THE ART OF THE DEAL: A GUIDE TO M&A STRATEGIES FOR THE MANAGED SERVICES PROFESSION

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Introduction

In business, perhaps no topic is more complex, more misunderstood, or more important than mergers and acquisitions (M&A). At the extremes, the process of two or more businesses combining can either create a new whole that is greater than the sum of its parts or result in a monumental failure. Unfortunately, there are likely more examples of bad M&A deals than good ones. Below, we outline the many reasons why this is the case. In particular, we focus on many of the issues that are unique to managed service providers (MSPs). The hope is that by highlighting these issues, we can help the MSP to both engage in smarter deals and run their businesses in a way designed to maximize their return when it's time to sell.

Even though the managed services industry has been in existence for more than a decade, there are relatively few M&A deals involving managed service providers to study. And of the few MSP M&A deals that have closed, most have been less than successful. We attribute this lack of success to a number of factors, and a lack of understanding of the managed services profession is at the root of many of them. When the buyer or seller (or both) does not fully understand the nature of the business and its unique indicators of health and profitability, an M&A deal has almost no chance of success. Closing a successful M&A transaction is difficult even when both parties have significant industry expertise.

This guide is meant for both M&A professionals and individuals who are considering the purchase or sale of an MSP. The M&A professionals and those considering an M&A deal will find this guide helpful to better understand the MSP business model and how MSPs should be valued. MSP owners will find benefit by gaining a better understanding of their industry and how their company should be valued. By understanding valuations, owners can start today to make changes to their operations that will pay huge dividends in the future.

This guide is also meant to educate MSPs on how to recognize bad M&A brokers and consultants. There are many so called "business brokers" who claim to specialize in Information Technology. But there are very few specialists who understand both M&A and managed services. The information presented below should help those considering an M&A transaction involving an MSP to carefully vet the intermediaries.

Why M&A?

There are many different motivations to enter into an M&A deal. Some parties look to M&A as a great way to increase their geographic presence while others wish to purchase a book of business they couldn't otherwise obtain organically. Some make acquisitions to incorporate new technological skills while others are motivated by personal or family reasons to sell the company. In our experience, the majority of MSPs use M&A to grow their client base.

Growth by Acquisition

"Consolidation" is often used to describe the future of managed services, but that description is a bit misleading. In general, consolidation occurs when a market is saturated with too much supply for the given demand. So, if the MSP market is heading towards consolidation, one may expect that there must be too many MSPs delivering services to the market. In reality, the MSP market is far from saturated. A conservative estimate is that 10-15% of the end-user business community has adopted managed services and market analysis shows that end-user demand for managed IT services is skyrocketing.

The so-called "consolidation" is really a growth by acquisition strategy. This strategy is adopted because of the inability of many IT services companies to adapt their business models to the proactive managed services model. So what happens is that organizations already on a managed services platform are in a great position to absorb the client base of inefficiently run "break/fix" service providers. The next 3-5 years will be marked by a rapid increase in acquisitions fueled by the need to grow market share and expand service, geographic, and market verticals.

Because M&A looms for many MSPs, we will examine what makes an M&A transaction involving an MSP different from M&A deals in other industries.

The Parties

In order to successfully complete an acquisition, it is important to understand the unique perspectives of each party involved in the M&A transaction. Lack of understanding of the other party's position can cause otherwise good transactions to end poorly. It is helpful to gain a general understanding of the parties involved and their concerns. Below we examine the role of the buyers, sellers, investors and intermediaries.

Buyers

Most buyers of MSPs are essentially purchasing a book of recurring revenue Because of that focus, they generally discount revenue streams which come from project-based or break/fix clients. Because of this, a seller who still derives a large percentage of revenue from ad hoc sales should expect to be unpleasantly surprised as to the buyer's valuation.

From the seller's perspective, not all buyers are good buyers. Many buyers are just not qualified to buy another company. Knowing how to identify the good from the bad is extremely important, particularly among small to medium-sized businesses (SMBs). Just because a company expresses interest in another does not mean there is ready access to cash or credit to make the purchase. When deciding whether or not to begin negotiations with a prospective buyer, sellers should always conduct their own due diligence to determine whether the buyer has the capacity to successfully conclude the transaction.

