IBM Global Services Acquires PwC Consulting

On July 30 IBM announced the acquisition of PricewaterhouseCoopers’ global business consulting and IT services unit, PwC Consulting. The discounted $3.5 billion purchase price will be in the form of $2.7 billion in cash, $400 million in convertible notes and $400 million in stock. This is IBM’s first major acquisition since Samuel Palmisano became chief executive officer on March 1, and the most important since it paid $3.5 billion for Lotus Development Corp. seven years ago.

The timing of this acquisition is extremely opportune. Though the IT implementation and management consulting industries have been declining for five consecutive quarters, IT investments will once again accelerate toward the end of 2H02. Additionally, the turmoil in the equity market has set an extraordinarily low value for this acquisition. PwC was planning to IPO its consulting arm, which was to be renamed Monday Ltd., in the coming weeks, but IPO success in this market environment was questionable at best. Government and corporate officials have been pressuring the Big Four accounting firms to separate from their consulting arms, alleging conflicts of interest between their auditing and consulting practices. PwC has been selling operations left and right to the highest bidder to drop out of the U.S. non-auditing businesses and cash out. The pressure to divest PwC Consulting had escalated sharply.

Perhaps a reflection of its new leadership, IBM acted quickly. The companies closed the deal in 10 days. In executing his first major deal, Palmisano showed decisiveness and leadership, dramatically increasing the revenue gap between IBM Global Services and the second-largest IT services company, EDS.

Why is IGS Buying PwC Consulting?

To Keep PwC Out of EDS’s Hands

EDS has been closing the revenue gap with IGS by posting higher revenue growth during the last several quarters. This deal will add $4.9 billion to IGS’s top line, giving the IBM division 77% greater sales than EDS. The picture would be completely different if EDS had acquired PwC Consulting; the combined companies would total $27.2 billion in revenue, or 21% short of IGS’s revenue of $34.6 billion without PwC Consulting. Besides that, on Dec 18, 2001 EDS and PwC Consulting announced a global alliance to provide companies with installation, delivery and maintenance services of SAP software. EDS also stated this alliance would generate substantial future sales, offering a single source for best-of-breed SAP Enterprise Resource Management services. This alliance was important to minimize EDS’s lack of management-consulting capabilities to implement major enterprise applications projects, and PwC was providing thousands of SAP-trained consultants to fill that gap. TBR believes it’s safe to say this alliance is over.
Synergy

IGS could use PwC Consulting’s management consulting capabilities to develop competitive BPO solutions outside the CRM segment. According to IDC, PwC Consulting is the No. 1 ERP implementer worldwide and the leader in CRM and supply chain services. Those qualifications will be extremely valuable to IGS during the process of deepening its BPO offerings. The only area where IGS is offering competitive BPO solutions is in the CRM area, and TBR believes IGS has, and will, expand its BPO offerings. Adding to that, TBR believes PwC Consulting will bring a whole new list of clients, representing another important channel to push hardware and software products.

Value
PwC Consulting was offered to Hewlett-Packard, EDS, IBM and several other companies on different occasions and at various price points. In September 2000, HP entered into negotiations with PwC partners and offered $18 billion in stock for the same 30,000-plus PwC consultants. But on Nov. 13, 2000, two days before its scheduled calendar 3Q00 earnings release, HP reported $0.41 earnings per share, $0.10 below Wall Street’s expectations, and PwC did not accept a lower price for its consulting business when HP’s stocks took a dive. Comparing $18 billion to $3.5 billion gives us the impression PwC lost a great sales opportunity, but adjusting the same $18 billion to HP’s stock price decline since than, the deal is worth around $5.0 billion today. At a valuation of 0.71 revenue-multiple, PwC is a bargain. Accenture, a former service arm of a Big Four PwC competitor, is traded at 1.36 ttm-revenue.

WHAT DOES THIS MEAN FOR MANAGEMENT?

- Samuel J. Palmisano, IBM CEO, strikes his first major deal, showing decisiveness and an opportunistic attitude.
- Doug Elix, group executive of IGS, will hold the most powerful position in the IT Services segment.
- Ginni Rometty, formerly the head of IGS’s Americas Services business, will become the general manager of the new Business Innovation Services unit, into which PwC will be integrated. Rometty will report directly to Elix.
- Greg Brenneman, CEO of PwC Consulting, will cash his $2.9 million “golden-parachute” and return to TurnWorks, the private-equity firm he founded in 1994.
- IBM prepared an equity-based retention package for the former PwC Consulting partners and senior managers.

WHAT DOES THIS MEAN FOR THE SERVICES INDUSTRY?

