DISTRESSED CARVE-OUTS

HOW TO NAVIGATE THE CHANGING LANDSCAPE OF CARVE-OUT DEALS

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8 EIGHT INTERNATIONAL

EIGHT ADVISORY

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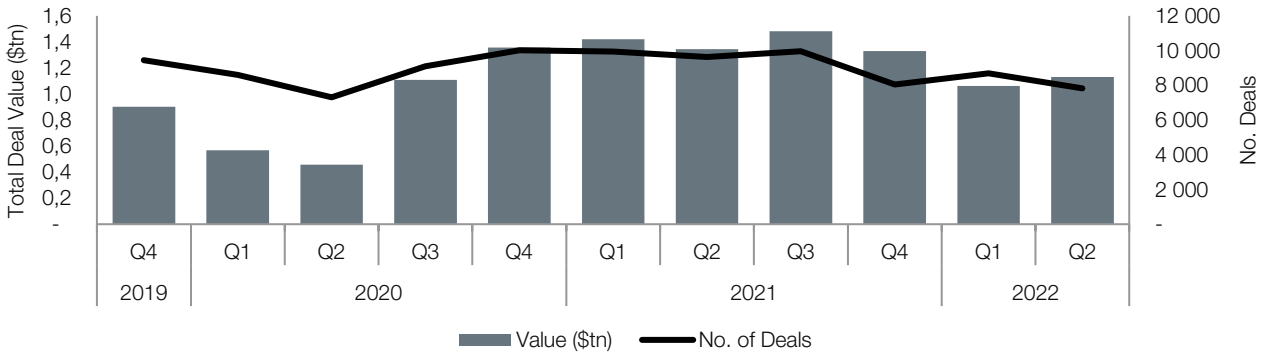
M&A ACTIVITY AND ECONOMIC BACKGROUND

M&A activity saw a buoyant resurgence in 2021, as activity slumped in H1 2020. As the world emerged from the coronavirus pandemic early 2022, activity remained strong even if slightly lower than 2021's pent up demand.

Global M&A activity by total value and number of deals



However, not all of the world has emerged from the pandemic, and as demand has outstripped supply in the global economy, many countries are facing high interest rates as central banks battle to control inflation.

This compounded with conflict in Ukraine as sent many commodities skyrocketing – putting a squeeze on businesses overheads as they seek to balance an increasing cost base with price inflation.

Many, including the Bank of England, predict recession; a drying up of capital, and M&A activity focused on businesses which are in distress. As large corporates did so during the last global recession, we are already experiencing an upward trend of non-core divestitures, as management teams seek to protect the core operations and sure-up balance sheets.

All of this points to an active carve-out market, and with an estimated $1.3tn of dry-powder still available, funds will have the ability to acquire well into 2023 and 2024 as interest rate rises start to take hold on available capital.

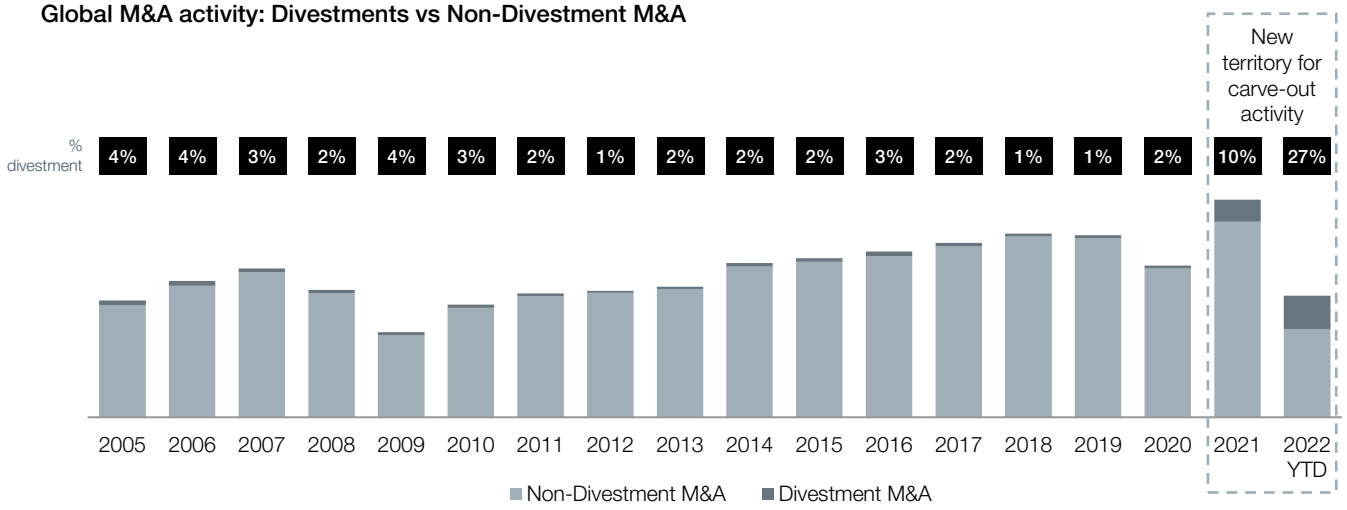
We outline in this deck our considerations to buyers and sellers in this market; what to look out for during diligence and how to protect and deliver value in the longer term.

