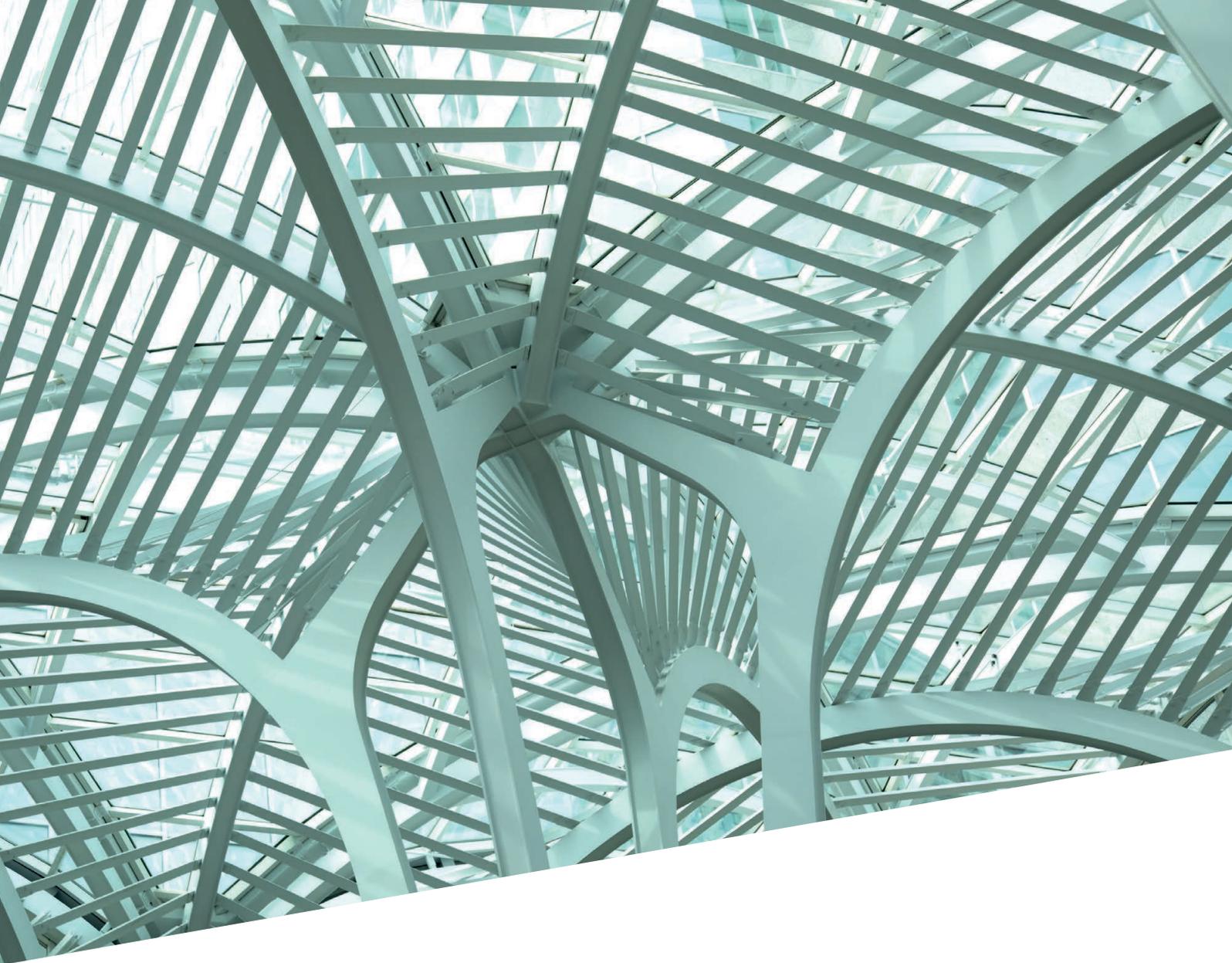


**Merger  
integration in  
a converging  
world**



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Building a better  
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“The key to convergence deal integration is more than figuring out how to guard the target’s operation so that the things you value about them – their ability to innovate, their culture, their connection to the market you’re trying to enter – don’t get damaged. It’s also about vigorously fueling their fire so you can accelerate all those things.”

