Key TSA provisions your M&A team needs to know now

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Companies are increasingly focusing on a rigorous Transition Service Agreement (TSA) as a key component in creating deal value. Companies that negotiate TSA terms early in the deal cycle and that pay particular attention to key scope and pricing issues can see better deal results. In addition, acquirers can shorten the time to close by utilizing a dedicated TSA work stream, implementing effective governance teams to manage the TSA, and implementing an appropriate TSA exit plan.
Leading practices for TSA negotiators

Management teams do not always devote sufficient time and resources to developing and negotiating TSAs. That approach is a mistake; the TSA process should begin early in the deal life cycle and be considered along with other important diligence issues. KPMG’s extensive experience in this area reveals that adopting the following leading practices can shorten the deal process and improve deal results.

Understand the key TSA negotiating issues

Setting the scope of the TSA is crucial

TSAs are often used when assets remaining with the seller are needed to maintain the target company’s operations. As an example, TSA services could cover invoicing, cash disbursement, access to IT infrastructure or services, or other critical corporate services.

As the scope of the TSA is being defined, a seller should focus on the deal perimeter and the services required to support operations on Day 1. The TSA should exclude sensitive or risk management–related functions, such as corporate, tax, legal, or insurance. Sellers should avoid replicating the management role; rather, the focus should be on the processing and use of shared services. And buyers should only request provisional services; it is only in the case of a highly entangled entity that services should be migrated.

To reduce their risk, buyers should consider drafting TSA service schedules with an entanglement mapping work stream to identify key functional areas, processes, and systems with dependencies. In businesses that have been combined for extended periods of time, entanglements may be hidden. Buyers must therefore clearly define the current operating processes and services being provided, develop an entanglement map, and identify critical transition service gaps that the TSA needs to address.
One of the most important components of any TSA is its duration. Accurately analyzing and planning the development of key internal capabilities required in the post-TSA period is one of the most important parts of the TSA process. Doing so will ensure that companies are adequately covered during the transition period and also provide the ability to exit TSAs in the agreed-upon time frame. To protect against unforeseen risks, buyers should request a service extension option for each TSA service. It is also important for the seller to understand how long they can effectively render a service. Often, third parties are needed in order to deliver TSA services, and it is not uncommon for IT vendors to limit the amount of time systems can be utilized on a transitional basis. Sellers should be aware of potential costs related to extending services, which can range from employee retention payments to incremental license costs and vendor fees. Lastly, sellers should know how long it will take to mitigate stranded costs related to shared assets needed for TSAs; early termination by the buyer could represent additional, unexpected costs for the seller.

Companies need to understand and develop an appropriate fee structure for services provided. Sophisticated sellers conduct an analysis of the full economic costs related to setting up, delivering, and exiting TSAs during diligence. Relying solely on existing cost allocations for pricing can result in an underpriced TSA. Often, automated processes breakdown and more manual effort are needed during the TSA. Moreover, allocations often do not include all the costs related to shared services. A detailed pricing structure will also allow sellers and buyers to understand the resources needed to support services and limit unexpected fee issues. Buyers and sellers should be aware of and negotiate one-time costs related to establishing services and certain wind-down costs related to exiting services.

The buyer and seller need to agree on acceptable service levels for each TSA service. A detailed description of each service level requirement, including metrics, should be documented and included in the TSA agreement. Also, specific penalties (reduced service fees, reimbursement for lost sales, etc.) for failure to perform an agreed-upon service should be detailed to protect the buyer and ensure recourse against the seller. Sellers, who are not in the business of outsourcing, could balance buyer demands by defining a robust governance process and laying the foundation for a positive relationship between buyer and seller teams.

Buyers and sellers should strive to maintain a collaborative relationship, particularly in longer or more-complex TSAs. If the deal process indicates that the relationship is more confrontational, then all the TSA terms need to be strictly defined, with limited room for interpretation.
Case study

A diversified industrial company divested businesses in its portfolio. The businesses tended to be highly centralized and used a shared service center for back office, IT, HR, and purchasing. The businesses’ operations also commingled distribution and manufacturing. KPMG was engaged to help the client identify entanglements and help develop an operating model for day 1 for “a typical asset in the portfolio.” This initial exercise formed the model to determine what a buyer would be expected to replace and what the seller would be willing to provide, and specific data elements were collected to help the client determine pricing and service levels. For example, in back-office processes, KPIs were collected, and estimates of FTEs needed to support the processes were established. High-level benchmarking allowed the client to determine how long it would take a buyer to replace services (i.e., via outsourcing) and how long the client would need to mitigate stranded costs. Scope, duration, and SLAs were documented in service schedules, which the client used as a starting point for their divestiture work. By working with functional teams, the company determined which services it would not provide and which services would be challenging to provide. The entanglement exercise led to potential actions that the client was willing to undertake in advance of future restructuring and divestitures. At the conclusion of the exercise, the client team worked with members of the corporate development team to develop a common understanding of the trade-offs between different TSA options.

