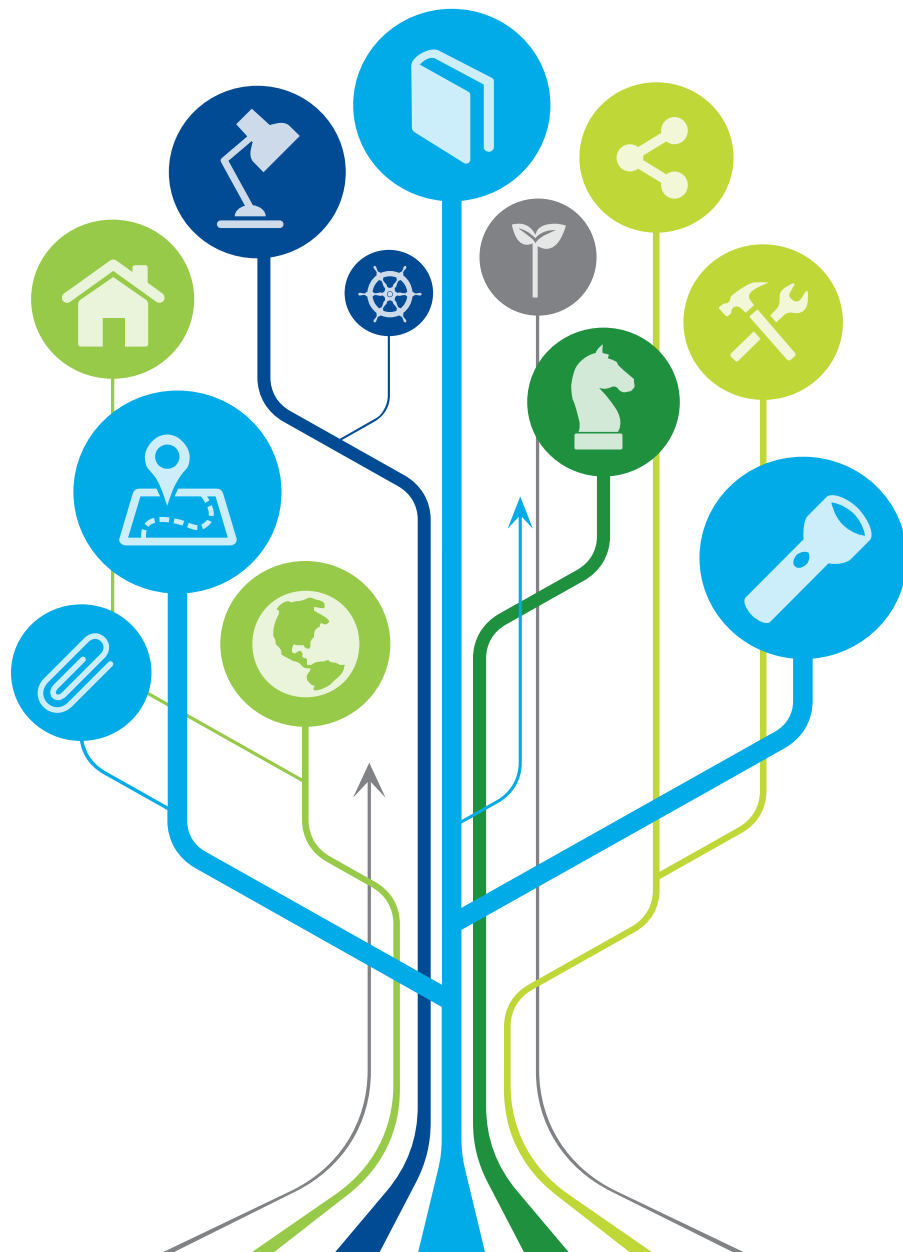


It's not easy to say goodbye
Perspectives on driving
divestiture and carve out value





Welcome

Dear Reader,

Whether you are contemplating your first divestiture, consider yourself a seasoned veteran of carve-outs, or are a functional leader working through complex separation challenges, this compendium was designed with you in mind. It is full of leading practices and insights that Deloitte has gained from leading hundreds of complex, global divestitures across numerous industries. It is our hope that you can benefit from our experience and insight.

Divestitures represent an opportunity to focus your attention on core assets, improve the overall value of your portfolio (“shrink to grow”), and to be more flexible and nimble in your core markets. They have the ability to potentially affect how your business operates — as well as the ability to slow you down considerably if not well planned and executed. In summary, there is nothing simple about divestitures.

If you are looking ahead to a strategic review of your portfolio or trying to work through existing divestiture challenges, this compendium can accelerate your thinking and course of action. And if you are looking for a sound advisor with real-world experience, we are ready to share our stories from the frontline.

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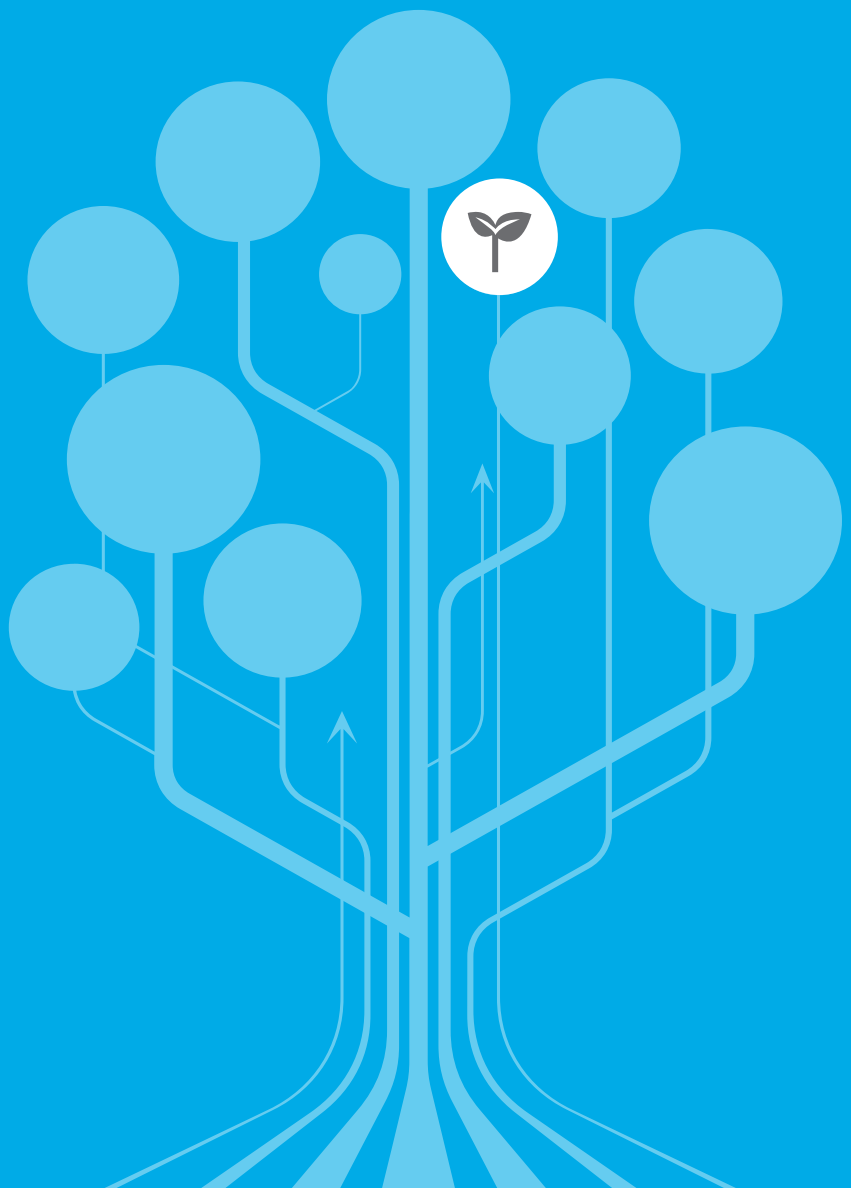
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Introduction







Introduction

Successful companies should consider not only about which businesses to grow, but also about which businesses to prune. Divesting non-core assets increases strategic and financial flexibility, allows sellers to focus their attention on the core business, and can maximize overall portfolio value. Successful divestitures require considerable planning, careful execution, and can consume considerable financial and organizational resources as companies navigate the risks to seller, buyer, and the carve-out entity.

Based on our experience from hundreds of complex, global divestitures, we have gained unique insights across the entire divestiture lifecycle. This collection of carve-out articles provides sellers and buyers with a deep-dive into the challenges they are likely to face during a divestiture and the leading practices to address those challenges. The articles explore unique divestiture challenges and offer practical recommendations for how to approach these situations and maximize shareholder value.

This divestiture collection is divided into four chapters: Divestiture Strategy, Transaction Execution and Due Diligence, Separation Planning and Value Realization, and Perspectives on Functional Separation Planning. The following are some highlights from each of the chapters:

Divestiture Strategy

The Deloitte Divestiture Survey presents an assessment of the market for divestitures today and in the future based on a survey of more than 100 executives.

Portfolio Realignment: A Business Imperative provides a holistic approach and process for building an “advantaged portfolio”, an optimal grouping of assets tailored to a company’s goals.

Sellers, Conditions are Ripe: Time to Take a Bite at the Apple features insights on the current M&A and tax environments and discusses some of the strategic opportunities that are available to companies seeking to increase liquidity.

Transaction Execution and Due Diligence

The Hidden Tax Value in Divestitures: Why Looking Beyond the Deal Can Pay Off Big explores the strategic

tax considerations in a carve-out and dives into some of the significant opportunities to improve the ongoing tax efficiency of each separated business after the transaction closes — thereby increasing the transaction’s long-term value.

Sell Side Due Diligence outlines an approach for efficiently producing a set of carve out financial statements by understanding the fundamental purpose of the financials, being able to effectively define the business being sold, and considering leading practices for addressing common accounting challenges

Separation Planning and Value Realization

Seven Secrets of Highly Effective Divestitures delves into the key question in any divestiture — how to achieve success. This article outlines seven leading practices for maximizing transaction value.

Building a Strong Transition Service Agreement explores leading practice approach, prioritization and scoping steps for building detailed IT transition service agreements.

Functional Carve-Out Perspectives

Every function has a different set of challenges that must be considered during a divestiture. This section provides leaders with deep insight and leading practice considerations in the areas of IT, Human Capital, Finance, Tax, Treasury, Real Estate, and Shared Services.

This compendium can be read cover-to-cover as a practical guide to maximizing shareholder value through careful divestiture execution or individually by going directly to the chapter or article that pertains to your current interest or situation. We hope that you will find this compendium and its breadth and depth of information to be a helpful resource.



Divestiture Survey





Deloitte.



Divestiture Survey
Report 2013
Sharpening
your strategy

Will your divestiture strategy hold up in 2013?

It's hard to imagine a year beginning with more economic uncertainty than 2013. Many are wondering, how will the last-ditch efforts to head off the fiscal cliff play out? Will the slow economic recovery continue or could we be hit with another recession? How will European economic challenges influence the capital markets?

In the first nine months of 2012, U.S. divestiture volume was down 14 percent, by far the lowest level over the past six years. At the same time, the average deal size has increased by 16 percent (from \$129 to \$149 million)¹, making the magnitude of each transaction that much more impactful for both buyers and sellers. Will this continue in 2013 or can we expect a return to the strong deal-making volume of 2011?

¹ Source: Thomson One Financial

As you plan your annual corporate development goals, many questions about your divestiture strategy may emerge. Is now a good time to divest? How do I receive a desirable value for my business? How do I motivate employees around the transaction? What are the preferred uses of TSAs?

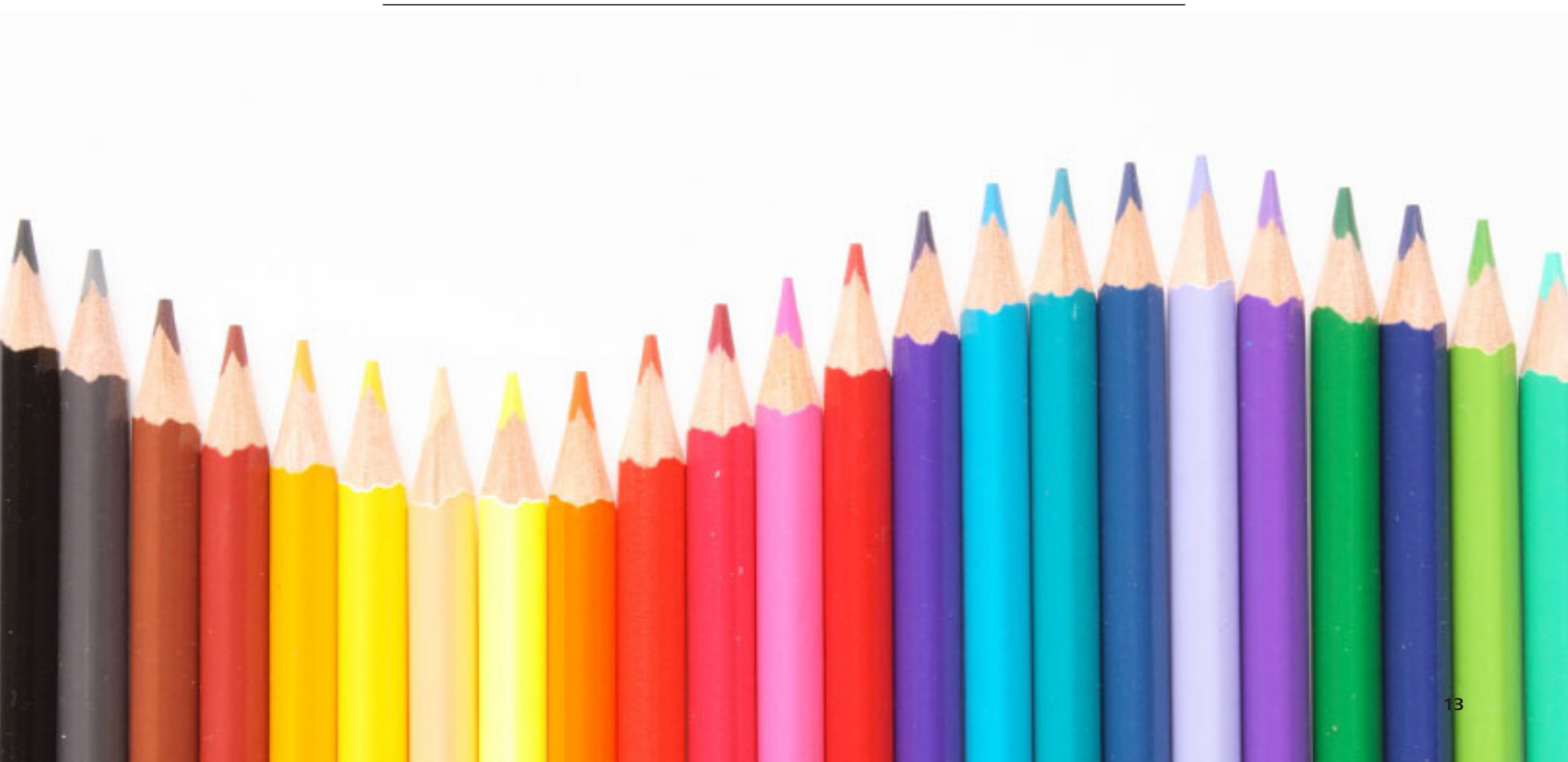
To understand how companies are addressing these and other issues, Deloitte surveyed approximately 150 professionals who have been involved in divestitures or carve-outs. Survey respondents were from companies that varied in size from less than \$500 million to multibillion dollar global enterprises. Perspectives span across the public and private sectors, domestic and international operations, and a broad range of industries. Read on to learn what we found in our survey results and insights from Deloitte's experience in the marketplace.

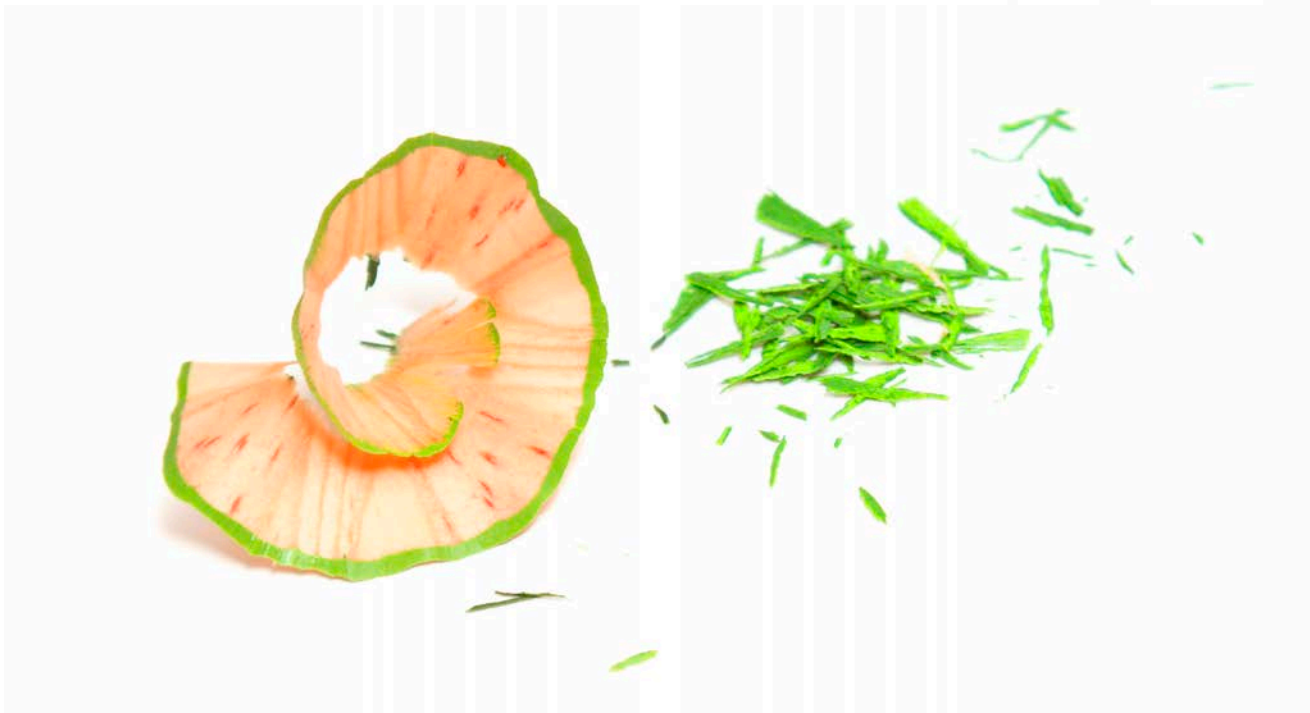




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The bottom line

Executive summary

As the U.S. economy strengthens, divestitures are becoming more a matter of strategy than survival. During the challenging economic conditions of the last few years, many divestitures were driven by the need to reinforce balance sheets, raise capital, and improve financial positions. While the ups and downs of the economy and market conditions will likely still play a big role in 2013 decision making, divesting is becoming an important tool for implementing corporate strategic goals and making a statement in the marketplace. With this heightened strategy comes a wave of tactical considerations to contemplate as you consider the important question: to divest or not to divest? And if yes, how to divest and to whom? Using divestitures to advance corporate strategy demands careful financial analysis to prepare a deal for market, a clear communication strategy for disseminating divestiture plans to stakeholder groups, and a recognition of the need to be sensitive to employee morale during the process.

Deloitte surveyed nearly 150 executives regularly involved in divestitures to assess the past experience of their companies, their outlook for the future, and the challenges they face.² While some findings were consistent with the results of Deloitte's 2010 survey, we did notice the emergence of some new, noteworthy themes.

Focus more on strategic, rather than financial, considerations

Many companies are increasingly realizing that divestitures need to become part of their core strategy rather than simply a way to improve finances. Eighty-one percent of executives surveyed indicated that pruning their business of non-core assets was one of the two most important reasons for divesting, up from 68 percent in the 2010 survey. In contrast, only 37 percent of executives surveyed selected financing needs as one of the two most important reasons to divest, down from 46 percent in 2010. As the economic recovery strengthens corporate balance sheets, the need to raise capital or unload poor performing assets appears to have become less important in driving deals.

Lead the way

Carve-out trends and leading practices

Companies are increasingly looking at divestitures in terms of strategic goals such as getting rid of non-core assets, rather than simply financial survival. But many companies are failing to undertake the strategic preparations needed to get the price they want.

Sellers looking for a fast close and multiple bidders may want to consider a new tool: seller diligence.

A preference for domestic buyers continues, but larger companies are often more inclined to look across borders. Companies with a global perspective can increase bidders and value.

Many companies that bled talent in the recession are now rebuilding corporate development teams so they can make divestiture a core part of their strategy — from annually evaluating business units to preparing them for increased buyer value.

TSAs may not always be the cheapest, more effective option, and if they are used, it's important to define costs and an exit plan.

² In this report, a divestiture or carve-out is defined as the sale of a subsidiary or a portion of a company's business, whether a plant or other facility, product line, business unit, or division.

Be a prepared seller

Careful preparation, including approaching the sale from the buyer's perspective, is important to increasing transaction value and reducing time-to-close. According to the survey, in choosing a buyer, *highest price* is ranked as one of the top two factors by 76 percent of executives, followed by *speed and certainty to close* by 54 percent. Yet many companies are not doing everything they can to prepare for the sale — only 55 percent of survey respondents say that *performing detailed pre-sale due diligence* is a key task in bringing a deal to market, and less than half say their companies evaluate individual business units at least annually to determine whether they should be divested.

Don't neglect people issues

Keeping employees motivated and providing clear line-of-sight into the divestiture strategy is critical to retaining and mobilizing talent around executing the transaction. Companies should prepare employees for change and help them manage through it. More than 90 percent of executives surveyed indicated managing employee morale is very or somewhat challenging when attempting a divestiture. Yet, only 46 percent of the companies surveyed establish a retention/incentive plan for management of the business for sale in their planning.

Consider cross-border deals

U.S. companies have historically preferred selling to domestic buyers, but a global perspective can result in more bidders and higher value. Fifty-nine percent of executives surveyed say their companies prefer domestic corporate buyers, down from 70 percent in the 2010 survey. While the overall trend is moving toward a global view of potential buyers, many companies are still limiting their target buyers to select geographies and potentially leaving money on the table.

Learn to manage TSAs/stranded costs

Transaction Service Agreements (TSAs) are viewed as a necessary evil by many companies, but they can be used as a strategy to close deals. Plan for them by developing accurate costs, defined service levels, and detailed exit plans. More than 50 percent of companies surveyed would prefer to avoid TSAs, but 80 percent of companies surveyed do provide TSAs if necessary to close the deal. Given these figures, it is in the seller's interest to be prepared to provide services and reduce the need during integration planning. In the survey, after TSAs, stranded costs were named as the biggest challenge once the deal closes. Addressing stranded costs requires a detailed program that considers the required cost/expense footprint for the entire organization.

Emerging trends

In addition to the survey findings, this report reflects the experience of Deloitte LLP's practitioners in divestiture services. Here are highlights of what we are hearing from the field:

- Demanding, impatient buyers are forcing tough deal negotiations.
- Good deals are pricing very well, with private equity bidding aggressively. But bad deals are struggling to close.
- Sellers are starting to focus more on preparation than in the past.
- Sellers are also working to close the gap between go-to-market and closing, which means less time for diligence.
- The mid-market is where the action is.
- Cross-border buying is driving a lot of deals. But cultural challenges should not be underestimated — they take time, patience and perspective.
- Corporate development teams are re-tooling and re-staffing after being cut during the recession. Companies are looking for creative ways to handle the ebb and flow of deal activity.



Economic uncertainty makes divestiture planning a challenge

The uncertainty over how the federal government might act to prevent the economy from falling off the so-called "fiscal cliff" made business planning for 2013 especially challenging. In late 2012, there was growing evidence the recovery was picking up steam in the U.S., with stronger than expected GDP growth and the unemployment rate dropping below eight percent. Yet, despite recent clarity on the fiscal cliff, the business community may continue to be cautious in decision making.

Both global and U.S. divestiture volumes were down significantly in 2012. Global volume was down 14.6 percent for the first nine months of 2012 compared with that period for 2011, the lowest volume in the past six years. In contrast, the first nine months of 2011 were the strongest three quarters in volume since 2005.

Global divestiture volume declined because of a dramatic drop in U.S. divestitures. U.S. volume was down 14.3 percent for the nine months ending September 2012 from that period a year earlier. That's the lowest level over the past six years and down 33 percent from 2006. If U.S. deals are removed, global divestiture volume in the first nine months of 2012 was actually higher than it was in 2006 and 2007. The decline in divestitures in 2012 may be partially explained by strengthening balance sheets, which reduced the need to raise money, especially compared to 2011 when companies were still climbing out of the recession.³

Mixed outlook for 2013

When surveyed in October–November 2012, most respondents indicated economic conditions would influence their company's decision to attempt divestitures in 2013, but few thought they would become more difficult to complete. (Figure 1) The survey results also indicate that executives, in general, expect 2013 divestiture activity to mirror what we have seen in 2012. These findings are both consistent with an outlook for near-term economic uncertainty and suggest the likelihood of continued strategic and opportunistic divestiture activity.

³ Source: Thomson One Financial

Figure 1: Expected influence of economic conditions on divestitures in 2013

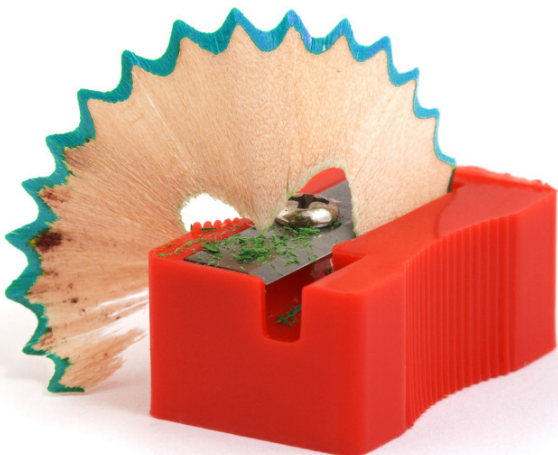
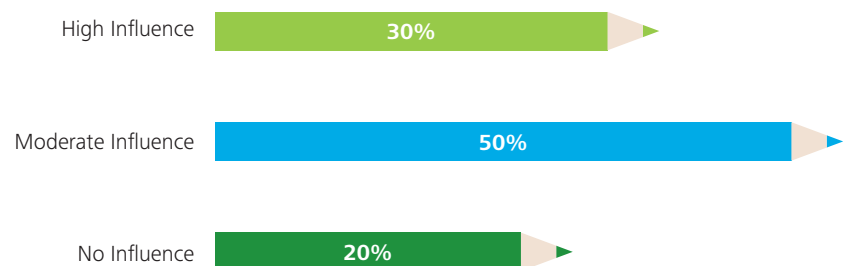
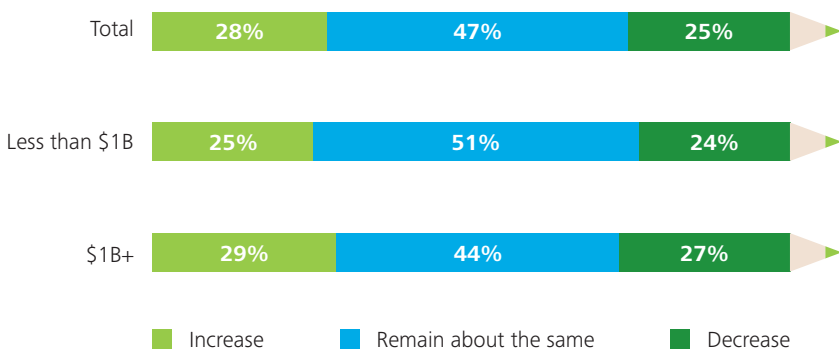


Figure 1a: Expectations of divestiture activity in 2013



“The M&A market continues to be a buyer’s market. Buyers are driving tough negotiations, especially around divestitures, and while financing conditions have improved, economic uncertainty continues to drive the need for speedy deal execution. Both buyers and sellers need to be prepared and rigorous in their M&A process to sign and close before market conditions swing due to geopolitical or global economic shocks.”

Andy Wilson
Partner, M&A Services, Deloitte & Touche LLP

Only 29 percent of executives surveyed believe divestitures in their industry would become more difficult to complete in 2013. These results appear to suggest that most surveyed executives are expecting the economic recovery to continue with no major setbacks. As the economy recovers, financing often becomes more available and companies are usually more willing to assume risk and invest their cash reserves, leading to a more active deal environment.

When asked about divestiture over the next 24 months, 72 percent of executives surveyed expect that their companies will attempt divestitures during this period. Surveyed executives at large companies were much more likely to anticipate their companies would attempt divestitures over the next 24 months than their counterparts at smaller companies.⁴ Eighty-two percent of respondents from large companies anticipate that they will attempt at least one divestiture, including 29 percent who expected three or more deals. In contrast, 56 percent of executives at smaller companies expect to attempt divestitures during that time period, with 13 percent expecting three deals or more.

Although surveyed executives at smaller companies expected they would attempt fewer deals, these divestitures would represent a larger portion of their revenues. Among surveyed smaller companies that expect to divest business units over the next 24 months, 74 percent of these executives say these deals will represent 5 percent or more of their companies’ revenues, compared to only 39 percent for the deals planned by large companies.

⁴ In this report, “large companies” refers to companies with annual revenues of \$1 billion or more; “smaller companies” refers to companies with annual revenues of less than \$1 billion.



Strategic factors important in driving divestitures

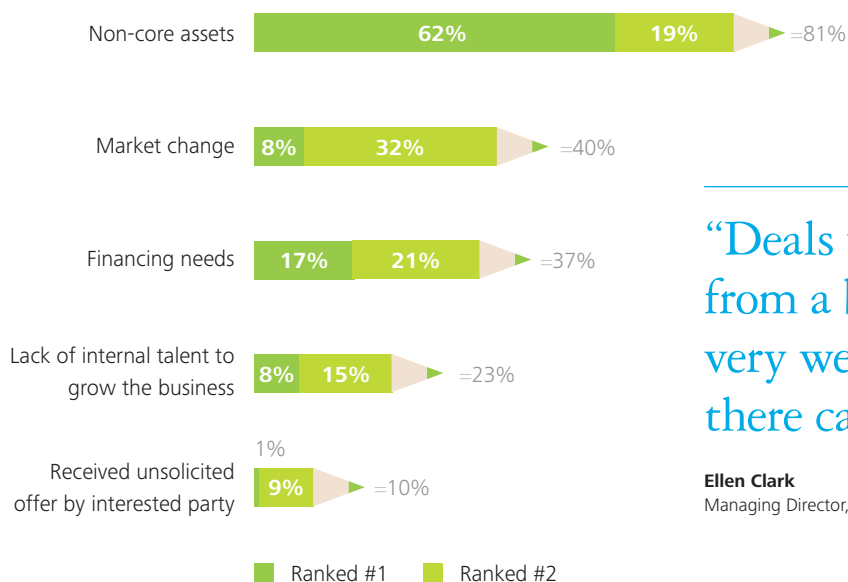
The deep recession of 2008–2009 and the subsequent slow recovery forced many companies to divest business units in order to raise cash or improve their financial position. Many of these divestitures were driven more by a corporate survival imperative and less by a long-term strategy for growth. As the economy has stabilized over the past year, strategic considerations have become a much more important driver for divestiture activity. The strengthening of corporate balance sheets, coupled with historically high levels of cash, is not just often increasing the appetite for acquisitions, but also leading companies to develop a more focused, longer-term strategy for divesting.

In the 2012 survey, 81 percent of respondents indicated that one of their two most important reasons for divesting is that the business was considered a *non-core asset*, up from 68 percent in the 2010 survey. (Figure 2) Further, 62 percent of executives surveyed indicated the decision that a business unit was a *non-core asset* was the single most important reason for divesting. In contrast, only 37 percent of surveyed executives chose *financing needs* as one of their top two reasons in 2012, down from 46 percent in 2010.

Strategic considerations are important at large companies as well. Seventy-three percent of surveyed executives at large firms indicated a unit being a *non-core asset* as the most important reason for divestitures, compared to 48 percent among executives at smaller companies. According to the survey, following the recession, smaller companies are more likely to have already contracted to their core businesses, or they never left it, while large companies are consistently refining their product portfolio. Among executives at large companies, only 13 percent of respondents indicated financing was the most important driver, along with 20 percent of those at smaller companies.

Underscoring the importance of market conditions in the decision to divest, among surveyed companies, *market change* continues to be a strong secondary reason for divesting, ranked as the second most important reason by roughly one-third of executives in 2012. (Figure 2) According to the survey, *market change*, especially in healthcare, energy, and technology sectors, may provide the opportunity or drive the business' need to divest, often in relation to an unsolicited offer from a buyer.

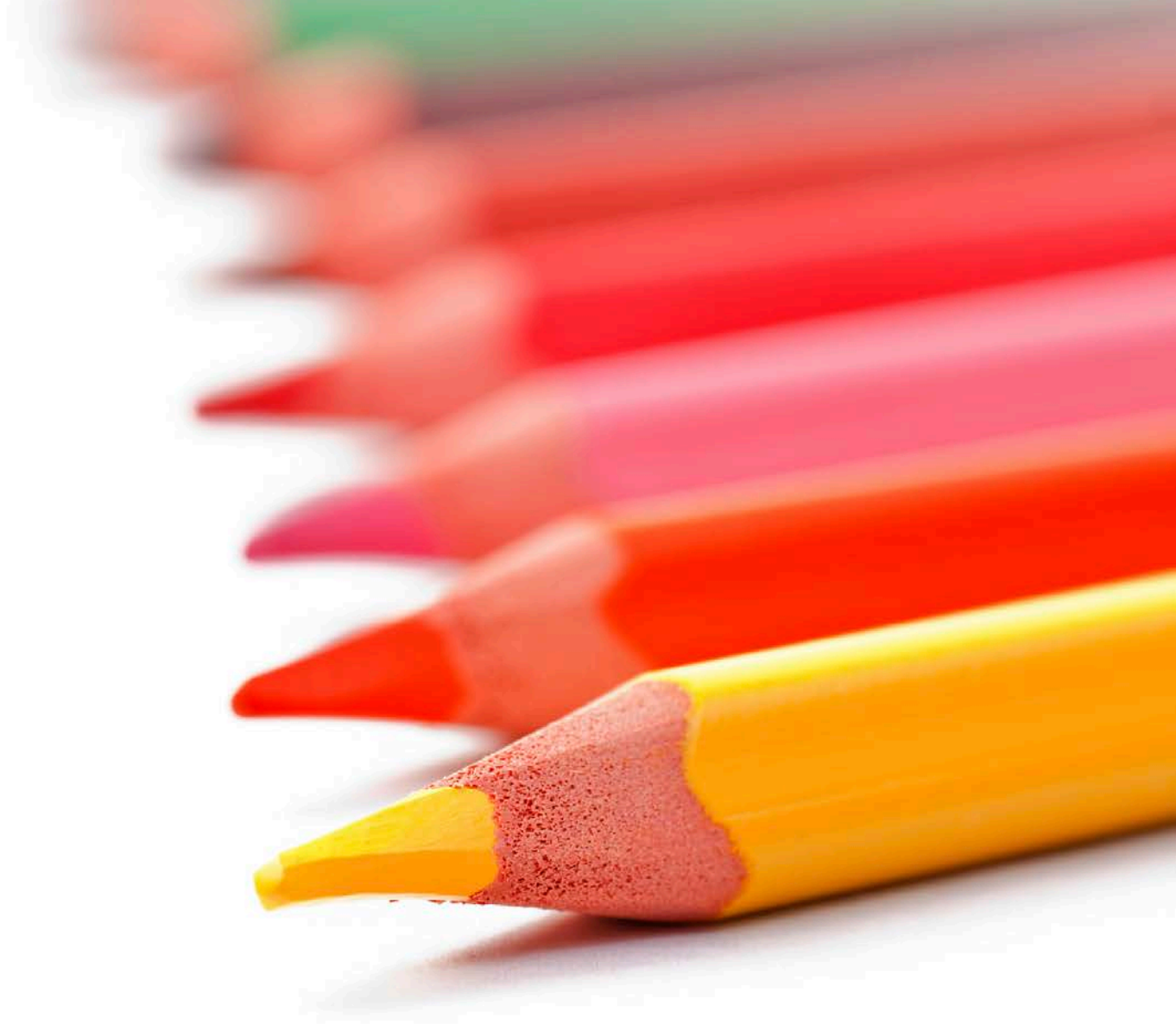
Figure 2: Most important reasons for divesting a business



Note: Some percentages do not add up to total due to rounding.

“Deals where the seller has prepared from a buyer’s perspective are pricing very well, but if the fit isn’t right, there can be a struggle to close.”

Ellen Clark
Managing Director, Deloitte Corporate Finance LLC



Non-core assets drive break-ups

When surveyed executives were asked specifically about the most important reasons their companies pursued divestitures over the last 24 months, their responses were similar, with roughly three-quarters saying the business unit was determined to be a *non-core asset*. *Market change* was selected by 37 percent of surveyed executives and *financing needs* by 32 percent.⁵

Interestingly, the only significant difference between the responses to these two questions appears to be that 21 percent of executives surveyed chose *received an unsolicited offer by an interested party* as a primary reason they pursued a recent divestiture, even though just 10 percent selected that as an important reason to divest in general. This may suggest that some companies allow

others to drive their divestiture decisions more than they care to admit. If companies frequently initiate divestitures in response to unsolicited offers, it can be an indication they are not doing a good job of regularly evaluating candidates for divestiture.

Among surveyed companies that divested non-core assets, the most common reasons were concerns over growth and product fit. Thirty-seven percent of executives surveyed selected *limited growth potential* as the primary reason, while 30 percent selected *non-synergistic products*. Other top reasons given for divesting non-core assets were *poor operating performance* (22 percent) and *weak market position* (11 percent). While non-core assets are traditionally defined as those that are not central to the company's strategy, companies can conclude that assets are non-core for a wide variety of reasons.

⁵ Percentages total to more than 100 since respondents could make multiple selections.



Raising the bar Receiving more value from your carve-out

Although strategic, rather than financial, factors are considered the most important drivers in the survey, companies remain intent on achieving the expected value, and an impressive 85 percent of sellers reported being satisfied with the value of their most recent divestiture. Sixty-eight percent of surveyed executives reported receiving the value they expected, while 17 percent walked away with a price that exceeded expectations. (Figure 3)

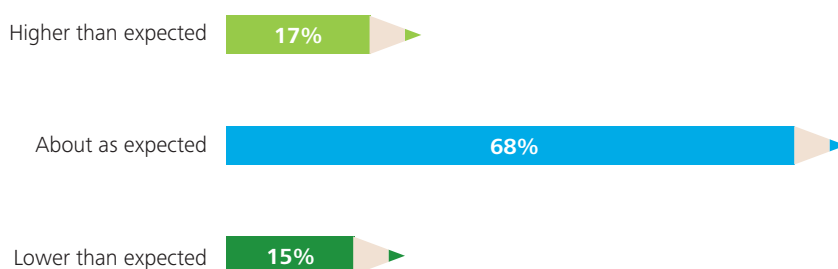
According to the survey, all-cash sales are by far the more common terms when divesting. Ninety percent of respondents indicated they typically accept an all-cash sale of the full business unit divested. Other terms commonly accepted are a seller note (25 percent) and continuing equity interest (22 percent).⁶

The most common reason selected in the survey for receiving a higher value than expected was *multiple competing bidders* (44 percent). Other factors selected by surveyed executives at companies that received a higher value than anticipated in their last divestiture were *strength and preparation of management team* (40 percent), *greater synergies than expected* (36 percent), *no significant diligence 'surprises/issues'* (32 percent), and *availability of financial information and analysis* (32 percent).⁷

In Deloitte's experience, sellers are now focusing more on preparation than they have in the past. However, sellers also want faster deal closure. Shortening the gap between putting an asset on the market and closing the deal often means less time for diligence. To adjust for this change in deal mechanics, sellers should develop a detailed separation plan: mobilizing resources around the deal execution and transition and to prepare themselves to support the buyer's diligence needs and mitigate the operational challenges that the buyer will likely face in closing the deal.

When it came to surveyed companies who had received a lower value than expected, only one-third blamed their management team. Instead, surveyed executives were more likely to cite factors outside the control of those handling divestitures — 64 percent indicated the most important reason for a lower value was *deteriorating market conditions* and one-half chose *deteriorating operating performance*.⁸

Figure 3: Value of most recent divestiture compared to expectations



“Companies can assess their business needs over a longer term, with short-term survival less of an issue than in 2010. Portfolio assessment and divestitures that might have been necessary to keep the lights on in recent years can now be more strategic and focused.”

Andy Wilson
Partner, M&A Services, Deloitte & Touche LLP

- 6 Percentages total more than 100 since respondents could make multiple selections.
- 7 This question was answered by 25 respondents at companies that received a greater value than expected in their last divestiture.
- 8 This question was answered by 22 respondents at companies that received a lower value than expected in their last divestiture.

Increasing the number of bidders for increased value

Forty-five percent of surveyed executives at the companies that received less value than expected for their last deal indicated a *limited number of bidders* was an important factor. The fact that the number of surveyed bidders was chosen by nearly one-half of both those receiving more value and less value than expected reinforces Deloitte's experience that sellers who want to increase sales price should avoid single-bidder, exclusive deals. While these deals can be attractive for reasons other than price, multiple bidders can increase the seller's leverage for improved terms overall. Additionally, a well-run auction, with proper levels of preparation by the seller, can actually be more timely than a single-bidder, exclusive deal, due to the competitive nature of the process.

Sellers looking for a quick deal with multiple bidders might want to consider commissioning a seller diligence report, an emerging trend for U.S. transactions. In Deloitte's experience, it can be an effective tool for facilitating a highly competitive auction process. In Europe and the UK, it is known as vendor due diligence.

A separation can offer significant opportunities to increase the tax efficiency of the separated business, potentially increasing the transaction's long-term value. Yet, many companies overlook these tax-saving opportunities until after the deal is done, when it is usually too late. Tax savings can benefit both the separated business and the parent company. As the parent company changes its operations and structure to fit its new size and scope, there may be opportunities to restructure operations in a more tax-efficient manner that can significantly impact its performance going forward.

Seller diligence reports — an emerging trend

What is it?

- Independently prepared, broad due diligence report used to facilitate a sale
- Allows prospective purchasers to receive identical independent information and analysis
- Paid for by the seller
- Supports auction/managed sale process with deep access to data
- Cleared with management for factual accuracy

Why do it?

- Facilitates and accelerates the sales process
- Reduces opportunities for buyers to re-trade on price
- Reduces disruption — target is subject to only one detailed due diligence process controlled by seller



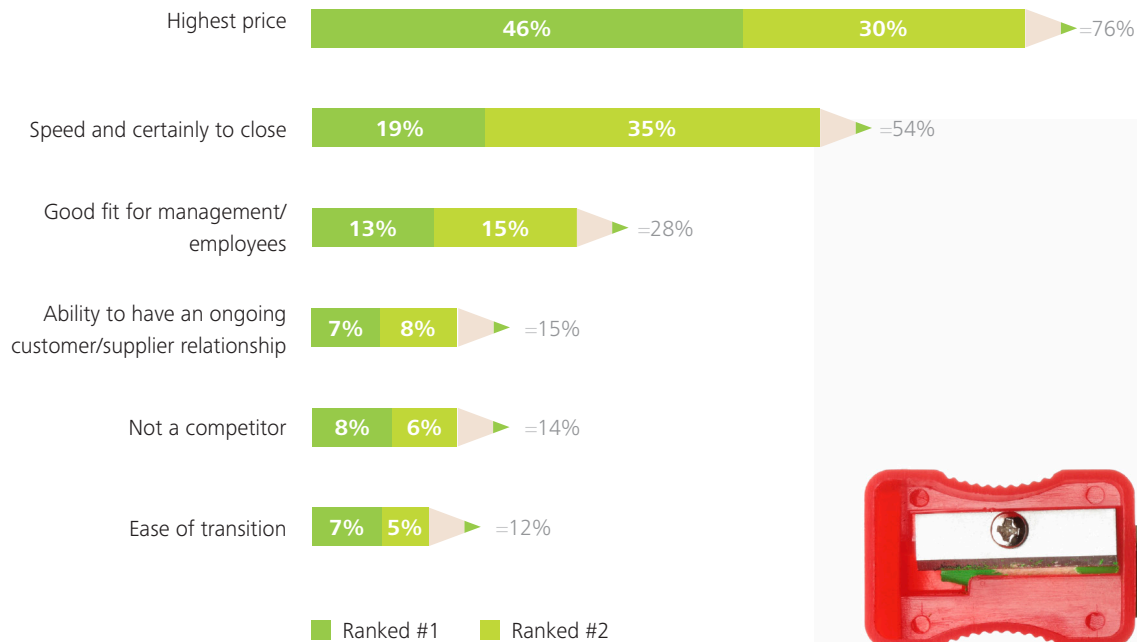


Finding the “right fit,” at home and abroad

Foreign and domestic buyer trends

According to the survey, price once again leads the reasons for choosing a buyer by a wide margin, with 46 percent of responding executives calling it the most important factor and roughly three-quarters placing it in the top two. (Figure 4) Fifty-four percent of surveyed executives ranked *speed and certainty to close* as one of their top two factors, but just 19 percent indicated it was the most important. The third most selected reason for choosing a buyer was *good fit for management/employees*, with 28 percent of respondents ranking it as the number one or two reason.

Figure 4: Most important factors when choosing a buyer



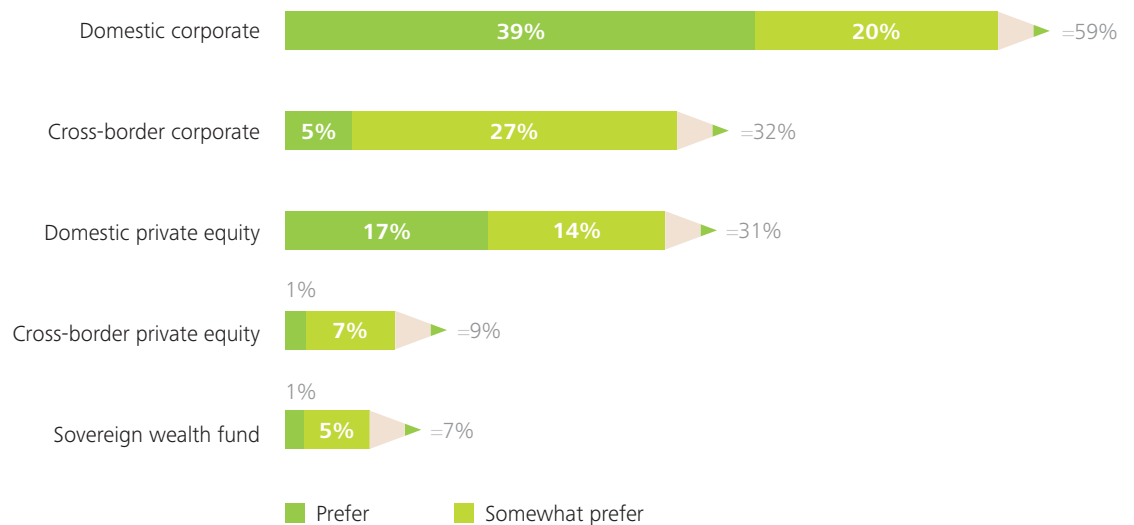
Declining preference for domestic corporate and private equity buyers

In the survey, respondents indicated that domestic corporate buyers were more often preferred, but somewhat less than in the 2010 survey. Fifty-nine percent of surveyed executives indicated their companies prefer or somewhat prefer domestic corporate buyers compared to 70 percent in 2010. (Figure 5) According to the survey, the other types of buyers that respondents favored were cross-border corporate (32 percent) and domestic private equity (31 percent). However, surveyed executives were less likely to prefer private equity buyers than they were in 2010. Only 31 percent of surveyed executives indicated their

companies prefer or somewhat prefer domestic private equity buyers, compared to 42 percent in the 2010 survey.

The declining preference for domestic corporate buyers among the companies surveyed is reflected in the actual deals in the marketplace. Domestic corporate buyers have represented roughly 70 percent of the buyers for U.S. divestitures from 2006 to 2010, but dropped to 57 percent in the first nine months of 2012. In contrast, domestic private equity bought 27.5 percent of the deals during that same period, showing significant growth. In Deloitte's experience, private equity has been bidding aggressively on good deals.

Figure 5: Preference for types of buyers



Note: Some percentages do not add up to total due to rounding.

Foreign strategic buyers also declined significantly as a percentage of the overall market for U.S. divestitures in the first nine months of 2012. They accounted for 11.8 percent of the buyer base compared to 14.5 to 19.4 percent from 2006 to 2011. But cross-border private equity buyers have become more prominent, acquiring 3.7 percent of the deals in the first nine months of 2012, up from no more than 1.1 percent from 2006 to 2010.

Based on these trends in the marketplace, companies might want to reduce their overwhelming preference for domestic corporate buyers when it comes to marketing deals. Eighty-four percent of surveyed executives indicated their companies marketed divestitures over the last 24 months to domestic corporate buyers, followed by domestic private equity (49 percent) and cross-border corporate buyers (45 percent). Companies that market more broadly beyond domestic corporate buyers will likely have the ability to expand the number of bidders and potentially the value they achieve.⁹

9 Source: Thomson One Financial



2012 showed big changes in who is buying U.S. assets, with a significant decline in domestic corporate buyers. Companies that look across borders and to private equity for potential buyers can increase their number of bids, which in turn, may increase their chances of getting the price they want.

Potential obstacles in cross-border deals

Cross-border buying is driving more and more deals. But don't underestimate the challenges.

