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CORPORATE FINANCE PRACTICE

Profitably parting ways:
Getting more value from divestitures

Companies often struggle to capture the full value of a separation. Here's how to do better.

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Most divestitures start with a strategic decision that a company is no longer the best owner of one of its businesses. It's a natural move for executives who see value in actively managing their portfolio of business units—recognizing that to grow, they sometimes have to shrink first—to deploy capital into a business with higher returns, for example, or to reshape the company's strategy. Indeed, past McKinsey research has shown that companies that more frequently reallocate capital generate higher returns than their peers.[1]

But once a company decides to sell, problems can arise. Managers devote their attention to finding a buyer but seldom scope deals from a potential buyer's point of view, even as they struggle to figure out exactly what should be included in the sale, apart from the productive assets that are its centerpiece. They often think about the separation process only secondarily, assuming they can separate a business and worry about stranded costs later. And they neglect the reality of internal competition for resources that can flare up between the managers who are staying and those who are leaving. Management and the board can get so caught up in the sale that the core business begins to suffer from neglect. All in all, divestiture turns out to be no panacea: sellers can take up to three years to recover from the experience (exhibit). Indeed, some companies are so wary of these pitfalls that they decide to muddle through with businesses of which they

are not the natural owners—another unsatisfactory result, as research suggests that these sales can produce significant returns for both the parent company and the divested or spun-off business.[2]

In our experience, even highly complex divestitures can work well, provided companies follow proven practices, especially in three areas: scoping the deal in detail, addressing the so-called stranded costs left behind when the revenue-generating assets are sold, and managing the expectations and concerns of employees.

These are not discrete goals—in fact, they are mutually reinforcing. Setting clear boundaries for the deal will enable managers to understand the implications of any subsequent adjustments to the scope and accordingly help them maximize value. Clear boundaries will also help the seller understand the costs that are likely to be stranded; knowing these early is essential, as they often require some time to wind down. And the process of defining the deal's potential boundaries lets companies be more transparent with employees about the deal process, its progress, and where they're likely to end up. Getting started on these activities quickly, in parallel with the search for a buyer, can unlock enormous value for buyer and seller alike.

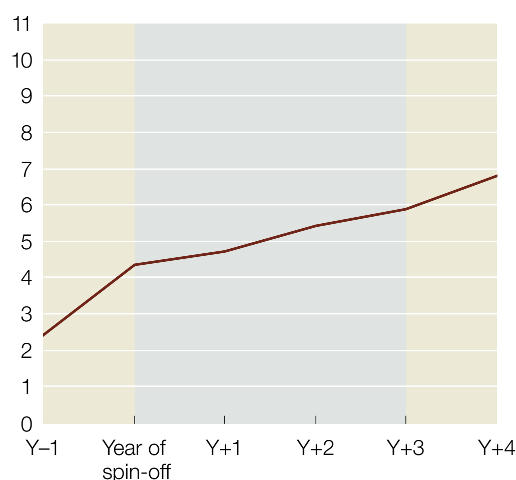
Taking the buyer's point of view

Few companies adequately study the likely boundaries of a deal before they start searching for buyers, preferring to start with a simple high-level

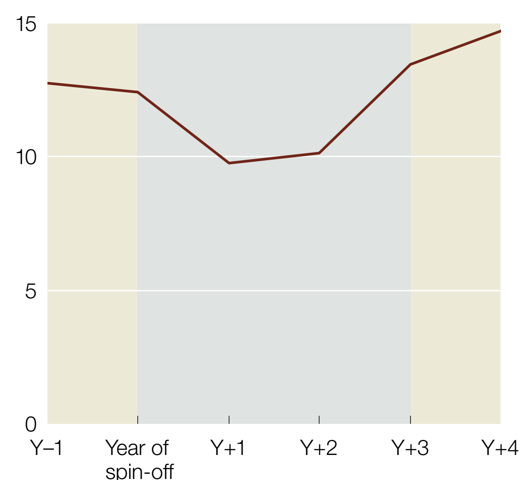
Exhibit

Parent companies can take one to three years to recover after a divestiture.

Parent year-on-year revenue growth,[1] %



Parent EBITA margin,[1] %



[1]Our analysis covered all 144 spin-offs valued over $1 billion globally between 1990 and March 2011; we excluded deals that did not have data on earnings before interest, taxes, and amortization (EBITA) margins 1 year before to 4 years after the spin, where the parent was acquired, or where EBITA is not a meaningful measure; n = 57 for revenue, n = 53 for EBITA.

