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A closer look at carve-outs

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Deloitte Corporate Finance LLC

About Deloitte Corporate Finance LLC

Deloitte Corporate Finance LLC (DCF) and the global practices of the Deloitte Touche Tohmatsu member firms offer sophisticated investment banking advice to companies participating in middle market transactions across the globe. DCF is a registered broker dealer and a wholly owned subsidiary of Deloitte Financial Advisory Services LLP. We provide clients with boutique levels of service and industry knowledge integrated with the market reach and technical resources of a global advisory network.

Introduction

What are some of the most important factors driving companies to divest or "carve-out" a subsidiary or a portion of their operations? To what extent do companies consider and sell carve-outs to strategic buyers vs. financial buyers such as private equity firms? What type of sales process is typically used and how long does it take to complete these types of deals?

To understand how companies are addressing these and other issues, Deloitte Corporate Finance ("DCF"), a subsidiary of Deloitte Financial Advisory Services LLP, surveyed 100 executives at major companies, including 75 who worked at companies that had executed one or more carve-outs within the last three years. The survey defined a carve-out as the sale of a subsidiary or a portion of a company's business, whether a plant, other facility, product line, business unit, or a division. The survey asked executives about their overall assessment of the market for divestitures today and in the future, and also about the specific carve-outs that their company has executed over the last three years. In total, the survey asked executives about 174 specific carve-out transactions.

Key findings

- **Impact of Economic Downturn.** Despite the recent turmoil in the credit markets and the economy, roughly two-thirds of executives said these developments have not led them to cancel or postpone planned divestitures, or "carve-out" transactions. Even for companies that have decided to delay their plans, the current environment may be a good time to plan ahead and prepare so they are ready to undertake their planned divestiture when the economic environment improves.

- **Key Drivers of Carve-Outs.** The conclusion that an entity was not core to the company's business strategy was by far the most important reason for divesting, cited as the number one reason in 66 percent of the carve-outs executed by respondents. A desire to generate additional capital was named as the number one reason in 14 percent of the divestitures, although it was the second most important reason in an additional 50 percent of the transactions.

- **Strategic vs. Financial Buyers.** Executives said strategic buyers had more interest than financial buyers in carve-outs and that strategic buyers had typically been the purchasers of their past divestitures.

  - Thirty-nine percent of executives said the level of interest in divestitures was high or medium-high among strategic foreign buyers, while 38 percent attributed a high or medium-high level of interest to strategic domestic buyers. In contrast, only 25 percent of executives described the interest among financial domestic buyers as high or medium-high.

  - Similarly, 43 percent of the executives said that the highest valuations were offered by strategic foreign buyers, while 40 percent said they were provided by strategic domestic buyers.

  - Sixty-three percent of executives anticipated increased interest over the next three years from strategic foreign buyers, while 53 percent expected more interest from financial foreign buyers and 48 percent expected more interest from strategic domestic buyers.

  - Roughly three-quarters of the divestitures executed by respondents were sold to strategic buyers—45 percent to domestic strategic buyers and 31 percent to foreign strategic buyers.

- **Factors in Selection of a Buyer.** The most important consideration in selecting a buyer was the ability to secure financing and close the transaction, cited by respondents as a very important factor in 85 percent of the carve-outs. Close behind were two financial factors: the total transaction value offered, a very important factor in 76 percent of the carve-outs, and the amount of upfront cash consideration, a very important factor in 58 percent of the carve-outs.

- **Reason for Unsuccessful Carve-Outs.** Sixty-seven percent of executives at companies that had unsuccessfully attempted a carve-out over the last three years said that their inability to obtain the price they sought was an extremely or very important reason why the deal was not completed.

The credit crisis and economic slowdown have created an uncertain outlook for carve-outs in the near term. On the one hand, some companies may be forced to divest operations quickly to raise additional capital. On the other hand, companies that do not need to sell quickly may prefer to wait until valuations recover. Despite the lower valuations now available, many buyers are also reluctant since they are eager to retain cash in the current unsettled economic conditions.

Yet, carve-outs remain an important means for companies to focus their business strategy, while strengthening their balance sheet. Many companies are deciding to proceed despite the weaker economic and credit conditions, while others can use this period to develop their carve-out strategy.

