Why IT is often the final nail in the coffin - Instead of contributing to M&A success

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1. M&A on the dying bed in 2023

Amid high inflation, rising interest rates and continued insecurities caused by warfare at the EU's doorstep, M&A activity in Q3 2023 fell by 29%[1] on the same period last year. This market volatility makes it more relevant than ever to ensure that those deals that do not tolerate delaying run smoothly and achieve their expected business value.

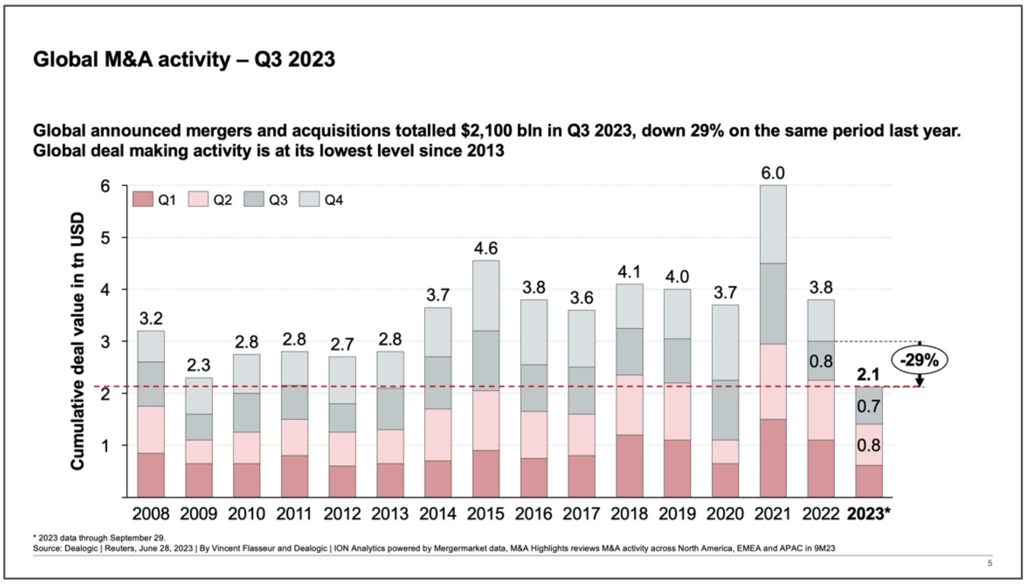

Figure 1 Global M&A activity up until Q2 2023

In this blogpost, we elaborate on the crucial role of IT in achieving the expected business value of M&A transactions, taking mostly the acquirer's perspective. Not only are there significant cost implications to failed IT integrations, in an increasingly digitized world, IT also becomes a high-potential success factor. Leveraging the potentials and mitigating the risks embedded in IT is thus key to successful M&A activities – particularly in an otherwise volatile market environment.

2. Ill-managed IT complexity accelerates the downfall of M&A

In a study conducted by global law firm CMS, respondents revealed their major motivations for engaging in M&A activities[1]. Among these, we selected those motivations that best lend themselves to highlighting the importance of IT for deal success and sustainably driving business value. Thus, we will be focusing on #1, 2, 5, 8 from Figure 2. Depending on the nature and ambition of an acquisition, the relative contribution of IT to the ultimate deal success varies.

- **Distressed M&A / Turnaround opportunities**: An analysis of sell-side drivers of M&A activity reveals that many relevant acquisition targets originate from difficult business situations. When a company is under financial distress, facing bankruptcy or requiring large-scale turnaround management, IT processes and platforms are often in bad shape, because necessary transformations have not been undertaken or modernizations failed. In consequence, unmaintained systems and technical debt decrease the company's operational efficiency and often lead to exploding costs – Mostly, but not only in IT budgets. Moreover, technical debt will inevitably make the transition and/or absorption process more complex and expensive. Potential acquisition targets should thus be carefully screened for such risk factors.

