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Edison tech spotlight

Edison investment research

Merger mania is back

In this issue:

- Introducing the Edison Global Technology M&A Database
- H110 saw the first six-month period of positive deal growth YoY since H207
- Asia is taking up the slack in the wake of the private equity bust
- Key M&A by vertical: healthcare IT, financial risk software, cloud computing, infrastructure, security software, data management and mobile

Edison Global Technology M&A Database

Our analysis of mergers and acquisitions in the global technology market over the past five years indicates that H110 saw the first period of y-o-y deal growth since H207. Global tech deals grew by 45% to $41bn in the period, almost half of which were cross-border. Most recently, DELL's and HP's increasingly expensive battle for loss-making business 3PAR indicates clearly that merger mania is back.

The bankers move east

The dominance of the US as a source of bidders is in decline (from c 80% to c 50%) with Japan, China and Taiwan all notable in their increasing presence. Most Asian deals are not cross-border but NTT's acquisition of DiData and Renesas's purchase of Nokia's modem division mark interesting developments.

Technology lines are blurring, thereby creating opportunities

The motivations for M&A are perennial: perceived low valuations, slowing growth prospects, fragmented markets, new disruptive technologies – perhaps even peer pressure. Technology has been the key driver recently: what is notable in the last two years is the blurring of distinction between hardware and software businesses. So, we see DELL buying a services business, Intel buying an application software business and Nokia selling maps. It's all up for grabs.

Key verticals to watch

Our work indicates that the key technology verticals for UK investors to watch for likely M&A activity are: financial services software (where we would highlight Innovation Group?, Monetise?), healthcare IT (EMIS?), cloud computing, network security (Endace?), infrastructure (Anite?), data management (Statpro?) and of course, mobile services (Bango?).

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Edison's new tech spotlight publication will discuss key themes in the sector and will be published fortnightly.

Merger mania is back

It feels like 2007 all over again: mergers and acquisitions are back en vogue in the tech sector. While dealmaking never totally stopped in the downturn (even in H109 – the nadir – there were over 800 tech deals globally), after two years of declining deal volumes, H110 saw the number and value of technology M&A deals increase by 18% and 45% respectively y-o-y according to Bloomberg. The Nasdaq 100 index also gained c 45% over the same period. That was the first six-month period of positive growth since the second half of 2007. The quantum of deal volume is still vast: a long tail of over 1,000 deals were done globally in H110 with the top 100 deals by value accounting for about 80% of the total deal value in the period. M&A activity remains very seasonal. Whether driven by corporate budget flush or banker bonus deadlines, we are unsure – although interestingly, Chinese M&A seems consistently seasonal too. The early indications are that H210 is setup to be a very strong period of activity across the globe. As alluded to above, in value terms the aggregate value of global M&A activity bottomed in H109 – no doubt, a function of the scarce deal volume and a trough in stock market valuations.

Exhibit 1: Global Technology M&A 2005-2010 summary

Note: Full database available on request.

	H105	H205	H106	H206	H107	H207	H108	H208	H109	H209	H110	Jul-Aug 2010
Number of deals	983	1516	1258	1670	1261	1833	1236	1513	863	1404	1020	328
Year-on-year	N/A	N/A	28%	10%	0%	10%	(2%)	(17%)	(30%)	(7%)	18%	N/A
Total deal 'volume' $bn	35	64	53	102	97	111	50	40	28	76	41	N/A
Year-on-year	N/A	N/A	51%	58%	81%	9%	(49%)	(64%)	(44%)	89%	45%	N/A
Largest deal $bn	10.6	4.4	16.8	16.2	27.5	7.3	13.0	3.0	5.7	9.8	6.6	6.6
Top targets by value	Computer services	Application software	Financial IT	Components, semis	Data processing	Data processing	Computer services	Computer services	Computers	Computer services	Enterprise software	Internet security

Source: Bloomberg

Blended average deal sizes and bid premiums are heavily influenced by the *mix* of deals in a specific period, so we would caution against reading too much into the apparent growth in deal sizes and bid premiums so far in H210. The trend of the largest deal in the period is perhaps clearer, with the largest deals of 2006 and early 2007 (c $20bn and c $28bn respectively) marking the top of the most recent era of leveraged buyouts. Incidentally, the largest deal between 2005 and 2010 was the $27.5bn leveraged buyout of e-commerce and payments firm First Data by KKR – over four times the value of the largest technology deal so far 2010. How times have changed!

