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DDV Thought Leadership

Carve-outs in a Volatile Market Environment

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Preface

Global mergers and acquisitions (M&A) activity has been steadily increasing in recent years. Looking back, we have seen various trends and developments in our clients' approach to delivering transactions. The era of steady growth, prosperous margins and relatively little public attention allowed for a primarily pragmatic and opportunity-driven approach. Prompted by the decline in global growth rates, margin pressure across many industries, increased market volatility and uncertainty, and the rise of shareholder activism, leading corporates have begun to professionalize and adapt their approach towards M&A as a strategic tool over recent years.

With our new Delivering Deal Value (DDV) Thought Leadership series, we want to shed light on these new trends and approaches to corporate M&A and transaction execution, and share our broad range of experiences in advising top-tier corporate clients in successfully planning and executing transactions with practitioners around the globe. Our goal is to enter into a fruitful and lively exchange, build M&A communities and prepare the ground for the establishment of best-practice to drive and enhance M&A efforts. "Carve-outs in a Volatile Market Environment" marks the start of this Thought Leadership series. We hope you have an enjoyable read and stay tuned for more!

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Table of Contents

Table of Figures

A Carve-outs and portfolio management in a volatile world

1 Dynamic and volatile corporate environment breeds Carve-outs

The macroeconomic corporate environment is becoming ever more complex and dynamic on an account of insecure and ambiguous future prospects, such as volatile global trade relations (e.g. US/China, Brexit), uncertainty regarding continuous availability of cheap funding, and often stagnating growth. Furthermore, activist investors mercilessly aim for maximization of shareholder value when they detect unrealized value potential.

Market conditions have been extraordinarily favorable to sellers over the last years. Cheap and plentiful financing opportunities for buyers have led to high demand in corporate assets and ever-increasing EBITDA multiples. The rise of Private Equity (PE) firms over recent years has also played a role, making the sale processes nicely competitive for sellers.

Yet with intensifying concerns and warnings of an impending economic downturn with dusty and ambiguous planning parameters, the tide is about to turn and sellers prepare to reduce the overall risk profile, broaden the applied risk funnel in corporate planning, and increase flexibility and agility for possible transactions.

Besides that, technological trends such as Artificial Intelligence (AI), Big Data and digitalized product offerings increase the pressure on companies to come up with or acquire groundbreaking technological innovations. To enable these innovations, companies need to scrutinize where they invest their capital and what they consider “core” to maximize returns and stand out from the competition.

All these factors have led to a Carve-out frenzy over recent years and Carve-outs have been gaining more relevance as a strategic tool for optimizing the corporate portfolio and for reducing the overall risk profile by deleveraging or collecting “dry powder” for making strategic moves when the opportunity arises.

Gaining a clear and detailed understanding of the corporate portfolio and how it fits with the operationalized strategic goals, as well as the complexity of underlying operational entanglement, is paramount in this context and defines successful divestors with a clear focus on value creation.

2 Recent Carve-out examples and their rationale

Recent examples demonstrate how leading global companies make repeated use of Carve-outs as a strategic tool for improving their competitive positioning and unlocking hidden value (see Figure 1). The underlying rationale of Carve-outs varies and serves many different strategic purposes. Firstly, we have pressure-driven divestitures to improve liquidity, reduce the debt burden or improve the overall risk profile. Other Carve-outs are driven by activist investors to maximize the market value of the corporate assets via "deconglomeration". Furthermore, the optimization of more operational aspects, such as regulatory burdens and the need to comply with antitrust constraints to enable larger acquisitions, are also potential reasons for Carve-outs. Finally, there are more strategic rationales, such as reshuffling the corporate asset base to improve the strategic fit.