Sellers

Sellers have many reasons they may decide it is time to sell their business. For some, they are ready for retirement while others do not feel capable of changing to meet the needs of the evolving marketplace. A sale can even be motivated by an emergency. The more a buyer understands the motivations of the seller, the greater the possibility of a successful acquisition.

It is also important to understand that the seller is likely to disagree with the buyer's valuation. As we will continue to emphasize, for the buyer, recurring revenue is king. From the buyer's perspective, the seller generally over-values their organization based on revenue earned from projects, break/fix and equipment resale. Meanwhile, the seller finds value in the trusted relationship they have established with their clients. And although project, product, and other revenue streams not directly tied to a contract can be valuable for a number of reasons, the buyer prefers to look at the customers under contract for a fixed fee per month.

Finally, MSP acquisitions generally require the ongoing support of the seller for a minimum time period after the closing date. It is important that the seller is motivated to actively contribute to a successful transition. Buyers should structure the deal to include the appropriate incentives to provide the seller with the desired motivation.

Investors

For our purposes, investors are inelegantly classified into three categories: institutional investors, community investors and friends and family. Examining each of these types of investors will help to understand how investors will behave when it comes to M&A. Because of their different motivations for being an investor, each group has different views when they are presented with the opportunity to engage in an M&A deal.

Institutional investors are in the business of lending money to companies. In return, they generally require collateral in the form of equity in the company and might also require control over staffing leadership positions. Whether called venture capitalists, private equity, or investment banks, these institutional investors invest in companies in order to derive a return on their investment, usually at the time of the sale of the business. Because they require a high level of control or equity, expect institutional investors to be heavily involved in any M&A activity. In fact, they may actively seek such an opportunity in order to divest or recoup their investment.

We refer to the second category of investor as "community investors." They are non-institutional individuals or groups that make structured investments in local businesses. Nearly every significant city has investment clubs that invest in startups or existing businesses. These groups often look for investment opportunities in local companies. Members can be law firms, accounting firms, industrialists, or wealthy members of the community. While a significant motivation for these investors is to make a profit, they may also take into account the effect of the deal on the health of the local economy.

The last category is "family and friends" of the entrepreneur. Such investors are typically not in the business of lending money to speculative endeavors. Instead, they are generally motivated by a desire to give a relative or friend the opportunity to succeed. Friends and family investors will not typically ask for company control in order to safeguard their investment—trust in the entrepreneur is many times sufficient collateral. Typically, such investors will be satisfied with a recurring payment or dividend on their investment, the balance of the invested amount to be repaid if feasible or if the company is sold. Family and friends rarely exert much if any influence on the M&A transaction.

Intermediaries

An important participant in any M&A transaction is the intermediary. This person is responsible for maintaining momentum throughout the process. Successful mergers or acquisitions are rarely concluded with only part-time attention to the matter. M&A deals should be shepherded along in order to prevent them from floundering. Most M&A deals take months to conclude, so it is unreasonable to expect anyone busy running a business to give the deal sufficient attention for the entirety of the negotiation.

Not every broker or intermediary is qualified to handle an M&A deal involving an MSP. A broker with experience dealing with fast food franchises, retail stores, or other businesses may have very little experience with high tech services firms. We detail below the unique characteristics of MSPs, especially with relation to valuations and deal structures, which make concluding a successful M&A deal challenging for the uninitiated broker. Most other professional services providers will rarely use brokers or intermediaries with no specialization or experience in those areas and managed services should be no different. Finding a broker or intermediary with MSP experience will greatly increase the chances of completing a successful transaction.

Valuations

The most important, and often most confounding, aspect to an MSP merger or acquisition is the question of how to accurately assign value to the company. Traditional valuation methodologies must be adjusted to accommodate the particularities of an MSP-modeled business. In an acquisition of an MSP, the buyer is essentially purchasing the seller's contracts. There may be some value in the physical assets, goodwill or intellectual property, but the bulk of an MSP's value is in its paper. Because of this, the following are what we consider to be the most important metrics to measure in order to gauge the true health and potential of a target MSP:

- Revenue Quality
- Customer Contracts
- Employees
- Real Estate
- Intellectual Property
- Risk Management

The weight given to any one factor will vary greatly depending on who is performing the valuation—that is part of the fun of the negotiation—but when working with someone from either side who is not talking about most if not all of these factors, consider finding a different dance partner.

