Investments • Advisory • Management

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Services Globalization - M&As in 2007

"Some time back, we had looked at the M&A space in services globalization and analyzed the deal making in the first half of 2007. Here, we present the analysis of deals globally for the year 2007, the critical events, and how they promise to impact the M&A activity in the near future."

What Drives M&As in the Services Space

The services market saw heightened M&A activity in 2007. The deals in volumes and value terms were of unprecedented magnitudes. The market saw a total of 306 deals globally, with an estimated cumulative deal value of $52 billion. The drivers fro M&A remained the same, quest for larger scale, well rounded service portfolio, and a global footprint. 2007 however saw an urgency not seen in the previous years. This was the year, where the market players moved out from their respective vantage points, to play on a more level playing field. As differentiators of low cost talent access, client access & relationships, domain knowledge, etc. started to grow thinner, there was a push to quickly tide over the relative weaknesses in the business model, and compete on equal footing on all parameters. Hence we saw global majors trying to shift a larger proportion of their workforce to lower cost locations, while the "offshore majors" made serious inroads into the "client geographies." We saw some of the Tier II players try to move quickly to the next level by acquiring larger firms, while some of them were gobbled up themselves. The process is not over though, and we anticipate this churn to continue for a few more years before things settle into a new world order.

Services Environment

Service Providers realize that one of the most important elements of demonstrating competitive advantage is to have a global presence. This is primarily driven by two reasons: increasing market penetration, and acquiring client domain skills and delivery capabilities in newer geographies. Most Tier I offshore service providers have been rapidly expanding globally. More and more, Tier II and Tier III service providers are aggressively scouting to expand inorganically and are looking at expanding their services to countries outside their home base. Mid sized Indian service providers have of late shown more aggression and hunger for larger deals than the Tier I players (case in point being Caritor's acquisition of Keane). The reason is obvious – building on a solid platform, they have a greater need to scale up, to be able to compete for larger deals.

A lot of acquisition activity is being fuelled by the backing of private equity players, especially for the mid sized services firms. While a large chunk of the deals are cross border in nature (offshotre firm acquiring a US/European firm), for getting a firm foothold in the demand geographies, mid sized offshore firms are also looking for acquisitions to scale up delivery offshore or to get into complimentary service lines.

Trends

India remains the most active offshore location when it comes to cross-border deals. There have been more than 145 cross-border deals originating from India since 2004. Some $5 billion worth of deals have been transacted in 2006, following $4 billion in 2005. Years of high-speed growth has made many companies in India cash rich and keen to expand abroad. Most of the deals were primarily aimed at gaining market access by acquiring customers and domain skills. In near future, we'll see Service Providers undertaking M&A to acquire delivery capabilities, specifically in complimentary markets such as the Philippines, Vietnam and the emerging economies of Eastern Europe. Service Providers from these economies will also actively make acquisitions in offshore.

Besides India, we are also seeing a lot of interest from other Asian companies, notably from Philippines and China, looking for acquisition opportunities in the client geographies like US, UK and Japan (for China based firms). They are also looking at augmenting their delivery base by establishing a presence in India through the inorganic route.

1. Scaling up has not been the predominant theme

Unlike conventional wisdom, most of the deals seem to be driven by motivations other than just scale. This is evident by the predominance of small deals, made with the intent of getting missing parts of the puzzle to get the overall value proposition in place. There have been as many as 181 deals with a value of less than $25 million. The first half of the year saw 121 such deals while there were 60 deals of less than $25 million value between July and December. Most of these deals were characterized by the motivation to either gain a complimentary set of services, or to get a foothold in a new geography. The numbers drop off thereafter with just 50 deals in the $25 - $50 million range. On the higher end of the deal size, we saw 20 deals of more than $500 million, with half of them exceeding a billion. Again, the first half accounted for 75% of these deals. The total value of the billion plus deals amounted to $31 billion, at an average of about $1.5 billion per deal. The billion plus deals formed 59% of the entire deal value in the services globalization space.

Large deals like these significantly alter the acquiring company's status and positioning in the industry, and at times redefine the rules of the game. The CSC Covansys deal for example, gives CSC the much needed offshore delivery platform that they had been struggling to create organically, for over a decade. While rivals like Accenture and IBM successfully grew operations in low cost locations like India and Philippines, CSC had not been successful in getting a comparable foothold. This deal comes on the heels of another similar one last year. Cap Gemini's acquisition of Kanbay last year added a credible offshore delivery platform to the European Giant's global business to create another strong player in the globalization marketplace. The largest deal of the year was SAP buying Business Objects for $6.68 billion – deals of this nature not just significantly alter the firm's profile, but have an impact on the market dynamics as well.

