

## The demise of the independent Managed Service Provider (MSP)

It was roughly two years ago that the term 'Management Service Provider' (MSP) was first coined. Long gone are the days that VCs would back these providers of remote IT infrastructure services with tens of millions of dollars. For many independent MSPs the money is now starting to run out and some have already shut their doors. However, the MSP market has some true potential and is estimated to grow to anywhere between \$3 billion and \$10 billion in the next few years. To capture this opportunity, MSPs such as SevenSpace and ClearBlue are executing roll-up strategies to build the scale necessary to survive and eventually prosper. Outside players, such as application hosting providers, IT outsourcers, value

## FEATURED RESEARCH TECHNOLOGY

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Two observations can be made from this M&A activity:

- The consolidation of the MSP industry is currently led by SevenSpace and ClearBlue. SevenSpace initiated the industry consolidation with its acquisition of StrataSource in the Summer of 2001, followed by the acquisition of Nuclio in early 2002. ClearBlue Technologies initially expanded its managed hosting business through the acquisition of Applied Theory and NaviSite. Subsequently, ClearBlue Technologies indirectly acquired Avasta, which had already acquired MSP SiteROCK. Through a financial restructuring in early 2003, ClearBlue Technologies' investor ClearBlue Atlantic became the direct owner of NaviSite (see Appendix, pg. 3).

### Exhibit 1: Selected acquisitions of MSPs and application hosting providers from Sept. 1, 2001 through Feb. 1, 2003

Date	Acquirer	Acquirer Type	Target	Target Type
01/29/03	NaviSite	Application hosting	ClearBlue Technologies Management	MSP
12/31/02	NaviSite	Application hosting	Avasta, Inc.	MSP
12/19/02	Interland, Inc.	Web & application hosting	Hostcentric, Inc.	Application hosting
11/04/02	Sanswire Technologies Inc	Wireless Internet	Virtualactive Technologies Inc.	Application hosting
10/02/02	Equinix, Inc.	Internet exchange services	i-STT	Application hosting
09/11/02	ClearBlue Technologies, Inc.	Application hosting	NaviSite, Inc. (79% of equity)	Application hosting
06/17/02	Electronic Data Systems	Systems management	Loudcloud, Inc., Managed Hosting	Application hosting
06/07/02	ClearBlue Technologies, Inc.	Application hosting	AppliedTheory assets	Application hosting
05/30/02	Avasta, Inc.	MSP	SiteROCK Corporation	MSP
04/17/02	Washington Capital Partners	Private equity	ServerVault	Application hosting
03/20/02	Paradigm Technology Partners	MSP	Esavio	MSP
02/06/02	Infocrossing, Inc.	MSP	AmQUEST, Inc.	MSP
01/22/02	SevenSpace Inc	MSP	Nuclio Corp	MSP
01/07/02	Bain Capital, Inc.	Private equity	USinternetworking, Inc.	Application hosting
09/06/01	SevenSpace Inc	MSP	StrataSource	MSP

added resellers (VARs), systems integrators and web hosters are also looking to enter the MSP space. Mirus believes that only a few leading independent MSPs will survive and that most of the opportunity will be captured by larger, more diversified IT players that provide management services as part of their offering.

### Consolidation is just starting to take off

Rapid consolidation of the MSP space has been predicted ever since MSPs emerged several years ago. In fact, by some estimates the MSP industry should already have been reduced to a handful of larger players. However, consolidation has not taken off as quickly as expected. Only a half dozen acquisitions of MSPs hit the radar screens in the last 18 months. Table 1 provides an overview of these key MSP mergers and also includes a selection of prominent acquisitions of application hosting providers over the same period.

- Outside players are entering the MSP space through acquisitions. The most notable example is ClearBlue Atlantic, which through acquisitions and restructurings combined application hosting with MSP services. In recent conversations with hosting providers, IT outsourcers, integrators and value added resellers, Mirus is seeing an interest from these types of companies in entering the MSP market and therefore believes this is the beginning of a broader trend.

Another important force shaping the industry in addition to M&A activity has been the fall-out among existing MSPs. Some players exited the MSP business and reinvented themselves using a different business model, such as LoudCloud and SilverBack. Others simply ran out of money and went out of business, such as AppGenesys, Intira, Logictier, iSharp and ManageIT.

