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Successful Integration In Transformational M&A Deals

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Law360, New York (August 21, 2017, 2:03 PM EDT) -- The past two years have been packed full of political and other changes that have grabbed the attention of the public and the C-suite alike. Companies face concerns over increasing nationalism and protectionism, and with such major geopolitical change comes uncertainty about policy. While these issues have dominated the headlines, many companies are nonetheless compelled to address a much more immediate concern: the need to protect and grow their customer base despite an increasingly disruptive and competitive environment. Rather than sit on the sidelines, we have seen companies continue to use merger and acquisition deals to acquire the new channels, products and technologies they need to transform their organizations and attain the capabilities needed to stay competitive.

A series of surveys conducted by PwC show that, increasingly, the biggest deals that companies are completing are transformational in nature and involve the acquisition of new technologies.[1] This strategy of using M&A to transform a company comes with unique challenges, however — often involving, on the seller's side, unwinding and separating interdependent systems and architecture and, on the buyer's side, effectively reassembling and integrating disparate and new technologies into an existing environment.

Indeed, a survey conducted by Deloitte confirms that it is no longer accurate valuation, sound due diligence or economic certainty that is the no. 1 factor in achieving a successful M&A transaction — it's effective integration.[2] Thus today, a major interest for sellers, on the one hand, is to set up an attractive target that is ready and able to be integrated, and for buyers, on the other hand, to prepare and plan for the eventual integration of the target as quickly and efficiently as possible.

The Modern Business Target

To understand the integration-related challenges for a modern M&A transaction, we should first examine what a modern target for acquisition looks like and the challenges of integrating such a company. First, every company has its core and noncore functions. The core functions are what drive the value for the company and the noncore functions are the cost centers that enable the company. Historically, companies not only conducted their core business but also kept their noncore functions (e.g., IT, supply chain, human resources, facilities and logistics, among others) within their own organization. If you were to acquire such a company, the integration process was mostly a matter of plugging the target into your own existing noncore environment and letting the business run.

But today, most targets don't operate in this fashion. Many of the target's noncore functions are outsourced. The target may host much of its data in a third party's cloud. It may conduct its human resources functions through a software as a service (SaaS) solution. Moreover, if a target is part of a larger organization, these outsourced functions are likely centralized by the parent and provided to the target through a shared-services organization. In these cases, the parent, rather than the target, may be the entity holding the licenses and having the contractual relationships with the service providers providing the company's noncore functions.

Thus, today the modern target likely has both contracts that are specifically dedicated to its business and also shared agreements that are enterprise-wide and centralized by the parent. The core business is now surrounded by a complex matrix of enabling services and technologies that are provided externally through third parties as well as internally through affiliates. This matrix of contracts and technologies supporting the target's operations brings additional challenges to the M&A deal.

M&A Issues for Dedicated Agreements

Generally, dedicated agreements are those contracts whose subject matter is limited in scope to the target business. Because dedicated agreements are specific to the target, transferring the agreements to the buyer usually does not entail complex M&A issues. In a stock sale, dedicated agreements just move with the target business to the buyer; thus provisions giving any third parties a termination right upon a change in control should be carefully considered. In an asset purchase, dedicated agreements will need to be assigned to the buyer, so it is important to look out for prohibitions on assignment. In general, sellers should be aware of any disclosure restrictions that prevent sharing the agreement with the buyer as part of due diligence. Moreover, if the contract pricing was based on enterprise-wide commitments, sellers should also assess any pricing renegotiation triggers that might be tripped as part of the transaction.

But even if the agreements have restrictions on assignment, change of control, disclosure and pricing, the primary issue for a dedicated agreement is obtaining the necessary consents. Regardless of the terms of the agreements, consents from nonrelated parties can be negotiated at the right price. Thus, the challenge for dedicated agreements in modern M&A deals is knowing what consents are necessary, who will pay for them, and what workarounds are available if a consent is not obtained.

M&A Issues for Shared Agreements

Shared agreements are those contracts providing for a joint use of the services under the agreement by different entities within a seller's organization, including the target business. In modern M&A deals, shared agreements generally present more issues than dedicated agreements. Shared agreements cannot be totally assigned to a buyer because the agreements are enterprise-wide and a seller will likely require their continued use. Sellers, however, may consider a few other options to provide buyers with the services covered by shared agreements, each of which come with their own issues.

