecommunications base stations are seeing their technologies adopted as the industry seeks to reduce costs through reduced energy consumption.

The Pre-Budget Report contained promises of an additional £120m of investment in wind energy and carbon capture projects, but while infrastructure projects take the headlines it is clear that the need to address the green agenda also presents investment opportunities within the ICT sector.

Niki Dixon
Tax Partner, Head of Technology

An interview with Axial Systems MD Ash Hussain

In 2008 Axial Systems, a UK-based supplier of datacomms and network analysis tools, underwent a NVM private equity-backed MBO. The company has consistently shown double-digit growth rates and reported a turnover of £20m in 2009. In an interview Ash Hussain predicted continued growth and told us about life with a private equity backer.



mergermarket: Ash, tell us a little about what led to the sale of the company in 2008.

Ash Hussain: It was really quite straightforward. Paul Spencer, who had founded Axial 20 years ago, had dedicated much of his time to setting up and growing the business. He wanted to spend more time with his young family and decided to look for a suitable buyer.

mm: How did you and the team go about finding the right partners to work with?

AH: We met with lots of different advisers but chose Grant Thornton because of the great rapport we established with members of the firm. It made the process that much easier.

mm: What were the chief attractions for prospective buyers?

AH: The company had a strong and stable client base with the Bank of England as a key customer. There was an impressive business portfolio, along with the company's remarkable growth rate. These factors made it attractive to private equity and trade buyers alike.

mm: And with all the interest, why did Spencer decide to sell to a private equity investor?

AH: Spencer was keen to find a buyer that would allow the company to continue to grow and benefit from the strong in-house management team. The best way of optimising the opportunities was to work with an equity partner in the

shape of a venture capital or private equity fund. There were a number of opportunities on the table and in the end it again came down to personal relationships. Ultimately, we went with the people that we all were comfortable working with.

mm: Tell us a little about the actual deal structure.

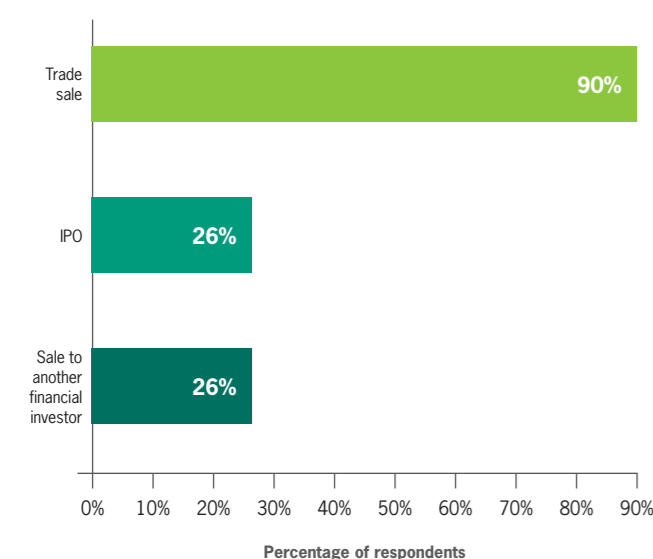
AH: The management team, including myself, put in a couple of million. The private equity backer, NVM Private Equity, invested an equity ticket of £5m while the remainder was financed by HSBC. Spencer still has a shareholding in Axial, which as part of the deal he is committed to hold for two years. The deal also included something that has since become increasingly commonplace in private equity-backed transactions – an earn-out clause that in this case was contingent on the company meeting certain financial targets in the financial year ending 2008.

mm: Axial has now been under private equity ownership for almost two years. What have the advantages been?

AH: Working with a private equity fund like NVM Private Equity has been great. They have let us focus on the day-to-day running of the business and have offered their expertise when the company has moved into new areas. The fund was instrumental in the appointment of a new financial director shortly after the sale and will also play a key role as Axial starts looking towards inorganic growth. The sheer wealth of contacts which private equity practitioners have is invaluable and a huge advantage to the business.

Getting out – how private equity exit their ICT investments

What do you believe will be the main exit strategy for private equity firms in the UK ICT sector over the next 12 months?



The relative robustness of ICT assets throughout the downturn is reinforced to good effect by the fact that a remarkable 90% of respondents believe the most likely exit strategy in the coming months will be a sale to a trade player.