Source: Data driven by Dealogic

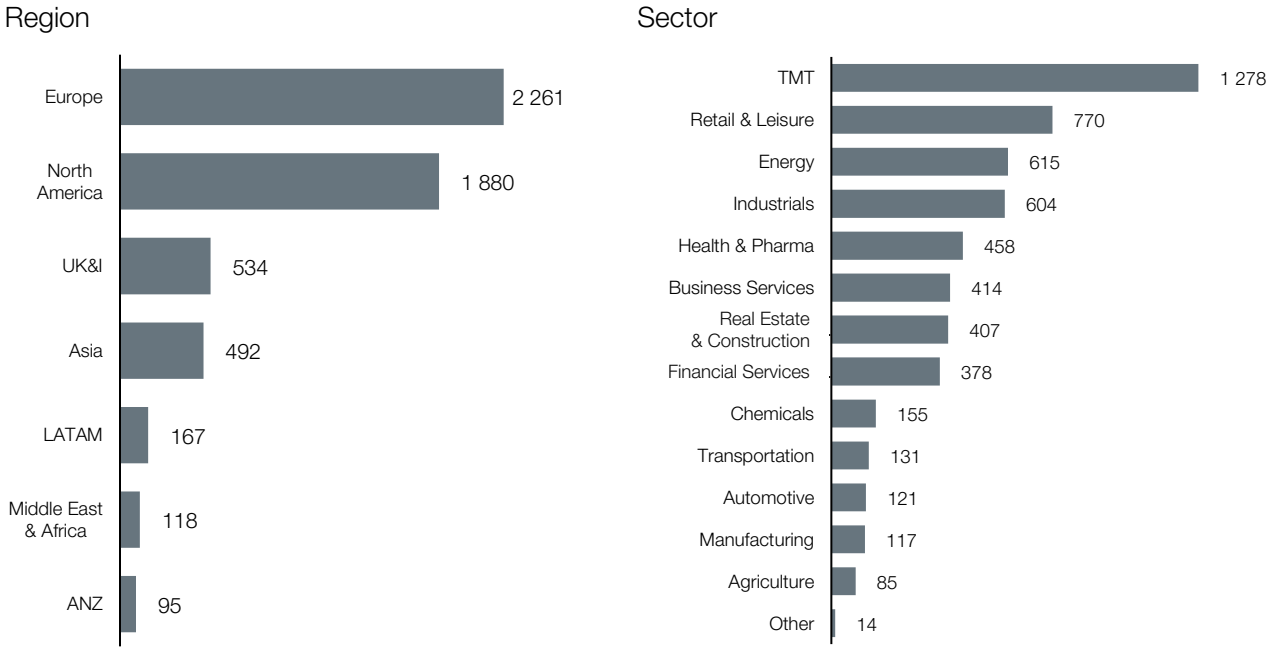
IMPACT ON DIVESTITURE

The volume of divestments as a percentage of total deal volume has historically been around 2% in the period up to 2020. However, as M&A activity bounced back in 2021 and 2022, divestments have become a key driver in the volume of deals done – with nearly a third of all deals being considered a divestment in the seven months to 31 July 2022.

Global M&A activity: Divestments vs Non-Divestment M&A



Global M&A activity: Divestments by Region and Sector (2020 to 2022YTD)



Europe and North America continue to lead divestment activity, with 75% of global activity between them. TMT is the leading sector by volume, with 23% of total deal volume while divestment in the manufacturing and automotive sector is less common.

