June 2020

McKinsey Quarterly

The telltale signs of successful digital deals

Digital M&A is challenging—and often a necessity for digital transformation. Sophisticated acquirers boost their odds by addressing the pain points that undermine outperformance.

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The old saw that the best deals are the ones you don't make doesn't apply when it comes to digital acquisitions—you've got to make them, our research has consistently shown. You also need to do them well, and that can be challenging, because buying in the digital, analytics, and technology space—what we call "digital deals"—is different enough from undertaking conventional transactions to raise the odds of costly lapses.

In this article, we show how to overcome those challenges, and join the ranks of companies that have achieved exceptional performance by energizing their digital-transformation efforts with successful mergers and acquisitions (M&A). Digital leaders pursue M&A about twice as hard as everyone else. They spend three times more on M&A (27 percent of their annual revenues, compared with 9 percent by others) and devote upward of 1.5 times more of their M&A activity to the acquisition of digital capabilities and digital businesses (64 percent, compared with 39 percent for their peers), and ensure that software acquisitions are among their highest priorities. And that was before the COVID-19 crisis, which is making it even more important for many companies to rewire themselves in ways that sometimes necessitate acquiring digital capabilities.

High-performing acquirers approach M&A in a programmatic way, from strategy to deal execution and on through integration. You can often spot their work by what they don't do: make unforced errors at key points in the deal life cycle. Sometimes, an acquiring company stumbles before it has even started, not thinking through its strategy or what types of assets and capabilities it needs to acquire. In other cases, the acquirer doesn't sufficiently understand the technology it's purchasing, or how to value it. And even when acquirers navigate the strategy and execution phases smoothly, they can still wind up foundering during integration.

Sophisticated acquirers know the common trouble spots. Three categories of challenges—across strategy, execution, and integration—are particularly worthy of attention. In this article, we address these challenges in turn, so that when your

Exhibit 1

Common errors occur at common points across the life cycle of the digital deal.

Deal phases

1 Conception	2 Transaction	3 Integration
Common errors		
Fuzzy thinking	Financial confusion	Postclosing stumbles
Unclear rationale: Why are we doing *this* deal?	**Misunderstanding sources of value:** Are we taking a broad view of the value proposition?	**Talent retention:** Are we doing enough to keep key employees and not just senior ones?
Poor technical due diligence: Do we know what we need to know about this technology?	**Limited valuation tool kit:** Are we using a full range of valuation techniques to get a clearer picture? Are we incorporating the right multiples?	**Sales-force conflict:** Are we aligning our salespeople and offering sufficient incentives to move the right products?
		Integration delays: Are we ready the day the deal closes and investing in integration after that?

organization moves forward with its digital deals, as it must, it can avoid common errors before they happen (Exhibit 1).

Strategic preparedness

Tried, trite, but true: luck really is the residue of design. So too is the negative: bad luck and poor outcomes follow ill-prepared—and sometimes downright absent—strategies. Don't expect that a deal done on a whim will turn out to be a winner. An acquirer must rigorously consider what it hopes to accomplish, why an acquisition aligns with its direction, and what exactly it is buying.

Be clear about the rationale

As our colleagues have demonstrated, fortune in the digital age favors organizations that have bold, tightly integrated digital strategies.[1] To succeed, digital reinvention must go beyond merely acquiring stand-alone products and services to bring to market. An acquisition should follow your strategic plan.

[1] See Jacques Bughin, Laura LaBerge, and Anette Mellbye, "The case for digital reinvention," *McKinsey Quarterly*, February 2017, McKinsey.com.

So be clear about the strategic gaps you are trying to fill. Why do *this* deal? Is it for market leadership? Technical capabilities? Talent? Some combination of those objectives, or perhaps for other strategic reasons? Just because a technology works, or is on track to work, doesn't mean it's the right asset for your organization. Different assets, in turn, may look quite similar on their websites yet fulfill very different strategic needs. And you're unlikely to recognize those disconnects if you haven't been rigorous in spelling out the deal's rationale. Articulate your strategy; then identify your target.

