



The preferred
private equity buyer:
Winning carve-outs

Introduction:

Carve-out transactions present private equity investors with significant potential for high returns, particularly when economic turmoil may prompt more companies to review their portfolio mix and shed non-core assets. However, carve-outs may also pose specific risks and challenges. This makes it vital for private equity (PE) bidders to have a deal strategy built around their strengths and designed to differentiate themselves as preferred buyers.



Background:

Carve-out opportunities

Carve-outs are an important feature of the mergers and acquisitions landscape. The impetus for businesses of varying scale to evaluate their portfolio and divest non-core assets presents considerable opportunity for both strategic and financial buyers. PE investors should actively consider these opportunities, as even after private capital was deployed at a record pace in 2021, PE firms still sit on more than \$1 trillion of capital for investment.¹

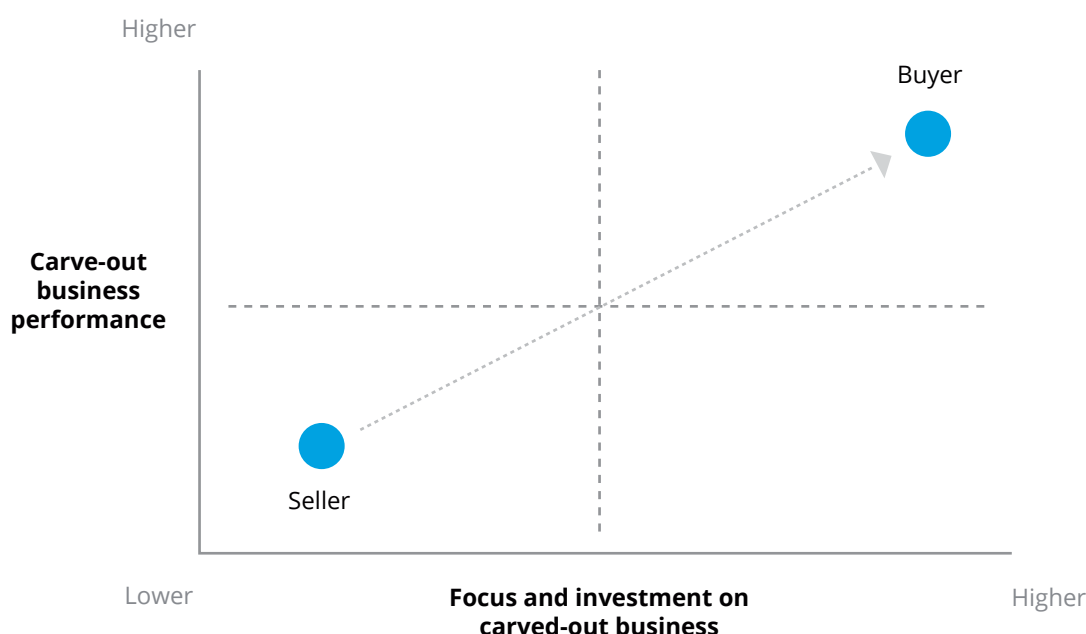
As COVID-19 has impacted global economies, companies have realigned their portfolios as they divest assets not aligned with their core business strategies. According to Deloitte's 2022 M&A Trends report,² more than half of responding executives engaged in a divestiture in 2021, while another third of them are currently considering at least one. Industry sentiment suggests that carve-outs may be even more common in an economic downturn. For comparison, in a survey conducted in 2009, during the last recession, 87% of surveyed corporate executives said they expected to execute a carve-out.

Today, with the complex macroeconomic environment having created dramatic change in the business environment and volatility in the capital markets, the need for companies to reevaluate their business portfolio may be greater than ever.

Carve-out deals typically present the potential for superior returns. For PE investors, assets that have not received adequate attention or capital infusion as part of a more diversified organization may be attractive opportunities for transformative top-line growth and margin improvements. PE buyers can bring more focused strategy for long-term value creation to these divested assets.³

Inherent to carve-out transactions, however, is a greater degree of complexity. These assets almost always come with a high degree of entanglement with the parent, and complications and risks around the change of ownership may persist well beyond the deal's closing. Buyers need a clear strategy and well-developed approach to meet—and capitalize on—the opportunities carve-outs present.