Considerations	
Target identification	<ul style="list-style-type: none"> • Difficult to define target • Multinationals may struggle to get initial interest from targets • Initial discussions may be one-sided with unreliable information provided
Negotiation process	<ul style="list-style-type: none"> • Traditional "Western" M&A process model often requires modification • Hesitancy of target to fully "open up" often necessitates long-term commitment • Significant amounts of patience and energy required • Decisions are often revisited, extending negotiations • Difficulty in enforcing and honoring terms
Price expectations	<ul style="list-style-type: none"> • Higher price expectations/premiums due to local growth and equity market • Aggressive growth model • Seller's price not always supported with valid valuation methodology/financial data • Peer comparisons can occur even when under confidentiality agreement
Information expectations	<ul style="list-style-type: none"> • Data often unavailable or unreliable (multiple sets of books) • Reluctance to provide actual financial statements • Timeliness of information
Due diligence process	<ul style="list-style-type: none"> • Unwillingness/slowness to disclose information • Target's lack of experience handling due diligence • Target can be overwhelmed by team and complex information requests

Middle market heats up

It appears that when a large company looks across a border for an acquisition, its goal is a big entity, and so the company is usually more likely to acquire a unit of a large company. But when it comes to cross-border private equity, even the larger private equity firms aren't often willing to take on a major commitment in another country, so they may look more to mid-market companies. Many private equity funds increased their focus on mid-market transactions following the financial crisis, and the middle market is expected to continue to play an important role in private equity deal activity going forward. In October 2012, year-to-date middle market multiples were at their highest levels since 2005¹⁰, and quality assets continue to trade at a premium.

Looking at the private equity market overall, the current high levels of uninvested capital held by private equity firms may significantly increase the demand for quality assets. In addition, companies continue to hold historically high cash balances. If the economy continues to improve and the capital markets stabilize, investors will likely press firms to put their excess capital to work. This potential increase in private equity and corporate activity may have a significantly positive impact on transaction multiples.

¹⁰ Source: Thomson One Financial

Shorten the waiting game

Closing your deal

Points to maximizing value:

- **Presale preparation:** Identify risks and potential issues that could derail the process or affect value retention; line up advisors early and clarify their roles.
- **Buyer courtship and qualification:** Provide buyers with the right information to engender commitment.
- **Closing:** Execute smoothly and relentlessly — establish a clear timeline for the sales process and post transaction services.

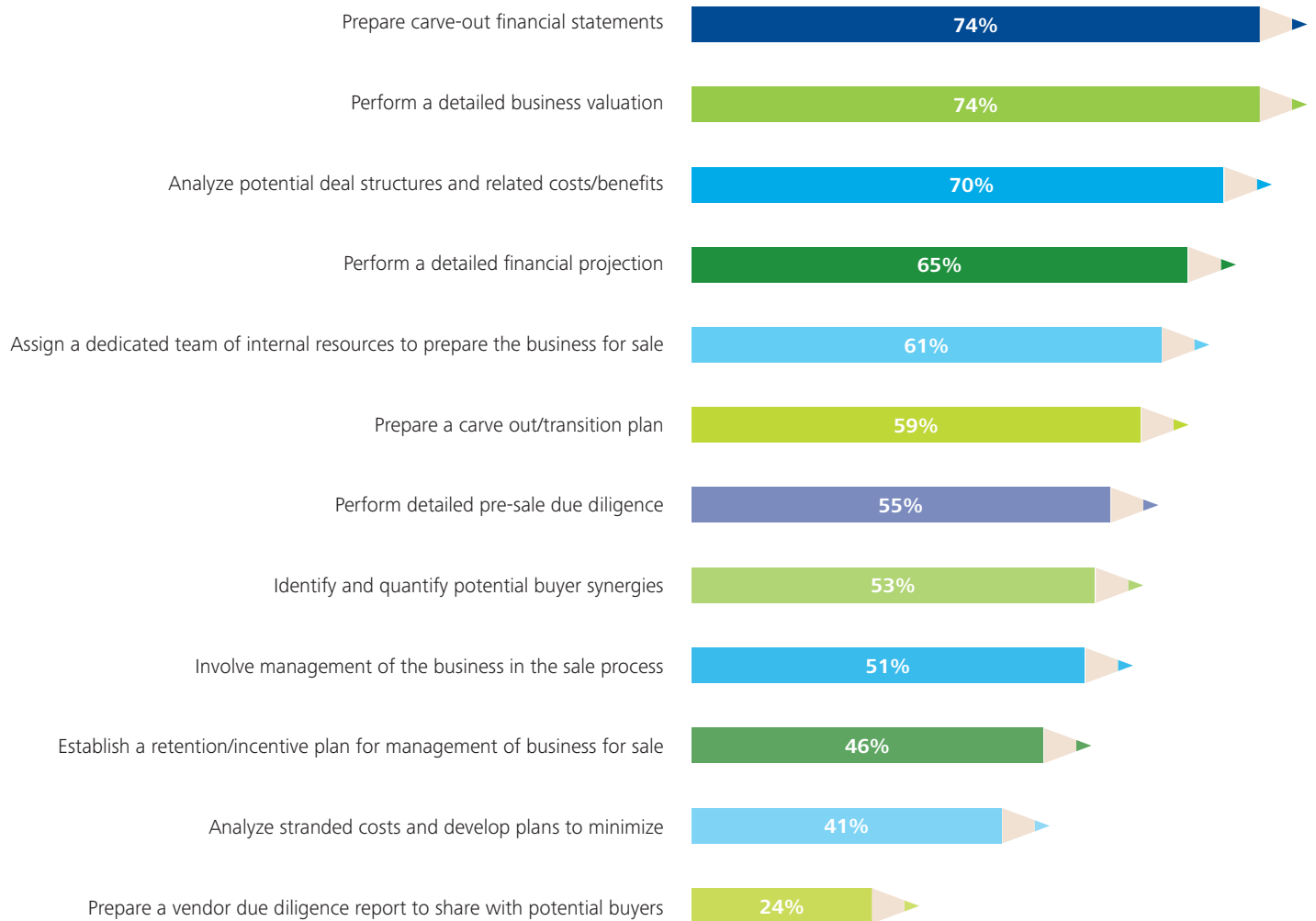


Getting a good deal for a carve-out should start with looking at the asset from a buyer's perspective. Sellers should study financial and operating data well before they reach out to potential buyers so they can develop a strategy for addressing issues buyers believe will cause difficulty and diminish value once the business is separated and sold. But less than half of survey respondents (43 percent) indicated their companies evaluate individual business units at least annually to determine whether they should be divested. Forty-five percent only consider divestiture when there are performance or strategic issues. This lack of routine evaluation may cause companies to miss opportunities, or rush distressed units onto market without adequately preparing for a sale.

Surveyed executives were more likely to list financial tasks as being important to bringing a deal to market. The top tasks named in the survey were *prepare carve-out financial statements* (74 percent), *perform a detailed business valuation* (74 percent), *analyze potential deal structures and related costs/benefits* (70 percent), and *perform a detailed financial projection* (65 percent). (Figure 6) These are of critical importance for deal execution — getting from first bid to signing to closing — and often have a long lead time, with support needed from internal parties as well as from external advisors. But a variety of more intangible tasks — such as developing a strategic focus for the business, development and succession planning in the carve-out, and separation planning for achievement — can ultimately drive value for both the buyer and seller six months, one, and five years later.



Figure 6: Key tasks in bringing a deal to market



Engage employees to boost morale

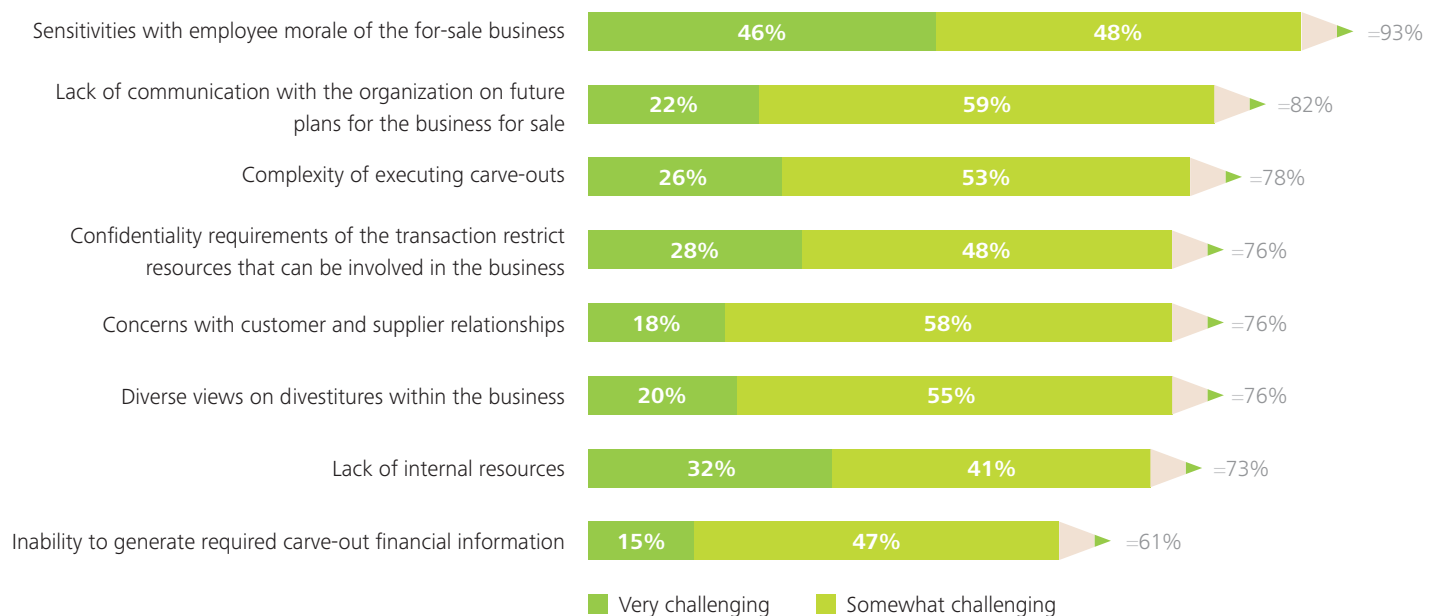
Major challenges when attempting divestitures have to do with employees and communicating with them. *Sensitivities with employee morale of the for-sale business* was selected as a challenge by 93 percent of executives surveyed, with 46 percent indicating it was very challenging. (Figure 7) Nearly as challenging was *lack of communication with the organization on future plans for the business for sale*, selected by 82 percent of surveyed executives.

These two issues are closely related — morale is often likely to suffer when rumors abound and employees speculate about their future. Effectively transitioning an organization requires a strategy to proactively engage employees and reduce their uncertainty. Preparing managers and executives to communicate with their people and lead them through change is important to the process. Employees need to understand the decisions that may impact them before any public announcements are made. Functions such as human resources, internal communications, and finance are critical in influencing employee morale.

But many companies fail to address employee engagement and morale when planning a divestiture. When asked about important tasks to perform in bringing a deal to market, only 46 percent of executives surveyed chose *establish a retention/incentive plan for management of business for sale*. (Figure 6) Short-term incentives based on performance milestones or a time horizon are effective for retaining specific employees and maintaining their focus. A divestiture often leads to ambiguity in roles and accountability, with conflicting priorities between the new and old companies, resulting in escalating levels of anxiety for employees. In Deloitte's experience, companies that implement an effective employee engagement strategy mitigate these challenges and bring their deal to market in a timely manner and more efficiently.

According to the survey, after employee morale, the factor most often selected as very challenging when attempting divestitures was a *lack of internal resources*, chosen by 32 percent of executives, with an additional 41 percent saying it was somewhat challenging. (Figure 7) Deloitte views the lack of qualified internal talent as a growing obstacle to effective divestitures. In the economic

Figure 7: Challenges when attempting divestitures
Percentage responding very or somewhat challenging



Note: Some percentages do not add up to total due to rounding.



downturn, many companies dismantled their corporate development teams due to a lack of deals and a drive to reduce expenses, and no longer have the talent needed to pull them off. However, many development teams are now retooling and re-staffing as companies look for new ways to handle the ebb and flow of deal activity. If a company doesn't have the know-how to plan and execute divestitures, it can be a critical obstacle to effectively closing deals.

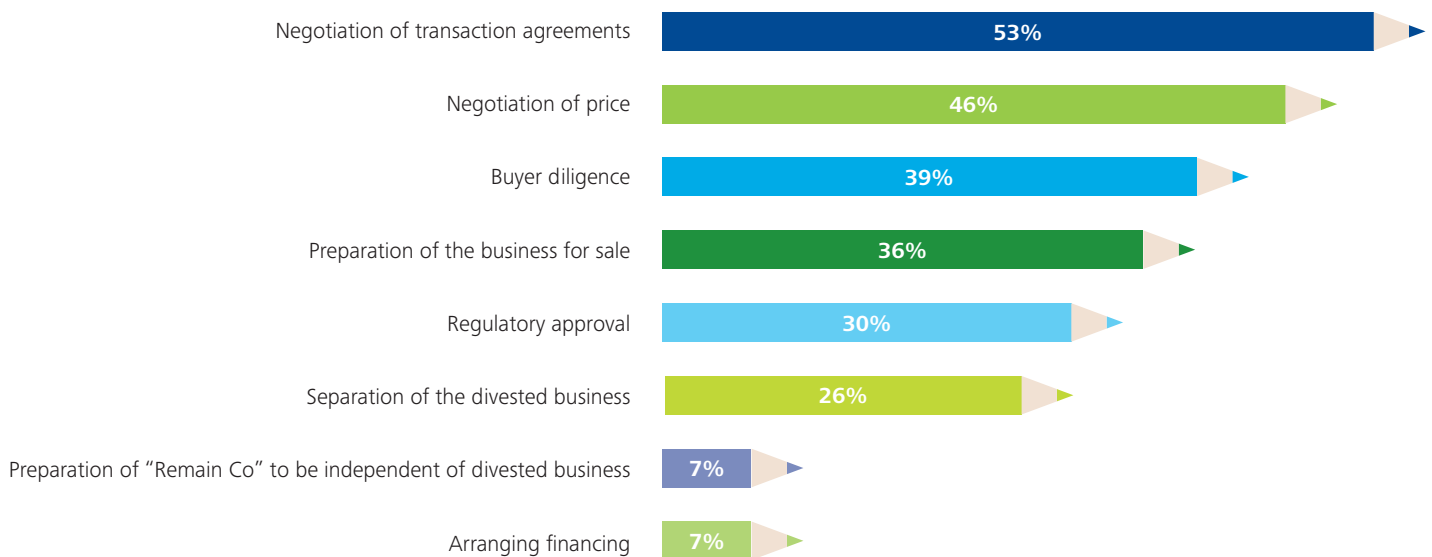
Since nearly three-quarters of executives surveyed selected a *lack of internal resources* as a challenge, it's not surprising that nearly all reported using external service providers to assist in completing divestitures. Ninety percent of the companies surveyed use external service providers, such as consultants, legal advisors, and banking advisors in divestitures at least sometimes, with 62 percent saying they use them always or often. Executives surveyed were more likely to say an important factor in their decision on whether to use an external service provider was the *complexity of the deal* (81 percent.) A little more than half of executives surveyed each chose the *deal size*, *availability of resources*, and *lack of internal expertise/capabilities*.¹¹

When it came to the time required to complete divestitures, roughly three-quarters of surveyed executives indicated their last divestiture required 12 months or less from the time the decision was made to sell the business until execution of the purchase agreement, including 25 percent who indicated it took six months or less. However, 51 percent indicated their last divestiture took more time than expected, while just 6 percent indicated it took less time.

Negotiating the deal was blamed as the biggest hold-up for executing divestitures. Roughly half of executives surveyed indicated both the *negotiation of transaction agreements* and the *negotiation of price* were primary reasons their company's last divestiture didn't close as quickly as planned. (Figure 8) Other common reasons chosen were *buyer diligence*, *preparation of the business for sale*, *regulatory approval*, and *separation of the divested business*.¹²

Figure 8: Primary reasons divestiture required more time than expected

Base = executives at companies where most recent divestiture required more time to complete than expected



11 Percentages total more than 100 since respondents could make multiple selections.

12 Percentages total more than 100 since respondents could make multiple selections.

Transition Services Agreements (TSAs)

Planning now for post-close

Divestiture tip

Often, the preferred candidates for developing the TSA language are the people who will manage the daily activities. They will likely have the experience to make the agreement more accurate and complete. Further, these individuals may also be in the best position to develop the TSA exit strategy and transition.

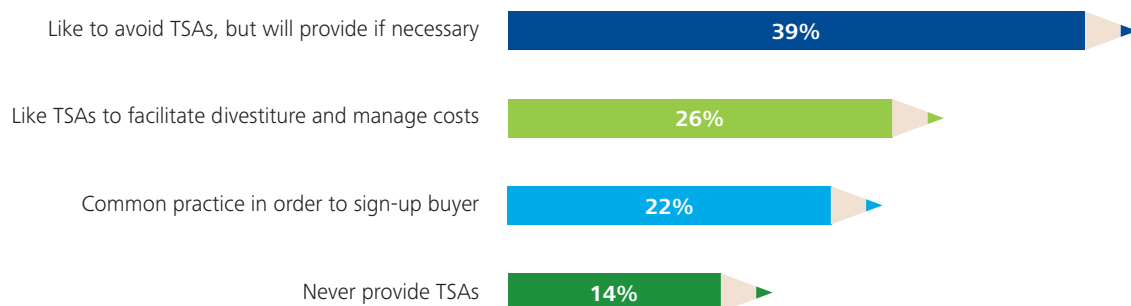
Transition service agreements (TSAs) are typically the default option when complex, hurried transactions require the parent company to provide transitional services to the divested unit after a deal closes.¹³ Eighty-seven percent of executives surveyed indicated their companies provide TSAs, but the largest percentage (39 percent) indicated they *like to avoid TSAs, but will provide if necessary*. (Figure 9) Twenty-six percent indicated their organizations *like TSAs to facilitate divestiture and manage costs*, while 22 percent indicated they are *a common practice in order to sign-up buyer*.

Companies can benefit by using TSAs as a deal-making strategy. Based on Deloitte's experience, transition services are a necessary, if undesired, part of many divestitures. Even in situations where the deal team does not want to use TSAs, planning for them avoids the possibility of unfavorable last-minute service negotiations. Companies can be better prepared for Day 1 and reduce risk if they plan for the contingency of using TSAs and then later, if feasible, remove or reduce the scope of services.

For surveyed companies that do provide TSAs, the services offered most frequently are finance/accounting (72 percent) and IT (71 percent).¹⁴ Twenty-eight percent of executives surveyed indicated their company typically provides services in purchasing and 23 percent provide other types of services. In addition to being offered more frequently, these services agreements for these services tend to have the longest required durations and the most cross-functional dependencies. Companies will likely want to consider this as they develop service delivery and exit plans to help avoid business disruption when the transition agreement ends.

Companies should consider drafting TSAs with the end in mind, having a clear idea of how they will exit the agreement. Roughly 80 percent of surveyed companies typically provide TSAs or Reverse TSAs for one year or less. Forty-one percent indicated the typical duration is six months or less while 39 percent indicated the agreements last 7–12 months.

Figure 9: Organization's practice for providing TSAs



¹³ Source: "CFO insights: Divestitures and Carve-outs: Becoming a Prepared Seller," Deloitte, 2010
¹⁴ Percentages total to more than 100 since respondents could make multiple selections



Don't lose money on TSAs

When it came to costs, 69 percent of executives surveyed indicated that they had found that cost estimates for TSA services were fairly accurate compared to expectations. Among the remaining executives, 23 percent reported costs were under-estimated, and 8 percent indicated they were over-estimated.

This finding indicates roughly a quarter of companies may routinely fail to charge a sufficient fee when they offer TSAs. When developing a proposed TSA service price, it is important for companies to do their internal homework. What are the one-time costs? What are the monthly recurring costs? In setting the service price, companies should consider different pricing options including cost-plus (cost plus a percentage surcharge), cost escalation (percentage increase each month over the duration of the TSA), and minimum fee (to protect against investments such as the cancellation of services soon after legal close of transaction).

In Deloitte's experience, there are often cheaper and more efficient options to TSAs since neither party is typically in the service-providing business. However, TSAs can also benefit the seller by giving it more time to restructure its systems and mitigate stranded costs.¹⁵ Organizations that provide TSAs should not rely on them as a way to avoid tough decisions. Parent companies should develop accurate costs, defined service levels, and detailed exit plans.¹⁶

The impact of inflation is often overlooked in service agreements. The option to increase or pass-through cost increases is an important negotiation point for sellers, particularly for multi-year agreements. For buyers, cost surprises tend to materialize in the form of TSA exit and replacement costs. If the seller is benefiting from economies of scale that the buyer cannot replicate, a pragmatic sourcing process can help reduce unexpected budget overruns.

TSAs and stranded costs were named in the survey as the biggest challenges after a deal closes. Twenty-eight percent of executives surveyed indicated TSAs were the biggest continuing challenge after their companies' most recent divestiture, while 23 percent indicated stranded costs. But neither issue appears to receive the attention it deserves at many companies. Only 55 percent of executives surveyed listed *prepare a carve-out/transition plan* as an important task to perform in bringing a deal to market, and only 41 percent selected *analyze stranded costs and develop plans to minimize*. Other common challenges after a transaction ends are *retained contingencies/exposure* (19 percent) and *shared customer issues* (12 percent).

When developing a stranded cost program, companies should not limit their view to exiting TSAs since they will risk "moving the sand around." Addressing stranded costs requires a detailed program that focuses on the required cost/expense footprint for the entire organization.

¹⁵ Source: "Corporate Development 2012: Leveraging the Power of Relationships in M&A," Deloitte, 2012

¹⁶ "CFO insights: Divestitures and Carve-outs: Becoming a Prepared Seller," Deloitte, 2010

If at first you don't succeed... consider putting your business back on the market

“Pulling a business from the market so you can refocus the strategy, refine its market message before re-launching a sales process, can be more effective than trying to close a deal that is going bad.”

Andy Wilson
Partner, M&A Services
Deloitte & Touche LLP

Nearly one-third of executives surveyed indicated their companies had one or more planned divestitures that didn't succeed over the last 24 months. The most common reasons for not completing divestitures, chosen by half or more of surveyed executives, were *unable to get acceptable value* and *unable to get acceptable deal terms*. (Figure 10) Roughly one-quarter blamed both *change in the external market* and the *buyer's inability to secure financing*.

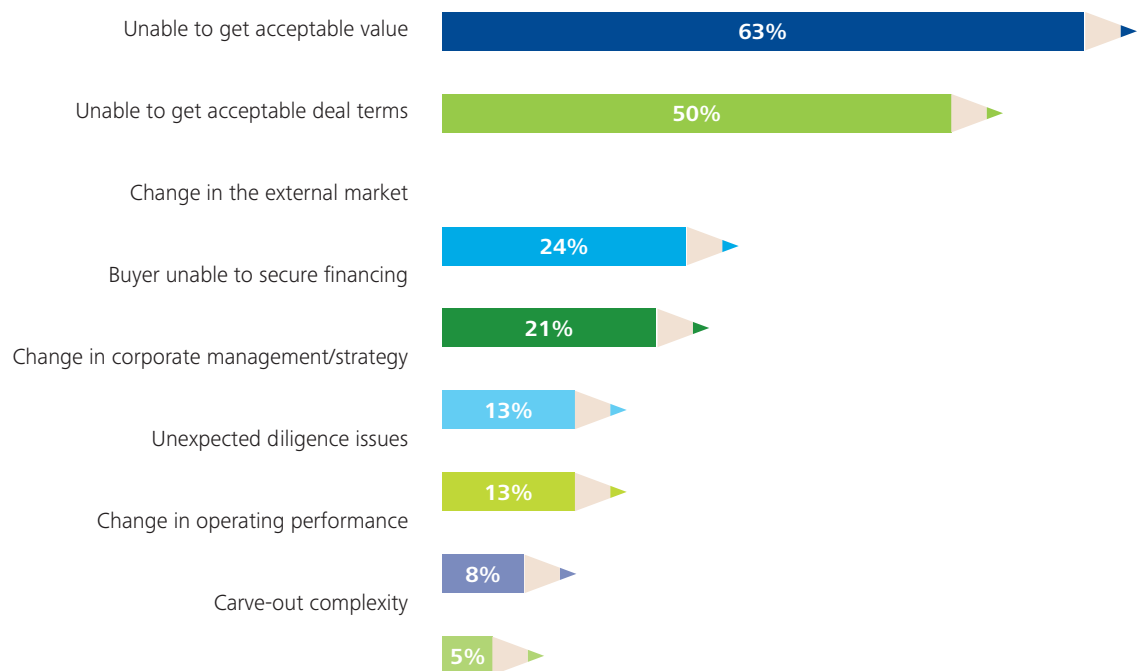
Whatever the reasons a divestiture was derailed, many companies don't wait long to begin searching for a new deal. Among surveyed companies that had planned divestitures over the last 24 months that didn't succeed, 64 percent reported they had put the business back on the market or were planning to. In Deloitte's experience, the sooner a company can bring a deal back to the table, the more its chances are improved. That way, they don't lose momentum, and much of the diligence work and financial preparation remain relevant.

Completing a divestiture effectively requires a proactive strategy of approaching the deal from a buyer's perspective. It's critical to recognize that the true value of a business is the current and potential income it will generate for the new owner. Carefully preparing the business for achievement after it is divested is another way to increase value. Identifying gaps for a buyer builds credibility and helps to eliminate uncertainties.¹⁷

¹⁷ "Corporate Development 2012: Leveraging the Power of Relationships in M&A," Deloitte, 2012

Figure 10: Reasons for not completing divestitures

Base = Executives at companies where some divestitures over last 24 months did not end in a closed transaction



Note: Percentages total to more than 100 since respondents could make multiple selections



Afterword

The art of divesting: Enhance value and save time

1. Make divestiture part of your core business strategy, regularly evaluating all assets as potential candidates.
2. Increase the number of bidders and strengthen your management team's understanding of the business being sold to increase the odds of getting the value you want.
3. Look across borders for potential buyers with ready cash and a need for growth.
4. Prepare for diligence and deal execution to streamline and accelerate the process.
5. Position the business from a buyer's perspective, anticipating their priorities and considering potential stumbling blocks.
6. Be prepared with detailed, consistent, accurate data (historical and forecast) and regularly update it.
7. Set and execute against a timeline.
8. Initiate tax planning up front.
9. Don't rely on TSAs as a default option — look for improved, cheaper solutions.
10. If you need to put an asset back on the market after a failed deal, move in a timely manner.

The federal budget negotiations, coupled with a fragile recovery, create significant uncertainty over the outlook for divestitures in 2013. Despite the lack of clarity, pent-up demand remains with both corporate and private equity buyers looking to spend cash and position themselves for growth.

Companies should consider making divestitures part of their core business strategy by regularly evaluating their portfolios to identify potential candidates for divestiture, rebuilding their corporate development teams, assessing sale readiness from a buyer's perspective, and carefully evaluating the effectiveness of TSAs. Thorough preparation and solid execution are important to increasing deal value and closing deals in a timely manner and efficiently.



Profile of respondents

Deloitte conducted a survey of 148 executives who have been involved in divestitures or carve-outs to gain insights on their experiences. The survey was conducted online from October to November 2012. Deloitte conducted a prior divestiture survey in 2010.

Roughly 60 percent of respondents worked at companies that had completed at least one divestiture within the last 24 months. Thirty-six percent of their companies completed one or two deals and 23 percent completed three or more. Sixty-six percent of the large companies (annual revenues of \$1B or more) participating in the survey had completed divestitures compared to 51 percent of smaller companies (annual revenues of less than \$1 billion).

Forty-two percent of the respondents worked for companies with less than \$1 billion in annual revenues, with 23 percent at companies with revenues of \$1 billion to \$5 billion and 35 percent at companies with revenues of \$5 billion or more.

The companies surveyed represented a variety of industries including 33 percent from manufacturing, 16 percent from financial services, and 12 percent each from the technology/media/telecommunications and energy/resources sectors. Seventy-eight percent of the companies are headquartered in the United States, and 60 percent are publicly-held.

Regarding the role of the respondents, 42 percent work in strategy or business development, 41 percent work in finance, and the remainder had other responsibilities.





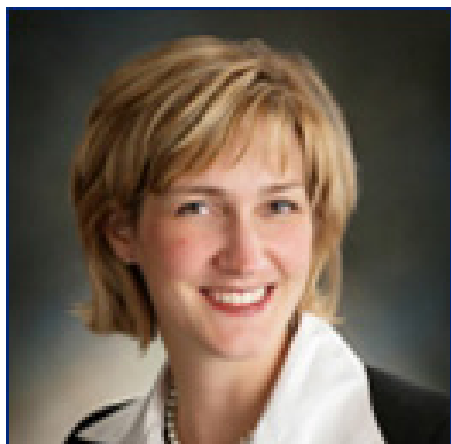
Deloitte's Divestiture Services practice

Deloitte, together with the Deloitte Touche Tohmatsu Limited (DTTL) member firms around the world, is a leading, global divestiture advisor. We have developed a divestiture methodology that leverages cumulative experience from thousands of transactions, and is tailored to the specific needs of each client. Deloitte has advised many of the world's leading companies through large, complex divestitures by helping them become a prepared seller, reducing risk, accelerating separation timing, and protecting the value of both the divested entity and the parent company. Whether they are sellers, buyers, or part of a business unit changing hands, Deloitte's approach can help business leaders confront the challenges across the divestiture lifecycle.

Our Divestiture Services practice is made up of more than 6,100 financial advisory, consulting, tax and accounting professionals within Deloitte and the DTTL member firms around the world. We provide corporate buyers and sellers as well as private equity investors with a broad continuum of advisory services supporting divestiture strategy, pre-sale due diligence, transaction execution and separation planning and value realization across many industries and business functions.



Meet our authors



Ellen Clark

Managing Director
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Ellen Clark is a managing director and member of the Deloitte Corporate Finance LLC's Manufacturing group where she focuses on Automotive OEMs, Suppliers and Service Providers. Ellen has more than 19 years in investment banking and has served as lead advisor for the sale or acquisition mandates of numerous public and private companies in industries that include automotive, metal, industrial, specialty chemical and marketing services. She has completed more than 75 transactions, including public and private debt and equity placements and merger and acquisition transactions for public and private clients.



Anna Lea Doyle

Principal, M&A Services
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Anna Lea Doyle is a principal in Deloitte Consulting LLP's M&A practice. She has helped clients solve complex integration and divestiture opportunities ranging from \$450 million to \$30 billion. She has been with Deloitte over 13 years of her total professional career (23 years) supporting engagements in banking, high technology, consumer products and manufacturing. Anna leads our U.S. consulting divestiture service offering. Her expertise and experience spans integration and divestiture (both global and regional) in the areas of program management and blueprinting, merger & acquisition (M&A) capability development and diagnostics, Day 1/Day 2 planning and readiness assessment (including cutover), synergy planning, transition services agreements, and implementation.



Andy Wilson

Partner, M&A Services
Deloitte & Touche LLP

Andy Wilson is the U.S. leader of M&A Seller Services, specializing in providing accounting, tax, and finance services relating to divestitures, carve-outs, joint-venture combinations and sales of businesses. Over the last 20 years, he has worked with many of Deloitte & Touche LLP's most significant strategic and private equity clients, leading buy- and sell-side due diligence services for domestic and international M&A transactions. In connection with this work, Andy has significant experience in helping companies increase the value of dispositions through effective sell-side due diligence. Previously the U.S. leader for M&A in the automotive sector, Andy's experience covers a broad range of industries, including industrial and consumer products, as well as general manufacturing, distribution and services. He has significant global experience, managing complex, global carve-out transactions and has established a broad network of global resources. Andy has been part of M&A Transaction Services for almost 15 years, before which he worked with Deloitte & Touche LLP's audit group.





Bob Coury

Managing Director
Deloitte Corporate Finance LLC

Bob Coury leads the General Industrials practice at Deloitte Corporate Finance LLC (DCF). DCF specializes in middle market transactions in various industries. These transactions include corporate sale mandates, corporate carve-outs and divestitures, buy-side transactions, capital raising, fairness opinions, and general business advisory.

Since 1986, Bob has been performing corporate finance and investment banking services including, mergers & acquisitions, business valuation, bond trading/portfolio management and general business advisory services. He utilizes DCF's industry specialists combined with the Deloitte and Touche LLP's Global Industry team to bring a targeted global solution to his clients.

Bob is a principal of Deloitte Financial Advisory Services LLP and a managing director with Deloitte Corporate Finance LLC. In each of his roles, he is focused on the marketplace. He utilizes the strength of a leading global financial services firm, with over 165,000 professionals, to solve client specific issues.



Jeff Weirens

Principal, M&A Services
Deloitte Consulting LLP

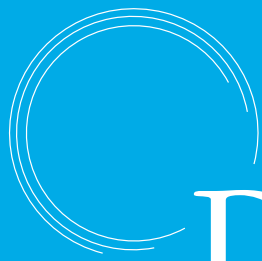
Jeff Weirens leads Deloitte Consulting's Global Merger Integration and Divestiture practice. He serves as a trusted advisor to senior client executive teams and Boards of Directors on improving shareholder returns through effective execution of acquisition, divestiture and restructuring strategies.

With over 20 years of experience, Jeff works closely with both strategic and private equity clients across the entire M&A lifecycle. He specializes in establishing merger integration and divestiture governance, organization, operating models, exceeding synergy targets, optimizing transition service agreements and resulting cost structures and planning and executing an issue-free Day 1 customer and employee experience.

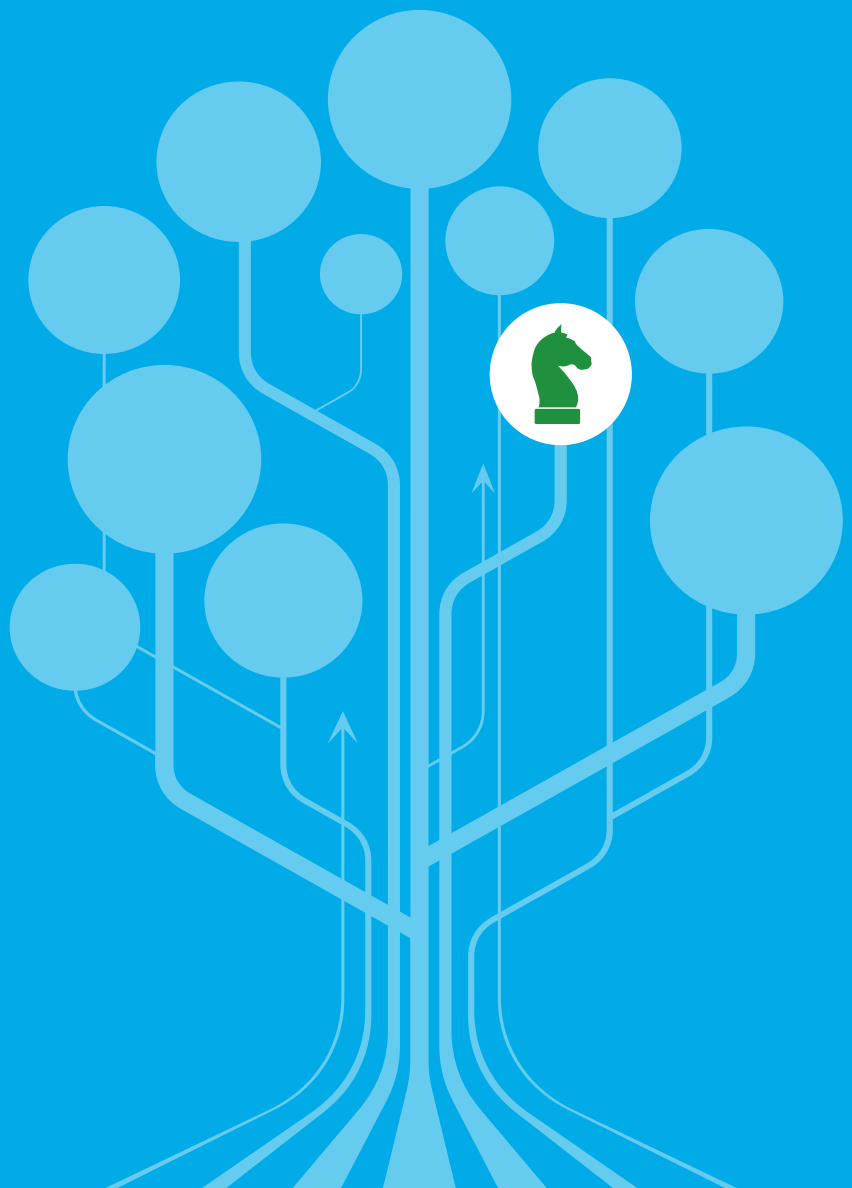
Jeff has led many of Deloitte's most complex projects through his work in Belgium, Brazil, Canada, China, Finland, France, Germany, Greece, Italy, Japan, Poland, Romania, Spain, Singapore, Switzerland, the United Kingdom and the United States.







Divestiture Strategy





Deloitte.

Sellers, conditions
are ripe.
Time to take a bite
at the apple





Why are conditions so ripe?

A confluence of market events that include tax law changes, pent up supply of corporate cash, uninvested private equity capital, renewed strength in the leverage markets, pending exits by private equity, and increasing transaction multiples generates a set of circumstances that could lead to a robust second half of 2012. Many sellers may be compelled to take a step into the M&A markets (i.e., their first bite at the apple) because of the favorable market conditions while others could look to explore recapitalizations and take some money off of the table, while helping themselves to a second “bite at the apple” upon a subsequent sale. In either case, conditions look to be ripe for both.

The current tax environment

Late last year, Congress approved and President Obama signed legislation that extended the more favorable Bush-era tax rates for individuals — which were about to expire — through 2012. The legislation also put into place a temporary estate tax regime for the same period. With the prospect of both of these tax laws scheduled to expire at the end of the year, individuals once again face the same uncertainty over future tax rates that existed through 2009 and 2010.

If Congress fails to adopt a more permanent tax structure before the end of 2012, the income tax and estate and gift tax rates would revert to pre-2001 law as shown in Exhibit 1. Such an event would usher in across-the-board tax increases for all taxpayers. Although there is nearly unanimous support for preventing tax increases

on low- and middle-income taxpayers, the debate over taxation of higher-income individuals continues.

Lawmakers continue to struggle with reaching an agreement in a timely manner during the 112th Congress, and that pattern is expected to continue as they focus on the expiring tax cuts as well as a host of other tax and budgetary issues. As a result, the tax landscape for 2013 may not become certain until days before the end of 2012. In the lame duck period that will occur after the November 2012 election, but before a new Congress and the next presidential administration take office, the path of least resistance for the current Congress and the White House could be a second temporary extension of tax cuts. A one or two-year extension would create the space for a tax reform debate that could resolve the issues on a permanent basis. However, the political environment next fall and the outcome of the November elections could alter this path.

Exhibit 1

Tax Rates	Current Law 2001/2012	2013	Change
Ordinary Income			
\$379,150–	35.00%	39.60%	4.60%
\$212,300–379,150	33.00%	36.00%	3.00%
\$139,350–212,300	28.00%	31.00%	3.00%
\$69,000–139,350	25.00%	28.00%	3.00%
\$17,000–69,000	15.00%	15.00%	0.00%
\$0–17,000	10.00%	15.00%	5.00%
Qualified Dividends	15.00%	Ordinary Income (up to 39.60%)	up to 24.60%
Long-Term Capital Gains	15.00%	20.00%	5.00%
Personal Exemption and Itemized Deduction Phase Out Limitations	Gone	Restored	



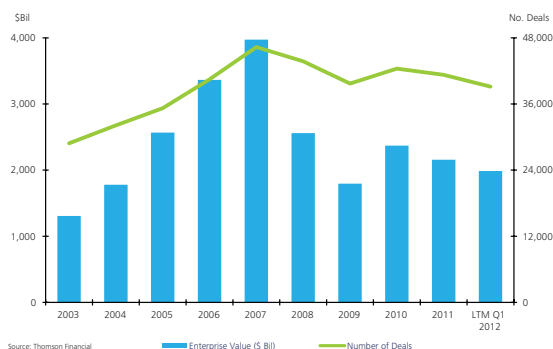
The price of indecision

This pattern of legislating does not afford individuals or companies the luxury of waiting to plan tax decisions until Congress reaches an accord. Companies (and individuals for that matter) would do well to consider tax planning decisions far before the end of 2012 based on whether one expects the current rates to continue or change beginning in 2013.

The prospect that Congress could act on broad tax reform in 2013 or 2014 raises new tax planning concerns. For more than a decade, high-income taxpayers have planned with an assumption that eventually taxes and tax rates would increase. Many reasonably may continue to hold that view, particularly with respect to rates on capital gains and qualified dividend income.

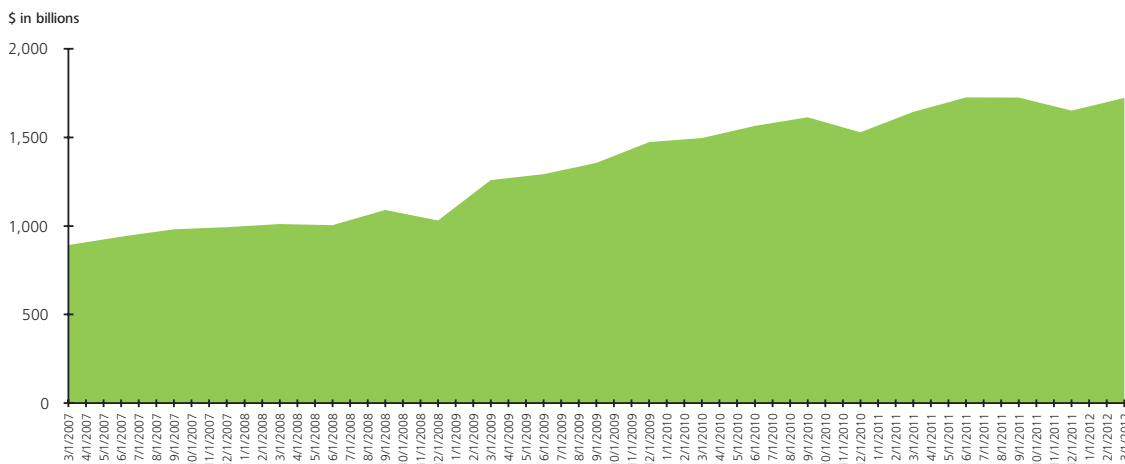
In the face of such uncertainty, it is tempting to do nothing on the grounds that it is too hard to know what to do. Of course, in tax planning, a decision to do nothing is still a decision and could be a bad one. It is believed significant tax changes will occur, although those changes may not occur before 2013 or 2014 and may phase in over time. Until change comes, taxpayers may find that disciplined planning under the present law could produce potential benefits.

Exhibit 2
Global M&A Deal Value Begins on a Slow Note in 2012, but Positive Indicators Remain



Source: Thomson Financial

Exhibit 3
U.S. Cash Holdings for Members of S&P 500 Index



Source: Capital IQ
Notes: Cash does not include short-term investments. Data limited to 477 companies reporting complete quarterly data over the past five years.

As shown in Exhibit 2, despite a rebound in M&A activity in 2010 off the lows of 2009, M&A has since pulled back in 2011 and into the latest twelve month period (“LTM”) ended Q1 2012. While economic fundamentals have improved, market uncertainty from the second half of 2011 appears to have affected transaction activity for 2012. Evidence of this decline is seen in both lower total transaction value (down 20.6% in LTM Q1 2012 compared to LTM Q1 2011) and in the reduced number of announced deals (down 8.9% in LTM Q1 2012 compared to LTM Q1 2011).

However, while there remains uncertainty in the market around the expiration of the Bush tax cuts discussed previously and general concerns with ballooning U.S. government debt, there are signs that point in favor of increased investment activity for the balance of the year.

The accumulation of cash and uninvested capital

The U.S. economic recession had several foreseen and unforeseen impacts on both corporations and private equity firms during the past few years. One of the most intriguing results has been the buildup of liquidity, which has helped to set the table for the anticipated growth in M&A activity.

Corporate cash

It has been well documented that, over the past few years, many companies have focused on deleveraging their balance sheets and enhancing their liquidity positions given the volatility in operations and uncertainty in the capital markets. This concerted effort to shore-up corporate balance sheets during the recession has positioned companies with reduced debt levels and strong cash balances, which could be used to pursue M&A activity as a vehicle for growth.

As illustrated in Exhibit 3, at the end of December 2007, cash holdings for members of the S&P 500 Index were just under \$1.0 trillion. This represented a relatively consistent level of cash from the previous few years. However, at the end of March 2012, this same group’s cash holdings had

grown over 73 percent to \$1.7 trillion, a near-record high. These historically high corporate cash balances, coupled with the slowly improving economy and the stabilization of the capital markets, will likely result in greater pressure from stakeholders to reduce cash balances and put this excess capital to work.

Prior to the most recent economic downturn, companies maintaining large cash balances often became a target of heightened takeover speculation or may have faced shareholder pressure to reduce cash holdings and/or return excess cash in the form of dividends. As the markets continue to stabilize and the economy improves, it is reasonable to expect these same pressures to mount, possibly resulting in a gradual decline of cash balances to lower historic levels. While companies have various options for utilizing excess cash balances, it is likely that acquisitions may be a significant component of the cash utilization.

While there are many different possible uses for this cash, including dividends and share repurchases, slow GDP and organic revenue growth could lead some companies to begin an acquisitive growth strategy. Further, companies with high cash balances have less need to rely on debt financing to fund acquisitions. At the same time, low borrowing costs of debt financing make funding acquisitions with debt very attractive.

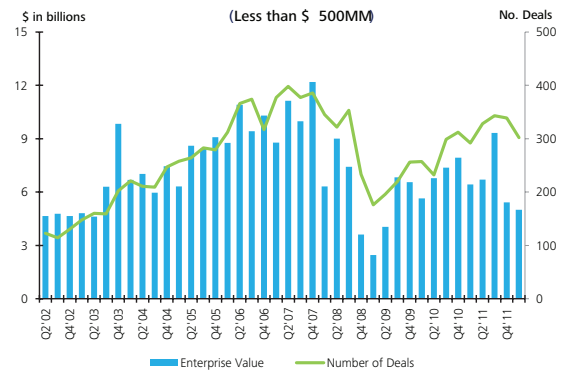
Private equity activity

During the economic expansion between 2005 and 2007, private equity played a significant role in the expanding M&A market. With access to relatively inexpensive debt capital and the ability to apply higher than normal leverage to acquisitions, private equity funds were able to offer competitive valuations and complete more deals.

However, the credit crisis in the fall of 2008 and the subsequent economic downturn decimated the number of private equity-led M&A transactions. In observing only the sub-\$500 million deals, private equity activity plunged 56 percent from its high point in 2007 to its low point in 2009 (with 398 deals with disclosed multiples observed in 2007 down to 176 deals observed in 2009). With the uncertain economic environment and the limitation on financing and liquidity, many funds largely pulled back on their investing and focused their attention on their existing portfolio and on raising additional funds. Relative to historical levels, the number of deals remains high (see Exhibit 4). However, the average transaction value per deal is smaller.

Exhibit 4

U.S. Mid-Market Financial Buyer Deal Value & Volume



Source: Thomson Financial

Private equity uninvested capital

Uninvested private equity capital has traditionally grown at a stable rate. For example, between 2001 and 2007, uninvested capital grew at approximately 6.6 percent annually, with private equity firms holding approximately \$207 billion in uninvested capital at the end of 2007. Between 2007 and 2010, however, the levels of uninvested capital grew by over 33 percent annually, reaching \$490 billion at the end of 2010.

At the end of the first quarter of 2012, private equity funds had \$425 billion of uninvested capital and, in addition, 409 new funds were in the process of raising additional capital.

These unprecedented levels of uninvested capital held by private equity firms are expected to increase the pressure and motivation for these funds to be put to work. While the ability of private equity funds to apply higher leverage multiples is still not at pre-recessionary levels, they have recently found a more welcoming financing market, which may enhance the competition for deals.

We expect that the build-up of uninvested capital, in concert with the improving financing market, may drive a significant pick up in the demand for quality assets. This anticipated potential increase in activity from private equity, coupled with a similar increase among corporate acquirers, may have a significantly positive impact on transaction multiples.

70% of existing private equity-backed portfolio companies were purchased prior to 2009.

Source — Pitchbook

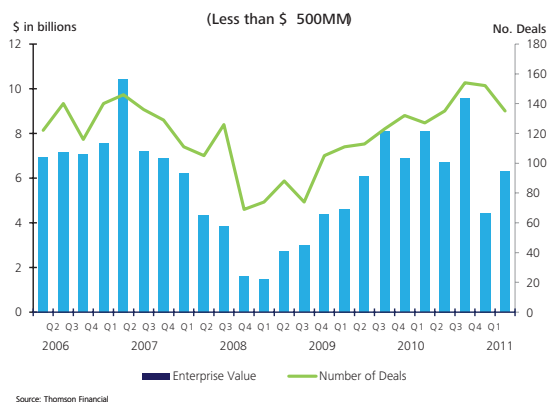


Private equity exit activity

Indicators exist that indicate that M&A deal volume could become more robust. According to Pitchbook, there are approximately 4,200 private equity-backed companies that sponsors are looking to exit in the intermediate future. Private equity sponsors may seek to take advantage of the potential trend of increasing enterprise value multiples to opportunistically exit their existing investments.

Volume has returned to pre-recessionary levels as seen in Exhibit 5. Private equity firms exited from \$6.3 billion of investments in 1Q 2012, compared to just \$4.4 billion in 4Q 2011. Private equity exits could remain strong in 2012 as, according to Pitchbook's *Private Equity Trends 1Q 2012*, the median time from buyout to investment exit for private equity firms was 4.8 years in 2011 and 70% of existing private equity-backed portfolio companies were purchased prior to 2009.

