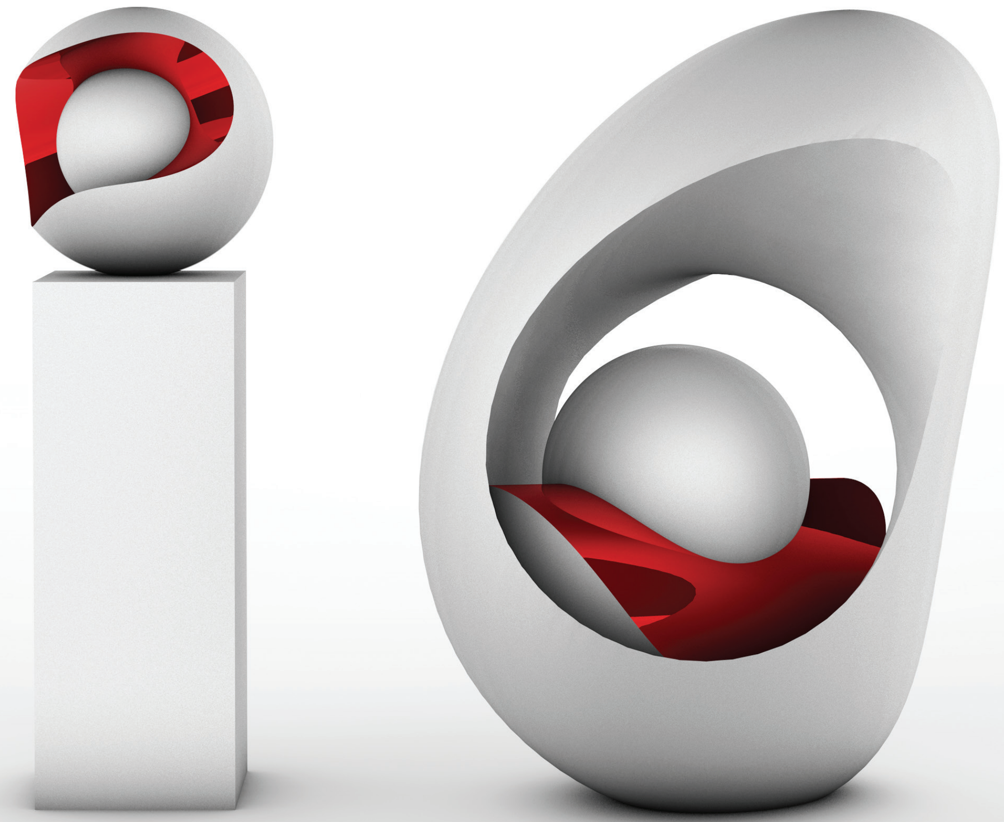
THE ART OF THE MODERN CARVE-OUT

Six steps to greater value



CONTENTS

In the past four years, Baker McKenzie has worked on 149 carve-outs valued at $100 million or more. Many were multi-billion dollar deals. This has enabled us to develop strategies that avoid loss of value.

Your biggest concern as a seller will be how you can get the best possible price for your asset.

As a buyer, it will be how to both avoid overpaying and taking on lots of unknown risk.

Whichever side you are on, experience tells us there are steps you can take to create the right circumstances for success.

You are in good company if you are considering a carve-out

In today's low-growth environment, corporates are under pressure to improve returns. Add to this activist shareholders and focused competition, and the pressure is unrelenting.

It is no surprise, then, that many corporates are withdrawing from activities where their businesses are least profitable or where there is no longer a strategic fit. Carve-outs can unlock value from these non-core enterprises.

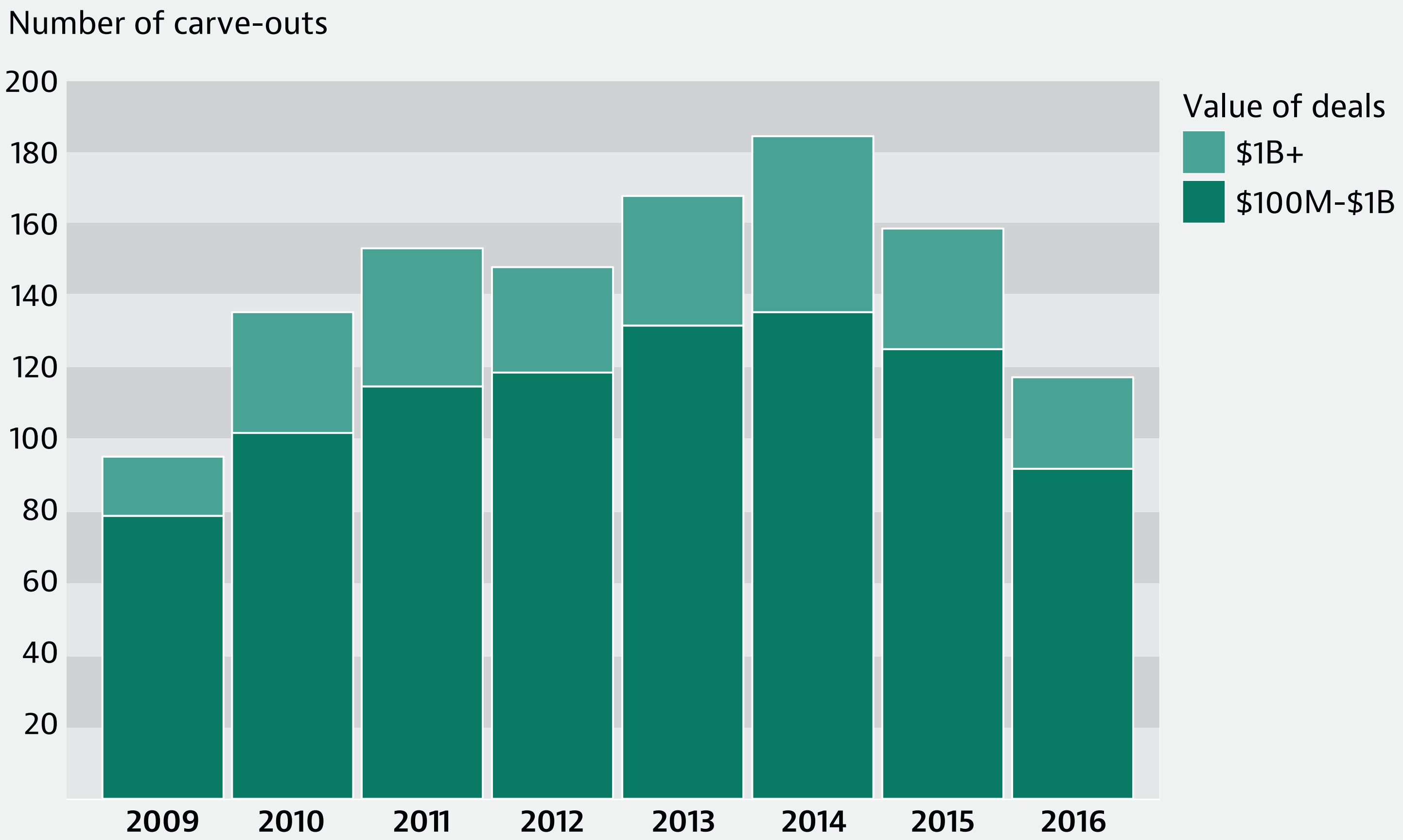
At the same time, private equity investors are taking a greater interest in buying assets that they have to carve out from the seller's business. There is often fierce competition for standalone assets, so investors are taking a more creative approach to building their portfolios.

