CARVE-OUT COMPLEXITIES

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Carve-outs are a growing part of a declining, though still historically strong, M&A cycle. Despite the projected drop from a record breaking 2016, or perhaps because of the steep valuations and competition for platform deals that have contributed to that decline, buyers with record amounts of dry powder are seeking alternative deal vehicles, of which the carve-out has become king. Indeed, carve-outs now account for 10% of all M&A activity globally – and it's a figure that's only climbing.

Given this ascendance, we devoted our most recent Accordion Roundtable to carve-outs and all that make them unique, however complex, opportunities. This intimate gathering of private equity professionals in midtown Manhattan confirmed what we have seen from our clients across both coasts (and a couple of continents): carve-outs are an inherently unique type of deal that can give pause to even the most serial of acquirers. Or, as one participant succinctly noted, "the variables beyond the financials are just so, so complicated."

Those complications tend to be bundled around four distinct topics:

1. **TALENT EQUATION**
2. **RELATIONSHIP GAME**
3. **STABILIZE/OPTIMIZE MANDATE**
4. **TSA TRAPPINGS**

NON-FINANCIAL CARVE-OUT COMPLEXITIES

- **Talent Equation:** Identifying, assessing and retaining the right talent to transfer with the acquisition, handle the transition, and realize the value drivers.
- **Relationship Game:** Cultivating the relationships that will provide deeper insight into the softer human capital needs that must be negotiated as part of the deal.
- **Stabilize/Optimize Mandate:** Finding the correct formula and timeline to balance the hard work of standing up or integrating a company with the optimization plans that informed the purchase.
- **TSA Trappings:** Answering the questions that inform the drafting and negotiation of the TSA – which can be the most critical element to carve-out success.

Talent Equation

The capabilities of the individuals transferring with the deal, from executive leadership to entry level individuals, are critical to the valuation, and can be extremely difficult to assess. Unlike a typical merger, the buyer is not absorbing the entirety of the selling company – they are getting only a piece of it, and therefore only a piece of its talent.

"And that piece never feels sufficient enough," - at least not sufficient enough to effectively tackle the complex standing up or integration of the business, while concurrently executing, and potentially exceeding, strategic value-creation initiatives.

"THE CFO IS A TRICKY POSITION TO FILL BECAUSE OF ITS DUAL TACTICAL AND STRATEGIC MANDATES." SEPARATING THOSE MANDATES CAN BE THE KEY TO CARVE-OUT SUCCESS... PLACING THE CFO AT THE EPICENTER OF THE CARVE-OUT TALENT EQUATION.

As we discussed during the Roundtable, that separation can take many forms. One technique is to fill the CFO position with an interim candidate who can focus on standing up the business, thereby deferring the strategic work to a later date, and to an executive more appropriate to that role. Others find separation and concurrent execution a more successful strategy: "We often procure external resources who are better equipped to handle the tactical elements of the transition, particularly in a PE-backed environment, while we fill the CFO role with an executive capable of implementing value creation initiatives."

In either form, what is clear is that those in charge of running the business day-to-day need to do so in partnership with the transition team, while the transition team focuses on planning for and troubleshooting tactical hurdles.

The Relationship Game

While the capabilities of the inherited CFO (and broader management team) often become clear from the start, the talent level a click below can be a more difficult asset to assess. "Developing early relationships with key management not only incentivizes them to more quickly align their interests with us (the buyer), but it also provides a source for critical information on the key executives that haven't yet been identified as part of the deal – but should be."

The importance of face-to-face contact with those senior members and, later with the other talented executives they've identified, cannot be underestimated. Nor, can the importance of looking beyond the distinct carve-out team to find the 'entangled' teams that should be part of the deal (often in the form of those that run shared services like IT and Finance).

The reality is, however, buyers (long used to assessing the financials of the deal) often overlook negotiating the 'softer' human capital assets as rigorously as they should.

"USING THE PRE-CLOSE PERIOD TO INVEST IN BUILDING RELATIONSHIPS, ASSESSING TALENT AND AGGRESSIVELY NEGOTIATING FOR THE HIDDEN EXECUTIVES KEY TO OPERATING THE BUSINESS IS TIME NOT ONLY WELL SPENT, BUT BEST SPENT."

The Stabilize/Optimize Mandate

Next to the 'who' question surrounding talent, is the critically important 'when' question that was a subject of much debate during the Roundtable. The job of standing up or integrating a business while still conducting day-to-day business is, in and of itself, a massively complex undertaking.

“IF, IN THE EARLY STAGES OF THE PURCHASE, THE BUYER CAN STABILIZE THE BUSINESS BY KEEPING MOST OF THE EMPLOYEES (THEY WANT TO KEEP) AND MOST OF THE EXISTING CUSTOMER BASE, THAT PROVIDES THE FOUNDATION FOR SUCCESS.”

The longer-term value creation goals of the business should be clear to all employees and stakeholders. It can be appropriately timed to coincide with the transition pace protecting business as usual (“BAU”) and avoid any Business Interruption (“BI”). The Roundtable identified this as the timed approach to a carve-out deal, wherein the typical 100-day plan requires a more linear approach to focus first on operating, and subsequently on optimizing.

The TSA Trappings

And of course, there is the ultimate question of ‘how’ – an answer significantly influenced by the Transition Service Agreement, which can be one of the most critical components to any carve-out scenario. It’s in fact too critical to leave its creation and negotiation up to only those who initiated the deal, and therefore is often fully developed between sign and close. The services and functions necessary to preserve BAU and achieve the value proposition must be identified and negotiated by the management team and functional experts/leads of the business being carved out. This places ownership on those who know the business and will be tasked with leading it.

The TSA that results must be structured sufficiently to ensure the buyer receives the support critical for the duration necessary. Well-developed TSAs are flexible enough to allow for inclusion of services post-close that were previously provided to the carved-out business, and not identified, to account for the ‘we don’t know what we don’t know’ scenarios that almost always arise.

Buyers Beware

Carve-outs can offer lower multiples and higher gains. But they’re an inherently complex deal that can challenge even the most seasoned M&A professionals. And that’s because carve-outs’ complexities occur in the periphery. Capturing carve-outs’ advantages requires the private equity investor to look beyond pro-forma financials, which are an imperfect reflection of the business. The financials don’t capture what’s missing - the resources and other elements needed to achieve the value drivers the investment thesis is predicated on and what is even more difficult to assess, the human capital and cultural complexities of the deal.

Finding the right formula, the right people and the right timeline to account for the un-accounted, to assess the softer assets and to prepare for the unknown can determine carve-out success – or, at least, to making its inherent complexities worth the risk.

We welcome continued discussions around the complexities of carve-outs including the what, why and where aspects, and look forward to seeing you at our next Roundtable. Stay tuned.