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[1] https://cms.law/en/media/international/files/publications/publications/cms-european-m-a-outlook-2022-23 and https://community.ionanalytics.com/ma-highlights-9m23-stagnant-waters

- **Strategic acquisitions**: In this type of deal, the acquirer is looking for a company that has capabilities that complement their own. IT plays a crucial role in these acquisitions: integrating the target company's systems, data, and processes with the acquirer's (or vice-versa) as quickly and cost-effectively as possible will be part of the overall value proposition. Therefore, a well-integrated target IT architecture (ranging from governance to architecture) is necessary to yield the anticipated increase in operational capabilities and a positive impact on the business case.
- **Bolt-on / tack-in acquisitions**: These types of acquisitions are aimed at acquiring a smaller company that can be quickly integrated into the acquirer's operations. In some cases, the acquisition target may not require specialized systems and could benefit from adopting the acquirer's systems instead. This strategic approach could lead to enhanced cost efficiency and positively impact the overall business case.
- **Acquisition of technology, new production capabilities or start-ups**: In this type of deal, the acquirer is looking to target a company that has innovative technology or products that can help gain a competitive edge. By the nature of this case, the acquirer has limited knowledge and experience with the target's (IT) requirements. Thus, special care should be given to the design of the target architecture and the degree of integration must be selected such that the target's needs are not compromised. Else, the integration runs the risk of jeopardizing the purpose of the deal altogether by negating the acquired potential.

Figure 2 shows an overview of additional IT success and risk factors in common deal types. Furthermore, we've highlighted deal types in Figure 2, where we believe IT plays a less critical role.

Key acquisition drivers impacted by IT

What drives an M&A deal?	How does this impact IT?		
Top M&A motivators[1], sorted by relevance	**IT key success factor**	**IT potential success factor**	**IT risk factor**
1 Distress/turnaround opportunities			✓
2 Acquisition focused on increasing operational capabilities	✓		
3 Non-core asset sales from larger companies			✓
4 Strengthen ESG ranking/performance/sustainable footprint	IT less critical		
5 Bolt-on acquisitions (smaller acquisitions in same sector) to increase market share		✓	
6 Capital raising for expansion in faster growing areas	IT less critical		
7 Regulatory changes within jurisdiction	IT less critical		
8 Acquisition of technology, talent, new production capabilities or innovative startups		✓	
9 To enable a major geographic expansion		✓	
10 Private equity divestments			✓
11 Succession issues	IT less critical		
12 Pick-up in valuations	IT less critical		

1: Sources: Statista, CMS

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Figure 2 Key acquisition drivers impacted by IT.

3. The Key to Salvation: Mitigating Risk and Leveraging Upside Potential with early IT integration

Given the criticality of IT for M&A success and the complexity of successfully merging / transforming legacy IT landscapes, IT should not be treated as an (expensive) afterthought. Instead, incorporating IT into every deal phase not only avoids costly discoveries after all ink has dried, but can also be a decisive value driver in and of itself.

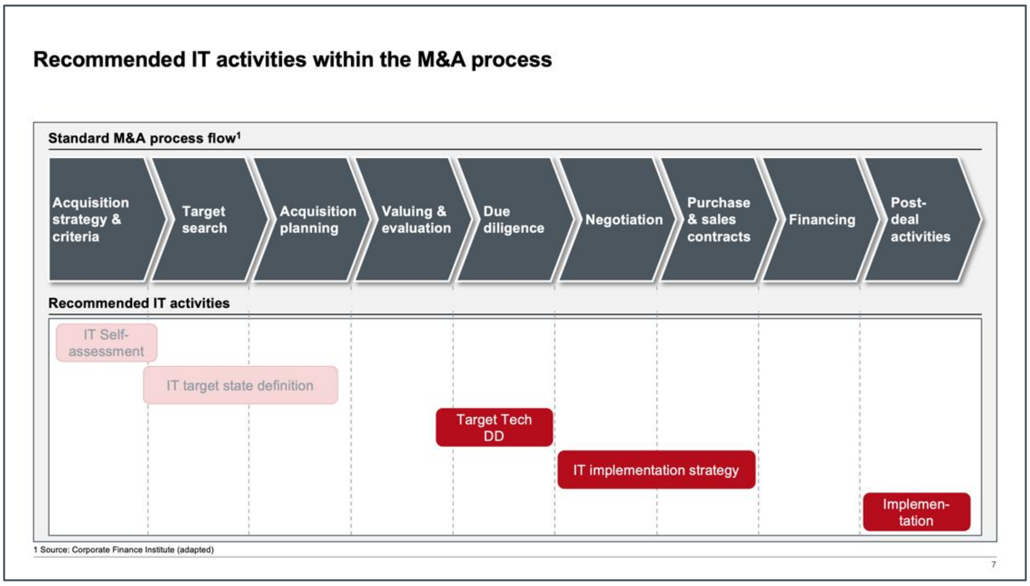

Figure 3 Recommended IT activities over M&A processes

Figure 3 shows relevant activities within the broad spectrum of corporate IT along the classical phases of M&A deals. For the purposes of this blogpost, we will focus on the latter stages of the deal, starting with due diligence. Preceding activities are relevant, but usually best carried out outside the context of acquisitions.

