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Why IT contract separation requires special attention in a carve-out project?

Roland Kuhn and Giacomo Pelloni

A carve-out of a business unit typically requires the separation of a complex and highly integrated IT infrastructure. While the separation of the infrastructure stays in the focus of every carve-out project, the separation of the affected supplier contracts is often neglected, with severe consequences.

Unfavorable rights to use (RTU) or transferability restrictions of software license agreements consequentially result in unexpected extra costs or lead to incompliance after day one. In the worst case, day one must be postponed due to missing operational readiness, hence, the seller cannot provide the required services agreed in the transactional service agreement (TSA).

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Introduction

Global M&A activity reached unprecedented heights over the past years and only marginally declined in 2019. For 2020 it was expected to remain robust, however, due to the Corona crisis it plummeted to its lowest level since 2016. Once the focus of most companies shifts back from business continuity to business as usual, a bounce back is expected with a potential acceleration and much faster growth than it did after the financial crisis in 2008/2009. The same picture is also reflected in Switzerland.[1]

The strategic relevance of acquiring companies is highlighted by difficulties of achieving top-line organic growth, while divesting divisions or business units is often seen as a valid strategy to sharpen overall business profile. What both have common is the goal of generating shareholder value.

Nevertheless, a high percentage of M&A transactions continues to result in wealth destruction rather than creation and fails to deliver expected benefits. This is often attributable to a poorly planned carve-out and the failure to involve the relevant stakeholders at an early stage during the due-diligence process. Forecasted benefits are often nullified by higher operational costs, post-closing price adjustments or costs related to incompliance, for instance for IT software licenses.

In a typical carve-out of a business unit, shared service organizations must be separated to ensure operational readiness after day one. This applies particularly to the IT organization and the entire infrastructure, which in most cases are integrated across different business units. The physical separation of the IT infrastructure is already complex enough. Legal restrictions of software license agreements – for example rights to use (RTU) or transferability limitations – make the project even more complicated. Due to that, the separation of IT contracts requires special attention in any carve-out project.

Footnote:
1. Source: Refinitiv, Global Transactions Forecast 2020, Baker Mckenzie https://www.bakermckenzie.com/-/media/files/insight/publications/2019/gtf-2020/gtf2020_factsheet_switzerland.pdf?la=en

Challenges

The dependency of the divested entity (DivestCo) on the existing IT organization and system landscape (level of IT integration) determines the complexity of the separation. Most IT system landscapes have grown over years if not decades, making it even more difficult to understand which application and IT services are needed by the DivestCo, by the remaining units (RemainCo) or by both. This leads to a constantly changing IT blueprint – also known as carve-out perimeter – during the carve-out project. Therefore, a high degree of flexibility is required to ensure a structured and comprehensive contract separation.

Identifying the suppliers and affected contracts often proves very challenging. Own or partially home-grown applications or platforms, often developed by external engineers and maintained by other suppliers, present substantial intellectual property challenges and imply further hurdles to identify and allocate supplier contracts to the relevant IT services or applications. The fact that a centralized contract depository (contract management tool) is often incomplete, not up to date or even inexistent makes it even more challenging. The internal software asset management (SAM) may provide an additional data source but is also often incomplete and the naming of purchased applications is inconsistent.

Software providers often exploit their dominant market position and insist on their standard terms and conditions. Lack of negotiation power of the license buyer and missing attention for a possible separation – which is usually not on the agenda at the time of signing – result in incisive RTU and transferability restrictions. The implications within a carve-out project are obvious, as these are key terms for separation. The fact that most IT contracts are based on suppliers' standard contracts and vary from supplier to supplier, makes a standardized or even automated contract analysis almost impossible and bears the risk that such key terms are overlooked.

The service provision to the DivestCo after day one – as defined in transactional service agreements (TSA) – is a common way to ensure operational continuity after closing. However, service provisions to non-affiliates requires specific RTU for the affected software licenses. This is frequently overlooked and leads to incompliance after day one. The result, unexpected extra costs that often impact the overall deal value. Hence, the buyer enforces a post-closing price reduction. In the worst case, the agreed services between the seller and buyer cannot be provided after day one and the operations of the DivestCo may be disrupted.

