

Breaking up is hard to do

Selling non-core assets in a downturn:
Agility is key



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Selling non-core assets in a downturn: Agility is key

As seen through the eyes of the following roundtable participants:

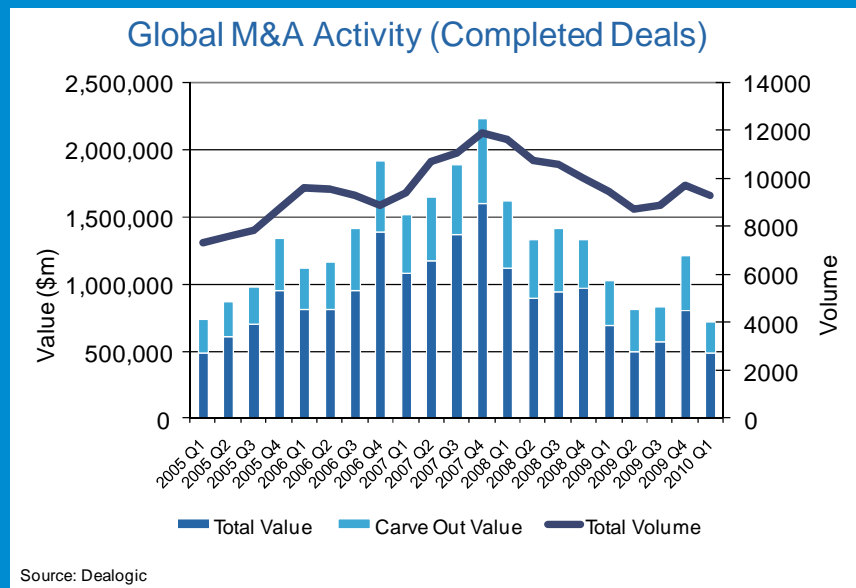
- Abel Martins Alexandre, Rio Tinto
- Caroline Hoare, Anglo American
- Colin Musgrave, BAE Systems
- Connie Kolb, Schlumberger
- David Batters, BAE Systems
- Duncan Wanblad, Anglo American
- Gordon McNair, London Stock Exchange
- Isabelle Jenkins, acting CIO Lehman Brothers (in administration)
- James Lawrence, HSBC
- Keith Taylor, Amcor
- Kevin Tallett, EDF
- Matt Mullan, BAE Systems
- Peter Hofman, EDF
- Philipp Liebfried, BAE
- Sascha Bucher, Roche
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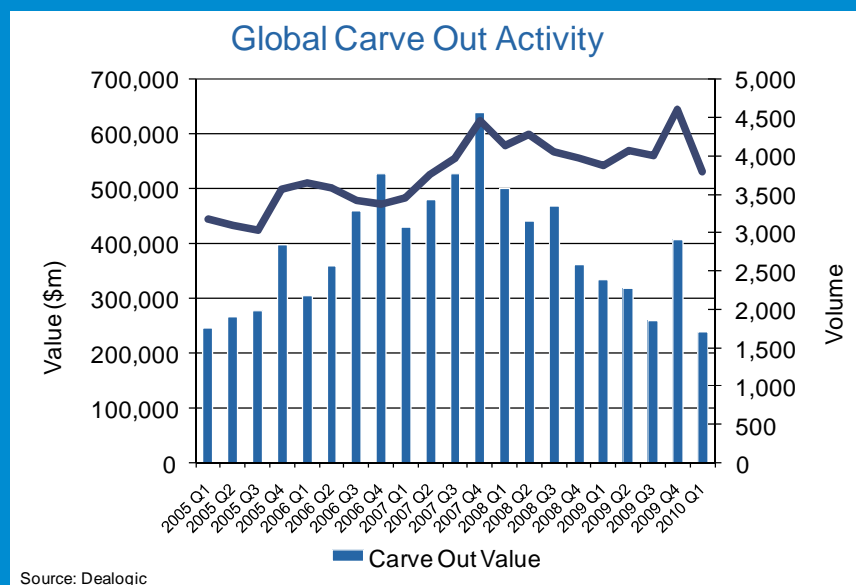
M&A conditions remain challenging, but activity is picking up

