

TS insights

Key considerations for successfully executing buyer due diligence in carve-out transactions

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The tumultuous economy opens the door for opportunistic buyers to acquire business units from distressed sellers.

As the global recession deepens and credit markets remain almost frozen, more struggling companies are looking to carve-out and sell portions of their operations in an effort to generate needed capital or exit noncore business units. Such an environment presents extraordinary opportunities for companies with strong balance sheets and available capital to expand market share and increase profitability. However, carve-out transactions are complex and each unique situation requires careful analyses by potential buyers. Companies engaged in carve-out transactions often benefit from the involvement of staff and advisors with carve-out experience.

The frenzied deal market over the past several years saw a reduced level of buyer due diligence as a result of high competition for businesses. In the current, much tougher deal market, the need for extensive buyer due diligence has increased – buyers now hold all the cards. Flexibility and time to properly complete due diligence allows buyers to significantly increase their level of scrutiny in performing due diligence and thoroughly evaluate acquisition opportunities from a number of perspectives.

Background

Although there is not an official accounting definition for a carve-out transaction, the term commonly refers to a variety of financial presentations that reflect a component of an entity rather than the entire legal entity. Examples of such transactions may include: equity carve-outs, spin-offs, split-offs and carve-outs of segments, business units, or lesser components such as product lines of a business. The entities resulting from these transactions are referred to as "carve-outs" throughout this document. In many cases, the carved-out business is sold to either another company or other investors, such as private equity funds. Depending on the buyer, the carve-out business will need to either: (1) function as a completely standalone entity post-transaction; or (2) be integrated into the buyer's existing infrastructure. There are a number of issues that should be considered and addressed while evaluating a carve-out business in an acquisition. The following commentary addresses critical deal considerations and suggestions on how an acquirer of a carve-out business might approach carve-out issues in performing due diligence.

Critical considerations for carve-out buyers

Presentation of Financial Information

Know what you are buying. It is imperative that a buyer of a carve-out fully understand how the deal carve-out financial information was developed. In many cases, deal carve-out financial information is developed by the seller for the first time in anticipation of a potential sale. As such, the financial information may not have been fully vetted and analyzed by the seller prior to making the information available in a data room. For example, the sellers may not have completely evaluated the financial and operational risks of the carved-out business and the financial trends of the business. In addition, the financial statements presented for the carve-out may not accurately represent the deal the buyer envisions or desires. That is, the financial information as presented may require adjustments to reflect the actual financial position and results of the business being pursued. Making these refinements to the presented financial information will allow the buyer to have a better perspective on the valuation of the business.

Bridge to the general ledger. The initial step in assessing the deal carve-out financial information is to understand the financial statement trail of the business. This trail should include a roadmap from the deal carve-out financial information or GAAP carve-out financial statements presented by the seller to the general ledgers of the legal entities or profit centers

that comprise the carve-out. This mapping is critical to 1) gain an understanding of the components included in the carve-out; and 2) to ensure the carve-out represents the business a buyer desires and excludes those that are not desired. This will assist the buyer in developing a shield against unexpected pitfalls, such as assuming contingent liabilities that are attached to a specific legal entity that could have been excluded from the transaction. Without obtaining the financial statement trail, a buyer is unable to fully assess potential risks or exposures associated with the transaction.

Depending upon the nature of the carve-out, the financial statement trail can be extremely complicated. Large or diverse companies typically have very complex organizational structures, which make it difficult to develop clean financial information for the carved-out business. For these large entities, the management team might have historically viewed or assessed the financial information for the business differently (e.g., profit center view versus legal entity view). The carved-out financial statements could be a combination of profit center financial information and legal entity financials and could contain multiple layers of consolidations and sub-consolidations. In these instances, the buyer should scrutinize in detail the financial statement trail during due diligence in order to avoid post-deal surprises caused by the business' historical legal and operational structure.

Clarify basis of presentation. A buyer should also consider the possibility that the information provided by the seller is limited. Although the parent entity may be audited, the financial information presented by the seller for the carve-out may not be audited or even subject to detailed audit procedures. The buyer should make certain that the sales and purchase agreement (SPA) clearly articulates the accounting policies and principles used to develop the carve-out financial statements. This also helps ensure that the methodology used to develop the financial statements at the transaction closing date is consistent with the financial statements that were subject to due diligence and the representations included in the SPA with respect to accounting policies.

This is particularly important in transactions that include a post-close, purchase price adjustment mechanism, such as a net equity target or an EBITDA target that could result in a change in the purchase price. These targets are typically developed using the financial information provided for due diligence and are agreed upon before the SPA is executed. A buyer typically develops a point of view on the appropriate target levels based on the information gathered during due diligence. In the time period from signing to

closing, the sellers could make changes in accounting policies and methodologies that could impact the result of the purchase price true-up associated with these targets. Properly defined and established accounting policies for the carve-out can protect the buyer against negative impacts of these issues.

Regulatory and financing requirements. If the buyer will be required to obtain audited financial statements for the post-transaction carve-out entity as part of a public filing or if an audit is required by a lender, consideration should be given to the potential cost of obtaining an audit; and the timeline required in to complete one.

In recent years, when credit and equity markets were free flowing, lenders were not as strict about the documentation they required before they would provide financing. However, in the current credit environment, lenders are requiring borrowers to provide more detailed financial information before they will lend and increasing the level of covenants associated with debt facilities.