Increased focus and capital for the business can boost performance under new ownership



Key challenges for PE buyers

The challenges that may be faced in a carve-out transaction, especially for a PE buyer, can be divided into two main categories.

Obstacles to thorough diligence

Carved-out assets are generally not in the peak of health and have poor financial data, less formal channels of knowledge transfer, and several hidden costs associated with corporate allocations of back-end shared services.

Hard deadlines to separate the business and create a fully stand-alone organization may add to the transaction risk. The seller may want to limit the time and effort it expends on transition service

agreements and will therefore make the speed of the transaction a critical factor in the selection of a buyer. This may put strategic and corporate buyers at an inherent advantage while pursuing these opportunities. Our conversations with executives at companies that are divesting businesses, and with the leadership of carve-out businesses, show they are not always geared toward PE buyers when setting a sales process.

Competition from strategic buyers

While pursuing a carve-out asset, a PE buyer often finds itself competing with strategic buyers that may be willing to pay a higher premium. Unfortunately, the playing field for pursuing carve-out deals is not level: Strategic buyers have an inherent advantage by leveraging their existing infrastructure in a number of ways. They can quickly disentangle the target business, lower one-time costs, achieve ongoing cost savings by using their scale, and benefit from commercial top-line synergies through their existing channels. This disadvantaged position versus strategic buyers applies primarily to direct platform acquisitions by PE companies. In contrast, the playing field is more even when the purchase is made as a tuck-in by a PE portfolio company (as we discuss in section 1 on the next page).

Our research has shown that depending on the deal and attractiveness of the target, strategic buyers are sometimes willing to pay up to 20% more for carve-out assets. As a result, private equity buyers may be forced into bidding wars with strategic investors. Given these inherent disadvantages, many PE bids for carve-out assets do not come to fruition, losing out to strategic buyers in the sales process. Indeed, a Deloitte analysis suggests that since 2015, just one out of four carve-out deals was a direct platform purchase by a PE buyer. What's more, a majority of carve-out assets bought by PE firms tend to be smaller assets (typically less than \$1 billion).⁴

A clearer path to carve-out success

Amid the opportunities and challenges that carve-out transactions present, PE investors need a strong focus on the practices that are most likely to succeed while bidding for the assets and creating value through the transaction.

1. Look internally

A PE bidder can gain advantage by pursuing a carve-out business that fits into an existing portfolio company. A neat tuck-in will enable PE investors to mimic the privileges of being a strategic buyer without losing any control or compromising on deal vision. In addition to traditional cost benefits from integration, a PE buyer should explore top-line synergy opportunities for tuck-in acquisitions. This revenue upside could be generated from levers including cross-selling, revamping pricing strategy, optimizing the product portfolio, and accessing new markets and customer segments. Ignoring revenue synergies in the preliminary stages of a deal, and thereby leaving value on the table, may hamper success while pursuing the deal.



Portfolio company synergies strengthen a bid

We advised a PE client that was seeking to grow its presence in technology by using an existing portfolio company as a platform for acquiring a non-core business from a large food and facilities service provider. Overlap between the portfolio company and the carve-out target asset made it possible to eliminate separation costs and drive back-office synergies. The biggest differentiator, though, was the ability of the PE buyer to accurately factor in revenue upside from cross-selling opportunities in the United States and the Europe, Middle East, and Africa region (EMEA) and underwrite those revenue synergies as part of its winning bid.



2. Structure creatively

It pays to take a creative approach to structuring deals, and the best and most innovative option may sometimes be to partner with a strategic buyer. This recognizes that strategic acquirers have natural advantages on carve-out deals. Typically, in this deal structure, the strategic buyer would tuck in the jointly acquired asset with their existing business and leverage their infrastructure to disentangle the carve-out business from its former owner. In addition to deal optimization efforts, the partnership could also create value through operational and top-line synergies.

