Preparing for Successful Divestments of Corporate Carve-Outs

As companies continue to execute their responses to COVID-19 and streamline their portfolios to drive shareholder value and address activist shareholders, we expect to see an increase in divestiture activity. We examine the strategic rationales for divestitures and explain how companies can prepare for the successful sale of a business unit or subsidiary.

Industry Commentary

William Blair Team Members

Simon Baertl
+49 69 509527 613
sbaertl@williamblair.com

Uwe Helin
+49 69 509527 640
uhelin@williamblair.com

Julien Darmon
+44 20 7868 4433
jdarmon@williamblair.com

Philipp Mohr
+49 69 509527 610
pmohr@williamblair.com

Strategic Rationales and Drivers of Activity

More and more publicly traded and private companies are taking an active portfolio management approach to their business units and subsidiaries. Boards and management teams are regularly asking themselves whether certain parts of their business are still core to their strategy as well as whether the company is still the best owner for an individual subsidiary or whole business divisions.

A divestment decision is typically driven by one or more of the following reasons:

- Need to generate liquidity
- Lack of fit with the company's group strategy and reduction of complexity
- Financial underperformance: the carved-out unit isn't meeting divisional targets, and management doesn't expect performance to improve in the near term
- Value maximization: a sale to a third party would generate greater value than continuing to operate the business
- Antitrust approvals: a potential merger with a competitor may require divestitures of certain businesses to receive antitrust approval

We expect corporate carve-out activity to increase even further during the next several quarters. There are two primary reasons underlying this expected increase.

- **COVID-19 response**: We expect especially companies that were already highly levered before the start of the pandemic and whose financial performance has further deteriorated during the last months to consider divestments. These companies view divestitures as a way to generate liquidity to either fund their recently launched restructuring programs and/or deleverage to avoid breaching their financial covenants. This need for liquidity makes it easier for boards to finally approve executing the divestiture of businesses that had already been earmarked for sale.
- **Shareholder activism**: We also expect activist investors to increasingly pressure boards to divest not only underperforming businesses but also healthy businesses whose value is either not appropriately reflected in the current owner's valuation or whose value is expected to be significantly higher if held by a more natural owner. This latter rationale is known as the "best-owner principle."

Investor Interest in Carve-Out Targets

Corporate carve-outs frequently generate strong interest from potential investors. Interest typically is especially strong from financial investors who assume that these businesses have not received adequate attention from the current owner both in terms of senior management capacity and capital spending during recent years. As a result, financial investors typically expect to find several unlevered value-creation opportunities when performing diligence on a carve-out.

Factors That Affect Carve-Out Complexity

Selling a business that has been integrated into a larger group is very different from selling a stand-alone company. And within the carve-out universe, the level of complexity in preparing for and executing a sale is a function of how entangled the business is with other group companies or business units. This level of entanglement can differ significantly among carve-outs.

Carve-out complexity tends to be lower for subsidiaries that are a separate legal entity that covers most of the value chain (e.g., R&D, procurement, manufacturing, sales) and relies on the larger group for only some administrative support functions (e.g., IT, HR, finance).

On the other hand, carve-out complexity is significantly higher for cross-border carve-outs, which are situations when the business's perimeter includes entities in several jurisdictions. Another situation that adds complexity is when the carved-out business shares manufacturing sites with other group companies and/or closely cooperates with other group companies in other areas of the value chain. This cooperation could come in the form of shared R&D activities, mixed sales teams to facilitate cross-selling, serving the same customers, or a host of other activities that span group companies. It is also important to realize that some carve-out targets have significant intra-company business relationships; for example, another group company might be the carve-out target's largest supplier or customer.

The complexity of carving out a specific business can be a decisive factor when thinking about the potential buyers for the business. Businesses that don't yet cover several critical steps of the value chain independent of the larger group may be more suitable for strategic investors who can easily provide these functions.

Pre-launch Process Preparation

While extensive preparation is important for every M&A process, it is indispensable for a successful sale of a carve-out business. This is especially true if you plan to run a competitive auction process with a broad buyer universe that includes both strategic and financial investors.