Corporate allocations/shared costs/standalone costs

Determining the standalone value of a carve-out is a complicated process. A buyer should consider if a carve-out might have benefited from the parent's infrastructure (e.g., treasury, legal, collections, procurement, tax) and economies of scale (e.g., cost of insurance coverages, employee benefit plans administration). Furthermore, a buyer should identify and assess other intercompany transactions, including intercompany sales, cross-selling of services to the company's customers, supply agreements, or shared facilities that might impact future operations and financial results. A full assessment of these transactions should be performed to understand their nature and terms as they could result in a material change in financial performance of the business after it is separated from the parent. A buyer should assess (1) the nature of services provided historically; (2) the cost of these services charged by the parent; and (3) the estimated post-transaction cost of these services.

In addition to understanding the services provided by the parent, a buyer should assess the one-time costs associated with ramping up the carve-out under new ownership, such as costs associated with implementing new processes and systems for treasury, tax, information technology, human resources, and finance.

Human Resources

A carve-out can have significant impact on the target employees' benefit and compensation plans. Given the importance of a seamless transition, a buyer should evaluate the potential human resources (HR) considerations as a part of the planning process.

Since target employees typically participate in seller's benefit and compensation plans, the carve-out can often create a 'termination event' from seller's programs. From a benefit plan perspective, a buyer will either need to establish standalone benefit programs or bring target employees onto buyer's existing benefits platform. In either case, the prospective benefit costs can differ (sometimes materially) from those reflected in both the deal carve-out financial information and the GAAP carve-out financial statements.

Additionally, an evaluation of the impact of how stock options, restricted stock, bonuses and severance will be handled is necessary for proper valuation of the carve-out (e.g., determine if sellers will be required to fund earned but unpaid bonuses at closing, determine if stock options will vest upon change of control and how in-the-money options will be settled). Understanding the benefit and compensation plans is also critical in developing an adequate retention plan.

Careful planning for key employee retention can help facilitate a smooth transition. Accordingly, the buyer should identify those employees critical to the ongoing success (or transition) of the business and ensure that an adequate budget for retention arrangements is included in the financial model. A buyer should also assess the impact of employment agreement terminations for employees who are not going to remain with the business once the transaction closes.

Finally, the buyer will need to consider whether additional HR resources will be required to provide HR functionality on a prospective basis. Associated costs, including one-time costs associated with establishing or integrating benefit plans, should be included in the buyer's financial model.

Information technology

Buyers should thoroughly evaluate the information technology (IT) platform of the carve-out business early in the due diligence process. Effectively planning an integration of the platform requires significant lead time. As discussed earlier, a carve-out typically depends on the parent for key transaction processing services that involve information systems such as accounting, human resources, treasury, procurement, back office support, and other operations. It is vital to identify the software, human

knowledge, and hardware the carve-out uses. Once identified, it is necessary to determine the components that should be transferred in the transaction or covered under a service agreement for a specific period of time. Early involvement and participation by key resources who understand the carve-out business' IT dependencies is necessary to ensure that all critical IT components are included in the transaction (or are covered in a transition services agreement) and that there is a formal plan for post-transaction transition.

Transition Service Agreement

Carve-out buyers are typically not able to achieve complete separation from a seller upon transaction closing, so companies often rely on transition service agreements (TSAs) during a post-closing transition period. It is important to determine whether the carve-out business will need to establish supply agreements or facility service agreements with the seller once the transaction closes. Furthermore, a buyer must understand the TSA impact on profitability and working capital. This allows buyers to identify both the services that should be covered by a TSA and the areas that will require the most attention before the TSA expires. While TSAs provide buyers longer lead time for the transfer of certain functions, buyers may want to limit their timeline because the seller's quality of service usually deteriorates over time.

Taxation

A number of tax issues are prevalent in connection with the purchase or sale of a carve-out. Tax due diligence is critical for identifying any assumed tax liabilities, ensuring proper indemnifications, and formulating the optimal transaction structure from a tax perspective. Carve-outs can make it more challenging to achieve the desired tax structure,

including obtaining the benefit of a step-up in tax basis under a 338(h)(10) election. As a result, there are great benefits to be derived from including skilled or experienced individuals in the early stages of due diligence. A sale of corporate assets will generally require the seller to recognize taxable gains whereas an equity spin-off may be structured in a tax-free manner. A buyer should be aware of all of the structuring alternatives available and the impact of each alternative on the seller. This will assist the buyer in negotiating the purchase price and structure of the transaction.

Additionally, the tax considerations of a carve-out can be simple or complex depending on the number of jurisdictions involved, the rules pertaining to each jurisdiction, and the structure of the transaction.

The preservation of tax attributes such as net operating loss carryforwards and capital loss carryforwards can also prove to be problematic in a carve-out transaction. These tax attributes should be fully assessed in order to assess the valuation of the carve-out. Tax due diligence and proper structuring of the transaction are critical in maximizing the value of the deal.

Conclusion

Properly understanding, evaluating, and valuing a carve-out business is a complex process. While focusing on these key considerations alone will not guarantee a successful acquisition of a carve-out, they highlight the importance of spending the necessary time, utilizing the necessary resources and asking the right questions required to properly diligence a carve-out. Not performing a thorough due diligence investigation in a carve-out situation could result in a transaction that does not achieve the desired outcome, or even worse, has a detrimental impact on the buyers' business.

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