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M&A and Carve Outs (Part 1)

TMF Group, Hong Kong

M&A happens fast

In the immortal words of Ferris Bueller, Life moves pretty fast. So, too, does the Merger and Acquisition process - especially once it's publicly announced. That's when everyone is watching your every move, waiting to see how it will pan out before they make investment decisions. Before they decide to work with you, or buy from you.

Yes, M&A may be essential for your growth, but it's even more essential to make sure everything happens as smoothly as possible, as quickly as possible, with no mistakes.

It's the same little things that can trip you up in this process:

- getting the scope of services and pricing mechanisms right in a Transition Services Agreement (TSA)
- plans for major service continuity issues
- making sure your team has on-site, local expertise for entity structuring, statutory accounting and filings, and a locally compliant payroll and HR servicing model.

And with M&As moving so fast, any one of the small details can be de-prioritised or even lost in translation while companies and lawyers focus on the deal's minutiae.

That's why it's recommended that multinationals working on a carve-out or M&A deal seek external compliance help from a single partner with in-depth knowledge of all markets involved in the deal. It could save money, resource - and, importantly, reputation.

A professional services partner can take that back-office burden away from the necessary parties, letting them focus on the much bigger issues, like exactly how to transfer staff and assets from one party to another.

Working with an external provider can also help the buyer shorten their time to market and reduce the dependency on a TSA. Randy Worzala, Head of

Sales – Americas at TMF Group, references one M&A transaction he worked on where the buyer was carving out a division of a competitor. The buyer was going to market to find local language capabilities and regulatory expertise in 20 different countries that they had not operated in historically, and consequently, did not have in-house expertise. The thought of sourcing 20 different RFPs, while managing a fast-moving M&A deal was a daunting task.

"*The buyer didn't have the time to sit around and hope they found the skill sets in each country. I told them the model in local expertise created a ready-made solution and, importantly, the resource to help them get to work ASAP. We now work with this company in all 20 countries as a trusted advisor and partner for growth.* "

Often in M&A transactions, the buyer's motivation is driven by geographic expansion. In a carve-out scenario, the buyer is acquiring a product line or business unit and is not getting any back office functions with the deal. This can be incredibly challenging for the buyer that has not operated in the various international geographies they have just acquired. A partner with truly in-house global coverage can get you operating in your new markets seamlessly, quickly and with minimal fuss. And that may turn out to be the best decision for your NewCo in the long run - because life moves pretty fast, and you can't leave a single piece of compliance to chance.

The lowdown on Transition Services Agreements

When a company is sold or when a division is carved out, there's an expectation the seller will continue to provide certain services to support the buyer while it establishes operations.

Often the parties enter into what is known as a TSA, governing the temporary provision of services to the NewCo. Both parties should consider if this is needed as early in the process as possible, what the scope will include, and what the duration of the TSA will be – based on the complexity of the transaction.

The responsibility is on both the buyer and seller to reach an agreement on certain key considerations prior to the closing of the M&A transaction, though the buyer is the one with the most at stake if things don't go according to plan. Consideration must be given to:

- the scope of services
- performance requirements
- review and audit rights
- data privacy concerns
- liabilities

- plans for major service continuity issues
- pricing mechanisms
- TSA duration and options to renew/extend

But no matter how detailed your TSA is, there are two big risks you may not be considering: the compliance risk of making incorrect assumptions about the services needed, and the ongoing cost of being serviced under a TSA.

Lessons from the field

Over the years Randy has been involved with billions of dollars' worth of M&A transactions.

"In recent transactions, having been called on by the buying organization, I have seen sellers agree to provide certain back office services for a period of time, but the buyer was paying millions of dollars for the privilege. The sooner the buyer could peel away from the TSA with their own back-office infrastructure, the more savings the buyer would realize, further amplifying the business case for the deal."

In a similar vein, a technology company recently completed a carve-out transaction that required the seller to provide some basic accounting activities under a TSA. The buyer quickly realised they weren't covered for any statutory requirements in a region that can be incredibly complex for compliance.

"I've found over the years that buyers assume all they need in these situations is the transactional side of company finance; they've never operated in these countries before, so it's an easy assumption to make. But there's no insight into the statutory requirements.

"A US buyer is typically focused on US GAAP, rightfully so, and they write the TSA with a US GAAP accounting hat on. The buyer thinks they're covered - and then day one of operations comes along, and they soon realise there's more to it. The buyer can easily underestimate local GAAP needs in the newly acquired countries, and that can be a very costly mistake."

