Capitalizing on the digital challenge

August 2016
The impact of digital on current business models is game-changing.

Digital is not a one-off investment, but a long, transformational journey that will take time to achieve success in the digital economy.

Can social media give dealmakers an edge?

Are revenues per square meter still the most important key performance indicator in evaluating retail businesses?

Where does intellectual property reside at a cloud-computing entity?
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Digitalization is creating major opportunities for businesses in today’s rapidly evolving economy. Technology and changing customer behaviors are disrupting all industries and driving sector convergence. As an enabler of strategic growth, digital has reignited investment in innovation and emerging technologies. Implementing a digital strategy introduces complexity and risk, demanding a greater range of competencies and accelerated pace. Key to confronting these challenges is to leverage M&A to build digital capabilities.

Digital is a broad term that is distinct from traditional e-commerce and digital marketing. It describes the disruption and reinvention of existing business models and the creation of new sources of revenue through business strategy and technical innovation. This blurring of the digital and physical worlds and disruption of existing businesses beyond the e-business is being enabled by a set of key technologies, such as the Internet of Things (IoT), artificial intelligence, mobile, cloud, robotics and analytics.

These evolving technologies, together with increased generation and sharing of information, have created a platform of new opportunities for businesses to operate and expand. Businesses will be looking at how they can monetize these expanding technological horizons and how digital can be a catalyst for business innovation and growth.

The increasing connectivity of customers and businesses through devices and the IoT will see devices and algorithms taking a more active role in the decision-making process. Digital assistants such as Siri, Cortana and Google Now are currently gathering and evaluating individual preferences to provide personalized and higher-value services.

Connectivity is also accelerating the growth of data sets that are both open and for sale. Taking advantage of connectivity and applying analytics to these data sets presents enormous opportunities for enterprises to reinvent business and delivery models, transform existing products and enter new markets.

The global marketplace is being disrupted by digital. This disruption is breaking down the traditional barriers of organizations, creating completely new customer value chains and new business opportunities that may be filled by new players rather than incumbent players. For example, online transportation network companies are challenging incumbents in the traditional transportation industry, while online marketplaces that enable people to list, find and rent vacation homes are impacting the hotels and hospitality fields. Shifts in the market are being driven by changing customer behaviors and attitudes.

Developing technologies, such as social media and mobile, have empowered the customer who expects greater choice and convenience with the ability to perform transactions anytime and anywhere. This is pushing businesses to focus more on the customer as opposed to traditional product or supply chains.

Companies will need to radically rethink their business models and the structure of their internal operations. Given the skills, experience and speed required to develop digital capabilities, many companies will prefer to pursue a model of open innovation, and leverage M&A to enhance innovation and value. Companies seeking to acquire or invest in the technology space need to be very aware of the challenges – digital aspects add to the complexity of deals.

Existing industry boundaries are being challenged, as is the dominance of leading players. By overlooking shifts in the market, ignoring new competitors or failing to innovate, today’s market leaders risk being toppled.
Digital transformation is changing business models — including revenue models

Almost 80% of companies say their customers are changing how they access goods and services.
Source: EY, Megatrends 2015

More than 51% of these companies are changing their pricing and delivery models.
Source: EY, Megatrends 2015

Digital transformation is fundamentally changing the relationship between businesses and their customers

Businesses are failing to use approximately 80% of customer data now generated
Source: EY, Megatrends 2015

Digital disruption is changing the market context and competitive landscape of most industries

By 2018, 1/3 of the top 20 firms in most industries will be disrupted by industry-specific data platforms.
Source: EY, Megatrends 2015

Digital technologies will increasingly augment or replace workers

47% of occupations in advanced economies are at “high risk” of being automated in the next 20 years.
Source: EY Capital Confidence Barometer, December 2015 | 13th Edition
Market trends

**US$626b**
in consumer spending via mobile by 2018
Source: Goldman Sachs, 2014

85% of business relationships managed without interacting with a human by 2020
Source: Gartner Group, 2011

99% of all devices that may some day join the network are still unconnected
Source: Cisco, Rob Soderbery, 2013

36% of organizations are unlikely to detect a sophisticated cyber attack
Source: EY, Global Information Security Survey 2015

81% of senior executives agree that data should be at the heart of all decision-making
Source: EY, Becoming an analytics-driven organization to create value, 2015

Digital is disrupting the traditional business ecosystem and competitive landscape. Sector boundaries are blurring as companies across industries respond to this disruption by developing their own digital strategies and solutions. Playing fields are being leveled, giving small start-up companies or non-traditional competitors the same level of market access as an established company. Organizations that were once on the periphery of an industry can suddenly become a real threat to the incumbents, thanks to innovative use of digital technology.

