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The power of goodbye: How carve-outs can unleash value

Separations can be a once-in-a-lifetime opportunity to create value for the remaining and separated companies. The secret? Get granular about support costs and personal about talent.

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The rationale for combining businesses into one company, or for splitting them apart, should be the same: to create more value. Yet we often hear leaders describe separations as the opposite of M&A integrations, at least in terms of “capturing value” in the near term. M&A, done well, unlocks value by realizing synergies. But it needn’t follow that separations must present a drag on near-term value creation under the assumption that the separated entity (“CarveCo”) needs to build back the same support structure it had used when it was a part of the divesting company (“RemainCo”), or because the transaction poses insuperable risks to business continuity.

There are costs and risks of separations, of course, but like every key business decision, these should be considered under a cost–benefit analysis. In fact, what may seem to be the most daunting costs of separations are often more perceived than real. Does CarveCo need an effective support structure? Yes, but that doesn’t mean it needs the same, equally expensive support structure that it had under RemainCo; the “scale benefit” of general and administrative (G&A) can be vastly overstated. Could business disruptions arise as a result of a separation? Yes, but in the aggregate, there is typically a greater cost to standing still, and identifying potential disruptions is the first step toward mitigating or even preventing threats to business continuity. And might employees of CarveCo feel unnerved by the changes, or perhaps even leave? Yes, again—but employees can also be reenergized by the transformation, attracted to a more nimble, purposeful company and inspired to make it even better.

Any “keep versus divest” decision will always be highly fact specific; even the very term “separation” encompasses significantly different types of transactions (Exhibit 1). For all of the variation, however, common lessons clearly apply—the most important of which is that separations present an unrivaled opportunity for both transacting and *transforming*—by anchoring in the question “what is most value creating?” The answer is almost never to do things the same way that they’ve always been done.

Exhibit 1

Decisions to ‘keep or divest’ are always case specific.

Examples of divestment options and dimensions to assess

Divestment options	Example	Details
Carve-out sale	Sale to strategic buyer (including PE with platform)	Competitor acquires a business unit or assets carved out by the seller
	Sale to PE	A PE fund buys the business unit or assets and creates a new, private company
Capital market exit	IPO	The carved-out business unit is listed as a newly formed public company; parent company usually retains a stake for a period of time
	Spin-off/ split-off	A new public company is formed and all existing shareholders receive stock in SpinCo (or “swap” stock in parent for NewCo stock)
Merger/partial exit	Merger with strategic buyer	Competitors merge business units or assets; parent retains a stake in MergeCo
	Joint venture/ sell stake	Creation of a new entity, which the parent company owns jointly with strategic or financial partners

Assessment dimensions

Feasibility/complexity

- Carve-out complexity/ operational separation
- Legal restructuring
- Tax impact
- Regulatory/antitrust considerations

Value/costs

- Value creation/realization
- Transaction costs
- Recurring costs/dis-synergies
- Stranded costs

Timing

- Expected completion
- Time-to-value realization (cash in hand)
- Impact of other corporate actions

