

Preserving Your Investments When Your IT Vendor is in Financial Difficulty

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Many vendors will be facing financial difficulties in the coming year. Enterprises need an early warning system for potential vendor failure, as well as a backup plan, in case they lose support.

Key Findings

- Recognizing early warning signs of a vendor in trouble will enable you to make decisions earlier and be better prepared when the vendor does experience financial difficulties.
- Temporary insolvency is not necessarily the end for vendors with headquarters in the U.S., although this may differ for vendors with their headquarters in other parts of the world. Personnel are likely to be distracted as there will almost certainly be job losses.
- Delivery will suffer while management and vendor employees are distracted by financial challenges.
- Acquisition by another company is not always good news. Count on at least some disruption to normal operations.

Recommendations

- Identify now, what impact the insolvency of selected vendors would have on your business. Set up a model to capture this analysis and follow on with a risk mitigation strategy.
- If part of your risk mitigation strategy involves changes to your existing contracts, trigger a renegotiation immediately. Renegotiation may mean, for example, dropping maintenance charges, or even increasing them, if the vendor can guarantee your continued support, even though others may not be receiving the same service.

WHAT YOU NEED TO KNOW

End user enterprises should pay attention to the financial health of their mission-critical vendors. Even financially strong vendors may be looking to rebalance their portfolios to cut less profitable product lines and focus on core business. Technology rich, but cash strapped smaller vendors, will make prime acquisition targets. Enterprises must be prepared to spot the early warning signs of trouble and take steps to keep applications running or make contingency plans for retiring applications that don't have a future.

Early warning signs that your vendor may be in difficulty can be subtle and hard to spot. Contact a Gartner analyst with in-depth knowledge of the vendor to get an opinion on its financial stability. Consider your options before taking drastic action when a vendor becomes temporarily insolvent. Stay on top of acquisitions of key vendors as they proceed — ask questions that will help you decide early on whether you can count on the continuation of the products you rely on.

ANALYSIS

The current economic climate means more insolvency in IT software, hardware and services markets. This research shows you how to plan and deal with potential business failures of vendors you have dealings with. We recommend increased vigilance on the part of IT management to detect potential problems, even before they are generally recognized or acknowledged by vendors themselves. Even strong vendors may be looking to rebalance their portfolios, by focusing on profitable and growing business lines. Similarly, smaller vendors with unique technology may be looking for exit opportunities. An acquisition is not necessarily the best outcome, as the newly acquired applications may have a lower priority. The human element will come into play, when people temporarily lose focus on the outside as they position themselves in the new company and/or make plans to change jobs.

You may spot early warning signs before the vendor experiences financial difficulty. For mission-critical applications or outsourcing deals, perform frequent risk management reviews.

Things to watch out for:

- An increased turnaround time for technical support issues.
- Unusually high resistance to discounts in favor of longer-term strategic wins, for example, by you agreeing to become a reference customer.
- Look for personnel turnover, for example, personal contacts no longer being available and vendor employees turning up at other companies you might be dealing with.
- Missed software release dates for upgrades or maintenance releases
- Failure to comply with terms of service-level agreements.
- Profit warnings.
- Failure over three or more quarters to meet earnings targets.
- More mergers, acquisitions and failures in the vendor's market segment.
- Demand weakness for a particular product or service.

Watch out for acquisitions. If you are relying on a large vendor with substantial portfolios and financial resources, an acquisition of another large vendor may de-focus the part of the

organization you are working with, as large acquisitions cause professional changes for everyone concerned. If you are relying on a small innovative vendor, you need to find out at least theoretically, which staff they plan to retain.

Our advice is valid no matter what the macroeconomic circumstances, but current conditions have enhanced the urgency of the problem. We recommend that you complete the steps we outline here within 90 days of any bankruptcy filing to protect any payment you may be able to get from possible recapture.

Not all of these steps will be required for every IT vendor used by your company. Establish some criteria for assessing the criticality of the vendor to the ongoing operation of your major systems and the daily operation of your business.

