June 2019

Roland Berger Focus

The carve-out challenge

A roadmap for success

Management summary

Carve-outs can create significant value for your company. But success is far from guaranteed – and a carve-out that goes wrong can wreak substantial damage on both the new company and the company it is carved out of.

How can companies overcome the challenge? We recommend that top managers follow a clear roadmap, asking themselves four questions: why, what, how and who? Why are they planning the carve-out in the first place: Are they under pressure from a regulator, seeking to boost their profits or in pursuit of agility and flexibility? What are the planned perimeters of the carve-out transaction – the precise scope of the unit to be carved out? How do they plan to approach the carve-out process itself: Is their top priority speed, quality or value? And who will be interested in buying the new entity – what does the buyer universe look like?

By following this strict roadmap and making strategy a priority, we believe that companies can overcome the carve-out challenge. In the following pages, we discuss our approach in detail and illustrate how companies can generate significant value from this methodical approach.

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1. Value creator or value destroyer

Carve-outs must be carefully managed

Carve-outs have the potential to create significant value. Evidence for this assertion is not hard to find: The Bloomberg US Spin-Off Index, which charts the performance of entities that have been separated from top firms in the United States, indicates that they have outperformed the S&P 500 by almost 11 percent points since 2015 in terms of total return. This success has made creating new value through a carve-out an increasingly popular option for companies.

However, look at individual cases and the picture is not quite as rosy. In Germany, for instance, Uniper (carved out from E.ON in 2016) and Siemens Healthineers (Siemens Healthcare, 2017) have outperformed their parent companies. Others, however, have clearly underperformed. Indeed, a mismanaged carve-out can destroy value both for the new company and the company that spawned it.

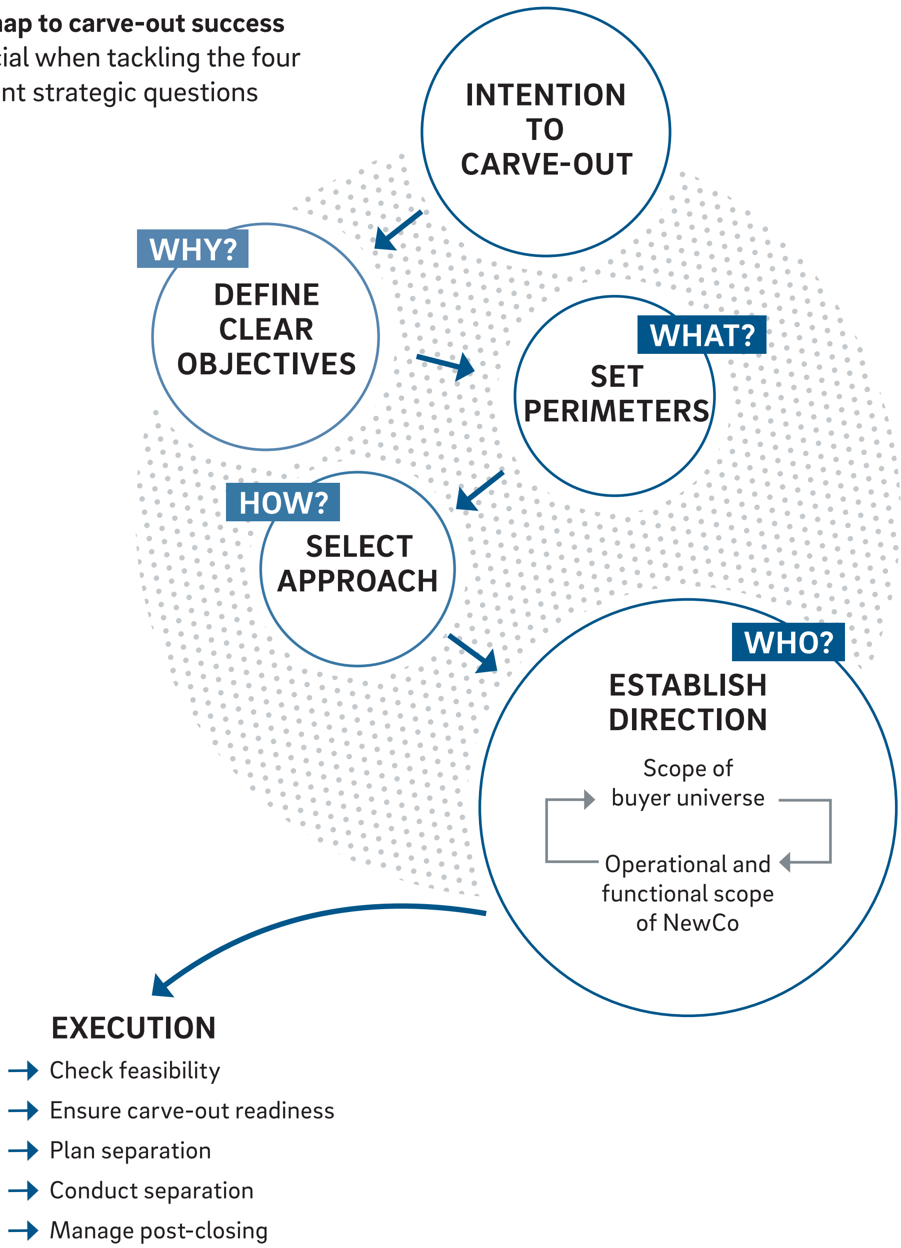
What lies behind this mixed picture? One reason is that the situations triggering carve-outs and the objectives of carve-outs can differ greatly from case to case. Top managers face a number of crucial questions: What is the intention behind the carve-out? Are there restrictions on potential buyers? How much time is available? What is the general market environment? Answering these questions, balancing the necessity, desirability and feasibility of different carve-out options, can be an extremely complex task.

