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Divestiture: stay or exit

Let's say you are the CEO of ABC Sports, which began its corporate life making footballs. It now has a leading brand in this product line. A few years ago, the management decided to leverage their strengths in the football business to enter footwear. The experiment has not been deemed successful, as your shareholders kindly pointed out to you during the most recent annual shareholder meeting. You are thinking of getting out of the footwear business and of refocusing on making footballs. Should you exit the footwear business and, if so, in what manner?

Divestiture refers to the process of reducing the portfolio of the businesses a firm owns. It is one of the two important ways in which a corporation reduces its scope. The other is outsourcing (the subject of Chapter 8). Divestiture occurs when the firm reduces the number of businesses it is active in by completely pulling out of the value chain and ceasing to offer the products from that value chain to the relevant customers. Consider ABC Sports, which is active in two businesses: footballs and footwear. If ABC Sports decides to *divest* the footwear business, this implies that it will no longer offer footwear. Alternatively, it may decide to *outsource* the manufacturing of the footwear, while

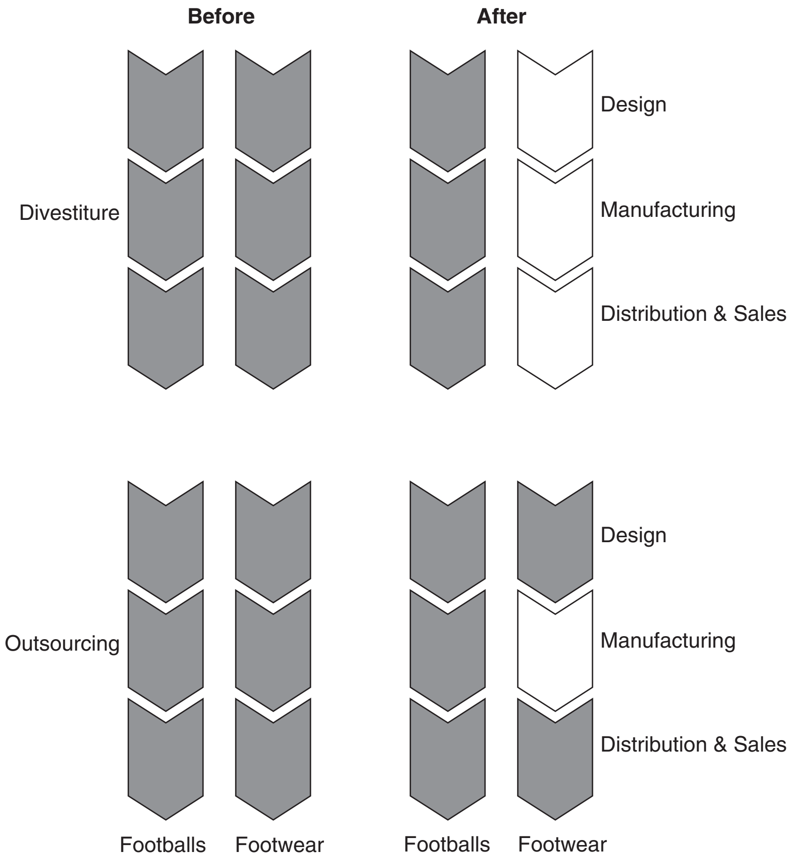

Figure 7.1 The difference between divestiture and outsourcing

still designing them and distributing them. The difference can be visualized as in Figure 7.1.

The two basic modes of divestiture are sell-offs and spin-offs. In a **sell-off**, the divested business is *sold to another company*. When the other company uses a significant amount of debt to finance its purchase, the transaction is called a leveraged buy-out (LBO). A special case of this is when the incumbent management of a business unit takes over the ownership of the business (again typically using debt finance); this is called a management buy-out (MBO). In a

spin-off, the shares of the divested business B are *distributed to the shareholders* (of the parent business A) and business B is listed on the capital market. Thus, the shareholders can choose whether they want to hold both shares or sell their stakes in business B. The parent business A may also choose to hold some residual stake in business B. This can be a tax free event, if the parent divests a minimum threshold of shares. In contrast, the corporate parent is liable to capital gains tax in the event of a sell-off.

