WHITE PAPER

ERP Considerations in Mergers and Acquisitions: Are You Overlooking Revenue Leakage?

ORACLE NETSUITE

azdan

Grab a seat and enjoy.
Read Time: 9 minutes

ERP Considerations in Mergers and Acquisitions: Are You Overlooking Revenue Leakage?

Merger and acquisition (M&A) activity comes fraught with pitfalls for both sides. AOL and Time Warner, Sprint and Nextel, and HP and Autonomy are just a few of the high-profile examples that demonstrate where things can go wrong. Lots of people spend lots of time trying to ensure that doesn't happen. Due diligence, the process of identifying and quantifying those pitfalls, requires a comprehensive review of all assets and liabilities of the target company spanning fixed assets, talent, intellectual property and more. However, an important, yet often overlooked, factor is the technology and integration considerations in M&A.

While technology like email clients, databases and security software often have straightforward solutions, the applications that tie directly to business processes, notably ERP, can become a significant challenge in some types of M&A deals. In particular, companies can experience revenue leakage due to customer churn with competitors taking advantage of the disruption or margins slipping because of the difficulty reconciling data across the disparate systems.

"I've heard a lot of stories from the founder community about how it's gone wrong and I know from several years of hindsight—it really comes down to organization, people and everyone having skin in the game," said Nate Chandra, Managing Director of Westhook Capital and 10-year veteran of many private equity acquisitions. "You need to have the vision or business group-level ownership of it. It always has to be critical and a focus. That never goes away."

The ERP system, which at a minimum houses a company's financial data, but often extends to customer data, inventory, supply chain and product or services-related information, is vital to organizational planning and the understanding of operations. While sale price, culture and customer overlap are all critical factors in due diligence, what ERP system the merged/acquired company will run needs to be considered early on.

"People are getting better and better at it, but they're not there yet," said Nitin Kumar, CEO of Appnomic and a veteran of many Silicon Valley acquisitions. "I would argue this should be factored into due diligence, but the corporate world is not there."

In Which M&A Deals is ERP a Factor?

Not all mergers and acquisitions require a decision around ERP, of course. Whether an acquired company has not yet implemented an ERP system and is managing its business on spreadsheets or QuickBooks, or if it's running an older, legacy ERP system or even the same software that the acquirer is running, both sides need to think carefully about consolidating ERP systems. In some cases, the acquirer is happy to let the target continue to run on its existing system with no need to tie into the new corporate parent in any formal way outside of general reports and spreadsheets. For others, an aging ERP system or an entry-level accounting system may be a warning sign of a lack of clear insight into the business, but other factors will convince them to wait until after the deal is closed to start worrying about the ERP decision and undertake that months later or longer. But that may not be the best approach.

"Three months is too long in my view because value starts leaking immediately," said Kumar. "They need to be evaluating during the integration planning."

If you think of M&A activities like a home purchase, day one is when you own the house, according to Kumar. It's late to be figuring out if the plumbing works with your existing appliances.

EY estimates that 1%-5% of EBITA flows out of companies unnoticed because contract management and payment follow-up processes are neglected. That sort of slow leakage becomes even more commonplace in M&A situations, according to Kumar. Leakage doesn't need to be confined solely to revenue. For example, when an acquisition is done with the intent of capturing a new customer base, customers can still leak out to competitors during that transition, in part because of a lack of insight from the ERP system. Under-the-radar revenue starts slipping away unnoticed, either as customers move to competitors or simply by holding back their business. Similarly, revenue and customers can leak out when a business makes an acquisition to help transition to a new business model, such as a subscription-based business. In that scenario, the slow leakage of customers who fail to renew while the acquirer is trying to get a handle on orders means recurring revenue and customer lifetime value can quickly dry up and impact the success of the deal.

Additionally, the lead-to-cash process, an area where well-functioning CRM and ERP systems are vital, can prove treacherous. When the systems aren't integrated, revenue and customers can leak out from the mid-funnel, top of funnel and across the process.

"The stability of lead-to-cash is nontrivial," Kumar said. "Even the most sophisticated guys struggle with that. It's a drastic change in the way you're operating."

Yet, the prevailing thinking about the importance of technology still tends to consider it a lower priority.

> "It's super rare that a technology thing would be a deal breaker. Worst case, companies just blast it and just redo everything with the acquiring company's system."

Jim MacLennan, Former CIO and Current Management Consultant

Understanding the Different Types of M&A Activity

It's important to understand what type of acquisition is being undertaken when evaluating ERP systems. For example, a small tuck-in acquisition designed to bring in talent is not going to require significant planning around ERP, Kumar noted.