The conventional relationships between companies are becoming more fluid and complex. Reinvented business models will drive operational changes, both internally and externally, as participants within the ecosystem connect to internal business processes. This is driving new alliances and the outsourcing of innovation and traditional services to more nimble and agile service providers. Harnessing the full power of digital technologies offers businesses the chance to better understand how best to engage with not only customers but also suppliers, partners and employees.

The evolution of the digital enterprise and the ecosystem presents significant challenges, including new competition, changing customer engagement and business models, unprecedented transparency, privacy concerns and cybersecurity threats.

**Traditional transaction e-commerce**

![Diagram of traditional transaction e-commerce](image)

**Emerging relationship-driven ecosystem model**

![Diagram of emerging relationship-driven ecosystem model](image)
The move to a digital economy is inevitable. The first question companies must ask themselves is whether they have the means to develop a digital capability internally. To succeed in the digital economy, companies need to be at the forefront of rapid innovation to gain first-mover competitiveness. Superior insight is required to be able to spot the trends and issues confronting specific industries. Also needed is deep functional knowledge and real-world business know-how, coupled with deep technical experience in how technology can be leveraged to change the world.

Given the challenge of building the necessary skills and understanding in an accelerated time frame, many companies prefer to acquire another company or business arm with existing digital capabilities that can facilitate the expansion of their business. By pursuing a model of open innovation, companies can leverage M&A to enhance innovation and value. This approach is often taken by very innovative companies that deliver many of their new products and services through acquisition rather than by pure internal development.

Adopting digital, coupled with M&A, can be challenging for many companies on planning. Making the right investment decision is complex. First and foremost, companies must invest time in developing a digital strategy that clearly defines the business objectives of the organization. It should take into account industry trends, competitors, customers and its organization. It is no longer enough to compete purely on the product, as the service and experience “wrap around” is becoming increasingly essential to effectively compete. Every layer of business strategy is now impacted by digital.
Digital threats

Digital assets are the lifeblood of a company’s portfolio. But with the digital business comes new threats and risks as we move to a world where people and machines can be connected 24/7. Information becomes the new currency and it is information that both characterizes and drives the business, whether it be the knowledge about the market that provides the competitive edge, product designs or customer data. What would be the impact if it was given to a competitor?

Among these digital assets are increasing volumes of customer data that delve into people’s lives. That raises privacy concerns. Digital businesses have greater obligations in information governance and management, and handling this data can determine success or failure.

The critical nature of data in modern businesses means that organizations are facing escalating risk that they will suffer an information security breach. Cybersecurity and data protection is the new frontier against fraud.

Defending against known threats is no longer sufficient. Fresh threats are constantly presenting themselves and successful organizations anticipate these threats and prepare for them.
Cybersecurity threats are evolving with unparalleled speed, complexity and impact. With reported breaches of information security rising annually by more than 50%, organizations should no longer ask, “Are we secure?” Instead, they should ask, “How can we be sure that the information most important to our business will be secure enough?”

By year-end 2017, more than 20% of enterprises will have digital risk services devoted to protecting business initiatives using devices and services in IoT.

Since 2010, time to resolve an attack has grown 71%.

Research from the Ponemon Institute shows the average total cost of a data breach is US$3.79m. The study also found that there has been a 23% increase in the total cost of a data breach since 2013.

“McAfee researchers said they saw more than 4 million samples of ransomware in the second quarter of 2015, including 1.2 million that were new.”

