Merge right: Capturing transaction value as mobility forces converge

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Automotive and technology—Detroit and Silicon Valley—are converging. We are already witnessing the impact on societies around the world resulting from the rapid pace of innovation and disruption. Those very real examples of innovations that have already disrupted mobility also only represent a fraction of what has been imagined. Significant levels of disruptive innovation may be forthcoming, and the speed at which such innovation occurs may continue to increase. Companies will need to keep pace. Many will turn to M&A as a core business strategy. But will traditionally tested and proven M&A methodologies capture the full value—the complete opportunity—of a deal in a mobility ecosystem where transformational forces, industries, and cultures are converging?

Transactions among organizations in this dynamic environment of technology and manufacturing are creating more than new nameplates and stock certificates. This convergence is fueling disruption that ultimately could lead to new business models and nontraditional ways these relationships are created and structured.

Companies that once competed over mechanical and electrical ways to achieve performance, safety, economy, and customer enthusiasm will instead compete over technologically advanced ways to reach new levels of the same standards. And, third-party technology companies, which for decades have provided add-ons to core automotive technology, may find in the future that their technology will be the core. ADAS (automotive advanced driver assistance systems), LIDAR (light detection and ranging), connected vehicles, ride-sharing, and car-sharing are becoming staples of the industry lexicon. Along with that lexicon will likely come new industry opportunities. Well entrenched global industry incumbents may increasingly see the need to evolve their business models. Today's relatively fixed capital production, and product sales businesses will likely give way to a model centered on providing "personal mobility." This new model entails partnering, building or acquiring capabilities that can serve the full range of transportation needs of both consumers and enterprises. Companies that once fit into simple categories like supplier or vendor are becoming competitors, enablers, and in some cases, M&A targets.

In this era of profound change, the automobile appears to be emerging as the ultimate consumer electronic device—and the business model that delivers that commodity to the customer is transforming as well. Traditional fixed price agreements are giving way to structures inclusive of corporate venture capital, cross-licensing, in-kind contributions, and revenue sharing models. What cues should deal-makers in Detroit and Silicon Valley take from this shift? And, how might the traditional transaction work like targeting, diligence, and integration evolve as a result?

Change will likely result in new opportunities

The future of mobility will likely be enabled through a complex intersection of talent such as roboticists, signal processing engineers, data scientists and telecommunication specialists. These evolving technology and talent needs of competing companies in this sector have led to uncommon tie-ups between industries. There are already a host of examples spanning telecom, automotive, and emerging mobility businesses to point to as evidence. That trend is likely to continue.

The drivers of value are likely changing and hence we are witnessing a shifting of M&A targets and partnerships to those companies with differentiated intellectual property and to those companies that manage customer relationships and data.

Additionally, as other nascent technologies mature and make their way into the automotive industry, it is expected that they too may become targets for partnerships, acquisitions and corporate venture capital investments. As an example, gamification, virtual reality and augmented reality have barely touched the surface of possiblilities in automotive. And, many additional acquisitions may come in the area of "over-the-air" software updates and connected vehicles.

Shifting of power in the automotive ecosystem

Technologies and services built on data analytics and predictive analytics appear to be enabling a power shift in the automotive ecosystem. We are witnessing increasing power by those that own customer relationships, those that own pathways to data, those that own data for anonymized or non-anonymized use, and the system integrators who tie it all together. Acquisition targets may emerge where there is scarcity of companies who provide key competencies and data inputs and those with defensible intellectual property that provides marked improvements in sensing, computing, and communicating.

New data combinations to unlock value

Previously disparate data sets are being combined and integrated with the car to more precisely maintain, value, operate, or insure the vehicle or that could be communicated to the individual to more precisely direct, assist, sell, and communicate to consumers. Different parties like insurers, banks, and maintenance providers will benefit from these data insights and may be motivated to offset consumer data and hardware costs to access this information.

Similarly, advertisers and retail companies could provide location-based services that are dependent upon a unique combination of location, demographics, and even calendaring and wish lists to provide more precision around the optimal time and placement of offers.

Gamification in the automotive industry

Gamification is transcending industry—from education, to healthcare and fitness, to food delivery and agriculture—we are witnessing the infiltrations of gamification. Automotive has likewise begun seeing entrants in this space—entrants, which focus on immersive experiences in the automotive design and build process to virtual reality (VR) training modules for automotive mechanics, VR and augmented reality (AR) have begun to increase in popularity. But this is likely just the starting point of entrants and players in this area of the mobility ecosystem given what is possible as gamification more fully envelops the automotive sector. For instance, could the automobile that we've spent over a 100 years engineering begin to train us? How might its evolving network of sensors, cameras, and feedback devices provide us not just awareness when we deviated from a lane, but to proactively perfect how we drive? Might we use augmented reality and virtual reality programs to master cornering, driving in snow or changing lanes? How could new brand-based rental fleets, and car-sharing companies benefit from employing training to people who now may be driving 20 different cars a year? And finally, what companies will enable all of these possibilities?

Companies that are finding new ways to engage with customers through gamification may be interesting partners and investment targets.

Different models of engagement require a different approach to diligence

Most companies are employing a broader toolkit to access innovation today. Given shrinking product development lifecycles and scarcity of talent, a third path beyond organic growth or acquisition is being utilized with increasing frequency. This third path—we call it leveraged growth—builds relationships with companies well in advance of, or in replacement of, an M&A event.