For **business-unit led deals**, the acquisition is typically to acquire a smaller piece of technology or talent, like a group of engineers. In that case, ERP is again not a significant factor.

In the case of **serial acquirers**, companies regularly gobbling up smaller businesses year after year, ERP also tends to take a back seat.

"Those 60-90 days or 12 months doesn't matter. These guys have deep pockets," Kumar said. "The time to implementation is not as big a deal for serial acquirer."

"The old classic example was back in the day, Cisco was legendary for being a serial acquirer—buying companies and within 90 days having them all on Cisco platforms," MacLennan added. "The other issue would be the very decentralized company where they buy companies and they hold them separately because they expect to turn them over in a couple of years. PE firms actually work like this."

Obviously, the ERP needs for a serial acquirer would depend on whether they follow a Cisco model or a PE model.

Carve-out activities and **divestitures** often present an opportunity to evaluate ERP. Many companies will want to get the new business running on a separate ERP instance. The buyer typically enters into a Transition Services Agreement (TSA) where it has to pay the seller for the use of the former parent company's previous ERP system until it can fully transition onto a new system. The TSA costs can be prohibitive, as a result the faster the new entity can be independent the more it will save in fees and other costs.

Joint Ventures might require an ERP decision if the two businesses are standing up a separate entity that will require financials. Those scenarios are often more comparable to a private equity activity that don't have the same sort of time pressure a merger might engender.

Industry veterans agree that acquisitions based on **adding a new business model**, such as a traditional software company bringing in a software-as-a-service (SaaS) company or a computer hardware company buying an internet of things (IoT) business, are scenarios where decision makers need to be very attuned to the ERP requirements. For example, a company accustomed to a standard fees for services or products will likely not be familiar with revenue recognition rules and its existing ERP system may have difficulty supporting that. Similarly, IoT businesses will need to integrate new data sources, potentially thousands. Having financial systems that can properly account for, and report on, those new requirements is vital to the success of the combined company.

> "From about 2005 until now, the new business model deals are more frequent. Digital is on us. It's here and now, hardware is commoditized, old age media is over and people have been unable to build their way through this. They've turned to acquisitions."

Nitin Kumar, CEO, Appnomic

In cases like moving from traditional upfront software licensing to SaaS or hardware companies adding IoT, the difference between getting big chunks of revenue up front vs. the slow trickle of subscription fees can strain systems, particularly the lead-to-cash process.

ERP Implementation Considerations

Making a decision around the ERP system should be informed by the planning that goes along with the merger or acquisition. Will the two companies standardize operations or be operated independently? Will a single finance team or HR team support both organizations? If so, running two separate systems will soon become untenable. Most M&A deals will have a timeline for merging departments and the ERP decision needs to be part of that.

A company moving an acquisition onto its existing ERP system needs to consider change management as well. If an ERP migration happens immediately, that's another disruption to an already chaotic time.

Leaders need to weigh the implications of training staff on a new system and whether the benefits of consistent processes and a single source of data will outweigh the disruption.

Yet, unless both companies are going to operate independently, running two separate ERP instances can be problematic. The costs associated with licensing two different sets of software and, in the case of on-premises systems hardware and databases, along with having to find and train staff on two different systems alone can make the move worthwhile. According to Accenture, companies that took the time to properly integrate their systems following a merger were able to reduce costs of key business functions by as much as 40%. But the benefits of a consolidated view of the business quickly make clear the advantages. The question then, is when to make the move.

For example, in March of 2011, Pfingsten Partners, a private equity firm, acquired SII Holdings, a manufacturer and distributor of playground equipment. Management felt it needed a system that could support its existing needs as well as

future growth. It brought in consultants to create an IT infrastructure transition in the fall and began implementing a new NetSuite ERP system by November.

Not everyone can work on that fast of a timeline, however. Acquisitions can be tricky and so can ERP implementations—a business might determine that the risk of revenue leakage is acceptable if ERP consolidation would be too disruptive.

Even if companies do decide to wait, ERP consolidation can be problematic. Plenty of implementations have been waylaid by poor planning or the wrong implementation partner, leading to lawsuits and worse.

In some cases, the ERP system the acquired company is running can add value to the deal. iAutomation, a supplier of machine automation products and services, acquired Integrated Motion in 2007, the first in a series of acquisitions. The cloud-based NetSuite ERP system that Integrated Motion was running turned out to be a better platform than the mix of Sage Peachtree, Goldmine and other on-premises applications iAutomation was running and, within a year, the combined company was running on NetSuite. By 2013, it saw double digit revenue gains to more than $70 million and customer service improvements, better pipeline forecasting and cross-sell opportunities as a result of the single system.

