Why the time is right for connectivity to explore strategic options

Q&A with Q Advisors managing director Andrew Gaffney

Andrew Gaffney has spent more than a decade as a TMT banker with Q Advisors, a Denver-based middle-market boutique investment bank. With a specialisation in the cloud communications and network services space, Gaffney has helped a range of clients achieve growth goals through M&A and recapitalisations, as well as debt and equity financings. Gaffney talked with Connectivity Business about why market conditions are so favourable for TMT companies to consider strategic options.

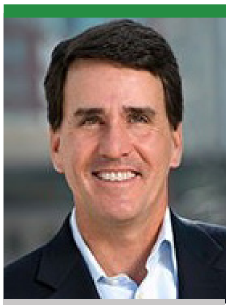
Katy Hunt: Please give a rundown on your background and work at Q Advisors.

Andrew Gaffney: We focus solely on TMT on a global basis. We do work both here in the US as well as Europe and other places. In particular, I would say our firm has developed a very strong track record in a number of subsectors of TMT, where we have a very good reputation. One of those would be cloud communications. We also do a lot of work in managed services, network services.

I've worked with a cross section of businesses, from growth stage to more mature companies, helping across the spectrum of investment banking services, from raising capital to ultimately, exiting in an M&A transaction with a strategic buyer or a private equity partner. My focus from an industry perspective is around service providers and cloud communications or UCaaS (Unified Communications as a Service) as you may hear it referred to, managed services, and network and connectivity services. Each of those sectors have been very active in recent years.

KH: What are you seeing in terms of consolidation in TMT?

AG: Focusing on the areas where I am most active, [we're] now into a very strong multi-year cycle of consolidation, particularly in UCaaS and managed services. We were, as a firm, fortunate to be involved in the cloud communications sector from really the very early stages of the business. This goes back to the late 2000s in its infancy and we became well tied in with the early players and provided advisory services to some of the early deals.



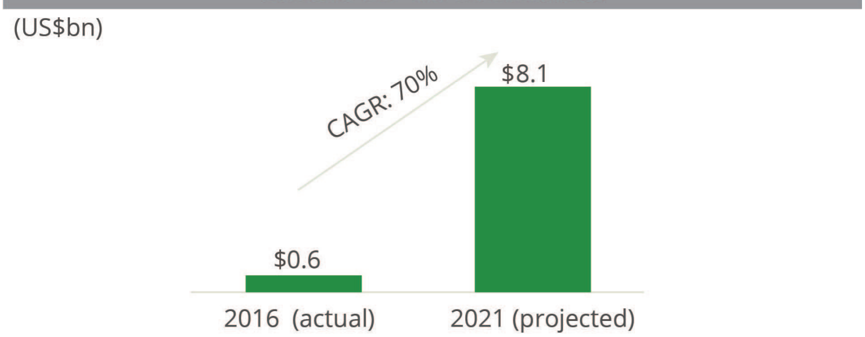
Andrew Gaffney
Q Advisors
Managing Director

We've helped dozens of clients over that time frame, with raising capital or M&A or what have you. It's been an active time. The consolidation activity in UCaaS, in particular, I would say has intensified over the last two to three years. For a while, it had been driven primarily by strategic acquirers, such as Vonage who has been very active, building their business communications through M&A.

More recently, what we're seeing has really been driven by the entrance of some PE-backed companies, like Evolve IP and others. The industry has reached that level of scale, where there's a lot of PE entrants and those businesses have been very active in further consolidating. We're now seeing that play out over in Europe as well, where our firm has announced several UCaaS deals. One of which was the Swyx Solutions transaction with Waterland Private Equity Investments, who is now becoming a consolidator.

On the managed services side, very similar dynamics. We've been active in particularly the managed network side with clients such as One Source Networks and Transbeam, and recently in a transaction with a company called Meriplex Communications. That market is probably

Global SD-WAN market



SD-WAN, or software-defined networking in a wide area network, simplifies the management and operation of a WAN by separating the networking hardware from its control mechanism. Research firm IDC projects the global SD-WAN market to grow by nearly 70% by 2021.

Source: IDC

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a little further along in the consolidation phase. You've had some really active acquirers like GTT Communications.

KH: What challenges and opportunities are your TMT clients seeing right now?

