Deloitte.

Faster divestitures through Transition Service Agreements (TSAs)

December 2023

Content

Foreword

In recent years, businesses have faced unprecedented challenges both globally (e.g. COVID pandemic, disruption of supply chains) and in the EMEA region (e.g. war in Ukraine). This has forced organizations globally to redraw their strategic plans and focus on protecting their core business lines. At times, this has meant redefining the 'core' itself. As a result, divestiture activity has increased, which provides insights into how global enterprises are looking to unlock value, exit their non-core assets or simply generate cash for growth or restructuring. Once the decision to divest is taken, the clock starts ticking on closing the transaction and adapting to the new operating construct.

However, it is not easy to discover the knotty labyrinth of dependencies built over many years within the short timelines of a deal. Both parties spend significant energies to cut the linkages, and speed through disentanglement of processes, systems, and talent. This is where Transition Service Agreements (TSAs) come into the picture. TSAs help maintain the business as usual, allowing the deal to get executed, while the linkages to the parent company are redrawn. This paper is intended to highlight some key challenges in setting up TSAs and laying out the must-dos to help reduce risk and maximise value from a divestiture.

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Setting the context

The recent global challenges pushed many businesses into a period of unprecedented uncertainty, resulting in increased operational costs, and decreased funding and market opportunities. Deal activity was also muted as companies and private equity funds adopted a cautious approach. As the world slowly emerged from the impact of the pandemic, the M&A deal space recovered; While there was a slight drop in deal values for the EMEA region in 2020, private equity firms had amassed unused funds which lead to an increase of deal value by appr. 82% in 2022 compared to pre-covid times. However, the market proved to be volatile due to political uncertainty, leading to a slight decrease in deal values in the same year. Despite this development, divestitures are expected to continue with businesses facing rising needs for cash as well as restructuring. These elements across the ecosystem have created the right conditions for several businesses to restructure themselves. As a result, businesses are expected to stay focused on selling off non-core assets and performing portfolio reallocation through divestitures. Though the deal space for divestitures looks promising, organisations will typically find that a divestiture involves executing a multitude of complex activities, for which they may not have the requisite experience within their teams.

This paper provides details of a frequently used instrument used to overcome some of that complexity. The instrument also helps set up the divested entity and continue with business as usual, even after separating from its parent.

[1]Source: Deloitte


Signature

Divestitures and their impact on business continuity

Divestitures are complex as they have an impact on people, processes, and systems that are deeply integrated within the parent business, especially when services and infrastructure are shared across multiple business units. Certain capabilities once owned by the parent can be transferred to the buyer on Day 1, whereas others can take a much longer time, often elongating the entire divestiture process. The complexity further increases as the legal separation from the parent can potentially have an impact on business continuity. Hence, organisations face challenges in successfully executing divestitures across multiple dimensions within a compressed timeframe while maintaining business as usual.

This is where Transition Services Agreements (TSAs) come into the picture. TSAs eliminate some of the complexity involved in setting up and ensuring the carved-out entity's business as usual, even after separating from its parent.

A TSA is signed between the two parties in a divestiture that provides key services across functional areas for businesses-in-transition after their legal separation from their parent companies. TSAs are most often used where the buyer lacks the necessary capabilities to support the carved-out business on its own at legal Day 1 of separation. These agreements are intended to minimise operational disruptions until the ecosystems of the seller and the buyer can be fully disentangled. Organisations also turn to TSAs when the deal closes even before the buyer's organisation or the seller's remaining organisation can accommodate the impact of carve-out.

Divestitures provide significant hurdles depending on the degree of entanglement of the divested assets between the parent and the divested unit. To understand the impact on the enterprise following the divestiture, identifying the changes that will occur across affected areas is important.

Vendor relations

Organisations usually manage their operations with a mix of third-party services or vendors. During a divestiture, the outsourcing entity's contract with the parent/seller must be extended to the newly unaffiliated firm. Failing to do that may result in continuity issues, affecting the business as usual.

