Capturing value through carve-outs
Eight winning tactics buyers and sellers can use now
“You can look at 100 deals and no two will look quite the same – but the essential steps buyers and sellers should be taking to identify, preserve and enhance value are very consistent.”

— Ron Charles, Transaction Advisory Services, Ernst & Young LLP

“As a buyer or seller, you need to have a clear idea of your motivations and your processes – you need a strategic blueprint.”

— Max Habeck, Transaction Advisory Services, Ernst & Young GmbH
Resurgence in the global economy tends to accelerate the pace of M&A. Carve-outs are again emerging as an attractive option for both sellers and buyers in terms of raising and investing capital. But whether approaching this market as a buyer or seller, there are tactics that either party can deploy to enhance their desired outcomes.

Counterparties to any deal have both complementary but at times conflicting priorities. Through a stronger understanding of the objectives and priorities of their counterparties, buyers or sellers can generally improve the value of their opportunities.

Typically, a carve-out transaction occurs when part of a business is financially and operationally separated from its parent, usually in advance of an IPO or sale. Before proceeding with a carve-out, however, executives should familiarize themselves with the most visible as well as the least expected sources of value and risk. Consider these scenarios:

- Having negotiated the price for a set of carved-out assets valued at US$2 billion, a buyer is surprised to discover a substantial up-front cost that had eluded due diligence: acquiring new software licenses. This expense drives a spike in the initial outlay and a steep shortfall in the investment’s expected return.

- In preparing the financial statements for its carve-out entity, which included operations in 10 EU countries, the seller failed to include the human capital with the skill sets needed to turn the assets into a stand-alone business. This intellectual property was not transferred as part of the deal, nor was its cost accounted for in the pro forma financial statements. The seller lost credibility with the buyer, resulting in a significant reduction in the bid.

The complexity of a carve-out presents an array of challenges. Recognizing the needs of the buyer, a seller must be transparent about costs, preparing thorough and accurate carve-out financial statements and providing sufficient and appropriate information. Buyers face a different set of challenges. These include valuing the assets, performing due diligence on the seller’s financial statements, as well as maintaining and continuously updating their own deal analyses. A buyer must also prepare for day one and overall integration – which will likely entail negotiation with the seller for a short-term Transition Service Agreement (TSA).

There are many issues, both significant and subtle, that can surface without notice. But by reviewing any transaction from the perspective of both buyer and seller, executives can avoid surprises, gain a clearer understanding of where value can be created or destroyed and, by following through, make a good deal even better.
Four steps

1. Understand buyers’ motivations.
2. Prepare carve-out financial statements.
3. Be transparent about costs.
4. Consider the impact on “remainco.”
1. Understand buyers’ motivations.

Understanding a buyer’s rationale is essential for the seller to execute the successful design, marketing and sale of carve-out assets. There are two types of acquirers for carve-outs: corporate strategic buyers and financial buyers. The first group is usually seeking assets to complement their existing business. They may integrate the carved-out assets into an existing operating structure and focus on synergy opportunities.

The second group often seeks to purchase a going concern, or to quickly turn carved-out assets into a stand-alone company. They are typically private equity (PE) firms whose goal is to invest, enhance, grow and then exit. They may integrate the carved-out assets into an existing operating structure and focus on synergy opportunities.

Given the varied motivations of buyers, it is important for the seller to carefully consider how the sale might be structured and how flexibility can be maintained in the process to market the asset to both financial and strategic buyers. For example, financial buyers will typically have a tax optimization structure within which to incorporate the carved-out business. A strategic buyer will likely need fewer back-office assets than a financial buyer and typically possesses a range of corporate functions, as well as a scalable information technology (IT) platform. While there may be interest in taking on a number of additional staff, particularly in areas where they lack expertise, strategic buyers generally need fewer of the seller’s personnel than financial buyers.

By contrast, a financial buyer who intends to run the acquisition as a stand-alone company is focused on whether the necessary infrastructure and personnel are in place as part of the transaction. If not, the buyer is more likely to require ongoing support from the seller, provided for in terms of TSAs. These are typically fixed-duration contracts for the provision of operational support from the seller. Expectations with regard to scope of services, duration, pricing and performance tracking are critical to both parties. TSAs can facilitate the close date, provide an incentive for the buyer to become self-sufficient and ensure that the business continues to perform as expected post-close but the tax implications of TSAs (in particular VAT implications) require careful consideration.

While buyers are aware of the more obvious synergy opportunities, the seller can enhance the potential value for the buyer by highlighting initiatives in progress, or other matters not evident to the buyer. Through review on a potential buyer, the seller can identify ways that intellectual property could enhance products or services within the buyer’s portfolio. Sellers may be able to maintain or enhance value by directing the buyer’s attention to potential tax synergies inherent in the carved-out assets.

