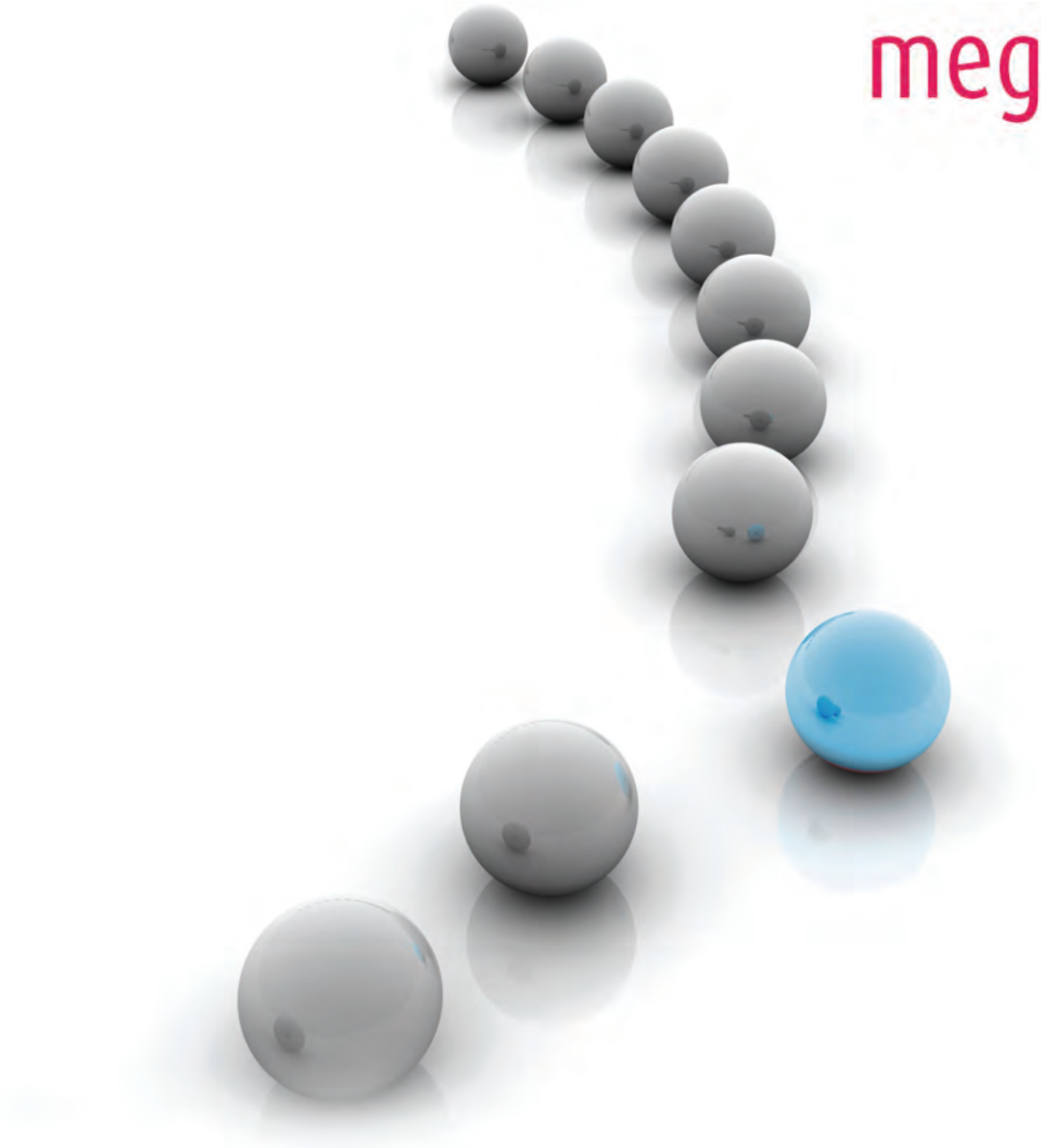
megabuyte forum



Cloud Managed Services

Holy Grail or business as usual

24 November 2010

Sponsored by:

Goldenhill Technology Advisors

Infrastructure Services | Annual review

Contents	Page
Executive summary	1
Peer group review	
Trading review	2
Share prices & valuations	4
Fundraising and M&A analysis	5
Cloud Managed Services	
Cloud building blocks	7
Cloud drivers & enablers	8
Challenges & rewards	10
Critical success factors	12

All share prices quoted in this document are as at the close of business on 16 November 2010

About this publication

Megabuyte Forum peer group reviews are designed to inform the reader about the industry trends, the trading environment, M&A activity and valuations within a particular segment of the technology sector.

Megabuyte Forum

The Megabuyte Forum is a networking group for company directors and investors in the technology sector. Under the banner of the Megabuyte Forum, we run a series of events each year with two main aims. First, to help members gain greater insight into key industry trends, valuations and the M&A environment in area of the sector which is of interest to them. Secondly, to enable members to network and make new contacts amongst their peers in the industry.

