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An Overview of Carve-out Deals

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Introduction

M&A statistics show that approximately one third of all deals are carve-out deals. In reality, the proportion of carve-out transactions is probably much higher with many other deals being hidden carve-outs with the targets not truly independent from the vendors in one way or another.

The term carve-out can be applied to any transaction which involves the sale of a group of assets or a business which, prior to the deal, is entangled with or not independent from the vendor and not immediately capable of operating on a standalone basis without some action being taken.

Carve-outs present a greater level of challenge than other forms of M&A for both seller and buyer. For the seller, the business needs to be separated from the remaining businesses, which could require some significant restructuring involving additional cost. In order to sell the business, the buyer needs to be presented with financial information regarding the business being sold. This may not be readily available, or the information that is available is not representative of the business on a standalone basis, or on the basis in which it is being sold. The seller faces difficulty in determining the level of preparation that needs to be undertaken, as this could depend on the identity and infrastructure of the buyer. For example, a seller would not need or want to create a standalone finance department for the business being sold, if the buyer had their own back office which could support the business with little or no additional headcount.

For the buyer, the reverse challenges are faced. The due diligence to be undertaken on the financial information being presented is that much more complex, as the financial information has been specially created for the sales process using assumptions. A buyer will need to verify whether this information represents the operating performance that it can enjoy under its ownership. The buyer will also need to carefully assess the level of additional costs which it may need to incur in bringing it under its own ownership, especially if the requirement is for the business to operate on a standalone basis. The other challenge for the buyer is the preparation that may be required to take ownership of the business. This is particularly challenging in the case of a transaction being

Undertaken in a territory where it doesn't have a presence and as part of the deal negotiation it is responsible for formation of a legal entity to acquire the business and assets in advance of the deal. In addition to the legal entity, all registrations licenses and facilities such as banks, payroll providers etc all need to be completed and operational before the transaction can be successfully undertaken.

Given these complexities and challenges, carve-out transactions involve a significant amount of interaction between buyer and seller during the deal process. This is especially the case between signing and closing. It is not in the interests of either partly to force the full burden of responsibility on the other party, or to watch the other side fail. Part of the cooperation process involves the development of Transitional Service Agreements (TSA), where by the seller continues to provide certain services to the business on a temporary basis, to enable it to continue operations free from interruption during the transition phase. The scope of these services, duration and cost are subject to a further level of contractual negotiation to the master sale and purchase agreement. These transition services can range from a few months duration to one or two years in the case of IT support, for example. In certain special cases, the relationship between buyer and seller may continue longer term Long Term Agreements (LTA) where it becomes impractical to replicate or create a standalone infrastructure. Examples, of such longer term arrangements, could include permanent use of real-estate, permanent access to certain site facilities or services, as found in industrial complexes, or permanent right to use intellectual property.

This cooperation either under a TSA or under a LTA, can also be both ways, with the buyer taking over the full functions and agreeing to provide services under reverse agreements to the seller. In some cases, the decision between TSA and reverse TSA, can be based on scale and the balance of activity, with the most significant user of a function taking on the primary responsibility for service provision. In other cases, the choice may come down to strategy or security on the part of the buyer, when they are buying businesses on much larger site, and it is known or suspected that the seller may sell off all remaining businesses on the same site, which would include the provision of site services. For the buyer, is may be much more preferable to take ownership of such functions rather than to risk them becoming interrupted if the functions where transferred to an unrelated third party, which could of course include a business competitor.

In the following sections we examine the different types of carve-outs, how to analyze them, the strategic decisions that need to be made by the buyer and seller during the deal process, how to execute, how to handle TSAs and what are the people considerations which may be even more complex than other forms of M&A.

Types of Carve-outs

Carve-out transactions can take various forms of differing levels of complexity. Each has its own specific characteristics, which are often not interchangeable with other forms, and so the form varies on a case by case basis. Some of the most commonly found carve-outs forms are described below:

Type	Description
Direct Asset Transfer	Transfer of specific assets, which may or may not form a complete business, from the seller to the buyer or a new legal entity established by the buyer. The consideration is paid in cash either by the buyer or by the receiving entity.
Direct Business transfer	Transfer of a specified business, including all operating assets and related employees, but which may or may not include enabling (back-office) functions, from the seller to the buyer or a new legal entity established by the buyer. The consideration is paid in cash either by the buyer or by the receiving entity. The ability of the buyer to pick and choose assets (and in particular employees) varies by the jurisdiction of the transaction.
Direct Hive down	The same form as a direct business transfer, however, the business is transferred in an exchange transaction often in the form of shares with the buyer subsequently purchasing the shares issued. The ability of the buyer to pick and choose is normally more restricted.
Indirect Asset or Business transfer	This is similar to the Direct asset/business transfer, but the transferee is an entity under common control of the seller, which is then sold in a stock deal by the seller to the buyer, such that it resembles a stock purchase transaction.
Indirect Hive Down	This is similar to the direct hive-down, except that the hive down takes place within the seller group, following which the stock of the hived down entity is sold to the buyer.
Subsidiary sale	In this case the stock of a subsidiary of the seller containing the business is sold in cash to the buyer. The carve-out aspect of this transaction is that group functions undertaken by other entities of the seller group are not part of the main deal, and that such functions need to be immediately performed by the buyer, or established during a TSA period, or be subject to separate negotiation between seller and buyer for additional people transfer.

