

IT Services M&A Update

We have read the recent analyst reports that suggest the IT Services sector is currently experiencing a period of stable, marginal growth (low to mid-single digit percentage range) that will continue for the next 3-4 years. Clearly, that differs from what we are hearing from our clients and seeing from the publicly traded IT services firms that we track.

The Global IT Services markets made a strong showing in 2006 both in terms of business activity growth and mergers and acquisitions and the sector is poised to build on this strength in 2007. Reflecting this strength, in 2006, all IT services sub-sectors followed by Updata outperformed the NASDAQ except for our Government IT Services index which lagged NASDAQ by 14%. The average revenue growth rate for the 70 IT Services firms we track was 12.6% through the September quarter (10.4% excluding the Indian Offshore firms). The IT Services M&A market had a very solid 2006 with \$24.2 billion of announced deal volume YTD.

This strong operating environment has translated into a healthy M&A market (see Table I). In the eleven months ended November 30, 2006 Updata tracked 358 Services deals, as compared to 304 for the same period in 2005 (see Table II).

Table II

Eleven Months Ended Nov 30,	2006	2005
Number of Deals	358	304
Median EV / Revenue	0.99x	0.95x
Median Deal Size (\$ in millions)	\$30.7	\$19.5

Why are we seeing an increase in number of deals and deal size? New buyers have joined the mix for services acquisitions, including offshore players who are slowly getting involved in the M&A game, as buyers and sellers. Three of the top ten deals (see Table III) this year have involved Indian Offshore services firms – EDS / Mphasis, KKR / Flextronics and Capgemini / Kanbay.

The Indian Offshore firms (especially the public ones) have the luxury of strong balance sheets and market capitalizations and can afford to pay a premium to a) enhance their offshore presence (Infosys acquired Citicorp's stake in Progeon for nearly 6.0x) or b) "come ashore" (Kanbay acquired US-based consultancy, Adjoined Consulting for 1.7x earlier this year – prior to the Capgemini deal). Indian Offshore firms are starting to realize they need

Table I

	Enterprise Value (a) as a Multiple of				LTM		LTM		Q/Q Rev		Share Price % of 52 Week High
	Revenues		EBITDA (b)		Price / Earnings		Gross	EBITDA	Growth		
Services Subsector:	CY2006	CY2007	CY2006	CY2007	CY2006	CY2007	Margin	Margin	Seq	Y/Y(c)	
Consulting	1.9x	1.7x	11.9x	9.6x	22.2x	19.7x	40.6%	15.3%	1.6%	16.6%	94.3%
Systems Integration	0.7x	0.7x	9.6x	8.2x	21.3x	17.4x	27.3%	7.4%	2.6%	8.4%	81.4%
Outsourcing	1.2x	1.1x	8.2x	7.7x	18.4x	16.1x	27.1%	12.6%	2.7%	11.1%	92.8%
Staffing	0.5x	0.4x	9.8x	7.4x	20.5x	15.8x	23.4%	4.0%	1.6%	8.0%	77.5%
Government IT Services	0.9x	0.9x	9.5x	8.7x	20.5x	17.9x	18.6%	8.7%	0.9%	8.2%	81.3%
Business Process Outsourcing	1.3x	1.2x	10.7x	9.0x	24.3x	20.7x	38.7%	14.4%	2.2%	10.8%	96.0%
Indian Offshore IT Services	3.7x	3.0x	19.1x	14.6x	31.6x	24.4x	37.7%	22.1%	9.7%	35.4%	91.0%
All Services Companies	1.1x	1.1x	10.9x	10.3x	10.3x	10.3x	32.1%	9.8%	2.2%	12.6%	89.2%

Note: All valuation data calculated based on market close price of 12/21/06. All valuation information for comparable public companies based on median data points

(a) Enterprise value is equal to market capitalization plus debt and preferred stock minus cash and cash equivalents

(b) EBITDA excludes all one-time charges and expenses

(c) Q/Q revenue growth represents most recent quarter year-over-year

Deal sizes have increased and valuations are up slightly as well. The median enterprise value in 2006 is \$30.7 million as compared to \$19.5 in 2005. The median Enterprise Value / LTM Revenue multiple was 0.99x for the eleven months of 2006 as compared to 0.95x for the same period last year. While deal multiples in certain sub-sectors, like Government IT Services, are trending downward, we are still experiencing a robust M&A environment in the overall IT Services space.

feet on the ground and customer-facing experts in the countries they do business to complement their low-cost offshore model.

