camber ADVISORS

Practical Solutions for Business

Private Equity Portfolio IT

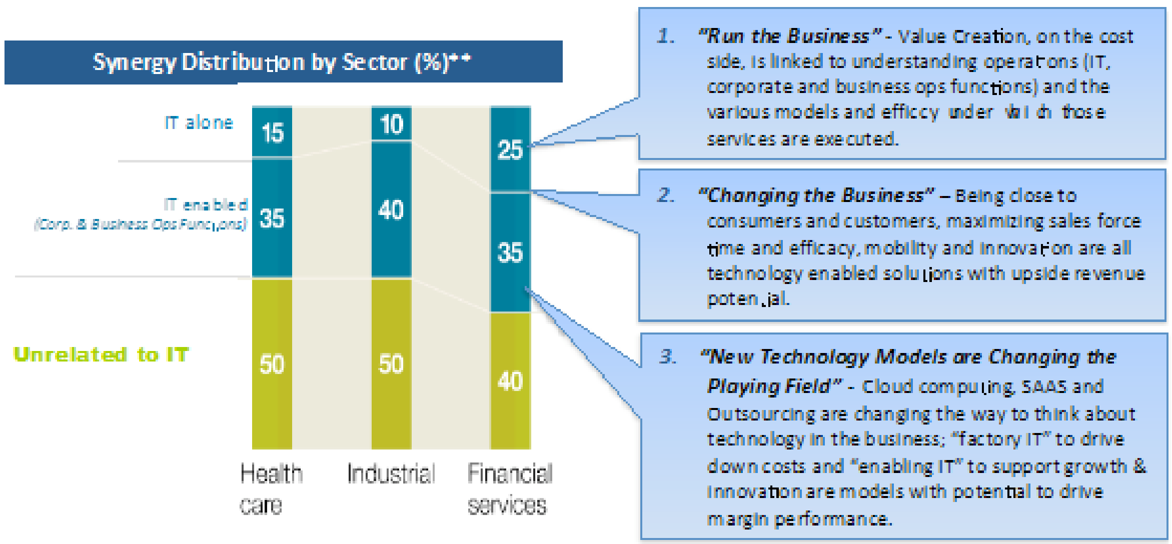
Driver of Value or Cost Drain?

By Gerry Mendelbaum, Partner, Camber Advisors

Information Technology has become key to unlocking value and realizing acquisition investment potential. Unfortunately, IT is often underplayed, overlooked or viewed merely as a cost reduction target by private equity firms both during and after the acquisition process.

IT has moved from storing data and being a source for record keeping to become a critical part in delivering the company's products and services. A recent McKinsey study (*Figure 1*) shows the strong link between IT and synergy capture in M&A.

Figure 1



**Source: *McKinsey*; January 2011

The reasons for this are varied, including:

- B2B and B2C increasingly rely on website information in their buying decisions and transaction completion.
- Studies have shown that IT can have a direct and substantial impact on the productivity of field sales and service forces, which until now have presented a unique set of management challenges.
- On the other side of the income statement outsourcing, cloud computing and utility computing models (SaaS) have created opportunities for cost reductions while presenting a unique set of IT management challenges.

These and other IT challenges and opportunities need to be a critical part to the decision to buy a business, the associated valuations and post-acquisition operations. However, the nature of due diligence poses unique challenges to conducting a thorough IT assessment.

"IT HAS MOVED FROM STORING DATA AND BEING A SOURCE FOR RECORD KEEPING TO BECOME A CRITICAL PART IN DELIVERING THE COMPANY'S PRODUCTS AND SERVICES."