Preparation for the sale of a stand-alone business sometimes starts just a few months before the process launches. Such a timeline typically isn't possible for a carve-out. For the divestitures we have been involved in, we regularly see preparation start at least 12 months before the launch of the formal M&A process. Of course, the actual amount of preparation time needed is a function of the carve-out size and complexity, the seller's experience executing carve-outs, and the extent of resources (internal team members plus external advisors) the seller can devote to the process preparation.

Diligence Focus Areas for Carve-Out Investors

Many of the due diligence work streams (e.g., reviewing market attractiveness, competitive positioning, and product/service differentiation) are the same whether the potential investor is evaluating a carve-out or a stand-alone business. There are, however, certain areas that are either specific to carve-out diligence or that investors will pay additional attention to during a divestiture process.

The following areas require additional focus from sellers during the preparatory phase so they can facilitate an efficient and value-maximizing due diligence process:

- **Operational carve-out blueprint**: Investors want to gain a very detailed understanding of how the business will look on a stand-alone basis. This is often referred to as the "carve-out perimeter," which many experts define along the following five dimensions: people, assets, processes, systems, and contracts. In assessing the perimeter, potential investors are likely to ask questions such as: Does the company already have a stand-alone, viable business model? If not, what entanglements with other group companies exist and how can these be resolved? For example, if the carve-out entity maintains shared manufacturing sites with other group companies, detailed site-separation concepts need to be developed and discussed with potential investors.
- **Stand-alone costs**: Much of the financial due diligence will focus on the stand-alone cost assumptions. During this critical review, investors will focus on whether the presented stand-alone costs are complete and whether the cost assumptions appear plausible. Estimating stand-alone costs can be complex and often requires input from internal and external experts across various functions. The first step is for the selling company to add back any potential group charges that are currently allocated to the carve-out business. Then the seller needs to make assumptions about the hypothetical stand-alone costs so that the stand-alone adjusted earnings can be calculated. These stand-alone cost adjustments, which can be separated into one-time and recurring costs, include FTE transfer and build-up requirements, modifications to IT costs, potential sourcing dis-synergies, and general reductions in economies of scale.

- **Transitional service agreements (TSAs)**: Investors want to ensure that they acquire a fully operational business at closing. That is to say, investors seek to make sure that the business operations will continue smoothly on the first day of their ownership. Depending on the carve-out complexity, there may be various central group functions (e.g., HR, finance, accounting, IT) that are currently provided by the seller, so the buyer will need time to either build up these functions from scratch or secure them through the integration into its own organization. Doing so, however, can take months; so to ensure business continuity during this transition period, the buyer usually enters into a TSA with the seller. Significant value can be embedded in the TSA terms depending on the type and duration of required support services, both of which are highly dependent on the ultimate buyer of the business. Sellers are well-advised to share TSA draft terms with potential buyers ahead of binding bids. This allows potential investors to consider any proposed mark-ups to these terms when reviewing the economic attractiveness of the received offers.
- **Employee transfer**: Identifying and ensuring that all relevant and top-performing employees of the business are included as part of the transaction and stay at the business post-closing will be a key due diligence focus area for investors. For transactions where the transfer of employees cannot be guaranteed, the parties need to find mutually satisfactory solutions to address this important concern.
- **IT**: No business can operate without fully functioning IT systems, and setting up a stand-alone IT infrastructure is a time-consuming, costly process. Investors will devote significant time gaining a detailed understanding of any IT entanglements with the seller, analyzing the quality and sufficiency of the existing IT infrastructure and assessing the potential need for new or upgraded investments. Investors will also critically review the IT separation concept, including potential associated costs for the carved-out business.
- **Intellectual property**: The investor needs to ensure that all patents, trademarks, licenses, and other forms of intellectual property needed to operate the business on a stand-alone basis will be part of the transaction scope.
- **Non-compete**: Investors will want to ensure that once they acquire the business, the seller will no longer compete in the same field. This is an important point of negotiations and can be stipulated in the transaction documents.

Where to Start with Carve-Out Preparation

We recommend starting the review of a potential carve-out opportunity with a feasibility assessment. In addition to addressing the diligence focus areas listed above, the feasibility study will help to assess the complexity and preparation needed, the likely buyer universe, and the potential valuation for the respective business. It will also allow you to quantify the likely divestment impact on your group's key financial ratios.

