Don’t Let Carve-Out Costs Compromise Value Creation

M&A UPDATE

JUNE 03, 2021

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A simple warning should be top of mind for all executives when planning and executing a divestiture: **Beware of separation costs**. Carving out a business’s operations from the parent company while still running daily operations is tremendously complex and, in most cases, quite expensive. Companies often incur unexpectedly high one-time costs, as well as ongoing costs that arise from transitional services, loss of scale, and inefficient post-divestment cost structures.

Moreover, the demands on all levels of the organization can elevate stress and distract from delivering business results.

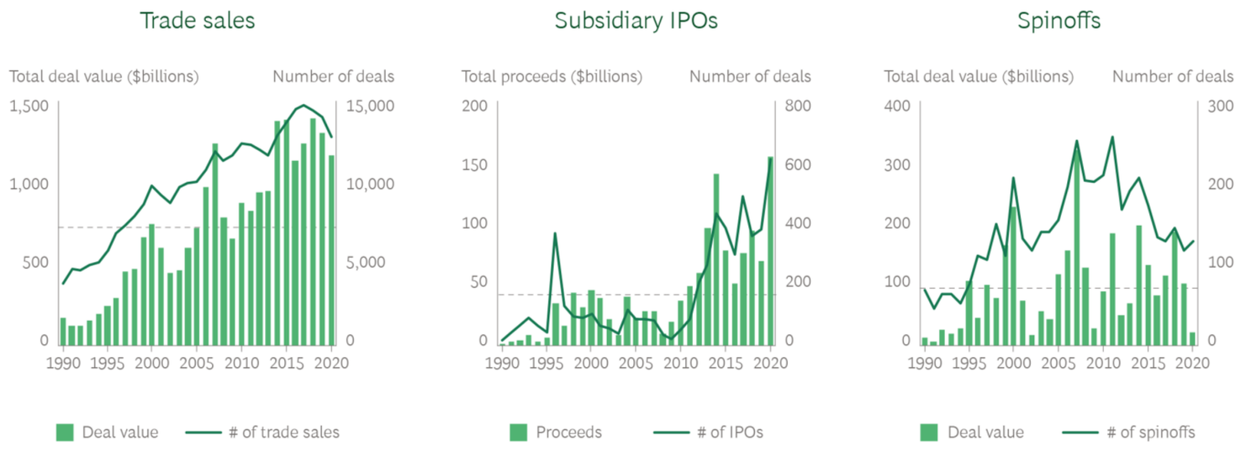
In today's environment, companies certainly have sound motivations for divesting businesses and assets. Investors, especially activists, encourage companies to sell noncore assets so that they can focus more strongly on value creation in their core business. Additionally, companies saddled with high debt during the pandemic have sought to raise cash and regain financial breathing room. Capital markets usually welcome divestitures and bid shares higher upon announcement.

Because separation costs are unavoidable, companies need to focus on them upfront and manage them proactively throughout the carve-out process. Our analysis identifies several imperatives that promote careful planning and rigorous execution in addressing separation costs. The effort will be rewarded with a breakup that does not break the bank.

CARVING OUT IS COMPLEX AND EXPENSIVE

Companies have three basic ways to divest businesses and assets: a trade sale, an IPO, or a spinoff to the company's shareholders.[1] Since 1990, the value and volume of trade sales and subsidiary IPOs have generally trended upward, whereas spinoff activity has shown more volatility. (See Exhibit 1.) During the pandemic year of 2020, the volume and proceeds of subsidiary IPOs reached record levels as companies sought to raise funds in the hot IPO market. Because spinoffs typically do not yield cash, they are less useful when the primary objective is raising funds.

Exhibit 1 - Divestments, Especially Subsidiary IPOs, Are at Historically High Levels



Sources: Refinitiv; BCG Transaction Center.

Regardless of transaction type, we commonly see two major categories of separation costs: transaction costs and operational separation costs. Broadly speaking, transaction costs are the expenses incurred to financially and legally separate the businesses. Examples include banking and underwriting fees in IPOs, legal expenses, and accounting or tax charges.

Operational separation costs are expenses incurred to carve out personnel, assets, technology, and contracts (that is, the transaction perimeter) from the parent company. These costs, and the effort to deliver the separation, come on top of the costs and effort of running the new company and the parent at full throttle. Their magnitude is a function of the degree of entanglement between the two entities. If the divested asset or business has already been operating as a distinct subsidiary, the separation can be fairly straightforward and entail relatively lower separation costs. However, if the entity is heavily entangled with the parent company's core business, the separation can be very demanding on the organization and expensive to deliver.

Primarily, the degree of entanglement reflects the extent to which the entities share IT (especially enterprise resource planning systems), production sites, supply chains (including warehouses), and internal processes. Carve-outs are notably more expensive in some industries. In health care, for instance, the main contributors to high costs are long separation timelines and the need for regulatory compliance. Similar restrictions apply to other highly regulated industries, such as financial institutions. Across industries, the size of the divested business is an important factor as well.