As corporate valuations across all sectors have generally remained depressed, it is remarkable that a trade sale is deemed a more likely exit route than an IPO, especially given the recent rally in the equity markets.

“Exit activity has been slow as many funds have adopted a wait and see approach. However, the market is picking up and firms are facing increasing pressure to return capital to limited partners. A marked increase in sell-side activity could be on the cards.”

“As an exit strategy for our European investments we are not even looking at IPOs. We expect to realise value predominantly through trade sales – if the IPO market does return then this will be the cherry on top of the pie.”

Elsewhere, the strong fundamentals of many firms operating in the sector have meant that some private equity investors have already managed to realise solid returns via a sale to a strategic investor. The top UK ICT private equity deal of 2009 is a case in point, with a consortium of financial investors exiting their investment in Playfish to Electronic Arts Nederland for a total consideration of £239m.

In a startling departure from trade sales carried out pre-financial crisis, one respondent comments that going forward they expect the sales process to be a “more discrete, private process with less aggressive auctions”. It will be interesting to see how such a shift in tempo will impact on deal valuations over the course of 2010.

Impact of the tax environment

The technology sector has benefited from a variety of tax breaks such as the UK R&D tax credit regime and incentives to both management and investors. However, the lack of clarity over the future treatment of overseas income, including that from intellectual property, has prompted a number of high profile exits from the UK. The impact of a less benign tax environment for individuals has yet to be tested, but the main problem for investors in the short term is the uncertainty around taxation after the general election. Some potential vendors may choose to realise value in the short term against a known tax outcome given the absence of any increase in capital gains tax in the Pre-Budget Report.

Looking to the future, the announcement in the Pre-Budget Report of the possible introduction of a ‘patent box’ regime with a 10% tax rate on patent income could provide a welcome stimulus to help the UK compete with low tax regimes such as that in the Netherlands. Unfortunately the proposals as set out would not come in before 2013 and are limited in scope with their focus on patent derived income. If the proposals survive past the general election they will need to be more widely drawn if they are to have a real impact on the ICT sector.

Niki Dixon
Tax Partner, Head of Technology

The IPO route

Only 36 companies had been admitted to the market by the end of December 2009, the smallest annual intake since AIM was established in 1995. Over half of them were reverse takeovers or transfers from the Main Market and there was only one IPO in the technology sector itself, raising £1.2 million for Avia Health Informatics plc. Although the year also saw the third highest amount of funds raised via secondary issues for existing AIM companies, with £4.8 billion raised to the end of December, only £143 million was raised by technology businesses. Among technology companies 30 left the AIM market 2009*. Companies have been delisting from AIM for a number of reasons, including takeover offers by investors looking to take advantage of depressed share prices, winding up of funds and financial difficulties. Takeovers of AIM-listed companies are likely to continue as small cap markets remain depressed and corporate, bank or private equity funding is available.

Meanwhile, the outlook for the IPO market in 2010 can only be described as uncertain. Discussions with brokers suggest that there is considerable interest in mining and other natural resource businesses but little evidence of a resurgent interest in technology. While there is believed to be a pipeline of businesses looking to secure admission to AIM via an IPO, there is no real consensus as to when the market will pick up again.

* Source: London Stock Exchange statistics

Colin Aaronson
Director, Capital Markets

The trade buyer

Naturally, the approach BT takes to any acquisition is driven by our focus on shareholder value, and ensuring that any investment delivers attractive returns in excess of the cost of capital. What we specifically look for are acquisitions that enhance our existing capabilities in platform based communications services, and we focus largely on existing growing and cash generative business where we can bring the benefits of the existing routes to market that BT has, in order to add greater capabilities for our customers and help scale those capabilities. We would define capabilities as People, Technology/next generation services, new verticals, geographic expansion, etc. We seek to fund the transactions largely from cost synergies with revenue synergies (cross-selling opportunities) as an upside.

