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Is there a hole in your synergy strategy bucket?

During mergers and acquisitions procurement has a critical role in ensuring that IT costs are kept to a minimum and that software lives up to expectations in the new organisation, say Simon Rycraft and Claude Fidelin

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By Simon Rycraft and Claude Fidelin

As the economy revives, restructuring has become a hot topic for surviving companies. Whether you are embarking on an aggressive growth strategy or selling off, now is not the time to get your IT strategy wrong.

Effective integration or unbundling of operational and commercial software can be critical in unlocking the full value from mergers and acquisitions (M&A) and divestiture activity. It is far from straightforward, however, as it must balance need for internal efficiencies at the same time as supporting the architectural plans for the new organisation.

As the world of software continues to evolve, the sourcing challenges for this category remain. They include contractual and licensing inflexibility; contract portfolio complexity; uncontrolled or unnecessary spends and high maintenance and support fees.

The impact of these challenges during a period of restructuring is dependent on the purpose of the software: disruption to straightforward desktop software used in a back office might be merely annoying, whereas disruption to software that drives a company's core operations could be very costly.

Procurement has an important role in navigating this minefield of challenges. Category managers often hold the key to vendor relationships, have deep contractual knowledge and are best placed to co-ordinate a successful negotiation strategy.

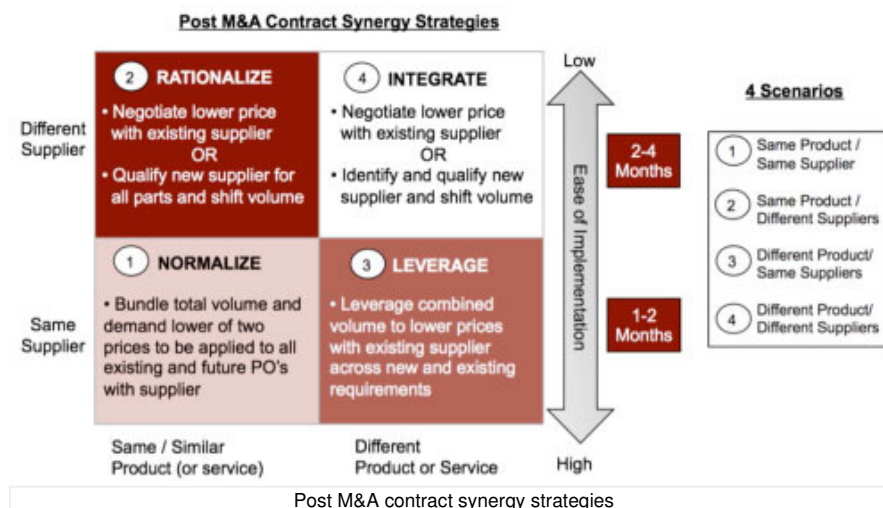
Preparation is key. Before the official purchase, sale or transfer of ownership date there is typically a 90-day window of opportunity to prepare to maximise value from these deals.

IT issues are a major cause of M&A failure, after operating philosophy and management practices. The preparation stage and beyond must therefore be a true collaborative effort between procurement, IT and the transition team in order to succeed.

But how can procurement add value? Although there are issues of confidentiality during M&A which can limit information sharing, there are typically four zones of value that procurement can tap into to identify synergies both before and after going live. These are contract analysis and risk assessment; market research; negotiation management; and should-cost analysis.

Contract analysis

Before going live the gathering of contract data from both sides can from day one vastly accelerate the delivery of synergies. As the language, structure and technical aspects of a software contract often differ, this analysis, albeit time consuming, is worthwhile. After go-live, when the two companies' contracts can be compared side-by-side, the first step should be to place different software products into synergy strategy buckets. These buckets, as in the diagram below, can be organised based on vendor and product similarity.



Whichever strategy is taken across a range of software applications and software-related support services, there are typically three key risks that the procurement organisation needs to keep under control:

1. Licence rights assignment

Very few software contracts contain clauses that allow for the free-of-charge transfer of ownership. Most software vendors will therefore request the new or acquiring entity to settle cure payments (payments made to vendors during an acquisition to cover any outstanding debt) before transferring licences. It is essential and a matter of urgency to fully understand these cure payments as they can affect return on investment (ROI).

