Mergers and Acquisitions in Tech, Media and Telecom

Charting a well-defined integration strategy

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Contents

Introduction

As the pace of technological innovation quickens, mergers and acquisitions can provide a fast track for accelerating product roadmaps, gaining access to new technologies and markets, and fending off competitors from both inside and outside one's industry.

This strategy is especially evident in the technology, media, and telecommunications (TMT) sector which in 2017 recorded an all-time high of 3,389 M&A transactions globally, worth a total of $498.2 billion.[1] A sizable majority of U.S. corporate and private-equity executives (68 percent and 76 percent, respectively) anticipate an uptick in the number of transactions across all industries in 2018. Over the past two years, 65 percent of corporate respondents said their cash reserves have increased, and the primary intended use of that cash is M&A deals.[2]

Some of these deals will involve acquisitions of well-funded "unicorns"—companies valued at more than $1 billion. While these transactions can yield big dividends, they present unique challenges—particularly when it comes to integration. Success depends on selecting the right strategy for feeding and nurturing the unicorn. This includes addressing a critical question that inevitably arises in these deals: Is it better to fully integrate the unicorn or to allow it to remain autonomous?

In this paper, we'll look at the two common types of acquisitions occurring across the TMT sector:

- Acquisitions of unicorns
- "Tech and talent" deals focused on small technology start-up firms

For each of these potential acquisition targets, we'll examine both the challenges they pose and the ingredients required for success.

Start with an end goal in mind

Companies choose to pursue mergers and acquisitions for a wide variety of reasons. According to a recent Deloitte survey, the top three motivations are technology acquisition (cited as the number-one strategic driver by 20 percent of survey respondents), expanding a customer base in existing markets (19 percent), and increasing/diversifying product offerings and services (16 percent). Other key reasons include digital strategy, gaining entry into new geographic markets, and talent acquisition.[3] And 44 percent of TMT companies that are early adopters of cognitive technology are pursuing acquisitions and investments to acquire artificial intelligence capabilities.[4]

Yet, while the reasons for many acquisitions may be sound, most are doomed from the start.

One prominent former industry CEO estimated that 90 percent of technology acquisitions fail.[5] What's more, in a 2016 study, 92 percent of respondents across the TMT sector reported that a recent acquisition fell short of expectations.[6]

Failed acquisitions typically have one thing in common: management didn't understand the value drivers for generating a return on their investments. Inadequate merger integration planning is another culprit; too often, a firm finalizes a deal without ensuring the rest of the business understands why the deal was done and what to do with it.[7]

To avoid these pitfalls and maximize value from acquisitions, executives need to begin the M&A lifecycle with the end goal in mind. What is the investment thesis? What are you trying to achieve? What is the value proposition? Can you articulate it succinctly?

Success depends upon adopting an operating model-driven approach to due diligence and transaction execution. This includes leveraging the drivers for a particular deal with a laser-like focus to fuel value from downstream activities.[8] In essence, the deal thesis should drive the operating strategy, and the operating strategy should guide the integration strategy.

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"Tech and talent" acquisitions

In most "tech and talent" deals, a smaller start-up is targeted to acquire its technology, its people (usually engineering), or both. The acquirer assimilates those assets and the start-up subsequently ceases to exist. Often, tech and talent deals are driven by the need to move quickly, either to steal a march on rivals or to catch up with them. The current gold rush around cognitive computing is a perfect example. Globally, companies spent $21 billion to acquire cognitive computing firms in 2017.[9]

Tech-and-talent acquisitions present two major challenges to the acquirer:

1. Ensuring that the acquired assets become—and remain—a priority across the business

2. Retaining key talent who may initially take a negative view of their new company's processes and leadership

Too often, tech-and-talent acquisitions suffer from inadequate merger integration planning and execution. In these cases, critical details aren't effectively communicated up front to all of the teams required to make the deal a success. When these organizations aren't incentivized to pay attention to the acquired assets, those assets can "wither on the vine."

