

UK TMT: Staying smart in a downturn



A report prepared by CFO Europe Research Services in collaboration with BDO Stoy Hayward

UK TMT: *Staying smart in a downturn* is published by CFO Europe Research Services, 25 St. James's Street, London, SW1A 1HG, UK. Please direct any enquiries to Emily Williamson on +44 (0)20 7830 7000 or at emilywilliamson@cfoeurope.com. CFO Europe Research Services is part of CFO Publishing Corporation, which produces *CFO Europe* magazine and *CFO* in the United States. CFO Publishing is part of The Economist Group.

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Sponsor's foreword

We are delighted to share with you the insights from our latest survey, which examines the risks and opportunities of the downturn for the Technology, Media and Telecoms (TMT) sector. It has been fascinating to be able to see how the views of the sector have changed in comparison to this time last year.

There is no doubt that the environment is far tougher now than it was a year ago – many more companies are forecasting a decline in revenues in 2009. But the situation is not terminal – strong growth is still forecast in the medium term.

Interestingly, there has been a significant change in how TMT businesses plan to grow. We are expecting to see an increase in strategic partnerships, with more businesses willing to collaborate in order to succeed. Last year, growth was all about acquisition, but a year on, innovation is the preferred route, combined with stretching existing products and services into new markets.

To fuel this innovation-led growth, TMT businesses are planning to maintain their investment in research and development. However, the number of TMT businesses that feel they have access to

the funding they need to operate effectively has fallen dramatically. As the economic environment remains tough over the coming months, the tension between the need to maintain investment and the scarcity of external funding will become increasingly critical.

If this situation continues, there is a real risk that investment in research and development, the lifeblood of many TMT businesses, will dry up, stalling UK innovation.

On a positive note, three-year growth projections are broadly in line with those set out in last year's survey – TMT continues to benefit from a healthy level of self-confidence and optimism.

I would like to thank all those who gave their time to provide us with their valuable insight into their strategies, ambitions and fears. We hope you enjoy the report.

Julian Frost
Partner, Head of TMT
julian.frost@bdo.co.uk
+44 (0)20 7893 2350

Executive summary

There is a surprising amount of optimism in the Technology, Media and Telecoms (TMT) sector, in spite of the challenges of doing business during the downturn. TMT companies are trying to protect themselves against inevitable threats - falling customer demand, increasing competition and shrinking credit availability. In doing so, they aren't fixating on short-term reactive measures, such as selling assets, outsourcing, or cutting back on R&D spending, and they have also turned away from their former inclination for M&A. Their focus now is on innovation, tapping into new markets and strategic partnering. Indeed, the majority of respondents are confident of meeting their longer-term growth targets. Here are the key findings:

Innovation and strategic partnerships have replaced acquisition as top growth strategies

Innovation has emerged as the main growth strategy among UK TMT companies. 31% say this is their top strategy for growth, compared with a mere 5% a year ago. This could also explain why 80% of respondents don't plan to cut R&D spending. The rise of innovation as a favoured choice of growth strategy reflects current market realities, in which merger and acquisition activity has been severely curtailed by a lack of funding. In keeping with this, UK TMT companies' appetite for M&A has lessened considerably since our previous research. At the same time, strategic partnerships are looking a lot more likely: 15% of respondents cite partnerships as their top three-year growth strategy, compared with just 5% at the end of 2007. Recent high-profile examples reflect this trend.

Slim growth in the next year, but three-year growth targets remain unchanged

The recession is carrying a sting for TMT companies, but in their view, it's a short-term one. 40% of respondents forecast 0-5% growth in the

>About this report

In January 2009, CFO Europe Research Services, a unit of CFO Publishing and part of The Economist Group, began a research project with BDO Stoy Hayward, the UK member firm of BDO International.

This report is based on the results of an online survey completed by 78 UK-based senior executives working in the Technology, Media and Telecommunications (TMT) sector. We asked about companies' growth strategies, access to capital, and the impact of the economic downturn. In this report, we compare the most recent findings with those from a similar survey conducted at the end of 2007, the results of which were published in a report entitled "Delivering fast-growth strategies in challenging times" in April 2008.

CFO Europe Research Services and BDO Stoy Hayward developed the scope of the research jointly. BDO Stoy Hayward funded the research and the publication of our findings, and we would like to thank their team for its insight and support. At CFO Europe Research Services, Emily Williamson managed the project and wrote the report.

