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THE ART OF THE CORPORATE CARVE-OUT

FROM DIVESTMENTS TO DEAL-MAKING

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AROUND THE TABLE

Our round table discussion has unveiled a wealth of knowledge and insights from leading industry experts into today's carve-out landscape. Here, they generously share their experiences and perspectives, making this paper a valuable and timely resource for businesses seeking to navigate the complexities and practicalities of carve-out situations.

INTRODUCING THE EXPERT PANEL

1. **Azeem Ahmed (AA)** – Corporate Finance Director, AlixPartners
2. **Dave Edwards (DE)** – Partner, FRP Advisory
3. **Chris Hawes (CH)** – Managing Director, PwC Debt and Capital Advisory
4. **Oliver Marshall (OM)** – Investment Professional, Sullivan Street Partners
5. **Tristan Nagler (TN)** – Partner, AURELIUS Investment Advisory
6. **Sophie Pollitt (SP)** – Director, Lincoln International
7. **Cem Yaslak (CY)** – Regional Director, BZ

THE ART OF THE CORPORATE CARVE-OUT

In recent years, corporate carve-outs have witnessed a remarkable renaissance, catalysed by an array of stakeholder motivations. This resurgence follows a significant trend among numerous corporates post-Covid as they re-evaluate their portfolio strategies. Carve-outs involve the strategic separation of specific business units, divisions, or assets from a parent company to establish autonomous entities. This restructuring approach enables groups to focus on core operations, unlock value, and pursue new opportunities, fuelled by a growing appetite for such deals among private equity sponsors and lenders.

Market forces continue to drive strategic carve-outs to the forefront of M&A activity, as evidenced by a record-breaking 3,808 deals announced in 2022. According to Mergermarket data[1], these transactions amounted to an aggregate value of US$429.4 billion, highlighting growing momentum in the market for these transactions.

EY's Private Equity Pulse[2] notes a significant increase in corporates executing substantial carve-outs in recent months, aiming to divest non-core or orphan assets. Approximately one-third of the top 20 deals in Q3 2023 were carve-outs, collectively valued at nearly US$25 billion. This marks a significant shift from Q1, where carve-outs constituted only 5% of transactions.

For private equity firms, particularly those with substantial funds, carve-out transactions serve as competitive differentiators. They offer opportunities to leverage their scale and operational expertise to drive substantial value. In 2023, private equity firms hold record levels of dry powder for such investments[3], exceeding US$1.96 trillion, marking a 21% surge from the US$1.62 trillion recorded in December 2021.

McKinsey & Company[4] emphasises that unifying or dividing businesses to maximise value creation hinges on the common objective of optimising value. This challenges the belief that separations inherently impede immediate value capture compared to mergers and acquisitions (M&A) integrations. They note that "The rationale for combining or splitting businesses should be the same: to create more value," highlighting that separations need not necessarily present a drag on near-term value creation.

This resurgence occurs against the backdrop of a challenging and ever-evolving market, leading Jannan Crozier, the global M&A chair of Baker McKenzie[5], to observe recently: "What's clear is that carve-outs are not a trend. They are a more complex way of delivering and preserving value in M&A, and they're here to stay."

Sources:

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2 Witte, P. (2023, October 25). Private equity pulse: Five takeaways from Q3 2023. EY UK. https://www.ey.com/en_uk/private-equity/pulse

3 Corporate M&A 2023. Global Practice Guides, Chambers and Partners. (2023, April 20). https://practiceguides.chambers.com/practice-guides/corporate-ma-2023

4 Dufour, L., Finck, G., Mattsson, A., & Silberstein, M. (2023, February 7). The power of goodbye: How carve-outs can unleash value. McKinsey & Company. https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/the-power-of-goodbye-how-carve-outs-can-unleash-value

5 Ryan, A. (2023, June 27). "carveouts are here to stay": Green energy deals dominate as major players see signs of a bounceback. Legal Business. https://www.legalbusiness.co.uk/blogs/carveouts-are-here-to-stay-green-energy-deals-dominate-as-major-players-see-signs-of-a-bounceback

ASSESSING CARVE-OUT VIABILITY

Despite the inherent difficulties and complexities involved in corporate carve-outs, scenarios such as these appeal strongly to investors and advisers for a multitude of reasons. Acquiring companies that current owners regard as 'unloved,' 'non-core,' and 'available for sale' poses a distinct set of challenges. However, the prospect of increased value creation when compared to conventional M&A transactions remains a compelling proposition.

