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Why Consider a Corporate Divestiture?

By John Waller

One aspect of a chief executive's job is managing the portfolio of assets that comprise the company. While a mutual fund portfolio manager can readily buy and sell stocks in their fund, it is much harder for a CEO to buy a target company or sell units of his company. But if generating a consistently high return on invested capital is the executive's goal, active portfolio management is as important for the executive as it is for the mutual fund manager.

Between acquisitions and divestitures, acquisitions seem more exciting. The company making acquisitions seems strong and growing and is an energizing place to work with expanding possibilities for employees. Divestitures, on the other hand, seem the province of companies whose fortunes are declining. After all, selling business units looks like admitting defeat, throwing in the towel, crying "Uncle." We believe an alternative perspective relative to divestitures is appropriate. In our experience with corporate divestitures, we believe that a well-planned and executed sale can enhance the value of a company and highlight the dynamic nature of the remaining business.

In one case, the parent company (Company A) designed and manufactured world-leading brands in industrial pumps, valves and monitoring and control equipment, offshore water treatment systems and plant optimization and efficiency systems. Production had been mostly vertically integrated for nearly 100 years, but as a global business, management felt it was increasingly important to source components from companies in the locations it was selling its products. This local sourcing increased sales because customers wanted to support local businesses when possible and, in some cases, lowered component costs.

Company A decided to explore divesting a large facility that was a captive supplier to its business. This facility had only one customer – Company A – and its systems, from ERP to IT and accounting to HR, even its phone system, were deeply entwined with the parent company. While these factors detracted from the value of the business, the facility had significant excess capacity, a highly-trained and motivated workforce and production capabilities that were rare in the United States.

We were retained to advise Company A on the sale of the business unit. We focused our efforts on acquirers who would understand the unique capabilities of the business unit, who could bring additional production volume to the business and who could continue to reliably supply Company A after the divestiture. In the end, we sold the business to a privately-held company that operated in a similar industry and whose customers would value a production facility in the location of the business unit. Company A was able to achieve its three main objectives in this corporate divestiture: it retained the business unit as a supplier of components for domestically purchased products; it gained the flexibility to source components previously supplied by the business unit from other producers around the world; and it preserved its corporate reputation by saving 250 jobs in an economically depressed region.

In another example, Company B had spent over 10 years improving a business unit (Divestiture Candidate) it had built through multiple acquisitions. Company B had increased profitability significantly, reduced working capital, consolidated facilities, introduced new and improved products and built a strong management team. Overall, the business was dramatically improved and positioned to thrive, but it remained a small player in a slow-growing market.

Company B's other businesses were much better positioned in their respective markets, and these markets were more dynamic and offered strong returns. Company B retained us to explore the sale of Divestiture Candidate. We conducted a thorough sale process for the business and in the end sold it for a valuation that far exceeded Company B's expectations. Company B used the proceeds to pay down corporate debt and invest in its other businesses that had higher returns on investment.

The State of Corporate Divestitures

Corporate divestiture volume in 2020 declined 15%, and value declined over 20% compared to 2019.¹ This decline may be a result of corporate management teams focusing internally during the pandemic and not having the time or inclination to pursue a divestiture. But whatever the reason for

the decline, corporate divestitures are likely to pick up in 2021 and beyond. Like a mutual fund manager, corporations need to periodically rebalance their investment portfolio, and the rapidly improving outlook for the resolution of the pandemic will begin to free up corporate resources that are needed to oversee a successful divestiture.

In fact, we anticipate meaningful increases in corporate divestitures during 2021 and 2022. A recent survey of mergers and acquisition professionals showed that 90% of these individuals expect divestitures to either remain at current levels or increase.²

The increase in divestitures will be fueled by a return to the market of transactions that were suspended by the pandemic and an increased sensitivity to corporate liquidity, especially for companies that took on debt during the pandemic and currently have higher debt loads than management is normally comfortable carrying. Finally, business units that were performing well prior to the pandemic and whose performance has declined may now be viewed as non-core and considered for divestiture.