A well-written TSA can help spell out parameters for the transfer of third-party services while still allowing enough flexibility to the divested unit. This may include the vendor's agreement to provide a short-term service or provisions for reasonable extensions with an adequate notice. The seller must refer to the original contract and discuss it with the vendor before finalising the TSA between the two entities, to ensure that the TSA is permissible and implementable.

Key human resources

During the separation, employees may be uncertain about the future state of the business and their respective functions. Key people from the support functions who have been providing services to the carved-out unit may be affected by the separation process. Any attrition amongst these key people is likely significantly affect the inherent value of the carved-out entity.

The seller needs to develop a risk mitigation strategy to counter such a scenario of resource attrition and preserve the value of the carved-out entity. In such cases, companies have often resorted to providing incentives to the key resources to ensure that they continue at least over the transition period. In other cases, additional contract employees from external service providers are onboarded to ensure that business continuity can be maintained over the period of the TSA. Close communications with the buyer will also be required to ensure that any issues are highlighted well in advance. Moreover, solutions should be well thought through and properly crafted in TSA that progressively transitions and disentangles the team from the firm over a reasonable time that would be required.

IT data and services

When a business unit is sold, IT assets from hundreds of suppliers of individual products, subscriptions, and services must be divided. If the divested unit does not require assets, the parent company would want to reduce its footprint to control stranded costs.

Case study

Given the significant IT entanglement between companies and the effort required to separate large-scale systems, IT TSAs are usually the most common and long-lasting functional TSAs. In the process of separating a globally leading Automotive company, a significant number of approximately 250 TSAs (incl. more than 120 IT TSAs) were created to guide the operational transition. An effective project management, monitoring, reporting and TSA exit planning were indispensable to navigate challenges and manage risks associated with the transition process while ensuring business continuity after successfully executing the separation process.

Source: Deloitte

In most instances, however, the parent company may be required to offer these services for a length of time after the divestiture, by way of TSAs. Due to the complexity and time required to separate IT assets and services, and establishing new ones, IT TSAs tend to be the most complex and run for the longest periods. Buyer organisations should adequately budget for obtaining IT services through the TSA mechanism, even as they are likely to be spending significantly to set up their independent IT operations.

Effective planning of TSAs

#1 Define the nature of services to be extended even before a buyer is identified

Even without an acquiring business in place, a divesting firm can do its disentanglement evaluation and probable TSA planning. This allows for early negotiations about what services and levels it is prepared to supply and what it would cost for the parent company to provide those services. The teams will need to leverage functional blueprints to agree on the scope of services or processes to be covered under TSAs. After a buyer is identified, the aim of both the entities should be to fix the scope of various services during the initial negotiations to provide both the entities clarity on the details of the services being negotiated. The final list of TSAs may differ from the original list as the buyer may have a substitute service/ process already in place either in-house or through a vendor providing similar services.

Case study

A leading global automotive Original Equipment Manufacturer (OEM) decided to carve-out its passenger vehicle business to form a joint venture with another OEM. This transaction was required to be executed in a relatively short timeframe and multiple dependencies existed across various teams of the OEM as well as multiple vendors. Many of these vendors are spread across different parts of the globe. In addition, there was a complex set of technologies and systems that had to continue to function since Day 1, to ensure that production would not be affected. To preserve continuity beyond Day 1, TSAs were drafted and executed for the carved-out entity, for over 125 services across functions, including manufacturing, sales and marketing, post sales logistics, product development quality, purchase, as well as enabling functions (such as IT, HR, finance and accounts, tax, and legal/regulatory). Three types of TSAs were identified – i) those with a fixed service scope and duration; ii) event-based ones where the exact scope would be available only in case the TSA was triggered (for example, technical support that would be provided on a need basis); and iii) pass through TSAs, for certain vendor-provided services that would continue to be availed after Day 1.

Source: Deloitte

#2 Set up the right team for the planning and execution of TSAs

Not identifying key people required for the service delivery while drafting a TSA can create a roadblock if the key people exit before the TSA is in effect. The TSA is set up correctly only when the roles of the seller's resources are established upfront. The operations and IT teams must be made part of TSA discussions right from the scoping stage as they would be the core part of the team delivering or availing the TSA.

