Cloud Migration Fuels Dealmaking in Hyperscale Cloud Partner Ecosystems

Financial sponsors and strategic buyers from multiple industries are aggressively looking to expand their services capabilities in massive, high-growth cloud ecosystems such as Amazon Web Services, Microsoft Azure, and Google Cloud Platform.

Industry Commentary

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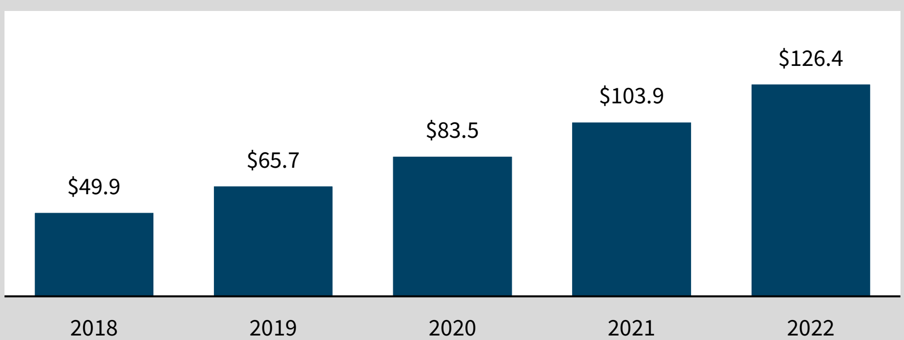
The ongoing migration by companies of all sizes from on-premises technology to cloud-based solutions has created a massive and growing need for companies that can facilitate transitions to Amazon Web Services (AWS), Microsoft Azure, and Google Cloud Platform (GCP).

"The worldwide public cloud services market is projected to grow 17.5% in 2019 to total $214.3 billion, up from $182.4 billion in 2018, according to Gartner, Inc."* This report will focus on service providers in the IaaS ecosystem. The market for IaaS, dominated by AWS, Azure, and GCP, reached approximately $50 billion in 2018 and is expected to grow at a compound annual rate of 28.2% from 2017 to 2022, according to Technavio. The market for cloud migration services is expected to reach $6.9 billion by 2022, representing a 22.6% compound annual growth rate from 2018, according to Technavio.

Accelerating Growth for Cloud Migration Services

The growth rate for cloud migration services, a subset of the larger cloud market, is expected to remain exceptionally high through at least 2022. This reflects the fact that we are still in the early stages of the overall migration to the cloud, particularly in heavily regulated industries such as healthcare and banking.

Market in Focus: Global Cloud Infrasctructure Services Market ($ in billions)



Source: Technavio

*Gartner Press Release, "Gartner Forecasts Worldwide Public Cloud Revenue to Grow 17.5 Percent in 2019," April 2, 2019. https://www.gartner.com/en/newsroom/press-releases/2019-04-02-gartner-forecasts-worldwide-public-cloud-revenue-to-g

The demand for IaaS and related services is almost certain to accelerate because we are still in the early stages of the overall migration to the public cloud. Large, heavily regulated industries, such as healthcare and banking, are just beginning to get comfortable with the idea of moving their sensitive data to the cloud. But these comfort levels will grow, representing a huge expansion of the total addressable market for cloud services. According to a 2019 report by McAfee, the number of files with sensitive data shared in the cloud increased 53% from 2018.

The size, growth rate, and adoption curve of hyperscale cloud platforms have resulted in robust ecosystems of partners that help companies develop roadmaps for transitioning to the cloud, migrate and/or develop the application, and then manage and optimize the environment once the transition is complete. As the demand for these services grows, customers will require fewer vendors to provide a broader array of services, fueling the need for consolidation and increased scale.

This trend has led to a flurry of acquisitions as cloud services providers position themselves to capitalize on the growing demand for their capabilities. William Blair has completed 12 transactions on behalf of next-generation cloud services companies since 2015. In this report we examine the trends that are shaping the dealmaking landscape for firms that provide services related to hyperscale cloud platforms.

Interest From All Corners of the Buyer Universe

These macro tailwinds have led to broad-based acquirer interest in the hyperscale cloud partner ecosystem. Financial sponsors initiated the current consolidation wave, which started in 2016 when William Blair advised Logicworks, a partner for AWS and Azure, on its acquisition by Pamplona Capital Management. Blackstone's acquisition of Cloudreach was another notable acquisition by a financial sponsor. In parallel with acquisitions, numerous growth equity investments have been made to scale teams and grow businesses; notable examples include Pamlico Capital's investment in 10th Magnitude, Sunstone Partners' investment in Onica, and Columbia Capital's investment in 2nd Watch and Contino.

