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Increasingly complex M&A in the technology sector puts the spotlight on effective due diligence to drive success

MICHAEL KNOTT

FTI CONSULTING

It is evident from the most casual glance at the news headlines that the European technology sector is experiencing a surge in merger and acquisition (M&A) activity levels in both the volume and value of deals.

FTI's analysis reveals that the disclosed value of European technology sector M&A deals over the 12 month period to Q1 2014 increased 70 percent compared with the preceding 12 month period, though total deal volume increased by a more modest 7 percent.

Three technology sub-sectors in particular – electronic equipment, instruments and components; data processing and outsourcing; and online services – experienced notable increases in average disclosed deal value, up 125, 339 and 58 percent respectively versus the prior 12 months.

However, an increase in deal activity has also been paralleled by an increase in *deal complexity* as firms hunt for ways to create value in a crowded market.

Our analysis of the 580 European technology M&A deals that occurred during Q1 2014 (source data: S&P Capital IQ announced and executed) shows that the vast majority of technology deals (approximately 90 percent) were driven



Michael Knott is a Senior Managing Director in FTI Consulting's Corporate Finance practice and leads FTI Consulting's Telecom, Media and Technology (TMT) group in Europe. He can be contacted on +44 (0)20 3727 1297 or by email: michael.knott@fticonsulting.com.

by more operationally complex motivations – such as ‘capability’ or ‘scale’ consolidation plays – rather than pure portfolio or leverage investments.

Crucially, both capability and scale transactions require much more complex commercial, financial and operational insight than other types of deals, as the operational and cultural challenges of combining different businesses must be addressed.

Capability-driven deals or, more simply stated, the acquisition of new strategically important organisational competencies to combine with existing assets, accounted for roughly 60 percent of technology deal volumes in Q1 2014. These deals were based upon the desire of the acquirer to add new capability to an existing company, typically with the intent of stimulating future growth potential. Amongst the capability deals we analysed, we observed a growing inclination amongst technology firms to acquire cloud-based, mobile, online and/or big data capabilities.

High profile examples include Twitter’s acquisition of both MoPub (mobile advertising) and SecondSync (big data capabilities for analysing social media conversations), as well as Google’s acquisition of DeepMind

(artificial intelligence). Google’s acquisition of DeepMind supports our belief that artificial intelligence will be critical in the next evolution of big data application.

Adding to the operational complexities of many technology M&A deals, we also witnessed more ‘carve-outs’, as sellers looked to divest non-core operations (at times, stimulated by shareholder activism) and buyers looked for less heavily competed sales processes. Microsoft’s acquisition of Nokia’s phone business was a notable recent example of both a carve-out (by Nokia) and of a capability-driven investment by the global software giant looking to acquire mobile capabilities as the battleground for consumer devices and software evolves.

Furthermore, our analysis shows scale driven deals accounted for roughly 30 percent of technology M&A volumes in Q1 2014 and essentially involve the acquisition of scale – acquiring similar products, services, manufacturing and/or operational capabilities to those already held by the acquiring company – in order to drive growth through commercial and/or operational efficiencies. Approximately half of scale deals were undertaken domestically and therefore were likely to be more motivated by operational synergies.

This was the rationale for many of the deals within IT consulting services and data processing & outsourced services sub-sectors in particular.

Scale deals also encompass the acquisition of rapidly growing segments across key strategic and geographic markets. It is common to see scale-driven deals amongst providers of data-enabled services, especially those that are appropriate for integration into shared global platforms. Examples include the rapid growth in the demand for real time credit-check and reporting services, which has been a strong investment theme in developed economies within Europe, led by the UK. Credit reporting agency Equifax’s purchase of debt collection service TDX Group illustrates this point well. Equally, there has been well publicised rapid growth in the demand for mobile payment platforms in emerging markets, and we’ve seen the UK’s Monitise, a mobile payments company, acquire Turkish mobile payments player Pozitron Yazilim in order to gain a foothold in fast growing markets. A focus on the strong growth in demand for data processing and storage has been another common theme among scale-driven deals, especially popular with private equity firms seeking cross-border rollups of



several complementary companies.

Scale-driven consolidation deals are pertinent to both corporates and private capital. A good example of a corporate scale driven consolidation acquisition is US-headquartered mobile handset distributor Brightstar's buy out of its European counterpart Mobile 20:20, which provided a European presence following its exit from a joint venture with Tech Data. Meanwhile, 'roll-ups', such as the acquisition of telecoms network equipment provider Tellabs by Marlin Equity – which combines with their earlier carve out of NSN's optical business and buyout of Sycamore Networks – are a growing strategy for many private capital companies.

