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

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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." ■

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