IN THIS SECTION

Executive Perspective
IT Index
News Room
Quarterly Earnings
Scoreboard
Spotlight
Tracker
VDI
Subscribe

BANKING ON THE CHANNEL

October 3, 2005

How the services boom is helping VARs expand their businesses with private equity

By Luc Hatlestad, VARBusiness
VARBusiness, Tue. Sep. 27, 2005
From the October 03, 2005 VARBusiness

When building a business, it never hurts to have an angel on your side...especially one with sacks of money.

In 2002, four years after its founding, IT consultant and longtime IBM partner Perficient hoped to bolster its IT services business with a broader range of offerings targeted at Global 2000 organizations. To do that, it figured it would need to add new people, new technology and even applications. But it needed money to make its dreams of greater revenue and profits come true.

Enter Mort Meyerson, the former CEO of Perot Systems and president of EDS. After leaving EDS, Meyerson moved on to create 2M Technology Ventures, a venture-capital (VC) firm. Meyerson offered some private investment in public equity (PIPE) funding after being introduced to Perficient by one of its existing investors. Good thing, too, considering that the Austin, Texas-based Perficient--which was originally funded by angel investors in 1998 before going public during the dot-com boom--had since found the secondary IPO markets much less welcoming.

Perficient CEO Jack McDonald says Meyerson recognizes value where other don't, which gives business executives such as himself not only the confidence to try, but the fuel to burn. For example, the money provided by Meyerson gave Perficient the security to conduct two more PIPEs in the following two years with other private equity firms, helping it survive the IT economic meltdown.

"The investments made us very well-positioned to survive the nuclear winter we were all living in back then, and gave us the ability to remain cash-flow positive during the downturn," McDonald says.

While many struggle to find secure capital, the truth is that plenty of other well-positioned companies are finding the funds they need to survive and thrive. That's especially true of solution providers in high-growth, high-margin businesses. Think wireless, VoIP, home networks and even the nascent but booming and still largely untapped midmarket. VARs and IT consultants in those sectors are finding access to new financing opportunities (see "Notable VC Investors," page 29), which, in turn, are motivating some to expand their businesses from local shops into regional or even national operations.

The risk is not for everyone, however, and the VC community still places the vast majority of its bets on classic IT product start-up companies. But the right VARs in the right markets at the right time could find the private-equity route the best way to propel their businesses to the next level.

Perficient certainly found that to be the case. The $58.8 million it generated last year in sales landed it at No. 306 on the VARBusiness 500 list. This year, its sales are expected to hit $80 million. The volume of business and transactions Perficient is turning have enabled it to borrow money from Silicon Valley Bank and Key Bank, two of the Valley's best-known lending institutions.

A Change In the Air

The last time service providers looked this good to investors was during the late 1990s, when the companies behind the dot-coms were believed to have unlimited futures. But their failures, coupled with the stock-market crash in 2000, essentially eliminated capital funding in services for nearly four years. During that time, the amount of money flowing to IT services companies was lower than at any time in recent memory. Yet as a general rule of thumb, IT services companies have always struggled for money because they simply do not scale the way product companies do, and because of the constant margin pressures they face. Until recently, many VC firms used VARs primarily as sounding boards for when they were researching potential investments in IT start-up companies.

"The channel is definitely on the rise because the software trend toward cheaper products and broader markets means technology vendors have to be multichannel companies," says Steve Bowsher, a general partner at Interwest Partners, a VC

firm in Menlo Park, Calif. "We spend a lot of time talking to VARs while doing our due diligence on a potential investment; they have a pretty good sense of what they can and cannot sell, and they aren't going to BS you."

But now some of these one-time sounding boards are becoming welcome targets for equity investors, due largely to the nature of changing technology delivery. As the tech-sector recovery continues, private investors have more money than they did a few years ago, and they've begun to broaden their definition of what a technology company is. It's no longer just about selling software or hardware, but solutions. And where there are solutions, there are solution providers.

