How did a private equity firm save nearly $5 million executing a carve-out of a $100 million retail operation? It didn’t look promising at the outset. When discussing potential strategies with an IT services provider, the provider proposed a nine-month implementation cycle to develop an industry-specific, customised IT platform for the new stand-alone company. Meanwhile, the firm would be paying $800,000 per month on the transition services agreement (TSA), or $7.2 million for the nine-month plan.

Instead, the firm decided to take a phased approach – it implemented baseline operational functionality such as order entry, receiving, shipping, purchasing, payables and financial reporting in 12 weeks, ended the TSA and then added custom functionality later. The cost of the 12-week implementation was $1.8 million, but they saved $4.8 million by shaving six months off the TSA.

Private equity firms executing carve-outs in the middle market have the same primary objective as with all their portfolio companies: optimise exit price within a limited timeframe. For carve-outs, that means removing dependency on the TSA as quickly as possible and positioning the stand-alone company for long-term success.

All too often, however, firms take an ‘all or nothing’ approach, with a flurry of activity starting midway through the exclusivity period to develop customised systems and infrastructure – a risky and expensive process. Firms often underestimate the cost and difficulty of executing the carve-out when negotiating deal terms and face an unpleasant surprise once they get to work. Then, each month spent developing and implementing appropriate systems is an additional month paying hundreds of thousands (and potentially millions) of dollars on the TSA.

To balance risk and practical considerations, private equity firms should instead take a three-phase approach to carve-out execution. Phase one begins early, before the letter of intent (LOI) and involves a quick, cost-efficient assessment to help gather more information that may impact deal terms. Phase two focuses on “blocking and tackling” post-close – using an industry template to get off the TSA while ensuring the company can continue running. Phase three starts post-TSA, and includes customising systems and implementing processes for long-term success.

Throughout the three phases, it’s critical to take a holistic view towards optimising value and understand the upstream and downstream intricacies of the deal from pre-LOI to post-TSA. While implementing systems and processes in phase two, make sure they can serve as a foundation for phase three and plan accordingly.

To ensure that carve-outs deliver shareholder value, GPs need to break free of transition services agreements as quickly as possible, write Dave Noonan, Tom Byrne and Bob Jacobson of McGladrey.
planning and start lining up contracts, all of which will ensure less time on the TSA and can help buyers negotiate a more favorable TSA in regards to personnel and other factors.

To set the right course for the carve-out, use the time before the LOI to start negotiating the TSA, as well as to articulate strategy changes for the new company. Once the LOI is signed and the TSA finalised, planning for the first “100 Days” can be initiated.

**PHASE TWO: REMOVE DEPENDENCY ON TSA POST-CLOSE**

Phase 2 is where implementation begins in earnest. This requires establishing a Project Management Office (PMO) and executing the ‘100-Day Plan’, all while focusing on items to get off the TSA – fast.

A management steering committee should provide strategic direction, define targets, align resources, help champion change, resolve issues and guide results. However, ineffective management teams can be an issue.

In McGladrey’s 2013 Private Equity Survey, an ineffective management team was the ranked as the most common reason for underperforming portfolio companies, with ineffective strategy or execution a close second.

Similarly, management capabilities and effective strategy and execution were given as the primary drivers of success (see left).

With carve-outs, there are two main concerns: first, the head of a $100 million division of a multi-billion dollar organisation may not make an effective leader of a stand-alone or platform company. Second, management may have difficulty changing their mindset about what the ‘right’ systems and processes are. For example, managers at a $130 million manufacturing division argued that forms and processes needed to be set up in a certain way – one that made sense when they were part of a huge global organisation, but was needlessly expensive and complex for the division alone.

A smaller internal workforce can also lead to internal control issues, including improper segregation of duties and inappropriate user/data access.

As such, removing dependency on the TSA fast often means investing in an outside provider that can provide experienced project leadership and work with management and the private equity firm to establish short- and long-term plans, facilitate and coordinate implementation, guide analytical priorities, allocate resources, monitor progress and ensure quality. This arrangement also allows management to focus on their core competencies and running the company.