Spin-offs	The term “spin-off” is usually associated with a carve-out transaction where there is no specific buyer and there is a plan to immediately, or over a defined period make the ownership of the spin off business independent from the seller, such as in the case of a separate IPO of the spin-off business.
Global Deals	In many cases a carve-out can be a multi-location and multi-country business. In such cases the form of the carve-out can vary country by country, and even location by location, each of which will require separate documentation and ultimately need to fit within a master global carve-out agreement

Within each of the above structures, further complications which will need planning on a case by case basis include the following:

a. The requirement of TSAs or LTAs for various functions or services provided by the seller to the buyer, or reverse TSAs or LTAs provided by the buyer back to the seller.
b. The creation of new license documentation for intellectual property, or for use of trade names or brands
c. The documentation of formal commercial terms for goods and services, which may or may not have been documented when the transactions where undertaken within or between entities in the seller group.
d. The planning for the settlement of accounts and balances between the buyer, the business acquired and the seller group, some of which may have been created through the undertaking of the various transfers during the carve-out process. The acquisition of the business is often agreed as a single value for settlement between buyer and seller, whereas ultimately there may need to be a network of settlements and payments on behalf, each of which will need effecting within a very limited time after the main transaction itself.

The Carve-Out Assessment Process

During the Carve-out process both Seller and Buyer will want to undertake a carve-out assessment. For the Seller, this assessment will take place early in the process before the business is put on the market. The Seller will also have the benefit of having the availability of time and greater ability to access detail of the carve-out business. However, the Seller can also be restricted in terms of access due to the requirement to maintain confidentiality, even to limiting contact to target business management during the early stage of the process. This is often overcome by strict internal non-disclosure agreements and/or the use of "cover/stories" to avoid raising concerns.

For the Buyer, the carve-out assessment process begins on receipt of information memorandum, and is restricted to the due diligence process with standard levels of limited access. Often the buyers understanding is facilitated by carve-out workshops to walk them through the carve-out hypothesis, also sometimes supported by a carve-out document or financial fact-book. It should be noted however, that the financial fact book will have been prepared by the seller or its advisors and may be one-sided in areas of subjectivity, and consequently, should not be used by the buyer as a substitute for their own rigorous due diligence process.

The purpose of the carve-out assessment is four-fold:

1. To understand the impact of the carve-out function by function within the business and related to the business on People, Process, Assets, Contracts and Technology.
2. To identify the areas of carve-out significance and list the areas of potential TSA, LTA or reverse versions.
3. To analyze the impact of the carve-out on the financial statements, in particular the cost base of the business when operating on a standalone basis, (and during the transition period)
4. To identify and estimate the areas of one-time cost on establishing the business on a stand-alone basis.

While the purpose may be the same between the buyer and seller, either party may have differing hypotheses on the meaning and requirements to achieve the stand-alone scenario. In most cases, a buyer may assume they can replace senior management functions undertaken at the parent level by the seller using its own management team, but each potential buyer will have different assumptions and requirements when it comes to other group service functions such as the finance function etc.

Regardless of whether you are the seller or the buyer, the approach to the carve-out assessment should follow a logical and structured approach. A recommended top-down assessment process is as follows:

a) Legal carve-out

While it is important not to get distracted by the legal structure, having a clear view of the legal landscape is a good place to begin with the assessment. Begin with the legal entity structure chart and use highlighter pens to identify:
-Entities wholly comprising business activities
-Entities largely comprising business activities
-Entities with mixed activities
-Entities with smaller business activities
-Entities containing service functions, asset holding, group management
-Employment companies
-Intermediate holding companies

The result will paint a clear visualization of the carve-out and will begin to crystalize an image of its complexity and the number of components involved. This process also provides the seller, and sometimes the buyer with some of the tax optionality behind the carve-out and related tax costs.

b. People Carve-out

Following the legal entities, the next step is to map the people. This should follow a three-step approach:

1. In the same way as the legal structure, work through the organization chart of the group identifying
    - ① Group management providing oversight to the business
    - ② Service functions supporting the business
    - ③ Shared management roles
    - ④ Dedicated management roles
    - ⑤ Groups or individual employees related to the business (e.g. Sales management) employed for convenience by non-business group entities.

2. Map each of the groups in 1. to the legal entities from the legal entity review.
3. For each location, in particular, for those overseas locations, undertake a similar process for any legal entity (local) management

Based on the review of the people carve-out the level of vacant positions and double-hatting will become clear, and set the scene for a people selection process for the carve-out business, and to define the number of roles to be filled, by re-deployment from elsewhere in the organization, new recruits, or to be left open for the buyer to fill from its own resources. This will also begin to form a view on the level of one-time recruitment cost, and incremental people cost which may arise from the carve-out.

c. Assets and Facilities

For each of the employee groups identify all related business locations and also whether these are owned or leased, and whether they are exclusive to the business or shared. This should include factories, related site services, warehouses, R&D facilities, sales offices, management and back office functions, call centers, shared service centers, and IT related facilities.