With an understanding of the type of M&A activity at stake, due diligence teams can begin factoring in if and when they want to bring in a new ERP system, whether to install a new instance of their existing system or let things continue until some later date. ERP implementations impact every part of the organization and can put tremendous strain on the finance team and others. Under normal circumstances, they require a great deal of planning and effort. When undertaking an ERP implementation before, during or directly after a merger or acquisition, the same advice applies. Gather executive sponsorship, make sure all data is cleansed and accurate before moving it over, invest heavily in training and user adoption, and be sure you're not simply migrating poor business processes to a new system.

As with a normal ERP implementation, there needs to be a project team that includes business process owners, IT, finance and an executive sponsor. With ERP implementations in M&A, it may take a larger team and one that's focused on the merger or acquisition as well.

Forming a Steering Committee

Any ERP determination as part of an M&A activity is going to have a steering committee that can get input from all departments across all entities.

> "So much of choosing the right system and having it be successful is relying on the people who are on that steering committee. People don't really want to do the heavy lifting around that. They think making the decision and moving the company over is good enough, but so much comes after the implementation."

Nate Chandra, Managing Director, Westhook Capital

Typically, a successful ERP implementation team will include an executive sponsor, someone in leadership who will champion the project and ensure resources are available, a project manager, end users and cross-functional team members, particularly IT and finance, and a report writer to help meet specific business needs. It also makes sense to bring in outside help or a gatekeeper to evaluate the target company's systems.

"Usually you'll have identified in diligence that the IT systems are either strong, average or subpar. In the course of the investment time horizon, you have to determine if you want to undertake the heavy lifting to improve the systems," Kumar said. "I can tell you there are a lot of things that can go wrong and usually there are other operational priorities that might lead to revenue generation."

Indeed, replacing or augmenting an ERP system may not turn out to be a top priority, revenue leakage or not. Yet it's important for companies to understand all the ramifications of whether or not to consolidate on a single system. ERP implementations, particularly on-premises systems with upfront investments in licenses and hardware, can be expensive and there are plenty of stories of ERP implementation failure. But costly consultants and software license fees are not the only area of risk.

ERP implementations can be notoriously disruptive, with delays far too common. As ERP software vendors and consultants have developed better implementation methodology, some of that risk has abated. Yet "disruptive" is not something people want to hear during M&A activity. Scope creep is often a reason for ERP delays and in an M&A-fueled implementation. Both sides will want to limit the scope of the work, most likely to core financials, and then expand to other areas once the merger is done. Businesses can implement financials on a cloud-ERP system in as little as 100 days now.

Additionally, ERP implementations require significant evaluation of a company's workflow and processes. If the two companies have processes that are highly specific to the business for something like invoicing or different inventory management approaches, they will need to decide which ones to go with, adapt them both or follow the practices of the software vendor to avoid excess customization. All of that can at best further delay an implementation or, at worst, lead to billing problems, stockouts or excess inventory.

> “Certainly, you want to lever up your people in IT and really be able to automate things and deliver a high level of service without using a lot of automation, a lot of well-documented process. And people shouldn’t be afraid of that because it doesn’t make you expendable. It makes you super valuable because relatively few companies have this.” Jim MacLennan, Former CIO and Current Management Consultant

Internal IT Expertise

Larger companies with more experience with acquisitions will tend to have a well-documented restructuring process and internal IT resources to help with integrations or a new ERP implementation. The resources and expertise at the company being acquired go a long way here as well.

Yet, as with a general ERP implementation, it’s often a good idea to bring in outside help with expertise in ERP implementations.

“A lot of times, we will recruit some sort of IT expert or consultant who can play traffic cop,” Chandra added. “What we don’t want to do—and a lot of the times the size companies we’re investing in don’t have a dedicated head of IT—is distract them from their day job.”

However, outside help may not prove a cure all. When it comes to finding help, companies may have trouble wading through the thousands of people with websites calling themselves ERP consultants or scared off by the huge figures the big systems integrators charge. Here, again, M&A teams can follow the advice for general ERP implementations: ensure they have sufficient technical and business skills; they understand the industry; have a track record of success; and, in the case of larger firms, make sure you’re actually getting the experienced team you were promised.

Licenses and Install Base

In a merger of companies of similar sizes, there are licensing issues to consider when moving to a unified ERP system. Who’s got the bigger install base, which is going to be more expensive to switch out? And what are the licensing costs?

A big increase in users can be tricky to negotiate with an ERP vendor as can the idea of merging two separate ERP contracts together. Indeed, the length of existing deals can impact decision-making on when to move to a single system, but that is usually outweighed by the business need for the merger in the first place. With on-premises systems, licenses are typically paid for up front, with businesses paying a percentage of those licenses for ongoing maintenance such as patches and new releases. By consolidating systems, companies no longer have to pay that additional maintenance fee, a charge many are happy to be free of since they don’t believe it brings much value. Cloud-based ERP systems are based on a per-user basis, with contracts typically between three and five years. Moving off of that additional ERP system before the contract is up may mean the acquiring company needs to eat those costs, something they need to account for when determining if and when to consolidate systems.

