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Fast break

A way to design and manage TSAs to achieve a fast and clean separation

By Indira Gillingham and Mike Stimpson

Introduction

Shifting economic forces are driving a big boom in divestitures. In 2007, 10 of the 40 largest deals were divestitures, and the trend appears to be growing.[1] One of the most critical elements of a divestiture is the Transition Services Agreement (TSA) in which the seller agrees to provide specific services on behalf of the buyer to maintain business continuity while the buyer prepares to receive and operate the new business. A TSA can accelerate the negotiation process and financial close by allowing the deal to move forward without waiting for the buyer to assume responsibility for all critical support services. However, divestitures that get the TSA wrong may drag on for much longer than expected, which is undesirable for both the buyer and the seller. This article provides senior leaders with guidance and practical advice to consider for using TSAs to achieve a fast and clean separation.

A complex challenge

Divestitures are usually tricky to pull off, particularly when the affected people, processes, and systems are deeply integrated within the seller's business, or when services and infrastructure are shared across multiple business units. Identifying and carving out the pieces in a divestiture can be a complex and time-consuming process; however, with experience and careful planning, an effective outcome for both parties can be achieved. During the planning process, participants from the affected business units on both sides must think through the transition period from Day One to Day Two to determine the strategy for each business process, associated applications, and underlying infrastructure. Depending on the strategy, it may be beneficial for certain services to be covered under a TSA.

A TSA is an increasingly important tool to help the buyer and seller arrive at an approach for achieving a clean separation and to bridge the time period between Day One and Day Two. The TSA is a legal agreement, separate from the separation and purchase agreement, in which the buyer agrees to pay the seller for certain services to support the divested business for a defined period of time. TSAs are most often used in carve-outs where the buyer lacks the necessary information technology (IT) capabilities or capacity to support the business on its own. For instance, many Private Equity (PE) firms rely on TSAs until they can identify and engage an IT outsourcing vendor. TSAs are also often necessary when the deal closes faster than the buyer's IT organization can respond.

The time between announcement and close is often driven by the size of the deal. Small carve-outs can close as quickly as 30 days after announcement; however, even large deals (more than $1 billion) average only 115 days to close. In many cases, this does not give the buyer enough time to respond, particularly when there are anti-trust concerns or confidential information that cannot be shared until after the deal closes. Therefore TSAs can become a vital part of allowing the business to transition or separate quickly.

The double-edged sword

Sellers generally want to keep the number of TSAs as low as possible and the duration of service as short as possible. Many are divesting the business so they can fund or focus on another part of their business, and from their perspective, TSAs can become a nuisance and a distraction from achieving this objective. Additionally, most sellers have little experience or interest in providing professional services to other companies. Buyers, on the other hand, tend to use TSAs as a way to address missed Day One requirements or defer difficult integration decisions.

If not used properly, a TSA certainly can be a crutch and a nuisance. However, when used wisely, a TSA offers some important benefits:

- Faster close
- Smoother transition
- Reduced transition costs
- Better end-state solutions
- Clean separation

Creating an effective TSA

Setting up effective TSAs is a complex, time-consuming task and should not be underestimated. IT specific TSAs are unique in that they often require input from stakeholders across the enterprise and take time to implement especially if third-party vendors are involved to provide the support.

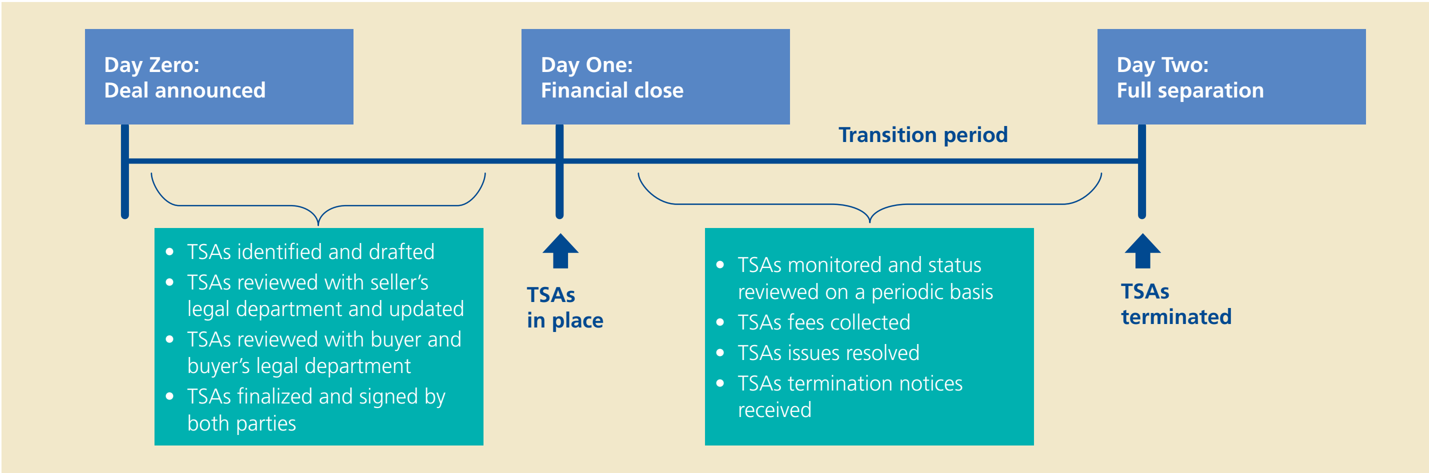
Below are some practical and time-tested tips to consider that could help both buyers and sellers avoid the pitfalls and create an effective TSA.

