



PEI Operating Partners Forum

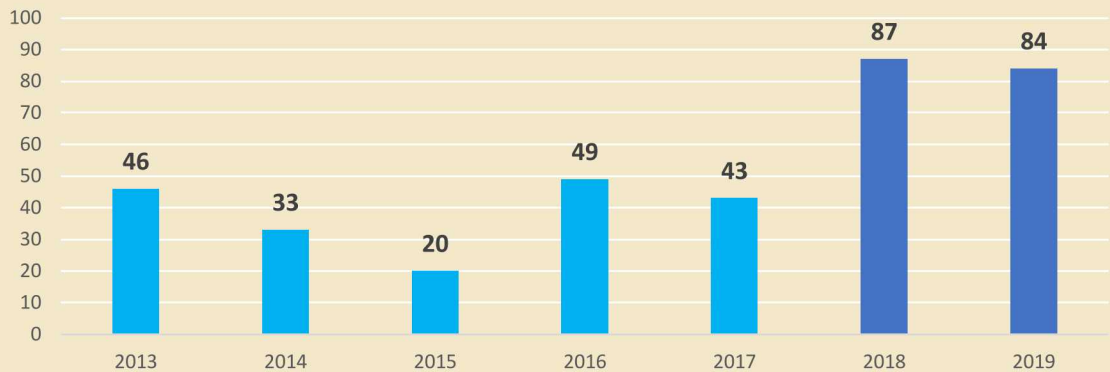
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Preparing for the Carve-Out Deal Deluge

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Carve-outs (or Corporate Divestitures) offer exceptional potential investment opportunities for private equity investors.

Percentage of Global Companies That Expect to Initiate Their Next Divestment Within The Next Two Years, 2013-2019



Source: EY Global Corporate Investment Study 2019

However, such investments also include a high degree of risk, a large portion of which is derived from operational execution risk embedded in the fact that a carved-out entity must be cleaved from the corporate parent.

Such a separation involves complex activities such as separating legal entities, physical assets, personnel, intellectual property, and even brand identity.

Furthermore, this split can occur across multiple functions and geographies.

Because of the inherent additional risk embedded in these activities, carve-outs are sometimes sold at a significant discount relative to the typical sale of an existing stand-alone entity.

The potential discount for purchasing a carve-out is often enhanced if the seller is facing an economically challenging environment.

In fact, carve-out deal volume appears unaffected by economic cycles unlike typical M&A activity. By some measures, carve-out deal volume is counter-cyclical to economic conditions.

This attribute exists because in times of economic difficulty larger entities may feel pressure to focus their resources on a few core areas and shed non-core businesses that may have been developed or acquired during more forgiving economic times.

In addition, the corporate entity may need to raise cash to pay down debt or generate funds for other purposes.

Clearly, carve-outs can be enticing to investors. However, the complexities must be fully comprehended in order to correctly assess the full investment opportunity.

Many of these complexities are derived from the level of integration the unit to be divested had with its corporate entity. How much reliance is there on corporate functions like Legal, Accounting, IT, and HR? Is there a shared Marketing and Sales function?

There are typically a minimal core set of functions that must be assessed and planned for separation during the purchase process.

Typical Carve-Out Areas

Business Area	Carve-Out Activity
Marketing	New Entity brand and website rollout timeline
Sales Operations	Communicating/Sustaining Key accounts Sales team training Sales process changes Customer contract and P.O. migrations New Entity Sales Protocol Changes
Services Contracting	Contract migrations Service level continuity
Supply chain Management	Supplier communication and transition Factory right-sizing Regulatory and license approval
Procurement	Contract migrations Service continuity
HR	New Entity Organizational design Payroll setup Employee transition to New Entity Benefit plan changes and setup
Real estate	Security and badging Lease Transfers IT access changes Location strategy changes
IT	Application/infrastructure integration and cloning Cutover planning and asset integration User acceptance testing (UAT)
Finance, Tax, Accounting	Financial close Opening balance sheet Banking strategy and cash management Data retention and audit Financial valuations Carve-out financials
Shared services Legal	Shared Service Separation Legal entity structure, formation, registration, integration (separation), and dissolution/liquidation

In addition to the challenges of executing the carve-out, certain additional characteristics can drive the complexity to an even higher-level.