Revenue Quality

Not all revenue is created equal. This is especially true within the MSP industry. As we've said, when examining revenue, buyers focus on how much of it is recurring monthly revenue. In fact, many potential buyers will discount the value of non-recurring revenue to nearly zero as company revenue from break/fix customers is of little value to the buyer.

The other factor important to the revenue valuation of an MSP is the concentration of revenue across customers. If an MSP has relatively few customers who constitute a disproportionately large percentage of revenue, the buyer will likely place a diminished value on the revenue from those high-percentage customers. However, if these high-percentage customers are in a long-term contract that includes an assignability provision in favor of the MSP, the value placed on the revenue from these customers should not be affected.

Some other considerations that will effect the revenue valuation are related to the customer itself. Potential buyers should consider the credit-worthiness of the MSP's client base as well as the desirability of any industry verticals that the MSP targets. The revenue of an MSP who specializes in verticals such as health care or financial services is likely going to be valued higher than the dollar-for-dollar equivalent revenue from an MSP that sells to less desirable verticals. On the other hand, the MSP that sells to a vertical, any vertical at all, is probably worth more to the buyer than one who has the same revenue, but no specialization.

Customer Contracts

We'll say it again, recurring monthly revenue is king. The only way to get valuable recurring revenue is to have clients contractually obligated to pay. But as with revenue, not all contracts are created equally. Factors to consider when evaluating the strength of customer contracts include the assignment provisions, term length, and termination provisions. Further examination of the actual customer base is also necessary to evaluate likelihood of renewals, collection risk and claims risk.

Having a large collection of recurring monthly revenue clients under contract means less to a potential buyer if the contracts are not easily assignable to the buyer. The easier this transition is to the buyer, the more value assigned to that contract. A buyer will look for contracts which can be assigned by the current service provider to another owner without requiring prior customer approval. The more onerous the transition process, the less value in the contract.

Another important contract provision to evaluate is the length of the term. The longer the term, the more valuable the contracts are to the potential buyer. During the due diligence phase, the potential buyer or broker will calculate value based on term-length and the state of the contract lifecycle at the time of the sale. That is, value will be assigned based on how long the buyer will have the current customer base under contract.

Having customers locked in to a lengthy term means next to nothing if the termination provision in the contract allows customers to cancel for any reason or no reason at all. Many template agreements floating around the Internet do not adequately address customer cancelation rights. Although taking a soft approach on termination in a contract may ease the negotiations when contracting with customers, it is exceedingly costly during an acquisition process as buyers will likely heavily discount the value of contracts which are easily terminated by the client.

When due diligence extends to the actual customer, the valuations tend to get fuzzier. One factor considered during valuation is the likelihood of customer renewals when their contracts expire. Buyers also examine the customer collection risk, which is based on estimations derived from historical accounts receivable numbers. Finally, the risk associated with the potential for claims against the buyer based on services provided must be considered. Values assigned based on these factors can vary wildly, as the metrics are not easily measured, but risks can be mitigated or shared between the parties by carefully drafting innovative purchase agreements, as we will see later.

Employees

Another valuable MSP asset is its employee base. Here buyers are not asking whether or not employees show up on time, or whether they tend to complain about customers—they are evaluating employment contracts. The buyer is interested in maintaining the same level of service after purchase. Having employment contracts in place helps to ensure the business continues delivering quality service. Are there retention agreements in place for key employees? Has each employee signed an enforceable non-compete agreement or non-solicitation provision? Affirmative answers to these questions increase the value proposition to the buyer. Without them, key employees could leave after close and take their relationships and knowledge down the street to a competing organization.

There are also potential risks associated with disgruntled employees filing claims against new ownership based on prior ownership activities. Though this risk is difficult to assess, it can be mitigated, as with the fuzzy valuation metrics in the customer contracts section, with carefully drafted purchase agreements.

Real Estate

The status of the MSP's real estate lease is quite important to potential buyers. For a buyer to understand the value of the business, evaluation of the MSP's real estate leases must be performed. A buyer can easily determine whether an MSP is in the red or operating at a profit, but if the real estate deal that is in place is out-of-line with what is available on the market, money is being left on the table and the valuation may be affected.

