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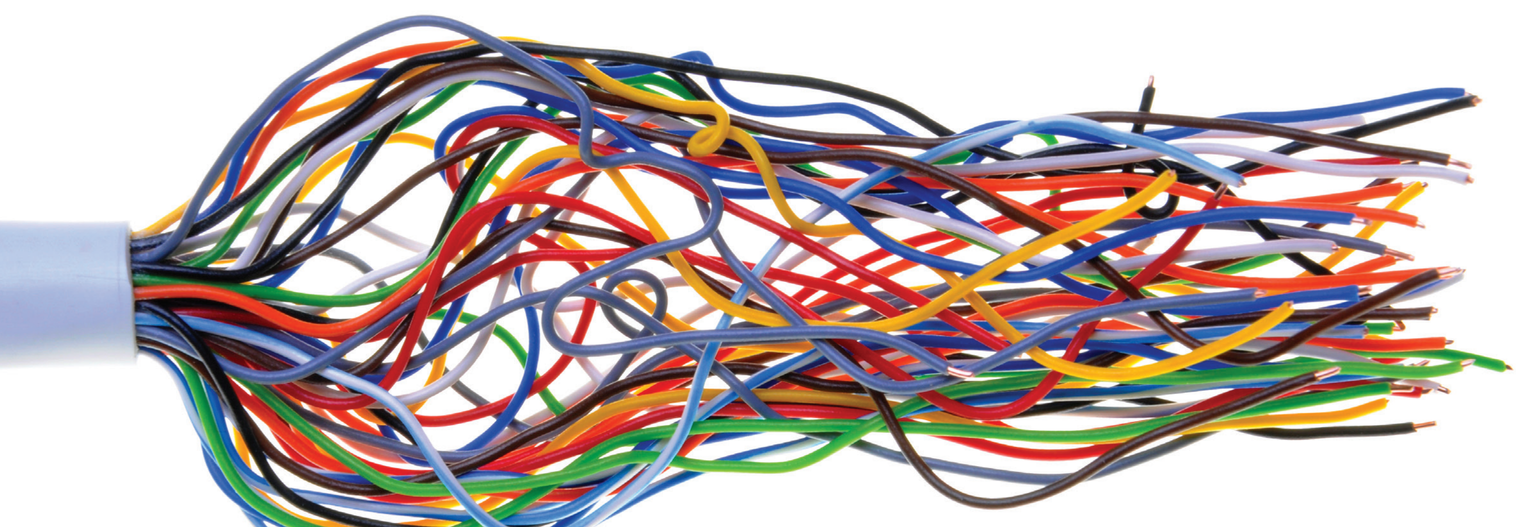
Making a "poison pill" easier to swallow: How to manage M&A-related software licensing costs and compliance risks

Part of the *Wired for Winning* series on M&A technology topics



CIOs that use a centralized, streamlined approach to M&A-related software license re-contracting may reduce costs, aid compliance, and enhance the value of the entity in play.

With M&A activity on an upward trajectory, CIOs of companies undertaking mergers, acquisitions, divestitures, and joint ventures may be facing millions of dollars of unanticipated software expenses—temporary and long-term licenses, transition services, and other third-party agreements—that often are unaccounted for in deal teams.