A clearly defined escalation path to resolve any issues, such as performance levels, functional support, and other exigencies will ensure a smooth transition. A regular cadence should be set up through a joint steering committee, involving the leaders of the seller and the buyer to resolve any key roadblocks arising during the TSA period.

#3 Focus on speed rather than achieving high-performance levels

The buyer and the seller need to agree on performance metrics to measure the delivery of services for each TSA service. Rather than focusing on building in higher-than-necessary service level targets, the focus should be on completing the transition as quickly as possible with the agreed service levels as defined in the TSA. Specific penalties should be included for cases where the seller fails to meet the agreed service levels.

#4 Be prepared for the post TSA phase

The buyer and the seller should agree on a TSA exit approach and transition timeline for each service in the TSA schedule to ensure a comprehensive approach that minimises exit risks. While developing the exit approach, the buyer's teams need to ensure that they decide on whether they plan to build, outsource, or terminate the function. TSA teams should work with functional teams to understand interdependencies in services and develop an exit plan that lists the required steps to exit. Early planning will provide sufficient time to validate exit plans with corporate functions and the affected business units. Both the buyer and the seller must be realistic about when the TSA can end. Having no visibility over the TSA end date can affect planning and result in a situation where the buyer is not prepared to assume the responsibility to develop the capabilities for the post-TSA period.

#5 Attend to data privacy and IP concerns

With reference to data protection and information security, the post-closing interactions between the seller and the divested firm are comparable to an outsourcing agreement. Even during the transition phase, the divested entity is no longer a group business but a third-party after the deal is completed. Various countries have data protection rules that require approval before disclosing Personally Identifiable Information (PII) to any third party, including the divested firms after the transaction is completed. Both the parties should understand what data is being shared and include the applicable requirements in the TSA.

Some of the considerations are mentioned below:

- What is the type of data and information being exchanged? Is there any PII data with respect to employees, customers, or vendors being accessed?
- How is consent taken from employees or customers for PII data? How are they notified?
- How is the data being exchanged between both the parties?
- Where is the data being transferred from?
- How will the parties ensure that data or information is returned or destroyed after services are completed? What will be done with backup data?
- What data protection and access controls are in place at each entity to control access to PII and secure confidential information? Do any additional controls need to be deployed?

Depending on the data and information being accessed, the parties may wish to include contractual terms around IP using separate agreements, such as an IP Cross Licensing Agreement (IPCLA).