Himanshu Raja
Chief Financial Officer, BT Design

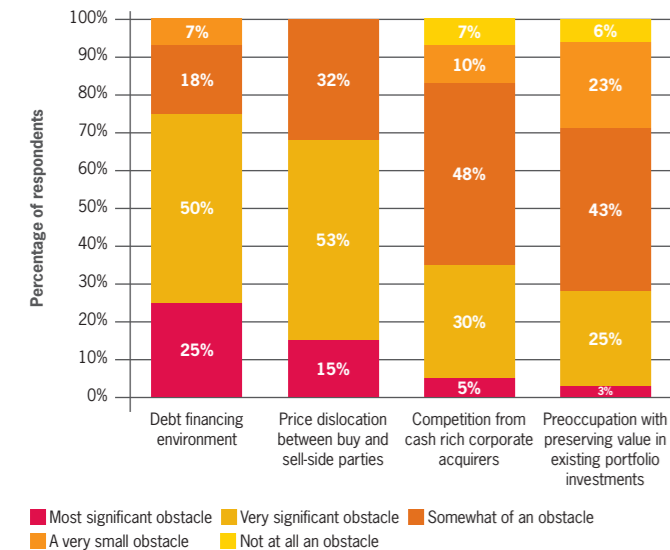
The customer perspective

When I look at this from the larger corporate’s point of view – the big users of technology – they are definitely being cautious about the investments, and many have delayed ICT projects in the current climate. However, if ICT providers focus on the efficiency they can provide, they should be able to persuade companies to invest.

Philip Keown
Partner,
Head of Technology Risk Services

Looking ahead at investment activity – what is in store for the UK’s ICT sector?

What do you consider to be the most significant obstacle for private equity firms looking to invest in the UK ICT sector over the next 12 months?



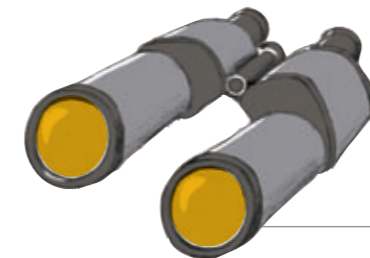
Despite the positive outlook for private equity investment in UK ICT assets, it is notable that investors still face considerable challenges when undertaking transactions.

Given the impact of the financial crisis on bank lending, it is of little surprise that the chief obstacles are the availability and cost of leverage. 75% of respondents remarked that the current debt financing environment is at least a significant obstacle to deal making, while 68% also cite the price dislocation between buy and sell-side parties. Interestingly, other issues were also identified with respondents commenting that the “general fundraising environment” will be a challenge as well as understanding key changes to the sector.

Given the scale and scope of the above-mentioned challenges, the nature of private equity deals in the ICT sector has changed as a result of the new economic reality. Somewhat unsurprisingly, 33% of survey respondents note that they have become increasingly selective, eschewing riskier investments in favour of companies that offer robust revenue streams. One such respondent remarked,

“We are focused on products that are viewed as must have rather than nice to have.” This view was reinforced to good effect by another private equity practitioner who said, “We are now looking at businesses which can represent a degree of certainty – companies with contractual and revenue stickiness.”

“We now have to be a lot more cautious, greater research and due diligence are done on all potential investments. We have to be 100% comfortable with what we are getting into,” one respondent said.



The results of this survey into the private equity industry’s history and experience of the UK’s ICT sector are not altogether surprising as far as 2009 is concerned. For those of us who are focused on this sector, particularly in the mid market, it is very encouraging to note that there is clearly an expectation of an increase in private equity investment in this sector and an appetite for private equity investors to make an investment over the next 12 months. One area we have seen an increasing interest in generally, in terms of transactions, is around public sector outsourcing and in particular the ICT arena, where the continued expenditure pressure on the public sector is going to drive ICT outsourcing at many levels.

Undoubtedly the ability to raise sensible levels of debt finance to support such investments will continue to be a challenge for investors, but overall our clients are looking at and engaging in a range of interesting investment opportunities and we are expecting a busy 2010 for our private equity ICT teams.

Mo Merali
Head of Private Equity

Challenges in securing investment

For business owners who require growth funding or an exit in the coming year, one of the greatest challenges is the much increased risk aversion of the private equity houses and corporate buyers. With access to capital more restricted than it has been in recent years, no individual investment director or business development director wants to be the one to get it badly wrong. This manifests itself in two key ways. First, there is an ever tighter set of criteria which defines a business as an attractive investment or acquisition opportunity and this tends to relate to what that business has already delivered rather than, as one might expect, what it is able to deliver going forward. Better a business delivering sustainable but unexciting profits than one with an erratic trading record and an exciting piece of intellectual property. For the latter, private equity and trade are likely to prefer to wait for the case to be proven.

