PRIVATE EQUITY'S GUIDE TO EVALUATING M&A CARVE-OUT TRANSACTIONS

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A carve-out transaction involves the sale or divestment of a division or assets comprising a specific business line, subsidiary or other unit of a larger business enterprise. Carve-out transactions create a path for sellers to discard businesses least aligned with core business strategies while also generating additional capital for the seller. There is anecdotal evidence that private equity buyers have obtained superior returns from investments made as a result of such carve-out transactions which are typically consummated at favorable valuations that come with ready managerial talent.

Carve-out transactions invoke unique challenges compared to standard M&A transactions. Being experienced in executing carve-outs and/or utilizing experienced representation is vital to identifying and resolving the distinct issues that carve-outs pose. Below is a list of key issues that private equity firms should consider when planning and executing a carve-out transaction and navigating the post-closing exit and integration process. This list is based on Koley Jessen's experience in closing carve-out transactions in a variety of industries, as well as from our extensive contribution to and review of the 2017 Carveout Transaction Deal Points Study published by the ABA Business Law Section Mergers & Acquisitions Committee's Subcommittee on Market Trends (ABA Carve-out Study).

KEY CONSIDERATIONS IN PRIVATE EQUITY CARVE-OUT TRANSACTIONS

The considerations noted below are bucketed in three categories: (1) Structuring Issues, (2) Diligence Issues, and (3) Transition and Integration Planning Issues.

1. Structuring Issues

a. Defining the Business and Determining True Cost of Operations
If the target is not already an independent entity, the buyer and seller will need to determine the assets comprising the business and how to segregate these from the seller's existing enterprise. If an equity deal structure is preferred, it may be preferable to spin off the target into a new subsidiary prior to closing. Anything that cannot be assigned to the new target entity or to buyer should be addressed in the TSA (see transition and integration planning issues below). Financial modeling implications of this issue are obvious, and a private equity buyer would typically spend significant time in determining the true-cost of operating the business as a stand-alone operation. See also, 2(a) below for diligence on financial statements.

b. Structuring the Transaction
Multiple sub-issues need to be considered for appropriately structuring a carve-out: (i) Like all other transactions, tax structuring is important and depends on existing tax structures of both buyer and seller (also see (c) below); (ii) Seller must consider how the transaction may

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impact its remaining business (i.e., seller may not want to lose permits and licenses, general disruption of business, time and focus); (iii) Potential regulatory approvals and contract consents (i.e., assignment versus change in control provisions); and (iv) contractual consents required for assignment or if contract defaults are triggered by an assignment. Although many buyers favor asset transactions versus equity transactions to reduce liability, private equity buyers at least consider whether the target business unit ought to be spun off into a separate entity because it simplifies integration and better packages the business for a future sale. This is reflected in the available deal studies data: 58% of deals in the ABA Carve-out Study were structured as equity transactions, while only 22% were structured as asset transactions.

c. Tax

The specific structure of the carve-out transaction has significant tax implications. For illustration, if the seller is a corporation, and seller's basis in the equity of the target (if the target is already a separate entity or spun-off as a separate entity) is higher than the target's basis in its assets, seller will want to structure the deal as an equity sale. Buyer will likely desire an asset sale (or at least a Section 338(h)(10) election to treat the deal as a deemed asset purchase), so buyer receives a step-up in cost basis in the target's assets. Further, from seller's perspective, selling underperforming assets could trigger an increase in seller's effective tax rate after closing. Buyer can consider reflecting future tax benefits in the purchase price valuation, as applicable.

2. Diligence Issues

a. Financial Statements

In carve-out transactions, the seller often has financials for the parent/seller level, but not separate financials for the relevant business unit(s) or lines of business(es). Lack of separate financials can inhibit buyer's assessment of the target, leading to delays in closing and impeding buyer's ability to obtain financing to fund the transaction. To streamline this process, private equity buyers seller should identify the scope of the target business and its specific revenue and expenses as quickly as possible, although this may be difficult when these items are commingled throughout seller's larger enterprise (i.e., intercompany sales and overhead costs such as marketing, human resources and IT). Disorganization on the part of seller may create leverage for buyer, who may respond by requesting a closing condition in the purchase agreement that such financial statements be "satisfactory to the buyer," which creates a de facto due diligence out in favor of buyer. As an aside, only 41% of sellers in the ABA Carve-out Study provided a representation and warranty that the target business's financials were audited.

b. Books and Records

Sellers typically maintain books and records on a consolidated basis, so the parties need to coordinate their efforts to

