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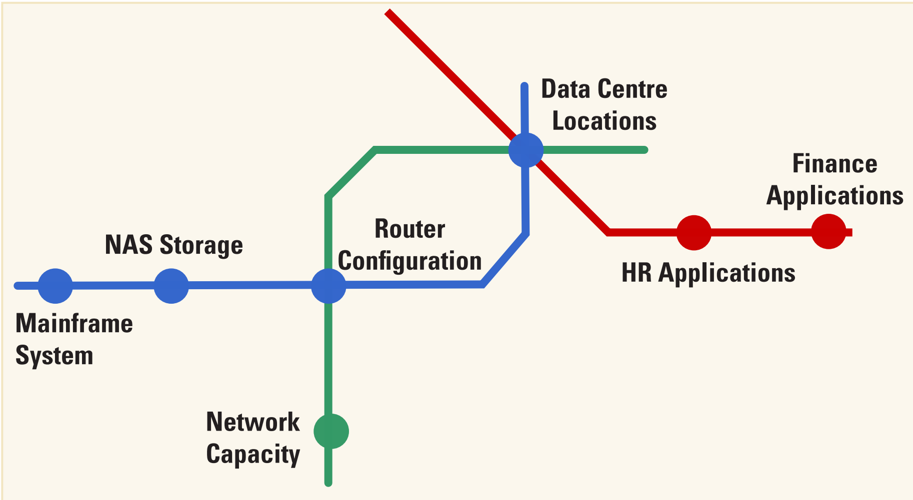
insight

Mind the Gap!

How companies can avoid common pitfalls when performing IT separations

By Ben Downe and Mark Purowitz



Henry Beck's 1933 map of the London Underground system was an incredible piece of work. It simplified the complex geographical maps of the time to a much simpler topological diagram. The billion passengers who use the map each year to navigate the system would be lost without it. The only real criticism of the map is that it can be difficult to estimate journey times between stations. As experienced travellers know, the physical distance between two stations can be different by a factor of 100 and yet all stations are equally spaced on the map.

Travellers through IT separations that often occur during a merger, acquisition, divestiture or change in strategy do not have the benefit of one of Henry's diagrams to guide them. They will need to work out for themselves what the optimal route is and where the critical path lies. They will find that some real world distances are larger than they appeared when planning their journey. Unfortunately, they will encounter unforeseen roadblocks and construction problems in creating new pathways. But experienced travellers will also find significant short cuts along the way, such as retiring unused software applications rather than completing a full migration.

This paper is intended as a starting point for anybody involved in separating an IT function as it describes what makes a successful separation distinct from an unsuccessful separation and how senior executives can ensure a successful outcome.

Two's company, three's a crowd

There are at least three parties involved in a separation exercise; the division being sold (the asset), the company selling the division (the seller), and the entity buying the division (the purchaser). Each party has a different (and sometimes competing) agenda.

One of the most significant aspects of a separation—often taken for granted—is that the asset needs to ensure its business continues to operate through a separation in spite of significant distractions. Employees are concerned about losing their jobs once the integration work commences and headcount reductions are identified. The jockeying for position that happens, particularly when an asset is being separated before merging with another company is invariably counter-productive,. With this internal focus, it is all too easy to lose sight of customers and associated revenue, thereby placing a negative value on the asset right at the time when the opposite is needed. Maintaining a focus on "business as usual" activities within all of the chaos caused by a separation is not easy, but it is essential.

The seller often faces significant challenges as it manages a complex separation with the goal of having minimal impact on the remaining business. When looking to maximise the price that it achieves, the focus should be on making the asset as attractive as possible to potential buyers. This is why maintaining the requisite level of "business as usual" is paramount to success.

On the other hand, the purchaser is often concerned about how aligned the separation work is with its needs. They need to be certain that the separation process causes no damage to the asset during the transition. If they are planning to integrate it within one of their existing divisions then they need to ensure that this can take place as quickly as possible after the sale is completed. This is where pre-deal due diligence and post-deal integration planning is often overlooked to the detriment of the separation plan.

