Transition Cost Management
Managing divestiture costs to maximize value

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At a glance

Regardless of a company's M&A experience, divestitures represent a different challenge and full value potential is often unrealized.

The three primary sources of divestiture deal value include:
1) Transaction proceeds
2) Transition costs
3) Parent/Seller optimization

During the deal process, transition costs pose the greatest challenge to obtaining full value from a divestiture. These costs are often difficult to determine and require structure and rigor to control.

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Introduction

Divestitures are complex and challenging – whether selling a non-core business (or assets) to a strategic or financial buyer, or spinning off to be a stand-alone entity. Companies often struggle to maximize deal value as a result of decisions made and actions taken throughout the divestiture lifecycle.

Regardless of a company's M&A experience, divestitures represent a different challenge and full value potential is often unrealized. Even companies with an established M&A competency tend to face challenges when it comes to divestitures. Missteps early in the process and during the transition quickly lead to value leakage.

The three primary sources of divestiture deal value include:

1. Transaction proceeds
2. Transition costs
3. Parent/Seller optimization

Savvy companies understand these sources of value and know where, when, and how to balance competing factors and focus resources to maximize divestiture value.

Sources of divestiture deal value

Transaction proceeds are the most obvious source of value that companies look to maximize. However, transition costs and parent/seller optimization can be significant, though are less distinct and often more difficult to manage. (See Figure 1)

Components of value	Description	Examples
Transaction Proceeds	Proceeds generated from the sale/spin of the divested business, less investment banking, legal, and advisor expenses	• Sale price • IPO proceeds
Transition Costs	Component costs associated with executing the transaction	• Separation costs • Transition services agreement (TSA) costs • Stranded costs
Parent/Seller Optimization	External and internal impacts resulting from the transaction	• Dis-synergies and leverage loss resulting from the separation • Post-deal contractual relationships • Competitive and geographic ramifications • Customer impacts (e.g., retention)

Figure 1 – Sources of value during a divestiture that should be managed collectively to maximize overall returns

During a divestiture, companies generally focus on transaction proceeds and parent/seller optimization as these comprise the bulk of the transaction value and are often easier to ascertain. Transition-related costs pose a greater challenge, however, as they are often more difficult to determine and require companies to look at their business processes, systems, and policies in a more objective manner (e.g., are allocations a true reflection of costs?). Additionally, availability of accurate information is usually limited, resulting in decisions or actions that may adversely impact transaction value.

Companies typically manage business units for operational efficiency, rather than as a portfolio of assets. Consequently, many companies leverage centralized services with integrated processes, systems, and polices for support functions (e.g., finance, human resources, and information technology). The costs for these centralized services are typically allocated across business units and functions, making it difficult to understand their true nature and drivers. As a result of the tight coupling of shared business processes, infrastructure, systems, and people, separation planning and execution in a divestiture can become quite challenging.

The challenge is exacerbated by the need for confidentiality early in the divestiture planning process, prior to deal announcement. People with the appropriate level of information and knowledge may not be brought into the planning process soon enough. Leveraging expertise within the organization or from third-party advisors who have experience with divestitures will enhance the odds of success. Taking time early in the deal process to carefully plan the divestiture is critical.

Transition cost management

Proactively identifying and managing transition costs throughout the separation can increase a company's success in improving deal value. Financial impacts of the separation and the required actions to manage them should be aligned to each phase of the divestiture timeline (e.g. planning, Day One, transition, TSA termination), providing companies with the opportunity to effectively control and manage transition costs. Understanding the cost impacts associated with divestitures will help companies improve their negotiating position and avoid unexpected cost impacts.

The three types of transition costs in a divestiture include: separation costs, TSA costs, and stranded costs. Each type of transition cost has its own unique challenges and considerations.

Separation costs

Separation costs are incurred through disentangling the divested business from the parent company's infrastructure. These one-time costs are incurred across support functions to establish independent operations. Companies need to understand both one-time and ongoing cost drivers to plan the separation approach and to negotiate with management of the potential Divestiture company in determining what costs will be incurred to set up the Divestiture company. Significant analysis is commonly performed by both the seller and Divestiture company.