To TSA, or to fully outsource?

There should be one more question on your early checklist: will you be better off, long-term, outsourcing the operational services to a trusted partner from the outset?

This can be more cost-efficient, and less risky, as you will receive local knowledge of regulations alongside the provision of services - knowledge that will stay with your NewCo, and not disappear at the end of a TSA.

Know what your responsibilities are

Whether you're acquiring a new entity or considering a carve-out of your own, you need to make sure the carved-out company can operate as a stand-alone entity. What will happen when the TSA comes to an end? Will you be able to legally trade, or will you fall out of compliance?

Claudia Poernig, Managing Director of DLA Piper's International Corporate Reorganization practice, has worked on multiple, multinational carve-outs and has seen just about every obstacle and pitfall that can befall a company.

"Even when dealing with real estate as a transferable asset - do you need an expert? Any given country could have a particular way of moving real estate, and you need to make sure you cover that. Carve-outs are truly a multidisciplinary undertaking."

Claudia lists major obligations for a carve-out fall into the same areas as compliant trading: accounting and tax, HR and payroll, structuring, and regulation and compliance.

Accounting and tax

First and foremost, even before the deal is struck, you'll need to carve out your balance sheet. Prospective buyers will want to see a separate balance sheet that only deals with the business unit in question so they can get a good understanding of what's on offer.

That balance sheet will need to not only have a profit and loss account, but also include details of any assets you think need to go with that business unit in order to separate.

Says Claudia: "There might be some particular assets that are important for that business unit, and you want to make sure they are being sold to the buyer. It's what the buyer is looking for as well - what exactly are they buying?

"And then obviously from a seller's perspective you want to sell and separate that business unit in the most tax-efficient way. You want to make sure that you don't trigger any tax, or if you have to that you keep it to a minimum."

The tax question will need to be dealt with at both ends of the deal - both from your own HQ, and from the country involved in the deal.

HR and payroll

It's a very rare carve-out that doesn't involve employees in some way. Those employees will need to be transferred to the new entity and company, and that transfer can be done in multiple ways.

You need to consider the actual transfer of employees–TUPE (Transfer of Undertakings (Protection of Employment) Regulations), fire and rehire, and so on - as well as any benefits they have accrued while working for the original company. Claudia gives the example of pensions in Europe: your employees won't be too happy if they lose their accrued pension interest, and buyers won't be too happy if they need to pay for pensions of long-retired employees.

She also gives a word of warning: "In some countries when you fire and rehire, it doesn't matter that you're rehiring the employee - they'll have the right to refuse to transfer, and you'll be subject to an open negotiation for settlement. You need to be aware of what the local risks are in HR."

Structuring

This is the nitty-gritty detail of the deal: how do you separate? Are you selling entities? Do you want to include assets and liabilities? Do you need to form new entities in a different country so that you can consolidate business units ready for sale?

"The ideal corporate scenario is that you have one holding company and underneath you have new carved out subsidiaries that you can just transfer the holding company to the buyer - that's the easiest way," says Claudia.

"But from a corporate perspective you have to look at your timeline. If you have a carve-out in China and you first have to incorporate a new entity there, it will take you some time because it's so regulated. You need to keep these things in mind when setting your deadlines."

Regulation and compliance

We're not just talking about the usual compliance needs here; there are certain industries where licenses will need to be in check before you can trade.

"For example, says Claudia, "if you want to carve out a pharma business, you want to make sure that your carve-out has all the licenses that it needs or that you transfer the licenses that it needs. If you have an insurance business, it's also regulated, so you want to make sure you bring in people who can help you with that."

Look after the details

Claudia's advice for carve-outs is simple:

1. have a timeline in mind and focus on it

2. be aware of your obstacles and prioritise correctly

3. be ready for anything.

"*Unfortunately the devil always lies in the detail, and sometimes things come up that maybe you didn't consider from the beginning. You need to be ready for that. You need to anticipate things because in my experience something unexpected always comes up."*

Global reach
Local knowledge

TMF Group helps its clients operate internationally and 'belong' wherever they are in the world. They do this by making sure their clients are properly set up to do business in any country and compliant with local and international regulations.

TMF Group firmly believe that the only way to be truly 'global' is to put local first, which is what their team of 7,000 in-country experts do for businesses of all sizes, every day.