Deloitte.

Cloud Enabled M&A
Use Transactions to Accelerate Transformation

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Key Findings

Market and technology trends – for example, the drastic changes during the COVID-19 pandemic and the ongoing digitalization and automation – put increasing pressure on especially large corporations to digitally transform their business and to re-evaluate their portfolio to ensure long-term profitability.

Transform While Transact uses the drive of an M&A transaction to digitally transform the business being sold. In a carve-out situation, such transformation increases the value of the unit being divested and, therefore, the overall deal value in a time- and cost-efficient way. Transforming to a fit-for-purpose IT landscape brings great benefits for strategic investors and financial buyers as it increases the flexibility of the business, enables transformation levers, such as new business models, and significantly reduces IT operating costs. With available methodologies for transformation, cutting-edge cloud platforms, and future-ready operating models, the approach should be considered for each transaction as it offers excellent opportunities to transform a business unit toward enabled growth and reduced costs.

Transforming an asset during the carveout transaction can significantly increase the overall deal value.

Digital Transformation as a Key Driver for M&A

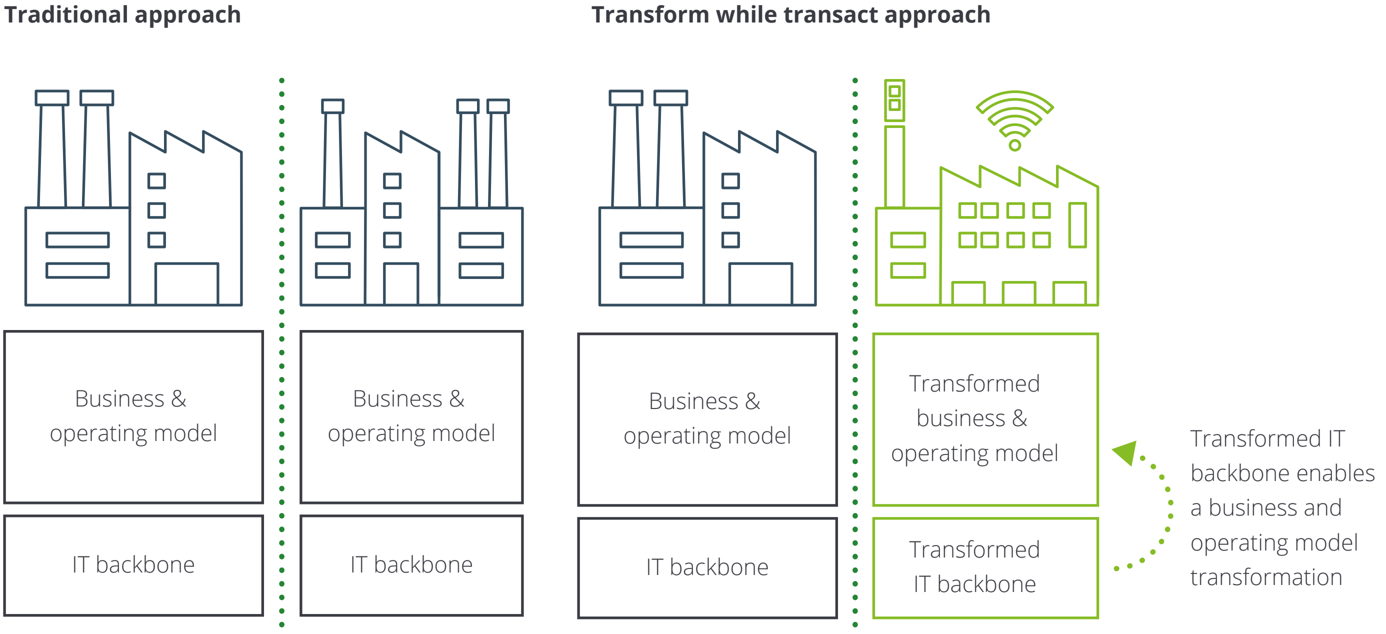
The 2020 M&A trends survey "M&A Trends Survey: The future of M&A 2020" reveals that one-third of dealmakers are responding to the COVID-19 pandemic by accelerating long-term transformation. They aim to leverage the change momentum and use this as a starting point to make structural changes. By forcing companies to adjust or rethink their businesses and operating models, the COVID-19 pandemic has accelerated the adoption of business transformations. Especially, companies with advanced digital maturity, or so-called digital champions, feel better prepared than those still trying to keep up with their transformation initiatives.

