Deloitte.

Deloitte
M&A Institute

M&A Industry Advantage
Technology

Coloring outside the lines
Incorporating dissimilar business models in technology industry M&A transactions

The U.S. technology industry is characterized by a continual reconfiguration of the ecosystem and everyone's place in it. Currently, a number of forces are blurring the lines that have traditionally framed market boundaries; among these are significant consolidation in sectors such as semi conductors and hardware; the rapid convergence of technology, media and telecommunications; and a growing interdependency between technology and retail.

The rapid evolution of technology itself is also reshaping the industry. Strong consumer and business demand for innovative products and services such as cloud and remote computing, security software, and more is outstripping many companies' ability to develop new offerings organically. Mergers and acquisitions (M&A) are a common way for technology companies to execute on their growth strategies as well as address market and shareholder demands for product and service innovation.

Increasingly, many technology firms realize that to stay in front of marketplace demands and drive future growth they may have to "color outside the lines" by expanding into areas traditionally occupied by their partners; forge new competitive relationships rather than new collaborative relationships; move into and beyond adjacent markets; and incorporate different business models into their existing operational structure.

Acquiring and subsequently operating a company with a different business model may generate challenges that many technology companies and M&A teams have not seen previously. However, companies can leverage the value generated by these acquisitions if executives begin the M&A lifecycle with the end goal in mind, adopt an operating model-driven approach to due diligence and transaction execution, and use the drivers for a particular deal with a laser-like focus to drive value from downstream activities.

Tech industry M&A: Rebounding from recession

The technology industry has a long history of using M&A as a tool to drive revenue and market share growth. After a recession-induced lag in M&A activity during 2008 and 2009, continued market stabilization in 2010 led technology companies to leverage their financial strength to pursue large acquisitions and increase total M&A deal value, despite recovering market valuations. Global M&A activity in 2010 increased 9.9 percent to $149.2 billion from $135.7 billion in 2009 (Figure 1).[1] The U.S. M&A technology sector has shown an even more dramatic recovery.

Software sector M&A was particularly active during 2010, recording four of the year's top ten deals. Purchasers continue to pursue software acquisitions in high-growth markets such as security, cloud computing, and business analytics (BA). SAP's acquisition of Sybase strengthens its ability to supply BA solutions. IBM continues to emphasize BA, with its Netezza and Clarity acquisitions being the most notable in 2010. Advanced analytics is expected to lead the next phase of growth in the BA market. Storage was another active sector in 2010, as strategic buyers shored up portfolios related to cloud computing infrastructure. EMC's acquisition of Isilon was the largest deal; however, HP/3PAR and Dell/CommVault were also notable.

Painting the technology industry with a broad brush the subsectors are experiencing different trends. For chip manufacturers, some M&A activity is centered on consolidation, with vertical acquisitions to obtain greater scale and efficiencies. Other sectors are seeing diversification plays, with companies buying assets that may be completely different from their historical business models. Recent examples include Intel's acquisition of cyber security company McAfee for $7.68 billion,[2] which was completed in first-quarter 2011;[3] Google's purchase of Motorola Mobility for $12.5 billion;[4] HP's purchase of British enterprise software company Autonomy for $10.2 billion;[5] and Microsoft's purchase of web video conferencing service Skype Technologies in an all-cash $8.5 billion deal.[6]

Figure 1: Global high technology M&A marketplace activity

1 Thomson Reuters

2 Intel Buys Cyber Security Giant McAfee for $7.68 Billion in Cash," Techcrunch, August 19, 2010. http://techcrunch.com/2010/08/19/intel-buys-cyber-security-giant-mcafee-for-7-68-billion-in-cash/

3 Intel Completes McAfee Purchase," The Inquirer, March 1, 2011. http://www.theinquirer.net/inquirer/news/2029675/intel-completes-mcafee-purchase