To avoid the risk of choosing the wrong strategy, or beginning the carve-out with no aligned strategy at all, we advise top management to structure the myriad questions facing them in a methodical manner. Our approach is to look in turn at the why, what, how and who of the carve-out. Why are you planning to carve out this section of the business in the first place? What are the perimeters of the planned transaction (legal entities, facilities, brands, and so on)? How will you carry out the carve-out (will you focus on speed, quality or value)? And who are the potential buyers? Answering these questions up front, generally in the order presented, will help companies make the right decision when it comes to embarking on the carve-out – as shown in the roadmap. → A

"Companies that do not strategically and operatively plan a carve-out in detail oftentimes end up destroying substantial value – both for the new standalone and the remaining entity."

– Head of Strategy & M&A at a global conglomerate

A: The roadmap to carve-out success
Timing is crucial when tackling the four most important strategic questions



Source: Roland Berger

2. Why?

Define your objective

The first question that top management needs to ask itself is why. Why are we embarking on this carve-out in the first place? What is driving us to take this potentially risky step? Are we being forced into it by a regulator or by the market maybe? Are we purely seeking to boost our overall profits as a group? Or do we need to ensure agility and flexibility in our core activities? The precise strategic objective – the why – will inform and influence the answers to the questions that follow further along the roadmap: the what, the how and the who.

"Setting up a carve-out playbook supported our own internal analysis and helped us immensely during the due diligence phase and in the subsequent negotiations with potential buyers."

– CEO of a major European packaging group

Various motives can exist for carve-outs. On the one hand, many listed companies use corporate carve-outs to set up a holding structure. Their aim being to avoid a situation in which the stock-market value of the whole company is less than that of its individual businesses – a phenomenon known as the conglomerate discount. Alternatively, a company may wish to concentrate on its core competencies, restricting its business to those areas that are necessary for its value proposition and which it is able to master itself, while relocating all other activities to a separate business entity. We describe this situation in detail in our recent Think:Act "Detox your business: A hands-on approach to succeed in complex markets".