Our experience with creatively structured deals has helped us to develop an understanding of the key complications that may arise, as well as the mitigation strategies to address them. Typically, financial and strategic buyers may have competing interests and priorities. To help ensure a successful transaction, it's vital for PE investors weighing a joint venture structure to preempt key points of contention (around investment strategy, for instance, or exit considerations) and find a solution during the diligence and transaction structuring phase. Done right, joint venture opportunities can drive significant value for PE firms.



Joint venture structure boosts value capture

A large PE firm undertook a multibillion-dollar acquisition of the health care business of a diversified company, bidding jointly with a health insurance provider. The joint venture between our PE client and the strategic buyer enabled faster disentanglement of the target assets from their former owner. The structure also accelerated value capture through the insurance company's existing care platform. A put/call provision in the deal allowed the insurer an opportunity to gain full ownership in three to five years at a price based on clinical outcomes and market conditions. This feature created a desirable holding period while minimizing exit risks and uncertainty for the PE investor.



3. Move quickly

Accelerated decision-making during the deal evaluation stage can improve the odds of success for PE buyers and can boost their chances of being viewed as a preferred buyer.

More agile diligence is imperative for nimble decision-making. Merely front-loading the due diligence process by investing more resources early on is not a prudent strategy. Instead, AI-enabled and analytics-driven diligence is more likely to help a PE

bidder achieve actionable decisions. Typically, a comprehensive diligence process that encompasses finance, tax, HR, IT, commercial, operations, and product and technology can help unearth incremental value potential. There is a premium on the PE buyer's ability to capture incremental value, which can be enabled through digital diligence tools and best-in-class value-creation practices. Such tools and processes allow PE investors to evaluate deep transactional data quickly and effectively and make decisions faster.

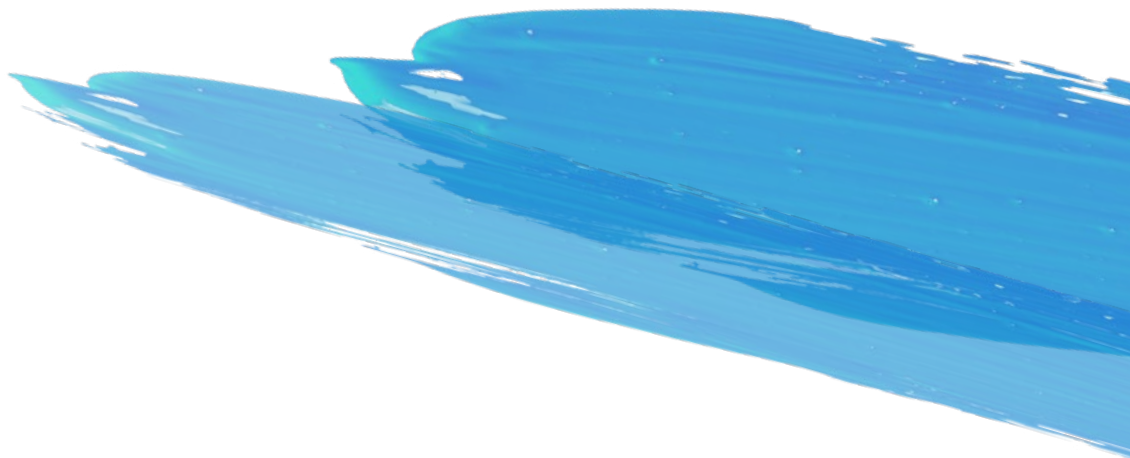
4. Drive exclusivity

Pursuing greater exclusivity during the bidding process can generate advantages for PE investors and help them become preferred buyers. There are some advantages that PE buyers offer that can help drive exclusivity.

For instance, a PE buyer may be less likely to attract anti-trust scrutiny. A number of sellers, in our experience, may prefer to have PE buyers when divesting large businesses (all else being equal) to avoid the regulatory scrutiny and potential delay that a strategic buyer might bring. This advantage also can drive a more open exchange of data between the seller and the PE buyers in the earlier stages of a deal.

