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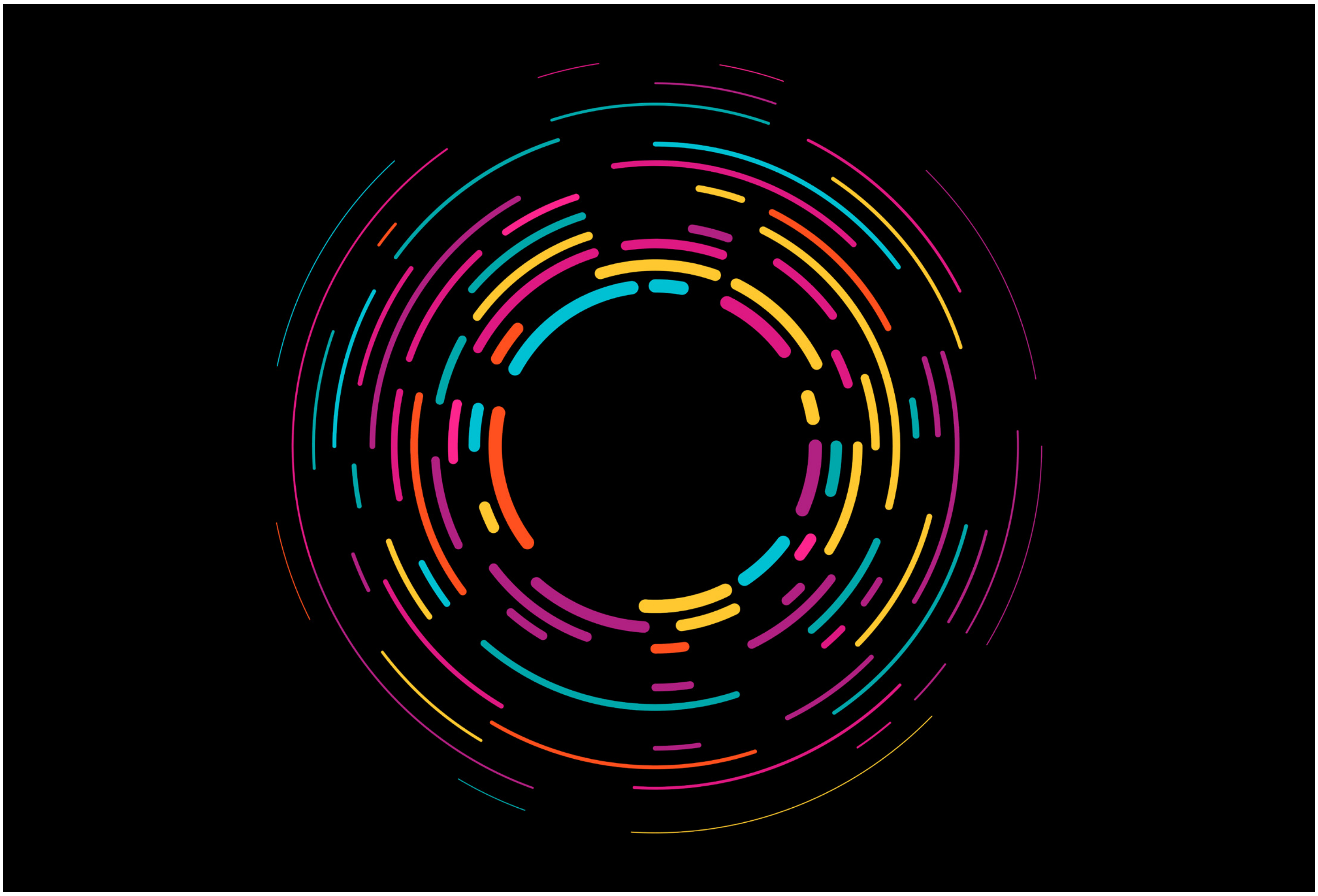

IT Transitional Service Agreements (IT TSAs): How much are they needed?

Transitional Service Agreements (TSAs) have been and continue to be required in transactions involving a carve-out of business units from a larger entity to ensure business continuity of those business units. This has been the case especially for services offered centrally by the larger entity or by a Shared Service Center, typically in the areas of Finance, General Administration and IT.

As a consequence, TSAs, and especially IT TSAs, have been a 'necessary evil' for both buyers and sellers when agreeing a deal to establish a standalone company.