One option that sellers may consider is duplicating or cloning shared agreements for the buyer. In this case, sellers should assess whether having a duplicate contract for the divested entity is desirable. Specific issues to consider are whether revenue or volume commitments under the agreements are appropriate for the divested entity or whether the scope of the agreement is entirely applicable to the divested entity. Another option that sellers may consider is cleaving the shared agreement to split its scope and any volume or revenue commitments so that they are appropriately allocated to the seller and the divested entity. The downside of this option is that cleaving shared agreements typically involves more negotiating time than cloning them, and a M&A negotiation is rarely considered to be leisurely paced.

If cloning or cleaving shared agreements are not practical options, sellers may also retain the agreements and provide continued access to the relevant technology or service for a transitional period through a transition services agreement (TSA). In this case, the terms of the TSA will be critical to ensure the success of the integration of the target into the buyer's business, as will be discussed further below.

Key Strategies for Sellers

Given the complexity of technological issues and the great importance of integration in modern M&A deals, a seller's goal is to present a target that buyers can confidently understand and successfully integrate with their own businesses. Having an attractive target ready to be acquired and integrated into a buyer's business can be achieved mostly through planning. M&A planning entails identifying in advance potential issues in the target that can be problematic from an M&A perspective.

Some key strategies that sellers may implement to increase the attractiveness of the target toward an M&A deal are: (1) standardize contract terms in the target's agreements; (2) negotiate dedicated and shared agreements that are as ready as possible for a potential M&A deal; (3) maintain an updated database of the target's agreements and identify which of the agreements have deviations from standard contract terms; (4) understand the target's internal capabilities and actual needs and have that information ready to be provided to buyers; (5) structure internal shared-services centers to act as if they were outside service providers; and (6) identify and suspend in-flight or upcoming projects in the target that a buyer may not need.

If a seller implements the strategies properly and effectively shows a full understanding of the target business, a buyer's fear of unknown risks will be limited. Thus, the buyer's confidence in the deal will likely increase and the seller's bargaining power will be strengthened. However, although these planning strategies are useful, they entail investment by the seller of a significant amount of time and money. Furthermore, no two buyers are alike and the relevant buyer for your target may have unexpected plans for the target. To mitigate these issues, sellers should be prepared to be flexible toward the needs of each deal.

Key Issues for Buyers

Buyers should be mindful that transformational M&A deals result in cultural and technological changes. These changes, when combined together with poor implementation and integration, can adversely affect the buyer's base business. Some key strategies that buyers can implement to avoid an adverse impact in their businesses and effectively integrate the target are: (1) understand the target company — not only the target's core business but also the target's enabling technologies and services; (2) know what the buyer's shared services organizations can (and can't) do for acquired businesses before agreeing what seller's technologies and services can be dropped; (3) ensure that focused due diligence is completed during the acquisition process; (4) assign an M&A team who should be responsible for integrating the two business and ensuring that the target has the enabling functions the buyer needs; (5) negotiate expansion and M&A support rights in its own contracts; (vi) include a form of TSA (if not already present) in the bidding process so that negotiations occur while there is leverage with the seller; and (7) have an integration plan.

Perhaps the most critical key strategy for the buyer is negotiating a TSA in the bidding process, especially because in transformational deals the buyer will certainly need the seller's substantial assistance at a point in time when the seller is no longer motivated to assist. Depending on the nature of the transitional services, the TSA should address appropriate terms intended to facilitate the integration process, including: (1) key personnel provisions ensuring that critical seller employees are not transitioned away as soon as the deal is signed; (2) where major technology implementation and integration efforts are required from the seller, provisions addressing milestone-based payment of held-back portions of the purchase price during the TSA period; (3) appropriate limitations on liability that will ensure the seller has enough skin in the game following closing; (4) intellectual property rights provisions addressing ownership of existing IP rights and any other future items developed during this period; and (5) privacy and data security provisions including segregation of data, access rights and safeguards in place during this period.

Conclusion

While geopolitical uncertainty remains a broader macroeconomic concern, many of your companies are still driving to expand their customer base and bring innovation through acquisition and, as a result, technology issues need to be front and center in the M&A planning process. This area of M&A planning should be primarily focused on achieving an effective integration of the target and its supportive technologies into the buyer's business. Within these integration efforts, rendering effective TSA services is critical to both sellers and buyers because they maximize the attractiveness and value of the target company and increase the likelihood of a successful integration. But even with an effective M&A plan, no plan survives first contact, so each party should be prepared to be flexible and ready to react to a changing reality.

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[1] PwC, M&A Integration: Choreographing great performance, p. 6, http://www.pwc.com/us/en/deals/ma-integration-survey/pwc-m-and-a-integration-survey.pdf.

[2] Deloitte, M&A Trends; Year-End Report 2016, p. 17, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/mergers-acqisitions/us-ma-mergers-and-acquisitions-trends-2016-year-end-report.pdf.