Source: Standard & Poor's Capital IQ; McKinsey divestitures transaction database

definition rather than dig into the details. Admittedly, it's a bit impractical to define exact deal boundaries before the identity of the buyer and its preferences are known.

To get around that problem, smart sellers define a number of different deal packages—of assets, people, and services—configured to attract interest from a broad spectrum of buyers. These packages not only broaden the field of potential buyers, often in ways that companies cannot envision at the outset, but also help the company cope with the tough questions that buyers inevitably have about what's in scope, how to separate, the transitional services they can count on, and the financials of the business. Sellers that haven't begun to define the deal will be unable to provide good answers—delaying the sales process and losing their competitive position, as well as leaving buyers to factor more risk into their valuation models and lowering the value they see in the deal.

When one European private-equity firm, for example, didn't get all the answers it sought about a company it was negotiating to acquire, it raised the level of assumed risk in its valuation model, suppressing the value of the deal and lowering the price it was willing to pay. To prevent such problems, a US industrial company divesting a subsidiary conducted a detailed analysis of its true sales, general, and administrative costs and, by clearly defining which activities were attributable to the business being sold, found them to be tens of millions of dollars lower than current allocations. That exercise provided detailed information for potential buyers, increased the profit of the business being sold, and helped get a higher price for the deal.

Sellers can construct sale packages for a range of buyers. Each buyer is unique and will have more or less need for infrastructure, capabilities, and a geographic presence where the assets for sale are located. To prepare for the wide range of needs, most sellers will want to develop basic packages for at least three types of bidder: a strategic buyer with a local presence, a strategic buyer from another region, and a private-equity firm seeking a stand-alone entity. Bundles for strategic buyers with no local infrastructure and for private-equity buyers typically include more support services

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than those designed for local strategic investors, which may only want the operational and market-facing parts of the business.

These packages represent two ends of the spectrum; in between, there are many possible configurations of support services to package with the assets. And there may also be buyers interested in cherry-picking parts of the core business instead of taking all of it—which, while probably not ideal, should not be discounted out of hand. Sale packages include pro forma financial statements tailored to represent the package being offered to each buyer or class of buyer that highlight the true value of the business, separation and transition plans, and details on proposed management and talent assignments.

When a large industrial company was looking to divest one of its business units in the late 2000s, its managers' first instinct was to sell to a large strategic buyer. But by conducting a form of due diligence on its prospective buyers (often known as a "reverse due diligence")—including some private-equity firms—the company was able to understand all the potential synergies each would gain by buying the business. That enabled managers to design a specific value proposition for each potential buyer. Eventually, they were able to attract—and sell the business to—a much smaller player that hadn't even come up in their initial scan for potential buyers. Even better, the company got a price 20 percent higher than first expected. In fact, all the bids exceeded expectations; the final list of bidders included a private-equity consortium and a few other unanticipated interests.

Rooting out stranded costs

One of the most challenging aspects of a major divestiture is that even sellers that control expenses well are inevitably left with some corporate costs associated with the business but not sold with it. Without the revenues to support them, these stranded costs are a direct threat to the bottom line. Stranded costs essentially can be any type of cost that does not automatically disappear with the transaction, from costs related to shared services, such as marketing and investor relations, to IT infrastructure. Some of these are fixed, such as the IT system, and cannot be readily reduced regardless of the size of the divestiture. Others are more variable and can contract, for example, with a lower head count—but they can still take years to unwind unless explicitly planned as part of the divestiture. As noted, sellers often take up to three years to recover from a divestiture.

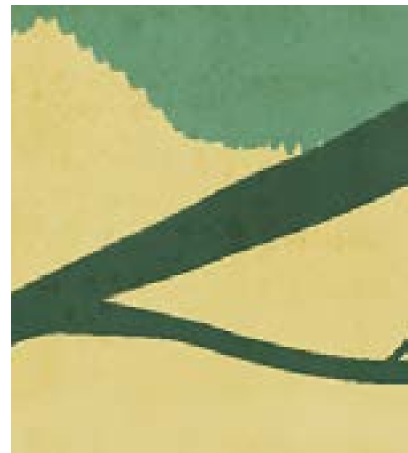
Sellers whose cost management is weak are all the more challenged by stranded costs and are often surprised by how much overhead they have. The divestiture typically reveals unsuspected layers of complexity or outright duplication within centralized functions.

We see three strong practices to reduce overhead. First, as we have discussed, defining the precise boundaries of potential deal packages early in the deal brings to light the full extent of the subsidiary's sales, general, and administrative costs. The parent company can make a better attribution of resources to the parent and the subsidiary. That benefits both companies.