2. Prepare carve-out financial statements.

Once the seller has defined the assets to be carved out, the next step is to prepare pro forma carve-out financial statements. These are typically prepared in two formats:

- **Retrospective audited or auditable carve-out financial statements** present revised financial statements for the business based on changes to historical cost allocations and using a level of materiality more appropriate to the business being divested.
- **Pro forma financial statements** view the business on a look-forward basis.

Avoid an incomplete tax picture

A carved-out business included land and buildings in a number of jurisdictions. In the past, the choice had been made to enable recovery of value-added tax (VAT) incurred in connection with some of these properties. This meant that the properties in question should have been subjected to VAT when they were sold as part of the carve-out. But the seller had no tax history of the properties and did not establish its VAT status as part of carve-out planning. Therefore, no VAT was charged and the seller was surprised to learn that the tax was due on the sale. To make matters worse, the purchase contract was silent on the VAT, so the tax could not be passed on to the buyer. Eventually, the buyer shared the VAT cost in return for a more favorable TSA. But the problem could have been avoided if the seller had given careful thought to the tax profile of the carved-out assets before the transaction.

Include the right people at the right time

Timely and appropriate communication is essential to an effective carve-out process. Early on, sellers must determine whom to involve and when. At first, the exploratory team should be small. But as the likelihood of moving forward increases, the group needs to expand to include functional expertise in IT, human resources (HR), accounting, tax and other essential disciplines. This is especially important during the TSA definition and negotiation phase.

Effectively managing the chain of communication is also critical. Sellers must preempt potential issues with proactive, clear and concise communications that address major stakeholder concerns. Conveying the messages in a positive, well-structured and properly vetted manner will reduce countless concerns.
Capturing value through carve-outs

Sellers beware: Six of the most common and costly mistakes

1. Weak executive leadership during any transaction leads to missed deadlines, oversights and errors – all of which will be apparent to the buyer pool and result in value erosion.

2. Inadequate resources, either in number or skills, will impact the timeline. A CFO recently lamented that he was being asked to close the books in November, do the year-end closing in December, complete an ERP implementation and, in his spare time, develop a carve-out financial statement and start sell-side due diligence.

3. Weak coordination or governance policies will cause unnecessary roadblocks and frustration. Each deal needs a dedicated steering committee with sufficient support to be able to drive functional teams to develop aggressive, yet achievable timelines and efficient functional work streams.

The pro forma financial information is more appropriate for valuation, but both the seller and buyer may require audited (or auditable) financial statements for funding or compliance purposes. Note that a carve-out entity will constitute part of the larger group and, as a result, will use services provided by the larger group. The new carved-out entity may need to reacquire these services post transaction, and the carved-out financial statements need to accurately portray the initial and ongoing costs associated with those services.

A seller may be tempted to downplay costs and amplify potential revenues. But should buyers detect such a pattern – and astute ones will – they will start questioning data presented by the seller at a much more tactical and detailed level, and potentially discount the bid. Moreover, the seller will likely be inundated with very detailed information requests, which will not only delay any transaction but distract the seller from its own go-forward business.

Inexperienced sellers may – knowingly or not – incorrectly estimate the impact of the separation on the carved-out business. For example, the current parent may provide services free of charge, or through numerous informal relationships that have developed over time, or benefits from being in the sellers tax grouping, that are inadvertently omitted from the carved-out financial statements. Sellers are often wary of including a cost that, while appropriate for financial buyers, may exceed the appetites of strategic buyers (and therefore result in undervaluing the asset). To ensure trust and momentum, sellers should be transparent about costs and about their assumptions where calculations may need fine-tuning.

3. Be transparent about costs.

Stand-alone costs, derived from an analysis of existing direct and allocated costs, are important to any financial buyer given their impact on after-tax cash flows. Often, sellers do not apply sufficient effort in defining a stand-alone strategy, and the required costs associated with implementing that strategy. If the seller is unable to answer detailed stand-alone questions from the financial buyer during due diligence, the buyer will increasingly focus on that area and potentially gain control of the negotiation.

The seller must have a clear understanding of the stand-alone value of any potential carve-out early in the process. The sooner a seller can obtain this insight, the sooner he or she will be in a position to confidently evaluate options. Could packaging the assets differently make them more attractive to the list of likely investors? Within the expected time horizon, should the seller invest time (and money) to enhance the market value? Is a carve-out the best approach, or could another avenue generate more value? What is the potential impact of different approaches on the seller’s overall tax profile and which is likely to generate the most after-tax value?