For corporates, carve-outs can be the ideal way to pick up specific assets, such as IP or talent, that they cannot develop themselves. Carve-outs can also enhance market share.

YOU ARE IN GOOD COMPANY IF YOU ARE CONSIDERING A CARVE-OUT

Number of carve-outs globally, $100M-$1B and over $1B since 2009

The overall number increases every year to 2014. Carve-outs are predominantly tactical divestitures, which is why there have been so many more deals under $1 billion than over.



Source: Global M&A/Thomson, December 2016

IF YOU DON'T GET IT RIGHT, VALUE CAN LEAK

Done well, these deals can generate a lot of value. But they are complex. There are many pitfalls, especially when the transaction involves businesses that operate in several countries.

The way the deal is executed impacts directly on the value.

Four common ways value is lost:

The seller fails to create competitive tension in the sale process.	The timing may not be right, or the right information may not be made available up front. The result is fewer bidders and lower offers for the assets.
Suboptimal structures lead to value leakage.	The price you get is inextricably linked to the tax structure you adopt, whether you package the target in an appealing way for the buyer, and whether you can flex the structure for different buyers.
Poor cash management leaves money on the table.	You need to be careful about leaving cash trapped in the business you want to sell. Cash is not an asset. Buyers often discount cash that is trapped in a business. They are unwilling to pay cash for cash.
Poor communication puts even strong relationships at risk.	It can be easy to underestimate the cost of not keeping major stakeholders well briefed. Competitors are usually ready to step in, and reputational costs can mount up.

Case study

UNWILLINGNESS TO PLAN LEFT A SELLER UNABLE TO JUSTIFY ITS PRICE

A multinational wanted to offload its contracts maintenance services business, which was tightly integrated in several jurisdictions. However, it was unwilling to spend money on professional fees to plan the carve-out before signing. This made it impossible for potential bidders to carry out thorough due diligence.

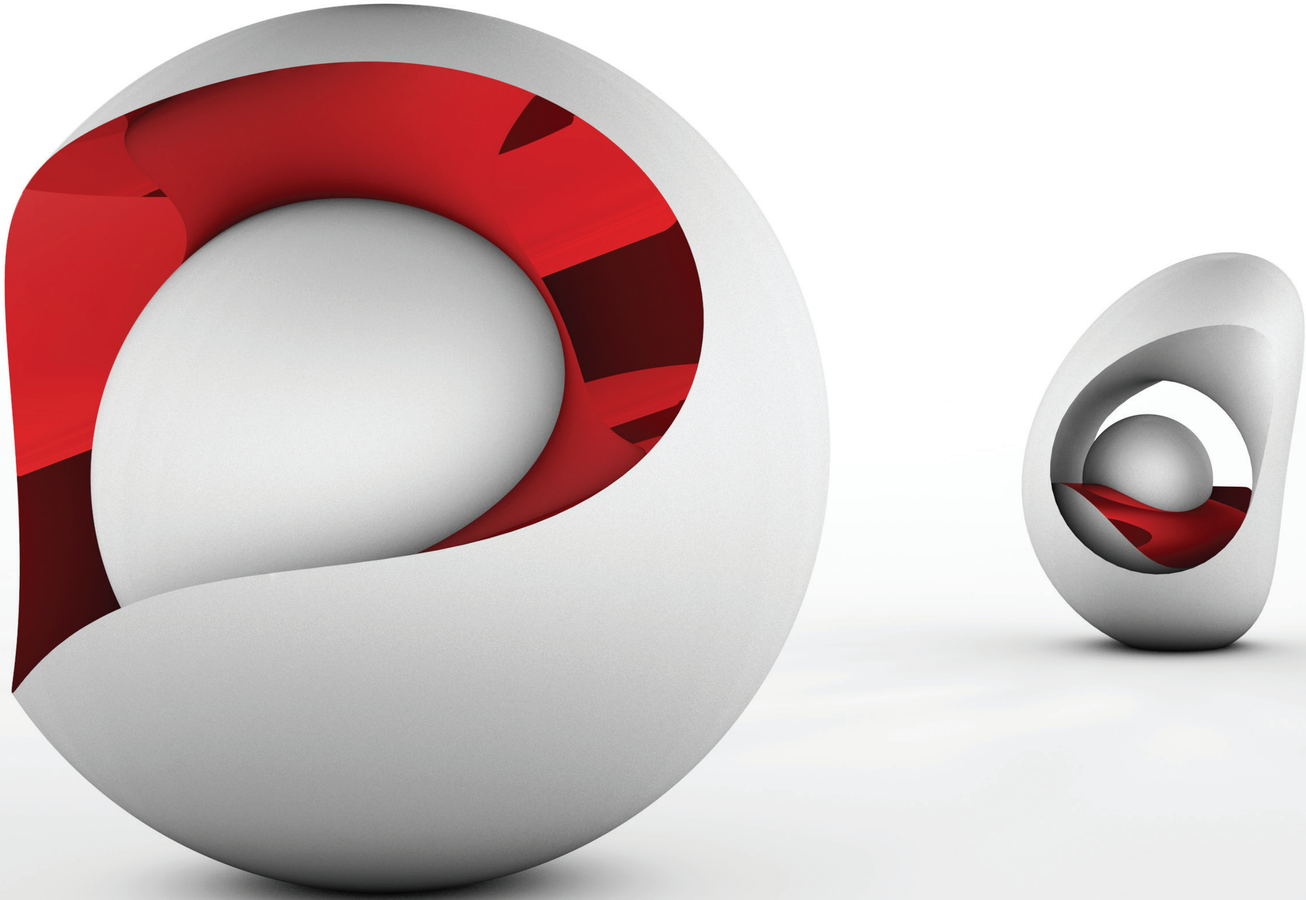
We acted for the buyer, a private equity house. Once our client became the preferred bidder, the seller's lack of planning became clear. We advised our client to seek greater protection for carve-out risk in the sales and purchase agreement.