**Faizul Ali**

Partner, Transaction Advisory Services  
Technology, Media & Entertainment and Telecommunications  
Ernst & Young LLP

# Merger integration in a converging world

## **When it comes to merger integration, convergence matters**

Leaders in the technology, media and entertainment, and telecommunications (TMT) sectors understand the challenge of creating long-term value from M&A, and likely are aware of a recent acquisition that failed to fully achieve pre-deal expectations. As the nature and purpose of TMT dealmaking evolves, corresponding changes to merger integration strategy and execution are lagging behind.

Meanwhile, the importance of getting TMT M&A right is increasing.

TMT companies are navigating through a cycle of relentless change – powered by transformational developments in technology – that is driving shifts in customer habits and preferences, disruption of entrenched business models and the emergence of unforeseen competitors. These changes are leading to a significant acceleration in transaction activity as companies seek to gain (or protect) a competitive edge. Consequently, TMT companies are recalibrating their acquisition roadmaps; however, many are only beginning to consider how to align their merger integration plans with the recalibrated intent of their deals. That delay puts at risk the value creation opportunity arising from TMT M&A.

For example, in October 2016's *EY Capital Confidence Barometer* survey, 92% of respondents across the three TMT sectors reported that a recent acquisition failed to meet their expectations, with some aspect of inadequate merger integration planning typically cited as the culprit. "As disruptive digital technology becomes ubiquitous, and technology advancement accelerates, it is shifting the rationales driving TMT dealmaking. But integration approaches aren't always shifting to support new deal rationales," explains Faizul Ali, a partner in EY's Transaction Advisory Services.

## **TMT deal rationales undergo "convergence shift"**

"Convergence deals" encompass two types of growth-seeking M&A that TMT companies have pursued from time to time, but which reached critical mass in recent years to become a core component of the growth agenda developed in executive suites and boardrooms across the sector. They are:

- ▶ **Future-growth convergence:** Acquisitions of small, often private, typically venture-backed start-ups to strategically position for anticipated future high-growth markets. Targets typically possess strategic technology elements, potentially disruptive digital business models, extremely hard-to-find talent or some combination of the three.
- ▶ **Immediate-growth convergence:** Larger-scale acquisitions to achieve more immediate growth by targeting adjacent industries. Targets typically are incumbents operating businesses that can extend from, or leverage the use of, the buyer's core business or infrastructure, complementing the buyer's existing revenue model.



Three factors have created the environment for convergence deals' explosive growth. First is the rapid evolution of disruptive technologies and the new business model possibilities they enable. These include some – such as the Internet of Things (IoT), artificial intelligence (AI) and big data analytics – whose potential is only now beginning to come into focus, simultaneously across a broad spectrum of industries. “Technology is moving so fast that there is a penalty for being third, fourth or fifth to market,” explains Ali. “That translates into a large premium on being fast and getting new technologies integrated into your strategies earlier rather than later.”

Second is convergence at the customer level of many adjacent sectors, leading to new kinds of offering bundles and extreme competition – particularly due to the emergence of the mobile device as the primary communications/entertainment/business tool. The “mobile first” transition presents a raft of challenges for TMT companies, from designing content and services optimized for mobile usage to different revenue models associated with mobile delivery compared with traditional, legacy platforms.

Finally, the third factor virtually guarantees the future of convergence-shifted M&A: growth in venture capital investment.

Over the course of the last five years, venture investment has grown steadily, placing a cumulative US\$314 billion (2012-2016)<sup>1</sup> and fueling the rise of start-ups around the world to develop new technologies and to pioneer new business models. It's a key driver for why the latest *Capital Confidence Barometer* (April 2017) reported that 26% of TMT executives cited “New product or service innovation” as the top reason for M&A outside their own sector.