There has also been an increase in carveouts by companies looking to offload businesses and to generate cash through the divestment of non-core assets.[1] Current studies show that during the COVID-19 pandemic companies have been looking for a way to divest non-core businesses quickly to either free some capital to restructure the core business or to adapt their portfolio to changing customer needs and trends. Conversely, acquirers have a proven appetite and cash for transactions.[2]

Considering these trends, accelerating digitalization and transformation has become a top priority for many companies, with M&A transactions being a valuable opportunity to achieve this. The traditional approach to clone the existing business not only brings risks and complexity, but also slows the digital transformation of the seller and the carve-out unit. Often-inefficient business processes and IT landscapes have evolved that made sense in the context of large cooperation, but are not at all suitable for the growth of the carved-out unit. The opposite is often the case, and companies are slowed down by the legacy processes implemented in systems.

These challenges, along with ongoing digital transformation, call for a new paradigm in M&A, requiring the union of transactions and transformations. Organizations simply cannot afford to lose valuable time and significant deal value when technological and methodological capabilities are available to do both in parallel. They should use this to boost the digital transformation, which gives the business a major competitive advantage and precondition to facilitate new business models.

Fig. 1 – Comparison with traditional approach



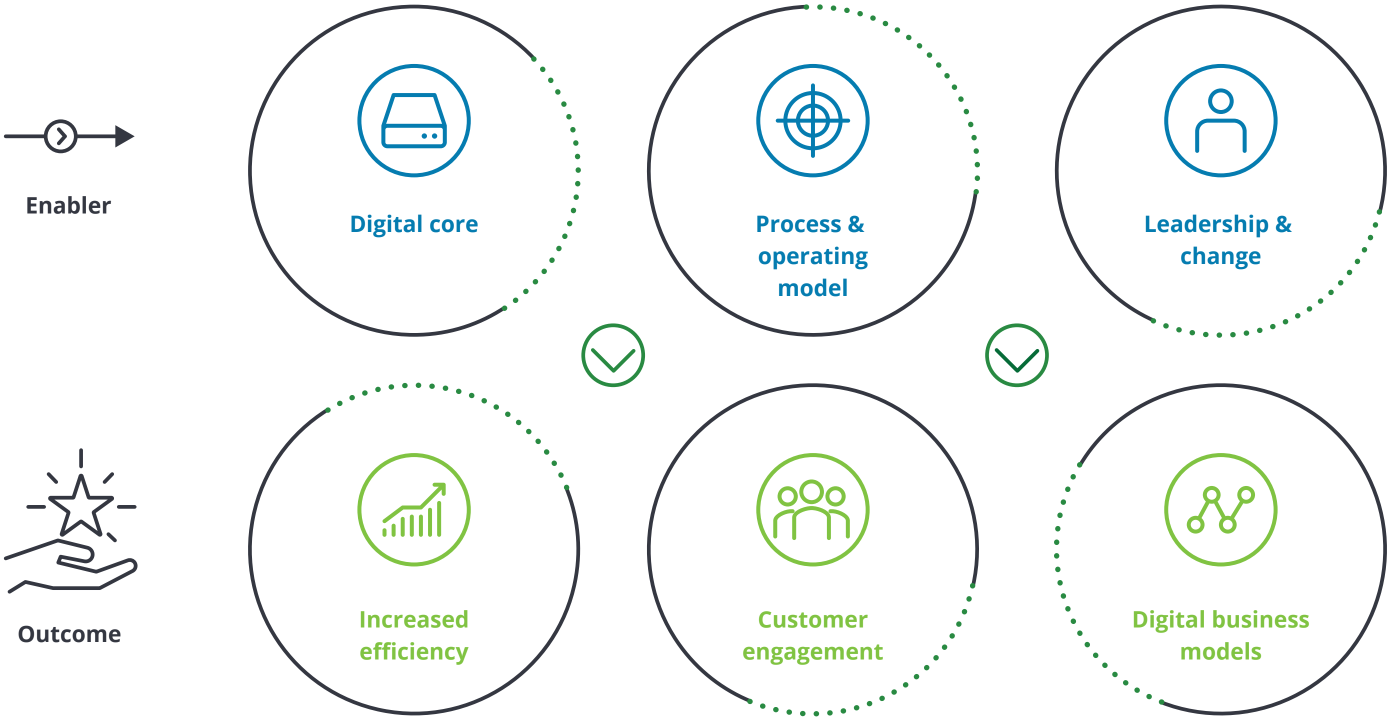
[1] Mergermarket 2020, accessed 1 March 2021, https://www.mergermarket.com/info/ma-predictions-post-covid-19-world-europe-edition-analysis, Intertrust 2020, accessed 1 March 2021, https://www.intertrustgroup.com/news-and-insights/insight-news/2020/increase-in-carve-outs-despite-covid-19?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration
[2] Bloomberg 2020, accessed 1 March 2021, https://www.bloomberg.com/news/articles/2020-12-24/m-a-deals-come-roaring-back-as-executives-plot-post-covid-future