The lack of planning by the seller enabled us to negotiate a substantial price cut at the last minute. The seller could not provide enough reassurance that they had prepared the carve-out properly.

01

SELLERS, THINK LIKE YOUR BUYER

Although you may not see a future for a particular asset in your company, to generate serious buyer interest and the highest price, you need to identify how other owners may value the asset differently.



01 SELLERS, THINK LIKE YOUR BUYER

First, decide who is likely to want the asset: a strategic buyer or a financial buyer

A strategic buyer will have an operating and legal structure into which the target asset can be fitted. The buyer may only be interested in IP or distribution, for example, and therefore be less interested in other aspects of your asset.

In contrast, a private equity buyer will generally look for a standalone entity. Private equity buyers often do not have any infrastructure to merge the target into. In some cases, the seller has to restructure the asset before the sale, and will often have to provide long-term transitional services.

Being able to package the asset with the flexibility to suit both types of buyer can help you get the best price. It is usually helpful to extend this flexibility to transitional services agreements and cost analysis.

Buyers that have less work to do may be willing to pay more

The easier it is for buyers to visualize the asset and how it would fit within their portfolio, the higher the price they are usually willing to contemplate.

Also, the more accurate and comprehensive the information you provide, the more likely you are to maintain buyer confidence. Information needs to be presented in an accessible manner.

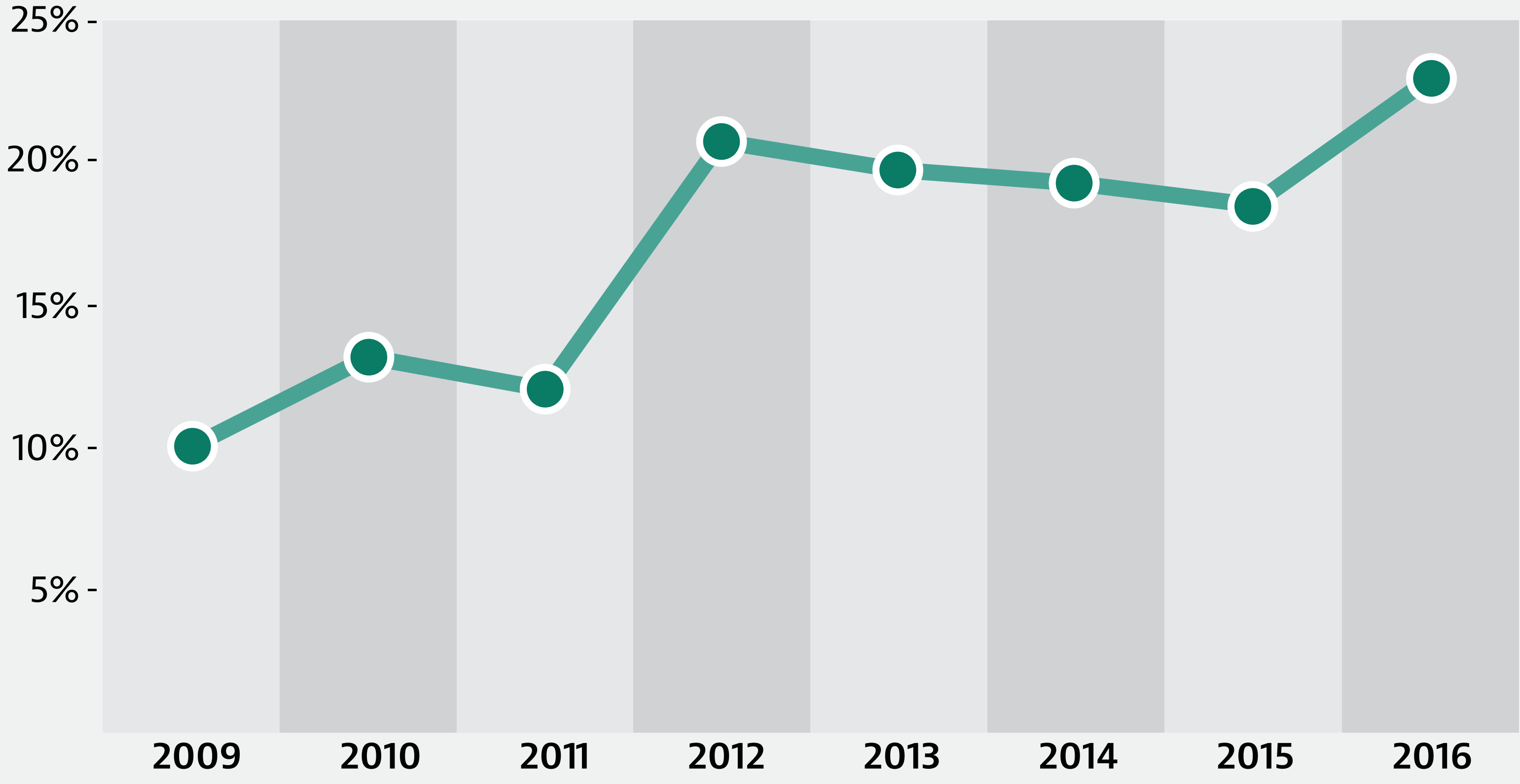
Address these criteria to improve the level of interest from bidders:

- ☐ Set out the legal structure of the asset that you will market. This needs to be tested so that it strikes the right balance between tax, operational and employment considerations.
- ☐ Define liability transfers: what liabilities may be carried over and taken on by the new owner, eg future pension costs.
- ☐ Call attention to intangible assets, such as IP, define them and assign them a value.
- ☐ Retain top talent. Incentives might include bonuses that will be paid out after the deal is done.
- ☐ Define ongoing supply or distribution networks.
- ☐ Identify the transitional services the target will need immediately after closing.

01 SELLERS, THINK LIKE YOUR BUYER

Percentage of deals, each worth $100M or above, where the buyer was a financial buyer, eg private equity

The proportion of financially-sponsored buyers has risen from 10% of all buyers in 2009 to 23% in 2016.

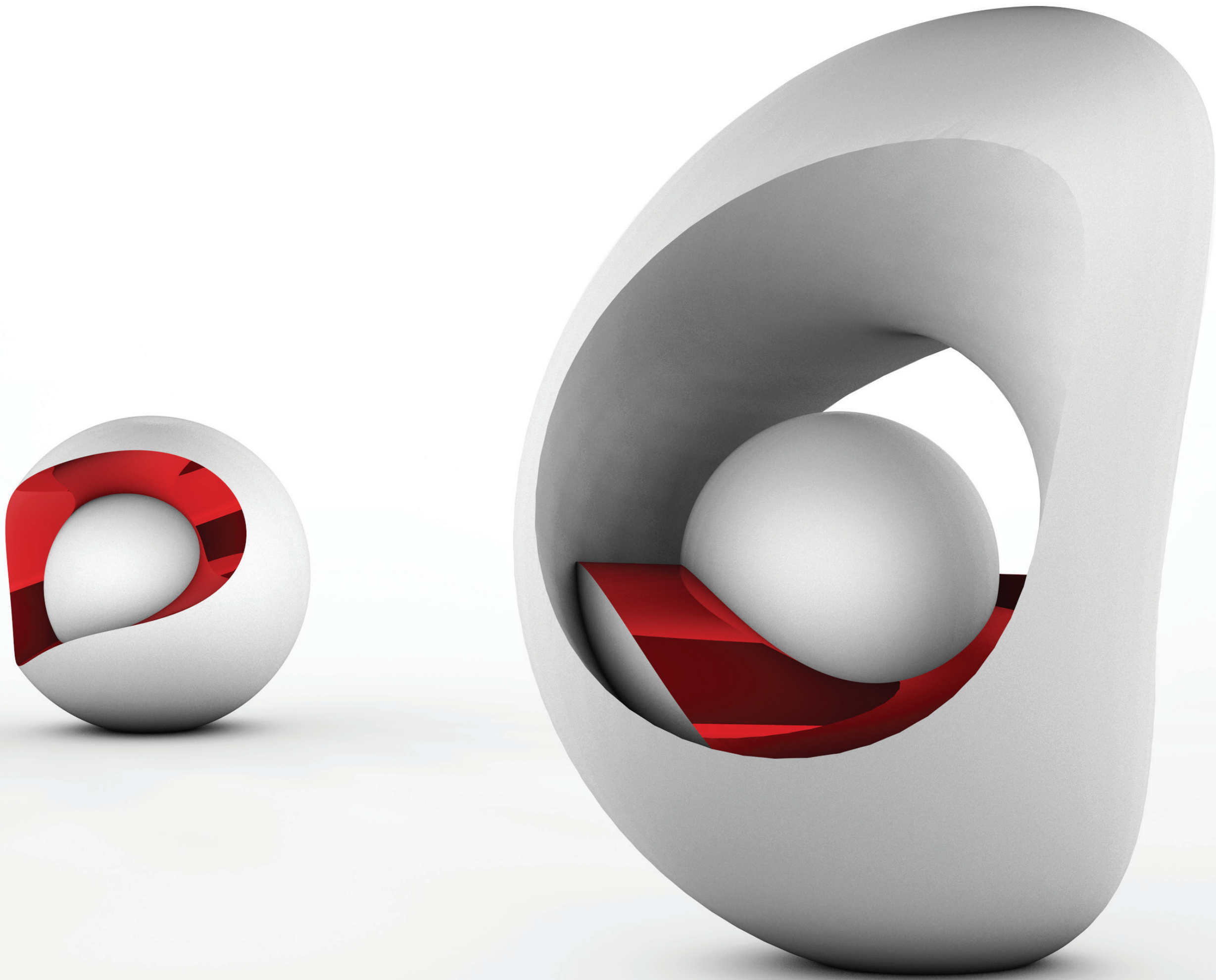


Source: Global M&A/Thomson, December 2016

02

BUYERS, FOCUS ON WHAT YOU WANT AND PROTECT IT

As a prospective buyer, you will probably know the price you are willing to pay for the asset as well as your objectives for the deal. However, you may not have considered other factors that could affect the price.



02 BUYERS, FOCUS ON WHAT YOU WANT AND PROTECT IT

Winning at auction comes down to more than price

The success of your bid will also depend on your demonstrating to the seller that you will be able to complete the deal quickly.

