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Achieving greater returns through carve-out transactions

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A greater return on ideas

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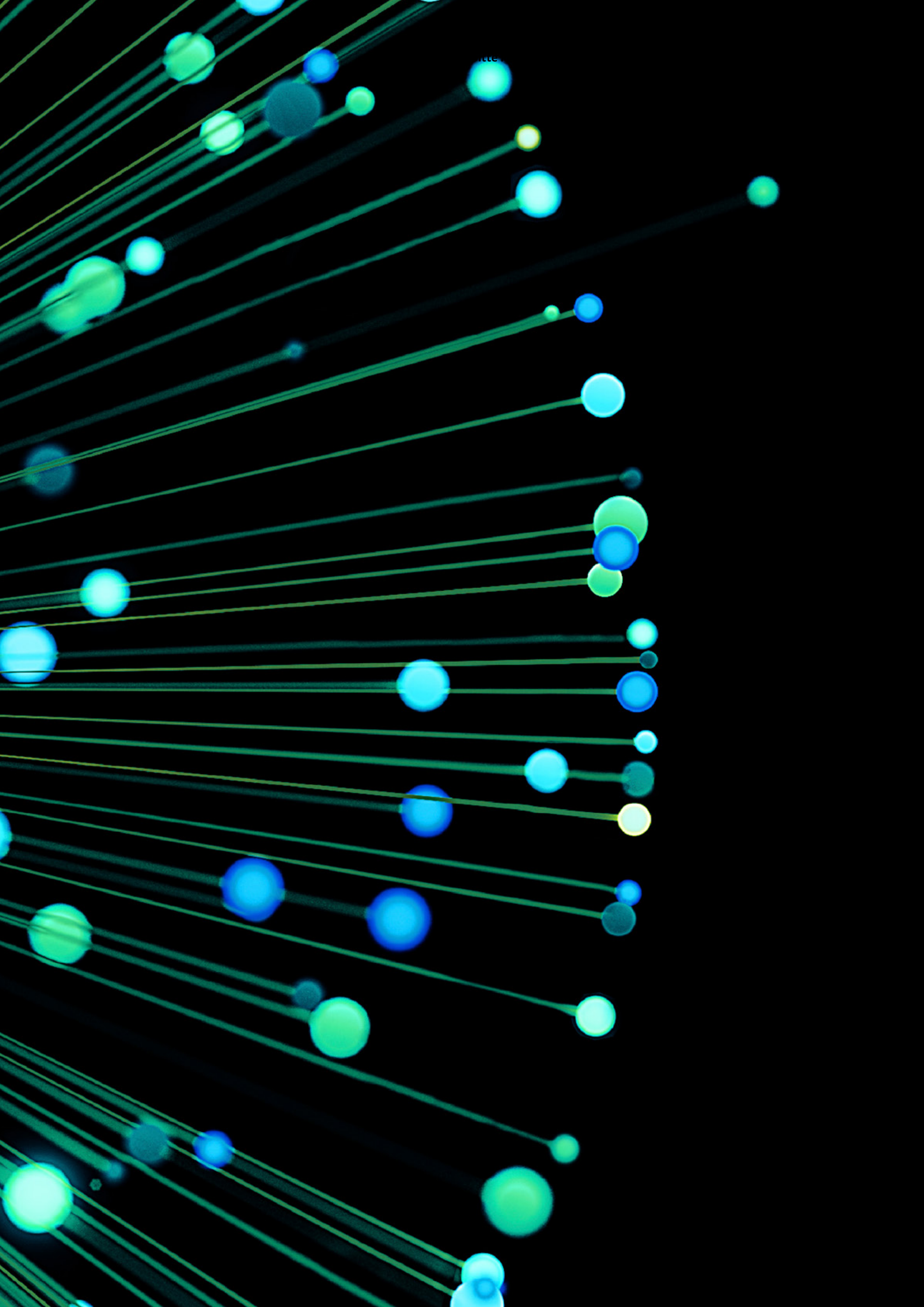

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Achieving greater returns for private equity in carve-out transactions.

Several industries and sectors appear to be on the verge of transformative change –with digital, AI, alternative fuels, and changes in consumption patterns are a few of the key contributing factors.

