Setting up a carve-out for success

Business in a box: Part 1

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 stand-alone entity ready to thrive unencumbered by operational, managerial, or financial issues.

But the value to be gained from divestment could be lost if the seller doesn't properly plan or execute the carve-out. Making the right decisions to generate a successful outcome, in turn, requires a clear methodology to build an operating model that best aligns with the seller's strategy. There are many components to a carve-out: financials (including tax), quality of earnings, standalone cost, tax/legal entity structuring; however, the papers in this series focus on the operational separation.

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

- Setting up a carve-out for success
- Developing an optimal delivery model
- Executing the delivery model
- Avoiding the pitfalls throughout the process

Why are carve-outs booming?

Carve-outs are booming because they have become the preferred investment of private equity firms. The value of private equity deals in the first half of 2022 reached $590 billion, an increase of 51 percent compared to the same period a year earlier.[1] U.S.-based strategic and private equity deals accounted for $1.41 trillion in the first half of 2022 alone.[1,2]

Companies divest businesses for many reasons—a change in strategic focus, to improve valuation, or to set up a different control structure and reduce bureaucracy. Life sciences players, for example, have been disposing noncore businesses and building specialty platforms—Takeda, for example, has been divesting $10 billion in non-core businesses to focus on what they see as their long term growth options such as gastroenterology and rare diseases. In many cases, they have been carving out consumer businesses and making acquisitions in specialty pharma development, contract development, manufacturing, and research.

Market conditions have been favorable

1. **Enthusiastic buyers.** Sellers have taken advantage of buyers' willingness to pay high deal multiples, allowing sellers to generate value by raising profitability and reducing debt.

2. **Activist shareholders.** There has been a significant increase in activist shareholders' demands to divest noncore and underperforming business units.

3. **Evolving business practices.** Many companies have shifted their corporate priorities, notably to highlight environmental, social, and governance (ESG) concerns and healthcare equality. In the 2021 KPMG U.S. CEO Outlook, for instance, 81 percent of surveyed CEOs specified that their focus had shifted to the social component of their ESG programming.

4. **Strategic capabilities.** Numerous organizations have sought to rapidly expand their capabilities and enhance their product offerings through acquisitions as they refocused their businesses on core or new initiatives.

5. **Turbulent times.** Companies negatively affected by COVID-19 and geopolitical conflicts have strengthened their financial health by injecting liquidity, reducing debt, and minimizing drag on their profitability. Sectors and companies less negatively affected have taken steps to increase their free cash flow and boost their valuations—which, in turn, has helped to drive deal activity.

[1] Source: KPMG US M&A research, July 2022

[2] Deal value total for strategic deals may differ from the sum of strategic deals of all sectors, as there may be a case(s) in which a deal is tagged to two sectors based on the target's primary industry and the buyer's primary industry. (Example: Target is tech, media, and telecom, and the buyer is financial services; in such a case, the deal is tagged to both tech, media, telecom and financial services sectors.)

Complexity and challenges

Carve-outs can be complex, often characterized by the divested unit's need for ongoing day-to-day operational support from the seller (known as "RemainCo"). As a result, standing up a fully functioning business on Day 1 is challenging for stakeholders on both sides of the transaction.

If the deal is properly executed, however, both buyers and sellers can reap significant rewards. For buyers, carve-outs can result in lower premiums compared to full-company acquisitions, and higher returns on investment. Sellers can benefit from a greater likelihood of deal closure, which enables the seller to focus on its remaining business(es) and utilize tax losses both to offset taxable income and increase the transaction's cash value.

However, if a carve-out is not well executed, the potential value for both parties is at risk. In some cases, the carve-out produces dis-synergies for buyers and sellers alike, such as compromised value proposition and reduced vendor negotiating power due to loss of parent-company contract terms. In Exhibit 1, we show five common pitfalls to avoid.

