



EXECUTIVE INSIGHTS

Advance Your Industrials Digital Roadmap With a Better Software Acquisition Strategy

When Emerson Electric and AspenTech announced their \$11 billion merger in October 2021, it marked the latest turn in a series of megadeals for industrials software. Just a few months earlier, Rockwell Automation spent \$2.2 billion to acquire Plex Systems. And in December 2020, Honeywell International acquired Sparta Systems for \$1.3 billion.

All told, 11 deals each exceeding a billion dollars took place over the three years culminating in Emerson's announcement. That compares with just two such transactions between 2010 and 2017. Although industrials companies still spend more on equipment makers in aggregate, software accounts for a growing percentage of industrials M&A in the U.S.,¹ with growth in software deals outpacing nonsoftware transactions by nearly a 4-to-1 margin.

Accelerating digital adoption

What's behind this software shopping spree? Industrials companies are diversifying their portfolios in response to a shift toward digital enablement and resulting new profit pools. For example, many companies are looking for solutions that add value to legacy products — think artificial intelligence (AI) for predictive maintenance — or for digital tools that enhance the customer experience. There's also the opportunity to add software-based services that boost customer loyalty and create stable, recurring revenue streams.

Together, these and other investment scenarios break down along what we call the four E's:

1. **Enhance** the value of current offerings (e.g., AI for predictive maintenance)
2. **Extend** the portfolio of offerings to include software and promote cross-selling (e.g., automation equipment player acquiring plant operations software)
3. **Enter** new digital markets or business models (e.g., data platform monetization)
4. **Employ** a new digital capability (e.g., tech-enabled service or digital marketplace)

Often a single acquisition can serve more than one objective (see Table 1).

Table 1
Sample software acquisitions and objectives

Acquirer	Target	Enhance value	Extend core offerings	Enter new markets	Employ new capability
Acuity Brands	Indoor mapping and location platform LocusLabs	x	x		x
Analog Devices	Sound recognition platform OtoSense	x	x		
Builders FirstSource	Building products software provider Paradigm	x	x		x
Emerson	Operations technology software provider Open Systems International	x	x	x	
Honeywell	Quality management system-focused software-as-a-service (SaaS) provider Sparta Systems	x	x		
Monsanto	Climate monitoring system provider Climate Corp.	x		x	
Tesco Controls	Control system solutions provider Trimax Systems	x	x	x	
Trimble	Construction software provider Viewpoint	x	x	x	

Source: L.E.K. research and analysis

Beyond the four E's, software investments bring a host of ancillary benefits. They can provide access to digital talent, yield valuable customer or product data, and help the company make an end run around competitors.

Industrials firms could build their own digital solutions to meet these objectives. But it's often faster or more economical to buy a software company that already has the capability. Buying also offers more flexibility and impact than alternatives like partnering or taking a share in an independent entity.

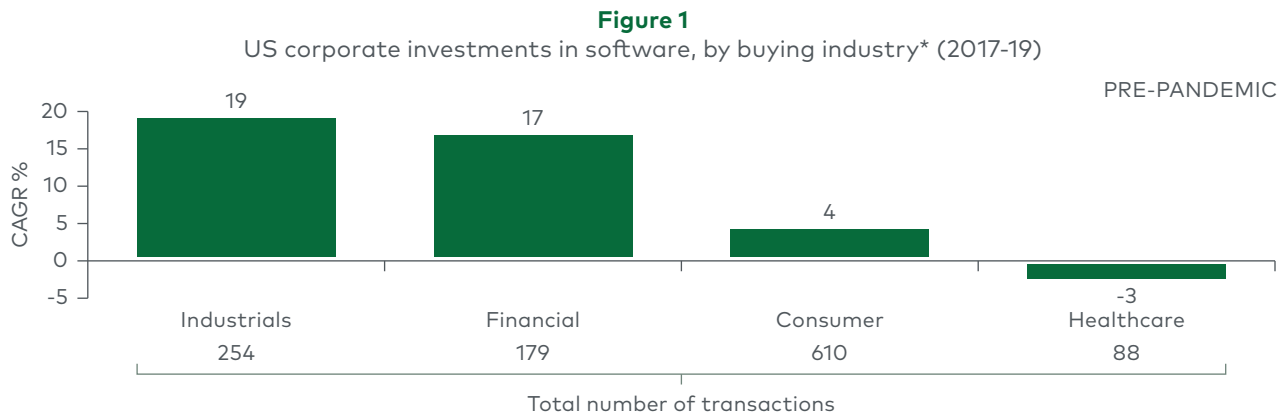
Bigger, more expensive deals

The COVID-19 crisis accelerated the push toward digital investment for most industrials firms. In a 2020 L.E.K. Consulting survey, a majority (83%) of U.S. industrials industry executives said that the pandemic would lead to a step change in their overall digital investment.

