UNTANGLING THE COMPLEXITY OF STRESSED CARVE-OUTS

ALVAREZ & MARSAL

LEADERSHIP. ACTION. RESULTS.℠

CONTENTS

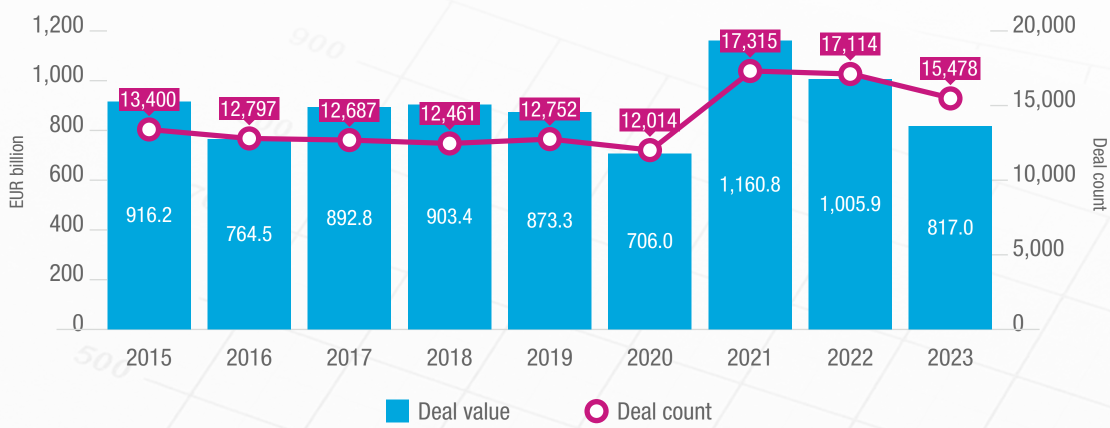
01/ INTRODUCTION

Corporate performance and balance sheets have been materially and globally impacted in recent times, particularly driven by high inflation, rising interest rates and geopolitical tensions in Ukraine and the Middle East. Businesses are facing a combination of disrupted supply chains, elevated operating costs, slowing consumer demand and an increased cost of capital. Those companies already saddled with significant debt are feeling the squeeze more acutely, as debt servicing costs have surged alongside rates.

Amid this economic uncertainty, many companies are reassessing their strategic and economic positions, resulting in a rise in divestment of non-core assets, also referred to as carve-outs. Whilst European M&A activity dropped 19% in value last year to €817 billion (10% decrease in deal count) compared to 2022, corporate divestments have held broadly stable in value and count despite this sharp decline in M&A, according to PitchBook Data, Inc.[1]

Carve-out deals in Europe for private equity (PE) and corporate buyers totalled €150 billion in 2023, slightly below the prior year and and an over 40% decrease from 2021.

Figure 1: European M&A Deal Flow



Source: PitchBook Data, Inc.

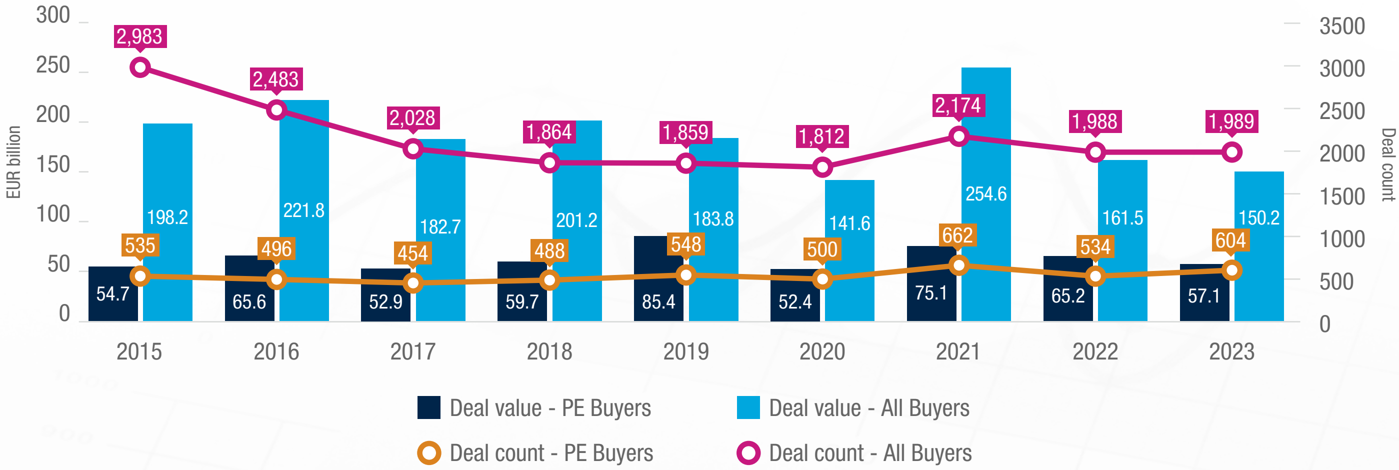
1 All deal figures in this report from PitchBook Data, Inc. unless specified otherwise.

Carve-outs have proven to be an attractive proposition to both sellers and buyers in recent years. PE buyers in particular have grown confident in the ability to realise value through carve-outs, often incorporating ambitious performance improvement plans or business transformations. Corporate sellers have taken full advantage of this trend, successfully divesting businesses such as TK Elevator, Upfield, Coty, Kantar Media, Philips Domestic Appliances, Vodafone Spain and FiberCopto, to name a few.

