KPMG

Avoid divesting pitfalls

Business in a box: Part 4

Carving out a business for divestment can be a great source of value for companies looking to focus on their core or eliminate underperforming units. Ideally, the seller should present the divested operation to potential buyers as a "business in a box"—a standalone entity prepared to thrive unencumbered by operational, managerial, or financial issues. There are many components to a carve-out: financials (including tax), quality of earnings, standalone cost, net-working capital requirements, and tax/legal entity structuring. However, the papers in this series focus on the operational separation.

You can't plan for what you don't know

The goal of this final paper is to shed light on key challenges of separation execution that drive approximately 80 percent of carve-out issues. We have identified the most frequently encountered pitfalls that disrupt translating the deal thesis into value creation and separated them into six categories:

This paper is the fourth in a four-part series that will examine the key phases of the carve-out process:

1. Setting up a carve-out for success
2. Developing an optimal delivery model
3. Executing the delivery model
4. **Avoiding the pitfalls throughout the process.**

Key challenges likely to impair value

1 Operational

There can be a disconnect between what the seller is separating by Day 1 and how the buyer will take over operations. If there were a walk-through with functional leaders from both buy and sell sides of the transaction, would there be agreement or understanding on how their function will operate on Day 1? Is it clear which of the financial reporting, billing, delivery, and compliance processes will be built new, supported by seller via transition service agreements (TSAs), or provided by a third party on Day 1? Misunderstandings in these areas can harm or disrupt the operational integrity of the business.

Mitigation measures:

- Ensure dependencies are all connected while planning for Day 1 to ensure that planning for one CarveCo[1] function does not negatively impact or disable another
- Highlight operational continuity imperatives to confirm that, in the midst of deal minutiae, these core capabilities (e.g., ability to sell product/service, issue invoices, pay vendors, ship product, etc.) continue on Day 1.

[1] CarveCo is the subsidiary, division, or other part of a larger business enterprise that is being carved out to be sold or stood up as its own entity.

2 People and communications

An effective communication approach is critical to anchor employees' experience and to manage external partners. In many carve-outs, management fails to communicate fundamental information (e.g., deal rationale, end-state vision, and business strategy) or establish a communication strategy and cadence that is optimal to their carveout timeline.

In terms of the organization itself, organizational design can become top-heavy, ambiguous, generally unknown, or redone multiple times as management adjusts its vision during a carve-out. It is critical to have "names in boxes" early on and ensure everyone knows who they work for, as lack of clarity around structure can contribute to loss of talent during execution. And it's important to identify key talent in the organization to minimize loss of necessary and valuable CarveCo-specific skills during the transition process.

Mitigation measures:

- Develop a list of key staff in CarveCo, communicate with them early on, and create retention plans for them
- Plan to incur incremental near-term full-time equivalent (FTE) costs in order to avoid significant FTE costs and headaches at the eleventh hour. Rather than wait until the last moment to hire necessary FTEs, budget for extra headcount or period overlap to mitigate compromising the transference of knowledge
- Overcommunicate rather than undercommunicate; leverage communication platforms and resources to connect with employees and ensure information comes from a single source in order to avoid mixed messages and/or misunderstandings
- Throughout the execution process, create clear guidelines for buyer and RemainCo[2] leadership regarding employee, vendor, and customer communications to ensure consistency and alignment for communications where there can be substantial overlap between buyer and seller. This includes internal communications related to Day 1 readiness and TSA enablement, and external communications to customers and vendors
- Assign names to the new organization structure immediately following L1 conceptual planning in order to drive ownership at the L2 and L3 tiers. The KPMG KODA organizational design-analysis and scenario-planning tool, combined with customized support, can help identify opportunities, gaps, and suggested target areas to achieve an optimal workforce plan

3 Legal entity operationalization

Asset sales require the buyer to take on the burden of setting up legal entities rather than a spin out, for example, where the legal entities are set up in-house. The formation of legal entities poses its own set of challenges, but operationalizing legal entities comprises a myriad of tasks across jurisdiction timelines and function requirements—each with a degree of regional and local involvement—that complicate those formation challenges.