Survey results

Continued activity expected, but smaller deals

Despite the economic downturn, most executives anticipated engaging in carve-out activity over the next three years. While 75 percent of executives said their companies had completed at least one divestiture over the last three years, 87 percent expected their companies would execute a carve-out over the next three years. (See Exhibit 1.)

These findings are consistent with recent transaction volumes. The number of carve-outs globally rose 3 percent in 2008 compared to calendar year 2007 according to Thomson Financial.[1]

While executives expected carve-out activity to continue, many anticipated the average size of transactions would be smaller. Forty-one percent of executives predicted the average size of divestitures at their company would be smaller in the next three years compared to the previous three years, while 26 percent expected the average size would grow, and one-third anticipated no change.

A decrease in the size of carve-outs would continue the recent trend after years of increase. While the average size of global divestitures increased by 24 percent from 2005 to 2007, the average deal size declined in 2008 by 26 percent compared to 2007 to reach $143 million, according to Thomson Financial.

The trend towards smaller transactions raises important issues for companies planning carve-outs. Smaller deals tend to generate less interest and are more difficult to execute. They require just as much due diligence and planning as larger carve-outs and often can take longer to complete as many of these entities do not have stand-alone management teams and/or systems. In addition, a small operation may have received less attention in the company and presenting and convincing buyers of the value in the acquisition opportunity requires preparation. Finally, it may be harder to gauge financial performance of the entity since a small entity's financials are often integrated within a larger unit or division.

How has the recent turmoil in the credit markets and the economy affected divestiture plans? Roughly two-thirds of executives at companies planning carve-outs said these recent developments had not affected their plans, while only 36 percent said they had decided to postpone their planned transactions.

The economic downturn has resulted in lower valuations for almost all industries, which has led some companies to delay their plans in the expectation that values will recover eventually. On the other hand, the worsening economy and the problems in the credit markets have placed more firms into financial difficulties, forcing many of them to divest operations to raise additional capital. Although many companies would prefer to wait until market conditions improve, some don't have that luxury. When companies are forced to divest operations quickly, however, they usually have less leverage in negotiations and often receive lower values than might have otherwise been possible.

Many companies are finding that completing carve-outs can be difficult given the current economic conditions. Many potential buyers are more reluctant to bid since financing has become more difficult to obtain, and they are also concerned about maintaining their own cash positions.

For the companies that have the option to wait, it may be a good time to undertake some preparation, so they can be ready when values rebound or credit becomes more available. Divestitures can take time to complete, often up to 12 months or longer. Companies should consider developing a plan, coordinating the involvement of multiple groups such as finance and legal, and engaging professional advisors, if needed. Companies that take advantage of this time to plan for an eventual carve-out can be in a position to act when the market improves.

Exhibit 1
Number of Carve-Outs
Base = Total Respondents

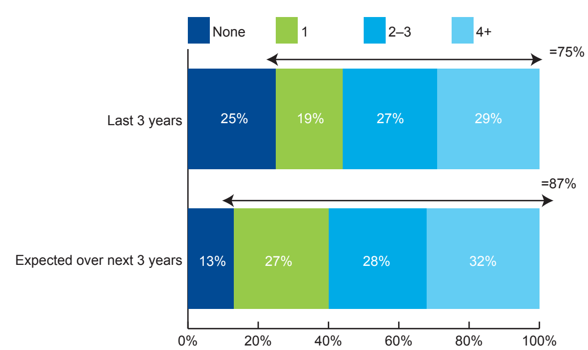


Exhibit 1 from Deloitte Corporate Finance's 2008 Divestiture Survey

[1] Thomson Financial data cited in Divestiture M&A News, Deloitte, November 2008. Note: These figures exclude deals valued at more than $10 billion.

Divesting non-core operations the key driver

What are the major reasons companies decide to divest an operation or entity? The key driver cited by survey respondents was that the entity was not considered core to the company's business strategy. This reason was provided as the number one reason in 66 percent of the 174 individual carve-outs analyzed, and as either the number one or number two reason in 81 percent of the transactions. (See Exhibit 2.) The need for cash to improve the company's financial position was named as the most important reason in 14 percent of the divestitures, although it was either the first or second most important reason in roughly two-thirds of the transactions.

Some of the drivers for carve-outs may shift over the coming year as companies respond to the economic downturn and the credit contraction. More companies are finding they need to raise additional capital, and some will look to divest operations to strengthen their balance sheets. As the markets began to contract in the second half of 2008, a number of companies facing financial difficulties announced their plans to divest operations to raise cash.

