Deloitte M&A Views podcast:
Controlling spin-off costs

Transcript

Greg: Welcome to Deloitte M&A Views, a Deloitte podcast series exploring the latest trends and topics in mergers and acquisitions. Today, the topic is spin-offs—the uncertainty, the costs, how to plan for and control both. We are joined by Deloitte's Jason Asper to discuss what to expect when planning for spin-offs.

Jason, appreciate you spending some time with us today to talk about spin-offs and divestitures, more specifically about their costs and the impact. I know this is a big deal for many of those listening since both are so hot right now. Everyone wants to know what they may be getting into, and let's get to it. So, say you're interested in pursuing a spin-off, just as one option among several potential deal models. What should you be anticipating in terms of costs?

Jason: Great, and thank you. Happy to be speaking with you today and share some perspectives. And that's a great question. We get this question quite often as our clients are considering a strategic transaction. I would highlight, the cost in general is a broad category, and I would typically think about cost in three major buckets. First, transaction—so think financing, tax, and legal fees. Secondly, in terms of separation costs, these are typically functional costs: IT, HR, and operations. And thirdly, employee-related costs, which can be structuring, severance, relocation, or other costs related to employees. To answer your question directly, there are no absolute rules for costs for a spin-off. However, when you look at a number of deals—and we've done some analysis on several deals over the past several years—we generally experience that costs are in the range of 4 percent to 8 percent of the spin company entity revenue. So there's no exact science to this and, in fact, each deal has its own complexity and variables that make it unique. But, typically, you can expect somewhere in the range of 4 to 8 percent of spin company revenues.

Greg: Got it, Jason. So what's driving these costs? What's behind them? Because I think if you want to have a fighting chance to better manage and minimize the costs, you need to know what's behind it all.

Jason: You need to look at those three buckets of costs that we talked about earlier, in the context of complexity. So let's start off with transaction costs. A key complexity driver for the transaction itself is focused around the complexity of the structure of the deal. It's around the number of jurisdictions and legal entities. And/or may be related to the complexity of the financing requirements in order to affect the spin-off. That's the complexity around the transaction bucket.

Around separation, the main driver of costs in a separation is led by the level of entanglement with the parent. Think about the IT systems, the finance systems and operations, the shared services. The level of entanglement between the two companies will really drive much of the complexity there, as well as the number of markets in geographic reach. If you have a company that's all US-based, and even though it may be fully integrated with the parent and the spin company, it's a little bit easier than a company that's planning to spin-off an entity or a company that has business in 40 different markets. So those are the two drivers in the separation cost bucket, and as I said, key drivers within that would be the level of co-mingled sales and commercial teams, the level of manufacturing and warehouse integration, as well as other functional and IT integration. Of course, as many know, ERP (enterprise resource planning) is often a big cost driver in any transformational program and certainly relevant here in a spin-off. The net of that is really the more integrated the business, the more complexities involved and the associated cost.

In the last bucket, the employee-related cost, that's really driven by the level of change in restructuring involved in the spin-off. Key drivers would be the reorganization to be able to affect this spin, or it might be the management of stranded costs. Sometimes when you spin-off a company, you're left with a huge infrastructure that's just not right-sized for the new parent company going forward. And other times, as you do with spin, the company wants to change the headquarters. Maybe it's better for growth to be in a certain geographic region, or the talent is better. So those are a number of drivers that can really drive the total cost of the transaction. In summary, you have these three buckets and there are drivers within each of them that can really make a big difference on the cost profile of the deal.

Greg: Jason, would it be useful to think in terms of phases (pre-close, post-close)? Is that helpful in a practical sort of way?

Jason: Yes, of course. And this relates to my earlier point around strategy and how the approach can make a difference on costs. We discussed that costs are often driven by complexity, but they're also driven, at least when looking at pre-close versus post-close, by the approach and strategy taken toward the spin. Let's discuss two examples and look at company A and company B.

Company A is focused on spinning off a division and really wants to reduce the burden of the parent company and minimize the cost in capital to close the transaction. In this case, the parent company when spinning off the entity will probably rely heavily on TSAs (transaction service agreements) or commercial agreements, but the ultimate result is that the two businesses will be quite integrated post-close. So, in essence, they can minimize the cost to separate pre-close, but they're going to make some tradeoffs, in that, as they get too close and look forward as two companies, they're going to be heavily integrated for a period of time. And, in fact, some of those costs will still be there as they have to split the company later.

Let's compare that to company B, who is really focused on restructuring their business prior to the spin-off to allow both companies the flexibility and readiness to drive business priorities following the spin. And there're some great examples of companies today that are using the spin-off to both drive change in the parent company as well as the spin company entity. These companies are very proactively making significant changes before the spin, and thus have a higher profile on the cost. So it's a bit more complex than these simple examples, but the point is, the strategy can have an impact on the total cost, but also on the timing of the cost. That said, I always encourage my clients to think about the total cost to separate. There are a number of strategic tradeoffs as you think about cost and spending in pre-close and post-close, but at the end of the day you really should think about the total cost of the program too, for the eventual separation. Then think about your strategic business priorities, and make those tradeoffs as it relates to cost.

Greg: So Jason, you talked a little bit earlier about buckets, and it sounds like it's going to cost us a bucket of capital in order to be able to do this sort of thing. Is there really any reasonable way that we can ameliorate these costs—that we can lower our expenses?

Jason: Certainly. There are ways to manage the costs on the spin-off and we discussed this broadly in the context of the approach and strategy. However, there are a number of specific levers, or areas of focus, that are also helpful to consider in line with the strategy. To highlight a few of them, first you want to focus around aligning the teams up front on strong guiding principles in alignment to the strategy and approach. The more the teams turn on decisions and approach, the more costs will escalate. Secondly, you really want to focus to utilize your top performers and employee base. Leveraging dedicated internal resources where possible will help to minimize external costs and drive progress. Thirdly, consider your go-to-market model and opportunities to leverage that model. When a lot of companies do a spin-off, they recognize that, particularly outside the US, they don't have the scale to be effective or to be profitable in X US countries, and some companies take the approach of 'just replicate whatever we have today.' Other companies take the opportunity to maximize, or optimize I should say, their channel and might decide to go to a distributor in one market. Or maybe it's not profitable to be in that market as a spin company. So, take the opportunity to look at the strategy, and the markets that you're in, and make sure that it aligns and is worth the cost to replicate what you have today.

The last two points I would say, like we talked about in the strategy, you can leverage your TSAs to reduce the upfront costs. Now you have to be a little bit careful about that because that creates some other strategic tradeoffs, and eventually you have to separate the business, so to some extent that's a delay of the cost as opposed to a total cost reduction. And then the last thing I would say is you really need to focus around strong program governance and cost management. And this is true with anything: the more you focus and provide visibility of the cost, the better that you can manage the cost. In summary, there are a number of areas that you can focus on to manage the cost of the spin. I think the most important aspect is to align the strategy with the objectives and goals of managing the cost, and to proactively put in place the structure and key levers to manage the cost during the implementation.

Greg: I'm Greg Jarrett and thanks for listening to Deloitte M&A Views, sponsored by Deloitte's M&A Institute. We release a new podcast once a month, and if you subscribe, you won't miss a single one. To stay connected and receive more information on Deloitte M&A service offerings, visit www.deloitte.com/us/masubscribe and follow us on twitter @DeloitteMnA. Until next time!