Two other modes of divestitures are equity carve outs and split-ups. In an **equity carve out**, the parent sells a fraction of business B's stock to the general public and keeps the rest. This is also called an initial public offering (IPO). Typically, parents keep initially around 80 percent of business B's shares. As such, they keep control, can consolidate the earnings of business B with the parent's other business, and avoid paying taxes on the money raised from the sale of shares (taxes are due if the fraction sold is above a threshold). Under a **split-up,** shares are created in the underlying businesses, while those in the former parent are discontinued. In Table 7.1 (p. 138), we summarize the differences between these modes of divestiture. In Figure 7.2, we highlight the ownership differences.

It is only in the case of an equity carve out that the parent firms continue to control and exert influence on the business. Yet, within a few years of an equity carve out, the vast majority of parents will have reduced their stake to only a minority or no stake at all by selling more to the general public, by distributing shares to the parent's shareholders (spin-off), or by selling to another company (sell-off). This raises an interesting question: if equity carve outs are temporary, why go through the trouble of doing one instead of opting directly for, say, a spin-off or sell-off? Staged transactions can offer certain benefits. A spin-off preceded by an equity carve out generates cash, whereas one without does not. This is handy for cash constrained companies. A sell-off preceded by an equity carve out

TABLE 7.1 *Modes of divestiture*

	Sell-off	Spin-off	Equity carve out	Split-up
Ownership passes to	Other company	Existing shareholders	Public	Existing shareholders and sometimes public
Generates cash	Yes	No	Yes	Yes if through equity carve outs; no if through spin-offs.
Parent remains in control	No	No	Generally (in the short term)	Parent ceases to exist
Tax free event	No	Yes, if percent of shares divested is above threshold	Yes, if percent of shares in the IPO is less than threshold	Yes

establishes a market price that companies can use in their negotiation for the sale of the business. This is useful when there is uncertainty about the value of the business.

In the remainder of this chapter we will focus on sell-offs and spin-offs. Split-ups are typically achieved through spin-offs and carve outs, and carve outs often end up as sell-offs and spin-offs.

The divestiture decision

Let us say your corporate portfolio comprises business A and business B. Whether you should keep or get rid of business B in the portfolio is the divestiture decision (see Box 7.1).

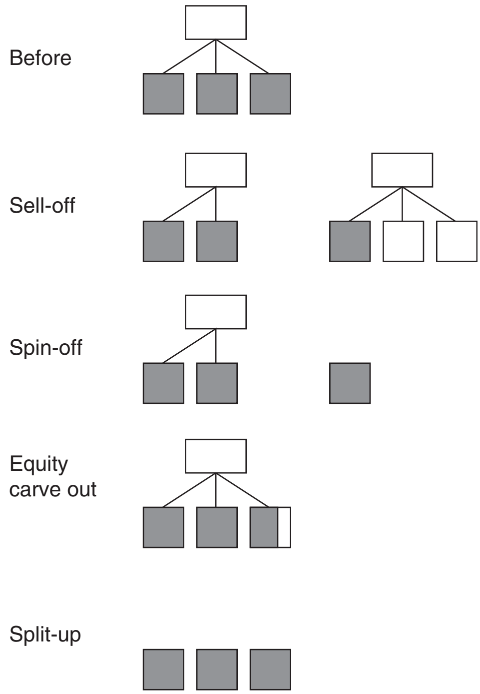

Figure 7.2 Ownership after divestiture

From the divestiture test it follows that a corporate parent should divest for one or both of the following reasons:

(a) Failing the synergy test.

(b) Another corporate parent is a better owner.

1. Failing the synergy test

In the absence of synergies, divestiture is a good option. Assuming $D_m[B] \geq V[B]$ (i.e., for a sell-off, the price of selling a business is at least the standalone value of that business; for a spin-off, $D_m[B]$ is the standalone value of that business), then a failure to pass the synergy test is sufficient to pass the divestiture test. The synergy test fails if separately operating two businesses is at least as good as jointly

Box 7.1 The divestiture test

The divestiture test can be written as:

$$V[A] + D_m[B] > V[AB]$$

V[AB] is the NPV of business A and business B when they are jointly owned, as in the status quo. V[A] is the standalone value of business A after divesting business B. $D_m[B]$ is the value from divesting business B for the original shareholders of the parent under divestiture mode m, either sell-off or spin-off. The key to operationalizing this test is estimating the NPV of business A and business B when separately owned.