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determine how to most efficiently assemble and organize due diligence materials of the target, so that buyer may evaluate the transaction and comply with recordkeeping requirements going forward. In addition, sellers need to have a plan in advance to ensure that they do not disclose significant information of other separate business units that is not relevant to the transaction. This is commonly handled through extensive redaction of documents or nuanced confidentiality agreements.

c. Intellectual Property

Whether seller, the target business unit or a third party owns relevant intellectual property (IP) is a crucial distinction in a carve-out transaction. The parties should devote time to identifying the specific IP to be used by the target business unit and strategize how to best accommodate such use after closing. For example, licensing IP used in both seller's and target's businesses is important, but the value of any IP (including costs of transferring or utilizing a licensing arrangement) should not be overlooked when negotiating the purchase price. Such licenses must also contemplate seemingly minor items such as a seller's logo appearing on packaging of the target's products or existing marketing collateral that may already be in the marketing channels. Software license agreements are nearly always held at the enterprise level, which facilitates discounted pricing for seller across its platforms, so the parties should consider how to

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effectively preserve these favorable pricing structures as part of the transaction while also noting that a seller may face penalties for decreases in volume under its existing licenses.

d. Customers/ Suppliers

In addition to usual steps to get comfortable that the target business unit's customers will continue to do business with the target after closing without material interruption or reduction, it may be necessary to disclose the deal to key customers prior to closing to make sure they are aligned with the goal of separating out the business from the mothership. When valuing customer relationships, buyers should take into account that calculations may be compounded due to existing cross-selling arrangements for seller's other products or services. Buyer should also review customer information to learn if any new relationships would cause conflicts with its current customers (i.e., one loyal customer might not want buyer to do business with one of that customer's competitors). Buyer should consider its operations goals as well and whether the target's suppliers and distributors are appropriate for larger (or smaller) orders.

3. Transition and Integration Planning Issues

a. Transition Services

Negotiating an effective transition services agreement (TSA) early in the deal process must be a priority for both the buyer and seller. 96% of deals in the ABA Carve-out Study utilized a TSA in the transaction. The TSA should contemplate key services that buyer requires from seller in order to turn assets into a standalone business as well as any services of the business unit that seller requires to continue its go-forward operations. TSAs commonly provide buyer with access to IT-related items that cannot be unwound from seller's infrastructure, such as enterprise resource planning (ERP) and other hardware as well as the assistance of seller's IT team to migrate information to buyer's network. TSAs can grant access to interim services for a set period of time, until post-closing covenants from the purchase agreement have been satisfied (for example, access to IP until assignments are completed or use of bank accounts until control is transferred) or until cancelled by one or both parties. The parties can also utilize the TSA as an alternative to a supply agreement to capitalize on favorable pricing arrangements and relationships of seller, which can eliminate the need to transfer any such contracts to buyer or terminate and start from scratch. Thinking creatively about ancillary items that are not traditionally included in the purchase agreement can also add significant benefits, such as considering value-added tax (VAT) implications (whether it is recoverable and if so, who is responsible for the cost) and other go-forward operations.

b. Employees and Benefits

The parties should take the time to identify key employees and management who will work for buyer after the transaction. This is especially important when there are employees with responsibilities that overlap between seller and the target business unit's operations. Aside from inclusion in the TSA, a limited-term consulting agreement could help ease such transition period as well. Early identification of employees who will work for buyer and involvement of such employees in the deal process can be a major advantage to buyer: such employees essentially serve as an "inside man" for buyer with regard to seller's and target's operations. With key employees, buyer may be required to negotiate new employment contracts, providing buyer with an opportunity to establish the terms and conditions of the employment relationship without an obligation to adhere to the original terms seller agreed to.

In respect of benefits, buyers should remain cautious that employees will typically expect benefits on par with what they received from the seller or target, so buyer should review the existing plans and policies and take such costs into account when valuing a transaction. Seller should also assess its plans and policies to determine if they should be amended due to a loss in volume of employees or similar requirements. Buyer will be well advised to keep its human resources team informed throughout the transaction, so it can process all necessary paperwork promptly after closing to avoid delay and potential holdouts.

CONCLUSION

As carve-out transactions become increasingly prevalent, private equity buyers and sellers need to do more than merely be aware of the existence of carve-out opportunities. Private equity firms must also understand and prepare for the key issues described in this article in order to capitalize on potential carve-out prospects as they arise and minimize the execution risk of the post-closing exit and integration process. The ABA and other programs will continue to collect and publish data on carve-out transactions, which will allow private equity firms to better seek out, investigate and incorporate such information into their financial and risk assessments. ■