M&A: Why is IT such a hotbed of activity?

Mergers and acquisitions have long played a major role in corporate strategy across all industries, for good and for ill. However, it seems that M&A plays a more active and integral role in IT than most other industries.

So, what is it about IT that creates such hyperactivity in M&A? Here are but a few of the factors we think are unique to the industry and that seem to make M&A an enticing growth strategy:

Size and growth: The sheer size and scope of the industry, which Gartner predicts will reach $3.3 trillion in revenues in 2008 (+5.5% vs. 2007), make it a large tent offering big opportunity and big rewards for aggressive companies.

Youth: Relative to other mature industries, IT is still a youngster. Consider that Microsoft is 33 years old, SAP is 36, Oracle is 31, Cisco is 24, Sun is 26 and Business Objects is 18. Then, of course, there is Yahoo! at 14 and Google at 10, and a whole slew of IT babies; MySpace.com is five years old, Facebook is four, and YouTube, still an infant, is only three years old. There's energy and vitality in the industry that's constantly infused with an infectious, entrepreneurial drive. It continues to be a make-it-happen environment.

Innovation: It's the industry's raison d'être, the fuel that drives growth and opportunity, and it's the one characteristic that separates this industry from all others. No moss grows on this rolling stone, as every day sees the introduction of revolutionary new ideas, technologies, products and services, with no end in sight.

Fragmentation: Beyond the fewer and fewer big-name brands at the top of the pecking order, the IT industry—notably services—is a truly fragmented category with hundreds of thousands of competitors. This breeds a healthy rivalry as companies look for new ways to grow and differentiate themselves.

Global reach: The market is the world. There are no boundaries. New companies, ideas and customers are to be found in every nook and cranny of the developed and developing economies, and they can be serviced from almost anywhere.

Entrepreneurial Lifecycle: Most startups and young IT service companies come from technology entrepreneurs—smart, restless, ambitious tech gurus who enjoy the thrill of creating new enterprises. Many of these companies grow to the point at which new skill sets are required to take the company to the next level. For many entrepreneurs, this is an opportunity to pass the company on to those with such skills, and then, for them, it's back to the drawing board to start anew. IT, alone among industries, thrives on this evolutionary business model cycle.

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M&A: Why take it on?

Our most successful, revenue-driven clients will tell you that without an ongoing M&A initiative, you're forfeiting over 50% of your growth potential. It's why we advise clients not to think of it simply as an acquisition, but as an investment for a more promising future. In no particular order, here are some of the strategic reasons why you may want to consider M&A as an ingredient in your growth strategy portfolio:

- Access to management or technical talent.
- Access to new intellectual property, ideas, patents, equipment, product lines and/or technologies.
- Access to new markets and new customers.
- Improved earnings and sales stability.
- Growth in market share in the sectors in which you compete.
- Enhanced reputation in the marketplace or with stakeholders.
- Reduction of operating expenses, realizing economies of scale and of scope.
- Competitive insulation.
- Attracting, retaining and rewarding key employees.

These are all valid reasons why one would choose to go the M&A route. However, this is just the beginning of an eventful ride. Buckle up and hold on.

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M&A: An Unatural Act?

M&A has often been referred to as one of the most unnatural acts in business. There has to be some truth to this characterization given the abundance of data that indicates that between 50% and 80% of all mergers and acquisitions fail to live up to the intended goal.

The reason cited most often for why M&A goes awry is the failure of planning for and implementing correctly the post merger assimilation of cultures, people, values, attitudes and styles . . . what is called the soft side of the equation.

It's an odd and intriguing twist of management fate that one of the most critical elements of a company's long-term growth strategy is governed upside down. Most of management's attention is focused on the upfront number crunching, due diligence phase of the project, which evidence suggests is one of the least likely areas where M&A runs afoul. The back-end—the post acquisition assimilation phase of the M&A—where research suggests 65% of the failure occurs and where management's experience and firm hand is needed, is what gets the short shrift.

Let's be fair and not put all the blame for these troublesome failure rates on post acquisition blunders. There are other textbook culprits eager to contribute to this dilemma, many of which are well-documented and need little embellishment here, to wit:

- Flawed corporate strategy by one or both companies.
- Executive hubris.
- Desperation and/or fear.
- False expectations of and subsequent proof of unrealized savings.
- Mischievous intent and documentation.
- Changing market conditions.
- Et al.

The consequence of failure for small-to-midsize IT services firms—without the financial reserves of their larger brethren, who can withstand an M&A miss or two and emerge humbled and bleeding but not broken—can be devastating. The question for these executives should not be whether to embark on an M&A strategy, but how to do it right.

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M&A: What are the lessons for small-to-midsize IT services firm?

Right off the bat, you'll have to come to grips with two hard realities. The first is that M&A is an inherently risky endeavor. Second, executing a successful M&A will be harder than you thought to close, more time-consuming than you anticipated to get operational and more costly than you planned to integrate. Those two realities being said, there are few experiences in business, natural or unnatural, more rewarding professionally, financially and personally than executing a successful acquisition when it's done right.

So, what have we learned about getting M&A done right? Here's a sampling of ten lessons learned which we've deposited in our intellectual bank:

Have a roadmap: Begin with the end in mind and know what you want and need before you buy, based on your overall, long-term growth strategy.

Hire a Sherpa: Enlist the services of a guide (and yes, that would be us) with a proven track record in navigating the treacherous terrain of M&A.

