MSP Performance & Valuation Insights

spring 2013

Emerging MSP Trends

The dominant emerging trend in the Managed IT Services sector is expansion of cloud, mobile, and hosted service offerings facilitating a more active role in customer IT management and planning. MSPs are increasingly finding themselves acting as the virtual CIO to their customers, taking a greater role in IT planning, special projects, and long term strategy development.

Newer, fast-growth MSPs are showing keen interest in extending monitoring and network management services to include IT consulting , real-time data and application management, managed security, cloud migrations, hosted infrastructure and other highly technical services which increase client interaction and overall company performance.
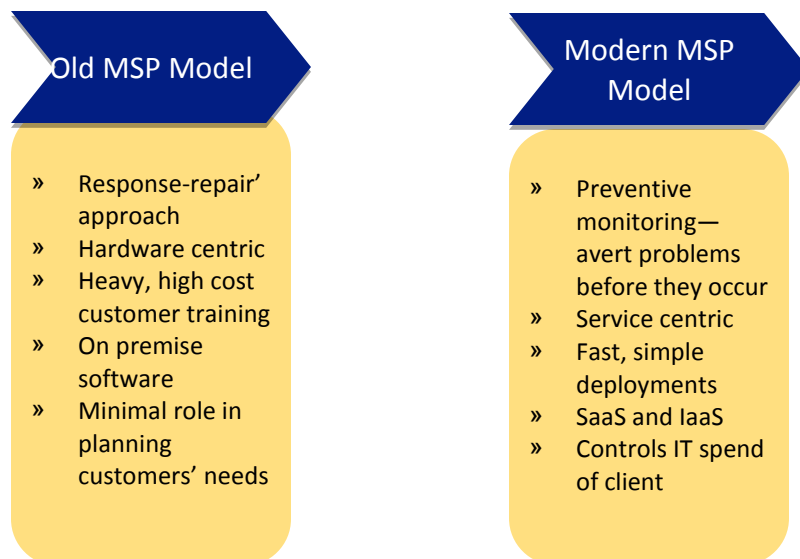
Meeting Current Challenges

MergerTech research indicates that nearly 30% of America's SME's alone will be subscribed to some form of Managed IT Services within the next eighteen months. Enterprise firms and the public sector however will be the largest consumers of Managed IT Services in this period, and capturing part of this growing market is fraught with both challenges and opportunities alike.

For MSPs attempting to broaden service capabilities, mid-market firms facing increased competition, and more mature players who wish to expand into new geographies and increase service oriented architecture and infrastructure, M&A strategies have been highly attractive options to increase competitiveness and profitability.   Developed services capabilities currently highly in demand by both customers and strategic acquirers include:

• Mobile device management
• Managed IT security and surveillance
   o   Government agencies in particular are placing greater emphasis on developing real-time security and disaster recovery capabilities
• Cloud migration projects including development of SaaS-based architecture
• Data center services and hosted infrastructure

Old MSP Model

   »   Response-repair' approach
   »   Hardware centric
   »   Heavy, high cost customer training
   »   On premise software
   »   Minimal role in planning customers' needs

Modern MSP Model

   »   Preventive monitoring— avert problems before they occur
   »   Service centric
   »   Fast, simple deployments
   »   SaaS and IaaS
   »   Controls IT spend of client

Operational Evolution

Larger pools of local competition means that MSPs are facing increasing pressure to distinguish their firms from competitors, leading to fluctuating tides of growth and revenue equilibrium. Clients watching this paradigm emerge feel they could easily change providers if they are not happy with current service levels or pricing.

MSP's often face a challenge in developing pricing models that are attractive when compared to competitors but simple enough to give customers transparency when developing their IT budgets. As end users access IT resources on an increasing number of devices such as tablets and smartphones, and as more IT infrastructure becomes virtual, pricing models will transition towards selling all-inclusive service packages which include proactive IT support services to capture higher margins.

Empowering Customers

> Corporate IT departments have been looking to streamline operations by investing in services that that lowers expenditure on physical infrastructure.

One of the ways MSPs have been developing closer relationships with clients is developing relationships with end users of IT services outside IT and operations departments. Presenting SaaS CRM and ERP architecture to clients and allowing end users to decide which options are most favorable rather than having software imposed by an IT department, has been key to customer retention and satisfaction. In some cases MSPs are able to make recommendations to end users on purchasing decisions and the nature of their IT vendor relationships, further facilitating better customer relationships while increasing cross-selling opportunities for the MSP.