The right support structure

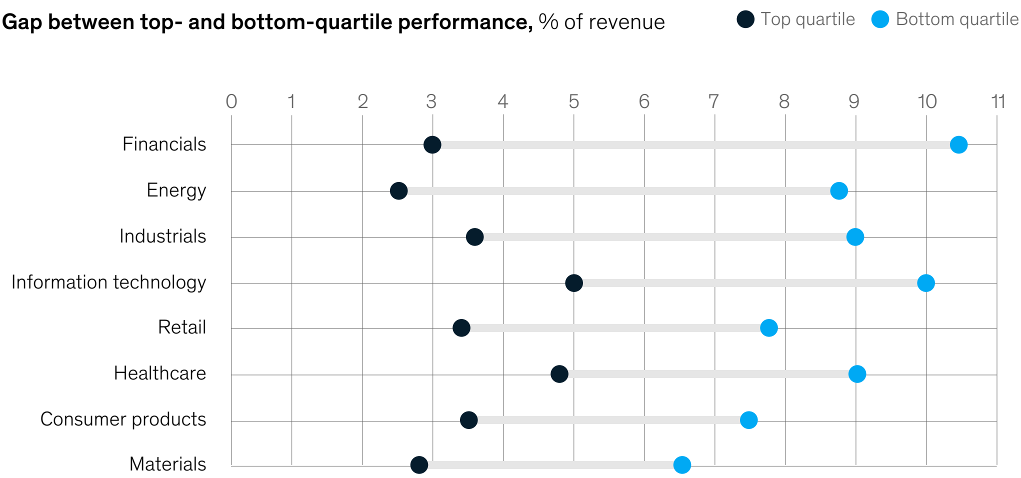
Building and maintaining effective support functions requires significant investment, no question. Across industries, there is a significant “G&A gap” between high and low performers of 4 to 8 percent of revenues (Exhibit 2). Understanding and addressing the gap can translate to significant value.

While both RemainCo and CarveCo require robust support structures, it’s a mistake to assume that RemainCo’s support structure will be necessarily applicable to CarveCo, or that CarveCo—given its purpose, size, and type of business—needs to scale all the way back up to its RemainCo levels for its business to thrive. In fact, we’ve found that companies can leave tremendous value on the table if they default to making CarveCo’s structure

Exhibit 2

General and administrative costs are significant across industries, and the gaps between industry high and low performers are notable—and expensive.

Gap between top- and bottom-quartile performance, % of revenue



Source: S&P Capital IQ; S&P 1200

a RemainCo "mini me," and elevate continuity as an end in itself, rather than to use the separation as an opportunity to transform. Companies should choose the right operating model for CarveCo, not just the familiar one. Five steps can be particularly helpful.

1. Create transparency

The first step in any separation is transparency. What specific roles, activities, assets, contracts, and people should support each business? Transparency provides a baseline. Achieving transparency is much more demanding than just a superficial review. It requires disaggregation. Think of the way, for example, that a mechanic would disassemble a motorcycle to understand what makes it go, or where its inefficiencies may lie. The goal should be clarity on a microlevel, with an eye not just to "what resources is this company using to support its operating model" but also "what resources *should* it be using given its specific circumstances as a stand-alone business?" While that degree of atomization may sound daunting, there are highly replicable templates that CarveCos can use to create and assess detailed, structured fact bases. Typically, many of the support costs and processes that CarveCos uncover when they create transparency and get down to constituent parts *are* rightsized—were CarveCo still to be a part of RemainCo. But when that's no longer the case, applying RemainCo's cost as the default setting for its constituent businesses is almost never optimal.

2. Compare and contrast with peers

To gain a clearer sense of what the actual "right size" is, it's essential to present a neutral, fact-based comparison both with peer businesses and with other parts of the business. Key focal points when comparing peer businesses include levels of automation, degrees of specialization, numbers of interfaces per process (this typically reveals clear opportunities for simplification), IT systems and applications that peers use, and the legal conditions in which peers may operate in achieving a leaner (or less lean) operation (for example, with respect to labor rules, reporting requirements, and occupational health and safety).

It's important to bear in mind that, while it's insightful to better understand peers' choices and outcomes, an effective separation shouldn't solve for CarveCo to be like its peers any more than it should solve to be like RemainCo. For example, in one separation, RemainCo found that the finance function of CarveCo was significantly larger compared with other companies in the same business benchmark. Rather than immediately starting to slash full-time equivalents (FTEs), however, the senior team looked deeper. As it disaggregated activities within the finance function, it discovered that beyond what could be considered traditional "transactional" financing activities (such as reporting, controlling, and budgeting), RemainCo's finance function was actually contributing to a number of value-adding strategic projects for CarveCo. Much of the separation and transformation efforts, the team determined, should therefore be devoted to the finance functions—bearing down, in particular, on what to protect, what to preserve, and how to improve. By gaining clarity at a granular level, the function was able to achieve a relatively fast 20 percent reduction—the "easy wins." The next 20 percent of reductions required significant investments in automation. These could not be made in parallel with the carve-out—but, importantly, RemainCo, CarveCo, and any new owner would have a clear understanding of necessary next steps and dangerous third rails.