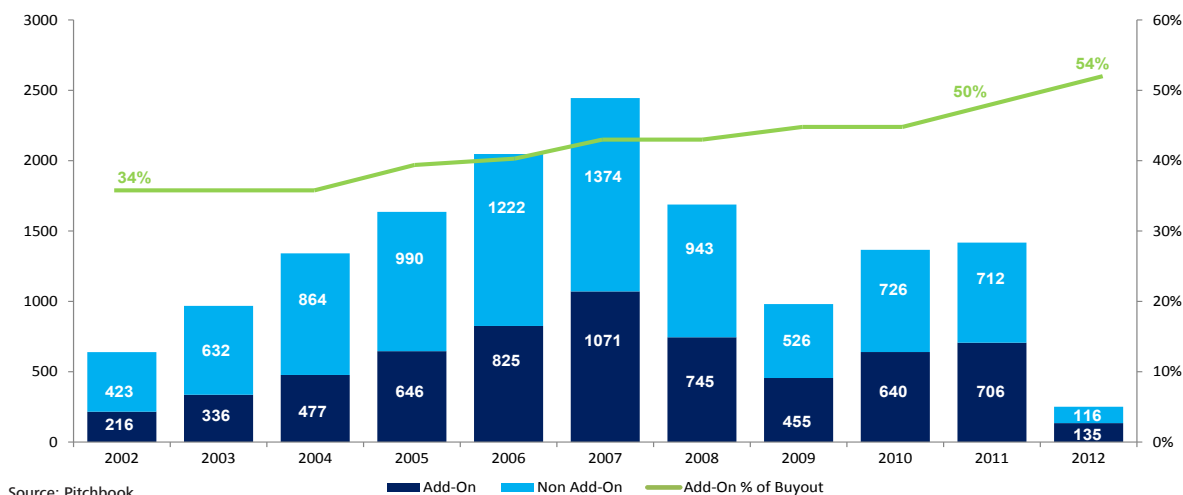
Exhibit 5
U.S. Mid-Market Private Equity Exits Deal Value & Volume



Private equity add-on activity

While the volume and transaction size of private equity deals has certainly curtailed since 2007, as shown in Exhibit 6, for the first time in the past decade, more than half (54%) of private equity buying activity was related to add-on investments in the first quarter of 2012. This is one

Exhibit 6
Private Equity Add-on Activity



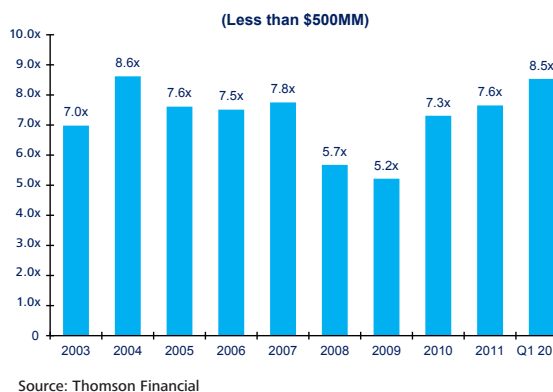
reason why the average transaction size has fallen in the past three quarters.

A closer look at transaction multiples . . .

With the economic downturn came depressed earnings multiples within M&A transactions. Exhibit 7 looks at disclosed deals valued under \$500 million across industries and the corresponding Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) multiples.

Since 2003, the average observed earnings multiple was 7.1 times EBITDA. During this same period, the lowest average earnings multiple for a given year occurred in 2009 with an average multiple of 5.2 times EBITDA, about two turns below the average. 2010 brought a healthy rebound in valuations and a significant strengthening of earnings multiples to 7.3 times EBITDA, just above the average. This rebound is especially impressive given the low financing levels that were still being experienced during most of 2010 and are likely due, in some part, to improved corporate earnings during this period. Earnings multiples have continued their upward trajectory increasing to 7.6 times EBITDA in 2011 and to 8.5 times EBITDA as of the first quarter 2012.

Exhibit 7
U.S. Median Enterprise Value to EBITDA Multiple



...and leverage multiples

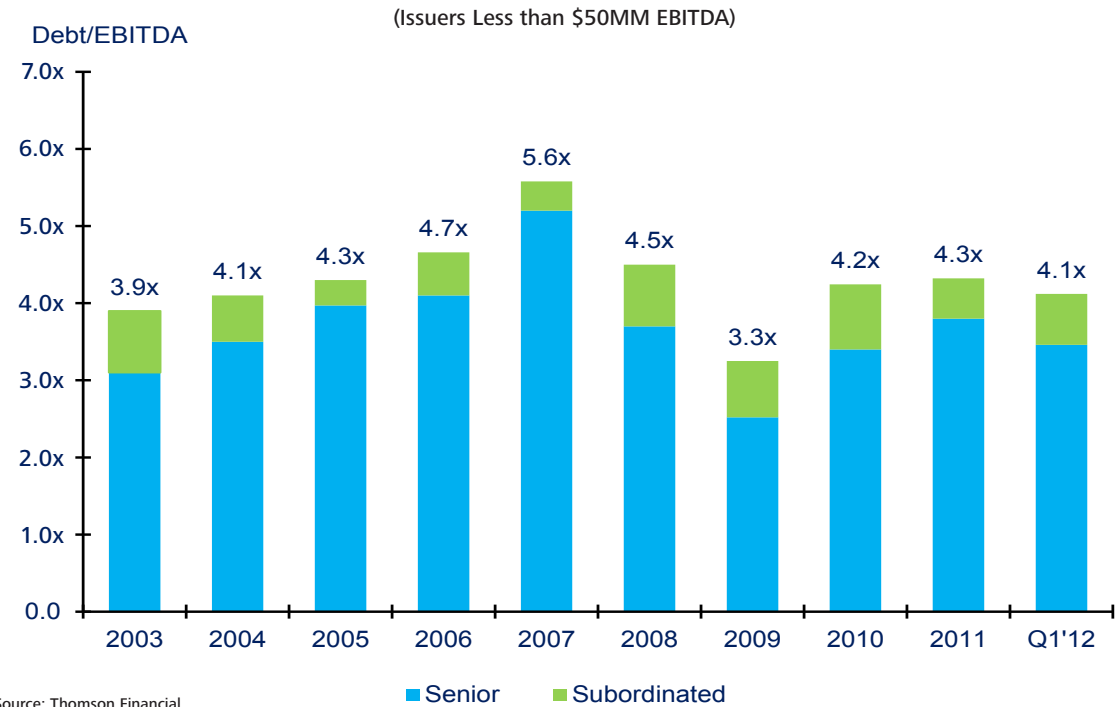
After the credit crisis, leverage levels for middle market debt issuers (defined here as those companies having less than \$50.0 million in EBITDA) plunged from a high of 5.6 times Debt/EBITDA in 2007 to a low of 3.3 times Debt/EBITDA in 2009.

Despite the increase in transaction multiples to 8.5 times EBITDA observed in the first quarter of 2012, as demonstrated in Exhibit 9, leverage levels have not followed suit over the same period and, in fact, have

declined slightly since 2011, which might suggest some hesitancy on behalf of lenders to more fully deploy capital.

However, while leverage has not returned to 2007 buyout levels, banks and other capital providers have returned to the credit markets in full force offering favorable terms and pricing. Total leverage has increased to just over 4.0 times EBITDA for 2010, 2011 and through the first quarter of 2012.

Exhibit 8
U.S. Mid-Market LBO Debt Multiples





Could the second bite taste better than the first?

What is a recapitalization?

In its simplest form, a recapitalization is a change in a company's capital structure. To change its capital structure, a leveraged company may opt to reduce its debt levels and issue stock to repay debt, while other companies that are over-equitized may buy back stock by issuing debt.

Equity recapitalization

Investors like private equity groups allow owners to create liquidity for themselves by buying up controlling or non-controlling equity stakes of a business and replacing debt with equity or replacing existing equity investors.

Advantages

An advantage of an equity recapitalization is that it may allow owners to take some money off the table but not completely exit the business. What's more is the opportunity for owners to take a second bite at the apple when private equity groups may look to exit the position after three to seven years and owners sell their remaining stake along with them. Given the experience that many private equity groups can bring in improving operational efficiencies and generating synergies, the second bite at the apple may potentially be more valuable than the first.

Disadvantages

Downsides of equity recapitalization may include some disruptions to the operations, a larger commitment of management time in the short-term to execute a transaction, an enhanced shareholder base that would reduce current owner control, and the requirement of the company to meet some of the restrictive requirements of a financial buyer, which may include board representation.

Leveraged recapitalization

In a leveraged recapitalization, a company takes on additional debt leverage with the intention of paying out a dividend or buying back shares. This strategy provides cash to shareholders and enables them to continue to participate in the future growth of the company, while bearing the risks of a leveraged balance sheet.

Advantages

This strategy provides liquidity to shareholders without forfeiting operational control of the company. A leveraged recap typically takes less time to execute than an outright sale, and it can provide the mechanism for realigning ownership and/or replacing disinterested shareholders.

Disadvantages

Potential downsides of a leveraged recapitalization are the financial strains of a leveraged capital structure, potentially restrictive debt covenants, and the potential for reduced flexibility to invest in future opportunities without further equity support.

“Owners who are desiring liquidity should consider executing a transaction prior to year end, before the expiration of current tax law, which could result in material tax savings.”

What is a dividend recapitalization?

A dividend recap is a leveraged recapitalization strategy that replaces a portion of a company's invested equity capital with debt financing. The proceeds of such financing are then distributed to the owners of the business in the form of a dividend. In doing so, owners are able to take some money off the table while still maintaining ownership in the business. That said, dividend recaps may only be applicable for companies that have a performance profile that would be attractive to the financing markets.

Why now?

As demonstrated in Exhibit 1, if federal tax law reverts to pre-2001 law, as is currently scheduled, then the tax on dividend income would increase from the current 15% level to upwards of 39.6% (depending on income levels), an increase of up to 164%! Furthermore, taxes on capital gains are also expected to increase, which means owners who are desiring liquidity should consider executing a transaction prior to year end, before the expiration of current tax law, which could result in material tax savings.

A good time to be a seller

Given all of the factors discussed above, it may be reasonable to expect that we are on the brink of a strong M&A market, which is likely to increasingly favor sellers for the balance of the year. The well-capitalized

position of most of the buyer universe, combined with the strengthening economy, and favorable financing conditions, provide compelling evidence to potentially increasing deal volumes, assuming the economic environment continues to improve.

There appears to be a window of opportunity for sellers to take advantage of these factors and to potentially benefit from the potential environment of premium pricing in the M&A market and the current favorable tax environment. These factors represent a significant change from the tepid M&A environment that immediately succeeded the recession in 2009 and one that may pay off for those sellers who choose to take advantage of the potential window of opportunity present in the market prior to the end of the year.

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Sell-side considerations for middle-market companies

Starting and growing a business is tough; exiting it can be even tougher. An owner of a private, mid-market company who is contemplating its sale should execute the process with forethought and precision; the owner should sell for the right reason, have an understanding of value, and be prepared to address a host of financial, operational, technology, and human resource issues during the transaction. The process can be daunting, especially because achieving goals in running a company — whether it is a longtime family business or an up-and-coming entrepreneurial firm — doesn't necessarily translate into achieving those goals when selling it.

When is it time to sell?

Owners of mid-market companies face numerous issues and challenges leading up to and during the sale process. One big question: When is the preferred time to pursue a transaction? Oftentimes, the decision involves three considerations: company-specific variables, existing market conditions, and synergy opportunities with potentially interested parties.

Owners of mid-market companies face numerous issues and challenges leading up to and during the sale process. One big question: When is the preferred time to pursue a transaction?

Company-specific variables

Many owners of entrepreneurial firms typically are good at starting businesses but may not be as adept at handling the myriad challenges typically encountered throughout a “normal” company lifecycle; at a certain point in the company’s growth, an owner may realize: “I’m great at marketing but need additional human and financial capital to take this business to the next level.” Another trigger might arise from a life event or from a desire to pursue other interests. Alternatively, a second-generation owner may feel that their passion for the business is waning or that their children aren’t interested in or capable of taking over the business.

Existing market conditions

Many people think their baby is the most beautiful in the world; however, pride of ownership can make it difficult for owners to determine the appropriate price for their company. An entrepreneur who has devoted years to building a business or an owner who considers a family company to be their legacy may find it difficult to take an objective view of the company, resulting in an inflated perception of value, and become frustrated in their attempts to consummate a transaction. Conversely, if an owner is looking for a quick exit and suggests a willingness to accept a price that is below the market’s perception of value, the owner not only risks forfeiting the financial rewards to which they are entitled (especially if estate and gift taxes are part of the sales equation) but also invites potential buyers to negotiate the price down even further.

It also can be challenging for owners to identify the “windows of opportunity” in which to sell the business at the desired price. Important questions to ask include: Is the overall market for selling companies favorable? Will my company’s recent performance garner an attractive price? Am I emotionally ready and financially prepared to exit my company? While conditions rarely align perfectly, the answers to these questions should be acceptable or the owner/entrepreneur may be better served to delay the possible transaction.

Fortunately for sellers, recent mid-market deal activity has been quite favorable (Figure 1). U.S. corporations today have more cash on hand than any time in history; concerted efforts to shore-up balance sheets during the recession has positioned companies with reduced debt levels and strong cash balances, which could be used to pursue Merger & Acquisition (M&A) activity as a vehicle for growth¹.

Figure 1: U.S. mid-market deal value & volume²
(Less than \$500 MM enterprise value)



Source: Thomson Financial

Additionally, private equity (PE) firms have considerable available cash to invest in private businesses. At the end of second quarter 2012, PE funds had \$423 billion worth of capital that they need to put to use,³ potentially via mid-market M&A. Another positive that may boost short-term, mid-market divestiture activity: Capital gains rates will likely remain at 15 percent until the end of 2012⁴, along with more favorable Bush-era tax rates for individuals and a temporary estate tax regime¹. The prospect that Congress may fail to extend these cuts or adopt a more permanent tax structure, as well as the potential for Congress to act on broad tax reform in 2013 or 2014, raises new tax planning concerns and could spur numerous transactions in late-2012 and early 2013, as owners who are desiring liquidity seek to attain material tax savings.

¹ "Sellers, conditions are ripe: Time to take a bite at the apple" Deloitte Corporate Finance LLC, June 2012

² "Middle Market M&A News, September 2012," Deloitte Corporate Finance LLC

³ Ibid

⁴ <http://www.forbes.com/sites/beltway/2012/01/24/capital-gains-taxes-are-going-up/>



While ample capital is available and tax conditions are favorable, many of today's buyers are more disciplined than they were five years ago and will be fairly rigorous with respect to acquisition prices. They may be willing to pay for quality assets, but a company seeking to be purchased needs to demonstrate that it has, among other characteristics, a defensible position, a proprietary product, and positive client relationships, in order to attract the most favorable valuation. Not all cash flow is created equal; current owners should demonstrate that when their company is in the hands of someone else, the new owners should be able to not only maintain but, in fact, significantly expand upon its historical achievement.

Synergy opportunities

Standalone mid-market companies may offer considerable synergy opportunities for potential purchasers; among them, access to new products, technologies, customer segments or geographic markets, accelerated time to market, and increased management depth and experience. It is important that the seller promote any potential synergies early in the sales cycle to increase market interest and improve valuation. Also, when a mid-market business is an important contributor (vendor, service provider) to a larger company, it may be easier for the mid-market owner to leverage that relationship and be acquired by the larger company. However, it is likely that the owner will need external assistance to determine if the entity is worth more as part of a bigger company or as a standalone, and when the time is right to approach potential buyers.

Sales transaction challenges

Once a business owner has decided to sell, navigating the transaction process can bring numerous other challenges. Among them: identifying and vetting interested buyers. There may be a lot of pretty candidates, but only a few really good matches. For example, is a strategic competitor or a PE firm a more practical option? What about a foreign versus domestic buyer? Also, how can the seller confirm bidders' credit-worthiness, their access to capital, and governance practices?

The next hurdle is the sale itself. If a business owner wishes to manage price, can a high price be achieved through a one-to-one negotiation? Or, must the owner pursue a broad auction process and risk possible confidentiality leaks and/or the reputational risk of having a wide sale process that ultimately may not be consummated? Either option can become a complex, nerve-wracking game between seller and bidder that weighs the optimism of the owner against marketplace realities: Buyers want to get a deal done at the lowest-possible price, while sellers are looking to leverage their after-tax proceeds from the transaction. The current financial and economic environment adds another wrinkle and can create additional pricing pressure⁵.

Even when a deal has been reached, the transaction is far from complete: the current and new owners have much to accomplish in the period between signing and closing, including developing an employee retention program, reconciling disparate compensation strategies, and creating and implementing an effective employee communications plan. For some, the process can seem never-ending.



Human resource issues can loom large in a company sale

Situation: a large Asian manufacturer is currently entering the U.S. market via the purchase of its third-largest U.S. competitor. As the manufacturer is entering a new geographic market, one factor to the achievement of goals in the acquisition is the retention of the management team.







Issue: The company is currently owned by a PE firm, and the management equity incentive plan will pay out multi-million dollar amounts on the change in control, providing executives with significant "walk-away" money.

Result: A detailed retention plan was developed with three facets. First, it was determined that the roles, responsibilities, and titles that the executives would have after the acquisition were critical to their continued satisfaction. A detailed organization structure, reporting responsibilities, and governance structure was developed to address this. Also, the senior U.S. executives were named to various Board positions in the global parent company, giving comfort to the management team. Second, a long-term incentive plan was redesigned, allowing executives to reinvest a portion of their existing equity. The rollover was matched by the company, providing enhanced opportunity for future wealth accumulation. Third, the business rationale and leadership team vision of the new organization was developed in detail and communicated by the leadership jointly with the target, helping to secure the buy-in of the extended executive team.

⁵ "M&A Seller Services: Preparation drives value," Deloitte Corporate Finance LLC, 2012

Experience counts

Because mid-market company owners often lack experience in M&A — and the financial implications of selling their business can be considerable, especially when the proceeds are needed to provide future financial security for an owner and their family⁶ — owners should consider enlisting a team of independent, experienced advisors to provide support before, during, and after the sale. These individuals and their typical roles to assist the seller are as follows:

					
Investment bankers	Attorneys	M&A accounting/forensics professionals	Tax professionals	Human resources professionals	Asset managers/estate planners
Establish a range of values and advise on the spectrum of possible outcomes; identify challenges early in the sales cycle; develop the selling story and marketing strategy; ⁷ “shop” the company to numerous potential buyers (so the seller has multiple parties with which to negotiate); assist owners with valuation and negotiation strategy.	Assist with negotiation of transaction terms; draft legal documents to effectuate the transaction; focus on those aspects that might create exposure for the seller post-transaction; understand and assist with regulatory approvals.	Conduct pre-sale financial due diligence with a focus on earnings quality, normalized working capital, and financial commitments (net debt). Such seller due diligence can help to reduce surprises during the transaction as well as the possibility of price chipping in the latter stages of the process. These professionals also review the consistency and accuracy of the data room documents. Upon assessing the value drivers, their focus often shifts to provide comments on the transaction agreements; prepare funds flow statements, conduct closing date balance sheet or working capital analyses; and assist in identifying purchase price adjustments.	Provide advice on the structure of the sale (e.g., receive a lump sum, stretch out the sale payments over several years, remain on the company payroll for a while as a consultant or advisor ⁸); determine the preferred domicile and type of legal/tax entity; obtain desired tax treatment of transaction (taxable or tax-free, where available).	Develop the organization’s talent strategy so that it is most favorable to the seller’s employees, including organizational design and integration under the new leadership; terms and conditions for retention of senior executives; separation agreements; rewards strategy and compensation packages; and employee communications plan.	Help seller assess whether the level of anticipated proceeds can achieve the owner’s hoped-for post-sale lifestyle and aspirations, given his or her appetite for investment risk.

It is important that external advisors work collaboratively, both with the owner/other company contacts and with each other — if they are from different firms, the advisors may have competing agendas and be more complex to manage. There should be no duplication of services but each major area should be addressed; a single issue could have tax, accounting, and HR impacts and thereby affect the valuation and negotiation of the transaction documents. As a result, these issues should be examined through different lenses.

Preparation can drive value

The goal when selling a business is often to capture the highest value possible. While a number of factors drive deal valuation — company prospects, competitive landscape, economic conditions, deal structure and tax considerations, among them — well-prepared sellers are generally better positioned to meet the challenges posed by potential buyers during the process. Among leading practices that can help a seller prepare for and execute a transaction that achieves their goals for deal value are the following:

⁶ Andrew Menachem, Andrew. “What to know when you are selling your business,” The Miami Herald, July 13, 2012. (c) Copyright 2012, The Miami Herald. All Rights Reserved. <http://www.miamiherald.com/2012/07/13/2894767/what-to-know-when-youre-selling.html>. Accessed July 24, 2012

⁷ “Using Investment Bankers to Sell a Business,” Gaebler.com Resources for Entrepreneurs, <http://www.gaebler.com/Role-of-Investment-Banker-Selling-Your-Business.htm>. Accessed July 24, 2012

⁸ Andrew Menachem, Andrew. “What to know when you are selling your business,” The Miami Herald, July 13, 2012. (c) Copyright 2012, The Miami Herald. All Rights Reserved. <http://www.miamiherald.com/2012/07/13/2894767/what-to-know-when-youre-selling.html>. Accessed July 24, 2012



Accurately value the company

Remember that the true worth of a business is the current and potential income it will generate for the new owner⁹. To manage the risk of overvaluation, company owners should work with an investment banker/financial advisor with experience valuing businesses in their sector; provide the broker with all the necessary financial information to facilitate the valuation process; and listen to the broker (who is more objective about the company’s worth).

Enlist seller services support

In collaboration with the legal and financial advisors described above, M&A seller services professionals can provide a broad spectrum of customized services and solutions to help mid-market company owners complete a divestiture across the sale lifecycle (Figure 2). Typical services include:

- Deal planning and preparation: Define what will and will not be included in the transaction; identify potential tax, accounting, labor, operational and system issues before going to market; determine whether the transaction structure is in line with company strategy; quantify the strategic value of risks and opportunities; address issues associated with the Confidential Information Memorandum, including the appropriateness and comparability of financial information presented.

- Due diligence/seller diligence: Identify financial and regulatory matters; examine compensation-related agreements; assess the quality of the information that will be made available to potential bidders; preparation of a Seller Diligence Report (see sidebar article), when applicable.
- Deal structure: Assess alternatives and structure the deal to meet seller’s financial objectives; estimate gains; analyze the allocation and preservation of tax attributes; identify potential perceived risks of prior tax positions.
- Transaction execution: Identify deal issues and develop negotiating positions; assess proposed purchase price adjustments and earn-outs; comment on representations and warranties to be included in the purchase agreement; develop a workable purchase price mechanism to reduce the potential for disputes over judgmental accounting areas and resolve tax and accounting issues.
- Transaction closing and post-closing support: Apply accounting principles and prepare historical financial statements; after deal has closed, help calculate the gain on the sale and assist in determining purchase price adjustments; assist in drafting transition service agreements and preparing the divested business for day-one readiness, including cutover of IT systems and the establishment of HR and financial functions.



Figure 2: Seller services across the sale lifecycle

Employing a structured approach to sales/divestitures can unlock and drive value at each step of the process

Phase I 4–5 weeks	Phase II 10–12 weeks	Phase III 3–4 weeks	Phase IV 6–8 weeks
• Preparing the business for the sale and pre-sale due diligence	• Marketing the business	• Buyer selection and due diligence	• Closing the transaction
<ul style="list-style-type: none"> • Discuss goals and objectives of management • Develop understanding of the company’s business model, competitive position and corporate functions’ allocations • Identify potential obstacles to sale and deal with them directly and upfront • Analyze strategic rationale for various buyer/investor groups • Develop understanding of union agreements • Assist management in developing and diligence finances (historical and projected) • Compile and review data room information • Prepare detailed valuation analysis to assist buyer/investor evaluations • Create executive summary and prepare the confidential information memorandum 	<ul style="list-style-type: none"> • Finalize list of potential buyers/investors and analysis of buyers/investors and analysis of buyer-specific synergies’ opportunities labor considerations • Direct calling on potential buyers at C-suite level • Distribute information memoranda to approved parties • Develop management presentation • Field inquiries from interested parties to minimize disruption to the company 	<ul style="list-style-type: none"> • Assist in evaluating letters of interest and qualifying buyers/investors • Arrange value with management for qualified parties • Facilitate flow of information to prospective buyers/investors • Assist the company in soliciting and evaluating bids • Evaluate price, structure, non-cash consideration, potential synergies and conditions set by buyers/investors • Evaluate buyers/investors’ financial capability to close transaction • Assist where applicable in drafting labor business case and related documentation and begin negotiations 	<ul style="list-style-type: none"> • Manage final due diligence process • Assist in negotiation of definitive purchase and sale and other ancillary agreements • Assist in structuring and closing the transaction • Continue to assist in preparing information to be utilized in labor negotiations • Ensure timely follow through and settlement of any post-closing obligations

⁹ Bannister, Adam. “Business valuation: the danger of overvaluation,” <http://www.businessesforsale.com/sell-a-business/articles/Selling-a-business-the-danger-of-overvaluation>. Accessed July 24, 2012

Tailor the story

While the strategic advantages and core competencies of the business do not change depending on the potentially interested buyer, how that third-party might utilize the seller's specific attributes and thereby manage value within the acquiring company can change from buyer to buyer and can evolve over time. To this end, having intimate familiarity with the strategic visions of potential buyers and knowing how to position the selling company such that the opportunity hits home with the C-suite of possible buyers can be a main determinant in achieving the seller's objectives. A financial advisor with deep sector experience and a track record of achievement may generate the type of buzz within an organization that yields the highest price.

Conclusion

A confluence of market events that include tax law changes, a pent-up supply of corporate cash and uninvested private equity capital, and favorable financing conditions are providing a window of opportunity for mid-market company owners who are seeking to sell their business. Yet optimism should be tempered by realism when determining company value, and owners should consider turning to financial, legal, and M&A seller services professionals for solutions to help them navigate the transaction, manage sales price, and enjoy the fruits of their labors.

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Sell-side due diligence can boost credibility, deal value

The credibility of a seller can have a dramatic impact on deal value. Incomplete or inaccurate information, particularly financial data, may have a direct, negative impact on sale price. Conversely, reducing uncertainties about the accuracy and reliability of information being provided — company description, sales, cost, and profit figures — may make a potential buyer more willing to pay full consideration — or even a premium.¹⁰

Sellers can expect that potential buyers will conduct due diligence on the data they provide; sellers, therefore, have a compelling reason to be thorough in their own analysis. Conducting sell-side due diligence before the sales process starts can help a seller anticipate issues that a buyer may raise and develop responses that can help to reduce uncertainty and enhance credibility during the buyer's examination of the company. Among main focus areas in sell-side due diligence:

- Understand intra-company transactions, allocated costs, shared services, and plans for providing support post-acquisition and during transition.
- Evaluate the quality of earnings and identify "non-recurring" items for which management may want to consider adjusting the financial information.
- Understand the assumptions in company forecasts and the bridge of detailed data from actual results to forecast information.
- Evaluate the cost structure for fixed versus variable costs, capital expenditure requirements, and the relevance of certain general and administrative activities to the business being sold.¹¹

¹⁰ "Sell-Side Due Diligence: Can you pave the way to a higher-value carve-out?" Deloitte Corporate Finance LLC, 2008

¹¹ Ibid



Releasing latent value through a captive center sale

A framework



Introduction

Over the past decade, many companies made investments in consolidating back-office processes and technology in offshore captive centers. While many of these companies initially realized significant cost savings, some have found it increasingly difficult to maintain their offshore captives' cost and service quality advantage over specialized external service providers. At the same time, the 2008 credit crisis and the recession that followed left many companies strapped for cash. These organizations faced — and continue to face — increasing pressure from shareholders to reduce costs and shore up their balance sheets.

The need to raise cash, coupled with the perception of diminishing returns from their offshore captives, have led a number of companies to sell their large-scale captives to business process outsourcing (BPO) or information technology outsourcing (ITO) firms. In such a transaction, sellers may pursue a variety of goals: to monetize assets; to reduce capital expenditures (CAPEX); to reduce sales, general, and administrative (SG&A) expenses; and, in some instances, to gain an optionality of economics where the sale includes a credit in exchange for long-term services. Buyers, on the other hand, may wish to expand their geographic footprint and/or capabilities and generate more revenue over the long run. For their part, BPO/ITO firms typically purchase captives in order to gain capabilities in a particular area, thereby improving their ability to capitalize on the global demand for services in that area.

Our experience suggests that the opportunistic nature of many captive sales often works against the seller's interests in two ways. First, an opportunistic approach can limit a seller's ability to appropriately position the captive in the marketplace. In this paper, we explore how a more methodical approach that structures the captive operation as an operating business — not as a pure asset — can help sellers pursue their goals more effectively. Second, an opportunistic sale may hamper the seller's efforts to divest the captive in such a way as to support its performance

after its acquisition by the buyer. Yet a divested captive's future performance is a critical long-term value driver for sellers that expect to receive services from its former captive through a contract with the captive's buyer. This paper therefore also discusses several factors to consider in the sale process that can help a seller prepare its captive to deliver the required level of service after it becomes part of the buyer organization — when Day 1 is the beginning, not the end, of a relationship.

The offshore captive model, which first gained popularity in the 1990s, has matured to the point where many organizations have sought to release value from their captive organizations by selling them to BPO and ITO providers (see Figure 1). With the nascent economic turnaround encouraging outsourcing service providers to prepare for growth, sellers today can have a window of opportunity to sell their captives to a receptive BPO/ITO marketplace.

Selling a captive service center, however, is often very different from a "typical" divestiture, where the organization being sold is a revenue-generating business unit. In most divestitures, the seller and buyer are free to go their separate ways after the transaction. In a captive sale, on the other hand, the seller and buyer more frequently maintain a strong, interdependent relationship after the sale is concluded, with the seller contracting to receive services from the buyer on a long-term basis. In fact, most sellers expect buyers to deliver these services through the seller's former captive. The captive's value to both the buyer and seller thus depends as much on its future performance as on its material assets.

This dynamic has significant implications for each phase of the transaction, from valuation, marketing, and buyer selection to deal negotiation and disentanglement. A company should understand and address these implications to help enhance deal value and reduce financial and operational risk.

Case in point: CoreLogic's divestiture

CoreLogic sold its Indian captive center to a service provider as part of an effort to refocus the company on its core operations. By divesting the captive and forming a long-term outsourcing agreement with the buyer, CoreLogic hoped to establish a service delivery model to support global expansion; increase the flexibility of its cost base; and enhance the efficiency and effectiveness of the business' IT platforms.

CoreLogic took several steps to increase the likelihood of achieving the desired results. It developed a master professional services agreement that specified what services the company wanted to buy back and provided for a flexible cost base. Well before the deal closed, it established a vendor management program office to manage the new service relationship on an ongoing basis. The company also addressed communications

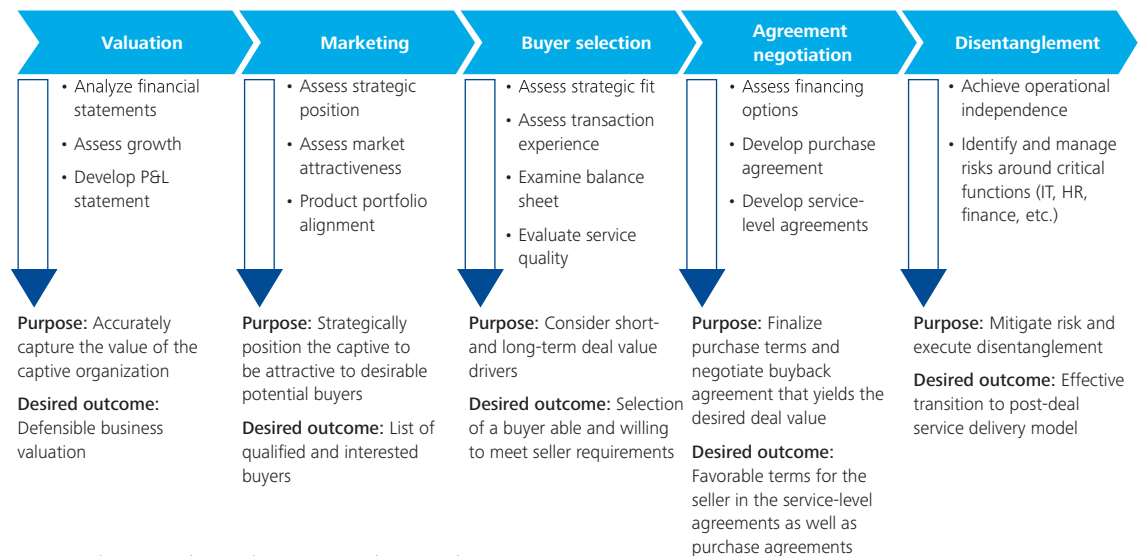
and change management throughout the deal process and the captive's subsequent transition to the buyer organization. Finally, the team negotiating the captive's purchase agreement collaborated with the team negotiating the service buyback agreement to understand how both agreements could be framed in a way that would yield a desirable overall outcome.

CoreLogic was able to find an appropriate strategic buyer for its captive and negotiate an outsourcing agreement that would allow it to obtain services from its former captive, but decrease the company's recurring fixed costs. Apart from helping to enable CoreLogic to focus on its core activities, the sale of the captive also gave the company a large cash injection. The company received an up-front cash payment for the captive as well as service credits to reinvest in its business.

A framework for a captive center sale

In our experience, companies selling captive centers can potentially increase deal value and help mitigate risk through a systematic approach to the five focus areas illustrated in Figure 1: Valuation, marketing buyer selection, agreement negotiation, and disentanglement.

Figure 1. Captive sale approach: Five focus areas



Source: Deloitte Consulting and DCF Captive Sale Approach



The pre-buyer selection stage of the sale process starts with a financial statement analysis of the captive center. Although formal financial statements may not be available for captives that historically did not generate revenue, the seller should develop an estimate based on the cost of running the captive, the CAPEX required to maintain service levels, and an assessment of the captive's intellectual property. This last item is particularly important to address early in the process: If the value of the captive's intellectual property is not identified until the due diligence phase, the seller will likely need to make adjustments to capture locked value. Unlike in a typical valuation exercise, the sale of a captive center should be treated as an annuity in which the buyer receives regular payments for services provided. In conjunction with the financial analysis, sellers should analyze the strategic position and market attractiveness of the captive center. In many cases, this marketing effort may require repositioning the captive's current service portfolio in order to make it more attractive to prospective buyers.

In the buyer selection stage, sellers should consider potential buyers' strategic fit with their business strategy

(increasing geographic footprint, platform compatibility, etc.). Sellers also evaluate the potential buyer's ability to provide services back to the seller as well as its ability to meet service quality levels.

In the post-buyer selection stage, the seller and buyer negotiate agreements around financing options, service buyback agreements (including service-level agreements), and handover dates. The seller should keep in mind that, unlike in most divestitures, it will probably continue to maintain a "partnering" relationship with the buyer. This ongoing relationship typically requires that the negotiation focus equally on the sale of the captive center as well as the buyback agreements. After the agreements are finalized, the actual disentanglement of the captive's operations takes place. This typically involves converting the internal captive center into a third-party outsourced service provider that will deliver services to the seller once the transition is concluded.

Figure 2 provides an overview of major differences between a typical divestiture and a captive center carve-out for consideration. The following section offers a deeper dive into the implications of these differences.

Figure 2. Differences between a typical divestiture and a captive center sale

Focus areas	Typical divestiture approach	Recommended captive center approach
Valuation	Value using explicit multiplier approach against projected revenue and EBITDA (earnings before interest, taxes, depreciation, and amortization).	In the absence of revenue history, develop implied multiplier based on the captive's expected revenue-generating potential after internal services are converted to externally provided services.
Marketing	Develop materials (including business value proposition, growth and profitability projection, product portfolio, organization and administration, and financial statements) based on historical financial performance. These materials reflect the anticipated synergies that would be gained by the buyer, along with an assessment of the divested business' organizational and strategic fit with the buyer.	Develop materials that illustrate the captive center's capabilities as a platform for growth. Synergy opportunities may often be secondary to the captive's locked-in revenue base from the service buy-back agreement with the seller; the ability to cite the seller as a client of reference; and the captive center's ability to generate incremental revenue for the buyer by enabling it to serve additional clients.
Buyer selection	Identify either strategic or private equity buyers based on their ability to offer a competitive price.	Identify strategic buyers based on both their ability to effectively continue to deliver services to the seller, and their ability to offer a competitive purchase price.
Agreement negotiation	Primary focus on purchase agreement; secondary focus on transition service agreements (TSAs) and commercial agreements.	Equal focus on purchase agreement, including TSAs and commercial agreements, as well as additional focus on the service contract through which the seller agrees to buy back services from the captive center after it has been acquired by the buyer.
Disentanglement	Terminate the divested organization's dependencies on the parent company to achieve full operational independence on Day 1 and/or at the end of a limited transition service period.	Convert the captive's dependencies on the parent company to those appropriate for an external service provider-client relationship. The seller should retain the level of access needed to support long-term service delivery by its former captive.

Source: Deloitte Consulting and DCF Captive Sale Approach

Valuation

Value the captive center as a business and not as a pure asset. Potentially significant incremental value can be generated from a captive sale if the seller values the captive, its activities, and associated intellectual property as a business and not simply as an asset. If viewed purely as an asset sale, a captive center is unlikely to obtain more than book value. When viewed as a platform for future revenue and profit generation, however, its value can multiply.

In order to develop an expected valuation, a seller will need:

1. A cash flow projection that estimates the revenue the captive could earn as an external service provider
2. Historical multiples as a basis for setting the valuation multiple

In contrast to most valuations, captive center valuations often take place in the absence of externally visible cash flows. One way to deal with the lack of historic revenue data is to think of the valuation as an annuity contract in which the buyer receives regular payments for services that the seller's former captive — as part of the buyer organization — delivers to the seller. In this approach, the anticipated revenue from the service buyback contract can be treated as cash inflow in order to arrive at a valuation. Although the final valuation will, of course, depend on the buyer and on prevailing market rates for the services in question, the seller should enter the market with a realistic range of potential valuations that it can use as a basis for decisions.

Cash flow projection

The first step in the valuation of a captive as a business should be to develop stand-alone financial statements that describe what the captive would look like as its own profit and loss center. Sellers may find this to be one of the hardest steps in the sale process, largely due to historically skewed practices regarding the internal pricing of services and corporate allocations or overheads. The cost component of the projection should not only account for the captive center's internal costs, but also include an allocation for corporate and other services as well as for overhead that may have not been carried as part of the captive center financials. Allocations that should be reviewed include personnel, finance, systems, real estate, and contracts/licenses. As a side note, the seller

should remember that these overheads now need to be redistributed back inside its own organization as part of the business case.

The revenue component of the captive's stand-alone financials will require an appraisal of the captive center's implied revenue and implied profit margin. These metrics are implied because companies that treat captive centers as cost centers rather than revenue centers typically do not maintain financials that reflect a captive's revenue and profit margin. In our experience, one of the most important ways for a buyer to substantiate the seller's revenue projection is to examine the buyer's own demand for the captive's services following the sale. If a seller signs service contracts as part of the sale and intended revenue to the buyer as part of the commercial agreement, the buyer may view the intended revenue from the seller as one of the sale's central valuation drivers.

Historical multiples

In a typical business divestiture, multiples are usually calculated and reviewed in terms of multiples of annual EBITDA or multiples of annual revenue. However, because captive centers are frequently not treated as revenue centers, information that can be used to develop valuation multiples is often limited and not well documented in public information sources and analyst reports. One effective alternative method of calculating a captive's valuation multiples can be to leverage the expected value, based on historical transaction data, of the seller's annual service buyback contract with the buyer. (This figure is often referred to as the "annual contract value.") The sale price valuation can then be assessed as a multiple of the annual contract value. Our recent experience suggests that this calculation method (multiple = sale price/annual contract value) yields, on average, a multiple of 0.8 to 2.0 for captive centers. A number of additional factors may affect the valuation, including potential sources of revenue in addition to the buyback contract with the seller, prevailing market conditions, and existing market capacity for the captive's service delivery capabilities. Ultimately, of course, the final valuation will be determined by the buyer's motivation and the captive's perceived value to the buyer organization. The more fully a seller approaches the valuation process from the buyer's perspective, the more likely it will be to enter the divestiture marketplace with realistic expectations about the range of valuations that prospective buyers may propose.



Marketing

Market the captive center as a business with a viable stand-alone value proposition.

In a captive sale, the core objective of the marketing process is to present the captive center in a way that can attract multiple potential buyers. Sellers in a typical divestiture usually market the operation being sold based on its ability to expand the buyer's geographic footprint and deliver efficiencies to the buyer. In a captive center sale, the marketing effort should focus more on the value of the captive's current revenue stream (if any) as well as its value as a potential platform for growth among particular customer or industry segments.

As in other sales, the marketing effort should aim to generate competitive bidding for the captive center. Hence, it is important to understand what factors might motivate a buyer to acquire a captive. It is essential to understand the range of potential buyers, the industries in which they operate, and their various methods of creating value in order to create a value proposition around the captive that can capture prospective buyers' interest. This can be difficult for some companies, as their own perceptions of the value their captive delivers can stand in the way of appreciating a buyer's likely perspective. For example, while a seller may place great value on its captive's specific skills related to the company's industry-specific legacy applications, buyers may be less interested in these skills than those that can be applied across many clients in a variety of industries. The captive's seller-specific skills, while they may help the buyer retain the seller as a client after the sale, may therefore not generate as much incremental value for the buyer as the seller may at first believe.

In a captive sale, the seller's marketing materials should address the following sources of value that the transaction can offer to buyers:

- **The seller's demand for future services:** The seller should describe the extent of its commitment to the buyer to buy back services currently executed by its captive. Such a commitment represents a concrete source of value to potential buyers.
- **Market credentials:** Buyers of captive centers often value the ability to use the seller's name as a reference in their efforts to drive new business development, especially if the buyer wishes to grow in the seller's industry.

Source of value	Value drivers
The seller's demand for future services	For buyers of captive centers, a seller's commitment to buy back services formerly provided by its captive represents a concrete source of value. Furthermore, buyers may appreciate the incremental sales potential represented by the seller's possible need for services outside its former captive's scope (e.g., services to additional business units, in additional functions, and/or additional service locations).
Market credentials	Some sellers can offer buyers a "pedigreed" client reference, especially if the seller is a top player in the buyer's target market. This source of value can be compounded if the seller is willing to allow its name to be used in the buyer's marketing materials as well as to serve as a reference upon request.
Platform for growth	A captive's services may draw upon knowledge, skills, technology, and/or processes that are not standard or prevalent in the market, making these assets potentially valuable to buyers that wish to gain these competencies to serve a larger client base. When marketing this source of value, sellers should carefully consider the range of potential buyers for its captive. While some buyers may view a captive's assets as standard or commonplace, other buyers may regard the captive's capabilities and knowledge areas as valuable additions to their overall service and/or industry portfolio.
Intellectual property	Ownership or joint ownership of patents, applications/delivery platforms, and/or tools can be a source of value to prospective buyers. That said, sellers may find it advisable to place confidentiality and usage constraints on intellectual property in order to retain an appropriate degree of control over this value.
Efficiency gains	Sellers should not be shy about pointing out opportunities for buyers to pursue unrealized efficiencies. For instance, sellers can highlight any efficiencies buyers may gain by combining support services, as well as the potential opportunity to increase the volume of service provided by the captive's existing headcount.

- **Platform for future growth:** A captive's functional and industry/business-specific skill sets can be valuable to buyers. Rare skills, high-quality processes, and/or proprietary technologies represent value to buyers that can leverage these assets to gain additional revenue.
- **Intellectual property:** The value of intellectual property can be a complex issue in a captive center sale. While many buyers tend to place higher value on gaining explicit rights to a captive's intellectual property, some may also find value in gaining indirect access to intellectual property.
- **Efficiency gains:** This source of value can have two components. The first is the possibility that the buyer may be able to execute efficiency opportunities that the seller did not pursue, but that could provide a near-term reduction in run rate. The second is the potential for the buyer to realize operational synergies after the captive's absorption into the buyer organization. Especially with captive centers that are much smaller than the target buyer, such as an information technology (IT) captive being targeted to a large IT services vendor, the integration process may offer the opportunity for an appreciable increase in volume.

Buyer selection

A captive center sale is usually an agreement, not just to sell the captive organization, but also to enter into a long-term service delivery relationship with the buyer.

In parallel with valuation and marketing, a seller should identify potential buyers for its captive center. While sellers can choose to host an open auction, our experience suggests that a targeted approach may be preferable. Most sellers should be able to draw on their knowledge of their captive center to develop a sound perspective on which potential buyers are most likely to value the captive organization. One of the biggest drivers for these sales is the potential of locking in a revenue-generating long term contract. Hence, the seller of a captive center is selecting not only a potential buyer but also a collaborator that will act as a service provider in the future. Therefore, sellers should carefully define the characteristics they desire in potential buyers with a view to enhancing returns and mitigating the risk of transitioning the services performed by its captive center to an external provider.

Of the many factors that play into buyer selection, the four described below are especially important.

Strategic fit and growth trajectory

Sellers should look at potential buyers that specialize in offering services that the captive center currently provides to determine whether these companies might perceive the seller's captive as a good strategic fit for an acquisition. Sellers should review prospective buyers' strategic plans for factors related to geography, service scope, industry, client base, and top-line expansion goals.

Service providers currently under contract with the seller, and those that the seller has used in the past, may be obvious initial candidates. However, the seller should consider not stopping there. Additional, non-incumbent vendors should be brought into the mix to make the process more competitive.

Experience with past transactions

The buyer's track record in executing similar transactions can reveal whether past sellers have profited from their transactions and unlocked both short- and long-term value. Companies that have shown themselves capable of acquiring a captive in a way that creates value for both the seller and themselves are more likely to inspire confidence in the seller than prospective buyers with less experience in executing such transactions.

Strength of balance sheet (margins and cash flow)

A company's financial strength can be of high importance when selecting potential buyers. A steady stream of cash flows can indicate a strong business and demonstrate sound financial management. Comparing prospective buyers' margins with those of their competitors can help sellers understand each candidate's operational efficiency. A strong balance sheet may also give sellers greater confidence in an organization's ability to deliver services over the term of the contract.

Service quality

Apart from the proceeds of the transaction itself, the value a seller gains from a captive sale depends largely on the quality of the service it receives from its former captive after it becomes part of the buyer organization. Sellers should consider the extent to which prospective buyers maintain quality programs such as Capability Maturity Model Integration (CMMI) or Six Sigma, as well as the degree to which these programs have improved the buyer's performance over time. Benchmarking buyers against industry competitors can also help sellers gauge the quality of the service each buyer is likely to provide.

Of course, if a seller wishes to spin off its captive into a stand-alone entity (e.g., through a management buyout) or sell to a private equity firm rather than to a strategic buyer, the above techniques for estimating potential service quality will likely not apply. That said, spin-offs and private equity sales tend to be rare for major captive centers, as most sellers prefer to sell captives to a buyer with a strong history of providing the kinds of services the seller will need to purchase after the transaction.

Agreement negotiation

The transaction agreement should address short-term purchase value and long-term service value.

Once a buyer is selected, the next focus area is the negotiation of the final agreement. As in a typical divestiture, the seller and buyer will typically create a purchase agreement that includes a letter of intent, signed by the buyer and seller at the start of the due diligence process, and a terms and conditions agreement, which is signed once the deal is closed. In addition, if the seller intends to retain the buyer as a service provider after the transaction, the seller and buyer should consider crafting a service buyback agreement that defines the scope, price, service levels, and terms under which the seller will



continue to receive services from the captive center after its acquisition by the buyer.

It is important to consider negotiating the purchase agreement in conjunction with the terms of the service buyback agreement to help maintain consistency between the two. This approach can encourage both the seller and buyer to negotiate and understand the short- and long-term sources of the transaction's value as a unified package. Conducting the two negotiations in parallel can also help mitigate risk as well as unlock additional synergies.

Purchase agreement

The due diligence phase begins when the buyer and seller sign the letter of intent. During due diligence, the buyer will evaluate the captive organization to arrive at a valuation and identify risks that may be associated with the deal.

Upon completion of due diligence, the buyer and seller can develop the terms and conditions agreement. This agreement should specify the value and assets included in the deal, as well as any efficiencies the transaction is expected to generate. It should also describe any conditions of engagement agreed to by the parties, including any interim transition services the seller will provide to the buyer.

Sellers can use a number of tactics to pursue their financial goals in a captive sale. For instance, in addition to contract price and transaction price, elements such as service credits and inflation caps can impact the transaction's financial outcome as well as its balance sheet and tax treatment.

Service buyback agreement

The development of the service buyback agreement usually commences after the letter of intent to purchase the captive has been signed. Issues for the seller and buyer to negotiate include the scope of the services to be provided to the seller, the pricing structure, and the length of the service contract.

While the structure of a service buyback agreement can be similar to that of a standard outsourcing contract, service buyback agreement may include references to the purchase agreement. Matters related to pricing, scope of services and service levels, and the terms of engagement are specific areas in which to maintain consistency between the two agreements.

Releasing latent value through a captive center sale 11

Five important areas to address in negotiating the service buyback agreement include:

- **Scope of services:** The resources and assets listed in the purchase agreement as part of the sale should align with the resources and assets that the buyer will need to deliver the services to the seller specified in the service buyback agreement. For example, a purchase agreement typically includes a list of software and hardware assets to be transferred to the buyer. A similar list should be included in the service buyback agreement based on the scope of work to be provided by the buyer to the seller after the transaction.
- **Minimum commitments:** The "minimum commitments" clause in a service buyback agreement specifies the contract term — that is, the minimum timeframe over which the seller commits to purchase services from the buyer. Buyers typically offer discounts to sellers based on the length of the contract term, with larger discounts offered for longer-term contracts. In some instances, a seller may choose to bring in another vendor to provide a portion of the services previously performed by the captive. This is usually done in order to keep pricing competitive and/or to establish redundancy for certain services, such as data center operations that are deemed business-critical.
- **Service-level agreements:** After the parties agree on the scope of work that the buyer will provide to the seller after the transaction, the seller should lay out specific criteria or service-level targets against which the buyer's services will be evaluated. These targets are usually based on industry benchmarking studies but should also take the buyer's prior performance into account. Among other things, service-level agreements may specify the metrics that will be used to measure service quality, the hours during which services will be provided, and the processes by which unsatisfactory performance will be addressed. Service-level agreements can also drive service pricing if the services in question are considered critical to the seller and require dedicated support.
- **Pricing structure:** As the value of a multi-year service contract may be many times a captive's sale price, it is critical to negotiate the sale price and the pricing structure for the service buyback agreement

in parallel. Factors that may drive service pricing include the scope of work, the performance targets and other expectations specified in the service-level agreements, and the minimum commitment. An additional factor is the financial baseline based on the current costs on the captive center as well as corporate allocations. Depending on the scope of services under consideration, benchmarking studies can be conducted to inform the pricing negotiations. The longer the contract to which the seller is willing to commit, the stronger the seller's position may be in negotiating discounts with the buyer. Additionally, the seller may need specific contract negotiation skills to develop a service buyback agreement in which the variable cost of engaging the buyer as a service provider is lower than the historic fixed cost of maintaining its captive.

- **Governance and relationship management:** A well-defined governance structure can increase the likelihood of acceptable service delivery and mitigate operational and business risk for both the buyer and the seller. When the buyer and seller develop mechanisms for governance and relationship management, they should take care to include elements that foster cultural alignment between the two organizations. For instance, the seller may specify that the buyer must continue to provide a similar level of training and support to the employees who will provide services to the seller so that service quality is maintained or improves. The governance structure should also specify the compensation as well as career progression structure to facilitate a smooth transition.

