



# Perspectives on the Impact of COVID-19: IT Services Sector

APRIL 2020

# Summary Impact of COVID-19 on the IT Services Sector

The effect of the COVID-19 pandemic on businesses across the globe has been immense and widespread. Within the IT Services sector, firms are grappling with the question of how to weather the storm while also positioning themselves to hit the ground running when a recovery begins. Now, perhaps more than ever before, the **importance of a sound IT infrastructure** and technological capabilities is paramount to surviving as a business and adapting to the rapidly changing macroenvironment. The **shift to a remote workforce**, the **need to support the remote workforce and the firm's overall infrastructure**, and the **ability to enhance output** via productivity applications are a few examples of real-time industry drivers that will persist long after COVID-19, as the effects of the pandemic leave permanent imprints on the business ecosystem.

Within this newsletter, we've included various perspectives and insights on the impact of COVID-19 on the IT services sector, drawn from our own experience as well as conversations we've held with hundreds of market participants over the past several weeks. We've also included informational pages on the breadth of Houlihan Lokey's financial services offerings, highlighting **particularly relevant services such as special situations, capital markets, financial restructuring, liquidity management, and distressed M&A**.

*As the market environment has shifted, so too have our conversations with clients. A precrisis focus on sellside M&A has given way to discussions regarding debt capital markets, liquidity preservation, and opportunistic buy-side M&A strategies.*

## Considerations and Strategies for Navigating the Current Environment

1

### Stress Test P&L With Extreme Scenarios

Build cascading contingency plans now for worst-case scenarios; waiting to plan will be too late

2

### Stay Close to Group of Key Clientele















Monitor large clients to stay ahead of any client liquidity issues; be well positioned for vendor rationalization

3

### Optimize Business for Bull Market

Stay vigilant and plan for the future; opportunistic hiring of talent; enhance efficiency and develop integration plans for tuck-in M&A, etc.

# IT Services: Sector Mapping and Coverage

	IT Solutions	IT Consulting	Managed Services	Cloud/Hosting	Software
Key Houlihan Lokey Focus Areas	<ul style="list-style-type: none"> <li>Hardware and Software Resellers</li> <li>Systems Integration</li> <li>Workplace Technology and Support</li> </ul>	<ul style="list-style-type: none"> <li>Digital Transformation</li> <li>Software Implementation and Engineering</li> <li>Vertical/Horizontal-Focused Providers</li> </ul>	<ul style="list-style-type: none"> <li>Regional/SMB-Focused Providers</li> <li>Application Managed Services</li> <li>Infrastructure Managed Services</li> </ul>	<ul style="list-style-type: none"> <li>Hybrid Cloud Hosting</li> <li>Colocation</li> <li>Hyperscale Cloud Connect</li> </ul>	<ul style="list-style-type: none"> <li>Cloud Monitoring</li> <li>Cloud Native Application Development</li> <li>Hybrid Cloud Management Platforms</li> </ul>
Representative Companies	<ul style="list-style-type: none"> <li>AVI  SPL</li> <li>ConvergeOne</li> <li>Insight.</li> <li>PRESIDIO.</li> </ul>	<ul style="list-style-type: none"> <li>accenture</li> <li>Cognizant</li> <li>Deloitte.</li> <li>SAIC</li> </ul>	<ul style="list-style-type: none"> <li>datablue</li> <li>AHEAD</li> <li>DXC.technology</li> <li>HITACHI</li> <li>REAN CLOUD</li> </ul>	<ul style="list-style-type: none"> <li>cologix</li> <li>FLEXENTIAL</li> <li>rackspace </li> </ul>	<ul style="list-style-type: none"> <li>APPTIO</li> <li>flexera</li> <li>snow</li> </ul>
Senior, Interdisciplinary-Focused Team	<ul style="list-style-type: none"> <li> <b>Thomas Bailey</b> Managing Director</li> <li> <b>Dan Dresner</b> Vice President</li> <li> <b>Javier Rodriguez</b> Associate</li> </ul>	<ul style="list-style-type: none"> <li> <b>Vik Pandit</b> Director</li> <li> <b>Andrew Shell</b> Vice President</li> <li> <b>Mike Bertram</b> Analyst</li> </ul>	<ul style="list-style-type: none"> <li> <b>Chin Pandya</b> Director</li> <li> <b>Pat O'Brien</b> Associate</li> <li> <b>John Quirk</b> Analyst</li> </ul>	<ul style="list-style-type: none"> <li> <b>R.B. McCutcheon</b> Vice President</li> <li> <b>Alex Scott</b> Associate</li> <li> <b>Greg Bellwoar</b> Analyst</li> </ul>	

