

Market View: SITS companies – Perspectives in challenging times (III)

In this third article of the series Jean-Marie Chauvet, the founder of Paris-based LC Capital, provides a French Perspective on the SITS (“Software and IT services”) companies there, their performance, M&A activity and investment climate. What follows is an independent perspective and does not necessarily coincide with Westchester’s own view.

Another French Paradox

Whether red wine decreases the incidence of cardiac diseases is a question best left to health researchers. The observation, however, that a diet relatively rich in Software and IT Services investments may prove beneficial to private equity funds operating in France might be notable in view of a tactical deployment of funds in that region.

The Vanishing French ISV

Indeed France-based independent software vendors (ISV) seem to be *à la mode* this summer. In contrast with the traditionally slow pace of the long summer holidays — which France is happily providing for with an abysmal social insurance budget deficit and plummeting rank in all Asian academic rankings of world universities whatsoever — this summer of 2008 was characterized by a surprising frenzy of transactions. In a matter of a few weeks IBM announced it was ready to acquire dual-listed Ilog (NASDAQ and Euronext) for a whopping \$340m; Sungard made a binding offer to acquire a majority stake in Euronext-listed GL Trade implying an equity value of 400m Euros; OnMobile Global, a major Indian provider of value added service and data solutions for mobile, landline and media service industries — however little known it remains by the *Rive Gauche* crowd — acquired voice-recognition start-up Telisma; and none other than the iconic Marc Benioff’s progeny, Salesforce.com agreed to acquire CRM and call-centre knowledge management specialist, Intranet, a start-up founded in 1999 by Business Objects alumni. And, quite appropriately, this shopping spree might indeed have been sparked by the mother of all transactions — at least *à la française* — the towering 4.8bn Euros acquisition of Business Objects by SAP last October. (Right after Business Objects itself acquired Cartesis earlier in 2007.)

While the jury is still out on whether these recent transactions will turn out to be resounding successes, these may leave an additional trail of worries for the ISV sector and IT-specialized private equity regional industry. Let us just consider France-based software vendors: it is becoming very lonely at the top. In 2007 only two ISV posted yearly revenues over 750m Euros — Dassault Systèmes and Business Objects — only one remains today since SAP’s acquisition; a meagre 165 ISVs posted numbers in the 2m to 750m range while a starved and restless crowd of 2,300 had less than 2m Euros yearly revenues!

This attrition comes at a time when local early-stage private equity investments are drying up. Venture capital firms in Europe invested in 167 young companies in the second quarter, 42% fewer than in the period last year. Venture dollars invested declined 35%, to \$1.3bn: the quarter was the worst since at least 2000. In France, only 5 venture capital deals were closed in the software industry segment for a total of 16m Euros invested, during the first quarter of 2008, out of a total of 160m Euros invested (down from 290m for Q1 2007). With the foreseeable shortage of early-stage funds availability and high churn-rate of mature targets at the upper level, many private equity firms believe the promising business may lie elsewhere: in the build-up and consolidation theme in IT Services.

IT Services: Crisis? What Crisis?

Apparently unabated by the subprime-mortgage-turned-financial crisis, the IT Services industry turned up a very good financial year in France for 2007. And judging by early 2008 figures disclosed by the major players, 2008 should be even more profitable.

The M&A market was nothing less than ebullient: 138 transactions were closed, for a total 2.7bn Euros, in France in 2007, up from 128 in 2006 for 1.3bn Euros. Out of these 138 operations, 95 involved IT

Services companies (v. 43 ISVs). Interestingly enough the average transaction amount raised to 12,4m Euros with several transactions — barring the Business Objects mega-deal — flying over 100m. In fact, large LBO funds were chasing more deals in 2007 than in 2006, 18 compared to just 6 the previous year, seeking new areas to deploy cash, if in smaller chunks.

Even though multiples today compared to the ones for the same period last year are a tad lower: the average decrease in sales multiple is at -17.8% (though being close to 1x in applied technology and to 1.5x software publishing), in EBITDA multiple at -11.3% (still over 6x), and in EBIT multiple at -6.2% (still over 8x), the trend is a solid one, at least in the mid-term horizon.

Several factors may help understand why. On the one hand, public markets are in a shambles. Even though most if not all the major IT Services companies posted increases in revenues and profits for the first half-year 2008, up from an already good 2007, their stock stays undervalued on Euronext, with smallish volumes exchanged, and little interest from institutional investors.

The IT Services sector, however, is driven by a combination of growth trends. The biodiversity of interested suitors and potential acquirers of IT Services and, to a lesser extent, software companies, in France has in fact recently expanded. Indian software and services behemoths are no longer satisfied with playing the role of the benign outsourcing facility provider: the shrewd ones are deploying more aggressive financial strategies. Large LBO funds are also moving in, on the look for new mid-size deals as the skimming of large and very large operations is nearly exhaustive. Even telcos, in a somewhat surprising reversal of strategy, deems it worthwhile to step forward in the M&A arena: the acquisition of Telindus by Belgacom, of Silicomp and Diwan Group by France Telecom being cases in point.

Consolidation is actively pursued in an industry driven by clients restricting the number of their trusted systems and software providers. Hence these cost-reduction strategies combined with the impact of an increasing regulation create a new requirement for large IT providers in France to become even larger. Finally as many in the current crop of established IT Services players were started in the seventies and early eighties, some of their ageing founders now feel ready to cash out and organize their retirement. This is indeed a growing source of MBO and build-up operations.

So, bafflement set aside, it may be time to revisit the Software and IT Services segment in France and, of course, enjoy a healthy glass of red wine.



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Jean-Marie Chauvet started a software company on a Macintosh in 1985, leaving Mitterrand's France for sunny Palo Alto, (Reagan's) California. He survived and thrived there during the decade that saw the PC, the Windows, the client-server and the Web revolutions, taking his company public on the NASDAQ in 2000, minutes before the Internet Bubble Burst. Jean-Marie originated and ran the Dassault family IT venture-capital arm from 1997 to 2004 and still pursues the arcane task of investing in young innovative technological companies through the Paris-based, independent fund management company, LC Capital, he co-founded in 2004.