Noerr

How top managers are driving digitalisation

An analysis of in-depth interviews with German business leaders

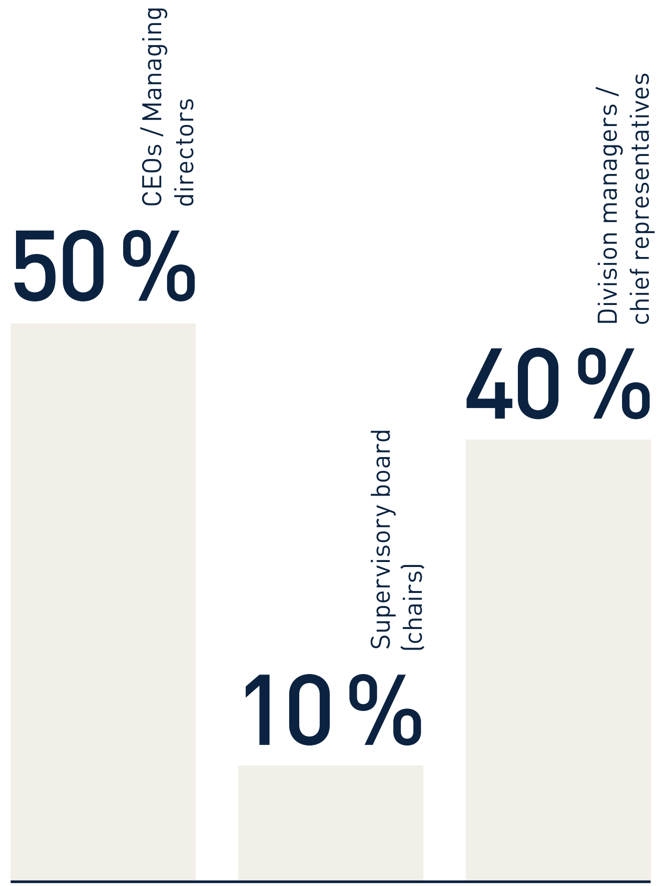
In cooperation with: Technical University of Munich

Introduction

While digitalisation is a top issue for companies which affects strategic decisions in all areas of an organisation today, the challenges facing top managers are vast. They need to build new know-how, change corporate structures and cultures, and modernise or even renew the core of their business, i.e. the products, services and business models. To this effect, top managers have to grapple with potential disruptors on their markets as effectively as they have to overcome possible resistance within their own organisation.

Back in 2019, Noerr examined the success factors of digital transformation in interviews with decision-makers. In cooperation with the Chair for Strategy and Organisation of the Faculty of Economics at the Technical University of Munich, the 2019 study identified the core elements of digitalisation management in large German companies. Building on this, Noerr has now conducted detailed in-depth interviews with top executives from management and supervisory boards, evaluated them and is now publishing the results of the findings in their white paper entitled "How top managers are driving digitalisation". This evaluation shows how top managers define their role in the digital transformation process and the focus of their strategies.

In addition to all aspects relating to the development of a digital strategy, the 'make-or-buy' decision also proved to be a highly relevant task for managers. It is clear that successful digitalisation is being driven both organically and inorganically. This is why the present analysis focuses specifically on digital M&A, i.e. digitalisation with the help of acquired digital companies or start-ups.



Who was interviewed?

Offices held by persons with whom Noerr conducted in-depth interviews

How top managers see digitalisation in their companies

How top managers see the state of digital transformation in Germany

- There is consensus across all business sectors today that digitalisation is vital.
- Digitalisation opens up new business opportunities and is therefore part of major companies' basic strategy decisions.
- Every corporate strategy today involves some element of digitalisation.
- Digitalisation permeates all fields of business. While digitalisation is well advanced in customer-related applications and organisational matters, for some companies there is still a long way to go when it comes to back-end.
- Digitalisation leads to new tasks and working methods.
- Large companies see themselves as being implementers rather than developers of digital technologies.
- Lacking acceptance within companies tends to hamper the implementation of digital strategies.

How top managers see their own role in digitalisation

- Top managers have a crucial influence on the success of digitalisation.
- Success can only be achieved if top managers credibly promote digitalisation top-down.
- Basic digital competence in management bodies is indispensable.
- Depending on the business model, companies usually consider it to be sufficient to have one or two digital experts on the management board.
- The supervisory board should also have the required skill set for its specific role to follow the developments in the digital world as well as the company's core business.
- Preventing digital disruption is one of the key drivers of digital transformation.
- If management and supervisory board members use digital tools, this tends to increase the efficiency of these bodies. Digital tools and digital communication are widely spread.
- Thanks to digital communication tools, there is no need for decision-makers to be physically present.

