Scaling up:

Why a new dawn of consolidation for SME IT suppliers is creating big business

Businesses that supply IT and web hosting services to SMEs are facing a dramatically changing environment. Whilst demand for their services remains strong, we believe underlying trends will now drive a period of accelerated consolidation of suppliers. For businesses in this space an important question has emerged - which scalable platforms can rise and lead the sector and which might decide to merge into it.

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Hg has been an investor in businesses that serve SME customers for over two decades. One area of focus we have developed in this sector is the website hosting and IT outsourcing space, specifically within the 'micro' end of the SME universe. To date we are fortunate to have backed a number of successful companies here and recent examples include Zitcom, Loopia (through our investment in VISMA), NetNames and DADA.

We believe that this sub-sector is now undertaking a significant evolution, perhaps best represented by Hg's most recent investment, Denmark's IT Relation. Compared to other Hg investments in this space, the company typically focuses on larger SMEs – with around 50 to 500 employees. This step up in customer segment size is no coincidence – IT Relation represents an emerging and exciting dynamic for us as investors.

A MARKETPLACE IN FLUX

IT outsourcing

SME IT outsourcing is a long-established category of managed service as most SMEs require a standard set of IT products and services to run their businesses. This typically includes Microsoft productivity software, an e-mail server, file servers and various on-premise software applications. They also have access management, cybersecurity, end user support and device management requirements for employees working onsite and remotely.

Why outsource?

Ask 100 small businesses and you will hear any or all of: availability, 24/7 support, security, GDPR compliance, cost savings, application performance, IT scalability, a need to focus on core business, a desire to move IT away from 'capex' to 'opex' model and a way to provide a roadmap to hybrid/ public cloud.

These are all legitimate reasons for outsourcing IT and can often be met better by a managed service provider than internal teams.

This is nothing new. To a greater or lesser extent, these are all trends that have been underway for many years and progress is incremental.

However, what we are now seeing is a significant acceleration of this trend.

What's changing?

We believe that the supply side of the industry is supporting this acceleration.

The key components of SME IT are now being built and designed to make it possible to provide them on large platforms, allowing suppliers to benefit from economies of scale.

Put another way, 10 years ago if you supplied IT services to 100 SMEs, you had to run 100 different versions of your customers' products, with all the management burden, complexity and user support requirements of each client aggregated together.

Today's environment enables you to run one platform for your 100 clients and share the benefits it brings - or at least that's the trajectory we are on.

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HOW HAVE SUPPLIERS CHANGED?

Three examples:

1. Most importantly, the improvement in APIs across a huge number of other typical SME applications and infrastructure software has allowed service providers to build tools, scripts and processes to deploy at scale with orchestration. At the same time, the standardisation and cloud delivery of key applications, such as Microsoft Office365, has removed much of the burden of configuring and patching each individual client.

2. The growth of virtual desktop infrastructure (VDI) and desktop as a service (DaaS) has broken the distinction between the device and the location of the device. It has also changed how user applications are installed, managed and supported. There are now large economies of scale available to service providers who can manage tens of thousands of devices from a single team in a single location, often using reusable processes to deploy hardware across clients. At the same time, SME customers assume connectivity and cloud functionality across their devices, driving demand for virtualised environments.

3. The IT Service Management Software (ITSM) platforms used to provide scaled end user support to thousands of clients have hugely improved. The experience curve of looking after a relatively standard set of SME applications allows for a more efficient and better quality end user support service than could ever be achieved by a small business alone. For example, IT Relation is supporting more than 70,000 end users with 80 support desk employees. They continue to drive up productivity whilst improving client quality.

WHERE'S THE VALUE?

This evolution is exciting and hugely value accretive.

We believe that it is creating a natural environment for consolidation towards a radically smaller number of providers. Meanwhile, the market continues to provide a compelling rationale for SME IT outsourcing over the next decade.

We also see the logic for single providers to deliver a wide set of services (e.g. hosting, operations, end user support, devices) given the links across these shared platforms. This is clearly demonstrated by IT Relation, where 75% of customers take a full suite of these services.

As this market consolidates we also believe that these companies will become key distribution partners for SME software as incentives move out of the old on-premise software reseller channels.

Together, this represents a marked shift and one which will prove significant for those, like IT Relation, who can establish themselves and lead this sector.