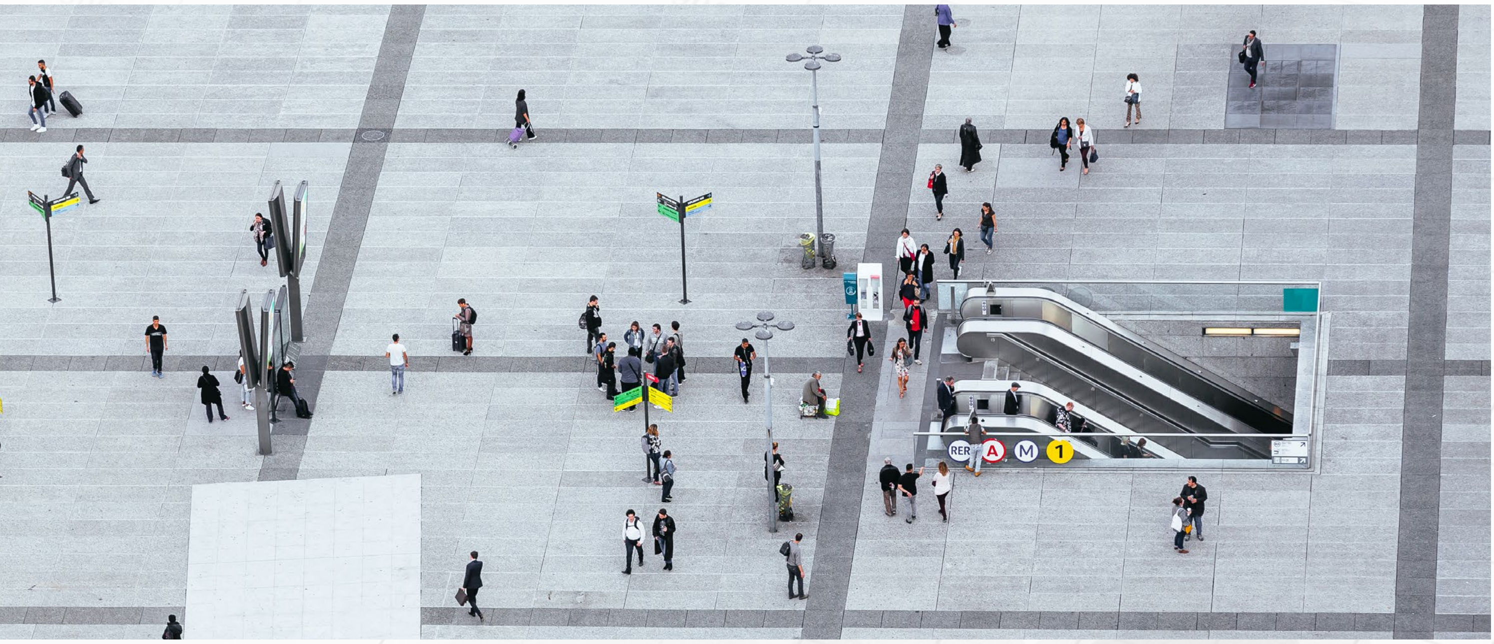
Now the current economic climate is fuelling operational challenges, liquidity issues and rising debt or interest payments, thus pushing more corporates to launch or revive long-awaited divestment plans. Furthermore, in Europe and the U.S. we see increasing activist pressure for companies to divest underperforming or non-core parts of their business to unlock value amid slowing growth.

While carve-out deal count has remained broadly stable since 2017 across all buyers, we are seeing an upward trend in the volume of carve-outs completed by PE investors. Despite the heightened appetite for carve-outs, there is a notable increase in complexity in execution. In many cases, this is due to the inherent degree of stress involved in the transaction driven by the macroeconomic pressures affecting the asset itself or the seller.

Figure 2: European divestitures (all buyers and PE buyers)



Source: PitchBook Data, Inc.



THE STRESSED CARVE-OUT RATIONALE

A stressed carve-out may involve the sale of a valuable part of a group under stress, or the sale of an underperforming asset within an otherwise healthy larger group.

Overall, where there are signs of stress (as opposed to scenarios of distress or restructuring), carve-out transactions can help corporates address issues such as:

Liquidity: Selling a business provides an immediate infusion of cash that can boost the company's liquidity position or fund a wider group turnaround programme.

Debt reduction: Cash from a sale can be used to pay down existing debt at the parent company level.

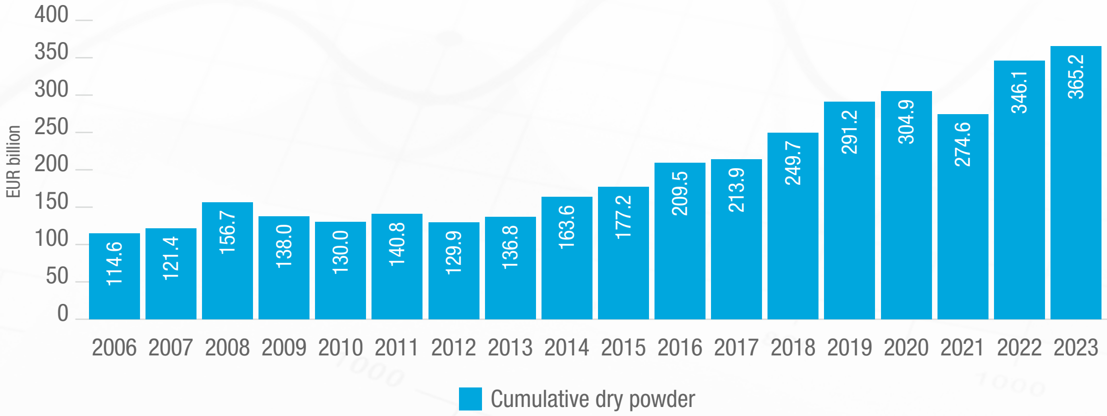
Capital reallocation: Divestments allow for capital reallocation to areas with higher growth potential or better returns.

Efficiency: Separating the stressed asset allows for focused attention on operational improvements, cost reductions and other initiatives to stabilise the business or improve profitability.

PE funds have long been attracted to carve-outs, given the opportunity to unlock value in undermanaged or underinvested assets to obtain superior returns.

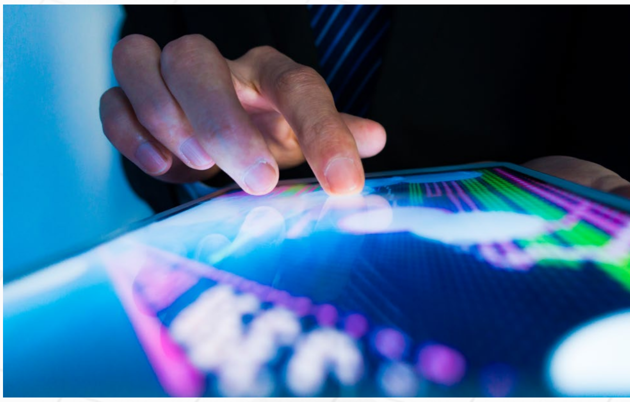
PE funds have long been attracted to carve-outs, given the opportunity to unlock value

Figure 3: European private equity dry powder



Source: PitchBook Data, Inc.

With plenty of other M&A to chase in the past several years, many PE funds did not look at the more complex carve-out situations due to the risks involved as well as the different experience and skills required to deliver them. Now, with less overall deal flow and global PE dry powder still running at all-time high levels, reaching €365 billion at the end of 2023, more funds appear willing to explore the carve-out opportunity.



HOW STRESSED CARVE-OUTS ARE DIFFERENT

The presence of stress influences a typical carve-out process in a number of ways, often including the six key characteristics:

Accelerated timeframe: Because the timing of a deal often hinges on the liquidity position of the seller or the divested asset, parties want to move through the process quickly to minimise value leakage.

Limited information: Plans and requirements are often limited in detail, with sellers investing less time, money and resources upfront to prepare for a transaction. Financial and operational data is likely to be limited, with buyers having to make a number of assumptions during diligence and separation planning.

Less business continuity support: Sellers tend to provide a minimum level of post-close support to buyers via transition service agreements (TSAs) or long-term agreements (LTAs), as a result of their own business continuity (and cost) pressures. Equally, a divested business may want to limit any reliance on TSAs or LTAs from a stressed seller to manage its own business risk.