Strategies employed by top managers

- There is no blueprint for digitalisation; top managers use a need-based approach.
- There is an increasing tendency to decentralise the responsibility for digitalisation.
- Digital training of staff and recruiting experts with digital know-how are high priorities.
- Reverse mentoring, i.e. managers seeking advice from digitally savvy staff, is on the rise.
- The company should make sure its technology remains up-to-date, but should avoid always chasing the latest trend in digitalisation.
- Digitalisation is also a means for achieving a defined increase in productivity.
- Digitalisation is sometimes achieved organically within the business. Alternatively, M&A can be used to acquire or expand a company's digital know-how. It depends on the company and its business model which way is best in a given scenario.

Where top managers see digitalisation issues

- Lacking agility leads to sluggish IT transformation projects.
- New features are not implemented in day-to-day work.
- Potential savings through digitalisation are often overestimated.
- Retaining specialists with digital know-how is difficult.

The most important findings from an academic perspective

Germany lacks successful platform companies that are leading the way in digital business models. In cooperation with the Technical University of Munich, Noerr was able to conduct extensive in-depth interviews with top managers to find out how large companies are moving forward on the road to digital transformation. The main issues discussed during these interviews were:

- Digital competence in management bodies
- Responsibility for digitalisation
- Digital disruption
- Digital skills of staff
- Digitalisation in day-to-day work
- Using digital tools and data generation
- Digitalisation through M&A
- Identifying targets
- Integrating acquired companies
- Retention management

Professor Isabell M. Welpe holds the chair for Strategy and Organisation at the Faculty of Economics of theTechnical University of Munich.
Together with Noerr, she conducted and analysed the in-depth interviews with top managers.

What value do these interviews with top managers on digitalisation have for you?
For me, the interviews have revealed very interesting insights. In addition to the previous survey we conducted on digitalisation with Noerr, which we were able to summarise in important quantitative results, these in-depth interviews with top managers provide detailed insights that a survey cannot accomplish. With the two methods combined we have been able to shed more light on the issue of the digital transformation of large German companies; after all, good studies on this issue are unfortunately scarce.

What were the most important findings?
First of all, the interviews confirmed that the urgency of digitalisation has been recognised by the top management of large companies, such as DAX-listed companies. In fact, most of these top managers appear to be very determined to master these challenges. This does not say, of course,

how well these plans are actually implemented in practice. And, the situation is more problematic in companies that have not yet begun driving forward the digital transformation of their business, organisational and management models.

What surprised you the most in the in-depth interviews?

We asked many of the managers about start-ups that they thought could pose a threat to their own business models. It was astonishing to see that many of them did not name or did not want to name any such start-ups. That surprised me, because these managers are certainly concerned about disruption. We know from strategy research that in their strategic decision-making processes managers mainly look at competitors from their own industry. I think this is a mistake in the fight against disruption, because disruptors are usually start-ups from other industries, often newcomers.

Don't big companies have their own units watching the start-up scene?

If they do, the findings of such units do not always reach the awareness of the top management. It is the top management, however, that decides on whether to copy, acquire or ignore a potential disruptor's business model.

Are companies delegating the issue of digitalisation too much?

In companies where digital transformation is really making progress or where digitalisation is part of the core business, the issue of digitalisation is clearly taken care of by the top management. It is the CEO who personally takes key strategic decisions and recruits digital talent.

Isn't a chief digital officer enough?

Generally speaking, appointing a CDO on the management board is not a bad idea. However, this entails the risk of the other management board members becoming less active when it comes to digitalisation and thus feeling less responsible. Today, however, every individual manager in each business area has to help drive digitalisation.

What digitalisation issues are particularly important to top managers?

The issue of how to deal with staff was discussed very intensively. How do you convince staff to get on the road to digitalisation? How does digital leadership and followership work? How do you allay staff worries? How do you deal with resistance? How do you prevent frustration? Above all, training courses are being sought everywhere to make employees fit for digitalisation. After all, it's not possible to recruit new staff for all new tasks.

Because digital talent is scarce?

The big renowned companies don't have any problem with recruiting talent. The problem is that after just one or two years, much of the digital talent that has been hired moves on, because transformation is not progressing the way they imagined and the way it was obviously promised to them when they were recruited.

One focus of the interviews was digital M&A. What did you find out here?

One issue I see with this is that acquisitions are aimed at integrating new technologies into existing business models. This, however, does not allow companies to become disruptors themselves. To do so, they would have to change their business models with new know-how and sometimes even replace them.