Fig. 1 Selected Carve-outs of European multinational corporates between 2018 and 2019

Volkswagen Financial Services	Merck	Siemens	BASF
Deal volume: N/A **Divestment:** Separation of credit and non-credit business **Buyer:** N/A	**Deal volume:** € 3.4 B **Divestment:** Consumer Health **Buyer:** Procter & Gamble	**Deal volume:** N/A **Divestment:** Gas & Power **Buyer:** Shareholders	**Deal volume:** € 1.2 B **Divestment:** Pigment Business **Buyer:** DIC
Rationale: Deregulation	**Rationale:** Refocus activities	**Rationale:** De-conglomeration	**Rationale:** Refocus activities

Akzo Nobel	Engie	Bayer	RWE
Deal volume: € 10.1 B **Divestment:** Specialty Chemicals **Buyer:** GIC, The Carlyle Group	**Deal volume:** € 2.6 B **Divestment:** Glow Energy **Buyer:** GPSC	**Deal volume:** € 6.9 B **Divestment:** Animal Health **Buyer:** Elanco	**Deal volume:** € 43.0 B **Divestment:** innogy **Buyer:** E.ON
Rationale: Refocus activities	**Rationale:** Refocus activities	**Rationale:** Refocus activities	**Rationale:** Refocus activities

Unilever	Linde	Evonik	Bosch
Deal volume: € 6.8 B **Divestment:** Spreads business **Buyer:** KKR	**Deal volume:** € 2.8 B **Divestment:** Americas business **Buyer:** Messer, CVC	**Deal volume:** € 3.0 B **Divestment:** Methacrylates **Buyer:** Advent International	**Deal volume:** € 0.9 B **Divestment:** Packaging **Buyer:** CVC Capital Partners
Rationale: Refocus activities	**Rationale:** Antitrust regulations	**Rationale:** Refocus activities	**Rationale:** Refocus activities

2018 | 2019

Source: mergermarket.com

"Breadth, size and a 'one size fits all' approach will be replaced by focus, speed and adaptability. That's how we'll ensure sustainable success of our businesses in the age of the Fourth Industrial Revolution, in which these new factors are crucial to compete." (Joe Kaeser, Siemens AG on carving out the Gas and Power business). Under this strategic direction, Siemens concluded a series of Carve-outs and divestitures over the last few years in an effort to "deconglomerate" its business and to maximize the overall market valuations in order to please investors.

Another example is Bayer, which recently sold its Animal Health business as major part of a multi-billion-dollar divestiture initiative to reshuffle corporate activities to better fit with their strategic definition of core business, and to alleviate the debt burden after the Monsanto takeover.

In the energy sector, E.ON and RWE decided to dissolve innogy and exchange parts of their businesses via a complex asset swap agreement to focus on different sub-sectors of the energy industry as part of their broader strategic refocusing initiatives.

The Linde/Praxair disposal of regional parts of their business facilitated their merger and pleased the antitrust authorities; the splitting up of VW Financial Services into the credit- and non-credit businesses helped to reduce regulatory burdens and thus improve operational efficiency.

However manifold the underlying rationale may be, Carve-outs clearly emerged from an operational need to a strategic enabler. To make effective use of Carve-outs, companies therefore have to build a detailed understanding of their strategy and desired core business and the extent to which it is currently being reflected by the corporate portfolio. At the same time, the underlying operational entanglements need to be understood and constantly optimized in order to ensure a supremely efficient business footprint and become successful value-oriented serial "divestors".

"Breadth, size and a 'one size fits all' approach will be replaced by focus, speed and adaptability. That's how we'll ensure sustainable success of our businesses in the age of the Fourth Industrial Revolution, in which these new factors are crucial to compete."