For example, the number of regions/countries can compound the volume of separation tasks as well as the required amount of coordination across the various carve-out work streams.

The number of systems that need to be newly implemented or cloned can also drive the separation complexity.

Characteristics that Increase Complexity

- Country locations
- Legal entity count
- Legal entity structure
- Sales timing
- Site sizes and location
- Headcount
- Customer base complexity
- Customer segmentation complexity
- Indirect Channel complexity
- Labor relations
- Contract Complexity
- System Complexity

Successfully managing a carve-out can be a daunting task. Because of the cross functional nature of the carve-out and the often detailed nature of the carve-out activities, the project team structure required to execute the carve-out can itself become unwieldy.

As is typically the case, most teams are capable of working within well-defined narrow structures and sets of responsibilities.

However, coordinating across functions and work-streams can lead to execution problems.

Creating an efficient implementation team structure is an important success factor in executing the carve-out.

The various teams required for the carve-out may themselves have specific characteristics that are geared for their specific purpose.

Separation Team

Separation Management

- Serve as liaison between PE Client and project team

Project Manager

- Day to day project management
- Provide weekly status updates
- Oversee four project workstreams

Workstream Leads

- Lead individual workstream teams
- Work with client to define transformation requirements

Workstream Support

- Complete process analysis and testing
- Coordinate Technology Change Issues
- Create detailed plans and tasks lists
- Establish new organization designs
- Establish new role definitions
- Manage and test transition process
- Provide coordination across workstreams
- Communicate up to escalate critical issues
- Coordinate changes with suppliers

Because a carve-out involves disconnecting from the corporate parent and then replacing many of those functions, the quantity of the tasks involved are enormous, and their criticality is evident in that missing even a single critical task or executing it poorly can have an amplifying effect.

An example of such a task may include transferring a software license or a necessary regulatory filing in a geographical location.

In fact, the scope of activities of a single work-stream, such as IT, can be daunting.

The particular nature of carve-outs and the similarity of certain components across carve-outs strongly supports using highly experienced resources in assisting in the carve-out activities.

Along with utilizing experienced specialists to increase the probability of a successful carve-out execution, recent technological advances and capabilities have altered the nature and potential positive outcomes of a carve-out.

For example, the availability of Cloud-based infrastructure has altered the potential timing and cost profile of standing up the new IT infrastructure for the carved-out entity.

Similarly, the availability of specialist outsourcing companies providing back-office services has greatly changed the stand-up time for a shared-services function for the new entity.

Cloud versus Traditional Infrastructure

Key Factors	Cloud	Traditional
Installation	Easy and fast	Time-consuming
Availability	On-demand	When bought and deployed
Investment	Less	High
Business Risks	Low	High

Cost Savings

In addition to lower labor costs, outsourcing cuts expenses on hiring, technology, software, rent, taxes, benefits, etc.

Ongoing workflow

Time difference advantage allows doing the work and solving the issues overnight

Significant pool of skilled resources

Outsourcing allows access to a bigger pool of experts with a wide range of skills that may be difficult to train in-house or find locally

OUTSOURCING POTENTIAL BENEFITS

Risk management

Services partner will become your reliable pointing to market risks and assuming responsibility for technological security

Expertise

Outsourcing providers have unique experience of working across various industries and technologies, which builds their expertise and makes their fresh look at your operations valuable

Flexibility

Outsourcing helps to manage temporary tasks and spikes in workload quickly and efficiently, without overspending on hiring

Speed

Outsourcing allows augmenting your team with the necessary skills in rapid manner

Exiting the TSA months earlier than had been previously possible as well as setting up a low-cost, variable, transaction-based cost model for back-office processing can lead to millions of dollars of incremental EBITDA improvement in short-order thereby significantly altering the investment profile of the carve-out.

Conclusion

With an economic downturn on the horizon in perhaps the short term, investors can expect a strong volume of carved-out entities hitting the market.

Though many of these opportunities will be appealing, prospective investors need to be cognizant of the specific complexities involving successfully executing a carve-out.

To this end, leveraging an experienced service provider has the proven tools is critical as is leveraging proven technological advances such as cloud computing and outsourcing to significantly improve the cost position of the carved-out entity.