Executives were also asked if their company had attempted any carve-out transactions over the last three years that they did not complete. Forty percent of the executives said that they had unsuccessfully attempted to divest one or more entities in the last three years. The most important reason that companies did not complete these transactions was that they couldn't obtain the price sought, which 67 percent of executives said was an extremely or very important reason that the transaction did not go forward. (See Exhibit 3.) Other reasons that were considered to be extremely or very important by roughly one-third of executives were that the buyer came back with reduced terms, they couldn't find a buyer, and the buyer was unable to secure funding.

Yet, most executives surveyed felt their company would not be deterred by these past difficulties. Thirty-nine percent of executives said it was extremely or very likely over the next three years that their company would again attempt to carve-out the entity they had unsuccessfully attempt to divest, while another 30 percent felt it was somewhat likely.

Exhibit 2
Most Important Reasons for Divesting Past Carve-Outs
Base = Total Respondents

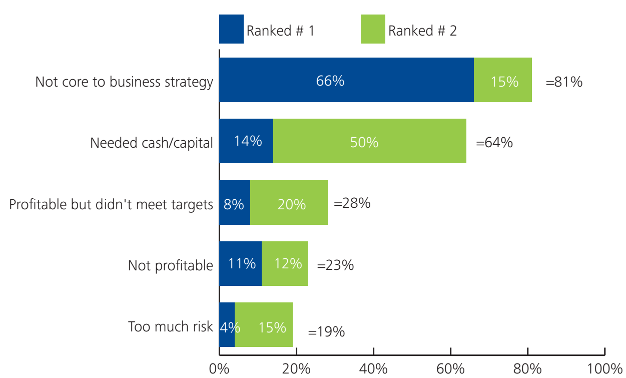


Exhibit 2 from Deloitte Corporate Finance's 2008 Divestiture Survey

Exhibit 3
Reasons that Potential Carve-Outs Were Not Completed
Percent Responding Extremely/Very Important

Base = Respondents at Companies that Attempted Carve-Out They did Not Complete within Last Three Years

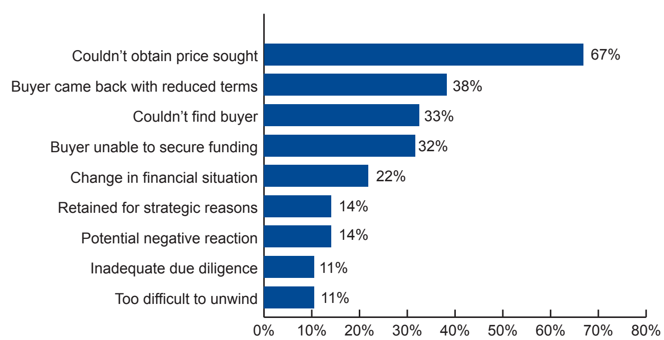


Exhibit 3 from Deloitte Corporate Finance's 2008 Divestiture Survey

Strategic buyers in the lead

There was a broad consensus among executives surveyed that strategic buyers, both domestic and foreign, show the greatest interest, offer the highest valuations, and purchase the most carve-out transactions. Financial buyers, such as private equity firms, were rated much lower in all these areas, although executives did anticipate increased interest from foreign financial buyers over the coming years.

Strategic buyers, both domestic and foreign, were considered by respondents to have the highest levels of interest in divestitures—just under 40 percent of executives rated the level of interest by each of these types of strategic buyers as high or medium high. (See Exhibit 4.) In contrast, only roughly one-quarter of executives considered financial domestic buyers to have this level of interest.

Consistent with strategic buyers having the highest level of interest, executives said strategic buyers offered the highest valuations—43 percent named strategic foreign buyers as providing the highest valuations, while 40 percent cited strategic domestic buyers. Only 18 percent of executives said that financial buyers offered the highest valuations—11 percent for financial domestic buyers and 7 percent for financial foreign buyers.

Financial buyers may offer lower valuations due to some of the additional challenges they face in acquiring carve-outs. Financial buyers may lack existing business operations in the industry, and instead must create the necessary infrastructure to manage their acquisition. In many cases, the existing management in acquired entities is not deep enough to stand on its own and successfully run the business post-close. While a strategic buyer can generally integrate a carve-out within its existing operations, often taking advantage of its current management, a financial buyer usually has to rely either on the existing executives in the carve-out or upgrade management if they are not viewed as strong enough. All of these factors mean that financial buyers often have to invest more to successfully manage a divestiture, potentially resulting in a lower offering price.

