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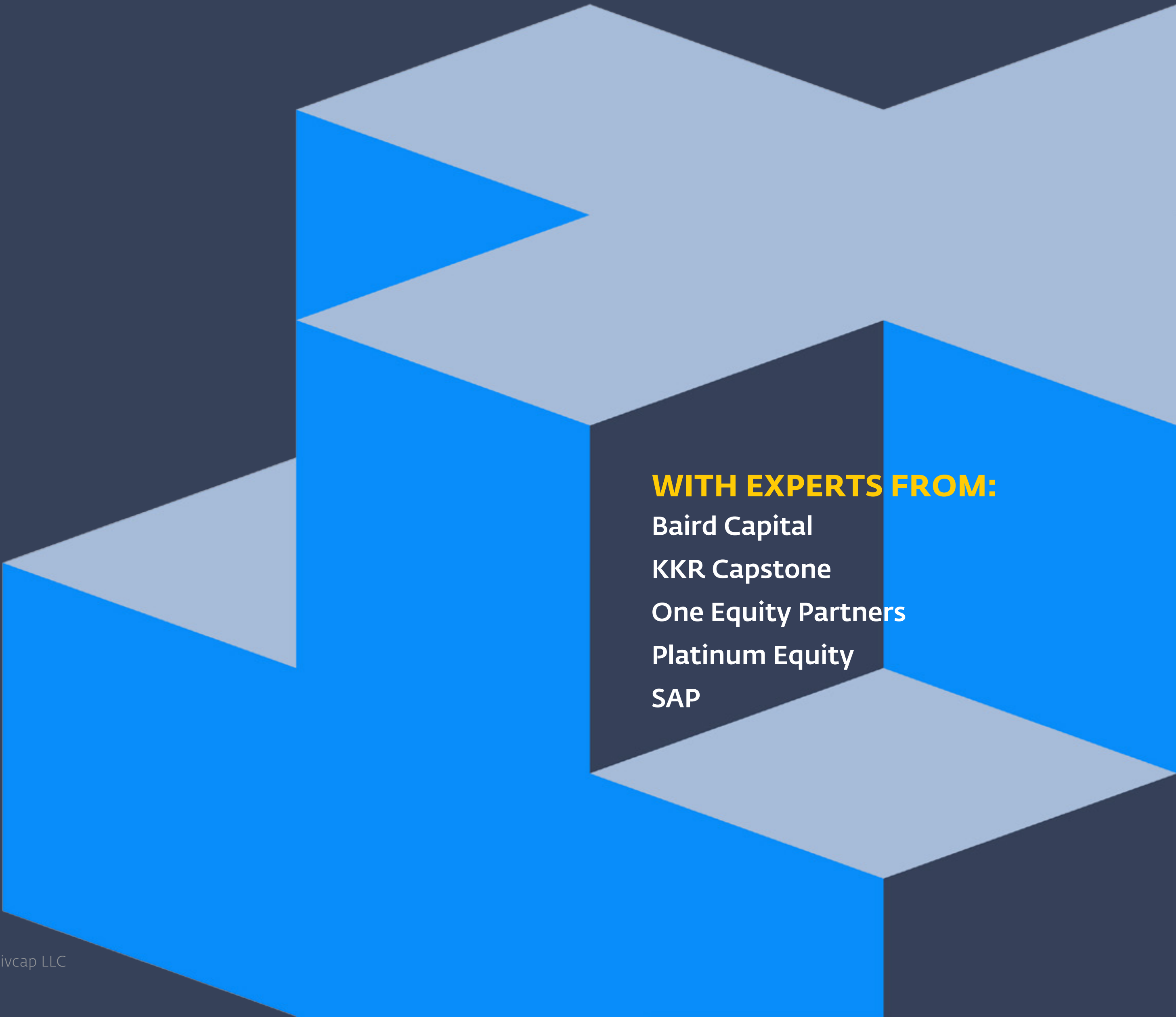
Q1 2017

ADDING VALUE Through Technology

/ Solving IT Complexities in a Carve-Out



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David Snow
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Untangling Value

The carve-out is a classic private equity deal that, when done right, validates the entire asset class as being able to deliver wealth-creation opportunities not available in public markets. In other words, carve-outs are hard to do, and relatively few people know how to do them.

