Breaking up is hard to do…

The sale of parts of a larger corporation offers the chance to reduce complexity through focusing activities, optimize business efficiency and monetize non-core assets. Those carve-outs, however, require a greater level of planning and a bespoke sales process compared to standard M&A transactions to be successful.

- **Focus on core business and cash generation**
  
  Corporates tend to diversify over the years and build complex business models. Carve-outs help streamlining operations and generating cash. Carve-out activity in Europe is rising and reached €45.5bn from 139 transactions in 2014, roughly 9.5% of the total value.

- **Simplifying the business model**
  
  A sale of non-core activities reduces complexity and makes it easier for management to run the business. A fresh view on simple operations improves performance.

- **Value enhancement and financial flexibility**
  
  A pure play is easier for investors to understand and unlocks hidden value. Monetizing underperforming assets provides financial flexibility.

- **Creation of sellable unit from a buyer’s perspective**
  
  A sustainable business model with clear growth and profit improvement perspectives is key to generating investor interest in a carve-out. This requires management effort and time.

- **Carefully prepared, customized M&A process**
  
  Carve-outs are complex as businesses for sale are often strongly integrated in to the seller’s organization. A clear roadmap for the split of operations and a bespoke sales process that allows for fine tuning of the carve-out concept according to investor needs is key for success.

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1 Source: Mergermarket
Rising market, more stable than total M&A market

Carve-out transactions - i.e. selling part of a larger parent company - are becoming increasingly popular. Carve-outs comprise a broad spectrum of transactions, ranging from the sale of assets to complete legal entities. If managed well, the deal will appeal to both trade and financial bidders, can facilitate a change in corporate strategy and provide a financial injection for future growth. This explains why the carve-out segment has doubled its importance within the total M&A activity since 2009.

In 2011 the European M&A market1 almost reached before crisis levels again and peaked with a total value of almost € 600bn. The sharp increase in 2011 compared to 2010 was particularly driven by mega transaction with a value of more than € 5bn each, of which only 6 occurred in 2010 but 18 in 2011.

In 2012 to 2014 the market was influenced by global economic uncertainties and the government debt crisis in Europe. In 2014 it reached a level of € 450bn from more than 5,200 transactions.

Carve-out activity also peaked in 2011 with a volume of € 51bn, experienced a sharp decline in 2012 but from then on increased again to more than € 45bn in 2014.

The importance of the carve-out segment, however, improved over time. In 2009 it reached only 4.3% of total deal value but improved to a record of 9.5% in 2014.

Looking at number of deals carve-outs represent only a small fraction of total. In 2014 5,561 deals were reported of which only 139 were carve-outs. This is probably due to the fact that carve-outs tend to be smaller deals which are often not registered in deal statistics.

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**European Carve-Out Market**

<table>
<thead>
<tr>
<th>Year</th>
<th>Value in €bn</th>
<th>No. of Deals</th>
<th>Average EBITDA multiple</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>397.3</td>
<td>3,643</td>
<td>12.7x</td>
</tr>
<tr>
<td>2010</td>
<td>373.7</td>
<td>4,706</td>
<td>15.9x</td>
</tr>
<tr>
<td>2011</td>
<td>591.6</td>
<td>5,373</td>
<td>11.0x</td>
</tr>
<tr>
<td>2012</td>
<td>447.1</td>
<td>5,229</td>
<td>7.7x</td>
</tr>
<tr>
<td>2013</td>
<td>532.4</td>
<td>5,456</td>
<td>11.3x</td>
</tr>
<tr>
<td>2014</td>
<td>469.4</td>
<td>5,561</td>
<td>7.5x</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>% PE by No. of Deals</th>
<th>% PE by Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009 13%</td>
<td>24%</td>
</tr>
<tr>
<td>2010 20%</td>
<td>25%</td>
</tr>
<tr>
<td>2011 19%</td>
<td>6%</td>
</tr>
<tr>
<td>2012 18%</td>
<td>14%</td>
</tr>
<tr>
<td>2013 18%</td>
<td>15%</td>
</tr>
<tr>
<td>2014 15%</td>
<td>9%</td>
</tr>
</tbody>
</table>