Examples of separation activities triggering one-time costs include:

- Cloning and/or implementing a stand-alone enterprise resource planning (ERP) system for the Divestiture company
- Carving out and migrating data specific to the business unit or assets being sold
- Dis-synergies from the divestiture (e.g., loss of scale reducing purchasing power, services no longer required by Divestiture company, or a duplicative capability that may have to be reestablished on a stand-alone basis)
- Support provided by third parties with an existing long-term contract, and associated penalties for early termination

Identifying one-time separation costs should be performed across all functions and includes assessments of the various separation options. These costs can then be compared against industry benchmarks for reasonableness and included in a centrally managed separation budget. Commonly overlooked separation costs include TSA setup and exit activities (including third-party costs). Establishing a process to monitor and govern expenditures during the separation planning and execution phases will assist in controlling separation costs.

Key considerations during separation cost analysis include:

- Assess operations of the Divestiture company to identify activities that may not be required or can be outsourced to a lower-cost provider, which will impact the value of each transition cost category
- Consider negotiations with the Divestiture company and /or potential buyers to determine who bears the separation costs under different deal scenarios
- Develop a thorough picture of recurring costs required to support the business unit or assets being sold (e.g., TSAs, vendors, internal support)

Transition Services Agreement (TSA) costs

TSAs are a mechanism to provide support on a temporary basis to the Divestiture company. TSAs should be "arm's length" arrangements with costs that are supportable. The process for pricing TSAs can be complex and is often a focus for negotiation between the parties involved in the divestiture. Factors adding to the complexity of this process include assessing all elements involved with delivering the TSAs (e.g., infrastructure, third party agreements, personnel), determining the Divestiture company's capabilities to "right size" the TSAs, one-time costs for establishing TSAs, and identifying recurring costs to deliver and wind down TSAs at the end of the transition period.

Structured correctly, TSAs favor both parties as they enable the transaction to close more quickly and smoothly transition the divestiture company. TSAs should not be used in lieu of executing separation activities, as this can lead to prolonged costs (through delayed separation activities) for both parties.

Typical cost categories associated with TSAs include:

- Information technology support (e.g., operating an ERP clone, help desk, infrastructure services)
- Finance and accounting back office support (e.g., transactional processing, financial and management reporting)
- Operational support (e.g., disaster management, environmental, health, safety, and security reporting)

Relying on the existing cost allocation of the parent/seller company to determine the price for TSAs can lead to lost value. Allocations often do not reflect the true cost to deliver the services, and the Divestiture company could be overburdened for the cost of services if the business was historically over-allocated or, the parent/seller company could be under-charging for services if the business was under-allocated. While this may initially seem trivial, these costs add up quickly with a large TSA scope and long durations. Ultimately, an inability for the parent/seller and Divestiture company to agree on TSA pricing/costs could lead to a prolonged deal negotiation process.

Validating specific service costs against industry benchmarks or third-party services can be a good initial start for determining TSA pricing. Identifying cost drivers and establishing pricing mechanisms based on these cost drivers will help companies get to the true cost for delivering TSAs at a fair market price.

TSA planning is typically operated as a separate workstream (or within the separation management office) to obtain input from the all functions. Additional support is often provided by the Parent's finance function to assist with accurate price determination. Someone with deep knowledge of the company typically spearheads the overall effort.

Key considerations during TSA cost analysis include:

- Evaluate allocated costs for alignment or deviation from industry and functional benchmarks
- Assess the time frame to exit TSA support (e.g., tiered pricing to incentivize an efficient transition)
- Validate that Divestiture company functions receiving TSAs are accountable for managing the receipt of services and the related costs post separation
- Evaluate opportunities to streamline operating costs by assessing options beyond TSAs and legacy systems and processes

Case example:
An industrial products company was divesting a non-core business to a financial buyer. TSA pricing was negotiated early in the planning process, with an agreement that TSA's would be priced at actual costs. The seller believed its actual costs were equivalent to existing allocations for the business being sold. Through benchmarking and cost analysis, the buyer was able to prove the seller had significantly over allocated costs to the divested business; actual costs to provide the services were much lower. The seller was not able to recover the allocation amount for the transition services. Had the seller taken the time to plan and understand the true nature of the costs early in the process, the seller might have negotiated a different pricing mechanism or scope of services for TSAs.