Understand the exit strategy. Do not use a TSA to put off decisions about the overall integration strategy. Every TSA should be written with an end-state solution clearly in mind. Not only does this understanding help the buyer identify the exact services it needs to develop, it also helps the seller provide the right solutions, services, and resources in the interim.

For example, if the buyer's long-term plan is to outsource payroll, the TSA should make the seller responsible for cutting all payroll checks. On the other hand, if the buyer plans to keep payroll in-house, the TSA should provide for sharing the existing payroll system until the buyer can install a payroll system of its own.

[1] Garver, Rob. "Take a piece of me," http://www.cfo.com/article.cfm/8909803?f=related, 2007.

Figure 1: TSA - Illustrative timeline



Source: Deloitte Consulting LLP

At a minimum, the buyer should identify its high-level strategy — e.g., build, buy, outsource, or terminate the function altogether. Once an overall plan has been established, the team can develop the timeline and estimated costs to implement the plan in the agreed time frame. It is important for both the buyer and seller to be realistic about when the TSA can end. Setting unrealistic targets with the idea that the TSA can be easily extended does not help either organization plan efficiently and ultimately results in the buyer's not being ready to inherit the process, system, or environment. When defining the exit strategy, it is also important to understand the dependencies within and across services to prevent systems and or services from breaking. For instance, security access and control services are typically one of the last to be transitioned, since controlling access to the environment is critical to guaranteeing service levels on services such as network routing and server hosting. Another example is tying services like e-mail and VPN to desktop support, since one can't typically provide support for one without the other.

Understand your costs. This is one of the most important elements of a TSA. To avoid disagreements down the road, both parties must go into the agreement with a crystal-clear understanding of costs and cost drivers. Clearly define the cost components and assumptions that will be used to calculate costs. Identify both fixed and variable cost elements, as well as the factors that will drive cost, such as headcount, office space, location, server utilization, and network bandwidth.

Understanding the cost drivers helps both parties develop a fair plan to migrate off the TSA. For example, activities that are likely to decrease over time (e.g., desktop support migration) might include "step-down events" where costs go down as the buyer becomes less dependent on the seller's services. Other activities that are more likely to remain constant (e.g., mainframe hosting) might be defined at a fixed cost until the last remaining user/resource is removed.

Note that identifying the costs and cost drivers for transition services can be quite a challenge, particularly since most sellers are not in the business of selling services and may lack the systems, tools, experience, knowledge, and skills to accurately analyze service costs. In such situations, sellers should attempt to identify some benchmarks that can serve as a gauge for identifying standard costs for their particular industry and size. These benchmarks can be obtained by performing a quick survey of outsourcing services and the current market rate for these services.

Define the charge-back rules. The TSA must clearly define what services the seller can charge for and how the charges will be made (unless these issues were already covered in the purchase agreement). Defining clear charge-back rules in the TSA allows the tactical teams to focus on delivering services without unnecessary debate.

Prior to Day One, both parties will need to agree on the scope of services to be covered under a TSA. For example, near the end of the TSA the buyer may be expecting the seller to provide migration services, such as extracting data, cloning systems, and sharing their knowledge and experience with the new service provider. Defining the charge-back rules for such activities before the deal closes helps both parties produce a better migration plan and leaves the buyer with some bargaining power with the seller.

Partner with the business. IT is a business enabler. Therefore, every business TSA should be evaluated and paired up with the corresponding IT TSA. Stand-alone TSAs should be avoided, unless there are no reasonable alternatives. Note that individual TSAs may be required for distinct and separate services and for different geographic regions that are providing or receiving service.

