GAZING INTO THE CRYSTAL BALL
M&A IN THE IT-BPO INDUSTRY IN 2009

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The thing about M&A activity is that it is always going to happen. It is a little bit like offshoring: when times are good, companies have the time and money to experiment with offshoring; when times are bad, they need offshoring because they have to cut costs. M&A is not very different: when the economy is flourishing, companies want to expand and grow rapidly, acquiring in the process; when the economy slows down, the weak cannot survive, and the fittest survive and grow stronger, at least in part through acquisitions. All that essentially changes is the nature of the transactions, such as the motives, the themes, the sizes. And this is something that one has seen often enough, through cycles and across industries.

So the question really should not be about whether M&A activity will happen, or whether we will see a growth or a slowdown in M&A activity in these “different” times in the IT-BPO space. The questions that we really need to examine are the following:

- What specific factors will boost, or slow down, M&A activity at an industry level?
- When will there be a significant shift in deal activity?
- What will be the key themes for the M&A transactions?
- What will be the transaction characteristics, in terms of size, functions and geographies?

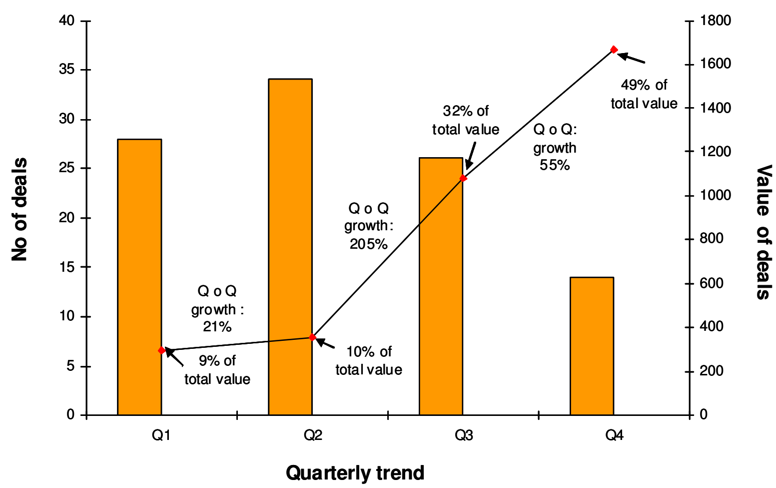
Looking back, looking ahead

Before we start seeking answers to the aforementioned questions, let’s do a quick recap of the recent M&A activity in the IT/ITES industry so as to establish a clear baseline and project lead indicators of future activity.

M&A deals involving Indian companies (as acquirers or otherwise) had a total transaction value of USD 3.4 billion in 2008, an increase of 18% from a total of USD 2.9 billion in 2007. Peeling the 2008 onion, however, shows the more interesting aspects: while the total number of deals has been steadily declining, the total value of the deals has been doing just the opposite – steadily going up – as evidenced in the graph below.

The preference, then, clearly seems to be moving towards larger deals. This makes eminent sense given that there is a minimum amount of integration effort required in any deal, making the returns poorer in smaller deals. Further, given the turbulent times, deals are being cherry-picked, which generally leads to larger, more strategic deals. Jumping a little ahead then, here is one trend you can clearly expect to continue in the next few quarters: the move towards larger, strategic deals. Beyond that, however, we expect a partial reversal, as the smaller fish struggle to survive and start getting consumed by the larger ones.

Quarterly M&A trends in the Indian IT-BPO industry[1]:



Another key observation worth making is that the proportion of outbound M&A deals dropped to about 67% (deal value) in 2008 as compared to 81% in 2007, primarily losing ground to domestic transactions, which moved from 13% to 23% in the same period. We believe that this trend will continue, and while Indian companies will keenly look to expand into other geographies, the opportunity for value-buys among Indian companies will dominate and result in a further increase in domestic transactions. This is particularly relevant in the context of a number of "professionally owned" and thus, "externally funded" outfits in the Indian space.

[1] BMR analysis

Finally, in terms of the share of overall M&A activity in India, the share of IT- BPO has almost doubled from 6% in 2007 to 11% in 2008. Therefore, while the overall growth in numbers may have been muted, the sector is still one of the more active ones, with good traction for pursuing strategic M&A activity in 2009. Additionally, looking at the landmark transactions of 2008 (HCL-Axon, TCS-CGSL, WNS-Aviva, etc.), one can also conclude that stronger players retain interest in pursuing strategic/ quality deals to implement their growth strategies.