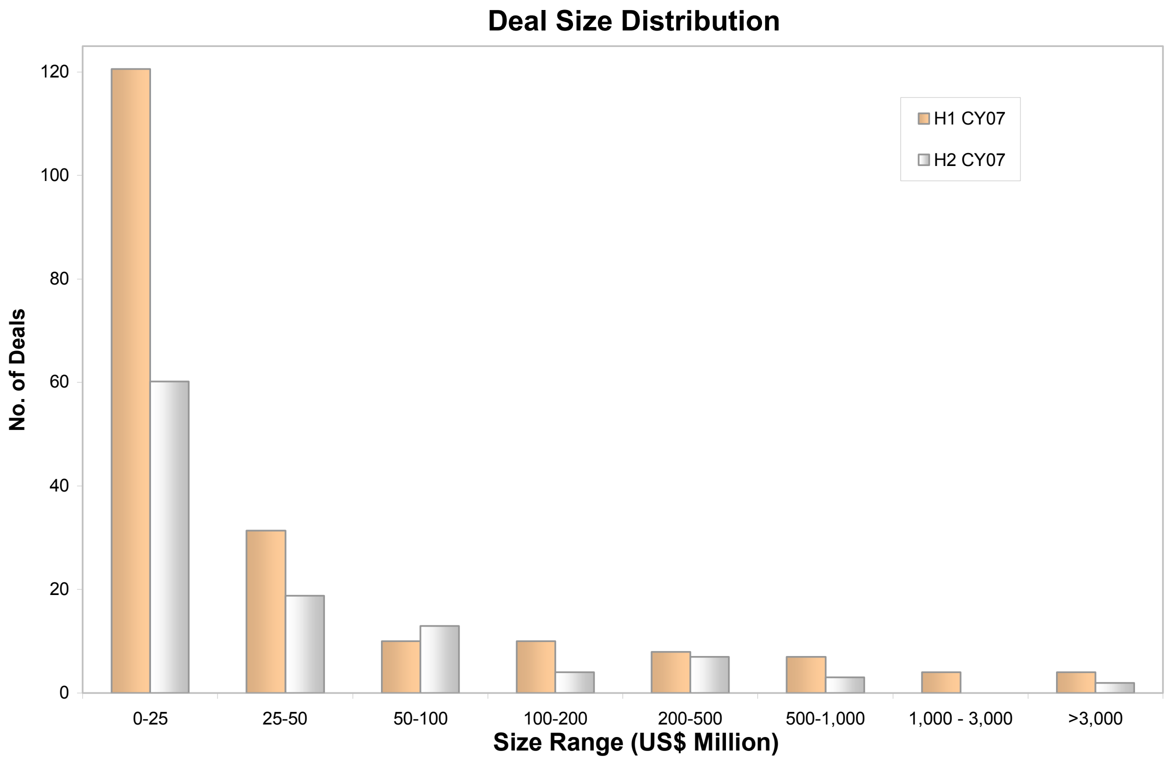

Figure 1: Source: Tholons

The average deal size was $171 million for all services deals globally. Most of the value though comes from a handful of billion plus deals. Excluding them from the mix, the average comes down to $72 million per deal.

2. Cross Border deals are in favor

About 45% of the deals (137 out of 306 deals) in CY 2007 were cross border in nature, worth about $24.6 billion (estimated), at an average of $180 million per deal. US and UK were the two most active countries with India being a close third, in terms of cumulative deal values. Europe accounted for a large chunk of the deals, with $13.6 billion worth of deals originating in Europe. In terms of cross-border deals, Europe exceeded even the US – with the bulk of acquisitions targets being in the US. While the global service providers are looking at Europe and UK as the thrust area for growing client base, Europe is trying to expand the client footprint in the US.

The increased M&A activity by Indian services firms was quite striking, especially on the cross-border deals. As opposed to 15 *(KPMG)* outbound deals over 2006, 2007 saw as many as 34 outbound deals. The fact becomes more significant, as the total number of acquisitions made by Indian firms was 44, which means about 77% of the acquisitions by Indian firms were outbound. In value terms, the total deal size moved from $ 858 million *(KPMG)* in 2006 to $ 1.5 billion in 2007. The average deal sizes though were small, with Indian firms investing about $33 million per deal on an average overall, and just $29 million per outbound deal. The prime motive here has been to gain client relationships and feet on the ground to expand the client base in the client geographies. Gaining high end domain knowledge was the second most significant reason.