It is therefore critical to focus on the most important issues. Too many challenges or questions can erode the seller's confidence.

Make the most of the vendor due diligence process

Detailed vendor due diligence can help your pricing strategy.

You should focus on the needs of your medium-term to long-term commercial plans, on what you need to do to achieve these, and on the reason for your purchase.

Look at the continuity of revenue streams, for example, or where the most valuable IP is registered.

Some buyers do not make the most of vendor due diligence, and repeat much of the same work again themselves.

Front-load the work you'll have to do later anyway.

Work out how ready you are to take on the new assets

You only get the synergies if you integrate effectively, but buyers sometimes fail to factor integration into their pricing.

For example, look at the footprint of the business by country, and identify the integration support you have to put in place.

If you plan to close down parts of the business, you might have to run dual operations for a while, and may have to follow regulations for how you can make cuts. These can be costly in some jurisdictions.

You can also identify where you might have to defer closing, and include that in your negotiations and planning.

> "Buyers often hugely underestimate cost of post-acquisition integration. They often do not leverage their due diligence and so waste efforts at the integration stage."
>
> **Peter Strivens**
> Partner

02

BUYERS, FOCUS ON WHAT YOU WANT AND PROTECT IT

Shape your pricing strategy by focusing on these issues:

BUSINESS SHAPE AND STRATEGY

- ☐ The costs and synergies with the enlarged portfolio
- ☐ What the combined group will look like after completion
- ☐ Transitional services that will be needed, and their cost
- ☐ How you want to operate in the future

OPERATIONS

- ☐ The process and costs of relevant HR issues, including contract renegotiations and redundancies
- ☐ Benefits and pensions arrangements for the current workforce
- ☐ The internal operational structure and headcount: number of shared resources and standalone teams
- ☐ The legal structure
- ☐ Which IP, suppliers and customer contracts are included or excluded, and which contracts have to be renewed
- ☐ How difficult integration of IT systems will be. How many systems have to be upgraded or replaced

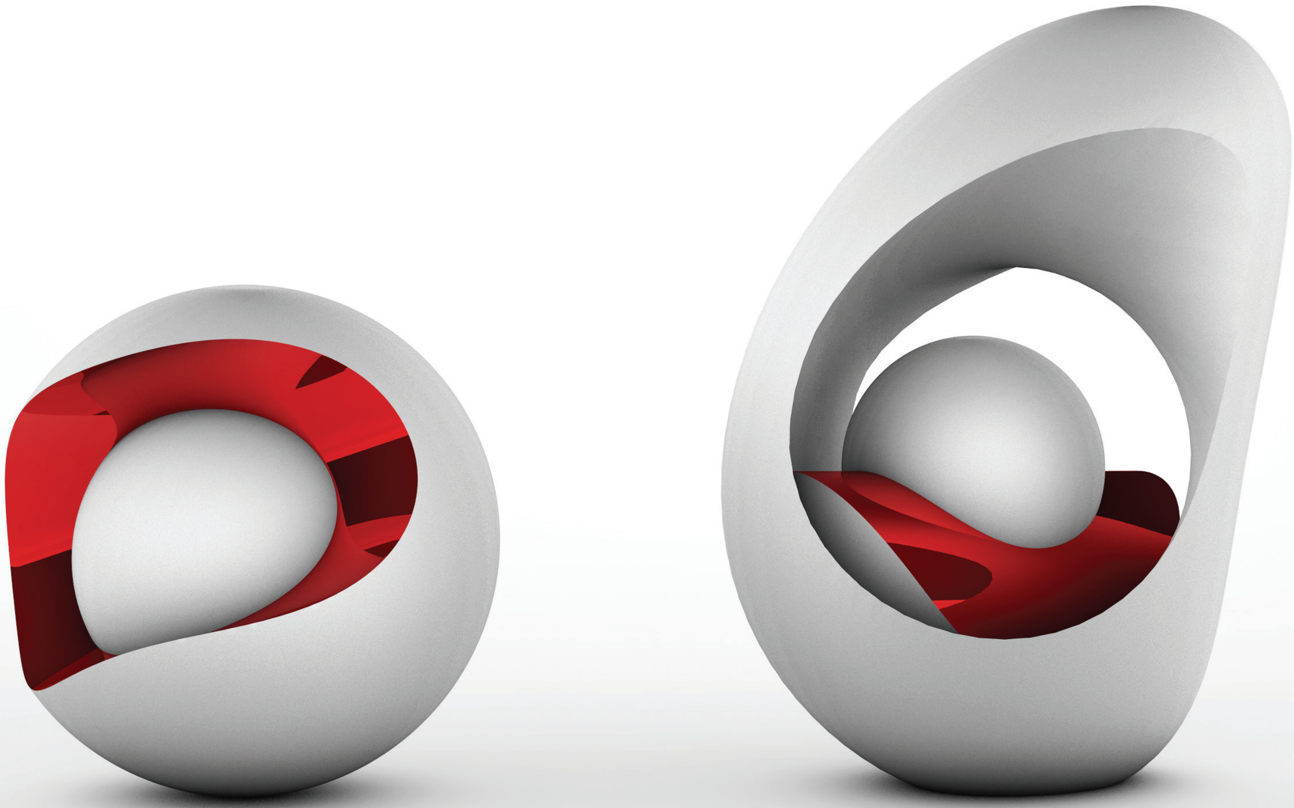
IMPLEMENTATION

- ☐ Where cash may be trapped in the structure, working capital and cash balances by legal entity
- ☐ Which assets and liabilities will be included in the carve-out, by legal entity
- ☐ Whether financing will be required
- ☐ What might lead to delays to final completion

03

DESIGN A DEAL STRUCTURE

There is always an acquisition structure that suits both the buyer and the seller. The ideal structure will maximize value for you and the other party, whether you are the buyer or the seller. It will also minimize business disruption through the separation process.