Criteria for assessing exposure include:

- What percentage of your IT budget do you spend with this vendor, external service provider or application service provider?
- What systems must operate 24/7?
- What are your customer-facing systems?
- What systems are business-critical?
- How much revenue does the system help to generate or process on a quarterly basis?
- How much have you spent with this vendor in the last year, or in the last five years?
- How long has the vendor been used by your enterprise?
- How much data do you have committed to this vendor's systems?
- How reliant are you on this vendor's proprietary systems and processes?

Big budgets, high uptime requirements and long histories are all signs that a vendor is vital to your IT operations. Pay attention to identify impending difficulties. There are many different categories of IT vendors. This exercise will help you divide them into categories. While investments in information worker support tools may not be the largest you are making, they are often the most mission-critical, because the most productive people in the company rely on them. Collaboration, business process management, document management, instant messaging, Web conferencing, Web content management, portal and information access vendors, are the tools with which most people work on a daily basis. They may also be among your most vulnerable vendors and their failure could have a significant affect on your enterprise. Do not equate "small investment" or "small vendor" with lack of importance to your workforce.

Regional Variations in Bankruptcy Law

In the United States, enterprises most commonly seek protection by filing a bankruptcy petition under the Federal Bankruptcy Act. The type of bankruptcy is known by the chapter of the Act that it refers to — the most well-known is Chapter 11. European countries have similar legal protection. Enterprises can emerge from bankruptcy or temporary insolvency and continue to do business. It is a legal protection frequently used by enterprises experiencing short-term financial difficulties, with a reasonable chance of continuing as going concerns. Achieving this is generally acknowledged to be more difficult in Europe than in the United States.

Despite the U.S. approach to bankruptcy, individuals working for a company that has sought protection from its creditors will be distracted at best, as they will be worried about their own

individual futures. Your personal connections will count for a lot here, as you may be able to rely on people you trust for truthful information. If individuals that you know have relocated to other companies, they are the best source of information. Now is the time to become a professional associate of trusted sources on LinkedIn (see Note 1 for details).

In the United States, studies have shown that companies filing for protection from their creditors under Chapter 11 bankruptcy law do emerge from bankruptcy. One study showed that 44% emerged as publicly registered, 26% emerged as not publicly registered and 21% were liquidated or dissolved. The remaining 6% were merged with another operating company. Larger public entities having a reasonable chance of emerging from Chapter 11 within a year. Among firms that do emerge from Chapter 11, financial performance is lower than that of matched industry peers during the next five year period. Bankruptcy and its aftermath give you some breathing room in terms of making your own plans for divestiture or switching from one vendor to another.

Legal Advice

Involve your company's legal department. For large, mission-critical contracts, retain the services of an attorney with a background in bankruptcy law. These proceedings may take years, so it is effective to have counsel domiciled in the same jurisdiction as the vendor. Counsel will help establish a plan to manage your enterprise's exposure and provide guidance for subsequent transactions. Gartner can provide operational and business recommendations, but our recommendations only supplement the advice of legal counsel. As business failures rise, the services of bankruptcy specialists are in high demand, with U.S. bankruptcy attorneys charging \$1,100 per hour.

Legal advice and involvement is compatible with keeping up good communications with the vendor. Enterprises that want to restructure and emerge from a state of temporary insolvency are motivated to reassure existing customers that their businesses are viable.

Step 1: Establish a Policy of Periodic Vendor "Health Checks"

Periodic financial and technical reviews should be an ongoing part of your relationship management with key vendors, no matter what the circumstances. Consider the partnership relationships of mission-critical vendors. A product can be at risk if partners are at risk. It may be appropriate to have protection clauses so that the prime vendor takes responsibility both for its own components and OEM technology.

After a vendor has acknowledged financial problems, you have every right to expect periodic updates regarding the vendor's financial progress. Establish contact between your legal department and the vendor's liaison officer. Monitor the activities of the vendor employee base, for example, are the technical personnel staying or going? You should also have a technical or operational contact to discuss ongoing provision of service. Use this contact if you experience a degradation of service provision. The same policy should be followed if vendors are acquired. When you are assessing the financial health of a vendor, pay attention to the balance sheet, which is available as a part of 10K filings with the Securities and Exchange Commission. In every publicly-traded company, there are key financial statements to look at when considering viability — the balance sheet, the income statement and the cash flow statement. The balance sheet tells investors how much money the company has, how much it owes and what it has left over for shareholders. The income statement is a record of the company's profitability and the cash flow statement shows you where the company is spending.