Following the initial assessment, preparation should start well before you anticipate launching the formal process. Given that corporate carve-outs usually require the close cooperation of various internal teams and external advisors (e.g., lawyers, tax advisors, IT experts, accountants, M&A advisors), we recommend forming and involving the whole project team right from the start of the process.

William Blair has extensive experience advising on carve-out transactions. If you want to learn more about our recent corporate carve-out transaction experience, or if you would like to discuss a potential carve-out project, please reach out to one of the William Blair team members at the start of this document.

Recent Selected Carve-Out Transaction Experience

AMPLEXOR has agreed to be acquired by acolad. Pending	CarePort a division of Allscripts has agreed to be acquired by WellSky Pending	GEA BOCK has agreed to be acquired by NORD Pending	Octane Fitness a subsidiary of Nautilus Inc. has been acquired by TRUE October 2020	CONNECTED ANALYTICS CHANGE HEALTHCARE has been acquired by KaufmanHall May 2020
Sierra-Cedar has sold certain assets to accenture February 2020	3M Advanced Ballistic Protection Business has been acquired by AVON Avon Rubber p.l.c. January 2020	Bristol-Myers Squibb has sold its manufacturing facility in Anagni, Italy to Catalent. December 2019	AFP a subsidiary of Jindal Poly Films Netherlands has been acquired by TRIOPLAST December 2019	inventus a subsidiary of RPX has been acquired by Legility December 2019
CLARIANT Healthcare Packaging International has been acquired by ARSENAL CAPITAL PARTNERS October 2019	LEADING EDGE JET CENTER has been acquired by INSTARAGF August 2019	Bemis Healthcare Packaging Europe European Flexible Packaging Assets has been acquired by KOHLBERG & COMPANY Nelipak healthcare packaging August 2019	ARSENAL CAPITAL PARTNERS has acquired SEALFORLIFE industries a division of Berry Global July 2019	Perrigo Animal Health Division has been acquired by PET IQ July 2019
TACONIC Finding a better way Asian Business & Global ADD Assets has been acquired by AGC June 2019	amcor Select North American Medical Flexible Packaging Assets has been acquired by TEKNIPLEX June 2019	APPRISS Knowledge for good. has been acquired by CLEARLAKE CAPITAL May 2019	CATTRON a division of Laird Ltd. has been acquired by Harbour Group March 2019	IDEAL NETWORKS has been acquired by cbpe December 2018
B&W MEGTEC B&W UNIVERSAL segments of Babcock & Wilcox, Enterprises, Inc. has been acquired by DÜRR October 2018	inmac wstore a division of Systemax has been acquired by BECHTLE August 2018	CHANGE HEALTHCARE (Extended Care Solutions software business) has been acquired by Netsmart Technologies July 2018	Rowmark (Engravables Segment) has been acquired by Windjammer Capital Investors June 2018	veco precision metal has been acquired by Gilde Buy Out Partners April 2018

Represents European transactions

"William Blair" is a trade name for William Blair & Company, L.L.C., William Blair Investment Management, LLC and William Blair International, Ltd. William Blair & Company, L.L.C. and William Blair Investment Management, LLC are each a Delaware company and regulated by the Securities and Exchange Commission. William Blair & Company, L.L.C. is also regulated by The Financial Industry Regulatory Authority and other principal exchanges. William Blair International, Ltd is authorized and regulated by the Financial Conduct Authority ("FCA") in the United Kingdom. William Blair only offers products and services where it is permitted to do so. Some of these products and services are only offered to persons or institutions situated in the United States and are not offered to persons or institutions outside the United States. This material has been approved for distribution in the United Kingdom by William Blair International, Ltd. Regulated by the Financial Conduct Authority (FCA), and is directed only at, and is only made available to, persons falling within COB 3.5 and 3.6 of the FCA Handbook (being "Eligible Counterparties" and Professional Clients). This Document is not to be distributed or passed on at any "Retail Clients." No persons other than persons to whom this document is directed should rely on it or its contents or use it as the basis to make an investment decision.