Examples of future-growth convergence deals are numerous, as mega-cap industry leaders across TMT invest in emerging players focused on IoT, AI, analytics, blockchain solutions, advanced advertising technologies, emerging video content developers and many others.

For immediate-growth deals, think content creation and distribution mergers, pay-TV and wireless hook-ups, telecom and internet combinations, software and social media linkages, or even automaker and digital mapping/telematics combinations.

### The convergence deal mismatch

By definition, convergence deals start with a mismatch. Often, it's a mismatch of scale, which can manifest in many different dimensions of each business. But almost always there are mismatches of culture, purpose, customer attitudes and more. Given these mismatches, the classic "cost-out synergies" portion of traditional deal rationales – the key driver of most merger integration execution plans – may take a back seat to other strategic priorities in convergence deals.

Instead, convergence deal success comes more from realizing an opportunity, which often lies down one of two paths:

- ▶ Accelerating the growth opportunity represented by the target, or scaling the technology throughout the new parent organization, without "ruining" it with the new parent's culture

Or

- ▶ "Reverse integration" – moving an existing team from the buyer into the target, which remains independent, or using the deal to drive changes in aspects of the acquirer's business processes, cultural behaviors or both to better match disrupted market conditions

"The reverse integration convergence deal concept allows new business models and new behaviors to flow backward into the acquirer," notes Axel Majert, EY Global Telecommunications Leader, Transaction Advisory Services.

First-quarter 2017 saw two notable examples of reverse integration, both involving AI technology for autonomous driving. In its US\$15.3 billion plan to buy Israel's Mobileye N.V., a provider of AI-based autonomous driving systems to multiple global carmakers, Intel said it will incorporate its own autonomous driving unit into Mobileye.<sup>2</sup> Intel's resulting Automated Driving Group will be run from Mobileye's Israeli headquarters and led by its cofounder, chairman and CTO. Similarly, non-TMT buyer Ford Motor Company is integrating its in-house virtual driver development team into start-up Argo AI as part of its planned US\$1 billion investment in return for a majority stake.<sup>3</sup>

**"The reverse integration convergence deal concept allows new business models and new behaviors to flow backward into the acquirer."**

**Axel Majert**

EY Global Telecommunications Leader  
Transaction Advisory Services

### **How merger integration thinking must shift**

Traditional TMT mergers oriented around cost-out synergies will continue and, thus, traditional merger integration approaches will remain relevant. But EY has identified several key shifts necessary for TMT companies to realize the full potential of future-growth or immediate-growth convergence deals.

The critical difference to keep in mind for convergence deals is that regardless of the goal – future growth through access to strategic tech or specific talent, or immediate growth through an adjacent business – you’re unlikely to get there without adopting important new business behaviors. Consequently, merger integration focus should be on behavioral and process change maybe even more than on synergies. Success requires the combined company to:

- ▶ **Identify value-driving business behaviors:** Single out the relatively few business behaviors that truly make a difference to a successful deal outcome – the behaviors that matter most in terms of driving value from the deal.

- ▶ **Consider strategic operating model redesign before closing:** In convergence deals, success often depends on operating model changes that promote the key business behaviors. It’s important to think these through before closing, because they often determine whether the deal meets expectations. Equally important before closing is to evaluate the reverse-integration option, depending on the nature of the envisioned operating model and the cultural differences between buyer and seller.
- ▶ **Consider modular integration:** Recognize that not everything needs to be integrated as quickly as possible – and perhaps some functions shouldn’t be integrated at all. Convergence deals are not like traditional merger integrations in which you integrate everything fast to obtain synergies. We recommend determining the different level of integration function by function. In many cases, it’s best to maintain a “loosely coupled” integration approach, which can allow for fast unwinding of a deal if this year’s brilliant deal becomes next year’s divestment.