- The deal 'frenzy' at the end of 2007 is a distant memory
- However increasing activity during Q2 2010



The volume of carve out transactions remains buoyant, but the average deal size is falling

- The value of carve out deals has declined at a relatively faster rate than volume
- The sub-separation of assets into smaller parts is becoming more common

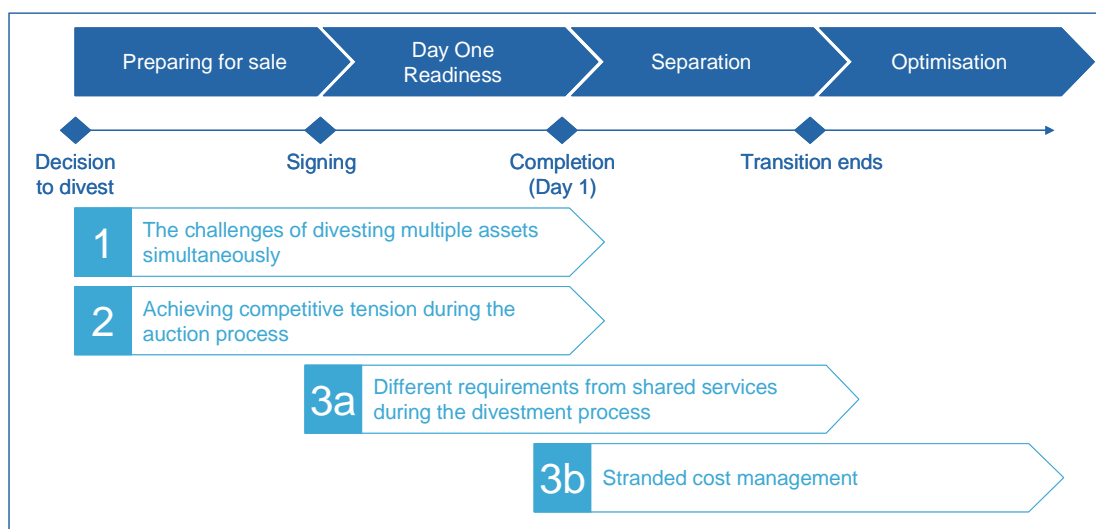


Introduction

The diversification strategies popular in the first half of the last decade, have been replaced by pressure from both shareholders and regulators to focus on core competencies and retrieve cash. Whilst overall M&A activity has taken a nose dive since the lofty heights at the end of 2007 (value has fallen by 70%), the level of 'Carve Out' transactions, involving the divestment of one or more non core asset, has remained relatively buoyant. Interestingly, the value of Carve Out transactions has fallen by over 60%, however the volume has fallen by only 15%. This reinforces our recent experience that sellers frequently need to break up assets that they might once have sold as a whole, into smaller parts, in order to overcome limited bidder leverage. Bidders are also more frequently joining forces in consortium arrangements, particularly for larger deals and are more cautious now than ever before.

For sellers to achieve divestments and maximise deal value, a different, more agile approach is required in this climate. Deal outcomes are more unpredictable than ever before and sellers therefore need to predict likely sale scenarios, including the types of bidders and their requirements and plan accordingly.

To provide business leaders opportunities to share best practices and learn from the obstacles and pitfalls their peers encounter in the divestment process, PricewaterhouseCoopers (PwC) facilitated a roundtable discussion. Composed primarily of M&A / Corporate Development leaders, participants shared their perspectives and experiences related to divestments, in particular related to the topics highlighted below. These areas of debate were also reflected upon in a recent Acquisitions Monthly article contributed by PwC Partner Hein Marais titled *"Return on divestment: selling non-core assets in a downturn."*



We hope you will find this summary of our roundtable participants' conversations both informative and enlightening. We think it provides a practical perspective to some of the challenges and potential solutions facing M&A professionals in the current climate.

Thank you to all who added to the debate and shared their experiences.

John Dowty
Global leader, Delivering Deal Value

Hein Marais
Divestiture leader

What creates
complexity in Carve
Out transactions?