In addition, structured incentives for meeting deadlines will share the benefits of getting off the TSA faster across the entire organisation, and can have a tremendous return on investment.

While more complex situations will require a longer timeframe, Phase 2 should typically be concluded in less than six months. Remember, the goal is to get off the TSA through ‘blocking and tackling’ tactics and disciplined project management to drive adherence. Don’t allow legacy employees to over-engineer the process.

The money saved by ending the TSA quickly can then be put to use in realising the value of the investment.

At the same time, it’s important to make plans for the future state of the business. There are numerous software packages and platforms aimed at middle market companies that can be implemented efficiently at a relatively low cost, and then customised as needed.

**PHASE THREE: OPTIMIZE FOR GROWTH POST-TSA**

Once the company is up and running on its own, it’s time to execute the future state plan developed in phase two. Implement, track and monitor master plan initiatives to achieve the strategic vision for the carve-out.

A 12- to 36-month performance improvement plan provides the necessary guidance and benchmarks for optimising value, but
implementing the plan often proves difficult. Respondents to McGladrey’s 2013 Private Equity Survey cite that management push-back is an issue, as is a lack of internal resources (see previous page).

When implementing information technology systems to optimise growth, consider cloud-based computing to avoid costly upfront infrastructure investments and to allow for scalability. Software-as-a-service (SaaS) will help to keep software applications up to date, potentially increasing exit price. Regardless of the approach, the company should have the necessary internal systems to measure results, avoiding another common roadblock to performance plan implementation.

Again, private equity firms must assess management capabilities and determine if outside help is required to ensure the right benchmarks are established, monitored and checked off in a timely fashion. One approach is to push accountability to managers but still offer suggestions and guidance, either through an operating partner or outside team, on how to increase efficiency and effectiveness.

CARVE-OUT PROJECT COMPONENTS

The earlier that private equity firms start the clock, the faster they can achieve success. Regardless of the timeline, carve-out execution projects have five core components:

- Project mobilisation
- Synergy and integration planning analysis
- Development of solutions and business case preparation
- Detailed design of implementation plan
- Implementation

Throughout the process, effective project management as well as communication and change enablement are a must. The critical elements of project management – managing risk, budget and time control, as well as scope and expectations – may overly burden internal team leaders who have other responsibilities. A PMO should be in place to provide overall transition structure and management, bring decisions and roadblocks to the steering committee, and oversee various project teams.

Education, communication and empowerment are all important transition agents to defusing pushback, and often require an outside resource that can serve as part of the transition team and as an advisory team to management, as well as assist with implementation.

To save time and effort, integrate project management as much as possible. Beyond technology, the carve-out may need some level of CFO advisory, process improvement support, financial transaction accounting, Risk Advisory Services (RAS) and other assistance.

INVESTING IN THE RIGHT OUTSIDE RESOURCES

A holistic approach to carve-out execution requires a depth of capability and capacity that private equity firms may not have on staff. Operating partners with brilliant strategic insights and process improvement experience may need help sorting through the details (like the amount of wiring needed to put in a new phone system) and providing the necessary level support to the internal management team, including the CFO.

Too many suppliers can lead to things falling through the cracks, whereas a single provider can think through the inter-dependencies of different items. For instance, a provider focused solely on implementing the technology platform may not consider whether the company needs fewer point-of-sale (POS) systems or warehouses following the carve-out; much less the potential risk and compliance issues involved. A provider focused on handling all of the carve-out needs, in contrast, will be proactive in streamlining wherever possible, addressing potential issues and communicating to all the relevant teams.

Private equity sponsors that are unable to dedicate their own resources throughout the carve-out should invest in an outside provider that offers a full suite of services and can coordinate internally, resulting in one point of contact for the entire process. Choose a provider that understands the nuances of carve-outs, as well as the private equity business model and general partners’ priorities.

CONCLUSION

A three-phase approach with a holistic view towards optimising value will help ensure the carve-out increases shareholder value. An early start, an appropriate degree of up-front investment and the right project management team will prevent post-close surprises, reduce risk, cut TSA costs and allow for more support to the areas instrumental to the company’s long-term success.

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