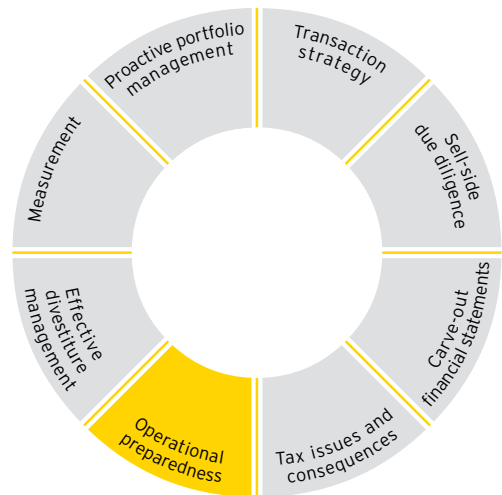


Operational preparedness

Operations are the heart of divestiture value. While preparing for a sale, sellers must retain focus on the business and plan a smooth transition to a new structure.



by Sharath Kumais and Sue Borgman

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Key points:

- ▶ Pay attention to operational issues at every stage of a divestiture
 - ▶ Develop a detailed stand-alone business model, reflecting the carve-out's future full cost structure. Such models enable buyers to value the business while helping sellers rationalize their own value chain
 - ▶ Develop a realistic "order-to-cash" blueprint early
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Many months may elapse from the moment a transaction is first contemplated and the time a purchase agreement is struck. During this interval, an intense focus on the quality of operations is crucial to maximizing deal value and minimizing sellers' risk. The reason is simple: more often than not, the true drivers of value are organizational know-how, managerial capabilities, employee engagement, customer relationships and brand equity.

Many sellers get so focused on the deal itself, or on post-divestiture life, that they begin to overlook the daily matters of the business. As the recession forces some companies to make quick sell-off decisions, they may take their eyes off the ball, causing disruptions and operational missteps that contribute to lower valuations and larger post-closing adjustments. Here are some leading practices for operational effectiveness in divestitures, especially carve-outs.



Recognize that value erosion is tied to operations. Too many sellers see the divestiture as a sale of fixed assets and not as an ongoing business whose value depends on stability. With senior management engaged in the deal process, it is essential to devise a strategy promoting operational continuity and interim performance throughout the entire divestiture and even post-close.

Integrate deal strategy with operational strategy from the start. Ideally, sellers begin developing the operational continuity strategy at the earliest sign that the divestiture is contemplated. The operations team – typically a mix of corporate and business unit managers – should begin assessing the risk to operations and asking how these can be avoided, mitigated or transferred. Buyers of a potential carve-out typically will ask how managers plan to make the business stand alone.

Anticipate risks. In a divestiture, employees can expect changes in everything from reporting relationships to job responsibilities to business processes. There are potential implications for suppliers, customers, partners and other stakeholders. It is incumbent on management to anticipate operational risks well before those risks become disruptions that reduce value. Having action plans to address such risks, and effectively communicating them, can demonstrate operational control during the distracting deal process.

Address operational issues throughout the divestiture. From an operational perspective, separating a business from its parent involves four critical time periods:

1. Pre-signing
2. Pre-closing
3. Stabilization
4. Independence

In the **pre-signing phase**, when the buyer's identity is still unknown, it makes sense to develop an employee communication plan and to identify key personnel to retain.

In the **pre-closing phase**, when the seller knows the buyer's identity but the deal has not been finalized, the seller should hammer out operations-related details: whether and how much to build inventory in advance, for example. Reverse supply agreements may have to be negotiated if the seller still needs the divested business to supply its products. Other tasks include determining where new legal entities must be established, retaining or transferring operating licenses, creating retention strategies for top talent, planning for communication and regulatory compliance as well as implementing transition plans.

In the **stabilization phase**, as processes migrate to a stand-alone status, care must be taken to ensure that business activities continue uninterrupted. Lacking a comprehensive stabilization plan, a buyer's Year 1 financial forecast may fall short.