Can M&A be a way of further digitalising the company?

Digital M&A: Objectives

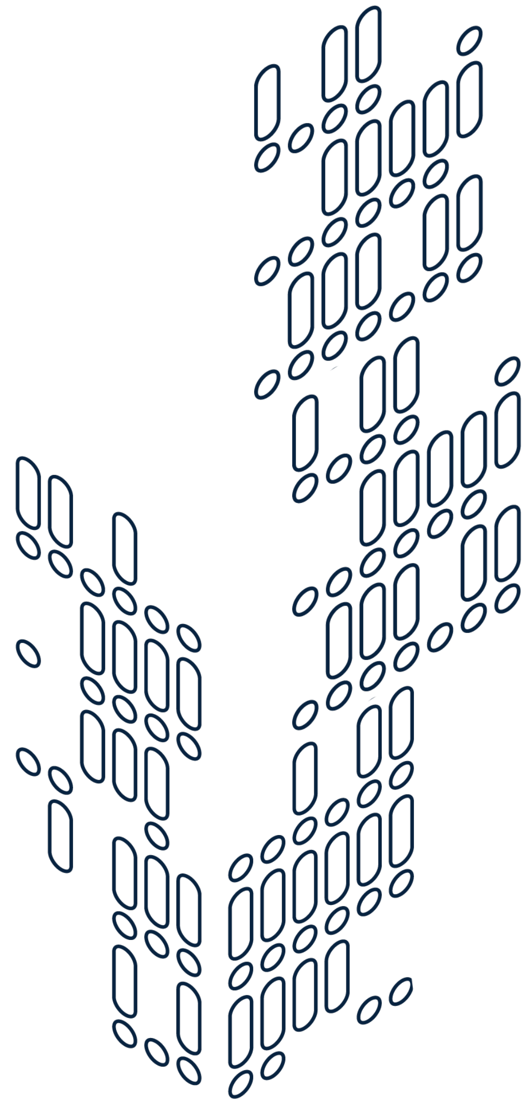
The in-depth interviews with top managers showed that digitalistion is primarily driven organically. However, there are also reasons for creating digital know-how inorganically. Selecting the right target company is key.

Motives

- When it comes to make-or-buy decisions, it is often the timeframe that is crucial. While 'buy' is used for short-term needs, 'make' is the preferred long-term approach.
- Acquisitions work as digitalisation catalysts.
- M&A is used to acquire the knowledge on which digital technologies are based.
- M&A transactions are also used to acquire patents and to secure technologies on the market.
- Usually, acquired companies cannot continue as laboratories operated alongside the organisation, but have to be integrated.

Targeting

- The key elements for selecting digital companies are the team's skills, cultural compatibility and the development edge in a certain technology.
- In digital M&A processes both traditional due diligence methods and digital tools (big data analytics) are used.
- Many companies have their own targeting units that are exclusively tasked with screening start-ups.
- Besides, external service providers are used to scout targets.



Digital M&A: Post-merger integration

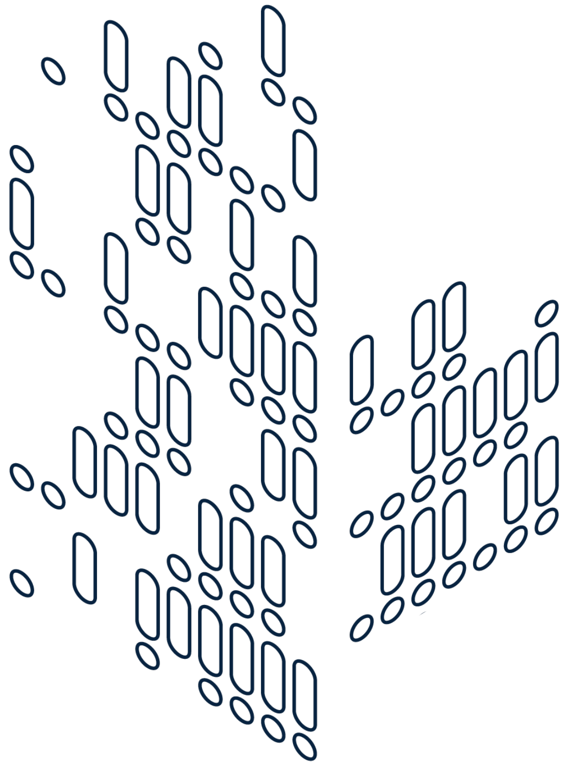
In the in-depth interviews top managers stated that acquired digital companies will only be able to significantly contribute to their group's digitalisation if key staff members of the acquired business can be retained and motivated.