For any major shared facility, it is also useful to look at the underlying site lay-out, and consider the need for co-location prior to the deal if not already done. Consideration of factory or site lay-out should also identify site services and utility flows and waste management as applicable to the business.

Where possible, any major operating assets which may be shared with other businesses should be identified at this stage.

d. Intellectual Property

Intellectual property is a complex area and complete assessment can only really be completed by access to the professionals within the organization with deep understanding of the underlying technology. Intellectual property includes patented technology, applications in progress, know-how, and R&D. It also includes product designs, manufacturing technology, service and related technology, including both hardware, and embedded software for electronic components.

If the above consideration isn't enough, a further consideration needs to be which IP is used exclusively in the target business and which is shared with other businesses of the seller. Following the deal, the shared IP could be made available on a free of charge basis or under a license. If the latter, the cost of the license will need to be known by the buyer to evaluate the business of course. A further consideration is the existence or not of "foundation IP" which is a pre-requisite for the IP of the business. For example, IP regarding a technology using GPS for a function, will require access to GPS technology. Another difficult consideration (and negotiation issue) is trends in the business environment, potentially requiring access to certain IP in the future, when that IP is already owned by the seller for use in an unrelated business. Finally, access to IP rights is one thing, continued access to related skills, including the inventors where relevant should also be considered. It is not uncommon for IP to be transferred, but the inventor to remain with the seller.

e. Contracts and licenses

The inventorying of contracts and licenses is an essential part of any divestment process, but takes on far greater significance in a carve-out transaction, not only from the amount of documentation to be undertaken but also the implication of the carve-out on the commercial terms of the business. Contracts can be with customers, agents, distributors, co-marketing, supply, logistics, IT providers, and internal or external service providers. Related to contracts are licenses, permits and similar, which can be for any part of the business from manufacturing, marketing and sales, inventory holding, environmental. The key issues relating to contract and licenses are:

1. What are the change of control considerations and procedures required under the contract?
2. Which legal entity is the party to the contract or license and is that entity planned to transfer with the deal or not? If not, is the contract or license transferable or will a new one need to be created or applied for.
3. In the case of a new license or permit application, what are the criteria for application and what is the time period required. In certain industries, new licenses can take a significant amount of time to obtain, which could potentially delay the transaction process. Additionally, there is often the requirement to have a designated qualified person on staff to obtain a license, if so are these people part of the people transferred?. Further, there may be strict product labelling requirements around the carve-out, which will need managing by careful inventory planning. For each, unfortunately the devil is in the detail, and the earlier this is known the better to avoid surprises during the sign to close process.

1. Joint contract relationships can also have significant economy of scale impacts on the deal, which can impact both buyer and seller. These will require financial assessment. For common suppliers, these can be assessed by looking at the relative purchase or usage volumes. A business which uses a small percentage of the total purchase volume of the group is likely to suffer the loss of purchasing discounts after breaking away from the group. The scale of these will vary by industry and type of purchase, but a reasonable estimate of financial impact can be made by detailed analysis.
2. Customer contracts can be much more complicated. Similar to supply contracts, customers may receive volume or bottom-line discounts. Sometimes these terms can vary across the nature of sale, such as discounts on equipment sales, for commitments to maintenance, or alternative discounted service periods offered in conjunction with the equipment sale. From the customer perspective, changes of terms after the carve-out will need careful management and the impact will need evaluation or planning around through a long term agreement.
3. Customer relationships are also potentially sensitive in carve-out deals as the purchasing screening and trade relationship determined by the customer could be determined based on identity or scale of their supplier. In cross-border deals this can lead adverse impact on customer relationships despite the new overseas buyer being more financial stable than the seller. Each of these issues will need to be worked through.

f. Information Technology

In all carve-outs, the issue of IT is one of the most complex areas to deal with. Separation of IT systems often requires the re-purchase by the carve-out business of IT licenses, which represent a significant one-time cost, and also can be significantly impacted by the loss of volume discounts. IT separations also take time. In most cases to get to a state to facilitate a day-one handover can easily take between 4-6 months of preparation, but to complete full separation and integration with the new owner can take much longer requiring long and complex TSAs. Transitional periods of between 1 and 2 years are not uncommon.

Analysis of the IT separation will take time and will require IT specialist input. It will also need to consider all aspects of the IT environment such as:

1. Hardware: To inventory all technology assets from Data-centers, servers, to PCs and other devices, and to which legal entity they are owned or leased. Shared assets should be assessed for potential additional purchase.