"Carve-outs are seen as an opportunity to identify low-hanging fruit with strong operational potential, and it's puzzling why investors would choose premium assets at premium prices with a debt structure that anyone can secure in the market, leading to heightened competition."

Tristan Nagler – Partner, AURELIUS Investment Advisory

TN: *Carve-outs often entail less competitive buying processes due to their complexity, which can lead to better value or more attractive entry prices compared to conventional asset sales. These scenarios attract specialised lending partners like BZ that provide tailored financial solutions that are hard to replicate. These deals have a high conversion rate, and sometimes there's a genuine opportunity for re-rating, which can lead to an overall improvement and revaluation of the entire group. So, the purchase price is just one part of the value equation.*

OM: *From a corporate standpoint, there is an increasing requirement to focus on portfolio optimisation to drive margin improvements, bring down leverage and improve focus. Since maintaining margins of the existing portfolio is getting harder, an alternative way to achieve better margins is through divesting margin dilutive non-core business units. Corporates are increasingly willing to do so, and we have found that the gap in value expectations has narrowed, creating more opportunities for financial sponsors.*

- Less competitive buying processes and high deal conversion rates.
- Carve-outs can offer re-rating opportunities.
- They attract specialist lending partners equipped to provide bespoke solutions.

CUTTING THROUGH COMPLEXITY

Over time, adjectives such as 'complex' and 'difficult' have become regarded as synonymous with corporate carve-outs. When presented with information about a parent company's plan to divest a firm, it is imperative to consider the commercial impact of this decision from the perspectives of multiple stakeholders. Key considerations involve evaluating how well the carve-out aligns with the parent company's strategy and examining the business's ability to operate independently, which entails a comprehensive assessment of its assets, revenue, profitability, liabilities, and growth potential.

CH: *The operational transition from theory into practicalities is extremely important, especially in respect of carve-out transactions. It's fundamental to understand the operational complexities and the cost of building up the operations involved as this impacts the potential value of the deal.*

SP: *Having clarity upfront on whether the entity can operate independently outside the larger business streamlines the process, but difficulties arise when businesses try to carve out a business line that lacks a clear standalone structure. This situation brings additional costs and limited information, making the diligence process less comprehensive, requiring individuals to take a view on various points.*

TN: *In carve-out scenarios, it's crucial to determine if the business can operate independently. A complete business is more valuable, but an incomplete one that requires the buyer to invest substantial effort and take on risk affects how we structure the purchase price. Ultimately, the main focus is to determine if there's a viable business here.*

OM: *Ultimately, you must always take a step back and evaluate the long-term value creation thesis and whether the upside is worth the risk. It's easy to become overly focused on the complexity and lose sight of the bigger picture.*

- Initial carve-out assessment focuses on business's viability and separability.
- Value hinges on seller's realism and completeness of the offering.
- Clarity on the entity's ability to operate independently is essential.

A QUESTION OF TRUST

In carve-out transactions, the question of whom and to what extent to trust has emerged as a critical discussion point. Evaluating the reliability of information provided by a departing seller in a carve-out scenario holds significant importance, especially when compared to transactions involving a standalone business. This discussion centres on establishing the significance and level of trust to attribute to statements made during the due diligence process, highlighting the challenges that arise when relying on the seller's disclosures in such circumstances.

AA: *When acting on the buy-side for a carve-out, a potential buyer or new financing provider needs to take what the seller says with a healthy degree of scepticism. For instance, corporate recharges, which involve allocating central costs and shared services, can be notoriously difficult to ascertain at a divisional level and can have a material impact on value. Therefore, a buyer needs to conduct thorough due diligence to ascertain an accurate view of value.*

TN: *In traditional private equity deals, there's usually a sense of continuity in performance and personnel, making it easier to trust the management's promises. However, when acquiring a business with an incomplete or inconsistent management team or uncertain performance history, it can become challenging to support them. Relying solely on the seller's claims is risky due to their vested interest, so confidence in your advisers and the ability to evaluate the deal independently are crucial.*

- Trust in exiting seller's information varies; diligence is required.
- PE deals with strong management teams offer performance continuity.
- Confidence in advisers and underwriting is essential in such cases.