Megabuyte is provided by I S Research which was founded by Ian Spence in 2007. Ian has been involved in researching and advising companies in the UK technology sector for over 15 years and was voted TechMARK analyst of the year in 2004 and again in 2008 making him the only analyst to win twice and the only independent analyst to be recognised in this way. In 2009, he was joined by Philip Carse, who brings 20 years telecoms experience as a consultant and equity research analyst, expanding Megabuyte coverage all aspects of communications services and technologies.

A word about our sponsor

Megabuyte Forum research for the Infrastructure Services peer group is sponsored by Goldenhill Technology Advisers. The sole focus of GTA's business is to represent and advise technology business clients in merger and acquisition (M&A) engagements. Engagements include providing services to sellers or buyers in M&A projects in the UK, USA, Europe, Australia, Canada and Latin America with specific focus in software and service businesses. GTA's partners are based and maintain offices in both London and California.

Goldenhill's work is frequently with private companies that are seeking either to sell their business, or to acquire new businesses for further growth. GTA also often works with public companies that are seeking to make acquisitions, or wish to divest non-core assets or business units.

For further details of how Goldenhill could help your business please contact William Berrington on 020 7958 9400 or william.berrington@gtallp.com

This document is published by:

I S Research Ltd
Davidson House
Forbury Square
Reading
RG1 3EU

T +44 (0) 01189 001 360
E info@is-research.co.uk

www.megabuyte.com

megabuyte

It's recovery Jim, but not as we know it

It's recovery Jim…

After a pretty dreadful year in 2009, UK based infrastructure services companies have enjoyed something of a renaissance in 2010. After an average revenue decline of nearly 5% (and even that was flattered by acquisitions and currency movements), analysts are now forecasting high single digit growth for quoted companies in the peer group in the current year. In most cases, this improving outlook has fed through into share prices which have improved dramatically and valuations, whilst still relatively low, have stabilised.

Moreover, after a period of subdued activity, the recent improvement in investor sentiment has started to precipitate increased fundraising and M&A activity within the infrastructure services peer group. NTT's bid for Dimension Data (at a healthy 10x EV/EBITDA) and 2e2's acquisition of Morse were perhaps the most obvious signs of confidence returning to this peer group.

…but not as we know it

But the cyclical recovery is only part of the story. As the market recovers, the advent of Cloud computing will lead to some fundamental changes in the way businesses procure their ICT infrastructure. In this report, we aim to evaluate the impact of these changes on infrastructure services companies and ask the question, Cloud managed services – Holy Grail or business as usual? In examining this question, we will look at three key areas.

Building blocks and drivers

Before we can dive into how Cloud computing is specifically impacting infrastructure services players, we first need to remind ourselves of the key building blocks and the underlying drivers and enablers of Cloud computing. As an introduction we examine three main Cloud building blocks looking at business models, delivery methods and service elements.

Turning to Cloud drivers, the ability to switch capex for opex has certainly been a key driver of uptake through the recession but flexibility and relative ease of integration have also been significant contributing factors. We also identify key enablers which will need to continue to keep pace if Cloud adoption is to continue. From a SaaS perspective, software repurposing and component standardisation has been a key enabler and, from an infrastructure perspective, optimised data centres, network reliability and information security are all key enablers.

Cloud challenges and rewards

Turning specifically to the infrastructure services segment, we discuss a series of opportunities and challenges for service providers as they strive to maximise the potential of Cloud computing whilst avoiding the pitfalls. Well positioned infrastructure providers will enjoy stronger growth, potentially higher margins with greater earnings visibility and tighter customer relationships. Crucially, we also expect service providers that are well positioned for Cloud services to enjoy a valuation premium to those vendors that are not.

But in pursuing these rewards, service providers will need to overcome some significant challenges. They must avoid cannibalising their own revenues, prepare for increased capital intensity and operational gearing in their businesses and they may have to re-evaluate their channel and M&A strategies.

Holy Grail or business as usual?

Having looked at the key challenges and rewards we then conclude our report by suggesting six critical success factors which infrastructure services providers will need to address if they are to successfully address the Cloud services opportunity. And as to the answer to the central question – you will need to read on to find our answer….

Peer group review

Trading review – from downturn to recovery

It is fair to say that 2009 was something of an annus horribilis for the UK technology sector and infrastructure services players were hit perhaps harder than most; especially in the area of easily deferrable project work. In the wake of the collapse of Lehmans in October 2008, demand very quickly fell away and most, if not all of the infrastructure services players were quick to cut costs ahead of a thin period for demand.

We can see from tables 1 and 2 that, in the most recently reported year, many of the companies delivered a decline in revenues. To give a different take on the overall performance of this peer group, if we sum the revenues for all companies, we see that they declined by 4.5% over the last reported year. Moreover, in many of the cases where growth is reported, this is due to acquisitions rather than an underlying improvement. We also have to remember that, for some companies on the list, currency movements have flattered the revenue performance.

Perhaps surprisingly, margins held up well in 2009. In fact, the average EBITDA margin increased slightly from 11.1% to 11.4% over the last 12 months. Taken another way, if we sum the revenues and EBITDA of all of the companies and look at the margins this way, the average has increased from 4.6% to 4.8%. We attribute this stability primarily to rapid action on operating costs and not chasing revenue at the expense of gross margin. As a result of this strong margin performance, combined EBITDA for the group has actually modestly increased over the last year.

