PRIVATE EQUITY PERFORMANCE IMPROVEMENT

Prepping IT Departments for Carve-out:

Hot Fixes to Turn IT from Bottleneck to Value Creator

Carve-outs catch many IT departments off guard. Whilst the overall process of preparing and executing a carve-out is becoming increasingly professionalized, with many organizations retaining dedicated merger and acquisition (M&A) and project management resources to support transactions, IT involvement seems to remain an afterthought. Although IT has long ceased to be merely a business support function, and despite our experience showing technology as both the biggest complexity driver, value lever and cost in transactions, we find that the collaboration on carve-outs between the functional project teams and IT is typically poor. Additionally, IT organizations tend to fail to anticipate the divestiture's impact and requirements on them. They rarely take an active role in the carve-out, are involved late in the process, and often end up being a bottleneck, posing a risk to the transaction and the value it creates.

Why don't IT departments play a leading role in their businesses' M&A activities? We identify two root causes and outline some practical short-term measures for CIOs to improve IT's role in divestitures.

1. The CIO fails to put IT on the carve-out agenda and project organization

To ensure a smooth divestiture process, the IT organization needs to be actively involved from the very beginning. As the carve-out rationale is usually driven by the business, the business typically drives the process. Therefore, it is a CIO's obligation to proactively put IT forward as a key workstream of the carve-out agenda, and to assume their key role within the project organization, ideally as a workstream lead reporting directly to the overall project leader. This ensures seamless communication and cross-functional collaboration between the business and IT. Failing to do so (which we find to be the rule rather than the exception) introduces structural issues into the divestiture process, leading to a weak carve-out set-up, increased carve-out costs, extended sign-to-close periods, badly set-up IT Transitional Service Agreements (TSAs) and potential stranded costs with the seller.

2. IT departments lack resources and experience to handle a divestiture's dynamics

Even when the CIO puts IT on the carve-out agenda, the IT department may lack the experience, appetite and resources to execute effectively. Trapped in a downstream technical service provider's role due to the time constraints and expectations of the transaction, IT departments often struggle to partner on an equal footing with buyers' specialized M&A and project teams. This may weaken the bargaining position of the sell side as specialized and experienced buyer teams capitalize on the limitations of the seller's IT team, shaping technical and legal agreements to their own benefit.

Whilst we appreciate that the root causes identified often can't be addressed in the short term, the remainder of this article provides some pragmatic measures that can be implemented quickly to improve the IT function's performance in carve-outs.

Understand scope, impact and implications of a divestiture

Once aware of a potential transaction, it is imperative for IT department heads to learn about the timeline, scope and objectives of the transaction, as well as the functions responsible for the divestiture. Rather than relying on M&A to get back to them, they should actively address the M&A department and position themselves as a partner.

Furthermore, IT heads should identify which systems, functionalities and IT services (e.g., helpdesk, security, infrastructure maintenance) will be in scope, and evaluate which IT employees and/or services are impacted. The initial list of services identified by non-IT departments are often incomplete and miss many important configuration items required to ensure business continuity of the transaction. IT leaders should have the initial information reviewed and augmented to finalize the scope and to avoid downstream errors. We suggest collecting any customer or supplier contracts in scope and conducting an initial review of key terms, change-of-control clauses in particular. Additionally, certification and regulation impacting any of the services in scope (e.g., security, financial or industry-specific approvals) require special attention as these need to be transitioned carefully to avoid business continuity risks.

Uncover, control and pragmatically close IT accountability gaps

Most organizations have business departments that procure and run IT solutions on their own. These are often not immediately recognized as IT services and become part of bundled TSAs that are then overseen by business departments. Often business departments lack the knowledge regarding technical dependencies of their solutions or approaches to be considered when disentangling them (e.g., considerations relating to security, hosting or Identity & Access Management (IAM)). These operational responsibility gaps are often surfaced during transactions and specialized buying teams aware of such structural issues will often succeed in transferring the cost and efforts of divesting these systems to the seller.

