

VIEWPOINT

ISSUE 23

A Publication of
Mirus Capital Advisors, Inc.

WHY THIS MATTERS:

- *Dramatic increases in litigation – plus the exponential growth in electronic and paper documents – have fueled explosive growth in the litigation and compliance support sector.*
- *This highly fragmented industry has already begun to consolidate, and we believe deal activity will continue in the coming months.*
- *Five market subsegments are growing fast, creating opportunities for transactions in compliance management, forensic analysis, document management and storage, content analysis, and offshore document review.*

GROWTH OPPORTUNITIES IN LITIGATION SUPPORT AND COMPLIANCE

By David Hoffer

Litigation is a growth industry these days. US companies with sales over \$1 billion now face an average of 556 lawsuits – and about half of them are sued 50 times a year.¹ Today, the average large corporation spends \$10.8 million per year on litigation, up from \$8 million in 2005.²

This increased activity – and the internet age's avalanche of electronic documentation – has meant that more and more corporations are looking for ways to manage the increased burden of producing and managing information required for lawsuits. A whole industry has emerged around litigation and compliance support, offering a wide range of technological solutions for information analysis, retrieval, storage and management.

The litigation and compliance support industry has become a fertile ground for M&A activity, as leading companies within the litigation and compliance support sectors seek to buy up complementary technologies, services and product offerings. In this issue of *Viewpoint*, we'll provide an overview of this dynamic market sector. We'll survey some subsectors of the market that are growing rapidly, as well as the companies that seem particularly well-positioned within them.

¹Third Annual Litigation Trends Survey, Fulbright & Jaworski, October 18, 2006.

² *Ibid.*

FIVE AREAS OF GROWTH

- PROACTIVE COMPLIANCE MANAGEMENT
- FORENSIC ANALYSIS
- HOSTED DOCUMENT REVIEW
- CONTENT ANALYTICS
- OFFSHORE DOCUMENT REVIEW

Within the *Viewpoint* series, this article is the first of occasional articles that focus on a specific industry. While most *Viewpoints* are not industry-specific, we think it's valuable from time to time to profile an industry that has been particularly active from a dealmaking perspective. As always, we welcome your thoughts.

AN OVERVIEW OF LITIGATION AND COMPLIANCE SUPPORT

The litigation and compliance support industry is a relatively young one. It has grown up as technological innovations such as email, the world-wide web, and ever more powerful and interconnected computer systems have produced an explosion in information. Currently, 100 billion emails are sent every day; federal agencies alone produce and receive some 30 billion emails each year.

Business records used to be a couple of walls worth of file cabinets. Today businesses create, receive and store an enormous amount of information – millions of pages of documents, emails, phone messages and web-based communication. As a consequence, the cost of sifting through all this information in preparation for a lawsuit has risen rapidly. Microsoft Corporation estimates that it spends \$20 million *per lawsuit* on e-discovery, or analysis of electronic data.³

Litigation and compliance support companies provide outsourced solutions to the problem, offering the software and services to analyze, evaluate, store and manage information. These companies include service-oriented business process outsourcing (BPO) firms (and their legal counterpart, legal process outsourcing – or LPO – firms), as well as infrastructure software companies. Most of these companies have grown up around a specific technology or service offering. As a result, the industry is quite fragmented at present. However, we expect this to change in coming years, as leading companies begin to buy up complementary technologies and service offerings.

Already, we've seen significant consolidation activity in transactions such as LexisNexis's acquisition of AppliedDiscovery, Xerox Corporation's acquisition of Amici, Pitney Bowes' acquisitions of Compulit and Ibis, and Merrill Corporation's acquisition of Lextranet. In 2006, Mirus counted 28 acquisitions of litigation support firms, 18 in electronic compliance management, 8 in information storage, and 6 in document outsourcing.

We believe that the litigation support and compliance industry will continue to grow, creating a wide range of compelling opportunities for financial and strategic investors. In particular, we are focused on five subsegments of the market: compliance management, forensic analysis, hosted document review, content analytics, and offshore document review.