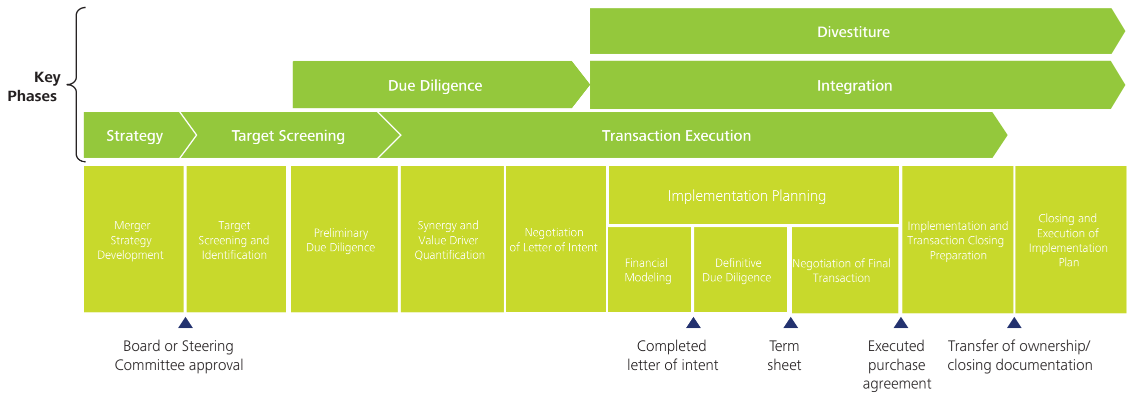
4 Google Buys Motorola Mobility for $12.5B; Says 'Android Will Stay Open," Techcrunch, August 15, 2011. http://techcrunch.com/2011/08/15/breaking-google-buys-motorola-for-12-5-billion/

5 "Confirmed: HP buys Autonomy for $10.2 billion," Business Insider, August 18, 2011. http://www.businessinsider.com/confirmed-hp-buys-autonomy-for-102-billion-2011-8

6 "Microsoft to buy Skype for $8.5 billion cash," MSNBC, http://www.msnbc.msn.com/id/42967056/ns/business-us_business. Accessed May 10, 2011

Figure 2: The M&A lifecycle

A multidisciplinary, integrated approach delivered globally across the entire lifecycle



Source: Deloitte Development LLC.

Technology companies are starting to live the reality they dreamed of in the late 1990s: converging business models and technology crossovers. Recent deals reflect a considerable blurring of the lines between the technology, media and telecom industries; certain companies are moving into each others' space and making acquisitions to support trends such as the accelerating convergence of hardware and software; increasing need for professional services for complex offerings; solutions-centricity requirements for go-to-market (GTM) and development collaborations; emerging cloud delivery models on delivery and commercial arrangements; industry value shifts to mobility and application-centric offerings; and "consumerization" of technology offerings.

Market conditions seem to favor a continued uptick in technology industry M&A in 2011. Many companies have large cash reserves and strong balance sheets, and credit is becoming available again. Thinking about transacting a merger or acquisition should reflect where an organization is in its product or corporate growth strategy. The dynamics of today's technology marketplace will likely dictate that companies quickly and efficiently formulate a flexible strategy that can support growth through a number of channels, including M&A.

The lines on the technology playing field have been redrawn. Competitors and allies from five years ago are different today and may be different again two years from now. Because competition may come from an unexpected source, technology companies should be diligent in scanning their market for disruptive innovators — companies with new or different business models — and be prepared to either combat or acquire them. If acquisition is the preferred approach, potential purchasers need to recognize that buying a company with a different business model may generate heretofore unseen challenges across specific stages of the M&A lifecycle — Strategy, Target Screening, Due Diligence, Transaction Execution, Integration, and Divestiture. Technology companies, therefore, should consider adopting a multidisciplinary, integrated approach to planning and implementation across an entire transaction (Figure 2).

Strategy: The opportunity next door

The ever-changing face of the technology industry can make it difficult for companies to define what market(s) they are in and to develop applicable growth strategies. Now, more than ever, tech companies large and small should view M&A opportunities through a wider lens and cultivate a better understanding of adjacent and new market segments.

Because competition is reconfiguring so fast, it is neither feasible nor advisable for a technology company to lock into a single growth strategy that is refreshed every six or 12 months. The M&A strategy cycle should be faster, shorter and include multiple scenarios that may play out in the marketplace; specifically, what actions, competitors might take and the company's responses to those actions which may include acquiring an organization with a different business model. The strategic planning process should encompass:

- Defining the company's integrated solutions strategy, which includes the market or product space to play in; targeted customer segments and unmet needs; a solutions path/end state; specific solution elements (hardware, software and services); and solution and capabilities gaps.