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coming year, while 16% forecast negative growth. The three-year outlook, however, looks more positive, and is largely in line with the results of the December 2007 survey, with around three-quarters of respondents forecasting annual revenue growth of up to 20% in the next three years, and around a quarter forecasting growth of over 20%. The confidence in longer term growth reflects a belief that innovation strategies and R&D spending will succeed in driving profits in 2010 and beyond.

CFOs are less optimistic about hitting their targets

Although nearly two-thirds of respondents are confident that their companies can meet their revenue growth targets for the next three years, this is still an 18 percentage point drop from the

81% who said the same at the end of 2007. The survey results suggest that this drop stems from external market woes due to recession, rather than matters internal to the finance organisation. Indeed, nearly three-quarters of all respondents are confident that their finance departments have the staff, resources and skills they need to support the company's growth ambitions.

The worldwide economy is the most important macro-trend facing TMT companies in the next three years

32% of respondents cite the worldwide economy as the most important macro-trend facing their companies in the next three years. More specifically, respondents cite falling customer demand, the availability of credit and customers extending or defaulting on credit terms – typical downturn-type threats – as the main risks to their companies' revenue growth targets. If TMT companies were going to take one-time reactive measures in response to these threats, most have already acted. The numbers of respondents

whose companies are planning to make cutbacks or restructure are low in comparison to the numbers of those who have either already initiated such changes, or who don't plan to. Instead, TMT companies will look to counter the threats to growth with proactive strategies – innovation, expansion into new market segments and new countries, as well as strategic partnerships.

TMT executives find accessing capital harder now than about a year ago

Accessing finance has become a lot more difficult. 38% of respondents are finding accessing capital easy, and 31% are finding it difficult. This compares unfavourably with last year's survey, when 72% said it was easy to get access to the funding they need, and only 13% said that it was difficult. It could also explain why some respondents appear to have already amassed the funds they need to see them through the worst – a quarter have no plans to raise any more capital in the next three years, compared with 10% who said the same in the 2007 survey.

From acquisition to innovation and strategic partnering

At the end of 2007, TMT companies were banking on acquisition to fulfil their growth plans, with 60% of respondents reporting that acquisition was their number one growth strategy during the next three years. Now, this appetite for M&A is limited, with only 12% of respondents saying their companies are planning acquisition as a long-term growth strategy. (See chart 1.)

No doubt the current recession has made raising credit for M&A an unrealistic prospect. As one media sector respondent to the recent survey pointed out, “there is extreme difficulty in executing M&A, other than through private mergers, [which] will reduce growth opportunities.”

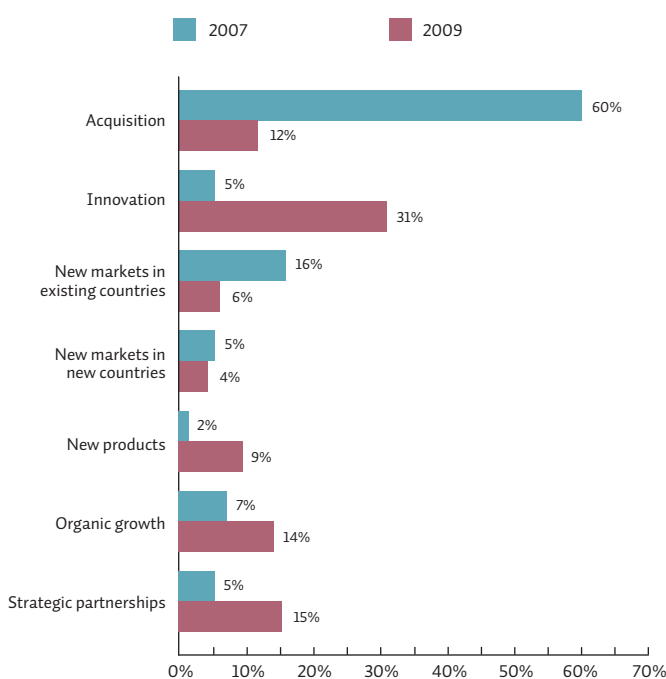
Certainly, consolidation has become much less of a driving force in the industry. In the 2007 survey, nearly two-thirds of respondents cited sector consolidation as the most important macro-trend

facing their company in the next three years; only 6% say the same about industry consolidation in the latest survey. All eyes are now focused on the perilous state of the global economy, which is seen to be the most important macro-trend facing companies in the next three years, followed by competition in domestic markets, industry consolidation and technological advances. (See chart 2.)