Disentanglement

The seller should approach disentanglement in a way that supports its former captive's long-term effectiveness.

Disentanglement — the operational separation of the captive's resources and assets from the seller and their handoff to the buyer — is frequently a complex process that can result in business risk and value loss if not executed in a disciplined manner. In a captive sale, furthermore, the disentanglement process may represent even more risk than in a typical divestiture, as an ineffective disentanglement can compromise the former captive's ability to continue to reliably deliver services to the seller. Sellers should strive for a disentanglement

process that aims to move the captive's knowledge, people, and processes to the buyer organization intact.

In most divestitures, sellers appoint a cross-functional separation lead to manage the overall disentanglement process, with functional separation leads (e.g., for human resources [HR], finance, IT, etc.) to manage disentanglement in their respective areas. In a captive center carve-out, the separation lead will not only need to address the operational separation requirements common to most divestitures, but also manage the conversion of the divested captive from an internal unit to an external service provider. Primary areas of concern should include service delivery, HR, finance, and IT. Sellers should follow a planned and structured approach that considers the impact of disentanglement on each of these areas.

Service delivery

As a part of the sales process, the seller will likely be expected to articulate the scope of services that will be divested with the captive center and the portion that will be retained by the seller (e.g., due to intellectual property, business knowledge, or other concerns that limit the seller's ability to outsource particular services). In cooperation with the buyer, the seller should refer to this description of the services transitioned to the buyer to develop a detailed operational plan for its interactions with the captive center as an external service provider. Particular attention should be given to defining process hand-offs, establishing the division of responsibilities between the seller and the provider, and determining the buyer's operational responsibilities.

HR

In most divestitures, the seller's HR concerns, apart from any residual TSA obligations, essentially end on Day 1, when the resources formally become part of the buyer organization. However, in a captive sale, the seller — as a continued recipient of services from the divested captive after the transaction — has a vested long-term interest in the performance of its former captive's personnel. Sellers should therefore consider crafting an HR separation strategy that explicitly addresses the way risks to business value and continuity will be mitigated in the transition process. Identified risks include the loss of critical personnel as well as overall resource attrition. Especially in tight labor markets, such as some Indian cities where many captive centers reside, these risks should be carefully managed.



Case in point: A captive sale in the financial services industry

With only two months between sign and close, a major financial services institution was facing the challenge of setting up its divested Indian captive as an external vendor. A key complication was that, to continue to serve the company as an external vendor, the captive center needed to comply with all security and compliance requirements applicable to outside providers. To do this, the company needed to convert the access rights for the captive's 1,000 employees from unsecured access to firewalled access. As part of the process, more than 600 applications were tested and a 24/7 "testing command center" was created to troubleshoot and fix access issues. The company was able to complete the conversion in six weeks, allowing the deal's critical-path IT requirements to be concluded on time.

Finance

In addition to preparing for the financial close of the deal and managing the captive's separation from internal accounting, the seller will also need to convert the captive from an internal center to an external billing entity. This can introduce additional complexity into the financial disentanglement process. The separation lead and the financial lead should work closely together to establish a third-party billing structure that is effective at close.

IT

Most captive centers, as internal service providers, have open access to internal corporate systems. When converting a captive into an external provider, the separation lead and IT lead should work with the seller's internal security, risk, and data teams to design a post-sale access strategy. The scope of the captive's access will likely need to be reduced, and appropriate tracking mechanisms should be put in place to monitor compliance. Sellers should keep in mind that creating firewalls and taking other appropriate security measures frequently involve long lead times for equipment and circuit acquisition. In addition, sellers should be aware that any privacy restrictions on sharing information with external parties will apply to a captive from the moment it joins the buyer organization. To reduce the risk of privacy-related violations, a seller should review the databases accessible by its former captive from a business risk perspective.

Conclusion

Captive center sales can offer businesses a way to increase cash flow and to sharpen their focus on their core competencies. While captives often represent significant value, however, many companies sell them in an opportunistic fashion driven either by ad hoc queries from potential buyers or discussions with existing service providers. Such an opportunistic approach can limit the seller's gains from the transaction in two ways. First, the time and resource pressures characteristic of an ad hoc sale can reduce the seller's ability to position its captive as a stand-alone business unit rather than as a pure asset. Yet a captive that is evaluated as a stand-alone business unit may fetch a much higher sale value than it would if its assets were to be sold individually. Second, the same time and resource pressures may prevent the seller from devoting appropriate attention to matters that can improve the odds of maintaining an effective long-term service delivery relationship with the buyer.

A process that specifically addresses the distinctive qualities of a captive center sale can result in a deal that delivers a mutually desirable outcome. By positioning its captive as a revenue-generating business, a seller can seek to obtain an appropriate price for the divestiture. By laying the foundation for a long-term service relationship during the sale process, the seller can seek to maintain effective service delivery from its former captive while giving the buyer the opportunity to pursue future revenue opportunities from the seller as a client. We encourage companies that are considering selling a captive service center to keep these points in mind in their efforts to execute a transaction that can yield short- and long-term value.

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Portfolio realignment A business imperative



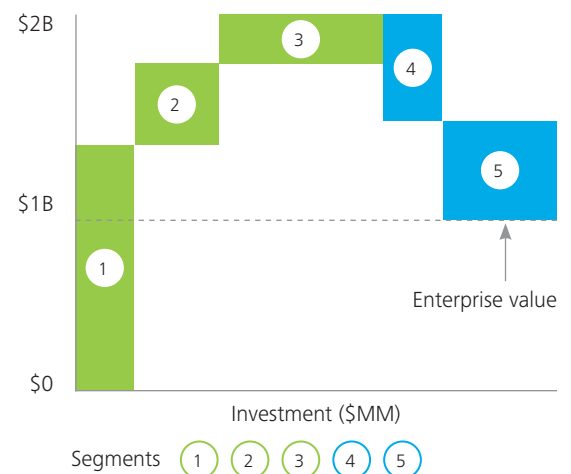
Companies are increasingly looking for opportunities to better understand which parts of their businesses are driving or destroying shareholder value, and to realign their portfolio accordingly. In addition, rising shareholder activism amid the perception that management is not doing enough to boost shareholder value is generating pressure at many companies to thoroughly evaluate their portfolio of businesses.

Recent examples of divestitures and spin-offs include Northrop Grumman's spin-off of its shipbuilding business, Huntington Ingalls Industries, Inc.¹; Sara Lee's separation of its North American meat business (Hillshire Brands 1753)²; Kraft's split of its global snack business and North American grocery business and hedge fund Third Point's pressure on Sony to spin-off its entertainment arm³. Among other apparent market catalysts, the pool of able and willing acquirers has been expanding as credit has become more readily available; corporations are seeing increasingly healthy balance sheets; leverage rates are at historic lows; and private equity firms are once again, looking to put investor money to work.

Many corporate portfolios, when disaggregated, exhibit a surprisingly wide range of contributions to shareholder value (Figure 1). While the majority of segments may perform well, certain ones may consume a large amount of corporate assets while making little or no (and sometimes, negative) contributions to overall value. Often, this is because they perform poorly as measured by returns on capital (ROC), a metric that is central to many capital-intensive industries such as manufacturing, energy, oil & gas, and consumer products and has been shown to have high correlation to shareholder value.

Figure 1: Value contribution

Disaggregating portfolio — allows the creation of a picture of a picture of portfolio segments creating value and eroding value and an understanding of investment in solutions.



- 1 "Northrop Grumman Completes Spin-off of Huntington Ingalls Industries, Inc." Northrop Grumman, March 31, 2011, [http://investor.northropgrumman.com/phoenix.zhtml?c=112386&p=irol-newsArticle&ID=1544584&highlight=Huntington Ingalls](http://investor.northropgrumman.com/phoenix.zhtml?c=112386&p=irol-newsArticle&ID=1544584&highlight=Huntington+Ingalls). Accessed July 16, 2013
- 2 "Sara Lee splits, takes Hillshire name for N.Amer business," USA Today, June 6, 2012, <http://usatoday30.usatoday.com/money/companies/story/2012-06-06/sara-lee-hillshire-brands/55416180/1>. Accessed July 16, 2013
- 3 "U.S. Hedge Fund Calls for Sony Entertainment Spin-Off," UK- Reuters, May 14, 2013, <http://uk.reuters.com/article/2013/05/14/us-sony-thirdpoint-idUKBRE94D0A320130514>. Accessed July 16, 2013

Portfolio realignment is becoming a business imperative for several reasons. Some companies that did not retool their portfolio prior to the recession have been unable or unwilling to dispose of their value-destroying businesses; today these companies may be finding their growth and profitability hampered by overly complex operations, uneven performance, and the need for fundamental improvements in business quality. Certain companies sold underperforming assets to raise cash during the recession but ineffectively utilized the resulting proceeds; today these organizations may be discovering that they are not well-positioned to address changing economic and credit conditions. Finally, some companies view portfolio realignment as part of a broader, ongoing revitalization process of adding new and shedding old assets to address globalization and value migration, or to align with a fresh corporate vision.

Figure 2: An Advantaged Portfolio is:

1	Strategically sound	2	Value-creating	3	Resilient
• Weighted towards competitive advantage	• Maximizes intrinsic value	• Effectively weighs feasibility and risk	• Aligns with value-maximising ownership	• Is robust across future scenarios	• Creates optionality
• Carries an optimal innovation mix	• Addresses key capital markets value drivers				
• Creates synergy					
+ Tailored criteria based on owner's goals and aspirations					

Steps to build an advantaged portfolio

A company's portfolio realignment process should begin with a view of the end-game — what an optimal grouping of assets might look like. We believe that this "advantaged portfolio" should be tailored to a company's goals and aspirations, and balance three characteristics, being strategically sound, value-creating, and resilient (Figure 2).

So how can a company create an advantaged portfolio? There are four major steps:

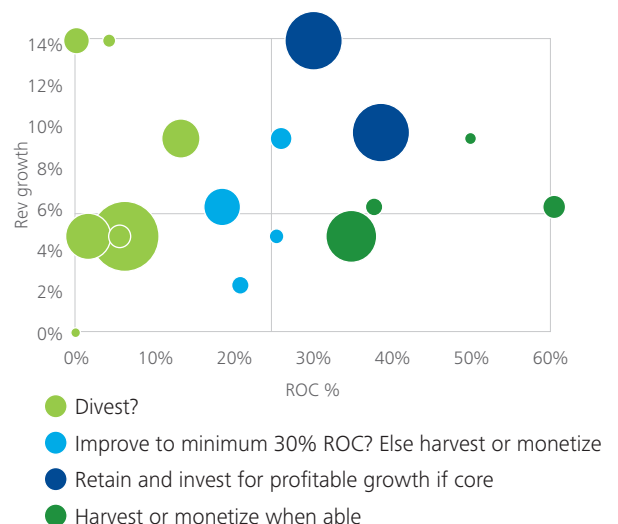
1	Analyzing/disaggregating the portfolio and disposing of value-destroying businesses and/or "cash hogs" that are not long-term strategic businesses.
2	Structurally improving the profitability of other established businesses according to their portfolio roles (e.g., cash generator, growth engine).
3	Growing new businesses through internal development and/or mergers & acquisitions (M&A) to support long-term vitality and to align with the company's strategic vision.
4	Evaluating/re-evaluating the new portfolio's fit with advantaged portfolio criteria.

The first step in portfolio realignment is an important part of a "self-funding" approach (e.g., generating cash for reinvestment) to unlock value and increase investment potential among core portfolio segments. Improving the core begins by assessing and understanding the current and potential future position of each business, and then defining its appropriate role. During this process, executives should address both the strategy and the structure of each business to help identify drivers/destroyers of value, structural costs, and growth opportunities. Important questions include:

- Where is the "magic" made in the business? What does the business do that is different and creates value and profits?
- How does the business strategy create value? Is the strategy clearly articulated and understood?
- Which assets, customers, markets, and products create value?
- Are the company's sources of growth and innovation engines clearly defined?
- How should segments be redefined to work with strategic and transaction planning?
- Which segments currently are creating or destroying value?

By disaggregating its portfolio in this manner, a company can develop a picture of how individual segments are creating or destroying value, and better determine its investment solutions going forward (e.g., rationalizing an investment in legacy solutions to strengthen the core and create growth options). As Figure 3 illustrates, this company's portfolio assessment reveals the need to both eliminate value drags and to develop or acquire new businesses in the growth/high-return quadrant.

Figure 3: Portfolio segmentation





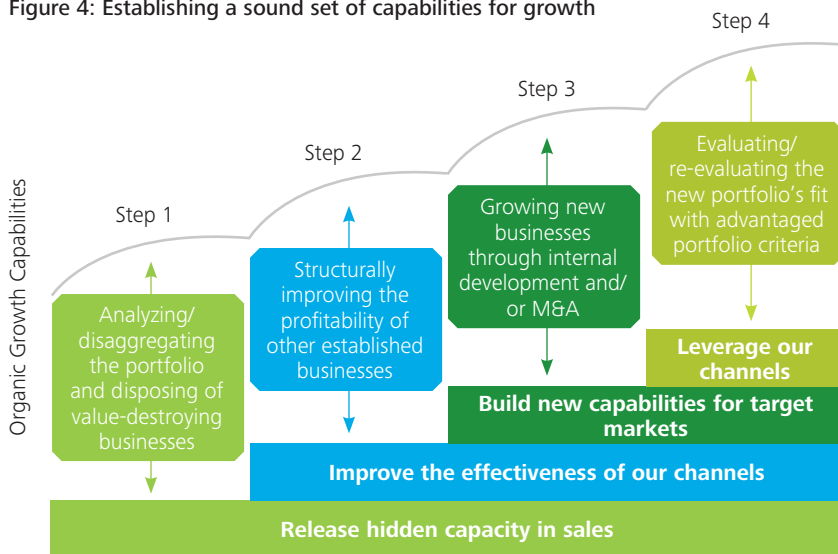
Companies should resist the urge to move directly to high-growth opportunities without first removing existing impediments to success. This may include divesting, shrinking, or not growing businesses with low returns. Growing businesses with existing impediments may actually accelerate enterprise value destruction and tie up cash needed to support high-growth opportunities. Considerable thought and analysis should be applied when assessing whether an underperforming business can or should be fixed; not all assets can be improved to the point where they are worthy of inclusion in a portfolio. For example, a changing competitive landscape, maturing markets, or large, outdated assets in the wrong part of the world can make transformation a difficult task that consumes precious management attention and resources that could be better applied elsewhere. In such cases, the business should be considered a growth impediment and be removed.

When considering options to cull poorly performing businesses from the portfolio, a company’s goal should be to maximize recovery rather than take the easy way out. A suggested approach is to either divest outright or to spin-off into a joint venture any business units which are unlikely to be transformed into drivers of increased value — extreme cases may even warrant shuttering a business that is a cash and/or management drain and that cannot be sold. It may be tempting to bundle several businesses that might not have logical buyers or that demonstrate widely varying financial performance; however, this action may sub-optimize the total price that could be recovered. Separate sales of several businesses may often net higher proceeds than a bundled sale.

For those businesses/assets that remain part of the enterprise, the next step is to make them more accretive to value by improving returns and/or generating profitable growth. Typical actions might include supply chain or operational improvements; customer and channel enhancements; product and value proposition innovation; new business models (e.g., value-priced total customer solutions); asset-light restructuring; geographic expansion; and other organic growth strategies.

Once an organization completes the portfolio clean-up and improvement stages, it should be in a better financial and operational position to pursue the remaining two stages of realignment — growing new businesses through internal development and/or M&A (Figure 4); and evaluating/ re-evaluating the new portfolio’s fit with advantaged portfolio criteria.

Figure 4: Establishing a sound set of capabilities for growth



The direction and goals of new business growth should be focused on the aforementioned portfolio analysis questions as they pertain to organic and M&A-fueled growth opportunities. Creating an advantaged portfolio requires as much discipline when growing businesses as when evaluating divestiture candidates. Growth solely for the sake of growth consumes critical corporate cash and management attention and can lead to value destruction rather than value enhancement. This same lens should be employed when evaluating M&A opportunities. One tactic to help screen M&A candidates is to evaluate them against designated criteria that include factors such as geographic location, innovation, and management oversight needs, among others. These factors may help executives gauge the relative risk and corporate focus required to manage the investment as compared to other opportunities. Finally, a realigned portfolio’s segments, including new businesses, should be regularly evaluated to determine their fit with advantaged portfolio criteria and their contributions to enterprise value.





Critical success factors

Portfolio realignment as part of a broader business transformation can be a complex, gut-wrenching, and time-consuming process. Companies should consider the following as they undertake the process:

1. Employing a holistic, top-down approach and enlisting strong executive leadership are essential since asset ownership issues are involved as well as specific elements of corporate strategy.
2. Securing an unbiased, external, industry-specific perspective can prove helpful. Dispassionate data analysis is critical...there should be no "sacred cows"; no "lemonade stands" (small assets). Preconceptions, personal history and bias typically are impediments to success.
3. Pursuing transformational versus incremental change is imperative. Portfolio realignment is not just about cleaning up assets; it should be driven by an enterprise-wide strategy for growth and renewal.
4. Utilizing informed estimates may be necessary for strategic decision-making. Precision is not consistently possible, so expect multiple iterations to get the data both "right" and representative. Providing demonstrable examples of the effectiveness of each recommended solution can add strength to the proposal.

Many companies need to consider cleaning up their portfolios to get rid of underperformers and value-destroyers. By approaching the process holistically and rigorously, they can improve strategic soundness, operational resilience, and drive value-creation.

Case study: Chemical company

Deloitte's value analysis of a chemical company's unreported business segments identified a sizeable opportunity for portfolio restructuring:

A business unit ("BU") for a chemical company was generating 28 percent of the company's EBITDA, but still destroying value. A return on capital analysis uncovered an opportunity to raise enterprise value by selling the BU, as the analysis suggested as much as \$7.70 per share in value was lost due to owning the BU's operations.

Results:

When the sale of the BU closed, the parent company's share price rose by significantly (approximately \$7 per share) despite the fact that EBITDA dropped 30 percent and a book loss was announced at the time of the sale; the value increase was nearly identical to the estimated value lost by holding the business.

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Eliminating stranded costs as part of a divestiture

Why entrenched systems, processes and cultures make it difficult to separate and operate entities cost-effectively

Overview

Portfolio Restructuring such as divestitures and spin-offs allow corporations to refocus their business and enhance shareholder value. This shedding of peripheral businesses and increased investment in core product or service lines creates a natural imperative for a company to evaluate its overall cost structure. Examining SG&A and shared service functions is a key component to overall enterprise cost reduction, especially as the corporation shrinks due to these restructuring activities.

The Enterprise Cost Reduction effort must not only ensure that corporate shared services cost do not balloon as a percentage of revenues as the company shrinks, but also provide an opportunity to deliver a leaner and more effective corporation following the completion of the divestiture. In order to ensure that the company is operating as efficiently and effectively as possible after the divestiture or spinoff, key activities need to occur such as setting cost reduction targets, planning cost reduction initiatives and executing the approved plans.

Every project is different, and project approaches are customized to fit the client's situation and needs. There are, however, best practices to adopt and pitfalls to avoid when optimizing the company while completing the transaction.

Approach

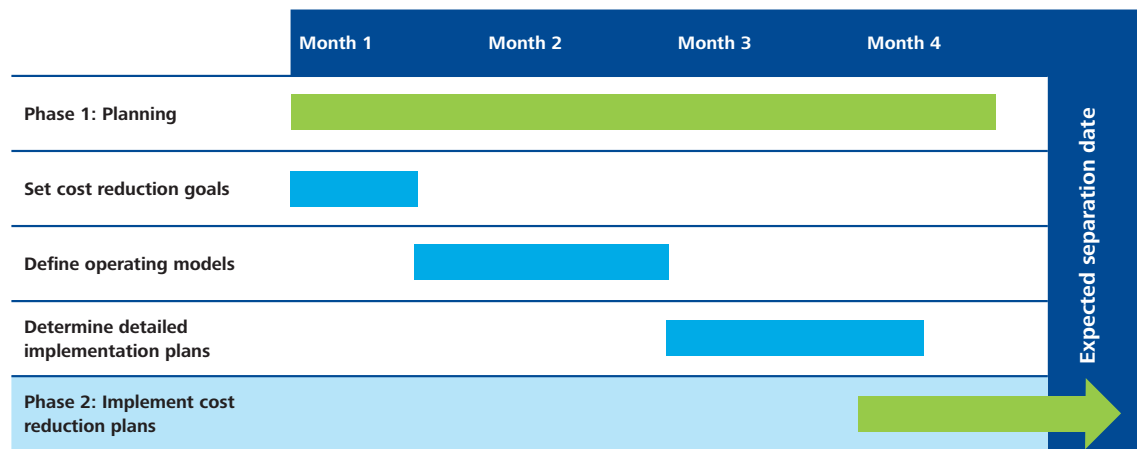
The project can be divided into two phases, planning and implementation. The approximate project timeline, as seen in Figure A, shows that goal setting, which should take two to four weeks, needs to start three to four months prior to Day One of the divestiture separation. Planning can begin before agreement with the buyer is closed, as many plans for the shared service function will not be dependent on the buyer profile.

For example, if the divestiture causes the corporation's top-line revenue figures to drop by 20%, the cost to the business units of the shared services functions should also drop by 20%.

This offers no real improvement over the company's current situation, but does prevent swelling overhead costs. The second data point is the current billing model and analysis of business usage. Cost reduction targets should factor in the drivers of costs and the usage by the divested business. In some cases, a divested business may have a higher usage pattern, such as use of software licenses or greater contract volume. This usages based on key drivers should be utilized to estimate the minimum reduction levels.

The third data point for target setting is to use benchmarks to examine median and world-class performance in the shared services function. For overhead activities, the company size in terms of employees, revenues, industry and other factors will determine the relevant benchmark group. Benchmarks will provide a directional indication on the optimal cost structure of a company and level of effort required to reach the goal. An understanding of the best practices associated with the benchmark should also be taken into account when evaluating the targets. Some companies, especially those who have lean operations, will choose to target only a parity plan. This will establish cost cutting goals that have a constant overhead to revenue or gross margin ratio. Other companies may choose a more aggressive approach, utilizing the portfolio change to drive down the overall cost structure. In this case, companies should take into account overall strategies, operating models and best practices to identify what is realistic and stretch targets beyond the parity plan.

Figure A: Divestiture cost reduction roadmap



Phase I: Planning for cost reduction

Step one — set cost reduction goals

As with any well-run project, the first step is to set cost reduction goals and commit to them. There are several data points and analyses from which to establish goals for financial targets. First, a base target can be set that keeps the shared services cost as a percent of gross revenues flat.

Step two — defining the operating models

The targets establish the financial goals, but the “how” also needs to be defined. In a few cases, the change required is minimal. In these cases, volume reductions account for the majority of the reduction. Examples of this include per employee license fees, per transaction third-party fees, and employee hotline call volumes. Reductions should be automatically achieved by the reduced volumes or through workforce reduction of the associated service providers.

Given the nature of many of the shared services functions, a parity plan is usually difficult to achieve through volume reductions due to economies of scale and leverage.

A change in the operating model is usually required. The operation model is defined as a combination of organization structure, process activities and service levels. Any new operating model should be defined based on alignment with the overall strategy of the company.

Several types of operational model changes can be identified to achieve the remaining cost overhang. These include organization structure redesign, process optimization and service level changes. Several different options may exist for organization structure redesign. This can include elimination of management layers, reduction in complexity of departments, elimination of overlaps of workloads, shift in the geographic footprint, overall reduction in headcount or outsourcing.

Process optimization can also provide opportunities to lower the cost structure. Elimination of activities or processes may be an option to streamline an organization. Re-engineering may also provide an opportunity to decrease cost. Given the short duration of a spin-off or divestiture, the time window may not be long enough to

realize the cost savings in time. This could result in a higher SG&A burden in the short term.

Service level reductions provide another opportunity to drive down the cost structure. Companies often provide premium services that are not required to do business. Examples of these are support of multiple PDA’s, training curriculum, innovation labs, international tax consulting, and engineering consulting. These can be eliminated or reduced to achieve the cost reduction targets.

In addition to achieving the parity plan, targets may have been set that reduce cost further. These cuts may require operating model changes beyond the function level. Changes may include collapse of functions, a corporate hub strategy, change in mission or absorption of activities by business units. These are usually longer term changes and require more time to plan and execute.

Companies should not underestimate the time required to define the operational requirement by each of the shared services functions. Depending on the size of the divestiture and the financial targets, these functions may be almost halving their annual budgets, forcing major, and sometimes gut-wrenching, changes. At least two months should be devoted to planning of the cost reduction effort.

The timing for approvals and agreements also should not be underestimated. Prior to gaining approval from senior leadership, functions must have agreements with other functions on activities and service level changes that directly affect one another. Working backwards from the start of implementation, two weeks (at a minimum) should be planned in order to gain approval from senior leadership, as well as business unit leadership, for the changes to be made to the shared services organization.

Step three — determine detailed implementation plan

Once targets and operating models have been set and approved by the executive staff, detailed planning can begin. Functions should complete a documented plan that details the various changes the organization will need to undergo in order to achieve the targets. Key elements of the plan include not only the operational model requirements, but also timelines and critical dependencies.



Critical dependencies are important to identify given the magnitude of concurrent changes. The divestiture magnifies the level of coordination required over a typical cost reduction effort. This is due to multiple changes to the portfolio, site moves and consolidations, and employee staffing requirements to support transition activities. These dependencies may impact the ability to reduce cost prior to Day One and should be identified and actively managed.

Critical dependencies will help drive the timeline. The timeline is a critical element to achieve the cost reduction targets with minimal Day One overhang. If possible, cost reduction plans should be implemented, and for some functions completed, by Day One.

In order to minimize the time that a company is spending at pre-divestiture levels, implementation should begin up to one month in advance of Day One, leading to layoffs and other structural changes effective on Day One.

In addition to timelines and dependencies, a process should also be established for defining and tracking success. The financial scorecard will be the primary driver, where monthly reporting against financial goals will be the key component. A process for milestone tracking and reporting is also critical to ensure the success of the project.

The final component to the plan is change management. This is one of the critical areas that is often overlooked but can be the difference between success and failure of a program. Key messages, two-way and top down communications, success stories, feedback loops, and transparency are critical elements to the change plan and should be planned well ahead of any major cost reduction efforts.

Phase II: Implement cost reduction plans

As soon as final plans are approved by the executives, functions can begin executing their plans. Functions must track their progress to reach their cost reduction targets within the given timeline. There are many aspects to a divestiture, not just cost reduction. There are issues and interdependencies that may directly affect achieving the cost reduction plans, therefore, each function lead needs to be aware of the status of other entities involved in the deal.

Communication is also a key component to the implementation phase. Executives will need to communicate the planned changes to maintain the employee's morale and productivity to the organization. As mentioned before, immense changes such as these can adversely affect a company's performance if its not planned and executed appropriately.

Best practices

A program management office (PMO) should be established to track planning and implementation progress. The PMO has many roles: coordination, communication, tracking and advising.

Conducting a corporate-level enterprise cost reduction effort at the same time as a divestiture requires constant diligence in coordinating a multitude of moving parts. The PMO needs to communicate with each of the shared service functions, the divesting business, other business units, and top executives. The separating business may have certain requirements of the shared services functions that will need to be incorporated into the cost reduction plans. These requirements will need to be reviewed when any service agreements are signed with the buyers.

The divesting business unit, as well as each function within corporate shared services, is likely operating in a siloed fashion. Given the barriers to communication, it will be up to the people in the PMO to effectively foster cross-function communications. Scheduling a weekly touch-point meeting throughout the project phases will enable the functions to discuss their plans and status with one another. A short (one hour or less) meeting that includes a roundtable discussion, has the potential for otherwise unknown issues to be brought forward in direct function-to-function communication. Additionally, the PMO should schedule meetings with and between other functions as necessary to meet the goals. This will be a common practice to adopt for the larger functions such as Information Technology, Corporate Real Estate, and Finance.

The PMO must also track key action items and dependencies on which the cost reduction effort is dependent. A centralized log, stored on an intranet site or e-mailed weekly to the function representatives will provide visibility into what tasks remain to be completed. This includes top level tasks like presenting plans to the CEO, as well as more detailed tasks that require individual actions. The action and dependency log provides accountability and visibility into the effort's inner workings.

The PMO should also act as an advisor to each of the function. The PMO should be a sounding board for vetting and fleshing out ideas for the cost reduction effort prior to reviews. The PMO can also assist in additional benchmark development and external research as required by functional teams to complete their plans. Once in the implementation phase, the PMO can advise groups on dates by which work should be complete and provide other on-demand support.

An important aspect of enterprise cost reduction is the reduction of headcount. Many organizations will find this to be the primary method for reducing financial costs. Best practices dictate that a person or team be designated to manage the layoff process, with the help of human resources and legal experts. The layoff team should provide the functions an extensive calendar of key dates, and key process to follow, as early as possible. During the divestiture process, it is important to align layoff dates to the overall timing of the separation. Having detailed plans to follow will facilitate the removal of headcount and the achievement of the financial targets.

Pitfalls

There are several key items to be aware of when completing an enterprise cost reduction effort in the context of a divestiture. The first major item is coordination with and adherence to any master services and service level agreements with the divesting business. A failure to properly coordinate provisioning of services to the divesting entity between Day One and Day Two may cause the company to be in violation of its agreement and seriously jeopardize the successful completion of the divestiture. Layoffs and reorganizations within the parent company may need to be delayed to serve the divesting business. It is vital that the appropriate personnel who need to support separation activities are retained through this period.

The second major pitfall to be aware of is change management. The divestiture itself and the resulting downsizing of the corporate functions cause a double dose of change for employees to digest. Special care must be taken to disseminate information in a timely basis to all staff, especially those affected by the changes.

Common worries of staff include:

- Will my job exist?
- How will my job change?
- How will the benefits and services at work change?

For this complex effort to succeed, it is imperative that staff is kept motivated through a reduction in uncertainty. Another key aspect to change management is communication. The more informed employees are, the less resistant to change they will be. Communication should also come from the top levels of the company. Employees need to understand the reasons behind the change, and they need to know that the top leaders in the company are driving the change. It is important to maintain productivity throughout the process, and this can be accomplished through implementing the appropriate change management processes.

A third area of concern is the consistent delivery of services by the corporate functions. Any disruption in the services provided by the corporation to its employees or business units will have negative effects on operations and productivity. It is important to keep all the stakeholders informed of changes in services delivered. Ultimately, the business unit leadership needs to understand the trade-offs between the cost savings for these service changes and the amount of disruption that will be caused to employees and operations. All service changes need to be evaluated for their overall benefit and be formally approved prior to implementation.

Accountability must be maintained throughout the process. If clear ownership of tasks and activities are not given and adhered to, then it is possible that the project will have major obstacles to overcome. Tasks and dependencies must have a resolution date and be assigned one primary owner. It is very important that the program manager for the cost reduction effort follow-up on near or past due items at least weekly. An unresolved action may have dependencies across the entire project, jeopardizing multiple work streams.



Case study

Our client was a \$7 billion high-tech manufacturing firm with interests in a variety of devices. In order to refocus the company and gain a 30% increase in stock price, the client undertook a major restructuring, divesting two business units, accounting for just over \$2 billion or 38% in revenue. In addition to requiring the corporate shared services function to reduce its costs by 38%, the CFO committed an additional amount equal to almost 47% of the corporate bill, a total of \$450 million.

Planning for the process began in earnest about four months prior to the close of the divestiture of the first business unit. Initial plans were submitted by the functions and then reviewed and enhanced over a two month period, leading up to a two-day review session by the CEO and CFO, about two months prior to the close day.

Because the company undertook two divestitures (one sale and one spin-off) at the same time and coupled it with a major enterprise cost reduction effort in the shared services function, the number of cross-functional interdependencies was staggering. The shared services function was tasked to rapidly reduce its operating costs by the 38% level and then to fundamentally restructure several of the functions to achieve the 47% reduction and become a more effective organization. Weekly meetings with each of the functions, an action log posted on the intranet, and weekly interactions with each of the separation teams kept things running smoothly. The goal was to mold the company into a world-class organization in both effectiveness and efficiency.

Although the long-term changes to achieve the target reductions are not yet complete (running more than a year after the close date), the progress is on track to achieve the committed cost reductions.

Conclusion

By utilizing the approach of setting goals top-down, defining functional operating models and defining implementation plans to achieve goals, companies can ensure shareholder value is maximized by keeping overhead costs in line with the overall financial model. The top ten things to keep in mind during a cost reduction effort include:

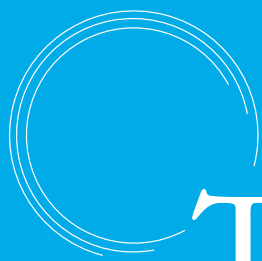
1. Plan for cost reductions in parallel to divestiture or spin-off activities (generally three to four months prior to separation)
2. Identify and communicate the baseline cost structure so all functions have clarity on the current costs they will be measures against
3. Set parity targets by function based on affordability, the business model and strategic objectives
4. Encourage functions to use the project momentum to identify further cost reductions or transformation opportunities beyond parity targets
5. Leverage external best practices and benchmarks to challenge functions to reach and exceed cost reduction targets
6. Drive functions to clearly articulate and quantify their cost reduction initiatives so they can be incorporated into an overall cost reduction roadmap
7. Centrally manage any work force management initiatives to provide consistency in timing and messaging and ensure legal requirements across multiple countries are met
8. Plan for longer cost reduction lead times in some areas and countries to reduce risk of cost overhang (e.g., sale of real estate and work force management in France and Germany)
9. Keep in mind any transition services due to the sale or spin-off that may be required of some functions (e.g., IT, Finance, HR) which may impact the timing of some initiatives especially headcount reductions
10. Do not forget to manage the change impact through communications and stakeholder management with the remaining businesses and functional team members

Contacts

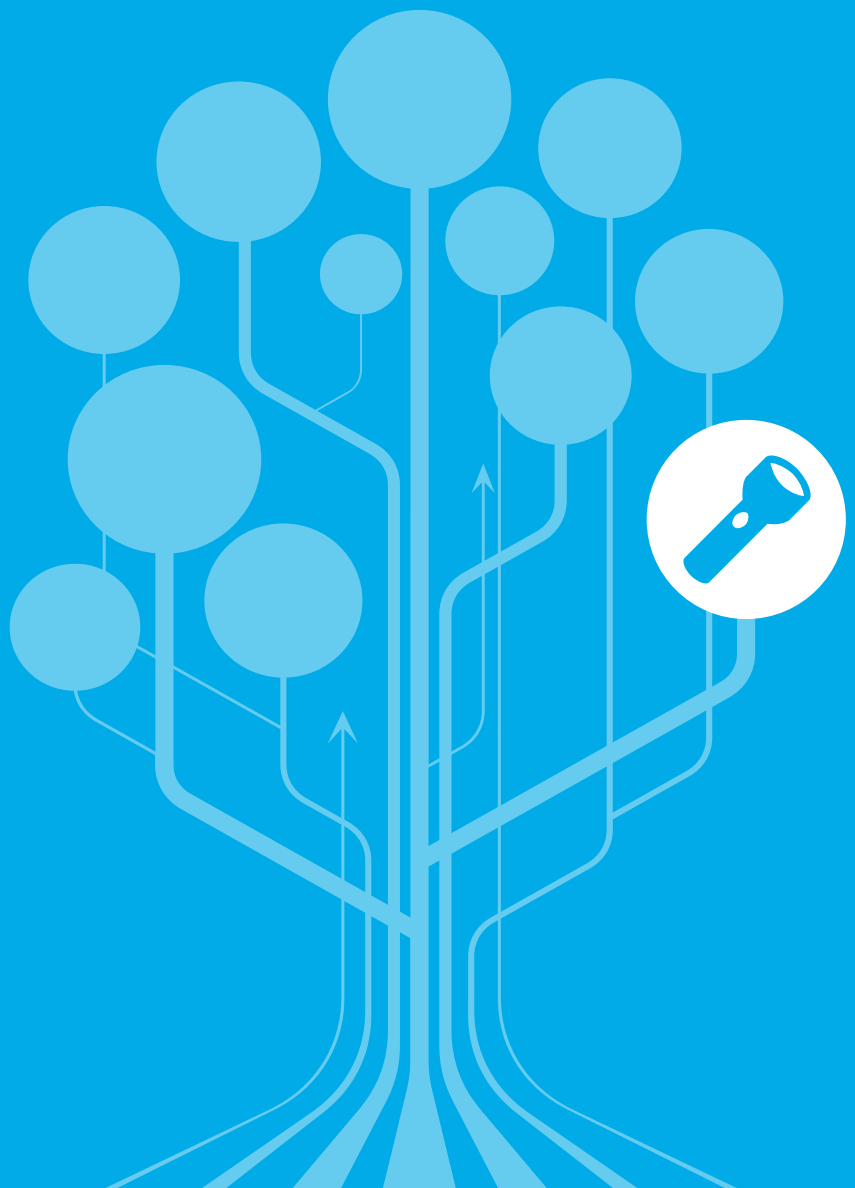
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Transaction Execution and Due Diligence





The hidden tax value in divestitures

Why looking beyond the deal may be valuable

If you're planning a spin-off or carve-out, you know how important tax considerations can be to realizing the full value of your transaction. But did you also know that a separation may offer significant opportunities to improve the on-going tax efficiency of each separated business after the transaction closes — and thereby increase the transaction's long-term value? Our experience suggests that many divesting companies tend to overlook this group of tax-saving opportunities. Here's how you can take steps to potentially increase value.

Hidden in plain sight

Some tax costs are pretty obvious, especially those associated with the transaction itself. For example, the tax that the selling corporation must pay when it disposes of a subsidiary or division is straightforward to quantify. Likewise, other transaction-related items (such as the taxation of executives' golden parachutes) are often of great personal interest to decision-makers in any deal. These transaction-related tax costs and opportunities tend to get plenty of attention, so we won't dwell on them further here.

However, other tax opportunities that frequently present themselves in spin-offs and carve-outs are often overlooked. These opportunities are directly connected to changes in the underlying business of one or both companies, rather than being associated with the transaction itself.

Many organizations, in our experience, simply don't focus on these opportunities until well after the deal is done, when it's usually too late to factor tax considerations into operational decisions about the newly separated entities. And it's not just the business being sold that ought to consider these opportunities. Depending on the size and nature of the divestiture, the parent company may also need to change its business operations to suit its new size and scope. The tax implications of these business changes can have a far-reaching impact on each company's performance going forward. Every business process that is

changed represents a legitimate opportunity to establish the new company's operations in a more tax-efficient manner.

Why do organizations sometimes fail to act? As noted above, the tax issues that tend to take center stage are often those related to the transaction itself, such as obtaining tax-free status for the spin-off, increasing the deductibility of transaction costs, and addressing the taxation of golden parachute payments. Any tax department energy left over from those issues is generally absorbed by the challenge of setting up the separated businesses' tax operations so that each can continue to function after the transaction. With all that to worry about, it's not surprising that analyzing the tax implications of the separated entities' new business processes can fall off the radar.

Fortunately, once the idea of increasing the tax efficiency of the new entities' changed operations is brought to the divestiture team's attention, it's relatively straightforward for tax personnel to do the necessary work to advise management appropriately. In spin-offs and carve-outs, unlike in mergers and acquisitions, information can usually be freely shared between the soon-to-be-separated businesses, making it feasible to start planning each company's operational structure well in advance of deal close. Moreover, in a pure spin-off, the divesting company normally has more control over the timing of the transaction than it could have in an acquisition. In short, if you're considering a divestiture, there are no good reasons not to consider the tax implications of operational decisions associated with the separated entities.

Places to start looking

So what areas of operations might benefit from a good look at their tax implications? Almost any planned business change should be considered, but especially those that involve relocating personnel, facilities, or assets. Here are a few of our top candidates:

Supply chain — A newly independent company usually needs to establish its own supply chain separate from its parent's. If the divested company is large, the parent may also need to make changes to its supply chain. In both cases, there may be opportunities to reduce federal, state, and foreign income taxes.

The use of a "procurement company" is one well-known example. Large companies often centralize their sourcing and procurement activities to achieve economies of scale. A company with such a centralized procurement organization may be able to realize savings, including tax savings, by isolating its procurement functions and assets in a separate legal entity — a procurement company — particularly when that company is located in a low-tax jurisdiction. The rest of the organization, which may be located in higher-tax jurisdictions, pays the procurement company to provide sourcing and procurement services; the overall tax savings occur because the procurement company's income is taxed at a lower rate than may likely have been the case if the assets had remained with the rest of the organization. Another advantage of this type of structure can be a potential reduction in recurring sales and use taxes on goods and services flowing through the procurement company.

Technology — Considering the tax profile of different jurisdictions can be important when determining the location for information technology (IT) assets and activities. If a company uses technology to perform a high-value, well-defined function — for example, a hotel chain that uses a proprietary room reservation system — the company should consider housing the IT assets and activities used for that function in a discrete legal entity located in a lower-tax area. Like a procurement company, this IT entity charges the rest of the enterprise for its services, and its income is taxed at a lower rate. A spun-off or carved-out company should be especially cognizant of this approach, as a divested company generally needs to build its own IT infrastructure from scratch and may be faced with decisions regarding the location of that infrastructure.

In addition, a divested company may be able to avail itself of a wide range of tax-saving possibilities, both immediate and ongoing, as it builds out its IT infrastructure. For example, a variety of approaches exist to reduce sales and/or use tax paid on software and hardware purchases, and companies may be able to deduct, rather than capitalize, substantial portions of the total cost of an ERP implementation. Some jurisdictions also offer research and development tax credits for internal use software projects, which may influence a company's choice of where to conduct its initial and ongoing software development. And training credits or grants may be available to companies that need to train or retrain its employees on new IT systems.

Facility location — Whether it's a warehouse or distribution center, a manufacturing plant, a data warehouse, or corporate headquarters, opening a major new facility often gives companies the chance to negotiate for tax credits and/or incentives with various tax jurisdictions eager to bring new business to the area.

These can range from property tax exemptions to corporate tax moratoriums to employee training and development credits. The more people to be employed at the proposed facility, the more significant these tax credits and incentives can be. Just as important, a divestiture may put existing credits and grants at issue, so a complete survey of the impact of the transaction should be considered.

Researching and negotiating for credits and incentives, whether new or those to be retained, can take time, so it's important to start looking into these incentives relatively early in the divestiture process. By allowing plenty of time to negotiate with taxing authorities before announcing the location of the new facility or facilities, a company can protect itself from being hurried into a less-than-satisfactory decision. Of course, it may be impossible to negotiate incentives with local authorities after a location decision has been announced — one more reason to start the process early.



Common tax divestiture pitfalls

1. Transaction taxes on asset transfers — Sales, Use, VAT and other transaction taxes can significantly increase the cost of the deal. If these issues are discovered too late in the process, it can be difficult, if not impossible, to restructure the transaction to reduce these burdens.
2. Tax-related transition service agreement (TSA) issues — It's common for the parent company to agree to provide some tax support for a limited period of time until the divested company can staff up and develop the IT infrastructure to manage its own tax affairs. The mistake many companies make is not being specific enough in the TSA language. For example, what does it mean when the parent company says it can provide "sales tax support"? Does it mean that they could prepare the sales tax returns, or provide the data for the returns, or answer questions if asked? A substantial post-close dispute about roles and responsibilities may be avoided with more careful language.
3. Payroll restarts — depending on the nature of the transaction, employee wage bases for FICA may need to restart, a burden to those highly compensated employees who have already "topped out" for the year. (While the employee can later get a refund on a personal tax return for the excess FICA paid, the employer cannot.) A more common issue is restarting state unemployment tax bases. Since state unemployment tax base limits are smaller (only \$10,000 or less in many states), it is not uncommon to have virtually the entire employee base be affected, and this can effectively double the state unemployment tax burden for the year of the transaction.
4. Facility announcements prior to credit negotiations — Many state and local governments may consider providing inducements to attract (or in some cases, just maintain) employment in a specific location. But if a spun-off company announces where its headquarters might be located, before negotiating with the local authorities, some negotiating leverage may be lost.
5. Nexus/Permanent Establishment refresh — Often a spin-off or sale may reduce tax footprint of one or both companies, which can reduce the number of jurisdictions where taxes must be paid. Unfortunately, certain tax departments sometimes simply follow what was done in the prior year, resulting in unnecessary filings and taxes.

Liberating tax department resources

As noted above, tax departments of companies that are undergoing divestitures can easily be overburdened. One way to create capacity in your tax department can be to critically analyze new information systems from a tax perspective so that the tax department doesn't need to generate the data that proper IT systems can do automatically. For instance, if the separated company's IT system can't generate legal-entity books, the tax department might need to generate them by hand.

With foresight, an emerging tax department can shape its policies and processes through the use of technology and significantly reduce the time devoted to tax return compliance and planning while generating higher-quality products in both areas. Here, a "clone and go" approach with respect to existing IT systems may actually be problematic. Supported by an analysis of how the tax department gets from "here" to "there," the new tax department can emerge as a smaller cost center with a focus on a number of critical tasks rather than solely on tax compliance obligations, which may be addressed through effective technology and data management planning

The bottom line

Obviously, the decisions you make about the separated companies' operations can be shaped by many business considerations other than tax. Our view, though, is that tax should be considered early in the process so that management can make operational decisions based on an after-tax rather than a pre-tax basis. While tax considerations shouldn't drive these choices, they're definitely an important part of the total picture, and they can have long-lasting consequences for the separated businesses.

Remember, too, that it's usually far easier to address the tax efficiency of a business as part of an overall business transformation than it is to make changes once the business has stabilized. In other words, once the business processes are set in stone, the tax consequences may be too — and you may find your future tax options somewhere between slim and nonexistent. Even worse than missing a potential tax opportunity, you may find yourself locked into a very undesirable tax position with only limited options for improvement. So take the time to look for ways to achieve tax efficiencies in the separated businesses' operations when you engage in a spin-off or carve-out.

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Spinning in circles

How to handle the circular dependencies that can stop a tax-free spin-off dead in its tracks

A tax-free spin-off is a transaction where one or more businesses (“Controlled”) are divested from a company (“Parent”) but continues to be owned by Parent’s existing shareholders. This type of transaction offers a number of advantages over a conventional divestiture, particularly when credit is tight and buyers are scarce.

As its name implies, one of the main advantages of a tax-free spin-off is that, if properly structured to meet the various requirements, the transaction is a non-taxable event to Parent, Controlled and their shareholders. Another advantage is that creditors often are more willing to fund this type of deal because it is considered less risky from a capital markets perspective. This may enable Parent to extract cash from the business of Controlled-- even in a market environment where potential buyers are having trouble raising capital for acquisitions.

In addition, the fact that both parties to the transaction are part of the same original entity gives management tremendous control over how the deal is structured. This turns out to be both a blessing and a curse. The upside is that Parent has the power to optimize many aspects of the deal, within the limits established for tax relief for the separation and distribution. The downside is that in trying to optimize the transaction, the company is likely to encounter several “chicken and egg” dilemmas where key decisions each hinge on one another. These circular dependencies can create a vicious cycle of indecision that brings execution of the divestiture to a grinding halt.

This article examines five common circular dependencies in a tax-free spin-off, and offers practical and tested advice to help companies avoid getting stuck in the mud.

Circular dependencies — And how to manage them

In our experience, five aspects of a tax-free spin-off are especially vulnerable to delays due to circular dependencies: Credit Ratings and Capital Requirements;

Private Letter Ruling and/or Opinion on tax-free status; Legal Entity Restructuring; Cash Transfers and Distribution; and Debt Strategy.

Many of the circular dependencies in these areas revolve around determining the end-state capital structures for Parent and Controlled. In fact, no activity presents as many circular dependency challenges. Decisions about capital structure influence (and are influenced by) a multitude of factors. As a result, executives often hesitate to settle on a final capital structure for either business until relatively late in the deal because they don’t feel they have enough information to make good decisions.

Generally speaking, a preferred way to address circular dependencies in all of these critical areas is to view the decision-making process as iterative, rather than strictly sequential. Decision-makers should be willing to take action on a variety of fronts based on incomplete information, and then steadily shepherd all of the disparate elements toward a consistent and optimal conclusion. Here is some advice on how to accomplish this feat.

Credit ratings and capital requirements

One key dependency that affects decisions about capital structure is the issue of obtaining a credit rating for each of the post-spin businesses. Credit rating agencies need to examine financial statements in order to issue a rating. However, management’s desired credit rating for each of Parent and Controlled will influence decisions about their capital structure — which, in turn, will affect the financial statements to be submitted to the credit rating agencies.

Capital structure decisions are also influenced by cost of capital considerations, and by regulatory requirements in certain industries such as financial services. To obtain regulatory approval for the transaction, management must file post-transaction pro forma financial statements with the appropriate regulatory agencies. However,



these regulatory authorities often have capital adequacy requirements, which means that highly-leveraged capital structures may need to be modified based on regulator feedback.

Based on our experience, it is not necessary to finalize either entity's capital structure before preparing the initial financial statements for credit rating agencies (or regulators in situations that mandate capital adequacy requirements). An interim, conservative capital structure that encompasses a range of scenarios will generally be sufficient for credit rating agencies to issue a provisional rating for each entity based on general credit worthiness. These preliminary ratings in turn should be sufficient for approaching the debt market to consummate the transaction and regulatory authorities for approval.

IRS private letter ruling and/or opinion of tax advisors/counsel

Obtaining tax-free status for a spin-off can have a huge impact on shareholder value — and can therefore make or break the deal. Determining whether a divestiture qualifies for tax relief depends on some of the more-complicated US tax rules around, including evaluations which are highly subjective in nature.

The US Internal Revenue Service ("IRS") offers a limited "advance ruling" program which provides management of Parent and Controlled with some assurance with respect to any "significant issues" (as determined by the IRS) that any such significant issues associated with the contemplated divestiture will satisfy the tax relief provisions. To participate in the advance ruling program, management must first determine, likely with some input from the IRS, whether there is a "significant issue" on which the IRS could issue a ruling. In such a case, management must submit a formal application, along with any necessary representations, agreements to conditions and documents and exhibits, all of which are intended to enable the IRS provide a ruling on the significant aspect of the transaction.