Case study

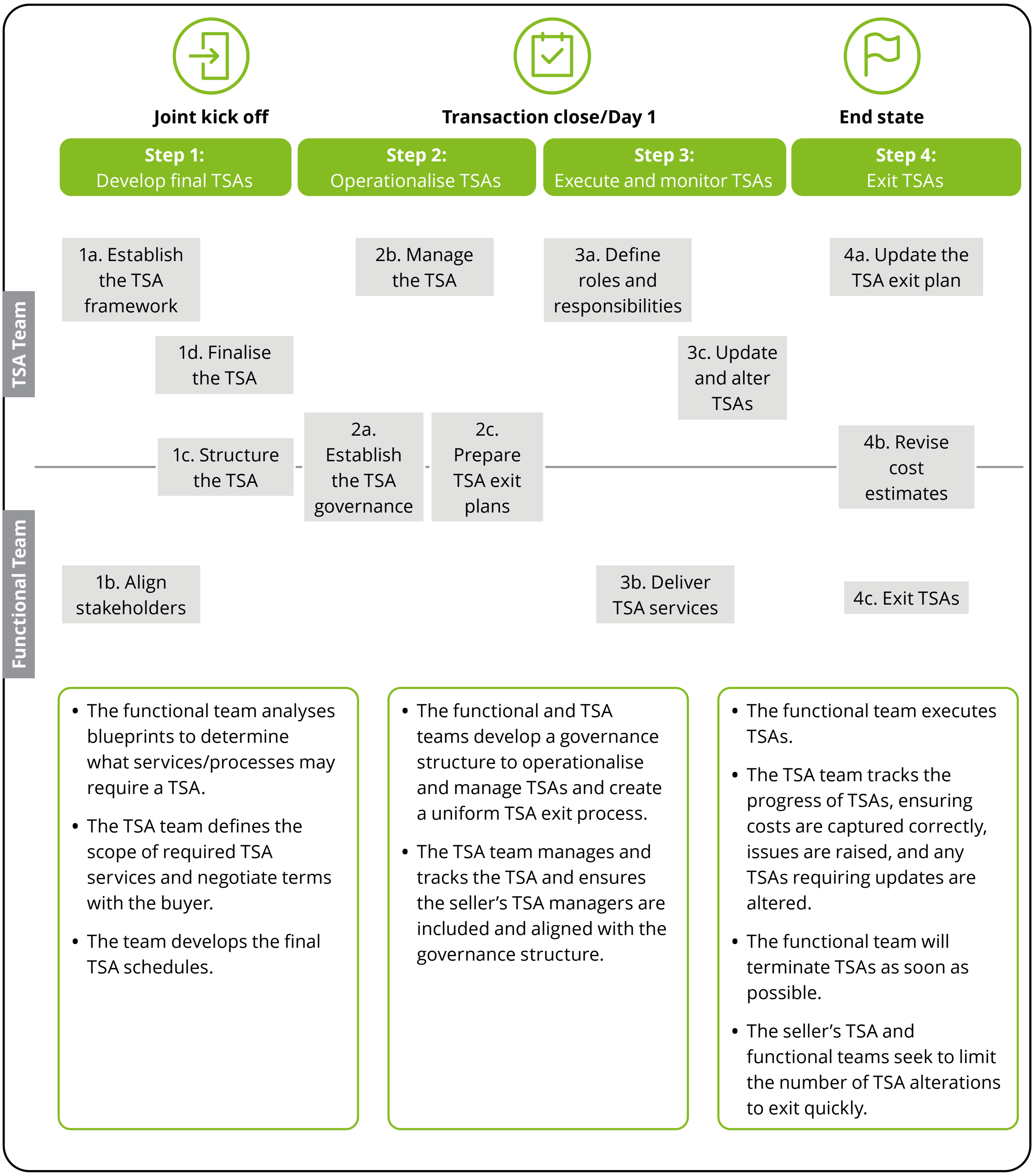
A UK-based pharmaceutical company was selling its consumer health care business to India's largest packaged consumer goods company. Various customer-facing websites and applications were being managed by the parent. As part of the deal, a few of these websites and applications were extended to the divested unit until they are migrated to the buyer. This required the parent to transfer sensitive consumer PII data, such as name, age, mobile number, and pictures, to the buyer securely using encryption. A comprehensive data migration framework was built to ensure business continuity by making the business-critical data available to users in real time.

- Users were informed about the transfer and consent text per privacy policies in consumer-facing websites for opt-in/opt-out.
- A dedicated buyer file server was set up in the UK for data transfer in compliance with buyer security policy for production server.
- The SFTP server was set up for secured file transfer and PGP was used to decrypt the data.
- Access to the data from the buyer server was restricted to select users who have signed up for the NDA.

Source: Deloitte

Setting up a TSA is a complex and time-consuming task. Both the buyer and the seller need to establish a framework for the functional and line of business leads to help develop TSAs. The figure below shows a framework that could help buyers and sellers create a TSA.

Figure 1: TSA process



Source: Deloitte

Cost and its impact on TSAs

Cost is a critical element of a TSA and both the seller and buyer will need to understand cost and its drivers for services being provided. Defining cost components and assumptions used to calculate costs is essential. The seller should conduct a thorough assessment of services and identify costs of delivering and managing these services. One-time fixed costs and recurring variable costs need to be accounted for while fixing service price. This will help both the entities to execute and manage the TSA smoothly.