2. Software: This will include all business applications (SAP/Oracle etc) used by the business and all utilities (MS Office, email, Internet). For each it is useful to understand the numbers of users, and relative importance, following which a system by system roadmap can be created. This will ultimately be impacted by the status and plans of the buyer. Options could include continued controlled access to seller systems by password, logical splits, or complete clones, each either on shared hardware or new hosts. For continued use of software users will require the appropriate license. For system splits or copies new licenses will be likely, but also new license applications could be required if their licensee is a new legal entity and the terms of the license prohibits transfer.
3. Network: the connectivity of all systems and related communications contracts will need to be understood. This is often a simple re-contracting process, but complications can arise with dedicated backbone.
4. Data management: This is likely to comprise a data-center/server location or cloud contract. Continued use, secure segregation, transition and long-term arrangements can be very technical, and much more than a physical location issue. Firstly, data coding will need to be investigated to confirm the separability of data. If data is comingled, system copies will need to be followed by potentially lengthy data-cleanse processes. Data-used to operate a system is likely also require access to historical data for a certain period, and in addition to this a business may be required to maintain access to historical data. For cloud storage, much will depend on how the data is referenced by the cloud provider.
5. Organization: The IT organization can comprise a mixture of inhouse people, or outsourced contracts and include IT management, Development, Operation, and Services such as helpdesks etc. The form of the standalone IT organization will require careful planning, especially in the case when the buyer has little or no in-country IT staff. The Organization is also not just about staff numbers, it is also about capabilities and access to capabilities. It the buyer is to be provided a clone of business systems, will the IT organization have the internal skills to maintain or modify the system post deal.
6. Projects: IT is often continually changing and a consideration of buyer and seller will be the impact of projects in the process of development. A buyer will not want to receive a version of a system which is going to be soon upgraded or worst still no longer supported by the vendor. Similarly, the seller will not wish to commit to long term support to systems that the remaining group no longer uses.

The analysis and planning of the IT transition should begin by the seller right from the outset of the carve-out project and continue through the entire process being updated and modified as the identity and needs of the buyer become known. The financial impact of IT can also be significant and should be assessed by both buyer and seller. Each component of IT cost allocated to the target business should be analyzed. The Standalone (to-be) cost can the be assessed component by component, system by system by a bottom up build, or benchmarked against the market or data from one of the host of data-providers like Gartner.

The one-time cost will need developing using a bottom-up approach and quotes, for hardware and software providers, and then both sides will need to strategize and discuss such costs. These costs are real, and so will need to be born by one side or another, directly or through the deal price. However, the magnitude of costs can be so significant, that both buyer and seller will need to collaborate to control costs through alternative schemes or transition arrangements.

g. Back-Office Carve-Out

For the Back-office carve-out, we are referring to all aspects of the enabling functions such as top management, finance, treasury, compliance, QA, legal HR, procurement, IT (if not already separately considered), and other similar services. These functions can be performed either directly in the business itself, by a corporate HQ, or by Shared Service Centers (SSC) around the group.

The functions are normally people related and key challenges are to reconcile the number of people coming with the carve-out to the number of people required to undertake the activities to the costs included in the financial statements of the business.

A good starting position is to examine the back-office costs included in the current as-is income statement of the carve-out business. These will include direct people costs, people costs allocated from HQ and SSCs and other costs. The people costs will give the gross number of people involved on the activity and the number of FTEs. Next is to validate the people need and ultimately to identify by name, considering the ability to combine functions while maintaining segregation of duties and supervisory functions. This can prove difficult in smaller functions and consideration will need to be given to outsourcing or creating a dis-synergy. (for example, it may be determined that legal services need to be undertaken inhouse, but the business has only used or been charged for 0.5 FTE for legal services).

A further difficult area to consider are the opaque corporate (HQ) services, those subject to a lump sum management fee, or potentially those not subject to recharge. It is common when business unit management are asked about management charges, the response is that they receive no services in return, or that such charges were for tax purposes only. In reality, a corporate HQ undertakes a wide range of enterprise wide management, compliance, strategic direction and soft business support, which either may not be recognized by business unit management, or are simply outside of their assigned responsibilities. A buyer should be able to assess their own management style and philosophy to ensure if any additional support is required in the target business. However, a difficulty for the seller is that the scale of these HQ activities will reduce over time if multiple divestments are undertaken.

h. Employee Benefits

In most carve-outs, there will be a movement of employees from one company or group to another. This potentially means changes to the benefits received by the employees, which will be a sensitive issue to ensure the smooth completion of the deal. The issue here is in the detail, and each benefit of each employee group will require identifying, and a process of designing an equivalent undertaken. Such benefits could include pensions, health insurances, car schemes, other fringe benefits, to the menu of the staff canteen. Replacement of such schemes by truly equivalent benefits can be difficult due to employee perception issues, or replacement can prove costly. Each will require a solution and communication plan prior to announcement to the respective employee group.