NEGOTIATION DYNAMICS

From a buyer's perspective, carve-out transactions present a compelling opportunity to acquire undervalued or underinvested businesses. In this panel discussion, participants emphasised the strategic advantage finance buyers possess in acquiring businesses through carve-outs, as opposed to leveraged buyouts. They stressed that buyers are frequently able to leverage a deeper understanding of non-core assets compared to sellers, creating a distinct asymmetry favouring the buyers in a 'David versus Goliath' scenario.

"Financing is crucial in completing these deals and directly impacts how value is created. If someone believes they can't secure debt for the transaction, it may lower their offer. However, if they can secure debt, it gives them a significant advantage, creating an asymmetric situation."

Dave Edwards – Partner, FRP Advisory

DE: *In many cases, buyers are better informed about the asset compared to the seller because they have gone into everything in more depth. Non-core assets are often not well understood by the seller, and their advisers may not be fully aware of all available options.*

AA: *Carve-outs present an opportunity for outsized returns because the value of the existing business may be considerably higher in independent hands. Although understanding the financial picture is challenging for the buy-side, this complexity also presents an opportunity for more sophisticated buyers to obtain a value arbitrage. In addition, some management teams will be really motivated by the challenge of leading an independent company, rather than being part of a larger corporate.*

When you have a management team operating within a larger corporate, you'll come across various scenarios. Some teams are eager to get out and lead the business independently with appropriate support, while others are more operator-focused and have been placed in roles for which they may lack the necessary skills.

CY: *Regarding that, how extensively do you engage with people management before carrying out a carve-out?*

OM: *Typically, the management team of the target doesn't hold as much influence. It's not like a traditional LBO, where the management team often wields greater power, therefore carve-out experience, and deliverability are critical.*

SP: *In the case of a carve-out, we rely heavily on the carve-out experience of the private equity house. Lenders tend to place greater trust and reliance on the PE house, rather than on the management side of a carve-out.*

- Asymmetry in information often favours buyers in carve-outs.
- Financing plays a pivotal role in negotiations.
- Lenders may rely more on the private equity house than management.

MOTIVATORS AND DRIVERS

Developing a robust value generation plan is essential when separating a business from its parent company or group. This plan should cover key elements such as cost optimisation, operational improvements, growth strategies, and exploring potential synergies with the new parent company or investor. The conversation shifted towards understanding the key drivers and motivations behind a corporate's decision to divest a relatively small segment of their business. The aim was to comprehend the dynamics at play, considering conflicting priorities, and determining whether parent businesses typically prefer a swift exit with a focus on deal execution or a riskier, more protracted process aimed at potentially maximising value.

TN: *The financial stakes may appear small, yet the individuals responsible may be incentivised to achieve the highest price, causing negotiation delays. Surprisingly, winning bidders value assets similarly, prompting the choice between speed with a discount and a prolonged approach. The key question is "What's the motivation?" The response is a consistent one: saleability takes priority over value. It's human nature for the buyer to favour testing a reserve price, while the seller clings onto the perceived value.*

CY: *I've come across a couple of carve-outs that commenced at the start of the year. The advisory process began, bids were presumably received but were not up to expectations, leading to a delay of around 6 months before relaunching the process. Does this kind of situation deter you when you're involved at an earlier stage?*

SP: *Fundamentally, if they're facing a liquidity breach or a similar situation, it becomes more of a buyer's market. In cases such as these, they might be more inclined to accept a lower value in exchange for the certainty of getting the deal done.*

I'm unsure about the benefits of delaying the process for six months unless there's been a fundamental change in the business. It's vital to establish a level of comfort with a certain point, as introducing additional uncertainty into the market may not be the best approach.

- Certainty and speed can outweigh higher values for corporate sellers.
- Complex hierarchies in corporate environments impact decision-making.
- Market volatility can influence decision-making and timing.

ECONOMIC IMPACT

Carve-outs involve numerous critical factors, necessitating a comprehensive situational analysis. This involves identifying and managing various potential risks that impact the process, including economic, political, operational, financial, legal, technological, and reputational aspects, and devising effective mitigation strategies. The panel focused on whether fluctuations in market interest rates are intensifying the challenges associated with securing financial support for these transactions.

"The quid pro quo here is that ideally, you're acquiring these assets at a discount commensurate with the transaction complexity. As a result, the leverage multiples shouldn't be as aggressive as they might be in a typical sponsored deal, and the cost of capital becomes less of a focal point. Certainty together with creativity around ensuring the financing structure works for the quirks of the deal are much more important."