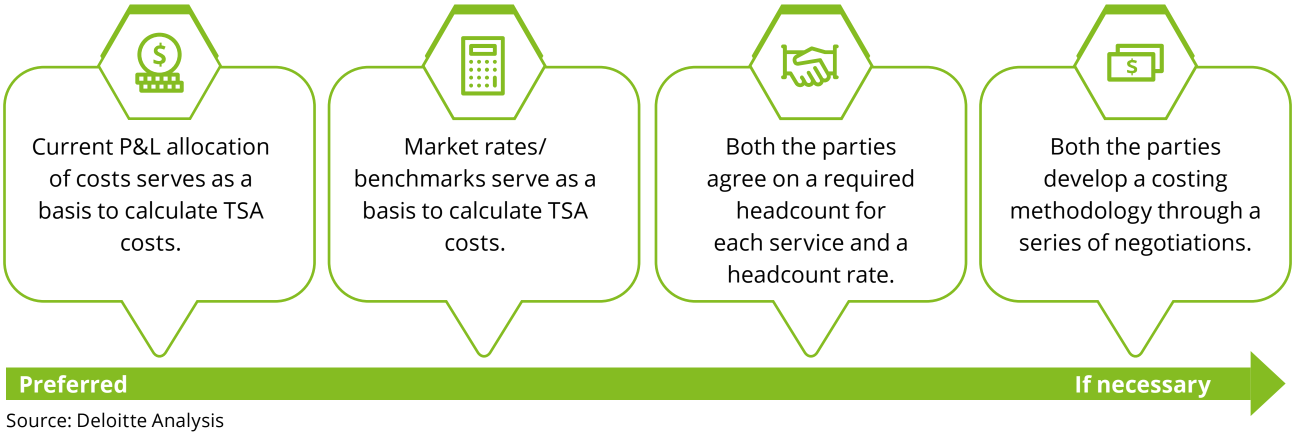
Case study

A global financial and industrial conglomerate decided to demerge its consumer lending and leasing business arm to a private equity player. A detailed IT implementation roadmap was developed for key separation planning activities for the list of items contained in the TSA. A detailed IT cost tracker with one-time and recurring costs over three years was prepared to carve-out the recommended IT applications.

Source: Deloitte

Miscalculating costs by not thoroughly accounting for the conditions that prevail at the time of delivering services may cause the seller to suffer a loss. The seller should ensure that a thorough assessment of services is performed, and costs are identified to deliver and manage these services even before the deal is signed. Multiple methods exist to analyse service cost. The service provider can start by using an existing Profit and Loss (P&L) cost figure. If that figure is unavailable, the provider can use market/benchmark rates to identify TSA costs.

Figure 2: Methods for estimating service cost



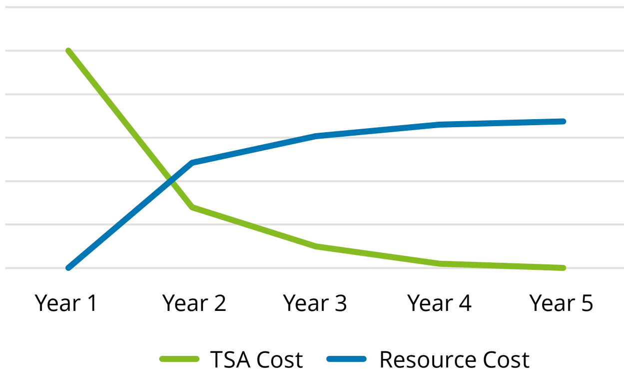
Source: Deloitte Analysis

After determining the cost, providers and recipients will need to agree on a service price. The price will usually have a markup over the costs determined, in addition to incorporating any incentives being given to employees performing services or for engaging third-parties to provide the agreed services.

For the service recipient, TSAs are supposed to be temporary. Understanding how TSAs are scheduled to roll off and when resources or systems are required to be onboarded will benefit the service recipient's planning and implementation.

As TSA resources are charged at a higher rate, the service recipient should analyse TSA roll-off timelines and ensure to build up in-house capabilities in a progressive manner.

Figure 3: Resource vs. TSA costs



Source: Deloitte Analysis

Guidelines for invoicing TSA services must be set up before executing a TSA. Cost centres that will be used to bill each service should be identified. TSA invoicing should include the acceptable payment mode and the billing threshold that is acceptable for billing frequency. TSA invoicing and payment terms should specify the process for filing and resolving billing-related complaints.