TSA administration requires a multifaceted approach to ensure effective management.

- Define documentation requirements and determine TSA billing process
- Define cadence for reporting, escalating, and resolving issues
- Establish single process to add, change, or terminate TSA service
- Governance, reporting and issue resolution
- Invoicing

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Include functional teams in the negotiation

The TSA is an important part of any integration effort and, ultimately, can have a significant effect on the deal’s success. Both buyers and sellers should prepare the terms of service for negotiation early in the deal process, and functional teams should provide inputs during the pre-negotiation phase. TSA extension guidelines and requirements should be communicated to the functional teams early in the process so they can align their planning assumptions to the TSA extension provisions. The duration of the TSA is another important negotiating point that can benefit from an operations perspective. In some cases, a “big bang,” or immediate exit works best; other times, a “phased” approach is preferable. Understanding and negotiating the exit approach is particularly important when IT and other systems support operations span numerous geographic regions or when complex interdependencies exist. Exiting all TSAs at once can be a risk unless properly planned for and executed.
Include a TSA governance approach

Part of the TSA process should include the creation of an effective program governance structure. This structure can, in turn, be used to quickly evaluate and remedy any TSA-related issues. This approach allows the integration lead to make operational decisions aligned with the TSA program-level guiding principles. The governance structure is operational during all phases of the TSA—scoping, negotiation, and execution—and the right teams should be in place to evaluate service level agreements, TSA pricing, and payments between the two companies.

TSA governance team structure

Case study: A governance program was a crucial component in a short TSA

A consumer products company acquired a major condiment business that was separated from its parent company. To ensure business continuity during the transition phase, TSA services were established, but the service duration was limited to only six months.

The company, assisted by KPMG, quickly developed an overall TSA program management team and a strict governance process with the seller to facilitate communication, resolve issues, and manage change requests. The company was able to transition off of the TSA services in multiple geographies within the required time frame and was able to avoid any disruptions to the business. Effective communications ensured alignment between the buyer and seller and allowed for a timely resolution of issues. A strong emphasis on exit planning contributed to early termination for some TSA services, which led to significant cost savings.
Plan early for your TSA exit

Both buyers and sellers need to agree on the activities, dependencies, and risks required to exit the TSAs in a timely and cost-effective manner and also agree on how to minimize risk to ongoing operations. Companies should aggressively manage toward exit and utilize the governance process to address any potential risks or issues. A mitigation plan should be developed to deal with any potential delays in exiting the TSA.

Additionally, the business, IT, and TSA teams need to be tightly aligned on TSA exit planning and should coordinate the timing of testing and migration of system-level master data. On the buy side, it is important to manage TSA exits in order to realize expected synergies. This can be particularly relevant in the event the TSA exit is tied to a large organizational effort like systems restructuring or a new system implementation.

Case study:
Advanced TSA planning aided a complex integration effort

A global healthcare services company operating in the biopharmaceuticals and medical products segments was conducting a integration of a global business unit. The integration effort spanned over 70 countries, with varying operational structures and utilizing multiple IT systems. The challenge for the company was how to ensure a timely, regionally phased TSA exit across all regions while still maintaining global business continuity.

Having dedicated TSA work stream leaders facilitated retained knowledge throughout the deal cycle, which was critical to developing, administering, and tracking the TSA. Including key leaders from functions during the early planning process helped successfully bridge the gap between the prescriptive legal language of the TSA and the operational nuances that existed. These functional leaders participated in open discussion between companies, which helped to manage expectations, align on interpretation of terms, and minimize ambiguity.
Conclusion

The TSA is an important deal component, and both buyers and sellers are advised to devote adequate resources to negotiating and drafting the TSA. Parties should understand the key terms, plan in advance, utilize cross-functional teams to gain input, develop a governance structure, and plan early for an exit. Utilizing these leading practices can improve deal results and shorten time to close.

How KPMG can help

M&A Services

KPMG advises clients on operational integration or separation of businesses across various corporate functions to deliver value in a timely manner. M&A Services takes an enterprise-wide view in the form of integration/separation due diligence, synergy and cost assessments, TSA development and management, day 1 planning and execution, postclose implementation, change management, and performance tracking.

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