To Buyout Firms, Smaller Is Better In Outsourcing

By Shasha Dai

Private-equity firms are thinking small when it comes to buying technology-outsourcing companies.

While several multibillion-dollar deals in the sector have collapsed recently, buyout firms remain drawn to the outsourcing industry for several reasons. The sector is experiencing rapid growth as companies increasingly farm out back-office functions like processing credit cards. It offers long-term contracts that provide stable cash flow and plenty of opportunities for consolidation. These were some of the factors at play in the buyout of SunGard Data Systems Inc. by a consortium of private-equity firms last year.

But such characteristics usually aren't found at the top of the food chain. Rather, they're more typical of middle-market companies in the industry, and that's where buyout firms now have devoted much of their attention.

"The middle market is a much more fertile ground," said Bernie Zaia, a managing director at investment-banking firm Barrington Associates.

Large deals for **Affiliated Computer Services** Inc. and **Computer Sciences** Corp.—both providers of such services as hosting Web sites, processing payments and managing accounts—fell apart earlier this year. But while the high-profile deals were coming undone, other deals were being hatched under the radar.

Nautic Partners LLC is in the process of acquiring Oasis Outsourcing Inc., a human-resources services provider, from fellow buyout firm **H.I.G. Capital Partners** LLC. Leveraged-buyout shop **Frontenac** Co. purchased SMS Systems Maintenance Services Inc., which maintains computer servers for corporate clients. **Siguler Guff** & Co. bought a stake in software design and development firm **EPAM Systems** Inc. And H-Cube LLC, a company backed by **GTCR Golder Rauner** LLC, acquired data-analysis firm Global Realty Outsourcing Inc.

While companies the size of Affiliated Computer have billions of dollars in sales, large market share and desirable customers, they also have slower growth rates and higher capital expenditures. This cuts into the all-important cash-flow metric, making them less able to support the debt levels that buyout firms like to apply.

For example, Affiliated Computer of Dallas, founded in 1988, had revenue grow 6% from a year earlier to $4.35 billion in the fiscal year ended June 30, 2005. At the same time, it spent $253.2 million on capital expenditures to keep its technology up to date. Without the capital expenditures, the company's free cash flow would have been 56% higher than the $450.6 million disclosed in its annual report.

"The large [capital-expenditure] requirements limit the amount of debt an LBO could support," Mr. Zaia said. While not ruling out more big buyouts in this sector, he predicted that "blockbuster deals are more likely to be dominated by strategics buying each other."

Smaller companies often have more of their operations in low-salary places like India or Eastern Europe, which means they can afford to hire more people as business expands and don't need to acquire expensive technology to improve productivity. Most of the 2,600 employees of call-center operator Zenta Group, an H-Cube division, are located in Mumbai, while most of EPAM's operations are in Eastern Europe.

Smaller companies, meanwhile, are in a market that is more fragmented and ripe for consolidation. The industry attracts a number of start-ups, and large corporations continue to spin out their in-house service units.

The consolidation is driving fast growth. Zenta Group's revenue has doubled annually since it was founded four years ago, primarily through organic expansion, as it has won more contracts from banks to do such work as processing credit-card payments and mortgage applications.

EPAM boosted sales by 84% in 2004 over a year earlier, in part by opening software-development centers and expanding business with existing customers like **Siberia Airlines**, for which EPAM recently launched an online-booking system.

To be sure, investing in the sector carries risks, such as rising costs, as companies based in India open offices in the U.S. to better serve clients. And as more dollars are funneled into the sector, prices could go up. Nowadays, outsourcing companies are valued at anywhere between eight times and 15 times Ebitda, or earnings before interest, taxes, depreciation and amortization, said Mark Dzialga, a managing director at **General Atlantic** LLC, who focuses on outsourcing deals.

Still, the growth prospects of smaller companies are enough to compensate for those risks—an advantage over their larger competitors. After the snags in high-profile deals, private-equity firms "are going to fish in other ponds," Mr. Dzialga predicted.