All too often, deep dives in understanding the respective IT landscapes are done after the deal is closed rather than when it is consummated which creates a lot of unforeseen issues and often disrupts "business as usual."

It is important that all parties cooperate effectively with each other. Completing the separation of the IT organisation in an efficient manner is in the interest of all three parties. It will increase the value of the demerged entity for the seller, lower separation costs for the purchaser, and reduce disruption for the asset.

Defining success

Company separations are a great opportunity to focus on strengths, but how well this happens is dependent on the separation process itself. Good separations can set both companies on a route to success and free from the barriers of the past. Poor separations will constrain growth and burden companies for years. Best practice dictates that a significant effort be undertaken to 1)evaluate the synergy savings and the impact of IT integration as soon as the deal is struck given all of the Day One and post-deal 180-day integration considerations, and 2) negotiate any transitional services agreements that need to be structured in order to maintain "business as usual."

Companies should aim to use a separation effort to drive lower overall IT running costs. In fact, synergy savings are often used to structure a separation deal, since it is easier for financial analysts to understand the impact of cost savings on the bottom-line than it is to calculate the revenue growth attributable to a deal. Experience shows that In the short term there will likely be an increase in IT running costs as management invests in those separation activities that can deliver long-term synergy savings. Poorly completed separations may actually increase running costs if services are simply duplicated with a direct copy being created in each entity

For more information contact:
Stephen Warrington,
Managing Partner, UK Practice
Stephen.warrington@diamondconsultants.com

Ben Downe
Manager, UK Practice
Ben.Downe@diamondconsultants.com

Mark Purowitz
Partner, Global Insurance Practice
mark.purowitz@diamondconsultants.com

Economies of scale and greater buying power that come from being part of a larger organisation are also lost in a failed separation. Fortunately, there typically are excellent opportunities for driving down running costs. For example many companies have only scratched the surface of the savings available from virtualising their data centres. Applications can be migrated directly onto virtual machines, driving a significant improvement in server utilisation and corresponding reduction in overall running costs. For example, at a recent insurance client we developed a server consolidation roadmap with total benefits of $30 million including $6 million in the first year.

It is vitally important that business continuity is maintained at all times during a separation. Unplanned system outages are a sign that an IT separation is not being managed effectively. This is typically caused by weak separation programme management and insufficient understanding of the dependencies between systems. It can also be compounded by the loss of key people. Effective separations will ensure that key people are retained during the separation. Poorly organised separations create uncertainty and encourage people to look for alternative sources of employment. A recent survey by the Chartered Institute of Personnel and Development found that managers and professionals are the most challenging group to retain in the majority of organisations.[1] This is also the same group of people who have the knowledge and skills to deliver your separation. They also found that 37% of respondents suggested that a key reason for employee turnover was a lack of development opportunities. Fortunately, most separation projects are not short on these if designed and managed appropriately.

Well designed and executed separations can leave a company with an advantageous legacy long after the two companies have split. However, not aligning the IT architecture with the business strategy creates a risk of constraining business growth as IT services are not designed to scale to anticipated business needs.

That risk is great, according to the 2010 Diamond Digital IQ survey. Our research of 592 business and IT leaders found that about half believe that the IT function and the rest of the business do not share the same understanding of the strategic direction of the enterprise. This is particularly noteworthy because top performing companies differentiated themselves by their closer integration of business and IT. Effective separation efforts further recognise that the environment will almost certainly change dramatically following the sale as the asset is integrated with the purchaser. They will therefore ensure sufficient flexibility in the design of the solution.

Unfortunately, some vendors and outsourcing partners see a company separating as a windfall opportunity to rack up some easy sales. Because most company separations were unforeseen when contracts were drawn up there are often opportunities for vendors to take advantage. An ineffective separation team will give into their demands whereas a good team will identify a work-around and negotiate effectively with vendors. On a recent project a vendor was looking to charge a very significant premium to continue providing web site services for our client after separation and was not interested in negotiation. Instead of giving in to the excessive vendor demands the team quickly duplicated their website on a different site within a week and the contract with the vendor was terminated.