**Total European M&A Market**

<table>
<thead>
<tr>
<th>Year</th>
<th>Value in €bn</th>
<th>No. of Deals</th>
<th>No. of carve-out Deals of Total</th>
<th>Value carve-out Deals of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>397.3</td>
<td>3,643</td>
<td>3.5%</td>
<td>4.3%</td>
</tr>
<tr>
<td>2010</td>
<td>373.7</td>
<td>4,706</td>
<td>2.6%</td>
<td>6.9%</td>
</tr>
<tr>
<td>2011</td>
<td>591.6</td>
<td>5,373</td>
<td>2.0%</td>
<td>8.6%</td>
</tr>
<tr>
<td>2012</td>
<td>447.1</td>
<td>5,229</td>
<td>1.4%</td>
<td>5.6%</td>
</tr>
<tr>
<td>2013</td>
<td>532.4</td>
<td>5,456</td>
<td>1.8%</td>
<td>7.4%</td>
</tr>
<tr>
<td>2014</td>
<td>469.4</td>
<td>5,561</td>
<td>2.5%</td>
<td>9.5%</td>
</tr>
</tbody>
</table>

---

1 European Targets, Source: Mergermarket
Valuations differ substantially over time and reached 7.5x EBITDA in 2014. The volatility is probably a result of the fact that many carve-out entities are underperforming companies.

As in overall M&A strategic investors prevail while financial investors play a minor role.

### Key success factor:
Creation of stand alone sustainable business model

**What is for sale?** Once management has decided to dispose of certain activities they need to be defined in detail, taking into account potential acquirers views and the perspectives of the remaining business.

From a seller’s perspective carve-out candidates often lacked management attention which frequently makes them to underperforming entities. On the other hand investors are keen to acquire sustainable operations with a solid business model and attractive growth and earnings outlook.

The first task is to define the perimeter of the business to be sold and to identify components that may be included or excluded.

This may already be a separate legal entity but could also be a business division or a combination of both. Thinking like a buyer helps to define an entity attractive to potential acquirers which generates investor interest and has the potential to achieve full value from a sale.

<table>
<thead>
<tr>
<th>Completion Date</th>
<th>Seller</th>
<th>Company</th>
<th>Carve Out Entity</th>
<th>Acquirer</th>
<th>Enterprise Value (€m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar 2015</td>
<td>Sabre Corp</td>
<td>USA</td>
<td>lastminute.com</td>
<td>Bravofly Rumbo Group Switzerland</td>
<td>96</td>
</tr>
<tr>
<td>Jan 2015</td>
<td>Duerr AG</td>
<td>Germany</td>
<td>Duerr Automation</td>
<td>Quantum Capital Partners Germany</td>
<td>n.a.</td>
</tr>
<tr>
<td>Dec 2014</td>
<td>Huhtamaki Oyj</td>
<td>Finland</td>
<td>Huhtamaki Films Germany</td>
<td>Deutsche Beteiligungs AG Germany</td>
<td>141</td>
</tr>
<tr>
<td>Dec 2014</td>
<td>ABB</td>
<td>Switzerland/Sweden</td>
<td>ABB Full Service</td>
<td>Nordic Capital Sweden</td>
<td>n.a.</td>
</tr>
<tr>
<td>Nov 2014</td>
<td>Vivendi SA</td>
<td>France</td>
<td>SFR SA</td>
<td>Altice SA Luxembourg</td>
<td>17,000</td>
</tr>
<tr>
<td>Sept 2014</td>
<td>Voith</td>
<td>Germany</td>
<td>DIW Instandhaltung</td>
<td>Strabag Austria</td>
<td>70</td>
</tr>
<tr>
<td>Sept 2014</td>
<td>Alstom SA</td>
<td>France</td>
<td>Arvos Group</td>
<td>Triton Partners UK</td>
<td>730</td>
</tr>
<tr>
<td>Okt 2014</td>
<td>GEA Group AG</td>
<td>Germany</td>
<td>GEA Heat Exchangers</td>
<td>Triton Partners UK</td>
<td>1,300</td>
</tr>
<tr>
<td>Sept 2014</td>
<td>Landesbank Baden-Wuerttemberg</td>
<td>Germany</td>
<td>LBBW CZ</td>
<td>Expobank Russia</td>
<td>80</td>
</tr>
<tr>
<td>Aug 2014</td>
<td>Daimler AG</td>
<td>Germany</td>
<td>Rolls-Royce Power Systems</td>
<td>Rolls-Royce Plc UK</td>
<td>4,860</td>
</tr>
<tr>
<td>Jul 2014</td>
<td>Arla Foods</td>
<td>Denmark/Sweden</td>
<td>Danapak Flexibles A/S</td>
<td>Schur Flexibles Holding GesmbH Austria</td>
<td>n.a.</td>
</tr>
<tr>
<td>Jun 2014</td>
<td>Solvay SA</td>
<td>France</td>
<td>Solvay Benvic France S.A.S.</td>
<td>OpenGate Capital, LLC USA</td>
<td>60</td>
</tr>
<tr>
<td>Apr 2014</td>
<td>Ahold NV</td>
<td>NL</td>
<td>Ahold Slovakia</td>
<td>Condorum Ltd Slovakia</td>
<td>n.a.</td>
</tr>
<tr>
<td>Jan 2014</td>
<td>Conversant, Inc.</td>
<td>USA</td>
<td>ValueClick, Inc.</td>
<td>IAC/InterActiveCorp USA</td>
<td>58</td>
</tr>
<tr>
<td>Jan 2014</td>
<td>VION N.V.</td>
<td>NL</td>
<td>VION Ingredients Nederland (Holding) B.V.</td>
<td>Darling Ingredients, Inc USA</td>
<td>1,600</td>
</tr>
</tbody>
</table>
Strategic investors are looking to improve market shares or expand into new products and regions. Financial investors are either looking for strong growth potential or possibilities to improve performance.

