

Solving the carve-out conundrum

Acquiring an asset that may remain entangled with its parent company poses a different level of complexity in assessing potential value. Due diligence on three critical challenges can help.

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You've found the perfect acquisition target—a complementary business with positive cash flow, a strong brand, and access to emerging markets that would take you years to develop on your own. But as you review the details, you find that the business comes with relatively few people and assets. You would acquire the brand, a few production sites, some sourcing contracts, and a general manager with sales teams scattered across various regions. IT and other shared services are part of corporate centers that the parent company would retain. The seller offers to provide limited transition services but not everything that would be needed to launch a fully functioning company at the deal's close.

Should you buy, or not? That's the classic conundrum for acquirers of so-called carved-out businesses, which may be formally divested but remain highly entangled with the corporate infrastructure of a parent company. Such deals are common among companies in pharmaceuticals and advanced industries, where R&D and the trade of intellectual property are primary sources of value creation. Other sectors are exploring such deals more frequently, given slow growth in their own industries, increased tax incentives, and the desire to quickly transform their portfolios.¹

Carve-outs come in a variety of flavors—specific assets, a portfolio of assets, or an entire business unit. The seller's goal is typically to release assets for which the company may no longer be the best owner or to capitalize on a business segment that may be outside of its core operations. Unlike fully standalone companies, carve-outs are characterized by the divested business unit's need for continued support from its parent to maintain operations. The complexity and costs associated with the transition can pose problems for both sellers and acquirers.

To accurately assess a carved-out business and succeed with an acquisition, prospective buyers need to effectively address three fundamental challenges:

1. **Knowing the scope.** The acquirer must understand the nature of the carved-out business, the extent of corporate shared services that will be included as part of the transaction, and capabilities not included that may be critical to the long-term success of the acquired business.
2. **Understanding the numbers.** The acquirer must put into context the financial information associated with the deal, which may not accurately represent either historical performance or the extent to which there might be additional costs for a buyer once a transfer is made.
3. **Cutting the cord.** The acquirer must assess all entanglements between the carved-out business unit and other aspects of the parent company's operations. It must ensure that the parent can provide sufficient services to fill any operational gaps as the acquirer transitions the carved-out business unit to its own infrastructure.

These factors may seem obvious. What's striking is that many acquirers we see—particularly those for whom carve-outs are still a relatively new strategic option—tend to neglect one, two, or all three of them. Both sides in the deal can fall victim to inertia and default to status quo planning initiatives; as a result, they may underestimate the cost and effort that will be required to draw clear boundaries around the assets or business units in question.

Our experience and research suggest that to gain the most value from such deals, companies need to tackle *all three* of these challenges. It's not enough just to understand the potential scope of the deal or the financials without simultaneously considering the impact of disentangling the asset in question from the parent company. Having a comprehensive view of the carve-out is the only way to ensure that the deal delivers on its promise.

Exhibit

When assessing value and deal synergies, buyers must consider the type of carve-out they are pursuing.

Type of carve-out	Variable contribution	Operational	Stand-alone
What's included in the deal (P&L view)	<ul style="list-style-type: none"> Revenue Cost of goods sold Selling costs 	<ul style="list-style-type: none"> Revenue Cost of goods sold Selling costs Operating costs 	<ul style="list-style-type: none"> Revenue Cost of goods sold Selling costs Operating costs Corporate costs
Likely buyer	Strategic motivation (some overlap) Buying sources of variable contribution for integration into an existing operator	Strategic motivation (no overlap) Buying assets to optimize or fill gaps in product portfolio or operational footprint	Financial or strategic motivation Investing in new corporate infrastructure or strategy to realize corporate and operational synergies
Implications for valuation	Low High	Low High	Low High
Implications for synergies	Few Many	Few Many	Few Many

Knowing the scope

No surprise, knowing what you are getting—and not getting—in a carved-out business is a fundamental pillar of success (exhibit).

