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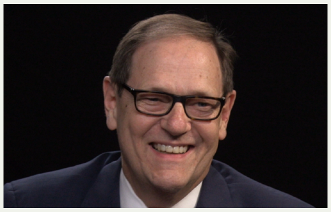
VIDEO SERIES

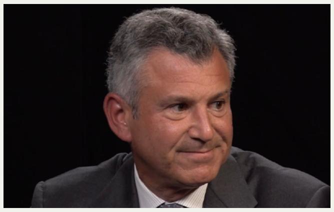
Briefing

Carve-out Fundamentals

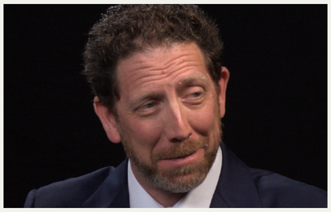
Three experts discuss the intricacies of separating a piece of a company from its parent, and roadblocks that can occur



Blaine Clark
RSM



Rob Rosner
Vestar Capital Partners



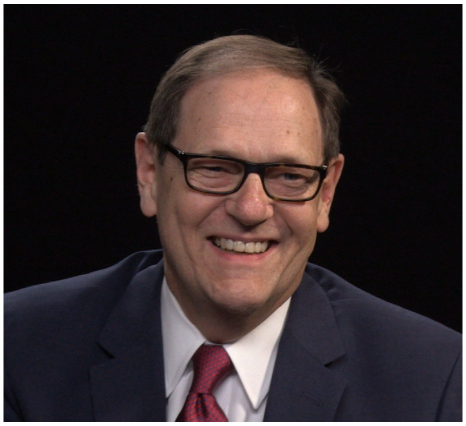
Lou Mintz
J.F. Lehman & Co.

Carve-out Fundamentals

Key Findings

1. A diverse set of qualities attract firms to carve-out opportunities
2. Familiarity with doing a carve-out is key in price negotiations
3. Businesses that are carved out start in different variations
4. Performing a carve-out transaction can be complex
5. Each PE firm may have a different "checklist" for the carve-out process

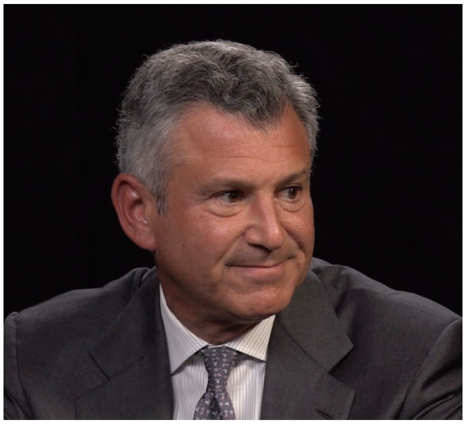
The Panelists



Blaine Clark
Director, Private Equity Consulting,
RSM

➜ BIO

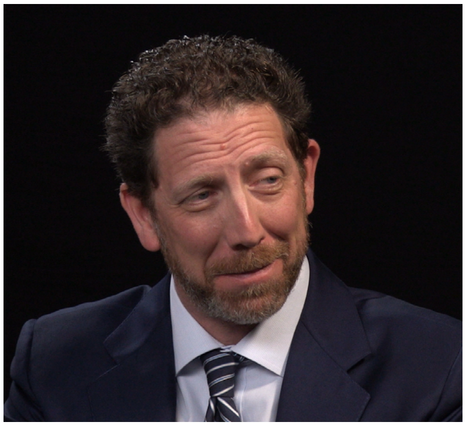
Clark leads private equity consulting for the Great Lakes region. He is responsible for engagement with RSM private equity clients and the delivery of the firm's value-creation solutions to those clients and their portfolio companies.



Rob Rosner
Founder, Co-president,
Vestar Capital Partners

➜ BIO

Rosner previously was based in Paris and served as president of Vestar Europe. He also heads the firm's diversified industries and financial services sectors. Prior to Vestar, Rosner was a member of the management buyout group of The First Boston Corporation. He holds an MBA from The Wharton School of the University of Pennsylvania and a B.A. from Trinity College.



Lou Mintz
Partner,
J.F. Lehman & Co.

➜ BIO

Mintz has been with J.F. Lehman since 1997. Previously he was a member of the private equity investment group at Odyssey Partners, L.P., and served as a vice president at Rosecliff, Inc. He began his career at Drexel Burnham Lambert in the corporate finance department. Mintz received a B.A. from Duke University.

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1 A DIVERSE SET OF QUALITIES ATTRACT FIRMS TO CARVE-OUT OPPORTUNITIES.

