Global mergers and acquisitions' activity in 2021 broke all prior records – with over 63,000 transactions recorded and a global M&A value of more than $5.1 trillion. We expect 2022 to be another very strong year in terms of M&A deal volume. We have outlined five trends we predict to significantly frame M&A activity this year: (i) enhanced deal scrutiny; (ii) ESG's aspects significance; (iii) the continued growth in the use of W&I insurance; (iv) carving-out of assets increasing deal complexity; and (v) the introduction of a potential corporate re-domiciliation regime for the UK.

TREND #4: CARVING-OUT ASSETS AND M&A DEAL COMPLEXITY

Increasingly, companies have been re-analysing their businesses with a view to directing efforts and resources to core profitable divisions. In turn, carve-out transactions for the sale of underperforming, inefficient or non-essential assets are being undertaken as a way of raising capital, enhancing their balance sheet and addressing the liabilities accrued during lockdowns.

Increasingly, companies have been re-analysing their businesses with a view to directing efforts and resources to core profitable divisions.

2021 saw a significant number of such transactions. Examples involving large companies include Daimler (now Mercedes-Benz Group AG), which divested its non-core trucks business in 2021 to focus on its automobile business; Lonza Group, which sold its speciality ingredients business (LSI) to private equity to focus on the growing healthcare industry; and IBM, which divested its IT infrastructure services unit to focus on cloud growth. In late 2021, Johnson & Johnson announced its intention to divest its consumer health business, and General Electric announced its intention to split itself into three separate companies, each focussing on a single core business.

This trend looks likely to continue or even accelerate in 2022, driven by the continued withdrawal of the monetary and fiscal support provided during the COVID pandemic, strong shareholder activist campaigns and the desire for business flexibility to allow companies to respond quickly to new consumer trends and disruption to their business models, supply chains or the geopolitical situation.

Carve-outs can present complex and unique challenges, which must be carefully managed in order to ensure a successful disposal and avoid business disruption. Key issues in a carve-out include how to split assets and liabilities, the allocation of debt and liabilities between the parent and the spun-out entity, and transitional agreements between the parent and the spun-out business.

These issues can be particularly difficult to resolve where a transaction is born of necessity and little groundwork has been laid to prepare the spun-out entity to operate on a stand-alone basis.

SHARED ASSETS

Many assets will be important for both the carved-out business and the retained business. Typical examples are enterprise-wide contracts, parent guarantees, intellectual property, shared real property, within-group supply arrangements, IT resources and management/corporate functions. Without early consideration of how these shared assets are to be separated and how they can be made available to the other part of the business as needed, sellers are more likely to experience delays and encounter difficulties when trying to run a competitive auction and when negotiating the transaction documents. Getting the buyer comfortable with what is being acquired and what is being left behind, and that it will be able to operate the divested business post-completion, will have a major impact on price negotiations.

Many assets will be important for both the carved-out business and the retained business. Typical examples are enterprise-wide contracts, parent guarantees, intellectual property, shared real property, within-group supply arrangements, IT resources and management/corporate functions.

Careful separation planning for carve-outs is therefore essential to increase deal certainty. In highly integrated companies with a large proportion of shared assets, a lack of preparation may pose a material risk to successfully achieving the divestment. This is particularly the case where due diligence reveals that a particular part of the carved-out business is essential to the continued operation of the retained business, meaning that such assets cannot simply be allocated to one of the businesses.

TRANSITIONAL SERVICES

Transitional service agreements (TSAs) will often be needed in carve-outs to ensure a full and smooth transition. They will provide for key services and resources that the retained business will need to continue to provide to the carved-out business following completion. A reverse TSA may also be entered into, pursuant to which the carved-out business will provide certain services or assets to the retained business. TSAs and reverse TSAs will be critical tools in bridging disagreements between the buyer and the seller on the allocation of assets that are critical to the operation of both businesses.

These arrangements can be difficult to negotiate because the parties' expectations are not aligned. For example a seller may prefer a clean break or may require a reverse TSA to support the retained business, whilst a buyer may require a TSA (or at least will find a carve-out business more attractive if it includes one) or may not want to commit to provide services to the retained business under a reverse TSA on the terms that the seller finds acceptable. Agreeing the costs of these arrangements can be a particular challenge in itself.

The need for one or more TSAs will complicate the sale process and generally can impact on the deal timeline. Further, in an auction, it is unlikely that all bidders would have the same transitional needs, which can make it more difficult to compare bids and can require the simultaneous negotiation of such arrangements with multiple bidders. Early engagement between the parties and with management will be crucial to understanding what will be needed and to ensure that the right transitional service arrangements are agreed.

FINANCIAL STATEMENTS

Carve-out transactions will usually require stand-alone financial statements, adding another layer of complexity and added scope for disruption. Carved-out businesses may well lack stand-alone financial statements, or such statements may be unaudited. From a buyer's point of view, stand-alone financial statements will be fundamental in determining the value of the carved-out business and a lack of stand-alone statements will make valuation very difficult. If the target business does not have stand-alone accounts, bespoke carve-out accounts will need to be prepared to set the targets for completion accounts.

Insufficient preparation regarding financial statements in a carve-out deal can lead to delay, difficulty in valuation and may risk late discovery of large tax or other liabilities.

Insufficient preparation regarding financial statements in a carve-out deal can lead to delay, difficulty in valuation and may risk late discovery of large tax or other liabilities. Therefore, in a carve-out context, the process for preparing or adapting financial statements for the purposes of the transaction must be considered at an early stage.

SUMMARY

Many companies are undoubtedly considering their businesses and the selling of non-core assets, and appetite for carve-out transactions is on the rise. Whilst carve-out deals present opportunities, they bring specific challenges that can complicate the negotiations and increase the risk of a deal not being agreed. This is especially true where transactions are borne out of necessity and little preparation has been made. With early planning and careful management, the additional risks associated with such transactions can be mitigated and successful divestment and transition can be achieved.

Click here *for the four additional trends in our M&A Trends 2022 series.*

CONTACTS

COLIN GRAHAM
colin.graham@gide.com

MATTEO MATTEUCCI
matteo.matteucci@gide.com

LAURE SAVANT-ROS
laure.savant-ros@gide.com