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Tools to Take Advantage of the Current IT Staffing M&A Market

by

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The current IT Staffing M&A market is active and we expect that it will continue to remain so for the foreseeable future. This article is written to provide you with useful insight into this market and to offer practical suggestions regarding actions which you can employ in order to take maximum advantage of these conditions.

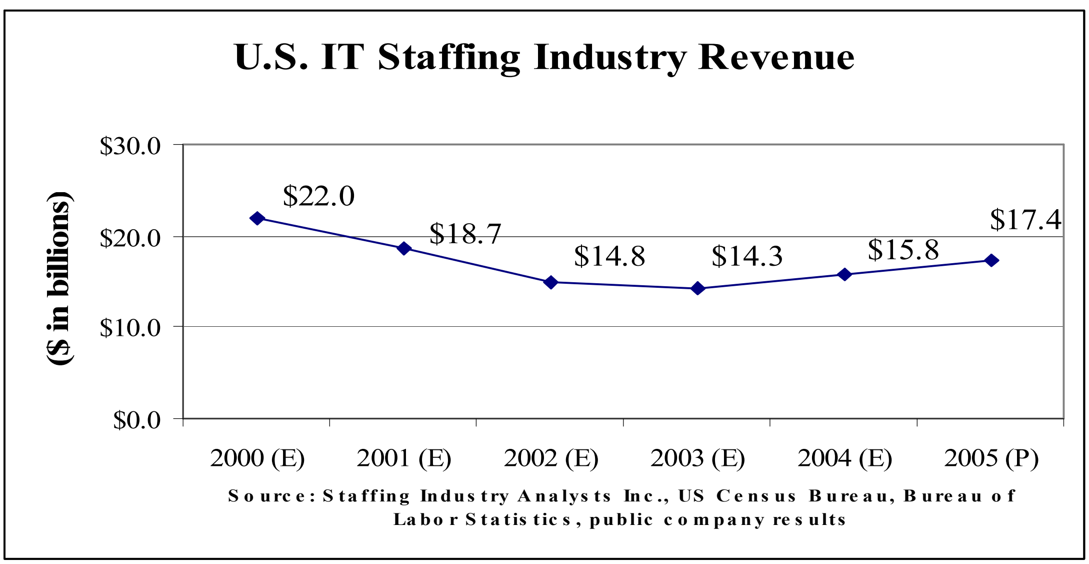
To accomplish this objective, we shall first briefly describe the industry environment, M&A activity, current pricing issues, and buyers' criteria. We shall then discuss specific short and long term actions which could add value to your business and increase your ability to execute a successful and highly satisfactory exit strategy.

Current Industry Activity

We believe that current conditions and the outlook for the IT Staffing industry are very encouraging. Contributing factors include:

1) Leading indicators are positive;
2) IT spending is increasing, in large part because of:
    a. Growing government and military expenditures;
    b. Escalating investments in security and privacy issues of all types; and
    c. Continued spending on corporate governance requirements.

The chart below illustrates the growth in U.S. IT Staffing industry revenue since 2003, following a steep three year decline:



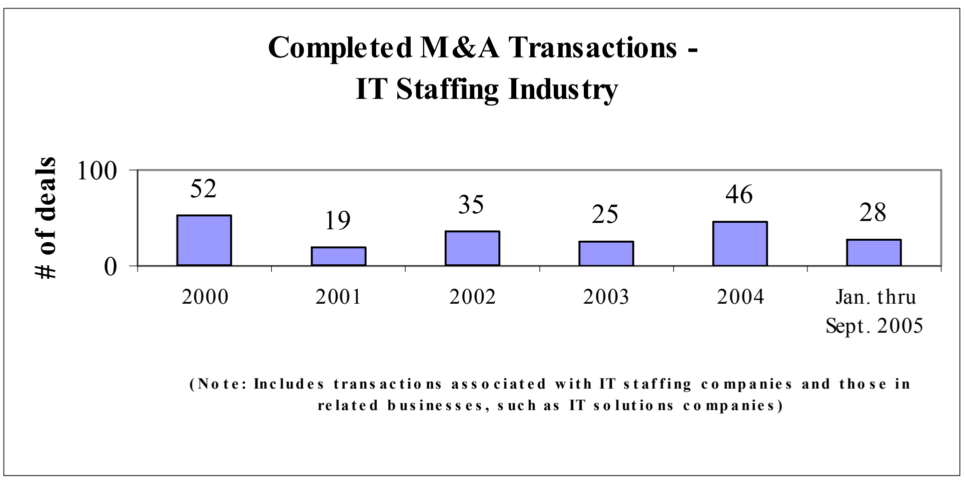
Current industry challenges include:

1) Increased outsourcing to Asia as well as to Canada and Mexico;
2) Continued vendor consolidation;
3) A renewed focus on staffing company markups and use of procurement teams, primarily by larger customers;
4) Vendor management systems;
5) Shortages of certain skills.

Current M&A Activity

Current M&A activity is brisk because:

1) Buyers have access to sufficient additional resources for acquisitions;
2) Acquisitions currently appear to be a more attractive option than growing organically;
3) There are more buyers in the market;
4) The industry outlook is positive; and
5) Earnings for potential sellers are at levels which are high enough to merit a price which meets their goals.



IT Staffing M&A activity increased dramatically in 2004 and will likely decrease slightly in 2005. We do not consider the reduction in 2005 to be significant. We expect transaction activity in 2006 to exceed 2005 as well as 2004.