Stranded costs

Companies commonly fail to appreciate the impact of a divestiture on their remaining cost structure or begin planning for stranded cost mitigation too late. The costs attributed to the divested business are often not proportional to the percentage of revenue contributed by the divested business. Without the divested business to absorb previously shared costs, they become "stranded" with the parent company post separation and become a drag on future profitability. (See Figure 2)

Illustrative Example of Stranded Costs for Information Technology (IT):

$ in millions	Revenue	IT Costs	IT Cost % of Revenue
Company Consolidated	5,000	100	2.0%
Carved-out Business Unit (BU)	(1,000)	(10)	1.0%
Remaining Company	4,000	90	2.3%

$ in millions	
Remaining Company	4,000
Post-separation IT Costs – 2.25% of Revenue	90
Revised post-separation IT Costs – 2% of Revenue	80
Stranded Costs	**10**

Note: Carved-out BU IT costs of $10 million represent actual costs that would be eliminated as part of the proposed transaction.

- The company manages and monitors cost as a percent of total revenue, assumed to be 2% of consolidated pre-separation revenue.
- Costs eliminated as part of the proposed transaction do not reduce costs to 2% post-separation revenue. The difference is the stranded costs, approximately $10 million.

Figure 2 – Illustrative example of stranded costs

Stranded costs typically include people (e.g., support functions with fixed levels of work, allocated services not transferred to the divested business) and non-people (e.g., fixed contracts, shared infrastructure) components. Often, these are not easily conveyed to the Divestiture company and remain with the parent company.

Examples of conditions that lead to stranded costs:

- Shared services centers (e.g., HR, legal, IT, procurement)
- Shared infrastructure (e.g., facilities, IT data centers)
- Long-term vendor contracts that support multiple business units (e.g., early termination fees)
- Corporate oversight costs allocated across multiple business units

Given these complexities, stranded costs should be identified and actively managed throughout the divestiture process. During the separation planning phase, it is important to identify areas where costs could be stranded with the Parent organization. During the separation execution phase, stranded costs should be quantified once the interim and 'to be' states are defined for both the Parent and divested business. Actions to mitigate stranded costs are then developed and included within the separation workplans (pre and post close). Post Day One, a rigorous focus should be placed on eliminating stranded costs and a tracking mechanism established to drive accountability.

Companies should consider costs to deliver TSAs during the stranded cost planning process. Resources and infrastructure supporting TSAs can be repurposed or eliminated at the conclusion of the TSA period. Additionally, functional/departmental operating budgets will require recasting to reflect the reduced operating costs.

Key considerations during stranded costs analysis include:

- Executive focus and involvement in assessing and managing stranded costs, particularly with managing stranded headcount (repurpose/redeploy decisions vs. termination)
- Design and execute strong communications plan to be transparent and address impacted employees
- Understand the true cost components (drivers) of existing allocations. Determine the "right size" headcount by function to support the remaining business
- Utilize external data, where possible, to begin planning long-term reorganization and cost structure optimization

Case example: *A global technology company planned to sell a profitable business unit that was no longer aligned with its core strategy. During the separation planning process, the company CFO realized he would not be able to proportionally reduce remaining company operating costs to offset the lost profitability provided by the non-core business unit. As a result, the CFO deferred selling the non-core business until he could develop a plan for reducing the remaining company's operating costs.*

Conclusion

Divestitures are complex and can easily result in lost value during the transaction lifecycle. Understanding the sources of value in a divestiture and how they can be influenced throughout the transaction lifecycle is critical, particularly when faced with tight timelines and the potential for the divested asset's value to decline over time. Companies that understand the levers that impact value will be the most likely to achieve their transaction objectives.

A structured and systematic approach to the divestiture process and transition cost identification and management helps articulate the value of the separated business, drives informed decision making, enables fruitful negotiations, and positions the remaining business for success.

While transition costs may be relatively small in comparison to overall deal proceeds, they can be significant overall and should not be overlooked. Further, understanding transition costs is a prerequisite for parent optimization post spin. Taking time to properly assess transition costs and establish robust processes for managing them provides operational stability during the transaction and transition period. This approach also provides a fact-based decision-making framework for the parent company to improve operations after the transaction is completed.

Acknowledgements

For a deeper discussion on the content of this paper or other deal considerations, please contact one of our practice leaders or your local PwC partner.

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