

Web Hosting M&A update

April 2015



Strong growth and high margins driving consolidation in USD50 billion web hosting market

The hosting industry has experienced strong growth in recent years and is currently valued at more than USD50 billion. Robust growth looks set to continue across all major hosting subsectors over the next few years. Further consolidation is anticipated during this time as larger market participants continue to pursue acquisition opportunities.

High profile hosting and telecom players are likely to drive future sector growth and consolidation as they look to penetrate new market segments and innovations. Private equity (PE) firms are also active in the sector, offering attractive valuations due to hosting companies' recurring revenue, high margins and expansion potential. This presents exciting opportunities for sellers. Indeed, smaller hosting players are advised to either build more scale or consider selling their businesses to larger companies given current market dynamics.

Key conclusions from this report include:

- Size and global presence are needed to attract large customers and/or build a strong brand.
- Creating more scale and improving buyers' offerings are key motivations for acquisitions.
- Innovation is key to attracting and retaining customers in private Cloud infrastructures.
- There is a clear trend between the size of the target and the multiple a buyer is willing to pay for that target.
- PE firms generally execute larger transactions and also tend to pay higher multiples for these transactions.



“Consolidation in the hosting industry looks set to continue as strong market growth and the need to offer scale, innovation and an international presence drives deal activity. Hosting companies and high profile telecom players will be active buyers in the next few years, with the latter looking to make important strategic acquisitions in order to break into new, high growth markets. PE groups are also expected to continue to execute a number of large hosting transactions, paying attractive multiples whilst doing so.”

Ron Belt, Partner
Capitalmind



Growing market

According to 451 Research, the global internet data centre market totalled approximately USD50 billion in 2014 and is forecasted to increase at a two-year compounded annual growth rate (CAGR) of 17 percent over the next two years (see Figure 1 opposite). Significant growth in the infrastructure as a service (IaaS)/Cloud space in particular is expected during this time.

Hosting segments

The hosting industry can be segmented in many different ways. For the purpose of this report, Mergers Alliance has split the sector into five different categories:

- Co-location services.
- Domain name services and website hosting.
- Desktop hosting.
- Dedicated hosting.
- Cloud providers.

All five segments, and the specific trends and mergers and acquisitions (M&A) factors at play in each, are assessed separately in this report.

Co-location services

Companies active in the co-location services area provide pure data centre services (such as space, cooling, power and connectivity). Leaders in this space include Equinix, Digital Realty Trust, Interxion and Telecity. Co-location activities are capital intensive and should be regarded as a separate class of real estate rather than technology providers. As a result, this segment is not explored in any detail in this report.

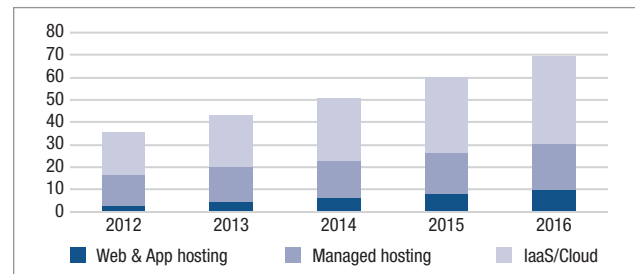
Domain name services and website hosting

Companies that focus on website hosting such as Endurance, GoDaddy, 1&1 and Web.com target the consumer and small and medium enterprises (SME) markets. Key performance indicators (KPIs) are revenue per subscriber, subscriber acquisition costs and churn. In order to survive in this particular segment, complete automation of the back-office is required and economies of scale are needed in order to mitigate price pressures and increasing customer acquisition costs.

Players such as Endurance and 1&1 have therefore fully focused their KPIs towards more telecom-related metrics. In order to be able to control the running costs of these operations, the back-end infrastructures are often based on deploying private or public Cloud solutions.

