HOW TO SUCCEED IN ACQUIRING A SOFTWARE COMPANY

INVENT'S 5 FACTORS FOR IT DUE DILIGENCE

INTRODUCTION

More and more organizations realize that their future is digital. This viewpoint is driving ever more businesses to acquire software companies as part of a strategy to grow their digital capabilities and extend their offerings.

This trend is fueled by the potential benefits of acquiring a software company, such as:

- The potential for greater profitability
- The potential for more efficient operations
- The potential for synergies and new opportunities

However, businesses often struggle to create the expected long-term value post-deal. Why might this be?

Software is essentially just lines of codes. Its value partly derives from the business case it attempts to address. But that is not the only determinant of its value. The quality of the code design, the organization of the development team, and other technical and non-technical decisions made during the software application's development fundamentally affect the value of the software and the likelihood of successfully integrating it into your own information technology (IT) capabilities.

Specialized skills are required to analyze the technical design and development practices of a software application, and ultimately the value of the software company.

This raises the key question: How to succeed in acquiring a software company?

THE FUNDAMENTALS OF DUE DILIGENCE IN M&A

Due diligence is a **crucial step** in every merger and acquisition (M&A). The purpose of due diligence is to deliver information and insights to make informed decisions. This is particularly important because 70% of integrations fail to deliver the expected results. Due diligence therefore qualifies and quantifies the risks, exposures, financial requirements, and leverage opportunities for an acquirer before making an investment in a target company. It is therefore also the foundation for post-merger integration planning.

Different types of due diligence exist. Commercial, operational, and IT due diligences assess the strategic, business, and technical impacts of a potential deal. These are supported by legal and financial due diligence.

Commercial Due Diligence

- Assess **business model** and its attractiveness
- Evaluate accurateness of **revenue or profitability forecasts**

Operational Due Diligence

- Assess **improvement opportunities** and feasibility
- Analyze structural and individual **human resources**

IT Due Diligence

- Assess **quality and security** of existing IT landscape
- Identify **improvement opportunities**

IT DUE DILIGENCE IS VITAL FOR M&A TRANSACTIONS

Information technology (IT) topics are a key consideration in M&A. The objective of IT due diligence is to determine the performance, risks, opportunities, costs, and investment needs associated with the target company's IT organization and digital capabilities. The effectiveness of the IT capabilities of a target company can be a make-or-break factor in an acquisition. 30% of mergers and acquisitions fail due to unresolved IT issues and 35% of IT integration programs run out of budget or are delivered later than expected.

IT due diligence therefore assesses a company's complete IT assets, systems, processes and procedures.

IT Due Diligence

1. **IT Organization & Governance**
2. **IT Systems**
3. **IT Infrastructure**
4. **IT Sourcing and Service Level Agreements**

ADDITIONAL ATTENTION ON IT DUE DILIGENCE IS NEEDED WHEN ACQUIRING A SOFTWARE COMPANY

In today's digitally driven business world, the opportunities and risks in the IT capability and technology functions of a target company can significantly impact an M&A transaction. However, acquisitions of software companies involve unique considerations. The value of software companies derives from their technology and the motivation for the acquisition is often to grow specific digital capabilities. Therefore, additional factors determine the successful IT due diligence of a software company. **Here are Invent's 5 factors to not forget when acquiring a software company.**

SUCCESS FACTOR ONE

Use a structured framework to evaluate all IT aspects of a company

IT within a company is a complex landscape. IT involves numerous stakeholders, processes, systems, vendor agreements, licenses, and technical applications. These must be evaluated with robust due diligence methodologies to ensure that all necessary IT aspects are analyzed by relevant (technical) experts.