Financial buyers' competitive positioning has been further impacted by the recent credit market constraints. In 2006 and 2007, financial buyers enjoyed a flood of equity and low-cost credit, fueling their interest in carve-outs, despite some of the possible difficulties in managing them. However, the recent problems in the financial markets have made credit scarcer, once again making it more difficult for financial buyers to compete for divested operations.

Most executives expected buyer interest in carve-outs to increase, especially among foreign buyers, both strategic and financial. (See Exhibit 5.) Almost two-thirds of executives believed the interest in divestitures among strategic foreign buyers would increase over the next three years, while 53 percent of executives anticipated interest among financial foreign buyers would increase as well. Similarly, 48 percent also expected more interest from strategic domestic buyers.

Exhibit 4

Current Level of Interest in Carve-Outs

Base = Total Respondents

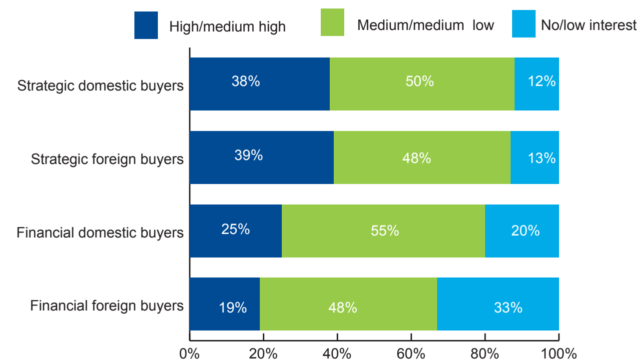


Exhibit 4 from Deloitte Corporate Finance's 2008 Divestiture Survey

Exhibit 5

Expected Change in Level of Interest in Carve-Outs over Next Three Years

Base = Total Respondents

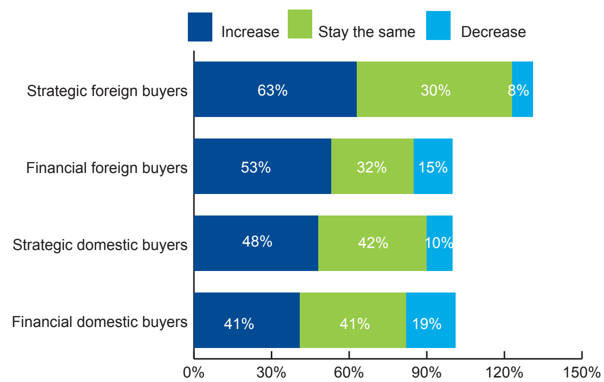


Exhibit 5 from Deloitte Corporate Finance's 2008 Divestiture Survey

In the early part of 2008, foreign capital was looking for deals driven largely by attractive pricing due to the weak dollar. Looking ahead, it is not clear whether this trend will continue. The economic downturn has placed many companies outside the United States in financial distress, leaving them with less cash than before to pursue transactions. In addition, the flight of capital to U.S. Treasuries led to a strengthening of the dollar, making U.S. divestitures more expensive for foreign buyers.

However, the emergence of important companies in China, India, and other emerging markets has led new players to enter the market. This emergence may serve to sustain the interest among foreign buyers, even if the appetite among European and Japanese companies for carve-outs is reduced.

Executives said that they considered a variety of types of buyers in their recent carve-outs. In 78 percent of the divestitures examined, strategic domestic buyers were considered, while just over half of the carve-outs considered strategic foreign buyers. (See Exhibit 6.) Companies, even mid-market firms, are increasingly thinking globally when they consider potential buyers for their carve-outs. Financial domestic buyers were also considered in 58 percent of the transactions, while roughly one-third considered financial foreign buyers.

But while financial buyers were often considered initially by survey respondents, these buyers were rarely selected in the end. Instead, strategic buyers were usually chosen—45 percent of the divestitures were sold to strategic domestic buyers, while 31 percent were sold to strategic foreign buyers. (See Exhibit 6.) Only 18 percent of the carve-outs surveyed were purchased by financial domestic buyers, and just 6 percent by financial foreign buyers.