Second, the process of investment or acquisition has become elongated by the need to cover off every aspect of risk in due diligence and legal drafting. Whereas deals used to take an average of six months to conclude, they are currently taking nine months+ even when there is clear will to complete on both sides.

There are steps that management teams and shareholders can take in order to position themselves effectively for investment or acquisition, even in this challenging market.

Entering the market with a degree of realism about multiples, deal structures and timetables is important. Vendors who don’t appreciate the characteristics of a private equity led deal in the current market are likely to be both disappointed and frustrated by the realities, and this can quickly sour relationships – turning a deal which could have been coaxed to completion into one which will inevitably founder on the rocks of mistrust.

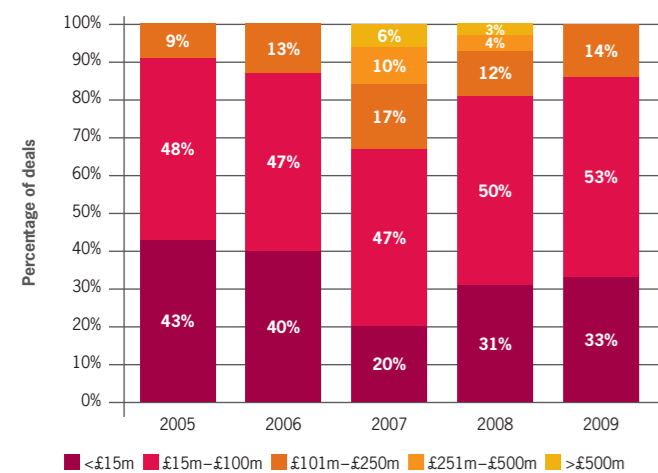
Also, preparing your business intelligently to go to market is important:

1. Where revenues are contracted, make sure this is fully documented and be expecting questions about termination dates, relationships and re-tendering risk.
2. Forecast growth will need to be robustly defended even before a private equity house is prepared to invest in due diligence costs. All increases in revenue streams or new customer assumptions will be treated with scepticism unless they can be supported by evidence.
3. Ensure you have enough resource either within the business or in your external advisory team to cope with the demands of the process and still run and grow the business effectively. Private equity houses and acquirers are no longer phlegmatic about any evidence of a dip in trading, and will down tools and wait until they are confident that there is no underlying problem.
4. Multiples will tend to be applied to EBITDA or EBITA depending on the capital spend profile of your business. Presenting your earnings streams in the most advantageous light is key to ensuring that any multiple is applied to the ‘right’ number. Giving a would-be investor or acquirer your unadjusted management accounts is likely to result in a disappointing early indication of price.

Wendy Hart
Corporate Finance Advisory Partner

Size matters – breaking down the size of private equity investments

Deal size breakdown of overall private equity activity in the UK ICT sector



A lack of market confidence and an austere financing environment have unsurprisingly led to private equity deal making largely retrenching to the mid-market space.

Indeed, the overwhelming majority of survey respondents (80%) note that debt-to-equity ratios have fallen over the last 12 months. Looking at private equity activity in the UK ICT sector over the course of 2009, it can be seen that 86% of deals with an announced value have fallen in the £5m-£100m range, compared to 67% witnessed at the height of the buyout boom in 2007.

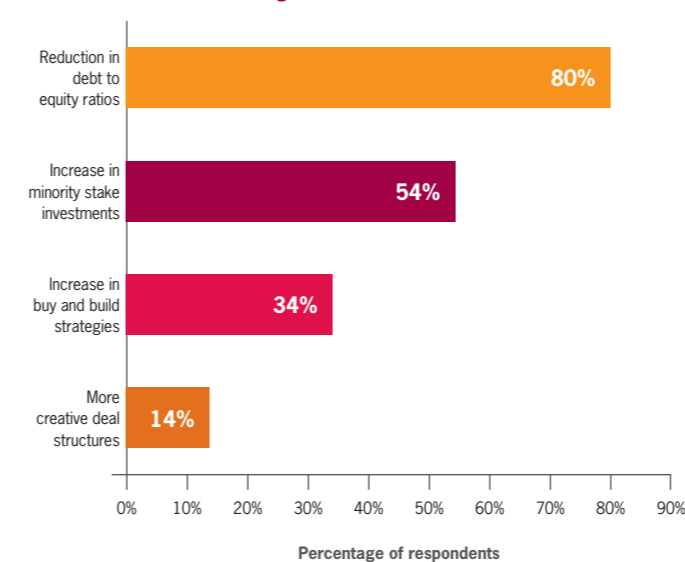
Looking ahead over the next 12 months this is unlikely to change, with 95% of respondents predicting that private equity activity will fall predominantly in the above-mentioned deal size range. “Deals in this range are still financeable. The banks are generally more willing to get involved in smaller deals where less debt is required.” This viewpoint is reinforced by the fact that private equity houses in 2009 have not been involved in a UK ICT deal, either on the buy or sell-side, which had an announced valuation exceeding £300m.