³"Microsoft reveals its e-discovery strategy", by Kathleen Lau, IT Business Canada, April 25, 2007.

FIVE HOT MARKET SECTORS

1. PROACTIVE COMPLIANCE MANAGEMENT

Over the last decade, the litigation support, compliance and information management markets are converging at an accelerating pace, creating a growing \$3 billion annual opportunity for companies in the "convergence zones" of these segments. Companies are no longer waiting to be sued before they start collecting and analyzing data; they are building compliance management into their information technology systems.

This creates opportunities for companies that offer:

- Document management systems tailored for legal documents;
- Electronic management of paper-based discovery processes through scanning and coding; and
- Discovery and management of massive quantities of electronic information.

This sector of the industry is sometimes referred to as "information risk management."

Vendors with an interest in these areas are already cashing in on the convergence zones. Guidance Software, developer of the EnCase suite of tools for collection and indexing of enterprise information, went public in December 2006. In July 2007, enterprise search vendor Autonomy announced that it was acquiring email archiving and eDiscovery vendor ZANTAZ for \$375 million in cash. The acquisition gives the new company a broad array of archiving, e-discovery, analytic and real-time policy management services.⁴

Compliance management, per se, does not necessarily address responsive litigation requirements. On the surface, the needs of compliance and litigation are very different; the convergence is taking place at the infrastructure level. That is, if they are designed with the proper architecture and implementation, information management systems can be made to serve both litigation and compliance needs.

2. FORENSIC ANALYSIS

Forensics, or data harvesting and collection, is another area of strong interest in the current market. Companies that specialize in forensics typically come in at the very beginning of the litigation process. Their primary role is helping clients inventory the data that they have and certify that this information has not been altered or corrupted. Data forensics providers can, among other things, restore damaged documents, find lost documents, reconstruct internet browsing history, determine whether files have been copied without authorization, identify changes that have been made to existing documents and trace deleted documents, including emails, that are required for litigation. Digital forensics have played an important role in numerous recent high profile investigations, including options backdating probes and inquiries into the TJX credit card data breach.

These companies have also become increasingly popular acquisition targets, because they are often hired in the very early stages of litigation. By providing these critical front-end services, they get to know the data, the client and the case early on, making them a natural incumbent for subsequent services like data processing, hosting and storage.⁵

⁴ "Autonomy Acquires Zantaz for \$375 Million," *eWeek*, July 3, 2007

⁵ Some litigants are creating a counter-trend – deliberately splitting off the forensic collections tasks to a separate vendor to take advantage of "pre-culling" approaches that reduce the volume of data to be processed downstream.

CASE STUDY: LEXTRANET

Lextranet, founded in 1992 by lawyers Neil Aresty and Harold Leach, created a suite of web-based tools that helped clients review documents, manage transcripts, stream discovery videos and manage and organize data online. By virtue of their expertise and tenure in the market, the founders built a platform that met the needs of the most complex cases and demanding lawyers. They also established themselves as thought leaders in the industry, speaking frequently and advising the largest law firms and corporations on document management strategies.

"Our longstanding relationship with the Mirus team, coupled with their deep understanding of our business and the broader eDiscovery and litigation support marketplace, made their selection as our financial advisors an easy choice. We found Mirus to be a highly competent and trustworthy advisor whose objective guidance throughout the process was invaluable."

— Neil Aresty, Co-founder and President, Lextranet

Mirus began advising Lextranet in 2002, consulting informally on strategic decisions and helping position the company for an eventual exit. In 2006, Lextranet had reached critical mass and needed additional management resources. Since the M&A market was hot, Mirus finally advised Lextranet to explore strategic alternatives, and Lextranet retained Mirus to market the company. Mirus leveraged its extensive industry contacts to bring a significant number of interested buyers to the table, articulating for each one how Lextranet could be integrated into its business to build competitive advantage. As the Lextranet founders had never sold a company before, Mirus worked closely with them to coach them through the process and helped them to evaluate the multiple offers they received. In March 2007, Lextranet was acquired by Merrill Corporation, a billion-dollar provider of technology-enabled services for the legal, financial, real estate and other corporate markets, that wanted to overhaul its technology platforms to compete more aggressively in the modern litigation support market.