They are necessary, because a separation of complex systems or processes does not usually fit into the timeline of a typical M&A transaction that involves a separation. They are evil, because transitional arrangements never actually fit in with the seller's or the buyer's strategy and they distort the EBITDA of both parties, thus may impact the deal value, depending on the closing structure.

As IT systems are increasingly a crucial part of a business, it is generally considered, incorrectly we argue, that the entire IT function has to be covered by a TSA lasting from 8-12 months, or even longer, depending on the complexity of the separation of systems.

We believe that IT TSAs should be avoided if possible and considered only as a last resort.

Why should IT TSAs be avoided?

Based on our experience, it is ultimately more beneficial to all parties of a transaction to complete the separation of the IT services, applications and infrastructure by the closing date. This is because the typical complexities of IT TSAs create four major constraints for sellers and buyers:

The **large amount of effort** required, in terms of IT TSA governance and management, when neither of the parties are professional providers of IT services

The **disproportionate operating costs** of an IT TSA that neither the seller nor the buyer would incur in the normal course of their businesses

The **legally binding commitments** of an IT TSA that lock in both the seller and the buyer

Limited control over systems and data under an IT TSA and **reduced scope for change** to the systems for the duration of the transitional arrangements.

The effort and complexity involved

IT TSA governance and management are complex and their cost is higher than the cost of outsourced commodity IT services offered by professional IT service providers.

IT TSAs are usually complex and long-lasting, and present a number of challenges, for example:

IT TSA costs might be underestimated. Larger companies struggle with limited visibility of the completion of Group IT costs and cost allocation keys often fail to fully or appropriately recharge those costs to the divested entity, leading to considerable stranded cost for the seller and an understated cost base for the buyer;

The description of IT services to be provided during the transition period may not be sufficiently detailed, leading to a misalignment of expectations about service quality and scope. The seller may be legally bound to provide IT services that it is unprepared and unable to deliver;

Due to a lack of support from the seller during the IT TSA period the buyer's IT team may be unable to implement new projects or make changes in the legacy IT systems, and the seller may be prevented from making changes in their own environment that could impact the buyer's business. This could lead to disagreements between the parties during deal execution with regard to priorities around the separation process; and

The seller may be legally bound by TSA terms to dedicate IT personnel to deliver transitional services, for whom there could be other plans, whilst the buyer may be effectively getting an inconsistent level of service as the personnel shift their focus.

The definition of the IT TSA duration may be important as it should depend on the speed of an effective separation or an implementation of a replacement environment. Building a standalone IT could take time, especially in the following areas:

- Setting up a core business platform: the time required depends on the technology, interfaces with the rest of the business value chain and business partners, and the level of customization required. Certain implementations can take two years or longer.
- Setting up a Wide Area Network (WAN) to interconnect sites and offices across the world: certain locations may require several months to implement network services, depending on the efficiency of the local telecom providers and types of connections required.

Data protection regulations may increase the complexity of providing IT TSAs.
Data protection regulations (e.g. GDPR, FADP) often impose requirements on how the seller handles data belonging to the buyer, especially in terms of the collection, storage and processing of personal data. The need to comply with data protection regulations or industry regulations may prevent sellers from providing access to their systems through IT TSAs, and may require establishing additional contractual arrangements such as a data processor or data controller agreements.

Providing access to business applications under an IT TSA may require vendor and licensor consent
A simple agreement by the buyer to continue providing access to some business applications through an IT TSA may be insufficient if, as it is usually the case, the applications have been built using licensed technology that places certain contractual or legal constraints on the buyer. In most cases, software vendors insist on granting the ‘right to use’ of their products or require a purchase of new licenses. To comply with their contractual obligations, buyers need to check their license rights in each of their software and subscription agreements, which is typically an expensive and time-consuming process. In most cases, license rights are granted only to the company that acquired the license and their affiliates. Licensors usually only allow licenses to be assigned to a divested entity if these rights are explicitly stated in the software license agreement, or only for a limited period of time and often at an additional cost. This additional cost might not be fully known at the time of the transaction being signed and is often a point of contestation between the parties, who should bear this cost.

Binding on both sides and reducing flexibility
Entering into an IT TSA means that both parties have legal obligations towards each other. The seller remains responsible for all agreed IT services and needs to provide the agreed level of service (similar to an IT service provider) while the buyer needs to consume the services as described, with limited ability to introduce change, and pay the associated fees, which are often fixed for the period.