Because the IRS has changed its advance ruling policy to no longer issue rulings covering the majority of the aspects of the tax-free divestiture, management will likely need to rely on outside advisors to assist in ensuring that the various requirements are met and properly documented. In order to gain comfort on the other requirements necessary to support the divestiture's qualifying as

tax-free, management should seek out a formal opinion from tax advisors and/or legal counsel. Management must work with its outside advisors and submit numerous representations, documents, and exhibits to enable outside advisors to issue an opinion.

A key circular dependency in this process relates to finalization of the tax cost Parent has in the stock of Controlled immediately before the divestiture. (If Parent filed a US consolidated income tax return with Controlled, under certain circumstances Parent's tax cost may be negative, in which case the divestiture would trigger a potentially unwanted tax upon Parent.) This "tax basis number" (whether positive or negative) is influenced by several factors associated with the divestiture, including preparatory transactions to move assets and liabilities between Parent and Controlled, as well as how the legal entity structure of Controlled was put together historically and in anticipation of the divestiture. Another important deal factor which directly influences this tax basis number is the amount of any cash distribution by Controlled and/or the amount of debt Controlled assumes or otherwise takes from Parent before the spin-off. Based on discussions with tax advisors and counsel during the opinion drafting process on how management will satisfy the complex rules for a tax-free spin may require changes to the originally-anticipated capital structure of Parent and Controlled, forcing management to submit revised *pro forma* financials in order to obtain the sought-after ruling and/or opinion.

As with credit ratings, management may consider adopting an interim capital structure for each post-spin business when preparing the financial disclosures for the advance ruling process. The thing to avoid is leaving money on the table by proposing an overly conservative capital structure based on an overly conservative tax basis number. In many cases, a middle-of-the-road proposed capital structure works better. This approach leaves room to tweak the capital structure based on the feedback of outside advisors and/or the IRS while staying within an acceptable range to achieve management's desired credit rating.

Legal Entity Restructuring

Legal Entity Restructuring is a complex, multi-step process that involves assigning new or special purpose entities to the appropriate corporate structure, aligning entities to the businesses of each of Parent and Controlled to meet legal and tax obligations in various jurisdictions, and eliminating cross holdings. In particular, the effects of unwinding



commingled structures can cascade through the financial statements and have a ripple effect on the capital structures of both Parent and Controlled.

During the process, in anticipation of or response to concerns raised by outside advisors and/or the IRS, management may propose changes to the originally envisaged legal entity structure. If this happens, the capital structure and associated *pro forma* financials of the parent and spin-off may need to be re-worked.

Given the time-consuming nature of the process, it makes sense to start early on the less controversial aspects of legal entity documentation and restructuring. It is also prudent to hold off on executing any plan to restructure or convert commingled businesses into separate legal entities until outside advisors have had a chance to review the documentation and support compiled by management and provide any observations or feedback. This reduces the possibility of reversals if the deal is not approved within the expected timeframe or with the expected deal structure. In addition, feedback and assistance from outside advisors can help management gain comfort with the transaction in the absence of input from the IRS. This delayed approach also can make it easier to design and strictly comply with the sequencing of preparatory transactions which place Parent in the position of being able to divest a completely separate Controlled as well as assist Parent in preparing the necessary documentation throughout the process.

Cash transfers and distributions

Cash transfers in a spin-off transaction can be the result of the internal spin or the external spin. Certain types of cash transfers revolve around transactions undertaken to create the sought-after distribution to Parent's shareholders of Controlled stock. These transfers, also known as the internal spin, involve transferring cash among various legal entities to square off inter-company holdings and borrowings. The external spin involves a one-time tax free cash distribution from the spin-off entity to the parent based on the tax basis number arrived at through a quantitative analysis by management in consultation with outside advisors.

Here again, the outcome is greatly influenced by any changes that need to be made to the legal entity restructuring and tax basis throughout the process of obtaining the opinion and/or ruling. Specific impacts can include: the number and size of transfers made as

part of the internal spin, the amount of cash that can be distributed as a dividend for the external spin, and the capital structure. The legal entity structure for each business is open to changes throughout the process of drafting the opinion and/or discussing any significant issues with the IRS. In addition, the dividend distribution must follow the exact sequence and timing laid out in the step plan. This means that the internal and external cash transfer strategy — as well as the projected capital structure — can be in flux until outside advisors and/or the IRS sign off on the transaction.

Companies typically go through several iterations of steps before settling on the final version of the transaction. And as with any iterative process, a key to arriving at a successful transaction is to understand which battles are critical to win, and which can be conceded without significant loss of value. The smoother the process, the faster the company can develop its cash transfer strategy and finalize its capital structure.

Debt strategy

Several factors related to the design of the transaction have a significant impact on the spin-off business's debt strategy. For one thing, the tax basis determines the size of the cash dividend from the spin-off entity to parent, which influences the amount the spin-off entity will need to borrow. This in turn affects the capital structure and the final *pro forma* financials provided to outside advisors, the IRS, regulatory authorities, and credit rating agencies. Furthermore, the activities laid out in the step plan to execute the transaction may affect the amount of cash available internally for distribution.

A deep understanding of how the IRS views certain aspects of the use of debt in a spin-off enables management to work with its outside advisors to examine the capital structure. While we understand that IRS advance ruling policy historically had been to provide that existing source of credit could not be used to satisfy debt used to finance the distribution. However, the IRS has issued a notice that it will not rule on transactions on which debt is created in anticipation of the spin-off. This development in IRS policy has a direct impact on a company's debt strategy by narrowing its options for raising capital. The logical time for executives to finalize the spin-off entity's debt strategy is after the form of the transaction has been established by outside advisors and discussed with the IRS, if necessary. Bankers may need confirmation from outside advisors

that all outstanding issues are cleared before placing any debt instrument on behalf of the spin-off entity. The confirmation is usually given in the form of an informal note from outside advisors discussing the comfort level with the transaction and that the opinion is in the process of being formally written up. Bankers look upon this confirmation for assurance that the deal will go through and that the spin-off business will indeed be allowed to begin life as an independent entity.

Leading practices in resolving circular dependencies

Although there is no one-size-fits-all approach for successfully navigating this maze of circular dependencies, our experience with tax-free spin-offs has revealed certain leading practices that apply across a wide range of industries and deal sizes. In addition to the activity-specific practices described earlier, here are four leading practices for managing circular dependencies in the overall transaction:

- **Communicate across functions.** While respecting the confidentiality that surrounds the deal in its early stages, the leaders of all functions involved in potential circular dependencies should stay in close communication so that dependencies can be identified and addressed in a timely fashion. Setting up a formal, cross-functional communication forum can help keep the various functions on the same page and reduce the chance of surprises.
- **Engage outside advisors early on.** With the institution of the new IRS policy that rulings will only be given in the case of a significant issue and that the IRS will only rule on such issue and not on the transaction as a whole, outside tax advisors and legal counsel play a vital role in assisting management through the process of developing the transaction. Involving outside advisors from the beginning can enable management to more easily and efficiently navigate the process. In addition, outside advisors will be able to assist management in identifying any significant issues that are ripe for a ruling by the IRS.

- **Establish a clear roadmap.** A project roadmap that identifies key milestones, highlights dependencies, and clearly defines the critical path, can help executives keep track of circular dependencies and proactively determine the points in the deal lifecycle when additional resources should be brought in to address them.
- **Get the go-ahead from every key function.** Functions such as Tax, Treasury, Finance, and Legal should be required to jointly sign off on any decisions that affect their respective areas. This encourages alignment, participation, and involvement across functions. It also helps ensure that all functions have considered circular dependencies and offered their input before any major decisions are finalized.

Crossing the finish line

To effectively execute a tax-free spin-off, a company must shepherd many interrelated decisions through a series of successive approximations before the decisions reach their final form. This process is more art than science, relying heavily on experience and intuition. However, recognizing and acknowledging circular dependencies early in the transaction can help company executives make better decisions, avoid undue delays, and improve the chances of achieving the principal objectives of this form of divestiture on time and within budget.

This paper attempts to address the transactional aspects of spin-offs. It does not touch upon complications presented by the operational aspects of planning and executing spin-offs or the touch points that these may have with the transactional aspects.

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Carve-Out Financial Statements

Why such a fuss?



Introduction

As soon as the discussion turns to the sale or spin-off of a portion of a business, someone inevitably brings up the need for financial statements. Obviously, the buyer and/or potential investors are going to need to understand the financial parameters of what they are investing in. Sounds easy, right? After all, the company has been preparing consolidated financial statements for years and each entity has a separate ledger within the trial balance. Unfortunately, as those who have been through the process can attest to, it's almost never that simple. Layers of legal entities, shared services, shared assets/liabilities, and competing priorities can grind some "carve-out" projects to a virtual halt before they even get started. That said, understanding the fundamental purpose of the financial statements, being able to effectively define the business being spun/sold, and immediately tackling some of the thorniest accounting-related carve-out issues can streamline the process greatly.

Understand the purpose

The term "carve-out financial statements" is a generic one used to describe the separate financial statements of a business that are derived from the financial statements of a larger parent company. The form of those financial statements may vary, however, depending on the situation. For example, if the acquisition is small, a strategic buyer of a carve-out business may be satisfied with an unaudited balance sheet and income statement for the most recent year. Another public buyer, however, may require a full set of SEC¹-compliant audited financial statements, including footnotes, for the three most recent

fiscal years², while yet a third buyer might ask that the periods be audited, but be completely unconcerned with SEC reporting considerations. Accordingly, assessing the potential audience is critical to understanding the basis of presentation and the number of periods needed. This can be particularly tricky when the carve-out financial statements are being prepared in advance of the buyer or potential buyers being identified.

Preparation Tip: Full financial information may not always be attainable in situations where the carve-out business is not a stand-alone entity and separate and distinct accounts have not been maintained. In these instances, public company buyers may request that the SEC staff accept audited statements of assets acquired and liabilities assumed (in lieu of a full balance sheet) and statements of revenues and direct expenses (in lieu of a full statement of operations). This type of "abbreviated" presentation, however, always requires pre-clearance with the SEC staff to ensure that the presentation will be accepted under Rule 3.05.

Similarly, the decision to spin off³ a division, subsidiary, or part of an SEC registrant into a separate stand-alone entity creates an even bigger set of wrinkles as it results in a requirement to file a separate registration statement with the SEC, typically on Form 10⁴. In addition to the baseline carve-out financial statements, a Form 10 will also need to include items such as a five-year table, Management Discussion and Analysis, and other capitalization and liquidity disclosures.

¹ Securities and Exchange Commission (SEC)

² Public buyers have to comply with SEC Reg. S-X, Rule 3.05 ("Rule 3.05"), which requires them to provide financial statements for significant acquisitions. The significant acquisition rules focus on three principle criteria: the investment test, the asset test, and the income test. If any of those tests exceed a threshold of 20%, at least one audited period (and potentially up to three if any of the tests exceed 50%) will be required.

³ A company may elect to spin off a division, a subsidiary, or part of a business, for a number of reasons, including (1) to maximize the spun entity's value as an independent company, (2) to highlight a business that has otherwise been overshadowed by other aspects of the consolidated group, or (3) to take advantage of certain tax opportunities.

⁴ A Form 10 is the spin-off equivalent of a Form S-1 filed by new registrants in connection with an initial public offering (IPO).

Preparation Tip: The purpose of the financial statements also greatly impacts the timeline, as carve-out financial statements filed for a public spin-off via Form 10 would need to be available at least 60 days prior to the spin, while carve-out financial statements prepared for Rule 3.05 purposes would need to be available within 75 days post-closing.

Determining the parameters of a carve-out business is less straightforward than one might originally think.

Define the carve-out business

Once the purpose has been identified, attention turns to defining the “business” to be included. While this exercise sounds simple — what’s in is in and what’s out is out — determining the parameters of a carve-out business is less straightforward than one might originally think. In the best case scenario, the terms and conditions in the purchase and sale agreement will outline the assets and liabilities and legal entities to be included. Preparing carve-out financial statements for a spin-off or in preparation of divesting a business in advance of such an agreement, however, is much harder as no roadmap exists per se — only the vague concepts that exist in the mind of the spinner/seller. That said, the following questions would typically be considered when defining the carve-out business and determining the historical financial information to be included:

- Operating and financial reporting structure — Is the carve-out representative of a defined segment of the parent? A reporting unit with defined financial results may serve as a springboard, but, often times, only a portion of a segment or reporting unit is being divested, increasing the difficulty of identifying the assets and liabilities related to the component.

- Legal structure — What does the legal structure of the carve-out entity look like? The legal structure may also serve as a basis to begin evaluating the historical financial results. Remember, however, that the legal entity structure is often established for tax purposes and may include multiple business segments, product lines, or geographies that may not align with the carve-out or spin-off. (See also Tax Considerations below.)
- Practical aspects — What people and assets are actually going with the deal and where did those individuals/assets reside previously? Understanding whether these individuals/assets represented a portion or all of certain operating, reporting, or legal structures may also provide some clarity as to the appropriate basis of presentation.
- Past performance — Is an entire business line being spun, or only a portion of one? Has the business been restructured over the years, or is it static during the periods in question? The existing business may be structured differently as compared to the historical operations. For example, recent acquisitions or divestitures need to be evaluated for inclusion/exclusion from the historical periods as the SEC staff believes that carve-out financial statements “should include all relevant activities that have been a part of the history of the business and that can be expected to repeat as the business continues in the future⁵.”

Preparation Tip: None of the above items is determinative in and of itself. For example, a prospective legal structure that leaves behind certain unprofitable operations does not allow a preparer to “cherry-pick” just those operations, as evidenced by the following example previously shared by the SEC Staff⁶:

⁵ Ibid.

⁶ SEC Staff Accounting Bulletin (“SAB”) Topic 1.B.1 notes that the SEC staff has required subsidiaries “to revise [their] financial statements to include certain expenses incurred by the parent on its behalf. Examples of such expenses include, but are not necessarily limited to... Officer and employee salaries, rent or depreciation, advertising, accounting and legal services, and other selling, general and administrative expenses.”



A company has 75 restaurants encompassing a certain theme, in a certain region of the country, and 25 of those restaurants have not been very successful perhaps because of their location, location of competitors, inability to hire good employees, type of labor market, or some other reason. The company is now going to put the 50 successful restaurants in a Newco and take it public. The staff would expect all 75 restaurants to be included in the historical carve-out financial statements until the other 25 have been sold or discontinued even though investors will only have an interest in the 50 successful restaurants since all of the restaurants (including the 25 unsuccessful) have been part of management's track record. It is expected that in the future Newco will expand by opening new restaurants and not all of them will be successful.

Tackle the thorniest accounting issues early

After the purpose of the financial statements is understood and the business to be presented is defined, the allocation process can actually begin. For many of the balances, this process occurs quickly, but for others, the process can be very time-consuming. Digging in on the most challenging issues at the outset of the project, rather than at the middle or end, can significantly assist in shortening the overall project lead times. Consider, for example, the issues presented by the following types of account balances:

- *Shared assets and activities* — Most companies are generally structured to gain synergies related to common activities and processes that can be centralized. These activities provide a benefit to the entire organization; however, the cost of these activities (e.g., information technology, cash management, human resources, accounting, etc.) is often not embedded within the historical operations of the separate business that is subject to the carve-out. As the SEC's view is that carve-out financial statements should reflect all of the carve-out entity's costs of doing business⁷, these activities need to be evaluated to determine an appropriate amount of expense to be allocated to the stand-alone business. In addition, the related assets and liabilities of these shared functions (e.g., buildings, equipment, leases, etc.) also need to be evaluated to determine whether they should be

included in the historical operations. For example, how should the company treat a manufacturing facility that will be contributed to the entity prospectively, but was not fully dedicated to manufacturing only products of the carve-out business? Or what about segment-level executives who were previously serving multiple businesses?

Preparation Tip: Some assets and liabilities may be more appropriately shown as part of the pro forma financial statements, particularly when contributed assets did not relate to the historical operations of the business. That said, the materiality of those assets and liabilities needs to be considered when reaching that determination, as the

Digging in on the most challenging issues at the outset of the project, rather than at the middle or end, can significantly assist in shortening the overall project lead times.

SEC may object to the inclusion of material items in the pro forma statements that have not been subject to audit.

- *Working capital* — Companies often have centralized cash management functions, complete with "sweep" accounts and centralized cash collection and bill payment centers. When overlap exists between the customers and vendors of the entity to be spun and those of its parent, specific identification of receivables and payables is not always feasible without an inordinate amount of work. In these situations, developing a "system" solution early on which can, for example, isolate individual SKUs and allocate shipping and tax charges appropriately is often critical to developing a set of financial statements that can withstand the rigors of an audit.

⁷ SEC Staff Accounting Bulletin ("SAB") Topic 1.B.1 notes that the SEC staff has required subsidiaries "to revise [their] financial statements to include certain expenses incurred by the parent on its behalf. Examples of such expenses include, but are not necessarily limited to...: Officer and employee salaries, rent or depreciation, advertising, accounting and legal services, and other selling, general and administrative expenses."

- *Debt* — When companies take on debt and finance their operations, these decisions are often done via a centralized cash management/treasury department. In these situations, it's not always clear what portion, if any, of these general corporate balances, and, in particular, debt balances, should be pushed down to the separate stand-alone financial statements of the carve-out entity. At a high level, some criteria to be considered include:
 - Business purpose of the debt
 - Whether the carve-out entity will actually assume the debt
 - Whether the carve-out entity was ever charged interest expense or if the debt was ever recorded on the entity's separate books
 - Whether the debt was undertaken to support the operations of the separate entity
 - Who the legal holder of the debt is
 - Whether the separate entity/business guarantees or its assets collateralize the debt
 - Whether the carve-out entity had positive cash flow during the historic period to meet operating cash needs

Preparation Tip: SEC SAB Topic 5J, Question 3 addresses the views of the SEC staff with respect to recording or "pushing down" acquisition debt incurred by a parent company in connection with or otherwise related to the acquisition of the subsidiary. SAB Topic 5J, Question 3 states that for circumstances in which the subsidiary subsequently files an initial registration statement, the parent company's acquisition-related debt, related interest expense, and allocable debt issue costs should be reflected in the subsidiary's financial statements if:

- *The subsidiary is to assume the debt of the parent, either presently or in a planned transaction in the future,*
- *The proceeds of the subsidiary's debt or equity offering will be used to retire all or a part of the parent company's debt, or*
- *The subsidiary guarantees or pledges its assets as collateral for the parent company's debt.*

- *Pension and post-retirement benefit plans* — Obviously, plans that specifically relate to, and will go with, the carve-out business will appear in the carve-out financial statements. Often, however, the carve-out business' employees are simply participating in the parent's broader plan. In those instances, the business would generally account for its participation in the overall single-employer pension plan as a participation in a multi-employer pension plan; and depending on arrangements between the business and the parent, the carve-out income statement would include either the entity's required contributions to the plan and/or an allocation of the parent's pension costs as net periodic pension cost.

The balance sheet treatment, however, is less straightforward, as only limited guidance exists concerning the proper presentation of pension assets and liabilities in carve-out financial statements⁸. Items to consider in determining whether pension assets and obligations related to the carve-out should be specifically identified and pushed down include, but are not limited to:

- Is there a formal arrangement for the carve-out entity to contribute funds to any parent-sponsored plan?
- Which entity manages the pension benefits and administration of the plans?
- Is there a plan in place establishing the legal structure of the transfer of the pension obligation and assets for the employees attributable to the carve-out?

That said, the ending balance sheet in the carve-out financial statements is often more relevant if it includes the amount of the liability that will be retained by the subsidiary and, hence, assumed by the purchaser.

⁸ No authoritative guidance directly addresses the treatment of the pension liability in carve-out financial statements being prepared in connection with a sale of a subsidiary. If a subsidiary's stand-alone financial statements are being prepared in connection with a spin-off, however, ASC 845-10-55-1 requires accounting similar to the division of a pension plan that was previously part of a larger pension plan (i.e., allocation of assets and liabilities between the plans).



The mechanics of the business carve-out can have a significant impact on the tax implications of the transaction. For example, the separation of the carve-out business may involve taxable transfers under Sections 301 or 1001, or tax-free transactions under Sections 332, 355, or 368, depending on the structure of the transaction. As a result, it is important to consult tax advisors early in the process to ensure the appropriate structure, and the associated tax consequences, are sufficiently considered prior to the transaction.

- *Tax Considerations* — The tax provision for a carve-out business is typically prepared as if the entity were a stand-alone tax filer (i.e., no longer consolidated with the parent). This creates additional complexity as allocations of benefits reflected on the “as filed” tax returns may be at odds with a stand-alone approach. For example, an entity may have operating losses or other attributes⁹ that were utilized by the parent that would not have been utilized on a stand-alone basis. Alternatively, an entity may have used losses that were generated by the parent or other entities within the parent’s consolidated tax group. As such, careful consideration should be given to how best to present the tax losses and other attributes on the balance sheet of the carve-out business and within the income tax footnote. Other tax considerations include:
 - *Legal Entity Structure* — Tax returns, which form the basis of an entity’s deferred tax balances and attribute carryforwards, are generally prepared on a legal-entity basis, despite how financial reporting information may be gathered. As such, it will be necessary as part of the carve-out process to identify the entities whose operations comprise the business being carved out and align the disparate accounting and tax information sources.
 - *Reserves for Uncertain Tax Positions* — The Company’s reserves for uncertain tax positions will need to be evaluated to determine which, if any, would be reported by the carve-out business. Lower materiality thresholds may also impact whether additional items are recorded as uncertain tax positions.
 - *Deferred Taxes* — The carve-out financial statement should include the inventory of deferred assets and liabilities that reflects the specific tax attributes associated with the carve-out operations. In some

situations, it may be easy to identify the deferred tax items that would be reported on the carve-out statements. In many situations, however, the company must allocate these deferred items based on a methodology, such as the percentage of assets to be carved out over the percentage of total assets.

- *Statutory Tax Rates* — The carve-out business may have a state or international tax footprint that differs from the parent, requiring additional evaluation and support for the statutory rates that should be used to record tax expense.

The carve-out process generally has additional tax implications beyond the carve-out financial statements. The transaction may trigger gains or losses arising from historic deferred intercompany transactions. Tax losses, including those that arise in the transaction, may need to be allocated between the existing and carve-out businesses, and both new and existing limitations on the use of such losses should be considered. The seller’s basis in the assets being acquired must be determined in order to calculate gain or loss on the transaction, and the carve-out may require an allocation of purchase price that impacts the seller’s gain or loss. Moreover, the seller may need to make tax elections relating to the transaction (such as the allocation of historic losses) which have important implications for both purchaser and seller. A prudent buyer or seller will consult a tax professional in advance for assistance in addressing these and other tax issues that may be involved in the transaction.

- *Goodwill and other intangible asset impairment* — Historical goodwill associated with a spun or carve-out business should be allocated to and included in the carve-out financial statements. Unfortunately, however, the accounting methodology utilized by the parent on a consolidated basis may not be the same methodology used to determine the goodwill for the stand-alone business. For example, while the parent company accounting for goodwill upon disposal of a business is based on the relative fair value of the disposed business, the stand-alone carve-out financial statements being prepared may need to follow a historical goodwill concept and reflect the acquisition-specific goodwill of any previously acquired entities that are part of the operations of the spun-off business. What do these differences mean? Goodwill may be different for the carve-out business and, as a result, additional analyses will be required to evaluate potential impairment of goodwill.

Preparation Tip: Parent companies typically operate with a higher level of materiality as compared with the level of materiality that would be assessed for the stand-alone component business. As a result, certain “immaterial” account balances may not have been scrutinized to the same level that will be required for the carve-out, often resulting in adjustments that would not (and have not) been recorded in the historical consolidated financial statements. The conclusions resulting from the increased level of scrutiny, however, may contradict conclusions and amounts at the parent level, creating issues for the parent company that will need to be carefully evaluated.

Final thoughts

Even the best laid plans can go awry in a carve-out, but understanding the intended purpose, describing and depicting the business appropriately, and then delving into some of the more challenging accounting issues sooner, rather than later, can certainly help streamline the process. Successfully navigating these waters requires early involvement from a number of constituents outside of the company’s internal accounting department, including, but not limited to, SEC counsel, the company’s senior management, and the company’s external auditors. Even so, preparers need to realize that no two carve-outs are ever truly the same, nor does any “cookie cutter” approach to their preparation exist, and that simple message, in and of itself, is what all the fuss is about.

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Sell-side due diligence

Can you pave the way to a higher-value carve-out?



Selling a business is rarely easy. A host of financial, operational, technology, and human resource issues must be addressed during the transaction. However, divesting a piece of an enterprise — such as a division, a plant, or a product line — can be even more challenging.

In a carve-out, the financial and operational data a potential buyer will rely on often isn't subjected to the same rigor as corporate data prepared for investors, lenders, and regulators. Also, certain information used to manage the business — intra-company transactions, corporate allocations, and financial adjustments — may not be relevant to the potential acquirer.

If your company is considering a divestiture or spin-off, it is crucial to anticipate and address the information needs and expectations of potential buyers as the business prepares for the sale. Incomplete or inaccurate information, particularly financial data, can have a direct, negative impact on the price you obtain in the sale. Conversely, there are certain preparations you can make — call it sell-side due diligence — that can help increase the value you'll realize from the deal.

It's all about credibility

We have observed that the credibility of the seller in a divestiture or spin-off can translate directly into higher or lower deal value. The fewer the uncertainties about the accuracy and reliability of information being provided, the more willing the buyer will be to pay full consideration, or perhaps even a premium.

But there is a harsh reality in any such transaction: Seller credibility is typically never higher than when the buyer

first receives information on what's being offered for sale. From then on, any discrepancy or other unpleasant surprise uncovered through buyer due diligence will likely reduce that credibility and, as a consequence, the buyer's trust and willingness to pay.

Therefore, it's imperative that sellers take actions to prevent surprises from occurring down the line. To do that, you must have confidence in the information you're providing from the very start. The sales, cost, and profit figures and the business description you initially provide — likely at a summary level — must hold up throughout the buyer's examination of the operation.

Should the buyer at any point in its due diligence challenge the numbers you've provided, it is critical for the underlying information — the details behind the summary you provide initially — to be consistent and support those numbers. The financial information you provide also should reconcile to those in the financial reports of the enterprise as a whole. Because internal financial reporting for operations that aren't managed as a separate business often is less rigorous than for the broader enterprise, it is vital that someone within or outside the seller organization take a critical look at the data from the buyer's perspective.

It's also important to have ready explanations for unusual events or incidents, such as a customer problem that produced a negative financial impact. Your management team should be able to provide an accurate account of what happened and how it was resolved.

Conducting “sell-side diligence” before the sales process starts can help you anticipate issues a buyer may raise and develop responses that help reinforce your credibility (see “Key Focus Areas of Sell-Side Due Diligence”). It will assist in tax planning to achieve higher after-tax proceeds. And it will help you better understand the impact of the transaction on the parts of your business you’re not selling.

Effective practices for sell-side due diligence

Preparing for a carve-out is a complicated undertaking requiring both proper planning and detailed execution. Here are several critical steps, or effective practices, that we believe can help improve results:

Identify the “3 Ps” — products, people, and physical property — early in the process

It’s not unusual for a company to embark on selling a piece of the business without completely understanding or defining what is actually being sold. What products are involved? Which people will be going with the business? What property, equipment, and plants will turn over to the buyer?

Sometimes the answers aren’t so simple. The sales force may be handling multiple product lines, some that are being divested, and some that will be retained. The products that will be sold in the transaction may be manufactured in the same plant as others that aren’t on the block. Also, the transaction may involve an array of people — from engineers and R&D personnel, to plant managers and hourly workers.

All of these issues must be addressed not only from an operational standpoint but also in financial terms (see “Accounting Areas of Interest to Buyers”). Providing a potential buyer with an accurate picture of the accounting, tax, and financial dimensions of the deal will hinge on having a clear view of the 3 Ps.

Additionally, a clear view of the deal’s parameters is critical to assessing the transition issues that will need to be addressed during the course of the deal. The stranded costs left from the carve-out business, the transition services needed in separating the business, and other, similar issues can be identified and planned for during the identification of the 3 Ps.

Appoint a full-time project champion outside of the product line or business

As noted above, carving out a portion of the enterprise to be sold will affect a variety of functional responsibilities and employee groups within the organization. Because of the breadth and weight of issues that inevitably will arise, it is imperative that someone with sufficient stature and authority lead the process. The divestiture will require different parts of the company to work together in new ways and in some cases buy in on decisions they don’t view as being in their best interest.

The executive put in charge will usually be a member of the corporate team, but could possibly be an external advisor. Either way, he or she should have standing and authority within the company to effectively manage inevitable cross-functional conflicts.

Commit to precision and detailed follow-through on tasks

Time is money in a divestiture. Company leaders are eager to complete the deal to realize the anticipated financial benefits, as well as control the cost of the bankers, lawyers, and accountants that support the transaction.

But shortcuts can create more issues than they solve. Taking the time to do things right the first time can be difficult, but is necessary to sustain a clean process and maintain credibility with the buyer.

For example, you should have a complete view of the financial statements before disclosing any information to a buyer. All of the historical data that you’re going to provide should be gathered, analyzed, and assembled in a data room at the outset, even if you’re only going to provide a

Key focus areas of sell-side due diligence

- Understand intra-company transactions, allocated costs, shared services, and your plans for providing support post-acquisition and during transition.
- Evaluate the quality of earnings and identify “non-recurring” items for which management may want to consider adjusting the financial information.
- Analyze the trend of working capital required by the carve-out business in order to develop a target working capital amount and mechanism in the purchase and sale agreement.
- Understand the assumptions in your forecasts and the bridge of detailed data from actual results to forecast information.
- Evaluate the cost structure for fixed versus variable costs, capital expenditure requirements, and the relevance of certain general and administrative activities to the carve-out business.



small portion of it to a broad group of potential buyers in the initial steps of the transaction.

You want to avoid sharing information early that ends up being contradicted or contested later in a more detailed portion of the process. Being well prepared and spending the time and effort to have precise information upfront translates into credibility and value.

Consider getting outside help

Companies routinely underestimate the amount of time and effort required to complete a divestiture. That's especially true if they want to do the kind of thorough analysis and preparation suggested here.

Even if there is a project champion, he or she is only one person who can't be expected to address the full range of issues involved. At the same time, day-to-day duties will likely limit the ability of others in the organization to contribute.

The company's investment bankers may provide some support. But, particularly from an accounting perspective, they aren't likely to have the resources or desire to do the detailed analysis required. An external third party with finance, accounting, tax, human capital, IT and other experience, knowledge and skills and an understanding of the cross-functional issues can help address this need, providing consistent issue resolution across geographies and interrelated accounts.

Why you may need audited carve-out financial statements

A buyer's financing plans or disclosure requirements may compel the seller to develop audited financial statements for the carve-out business. It's important for both parties to understand that the numbers included in these audited statements may not — in fact, probably should not — agree with the numbers that come out of the due diligence process.

Why? A number of accounting issues can arise in preparing the adjustments required for these two different types of financial statements, and these need to be addressed in detail to substantiate the amounts subject to external audit. The treatment of pension plan information when the parent company retains the pension plan serves as a good example.

In this example, for the carve-out audited financial statements, you would have to reflect your pension plan financials as they existed historically for the business. For instance, if the parent company had less than stellar results from some of its past pension investments, there likely would be additional expense to the business — i.e., the return on the investment underlying the pension plan would not be portrayed as positive. However, in the financial reports prepared for sell-side diligence, the company would typically restate those results to exclude the unusual gains or losses because it wouldn't assume that the buyer is going to have the same results as the seller has had in the past. So the seller — and the buyer — would want to portray the numbers in a more neutral light.

This means essentially that there will be three sets of numbers prepared for the carve-out scenario: the internal numbers for the seller's management team; the normalized sell-side numbers prepared for prospective buyers; and the audited carve-out numbers that comply with SEC rules and GAAP. A key part of retaining value in the transaction is understanding the differences and clearly articulating to the buyer why the normalized numbers are the most appropriate indicator of future profit and performance.

Paving the way to a more rewarding deal

If you're planning to sell a piece of your business, you can expect any potential buyer to conduct due diligence that shines a bright light on the data you provide. As the seller, you have a compelling reason to be thorough in your own analysis — the final value of the deal, and any profits you might enjoy, may rest on the rigor that you bring to this pre-sale process. Consider applying the carve-out practices outlined here to help you produce solid, supportable data that holds up throughout the carve-out process and help strengthen your credibility with the buyer and realize greater value from the transaction.

Areas of interest to buyers

One of many financial accounting issues that frequently arises in a carve-out is treatment of corporate allocations. This will vary depending on the company. For example, a seller may choose to leave allocations, such as human resources, accounting, and treasury, in the financial results because they reasonably approximate what the actual standalone costs for those functions will be. Other times, the seller may feel that the financial picture can be improved by removing the allocation amounts and disclosing to the buyer the types of functional costs that are not included in the business's results.

To be well prepared for when prospective buyers knock at your door, consider the following accounting information that buyers generally want to see:

- Intercompany receivables and payables
- Corporate allocations
- Acquisitions and divestitures
- Restructuring reserves
- Asset impairments
- Foreign exchange
- Derivative financial instruments
- Pensions and post-retirement benefits
- Stock options and deferred compensation

Another consideration is the tax complexity of a carve-out, which will vary from deal to deal. Cross-border deals — which include legal entity sales (i.e., stock deals) more often than purely U.S.-based carve-outs — tend to be more complicated and require focused effort on the part of buyer and seller. Also, the buyer will need certain information, such as details around payroll tax compliance, to support uninterrupted post-acquisition tax planning and compliance. As a result, it is important that both parties understand country-specific tax requirements and work with local country tax specialists and personnel who can help address the applicable tax provisions.

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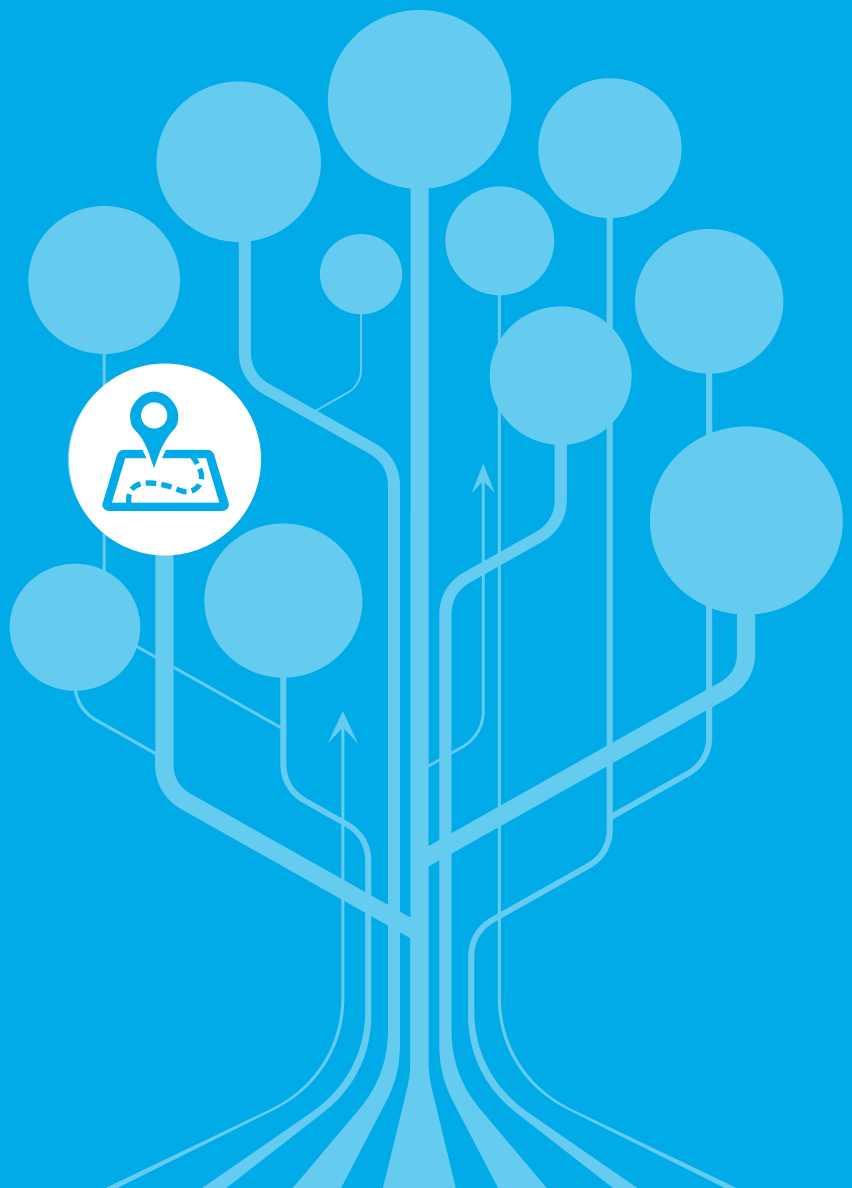
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Separation Planning and Value Realization





The Frosting on the cake Managing relationships for more effective TSAs

Transition Service Agreements (TSAs) are a necessary consideration in many transactions where the buyer may not be able to fully transition or support the acquired business promptly after the transaction closes. In many cases, facilitating an orderly transition while not impacting the business just takes time... typically more time than is available before the targeted close date. In such cases, the seller may be asked or required to continue supporting the sold business until the buyer can fully support that business within its own operations.

Deloitte's Divestiture Survey Report 2013 found that out of 300 executive professionals involved in divestitures, 87% had provided Transition Service Agreements (TSAs). Despite this, 39% indicated that they like to avoid TSAs if possible, but will provide them if necessary, as refusing to provide TSAs could limit the pool of potential buyers and reduce the value of a deal in the marketplace.

Transition Services can include back office support such as payroll support, benefits management, IT and Help Desk Support, front office support including customer service and distribution, or any other type of support that is required to ensure that the business continues to operate as normal during the transition period. These Transition Services are commonly negotiated and contracted through TSAs between the buyer and the seller.

Transition Services are usually seen as being an operationally focused, service activity from provider to receiver. However, this is not normally the case. Our experience has shown that effectively managing the receiver to provider relationship can yield unexpected tangible and intangible value — the frosting on the transaction cake.

Transition Relationships

The notion that the relationship between the parties involved in a transaction can impact value is not a new one. It is, however, a notion that is not usually considered until the pain of managing deteriorating relationships cannot be ignored.

To understand the two broad categories of Transition Services relationships, consider the following scenarios:

A division of a company is being acquired by a strategic buyer with infrastructure in place to absorb and support the acquired business. There is a close business relationship between the parties with a high level of trust, and there may be a strong possibility of minimizing, accelerating or even eliminating the need for some Transition Services. In this example, both parties have incentives to support the transition of the business and rapidly exit TSAs. This shared goal tends to create a "*Symbiotic Relationship*" between the two companies, and they will likely quickly look for ways to operate on their own as efficiently as possible during the transition period.



However, if the same division is being acquired by a financial buyer with limited means of providing operational support, and low levels of trust and familiarity between the organizations, there is a strong likelihood that the buyer may seek to develop extended Transition Services and exert tight control during the transition period. This is particularly true of Financial and Accounting functional areas. If each company has a different set of goals and needs, they will likely be expressed in a “*Transactional Relationship*”.

Determining whether a relationship between the buyer and seller may be Symbiotic or Transactional is critical to the success of the Transition Service period. Each type of relationship can require different areas of focus, levels of detail, and incentives in the development of TSAs.

Symbiotic Relationships

When both parties see each other as business partners and have an established trust between them, a symbiotic relationship develops due to the confidence each party has in the other’s ability to provide a mutually desired level of service. This confidence can also arise due to one or both parties having significant experience in M&A deals and even Transition Services. Both parties have an incentive to exit Transition Services quickly, while maintaining business continuity, so durations of these Transition Services are typically short with some containing contingency extension clauses.

Symbiotic relationships also tend to offer the service receiver more flexibility in exiting services as the service provider may do whatever is necessary to transition away from the service. This may even include temporarily absorbing some of the stranded costs of a discontinued service.

Over half of the respondents to Deloitte’s Divestiture Survey said that the carve-out process took longer than anticipated. Of these deals, the primary reason identified was that additional time was needed to negotiate Transaction Agreements. Symbiotic Transition Service relationships usually have service performance metrics that are described at a high level, and pricing is often tied to internal pricing schedules or other fixed price methods, typically resulting in quick negotiations. Complexity is also reduced by having fewer, broader TSAs that are developed in the spirit of the agreement.

It is important to remain diligent and not get complacent when developing TSAs in symbiotic relationships by documenting the lion’s share of verbal agreements and covering all bases. However, without the lower level of detail around service performance, cost, and exit criteria, the post-close oversight requirement is usually lower, freeing resources to focus on completing the actual transition, allowing for an efficient exit and mutually beneficial Transition Services period.

Case in Point

In a recent Pharmaceutical transaction based on an asset swap, the buyer assumed a significant stake in the seller’s company as part of the transaction, and the seller retained a minority stake in the new company formed to stand up the acquired assets.

This situation created a mutual dependence that fostered a highly cooperative environment as the future of both companies could be negatively impacted by a transactional relationship. The TSAs for this transaction were defined loosely at a high level, with broad cost estimates and few penalties. The Transition Services development timeline was impressively short, and the time spent managing the relationship after the transaction closed was minimal. The strength of the relationship provided significant incentives for both parties to operate in their collective best interest, while hastening the exit of TSAs.

In symbiotic relationships, the management overhead applied to developing and managing transition services is low, which creates value by reducing complexity, stress and real hours expended.

It also frees up management from the distractions of managing TSAs and increases focus on exiting TSAs and running the business.





Transactional Relationships

The transactional relationship is born out of a low-trust environment between parties and lack of confidence in a quick integration. This could be due to a competitive relationship between the organizations, a lack of experience with M&A deals or Transition Services, or the sheer complexity of the transition. Parties tend to develop TSAs with rigorous operational and legal documentation that allows for every imaginable contingency, typically featuring a high number of detailed service schedules over a long period of time. While a rapid exit is preferred, incentives should be structured around the quality of service being provided.

If service providers have a high fixed cost structure associated with Transition Services, there may be very strict agreements around exit dates and notification. However, little flexibility in the agreement may actually lead to higher costs. For instance, although the service receiver may want to accelerate the exit of the TSA, the service provider may not be able to quickly ramp down resources and may therefore encourage the Transition Services to run their natural terms to avoid stranded costs. This amounts to the service receiver subsidizing the provider's workforce and can lead to even tougher negotiations in other areas.

When it comes to pricing, transactional partners tend to develop highly detailed rates and usually include a high proportion of variably priced Transition Services based on usage volumes. This can result in specific definition and tracking of service levels, with a high level of governance and frequent contact between buyer and seller. Invoices can be comprehensive and detailed, and are likely to be scrutinized by the service receiver. A detailed dispute resolution process should be developed in order to handle disagreements over invoicing and service levels.

In addition to the lack of trust, transactional relationships tend to require a high degree of post-close oversight to keep track of service performance, costs and exits. These Transition Service management activities can absorb time and resources that could otherwise be used to accelerate the integration/divestiture effort.

The transactional relationship does have benefits — it offers more comfort that the required services will be provided for the time needed and at a known price. Keep in mind, this level of certainty and control adds a requirement for further time-consuming and costly negotiation.

Case in Point

A multi-national bank divested a large business unit in an effort to refocus its future strategy. The purchaser, a competing company, acquired 100% of the assets in a very complex transition, resulting in an entirely transactional relationship.

While both companies were being fairly compensated for transitional services provided, there was no mutual dependency on the separation/integration; the seller was motivated by legal requirements and reputational integrity, not an interest in the future business. The purchaser recognized these facts, and the result was a low-trust relationship that featured a significant number of TSAs with long durations and stringent requirements. Processes and performance reporting were rigorously documented and the project management was substantial for both entities. While both the seller and the purchaser were anxious to close TSAs, the purchaser did not hesitate to ask for additional services to be provided, which conflicted with the goals of the seller and caused additional strain to the relationship.

The level of detail and scrutiny involved in the process was necessary to ensure that the many complex service operations continued to be provided at 'business as usual' service levels, with buyer and seller satisfied with negotiated, systematic processes and pricing.

In Transactional relationships, the increased need for management oversight and time spent developing very detailed TSA service descriptions and costs distracts from focusing on exiting TSAs and managing ongoing operations. This type of TSA usually creates a high stress complex TSA environment.



Align TSA Program to Relationships

Skilled craftsmen can tell you, having the right tools can make all the difference when completing difficult tasks. In the same way, it is also important to develop the right Transition Services program to suit the type of relationship between the parties.

To effectively manage the Transition Services relationship, both parties should work to explicitly or implicitly understand the type of relationship that best supports their needs, and the tradeoffs that are associated with each type of relationship. Misalignment on one or both of these criteria usually results in friction that eats away at the frosting of additional value.

Being aware of these relationships and tradeoffs ahead of time provides the CFO and Transaction Team with a perspective on how to structure Transition Services negotiations to develop and support the desired relationship. For example, a transaction between an established organization and a Private Equity buyer may likely be expected to evolve into a transactional relationship, but an astute CFO can make strategic tradeoffs during the negotiation and guide the relationship towards more of a symbiotic relationship that can accelerate TSA exits and minimize the management burden... if this is desired.

Corporate culture also plays a role in structuring the right type of TSA. Mature companies with a culture of detailed cost control could be likely to favor a transactional approach to Transition Services, looking for a higher level of accountability throughout the business regardless of experience or trust.

Whether it is through a transactional or a symbiotic relationship, Transition Services can be an important lever for the CFOs of both organizations to unlock additional transaction value beyond the pure 'TSA Rate' considerations. A key is making sure sufficient consideration is given to the strategic elements of Transition Services early in the deal cycle to ensure that value is not eroded through an unnecessarily lengthy, detailed, and ultimately costly transition process.

To learn more about how we can help your company address these and other TSA opportunities, please contact:

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Sell-side considerations for a cross-border divestiture

Carve-outs and divestitures are a vital means of advancing corporate strategy. They are also complex — and are likely becoming more so as sellers increasingly adopt a global perspective in an effort to attract more bidders and generate higher value. U.S. companies have historically preferred selling to domestic buyers; however, this preference appears to be eroding, with the percentage of executives preferring a domestic corporate buyer dropping from 70% in 2010 to 59% in 2012, according to the Deloitte 2013 Divestiture Survey.¹

Although certain preparations are leading practice regardless of the geographic scope of the transaction, there are some specific considerations in a cross-border divestiture (summarized to the right) that may significantly impact whether or not the seller can effectively execute the transaction and obtain their desired price.

Due to these and other considerations, sellers should be mindful that a cross-border divestiture usually takes more preparation and patience than anticipated.

Specific considerations in cross-border divestitures

- 1  **Determining what's really for sale**
 - Geographies to be included
 - Which shared country assets and resources are part of the transaction
- 2  **Compiling the financials and considering the deal structure**
 - US GAAP vs IFRS
 - Tax regime and consequence of asset vs stock deal
- 3  **Knowing the laws at home and abroad**
 - Government intervention
 - Foreign Corrupt Practices Act
 - Regulatory filing process
- 4  **Marketing the business and adapting to foreign buyers**
 - Cultural differences
 - Time zones
- 5  **Planning for the separation**
 - Entry rights and visa issues
 - Pension, healthcare, and insurance liabilities

¹ "Deloitte 2013 Divestiture Survey, Sharpening your strategy," January 2013, www.deloitte.com/us/ma/divestiture-survey-2013



Determining what's really for sale

Compiling consistent underlying financial data facilitates cross-border due diligence.



Situation:

A global automotive parts manufacturer headquartered in the U.S. divested a multinational business unit to another automotive parts manufacturer headquartered in Asia. The business unit operated within several different geographies. These operations were maintained within legal entities that also housed operations for some of the seller's other business units, resulting in commingled financial and operating information. Standalone income statements and balance sheets for the business unit did not exist for the majority of these entities. In addition, the underlying supporting data for the financial results of these entities was not available centrally or in a consistent format. Changing deal assumptions and tax considerations resulted in frequent modifications to the transaction scope, which complicated the task of performing seller diligence and assembling standalone financials for the businesses being divested.

Result:

Pro forma income statements and balance sheets were created for each of the entities to be included in the transaction. These were modified throughout the diligence process as the deal structure changed to include or exclude certain entities and geographies. Having a diligence team working in a centralized location facilitated a more streamlined approach to the creation and continuous modification of these standalone financial statements. Overall, compiling consistent underlying supporting data for the financial statements facilitated the seller diligence process. Of note, structural planning prior to the divestiture, with minor changes to accommodate a potential buyer's structure, can expedite the diligence process and lead to a faster close by avoiding such a high degree of complexity.

What exactly are you selling? The answer might seem obvious at first glance, but determining which assets are for sale can be difficult, especially when the team at the Corporate Headquarters does not have much in-country knowledge. Oftentimes in international companies, key assets, as well as managers, are shared among multiple business units but are often housed in one legal entity. Deciding which of these assets and people stay with the parent and which ones go with the sale can be complicated and expensive, particularly if economies of scale will be lost, factories are shared, or repatriating employees is being considered. Not knowing what infrastructure the buyer has in place can make this component even more stressful. In cross-border carve-outs, it is fairly common for buyers and sellers to argue over what is included in the transaction well into the final stages of the deal negotiation.

This challenge is often amplified by the complexities of operating in multiple tax jurisdictions. A country-by-country analysis is usually required to effectively evaluate how to segregate assets that are to be retained versus sold, and how to transfer those earmarked for sale in a tax efficient manner. In addition, transfer taxes and "de-grouping" charges are very common in many foreign countries, so the seller should be prepared to incur them. From a U.S. tax perspective, different types of transactions can affect the company's ability to claim foreign tax credits, and thus impact its effective tax rate.

These potential implications argue for careful analysis and structuring of the assets for sale. They also call for assembling the appropriate team early in the deal process. To be effective, this team should be multi-disciplinary, have extensive M&A experience, and be intimately familiar with local customs and business practices. For many companies, this means engaging experienced external advisors who can help to streamline the process early on before it becomes overwhelming. Well-qualified external advisors may be able to help accelerate deal close and value realization by guiding the company through the intricacies of doing a cross-border deal.



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Compiling the financials and considering the deal structure

There are two types of financial statements that can be compiled as part of a carve-out transaction: (i) The Deal Financial Statements prepared to help value the business to be sold, and (ii) those prepared under U.S. GAAP or IFRS for Audit purposes, which may be required by the seller as part of the terms of closing. While the two types overlap, the Deal Financial Statements include forward-looking projections, whereas the Audited Financial Statements do not. The Deal Financial Statements also include more detailed analysis of shared costs and standalone profitability, assets and liabilities than the Audited Financial Statements.

