WHAT TO DO WHEN LESS IS MORE
Planning and Managing a Corporate Divestiture

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The Role of Divestitures in Profitable Growth

Strategy is as much about what you do not do as it is about what you do, says Harvard's Michael Porter in his classic *Harvard Business Review* article, "What is Strategy?"

"Leading companies view divestments as a fundamental part of their capital strategy" concluded Big 4 accounting firm EY in its *Global Corporate Divestment Study 2015*. EY also found that nearly three quarters of the firms studied are using divestitures to fund growth and two thirds achieved a higher valuation multiple after divestment.

As a company grows and evolves in a changing environment, and as it makes significant acquisitions, some business units no longer fit well or perform well and may be worth more to others, while the divestiture proceeds can be redeployed profitably in the core business. That's when less is more.

A pruning exercise, or corporate divestiture, can create significant value for shareholders as well as increase opportunity for unit employees and other stakeholders.

The Board and C-Suite executives responsible for a divestiture may need to be as concerned about managing risks and protecting the company's reputation with key constituencies as they are with purchase price. This article addresses both concerns.

Two keys to creating maximum value with minimum risk when divesting a business unit are: 1) adequate planning and 2) professional execution. These tasks may require specialized resources from outside the company.

The Divestiture Process

The divestiture process begins with reviewing operating results and growth plans, and raising questions about the future role of each business unit.

If a company decides to divest, a divestiture team must be assembled to begin planning the project. When the project is initiated, execution will fall into two types of tasks: managing the unit to be divested and managing the divestiture process itself.

The Divestiture Team

In a large company, the corporate development department often manages the divestiture process, and may engage and oversee an M&A advisory firm to handle most activities. In a smaller company, the chief financial officer typically leads the project, with outside advisors.

A financial executive is often assigned to verify the numbers that will be presented to a buyer, adjust unit financial statements to a pro-forma stand-alone basis and, at closing, “unhook” the unit from the company’s IT systems or arrange transitional services for the buyer.

Raising The Question

Whether part of a periodic review of unit performance or a larger corporate strategic decision, the divestiture process begins with raising The Question: ‘Should this unit be divested?’ - and a number of related questions, such as:

Does this business unit have strategic value in the company’s future?

What are the value drivers for the unit? For example:

- Intellectual property, proprietary products, services or skills
- Customer base, access
- Skilled management team

Would the unit be more valuable to another owner? What kind of buyer?

What financial effects would divestiture have on the remaining business?

- Unabsorbed overhead
- Reduced design capabilities
- Loss of inter-divisional sales

How can any negative effects be prevented or minimized?

- Sale of idle facilities
- Outsourcing
- Long-term supply agreement with the buyer as part of the deal

The Decision

The *recommendation* to divest is usually made by the operating executive above the unit, but the *decision* is often made by the CEO, after appropriate involvement by other senior executives and the Board of Directors due to sensitivity to the impact of the divestiture on employee morale and strategy.

A decision of a public company to divest may have less emotion than the decision by a private company owner to sell his or her business, but it can be difficult nevertheless. Non-price considerations, like loss of jobs in the local community, risk of shared brand names, and environmental stewardship may be very important to the divesting company's reputation. In smaller divestitures, price may be overshadowed by these concerns to protect the company's reputation.

If the decision to divest is made, a second set of questions is raised:

What type of transaction would fetch the highest price and best terms?

- Sale to strategic acquirer
- Sale to international strategic acquirer
- Management buyout with private equity sponsor
- Partial sale to a private equity group and management
- Employee Stock Ownership Plan leveraged buyout
- Spin-off/Initial Public Offering
- Liquidation/shut-down

Do we want a long-term supply agreement with the unit?

When is the best time to begin the divestiture process for this unit?

- Industry and macro-economic conditions
- Unit-specific situation
- 'Fix-up' activities needed to maximize value

How will we manage the unit until it is sold?

How will we execute the divestiture process?

Pre-emptive Due Diligence and Planning

Before contacting buyers, management (with the support of financial and legal advisors, and other consultants) should identify and address potential issues that would concern a buyer. The benefits of thoughtful planning and resolving risks up front include:

- Increasing the likelihood of a timely, successful process.
- Presenting more accurate and reliable financial information in the divestiture marketing materials
- Identifying and documenting adjustments with positive financial impact (rather than reacting to a purchaser's negative adjustments).
- Strengthening negotiating position on risks at the beginning of the transaction
- Preparing the management team for likely questions by potential purchasers.
- Minimizing disruptions to ongoing business and management.

