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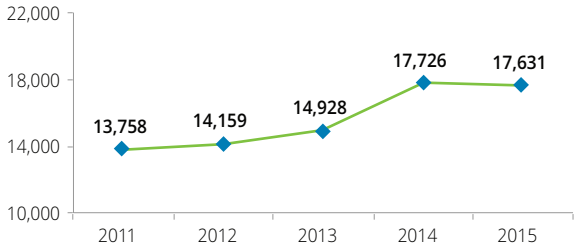
Outsourcing the M&A back-office headache: Opting out of TSAs and in-house integration

During Mergers & Acquisitions (M&A) there is a need for efficiently integrating multiple back-office functions post transition. Through this paper, we provide a perspective on how outsourcing can create value during the integration of services following two important types of M&A transactions: divestitures and acquisitions. From our experience helping our clients to execute multiple projects, we describe the advantages that outsourcing can deliver during these transactions.

Global M&A landscape

Global M&A transactions have seen a significant increase in volume over the last five years, rising to over 17,500 deals in 2015, indicating a growth of 28% from 2011[1].

Figure 1: Volume of global M&A deals (includes deals with undisclosed value)[1]



By sector[2]

- Technology was the most active sector in terms of deal activity in 2015, ranking as the top industry for the second consecutive year
- Energy, powered by the oil and gas subsector, surged to second in the ranks of the most likely areas for consolidation
- The healthcare providers and plans space stood as the third most active sector

By market[2]

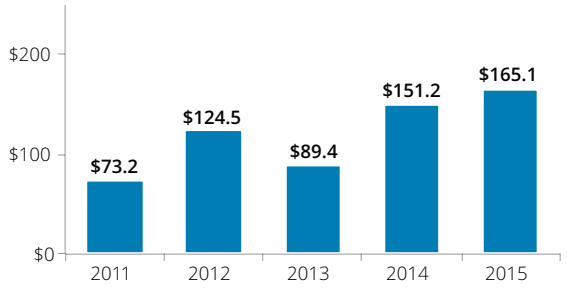
- China, Canada and UK were the top foreign market choices for expansion
- Several developing markets like Brazil, Mexico, and India ranked in the next batch of targeted countries for expansion

Divestitures

Overview

In Deloitte's 2016 M&A survey[2], a high percentage (52%) of corporate respondents reported that they anticipate shedding a business in forthcoming years. The survey further suggests that "releasing non-core assets" and "market change (countering competitor tactics)" are main drivers of this trend.

Figure 2: Globally announced divestiture deal value (USD B)[1]



Globally, the total value of divestiture transactions has been significant in the last 5 years (2011–2015), averaging $120B annually.

Need for continued services post divestiture

The transactions we focus on here are divestitures where the parent company ("Seller") sells a specific business unit or entity ("Business") to another company ("Buyer") for strategic/financial reasons.

While the benefit from scale of services being provided is reduced/lost post divestiture, there is a need to provide continued support for multiple back-office functions in most transactions. Traditionally, Transition Service Agreements (TSA) have been used to provide this support.

[1] Mergermarket Database

[2] Deloitte M&A Trends Report 2016

TSAs—Importance and challenges

What is a TSA?
A **Transaction Service Agreement (TSA)** is an agreement negotiatied between the Buyer and the Seller in a diverstiture transaction that governs the services that the Buyer will receive from the Seller for a pre-determined duration from the day of closure of the transaction (Day 1).

The objective of TSAs is to ensure service continuity for the buyer during a divestiture transaction.

Services included (commonly in TSAs)

- Finance & Accounting
- IT
- Procurement
- HR

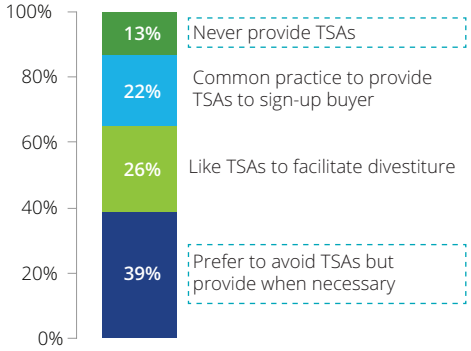
Commonly, both Sellers and Buyers have used TSAs to ensure continuity of back-office services. Deloitte's 2013 Divestiture Survey observes that, for companies that provide TSAs, the services most frequently offered are Finance/ Accounting (**72 %**) and IT (**71 %**).
80% of surveyed companies report that the typical length of time a TSA is provided is one year or less.

- **41%** indicated the typical duration is 6 months or less; and
- **39%** indicated the typical duration is 7–12 months

The motivation to use a TSA is too often driven by a **limited awareness of other alternatives, coupled with the hurried nature of the divestiture process.** In our experience a better alternative exists but is frequently overlooked.

