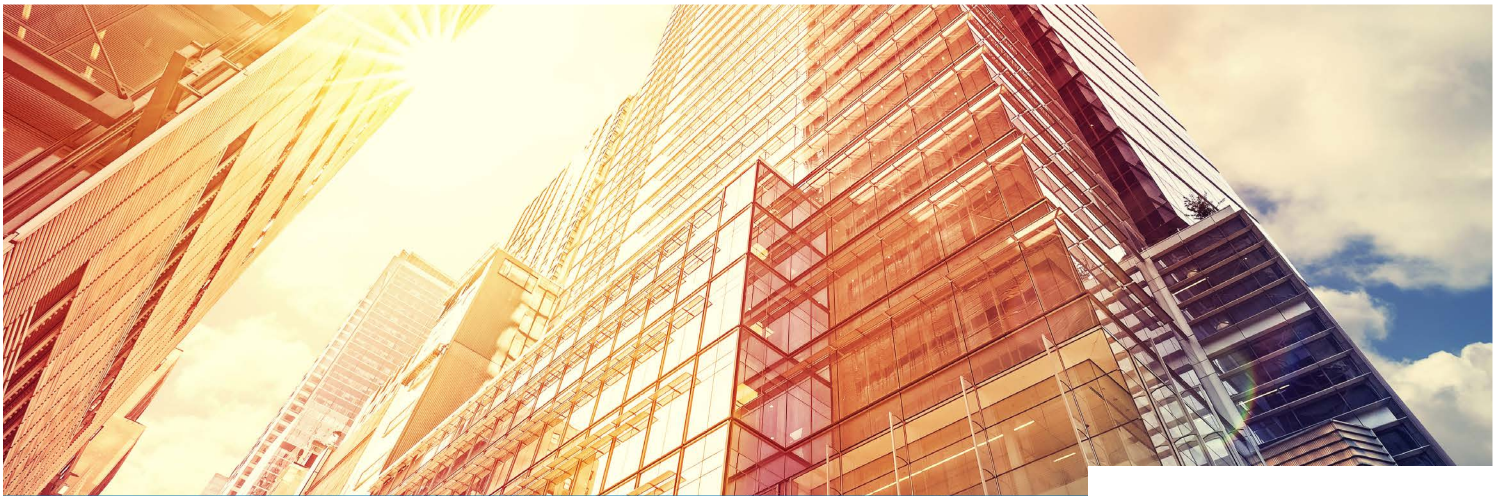

Business Continuity: Three Nuanced Focus Areas for Divestitures

During a divestiture/carve-out, focus on continuity of business on Day 1 (i.e. immediately after ownership transfers), is often deprioritized. Improper separation planning when selling a business can have adverse effects for both the seller and the buyer. In this article, FTI Consulting transaction professionals suggest three nuanced focus areas to ensure business continuity, especially when separating or buying a manufacturing operation with commercial operations in multiple states or countries.

A Focus on Day 1 Business as Usual Preserves Value for Both Seller and Buyer

The focus on divestiture planning and execution is to preserve value for both the seller and the buyer. Transaction teams usually focus more on the front end of the transaction. This approach can be summarized into the following areas:

1. **Valuation and Pricing:** Pricing the current and future earning potential of the business
2. **Transaction Structure:** Being well prepared across the tax and transaction structure
3. **Deal Perimeter:** Including assets and legal entities in the deal perimeter
4. **Business Continuity:** Ability of the carved-out business to be operational and ready for Day 1

The first three items above are table stakes in any successful carve-out and are the usual focus for most sellers. Sellers invariably deprioritize the fourth item, business continuity such as the ability to continue business as usual ("BAU") after closure. Post-close inability to continue BAU could adversely impact operations and reduce revenue and EBITDA for the buyer and valuation for the seller if the Sale Purchase Agreement included any deferred consideration.

Business Continuity focuses on all operational aspects of the transaction that might influence the carved-out business functioning as an independent entity post-close. It usually can be categorized into two sections — (a) typical and (b) nuanced business continuity focus areas. Transaction teams usually focus on typical business continuity aspects with the nuanced focus areas being commonly deprioritized. The focus of this paper is to discuss the NF areas in more detail with a brief reference to some typical priority areas in carve-outs.