Performing poorly in just a few of these dimensions would be enough to turn a successful project into a black hole that sucks in ever more resources and time. The next section will therefore look at how this can be avoided.

Rising to the challenge

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Fortunately, the risks of a bad separation can be reduced with the right approach. Diamond has identified some key actions which can significantly improve the chances of success. These vary considerably depending on individual characteristics of the scenario and so we have restricted this section to the seven most common actions:

Pre-deal due diligence and post-deal integration planning is paramount to success. The earlier this process is undertaken, the greater likelihood that red flags will be identified and risks mitigated. It is not uncommon for big IT challenges to be uncovered during the pre-deal due diligence that alter components of the deal and resultant valuation. Conversely, it is very common that there are too many IT "gotchas" that don't arise until after the deal is closed which can significantly impact the synergy savings structured in the deal and start the separation in a deep hole that discourages customers, shareholders, bankers and analysts.

Sequencing the separation is often the first major decision to be made on an IT separation project. Most important is the timing of the sale in relation to the timing of the separation. In a separation and resultant integration, we typically find that companies are better served by working through separation activities in earnest before the sale is completed, whereas companies that are being carved out to run as an independent firm can be successfully separated after the sale has taken place. For example, when BAA sold off their World Duty Free subsidiary in 2008 they sold the business first and then separated the IT systems. When it came to Gatwick, which was much more tightly integrated into their core infrastructure, BAA decided to separate a significant portion of the business first, before completing the sale.

Negotiating a Transitional Services Agreement (TSA) is critical if a company decides to complete a separation after a sale. The TSA should explicitly detail service level agreements between companies during the separation period. It is worth dedicating sufficient time and energy to this document as it will be important if there are any disagreements during the separation exercise. This is highly critical to maintaining business continuity for customers and internal operations.

Companies can approach the writing of these documents in two ways. They can either spell out in detail the precise services and services levels that will be provided or they can set out broader agreements such as the intention to provide a service level comparable to that delivered during the previous twelve months. The right level of specificity depends on the relationship between the two companies in addition to the complexity and criticality of the services being provided. A recent initiative Diamond was involved in utilised a hybrid option. The two parties specifically identified critical business services and specified expected service levels while other services were described in more general terms.

Dividing resources such as computer hardware or software licences that are currently shared between the seller and the asset can be challenging. Having a depreciating asset on the books that is not being effectively utilised and requires maintenance can be as expensive as purchasing new software or hardware to replace shared assets.

Changing ownership of assets between companies is much simpler to do when they are part of the same group. Even if the bulk of the separation is happening after the sale it still makes sense to align ownership of assets in advance of the sale. Getting the three parties to a quick Pareto Optimal agreement (where no further adjustments can be made without leaving one of the parties worse off) about which items will taken by which party is therefore fundamental to a successful

“By creating a clear strategy upfront and resolving potential high impact issues efficiently, World Duty Free was able to complete a major separation from BAA and integration with Alpha retail over an aggressive nine-month period. The work was completed a week ahead of schedule and delivered all the planned business case benefits.” Rebecca Slater, Executive responsible for separation program at World Duty Free.

separation. Companies often utilise third parties for this step to identify an objective and independent allocation. For example, during a recent separation a senior manager had established a blanket assertion that all software licences were to be retained by the parent organisation. After some detailed analysis we identified that this was self-defeating as the parent organisation would be paying maintenance costs for those licences without any business benefit. The relevant licences were ultimately distributed between the organisations, saving money for both parties.

Retaining the right people during a separation is a critical task for the IT separation team. During these uncertain times for employees it is often better for an organisation to retain a small number of highly skilled and knowledgeable staff while losing a larger number of less skilled staff. Unfortunately, this isn’t the way things normally play out in practice. Your top performers are likely to find work relatively easily with your competitors if they feel that their jobs aren’t secure in your new organisation. Losing people’s time and concentration to job interviews during an intensive separation effort is something that must be avoided.

