

The cutting edge

IT M&A outlook in 2016

Deal value in IT was up 47% year-on-year in 2015, as the industry continued its evolution. But what constitutes a sound strategy in this fast-moving sector? What role do link-ups play, and how can established players compete with rising start-ups? Toppan Vite, in partnership with Mergermarket, asked three IT M&A experts for their thoughts on the year ahead.

MM **Mergermarket:** What has been the single biggest shift in the IT industry in recent years, and how have established players reacted to it?

RC You refer to the “IT industry,” and in that phrase you see the single biggest shift. I don’t think one can speak of an IT industry anymore. What was once called the IT industry had a particular business model, but the business models have changed significantly due to the speed of change, brought on by disruption, convergence, and so on. Disruption in the industry has resulted in all these companies and established players reassessing business models, trying to find new revenue streams, and essentially having to evolve and adapt to very rapid changes.

TJ The main shift is that many high-profit-margin products have been commoditized, for example personal computers. And that process is now beginning to convert sexy smartphones into consumer commodities as well. The razor-thin margins that result from commoditization have reduced research and development budgets and forced big companies to move to a-la-carte pricing of technical support. That commoditization, the squeeze on profits, and breaking out pricing for services has fundamentally changed the IT space. Big companies have consolidated, and since they face stiff competition from Asian competitors, they’re often forced to shut down domestic manufacturing in order to convert to low cost Asian contract manufacturing, leading many companies

The experts:



1. Robby Coelho (RC)
 Partner
 Webber Wentzel

2. Tom Jarvis (TJ)
 Partner
 Winston & Strawn

3. Andrew Bozzelli (AB)
 Director
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to compete on price. Patent and trademark protection are two of the best ways to survive in this market.

AB There have been several major shifts, as Robby and Tom have mentioned, but in terms of M&A activity, we are seeing a lot of deals focused on data and risk specifically. Those two areas cover a broad spectrum—the Internet of Things (IoT), big data, security, analytics. Ultimately, buyers—whether financial or strategic—are highly acquisitive of companies that are helping customers access, assess and make sense of data, as well as manage risk using that data. And of course, buyers are looking for the ability to monetize that software in a scalable and recurring manner.

MM **We've seen a couple of huge IT deals recently, with the Dell-EMC merger and HP splitting itself into two entities. Are these deals part of a wider trend in the traditional IT space?**

TJ IT has a long history of rapid evolution, and this is just the newest phase. Megadeals like these enable consolidation of support functions—accounting, sales, human resources and so on. Consolidation of highly scalable support organizations reduces costs and enables delivery of goods and services that are targeted at a higher position in the value chain. Unless they can move up the value chain, most companies face

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Andrew Bozzelli, Livingstone

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unrelenting competition from Asian competitors. Positioning on the value chain has everyone's attention right now.

RC It may depend on the rationale for the deals. What's interesting with the Dell-EMC and HP deals is that they arguably reflect different strategies. Clearly, organizations have differing perspectives on what the future looks like, and different companies have different models for adapting. So, Dell-EMC is more of a consolidation and arguably the pairing of complementary products and services, whereas HP is a split into different hardware and software companies.

We're certainly going to see a trend of a lot more activity in the industry, but the underlying strategies may be quite different among various players and in different jurisdictions. In South Africa, for instance, we've seen a lot of activity, but arguably it has been influenced by a contrasting set of factors. Perhaps a regulator has been slow to liberalize the telecoms market and you see deals being done where particular players are trying to get access to facilities and frequency that others may be sitting on. The rationale for the deals is also influenced by local requirements where those entities are operating.

AB What's relevant to us and our clients is how these larger transactions impact the M&A appetite of the broader industry. In the near term, we do not

anticipate any significant changes in the M&A environment and believe it will continue to be a seller's market. With that being said, if you are an entrepreneur or middle-market fund and you are thinking about exiting your business or investment in the next two to three years, we strongly advise you to consider accelerating those plans to capitalize on this current environment.

MM **What are the biggest challenges facing the IT industry across the market at the moment?**

AB From a mid-market M&A perspective, the largest challenges are navigating buyers and valuation expectations. When I say buyers, I am talking from a seller's perspective, and that covers both the proliferation of buyers and qualifying those purchasers. In today's mid-market environment, business owners are getting contacted constantly from financial buyers, whether it's venture capitalists, private equity firms, or family offices. The sheer number of these buyers is increasing substantially. In certain instances, they may get inbound interest from a strategic, which often has a previous business relationship with the firm.

Ultimately, it is critical for potential sellers to make sense of this interest, qualify the approach, and develop a sale process to maximize value and ensure a successful close. With respect to valuation expectations, the buyer community openly laments the current M&A market for driving increased



competition and higher multiples. Buyers will also say that a dichotomy exists between the number of deals in the marketplace and pipeline, and the quality of those deals. So it is important to remember that not every deal is the same. If your peers are trading at one multiple, that doesn't always mean that your business will also trade at that multiple.