Where to start – digital strategy

As boundaries of organizations begin to blur, companies need to evaluate their key commercial, supply chain and operational functions to be better integrated, not only internally but also to incorporate customers, suppliers and partners within the ecosystem. The digital strategy needs to take context from the company’s corporate and customer strategy; identify the initiatives, enabling capabilities and priorities; and provide a clear road map. A digital strategy must be all-encompassing, otherwise innovation and benefits may be stifled.

The focus of digital is not technology, IT strategy or a one-off investment. It is a long, transformational journey that will take time and continual investment to achieve success in the digital economy. A coherent and comprehensive digital strategy is the catalyst for business innovation and growth.

As a key enabler of the digital strategy, open innovation has become an increasingly popular motive for partnering, setting up joint ventures or mergers and acquisitions in building a company’s digital capability. This provides an excellent opportunity for the C-suite and Chief Development Officers to expand their horizons and remit to cover innovative companies or platforms that will change the way the business goes to market and operates.
The entire process of deal-making is being transformed. Increased competitive intelligence and better opportunity analysis are required to spot and make the right deal in today’s complex marketplace. Companies need to be more proactive in terms of pipeline management and deal origination, dedicating more internal resources and time than they did in the past to identify the right targets. They now have to evaluate potential acquisitions much earlier, long before the actual transaction. Corporate development functions will need to be able to use advanced analytics of big data, mining vast amounts of structured and unstructured information and turning that into a commercial advantage.

New ways of measuring performance through diligence — social media diligence, for example — will help assess whether assets fit the strategy or help change the strategic direction of a business.

Evaluating a company’s digital readiness is now crucial in a transaction. If a potential target company is not set up to adapt to digital disruption, then it will be complicated to try and bring it into a business that’s already digitally focused. The question you should be asking is: “How well does it fit into my ecosystem?”

Innovation has changed: faster, wider

M&A is key to innovation and growth
EY capabilities

Strategy Services
- Identify investment targets – build or buy platforms to help implement digital capabilities
- Identify digital assets, technology and IP that could enhance portfolio businesses’ products/services
- Assess the market and competitive landscape, including digital opportunities and risks related to industry value chains, the target’s operating model and value proposition to customers
- Assess the target’s business model in terms of digital readiness and considering the strategic fit
- Advise on the digital transformation potential of the target by applying scenario planning
- Perform commercial due diligence of pure online/technology businesses, considering the impacts of digital disruptions
- Conduct digital gap analysis, focusing on overall strategy and business model as well as customer experience

Transaction Support
- Conduct transaction diligence, assessing revenue threats and opportunities caused by digital innovation
- Advise on the nature of the revenue base of a digital business
- Advise on the growth drivers, what is the digital strategy of the business and how will this disrupt the market and impact growth
- Analyze the order book and pipeline of the business, and historical success in signing new customers to digital services, or converting existing customers to new services
- Assess impact of digital transformation on the entity’s economics and operations
- Assess the roadmap and potential impact of future revenues of product launches and upgrades
- Conduct exit readiness assessment with consideration for digital transformation initiatives

Operational Transaction Services
- Perform operational and IT due diligence to validate the operational capability and investment required by the target’s digital businesses
- Conduct technical assessment of the digital platforms, focusing on scalability, data proposition, investment and management teams
- Perform synergy assessment, provision and tracking of digital acquisitions
- Assess the cyber threat of new digital business
- Assess digital platforms and advise on how to protect IP and data
- Advise on benefits of mergers or integration of new digital businesses
- Develop the separation and integration blueprint for digital businesses
- Support creation of stand-alone entities
- Maximize performance and value of digital portfolio

Valuation and Business Modeling
- Help clients to identify the sources and economic impacts of digital disruption for clients
- Help clients build new use cases to inform corporate strategy that leverages benefits of digital disruption
- Help value new technology platforms, IP and new digital assets
- Help clients to build a model for investing in digital capability, new revenue sources and operating model changes
- Apply analytical diligence techniques through data processing, real-time data exploration and the support of deeper and faster insights
- Provide “analytics as service” for clients whereby data feeds received are aggregated and analyzed, providing clients with actionable insights

Capital and Debt Advisory
- Identify funding and financing options for technology and IT spend, including improving funding and financing structures
- Advise on how to enhance funding structures for digital strategy development
- Advise on raising debt and equity required for digital investments
- Perform capital structure assessment and advisory
- Assist in the identification and implementation of financing alternatives