# Our Perspectives on COVID-19 and IT Service Providers

The outbreak of COVID-19 has resulted in a global health emergency and severely dislocated financial markets. Houlihan Lokey presents an assessment of the impact of the virus on the IT services sector, specifically highlighting key investor focus areas.

## Secular Drivers and Near-Term Impact



- Digital transformation initiatives expected to be put on hold while **business continuity efforts take priority** (remote workforce, productivity applications, and supporting infrastructure)
- Shift to public cloud and automation initiatives will continue once the macroenvironment stabilizes, and we could see a boost as companies look to reduce capex/IT spend

## Service Mix/Recurring Revenue



- Recurring revenue mix a key risk variable—business models that have a good balance of managed services with **long-term contracts are increasingly more attractive**

## SMB/Vertical Exposure



- **Investors will value a high-quality customer base**; SMB exposure seen as a risk
- Given energy, hospitality, retail, and travel being particularly impacted, investors are focusing on software/services companies without meaningful exposure to macro-sensitive verticals

## Existing Customer Contribution to Revenue vs. New Logos



- Travel disruptions may have a bigger impact on new logos than customer expansion
- Investors focused on pipeline mix: **percentage of revenue derived from expansions, renewals, and upsells into existing customers** versus percentage of revenue from new logos
- Ability to convert professional services/past digital transformation efforts

## Public Cloud Dynamics



- **All three leading public cloud players are likely to see a near-term slowdown**—AWS and GCP have greater exposure to startups, SMB sector, and travel/hospitality than Azure
- Public cloud adoption trends expected to continue at strong growth rates as agility and flexibility will become increasingly more important in a downturn

## On-Prem/Private Cloud Dynamics



- In the short-term, businesses may seek to maximize current infrastructure and compute to keep costs down
- Large remote workforces run the risk of overwhelming on-prem/private cloud infrastructure
- **In the long-term, the shift off-prem to public cloud will likely accelerate** as flexibility/compute elasticity becomes attractive
- Highly levered private cloud/colocation facilities are likely to become pressured

# Insights From Market Participants

Throughout hundreds of conversations with founders, owners, and executives across the IT services landscape, Houlihan Lokey has gleaned the most important insights into how firms are reacting and adapting to the current environment.

## IT Services Strategic Buyers

### Common Themes

- Assessing the situation on a day-to-day basis, using increased caution, and **scanning for opportunities** that present themselves
- Expect discretionary spending (e.g., transformational projects, marketing services, development) to take a hit in the near term but rebound coming out of the pandemic; **seeing an increase in infrastructure and support work**

### Select Conversations

- Prioritizing their own full-time consultants and **strategically thinking about areas to reduce costs**, including the use of contractors
- Looking to be opportunistic as high-quality talent becomes available
- **Using cash more selectively** now that generating cash flow has become more difficult; expecting new orders to slow down materially
- See COVID-19 as a **setback in the short term but an accelerant in the long term**; expecting a huge uptick in orders about 18 months from now as firms realize the importance of having access to customers and employees digitally
- Ability to rapidly move the majority of their workforce to a remote environment allowed for more business continuity than firms in other industries

### Common Themes

- General **pause in buyside activity** to allow for focus on business operations, while select firms are positioning themselves to be opportunistic
- Using this time to maintain relationships, conduct check-ins, and hold introductory calls with potential targets
- **Ready to take advantage of opportunities** that arise

### Select Conversations

- M&A still very important, especially as **organic growth expectations dwindle**
- **Trimming down pipeline** to focus on deals that are highly strategic
- High levels of dry powder ready to strategically deploy; believe their stable platform can be attractive to owners/operators during this time
- Not expecting new process launches to normalize until mid-summer

