Building a better working world

Supply chain considerations during a divestiture

The modern supply chain, with its interdependent components and processes, is inherently sensitive to change. Planning for these interdependencies is essential when an organization undergoes a divestment, as 84% of companies plan to do in the next two years, according to the EY *2019 Global Corporate Divestment Study*. Failing to address this complex entanglement can lead to unexpected costs for both the seller and the buyer. It can also delay completing the divestment.

It is essential for CFOs, corporate development officers and supply chain executives to manage and prioritize key separation challenges early in the process to enable speed to close.

Our experience in helping to facilitate hundreds of divestitures has revealed several leading practices across the deal life cycle. Companies can adopt the following practices to drive value for both RemainCo and DivestCo and to ease separation while ensuring business continuity on day one.

Frequent supply chain separation challenges

Supply chain costs
High separation and stranded costs for the seller and transition services agreements (TSA)/ stand-alone costs for the buyer

Organization
Ensuring that DivestCo has adequate resources (e.g., conveyed headcount) to support the new business without impairing RemainCo's ability to continue to operate (e.g., retained headcount).

Interdependencies
Designing the future state supply chain organization and operational processes in alignment with the legal entity and tax efficiency structure and other core business functions

Trade-offs
Managing supply chain performance trade-offs across reliability, responsiveness, agility and costs to align with business objectives and future state operations

Geographic footprint
Determining the right level of centralization or decentralization, given the global nature of most supply chain operations, may further complicate the operating model design

Leading practices in supply chain separation

1

Prepare ahead of time

Assessing the level of entanglement across the supply chain in advance not only helps prevent business disruption on day one but also significantly enhances the level of preparedness for buyer discussions. This can boost both buyer confidence and valuation. Our experience shows that identifying the critical entanglements and stakeholders early — including suppliers, employees and customers — ensures adequate time to plan accordingly, obtain the necessary buy-in and preempt risks.

2

Collaborate early to develop a day one operating model and governance structure

Developing an early plan for the day one supply chain operating model enables leadership to understand the capabilities that need to be stood up, supported through TSAs or replaced for DivestCo and RemainCo. This can help mitigate any potential business interruption on day one. Focus areas include people, processes, technology, contracts, assets and the geographic distribution of these components.

Additionally, defining a robust governance structure at an early stage allows organizations to dedicate the right leaders and resources and empowers decision-making within the team, which helps accelerate the overall deal timeline. As part of this planning, management must establish both the day one (interim) and the future state operating models. This includes executing supplier, manufacturing and commercial agreements between RemainCo and DivestCo to ensure business continuity.

Early planning helps accelerate negotiations
During a divestiture of a leading global auto parts supplier, the seller prepared a function-by-function day one operating model point of view. The seller also identified the key separation considerations, TSA requirements and the separation management governance structure in the pre-diligence phase. This helped the seller to prepare for potential diligence questions in advance and provided significant confidence to prospective buyers, which in turn significantly accelerated the buyer discussions, negotiations and the sign-to-close period with a successful "event-free" day one.

3

Limit potential business disruption on day one by minimizing operational change

The primary objective of day one is to ensure business continuity. This means minimizing changes that can wait. Every transaction is different. In some cases, the objective is to deliver a stand-alone business on day one. In others, utilizing TSAs and transition manufacturing agreements (TMAs) to support business-as-usual operations on day one may be desirable in order to close as fast as possible. The scope of these transition support services can expand across the supply chain focus areas, including:

- **Planning:** demand and supply and a broader S&OP process
- **Sourcing:** procurement activities and extension of services through existing licenses and contracts
- **Manufacturing:** support for products specific to DivestCo business
- **Distribution and logistics:** including freight contracts, import/export and trade compliance

4

Balance the need for oversight, control and incremental costs

Excessive governance and service level controls will result in superfluous administration and stakeholder management. This will eventually slow the decision-making process. Additionally, management should differentiate capabilities that are "must have" versus "good to have," to minimize stand-alone costs for DivestCo and drive value.