A carve-out may also be driven by the company's desire to redesign their corporate structures and working methods in a leaner, more efficient way. By establishing individual corporations for business units, the business units are freed from the legacy of the parent's structures, become more agile and are able to better react to changes in the market. The desire for flexibility and agility has become a major trend in recent years as increasing numbers of industries are affected by digitalization and disruptive innovations, leading to greater uncertainty. In this VUCA (volatile, uncertain, complex and ambiguous) environment, where a clear picture of the future is hard to grasp, the ability to react and adapt quickly enhances a company's resilience and prepares it for the changes ahead.

Another objective for carving out part of the business and creating a new company (NewCo) is to dispose of poorly performing units or units that no longer fit the company's strategy, and at the same time free up capital for strategically interesting investments by the remaining company (RemainCo). Separating NewCo from RemainCo can also have positive effects on the performance of NewCo: Eliminating bureaucracy or lines of management can add value, and NewCo may be a better fit for the buyer's portfolio than RemainCo's portfolio, leading to additional synergies.

In some cases a carve-out is required by the regulator. An acquisition may trigger antitrust regulations, for example, meaning that the company has to divest itself of certain parts of its operations as a remedy. In this case the main goal may be to strengthen RemainCo's overall position, that is, to find ways to comply with antitrust regulations while having minimal impact on RemainCo's business. At the same time, the company will be pressing for rapid implementation so that the acquisition by RemainCo can go ahead as quickly as possible.

3. What?

Set the perimeters

Once the why of the carve-out is clear, top management needs to turn to the what. This second step involves setting the perimeters of the transaction, in other words, the scope of the unit to be carved out. That includes the geographical scope of the carve-out and the legal entities affected, followed by the specific functions such as R&D, purchasing and sales and distribution. Additionally, tangible and intangible assets need to be included, such as facilities, equipment, intellectual property and brands.

At first glance, setting the perimeters of the deal may seem simple. In practice, however, defining what exactly is to become part of NewCo is often a complex undertaking. This is particularly so in the case of business units that are highly integrated into RemainCo. In this situation it is difficult to define the perimeters of the deal such that NewCo is attractive, while at the same time ensuring that RemainCo maintains or improves its levels of efficiency and productivity.

For example, what if the unit to be spun off uses the same brand as the rest of the company for its products? Should NewCo be allowed to continue using the brand, potentially diluting its value in the future? And if not – if rebranding takes place, which will inevitably affect customer identification with the brand – will NewCo be able to achieve the envisaged valuation? These problems can affect tangible assets, too. If the unit to be spun off shares locations, sites and facilities with the rest of the company, which of these should stay with RemainCo and which should go with NewCo?

In all such cases it is as important to consider the impact on RemainCo as it is the interests of NewCo. Decision-makers must also take into account the interests of potential buyers, of course, and managing this delicate three-way balancing act can prove a considerable challenge.

4. How?

Choose an approach

Having established the why and the what of the carve-out – its objective and the perimeters of the deal – top management now needs to turn to the how. Choosing the right approach is no simple matter. Companies often find themselves in a tug of war between three competing priorities: speed, or carrying out the carve-out as quickly as possible; quality, or carrying it out smoothly and carefully; and value, or achieving the highest valuation possible for NewCo while minimizing the one-time costs.

"The exact deal scope remained in flux until the very end of the deal due to the different nature of the two final bidders, namely a financial and a strategic investor."

– Board Member at a major European retailer

We can imagine these three goals as the three points of a triangle. → B Ultimately, it is the objective of the carve-out that determines which point of the triangle the company moves closest toward. Inevitably, trade-offs will be needed between the three.