Although M&A and fall-out have reduced the number of MSP players, several dozen independent MSPs still exist. Consolidation has only just begun.

### **MSP market fundamentals are attractive**

Despite fall-out in the industry, the fundamentals for the MSP space are attractive. Outsourcing IT infrastructure management tasks to a specialized player yields significant cost savings, which are attractive when IT budgets are drastically cut. Another benefit that is particularly compelling for middle-market companies is the access that MSPs provide to skilled IT staff and expertise, which would otherwise be difficult and expensive to develop and maintain in-house.

Customers are becoming increasingly aware of these benefits of MSPs and are proving receptive to the outsourced IT management value proposition. According to Meta Group, 70% of the executives surveyed in 2002 recognized MSPs as an available tool for proactive management of their IT infrastructure, compared to 20% in 2001. Correspondingly, most analysts have rosy forecasts for the size of the MSP market, ranging from \$3.2 billion by 2005 (Gartner) to \$10 billion by 2004 (META).

The case for MSPs is further strengthened by the failure of narrower Network and Systems Management (NSM) tools to deliver on the promise of simplified and cost-effective IT management and out-of-the-box functionality. Gartner Group estimates that 70 percent of internal NSM implementations have failed outright or never delivered the expected benefits and value. The outsourced infrastructure management services provided by MSPs provide a more integrated alternative to in-house NSM implementations.

### **Size and scalability are key**

Despite the attractive fundamentals, most MSPs will not be able to survive independently. The investments and fixed costs involved in running an MSP are sizable and require substantial scale for profitability. The need for sufficient size is emphasized by the fact that customers are looking for a credible and reliable provider. Sub-critical size easily turns into a downward spiral, where poor business economics and financial instability impair the ability to attract new customers, and vice versa.

However, size alone is not sufficient. A requirement for any long-term viable MSP is an operating model that scales well. Only if new customers can be served at minimal incremental cost can an MSP grow to profitability. Two key ingredients for such profitable scalability are a high degree of automation and standardization of business processes.

Automation is particularly important for the IT monitoring function of an MSP. Event correlation methods cluster events from different sources within the IT infrastructure and filter out only relevant events that require intervention. In this way, IT personnel can be

used efficiently to resolve relevant and meaningful events, allowing a limited amount of staff to service a large customer base. Standardization of business processes is important for scalability to minimize time-consuming ad-hoc solutions and to safeguard service quality at greater size. In response to the need for industry best-practice processes, the IT Infrastructure Library (ITIL) will continue to emerge as an important standard for IT infrastructure management processes.

### **Consolidation will continue**

In industries with more than a handful of players, consolidation is often predicted. However, many industries have remained highly fragmented, with new companies entering the industry outweighing fall-out and M&A activity. For example, strong consolidation of the ISP industry has been predicted for a long time, but the number of ISPs has steadily grown since 1990 (see Exhibit 2). The survival of fragmented industries is to a large extent driven by the underlying economics. In such industries, lower start-up costs and limited economies of scale allow new players to more easily enter and survive.

#### **Exhibit 2: The ISP industry is an example of a highly fragmented industry that has not consolidated as expected by industry observers**

When there were only 200 ISPs: *April 9, 1996* "a major shake-out over the next few years will result in about 200 ISPs by 2000"

Over 3200 ISPs: *November 11, 1997* "Internet service providers are consolidating fast, and most industry players expect the trend to continue until the field has been narrowed to a handful of players"

Up to 6000+ ISPs: *February 26, 1999* "ISP consolidation is well under way, and is expected to continue until the field narrows to a handful of players. Once dominated by small 'mom-and-pop' ISPs, those players are now overshadowed by large players"

More than 8000 ISPs: *January 2003* "..."

Source: XSPsite.net

However, the MSP industry is an example of an industry where further consolidation seems inevitable. Start-up costs to establish a management services platform run in the tens of millions of dollars and MSPs require significant size to ever be profitable. Smaller players will not be able to survive independently and new entrants will have a very hard time reaching a size sufficient to earn back the initial investment.

## M&A activity will drive further consolidation

Struggling MSPs may also be able to find another MSP in a similar position and merge operations. Such mergers typically require drastic cost cutting and/or additional financing to benefit from the combined scale. Another option is acquisition by a financially stronger MSP that intends to build scale through a roll-up strategy.

