

The Impact of Human Capital on M&A Activity in the Software Arena

BY KARL AAVIK & PATRICK WALSH

Human capital is arguably the most important form of wealth in the world today. It is estimated to be three to four times the value of stocks, bonds and other assets, and is rapidly becoming the critical currency of our knowledge-focused economy.

Despite its value, businesses have long overlooked this vital asset, often failing to consider the human capital variable when undertaking corporate restructurings, leveraged buyouts or M&A activity. In many corporate transactions, “people issues” are relegated to secondary status behind financial and strategic concerns. Yet failing to appreciate this component of success is often at the root of missed expectations.

As executive search consultants serving the technology and communications industry, we are highly sensitive to the impact of leadership and management issues on corporate strategy and decision-making. Through our Strategic Leadership Services, we counsel companies undergoing mergers, acquisitions and other corporate transitions on their human capital assets, helping them assess and structure leadership teams. But just how many companies take this kind of informed, strategic approach to human capital due diligence? Our hunch is that the instances are rare. More often, the approach is likely haphazard – involving modest resources for evaluating talent.

To provide a window on this activity in the software arena, we surveyed over 2,000 senior-level executives at a range of public and private companies on their approach to mergers and acquisitions. We confirmed that M&A activity in the software arena is strong and growing, yet is often not pursued and addressed systematically. Typically there is no formal process or team for evaluating targets, and many important factors are all but ignored, such as the quality of the executive management team. The findings confirm our suspicions that companies are neglecting to consider human capital issues during the M&A process – one of the chief success factors of any deal.

M&A Activity Rampant...

FINDING: Seventy-three percent of surveyed companies completed at least one M&A transaction over the last three years. For those estimating M&A activity at more than one deal, the average number was nearly seven – with public companies averaging nine transactions and private companies three. The average value was \$246 million.

OBSERVATION: \$140 million was the average reported size of transactions, with private-company deals ranging from \$900,000 to \$500 million and public-company deals ranging from \$3 million to \$800 million. It appears that very large deals are the exception rather than the rule, occurring at a limited number of exclusively public companies.

...And Expected to Grow

FINDING: Nearly 60% of respondents anticipate an “increased number of transactions” over the next three years, and 85% expect deals that are “equal or greater in size.”

OBSERVATION: Even in today’s depressed market, software executives are bullish about the use of mergers and acquisitions to create value, indicating no ebb to merger mania in this sector.

Casual Approach to Identifying M&A Targets

FINDING: Nearly 60% of responding companies take an “opportunistic and informal approach” to identifying M&A target companies, versus following a “systematic and formal process.”

OBSERVATION: This finding, which encompasses both public and private software companies, is quite surprising given the amount of merger activity in this sector. The huge value-creation lever that M&A provides, and the inherent window it gives on emerging technologies, suggests that a more systematic process for identifying targets would be beneficial.

Formality Mounts at Evaluation Stage

FINDING: When evaluating M&A targets, companies typically grow more strategic, with nearly 40% following a “systematic and formal process” and another 40% relying on an “ad hoc team employing an established process.”

OBSERVATION: Public companies are primarily responsible for the upswing here, with nearly all relying on an established process for evaluating M&A targets. Nonetheless, in the evaluation stage, even public companies lack processes for assessing the human capital of targets – so critical to driving value. When it comes to evaluating targets, private companies are likely to employ an “ad hoc team using its best judgment.” However, with changing IPO markets and longer launch times for taking companies public, we expect that private companies will soon begin implementing more formalized processes.

CEO Leads the Process

FINDING: At the majority of companies – nearly 65% – the CEO oversees the M&A process, with “strategic planning/business development” cited second-most frequently. At 13% of responding companies, division unit heads oversee M&A activity in addition to their other responsibilities.

OBSERVATION: Our findings here reinforce the notion of M&A as a powerful value-creation tool. The “proof is in the pudding” when executive leadership plays a direct role in evaluating key targets.

Profit-Focus Drives Deals

FINDING: When identifying the driving forces behind M&A activity, respondents point to three objectives as more important today than three years ago: “increasing earnings per share,” “growing top-line revenues” and “assembling a more complete product or service.” “Achieving critical mass” was identified as more important by private companies only.

