Channel Consolidation: Why Partners Are Pairing Up

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Like any fragmented marketplace populated with small, specialist or locally-focused entrepreneurial businesses, the telecom equipment and service channels have been home to a few mergers and acquisitions over the years. But several closely timed transactions begged the question, is a larger consolidation among channel partners beginning? That is the premise of this article. Absent an overwhelming supply of empirical evidence save a few recent deals, the anecdotal evidence suggests indeed market conditions may be right for partners to come together.

And what might those be? At a high level some predictable factors include the recession, increasing technology complexity, escalating customer requirements, emerging delivery models, supplier policies/requirements, etc. All of these conspire to create opportunity for channel partners but also put pressure on them to evolve beyond the status quo — a decision point that often ends with a plan to buy, merge or exit.

Answering the channel consolidation question is complicated by the fact that there are several partner types — agents, VARs, dealers, interconnects, consultants, systems integrators — each with different business models. To simplify this discussion, however, the greatest contrasts will be drawn between the residual-based services businesses (agent) and the margin-based gear businesses (VAR/dealer). Some of the drivers are common, but some are unique to each by virtue of their model.

Glass Ceiling. In all cases, the impetus is that the business progress to the next level. What that means varies by the starting point. For the sole proprietor, it's often a recognition that they've hit a wall in terms of the revenue they can produce and maintain on their own without making significant changes to the business, e.g. bringing on employees, partners, etc. In this situation joining up with a larger entity can jumpstart that plan.

This was the case for agent Jana Beck, who in April sold her successful agency JB Telecom Consulting to master agency Concierge Communications. Perry Chrisler, president and founder of Concierge, said Beck was reluctant to "complicate" her business by taking on partners, but ultimately decided she did not want to spend the time replicating the consultative model and back-office systems that Concierge already had developed and which she had seen firsthand as a subagent. As part of the acquisition, Beck is now one of three principals at Concierge and she also serves as vice president of sales. For Concierge's existing principals Chrisler and Clark Atwood, bringing Beck on represents an opportunity for them to begin to shift out of the day-to-day operations and focus more intently on business development. Chrisler recites the adage that he is now able to spend time "on" the business instead of "in" the business. As Concierge grows — organically and by acquisition — it can add principal partners or junior partners in much the same way as does a law firm, Chrisler said.

The limited bandwidth of the company principals also was a factor in the April acquisition of telecom agency NetGain Communications' account base by fellow agent ARG Inc. NetGain's principals CEO Peter Callowhill and COO James Larsen were being pulled in multiple directions maintaining an agency, growing a separate TEM business (iTEMize Technologies Inc.) and pursuing an upstart energy business. "Ultimately, it comes down to bandwidth — how much can you manage simultaneously," said Callowhill, saying that divesting the agency business gave them "opportunity time." Clearly there also was financial gain, presumably of the sort (cash or residual) that would support the remaining two businesses, but the terms of the deal were not disclosed.

A similar opportunity was gained for the principals at partnerTEL, who in February sold their agency base to Intelisys for a combination of cash and recurring residuals. partnerTEL's co-founder Steve Gareleck said the agreement enables partnerTEL to shed the burden of managing carrier agreements and increasing volume commitments while enabling it to focus on its reseller and managed services businesses. Presently, partnerTEL has wholesale agreements with carriers that it resells. In addition, it operates a back office out of Costa Rica that provides business process outsourcing, such as TEM, MACD and change management services.

Analyst Tiffani Bova, vice president of research for indirect channel programs and sales strategies at Gartner Inc., said some agents like NetGain and partnerTEL are choosing to get out of certain pieces of their business and focus on other areas. "The most effective way to do this and not disrupt the customer experience would be to sell to a 'like entity,'" she said. "By doing so, the reputation of the selling partner remains intact and the buying partner gets a book of business, which they can further service."

