Perspectives on the IT target operating model in carve-out transactions

Executive summary

Designing the right IT operating model is vital to the success of any carve-out process. A disjointed IT can lead to significant overhead costs, impede processes and put business objectives at risk. Whether you are involved on the sell side or the buy side, it is essential to obtain clarity and guidance about post-closing IT operations to avoid unforeseen costs and unexpected delays.

Different carve-out archetypes call for different approaches, and IT is a crucial driver for business value in every archetype. Sometimes, an existing IT landscape can be separated and remain in use post-closing. Or the buyer can migrate the IT landscape to an existing system by transferring all the seller's relevant data. Alternatively, the buyer might implement a new cloud solution that accommodates more features and advanced technologies.

The type of IT target operating model will depend on the seller's objective in divesting the business, the business dynamics with respect to the bidding landscape, the buyer's strategy in operating IT and the existing IT landscape of the business to be divested.

Using Deloitte's IT target operating model framework as a basis, this paper provides insight on key issues to consider for three carve-out archetypes that have been defined in this paper.

There may not be a one-size-fits-all approach when it comes to developing an IT target operating model, but you can rely on our basic framework to make sure you cover all the critical topics and avoid any major pitfalls that may impact IT operations in the future.

Starting with a solid understanding of IT target operating models can help you reduce business continuity risks and better forecast IT costs. Our experience with carve-outs in the past has shown that IT costs account for a significant percentage of total costs relative to non-IT costs. If the buyer needs to set up a separate stand-alone IT organization or rebuild numerous applications, most of the one-off costs are for IT.

This paper will shed light on the complexities and dynamics of three carve-out archetypes from an IT perspective to help IT executives better navigate carve-out transactions.

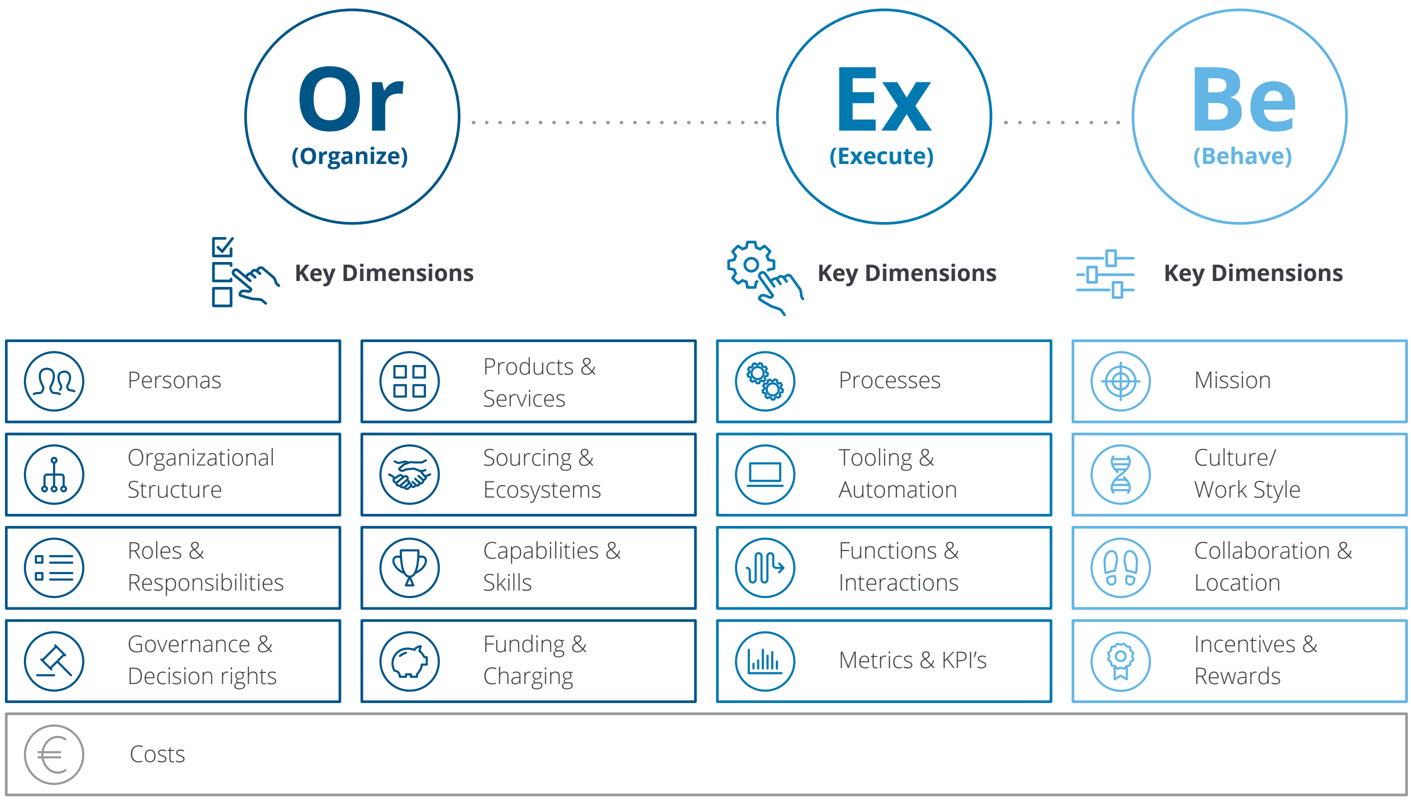
Designing the right IT operating model is vital to the success of any carve-out process. Different carve-out archetypes call for different approaches, and IT is a crucial driver for business value in every scenario.