OBSERVATION: These driving forces provide an interesting contrast to last year’s Internet euphoria – indicating a “back to basics” profit-focused approach to corporate transactions. That “increasing earnings per share” is the most important objective driving M&A deals suggests that CEOs believe financial metrics used to value technology companies are converging with those used in more traditional industry.

Other Driving Forces

FINDING: Equally important today as three years ago are “gaining market share,” “accessing specific technology” and “achieving critical mass.”

OBSERVATION: Three years ago, “gaining market share” would have likely been the “buzz” surrounding M&A activity. Today, it plays second fiddle to earnings concerns. This marks a change in the valuation applicable to target companies that are not yet profitable. Nonetheless, acquiring market share and new technologies and achieving critical mass are still important drivers.

Leadership Secondary in Assessment of Deals

FINDING: Nearly 30% percent of respondents do not consider the quality of the executive management team an important consideration in M&A activity, while 64% view this as “one of several equally important factors.”

OBSERVATION: While all companies evaluate the financials of a proposed target, they often pay scant attention to the leadership team – neglecting to consider one of the most critical components of success. We believe there is a huge opportunity to increase the likelihood and magnitude of deal success by paying more attention to people.

Executive Evaluation Methods Haphazard

FINDING: When assessing executives during the due diligence stage, 80% of respondents use an informal process largely limited to face-to-face interviews.

OBSERVATION: It’s surprising that so many companies neglect to seek broad and objective input when evaluating a management team. Thorough referencing, 360-degree assessments and other benchmarking tools are valuable means of obtaining information on executives that would not be evident from one-on-one interviews. Independent research conclusively shows that these tools significantly increase the ability to predict the future performance of executives.

Surprisingly, Cultural Fit a Deal-Breaker

FINDING: “Poor cultural fit” was the most often cited reason for walking away from a deal, identified by 70% of executives. Other significant reasons include “weak executives,” identified by 50% of respondents, and “concerns about retention,” cited by 35%.

OBSERVATION: These responses are striking, particularly when contrasted with respondents’ seeming lack of concern regarding leadership assessment. It appears that decision-makers do not place formal assessment of the management team high on the priority list when evaluating deals. However, during the ongoing evaluation process, cultural and human capital issues are the most common deal-breakers. This underscores our belief that assessing the human capital aspect of M&A transactions in a systematic fashion is important and should play a key role in the evaluation of deals.

About Spencer Stuart

Founded in 1956, Spencer Stuart is the world's leading privately held executive search firm, offering a range of human capital solutions, including senior-level executive search, board director appointments, strategic leadership assessment and, through its web-based recruiting division – Spencer Stuart Talent Network (SSTN) – mid-level executive recruitment. With over 50 offices in 24 countries, more than 300 consultants and 1,200 staff, Spencer Stuart conducts 4,500 searches annually through a global network of industry and functional practices. Clients range from Fortune 500 companies to smaller, emerging firms.

About the Authors

KARL AAVIK and PATRICK WALSH are consultants in Spencer Stuart's Chicago office and members of the firm's Global Technology & Communications Practice.

Karl is the co-leader of Spencer Stuart's Software specialty practice. Prior to joining the firm, he led the North American Internet practice of another international search firm. Before entering the executive search profession, Karl was vice president of sales and marketing with Blackwell Consulting Services, a startup technology and Internet consulting firm in Chicago. He began his career with IBM as a systems engineer, advancing through various sales and marketing management roles to become a business unit executive in IBM's software organization. Karl holds an M.B.A. from the University of Chicago and a B.S. in mechanical engineering from the University of Illinois.

Pat is active in Spencer Stuart's Technology & Communications Practice, focusing on recruiting sales, marketing and general management executives for both established and newly launched software companies. He was recently awarded the Lou Rieger Quality Award for excellence in search. Pat began his career with Price Waterhouse and joined McKinsey & Company in 1991. At McKinsey he led engagement teams serving senior management on strategic and organizational issues. He most recently was director of sales and business development in a venture-backed information services company. Pat holds a B.S. from Miami University of Ohio and an M.B.A. from the Wharton School.