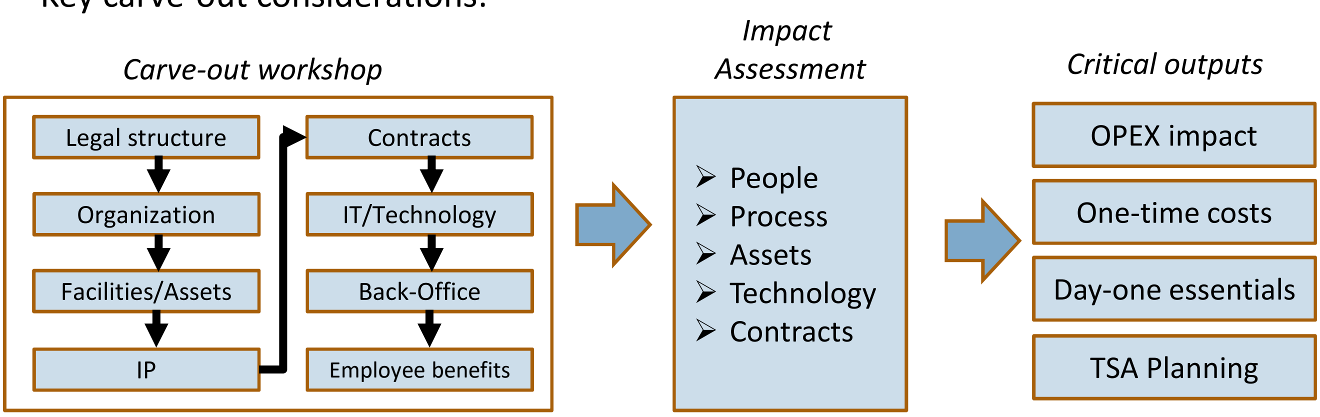
A common complication is equity compensation and similar for top management. This not only has an implication of matching of annual grants by equivalent benefit amounts, but historical cumulated benefits may be at risk, i.e. how to compensate for a stock option which is currently out of the money, but may come into value in the future.

i. Other carveout issues

Two other issues require careful consideration during the carve-out process:

1) Branding is an important consideration especially for the buyer. Product names and trademarks may come with the business if they are unique. However, if some of the business relationships were dependent on the corporate identity of the seller then this becomes more complicated. In certain cases, continued use of the seller brand for a limited period of time may be allowed, in other it may be severely restricted. If rebranding is required, this will come a cost both for one-time design change but increased marketing. Signage, logos, website designs, even color schemes may need to be changed. Corporate name changes also bring with a long list of registration changes. Finally, the embedding of names in the product process should be confirmed as these can be found in printing and stamping processes.
2) Group Insurance. Upon change of ownership the insurance arrangements of the business will need to be changed from the umbrella of the seller to that of the buyer. This can be a time-consuming process for the buyer, especially when changes are made to the insurance provider, given the need to re-undertake the risk assessments of the target business. This lead time can be shortened by continuation of the same insurance company as the seller for a while. Given the differences in each groups insurance philosophies and also purchasing power with insurance companies, then the insurance premium costs may be expected to change on the deal.

Key carve-out considerations:



Sellside Carve-out Strategy Considerations

In any carve-out there are many variables, and as a result there are a range of outcomes. A seller of the business can positively influence the outcome of a transaction by making various strategic decisions to maximize its own total return. The greatest impact comes at the planning phase before any potential buyer gets involved. At this stage, a seller plans for its carve-out divestment and prepares a document for the potential buyers outlining the business the carve-out perimeter and its financial performance.

Here there is an opportunity to influence the deal process by describing the business, and its performance, not from the perspective of under seller ownership, but from the perspective of its potential or "Target Operating Model", under which it could immediately begin operating under the ownership of the buyer. This would include any justifiable operating improvements in addition to stand-alone carve-out adjustments. The information memorandum and related comprehensive financial factbook should show the business in terms of the target operating model. In the deal process, the buyer would expect to see a reconciliation between actual figures and those of the proforma, and so each of these adjustments which you reflect should include a clear description and, as far as possible, hard evidence for adjustment amounts. An example here may be a third-party quotation, or an independent expert certificate.

By adopting this approach, while the business may have never generated the levels of profits as you are disclosing, and a buyer will want to validate to proposed changes, the deal discussion and mindset of the buyer is set at the TOM business. Given the impact of profit improvements on value, using valuation multiples, every $1 million of profit increase you justify, provides maybe say $10 million of value.

To arrive at the target operating model, the seller should review its business with a critical eye, considering the standalone improvements possible, and operational improvements, without the constraints of the seller organization policies. Of course, these must be plausible and justifiable, and one strategy here is to link these improvements and the realization of related value to deal incentives especially for target business management. These initiatives will vary on a case by case basis, but could include:

- Capital structure changes
- Alternative lease or buy decisions
- Facility relocation (especially HQ and back office) to reduce costs
- Offshoring

- IT rightsizing or move to a cloud strategy
- Cessation of Seller group specific reporting, or training etc.
- Changes to supply chain or logistics
- Change in inventory holding;

The more justification to any proposed adjustment the better. Better still is evidence that action has already started to realize the TOM. Furthermore, a comprehensive Financial Fact Book similar to a sellside due diligence report or detailed information package is very persuasive. And in addition, all due diligence documentation and discussion materials should be created and presented in a consistent form.

The only downside to this approach is the planning and preparation time required in identification of such changes and in preparing the comprehensive proforma information. However, these should be considered as value potential, and as explained below, a well-prepared buyer will also be considering a similar approach, and it is unlikely that they will pass the impact of their value creation ideas to the seller.

In developing the TOM, however, a seller should also look at the impact of the carve-out on what remains with the seller after the deal. This includes the assessment of “off-loading” excess people or idle assets with the carve-out. This may negatively impact the value, but reduces the burden of post-deal right-sizing itself. Related to this, it its assessment of “stranded cost” which will remain with the seller after the deal, which beforehand were past on to the target business.