This is often easier said than done. For instance, a pharmaceutical company buying a carved-out business from another industry player determined that the seller would not be including in the transfer of the business its right to use a third party's intellectual property (IP) that was essential for producing a specific drug. So the acquirer engaged in extensive negotiations to attain that right from the IP owner. But the pharma company overlooked an important detail: the carved-out business was going to continue to operate in the same location, and the buyer never negotiated with the pharmaceutical company about access to the parking lot outside the main building. As a result, hundreds of employees of the carved-out business were left with nowhere to park on the day of the business's relaunch.

Carved-out assets or businesses often remain tethered to the parent company because of shared customers, suppliers, production processes, corporate functions, and technology infrastructure. Transactions often end up being structured as a mix of both shared and distinct legal entities, with employees and operating assets spread out in various countries and jurisdictions.

The best acquirers perform thorough *business due diligence* to assess the nature of the carved-out business they're targeting and the scope of the proposed transaction. They look at the carve-out using four lenses: people, processes, platforms (such as systems and vendors), and places. Specifically, who are the people needed to run the acquired business unit and deliver the numbers projected in a valuation model? What processes will create revenue and support operations, and where do gaps exist? What platforms are needed to deliver the products or services in the volumes

upon which the business plan is predicated, and are these included in the transaction's scope? And finally, where does the acquired business operate, and will those locales be supported at closing to ensure business continuity? Such business due diligence allows companies to ensure that they understand what they are getting and figure out how to obtain what they need.

One industrial manufacturer analyzed its acquisition of one of its main suppliers in this way. Because talent was a critical component in the deal, the buyer closely examined employee transfers in and out of the supplier's business in the 12 months preceding negotiations. The examination revealed that the parent company had systematically cherry-picked the best people from the organization and kept them for itself while transferring hundreds of underperformers to the carved-out business. The carve-out was gaining a reputation as the place where the company sent employees with limited potential. The buyer responded to these findings by proposing clauses in its contract with the parent company regulating internal transfers of employees of a certain tenure.

Understanding the numbers

Naturally, a comprehensive understanding of the financials of the carved-out business is critical for calculating deal valuation and synergies.

Furthermore, companies need to account for the lack of synergies or for stranded costs. The new, combined company may have lower purchasing power, for instance, or fewer economies of scale than when the carved-out business was still a part of the parent company. In other cases, people, processes, and platforms may no longer be needed to support a leaner, more streamlined business, leading to stranded costs.

Understanding these financials poses challenges for acquirers. Because carve-outs may never have been reported out separately, parent companies may not be able to provide audited historical financial statements for them beyond specially prepared pro forma statements. Even in instances where historical financial statements exist, they may be difficult to properly evaluate: the parent company's business model and operating footprint may not be the same as that of the carved-out business unit. Moreover, given the high stakes of divestitures and separations, there may be incentive for the parent to embellish the carve-out business with glowing historical and future performance measures.

Even so-called audited carve-out financials tend to present the carve-out as an integrated part of a corporation. Such numbers are based on historical figures and say little about what the costs might

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be in a stand-alone situation or if the carved-out business were to be integrated within a corporation with a different operational footprint, and what the impact of separation might be on future revenue streams.

The best acquirers perform thorough *financial due diligence* to understand the numbers, how they have been prepared, and what they actually represent. In this way, they can assure themselves they are getting the best value from the deal—and if they are not, they have recourse for negotiation. They assess both historical quality of earnings and the potential financial performance of the carved-out business as a stand-alone entity.

In one transaction between pharmaceutical companies, the buyer's financial due diligence process revealed that a significant portion of the income of the target business unit came from patent licensing royalties. But many of the patents in question were common to other products in the parent company's portfolio. This prompted a discussion about whether the buyers would be paying royalties to the parent for continued use of the patents, and at what cost. This led to the creation of a separate licensing agreement ensuring the buyer's long-term access to the patents. In another deal, the purchasers realized that the parent company had restated its allocations to the carved-out business, which reduced allocated costs by tens of millions of dollars, thereby significantly increasing the theoretical value of the carve-out.