With M&A looking unlikely against the backdrop of recession and with competition intensifying, how are TMT companies looking to grow? Well, 31% of respondents say that innovation is their companies’ top growth strategy; a result that stands in stark contrast to 5% who said the same in the 2007 survey. Rapid innovation has always been a viable option for the TMT industry and, of late, one of its shining stars has been the development of affordable mobile wireless internet that is available via PCs. The development of wireless internet is also responsible for the rapid evolution of the Smartphone: the launch of the application-heavy iPhone and the Blackberry Bold, for example, means that Smartphones are no longer the reserve of the businessman and are quickly becoming a consumer commodity. According to Oliver Wyman’s 2009 “State of the Industry” report for the communications, media and technology sectors, shipments of Smartphones grew from 16m in 2004 to 120m in 2008.

Another notable difference between the 2009 and 2007 surveys is a stronger leaning towards strategic partnerships. 15% of respondents cite this as their top growth strategy for the next three years, compared with 5% at the end of 2007. (See chart 1.) When capital is in short supply, collaborating and sharing assets with rivals and equals alike is a good battle tactic, and there have been some recent high-profile examples of this. In March this year, for instance, former arch rival mobile phone network providers Vodafone and Telefónica, the owner of O2, announced a plan to share their network infrastructure in Germany, Spain, Ireland and the UK to generate hundreds of millions of pounds in cost savings over the next

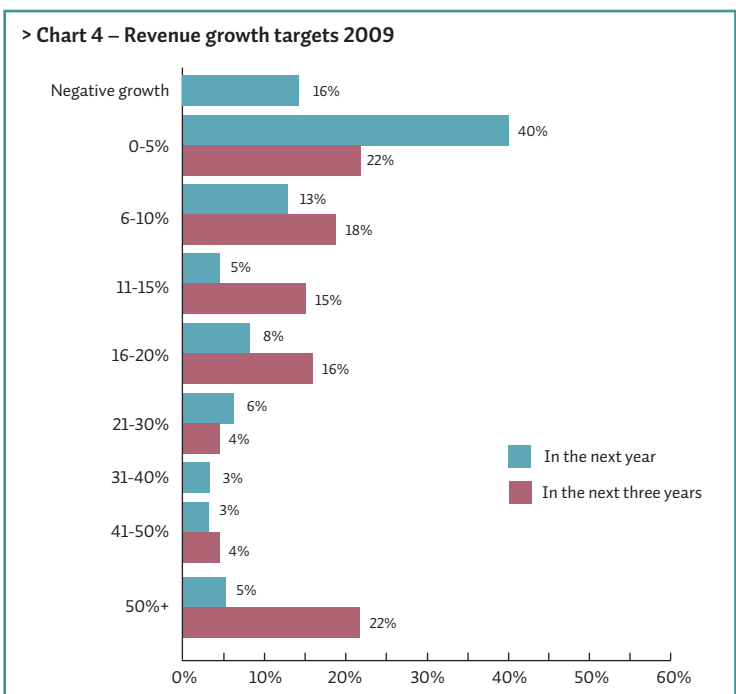
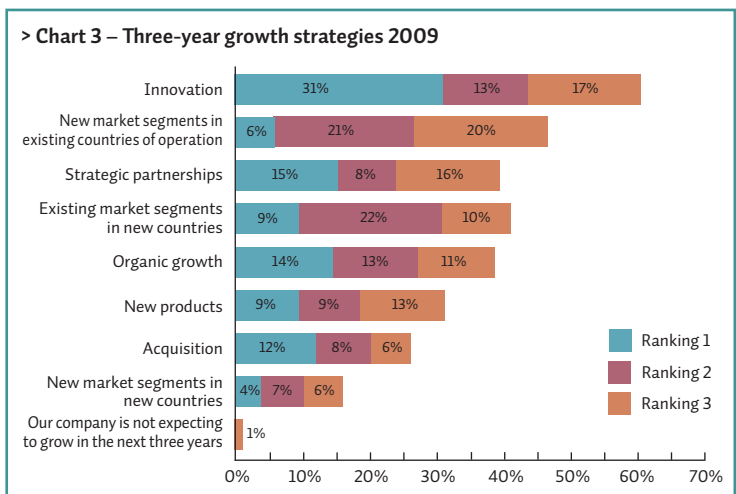
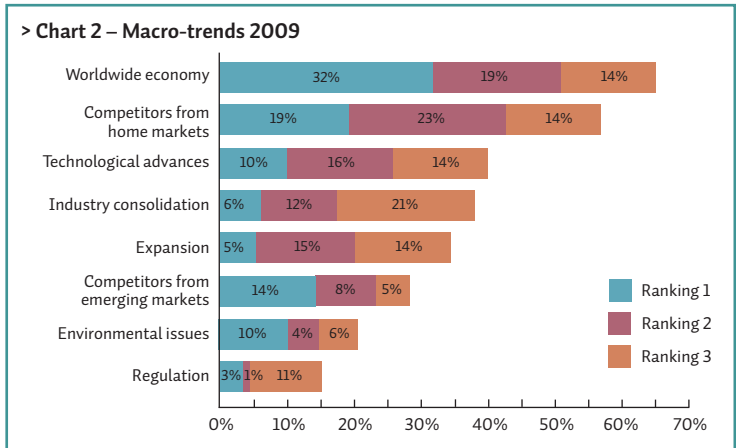
> Chart 1 – Top three-year growth strategies: 2007 versus 2009