There are different circumstances leading to a private equity firm finding a carve-out opportunity. Sometimes it happens when a portfolio company acquires another business. Rob Rosner, founder and co-president of Vestar Capital Partners, says that his firm has found carve-outs a number of ways. Within the acquisition, there may be divisions or other lines of the business that are no longer core to the acquiring company and may be ripe for divestiture.

"Today, there's a lot more focus on activism and on increasing shareholder value," Rosner says. "In some cases, there are businesses held within a portfolio company that don't necessarily have the growth or core position in the market compared to some of the positions the parent company has."

Lou Mintz, a partner at J.F. Lehman & Co., says that in the space his firm operates in—aerospace, maritime, and defense—there is constant aggregation and disaggregation of companies, although a shift is taking place. "We're now in a very different budgetary environment," Mintz says. "Pressure is on corporates to rationalize their portfolios.... So we believe we're at a tipping point in terms of that particular space, where the disaggregation part of the equation is going to start coming about with increasing speed."

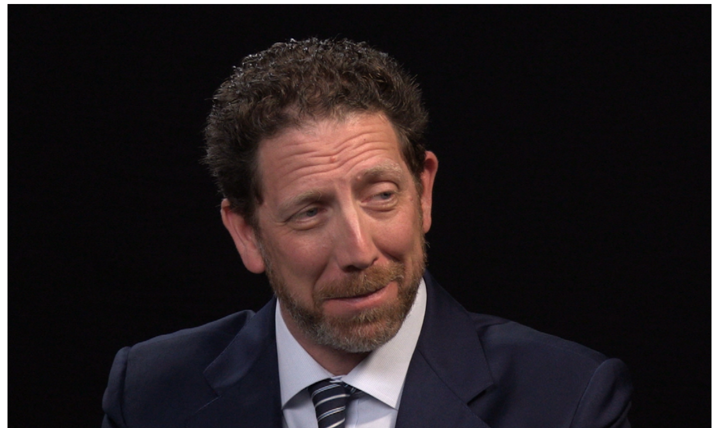
2 FAMILIARITY WITH DOING A CARVE-OUT IS KEY IN PRICE NEGOTIATIONS.

Not having a track record of carve-outs can be a hindrance when an opportunity arises and a sit-down with a seller is arranged. Familiarity with any issues that might arise and the ability to deliver on the transaction are key discriminators in getting a seller comfortable or to even start considering a transaction with a PE firm, says Mintz of J.F. Lehman.

"The more embedded the unit is, the more complicated the tear-out is, the more that confidence is a requisite for having a real audience with the player," he adds.

Rosner agrees that they'll care about a price within a fair value and "they're going to care about working with a partner who can help them do it in the least disruptive way," with employees taken care of. "Sometimes these are businesses that are a little harder to package, because they're not free-standing with fully stand-alone, audited financials."

Sometimes after the carve-out deal is closed, the relationship will continue, says Mintz—and not just in the form of a temporary transition-services arrangement. "We've been involved in some situations where, for instance, the manu-



A Blueprint for Independence

Lou Mintz
J.F. Lehman & Co.

When it comes to a transitional services agreement, the seller of the business needs to take as much ownership of it as the buyer, says Lou Mintz of J.F. Lehman & Co. This is a critical linchpin in getting a carve-out transaction "out of the shoot smoothly for both parties," he adds. Once the TSA has been crafted and the cost of services has been figured, then there's a need to loop back into stand-alone financials and make sure there's not a disconnect between this elaborate agreement and all of the assumptions in other documents to buy the businesses.

There's an incentive on everyone's part to gain independence as quickly as possible; it could be two or three months or up to 18 months, Mintz says.

"I view the whole process in many ways. It's sort of like building a house where [drawing it] on the back of a napkin will produce one result, or you can build a house from a detailed set of plans and you're going to get a different result. And these TSAs and all that go into them are really the blueprint for independence."

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> "If you look at the services that you're buying from corporate and the money that you're spending on that, that's a focus drain and a cash drain. And the sooner you can unplug those, the more prepared you are to focus on the value-creation strategy going forward."
>
> –Blaine Clark, RSM

facturing plant that was being conveyed with the unit was actually doing some work for the parent. So we entered into reciprocal supply agreements over the medium and long term where each company was, in fact, dependent on the other to continue to deliver that particular good or service."