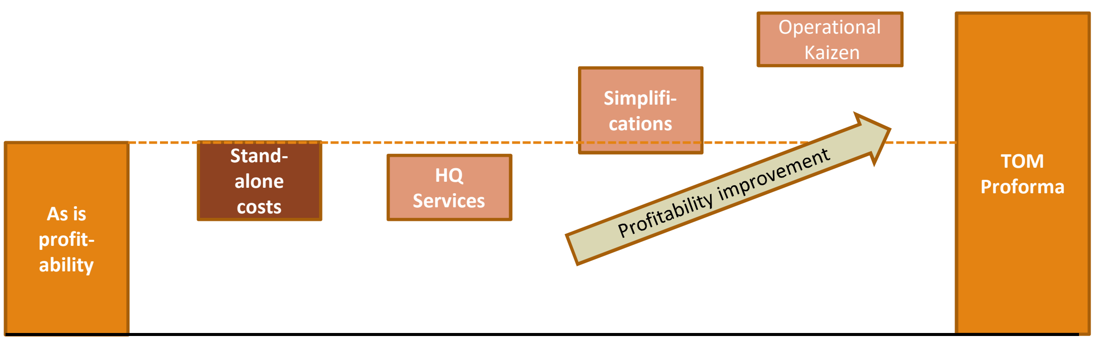
Related to the TOM changes and the various carve-out initiatives, a further strategic consideration for the seller is its position with regards to one-time costs. Should the seller incur the costs itself, agree to fund the costs incurred by the buyer, or pass on the responsibility of taking action and incurring cost to the buyer. The decision depends on the sellers view of the level of control over those costs it wants to have, and its perception of the expectations of the buyer. These expectations may vary based on the identity of the buyer, with some costs being avoidable if the buyer already has a sufficient infrastructure already in place.

The final strategic consideration is the level of TSAs, the basis for charging and the duration. Fundamentally, the seller is not in the business of provision of transition services, this is a special activity arising out of the transaction, so ordinarily they will want to minimize the burden and the responsibility in providing TSAs. It is common that services such a treasury, legal, compliance, or employee communication are considered the immediate responsibility of the buyer, and that a seller would not agree to provide for transition services in such areas (just in case something goes wrong). A Seller is usually willing to provide information support services to hand over a function to a buyer, but would not want to risk receiving never ending persistent questions. Such services would be provided for a limited number of hours and for a short period no longer that 3 months. Other services vary, and while IT may be troublesome, a seller would like to restrict the number of TSAs extending over a year to the very minimum.

A Seller may want to consider including a commercial margin to its TSA pricing, but this will depend on the level or extent. With or without a margin the seller should introduce a process to ensure it adheres to its stipulated service levels and captures the TSA execution cost accurately for invoicing purposes.

In the carve-out, the Seller should also consider what is to remain with the seller after the transaction and whether the remaining operations are optimal or require some right-sizing adjustments. This future seller side state should also be planned early on in the process, so that decisions can be taken during the scoping of the carve-out on re-deployment of potentially excess people. These could prove to be a solution to some of the standalone people requirements, or otherwise may present an attractive alternative at presenting these in a positive light in the carve-out if it would lead to a lower net cost/value reduction to the seller in the carve-out than having to continue with these people and subsequently pay for their termination.

Value Creation in Carve-outs



Strategic Considerations for the Buyside

The buyer in a carve-out transaction also has a number of strategic decisions, but most are no different from the decisions taken in regular M&A and relate to what they should request in negotiations, or deduct from their offer price versus what they should accept or forfeit in order to get the deal or at least not jeopardize it.

During the initial stages of the deal, however, the buyer should be quick to understand the nature of the carve-out and begin a critical assessment of its own infrastructure and capabilities, so that it can formulate its approach. Having an initial view of how the buyer can support the carve-out business, and what should its response be to big ticket carve-out matters such as IT, will be very useful in progressing through the complicated due diligence and later TSA discussion process.

The other strategic area relates to its view on the reliability of the disclosed proforma financial information and the standalone and one-time costs, especially where there are significant seller side TOM related proforma adjustments. With the one-time cost, the decision to be made is does the buyer accept the risk of the one-time cost or does it push the responsibility for establishing a true standalone position and related one-time costs on the seller. Ultimately, this will depend on its own capabilities, and it is often found in the case of cross-border market entry type deals, the buyer is best to try and leverage the seller as much as it can, out of practicality.

People Issues in Carve-Out Transactions

People issues are significant in all M&A transactions, but these are even more complicated in carve-out deals. In a carve-out, most people will be involved in some change of legal employer, which will involve some change of benefits or benefit provider, and additionally in many cases consent will be requested to the proposed change. This provides the opportunity and increases the risk of some employees not agreeing to the proposal.

Further, the carve-out will involve a greater amount of change, which in a simple stock deal may not be readily apparent. In the carve-out, a business will change from part of a large business and become either standalone separate legal entity, or a division of its new owner. Daily processes are likely to be different and a significant amount of the changes taking place will ultimately be requested of the management and employees of the target business.