ten years. The companies will still compete for customers whom they will continue to manage independently; nevertheless, partnership on such a grand scale would have seemed highly improbable before the economic downturn.

Partnerships between non-rivals are a sensible move for taking on the might of the competition, which is the second important macro-trend facing UK TMT companies in the next three years. In February this year, for example, Google and Vodafone teamed up to challenge the dominance of Apple's iPhone in the European Smartphone market with the launch of HTC Magic. The Magic handset, which features a touch-screen, camera, GPS and Wi-Fi, was developed by the Taiwanese HTC Corporation. It uses Google's Android operating system and will be exclusively available on the Vodafone network.

TMT companies will also look to tap into new market segments as well as new countries. (See chart 3.) For those planning to grow the business by entering new markets in new countries, Western Europe is the most popular choice. This makes sense in light of the fact that more respondents see competition coming from home rather than emerging markets. (See chart 2.) New markets and new countries were ranked second and third in a list of preferred growth strategies in the 2007 survey, but whereas that seemed likely to happen via mergers and acquisitions, this time, TMT companies are banking on innovative products and strategic tie-ups.



Growth, expectations and risks

Most companies' revenue expectations for the year ahead are modest at best. The majority of respondents forecast 0-5% growth in the next year, while another 16% forecast negative growth. (See chart 4.)

Expectations for revenue growth over the next three years are more mixed, with 22% forecasting slim growth of 0-5% and another 22% forecasting massive growth of 50% and over. Respondents' comments reflect this view of mixed fortunes ahead, with some about to seize on new opportunities and others seeming bogged down in difficulties. For example, one finance executive in the technology sector says that the trading environment is "tougher than I can ever recall," adding that "2009 will be make or break for a lot of companies in our sector." Another respondent reports that "the opportunities are fewer but still very good, provided... the project finances [can be found]." And the finance chief of one software company said the current market conditions "provide diverse opportunities that we did not experience before."

Meanwhile, in telecoms, one respondent claims that there is still sufficient customer demand despite the downturn, while another counters that customers are now "cautious about investing in long-term projects," making "forecasting and planning very

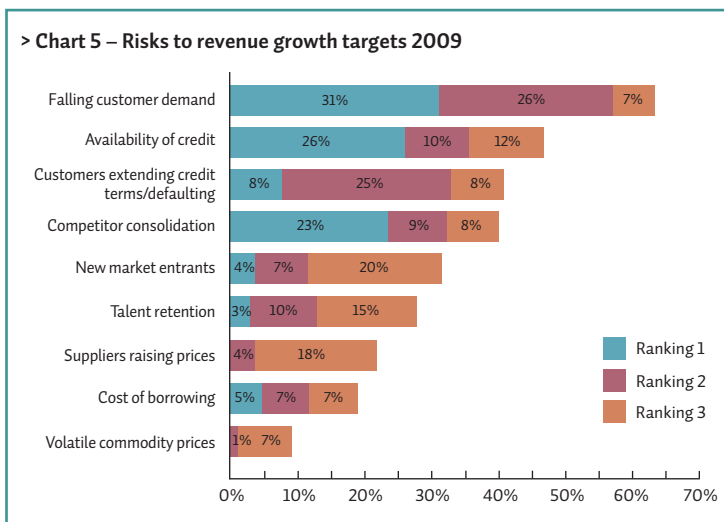
difficult." The mixed messages continue in the media sector, where some respondents complain that new client wins are taking longer to sign off, while others see a golden opportunity to take customers from failing competitors.

