Private equity carve-outs

The profits and pitfalls

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GPs can pick up non-core businesses with a lot of value potential. Writing in Private Equity International, Baker McKenzie’s Jannan Crozier and Richard Needham say getting everything right in these transactions is not simple.

Safe places to invest no longer exist in the traditional sense.

The global marketplace has been trading on shaky foundations since 2008’s financial crisis. Even traditionally stable economies, such as the UK and US, have shown a capacity to shock investors through unexpected political change and uncertainty. For private equity funds seeking to retain their historically strong returns, realising value is therefore harder than ever.

One increasingly popular investment option, on which we at Baker McKenzie regularly advise, is the carve-out transaction: the acquisition of non-core assets and businesses from global corporate conglomerates. These are nothing new, and traditionally have been used by corporates to divest of underperforming assets. The modern day carve-out is different.

Today, as unwieldy corporates are out of favour with investors, they face growing pressure to divest non-core assets that do not fit a more focused strategic picture, even if they are profitable. This is resulting in strong and viable global businesses being auctioned by means of highly competitive processes.

While complex, the benefits of investing in carve-outs are many, particularly for private equity funds. When an unloved asset is freed from the shackles of a much-larger listed corporate entity, there is the potential to unlock great value. The management team can be reorganised to fit the new standalone structure,
without the need to toe a broader strategic line that is out of sync with the core business.

Further value can be realised from synergies achieved by integrating the carved-out business with complimentary portfolio assets. Many of these benefits can be seen in deals we have worked on in the past year, including Emerson Electric’s $5.4bn divestment of two non-core businesses, the largest being the $4bn sale of its Network Power business to Platinum Equity.

Richard Needham

In the near future, the likelihood of more carve-outs and spin-offs coming to market is strong, especially in the industrial and manufacturing sectors, where we are seeing the impact of a growing focus on digital strategies and depressed commodity prices. Also, if President Trump follows through on his proposed tax reforms, more US multinationals could bring money held overseas back to the US. More cash in the market will inevitably lead to more spending on M&A, but will also increase competition and valuations. That competition will not just be from other financial sponsors, but also trade buyers, who can leverage off existing legal and operational structures (such as back office functions like HR, IT and legal) to avoid some of the pitfalls that might otherwise hamper private equity buyers.

Private equity houses still have the edge, though, when it comes to bidding for carve-out targets, especially if they prepare properly. They can be nimble in the marketplace and act quickly when an opportunity arises, particularly when it comes to the timing and pricing of a deal. Although they may need more transitional support to get to a standalone structure through Transitional Service Agreements, where the seller agrees to provide back-office functions for example, they typically carry less baggage from a merger control perspective which can help shorten deal timelines, and they come armed with experienced deal teams.
Gaining the edge is crucial, but it can only be achieved if all the right pieces are in place from the outset. The two most important aspects of any carve-out deal are timing and price. It is impossible to get the timing right if you have not properly mapped out the perimeter of the target business and prepared the right tax and legal acquisition structure.

To succeed in this task, it is important to engage experienced carve-out counsel. With these transactions, the success is in the detail, and if your external advisors have limited specific expertise, issues will be missed and the deal put at risk. Carve-out counsel should be able to take a holistic view of the carve-out, not just on the corporate and tax structuring, but also in crucial areas such as employment, pensions, real estate and cash repatriation. They should be fluent in the issues applicable in every jurisdiction. Failure to identify, manage and resolve local carve-out issues can lead to delays and value leakage (e.g., by way of price chips or excess cash trapped within the target business).

Additionally, as the complexity of carve-out deal increases, it is vital for the deal team to have integrated project management support to manage big data sets and harness modern technology to control from start to finish.

In a world where private equity funds are having to be more adventurous in what they invest in, the carve-out offers a bold alternative to the ever-diminishing number of standalone investment opportunities. Inevitably this comes with risk, but with the right guidance and experience behind them, private equity sponsors can attain a significant edge when it comes to the timing, pricing and structure of a successful carve-out.

Get these factors right, and the rewards on returns can be dramatic.

Jannan Crozier is an M&A and private equity partner who has advised clients on deals including carve-outs, cross-border mergers and acquisitions, infrastructure transactions, joint ventures and corporate reorganisations. Richard Needham is a senior associate who advises clients on corporate maintenance, compliance and general corporate law. Both are based in London.