Another positive feature of the downturn was a significant improvement in cash generation from several of the infrastructure services companies under our coverage. Those with relatively high levels of product revenue in the mix such as Computacenter and Datatec saw very high levels of cash conversion as stock levels declined.

Table 1: Infrastrucutre Services results

	Date	Period	Revenue £m	EBITDA £m	FCF £m	Net cash £m
Computacenter Plc	Dec	FY-09	2,503.2	76.6	153.5	37.3
Datatec Ltd	Feb	FY-10	2,336.3	84.0	180.6	116.2
Maxima Holdings Plc	May	FY-10	51.0	6.2	4.7	-11.8
Group NBT	Jun	FY-10	43.9	9.7	6.8	11.5
Phoenix IT Group PLC	Mar	FY-10	245.8	47.9	16.9	-67.9
RM Plc	Sep	FY-09	346.9	29.4	3.0	5.0
Quantix Ltd	Sep	FY-09	8.6	1.8	0.6	1.9
Ioko365 Limited	Sep	FY-09	33.8	1.4	0.7	2.7
2e2 Group Ltd	Dec	FY-09	200.8	30.1	-2.0	-163.4
Trustmarque Group Ltd	Aug	FY-09	123.1	3.6	-1.7	-23.7
Attenda Ltd	Dec	FY-09	33.2	4.5	2.8	-6.5

Source: Megabuyte, Company accounts

It is also important to look deeper than the headline numbers to see how demand patterns have shifted over the last 18 months. For most, if not all of the infrastructure services companies under Megabuyte coverage, a steep decline in hardware and project related professional services revenues was, to some degree, compensated for by relatively strong demand for managed services. This factor provides an important clue to future demand patterns; a theme we will cover in more detail later in this report.

Peer group review

Cyclical rebound

Having survived the rigours of 2009 in reasonable shape, infrastructure services players have seen a gradual improvement in demand during 2010. Of particular note has been the tangible and rapid rebound in project work.

Perhaps the best illustration of this rebound is the changing fortunes of Computacenter; and its product revenue in particular. For the first half of 2010, Computacenter's underlying product revenues were up nearly 15% and related professional services revenues increased 8% in the UK and 11% in France. This performance is almost a mirror image of the company's performance in the first half of 2009 when product revenues declined by 14%.

Table 2: Infrastrucutre Services Growth Rates and Margins

	Revenue growth	EBITDA growth	EBIT margin	EBITDA margin	OCC
Computacenter Plc	-2.2%	14.5%	2.4%	4.0%	248.6%
Datatec Ltd	-10.8%	-11.6%	2.7%	3.6%	167.8%
Maxima Holdings Plc	-9.9%	-29.9%	11.0%	12.2%	94.6%
Group NBT	5.8%	13.9%	18.7%	22.2%	96.8%
Phoenix IT Group PLC	-2.9%	-2.0%	14.2%	19.5%	91.9%
RM Plc	19.8%	17.9%	5.8%	8.5%	50.6%
Quantix Ltd	5.0%	33.5%	19.7%	21.1%	21.8%
Ioko365 Limited	-11.2%	-55.4%	0.4%	4.2%	117.7%
2e2	3.7%	22.2%	10.8%	15.0%	47.8%
Trustmarque Group Ltd	4.9%	-18.1%	2.7%	2.9%	8.9%
Attenda	26.0%	67.3%	3.8%	13.5%	153.9%
Average	2.6%	5.0%	8.4%	11.4%	100.0%

Source: Megabuyte, Company accounts

Whilst product and professional services revenues have rebounded, managed services revenues, which were resilient through the downturn, have remained solid as the market has recovered but, interestingly, have not really seen an uptick as market conditions have recovered. However, as we will see later, to treat all managed services as one revenue line is something of a misnomer.

As improving market conditions have started to show through is stronger financial performance, so analysts' estimates for the quoted companies in our universe have also started to move up. Consensus estimates for all of the quoted companies under coverage in this peer group suggest a return to growth in the current year typically in mid to high single figures.

Profits are also expected to show healthy growth this year although, interestingly, average margins are expected to contract slightly. Also, with renewed top line growth, we would not be surprised to see cash conversion drop this year pulling back from very high levels achieved by many infrastructure companies last year.

To a large extend, it has been a rebound in confidence in the financial services sector which is driving renewed growth in this part of the market (as it is across the technology sector). This is especially true of the investment banking sector where many of the projects which were deferred in the wake of the Lehmans collapse and subsequent industry restructuring, have come back on stream in 2010. Conversely, project work in the public sector markets has started to dry up although, as was the case for the financial services sector in 2009, we expect an upswing in demand for managed services in the public sector as Government looks to save cost through outsourcing.

Peer group review

Share price performance

The share price performance of infrastructure services companies through the early days of the recession reflected the fact that they were arguably the worst hit by the downturn; especially those that were heavily exposed to product and project services revenues. However, as is often the case, the stockmarket assumed the worst and marked down share prices savagely.