- Formulating a high-level, required capability profile for the new organization that needs to be either purchased or created.
- Identifying the value drivers for an acquisition, including what benefits it would provide; how it would fit in with the existing core business (if the acquisition has a different operating model); and whether it would be integrated or stand alone.
- Aligning stakeholders on various acquisition and integration options. Representative questions might include: Based on its identified solution gaps, should the company acquire a small, IP-focused company, a larger, established company, or a string of companies? If the acquisition is a large company, what is the preferred approach to drive integration towards an integrated solution offering?

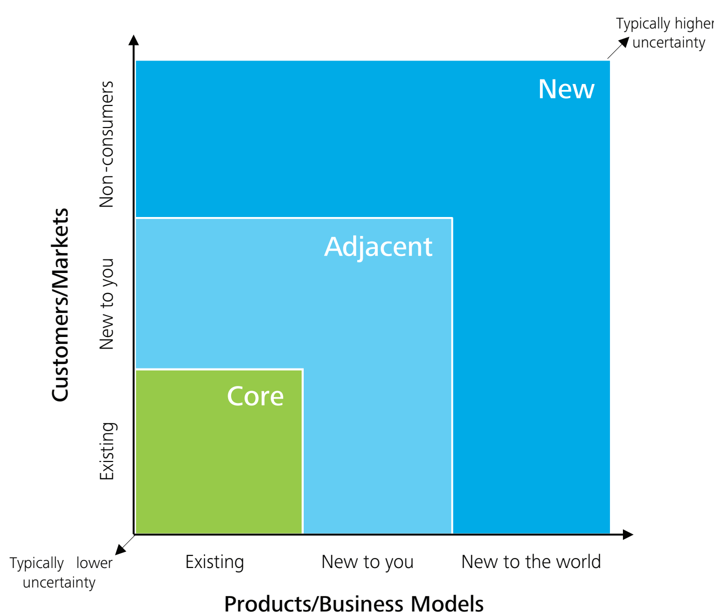
Target screening and due diligence: You don't know what you don't know

Acquiring a company with a different business model often forces an organization to rethink its target screening and due diligence processes. Some technology acquisitions that looked good on paper have failed because the purchaser did not really understand what it was buying or its in-house staff did not know the right questions to ask when conducting due diligence.

Stated simply, you don't know what you don't know. For example, hardware company executives may not be aware of advantageous acquisition opportunities in the software space. Small or mid-sized technology firms accustomed to growing through alliances or teaming opportunities may not have the bandwidth necessary to identify and evaluate potential targets. A traditional approach to conducting due diligence, with its focus on market, legal and financial issues, may not be enough when trying to determine whether to acquire a fundamentally different business model. When a company steps outside its institutional comfort zone and knowledge base to screen potential M&A targets it is important to incorporate broad research of its own and to leverage research by others in the due diligence process (Figure 3).

Figure 3: Growth opportunities through M&A

Opportunities in core, adjacent or new business fields mold where to focus due diligence activities



Due Diligence/Operating Model Focus

Core — "Efficient Engine"
- Sustaining incremental improvements
- Beating the competition
- Exploiting niches
- Managing costs, synergies

Adjacent — "Capability Expansion"
- Value capture justifying acquisition premiums
- Integrating new opportunities and capabilities to existing business
- Shifting organizational focus

New — "Colliding Worlds"
- Embracing new capabilities
- Mitigating high risk of failure
- Establishing footholds
- Prioritizing with long-term payback
- Nimble decision rights, governance

Source: Deloitte Development LLC.

A specific operating model that envisions how the combined company can realize value capture is an important success lever during the target screening and due diligence process. This Strategic Due Diligence (SDD) operating model, which defines the new organization's go-to-market strategy, product lifecycle, operations, and specific enablers (e.g., talent, infrastructure), guides traditional SDD activities and likely drives the go/no-go decision. It can help to clarify market and cost synergies, provides a more defined understanding of the capabilities needed to capture value, and outlines integration timing and requirements (Figure 4).

