

EquaTerra Position: Service Provider M&A – Change of Control Doesn't Have to Mean Loss of Control

by: Phil Morris, Managing Director, Europe and Asia
Paul Cornelisse, Principal Consultant

The outsourcing service provider market has historically experienced a steady stream of mergers and acquisitions (M&As) which began to pick up in 2007. An M&A event can cause concern for a buyer actively engaged with one of the parties involved, particularly if the provider is on the receiving end of a hostile bid. A solid outsourcing arrangement, however, is structured to anticipate and respond to futures changes. This is a necessity in a business relationship that spans multiple years. M&A is an event that buyers must proactively address as part of their outsourcing strategy.

The momentum gathered in 2007 in the mergers and acquisitions (M&A) market for outsourcing service providers shows no sign of abating in 2008. In the past several quarters we have seen a number of service providers changing hands, such as Northgate to Kohlberg Kravis Roberts (KKR), Syan Holdings to ACS and Getronics to KPN. The ownership and structural changes in the market are also marked by their differences; private equity investments, market competitor M&A and non-competitor mergers are all in play. But what does all this mean for clients of the service providers caught up in this M&A activity?

Clients frequently assume that when their service provider is acquired – in whole or in part – it is a “bad” thing fraught with risk. But when you step back and realise that the acquiring company is really buying client contracts, service delivery assets, revenue and people, the reality is that acquisitions generate unique opportunities for both parties to re-evaluate the current agreement. This can result in a more productive relationship

with the added potential of access to the new “parent’s” capabilities. So, if you are a “good” client, you will not be stranded. Instead, you will be approached not only by the new owning company (to ask for assurances that you will assign the contract to them), but also by other outsourcers interested in winning your business – a situation potentially rich with opportunities.

Change of control

M&As have existed in the service provider community for a considerable time, but the visibility and activity has increased over the past several quarters. Every week seems to deliver a different example, and each example demonstrates something unique or innovative to set it apart from the rest. This M&A market has many more active players than ever with market competitors, private equity, venture capital and sector-aspirant companies all continually scanning the market for the next move. It seems that no matter how large or small, if you are in the right portion of the service provider industry, some other organisation, somewhere, will find you an attractive M&A proposition.

The potential implications of M&A for your outsourced services include the following:

- Being served by an organisation that is less capable or less focused on you and your needs, or by one you simply would not have chosen
- Having the talent you depend upon stripped from your account relationship
- Creation of more complex and costly governance – especially when it’s a “carve-out” M&A
- Facing hostile or aggressive renegotiations when the new owner has a strategy to improve margins
- Being issued a termination notice by a major services supplier

Given that your engagement with your service provider may be affected at some point by some level of M&A, how can you ensure that you are prepared? The best defence is proactive preparation. Do not wait to hear from your provider. Use market intelligence to inform yourself of pending changes so that you can be more prepared than your provider will expect when you receive official notice of the change. The world of M&A is notoriously 'leaky' and you will be told well ahead of time by the service providers' competitors if not the service provider themselves. Be wary, however, that last minute changes and cancellations in the M&A world are common and often M&A efforts can get very protracted.

Follow these steps to ensure you are ready:

Step One: Review your contract, know where you stand

Good service contracts have specific clauses that deal with the following:

- Change of control
- Change of beneficial owner
- Assignment and/or novation (substitution of new legal obligations)
- Obligation to serve – either through notice flexibility, transition assistance or the removal of the service provider's option to break the contract

These clauses enhance your options and underline the security of service provision. Most modern service contracts contain change of control provisions. Far more rare is the 'obligation to serve' as it is seldom anticipated; but it can be brought into sharp focus when a new parent company has a rationalisation and cost cutting agenda for its new acquisition – the impact of which may well be a termination for convenience by your service provider. If your contract does not include these clauses, you may want to revisit the contractual terms sooner than later.

Step Two: Revisit why you chose your supplier in the first place

An impending M&A is an ideal catalyst for revisiting your service provider evaluation and selection criteria for two specific reasons. The first is obvious: you evaluated your needs and selected your provider based on a variety of factors including range of services, scalability, relative size, financial stability,

geographies served, etc. But, would you have chosen the same service provider in its new configuration? The second is that your needs are likely to have evolved since you began working with your provider, and these changes might potentially alter the way in which you would evaluate any future provider. Now is the time to proactively and positively re-evaluate your sourcing strategy, e.g., what you want to buy, how and from whom. Then apply these criteria to the new situation.

Step Three: Evaluate performance

Assuming an acquired provider was profitable, the buyer or investor will want to keep the current business. But M&A brings with it an odd dynamic for retention of current clients; both the target and the acquirer can little afford to lose clients either before or after the transaction. This places obvious pressure on ensuring incumbent clients are satisfied and well-served, which places you in a very strong position to negotiate, especially if service performance has not been up to par.

Performance is evaluated in a variety of ways:

- Price
- User satisfaction
- Interfacing and cultural alignment
- Technical performance, e.g., Service Level Agreements and Operating Level Agreements
- Innovation and added-value

Each of these must be assessed to determine negotiation, leverage and necessary change points.