Framework for defining an IT target operating model

The IT target operating model is an integral part of the overall carve-out journey. Having an effective delivery and management for the existing applications and infrastructure is no longer enough to build and operate the new entity's IT activities. Enterprises have to pre-empt disruptions on the technology landscape and find ways to deliver business value. Dramatic shifts in technology, work models, and business expectations are changing the way we want technology to organize, execute and behave. An operating model helps enterprises ensure their business strategies and goals are aligned, outlining the different ways technology can create value for the organization.

Deloitte's IT target operating model framework covers 17 separate areas grouped into three central categories: "Organize", "Execute" and "Behave".

Fig. 1 – Framework for IT target operating model



We use Deloitte's IT target operating model framework as a basis for the IT carve-out archetypes in this paper. When it comes to M&A deals, cost is usually one of the key topics to consider. Here, we focus on the IT structure by outlining the implications of and approaches to the three carve-out archetypes in five of the above 17 areas. Based on our experience in previous projects, the areas that are particularly relevant in M&A settings, and those addressed in this paper, are as follows:

Products & Services
Identify which products and services the entity has at the macro level. Consider what channels clients use to obtain those services, including long-standing value streams for the business. Assess what services are provided and what technology solutions are in use. Determine if you can use standardized solutions for any services as well as their corresponding application(s) and infrastructure, and where you may need custom solutions.

Capabilities & Skills
Determine which capabilities and skills you need, and at what proficiency level, in order to execute the processes with the level of maturity required. Detect where gaps exist and what improvements are necessary to deliver on the business strategy. Define what features you can standardize and manage centrally versus those that need to be managed regionally or assigned to different business units to reduce complexity and drive productivity.

Organizational Structure
Identify the existing IT structure and the way tasks are structured into logical groupings. Clarify the associated reporting lines and responsibilities. Consider which regions and countries should ideally be included in the IT division's geographical footprint. Decide which main locations and regional hubs (if required) are relevant. Keep in mind how to source the capabilities you need and group them in a way that minimizes unnecessary bureaucracy and offers more agility and higher profits.

Governance & Decision Rights
Define who makes IT decisions within the enterprise, how responsibilities and mandates are assigned, and what decision-making structures are in place. Take into consideration how to streamline IT structures and roles to foster efficient decision making. Specify global and local rules for managing the product portfolio to deliver against the company's strategic objectives.

Costs
Estimate the financial implications (one-off costs) of the carve-out and implementation of the new entity's IT landscape. Assess the (annual) costs needed to operate the target IT landscape (run rate). Pay close attention to the underlying assumptions used for this calculation. Identify any potential for cost optimization and synergy/dissynergy effects associated with this type of carve-out.