Buyer-led planning: The onus is often on the buyer to develop their own view on the carve-out complexity, cost and requirements, sometimes even developing the carve-out plan on behalf of, or in conjunction with, the vendor.

Funding challenges: Financing an underinvested asset or one showing signs of stress is hard given the higher operational risk and financial uncertainty.

Management capacity: Increased workload associated with a transaction, and the turnaround and value creation efforts post-deal, can put existing personnel under strain, leading to retention issues that can derail the carve-out plan and add to the stress.

In this report, we will look at how the notion of stress may lead to a different approach in assessing, planning and delivering a carve-out successfully.

As part of our analysis, we will examine a stressed carve-out through various operational lenses including tax, finance, IT, pre-deal assessment and diligence, deal signing and execution, from both buyer and seller perspectives.

Finally, we will explore the alternative solutions available to both sides to mitigate risks, accelerate execution and maximise value in these transactions.

KEY LEARNINGS FROM OUR EXPERIENCE IN STRESSED CARVE-OUTS

Drawing from A&M's experience in assessing and delivering operational activities involved in carve-out transactions, we've distilled eight key recommendations to help buyers and sellers successfully navigate stressed situations:

01/
Collaborate on the carve-out plan

Timelines can be accelerated if sellers engage in developing a mutually agreeable carve-out plan. Incorporating buy-side input can benefit sellers by increasing the deliverability, whilst supporting the buyer's operational needs.

02/
Focus financial due diligence on cash

Buyers should conduct a slightly more targeted financial due diligence that focuses on understanding the cause of underperformance, the business' cash position and near-term funding needs.

03/
Pursue targeted value creation

Put emphasis on a few core activities that will yield rapid and material value creation, or at the very least stop value leakage. Finding ways to start execution as early as possible, and well before closing, can make all the difference.

04/
Seek opportunities for tax optimisation

Material change to the legal entity structure, including where IP is held, can significantly change how profits are allocated and where profit is taxed. Opportunity exists for tax optimisation and cash benefits.

05/
Concentrate on execution

Success in a stressed situation depends far more than usual on execution. Buyers must therefore consider the practicality of execution and implications for sequencing of activities as part of a consolidated plan.

06/
Prioritise speed and cost for IT separation over complexity

Prioritising speed and cost when standing up technology infrastructure can accelerate implementation and ensure business continuity.

07/
Be flexible when defining perimeter and TSA

Buyers should be mindful of the financial health of the seller when settling on a transaction perimeter and TSA support required, including by developing an alternative TSA exit plan.

08/
Support management capacity

While the management should not be relinquishing control, they should think ahead and find ways to supplement teams where there are gaps in knowledge or experience, including with interim solutions.

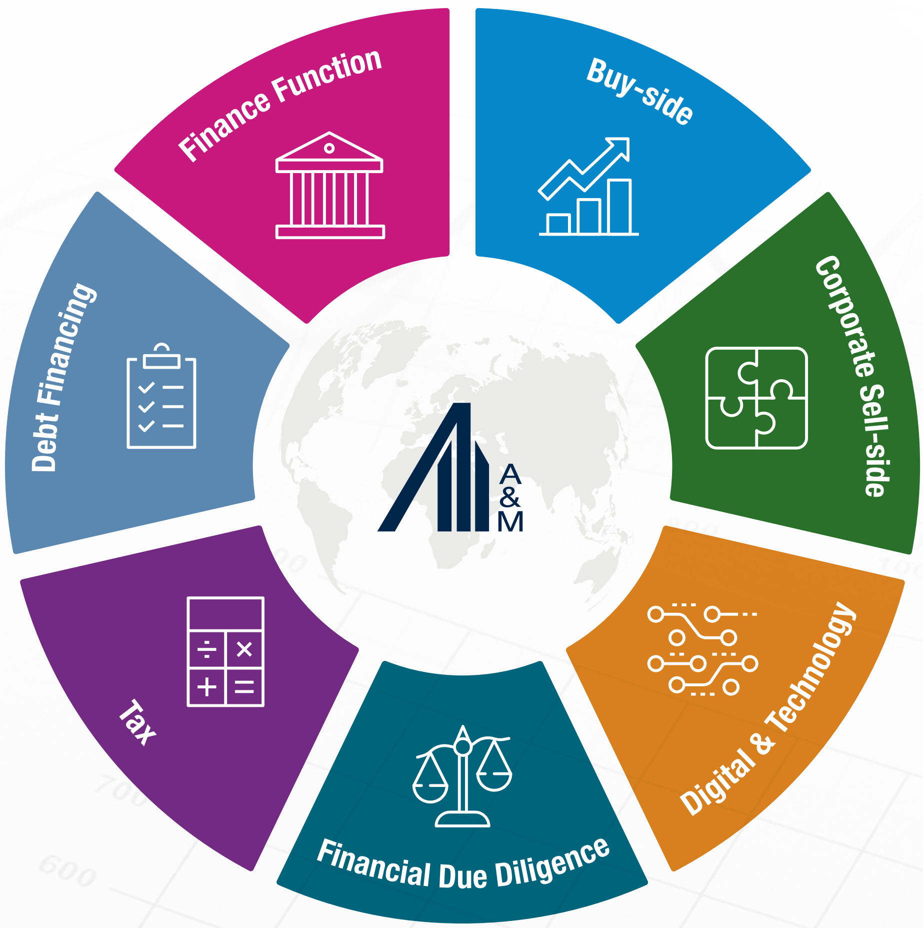
In the subsequent chapters, we will explore these recommendations further and discuss how they can be applied to the various stages of stressed carve-out transactions.

THE A&M APPROACH

A&M's experience in stressed carve-outs is part of a full-service advisory offering from a multi-functional team that deals with the complexities inherent in these transactions.

Our operational turnaround and restructuring heritage gives us significant experience in planning and executing complex carve-outs. It also makes us uniquely positioned to work at pace, often with incomplete information, to understand the degree of stress of the transaction, and act decisively to protect value for buyers and sellers.

A&M's cross-functional team includes professionals with deep experience in the financial, operational, IT, tax and lending challenges that arise in carve-outs. We draw on this multidisciplinary expertise to provide tailored support, including interim management, across the full length of the carve-out programme – from pre-deal diligence through to separation and value creation. We offer cohesive carve-out and transformation support for clients including corporates, financial sponsors and lenders.



A&M's experience in stressed carve-outs is part of a full-service advisory offering from a multi-functional team

02/ THE BUYER APPROACH

PRE-DEAL

CARVE-OUT STRATEGY

In transactions involving stressed assets, the pressure is typically on the seller to make the deal successful by meeting the desired timeline, price and/or key commercial terms. As a result, other elements of the deal become “open for discussion” between the parties, thus pushing buyers into a position of strength in negotiations.

Here’s how buyers can shape the transaction to their advantage.

