

The Journal

The Value of IT Due Diligence

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Traditionally, acquisition due diligence has focused on financial valuation, legal matters, business strategy, and risk management. During the last several years, however, as businesses have become more reliant on information technology (IT) to enable growth, contain costs, ensure compliance, measure performance, and support decision making, IT due diligence has become increasingly critical. Many times, this need becomes apparent very early in the financial due diligence process when the investment firm requests various data, reports, or operational metrics, and the response from the target company's CFO sounds something like this: "Well, we don't have that data; give me a week to get back to you."

Information technology has a significant impact on the transformation of business processes and services. Consequently, understanding IT maturity and its ability to support the investment thesis is critical to success and long-term value creation. IT due diligence can add value in four areas:

1. Aligning the investment thesis and IT scalability
2. Identifying IT investment needs
3. Identifying cost reduction opportunities
4. Reducing business risk during carve-outs

First, it is critical to understand whether alignment exists between the proposed investment thesis and IT. Specifically, you will need to understand and evaluate the critical inputs, including (1) growth strategy (organic vs. acquisition), (2) long-term growth targets (e.g., 10% CAGR), and (3) holding period. Can IT—including core applications or infrastructure—support a business that is planning to grow by four to five times with minimal investment? Or, will growth require new systems, new processes, and potentially new people, and how will this affect EBITDA and cash flow? Understanding the long-term growth strategy and hold period are ►

critical factors for assessing the ability of IT to scale and support the investment thesis. Without this alignment, additional and unexpected IT investments may be required.

Throughout the due diligence process, identifying the required future investments is critical to determining valuation and formulating an appropriate offer price and transaction structure. Investments may be required in several aspects of the business, especially considering the aggressive growth objectives that typically exist within an investment thesis. In fact, this is no different than buying a house; the buyer should understand, up front, the need for a new roof or other key investments that may materially impact the purchase price. That said, understanding IT investment requirements is a key driver for performing IT due diligence. Investment firms should evaluate three areas, in particular, including (1) reporting / business intelligence, (2) customer relationship management (CRM), and (3) enterprise resource planning (ERP). When it comes to reporting or business intelligence, no amount of data is too much for a typical investment firm. Specifically, being able to ‘slice and dice’ various financial and operational metrics is vital for measuring ongoing performance and guiding decision making. Likewise, the rise in financial reporting legislation has increased the emphasis on reporting maturity. A second key area is CRM maturity, which includes the processes and tools utilized to drive customer acquisition, market penetration, pipeline management, and sales. Effectively utilizing CRM capabilities can have a significant effect on top-line revenue. IT due diligence can help estimate the cost of implementing a right-sized CRM solution (within the context of the investment thesis) and provide estimates of investment return. Finally, the organization’s ERP system is an integrated system that enables its key business processes; for example, order to cash, procure to pay, and plan to produce. If an organization does not use technology to enable these critical business processes, its ability to scale may be hampered. Identifying and quantifying these additional IT investments during the IT due diligence process can have a tangible impact on financial valuation.

Identifying cost reduction opportunities is a third area in which IT due diligence can provide considerable value. Effective utilization of IT provides significant opportunities to streamline business processes and reduce operating costs—directly improving EBITDA and cash flow. Most organizations have pockets of manual effort, data duplication, or task redundancy that they can eliminate by leveraging IT more effectively. Even IT organizations, themselves, have opportunities for cost reduction, and IT due diligence can be instrumental in identifying these. Does the IT organization run efficiently? How much does the target company spend on IT, and how does that compare to industry average? Typically, most IT organizations have common areas of IT waste or over consumption. This may stem from mismanaged third-party contracts (outsourcing, telecom, hardware), overspending on software licensing (companies oversubscribed between 15 to 25 percent, on average, with many as high as 35 percent), or poor implementation and adoption of technology. Through IT due diligence, an investment firm can identify business and IT cost containment opportunities. While some of these may produce only minimal cost savings, others may be significant and could improve investor returns. ►

Executing a carve-out requires strict planning and sound execution, and IT due diligence can offer similarly significant benefits in these scenarios. The complexity, speed, and seamless nature of a carve-out transaction all shine a spotlight on IT. The value of IT due diligence begins when building an IT budget from the ground up. Specifically, formulating a detailed line-item IT budget that incorporates all cost estimates is critical, both during the transition services agreement (TSA) and beyond. This budget is essential, since most organizations underestimate the IT costs associated with performing a carve-out or corporate divestiture. Secondly, understanding how to structure a new organization's various IT components (infrastructure, applications, hardware, software, or outsourcing) can save considerable investment. For example, separating from the parent company typically presents several opportunities to adopt new and different technology that could save substantial costs. A technology solution or platform that is appropriate for a \$1 billion parent organization may not be right for the \$100 million carved-out entity. Third, it is paramount that the carved-out entity maintains seamless business operations and customer services—at the beginning of the TSA, throughout the life of the TSA, and after the TSA expires. Making sure all the IT components are in place to enable the business processes and services cannot be underestimated. If done properly, IT due diligence for a carve-out should conservatively pay for itself three to four times over throughout the life of the TSA and beyond.

As existing companies evolve and new companies form, technology plays an ever-increasing role in streamlining operations, enhancing customer experience, measuring performance, and supporting effective decision making. Understanding the maturity of a target organization's IT strategy, technology, processes, and people is critical as investment firms evaluate potential deals. For some organizations and industries, IT may play a big role, while for others the impact may be less. But, regardless of the organization's current state, its future success and competitive advantage almost certainly will depend on its utilization of technology. In the past, many investment professionals have been burned by not performing IT due diligence. Although it will never supersede financial or legal diligence, it can play an increasingly important role in building value as business models evolve and competition increases. ■

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Matt is a Director in West Monroe Partners' Chicago office, focusing on expanding the firm's unique offerings to the private equity and alternative investments market. With West Monroe, Matt helps private equity and strategic (corporate) buyers by assisting buyers with pre-deal IT and Operational due diligence, as well as post-close integration, merger and carve-out activities.

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