Step 2: Assessing the Risk

Temporary insolvency is not necessarily the end. You need to assess what you think the outcome of your vendor's difficulties will be. That will depend in part on the vendor's area of technology, who its potential buyers are and what the overall state of the market is.

There are four possible outcomes:

- The vendor is able to obtain refinancing or negotiate a loan to continue in business.
- The vendor is acquired by a third party.
- The company may be liquidated to pay off its debts. This outcome does not necessarily mean the end of the technology because this may be one of the assets to be sold.
- The company ceases to trade and any software that it has created is, thereafter, unsupported.

Ask the vendor its recovery plans. Check with independent sources as to the nature of the company's problems. Is it giving you an honest assessment? Does the plan for recovery seem feasible? The accountants and financial analysts in your enterprise would be qualified to judge vendor plans for financial recovery and debt restructuring. Consider the attitude of the vendor's key technical staff. If crucial personnel leave the company, its chances of recovery will diminish. What incentives do they have for retention?

It is best to wait for a reasonable period of time after the company has entered short-term bankruptcy protection. Most of the cost of doing business with any vendor is paid upfront in selection and implementation costs. If the vendor is still servicing your enterprise needs on a day-to-day basis, wait for a month or two before taking any action. You can use this time to implement fallback plans. The key issue here is timing. Buy yourself time while assessing the possible outcomes.

Step 3: Assessing the Impact

There are a number of considerations here.

- Is the system mission-critical?
- Who will support ongoing operations?
- How much data is committed to the system?
- Is the architecture proprietary or open?
- How close is this system to the natural end of its life?
- How much have you already invested in the system?
- How much customization has been done?
- What is the cost and risk of data migration?

If the answer to five or more of these questions is "yes" or "high," senior managers must take charge of the problem immediately. This is a problem that should be escalated to the CIO. Three or more "yes" or "high" answers will mean that a risk manager should be assigned to monitor the situation on a weekly basis. Two or less should be regarded as cause for alerting the legal department to potential difficulties that require periodic review of the company's circumstances.

Step 4: Assess Your Skills Base

No matter what the eventual outcome, there will be some disruption in the short term. Assess the ability and willingness of internal IT to support the software and how quickly or easily you could move support to another vendor. This would include what the vendor would normally cover in first- or second-level support. If you have the skills to support it in-house and have been doing so, you don't need to take any action. If you do not have the skills and rely on the vendor or a third party, consider obtaining them. Use contract labor if it is available.

Step 5: Mitigation Strategies

With most technology, the costs to install, train and maintain are more significant than the acquisition costs. All technology has a life cycle and the further along you are the less reason there is to change. You can find a way to keep the software going while it lives out its useful life. The closer you are to end-of-life, the more feasible this option is.

Your exit strategy should include:

- A list of selection criteria for a replacement vendor.
- Legal and financial strategies for obtaining source code.
- An understanding of the transition responsibilities.
- An understanding of the level of documentation for the supported systems, as well as the timeliness of the documentation.
- A plan and schedule for keeping the software running through an interim period.
- Data and process migration plans.
- Independent advice on replacement vendors.

Create a schedule of your expectations for the vendor's recovery that extends for the next twelve months. If your expectations are not met, you must begin to execute your exit plan.

RECOMMENDED READING

"BearingPoint Should Maintain Service Despite Chapter 11 Filing"

"Prepare for Aftereffects of Satyam Accounting Scandal"

Additionally, Gartner provides advice on how to proceed with individual vendors, such as Satyam, when financial crises occur.

Corporate Financial Distress and Bankruptcy, by Edward I. Altman and Edith Hotchkiss (refer to page 81).

Note 1

From Facebook and the Emerging Social Platform Wars

LinkedIn. This site can be viewed as an "all business, all the time" networking site, an "online Rolodex" of career contacts, resumes and mediated social introductions. If you are a career-oriented professional with an eye on the next rung in the career ladder, you are likely to be cultivating your network on this site.

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