A broader view of the three-year growth target projections show them to be in line with those of the 2007 survey. Around three-quarters of 2007 and 2009 respondents forecast annual revenue growth of 0-20% in the next three years, and around a quarter forecast growth of 21-50%. The degree to which respondents feel that the credit crunch has harmed their companies' abilities to fulfil strategies for growth has similarly stayed the same - 64% this year versus 68% at the end of 2007. However, the worldwide economy now ranks as the most important macro-trend facing TMT companies in the next three years, and in keeping with this, respondents report that the top risks to their companies' revenue growth targets are falling customer demand, availability of credit and customers defaulting on credit terms. (See chart 5.)

The bleak economic situation and its repercussions for doing business have made the idea of an exit strategy less likely – for the next 1-2 years at least. Only 6% of respondents say that an exit strategy is part of their business plans in the next 1-2 years, compared with 20% who said the same in the 2007 survey.

Are TMT CFOs feeling confident of their ability to fulfil their growth expectations in spite of the challenges they are facing? The levels of confidence in revenue generation have certainly dropped since the end of 2007, but, in view of the severity of the crisis, are still fairly high: 63% of those surveyed in 2009 are confident that their companies can meet their revenue growth targets for the next three years, a 20 percentage point drop from the 81% who said the same in the 2007 survey. Internally, however, CFOs are as confident as ever. Nearly three-quarters of them are confident that their finance department has the staff, resources and skills needed to support the company's growth ambitions – 71% compared with 78% in 2007.

> Chart 5 – Risks to revenue growth targets 2009



Planning for the future

Unsurprisingly, TMT companies are finding it much harder to raise capital now than they were at the end of 2007, and just over a quarter of respondents cite the availability of credit as one of the top risks to their companies' growth strategies. (See chart 5.) While 38% of respondents say that it is proving easy to get the funding that they need to operate effectively, 31% say they are finding it difficult. This compares unfavourably with 2007's survey, when 72% said that it was easy to get access to the funding they needed, and only 13% said that it was difficult. (See chart 6.)

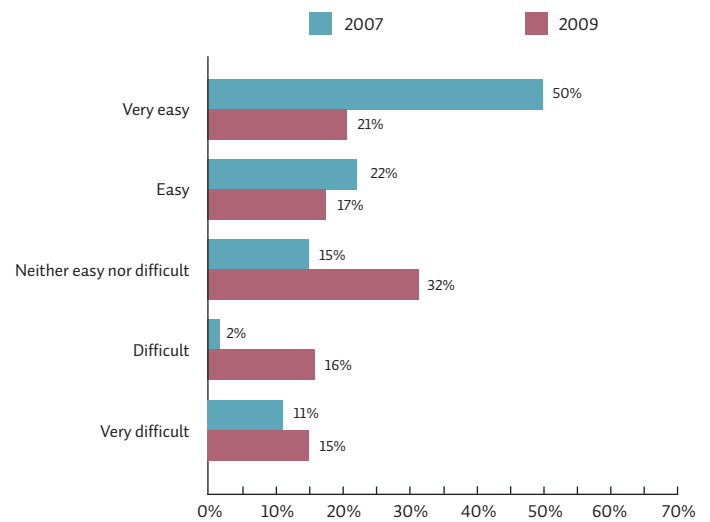
Respondents at companies that are finding it difficult to access funds at the moment report that there is "virtually no availability of equity financing," while debt is "only available at prohibitive cost [and] on unrealistic terms." Others say that alternative sources of private funding are also drying up: "[Venture capital] funding has dropped off significantly", and "Valuations render funding extremely expensive, with high risk of large dilution and loss of control."

It is clear that the capital markets have all but dried up: only 1% of respondents plan to try the markets for capital in the next three years, compared with 18% at the end of 2007. Investment banks are another closed avenue, with 1% planning to take this route, compared with 21% of respondents in our previous survey. (See chart 7.)