3. Be open to nuance

While baselining and benchmarking help to recognize and prioritize areas where significant value may be untapped, actually realizing meaningful opportunities again requires teams to get very granular—to understand the specific activities that CarveCo needs to conduct and to identify the appropriate level of support that its business or businesses need, including spans of control and reporting lines. Many activities may, but need not, be provided by CarveCo in-house. But others can often be either outsourced or stopped entirely.

In one effective separation, team leaders discovered that CarveCo's human resources function was spending several days onboarding new employees and conducting additional training sessions on an ongoing basis. Those activities were necessary before the separation, when there were certain details and updates that many employees of the RemainCo conglomerate needed to know. But those additional details and steps simply weren't relevant for the single-business CarveCo, where learning the ins and outs of the larger corporation wasn't necessary. Much of the onboarding, the team found, could be scaled back, and several trainings could be eliminated. Business-specific training was made available on an as-needed basis from a third-party provider.

By examining and aggregating individual use-case examples, companies can begin to identify significant efficiencies. Being open to nuance helps avoid the trap of too easily sorting into "keep/outsource/eliminate" outcomes. It's often the case that a function that had employed, say, ten or more people when the business was part of RemainCo should neither be eliminated nor outsourced, but instead reduced to a fewer number of people who may (or may not) perform other roles. It may also be the case that in order to achieve *net* reductions, hiring or reskilling people with different capabilities will be a necessary precondition. Reductions may also need to be scheduled in sequence, as complications can arise if every move is executed at once. Continuity, after all, matters a lot—but as a means to preserving and creating value rather than as an end or coequal objective.

4. Rethinking technology

Technology is a unique consideration in separations. IT is itself a separate function, and like every function, it should be scrutinized for potential cost savings and efficiency improvements once the business is no longer part of a larger company. At the same time, the use of IT systems, infrastructure, and support is integral to and runs across every part of CarveCo. While RemainCo may require a more expansive range of hardware and software, CarveCos can, in many cases, perform many—and sometimes all—of their core needs using common applications (such as Microsoft Excel) and off-the-shelf or lightly tailored options. This can greatly reduce IT expenses without sacrificing much (if any) of the functionality that a smaller company needs.

Many effective CarveCos conduct joint workshops among support functions and IT in order to align on business needs and to identify outdated and unused IT systems, which should be eliminated. They also align on a separation approach, transitional service agreements, and appropriate lead times to ensure that essential technology is operationally ready from the moment the businesses are separated.

In one successful separation, the leadership team decided to stop using an advanced HR management software; the technology was ideal for larger organizations but expensive, and indeed obtrusive, for a company of CarveCo's size. Choosing a less bespoke option not only immediately and directly reduced expenses but also eased the transition to CarveCo's "Day 1": the transfer of data to Excel could be done ahead of time, with no need to negotiate a new software license or to draft transitional service agreements.

5. Create your road map

Identifying the appropriate G&A within and across CarveCo functions is a necessary but insufficient step to building a more value-creating business. To get from point A to point B, companies need to create a road map that spells out how to turn ideas into action. The details and timing of next steps should be clear.

The exercise should begin with outlining the new organizational setup based upon the activities reviewed, the opportunities identified, and the program conceived for IT simplification. A robust road map encompasses all functions, highlights key milestones, and identifies the interdependencies that will be critical to achieve a business-ready CarveCo. It can also define the spans of control, reporting lines, and how different functions should interact with one another. While traditional road maps are useful to see the big picture, for great maps, granularity is once again essential. Any practicable (as opposed to merely aspirational) road map sets forth FTE sizing at the level of an individual employee—or, more precisely, the specific activities and roles that individual employees should undertake. The detail reaches well beyond senior management.