In summary, here are some suggestions for how technology companies can work to improve the effectiveness of their due diligence process:

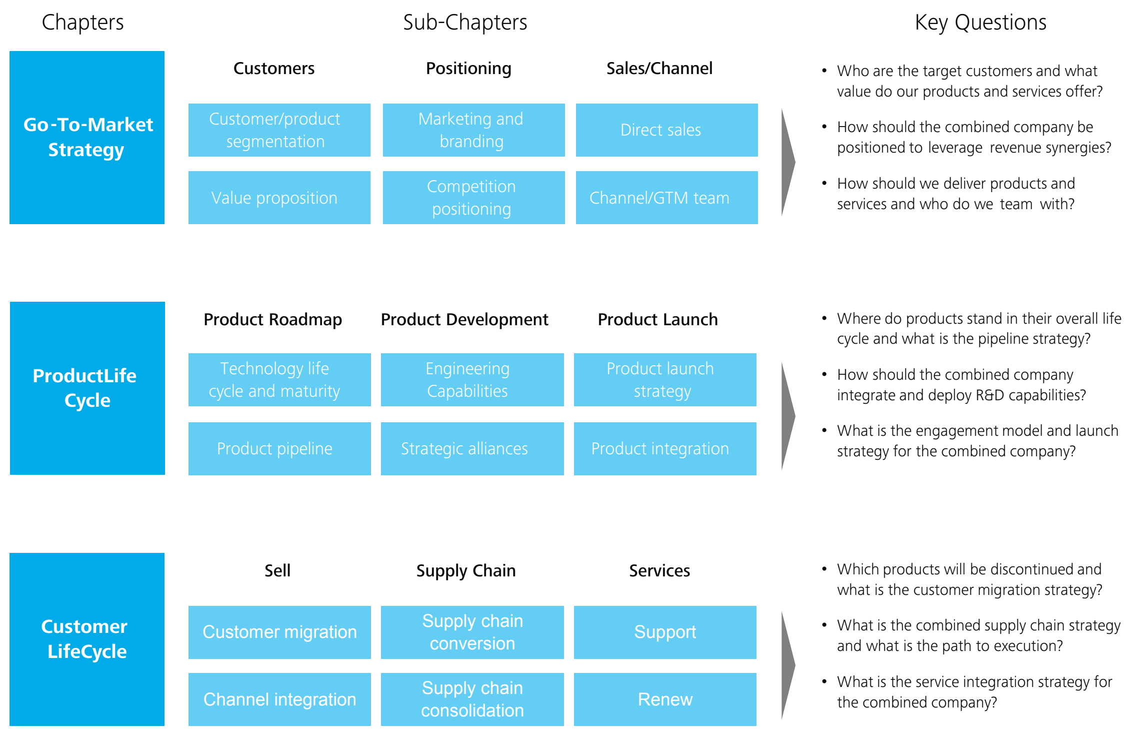
- Focus on specific levers that drive ~80 percent of anticipated value capture.
- Involve functional teams early to help them understand the complexities of integrating a different business model.
- Conduct traditional commercial and operational diligence iteratively, guided by the changes and assumptions outlined in the operating model.
- Review revenue and cost synergy potential, aligned to the required capabilities and timing to achieve them.

Divestiture dynamics

As technology companies make larger acquisitions and use M&A to fill portfolio and capabilities gaps and expand into adjacent and new markets, it may become likely that some of an acquired company's assets may not fit the strategy in play or be too far outside of the core business model and, thus, need to be shed. There are many options available when considering a carve-out or divestiture, such as selling parts to another strategic or financial buyer, spinning them off on their own, or breaking them up and selling the assets. Divestitures oftentimes can be more complex than acquisitions, as they need to be separated, stood up and operated by the time the deal closes. To accomplish this accelerated task, many divesting companies make extensive use of Transition Service Agreements (TSAs) and, in fact, often enter into a robust definition of the carve-out business' operating model, taking only those parts and capabilities that are needed by a smaller and more focused carve-out.

Figure 4: Value-driven operating model for M&A transactions

The Strategic Due Diligence (SDD) operating model playbook identifies which required capabilities of the combined company should be retained, changed or built



Source: Deloitte Development LLC.