Typical Focus Areas Usually Emphasized:

- **Approvals:** Regulatory filings (anti-monopoly — HSA, FTC, etc.)
- **Novation**: Transfer of asset and legal entity ownership documents and related vendor and customer contracts
- **Employees:** Employee Payroll and Benefits ("EPB") readiness
- **Banking**: Order to Cash ("OTC")/Procurement to Pay ("PTP") process readiness including the ability to receive and make payments
- **Reporting:** Day 1 financial and management reporting
- **TSA scope:** Transition Services Agreements ("TSA") and schedules
- **Seller's obligations** to support all the above activities

The typical areas listed above are valid and should be the initial focus area for the sellers as they prepare for divestiture. As the deal progresses toward the Sign to Close phase, the focus should also be applied to "Nuanced" key items which if deprioritized, could:

- **Increase workarounds:** Seller (and buyer) might need to create manual workarounds to support breakages in processes/systems. Examples of workarounds could include building up inventory before close to offset any interruptions to Day 1 production, or using Excel instead of business intelligence software for financial consolidation or reporting purposes, etc.
- **Increase seller concessions:** Have the potential to adversely impact the transaction value due to concessions being ceded by seller to buyer to ensure that the deal closes on time with no adverse impact on business continuity. Concessions can include seller manufacturing on behalf of buyer, seller importing material on behalf of buyer, or increased TSA duration with resulting implication on seller's stranded costs, etc.

Based on real-life examples from our divestiture team and former clients, some Nuanced business continuity areas commonly deprioritized are as under:

Nuanced Business Continuity Focus Areas:

A Customs Account:

- **Importance:** In some jurisdictions, manufacturing facilities, especially in process industries, import raw materials on a pre-determined schedule. Usually, any import dues are automatically debited from the Company's bank accounts as goods get cleared by the Customs Authorities.
- **Impact:** In the absence of a similar process on Day 1, the buyer might see interruptions to Day 1 continuity of operations resulting in loss of revenue and profitability and potentially increased dependence on Seller TSAs and/or Commercial agreements.

- **Solutions:** Post-close, we need to ensure that the NewCo Legal Entity has a similar arrangement in place (i.e., setting up a new customs account) ensuring connectivity to a bank account connected to the auto debit facility, and appropriately fund this account at closure. As a workaround, seller might have to import raw materials on behalf of buyer and/or build inventory prior to closure — both activities needing to be planned for, evaluated for risk, and approved by seller leadership well in advance of closure.

Note: Similar issues might also impact the export side of the equation.

B Surety & Performance ("S&P") Bonds:

- **Importance:** Depending on the terms of the sales purchase agreement, the seller usually requires the buyer to substitute all customer S&P bonds effective Day 1.
- **Impact:** In the absence setting up new bonds by the buyer, the seller will continue to be responsible to third parties for any liability arising (e.g., for performance or financial damages), which would be covered by the S&P bonds issued before Transaction Close.
- **Solutions:** Setting up new bonds and cancelling existing ones needs to be planned well in advance, as buyer needs to guarantee these bonds issued by its agents, banks and portfolio company (e.g., a monetary liability for the buyer). Also, keep in mind that this process takes time to plan and execute.

C Delayed Close Commercial Models:

- **Importance:** The ability to close on the same day on every market, jurisdiction or country might not be possible in certain cases, given:
  - regulatory complexities
  - inability to set up legal entities/ manufacture/sell in markets
  - failure to transfer employees on time, etc.

In such multi-site and multi-jurisdiction cases exhibiting the above complexities, a solution must be developed to enable continuity of business across the brand or multiple jurisdictions and customers.

- **Impact:** Not having a solution to address the above complexity could result in a delay in the transaction closing, postponement in sale proceeds being received by the seller and a potential adverse impact on valuation of one or more of the components of the deal.
- **Solutions:** Many solutions to the above situation (delayed close) are available for a competent and experienced carve-out advisor to prepare for and execute. These could include planning in advance, by jurisdiction involved, for:
  - **Evaluating commercial feasibility** to sell in the local market (e.g., permits and ability to store product and distribute product).
  - **Identification of delays arising from compliance requirements**, e.g., batch testing of inventory once NewCo Legal Entity has received a fresh supply of finished good(s) requiring buildup of approved FG inventory at distributors before closure).

- **Creation of Net Economic Benefit ("NEB") Model** in a divestiture scenario, for assets that the buyer cannot take ownership of until a later time (i.e., delayed closing). The NEB Model dictates how the net proceeds received from delayed closing assets, managed by the seller on behalf of the buyer, will be remitted to the buyer by the seller.
- **TSA and/or Commercial agreements** implications in mitigating or reducing impact of delayed closing assets.

In conclusion, while other areas might also need to be emphasized, depending on the level of complexity of the divestiture, the above three areas usually address the key nuances arising from most transactions.

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