APRIL 2013

FTI CONSULTING
Critical thinking at the critical time™

MANAGING YOUR DOWNSIDE RISKS WITH IT SERVICES INVESTMENTS

A Perspective from FTI Consulting

MANAGING YOUR DOWNSIDE RISKS WITH IT SERVICES INVESTMENTS

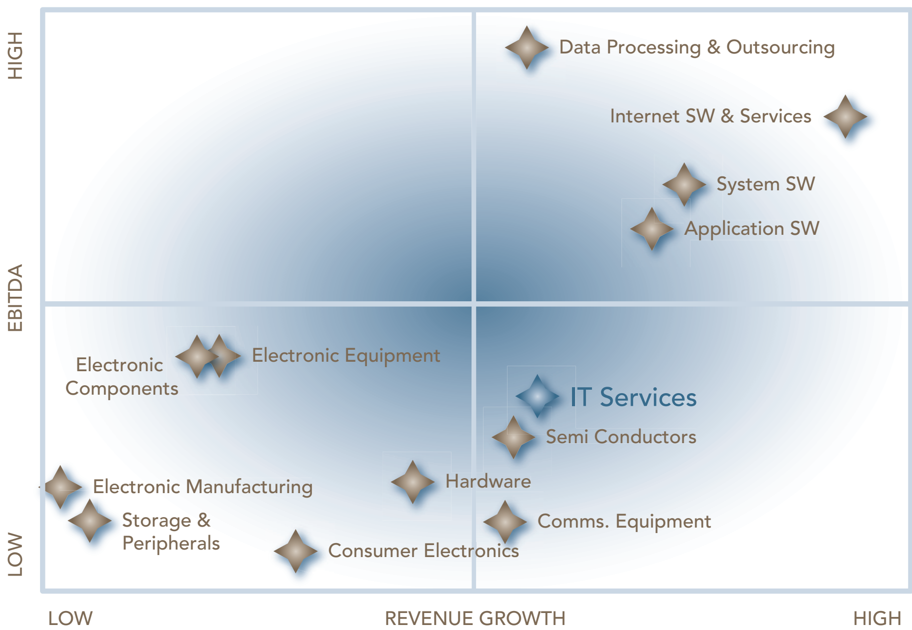
IT Services companies typically have some combination of: (i) software and/or hardware solutions or pass-through, (ii) professional/technology services (IT specialists, systems integration, business advisory) and (iii) managed services (multi-year servicing/outsourcing).

Secular trends influencing this sector and the challenges they present from a profitability perspective are well known and include:

- Sustained price pressure, typically exacerbated by low-cost ("off shore") players
- Consolidated strategic sourcing approach to procurement, especially within government and large enterprises
- Increased vertical specialisation
- Movement towards cloud, mobility and open source
- Growth in managed services and solutions (and away from time & materials)

The combination of these trends has meant that, on average, IT Services firms have performed at the median compared to other Technology sectors (as the figure below highlights).

EBIDTA vs. 5 year Revenue Growth (2011/2012)



However, despite this medium performance, IT Services companies can face a number of unique downside risks because of the nature of a "services" business and by the fact that assets are typically more nebulous or intangible. 2e2 of the UK and Satyam of India are but two of the many examples which service to highlight these risks.

In today's world, it is equally – if not more – important to manage your *downside* risk as it is to develop strategies to drive upside. To this point, FTI Consulting has compiled a list of what we believe are the "top 10" issues/risks to watch out for – and manage – associated with IT Services companies / investments.

www.CartoonStock.com

1. CATCHING – OR CRASHING ON – THE GROWTH WAVES

IT Services companies typically go through step changes in organisational maturity – and funding requirements – associated with life cycle events such as software/hardware 'industrialisation', geographic footprint expansion and/or large scale 'transformative' client contracts. In many cases, these growth waves are also driven by repeated acquisitions to gain scale which disguises the underlying performance trend. This can have the effect of building out a company's breadth of activities (which can mean taking on a lot of expensive people with all sorts of legacy entitlements) in an attempt to secure blue chip customers (reference clients), but ultimately not generating sufficient profitable activity to support the expanded cost base. That is: chasing sales ("at any cost"), not knowing if they are adding profitable business given the complexity of the contracts (disconnect between sales and operations), and failing to monitor and manage underlying performance and understand the profitability of activities (financial reporting failed to mirror underlying operational activity).