Potential friction areas while drafting a TSA

A TSA is complex to plan and execute. As a result, both the buyer and the seller often underestimate the effects of the agreement, losing opportunities to execute it well. The absence of a TSA during a divestiture process will affect the business continuity of the divested business. Poorly planned and managed TSAs can also turn out to be counterproductive. This can result in business interruption, legal uncertainty, and, most importantly, the financial risk to the deal. On the other hand, well-executed TSAs can pave the way for quick, seamless transitions. A few areas where issues can arise during TSA planning are mentioned below.

Terms of services

Differing goals and expectations between the seller and buyer may create some issues. The recipient of transition services will most likely require TSA terms to be relatively flexible, with options to extend it. The service provider who has committed to either scaling back or reducing its commitments to provide transition services (consistent with its internal drive for increased operational efficiencies) will need to know that there is a definite end date. In such cases, a clause to increase the service cost after the agreed time has passed can be added. This move will disincentivise the buyer from extending the term, while at the same time, building flexibility in case of contingencies.

Costing

Given the transitory and short-term nature of TSAs, a service provider should ensure not to underprice their services. They should also keep the costing mechanism and any related reporting or administrative requirements as simple as possible under the agreement.

On the other hand, buyers are wary of overpaying for services, and will usually desire a little more detail in costs.

While the actual cost of resources necessary to supply services should be referenced by the seller, a complex pricing model is likely to require stakeholders to spend significant time in understanding and negotiating costing.

Human resources issues

Staff instability or attrition might put the supplier of transition services at risk of not being able to meet its contractual obligations under the TSA. This is worsened if transition services staff believe they are just performing a temporary duty and maybe retrenched after the transition services contract is over. The parent company may wish to give appropriate retention incentives or other perks to persuade people providing TSA services to stay until the TSA is completed. Even after these controls, some attrition will be inevitable – working around that will become critical to ensuring that TSA services continue to be provided. In such circumstances, the transition service provider may have to rely on third-party service providers to support in areas where internal employees may have exited.

Performance levels

In traditional services and outsourcing contracts, a client usually ties the service provider to contractually binding performance levels and attach penalties (payable to customers) in case the provider fails to fulfill the service level. Although some provisions in a TSA regarding the level of service to be provided to the recipient are possible, a detailed service level will not be appropriate. As a TSA is not a traditional commercial transaction entered into for profit, a service provider will not be motivated to supply transition services if full cost recovery is jeopardised in any manner. Second, a precise service level is not only complex to develop but also time-consuming to negotiate, and run and report against. None of these fits into a quick, short-term agreement.

Negotiation

Based on the extent of service relationships to be covered, negotiations can be an iterative process. The aim of both the entities should be to fix the scope of various services during the initial phases of negotiations to have clarity on details of the services being negotiated. Lack of clarity can lead to unnecessary iteration, and loss of time and effort. Key parameters, such as dependencies, service price estimates, business criticality, and TSA roll-off timelines, should be identified before the initiation of negotiations. After finalising service scope, other important parameters, such as duration and service cost, can be worked out between the two entities.
In special cases, such as joint ventures where the parent company continues to hold a stake in the divested unit or the new company, TSA service delivery can take place from either the parent or the buyer company. In such cases, the Separation Management Office (SMO) is responsible to oversee that the right elements have been covered in the TSA and should work with both the partners to finalise a list of TSAs.

Conclusion

The TSA is a powerful instrument that companies can use to maintain business continuity during divestitures. Both the seller and the buyer typically prefer to minimise the scope of TSAs. The key to a fast and smooth separation is to understand the most common TSA pitfalls and take steps to avoid them. Collaborative communication and selective utilisation of TSAs are crucial. They can help provide both the buyer and the seller the greatest chance of effectively managing the ongoing relationships and achieving their deal objectives. Entities participating in a divestiture can use the inputs provided in this paper to plan and execute TSAs to make them more productive and avoid some of the risks that typically arise through their lifecycle.

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