According to the respondents, what were some of the key factors driving the choice of a buyer? It was notable that price was not the top reason for selecting a buyer. Instead, for 85 percent of the carve-outs surveyed, the ability of the buyer to close was cited as a very important reason for their selection. (See Exhibit 7.) However, following close behind were two key financial considerations: the total transaction value, which was a very important factor in the choice of a buyer in 76 percent of the divestitures, and the amount of upfront cash, a very important factor in 58 percent of the transactions.

Exhibit 6
Types of Buyers Considered and Sold to
Base = Total Respondents

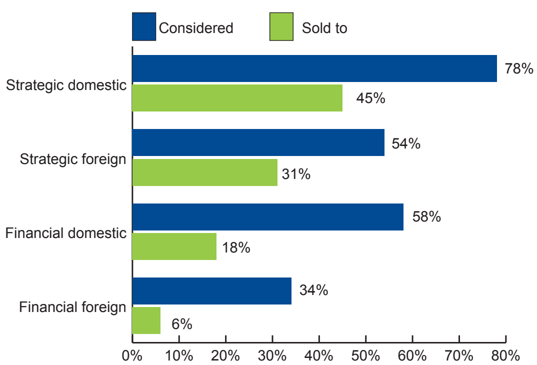


Exhibit 6 from Deloitte Corporate Finance's 2008 Divestiture Survey

Exhibit 7
Importance of Factors in Selection of Buyer
Percent Rating Factor Very Important
Base = Total Respondents

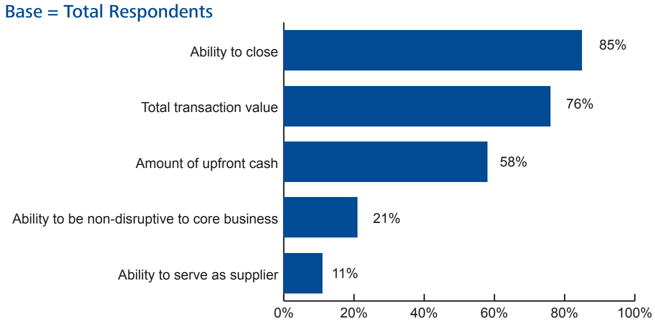


Exhibit 7 from Deloitte Corporate Finance's 2008 Divestiture Survey

Sales process

According to the executives surveyed, the most common types of sales processes used were auctions with limited distribution, used by 42 percent of the transactions analyzed, and direct negotiation with a single buyer, used by 40 percent.

Cash was received in 86 percent of the carve-outs surveyed with only 14 percent receiving equity and 12 percent a seller note.[2] (See Exhibit 8.)

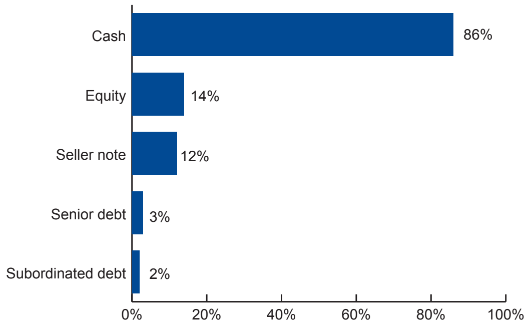
The survey results showed a broad range of time frames required for companies to complete their divestitures, from when the company decided to sell the entity until there was an executed purchase agreement. Roughly one-quarter of the carve-outs considered required only three to six months to complete, while 40 percent required six to 12 months, and 20 percent required 12 to 18 months. (See Exhibit 9.) Nine percent of the transactions required 18 months or longer to complete.

In most divestitures, executives indicated that their companies engaged external professional service providers or advisors. According to the survey, the most common use of professional services was to advise on legal negotiations—64 percent of the carve-outs used professional services for negotiations over legal documents. Many divestitures also used outside advisors to provide transaction advisory services (37 percent), to conduct a carve-out audit (30 percent), to assist with tax structuring (26 percent), or to conduct sell-side due diligence (24 percent). Only 10 percent of the transactions did not use any outside professional service providers or advisors.

Exhibit 8

Types of Consideration Received

Base = Total Carve-Outs



Note: Percentages total to more than 100 percent since respondents could make multiple selections.