Red flags

- Poorly designed or old technology stacks
- Poor use of tooling and lack of quality control processes
- Poor governance and organizational structures
- Poor cost and contract management

Consequences of getting it wrong

- Undiscovered risks that may lead to a later financial write-off or other unexpected costs that will ruin your business case
- Difficulties integrating the software into the acquirer company and deriving the intended value from the application post-deal

The benefits of getting it right

- Empowered decision-making based on a holistic view of the target company's IT organization, processes, application development, operations, and security

SUCCESS FACTOR TWO

Understand the development cycle of the software team

The development team collaboratively develop the software application. Understanding their processes and technical methods is necessary to determine the quality of the software application and the ability to integrate it into a new environment.

Red flags

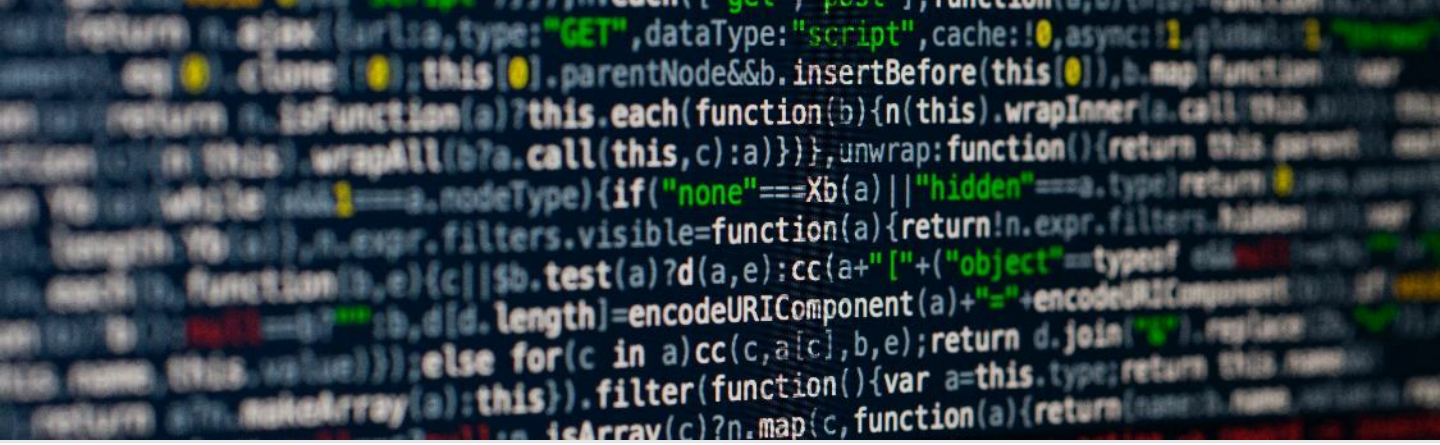
- Lack of development cycle planning, decision-making procedures and artefacts
- Lack of a modern DevOps approach
- History of long time-to-production and unsuccessful or ineffective releases
- High team turnover

Consequences of getting it wrong

- Quality issues in the application leading to high maintenance costs
- Inability of the development team to adapt the product to market changes
- Difficulty maintaining the software and integrating it in the new company

The benefits of getting it right

- An understanding of the development team's processes and standards that reveals the adaptability of the team to change and the quality of the product they develop



SUCCESS FACTOR THREE

Review the source code and documentation, with attention to secure programming

The source code is the fundamental component of a computer program and its functioning should be explained with documentation to ensure maintainability. Furthermore, the architecture and design of the code should facilitate its security, reliability, maintainability and scalability.

Red flags

- Poorly designed code that is difficult to maintain, test, and scale
- Lack of secure coding practices
- Lack of automated checks and a poor track-record of proactive quality control
- Lack of proper documentation on functional decisions

Consequences of getting it wrong

- Needing to spend time and money remedying technical issues in the code
- Negative impact on the innovation cycle
- Privacy risks and compliance issues leading to compromised data, financial penalties and reputational damage

The benefits of getting it right

- Quality, security, and low technical debt of the software that helps keep costs low and helps ensure continued compliance
- Assurance that controls and guard systems are in place to avoid software vulnerabilities and to protect against (external) attacks

SUCCESS FACTOR FOUR

Be very careful when open-source software is used

Open-source software is source code made publicly available for use, modification, and distribution within the terms of a distribution license. Many software teams adopt open-source software to test and debug prototypes cheaper and faster without presale agreements and with the support of an active developer community or an enterprise open-source vendor.