Key considerations

- One off and ongoing costs to replace shared process, systems and people.
- 'Hard stop effect' - the Transitional Service Agreement has a termination date and therefore the separation, unlike an integration, can't be stopped halfway, requiring a higher focus on separation planning.
- People issues:
 - Some employees may naturally resist new ownership and leaving a parent company they have been part of for an extended period;
 - Being part of a non-core business and unsure if you have a role at the end of the transaction clearly impacts motivation; and
 - The principle of retention payments is relatively straight forward, however, identifying key employees who hold critical legacy knowledge, for example IT expertise in a heavily customised application, is more challenging.
- Duplication of costs - although the standalone entity is usually supported by the Parent during a transition period, management of the asset to be divested ('target management'), tend to build their own internal capabilities, duplicating the central function costs during migration.
- Diverging priorities appear between the seller who tries to maximise the value from the asset disposal and the target management who have a tendency to 'sand bag' their standalone cost assumptions in order to secure upsides when under new ownership.
- "Camps" are formed early in the auction process and the trust relationship between Group and target management can become undermined.
- A key challenge to any divestment process, is balancing business as usual and separation planning activity and protecting the core business whilst maximising deal proceeds.

Private Equity perspective

Key considerations

- Risk & Opportunities
 - Planning – For Private Equity (PE) to invest in a business, they want to understand the strategic rationale and be comfortable that the implications of the separation are well understood and a clear separation plan is defined. Seller should focus on the separation implications before thinking about putting an asset on the market.
 - Ownership of the business plan - PE need to have confidence in the target management team that they can deliver the business plan, including a smooth separation.
 - Upside - PE will always assume that there is an upside in the standalone business. This upside can come from many areas, for example corporate tax optimisation, lower cost of governance, or procurement by a greater focus on cost savings to offset any loss of scale benefits. Don't assume that diseconomies of scale will always arise following separation.
- Technology
 - Usually the most complicated and costly separation area, which tends to concern PE the most. Recent financial services divestments where PE are serious bidders and technology is a key business driver, reinforce this view.
 - PE rely heavily on robust financial and in particular, cash reporting and therefore need to be comfortable that the standalone entity will be able to deliver this information.
 - PE usually assume there is an upside in the IT costs of the standalone business, on the basis that the standalone entity can operate effectively with cheaper and more flexible systems that are fit for purpose, compared with systems used by larger enterprises.
- Migration
 - PE will be focused to complete the migration as fast as possible, in order to stabilise and take control of the business.
 - One off costs and the costs of transitional services usually represent an upside opportunity for PE. Sellers therefore need to be very clear on the structure of the TSA (transitional service agreement) costs and associated migration activities before entering deal negotiation with PE bidders.

Top Ten Seller Concerns*

* As viewed by participants

Overview

- A short survey was conducted among the roundtable participants to better understand their key concerns when divesting assets. Participants were asked to rank a pre-defined list of seller concerns from one to ten and were given the opportunity to specify one concern not included in the list (shown as 'other' in the table below). We view the survey results as a reasonably accurate indicator of the challenges associated with divesting assets and the results echo our own experiences from supporting clients prepare for Carve Out transactions.
- Overall, the results highlight that no single area of concern stands out as being significantly more important than the rest, as demonstrated by the spread of the relative weightings being quite close (4%-14%). Not surprisingly, given that 80% of the roundtable participants were M&A / Corporate Development Executives, the top 3 concerns go to the heart of deal value and protection of the core business. More surprisingly though, is the high priority given to the loss of key employees, which does not normally directly affect deal value, but can de-rail a transaction if bidders believe the loss will undermine the ability of the target entity to achieve its business plan (e.g. the loss of a critical sales or R&D employee).
- The management of stranded costs* and meeting TSA obligations was given a relatively low priority. In our experience, the financial impact to the seller can be material if stranded costs are not mitigated adequately (although it does not impact deal value per se). Similarly, if the seller does not manage its transitional service obligations (and requirements) effectively, the disruption to the core business can be significant. 'Other' concerns specified by participants included maintaining control of the disposal process, value leakage post closing through the SPA mechanism and the accuracy of seller's due diligence work.
- We refer to each of the seller concerns in more detail in the remainder of this document.