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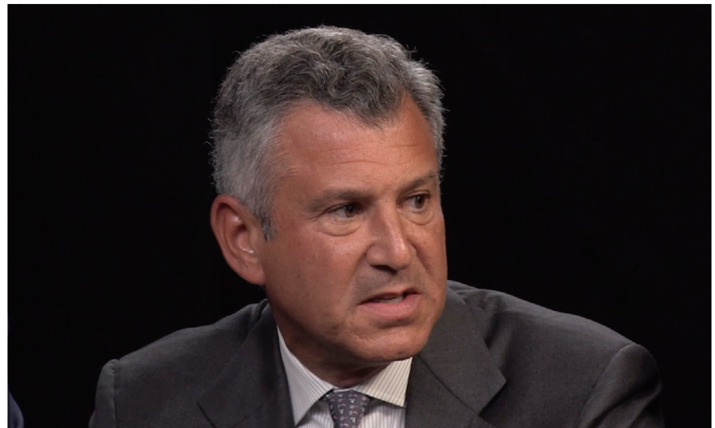
3 BUSINESSES THAT ARE CARVED OUT START IN DIFFERENT VARIATIONS.

A carve-out transaction may come to the process in a range of states. It could be a robust, nearly independent business or simply a product ready to break away from its parent company.

An organization such as Procter and Gamble may have decided to divest several divisions, and work may have been done internally to prepare them for sale, says Blaine Clark, director, private equity consulting at RSM. "They're probably in a little bit better shape than you might see in other environments," he adds. "But there are cases where it's really up to you as the buyer to rip it out and stand it up again."

Rosner says that Vestar Capital has been involved in the full gamut of carve-out situations, like a brand or product line out of a business that sold other brands and somewhat similar product lines. "So you had to actually



Beware IT Challenges

Rob Rosner
Vestar Capital Partners

When a company is carved out of another, there can be challenges that pop up. One of these could be related to information technology (IT). Sometimes the reliance on the parent company's prior system was taken for granted, says Vestar Capital Partners' Rob Rosner. There may have been an ingrained way of doing business, of formatting the access to data, of how information was provided. And the company being carved out may underestimate the current cost of replacing that.

It takes time "to develop the database…the hiccups along the way of getting it to report right. And it's very common for companies in a first year of IT transition to run into cost overruns, delays in rolling it out. Mixed-up data sources and reporting leads people to be a bit confused."

Because of this, it's important to build in a cushion and allow more budgeting of time and dollars spent to make sure these possible situations are reflected in the transition services agreement, Rosner adds. "[Make sure] you've built in extensions if you need to rely on the parent company's systems a little bit longer."

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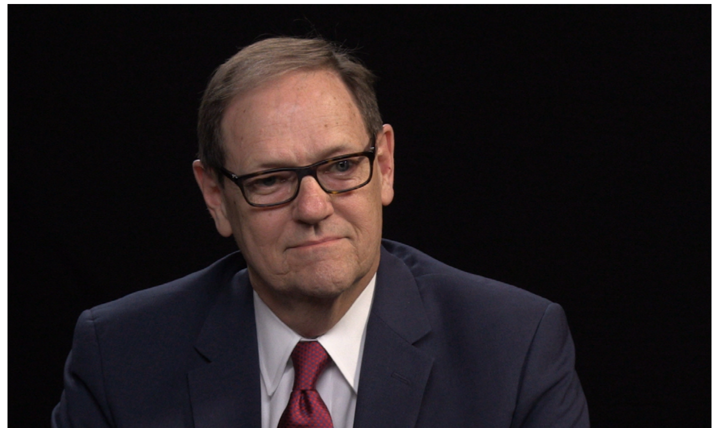
"In some cases, there are businesses held within a portfolio company that don't necessarily have the growth or core position in the market compared to some of the positions the parent company has."

–Rob Rosner, Vestar Capital Partners

start with carving out between the parent company and the new company being sold, almost like you were picking teams...[what] sales professionals go with the new company and stay with the old company. You actually create an org chart as part of it, with the sharing agreements ongoing for a period of time."

A controller "who had no idea that he was the MVP of the transaction," was at the center of an extensive tug-of-war when the parent company was reluctant to part with him, Mintz says. Ultimately, J.F. Lehman prevailed, but the incident highlighted the fact that the basic allocation of talent inside the organization, and who's going where, is not readily packaged and needs to be worked through with the counterparty.

In many cases, because of the nature of the carve-out transaction, it might be a first-time buyout as opposed to a business that's been stand-alone and already owned by PE investment firms, says Rosner. "That lends some of the interesting upside and opportunity, because in many cases the management team is, for the first time, experiencing the entrepreneurial enthusiasm and culture that comes with being owners of their business."