Ultimately maintaining competitiveness in the current IT services environment will demand some form of consolidation to facilitate MSPs expansion of services, break out into new geographies, increase margins, and win larger clients.

Other Sources of Growth In MSP Demand & M&A Activity

a._Efficient Use of Capital_ – Till the cloud market developed, IT environments were configured towards over-resourcing in order to manage significant but infrequent spikes in demand, or meet future long term capacity requirements, while excess supply laid unutilized at great cost. MSP firms have been increasingly offering cloud-oriented configuration which enables high levels of flexibility and real-time pricing.

This new paradigm greatly assists customer balance sheets and budgeting processes, freeing up significant resources in the capital budget that would otherwise go to large depreciating fixed costs—replaced instead with smaller incremental services payments over time.

Many MSP services matured through startups that were very successful in implementing their technology but required the customer accounts of large players in order to grow and realize their true potential. Those IT conglomerates have had the most cash to deploy, yet have struggled in attempting to build Cloud infrastructure in-house. Inevitably an M&A wave has followed, with an immense diversity of buyers and acquisition rationales.

b._Focus on Core Services_ – Managed Services solutions allow customers the same if not higher levels of access to technology and services, best IT practices, and an IT helpdesk that may
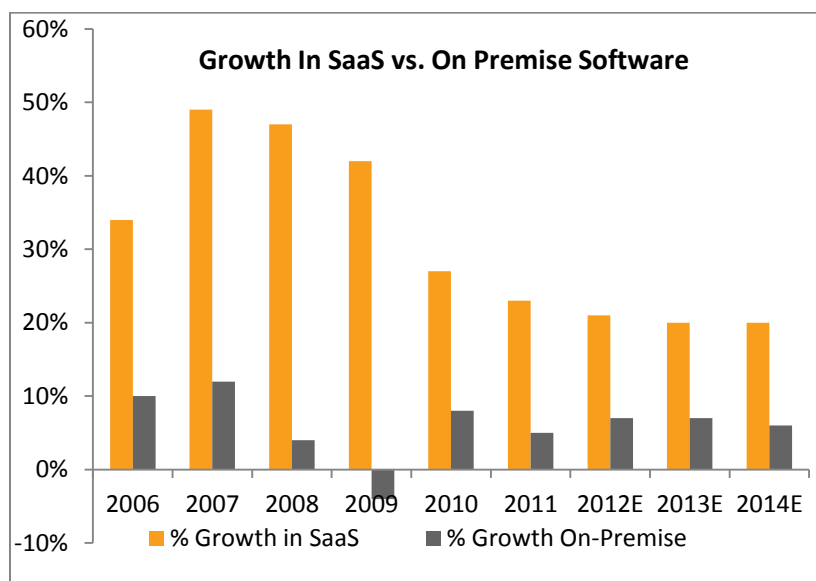
> The public cloud market is estimated to be worth over $80 billion by 2015.

otherwise be unavailable in-house, while leaving the client free to focus on the core operations of their business. The MSP value proposition has been a fantastic boon to MSP M&A activity.

As more and more MSPs deploy SaaS based solutions for clients, their value proposition for buyers has increased dramatically.

c.Comprehensive IT Planning – Highly valued MSPs help clients plan and deploy the optimal mix of technology and operational support resources, maintaining a high level of control or influence over the client's own IT budget. This not only allows provider and client to function together more efficiently, but allows the MSP to help configure the client's IT to fit their business objectives.

Growth In SaaS vs. On Premise Software

Chart showing % Growth in SaaS and % Growth On-Premise from 2006 to 2014E. SaaS growth: 2006 ~34%, 2007 ~49%, 2008 ~47%, 2009 ~42%, 2010 ~27%, 2011 ~23%, 2012E ~21%, 2013E ~20%, 2014E ~20%. On-Premise growth: 2006 ~10%, 2007 ~12%, 2008 ~4%, 2009 ~-2%, 2010 ~8%, 2011 ~5%, 2012E ~7%, 2013E ~7%, 2014E ~6%.

Valuation Trends

Determining a valuation range for a given MSP is both an art and science, and is heavily dependent on the individual company's revenue, margins, service mix, geography, quality of consultants, and many other factors.

Strategic and financial acquirers highly value recurring revenue, with assignable service contracts that ensure continual cash flow. In equal measure they like to see revenue diversity coming from a variety of clients and services, with no customer concentration issues or exposure to large client attrition. As a general rule of thumb the most highly valued MSPs do not have a single client that makes up more than 12% of revenue with the top ten clients accounting for less than 40% of revenue.