Retention of employees becomes much more of an issue, and effects both buyer and seller. In carve-out there is a greater chance of employee uncertainty and turnover before the deal closing than in a stock deal, where there is often a shorter announce to close period. Sellers can reduce the risk by introducing a plan for transaction bonuses. This however can add to the retention risk of the buyer, who could consider the needs for additional incentives required on its own part

The biggest issue in carve-outs and one which is quite unique in such deals is the distinct change in allegiance of target company management during the deal process. At the outset, Target management are aligned with the seller and may be incentivized by seller provided bonuses. However, in undertaking the carve-out, and during the extended periods of exposure between the buyer and target management, the target management slowly become more aligned to their future employer, and may be very supportive to the buyer. This presents a potential risk to the seller in that the level of commitment of target management to seller side hypotheses reduces and can begin to work against then. This is particularly so when it comes to the execution of the carve-out and making decisions on post deal staffing decisions. Even if the deal process was initiated and driven by the Target management initially, the seller should ensure it maintains governance over the deal process for the benefit of the seller.

Unique Features in the Execution of Carve-out Transactions

A carve-out deal essentially follows the same pattern as all other M&A transactions, but varies in certain aspects depending on the relative steps of the seller and buyer. A summary of the major differences is as follows:

a) Seller side preparation. As the business being sold does not operate on a standalone basis, the level of advance preparation of the seller, as explained above, is likely to be very significant. While this varies between different sellers it is common for detailed carve-out "financial fact books" of the business to be prepared, especially where changes to the operating model are being put forward.

b) Due diligence Process : The Due diligence process is likely to be much more interactive than with regular M&A. The Seller will wish to be clear on the perimeter of the carve-out and will need to be much more open on the basis of preparation. The buyer will have greater uncertainties to address, given they are assessing a state which has yet to exist, and feel uncomfortable about the lower level of routinely produced (let alone audited) financial information.

c) Sign to Close period: In many cases of carve-out, while the separation will have been planned, sellers may not begin to take separation actions until there is a clear buyer agreed. In certain countries in Europe for example, where there is a Works Council consultation process, carve-out activities may not begin until after the consultation process has been completed. This means the period between signing and closing will often be longer than other deals, partly because of the huge volume of activities that need to take place. If an IT separation is involved a minimum of 3-4 months is often required to reach a transferable environment. A slightly shorter, but still long period is required if the buyer has to set up legal entities from scratch. Group insurance arrangements can take 2 months. However, often the longest lead time could be application for new business licenses which can be even longer, although depending on the willingness of either party, some "bridging" or "concierge" solution can often be found to help get around this impact.

d) Transition Service Agreements: A key feature of all carve-out deals is the need for Transitional Service Agreements (TSA) and sometimes Long-Term Agreements (LTA). TSAs define the services to be provided by one party to the other (Often by the seller, but reverse TSAs provided by the buyer are still common) for a temporary period of time. These can be as simple as agreeing to answer questions about a particular matter for a short time after closing, or be provision of complex IT services for an extended period during which a permanent separation solution is implemented. LTAs include unavoidable provision of continuous services, such as site services on a factory complex. The TSA (and LTA) is a separate legal agreement covering the provision of services. These can be simple, but it is often recommendable to make the TSAs as detailed as possible or at least have an attached service level agreement to avoid disputes of what was agreed and what was not. The TSA should state the duration, billing frequency and a basis of charge or better still amounts themselves. Both Buyer and Seller should establish their own governance processes for monitoring service levels, and amounts invoiced, and to deal with any unclear matters or even disputes.

A common question arising in carve-outs is when the TSAs should be signed and in what form. Both Seller and Buyer will wish to confirm that TSAs will be provided, and also have some certainty as to the costs they will face during the TSA periods. However, the reality is that at the time of signing the Sale and Purchase Agreement both sides are unlikely to know the full extent of services required and most definitely detailed service levels will be unclear. This requires a flexible approach, and two treatments are commonly seen in practice. First, is to include a framework TSA in the SPA, and a list of areas to be covered (and potential pricing approach). As a condition to Closing, it will be agreed to finalize the TSA list and complete the service levels, and sign the agreements by Closing. A Second Approach, is to make a best efforts basis and to sign a TSA at the same time as the SPA, but with the explicit condition that this can be edited and added to in good faith between signing and close. Whichever approach is followed, it is almost guaranteed that new areas of TSA support will be identified during the sign to close period, or day one preparation will differ from plan requiring addition or deletion of previous anticipate support.

e. <u>Contents of the Sale and Purchase Agreements.</u> While the SPA agreement for the carve-out will be the same as for regular M&A, a few different things that can be anticipated, as follows:

- On many occasions some of the entities in connection with the deal, do not exist at signing. Consequently, there will be greater "on-behalf of" clauses and assignments necessary, as well as modified Representations and Warranties
- There will need to be an extensive description of the carve-out perimeter detailing what is included and what is excluded.
- Mistakes in the carve-out are highly likely and so a customary "wrong pockets" clause to restore what was intended to happen is needed.
- There are likely to be extensive "Conditions Precedent" one of which would be the completion of the carve-out stipulated and the finalization of the TSAs etc
- There is often greater detail on confirmed employee transfer and management retention, with undertakings of countermeasures

f. <u>Price Adjustment Mechanism and Closing</u> Price adjustment mechanisms in carve-out transactions can be complicated, as the entities of the deal do not exist at the time of signing, and the financial information presented during due diligence is proforma. Consequently, it is very rare for carve-out deals to be presented as a "locked box", but similarly Closing Accounts need to be modified to traditional deals. The more common approach is to define the carve-out and the assets that this represents, and use this as the commitment of the delivery of the seller either into a pre-closing locked box entity, or upon closing.