Unplugging from the Parent Company

Blaine Clark
RSM

Trying to disconnect the IT systems of the parent company from the company being carved out can be challenging, and focus is key. Trying to do too many things at once is a recipe for disaster both during and after the transaction.

"I've seen situations where, if you'd focus on what's absolutely required to run the business, you can unplug a lot quicker," says RSM's Blaine Clark. If you get into a situation where the employees of the carved-out company want what they had before, the process can take many months.

There are two other areas related to IT where problems frequently crop up. One is data, Clark says—specifically, who owns the data, what data you are going to get, and how you would handle the fact that you may not get what you want. The second problem area is integration—"or maybe lack thereof," he adds.

"When you try to stand up a system that came out of a corporate environment, but you unplug it from all the systems that were in the corporate environment, sometimes that's just a real nightmare," Clark says.

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4 PERFORMING A CARVE-OUT TRANSACTION CAN BE COMPLEX.

The complexity of a carve-out transaction can have many levels. Mintz points out that the process starts with how prepared the seller is to execute the transaction. It could be a relatively independent enterprise that has some connections to the parent company and is back-office oriented. Or at the other end, there's a product or part where the people, machines, and facilities aren't bound to the seller.
"The key from the buyer's standpoint is to relatively quickly assess where you are on that spectrum, because the resources and energy you're going to need to bring to bear on the latter are radically different than what would be required to execute the former," Mintz says.

Other scenarios involve a recently acquired company, with the buyer planning to divest some businesses, and also a business that has grown up with the parent company and has more emotions and history involved. "Some of the employees will stay," says Rosner. "Some will go. All of the back office or support functions might have to be re-created from scratch. Those are, in many cases, the most interesting because from a roll-up-the-sleeves-and-create-value point of view, there's so much to work on."

Another unique situation could involve a business distributed across multiple geographies, with the parent company organized by where it's based, and no central human resources, IT, or sales and marketing. "In some ways, you're doing multiple transactions to get the single transaction done, because there really is no unified seller," Mintz says.RSM's Clark says that it's difficult to arrive at the value of a carve-out deal like this because EBITDA could be different for a stand-alone company, due to the many variations. Many times there's not an EBITDA established for what's being carved out, he says, and it needs to be figured out. "It's essentially a project to model what the new company's going to look like after you pull it out of the corporate," he adds.

5 EACH PE FIRM MAY HAVE A DIFFERENT "CHECKLIST" FOR THE CARVE-OUT PROCESS.

There may not be a standard checklist involved when a private equity firm performs a carve-out, just as there is no standard carve-out transaction. Clark of RSM says that while a checklist isn't discussed, the "big rocks" that can be run into—human resources, supply chain, IT, finances in a shared service organization—are talked about. "Certainly those are big things that have to be taken care of," he says. "And be ready to go on day one."

> **"The more embedded the unit is, the more complicated the tear-out is, the more that confidence is a requisite for having a real audience with the player."**
>
> –Lou Mintz, J.F. Lehman

Rosner says that a sticking point he's seen is a tendency to underestimate the glue between the carved-out business and the parent company, "just because so many things are taken for granted on a day-to-day basis." Keeping the relationship healthy with the parent company throughout the process is important, he adds.

His firm, Vestar, uses something resembling a 100-day plan for a carve-out, which he says management appreciates. He's also noticed that when developing a separation agreement, the "simple way to think about it might have been simply to say that there will be a cooperation agreement for a period of a year" that can very specifically narrow down the areas of interaction with human resources, legal, tax, and so on. Making a full list of these tasks to be checked off can be motivating for management, he adds. In a transition services agreement, money is sometimes spent that doesn't need to be. "If you look at the services that you're buying from corporate and the money that you're spending on that, that's a focus drain and a cash drain," Clark adds. "And the sooner you can unplug those, the more prepared you are to focus on the value-creation strategy going forward." ■

Expert Q&A

With Blaine Clark
Director,
Private Equity Consulting,
RSM

What is included in RSM's PE consulting services?

Clark: The private equity consulting services include all of the services that we offer our normal clients—assurance, tax and consulting. The thing that sets us apart for private equity is that we have more than 1,000 private equity clients and thousands of engagements. And we have incredibly deep experience in private equity. That allows us to bring the right tools and the right people and the right methodologies to the table, whether it's at the fund level, or for a particular transaction type, or at a particular point in the investment lifecycle to help create value for the fund, and therefore, for their limited partners. ■

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Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communi-cations services to market participants.

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