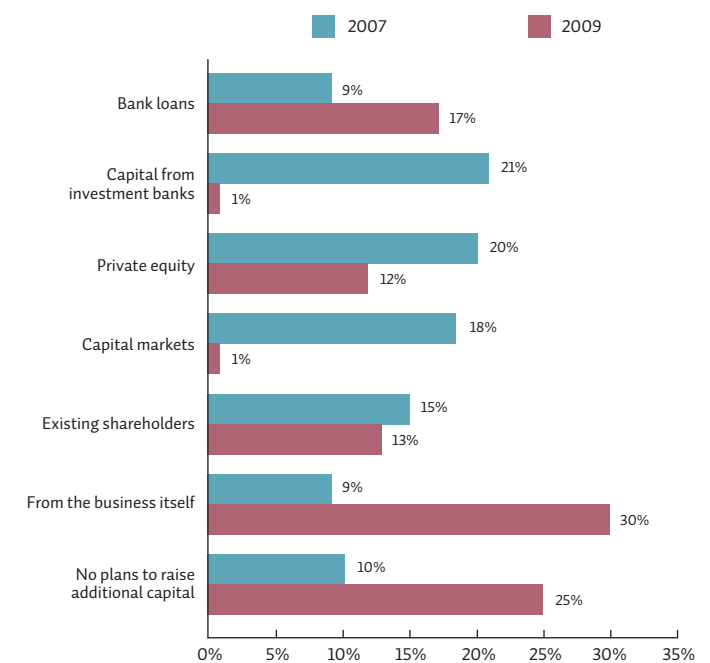
However, it seems that some companies are already prepared for the shortage of capital, and have amassed the funding they need to see them through the worst. A quarter of respondents say that their companies have no plans to raise additional capital in the next three years, compared with 10% who said the same at the end of 2007. Another 30% plan only to free up capital from within the business itself (compared with just 9% last time) although even this is not ideal for some: "We require access to bank debt

on an ongoing basis and at acceptable cost," says a respondent who describes their company as asset-rich. "We are cash generative so we can turn off CapEx and pay down debt comfortably, but this limits potential for growth."

> Chart 6 – Ease of accessing funding: 2007 versus 2009

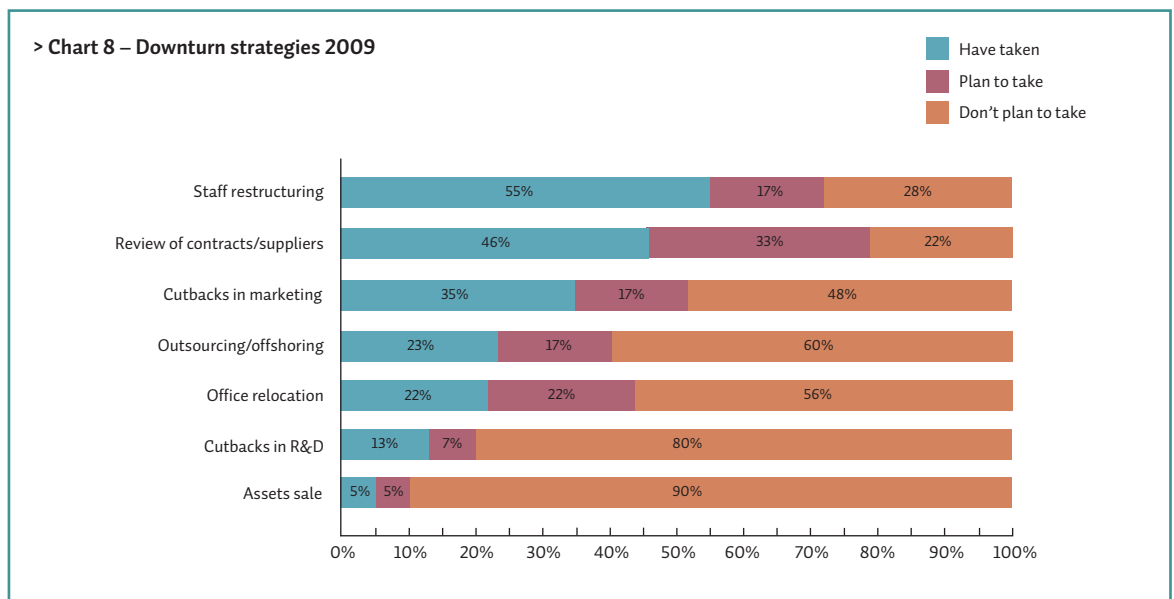


> Chart 7 – Three-year plans for raising capital: 2007 versus 2009



This sense of having taken action already is reflected in the fact that most of the companies planning to take one-time reactive measures in response to the downturn have already done so. The numbers of respondents whose companies plan to cut budgets or restructure are low compared with the numbers of those who have either already initiated such changes or who say they don't plan to. Of the seven reactive measures listed, most companies have only taken two: 46%

