Top of mind

Keep your options open with loosely coupled deal integration

It's a chief development officer's nightmare: complete a costly, complex, lengthy and emotionally challenging integration of a major acquisition, only to have the board decide to sell (or shutter) the operation after a few months of further study. Sadly, technology industry business strategy is evolving so fast nowadays that this nightmare scenario is increasingly likely.

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In the current environment, company building is no longer a straight-line pursuit. Innovation based on the five megatrends (mobile, social, cloud, big data analytics and accelerated technology adaptation) is causing corporate dealmaking to accelerate dramatically (as the rest of this report attests). But that same innovation virtually guarantees that technology company business strategy will continue to change. In the past five years, one software company we know acquired approximately 60 companies while divesting a different set of 10 entities.

"Integration practices have to catch up with the reality of an extremely fast-changing technology landscape," says Dean McCauley, Principal, Transaction Advisory Services at Ernst & Young LLP.

Traditional tight integration still technology's default

Many acquisitive technology companies default to tight, permanent integration even when the strategic rationale may be temporary, such as closing a market share gap or gaining access to content or intellectual property (IP). Integration activities still bias toward hard-wiring a target's organization and processes into the parent in order to achieve key objectives (cost reduction, standardization and shared processes and systems).

Loosely coupled, modular integration should be considered

Technology companies may increasingly regret defaulting to tight integration as strategic priorities continue to shift, leading to divestiture of even recently acquired assets. Companies require new integration thinking that recognizes togetherness is not forever; what is bought might eventually be sold. In many technology deals, buyers should consider whether tight bonding to the parent or a looser approach is preferable, on a function-by-function basis. In this approach, corporate entities are treated like Legos: modular and easy to move in and out of the corporate structure to meet changing strategic imperatives.

Of note, this modular, "portfolio" approach is how PE firms always have treated their investments. It's due, in part, to their "acquire, improve profitability, divest" business model, as well as restrictions on integrating companies within a PE firm. Of course, exit is a given for PE investors. But the loosely coupled integration approach described in this article enables technology companies, too, to maintain exit as an option. With this integration approach, companies can have the best of both worlds: emulate and enjoy the benefits of the "nothing is forever" PE mindset without being constrained in synergy attainment by PE strictures.

Alternative success metrics for loosely coupled integration

"Modular integration enables technology companies to keep their options open — but success with the approach demands rethinking integration success metrics," explains EY's McCauley. By themselves, traditional metrics such as maximizing cost synergies or minimizing the time to combining product road maps and processes are not enough to drive the modular approach. Equal importance should be given to minimizing the time to gaining strategic value, driving flexibility in repurposing the asset and maximizing the net value of a potential exit.

Recommended practices for loosely coupled integration, by function

Thinking through integration strategy function-by-function should enhance the flexibility of a business strategy. "But most acquirers do deal-specific integration thinking only for functions such as sales, marketing and product development, while relying on a standard playbook for everything else," says Iddo Hadar, Technology Transaction Integration Advisor, Transaction Advisory Services, EY. The loosely coupled approach enables companies to avoid irreversible (or costly-to-reverse) integration steps — unless the business strategy warrants them.

A sampling of our recommended integration practices, by function, includes:

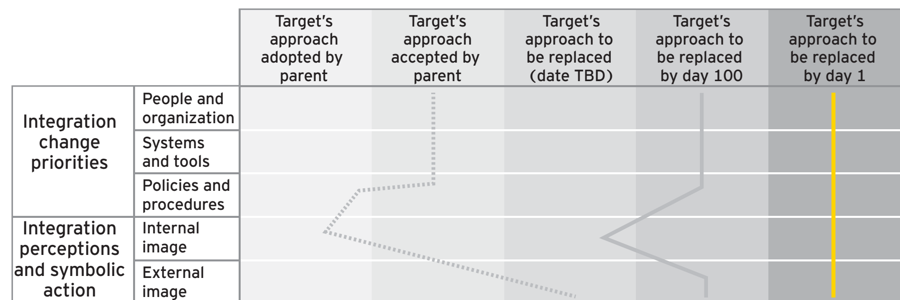
- **Shared services:** Set up shared services operations as truly arm's-length relationships, with full commercial conditions and contracts and a willingness to service other companies. With this approach, sale of a business entity does not require fundamental change — merely new contracts for the buyer. The new owner would be able to rapidly gain the strategic benefit of the asset without wasting time on low-value, high-complexity work such as order-to-cash process migrations.
- **Human resources:** On the HR front, a one-size-fits-all playbook is rarely effective. In many transactions, technology companies buy smaller, more agile companies as platforms for future growth. To enable such growth, HR integration should be "light-touch" and nuanced. This approach, for example, would allow a unique start-up culture to thrive, attracting new technical talent and subsequent business deals. Figure 5 frames a simplified view of integration architecture options that meet operational needs without sacrificing target business practices or symbolic behavior (which often is important for key talent retention).
- **Information technology:** In the IT realm, an easy improvement over tight integration is to keep servers separate for each operating entity. At a modest cost in storage efficiency, this can greatly ease data migration issues when an entity is sold. A bigger decision is whether to integrate major back-office systems. The saving potential can be great, but so can the degree of lock-in. Often, cloud-based solutions with proper interfaces and compatibility maximize flexibility for future business scenarios.
- **Accounting:** Charts of accounts and audit approaches should be designed so that business units that might someday be sold have clearly delineated and independently audited financials. This increases the annual audit cost by a small amount but has high value come sale time. When auditors have to work backwards to generate audited financial statements for the sale of a business that was not handled in this way, it can delay the sale of the business by four to six months and cost several million dollars.
- **Allocations:** In a related vein, be thoughtful about allocation methodologies. Approaches that are not aligned with the characteristics of the industry within which the new business operates would initially create an inaccurate guide to profitability for potential buyers of the business, delaying close. Later in the buying process, such misalignment may complicate the creation of standalone financial statements and transition service agreement pricing.

Modular thinking can also improve a target's salability

On the flip side, companies looking to be acquired should also think about flexibility. We recommend: stay in shared office space with short leases, outsource non-core processes, develop robust and standard contracts with vendors and customers, maintain centralized control over contractors and rent IT systems and capabilities by the hour. Finally, eschew using open-source computer code in your products (as opposed to your IT infrastructure). While a short-term time saver, open source presents complications for large acquirers. Experienced buyers will walk away from a situation that promises integration risk, even if the strategic value is apparent.

Concludes McCauley, "I believe this kind of modular thinking, aiming to increase the options open to technology dealmakers, will be the key evolutionary change in corporate development strategy over the next five years. At companies where this is done well, transactions will be executed with less business disruption, faster value creation and tens of millions of dollars less in one-time costs. Yet management will retain flexibility to rapidly execute new business combinations, as required by the evolving technology landscape."

Figure 5: Integration architecture options



This is a greatly simplified view of a range of integration architecture models that EY has developed for discussion with clients, covering a broad range of different acquisition scenarios.

Source: EY analysis.