### *Impact on Operations*

### *Effect on M&A Appetite*

## IT Services Owners/Operators

### Common Themes

- Decrease in orders, but not quite as dramatically as expected
- **Predicting a spike in orders when a recovery begins** as customers recognize the need to be invested in technology, particularly given the impact of COVID-19
- General **uncertainty in project timing**; seeing both postponements and extensions
- **Working with clients that are being hit the hardest** to ease the burden; negotiating new terms or offering free services in some instances

### Select Conversations

- Strong **focus on retention of top talent**—remote IT services businesses that can offer higher pay with less overhead may be ahead in the war for talent
- Taking a hard look at cost structure and making strategic decisions where it makes sense
- Using this opportunity to look at how they can reposition themselves, innovate, and **possibly add new revenue streams**
- Some clients paying a retainer to keep IT services firm from going elsewhere

### Common Themes

- Interested in being opportunistic from the buyside at attractive valuations
- **See M&A as a way to spur growth** while organic growth is hampered

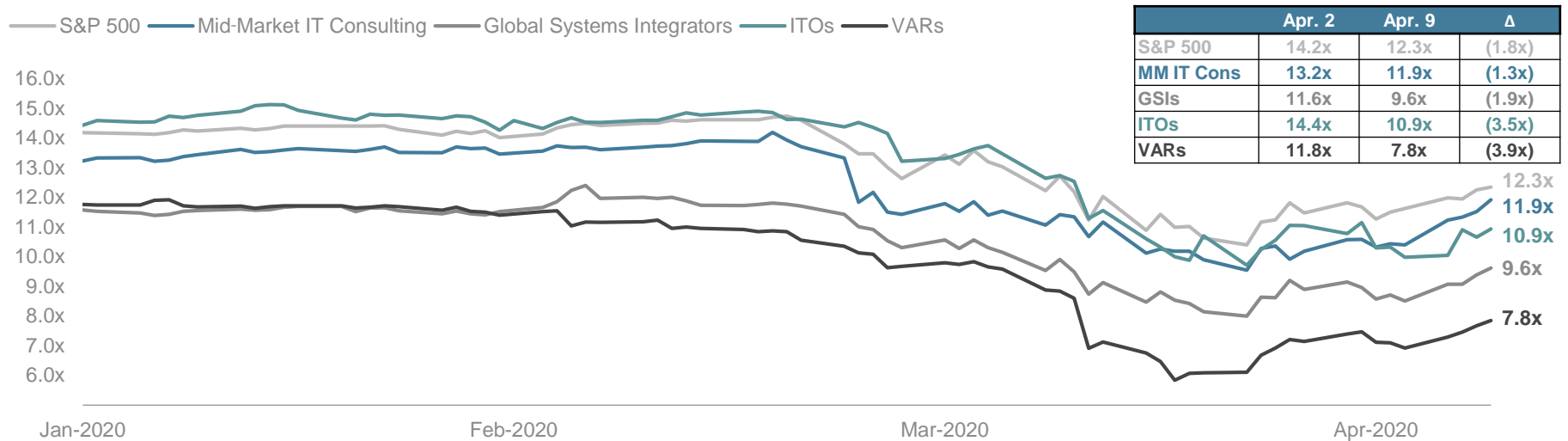
### Select Conversations

- Aiming to bolster any acquisition-related growth with immediate cross-selling efforts to accelerate trajectory
- Want to identify opportunities to put resources to work and **willing to move quickly** in processes if they can find the right fit
- Were previously involved in buyside acquisition discussions that have since fallen through
- Valuing liquidity but **keeping a close eye on the market** for opportunities
- Interested in making bolt-on acquisitions in specific product suites