Joe Kaeser, Siemens AG on carving out the Gas and Power business

B Carve-out-focused portfolio management

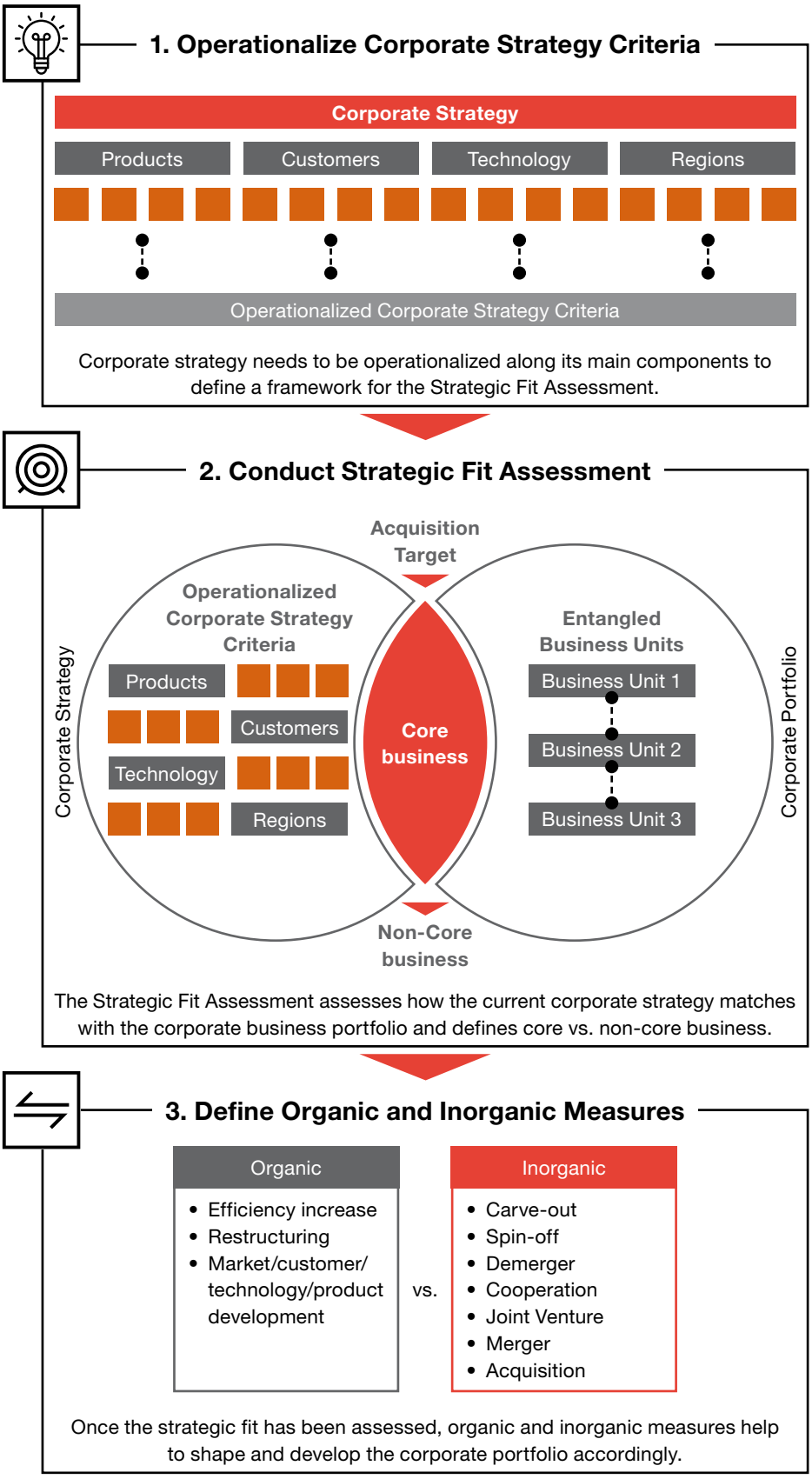
1 What: Strategic Fit Assessment

Firstly, a constant validation and adaptation of corporate strategy is required to make it optimally meet the ever-changing needs of global markets and to make sure that it identifies the best opportunities to exploit value potential and thus realize the best return on investment.

Secondly, a criteria-based operationalization of the corporate strategy across the key dimensions – product, customer, technology and region – and an understanding of how each dimension contributes to achieving the strategic goals is paramount. This ensures that the Strategic Fit Assessment between the corporate strategy and existing corporate portfolio is not based on top-down judgement or blurry criteria, but rather transparently derived from the operationalized strategy via a clearly defined and institutionalized approach (see Figure 2).

By constantly assessing the existing corporate portfolio against the operationalized corporate strategy criteria, companies can distinguish their core business from non-core business. This distinction makes it possible to tailor the organic and inorganic corporate development measures in order to optimally shape the corporate portfolio and stand out from competition.