In this environment, carve-outs are an effective way to reconfigure companies that are holding onto declining businesses, growth businesses not core to their portfolio, or assets that are less than productive without sufficient capital. But whether you are a private equity investor looking to scale or take costs out of a business, carve-outs should be a core competency to consider.

Right now, however, it's strategic buyers who acquire an overwhelming majority of carve-out assets, accounting for more than 70% of carve-out transactions by volume and value between 2019 and 2023 – and closer to 85% within the tech and healthcare industries.[1]
This underscores a perception that strategic buyers are better equipped to absorb carve-out assets, can create greater value on these transactions, and will therefore pay higher for the asset.

But there is potential to achieve more balanced odds between strategic and private equity investors when it comes to winning carve-out transactions. Below, we discuss some key areas of the carve-out transaction lifecycle that have odds in favor of Private Equity (PE) buyers and what can be done in those areas where the odds seem to favor strategics.

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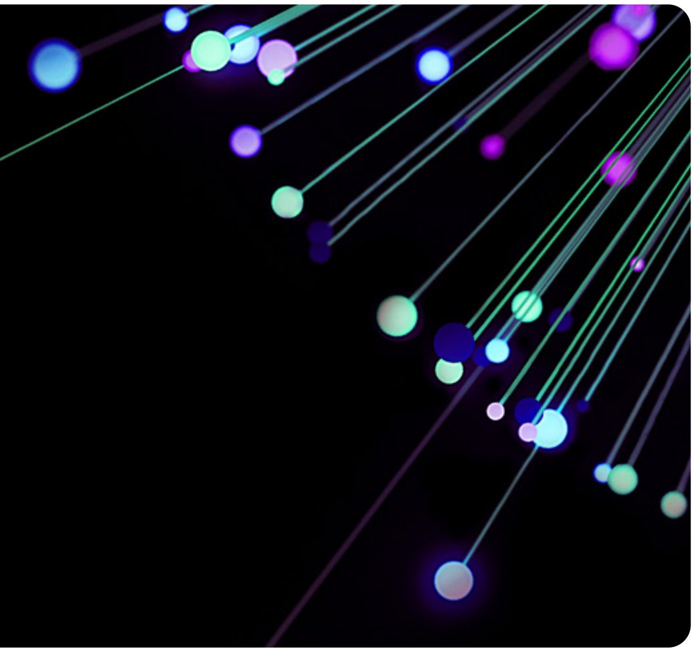


01

Deal originations

Verdict: tie

A winning strategy for all buyers is to identify portfolio rationalization opportunities in sectors and end-markets that align with their investment strategies.

The next step is to proactively work with potential sellers to originate carve-out transactions and avoid a competitive bid. But neither corporate development leaders nor private equity deal teams consistently pursue this strategy, which is why a majority of carve-outs are initiated by sellers themselves or by investment banks, resulting in auction situations. Going forward, PE deal teams, who have more capacity and experience than corporate development leaders, should execute on this play more consistently. By doing so, they can:

- Reduce diligence costs, which can be allocated toward other transaction uses.
- Define a mutually beneficial deal perimeter to manage, i.e., identify what hurdles may be faced (e.g., employee matters, regulatory registrations, and other operational hurdles) during the period following close.
- Collaborate with the buyer to align on a deal perimeter that allows faster close, fewer knowledge transition gaps, reduced stranded costs, and overall operational continuity of the acquired business.

