Under the Buzz

Commentary on Business Strategy Issues for
Executives in Enterprise Systems & Software Companies

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Under the Buzz is an email "viewsletter" authored by Philip Lay, managing director at TCG Advisors, a Silicon Valley-based firm that helps to *catalyze* the strategy and transformation efforts of executive teams in enterprise systems and software companies. This journal is published periodically and delivered free to subscribers via email. It is also posted on the TCG Advisors website at: http://www.tcg-advisors.com/Library/utb/utb.htm. Back issues are available at the same address.

This edition's main topic:

Reversing the Dismal Track Record of M&A in High-Tech

M&A Strategies along the Category Maturity Life Cycle

I am indebted to Bryan Stolle, CEO of Agile Software, for some of the ideas from his keynote at the Enterprise 2005 conference in addition to other conversations with him on this topic.

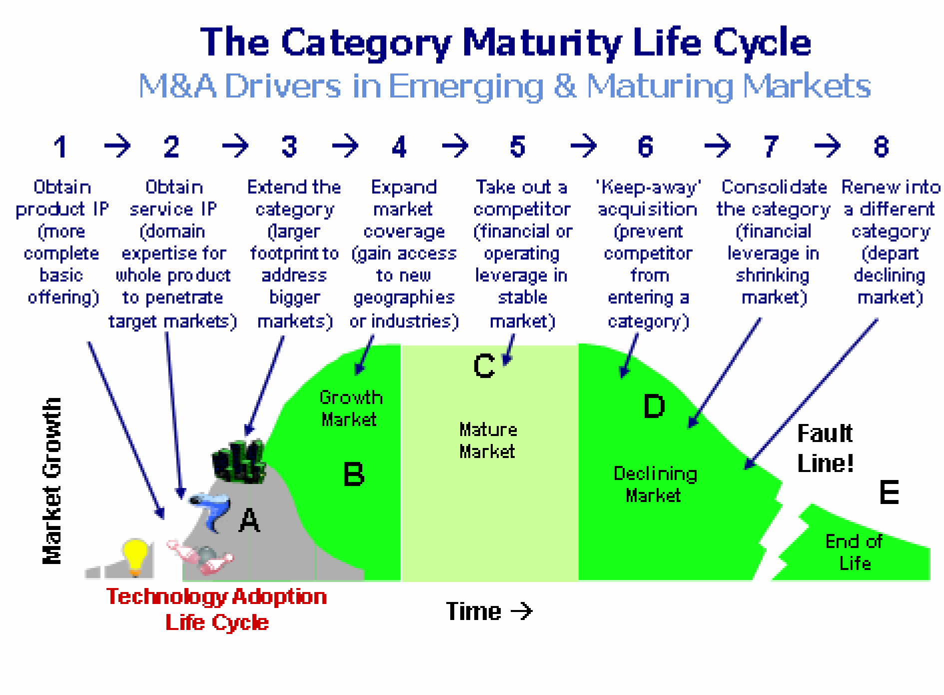
As has been proven over the years, the dirty secret of the M&A business – as every M&A banker will tell you over a glass of cabernet – is that 90%+ of all acquisitions in high-tech prove either significantly more challenging than expected, and many prove disastrous or, at best, mediocre. This applies to both the acquiring organization and the acquired parties who sell out for stock and may stay on in the newly merged organization, and then have a miserable time adapting to an entirely new situation and culture. For example, it is always a shock to hear about companies that end up spending large sums for assets – such as products – that are fraught with defects, or even non-existent.

With so many companies today focusing on acquisition either as an exit strategy, or in order to beef up their flagging businesses, I thought it would be helpful to offer readers a guide as to when specific types of acquisitions make most sense. My hope is that, if we can make even a small contribution to making every acquirer and 'acquiree' smarter about the justification and timing for critical decisions in this realm, the entire industry will be better off.

The model I am using plots key acquisition drivers according to how far a company's product category is in its life cycle of adoption, growth, and maturity. The diagram below charts suggested optimal timing for implementing eight different acquisition strategies, from making an acquisition in order to fill out one's basic product, to renewing into a different category in order to depart a declining category and market.

In the former situation (acquiring in order to fill out a basic product offering), youngish companies that realize after a few years in the marketplace that life is tough selling a product or service that more resembles a feature in someone else's product set than a freestanding product on its own end up deciding to increase the scope and span of their offering by acquiring a complementary product that is suffering from the same problem. One example of this might be a company that produces customer service resolution software deciding that unless it acquires more technology to fatten up its basic product offering, it will be made irrelevant by competing offerings that promise the same benefits as a part of a customer service/support software product set, or even as part of a customer relationship management (CRM) suite.