Organisational integration

- Dedicated teams exclusively handle post-merger integration.
- The aim of integrating a digital company is to maintain its creative drive and make use of its innovative strength.
- There is no standard approach to integration, as every company acquired has its own unique characteristics.
- Cultural differences between the acquiring company and the acquired company must be overcome.
- The major challenge is giving the acquired company's teams the freedom they need and at the same time integrating them into the acquiring company's structures.

Retention management

- Apart from the technology or a source code, key staff members are often the only assets digital companies have.
- The aim is to motivate key employees individually in such a way that they stay with the acquiring company.
- The digital company as a whole must be assigned a clearly defined role that motivates its staff.
- Financial incentives and an inspiring personal role at the acquiring company help to retain staff.
- Having the right team of managers from both companies in place is essential for successful integration.



What matters when acquiring digital know-how

Anyone planning to take over start-ups must understand their team spirit in order to be able to retain their most creative minds long term, says Gerald Reger, partner, co-head of the Capital Markets practice and member of the Corporate / M&A practice at Noerr. Due diligence checks in digital M&A transactions therefore also have to include cultural factors and lead to efficient retention management.

What role does M&A play in digitalisation for companies?

Digitalisation is being driven both organically and inorganically. For a few years now, we have been seeing an increase in digital M&A transactions. Top managers often seek to tap potential for renewing business models in this way in order to reduce the risk of disruption. While most big companies would be able to manage this on their own, it is the time factor that's crucial. A car manufacturer, for example, would need too long if it were to develop the many digital components for autonomous driving on its own.

To what extent do classic and digital M&A transactions differ?

In terms of company law, there are no differences. However, the key assets of young digital companies often consist of intellectual property, and this must be well protected. Apart from that, a start-up's creative minds represent its value. A due diligence review therefore has to examine not only the key financials as well as legal and tax aspects, but also the start-up's basic philosophy as well as the founders' and key staff members' objectives and values. This requires an entirely different kind of talks and negotiations.

What needs to be taken into account?

Most importantly, buyers need to know precisely what know-how or technology they need for digitalisation and what they expect from the start-up they want to take over. They then need to check whether the founders and their team are able to achieve this goal at all. Only buyers who have precisely understood the target's team spirit and corporate culture can assess whether the target can deliver what's expected of it. This is particularly difficult when it comes to the source code.

Why is that?

The buyer's IT experts have to check whether the code can be used and is scalable and whether it can be further developed for the acquiring company's purposes. However, a start-up will keep its source code secret for as long as possible and will not make it accessible until the transaction is highly unlikely to fail.

What needs to be taken into account when integrating a digital company?

Retention management in particular is crucial for the success of integration. The objectives will usually only be achieved if the most important minds can continue to be motivated and retained in the long term after the takeover. Staff members must be allowed to keep the necessary freedom and nevertheless be integrated into the group. This is a difficult balancing act.

> The due diligence audit therefore has to examine the start-up's basic philosophy and the founders' objectives and values.

Don't companies have experience on how to succeed with this balancing act?

They do, but every founder, creative person and team is driven by something different. That is why new individual solutions have to be found for every takeover. It must be avoided that the new staff members no longer identify with their tasks and no longer have any emotional connection to the company. Money alone cannot motivate people. It is about feeling respected and being assigned appropriate challenges. The worst thing would be for a start-up to be fully integrated into the company and for the next highest group hierarchy level to make the decisions.

What would happen then?

This may lead to an exodus from the company that is almost impossible to stop. This can be prevented if the start-up's executives retain their responsibility and are granted a great deal of freedom with respect to how to achieve the agreed objectives. One issue remains, however: in large business units, a series of restrictive requirements are unfortunately inevitable due to group compliance, group reporting and decision-making processes.

Digital M&A: Forms of participation

The are many different ways in which large corporations can participate in digital companies and structure the terms of their partnerships with these. According to the findings of our in-depth interviews, the following forms are relevant.

Majority interest

- This form is often chosen if the objective is improving technological competence or portfolio expansion or if full access to know-how and personnel shall be achieved.
- Usually, 100 per cent of the shares are acquired.
- A 100 per cent takeover is considered justified if the target has a development edge.

Investment funds

- Venture capital investments in funds are used to gain access to the digital scene.
- Large companies choose investments in funds if they want to make a targeted investment in digital technologies rather than in specific companies.

Minority interest

- Minority interests are used to ensure that a digital economy service provider will not be taken off the market and that the target will continue to be perceived as (largely) independent.
- As shareholders, companies are looking to influence a technology's further development. Furthermore, they may want to gain certain access to know-how.
- Minority interests in independent platform companies are often considered expedient.