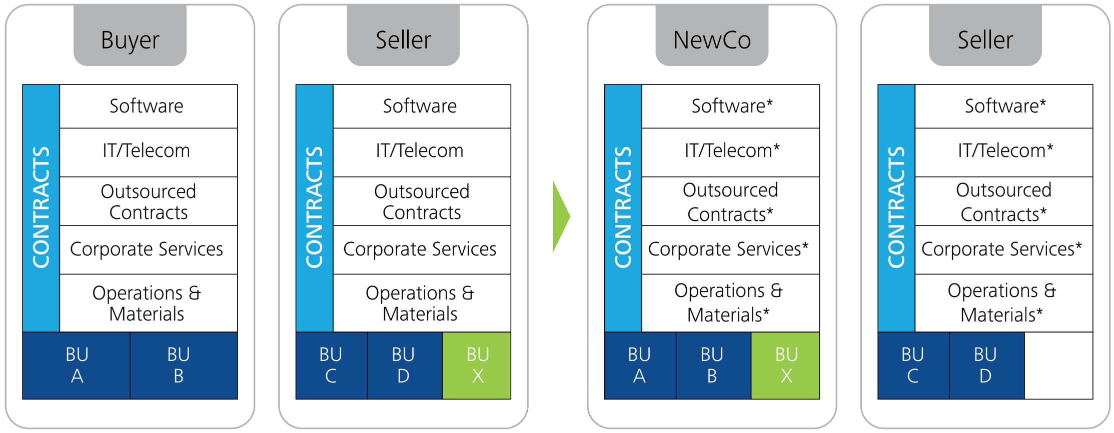
CIOs can make this "poison pill" easier to swallow by using a centralized, streamlined approach to M&A-related software license re-contracting. Doing so may help to reduce costs, aid compliance, enhance the value of the entity in play, and raise awareness of the IT organization's value at the highest levels within the company.

During a recent divestiture of a Fortune 200 diversified energy company, centralizing and streamlining IT contract separation resulted in cost avoidance of approximately $50 million through license transfers and negotiated savings.

The need for IT re-contracting

A number of factors differentiate the rights associated with software, and to some extent, hardware purchases from other assets a company buys. Software license agreements contain legal protections for intellectual property (IP) that restrict how and by whom the software can be used. Additionally, software licenses are bought but never "owned" and this distinction can be a costly challenge to conducting business as usual on the day a company sells or acquires another entity ("Day 1") (see figure 1).

Figure 1: Day 1 IT contract needs



*Need to be right-sized (i.e., capacity, synergy)

Key takeaways

- Buyer plus the newly acquired business unit (NewCo) will need additional capacity
- The acquired Business Unit (BU) will require its current licenses, at least temporarily
- The seller will have surplus capacity and stranded costs

A typical business relies upon hundreds, if not thousands, of IT contracts to support systems and applications used across the company. These contracts lock in millions of dollars of assets and restrict their use to only the licensee and their affiliates. As a company evolves and restructures through M&A, the portability of licenses to move with users should not be assumed; license restrictions can make what many thought were assets of the organization worthless in certain situations. Therefore, effective on Day 1, a company that sells or acquires another entity needs to obtain rights to the licenses that underlay day-to-day operations. Table 1 describes the challenges of following a traditional path to renegotiating these contracts in order to support the M&A event.

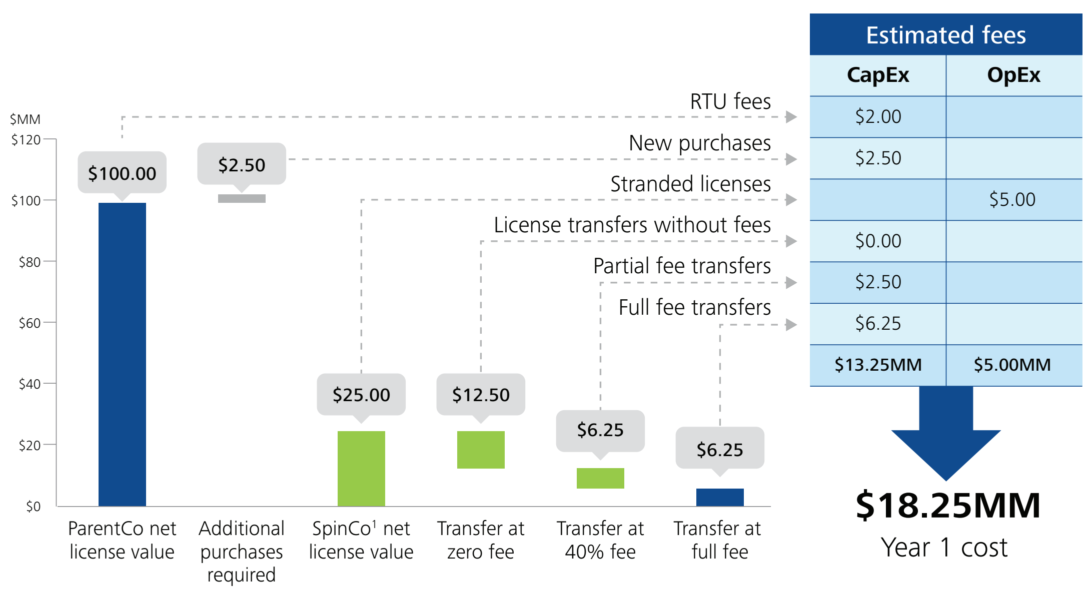
While IT integration as a whole is nearly always a key focus area leading up to, and for a year or more following a deal's close, re-contracting software agreements is often an after–thought, and can result in substantial, unexpected expenses—sometimes totaling in the tens of millions of dollars—in the form of legal fees, right-to-use fees, software repurchases and, in the worst cases, fees and penalties for non-compliance, as indicated in figure 2.