Best practices and pitfalls when establishing the IT target operating model in three carve-out archetypes

There are many possible archetypes in terms of the long-term legal structure and operations of a carve-out entity after an M&A deal. Our paper focuses on three carve-out archetypes as presented below, which cover the most common cases.

Fig. 2 – Carve-out archetypes

Stand-alone carve-out	Acquisition carve-out	Joint venture carve-out
Carve-out entity as a stand-alone entity not integrated into the buyer's existing structure	Acquisition of the carve-out entity by a third party (buyer)	Alliance of two or more (often similar) units to establish a new, separate and typically jointly owned entity

Figure 1

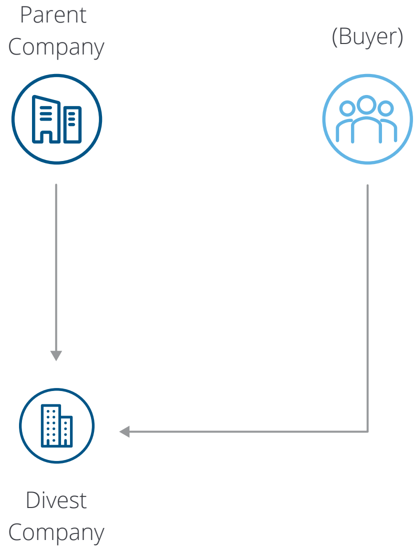


Figure 2

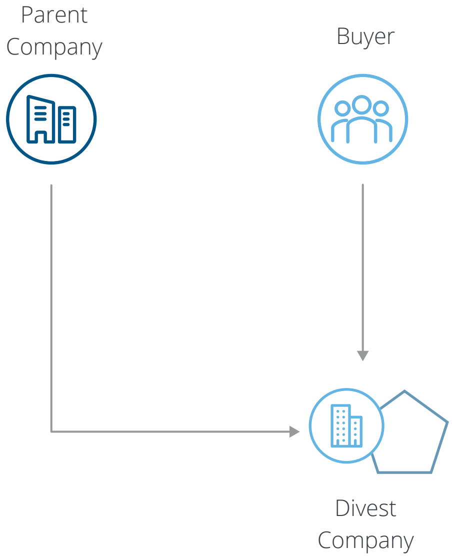
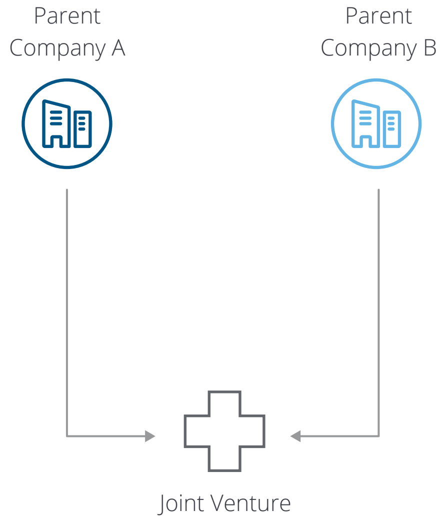


Figure 3



These three carve-out archetypes differ depending on the way the carve-out entity (hereafter called Divest Company or DivestCo) is run from an IT perspective after it separates from the Parent Company (ParentCo). If the DivestCo is not integrated or merged with another entity, it becomes an independent entity (stand-alone carve-out, Figure 1). In both an acquisition carve-out (Figure 2) and a joint venture carve-out (Figure 3) there is a fusion with another entity, which may require significant integration effort once the entanglements with the ParentCo have been dissolved. In the case of an acquisition carve-out (Figure 2), a third party buys DivestCo, and the buyer controls all IT operations after the separation from the ParentCo is complete. The buyer can integrate DivestCo's IT operations into its own IT landscape, provided it has one. For the joint venture carve-out (Figure 3), two entities form an alliance to pursue a common objective. They will have to build a new IT system based on the system at one or both of the ParentCos or, alternatively, build a new greenfield solution. The two ParentCos share responsibility for the joint venture and work together on the IT set-up.