have reviewed their contracts or suppliers, and 55% have implemented a staff restructuring. Other moves are far less common – only 10% have sold assets or plan to do so, while cutbacks in R&D and new outsourcing strategies are also rare. Clearly companies aren't thinking in terms of short-term fixes – R&D in particular will be an especially important activity in which to invest if companies are relying on innovation to see them through the tough economic times. (See chart 8.)



Conclusion

There is no doubt that the state of the worldwide economy is making life more challenging for TMT companies. Access to cash has become more difficult, M&A is no longer the preferred path to growth, and many CFOs expect a fall-off in the consumer market.

In this light, innovation is looking like the surest way to secure future growth. Innovation has led to industry-wide expansion in the past, and companies are clearly hoping that it will spell success once again. For this reason, the majority of surveyed TMT companies are wisely not cutting back on their R&D spending.

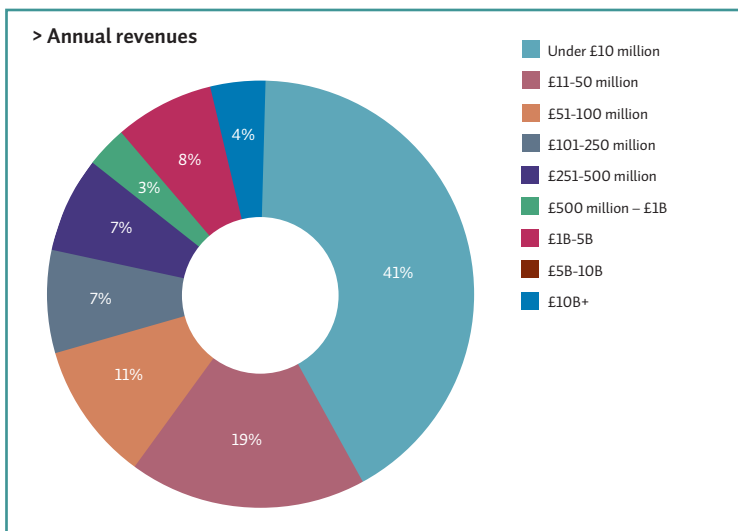
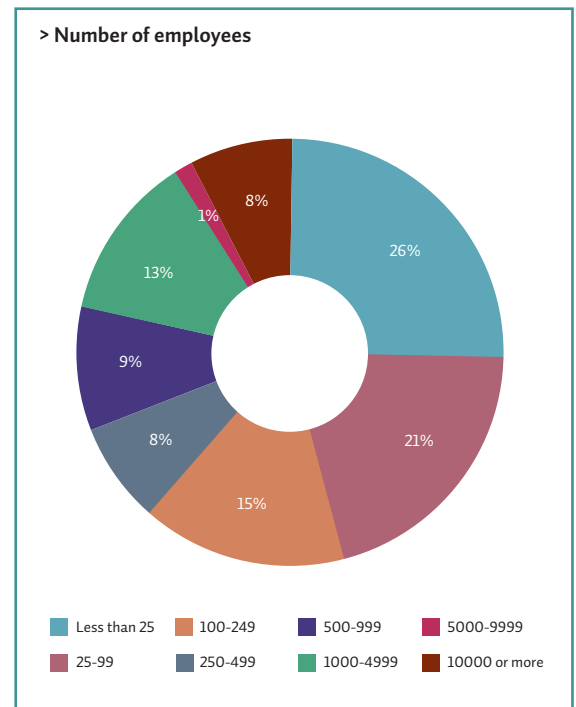
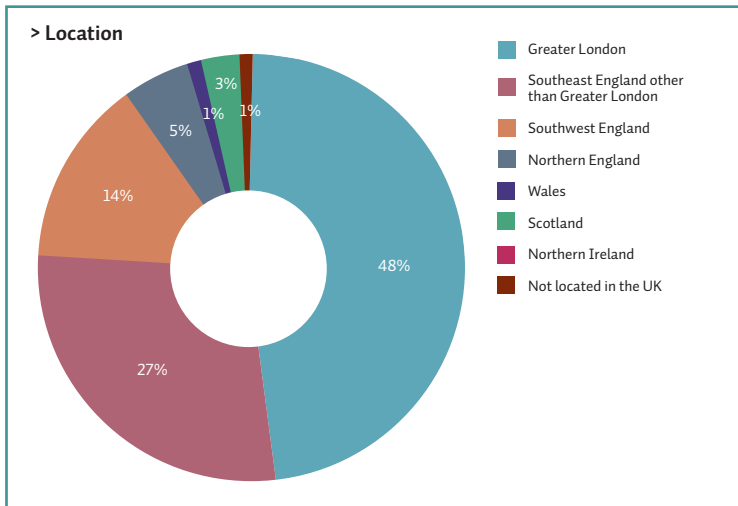