Influencing planning and perimeter

Given their stronger negotiating position, buyers should be able to pick and choose assets or at least heavily influence the vendor’s view on the perimeter.

For example, they can transfer more resources into the perimeter – such as critical supplier contracts or leadership from shared functions – to reduce reliance on the vendor post-deal and thus mitigate the risk of business disruption. Conversely, acquirers may wish to reduce the perimeter to leave behind as much potential liability and excess as possible.

Also, because stressed sellers may lack the time and management bandwidth for thorough pre-sale planning, sophisticated buyers have the opportunity to credibly challenge the assumptions contained in their (often incomplete) plan.

They may be able to exert their influence in specific areas such as the definition of the standalone operating model or target operating model (TOM), organisational structure and headcount, as well as the appropriateness of the cost base. In some cases, acquirers may even be able to shape the entire carve-out plan, particularly impacting the timeline, sequencing of activities, and level of TSA or LTA support.

This leadership in the transaction process brings significant advantages that would likely be off-limits in a regular carve-out. More control over the carve-out planning will help buyers manage their own priorities and critical risks, while directly impacting their ability to realise the standalone EBITDA and value creation benefits.

In stressed transactions, the pressure is typically on the seller to make the deal successful

A vendor's lack of focus and attention on the non-core asset makes it even harder for buyers to validate the state of the business and its performance

FINANCIAL DUE DILIGENCE

A vendor's lack of focus on the non-core asset makes it even harder for buyers to validate the true state of the business and its historical performance. Here we explore how due diligence can be tailored to overcome these issues.

Focus diligence on cash

With limited financial information provided by the vendor, and the pressure of time, bidders must centre diligence work on two key risk areas: liquidity and sustainability of earnings.

Identifying the cash flowing in and out of the businesses is critical for both a robust 13-week cash forecast and a long-term business plan. Therefore, any analysis should cover both operating cash flows as well as the cost of separation.

Quality of earnings including standalone and pro-forma adjustments are particularly relevant here. As historical reported earnings may not be relied upon (for not capturing the issues associated with recent underperformance or the standalone cost base), buyers may wish to consider making adjustments to the business plan to reflect the underlying revenue and cost post-separation. There is likely to be inherent subjectivity to the quantum of such adjustments, with a robust approach in this area critical to establishing a financial baseline upon which valuation can be assessed.

Filling the gaps with expert support

Crunched timeframes and a potential lack of seller preparation can limit the scope and quality of the information available for buyers. The diligence gap can be greater for financial investors, especially if sell-side materials are designed towards strategic buyers who are perceived as being able to integrate the target more easily into their own operations.

Bidders need to find a way to bridge these gaps to gain as much insight into the stressed target as possible. Leveraging those with in-depth experience of the carve-out issues, or insights into specific operational areas, can provide conviction to bidders and accelerate deal execution.

Pension hazards

Diligence efforts should aim to identify critical pension risks and introduce appropriate safeguards into the sale agreement to mitigate these risks. This will also enable buyers to prepare for potential engagements with regulators and pension trustees, who in some countries are taking an increasingly active role in scrutinising the pension requirements of carve-out deals (and stressed carve-outs in particular).

Certain pension issues on carve-outs that may not be apparent upfront can result in expensive solutions post-deal, posing a risk to the transaction's success.

TAX DUE DILIGENCE AND STRUCTURING

A tailored tax lens on diligence and deal structuring can help minimise exposure to the higher risk inherent in stressed situations.

Asset vs. share deal

Asset deals offer buyers a clean start from prior corporate history, allowing for a selective transfer of assets and usually isolating a buyer from potentially unknown liabilities. But sometimes, historical tax attributes that may generate a future cash tax saving (e.g. brought-forward losses, other allowances) may be lost. Furthermore, an asset deal is likely to be more costly for the seller from a tax perspective. So it is important to assess the nature of the assets being sold and the potential tax implication of the sale.

If decision-making is dictated by transaction timing, a share deal tends to be simpler and faster to complete. But in this structure, buyers will inherit the target's tax history, including previous tax burdens.

Due diligence needs to be carried out at speed to identify tax liabilities that the buyer does not want to take on and seek a comprehensive tax indemnity from the seller or a tax insurance provider against any historical tax risks. This may offer protection from issues caused by any subsequent distress of the parent.

Secondary liability risks

Tax liabilities are a common carve-out risk that can occur when an entity within the transaction perimeter bears liabilities arising from obligations of the seller or its group. Due to time constraints and high legal costs, buyers may not get tax covenants or warranties against that risk in a stressed scenario.

One pragmatic approach is to increase the diligence focus on assessing the degree of stress in the business, to help guide the negotiation of any contractual protections. Buyers can also seek tax insurance against general or specific tax risks.

Tax allowances

Tax benefits identified during due diligence offer rich pickings for cash flow-conscious buyers. A valuable, yet often underclaimed, form of tax relief is tax attributes from capital allowances in relation to fixtures in commercial properties (if included in the deal perimeter). Maximising the allowances position during diligence is vital in protecting value. Appropriate tax diligence will also be able to explore potential R&D credit claims for the target business, including by evaluating whether research credits are sufficiently documented to support claims.

VALUE CREATION POTENTIAL

Carve-outs have long been seen as a trigger point for buyers to address operating performance (notably within the organisation structure, general & administrative functions and IT) while executing the separation plan. This remains true in stressed transactions, although the focus shifts to speed of execution and the prioritisation of value creation activities.

Starting early

With a stressed asset, buyers tend to have a significant transformation agenda to deliver. It is likely the inherited operating model will not be aligned to their view, and that business-as-usual approaches will have to be fundamentally changed.

So the sooner the standalone end-state operating model is defined, the sooner buyers can work on the value creation initiatives that will unlock the most cash and alleviate stress.

Whilst not so critical for PE buyers, trade buyers can benefit from establishing a "clean room" between deal signing and closing to allow deal teams, including advisers, to perform business performance analysis faster and thus paving the way for a smoother implementation of the value creation plan.

Focusing on a few core activities

Trying to deliver highly intricate value creation plans with a long list of performance levers becomes impractical where time is limited. Management tasked with delivering such long and drawn-out plans have to juggle multiple strategic priorities after deal-signing and can easily become overwhelmed.

Like turnaround programmes, stressed carve-outs require a focused emphasis on a few core activities that are expected to yield rapid value creation. Deep industry knowledge and performance improvement expertise are vital in defining this set of target initiatives from the outset and at the necessary speed.

In a recent stressed carve-out involving a care home business, A&M's performance improvement professionals identified that improving the occupancy rate, which significantly lagged typical market levels, was critical for success. Based on this, the acquirer proactively began recruiting new sales professionals during the sign-to-close period, ensuring a fully operational call centre was in place on Day 1 to capture the clear opportunity.