IT Due Diligence

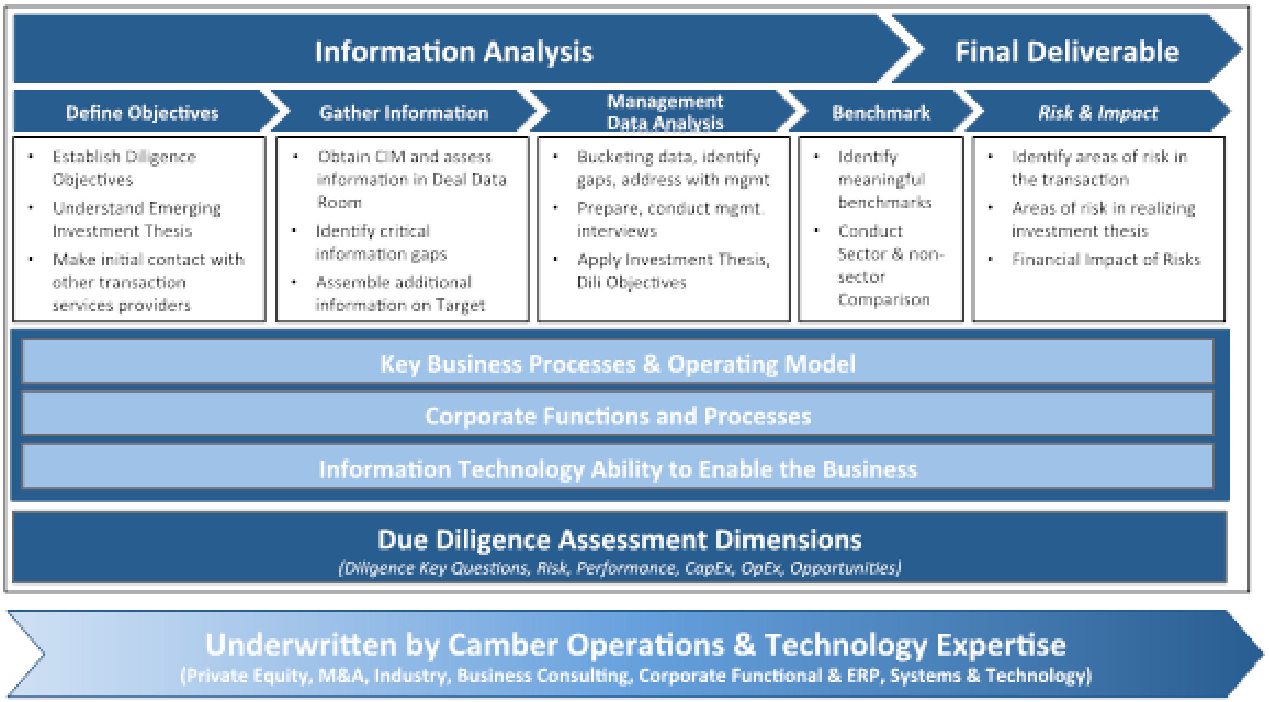
Too often the IT component of an acquisition is ignored or the work is done in an infrequent and haphazard fashion. Major near term capital needs are not identified, cost reductions opportunities are overlooked and structural weaknesses in the business model are poorly understood. As a result the acquirer pays too much, is faced with unpleasant surprises and may be accepting more business risk that they understand.

"UNLOCKING THE REAL POTENTIAL OF IT MEANS GOING BEYOND THE WALLS OF THE IT FUNCTION AND ASSESSING HOW WELL IT SUPPORTS CRUCIAL ASPECTS OF THE BUSINESS."

Due diligence is typically performed quickly and with little advance notice. It is not uncommon for targets to open their data room for only a few days and to limit the time and individuals available during site visits. Because IT is rooted in the details – what hardware is being used, structure of vendor contracts, packaged and custom applications, data structures and volumes, security, disaster recovery, and other topics – performing an effective due diligence with limited information and time presents a special challenge.

These challenges can be overcome through familiarity gained by repeated experience and focus. Just knowing what to look for however, is insufficient to produce a reliable and repeatable result. A tested methodology (*Figure 2*) is the first step to ensuring consistency and efficiency.