Despite the recent re-ratings in stocks, the vast majority of acquisitions in 2010 are being funded exclusively with cash. On the face of it, this seems rational given that the majority of the large-cap deals seem to be dilutive on a P/E basis (the P/E multiple of many of the acquired businesses post-bid being higher than that of the acquirer) so paying with cash probably makes sense.

We note that bid premiums are expanding, especially in the competitive arena of cloud computing. This is well demonstrated by DELL's recent $1.15bn bid for cloud computing 'newbie' 3PAR, for $18, approximately an 80% premium over the pre-bid share price. This offer was then bettered by HP's bid of $1.6bn, another 30% or $500m premium – all this for a business that remains loss making since its 2007 IPO, and generated annualised cash flows of just $4m in its most recent quarter.

The top five technology deals of 2010 clearly indicate the diversity of the M&A market (both regionally and technologically). The top deals of the year-to-date by value are:

- US-based Intel's bid for McAfee ($6.6bn)
- Germany-based SAP's bid for Sybase ($5.3bn)
- Japan-based Nippon Telegraph's bid for Dimension Data ($2.6bn)
- Sweden-based Hexagon AB's bid for Intergraph ($2.125bn)
- US-based MSCI's bid for Riskmetrics ($1.6bn)

What's driving the resurgence?

Studies have shown that the majority of M&A deals are value destructive, although this can often (but not always) be very hard to prove with hindsight given the typical lack of disclosure of performance post integration. However, a realist would say that many of the leveraged buyouts of 2006-07 will end in tears (for the buyers, and the acquired companies) given the high debt levels that many of the companies were subsequently burdened with (cf NXP Semiconductors and the aforementioned First Data, which failed to IPO earlier this year). There is also likely to be some truth to the view that companies will often seek out acquisitions as a substitute for waning growth in their core businesses. In fact, certain technology companies seem to be perennial acquirers. We would highlight Ericsson in the Svanberg era and Cisco Systems, which is much more a technology business acquirer and integrator than a true technology innovator. Such hyperactivity – given the usual associated restructuring costs – makes analysing the underlying businesses from the outside more troublesome, a fact not lost on most senior management teams. From an investor perspective, at a minimum we would suggest that previous M&A booms have shown that corporations themselves are not necessarily good market timing indicators, and in fact may be better contra-indicators given that the last M&A booms all led quickly to market tops.

We see several drivers of the resurgence in activity:

Companies cashing in

The hangover from the private equity 'party' in 2006 and 2007 caused much pain and continues to this day. Many PE funds suffered severe liquidity issues in 2008 and 2009 and there is now evidence that private equity investment portfolios are being divested swiftly: Bain, KKR and Vista all divested technology businesses for above $500m in 2010. In August, Bain and KKR also finally managed to IPO NXP (the former Philips semiconductor business), albeit at a much reduced valuation of about 0.9x sales compared to an acquired price of c 1.8x sales in 2006. Investment bankers (and therefore companies) too are aware of the 'health' of the M&A market and are taking the opportunity to monetise assets, which might be benefiting from the cyclical upturn but may not necessarily be strategic to the group in the medium term. Infineon is one such company where there are strong rumours that its wireless division is up for sale. Similarly, ST's decision to divest its loss-making flash memory business Numonyx cannot have been a huge surprise. Meanwhile, other sales – such as Palm Inc and the telecom equipment divisions of Nortel and Motorola –were far less voluntary.