In the NetGain-ARG deal, this criterion was front and center for Callowhill and Larsen, who wanted to make sure that NetGain's customers and several loyal employees would be taken care of. NetGain and ARG share a long association and a philosophical approach to the business, Callowhill said, explaining his comfort level handing over this business to ARG.

Talent Search. ARG, in contrast, is cultivating the growth of its core agency business and was looking not only for the bump in its customer base and monthly billings, but also the experienced talent needed to support a business that was growing organically very quickly. ARG CEO Greg Praske commented at the time of the acquisition that bringing on NetGain staff was a significant factor in the deal since it needed to hire to keep pace.

Acquiring talent is not an insignificant driver for consolidation in the channel. Think about what it might take to lure a veteran of 10, 15 or 20 years from their current assignment, especially when their job title is "owner." Concierge's Chrisler said it's difficult to find people with that level of experience. That was a motivator for the master agency's most recent acquisition in June of Streamline Management Group, a subagent and technology optimization company. Along with the deal, Concierge got Gregory Garbero, SMG's co-founder and director, on board as part of the company's business development team. His industry contacts and experience as well as his familiarity with Concierge's carrier base and consultative model make him a valuable addition to the company, Chrisler said.

Portfolio Play. SMG's experience in TEM, auditing and energy also was attractive to Concierge, Chrisler said. While Concierge already offers TEM on a SaaS basis, the auditing expertise will make a great addition to the company's capabilities.

Acquisition to gain domain expertise or a thriving practice in a new area is a common strategy. "As the partner ecosystem continues to evolve the businesses and move them into more services (either consulting, integration or managed), they are faced with a build versus buy scenario," said Gartner's Bova. "Partners can find themselves in a high investment proposition when adjusting business models to include higher value services, so an easier path may be to acquire a business which gets them the skills they need quickly.
Though they are bound to exist, examples of dramatic pairings between unlike businesses — say a VAR and an agent or an MSP — are hard to come by unless you count the June 8 purchase of Quagga Inc., a top Avaya partner, by PAETEC Corp., a CLEC. While not exactly a partner-to-partner transaction, it does highlight the potential for cross-skill acquisitions. In this case PAETEC is adding to two previous acquisitions made a decade earlier to form its Integrated Services Group. The initial capabilities additions occurred then, so the Quagga deal is more of a geographic expansion for PAETEC.

Most other acquisition examples are baby steps away from the acquirer's core competency as in the Concierge-SMG pairing or in XETA Technologies' mid-May acquisition of Lorica Solutions, a managed services provider serving the hospitality industry. For XETA, one of Avaya's largest partners, this acquisition was a chance to bolster its position in the hotel market by acquiring not only Lorica's customer base but its intellectual property in the form of proprietary technology called the Lorica Room Center, which is a communication hub and monitoring node that enables and manages IP-based applications, delivers wired and wireless Internet access, manages in-room devices, connects and powers IP phones, and delivers content to set-top boxes.

This activity and perhaps more dramatic ones are likely to bubble up as the imperative to transform into a next-generation partner becomes stronger, e.g. when it becomes more difficult to win and maintain customers with existing siloed portfolios.

Bigger Is Better. For now, however, the majority of mergers and acquisitions are driven primarily by scale. It's a size thing pure and simple. Yes, synergies (i.e., cost savings) always figure into due diligence on any deal, but the motivator for scale here is being bigger from both a coverage and revenue perspective. This is happening in both the agent and VAR markets.

ARG's and Intelisys' acquisitions of like bases are examples of larger agencies getting larger. In the dealer world, top Avaya Partner Carousel Industries, for example, has made two acquisitions of Avaya partners in the last year or so — Daycom Systems, San Diego, Calif., in March 2009 and the U.S. division of BrantTel Networks, (a Canadian Avaya and Nortel dealer.

