William Blair

Consolidation in Cloud Services Accelerates as Ecosystems Grow and Mature

Strategic and financial acquirers have been aggressively pursuing services companies focused on salesforce.com, Workday, ServiceNow, Amazon Web Services, and other leading cloud-based platforms.

Industry Commentary

Jim Suprenant
jsuprenant@williamblair.com
+1 312 364 8592

Scott Stevens
sstevens@williamblair.com
+1 312 364 8337

Michael Amez
mamez@williamblair.com
+1 312 364 8453

As cloud-based applications and platforms continue to reshape the way businesses manage everything from sales and marketing to IT infrastructure to human resources, M&A interest in companies that provide consulting, implementation, and managed services for these applications and associated ecosystems has accelerated. Over the past 18 months, William Blair has completed six transactions for companies that deliver various forms of value-added services related to leading cloud-based platforms.

We examine the factors that are driving strategic acquirers' and financial sponsors' heightened interest in cloud services and the dynamics that have influenced valuation in these recent transactions.

Strategic Consolidators Increasingly Turn Focus to Cloud Services

Over the past year or so, leading cloud ecosystems continued to mature and grow as their respective solutions gained increasingly widespread acceptance. With this continued growth, the services opportunities related to these platforms have expanded to the point where large providers without existing, strong practices are now focused on acquiring scale and capabilities in these cloud solutions.

Several of William Blair's recent transactions illustrate this trend. In September 2015, William Blair advised Fruition Partners, which provides consulting services related to the ServiceNow platform, on its acquisition by CSC. In May 2016, William Blair advised Bluewolf, a consultant and optimizer for salesforce.com, on its acquisition by IBM. In November 2016, William Blair advised DayNine, a consulting and deployment services provider for Workday, on its acquisition by Accenture. And in November 2016, William Blair advised Appirio, which provides consulting services for salesforce.com, Workday, and other cloud applications, on its sale to Wipro.

Other high-profile acquisitions by global services firms include IBM's September 2015 acquisition of Meteorix (Workday), Accenture's October 2015 acquisition of Cloud Sherpas (multiple platforms), and Mercer's January 2016 acquisition of CPSG Partners (Workday).

In cloud services, consolidation has tended to trigger more consolidation. Accenture's acquisition of Cloud Sherpas increased pressure on IBM to strengthen its salesforce.com capabilities, which IBM did by acquiring Bluewolf. Similarly, IBM's acquisition of Bluewolf and Accenture's acquisition of DayNine gave Wipro added incentive to acquire Appirio so that Wipro could enhance its salesforce.com and Workday capabilities with a single transaction.

For Emerging Ecosystems Domain Expertise Trumps Business Model

Many cloud services companies have had success expanding beyond one-off consulting or implementation projects by adding managed-services capabilities. The ability to generate recurring revenue certainly is an important value driver, particularly in the eyes of financial sponsors. But having domain expertise, referenceable success, and talent in emerging ecosystems, such as Amazon Web Services, Google Cloud, Microsoft Cloud, salesforce.com, and Workday, remains the most important factor, by far, in cloud services M&A. Companies with purely project-based business models continue to attract significant interest from strategic acquirers, as long as the target focuses on a high-growth application ecosystem that is complementary to the buyer's existing capabilities and growth strategy.

Companies that have managed-services capabilities in the right ecosystems are the ones that can command outlier valuations. Logicworks and OneSource Virtual (see more information on these last two transactions below) are recent William Blair clients whose recurring-revenue-based business models added to the competitive M&A process dynamic and led to premium valuations (and also allow financial sponsors to be more competitive).

Acquirers Grasp the Scale of Cloud Services

A major driver of consolidators' increased interest in cloud services is a growing understanding of the

Generating recurring revenue through managed services is an important value driver in cloud services M&A. But having domain expertise in the right ecosystem remains, by far, the most important factor.