03 DESIGN A DEAL STRUCTURE

Sometimes the best value isn't the cash price: it's the price and structure that works best for both parties

Tax should always be front of mind. With careful planning, you can minimize the exit costs for the seller and set up a tax-efficient structure for the buyer.

The way in which this is done depends very much on the existing tax structures of the buyer or the seller.

Decisions on the structure may also affect the deal timetable, depending on any local rulings or registrations that you need, and how long it takes to set those up.

The best legal or tax structures do not always reflect how the business actually wants to operate

This can present a problem. The logical way to separate, from an operations perspective, might not be the most tax-efficient. Our recommendation is to try to preserve as many of the target's tax attributes as possible while still working closely with the business to sketch this out.

Deals are often negotiated on the basis of a cash-free and/or debt-free position

As the seller, there are ways for you to move cash out of the target business: dividends, loans, and ways to run down cash. Options like these take time, so start your planning early.

Any cash or distributable reserves may be subject to foreign exchange controls in the context of a deal across jurisdictions.

Local entities may be able to declare interim dividends. If not, there are other ways to repatriate cash.

> "Today's more robust tax structures have to be defendable at a time when laws are tougher – BEPS, for example – and where perceptions judge companies more harshly."

James Smith
Partner

03 DESIGN A DEAL STRUCTURE

Four common ways to repatriate cash in a carve-out:

DIVIDENDS	INTERCOMPANY LOANS	RETURN OF CAPITAL	CAPITALIZE NEW LEGAL ENTITIES
☐ Financial information will usually have to be prepared in advance. ☐ In some jurisdictions, there will be timing restrictions on when an entity can declare a dividend. ☐ There may be a lack of distributable reserves. ☐ Interim dividends may be available.	☐ Consider local law or tax issues when making an inter-company loan. ☐ There may be restrictions on borrowing under the deal terms or on cross-border lending. ☐ If the loan cannot be repaid, it could be repositioned within the target group.	☐ Statutory processes, financial information and reporting may be needed. ☐ This can be sequenced with other steps, e.g. stock transfers. ☐ Third-party audit reports may be required.	☐ Manage cash to the lowest possible cash balance. ☐ Use cash to fund the carve-out or to capitalize the new entity. ☐ Use letters of direction to position cash in other jurisdictions. ☐ Be aware of defined benefit pension schemes. ☐ Treasury can review bank accounts, currency trades, cash flow planning and working capital.

Case study

BY ENGAGING WITH SENIOR MANAGEMENT AT THE RIGHT TIME, POTENTIAL BUYERS CAN BUILD RELATIONSHIPS EARLY WITH THE PEOPLE WHO ARE BEST PLACED TO LEAD THE BUSINESS BEING ACQUIRED

Our client – a private equity investor – prefers to pick targets that need restructuring, and that are more complex to carve-out from the seller's business. These deals attract fewer bidders, and tend to be businesses that have been ignored for some time, that are under-performing and that operate on very low margins.

Senior management can often see the opportunities to improve, especially when they are incentivized through equity allocation or ratchets. They can make life-changing amounts of money when the private equity investor exits.

The target's management will sometimes get a say in the auction process. Our client engages as soon as they can with senior management during the auction process, to understand their vision for the business and build relationships with them. This can help them win the bid, even if they may not be offering the highest price.

04

FOCUS ON THE DETAILS WITH A TEAM THAT KNOWS THE LOCAL MARKET

Whether you are the buyer or the seller, unforeseen delays will be costly. Small local issues can turn out to be material to the deal, or they can change the structure of the transaction.

04 FOCUS ON THE DETAILS WITH A TEAM THAT KNOWS THE LOCAL MARKET

Local management knows how the business operates in their jurisdiction

Sometimes assets do not look the same on the ground as they do on paper, so local due diligence is vital.

Sellers that collaborate with local management can usually identify potential problems early, and this local knowledge helps set realistic close dates.

If the buyer does not operate in that jurisdiction, you cannot always know when they will be ready. Licenses and government approvals, for example, can delay closing.

Local experts can translate the global deal into a local context

A global overview is important, but local experience is essential because laws and timeframes in different countries can cause surprises.

Normally there are local laws or practices that differ between jurisdictions. These may include how new companies are set up or how licenses are awarded.

Local experts understand their market and can manage potential problems to protect the global deal.