Acquisitions in this area are typically motivated by the need to acquire more scale (for example, buying subscriber bases). The developed technologies of the target are often fully integrated into the technology of the buyer in order to gain cost synergies. Service desks and overheads are also likely to be fully integrated into the buyer. As the target frequently generates relatively cheap (branded) traffic, its brand often continues to exist.

Figure 1: Global Internet Data Centre Market



Source: 451 Research

One of the leaders in this segment is GoDaddy. Unlike many other companies, GoDaddy has a clear strategy of acquiring additional technologies and services for its customer base. This was GoDaddy's motivation in acquiring the six companies listed in Table 1.

Table 1: Go Daddy Offering Enhancement Acquisitions

Date	Target	Core business
Aug-14	Mad Mimi	Email marketing services
Oct-13	Ronin	Online invoicing services
Sep-13	Afternic	Specialist in aftermarket domain sales
Aug-13	Locu	Data sharing and promotion with other services via Locu's platform
Feb-13	m.dot	Mobile website design tool
Jul-12	Outright	Simple business management applications

Source: Mergers Alliance

Desktop hosting

The traditional desktop business in the IT industry was based on hardware sales and software installations. Services around the desktop were often executed locally, using specialised firms that would visit customers to handle issues. Over time, more online deployment and remote management has been introduced and, with the emergence of virtualisation, the 'functional' desktop has been placed on servers (either in-house or at third-party data centres). The virtualisation trend has benefitted companies such as VMware, which is now one of the leading providers of Cloud technologies.

Growth in the desktop hosting space has accelerated over the past few years due to solutions such as Google Apps for Work and, more recently, Microsoft's successful Office 365 offering. Although both companies offer a Cloud-based solution, their desktop offerings are generally sufficient for the average white-collar employee.

Specialist desktop hosting providers are needed in circumstances where more dedicated remote solutions are required (for example, accounting or applications for a specific industry). Such providers often offer a wide variety of (smaller) specific applications and are capable of running these remotely and in parallel with other remote applications.

Desktop hosting is often combined with the dedicated hosting offering.

Dedicated hosting

Dedicated hosting typically involves more complex software solutions that have been built specifically for individual customers. A large proportion of such dedicated solutions run within customer premises. The remainder run within the data centres of large system integrators (such as Accenture, Atos, Cap Gemini, HP and IBM) or are managed by specific dedicated hosting specialists. The latter usually focus on the uptime of the technical infrastructure or basic services (including databases and enterprise resource planning systems) whereas system integrators also provide functional management of the applications that are being hosted. Traditionally, digital marketing firms (such as Publicis LBi) would not only develop multi-channel solutions for their clients but would also typically host these solutions. This has changed over the last decade, however, as a number of these marketing firms have transferred hosting responsibilities to specialised dedicated hosting providers or, more recently, developed public or private Cloud environments.

Dedicated hosting is executed using multiple year contracts in a managed service offering using Service Level Agreements. The hosting provider must warrant specific uptime guarantees and/or response times. Size and scale are crucial elements to managed hosting as customers often rely on the software solution that is hosted by the provider. There are various quality standards that need to be adhered to when servicing a large customer base.

These include:

- ISO 9001 – standard on quality management systems.
- ISO 27001 – information technology, security techniques and information security management.
- ISAE 3402 – global assurance standard for reporting on controls at service organisations.

Such standards require certain thresholds (often measured by organisations’ revenue) and are therefore difficult to achieve for smaller companies. In addition, many dedicated hosting providers and most of the larger system integrators

have deployed public, private or hybrid Cloud solutions that allow customers to migrate from dedicated infrastructures towards more modern and scalable Cloud infrastructures.

Profit margins at dedicated hosting companies generally rise with the size of the organisation. This can be explained in large part by better efficiency ratios within larger organisations. For example, the expertise of an Oracle database analyst can be deployed more efficiently if multiple customers require such a service.