SPEED

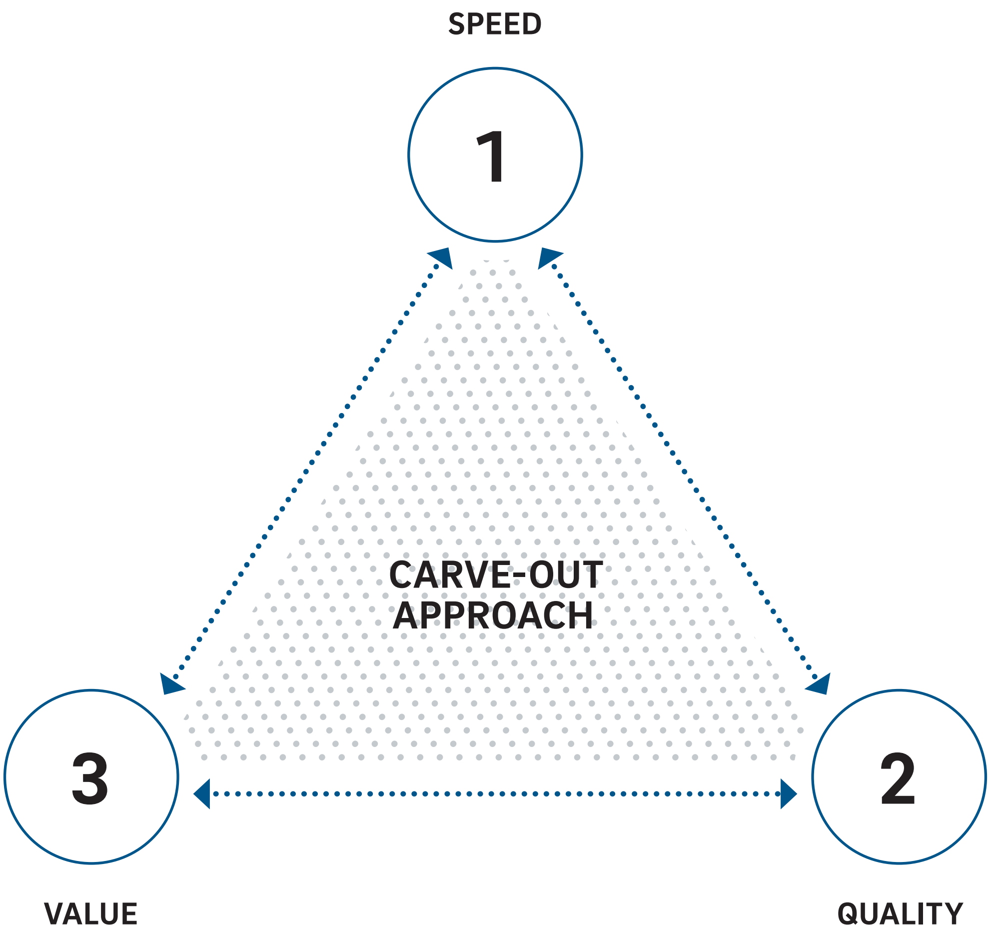
If the company needs to carve out a specific business unit for strategic, regulatory or economic reasons, it will often favor a rapid carve-out. Speed is of the essence here, whether it is to avoid missing a window of opportunity on the buyers' market or to avoid legal issues. The same is true if the plan is to float the NewCo on the stock market. With various regulatory requirements to be met, timely preparation will be essential, even if it means that the one-time expenses are higher and the valuation of NewCo is lower than could be achieved with a slower, more meticulous approach.

The risk, of course, is that NewCo is not yet capable of standing on its own two feet. It may lose key resources such as talent or even entire departments during the carve-out, diluting the value of NewCo, RemainCo or both. If the carve-out attracts bad press, it can also potentially damage RemainCo's brand. But if speed is paramount, these are risks that the company has to take.

