Cost-conscious M&A: Estimating and managing IT costs effectively

Part of the #Tech @the heart of M&A series on M&A technology topics
One of the major tasks that company leaders typically assign to information technology (IT) executives during an M&A event, be it an acquisition or a separation, is to provide an estimate for one-time IT costs resulting from the transaction. These costs typically include capital expenditures (capex), operating expenses (opex), and run-rate expenses that normally don’t occur during regular business operations.

Accurately estimating and effectively managing M&A-related IT costs involves foresight, planning, and collaboration, as various factors can increase the complexity of the process:

- **Early, locked-in estimate.** IT executives are expected to provide an estimate for one-time costs at the inception of an M&A deal. Once they put that estimate on the table, they are typically locked in and expected to manage IT costs to remain within their initial estimate for the duration of the transaction. It is important, therefore, that IT executives have strong processes and methodologies in place to quickly create realistic cost estimates.

- **High cost, high visibility.** IT typically has a high cost to integrate or separate relative to other functions. Restatements are highly visible to company leadership and, oftentimes, to company auditors and Wall Street. Cost overruns may require that funding be appropriated from other essential programs or that IT absorb the overages in its operational budget.

- **Long integration time.** IT is typically the longest pole in the tent; in addition to usually having the highest cost to execute, the function often takes the longest time to integrate or separate (generally a number of months or years, depending on the size and complexity of the systems involved). Oftentimes, personnel in non-tech areas (e.g., sales, marketing, HR, and procurement) have completed their function-specific deal execution and moved on to their new roles while IT remains stuck in the throes of the recently concluded M&A event. IT’s long M&A execution timeline can blur the line between a restructuring charge and business as usual (BAU) expense.

These factors can place considerable pressure on IT executives to get an M&A-related one-time cost estimate right the first time and do it with foresight and precision. This article suggests leading practices to help IT executives accomplish these objectives.

### Estimating one-time IT costs

Each M&A transaction is unique, so an IT cost estimate should be right-sized for the specific circumstances related to the current transaction. Among leading practices to consider:

- **Meet in the middle.** This alignment process typically begins with estimating one-time IT costs by performing two types of analysis: top-down and bottom-up. The realistic estimate is often somewhere in the middle. Top-down analysis is typically performed by identifying cost benchmarks based on similar transactions, expressed as a percentage of the current operating budget. Transactions are like fingerprints: each is unique and so is the cost estimate needed to finance the transaction. So, while benchmarks may not be totally accurate, they can provide a basis for comparison. Existing cost allocations may also be used to help understand the run-rate impacts of separation.

To help offset the common limitations of top-down analysis, companies should also consider conducting a bottom-up estimating exercise with the IT management team. This exercise may be restricted by the confidentiality requirements of the deal that could, in turn, generate questions and confusion; however, to the extent it is practically possible, the entity management should consider bringing the primary IT management team “under the tent” to aid in the alignment on overall assumptions and generate estimates. This helps increase ownership for these estimates when managing to them. The final estimate could be expressed as a best/worst case, considering both the top-down and bottom-up estimates. These estimates would be bolstered by assumptions that are consistently reviewed and reassessed during execution of the M&A event.

- **“Bite size” it.** It is critical to maintain focus on key components when estimating one-time IT costs; these typically include capex, opex, hardware, software, and labor. The components should be further decomposed into views such as “by geography” and “by time” to better understand the levers in transaction costs. Given that the size of the IT cost bucket is often significant, it is subjected to external scrutiny; therefore, it is important that cost category definitions are confirmed with the company’s CFO and auditors to help minimize future reclassifications between capEx and opex. For example, should contract project managers and programmers be classified as capex or opex? Should a license discovery tool that was procured during the transaction but is
expected to be leveraged by only one of the companies after execution be called capex or opex? Classifications are also important in defining which transaction costs can be considered as restructuring costs to be reported to Wall Street and other external parties, and which costs can continue to hit the operating budget.

- Don’t forget. M&A transactions, especially separations, include specific costs such as stranded costs and IT Transition Services Agreements (TSA) costs. In a separation, stranded costs are the fixed components of costs that stay with the remaining entity (RemainCo) despite the decrease in the number of users. Prime examples are excess hardware, network services, and fixed or semi-variable license fees. These costs typically comprise five to fifteen percent of major contracts.

IT TSA costs are costs that RemainCo will typically incur to provide temporary IT services to the divested entity (SpinCo) after legal separation. In contrast, reverse TSA costs are the costs that SpinCo will typically incur to provide temporary IT services to RemainCo after legal separation. An example is when SpinCo needs to continue using RemainCo’s ERP platform after legal separation. The IT infrastructure, software, and labor costs to maintain the service for SpinCo users, as well as the eventual costs of separating the platform, should be taken into account. These costs may vary and estimates should be based on input from the IT management team.

Also, it is important to include a buffer for unexpected expenses that may emerge during deal execution. These can be anywhere between five and fifteen percent of the final estimate. As well, a best practice is to document all assumptions involved in the estimating process, revisit them frequently, and highlight changes over the course of the transaction.