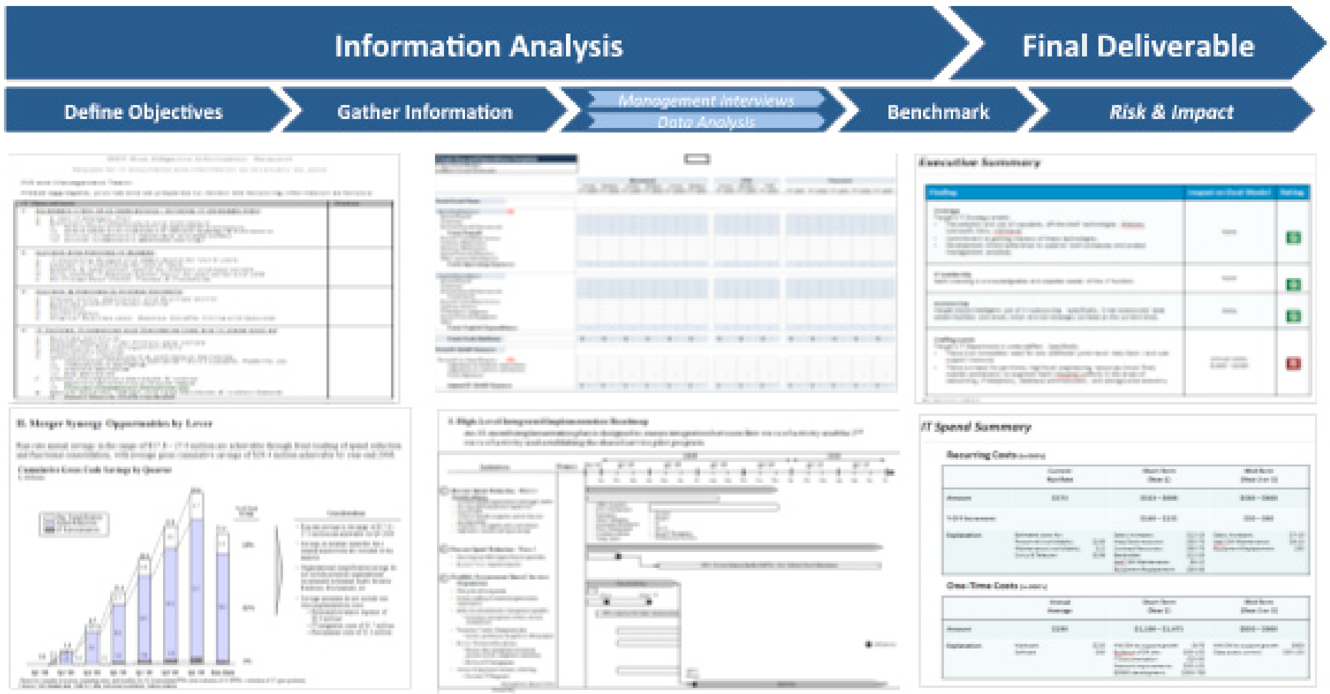
Figure 2



The approach shown above, goes beyond looking solely at IT technology and infrastructure and includes the operations of the IT function. Unlocking the real potential of IT means going beyond the walls of the IT function and assessing how well IT supports crucial aspects of the business. For example, looking at a recent deal involving the acquisition of a direct marketing business meant evaluating the performance of IT in critical business areas such as: developing and maintaining the marketing database; supporting the analysis of customers to improve targeting and how IT can assist in the design of the company's products and services. In this case, several areas were identified and quantified where IT and/or business improvements were possible that could improve the overall business value and should be a consideration when developing the valuation.

As noted before, time is usually at a premium in due diligence. While a well designed and familiar methodology is crucial, it isn't sufficient to ensure that all critical areas get covered and all appropriate information is gathered and analyzed. For this purpose, a complete set of tools and templates is needed (*Figure 3*) including a quickly customizable IT data request; a set of interview topics and questions aligned with IT roles and responsibilities, a framework for projecting and analyzing IT OPEX and CAPEX, and a best practices / benchmarking model for identifying potential IT based improvements in business value.

Figure 3



Even when Due Diligence is performed completely and correctly, it at best provides the acquiring company with a road map for managing and improving the IT function. Too often, especially in mid-market acquisitions, the target's IT management is weak and/or simply does not have the necessary depth of knowledge in today's complex and changing IT environment. In many ways the complexity and challenges of an IT operation in a $100 million company is comparable to those found in businesses 10 times or more larger. For example, each may have:

- The need to rapidly process and manage large transaction volumes
- A complex set of systems and processes (Web sites, CRM, Call Centers) for interacting with customers and a need for 100% availability
- A need to meet current best practice standards for securing customer information
- Complex relationships with product and service vendors that require sophisticated program/contract management.
- A large and expensive asset base that needs to be maintained, secured and refreshed on a regular basis

The reality is that while IT costs are somewhat scalable the expectations of the business community, and its customers / suppliers are not. They expect a similar level of sophistication regardless of the business's size or they will take their business elsewhere. For these reasons and more, due diligence is the tip of an iceberg. The real work begins when the acquisition is completed and the new owner has to drive the car.