For tech-and-talent acquisitions to maximize value, company leadership must ensure that the acquired assets remain a priority, and that key stakeholders are held accountable—for up to two to three years, if necessary.

Then there is the additional challenge of retaining talented employees (usually engineers) who now find themselves in a larger company that may differ significantly from their previous firm. Often, these new employees are millennials who felt passionate about creating technology that could literally "change the world." Complicating matters is the fact that the acquired start-up's leadership team may no longer be part of the new organization—or may find themselves in "lesser" roles.

How can acquiring companies continue to fuel the passion of their new employees?

The solution begins with communication: making sure the acquired employees have a clear understanding of the future and their specific place in it. This includes showing employees how the new organization can advance their career path and providing retraining as necessary to ensure this happens.

Another important step is making sure the acquired employees find a strong leader to follow. In some cases, this could mean integrating the acquired CEO within the larger organization's C-suite. In situations where the start-up's CEO is no longer part of the new organization, it's essential that acquired employees establish a strong connection with a new leader.

Senior leadership must remain highly visible during and after M&A transactions so that employees understand the organization's direction and how this influences their job or the company as a whole.[10]

Clearly, the success of tech-and-talent acquisitions hinges heavily on retaining and motivating talent. Uninspired employees have a direct impact on company performance: according to one study from the semiconductor industry, acquired inventors generated patents at less than 50 percent of the rate of a comparison group of non-acquired inventors.[11]

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Unicorns: Addressing the integration dilemma

As opposed to tech-and-talent deals, acquisitions of larger firms—including unicorns—are much more strategic in nature. In these deals, the acquired organization continues to operate rather than being dissolved. Eventually, however, the acquirer will need to decide whether it's best to integrate the acquiree (entirely or partially) or allow it to operate autonomously.

In some cases, the unicorn may become a subsidiary or business unit of the buyer. This can even involve moving an existing team from the buyer into the target, or using the deal to change certain aspects of the acquirer's business processes, cultural behaviors, or both. For example, as part of its $15.3 billion acquisition of Israel's Mobileye N.V., a provider of AI-based autonomous driving systems, Intel transferred its own autonomous driving unit to Mobileye. The company's combined Automated Driving Group is run by Mobileye's cofounder, chairman, and CTO.[12]

If the acquired company becomes highly successful, the buyer may also want to consider an IPO strategy. In that case, it's usually best to keep the unicorn separate rather than integrating it.

Acquisitions of unicorns present a couple of immediate challenges:

1. They come with lofty growth expectations: The acquirer typically pays a high price for a unicorn based on its valuation. That valuation is often predicated upon "hyper" growth—something that is difficult for large companies to achieve and/or sustain. Acquirers also may have business processes that unicorns view as being unconducive to rapid growth.

2. Unicorns have a homogeneous vision that may need to change: Unicorns are accustomed to rallying their people around the same focus every day. After an acquisition, that vision may change. In addition, unicorns will have to figure out the best way to leverage the new assets they've gained through the deal.

Perhaps the biggest challenge, however, is that the business models of unicorns usually bear little resemblance to those of the companies that purchase them. This clash of business models often results in the unicorn remaining autonomous. Neither the acquirer nor the acquiree wants to inhibit the innovation that made the unicorn an attractive target in the first place.