Here again, Computacenter probably best demonstrates the extraordinary ups and downs of the last two years. Computacenter shares dropped by over 75% between the beginning of 2007 and the fourth quarter of 2008 taking them significantly below their previous post dotcom low in 2002. However, since then, the shares have risen nearly six fold.

Table 3: Infrastrucutre Services peer group share price performance

	Mkt Cap £m	Share price	Share price 1 month	Share price 3 months	Share price 1 year
Computacenter	569.1	3.70	6.8%	6.8%	33.1%
Datatec	560.6	3.05	-3.9%	-3.9%	43.2%
Maxima	20.9	0.83	-5.7%	-5.7%	-7.3%
Group NBT	100.6	3.89	3.6%	3.6%	21.7%
Phoenix	167.7	2.23	-11.7%	-11.7%	-0.1%
RM	139.9	1.50	-12.2%	-12.2%	1.1%
Infrastructure services			-3.8%	13.8%	15.3%
FTSE All Share			-0.5%	8.0%	6.4%

Source: Morningstar

Having snapped back fairly quickly from their post Lehman's lows, shares in infrastructure services companies has enjoyed mixed performance during 2010. Some, such as Computacenter and Datatec has continued to rise whilst others, such as Maxima and Phoenix, have not. Overall, the infrastructure services peer group has significantly outperformed the All Share over the last 12 months, although this outperformance has rather run out of steam in recent weeks.

Valuations

Turning the discussion to valuations, it its interesting to note that, whilst trading conditions have improved substantially over the last year, valuations has remained broadly flat suggesting that upgrades have been the primary driver of share price recovery.

Table 4: Infrastrucutre Services current year valuation multiples

	EV/Revenues	EV/EBITDA	PER	Div Yld %
Computacenter	0.2	6.4	12.0	3.2
Datatec	0.1	4.1	10.4	2.4
Maxima	0.6	4.9	5.9	3.9
Group NBT	1.9	8.5	15.4	1.3
Phoenix	0.9	4.6	7.5	3.1
RM	0.4	4.7	9.5	4.4
Infrastructure services	0.7	5.5	11.6	2.2
All ICT services	1.4	6.5	11.0	2.4
Megabuyte Universe	1.7	9.6	15.0	1.6

Source: Megabuyte, Morningstar

Peer group review

As an additional point, it is worth noting the impact of cash generation on EV related valuations over the last 12 months. The net cash positions of Computacenter and Datatec, for example, have improved by over £100m each in the last 12 months. As a result of this, the improvement in EV/EVITDA valuations has not kept pace with the increase in PE valuations.

Despite the strong relative share price performance amongst infrastructure service companies, we can see from table 2 that, on an EV/EBITDA basis, as a group, they continue to trade at a modest discount to the ICT services universe and a substantial discount to the wider Megabuyte universe.

Fundraising and M&A analysis

The third element of our peer group review is to look at the fundraising and M&A environment for companies in this peer group. As we can see from the table 5 over the pages, there has very little M&A and fundraising activity in this part of the market over the last 12 months. Given the poor state of investor sentiment towards infrastructure services companies until fairly recently, this is perhaps not surprising.

Up to very recently, there had only been a handful of very small transactions in the peer group and many of these were overseas purchases. However, as investor sentiment has improved and share prices have recovered, so M&A and fundraising activity has also started to wake up. We would highlight three recent deals in the sector.

The most significant transaction within this peer group in 2010 has been NTT's acquisition of Dimension Data. Although not technically a UK deal, DiData was listed in London so it has made it onto our list. What was also interesting to note about this transaction was the valuation; NTT paid a very health 10.4x EBITDA for DiData which is almost double the average valuation for the quoted peer group.

Which leads us on to the second recent landmark deal in the sector; 2e2's acquisition of LSE listed Morse. 2e2 acquired Morse with funding from Hutton Collins; a new investor in the company. As well as being another sign of improving confidence in infrastructure services, this deal was interesting because it also signified returning interest in the IT services sector by private equity investors.

Whilst this may be only one data point for renewed PE interest in this part of the market, we do see this as symptomatic of a wider recovery in interest. Importantly, this interest is partly predicated on the trend to more visible revenue streams as managed services make up an increasing proportion of revenues for many infrastructure services companies. Contrast this with a striking lack of interest both from the stockmarket and PE investors for project based IT services companies where revenue visibility remains poor and margins remain under pressure.

There is one other, smaller transaction which went under the radar of many observers but we think is worthy of note; Telecity's acquisition of hosting business IFL from Attenda. This deal is interesting for two reasons. First because of the valuation paid by Telecity for the business; whilst precise numbers were not released, Telecity commented that the valuation paid was broadly in line with their own. This would imply and EV/EBITDA multiple of at least 10x. The second interesting aspect to this deal was the fact that the management team of Attenda chose to keep the application management piece of their group. This may provide a clue to the longer term relative valuation trends in application managed services versus plain vanilla hosting services.

Peer group review

Convergence all around

As we will note later in this report, the advent of Cloud computing is leading to some fundamental changes in the structure of the software and ICT services supply chain. Inevitably, this structural change is having an impact on the M&A scene and, we believe, will have an even more profound effect as the trend to Cloud computing gathers momentum. We see this trend playing our in two key ways.

