Summary: Outsourced Customer Care M&A Report

By Baird Investment Banking

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Industry Overview

The **Outsourced Customer Care** industry is one of the key "back-office" business processing segments benefiting from companies' increased willingness to outsource non-core services related to their underlying business. Baird believes that the continued evolution and increased sophistication of the industry will drive above-average growth, benefiting both industry participants and their end-users.

There are varying estimates on the size of this sector depending on how it is defined and which services are included. Overall, the global contact center market is estimated to be approximately $300 billion as of 2006 and is expected to reach $400 billion by 2011. However, the portion of the industry that is outsourced is expected to grow much more rapidly, from $58 billion in 2006 to $105 billion by 2011, an annual increase in excess of 12 percent. At these growth rates, outsourcing would represent just over 26 percent of the total market, up from 20 percent today. The industry remains very fragmented and is in the early stages of a significant consolidation wave which will result in long-term fundamental changes to the competitive and operating environment. This activity was especially evident in 2006, which experienced a total of 132 global transactions, a 63 percent increase over the total for 2005. In fact, the total number of global transactions in each of the past four years has exceeded the ten-year average of 66 transactions per year.

Industry performance continues to rebound from a significant downturn in the early 2000s, resulting from a series of negative events that impacted revenues and margins. These factors included:

- Overcapacity resulting from aggressive center openings during the late 1990s;
- Overall global economic weakness and "bursting" of the stock market bubble, which severely impacted many sectors, including the technology and telecom sectors, which are heavy users of outsourced customer care services;
- Reduced outbound call activity resulting from "Do-Not-Call" legislation;
- The initial effects of the switch to offshore locations, which carry lower billing rates relative to domestic locations and initial start-up inefficiencies;
- Loss of business due to mergers by customers in industries with high customer concentration.

This overcapacity and slower market growth led to significant pricing pressure and longer selling cycles, further reducing industry profitability. In addition, many basic services were viewed as commodity services, adding additional pressure to margins. During this time, a number of weaker industry participants exited the market and many firms underwent major restructurings, with numerous facilities sold or closed.

Beginning in mid-2003, the operating trends began to rebound, contributing to improved revenue growth and increased profitability. Driving this recovery has been:

- Improved economic conditions, particularly a low unemployment rate, which makes it more difficult to recruit employees for in-house facilities;
- The rebound in the technology and telecom markets, as well as the development of new customer care verticals such as healthcare and government;
- Continued growth in offshore business has increased utilization and efficiencies, eliminating the drag on margins;

- Improved technology; and
- Improved pricing.

Key Industry Trends

Outsourcing of In-House Functions – The primary industry growth driver will be the continued migration of services performed by in-house personnel to outsourced providers. Increasingly, businesses are focusing on core competencies as competitive forces are driving firms to reduce non-essential expenditures and improve operating efficiencies, resulting in increased demand for outsourced services. We believe that customer care services outsourcing is also benefiting from increased awareness by senior management of both the benefits associated with outsourcing as well as the growing importance of customer service. Some of the primary reasons companies outsource include:

- **Improved Organizational Focus and Structure** – Eliminating the need to manage non-core functions allows management to focus on core business operations, free up resources, and better utilize existing assets.
- **Higher Quality at Reduced Costs** – The outsourcing of customer care services typically offers the client company best-in-class services and technology at reduced costs.
- **Specialization** – Outsourced service providers have specialized expertise in their field, which would be extremely difficult, costly, and inefficient for an in-house department to replicate.
- **Scalability and Flexibility** – Outsourcing allows a company the ability to better match resources with demand. Using an outsourced provider allows a company to provide maximum staffing coverage to coincide with peak periods of demand without the need to maintain a full staff during slower periods.

Shift to Offshore Locations – The primary appeal of offshore locations is the significantly lower labor costs coupled with a highly-skilled applicant pool. Rapid improvements in technology and the telecommunications infrastructure have opened up significant new opportunities to locate facilities in emerging markets offshore, taking advantage of substantially lower labor costs with access to a large and educated pool of potential employees. Offshore facilities provide clients hourly rates that are about half of those in the U.S. This offshore shift gained momentum in the early 2000s when industry leaders such as Dell and General Electric moved their contact centers offshore. Other companies quickly followed suit, amplifying the offshore movement by both captive and outsourced providers. Much of the initial movement was into India, which today remains the largest offshore market. However, a number of new markets have emerged, such as the Philippines and Costa Rica, backed by significant government investments and initiatives designed to attract foreign investment. Over the next several years, we expect this offshore trend to continue, with offshore locations adding capacity at the expense of the U.S. market.