Deep dive 1
Stand-alone carve-out

Overview
- In a stand-alone carve-out, the DivestCo will typically operate the business on its own without relying on the ParentCo or the acquiring company. It therefore requires its own HR, Finance and IT departments as well as other corporate functions. This is a typical scenario, for example, in the context of an IPO where a ParentCo plans to sell, either in part or in full, its stake in one of its business units to the public. Or if the buyer is a financial investor with multiple companies in its portfolio that are operated independently of each other. There is no added complexity in this scenario when the entity is divested again at a later date.

Implications
- It typically takes a lot of time and effort to create a new legal entity with a dedicated management team and board of directors, to establish new corporate functions and to avoid stranded costs (managing cost structure on ParentCo side). IT is one of the major drivers of complexity because of the extremely entangled processes and systems that exist between the ParentCo and the DivestCo.

- Setting up separate and independent IT departments for both the ParentCo and the DivestCo will generate one-off costs to separate the operations and the systems (e.g., ERP) and to build a stand-alone IT target operating model incl. IT infrastructure.

Target Operating Model
A lot of planning goes into a stand-alone carve-out of IT to ensure business continuity as the deal progresses. When you are defining an IT target operating model, there are several strategy considerations in terms of the overall business rationale, the preparation and transition activities (TSAs) and target-setting for the future IT. The following factors provide insight and guidance for designing an IT target operating model in this scenario:

Products & Services
In a stand-alone carve-out, it is essential to define the nature and scope of the products and services before setting up the future application and infrastructure landscape. There are different approaches you can use in this context, e.g., starting with the services provided by the ParentCo. A carve-out also offers an opportunity to streamline and modernize the IT landscape of the stand-alone entity. This promises a lot of benefits for the future business, including reducing the projected operation costs (run rate) of the IT applications/infrastructure, improving usability and increasing productivity. To identify which products and services are needed and to optimize their potential, everyone from IT and business stakeholders to the DivestCo executives need to be involved. This will ensure that you address the needs of the future business and track the improvements, typically leading to a trade-off between using an existing and proven IT landscape and considering the potential of an upgrade while also ensuring business continuity throughout the carve-out process.

Capabilities & Skills
Capabilities help to reflect different business needs, and as such they can be a useful tool during the design of a stand-alone IT target operating model for strategic planning, aligning business processes with previously defined products and services and supporting design decisions. Stakeholders from business and IT should be consulted during the carve-out to pinpoint the capabilities required, which might extend to new developments in the IT landscape set-up (e.g., cloud infrastructure). They can rely on a capability mapping tool to assess what is needed in the target IT organization. This will allow IT leaders to identify gaps in the products and services and close them with new capabilities in the target IT organization as part of the transfer of resources.

Organizational Structure
It is common during a carve-out to design a structure for the stand-alone IT, because it provides a clear overview of the different tasks to be assigned and the resources required. This can then be used as a guide when designing an effective IT structure.

A common question that arises in this context is whether the ParentCo can transfer existing staff to the DivestCo or whether the DivestCo needs to build up and recruit its own resources during the transition. Where the latter is the case, the DivestCo can initiate a talent acquisition and hiring process designed to fill any gaps in capabilities and skills.

Governance & Decision Rights
Governance plays a significant role in IT decision making, and as a result the new entity must define its governance struc-

tures early in the carve-out process. After all, there will be a lot of decisions to make during the development of the stand-alone IT target operating model, especially during a carve-out transition. With a proper governance model in place, the entity can initiate and manage those decisions.

Among the measures to be considered and carried out early on are, for instance, onboarding a CIO immediately after signing and setting up a program for the transition period (including roles and responsibilities, SteerCos, architecture governance, decision making, risk management, budgeting, escalation processes, etc.). This will ensure business continuity throughout the carve-out process and an orderly TSA exit.

IT Costs

It is important to estimate the one-off costs associated with a stand-alone carve-out of IT (costs for the separation and development of a stand-alone IT target operating model) and the projected run rate (annual IT spending).