One of the most striking aspects of these changes is how software vendors and IT services companies, that may have previously been partners, are increasingly finding themselves as competitors. As well as massive investment in hosting capacity by software gorillas such as Microsoft we see an increasing amount of M&A activity which is acting as an accelerant to the trend.

A good example of this was Advanced Computer Software's acquisition of Business Systems Group (BSG) in 2009. BSG was clearly positioned by ACS's management as a platform into which it could plug its suite of applications as a means of providing them on a hosted basis. Another similar deal was the acquisition of DigiMIS by K3 Business Technology Group earlier this year. Whilst DigiMIS was a relatively small deal for K3, it has been quite fundamental in terms of shaping the group's strategy and service offering going forward.

Table 5: Recent Infrastrucutre Services M&A Deals

				Exit multiple		
Acquirer	**Date**	**Target**	**Price**	**EV/sales**	**EV/EBITDA**	**PBT/PAT**
Ingram Micro	27.10.09	Computacenter CDD div.	£0.0m	na	na	na
Computacenter Plc	30.11.09	Assets of Thesaurus Computer Serv		na	na	na
Computacenter Plc	26.11.09	becom Informationssysteme	€ 3.2m	na	na	na
Dimension Data	3.2.09	Teksys		na	na	0.0x
Dimension Data	7.4.10	Magenta Computacion		na	na	na
NTT	15.7.10	Dimension Data	£2,050.0m	na	10.4x	21.4x
Datatec	9.4.10	BDA Connect		na	na	na
Datatec	1.10.09	Datastor		na	na	na
Datatec	8.12.09	NetStar Group	$19.8m	0.3x	3.4x	na
Datatec	17.9.10	Biodata IT		na	na	na
Datatec	20.9.10	Touchbase Singapore		na	na	na
Phoenix IT Group	23.12.09	Certain assets of Office Shadow ltd	£0.7m	na	na	na
Phoenix IT Group	3.2.10	Aghoco 1000 ltd from KCOM	£1.8m	na	na	na
RM Plc	15.5.09	Isis Concepts	£2.7m	0.3x	na	3.0x
2e2 Ltd	21.6.10	Morse	£69.8m	0.3x	6.0x	na
Telecity	2.8.10	IFL (Attenda)	£21.1m	na	na	na

Source: Megabuyte, company announcements

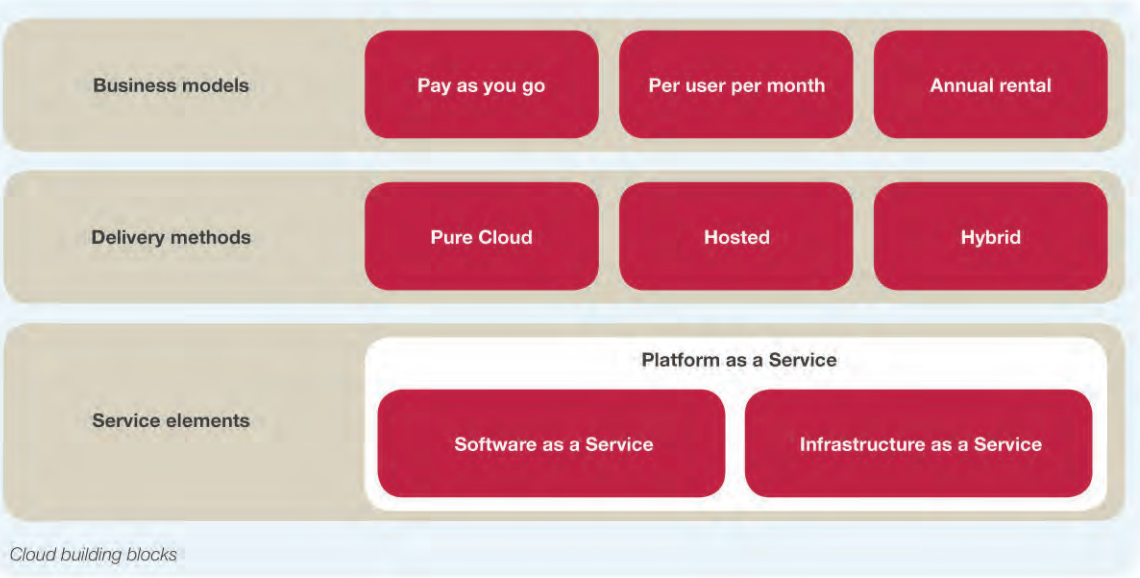
The other key element to convergence in the M&A landscape is the rather slow but nevertheless important convergence between IT and Communications services companies. The obvious recent example of this was the acquisition by telecoms giant NTT of Dimension Data.

We expect this trend to accelerate over time as corporates customers look to further consolidate suppliers with the move to Cloud computing as a catalyst. Consequently, we expect M&A between certain groups of companies which might previously have seemed unlikely to become more commonplace.

Cloud managed services

Cloud building blocks

So turning to the specific topic of this report, as we discussed earlier, as recession turns to recovery, demand patterns in infrastructure services are changing. Whilst there is undoubtedly a welcome upturn in project related revenues, we see this as a cyclical rather than structural phenomenon. The more important underlying trends relate to the shift to Cloud based infrastructures. However, the key question is – do Cloud managed services represent a Holy Grail for infrastructure services vendors or simply business as usual?