	Weighting
1= Not able to keep competitive tension	14%
1= Disruption of core business	14%
3 Leaving value on the table	13%
4 Losing key employees and resulting people issues	12%
5 Surprises late in the auction	11%
6 Last minute price reductions	10%
7 The extent of stranded costs*	9%
8 Not meeting TSA and migration support obligations	7%
9 Other	6%
10 Not knowing whether the process is on track	4%
Total	100%

*Stranded costs are the people, processes and property that will no longer be required by the seller at the end of the TSA period

The challenges of divesting in the current market

“With the benefit of hindsight, we should have enacted on our desire to keep options open and done more work in sub-separation and had a better estimate of the sub-separation cost”

“Management don’t necessarily work on the fit for purpose scenario, they certainly want a Rolls Royce”

“It is very important to understand how they (the different bidders) will approach the (separation) plan and costs in the negotiations”

As seen through the eyes of the participants...

- There is a tendency for seller's to adopt the simplest separation planning approach, assuming the simplest sale scenario (i.e. one buyer, one whole asset). Not surprisingly, both Group and target management, tend to initially resist the more complex planning scenario, which might assume breaking up the asset further (sub-separations);
 - The perceived more complex sub-separation sale scenarios may not be as costly or disruptive as first assumed. Any initial, high level cost assessment should be treated with caution and validated by target management; and
 - There is often misalignment between Group's and target management's view of one off costs.
- "Certainty of the bidder universe" should dictate the approach to separation planning and degree of flexibility built into the plans. For example, if PE (and trade with no existing infrastructure) are serious contenders, a fully standalone cost scenario, assuming no existing infrastructure, should be planned for and costed.
- It is important to understand how PE may approach the separation plan and costs differently from trade bidders. PE are likely to:
 - Require significantly more detailed information to enable them to gain comfort on target management's standalone plans (be "data hungry");
 - View high standalone costs as an opportunity to make savings to management's plans; and
 - Demand a broader scope and higher service levels for transitional services.
- Keeping management on board during a protracted, multi-asset disposal process, is critical to the success of the separation to all parties involved:
 - Keep target management sufficiently informed of deal progress to empower them, whilst retaining control of the process. They need to feel that they have a future;
 - Group management should invest time in understanding the business to be divested and the stakes involved, including participation in the due diligence process for example; and
 - Incentives can be a 'double edged sword' if the desired objectives are in conflict with the buyer.

PwC's point of view

- The absence of sufficient leverage available to buyers means that non core assets often need to be presented for sale with the built-in option of sub-separating into two or more smaller units, which has happened a number of times in recent divestments.
- The key to success is to maintain maximum flexibility by planning for likely outcomes. This is not necessarily the simplest separation approach and one size does not fit all, with regard to PE versus trade bidder requirements.
- Adopting a simple planning approach initially, will at best only defer the time and cost required, but may delay the sale and cause loss of momentum. We have worked for bidders that have walked away from deals recently when presented with inadequate separation plans.
- Adopting a more modular and agile, scenario based, planning approach, will enable the seller to adapt to frequently changing bidder requirements.
- Anticipate an 'us and them' culture between Group and target management, particularly as a preferred bidder emerges. Mitigate by identifying and incentivising key employees.

Achieving competitive tension during the auction process

“We wanted to be able to look in the eyes of the bidders and say we have this plan and we think it is doable”

“We wanted to be authoritative enough to show that we had started to implement”

“We wanted to do just enough to keep both avenues open”

As seen through the eyes of the participants...