QUALITY

Where the company's priority is to ensure operational continuity, maintain core resources such as staff and not put supplier relationships at risk, the management should prioritize quality. The aim is to ensure as smooth and careful a carve-out as possible. Accordingly, the company will strive to limit the impact of the carve-out on ongoing operations and use change management and stakeholder management to ensure careful execution. It will want to ensure a precise separation of

B: The trade-off triangle
How to strike a balance between conflicting approach objectives



Source: Roland Berger

contracts, customers and suppliers, clearly defined service level agreements (SLAs) and carefully disentangled IT systems. Indeed, the carve-out may represent a rare opportunity for management to screen the company's processes and capabilities for further optimization; few other transformation projects require such a deep analysis of processes across a wide range of functions. → B

VALUE

Sometimes, the primary goal of the carve-out is to raise money. In this case, the main priority is to achieve a high valuation of NewCo by optimizing its running KPIs. The company will also want to keep the one-time expenses of the carve-out as low as possible.

To achieve as high a valuation of NewCo as possible – to squeeze the lemon, so to speak – the seller may decide to carry out a program of targeted initiatives at the business unit to be spun off. Pushing up NewCo's key performance indicators in this way will help it achieve a higher valuation. In other cases, such a program of initiatives may be necessary simply to ensure the survival of NewCo – for example, if it was kept alive in the past by the rest of the company.

It should be remembered that carrying out a program of target initiatives requires time, money and management attention. Initiating such a program at the same time as preparing the carve-out can be a damaging distraction and a drain on resources. For this reason, if speed is not a priority, companies should implement targeted initiatives several months prior to initiating the carve-out transaction. In this way, the impact of the measures will already be seen in the P&L (profit and loss account) and the valuation will be correspondingly higher. → B

"Thorough preparation and analysis of various carve-out options and scenarios right at the beginning of the deal lifecycle pays off at the end. Execution and transaction closing are much easier then, and it even helps with strict post-close management."

– Global Head of Carve-out Programs at a global telecoms player

5. Who?

Identify a buyer

Having established the objectives of the carve-out, the perimeters of the deal and the most suitable approach, management should now turn their attention to identifying a buyer. In other words, the question of who.

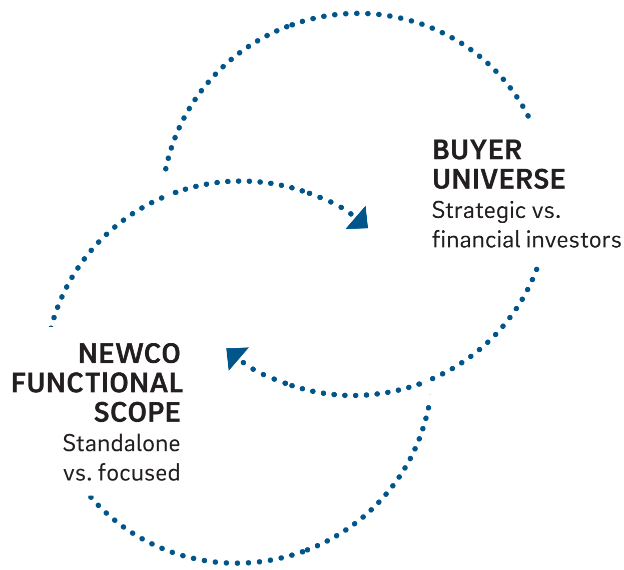
The buyer universe – by which we mean the various potential buyers of different types who may be interested in NewCo – can include both financial investors, such as private equity firms, and strategic investors looking to expand horizontally or vertically. Sometimes, the motive for the carve-out and the resulting approach may exclude certain potential buyers. This is particularly true if certain regulatory, political or geostrategic reasons need to be taken into account. To address the concerns of internal stakeholders (such as the workers' council), it might make sense to exclude buyers with a strong restructuring focus.

However, if the seller needs to dispose of specific assets to comply with antitrust regulations, it will need to do so quickly, separating off the assets without building up standalone capabilities. This might put some financial investors who lack the necessary capabilities themselves out of the picture. If, on the other hand, the objective is to generate income from the sale, then the approach will focus on value and all potential buyers can be targeted in order to achieve the highest possible valuation.