Players outside the MSP space will be another source of industry consolidation. For example, application hosting providers are entering the MSP space, as illustrated earlier by ClearBlue's acquisition of Avasta. The logic for such acquisitions is that customers, reluctant to outsource their entire IT infrastructure, are more susceptible to management services that leave them in control of their critical IT assets. NaviSite product manager Sidney Kuo commented to theWHIR.com: "I think you're going to see more and more [managed hosting] players getting into this [MSP] space. We're definitely seeing higher demands right now [for MSP services] than ever before." Other managed hosting providers may follow, using acquisitions as a tool to enter the MSP space.

During recent conversations, Mirus is seeing interest in MSPs from web hosting providers, IT outsourcers, systems integrators and Value Added Resellers (VARs). For all these types of players, the key reasons to target the MSP market are the opportunity to deepen customer relationships and the prospect of earning high-margin annuity profit streams generated by MSP services. Particularly the larger, more diversified players seek to cherry-pick the remaining independent MSPs for acquisition and leverage their

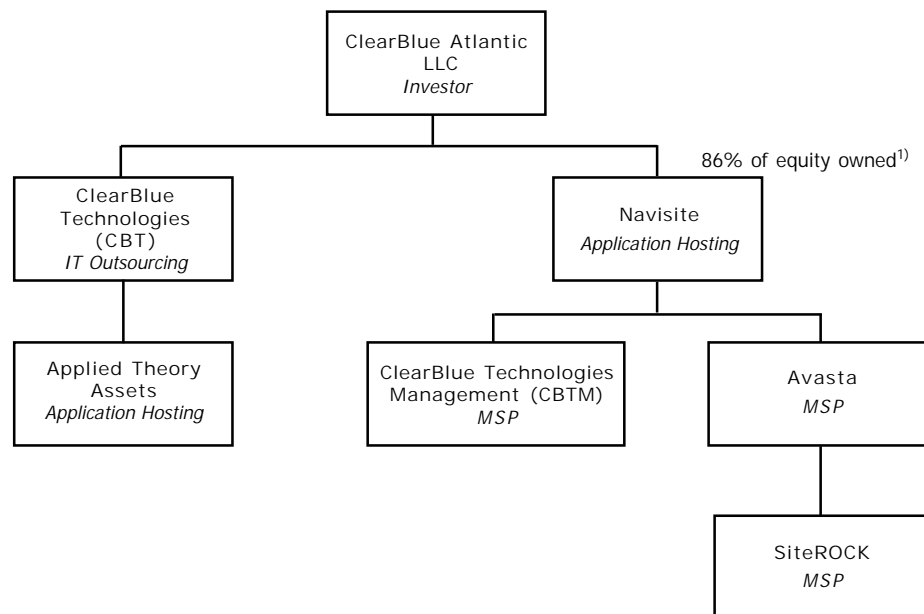
platforms to serve a larger customer base. Mirus believes that these larger players will be in a prime position to capture a major portion of the MSP market opportunity.

An alternative to selling the entire company is selling only the customer base. This type of transaction has already been seen in the managed hosting space with, for example, Inflow buying Interliant customer contracts. There are also examples of IT service companies buying customers from VARs. These customer base acquisitions provide the buyer with the advantage of increased scale, without the need for cumbersome integration and cost cutting efforts.

## Conclusion

Mirus believes that the management service provider space has attractive fundamentals. Industry consolidations has only just begun and is likely to continue due to the need for critical scale to survive. To date, consolidation has been driven by fall-out among existing MSP players, but the industry will be increasingly shaped by continued M&A activity. Going forward, smaller MSPs will merger or acquire to build scale, while various larger IT players such as web hosting providers, IT outsourcers, integrators and value added resellers will cherry-pick acquisition targets to build an MSP offering. Mirus believes that only one or two MSPs will survive independently, with larger IT players capturing most of the MSP opportunity.

### Appendix: ClearBlue Atlantic combined MSPs and application hosting providers through M&A



1) ClearBlue Technologies (CBT) acquired a majority stake in Navisite on 9/11/02. In a financial restructuring of NaviSite announced December 13, 2002 CBT transferred its stake in NaviSite to its shareholder ClearBlue Atlantic.

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