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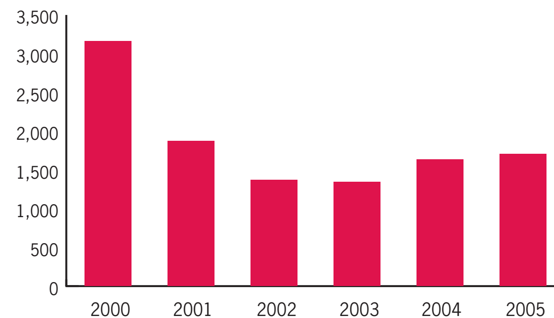
Software industry continues to consolidate

In 2005, merger and acquisition (M&A) activity in the software industry remained strong, serving once again as the most active M&A sector and representing 16 percent of the 10,716 deals closed in the United States throughout the year. This level of activity was in large part driven by the overall health of the economy, the availability of capital and a number of software industry specific trends that aligned, making 2005 one of the most active M&A years since the 2000 "bubble."



Source: Mergstat

Industry trends

One of the principal drivers of this rise in software M&A activity is the corporate information technology (IT) managers' desire to get a broader suite of offerings from fewer vendors. During the late 1990s and early 2000s there was a dramatic increase in the number of new, often niche, software products brought to market. Many of these small to mid-size software providers offered narrow point solutions with hundreds of features. Many large organizations, governments included, found themselves dealing with dozens of software vendors which proved difficult and expensive to maintain, and more often than not, these different software products did not work well together. IT managers now prefer to deal with fewer strategic vendors who can offer a richer portfolio of products, as well as ensure that those products work well together from the start. As a result, software providers are consolidating as customers demand reduced complexity and lower costs.

The demand for reduced complexity is also driven by the stricter financial constraints which have been placed on IT budgets. As overall IT spending grows at a relatively slow rate of 2 to 3 percent per year, IT providers, and especially software providers, cannot assume they will grow organically by 20 percent per year. With this in mind, software providers strive to make strategic acquisitions that will ultimately help them capture a larger portion of the overall corporate IT budget.

Strategic acquirers

At the same time, some of the larger well-known IT companies have benefited from improved profitability, which has translated into significant cash war-chests. Currently, Microsoft, Cisco, IBM, EMC and Oracle combined have more than $63 billion in cash on their balance sheets available for acquisitions. Many of these larger players have shown they are ready to step back into the M&A market after periods of relative inactivity. For example, IBM acquired 16 companies during 2005, compared to four in 2003.

On the sell side, an increasing number of small to mid-size software companies are considering their exit strategies as it becomes progressively more difficult for companies with revenues less than $100 million to grow and make money. According to one industry commentator: "Small software vendors are facing a difficult situation

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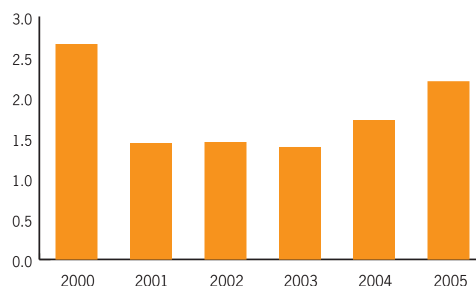
with widespread commoditization of products threatening them from below and larger vendors invading their space from above."

These are signs that the software industry is maturing. While there are bright spots of growth (compliance software, open source software, security software, virus protection and anti-spam software), some sectors such as enterprise resource planning (ERP) and customer relationship management (CRM) have matured and largely leveled off. Take the ERP software market for example. This sector has transformed from 400 ERP companies 10 years ago to approximately 20 players today. And, while many companies remain profitable (especially large, global software providers), there is an undeniable glut of companies chasing a revenue pool that has ceased to expand quickly enough to support them all.

Valuation multiples

Increased M&A activity typically leads to increases in valuation multiples, at least for a period of time. As the chart below shows, the median price paid for mid-cap software companies increased to 2.2 times sales in 2005 - the first time since 2000 that revenue multiples have been in excess of 2 times.



Source: Capital IQ

However, it must be noted that even though the median sales multiple is 2.2 times, there are significant variations depending on the specific sector in which a company operates. This is evidenced by the multiples of publicly traded software companies. A quick analysis of enterprise to sales multiples reveals that publicly traded companies providing software security products and Internet infrastructure are trading at a median multiple of 5.2 times trailing twelve month (TTM) sales, while some of the smaller ERP and CRM companies are trading at a median of only 1.7 TTM sales.

With corporate spending and deal making on the rise, the short-term outlook for M&A activity in the software industry remains positive. The continuous cycle of innovation which leads to growth in new products and services, followed by maturation and consolidation, will persist as long as low barriers to entry continue to provide start-up software companies with a reasonable chance of success, allowing them to develop unique solutions to address the information technology challenges of today and the future. Thus, the pool of small to mid-size software companies looking for an exit strategy will remain plentiful as long as the economy stays on track, and both consumers and business purchasers continue to accept and adopt new technologies.

For more information regarding technology industry M&A, please contact Stephen McGee, director with Grant Thornton Corporate Finance, at Stephen.McGee@gt.com or 617.848.4988.

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