Top managers should act quickly once they agree on the type of investor they have in mind. In the case of a strategic investor, the acquirer will usually be looking for synergies with its own operations. This may mean staff reductions in the head office, sales organization or even production. Many large corporations have strong employee representatives, and management must begin the discussion with them early so that the process is not derailed later on.

As a rule, the type of investor – financial or strategic – also determines the functional scope of the carve-out, in other words, which functions are included in the sale.

C: A double sided dependence
Choosing a type of investor and the carve-out scope go hand in hand



Source: Roland Berger

A strategic buyer may want to acquire the unit with no headquarters function, whereas a financial investor will likely require a higher degree of standalone capability from NewCo. Exceptions to this general tendency also occur: A strategic investor may have its own reasons for wanting to acquire a NewCo that is still dependent on RemainCo. Accordingly, the company will need to carefully finetune the perimeters of the deal. It should configure the different functions so that they fit both the objectives of the carve-out and the needs of the buyer. This means working along the entire value chain, carefully defining all the functions and departments of NewCo, including R&D, purchasing, operations, and sales and distribution, as well as overhead functions such as IT, HR and finance.

A key consideration when allocating specific functional capabilities to NewCo is the impact of the carve-out on the business of RemainCo. For example, what will happen if specific R&D functions are sold that are essential for NewCo but also previously supported RemainCo? Or if the sales and distribution network have to distribute products for both NewCo and RemainCo? And who should gain ownership of the company's intellectual property? Solving this puzzle can be particularly tricky if NewCo and RemainCo are highly integrated, with shared services, employees not dedicated to specific business units, shared assets such as real estate, bundled sourcing contracts, shared IT systems and other intertwined areas.

A solution often employed during the first few months after a carve-out is transitional service arrangements or TSAs. Under a TSA, RemainCo agrees to provide services such as HR, accounting, IT or other infrastructure post-closing, for a fee. This can be particularly useful where the strategic investor is not already established in the industry or market in question and therefore does not have its own back office or infrastructure. TSAs help ensure that NewCo has all the capabilities it needs in order to function from Day 1 during the transition phase.

Drawing up TSAs is an important part of "post-closing management" – a topic that we plan to return to in a later study. Along with clearly allocating resources and implementing efficient tracking and controlling systems, it creates value for NewCo. When the TSAs expire, effectively managing "stranded costs" – investments in infrastructure that is now irrelevant – becomes another critical task. → C

"Right from the beginning, we decided that from Day 1 we wanted to have a clear cut and avoid any TSAs, even if that meant incurring certain costs or dissynergies due to having to build up certain functions at the carved-out unit."

– Head of Corporate Development at a leading European manufacturer

6. Countdown to success

A question of strategy

It is often said that the devil is in the detail. However, in our experience, high-level strategic considerations can also be, and often are, a cause for failure. This is particularly the case with emotionally charged processes such as carve-outs. Like a divorce, the separation from a long-standing business unit or product range with which top management and employees have developed high levels of identification can be very difficult, blurring the opinions and decisions of otherwise rational and strong leaders.

With this in mind, we strongly advise top managers to follow a robust, rational methodology when approaching carve-outs, such as that outlined above. Answering the why, what, how and who questions builds a foundation for success and prepares the company for effective execution.

Going forward, thinking about the strategic questions is set to become more important than ever: Companies are increasingly focusing on their core activities and aiming for a "pure play" strategy, with all the advantages that this offers for the company's valuation. Carve-outs are – and will no doubt remain – a challenge for top manangers. But with the help of strong foundations, a well-defined roadmap and the use of expert help if necessary, we believe that companies will be able to rise to the challenge.

"In our case the carve-out generated substantial value through leaner structures, faster and more streamlined decision making and better alignment of managerial incentives within the carved-out entity."

– CEO of a machinery business

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