Connect the dots. A master services agreement (MSA) can provide an overall structure for all of the TSAs, explains the hierarchies of various documents, and lists the services to be provided. It can also define the billing terms and conditions and describe the overarching principles for terminating the TSA. Last but not least, an MSA can help avoid contradictory language by providing a central location for legal terms and conditions so they can be defined once and then referenced in supporting agreements and exhibits.

Put it in writing. Once the services that will require TSAs have been determined, it is time to put pen to paper. TSAs for every function should follow a standard format and template that has been approved by Legal (see sidebar: Key elements of a TSA). Keep in mind that this is the most time-consuming aspect of finalizing TSAs as both parties contribute to the editing of the content, and both legal departments must approve the verbiage.

> Description of services not included under a TSA — This helps to provide additional clarity on services or portions of a service that the seller does not intend to provide. Remember that the roles and responsibilities of support groups can vary greatly by organization, so they need to be clearly defined.

Designate the manager or executive responsible for delivering the transition services as one of the primary authors of the TSA. This helps produce a better, more realistic agreement and helps avoid confusion and finger-pointing later on. Also, get input from subject matter specialists in each service area (e.g., telecom, networks, help desk) as early as possible.

Writing should be consistent, clear, and concise. Try to be specific and exact, rather than open ended and general. Detailed service descriptions can facilitate more accurate cost estimates and can provide a clearer understanding of what is or is not covered. They also can make it easier to "step down" from individual services when they are no longer required. For example, an "IT hosting" service actually comprises many lower-level services that in certain situations could be phased out individually. Breaking the high-level "hosting" service into more discrete services, such as "platform" (e.g., Wintel, Mid-Range, Mainframe), "job scheduling," "backup," and "server monitoring," could allow a step down in TSAs, thereby reducing costs and accelerating the transition. The specifics of the step-down arrangements should be detailed in the TSA, as in some cases there are no cost advantages to terminating certain services early if the agreement is structured as an "all or nothing" arrangement.

Key elements of a TSA

All TSAs should have the same format and template, and once they are established, they should not be changed for individual TSAs. Here are the major elements to consider for a standard TSA:

- Identification of provider(s) and receiver(s) of services
- Description of services not included under TSA: This helps to provide additional clarity on services or portions of a service that the seller does not intend to provide. Remember that the roles and responsibilities of support groups can vary greatly by organization, so they need to be clearly defined.
- Support processes: These processes should be as close as possible (if not identical) to those currently in use. Be sure to describe the issue management process, current severity levels and their definitions, as well as any associated service level agreements (SLAs). Describe the outage management process and incident communication plan. Because a support arrangement may exist today, the team should attach any existing SLA, trouble management process, or system availability agreement to the TSA as an exhibit.
- Geographic coverage: For multinationals it is important to differentiate where the service is being provided from (and for whom) so there is no confusion regarding overlapping agreements at the global and local level.
- Servers and instances: Specify the service level differences between production and nonproduction environments. Keeping service levels for nonproduction environments can be extremely important, as environments will change in preparation for isolation and separation.
- Special needs: Use this section to capture scope-related items not contained within a previous section. Examples include:
  - Table maintenance: If the service requires frequent access to maintain tables, the team should spell out the table maintenance arrangement.
  - System development: If the teams expect to need systems development (beyond break/fix) during the TSA period, the team should describe system development expectations.
  - User administration: If the team needs the ability to add/modify/remove users from the system, the team should describe the agreement.
- Planned exit strategy
- Length of agreement/termination of TSA
- Cost and invoicing: This section should list the cost and terms (e.g., flat fee, monthly, by user) as well as specify the invoicing details, including process, content, and timing.

Splitting broad services into discrete elements requires an understanding of performance dependencies across different services. Generally speaking, the buyer and seller need to agree about when certain performance levels can switch to a "best effort" basis as a result of changes in other services. For example, if the buyer has taken over responsibility for application monitoring, the seller will not be able to guarantee application up-time.