A careful review of the unit to be divested should be undertaken. That review should include:

- Predictability of future revenues; market conditions and trends; any issues with key customers
- Financial records and results, including detail accounting records, systems and budgets

- Infrastructure and operations – supply chain/raw materials, products, hazards, and technology
- Environmental and regulatory compliance
- Employee policies and agreements; healthcare issues
- Contracts – review for risk transfer provisions that may have promised indemnification or conferred additional insured status on the seller's suppliers, customers, or past or present corporate affiliates.
- Current risk management/insurance program

To maximize value and minimize risk, it is important to protect against liability exposure, so the planned due diligence should include:

- *Insurance**[1] – organizing in a database all historic insurance policies, applications, schedules of insurance, claims data, insured and uninsured liabilities, corporate history, and a summary of losses by line of insurance. The insurance program should be reviewed to determine: (1) there are no gaps in coverage; (2) there are adequate limits; (3) there are no notices of cancellation; (4) whether the policies are 'claims made' or 'occurrence based': (5) whether there are high deductible, fronted policies, or retrospective premium programs; (6) if there are exhausted policy limits; (7) if there are any open or pending notices of claims to insurance carriers; (8) if any of the policies require an extended reporting period; (10) if there are any weak insurance carriers on the historic insurance program; and (11) if there are any "change-in-control" provisions in the insurance policies that either restrict coverage or eliminate coverage with a change in ownership.
- *Environmental and pollution liability* – ensuring that all information regarding Phase I, EPA inspections, past use of property and disposal activity documentation is available.
- *Property appraisals* – gathering documentation for all property to be transferred
- *Overall risks* – identifying risks and establishing that those risks have been adequately addressed and covered; consider reps & warranties insurance for matters of concern to a buyer.
- *Locating, reviewing and organizing corporate records* - the articles of incorporation, by-laws, corporate minute books, and stock transfer records

A virtual data room (VDR) can expedite closing by making the due diligence documents easily available on-line and provide appropriate security and monitoring capabilities. The cost of this service for mid-size transactions has dropped considerably in the last several years.

Managing the Unit Being Divested

Management of the unit being divested focuses on enhancement of its attractiveness and selling price. Focus is on unit profitability. Inventories and receivables are managed aggressively. Capital expenditure requests are reviewed carefully, but not necessarily turned down.

People, too, are important assets, and communicating with employees and key customers – both the message and timing - deserves careful attention. Some companies develop a detailed written

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*The parties should discuss whether the buyer is going to have rights to the seller's insurance policies. Depending on the type of transaction contemplated between the buyer and seller (asset or stock purchase) and the jurisdictions involved, if the buyer is to have rights to the policies, the parties should discuss the best way to effect an assignment of the policies and specifically address this issue in the Agreement.

‘announcement plan’. Non-compete agreements, ‘stay’ packages, and other means to secure the cooperation of key unit personnel can be helpful.

Managing the Divestiture Process

The Divestiture Team’s job is to create the most effective form of competition for the unit among motivated, qualified buyers, although not all divestiture candidates are attractive enough to enable an auction.

Most companies offer a unit pretty much ‘as is’. They often are, however, willing to warrant the big items, and take seller notes as part of the consideration when necessary to close.

Finding the best buyer candidates and structuring the transaction creatively are skills necessary for a successful divestiture. There are a number of buyers that specialize in acquiring divested businesses, as well as logical strategic acquirers and private equity firms with interest in the relevant sector.

With the range of possible transaction types cited earlier and considering the size of the unit to be divested, the divestiture team may need specialized resources to handle these tasks effectively. If they are not available in-house, an M&A advisor with relevant divestiture experience can be well worth the cost.

Confidentiality will be a top priority of the Divestiture Team throughout the process. Companies typically have individuals involved in the divestiture process sign a confidentiality agreement.

Providing the right information to buyer candidates is essential in achieving the best price. The value drivers and the unit’s future financial potential under an achievable ‘stretch’ scenario must be communicated in writing and discussed by unit management. DVDs enable a buyer to ‘see’ processes and locations. Sector background is helpful where buyers may not be familiar. Giving potential buyers access to all or part of the VDR can also help move the divestiture process along.

Audited financial statements for the unit strengthen a buyer’s confidence and should be provided whenever practicable. Alternatively, if there are no stand-alone financial statements for the unit, they must be extracted from the records of the larger entity. In the case of a large company selling a small unit, this may be a time-consuming but necessary activity because if the buyer doubts the reliability of the unit’s numbers, it can impede or kill the deal.

A divestiture is an important management activity because it can increase shareholder value. It requires the right people, careful planning, creativity and attention to detail.

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