Private equity buyers have also joined the game. Five of the top ten deals this year – West Corp, Emdeon Business

Table III

YTD Stock Price Performance

Nasdaq Composite	10.1%
BPO	39.6%
Indian Offshore IT Services	36.8%
IT Systems Integration	23.7%
IT Outsourcing	22.5%
IT Staffing	18.2%
Consulting	16.3%
Government IT Services	-4.0%

Services, NCO Group, Flextronics and Pearson Government Solutions – were effectuated by financial buyers. Updata has tracked 20 services deals year-to-date involving financial sponsors, compared to 12 in 2005.

According to the Dow Jones Private Equity Analyst, global mergers and acquisitions by financial sponsors hit \$570 billion during the first nine months of the year, up 51% from the prior record set during the first nine months of 2005. Private investors are playing a bigger role in M&A, which has traditionally been dominated by large, publicly held corporations. At the end of the third quarter of 2006, private equity groups in the U.S. alone had raised \$172 billion. This total is an increase of approximately 72% compared to the figure at this point last year. The total this year has already exceeded the \$163 billion raised in all of 2005. If fund raising continues at the current rate of more than \$57 billion per quarter, it is projected that 2006 will end with as much as \$225 billion raised by U.S. private equity funds.

Consulting

We continue to see a strong demand for consulting services as evidenced by Accenture’s recent Q1 earnings release which showed revenue growth of nearly 20%, sequentially, and 13.7% over the first quarter last year. Our IT Consulting index has rebounded recently and is up 16.3% on a YTD basis. Updata’s Consulting subsector is currently trading at a median enterprise value to 2006E revenue multiple of 1.9x and just shy of a median enterprise value to 2006E EBITDA multiple of 12.0x. This group of companies is up slightly compared to the end of September 2006 when they were trading around 1.6x but is down slightly from the 2.0x level in Q3 2005, on a revenue basis. This is a highly profitable group of companies with a median EBITDA margin of over 15% and median gross margin of nearly 41%.

There have been nearly 80 Consulting deals, year to date, as compared to 67 in 2005. The median enterprise value to LTM revenue multiple is 1.2x, compared to 1.1x in 2005.

A strong job market has caused a talent crunch for highly skilled positions and consultancies have had to offer

attractive compensation packages to highly sought after consultants. Bill rates have slowly ticked up as buyers of Consulting services appear more willing to spend on specialized services and domain expertise.

Systems Integration

Updata’s IT Systems Integration Index is up 23.7% year to date and has returned to the level it was trading at back in April and May of this year. This subsector is currently trading at a median enterprise value to 2006E revenue multiple of 0.7x and nearly 10.0x enterprise value to 2006E EBITDA.

This group of companies contains quite a few “hybrid” type services firms like Ciber, Keane and MPS. These firms really offer the full spectrum (Staffing to Consulting) of IT Services, but we feel their model aligns most appropriately with Systems Integration firms.

We continue to believe that pricing pressure from the offshore/nearshore service providers will affect the basic application development and maintenance services providers, but those integrators that can offer “non-offshorable” solutions will continue to see a significant portion of IT spending. A recent Forrester survey suggests that 40% of 2006 IT services budgets will go toward systems integration and consulting services. Two horizontal areas of particularly strong demand are Business Intelligence and Data Warehousing.

We have also witnessed a very strong demand for SAP services. From an M&A perspective, over 20 SAP service providers were acquired this year alone (see Table IV). The most aggressive buyer continues to be Axon Group who has acquired four US-based SAP firms in the last two years – Zytalis, PermierHR, TUI Consulting and Feanix. The most notable SAP services deal this year was Kanbay’s \$165 million acquisition of Adjoined Consulting.

The number of systems integration deals this year has already increased nearly 50% compared to 2005. 93 deals have announced this year and the median enterprise value to LTM revenue multiple is 0.7x, up slightly over 2005’s multiple of 0.5x.

Staffing

Updata’s IT Staffing Index has pulled back slightly since peaking this year in late May, early June. The IT Staffing companies tracked by Updata are currently trading at a median enterprise value to 2006E revenue multiple of 0.5x and a median enterprise value to 2006E EBITDA of 9.8x. The IT Staffing sector remains the least profitable IT Services sector with an EBITDA margin of 4.0%, which is relatively unchanged compared to a year ago.