"We tend to view technology less as a business sector than as an underlying component in every sector," says Mark Barnhill, senior vice president of corporate and investor relations at Platinum Equity, an M&A and investment firm in Beverly Hills, Calif. "In the past few years, we've acquired companies that aren't traditional IT in any sense, but they play in sectors that are being roiled by technology advances. There are a lot more funds lately in M&A and private-equity firms that are looking for a place to land, which has made us much more attentive to looking look for companies that can help us make more acquisitions."

One of Platinum's investments was in CompuCom Systems (No. 50 on the VAR500), a Dallas-based reseller and IT consultant that Platinum bought last October and combined with General Electric's IT business-solutions unit. The merger created a new company under the CompuCom name with roughly $1.7 billion in revenue, roughly $500 million of which is services.

"Business sectors are undergoing some kind of transformation toward services, and some IT companies are starting to build critical mass with some sort of services component, and that's particularly the case with CompuCom," Barnhill says. "Their services are still a relatively small percentage of overall revenue, but there's a transformation taking place."

But merely having a services component doesn't necessarily make a business a good investment. San Ramon, Calif.-based Martin Wolf Securities provides M&A advisory services to its clients. President and managing director Martin Wolf says VC firms, angel investors and other institutional financiers are beginning to recognize certain types of resellers the same way they would any other IT company.

"They're interested in people who know what they're doing and whose earnings and growth look good for the future," he says. "Clearly, any VAR with low growth or high debt wouldn't be an attractive candidate."

What Attracts Investment

Though it would be premature to call it a full-fledged boom, public and private investors have been looking toward the IT-services space for the past few years, especially services with the potential to create broad market appeal, high margins or long-term revenue streams for the provider.

"When funding a company, the first question an investor asks is what market the company is playing in," says Tim Walsh, managing director and head of technology investment banking for Lane Berry, a Boston investment banking firm. "VARs are intermediaries, and investors focus on the end markets. Venture capitalists, in particular, focus on emerging markets or ones that are underserved, such as wireless, VoIP, security and the federal government."

Wolf says that like any other IT company seeking investment, resellers must prove to investors that they're looking well beyond the next handful of financial quarters.

"The market's not growing like it used to, so if you're not doing the things you need to do to build a serviceable entity, you're not taking a longer view," he says.

A demonstrated plan for intelligently expanding your business also helps make a solution provider more attractive to investors, especially if you have the ability to bolster other vendors' offerings with your own intellectual property, a la Spanlink Communications. Founded in Minneapolis in 1988, the company was bootstrapped by its founders and eventually went public in 1996 before numerous market factors prompted its directors to take it private again in 2002.

Spanlink has recovered from its setbacks to build a successful business around its VoIP, call-center, telephony and messaging systems. Things have been so good that in the past few years Spanlink made two acquisitions and this summer secured $12 million in VC funding.

"Our business was going extremely well, and we wanted to grow faster," says Spanlink CEO Brett Shockley. "We spent about a year trying to find the right combination from investors of interest in our business and [who had] access to capital."

The 17-year-old company began as a telecom solution provider and now resells a comprehensive line of Cisco Systems IP-communications products, while also partnering with Nortel and Avaya, among others. Where Spanlink breaks free of the traditional reseller role is in developing its own line of customer interaction and management products for VoIP installations and providing services around these solutions.

"The traditional voice business was all about selling boxes," Shockley says. "Today, the model is upside down because voice applications are what add value for the customer, but customers still want complete solutions from one vendor when they can

get it."

Spanlink has repositioned itself during the past few years the way an IT vendor would, first by acquiring natural-language technology developer Discern Communications in 2003, and by buying Norstan's Cisco business practice from Black Box in March. Those and other moves helped enable the company to secure the VC funding this July from BlueStream Ventures and Split Rock Partners.