Second, successful sellers often use the momentum generated by the divestiture as a catalyst to reduce stranded costs—and to improve the performance of any bloated or inefficient corporate-center activities revealed by the divestiture. (This mirrors a similar effect of transformational acquisitions, in which buyers take advantage of

the circumstances of an acquisition as a catalyst to restructure costs more broadly.[3]) Companies can seize the impetus of the divestiture to reexamine their entire cost base using benchmarking analysis to highlight potential inefficiency or even zero-based budgeting to encourage a radical rethinking of the corporate infrastructure.

Rooting out stranded costs takes a separation manager with the foresight to rethink the parent company's cost base and the authority to make it happen—the third good practice.

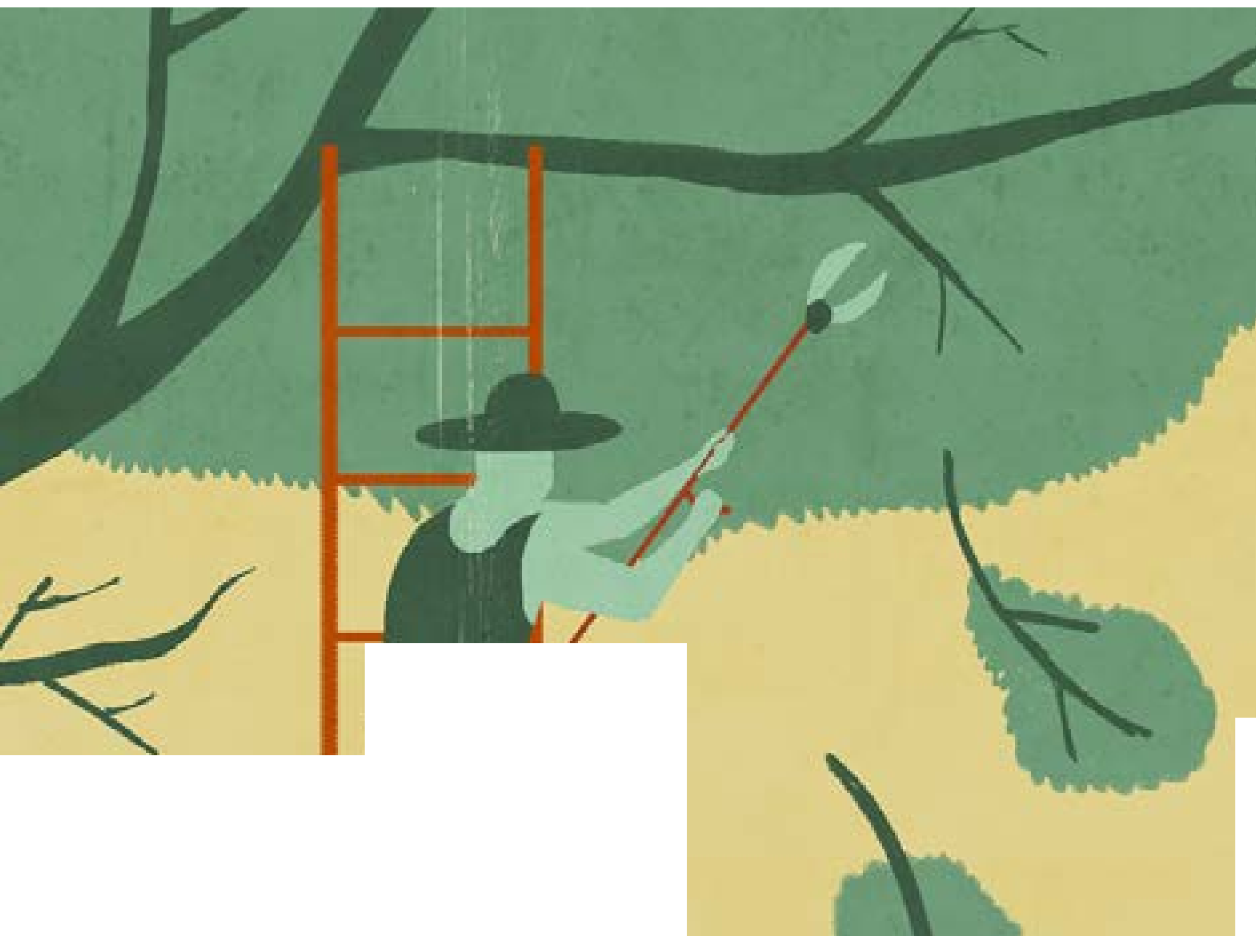


One industrial organization had divested a few units over the years, but it had not followed suit with its corporate functions, which were still sized for their earlier duties. When it came time to shape another big divestiture, representing about 10 percent of revenues, the company conducted a thorough search for the stranded costs that lay within individual support functions, as well as costs that cut across functions such as real estate. All told, these added up to hundreds of millions of dollars. That proved to be a catalyst for an even broader cost restructuring.