RC

From a legal perspective we are seeing more regulation. You're seeing increasing protection of data and personal information, and those issues are becoming ever more prominent. Moreover, all these deals are happening in an industry that is changing significantly and at a pace where the laws aren't keeping up. So they're operating under increased regulation on the one hand, and on the other the industry is adapting and evolving in areas where the laws don't accommodate those business models. A classic example of an uncertain environment is on-demand businesses, where often they operate in industries that only accommodate a traditional business model rather than an online, on-demand model. This ties in with challenges regarding revenue streams as well.

The other challenge we're seeing is the cannibalization of businesses. Entities are becoming redundant and have to evolve quickly to remain relevant, and they're facing issues in doing that. Increasingly, you're finding that the barriers to entry are lowering quickly—the traditional larger entities are finding

it's easier for the smaller, more elastic companies to move in very quickly, cost effectively, and compete effectively. This is a challenge for established players.

TJ I would say the biggest challenge is probably the squeeze on profitability, as Robby mentioned. Highly profitable products are quickly commoditized by competitors who deploy small design teams and use low-cost Asian contract manufacturers to deliver products with minimal investments. Cost-effective internet marketing, coupled with the new internet distribution channels such as Amazon, can saturate the market with competing products in a very short period of time. Constant innovation by market leaders, coupled with effective IP enforcement, are the best tools for preserving profitability in these situations.

MM **What are the main challenges faced in large IT deals?**

RC Large is a relative term when it comes to IT deals, but when you deal with transactions that are multijurisdictional, there are inevitable challenges. You often come across issues around antitrust and competition law. There are also the challenges of licensing restrictions and approvals—for instance, obtaining telecoms licenses. Then you have the traditional challenges of integrating people, and in some cases of dealing with redundancies, as well as restructuring the deals to accommodate the

underlying business model and rationale of the deal. In some jurisdictions and regulatory regimes, that is tied to union issues.

Also, in these large deals you have to consider intellectual property (IP) rights—the integrity of IP rights and the ability to exploit IP in different jurisdictions. Since that often forms the basis of these deals, assessing the integrity of those rights to the key assets of the business is one of the big challenges.

AB Since we work on IT deals worth less than US \$250mn in enterprise value, the buyer is often a strategic with a proven integration plan for bolt-on acquisitions. However, in addition to running a sale process to maximize value and enhance certainty to close, we also stress the value of finding the right partner for the business going forward. That generally means finding a buyer with a similar culture or shared vision or strategy. Helping clients ensure that the cultural fit is right during the process helps to minimize hiccups post-close.

MM **How can IT companies compete with the new wave of start-ups?**

RC Certainly what you can't do is to ignore them. What you will increasingly see is that you compete by investing either in new technologies or new opportunities. In some cases, there are good prospects to acquire start-ups even if they're unlikely to move the needle or the business is very

young. They can allow the buyer to expand or provide complementary products and services for the existing business model. I think what we'll see and what we've seen is this evolution of adapting and evolving to anticipate the threat of these start-ups, and to avoid the disruption they bring.

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**Tom Jarvis,
Winston
& Strawn**

One of the issues for the large IT companies is that they're often burdened by internal bureaucracies—policies, procedures, etc.—which delay decision-making or have a long decision-implementation process. Start-ups, by contrast, move quickly and adapt quite quickly. So it's about looking at the model, looking at the opportunities, and looking at acquisitions of those startups and anticipating the areas they are going into. But it's also about adapting and changing the way companies operate in approaching those opportunities, and moving a lot quicker.

AB

From an M&A perspective, doing a defensive acquisition can be an option, as Robby said. But we usually see acquisitions of competitors succeed best when there is a growth strategy driving the rationale. Taking the other side, exiting to a strategic or finding a new financial partner can aid in positioning against a newly funded competitor. There is an abundance of strategic and transaction alternatives available to most middle-market companies.

TJ

Established US players can monitor new tech companies, make strategic acquisitions and maintain a position on the cutting edge of competition using incredibly efficient Asian manufacturing capacity. It's really the combination of those three forces—established major players with strategic vision, acquiring new technology companies, then leveraging low-cost Asian manufacturing that will win the race in the IT industries.

MM **What do you think will happen in IT M&A in the coming 12 months?**

AB As I mentioned earlier, we believe the IT M&A environment for the middle market will remain robust over the next 12 months. Activity should remain strong in the areas of data and risk, and companies that have a differentiated platform within those verticals will continue to garner strong interest from both strategic and financial buyers. In addition, we believe the buyer universe will continue to be global. We market nearly all of our clients to global buyers, since international buyers can be an ideal exit option—even for software companies that are sub-\$20 million in revenue.