Mitigation measures:

- Establish a governance structure at the outset that is appropriate for the carve-out footprint with essential global, regional, and local stakeholders
- Ensure stakeholders and contributors involved in operationalizing legal entities understand the end-state vision at both country and regional levels and have the necessary expertise to marry the vision with the operational requirements
- Note critical dependencies across core functions like Finance, IT, and HR, and secure strong function leadership for these workstreams.

4 Joint planning

Once the deal has been signed, the buyer and seller are required to immediately and abruptly pivot their mindset from negotiation to collaboration as they initiate the planning and execution stages. However, buyers and sellers have fundamental differences in their planning and objectives, and methods to achieve these goals can become adversarial when the line between what is defined as a separation activity versus an integration activity starts to blur. Complexities around joint planning can be magnified by asymmetrical information between the parties: while the seller has been planning the carve-out for months, the buyer will need to be brought up to speed.

Mitigation measures:

- Before negotiations end, seller should prepare a synopsis of separation planning conducted to-date for the buyer
- Begin planning immediately after the deal is signed to minimize the impact of circulating rumors on either side of the transaction
- The buyer and seller should look to build bridges immediately after negotiations are complete and align on ways of working early in the process, including how teams interact, the joint meeting cadence, and any data transfer boundaries

[2] RemainCo is the parent company or seller that is divesting the CarveCo business.

5 Regulatory

Regulatory and compliance teams are often engaged too late in the game to minimize complexity. As a result, these teams often play catch-up and have to rework dependencies between workstreams and jurisdictions in their workstreams, with much of this centered around managing the ability to do business in these regions by Day 1.

Although organizations may assume that all regulatory documentation and licensing can be completed on similar timelines in all jurisdictions, country, and regional bureaucracies are rarely aligned. Different countries have different durations for regulatory filings, and in some cases there are in-country federal and local regulators with differing requirements (e.g., Brazil). The number of timeline complications the regulatory workstream encounters across jurisdictions, country and regions—as well as varying timelines across an organization's own jurisdictions—can increase the risk of mistimed or entirely missed regulatory certificate change approval(s). There are also instances where customs regulators may reject regulatory applications for which an organization requires immediate approval to conduct business.

An additional consideration for the regulatory workstream centers around RemainCo's logo presence: if the logo is more prevalent than anticipated in documentation and on-product, the number of required changes further increases complexities the workstream must overcome to achieve success.

Mitigation measures:

- Start the compliance and regulatory workstream early in the carve-out process
- Consider how CarveCo tax and legal entity structures can be developed within existing naming conventions to minimize labeling and regulatory roadblocks[3]
- Identify countries with regulatory grace periods to be leveraged (e.g., 1–2 years grace period for product labeling)
- Ensure all certificates are mapped out in the Day 1 planning and readiness assessment and account for realistic lead times aligned with regulatory function leadership
- Consider intercompany agreements as a tool to mitigate regulatory risks to continuity on Day 1 (for example, product may transfer with old company to old company license, or they negotiate with the customs agents where it is acceptable to do so)
- Prepare for markets with traditionally longer delays by building up inventory in advance of Day 1
- Negotiate a TSA for branding to protect CarveCo, and enable use of RemainCo logo to allow sufficient time to update documents, websites, etc.
- Confirm third party provider support for regulatory and compliance to ensure completion and accuracy in submission, approvals, etc.
- Update and change Instructions for use as applicable.

6 TSAs and stranded costs

CarveCo and RemainCo complete TSAs at too high a level, without sufficient detail to tie costs to services, thereby limiting RemainCo's ability to achieve efficiencies after the carve-out.

Mitigation measures:

- Deliver only what is absolutely necessary for business functionality via TSA (i.e., limit durations, scope, service level, etc.) and use simple, straight forward language whenever possible
- Identify preferred and maximum duration limits
- Develop a cost structure and model that accurately calculates the activity-based costs of providing the transition service(s)

Read more about the KPMG perspective on TSAs.