Step Four: Evaluate your options

The three above steps provide you a range of information, subjects for discussion with the new owners and, depending on contract provisions, options to evaluate, e.g. termination or negotiation. Even if your contract is lacking specific protective clauses, you do have some significant powers of self determination in your hands.

Both the termination and negotiation options need to be assessed for risks, opportunities and potential costs. Further, you must consider the need to seek alternative supply if negotiations fail or the new owner has a strategic direction that excludes supplying to you and your business. When evaluating options, ensure that you know simple things like the implications of

the Acquired Rights Directive in Europe, who owns assets and intellectual property rights, what investments have been made that are amortised, and which service elements are shared or leveraged, as these will all have a bearing on the practicality and commercial viability of any option.

Step Five: Engage the Board and expert support

Major change events are reason to mobilise every talent and asset from within your organisation. As the services that will be affected are critical to your business, contract changes will likely be significant and thus may well require Board approval. Given the nature of the change, the Board should be re-engaged, and whatever support it can offer should be accepted.

The support, assistance and thought leadership of external specialist lawyers and consultants can also help ensure a safe and economically advantageous outcome. While M&A events are becoming more common in the overall marketplace, they are rare occurrences for individual client organisations. The return on investment of using experienced and qualified external expert support can be significant.

Additional considerations for partial M&As (break-ups)

In some instances, your service provider may be divesting some, but not all, of its business. When you have a multi-function/multi-process outsourcing agreement with your provider and only some of the areas covered in your outsourcing agreement are being acquired by the new company, an additional dimension is added. Areas to consider in this situation include:

- **Technical:** Splitting functions or processes may appear relatively simple and logical; in reality it can be quite challenging. Service monitoring and end-to-end responsibility of overall performance can be very difficult. The core schedules of your contract and service catalogs will also change.
- **Financials:** When functions are split from your existing service provider, the financial aspects are of benefit to you in the majority of cases. The situation forces greater transparency in pricing and costs, and eliminates any element of cross-subsidisation.
- **Governance:** Greater attention to governance is required during any interruption to business as usual, but it becomes increasingly important when services are spread across multiple suppliers. Multi-provider governance requires extra investment and management focus, but in many instances results in greater satisfaction.
- **Legal issues:** This can be the same as for the section above. Check your contract, as there will be both opportunities and risks.

Ultimately, in addressing the above areas, you are reengineering your sourcing strategy. While this acquisition is unlikely to have occurred at a time when you were planning your own internal reviews, and thus will require unplanned activity, it opens your organisation up to new opportunities that may otherwise have remained unseen.

Although the acquisition of your service provider – and the ensuing reviews – may initially be a bit unsettling, they ultimately can provide you with a much better end result.

Conclusion

M&A in outsourcing is present and increasing. It presents both risks and opportunities to the continuity of service, and can be a major unexpected distraction for your business. But since there is very little you can do to prevent the actual transaction from taking place, the key to turning such a situation to your advantage is to be prepared. Make sure your contract is fully prepared for this scenario and, when the time comes, utilise internal support such as your Board and the external support market of lawyers and professional advisors to ensure the outcome is a good one.

About EquaTerra

EquaTerra sourcing advisors help clients achieve sustainable value in their IT and business processes. Our advisors average more than 20 years of industry experience and have supported over 2000 transformation and outsourcing projects across more than 60 countries. Supporting clients throughout the Americas, Europe, Middle East, Africa and Asia Pacific, we have deep functional knowledge in Finance and Accounting, HR, IT, Procurement and other critical business processes. EquaTerra helps clients achieve significant cost savings and process improvement with internal transformation, shared services and outsourcing solutions.

www.equaterra.com

Contact Us

If you would like to know more about EquaTerra please contact us.

BeLux
 Pegasuslaan 51831
 Diegem (Brussels), Belgium
 Tel: +32 (0)2 709 29 32
infobelux@equaterra.com

China
 Level 31, Jin Mao Tower, 88 Shi Ji Avenue
 Pudong, Shanghai 200120, China
 Tel: +86 (0)21 28909093
infochina@equaterra.com

Finland (Baltics and Russia)
 Mannerheimintie 12b, 5th Floor
 FIN-00100 Helsinki, Finland
 Tel: +358 (0)9 2516 6368
infofinland@equaterra.com

Germany
 Herriotstrasse 1
 60528 Frankfurt, Germany
 Tel: +49 (0)69 67733423
infogermany@equaterra.com

India
 Level 4, Rectangle No.1,
 Commercial Complex D4, Saket,
 New Delhi 110017, India
 Tel: +91 (0)11 4051 4227
infoindia@equaterra.com

The Netherlands
 Postbus 75090
 1070 AB Amsterdam, Netherlands
 Tel: +31 (0)88 002 2900
infonl@equaterra.com

Sweden (Nordic HQ)
 Strandvägen 7a
 114 56 Stockholm, Sweden
 Tel: +46 (0)8 662 30 67
infonordics@equaterra.com

United Kingdom
 150 Minorities, London EC3N 1LS
 United Kingdom
 Tel: +44 (0)845 838 7500
infouk@equaterra.com

Americas
 Three Riverway, Suite 1660
 Houston, TX 77056
 United States of America
 Tel: +1 713 470 9812
infoamericas@equaterra.com