Sellers need to develop a robust valuation model that factors in variables such as whether to add or exclude certain assets, stand-alone costs, conditions of TSAs, tax considerations and potential synergies with different buyers. Such a model will support the seller with greater flexibility and speed in responding to evolving scenarios or the late arrival of an unexpected suitor. The appropriate model can help a company pursue multiple scenarios simultaneously, raising the chances of success.
4. Consider the impact on “remainco.”

The potential negative impacts of a carve-out transaction to a seller’s remaining business often go unrecognized until it’s too late. Sellers must evaluate how the carve-out might affect continuing operations, cash flows for the retained business, and tax structure. For example, excising underperforming assets may trigger significant impairment or an increase in the seller’s effective tax rate.

A major concern is the extent to which a sale can lead to stranded costs (i.e., the costs that were shared by the carved-out business) that must be absorbed by the remaining business. Given a buyer may not want to acquire all of the personnel associated with the carved-out business, the seller needs to consider the potential costs of right-sizing, or potentially reengineering the remaining organization.

Sellers beware: Six of the most common and costly mistakes

4. A failure to anticipate would-be buyers’ needs can create many last minute requirements that can frustrate and potentially burn out the transition team. For example, if a deal is material to a public buyer, PE or other financial buyers, then the development of audited financial statements should commence early on. Additionally, sellers should consider tax structures that might be efficient to buyers and sellers in the early stages of the transaction.

5. Insufficient or incomplete thought as to the form of the transaction can potentially result in transferring control of certain key components of the negotiations to the buyer or unnecessary tax leakage. Sellers should consider the potential buyer pool before deciding on the form and structure of the transaction.

6. Failure to properly consider the buyers’ day one functionality requirements could result in significant money being left on the table. Sellers too often focus on their own separation issues and not enough on delivering a stand-alone, ready-to-run business.
Four steps

1. Come to terms with the components of the asset.
2. Assess up-front and ongoing costs.
3. Make readiness a priority.
4. With TSAs, focus on the details.
When the transaction closes, the seller’s work, with the exception of any TSA commitments and stranded costs issues, is fundamentally complete. The buyer’s journey is just beginning. The most capable buyers of carve-out assets and/or businesses begin with a clear and strong operational awareness. They know what they want, why they want it, how they want to get it, how they are going to use it and how they are going to measure its success. Such buyers have a stronger understanding of valuation, as well as an appreciation for the level of difficulty involved in integrating assets into an existing business or operating the assets as a stand-alone business.

1. **Come to terms with the components of the asset.**

   It may seem obvious, but buyers need to know exactly what their organizations are getting: exactly which assets, which legal entities, which accounts, which people who directly support the assets, which people who partially support the assets and so on. But in practice, many prospective buyers experience misunderstandings right up until closing – or, worse yet, find serious discrepancies after the close.

   It is imperative for the buyer to get an accurate understanding of the boundaries of the target or “what’s in and what’s out” early in the transaction in order to be able to start identifying synergy opportunities, tax implications and post-close operating options. A comprehensive assessment of the operational considerations of the transaction through operational and integration due diligence is critical for accurate pricing and achieving the deal value drivers.

   Once the boundary of the target is defined, it is important for the buyer to start understanding the risks and tasks involved in transferring and transforming those assets at close. For example, an assessment will need to be performed on what licenses and registrations will need to be re-established in order to operate post-close, what communications will need to be made to unions and work councils in order to efficiently transfer people and what consents will need to be obtained from customers and vendors in order to assign contracts.

2. **Assess up-front and ongoing costs.**

   A buyer must concentrate on evaluating the accuracy and completeness of the seller’s cost assessment. While the obvious areas include IT, real estate/facilities, HR and tax – any of which can be the source of significant surprises – it is important to examine less obvious areas such as insurance and environmental health and safety costs and customer contracts and tenders. Other potentially complex cost considerations include replacement of corporate shared services, acquisition of software licenses, renegotiation of leased facilities, severance, “hidden” HR costs and often overlooked tax issues.
Buyers beware:
Six of the most common and costly mistakes

1. Buyers often underestimate up-front and ongoing costs. Instead, buyers should start early in understanding “what’s in and what’s out,” the tasks that need to be performed to successfully transfer assets at close and any service gaps that may exist post-close.

2. Relying too much on the seller in TSA discussions conveys advantage to the seller. Buyers need to devote their own resources to gathering information relevant to the negotiation of TSAs. In one transaction, having relied on the seller to value its TSAs, a financial buyer later learned the agreed-upon services had been overvalued by as much as 50%.

3. Improper planning for legal entity establishment can be crippling. The tasks needed to make legal entities operational - i.e., obtaining regulatory approvals or re-establishing licenses - can involve long lead times. Inadequate planning for such tasks may lead to costly workarounds at close, or, worse yet, a delay in the close.