Of course, besides the competitiveness of the rental rate, lease provisions such as the term and assignability are also important considerations for the buyer. A rental deal may be unfavorable, but a savvy buyer could work a better deal to immediately improve profitability, provided he has that opportunity due to an expiring lease. Likewise, an extremely favorable lease arrangement could be moot to the buyer if the lease is not assignable and the purchaser is forced to negotiate a new and potentially less favorable lease with the landlord.

Finally, a buyer should perform due diligence on the landlord as well. If the landlord offers a high quality of service to its tenants, the value of a long term lease at comparable rental rates will increase. On the other hand, if the landlord's service is subpar, the value placed on an otherwise reasonable lease will be diminished.

Intellectual Property

Most MSPs understand that trademarks and copyrights have value, but they may not know whether they own the rights to the intellectual property (IP) that they use in their business. Often, intellectual property is transferred without a full understanding of the nature or extent of the transfer by the owner.. Because IP is not tangible, a seller might not know that he is no longer the owner of a trademark that has been used for years. Also, many MSPs do not take the time to register their training materials or other documentation for copyright protection. An IP audit will most likely be performed by the buyer during due diligence, so it is critical to perform an internal audit before considering sale to avoid disastrous surprises.

An audit should examine whether IP is registered with the appropriate government agency, as well as the contractual and physical security of the property. For instance, trade secrets should be adequately secured against discovery by those not cleared for access to the information. Further, customer, vendor, employee and partner contracts should be reviewed to ensure that the IP provisions adequately protect the MSP's IP.

Insurance

The presence of adequate insurance policies is as important as any valuation metric discussed. Most of the risks highlighted above can be mitigated through insurance. For example, a buyer will generally require a seller to have sufficient general liability insurance; including tail coverage for claims that accrued prior to closing but were not asserted until after the sale. Buyers like to see professional liability insurance to cover errors and omissions and employee practices liability insurance for those specific instances of risk. While avoiding insurance premiums can increase the profitability of the MSP, savvy buyers prefer a slight hit to the margins in exchange for the peace of mind that comes from the knowledge that they will not be paying for the mistakes of the seller.

It is also advisable for the seller to conduct a vendor compliance review prior to serious negotiations with a potential buyer. Specifically, the seller should review vendor contract requirements and then examine the policies and procedures in place in order to comply with those requirements. For instance, buyers should want to know what software is being used and see sufficient license purchases to show compliance with the software licenses.

The Negotiation

Prepare to Shop

When shopping, most of us prepare for the endeavor. We have an idea of what we want to buy, we do our homework on the products or services we want, and we determine if we can afford the purchase. The same process should be followed when buying an MSP. Buyers must have a very good idea of not only the type of MSP they want but also how they plan on structuring the deal. It may come as a surprise that many buyers embark on their purchase having put very little thought into their strategy. In fact, many companies would be hard-pressed to demonstrate any strategy whatsoever regarding their plan to identify, purchase, and operate a newly purchased MSP. It cannot be stressed enough that buyers should plan thoroughly in advance of starting down the M&A path and sellers should ask questions of buyers to determine if the sale is a good idea.

Credit plays a crucial role in an M&A transaction just as it does in the real estate industry. When buying a house, one of the first things a seller asks to see is the buyer's access to credit. After all, nobody wants to negotiate for any substantial period of time only to find out the buyer cannot fund the deal. The same is true with M&A. Buyers should prepare by obtaining the necessary credit, determining how much cash will be required, and determining the internal resources necessary to see the transaction through to fruition. Keep in mind that the buyer's business must also stay focused while the M&A process takes place.

Finally, botched M&As can leave the parties in a far worse situation than they were prior to engaging in the negotiations. This can happen when the acquiring company fails to conduct its due diligence on the acquisition candidate. It is highly recommended for the parties to obtain the special insurance products available to minimize liability both during and after the negotiation.

Confidentiality

Each party to the negotiation should begin by signing a confidentiality agreement. This agreement must be carefully drafted to ensure that both parties are equally bound to keep confidential sensitive materials. Because of the all-encompassing nature of the due diligence investigation, these agreements are vital. Modified confidentiality agreements found on the Internet rarely do a sufficient job protecting the sensitive information shared during an M&A transaction.