Cloud building blocks

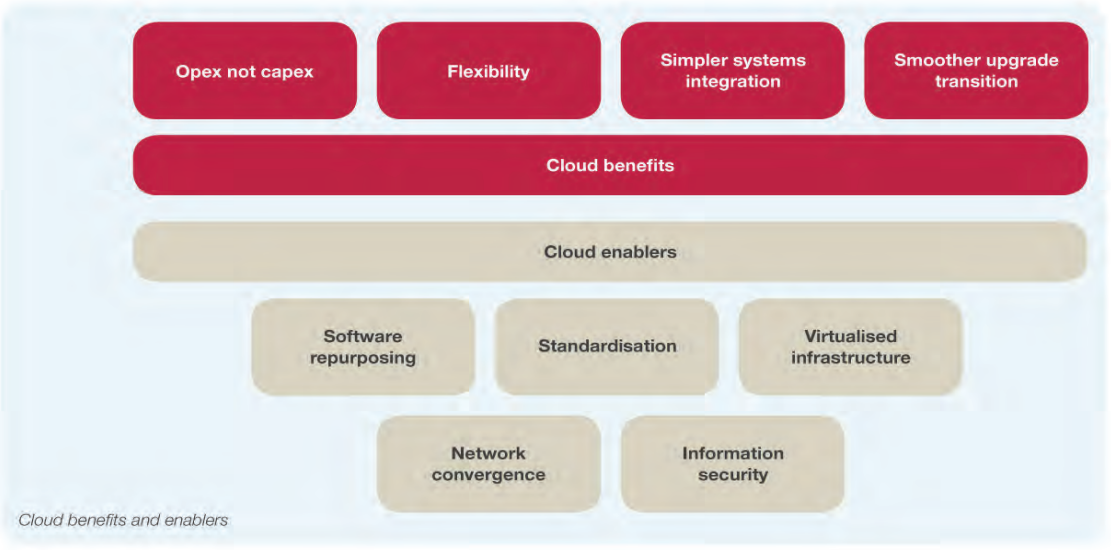
Before we get into the meat of the discussion, it is worth reminding ourselves of the key building blocks and drivers of Cloud computing. In the diagram above we aim to show the key elements of Cloud Computing as we see it.

- **Business models** Whilst it is difficult to precisely nail down one single Cloud business model, the advent of Cloud computing has undoubtedly brought a fundamental change in the way that vendors charge (an increasingly customer expect to pay) for software and IT services. Whether is it on a usage basis, per user per month or on an annual rental basis, the underlying trend in Cloud computing business models is to a lower up front charge and a higher ongoing fee.
- **Delivery methods** In terms of technology, Cloud computing clearly brings a fundamental change in the way technology is delivered to the customer. Whether it is what one might describe as a pure Cloud model, a hosted model or somewhere in between, the key trend is that computing power is moving out of the premises and into the data centre.
- **Service elements** The third key element to the Cloud Computing taxonomy is the service elements; software and infrastructure. Both of these key elements are moving over to a cloud model but we see differences in the way they are developing. Crucially we also see differences in the way these service elements will be delivered in different enterprise categories (SME, mid-market and Enterprise) a subject we will come back to later.

Cloud managed services

Cloud drivers & enablers

Having looked at the main Cloud computing building blocks, is also instructive to understand why Cloud Computing is developing so rapidly; what are drivers of adoption from a customer point of view and what are the potential enablers of continuing adoption.



Cloud benefits and enablers

Cloud benefits

Whilst some observers perhaps get caught up in the technical aspects of Cloud computing, we believe that the business benefits have, and will continue to be, the key drivers of adoption. Primary amongst the business benefits is the ability with Cloud computing business models to replace capex with opex; this has been particularly attractive during the recession for obvious reasons.

However, it is not just the ability to defer the cash cost of IT investment but the increased flexibility of most Cloud computing business models which is a key attraction for CIOs. Pay as you go or per seat models enable the user to more closely match requirements to costs. In addition to the key elements of cash cost deferral and increased flexibility, benefits include simpler systems integration and smoother upgrades resulting from systems being hosted centrally.

Cloud enablers

Whilst there has been great strides in Cloud adoption, there remain certain key enablers where ongoing enhancements need to be maintained if Cloud adoption is to continue. Applications will need to continue to be repurposed in order to optimise their use in a Cloud environment. The use of standardised components will make this process more cost effective whilst, at the same time, enable simpler integration with other applications.

From an infrastructure perspective we see three main enablers; efficient (virtualised) data centre infrastructure, reliable and converged networks and robust security. Without optimised infrastructure is will be difficult for service providers to maintain quality of services in tandem with generating an acceptable margin. Equally, users increasingly expect ubiquitous access to Cloud based services which means improvements in network quality and convergence must continue. Also, crucially, great strides have been made in allaying security fears but developments in data security must keep pace with adoption of Cloud computing.