“Equity has become an increasingly important source of capital. Buyers have also become more cautious as the growth potential of firms is now less visible.”

It should be noted that increased M&A activity at the lower end of the market is not unique to the ICT sector. Issues surrounding leverage have impacted upon deal making across all sectors, and these are generic challenges facing any private equity investment in the current environment.

Looking ahead – private equity in the future

In what way(s) have private equity deals changed in the UK ICT sector since the acute onset of the global financial crisis?



The financing environment is undoubtedly presenting a key challenge for private equity investors. Indeed, the majority of respondents (80%) believe that a reduction in debt-to-equity ratios is the principal way in which private equity deals have changed since the acute onset of the financial crisis.

However, banks’ inability to adequately meet the financing needs of corporates is also creating a significant opportunity. A large number of companies in the ICT sector are currently facing a liquidity crunch, with 39% of respondents suggesting that firms’ requirement to access cash for investment and innovation will create the most significant investment opportunities over the coming 12 months. Underpinning this point, one respondent said, “Private equity is now a solution to the scarcity of debt, with firms providing much needed growth capital.”

Private equity certainly appears to have the appetite to do deals, with the asset class sitting on vast amounts of dry powder. Under pressure from limited partners to put capital to work, and facing a relative lack of viable acquisition targets, financial investors have become increasingly creative with funds looking to step up and ease the debt burden of a company in return for a minority stake. Indeed, it is telling that 54% of respondents believe that an increasing number of minority stake transactions have been undertaken since the onset of the global financial crisis.

The credit squeeze has also seen acquisitive ICT firms turn to private equity as a source of acquisition financing, with banks seemingly unable to provide leverage at acceptable terms. Going forward, mergermarket intelligence suggests that Outsourcery and Vertical Group are just two of the firms which could turn to the asset class to finance large-cap transactions in the coming months.

“While private equity tend to be braver than banks, the financing environment for firms that are not asset based is very tight.”

Smaller ICT firms are finding securing finance even more difficult. The economic downturn has resulted in private equity houses committing less speculative investment at the start-up level. As a result, these companies are facing a sharp liquidity crunch, further exacerbated by the banks’ continued reticence to lend at acceptable rates. Going forward, such companies could be ripe for acquisition with private equity-owned portfolio companies perhaps the most likely candidates to step up, especially as valuations continue to slide.

To an extent, this trend has already materialised with 34% of respondents noting that the volume of buy and build strategies has increased over the last 12 months. The most notable example in the UK market saw LDC-owned Pro-Bel move to acquire Snell & Wilcox, the designer and manufacturer of electrical components owned by Advent Ventures, for a total consideration of £72m in March 2009. Post-deal, the two companies were merged with LDC and Advent taking a combined stake of around 80%, with the management holding the remaining equity.

Going forward, the level of buy and build activity is set to increase further with several situations in the pipeline. Most significantly, August Equity-owned SaaS firm 4projects is actively eyeing domestic bolt-on acquisition targets, proof that private equity houses are continuing to adapt to the economic downturn with a renewed focus on value creation at portfolio company level.

In-depth interview: MML Capital Partners

Derived from an interview with Bal Johal, Managing Partner, MML Capital Partners LLP

Bal Johal, Investment Director at MML Capital Partners, argues that it is a good time for private equity houses to invest in the UK's ICT sector. While deal making activity was understandably subdued over the summer months in the niche, there has recently been a significant increase in the number of opportunities. "There are attractive deals out there and it's possible to get into some really good businesses at the moment," says Johal of the current investment climate.