An underperforming business will typically be ripe for a host of cost improvement initiatives. The challenge will be to identify and prioritise those initiatives early in the process, while considering the steps required to deliver the carve-out. Stressed assets also provide an opportunity to enhance value through balance sheet optimisation. This includes reassessing and executing working capital improvement initiatives in a post-carve out context.

Attention on management capacity

The increased workload associated with the transaction and the turnaround or value creation efforts post-deal can put existing personnel under strain, leading to retention issues that can derail the carve-out plan and aggravate stress.

Acquirers often need to be swift in finding replacements or using interim management roles if necessary. This should be tied to wider considerations around identifying the talent that must be transferred to the carved-out unit and talent that should stay with the seller group. Deal teams should also look at potential gaps in knowledge and experience in the new leadership team and whether they will require special training or support.

Whatever the management solution is, it is important to keep proactive communications with the key leaders to build alignment and trust, as well as to address their potential concerns.

Debt financing implications

Debt will likely be more expensive, and lenders will typically demand more stringent terms to mitigate the heightened risks inherent in a stressed transaction. Making the credit story robust enough to attract lenders in a short timeframe is another challenge.

For a buyer, the focus should be on presenting a clear strategy for the asset post-deal, including any turnaround or performance improvement plans, the level of capex investment required and further disposals or M&A on the horizon. This long-term operating viewpoint is critical to define the right capital structure for the asset.

Experienced buyers in these situations tend to leverage external support to bring the debt expertise and speed of execution required. When involved early in the deal, ideally during diligence, experts can start feeding debt insights into the deal structuring and perimeter definition sooner rather than later.

Debt expertise will also feed into considerations around business continuity on Day 1. One often neglected aspect is the provision of ancillary banking facilities (e.g. guarantee lines, letters of credit, bank accounts and credit cards). Existing lenders may want to exit those facilities as soon as the entity is carved-out, making it imperative for buyers to have an alternative solution in place and avoid business disruption.

KEY TAKEAWAYS
PRE-DEAL

- Centre financial due diligence work on liquidity and cash flow, paying attention to quality of earnings including standalone and pro-forma adjustments
- Determine the vendor/asset stress to inform decisions on the deal perimeter
- Apply a tailored tax lens to deal structuring to avoid inheriting any tax risks from the seller
- In value creation, start early and focus on the few but core activities that will yield rapid and material value
- Keep focus on management capacity, looking at gaps in knowledge and experience in the new leadership team and whether support is needed

POST-SIGNING

TSA PLANNING

TSA planning and execution is a key activity that can unlock value or significantly hamstring all parties in the process. TSAs define the coverage and level of service provided by the seller to the carved-out entity after the transaction closes, often including areas such as accounting, transactional finance, HR services and technology, among others.

A seller experiencing liquidity or operational difficulties will likely reduce the level of support, or even cease to provide services entirely, creating material business disruption risk to the carved-out entity. Here, we discuss how buyers can best approach this and mitigate the risks.

Determining the degree of stress

Acquirers may seek to minimise the scope and duration of TSAs to reduce reliance on the (stressed) seller upon deal closing. In these instances, planning activity should focus on standing up the organisation and its functions so the business can operate independently from the parent as early as possible.

Preparedness will also help buyers in a scenario where stress reduces the timeframe between deal signing and closing, and the keys to the business are handed over sooner than would otherwise be the case. That said, sub-optimal interim solutions may need to be deployed as a trade-off to increase implementation speed.

If it is the target business facing stress, buyers may instead look to extend TSAs or LTAs to ensure the vendor can provide as much support as possible. However, it is crucial not to overlook the need to balance and build the capabilities of the new business, optimise its cost base and shape functions to an appropriate size.

Overall, quickly determining the degree of stress in a seller or target business is a critical element in TSA planning. Leaning on operational restructuring and turnaround experience can help. With a clear methodology to detect the various signs of stress in any given transaction, experts can inform the optimal approach to a dependency on TSAs or LTAs and reduce risk to all parties.

Establishing emergency plans

Stressed transactions can require more of a transformation or restructuring mindset than a regular project management approach.

Our experience highlights that buyers need to be prepared to deal with a range of scenarios and develop a holistic emergency response plan that prioritises 3 areas:

1. **Identifying the business-critical areas most at risk**, or those likely to have the greatest operational impact if a seller does not or cannot provide a service, and developing an implementable mitigation plan.
2. **Determining the action steps required**, including engaging potential third-party partners to help implement the alternative solutions to the sell-side TSA support, particularly relating to IT systems and infrastructure.
3. **Planning for unexpected events** that allow a buyer to accelerate TSA exit and achieve independence from the seller.

The above examples would equally apply to situations where the target business fails to provide reverse TSA support at the agreed levels due to deterioration of its own financial or operational position.

TSA planning and execution is a key activity that can unlock value or significantly hamstring all parties in the process

TAX OPERATING MODEL

A stressed scenario will require special attention to certain tax considerations that can limit tax leakages and optimise the long-term standalone tax model. Below are some of the areas we recommend looking at:

- **Legal entity requirements:** Stressed carve-outs often lack a well-defined legal entity plan. This challenge is magnified in PE transactions, where the buyer is unlikely to have operational legal entities to house people, assets and contracts transferring with the target perimeter.

  The key tax consideration when defining legal entity requirements is how best to manage the compliance in jurisdictions where the standalone business will have a taxable presence. This needs to be balanced against operational requirements to arrive at an optimal solution, which often requires a deep technical tax analysis.

- **Logistics:** Key questions around logistics and the supply chain need to be addressed within a short period of time, particularly around preferred locations for warehouses, terms agreed with customers, adoption of consignment stock arrangements, use of bonded warehouses, etc. These logistics issues often have significant tax implications, especially around VAT and customs, and if unaddressed could lead to blockages, delays or significant leakages on Day 1.

- **Staffing and recruitment:** As the number of FTEs transferring from the vendor may be limited, standing up business functions for Day 1 may require significant recruitment within a short period of time. The location of these FTEs, especially those with regional or global roles, can have a material impact on the standalone tax model. Alignment is required to ensure that the recruitment plan takes into account tax considerations where possible.

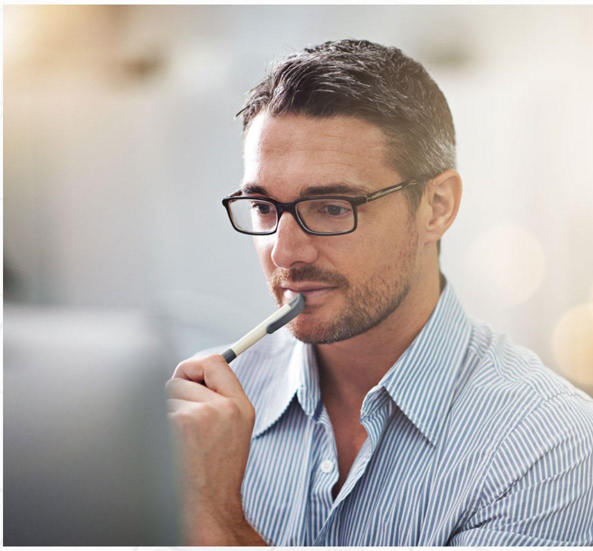
- **Contractual framework and IP:** The contractual framework has a significant impact on how profits are allocated across group entities and the jurisdictions where the profit is taxed. In a stressed scenario, the default is to adopt the vendor's approach, but vendors are unlikely to define a framework that maximises the use of favourable tax attributes available to the standalone business. To avoid any missed opportunities for cash tax optimisation, tax input is required when defining the contractual framework.