Besides potential buyer interest the objectives of the seller and its remaining business should be taken into account to guarantee for a successful ongoing business.

Next step is to identify links between the business for sale and the remaining operations and a concept to cut these links.

Crucial issues typically comprise customer and supplier relationships, sales organization, manufacturing, IT, research and development capacities and intellectual properties like brands and trade names.

Shared services like financing and controlling, marketing, HR, insurance, tax etc. are often provided by the parent and support the carve-out entity. They can be split up, remain with the parent which continues to provide them or the carve-out entity purchases them from third parties.

A competent management team, that feels like a shareholder rather than a business administrator, is fully committed to the carve-out entity and free from limitations from the parent is a key value driver.

The carve-out entity needs structure and processes adjusted to its stand alone status. A lean organization with less bureaucracy due to the smaller size of the carve-out entity combined with higher decision making authority for its management improves cost structures and enhances the dynamics to drive the business forward.

Proactive design of the business model and its organization is a must.

As a result of this exercise a competitive stand alone business model should be in place while at the same time getting rid of burdens for the remaining operations. A clear separation rises the value of the carve-out entity while dependence on the parent means risks for the buyer which leads to discounts.
What is the financial position of the carve-out entity? Solid stand alone historic financials and a sound business plan help buyers to assess the acquisition opportunity

Carve-out entities are difficult to assess for buyers, as stand alone financials regularly do not exist. Even if a legal entity is for sale, financials often don’t show the business on a stand alone basis but influenced by the parent.

Required normalizations to the historic financials frequently comprise cost allocations from shared services, transfer pricing for raw materials and finished products and cost advantages which the parent achieves from its size and transfers to its carve-out entity.

Additionally measures from the cut of links between parent and the carve-out entity must be taken into account to present a true stand alone financial picture.

If possible, all adjustments should be based on audited financials. This exercise requires transparency of the parent with respect to cost structures and is not easy because internal procedures often exists since years and cost allocations are accepted without questioning them. A financial fact book prepared by an outside accountant helps to establish reliable figures and is a valuable tool to provide investors with a clear view on the carve-out entity’s financial situation. Having this not available during investor negotiations means destroying value.

The equity story going forward is the key value driver for the sale of the carve-out entity. Acquirers look for attractive strategic positions in promising markets and a sound business model that provides future growth and earnings potential.

The financial forecast should be based on a carefully developed operational business concept with a set of reliable underlying measures, which management is able to defend with potential acquirers. Quality of future earnings, efficient cost structures the ability to successfully operate without the parent are major factors for buyers to assess the value of a carve-out entity. An estimation of synergies for the buyer can even further enhance its value.

A value story linking historical and forecasted operational results, financing needs and required capital expenditures backed by a careful assessment supports consistent messaging and improves credibility with potential acquirers.

A solid preparation of this phase takes time and needs management attention but rises transaction certainty substantially.
How to separate the carve-out entity from its parent? Carve-out entities are often strongly interlinked with its parent. There is a danger to destroy value, if the separation is not carefully prepared.