PE buyers also can successfully differentiate themselves by taking a view of carve-out deals that goes beyond any individual transaction. Engaging longer term with Fortune 500 companies that are serial sellers can boost the credibility of a PE firm, making them more likely to be perceived as a friendly buyer. Ideally, this can drive exclusivity and prevent bidding wars with strategic buyers and other PE competitors. Also, some of our PE clients have advanced their credibility with sellers by collaborating on creative compensation strategy to share a portion of the business upside with employees at the target through merit bonuses, boosting retention and morale.

By showcasing their proven track record throughout the bidding process, PE investors can ultimately drive additional trust from the stakeholders and establish themselves as preferred buyers.



5. Disentangle quickly

The ability to stand up a business in an accelerated fashion may be a critical factor to win the bidding process for a carve-out business. Limiting the ask for transition service agreements (TSAs) can be attractive to sellers that are trying to turn their resources and management attention elsewhere. PE buyers can bolster their execution capabilities through a range of creative approaches that help limit the dependence on TSAs, while also reducing redundant costs as they stand up the newly independent business.

Our experience suggests that IT support from the parent company can account for a significant portion of the entanglements for the carve-out asset with the parent. A PE buyer can bring a unique ability to rightsize the IT landscape for the acquired business. Preliminary diligence related to key IT components can help identify opportunities. For instance, cloud migration may offer the ability to quickly transition a target business off the seller's IT infrastructure and onto a customized software solution. Strategic buyers, on the other hand, may be limited in their options because of existing vendor relationships or infrastructure, dragging out the timeline for IT support from the parent.

In a similar manner, PE investors can implement a focused separation strategy while approaching indirect support areas such as HR and payroll, finance and tax, logistics, and facilities. One such strategy for PE buyers is to outsource these supporting functions to external agencies (if supported by a strong business case). They may also leverage a group purchasing organization model to drive cost savings across the entire portfolio. This can also accelerate the disentanglement process and counter any dis-synergies due to loss of scale.

Leveraging analytics to perform rapid assessments in the early stages of a transaction, as the deal is being structured and diligence performed, can help identify areas of significant entanglement with the seller. Early knowledge of these issues (e.g., contracts to be addressed) will inform the chosen separation strategy. Implementing repeatable execution policies and guidelines for indirect costs can serve as an additional lever for PE investors to reduce general and administrative costs and justify higher deal premiums.

Conclusion

Given the emerging themes in the marketplace, there may be plentiful opportunities for companies to pursue carve-out acquisitions. Such transactions will involve specific challenges and risks, but they will also offer significant potential for strong returns for PE buyers that have a well-developed playbook.

On complex deals, the key to success is often differentiation. Traditionally, PE buyers have been at a disadvantage when bidding for carve-out assets, perhaps unable to bid as high as strategic buyers. But when the hurdles are tackled with a focused strategy that includes creative deal structuring and nimble decision-making, and an approach that leverages potential strengths, PE bidders can increase their success rates on carve-out transactions.



Endnotes

1. Wylie Fernyhough, Jinny Choi, and Dominick Mondesir, [PitchBook Analyst Note: How PE firms will navigate today's complex macro environment](#), PitchBook, May 27, 2022.
2. Trevear Thomas et al., [The future of M&A: 2022 M&A trends survey](#), Deloitte, 2022.
3. Bhuvy Abrol et al., ["Private equity: A new era for value creation,"](#) Deloitte, 2020.
4. Based on Deloitte analysis on Mergermarket data of all divestiture transactions between 2015 and 2019 for all deals greater than \$100 million in purchase consideration.

Authors

Bhuvy Abrol

Private Equity and Alternatives Leader
Deloitte Consulting LLP

Deepak Subramanian

M&A Strategy Managing Director
Deloitte Consulting LLP

Varun Madan

M&A Strategy Senior Manager
Deloitte Consulting LLP

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