Stakeholders can take a bottom-up approach to calculate the one-off costs by estimating the effort required to implement each IT service, including the purchase of any additional hardware and software. Incorporating knowledge of previous transactions and from (internal or external) experts will make these estimates more accurate. Accuracy can vary, however, depends on the underlying assumptions (the technology stack, the degree of on/offshoring for implementation projects, the scope and scale of the effort required for customization, migration, etc.) and needs to be refined throughout the transaction.

Bottom-up and top-down approaches, or a combination of both, can be used to determine the projected run rate. A top-down approach relies on benchmarks and metrics, ideally specific to the carve-out context (industry, expected number of employees, projected revenue, etc.). A bottom-up approach takes into account the existing internal charges relevant to IT for the specific business unit, while also analyzing potential adjustments to the stand-alone IT target operating model for issues such as products and services, geographical reach of the IT organization and underlying technology.

Key Takeaways and Recommendations

- A stand-alone carve-out requires extensive planning because of the complex entanglements between the DivestCo and the ParentCo as well as the need to create a separate IT for the DivestCo without jeopardizing business continuity.

- The design of the IT target operating model must reflect the need for a stand-alone IT as well as any future business requirements. It is important to consider the following early in the process: obtaining buy-in, finding the right target IT landscape, setting up governance structures (including a wide group of stakeholders from business and IT) and ensuring staff with the required skills is involved and available during the transition and for the stand-alone IT target operating model.

- IT costs are often high in a stand-alone carve-out, including the cost of operating a stand-alone IT function, which we can estimate using a bottom-up or a top-down approach, or the one-off costs to build the stand-alone IT target operating model. It is important to calculate the projected one-off costs early on (typically in a bottom-up approach) to ensure that you have the budget in place and that the payment terms are agreed in advance (e.g., as part of the pre-signing or negotiation phase with potential buyers).

Deep dive 2
Acquisition carve-out

Overview

- In an acquisition carve-out, a third party is the buyer, which typically integrates the DivestCo fully into its own organization. The DivestCo is dependent on the corporate functions of the buyer and will typically adopt these functions. The new entity tends to use the buyer's IT systems after the transition phase; however, it may have additional requirements that are not yet covered by the buyer's existing IT target operating model. There may also be specific business processes that only apply to the DivestCo. In some cases, the buyer might also consider adopting certain systems, processes, etc. in use at the DivestCo.

Implications

- A key issue in the acquisition carve-out archetype is whether the buyer's IT organization is prepared and mature enough to integrate the DivestCo into its existing platforms and processes. This will depend on how easy it is to close potential service gaps and how quickly the buyer can adapt its IT operating model to fully integrate the DivestCo, including the transition timing and the TSA terms. To ensure seamless integration and business continuity, it is vital to identify whether all relevant IT services are covered by the buyer's existing IT structure.

- Potential challenges that can arise in an integration such as this relate to change management (e.g., dedicated training for the employees of the DivestCo), data integration (e.g., due to migration efforts or finding the right temporary interfaces), asset management (e.g., due to upscaling or rightsizing of existing IT contracts) as well as systems and processes (i.e., whether the buyer's IT organization is prepared and mature enough to integrate the acquired business).

Target Operating Model

Products & Services

In preparing for the carve-out transaction and the subsequent transition to the new carved-out entity, it is essential to analyze the products and services required for the DivestCo and to make decisions on how to proceed in the future. Depending on the size of the DivestCo, it may be useful to consider upgrading the buyer's IT systems as part of the acquisition. The next step is to ensure that all of the DivestCo's business critical products and services are covered in the buyer's IT set-up, ensuring the terminology used in the systems is compatible and that the product versions of the various systems have been mapped and validated to avoid gaps.

Capabilities & Skills

The skills required for the carved-out entity's operations will mostly be provided by the buyer. During the transition phase, the buyer must prepare any capabilities in support of DivestCo's business processes so that they can be implemented and maintained as needed. That is why it is so important to identify the required capabilities and skills early on and to make sure they are aligned (e.g., by involving different stakeholders or by analyzing business processes and the existing IT structure). This will guarantee that specialist talent is available after the transition period and to mitigate potential risks to business continuity. The new entity should leverage the buyer's existing capabilities as far as possible to maximize the synergistic potential and to eliminate the operating costs for IT services dedicated solely to the DivestCo. For instance, the buyer might review its existing "Service Support Management" as part of the deal and decide to shift existing resources or hire additional staff to handle the anticipated increase in IT incidents resulting from the larger user base.