Fig. 2 Three-step approach from Strategic Fit Assessment to derived measures



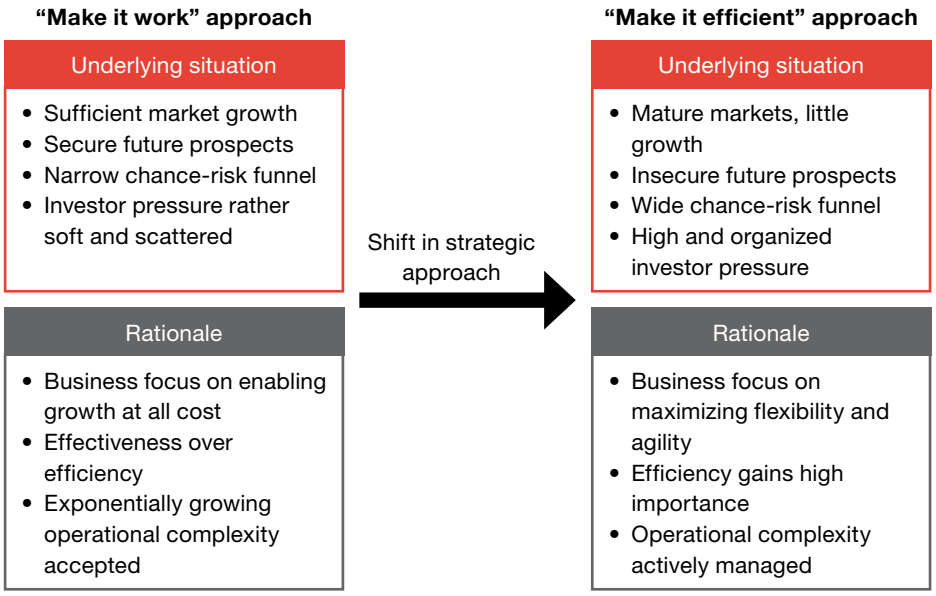
Top Management teams should discuss the strictly operationalized Strategic Fit Assessments at least once a year and balance the organic with the inorganic strategic measures. Opportunities for high organic growth might require funding, and the sale proceeds of a non-core business can be used to invest in a core acquisition target. With our focus on Carve-outs, the key outcome of the Strategic Fit Assessment is an answer to the question of what defines "non-core" and how to shift the invested non-core resources into more profitable core parts of the business, primarily via Carve-outs.

2 How: Understanding operational entanglements

Once a solid Strategic Fit Assessment has been conducted and the decision as to what should be carved-out has been made, the focus needs to shift to the "how", and to a professional operational end-to-end Carve-out management. This requires a detailed understanding of the current business footprint and its underlying operational entanglements between RemainCo and DivestCo.

Strong growth, increasing internationalization and ever more complex regulatory requirements over recent years have necessitated more dedicated and complex corporate business structures. Typically, these have evolved erratically over the years with a "Make it work" approach (see Figure 3), since sufficient growth and less investor pressure left enough headroom for companies for not being forced to put major attention to the details of operational entanglements and their hidden value potentials.

Fig. 3 "Make it work" vs. "Make it efficient" approach in business footprint design