Use of At-Home Agents – Significant advances in technology, specifically the increased use of VoIP (Voice over-Internet Protocol), are driving rapid growth in "home-shoring," or the virtual call center. Technology allows calls to be routed outside of a centralized location to employees working in smaller centers and individual agents working out of their own homes. These home-based agents are often referred to as virtual agents or on-demand agents. The numerous benefits of this operating model are expected to drive even faster growth over the next several years

Globalization – Although the customer care industry is generally viewed as local or regional, an increasing number of industry participants are expanding globally and we expect this trend to continue. This is being driven by industry participants' desire to use a mix of on-shore, near-shore, and offshore facilities in order to provide continuous, around the clock coverage to clients around the world. For example, SITEL operates in 28 countries worldwide; Convergys operates in 70 countries and Teleperformance in 42 countries. This global expansion has driven a significant amount of acquisitions as companies look to add new foreign locations and often find it more efficient to acquire existing, local firms rather than build new facilities from scratch. This trend includes many non-U.S. firms acquiring U.S. companies to gain added vertical expertise and geographic breadth, such as the acquisitions of Phase2 Solutions by eTelecare (Philippines) and Affina by Hinduja TMT Ltd. (India).

Impact of Technology – Over the past several years, new technology has radically transformed the industry by changing the way services are delivered, increasing operating efficiencies, lowering costs, and improving the customer experience. The offshore trend would not have been possible without the technology to cost-effectively route calls globally. This trend favors larger companies which are able to make the necessary on-going investment in new technologies required by the large corporate customers. These technologies allow companies to not only reduce operating costs but also offer the end-user a wider variety of delivery options.

Consolidation Drivers

There are a variety of factors driving the trend of M&A in outsourced customer care. The key drivers that Baird has observed include:

Highly Fragmented Market – The combination of historically low barriers to entry and rapid market growth has resulted in an extremely fragmented market with thousands of global competitors. However, the majority of these companies are small, private firms with a narrow focus and limited financial resources. Most of the companies lack the capital, resources, and technology necessary to remain competitive as corporate customers demand more sophisticated capabilities and broader service offerings at lower costs. While many of these companies may ultimately survive, it will become more difficult for them to succeed without the scale and capabilities that can be achieved by being part of a larger, more diversified entity.

Broaden Service Offerings and Expertise – Many industry participants are using acquisitions to build out their capabilities and offer a broader array of services. Existing market trends dictate that customers prefer fewer vendors and companies are responding by adding additional services to provide "one-stop shopping." As a result, there has been significant M&A activity in the industry as firms look to build out these capabilities. These acquisitions include: (1) transactions which add complementary services to existing capabilities; (2) completely new services necessary to further penetrate existing customers; and (3) entry into new categories which offer better growth opportunities and higher margins.

Improve Economies of Scale – The ability to leverage overhead and operating expenses enables larger firms to generate greater margins and profitability. As a result, many acquisitions are driven by the ability to eliminate duplicative and/or inefficient overhead operations at the target company and spread fixed costs over a larger base. One key measure is agent utilization and an acquisition typically increases this measure, particularly with offshore locations.

Geographic Expansion And Diversification – A number of factors are contributing to an increased amount of cross-border transaction activity. The ability to attract large national and international accounts requires a broad international footprint. Numerous offshore acquisitions have been made by U.S. and European companies looking to establish and/or expand operations in low-cost markets such as India and the Philippines. Latin America and Eastern Europe are increasingly popular as delivery locations given their large domestic markets.

Target New End-Markets and Customers / Mitigate Customer Concentration – Many outsourcing providers are highly dependent on a limited number of large companies in a few industry verticals. Customer concentration results from either: 1) an outsourcing company that is spun-off from a parent and retains a substantial amount of business with the parent company; or 2) industry expertise coupled with rapid volume growth can leading to multiple programs and high volume with one or two companies in an industry. This concentration is a major concern for investors and an execution burden for industry participants. Companies are also targeting new end-markets such as the healthcare, utilities, and government sectors which offer above-average growth prospects and potentially higher margins. Acquisitions can help reduce such customer concentration levels and also establish an immediate presence in new markets.