Working Capital
- Release cash trapped in working capital
- Advise on process improvements to attain sustainable adjustments in working capital investment

M&A Advisory
- Identify digital assets to enhance shareholder value
- Advise on acquiring or divesting digital assets to accelerate profitable growth and maximize their potential
- Provide M&A advice throughout the transaction life cycle on digital acquisitions
- Communicate new M&A strategy through understanding new business models and innovative joint ventures

Transaction Tax
- Navigate current digital tax environment uncertainty to assess potential historic exposures in transaction context
- Define the tax impact associated with realigning legal and operating structures to achieve digital strategy
- Conduct federal, state and international tax risk analyses
- Perform customs, duties, value-added tax and other indirect tax assessments
- Evaluate significant tax exposures
- Assess optimal transaction structure
- Identify post-transaction tax reduction minimization options

Restructuring
- Help facilitate the turnaround of failing digital business
- Assist in crisis stabilization – critical appraisal of short-term cash flow forecasting, management procedures and review of business plans
- Apply business deconstruction/reconstruction techniques (a cost-value approach to business analysis and operational restructuring)
- Assist in financial restructuring – stakeholder analysis and intermediation to advise stakeholders on the restructuring of a corporate’s capital and financial structure
- Advise on optimum legal entity structure of digital business
EY has a complete digital approach in place for all of our clients’ digital challenges and we are constantly expanding our offerings and recommendations to fulfill the demands of the ever-growing digital ecosystem.

Global transaction pre- and post-deal implementation support

- Eleven distinct offerings address digital across sectors and domains.
- Each offering is a suite of alternatives to suit the needs of the client.
- Approaches are customized to prioritize specific recommendations over holistic approaches.
- Benefits enhancement frameworks are embedded in each alternative to facilitate expected business outcomes.
- EY’s recent acquisitions, partnerships and internal initiatives bolster the tools and technology partnerships need to digitize end to end.
Digital disruption is driving industry convergence. The scale, complexity and pace of change can be overwhelming. Businesses need help to structure, value and protect the digital investment as they transform their business.

A digitally enabled business goes way beyond enhancing software and IT capabilities – it involves a radical transformation of businesses and operating models. It is not a short-term investment. It requires sustained capital investment and C-suite ownership to future-proof the business and drive sustainable growth.

The capital strategy is critical to achieving success in a digital world. This should include organic and inorganic growth (M&A) and divestments that offer the chance to reshape the business and enable reinvestment into digital capabilities. The right investment choices will enable the innovation needed to transform and grow businesses.

Acquisitions, joint ventures, alliances, partnerships and licensing options are increasing as digital disrupts traditional ways of doing business. This is creating unprecedented collaboration and relationship opportunities involving customers, suppliers and competitors.

While the advantages of additional speed and increased efficiency are clear, corporates looking to acquire or invest in the digital space need to be very aware of the challenges, as evolving technologies are undeniably adding complexity to deals.

EY can help you develop your capital strategy in a digital world to achieve your transformation.

According to the latest Capital Confidence Barometer – Technology

- 45% of technology executives plan to pursue acquisitions in the coming year, following seven consecutive quarters of record volume in tech M&A.
- 37% of technology executives say digital disruption is driving their acquisition strategy.
- More than one-third (34%) of technology executives are also planning acquisitions outside their own sector.
- New customer behaviors are cited above all others (46%) in driving technology companies to buy non-tech companies, and new product innovation ranks second (21%), according to the report.
- However, technology executives also said that the deal process itself is subject to significant cyber risk, according to 91% of those surveyed. Cybersecurity due diligence has become standard practice for more than half of executives (54%).
Digital adoption – where to start

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Time is of the essence. Start now!

☑ Understand that digital disruption is happening now – it is not an option.

☑ Seize the opportunity to innovate

☑ Develop a holistic strategy

☑ Invest long-term – look for innovative ways of raising capital – crowdsourcing JVs, IPO

☑ Leverage M&A to accelerate and drive innovation by licensing, partnering and forming joint ventures
About EY

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