7 Trade compliance

A company must be registered to import or export in every jurisdiction in which they are present—this requires the establishment of a legal entity prior to Day 1 for registration procedures in the respective jurisdiction. Trade compliance is a priority to ensure business continuity, but CarveCo is often entangled with RemainCo in this area because the teams typically run lean, with each person wearing multiple hats.

Trade and customs is generally considered the movement of goods; however, companies involved in export also must consider the technology within their products because U.S. regulators control information and technology exports (in some cases, "deemed exports" may only be made accessible to U.S. nationals).

[3] Please contact us to learn more about this structure and strategy

Mitigation measures:

- Ensure trade compliance is involved in foundational discussion and decisions regarding Day 1 operational readiness
- Prioritize understanding and awareness of data and governance in your trade and compliance workstream, and your readiness plan
- Conduct a trade and compliance risk gap assessment early on in the process
- Ensure clear understanding of how split headcount will be handled since trade compliance is typically a highly entangled function across CarveCo and RemainCo
- Confirm roles and responsibilities within trade compliance in the new organization structure

Setting up guiding principles

By establishing clear separation guiding principles, sellers can begin to mitigate pitfalls before they arise and develop a decision-making matrix that empowers teams and functional leaders. These clear guiding principles can ultimately minimize the volume of issues escalated to both the Separation Management Office (SMO) and the executive steering committee.

Principle	Outcome
1 **Align strategic rationale**	• Strategic and operational clarity and executives aligned on objective(s) • Committed senior management aligned on overall separation strategy, project governance, transaction priorities, roles and responsibilities, Day 1 operating model, etc.
2 **Establish command, control, and manage planning to achieve Day 1**	• Clear governance and Responsible, Accountable, Consulted, and Informed (RACI) matrix • Clear objectives and accountability with rigorous tracking • Critical processes (e.g., decision-making, issue escalation) in place • Objective decision-making, resulting in "adopt and go" efficient progress • Accelerated issue resolution • Early pre-close and detailed planning to enable rapid execution • Clear Day 1 priorities and must-haves • Minimize negative customer, employee, or business impacts
3 **Proactively manage employee experience**	• Anticipate hypercare support needed during—and after—the Day 1 cutover. • Consistent communication early and often • Early appointment of senior management • Upfront management of employee impact issues • Cultural implications identified and addressed
4 **Early IT decisions, business alignment and execution support**	• IT strategy and initiatives aligned with separation priorities • Early execution of long lead-time items • Resources and support arranged to execute IT transition
5 **Focus on Customer Experience (CX)**	• Core group of resources managing the impact of separation on customers • Proactive customer experience planning

In conclusion

In this series, we have walked through four key areas of the carve-out lifecycle: developing the initial blueprint, determining your global service structure, executing on these plans, and now identifying pitfalls to be mindful of and avoid throughout the process.

These are the primary components in the operational separation, but there are still other core components beyond this, such as: financials (including tax), quality of earnings, standalone cost, net-working capital requirements, and tax/legal entity structuring. You can provide your team with every available template and roadmap, but in mergers and acquisitions, as in military strategy, experience and "war stories" are the difference between meeting your definition(s) of success or failure.

Most carve-out plans are vague, and improvisation becomes a necessity when plans are confronted by challenges. But improvisation and firefighting will only bring you as far as the next crisis, and neither one is ever a substitute for planning ahead through completion of the end-state envisioned in the deal strategy.

In concluding this series, we leave you with three final pieces of advice:

Prepare for the unexpected...	...and plan thoroughly
Plan for likely underestimation of effort and operational interdependencies	A clear governance structure facilitated by an SMO will position you to be proactive instead of reactive
Be flexible in prioritizing risks, issues, and bottlenecks, which are likely to change throughout the separation	Thoroughly plan for a complex, multidisciplinary separation focused on minimizing value leakage
Ensure that the separation program is sufficiently resourced and has the full commitment of senior executives	Identify, monitor, and resolve dependencies throughout the separation program

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