Among industrials executives who considered their companies digitally advantaged to begin

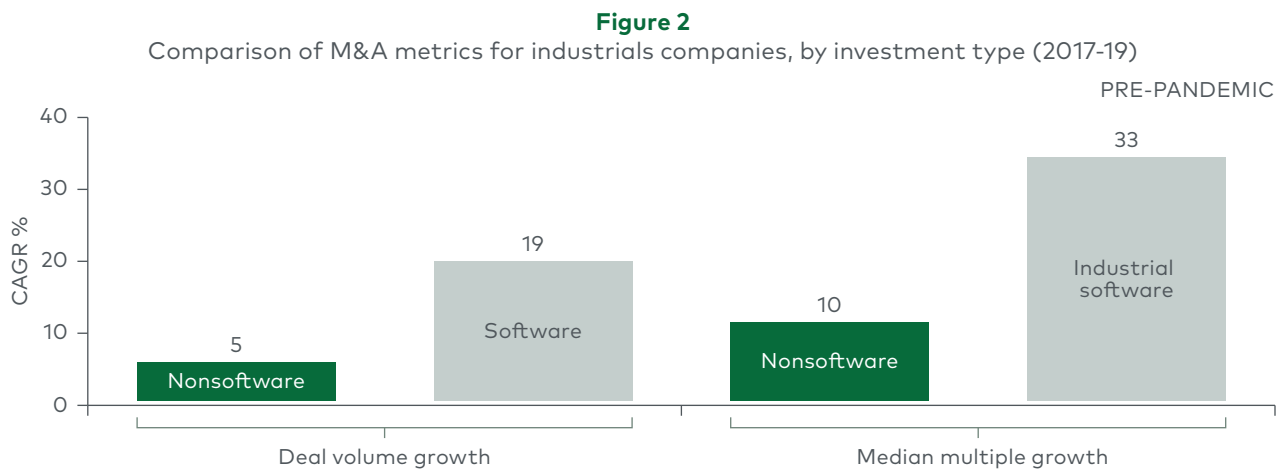
with, nearly all (97%) said they were likely to accelerate their digital investments – a dynamic that is expected to widen the digital capability gap.

But to understand how industrials software investing is playing out in the M&A market, consider what was going on even before COVID-19 hit. Between 2017 and 2019, U.S. industrials firms made 254 software acquisitions with published deal terms, with annual growth in deal volume approaching 20% – a faster rate of increase than what was seen in any other nontech sector (see Figure 1).



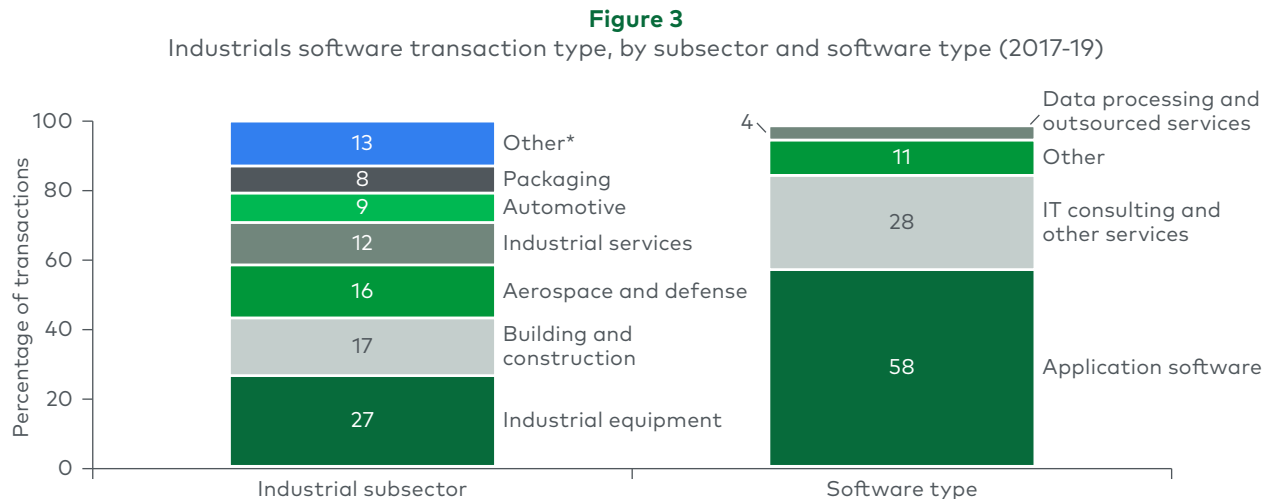
Note: Analysis is based on transactions with published deal terms within the S&P Capital IQ data set (30%-40% of transactions)
 *Excludes software buyers and financial sponsors
 Source: S&P Capital IQ; L.E.K. research and analysis

Within the industrials sector itself, software deal volume had nearly four times the growth of nonsoftware transactions. For industrials software specifically, deal multiples saw 33% growth compared with just 10% growth for nonsoftware transactions (see Figure 2).



