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Reflections on digital M&A

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What exactly is digital M&A and how does it compare to garden-variety dealmaking?

The buzz in the world of mergers and acquisitions these days is often around so-called digital M&A. But it's not clear the term means the same thing for everyone, or if they even realize how it differs from garden-variety deal making.

McKinsey's **Werner Rehm** checks in with **Robert Uhlaner**, who's worked on digital deals, to sort it out.

Podcast transcript

Werner Rehm: Robert, we have been talking a lot about digital M&A in the last year and a half or so. And part of the reason is that since 2016 we see about 4 or 5 percent of M&A volume in what we call digital M&A. It does seem there are two different types of digital M&A. One is a company buying analytics, skills, and software to improve how they make their product. Another is where you buy a sensor or Internet of Things applications, and put them into the products that you make to make the products better and secure for the future. Are those two different things?

Robert Uhlaner: Yeah. I think there's actually a third one. I made the same point just this week and almost everybody added a third piece, which is social: dealing with other means by which there are disruptions from an Uber-like play, or other types of online marketing, or online business models which is a little different than Internet of Things, where you're improving the value proposition of the product.

Werner Rehm: An online business model for traditional companies?

Robert Uhlaner: Yeah.

Werner Rehm: Typically what I see is that it's traditional companies trying to do this, rather than Microsoft buying yet another software company.

Robert Uhlaner: Yeah that's right. And that's why it's so hard. I was reflecting that in the last wave of tech M&A, and in a flurry of activity 15, 20 years ago, it was a lot about industrial clients trying to carve out technology and get a valuation.

This time they're actually trying to change their business model or operations. As opposed to discovering that they had a little bit of software revenue in a hardware company and trying to monetize that. Now it's a lot more around legitimate business building or acquiring a new capability.

Werner Rehm: And when we talk to these companies, while fundamentally it is still M&A and the traditional process still applies, there's a lot of other things that make this difficult, let's say, for a traditional industrial company. Things like high levels of uncertainty about the product and the target. Or low target visibility; sometimes you don't even know exactly what you're buying. What is different about this than an industrial company buying another small industrial company and plugging onto the product there?

Robert Uhlaner: Fundamentally the biggest difference is it's very hard to do traditional M & A. You need to do valuation. But an industrial company buying a small in dustrial company will look at a standalone intrinsic valuation, maybe using a discounted cash flow. They'll look at cross-sell and cost synergies to arrive at the value of a company to them and be able to set a price.

Digital M&A, particularly if it's around a new business model, to your point, there's uncertainty where you're creating potentially a whole new profit and loss statement that's unproven. But even in the case where you're just acquiring capability to improve your production or efficiency, the value of the company is going to be based on a different methodology - in terms of the value to you, versus the perception that your target company will have, which they'll see as selling stuff into some market.

Werner Rehm: Practically, how do I go about this? A traditional method is, I buy a company, I can maybe cut some costs and attach some product, and that gives a discounted cash flow value to me. Then I hope I pay less than that. Here it feels like you need the business plan first and then you figure out how to fill it up. It's less about a single deal and more about how much you can spend to get the whole business going. Is that the right way to think about this?

Robert Uhlaner: I would argue that's a discipline that should have always been used; figure out the strategy and build an understanding of the valuation, and then apply that to various targets to see how well it fits. But in this case, if you don't have that discipline, it's unlikely you'll be able to start a productive conversation internally.

I think that despite the trend - that's increasing digital M&A that we're seeing - there is a much larger number of companies looking at digital deals and struggling to figure out how to justify them. The valuation in particular is a real barrier to a 'go-no-go' decision because it does require discipline around an operating plan. And then, in turn, an integration plan, which is the second challenge these companies have.

Werner Rehm: We're going come to integration in a second. But I do want to explore this notion of, "What changes in how you look at deals?" Because a lot of companies that I've talked to still have the mindset that any deal has to be earnings per share accretive in two years. Or maybe operating income accretive. Or the synergies have to outpace the implementation cost. And it feels like here you're likely to buy something that you actually have to invest in before it becomes something bigger in four or five years. So how do you guide companies to think about the value creation from these deals when they're a little bit stuck in the old way to think about this?

Robert Uhlaner: Whether it's a business model or a capability internally, you need to build a profit and loss statement and an operating plan so you can understand what the value at stake is. Then you need to figure out how much capability you're going to have to invest in internally, versus what the contribution is of buying a company.

At the end of the day it's going to be a judgment call as to whether buying capability will either reduce the cost, or increase the speed by which you can achieve the business objectives.

The good news is that these aren't large transformational deals; they're smaller deals. You are really trading this off around internal investment to build capability. Many of these things are expensive. I predict, though, that you're going to have rules of thumb emerge like we saw in tech M&A and software M&A decades ago; more metrics around things like a million dollars per engineer. As opposed to anything that's tied to the target company's P&L or revenue.

Werner Rehm: Particularly when a lot of these things don't have any revenue or profit to speak of.

Robert Uhlaner: I'd argue that just like we saw in software M&A, generally you see that if you have legacy revenues with digital companies, it's more a liability because it's unlikely that you're going to be wanting to continue that business. That's the other wrinkle - things without revenue are probably, in many ways, more attractive. Because it's more likely that it'll be easier to have it fit into what you want to use the asset for without having to worry about legacy customers.

Werner Rehm: It does feel like that kind of conversation, in the broader context of a strategic plan and a business plan, is not something you can just go to your head of business development and say, "Go find me five companies that have this technology," right?

It feels like a broader investment into finding the right skills, finding the right companies, and driving the discussion towards the outcome, rather than going and valuing a company and just buying it, right? It feels broader than classic M&A target hunting.