While financial sponsors remain very active in the space, strategic buyers from several segments have recently intensified their efforts to expand their capabilities related to hyperscale cloud platforms. Diversified industrial players, such as HP Enterprise, with its 2017 acquisition of Cloud Technology Partners, and Hitachi, with its 2018 acquisition of REAN Cloud, are buying into the partner ecosystems to meet the current and future needs of clients. REAN Cloud, which William Blair advised on the transaction, addresses a gap in Hitachi's capabilities for helping companies leverage the cloud.

Almost every large IT services company has shown an interest in AWS and/or Azure premier partners. Scaling up their capabilities internally in these areas to fully meet demand is challenging for global IT services firms given the shortage of qualified professionals, so these companies are looking to buy into the partner ecosystem to augment internal hiring efforts. Strategic interest has also been driven from additional segments of the technology landscape, including telecom companies, hosting providers, and value-added resellers/ distributors as the growth of public cloud ripples through and disrupts multiple business models.

Assessing the Business Models: Professional Services vs. Managed Services

The partner ecosystem for hyperscale cloud providers is broad and diverse. There are nearly 100 Premier Consulting Partners for AWS alone, plus thousands of additional consulting and technology partners. The universe of cloud service providers can be divided into two

Business Models of Cloud Services Providers

The partner ecosystem for hyperscale cloud platforms comprises two primary types of business models: professional services and managed services. While managed services companies historically have commanded higher M&A multiples, the gap is narrowing—or disappearing.

	Professional Services	Managed Services
Cloud journey focus	• Plan & Design • Build & Migrate • Optimize	• Run & Operate • Optimize • Scale
Revenue model	• One-off or reoccurring project-based work • Fixed-free or time and materials based • Potential for large-scale, multiyear mass migration work	• Contractually recurring • Flat fee and/or % of hyperscale cloud usage • Often includes "cloud pass-through" or "managed public cloud" revenue – typically recognized "net"
Typical client base	• Varied – from largest enterprises globally to SMBs	• Most relevant for midsize enterprises and smaller • Large enterprises increasingly showing interest
IP enablement	• Software-based IP to enable rapid, secure, and compliant mass migrations • Substantial people- and process-based IP	• 24x7 NOC / SOC support • Real-time, automated threat detection and remediation
Best-in-class characteristics	• Significant reoccurring project-based work within a client (land-and-expand) potentially leading to multiple years of work • Highly skilled / credentialed delivery team • Fixed-fee engagements generating higher margin	• Highly automated, low-touch technology platform • Exceptionally low or net negative churn (expansion from client base exceeds any churn) • Elevated gross margin profile

main types of business models: professional services and managed services.

Professional services–centric firms tend to focus on the earlier stages of a client's cloud migration journey, providing one-off or reoccurring project-based work related to the plan and design, build and migrate, and optimize phases. Their client bases include companies of all sizes—from small- and medium-sized businesses (SMBs) to global enterprises.

Managed services–centric firms, on the other hand, focus on running, operating, and optimizing cloud environments after the migration has occurred. Managed service offerings can range from proactive monitoring and management of the cloud environment to automated security and compliance reporting—often supported by a 24/7 network operations center (NOC) or security operations center (SOC). Historically, their target clients tend to be medium-sized enterprises and smaller companies with less sophisticated internal IT teams that are likely to outsource specific functions, although large enterprises are increasingly looking to managed services providers to manage cloud environments.

Managed services offerings often are supported by some element of intellectual property, often patent-protected; as a result, they usually have higher gross margins and operating leverage than professional services providers, whose most valuable assets are their people. These characteristics historically have resulted in managed services providers commanding higher M&A valuations than professional services providers.

We have observed, however, that the valuation gap is narrowing—and in some cases disappearing. This is being driven by the fact that large enterprises have shown a reluctance to enter long-term contracts for managed services that their in-house IT teams should be able to handle. Another factor causing the valuation gap to narrow is that while professional services contracts are project-based, cloud migration and optimization efforts often are multiyear engagements that require "reoccurring" services—leading to a steady and growing revenue stream.