3.1 During Due Diligence: Evaluate the maturity of IT and magnitude of accrued IT debt

For companies whose business models rely heavily on digital technologies, the maturity and availability of digital infrastructure is critical to their valuation and to the prospects of being able to successfully execute the value proposition. Thus, particular care should be laden upon the due diligence process, particularly regarding the state and condition of the IT infrastructure, processes, and governance.

The due diligence process aims to shed light on qualitative valuation factors and risks, financial and legal, that assist in understanding a company's potential (pitfalls). While traditional analysis frameworks focus on potential revenue increase, margin increase, potential cost savings and the distribution of cost within the company, holistic assessment in the digital age requires a rigorous look at IT (see *Figure 4*).

To this end, we have proposed a reference IT Due Diligence Framework in our blog post *"IT Due Diligence for M&A Deals – Implementation of a structured IT due diligence increases synergy potentials in operational harmonization"*, 2020.

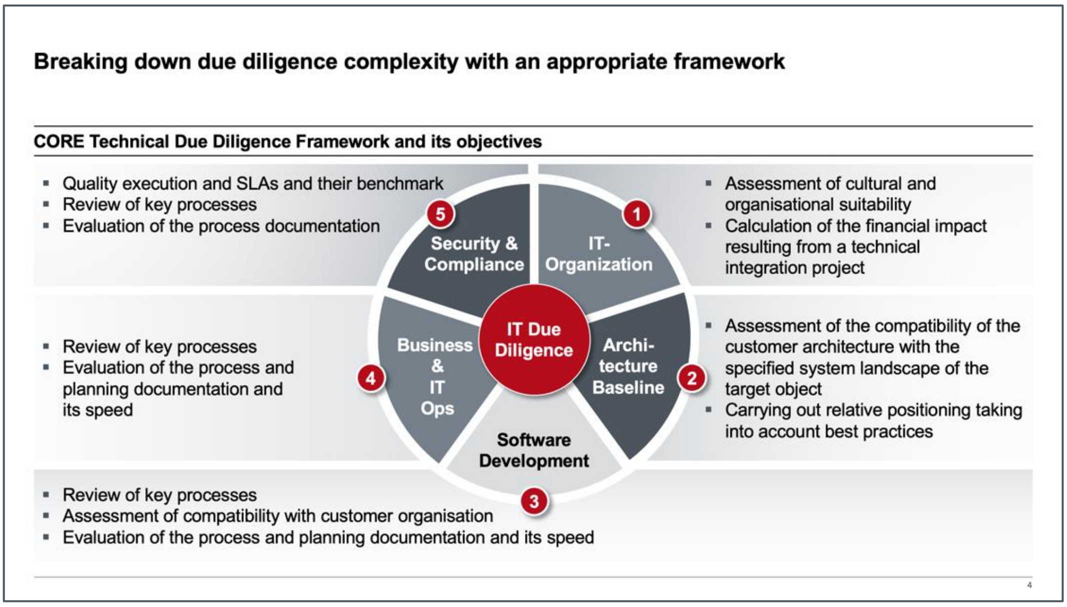

Figure 4 CORE's technical due diligence framework

3.2 During negotiations: Understand the impact of accrued IT debt on the business case and valuation

The selected implementation approach has an impact on the structure, content, and conditions of the deal's term sheet; i.e. reducing the target's valuation according to the poor state of IT, if applicable. Thus, having selected the implementation model is a prerequisite for successful negotiations.

In other words: Once the strategic goal and the IT target state are agreed, the acquiring party must detail the implementation plan before Closing. In M&A transactions, there are several commonly used approaches on how to implement the future IT, e.g., green field, brown field, big bang, forced migration, etc. (see Figure 5). To identify which approach is best suited for the given deal structure, strategic goals, timeline, and the financial case need to be considered.