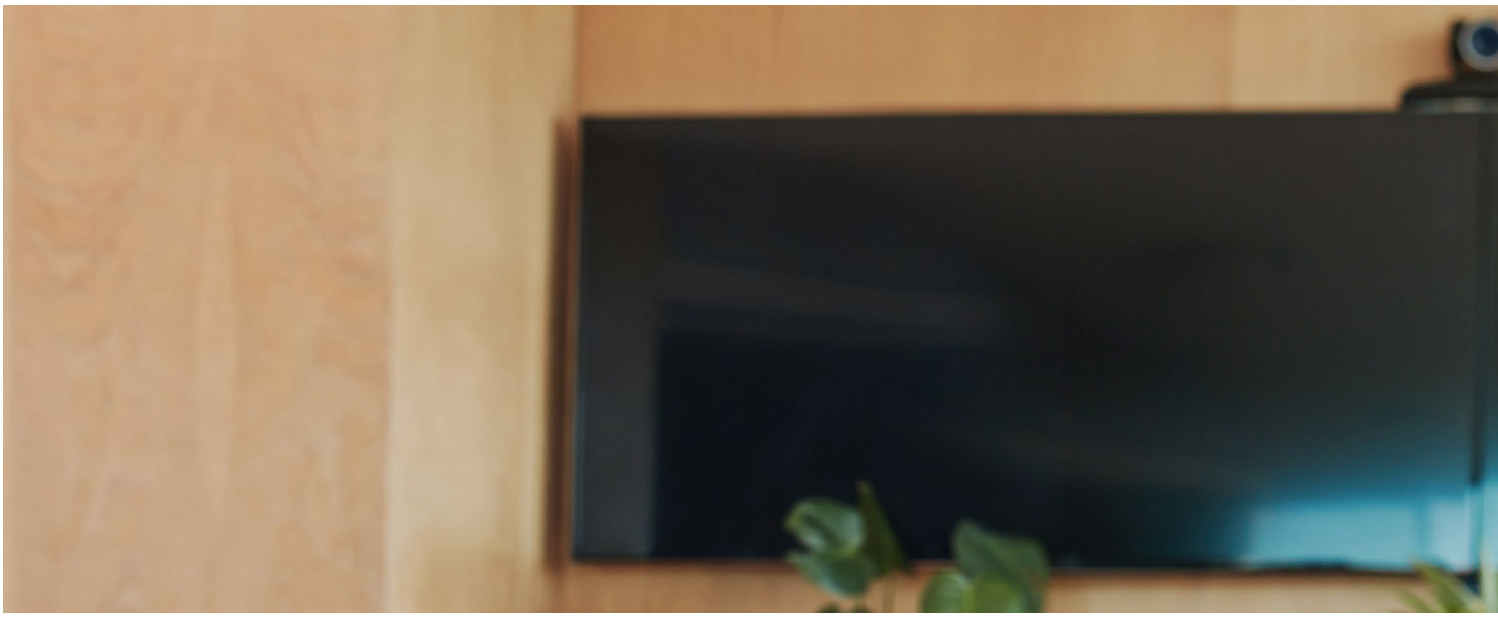
What Transformation Actually Means

Transformations will only succeed with a holistic approach that takes all relevant factors into account. There are three main dimensions of transformation: increasing efficiency, finding new ways to engage customers, and enabling digital business models.