Table IV

SAP IT Services Deals

Date Announced	Buyer	Seller	EV	Rev	EV/Rev
11-Dec-06	Fujitsu	TDS AG	\$108.0	\$123.0	0.9x
01-Dec-06	Axon Group	Zytalis (1)	\$15.0	\$30.0	0.5x
13-Nov-06	Electronic Data Systems	Global Enterprise Management Solutions	NA	NA	NA
01-Nov-06	Axon Group	PremierHR	NA	NA	NA
26-Oct-06	Zetes	PEAK Europe	\$10.0	\$42.0	0.2x
18-Oct-06	Ordina N.V	Iterion	NA	NA	NA
02-Oct-06	Affiliated Computer Services	Systech Integrators	\$65.0	NA	NA
11-Sep-06	Systems Integration & Technology Distribution	T-Systems IT and SAP activities	NA	NA	NA
01-Sep-06	Systems Integration & Technology Distribution	Unitis	NA	NA	NA
21-Aug-06	TietoEnator	TOPAS Consulting GmbH	\$9.4	\$10.9	0.9x
12-Jun-06	Scandent Solutions Corporation Ltd	Nexplicit	NA	NA	NA
30-May-06	CGI Group Inc	Plaut Consulting SAS	NA	\$18.0	NA
25-Apr-06	ABeam Consulting Ltd.	Qorval Integrated Solutions	NA	NA	NA
10-Apr-06	Horizon Technology Group plc	Enterprise Process Consulting Group Limited	\$1.6	NA	NA
07-Apr-06	Accenture	Pecaso Limited	NA	\$56.0	NA
04-Apr-06	Mindteck	ISS Consultants Inc	NA	\$11.0	NA
23-Feb-06	ABeam Consulting Ltd.	Magnus Management Consultants SB	NA	NA	NA
13-Feb-06	Kanbay International	Adjoined Consulting	\$165.0	\$95.3	1.7x
16-Jan-06	EDB Business Partner ASA	Spring Consulting	\$24.0	\$19.6	1.2x
10-Jan-06	AcandoFrontec AB	E-motion technology AB	NA	\$6.5	NA
10-Jan-06	Titan Technology Partners	Titanium Consulting	NA	NA	NA

The number of IT Staffing deals announced this year is 18 compared to 13 in 2005. Deal values are typically in line with the publicly traded company multiples on an enterprise value to revenue basis, with a median enterprise value to LTM revenue multiple of 0.4x. The most notable deal this year was Adecco's \$770 million acquisition of Deutscher Industrie Service AG (the CEO and CFO of DIS would later become Adecco's CEO and CFO). Another intriguing deal was Terra Nova Acquisition Corporation's, a Specialty Purpose Acquisition Corporation, acquisition of Clearpoint Business Resources (formerly Mercer Staffing) announced in August for \$40 million.

Staffing firms have operated in a healthy environment for the past three years, and this trend is expected to continue at least through 2007 according to the latest report released by Staffing Industry Analysts, Inc. (SIA). In its August report, SIA forecasted the total staffing industry revenue will be \$131 billion in 2006, up 9.9% from \$119.2 billion in 2005. According to SIA, temporary staffing growth in the IT sector is stronger than it originally predicted. SIA revised its February predictions of 8%, and now is forecasting 10% growth to \$19.1 billion in 2006, and 9% growth to \$20.8 billion in 2007. Similarly, IDC forecasts that worldwide recruiting and staffing services spending will experience a Compound Annual Growth Rate (CAGR) of 8.3% during the 2005-2009 forecast period. Correspondingly, Bureau of Labor Statistics data shows IT staffing is now above the 2001 peak.

Outsourcing

Update's Outsourcing Index is up 22.5% year to date. The Outsourcing subsector is currently trading at a median enterprise value to 2006E multiple of 1.3x and a median enterprise value to 2006E EBITDA multiple of 8.2x. The outsourcers are trailing only the Indian Offshore firms and the IT Consultancies in Q/Q, year over year, revenue growth with 11.1%. IT Outsourcers continue to seek out offshore and nearshore support centers in locations such as India, China, Latin America, Eastern Europe and Canada to complement their US front-end offering.

According to Gartner, the worldwide IT outsourcing spending will rise from \$193 billion in 2004 to \$260 billion by 2009. The Latin American market will see the greatest growth, from \$6.6 billion in 2004 to \$11.7 billion by 2009.

Companies appear to be steering away from large "sole source" outsourcing deals and seem to be more comfortable distributing large contracts among numerous outsourcing providers, increasing the competitive landscape.

