

Seven Deadly Sins of Middle-Market IT Due Diligence

How Gaps in Information Technology Due Diligence Impact EBITDA

As Published in the
Buzz Newsletter
Distributed by



When contemplating a middle-market asset acquisition, buyers should take an adequate amount of time to assess the hidden deal risks within the Information Technology (IT) landscape. Middle-market companies may not have the vision, technology architecture, or appropriate skill mix to support aggressive growth after the acquisition closes. IT due diligence involves more than filling out asset listings and checking off boxes. A skilled due diligence team understands that big EBITDA impacts can be found within seven crucial areas.

1. Fundamental flaws in the systems and data structures that feed the financial reports

Middle market companies often have spreadsheet silos containing key financial information. When this information is consolidated to create financial reports, there can often be conflicting views of reality based on differing calculation methods and assumptions from department to department. Dual entry or manual consolidation processes allow for the greater possibilities of errors. It's important to validate these financial reporting structures and processes before the financial due diligence team begins its investigation of the numbers themselves.

Failure to complete this necessary step can seriously undermine the financial due diligence process, allowing the buyer to enter into a bad deal or significantly overpay for the acquisition.

2. IT contracts that have not been renegotiated regularly to obtain more aggressive pricing

After the initial contract is executed with a new vendor rubber stamp renewals can result in lost opportunities for significant cost reduction. In the telecom and outsourced hosting space, increased competition over the last five years has made it easier to find competing bids which can result in cost savings even when staying with the same vendors.

If IT contracts don't come under scrutiny during due diligence, the company may miss a significant cost savings opportunity.

3. Inadequate business continuity and disaster recovery policies and processes

The easiest part of the assessment in this area is to determine if business continuity planning and disaster recovery processes exist. The team must also examine the documented results of disaster recovery drills, and determine the extent to which processes and policies in these areas align with accepted best practices. In this case, an ounce of prevention is really worth more than a pound of cure, and the cost of disaster is easy to estimate in terms of daily revenue loss.

4. Outdated or proprietary applications supporting mission critical business processes

A detailed inventory of all hardware, software, and IT contracts should be part of the due diligence package. The IT due diligence team needs to define the going-forward disposition of each item in the inventory along with a preliminary cost estimate for any required upgrades or replacements of components or contracts that are nearing the end of their service lives. These risks are often not apparent to due diligence teams without significant real-world IT experience. Failure to identify them

before the deal closes could result in significant unplanned capital expenditures in the first year after the deal closes.

5. IT skill sets and staffing that will not support new plans for growing the business

The business goals of the deal set the direction for the IT roadmap. In addition to estimates for the hardware, software and professional services to support the roadmap, the go-forward budget must include the costs of reshaping the IT organization, through replacement, addition, or retraining.

It's critical that the new owners take a careful look at the current IT organization and eliminate underperformers or workers whose skills no longer align with the new IT strategy. If current staff can be retrained and retained, the training costs should be part of the cost model.

6. Failure to include or appropriately implement outsourcing of application hosting and IT functions

In-house hosting of all applications and having a dedicated internal support group may not be a long-term cost effective solution. Estimating the total cost of outsourcing is not an easy task. It is crucial to include secondary cost factors as part of the model. Failure to complete the detailed financial modeling step of the outsourcing vendor evaluation process often leaves companies blindsided by hidden costs that only become apparent after the migration is complete.

7. Lack of formal change control over the IT environment

The due diligence team needs to ensure that both version control systems and processes exist so that changes are proposed, tested, and rolled out in a way that minimizes adverse business impact. Lack of a formal change control board is often indicative of a broken relationship between IT and the business it serves. If the current IT environment has grown up in an uncontrolled and under documented way, upgrade and migration costs may be underestimated. A skilled IT due diligence team can factor this in to the cost model.

It's clear that comprehensive IT due diligence to assess these weaknesses goes beyond checking off the boxes. The due diligence team must begin with an understanding of the investors' goals for the acquisition and conduct a comprehensive evaluation of the entire IT organization and architecture to ensure these goals can be supported going forward. Existing risks become tools to leverage in valuation and shaping the final deal structure. Plans for mitigating those risks are the basis for projecting a year one IT budget.

While some buyers may shy away from requesting IT due diligence of this depth for fear that it will take excessive time, a small, skilled team with a structured methodology can deliver IT due diligence findings for middle market targets within 2-3 weeks.

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