Table 1

Compliance	IP protections introduce the risk of non-compliance and significant costs to maintain compliance to any M&A deal.
Timeliness	The need for IT agreements following an M&A event is essential and the time required to establish these agreements can be substantial.
Unique knowledge	The nuances of IT agreements require special knowledge of IP restrictions combined with an understanding of the technical requirements.

Figure 2: Traditional approach to contracts separation may result in substantial fees (Illustrative)

For a company that spends ~$20MM on SW maintenance, the cost is estimated to be over $18MM for license rights to divest 25% of company



Estimated fees	
CapEx	**OpEx**
$2.00	
$2.50	
	$5.00
$0.00	
$2.50	
$6.25	
$13.25MM	$5.00MM

[1] SpinCo is the divested entity

The traditional approach to software re-contracting (see figure 3) relies heavily upon the involvement of corporate or outside legal staff, the corporate procurement department (which may not understand the nuances of IT agreements), or individual users (who likely lack an enterprise-level perspective). When a deal is announced, the buyer's legal representatives typically process on a piecemeal basis what can be a flood of re-contract requests in an effort to stem compliance concerns. Meanwhile, the purchasing department or individual users contact vendors to obtain additional licensing to support the divested or acquired entity on Day 1. This one-off-based approach often produces a host of unexpected, non-compliant situations due to the backlog of agreements still waiting for legal approval on Day 1. It also results in the divested entity incurring higher-than-forecasted license costs. The seller, in turn, may find that it retains responsibility for maintenance payments for licenses stranded in the department that previously supported the divested entity, but did not go with the sale. Ultimately, the seller faces a stranded cost implication.

In contrast, CIOs that use a leading practice approach centralize all deal-related license re-contracting issues to better control costs and reasonably make certain that on Day 1, all parties have access to the software they need while reducing stranded cost across the ecosystem. These CIOs enhance their value to the organization by reducing licensing fees, shortening costly and cumbersome Transition Services Agreement (TSA) periods, and using the visibility afforded by an M&A event to improve licensing costs across the entire organization. Importantly, CIOs understand that this approach requires total alignment of the executive leadership team, highly governed project management to meet Day 1 requirements (e.g., establishing governance, gathering data and reviewing contracts, defining strategies, and negotiating mutually beneficial agreements), and partnering with vendors to make the separation process beneficial for both parties while maintaining the useful value contained within existing licenses.

Figure 3: Typical versus leading practice approach

Typical practice approach

1 **IT project teams identify software needs**
- Contracts and needs are missed
- Higher risk of compliance on Day 1

2 **Conduct individual negotiations with vendors**
- Time consuming
- Day 1 deadline favors the vendor
- Higher cost due to lack of leverage

3 **Estimate future licensing needs**
- Over buying licenses
- Inflated separation cost

4 **Buy licensing to stand up SpinCo**
- Re-buy of existing licenses
- Higher total cost

Leading practice approach

1 **Obtain Right to Use transition period**
- Transition time to migrate data
- Mitigate compliance risk
- Substantially reduce Day 1 costs