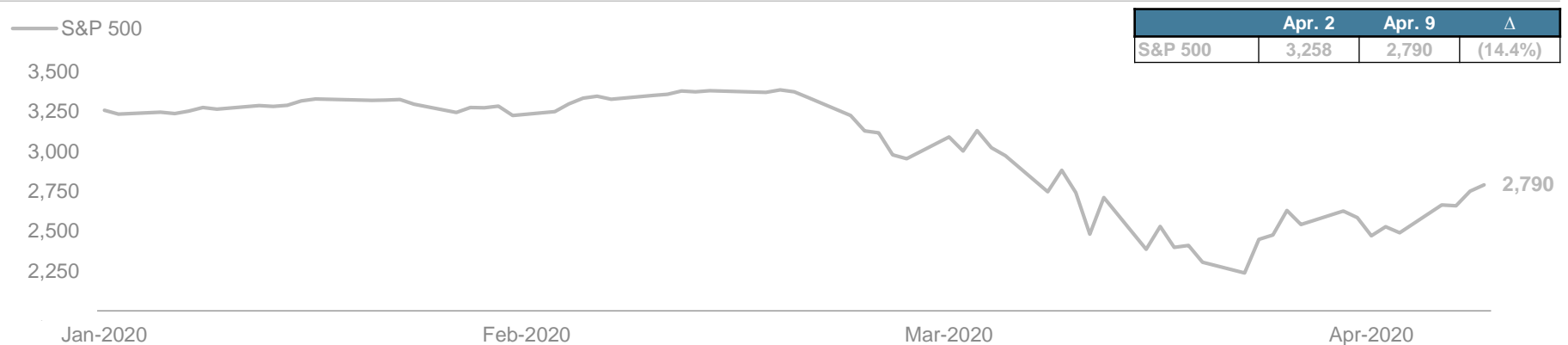
# Impact of COVID-19 on Publicly Traded IT Services Companies

Mid-market IT consulting firms have been most resistant to the COVID-19 outbreak, while VARs and ITOs have suffered considerable declines; global systems integrators have experienced a slightly more pronounced dip than the overall market.

## EV/LTM EBITDA

















## S&P 500 Performance



Note: Mid-Market IT Consulting Index composed of Computer Task Group, FTI Consulting, Hackett Group, Huron Consulting Group, ICF, and Perficient; Global Systems Integrators Index composed of Accenture, Capgemini, Cognizant, IBM, and NTT; ITOs Index composed of Genpact, HCL Technologies, Infosys, Mphasis, Tata, Tech Mahindra, Virtusa, and Wipro; VARs Index composed of Computacenter, ePlus, Insight Enterprises, and PC Connection; Source: S&P Capital IQ

# Recent M&A in the IT Services Universe

Although the pace of M&A has slowed since the outbreak of COVID-19, there remains a healthy appetite for acquisitions of IT services firms, particularly digital transformation and cybersecurity specialists; as companies continue to realize the criticality of digital capabilities and enhanced security, these firms should expect an increasing demand for their services across all landscapes.

Announced Date	Acquirer	Target	Target Description
3/2/2020	 Insight.	 vNEXT Plus digital, Plus humain	vNext is a market-leading digital consulting firm that specializes in Microsoft Cloud solutions in France
3/2/2020	 inspirage	 VERTICAL EDGE CONSULTING GROUP	Vertical Edge Consulting Group is a leader in full-service Oracle enterprise performance management and business intelligence solutions
3/5/2020	 EPI-USE™	 afonza	Afonza specializes in creating tailor-made cloud solutions for clients based on AWS
3/6/2020	 accenture	 context	Context Information Security is a leading cybersecurity consulting firm, providing high-end cyber defense and incident response services in the U.K.
3/9/2020	 WatchGuard	 panda	Panda Security is a leading provider of cloud-based endpoint security and adaptive defense solutions
3/17/2020	 Deloitte.	 zimbanii	Zimbanii is a cybersecurity specialist noted for its expertise in the cyber architecture and engineering space in the Australian market
3/23/2020	 Cognizant	 Lev+	Lev is a digital marketing consulting firm that uses Salesforce Marketing Cloud to deliver data-driven insights and drive clients' revenue
3/23/2020	 PERFICIENT	 brainjocks	Brainjocks has a strong Sitecore platform focus and boasts expertise in web and content platform development
3/25/2020	 Capgemini	 WhiteSky Labs	WhiteSky Labs is one of the largest independent MuleSoft consultancies globally and specializes in digital transformation services
3/25/2020	 CGI	 TERATHINK	TeraThink is a consulting firm specializing in the delivery of digital, enterprise finance, risk management, and data analytics services to government clients
4/2/2020	 Pythian love your date	 AGOSTO	Agosto is a Google Cloud Premier Partner and leading cloud services and development company
4/7/2020	 accenture	 REVOLUTIONARY SECURITY	Revolutionary Security is a cybersecurity consulting firm that defends Fortune 500/Global 1000 clients' critical infrastructure networks from threats

# Capital Markets Experience Extreme Volatility

Heightened concerns surrounding COVID-19 continue to cause volatility across markets and weaken investor sentiment.