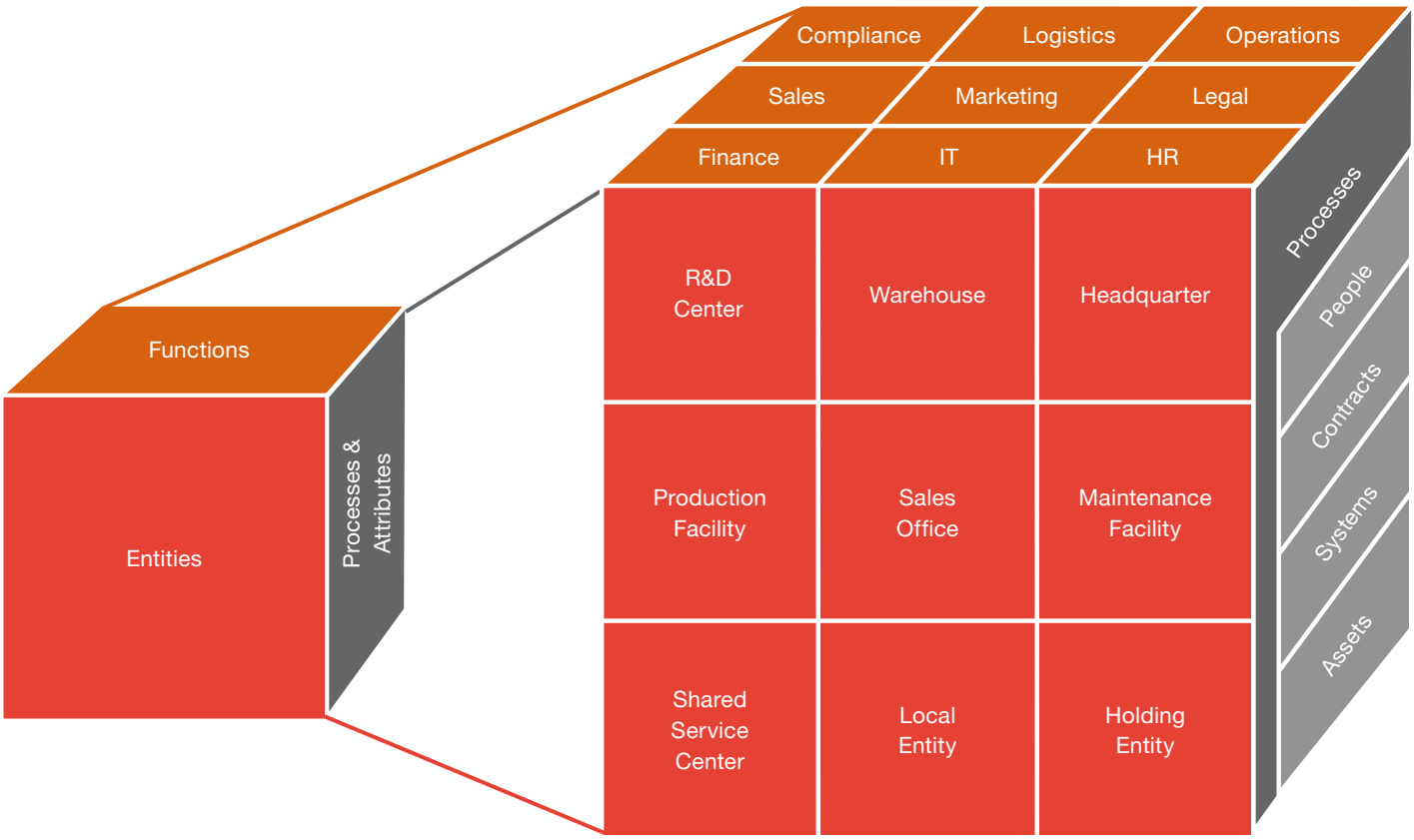


But now, since the market tide might be turning, successful companies need to develop a deep understanding of the complexity of their operations and transition from the established "Make it work" approach to one of deliberately assessing, designing and managing operational entanglement – the "Make it efficient" approach. This makes it possible to increase efficiency by developing more streamlined and rationalized corporate structures and also to become more agile and cost-efficient with future transactions.

The assessment of operational entanglements thus runs along the three dimensions of "Functions", "Processes and their attributes"[1] and "Entities" (see Figure 4).

Actively managing these operational entanglements results in shortened lead times to deliver transactions, e.g., for a business unit which was no longer considered core during the Strategic Fit Assessment. Moreover, planning for different divestiture scenarios (e.g. corporate vs. PE buyer, fire-sale vs. opportunistic sale) helps to devise the most suitable approach and deliver the transaction seamlessly and in a value-oriented manner. Looking beyond these transaction-driven benefits, the operational entanglement assessment will also make it possible to implement a less complex and more cost-efficient business footprint that helps to improve the competitive positioning of a company.

Fig. 4 Corporate Entanglement Cube illustrating the interplay between functions, processes & attributes and entities



[1] Next to processes, this dimension consists of assets, people, systems and contracts.

C Operational entanglement assessment and resolution/optimization methodology

The general operational entanglement assessment methodology draws on intra-company process relationships between different entities across various functions of a company.

In the context of a planned Carve-out, the operational entanglements relate to the relationships between the selling part (RemainCo) and the part that is to be sold (DivestCo) (see Figure 5, step 1). Purely dedicated processes are not the focus of the entanglement analysis, since these can be transferred as they are and thus do not mean Carve-out complexity. Operational entanglements thus mainly relate to the more standardized and less business-specific overhead services (e.g. SG&A-related) and less to the more business specific operations (e.g. COGS-related).