Note: Analysis is based on transactions with published deal terms within the S&P Capital IQ data set (30%-40% of transactions)
 Source: S&P Capital IQ; L.E.K. research and analysis

It's not just particular subsectors that are seeing all the activity. Tech-related M&A, particularly for application software, is taking place across the board — from packaging to industrial equipment to aerospace and defense (see Figure 3).



*Other subsectors include energy (5%), diversified industrials (3%), chemicals (2%), industrial distribution (2%), metals and mining (1%), and agribusiness (1%)

Source: S&P Capital IQ; L.E.K. research and analysis

Although most of the deals are for application software, industrials firms are investing across the board. Each asset type conveys different strategic benefits. Here's a brief rundown:

- **Application software** is specialized software to perform certain tasks or analyses (think workflow automation). Owning the software means the company gains control over software features and design and can adapt it better to current customer offerings. Examples include AspenTech's OSI and John Deere's Harvest Profit.
- **Technology consulting and information management services** give industrials companies a chance to expand their client base, deepen their relationships and improve their domain expertise. Examples include Tesco Controls' Trimax Systems and Cook & Boardman's A3 Communications.
- **Software for data analytics** is designed to obtain data and/or insights that can help the company enhance its market knowledge and service offerings. Examples include General Dynamics' Deep Learning Analytics and Woolpert's Geomatics Data Solutions.

Positioning for the win

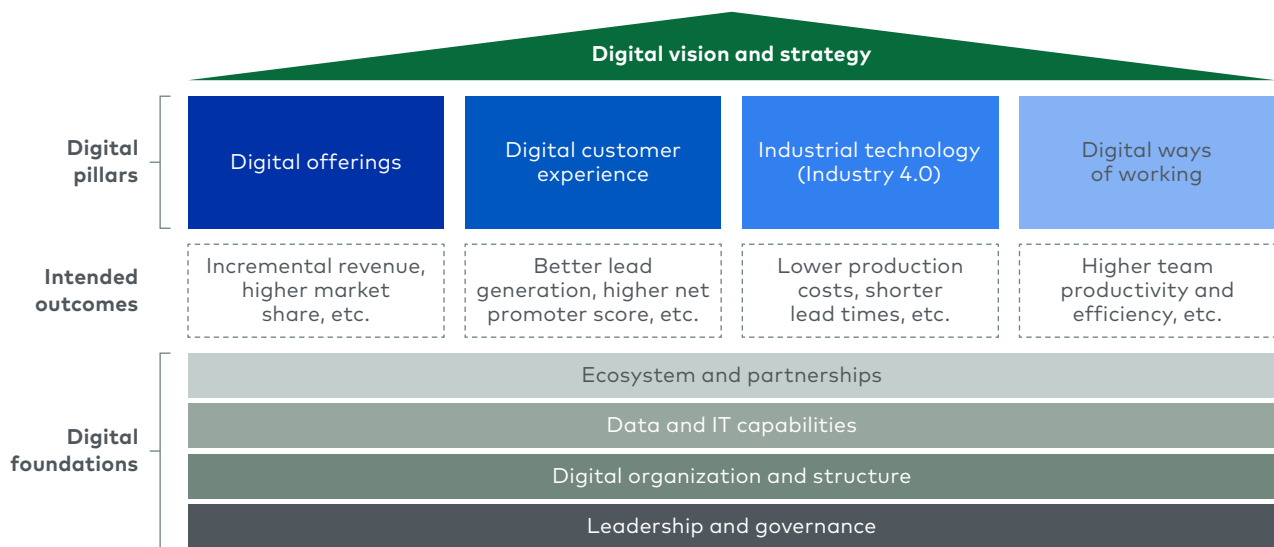
A crucial challenge with a software acquisition strategy is that software is a very different business model for the vast majority of industrials companies. Three of the most common

stumbling blocks show up during the acquisition process: lack of a clear digital strategy, inadequate software deal experience, and the difficulty many companies have in justifying the deal (or the multiple) to the board or investors. A fourth concern, incompatible culture and talent, may not be obvious upfront but can sink the post-merger integration. Let's look at ways to address each of these.

