US Technology M&A Insights

Is the technology industry poised for a wave of divestitures?

A publication from PwC's Technology Institute

PwC's Deals practice

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At a glance

Consolidation in the technology industry, the current macroeconomic environment and shifting technological landscape have driven technology companies to reconsider current strategies to align their businesses for the future.

Technology businesses are adapting to the demand for cloud-based services and consumer-oriented products and evaluating current product and service portfolios including consideration of divestiture candidates.

With improved credit terms for financial buyers and extensive capital waiting to be deployed, advanced divestiture preparation and a robust process can help sellers unlock the full value of their divestiture.

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Introduction

Technology businesses operate in a truly dynamic environment, filled with shifting landscapes, robust competition, rapid innovation and a demanding consumer base. The demands placed upon technology companies create a voracious appetite for innovation and thus a market for mergers and acquisitions (M&A) that is unmatched. Over the past 15 years, the technology industry has experienced the highest volume of M&A activity when compared to any other industry fueled by innovation pressures but also by a decade long consolidation. For example, in a year of declining M&A for all industries, technology companies generated nearly double the volume of acquisitions in the first three quarters of 2012 than either the industrial products or financial services industries.

Despite being the most active industry for M&A, the technology industry has experienced a decline in transaction volume driven largely by the macroeconomic climate. Deal volume in the first three quarters of 2012 declined 10% over the prior year and deals are expected to continue at similar levels through the end of 2012. However, the recent slowdown in the deal volume highlights some underlying factors that may point to a looming wave of divestiture preparation and execution in the year to come.

Motivations for divestitures

In the last 15 years, divestitures as a percentage of overall technology M&A comprised between 14 and 23 percent of total deal volume. Periods of lower relative divestiture volumes tend to occur during years of high overall M&A activity, as was the case in 2000. These years are generally followed by an increase in relative divestiture activity as the M&A market cools and divestitures become a more substantial portion of overall deal activity. In 2007 we saw a similar drop in relative divestiture activity as the technology M&A market peaked and then subsequently declined, resulting in a short-term increase in divestiture volumes but a substantial decline thereafter. Somewhat of a departure from prior trends is a recent decline in overall and relative divestiture volumes over the last five years. While this unusual trend began during the Great Recession, companies have been pressed to reevaluate their portfolio and product strategies.

Like many other industries, technology divestitures are driven by several reasons:

- ***Normal portfolio balancing***—Companies continuously evaluate their portfolio of products and services in light of the current strategy and make strategic decisions to shed unwanted assets. Constant need for innovation quickly shifts products from next generation to legacy and necessitates ongoing assessment of product mix strategies.
- ***Refocus on core markets***—In an industry marked by high acquisition activity, a return to core competencies is not uncommon for technology businesses. With previous acquisitions in adjacent markets that have not managed to meet expectations, some companies find themselves exiting these investments in favor of core markets.
- ***Capital needs***—Although cash balances seem to abound at technology companies—the Fortune 1000 technology companies boasted in excess of $400 billion at the end of the third quarter - businesses may also divest of less strategic assets in order to harvest capital for higher priority investments.
- ***Regulatory requirements***—In some situations the need for divestiture is mandatory, such as when significant acquisitions are approved by US governing bodies (e.g. the Department of Justice) upon condition of divesting certain assets post acquisition.

Over the last three months, PwC has witnessed an increase in client discussions related to divestiture planning. In addition, in a polling conducted of 30% of the Fortune 1000 technology companies, approximately 75% of these businesses indicated they expect to engage in divestiture activity in the next 12 months. The most common reasons for planned divestitures were a refocus on core markets and normal portfolio balancing, or in some cases a combination of the two.

Factors driving divestitures

In addition to these polling results and anecdotal indications of potential divestiture activity, several factors come into play that build a strong case for a substantial volume of divestitures in the coming year.