As with website hosting, acquisition strategies for dedicated hosting companies are often driven by the desire to increase economies of scale. Another objective is acquiring technology to customise offerings for specific customer verticals. In addition, as well as extracting cost synergies in the finance and human resources departments, further headcount efficiencies can be achieved if the acquiring company already has similar specialists in-house. The brand name of the target is of lesser importance and will often be phased out. The key issue in acquiring dedicated hosting companies is the quality of the customer base.

Cloud providers

Cloud hosting services provide hosting on virtual servers, which pull their computing resource from extensive underlying networks of physical web servers (see Figure 2 for a selection of high profile players in the Cloud providers’ space). It follows the utility model of computing in that it is available as a service rather than a product and is therefore comparable with traditional utilities such as electricity and gas. Broadly speaking, customers can tap into the service as much as they need, depending on their demands, so they only pay for what they use.

Cloud services provide strong benefits over traditional hosting. Traditional hosting solutions require customers to either buy or lease the equipment they need to operate their software. Such infrastructures are often set up to cope with maximum usage and require more capex with success as more servers are required. In a downturn situation, these servers have already been bought and the infrastructure often becomes expensive.

Figure 2: Examples of High Profile Cloud Providers



Source: IDC

Practical examples of Cloud hosting can fall under both the IaaS and Platform as a Service (PaaS) classifications. IaaS offers clients virtualised hardware resources on which they can install their own choice of software environment before building their web application. For PaaS services, meanwhile, this software environment is provided (for example, as a solution stack that includes an operating system, database support, web server software and programming support), meaning customers can proceed immediately to installing and developing their web application.

More obvious examples of Cloud hosting involve the use of public Cloud models – hosting websites on virtual servers that pull resources from the same pool as other publicly available virtual servers and use the same public networks to transmit data. This data is physically stored on underlying shared servers, which form the Cloud resource.

Public Clouds include some security measures to ensure that data is kept private and these measures are likely to suffice for most website installations. However, for businesses where security and privacy is a priority, private Clouds are a popular alternative given ring-fenced resources are used for servers and networks, whether located onsite or with the Cloud provider.

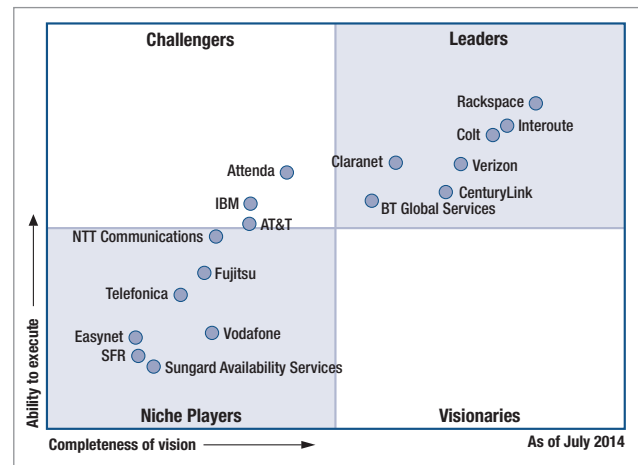
Hosting companies' customers are increasingly moving towards using IT solutions that run on public and private Cloud infrastructures. Over time, older and existing infrastructures will be phased out as they are typically difficult to migrate. Companies that transition to newer infrastructures may outsource the old infrastructure to a dedicated hosting provider.

That said, despite the obvious strengths of Clouds, they still only focus on one particular type of application. Indeed, a significant amount of IT workload remains unsuitable for

Cloud solutions offered by Microsoft Azure and Amazon, for example. Opportunities therefore remain for service providers to differentiate their infrastructure, although this is undeniably getting more difficult.