Oliver Marshall – Investment Professional, Sullivan Street Partners

SP: *I believe the main challenge in today's market, given the current interest rates, is debt serviceability. If you don't have a firm understanding of the business's cash flows during a carve-out, it can be challenging. Cash flow considerations are crucial in today's business environment. When dealing with a standalone business with a proven history, it's easier to assess cash flows. However, during a carve-out, when you need to make assumptions, it often leads to a more conservative approach in structuring the deal.*

DE: *I don't believe so, especially since ABLs don't seem to be facing the same challenges as traditional leverage financing. There's a significant amount of debt firepower in the UK now, a stark contrast to the situation 15 years ago. Now, the opportunity for ABL might be even greater, considering the uncertainty in the market. Financing against a business's assets seems like a safer bet than relying on potentially volatile earnings.*

- Financing for carve-outs, especially with ABL, isn't significantly affected by changes in market interest rates.
- Debt sensitivity and cash flow considerations are key challenges in today's market.
- Certainty and creative deal structures are essential in carve-out financing.

POST-ACQUISITION STRATEGIES

After completing the due diligence process, securing financing, and completing the deal, Private Equity houses, investors, management teams, and lenders move into an intensive post-acquisition phase. This involves several key steps: ensuring the acquired business aligns with initial expectations, providing continuous working capital for its growth as an independent entity, incentivising the management team to drive change, initiating the value creation process, and implementing enhanced reporting procedures.

OM: *One of the most significant steps is to establish incentive schemes for the management team, to ensure they are fully aligned and committed to driving the necessary changes. We also try to distinguish the multitude of tactical actions needed to ensure the business can operate on a standalone basis from the longer-term strategy needed to grow.*

TN: *Firstly, it involves checking that you've acquired the business you thought you'd bought. Building strong relationships and getting acquainted with the management team is a top priority. The next step is to swiftly initiate the process of value creation. This means identifying opportunities to enhance profitability, engaging a debt partner, and taking the necessary steps to boost liquidity.*

If there's an ongoing relationship with the seller, the aim is to extricate yourself from it as soon as possible. It's crucial to establish robust reporting practices, especially because the management information is often lacking in quality. In essence, the focus is on creating a reporting culture to gain a clear understanding of what's happening.

- Build strong relationships with the management team and establish incentives.
- Initiate value creation by enhancing profitability and boosting liquidity.
- Establish robust reporting practices for accurate information.

LEARNING FROM MISSED TRANSACTIONS

The discussion shifted towards reflecting on past experiences and cases where transactions didn't proceed as anticipated. The panel focused on pinpointing recurring themes and patterns, extracting valuable lessons from these instances to guide future carve-out transactions.

"From my previous perspective as a lender, maintaining headroom in debt facilities is vital. Management teams may not be as sophisticated in addressing these issues, and headroom can rapidly erode. That's why having a reliable sponsor, adviser, and debt provider to build sufficient headroom into the facilities is essential."

Chris Hawes – Managing Director, PwC Debt and Capital Advisory

CH: *Equally important is the ability to manage debt serviceability and the associated numbers. This entails a combination of ABL generating funds on a revolving basis, without aggressive amortisation, and the capability to model the numbers and headroom for both serviceability and availability.*

TN: *We frequently come across businesses that sellers are keen to divest because they are perceived as lower-growth or more problematic. In contrast, corporate sellers tend to prioritise their high-growth businesses. On the company side, several factors come into play, including the quality of the business, its personnel, relationships with customers and suppliers, and stakeholder alignment. Unforeseen events such as losing a customer or a change in supplier terms can impact the business heavily. The complexity of these deals cannot be understated, and numerous things can go awry. Therefore, having experienced investors who have navigated such complexities before, and lenders who can take a big-picture view, is invaluable.*

- Multiple factors can impact the success of carve-out transactions.
- Maintaining headroom in debt facilities is crucial to address challenges.
- A reliable sponsor, adviser, and debt provider are essential for success.

THE FUTURE OF CORPORATE CARVE-OUTS

The panel contemplated the future trajectory of the corporate carve-out market, assessing the possibility of heightened transaction levels amid current market uncertainties. They discussed the attraction of carve-outs in value creation and debated that although some divisions are strategically classified as non-core, certain corporates might opt to observe how future developments play out before committing to a carve-out.