As transferred supplier contracts are important assets of any deal, they must be properly prepared and reflected in the virtual data room (VDR). This often plays a secondary role, resulting in an incomplete or incorrect inventory in the VDR. As the contracts listed therein are part of the business transfer agreement (BTA), incomplete or outdated contract data in the VDR may lead to a post-closing price reduction.

TALOS Approach

The above shows, successful carve-out projects require – among others – adequate attention and a masterfully crafted plan for the supplier contract separation, particularly for IT contracts. A careful planning and a structured approach – starting with the VDR preparation – prevent the seller from unexpected costs and contribute significantly to the day one readiness. To ensure a smooth contract separation, TALOS focuses on six key areas, on which we keep an eye on throughout the entire project (see figure 1).

A cornerstone for a successful separation is the appointment of a dedicated contract separation team, that takes responsibility for all mat-

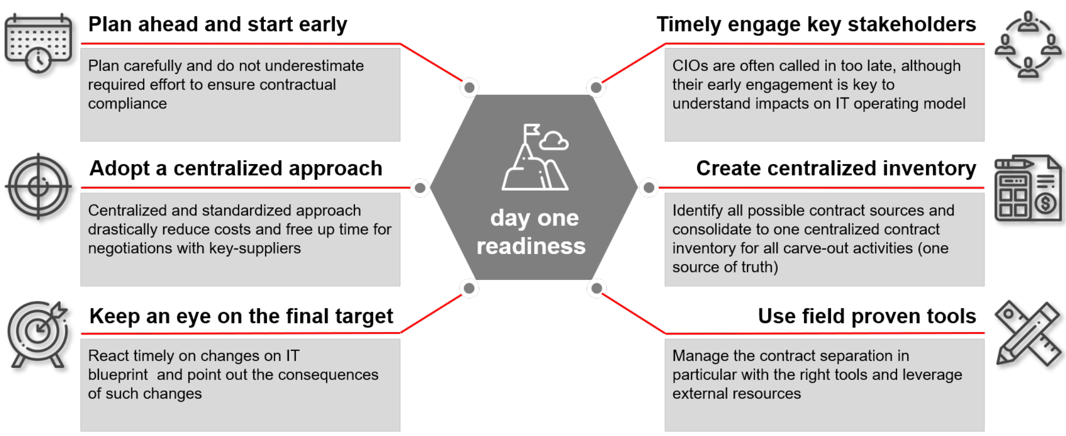

Figure 1:
Six key areas for contract separation

ters related to supplier contracts. This team needs to be set up at a very early stage, to ensure a proper contract identification – considering all relevant contract data sources – and to create the contract inventory as single source of truth for the entire project. This prevents from deviations in the VDR data to the contracts effectively transferred, as defined in the BTA. Hence, unpleasant adjustments of the contract inventory – leading to a potential post-closing price reduction – can be avoided.

The fact that the IT blueprint often changes during the carve-out project, requires a deep understanding of the IT infrastructure and the connection to external sourced IT services and software licenses. Only this can ensure, that consequences of such changes are understood and addressed. Possible solutions can be found with the suppliers and agreed in contractual amendments. A closed cooperation with the IT carve-out team is therefore key to gain the needed understanding of the IT infrastructure and the IT team can be sensitized regarding consequences of IT blueprint changes.

To ensure a structured and smooth separation, we use our own developed proven tools and methodology by applying our five-step approach (see Figure 2).

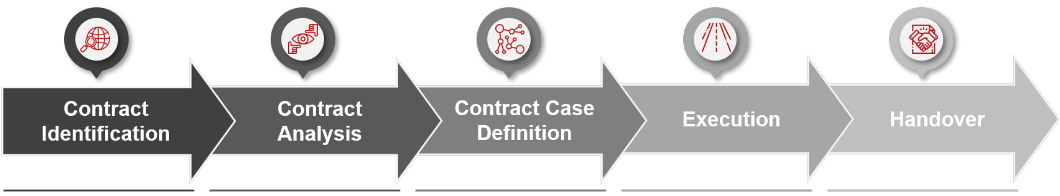

Figure 2:
TALOS contract separation approach

It starts with the identification and location of all supplier contracts in scope, meaning all contracts that might be somehow affected by the carve-out. A centrally managed contract inventory is created as baseline for the upcoming contract analysis as well as for the VDR upload and later for the transfer contract list in the BTA. As most IT contracts are based on suppliers' templates, they differ substantially in structure and content. This makes an automated analysis rather difficult if not impossible and considerably increases the susceptibility to errors. For these reasons we recommend manual analysis with strict procedures and predefined instructions.