  Similar considerations are needed when deciding which legal entity in the carved-out business should hold the IP, as the associated tax attributes of amortising intangible assets can have a material impact on the cash position.

- **Interim operating model:** Interim operating models are frequently adopted in stressed carve-outs due to the tight transaction timelines. Such models pose unique tax challenges, including the need to define invoicing flows between vendor and buyer with minimal leakages. These tax issues are best addressed as the interim model is designed, with input from both parties.

- **Tax function:** It is more likely that there will be no tax function or team set up by the vendor for the standalone business, making it crucial to establish a dedicated standalone tax function for Day 1, both to assist planning for the value creation and also to address any tax leakages or lost opportunities from the carve-out.

A stressed scenario will require special attention to certain tax considerations that can limit leakages and optimise the long-term standalone tax model



THE FINANCE FUNCTION

In a stressed carve-out, the more holistic approach of Finance transformation should give way to pragmatic considerations around cash management and liquidity risks.

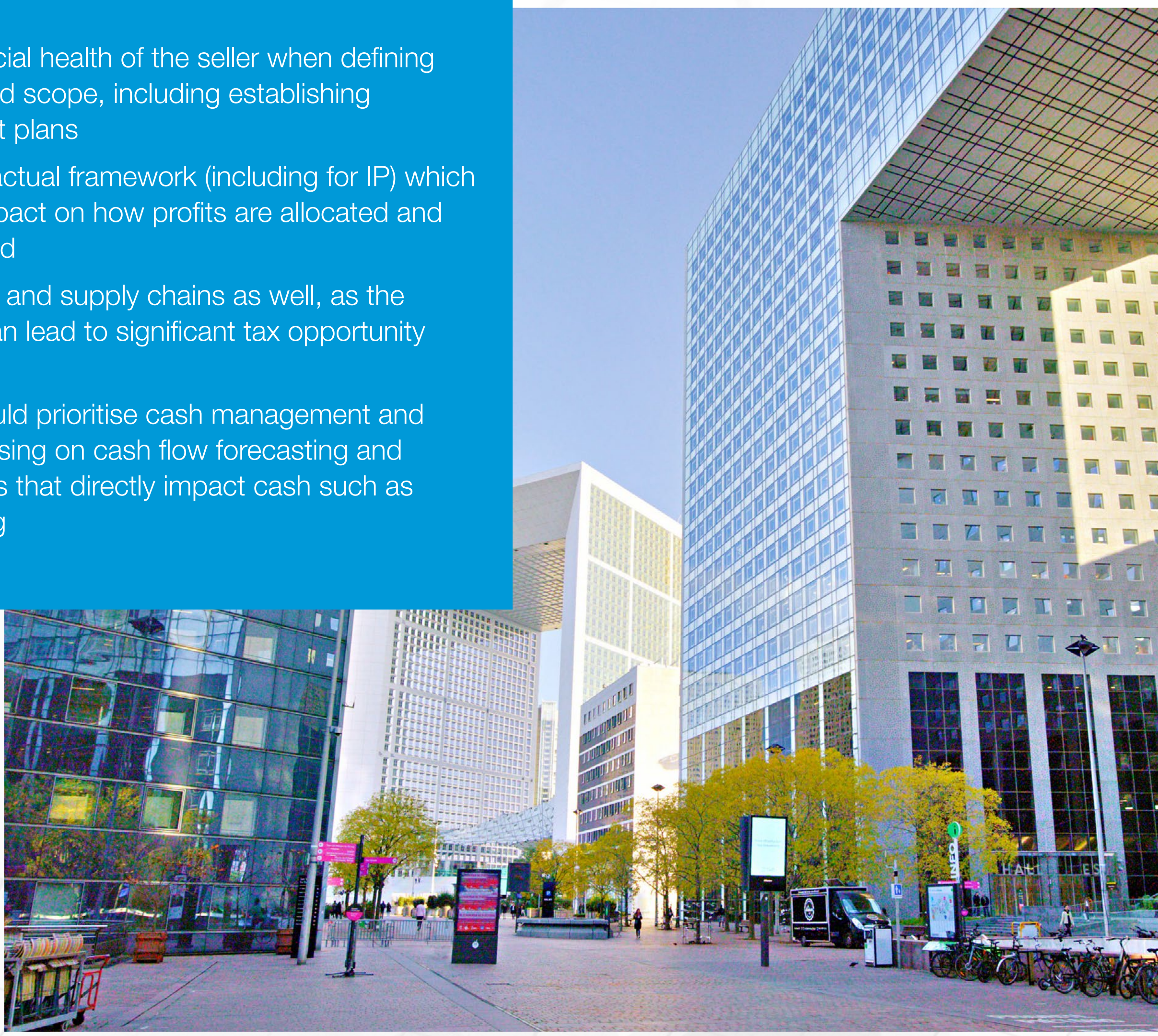
Top of the finance function's agenda should be establishing a rigorous 13-week cash flow forecast. This will provide insight into the cash runway of the business and peak funding requirements in the near term, especially if the transaction is being funded with debt.

In addition, appropriate reporting frameworks should be put in place to enable management to make real-time decisions based on cash flow dynamics, even on a daily basis if necessary. Collection, order management and billing practices must be reviewed sooner rather than later, given their potential to release cash back into the business. Bank accounts as well as a comprehensive reporting framework for PE buyers may need to be established.

While acquirers and management teams should not lose sight of the role of automation tools such as AI and RPA in driving efficiency, their deployment in core finance functions can be delayed to a later point in the value creation plan. Instead, buyers should look into leveraging existing ERP systems to optimise processes such as invoicing and collections.

KEY TAKEAWAYS POST-SIGNING

- Scrutinise the financial health of the seller when defining the TSA support and scope, including establishing emergency TSA exit plans
- Consider the contractual framework (including for IP) which has a significant impact on how profits are allocated and where they are taxed
- Separating logistics and supply chains as well, as the staffing footprint, can lead to significant tax opportunity and implications
- Finance teams should prioritise cash management and liquidity risks, focussing on cash flow forecasting and reviewing processes that directly impact cash such as collection and billing



03/ THE SELLER APPROACH

Today's challenging market is raising the stakes for companies undergoing strategic portfolio reviews. Those considering a carve-out are facing selected buyers and less strategic interest, which can lead to lower enterprise values and increased demand for operational support post-deal. Debt financing is also less available and more expensive, increasing all-round uncertainty in completing a transaction.