2 **Duplicate contracts for SpinCo**
- Reduce level of effort required
- Business ready on Day 1
- Maintain favorable contracts for SpinCo

3 **Gain approval for cost-free license transfers**
- Reduce OpEx by allocating to meet needs of both companies
- Avoids SpinCo re-buying licenses

To begin contract separation, the seller and/or buyer should dedicate resources to a centralized contracts management office, which is completely focused on contract separation activities, controlling outward communication, and reducing the need for legal involvement by using a standard amendment to leverage existing contracts for the new entity wherever possible. This approach shifts the re-contracting effort from legal staff, allowing them to focus on myriad other deal-related requests. In addition, leveraging the agreements currently in place for a divested entity (particularly if they were for a larger enterprise) reduces the quantity of new software and other IT agreements required prior to Day 1. This lessens the procurement burden, bolsters the buying power of the combined organization, and quickly positions the new entity for success. Following the divestiture or acquisition, a full assessment of the IT portfolio, preferably via an automated process utilizing scripts, allows the contracts team to identify potential software for transfer and other areas where licensing support costs could be reduced, as well as to re-negotiate or source new agreements where business needs have increased. Using these techniques, companies have realized significant reductions in software costs, as illustrated in figure 4.

> Using the leading practice approach, a Fortune 200 diversified energy company divesting a significant portion of its organization saved nearly 90 percent in estimated separation license costs.

Figure 4: Using the contract separation process may avoid significant costs (Illustrative)

A structured approach can reduce 80% or more of IT license cost associated with divestitures

Estimated costs			Estimated avoided costs	
CapEx	OpEx		CapEx	OpEx
$1.2		RTU fees	$1.2	
$2.3		Negotiated savings on new purchases	$1.1	
		License transfers without fees		
$3.5		License transfers with partial fees	$3.5	
$8.8		License transfers with full fees	$8.8	
	$7.0	Stranded licenses		$6.8
$ 16.8MM	$ 7.0MM		$ 14.6MM	$ 6.8MM

$22.8MM
Year 1 cost

$21.4MM
Year 1 avoided cost

Strengthening the vendor-client relationship

Although a centralized contracts team is likely to work more efficiently using a "war room" approach—requesting a standard set of terms from vendors—it is important to work directly with vendors that have high-value agreements or particularly impactful relationships with the organization. Because of its annual maintenance payment structure, key IT vendor-customer relationships should be viewed as a partnership: In return for consistent revenue, the vendor provides support and services for all contracted products. Offering a customer flexible solutions during a time of transition adds value to this relationship, thereby enhancing the vendor in the customer's eyes, earning it a place in the IT portfolio for both the divesting and divested entity, and strengthening the vendor-client relationship in the near and long term.

Benefits of a centralized approach

The effort, time, and cost required to maintain software continuity through a merger, acquisition, or divestiture can be substantial; however, the impacts of mismanaging the re-contracting effort may be much worse—risks of noncompliance, penalties, transfer fees, and duplicate licensing, among others. Although the re-contracting period prior to Day 1 is not ideal for making wholesale changes to the goods or services under contract, it is an opportune time to leverage existing volumes and contracts for the new entity and determine those that are no longer needed in the post-deal world. Taking a centralized approach to software re-contracting may generate considerable benefits (see table 2).

Table 2

Partnership	A coordinated process with vendors as partners, rather than adversaries, can help reduce expenses.
Leverage	Existing agreements can be leveraged for new entities to reduce legal commitment, expense, and speed to contract.
Cost improvement	IT leaders can use the visibility and appetite for change afforded by an M&A event to more broadly examine license deployments and improve costs to the organization.
Asset management	A well-executed M&A re-contracting process provides visibility into IT assets and their significant value.

By managing M&A-related software licensing costs and compliance risks more effectively, CIOs and the IT organizations they lead can exit a deal with an improved cost structure, a better understanding and command of the assets they control, strengthened vendor relationships, and the ability to better satisfy the needs of their internal and external constituents.

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