	Buyer focus group	Seller focus group
IT	Revenues > USD 200 million	Revenues < USD 500 million
BPO	Revenues > USD 100 million	All

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"Author name" is a "Designation" with BMR and can be contacted at "official email ID"

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Factors impacting M&A activity in 2009

The table below outlines the key factors that we believe are likely to have an impact on M&A activity in the IT–BPO industry:

Table I: Factors affecting M&A in IT-BPO in 2009

M&A accelerators		M&A decelerators	
Factor	**Impact**	**Factor**	**Impact**
Value creation potential for Buyers/ Sellers through strategic tie-ups or partial acquisitions/ divestments	High	Valuations (will attract Buyers, but make targets hold out aggressively)	High
Weak financial positions in many smaller-sized companies	High	Willingness to buy in weak and uncertain economic environment	High
Ability to meet target growth rates organically despite lowered expectations	Low	Availability of funds for acquisitions (partial decline in internal accruals and drying up of external funding)	Low

A consolidated quantitative and qualitative analysis of the factors leads us to the following conclusions: M&A activity is likely to remain at similar levels to the preceding quarters, but the drivers and kinds of transactions will be very different. Most Buyers and Sellers will prefer to wait for stabilization in the economic conditions. Some larger and well capitalized players will pursue strategic and value picks aggressively. On the flip side, special situations such as financial distress will drive some sales irrespective of valuations. The favoured route by most companies at the current juncture is likely to be that of strategic investments or of forming key partnerships - this gives targets a means to survive and grow while offering Buyers an opportunity to get into target companies at good values.

The deal on "deals"

While the temptation to execute deals is understandably strong, what with the attractive valuations for Buyers and the weakening financial positions of the targets, the big cause of this whole situation is also the big spoiler – the very uncertain global economic environment. Nobody really seems to know just how deep the rabbit-hole goes, and hence companies are likely to stay on the fences in the first half of 2009 except where the risk-reward ratio is very attractive (or survival is impossible). That said, large, strategic deals are likely to pick-up, and hence in value terms M&A might continue to gain strength.

With some stabilization, the caution will decrease, and a pick-up towards the end of 2009 and into 2010 is highly probable as Buyers regain confidence and focus on value-buys to augment their organic growth. And if we see a sustained economic slowdown, the number of Sellers is likely to increase exponentially as companies are forced to sell out. A number of PE funds with access to cash are also likely to step into the market at that stage.

Key themes for the M&A transactions

The focus of M&A activity is likely to be significantly different in 2009 as compared to the past couple of years. A large chunk of the past M&A activity has been centered around service offerings – whether is was plugging the gaps within existing capabilities through niche complementary acquisitions, or through broad-based capability acquisitions to enter new service areas. The current environment, with its new challenges, is seeing a shift in focus, a trend which is likely to get exaggerated over the next year or so.

We believe that there will be two over-arching themes for M&A in the IT-BPO industry: expansion into new geographies and acquisition of new customers.

It's also worth noting there that these themes will change in the next couple of years. If the economic slowdown continues, pressures to continuously reduce costs will lead to customers moving to even lower-cost locations than India, driving Indian companies in turn to look at overseas acquisitions to strengthen their global delivery networks.

Transaction characteristics, in terms of size, functions, geographies

From a functional perspective, IT companies are likely to sharpen their focus on ERP consulting skills, both as a means of offering more complete ERP services as well as making entries into new geographies through onsite / near-shore acquisitions. (Example: WNS-BizAps.) The other big bet will be on companies which have products/ platforms/ tools to automate processes and de-link revenue and headcount growth. (Example: Wipro-Gallagher Financial.)

Within BPO, we expect little change in focus, with F&A, BFSI-specific transaction processing, and value-purchases in research and analytics continuing to be the favorite targets. Procurement Outsourcing (PO), might, however, become the new flavour of the season and see some good activity as suppliers start maturing and expanding their capabilities in the supply-chain area.

From a geographic perspective (client location), Europe and Japan are the undisputed hot picks for a very vast majority of the Indian industry. While we believe Europe will see some success on the M&A front, Japan is unlikely to see any serious traction, although the industry's efforts in 2009 are likely to pay off in the following years. And finally, even though companies will continue to make an effort to reduce their North American presence, USA still represents a significant market which will ensure that acquisitions focused on the US will continue to contribute substantially to the M&A activity.

Among the target industries, BFSI[2], while contributing a disproportionately large amount to the Indian IT/BPO services industry already, still represents a big opportunity due to the sheer size of the global industry. The only other industry which might be targeted in a significant fashion is the retail industry, but with the recessionary uncertainty, industry players are likely to sit on the fence for a while till some stability is seen.

And across IT, BPO, geographies, industries – everybody loves captives, and will continue to do so! Captives offer a much-needed opportunity today for IT/BPO companies to get assured annuities and get deeply entrenched into high-quality clients, and hence are likely to remain on the favourites list for a while.

[2] Banking, Financial Services, and Insurance

Survival of the fittest

For better or for worse, the talk about the "consolidation" in the Indian IT-BPO industry is finally going to become a reality. The value-creation potential through M&A is at a level like never before, whether it is through strategic tie-ups, partnerships, partial divestments, mergers, or outright acquisitions. Availability of capital, while marginally lower than before, is still adequate to fund a very large increase in M&A activity. Lower valuations will make M&A very attractive for Buyers, although targets will hold out until their coffers runs out or the offers become too attractive (relatively), with both possibilities likely to occur in the not-too-distant future. A large number of small deals will reduce the clutter in the IT-BPO supplier landscape, but a small number of large deals will get most of the headlines. To use the much abused, but very true and relevant cliché – it will be a case of survival of the fittest. And the corollary will also hold true: the "new" industry that emerges will be fitter, stronger, and better than before.

Authored by:

Vivek Gupta, Sheetal Bahl and Shivani Nagpaul, BMR Advisors

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