As a result, we have seen a number of transactions where broader-based litigation support companies have bought forensics capabilities — such as Navigant's acquisition of Kroll Lindquist Avery and Computer Forensics Institute, both in 2005, the acquisition by Whitmont Legal Technologies (since acquired by Aptara) of data recovery specialist eFor Incorporated in August 2006, and the acquisition by First Advantage of DataSec UK in December 2006. Financial investors have been active as well, with Greenhill Capital investing \$30 million in digital forensics firm Stroz Friedberg early in 2007. We expect this trend to accelerate, with growing interest in and by companies that specialize in forensics, such as FTI Consulting, Daylight Advisory, The Oliver Group, Forensics Consulting Solutions, and Norcross Group.

3. HOSTED DOCUMENT REVIEW

A third area where we're seeing significant growth — and deal activity — is hosted document review. These companies enter the process after data has been collected, cleaned up, and processed. Their role is to store the many millions of pages of discoverable materials that may surface in a case and make them readily available, whenever required by the attorneys in the case.

Because hosted review vendors physically store companies' data over the course of the entire litigation process, they have the longest, closest relationships with customers of any sector of the litigation and compliance support industry. Or put another way, the company that owns the data owns the customer. These vendors also typically enjoy a more stable, recurring revenue stream than companies that work on a project basis.

For these reasons, as well as the strong growth potential in hosted review, these companies have been frequent targets for acquisition and strategic investment. In February 2005, FTI Consulting paid \$35 million for Ringtail Solutions Group, a leading provider of knowledge management systems for legal firms. Lextranet, a leading provider of hosted litigation support software, was sold in March 2007 to Merrill Corporation (see sidebar).

HOSTED DOCUMENT REVIEW IS GROWING FASTER THAN ANY OTHER SEGMENT OF THE LITIGATION AND COMPLIANCE SUPPORT MARKET, AND WILL ACCOUNT FOR 60% OF THIS MARKET BY 2011, ACCORDING TO FORRESTER RESEARCH.⁷

Anacomp acquired CaseLogistix in May 2007. Other prominent companies in this sector which bear watching include CaseCentral and Catalyst Repository Systems.

4. CONTENT ANALYTICS

As electronic data proliferate, it becomes more and more expensive for human beings to sift through them, creating a new need for advanced search technologies. These technologies can be applied to internal investigations (targeted search and retrieval), early case assessment (insight into the document collection), and document review (intelligent culling).

As an example of this last application, a recent law journal article⁶ asks the reader to consider a lawsuit whose universe of evidence is roughly one billion emails. Many of these emails have attachments — documents, spreadsheets, images and video. If the most junior lawyers review this evidence at a rate of roughly 50 emails an hour, and charge \$100/hour for their work, this effort would take 100 people roughly 54 years to complete — even if they worked ten hours a day, seven days a week, fifty-two weeks a year. Moreover, it would cost approximately \$2 billion in legal fees. Given the sheer volume of information, it may cost more to prepare for even fairly routine lawsuits than simply to settle — unless one can automate the search for relevant documents.

⁶ George L. Paul and Jason R. Baron, "Information Inflation: Can the Legal System Adapt?", *Richmond Journal of Law & Technology*, Volume 13, Issue 3 (2007)

⁷ "Believe It — eDiscovery Technology Spending To Top \$4.8 Billion By 2011," Barry Murphy, December 2006 Forrester eDiscovery Forecast.

A number of companies have sprung up to address this need. They offer a variety of intelligent search technologies that help companies (and their lawyers) focus on relevant materials quickly.