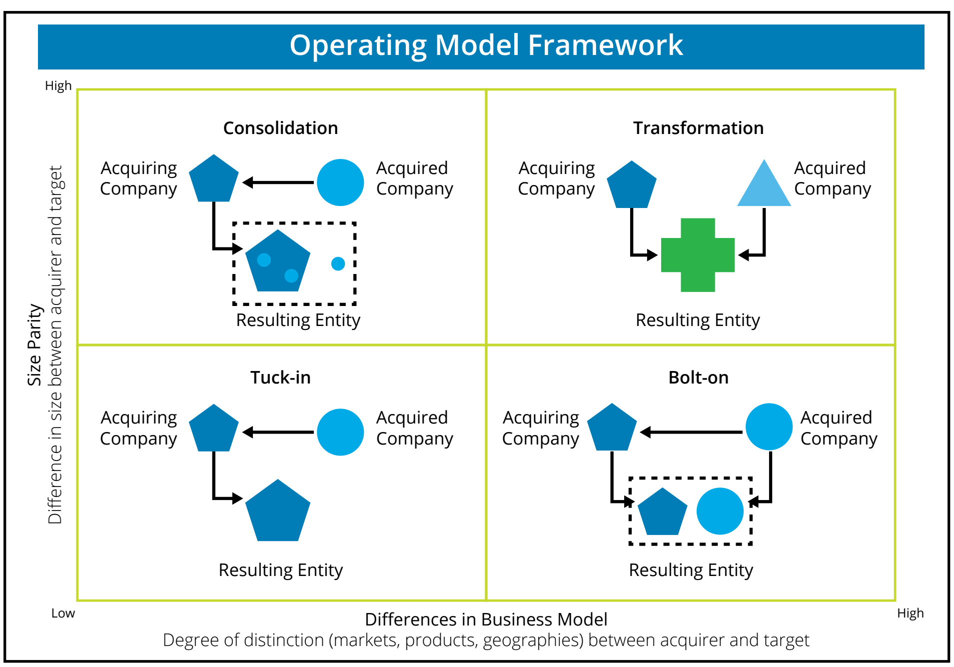
Using size and business model similarity to answer the integration question

Two factors can help TMT companies determine whether to integrate an acquired company or allow it to operate separately: its size and the similarity of its business model. Business model is especially important. The more similarities there are in how two entities operate and make money, the more likely it is that integration will create the most value.

The operating model framework (figure 1) illustrates four typical integration approaches companies can follow to help solve the integration dilemma.

The "Tuck-in" model (lower left quadrant) features a large disparity in size between the acquirer and target company but similar business models and products. In these kinds of deals, the acquired company often does not have the infrastructure, process maturity, geographic spread, or scalability of the acquirer. As a result, the target firm is assimilated into the acquirer's operations. This model accounts for more than 90 percent of all acquisitions in the TMT sector (often, these are small, non-public companies, and sometimes the transaction is not even mentioned). Companies adopting this approach are not looking for cost synergies. Their goal is to acquire a smaller technology/team/product and then scale it.

Figure 1



Source: Deloitte Consulting LLP, 2016

By contrast, the "Bolt-on" approach (lower right quadrant) is characterized not only by a large size disparity between acquirer and acquiree, but also by significant differences between their respective business models, markets, products, geographic relevance, and cultures. In this case, assimilation is not necessarily the right formula for all functions. Some or most of the target's operations should remain separate. The Bolt-on model can take many forms:

- The acquired company becomes a completely unintegrated and autonomous subsidiary
- The acquiree is a strategic business unit that remains mostly autonomous (and responsible for its own profitability)
- The targeted company becomes a division that is partially integrated (usually assimilating corporate functions such as IT, HR, finance, and real estate) but has separate product/R&D, specialist sales, and support functions
- The companies decide upon a hybrid approach focused on operating the target and achieving synergies inherent in the deal thesis

The "Consolidation" scenario (top left quadrant) applies when both the size and business models of the acquirer and acquiree are highly similar. By consolidating most business functions, the new entity hopes to gain scale and cost synergy or capture a key piece of a value chain. The semiconductor industry has seen several of these deals in recent years, and more are expected as capital-intensive businesses attempt to reduce fragmentation and achieve economies of scale.

Finally, the "Transformation" model (top right quadrant) comes into play when the acquirer and target have similar sizes but different business models. Due to their relatively large sizes, both companies can probably gain economies of scale by integrating some operations. However, the focus is on transforming the organization to reposition it within the existing ecosystem, or in the environment toward which the market is heading. The Transformation approach often is combined with divestitures to shed business units that are no longer strategic to the transformed entity. The combination of similar size and dissimilar business models means that Transformation is the most difficult to pull off, but it can create the most value when done right because both companies change substantially. Often, the vision is to change the business model and increase scale simultaneously by integrating complementary businesses.