If the carve-out process includes multiple locations and new legal entities, the formation of the standalone carved out entities itself can generate new intergroup balances. The settlement for the transaction will be agreed as a single payment amount from Buyer to Seller which covers all amounts. Immediately upon change of ownership all amounts owed to the seller will be settled. Consequently, there will be an extensive network of payments on behalf which when combined with the operating funding requirements of each of the target carve-out entities will result in a complex funds flow. This will require careful planning and documentation, step by step, and often hour be hour, to reach the final post close settled state.

The carve-out process

	Strategy	Planning	Due Diligence	Day-one readiness	Post deal
Sellside	Strategic portfolio review	Stand-alone and one-off costs	Carve-out workshop	Separation execution	TSA service
	Feasibility assessment	Proforma Financials	DD Q&A	IT separation	TSA exit
	Target operating model	Initial TSA plan	TSA Finalization	TSA process implementation	Residual right-sizing
	Impact assessment	Due diligence preparation	SPA execution	Employee Communication	
Buyside	Opportunity Identification	IOM review and initial offer	Carve-out workshop and DD	"Docking station" creation	TSA Service monitoring
		No access assessment	Stand-alone and one-off costs	IT environment creation	TSA exit
		Initial TOM and gap analysis	Impact assessment	Key person retention	TOM implementation
		Baseline TSA planning	TSA and SPA	Employee Communication	PMI

Day-one Readiness in Carve-out Deals

If the business does not exist as a standalone basis at the time of signing the SPA, it can easily be imagined the amount of effort that needs to be undertaken to complete the carve-out is substantial. Day-one readiness checklists can extend to many hundreds of activities all of which needs coordinating not just within one party but also between buyer and seller. Key areas of effort, include the following;

a) Legal entity set-up: This includes legal formation, director registration, business licensing, tax registration, labor registration, bank account formation (including electronic banking system)

b) Employee transfers: This will include any consultation requirements, new benefit design, obtaining consents etc. One particular time-consuming issue which is common is that of sales networks in global transactions. Sometimes the businesses for sale have small numbers of (sometimes single) sales people in many countries, which are employed by the local subsidiaries of the seller. If these sales people are to be part of the deal, then the question becomes who should be their employer post deal. Should they become freelance, or a legal entity be formed for those people, or an intermediate ("employer of record") solution. This becomes a time-consuming process.

c) Customer/Supplier Transfer: In addition to communication and contract transfer, the official "account registration" procedures at customers etc needs to be completed for them to be able to buy things and pay invoices post deal.

d) Compliance registrations: All registrations including appointing "qualified representatives" for each criterion need to be made

e) IT separation: As discussed above, this will include the minimum level of separation, including data-separation and testing, as agreed between the buyer and seller.

f) TSA Verification and Completion.

g) Financial and Management reporting: In carve-out situations financial reporting and management reports on a consolidated basis for the target business do not exist. These will require implementation. In addition to this, finance management in the carve-out business should be confirmed as to whether they have the skills to undertake the new requirements. (Often this is not the case)

h) Group Insurance for the carve-out business needs to be arranged by the buyer. This requires close coordination to gather information of the target risks, and can taken and extended period of the time is site inspections and new risk assessments are required.

In conclusion

Carve-outs represent over a third of all M&A, yet the challenges involved for both buyer and seller are significant. A poorly planned carve-out for the seller, can lead to missing out on the opportunity to achieve increased value. For the Buyer, a poorly executed carve-out can increase risk, lead to business disruption and a whole range of operational challenges. Following a methodical approach, focusing on the issues at hand at each step of the process is the key to achieving value and realizing your strategic objectives.

How we can help

Crossborder PMI Advisors offers a wide range advisory services on both the buyside and sellside of cross-border deals, helping clients navigate the challenges and to engineer success. All services are specifically tailored to working in a multicultural crossborder environment, and range from cultural and overall PMI advisory services, to a modular approach to PMI, Carve-outs, Joint ventures and alliances, and other related areas. As such we offer a flexible approach to working with our clients, including working with your other PMI advisors in a cross-border SME capacity.

At Crossborder PMI advisors, our mission is simple: To help our clients succeed in cross border M&A. The key to crossborder success is to do the right deal, to pay the right price, and to manage your investment through realizing synergies, reducing risk through effective governance, managing people across cultures, and global leadership.

We look forward to working with you on your journey. Please contact us any time for further information and to discuss your needs at: info@xbpmi.jp

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