Exhibit 8 from Deloitte Corporate Finance's 2008 Divestiture Survey

Exhibit 9

Time Required from Decision to Sell until Executed Purchase Agreement

Base = Total Carve-Outs

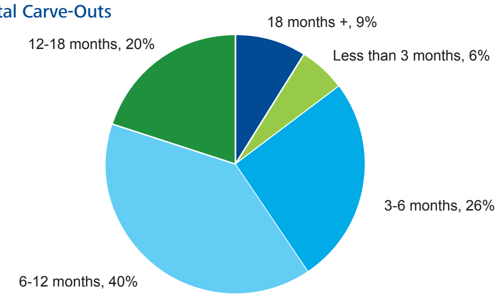


Exhibit 9 from Deloitte Corporate Finance's 2008 Divestiture Survey

[2] The percentages total to more than 100 percent since some carve-outs received more than one type of consideration.

Looking Ahead

With global and financial uncertainty abounding, one thing remains constant; organizations strive to maximize the value of their business unit portfolio. This becomes even more important when faced with a potential market downturn where underperforming, or less strategic businesses, are often divested. Whether you are the seller, a financial or strategic buyer, or the transaction is executed through an Initial Public Offering (IPO)—divestitures present a unique set of challenges that make them much more complex than typical merger integrations.

Challenges to consider during a divestiture

- **Multiple parties and diverging agendas**. Typically, there are several parties involved in any divestiture transaction, and their agendas are usually not aligned. During the transaction ineffective communication may also become an issue. The seller's focus often shifts away from the unit being divested, while the spin-off management team typically begins shifting its allegiance from the seller to the buyer—creating a communication vacuum. The buyer may try to leverage this vacuum to gain a competitive advantage by re-examining the contract terms as they learn more about the business they are acquiring. With diverging agendas, open ended aspects built into the agreements, and potential communication issues, executive alignment is needed to facilitate the resolution of any problems that arise so that they do not become contentious or, worse yet, legal battles.

- **Tightly Integrated Businesses—Carve-out Complexity**. As a result of the trend toward tightly-integrated businesses largely driven by ERP implementations over the past 20 years, carving out and divesting business units has become more complex. As ERP solutions and corporate shared services have replaced previously decentralized systems and processes, significantly more planning and resources are required to create a stand-alone business unit. With emphasis today on rapidly closing transactions, a multi-year ERP journey may have to be unwound in a matter of months. For strategic buyers, the business unit first has to be disintegrated, and then either made to function as a stand alone business, integrated into the buyer's existing organization, or function as a combination of both. For financial buyers, and in the case of IPOs, the divested business unit needs to be able to operate as a stand alone unit. This often requires systems and processes to be built from scratch and/or outsourced. Regardless of the type of transaction, carving-out, integrating with the buyer, or setting up an independent business unit is more complex than ever due to the tight linkages that exist in today's organizations and the myriad of legal, regulatory, and reporting requirements.

- **Transitional Services—Continued Connections**. Due to the complexity and accelerated timeline of divestiture transactions, the seller is often required to provide transitional services to the carved-out unit for an interim period after transaction close. Transitional Service Agreements (TSAs) are used to detail the specific services to be provided. In addition to the seller providing these services to the buyer, the buyer often provides reverse TSAs back to the seller through the carved-out unit. TSA management ultimately becomes a business relationship maintenance activity. Consequently, it is particularly important to choose the TSA negotiators/managers wisely, as it will be their role to negotiate and resolve conflicts over TSAs in good faith to avoid potential legal action. If the relationship becomes contentious, the parties may find themselves referring to legal documents to resolve issues, and this is not an effective way of managing TSAs. The bottom line is that TSAs are a necessary part of any divestiture transaction. However, they should be used sparingly, managed effectively, and exited as quickly as possible to reduce complexity and business risk, accelerate the divestiture process, and increase cost effectiveness.