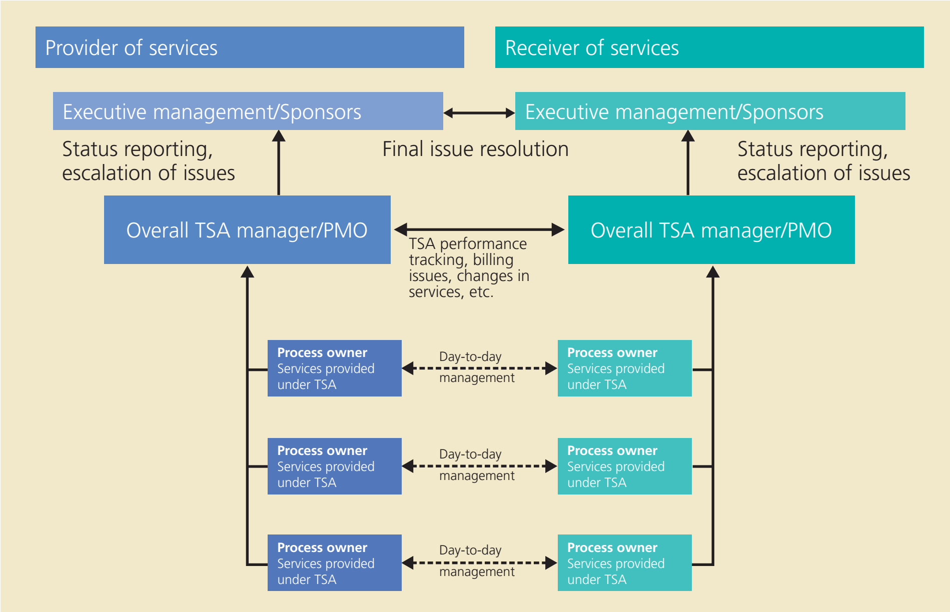
Managing TSAs

Get to work. Signing the TSAs are just the end of the beginning. The real work starts when the deal closes and the TSAs go into effect. As the services are being delivered, it is important to continually track and manage the services that are being performed. It is also critical to keep track of the migration activities and related step-down in services.

The relationship between buyer and seller will inevitably change once the deal has closed, regardless of how well they might have worked together leading up to Day One. Sellers will focus on cleaning up the bits and pieces that the divestiture left behind, and then quickly shift their attention to their retained businesses and other priorities. Buyers may find themselves wrestling with unanticipated service costs and struggling to capture the promised integration synergies as quickly as possible. For both parties, the honeymoon will definitely be over.

To keep things moving forward, each company should identify and assign a service coordinator to manage their part of the overall relationship. These people are similar to the vendor managers who currently exist in many organizations. They do not need to delve deeply into the details of day-to-day operations; rather, they need a holistic view of the services being provided and an understanding of the overall requirements. Their job is to monitor the services being delivered against the TSA and keep the separation activities on track.

Figure 2: TSA management – Example structure



Source: Deloitte Consulting LLP

Retention of key transition resources is another important issue. Sellers will generally want to get on with their business by shifting people to new assignments as quickly as possible. To maintain adequate staffing and performance during the transition, buyers must specify in the TSA exactly which key resources and groups will be retained to execute the promised services.

Be realistic about performance levels. Avoid the common trap of demanding (or promising) better service than existed prior to the transition. In most cases the historic service levels were sufficient to support the business and struck a reasonable balance between service cost and true business needs. Buyers and sellers should focus their attention on completing the transition as quickly as possible, rather than get distracted trying to maintain high-than-necessary service levels.

That said, it is important to precisely define in the TSA what service levels are expected. Simply stating that "existing service levels" will be maintained is generally not sufficient. Often, the seller has not been measuring performance for the services in question. In these cases, it is critical for both parties to agree on the performance metrics and, once agreed, to document them in the TSA.

Establish an exit protocol. A formal exit protocol is the final step in the effective use of a TSA. Both parties should understand and agree on the process required to terminate the service provider relationship (for example, requiring the buyer to provide a 30-day notice to terminate e-mail services). In turn, the seller should acknowledge the termination, clarify any termination fees, and bill appropriately. Additionally, the seller should complete any knowledge transfer that was agreed to in the initial planning, close out the accounting, and take care of any cleanup activities, such as deleting, archiving, or inactivating the resources receiving the service.

Guiding principles

- Draft the TSA with an exit plan in mind.
- Create an agreement that is simple but clear; someone new to the process should be able to pick up the document and do the job.
- Get everything in writing. Assume if something is not written in the TSA, it will not get done.
- Be specific. Relationships change. People forget. Clarify who will provide support, how performance will be monitored, how payment will be received, and how issues will be escalated and resolved.
- Focus on completing the transition, not achieving a high level of service.
- Leverage existing information, including costs, performance metrics, reporting mechanisms, etc.
- Allow enough time for both parties to review and revise the document.
- Track costs religiously.
- Only request changes that are truly critical to the business.
- Agree on a communication plan; continually monitor status and stay in touch.
- Stay engaged and be patient. Developing a robust TSA is an iterative process — not a "one and done" effort.

Conclusion

A TSA is, by definition, supposed to be temporary. Yet, all too often, buyers and sellers feel as though they are stuck in a TSA that will never end. The key to a fast and smooth separation is to understand the most common TSA pitfalls and take steps to avoid them. Both buyers and sellers should consider the practical and time-tested insights provided here in their efforts to design and manage TSAs more effectively.

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