Rather than tackling each dimension one by one, the focus should be more on the bigger picture. Key support comes from a (global) digital core, efficient business processes and operating models as well as strong buy-in from leadership.

Fig. 2 – Enabler and expected outcome of transformations





Establish a unified digital core
The digital core is the technological backbone of the company, which consists of all applications, systems, IT services, and interfaces needed to operate and grow a company. In most companies, this core is often fragmented as it is growing over time and therefore often has several inefficiencies. A cutting-edge digital core enables broader business transformation.

Redesign processes & operating models
Besides the transformation of the digital core, the business process must be redesigned and radically simplified. The standardization and adoption of industry best practices is especially becoming an important effort to reach efficiency, compliance, and long-term success. The use of a state-of-the-art digital core allows companies not only to automate many process steps, but also enables a new way of working when combined with an agile operating model and clearly defined roles.

Facilitate leadership & change
Transformation requires change at scale, and these changes can be very daunting for any organization. Accordingly, leadership commitment is key to ensuring an all-round development of the organization and to generating maximum benefits from the change management process. The balance between new leadership momentum and leadership continuity is also critical. On the one hand, new leaders bring new ideas with an unbiased position, while, on the other hand, working with the existing leadership team brings stability and security to the change process. A change in the ways of working is required; therefore, it is crucial to involve all employees across the company and to create a common narrative. Only with the buy-in from the employees and their readiness to adapt to change and to work in a different mode do other levers generate their value.

Increase operational efficiency
Processes connect talent, information, and technology and are crucial to a company's value creation chain. By adjusting the depth of value creation, simplification, and, in particular, the use of automation and cognitive technologies, companies must consider exploiting growth opportunities, reducing costs, increasing efficiency, and anticipating market trends at an early stage. By managing the business process as a key transformation value lever, companies can redesign their ways of working to achieve results with greater efficiency, lower costs, and improved effectiveness.

This can also include an overall restructuring of service delivery, such as business process outsourcing. Especially during fundamental transformations, a BPO provider can accelerate transformation and provide standardized and efficient processes while reducing effort for the existing organization.

Significantly more dynamic markets require companies to continuously question their competitiveness. It is key to develop and pragmatically implement resilient measures. Digital technologies for the end-to-end simplification of structures and processes, optimization of one's own value creation within the ecosystem, and automation, process standardization, and cognitive technologies thus create new and deeper optimization potentials.

Enable customer engagement
In today's digital world, the rules of customer engagement are changing. To continuously attract and retain customers, companies need to recognize and adapt to these new dynamics. In the process, a radical and far-reaching transformation of customer service must take place at many companies. These transformations are driven by the rapid adoption of technology, changes in customer behavior, and increasing competition. New channels and technologies open new opportunities for a company to generate more insights from its customers and to stand out from the crowd. Hence, transforming the customer interface not only improves the user experience but also helps companies find new and innovative sources of value. To do so, technology enables companies to move closer to their customers and to have more direct interactions via mobile apps or customer portals.

Shape digital business models
Shaping new business models by exploring emerging customer needs and dynamics in the company's ecosystem has become increasingly relevant to compete. Especially service-based business models that are operated fully digitally are merging and need an IT backbone to support provisioning. Thereby, a true shared understanding of the case for change is the foundation for successful business transformation. The initial assessment of transformation archetypes can help in deciding whether to focus on the core business or create something completely new by actively driving disruption and taking ownership of it. Businesses develop new business models when they are threatened by external disruptions, whether they arise from market trends such as COVID-19 or from new incumbent competitors. Companies can reinvent the core or disrupt their own to stop the bleeding of the business or proactively build new capabilities and technologies.