Quagga co-founder Ken Apperson said these kinds of acquisitions are a relatively new phenomenon in the dealer world, but seem to be happening with increasing pace. It's no longer good enough for dealers — at least those targeting large enterprises — to be a locally focused player. While Quagga, a regional player serving six states in the West coast, has fended off recent overtures from other dealers, it has felt first hand the sting of being too small, Apperson said, noting that his company has lost enterprise deals at the last minute to larger telco-size dealers because customers wanted the safety of a billion-dollar company. That's one of the reasons Quagga agreed to become part of PAETEC; it can continue business as usual but with a $1.6 billion company behind it.

Not everyone is going to have a billion-dollar company knocking at the door, so they are building their businesses with more modest partner-partner pairings. And, in the dealer world, there are some deals to be had for sure due in large measure to the devastating impact of the recession on equipment VARs. Those capex-dependent businesses found themselves losing traction as customers cut back on expenditures, noted Heather Margolis, founder of Channel Maven Consulting. Not only that, she said, many lost existing customers who turned to less expensive options available readily via the cloud. "When all your infrastructure is in the network, there is less hardware business for the smaller folks," she said, noting that they are then looking for a way out.

In some cases distressed companies end up being acquired or "tucked in" to a larger company. XETA Technologies' CEO Greg Forrest said the "tuck in" isn't a regular buyout, but the larger company takes on the base, debt obligations and some of the staff while the owners come on as salaried employees rather than lose the business altogether.

The Nortel bankruptcy has exacerbated the predicament for many Nortel dealers, which suffered through customer's crisis of confidence for many months before the enterprise division was purchased by Avaya. Many such Nortel dealers are looking for homes among the Avaya dealers like XETA and Quagga, and those larger dealers are see this as an opportunity for channel consolidation. In April, for example, XETA bough fellow Avaya-Nortel dealer Pyramid Communications Services Inc., Carrollton, Texas.

In the agent space, the recession had more of an indirect impact. Most agents have reported holding their own during the downturn as customers sought to move to less costly services and also considered hosted (opex-centric) options at unprecedented levels. However, their suppliers, the nation's carriers, felt the recession profoundly and as a result began to scrutinize their costs, including channel commissions and support. This review caused many providers to tighten quotas or contracts, or begin to enforce existing ones for the first time. While there remains controversy over the legality of some of the consequences of these moves (i.e., contract cuts) by some carriers, it is no less indicative of a greater trend toward greater performance requirements.

Word on the street is that bases are being sold to protect commission streams for agents and subagents where quotas are going up or being unmet. In some cases, only the bases for certain carriers are sold so the agent can focus on meeting volume commitments for fewer carriers. While agents traditionally have been disincented to sell because of the advantages of a recurring revenue stream, these stricter requirements make it less easy for agents to maintain their base without an active role in doing so. The idea of riding the base into the sunset as many have done in the past is a less realistic scenario.

Aside from the perceived penalties, carriers also are beginning to reward ever-greater size. Qwest Communications International Inc., for example, in May announced the addition of a Premier Elite Business Partner level, which offers the most attractive commission rates and contract terms the carrier has ever had, but the minimum monthly billing threshold is $2.5 million per month or $30 million a year.

While striving for scale naturally brings up M&A strategies, it is not the only avenue that agents have, however. Some are considering other mechanisms like franchising. Digital Planet Telecom in June announced just such an approach to replicate the agency's proven model for providing telecom services through communications equipment VARs and interconnects.

Digital Planet President Shawn Schmidt told PHONE+ the goal is to have national coverage with 40-50 franchisees by the end of 2011.

A franchise partner serves as an extension of Digital Planet in the local or regional market. Digital Planet provides the blueprint, training and expertise while the franchisee provides the local presence and business knowledge.

Franchises are exclusive and cost $30,000 plus a 2.5 percent override on the monthly carrier billing. Franchisees receive 100 percent of Digital Planet's commissions from the carriers.
Schmidt said that early inquiries are coming from entrepreneurs, but the company will entertain applications from existing agencies. In that case, it may make sense for Digital Planet to buy out the base and assume the carrier contracts.

While there isn't one tried-and-true approach or driver, it seems that there is reason to conclude that consolidation in the channel is beginning if only one deal at a time.