MidMarketCapital,Inc.

Build Versus Buy – A Merger and Acquisition Strategy for Information Technology Companies

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As a Merger and Acquisition advisor, we regularly dialogue with the top executives in the information technology industry. We have to chuckle when we reach a decision maker with a large IT company and he says, "We have a corporate policy that we do not buy companies." Does this guy read the industry publications? Is his company's development group that good? Does he understand the first mover advantage or window of opportunity? We have gotten past the dizzying array of dot com product introductions, but the pace of technology introduction has again returned to robust levels. Any large company that feels it can keep pace with this force through internal development efforts alone is headed down the path of extinction.

Almost everyone will agree that information technology will be a primary driver of controlling costs in U.S. industry. Technology is our answer to remaining competitive in this world economy. A great deal of the technology development is coming from small, entrepreneurial, nimble, low overhead companies. There is, however, a huge paradox in the market. The institutional buyers of technology are relatively conservative late adapters. This prevents the expected innovation and commercial success that should naturally follow the innovation and passion of these small technology innovators.

These entrepreneurs respond to a market need and achieve encouraging initial success from the early adopters. They soon hit the wall and are not able to "cross the chasm" from a small group of early adaptors to general market acceptance from the conservative majority. There is little economic value created when good technology is in the control or a failing company and the technology never reaches broad acceptance.

Most of the blockbuster new products are the result of an entrepreneurial effort from an early stage company bootstrapping its growth in a very cost conscious lean environment. Think of some of the new developments from companies like Google. The big companies, with all their seeming advantages have a very high internal cost structure for new product introductions and the losses resulting from those failures are substantial. Don't get me wrong, there were hundreds of failures from the start-ups as well. However, the failure for the edgy little start-up resulted in losses in the $1 - $5 million range. The same result from an industry giant were often in the $100 million to $250 million range.

For every Yahoo or Ebay there are literally hundreds of companies that either flame out or never reach a critical mass beyond a loyal early adapter market. It seems like the mentality of these smaller business owners is, using the example of the popular TV show, Deal or No Deal, to hold out for the $1 million briefcase. What about that logical contestant that objectively weighs the facts and the odds and cashes out for $280,000?

As we contemplated the dynamics of this market, we were drawn to a merger and acquisition model that is used in the networking technology market by Cisco Systems. We believe that model could also be applied to great advantage in the Information Technology industry. The giant networking company, is a serial acquirer of companies. They do a tremendous amount of R&D

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and organic product development. They recognize, however, that they cannot possibly capture all the new developments in this rapidly changing field through internal development alone. Cisco seeks out investments in promising, small, technology companies and this approach has been a key element in their market dominance. They bring what we refer to as smart money to the high tech entrepreneur. They purchase a minority stake in the early stage company with a call option on acquiring the remainder at a later date with an agreed-upon valuation multiple. This structure is a brilliantly elegant method to dramatically enhance the risk reward profile of new product introduction. Here is why:

For the Entrepreneur:

1. The involvement of Large IT Investor – resources, market presence, brand, distribution capability is a self fulfilling prophecy to your product's success. The halo of the big secure company helps you cross the chasm to the conservative majority institutional customer.
2. For the same level of dilution that an entrepreneur would get from a venture capital, angel investor or private equity group, the entrepreneur gets the performance leverage of "smart money." See #1.
3. The entrepreneur gets to grow his business with Large IT Investor's support at a far more rapid pace than he could alone. He is more likely to establish the critical mass needed for market leadership within his industry's brief window of opportunity.
4. He gets an exit strategy with an established valuation metric while the buyer/investor helps him make his exit much more lucrative.
5. As an old Wharton professor used to ask, "What would you rather have, all of a grape or part of a watermelon?" That sums it up pretty well. The involvement of Large IT Investor gives the product a much better probability of growing significantly. The entrepreneur will own a meaningful portion of a far bigger asset.

For the Large IT Investor:

1. Create access to a large funnel of developing technology and products.
2. Creates a very nimble, market sensitive, product development or R&D arm.
3. Minor resource allocation to the autonomous operator during his "skunk works" market proving development stage.
4. Diversify their product development portfolio – because this approach provides for a relatively small investment in a greater number of opportunities fueled by the entrepreneurial spirit, they greatly improve the probability of creating a winner.
5. By investing early and getting an equity position in a small company and favorable valuation metrics on the call option, they pay a fraction of the market price to what they would have to pay if they acquired the company once the product had proven successful.

MidMarket Capital has created an information technology M & A practice that combines 20 years of industry experience with the investment banking experience to structure these successful transactions. We can either represent the small entrepreneurial firm looking for the "smart money" investment with the appropriate growth partner or the large industry player looking to enhance their new product strategy with this creative approach. This model has successfully served the technology industry through periods of outstanding growth and market value creation.

David Kauppi is a Merger and Acquisition Advisor with Mid Market Capital, Inc. MMC is a private investment banking business brokerage firm specializing in providing corporate finance and intermediary services to entrepreneurs and middle market corporate clients in high tech and a variety of industries. Dave began his high tech Merger and Acquisition practice after a twenty-year career within the information technology industry. His varied background includes positions in hardware (Storage Technology Corporation), IT Services (IBM's Service Bureau Corp. and Comdisco Disaster Recovery), Software (Metaphor Computer Systems), computer leasing (Bell Atlantic Systems Leasing), datacom (Paradyne Corp.), and Internet (DigitalCars.com). The firm counsels clients in the areas of merger and acquisition and divestitures, succession planning, valuations, corporate growth and turnarounds. Dave is a Certified Business Intermediary (CBI), a licensed business broker, and a member of IBBA (International Business Brokers Association) and the MBBI (Midwest Business Brokers and Intermediaries). For more information or a free consultation please contact Dave Kauppi at (630) 325-0123, email davekauppi@midmarkcap.com or visit our Web page www.midmarkcap.com
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