Bypass the "for sale" signs: Assiduously avoid those seductive but distressed tactical properties in favor of ferreting out those hidden "not for sale" gems.

Beware the "winner's curse": This means the excessive premium paid for a property, spurred on by the emotional and irrational exuberance of the "deal" that, down the road, wipes out any gain you hoped to achieve.

Paint a vivid picture of the ideal prospect: Look for the company that fills the white space in your operation, and don't waver from this profile.

Don't buy capability: Buy opportunity; buy the future.

Know the valuations: Right now, prices are up about 10% vs. year ago and this trend is likely to continue for the next couple of years.

Know what you can afford: We've found that a firm 50-100% of your company's size is fundable through debt and cash flow in most cases. Private equity and venture money is available for more aggressive acquisitions.

The real work comes after the courtship: It's not enough to close the deal and leave the integration to others. In fact, most of your blood, sweat, and toil should be directed to your post acquisition strategies and implementation.

Be ready to walk away: This is the cardinal rule of all negotiations, and it applies to M&A as well. The best way to ready yourself for both the pursuit of an acquisition and the need to break away from one if necessary is to keep your emotions in check.

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"You're ready for an M&A when your revenue is over $5MM; you're growing at least 10% per year; you have a mix of 50/50 project/staff work; your business processes are well-defined; your business units are aligned; you're financially healthy with little long-term debt; you're successfully scaling the business organically now, and you're in a position to take a risk."

—Revenue Rocket

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A conversation with Bhaskar Panigrahi.

This month, we're pleased to present a conversation with Bhaskar Panigrahi, chairman and CEO of Cambridge Technology Enterprises (CTE), in Cambridge, Mass. CTE is a global technology services and outsourcing company serving the midsize market of enterprises and the midsize units of Global 2000 companies.

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>
> —Bhaskar Panigrahi

How did you get started, and what's the background of CTE?

I'm a computer science graduate, with a BS from the National Institute of Technology in India. Early in my career, I was a technologist at IBM, State Street Bank and TELCO. In 1999, I co-founded e-Solutions Integrator, an e-business consulting firm, which merged with Unique Computing Solutions, where I served as CEO. From there, I served as CEO of CellExchange, an enterprise systems developer. While at CellExchange, we created Cambridge Technology Enterprises, which we spun off in 2005 as a separate business unit with its own identity. Recently, we completed a successful IPO of CTE on both the Bombay and National Stock Exchanges in India.

Why is CTE unique?

When we build companies, we look at three things: a good technology trend, a good industry trend and a good arbitrage trend. The technology trend we saw was SOA (service-oriented architecture), which we felt was the wave of the future. The industry trend is our assessment that in five years there will only be five software companies—IBM, SAP, Microsoft, Oracle and Open Source. The rest will either become insignificant, or, if they are significant, they'll be bought. Then there is globalization and how you do off-shore, on-shore, and near-shore implementations in places like China, Vietnam, India, and Europe.

We also saw that there were two types of customers. One is the Global 2000 companies with centralized IT. The other is the midsized companies—either stand alone business units of the Global 2000 companies or stand alone companies. We determined that we wouldn't have a good chance going after the Global 2000 companies because these would be well-served by the big players. We decided instead to focus on serving the midsize market—companies that would be challenged in integrating the trends of SOA, vendor consolidation and globalization. We believe we're one of the few, probably the only, company that knows how to integrate these trends for the midsize market.

How do you see 2008 unfolding? What are the top issues for the year?

I don't see any difference between 2007 and 2008. Despite what we hear of the "R" word, I don't see how it's going to impact IT in a big way. Technology companies are not showing any signs of slowing down. The three big issues I foresee are: first, the weak dollar; second, the maturity of SOA is not happening as fast as everybody would have expected; and third is the continued lack of alignment between business and IT, though it's slowly getting better.

You are an advocate of M&A as a growth strategy. Why?

Over the years, I've done more than 10 mergers/acquisitions/strategic investments, including three at CTE last year with two more planned this year. The positive impact of M&A is obviously growth. We were a $5MM company a year ago, and now we're a $20MM company. We believe that as vendor consolidation happens, then services provider consolidation also happens. So, as technology vendors grow fast and big, we also want to grow fast and big.

What does the M&A market look like over the next few years?

I think M&A activity will continue to be robust over the next few years. Because of the stock market turbulence and equity market downturn, I think what you'll see are more pure-cash deals, versus pure-equity, or cash-plus-equity deals.

What is it that you look for in companies you buy?

Very simply, I look at three things: the quality of management, distinctive capabilities that we don't have and enterprise valuation.

What have you learned about M&A along the way?

My first merger failed. I paid a hefty price, and I thought I could turn it around. Since then, we learned a lot, and the last six to seven mergers have been very successful. What I've leaned is to be upfront with the candidate management. Understand from everybody what they expect post merger, and get the buy-in before the transaction is done. That's the one single most important lesson I've learned. Another is to get my management buy-in because if my guys don't believe in the capabilities of the target company, then things won't go well at all. Also, most people try to measure success in the first 90 days, when most things look good. True success is measured over 18 months.

Why do acquisitions fail?

I think there are three primary reasons. First is what I call the "deal heat". The desperation to get a deal done often leads to bad deals. Second is overestimating the potential of the acquisition. Third is not doing the integration planning work upfront. This is often left until the deal is closed, but by then you're already in trouble.

Click HERE to visit the CTE Website.

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