

GLOBAL

Carve out planning to avoid business disruption and value erosion

by Rick Van Dommelen, Hein Marais and Christian Knechtel

In response to the recent economic and financial market turbulence, companies are increasingly faced with the challenge of how to focus on their core businesses, reduce costs, and enhance the balance sheet. Although the volume of M&A activity has slowed as funding has become harder to get, chief executives and business leaders recognise that the long-term success of a business requires a constant evaluation of their portfolio of assets and capabilities. This pressure on companies to constantly revisit their strategy to focus on what it does best, has fuelled companies to increasingly spinoff parts of their business, known as carve outs. The drivers for these carve outs are many fold and range from the need to raise funds, or capital, to a desire to restructure the business portfolio by divesting non core or low performing assets.

But regardless of the key driver for the divestiture the overall objective of most companies is to strive for the maximum value – i.e., the highest price. However, the difficulty with these types of transactions is that the business to be carved out was not set up with the idea that it would be sold on one day. Besides, these carve outs – from the point of view of the seller or from the integration perspective of the buyer – are often neglected assets, underfunded and under resourced. In some cases, we have seen that important elements of the carve out business were not even included in the sale, such as critical information systems or important intellectual property. Very often this is due to the fact that management tend to underestimate the complexity and time necessary to complete a successful carve out transaction, typically ranging from 6-18 months. Carving out a business disrupts large parts of the organisation and takes a lot of effort and considerable resources. Many companies start with good intentions, but as time elapses and the focus of the seller shifts away from the unit being divested to the retained core business, they end up simply completing the deal at whatever price they can get. This value erosion is further exaggerated when carve out management begins shifting its allegiance from the seller to the buyer – creating a communication vacuum. But the business targeted for divestiture might also suffer in other ways as employee turnover increases, productivity declines, focus is lost on customers or critical management weigh up their options and leave the company for other opportunities. In other cases we have seen that competitors use the opportunity to lure away customers, especially when new products are put on hold or research and development programs are delayed. Especially in today's economy, where buyers are subjecting acquisition candidates to far more scrutiny and comprehensive due diligence – leading to lengthier divestiture processes – the development of a thorough, consistent and compelling business case and carve out plan is required. Such plan is critical to a successful carve out.

Building the business case

It all starts with the often challenging step to have a clear understanding of what encompasses the transaction. When developing this, the company should carefully study the overall business to clearly outline the parameters surrounding the assets to be divested. As the business targeted for disposal rarely operates on a standalone basis it is important to set the strategic focus of the new business and determine what is included and excluded within the scope of the transaction to identify the revenues and the new cost base of this business. For this, an analysis needs to be executed mapping all resources, assets and people moving with the transaction, remaining with the parent company or to be deployed outside the organisation. It is critical in this phase to acknowledge that different skills, competencies and capacity may be required for the success of the business. The analysis should also address issues like the quality of management in light of the growth strategy of the business, the sufficient scale of the operations, working capital needs and cost savings if run independently. In our experience, one of the key

areas where sellers lose value in a carve out is by not challenging the status quo and not streamlining the operating model – by simply cloning the existing operating model, significant value is left on the table. By simply asking the question ‘what does the business really need’ as opposed to ‘how do we replace what we had always done’, significant value can be gained. Equally important in the assessment is the impact on the retained business. Are there any dissynergies or unexpected stranded costs being left with the seller? Too often, these issues are mere afterthoughts that lead to value deterioration, closing delays or ‘Day One’ difficulties for both parties. Or said by one of our clients: “a strong pro-forma model, that the buyer can use to model its own cash flows is key. Doing due diligence on your own internal model before sharing with the prospective buyer is critical”.