In this situation we recommend that companies identify the most critical or “keystone” individuals and incent them to remain within the organisation for the duration of the separation effort. For example, a retail client identified two key individuals that had a comprehensive understanding of the IT estate and signed them up to medium-term contracts, thus ensuring their dedication throughout the separation project.

Reshaping the IT organisation is something that can and sometimes should be done during separation. Cost models that made sense when servicing twenty thousand users often don’t make sense for an organisation with hundreds of users. Instead of simply duplicating existing systems during a separation it often makes sense to realign all IT services to the new business reality. Otherwise companies are forced into two costly migrations, the first to separate from the parent organisation and then again to migrate from the replicated environment to the rightsized environment. Use the separation as a catalyst for change.

Managing other IT projects can be a major distraction for companies undertaking separations as they consume the time of key resources and create additional complications for the separation team. They can also be creating critical functionality that the company needs to stay competitive. Making the right compromises between projects and separation is therefore critical to the long-term viability of the business as well as to the success of the company separation. Problems arise when decisions to postpone projects become political and based more on the individual aspirations of function leads than on the overall business impact.

We recommend that companies adapt their project prioritisation process to account for the interdependencies with the separation process. For example, a retailer might decide that a point-of-sale upgrade should be delayed until the end of the separation due to a dependency on the replacement network infrastructure. The relevant business executives will need a compelling case to accept this analysis but the greater good must take precedence.

Conclusion

IT separations are great opportunities to create value for both seller and purchaser but only if they are managed effectively. Diamond has helped to separate the IT organisations of companies in the financial services, insurance, consumer goods and retail industries, among others, and has worked directly with sellers, purchasers and assets. We understand the typical challenges each party faces and are skilled at identifying the right solutions for all parties involved.

A good starting point would be to address the following areas:

- How early can we start the IT due diligence and integration planning activities?
- Is the separation sequenced effectively to minimise risks?
- What kind of formal agreements are needed during the separation?
- How to can resources be allocated efficiently between the two companies?
- How can key managers be retained and motivated?
- Is the IT organisation effectively aligned with the business strategy?
- What projects are a now a distraction and how can they be delayed?

Endnote

[1] 2009 Recruitment, retention and turnover report by the Chartered Institute of Personnel and Development (CIPD)

About Diamond

Clients trust Diamond Management & Technology Consultants (NASDAQ: DTPI) to help their companies grow, improve margins, and increase the productivity of their investments. Working together to design and execute business strategies that capitalize on changing market forces and technology, Diamond's consultants are experts in helping clients attract and retain customers, increase the value of their information, and plan and execute projects that turn strategy into measurable results.

Diamond's capabilities are rooted in deep strategy, technology, operations, and industry experience. The firm's approach to client service is based on objectivity, collaboration, and an unwavering commitment to its clients' best interests. Headquartered in Chicago, Diamond has offices in New York, Washington, D.C., Hartford, London, and Mumbai. To learn more visit: www.diamondconsultants.com.

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About the Authors

Ben Downe has extensive global experience in the financial services, consumer goods, and telecommunications industries, specialising in projects that involve a combination of business and technology challenges. Having worked at Diamond the last nine years, Ben has a detailed technical understanding and is able to apply this experience to business problems. His work in developing separation strategies for IT organisations and devising new information-driven business opportunities has achieved measurable results for his clients.

Mark Purowitz, a Partner in Diamond's Global Insurance Practice, has 25 years of global industry and consulting experience across the property & casualty and life insurance sectors. Mark specializes in helping clients align business and technology strategies, developing new business models, and managing through the complexities of merger integration.

Diamond
Management & Technology Consultants

Suite 3000 John Hancock Center
875 North Michigan Ave.
Chicago, IL 60611, United States
T (312) 255 5000 F (312) 255 6000
www.diamondconsultants.com

10th Floor, Orion House
5 Upper St. Martin's Lane
London, WC2H 9EA, United Kingdom
T (44) 20 795 9 7700 F (44) 20 795 9 7710
www.diamondconsultants.com