Corporations Continuing to Divest Non-core Assets – Corporate divestitures have been a major component of recent M&A activity globally, and there has been a significant amount of this activity in the outsourced customer care sector. In fact, some of the largest and most successful customer care firms started out as subsidiaries of larger firms. Citigroup has been in the news recently announcing that it is considering various options for its BPO unit, Citigroup Global Services. We expect additional divestiture activity as companies continue to fine-tune their operating strategies and focus on their core business. These divestitures will most likely involve captive facilities, as most are not profitable, have limited growth prospects, and are generally run less efficiently as part of a larger corporate organization.

M&A Activity

M&A activity in the Outsourced Customer Care industry is showing signs of accelerating due to positive fundamentals and growing interest in the industry. There has been a particular growing interest in the industry by private equity firms, which are attracted to the high level of industry fragmentation and subsequent consolidation opportunities, the global scope of business, attractive long-term industry growth potential and favorable business models with long-term customer relationships. Equally important, there are attractive exit opportunities, consisting of other private equity firms, active public and private company consolidators, and growing public market interest in the sector, affording the opportunity for an initial public offering.

Strategic buyers, primarily those that are publicly-traded, have also been more active, benefiting from the improved industry fundamentals, resulting in increased profitability and higher stock prices.

On a global basis, Baird identified 704 transactions from 1996 through April 30, 2007, with a disclosed value of more than $34 billion. We believe that the actual number of transactions is significantly higher than reported due to the fact that the assigned North American Industry Classification System (NAICS) codes do not capture all industry participants, the fact that many small or private-company transactions are not reported, and the lack of a clearly-defined industry. Activity by number of deals has increased significantly over the past few years and 2006 was the most active year to date with 132 global transactions. Transaction dollar volume also reached a high in 2006, driven by a number of large deals including the take-private transactions of West Corp. for $4.1 billion and NCO Group for $1.2 billion.

For U.S. M&A activity in this sector, we identified a total of 389 transactions over the same period. Again, we believe that the actual number is likely much higher since a large number of small transactions are not reported to data providers. Last year was the most active, with a total of 66 transactions. Aggregate value has fluctuated more as a result of the year-to-year changes in median transaction size and the variability of financial disclosure. Those transactions with disclosed financial terms (39.8 percent of the total) aggregated $30.5 billion in value.

Public Company Analysis

Over the past one-, three-, and five-year periods through June 30, 2007, the stock prices of Outsourced Customer Care and BPO companies have performed well and significantly outperformed the overall market as defined by the S&P 500 Index and NASDAQ Composite index over the longer time periods. During the 12-month period ending June 30, 2007, Baird's index of companies increased 19.8 percent, in line with both the S&P 500 Index and the NASDAQ. Over the three- and five-year periods, the gains were more impressive. For the three years ending June 30, 2007, the index nearly doubled, rising 80.2 percent compared to gains of 31.8 percent and 27.1 percent for the S&P 500 and NASDAQ Index respectively. For the five-year period, the index again substantially outperformed the overall market indexes, rising 103.3 percent. This positive performance reflects growing investor enthusiasm and awareness regarding the current industry dynamics and long-term growth potential.

Baird believes that this strong performance has contributed to a rebound in equity offerings for the group. IPO activity is currently the strongest it has been since 1996. Existing public companies are also taking advantage of this market strength. During the past 12 months, there have been six IPO or follow-on offerings, raising almost $700 million. This level of activity has not been seen since the mid-1990s.

Conclusion

Although the lack of clearly-defined industry parameters results in limited research coverage, Baird believes that the growing enthusiasm for the Outsourced Customer Care sector will result in increased investor interest, thereby leading to continued above-average market performance. This higher level of equity valuations should also act to accelerate the ongoing consolidation. Overall, Baird expects that M&A activity in this sector will remain strong as companies continue to strive for maximum efficiency and profitability.

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To request a complete copy of Baird's "Outsourced Customer Care M&A" report, contact Karen Seaman at MacMillan Communications, karen@macmillancom.com, (212)473-4442.