Transaction execution: Start with the end goal

Proper execution of an M&A deal begins with identifying the transaction's end goal: What is the purpose of this acquisition? Is it to defend a market segment, enter an adjacent or new space, jump start product innovation? Answering these questions at the onset of the M&A process can suggest ways of guiding transaction execution.

When developing and transacting a purchase agreement it is important to have the right counsel involved to help work through these and other issues that may emerge during due diligence and to make sure that the acquiring company is adequately protected in escrows and indemnities.

Technology industry M&A tax issues

A typical M&A transaction raises a host of income tax, indirect tax, and transfer pricing issues which must be addressed at various points across the M&A lifecycle. The scenario in which a company makes acquisitions outside its core business is more likely to present due diligence challenges in terms of identifying potential tax contingencies. An example to consider is sales tax in the context of a semiconductor company that is buying a services business or a business that makes business-to-consumer sales. Semiconductors made by the buyer may be used by customers that incorporate them into the products that they manufacture (e.g., cell phones, computers, etc.). As a result, from a sales tax perspective, the buyer's product sales may be exempt from sales tax (provided appropriate certificates are produced). The buyer may have a reasonably well-defined universe of clients and may not have salespeople traveling extensively to solicit new customers. As a result, the buyer may be less sensitized to the criteria that can create tax filing responsibilities in states where it has not previously established a nexus. Therefore, when undertaking due diligence on a target which has business-to-consumer sales (versus business-to-business sales), which has sales people that are traveling to many different places, or which provides a service offering that is unfamiliar to the buyer's tax department, there is a greater likelihood that important tax issues will go undetected.

Given the increasingly global footprint of most technology companies, it is vitally important during due diligence and when modeling post-acquisition synergies to identify tax issues related to transfer pricing. Typical transfer pricing issues that arise when businesses are combined include the proper pricing of entities along the supply chain (procurement, manufacturing, and distribution); and the identification, allocation, and pricing of services provided in connection with executive management, back office support, sales and marketing, etc. There also are multiple, complex decisions that should be made with respect to the development, maintenance, and migration of intangible assets. The potential complexity of these items is magnified when coupled with the acquisition and integration of businesses that operate in substantially different markets, industries, or regions.

In Deloitte's experience, the first step in addressing any of these issues is to understand the extent to which the buyer and target businesses are to be integrated from a tax perspective; that is, whether the businesses are to be operated autonomously, combined to maximize any available synergies and economy of scale, or some combination of the two. Consider a scenario where the buyer intends to run the target as an autonomous business unit; for example, a transaction in which a hardware organization acquires a provider of software as a service. In this case, aspects of the services business may not be directly compatible with the hardware sold. Thus, the acquirer needed to determine where it could centralize operations and where the businesses needed to operate separately. Generally, the acquirer in these cases will centralize the executive management and back office groups to benefit from economies of scale. However, it may leave in place the target's management along with critical parts of the supply chain. The most substantial work, from a transfer pricing point of view, will likely relate to the development of a plan that provides seamless identification, allocation, and pricing of management and back office service activities allocable to the group. The tracking of these costs is relatively complex. Surprisingly, the issues are sometime less technical than emotional, as the management of the acquirer and target's affiliates may push back on new headquarters charges. Management's implementation and explanation of the fees becomes as important as the technical application of the transfer pricing rules.

Issues related to IP management also assume more urgency when dealing with divergent technologies. Typically, technology companies will acquire a business for its underlying intellectual property to advance their current development efforts with respect to new technology or to add to their current capabilities. One of the core issues with these efforts is the alignment of the intellectual property post-restructuring. In some cases, the acquirer may have located its IP in locations different from that of the target's IP. If the IP is materially unrelated, the acquirer may continue to maintain these IP holding companies, which limits the taxes that can result from the migration of IP; however, doing so may make the allocation of operational, management, back office, and R&D costs more difficult. Alternatively, the acquirer could choose to align the IP within its group, which may or may not ease the administrative burden but will likely trigger an exit tax as the IP is migrated.