It's fine to make a trade-off between commercial scale and cash flow, on the one hand, and more speculative (though potentially pathbreaking) innovation, on the other, so long as you know what you should be shopping for. This is why acquirers that buy profitable, mature assets and then expect game-changing innovation can wind up feeling frustrated. Other times, companies expecting immediate growth or earnings accretion are disappointed when they buy compelling intellectual property (IP) with little commercial traction. Sophisticated acquirers know the difference. They make sure they are paying for what they need, not for what they don't. If a deal, however attractive, doesn't fill a demonstrated gap, the acquirer is setting itself up for disappointment.

One technology-services buyer, for example, wanted to beef up its DevOps portfolio and discovered a profitable software company that seemed to fit the bill. But most of the target's revenues—and all of its profits—derived from a mature, unrelated product with little strategic value to the acquirer. The target's DevOps solution, while capable, turned out to be a niche product, with limited market size and upside potential. The acquirer's strategic goal, assumed by its senior leaders but not clearly spelled out to its business-development team, was to achieve both innovation *and* scale. This deal achieved only the first goal. Returns were compromised because the company hadn't pursued assets more in line with its strategy.

Commit to technical due diligence

Even if your strategy is clear, it will be compromised if what you buy from a technical perspective turns out to be not what you thought you were buying. The problem happens more than you may suspect. In our experience, technical due diligence is the single biggest differentiator of deals done well—or poorly. What's more, technical due-diligence failures can usually be avoided. Almost always, the disappointed acquirer insufficiently vets the technology and discovers too late that it fails to work as advertised. Or the technology *does* work, but only in constrained environments, and won't scale. In other cases, crucial parts of the IP turn out not to be owned by the seller.

Some organizations do less technology due diligence on targets they plan to acquire for hundreds of millions of dollars than on companies they are evaluating (say, for an internal pilot program) for a fraction of the price. One reason is the necessary confidentiality associated with M&A. Large, market-moving transactions require discretion—which can be problematic for digital deals if it inhibits leaders from bringing individuals with critical engineering know-how into the information loop. Further complicating matters: some organizations may not even have the in-house capability to establish that the target can do what it purports to do.

Seasoned acquirers always seek to evaluate the target's technology before a deal. Digital M&A is a capability, and best-in-class acquirers treat it that way, with dedicated technology teams to stress-test prospective acquisitions. It's ideal to be a customer before you become an acquirer; this element alone can dramatically reduce risk. If that's not possible, do whatever you can to become well versed in the technology before you buy it, and understand how it will operate within your organization under real-world conditions. Digital deals aren't plug and play.

A case in point: one healthcare-equipment manufacturer purchased an imaging-technology company with sophisticated code that worked stand-alone but turned out to be incompatible with the technical architecture of the acquirer's installed base. The expensive mistake could have been avoided had the acquirer simply tried experimenting with the target's products. In another case, a communications-hardware manufacturer acquired a successful company that made remote-network-monitoring software. It was a great product, and a great fit, but it had one great problem: it relied on software code that was licensed, but not owned, by the acquired company. Soon after the acquisition, the company that did own the code was itself acquired by one of the hardware company's competitors. The code became unavailable as a result. The hardware company had to redevelop the missing IP at a cost of tens of millions of dollars and a 24-month delay. An avoidable due-diligence oversight doomed the investment's returns.

Financial perspective

Getting the valuation wrong can of course doom returns as well. Sophisticated acquirers take care to understand value from a range of perspectives—not only from the perspective of the acquirer, but also from that of the target and "the market." Acquirers less familiar with digital M&A may fail to value a digital asset properly. That often stems from misconceptions about the value proposition.

Consider the sources of value

Because M&A in the digital, analytics, and technological space is so critical, it is usually expensive. "Underpaying" is unrealistic; bid too low, and you'll probably miss out. But what does it mean to "overpay"? Consider one acquirer, which we'll call Company X. At the time of an important deal, this organization was numbered among the most valuable technology companies in the world. It had experienced several years of impressive growth, and its talented workforce had an enviable reputation as an innovation engine.