Both types of financial statements will need to be adjusted to account for costs shared by the parent company and the division to be sold, while the Deal Financial Statements will factor in forward-looking costs associated with the transition. For instance, the carve-out may incur additional costs once it splits off from the parent. These costs could include new management positions, back-office services that were previously the responsibility of the parent, and higher prices for materials, insurance, and professional services as a result of decreased purchasing leverage. Transition service agreements (TSAs) may also be necessary, which require time, effort and negotiations to set up. In comparison to a domestic transaction, these types of costs could be larger in a cross-border deal since a foreign buyer may not have existing facilities and staff in the countries where the carve-out operates.

Valuing a carve-out, however, isn't only about assessing the costs. On the flip side, positive synergies could be generated such as price or volume increases, facility and staffing rationalization, and other cost savings. In addition, brands and expertise could be transferred to the buyer, which could be utilized elsewhere. The extent to which the seller is able to help a buyer understand and quantify these synergies can largely determine the price they are willing to pay.

Tax consequences should also be considered in structuring the deal, since they are omnipresent in settling or transferring intercompany payables and receivables in a cross-border divestiture. As such, the seller should evaluate these consequences in an effort to propose a tax-efficient solution. This solution usually includes a tax-efficient way to repatriate cash from the entity to be sold, and it requires the seller to gather information related to intercompany cash balances and distributable reserves. Additionally, the seller will need to determine if there is "trapped cash" in the system.



Coordinate early and often for better financials and a smoother sales process.

Situation:

A multinational pharmaceutical company divested a US-based business unit with operations in various foreign jurisdictions. The parent company, along with their buy-side investment banker, brought several bidders to the table.

Result:

In order to effectively deal with language barriers and cultural differences, a broad diligence team was assembled that put "boots on the ground" in each of the relevant jurisdictions. This team was governed by a single operating leadership group, which served as the project management office. Through early coordination with the buy-side investment bankers, the sell-side diligence team was able to confirm that the financial information to be included in the Confidential Information Memorandum (CIM) was consistent with the information in the data-room, and it was reconcilable to the company's accounting book of record. Consequently, very few reconciliation issues arose regarding the financial data provided to potential buyers, and management was well prepared to answer fluctuation questions. By averting financial surprises, this upfront coordination facilitated a smooth sales process, which culminated in a very effective auction.



Knowing the laws at home and abroad

Local knowledge is crucial in a cross-border deal.



Situation:

A global manufacturing business headquartered in the U.S. divested a majority-owned joint venture to its joint-venture partner, a global manufacturing business based in Asia. A unique tax law applicable to related party transactions required each of the businesses being divested to be valued for tax purposes using a non-traditional valuation approach. During the negotiation process, tax considerations became a key element of the discussions concerning the overall transaction structure.

Result:

The sell-side diligence team enlisted both U.S. and local South Korean tax professionals. Having local professionals on the team was essential because they not only knew the tax rules and valuation methodology but they were also familiar with the local language and cultural norms. The blended team expedited the diligence process, helped the buyer and seller to arrive at a mutually beneficial deal structure, and enabled the seller to preserve deal value in negotiations with its joint-venture partner.

Legal violations and government intervention can potentially derail a deal. In cross-border situations, these factors can be even more important to consider. On one hand, selling to a foreign buyer can present fewer antitrust issues if the buyer does not have a presence in the market. On the other hand, national security concerns can trigger government intervention. For example, a state-owned Dubai company dropped out of a transaction that would have allowed it to manage some terminal operations at American ports due to resistance from the U.S. House Appropriations Committee and pressure from its own government, which became fearful of the public relations implications of the deal on the international stage.²

For U.S. companies, as well as foreign issuers of securities traded in the U.S., the Foreign Corrupt Practices Act (FCPA) also comes into play. Enactment and enforcement of anti-bribery laws appear to be increasing throughout the world. Given the prevalence of these laws, companies engaging in cross-border M&A transactions should consider expanding their due diligence efforts to include a forensic component aimed at uncovering possible practices that could be considered problematic under applicable laws before proceeding too far with a prospective buyer.

The complexity of the regulatory filing process poses another potential impediment when divesting a business in a foreign jurisdiction. In many cases, this process is lengthier than in the U.S. and filing thresholds are lower, making it necessary to file for approval on much smaller deals.

Local differences regarding the preparation and presentation of the carve-out's financial statements should also be considered, such as the number of periods required to be included therein and conversion considerations between U.S. GAAP and IFRS or local GAAP. Accordingly, the seller may need to provide additional financial information to the buyer to help meet these requirements in a cross-border transaction.

² "Under Pressure, Dubai Company Drops Port Deal," *The New York Times*, March 10, 2006, <http://www.nytimes.com/2006/03/10/politics/10ports.html?pagewanted=all&r=0>





4



Marketing the business and adapting to foreign buyers

Sellers should be aware of different cultural norms and expectations when working with foreign buyers. These cultural differences can affect many aspects of the sale, from negotiations through closing and transition management. From the outset, foreign buyers may have corporate governance structures that are more rigid and bureaucratic than those of U.S. businesses. This may translate into more approvals, a longer process for obtaining sign-offs, and consequently, more time to complete the transaction. Negotiation dynamics too will likely differ from a domestic deal, especially when language barriers are an issue.

Selling to buyers in certain regions will likely also require a heightened level of management involvement. Some foreign buyers eschew e-mail and electronic document exchange in favor of phone conversations and face-to-face meetings. There can also be an expectation that senior executives will be available at any time to attend meetings and answer the buyer's questions. These requirements can place unexpected demands on the seller's organization, but being able to work through these cultural differences can allow for a broader pool of potential buyers and, ultimately, potential to increase sale price. If the seller is able to engage in-country leadership or at least regional leadership in the process, then this can add local knowledge and experience to more efficiently answer the buyer's questions.

Throughout the marketing process, prepared sellers should be willing to adapt their tactics accordingly in an effort to maximize value and maximize deal terms. This includes remembering that carve-outs are often underperforming businesses with potential. Non-core businesses located far from headquarters are sometimes undermanaged since senior company leaders lack the bandwidth to focus on them. In many of these situations, the prevailing sentiment becomes: "We believe this can be a great business in someone else's hands." While there's a lot of validity in that statement, it's important for the seller to adequately communicate the turnaround opportunity to foreign buyers, without making it seem overwhelming. This can often be accomplished by highlighting the strength of the current business along with suggestions for improvement.





Planning for the separation

Assembling the appropriate team

Putting “boots on the ground” in the buyer’s country is a significant consideration when assembling the separation team. Being able to work face-to-face, in the same time zone, and speaking the same language is often an underestimated and overlooked aspect of assembling the team. The benefits are not without their challenges — entry rights to some countries can be hard to obtain and maintaining them can involve a good amount of effort. However, providing local points of contact to the buyer’s team can often help in avoiding delays related to work-hour differences and language barriers.

Being a prepared seller

Understanding the buyer’s motivations, capabilities, and integration strategy (e.g., bolt-on, full integration, etc.) can help the seller to scope their effort and plan the governance model appropriately. For example, if the buyer is entering new markets or geographies through the acquisition, the seller should be prepared to play an active role in planning, and even executing, the integration. This can include supporting the buyer in a variety of activities, such as identifying action items with long lead times, filling capability gaps, and collaborating on integration and separation plans.

Being a prepared seller in a cross-border transaction also means not using TSAs as a crutch to get the deal done, especially since delivery of services can expose the seller to significant value-added tax (VAT) liabilities, and the negotiation and review of service contracts can require government approvals in some countries. Plus, IT vendors may restrict the buyer from accessing the seller’s systems in certain markets, adding yet another layer of complexity to service delivery. Prepared sellers should have a firm grasp of the potential implications of relying on TSAs too heavily, and instead develop a process that drives separation and deal objectives.

Sellers should additionally be poised to manage special accounting requirements when selling to a foreign buyer. For instance, the sale of a U.S. business to a foreign buyer will often create accounting considerations for the legacy business, such as how to comply with SEC reporting requirements and how to account for discontinued operations.

Managing the employee experience

Understanding and managing the people-side of the separation doesn’t typically get corporate development teams excited, but ignoring the needs of employees, customers and suppliers can have devastating effects on the deal itself as well as on the retained business. The public relations impact of selling to a foreign buyer, for instance, can greatly affect employee morale as well as decrease the value of the retained business if factories/offices are closed and jobs are lost in the home country.

In addition, employees in some foreign jurisdictions can wield considerable power and in some countries can even block a deal. Sellers should be aware of the different human resources and legal considerations with regard to gaining the consent of works councils and unions and to be mindful of the required notification periods. The pension laws in the U.K. provide a good example. There, buyers may be required to fund pension deficits associated with the carve-out, which can be significant. Pension trustees and pension regulators also have significant influence and can potentially block a transaction if it is not in the interests of the pension plan members.

Healthcare liabilities can raise similar concerns since the buyer may be expected to fund employee health insurance programs, and employees and regulators can have considerable say in whether or not proposed solutions are acceptable. Again, this situation can vary greatly throughout the world depending upon whether the country has a national healthcare system or if it relies on private health insurance as in the U.S.





Conclusion

Carve-outs in general are challenging; working across borders can make them even more so. Cross-border divestitures, nonetheless, are becoming more and more common in an increasingly globalized economy. In comparison to domestic deals, these transactions often require more of everything, including greater due diligence, ability to navigate different financial and tax reporting structures to identify what is being sold, and extra time to prepare the financials. Understanding a foreign buyer's culture and ways of doing business can also be vital to facilitating the transaction closing and help avoid costly delays.

How Deloitte can help

M&A experience

Deloitte has supported hundreds of divestitures across the entire transaction lifecycle for companies in nearly every industry and geography. We offer more than just general knowledge; we offer practical, hands-on support rooted in experience with deals just like the one you may be facing.

Our services include:

- Portfolio strategy assessment
- Buy-side and sell-side advisory support
- Carve-out financial statement development
- Organizational separation and reorganization strategies
- Transition service agreement development and optimization
- Day-1 planning and readiness preparation
- Stranded cost identification and elimination

Global M&A footprint

Deloitte has access to a network of more than 100 offices around the world, and a deep understanding of leading practices in each of the BIC countries (i.e., 11 offices in Brazil, 15 offices in India, and 16 offices in China). Through this global reach, we can put M&A specialists with local language and business skills on the ground wherever you need them with an understanding of local culture and business environments.



Cross-border divestitures often require more — of everything.

Situation:

A U.S.-based manufacturing business sought to carve-out and sell a multinational business involving several plants, regional distribution centers and 50+ sales organizations. Each applicable reporting unit was responsible for providing several years of information, which required heightened levels of organization and analysis. Reporting formats and accounting systems were also inconsistent among the different countries and regions. Seller involvement was additionally limited, leading to bottlenecks in obtaining the required information.

Result:

The transaction team developed standardized, yet adaptable, templates to facilitate information gathering and to define a consistent reporting format across countries. Additionally, each region was assigned a single point person who was responsible for coordinating and managing data flow. An e-room was also established for convenience in working across borders and time zones. To help alleviate data collection bottlenecks, the team enlisted the assistance of a senior leader within the parent company to help manage the process and hold employees accountable for submitting information on-time. Progress was monitored through regular status meetings and frequent follow-up. Largely due to these efforts, the carve-out was effectively sold to a Brazilian subsidiary.

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Fast break

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



Introduction

One of the most critical elements of a divestiture can be 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.

According to a Deloitte survey of 150 executives regularly involved in divestitures, more than 50 percent of companies surveyed would prefer to avoid TSAs, but 80 percent of companies surveyed do provide TSAs, if necessary, to close the deal.¹ While TSAs are often viewed as a necessary evil, TSAs can accelerate the negotiation process and financial close by allowing the deal to move forward without waiting for the buyer to assume full 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 can be 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 between the deal close, "Day One", and full separation, "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 the large divestitures (more than \$1 billion) that were announced and closed in 2013 averaged only 81 days to close.² 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

¹ Divestiture Survey Report 2013: Sharpening your strategy

² Thompson One Financial



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.

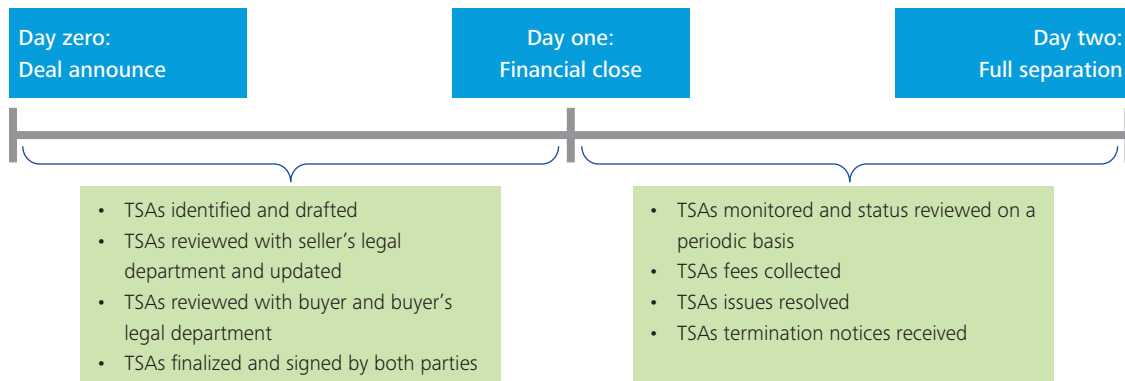
For example, if the buyer’s long-term plan is to outsource payroll, the TSA should make the seller responsible for cutting all payroll checks. On the other hand, if the buyer plans to keep payroll in-house, the TSA should provide for sharing the existing payroll system until the buyer can install a payroll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

Reverse TSAs — While less common than standard TSAs, reverse TSAs are sometimes used when the seller is unable to replace a service that the divested business unit provided to the broader organization. An example from the field is a seller that needed ongoing assistance and knowledge transfer from a group of cross-functional developers who were part of a divested BU.

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 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.

Find your guardrails. It is critical for the seller to truly understand the capabilities and constraints of the services that it may provide under a TSA. For instance, it might not be possible to separate a specific service like payroll from the overall HR system. From an external view, it is also critical to understand any limitations that may be imposed by vendor contracts. Many software license agreements prohibit reselling services or providing services to another legal entity. Review vendor contracts early and allow time to negotiate with vendors prior to Day One.

Figure 1: TSA — Illustrative timeline



Source: Deloitte Consulting LLP



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. Consider using milestone-based TSA cost adjustments to align buyer and seller incentives. 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. Alternately, terms may include penalties and monthly cost increases for TSA services that are still required after the agreed-upon end date.

Be sure to involve tax professionals in the TSA costing process. TSAs may be subject to withholding, sales, use, and/or VAT taxes. Be especially conscious of the complexities that come with cross-border payments. To avoid unnecessary surprises, be sure that both parties are aware of tax gross-up requirements.

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 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 editing 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.



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 non-production environments. Service levels for non-production 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.

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. Engage the service owners to partner in developing the TSAs to drive alignment on the services they will be providing. Consider driving alignment through a process where each service owner must sign-off on the TSAs relevant to services that they own.

Writing should be consistent, clear, and concise. Detailed and rigorous operational and legal language is especially important where there is a low level of trust between buyer and seller. Precise service descriptions can facilitate more accurate cost estimates and can provide a clearer understanding of what is or is not provided.

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.

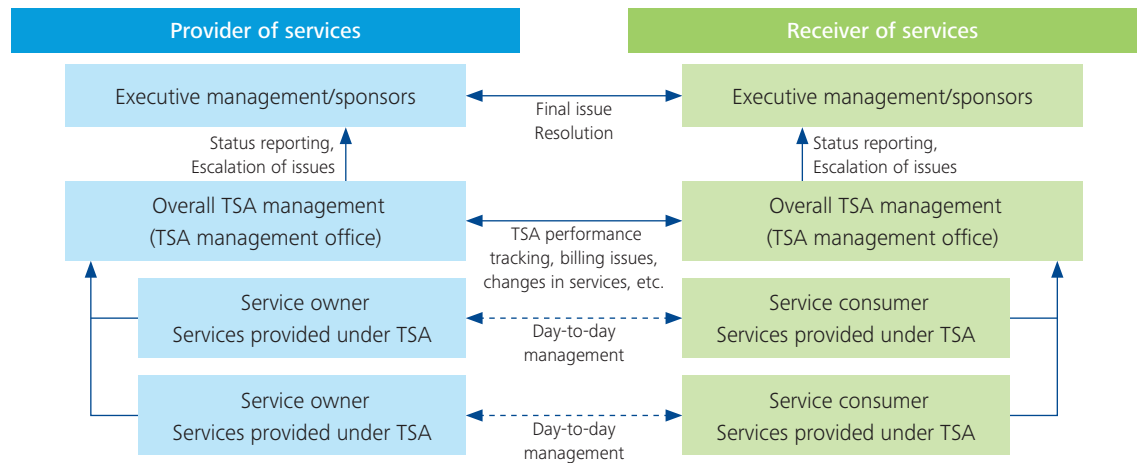
Managing TSAs

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, both the buyer and seller should consider creating a TSA management office (TMO) to manage the overall relationship. TSA management offices are responsible for understanding all of the TSAs at a holistic level, tracking progress towards TSA exit, managing TSA charges, and serving as the initial point of escalation for service issues. The TMO is also responsible for developing TSA scorecards and dashboards, as well as keeping executives informed on TSA progress.

Figure 2: TSA management — Example structure



Source: Deloitte Consulting LLP

Retention of key transition resources is a common challenge. 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 being distracted by trying to maintain higher-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 (e.g., 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. The seller should also 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

- TSAs should be avoided where possible. Consider alternative such as cloning services and outsourcing before deciding on a TSA.
- 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 that 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.
- Engage all required parties, such as vendors, tax professionals, and legal counsel early in the process to avoid last-minute surprises.
- 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, by definition, is 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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Building a Strong Transition Services Agreement

A carefully crafted TSA can save parent companies and their IT departments major headaches after the deal closes and during the transition.

Your company is in negotiations to sell an underperforming business unit to a competitor. As the talks wind down, the prospective buyer makes one final proposal: As part of the deal, your company will provide IT services for the business unit “during the transition.” Not wanting to derail an agreement, the deal team leader agrees to this open-ended proposal, unaware of the potential ramifications of the decision.

Because members of your company’s deal team did not prepare a detailed transition services agreement (TSA) prior to entering the negotiations, they are ill-prepared to negotiate terms that could limit obligations and help manage risks. It will now fall to you, the CIO, to deliver a poorly defined set of IT services to a potential competitor for an indefinite period of time. Moreover, without a formal separation plan, you could get stuck with a variety of stranded costs.

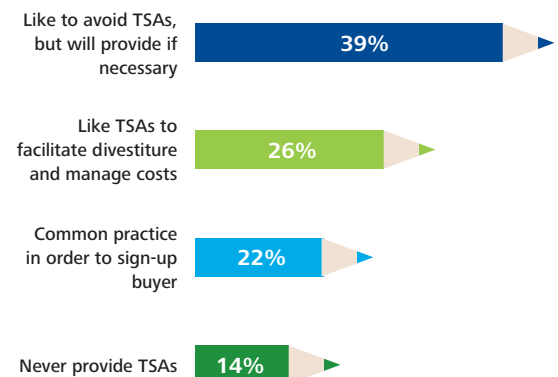
Prepared sellers can avoid this scenario by creating a list—in advance of negotiations—of all IT services the parent company currently provides to the business unit to be divested. Leadership determines which services on the list it can or would provide to the buyer by evaluating the potential risks or costs involved in becoming a “service provider.” For example, would IT have to build firewalls to prevent the buyer from accessing sensitive data? Would providing services during a transition period raise regulatory concerns as two competitors—particularly those in highly regulated industries such as financial services—begin working together in this way?

Preparing a decision matrix that clearly articulates which services will and will not be available to the buyer after the transaction closes, as well as the rationale behind these decisions (non-transferrable licenses, key personnel transferring with the deal, etc.), can add objectivity to what can often become a highly charged conversation.

Once services are agreed upon, the close documentation can clearly stipulate the provided services as well as those that are out of scope. In addition, such agreements typically define the IT services to be provided, along with the duration, extent, and cost of the support, among other details. IT services, specifically, require this level of rigor to set expectations between parties and assist in issue escalation and remediation during the term of the agreement.

Figure 1: TSAs in Divestitures

What is your organization's practice for providing TSAs?



Deloitte Development LLC

In Deloitte’s 2013 Divestiture Survey of 148 executives who have been involved in divestitures or carve-outs, 87 percent indicated their companies had provided TSAs as part of the deal. Yet, perhaps not surprisingly, 39 percent of those surveyed said they would like to avoid having to create TSAs whenever possible.

“Providing transition services after a deal closes is a bit like paying alimony—nobody wants to do it. Yet, in a divestiture, it is often a condition of doing a deal.” says Jeffery Weirens, a principal with Deloitte Consulting LLP, who specializes in M&A and restructuring. “Preparing a detailed TSA before divestiture talks begin can help parent companies avoid the possibility that last-minute service negotiations result in unfavorable terms.”

The Ties That Bind

For a host of reasons, many CIOs would rather not think about providing transition services at all, says Weirens. “For CIOs, this represents numerous potential pain points. For example, the buyer may be a competitor, yet it will be using the seller’s systems. During the transition, the CIO will need to protect data access and integrity (e.g., customer and vendor master data) while maintaining compliance with anti-trust regulations. To make matters worse, the CIO may need to support changes the buyer wants to make to the system.”

By taking the following steps to create a TSA during the early planning stages of a deal, CIOs may address these and other challenges more effectively during the transition:

Establish a set of guiding principles. No one better understands the systems and IT assets that the divested unit utilizes than the CIO. As such, it falls to the CIO to determine which IT services the parent company will provide during a set transition period, at what level, and, perhaps most important, which services the company will not provide. These defined service limits can form the guiding principles of the TSA that the deal team can use to negotiate more detailed terms. According to Weirens, the divesting company’s goal is typically to provide the fewest services for the shortest period of time. “Most companies are not in the business of providing third-party services, so they shouldn’t overcommit,” he says. Providing upfront guidance around things such as service levels, access rights, and application customization will provide planning clarity to both buyer and seller which results in accelerated Day One planning.

Create a separation plan. Weirens says TSAs should be drafted with the end goal in mind: Bringing an orderly end to the transition phase and exiting the agreement. A step-by-step separation plan that lists incremental milestones, deadlines, and the transitional responsibilities that each party must meet can help prevent delays and manage associated risks. “One might assume that the buyer should be responsible for crafting a separation plan,” says Weirens. “After all, it is in the buyer’s interest to maintain service continuity once a deal closes. Yet, as CIO of the divesting company, you would much rather play offense than defense. The buyer doesn’t know the systems, processes, and people as well as you do, and might come up with a lot of bad ideas that could ultimately disrupt transition progress.”

CIOs should also consider the maturity of the buying IT organization and its ability to deliver on the separation plan. Mapping out your long-term strategic plans with buyer integration activities will allow you to monitor and potentially avoid surprise delays caused by integration delays.

Prepare an accurate set of costs. When asked about transition costs, 23 percent of Divestiture Survey respondents indicated that their companies underestimated how much it would cost to provide IT and other services during a defined transition period. As CIOs calculate a proposed TSA service price, it is important that they do their homework. What are the monthly recurring costs that the divested asset will incur? Are there license renewals looming that could result in higher fees? What scenarios could lead to an extension of the transition period and how much should the parent company charge to provide IT services for longer than originally planned?

Moreover, in setting the service price, companies should consider different pricing options, including cost-plus (cost plus a percentage surcharge), cost escalation (a percentage increase each month over the duration of the TSA), and charging a minimum fee (to protect the investment made to provide services should the buyer unexpectedly cancel service soon after the legal close of a deal). “With this information, the deal team can negotiate transition terms that are consistent with the parent company’s overall financial goals for the deal,” says Weirens.

While resistance to providing post-deal IT transition services—aka alimony—is understandable, according to Weirens such services can actually benefit both parties. “The fundamental reason to provide transition services is that without them, the value of the asset being divested would crater,” he says. “With a carefully planned TSA, CIOs and deal teams can protect the value of the deal, while limiting the parent company’s obligations and potential risk.”

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Seven secrets of highly effective divestitures



Why divestiture execution is so difficult

Divestiture execution is not business as usual. It is often counter-intuitive and requires different skills than those needed to run the day-to-day business. Processes, systems, policies, and strategies that seem to be working well all have to be evaluated, confirmed, and/or modified in order to extricate those parts needed by the NewCo. Also, a new business plan will need to be created, even as the company continues to execute the old one.

Key people often find themselves burdened with a second divestiture “job” while doing everything they can to keep the existing business running smoothly. Without proper central coordination, the increased workload and political issues that surround a divestiture can quickly paralyze the organization.

The number of large scale divestitures around the world has increased significantly over the last few years. In 2013 the market saw continued strength as the total number of divestitures with an enterprise value of over \$100MM was up 27.7% from its 2011 levels¹. With the consistently changing landscape of the global economy we expect this trend to continue as companies use divestitures as a tool to optimize their asset portfolios in search of shareholder returns. Of course, signing a sales agreement is only the first step toward creating shareholder value through a divestiture.

Given the incredibly high stakes, what can management teams do to improve their chances for an effective long-term outcome?

To help answer this question, Deloitte Consulting LLP (Deloitte Consulting) recently conducted a study of several large and complex divestitures across various industries.

Our study revealed seven key practices that companies should consider to achieve desired results in divestiture execution.

1. Maintain business continuity

One of the keys to an effective divestiture is to stay focused on running the day-to-day business. For the parent, this means not letting the carve-out become a distraction for the company’s other business units. It may also mean helping the carved-out unit maintain momentum throughout the transition.

Letting the carve-out become a distraction from the management of core operations can have a significant impact on the parent company’s overall top and bottom line growth, detracting from efforts to increase shareholder returns through the transaction.

Furthermore, NewCo business leaders must have the opportunity to continue to run their business. Certainly the buyer expects their new unit to hit the financial and operational targets established during due diligence. For an IPO spin-off, missed earnings targets can have a disastrous effect on demand for shares in the new company. This can lead to a softer price, or in the worst case, to the IPO being canceled altogether.

To maintain business momentum, it is important that leadership continues to focus on top line growth and bottom line results. This can be challenging since there is a

lot of uncertainty that comes with a divestiture especially around future employment. Effective organizations offer three lessons learned to maintain business as usual:

1. Communicate early and frequently with employees to reduce uncertainty as much as possible and keep employees focused on their day job
2. Be clear about who should be involved in the divestiture planning to allow others to focus on their regular activities and avoid distracting too many people with divestiture planning
3. Continue the regular cadence of management targets and reviews to drive accountability and business momentum

From the Trenches

Situation: A Large Automotive Company was cost conscious and looked for ways to keep costs at a minimum throughout the transaction. To achieve this, the client looked to monitor its transaction expenses by developing processes to track all time spent by its employees on the divestiture in ten minute increments.

Key Takeaway: These processes created a large, unnecessary burden on the company and shifted the focus away from expediting the completion of the transaction to time spent developing and monitoring expenses. In the end, transaction expenses increased due to the lack of focus on the core task at hand, getting the transaction completed. The company would have been better off focusing its efforts on the big picture of transitioning the carve-out to NewCo rather than micro-managing its transaction expenses. Any benefit seen from processes set up to track expenses is often lost in the work it takes to set up those processes.



2. Establish an effective governance model

Company leaders preparing for a divestiture are likely to find that they have never been involved in a more counter-intuitive or complex undertaking. Integrated systems and processes that may have taken decades to develop must be undone in a matter of months. At the same time, market pressures typically force companies to perform this disentanglement while minimizing any cost increases.

A divestiture is simply too complex to be managed in a decentralized manner. It requires strong, focused, and dedicated leadership from the center, with end-to-end alignment from the board of directors to the CEO, executive suite, and steering committee. In the most effective divestitures, companies generally stay away from divisional autonomy and adopt a central “command and control” environment with dedicated resources empowered to define and drive the divestiture’s milestones and activities. They also usually have central leadership that reports to a steering committee of senior executives to help maintain executive alignment.

A steering committee should be established (Figure 1) to act as a central governing body during the divestiture process. Perhaps the most critical element of this steering committee is its composition. Highly effective steering committees are often on the smaller side to avoid long, drawn out debates over milestone decisions. There must also be representation of all the critical functions on the steering committee. This does not however mean that each function needs one person; a steering committee member may represent the interests of multiple functions. Finally, all members on the steering committee must have decision making authority. Without this authority, there is an increased risk that the transaction will suffer setbacks and delays as the committee is required to socialize milestone decisions with the key decision makers.

This centralized structure creates a new layer of authority. But rather than undermining the current leaders, it gives them a framework for coordinating activities and milestones.

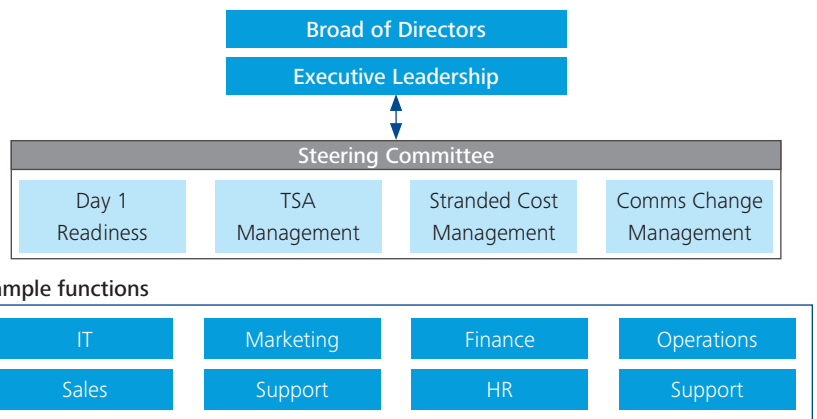


Figure 1

From the Trenches

Situation: As a Large Technology Company began its preparation for Day One, it assembled a steering committee consisting of the CFO and CIO. The composition of this committee did not fully reflect all the critical functions of the transaction, leading to certain critical issues being missed and addressed late.

Key Takeaway: There are two items that should be addressed when designing a steering committee to help drive the process. First, the committee should be made up of a small group of members all of whom should have decision making rights. This helps the committee to be efficient and effective during the process. Second, there should be representation from the critical functions on this committee. It doesn't have to be one person from each function but it should be someone who has a tie to the function and will represent its interests.

3. Make an early decision on shared IT systems

In general, the lengthiest and most expensive divestiture challenge is separating IT environments. Most companies have spent years or decades consolidating their business technology into a small number of highly integrated systems, and now they face the daunting task of extracting key components without disrupting the business.

Literally thousands of issues come into play when setting up new systems and infrastructures. Initially, these can lead to slow progress and analysis paralysis. Many companies have found it takes just as long to define a strategy and direction for separating IT systems as it takes to actually separate them. Yet IT systems are usually on the critical path for the divestiture, which means a company simply can't afford a delay or slowdown — even for a short period of time. Our study shows that the most effective way to keep things moving is to break the task into simpler decisions, all aligned around a set of principles that facilitate decision-making and early traction.

Here are some other techniques the companies in our study used to kickstart their IT effort:

- Map the usage of the applications, servers, and networks to the parent's or NewCo's business processes
- Establish an end-state blueprint for IT systems that provides the right mix of functional support and cost structure for the two businesses
- Use the blueprint to rapidly define who will assume ownership for each of the existing applications or assets. Then develop a strategy (figure 2) for the other party to fill the gap (lift & shift, clone & go or build/ outsource)
- Divide IT staff along the same lines as the applications and assets, while striving to achieve a fair division of skills.

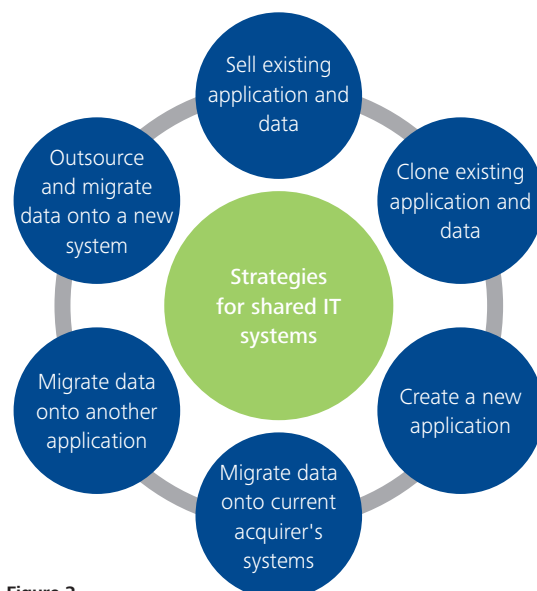


Figure 2

From the Trenches

Situation: A Large Financial Services Company had not conducted a detailed analysis of the IT separation before the transaction execution, which led to uncertainty around what data was housed on each of its data centers and servers. As a result critical parent data was unknowingly 'sold' to NewCo and had to be retrieved and erased post close and vice versa. Because of legal and operational complications dealing with data in production environments post close, separating IT and data for the company became an 18 month project that required hundreds of resources to manually review and create an inventory of all the company's data server by server.

Key Takeaway: Defining the IT separation strategy up front and execution on an asset level is critical to avoid the manual process of confirming data and expending critical resources.

Quick Fact: A divestiture is one of the most difficult and complex challenges a business will ever face. Our study shows the importance of assigning experienced program managers — rather than subject matter specialists — to lead the divestiture effort. Subject matter specialists often find it hard to disengage themselves from the details of their specialty area. In contrast, experienced program managers tend to be better equipped to lead these large, all-encompassing projects. They have been trained to juggle a variety of interdependent tasks and decisions, while intuitively applying rules such as 'speed over elegance' that helps keep the divestiture on schedule.

Critical lessons about TSAs

- Allow enough time to develop, negotiate and sign all TSAs prior to divesting
- Develop each TSA with a clear exit strategy and well-defined transition period
- When creating a TSA, get direct involvement from the people who will manage its day-to-day activities (on both sides). The resulting agreement is likely to be more accurate and complete.
- Identify practical, service-level metrics prior to signing the TSA
- Define a clear path for escalating issues with TSA owners, central TSA coordinators, and the executive committee



4. Identify transition services and exit plans

The companies in this study were generally unable to achieve complete independence from each other at the time of formal separation. The time required for separation activities typically exceeds the divestiture timeline, particularly in shared services areas such as IT. For these areas, organizations often use transition service agreements (TSAs), which enable them to continue providing services to each other on a temporary basis under more favorable terms than if the two companies were completely independent.

TSAs allow a company to close the deal even when critical services and operations cannot be separated beforehand. However, they are not a cure-all, and should not be used as a crutch to avoid tough decisions. With most divestitures, neither the parent company nor the NewCo management team has any experience providing services under a TSA, and may struggle to provide the necessary quality needed to manage this arrangement. Often the quality of 'outsourced' services under a TSA suffers with the amount and duration of the TSA-s.

The most effective organizations in our study treated TSA-s as a last resort and did not view TSAs as a long-term alternative to outsourcing. They stayed focused on their goal of becoming as independent as possible by the date of separation, which meant limiting the number of TSAs and working aggressively to complete their TSAs as soon as possible. Many even created financial incentives to encourage both parties to exit the TSAs quickly.

From the Trenches

Situation: A Large Industrial Company proceeded through a rushed divestiture supported by TSAs. However there was no transition plan set in place which led to confusion on how and when to handoff responsibilities to NewCo. Not only did it create uncertainty about how long the parent had to support NewCo, it also impacted NewCo's abilities to serve its customers as the parent was not willing to invest or change the services agreed to under the transition service agreements.

Key Takeaway: Proper planning and development of a transition plan can be crucial towards helping a company to maintain operations and create a culture as a unique company. Without a transition plan in place there can be serious risk that the NewCo will not meet timelines and will have to seek TSA extensions at grave financial penalties.

5. Drive out overhead costs before the divestiture execution

Divesting a business tends to reduce economies of scale, which may bring back costs that the company had worked hard to reduce. Some of these cost increases may be unavoidable; however, effective managers realize that divestiture execution is no time to relax their cost discipline.

In fact, a divestiture can present a wealth of new opportunities for cost reduction by forcing an organization to recalibrate its strategy, processes, and scale. In our study, companies built effective cost reduction programs by analyzing their end-state operating model, and then establishing cost- reduction targets, timelines, and transformation plans. Very often the opportunities for largest cost reduction were in corporate functions where scale economies were going to be lost, such as HR benefits administration, training, IT, and finance operations.

Nonetheless, these companies also found that the divestiture period is not the most opportune time to reengineer the organization. According to our study, an effective approach for reducing costs during a divestiture is to initially focus on opportunities that don't create large disturbances to existing business processes, and then to tackle the more disruptive opportunities once the divestiture is complete.

From the Trenches

Situation: A large Electronic Device Manufacturer completed a divestiture that fundamentally changed the operating model of several remaining business units. To understand the true cost of operating business in a new reality, client embarked on activities to identify stranded costs to be removed, and tied that to the operating model design of the future state to avoid cutting too deep in an area.

Key Takeaway: Beginning to adjust and socialize management operations reports ahead of time can allow the parent management team to start making business decisions to avoid stranded costs and rightsize operations based on accurate post transaction projections.

6. Evaluate and renegotiate contracts early

Although it might not be obvious at the outset, most supplier and customer contracts will likely need to be reevaluated as a result of the divestiture. At some point the company will need to determine whether to: retain the contract, assign it to NewCo, replicate it, or renegotiate it. According to our research, even a mid-size company can have hundreds of thousands of such contracts. To further complicate matters, many of these contracts may not be centrally controlled, which means that determining the right action for each contract may require evaluations from several perspectives, including: a legal evaluation of the terms (e.g., assignability and change of control), a tax evaluation of the financial implications, and even a business evaluation to determine whether the parent or spin-off would be the most appropriate contract owner.

In determining whether contracts are still appropriate for the parent company after the divestiture, there are two lessons to keep in mind. The first lesson is to not underestimate the effort required to assemble an inventory of all active contracts. Executives often believe their company has all of its contracts at its fingertips. Our research shows quite the contrary, where collecting, evaluating, assigning, and re-negotiating contracts often takes much longer than anticipated. The second lesson is to define a negotiation strategy that takes advantage of leverage and timing. In some cases, the shared strength of the combined company prior to separation may offer the most leverage. In other cases, the combined leverage of the separated organizations might be better. Regardless of the ultimate strategy, it's a good idea to form a dedicated contract team — and to start early.

From the Trenches

Situation: An Oil and Gas Supermajor had invested millions of dollars in its IT asset base and held IT contracts and commitments that represented millions in annual operating expenses. Many IT contracts restricted transferring licenses and had to be evaluated for renegotiation.

Key Takeaway: To be successful, a company can deploy the following four step approach towards re-contracting.

1. Define guiding principles, structure and templates
2. Collect, analyze and profile contracts and agreements
3. Define contracting strategies and approach by type
4. Execute process to get contracts in place and re-negotiate where needed

7. Rigorously certify Day One readiness

The only true measure of divestiture effectiveness is performance in the marketplace. It's all about securing existing customers, and then expanding your customer base. Unfortunately, holding on to your customers during a divestiture is no easy task.

Customers can easily get confused and frustrated by uncertainty and lack of information during a divestiture — a lesson that even some of the world's largest companies have learned the hard way. According to our study, the most effective organizations place a high priority on achieving an issue-free Day One. They typically establish a “mission control center” to prepare for the separation, and then attack any issues as if their lives depended on it.

The Day One Readiness Team manages the impending separation with a highly disciplined approach for achieving milestones, completing checklists, and rigorously testing customer-facing processes through process simulations. One of their first jobs is to prioritize the processes that will require testing based on each process' importance to the business and level of change on Day One. Top priority is generally given to processes that have a direct impact on growing revenue, taking new sales orders, or serving customers. In the most effective divestitures, process owners had to get certified for separation readiness by performing an end-to-end process walkthrough with the Day One Readiness Team.

From the Trenches

Situation: A Large Technology Company looked to prepare for Day One customer readiness so that there was a seamless transition from the old parent to NewCo. To be successful, the company analyzed the complete customer value chain to understand the pre/post transaction impact on how it did business with its customers.

Key Takeaway: Development of a customer playbook allows companies to be proactive when positioning themselves for Day One readiness. It outlines all the changes that the customer will see during the change management process and also helps clients address and communicate all the issues with its clients for Day One and beyond.



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Succeeding as a separation manager

Simple ideas that can make a big difference

Ever since your company made that big divestiture announcement, you've been expecting that tap on the shoulder. Now, it's happened: leadership just officially appointed you "separation manager," the executive responsible for separating a part of the business. If you're like many separation managers we've worked with, the excitement of being chosen may have been swiftly followed by that uneasy "now what?" feeling. It was a great honor to be asked — but what exactly does it take to succeed in the separation manager role?

Of course, it's not hard to find high-level advice on what makes for a successful divestiture. According to many of the books and articles written on the subject, the characteristics of a successful separation include an unyielding focus on key value drivers, an issue-free Day 1, and an aggressive plan to exceed the cost reduction targets your CFO announced to the Street.

For executives: How to pick the right person for the job

Wondering whom to entrust with that all-important separation manager position? You already know you want an experienced, well-respected executive with a reputation for being able to get things done. Those are all table stakes — but to find someone who can truly bring the new entity together, look for a person who excels at the skills described in this discussion. You should identify a person who is comfortable with chaos, has a broad knowledge of his or her own organization, and possesses strong decision-making ability when presented with incomplete or limited information. Above all, we feel that you need someone who excels at perceiving and channeling the emotional currents that can pervade the organization at this potentially turbulent time. After all, effective separation management is as much about navigating political minefields, defusing conflict, and providing emotional grounding as it is about keeping the separation team's noses to the grindstone.

What these books and articles don't tell you, though, is that accomplishing these things usually takes more than great project management skills. Deloitte Consulting LLP (Deloitte Consulting) has provided services in support of hundreds of successful divestitures, and we have worked closely as trusted advisors to many separation managers just like yourself. Here is what we tell them.

1. Enjoy the ride!

Especially in a significant divestiture, the separation manager role can make or break the effort. And as you've probably already realized, being put in the separation manager role can make or break your career. But while the job is not without enormous stress, and may bring you within inches of being fired on a daily basis, there are some significant potential rewards to be reaped if you do an effective job. The role can give you a very high degree of visibility at the most senior levels of the organization.

If the separation goes well, you will not only have demonstrated that you can be counted on to get results, but you'll probably have developed working relationships with many executives that can help to further your career. Many separation managers are later called upon to execute other transactions such as acquisition or assist the organization in high-visibility, high-risk but high-value projects such as new ventures. So remember: as long as you're effective in the role — and the following tips should help you with that — this could be the toughest job you've ever loved.

2. Find your second-in-command early.

We believe that there are at least two good reasons to find and mentor an understudy to be your second-in-command as soon as possible in the separation project. First, there's so much work to be done, usually in a very compressed timeframe, that it's vital for you to have qualified help. And second, if you're pulled off the original separation project to work on a newer transaction — which is a real possibility at large companies that do multiple, sometimes back-to-back transactions — your second-in-command, having experienced "on-the-job training" while working

with you, should be well prepared to take charge of the first separation effort. There is a high degree of risk in not completing the work on one transaction before a second transaction is foisted on to the core business. Consequently, the identification of a second-in-command, especially one who is familiar with the original project, can help provide the continuity to complete the first separation even if a second deal is already in the works.

3. Be the decision accelerator.

Separations generally demand thousands of decisions on strategy, products, services, organization design, cost reduction, investments, communications, information technology (IT) applications, and many other areas, all to be made in a very short timeframe. How will you get all that done? Certainly having a strong team and adequate resources is part of the answer. But the most important factor can be rapid decision-making — and that means that you will have to set the pace.

You can accelerate decision-making in several ways. First, set clear deadlines for decisions and hold your team accountable for meeting them. If they resist the pace you set, explain that if they don't make the decision, either you will, or you will have an executive make it for them. Second, structure the agenda for your executive steering committee meetings as a collection of options, recommendations, and decisions. Use the meetings to drive key decisions from executives rather than simply to update them on separation status. Finally, host cross-functional decision-making workshops and don't let them leave the room until they've made a decision.

4. Guard your teams, your scope, and your cost center.

We often see a "pile-on effect" in larger transactions in which various other groups attempt to latch on to the project, claiming that their own projects are part of the larger effort. However, a separation manager must maintain a laser-like focus on managing the efforts that were originally identified as yielding the desired results. Projects piled on beyond the original scope not only tend to slow down the separation process but can also dilute the potential cost savings, adding costs without yielding short-term savings. What's more, if you allow extra projects to ride the separations coattails, others outside of the project will quickly see that the separation efforts are attracting the "cats and dogs," and they may question your commitment to achieving the original objectives.

So don't let yourself be distracted by add-on projects unless the sponsors can demonstrate to your satisfaction that the additional activities will add real value to the separation. For every extra project that is proposed, ask for a quantitative business case that details how much of a return it might provide and how soon it can be expected for the effort and money expended. A rule of thumb we often use: if the extra project doesn't yield at least a twofold return on its cost, it probably doesn't make sense.

5. Play nicely if you're one of "two in a box."

In some large separation efforts, executives staff the separation manager role using the "two-in-a-box" technique — that is, they appoint two separation managers, one from the legacy company, and entity being separated to jointly lead the project. As a separation manager, you may not have a choice of whether you share the sandbox with another. If you find yourself with a colead, we would suggest that you focus your energy on making the relationship work. You don't both have to attend every meeting or make every decision together, but you do have to communicate openly, often, and completely, as well as divide the work in a way that makes sense. Most importantly, don't let the organization play the two of you against each other — which, unfortunately, is a real possibility in some cases. More than likely, you will quickly realize that each of you brings knowledge and skills that complement each other in a very difficult role.

6. Manage by walking the halls.

As separation manager, you'll likely find yourself drowning in seemingly endless planning, discussions, and meetings to coordinate the many groups required to carry out the separation. But remember, you need to do more than manage everyone's effort. You also need to continuously communicate progress and direction, providing the emotional grounding that is often so important for companies in a time of transition.

To keep issues from blowing out of proportion, and to help the entire organization understand the decisions and direction of the separation, you need to continuously keep your ear to the ground by walking the halls, talking with people, and taking their pulse on sensitive topics. Make the time to do it between meetings and calls, even if it means that you have to be at work earlier and leave later than everyone else (which you'll probably be doing anyway). Even if there is no clear answer to an issue, it's important that the separation manager proactively acknowledge that it's been raised and is being considered.



7. Pay attention to amygdalas.

In our brains, the neocortex, the “thinking” part, governs reason and analyzes facts. The amygdala handles all basic emotional reactions, such as fear, anger, and excitement. People who are exceptionally aware of their own and others’ emotional responses are said to be “emotionally intelligent.”¹ To be effective, we believe that separation managers need this trait in spades. Obviously, a separation can give rise to a host of negative emotions that can easily be amplified by rumors and hearsay. It’s important to be prepared to face uncomfortable situations and to be sensitive to how these are managed. For example, when planning a major organizational redesign, think carefully about who will gain, lose, or otherwise change responsibilities and power, and anticipate how certain individuals will react to those changes. Try to reduce anxiety by explaining how the separation team will design the organization and how the selection process will work, as well as by clearly communicating the timeline for change.

Less obvious, but no less important, is to seize the opportunity to harness the excitement that transactions and separation can bring. There will probably be many potential change leaders both inside and outside your separation team — formal and informal influencers who are well respected in many different areas of the organization. Help them paint a compelling picture of the future and ask them to talk it up. Share positive news about the separation progress with them first, and ask them to get the word out to their constituents. You can also ask them to occasionally take the pulse of the organization and get that feedback to you.

To sum up: The challenges of managing a separation can provide an excellent opportunity to build on your strengths and to take your own effectiveness — and your organization’s — to a higher level. You already have the reputation, the ability, and the authority to get things done; that’s why you were chosen to lead the separation in the first place. Now, you have the chance to demonstrate that you can get things done in the time-pressured, volatile, often chaotic environment of a divestiture. Draw on your strengths and keep our seven tips in mind — and enjoy the ride!

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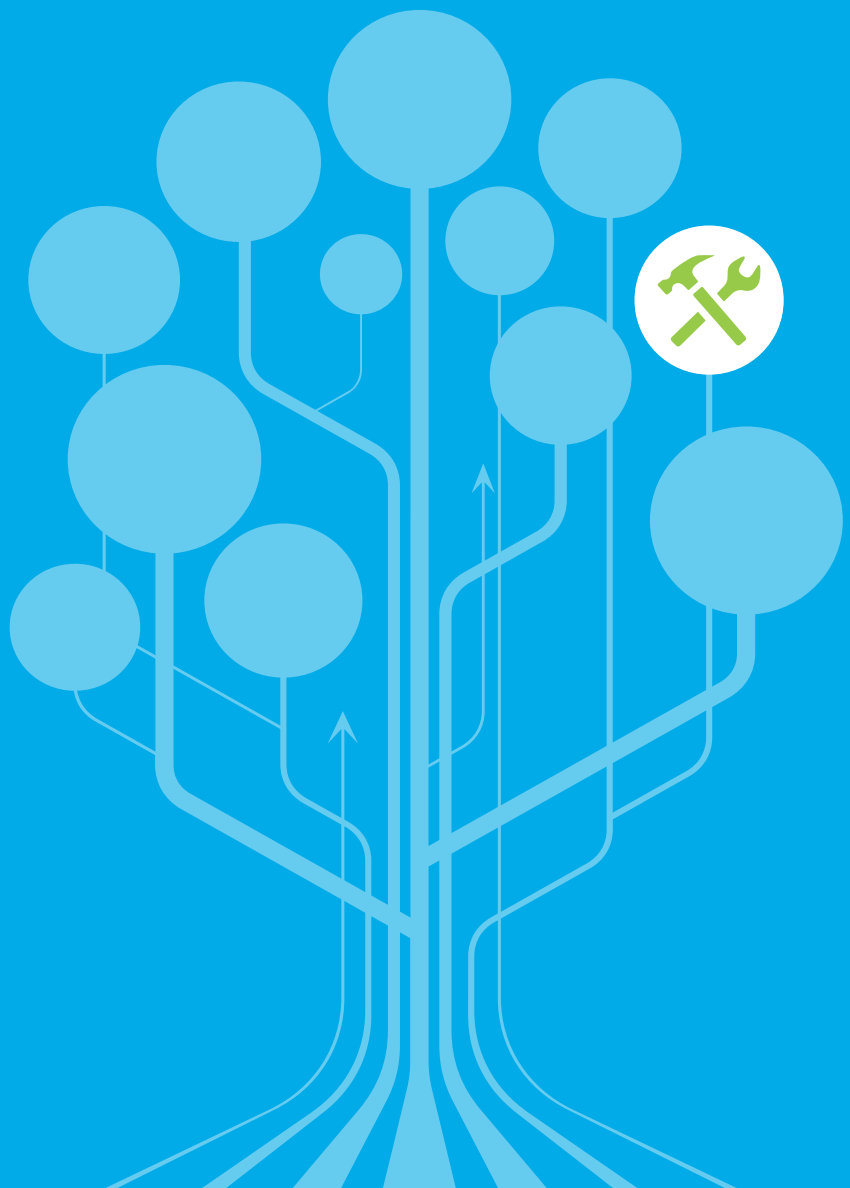
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Functional Carve-Out Perspectives





Divesting your Shared Service Center Leveraging your Shared Service Center as a Springboard to a Profitable Outsourcing Relationship



Outsourcing initiatives are a well-recognized driver in reducing costs and increasing service levels while enabling a business to focus on its core functions. They also act as a catalyst for broader transformation and send a change signal to the rest of the organization. Traditional approaches to outsourcing focus on procuring services from an external partner, where the transfer of assets — people, systems, intellectual property and often buildings — is a secondary consideration. However, as large Shared Service Centers (SSCs) created by companies have now begun to reach maturity and as service providers look to scale up through acquisitions; these centers are beginning to offer a credible asset that can be divested. A window of opportunity has opened up for companies with mature SSCs to monetize them by selling them to an outsourcing service provider. This can generate immediate cash, and through the relationship with the service provider, further savings and service improvements can be realized.