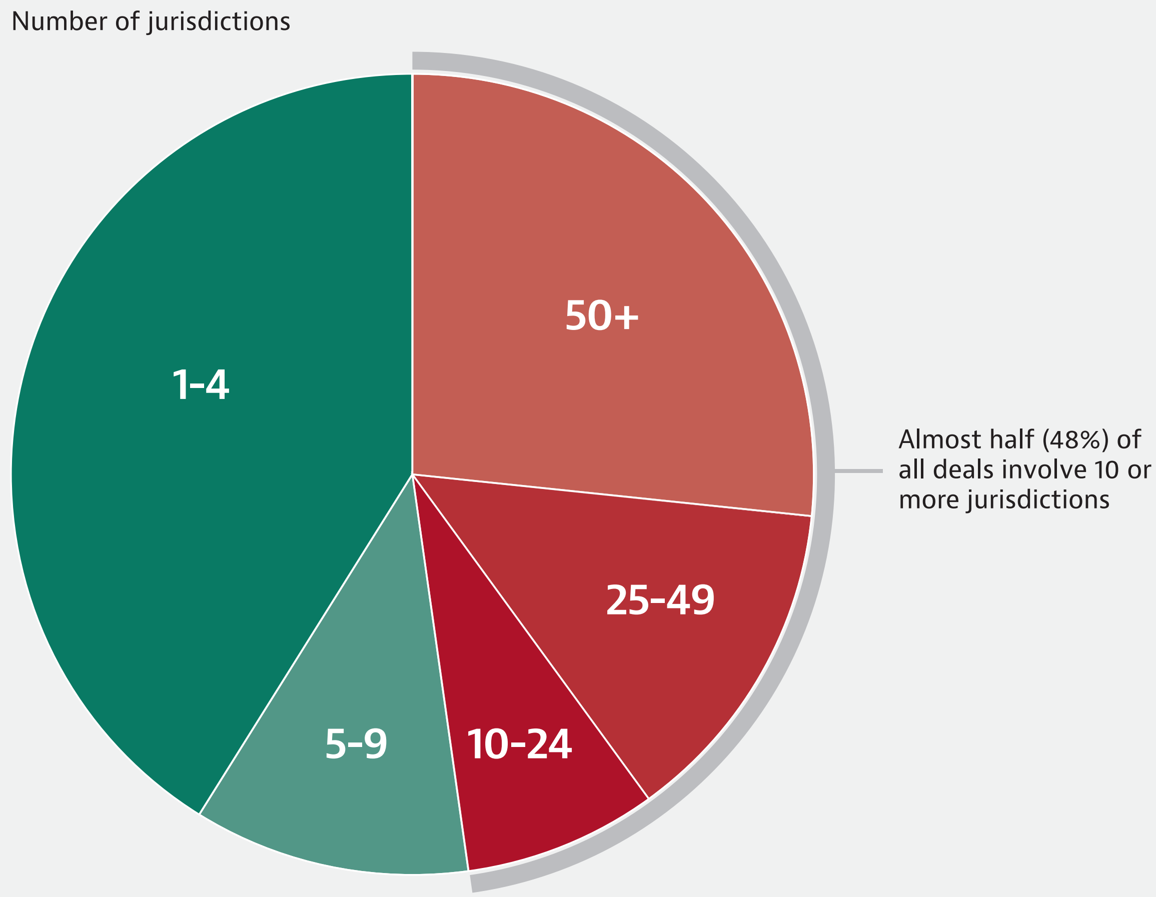
Local and global teams need to find efficient ways to work together

Sometimes global teams do not communicate well with local teams. They work from different fact patterns, or information from different sources.

To avoid a fiasco where teams end up working at cross-purposes, we also recommend thinking about how two-way communication can be most effective and what support is needed through the deal process.

04 FOCUS ON THE DETAILS WITH A TEAM THAT KNOWS THE LOCAL MARKET

Number of jurisdictions involved in the sell-side of the world's 90 largest carve-out deals, 2012-2016
Almost half (48%) of all deals involve 10 or more jurisdictions.



Source: Global M&A/Thomson, December 2016

05 PLAN YOUR HR STRATEGY

HR should be strategic, not tactical. HR issues are sometimes left until the implementation stage, rather than addressed when the deal team plans its strategy.

05

PLAN YOUR HR STRATEGY

Thinking about the HR issues early on makes a big difference

Keeping your people engaged is important. This can be done through careful planning and communication.

Negotiations can go awry when deal teams leave HR colleagues out of the room at the planning stages while they engage more enthusiastically with Corporate, Tax and Business Development.

Don't base your people plan on wishful thinking

Lots of plans calculate synergies, but do not look more widely at whether those assumptions are realistic. You should ask yourself whether the core concept works – with your people in mind.

Due diligence at early stages can validate the thinking behind the core drivers of the deal. Without this, the deal plan could be based on false assumptions.

Your negotiations with employee representatives may be complex, so prepare a strategy from the start

A large parent company protects employees from economic cycles or weakening performance. This may not be the case when part of the business is spun off. Employees sometimes perceive their future employment to be less secure. They may lose generous benefits packages. They may have other objections against the buyer, such as not wanting to join a competitor. Unions tend to focus on all these difficult issues.

Unions can be powerful in the EU. They often share information. They have learned that they can strengthen their negotiating positions by collaborating across borders.

Unions and employee representative bodies worry most when they see a private equity buyer. Such buyers have a reputation - not always based on reality - for harsh employment practices. Talks can be combative from the start.

Consultations should be planned with care, given the powerful positions of unions and works councils in many areas of the world. Think about your timing and budget.

05 PLAN YOUR HR STRATEGY

Communicate well, and your people will be less likely to leave

Some in-house HR teams may not have worked on a transaction of this scale.

Deal teams should plan their consultation with care. There are formal requirements for information and consultation, but it is important to keep in mind what impact the change may have on people. Good communication can alleviate a lot of concerns. However, do not over-promise. You could create legal liabilities if you get this wrong.

Decide how to package pension liabilities

When you separate a business, benefits and compensation are usually protected going forward. Of all the HR decisions made in a carve-out deal, the most complex is normally how to deal with pension plans.

Few companies have final salary or defined benefits plans still in place. The UK, Germany, the Netherlands, Sweden and Japan are exceptions where there are frequently onerous rules protecting beneficiaries.

> “I often see HR issues not properly recognized from the outset of deal planning. I have seen many business plans fail the reality check of tough unions and works councils, in particular in the EU.”

Guenther Heckelmann
Partner

Case study

WHEN THINKING ABOUT PEOPLE, CONSIDER BOTH LEGAL AND CULTURAL ISSUES. EXPERIENCE HELPS.

Our client was one of Europe's largest construction companies, with global operations. It employs nearly 100,000 people. The company wanted to sell a major division.

In the planning stage, it became clear that employment issues might scupper the deal. Unions and works councils had decided that our client's collective bargaining structure would put employees at a disadvantage.