Digital strategy

An important step in clarifying the digital strategy is to empower a leader, often a chief digital officer, who reports to the executive leadership team. A digital leader prioritizes software initiatives in the organization and monitors their financial and nonfinancial performance. But this approach should include support of a broader digital strategy that the digital leader works out in collaboration with the leadership team and business units (see Figure 4).

Figure 4
A digital leader takes a broad view of digital strategy



Source: L.E.K. research and analysis

A digital strategy reflects business dynamics like:

- How the market is evolving and who the competitors are
- What customers and suppliers are likely to need amid changes in their economic and regulatory environments
- What the business is likely to need (including strategic goals and operational enablers)

A digital strategy also identifies:

- The strategic assets of the business (including hidden ones like data)
- The art of the possible with digital business models and technology
- Any maturity gaps that exist in the organization's information and operational technology

Software deal experience

If the company doesn't have a lot of software deal experience, you should prepare for important differences in commercial due diligence. To illustrate this, suppose an industrials company is weighing whether to acquire a SaaS provider. Ordinarily the company would evaluate factors such as:

- Current market size
- Macroeconomic growth drivers
- Competitive intensity and positioning
- Purchase process and key purchase criteria
- Operational synergies

But for a software company, these factors are insufficient at best and poor indicators of value at worst. A potential buyer will also need to assess attributes like:

- Total addressable market
- Market penetration growth
- Migration J-curve marking the valley between traditional perpetual licensing and a subscription-based model
- Ratio of customer lifetime value to customer acquisition cost
- Customer churn rate
- Net revenue retention

And the differences don't stop there. The potential buyer will also need to answer vital diligence questions such as whether the code is scalable, what rights the acquiring company would have with the data and what the exposure to cyberthreats would be.

Justifying the deal

When it comes to software, one way to justify a deal is to determine whether the potential acquirer has the "right to own" it. There are two ways of looking at this. One is to determine the benefits to the **acquiring** company versus other would-be suitors, which could include other industrials firms, software businesses or even private equity buyers. If the acquiring company stands to benefit more than other potential buyers — the acquirer would get more benefit out of new vertical exposure, for example — then that could help justify the acquisition.

The other (and more frequently overlooked) way to evaluate the right to own is to spell out the benefits that the acquiring company brings to the **target** versus other possible owners. For example, software targets' high multiples often reflect their growth potential. An industrials company may be able to fuel that growth by offering a large installed client base, unique domain expertise or other attributes that other potential owners can't match.

Culture and talent

In a 2018 survey, L.E.K. asked respondents from industrials firms about the top barriers to implementing new digital capabilities and technology in their organization. The most common barrier was the lack of digitally capable talent, followed by organizational alignment and structural limitations.

In failed post-merger integrations, the latter can give rise to the former. It often comes down to a culture clash between the acquired company and its new owner, making it hard to operate effectively and prompting talent to seek opportunities elsewhere. To head off an outcome like this, consider taking the following steps:

- Recognize that not all talent is created equal (software engineers are expensive)
- Support remote work as a recruiting and retention tool
- Emphasize the benefits of the business combination and how the acquiring firm provides a new "launch pad" for the software company

Depending on the circumstances, it can be better to maintain the acquired company's independence. That way, the culture that contributed to the software company's value can stay intact. This approach also helps maintain a critical mass of talent and redundancy. Finally, separate profit and loss goals may be more in line with investment needs and performance expectations.

An acquisition strategy for the post-digital era

Industrials companies face no shortage of obstacles to software investing. Overcoming them takes insight into where the challenges are, along with a firm grasp of what makes a software acquisition successful. A good start will make use of the following practices:

- **Carry out software deals** only in the context of a **broader digital strategy** established by an empowered digital leader
- **Determine what success looks like** amid key differences in diligence issues and process
- **Understand the right to own a software asset**, internally and externally, given the alternatives
- **Be mindful of the cultural issues** that can arise when an industrials company buys a software company, and the effect those cultural issues have on talent retention

Industrials firms are increasingly turning to software acquisitions to enhance and diversify their business portfolios while supercharging their R&D efforts and bringing new product value to their customers. At the same time, competition for deals is growing rapidly as digitally advanced corporate buyers and private equity funds increase their activity in the space. Add the effects of COVID-19, and the stage is set for a lively M&A scene that favors those with a well-thought-out software acquisition strategy.

For more information, please contact industrials@lek.com.

Endnote

¹ Bloomberg.com, "Manufacturers Are Bingeing on Software M&A." <https://www.bloomberg.com/opinion/articles/2021-07-16/industrial-strength-manufacturers-are-bingeing-on-software-m-a-kr6pm5xv>

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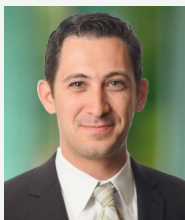
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