In this section, we outline the considerations that sellers must keep in mind when planning and executing a carve-out under these stressed conditions.

CARVE-OUT TIMING

A poorly timed carve-out decision may not only lower the deal value, but also hurt the risk profile of the remaining businesses of the seller. Many companies that have held back portfolio decisions in recent years are facing added stress from the delay, placing them closer to the tipping point from which they must now act to sell assets.

As proceeds from a carve-out sale are typically reinvested into the remaining business portfolio, rather than to pay out dividends, any delay in the timing of a deal will have a direct impact on the cash available for the parent company and its financial health.

DIFFERENTIATING BUSINESS PORTFOLIO

Sellers, particularly if they are publicly listed entities, must pay attention to differentiating their portfolio businesses to analysts so there is no confusion as to which units are considered core and which are non-core (and therefore potential carve-out candidates). Listed corporates need to develop a clear view on non-core businesses and their perimeters to help guide internal messaging and M&A decisions as well as to offer clarity to the market about intent.

This exercise will also help sellers consider who may be a better owner for the carved-out units, be it a strategic or a financial buyer.

MAKING A BUSINESS TRANSACTION READY

Sellers in a stressed scenario must be able to clearly articulate the long-term viability of the business for sale. The seller should focus on the preparation of robust financial information – providing transparency around the transaction perimeter, showcasing its ability to operate on a standalone basis and clearly articulating the long-term viability of the business for sale.

One way to reassure buyers is to provide plenty of support and comfort in the deal via long-term TSAs. However, bidders are likely to pay close attention to the terms of the TSA and may even doubt the seller's ability to deliver a long-term TSA offering if under stress.

Another approach gaining popularity in complex carve-outs is for the seller to invest more heavily upfront in the carved-out unit to ensure it is operating fully standalone with well-articulated viability. Whilst this "carve-in first" strategy requires more upfront investment, it also helps increase transaction security for both parties and speeds up the transaction process in a way that allows the seller to focus on its core businesses sooner.

An additional consideration as part of the separation planning, is defining a clear tax structure outlining the approach for transferring assets, contracts and people functions. Crucially an approach that anticipates and mitigates any significant upfront tax charges will support the overall transaction by informing the structure and timing of the transaction.

MITIGATING OPERATIONAL RISKS

Sellers need to adopt a risk management approach to correctly identify, assess and mitigate potential risks including operational disruptions, regulatory compliance and customer experience. Whilst selling to a strategic buyer may come with some potential advantages in terms of operational familiarity and availability of infrastructure, the pool of such buyers may be small and there is greater risk of antitrust scrutiny.

Developing a turnkey solution can be a powerful strategy to accelerate the deal process as it reduces the need for customisation and allows for streamlining operations, whether the deal is strategic or PE-led. Mitigating risk of disruption and dis-synergy with actual, tangible value capture initiatives is a best practice both in terms of value optimisation for the asset and to expand the potential pool of buyers.

Experienced sellers may also use other strategies to support a transaction such as developing a risk metrics framework, with the aim of increasing confidence and therefore the appetite of banks to provide lending.

VALUE-SHARING AND RISK-SHARING

It can be helpful for parties negotiating the carve-out to set up metrics that include both value-sharing and risk-sharing elements. Sharing some of the value generated can help decrease the pressure of financing the deal, as the buyer can offset some of the financial burden associated with the acquisition, especially if there are legacy liabilities involved. For value-sharing to be successful, it is important to define clear performance measurement indicators and ensure interests are aligned. By the same token, sharing risks and liabilities associated with the carved-out business can prevent valuation mis-steps and unforeseen liabilities.

Today's challenging market is raising the stakes for companies undergoing strategic portfolio reviews

KEY TAKEAWAYS SELLER APPROACH

- Clearly define those units considered core and non-core (and therefore potential carve-out candidates) to offer clarity to the market about intent and generate buyer interest
- Reassure buyers by articulating long-term viability of the business, providing plenty of support in business continuity with TSA support and long-term TSAs
- Mitigate potential operational disruption by considering a turnkey separation approach to increase transaction security and speed up the carve-out process
- Reduce focus on execution complexity to steer buyers towards a better discussion on the actual performance levers of the business
- Maintain a good balance of value – and risk-sharing, defining clear performance measurement indicators and ensuring aligned interests

04/ TECHNOLOGY CONSIDERATIONS

Information technology (IT) typically comprises one of the largest cost lines in any carve-out, where as much as 60% to 70% of one-off costs may be related to separation of IT from the seller, including enterprise resource planning and other areas. It is therefore critical to ensure the right technological considerations from the outset.

BALANCING SPEED AND OPTIMISATION

Failure to launch compatible IT systems from the get-go can increase the pressure on vendor relationships and subsequently on TSAs. The IT separation plan is often, but not always, a major driver of the separation timeline and critical path. And when activities in a stressed carve-out need to be prioritised between speed, cost and complexity, the latter is often sacrificed.

At the same time, a carve-out offers an opportunity for the buyer to leave behind any legacy IT infrastructure deployed by the seller, and the potential to integrate systems for better compatibility with future technologies and strategic priorities of the buyer. It helps to be clear at the outset whether the carved-out business is to operate as a standalone asset or as a bolt-on to an existing platform.

In both scenarios, buyers will want to optimise processes during the carve-out to avoid transitioning twice (separating and then optimising), but there needs to be a balance between business continuity risk and the speed of execution.

RED LINES AND GUARD RAILS

Our experience in stressed carve-outs highlights that businesses often do not pay enough attention to data management and access. For example, the seller may be reluctant to share access to tech or data systems that it is also deploying for the rest of its business, which causes material business continuity risk.

With less time to conduct sufficient IT prep, businesses need to leverage practical hands-on experience and ensure guard rails are in place to help ramp up business processes quickly. Buyers and sellers need to have a strong point of view on the key elements, down to the granular detail of tech stacks, operating models, system set-up and data.

VENDOR ARRANGEMENTS

Stress may reduce a company's ability to negotiate with third-party vendors on technology and software contracts, making it important for the buyer to swiftly establish trust with IT vendors and reassure them in the stability of the carved-out business.

From a buyer's perspective, it's also important to ensure the seller does not take on longer-term financial burdens for the carved-out business before deal closing – for example, entering a multi-year contract with a software vendor that may be inappropriate for the buyer may prove costly and difficult to exit. On the other hand, from a seller's perspective, it is important to minimise stranded IT costs, although it may come down to the parties making decisions about trade-offs between high one-time costs and protracted vendor battles.

IT SKILLS AND CAPABILITIES

To reduce the risk of losing mission-critical talent due to attrition and disengagement, it is crucial to identify the IT personnel required to manage any separation, including those responsible for delivering the TSA services or supporting the tech migration post-deal.