Due Diligence

As is clear from the number of different factors consider when valuing an MSP, it is important for the buyer to perform a thorough investigation of the target company prior to the sale. This may seem like a simple concept but in a majority of deals, especially smaller deals, very few companies do this task very well. However, especially in this industry, knowledge of the sort that will be uncovered during the due diligence phase of the negotiation will materially affect the valuation.

Buyers are encouraged to keep careful documentation of the due diligence process to ensure that nothing critical is overlooked. A checklist sent back and forth between the parties can go a long way to ensuring a complete investigation. The following may be helpful when creating a list of documentation that a buyer should examine during a due diligence investigation:

- Financials (income statement, balance sheets, customer lists, bank statements, A/R, A/P, etc.)
- Inventory (including furniture, equipment lists, etc.)
- Contracts (vendor, customer, employee, leases, insurance policies, licenses, etc.)
- Employee lists
- Marketing materials
- Corporate documents (formation documents, bylaws, minutes, etc.)

- Legal documents (any documents related to pending or threatened claims or current litigation)

The above list is not exhaustive, but it illustrates how carefully each merger and acquisition should be considered by each party. The overall success of any M&A turns on how comprehensively the buyer engages in the due diligence phase. The more complete the buyer's knowledge of the target MSP, the better equipped both parties are to structure a successful deal.

Civility During the Negotiation

For MSPs, combative M&A negotiations are almost never concluded successfully. Many of the problems are created during the negotiation process—either the terms of the deal are not clearly articulated or one of the parties feels insulted or bullied. While most business transactions require both parties to act in a civil manner before, during, and after closing, this is especially true in the case of MSPs

When selling an MSP, buyers usually include an "earn out" provision for the seller wherein the seller remains with the company after the sale. The details of the "earn out" provision is discussed in the Risk Management section below. Keeping this in mind, buyers should work to ensure a good working relationship is maintained with the seller throughout the negotiation process. On a more practical level, buyers would also be well advised to maintain civility in order to discourage future competition. We have seen cases where the staff, discouraged by an insulting negotiation process, leaves the organization and create a competing company.

The Deal

As detailed above, there are many different factors to consider when entering into a sales agreement for an MSP. Because of varying stakeholder motivations and long list of valuation factors to be considered, M&A deals in the managed service provider industry can take many different forms. Determining whether to structure the deal as an asset purchase versus stock purchase or how to balance the financing is something that must be evaluated on a case-by-case basis, but these are issues common to every acquisition agreement. Instead, we will focus on some of the areas which are unique to MSP deals rather than examining issues common to all M&A transactions.

Representations and Warranties

In this section the seller should be asked to make the typical representations regarding corporate ownership, consent, the accuracy of financial statements, undisclosed liabilities and the like. However, because customer contracts, software license compliance, and intellectual property ownership are highly important to the value of an MSP, representations concerning these issues should also be made. Included with these representations, it is recommended that copies of contracts material to valuation, software licenses and network software audit materials, and intellectual property registrations should be attached to the final agreement.

Managing the Relationship After the Deal

Because of the nature of the MSP and the critical importance of maintaining customer relationships, even where contracts are in place, most MSP sales will require the seller to remain with the business for some period of time after closing—what we referred to above as the "earn out" provision. This agreement, sometimes called a transition services agreement, should outline not only the requirements for services provided by the seller, but also must enumerate the sales, customer retention, or profitability goals that must be met prior to the seller earning the remainder of the purchase price. How the payout is structured should be subject to careful negotiation and consideration based on many of the factors we have already discussed. Commonly, the sellers will be required to achieve certain benchmarks, like transferring clients or maintaining revenues, before they will be paid the remaining balance of the transaction. This type of arrangement allows risk to be spread across both parties.

These are the key issues, unique an MSP acquisition, that must be fully considered prior to closing. We highly recommend seeking out a professional with experience in MSP acquisitions to craft the final agreement in order to avoid entering into a purchase and sale agreement that fails to address these characteristics unique to MSPs.

Maximizing MSP Value Today

Applying the valuation methods we outlined above to an MSP will usually shed some light on areas within an organization that could use improvement. Any steps taken to address any of those issues will ultimately increase the value of the MSP. However, the following two issues are very important when the goal of the MSP owner is to dramatically increase the value of the MSP.