Current Pricing

To effectively describe current pricing, we must first describe the primary factors and methods that determine value. IT Staffing firms are typically valued by applying a multiple to a "representative" level of earnings. Earnings are generally defined as adjusted earnings before interest, taxes, depreciation and amortization ("AEBITDA"). Adjustments include revenues or expenses which are non-recurring or which would not continue under new ownership.

The "representative" level of earnings may be any of the following:

1) Last calendar or fiscal year earnings;
2) Current rate calculated by extrapolating a recent period;
3) Current rate calculated by applying the current year to date percentage change in earnings to the prior full year's results; and
4) The trailing twelve month period ("TTM").

In the majority of transactions, TTM is the preferred choice for "representative" earnings. The other methods are used in appropriate circumstances as agreed by buyer and seller.

The pricing process always involves negotiation between the parties based on the specifics of each proposed transaction. For example, if earnings are rising, buyers will argue to use the last twelve month period, whereas the seller will prefer to determine the "representative" earnings level based on a current rate. We recommend that sellers focus more on earnings levels than on multiples because earnings generally have a far greater impact on price than do multiples.

Multiples are higher for firms providing consultants that have specialized skill sets. Margin levels at these specialty firms are typically higher, and their services are often in demand from companies seeking to use these consultants to place in projects as well as to train their internal staff.

Buyers and Their Criteria

The primary buyers for IT service firms include private and public companies operating primarily in the IT service space, and private equity firms, which typically invest across several industries. We have noted a trend amongst buyers today to be more tactical and disciplined when evaluating acquisition targets. Consolidation focused business plans are less common and the emphasis has shifted to targeting strategic matches for existing well-run operations.

Strategic buyers seek compatible companies to increase sales and earnings, add products and services, expand markets and clients, or diversify revenue. Private equity groups look for a return on their capital, and may be interested in buying a "platform" company or an "add-on" operation to an existing platform company. A platform company is one that has management and a well-developed, scalable infrastructure, which can support substantial growth.

Actions You Can Take Today

Business owners should consider selling when their personal objectives and market conditions are aligned. If a prospective seller waits for the "perfect wave" he risks a possible leveling off of growth becoming visible. He will then likely have to wait until the next cycle.

There are many actions which we would recommend a firm consider in order to build value. Some require years, but others can produce results almost immediately:

Immediate Actions

Following are some of the actions that can be implemented even as you begin your preparations for a sale. In general, the time from deciding to sell to closing ranges from five to eight months:

Working Capital

A decrease in working capital requirements results in more cash which benefits the seller. This can be accomplished primarily by improving receivable collections.

Gross Margin

Prospective buyers often look at the gross margin as a percent of revenue as an indication of the quality of service and earnings being provided by the prospective seller. A higher gross margin percentage indicates your firm's services are sold more as a value proposition than a price driven sales process.

Consider the impact of a low margin account on your earnings. In addition, many buyers view high SG&A costs as manageable, whereas a low gross margin percentage may be more difficult to improve.

Seek Advice

Be active in soliciting advice from all sources. Select your M&A advisor early. You want to position yourself to be in line with current buyer preferences. Your M&A advisor can also ensure an effective presentation, identify the best buyers, protect your privacy and greatly reduce the need for your personal involvement in the sale process.

Be sure that your attorney is experienced in M&A transactions and preferably in the IT Staffing industry. Qualified counsel on both sides is very important in determining whether transaction issues are easily resolved or cause stress to the principals and risk to the transaction.

Longer Term Actions

Reduce Customer Concentration
Other things being equal, low customer concentration equates to less risk for a buyer and therefore increases the price. Conversely, a high level of customer concentration can have a materially adverse impact on the buyer's valuation.

Optimize Your Tax Status
If your business is a C corporation for federal tax purposes, you should consider changing to an S corporation, LLC, or LLP or another type of flow-through vehicle, depending on the state(s) in which you are incorporated and operate. If you make this change, you should obtain an independent valuation from a credible firm. This will pull down a "curtain" between operations as a C corporation and as a flow through vehicle.

Other things being equal, a transaction where the seller is a C corporation results in lower net after tax proceeds to the seller. This occurs either thru a sale of assets where the seller(s) pay more in total corporate and individual taxes or in a sale of stock, in which the buyer pays less to buy stock than it would to acquire assets.

Prepare Projections
It is important that you prepare careful projections for a minimum of one year from the estimated date of closing. This is appreciated by buyers and speaks very well for the quality of management. In addition, these projections will help you when negotiating an "earnout". An earnout is that portion of the price which is based on future performance. To the extent that you are comfortable with your future growth, you will have the confidence to negotiate an attractive earnout.

Acquire or Merge Before a Sale
We are often asked by sellers if they should acquire a particular company that appears to be a good fit, in contemplation of a sale. Buyers will not give credit for an acquisition which has not been integrated. Integration is essential if the prospective seller expects to benefit from an acquisition in the ultimate sale.

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You are in an exciting business with a positive outlook. There are many actions you can take to transform your success to an effective exit strategy. It is never too early to begin.

Alfred De Bellas and David DuMay are President and Vice President, respectively, of De Bellas & Co., the leading investment banking firm serving the IT Services and Staffing/HR industries in mergers and acquisitions, valuation and litigation consulting. Now in its twenty-first year of serving these industry sectors, the firm has completed over one hundred and forty transactions.