RC I think we'll see more investments in new, disruptive technologies, including acquisitions of start-ups where appropriate. It depends on jurisdiction, of course, but we'll see more consolidation happening, more acquisitions up and down the value and supply chains, as well as more investment in synergistic products and services. And importantly, you're going to see increasing opposition by industry competitors and attempts to scupper these deals, whether through regulators, antitrust complaints and challenges, and possibly through litigation related to IP rights.

TJ The global challenges to profitability in mature markets are very apparent right now, but I believe there will be a new wave of products and services

that will usher in a new wave of profits. There's good reason to be optimistic. IoT is a great example — machines will talk to each other constantly and take care of things that now consume human time and energy. In the near future, something as simple as your coffee maker could remember the number of cycles it's been used, know how many coffee filters you last purchased at the supermarket, calculate whether you need more filters, initiate a purchase, and the supermarket will deliver it to your door. That's a mundane example, but it's a breakthrough use of technology to provide consumers with the freedom to spend their time more productively and enjoyably — just one of the thousands of new business models on the horizon.

The development and rollout of 5G wireless technology will also fuel a new wave of electronic devices. Cost is going to be great and rollout has to be very efficiently executed in order to capture the return on investment. It's a new technology, so there was a huge R&D expense. Rollout is going to be complex and expensive, and unless it's done correctly they won't capture investment costs. But 5G will be a trend in IT deal-making for the next year.



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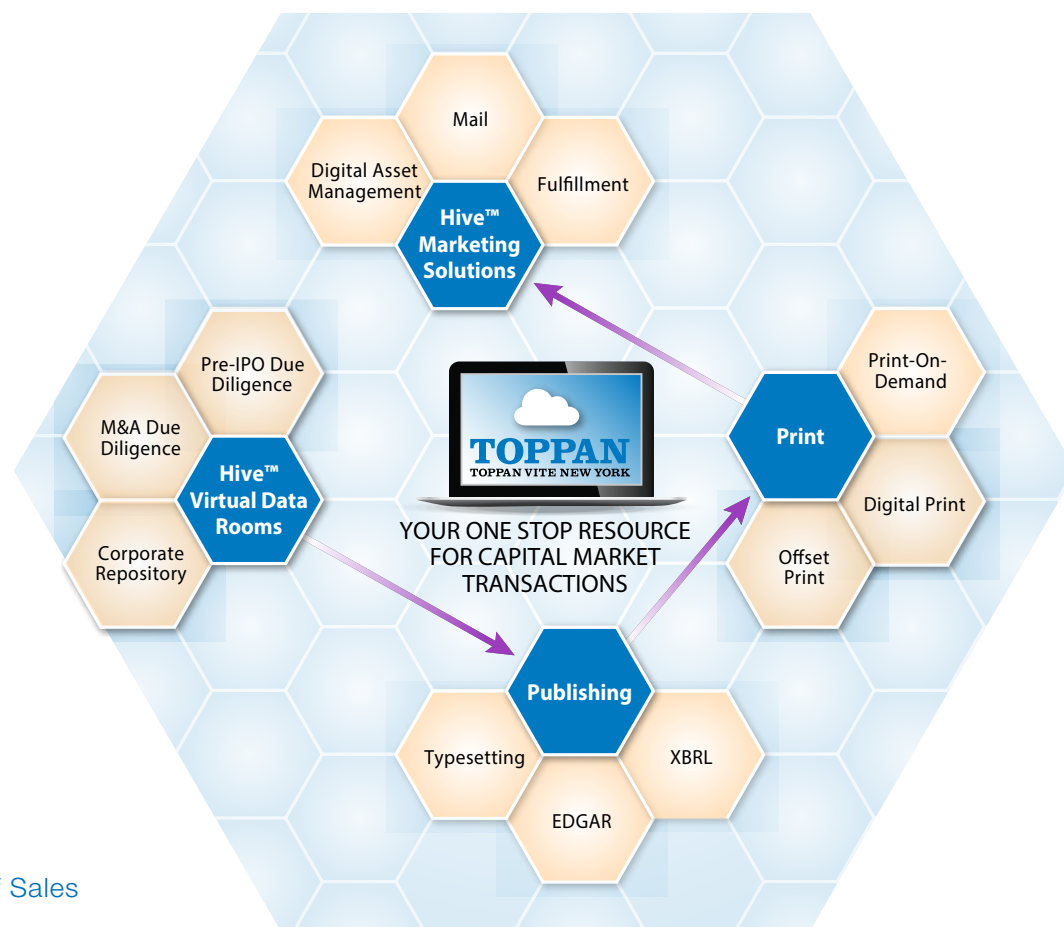
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