Cloud managed services

From desktop to data centre – shifting service requirements

So to move the discussion on from the general trend to Cloud computing to how it might impact the infrastructure services peer group. In order to understand this, we need to look at the business models of infrastructure services players in more detail. Whilst one can slice and dice these services in many ways, we find it useful to break them down into three broad categories.

- **Product resale** The provision of third party ICT infrastructure and software either as a stand alone service or as part of a project.
- **Project services** The provision of services related to the preparation, installation and commissioning of ICT infrastructure and software applications.
- **Managed services** The monitoring and maintenance of ICT infrastructure. We find it useful to further subdivide managed services into three groups. Infrastructure managed services, Network managed services and Application managed services.

In addition to being clear about the service lines of infrastructure services players, we also need to look a little deeper into the business model for managed services. In addition to splitting managed services into infrastructure, network and applications, we can also look to categorise them as either people related managed services or platform related managed services.

As the name suggests, people related managed services involve technically competent people monitoring and maintaining infrastructure, networks and applications. Conversely, platform related managed services are those that primarily use the service providers' technology assets to provide infrastructure, networks and applications to the end user. In many respects, platform managed services are a proxy for Cloud managed services.

The impact of Cloud

Having looked at these key service lines, we can then start to look at how Cloud computing might impact each of them.

As an overall point, we can be clear that, as Cloud computing develops, the emphasis on services will move from the desktop to the data centre. Whilst this may seem like a simple point, it is of fundamental importance for infrastructure services companies to understand this as they plan their service offerings in the years ahead.

We see three the key implications of the move from desktop to data centre as follows:

- **Desktop commoditisation** On the negative side, we see continuing commoditisation of desktop equipment and related managed services. Indeed, we see the advent (or return, depending on your perspective) of the dumb terminal as a realistic prospect in many instances over the next five years.
- **Data centre demand** The corollary of the commoditisation of desktop equipment and services, is increasing demand for the supply of data centre related equipment and services. Related to this, we see increased demand for network managed services as more businesses shift the location of their systems from on premise to data centres.
- **Platform managed services is the epicentre** But perhaps the most significant implication of the move to Cloud computing is the rise in demand for platform based managed services. We see application hosting in particular as the epicentre of cloud services; initially for point solutions such as hosted email, security or voice but developing into more complex hosted application services.

Cloud managed services

Cloud challenges and rewards

We have seen that Cloud computing is already leading to a fundamental change in demand patterns for infrastructure services. As infrastructure services players aim to position themselves for these changes, it is worth examining the challenges and rewards of successful repositioning in this way. These challenges and rewards are summarised in the following diagram and explained in more details below.

Cloud challenges and rewards

Rewards

- **Higher growth** Whilst some observers see the move to Cloud Computing as a revolution, we see it more as an evolution. As such, we do not expect businesses to switch over to Cloud infrastructure en mass. However, we do expect an increasing proportion of new systems to be deployed using Cloud based technologies and, hence, those suppliers with a strong Cloud offering should grow proportionately more rapidly than those that do not.
- **Increased margin potential** As infrastructure services vendors move to become Cloud service providers we foresee the potential for higher margins although, as we will see below, this comes hand in hand with increased capital intensity.
- **Tighter customer relationships** From a contractual perspective, the extent to which the move to Cloud computing will lead to tighter customer relationships will depend on the flavour of Cloud business model deployed by the service provider. However, regardless of the change in contractual relationship between customer and vendor, because the customer becomes so much more dependant on the vendor in a Cloud scenario, we see that relationships inevitably become tighter.
- **Greater visibility** There is some disagreement about whether Cloud based business models provide more, or less contractual visibility. However, regardless of the changes in the contractual nature of the relationship, we believe that the tighter customer relationships should deliver greater revenue visibility, whether contractual or otherwise.
- **Higher relative valuation** We are already seeing those vendors with stronger Cloud positioning enjoying higher valuations and we expect this trend to accelerate. However, it is important to note that higher valuations will only result from the enhanced financial performance that Cloud computing enables, not simply by adopting the moniker.

Cloud managed services

Challenges

- **Cannibalisation of existing revenues** As with any new technology wave, one of the key challenges faced by established technology companies is to take advantage of the new growth opportunities whilst at the same time not destroying existing relationships. For us, the most significant challenge for any technology company looking to offer more Cloud based services is in setting the business up for recurring, rather than up front revenues.
- **Increased capital intensity** Whilst it is by no means a pre-requisite of providing Cloud services, many service providers will need to invest in their own data centre capacity. This will clearly add increased capital intensity into the infrastructure services business model which had previously been 'capex-lite'.
- **Higher operational gearing** As we noted in the peer group review, as a group, infrastructure services companies suffered very little margin pressure during the recession and this is primarily because there is only limited operational gearing in the business. As infrastructure services companies become more capital intensive and asset rich, whilst this does increase potential margins, it also increases operational gearing.
- **Shifting channel loyalties** As we noted in the peer group review, one of the key themes of the move to Cloud computing is the potential for shifting channel loyalties. Vendors that used to be partners could become competitors and seemingly unrelated companies may now become acquisition targets.