Depending on the TSA exit arrangements, the buyer and the seller might be unable to develop their planned business strategy while the IT TSA is in place. For the buyer this is typically due to limitations to the degree of systems change and development allowed under the TSA conditions due to or commercial sensitivities while data and systems are maintained, and often controlled, by the seller. From the seller perspective, the TSA conditions often put constraints on resources, and the buyer may need to maintain third party contracts associated with the systems under the TSA, some of which could be undesirable post transaction.

The cost of IT TSAs
Additional investment is required to support the separation.
The seller may have to increase its IT Infrastructure capabilities (e.g. connectivity bandwidth, data storage, number of servers) to support the separation, depending on legal requirements with regard to systems and data handling. These costs would not have been historically considered as operating cost of the divested business, however could have an impact on the IT TSA costs, inflating the IT cost base for the buyer. The seller on the other hand may need to increase workforce or enter into additional third party contracts to maintain the extended environment.

IT TSAs running costs usually consist of staff costs (the people needed to operate the IT processes) and the cost of licenses.. These costs typically affect the EBITDA of both the seller and the buyer, unless the buyer agrees to pay for them, in which case, the buyer would be determined to subtract the estimated costs from the deal value.

Buyers are usually also exposed to additional operating costs due to a ‘dual running’ of IT systems. These costs are typically incurred towards the end phase of the transaction, when the buyer continues paying the fees for the IT TSA but is also beginning to bear the cost of replacement technology services for the divested entity.

Can IT TSAs be avoided?

A fundamental question that arises is ***how*** can IT TSAs be avoided? **Is there a suitable alternative?**

Leverage new technologies to accelerate the separation

An increasing number of IT solutions are becoming available in the market that could be used to accelerate a separation of IT systems and a transition to a standalone IT estate. These might be:

- Software as a Service (SaaS)
- Cloud infrastructure such as Infrastructure-as-a-service (IaaS)
- Integrated application and infrastructure solutions in the cloud referred to as Platform-as-a-Service (PaaS)
- Cloud-based applications (e.g. Office 365, Salesforce.com, Dynamics 365, one sap)
- Device-as-a-Service (DaaS)
- Automated data migration tools

The above solutions help accelerate separations, as there is no necessity to stand up physical infrastructure, which typically has long lead times and relies on external, specialised supply chain. Standard Cloud-based technologies are also instantly, or near instantly, available for adoption, configuration and training, however they typically require changes to business processes. In addition, it is also possible to avoid a significant up-front investment to implement those solutions.

Outsourcing an entire IT environment or a significant part of it prior to Day 1, should allow the buyer avoid the need to set up the hardware, which could take several months to acquire and configure. The long lead time required to set up a network infrastructure and the core platform could be avoided, and this should shorten the duration of any IT TSA that is considered necessary.

Also, the buyer would not be required to right-size its IT organization from Day 1, avoiding the cost and effort to recruit a number of IT specialists.

The table below summarizes key aspects of the aforementioned solutions in terms of timing, cost and skill requirements, which could be considered when deciding on the necessity or duration of an IT TSA.

Technology	Time	Cost	Skills required
SaaS	Available immediately*	Pay as you go	No technical skills required
DaaS	Device image (default parameters of the device) needs to be configured once	Pay as you go	No technical skills required
IaaS	Available immediately*	Variable, depends on usage	Technical skills required (infrastructure capabilities)
PaaS	Available immediately*	Variable, depends on usage and bandwidth consumption	Technical skills required (development capabilities)
On-premise or owned solution	Time for implementation required	Investment for the set-up. Possibly additional license fees	Technical skills required to develop/maintain the solution

(*) Once relevant subscription contract goes live

Based on our experience, investment costs (e.g. to rebuild an IT environment) are mainly those required to set up a core business platform, for example an ERP, and to reacquire infrastructure licenses (e.g. Microsoft server licenses, Oracle database licenses) that would normally not be part of the deal, at least from the seller's point of view.

In some cases however, an investment related to setting up a standalone cloud-based IT environment could potentially be absorbed by the service provider and charged back on a monthly basis to the buyer, as part of the managed service fees. This would allow both the seller and the buyer to reduce impact on the deal value, by spreading the one-off separation costs, or capital expenditure, as operating expenses over a period of time. Such arrangements are subject to negotiation with the future service provider, who may in return require the buyer to agree to a longer minimum contract commitment (for example five years or longer, instead of the usual three years).