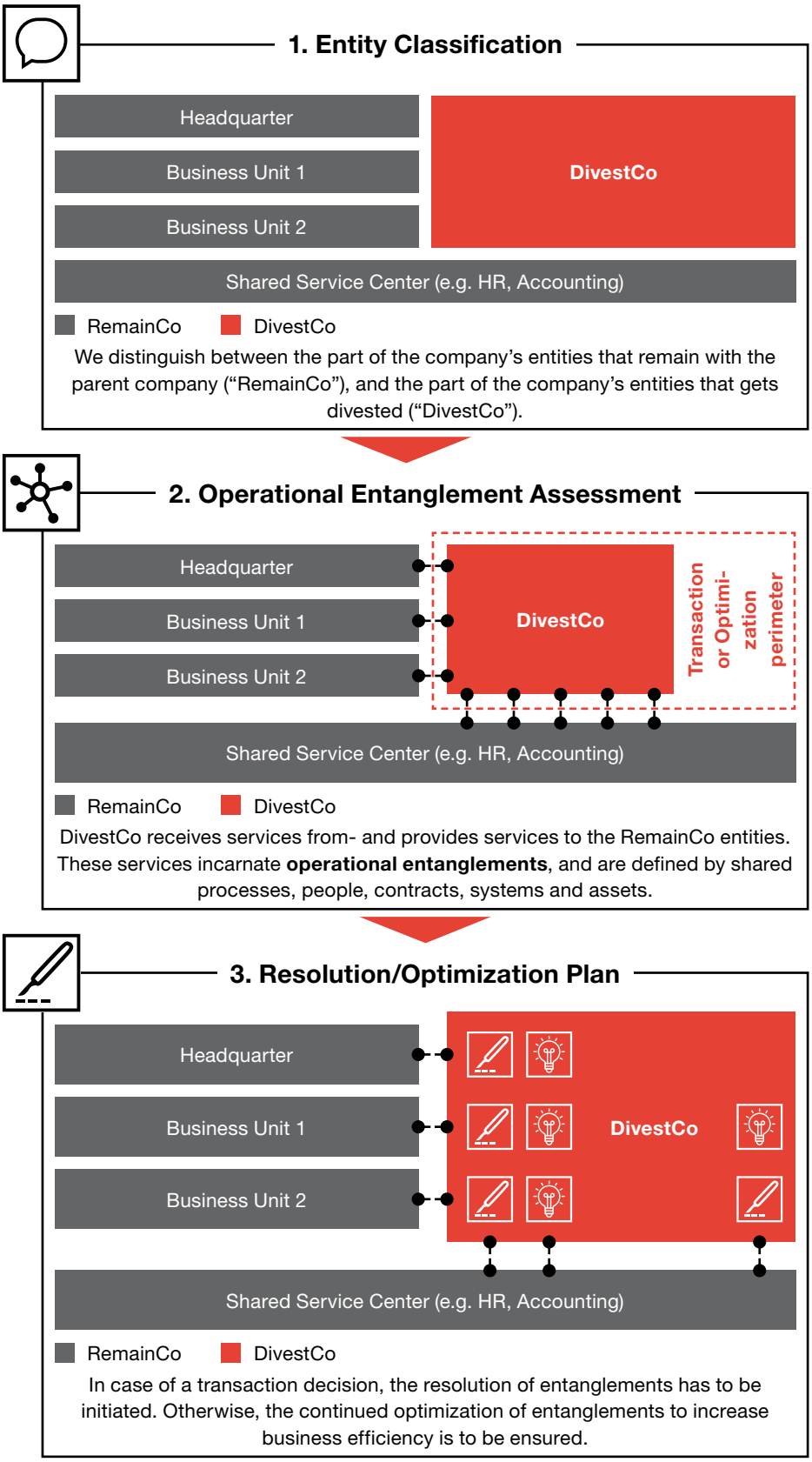
The operational entanglement between entities is reflected via a specific process that possesses different process attributes, since the process cannot deliver itself independently. The process attributes are categorized either by assets (e.g. office, brand right), contracts (e.g. supplier or customer contract), systems (e.g. business applications or IT infrastructure) or people (e.g. shared employees or outsourcing service provider).

The process entanglements between the different RemainCo and DivestCo entities can go in both directions (see Figure 5, step 2). Mostly it will run from RemainCo as the provider to DivestCo as the receiver. However, for specific services, selected reverse operational entanglements from DivestCo to RemainCo might exist.