Independence describes the moment when the spin-off or carve-out is operating on its own and no longer depends on the former parent. Buyers typically view long stabilization periods as adding risk.

Develop a stand-alone business model. This is a series of calculations that shows “what's in and what's out” of the transaction: which sales offices, vendor contracts, employees, factories and so on will migrate to the new entity. Sellers must calculate clearly to avoid inadvertently lowering the value of the business.

The existence of corporate shared services complicates everything from deal valuation to post-deal operation. Typically, deal prices are based on a multiple of EBITDA, so buyers and sellers primarily focus on stand-alone recurring costs – the costs of managing the business – when performing valuations. But where shared services and processes are involved, valuation also is affected by new cost structures as well as any long-term TSAs or supply agreements that may be required.

Stand-alone business models can help sellers package the business being sold to maximize its value. If there are assets that could erode value – a highly polluting plant, say, or one making a near-obsolete product – sellers should decide whether and in what way these should be part of the deal.

Strengthen the value chain. Developing a stand-alone business model requires sellers to examine each link in their value chain to see if they can take some operational step to enhance value or to keep it from eroding. Tough questions should be asked at each point:

- ▶ **Sales and marketing** – Would the company benefit from expanding into new sales territories? Hiring or letting go sales people? Investing in new IT or automation?
- ▶ **Manufacturing** – Can plants be consolidated or production outsourced to a third party?

- ▶ **Distribution** – Does the company need its own storage warehouse?
- ▶ **Finance and accounting** – Would it add cost-effectiveness to outsource and “offshore” accounts receivable and cash management functions?
- ▶ **Treasury** – Can several regional bank relationships be consolidated?
- ▶ **HR** – What is the right benefit and compensation program to meet the needs of the smaller stand-alone business?
- ▶ **Procurement** – Can the process be rationalized?
- ▶ **Tax** – Can tax efficiency be improved by restructuring holding companies or other legal entities?

Operationally astute companies will examine their supply chains to consider how they can be improved, identify which assets add most value and, in general, figure out what the business needs, as opposed to what it's used to having. Acting on this analysis can help sellers improve balance sheets and income statements.

Develop an “order-to-cash” blueprint. Spanning the entire spectrum of operational preparedness is a concept called “order to cash” (OTC) - a phrase encompassing anything that must be in place to make a business operational. OTC includes the ability

to get the product out of a warehouse, import it legally to a particular market, store it there, take orders from customers, generate invoices, deliver the product and receive payment in the bank account of a stand-alone business entity.

Even sellers experienced in transactions may fail to appreciate the input required to produce an OTC blueprint. In an equity carve-out, for instance, it's easy to overlook key bits of infrastructure needed to make Day 1 work. The regulatory environment may present obstacles to importing and selling products in particular markets.

Sellers wishing to control the process often take responsibility for OTC planning so they can determine when they will receive cash and reduce their transaction risk. Sometimes, however, the buyer may want to handle the OTC process to ensure correct setup of the new legal entity. In either case, both sides must clearly understand their roles to make sure that crucial deadlines are kept.

Different deals call for different OTC plans. In a stock deal, the buyer acquires shares of an existing legal entity, rather than buying its assets or liabilities. In an asset purchase, a new entity must be created, raising the risk that some customers may not consent to transfer their contracts. In such cases, a risk analysis by either buyer or seller would be a proper part of OTC planning.