Utilizing your SSC as a springboard to a profitable outsourcing relationship

Many leading organizations are seizing the opportunity to outsource their SSC operations to service providers in a move to realize additional up-front value from their SSC investment. Such relationships can help to reduce costs further, and through investment in the SSC by the outsourcing service provider, they take service to a new level.

New skills and capabilities of the outsourcing service provider are accessed while, crucially for some businesses, disruption may be reduced. The organization can then be positioned to execute a business strategy focusing on its core business while still providing a high quality of back office services through working with an external provider.

Outsourcing grows, with spin-offs providing the catalyst

The pressures on the economy are forcing many companies to renew their focus on their core business, while contemplating an outsourcing relationship to provide non-core activities. As a result, the Business Process Outsourcing (BPO) market continues to grow rapidly on a global scale. Economic pressures, coupled with the availability of mature SSCs as an internal asset, have led to a new appetite for a divestiture proposition. Service providers, both onshore and offshore, are racing to bulk up capabilities as the BPO market moves out of its adolescent phase.

This imperative is shaped by the need to acquire new capabilities, enter new geographies, even out the impact of currency depreciation, or simply to bulk up their contracted volumes. These vendors are seeking out mature SSCs or internal businesses that can be divested.

Sales of a mature SSC can be seen as strategy for transformational service improvement

The sale of a mature SSC to a service provider is sometimes viewed as a logical next step to realizing further value in the operation of a shared services environment. The sale presents a cost reduction opportunity to release cash and the ability to transform a fixed cost into a variable cost. However, there are complex tax considerations which should be carefully evaluated in order to reduce the tax cost of the sale. When contemplating the sale of an SSC, a company should be asking the following tax related questions:

- What is the tax cost of the sale and how will the sale impact the effective tax rate and the cash tax rate?
- Will local country taxes that are incurred be creditable in another jurisdiction?
- Is the purchase price that is being paid wholly related to the SSC or is a portion being paid for intellectual property that may not be owned by the SSC?
- What is the tax impact of allocating the purchase price between the interest in the SSC and other intellectual property?
- Can the SSC be restructured in advance of a sale to reduce local country tax?
- Will a change in control of the SSC result in lost incentives or tax holidays?

The sale also provides a business model for the SSC that encourages ongoing investment in the technology and operations of the SSC, now in the form of a long term outsourcing relationship. The sale can also presents an opportunity to increase the critical mass of back office operations, increase staff retention through greater career opportunities for staff in the SSC and improve service levels through the creation of an external service culture and contractual metrics. Often, staff retention and future career development opportunities are the biggest operational issues facing a mature SSC, especially if they are in a low cost location. By providing the SSC operations and personnel

Case Study Overview — CoreLogic's India Divestiture

CoreLogic recently sold its India captive operations to an outsourcing service provider. CoreLogic was seeking to achieve the objectives of greater flexibility, global scalability, higher effectiveness and efficiency of existing operations, development of new tools, technologies, and processes to support and grow CoreLogic businesses. These operations represented over 40% of the company's employee base. Apart from enabling the company to focus on their core activities, CoreLogic's sale of this part of the business also resulted in a large cash flow injection. The company received an upfront cash payment and service credits to reinvest in its business.

There was low disruption to the business with an integrated transition between sourcing the service provider and the service provider providing BPO and ITO services. The ongoing outsourcing contract was structured to provide enhanced value and the flexibility they required to match the strategic objectives of the business. CoreLogic also developed a structured vendor management program office (VMPO) to manage the new relationship as well as its other vendor relationships.

As a leader in Outsourcing Advisory Services our dedicated team that advised CoreLogic on this divestiture was composed of skilled practitioners from various service lines including Strategy & Operations Consulting, Human Capital Consulting, Accounting, Tax Advisory, and Corporate Finance. Using the network of member firms, the As One Deloitte advantage translated to a short ramp-up to get the project launched, streamlined communications and the leveraging of multiple service lines to help the client reach advantageous terms on both the sale and long-term master professional services agreement and to effectively establish the VMPO.



with a new home in a service provider organization, the organization may be better equipped to retain talent. A sale to service providers may also reduce disruption to the business in the transition period, should the service provider take over and continue to provide BPO services. However, extra effort is usually required to change the culture within the SSC from that of serving internal colleagues, to a culture of providing an external service to clients.

Vendors are willing partners to scale up their capabilities

The acquisition of an SSC by a service provider provides an opportunity to rapidly scale up a business's capabilities in a growing and competitive market — with a geographic, process or language scope. It also provides the service provider with a long term annuity based relationship with a potentially large, new client. Additionally, it can enable a service provider to get into a new business area and gain access to a new geography.

As the BPO market matures, service providers are moving to the provision of complex business processes, such as Knowledge Process Outsourcing, Financial Services Outsourcing and other business processes. In such relationships where knowledge transfer is difficult and the capabilities being transferred are known intimately by the client organization, innovative operational and commercial structures are required. Very often such relationships require an outsourcing and governance framework which resembles a divestiture or joint venture to promote the full effectiveness of the arrangement.

The growth of offshore BPO players is another catalyst. An onshore service provider is seeking near shore or offshore presence, while for an offshore service provider an onshore presence can bolster its sales and market position. The acquisition of a complementary SSC center may reduce risks inherent in building a "greenfield" center. It may also give life to the operational center through an existing service relationship.

Second Generation Deals

The divestiture proposition is in its second generation. First generation divestitures created stand-alone businesses in their own right. In recent times, second generation

divestitures have started to occur where mature SSCs were divested by the parent company. In the process, the companies achieved their strategic objective of focusing the organization on its core business activities, while helping to realize value beyond a traditional outsourcing relationship. In addition to a standard long term outsourcing contract, the acquiring vendors paid up-front cash value for the assets, Intellectual Property and people acquired as a result of the transaction. Unilever's spin-off of its Latin American SSCs to an outsourcing service provider and CoreLogic's spin off its India SSC to outsourcing service provider are in the vanguard of second generation divestitures.

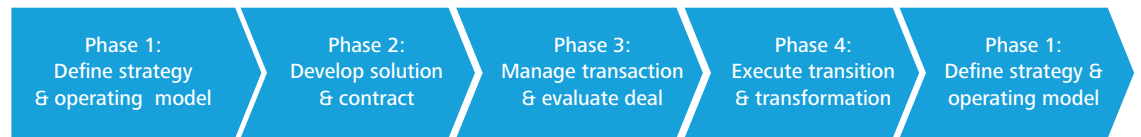
Case Study Overview — Unilever's Latin America Divestitures

Unilever sold two of its Latin American SSCs to an outsourcing service provider. This brings the company's Latin America operations in line with their global strategy to outsource non-core finance activities, thereby allowing them to focus on becoming a business partner. These centers were operated by 450 employees and provided services to 20 business units across Latin America in three different languages.

Apart from enabling the company to focus on their core finance activities, Unilever's sale of these businesses also resulted in a cash flow injection. The company received an upfront cash payment for their centers from the vendor that included a significant amount for goodwill.

With low disruption to the business, there was an integrated transition between sourcing the service provider and the service provider providing BPO services. The ongoing outsourcing contract was structured to provide enhanced value and the flexibility they required to match the strategic objectives of the group.

As a leader in Outsourcing Advisory Services our dedicated team advised Unilever in this divestment, from the time a vendor was selected to the time that a contract for sale of center, as well as a long term outsourcing contract, was negotiated with the service provider.



Deloitte’s capabilities

Deloitte’s Outsourcing Advisory Services, Tax, and Financial Advisory Services team supports similar engagements to the ones outlined above. We provide a structured approach to assisting clients in assessing the viability of an SSC divestiture utilizing Deloitte’s demonstrated methodology pictured below. First, it is essential that we assess the strategy, value potential, and tax implications of such an arrangement, the scope and structure of what to outsource, which leads up to a market assessment and service provider engagement for divesting the asset. The next phase, after the due diligence activity, is engaging in detailed contractual negotiations for selling the asset as

well as developing a long term contract with the service provider acquiring the SSC. Then a transition of services from the client’s SSC to the service provider should be completed. Finally, a vendor management and governance structure should be established to manage the service provider and on-going operations. On-going monitoring, through the vendor management organization, focuses on alignment to business goals, adherence to required service levels, risk management, continuous improvements, and tracking value for money.

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Deloitte.

*Aligning your financial close to the
transaction close*

Effectively executing the dreaded
partial period close



The execution of the fiscal period-end financial close and consolidation processes is one of Finance's most important and visible fiduciary responsibilities. Providing timely and accurate financial statements becomes even more difficult when integrating a newly acquired business — a situation further complicated by the timing of the transaction close and the integration approach.

Some companies attempt to time the transaction close date to correspond to their fiscal month end to avoid complications. Although this is a noble goal, various difficult-to-control factors, such as shareholder approval, funding, and regulatory approval, can cause the transaction close date to move around. (See case study: Trying to hit a moving target.)

It's crucial that your Finance organization knows how to handle the mid-month transaction close from an accounting perspective when an additional off-cycle or mid-month close is needed to create a stub accounting period and to align fiscal periods. Analysis of publicly available data showed that about 80% of more than 300 transactions (deal value over \$1 Billion) completed globally during calendar year 2008 were closed during the middle of the month.

This article explains the drivers behind a mid-month close, cut-off options, and the decision process you should consider when evaluating your options.

Assess the drivers for your financial cutoff

As of the transaction close date, a clean cutoff is required in order for the existing business to shut down and the new company to begin operations as a new entity. A clean cutoff is expected to facilitate:

- Accountability for recognizing financial performance (such as reconciliations between shipments and attributes related to the cash conversion cycle).
- Determination of the purchase price of an acquisition based on balance sheet attributes.
- Ability to perform required asset valuation and purchase price allocation activities.
- Identification of tax obligations of acquirer and target.
- Establishment of clear ownership of existing debt obligations assumed by the new company.
- Creation of auditable financial statements with appropriate controls, balances, and detail.

Case Study: Trying to hit a moving target

Coordinating a deal close date with a fiscal month end is usually not possible. It's not unusual for a target close date to move several times before the deal actually closes. In this real-life scenario, the communicated transaction close date moved three times before the deal finally closed. This is how the complications unfolded:

- Shareholder approval: • Shareholder meetings are typically not set in stone. In this company's case, the meeting was moved out a week due to reasons unrelated to the transaction. This caused the target close date to move correspondingly.
- Funding difficulties: • Due to uncertain economic factors, difficulties in repatriating cash from foreign entities, and debt issuance related to the acquisition, the acquirer fought to push out the transaction close by two weeks, which was the second delay.
- Regulatory approval: • When it comes to government or regulatory approval, deals are often at the mercy of the regulating bodies. Although the acquirer received Hart-Scott-Rodino clearance from the U.S. Department of Justice, the members of the European Commission asked the acquirer to delay the filing for an additional month while they reviewed the details of the deal and its industry impact. This hurdle caused a third delay in the close date.

Delays caused by shareholder approval, funding, and regulatory approval contributed to the movement of the transaction close date on three separate occasions, eventually pushing it out by two months.

For Finance, it is almost always preferable to have the transaction close date align exactly with a period end close; the preparation, planning, and documentation associated with a mid-month close can be daunting. If you can satisfy all the organizational requirements, avoid a mid-month close if you can. However, more often than not there are legitimate and sound business reasons why this situation simply cannot be avoided.



Typically, the drivers for a financial cutoff fall into two groups: accuracy and reasonableness.

Examples of the need for an accurate cutoff

Acquisition price based on the ending balance sheet:

In a deal between two pharmaceutical companies, the acquirer purchased a manufacturing business from the target, including fixed assets, inventory, and prepaid leases. They needed an accurate cutoff to ensure that the valuation (and thus the purchase price) corresponded with assets on hand as of the transaction close date.

Carve-out of a business from the parent company: In the same deal, the target owned the financial performance of the business up to the transaction date, and the acquirer assumed responsibility thereafter. They needed pro-forma financial results reported in the respective public filings of the acquirer and target companies.

Examples of the need for reasonable cutoff

Full merger (or 100% acquisition): For tax and statutory reporting requirements, there must be an end point when the individual companies shut down and the newly formed company begins operations. In this case, as long as there is a directionally correct cutoff, and financial results and tax obligations are reported reasonably, the cutoff should be acceptable.

Independent audit requirements: Auditors provide assurance/opinion on financial statements as of a certain date. The rigidity of the cutoff may depend on the internal controls in place and other factors influencing the auditor's comfort level. These will dictate whether a reasonable cutoff is acceptable.

Non-public companies: Since the audience of external financial reporting may be limited to non-regulatory agencies (lenders, joint venture partners, etc.), the acquirer's management team members have more discretion to dictate their desires for the cutoff date.

It's important that you first understand the drivers behind your company's transaction. These will determine which cut-off options are available to you.

Evaluate your financial cut-off options

If you find that there's no way to avoid a mid-month transaction close after assessing the transaction drivers, then you must evaluate your options. We commonly see two options, listed below, for dealing with a mid-month

M&A transaction. Each option has its advantages and disadvantages. (See box: Cut-off Options, Pros and Cons.)

Mid-month hard close. Perform all the steps as you would during a normal month-end close cycle: cutoff financial activities on the transaction date, close out the ERP and related sub-ledgers and feeder systems, perform accruals, and publish a set of financial statements for the period ending on the transaction date.

Mid-month soft close. Use the prior fiscal month-end financial statements as a starting point and build forward, using transactional data and required balance sheet adjustments up through the transaction close date.

	Advantages	Disadvantages
Mid-month hard close	<ul style="list-style-type: none"> Financials are accurate. Existing internal controls are leveraged. Normal close and consolidation cycle are consistent. 	<ul style="list-style-type: none"> Systems testing and set up work. Finance staff must perform an additional close cycle. Offline, manual processes may have to be utilized to compensate for system limitations.
Mid-month soft close	<ul style="list-style-type: none"> Few changes are needed to regular month-end close cycles. Few adjustments are needed to existing systems. Fewer resources are required. Approximate estimate of ending balances and results is directionally correct. 	<ul style="list-style-type: none"> Financials may not be 100% accurate Additional controls may be required to satisfy external audit requirements. May not be acceptable for financial reporting on stand-alone entities.

Selecting the most appropriate option to adopt

So how is the choice made? The Finance and IT organizations must work together to evaluate options since the one ultimately chosen can dramatically impact the work effort of both groups. Here are the questions that must be answered.

Hard or soft close? The first criteria should be the degree of accuracy needed and the risk of not closing the books correctly, which can lead to inaccurate financial statements, weakness in controls, and loss of historical and comparative data, among other things. Answering this question can help you quickly decide on the need for a hard or soft close. Generally, the need for a high degree of

accuracy and desire to mitigate overall risk will dictate the choice of a hard close.

What are the risks? The next step is to prioritize the cut-off options by weighing the risk of an inaccurate close. An incorrect accounting close could lead to inaccurate financials being released to the public, future restatements, and loss of historical and comparative data, etc.

Can Finance and IT handle it? Weigh each option based on the demands it will place on Finance and IT and decide whether the organizations have the bandwidth available for implementation. For example, a close with high IT involvement would lead to a more automated close process, whereas heavy Finance involvement with low IT support would lead to a manual close process.

What are the other risks? Weigh the risk of each cut-off option using the following criteria:

Impact on business operations: How will the business (non-finance groups) be affected? Will they have to do anything different to accommodate the option? Will it affect the order to cash or procure to pay processes in any way?

Impact on financial close: What is the level of effort required of the Controllership staff? Will there be a need for offline/one-off processes to accommodate the option?

Adjustments to financial systems: How will the ERP need to be adjusted? Can the ERP accommodate adjustments without code changes? What is the level of testing required? Will it put the ERP at risk and necessitate a robust backup plan? Are there other boundary systems or databases impacted?

Resources required: What are the additional technical, finance and business resources required to execute this option? Where will the monetary and people resources come from? How much time will there be before the next close?

Impact to other systems: How does this option affect other systems besides the ERP? Can the other systems accommodate this option? What is the level of testing?

Level of effort and time to implement: How long will it take to implement the option? Will it cause undue strain on staff and take focus away from other pressing needs related to the acquisition or normal course of business?

Mechanics and the overall workload for executing a mid-month close can vary based on the decision for a hard or soft close. So it is important to carefully consider all the available options and requirements for necessary changes to the close process and related systems before you go down any path.

Case Study: Choosing a mid-month close option

Two companies in the media and entertainment industry agreed to a merger. They choose a transaction close date in the middle of a fiscal month; it was up to the Finance organization to execute this mid-month close.

Several options of hard and soft closes were identified, including copying the target's ERP, changing the calendar date in the ERP, and even potentially stopping the shipment of products during the first 10 days of the month.

Key considerations included limiting the impact on the business stakeholders, close process, and boundary applications. In addition, due to the timing, the acquirer considered the availability of key resources and the effort that would be required to make complex changes to the financial systems. After carefully evaluating all of the options, the decision was made to perform a soft close by cloning the ERP production environment.



Below is a summary of the process they followed to perform the soft close.

Previous Fiscal Month End	Transaction Close Date	Finalized Soft Close Proces	Next Fiscal Month End
<ol style="list-style-type: none"> Continued to process trasactions in the target company's ERP from previous month end through transaction close date 	<ol style="list-style-type: none"> Transferred sub ledger data into general ledger at transaction close date Made copy of the target company's ERP environ-ment and secured copy for one time in creating cut-off/final financial statements for pre merger entity Completed financial close process in copied environment 	<ol style="list-style-type: none"> Created journal entries to establish beginning balances on acquirer's ERP Created "new companies" in the acquirer's ERP to store and retain the target company's historical P&L data Moved balances of the target company's financials into the new company codes in the acquirer's ERP for go forward usage 	

These steps allowed the acquirer to continue ongoing operations with little impact to their ERP production environment while preserving historical pre-merger data.

Pros

- Created a 'clean balance sheet' for the mid-month transaction close date
- Provided the ability to run reports pre- and post-merger dates
- Offered an audit trail for pre- and post-merger dates
- Allowed the Finance organization additional time to perform close activities without impacting the ERP production environment

Cons

- Required additional set up in the financial systems for allocating PTD and YTD balances for pre-merger historical data
- Required extensive testing by the Finance team
- Required updates to system-generated reports

Lessons Learned

Keep these tips in mind as you consider implementing a mid-month transaction close date:

Decide early. Clearly identify all the options and make your selection early in the process. This will allow time to change course if the option goes awry during the early stages of planning and execution.

Be sure to test. System changes and newly designed processes should be tested. Typically, the fiscal month end prior to the transaction date is a good time to perform a dry run/mock close.

Don't underestimate resource needs. These are uncharted territories for you and your staff. Even if you've been through other transactions, no two deals are alike. Closing the books will be tougher than expected — so plan accordingly.

Keep an eye on internal controls and reporting.

Although the mid-month close process will only be performed once, be sure that acceptable controls and reporting are in place. Otherwise, you may be left with historical comparative reporting and reconciliation challenges for many months to come.

Document, document, document. Document the new process so it is transparent, clearly understood by everyone involved, and available to internal and external auditors during their next quarter-end fieldwork.

Have a backup plan in place. Nothing is worse than having all your eggs in one basket. Make sure that if your first choice option fails, you have something to fall back onto. Remember, transaction close dates frequently change at the last minute.

Summing it up

More than likely, you'll be faced with executing a mid-month close related to a M&A transaction, no matter how hard you may try to avoid it. Upfront planning is the

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Real estate considerations in M&A and divestiture activity



Real estate and facilities are integral to realizing synergies

The key components of a successful merger, acquisition, or divestiture are those that contribute to achieving the objectives of the newly restructured operation. The new

organization's leadership team, market positioning, and branding strategy are all key considerations in the effort to realize synergies from economies of scale, process efficiencies, leveraging purchasing power, reduced cost structures, and technology enhancements.

“Company leaders need to communicate the message that real estate is a key enabler to successful M&A integration or divestiture initiatives.”

In addition to leveraging the key components mentioned above, organizations should also consider the significant synergy opportunities associated with improving the real estate and facilities function, which we believe to be one of the core enabling functions of the enterprise (the others being Finance, HR and IT). Responsible for what is typically a company's second or third largest spend category, the real estate and facilities function is often one of the forgotten levers that can serve as a lynchpin to success in an integration or separation, enabling physical adjacencies, helping drive businesses to the right locations, and disposing of excess assets and space.



At Deloitte, we understand the value inherent within a company's real estate and facilities portfolio. This (potentially) hidden value can be unlocked as a part of merger, acquisition, or divestiture activity and we have developed numerous service offerings to support such efforts.

Our experience is that real estate and related physical assets are too often perceived as simply another cost center or as an afterthought to a merger, rather than a strategic priority that, through effective planning and execution, can impact shareholder value from Day 1. We believe that mergers, acquisitions, and divestitures represent unique opportunities to reconsider the role of the real estate and facilities function and how it supports strategic business objectives.

During the extraordinary wave of change that marks a major merger, acquisition, or divestiture, the attention of company leadership naturally turns to thoughts of who will run which business, how to retain customers and cross-sell new products, how to rationalize the supply chain, how to fund growth, and how to retain key personnel. Part and parcel to these concerns are questions regarding where the company's major businesses will be based, how to leverage physical assets to reduce spend and generate cash through asset sales. Questions regarding how to geographically position the company for success with customers and suppliers, and how to use real estate to integrate potentially disparate cultures and improve employee engagement/productivity should also be top of mind. The true value of the real estate and facilities can be uncovered as companies begin to address these questions.

In our work supporting some of the world's largest and most complex mergers, acquisitions, and divestitures, Deloitte has identified two key lessons learned relative to the ways companies leverage their real estate and facility assets to help achieve their overall value proposition.

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Lesson learned #1: Drive value by supporting the new entity's strategic priorities

First, **the real estate and facilities function needs to have a seat at the table**. Company leaders need to communicate the message that real estate is a key enabler to successful M&A integration or divestiture initiatives. As a strategic value lever, you should expect as much from real estate as you would from the other enabling functions, namely, Finance, HR or IT.

Develop a coherent real estate strategy and accelerate achievement of that strategy. If you expect to save \$50M annually from reducing your footprint, then a one-week delay in strategy implementation can burn a million dollars. Most delays in rationalizing the portfolio stem from slow decision making. So get the right people in the room, put the required analysis in front of them and hold them accountable for their decisions, as well as for the impacts of delays.

Work with individual business units to support them in thinking through location strategy, and as appropriate, convince them to consider not just the needs of their individual business, but those of the broader enterprise (co-locations, consolidations, etc.). Successful location decisions are often more complex than merely choosing between the existing locations of newly merged, acquired, or divested business units. Take into account industry clusters, customer and supplier locations, opportunities for labor arbitrage, and other factors in determining the appropriate locations for the new enterprise.

Leverage the environment of change that M&A or divestiture activity fosters to encourage new ways of working. In most businesses, 40–60% of their seats are unoccupied at any given moment. An integration or separation event is the perfect opportunity to embrace advanced workplace strategies. In businesses where face time is not vital, encourage work from home. Where space needs to be refurbished, use the opportunity to improve asset utilization with advanced workplace designs and tools & technologies that shape the workspace around a culture of mobility. Where policies are being combined or changed, take advantage of opportunities to endorse new work styles by emphasizing results over presence, further reducing the real estate footprint.



Project Spotlight

Global Media Corporation — Merger Integration Planning & Implementation

Background

This organization made a takeover bid to acquire a competitor in one of its many business lines. The new organization would be a leading service provider in its industry in terms of revenue. The deal was completed a year later and on Day 1, the new organization consisted of more than 50,000 employees operating in nearly 100 countries, 300 cities, and 600 facilities worldwide.

The challenge

Corporate real estate was charged with two goals: 1) Assist in delivering an issue-free Day 1, and 2) contribute approximately 10 percent of the total synergy projection, primarily through portfolio optimization. A directive from the CEO also required collocation of staff by function on a global basis to support cultural integration within a one-year timeframe. Physical collocation was seen as a key driver to establishing and formalizing the new organization. To address these challenges, the company retained Deloitte's Capital and Real Estate Transformation practice to help them in their pre- and post-merger integration efforts and to help them in their efforts to develop a portfolio optimization strategy focused on achieving real estate synergy targets.

Project approach

Deloitte initiated our services in support of this project by working with the company to develop Day 1 goals for real estate. Six work streams were established to achieve these goals and a multi-disciplinary real estate program management office (PMO) was established to evaluate synergy opportunities and provide oversight for the portfolio optimization strategy and migration planning activities.

In support of post-Day 1 consolidation and migration activities, Deloitte participated in interviews with key business unit leaders to understand their business growth plans and corresponding space needs to validate their portfolio strategy. Teams of external and internal resources — Architects, brokers, movers, HR, IT, Finance, and Communications — were identified and engaged to support planning in each of 50 key cities. City-level “real estate playbooks” were developed, in conjunction with the IT organization, and used to communicate migration strategies to leadership and client-side implementation teams in each city. Deloitte also helped the company develop robust planning and management tools to phase, track, and monitor migration activity.

Results

The company experienced a successful and issue-free Day 1. The centralized real estate PMO provided oversight to a program that completed over 20 major capital projects and successfully migrated over 8,000 people in eight months. The overall real estate program is on-target to contribute to the total organization's synergy plans, primarily through the consolidation and disposition of existing activities. Deloitte helped the company establish a process for reporting on and monitoring the overall global consolidation and migration program, which continues as a part of ongoing implementation activities.

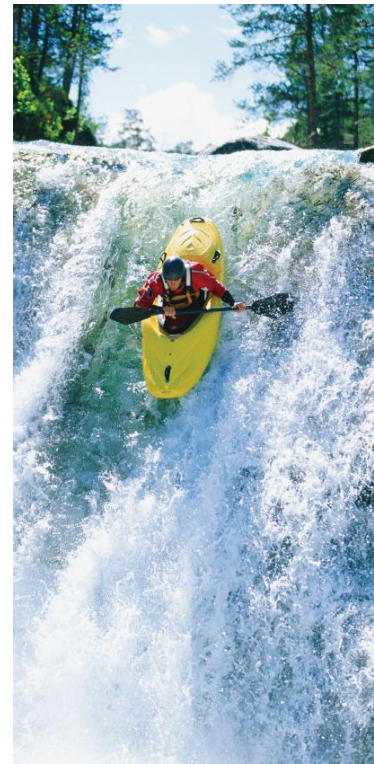
Lesson learned #2: Drive value creation within the real estate and facilities function

Take the opportunity presented by a merger, acquisition, or divestiture for a deep dive into real estate operations. Standardizing and streamlining real estate processes across the enterprise can help create efficiencies, improve customer satisfaction, and reduce risk. Implementing technology to support the end-to-end real estate and facilities operations life cycle can facilitate visibility into enterprise data and support process/governance standards, while improving decision-making and accountability.

Revisit own vs. lease decisions. Many corporations today are stuck with legacy buildings and other physical assets that do not fit the combined company's strategic priorities. In many cases, capital invested in these assets can be put to better use, especially given the investments required to make a merger, acquisition, or divestiture work. At a minimum, evaluate assets with an eye towards improving utilization through more efficient design or by taking a life cycle approach to asset management. Also, analyze the implications of surplus assets based not only on book value and depreciation, but rather by understanding the tax basis and market values as well. Decisions based on short-term benefit may yield long-term problems.

Look for cost savings from within real estate and not merely from staff/headcount reductions. Review major processes to determine which can be performed more efficiently through the use of outsourced real estate service providers, using standardized processes and rationalized service levels. Integrate real estate and facilities information technology to eliminate redundant point solutions. Consider whether the combined firm's scale improves the business case for investing in an Integrated Workplace Management Solution (IWMS) that integrates with the new technology stack of the enterprise, the legacy systems, and outsourced/ASP solutions offered by service providers.

Lastly, **invest in the resources required to meet the combined company's needs**, upgrading real estate and facilities capabilities in alignment with restructured service level. Customer relationship management, performance management, and the strategic implementation of an IWMS are good places to consider as starting points.





Bottom-line benefits

Effectively considering real estate and facilities as part of a M&A or divestiture transaction can help organizations in their efforts to:

- Accelerate achievement of synergies and often desired “One-New Company” focus through the physical alignment and integration of business units
- Reduce costs by disposing of excess space and by locating business units in cost effective locations aligned with the business strategy
- Improve employee engagement and reduce costs by driving advanced workplace strategies
- Free-up capital by divesting of assets which do not fit the location strategy or evolved capital plans
- Reduce real estate function costs through outsourcing, standardization and organizational re-alignment

Getting it done

The impact of real estate and physical asset management is highest during the tumultuous change that accompanies a major merger, acquisition, or divestiture. It is also the time when the real estate function is most challenged — resources are stretched and morale endangered, as staff is pushed into unfamiliar roles.

In these situations, Deloitte can provide M&A and divestiture focused services that feature time-tested tools and methodologies to support your team as it tackles these challenges head on. Our Capital and Real Estate Transformation professionals combine deep knowledge of strategy and operations, real estate, and facilities management with extensive hands-on consulting experience at the leading professional services firm in the United States. We help our clients in their efforts to develop and implement value-based, executable strategies that provide them with a foundation for achieving results that matter.

Project Spotlight

Global Pharmaceutical Company — Divestiture of Non-Core Division

Background

This organization decided to divest a non-core division as part of a broader effort to refocus around their core pharmaceutical business. The headquarters of this division had been developed as a key strategic site for the company, and it would need to be considered for carve-out with the divestiture. With Deloitte’s support, the company created an Operations Divestiture Team and charged them with supporting the Deal Team through due diligence, analyzing site options and making recommendations for assets, operational strategy and management of the transition planning effort.

The challenge

A primary challenge in selling this division lay in unraveling its operations from the parent company. Divisional management and R&D functions were operationally and physically embedded in the parent business. Furthermore, the company was faced with preparing the division for divestiture within a rapid timeframe, requiring completion by fiscal year end.

Project approach

To address these challenges, Deloitte helped the company establish a multi-disciplinary team, including: Divestiture Program Management, Real Estate, Operational Strategy, Change Management, and Tax Incentives. This Operations Divestiture Team was charged with developing the Divestiture Real Estate and Operational Strategy. Deloitte also helped the company establish a comprehensive process for developing and assessing real estate asset separation options. These scenarios were analyzed, holistically testing their impact on tax incentives, operations, organization and deal valuation. Recommendations were succinctly communicated to leadership and the Deal Team for rapid decision making.

Once a final decision was made, the company effectively addressed the multiple business and human resource issues required for successful separation, including:

- New organizational models for the operations and service organizations
- Development of a Transfer Services Agreement (TSA) and Service Level Agreements (SLAs) to codify work rules and services
- Detailing of the transition plan to encompass Asset Separation, Operational Strategy and Communications.

Results

The resulting alignment and enhanced business focus among stakeholders allowed the company to successfully develop, select and implement a real estate asset separation strategy. This initiative helped the company achieve significant value in terms of business process impact, infrastructure impact, and implementation, resulting in deal valuation and financial value of approximately \$200MM.



A guide to creating your new finance organization

Time to move out. Now what?



It could happen when you least expect it. You get word that your company is planning to carve-out a division. If you are part of the division being sold, you probably have a range of emotions, excitement, dread, fear, which may mirror what you felt when first leaving home, whether you were moving into a college dorm, your first apartment or maybe even your own house. If you are part of the parent company that is carving out a division, you may have some of the same feelings but from a parents point of view when a child is leaving home for the first time (e.g., how much will this cost me?). This article outlines some important considerations as you prepare for a similar life-altering transition for your finance team.

Leading a finance organization through a carve-out is no small feat, and your perspective and priorities will vary depending on if you are part of the remaining parent or the division being carved out. As part of the remaining parent organization, you will need to focus on business-as-usual, and start planning for how you will reduce the size of the finance group in order to support a smaller parent organization. As part of the division being carved out, you will be expected to maintain business-as-usual operations, but you may also have to create a new organization with a new or different set of short- and long-term goals which affect your people, processes, and systems.

Each divestiture has unique characteristics, but business unit carve-outs usually fall into one of the following three categories:

1. Sale to another public company.
2. Sale to private equity investor (PEI)
3. Spin-off as a separate public company (IPO)

The parent organization's considerations post carve-out remains largely the same, regardless of the type of carve-out; however, if you are part of the division being carved out, it is a different story. Each type of carve-out comes with its own set of increasingly complex challenges, but in most cases you will need to follow a process that allows you to consider your mindset, find your baseline, create a transition plan and prepare your people. At the same time, you need to consider the impact the transition will have on your own future and career.

A. The Carved Out Division's Perspective

1. Sale to another public company

When your division is sold to another public company, the challenges are similar to leaving home and moving into a college dorm. You pack up your clothes, sheets, and TV — but you can count on a bed, desk and cafeteria meals being provided for you. You'll need to adjust to a whole new set of rules and expectations. Back home, your parents are probably already making plans to convert your bedroom into a media room. There's no going back.

When you're moving from one public corporation to another, your new parent will often take care of shared back-office services and infrastructure. And you probably won't be responsible for corporate financial concerns like investor relations, information technology, tax, and treasury. Instead, your job is to focus on untangling your organization from your current parent, managing the move, integrating into your new parent's organization, and retaining your key people.

On top of the logistical challenges, you have to deal with mixed emotions; this is a big change for your employees — and you. In this situation, you are very likely to have limited information and will need to deal with an employee base that is anxious and uncertain. In many cases, your personal role as part of the divisional finance team can also be very uncertain.

Special considerations for this carve-out:

Consider your mindset.

When your division is carved out for sale to another company, there's no way to know what will happen to your position. If your division extends the acquirer's products or services, your role maybe fairly secure — perhaps you'll even have new opportunities for advancement. But if there is substantial overlap with the new parent, it's possible your position maybe targeted for elimination. The uncertainty can be unsettling, and you may be tempted to return that headhunter's call — just when you're needed most. However, consider sticking around to see what will happen. Even if your position is short-listed for elimination, your new parent will need you to help with the transition, and you'll likely be in a strong position to negotiate a good retention plan.



Whatever you do, resist any temptation to disengage. Learn as much as you can about your new parent's industry, products, and customers. Research your future colleagues through your personal professional network or on online sites. Regardless of the final outcome, a carve-out situation will likely create many opportunities for you to increase your personal network and build your resume by leading a well-managed transition.

Find your baseline.

It's difficult to pull together an effective transition plan unless you know your starting point. Be sure to identify any particular requirements that the new parent company will need to support to keep your business unit operating smoothly. While most of the people, processes, and systems that will move with you are obvious, some may be harder to discern, such as shared systems and staff. You'll have to figure out exactly what your organization is using now so you can perform a gap analysis against your new parent's systems and processes.

Create a transition plan.

In most cases, your organization's future end state will be clear — you will adopt your new parent's financial processes and systems, which may be very different from the ones you've used in the past. You and your team will likely need to adjust to different accounting policies, close calendars, and technology. The challenge will be to set up an interim solution so that on Day One, when your division is folded into its new parent, your financial operation will be able to collect cash, pay employees and suppliers, and meet your new parent's reporting requirements. After Day One, your goal should be to lead a more permanent adoption of the new parent's systems and processes while meeting any synergy targets intended when the deal was struck.

Prepare your people.

Even before the transaction is announced, the rumor mill will probably be churning among your people, creating uncertainty that can undermine your plans. You'll need to act fast to develop a proactive communications plan to address employee concerns. Even if many decisions haven't been made, it's good to affirm to employees you will keep them informed on important milestones and activities as soon as it is permissible to do so. This step by itself can have a very positive impact on productivity and retention since many employees will assume the worst when communication is absent.

Try to learn as much as you can about the new organization's employee benefits and reward programs. This will help you determine the potential impact on your people and proactively develop strategies for dealing with any significant differences. Finally, identify your key people, including those with critical hard-to-replace skills and knowledge. Share transition plans with them early in the process, and let them help develop the tactics forgetting the job done. In some cases you may also want to pursue an incentive strategy, which can include financial and non-financial rewards aimed at making sure you retain the people you need most.

2. Sale to private equity investor (PEI)

Leading the transition from division to a stand-alone company is a much larger undertaking. Like moving into a new apartment where you'll be responsible for cooking your own meals and washing your laundry, you will likely need to become self-sufficient in many areas that were previously provided by your parents. But along with new responsibility comes new freedom — as you get to decide how to arrange the furniture and what food you'll stock in the fridge.

When your organization is carved out and sold to private equity investors, you become the leader of an independent private company — often being groomed for an IPO or later sale. You will decide which systems and processes to utilize and how you want to reward your people. However, the PEI in many cases will want to keep any additional equity investments to a minimum, so you'll probably be working with tight budget. And your long-term planning horizon as a private company may also be relatively short.





Special considerations for this carve-out:

Consider your mindset.

Leading your own stand-alone organization is an exciting opportunity — but it comes at a cost. You'll quickly learn there is nowhere to hide. Your new owners are likely to be frequently looking over your shoulder to make sure their investment is protected. To them, cash is king, and they typically have little tolerance for less than stellar financial performance. Here's your chance to shine — or fade. Make sure you are ready for the challenge.

Find your baseline.

Once again, it's best to start by gathering your baseline information. You will need to identify the corporate services previously provided by your parent that your new stand-alone organization needs to now be capable of doing on its own. Many of these may be clear, such as tax, treasury, and corporate finance. But there are probably other, less obvious, corporate requirements that could create problems if you don't ferret them out. Finally, you'll also want to reevaluate the divisional systems and processes your finance organization is using now because you may wish to right-size them later to fit your smaller, stand-alone organization.

Create a transition plan.

Once you've identified the services previously provided by your parent company that you want to continue — you'll need to discern how to deliver them in a cost-effective manner for your new operation. Rather than copying your parent's complex financial systems, you will want to look for systems and modules that are more appropriate for your new organization's size.

It's unlikely that you'll have your financial systems built-out by your division's first day as a stand-alone company (DayOne). Setting up transitional service agreements (TSAs) with the parent company is a common interim solution. With a TSA, the parent agrees to provide support, in exchange for a fee, until your new organization's systems and processes are up and running. From your perspective, TSAs may be viewed as expensive, but they are usually a necessary stopgap to allow your company to operate until you can transform to your new stand-alone environment. On the downside, your old parent typically isn't in the business of selling support services so you'll probably find that your needs are at the bottom of their priority list. Sooner or later, you'll need to establish new infrastructure to support your company, either by building them in-house

or by outsourcing to an external provider. In either case, the sooner you exit the TSA, the better — you'll have more control and often lower costs.

Prepare your people.

It's also important to right-size and right-skill your team. While you may hire someone internally to oversee specialized areas such as Human Resources, Tax or Treasury, consider hiring an external provider that can support smaller foreign locations or episodic bouts of transactional work, rather than staffing up. You'll also need to think of new ways to motivate the employees who are moving with you. Stock options are no longer a viable option since the company is now private, so you'll have to be creative in devising alternative incentive plans that work. Motivation will be an important part of your success, as it is likely your entire staff will need to step up their game to effect the stand-up transition while also dealing with the increased visibility and pressure to perform that comes with new ownership.

3. Spin-off as a separate public company (IPO)

It doesn't happen as often, but sometimes a division goes straight from the protective harbor of the parent company to becoming a publicly traded company in its own right. It's like leaving home and buying a five-bedroom house right away — you'll need to develop a wide range of capabilities to negotiate mortgage loans, take care of your own maintenance, and deal with nosy neighbors. But with this added responsibility also comes a great deal of freedom--- if you want to, you can knock out the kitchen wall and paint the dining room fire-engine red.

When your division is spun off into a new public company, the pressure is on to demonstrate your organization's worth to the investment world — and to showcase your ability to lead a public company. This is one of the most complex types of carve-outs; you will need the infrastructure of a private stand-up as discussed previously — plus the capabilities needed to meet investment community expectations, provide external financial reporting, and comply with Security and Exchange Commission (SEC) and other regulatory requirements. The opportunity provided to a high-level financial executive in a new public company can be great — and so can the risks.



Special considerations for this carve-out:

Consider your mindset.

Going from leading a division to running your own public company — what a career leap! If you and your organization meet or exceed Wall Street's expectations, you can reap substantial rewards. But you'll also be put under the microscope — not only by your shareholders, but also the media. You'll need to present yourself and your organization to the world with confidence, skill, and knowledge. You will need to get up to speed fast.

Find your baseline.

In addition to having to do the things described above in the PEI sale, finding your baseline takes on even greater level of importance in the case of an IPO. Since the SEC requires multiyear historical financial statements prior to an IPO, you'll have additional workload on your hands. Given that parent companies often don't generate full balance sheets for divisions, you will probably need to develop a methodology to create estimates based on historical information. You'll also need to work with your auditor to have these reviewed and finalized to support your filings.

Create a transition plan.

With an IPO, you need to develop and communicate (both internally and publicly) a long-term vision supported by a business model that's sustainable. You'll need a plan that incorporates the key people, processes, and technology that will allow you to attain the vision. And you need to execute your plan so that your people, processes, and systems are up and running on Day One. Plus, as a public company, you'll be expected to announce — and hit — short-term targets to uphold shareholder confidence (and your company's stock price).

Prepare your people.

Your new company will require a different mix of skills, many which may not exist within your current staff. In addition to needing people who can support corporate finance functions, like Treasury and Tax, you will also need people skilled in investor relations and regulatory compliance. Though your former parent may provide you the option to take a few people in these areas, in most cases, you will need to look outside your organization to fill the roles, either through new hires or relationships with external providers. While you are busy filling these roles, don't overlook your existing employees. Extensive training and communications must be carefully planned so that Day One goes smoothly. Provide support for any released

employees; those staying on will be watching how they are treated as a sign of the new company's culture.

You can't go home again. (And why would you want to?)

It's not easy to leave the safety net of your parent corporation. Even the simplest carve-out requires deft planning, communication, and execution to capture the value of the deal. At the same time, you must minimize the impact on your customers, suppliers, and employees. The key is to keep your end-state vision in mind as you build the right mix of people, processes, and systems. And when things go well, you are likely to find you enjoy your newly found freedom and opportunities.

B. The Parent Company's Perspective

The carved out division has a lot to think about regardless of the type of transaction, but what about the finance organization remaining with the parent company? The parent company is not left unscathed during a carve-out. Much like parents sending their child off to college, you need to get your house in order (convert the bedroom to game room you say?).

Special considerations for the parent:

Consider your mindset.

You may initially be thinking that your responsibility is shrinking because the size of the company you are responsible for is shrinking. However, this is a great opportunity to reassess how the finance organization is structured and managed. While not the same fresh slate as the carved out division, you should take this opportunity to think about where you might have inefficiencies, where you are not meeting business needs, and where you can leverage the changes resulting from the carve-out to improve the remaining business.

Find your baseline.

The size and scale of the finance organization is changing, and you need a new baseline for the go forward company. New baselines will need to be created for the number of customers, vendors, and internal stakeholders you will be serving. You will need to take an inventory of the systems currently being used and what will be needed on an ongoing basis. You also will need to assess how much work it will be to report financial earnings without the

carved out division. If the division had separate standalone financial statements, this can be easy, but if everything was done at a corporate level, it may take a fair amount of work to accurately recharacterize the historical financials so you can have accurate comparison points going forward. Finally, you should understand the cost of the entire finance organization before the carve-out and then estimate what it will cost to run the finance organization after the carve-out. The parent company will typically be left with stranded costs, which are the result of reduced scale efficiencies.

Create a transition plan.

The transition plan should have three major focus areas: separating the finance organization division being sold, quickly exiting Transition Service Agreements (TSAs), and creating a new finance organization for the remaining parent company. The first focus area will likely involve substantial partnering with the future finance leader of the carved out division. You want to help him/her be successful because his/her success will directly impact the TSAs and the speed at which you can make your own changes. Once that is done, you should create plans to exit the TSAs quickly. You are likely not in and do not want to be in the professional services business, which means you probably do not have the efficiencies to support the carved out division, which can lead to increased costs and burden for the parent company. Finally, you should use this opportunity to create a plan detailing the changes you want to make after the division is carved out and TSAs exited, which should include how to reduce or eliminate the stranded costs.

Prepare your people.

Many of the above points related to the carved out division hold true here as well. The rumor mill will churn, and people will be worried about their jobs, but you still have an organization to manage and that is where your and your teams' focus needs to be. Everyone will have separation anxiety and most people will have a desire to help their former co-workers after they are gone. It can be difficult for people to separate business from emotion, but it is something that is critical for the success of the parent company. Once the division is carved out, people should only provide those services detailed in the TSAs. This both establishes that you can track and monitor the services being provided, but also that your team is focusing on critical tasks.

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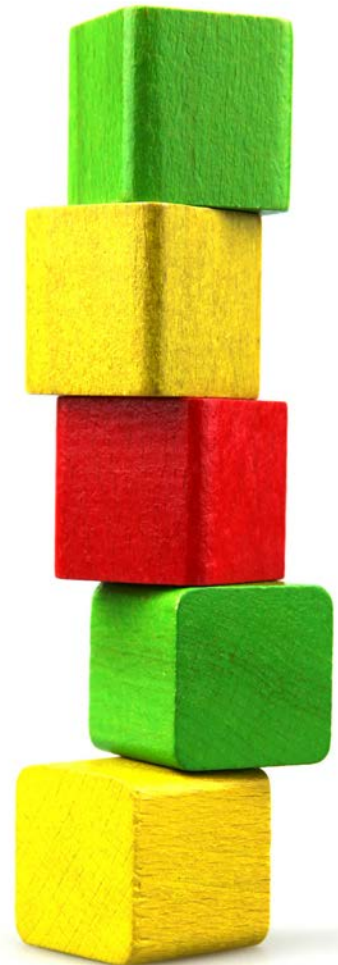
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Building a treasury organization from the ground up

Steps to consider in establishing NewCo on solid financial ground



Corporate leadership teams are constantly faced with meeting organization-shaping goals within aggressive timeframes to strengthen their market presence, establish eminence, or simply remain competitive. As leaders of a new enterprise ("NewCo") formed as a result of a carve-out — a divested business of a larger enterprise — you face an even tougher job. In addition to meeting market demands, you have to separate NewCo from its parent company and build a solid, right-sized and scalable infrastructure.

The pressure to deliver is high at all levels within the organization. In all likelihood, NewCo carries debt obligations used to finance the transaction, forcing the need to have lean operations while maximizing output to sustain operations and drive growth. Since depending on the former parent is no longer an option, NewCo must stand up capabilities to perform day-to-day treasury functions as well as develop a strategic focus to provide value-add to the business. This article outlines considerations as you build treasury services to meet your new company's short and long-term needs.

Build by Day 1 or negotiate for transition support?

In some cases, the parent company may provide fee-based transition support for a defined timeframe to smooth NewCo's transition into an independent entity. Treasury services are frequently excluded such transition service agreements (TSAs) primarily because the parent wishes to shield itself from NewCo's liquidity and cash management risks, necessitating the need to perform treasury services in-house.

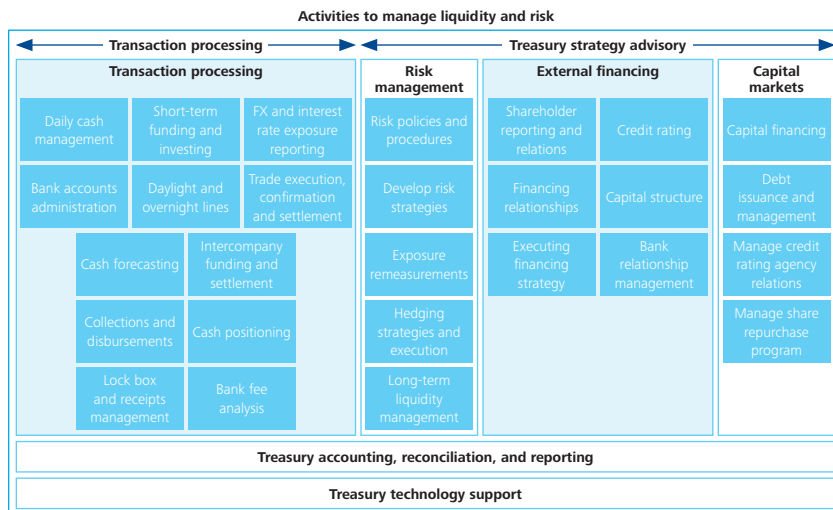
While having TSAs in place can offer short-term relief, they could create complacency within the organization and slow down operational separation to standalone operations. To be a successful standalone entity, NewCo should consider establish its credibility in the marketplace as a viable business and build relationships with operational banks. Although these relationships might be heavily influenced by agreements with financial institutions that underwrote the transaction, it is still beneficial for to NewCo to establish them early to help address liquidity risks.

Sooner or later, NewCo should consider build treasury capabilities to complete its operational separation from its pre-carve our parent. NewCo should consider develop core capabilities in cash management, financial risk management, debt management, employee benefits and insurance to have issue-free operations as a standalone entity. Ideally, these capabilities are developed before the deal is closed since many carve-out activities depend on the Treasury organization.