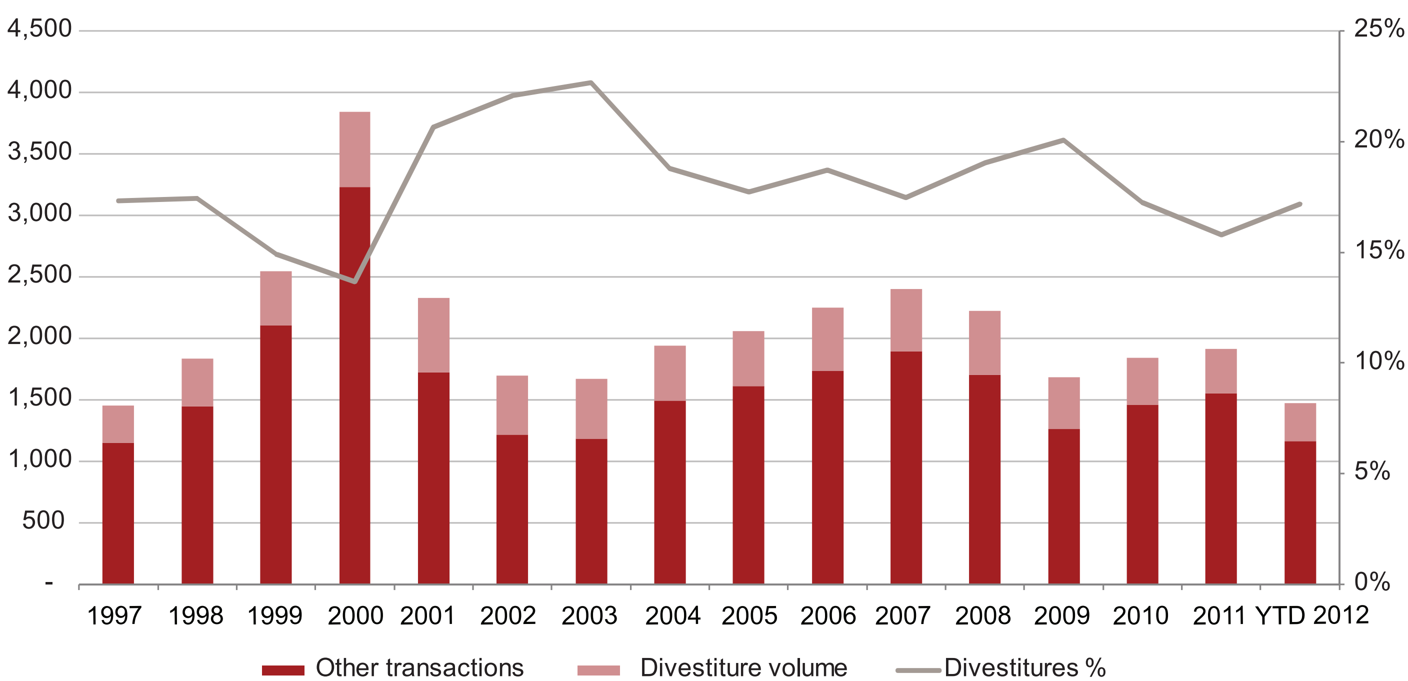
- ***Shifting technology landscape:*** Consumption of the IT stack is shifting to the cloud. The number of customers for high-end servers and data centers is condensing and the ability to sell software and services to a larger number of end-users continues to multiply; lower cloud price points enable expansion of the customer base and business strategies are shifting accordingly.
- ***Prolonged period of consolidation:*** A decade-long period of consolidation predicated on concentrating "on premises" hardware with services capabilities in larger end-to-end enterprise vendors. This period of inorganic growth and expansion has masked the need for systematic reassessment of products and services of acquired companies. Prior acquisitions tend to be less embedded in operations and easier to measure, evaluate, and sell than organically nurtured products.
- ***C-suite changes and a refocus on emerging economies:*** Frequent recent changes in executive leadership force companies toward new strategies and bring a fresh outlook on product portfolios. Combined with the continued strength in developing nations, assets are being redeployed for longer-term growth and higher rates of return; the opportunity cost of current investments come into question under new leadership.
- ***Macroeconomic recovery:*** Low valuations immediately following the recession generated market consolidation and created newfound economies of scale. Competitors, now with compressed margins, are forced to evaluate long-term return rates, while horizontally integrated technology firms must reassess the market strength of non-core products and evaluate the strategic fit of impacted product lines.

Conclusion

Thus after nearly a decade of industry consolidation, along with the current macroeconomic climate and changing technological landscape, businesses have ample reason to reconsider current strategies and make adjustments to align their businesses with expectations for the future. With technology companies shifting to adapt to the demand for cloud-based services and consumer-oriented products, divestitures are bound to occur.

With some of the lowest credit rates in recent history and a significant stash of dry powder needing to be deployed in the coming year, tech-focused private equity firms are in a position to buy up divestiture candidates so long as valuation expectations from would-be sellers don't hamper expected returns. Coupling corporate factors with improved credit terms for financial buyers and the immense amount of capital waiting to be deployed, the next wave of divestitures appears to be on the horizon.

Technology Divestiture Trends



Source: Thomson Reuters

About PwC's deals practice

PwC's Deals practitioners help corporate and private equity executives navigate transactions to increase value and returns. In today's increasingly daunting economic and regulatory environment, our experienced M&A specialists assist clients on a range of transactions from smaller and mid-sized deals to the most complex transactions, including domestic and cross-border acquisitions, divestitures and spin-offs, capital events such as IPOs and debt offerings, and bankruptcies and other business reorganizations. We help clients with strategic planning around their growth and investment agendas and advise on business-wide risks and value drivers in their transactions for more empowered negotiations, decision-making and execution. We help clients expedite their deals, reduce their risks, capture and deliver value to their stakeholders and quickly return to business as usual. Our local and global deal strength is derived from over 1,400 deal professionals in 21 cities in the U.S. and over 9,800 deal professionals across a global network of firms in 75 countries. In addition, our network firm PwC Corporate Finance provides investment banking services within the U.S. For more information, visit www.pwc.com/us/deals. www.pwc.com/technology.

About the data

We define divestitures as the sale of a portion of a company (not a whole entity) by a US-based seller. We have based our findings on data provided by industry-recognized sources. Specifically, volumes utilized throughout this report are based on completion date data for transactions with both disclosed and undisclosed deal values, as provided by Thomson Reuters as of October 31, 2012.

PwC can help

There is a great deal of value to be unlocked through divestitures in today's market, but proper preparation to capture value takes time. For a deeper discussion on technology deal considerations, please contact one of our practice leaders or your local Deals partner:

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Let's talk

Please reach out to any of our technology leaders to discuss this or other challenges. We're here to help.

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For more publications from PwC's divestiture practice, refer to the following links:

Corporate divestitures from strategy to execution

Corporate exit strategies

Preparing carve-out financial statements

Preparing carve-out tax provisions