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Tips to Make Your Carve-Out Transaction Stand Out

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Does your company have a particular line of business that is underperforming or no longer aligns with your core business strategy? Value is in the eyes of the beholder, and what may be of little to no value to your organization may, in fact, unlock another business's ability to expand its profit margins and overall value.

A carve-out is a sale of a business line or portion of a larger company, with the potential to generate capital relief to the seller, and future capital gain to the buyer. A carve-out can attract a type of buyer looking for specific assets, such as specialized human capital or intellectual property, which would otherwise require time, talent, and substantial cost to develop, or a private equity investor ready to transform a fledgling standalone target business with a lucrative masterplan.

While there is potential for significant capital returns, carve-outs can be extremely complex and require careful consideration. The core business may be deeply interwoven with the target business. Early preparation and planning are key for avoiding potential transactional pitfalls and maximizing a seller's profit margin. Done right, a seller can prevent value leakage of the target business with a price tag to match.

This checklist focuses on the seller's perspective of a carve-out transaction and limits the scope of discussion within the U.S. Additional considerations are implicated with cross border transactions. Consider the following, and your carve-out can be a standout:

Engage the Right Cross-Functional Team Early

In every M&A transaction there is tension between maintaining the confidentiality of a deal and bringing employees from the target business "under the tent" to assist in the sale process. However, in carve-out transactions, identifying the right team is critical due to the complexity of first identifying the perimeter of the business and then separating assets and liabilities of the carved out business from the remaining business lines.

- Be proactive about forming the right team of knowledge specialists (e.g., corporate legal, finance, tax, IT, regulatory and employment) to determine realistic and strategic deal objectives.
- Consider the long-term cost benefits to mobilizing a strategic team early to plan for business entanglements that, if left unresolved, would otherwise create future expenses.
- Weigh the risks of early leaks about a potential sale, including potential impacts on employee morale.

Know the Target Business That You Are Selling

A clear and comprehensive picture of the target business will increase buyer confidence, which can result in a premium price and accelerate momentum to closing. Carve-outs are inherently messy and to make matters worse, it is not unusual that the business to be divested may have been neglected operationally and suffer from a lack of in-depth seller knowledge. A wise seller will invest early in understanding the market and what might attract buyers, while getting a concrete handle on what specific assets and liabilities exist that are related to the business.

- Establish transaction perimeters. What will be sold? What will be retained?
- Understand why you are selling the business and what levers will generate value in the transaction for you as seller.
- Craft a compelling narrative about potential value in the target business.
- Identify any value sweeteners for the buyer that could be included in the deal if you are pressed.

Design an Optimized Deal Structure

The best value in a carve-out isn't always the cash price being offered by a potential buyer. Evaluating offers should involve weighing both the purchase price and the proposed deal structure.

The ideal structure will maximize value for both buyer and seller, while at the same time minimizing business disruption through the separation process.

- Keep tax front of mind and plan from the outset structuring that can minimize tax costs while preserving tax assets that can drive value. Even good tax losses, i.e., selling the business at a loss, can be valuable.
- Examine whether assets are locked by unfavorable contract provisions, including those that could restrict future assignment. While re-negotiating problematic contracts is possible, simple steps such as changing forms used by the business to allow assignment or to separate services by lines of business can save major headaches down the line.
- Involve operational teams early to weigh in on proposed structures to help identify problems early. Remember that even the best legal or tax structures do not always reflect how the business actually wants to operate.
- Remember that market temperature also matters. In a hot market, the seller has more leverage in the deal and may be able to push its preferred deal structure.

Map Your Employees and Develop a Communication Plan

Talent drives business. The value of the target business includes human capital. Chaos and misinformed rumors can spur valuable talent to run. Determine in advance who will stay, transfer, or leave after deal closing. Consider how, when, and in what form information will be shared. Strategize with the senior HR team to ensure that the target business continues to function during and after the deal.

- Determine employees who will stay with the legacy business, who will transfer with the target business, and who will be let go upon closing. Ultimately, seller should ensure that they are assigning sufficient employees to move with the carve-out business to drive knowledge transfer, integration, and successfully operate the business.
- Manage and strategically time employee communication about deal process to retain key talent and mitigate disruptions in the target business. The communications strategy should address compensation, process, transition arrangements and other similar details that are important to the employees.
- Prepare for additional considerations with unionized employees.
- Create an HR playbook to curtail employees exiting the target business as a result of learning about the deal. Consider incentive plans and strategies (i.e., retention bonuses and benefits).

Plan for Business Engagements

Separating a business is a process. Examine where the target business connects with the core business (e.g., internal operating systems, employee pension and benefits plans, or vendor and customer contracts where discounts are contingent on shared services). Recognize that the buyer was attracted to the target business when it was running with the core business. Manage expectations by planning and beginning the separation process early.

- Determine what the buyer needs post-closing, such as temporary shared services, access to software systems, or employee transfers, to operate the target business through a Transition Services Agreement.
- Start early with managing shared contracts. Consider splitting contracts or revising assignment provisions when renewing contracts to separate the retained business from the target business.

Prepare for Carve-Out Financials

Separating the financials of the target business from the core business can be challenging. Financial statements are often prepared for the company and not delineated by business lines. Secure a competent finance team who can jump in and strategically separate the target assets and liabilities to attract more willing and ready buyers. Depending on the scale of the carve-out, a buyer may need to consider debt financing to acquire the target business, in which case the buyer will need the target business's additional financial statements.

- Mobilize your finance team.
- Identify and separate target business financials from intercompany transactions by isolating target business' assets, liabilities, and expenses from the core business.
- Recognize that a buyer may need specific financial statements to acquire the target business, (e.g., in connection with debt financing) and start dialogue early about what will be needed.
- Know whether the carve-out transaction falls under Rule 3-05 or Rule 8-04 of Regulation S-X, for which financial statements must be filed with the SEC.