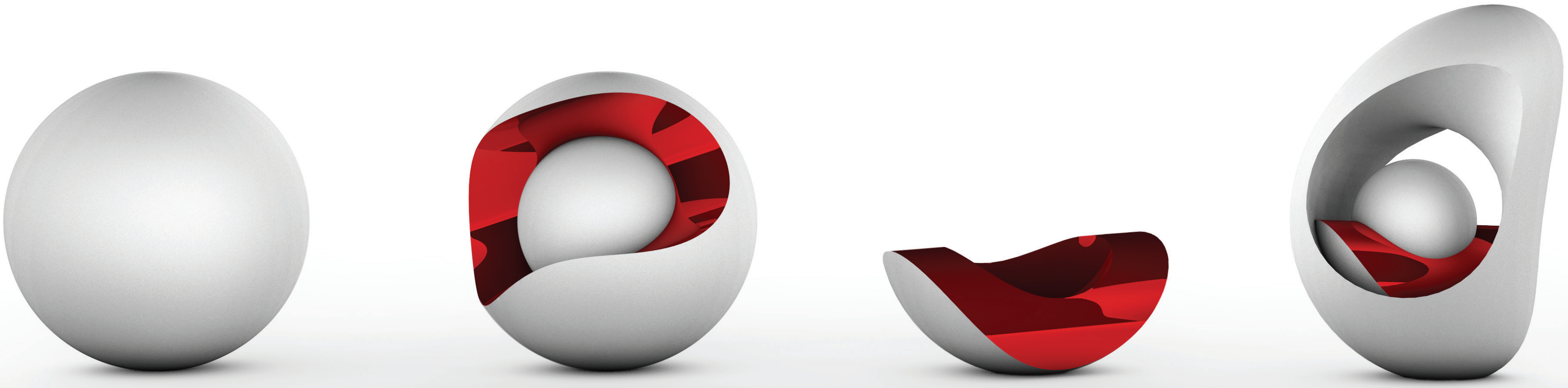
In Germany, employees have the right to refuse to move to a buyer. A collective objection is a forceful tool.

We worked on the pre-planning, talking to unions and the Works Council, about significant transfer arrangements to protect employees in Germany. This involved several thousands of employees.

The deal was completed.

06 PUT EVERYTHING TOGETHER

You want to get the best price for your assets. It's important to you that your buyer and other stakeholders are confident in the process and not surprised as the transaction progresses. Good planning is key to creating this confidence.



06

PUT EVERYTHING TOGETHER

There are many moving parts to coordinate…

Once the deal terms have been agreed, you embark on the final, most complex stage of the transaction: implementation. This is not easy when you have engaged many teams of different advisers, when the deal depends on thousands of lines of data, and when there are local variations for transitional service agreements, approvals and contracts. There are countless opportunities for errors and misunderstandings.

…and many stakeholders to keep on side

You may be following due process, but if you haven't engaged well enough with your stakeholders, you may find they simply walk away.

Valuable employees might leave if they do not feel it is in their best interests to stay with you

Consulting employees can help retention and prevent the heavy costs and damaged reputation that may result if unions or works councils take legal action.

Customers and suppliers might walk if not engaged early

Serious churn can be avoided if you make a point to communicate openly and regularly with your major customers and suppliers. Clear messages from within the business are always important, and most of this can be planned. But this is often a source of anxiety for in-house legal teams. Shared contracts and transitional service agreements might cover some important areas of the business for the short term, but not for the long term. Keep in mind that suppliers react better if they are kept informed before the deal is finalized.

Landlords might decide to be difficult about leases and hold you to ransom

However, they may be more flexible if they are consulted early and kept informed.

06

PUT EVERYTHING TOGETHER

Far from being an overhead, strong planning underpins a successful transaction

Given the complexities of these transactions, planning and project management should not be an afterthought. They create confidence early on, and make integration considerably more successful.

Based on our experience, the organizations that achieve the greatest success with their carve-out transactions tend to place project management at the center of their approach.

With good planning they can anticipate deferred closings earlier in the process and allow appropriate arrangements to be made, such as escrow accounts, working capital plans and secondment arrangements.

Great execution leads to faster completion and maximizes value

For large-scale and multijurisdictional projects, an integrated project management team is very effective – lawyers, accountants and other professional advisers working alongside professional project managers.

These specialists piece together the puzzle. They understand the deal issues and design reporting frameworks and escalation paths for hundreds of different workstreams.

> “There are lots of quirks between pensions in different countries. It is important to understand the detail if defined benefits plans are involved, as the liabilities can be substantial.”

Jonathan Sharp
Senior Associate

Case study

INTEGRATED PROJECT MANAGEMENT CAN LEAD TO A FASTER COMPLETION

We acted on a large disposal for a multinational that wanted to divest an underperforming business unit. The unit was tied to other parts of the business across multiple jurisdictions.

We were brought in early enough to help design the disposal process. We focused on implementation, and that enabled us to solve a number of local law complications with the transfer of assets.

This clear plan instilled confidence in bidders, allowed rapid due diligence and sped up negotiation of the purchase agreement. It enabled our client to identify tricky areas ahead of time and prevent problem jurisdictions from delaying the closing.

We completed the sale within a month of signing.

ABOUT US

More companies choose Baker McKenzie than any other law firm for their important cross-border transactions.

Cross-border deals are often highly strategic and even transformative for a company. They are significant and complex undertakings for any organization and require experience and efficiency to maximize deal value.

We are consistently ranked "No. 1" by legal directories, with more than 13,000 lawyers in 77 offices across 47 countries.

Our global M&A team is fully integrated and works seamlessly across time zones, cultures and languages to get the deal done, manage risks and achieve desired synergies.

We have deep experience in cross-border deals: more than 60 years investing in and refining our precedents and processes to drive efficiency and provide the highest quality standards and deal practices.

Our experience enables us to take a broad view of the transaction, from inception through integration. We help you identify and address potential timing issues early on to avoid delays and increase deal certainty.

Our carve-out deal analysis

For this study, we analyzed 1,160 carve-outs of at least US$100 million in value (at that time), based on data provided by Thomson Reuters.

The deals were either reported as intended, pending, announced, partially completed or completed between 2009 and 2016. To ensure the deals reflect the subject of this study, we have included divestitures, spin-offs, split-offs and equity carve-outs. We actively selected deals that involve a transfer of units, department, division or business (up to 100%) from one seller to one buyer. We have excluded property acquisitions, joint ventures, mergers, buy-backs, recapitalization and secondary buy-outs.

www.bakermckenzie.com/carve-outs

If you would like to explore these issues in more detail, please speak to your usual contact at Baker McKenzie or email **carve-outs@bakermckenzie.com**.

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