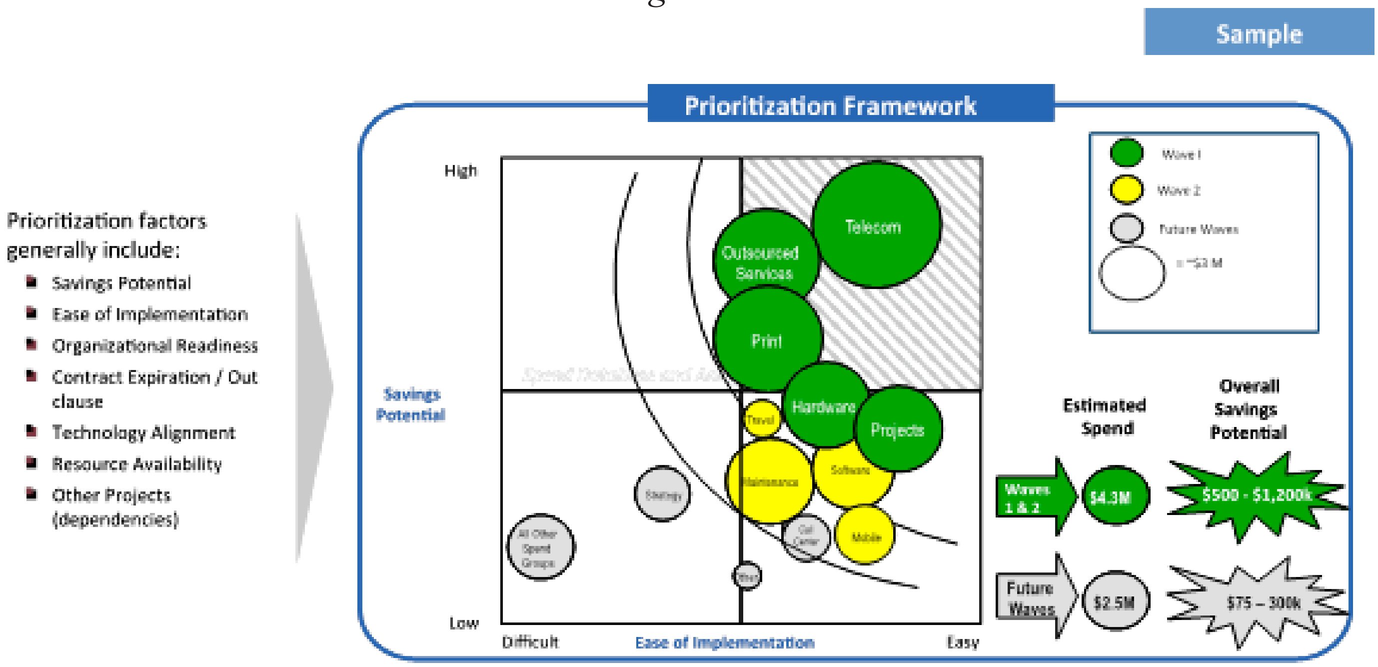
"...WHILE IT COSTS ARE SOMEWHAT SCALABLE THE EXPECTATIONS OF THE BUSINESS COMMUNITY, AND ITS CUSTOMERS/SUPPLIERS ARE NOT."

Getting Results

Due diligence draws the roadmap. In many cases, once the acquisition closes, IT becomes both a storehouse of value and a key to meeting the new owner's goals.

Either at the conclusion of due diligence or as the first activity after acquisition a complete understanding of IT initiatives must be developed and prioritized. This includes ongoing and planned projects with their associated costs/benefits and all changes / projects identified during due diligence. A straightforward approach to prioritization works best which typically is the tradeoff between potential savings (or revenue gains) versus the ease of implementation (including associated costs). Because of the tight integration between operations and IT, savings should not be limited to the costs of running the IT department. For example, improving the company's ability to support field sales / service personnel through a cloud based model could reduce IT spend while improving productivity of the people in the field and possibly driving additional revenue. All of those benefits need to be included when developing the go forward plan. The figure below shows a typical tradeoff of IT projects and the associated prioritizations.

Figure 4



It is not uncommon for projects with a large IT component to struggle with execution. They take longer then expected, deliver fewer results and cost more than planned. This is particularly the case with mid-market companies, as they tend to do projects less frequently and lack project management competency. While IT failures are problems for any organization, it can be devastating for a newly acquired business where integration with existing businesses and/or restructuring can be critical to meeting the new owner's goals.

Figure 5

Given the unique opportunities that a change of ownership presents an IT transformation should be part of the acquisition's integration plan.

Figure 5 shows many – but not all – of the value levers of a typical IT operation. Examining and aligning these with the new owner's goals should be part of every 100 day transition plan. However, the strong bonds between IT and operations in most businesses means that these components should not be examined in isolation of the IT department. The preferred approach is to develop a comprehensive Integration Management approach that comprehends the interrelated value creation of IT and operations and manages all transition initiatives in a common framework.

"WHILE IT FAILURES ARE PROBLEMS FOR ANY ORGANIZATION, IT CAN BE DEVASTATING FOR A NEWLY ACQUIRED BUSINESS."

Conclusion

IT has evolved from being a primarily supportive function to today's reality that it is integral to delivering a company's products and services. For this reason, IT should be a central consideration in any acquisition and viewed as a way to generate value, not just a place to reduce costs.

This begins with due diligence where the IT operations and business value are rapidly assessed and reflected in the valuation decision. Realizing the value goes beyond the identification and road-mapping of due diligence, should be incorporated with the business changes defined in the transition plan, and a key part of the overall Integration Management process.

Contact Information:

Gerald Mendelbaum, *Partner*
(917) 862-0755
gmendelbaum@camberadvisors.com

Mark Neibart, *Partner*
(917) 903-3992
mneibart@camberadvisors.com

Martin Glenn, *Partner*
(914) 584-9629
mglenn@camberadvisors.com