Sellers should consider retention strategies and incentives, especially for those expected to transition to the buyer, reassuring them on the team's stability and value to the employer.

Stressed carve-outs for IT in particular require people who are methodical, creative, level-headed and understand the wider business agenda. Experienced sellers and buyers often leverage external support and/or an interim CIO to help manage the transition, by expediting key or strategic technology decisions.

SOFTWARE IN ESCROW

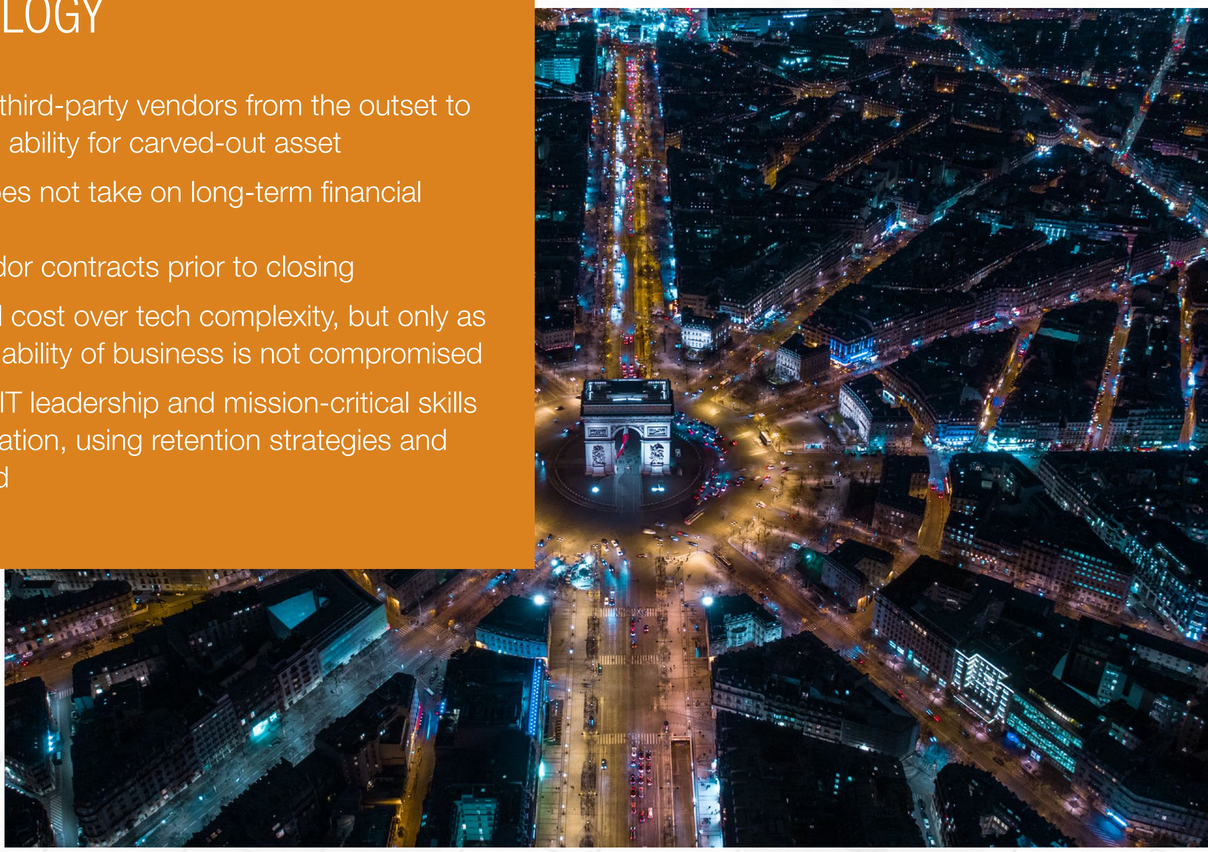
In cases where the buyer may not know the provenance of the seller's software code and maintenance, especially for custom-designed software and services where the seller retains the IP, it may be necessary to ensure continued access in the event of a seller default or bankruptcy. Software can be placed in escrow, after verifying and validating the source code and defining the terms under which ownership is released to a buyer, such as at the point of TSA exit.

Such an arrangement can help mitigate risks, protect intellectual property and ensure business continuity.

IT typically comprises one of the largest cost lines in any carve-out

KEY TAKEAWAYS TECHNOLOGY

- Establish trust with third-party vendors from the outset to improve negotiating ability for carved-out asset
- Ensure the seller does not take on long-term financial burdens with
  new multi-year vendor contracts prior to closing
- Prioritise speed and cost over tech complexity, but only as long as long-term viability of business is not compromised
- Identify and secure IT leadership and mission-critical skills to manage IT separation, using retention strategies and incentives if required



05/
KEY TAKEAWAYS

HOW TO MAKE A STRESSED CARVE-OUT TRANSACTION SUCCESSFUL:

01/
Collaborate on the carve-out plan

02/
Focus financial due diligence on cash

03/
Pursue targeted value creation

04/
Seek opportunities for tax optimisation

05/
Concentrate on execution

06/
Prioritise speed and cost for IT separation over complexity

07/
Be flexible when defining perimeter and TSA

08/
Support management capacity

06/ A&M'S CARVE-OUT SERVICES

BUY-SIDE

- Financial due diligence
- Cash tax optimisation
- IT due diligence
- CFO services
- Operational due diligence
- Debt advisory
- Carve-out diligence, sign-to-close planning and execution
- Performance improvement and transformation
- Tax due diligence and structuring

SELL-SIDE

- Business portfolio review
- Performance improvement, value creation and transformation (pre-sale)
- Vendor carve-out diligence, vendor assist and execution
- Vendor tax due diligence and separation planning
- CFO services
- Debt advisory

DOMINIC ORCHARD
MANAGING DIRECTOR, PRIVATE EQUITY PERFORMANCE IMPROVEMENT
dorchard@alvarezandmarsal.com

MAIREAD WARREN DE BURCA
MANAGING DIRECTOR, TAX
mwarrendeburca@alvarezandmarsal.com

GUILLAUME MARTINEZ
MANAGING DIRECTOR, CORPORATE TRANSFORMATION SERVICES
gmartinez@alvarezandmarsal.com

YAWAR MURAD
MANAGING DIRECTOR, BUSINESS TECHNOLOGY
ymurad@alvarezandmarsal.com

PHILIPP OSTERMEIER
MANAGING DIRECTOR, CORPORATE TRANSFORMATION SERVICES
postermeier@alvarezandmarsal.com

PATRICK SCHAUB
MANAGING DIRECTOR, TRANSACTION ADVISORY GROUP
pschaub@alvarezandmarsal.com

ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 9,000 people providing services across six continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

To learn more, visit: **AlvarezandMarsal.com**

Follow A&M on:

ALVAREZ & MARSAL
LEADERSHIP. ACTION. RESULTS.℠