2. MANAGING "MANAGED SERVICES"

Managed services are great in that they provide stability in the top-line and often key reference clients. However, even a number of the "big boy" ICT players have done a systematically poor job of managing multi-year contract profitability due to poor commercial sales capabilities/processes and poor transition/delivery management. Moreover, there can be a multitude of sins embedded in these deals which include: (a) upfront vendor financing and/or Capex/Opex trade-offs; (b) employee transfer obligations; (c) low/zero margin product pass-through and/or subcontracting with misaligned payment terms; (d) exchange rate and/or inflation risk; and (e) aggressive revenue recognition which is misaligned with contractual/project milestones. In this context, leverage covenants may fail to provide stakeholders with the expected level of protection.

> "We found that everything was on a 'lease-and-buy-back' – even the software. The only asset they owned was a data centre that was prone to flooding"
>
> FTI Consulting Project Lead

3. "ASSET LIGHT" – NOT ALWAYS THE BEST DIET

In many cases an asset light strategy is pursued in order to reduce lumpy investments and improve certain financial metrics, which is in theory all good. But if things start to unwind you could be left with a 15-year lease liability instead of an owned asset (e.g., data centre) to sell.

4. "PARTNERING" PERIL

Partnering – for product development, offshore delivery, channel enhancement – are all valid strategies, but it is always important to understand the commercial construct, respective asset contribution and break-up strategy.

5. THE "GLOCAL" PARADIGM

For large multinationals it is often still challenging to get the right balance between global, low-cost production/delivery and local sales/marketing. For smaller IT Services companies, this can represent a real pressure on underlying profitability.

6. TO INTEGRATE OR NOT TO INTEGRATE

Often IT Services companies come with a specific (horizontal or vertical) solution that requires integration into the wider suite of corporate clients' systems. It is tempting, therefore, for IT Services companies to get into systems integration in order to drive adoption of their products; however, this can quickly turn non-profitable if the capability is non-differentiated, non-industrialised and/or inexperienced.

7. KNOW YOUR 80/20

It is typical that 20% of clients/products will represent 80% of revenues (and potentially a higher proportion of profit). However, not all IT Services companies have the required systems/processes to fully understand cost allocation and tracking of profitability by product and customer. Without this insight you are flying blind.

8. WORKING THE WORKING CAPITAL

Although it is often cited that it is optimal for working capital (defined as the ratio of current assets over current liabilities) to be between 1.2 and 2.0, it is not so much the absolute number as the trends – and underlying factors – which are critical to monitor. As mentioned above, there are a number of elements which can influence this – such as upfront financing, revenue recognition, pass-through, sub-contracting, etc. Understanding the payment terms of key creditors and debtors – and how these are / are not aligned – can also be critical.

9. ADDRESS IP (NOT TO BE CONFUSED WITH IP ADDRESS)

Intellectual property (IP) associated with an IT Services company's proprietary hardware and/or software solutions may be one of the few things of value in an "asset-light" IT Services company. However, few IT Services companies make the investment (in time and money) to understand, protect and value their IP portfolio. If this isn't done as a going concern, stakeholders may find there is no time to address it adequately through an administration process.

10. CASH IS KING … BUT MAKE SURE HE HAS CLOTHES

If times are tight, common practices such as high operating leverage combined with extensive usage of finance and operating leases, creditor stretch, subcontractors, temporary working capital facilities (not committed) as well as prior acceleration of receipts (large deferred income vs the debtor book) can mean that when the business suffers a liquidity shock there are limited options available and limited time to find a solution for what may be by then a heavily loss making business with limited unencumbered assets.

Transparency and insight to these potential risks is the first step towards managing them. Asking the right questions helps. Having good management systems and controls also helps. External "health checks" / performance reviews can also help. FTI Consulting can help assess and manage these risks.

FOR FURTHER INFORMATION,
PLEASE CONTACT:

AUTHORS:

Michael Knott
Senior Managing Director
DD +44 (0) 203 077 0521
M +44 (0) 7515 295 633
F +44 (0) 203 077 0599
michael.knott@fticonsulting.com

Christopher Ruell
Senior Managing Director
DD +44 (0) 20 3077 0522
M +44 (0) 7733 300 808
christopher.ruell@fticonsulting.com

FTI CONSULTING™

CRITICAL THINKING
AT THE CRITICAL TIME™