Mergers & Acquisitions

Considerations for Spinout Transactions

When buyers are contemplating the purchase of a subsidiary or assets from a large seller, there are several additional items to consider when conducting insurance due diligence.

Considerations When Buying a Division or Assets from Larger Seller Entity

Particular focus on expense methodology, balance sheet reserves and where reserves are held as well as access to seller's pre-close insurance policies is critical.

This case study outlines some of the issues that can arise when buying a division of a large seller. The items identified below are not meant to be all inclusive and there are several other considerations, including: access to seller insurance policies, settlement of claims, sharing of technology systems and impact on cyber insurance, Directors & Officers Liability, environmental, etc.

When contemplating a transaction involving a division of a larger parent, it is critical to have the right risk advisor. Alliant M&A has worked on thousands of transactions and understands how to apply the right focus to quickly uncover issues as well as opportunity for better management as a stand alone entity.

Case Study

Buyer: Private Equity Firm

Target: Division of Large Publicly Traded Company

Industry: Industrial/Manufacturing

Challenge: Buyer was targeting the purchase of a division/subsidiary of a large publicly traded company; division was approximately $200 million in revenue, representing a very small percentage of seller's overall business.

The division was also considered a high-risk company with significant cost and claims activity related to worker injury and vehicles. This division was afforded insurance as part of the parent's program.

Under the parent's program, there were significant deductible thresholds, ranging from $1 million to $5 million which further complicated handling of pre-close insurance liabilities as well as impact to insurance cost post-transaction as a stand-alone business. The negotiated structure of transaction was for the buyer to assume pre-close insurance related liabilities which complicates insurance considerations further. Additional areas of concern included:

- **Risk Transfer Loss of Economies of Scale.** The division will need to secure coverage on a stand-alone basis and will lose benefits afforded by a large parent program as post-transaction no insurable interest will exist. Additionally, the deductible thresholds for the parent entity are greater than the risk tolerance levels that the divested entity could sustain on its own. As such, it is critical to quantify this potential financial impact as soon as possible in due diligence. In this case, the increase represents a $1.5 million – $2 million increase in cost.
- **Self-Insured Expense.** To compound matters relating to the expense, the seller has been under-expensing self-insured deductible claims/losses at the subsidiary by over $0.5 million, resulting in another significant impact to EBITDA post-close. This was likely not uncovered by the seller's advisors as the amount, while significant for the division on a stand-alone basis, was immaterial to the seller entity as a whole.
- **Adequacy and Location of Balance Sheet Reserves.** As is often the case when there is an underreporting of self-insured expense, the balance sheet reserves were found to be inadequate by over $3 million. Additionally, the reserves were held on the parent's balance sheet and these current and long-term liabilities, approximately $8 million, needed to be pushed down to the subsidiary balance sheet which impacted overall liquidity of the business on a stand-alone basis.

Solution

While the above is not all inclusive of the issues to uncovered, Alliant was able to identify the following opportunities to mitigate the issues uncovered:

- **High Claim Costs.** Upon a benchmarking review, the claims costs appeared high by approximately 20-30% when compared to industry and jurisdictional peers. This was likely the result of a forgotten subsidiary by a large seller and by applying the right focus to pre- and post-loss initiatives, Alliant was confident that the cost could be reduced. After a couple years of work, the Alliant team was able to work with the stand-alone company to reduce expense by over $1 million.
- **Unmanaged Legacy Reserves.** Similar to the lack of focus on safety and post-incident actions, the division pre-close legacy reserves appeared quite high. Alliant worked with the stand-alone company to accelerate the closure of legacy claims and appropriately reduce balance sheet reserves. This resulted in a reduction of legacy Balance Sheet reserves by 25% or $2.2 million.

Alliant M&A is a leading advisor to the private equity community, comprised of a team of approximately 100 people nationwide.

Focused on solutions for private equity firms from Letter of Intent to Investment Exit including the following disciplines focused on pre-close advisory and portfolio management solutions:

- Insurance/Risk Management.
- Employee benefits/Human Capital.
- Transactional Risk (e.g. Rep. and warranty insurance, tax insurance, litigation insurance).
- Cybersecurity, technology and privacy consulting.

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