The blurring of technologies creates opportunities

In the 1970s, vertically-integrated technology conglomerates were common (think Motorola, GEC, Philips, and Siemens) – all activities from manufacturing equipment, hardware product design, manufacturing, and notably software development were developed in-house. The subsequent two decades saw a period of dis-integration of this model, with the emergence of dedicated industries and businesses serving each part of the supply chain (most of the aforementioned remain conglomerates, albeit highly specialised ones). Until recently, few companies managed to execute hardware and software strategies in parallel: it quickly became obvious that it was highly inefficient for the conglomerates (like, say, IBM) to compete with the specialists (Microsoft). This seems to be changing and it is extremely interesting to see something of a revival of the vertical integration of seemingly disparate technologies.

The big difference today is that we see this more a function of the evolution of technology rather than an evolution of business strategy – we are not calling the return of 1970s conglomerates! The highest profile example of this is Apple, which continues to develop both hardware and software platforms in-house. This is in stark contrast to most of its major competitors like DELL and Nokia, who typically buy in or outsource generic software such as operating systems (Nokia recently divested its stake in the major operating system developer Symbian and sold its in-house semiconductor and modem design divisions). Notably, though, both Nokia and DELL are aggressively buying up software and services assets (the former having spent over €10bn in recent years) in specific areas. While there will always be a place for specialist outsourcers within the value-chain, investors should notice the trend and the market advantages that companies like Apple enjoy from its integrated strategy. Expect more to follow suit.

Companies already vertically integrating technology:

- Apple buys PA Semis (Apple previously bought off-the-shelf processors)

Hardware companies buying software companies:

- Dell buys Perot Systems/3PAR (DELL previously was a reseller)
- Nokia buys Navteq (Nokia is integrating GPS maps onto its high-end phones)
- Intel buys McAfee and Wind River (allows the integration of security software and OS's onto hardware)

Software companies buying hardware companies:

- Oracle buys Sun Microsystems (makes Oracle a player in the 'cloud' market and a competitor to IBM)

The technology market place is in the midst of dramatic change. For example, mainstream internet access speeds now mean that *remote* hosting of software applications (so-called 'cloud' computing or Software as a Service – SaaS) is now viable and fast becoming pervasive. Furthermore, this trend is on the cusp of moving to the mobile device marketplace. This is having dramatic repercussions for the PC and mobile phone *hardware* incumbents who are seeing their core businesses stagnate with most of the value in the PC industry now shifting to the mobile applications or cloud infrastructure. So, with this in mind, it is no surprise that the biggest and most sensational M&A deals have been announced by one-time leaders in the PC and mobile technology hardware markets who are seeking to diversifying into these hot new areas. Intel, DELL and HP are great examples of this.

Disruptive technologies

Disruptive technologies will always be potential bid targets by definition (because they are disruptive, they tend to be smaller companies) and tend to be either private acquisitions or floated as IPO. A good example of this was the $140m acquisition by Salesforce.com (the SaaS CRM vendor) of Jigsaw Data Corp. Jigsaw built an innovative and proprietary business social network that could be leveraged by enterprise software.

Consolidating fragmented markets

Perhaps one of the most compelling reasons – from a return on capital perspective at least – for M&A activity is to consolidate a fragmented market. Such activity allows companies with large market shares and strong balance sheets to take advantage of weaker competitors – especially in times of distress. Reducing the number of competitors is a sure way to boost returns. Sometimes this happens naturally due to attrition, at other times it is preferable to acquire a declining business while customer relations and quality of the workforce are still intact. Since the 2008 financial crisis, credit constraints have led to an increased number of borderline businesses becoming marginal or close to insolvent. Some examples of consolidation immediately come to mind:

- The UK SME telecoms sector is extremely fragmented, with more than 600 telecoms resellers accounting for over 30% of the £5.5bn fixed telecoms market. There is a clear opportunity for consolidation in this market – a strategy that Daisy Group has executed very well to date.
- New technology standards can be very fragmented in the early years of development. The global Bluetooth chip market has consolidated in parallel with the stabilisation of the Bluetooth communication standard in recent years. The US market in particular saw extensive M&A in this segment (to catch up with UK-based CSR's organic position). In recent years, Broadcom acquired Zeevo and Widcomm, RFMD acquired Silicon Wave (which was subsequently acquired by Qualcomm) and in Europe, Infineon acquired Ericsson's microelectronics business.
- The semiconductor industry is maturing and, given the large fixed manufacturing and R&D costs within the industry, scale matters. We can see several deals this year reflecting this trend: Micron buying Numonyx, ON Semi buying Sanyo Semiconductor (Japanese semis), Intersil buying Techwell (Japanese auto semis), Synopsys buying Virage Logic (a competitor of ARM's Artisan), Microchip buying SST and many more. We see further opportunity for consolidation of fabless (ie those businesses unencumbered with expensive manufacturing facilities) companies – especially those that enjoy niche positioning.

Geographical trends

Of course, the US remains the dominant region for M&A activity by far, with almost 50% of the value of all deals originating there. It is particularly notable that this mix is considerably lower than five years ago. Back then, as the world was experiencing its credit boom, typically 80% of the value of M&A activity emanated from the US – a reflection of credit availability. The tables have turned now, as shown in the table below, with a fall in the proportion of deals from the US and a coincident rise in deals from China, Taiwan, Japan (up to H209) and, notably, Canada.

Exhibit 2: Global technology M&A mix (by value) 2005-2010 by country of origin of acquirer

	H105	H205	H106	H206	H107	H207	H108	H208	H109	H209	H110
US	80%	71%	82%	74%	77%	55%	68%	39%	53%	47%	49%
Canada	0%	0%	0%	0%	0%	0%	0%	0%	0%	10%	6%
UK	4%	5%	5%	16%	4%	0%	0%	7%	4%	0%	7%
Europe	2%	2%	1%	0%	6%	20%	8%	4%	0%	0%	13%
Japan	6%	5%	2%	3%	0%	0%	5%	19%	29%	16%	0%
South Korea	0%	0%	0%	0%	0%	0%	0%	0%	4%	0%	0%
China	0%	0%	0%	3%	0%	0%	0%	8%	0%	4%	9%
Taiwan	0%	0%	1%	0%	0%	0%	4%	0%	2%	18%	0%
Other	9%	16%	10%	3%	13%	25%	15%	22%	8%	6%	15%

Source: Bloomberg

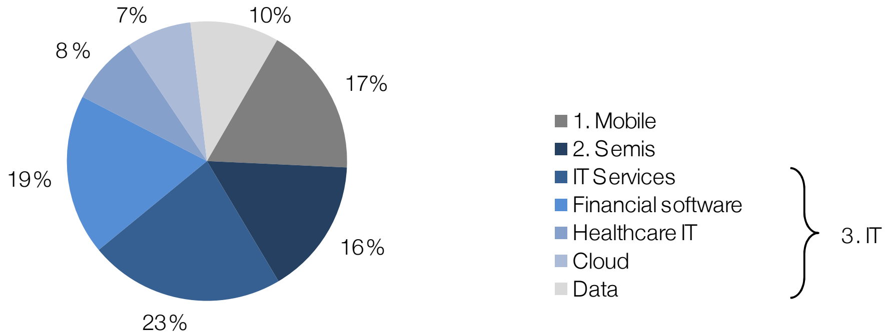
The stronger Japanese yen (and the corresponding weaker pound, dollar and euro) will likely play a part in the growing strength of Japan (and Asia in general) as a source of acquisitive capital in coming years. Japan's M&A activity was particularly notable in 2010 because it involved substantial cross-border deals: NTT's purchase of Dimension Data for $2.6bn, Renesas's purchase of Nokia's modem business for $200m, NTT Data's purchase of Intelligroup for $172m and Matsui's purchase of TPV speak of a country that is far more outward looking than we have been used to. This compares with just one (albeit substantial) cross-border deal in 2009: Canon's $1.9bn acquisition of Netherlands based Océ.

Trends by vertical

Based on the top 100 or so deals by value that have been announced so far in 2010, we are able to discern six key trends by vertical. The category definitions are subjective: for example, Sybase (SAP's acquired business), could be interpreted as a mobile application business but also – in a sense - a play on cloud computing. Nevertheless, we think the split is representative of where the action currently is.