Solving the Scale Challenge

During an M&A process involving a hyperscale cloud partner, one of the most important aspects of the due diligence is assessing the provider's ability to aggressively scale to support drastically higher numbers of customers and increasingly complex engagements.

Through our sell-side engagements, we have identified four distinct ways that hyperscale cloud partners can successfully address the scale question and, as a result, increase their valuations:

Intellectual property – Many high-growth providers use proprietary software and/or processes to enhance efficiency, automate functions, and more fully leverage their cost of goods sold.

Effective use of off-shore resources – Expanding operations in lower-cost countries can mitigate concerns about the cost profile of additional resources and the shortage of talent in more developed countries. High-end professional services firms with extensive client-facing engagements, however, have been reluctant to pursue this model.

Internal training academies – One of the most effective ways companies are addressing the shortage of cloud-specific talent is by creating internal training "academies" or "universities." This model allows companies to attract younger or otherwise less experienced professionals and upskill them to meet client needs.

Increased managed services mix – Technology-enabled managed services and automation have enabled partners to scale their number of customers while fractional resource optimization has limited the need for additional employees.

Analyzing the Role of Intellectual Property

As noted above, intellectual property (IP) plays a vital role in a cloud service provider's ability to scale and, thus, its attractiveness as an acquisition target. In several recent sell-side transactions, William Blair's clients were able to enhance their valuation

Four Proven Ways to Scale Cloud Services

With any cloud services company that is an acquisition target, the company's ability to scale and handle increased customer volumes is the leading focus of the diligence efforts. We have identified four distinct ways that cloud services firms can successfully scale.

Model	Description
Intellectual Property	Proprietary tools that increase automation, eliminating/reducing the need for increased headcount, driving down costs
Offshore	Moving headcount (and costs) offshore where the cost of labor is lower, allowing for lower COGS and SG&A, even though headcount may be higher
University	Established, from the ground up, training program for new hires to ensure excellent delivery and advisory skills
Managed Services Mix of Efficiency	Recurring managed services revenue allowing for a land-and-expand model and confidence in revenue growth – attractive LTV/ CAC typically

because they had internally developed IP that was heavily scrutinized by global strategic acquirers during the diligence process.

The IP being developed and used by next-generation cloud services providers can generally be classified as software-based or people-centric. Software-based IP often is used to facilitate cloud migrations and to run and optimize the cloud environment once the migration has occurred. REAN Cloud's Infrastructure-as-Code offering automates many processes and drastically accelerates cloud adoption—reducing transformation timelines from years to months. Logicworks' Pulse platform integrates intelligence across cloud tools and systems, monitors costs, and alerts clients to potential security risks.

Cloud services companies that have limited opportunities for technology enablement must answer the question of how they can scale beyond simply adding more people. The fastest-growing firms are doing this through IP that focuses on people and processes, rather than software. In addition to the aforementioned academy model that enables upskilling of new hires, companies are achieving operating leverage through innovative, efficient approaches to how they staff their teams and manage client engagements, such as templates, code repositories, and reusable tooling.

Despite all of the talk about the cloud, it is worth repeating that the overall migration of companies' IT infrastructure to the public cloud across industries is still in the early phase. The scale of cloud adoption should increase as healthcare, banking, and other heavily regulated industries become more comfortable with cloud environments—and as cloud security approaches advance to the levels needed for enterprises with highly sensitive data.

To learn more about these and other trends that are shaping the dealmaking environment for cloud services providers, please do not hesitate to contact us.

Recent Acquisition Activity

2016 – YTD 2019

Ecosystem	Date	Company Acquired	Acquirer
Amazon Web Services (AWS)	Oct-16	Logicworks	Pamplona Capital Management
	Feb-17	CloudReach	Blackstone
	Sep-17	Cloud Technology Partners	Hewlett Packard Enterprise
	Aug-18	TriNimbus	Onica (Sunstone Partners)
	Aug-18	Relus Cloud	Cloudreach (Blackstone)
	Oct-18	Mission (Stratalux / Reliam / G2 Tech Group)	Great Hill Partners
	Oct-18	REAN Cloud	Hitachi
	Nov-18	Stelligent	Mphasis
Microsoft Azure	Oct-16	10th Magnitude	Pamlico Capital
	Mar-19	SADA (Microsoft Business Unit)	Core BTS (Tailwind)
Google Cloud Platform (GCP)	Mar-18	Cloud Technology Solutions	NorthEdge Capital
	Apr-19	Cirruseo	Accenture