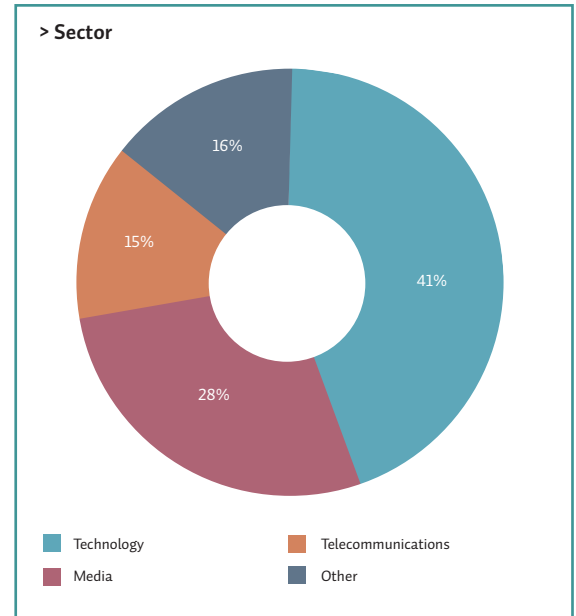
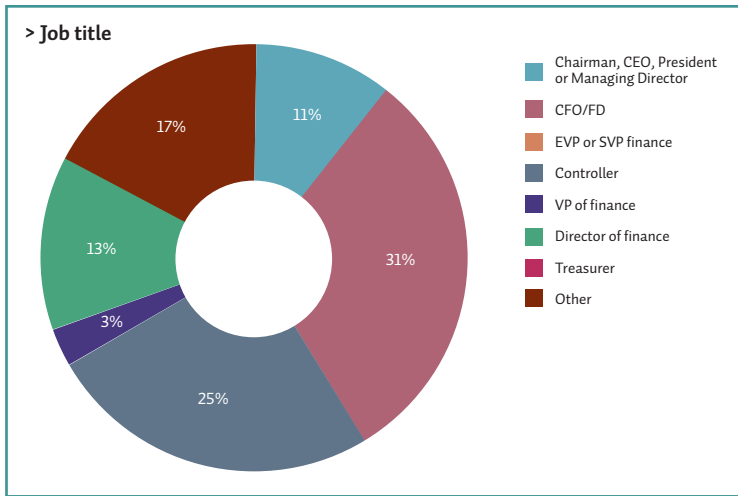
As the turmoil in the world economy subsides, and with innovation as their primary avenue of growth,

TMT companies can expect a fiercely competitive market place, with a defined batch of winners and losers. This is where strategic partnerships will really be of benefit, with asset sharing and product synergies leading to cost savings as well as revenue growth, and the survey results show a trend starting to emerge here. As the saying goes, if you can't beat 'em, join 'em.

Despite a knock to their optimism, most senior finance professionals are still confident about being able to meet their companies' long-term revenue growth targets, and many see the opportunities as well as threats thrown up by the economic crisis. On the whole, the three-year outlook for TMT companies looks fairly robust. As one respondent sums up, "TMT has been damaged, but not terminally."

Study methodology

In January 2009, CFO Europe Research Services conducted a survey of 78 senior executives in the UK in TMT companies. Here is a breakdown of the demographics:



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