Just as Company X reached its highest valuation to date, it acquired a new software platform for $50 million. The platform had generated virtually no revenue when the deal closed but had the potential to complement the company's software offering and reach a new market of mobile users. The platform produced no revenue over the year after the closing. Nor did it generate revenue the year after that or the following year as well—zero revenue, not just zero earnings, for three years. Did Company X misunderstand the target's value proposition? Hardly. Company X was Google (now Alphabet), and the target was Android, today an immense platform that ships on over 80 percent of all new smartphones. In 2018 alone, Google made $25 billion, enabled by Android's massive installed base, from Google Play.

Value in the digital context is no different from value in other sectors—companies generate value when their return on invested capital exceeds their opportunity cost of capital. But the path from deal conception to value creation can be different enough that if you approach digital M&A valuation solely by traditional means, you're liable to get an incomplete picture. When assessing digital acquisitions, take care to set clear expectations about synergies and time horizons. Revenue synergies typically matter more than cost cutting. Don't overindex on earnings; digital acquisitions made today may not increase cash flow for multiple quarters to come. If you're buying a digital asset to strengthen your technological capabilities, recognize that financial results will manifest indirectly.

The digital whole really does exceed the sum of its parts. An acquirer may have a suite of products that has a gap; the right acquisition will make the entire suite more valuable, driving sales not only for the acquired product but also for adjacent products. For example, one IT hardware company purchased a security-services company and found revenues increased not just from the security products it could now offer but also from higher renewal rates for annual service contracts on the company's core product.

Expand your valuation tool kit

Pegging the appropriate value of a digital target is hard, and you do yourself no favors if you constrain your valuation methods. As in any deal, you should always run a discounted-cash-flow (DCF) analysis. But in digital, that DCF should come in two flavors. The first should be from the point of view of the acquired company as a stand-alone entity, using target management's current financial projections as a guide. The second should model what the target may be worth *inside* the acquirer. In this second scenario, some costs may be higher (for example, acquirers often have higher labor costs than start-up companies have). Yet there may also be both cost and revenue synergies, such as accelerating sales.

The use of comparables, too, should go beyond the traditional. "Seven-times EBITDA" (or whatever your earnings comp may be) doesn't make sense when you're buying an early-stage technology—comp on revenue instead. Moreover, get under the revenue-driver hood, using metrics specific to the target, such as multiples based on numbers of users or subscribers.

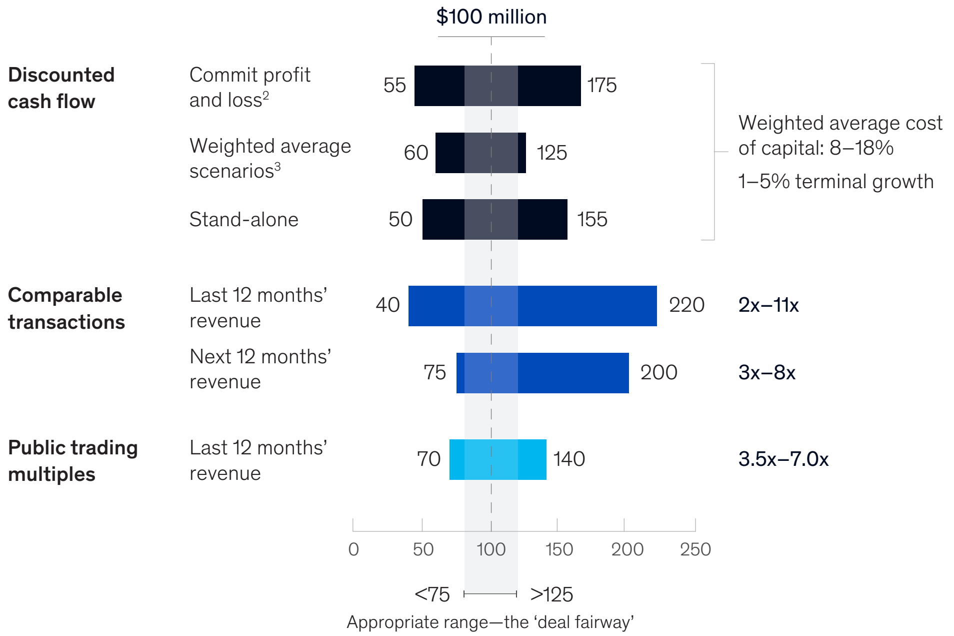
At the same time, don't fixate on a single comparable in isolation. Multiples are a spice. If you treat any one multiple or simple combination of multiples as the main ingredient, you're likely to spoil the valuation broth. (Why, for example, pay a multiple on users if only a subset of users will purchase subscriptions? And why fixate on a multiple on subscriptions if the subscription price is not in line with market rates?) Yet multiples do provide a fuller flavor of the deal. They help set the parameters of a "fairway," feeding into market baselines and meeting the target company's expectations on price (Exhibit 2).