Impact on the corporate environment

In addition to the challenges and rewards presented by Cloud computing, the impact on the corporate environment is likely to be profound. We have already noted above that valuations for Cloud services vendors should be higher than those that fail to make the transition. We have also seen that M&A activity across the sector is increasingly being shaped by the need for software and IT services vendors to position themselves for the Cloud.

Bringing these two themes together we can foresee a scenario whereby those that have been early to adopt a Cloud posture may quite quickly develop a significant advantage over those that have not. As the valuation gap start to open, those that have left it late to make the transition may find themselves unable to close the gap because their valuation is too low to make earnings enhancing acquisitions of companies that will enable them to catch up. As a result, we may end up with a two tier supplier base and those that get left behind will either find themselves being consolidated or, worse, unable to generate renewed growth as market recovers. Indeed, we can already see some examples where this is happening.

Mid market opportunity

One last, but very important, point to make on the development of Cloud services is that we see fundamental differences in how different sized businesses will adopt Cloud technologies. Whilst SMEs are perhaps the greatest potential beneficiaries of Cloud computing, we do not see a significant opportunity for Cloud services vendors as we feel that the software vendors will dominate. Likewise in the Enterprise space, where we see the global leaders such as IBM and Oracle as the most likely Cloud services providers.

However, we see a substantial opportunity for UK based infrastructure services players in the mid-market as Cloud computing develops. Indeed, as Cloud computing adoption increases, we believe that well positioned infrastructure services vendors have the ability to work their way up the value chain and, in some scenarios, become the dominant ICT providers to mid market companies. We would describe this as becoming a Cloud Platform provider.

Cloud managed services

Critical success factors

Bringing all of our analysis of the impact of Cloud Computing together, we put forward some conclusions in the form of our assessment of the critical success factors for infrastructure services companies as they make the transition to Cloud services. Here we outline what we see as six key critical success factors:

1. Be clear about your Cloud proposition

As we have seen, there are many moving parts to Cloud computing and infrastructure services players need to be clear about their proposition in terms of the services lines they aim to provide and the enterprise segment they are targeting.

2. Maintain a balanced portfolio

The trend to Cloud Computing is an evolution not a revolution. As such, it is important for infrastructure services players to maintain a balanced portfolio of services rather than make a sudden switch to Cloud services. In this way, service providers will be able to guide their customers through the transition rather than forcing them into early adoption.

3. Emphasise the data centre and platform based managed services

However, in maintaining this balanced portfolio, service providers should avoid increased emphasis on desktop products and services and favour instead a focus on data centre related products and services. Also, with regard to managed services, service providers should favour those based on a technology platform rather than those dependant on headcount.

4. Be prepared to re-evaluate your partner and M&A strategy

The shift to Cloud computing is precipitating some fundamental changes in the supplier landscape. Infrastructure services vendors need to make sure that their partner relationships remain relevant as the Cloud trend develops and that they have examined all potential routes to market. Equally, infrastructure services vendors could potentially look at acquisition targets to enable them to take full advantage of the trend to Cloud computing which may have previously been out of scope.

5. Make sure you have a strong capital base

As the requirement for capital expenditure by service providers increases and the interdependency of customer relationships develops, infrastructure services companies will need to have a robust balance sheet and, also, be seen as stable.

6. Aim to be a thought leader

In the formative stages of Cloud computing, customers will be looking for guidance to help them understand the options open to them. Whilst thought leadership must clearly be backed up by a strong proposition, service providers with the right positioning in the market are likely to be disproportionate beneficiaries of these customer enquiries.

In conclusion therefore we must return to the central question; Cloud managed services – Holy Grail or business as usual? Having evaluated the trends, challenges and rewards for infrastructure services companies in the move to Cloud services we have to conclude that the answer is, in fact, both. To explain, we believe that Cloud services have the ability to fundamentally improve the business models of infrastructure services players (the Holy Grail) but, equally, that they should see the transition to Cloud as business as usual. If they do not see it as such, then the consequences over the medium to long term, could be severe.

Disclaimer

IS Research Ltd will not accept any liability to any third party who for any reason or by any means obtains access or otherwise relies on this report. IS Research Ltd has itself relied on information provided to it by third parties or which is publicly available in preparing this report. While IS Research Ltd has used reasonable care and skill in preparing this report, IS Research Ltd does not guarantee the completeness or accuracy of the information contained in it and the report solely reflects the opinions of IS Research Ltd.

The information provided by IS Research Ltd should not be regarded as an offer to buy or sell securities and should not be regarded as an offer or solicitation to conduct investment business as defined by The Financial Services and Markets Act 2000 ("the Act") nor does it constitute a recommendation. Opinions expressed do not constitute investment advice. Any information on the past performance of an investment is not necessarily a guide to future performance. IS Research Ltd operates outside the scope of any regulated activities defined by the Act. If you require investment advice we recommend that you contact an independent adviser who is authorised by the Act to conduct such services. IS Research Ltd does not have any direct investments in any companies contained in the report and has compiled this report on an independent basis.

I S Research Ltd
Davidson House
Forbury Square
Reading
RG1 3EU

T +44 (0) 01189 001 360
E info@is-research.co.uk

www.megabuyte.com

megabuyte