Source: Data driven by Mergermarket; Note: 2022 YTD is the seven months to 31 July 2022

WHAT MAKES DISTRESSED DEALS, DIFFERENT?

Carve-out programmes always introduce levels of complexity to the deal and delivery teams. Indeed, no matter how much planning and preparation goes into Day 1, there is always an element of nervousness as the change of ownership takes place. However, a well-structured programme with the appropriate focus will de-risk separations and ensure business continuity around Day 1.

Not all carve-outs are the same – some are relatively light in complexity, and require limited transitional support across Day 1. For most though, the businesses are connected for many months, even years, post Day 1.

Separation complexity is greater in a distressed carve-out because the environment is not stable, there is less management oversight and things can go wrong more easily. This puts focus on getting deeper into the detail but with less time and often less seller involvement.

What makes a distressed carve-out different?

The seller may not be as focused on supporting the sale – vendor's resources, cash and people may be constrained and more unusually weighted to focusing on the core business

Separation documentation is often not as comprehensive – buyers will need to make more assumptions during diligence as fewer questions raised in the Q&A process will be answered

Sellers often assume a corporate buyer – they do not adequately prepare the asset for sale to a financial sponsor

The confidence buyers have on the delivery of transitional services is reduced – sellers are restructuring their operations much more materially that during a normal post sale right-sizing

People are stressed too – working with less information, to tighter timescales and with uncertain futures makes for a tough environment. Stressed people make mistakes, are less predictable and often not as collaborative on carve-out programmes

WHAT DOES THIS MEAN FOR BUYERS?

Buyer's beware – the market for acquisition is likely to be different to how it has been for several years, and specialised firms may benefit from their well trodden paths to success!

Although PE firms may still have an estimated $1.3tn of dry powder, the ability to raise new capital is likely to become harder in the coming years. This means investment committees may start to tighten the purse strings, and hold out longer to acquire the best assets. Which are in turn likely to be surrounded by stronger competition as bidders crowd around the most promising businesses.

Special situation firms may find that their time has come. Experience in buying distressed or non-core business will become hugely valuable in winning bidding processes while equally not overpaying for assets.

For buyers we have eight key considerations for diligence, and realising value post Day 1:

1. **Consider a broader set of due diligence (e.g. Ops, IT and others)** – assets are likely to have had years of underinvestment and could be exposed to operational risks (e.g. cyber attacks, high attrition etc.).
2. **TSA services may also be in decline** – lock in fixed prices and exit quickly. Reject TSAs you feel you can live without or migrate before Day 1. **Put focus on the integration and value creation plan** early – build these into the deal logic and accommodate flexibility as the transaction progresses.
3. **Consider expanding the perimeter** – transfer more of the operating model into the sale perimeter and remove associated TSAs.
4. **Ensure the vendor has the relevant support to provide the carve-out** – and ensure it has been appropriately funded.
5. **Use joint sources of truth** – this enables a consistency in understanding across the transaction – e.g. run a Joint SteerCo and hold jointly used data in a shared space (where feasible).
6. **Employ robust governance practices** – the separation programme should be able to withstand adverse conditions with a degree of agility.
7. **Assume the asset has been underinvested** – allow for broader technology, operational and support investment and capex over the short term.

WHAT DOES THIS MEAN FOR SELLERS?

Sellers who appreciate the buyer's concerns, and provide a clear articulation of the financials, plan and carve-out complexities, will benefit from more bidders at the table!

A distressed carve-out sale process is nothing new, but the volume at which they come to market in future years will be. While special situation buyers may be familiar with distressed sale processes, other bidders may find this new territory an uncomfortable ride.

Sellers who help to make that ride smooth for all bidders, will benefit from greater competition within the bidding parties, which can push up asset sale values.

However, distressed carve-outs happen for a reason, and vendors will not have the luxury of time to ensure the process is always as comprehensive as would be in normal circumstances.

We believe there are eight key considerations for venders during distressed sale processes:

1. **Dedicate people to the deal** – having a small, nimble and well connected carve-out team introduces pace and reduces distraction on the RemainCo.
2. **Appoint an empowered, ambitious leader** – use the programme to develop future top talent. These programmes are interesting – so it'll also give them reason to stay. Provide them with a well networked side-kick.
3. **Prioritise the key sale documents** (e.g. VDD, Separation Report, Business Plan) – cutting corners on these will erode value and scare bidders in the initial phases of the deal.
4. Provide **assurances around Day 1** and **transitional services early.**
5. **Streamline the governance** and build a **right first time mentality**, quickly.
6. **Centralise relevant data** in a shared space and keep it consistent – make it easy for people to respond to the Q&A.
7. **Work with the buyer** – to build a joint separation programme, governance structure and to inform their separation strategy.
8. **Connect dependencies between RemainCo transformation and the carve-out entity**, particularly where transitional services or long term agreements are concerned.