While you may encounter accounting issues such as potential write-downs in the treatment of the target's service revenue, these shouldn't influence your view of the deal, so long as actual cash flow is not affected. Be aware, though, that write-downs can occur and that you'll need to understand the issue in detail in order to have clear investor

Exhibit 2

Use a range of approaches to hit the deal fairway—it will help you decide when to do a deal and when to walk away.

Disguised example from cloud-company acquisition, implied equity value,[1] $ million



[1] Net of balance sheet cash.
[2] Value of company to the acquirer, taking into account its cost of capital.
[3] Scenarios assuming the target is acquired.

communication at deal announcement. Understand, too, that costs nearly always go up when acquiring a digital start-up company. Start-up employees are often paid below market salaries in exchange for stock options, and work in below-standard office spaces. That means the target's earnings trajectory can flatten, at least in the short term, after the deal has closed. Revenues take time to grow, but expenses begin to bite immediately. Experienced acquirers factor this in when they create their earnings forecasts.

Execution follow-through

Unfortunately, even when the strategic, financial, and accounting stars align, before-deal expectations and after-deal results may not. To better your odds for success, bear down on postclosing execution. Three types of unforced errors are among the most prevalent, and preventable.

Prioritize talent retention

It's difficult to overstate the importance of talent retention. In digital M&A, you're acquiring not just IP but also the skills of those who make that IP go. Software engineers are not always interchangeable in the ways that people in other skilled positions are. Retention incentives are common, which may add to the deal price. But scrimping on employee compensation can be a prescription for disaster. Don't be pound foolish.

Very frequently in digital M&A, and as is common for companies that are start-ups or a few years older, you'll be buying a business with different classes of shareholders. Depending upon how many rounds of financing a target has been through (and sometimes within a single round if the investors negotiate unique terms amongst themselves), you'll be dealing with sellers who have disparate interests, incentives, and contractual rights, especially liquidation preferences.

That's why you should always ask for the target's capitalization table, shareholder agreements, and other agreements between and among the company and its shareholders before landing on a final deal price. In some cases, small changes in price may disproportionately affect the attractiveness of a deal for one group of the seller's shareholders over another. Several acquirers have encountered scenarios in which the target's preferred series of investors made a tidy profit from selling at a given price, while some employee–shareholders received nothing. As a result, you may be dealing with disgruntled personnel right from the start.

Buyers typically do try to retain key employees. Yet it is rarely obvious from an acquirer's perspective who the most critical personnel actually are. One common mistake is to confuse seniority with importance. Engineers, even junior ones, can be essential to making the acquired IP function smoothly. Conversely, some of the target's executives, even very senior ones, may not matter for sustained success; they may be serial entrepreneurs or serial start-up chief experience officers (CXOs) who specialize in grooming VC-backed start-ups for acquisition but lack the desire or skill set to manage within large acquiring organizations.

One industrial company did a retrospective study of 40 digital, analytic, and technology acquisitions stretching back over two decades. It found that there was no relationship between acquired CXO attrition and success or failure, and a very clear correlation between engineering attrition and failure. Strikingly, retaining the top one or two executives didn't correlate (positively or negatively) with the success of acquisitions. But broadening the retention program did.