Leveraged growth can take many forms such as corporate venture investment, partnerships and joint development agreements, and it can have many advantages over traditional methods of innovation capture, including the ability to spread finite investment dollars farther through a milestone-based approach where you only invest as the company/partnership meets its objectives. By building an ecosystem through a combination of M&A and leveraged growth, you may be able to impact your market faster, influence a company's development path in a manner commensurate with your own, and ready your company to act fast if an opportunity to acquire that company, or its competitor, presents itself. Crafting a diligence approach that meets these evolving situations requires up front planning and focus. Our experience shows the following leading practices can help:

- **Make a positive first impression:** What if you show up for diligence and your diligence team is bigger than the headcount of the target? Automotive companies need to tread cautiously around technology investments. A prospective acquirer may think they are demonstrating commitment and being responsive by bringing a large team of specialists. This approach can signal that cultures aren't compatible and give the target workforce a worrisome first impression of their new partner.

- **Focus on what matters:** Why is the target valuable? Technology, talent, products? Whatever the answer, limit the initial engagement to due diligence specialists in that core area. Bring people that can speak the same language as the target and work directly with their engineering and business development teams in a familiar way.

- **Know the lay of the land:** In finance and legal diligence, bring a team that can work quickly to identify relevant issues—a team that knows topics like software accounting or the intricacies of venture capital funding (e.g., liquidation preferences, equity kickers, and convertible notes). Focus on topics that matter in an emerging company, such as cash burn, revenue model, customer acquisition costs, or product time-to-market.

- **Planning the exit is as important as closing the deal:** New deal constructs such as venture capital investments and partnerships can be executed in as little as two to three months, which presents a time advantage to an acquisition which may take six to nine months or longer. These new deals are subject to exit events—an IPO, a sale to a private equity or strategic buyer, or your acquisition of the business. Hence, scenario planning up front is important. Understanding how the monies flow to the different investor classes in these scenarios and how a joint development agreement is or isn't impacted by the sale to a competitor are important nuances to consider and negotiate up front.

- **Invest in building trust:** There's a reason several automakers, Tier 1 suppliers, and emerging automotive technology companies have set up innovation hubs and/or formal scouting programs in Silicon Valley. By maintaining a presence outside of traditional automotive centers, companies can build their own brands within the technology community, work more closely with their technology partners, and get early access and perspectives from market disrupters.

- **Look beyond the dollar signs:** There's no shortage of liquidity for a good idea, and the competition for great automotive technology companies is coming from new sources such as telecom and technology venture funds, IT and semiconductor companies and media firms. Automotive companies may find bringing financial resources alone isn't enough to close a deal and that understanding emerging company vernacular and deal constructs is table stakes today. Stress the value and practical product and market experience the automaker can bring to the discussion. For example, rarely will an emerging company have regulatory, quality, and international specialists on staff. Be prepared to discuss what you can bring to fill those holes and get the commitment of your company in advance of the diligence meeting. Show innovators and entrepreneurs flexibility, and be openly excited about the prospect of being better together.

A new business model may bring new challenges

The business model that underpins a technology company differs significantly from a traditional automotive model. The focus on multi-year purchase orders for components, four-year product lifecycles, complex inventory and supply chain management, and a host of other activities that automotive companies have mastered for decades appears to be on the decline.

Technology companies, and software companies in particular, often have unique contracts with each customer. They can provide a variety of goods and services under each agreement, such as hardware, software, professional services, development, and maintenance/support. In many instances there is no "hardware" or tangible, physical product. In addition, many technology companies are very adept at developing partnership agreements and different go-to-market strategies within their ecosystems. Their contracts often allow them to generate ongoing revenue with partners, through partners and for partners. This is unchartered territory for many automotive companies.

The differences between the business models can have a significant impact on the effort and complexity it takes to integrate even a small technology company into an automotive company. Those challenges can be easy to underestimate. For example, revenue recognition is no longer as simple as a shipment to an OEM customer or dealer. A technology company may require finance and IT specialists to properly evaluate, recognize and monitor revenue transactions with customers. In another example, a software as a service (SaaS) business may have thousands of customers, each of which requires its own billing, invoice generation, accounts receivable monitoring and cash application. That's a big leap from the traditional supplier model, where a company might work with as few as five to 10 significant customers or an OEM might sell into a well-established and stable dealer network.

Integration complexity can also arise in the area of human resources. Many technology employees are not only used to a fluid daily working environment, but also to a rewards system in which employees in all levels of the organization get a large portion of their compensation in the form of stock. They also often live in an ecosystem where stability isn't always a virtue—business models, companies, and employees come and go.

The compensation, benefits, and work rules that have served the automaker so reliably may not be enough to retain the key talent that will make an entrepreneurial acquisition work. The automaker should consider how to develop a compensation and benefits structure that preserves the incentive-based drive to innovation that fits under the parent structure but doesn't divide employees in an implicit class system. The value of clearly communicating that strategy, and the intent behind it, can be as valuable as the strategy itself in helping to integrate culture, business models and incentives.

What does the future hold?

The fully autonomous car is in the headlines. When will we see the tipping point that leads to mass consumer adoption? Regardless of when that innovation and others like it reach their full potential, the convergence of the automotive and technology industries is likely to accelerate. Automotive manufacturers that recognize and embrace technology and technology partners will likely have a competitive advantage. Joint ventures, partnerships, investments and acquisitions can unlock and accelerate the development and innovation the industry needs, and the leaders who make those deals should think outside their traditional constraints from the outset.