This increasingly complex and dynamic landscape of technology M&A deals means that the need for, and value of, effective due diligence – whether commercial, legal, financial or *in particular* operational – is becoming ever more vital.

With nine-out-of-ten technology deals seeking to combine companies/assets post acquisition (either for scale or capability reasons) the role of commercial, legal and financial due diligence becomes more complex. Commercial diligence is likely to need to look at sales, channel and

product synergies as well as potential dissynergies. Legal diligence may be required to support competition and regulatory arguments or IP portfolio assessments and valuations. Financial due diligence can be made more complicated with the requirement to articulate consolidated pro forma earnings and assess combined legal entity structures and tax optimisation.

Most significantly, however, the role of operational due diligence (ODD) has become critical in the context of the rise in increasingly complex technology transactions. While it has traditionally focused on areas such as the review of target company management, employees, plant and equipment, functional capabilities and key processes, its role is now also crucial in assessing the scope and quality of the target asset in detail, within the context of its acquiring entity. Specifically, this adds three layers of due diligence complexity:

Scope and quality of the standalone asset. In conjunction with FDD, ODD is essential for understanding the pro forma profit and loss account and the balance sheet definition, as well as, where relevant, assessing the quality of IP assets and, in the case of carve-outs, an understanding of the central shared service costs and other

capabilities that are excluded from the transaction.

Synergy/dissynergy value. For the 9-in-10 technology transactions that will involve some form of post-deal integration of the target company, operational due diligence plays an instrumental role in determining the long term synergy/dissynergy value of the target asset within the context of the acquiring asset. Cost synergies are often the sole consideration when building a business case for consolidation plays (with any revenue upside as an additional benefit), and yet the implications in practice are often much more complex and dynamic. The potential duplication of shared services (for example, HR, IT, finance) and management overheads are often a standard consideration. However, a clear understanding of the potential operational cost synergies involved often requires functional and deep sector knowledge to properly assess. For technology, this often includes the optimisation of sales, customer services or distribution networks, and requires understanding such elements in terms of fixed and variable cost trade-offs, route density and/or asset utilisation considerations. More esoterically, it can even include an understanding of how and where VAT



is applied. An example of this relates to an acquisition that a specialist technology company serving the financial sector made of a competitor. Post transaction, the company was able to in-source an activity that had previously been outsourced and had naturally incurred a 20 percent VAT charge. Once in-sourced, VAT was no longer applied and the 20 percent cost benefit could drop straight to the bottom line. Finally, when undertaking a consolidation or roll-up acquisition, it is essential that full consideration is also given to *dissynergies*. For example, where there is a common product portfolio and geographic overlap between the acquiring and the acquired companies, there can be negative financial impacts from sales and/or product overlaps.

Costs-to-achieve. Countering the net synergy value is the cost to achieving these combined entity benefits in terms of transaction and transformation charges. ODD

is responsible for determining all timings and costs from consolidation. For example, complexities may arise from possible redundancy processes, temporary contracts, lease exit costs, offshore/outsourced migrations and the alignment of IT and data architecture between the companies. For technology deals in Europe it is not uncommon that union negotiations can lead to 3-6 month delays to benefit realisation, while IT enablement may take 12 months or longer. ODD must assess the value and timing of all of those costs-to-achieve as well as clarify which are one-offs versus longer-term costs of doing business.

Ultimately, in light of such increasing complexity, there is a real requirement for tighter coordination and management across all forms of due diligence. This is vividly illustrated in relation to intellectual property assets within technology companies, whereby: (i) operational due diligence is responsible for assessing the

(often software-based) IP assets and determining how they can be both utilised operationally and protected; (ii) legal due diligence will determine the 'uniqueness' of the asset, coordinating with ODD; (iii) financial, legal and operational due diligence can all input in valuing the IP assets; and (iv) legal and tax due diligence dually determine how and where to structure IP ownership within the newly formed group.

The above identified synergies are often the differentiating factor both in the acquirer being able to offer a higher price for the target than others (and hence winning in the bid phase) and in driving enterprise value from the combined entity post-deal. With 9-in-10 European technology deals being strategically motivated leading to scale- or capability-based consolidation, the role of due diligence – and, in particular, operational due diligence – is critical for driving successful deals. ■