The challenges and opportunities facing Cloud companies are well depicted by the Gartner Magic Quadrant in Figure 3, which shows different vendors in the marketplace and provides an evaluation of the strengths and capabilities of each. Those categorised as 'Leaders' have proven staying power in the market, the ability to innovate on existing products and are capable of fulfilling enterprise needs. These companies have the scale and expertise necessary to exploit market opportunities whilst those in the 'Niche' and 'Challengers' quadrants are likely to be challenged by their focus on small, segmented markets and limited understanding of the market direction.

Figure 3: Magic Quadrant for Cloud-Enabled Managed Hosting, Europe 2014



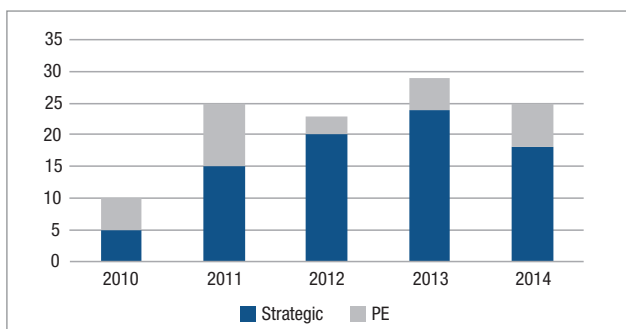
Source: Gartner

Acquisitions

A number of prominent hosting companies operate across the five segments explored in this report. Several have made acquisitions since 2010, particularly Claranet, Endurance and Iomart with eight purchases each (see Table 2 on page 5). Telecom companies and PE firms have also been active in the hosting M&A market during this time.

This is supported by Mergers Alliance data showing the amount of M&A deals (strategic and PE) in the hosting space over the last five years¹. As Figure 4 shows, deal activity continues to run at a strong pace, with strategic transactions making up the majority of activity from 2012 onwards.

Figure 4: Number of Hosting Deals – 2010 to 2014



Source: Mergers Alliance, deal announcements & annual reports of various buyers (N=100)

“The market as whole is going to have quite a transformation over the next year or two. Hosting companies that really put their bet in asset-heavy builds in data centres and infrastructure are going to really struggle. They will either have to get acquired by one of the Big Three (Amazon Web Services, Microsoft Azure or Google Cloud), or they’ll end up having to fairly drastically change their company direction. And they’ll find that hard because if they’ve got 15 years of data centre that they’ve got to right off, that’s not something that can be financially done very easily. There’s going to be a lot of consolidation and acquisitions happening over the next couple of years.”

Martin Saunders, Corporate Development Director
Claranet

Table 2: **Prominent Hosting Companies' Operations and Activity (Numbers in USD)**

Country	Company	Year	Revenues	EBITDA	%	Acquisitions (2010-2014)	Webhosting	Desktop hosting	Dedicated/Managed	Cloud offering	Co-location	Other services	Private equity	Part of
US	Rackspace	2013	1,535	506	33%	4				X				Public
Germany	1&1	2013	1,152	224	19%	1	X					X		United Internet
US	GoDaddy	2013	1,130	199	18%	7	X						KKR, Silver Lake, TCV	Filed for IPO
US	Web.com	2013	534	153	29%	3	X							Public
US	Endurance	2013	520	208	40%	8	X							Public
UK	Interoute	2013	417	91	22%	0				X		X		
France	OVH	2014	292			0	X			X	X			
US	Internap	2013	283	58	20%	2			X	X	X	X		Public
UK	Host Europe	2013	223	84	38%	6	X				X		Cinven	
UK	Claranet	2013	213			8		X	X	X	X	X	Abry Partners	
Germany	Strato	2009	135	48	36%	0	X							Deutsche Telecom
Canada	Peer1 Hosting	2012	134	30	23%	2			X	X	X			Cogeco Cable
Italy	Dada	2013	100	14	14%	1	X		X	X				Public
Netherlands	Leaseweb	2012	96	35	36%	1	X			X		X		Ocom
UK	lomart	2013	87	37	42%	8	X		X	X	X			Public
France	Cheops Technology	2013	77			3		X	X	X				
Netherlands	Schuberg Philis	2012	75	14	19%	0			X	X				
UK	Pulsant	2013	69	25	36%	4			X	X	X		Oak Hill Partners	
Norway	Basefarm	2012	67	13	20%	1			X			X	Abry Partners	
US	Carpathia	2011	61			0			X	X				
US	Hostway	2013	60	29	48%	0	X						Little John & Co	
France	Arsys	2013	55	8	15%		X					X		United Internet (rev. €2,656m)
UK	Adapt Group	2011	51	5	9%								Lyceam Group	
France	Adista	2013	51	5	9%	1		X	X	X	X	X	Family-owned	