The most obvious example of a complexity unique to carve-outs comes in the form of IT. Regularly operating businesses have crumbled as a result of IT missteps, and so a business going through a transformation as jarring as a carve-out is particularly at risk of getting this vital component wrong.

As you'll learn from the experts in this report, forming a newly independent company's IT infrastructure requires some of the deepest diligence and strategic thinking. Experienced carve-out backers know that a company can't thrive if it can't properly access the knowledge it relied on while a division of its former parent. And not having adequate support from said parent during the transition can lead to a demoralizing operations fiasco.

Knowing this, the best private equity firms have added in-house experts who can help companies stand on their own once independent, including IT experts who spend most of their time assessing how complicated the transition will be, and then deciding what IT and human capital infrastructure needs to be in place to support the new company's plan for growth.

We hope you find the information instilled in the following pages by these operations experts enlightening.

Enjoy the report,

David Snow
@SnowsNotes

Why Not Paying Attention to Tech in a Carve-Out Could Cost You

Two experts on the nuances of carve-out transactions explain why paying attention to the ever-more-complex technology component, starting when the transitional service agreement is drawn up, is crucial

Benedict Rocchio
Partner,
Venture Capital Team,
Baird Capital

J.B. Cherry
Senior Managing Director,
One Equity Partners

When a corporate parent sells off a business unit in a carve-out transaction, parties on all sides of the deal work hard to make sure the company that's spun out doesn't spin out of control. A smooth transfer of technology is a crucial aspect to successful carve-outs, and experts say the importance of this transition represents an increasingly complex part of an always challenging process.

From the beginning of the process, when the transitional service agreement (TSA) that forms the blueprint of the new company is created, to preparing the information technology staff that will power the stand-alone business, the tech piece of the carve-out puzzle is multilayered and provides opportunities to create value, though capitalizing on those opportunities requires detailed expertise and meticulous execution.

Benedict Rocchio, a partner on the venture capital team at Baird Capital, says it's crucial to understand how the parent corporation's organization of IT will affect the new stand-alone company. With a comprehensive assessment, often aided by third-party experts, buyers can set up a detailed plan to address every aspect of tech issues in a carve-out. That adds confidence as a TSA gets negotiated and signed. Rocchio says the process is increasingly complex as IT assumes greater importance in all aspects of a business.

"The biggest change in the last decade or so is how much the sophistication of corporate IT infrastructure has become," he says. "Even with the advent of the Internet in the 1990s, corporate IT wasn't as robust. Now the level of technology that touches every aspect of business, both inside the walls and in terms of customer interaction, has become more complex. That poses a bigger challenge in a carve-out."

J.B. Cherry, a senior managing director at One Equity Partners and a veteran of several carve-out transactions, says a broad view of the technology dimension is vital to creating value in the carved-out company. Ensuring operational continuity is the first step.

"The business is up and running the day after you own it, and everything needs to be running smoothly," Cherry says. "You can't bounce checks. You have to make sure employees are paid, and all of those go back to the IT platforms."

A detailed understanding of the IT costs to the parent may also help reduce them in the new

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company. Cherry says the balance of the costs between the parent and the soon-to-be-independent company is often an area of increased cost risks.

"You need to understand what those costs are, and you need an analysis that says that at some point these functions can be performed independent of the parent," he says.

Third-party experts can often add value to the ultimate results of a carve-out, says Rocchio. While the general partners work on the best deal structure, the sophistication of current corporate IT is such that specialized expertise is crucial, he says.

With that level of detail, it's also possible to improve the IT framework of the new company, shedding cumbersome, sometimes costly or poorly integrated systems in favor of more agile, often cloud-based solutions. While the transfer of licenses and other technology agreements may increase because the vendors take the opportunity to raise prices for a smaller customer, that's a point of negotiation. The new company doesn't have a blank slate for technology, but it can be organized efficiently and cost-effectively.

"It's an opportunity to build what you want when you're buying out what becomes a new business," Rocchio says. "This is a chance to get an ultra-modern IT system in place from the start, with all the possible cost and technological efficiencies."

Having the right people in place on the tech side is a critical piece of the puzzle. There's a balance to be struck between understanding the legacy IT and operational issues of the new business as they relate to the parent corporation and seizing the opportunity to modernize and install high-level tech talent throughout the carved-out company.

While many dealmakers cultivate and use networks of skilled IT managers to lead or supplement tech teams at newly carved-out companies, the human capital costs—and potential value—often depend on the IT organization of the parent company, Cherry says.

