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,
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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. ■

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