Getting More out of Transactions

Traditionally, M&A deals follow a certain pattern. The first step after an acquisition, merger, or divestment is to stabilize the organization or the integrated target. The next step is to transform the overall organization through the redesign and optimization of the acquired business, adapting its key processes to meet the specifications of the acquirer. According to studies, somewhere between 70% and 90% of M&As fall short of expectations, and delays in post-M&A integration are one of the key reasons. These delays can drain the energy and excitement of a deal while leaving parts of the organization completely unchanged and far from optimized.

A forward-thinking strategy offers parallel transformation under a transaction in which both approaches are executed simultaneously. During the transaction, key stakeholders within the organization are in the mind frame of envisioning the possibilities of transformational change. Leaders from both acquiring and divesting entities should use the energy and momentum from a transaction to transform and redefine their business model. This article describes the various aspects of value creation, including the perspective of a financial and a strategic buyer.

Reach the target state faster

Paralleling the transformation and the transaction allows buyers to reach the target state of the acquired company much faster. Instead of subsequently executing the transformation, accelerators such as the pre-configured platform and the methodology can be used to parallelize without adding complexity for the buyer. This leads to a significant cost optimization for the buyer.

Deal value increases

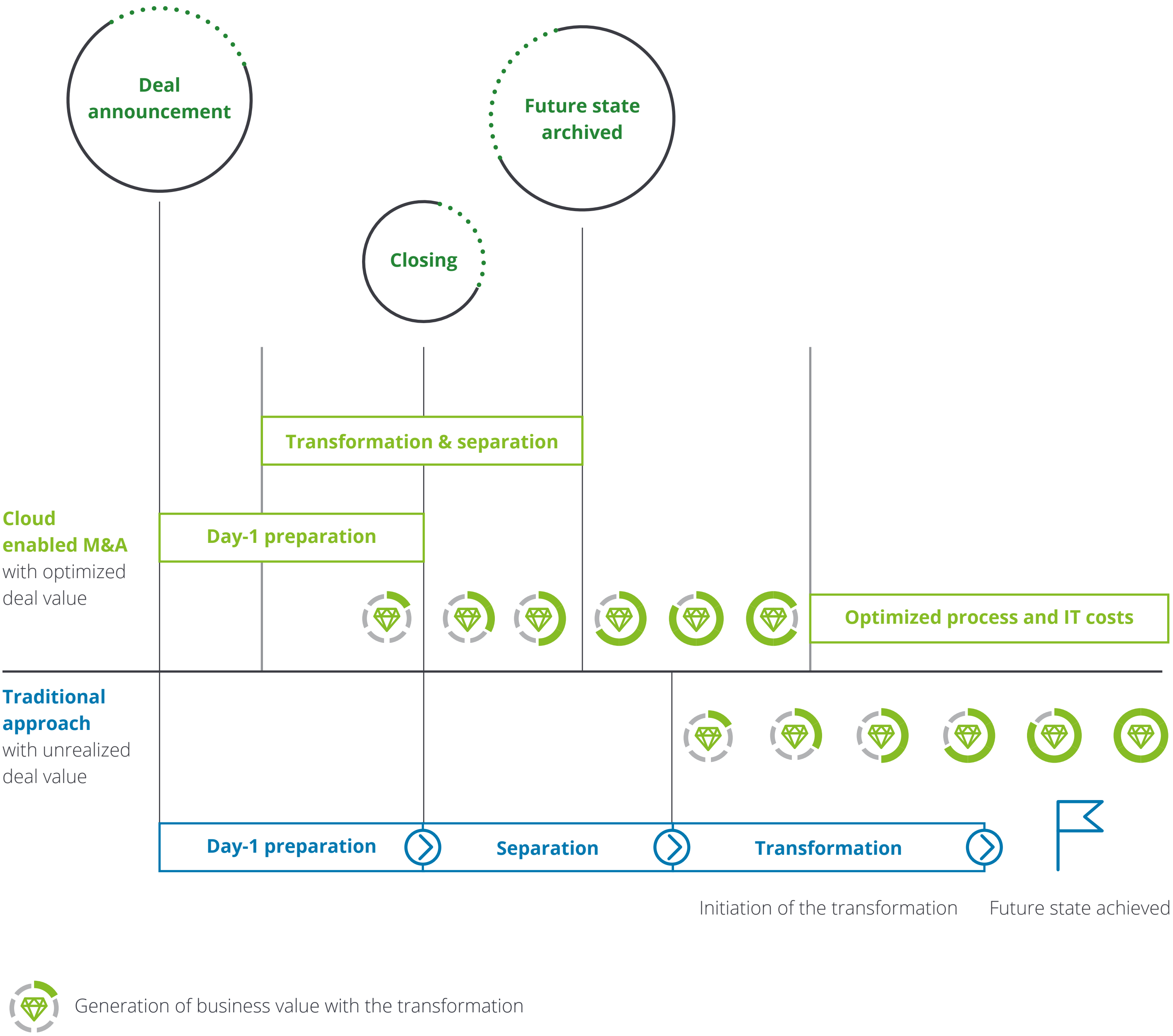
Besides the accelerated timeline, sellers can reach a higher valuation for the carve-out unit. On the one hand, the transformation increases flexibility and allows better timing. On the other hand, the efficiency optimization allows a reduction in operating costs. These factors also help buyers generate higher revenues from the unit much earlier, without the need to pursue expensive transformation initiatives at a later stage.