AA: *Management teams of divisions operating within a larger corporate can vary significantly in terms of skill and motivation. Some leadership teams are capable and enthusiastic to lead and drive the business on a standalone basis, while others can be more purely functional and may not have the desire or necessary skills to lead a business independently. For financial buyers, identifying talented leaders is a key driver of value for any newly carved-out business.*

TN: *In many cases, it's quite apparent when examining corporates that there are underperforming businesses within their portfolios. Several factors act as catalysts for change, such changes in leadership, the rise of activism, fiscal or financial pressures, and liquidity challenges. When there's an underperforming business, it's a constant struggle to fix the issue, often requiring regular injections of capital. This can be uncomfortable as they try to explain away the underperformance of a non-core business, which drags down the overall value.*

As long as public companies face scrutiny, the trend of corporate carve-outs is likely to continue. Many private equity firms are taking businesses private, diversifying their portfolios, breaking up companies, and selling off non-core parts. The market environment and the performance of the business are key determinants in shaping the value of a deal.

When the market is challenging, the business is underperforming, and it lacks a strong management team, it typically results in a more conservative valuation. Multiples in these scenarios are unlikely to reach extremely high levels like 10 to 15 times or more. Instead, they tend to stay within the range of 2 to 3 times debt.

- Private equity firms are increasingly participating in corporate carve-out deals.
- Deals in challenging market conditions with underperforming businesses tend to have more conservative valuations.
- Multiples in growth buy-out scenarios are likely to stay within a range of two to three times debt.

UNDERSTANDING THE NUANCES

Guiding a corporate through a carve-out involves defining the scope, clarifying costs, and formulating a funding and equity exit strategy that aligns with potential buyers' needs. However, past experiences highlight the importance of a nuanced understanding when handling these subsidiary divestments, where specific targeted expertise is critical to delivering optimal outcomes.

"On the sell-side, crafting the equity story to reflect the leading buyer's strategic priorities is paramount. As part of this, defining the sale perimeter precisely, gaining clarity around the costs, understanding the carve-out EBITDA, and preparing adequately for any potential deal issues are all essential to drive value."

Azeem Ahmed – Corporate Finance Director, AlixPartners

AA: *A forced sale that aims for an accelerated divestment can lead to bumps in the road, which can be detrimental to value and getting a deal over the line.*

Another key aspect for carve-out sale processes with material financial buyer interest is packaging the business appropriately for a potential debt raise. Key areas include ensuring a clear and detailed financial picture that will enable lenders to facilitate rigorous due diligence.

CH: *In a situation we came across last year, the previously prepared information memorandum didn't have sufficient focus on the assets, nor the ability to finance those assets. This created opportunities for us to step in, improve the preparation, and educate potential lenders about the deal.*

- It's crucial to focus on preparation, scope definition, cost clarity, and packaging the business for potential debt raise.
- Lenders and advisory communities need to educate clients about ABL.
- Education should extend to understanding the asset base, jurisdictional risk, and lending restrictions based on asset location.

MULTI-JURISDICTIONAL DEALS

The diversity in lending regulations across borders often results in complex due diligence and legal processes. Consequently, in multi-jurisdictional transactions, a common question arises about lenders' relative abilities and commercial appetites to finance deals spanning different regions.

SP: *Some lenders are more comfortable with different jurisdictions, while others adopt a harder stance. Consequently, there's an ongoing process of education and navigation required within the lending markets. This is where an intermediary debt adviser is useful, as they can help navigate the increasing lender pool and understand lenders appetite. It's not a case of one-size-fits-all.*

CH: *And subject to regulation you can lend in lots of countries. It's getting your money back that's the issue from the lender's point of view.*

THE RISING ROLE OF ABL

As the enlightening session reached its conclusion, the focus turned to Asset-Based Lending (ABL) as a valuable strategic funding tool in supporting carve-out transactions in a challenging environment.

"ABL will continue to be fundamental to the carve-out market. It's challenging to envision executing these transactions swiftly and efficiently with a cash flow lender that's likely to have to take a view on a number of moving parts, especially in the current market conditions."

Sophie Pollitt – Director, Lincoln International

- Lenders have varying comfort levels with different jurisdictions.
- ABL continues to remain crucial for the carve-out market.
- Collaboration with specialist ABL lenders is instrumental in managing growing complexity.

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