Organizational Structure

Integrating the carve-out entity into the buyer's structure can make or break the success of the transaction. The buyer may have to adapt certain aspects of its organization, e.g., the size of existing units or the different time zones used in the various departments where geography is a factor. It is, however, best practice to leverage the existing structure as much as possible to serve the DivestCo. Where there are gaps, it is important to make a careful analysis and rely on the existing structure wherever possible without introducing new hierarchies or units specific to DivestCo. There may be a benefit to assessing the DivestCo's best practices to determine whether they could add value for the organization as a whole.

Governance & Decision Rights

In general, the buyer's existing governance structures and policies remain in place. It is important to inform IT users at the DivestCo about the relevant governance processes and policies to ensure a seamless transition of IT services from seller to buyer. An assessment of the changes made to the existing governance structure and policies for the DivestCo will determine whether they might be applicable throughout the buyer's organization. Implementation takes place only after a detailed impact analysis.

IT Costs

There are numerous factors to consider when it comes to the IT costs associated with an acquisition carve-out. The main goal is to keep the buyer's IT costs relatively stable without any significant increases. The first step is to analyze any changes to IT costs that are a direct result of the carve-out, whether it is adjusting for new geographical reach, rightsizing staff or adopting new services. Where there are redundancies in IT services or IT assets (e.g., data centers or ERP systems), an in-depth analysis may find positive synergy effects in consolidation. There are, however, additional one-off costs for integration or consolidation, so it should be budgeted for the purposes of a cost benefit analysis.

Key Takeaways and Recommendations

- In an acquisition carve-out, it is vital to identify the IT requirements of the DivestCo and to evaluate whether the buyer's existing IT landscape can accommodate them for the integration to succeed. This may force the buyer to make adjustments in terms of capabilities and skills.

- Imposing the buyer's way on DivestCo could lead to loss of staff and/or motivation impairment.

- The DivestCo's data and assets must be integrated into the buyer's IT landscape by the end of the transition period to keep the DivestCo in operation and avoid any business continuity impacts.

- Embracing synergies and closing gaps in the IT landscape and in the product and service portfolio is critical for the success of the acquisition process as a whole.

Deep dive 3
Joint venture carve-out

Overview

- In a joint venture carve-out, two or more companies come together and form a new alliance. The joint venture is designed to address a strategic need that they were unable to or did not want to fill on their own. Managing M&A deals is difficult, and joint ventures come with a specific set of challenges that need to be addressed.

Implications

- The joint venture partners typically conduct extensive negotiations to formalize their commitment in a partnership agreement. This involves senior executives of the companies specifying the nature, the strategy and the execution of the joint venture.

- IT can be a differentiating factor in a joint venture's success. Depending on the strategic goals of the alliance, a greenfield solution might be the best option or a best-of-breed concept that relies on the existing IT landscape of either one of the joint venture partners, including add-on transition services agreements where necessary.

- Setting up a stand-alone IT function specifically dedicated to the joint venture may generate one-off costs for separating all operations and systems (e. g. ERP), if applicable, and for building a stand-alone IT target operating model including the necessary IT infrastructure.

Target Operating Model

Products & Services

The nature and the strategic goals of the joint venture usually determine which products and services are required. IT provides services in response to the needs of customers as well as the business. The resulting portfolio might be very similar to that of the joint venture partners, but it can also vary significantly if the new entity operates in a different field than the joint venture partners. The product and service portfolio serves as a starting point for the definition of the IT target operating model and therefore has to be closely aligned with stakeholders from business and IT.

Capabilities & Skills

For the joint venture to be a success, it is crucial to define the exact set of capabilities and skills that is needed early on to implement the business requirements, typically by obtaining a commitment from the management of the joint venture.