In the latter situation (renewing into a different, more vibrant category), a company may have established a thriving business over several years, but comes to see that growth is now limited or, more probably, revenues are declining. Instead of introducing their own new innovation – or possibly alongside it – they prefer to use their capital or stock to acquire an existing business in an adjacent category that still has growth potential, or that will make a synergistic contribution by revitalizing the acquiring company's existing business. A good example of the latter in recent times has been storage hardware company EMC's acquisitions of software companies Legato, Documentum, and VMWare, on its way to becoming a full-blown storage and content management systems company.



In-between the two extremes in this sequence of eight distinct strategies, there are six other acquisition drivers:

Obtain service IP
This strategy applies particularly when a company needs to beef up its domain expertise or professional services in order to gain access and traction in a vertical market with which it is relatively unfamiliar. Partnering may have failed to solve the problem, and the company decides that it will be more able to gain credibility with target customers by incorporating a limited number of service resources, along with their documented methodology, in order to be sure of delivering on critical projects.

Enlarge the category
This driver arises when a company realizes that its still-emerging product category is likely to be co-opted by a larger vendor that provides a number of related applications or systems utilities; alternatively, it may come to recognize that the business potential of its current offering is simply too limited in the revenue volume and growth it can produce. An excellent example of a company that pulled off a masterful category expansion strategy in the mid-90s was Siebel Systems; after three years or so of rapid growth in its original category, client/server sales force automation (SFA) software, Siebel made the acquisition that allowed it to claim a leadership position in the then-emerging super-category called customer relationship management (CRM) when it bought Scopus, one of the four leading customer support software companies. Another example of a company-making acquisition of this nature was BEA's acquisition of WebLogic in the 1997-98 timeframe. A more recent example of this frequently used approach in tech is Agile Software, which has made a number of 'footprint-enlarging' acquisitions in the past three years, on its way

from expanding its product offerings from managing NPI (new product introductions) for businesses using outsourced manufacturing to a broad product line in the PLM (product lifecycle management) super-category. In this migration, cost management (sourcing) was the first add-on application. And, a final example is Business Objects, which acquired Crystal Reports a couple of years ago in order to compete with a more complete business intelligence and reporting offering against Cognos, its closest competitor.

Expand market coverage
A common example of this strategy is when companies that have successfully established their businesses in a few markets decide to acquire their way into new geographies or industries rather than expand organically, in the belief that the former approach will result in quicker results. Many smaller regionally established enterprise applications companies over time have exploited this strategy. A recent example of this approach has been demonstrated in Lawson Software's proposed merger with Intentia. Whereas Lawson has a strong presence in the U.S. but a weak one in Europe, Intentia is strong in Europe but weak in the U.S. After a number of attempts at organic expansion over the years, both companies believe that they are more likely to succeed in becoming a global player in their target markets by combining than by continuing with the previous strategy. (As an added bonus to strengthen the strategic value of the merger, both companies also bring new product categories to the mix, Intentia contributing EAM – enterprise asset management – offerings to enrich Lawson's ERP products.)

Take out a competitor
This strategy applies when growth has declined to vegetative levels and most potential customers have adopted products in the category, and many have even upgraded their systems more than once. Faced with a diminishing pie for new business opportunities and loyal installed bases, some companies acquire a competitor in order to reduce the number of vendors in their space. The hostile acquisition of PeopleSoft by Oracle that was cemented late last year is a good example of this type of strategy in action, and HP's acquisition of Compaq was based on the same allegation of increased financial leverage to be gained by taking out a close competitor.

Keep-away; acquisition
This approach is adopted when one acquirer steps in to eliminate a player before another of their competitors can do it. Often, the 'winner' has little or no original desire to make this move, but decides to do so in order to prevent their competitor from getting stronger by doing it first. The case of the Retek acquisition by Oracle is a perfect example of this strategy in action. It's worth pointing out that in these cases the winning acquirer often takes chances with their existing business by doing this, as in the case of Oracle: just a few months after starting to digest PeopleSoft, a large and disparate organization, Oracle had to suddenly complete the Retek deal in order to avoid SAP getting the company.