Intelligent search goes well beyond simple key word search in finding the appropriate documents. For instance, imagine that your company is involved in a lawsuit over whether or not you stole software code written in the Java programming language. A key word search for "java" will turn up a massive pile of documents, some concerning software, others related to coffee, still others involving an island in Indonesia. An intelligent search technology would focus in only on the programming documents, and could further narrow your search to only a handful of relevant items.

This not only saves time and money in preparing for discovery, it can also give companies an early indication of how likely they are to lose a given case, particularly if they're able to find a "smoking gun" early on.

Some of the larger search software vendors have already started to move into this arena, including Fast Search and Transfer, a large, Scandinavian search company. In addition, there are a number of smaller, venture-backed companies that offer specialized technologies (see below). For example, some firms have focused on visual representations of information clusters, which show how documents relate to specific concepts or combinations of concepts in graphic form.

We have already seen the beginnings of consolidation in this sector. Kroll Ontrack, a pre-eminent litigation support firm bought intelligent search pioneer Engenium in November 2006. Xiotech doubled down on its Daticon bet by acquiring DolphinSearch in July 2007. Autonomy, whose proprietary Intelligent Data Operating Layer™ software provides real-time cataloguing and analysis of information from more than 1000 different formats, including text, voice and video, has recently established itself as a consolidator in this space by virtue of its acquisition of ZANTAZ (see above). Other companies will undoubtedly follow suit as they seek the competitive advantage that owning a proprietary search technology may bring. A number of the more interesting companies in this space remain private, however; offering likely targets for future M&A activity. These include Attenex, MetaLINCS, Cataphora, Stratify, H5, ZyLAB, and Syngence.

One major question mark surrounding the search sector is whether these technologies will stand up in court as acceptable ways of filtering evidence. In other words, if a lawyer uses a search technology to winnow one billion documents down to a more manageable set, can opposing counsel challenge the lawyer for not

SOME 32 MILLION EMAILS WERE SUBJECT TO DISCOVERY IN U.S. V. PHILIP MORRIS, THE RICO LAWSUIT FILED BY THE GOVERNMENT IN 1999 AGAINST TOBACCO COMPANIES.⁸

having identified and produced all responsive documents? Some experts fear that judges may ask counsel to describe exactly how they've narrowed down the pool

— and that, since the technologies are more or less a "black box," they may be penalized for not being able to provide a satisfactory answer. Because penalties for withholding evidence are so steep, these fears may have constrained the growth of the search industry to date. Yet, so far, no such challenge has been attempted, and this fear seems to have receded.

5. OFFSHORE DOCUMENT REVIEW

The fifth and final area of growth is offshore outsourcing. Even with extensive electronic document screening, many experts estimate that 80% of the cost of litigation stems from attorneys' fees. Some companies have begun to address that cost by hiring offshore lawyers to review documents, at a lower cost without sacrificing quality. A December 14, 2006 article in *The Economist* observed that, today, "About \$250 billion is spent on legal services world-wide, about two-thirds of it in America, and as yet only a tiny proportion goes offshore. Forrester, a research outfit, has estimated that, by last year, 12,000 legal jobs had moved offshore, and forecast that this will increase to 35,000 by 2010. India, with its English-language skills and common-law tradition is well-placed to secure a big share of the business."

SEEKING GROWTH OPPORTUNITIES IN LITIGATION SUPPORT

Transaction activity has already heated up in the litigation and compliance support, and we believe that this trend will continue. Moreover, we look for further sector consolidation, with more and more providers seeking to offer comprehensive, end-to-end solutions for clients.

Mirus has been involved in this sector for several years, offering investment banking consulting and services to leading companies in the litigation and compliance support industry. Mirus advised Ibis Consulting in its sale to Pitney Bowes, Daticon in its sale to Xiotech, and Lextranet in its sale to Merrill Corporation. For more information about our capabilities in this area, please contact: **David Hoffer at 781-418-5922 or hoffer@merger.com.**

⁸United States v. Philip Morris USA, 449 F. Supp.2d 1 (D.D.C. 2006) (16,000-page opinion by Judge Gladys Kessler).

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