1. Mobile applications (eg SAP's acquisition of Sybase, a developer of mobile applications)
2. Semis (eg ON Semiconductor's acquisition of Sanyo Semiconductor)
3. IT
    - IT Services (eg NTT's acquisition of Dimension Data)
    - Financial risk management software (eg ICAP's acquisition of TriOptima)
    - Healthcare IT (eg Merge Healthcare's acquisition of AMICAS)
    - Cloud computing/Software as a Service (SAAS) (eg DELL's/HP's bid for 3PAR)
    - Data management (eg Hexagon's acquisition of Intergraph)

Exhibit 3: Estimates of 2010 M&A deal value mix by vertical



Source: Bloomberg, Edison Investment Research

Possible winners

While we recognise the dangers involved in attempting to predict the next wave of bid targets, we feel it is incumbent upon us to discuss some of the UK stocks that either seem to be constantly rumoured to be take-over targets, and those stocks we think fit in with some of the themes we have already seen this year (we will leave detailed discussion of valuations to a future note).

In no particular order:

- Anite: Anite is a play on two trends that we have seen this year: telecom equipment consolidation where Anite's promising position in LTE test software should make it a strategically attractive asset, and travel. Ixia has been a consolidator in the former and possibly needs to boost its wireless offering. In normal circumstances the travel business would need to diversify its customer base to make a bid more likely, but with activity levels so high (cf Google's acquisition of flight software business Ita), we wouldn't rule out an earlier move.
- Endace: Endace is also involved in a sought-after market: network security, which has become increasingly high-profile since Intel's bid for McAfee and comments from CEO Otillini that "security has become the third pillar of computing". Narus (an OEM customer of Endace) was acquired by Boeing Defense, who seem to be on the acquisition trail, and Arbor Networks was acquired by Tektronix (part of Danaher).
- Innovation Group: Financial service software M&A, while not a substantial part of the value mix, have comprised a large portion of deal volume and is an area that is ripe for consolidation. Innovation Group is a play on insurance industry outsourcing so could be attractive. It is also worth mentioning EXL - a peer that trades at significantly higher multiples.
- Monitise: A play on mobile banking and payments, Monetise is not yet profitable so cannot be deemed ostensibly cheap but if M&A momentum continues this type of business could attract suitors.
- EMIS: Healthcare IT is a vertical that will continue to drive M&A. Companies such as Philips, GE and Siemens are mopping up all kinds of healthcare services businesses. EMIS supplies software to over 50% of British GPs and could be attractive to a larger player, particularly in light of the imminent changes to GP purchasing decisions.

- Bango: Mobile payments businesses continue to look attractive.
- StatPro: The portfolio analysis and asset valuation services provider has established its strong position through an acquisition strategy, but now could find itself a target as it looks attractively priced compared to recent deals in the US. We would highlight MSCI's acquisition of Riskmetrics. If StatPro's new SaaS product is successful, it could add to the attraction as it will up the pressure on competitors.
- IDOX: While the risks to government spending and their suppliers are well documented, all of IDOX's quoted peers (public sector software providers) were taken over around 2008. Constellation Software, which recently purchased Gladstone, appeared on the IDOX share register earlier this year with just over 5%.
- ARM Holdings: ARM's position as one of the few highly successful IP business in the global tech market is due in no small part to its independence within the semiconductor supply chain which facilitated its market dominance. It already offers far-reaching 'architectural' licenses to key customers for increased access to its low-level IP, so an acquisition would make no sense commercially. A private equity buyer might see opportunity for cost cutting attracted by the lucrative royalty streams but this seems a stretch at today's valuation.
- CSR: CSR's share price reflects concerns over its ability to remain relevant to the handset industry as well as litigation risks. Nevertheless, a strategic or private equity investor should be able to take more informed view on the relevance of CSR's products and roadmap, and the company retains best-in-class engineering talent (shame the CTO left) and tier 1 western OEM relationships. This, combined with a low valuation, makes it a long-shot target possibly by an Asian competitor such as Taiwan-based Mediatek.

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