What are the benefits and risks of not having IT TSAs?

Whilst attempting a separation without a TSA offers a range of benefits, there are a number of transaction, commercial and business risks that should be considered early in the transaction lifecycle. The table below provides a few examples of those risks, alongside the expected benefits.

Transaction without IT TSAs

Benefits/Advantages	Risks
From a buyer's perspective	
• Ability to capture IT synergies from the Closing date • Ability to execute the target IT strategy (no dependency on the seller's company) • Ability to gain a full control over the IT environment and the data from the Closing date	• Upfront investment required, often prior to deal signing • The timing of implementation activities need to be clearly assessed as they may need to commence before the Closing date • A longer period between Signing and Closing may be required to allow for the separation to complete
From a seller's perspective	
• Ability to offer a fully standalone target IT estate (no dependency on the parent entity) • Potential elimination of stranded costs from the Closing date • Ability to right-size the retained IT environment post transaction	• A deal may lose its appeal, may collapse or may take longer to close to allow for the full separation • The commercial benefits (cash or shareholding) may take longer to realise • The cost of setting up a standalone IT environment could be high and in excess of initial estimates

Each carve-out is unique and no two risk registers are the same. It is therefore recommended that M&A teams undertake comprehensive risk assessments when considering the route of no TSA. While the issue of deal confidentiality limits access to experts that can provide important input into such risk assessments, they often provide valuable insights and contribute to an appropriate selection of essential deal evaluation criteria. Moreover, they also provide an input into the feasibility, timing and potential duration of subsequent stages of a transaction.

An option for a compromise?

In circumstances when a seller is unable to fully separate the divested division from its retained business ahead of deal Closing, and has to offer TSAs for various reasons, there are options to limit their participation in the actual delivery of the transitional services.

While the seller and the buyer share the IT environment post the Closing date, we have seen examples of the parties outsourcing the management of the portion of the environment used by the buyer to a third party professional service provider. This way, the seller avoids committing their personnel in the day-to-day delivery and the buyer receives services from an experience provider contracted directly with the carved-out entity.

This is a compromise. Although the transaction documentation would avoid including a TSA, two commercial agreements would need to be put in place to ensure continuity of the divested entity; one between the professional provider and the buyer, and the other between the seller and the same professional entity, as long as the seller remains the owner of the portion of the environment subject to these contracts.

Conclusion

When considering a 'no IT TSA' option, business leaders should consider carefully the following issues:

- **Date of Closing** – "Will I have enough time to engage and to complete all IT separation activities in due time before the Closing date?"
- **Level of entanglement of applications and infrastructure** – "How complex would it be to separate applications that I'm using or to identify the servers that my critical applications are running on"
- **Ability to provide early access to production data** – "Will the seller/ local regulation allow us to segregate and transfer data before the Closing date?"
- **Ability to migrate into cloud-based or standard solutions** – "Is there any technical limitation that would prevent a move to the cloud or to leverage commercial off-the-shelf (COTS) applications"
- **Scope of the transaction** – "Is whole or part of the current IT organization being transferred? What would be the effort to rebuild/ outsource some IT activities"
- **Target operating model** – "Will the carved-out business operate as a separate organization and so justify investment in an independent standalone IT environment, or does the buyer intend to integrate large parts of the IT environment?"

Avoiding IT TSAs is feasible… however this option needs to be assessed carefully as part of the entire deal value proposition and deal risk, prior to triggering a sales process. Depending on the complexity of the separation, the seller may need to start investing early to separate the systems and data, even before the deal is signed. Whilst this should improve the deal value, if the deal collapses, these would need to be non-regret costs.

The buyer may need to accept a longer period between Signing and Closing, but should benefit from better control over data and systems at Closing.

In our experience, smaller carve-outs from very large entities realise greater benefits by avoiding TSAs, as it is typically easier to establish smaller standalone platforms. These benefits, combined with a total independence from the Closing date, outweigh the cost of having to re-engineer the separated entity's business processes from ground up. Avoiding TSAs for larger entities continues to be a challenge. This is where we would always recommend that sellers do a thorough options analysis and a risk assessment before contemplating a deal, while buyer assess such options considering their existing environment.

If you would like to find out in more detail how this approach could work as part of your M&A strategy, please let us know.

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