## Equity Capital Markets

- Volatility, as measured by the VIX index, peaked at an all-time high on March 16, exceeding the levels seen during the financial crisis. Volatility has since reduced from the peak, with the VIX index currently around 44, but this is still three times higher than the low levels seen in early 2020 before the COVID-19 pandemic.
- Markets have recovered strongly, with major indices up more than 15% since their lows on March 23. However, volatility is likely to remain until there is more visibility on the progress of the virus, potential COVID-19 exit strategies, oil price stability, and the impact that each will have on the broader economy and corporate earnings.
- Companies across the globe have cancelled dividends and share buybacks and dialed down capital expenditure programs despite unprecedented fiscal and monetary policy response.
- A number of companies in directly affected sectors have tapped equity markets, successfully raising equity as they seek to ensure they can absorb operational disruptions for an extended period.
- IPOs across Europe scheduled to launch before Easter have been postponed, and it seems likely that IPOs planned to occur before the summer will also be postponed, even if market volatility continues to settle down, as management teams assess any damage from the pandemic and its economic consequences, including on their guidance to the market.
- While there has been significant disruption, bear markets caused by external shocks have been the fastest to recover historically.



## Debt Capital Markets

- International governments and central banks remain at the ready to support their respective economies with necessary monetary and fiscal policies to soften the impact of COVID-19.
- In the leveraged loans and high-yield markets, there have been no new primary issues for a month (apart from some small add-ons), although early April has seen four BB issuers emerge in the U.S.
- Bank underwriting has withdrawn, except for deals committed pre-crisis, while there has been some investment (in the direct credit market), albeit again on deals nearly complete before the crisis.
- The direct market has liquidity; however, we are still in a stage of price discovery, as secondary public markets have highly attractive current yields and are typically with much larger companies.
- In March, credit rating agencies downgraded ratings at the fastest pace on record, with the level of downgrades forecast to remain high over the coming weeks. There is a possibility that downgrades will force further selling pressure.
- The secondary market has seen a major selloff across industries in both the leveraged loan and high-yield markets, in part influenced by the rating downgrades (with the short-term dislocation presenting opportunities to some investors). However, investment-grade issuance has been at all-time high volume levels, and this has underpinned upward price movements in sub-IG of 5%–10%, with the BB index at about 5% and the single-B index at about 10% in early April.



# China: A Look Into the Future?

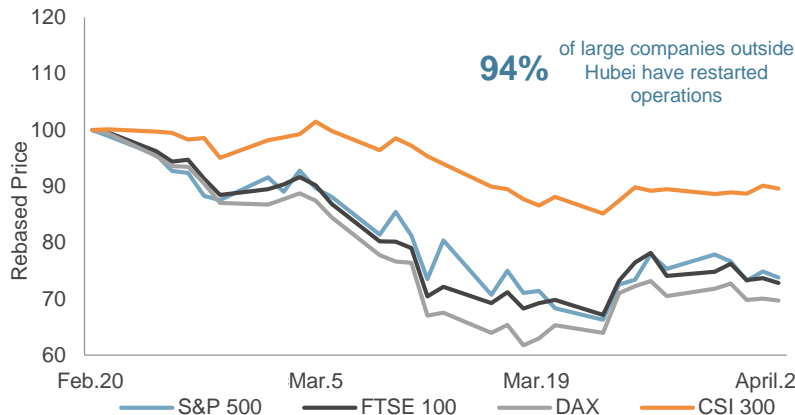
China will be used as a natural high-water mark to provide early insights as to how Western markets will recover from COVID-19.