The pandemic has introduced new challenges to the divestiture process: senior management not only has a business to run, but it must also deal with the impacts of the pandemic on the business and its people; face-to-face meetings have been converted to virtual meetings; and both buyers and sellers must try to figure out the long-term impact of COVID-19 on the business being divested and agree on how that impacts valuation. While these pandemic-related factors will begin to wane, the usual challenges in divestitures remain, such as creating carve-out financial statements, addressing employee concerns, identifying which assets and liabilities will be included in the transaction and negotiating the myriad details contained in a transition services agreement.

What Preparation is Necessary to Complete a Successful Corporate Divestiture?

A classic *Harvard Business Review* article outlined the four general rules companies that successfully divest businesses follow:

1. They set up a dedicated team, including outside advisors such as bankers, accountants and lawyers, to focus on divestments.
2. They avoid holding on to businesses that are not core to their portfolio—no matter how much cash they may generate.
3. They make robust de-integration plans for the businesses they intend to sell.
4. They develop a compelling exit story to use internally and externally, taking the buyers' and employees' perspectives into account.³

The remainder of this article, which borrows heavily from “The Pandemic End Game: Preparing for a Resurgent M&A Market” by my colleague Terry Bressler, will highlight some specific actions to consider in preparing for a corporate divestiture.

Management must address a number of items before any divestiture. In addition, in the current pandemic environment, there are several pandemic-specific preparations that should be made as well.

Basic corporate divestiture process preparations include:

- Prepare Financial Information – Make sure the business unit has strong accounting systems to accurately report on its operations. Corporate divestitures are often completed without GAAP financial statements, but, as a rule of thumb, the more reliable the financial information, the higher the valuation and the quicker the transaction, all else being equal. If the divesting company does not have a team that can produce financial statements for the divestiture candidate, consider retaining an outside account to prepare them for the business. Likewise, including a strong CFO or accounting controller in the management team will enhance valuation and timing.
- Identify Corporate Expenses and Normalize Add-Backs – Expenses the business incurs that may not be needed under a new owner should be identified and presented as add-backs. These expenses could include an allocation for executive salaries or other corporate overhead such as legal or environmental expenses. One-time or unusual expenses the business unit incurs should be identified and added back to present normalized earnings of the business. This information will be used to develop a set of proforma financial statements to show performance as if it were owned by a third-party strategic or financial institution.
- Develop a Management Team – Units that a corporation decides to divest are often not run as a stand-alone business; as such, they may not have a traditional management team and hierarchical structure. Developing a management team is often critical in achieving a successful divestiture at an attractive valuation. A divestiture with a complete, strong team is more valuable than one with significant openings in the management group.
- Implement Management Team Incentives – In most divestiture situations, the divesting unit's management team participating in the sale process and remaining with the business post-transaction is essential. Determine which management team members to include in the process and build a retention and incentive bonus plan to reward them for aiding in the business sale and remaining with it post-close.
- Document Customer and Supplier Relationships – Many corporate divestitures are structured as asset sales rather than stock sales. As such, it is critical for sellers to know which customer and supplier contracts can be transferred to an acquirer of those assets and which will require prior approval. For those that require approval, management should estimate the likelihood of having difficulty making the transfer and develop a plan to secure the necessary approvals.