- **Business Disruptions—Negative Customer and Employee Impacts**. As with any breakup, divestitures are typically disruptive to stakeholders. The uncertainty and change that accompanies divestitures typically saps efficiency at the very moment companies need to operate most efficiently. Fear of job loss, relocation and change in general can have a profound impact on employee morale and productivity. During divestiture transactions, employees are typically expected to perform their day-to-day jobs along with any project-based separation activities. With the added burden of internal and external factors caused by the disruptiveness of the divestiture, employees performing separation-related work are typically stretched very thin. The volume of work that must be done in a short amount of time to complete the transaction can be overwhelming. Additionally, maintaining business continuity for both the parent and the unit being divested becomes a challenge. Customers will be wary of something going wrong during the transitional period, and competitors will attempt to lure away customers and employees. To further manage negative impacts on employees and customers, companies typically deploy certification programs to determine whether the critical elements for an effective Day-One are in place. These programs can be a formal, site-by-site walkthrough and validation of key business processes and activities performed by the people that will be taking over these responsibilities or providing the services. Alternatively, they can consist of a non-negotiable checklist of critical items to facilitate a successful Day-One or any combination in between. The important point is that these business critical processes and systems must be pressure tested prior to the transaction close to help facilitate business continuity.

- **Disproportionate SG&A Cost Structure**. When a company divests itself of a sizable business unit, it is frequently left with a disproportionately large cost structure relative to its new size. Sometimes, companies neglect to consider these stranded costs and simply assume that the cost structure will be brought back in line automatically or transitioned with the sale—only to be rudely surprised with a ballooning cost structure post-close. As described earlier, most organizations today have reaped the benefits from tightly integrated systems and processes. Companies involved in serial-divestitures know that cost parity, i.e., holding selling, general, and administrative (SG&A) costs constant relative to revenues, does not occur by itself. It is equally critical for the spin-off entity that the new baseline budget correctly reflects the new cost structure. Since many services that were previously provided by the parent may be replaced, it is critical to carefully estimate these costs. For example, in the case of an IPO, establishing the run-rate cost structure for cash management, treasury, tax, and financial reporting will be critical. Cost parity should be considered table stakes. As the survey results illustrate, companies are rebalancing their business portfolios to focus on their core business, and they are looking to further reduce and streamline their costs structure as part of the overall transaction.

Appendix

Profile of respondents

Deloitte Financial Advisory Services LLP engaged Bayer Consulting to conduct a survey of executives on their experience with carve-outs. The survey was conducted online from June 5 to October 31, 2008 and was completed by 100 executives.

Among these 100 executives, 75 worked at companies that had conducted at least one carve-out transaction within the last three years. In fact, 27 percent of executives were from companies that had executed two or three carve-outs during this period, while 29 percent were at firms that had completed four carve-outs or more. (See Exhibit 1.) These executives were asked a series of questions about each of the carve-outs that their companies had completed during this period. Executives from companies that had completed more than three carve-outs over the last three years were asked about their three most recent carve-outs. Executives participating in the survey reported on a total of 174 individual carve-outs.

The executives surveyed were from companies in a variety of industries including 50 percent from manufacturing companies, 21 percent from financial services companies, and the remainder from other industries. (See Exhibit 10.)

Roughly 60 percent of the executives surveyed came from companies with less than $5 billion in annual revenues, with 23 percent having revenues of $5 billion to $25 billion and 20 percent having revenues of $25 billion or more. (See Exhibit 11.)

Exhibit 10
Industry
Base = Total Respondents

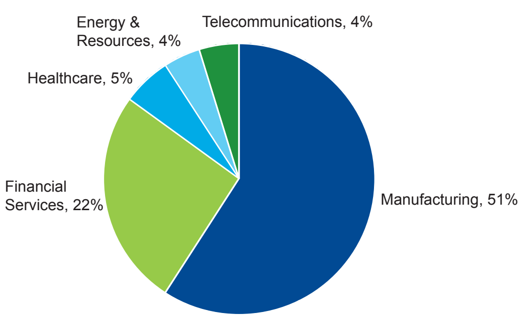


Exhibit 10 from Deloitte Corporate Finance's 2008 Divestiture Survey

Exhibit 11
Annual Revenues (Q23)
Base = Total Respondents

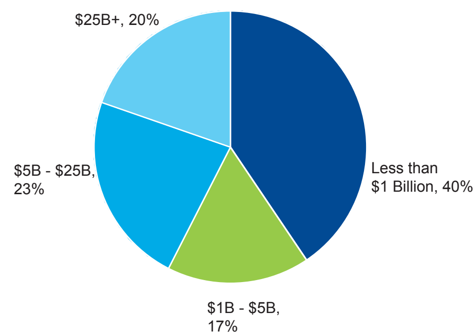


Exhibit 11 from Deloitte Corporate Finance's 2008 Divestiture Survey

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