When does senior leadership need to decide?
In a recent life sciences transaction, the seller established a separation management office (SMO) governance structure to facilitate the divestiture of a clinical research business. The structure included multiple layers of steering committee bodies to supervise issue resolution and decision-making. Senior leadership needed to be involved in and approve simple functional separation decisions on a day-to-day basis, resulting in frequent bottlenecks and delays in responding to diligence questions, finalizing transition agreements and planning for day one readiness. This further resulted in an extended pre-sign and sign-to-close period, which took four to six weeks longer than planned and created other inefficiencies across the organization.

5

Understand the regulatory landscape

Global organizations are subject to an array of local, regional and country-level regulatory requirements. Failing to obtain the right permits and certifications or otherwise meet regulatory requirements can lead to significant stress for the seller.

Business operation impact assessments, along with compiling the regulatory filing requirements and timeline, must start early. Each phase of the divestment also needs to be made contingent on achieving regulatory milestones.

Managing regulatory requirements as an independent work stream with a team of dedicated specialists is pivotal to ensure successful and timely deal closure.

6

Optimize the legal entity structure

Legal entity rationalization is not a simple task for organizations to execute. A divestiture often provides a business case to review the legal entity footprint for both DivestCo and RemainCo to optimize business operations globally. However, as organizations think through legal entity restructuring, they must assess the supply chain operating model as well. Considerations must be given to identify dependencies between physical product flows, financial flows and the legal entity structures

7

Keep tax considerations top of mind

A transaction inherently transforms a business, so management should always consider a tax-efficient supply chain operating model when outlining the future state. This includes evaluating opportunities to apply leading tax planning practices and locating cost and profit centers in strategic tax jurisdictions. This can help decrease risk and maximize value and profit for both DivestCo and RemainCo.

Leading tax planning practices include:

- Assessing local tax consequences in low-cost sourcing jurisdictions
- Analyzing customs duty opportunities
- Evaluating transfer pricing implications
- Identifying indirect tax consequences
- Aligning potential tax outcomes from identified operation model options (e.g., centralized or decentralized, onshore or offshore and others).

8

Enable cross-functional alignment on deal execution

The supply chain function for most organizations has interfaces across business functions (finance, legal, tax, IT and others) and business processes (order to cash, procure to pay). Additionally, the global nature of most supply chain operations and the different degrees of centralization and decentralization of business processes may further complicate the operating model design for both RemainCo and DivestCo. Cross-functional alignment at a local, regional and global level will help streamline the divestiture process and ensure end-to-end coverage.

Case study: streamlining a health care supply chain

A health care imaging company was divesting part of its business to a private equity buyer and was considering the divestment of another business simultaneously. As a result, RemainCo's supply chain organization needed to be streamlined to align with significantly reduced revenue and growth projections.

EY teams helped develop a future state supply chain model that supported the streamlined global operations, aligned to the new go-to-market strategy, optimized the legal entity landscape and maximized tax benefits for RemainCo while also developing a future state SG&A model.

To achieve this, EY professionals began with a market participation analysis to establish the go-to-market strategy (direct, indirect, wholesale/distribution). Following that, an assessment was done to understand the regional and global layout of supply chain and other functions that were either owned, leased or outsourced. The assessment ultimately informed the optimum legal entity structure, including where legal entities needed to be located and under what configuration (principal company, limited risk distributor or other), and aligned the structure with the efficient tax operating model. EY leveraged vendor, customer and distribution data to conduct tool-based computing analysis and to align supply chain manufacturing, distribution and the supplier network to these legal entities. Additionally, EY professionals also conducted multiple interviews and strategy alignment sessions with the CEO, commercial leads across business units, and other executive and senior management teams across functions to determine the key attributes of a holistic future state supply chain operating model.

The redesigned RemainCo operating model eliminated more than US$100m in stranded costs, and 45 legal entities were rationalized, generating cost savings of about US$25m. The sales and marketing organizations were redesigned, cutting SG&A by 23%.

In conclusion

The primary objective of the supply chain function during the divestiture process should be ensuring continuity from day one. But, organizations can also get a head start on preparing for future business strategy needs and functional design requirements, including process innovation, technology enablement, tax efficiencies, regulatory obligations and legal entity rationalization. To do this, they should focus on key supply chain value and risk drivers before and during the pre-close period. Organizations that do this often enjoy an accelerated head start in achieving an efficient end state operating model while avoiding common profit-destroying pitfalls.

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