Optimized investment spend

When carried out effectively, the approach offers a third advantage. Usually, a transaction creates momentum and requires several carve-out activities in turn and significant project budget. With the Transform While Transact approach, significant synergies between the transaction project and the transformation can be realized. Financial buyers lacking the intention to integrate the carve-out unit in particular attain large benefits from receiving a stand-alone business where no expensive TSAs (Transitional Service Agreements from the seller company) are needed and no technology transformation is necessary anymore. The transformed IT backbone offers reduced IT OPEX and accelerated business growth through, for example, the enablement of digital business models.

For strategic investors, this approach can also bring several benefits. Integrations become much easier when the purchased business unit runs on standardized industry processes and the IT landscape with state-of-the-art technologies. It also gives the strategic buyer the opportunity to utilize the target state of the purchased unit as a blueprint for parts of their own transformation.

Fig. 3 – Increase of deal value by parallelizing transaction and transformation



How to Execute Cloud Enabled M&A

From a methodological perspective, a joint project setup is the core of the Cloud Enabled M&A approach. M&A activities must be closely aligned with technology implementation and other transformation projects. Therefore, a combination of transaction and transformation teams is essential to fully utilizing the benefits of the approach. Combining top-down transaction planning and day-one preparation with agile implementation projects requires a hybrid approach.

Besides a suitable project setup, several technological accelerators can be used to deliver the required technology assets on time:

1. Preconfigured application architecture: Applications with industry-specific applications with industry-specific, standardized business processes are key to developing a new application landscape at a required speed.

2. Cloud-based infrastructure: A modular and highly scalable IT infrastructure must be in place to support the fast ramp-up of new applications.

3. Tailored and managed IT services: IT services that can be delivered directly by the organization during the transaction need to be taken over by an interim transformation partner to ensure business continuity.

With these key components in place, organizations can handle the simultaneuous execution of a transaction early while performing the transformation concurrently without having to invest key resources into service provisioning or application separation.

Find the right time and opportunity
When possible, the ideal time to begin a transformation process is before a deal is even signed. Starting early can help to create a broader view of value creation opportunities and potential transformation results and benefits. Pre-deal transformation can provide a smooth landing for integration or separation. It is advisable to prioritize revenue and customer-originated processes, as well as operational support.