- The development of a separation plan lays the foundation for a standalone business plan. Management should adopt the mind set of PE when developing the plan to enable a level playing field. The plan should detail:
 - What the standalone operations will look like;
 - How they will be created;
 - The level of investment needed to separate; and
 - The ongoing cost / revenue impact.
- IT is usually the key driver of both separation cost and time.
- Target management will be motivated to develop a robust plan and impress the potential purchaser, particularly PE, but Group need to guide and challenge management.
- The decision to invest in the early execution of part of the separation plan should consider:
 - The level of bidder interest / certainty of sale;
 - The complexity of the separation;
 - The need to do just enough to engage bidders and present a “credible plan,” without over investing too soon; and
 - ‘Isolation costs’ related to activities required regardless of the bidder (e.g. data separation), versus ‘separation costs’ which are bidder specific.
- The upsides of executing the plan early include demonstrating to trade bidders that PE are serious contenders and compressing the time line between signing and completion.
- Invest time before Day 1 defining detailed definitions of which parties are responsible for which separation costs. General principles are only the beginning.

PwC’s point of view

- Target management need to own the separation plans and be seen to own them by bidders, particularly PE, who are usually fully dependent on the existing team to implement these plans.
- The plans should reflect upside opportunities that PE can realistically achieve from the standalone business. Sellers often overlook this, with target management opting to replace services and infrastructure provided by the parent today on a like for like basis, rather than taking the more difficult path and defining an optimised standalone operating model.
- IT is usually the biggest barrier to execute the separation plan, but usually presents the most significant opportunity to right size the standalone operating model.
- In our experience, bidders do attribute value to robust plans that are well supported, particularly if management has taken the first steps to achieve the savings.
- Financing banks are paying more attention than ever before on management’s separation plans, due to the high perceived execution risk.

Different requirements from shared services during the divestment process and stranded cost implications

“The sub-separation required a regular scenario analysis to plan possible implications, requirements and risks”

“ We had regular TSA reviews with each buyer to ensure service performance is delivered, strong involvement of IT teams from both sides for isolation/separation coordination with transition implications”

“Obtain sign-off of the TSAs prior to signing when buyer demonstrate willingness to manage transition”

As seen through the eyes of the participants...

- Different parties have different priorities, which affect transition service provision:
 - Group objectives – maximise deal proceeds, get the deal done quickly, exit service obligations as soon as possible, minimise the impact of stranded costs;
 - Target management objectives – protect business as usual / minimise disruption;
 - PE objectives – maintain Group support for as long as possible, whilst minimising transition costs; and
 - Trade objectives – maintain Group support long enough to migrate onto existing infrastructure, whilst minimising transition costs.
- A central Service Delivery Manager plays a crucial role in managing transitional arrangements across multiple parties:
 - Provides a holistic view of issues and dependencies across all service areas;
 - Acts as a mediator across the various parties and their differing requirements; and
 - Ensures delivery of TSAs / migration requirements.
- Keep the governance structure simple and pragmatic. Utilise existing service level agreements where possible (don't re-invent the wheel).
- Don't overlook the impact of stranded costs to the retained business. Assign responsibility early in the planning process, in order to estimate the potential downside and develop mitigation plans.

PwC's point of view

- The provision of transitional and long term service arrangements becomes a lot more complex in a sub-separation environment. Often a third party is introduced (e.g. a PE fund), that will become the provider of key support services back to the seller or sister entity.
- The execution risk for sellers is significantly higher in this environment. Sellers need to fulfil service obligations to multiple parties (and buyers to other buyers), whilst meeting the requirements of their core business. Sellers should consider ring-fencing employees to protect their core business.
- Appropriate HR strategies are needed to keep and motivate employees, in roles that will end when transition services terminate. Paying retention bonuses to retain legacy knowledge (of core systems for example), is as important as rewarding performance.
- The extent of stranded costs is not usually a priority for the M&A team, as illustrated by its ranking as the seventh* most important concern of sellers, however it has represented tens of millions of pounds for some PwC clients. Don't let it fall through the cracks.