Time

Timing is always a consideration in M&A and ERP implementations have been known to take years and gobble up resources.

"Potentially the investment time horizon won't match up with the implementation time," Chandra said. "You may leave that meat on the bone. You identify room for improvement from a tech standpoint, but you might leave that for the next investor."

Indeed, for a company looking at an acquisition as an exit strategy, undertaking their own ERP implementation might be a smart move.

> "Companies are looking to maximize value and if they have time on their hands to get it right, then yeah, they should do it themselves because that's an attractive selling point."

Nate Chandra, Managing Director, Westhook Capital

Cloud-based systems that require few if any IT resources and can be deployed with an internet connection and a browser offer a faster, easier implementation. Some systems, featuring core financial functionality, can be implemented in as little as 100 days, meaning the system can be up and running just months after the deal closes.

The Two-Tier ERP Option

Often, an acquiring company is running a larger, older ERP system. It doesn't have the inclination or time to implement a new instance of the corporate ERP system at a new acquisition. Many organizations turn to a two-tier model in which a newer, easier to implement system, typically cloud-based, can be launched at the acquired business. Through pre-built integrations, that cloud-based ERP feeds information up to the corporate parent while giving the acquired company the agility it needs to continue operations.

How Upgraded is Their Use of ERP

The level of ERP expertise becomes an important consideration as well. Insiders agree that the ability to test and benchmark where a company that is to be acquired is in the managing financials and automation of key processes is an important consideration in the due diligence phase.

In a smaller, early-stage, founder-owned scenario the target company is often running QuickBooks. This can mean easier reporting and less of a need for an immediate ERP implementation but it's also an opportunity to add systems and build out capabilities. Timing is critical. A key decision must be made when the early stage company goes through some growth (geography, complexities in billing, contracts, manufacturing, etc.), and then is evaluating an upgrade to QuickBooks.

More established companies may already have an ERP system but one that is running on older, on-premises software that is due for an upgrade. In these scenarios, a new implementation as part of the acquisition may be in order or companies may want to hold off until the licenses run out.

"There's often a legacy Microsoft Dynamics-type system in place, for example," Chandra said. "We knew that there was going to be a short-term agreement that they already made an upfront investment in Dynamics and it made sense to continue on with that."

Yet, for acquisitions of companies running older, on-premises systems, a need will likely arise to replace that system at some point down the road that should be factored into the economics of the deal. The IT overhead required and the lack of investments being made in legacy systems as ERP vendors shift their resources to cloud-based products mean older systems quickly fall out of date.

ERP Mistakes in M&A

Even if an organization includes ERP systems in due diligence and determines it's a worthwhile step to implement a new system before or immediately after an acquisition, that's no guarantee it will go well. ERP systems, like business, can be complex. A typical mistake is not having the right people on the steering committee and not capturing input from every contingent in the company.

"You may have gaps where you don't have enough input from other people," Chandra said. "Not having a dedicated person truly living it for a year can be a problem."

The typical challenges with an ERP implementation obviously apply here as well: poor data quality with the source systems and poor data migration, a vendor that doesn't understand your particular industry, lack of executive support all the way through the project, and more.

NetSuite for M&A

For M&A activity that warrants a new ERP system, it's clear that time, agility and adaptability are important factors. NetSuite has been providing cloud ERP for more than 20 years and now counts more than 24,000 customers, including many that have been part of M&A activity.

NetSuite realizes that companies in M&A need the financial reporting capability to stay agile in the face of restructuring and massive change. With SuiteSuccess, an implementation and customer engagement solution that features leading practices and pre-built roles and reports by industry, companies can be up and running on a single cloud-based financial solution in as little as 100 days. With it, companies can expedite daily financial transactions, accelerate the financial close and gain real-time visibility into the financial performance of the business from a consolidated level down to the individual transaction.

Its flexible, agile and scalable solution empowers companies to transform their business. Complex companies are equipped with a cloud-based solution designed for innovation and business transformation, no matter where the business is in its lifecycle.

For more details, visit www.netsuite.com/pe.

> "I've heard stories of how people have implemented and spent the money, but utilization and the adoption rate has failed and they've had to run two different systems. They have a path to replace ERP but migrated back to the legacy systems. That's significant sunk costs, even though the right decision was to move to a new system."
>
> **Nate Chandra, Managing Director, Westhook Capital**

āzdan