Robert Uhlaner: Yeah. I think you need to be very focused on what you're building, with a business leader or functional leader really taking that ownership. But again, I'd argue that's best practice even if it's traditional M&A. You need to have a clear strategy and be able to fit it into a business plan. But in this case it's nearly impossible to execute these, given the range of assets that you might be looking at, unless you're actually screening them against a real operating plan.

Werner Rehm: A couple of minutes ago you mentioned integration. I've heard both, "Let's integrate everything and put them in our system," and, "Let's keep everything separate because it's a small company, and we don't want to put our old traditional company spirit over the young spirit." How do you think about that? What have you seen that works?

Robert Uhlaner: First of all, you want to make sure you're integrating these acquisitions into one thing; as opposed to buying a bunch of things and hoping that they'll somehow collaborate. It's unlikely that only one acquisition is going to drive a digital strategy under any of the different objectives we've talked about. So you are going to be buying multiple companies. And you're going to have to figure out how to structure and organize those companies into a clear operating organization.

I think that many of these companies are young and would welcome the benefit of mature processes, if they are delivered, to relieve them; as opposed to having more administrative overhead. So, traditional finance, recruiting, even operational skills, I think should be selectively integrated to help these companies so they can focus on the innovation.

But a lot of mistakes [are made] when traditional companies - whether they're industrial, or pharma, or travel and infrastructure companies – buy more technology-oriented or different cultures in these assets. There is this sense that they need to leave them alone, which almost accelerates the failure rate. It's almost self-fulfilling.

Werner Rehm: Can you give an example of where this integration worked or didn't work?

Robert Uhlaner: There are traditional examples that are true today. Take the whole payment space. You get an anchor acquisition and then you string together 30 or 40 other payment companies throughout the world, but it's done systematically to create a unified payments platform. The vision is to create a global platform, so you bring these assets together. I think that concept of building a platform and a vision for how you string these things together is applicable today even in areas like trucking. You see companies putting a lot more sensors into physical Class-A trucks, and then providing performance data and predictive maintenance data in order to pool across, not only potentially the trucks they sell, but fleets that may have a variety of different manufacturers. That's really the choice point. It's a bunch of decisions around, "Are you actually going to build a platform? Is it going to be open or closed?" Closed being just your products. Or open to pool data between you and your partners.

We see failure occurring when you only put a toe in from the very beginning. You deal with uncertainty by not only looking for something that's cheap, but on top of that, you may hedge your risk by doing an earnout on the current profit and loss statement, because you really don't know how else to defer payment. And as I said earlier, the likelihood that you're going to be running the business or using that capability and generating the same profit and loss once you acquire it, is pretty low. And if you put an earnout around it and don't have a plan for integrating it, even if you did get lucky and get what you needed cheap, it's going to be nearly impossible to integrate the thing.

Werner Rehm: Interesting. It does raise a question that we haven't addressed upfront. To use some old terms, "How do I know what I should buy, versus make?" Because some of this doesn't feel too hard to do yourself. When you think about hiring software engineers for Internet of Things and putting sensors on products, you could be contractually better off than buying; especially when you have areas, like technology that are moving quickly and you need intellectual property that is protected. To a certain extent, you don't quite know what you really need in 5 years. Wouldn't you be better off just having a contractual relationship rather than buying some of these companies?

Robert Uhlaner: The simple answer is it's a lot harder to do a joint venture or even a contract because it requires not only this vision of an operating plan but, just like any other procurement, you have to step into a fairly granular definition of what the business requirements are. In this case, sure, if you can do that, and do even better through an equity investment so you have a stake in the company, and can ultimately potentially convert that into an acquisition if things go well, then I think that's a great strategy. It's just a lot harder. It requires a lot more work upfront. Classically, in terms of work, you get what you pay for.

My guess is for really promising technologies and capabilities it's going to be really tough to control and shape the IP and the roadmap without ultimately having control of the asset. But to the extent that you can fund specific activity, or license certain technology, that's a great option.

You still run into the same problem though, because if you don't have the internal capability to manage those projects contractually, it's going to be really tough to make sure you're getting what you want.

Werner Rehm: That makes sense; especially the point about controlling the intellectual property and taking away some promising technology from your competitors as well by having unique access.

We said earlier this is less than ten percent or so of M&A volume right now. What do you think of as a bold prediction? Is digital M&A going to be the majority of M&A that industrial companies are doing? Or is it always going to be small compared to large deals?

Robert Uhlaner: Given that, for the most part, these will be capability plays - they will be small deals. As new and successful business models emerge you can imagine you'll begin to see, across all sectors, much more significant movement to things that we're going to call 'digital deals'. It's going to be hard to score it. Given where this trend is going, you're going to see companies that have a mix of the two. My guess is that at a minimum, in ten years, 20 to 30 percent of M&A will have a real material digital component to it at a minimum. But it's going be tough to isolate digital deals from non-digital deals.

Werner Rehm: That makes a lot of sense. So the only thing we do know then is that it's important for everybody to have the skills to look at the digital space, the technologies, the intellectual property, as they do on most any kind of deal.

Robert Uhlaner: I would say ten years from now, it's almost inconceivable that any company, in any industry, will be able to ignore a digital business model or digital capability to remain competitive. That's the big difference this time. It's not just taking advantage of some bubble in software valuations and hoping to get a piece of that. It's really going to be core to being competitive in 5 years, let alone ten.

Werner Rehm: Digital M&A is here to stay. Robert, thanks very much for joining us.

Robert Uhlaner: I appreciate it. Take care.

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