The attractiveness of ICT assets in the UK is enhanced by the fact that valuations continue to be depressed. Indeed, the global economic downturn has forced vendors to accept a new norm in valuations as demand for assets and the austere financing environment ensure multiples stay at relatively low levels. As debt financing remains the principal challenge to doing a deal, private equity funds have had to be more flexible in terms of how transactions are structured. One way buyout houses may look to bridge the financing gap is by providing the debt themselves in deals, with a view to refinancing when the state of the debt markets improves. Clearly the opportunity for growth capital providers, like MML Capital, is to take minority stakes without raising bank debt.

Notably, debt financing is substantially easier to obtain for private equity houses looking to do deals in the mid to low end of the market. "MML has not faced problems financing deals in the current environment," comments Johal, "generally the debt component in transactions done by MML is less than £100m and we've found that banks are more willing to back deals in this space." Indeed, MML recently did a deal in the healthcare space, backing the £31m management buyout of Vanguard Healthcare Solutions, and Johal remarks that the firm received offers from several banks to provide the debt element in the transaction.

While representing a challenge, it is interesting to note that the financing environment is also creating opportunities for private equity investors. Companies across every sector are facing a liquidity crunch, with banks generally only willing to lend to firms with which they have a strong relationship. Johal notes, "ICT companies need growth capital to invest in the development of the next generation of products for both the corporate and retail markets. With banks not lending, there is an opportunity for private equity to step up and fill the current void in financing."

The economic downturn has meant that different types of deals are now being done, with an increasing number of minority equity opportunities coming to the market. Johal says, "These are advantageous for shareholders as they can release a minority of the equity for a variety of reasons, including easing the balance sheet or making an acquisition, with the option to dispose of the remaining majority stake when market conditions improve and valuations reach more attractive levels."

Elsewhere, the current economic climate also represents a good opportunity for financial investors to undertake buy and build strategies in the sector. This is borne out by low valuations and a relative abundance of firms which, being hamstrung by the financial crisis, are ripe for acquisition.

"If you can afford to do a deal there has never been a better time to acquire competitors," Johal adds.

Looking at future buyout activity in the sector, it is likely that IT services and software and traditional "nuts and bolts" IT will see a good level of deal making in the coming months. However, speculative investment in start-up companies will fall as financial investors look to generally target established businesses with proven track records, and concentrate on adding value through improving existing technology. In terms of private equity exit strategies, Johal remains cautiously optimistic over the initial public offerings (IPO) market, "We are constantly being asked by investment banks if we are interested in listing portfolio companies. The IPO market will return in time, although I would expect firms to try and wait until a greater semblance of normality returns to the market."

There is also continued buy-side interest from cash-rich trade acquirers and this, coupled with steadily improving market conditions, should ensure that corporate valuations trend upwards over the medium term. Likewise, the value of ICT businesses that survive the recession and subsequently prosper will increase significantly, and this will be beneficial for private equity houses with current investments in the space.

In-depth interview: Lloyds TSB Development Capital

Derived from an interview with Yann Souillard, Director, Lloyds TSB Development Capital

In keeping with almost every other part of the global economy, the UK ICT sector has been adversely impacted upon by the financial crisis. Yann Souillard, Director at LDC, notes that the business-to-business space has been more resilient and he highlights that significant investment opportunities remain in this market.

There is an acute need for information, and decision making tools which help companies operate in an ever more complicated world are especially sought after, even in the current austere trading environment. Souillard notes, "In the land of the blind the one-eyed man is king," and the ever increasing appetite for information ensures that the niche has relatively strong growth prospects and remains an attractive investment location for LDC and other financial investors.

However, it is notable that a challenging dynamic is emerging within the ICT market in that while the demand for information is increasing, the value attached to "raw" information is actually falling. Consequently, the commoditisation of information has seen private equity houses moving up the value chain from pure data companies to companies that provide decision insight for its customers. LDC has successfully brokered deals in this area with a prime example being its investment in Ascend, the UK-based provider of information and consultancy services to the Aviation industry.