To Resell or Not to Resell

Companies who choose to resell managed services have their reasons for embarking down this path. However, if the company has no long-term strategy for bringing those managed services in-house, then a financial readjustment must take place. As we have repeatedly stressed, unless a company has the contract that says they own the client, there is very little corporate valuation that remains. If the acquiring company cannot buy the contract with the client, then the company is of little value. Reselling managed services can be a great way to enter the profession, but a strategy to move towards in-house support is a must.

Service Level Agreements

Service Level Agreements (SLAs) are the agreements any MSP must have in place with their customers. SLAs set customer expectations, assign risk and describe the available method to dissolve the customer relationship. Because recurring revenue is king, MSPs must ensure that their SLAs protect their interests in a way that retains value in the contract post-transaction.

The following are just a few of the ways in which a properly drafted SLA can benefit your managed services practice.

1) New Client Acquisition. When MSPs are selling their services to prospective clients, having an agreement that clearly identifies the boundaries of the relationship tends to make everyone more comfortable and secure. A well drafted SLA can set forth the types of services the client can expect, along with the general terms involving the cost of those services, as well as what those services will not cover. The SLA can also help your sales cycle in terms of providing boundaries for how you sell and bring on those new clients.

2) Managing Existing Clients: It is not uncommon for clients and MSPs to disagree on the scope of a managed services relationship after the agreement has been signed. Therefore, it is important for both parties to have a properly drafted SLA that enumerates the obligations of both parties in a clear manner. Having such a document can help the MSP avoid disastrous and costly consequences when the client insists that a particular service is part of the managed relationship when in fact it is not.

3) Managing Risk in a Bad Relationship: If the relationship between MSP and client does become spoiled, then it would be safe to say that the outcome of the disagreement may in fact rest on the SLA. Improperly drafted (i.e., the use of template SLAs) may sometimes be the cause of such disagreement whereas a properly drafted SLA can often bring a swift and less costly resolution to the issue.

Having these agreements carefully drafted by an attorney familiar with the industry is extremely important. Many available SLA templates do a poor job of protecting the most valuable aspects of these contracts. Taking the time now to revise your SLA can benefit you tenfold in the future.

M&A Trends in the Managed Services Industry

The first few years of this century saw an increase in M&A activity fueled by starvation and desperation. Starvation derived from rapidly shrinking revenues while desperation sprung from the frantic belief that only a cash rich buyer would be able to salvage a failing business. This activity produced many erroneous predictions about the managed services industry at the time. Primarily, many analysts and consultants predicted that by now there would only be a few MSPs remaining. We feel it is safe to say that this prediction was incorrect.

Today, we agree with others that there is another wave of consolidation on its way. However, we think this consolidation is at least a few years away. The industry is still maturing and many companies are still working out the best way to operate within this business model. In addition, the potential customers are still in need of education on the value of the MSP model over the familiar break/fix billing arrangements. Once the education of the customer takes hold and smaller MSPs understand how to successfully market and deliver these services, there will likely be a large wave of deals taking place as larger MSPs attempt to gain clients via acquisition.

In addition, venture capitalists and private equity firms are beginning to look at managed services as a viable investment vehicle. Instead of investing only in technology enabling vendors, investors are increasingly evaluating MSP companies for strategic funding. Of particular interest are mature MSPs who exhibit strong potential for growth and a clearly articulated exit strategy.

MSP valuations should increase as well. As long as the revenues are tied to a contract, the profit margins are where they should be, and due diligence has been performed, sellers should see a healthy increase in their valuation multiples. Over the next several years, there will be many opportunities to buy good companies in the managed services industry.

Conclusion

The managed services industry has evolved in many significant ways over the last 15 years. Now that the world has embraced the concept of managed services, MSPs have a bright and prosperous future ahead. While the down global economy has provided some challenges for MSPs and their clients, it has simultaneously helped to teach the market that managed services companies provide legitimate answers to some difficult business problems.

Many companies are enjoying the benefits of leveraging an MSP to assist in managing their IT assets. Today, there are not enough MSPs to service the number of growing end-users who demand such services. This shortfall must be addressed if MSPs are to continue their evolution. Organic growth through natural means will play a part in the ongoing maturation of the managed services profession but M&A is likely going to be the primary method used by MSPs to expand and mature their services until the global demand is finally met.

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