Cloud Services – Valuation Drivers

			Best-of-Breed
Business Model	Nonrecurring, project-based services	Mix of project-based services and managed services	Fully recurring managed services
Spend Magnitude	Tens to hundreds of thousands per client	Millions for largest clients	Millions per client
Key Cloud Platforms	Various platforms, including: Amazon Web Services, Google, Microsoft, Salesforce, ServiceNow, Workday, and others		
Contract Length	Project-based	1–3 years	3–5 years
Revenue Growth Rate	<10%	10%–30%	>30%
Recurring Revenue	<20%	20%–50%	>50%
Gross Margin	25%–30%	30%–40%	>40%
Valuation	Valuation for high-growth cloud services companies can range from 2.5 to 4.0x LTM revenue with more established providers yielding valuations of 8–14x LTM EBITDA		

Source: William Blair analysis

potential customer spend and of the total addressable market size. Until recently, strategic buyers largely viewed the revenue opportunity surrounding a salesforce.com implementation or a ServiceNow project, for example, as being subscale relative to the massive projects services firms did within ecosystems like SAP and Oracle.

That mindset has shifted dramatically over the past two to three years. Consolidators have realized that cloud implementations and associated services can be massive projects. One of William Blair's clients had several $10 million-plus projects related to a cloud application. Having even a few of these large clients can be an important value driver in cloud services M&A as it proves to the buyer the levels to which client spend around cloud implementations can grow.

Strategic buyers have also gained a better understanding of the additional spend beyond just the implementation work that often is required whenever a cloud-based application is adopted. For example, a salesforce.com implementation usually involves some level of change management consulting, work that is right in the wheelhouse of global services firms. In many cases, the adoption of a cloud application is a harbinger of transformational change in the enterprise. Implementing Workday, for example, often is a sign that the company may be rethinking its broader human resources strategy or considering outsourcing some of these functions. Adding cloud services capabilities strengthens a services company's ability to be a meaningful part of these transformation efforts.

Size and Focus Matter

When global services firms evaluate opportunities to expand their cloud services offerings through M&A, transaction size plays a large role in influencing the company's buy-vs.-build decision. For strategic acquirers, the target needs to be large enough that it moves the needle, but the transaction size must be within a range that acquiring the capability still makes more sense than trying to build it internally. For fast-growing cloud services firms that have not yet achieved optimized profitability, we believe that this sweet spot generally

When global services firms evaluate opportunities to expand their cloud services offerings through M&A, transaction size plays a large role in influencing the company's buy-vs.-build decision.

ranges from $75 million to $250 million of enterprise value. For more mature companies where profitability and margin enhancement are part of the acquirer's investment thesis, the upper range of this sweet spot can be significantly higher.

Strategic acquirers also pay close attention to how well the target's capabilities and end-market focus fit with the buyer's existing capabilities. Companies that focus on one or two applications are more likely to find a buyer willing to assign a high value to every dollar of the target's revenue, versus a target that is more diversified from an application focus perspective. In terms of end-market focus, companies with clients in financial services, healthcare, life sciences, consumer, and other high-growth industries typically are able to command premium valuations. As always, buyers also will look closely at a target's gross margins and average client size during the diligence process.

For Established/Legacy Ecosystems Business Model Is Critical

As end-customers become more educated and familiar with the benefits of cloud-based operating models (pay-as-you go costs, limited capital expenditures, instant technology updates, etc.), companies desire a similar "cloud" experience with their traditional on-premise enterprise applications. Given these applications are traditionally mission-critical to the success of the organization (ERP, databases, business analytics), the shift from on-premise to an outsourced/hosting model is still in its infancy. A few notable managed service providers that are focused on this emerging trend are Data Intensity, Secure-24, Symmetry, TriCore, and Velocity. We believe that these companies (as potential acquisition targets) and the overall opportunity for application-driven hosting focused on large-scale applications, like Oracle and SAP, will become more important over time. Traditional services providers will begin to value these offerings more as they seek new and profitable opportunities to monetize their relationships and the installed base of "legacy" ERP and database applications.

To learn more about these and other trends shaping M&A activity in the cloud services industry, please do not hesitate to contact us.