

Capital Mergers And Acquisitions, LLC (CMA Group)

Consolidation in the E-Discovery Service Market...A Good Time to Buy And Sell?

Summary:

In Gartner's annual "state of the industry" MarketScope Report for E-Discovery Vendors, the authors wrote "by the end of 2011...there will be 25% fewer vendors in the e-discovery market as a result of mergers and acquisitions and vendors exiting the market." In this report, we take a closer look at the idea of consolidation in the e-discovery service sector and examine the market trends which could ultimately accelerate the M&A process. Our conclusion is that in the "calm after the economic storm" of 2008-2009, the deal making process could accelerate, driven by the convergence of firms expanding size and scope to capture a bigger piece of the growing volume of e-discovery requests (and in the process, create cost and production efficiencies) and those looking for liquidity and the umbrella of a larger organization. Further, with the recovery in the equity and debt markets over the last year (and a proverbial light at end of the tunnel for the "main street" economy), both potential buyers and sellers are becoming more comfortable that now is a good time to buy and sell, respectively.

The E-Discovery Marketplace Then And Now:

According to George Socha and Tom Gelbmann, two well known industry consultants (and authors of the annual "Socha-Gelbmann Electronic Discovery Survey), the number of EDD providers surpassed 600 in 2009. This is, more than likely, a conservative estimate of the actual number of market participants, as many "too small to count" local and regional firms specialize in providing one or two services from EDD paradigm to geographically proximal customers. The boom in service vendors has been a logical extension of the growth in the volume and importance of electronic data and the changes to the Federal Rules of Civil Procedure in 2006. As organizations grappled with how to fulfill their legal responsibilities, virtually every enterprise already providing some type of service to the legal vertical was eagerly maneuvering to provide services aimed at easing the burden of electronic discovery. From 2002 to 2007, the market increased more than 10 fold and a flood of new entrants entered the market. Fast forward to 2010 and industry growth has slowed (while the volume of work continues to rise and estimates of demand point to steady, 20%+, increases into the future, prices have been falling), competition is high, and the number of service providers has swelled.

Where Does The Industry Go From Here?

In the contextual framework of the industry lifecycle model, the electronic discovery market seems poised to enter a "shakeout" stage. In this stage of the industry lifecycle, demand for products continues to grow but lower price points dampen overall market growth. Additionally, consolidation typically plays a major role. The logic behind consolidation is intuitive; as price competition increases, industry participants seek to gain cost efficiencies and economies of scale by increasing both the size and scope of operations. The big get bigger through acquisitions, and in the process, increase pressure on smaller providers to compete, creating a self sustaining trend. Indeed, market forces in the EDD service segment seem to be setting the stage for this phenomenon to occur. From Gartner's 2009 report, "Oversupply has led to price cutting and, as the ranks of service providers have swelled since 2006, pressure to provide e-discovery services that are inexpensive, quick and good has increased. In other words, business is up for them in terms of cases and data volumes, but prices are down because they had to cut them to compete."

Sector: *Electronic
Data Discovery
Services*

Why We See More Consolidation in the Near Future And Why Is Now a Potentially Good Time to Buy And Sell:

While competition is heating up and prices are generally lower, the volume of electronic discovery work continues to rise and forecasts for a heightened regulatory and legal environment continue to point to increases in demand. From a potential acquirer's point of view, the appeal of buying up smaller competitors is winning a bigger share of the e-discovery pie while also eliminating cost overlaps, cross-selling services across client relationships, and decreasing volatility by diversifying across customers in different industries. As the big get bigger, they can also exert greater influence on industry standards and professional and technical guidelines, potentially to the detriment of smaller competitors. As industry consolidators increase in size and scope and control key relationships with customers, smaller players will face increasingly stiffer competition. Lastly, the current anemic returns on cash (0.33% for 1yr treasuries at the time of this writing) and a proverbial "light" at the end of the economic tunnel are giving buyers impetus to act in the near term. From a potential seller's point of view, business has improved and the worst of the economic recession seems to have passed. Business valuation metrics have improved and stock market multiples have risen from their 2009 lows. With many smaller companies lacking sufficient capital or energy for expansion, the opportunity to grow as a part of a larger company is tempting. Bottom line, entrepreneurs looking to sell might find that the time is right, both from a business stand point and a valuation stand point, to start looking at potential transactions.

Key Market Trends In The EDD Services Market:

- **Rise in E-Discovery Requests:** Going forward, litigation and regulatory requests are expected to continue increasing, driving higher numbers of requests for e-discovery.
 - **In a survey conducted by Clearwell and the Enterprise Strategy Group, 81% of respondents indicated they expected higher numbers of lawsuits and regulatory inquiries in 2010, with 53% of respondents expecting increases of 20% or more.**
 - **A May 2010 survey by CompTIA study showed "88 percent of attorneys surveyed expect law firms to engage in the e-discovery processes more frequently as more and more cases involve electronic information."**
 - **A 2009 survey of over 400 corporate counsels commissioned by Fulbright & Jaworski found**
 - **An increase in respondents expecting more disputes over the next 12 months. 40% of respondents expected increases in legal disputes while only 7% expected decreases.**
 - **Almost a quarter of companies with \$1 billion or more in revenues expect more internal investigations over the next 12 months.**
- **Higher Price Sensitivity on the Part of Customers:** In the aftermath of the economic downturn, enterprises are continuously looking to cut/contain costs. This, coupled with the rises in e-discovery requests is leading many companies to focus on price as a differentiator in choosing a service provider.
 - **In a 451 Group survey of over 150 e-discovery users, 79% of respondents picked cost as a factor in determining a vendor/service provider. This was the most chosen answer.**
 - **In the 2009 Socha-Gelbmann annual survey, the authors saw a decline in the overall size for services and software, while simultaneously seeing an increase in the volume of business, suggesting a lowering of prices.**
- **Firms are Moving E-Discovery In-House:** To further control costs, firms are moving aspects of e-discovery in-house, creating more downward pressure on prices.
 - **In a Cowen Group Q1-2010 survey of 78 major law firms, 31% of respondents anticipated moving more eDiscovery work in-house over the next 3 months.**
 - **In a Cowen Group Q1-2010 survey of 47 major corporations, 22% of respondents anticipated moving more eDiscovery work in-house over the next 3 months.**
 - **In a Clearwell survey of over 100 Fortune 200 enterprises, 40% of companies were looking to bring aspects of ESI preservation and legal hold management tasks in-house.**
- **Other Considerations:** As the EDD market matures and enters a new phase of growth and consolidation, there are other market trends on the horizon to consider.
 - **Vendor Consolidation:** Customers looking to cut costs and limit the number of hands through which their sensitive data travels could accelerate the consolidation of their vendor relationships.
 - **Adoption of Standards:** The adoption of industry wide standards and professional guidelines could favor larger, well established industry participants as these standards are likely to be influenced by companies with greater financial resources and industry influence.