Most separation activities occur between signing and closing but early planning can shorten its implementation and thus the time-frame till closing. A credible separation strategy shows buyers that the business can be separated without disruption of the business and loss of its value. Sellers should take a number of issues into account and develop a clear plan for the separation of the carve-out entity:

<table>
<thead>
<tr>
<th>Operations</th>
<th>Legal issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>how to handle customers and suppliers of both entities; separate or newly establish important functions like manufacturing, sales &amp; marketing etc.; split of shared services; concept for transfer pricings and volumes. Buyer needs to identify what it will take to run the business on a standalone basis. Thus, there is a need to understand what pieces are missing to fully operate the business.</td>
<td>legal structure of the carve-out entity; transfer of contracts; change of control clauses; possibilities to sub-contract services; litigation claims.</td>
</tr>
<tr>
<td>Deal structure and timing</td>
<td>IT</td>
</tr>
<tr>
<td>asset deal or share deal; sequence of steps to separate activities</td>
<td>transition from seller’s to buyer’s systems</td>
</tr>
<tr>
<td>Working capital management</td>
<td>Intellectual property</td>
</tr>
<tr>
<td>handling of inventory; collection of receivables etc.</td>
<td>brands; patents; licensing agreements</td>
</tr>
<tr>
<td>Company and deal financing</td>
<td>Tax planning</td>
</tr>
<tr>
<td>securing liquidity; allocation of bank loans; pledges etc.</td>
<td>avoid taxes on hidden reserves</td>
</tr>
</tbody>
</table>
The list of selected issues already shows the complexity of carve-out processes. Due to this complexity, many different internal stakeholders become involved to develop customized solutions and handle specific issues. This requires a clear process control and monitoring of results to coordinate all internal and external participants. It makes sense to develop a roadmap for the carve-out ahead of the transaction, but it should remain lean and flexible enough to adapt the roadmap to the requirements of potential buyers.

Seller will agree with the final buyer on certain steps of the roadmap that will be implemented before closing. The remaining steps will be included into a transition service agreement and executed after closing. An open discussion between seller and buyer is more effective and leads to more transaction certainty than just negotiating price. The transition service agreement will clearly define separation steps, responsibilities, timing, services over a transition period and corresponding fees and it will guide both parties from the close of a deal to the final separation of operations.

Carve-outs require success based thinking in process design. Focus on concepts and key issues first while remaining flexibility and adding details down the road avoids sunk costs if pre-designed structures do not meet market requirements.

Standard M&A processes start with a defined target which is for sale - this is different in a carve-out scenario. The corporate may have a clear view on what it wants to sell but does this meet investor demand? A step by step process helps to avoid spending too much time and efforts in businesses and structures not attractive to potential acquirers.

In a first step a virtual carve-out prototype and related key financials and performance drivers can be established together with red flag analyses on separation issues.

This concept can be tested in pre-screening meetings with selected anchor buyers based on short presentations and their feedback provides valuable information to adjust the model to the needs of the most probable acquirers. Fine tuning of the model allows to define a marketable carve-out structure and an attractive equity story that meets investor demand.

The preparation of the sales process starts only then: with drafting of marketing documents, accountants working on carve-out financials, list of potential acquirers and the gathering of documents for the data room. Selection criteria for strategic buyers are the strategic fit and their financial strength, financial investors have specific requirements regarding industry, region, ticket size, performance and they consider exit options already at entry. The more complex a carve-out is, it may be easier for local buyers as they are familiar with the local environment, like legal or employment issues, in particular in loss making situations.

What follows is the marketing phase of the sales process – again customized to the special carve-out situation. A personal discussion of a summary marketing document with carefully selected buyers helps to identify potential acquirers with a true strong interest and to receive attractive indicative offers.
During the due diligence phase the focus is on the investor presentation and Q&A sessions. A well trained and highly motivated management is able to inspire bidders for the equity story and thus strengthen investor interest. Final negotiations should be held on the basis of seller prepared drafts of a sale and purchase contract and a transition service agreement, backed by a binding and fully financed offer.

The results of this procedure are:

- Significantly reduced cost due to clear definition of transaction perimeter and flexibility to adjust them
- A value maximizing structure for the sale of the carve-out entity, and
- Increased transaction certainty through close cooperation with potential buyers already at an early stage.

Confidentiality is key in M&A transactions: the higher the number of people involved, the greater is the risk of leaks. Given the potentially high number of people involved in carve-outs it is important to manage confidentiality and to establish a clear communication strategy, internally and externally.
Certain issues frequently occur at the sale of carve-out entities – but there are ways to overcome them

Price Gap
Principally nothing specific, but somewhat more complex as the earnings potential of the carve-out entity is often more difficult to assess because it does not have a history as stand alone business. The two basic tools to come to an agreement are earn out structures and vendor loans. Earn out arrangements make the price dependent on earnings, achieved in the future and the challenge for the seller is to exclude negative earnings impacts caused by the acquirer. A vendor loan can help, if deal financing is an issue for the buyer. The seller grants a loan to the buyer and the proceeds immediately flow back to him as a higher purchase price. The loan itself will be repaid from future cash flows of the carve-out entity.