Where do these 'hidden' IT services and functions tend to appear? We usually discover them in relation to Finance solutions (e.g., payroll, financial shared service centers), Enterprise Resource Planning (ERP) and Manufacturing Execution System (MES) systems as well as around Human Resources (HR) systems (e.g., HR or shared HR service centers) in scope and their interfaces with wider IT. However, Analytics systems or easily procured software-as-a-service (SaaS) solutions are also prone to covertly becoming business-critical dependencies. Once found, it's crucial for IT and the business to close these gaps by agreeing accountability in relation to the full divestiture process including the TSA set-up, budget, resources, service costs, escalation paths and reporting standards applicable.

Identify IT resource and skill requirements and allocate appropriate teams

Whilst M&A teams immediately move on to other activities after signing, the involvement of IT in a divestiture is long-term, requiring specialized knowledge and sustained effort. We recommend that IT departments always identify an individual who takes operational responsibility for the divestiture and acts as a pivotal point between legal, the M&A department, the buyer and the IT team. Also, they should rapidly identify team members to contribute to the transition, either when setting up a TSA, operating a service under a TSA or cutting over a service at a service or system transition. Often such IT divestiture support teams are only created once the transaction is in full swing and find it difficult to balance their operational responsibilities with the substantial time requirements of the deal. Therefore, resource planning (including experienced external advice) should start early and, if possible, IT departments should plan for the additional resource requirements and consider the sell-side IT cost of the divestiture in their budgets.

Contribute to legal agreements

Sales and Purchase Agreements (SPAs) are often closed without involvement of the seller's IT representatives, yet experienced buyers will often legally bind IT departments to operational or financial obligations. Since IT representatives are typically only involved late in the bargaining process (if at all), SPAs often fall short from an IT perspective in terms of suitably addressing limitation of liabilities, indemnification, IT separation planning as well as compensation and IT divestment timelines. IT leaders should seek to be involved in the SPA process early and offer the legal and M&A teams their experience in reviewing the terms and highlighting associated financial and operational risks.

Similarly, if TSAs are part of the SPA, IT leaders should take ownership of the relevant agreements, seeking to agree on service accountability, terms, service levels, fees and exit flexibility with the buyer early on. If procured services are to be transitioned to a buyer, suppliers need to be involved so that the cost of the transition support, as well as terms of service transitions, can be negotiated with them. Often IT organizations fail to obtain their vendor's consent when continuing to provide a procured service to a buyer organization (e.g., under a TSA) exposing them to license or compliance risk.

We recommend paying particular attention to IT security services provided throughout the transition process. In practice, IT departments of the selling organization often remain accountable for IT security of the buyer after closing date, so appropriate agreements with the buyer's team and clear reporting guidelines on security-related events need to be considered as part of the TSAs.

Communication, communication, communication

Finally, IT needs to continue to maintain the company's awareness of its role and contribution to the transaction. Whilst most executives turn their attention to other matters post-close, IT departments need to remain alert as the business-critical transition of IT services from seller to buyer is far from over. Even during supposedly calm TSA-supported transition phases, the transaction continues to create IT risk as well as separation effort and cost, which need to be managed closely. Naturally, the IT divestiture team needs to manage both IT and business stakeholders' expectations and priorities. Additionally, the IT leadership must communicate internally about the status of the deal to keep their staff informed, involved and motivated.

> Change management is key, and we suggest providing lessons-learned workshops after the deal to review performance,

update the IT department's divestiture approach and foster a culture of continuous improvement in the department.

The value of IT departments is underestimated and unleveraged in divestitures

Although they play a key role in the success of carve-outs, in practice we see IT departments often ineptly stumble into divestiture processes and end up in defensive positions towards buyers and their own organization. As such, we advocate that IT departments become aware of the contribution required of them in transactions and put in place the preparation and resources to deliver it. Although structural issues remain unsolved in many IT departments, the process of divestiture initiation usually leaves enough time to at least set up some of the rapid measures discussed, allowing for an active and effective role in the carve-out. Understanding IT implications of a divestiture, gaining control over accountability gaps, identifying resource requirements and getting involved in the contract negotiation early will support both IT operations and divestiture teams before the closing and up to the transition phase. Thereafter—since most specialized M&A project teams are outlived by the TSAs, IT separation plans and carve-out activities—mindful management and consistent communication are necessary to show and provide value to the selling organization, even long after Day One.

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