Paying attention to cultural fit improves retention as well. Morale issues can spring up unexpectedly, as they did when a large US-based software company acquired a small Canadian digital start-up, which was proud of its "beer Friday" in the office. That would have been unacceptable for the Fortune-100 acquirer. Beer Friday, lamentably, went down the drain following the acquisition (at least in the office break room), but the effect on morale was relatively tame because this sophisticated acquirer had been proactively generous with retention bonuses for the engineering staff. Other successful acquirers have found ways to be flexible about more conventional traditions, such as free snacks.

Recognize sales-force sensibilities

Closely related to talent retention, but distinct in its own trip wires, is the need to minimize sales-force conflict. When acquired companies come with their own sales forces, these employees often encounter hurdles in their new environment. For one, they may no longer be allowed to reach out to customers directly, instead needing to go through a series of unfamiliar channels and gatekeepers. Sometimes there can be multiple relationships with a single buyer that need to be clarified, or the target's salespeople may be expected to sell into unfamiliar industries. Each of these issues can quickly lead to frustration and attrition.

Mapping two sales forces together is always a challenge. Often, a best practice is to convert the acquired sales force into an "overlay" function. This approach is ideal when the acquirer and acquired have a similar subset of customers, and the buyer also has a much larger set of customers, relationships, and salespeople. It's also a best practice to over-incentivize sales of the acquired product in the first one or two years. This way, the acquiring sales force, which may well have a lot of products to promote, won't neglect the new addition.

Often, the acquired company has no sales capability; the target is simply too early-stage. At one energy company we know, which acquired a small analytics provider, all of the target's sales were CXO-led. The energy company planned to deploy its own sales force to sell the acquired technology to its existing customer base, but the product was sophisticated and difficult for the acquirer's sales team to grasp. Although its market-expanding potential was significant, it was a high-complexity, relatively low-price technology when compared with the acquirer's other offerings. As a result, the acquirer's sales force ignored the lower-commission, more complicated acquired product, and the acquisition missed its financial targets. Those missteps could have been averted by having a plan to train existing salespeople sooner, and establishing an incentive package to reward salespeople for selling the new product right from the start.

Keep up the integration momentum

Unfortunately, delays in integration are a common hazard in digital M&A and occur well beyond the sales force. The vast majority of large corporations' digital acquisitions are small (less than $50 million in target revenues) relative to the buyer. As a result, acquired digital assets can wind up neglected, sitting adjacent to other products in an acquirer's portfolio—out of sight and out of mind. That risks letting revenue synergies go untapped, or become stale after sitting too long.

Let's face it, integration is nitty-gritty work. Employees' enthusiasm for integration into the mother ship may or may not be high to begin with, but it rarely gets higher over time. Moving quickly after an acquisition is a challenge in any sector, but, in digital—where technology evolves so rapidly—failing to do so can be ruinous. Sophisticated acquirers have an integration plan, head count, and budget in place before the acquisition is closed. High performers assign a full-time integration leader from the parent company for at least one year, on-site if possible. Combining the acquired workers into one physical location with the parent isn't always possible, but is advisable if it doesn't involve making the whole staff relocate to a new city. It's preferable not to leave the acquired company in a separate facility any longer than necessary.

When times get tough, one of the easiest expenses to cut is acquisition-integration spending. Resist the temptation; a loss of momentum can doom an acquisition. This happened with one deal in the energy software space, when sales at the parent company suffered for macroeconomic reasons a few months following the acquisition. During the downturn, the operating budget to integrate the acquired company was pared. As a result, it missed its commercial targets, a problem that quickly turned into a negative spiral and eventually led to the write-off of the acquired business.

Digital M&A is an engine of digital transformation, and sitting it out is an invitation to falling behind. Getting deals in the digital, analytics, and technology space right can turn, to a surprising degree, on limiting unforced errors at points where they can often go wrong. Sophisticated acquirers know where the missteps can happen. They cultivate digital M&A as a core competence. And while there is no foolproof, step-by-step road map for getting each deal right, every company should know where the common hazards may be, and control for what they can. Q

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