Increasing Deal Value: Application Rationalization

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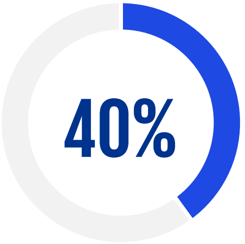
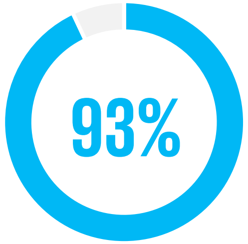
Introduction

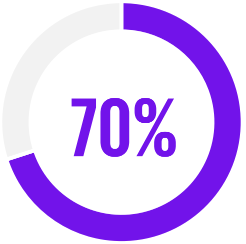
In many instances, large, multi-national companies can have sizable application portfolios (collection of software and software-based services) to serve the functional requirements of multiple business units. However, the applications may not necessarily be required for individual business entities on a standalone basis after a transaction, leaving buyers and sellers with additional costs to maintain the applications. One of the primary challenges in a post-deal environment is to lower operating costs while continuing to support business functions. Application rationalization can help companies meet this challenge head on by reducing the number of applications to a more manageable subset. Subsequently, the application rationalization process replaces some of the remaining applications with Software as a Service (SaaS) solutions (cloud-based software hosted by third-party providers) in order to optimize the subset of applications. According to the latest cross-industry report published by Computer Economics, IT Spending and Staffing Benchmarks, business applications and supporting personnel account for approximately 40% of yearly IT operating costs. Additionally, according to the 2022-23 KPMG Global Tech Report, 93% of technology executives said that they wanted to advance their adoption of SaaS solutions that generally drive lower operating cost. Furthermore, a recent Wall Street Journal research indicates that 70% of M&A-driven IT integration initiatives fail as a result of missteps in the earliest stages. This research shows the importance of commencing the application rationalization process soon after the deal closes.



Costs for IT business applications and supporting personnel as a percentage of yearly IT operating costs.



Percentage of technology executives who said that they wanted to advance their adoption of SaaS solutions that generally drive lower operating cost.



Percentage of M&A-driven IT integration initiatives that fail as a result of missteps at the earliest stages.

This whitepaper is part of a series focused on how IT can increase deal value and minimize business risks during a transaction. The series will highlight principles that the Technology M&A team in KPMG Canada leverages to help maximize value and minimize risks for clients across industries.

Key benefits

Enable long-term strategic initiatives

In a separation, the seller can take stock of its application portfolio, eliminate costs for applications that are no longer required, and optimize remaining applications to enable long-term strategic initiatives.

Enhance scalability

Post-transaction, on-premise applications can be migrated to modern SaaS solutions that are generally less expensive to maintain or are more scalable.

Optimize deal value

In an integration, the buyer can rationalize applications to streamline the business processes, decrease recurring costs in supporting those processes and thereby, optimize deal value.

Application rationalization is a reliable means of reducing costs and streamlining operations by consolidating a large portfolio of applications into a smaller subset of lean, vital, necessary and cost efficient software resources. The application rationalization process can prove critical in reducing operating costs following a transaction, thereby enhancing the deal value for all of the involved parties.

Application rationalization has advantages for both buyers and sellers undergoing an integration or separation/divestiture, respectively. In a separation, the process helps the seller take stock of its application portfolio, eliminate costs for applications that are no longer required, and optimize remaining applications to **enable long-term strategic objectives.** Conversely, in an integration, the buyer can rationalize applications to **streamline the business processes, decrease recurring costs** in supporting those processes and thereby, **optimize deal value.** Moreover, the exercise helps buyers determine an enhanced bid price that reflects the incremental value of an optimized application landscape. This can be achieved by a pre-deal application portfolio analysis in order to estimate the reduction in operating costs that can be derived in a post-deal environment.

Clearly, there are advantages to making application planning a priority. The application rationalization process can lead to decisions to migrate existing on-premise applications (software installed on computers on the premises of the organization rather than in the cloud) to modern SaaS solutions. These solutions are generally less expensive to maintain or are more scalable compared to on-premise solutions resulting in savings in terms of annual licensing fees and maintenance costs. Therefore, moving to SaaS solutions can reduce operating costs, thereby **increasing EBITDA on an ongoing basis** and **enhancing the value of the business entity.**

Execution steps

- Application rationalization starts with the analysis of the functional processes that will be supported by software applications once a business transaction is complete. The second step is to eliminate existing applications that are no longer required upon exiting the Transition Services Agreement (an agreement for the seller to continue providing shared service support temporarily post-deal). The last step is to identify anchor applications (core applications that can be integrated with smaller solutions) and SaaS applications that are fit for purpose for future business requirements.

- Application rationalization is carried out from a business standpoint. This ensures risk mitigation for the operational continuity of critical functions. Nevertheless, the aggressive rationalization towards a newer application landscape might pose a risk to the business given that it requires sufficient implementation time and user training. There is a need to balance the requirement to build a focused set of applications that are easy and inexpensive to maintain, with the necessity to drive operational performance in a post-deal environment.

Case study: Enhancing value, diminishing risk

If performed correctly, application rationalization can result in significant payoffs. Consider, for example, the recent carve out of a business unit from a global manufacturing company. The target business unit being divested was supported by over 600 applications, of which 50% were shared across the parent company and therefore required separation. The divestment of the business required the entire application portfolio to be used on a standalone basis. However, due to the limited transition period, complexity of this migration and needs of the standalone business unit, the migration of these 600 applications as a whole was untenable. As such, KPMG supported the target business through an application rationalization analysis, in which a standalone IT blueprint was developed and costed with a significantly reduced application portfolio that was optimized to suit the needs of the standalone business.

This analysis resulted in a robust estimation of a lower standalone IT operating cost for the target business pre-deal. The key drivers of the IT operating cost reduction as a result of the application rationalization analysis were:

- Lower software vendor costs as a result of fewer software applications
- Lower IT personnel costs required to maintain fewer business applications, and
- Lower operational staff costs, as the result of operational streamlining of business processes

The analysis resulted in best-in-class applications for HR planning, time tracking and payroll administration, as well as financial reporting enablement. The activity also resulted in the decision to migrate on-premise ERP systems to cloud platforms, resulting in further optimization. Overall, the **pre-deal application rationalization analysis resulted in 30% fewer applications and a 35% reduction in IT operating costs** for the standalone business.

In this instance, **application rationalization ultimately led to an increase in deal value**. As the business was sold for a ten-time EBITDA multiple, the deal value gained was equivalent to ten times the value of the IT operating cost reduction resulting from application rationalization.

Summary and Conclusion

Application rationalization has the potential to add significant value to buyers and sellers alike. It does so by:

Enabling long-term strategic objectives: The application rationalization process helps organizations assess application functionalities required in the future, identify best in class anchor applications, minimize the repository of on-premise legacy applications, and inform decisions to migrate to SaaS solutions.

Streamlining business processes: After a deal closes, rationalizing one's application portfolio optimizes business processes, reduces the need for personnel across the organization and minimizes the risk of errors, duplicated efforts, and system vulnerabilities.

Optimizing deal value: In a deal, application rationalization can increase EBITDA by reducing operating costs and add incremental value to a business by enhancing operational performance. The activity, when performed before the transaction, can also help in arriving at an improved bid price.

A focus on application rationalization can therefore improve the bid price during the negotiation process pre-deal, as well as realize the upsides of a lean application portfolio to drive value post-deal and minimize risk for your business.

To learn more about increasing deal value through application rationalization, please feel free to contact us.

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