Source: Mergers Alliance

¹ For the purposes of this report, we have focused on large US and European hosting deals.

Private equity deals

As already mentioned, the hosting industry has attracted investments from several PE firms due to hosting companies' recurring revenue, high margins and expansion potential (see Table 3). In particular, larger hosting providers with revenues of more than USD10 million attract spontaneous approaches by PE players. There is more of a reluctance on the part of PE groups to target hosting companies with revenues of less than USD10 million given they are often required to make

significant one-off overhead investments when revenues rise above this amount.

Valuations offered by PE firms are typically attractive, driven in part by the relative ease in acquiring bank financing for such deals in today's market. Sellers often forget that PE firms' deal structures can be complex and selling shareholders often have to provide part of the acquisition financing via vendor loans or preferred equity.

 Table 3: **Selection of Private Equity Backed Acquisitions**

Date	Acquirer	Country	Target	Country
Nov-14	Isatis Capital / NextStage	FR	Ecritel	FR
Jul-14	Vitruvian	UK	ASP4All	NL
Jun-14	Oak Hill Partners	US	Pulsant	UK
Jun-14	Ardian	FR	lkoula	FR
May-14	Naxicap Partners	FR	Jaguar Network	FR
Mar-14	Broad Horizon	NL	Multrix	NL
Dec-13	Little John & Co	US	Hostway	US
Jul-13	Cinven	UK	Host Europe	Germany
Jun-13	Broad Horizon	NL	Trueserver	NL
May-13	LDC	UK	Node4	UK
May-13	Keensight Capital	FR	Oodrive	FR
May-13	GMT / VSS	UK/US	IT-Ernity	NL
Dec-12	Abry	US	Basefarm	Norway
Sep-12	Institut Lorrain de Participation	FR	Adista	FR
Nov-11	Oakley	UK	Intergenia	Germany
Nov-11	Warburg Pincus	US	Endurance	US
Oct-11	ISIS Equity Partners	UK	Onyx	UK
Sep-11	Lyceum Capital	UK	Adapt Group	UK
Sep-11	HGC Capital	UK	Netnames Group	UK
Aug-11	Darwin PE	UK	Attenda	UK
Jul-11	KKR, Silverlake, TCV	US	Go Daddy	US
May-11	Oak Hill Capital	US	Intermedia	US
Apr-11	LDC	UK	UK2	UK
Apr-11	LDC	UK	UK Group	UK
Nov-10	Bridgepoint	UK	Pulsant	UK
Sep-10	Montagu	UK	Host Europe	Germany
Sep-10	Silverlake	US	Locaweb	Brazil
Mar-10	Scottish Equity Partners	UK	Control Circle	UK

Source: Mergers Alliance

Telecom deals

Telecom companies are also active acquirers in the hosting market, targeting a number of large hosting businesses since 2009 (see Table 4). Indeed, the telecom industry is at a crossroad as traditional high margin products such as voice and SMS have evaporated and new services including mobile broadband, the Cloud, information and communications technology (ICT) services,

machine-to-machine (M2M), social media and m-advertising will determine the future market landscape.

Significant investment in the hosting space has therefore occurred and telecom companies are likely to be key players in future sector consolidation. Most telecom companies prefer the domain name segment, and web hosting in particular, due to the similarities with their own business models.