02

Pace and discipline in due diligence

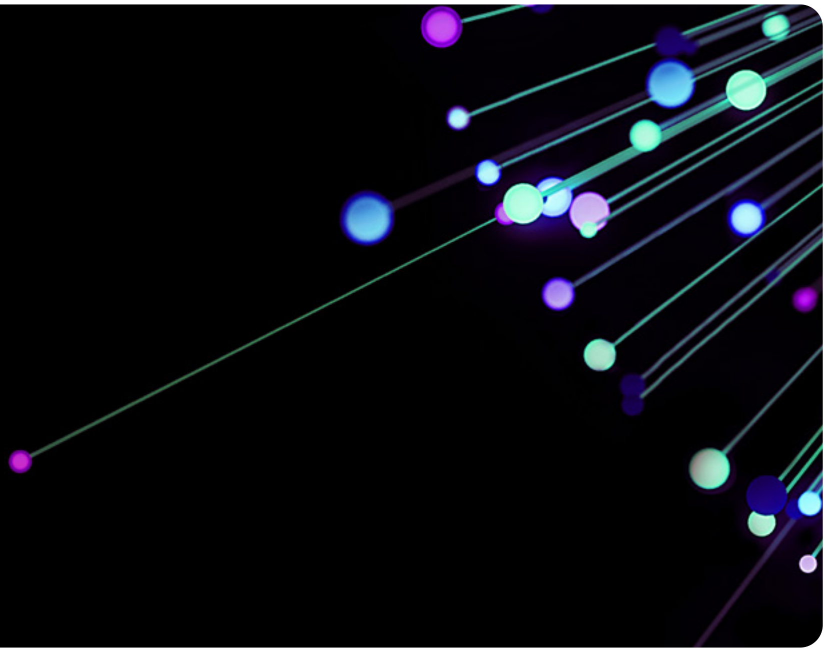
Verdict: advantage private equity

Successful carve-outs require trust and real-time coordination between teams (both internal and advisors). And it is important that various advisors actively collaborate over creative constructs that can help enhance potential value and manage disruption risks.

For example, in asset sale transactions, parts of the business may need legal entity support through agency agreements. Identifying and drafting such arrangements requires combined thinking from operational, technology/ IT, tax, and legal teams. Similarly, arrangements such as reseller agreements, shared intellectual property, and contract manufacturing require inputs from different teams. Building teaming relationships between the advisors can go a long way in achieving favorable deal outcomes.

Private equity buyers typically have a bench of advisors that can organize in a matter of hours to initiate due diligence. Additionally, most private equity buyers have a panel of industry experts (particularly in areas / sectors of focus) that offsets the experience strategic buyers may bring with their internal teams. Often private equity buyers engage with the same group of advisors on various carve-out transactions[2]. This can enhance ways of working, especially in "crunch time" when getting a carve-out to deal signing.

03
Creative deal structuring
Verdict: tie



Strategics often have operational legal entities that can absorb an acquired business and simplify deal structure requirements, allowing for flexibility between asset and entity sales.

But private equity buyers can offset this inherent advantage by creatively structuring carve-outs in a way to secure adequate protection from operational disruptions and one-time cost overruns.

Potential arrangements such as reseller agreements, shared intellectual property, and contract manufacturing can create an acceptable Day 1 operating model. With the right legal and operational advisors, PEs can develop constructs that balance speed, while managing risk of disruptions.

While strategics are more prone to get to a quick close with a more vanilla deal structure, PE's cohesive teaming units can quickly ideate, socialize, and document creative structures that mitigate the inherent capabilities of potential strategic buyers.

> *"But private equity buyers can offset this inherent advantage by creatively structuring carve-outs in a way to secure adequate protection from operational disruptions and one-time cost overruns."*

04

Managing carve-out complexity

Verdict: advantage strategics

This is one area where strategic buyers hold a distinct advantage that is difficult to holistically mitigate. Historically, strategic buyers are considered a natural fit for carve-out assets due to existing infrastructure that can absorb acquired businesses quickly and without a larger standalone cost adjustment.

Hence the fact that over the past decade a majority of all carve-outs were acquired by strategics.[1] But there is more than what meets the eye in this area. By classifying carve-outs into different categories we can uncover how private equity can offset strategics' advantage when it comes to fully separating carve-out assets and standing them up.

- **Lower complexity: carve-outs that are relatively standalone, except for back-office**
  Private equity buyers can effectively stand up back-office operations within six to nine months after close. In fact, unlike strategics, private equity buyers are not locked into a G&A overhead structure. By right-sizing the back-office footprint, technology stack, organization/headcount, and fringe, private equity buyers can create more value than their strategic counterparts. Of course, that comes with a higher one-time effort to stand up.