* Based on a survey among roundtable participants

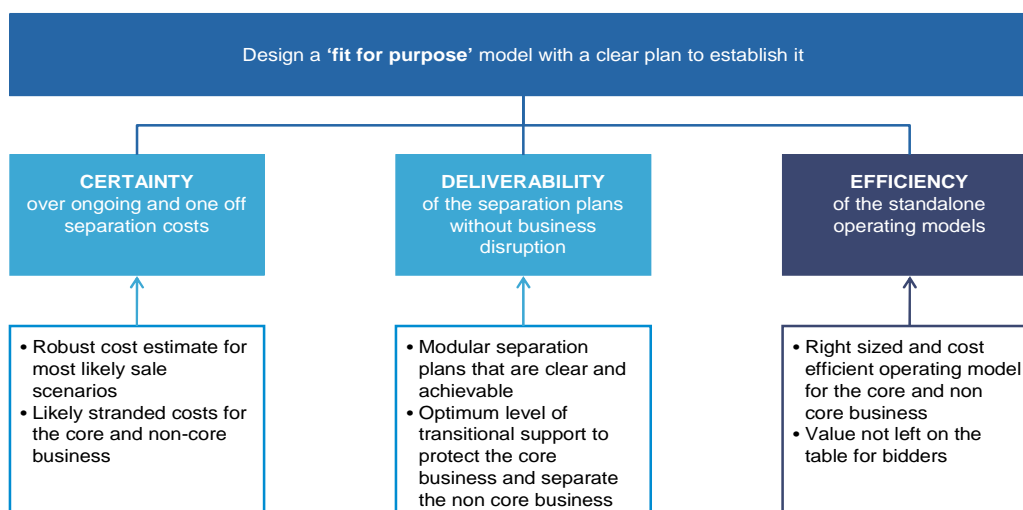
Key takeaways

Market trends

- Deal outcomes have become much less predictable.
- Entities being carved out have become smaller and more complex.
- The market demands more detailed analysis and implementation planning and the operational implications of divestment have become more severe, given an increasing focus on costs in the current climate.

Separation planning implications

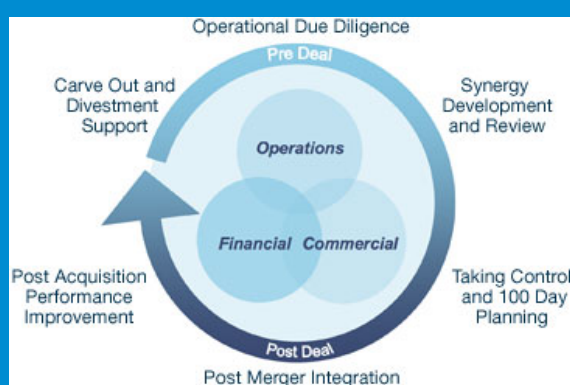
- A more robust and agile approach is needed to succeed. Upfront investment in robust separation plans, reflecting realistic sale scenarios, does pay off.
- Competitive tension needs to be created by the seller, to compensate for the current climate.
- M&A practitioners tend to focus less on the operational implications of divestitures, areas where value is typically lost.
- Value is left on the table when the standalone operating model is merely replicated, rather than developed to be fit for purpose. Use the separation as a catalyst to challenge the current operating norms.
 - Addressing ‘certainty’ over future costs and ‘deliverability’ of the separation plans protects deal value. Considering ‘efficiency’ of the standalone operating model creates value (see illustration below).
 - IT is a key driver of separation cost and complexity, but usually represents the greatest opportunity to right size the standalone entity.
- Stranded costs in the parent company, which were previously absorbed through growth in underlying activity levels, now need to be actively managed.
- Service delivery management is key to ensure that legal transitional service obligations are met and business disruption is minimised.



About PricewaterhouseCoopers' Delivering Deal Value group

The PricewaterhouseCoopers Delivering Deal Value (DDV) group consists of over five hundred specialists across Europe, the Americas, Asia Pacific, Africa and the Middle East. We assist corporate and private equity clients to deliver deal value, by addressing the operational aspects of transactions.

Corporate and private equity buyers/sellers need to quickly and effectively understand the main business drivers, as well as the key areas of upside opportunity to deliver deal value from transactions as quickly and efficiently as possible. Our dedicated deal team consists of industry, technical and IT experts, ensuring you have the best information and experience to maximise deal value through both pre and post deal phases.



Our Carve Out expertise can help you to achieve a successful outcome in the current challenging environment, where liquidity is restricted, relatively straight forward "one-on-one" strategic purchases are a rarity and the only certainty is that deal outcomes are unpredictable.

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