Seller remains as Customer
If the seller remains as a major customer or sales channel of the carve-out entity its value may depend on the continuation of this relationship. In such a situation a “reverse earn out” may help. Both parties agree on certain products and volumes the seller has to purchase from the carve-out entity over a certain period of time at agreed upon terms. If targets were not achieved, the seller has to repay a portion of the sales price.

Supply of materials and service
If the seller supplies the carve-out entity with certain products and services a clear concept is required for full separation. This should clearly define products and services, volumes, terms and a time frame until the carve-out entity has reached full independence from its former parent.

Deal Financing
Sellers should carefully review the financial strength of potential buyers in advance and select only those buyers who can pay for the acquisition. The selection of supporting banks depends very much on the nature and size of the carve-out entity’s business. Proof of financing capacity may even include the check of loan agreements.

Non Competition
As the seller often is a larger corporate with financial muscles compared to a smaller acquirer the buyer wants to protect himself and exclude the seller from entering the same business again. Non competition clauses can help only to a certain extend because they are limited by non competition law. In the end the buyer must take the risk and be confident that the seller keeps on regarding the carve-out entity’s business as non core.
EquityGate advised Econocom on the sale of a non-core underperforming business unit and establishment of a long-term partnership

- **Client / Task**
  - The unit was part of the France based IT service group Econocom with total revenues of € 2bn +
  - Before the sale the unit had faced severe difficulties and thus strongly declining revenues
  - Due to such development the unit had become subcritical to the owner and the decision was taken to sell

- **Solution / process:**
  - EquityGate’s tasks was to find a better owner who at the same time
    - would be able to handle the still difficult situation
    - had a strong market reputation to serve the unit’s blue chip clients
    - was prepared to still pay a decent price to the seller
    - would represent an attractive employer for both the management and the employees
  - Together with the local management EquityGate prepared a business plan and marketing documents in order to address a selected number of strategic buyers
  - EquityGate assisted all parties who initially showed interest to fully understand the business and the intrinsic value going forward

- **Results:**
  - Finally EquityGate identified a strategic buyer, who met all the above criteria
  - In addition to the transaction the seller and the buyer agreed to establish a long term partnership which is expected to lead to significant incremental revenues for both parties

“I am delighted that Econocom Managed Services and its employees will belong to one of the leading IT Services companies in the German speaking region. This transaction marks the second successfully closed transaction for us in the IT Services sector within the last 24 months. With 80 closed transactions in the ICT sector over the last five years, EquityGate and its international partners are well placed to offer advice in this sector.”

Oliver Lennertz,
Managing Director
EquityGate Advisors
Selected transactions

**econocom**
- sold Econocom Managed Services to **TECGroup**
  - EquityGate acted as exclusive financial advisor to the seller

**T·Systems**
- sold its French Systems Integration activity to **NOVIA**
  - EquityGate acted as exclusive financial advisor to the seller

**AIR LIQUIDE**
- sold **Cryotherm** to its management and private investors
  - EquityGate acted as exclusive financial advisor to the seller

**CURRENTA**
- a joint venture of **Bayer** and **LANDESK**
  - EquityGate acted as advisor in relation to potential carve-out / sale of **TECTRION**

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About EquityGate Advisors

EquityGate Advisors is a private independent financial advisory boutique. For the last ten years corporate clients have been relying on EquityGate's unbiased and quality financial advice to make their complex and mission critical financing, financial restructuring and mergers and acquisitions transactions work.

Our clients benefit from our sector insight, our strong local relationships and international presence through the Mergers Alliance Partnership. 300 financial advisors across Asia, Europe and the Americas offer access to strategic and financial investors, uniform execution standards and top-notch resources. Over 50 successful transactions in Germany/South-Eastern Europe over the last 48 months and over 120 successful transactions globally only last year demonstrate our ability to get your deals done.

EquityGate Advisors have received several awards for their work such as: “Best of Consulting” (WirtschaftsWoche), “Corporate Finance Boutique Firm Germany” (Finance Monthly Magazine), “European Boutique Investment Bank” and “European Financing Restructuring Advisor” (M&A Advisor International Awards), “Equity Financing of the Year Europe” (M&A Advisor Awards), “Top 10 Debt Advisors” (FINANCE magazine).

www.equitygate.com

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