Out of the 34 outbound deals by Indian firms, 22 were acquisitions in the US, followed by 7 in Asia Pacific and others in Europe, clearly indicating that US remains the predominant growth area for Indian companies , and gaining client access there has been the flavor of the last six months. Few mid sized players have made high value outbound acquisitions, like the HOV – Lason deal have happened with the intent of gaining market share, and becoming a major player in the respective areas. Integration challenges notwithstanding, we expect large chunks of work from these deals to come offshore.

Cumulative Deal Volumes (USD Million)

Target Geographies

Acquirer Geographies	Asia Pacific	Europe	India	UK	US	Grand Total
Asia Pacific	76	-	-	125	94	**295**
Europe	16	7,650	25	1,028	4,959	**13,678**
India	215	25	465	56	660	**1,421**
UK	-	537	-	517	861	**1,915**
US	111	1,000	2,065	576	26,475	**30,226**
Grand Total	**419**	**9,211**	**2,555**	**2,302**	**33,048**	

US companies have been on an acquisition spree as well. This year registered a total of 174 acquisitions made by US firms in the services space, out of which 45 were outbound, and 129 domestic. The outbound deals cost the US companies a total of US $ 8.3 billion at US$ 185 apiece. The domestic deals accounted for US $26.5 billion overall at US$ 205 million per deal. Of the 45 outbound deals, 17 were acquisitions in Europe, followed by 12 in India, and 10 in UK. As a country, India remains the single most important target geography for the US firms, with Fidelity's acquisition of eFunds being the largest in this category.

The curious fact to note is that, overseas deal sizes were seen to be significantly lower than the domestic deals, implying that on an average, cross border deals were made for gaining a strategic advantage like new lines of services, access to talent, and client contacts, while the domestic acquisitions were primarily for scale.

3. Slowdown in M&As?

One of the most notable trends in 2007 was the slowdown in M&A action towards the second half of the year. Compared to 195 deals between January and June, the second half saw just 111 deals. The total deal value also dropped from $33 billion in the first year to just $19 billion in the second half. This is in stark contrast to 2006, where we saw deal volumes peaking towards the last few months of the year. The action in the billion plus deal sizes also slowed considerably, from 8 deals in the first half to just 2 in the second half. The largest deal of the year (SAP – BO for $6.68 bn) however happened in the second half, and contributed to about a third of the entire deal value between July and December.

Does this mean that the frenetic pace of deal making is over? We don't think so. The sub-prime lending crisis made credit a lot tighter, and literally took the wind off the sails of M&A. The impact was felt across sectors. So, this phenomenon is more macro in nature and does not point to any change in dynamics in the globalization arena. The fundamental motivations for M&A still remain strong, and we have not seen anyone shelving their acquisition plans. The lack of liquidity will definitely lead to elongation of the deal closing cycle, and tougher negotiations on valuations. Nevertheless, we expect M&As to continue at a healthy rate under more rational terms. The corporates and PEs alike still view this sector as a potential value enhancer, and are willing to put in money to fund transactions. The sub-prime crisis has forced all the players to take a step back and re-think their strategies and modify the execution plans. We expect renewed activity starting first quarter of 2008.