Here are a few examples of these:

- Legal requires capital accounts to set-up new legal entities
- Accounts Payable needs banking information to ensure payments are made from appropriate NewCo accounts;
- Accounts Receivable needs information to ensure receipt of customer payments and tracking down mis-directed cash;
- Accounting and Tax need bank guarantees and insurance to lock in leased properties or establish VAT and customs capabilities in foreign countries;
- Finance and senior management need reports on liquidity availability and requirements for tactical and strategic planning purposes;
- Payroll requires accounts in New Co's name to ensure timely payments to employees; and
- Human Resources requires corporate credit cards to replace the parent company's program

Figure 1: Overview of Corporate Treasury's Responsibilities





Planning for Day one and beyond

A broad planning approach — called "blueprinting" — can help you establish a Treasury organization designed to support NewCo's success. The blueprinting process starts with the end in mind, which in this case is a vision for the Treasury organization's end-state that can support NewCo's strategic goals. An interim state is "Day 1", which will outline NewCo's vision for operational separation from the parent. The blueprint should outline what can be needed from Treasury to attain Day 1 readiness as well as the end-state goals. Figure 2 outlines milestones and tasks that should be considered while designing NewCo's Treasury blueprint.

This blueprint can only be drawn from a deep understanding of the short, medium, and long-term

capabilities that might be required of Treasury, including transition support (if any) provided by the seller, as well as interim and on-going interdependencies with other NewCo departments. The blueprint should include the Treasury organizational structure and governance model needed to meet Day 1 goals, as well as specifying how these can be refined to meet NewCo's end-state needs.

Do you know where your money is?

For Day 1 and beyond, well-designed liquidity and cash management structure should be established to provide global and real-time visibility to NewCo's cash balances, as well as the ability to efficiently move cash across jurisdictions and entities where possible.

Figure 2: Example treasury report

High-level milestones	Rapidly stabilize and prepare for end state				Capture sustainable value
	Day 1				
Carve-out planning	<ul style="list-style-type: none"> Develop treasury merger integration plan and milestones Distinguish between Day 1 "must have" and "nice to have" initiatives Manage dependencies with IT and Finance 	<ul style="list-style-type: none"> Current state analysis of merged organizations Benchmark against leading practices Develop a future state "to be" vision of the combined treasury function 	<ul style="list-style-type: none"> Develop project plan listing all tasks Obtain Management commitment and sponsorship Communicate project plan to all team members and secure their commitment 	<ul style="list-style-type: none"> Define centralized and regional treasury responsibilities and handoffs Execute the project plan 	<ul style="list-style-type: none"> Developed functional and technology capabilities of treasury organization Enhanced Corporate Treasury oversight over subsidiaries and regional treasury centers
Banking and cash management	<ul style="list-style-type: none"> Transfer relevant bank accounts Coordinate with HR/AP/AR on new bank accounts requirements Establish new bank accounts 	<ul style="list-style-type: none"> Design efficient cash management structure Define banking strategy in line with the Treasury future state vision Operational credit limits maintained through merger e.g., survey bonds 	<ul style="list-style-type: none"> Determined preferred banking business partners Refine cash mobilization and pooling with Tax input Establish ZBA and Pooling Cash Management policies and procedures 	<ul style="list-style-type: none"> Global cash visibility Establish inter-company process to optimize liquidity Released trapperd cash 	<ul style="list-style-type: none"> Streamlined account structure Cash optimization Detailed policies and procedures Defined notes and responsibilities with segregation of duties Technology enable STP
Interest rate and FX hedge execution	<ul style="list-style-type: none"> High-level assessment of interest rate and FX exposures Plan and execute hedges for significant exposures associated with acquisition 	<ul style="list-style-type: none"> Define unified risk management philosophy and tolerance in policy Roles, responsibilities and escalation protocols Obtain credit limits from banks for hedge execution 	<ul style="list-style-type: none"> Derivative instruments usage including exotics Net intra group exposures and the minimize third party dealing ISDA and mutual cash collateral agreements 	<ul style="list-style-type: none"> Measurement of exposure versus policy Advanced risk measurement VaR/EaR Hedging strategies performance assessment 	<ul style="list-style-type: none"> Consistency in hedging practice and techniques Speed and accuracy in risk analytics and identification
Governance structure and counterparty exposure controls	<ul style="list-style-type: none"> Governance and internal control planning for Day 1 	<ul style="list-style-type: none"> Develop and define roles/responsibilities for RMC Establish Treasury risk and cash management and policies and procedures 	<ul style="list-style-type: none"> Segregation between front-office, middle-office, and back-office functions Define risk limits including counterparty exposure limits 	<ul style="list-style-type: none"> Develop risk control framework Monitor compliance Establish limit exception procedures 	<ul style="list-style-type: none"> System enabled segregation of duties and notification for limit breaches Instructionalized internal controls
Hedge accounting	<ul style="list-style-type: none"> Accounting implications existing and proposed hedges is understood 	<ul style="list-style-type: none"> Hedge accounting training to risk management/accounting 	<ul style="list-style-type: none"> Hedge manual to support new hedges Financial footnote disclosure information related to derivatives activity 	<ul style="list-style-type: none"> Systems enabled generation of hedge accounting journal entries and automated posting to the G/L 	<ul style="list-style-type: none"> Statistical approaches to assessing hedge effectiveness Ineffectiveness measurements methodology Templates for hedge designation
Treasury system	<ul style="list-style-type: none"> Assess existing systems/spreadsheets and integrate 	<ul style="list-style-type: none"> Treasure technology gap analysis to assess ST and LT debt, cash management and hedging requirements. 	<ul style="list-style-type: none"> Assess adapting existing systems/processes to meet gaps and avoid investment in new systems 	<ul style="list-style-type: none"> Vendor analysis for new system (of necessary) RFP and system selection 	<ul style="list-style-type: none"> System implementation Go live
Human resource	<ul style="list-style-type: none"> Determine Treasury team for merged organization Roles and responsibilities for merger integration initiatives 	<ul style="list-style-type: none"> Rationalize treasury organization Define end state Organization Structure and budget 	<ul style="list-style-type: none"> Confirm roles and responsibilities 	<ul style="list-style-type: none"> Transparent and credible performance evaluation system Performance incentive for Treasury personnel 	<ul style="list-style-type: none"> Attract the best people Regular review and assessment Highly motivated and specialized team

▲ Milestone review

Developing this structure starts with having a broad understanding of NewCo's banking requirements. The first step is to identify the operating accounts needed to sustain local operations. Next, overdraft lines to support these accounts and the need for local letters of credit should be assessed. Bank guarantees may be required to pay taxes mandated by local regulation, and guarantees may be required to secure leases for local properties. Foreign exchange lines also need to be assessed up front.

Once consolidated banking needs are identified, defining specific banking relationship (or relationships) is the next step. Depending on NewCo's credit rating, debt load and financial covenants, banks may not offer the same services and pricing as the former Parent.

This may result in a need to shop around for banking relationships that can provide NewCo's basic requirements and understand the trade-offs. There is a cost to effective liquidity management, but the price does not have to be onerous if you identify critical banking services and augment these with in-house services provided by NewCo personnel (e.g. maintaining a target balance in-country rather than automatically sweeping daily).

Building your internal bank

Ultimately, NewCo's Treasury group should see itself as a value-adding partner to the broader organization that evolves with the company's needs. When a company is domestically focused, Treasury's operations are usually simple, possibly providing a one-bank solution with collections (lockbox) and payments (checks, ACH, wires) as the main operating drivers. However, as NewCo expands, so does the complexity of Treasury's operations, including the ability to adapt to greater risks due to foreign exchange rates, interest rates, and commodity prices. Also, as international operations grow, many intercompany transactions may pass through increasingly complex legal and tax structures.

Treasury is often tasked with executing cash settlements for these transactions, as well as monitoring cash balances for repatriation and providing data to Accounting and Tax for compliance and reporting purposes.

In this more complex environment, you can benefit from having an internal advisor: a Treasury leader who understands NewCo's business and markets and how these are affected by factors managed by Treasury, such as banking and counterparty risk, foreign exchange trends, interest rate fluctuations and working capital techniques. A highly knowledgeable Treasury organization

can allow NewCo to eliminate unnecessary and expensive transactions running through its external banking network (e.g., processing multiple foreign exchange contracts rather than netting and going out to the market with consolidated transactions).

Having this knowledge in-house also can enable NewCo to process in a bank-neutral environment and not be beholden to specific bank relationships

Growing with the business

As NewCo's business grows, Treasury processes should be continually streamlined, and its control structure should be enhanced. If NewCo's treasury needs are basic, using Internet banking portals and certain spreadsheets may be sufficient. However, as NewCo's operations evolve in complexity, NewCo Treasury employees may be challenged with highly manual processes that involve accessing multiple portals, manipulating various complicated spreadsheets and fielding information requests with ad-hoc solutions.

To reduce operational risk and improve efficiency, Treasury leadership should develop a strategic view to transform its operations after Day 1. Mature Treasury organizations utilize effective technology solutions to automate processes, enable straight-through processing, and free up resources to focus on non-repetitive tasks. Such solutions include not only a treasury management system, but also a standardized bank communication approach across the company's banking relationships, sophisticated technology add-ons to address more specialized requirements, and direct interfaces with the company's broader finance and accounting systems. While achieving this level of sophistication is an end-state goal, Treasury management should keep abreast of new solutions that become available and continually update operations using the leading-fit tools which allow it to evolve as the business grows.

Building from a strong foundation

As a newly created entity, leadership might sooner or later be confronted with building a Treasury organization for NewCo. With a Treasury blueprint designed with NewCo's short-term needs and long-term strategy in mind, the process of separating from the Parent can be easier and NewCo may be better positioned to build a solid and capable infrastructure to support the creation of sustainable value.



Contacts

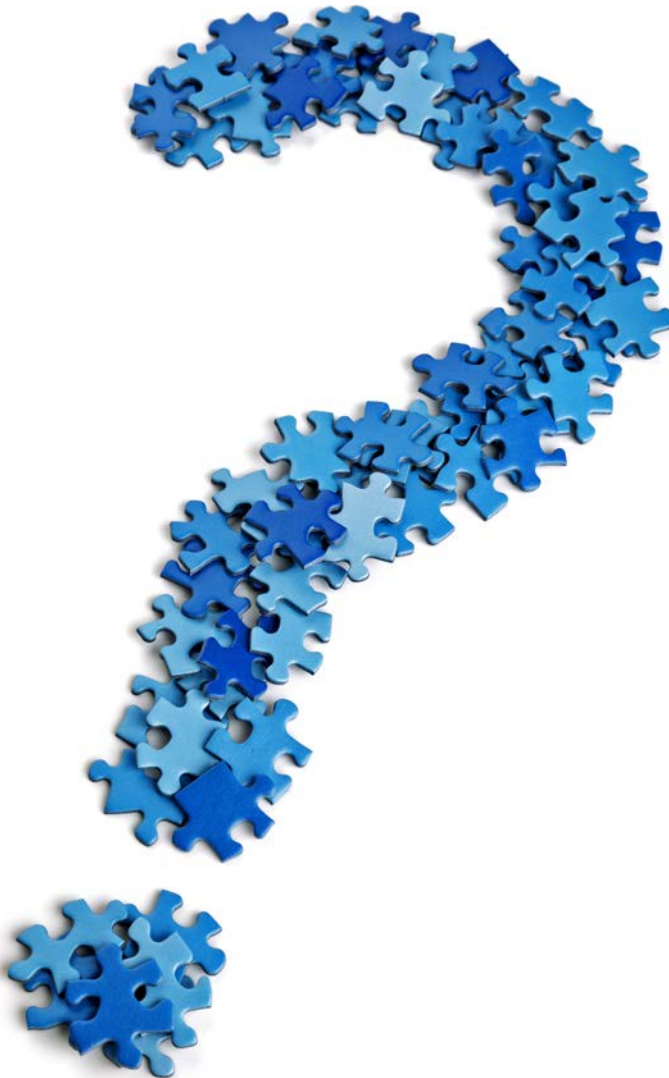
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Five questions every CIO should ask when divesting a business

Introduction

In any large divestiture, some of the hardest jobs fall to the CIO: segregate those corporate systems and services needed by the carved-out business; untangle applications and infrastructure (some of which took years to put together) in a few months; do it without disrupting service to the ongoing business, while often holding or even cutting costs.

Working with companies from every industry, we've seen the same pattern again and again: CIOs end up with their feet in two fires, expected to provide service above and beyond what they're used to for not one, but two organizations. Support the parent company and the divested business; be a profit center and operate on shoestring budget; have a long-term strategic vision; and work at breakneck speed. No wonder "breaking up" can make the CIO feel a little like Dr. Jekyll and Mr. Hyde.

Can anything relieve this pressure? Yes.

First, the CIO's office should be included on the deal team. The expectations put on the Information Technology (IT) organization escalate when Transition Services Agreements (TSA) for the deal are coined. When the CIO is part of the discussion (What can the IT organization reasonably accomplish with current resources? What should the TSA promise? How long should it be in place? What are appropriate rewards/punishments for meeting/missing this timetable?), they can influence the outcome.

Second, in planning for the divestiture, the CIO can ask five critical questions — questions that help frame the IT organization's work, rationalize its use of resources, and direct everyone's efforts toward a directed conclusion.

1. Will the divestiture change the nature of the business and, therefore, the purpose of IT?

Sometimes, the carving out of a business can change the fundamental strategic direction of the ongoing enterprise. In most cases, the strategic intent behind a divestiture is to realign or refocus the business — to do away with noncore businesses and heighten the focus on core businesses. Therefore, the CIO needs to ask, "What are the rightsizing implications?"

For example, a company that had been experimenting with innovation — new products, new markets, or new technologies — might shift gears, deciding to sell off its more aggressive operations and reinvest in its older,

commodity products. The role of IT would radically change, from developing cutting-edge solutions to providing low-cost services for a low-margin business. (Of course, a company could use a divestiture to move in the opposite direction. The impact on IT would likely be just as dramatic.)

The sooner the CIO knows of any strategic shift caused by the divestiture, the better — not only because it would affect choices made during the transition period, but because it would have significant after Day One impacts on resource requirements and utilization, on investments, and on performance expectations and measurements.

Tactical tips

- After a carve-out, the company's footprint will likely shrink materially. IT needs to align or rationalize infrastructure, capacity, and applications to fit the new size and shape of the business.
- To perform the rightsizing analysis early in the planning process, the CIO should engage the business in defining the nature of the company's new business model.
- Rightshoring/offshoring options need to be evaluated with the intent of both reducing the in-house performance of noncore activities and increasing leverage of core activities kept in-house.

2. Should we move the divested business, as fast as possible, from limited to complete separation?

One secret to an effective divestiture is keep the end in mind: What is the immediate and eventual relationship between the seller and the divested business? For the CIO, the ultimate goal is nearly always complete separation (isolation) of the two entities with the timeline being the variable aspect. It is usually in the seller's best interests to support the carved-out business for a while, until the buyer is fully equipped to operate the business. If the seller takes its hands off the carved-out business too soon and the business fails, shareholders will blame the seller.

What's important is a direction for going forward. How will the seller's obligations change over time (Figure 1)? What do both businesses expect from the IT organization at each stage? These expectations, as well as performance metrics, have to be part of the TSA, which should align the goals of the two organizations.

Tactical tips

- If the goal of the divestiture is complete separation as soon as possible, the TSA should be rigid, with escalation clauses that clearly define strict penalties for not adhering to the schedule. Extending the agreement should trigger a hefty surcharge. In pre-sale planning, the seller has responsibility for controlling the outcome of the carve-out.
- Before Day One, all commingled systems and infrastructure should be carved out into separate domains.
- If the separation is not time constrained, and if the seller sees a benefit in supporting the divested business indefinitely, the TSA should be flexible. The schedule for complete separation might be negotiable or even open-ended. The TSA should include extension clauses for services to be provided at fair market value. The TSA should also spell out any activities that could be discounted based on volume and service levels. (Note: In reality, it's uncommon for a seller to opt to become a service provider over the long term.)

Figure 1: IT separation continuum

	Degree of separation →			
	Limited	Logical	Physical	Isolation
Infrastructure	Shared	Shared	Shared/separated	Separated
Applications	Shared	Shared/separated	Separated	Separated
Data	Shared	Shared/separated	Separated	Separated
IT Services	Shared	Shared	Shared	Shared/separated
Access	Open	Constrained	Restricted	Very limited

Source: Deloitte Consulting LLP

While complete separation (isolation) is usually the ultimate goal for the IT organization, an interim “limited or logical” separation is usually necessary when:

- The deal will close quickly (e.g., within three months).
- Confidentiality of parent data/information is not critical.
- The deal is still being developed and/or multiple buyers are being considered.
- The parameters/scope of the deal will develop over time.
- It's important to minimize transition impacts to the divested business.
- The application landscape will likely not change significantly.

For each process or application, IT needs a Day One strategy, an interim strategy, and an exit strategy. The IT organization's position on the spectrum (which changes over time) can affect how data/information is managed, what reports are maintained and generated, and the type and level of service provided.

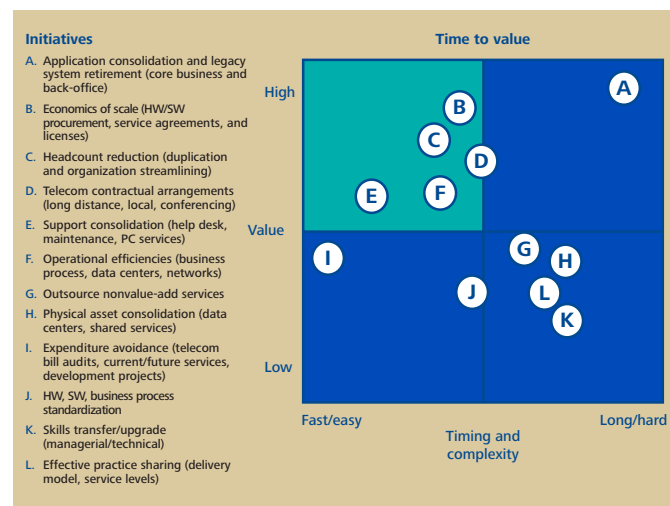
One of the CIO's particular challenges is resource availability and utilization, especially if either business (the original or the divested) is undertaking a major project, such as a systems upgrade, installation, or integration at the same time. Another consideration: the CIO's operating budget. Sometimes, the speed with which the IT organization can move from the far left to the far right of the continuum depends on financial constraints and synergy targets. If the CIO has to cut the budget by 10 percent in six months, that automatically impacts the timetable for achieving isolation.

3. Where can we cut costs?

The rationale behind a divestiture usually includes cost savings, as the business being carved out is typically not an efficient part of the enterprise portfolio. Also, incidental savings — for example, redundant real estate holdings or IT infrastructure consolidation — can become possible as a result of the divestiture.

The sooner the CIO can calculate potential savings, the better. Foresight about ongoing operating costs is necessary for the IT organization to continue to work with fewer resources. What can be done, realistically and reasonably? The IT organization should answer that question by analyzing the value of various possible

Figure 2: IT synergy opportunities and priorities



Source: Deloitte Consulting LLP

Observations

- In many cases, the quickest and highest impact synergies in IT are decisions NOT to do something — canceling duplicate projects is quick and can have significant short-term cost savings
- Once a common infrastructure standard is selected, implementing consolidation is relatively quick — the key is making the decision on standards quickly and early in the process
- Application consolidation and legacy system retirement are the hardest and most time consuming to integrate, but offer “by far” the highest value
- Standardized technology and business processes are a fundamental enabler for IT integration
- Forward-thinking IT organization have performance-driven cultures and a strong focus on continuous improvement. Metrics should be balanced, promote accountability, and effectively reflect the status of the IT organization



Technique	Advantages	Disadvantages	Cost savings/Risk	
Clone-and-go Set up a copy of production/application on a separate instance; operational Day One	Time-efficient solution; incorporates flexibility needed for “moving” divestiture	Sensitive data might be exposed to the buyer	High	High
Clone, vitiate, and go Clone copy, clean out sensitive data (legal and competitive), release for production use	Competitively sensitive data is masked from the buyer; incorporates flexibility; is operational Day One	Requires more time than clone-and-go	Low	Low
Copy, configure, and load Create a configuration only copy of application, then load relevant master and transactional data onto new/separate instance	Outcome is predictable; know-how for doing this is widely available	Longest timeline; scope needs to be static; more expensive	High	Low
Extract and go Extract data from production systems, put in flat file, and hand over to buyer	Quick and easy for seller; low-cost option	Potentially nonviable option for the buyer (may not have an operational business on Day One); significant pressure on buyer to keep the business operational during the transition	Low	High
Give and go Hand off production system to buyer	Buyer is operational Day One with a system that is familiar; users are comfortable; seller costs drop immediately	Deal will involve personnel seller will no longer have access to historical data; potentially sensitive data will be left in the system	Low	High
Hybrid Choose different techniques for different application suites	Overall risk is better managed; more options to effectively get to day on	Requires detailed planning early on for each suite; business participation is increased	Medium	Medium

Source: Deloitte Consulting LLP

Tactical tips

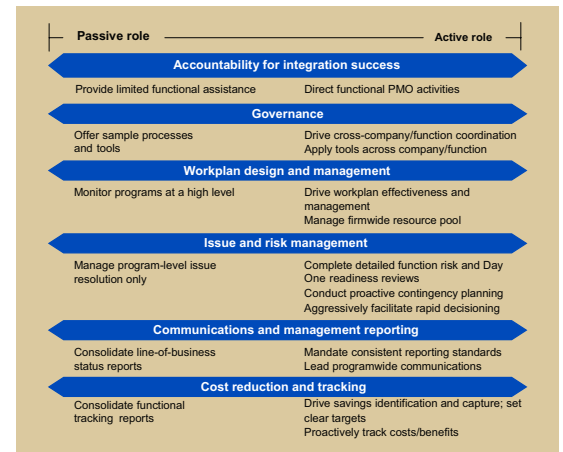
- Most deals have top-line synergy targets. The CIO should hold a series of blueprinting workshops to identify the bottom-up opportunities to capture synergies by function, by application, by infrastructure, and by activity. (For insights about blueprinting, read the article “A new house begins with a blueprint” by Anna Lea Doyle, principal, and Mark Walsh, principal, Deloitte Consulting LLP). Blueprinting also allows the CIO to prioritize projects, again with synergy capture as the driver.
- For large applications with significant associated costs, these carve-out techniques should be evaluated.
- Benchmarking should be taken with a grain of salt. While an IT cost model addresses the value of IT assets relative to their costs, the actual importance of any given IT asset varies by a company’s industry, revenue, number of employees, and other factors. That’s why benchmarking, while a great tool for promoting creativity, should not be considered the source for “black and white” metrics.

4. How can we effectively manage the timetables and risks of the divestiture process?

In the typical carve-out, time frames are shorter, the scope of activities is bigger, the number of stakeholders is larger, and the risks are greater than the IT organization’s comfort level. Hence, the need for a separation management office (SMO) modeled on a program management organization (PMO).

There are two possible types of PMO: decentralized (passive) and command-and-control (active), as shown in Figure 3. For an SMO, the latter — the command-and-control model — is required because of the high risks of the deal. The SMO has to be involved in every aspect of the carve-out planning and execution — not from a status-gathering perspective but from a work-enabling perspective.

Figure 3: PMO roles and responsibilities of two models



Source: Deloitte Consulting LLP

Early on, the SMO answers questions like:

- What are the critical IT activities that must be prioritized for immediate implementation?
- What tools and techniques can be leveraged to accelerate transition planning activities?
- How can the integrating firms enable rapid decision making?

The command-and-control model used in a divestiture should include guidelines on the appropriate depth of planning and plan maintenance, a fast-track mechanism for problem solving or issue escalation, and the definition of penalties for decisions not made. For example, in one deal the steering committee was told that if it could not make a decision within 48 hours, one of the members would have to buy dinner for the entire SMO team.

Tactical tips

- The SMO should be more content-heavy and less status reporting-heavy. While many management offices focus on weekly status reports, the SMO is all about understanding the carve-out technique, identifying roadblocks, making decisions, expediting processes, and keeping momentum moving forward.
- During pre-planning, the use of a “clean room” can help direct the team down the appropriate path.
- The surfacing of issues should be rewarded, not penalized. (Everybody can use another iPod). Change should be embraced and encouraged; status quo should be discouraged.
- The steering committee’s role is to enable efficient and effective decision making.

5. What are ways to retain key talent for the future?

Of course, one of the greatest risks in a divestiture is that the parent company will lose people whose knowledge and skills are necessary to operations after Day One. Well-planned communications and retention strategies can diminish the negative impact.

Tactical tips

- Very early in the process, the CIO needs a detailed analysis of skills required for achieving the desired outcome (not just technical skills, but interpersonal skills) and the names of the people with these skills. Are the right people available inside the company? Will the IT organization have these skills after the carve-out? Also, the CIO will want to determine a mix of full-time equivalent and external resources right for the future operating model.
- The CIO should establish a separate contract approval process for HR retention bonuses. Innovative retention techniques can also include new job descriptions, roles, and responsibilities. In fact, an emotional appeal is typically more effective than a financial incentive.
- Clear and consistent communication can help reduce the number of critical employees that leave during the transition period, can foster commitment to the change and the new organization, and can build support and trust. Town hall meetings are a good, open format for communicating decisions that have been made (and not made), including timelines. The CIO should communicate widely and often; interactive decision-making is highly encouraged.

After the break-up, life goes on.

A divestiture is hard on an IT organization — no question about that. Being prepared will help ease the pain all around. These five questions point to an underlying truth: Good planning and IT participation can make all the difference.

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Deloitte.

13 tips for carving out an IT function



Introduction

The rumors are true: Your division is being carved out. It's time to move! (Does that make you panic?)

No matter the size and complexity of a carve-out, the list of Information Technology (IT) related activities that need to be completed quickly is long and urgent. If you have never gone through a carve-out, you'll have more questions than answers. And the clock will be ticking.

The experience of a carve-out is a lot like your parents letting you know it's time to move out. Can you make it on your own? The goal of moving out — whether from your parents' house or from your parent company's shelter — is to achieve long-term prosperity with limited short-term pain and failures. You should consider whether our transition tips can help.

1. Take control of your destiny

Do lots We have all heard the adage: "Control your own destiny or someone else will." As you will likely learn, there are a lot of different ways to plan and execute an IT carve-out. Since you're the one who will have to live with the consequences of the planning and execution activities, set up the effort for positive results by establishing an aggressive "command and control" IT program management office (IT PMO), closely aligned with the overall program PMO.

The IT PMO must be more than just status reports and issues logs. It should serve as your vehicle to actively plan and manage the carve-out from an IT perspective. Our evaluation of 17 M&A IT transactions illustrated to us the importance of an IT PMO in key carve-out activities, including Day One and end-state requirements gathering (blueprinting), IT synergy identification and capture, carve-out work plan development, and rapid decision facilitation.

Unlike many other events in a company's life, a carve-out can change many if not all of the "value levers" of the business — and most of the movement impacts or is dependent on IT. If IT is not at the table to help to shape the future, then gaps and disconnects are very likely.

2. Do lots of planning before you agree to move out (don't reserve the moving truck just yet)

IT is typically the largest synergy-enabler in M&A transactions. In addition, IT is also usually the "long pole in the tent" in carve-out planning and execution. Yet,

from our experience, IT is often the last to know about a transaction and is left out of the early due diligence and planning activities. To position your organization for positive M&A carve-out results, you need to raise the yellow flag as early as possible — before a transaction is contemplated — so that IT is included from the conceptual stage of the deal.

IT may not seem important to the business development group or deal team, but IT is quite often material to the deal's costs and timeline. If the IT infrastructure, applications, and organization are tightly integrated (or even partially integrated) with the parent company, the carve-out will likely take significant time, resources, and money. Before you even think about renting a moving truck (or letting your deal team sign a letter of intent), carefully think through the most efficient and cost-effective way to conduct the carve-out to meet the Day One close date, as well as to expedite full separation thereafter.

There are many short-term and long-term IT application carve-out options, from transition services agreements (TSAs), clone-and-go, give-and-go, extract-and-go, to new build. Advanced planning, before a letter of intent is signed, can provide significant benefits since, at that time, more cost-effective options are still available, alternatives to jump-start detailed planning can still be pursued, and material timing and cost implications can be incorporated into the valuation model.

The last thing you want is the moving truck in the driveway before you have finished packing.

3. Read the lease carefully before you sign it

Believe it or not, we have found that, in many cases, the scope of an IT-related carve-out is agreed to by the deal team and legal counsel before the CIO even knows a deal is in the works. Although the deal team and legal counsel can have the best of intentions, they rarely have a clear understanding of the impact that offering memoranda and purchase agreement language have on IT planning and execution activities. For one thing, when it comes to IT, many of the promises are vague or not achievable tactically. For example, with regard to ownership of IT assets (e.g., applications, hardware, software, and licenses) and of setup and exit activities, legal language is typically kept to a theoretical level that is often difficult to interpret. If there are a lot of shared assets, the picture is even more complex.



To effectively position your organization for positive results, develop a relationship with one of your attorneys (no, there is no lawyer joke following this statement). The deal attorneys clearly want to make the legal documents as clear as possible. By building an alliance with them early in the process, you can share your ideas, answer key questions, and express your concerns. Your goal should be to help include language that eliminates confusion, keeping your overall strategy in mind, while you still have some negotiating leverage.

4. Think through all of your options; don't rule anything out

When you are making large-scale changes in an M&A environment, both operational and financial, in a very short time frame, the rules will change. During a carve-out, replicating current operations probably should not be the answer. But before you can begin to paint a picture of your future IT organization, you must first establish and understand the basic guiding principles and constraints (overall and IT-specific) for the carve-out. The delivery options typically viewed as taboo yesterday (e.g., IT outsourcing, less scope, offshoring, reduced functionality, or buy versus lease) may be the only viable answers tomorrow. Don't rule anything out!

Actively encourage your internal business and IT resources and your external relationships to challenge the status quo: "Think out of the box" and diligently brainstorm how you can create the desired future state. In IT carve-out situations, it is often easiest to start with the minimum mandatory IT requirements and build from there. For example, what is the required applications functionality for the business to continue operations and hit the future business goals? What are the mandatory IT infrastructure requirements to support the business? What are the most cost-effective methods of delivery? While questions like these can create some difficult dialogue between the business and IT, they're absolutely necessary to achieve the carve-out goals. If the business (the entire business) and IT can join forces and stay "connected at the hip" to challenge the status quo and lay the foundation for change, the carve-out can truly represent a significant opportunity for the organization.

Ten times a day ask yourself, "How are we possibly going to get this much work done in the time allotted?" Regardless of your carve-out plan, there will be a lot of parallel work and an aggressive timeline. The IT PMO (see

tip number one above) must play a key role in laying out the plan, identifying cross-functional and cross-project dependencies, and helping to orchestrate the program. Everyone must understand the timeline and commit to getting their piece of the puzzle done. The speed and multiple parallel moving pieces associated with an IT carve-out are typically very difficult for IT outsource providers to deal with using their standard processes. If your activities involve IT outsourcing, take the necessary steps to prepare the outsourcer to accelerate standard processes and approval procedures to enable an aggressive timeline.

5. Convince your parents to let you take what you need (and nothing more)

See the moving truck filled with furniture? The carve-out is one of the most important moves of your life. To achieve the benefits of this tip, you will need to start thinking early about your "wish list" to be put into the deal documents. But be careful: Don't ask for everything you could possibly take (e.g., people, assets, applications, infrastructure components, historical data, licenses, TSA set-up and exit, and knowledge transfer services). Rather, keep it simple. Ask only for 1) what you truly need, 2) what you can afford; and 3) what will help your budget regarding carve-out set and/or run costs later. You'll want to ask for more, but avoid the urge with one major exception: free services.

One common issue of contention should be addressed early, and that is the separation of shared assets (e.g., people, hardware, software, application, telephone switches, licenses, etc.). To reduce the cost, risk, and arguments created by these situations, gain clean agreement and then document a tactically possible approach (don't forget to agree on who will pay the costs). This topic may seem trivial, but it's a fight-starter on almost every deal.

Another often overlooked item in this area is TSA exit support. There usually is a major focus on getting to Day One and setting up the required TSAs, but most CIOs don't think about securing TSA exit support from their parent while they still have some leverage. To position your organization for a rapid and cost-effective TSA exit and transition, before the deal closes you must discuss, document, and agree to all the services and help you will need (from pre-Day One through the end of the TSA period and beyond). Once the transaction closes, you will

lose negotiation leverage and be at the mercy of your former parent to set terms and conditions.

6. Be prepared to eat lots of soup

Eating soup is not bad if you like soup. But if you're used to drinking fine wine and eating filet mignon, soup will be thin fare indeed. Since most carve-outs involve separating a business from a larger parent — a parent with deep pockets — you should be prepared to make significant changes to your expectations. As a CIO, one of the first things you will need to do is identify your likely going-forward IT budget. It's likely that your new budget will be a fraction of your old one, and you'll quickly realize that backing into the budget on a short-term basis is extremely difficult, if not impossible. There are, however, a number of key things you should consider to improve your position:

See tip number 4. You will absolutely need the flexibility and cost relief.

See tip number 5. You will need short-term help. It's better to have used furniture than no furniture at all.

Put on your scope control hat and take your relationships with the CEO and CFO to another level.

Given budget constraints, you will need to work with your IT leadership team and the business leadership team to evaluate and rationalize IT scope. Keep it simple. Strive for plain "vanilla" implementations wherever possible. Be ruthless with scope. Every request for non-standard functionality should require close scrutiny and approval. If you set an example early in the process and keep the scope tight, the requests will slow over time. But you can't do it alone. You'll need a lot of help from the CEO and CFO to set the stage for the organization to "think lean": everyone needs to understand that for the carved-out organization to be successful, it won't be able to afford a lot of IT bells and whistles.

Enlist the help of your external relationships. In most carve-out situations, there is a need for some external resources to help meet short-term IT budget requirements. (But if you don't ask for help, you will absolutely not get it.) This help can and should take many forms: IT procurement pricing discounts, contractor and consultant price reductions, software leasing versus buying, spreading carve-out set-up cost payment over an extended period of time; potentially back-end loaded to a period where you can better afford payment, to name a few.

Plan for the depreciation bubble. In most cases, IT carve-outs require significant one-time setup costs (e.g., IT infrastructure setup, equipment purchase, ERP implementation). All of these present CIOs with yet another budget challenge: the depreciation bubble. Given the constraints of the typical IT carve-out, there is little CIOs can do to avoid the bubble, but there are some tips you should consider to help reduce its impact on your short-term budget: for example, you can make new decisions about leasing versus buying hardware and software, leasing existing data center space versus building new, transferring existing software licenses from your parent, and taking existing fully depreciated PCs from your parent. While there are no silver bullets in this area, if you're aware of the bubble and manage it, you have a fighting chance to hit your budget.

The CIO can pull a lot of internal and external levers to achieve short- and long-term budget requirements. You still might have to eat soup most days, but at least you will have the chance to splurge once in a while down the road.

7. Make sure your parents commit to giving you a lot of help initially (you will likely need it)

If your IT operations are heavily integrated with your parents and if you have an aggressive close window, you will likely need transition service agreements (TSAs) for a short period of time (typically 6 to 12 months). The development of the TSAs should be viewed as a critical strategic instrument. They are important for two reasons:

First, they will have a major impact on the effectiveness of Day One. If the TSA services are not ready and done correctly, you will have a major problem as a separate entity and your business may be put at risk.

Second, they are a vehicle for efficiently migrating to the future state. If the TSA period is bumpy, chances are your migration to the end-state will be difficult as well. Here, your best defense is a strong offense: The party that drives the TSA development usually ends up in a better position from a service delivery and pricing perspective.

You can and should play a major role in the development of the TSAs in the following areas:

Service definition. Even though the TSAs are legal documents, you and your team (not the attorneys) should provide the most important input. Play a leadership role in identifying and clearly documenting the short-term services



you need. Make sure the services are clearly spelled out in the document. If the service request is vague, it will likely lead to contention later. Gain clear agreement in writing while you still have some negotiating leverage.

Service levels. Chances are your parent is not set up to be a service provider and cannot routinely provide the performance metrics of a typical outsourcer. But that should not prevent you from demanding specific service levels to keep your business running efficiently for the TSA duration period. Make sure appropriate monitoring and issue resolution processes and tools are put in place so you can protect your business. You'll be happy you pushed this issue if you do have a problem later.

Duration. In most cases, you will want to limit the duration of the TSAs for cost and risk reasons (not to mention the fact that your parent will not want to be in the service provider business any longer than it must). Be careful, however, to make sure the TSA duration gives you and your team enough time to unwind the TSAs and smoothly transition to the exit solution. If you don't build in enough time, you may find yourself implementing a less effective solution and spending extra money just to hit your deadline. Set an aggressive, but achievable, timeline for TSA exit.

Pricing. Negotiate the TSA pricing as early as possible, certainly before the deal is signed. If you wait too long, you will lose your negotiating leverage. Nobody will want to delay deal closure because the CIO can't achieve favorable TSA pricing. The TSA pricing will be a rounding error for the overall deal, but it could be a showstopper for your short-term run rate.

Exit-cost relief. A key strategic component of the TSA pricing is exit-cost relief. You will likely exit the TSA in phases, so you need to address the cost relief issue early and clearly. A well-schooled seller will give you cost relief only when the total TSA is exited. Be aware of this issue or you might pay double for services.

Exit support. The last consideration is exit support (often overlooked, but very important). If you have a well-thought-out TSA exit solution, but don't have the migration or knowledge transfer support available from your parent, you will have a major problem. Before you sign any TSAs, make sure you and your team clearly think through how you will exit from the TSAs and what support

you will need from your parent. Also, identify who will bear the cost of migration activities. In most cases, the exit costs can be material. Try to make your parent bear the cost of the exit support. The parent wants to close the deal, so usually that strategy will work.

8. Expect to wait until your parents' cribbage game is finished before they will return your calls

Expect your relationship to change. When you were a child, your parents responded immediately to your requests. Once you move out of the house, you might not get the same attention. The pattern is no different for IT carve-outs.

When you are owned by the parent and contributing to the profit and loss, you are a top priority. When you are a carve-out, your position on the priority list will drop, sometimes dramatically. To protect yourself from the changing relationship, do your due diligence, planning, and negotiations immediately. Your best friends today may not even answer your calls tomorrow. The people left behind at the parent company have bosses to please and — guess what — your priorities aren't theirs anymore. Also, your parent's memory is not what it used to be. Get everything in writing (even if it's just in an e-mail). If you have a disagreement after the close and you don't have promises and agreements in writing, chances are you'll have a battle on your hands.

9. Stay close to your best friends

The one characteristic of every effective IT carve-out is the strong relationship and alignment between the business and IT. To be effective, IT must stay "attached at the hip" with the business (your best friends). In designing a blueprint for the future, the business and IT need to spend quality time together, function by function, process by process. As you discuss future operations from three perspectives — people, processes, and systems — given carve-out and budget constraints, you will need to pull multiple levers and make some difficult decisions to achieve your goals. If you complete the process together, collaboratively, you will reach your goals with a clearer understanding of why decisions were made, why scope elements were eliminated, and how you can work together to make the blueprint work.

Don't be afraid to lead and teach the business. The typical IT organization thinks in "MS project" mode that's all about projects, planning, and execution. The typical business function doesn't. If you help the business through the planning process, you will have joint ownership of the plan and joint ownership of implementation results.

10. Choose your roommates carefully

Effectively completing a carve-out is difficult. If you don't have the right team (the right roommates), it can be impossible. One of the first tasks that you should work on is picking people who have the right skills, the right experience, and the right caliber. You probably won't be able to take all of the A players with you, but don't settle for a cast of C players. If there are A players critical to your business, fight for them. If you believe your parent is using the carve-out as an opportunity to clean house (yes, this does happen), demand the names be removed from the transfer list. If you accept surplus resources today, you'll bear the cost of addressing the situation later.

If you can't find the right employees in the parent organization, don't be afraid to look externally. In many carve-out situations, the role of IT changes dramatically and the skills to support the new operation may not reside in the company. For example, if you're moving from an internal-oriented IT environment to a largely outsourced environment, your team may require new and different skills and experiences.

Don't be afraid to let go of some parts of your past. You need to design and staff for the future.

11. Paint a picture of how great your independent life (freedom) will be

The good news is the carve-out could position IT to reach new heights; the bad news (real or perceived) is you will no longer be part of a larger organization (with all the perks). Some of your A players may not want to go with the transaction, because they can't see the upside or don't want to take the risk of working for a smaller company. You will need to become a sales person. To recruit and retain high-caliber staff, you will need to convince them of the opportunity. This may be difficult (especially if you also feel some reluctance), but the organization's long-term results will depend on your ability to create and sell the future vision.

12. Set an aggressive, but achievable, plan to reach your goals

M&A IT is different from most IT projects. Due to hyperaggressive transaction milestones, it is usually not an option to complete rationale project planning. In most IT projects, you lay out the work, estimate the time required to complete the work, and arrive at a go-live date. For carve-out projects, the timeline is typically driven by the deal team, which wants to close the deal quickly. In most cases, the idea that "time is money" drives the Day One timeline. In addition, the final separation/TSA exit date is heavily influenced by the seller (which typically wants to cut off support as soon as possible to limit risks and distractions).

Be ready to plan to very aggressive (sometimes seemingly irrational) timelines. Think and act creatively. Backward scheduling will become your new forte. You are not the first CIO to be put in this position, so leverage lessons learned and strategies from experienced people. Every deal is unique, but there is no reason to reinvent the wheel. Ask consultants for some tips (it won't cost you a dime to ask);





they're usually more than willing to share war stories, and you may just find the one idea that you were searching for.

13. Be prepared to please the boss (there's always a boss!)

Regardless of the type of transaction — a purchase by a strategic buyer or a purchase by a private equity firm, sovereign wealth fund, or IPO — one thing is clear: You will have a new boss. Your new boss's expectations will likely be very different from your old boss's. Find out what makes the boss tick early on, and then make sure your goals align with his or her goals. The early days of the carve-out (even before the deal is closed) will be your tryout; as long as you are aware of that fact and leverage the tips outlined above, you will position yourself and your team to start out strong.

Leaving the nest is difficult, but the rewards can be great. Sure, you'll have to take a few risks, and you will hit some bad weather on your journey (you can't cross the ocean without losing sight of land). But if you leverage these tips from people that have made the trip before you, you will have a much better chance of achieving excellent results.

Good luck, and have some fun along the way.

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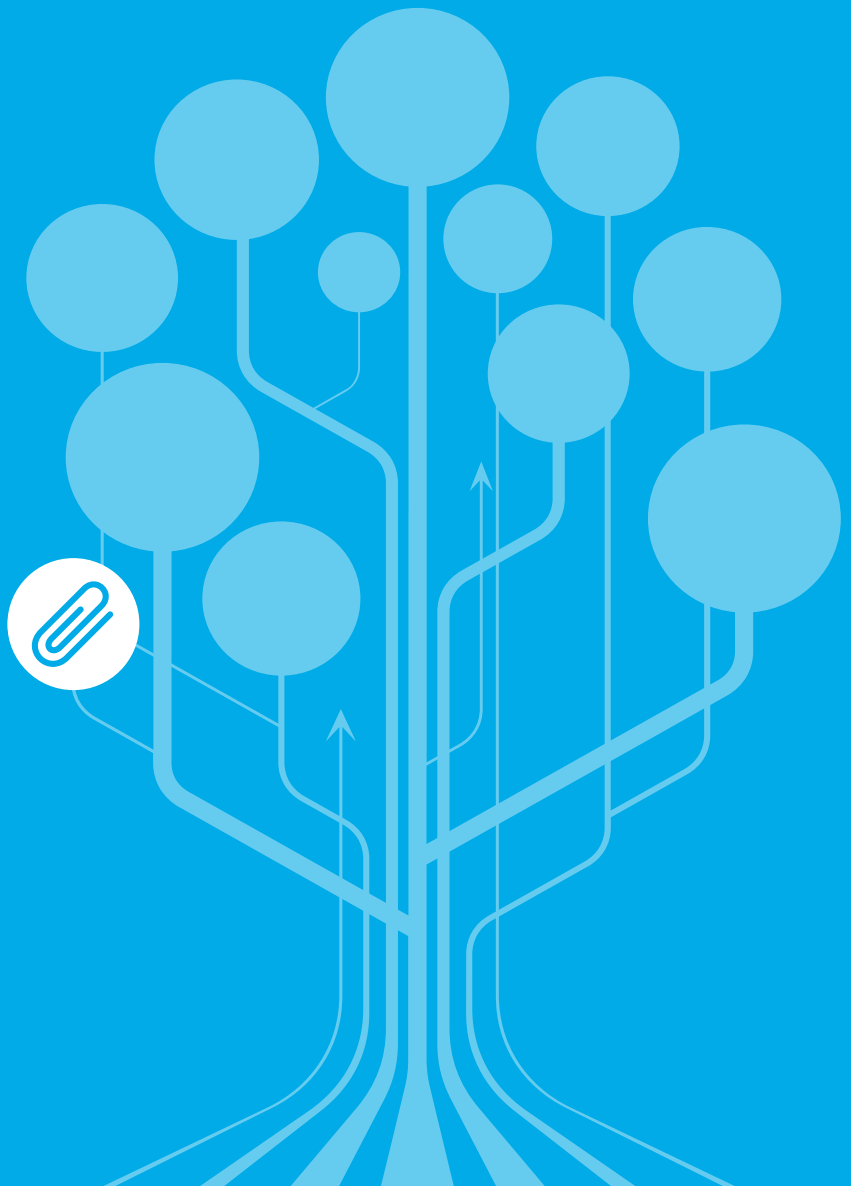
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Epilogue





Epilogue

Divestitures are not simply merger integration in reverse, they are a complex endeavor often involving both breaking things apart and pulling the remaining pieces together into a cohesive and stronger entity. It takes constant discipline, careful planning and rigorous execution to successfully navigate the risks to both buyer and seller, while staying relentlessly focused on capturing value. There is nothing simple about divestitures, but having a robust plan, clearly defined end-state and knowledgeable team can help minimize transition costs and increase transaction speed.

Deloitte is a leading, global divestiture advisor and has developed a proprietary divestiture methodology that uses our cumulative experience from more than 1,000 transactions. Deloitte has advised many of the world's leading companies through large, complex divestitures by helping them reduce risk, accelerate separation timing, and protect the value of both the divested entity and the parent company. Whether they are sellers, buyers, or part of a business unit changing hands, Deloitte's comprehensive approach can help business leaders confront the key challenges across the divestiture lifecycle.



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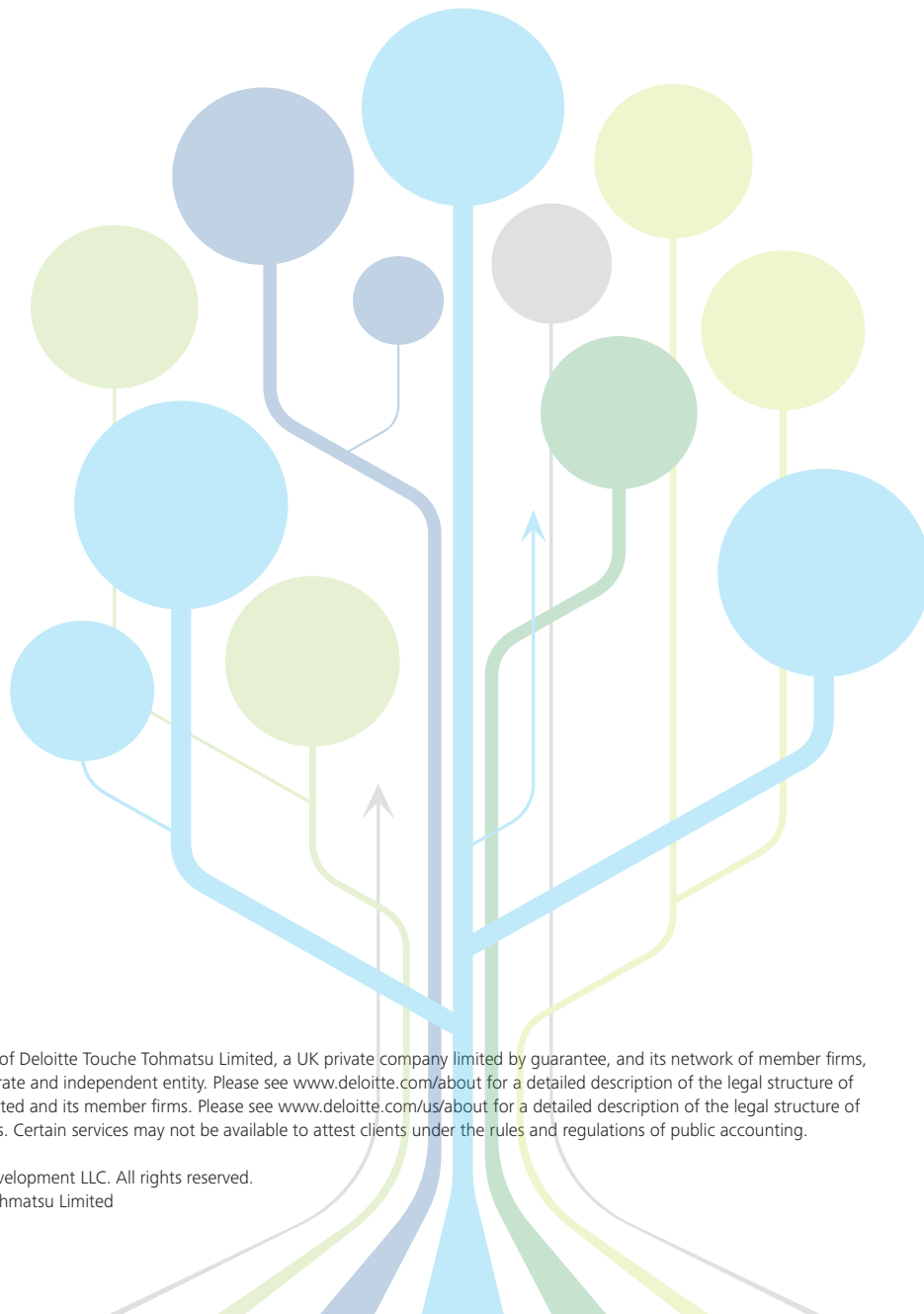
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