AG: On the challenges side, I'll answer that from a couple of different perspectives. Number one, from the client's perspective and I'm not sure I'd even necessarily call it a challenge, but I think organic growth is always something that the companies we run across are trying to improve. The underlying economy is strong, macro factors are very good. The sectors that they operate in are just very dynamic, highly competitive industries. Therefore, achieving very nice top-line growth through organic sales can be a challenge. It's tough to find the truly elite sales execs that really drive that top-line growth.

What we're seeing is a lot of companies, that's why they're turning to M&A because they're looking to supplement organic growth with M&A initiatives. The other thing I would mention is, it's more from a deal perspective, but the challenge relates to valuation expectations. The economy is strong, valuations are very high, but we say it to our clients all the time, "Valuation is an art, it's not a science".

KH: Are there any other opportunities that TMT companies are seeing?

AG: Certainly, on the connectivity side, one of the key drivers we're seeing is the impact of SD-WAN. In our view, we're definitely in the very early innings there. From what we can see, the services providers that can really deliver a managed SD-WAN solution are increasingly taking share from some of the legacy connectivity solutions, like MPLS. As those MPLS contracts start to roll off over the next several years, we think there's going to be a pretty fundamental shift towards SD-WAN. We are definitely continuing to see the trend of companies expanding the scope of their service offerings through M&A. An example of this would be Vonage, their recent acquisition of New Voice Media, which is a VC-backed provider of cloud contact centres.

KH: What are you seeing in terms of cost of capital right now?

AG: The biggest change we're seeing there is certainly in the debt markets. Cost of capital has been increasing as interest rates have been increasing across all parts of the yield curve over the last 12 months or so. It's interesting because while it hasn't necessarily been a dramatic move, it's just been a slow, steady march higher. The 10-year treasury is nearly a full percentage point higher than it was a year ago. At the shorter end of the curve, it's probably even more dramatic than that.

Interest rates and debt-financing costs, while having been artificially low for such a long period of time, they're definitely now normalising and that's obviously increasing the cost of capital for folks. I think the thing that's been helpful is that the Fed has been pretty transparent that this was coming, and the markets have been able to digest it in a pretty orderly way. Even with the increase we've seen on the cost of debt, it's still really favourable on a longer-term basis.

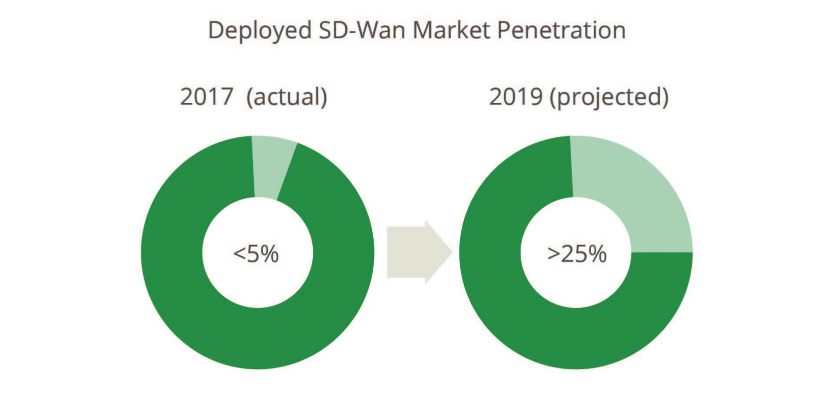
KH: What is the EBITDA range of the companies you work with? How much debt financing do you use?

AG: We, as a firm, operate primarily in the middle markets. Most of our clients are going to be in the sub-US$25m range on EBITDA. That said, we've had a number of clients that are significantly larger than that, including several that we're working on in the shop right now. On the debt side, our firm does have a pretty active debt practice, particularly on the infrastructure side, that team works on a lot of financings in the wireless infrastructure space. Those deals can be multi-hundreds of millions of dollars.

KH: Are there any other trends that you're seeing in your connectivity space? Where we should be looking at interesting deals?

AG: Generally, if you're a business owner or a private equity firm with a portfolio company in the space, I think it's just a tremendous time to at least explore strategic options, the market conditions are as favourable as we've seen in a long time. Whether or not you think it's the right time to sell or bring on additional capital, I think it's at least worth exploring those conversations.

SD-WAN market penetration



SD-WAN market penetration is expected to increase to more than 25% by 2019 from less than 5% in 2017, according to research firm Gartner.

Source: Gartner

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