The critical difference to keep in mind for convergence deals is that regardless of the goal you’re unlikely to get there without adopting important new business behaviors.



### Identifying key business behaviors

The truly impactful difference-making behaviors are typically few, and unique to each deal. Key questions that can lead to identifying those behaviors include:

- ▶ What behaviors best support our post-deal business strategy?
- ▶ What behaviors most reinforce our unique advantages over competitors?
- ▶ What behaviors best support the way we plan to provide value to our customers as an integrated company?
- ▶ What is our time horizon for realizing the benefits of the deal? (Future-growth convergence deals may have time horizons of up to five or more years, whereas immediate-growth convergence deals should be measured more like a traditional deal.)

The transformation in progress of large incumbent software companies from licensing software to a SaaS subscription model, being accomplished largely through convergence deals, serves as an illustrative example of behavioral and operating model change that must be incorporated into merger integration.

Traditional licensed software models require a significant up-front sales effort to win the initial outlay that business customers must make. So the salesforce's incentives focus on driving high-revenue up-front wins, not on consistently delighting the customer over time; and the customer service team is separate and lower-paid. In the subscription delivery model, however, revenue flow is earned over time for as long as you can retain that customer.

Consequently, SaaS providers have a completely different operating model that incentivizes continuous just-in-time, always-on customer service. Their model requires an integrated sales and service team that creates constant service, and is much more mapped to the continuous revenue flow of the business. This model is better suited to sense and respond to changing customer needs as they evolve and provides more options to both delight or disappoint the customer, and to also optimize incremental revenue.

As incumbent software firms acquire smaller SaaS companies, often with multi-billion-dollar valuations, they must find ways to reorient their operating models and cultures around these dramatically different approaches – including evaluation of the potential impact of changes in revenue recognition and tax accounting. The mandate for the integration management office (IMO) is to figure out how to accelerate adoption of the new approaches through the merger integration process and related operating model redesign.

### **Consider operating model redesign “pre-deal”**

EY’s Ali notes that when it comes to convergence deals, operating model redesign must be considered long before close. “By the time you’ve done all that work, choices get embedded and your ability to turn toward the future target operating model has been limited,”

Ali says. “Deals of the future will have to look more closely at the post-integration operating model pre-deal, to see whether it’s viable and achievable within a timeline that meets the growth, market capture and value-creation upside metrics that the deal requires.”

For example, if a future-growth convergence deal is primarily about innovation, it needs to orient its operating model around related factors such as percentage of revenue derived from new products and time-to-market – not low-cost leadership. It should consider an organizational structure built around use cases and customer needs, not products or geographies.

Further, if rapid time-to-market is a goal, then a key business behavior to cultivate would be explicit clarity as to who in the organization has decision rights on product design, pricing and marketing issues, and how quickly those decisions must be made. But unlike in a traditional integration, defining short-term sales growth targets may not even apply, especially for still-embryonic markets such as AI and IoT, where all the uses of the technology may not yet be clear.

“Overall, the idea behind a convergence deal’s operating model is to give the acquired company all the benefits that make sense from the parent, while isolating it from the standard metrics that would be applied to an internal group or a traditional acquisition,” explains Clarence Mitchell, EY Global TMT Strategy Leader. Those metrics can be imposed later, when it makes more sense in the context of the market’s rising maturity. “Don’t let ‘pre-digital’ metrics derail convergence deal success,” adds Mitchell.

“Don’t let ‘pre-digital’ metrics derail convergence deal success.”

**Clarence Mitchell**

EY Global TMT Strategy Leader

### **Also consider modular integration**

In Mitchell's view, convergence deal buyers should strive to avoid the "all or nothing" approach of traditional merger integration: either total integration to maximize operational synergies across all functions or "leaving them alone" as a separate subsidiary, with no consideration of a reverse integration. Instead, buyers should consider whether tight bonding to the parent or a looser approach is preferable, on a function-by-function basis.