In all of these approaches, however, companies should focus on making sure they're adopting the appropriate integration model, based on a realistic assessment of their circumstances. Too often, the combined operating model ends up looking too much like the one that existed before—often a direct result of companies trying to limit the amount of transformation they're willing to undertake. True transformation requires enormous effort, focus, and fortitude.

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Integration: Final considerations

If a decision is made to keep a unicorn separate, the acquirer should ensure that there are sound reasons for doing so. Companies sometimes choose autonomy simply to mask a lack of merger integration planning or to deal with acquired personnel. In short, they haven't figured out what to do with the acquired firm and "leave it alone" by default.

When it comes to integration, generally there are two options: 1) integrate all functions right from the start (the traditional method), or 2) begin by integrating just a select set of functions that support specific, value-driven objectives.

More and more, acquirers are choosing the latter alternative. This approach works best if the acquirer thinks in terms of "interfacing" with the acquiree rather than simply integrating it. This is accomplished by defining interactions through a series of "interfaces" that drive specific value. For example, after an acquisition, you "interface" the new technology from the unicorn and you interface back-office processes from the acquirer. In choosing which interfaces to pursue, a key consideration should be how the buyer's assets can most immediately help the unicorn.

This "hybrid" approach to the integration-autonomy dilemma has benefited firms in several industries. For example, one study determined that pharma acquisitions performed better if buyers rapidly integrated all non-R&D functions but left the acquired R&D groups autonomous.[13]

In the final analysis, most buyers will achieve greater success by integrating unicorns versus allowing them to remain autonomous. Of course, there are always exceptions. However, because these acquisitions are highly strategic in nature, keeping the unicorn separate is rarely a good move over the long haul. Too often, that has led to spin-out scenarios, complications eventually arising from incompatible systems and processes, engineering teams ultimately not moving to the parent company, and other issues.

For companies that aren't ready to deal with the challenges of integration, there is another alternative: investing in a unicorn rather than acquiring it. Venture funds provide an effective way to gain a piece of innovative companies that may become future disruptors. This strategy also enables firms to track, and potentially pre-empt, unicorns that could potentially disrupt them down the road. For example, Google has two investment arms: one focused on generating quicker financial returns, and another, more strategic one that emphasizes lower initial financial returns and a longer-term payoff. Other tech firms are using a similar approach.[14]

Due diligence

Checklist for M&A success

Although many TMT mergers and acquisitions fail to meet expectations, you can improve your chances of success by using the following checklist[15] to address up-front strategy/due diligence and integration:

Up-front strategy/Due diligence

- Identify end goal: what's the purpose?
- Define the company's integrated solutions strategy
- Formulate a high-level, required capability profile for the new organization
- Identify value drivers for the acquisition
  - To support post-deal business strategy
  - To reinforce unique competitive advantages
  - To establish a way to provide value to customers as an integrated company
  - To suit a time horizon for realizing benefits of the deal
- Align stakeholders on various acquisition and integration options
- If necessary, rethink target screening and due diligence processes
- Focus on specific levers that drive about 80 percent of anticipated value capture
  - Involve functional teams early
  - Conduct commercial and operational diligence iteratively
  - Review revenue and cost synergy potential
  - Consider strategic operating model redesign before closing

Integration

- Retain innovative practices of acquired company
- Assimilate all capabilities or leave some to stand alone
- Consider modular integration—function by function rather than all at once
- How to measure and manage a different business model if acquirer's business practices are incompatible
- How to retain execs from incoming business

Endnotes

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7. Note: In Deloitte’s recent report, “State of the Deal: M&A Trends 2018," survey respondents cited effective integration, accurate valuation, and economic certainty as the three most important factors for a deal’s success. Other key influences were a stable regulatory environment, proper target identification, change management, the quality and timeliness of data, and capturing synergies.
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