Carve-out costs also depend heavily on the type of transaction, and, in the case of a trade sale, on the type of acquirer. For instance, a financial sponsor (such as a private equity firm) typically expects to acquire a fully operational standalone business to incorporate into its portfolio. In contrast, a strategic acquirer has existing in-house capabilities and thus would not require the full complement of support functions for the business.

Executives' lack of experience in separating business operations, owing to the rarity of large carve-outs at any given company, is a major contributor to unexpectedly high separation costs. We have observed that some companies do not even take the basic step of making an initial cost estimate, and many do not have a rigorous process for tracking separation expenses. Only a few make decisions based on whether a cost item is in the budget and most would revise the budget to include unexpected costs. Often, companies fail to clearly distinguish between separation costs and optimization costs (such as costs to upgrade systems), which makes it challenging to assess whether separation costs are reasonable.

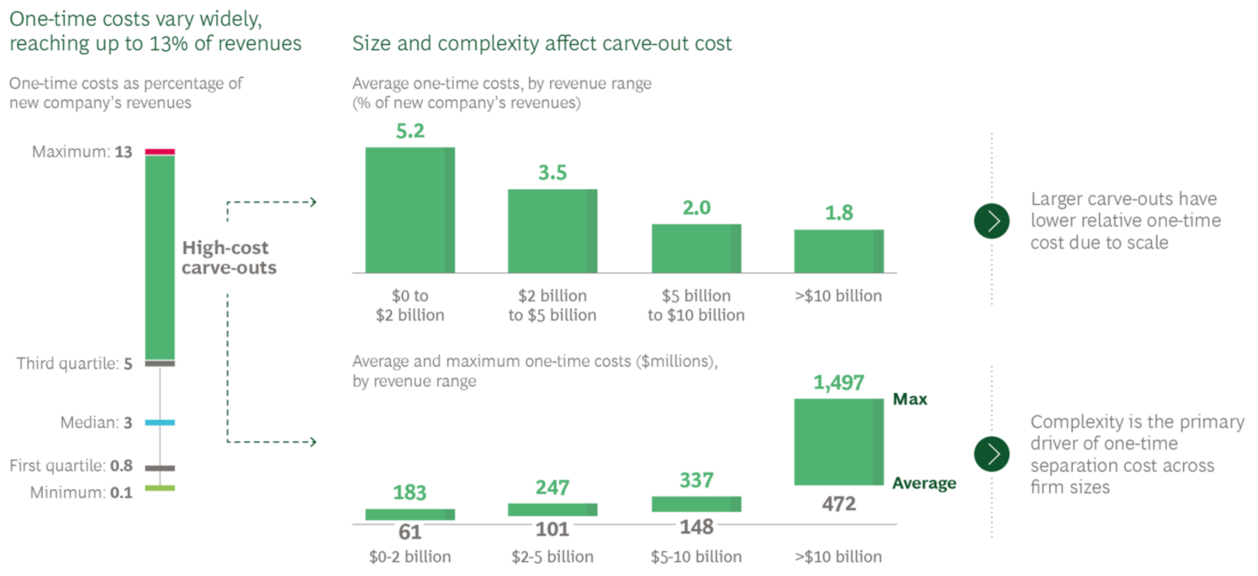
FOUR TYPES OF SEPARATION COSTS TO CONSIDER

To provide clarity, we differentiate four types of separation costs: one-time costs, transitional services, dis-synergies, and stranded costs.

One-Time Costs. Parent companies incur one-time costs to separate operations and assets and implement the related restructuring of the businesses. These include costs for relocating operations and people and for severance payments.

To gauge the size of one-time costs, we compiled and analyzed separation cost data on more than 50 divestitures. (See Exhibit 2.) In total, separation costs are remarkably high, ranging from approximately 1% to 5% of the divested business's revenues. In some large and complex carve-outs, these costs reach up to 13% of revenues. Because the effort and costs to separate a business are often similar regardless of deal size, it is common to see lower one-time costs (as a percentage of revenues) for larger divested businesses. Separation costs are also driven by complexity—for example, the number of legal entities being separated or, as noted, the extent of entanglement among processes, systems, and assets.

Exhibit 2 - Separation Costs Can Be Very High, Especially for Complex Deals



Sources: Annual reports; public information; S&P Capital IQ; BCG Transaction Center.
Note: n = 59 divestments with deal value greater than $1 billion; includes transaction costs.

Transitional Services. Costs related to transitional service agreements (TSAs) can be an especially heavy burden. In a TSA, the parent agrees to provide services to the buyer in order to ensure continuity of operations for the divested business. These services often relate to support for back-office operations, finance, maintenance, manufacturing, marketing, and sales. TSAs are typically in effect for 3 to 24 months after the closing. It is important to note that TSAs can be a two-way street. This happens if the parent company sells critical assets or transfers personnel along with the divested business—which is often done to dress up the new company for a subsequent sale or IPO. In such cases, the parent relies on the new company to provide transitional services in reverse.