2. Licensing model and location of use

In the event that a company has unlimited licence rights for use in one region, for example Europe, the software vendor contract may still restrict spare licence use in a different or additional region such as North America. An argument often given is that regions are governed by different country laws, which may not have been considered when the original user licence agreement was negotiated.

3. Restrictions on licence use by different legal entities

Software contracts often restrict licence use for more than one legal entity (or for example by a third party such as an outsourced service provider). This restriction can cause issues especially during restructuring, often the point at which legal entity changes are made (for example as new affiliates or new outsourcing arrangements are adopted as part of the M&A).

Market research

An M&A is often a perfect time to re-evaluate sources of supply. A review of options is critical to maintaining competitiveness even if this knowledge is used simply to renegotiate existing terms or persuade a software vendor to allow you to normalise costs across the "new company".

Negotiation management

In addition to identifying viable alternatives, procurement is also well positioned to develop a negotiation strategy to ensure the selected software solution delivers synergies to the new entity. This activity should not be underestimated. Following an M&A, vendors often know they have the upper hand, particularly if integrating existing contracts is a complex process, outside the parameters of the existing terms or under time constraints. Successful tactics are:

1. Have the right negotiation team

An extended team should include management and operations from both entities. Even if the extended team does not participate in the negotiating they should be kept up to date and called upon when needed.

2. Fully understand the supplier's goals

They are not always as obvious as you may think but understanding them will help bring value to the negotiation table.

3. Take the opportunity to consolidate smaller contracts with a particular vendor

You may not have realised how many contracts you had with a supplier across different parts of the organisation. Aggregating them will increase bargaining power.

4. Reduce ongoing maintenance in exchange for more licence revenue

This can be very effective, especially when sales representatives are incentivised on revenues received upfront or are short on their sales target.

Should-cost analysis

Software is sometimes known as an intellectual capital based product with fictitious pricing. Prices don't follow a standard supply and demand curve and typically depend on the ROI they deliver to different customers, the brand, who owns the intellectual property rights and the product lifecycle. There are also multiple pricing models: perpetual licence based on number of users, servers or the region; unlimited enterprise wide licences; "software as a service" (which includes maintenance costs) and so forth.

Procurement can help to overcome this challenge by:

1. Reviewing the new organisation's requirements and considering software contractual terms that affect pricing. Procurement should consider scenarios such as how many licences will be required in five years; how many years the company is expected to use this software; what restrictions there are on volume, regions or usage; what are the terms of support and upgrade; and whether there are any commitments.
2. Understanding external factors which may have affected pricing when the legacy contracts were signed. Ask questions about the brand image of the provider; the competitive landscape; and the company's financial health.
3. Assessing the ROI of consolidating legacy contracts. If benchmark pricing is not available, compare the cost of the software to the value to be delivered to the new organisation. What is the ideal and minimum ratio that should be achieved?

Armed with good background data, a clear view of future requirements and ROI targets, the procurement organisation can increase their chances of a realistic price and an agreement that is beneficial to all parties.

What about in a divestiture situation? The key challenges here are different and include:

1. The sale agreement often including only vague details regarding the handling and unbundling of software contracts.
2. The contract strategy of disentanglement also including the transfer of a number of licences and terms over to the acquiring organisation.
3. The official separation date not always signifying the end of the relationship with the acquiring entity. Third-party support agreements often come into play here. These types of agreements add another layer of complexity due to interdependencies that can also lead to unexpected costs and potential penalties (due to contractual restrictions on third-party licence use and assignment).

However, even with these challenges in mind, procurement can still deliver against the four zones of value mentioned at the beginning of this article. There are even some advantages in the divestiture scenario such as being able to review contracts and prepare for the go-live date in advance, with no restrictions on internal information sharing. Negotiations can also begin earlier for the selling entity than in an M&A as existing vendors are already bound by confidentiality agreements.

All of these types of restructuring initiatives provide a perfect opportunity to revisit and evaluate existing internal processes on

software buying as a category. While optimising contracts for licences and maintenance spend will help deliver costs savings, these savings need to be sustained through process improvements in demand management. Ensuring that all new future software product purchases over a certain value are approved by procurement and the IT architecture team is essential to avoid maverick spend. If this type of activity is not caught early enough the impact on cost can be much higher than anticipated for years to come. It is not called the "software trap" for nothing.

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