Organizational Structure

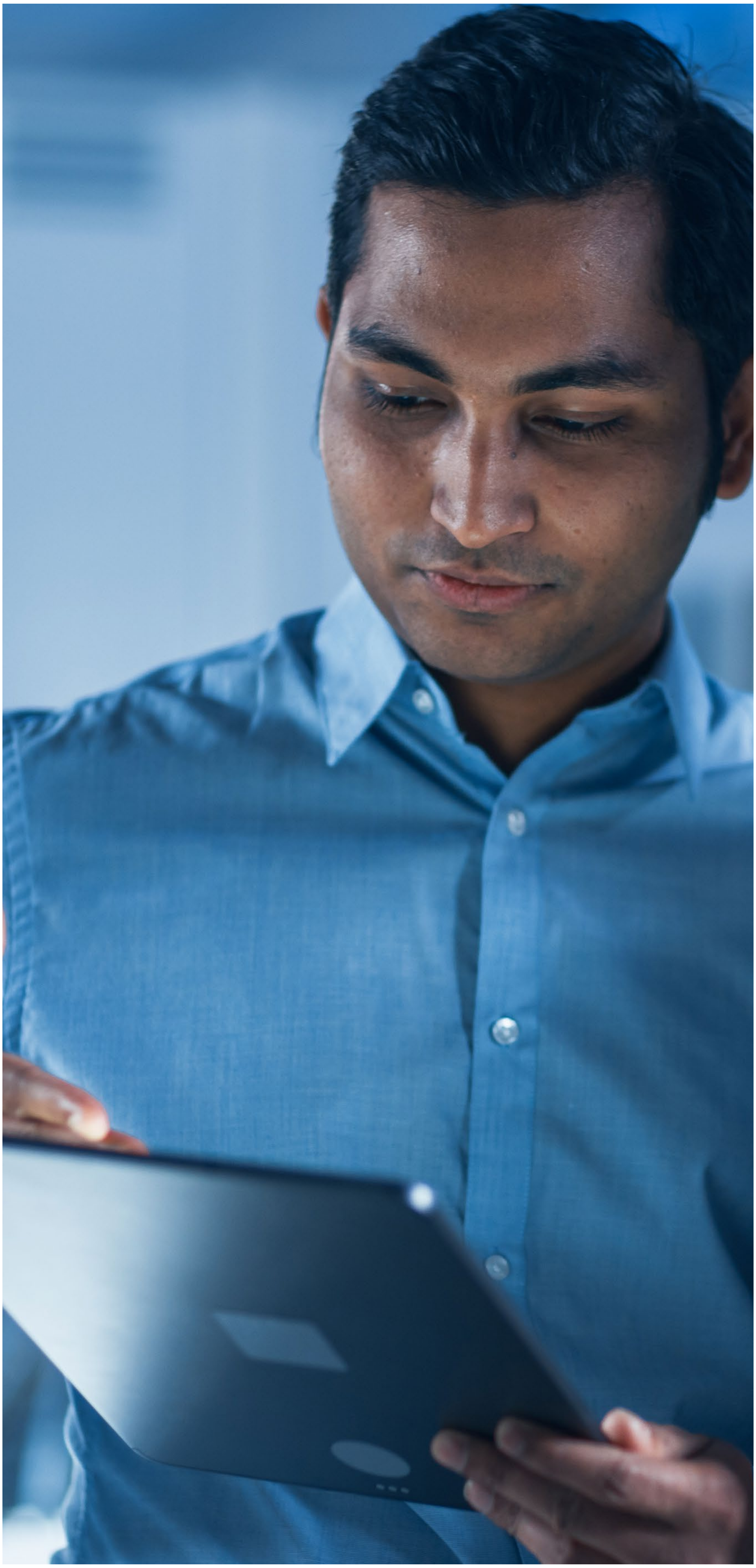
Ideally, a dedicated team manages the entire transition, making sure that the IT is up and running. At the same time, the joint venture partners should be deciding on the IT structure based on the customer requirements that are driving the relevant products and services. This enables the new entity to aggregate the respective capabilities and skills into logical groups and adopt a staffing model. The best way to transfer expertise from the partners to the joint venture itself is by transferring people rather than processes and contracts. Depending on the degree to which the new entity is dependent on the joint venture partners, a supplier network might include external and internal resources.