A large stone has been cast into the professional services industry pond. Several will feel the ripples of IBM’s expansion in the near future, most especially those companies that were integrating IBM’s technology and those using PwC Consulting as a channel partner, like EDS, Sun Microsystems and HP. Competitors will have to reassess the value of their relationships with the behemoth; IGS has been a strong partner for many of the legacy Big Five consulting companies, which have been a significant channel for IBM’s hardware and software. Bids for large government contracts could be affected in the near term – currently IBM is partnering with CGEY on its Delta Blue team, which is multibillion-dollar deal for the Department of Defense to build the largest integrated pay/personnel system in U.S. government history. Accenture claims to be “one of the world’s largest integrators of IBM technology”. The acquisition allows IBM to move up the value chain in IT services and opens up developed relationships with Fortune 100 companies. IBM has sought to move from technology vendor to solutions provider; this acquisition ends any question about IBM’s plans.

WHAT DOES THIS MEAN FOR COMPETITORS?

Many say IBM will make this acquisition work; the question for competitors and partners is when? TBR’s suggestion to IBM competitors is: Don’t bet against IBM’s ability to execute this integration well and start to realize growth opportunities by early 2003.

Accenture

Accenture has teamed with IBM, the market leader in e-business technology, to resell IBM hardware and software products in order to deliver fully integrated, technology-based business solutions for its global clients. Accenture will need to strengthen its hardware relationship with Dell, Sun and HP, as well as concentrate on its other software partners. IGS’s push into the BPO space down the road is something Accenture will have to counter.

ACS

The rising star of ACS is still burning brightly, but it has stirred the competitive juices of its competitors. With IGS gunning for its bread-and-butter BPO sector, trouble could be brewing for this burgeoning outsourcing player. The Proctor & Gamble deal will put the company in the big leagues, but competition is ratcheting up.

CGEY

Cap Gemini Ernst & Young’s sales have been dropping precipitously and it is in the midst of reorganization. CGEY has been a partner of IBM’s on large government bids, which means a significant relationship could be altered. Like
Accenture, CGEY will need to focus on its other technology vendors and expect more competition on transformational outsourcing bidding after the new IGS has moved into that space.

**CSC**
Computer Sciences Corp. has been benefiting from strong government spending and its early 2001 restructuring, but IBM has been a significant partner on several government contracts. Now this systems integration business could be steered away from CSC to PwC Consulting. The success of IBM government bids could have an impact on CSC in the near future; however, CSC has won its fair share of bids on its own, like with the Internal Revenue Service, National Security Agency and Department of Defense).

**EDS**
Electronic Data Systems has been moving to capture more systems integration work in-house; however, the company has been using PwC Consulting as a prominent partner. With this crutch likely no longer available, EDS could try to rapidly develop its systems integration outfit, partner with another legacy Big Five consulting firm or acquire a systems integration firm in a bid to one-up IBM. TBR believes EDS should choose the acquisition path, targeting KPMG Consulting, Unisys or Deloitte Consulting.

**HP Services**
At this moment HP’s management team should be simultaneously relieved and anxious. Relieved because it did not pay $18 billion for PwC Consulting in the fall of 2000, and anxious because IGS is putting more pressure on everybody with this move. HP, like EDS, has to develop systems integration capabilities in other to tap into the growing and higher-margin BPO business. HP is busy digesting Compaq, leaving little room for another acquisition in the services space. Having said that, HP has pretty much one option, to strengthen its alliances with Accenture and KPMG Consulting.

**KPMG Consulting**
Without any significant outsourcing deals, KPMG Consulting’s government business could be imperiled by the new IBM’s full range of services that could be leveraged when bidding on government contracts. With PwC Consulting off the block, KPMG Consulting’s low market valuation ($1.6 billion) and pending rebranding, the company could be an acquisition target depending on how IBM’s larger competitors (notably EDS) react to the acquisition.

**Unisys**
Like many others in the technology industry, Unisys has been focusing on services. PwC Consulting was not a significant partner, so the company should only have to deal with increased competition from the invigorated IGS, which could force it into niches or enable its acquisition by one of IBM’s concerned competitors. The company is currently trading at a considerable discount and has shown signs of life.

**WHAT ARE THE RISKS TO IBM?**
Like in any acquisition, loss of revenue and restructuring charges are expected, and this one is not different. In regard to restructuring charges, IBM expects this deal to reduce EPS by almost $0.30 in 4Q02. IBM is forecasting the acquisition will be accretive in 4Q03. So by year-end 2004, IBM anticipates the Business Innovation Services unit, where PwC Consulting will be integrated, will contribute double-digit revenue growth at a profit margin comparable to the rest of IGS. IBM believes the $4.9 billion in additional revenue is a conservative estimate, meaning it’s adjusted to the expected revenue loss.

Also, PwC is not likely to stop providing consulting services outside the United States. Adding to that, IBM should expect response reactions from competitors, from acquisitions to blocks of competitors strengthening their alliances to compete against the “big blue”, which just became bigger. Adding to that, any integration process can be distractive and IGS’s mammoth size could slow down its decisions, but TBR does not believe it is wise to bet on that.