OUR KEY TAKEAWAYS

Assets are susceptible to greater value erosion risk due to the current macro-economic environment. Asset owners who are better prepared and able to move quickly will mitigate value erosion.

Five years from now, there will be many investors, leaders and operators who will know they left value on the table during this time. Value lost either during the transaction negotiation, the immediate carve-out or integration delivery, during the years of ownership and / or in the lead up to exit.

Though there is opportunity during this time. Savvy investors will acquire discounted assets which will recover value as the market improves over time. Those non-core assets, which have not had the focus and attention of the parents, are often able to flourish under PE ownership.

Our methodology for distressed carve-out centres around getting things right first time and early, this enables all parties to move at pace which captures and protects value.

We feel these principles are relevant to both buyers and sellers in distressed situations:

Have a clear vision for the carve-out, and articulate it well

Develop nimble teams who can react to the environment quickly

Involve both sides, and commit to solving problems early

Remove distractions, and prioritise activities which build and protect value

HOW WE CAN HELP

Our teams have deep experience in carve-out transactions, with both buy-side and sell-side situations. This experience has been developed through pre-deal due diligence and post-deal separation and integration programmes – often in distressed situations.

Should any of the below apply to you, or your transaction, please feel free to contact us and we would be happy to help support you and your teams.

Buy-side

- **Separation due diligence**
  Helping you to understand the carve-out considerations on your target.
- **Assessing standalone financials**
  Quantifying risk areas and identifying upside potential.
- **TSA assessment**
  Determining the level of transitional support required within the transaction, and assessing what the vendor has presented.
- **Separation support**
  Delivering separation programmes:
  - Mobilising teams & governance
  - Developing the standalone target operating models
  - Managing standalone financials
  - Building separation & TSA exit plans; tracking, managing & reporting
  - Engaging people & delivering change
- **Optimising the standalone entity**
  Value creation within a broader transformation.

Sell-side

- **Vendor due diligence**
  Providing assurances to bidders through financial, operational and technology DD that includes carve-out and transition topics.
- **Vendor assistance**
  Supporting you throughout the deal process to mitigate value erosion and provide assurances to bidders.
- **Separation strategy**
  Providing a clear pathway for separation, detailing the perimeter, financial impact and TSA requirement.
- **Stranded cost control**
  Right-sizing the business when TSAs are exited by the carve-out entity.
- **Sell-side separation support**
  Delivering separation programmes:
  - Mobilising teams & governance
  - Managing the Q&A process
  - Building separation & R-TSA exit plans; tracking, managing & reporting
  - Engaging people & delivering change
- **Optimising the retained business**
  Right-sizing through value creation.

HOW WE ARE DIFFERENT

We differentiate our client service by differentiating our operating model – our focus on senior-led engagements, combined with an agile approach enables us to deliver high quality work alongside a commercially sensible fee structure.

Genuinely one team

Our colleagues operate and act as one team. There are no "departments" in Eight Advisory and our working environment is fully mixed across service specialisms – all with experience of carve-out programmes

- Operational specialists
- Financial due diligence
- Tax advice
- Valuation & modelling
- Tech, IT & Data

Senior involvement

Our scale means our senior people are hands-on in delivery, providing insight directly to our outputs

- One-third of our London team is Partner or Director grade
- People work for us because they enjoy delivery
- Strong sector and industrials expertise
- Experts who have lived carve-outs from start to finish
- Our people have held senior positions in previous roles

Deal experience

Our people work around the deal; including buy and sell-side, and pre and post completion. They have a clear understanding of post-deal implications during diligence and advise accordingly

Deal strategy → Due diligence → Valuation → Integration & Separation → Transformation & Exit Support

Client impact

Our clients benefit from focused support which is value-driven and delivered at pace

- Insightful & valuable outputs
- Delivered at pace
- Fast issue identification
- Informed pre-Day 1 assumptions
- Comprehensive scope coverage

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