- Determine the Tax Consequences of a Transaction – Proper structuring of a sale can reduce taxes for both the seller and the buyer, and knowing the tax alternatives early in the sale process will likely speed up the closing process. Consult with your tax professional to determine whether a stock sale is possible or if there are actions you can take to lower taxes under either a stock or asset sale. Knowing where you stand on important tax issues will aid in negotiating deal structure.
- Evaluate the Company’s Facilities and Real Estate – Determine whether you want to continue to own the real estate the business operates from or sell it in the transaction. An appraisal and an evaluation of the rental market will be useful to determine real estate value and aid in developing the add-backs relative to the asset.
- Gauge the Competitive Landscape and Business Strategy – Make sure you have a firm grasp on the unit’s industry, competition and position in its industry. Management should articulate the business unit’s competitive strategy and how it will build value in the future. Acquirers are interested in future potential, so provide them with a road map.
- Formulate a Financial Forecast – When divesting a business, acquirers evaluate past performance metrics, but the buyer is really interested in the future results of the business. It is important to have a well-thought-out three - to five-year business plan to show the potential buyer what the business could become and how it will get there.
- Plan for Negotiating a TSA – Corporations often provide services to their business units that they will need to continue to provide for a few months or years after the sale is completed. The agreement to provide these services is called a Transition Services Agreement (TSA), and negotiating it can be a drawn-out process in a transaction. Preparing for the TSA early in the sale process can expedite the closing and help the seller fully separate from the business sooner.

In the current environment, companies divesting businesses must prepare to address issues related to the COVID-19 pandemic. Many of these pandemic issues require a collection of unique information, so cultivate an awareness of what could be asked by buyers and why. Anticipating what additional risks and concerns will be articulated by the buyers will be important to develop the proper information package and address buyer concerns.

- Identify Pandemic Period Revenue Items – If the business unit’s revenue declined because of the pandemic, develop a list of “lost revenue or cancelled orders” and documentation to support these items. This information will be important to show a proforma picture of the business unit’s revenues without a pandemic. On the other hand, if the business units’ revenue increased due to COVID-19, document the increased revenue and, if possible, develop supporting data to explain why the pickup might be sustained post-pandemic.
- Classify Pandemic Period Expenses – Evaluate any expenses the business unit incurred that are directly related to the pandemic, such as costs to ensure employee and customer safety and continuation of operations. Develop a list of pandemic-related expenses such as extra cleaning, personal protective equipment, pandemic bonuses, etc. to proforma the business unit’s operations for a non-pandemic environment.
- Determine Pandemic Supply Chain Issues – Ascertain any supply chain issues that affected the business during the pandemic. For example, were there excess freight charges due to strained shipping capacity? Were orders delayed? Were there premium charges due to raw material scarcity? Alternatively, has the business unit improved its supply chain, including a contingency plan, that will help the business in the future?

- Assess Company Risk and Mitigation Strategy – The business unit has just implemented a series of actions that enabled it to survive a significant natural disaster, one that (hopefully) will not be repeated in our lifetimes. Can these actions benefit the business in the future? Be prepared to provide a candid risk assessment of the business, including what worked and what did not work during the pandemic. The goal is to show how the business survived and how the impact of future events such as this one will be mitigated.
- Evaluate Government Support – Many companies availed themselves of the PPP Loan program and other federal and state support during the pandemic. If used, provide documented evidence of these programs and determine how they will be treated in a deal. These loans are attractive financing and may be passed on to the buyer or, in the case of “granted” PPP loans, may benefit the seller. In any case, details will be critical to the proper treatment of these loans and support in the deal process.

Even with the pandemic, the current deal environment provides an excellent opportunity for executives to contemplate a divestiture for their company. In the short run, the pandemic can still pose deal challenges, but the investment banking community is developing work-around strategies to address these challenges. In the meantime, all executives should evaluate rebalancing their business portfolio to ensure high returns for the parent company. Preparation is key. Keep in mind that the typical M&A deal, including corporate divestitures, takes six to nine months from engagement to closing. If you want to consider a divestiture, it is critical that you work with your advisor to prepare your Company for an M&A process. If you want to sell in 2021, the time to begin is now.

¹ Winger, Jim and Rujana, Jorge. “Divesting during Covid-19, It’s time to lean into the challenges.” Bain & Co. February 16, 2021. <https://www.bain.com/insights/divesting-during-covid-19-m-and-a-report-2021/>

² Ibid.

³ Mankins, Michael, et. al. “How the Best Divest.” Harvard Business Review. October 2008. <https://hbr.org/2008/10/how-the-best-divest>

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