Specifically, we'd like to highlight some proven areas of consideration:

- Analyse and clarify documented and undocumented services. Where necessary, negotiate transitional service agreements and/or reverse transitional service agreements
- Define SLAs corresponding to the strategic target state and mitigating potential penalties and indemnities
- Rank the top supplier contracts by cost and business-criticality
- Manage and (re-)negotiate supplier change of control clauses and scope changes
- Manage regulatory requirements for e.g., contract data processing, outsourcing agreements, data protection agreements, Information security management and standards, and business continuity

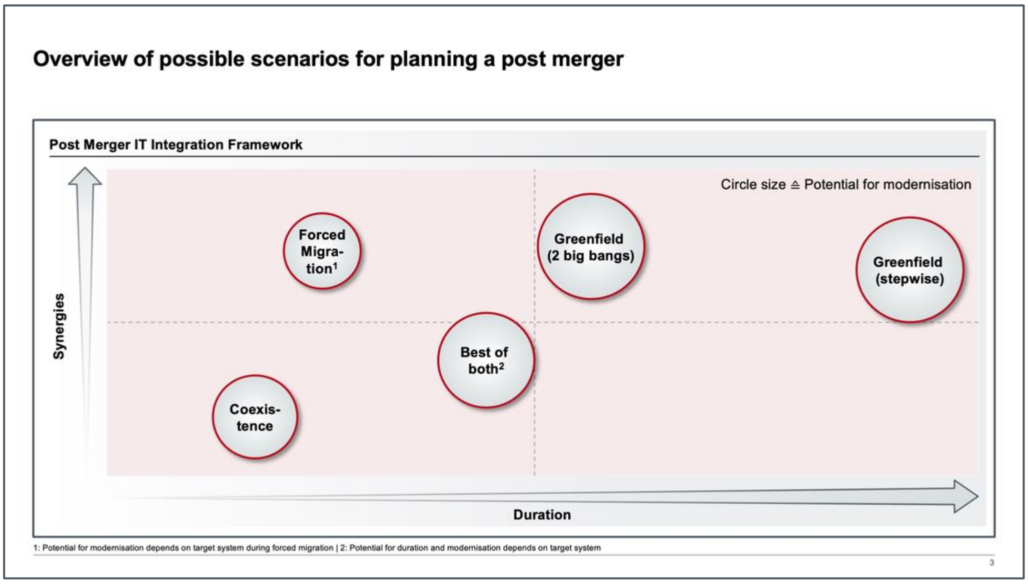

Figure 5 Possible PMI scenarios

Read more on risks and potentials of commonly used PMI scenarios in our whitepaper *“Post Merger Integration in the Financial Industry”, 2023*.

3.3 During Post-Merger Integration: Successfully execute the strategy through realistic planning and effective management

Once the target is acquired, the real work begins. Technology transformation is a complex undertaking that relies on great planning and effective programme management to succeed. The differences in values, cultures, and usances of the formerly separate entities further add to the complexity of post-merger transformation efforts. To ensure long-term success in deals where IT is a central business value driver (or largely contributes to it), both project management expertise and deep understanding of technology must be unified.

Some key success factors for program management in a complex environment are (excerpt):

- Early, consistent, and recurring involvement of all relevant stakeholders
- Rapid decisioning processes including KPI-based tracking of decision speed
- (Pro-)active management of program risks embedded in an open and collaborative working culture

A more in-depth look at the intricacies of programme management as well as additional recommendations from our experience in managing challenging programme situations may be found in our whitepaper “*The Way Back – Realignment for Success”, 2021.*

4. At the Gates: The Power of Early Expertise Safeguards Business Value

The thoughts and experiences laid out above shed light on the value of technology-driven deal advisory. While tech-focused advisory does not significantly contribute to the delivery of tangible value early in the process, it acts as a safeguard against deal-breaking complexity and cost explosions down the road. Moreover, involving tech-specific expertise early on allows the acquirer to reap the benefits of successful integration comprehensively and sooner.

By assessing IT maturity during due diligence, understanding the impact of accrued IT debt during negotiations, and managing post-merger integration through realistic planning and effective program management, IT is given the attention it deserves to drive business value.

Crucially, a holistic advisory is not only experienced in understanding technology-driven complexity but is similarly versed in the art of M&A. Under the right conditions, the advisory given during the deal phase already sets up the transformation roadmap for the integration / absorption process, thereby delivering value far into the process.

Please visit our website for more information or reach out to one of our experts.

Authors

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Mara Wiltshire is Transformation Manager at CORE, leveraging her background in physics to fuel a profound interest in all things tech and an unwavering commitment to continuous learning. Within CORE, Mara specializes in project management of complex IT transformations and technology-driven M&A deals, with a particular focus on the financial services sector.

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