Red flags

- Use of restrictive open-source licenses or software with contradictory licenses
- Lack of awareness on how well maintained an open-source project is
- Lack of processes or service agreements to discover and respond to security issues

Consequences of getting it wrong

- Issues with intellectual property and potential financial losses due to licensing
- Difficulty maintaining your copy of the open-source code and its updates
- Risk of a security vulnerabilities due to overlooked security patches

The benefits of getting it right

- An understanding of the risks in how open-source software is used in the application
- The correct management and maintenance of open-source software
- Potentially faster and cheaper time to market by using best-of-breed solutions

SUCCESS FACTOR FIVE

Use a valuation method that is right for the company

An important consideration in M&A transactions is the price of the deal. This requires a fair assessment of the value of a software company, especially the value of their software application. However, development costs and value of an application can be calculated in various ways.

Red flags

- Discrepancies between the value of the code and the value of the company
- Discrepancies between valuation methodologies that cannot be explained
- Unwillingness of the target company to share relevant information

Consequences of getting it wrong

- Failure to properly estimate the value of a target company
- Overpayment that increases costs and creates financial risk for the acquirer

The benefits of getting it right

- A fair valuation of the software company with an understanding of the:
  1. application's value as an asset,
  2. costs of rebuilding the application,
  3. revenues generated from the application,
  4. market value of competing solutions, and
  5. historical investment costs
- An understanding of the reasons for deviations between different methods
- Avoidance of write-offs and depreciated investments

WHAT CAPGEMINI INVENT OFFERS?

We deliver value to clients considering the acquisition of software companies by conducting a comprehensive IT due diligence assessment that reveals the red flags and their impacts on a M&A transaction. Our structured framework that evaluates both the technological and the organizational aspects of the target company ensures that key issues are discovered pre-deal.

Client case study

Situation: Our client wanted to extend the features of their software platform application to make it more functional and appealing to customers as well as to establish additional revenue streams.

Solution: We conducted a full IT due diligence assessment on the target company, covering IT governance, strategy, organization, infrastructure, security, sourcing, costs, and the application solution. We uncovered concerns in the use of open-source software with high-risk licenses, poor performance on security penetration testing that could prevent the scalability of the application, and issues with staff turnover in the development team that could negatively affect the continued development cycle of the application.

Benefit: The client discovered red flags in several areas of the target company and decided not to proceed with the deal. Our IT due diligence guided the client's decision-making with the impact of avoiding a potential investment write-off.

THE WAY FORWARD

Organizations face a pressure to digitize. This is driving M&A between businesses and software companies. However, software is a complex product. To create value from a software acquisition, businesses need to conduct rigorous due diligence that is specific to the IT landscape.

Capgemini Invent combines its deep knowledge about technology with its services in M&A to offer clients a strong and structured framework for IT due diligence. Our experience tells us that 5 factors are specifically important for IT due diligence when software companies are involved:

1. Use a structured framework to evaluate all IT aspects of a company
2. Understand the development cycle of the software team
3. Review the source code and documentation, with attention to secure programming
4. Be very careful when open-source software is used
5. Use a valuation method that is right for the company

We provide our clients with the material for informed decision-making and have done so for more than 50 deals in the past 3 years.

So, what about your next deal? Do you want to know if you are buying the right company?

Discover how Capgemini Invent will support you in your IT due diligence:

https://www.capgemini.com/nl-nl/services/enterprise-management/zakelijke-transformatie/business-technology/

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For more details contact:

Ludvig Daae

ludvig.daae@capgemini.com

Authors

Dr Martin Page is a business technology and innovation consultant at Capgemini Invent.

Ludvig Daae is head of digital advisory and global lead for IT in Mergers and Acquisitions at Capgemini Invent.

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