Government

Update's Government IT Services Index was the only subsector to under perform the NASDAQ, down 4% year to date as a result of the slowdown in Federal spending. This group of companies is currently trading at a median enterprise value to 2006E revenue multiple of 0.9x, as compared to 1.2x at the end of Q3 last year.

The Federal IT spending request for Fiscal Year 2007 increased only 0.5% over the Fiscal Year 2006 enacted budget. INPUT estimates annual contracted federal IT spending to grow at a 5% CAGR from \$63.3 billion in 2006 to \$80.5 billion in 2011. By contrast, state and local IT spending will grow an average of 7.6% percent from \$50 billion in 2006 to \$72 billion in 2011.

National Defense, Intelligence and Homeland Security will continue to see their budgets increase as the Global War on Terror and increased border security have intensified the federal government's commitment to strengthen our military, intelligence and homeland security capabilities.

The Federal government's five-year budget forecast is driven by two main factors: 1) an estimated 4.4% growth in total federal IT budget spending, and 2) an increase in the outsourced percentage of the total federal government IT spending from 84% in 2006 to 86% in 2011. The average age of federal employees is now over 50 years old (up from 42 in 1989 and 47 in 2004). It is estimated that 45% of federal workers will be eligible for retirement by 2008. It is estimate that the government saves an estimated \$0.20 per \$1.00 on outsourced spending.

Improved efficiencies and effectiveness across Government agencies is a area where the OMB is focusing its attention as the pressure agencies to improve processes and consolidate redundant systems.

The good news for the larger players in the space is that INPUT recently reported that the percent of federal IT prime contract dollars going to large companies increased from 50 percent in 2003 to 65 percent in 2005. The growth in percent of spending comes at the expense of small- and medium-sized businesses that saw their share decline by 15 percent during the same period.

Ironically, the number of companies participating in the market has increased at all levels. The number of companies earning less than \$10 million in spending on prime contracts has increased from 11,000 companies in 2003 to 18,000 companies in 2005. The money spent by the federal government is getting spread over a significantly larger number of companies, which demonstrates that the barriers to entering the market have decreased.

Offshore

Updata's Indian Offshore IT Services Index showed no signs of slowing in 2006. Second only to Updata's BPO Index, the Offshore Index was up nearly 37% year to date. The Offshore firms continue to grow the quickest (a median of 9.7% sequential Q/Q and 35.4% Q/Q year-over-year) and are the most profitable group of companies tracked by Updata

with a 22.1% median EBITDA margin. This impressive growth and profitability translates into the industry's highest median enterprise value to 2006E revenue multiple of 3.7x.

India is still recognized as the premier destination for offshore technology services. According to NASSCOM, the total combined Indian IT services and IT-enabled services export market in fiscal year 2005 was nearly \$18 billion and projected to grow to \$49 billion by 2009.

India's stronghold on the outsourcing market will start to wane as other countries in Asia, Eastern Europe, Latin America and even Africa join the mix. IDC estimates that China's software outsourcing exports reached \$600 million in 2004 and predicts that the market will grow to \$4.7 billion by 2009.

BPO

Updata's BPO Index is up 39.6% year to date and has outperformed all other IT Services subsectors. The BPO firms tracked by Updata are currently trading at a median enterprise value to 2006E revenue and EBITDA of 1.3x and 10.7x, respectively. Five of the top ten deals announced this year involved BPO firms – West Corporation, Emdeon Business Services, NCO Group, ADP Claims Services Groups and Mphasis. Private equity firms continue to be active buyers in the space. Besides the West, Emdeon and NCO deals there were two other significant BPO deals that involved private equity buyers in 2006 were Apollo Management's acquisition of SOURCECORP and Investcorp's acquisition of Conduit Limited.

The worldwide BPO market should see a compound annual growth rate of 10.9% over the next five years, climbing from \$318 billion in 2004 to \$533 billion in 2009, according to a report from IDC.

IDC forecasts that areas where BPO has traditionally been big, such as customer care and logistics, will remain strong and that process-intensive areas including HR and F&A also have good potential for strong growth.

Smaller, newer areas such as procurement and training BPO will grow at a "high double-digit" annual rates.

Knowledge Services is the fastest growing sector in the BPO industry. According to NASSCOM, the KPO sector in India may reach \$15.5 billion by 2010, up from \$1.2 billion today. As the sector matures and new services are defined, this projection could eventually reach \$50 billion.

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