I Case study I

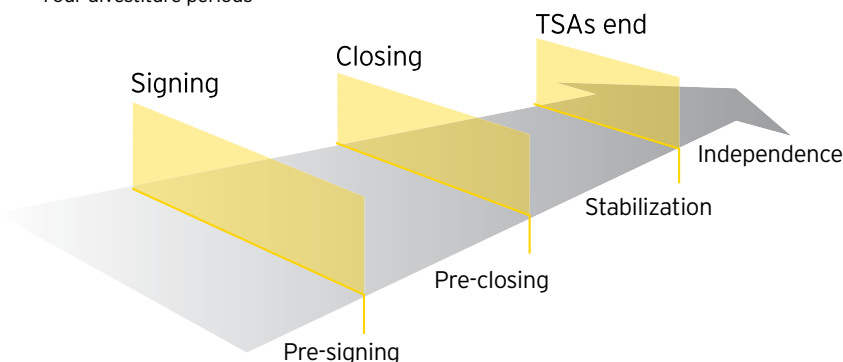


Companies B and C: toward operating independence

Company B wants to sell a division. The business has good margins, but relies on the parent's purchasing leverage to get discounts on supplies, freight and phone service. The division also uses the parent's data center and software. A stand-alone business model will identify the impact on margins and operating processes when the business no longer benefits from its connection to the corporate mother ship.

Company C provides financial services and raw materials, at a below-market rate, to one of its business units. Now that unit is on the block. To value the divestiture accurately, the seller must quantify these subsidies. The result will be part of the stand-alone business model.

Four divestiture periods



The OTC model is intended not simply to replicate the activities of the parent company, but to leverage the customer base – to grow orders or improve customer service, for example. Buyers would do well to consider how they might change their order processing protocols to fit a new customer profile or whether distribution can be altered to consolidate spending or optimize resource use.

Deeply familiar with the business being sold, a seller can point to OTC improvements. New owners may have an opportunity to reshape systems, create new revenue streams or be more responsive to customers. By analyzing existing processes and communicating their potential to buyers, sellers can distinguish themselves in a buyers' market and enhance deal value.

Pay attention to TSAs. Transition service agreements (TSAs) are temporary contracts in which sellers agree to continue providing HR, IT, finance or other forms of service or support to the business after it is sold. Many buyers, including PE firms, are not equipped to provide such services on Day 1.

TSAs document the nature and duration of the parties' post-closing responsibilities, allowing the legal and financial aspects of the deal to take place before operational separation is complete. Although TSAs must be tailored for each deal, certain elements are standard. Service levels must be defined, allowing for flexibility and ease of administration. The parties must agree on pricing, billing and any administrative fees. Above all, timing must be clear.

Lack of clarity about expectations and responsibilities may create hostile or unproductive relationships, adding inefficiencies and costs. As a result, transition periods may be stretched longer than necessary while the accompanying disorganization provides competitors an opportunity to steal market share.

TSAs exist to protect value for the buyer, so negotiating them is critical to the success of a sale. It is important to begin designing TSAs as soon as a potential buyer is identified. If the

closing date arrives before all TSAs and operating requirements are finalized, workarounds and stopgap measures allow the deal to close on time. Nontraditional TSAs may allow for the operations to continue through the seller's legal entity, but transfer to the buyer all economic benefit and risk.

The less clean the closing, the more distracted and concerned the buyer likely will be. Ragged transitions may create confusion among customers. Buyers, aware that a new entity's management team will be concerned about stabilization for its first six months of operation, may push to reduce the price.

Promote collaboration across functions. Business operations are juiced by numerous "value drivers" – organizational know-how, managerial capabilities, customer relationships and brand equity – reflecting the knowledge and skills of multiple business functions. Companies wishing to enhance sell-side deal value must promote cross-functional collaboration to build operational strength.

Prepare for an effective post-closing stabilization period. As "for sale" progresses to "sold," it becomes important to establish close ties between seller and buyer. Typically the buyer wants to have input on key decisions that will affect the quality of operations at closing. Good communication enables such input, preserves value and keeps the management team focused on the business. A good model is a joint governance framework covering the time between deal signing and deal close, and continuing for at least one additional reporting period after close. ▼

Sharath Kumar is a member of the Transaction Advisory Services practice of Ernst & Young LLP. He is based in Chicago, Illinois.

Sue Borgman is a member of the Transaction Advisory Services practice of Ernst & Young LLP. She is based in San Jose, California.

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