Integration: Realizing the value

Acquiring a company that has a business model with different products, customers, alliances, and employee dynamics requires a thoughtful approach to integration to retain the specific capabilities that made the company work in the first place.

Some deal teams do not spend enough up-front time thinking about the end state of a newly integrated company and the operational challenges that may emerge. For example, Company A is a hardware manufacturer and its backbone is based on warehouse shipments and immediate invoicing and payment. It acquires Company B, a software developer that generates revenue over time via a subscription model. The combined entity now has two sets of sales, production and billing cycles, as well as different accounting and taxation requirements. How does the company integrate and operate these two models?

Among the integration issues to consider are:

- How to recognize different or innovative practices that the target company has used to great effect, and then determine how to retain and/or extend them to the entire combined organization. (e.g., subscription pricing or licensing management).
- How to determine whether to assimilate all capabilities or leave some to stand alone.
- How to measure and manage a different business model if the acquirer's current practices are not suitable.
- How to retain executives from the incoming business when they may have limited career options to move laterally in the combined organization. (Post-acquisition executive turnover can be extremely high: An average of 24 percent of the top management team departs during the first year. By the end of the third year, more than 50 percent of the original top management team is gone, with 68 percent gone by the end of the fifth year.[7])

Assimilation is no longer the de facto integration model for technology M&A transactions when different business models are involved. Executive leadership should explore the full spectrum of integration options at all levels of the operating model: An acquired company could be folded completely into the larger organization; it might form a new division or line of business under the corporate umbrella; or it could operate as an independent brand. For example, Skype will become a new business division within Microsoft, and Skype CEO Tony Bates will report directly to Microsoft CEO Steve Ballmer.[8] How the combined company will likely operate and execute to achieve M&A value creation and synergy goals should drive the integration process.

Positioning to create and exploit M&A opportunities

How might technology companies more effectively transact and leverage M&A opportunities that may require them to incorporate new or different business models? Based on Deloitte's industry research and field experience, we suggest that executives:

- Identify the value drivers for a particular deal during the M&A strategy phase and use them with a laser-like focus to orient the due diligence and integration processes and to drive value from downstream activities.
- Rethink how to focus the due diligence process. Evaluating a company with a different business model requires asking a new set of questions, and possibly having different people ask them; perhaps an objective advisor. Current staff members may not know what questions to ask about a new market segment, product type, or revenue model.
- Start with the end goal in mind. Think through how the new operating model is expected to work to retain and grow the acquisition's value, including what parts of it will and will not be integrated, and how. Consider the impacts on a newly expanded product and services portfolio, supply chain relations, delivery methods, customer service and support.

Closing thoughts

Technology companies large and small are expected to continue investing in different business models as they seek growth and adapt to rapidly evolving technologies and customer needs. Spurred by the convergence of telecommunications, media, technology, financial services, consumer products and retail, more companies are likely to adapt traditional M&A tactics to play a more accountable role in delivering tangible value from evolving business models, product portfolios, and reconfigured customer, supplier and partner ecosystems.

---

7 Krug, Jeffrey A. and Aguilera, Ruth. 2005. Top management team turnover in mergers and acquisitions. In C. L. Cooper & S. Finkelstein (eds.), Advances in Mergers & Acquisitions, 4: 123-154. Accessed May 10, 2011

8 "Microsoft lands Skype but investors skeptical," MSNBC, http://www.msnbc.msn.com/id/42967056/ns/business-us_business/t/microsoft-lands-skype-investors-skeptical/. Accessed May 10, 2011

Contacts

Marco Sguazzin
Principal
M&A Consultative Services
Deloitte Consulting LLP
+1 415 783 6860
masguazzin@deloitte.com

Garrett Herbert
Partner
M&A Transaction Services
Deloitte & Touche LLP
+1 408 704 2975
gaherbert@deloitte.com

Richard Perkins
Principal
M&A Transaction Services
Deloitte Tax LLP
+1 408 704 4603
riperkins@deloitte.com

Joost Krikhaar
Senior Manager
M&A Consultative Services
Deloitte Consulting LLP
+1 415 783 4091
jkrikhaar@deloitte.com

For additional information about Technology M&A, please visit:
www.deloitte.com/us/matechnology