4. Lack of involvement in the carve-out pre-close can lead to misunderstanding and delay. Buyers need to have transparency into the progress sellers are making in carving out the target. Moreover, buyers need to define for sellers their post-close operational requirements to receive the assets.

Buyers should obtain a detailed inventory of the services provided to and required by the carved-out entity in order to form an independent view of their true economic value. Often, the carved-out business will lose access to important corporate services from groups such as treasury, sales, audit, finance, HR, tax and IT that must now be replicated.

Frequently, large organizations pool costs for certain services and then charge them back to the businesses using various allocation methodologies. The methodology and consequent allocation may not represent the actual value of the service supplied or consumed. In addition, certain services may be provided free of charge. Less frequently, businesses are required to buy goods and services internally that they could purchase more cheaply in local markets.

One effective tool to assist buyers in determining these costs is benchmarking. Buyers should look to all available sources of public information to extrapolate appropriate staffing levels based on comparable businesses. Other sources of key information might include specialist IT consulting groups, industry associations or detailed benchmarking analysis.

3. Make readiness a priority.

All buyers need to prevent loss of value, and get the new assets productive as quickly as possible. If the business is standing alone, this means getting the operations (people, systems, processes) stabilized after the upheaval of the change in ownership. If the asset is being combined with another entity, it means getting the Project Management Office (PMO) running efficiently with a clearly articulated sense of purpose, governance and change management policies. Even experienced acquirers of carve-out assets underestimate the work required for timely capture of transaction value drivers. Meanwhile, the market is watching and ready to critique transition performance.

At the start of transition planning, focus attention on those business processes most critical to success. For a global manufacturer of consumer goods, it may be the order-to-cash (OTC) processes that generate positive cash flow. Sophisticated buyers understand they must focus on critical processes as early as possible. For example, OTC lead times, especially in the case of regulatory approvals, can range from three to nine months or longer depending on geography. Similar timeframes are often needed to update essential IT functions, such as ordering. The buyer will need to determine an appropriate short-term, mid-term and long-term integration and/or stand-alone IT strategy.

Additionally, when buying assets in a jurisdiction where the company does not currently do business, it may be necessary to set up a new legal entity and consider a new tax environment. This requires significant planning and can take several months. While a buyer might incur expenses on a bid that fails to close, such risks must be balanced against not only the expenses but also the lost opportunities associated with a slow start to a new business in a new geography or market.

4. With TSAs, focus on the details.

TSAs are essential to the effective integration of carve-out assets. Too often, having disposed of its carve-out assets, the seller may lose the ability to provide services at the expected level due to changes in staff or structure. This can lead to deterioration in the quality and timing of operations, which can seriously disrupt a newly launched business.
Detailed TSAs should address who will be accountable for delivery of the TSA contracted service, what is the issue escalation process and a number of other very tactical considerations for example, whether VAT incurred by the seller or buyer is recoverable and if not, who is responsible for the cost. These must be defined, in detail, prior to close. Leaving matters such as TSA performance reporting, pricing, penalties and the like to the last minute can have significant post-close consequences.

Penalty payments for shortfalls in service levels are far less valuable to a buyer than is the quality provision of essential services included in a TSA. In most cases, a buyer should negotiate as few such agreements as possible, and for the shortest duration. Both sides need to reach a realistic consensus about what the buyer needs functionally, and how long it will take the buyer to develop the capability to perform the operations.

5. Inadequate attention paid to day one operation can potentially result in significant increases in operational costs and potential loss of top line revenue. Buyers need to plan early on and carefully to ensure the acquired assets are ready for full operation, and the expected full suite of products are ready for sale, immediately following the transaction close.

6. Lack of a defined transition governance structure can lead to a loss of control and a failure to achieve objectives. Corporate strategic and financial buyers alike need to assign accountability to ensure that pre- and post-close tasks are properly performed. Particular attention should be paid to those steps needed to enable key drivers of deal value.

Conclusion

Cultivating carve-out capability

Using a well thought out carve-out process, a company can be more nimble in its ability to address the needs of the market in a timely and efficient way. Knowing when and how to sell assets through carve-outs becomes a powerful means of managing capital within a business to increase shareholder value.

For buyers, acumen in carve-out acquisitions can dramatically improve the ability to exploit the pipeline of growth opportunities. With experience, a company becomes more adept across a range of essential carve-out, buy-side tasks. Essential skills range from identifying likely prospects and estimating future business costs and revenues, to understanding tax and supply chain implications, fine-tuning bids and ultimately integrating new assets. While each presents unique challenges, developing strong capabilities across the full range of carve-out tasks can deliver a profound competitive advantage.
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