The last year has seen a number of high-profile corporate carve-outs come to market. In a competitive buyout industry, private equity firms have been eager acquirers of these unloved assets.

TOUGH LOVE

By *Madeleine Farman*

Corporates are increasingly eager to offload unwanted subsidiaries, and private equity firms have been more than willing to give them a helping hand.

According to an Aurelius report released earlier this year, which polled more than 200 corporate and adviser contacts, 51 per cent of respondents predicted that the volume of companies looking to divest European assets would be higher this year than last. Around two-thirds of respondents also believed corporates' refocus on core operations was a key driver of disposal activity.

The growing interest in the opportunities that carve-outs can offer comes as the market anticipates the completion of heavyweight deals, such as consumer goods conglomerate Unilever's £6.5bn sale of its spreads business and Dutch paint maker Akzo Nobel's spin-off of its €10bn chemicals division. Biopharmaceutical company Pfizer, meanwhile, is mulling a sale of its consumer healthcare unit which, according to reports, could fetch up to $15bn. Reckitt Benckiser has already offloaded its food business, selling to to US spices and seasoning producer McCormick & Company in July for $4.2bn.

As businesses look to spin off their non-core assets, the potential for private equity is considerable. Carve-out deals, however, remain among the most complex to execute.

Slimming down

The majority of people *Real Deals* spoke to for this piece acknowledged an uptick in the number of carve-outs they had seen in 2017, and there is a sense that activity is likely to continue to climb.

Although there are a number of reasons why spin-offs are considered by corporates, one reason given for the recent increase was a refocus on value by shareholders following relatively stable growth environments since the global financial crisis.

"Shareholders are asking: 'Where are we getting our money from? How are you going to pay us more? Are you bloated, having spent five, ten years buying companies?,'" says one London-based private equity lawyer. "All these corporates are looking at themselves and asking: 'Is this increasing our business?' If you're Reckitt Benkiser, you're thinking: 'Should I be doing food as well as all this other stuff?' Unilever's asking itself the same question."

Alongside its traditional corporate base, activist shareholders are also playing their part in facilitating potential spin-offs by forcing corporates to think differently about their businesses.

"Activist shareholders are definitely agitating and creating a whole lot more. It's become a more established feature. The corporate would probably just like to carry on growing nicely and not have to sell stuff. Most executives get famous for buying businesses and for being builders of businesses. You don't get quite as famous for shrinking businesses," says Tristan Nagler, managing director at special situations firm Aurelius.

Current shareholder pressure, however, looks like it is starting to change attitudes. A report issued by Bain & Company in June studied 2,100 public companies and found those engaging in focused divestment outperform those that do not by around 15 per cent over a ten-year period, when measured as part of total shareholder return. Those corporates with repeatable M&A models outperform inactive companies by nearly 40 per cent over a ten-year period and generate more than twice the sales and profit growth.

But not all situations provide corporates with the opportunity of being on the front foot. Another trigger is a profit warning, which may lead to a change in management. A fast way to show shareholders that you are turning around a business is by spinning off a non-core asset.

Regardless of the number of big name corporate spin-offs in 2017, much of the evidence of their prevalence is anecdotal and there are some that argue we are yet to see a significant number beyond larger-cap deals.

Humatica managing partner Andros Payne says there have not been as many carve-out deals this year as some would have predicted. This does not mean, however, that we won't see the number of disposals rise. "Right now, the economic environment is very benign. There's a huge amount of money around, and it's also in corporates. The pressure to carve out, to focus, is not really there. When the market turns we're going to see a lot more being carved out," he says.

Not your plain vanilla M&A

Carve-out deals are suited to private equity – these undermanaged and often under-loved parts of larger corporates have operational potential, giving buyout firms a significant chance to transform the business with the prospect of a sizeable return.

Due to the complicated nature of defining and selling a carve-out deal, corporates may slim down the auction process to find an investor with experience that they can work with. One adviser says they often see these deals "become a one bidder show very quickly".

But the potential rewards that entice private equity at the outset do come with the premise of complexity after the deal is finalised. Many warn that firms need to know exactly what they're getting into. "Completing a corporate carve-out is not straightforward, it's not always plain vanilla M&A," Nagler observes. "You can't as easily encapsulate a corporate spin-off asset in a nice, glossy disposal process."

From the start, private equity may not have a set of organised, clean financials when considering the acquisition of a carve-out. It can often be difficult to value that part of the business which may have been accounted with, or relied heavily upon, the reporting of the parent company.

One lawyer warns that private equity will have to get its head around how it will value that company, measure the legal risk and consider how transformational arrangements will be mechanised going forward.

Carve-out deals could also become more expensive for buyout firms. Payne argues that corporates have become more sophisticated through the sales process.

51%

of corporates and advisers polled by Aurelius predict that the number of corporates seeking to divest assets will increase

$4.2bn

the value of Reckitt Benkiser's food division, which was spun off earlier this year

“Corporates have been watching private equity buy an asset for a low valuation and then in three to five years sell it at 2x to 3x return.

“They’ve got smarter as well and are asking why they need to give this 2x to 3x return to someone else. If I don’t need the cash immediately and I’m able to focus enough on these assets, can we not grow the value and sell it to an industry buyer that’s willing to pay a premium based on the operational synergies that are available?” he says.

When it comes to showing private equity’s strength and completing a carve-out successfully, Nagler says it’s important to have either strong external advisers or operational bench strength. “You do need a lot of operational engagement. It’s not enough to just have an investment team which does the deal and moves on. You do also need operational resources to understand the operational linkages between the seller and the business that’s being sold.”

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The break up

After the acquisition of a carve-out comes its transformation into a standalone business, or its integration into another portfolio company. It’s a process that is ridden with an array of issues that come with its legacy as a non-core asset.

A common example of issues new owners face is unbundling and creating new IT systems. Beyond separating the divested company away from its parent’s infrastructure, Payne says dealing with fragmented legacy IT systems to set up a new, standalone business may require longer term capital requirements from private equity. “The people who made and designed the systems may not even be there any more. I have seen cases where the risk is truly underestimated because the systems are underlying the way people work and drive cost. In a way, the underlying hardwired systems prevent the necessary cost-reductions and process improvements needed to be able to compete effectively.”

When it comes to talent in the company, a cohesive team may have also been overlooked by a corporate whose focus was on its core asset. “It’s non-core so it doesn’t get the most attention and the best talent in the parent company,” Payne says. “In the selling company, it’s not where people really want to make their careers, so often the journey that the private equity firm wants to take that carve-out on is not one that the management is capable of executing.”

On a larger scale, a future relationship with a parent company may be unavoidable. Due to their previous relationships, some carve-outs may be tied to their former corporate owner in ways that underline the success of its business. A spin-out may still hold significant trading relationships with its former company and rely on its client base. In other scenarios, divested groups may even keep the name of their former parent and act as an international subsidiary.

“With these deals there’s often a lingering relationship that is sometimes as simple as IT but often is hugely more complex,” Nagler says. “The relationships often are transitional, but sometimes they don’t transition off: it can be ongoing supplier and buy-side relationships with the seller, plus some service relationships.”

But regardless of this complexity, if entered into with a rigorous approach and willingness to spend the capital that the business needs, there are diamonds in the rough for private equity to unearth.

“Private equity can do a lot with a carve-out because often these are undermanaged parts of companies, and that undermanaged element is exactly the synergy potential,” Payne says. “It’s not necessarily a negative thing to have an asset which requires a lot of work. Provided you understand what work needs to be done, you price that in properly, and you’re able to undertake that work at pace afterwards, it’s actually a great thing.” ●