## China is back up and running...

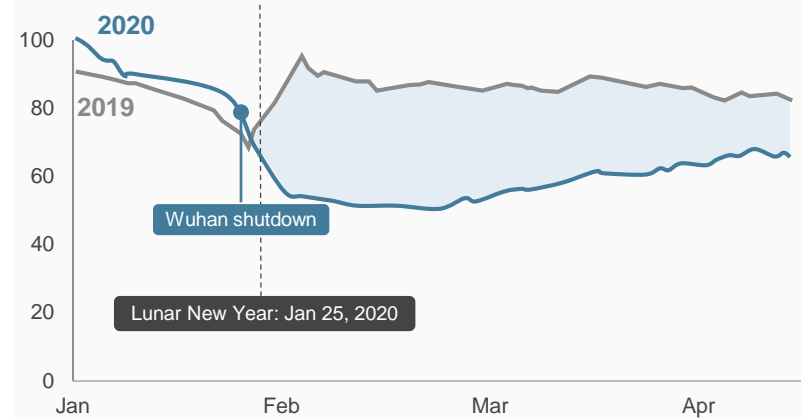
- Over the past several weeks, Chinese government efforts have been geared toward normalizing production and reducing supply disruptions
- While not at prior-year levels, 25 provinces (which account for 89.2% of GDP) are reporting full resumption rates
- Early indicators for electricity and coal power generation, port traffic, passenger activity, and car sales have shown signs of improvement as factories gradually resume production

**80.6%** Current production levels at China's large industrial and manufacturing enterprises **65.3%** Production levels one month prior

## ... outperforming Western markets...

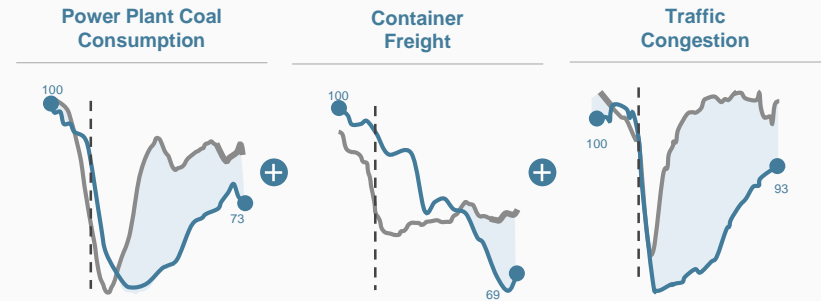


## ...emerging from lockdown...



FT China Economic Activity Index (2019 vs. 2020), as of April 5, 2020

## ... and showing initial signs of positive progress<sup>(1)</sup>



FT China Economic Activity Index – selected subindices (2019 vs. 2020), as of April 5, 2020

# Houlihan Lokey's Integrated Special Situations Approach

Houlihan Lokey's approach to special situations and liability management is to utilize expertise across business units to best advise our clients.

## Capital Markets Solutions

- Largest capital markets team on Wall Street at a non-balance sheet bank, with about 45 professionals
- Raised more than \$11.5B across approximately 55 transactions during 2019
  - Private placement of senior and subordinated debt, structured equity, off-balance sheet financing/sale leaseback transactions, and growth equity

## Financial Sponsors Coverage

- More than 900 covered private equity firms in North America and Europe
- More than 250 covered hedge funds
- More than 125 covered family offices



HOULIHAN LOKEY

## Special Situations and Liability Management

- Combines relevant and diverse capabilities under one roof
  - One firm ensures seamless execution
  - Unbiased advice
- Allows for the simultaneous pursuit of multiple paths
  - Liability management, comprehensive refinancing, rescue financing, out-of-court restructuring, asset/business sales, etc.

## Mergers and Acquisitions

- #1 M&A Advisor
  - Sellside and buy-side advisory
  - Partial sale or divestiture
  - Joint ventures
  - Strategic alliances

## Financial Restructuring

- #1 Global Restructuring Advisor
  - Restructuring debt/equity
  - Debtor-in-possession (DIP) financing
  - Plans of reorganization, Section 363 M&A
- Worked on more than 175 restructuring-related transactions in 2019 on behalf of companies, their creditors and shareholders, and other constituents

## Industry Coverage

- Dedicated industry expertise spanning 15 different industry verticals
- #1 M&A advisor in business services; consumer, food, and retail; healthcare; industrials; media and telecom; and technology transactions under \$1B<sup>(1)</sup>
- Industry practices led by senior bankers with extensive experience and complementary skill sets

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