From the Seller's side, we are seeing an increased reluctance to provide TSAs. While 87% of surveyed executives revealed that they provide TSAs, a significant percentage (39%) indicated that they would prefer to avoid them if possible and only provide such services when absolutely necessary.

Figure 3 Preference for TSAs[3]



An increasing number of Buyers also understand that, while TSAs may appear to be a "quick-fix" solution, they come with complications that must be carefully considered before proceeding.

Challenges in adopting TSAs

Some key challenges we observed while using TSAs in divestitures include:

01. **Limited focus on core business**—Drafting and managing TSAs can consume significant time and resources on the Seller's part, limiting the ability to focus on its core business following the divestiture.
02. **Potential misuse**—Post deal closure, the Buyer and Seller entities often have diverging interests which may lead to exploitation, or its perception, of one party by the other. For example, Buyers may misuse TSAs to address missed Day One requirements, while Sellers may offer inadequate resources and services to the Buyer during the performance period.
03. **Potentially sub-optimal service levels**—The services provided as part of TSAs are unlikely to meet industry standards, nor be customizable; this is an unfortunate, though hardly unexpected, outcome since the Seller is likely not in the business of providing such services to external customers and has not constructed a delivery model to do so.
04. **Legal risks**—Buyers can be inadvertently exposed to the risk of legal non-compliance by the Seller, and vice versa.

From Deloitte's experience with our clients during divestitures, outsourcing may be a preferred alternative to TSAs for many Sellers and Buyers. This document explores its benefits in a later section.

[3] Perspectives on driving divestiture and carve out value, Deloitte

Acquisitions

Overview

An acquisition is a corporate action in which a company buys most, if not all, of the target company's ownership stake in order to assume control of the target firm. Acquisitions often comprise a critical element of a company's growth strategy when it is determined to be preferable (perhaps because it is faster or cheaper) to organic growth.

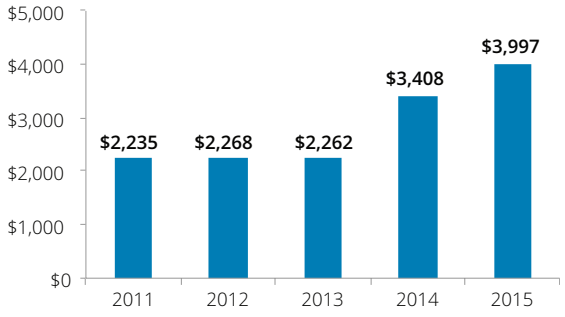
Acquisitions have been the largest contributor to the overall M&A pool, with the acquisition value averaging $2.8 trillion annually from 2011 to 2015, rising to about $4 trillion in 2015[4].

Acquirers are broadly classified into two categories—Serial Acquirers and One-Time Acquirers.

Serial Acquirers are those companies which regularly seek acquisition targets for strategic / financial purposes; their primary mode of growth is inorganic.

One-Time Acquirers have a specific focus for the acquisition which may well be satisfied once the merger has been completed and their goal achieved.

Figure 4: Globally announced acquisitions deal value (USD B)[4]



Back-office integration challenges

Similar to a divestiture, an acquisition poses challenges from a back-office services continuation perspective. Serial Acquirers will, over a period of time, acquire many firms, each with its own IT platforms and divergent back-office processes. Even in the case where they standardize on one IT platform, the *use* of that platform is often not standardized and thus does not derive the scale benefits that could otherwise be achieved.

Using an outsourcing partner can provide key benefits, including: resources to enable a more rapid integration of the organizations, and cost / performance synergies from a provider who can update or re-platform divergent applications and processes onto a common set. This can reduce infrastructure and maintenance costs; improve new application development and maintenance by training the entire team on one, modern, leading practice approach; and increase the time by which synergy benefits of operations are achieved.

Outsourcing as an enabler during divestitures and acquisitions

Overview

Outsourcing

Outsourcing is a contracting arrangement in which a third party provides services of back-office functions

Services included

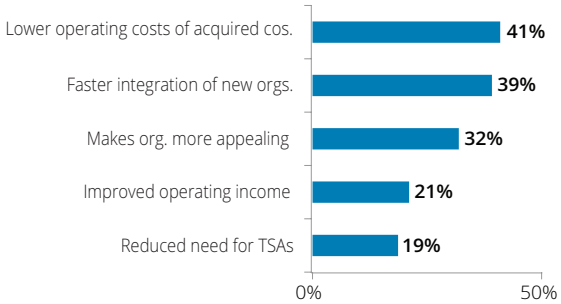
- Finance & Accounting
- IT
- Procurement
- HR

[4] Mergermarket Database

In the context of Mergers and Acquisitions, there are a significant number of potential benefits for the Buyer and the Seller (in the case of divestiture transactions) from outsourcing back-office functions to a third party vendor.

Deloitte's Global Outsourcing Survey 2016 reveals that around 45% of respondents see outsourcing as a key enabler of M&A activity. Organizations surveyed used outsourcing to deliver different benefits.