The buyer usually pays the cost of ongoing TSA services, except in reverse services. The parent should charge a rate based on realistic estimates—usually using a cost-plus method. However, the one-time costs to stand up TSAs are commonly borne by the parent. These one-time costs can be quite high and difficult to recoup. Getting an early view on the expected TSA stand-up costs enables better carve-out planning and helps avoid sticker shock as the transaction progresses.

Dis-synergies. Carving out a business commonly entails dis-synergies because decreasing economies of scale promote higher unit costs. For example, because the parent and the divested business must set up separate procurement functions, they lose the benefits of scale when negotiating with suppliers. We commonly see dis-synergies in the areas of the parent's administrative and IT services costs—the dis-synergies result from lost scale in shared services, as well as underutilization of shared plants, warehouses, and real estate. Further, dis-synergies often occur as businesses lose critical mass, especially in the smaller markets they serve. Finally, revenue dis-synergies frequently arise as each business loses important cross-selling opportunities because it sells fewer products.

Stranded Costs. A parent company's cost structure often includes expenses that are linked to the operations of the divested business and cannot easily be eliminated after the carve-out. These stranded costs typically relate to personnel who stay on the parent company's payroll while delivering TSA services to the buyer. The problem intensifies after the TSA period concludes, because the parent does not fully utilize these personnel. This makes it imperative to have a strategy in place to address these costs, which requires thinking creatively about how to work more efficiently in the context of a smaller organization. Further, to motivate employees to deliver optimal TSA services, companies need a robust change management plan to address employees' concerns about their present and future roles, as well as to provide them with incentives, such as retention bonuses.

Parent companies need to get an early start identifying stranded costs. These costs can take significant lead time to address because they may not be immediately visible, and eliminating them often requires significant change management. In many cases, managers are slow to acknowledge that they do not need the same cost structure after the carve-out.

FOUR IMPERATIVES FOR CONTROLLING COSTS

Although stranded costs and dis-synergies are often significant, especially from the perspective of net present value, companies also need to focus strongly on one-time costs. As our analyses show, these costs, especially in large, complex separations, are quite sizeable and need to be dealt with early on to be kept in reasonable ranges.

To keep separation costs under control, companies should follow four imperatives.

1. Follow clear strategic design choices to set up the carve-out. Strategy and deal teams should gain clarity on the motivation behind a deal as early as possible, so that they can identify the right type of divestiture and potential acquirers. This, in turn, helps companies plan for the effort that will be required in the carve-out. A trade sale to a strategic buyer will probably involve less effort than setting up the standalone structures needed for an IPO or spinoff.

Identifying the likely final bidders upfront allows the seller to design the deal for optimal value. For example, strategic buyers typically want to avoid acquiring administrative functions so that they can integrate the business into their overhead cost structures without, for instance, incurring severance expenses. The upside to strategic buyers of acquiring a business without administrative functions translates into higher deal value for the seller.

2. Set a plan for controlling costs. An early perspective on carve-out costs, including an initial budget, is essential for controlling them during the separation process. A top-down approach, validated by external benchmarks, is a good starting point and should be part of every separation planning exercise. The exercise should also clearly differentiate between the budgets for separation costs and optimization costs and get an early start on tackling stranded costs.

3. Stick to the plan. Having a strong separation management office (SMO) is essential to keep costs under control. The SMO should start by breaking down the separation costs into regional and functional categories, thereby generating and ensuring accountability with the respective executives. Once budgets are established, the SMO needs to establish a rigorous approval process for budgetary changes, challenge cost overruns, and ask project teams to reconsider their approach if overruns persist. Companies that could face significant costs from IT changes should negotiate a detailed IT provider contract that ties payments to the achievement of agreed-upon milestones in time and budget.

4. Tackle stranded costs early and take a long-term view on dis-synergies. The SMO should give priority to reducing stranded costs wherever possible, running the process in parallel with the overall carve-out process. If some stranded costs cannot be addressed until the divestiture is completed and TSAs have ended, the company should have a plan in place to tackle them as soon as possible. Over the longer term, to address dis-synergies and any previously unidentified stranded costs, the company may need to rethink aspects of its operating model. A zero-based budgeting exercise, for example, could facilitate that effort.

A poorly planned and executed separation of operations invariably results in excessive costs and distracts leaders from effectively running day-to-day operations. Given divestitures' important role in helping companies to raise funds and meet investors' expectations, no company can afford to let high separation costs impede the achievement of its value-creation objectives.

The authors are grateful to Matthias Gerg and Daniel Kim for their valuable insights and support in the preparation of this article.

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1 During large-scale transformations of their operating model, companies may separate a business without divesting it, a practice known as an "internal carve-out," by setting up an independent management structure.

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