In this approach, corporate entities are treated like Legos: modular and easy to move in and out of the corporate structure to meet changing strategic imperatives. Such a merger integration approach reflects TMT companies' increasingly modular approach to business in general, as strategies continually shift in a fast-changing environment.

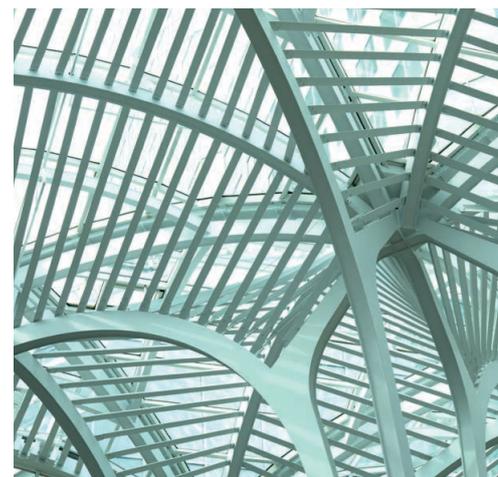
Deliberately thinking through integration strategy function-by-function should enhance the flexibility of a business strategy. It's important to separately assess, for example, shared services, human resources, accounting and information technology and, in each case, determine whether to design approaches that maintain independence and accountability for the acquired entity in a way that can be unwound in the future.

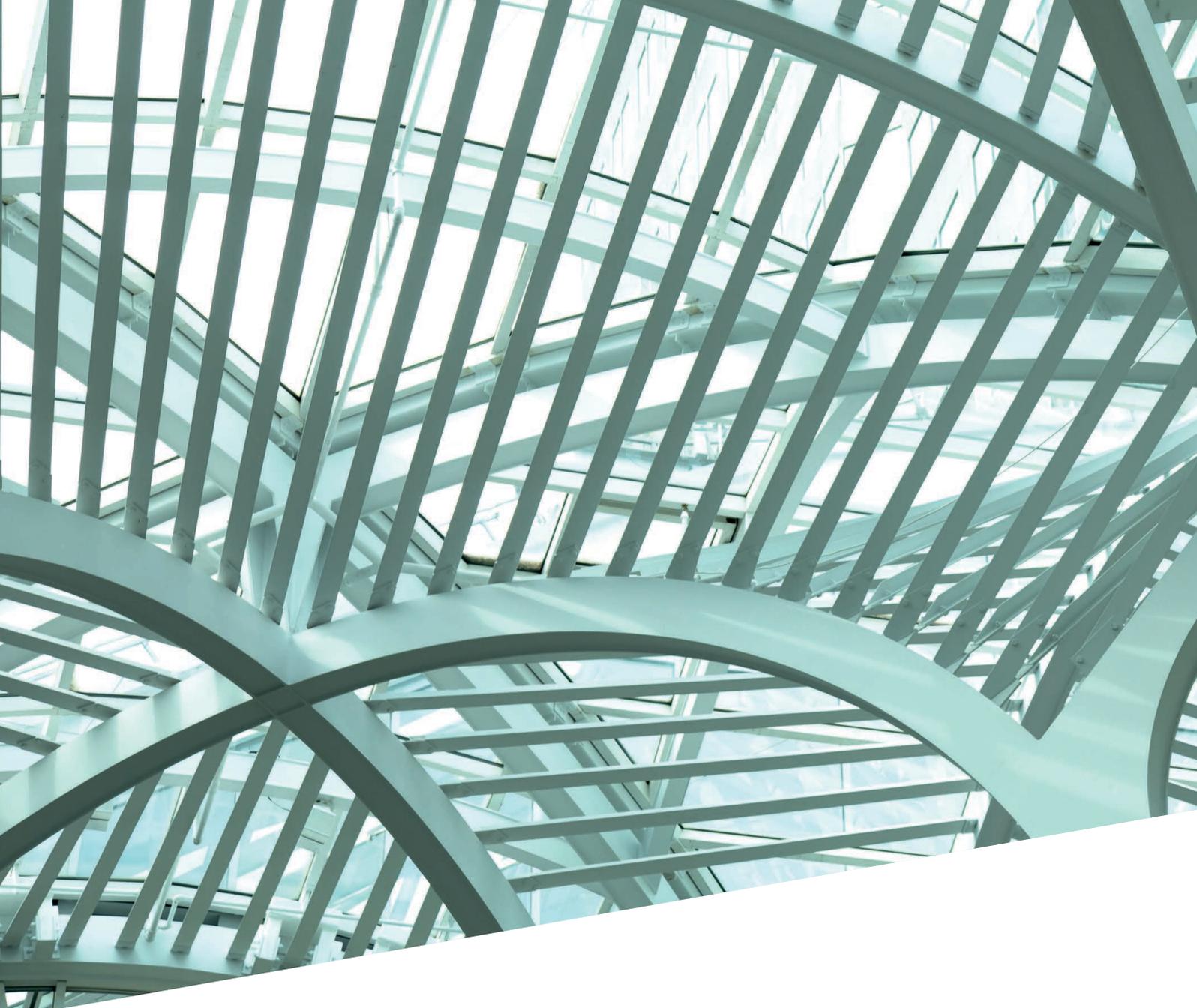
This loosely coupled approach can preserve the strategic value originally sought through the deal and enable companies to avoid integration steps that are irreversible or costly to reverse – unless the business strategy warrants them.