Figure 5: Top organizational benefits of Outsourcing (% respondents)[5]



A Buyer in an acquisition or divestiture can enjoy multiple benefits like access to higher quality of services at lower cost, access to higher capabilities through the outsourcing partner, and better risk management. In the case of divestitures, outsourcing can replace traditional TSAs while also providing the Seller with such benefits as a higher deal valuation and an increased ability to focus on its core business.

The timing to engage an outsourcing partner is a critical factor. While there are clearly tremendous potential advantages in leveraging outsourcing in M&A activities, a well-constructed agreement is necessary to draw out those benefits, and that requires planning. Engaging the outsourcing partner with appropriate time to spare prior to "Day-One" can improve operational efficiency and greatly reduce risks to realistic levels.

[5] Deloitte Global Outsourcing Survey 2016

Benefits of outsourcing

01. **Higher valuation**—The ability to demonstrate higher cost savings and, thereby, higher margins can create a material increase in deal value. In one of Deloitte's recent engagements, the client was able to demonstrate significantly reduced costs from outsourcing its F&A, IT, and Operations functions, and this translated into an increased price of the Target to 10x the identified savings. The final deal valuation, in this particular example, provided a strong case for outsourcing as a compelling tool in this arena.

02. **Enhanced capabilities**—Through years of experience providing services, along with the bench strength it can deliver, the outsourcing partner can bring significant capabilities to bear both to expedite the transition (in the case of a divestiture) or the transformation (in the case of an acquisition), and the steady state performance of in-scope functions. In many cases, the outsourcing vendor can be a permanent partner for a serial Buyer (e.g., PE firms). The right outsourcing partner can provide the Buyer confidence that the transition of services will be managed effectively.

03. **Lower cost of delivery**—Outsourcing contracts, when properly structured, provide economic benefits to the Buyer due to economies of scale and labor arbitrage. As observed in typical Deloitte engagements, companies typically receive 15% to 30% reductions in in-scope operational costs through outsourcing. Cost reductions up to 50% are not unprecedented in situations where transformational change is coupled to the outsourcing initiative. Interestingly, IT cost reductions often constitute a significant proportion of the expected, overall synergy benefits in an acquisition. For one client, the IT synergies comprised 70% of total cost reduction.

04. **Quality of service delivery**—An outsourcing partner can provide the Buyer an opportunity to negotiate service levels comparable to leading industry practices, including enforceable service level credits/ penalties.

05. **Focus on core business**—The outsourcing provider can augment Buyer capabilities to ramp up services, and expedite the integration of services more quickly than could be safely done otherwise. Similarly, with fewer resources and less time spent providing services to the Buyer, the Seller can focus on its strategy and core services. For one client involved in a spin-off, the F&A functions of the target were efficiently managed by the outsourcing partner, allowing the Seller to focus on its core business. The seller reduced governance costs by limiting the management time spent on segregating and assigning its current employees to do F&A transactional work for the two different companies.

06. **Expedited de-linking of seller and buyer (specific to divestitures)**—Unlike TSAs, outsourcing can help to de-link the Buyer and Seller, and this can help to mitigate legal and other compliance risks. One area of high concern from the Selling entity is the separation of assets (IT, real estate, etc.) and resources of the Target. An outsourcing partner, with its advanced capabilities, resources, and tools can often manage this process more effectively.

07. **Better risk management**—Competent outsourcing partners may provide an option for risk sharing during the outsourced processes, thereby limiting the Buyer's risk, and also minimizing business delivery risk by offloading non-core processes the Buyer is less capable of executing.

Outsourcing risks and mitigation steps

As with any outsourcing process, risks with respect to transition/ implementation, vendor management, change management, and achieving the expected return on investment must be managed. Most of these can be successfully mitigated through a structured process involving a robust transition strategy, focused vendor management office, and a well-designed business case. Fortunately, the state of the art in the outsourcing world has improved dramatically over the years, and it should be expected that in a well-designed agreement the Buyer's and/or Seller's business objectives can be achieved with nominal risk.

Conclusion

Usually, outsourcing has been considered within the context of M&A activity once stabilization has been achieved, and then with the primary objective being to develop new service delivery models and reducing operating expenses; however, given the many benefits associated with adopting this model early in the M&A transaction, outsourcing can accelerate deal benefits for both the Buyer and the Seller and should be considered as an important option within any M&A transaction.

Contacts

Simon Tarsh
Deloitte Consulting LLP
New York, NY
Tel: +1 347 268 4376
starsh@deloitte.com

Douglas Plotkin
Deloitte Consulting LLP
Boston, MA
Tel: +1 617 437 3788
dplotkin@deloitte.com

Prahalad Mukundan
Deloitte Consulting LLP
Bengaluru, India
Tel: +91 96201 11297
prmukundan@deloitte.com

Deloitte.