Looking at the wider issues facing private equity houses investing in the sector, the cost and availability of leverage continue to be the principal impediments to deal making, especially towards the top end of the market. However, there is a relative abundance of potentially attractive targets in the mid-market space, and as a result the lack of debt financing is

not proving to be an insurmountable problem in deals which require a higher equity component. On this subject Souillard adds, "We have not been greatly impacted by the lack of leverage as we are focused on delivering returns through growth rather than through financial engineering."

The level of competition from other investors for attractive assets is also often significant, and private equity practitioners are finding it challenging to find a target that hasn't already been identified as a likely success story by the wider market. Souillard comments that potential winners within the ICT sector are generally easiest to identify on the information services side, whereas within the general ICT sector it can be difficult to pick out the winners from the rest. "There are a lot of very successful and fast growing pure IT companies, but equally a lot of investments in this niche fail to grow beyond a certain size."

Elsewhere, a positive development for investors in the UK ICT sector is that the barriers to entry for companies have fallen along with the cost of technology. As a result, many small and medium-sized enterprises are now able to compete with FTSE 250 companies. Indeed, a lack of size is not necessarily a disadvantage as smaller firms are often more nimble and are able to leverage technology without spending a huge amount of money. Souillard does concede, however, that credibility can be an issue, "In order for an

SME to compete with the larger players it is essential that the right business model and management are firmly in place."

In terms of likely exit routes over the coming months for existing private equity ICT investments, it is notable that the initial public offering (IPO) market is beginning to thaw, although Souillard predicts that this will not fully open up until next year. Trade acquirers that have been particularly hamstrung by the economic downturn are not currently looking to conduct M&A transactions, although such buyers will return to the market once their balance sheets have been repaired. Over the short term, the most likely exit strategy will likely involve disposals to cash rich trade acquirers and other private equity buyers. Indeed, Souillard comments that demand for the right asset has always existed to a greater or lesser degree, "It is rather intuitive that well managed firms operating in a growth sector will always be attractive to acquirers." At a time when buyers are generally reluctant to do deals, the fact that assets are still being actively eyed by acquirer's serves to emphasise the attractive fundamentals of the UK ICT sector. The cash flow of a significant proportion of companies in the niche is strong and Souillard underlines this by remarking that LDC's ICT portfolio has fared remarkably well over the course of the economic downturn.



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Contact us

Head of Technology Niki Dixon

T 01223 225672
E niki.dixon@gtuk.com

Belfast

Dominic Preston
T 028 9031 6527
E dominic.a.preston@gtuk.com

Birmingham

Simon Clewlow
T 0121 232 5122
E simon.clewlow@gtuk.com

Cambridge

Niki Dixon
T 01223 225672
E niki.dixon@gtuk.com

Glasgow

Neil McInnes
T 0141 223 0618
E neil.mcinnnes@gtuk.com

Leeds

Tim Lincoln
T 0113 200 1521
E tim.lincoln@gtuk.com

London

Philip Keown
T 020 7728 2394
E philip.r.keown@gtuk.com
Neil Pamplin
T 020 7728 2778
E neil.c.pamplin@gtuk.com

London Thames Valley

Jim Rogers
T 01753 781105
E jim.n.rogers@gtuk.com

Oxford

Wendy Hart
T 01865 799938
E wendy.e.hart@gtuk.com

Reading

Wendy Hart
T 01865 799938
E wendy.e.hart@gtuk.com

Sheffield

Paul Houghton
T 0114 262 9761
E paul.houghton@gtuk.com

Southampton

Norman Armstrong
T 023 8038 1114
E norman.armstrong@gtuk.com

Head of Private Equity

Mo Merali
T 020 7728 2501
E mo.merali@gtuk.com

For other queries please contact your local Grant Thornton office:

Belfast

T 028 9031 5500

Birmingham

T 0121 212 4000

Brighton

T 0870 381 7000

Bristol

T 0117 305 7600

Bury St Edmunds

T 01284 701271

Cambridge

T 01223 225600

Cardiff

T 029 2023 5591

Edinburgh

T 0131 229 9181

Farnham

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T 0191 261 2631

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T 01604 826650

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T 01603 620481

Oxford

T 01865 799899

Reading

T 01189 839600

Sheffield

T 0114 255 3371

Slough

T 01753 781001

Southampton

T 023 8038 1100

Or alternatively, email us at heretohelp@gtuk.com