- **Medium complexity: carve-outs that have entangled operations (manufacturing, distribution, products, sales force, brand)**
  Club deals, particularly through partnerships with other PEs, that may have an existing portfolio company that can absorb operations of the carved-out asset can be a game changer. Carve-out transactions predicated on a thesis of rapid roll-ups can similarly provide eventual synergies on future transactions. PE buyers may consider leveraging these synergies in formulating bid packages. They should scan sectors they invest in and seek partnerships with a network of channel partners such as contract manufacturers, distributors, resellers, and intellectual property owners. These partnerships can provide favorable rates and a faster path to separation of the carved-out asset.

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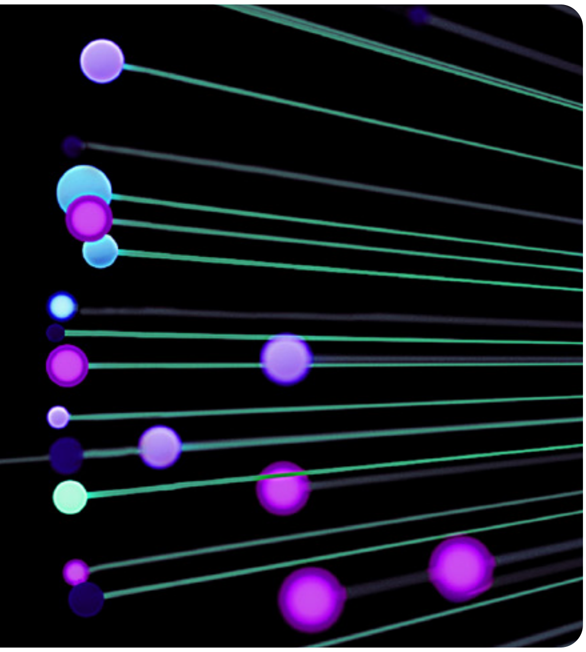
- **High complexity: carve-outs that, alongside entangled operations, comprise sub-scaled markets and may be materially disrupted by the transaction.**
  These deals are not for the faint-hearted. In addition to the strategies above, PEs may have to get creative around potentially changing go-to-market models or even exiting certain markets. Licensing brands or finding distribution partners to take over certain regions and markets may also prove to be effective, especially when looking at a large and under-scaled geographic presence. The good news is that such transactions may also not be easy for strategic buyers, especially in industries where a complex supply chain needs to be integrated.
  As such, PE buyers must remain objective about the run-rate and one-time costs as well as inherent risk of disruption in such complex carve-outs and adjust their proposed deal value against these risks and investments. It is important that PEs reflect on the capabilities they bring to the table when contemplating these transaction types and account for sizable one-time costs, especially for third-party advisors, in the deal model.

Regardless of the transaction type, the following leading practices should be deployed to manage carve-out risks:

- Include operating partners or advisors in TSA master agreement negotiations: TSA master agreements should have bespoke elements and should not be left to be negotiated exclusively between the respective legal advisors. The TSA master agreement presents an opportunity to codify post-close governance at a point when the buyer's leverage is at its peak. Key items to align on are (i) processes to add missed TSAs ("Omitted Services" clause); (ii) framework for early and partial exits from TSA services, including costs step down; and (iii) framework for steering committee involvement to incorporate outlier events such as business critical changes to IT systems due to changing regulations or customer demands.

- Build a knowledge base of contracts where third-party consent may be required during diligence: The seller is not the only party that will seek to get monetary concessions from the buyer. Customers and vendors that have consent provisions will likely seek to extract payments to waive this clause. Getting an inventory of these during diligence provides an opportunity to better estimate one-time costs and align with the seller on whose responsibility it is to secure these consents prior to close.

- Create an expansive list of closing conditions specific to the transaction at hand: Transaction advisors should collaborate to identify any specifics of the deal the seller must accomplish for the carved-out unit to function on day one. Achieving these should be clearly laid out in the deal documentation so there is no misalignment between the parties on what it will take to be operationally ready once the deal is closed.



05

Transaction execution and close

Verdict: advantage private equity

All else equal, a private equity buyer brings a higher probability of closing a transaction and doing it faster given streamlined stakeholder approval processes and fewer regulatory approvals. Sellers value this and may be willing to take some "haircut" on the purchase price in favor of the close certainty a private equity buyer brings.