To illustrate these leading practices, we highlight the experience of a Deloitte client, “ParentCo,” which recently transacted a separation. ParentCo separated into two equal halves—RemainCo and SpinCo—to focus on the core competency of each entity. RemainCo retained most of the IT assets and SpinCo had to build its IT infrastructure from scratch to cater to the new organization’s specific needs. To create an estimate for separation, ParentCo leveraged benchmarks from similar companies that had undergone separation and factored in costs specific to its situation, such as the stand-up of an all-new IT infrastructure. The company estimated its one-time IT separation costs as 1X its current operating budget based on consideration of the specific circumstances related to their separation. ParentCo established targets for the components of its IT separation costs and divided them into three equal buckets—hardware, software, and labor. It further broke down these costs as capex and opex, with input from its accounting group and primary members of its management team. The process and eventual estimate were vetted with appropriate ParentCo executives, including the CEO and CFO. This process established accountability among stakeholder groups for crafting the final IT separation estimate.

Managing one-time IT costs
M&A-related, one-time IT costs not only need to be accurately estimated, they need to be effectively managed to help minimize unexpected or stranded costs that may carry over post-transaction. Among leading practices to consider:
- Realize M&A is different. Existing cost management processes used during normal business operations typically do not work for managing costs incurred during an M&A transaction. This is primarily due to the quick turnaround involved in monitoring costs during the transaction execution. For example, most IT service vendors do not issue purchase orders (POs); rather, they invoice their client one to two months after rendering their services. Once the company receives an invoice, it generally takes between two and three months to pay the invoice, based on the contract terms. By the time the company records payment against an IT service delivered, often three to five months have passed and this may not be a luxury that a company can afford when trying to manage its IT costs mid-deal.

In cases where companies use forecasting tools to manage their normal IT operating costs, they do not typically track costs to the granular level needed for managing M&A transaction costs. For example, forecasting tools usually only track the total monthly cost expected for a service contract, not the per-resource details that often become important during a transaction. To help circumvent such delays, companies should supplement their existing cost management processes that involve ERP systems with manual processes that match forecasts against commitments against actuals. Tracking this life cycle manually can provide crucial flexibility and responsiveness.

The finance department is often an integral part of implementing and monitoring costs during an M&A transaction, so involving finance and other stakeholders when developing an interim tracking process can be important. Also note that ERP systems tend to be a vital part of the cost management process; companies should consider establishing cost codes against each work stream that is incurring costs and track actuals in the cost management process.

- **Trust, verify, refine, and repeat.** Once a cost management process is rolled out to the IT management team, the company’s top executives should advocate the importance of adhering to a verifiable cycle of forecasting and refining. Cost management should become a critical discussion point in executive meetings to help maintain accountability and accuracy. The IT management team should own its forecasts, commitments, and actuals. A recurring assessment by the CIO and steering committee should occur, in which they ask for historical comparisons against the project run rates to validate the cost data and the assumptions on which they were based. Forecast variances should be managed through change requests that are reviewed on a regular basis, such as weekly. Budgets should be refined based on forecast probability estimates. Any known buffers should be visible and reserves watched carefully. Reserves should be compared against the effort depicted in the project plan and the resource plans that would be used to separate them. This is typically the point in the M&A timeline where the process starts to unravel if good planning is not supported by good follow-through; ongoing executive oversight can help move the process forward as designed.

- **Connect the dots.** IT cost management is only as effective as the project implementation plan that supports it. It is important for IT executives to connect the dots and develop the separation project plan using detailed and realistic cost estimates. The plan should be loaded and leveled to understand the types of resources involved and the utilization of each resource. For example, labor estimates should be based on the duration as well as the effort involved in plan execution. Any change in the project plan should be validated against changes in associated costs. Similarly, changes in the transaction strategy should be aligned with changes in the project schedule and costs.

In addition to connecting the dots at the project level, IT executives should connect the dots for their fellow executives by consistently communicating progress on the execution roadmap and in executive forums. Any cross-functional implications or support should be called out to help minimize surprises in later stages of transaction execution.

Realistically, most of the estimating and managing process has to be done manually as existing automated budgeting and cost processes are often not granular enough for purposes of budgeting and tracking costs related to an M&A transaction. Therefore, it is critical to identify a team of detailed-oriented resources and strategic resources who can visualize and manage the process from cradle to grave.

Continuing our case study from above, ParentCo implemented a manual process to collect the forecast and commitments from the various sources of input. Actuals were provided by the ERP system, which were mapped against the same cost elements used in the manual tracker. Budget buffers were clearly called out. The CIO validated changes to the cost estimates using change requests on a weekly basis and compared actuals and commitments against forecast on a monthly basis. The IT management team was asked to explain variances and refine estimates regularly.
Conclusion
One-time IT cost estimating and management is vital to the effective implementation of an M&A transaction. IT executives should understand the implications of accurately estimating and effectively managing these costs and bring their team and fellow functional executives with them on the journey to completion.

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