Companies of this size often face a special problem in rooting out stranded costs. For many large multinational companies organized by matrix, the only pragmatic method is for senior management to lead a cross-functional initiative to tackle cross-cutting opportunities such as shared-service and outsourcing operations, as well as the change programs required to support the cost transformations.

Managing employee expectations

The challenges of talent management in a divestiture start at the moment companies begin defining the boundaries of different sale packages and continue right through to the close of the deal. First and foremost, managers struggle to figure out what to say to the people involved. Most choose to say nothing at first, reflecting the genuine uncertainty about what will happen. Sometimes company leaders will choose to keep plans for the deal confidential up until signing—as one global CEO and seasoned divestiture veteran told us, "I just deny everything until the deal is signed. It's easier that way." This may be true, but it creates a communication challenge. Many employees inevitably will know about the deal because of the massive preparation work that is impossible to conceal. But if management officially denies the reports, it becomes very



difficult to put in place communication plans and other measures to minimize the concerns that always arise in such situations—all employees want to know, "What happens to me?"

Some form of short announcement is essential. Once managers make an announcement, they should clearly define and communicate the selection process to keep employees motivated while they wait for news of their fate. That can, of course, be challenging in situations where the deal boundaries are unclear until late in the process. Ideally, the communication plan should be part of a compelling story that shows not only employees but also investors, analysts, and customers why the divestiture will leave both buyer and seller better off.

Once the word is out, other challenges begin. In almost every divestiture we've worked on, tension has arisen from the moment it becomes clear who is staying and who is going. Given the role the exiting managers will play in communicating the business's value to potential buyers, delay in informing them is undesirable. But once they are informed, they immediately become another party at the negotiating table, bargaining for the talent, assets, and contracts they feel they'll

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need to be successful and trying to avoid the ones they don't want.

Failing to manage the tension between the two groups can be damaging. When a global industrial company divested a multibillion-dollar division, for example, it began to receive a lot of applications for transfers from the entity to be divested back into the parent company—so many, indeed, that the company was at risk of visibly depleting the divested company of talent and experienced leadership, potentially affecting its value. To discourage the transfers, it aligned the incentives of people in the departing unit to the characteristics of the sale. It decided to reward managers based on earnings before interest, taxes, depreciation, and amortization (EBITDA)—a critical negotiating point with the private-equity firm that ultimately bought it. The emphasis on EBITDA motivated exiting managers to minimize the overhead they took with them; it also reduced transfer requests.

This approach did leave more overhead for parent-company managers to deal with, just as they too were striving to reduce overhead costs. But they made a conscious choice to accept this, believing that the right way to deal with broader cost issues was, as we discussed above, as part of a thorough change process in the wake of the divestiture.

Parent-company managers often lack the incentives that would compel them to take care of the departing entity. If they do not feel responsible for the unit's success, they may stop investing in value-creating projects, caring for employees and customers, or watching costs. In our experience, it is important to define and implement a set of performance measures and rewards aligned with value maximization, and to use these with all key people involved in the divestiture process. The most obvious rewards are monetary, but research shows that other incentives (such as recognition and promotions) can be equally if not more important determinants of performance.

Negotiations over talent are particularly sensitive. The first inclination of parent-company managers is to keep the best performers and send the rest with the divested business. That's not practical, in the end, because regardless of the type of buyer, the divestor has a moral obligation—and in some places a legal one—to make sure the business is a going concern. Furthermore, sellers who intend to divest multiple businesses in the future do not want to be perceived by the market as selling bad businesses stripped of key talent, as this will of course affect their ability to make future deals. At the same time, the parent company must retain critical resources, and quite often, the exiting managers have the very skills they need. Thus, successful divestors will address the issue of

talent early in the process and start building or acquiring the skills needed in both the parent organization and the business to be sold.

Much of the value of a divestiture depends on the effectiveness of the separation process. Defining the right deal, managing talent uncertainty, and rooting out stranded costs can make the difference between a deal that succeeds and one that destroys value. And skill in divestiture is comparatively rare; doing it well can help companies get a competitive edge.

[1] Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," mckinseyquarterly.com, March 2012.
[2] Bill Huyett and Tim Koller, "Finding the courage to shrink," mckinseyquarterly.com, August 2011.
[3] Marc Goedhart, Tim Koller, and David Wessels, "The five types of successful acquisitions," mckinseyquarterly.com, July 2010.

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