The contract case definition constitutes the most important step and contains the definition of the target state after day one for each contract and what actions need to be taken to achieve this. For instance, a software licenses agreement concluded with DivestCo, is needed by RemainCo for TSA service provision. In this case the contract case might be: DivestCo transfers the contract to RemainCo and RemainCo ensures RTU for DivestCo during TSA period. For this definition, the IT blueprint must be finalized – last minute changes require a complete reassessment.

Depending on the contract case and the contractual restrictions – as identified during the contract analysis – it must be defined, if physical supplier negotiations are needed or a standardized communication (e.g. written or deemed consent letter) is adequate. Before closing the project, updated and separated contract database are being handed over to both parties (DivestCo and RemainCo) and a proper knowledge transfer about all suppliers and contracts in scope is conducted.

To avoid later demands or unjustified claims from suppliers, a full project documentation with the description of all contract cases and documented proof of compliance is created and handed over.

Conclusion

A successful separation of supplier contracts in a carve-out project requires not only a strictly managed and well-structured approach. Particularly IT contracts require special attention due to complexity of the separation of the IT infrastructure and unfavorable restrictions regarding RTU and transferability, which are common in software license agreements. The set-up of a dedicated contract separation team at the very beginning of the carve-out project, equipped with the right skills and tools, is key for a smooth separation to achieve timely day one readiness.

Owing to our vast experience in carve-out projects – particularly for contract separation, we are in a unique position to partner with our clients to successfully manage the separation project and overcome the challenges posed together as a team. Thanks to our further offerings in Supply Management as well as in Transformation & Change Management, we are able to assemble a team with experts in business transformation with profound understanding in changing IT landscapes and operating models and specialists for vendor and contract management (also with legal background), experienced in negotiations with large software providers (Microsoft, SAP, Oracle VMware etc.). Leveraging the expertise of our consultants – combined with their pragmatic hands-on approach – will facilitate the day one readiness of your next carve-out project in an efficient way.

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Who we are

TALOS is continuously striving to shape new standards in management consulting. As a specialized consulting boutique of Swiss origin, we are serving the European financial services industry from our local offices in Zurich and Luxembourg.

Founded by experienced management consultants in 2008, we have grown since then to a renowned consulting company with a complementary service offering across various disciplines.

With our tailored hands-on approach, we accompany our clients in mastering the fundamental challenges the industry is facing.

We are a trusted partner for our clients helping them to increase their organizational effectiveness and operational efficiency.

We strive to be recognized as one of the leading management consulting boutiques for the European financial services industry.

Your Contact

Roland is Associate Partner at TALOS and has joined the company in 2014. His areas of expertise include Project- and Transformation Management, but also Supply Management & Procurement, with more that 10 experience in several Supply Management roles (in his last position as Head Sourcing of a leading Swiss Insurance Company).

Roland Kuhn
Associate Partner
roland.kuhn@talos-consultants.ch

Giacomo is Senior Consultant and has joined TALOS in 2018. He has been working as a management consultant for 9 years and is specialized in compliance, marketing and portfolio-structuring projects across the whole spectrum of the financial services industry.

Giacomo Pelloni
Senior Consultant
giacomo.pelloni@talos-consultants.ch

Zurich
TALOS Management Consultants
Bleicherweg 45
CH-8002 Zürich
Tel. +41 44 380 14 40

Luxembourg
TALOS Management Consultants
6, Rives de Clausen
L-2165 Luxembourg
Tel. +352 26 20 23 54

www.talos-consultants.com
www.shapenewstandards.com