The use of a standardized process framework and standardized operational entanglement categories helps to achieve comparability and to define a measure for the resulting degree of operational entanglements and the related Carve-out complexity – both over time and via benchmarks against the relevant peer group.

This builds the basis for the definition of either a plan to resolve the operational entanglements with a focus on speed and value creation (if a Carve-out is planned) or optimize the business footprint in order to realize efficiencies and become more agile with transactions (see Figure 5, step 3).

Fig. 5 Three-step approach to assessing and managing operational entanglement



In the context of an upcoming Carve-out, the definition of a plan to resolve the operational entanglements is the ultimate step. Predefined resolution measures for each operational entanglement attribute help to standardize the Carve-out approach and realize value potentials to maximize the Carve-out proceeds.

For example, shared people-related entanglements can be resolved by either outsourcing the relevant service, transferring the relevant employee in scope, or reshuffling the service to an existing dedicated DivestCo employee to realize operational synergy and thus feed into the potential buyer's value proposition.

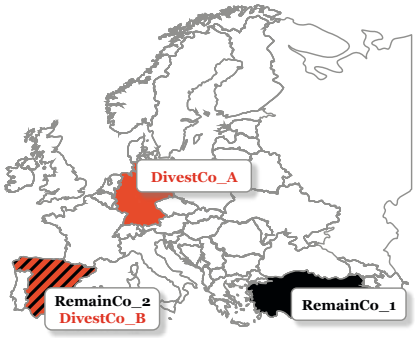
Preparing and establishing standard approaches for all these possible measures helps to significantly reduce Carve-out lead times, costs and remnant costs and simultaneously maximize Carve-out proceeds. If no immediate Carve-out is planned, the focus should be on constantly optimizing the current operational footprint. This helps to streamline and harmonize the business footprint and to realize untapped value potentials.

PwC is a market leader in the field of strategic and operational transaction support and regularly advises iconic companies in their efforts to optimize their corporate portfolio. Based on this wealth of experience built up over the last decades, PwC has developed a tool-assisted standardized Carve-out and Operational Entanglement Methodology, the "Exit Readiness Accelerator". This helps top executives to assess the strategic fit and competitive fitness of their corporate portfolio and sheds light on the level of operational entanglements and exit readiness of business units that are to be divested! **Get in touch!**

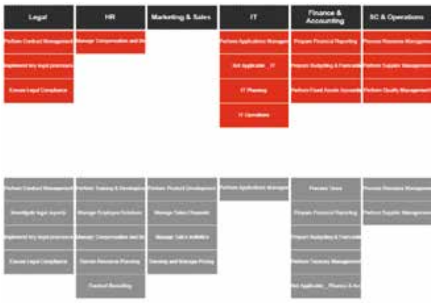
Key features of the "Exit Readiness Accelerator":
- Structured identification and assessment of operational entanglements between RemainCo and DivestCo
- Various complexity analysis views across entity, function, process, or on consolidated level
- Future state standalone entanglement resolution plan

Examples of "Exit Readiness Accelerator" features:

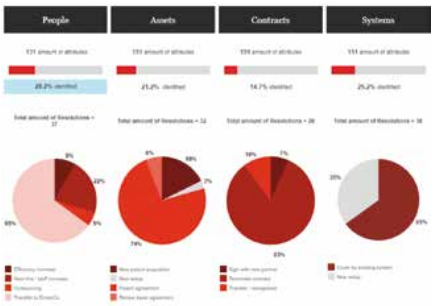
Global Entanglement Footprint
Visualization of the global entanglement footprint between RemainCo and DivestCo entities.



Entanglement Analysis Cockpit
Overview and analysis of the level of entanglement per function, process and entanglement attribute on different levels of granularity.



Future State Definition
Definition and visualization of the entanglement resolution plan and standalone approach per entangled function/process/attribute.



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About us
Our clients face diverse challenges, strive to put new ideas into practice and seek expert advice. They turn to us for comprehensive support and practical solutions that deliver maximum value. Whether for a global player, a family business or a public institution, we leverage all of our assets: experience, industry knowledge, high standards of quality, commitment to innovation and the resources of our expert network in 157 countries. Building a trusting and cooperative relationship with our clients is particularly important to us – the better we know and understand our clients' needs, the more effectively we can support them.

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