### **Scale differences are a unique integration challenge**

EY's Dorian Swerdlow, US - Northeast M&E Leader for Transaction Advisory Services, warns that differences in scale present their own challenges to integration managers. "Whether pre-revenue or not, the key thing is that future-growth convergence deal targets are often very small. Compared with incumbent TMT companies, they have few people wearing many hats," Swerdlow notes. In deals he's witnessed, the integration process itself threatened to "smother" a target. In one case, the buyer had up to 10 people working on the integration who wanted to interface with a single person at the target.

Explains Swerdlow: "That's where the integration management office must have the discipline to say, 'If we want to bring in this company and not kill it, what is the minimum we need to do to achieve the value proposition?' And then if you want to integrate any further, you have to be very thoughtful about it."

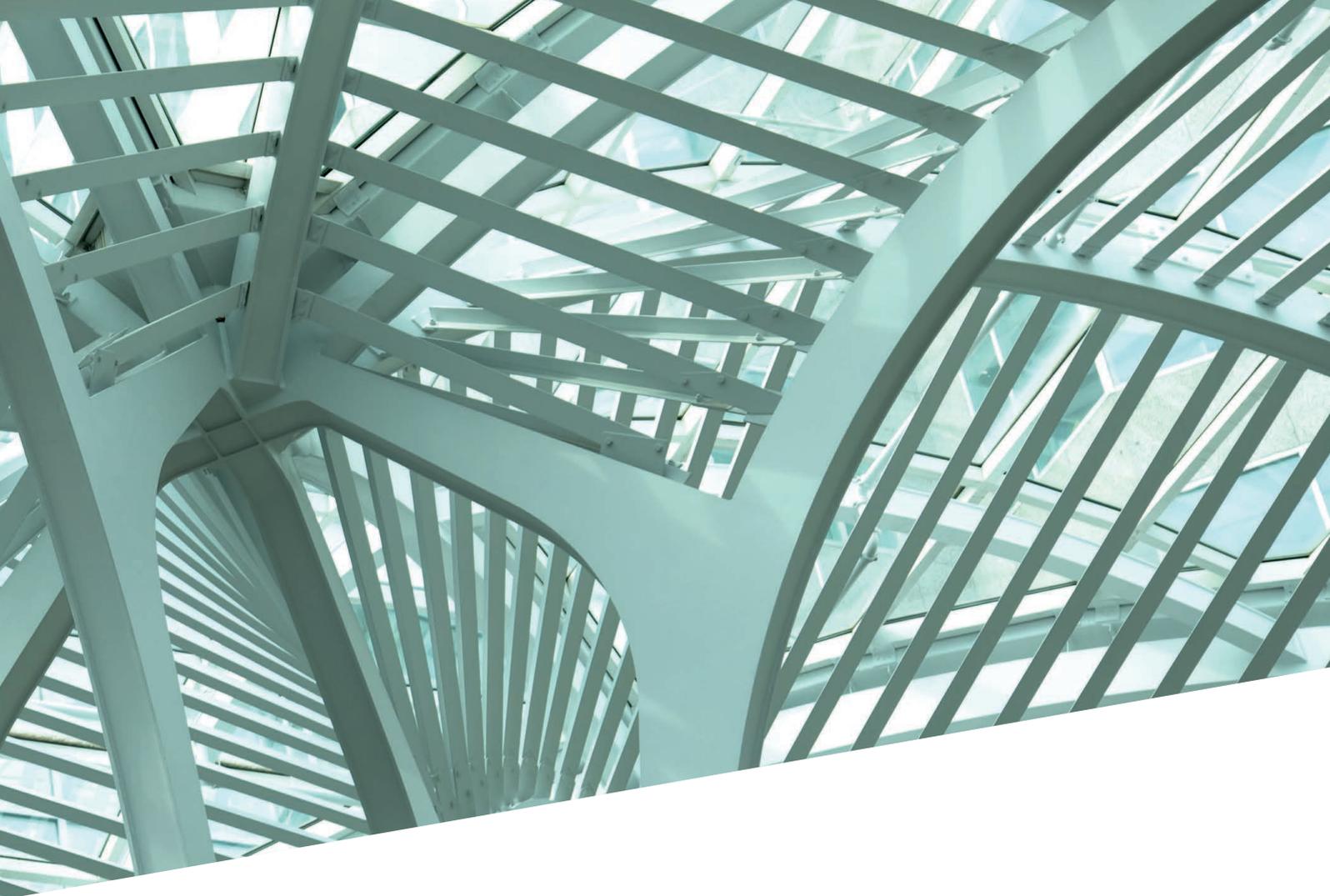




# Conclusion

With venture investment seeding the bloom of thousands of start-ups and yielding more powerful waves of disruptive digital technologies, it's more frequent that the path to TMT success will involve significant convergence M&A activity.