Table 4: Selection of Deals Involving Telecom Companies and Hosting Targets

Date	Acquirer	Country	Target	Country
Jan-15	Orange	FR	Cloutwatt	FR
Aug-14	KPN	NL	Argeweb	NL
Dec-12	Cogeco	Canada	Peer1 Hosting	Canada
Jun-11	Telefonica	Spain	Acens	Spain
Feb-11	Time Warner Cable	US	Navisite	US
Jan-11	Verizon	US	Terremark	US
Nov-09	Deutsche Telecom	Germany	Strato AG	Germany

Source: Mergers Alliance

Hosting deals

Acquisition activity between peer hosting companies has also been a key driver of consolidation activity as buyers seek to realise economies of scale, improve offerings and achieve international expansion. The market remains highly fragmented, meaning more consolidation is expected in the coming months and years. This is also due to the fact that the Cloud is still an emerging market in many parts of the world and therefore has significant untapped potential.

Table 5: Selection of Acquisition Deals Involving Hosting Companies Acquiring Sector Peers

Date	Acquirer	Target
Oct-13	Go Daddy	Media Temple
Oct-13	Host Europe (Germany)	Telefonica Germany Online Services GmbH (Germany)
Sep-13	Iomart Group	Redstation Ltd
Sep-13	Endurance (US)	Directi (India)
Dec-12	Claranet	Typhon SAS
Aug-12	Iomart Group	Melbourne Server Hosting
Aug-12	Iomart Group	Skymarket
Jun-12	Endurance International Group	Host Gator
Apr-12	Adapt Services	eLINIA Webservices
Jan-12	Host Europe	Red Coruna
Oct-11	Hosting.com	Neospire
Aug-11	Host Europe	Heart Internet
Mar-11	Host Europe	DN (Switzerland)

Source: Mergers Alliance

Valuation of acquisitions

In order to determine average valuations paid by acquirers between 2010 and 2014, Mergers Alliance analysed over 100 hosting deals and segmented these transactions by size (using revenue and EBITDA ranges). As Figures 5 and 6 show, there is a clear trend between the size of the target and the multiple a buyer is willing to pay for that target.

Figure 5: Average Revenue Multiple by Size of Target

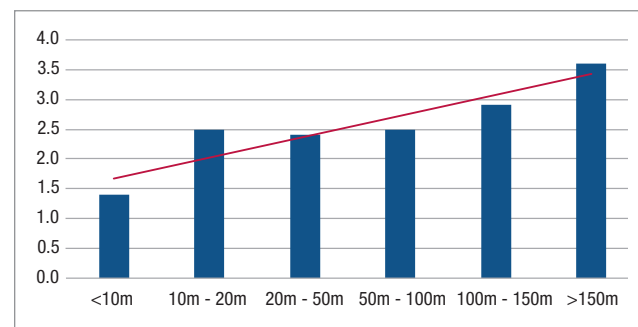
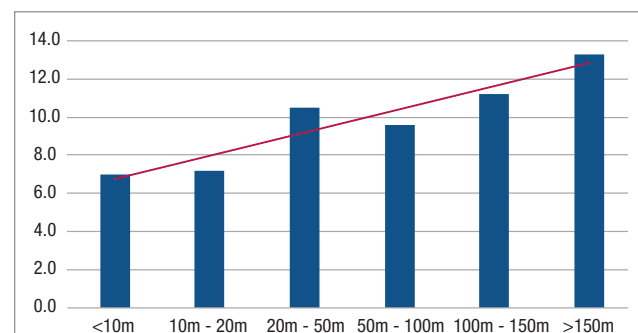