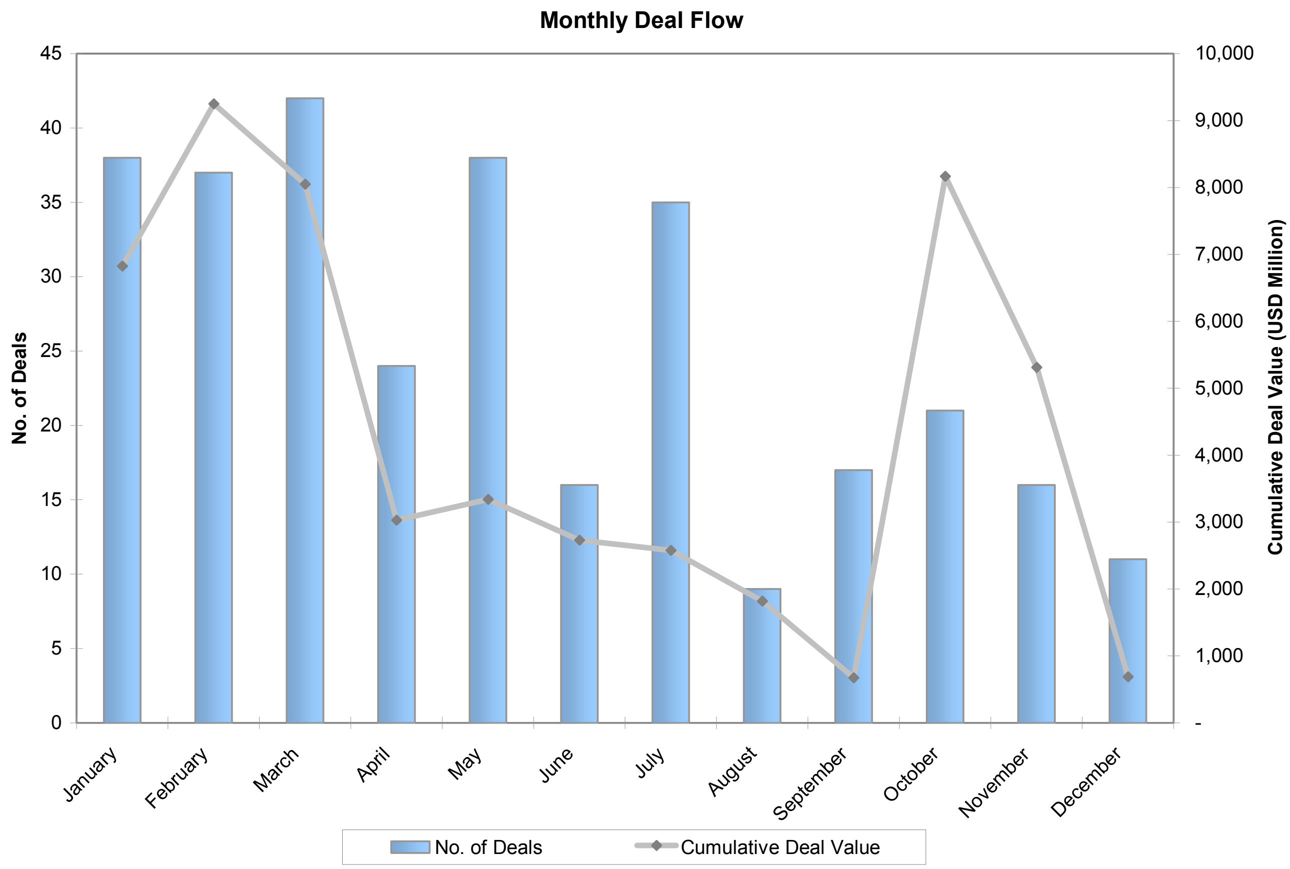

Figure 2: Source: Tholons

4. Small acquisitions to redefine the landscape

The acquisition landscape over the year was dotted with small deals which promise to redefine the space in the long term. We saw a number of instances of small steps being taken to build the leaders of the future. As ITO and BPO become mainstream, newer areas are emerging, with significant potential for growth and value creation. Engineering services, Revenue cycle management, Software testing, to name a few are areas which hold a lot of promise. Unlike the now traditional ITO and BPO markets which took a along time before consolidation set in, the newer service areas having had the benefit of precedence, are witnessing a lot of early stage action. The last six months saw a number of deals bringing together niche capabilities in complimentary service areas in an effort to create a winning “BPO Platform” for the future. We expect to see this trend continuing, with small acquisitions that may not move the needle for total deal volumes, but will slowly and surely give the market some interesting business models.

Conclusion

From being a one off event in the lifecycle of firms, acquisitions have of late become a bread and butter strategy in the services space. Potentially every firm is looking for acquisitions, and every firm can be a target. While this remains theoretically true for all industries at all times, right now in the services space, the statement has a much greater ring of truth. While rapid hiring and hunt for locations for scaling up continues unabated, M&A has become a commonplace strategy for leapfrogging the years needed for achieving results through organic growth. Sub-prime crisis has put temporary brakes on the pace of M&As, but the fundamental motivations remain intact, and will force the players to draw out fresh battle plans. The late adopters realize that they have missed a good opportunity, and will need more innovative ways of getting there. We expect to see more innovative deal structures and maybe stretched out performance/contingency based transactions, as finding and paying for the “right” value assumes greater significance.

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About Tholons

Tholons is a Services Globalization and Investment Advisory firm that combines "Best of Breed" consulting experience with deep execution expertise and investment insights to deliver truly effective services to its clients. Tholons offers a detailed understanding of business processes and combines it with practical hands-on expertise in executing the strategy. Tholons draws upon the considerable experience of a hand-picked team, which has successfully formulated and executed globalization strategies to unlock value for Global Fortune 1000 companies. Service providers leverage Tholons expertise to optimize their global delivery model. Tholons advisors engage with government bodies to build compelling strategies for making countries attractive destination for outsourcing.

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