But today, TMT M&A success can mean discarding the old merger integration playbook when it comes to all-important convergence deals. Driving deal value requires new thinking and new approaches. As TMT companies move toward doing more convergence deals, the focus of merger integration may shift from operational synergies to talent or technology access and protection; from revenue and income growth targets to innovation and technology maturity targets; and from full organizational and functional integration to reverse integration, adoption of the target's cultural behaviors and separate evaluation of each function to determine the appropriate level of integration.



For further discussion of EY's TMT merger integration thinking, contact our article contributors named on the back page of this report.

#### Source notes

- <sup>1</sup> VC investment data from Dow Jones VentureSource.
- <sup>2</sup> "Intel to Acquire Mobileye", Intel press release, 13 March 2017, Intel acquisition of Mobileye, 2017, accessed via <http://intelandmobileye.transactionannouncement.com/wp-content/uploads/2017/03/Intel-to-Acquire-Mobileye-.pdf>, 17 April 2017.
- <sup>3</sup> "Ford Invests in Argo AI, a New Artificial Intelligence Company, in Drive for Autonomous Vehicle Leadership", Ford Media Center, 10 February 2017, The Ford Motor Company, 2017, accessed via <https://media.ford.com/content/fordmedia/fna/us/en/news/2017/02/10/ford-invests-in-argo-ai-new-artificial-intelligence-company.html>, 17 April 2017.

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