Partnering

- Contractual partnerships are often sufficient to learn from digital companies without taking over full entrepreneurial responsibility.

What needs to be considered when choosing the form of participation

The type of participation in a digital company is an important strategic issue that is key to the success or failure of a transaction, explains Michael Brellochs, partner and member of the Capital Markets and Corporate / M&A practice groups at Noerr. Selecting the right form of participation should also take into account the impact on the start-up's business relations and staff motivation.

Are there any forms of participation that are particularly recommended for digitally-driven M&A transactions?

Ultimately, the form of participation always depends on the specific situation and objective. There are a host of motives for digitally-driven M&A transactions. That's also why it is good to have so many different ways of structuring co-operation with digital companies, from minority and majority interests, to 100 per cent acquisitions, or even cooperation arrangements by way of a joint venture or contractual partnership.

Based on experience, what forms of participation are used most often?

Majority interests are often chosen to acquire know-how and personnel. Minority interests are sometimes used to gain access to a particular market or technology. Contractual partnerships allow institutional learning, without taking on any entrepreneurial or financial responsibility for the digital company itself.

A majority interest seems to be the easiest form. Why isn't it chosen more often?

Founders of digital companies often want to continue to feel like entrepreneurs and to retain the majority of their shares and thereby also control over their companies. But even buyers sometimes have no interest in holding a majority interest as this would mean entrepreneurial and financial responsibility for the target's further development. Taking a minority interest sometimes makes it easier to retain the founders because they are able to keep the entrepreneurial responsibility for their business. There is another aspect, namely market presence: A majority interest can prove to be an obstacle where the digital company wants to continue to act and present itself as an independent firm on the market.

Why is that?

How the acquired company is perceived in the market with the new shareholder can be an extremely important aspect. It may be that existing customers turn their backs on the company because they fear that information and know-how will be passed on to the new owner, for example in the case of an IT service provider for a particular sector. Such problems can arise even with a minority interest.

Does the law provide for any options that afford protection against this risk?

Yes. German law governing limited liability companies (GmbH) allows contractual freedom in this regard, so that information flow from the company to shareholders can be controlled. As opposed to that, under German law governing stock corporations (AG) shareholders' rights to receive information from the company are limited. Irrespective of these legal considerations, it is ultimately an issue of market presence and credibility. If the target's independence is central to both partners in a transaction, a contractual partnership rather than acquiring a majority interest in the company may make sense.

> **Choosing the right form of participation is key to the success of a digitally-motivated M&A transaction.**

What else needs to be taken into account when deciding on whether to take a majority or minority interest?

The list of issues is long. In addition to the issue of information flowing to the shareholder, HR issues are key. When choosing a majority interest, it may be more difficult to keep the start-up team or the people who make a difference to the business model motivated and on board and also to integrate them into the acquirer group's structure which may be much more complex. This is a major challenge. There are different models for mastering this.

What are these models?

One option is a virtual participation (e.g. a virtual share performance plan). Another one is an earn-out clause in the purchase agreement which allows that a portion of the purchase price is paid at a later stage depending on the business' future success. This way the founders participate in the company's success, for which they are also responsible. This ensures that they remain motivated, have an incentive to deliver on objectives and stay committed to the company.

Study: „A blueprint for digitalisation"

The results of the in-depth interviews with top managers were preceded by a survey conducted in 2019 among 150 decision-makers from German companies on the digital transformation of business models. They were also asked what role M&A plays in digitalisation. The results were presented by Noerr and the Technical University of Munich in the study entitled "A blueprint for digitalisation".

The study's key findings include the following:

- A clear digitalisation strategy determines whether digital transformation of business models is successful.
- Companies that have a clear digital strategy tend to be much more active in acquiring digital know-how.
- Digital M&A transactions are beneficial if they succeed in integrating the organisational structures and culture as well as information systems of the target company and keeping its staff on board.

The study can be downloaded here:
https://www.noerr.com/en/newsroom/news/research-ma-can-boost-digital-transformation

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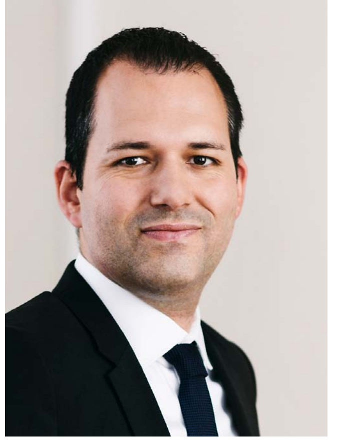

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