You would need to talk to an M&A advisor to get meaningful insight as to what your company is worth, but in general terms MSPs which have their own hosted infrastructure and do high-stakes projects and implementations for their client base can see much as 10x EBITDA in the

M&A market. Smaller MSPs with recurring revenues and healthy margins but a local SME client base and lower tier support, are generally in a slightly lower range.

Solution Providers with a revenue mix heavy on product resale and light on services will see lower multiples with generally less cash up front and longer earnouts based on long-term EBITDA targets.

($ in millions)

Announced	Acquirer	Target	Industry Classification	TEV [a]	Target TTM Rev.	TEV/ EBITDA	TEV/ Revenue
10/02/12	Datalink Corporation	StraTech	Hosted services / General	$ 15.5	na	na	na
08/13/12	Glowpoint, Inc.	Affinity VideoNet Inc	Hosted services / Managed messaging & collaboration services	16.1	na	na	na
07/02/12	Ixia	BreakingPoint Systems, Inc. [fka Security Test Systems]	Hosted services / Managed security services / General	160.0	$ 36.7	4.4	na
02/21/12	Salient Federal Solutions, Inc.	ATS Corporation	IT Consulting and Other Services	76.5	91.4	0.8	7.6 x
02/01/12	ShoreTel Inc.	M5 Networks, Inc.	Hosted services / Managed messaging & collaboration services	146.3	47.5	3.1	na
01/03/12	Internap Network Services Corporation	Voxel dot Net, Inc [aka Voxel]	Hosted services / General	30.0	14.0	2.1	na
11/07/11	Best Buy Co., Inc.	mindSHIFT Technologies, Inc.	Hosted services / General	167.0	110.0	1.5	na
10/03/11	Datalink Corporation	Midwave Corporation	IT Consulting and Other Services	22.4	71.5	0.3	6.9
08/03/11	Web.com Inc. [fka Interland, Inc.]	Network Solutions [General Atlantic]	Hosted services / Web hosting	756.0	266.0	2.8	na
07/15/11	Warwick Valley Telephone Company [dba WVT Communications]	Alteva, LLC (assets)	Hosted services / Managed messaging & collaboration services	15.0	4.8	3.1	na
06/30/11	Dimension Data Holdings plc [Nippon Telegraph and Telephone Corporation]	OpSource, Inc.	Hosted services / Managed hosting	90.0	33.0	2.7	na
05/26/11	Oak Hill Capital Partners	Intermedia.net, Inc.	Hosted services / Managed messaging & collaboration services	140.0	50.0	2.8	na
05/03/11	Novacap Technologies III, L.P	iWeb Group Inc.	Hosted services / General	69.6	30.1	2.3	na
04/20/11	West Corporation [Thomas H. Lee/ Quadrangle Group]	Smoothstone IP Communications	Hosted services / Managed messaging & collaboration services	120.0	35.0	3.4	na
02/13/11	EchoStar Satellite Services, L.L.C.	Hughes Communications, Inc.	Alternative Carriers	2,124.2	1,043.3	2.0	8.9
02/01/11	Time Warner Cable Inc.	NaviSite, Inc.	Hosted services / General	276.9	128.9	2.1	na
01/04/11	Dell Inc.	SecureWorks, Inc.	Hosted services / Managed security services / General	612.0	120.0	5.1	na
Mean				$ 284.6	$ 138.8	2.6	7.8 x
Median				120.0	50.0	2.7	7.6
High				2,124.2	1,043.3	5.1	8.9
Low				15.0	4.8	0.3	6.9
Mean excl High and Low				179.9	79.5	2.6	7.6

In order to stay competitive and realize the value of their businesses, MSP owners will need to both expand their service offerings, play a greater role in their client's IT decision-making, and explore inorganic growth options. Meeting future growth targets and capturing a share of the expanding MSP market will also require investment in hosted architecture and systems in order to meet the growing IT demands of the enterprise market.

_____**About MergerTech**

MergerTech's mission is to enable medium-sized technology companies to realize the value of their business. Our bankers have personally founded, grown, and sold numerous technology companies to a variety of global buyers. This experience enables us to emphasize your company's unique selling points to buyers, thoroughly understand the concerns and objectives of the entrepreneur, and maximize value in a transaction. MergerTech has strong domain expertise in all aspects of technology investment banking, and has completed over 100 engagements worldwide.

If you are interested in learning more about how a successful M&A strategy can help you and your business, please contact Ash Sethi at 925.380.2364 or via email to asethi@mergertech.com.