"In many cases, the carved-out company has a head of technology or a chief financial officer who is already fluent in these systems and understands inherently what the parent is providing and what they lack," he says. "There are times you may have to add to the human capital aspect of the deal, particularly if you have a parent company where the IT is done centrally. You may need to find someone who can think more strategically for the carve-out."

Once the technology architecture is in place and the right leadership is selected, the standalone company begins its history as an independent business. There's no lockstep process for evaluating the success of the technology side of a carve-out, but getting to independent, robust operational status is always the primary goal. A clear distinction between the onetime costs of the transition and the ongoing costs in the period governed by the TSA is vital.

Rocchio says getting past the time when the costs of the shared-services agreement affect the carve-out is always a desired aim, as is a smooth operational liftoff. Avoiding data-migration hiccups and machine downtime are always desirable aims as well, he says.

"Cost and time are always the two biggest factors," he says.

Cherry, who has both executed carve-outs for buyers and been part of one when his own firm was spun off from J.P. Morgan in 2015, says his experiences were instructive.

"It's a monumental undertaking," he says, regardless of what side of the transaction you represent. "I have a new appreciation for all of the things that our management teams go through."

A crucial factor in One Equity's technological transition—one that's tough to quantify but always very important—was the support the midmarket buyout shop got from J.P. Morgan.

"We made extensive preparations, but of course there was a period where they supported us—like any good parent should," Cherry says. "It's impossible to just flip a switch on day one." ■

Why Technology Increasingly Complicates Carve-Outs—and What to Do About It

The key to technological success in a carve-out isn't found in the cloud or a new company's servers, but in the fine print of the paperwork that creates a new entity from a corporate parent. Usman Rabbani, a director who leads Technology, Media and Telecommunications at KKR Capstone, the firm's operations group, says the structure and quality of the transitional service agreement (TSA) can materially impact the transaction and the buyer's ability to create value.

Usman Rabbani
Director,
KKR Capstone

Privcap: Where do you set the foundations of a successful carve-out from the technology side?

Usman Rabbani, KKR Capstone: Technology is one piece of a very complex puzzle. We start with a 100-day plan for the new entity and try to focus, or refocus, on the top three to five things that make it a successful investment. One of the most important considerations is the actual transitional service agreement with the parent. Take the example of a large company like GE, which carved out its consumer finance business in Australia. The subdivision of GE we were purchasing lived atop the corporate parent's IT and systems infrastructure. That included quite a lot: hardware, data centers, software, telephony, third-party relationships, networks, and end-user applications. One of the biggest technology-related decisions was how to structure that TSA—and how to price it.

What are some of the biggest issues and potential complications in setting that up?

Rabbani: The pricing is where some commercial risk exists. Let's say a large corporation has a $500M budget for technology, and five main divisions. That money isn't allocated equally in $100M chargebacks—it's never as clean as that—and internal allocations change over time, too. So one of the biggest considerations is what the corporate parent will charge the new, stand-alone entity. You have to assess how the internal transfer pricing currently works, when software licenses and other major assets are up for renewal, which contracts can and can't be renegotiated, what servers are shared across other businesses that you're not buying, etc. There's a lot to sort out. Issues related to these complexities are probably the biggest source of value creation—or value destruction—in a TSA.

How has the role and importance of technology changed in the time you've worked on carve-out transactions?

Rabbani: Technology … has a profound operational impact—you are essentially "standing up" a new company for which the technology backbone either doesn't exist, or must be surgically removed from ongoing operations in the parent without breaking the parent company or the division being sold. The PE industry now must use multiple lenses to understand the technology impact on any potential deal. So many business processes are automated, and so many functions are tech-dependent.

What are some common tech issues that can be addressed in a TSA?

Rabbani: To increase flexibility and manage costs, we look at how much of the parent's legacy technology can be migrated to cloud-based applications. There are cloud-based solutions, services, and infrastructure available now that didn't exist five, 10, or 15 years ago when these companies built and deployed their technology platforms. Much of what's available now is more cost-effective and easier to scale up and down with revenue growth or contraction versus large fixed costs. Very often, for example, the new company won't need to own lots of hardware or invest in data centers. Another thing we also look at closely is software licenses. If the parent company is licensing software on a large scale, it may be able to get it on very favorable terms. Software suppliers will see the carve-out as an opportunity to create a new contract at higher prices. These factors need to be addressed, or they can lead to negative surprises. ■

Why IT Should Be at the Top of Your Carve-Out List

Experts from Platinum Equity charged with vetting and improving the operations of portfolio companies discuss the unique complexities of helping a carved-out business establish an IT function

Privcap: What is the importance of getting IT right when trying to stand up a former corporate division as an independent business?