Research has shown that the inability to generate the expected operating improvement from a transaction is one of the primary reasons that businesses fail to deliver value. The less they must worry about transactional disruption and the more they can focus on the customer and the customer experience, the better they perform. Companies should not seek transformation in every transaction. Transformation during a transaction is only appropriate when there is an opportunity to create value, transform, and advance capabilities and operations, and when there is an appropriate window of opportunity to effect change. In such cases, companies should carefully consider how best to take advantage of the opportunity for transformation—and make the most of it. Implementing Transform While Transact can only be done if the current financial earnings situation allows it. Here, in particular, it is important to know in which phase of the transformation the company is located. The so-called Save-to-Transform approach can ensure that parallel transformation can be financed through ongoing business operations.

Furthermore, the size of the company matters as do performance commitments made to investors and analysts. The degree of change and disruption a company can withstand must also be weighed. Some companies are better equipped to handle change, although this is difficult to measure.

Identify challenges and barriers to overcome

In the last 10 years, 85% of companies have gone through more than one transformation, of which only 30% could achieve their defined goals.[3] Accordingly, there are several risks and pitfalls that can stand in the way of a successful transformation during a transaction:

- Insufficient leadership and ineffective decision-making jeopardize the desired outcome of the transformation: Organizations can improve their transformation performance by balancing the need to create leadership momentum while maintaining leadership continuity. This can be achieved by building a coalition of new and existing leaders to promote the change.

- Cloud solution scope is not sufficient, and individual customizations are not feasible. To cover the full range of functions, the right solutions should be selected to enable seamless integration and avoid vendor lock-in. Until now, cloud solutions often have not had a full function scope, and important parts were missing. But as solutions mature and hybrid models are used, the best of both worlds can be leveraged by standardizing processes in the cloud, but also integrating enterprise-specific applications.

- Investment is crucial when it comes to setting up cloud and transformation projects. A balanced transformation will focus on structural, company-wide changes and use cost-saving initiatives to lower expenses and improve margins for years to come. The question is no longer "if" a company should transform, but "when" it should. Transform While Transact is a game-changing opportunity to pursue M&A deals and a comprehensive transformation agenda at the same time.

- Business continuity is at risk due to a move to a new IT landscape and new processes: Decision-makers concerned about business continuity will often try to clone their existing IT architecture before migrating to a new IT platform. Especially in times of change, it is important to promote continuity and progress in equal measure while embracing new ideas. Digital tools can support this.

- The location and security of data cannot be controlled; therefore, data protection issues might occur. When it comes to moving to the cloud, concerns about the area of data protection are raised. To mitigate these risks, all providers also offer their services within a private cloud that can be hosted in a data center in Europe either by the vendor or directly by the client.

Our experience from previous projects

An American technology company wanted to divest its unprofitable software unit with approximately 9,000 employees and could not score a sufficient valuation.

Low efficiency and growth were caused by complex and interwoven processes and IT landscapes. The software company was not able to bring products to the market quickly enough, as it relied on the IT and processes of the holding company. When the technology company considered selling the business, the valuation was quite low. That's why the company decided to invest $150 million in the transformation of the company before selling it to move it to a fit-for-purpose IT landscape to increase efficiency.

Together with Deloitte, the company was able to lower the number of custom IT solutions by 50%, which reduced the maintenance effort considerably. They moved 80% of their applications into the cloud to have full scalability and flexibility of hosting. In addition, 15 sales and CRM systems could be consolidated into one solution. Overall, they achieved a $500 million deal value increase and sold the company at a much better price. The IT OPEX cost was reduced by 30%, and the company was able to bring products to the market twice as quickly. This allowed the company not only to operate more efficiently but also to conduct a full transformation of the business and the operating model.

[3] Deloitte & University of St. Gallen 2020, accessed 1 March 2021, https://www2.deloitte.com/de/de/pages/strategy-analytics/articles/transformation.html

Conclusion

With the maturing of technological capabilities and the increased pace of transformation, we expect a clear shift toward the Transform While Transact approach. Utilizing transactions to transform a business is a great opportunity for companies to increase value and reduce costs. Deloitte as a full-service provider can provide all required assets and services, orchestrated by experienced M&A, transformation, IT, and implementation experts. The next time an M&A deal appears on the horizen, it is worth considering whether this might be the ideal opportunity to "Transform while you Transact".

Mergers and acquisitions often provide a unique opportunity to drive digital transformation – make this a key consideration in every deal.

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