Better practice, still, is to anticipate what could come next and plan for scenarios under a "next generation" organizational setup. Best practice is to spell out the next-generation arrangement and define changes that are implemented in the premarketing, preclosing, and postclosing phases. Those, of course, can differ depending upon the specific buyer and real-world time constraints. Sometimes, a buyer will offer a price that is so clearly value creating for RemainCo and above what RemainCo could reasonably expect to receive in even the best-planned separation; in those cases, the main goal will indeed be to get the deal done as quickly as possible while making a clean, legal break. But usually, judicious forethought is a value multiplier. By thinking about a separation in a rigorous and imaginative way, challenging assumptions about support structures, identifying potential disruptions, and being very clear in planning (and communication), companies can create the conditions that add up to a higher price—and that drive better businesses. The more detailed the road map, the more likely that RemainCo and CarveCo will create more value.

In addition to transaction timing, another major factor influencing the degree of implementation of the transformation plan is the likely exit route. A spin-off or IPO will, by definition, require a capital-market-ready organization; a divestiture to a strategic buyer should keep degrees of flexibility to avoid postclosing restructuring costs; a financial buyer will likely focus most on RemainCo as a stand-alone business (though likely with some differences to come, depending upon the specific acquirer). But any buyer, even a disbursed group of shareholders in the case of a spin-off, would recognize the upside in transforming legacy structures and building a fit-for-purpose G&A function.

Culture as catalyst

Precisely because the opportunities are so great in separations—when every support cost is on the table and a highly technical, bottom-up analysis is so essential—it's possible to overlook the personal aspect that can make or break a separation. Research shows that about 70 percent of the time, transformations beyond the separation context fail, and that the human element is a critical reason why. It's natural for people to resist change; in the context of separations, trepidation is heightened. While some jobs are added, others are eliminated or transferred; the uncertainty would put anyone on guard. Moreover, even the most high-performing, critical-to-retain employees can be subject to the same cognitive biases that are long programmed into the human condition. These include the status quo bias ("this is the way the job has always been done, so this is what we should keep doing") and the "prudence trap" ("this is all I can reasonably achieve, to be on the safe side").

Yet just as separations are a unique opportunity for companies to shake off old perceptions about the "right" support structures and systems, the transactions can be uniquely fortuitous for employees, as well: a chance to break free from old expectations, benefit from a fresh start, and help build something new. We've found that it's especially important for senior leaders, particularly at the CEO level, to lead calls to action. McKinsey research has found that respondents were nearly four times more likely to report a successful transformation when managers prioritized leading and developing their teams, more than five times more likely when leaders role modeled desired changes, and a remarkable eight times more likely when senior management communicated openly about the changes.[1]

In a recent carve-out, company leaders invested significant time crafting their change stories and sharing them with immediate teams and a broader range of employees in small group discussions and in town halls. The excitement was palpable. We've also seen the enormous benefits that can come when leaders put words into action and role model change. Even small actions add up; for example, in one separation, the leadership team requested for the first time that HR collect upward feedback about the leaders' own performance. Executives also moved their offices so that they would not sit among themselves but instead with their respective teams. Additionally, every key team meeting had someone play the role of "value-adding police," empowering team members to speak up any time they felt a request for information or analysis was not value adding.

It's natural to be skeptical of change—but it should be even more concerning when the default is for more of the same. Separations can unlock tremendous value. The odds for success improve when the separate company adapts a cost structure and culture that befits its specific needs—not those of the original conglomerate. Newly divested businesses can continue to generate and even grow revenues with a much smaller, more appropriate support structure. But it's the employees who may reap the greatest reward. It's exciting to be in a company that operates under its own unique business model and that isn't just a smaller version of a larger conglomerate. After all, why be a duplicate when you can be your own best self? Q

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[1] "The T-word," *McKinsey Quarterly Five Fifty*, March 20, 2018.