Stephanie Barter, Platinum Equity: The IT component of a carve-out can actually be the most important task. It needs to be in place in order for us to ultimately realize our value-creation plan. So when we've got a vision of how we will transform an organization, in many cases we can't start until that company is actually carved out from its parent. And in many cases, IT is the long pole in the tent. Until that can get done, there are many, many other next-step things that cannot be completed until that's taken care of. So when we think about this in terms of the project plan, this is always at the very beginning of the list.

Eric, what do you look for during due diligence in a carve-out situation?

Eric Yap, Platinum Equity: When we start our IT diligence, we try to understand how the business operates. We try to understand what complexities could be within the business that actually would drive complexities from an IT carve-out perspective. So a quick understanding of the lay of the land on the business side helps drive the same activity within IT diligence. And then we dive down into the specifics of activities that need to be taken care of to actually separate the entity from the parent.

What are the key IT risks when separating a unit from its parent?

Yap: There's a risk that you don't have access to the knowledge that you need. And then there's also some contractual items—for example, a limited TSA [transitional service agreement] period that could put risk on carve-out activity.

Barter: Every traditional systems-implementation or technology-conversion risk also applies to a carve-out. In a carve-out, you're getting something that you didn't build, getting something that you don't have full control over. So it accelerates risks to a unique place.

What are the human-capital challenges in transitioning the IT function from parent to carve-out?

Yap: It's deal-dependent. Your team is completely dependent on what is coming over and what is not coming over. And so in some deals, there are capabilities within IT organizations to take on the majority of the transition work themselves. But sometimes we're building IT organizations from the ground up, because you inherit no resources in the deal.

Barter: The Platinum team is a resource for the portfolio companies. We can bring very experienced resources. Tasks like separating email, separating back-office infrastructure, doing the systems conversions—these are things that our group has done hundreds of times, and there is a predictability. This makes a difference in your ability to predict the outcomes. ■

For a Successful Data Carve-Out, *Get in Early*

> **An expert from SAP details what makes and breaks a divestiture when it comes to data and other information that needs to be separated from the commingled company**

Alexandre Garske
CoE Director, Specialist in Divestitures, SAP

Divesting of a business in a carve-out is never an easy process—especially when data and other information needs to be untangled. But with the right process in place, the carved-out company can operate uninterrupted.

Alexandre Garske, CoE Director, Specialist in Divestitures at SAP, says the firm works with companies to carve out data into a "standup" system—where the carved-out company will stand by itself—as soon as possible during an assessment phase, ideally prior to a divestiture starting and a transitional service agreement (TSA) being in place.

The full process typically takes four to six months. In order to migrate the data, several things need to be considered. "First, you need to understand the requirement of the divestiture," he says. "We look at historical data [from the company], look at how business processes should work in the divested thesis, look at what are the business scenarios."

The goal with any divestiture is to have uninterrupted service in that carved-out company. "We can expedite the divestiture and reduce the TSA time by establishing a demilitarized zone [on the buyer's side] and a separate environment with only the data to be carved out," he says. "SAP can be considered a neutral provider to execute on the seller's side and establish a complete environment of historical data as of day one of the TSA."

To ensure the continuity of business, if the seller gets a business order for the carved-out portion of the company, SAP can separate it from what the buyer will ultimately get. "You can have complete commingled data on Friday and, on the following Monday, have the divested data with historical data [included]. It's uninterrupted," explains Garske.

One consistent concern is when the data or other information can be looked at during the divestment process. "The major challenge is if the seller doesn't want to disclose information," he notes. "If I look from the buyer's side, I might be blind and need to accept the TSA as is, and run things as is until the data is carved out."

Many of the companies that SAP works with on data divestment—both on the buy and sell sides—are in the oil and gas industry, he says, but other sectors that they work with include automotive, consumer products, and the food industry. "Whenever you see a big divestiture and it has an SAP footprint, it's probably an SAP customer," he adds. ■