Figure 6: Average EBITDA Multiple by Size of Target



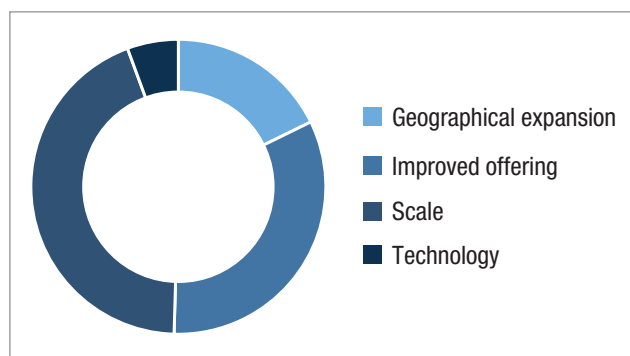
Source: Mergers Alliance, deal announcements & annual reports of various buyers (N=100). Revenues in USDm.

Motivations behind acquisitions

When assessing non-PE transactions only, it is clear motivations for acquisitions include improving buyers' offerings (for example, the purchase of a Cloud hosting firm by a managed hosting firm) or simply creating more scale (see Figure 7). International expansion is also a factor, albeit to a lesser extent.

Taking the analysis a step further and splitting the acquisitions between those carried out by PE firms and strategic buyers, it is evident PE firms generally execute larger transactions and also tend to pay higher multiples for these deals (see Table 6).

Figure 7: Reasons for Acquisitions Involving Non-PE Participants



Source: Mergers Alliance, deal announcements & annual reports of various buyers (N=100).

Table 6: Average Deal Multiples Paid by Strategic and PE Buyers

	EV/REV	EV/EBITDA	Size*
PE	2.5	10.6	90.2
Strategic	2.2	9.0	42.9

* Size defined in revenues & USDm

Source: Mergers Alliance

A number of companies mentioned in this report are listed on the stock market. Table 7 shows the average valuation of this peer group of companies. Over time, PE investors are seemingly investing around the average trailing twelve months (TTM) valuation of this peer group.

Table 7: Average Valuations for Listed Companies

Company	Price	EV	Revenue			EBITDA			EV/Revenue			EV/EBITDA			
			2013A	2014E	2015E	2013A	2014E	2015E	2013	2014	2015	2013	2014	2015	
United Internet AG	33.7	6,800	2,656.0	2,900.0	3,660.0	407.2	587.0	770.0	2.6	2.3	1.9	16.7	11.6	8.8	
Web.com	20.0	1,632	533.7	570.0	551.0	153.3	162.0	152.0	3.1	2.9	3.0	10.6	10.1	10.7	
Rackspace	32.6	4,528	1,534.8	1,796.0	2,078.0	505.8	601.0	705.0	3.0	2.5	2.2	9.0	7.5	6.4	
Intermap Network Services	6.9	691	283.3	335.0	351.0	58.0	77.9	89.3	2.4	2.1	2.0	11.9	8.9	7.7	
iomart Group	246.8	284	43.1	55.6	66.1	23.6	28.4	32.7	6.6	5.1	4.3	12.1	10.0	8.7	
Dada	3.1	87	75.3	71.5	75.1	10.6	10.0	11.0	1.2	1.2	1.2	8.2	8.7	7.9	
Endurance	16.3	3,191	520.0	645.0	747.0	207.9	234.0	285.0	6.1	4.9	4.3	15.4	13.6	11.2	
									Average	3.6	3.0	2.7	12.0	10.1	8.8
									Private Equity M&A	2.5			10.6		
									Strategic M&A	2.2			9.0		

Source: Mergers Alliance

Future M&A Prospects

The hosting sector is likely to remain an active M&A market in the coming months and years. The sector is highly fragmented and large, strategic buyers are likely to look to consolidate their market position by continuing with their acquisition strategies. Ultimately, the 'end-game' seems to be in the hands of large telecom providers that have scooped up the largest players in the industry over the past few years.



Selected Mergers Alliance Deals

 <p>Merged with</p>   	  <p>Partly sold to</p>   	 <p>Acquired</p>    	 <p>Acquired</p>   
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Web Hosting



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