"Venture capitalists generally aren't interested in investing in traditional VARs, but we have our own intellectual property and aggressive goals to grow our business," Shockley says, adding that the 200-employee company currently is growing revenue at about 50 percent per year.

"We're selling an ever-growing percentage of our own software to end users," he adds. "When you get this number to more than 35 percent or 40 percent of revenue, investors start valuing you more as a software company than as a reseller."

Other People's Money: What You Need To Know
Solution providers don't necessarily have to develop their own technology to attract investor attention; being a fast-growing company in an equally promising market can work just as well.

Lee Travis is CEO and founder of Home Technologies, a home-systems integrator in Bellevue, Wash. Home Technologies installs and maintains systems for home theater, lighting, networking and security primarily in the high-end residential space and in multidwelling units. When looking for start-up funding, Travis pitched his company to VC firms, but wound up going with angel investors instead.

"Some friends and previous clients put us in touch with VCs, but they generally only do deals in the $3 million to $10 million range, and a lot of them want ownership and control over the company," Travis says. "We raised $2.5 million from 16 different investors, so no one owns more than a small part of the company."

The desire for more institutional funding could change as Home Technologies ramps up its mission to expand beyond its Pacific Northwest base. The company has expanded its dealer locations and, in March, bought a Washington audio/video services company.

"The residential-technology space is growing rapidly and has good margins," Travis says. "The industry has no regional or national players right now, and we're trying to become a regional player."

Solution providers who think they might like to take the plunge into the VC-funding world need to be aware of how these investors evaluate companies; the process is much more rigorous than, say, applying for a small-business loan. But even those who have no desire to attract a VC firm can learn a lot about how to better position themselves to their end users, vendors and distributors.

Lane Berry's Walsh says that to attract VC dollars, it's not enough to just be a VoIP, wireless or security solution provider.

"It's necessary to be in these high-growth markets, but it's not sufficient to secure the funding," he says. "A company's exit strategy is very important, as is the return on investment the VCs can expect."

Travis says that his flirtation with VC firms showed how thoroughly these investors evaluate companies.

"They don't want to see an 80-page business plan. People poke holes in what you give them, then you revise the plan and get answers for the questions they have, so the presentation gets better over time," he says. "At the end of the day, they're buying you--the individual or the management team--but you will get rejected from time to time. Just like sales, it's part of the deal."

Although Home Technologies wound up using angel investors rather than VC firms, Travis says the process helped the company hone its long-term goals.

"We originally planned to franchise our business across the country; half the investors we spoke to were for it, and half were dead set against it," he says. "Now, we plan to grow from three locations to 10 within the next few years."

Any reseller with ambitions to grow beyond its own backyard into a regional or even national player should know that opportunities to do so could be a lot more readily available than most people realize. It's not just an opening for those that are in the emerging markets; the explosion of network usage among small and midsize businesses means those organizations are keen to find resellers that can cater to their unique needs. Plenty of vendors and VARs have been addressing that space for the past few years, but there still are ample openings to expand a reseller's business, perhaps even on a grand scale.

"The midmarket hasn't gotten a lot of attention so far," Walsh says. "The question is whether there are inefficiencies in the market that could be addressed by someone with a plan to integrate all these elements into a single business. It's difficult to tell if the time is right for such an organization, but it's not clear that it's the wrong time."

For VARs who have been pondering whether to expand their businesses into something much more far-reaching with the help of institutional funding, they could discover that there's no time like the present.

Back to News Room Archive

SUBSCRIBE

Receive free intelligence reports and M&A analysis from martinwolf's team of industry experts.

Name*

First Last

Company Name*

Title*

Email Address*

How did you hear about us?

Submit

MARTINWOLF
Global M&A Advisors | 925.355.0110
Get Directions

MARTINWOLF SUBSCRIBE

Receive free intelligence reports and M&A analysis from ***martin**wolf*'s team of industry experts.

SUBSCRIBE