Savvy acquirers realize that costs allocated to the target business don't represent the market cost of replacing the services in question. Nor do they accurately reflect the actual burden of maintaining corporate shared services after transitioning the target company to the buyer. We've observed cases in which the allocation replacement costs were as high as 200 percent of current allocations and represented a material impact on the ongoing cost structure for the carved-out business.

Cutting the cord

Typically, when a company acquires another business outright, the acquirer can choose to operate the target company in much the same way it did before the deal closed. There may be minor disturbances related to transitioning employees or customers, but people generally keep to their work routines, systems continue to function, and supply and distribution operations keep on rolling. The business remains viable.

This is not necessarily true when acquiring a carved-out business unit. The acquirer is not necessarily getting *everything* it needs to keep the business going on its own. For instance, some critical roles may be vacant, certain products may be manufactured or stored in facilities that are out of the scope of the acquisition, important IT capabilities may remain with the parent company, and some legal entities and regulatory permits may not transfer to the acquirer.

The best acquirers of carved-out businesses understand there is no substitute for early and meticulous *operational due diligence* on entanglements. Even in situations where the target business appears to be independent of the parent company, there are usually codependencies to address. In one acquisition involving two consumer-product companies, both parties paid little attention to the shared order-to-cash process, and at the close of the deal, both faced issues with botched product deliveries and invoicing errors. In another example involving a carve-out in the oil and gas industry, the buyer had to pay new employees with physical checks shortly after the close of the deal because a third-party payroll provider had missed a critical deadline in moving employee data to the new owners.

Savvy acquirers emphasize comprehensive planning: they identify codependencies and capability gaps early, define and prioritize solutions, and track their progress in disentangling target businesses from

their parent. Armed with this information, acquirers can pursue any number of options to address capability gaps—among them, the acquirer and the parent company can jointly develop a new capability to fill the gap, the acquirer can procure services required from third-party providers, or the acquirer and the parent company can adjust the scope of the deal.

A common solution is for the parent company to provide transition services or supply agreements to ease the transfer of assets; it is advantageous for them to do so, after all, to make the carve-out more attractive to buyers. But while such services and agreements can be vital for facilitating a deal, they may also be a source of contention and dispute. For instance, a healthcare company refused to provide an acquirer with a transition services agreement (TSA) for human-resources information systems because it didn't want to be held liable for potential data breaches during the transition. As a result, the acquirer needed to rapidly develop a costly data-migration plan in time for close. In another deal, two retail companies disagreed on the maximum length of time that transition services would be provided. The acquirer was forced to accelerate its planned spending on new IT platforms and new hires.

TSAs typically last between three and 18 months. They may include, for instance, access to business systems, use of office space, or continued use of corporate shared services. In more complicated setups, parent companies will often need to temporarily import, distribute, or sell products on behalf of the acquirer after the close of the carve-out transaction. Supply agreements can last even longer, particularly in industries like biopharmaceuticals, where the transfer of IP and market authorizations is a long, complex process requiring approvals from multiple regulatory bodies.

It is incumbent upon parent companies to ensure that they and the acquirers agree on a comprehensive set of transition services when the deal is signed, not during the period between signing and closing. In this way, all parties can reduce the potential for surprises in determining the scope, cost, and effort required to implement services before deal closing. Additionally, acquirers and parent companies will need to jointly estimate the time it will take for the acquirer to fully take over the business activities covered under transition services and build those time frames into the agreement. For their part, acquirers may want to negotiate TSAs with provisions to add services later in case aspects of the transition are inadvertently overlooked.



Acquiring a carved-out business unit or asset can be a fantastic opportunity for creating value, but unique risks accompany any deal. Due diligence across the scope, financials, and transfer of the business or asset can improve chances for success. ■

¹ See Obi Ezekoye, Jannick Thomsen, and Andy West, "Understanding how US tax reform will affect divestitures," April 2018, McKinsey.com; and Obi Ezekoye and Jannick Thomsen, "Going, going, gone: A quicker way to divest assets," August 2018, McKinsey.com.

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