Governance & Decision Rights

A structured partnership can only work if there is mutual agreement on the respective contributions, limitations and future operation of the joint venture. For the launch of the joint venture to be a success, it is critical to put together a project management plan early on. It can be particularly challenging to set up the joint venture's board and establish its governance structures, because each partner has different agendas, needs, ideas and priorities. Acknowledging each stakeholders' interests can lead to delays, unresolved issues and political difficulties. A governance structure that is established early on promotes shared and clearly defined responsibilities that will help facilitate decision-making and issue resolution. This will enable management to deliver on the requirements of the respective joint venture partners and the venture's actual business. The challenge lies in finding the right balance between promoting entrepreneurial spirit and providing sufficient structure for the joint venture.

IT Costs

Since the joint venture partners provide certain services for the joint venture in most alliances, the new entity may not need to setup IT services itself. Certain one-off investments will still be needed for the IT landscape, which, depending on the type of set-up, may include separation expenses, the cost of hardware and licenses as well as various project costs associated with the set-up.



Key Takeaways and Recommendations:

- Joint venture partners should make decisions about the IT target operating model guiding principles early on rather than during the execution phase. Some of these decisions will relate to delivering the IT target operating model, with target milestones and financial commitments reflected in the partnership agreement.

- If they fail to do so, the disparate interests of the joint venture partners and the multilateral decision-making process will prevent the partnership from achieving its strategic goals.

- It may take a lot of effort for a partnership to become operational, which is why it is so important to define a cohesive IT target operating model and establish a product-centric IT structure.

- Clear organizational and governance structures as well as decision-making protocols are essential for the success and the financial performance of the joint venture.

Basic considerations when defining an IT target operating model

As described above, there is no one-size-fits-all solution to create an optimized IT target operating model in a carve-out deal. The plan should be developed based on the post-deal structure of the carve-out entity and in close collaboration between seller and buyer to come up with a win-win solution.

When it comes to defining an IT target operating model, there are some considerations that apply in every scenario. We use the insights gained in recent projects to describe these considerations along with some good practices designed to reduce risks and improve transparency. There are also some issues to be aware of that will help stakeholders avoid negative impacts during the carve-out.

Good practices

- Obtain buy-in from the DivestCo management on the IT target operating model plan to ensure all business impacts are considered and secure firm commitments for the execution of the agreed approach.

- Include IT experts from ParentCo and DivestCo in the IT target operating model planning, as they have the most profound knowledge about the respective IT environments and the potential implications of the carve-out.

- Estimate costs using a bottom-up approach, while also leveraging any data points from past carve-out projects, as opposed to relying only on top-down benchmarks to make estimates more realistic.

- Consider the location strategy in terms of costs, the business premises and scalability to ensure all critical business locations are covered with the appropriate time zone .

- Validate the available information on existing IT applications for the carve-out entity in a review process led by IT experts as well as business owners.

- Establish a process for dealing with gaps that arise despite careful planning during the carve-out, (e.g., extending services that were received as part of the business-as-usual activities prior to separation at a similar cost plus an appropriate margin). It is also vital to agree a mechanism for closing service gaps and avoiding unnecessary delays prior to the process.

Issues to avoid

- Planning major changes to the IT landscape on Day 1 if they can also take place during the transition phase. You need a robust system and staff readiness to handle that much change management on Day 1. As ownership of the carve-out entity does not transfer to the buyer until Day 1, it can be challenging to delegate tasks to people who are not officially on the buyer's staff or working for the JV yet, e.g., conducting trainings.

- Not having a clear understanding of the cost ownership for the separation of the IT system and any re-build required, as this can be a potential point of contention during execution.

- Inheriting legacy systems and their complexity as well as creating potential redundancies (especially in systems, data and business process).

- Lacking information around end-of-life systems and their implications in terms of hardware and risk. Depending on the risk, the DivestCo might need to upgrade the technology baseline after closing, which requires additional planning, effort and cost, and may delay other re-build activities.

With so many parameters impacting the carve-out transaction, it is vital to carefully plan and thoughtfully consider these critical issues when you are developing a suitable IT target operating model. Transparency and communication between the seller and the buyer always play an important role in this process.

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