Exhibit 1. Five common pitfalls to avoid in carve-out planning

Challenge	Root cause	Impact
Carve-out scope	• Buyers and/or sellers treat the carve-out as they would a general M&A transaction, despite increased complexity (e.g., the deal parameters may be too loosely defined)	• Misdirected efforts in the planning phase lead to challenges in the execution phase, potentially increasing costs; and future delays • Inability to define and set up comprehensive product and financial flows
Multiple stakeholders	• Central management isn't aligned with the common objective	• Competing priorities between RemainCo and CarveCo[3] • Duplicated carve-out activities and misdirected resources • Extended time until deal closes
Limited resources	• CarveCo employees supporting carve-out activities must handle existing responsibilities as well as assigned M&A-related activities	• Reduced employee morale • Departure of key CarveCo personnel • Negative impact on client and business relationships that might already be strained
Entanglement identification and management	• RemainCo and/or CarveCo misrepresentation or misunderstanding of entanglements	• There is risk of recreating the old model rather than developing the best structure for CarveCo. • Financial buyers balk at investment required to set up CarveCo. • Operational structure may be an obstacle to meeting expectations and competitive requirements.
Structure of shared services via global delivery model	• High CarveCo dependency on RemainCo across target operating model dimensions[4] for all functions	• There is risk of recreating the old model rather than developing the best structure for CarveCo. • Financial buyers balk at investment required to set up CarveCo. • Operational structure may be an obstacle to meeting expectations and competitive requirements.

[3] 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.

[4] Including, but not limited to, process, technology, assets, contracts, people, etc.

There are important steps that sellers can take to mitigate or help minimize the carve-out pitfalls we've identified and reduce the risk of an unsuccessful transaction (Exhibit 2).

Exhibit 2. Action steps for success

Challenge	Impact
1. Don't just dump toxic assets	• RemainCo must create a business that can show a clear path to value. This means resisting the temptation to simply carve out what is perceived to be a burden to RemainCo. Start the process with a feasibility study and develop a specific definition (i.e., deal parameter) of the carved-out business.
2. Sell what people want to buy	• Analyze the buyer pool prior to developing the carve-out plan. Rather than developing a product and then finding a customer for it, carefully define the "business in a box" that can be sold.
3. Define "no regrets" moves	• Identify the initial decisions you can make without regret that define the transaction's direction and scope.
4. Control the process	• Specificity and detail are critical components across the core pillars of the execution process, including central planning, roles and responsibilities definition, and timeline development.
5. Build the blueprint	• Identify the finish line for CarveCo and develop the blueprint to reach it. Creating a central, cohesive source for operating-model components will help drive the shared vision for all stakeholders. It's important to note that the structure of the separation is equally as critical—if not more so—as equipping CarveCo with what it needs to run as an independent business.
6. Do the deal in stages	• Take a phased approach that manages rollout pressure while allowing the team to build momentum and learn from initial deployments, as well as to adapt for more complex execution plans later. • We discuss the phase of carve-out execution further in the third paper in this series, "Executing the delivery model."
7. Develop shared services via global delivery model	• Establish a shared and centralized services structure for CarveCo that aligns with CarveCo's strategy. Shared services will include the most entanglements and TSAs, and the CarveCo team is likely to refer to the previous structure when building the new one.

Creating the right blueprint

A major multinational medical device company wanted to understand its options for carving out a product division for purchase by a financial buyer. The division was underperforming, but the company had retained it to offer a complete portfolio of products. Although the company had not yet identified a specific buyer, it had assessed a number of them and planned the diligence process to begin within six months after completing a carve-out blueprint.

To develop the blueprint, KPMG advisers asked CarveCo's leadership to envision the new organization's operations and worked with functional teams to create the foundational blueprint for the future. CarveCo's leadership and teams, with KPMG guidance and methodology, built a viable stand-alone business structure that, despite its challenges within RemainCo's portfolio, set the organization on the critical path to value.

Defining the blueprint is the first step in a complex process, and we will review key steps in the process through this four-part series. Our next paper, *"Developing an optimal delivery model,"* discusses how to evaluate global delivery models for shared and centralized services, determine the locus of control for functions, and review considerations for global corporate governance.

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