KEYNOTE INTERVIEW

Carve-outs continue to fly


As corporates face pressure to divest non-core assets, private equity firms remain willing and attractive buyers, say Baker McKenzie partners Steven Canner and Michael Fieweger

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Q Carve-outs were a growing theme for private equity in 2021. What activity have you seen in this space and what is driving sponsor appetite?

Steven Canner: Corporate America, and indeed corporates globally, will engage in carve-outs from time to time to enhance stockholder value and shed non-core businesses competing for capital. Whether driven by previous consolidation activity bringing in assets corollary to the main business, management transition or changing consumer demand, businesses cannot tolerate resources and money being devoted to assets that are not key.

The pressure on companies to perform better each quarter coupled with the challenges posed by inflationary trends and the possibility of rising interest rates, will likely result in companies focusing on their core business and divestitures of other operations.

Michael Fieweger: There are myriad reasons why corporations carve out assets, and many different ways of doing so, including spin-offs and IPOs. Corporations constantly look at their business and assets to see if they are aligned with their core business. Some assets are divested if they are not aligned with the core business or produce returns on capital which are not justified given the corporation's stock price.

Alternatively, high-performing assets that are not valued in their current form may be divested to unlock additional value. We have seen retailers selling their internet businesses, for example, because those are more valuable if sold rather than held.

There is also the need to deleverage – a lot of companies levered up during covid and now need to lever back down. That is going to be a theme in 2022, particularly in capital-intensive industries like automotive, energy and chemicals.

With the amount of cash available on the buy side, with firms paying high valuations, this makes it quicker and easier than ever to divest assets, and it makes carve-outs to private equity firms highly attractive.

Q What is behind the number of carve-out opportunities coming to market, and why might private equity buyers be attractive to corporates?

MF: These deals offer financial sponsors an opportunity to work constructively with a seller to structure a transaction and to identify and pull assets out, rather than just bidding in another auction process. In an extremely competitive M&A market, financial sponsors are looking to uncover and create dealflow and our clients are spending a significant amount of time in their chosen industries talking to large players about assets that do not necessarily fit. Size matters too. A lot of funds are now so large that they need large multi-jurisdictional carve-outs to deploy a significant amount of capital and create global businesses.

From the seller's point of view, the intrusive nature of a carve-out transaction means that a seller is more likely to prefer working through the detailed diligence, separation planning and ongoing transition support with a private equity sponsor than with a competitor. A seller does not want a competitor coming in and doing detailed due diligence on part of its business, and it does not want them raising antitrust concerns as potential buyers. Private equity sponsors also tend to provide good homes for carve-out assets as they can take an orphan asset, stand it on its own two feet, give it attention, capital, and management incentives to drive growth.

SC: The private equity fund can be viewed as a solution provider. The fund is most likely a non-competitor that will use proprietary information only for the benefit of the business to be acquired. The fund usually has managers with enormous amounts of grey matter to do the financial engineering and create the right platform for the spun-out business. After the deal, when the new company seeks to expand its relationships, there are capital resources available for future investment to grow the business in the right way. It can be a very elegant partnership.

Q What are the key challenges of identifying carve-out targets and conducting due diligence?

SC: The hardest issues surround the identification of the business, quarantining it, and knowing what needs to come with it. Leaving behind something key or dividing an asset up in the wrong way can be detrimental to the new business. Due diligence is critical.

Dealing with compliance issues when you spin out a business with operations in 70-odd countries is going to be a challenge, as is managing the

Q Where are the execution challenges, including in relation to regulatory and antitrust issues?

SC: These deals are usually global so there are myriad laws in different jurisdictions that apply and need to be studied. Every country that the business is operating in should be explored from an antitrust perspective. You need to start from the ground up and it is a painstakingly granular process.

You need an entity in many of the jurisdictions where the new business will reside and then you deal with migrating the assets and people, as well as looking at all the applicable regulations and laws.

MF: Private equity buyers do not tend to raise many competition law concerns, but both sides need to understand the filing regimes and their timings, which vary greatly around the world. A Brazilian or Chinese review, for example, can have a significant impact on the deal timetable.

Then there are foreign investment rules, which are increasingly impacting private equity investment. The definition of 'national security' is being expanded to implement economic protectionist policies. Private equity is not immune to these trends and in certain markets is seen as a threat, whether real or not – to local employment. As the people aspect tends to be the most sensitive point in carve-out transactions, sponsors will need to work closely with sellers and with the target management and employees to ensure that all parties are aligned with respect to the business plan for the carved out assets.

migration of the workforce and dealing with the labour issues that come up in various countries. Also, if there are any privacy or intellectual property-related issues, you need to make sure that everything comes over not only with the necessary licenses and IP but also with the right policies in place to operate efficiently and legally in each market.

Ultimately, private equity firms buy companies to sell in the future, so they want to minimise entanglements with the selling corporation – simplicity is key. There will be a level of transition, but the buyer will want that to be short-lived.

MF: It is difficult to find the perimeter of a deal and there is a lot of negotiation to identify that perimeter. A buyer must constantly appraise the perimeter throughout the process because, invariably, someone on the sell side will have a different view as to what assets, people and support are part of the business being carved out.

You cannot take a high-level approach to this, sponsors have to drill down jurisdiction-by-jurisdiction into what assets, what people, what facilities and what IP is coming. That is in part why these deals can take so long to complete. The more that a private equity firm can get ahead of a transaction and do it outside an auction, the more time there is to get it right.

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>
> **STEVEN CANNER**

Q How can managers maximise value-creation opportunities, given the amount of work required to create new, independent companies?

SC: Growing the business is typically the biggest focus, particularly if it was a captive supplier to the parent company and now has the potential to build a sales force and cater to previous competitors. It is about investing in the business in the right way to grow it, making sure management is incentivised and that the investment thesis can be realised.

Day one is usually about stabilisation, but private equity firms rarely move slowly so there will be a push to implement changes while making sure the business carries on operating smoothly.

MF: The growth plan obviously depends on the asset, but it should be able to grow on its own more efficiently than in its current home. Often growth comes from building an independent market presence and may involve investment in acquisitions or people. If it is a regional business, it could be about going global. It can also involve providing capital to enable the business to achieve its objectives – another reason why private equity firms are such attractive buyers.

Q Where do you expect to see the most carve-out activity in 2022 and beyond?

MF: There are two areas that look particularly ripe. The first is older, capital-intensive businesses that are refocusing their business models, with a prime example being automotive and the move to electric vehicles. There are a lot of assets out there that are productive and non-core, and the same is true in sectors such as chemicals and energy. When combined with the rising cost of funds, that is going to put more assets on the line.

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>
> **MICHAEL FIEWEGER**

The second is areas like technology, healthcare and healthcare services where there are divisions that are not being given appropriate valuations within their existing businesses. There are also more covid-impacted markets, such as entertainment, where we would expect some conglomerates to spin out parts of their businesses as they emerge from the pandemic.

Wherever you see large strategic M&A you can also expect to see carve-outs shortly afterwards as assets need divesting, sometimes due to competition law concerns. Private equity sponsors are well positioned to acquire these assets in a manner that does not raise further regulatory concerns.

SC: Activists strike all the time and public companies are victims or beneficiaries. A lot of the time the reaction requires close investigation of the business, and often results in non-core assets being sold.

There are also companies that are vulnerable to rising interest rates, particularly debt-laden companies or those in the financial services industry that may need to raise cash. All in all, we see a lot of reasons to anticipate another busy year for carve-outs. ■