While carve-outs for private equity sponsors are not as naturally synergistic as they are for strategics, PE buyers bring a differentiated set of factors that may make a transaction more appealing. By bringing the right set of advisors across all disciplines, identifying, and protecting against risks, and thinking about the longer term, PEs can de-risk deals while enhancing exit values.

Deloitte research shows that carve-outs are an increasingly large part of M&A, rising from 6% of deals in Q4 2021 to 11% of deals in Q4 2023[3]. All PEs irrespective of previous carve-out experience should position themselves to succeed in this domain.

To close the gap with strategic buyers, win deals, and extract more value throughout the lifecycle of the deal, PEs should focus on the who (relationships with corporate and sponsor counterparty/sellers, advisors), the what (priority sectors, capabilities to acquire), and the how (deal structuring, execution) to minimize cost, control complexity, and maximize value

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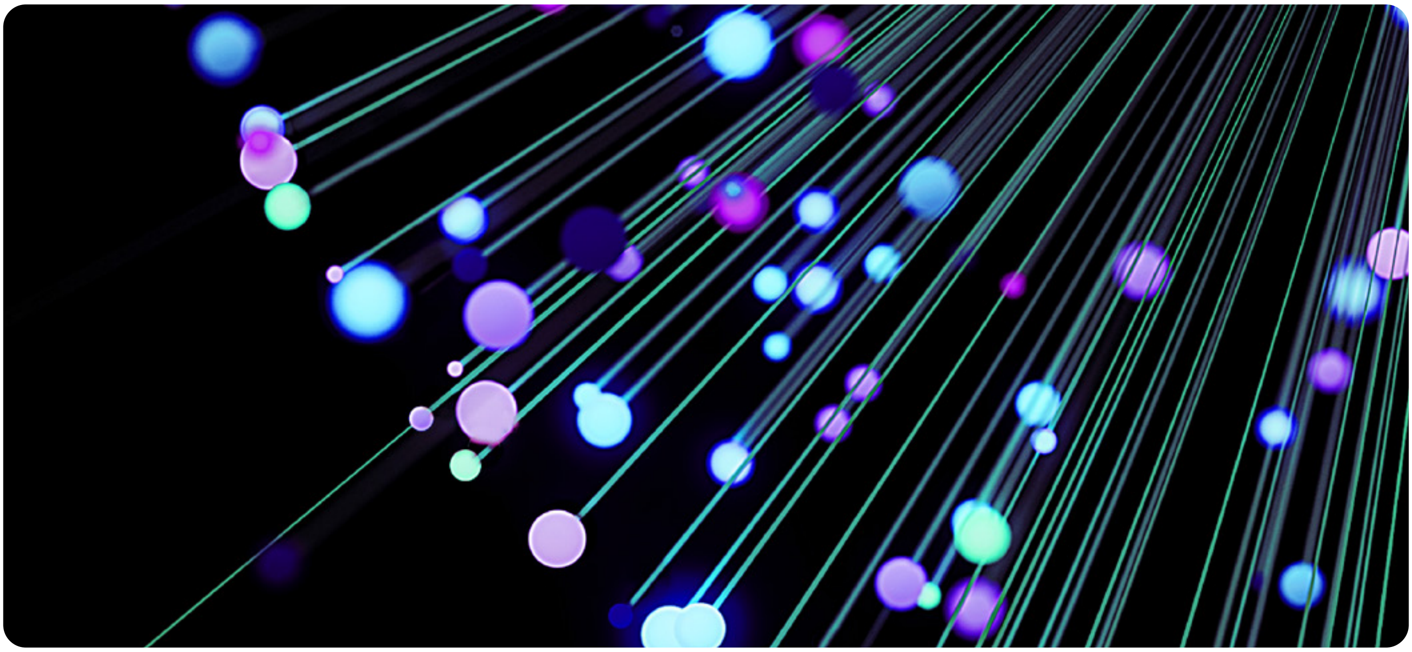

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End Notes

1. Based on Deloitte analysis on Mergermarket data of all divestiture transactions between 2019 and 2023 for all U.S. deals with a disclosed deal value and >50% stake divested
2. Deloitte analysis
3. Pitchbook 2023 Annual US PE Breakdown, Clarke, Hinds, et al

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