Consolidate the category
This strategy is generally undertaken by an operationally strong company that understands how to quickly realize financial gains by taking over sick or declining players in a given category. Under-leveraged financial value in the form of loyal installed bases that pay recurring fee revenues (maintenance contracts, subscriptions, etc.) to the target vendor are usually the inducement for acquirers like this to act. Computer Associates (CA) has been the tech industry's favorite example of the so-called scavenger that most often plays this role. Today there are many others, such as ERP 'roll-up' organizations SSA Global, Infor (formerly Agilisys), and Best Software. Now, in the absence of any new paradigm to exploit, Oracle has volunteered to become the industry's client/server applications vacuum cleaner, and its sucking sound is already reverberating around the enterprise applications space. Interestingly, however, Oracle has yet to invest in "cleaning up" in the database space, which is its home turf. Instead, it is insisting on doing everything to make life hard for the enterprise applications gorilla, SAP. In true European fashion, SAP is refusing to take the 'acquisition-war' bait and is pursuing a different, new-paradigm strategy built around developing a new partner-centric ecosystem on top of a services-oriented architecture. My prediction here is that Oracle's more tangible and immediately

realizable strategy will show signs of paying off before SAP's. Thus, SAP will have to hold its nerve during the time it takes to establish its new strategy successfully in the face of Oracle's belief in the long tail of client/server apps.

Having seen a little of what these eight different acquisition strategies are about, what can we say about the rewards or penalties for choosing them earlier or later than indicated in the life cycle? From all the cases one sees in the real world, there is nothing to indicate a hard and fast rule one way or the other. That said, I would suggest that making a market expansion acquisition in order to expand into new geographies worldwide when you have yet to establish traction with more than a handful of actual customers may be foolhardy. Overall, rather than say that a given strategy is wrong at a given stage, let's just agree that it may lose some of its potential benefits. At worst, of course, it may be preordained to failure.

What to do with this model if you are a potential, current, serial acquirer?
Use it to think carefully about the various drivers, to make sure that when you embark on a possible acquisition negotiation, you know exactly why you are doing it. This will also help you to price the deal more closely to its actual value. It is not unusual to hear a lot of vacuous rhetoric about an alleged "strategic fit" from CEOs or boards of companies that have given up the ghost in terms of growing their businesses the old fashioned way, and just want to find some relief by buying increased revenues. Misleading yourselves as well as the acquired party about your reasons for making the acquisition inevitably causes misaligned expectations among investors, executives, and (especially) customers and employees on both sides, and can result in deals turning into absolute nightmares.

What to do if you are a candidate to be acquired?
My best advice to potential acquirees is to study this model and figure out all the drivers that might (a) help you cull an initial list of potential acquirers to the most suitable ones in terms of value (and therefore price, and (b) help you to refine your value proposition for the deal (thus also helping to price it eventually). Both of these factors can lead a target acquirer to want to make a move to acquire you on terms that more closely suit your company's objectives, because you can use these insights to pursue value-building strategies that will ensure a closer fit with their own market strategies. Furthermore, you can use the added time that this approach entails to get a sense of the cultural fit between the companies and gauge the future value (and pain) of current management staying on as part of the acquisition.

Since it is difficult to "pretty yourself up" in the short term in order to attract a desirable acquirer (many acquiring companies and their investment bankers were not born yesterday and can see such antics a mile off), it is advisable to think through this approach carefully. For one thing, it may take a lot of energy on your executive team's part to make progress against an objective like this – energy that might be better spent staying focused on building your business in accordance with your existing strategy, and letting favorable acquisition winds blow your way when you least pursue it and most deserve it.

What about the other option – the "merger of equals" – where does this fit in?
My answer is: nowhere. In M&A there is *always* a prime mover and a responder, always a suitor and an object of their desires, always one side that is basically going to run the show and another that is going to be absorbed into the new organization. Thus, all the time spent protesting to the world that the two organizations are coming together in a blissful and super-adult spirit of total equality and collaboration is a lie designed to soothe egos. Worse, it wastes considerable time and erodes value. There.

And what about the non-combatants, among whom are well-known examples like Dell, which is virtually dedicated to organic growth? Michael Dell's famous witticism about Dell's growth strategy at the time of the HP-Compaq transaction - "*We acquire our competitors one customer at a time"* - still rings out as a condemnation of those companies that resort to acquisition as their growth strategy of record.

Perhaps the worst indictment of M&A is when we see that company acquisition has in effect become a *substitute* for strategy rather than a *tool* of strategy. Before charging ahead with one of the riskiest decisions any company can make, acquisitive executives would be well advised to ask themselves if there isn't a more suitable way of achieving their growth objectives than making an M&A deal in order to provide a return to their investors. In today's tech industry, for example, I see clear signs of endemic growth potential still to be exploited if companies can only get past the reigning belief that all growth potential has evaporated for the enterprise software and systems sector. One sign of this growth potential is the marked increase in private equity and late-stage VC funding in under-leveraged tech companies.

Under the Buzz offers commentary on enterprise software and systems business and management issues. The goal is to provide provocative and accurate insights into the latest events and thinking shaping this continually evolving technology sector. *Under the Buzz* also provides commentary on strategies for building sustainable competitive differentiation and maximizing market valuation.

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