Running the carve out plan

Once it is clear which assets to divest, it is essential to define a formal transaction process plan that sets out clear roles and responsibilities, and ensures the accountability between parent company and the to-be-carved business. As there are typically several parties involved in the carve out process, with diverging agendas, this plan should be formally approved by the board and supervisory board, what by itself could become a very complex and time-consuming process. Second, a company must put in place effective program management. Particularly, in case there is a high degree of internationalisation and the interconnection between parent and to-be-carved out business is complex, the process could necessitate a dedicated carve out office as the volume of work that must be done in a short amount of time can be overwhelming. The carve out office ensures business continuity for both organisations to safeguard the value of the existing business, but equally important to capture the value of the carve out, not just the closing of the transaction. This office articulates the responsibilities of each organisation, designs the specific steps to measure against goals at each stage of the carve out process. Third is effective communication, both internally and externally. The carve out office also ensures that the company communicates the future business case consistently and accurately during the entire process, e.g., in the offering memorandums, management presentations, data rooms or other related uses. By doing so the office helps to minimise uncertainty associated with the deal. Especially in today’s credit and equity markets, the seller should expect a rigorous diligence process and should prepare beyond what they would normally do. Lastly, the office should also coordinate the numerous additional issues that can surface when carving out a business, like tax implications, pension plans or how the people are affected by the carve out. Critical is to maintain an open dialogue with all stakeholders and stay flexible as the transaction unfolds. The most successful carve outs are those in which businesses maintain their flexibility, and pursue multiple options for as long as they can to help maximise the value that can be gained from the deal.

Closing the deal

In today’s financial markets, finding reasonably priced debt is a challenge, leading to fewer bidders and a higher level of anxiety around the execution risk associated with a carve out. The key to a successful closure requires the preparation of a robust carve out plan including the provision of transitional services by the seller, the buyer’s Day One requirements, performance metrics and timelines for transitioning of people and services and a fully costed model reflecting the above.

As each deal is different, and especially a carve out deal, the drafting of proper sales agreements is challenging. The key to success is to manage two competing challenges: getting the best possible price for the business and concluding on the best possible terms for the transition services. The best way to do this is to negotiate the service contract and the sales price at the same time by structuring the sales process in such way that a short list of credible buyers is invited for the auction, where the equity case is clearly presented and the prices for the transitional services are set at the same time.

Bottom line

In today's financial markets, with financing banks applying higher levels of scrutiny to separation issues, the sale of a carve out business not only requires a compelling equity story but also a thoroughly prepared separation plan for the carved out business, in which the separation steps, the associated risks and the one off and ongoing costs impact are fully addressed. Only in this way will it attract maximum competition and achieve the highest price for the business.

Rick Van Dommelen

Partner
Amsterdam, Netherlands
T: +31(0)20 568 52 32
E: rick.van.dommelen@nl.pwc.com

Rick Van Dommelen is a partner within PwC's Transaction Services practice in the Netherlands, with over 12 years of transaction experience advising strategic and financial clients across Europe providing buy-side and sell side consulting. He has extensive transaction experience in complex projects managing change, e.g., mergers, carve outs, post deal work and restructuring projects.

Hein Marais

Partner
London, United Kingdom
T: +44 (0)20 7212 4854
E: hein.a.marais@uk.pwc.com

Hein Marais is PwC's Global leader for M&A Divestitures and he has worked on more than 50 carve out projects over a period of more than 10 years. Hein has extensive experience in complex multinational sell side engagements, specifically in the area of preparing for sale and operational issues associated with carve-outs.

Christian Knechtel

Partner
Frankfurt, Germany
T: +49 (0)69 9585 3188
E: christian.knechtel@de.pwc.com

Christian Knechtel is partner within PwC's Transaction Services practice in Germany, where he focuses on Strategy and Operations. He has over 13 years functional industry and consulting expertise gained with PwC Germany and with Mannesmann Rexroth in the Automotive Industry. His educational background is MBA, Dipl.-Ing. (FH) and Betriebswirt (VWA).

PricewaterhouseCoopers (PwC) is a global network of firms operating in 151 countries, with more than 163,000 professionals joining efforts to achieve excellence and innovation in the supply of services. In the context of this article, PricewaterhouseCoopers Transaction Services, is a leading professional services business and is the most integrated of the Big 4 in terms of service delivery. Our services span the entire deal spectrum – from evaluating your acquisition/disposal strategy to helping integrate the acquired business. We have the most experienced and longest established network of deal specialists. Transaction Services comprises more than 6500 people including around c4000 in Financial DD, c1800 in Commercial/Strategy, c650 in Operations and c100 in Structuring. These are supported by a full range of functional deal specialists. Clients tell us that our process returns 8 to 10 times (based on review of 300

deals in 2008) our fees by reducing the purchase price by 6 percent on the buy-side, adjusting significant terms and conditions of the purchase agreement 75 percent of the time, and improving tax or financial statement structure 63 percent of the time. For more information, visit www.pwc.com.