Divestiture mode (m)	**$D_m[B]$**
Sell-off	The price for which business B is sold to another company
Spin-off	The value of business B as an independent, divested unit

operating them (i.e., V(A) + V(B) ≥ V(AB)). For instance, there are no benefits from collaboration and each business would be better off making their own, independent decisions. The synergy test also fails if there are negative synergies. For instance, business B supplies business A and business B has difficulty attracting other customers as long as it is jointly operating with business A. Thus, failing the synergy test is grounds for a divestiture. It goes without saying that before proceeding to divest, we should also look at the possibility and feasibility of taking measures that will ensure that we pass the synergy test, such as restructuring, re-engineering, and synergy projects.

2. Another corporate parent is a better owner

If business B is better off with a different corporate parent than the current one, then it's time to divest business B. This might be the

	Synergy test: Pass	Synergy test: Fail
Is there a better parent? Yes	Situation 1: Sell-off	Situation 4: Sell-off (if high premium or low taxes) or Spin-off (if low fees)
Is there a better parent? No	Situation 2: Keep in portfolio (if full ownership is best), Equity carve out (if partial ownership is best), or Spin-off (if no ownership is best).	Situation 3: Spin-off

Figure 7.3 Choosing a divestiture mode

case even if business B is performing well and is benefiting from the presence of business A. Thus, it is not necessary to fail the synergy test; even if the synergy test is passed (i.e., V(AB) > V(A) + V(B)), as long as you can get a really good price for business B (i.e., D[B] >> V[B]) then you should still divest. This might happen, for instance, if some other corporate parent has even stronger synergies with business B than you do (or thinks that they do). This is one of the reasons that an active policy of looking for divestiture opportunities is sensible.

Whether the divestiture test is passed in one or both ways noted above has implications for the mode of divestiture. The joint implications are laid out in Figure 7.3. Suppose the synergy test is passed. If there is a better parent (Situation 1), i.e., the other parent can pay more for the business than that what it is worth to you, then a sell-off is an attractive option. If there is no better parent (Situation 2), this leaves several alternatives for how best to exploit synergies. Chapter 5 uses equity levels to distinguish governance structures, e.g., non-equity alliance, equity alliance, and full ownership. If full ownership is best to exploit synergies, then keeping the business in the portfolio is preferred. If partial ownership reduces the governance costs, then an equity carve out can be considered. If no ownership allows synergies to be exploited at the lowest cost, then a spin-off should be considered.

Suppose the synergy test is failed; then we have effectively ruled out the option of keeping the business in the portfolio, and we must still decide between spin-off and sell-out. If there is no better parent (Situation 3), then the option is clear: a spin-off. The case where you fail the synergy test and believe you can realize a gain from sale to another parent is an interesting one (Situation 4). You should consider a sell-off, especially if the other parent is willing to pay a high premium compared to what the business is worth to you. However, capital gains are typically taxed. So companies may still choose a spin-off, possibly preceded by an equity carve out. The choice between a sell-off and a spin-off will depend on considerations such as the expected valuation in each mode, the applicable tax rate, and the underwriting fees (for the equity carve out), see FAQ 6 (p. 150).

Basic facts about divestitures

The basic facts about divestiture to emerge from existing research relate to two areas.

1. When does a divestiture occur?

(a) **Unrelated diversification**: Companies that are most diversified are more likely to divest a business, and they are most likely to divest the business that is unrelated to their other businesses. It could be that synergies are fewer (e.g., jointly operating value chains does not create value) or harder to exploit (e.g., top management time is limited).

(b) **Poor operating performance**: Companies that perform poorly (e.g., low earnings) are more likely to divest a business, and they are most likely to divest the business that does worst.

(c) **Poor stock market performance**: A company with a substantial diversification discount is more likely to divest, i.e., if it trades at a discount relative to non-diversified companies (see the SOTP analysis in Chapter 1 and also Chapter 4 on diversification). Such a discount arises if shareholders and analysts have difficulty in valuing the different businesses or appreciating the synergies between them (e.g., when the company has an unusual mix of businesses). Analysts are typically organized by industry, making it harder for them to appreciate value creating opportunities that span multiple industries. After a divestiture, the company might be easier to value (but possibly at the loss of synergy exploitation).

(d) **External pressure**: Activist investors often demand a divestiture, especially if a company is diversified into unrelated businesses, or has poor operating or stock market performance. Thus, external pressure amplifies the preceding conditions.

(e) **New CEO**: Divestitures often coincide with the appointment of a new CEO. A divestiture can be a transformative change for a company and a new person may find it easier to take and implement such a decision than a CEO who has been in the job for many years.

Other important, but somewhat idiosyncratic, reasons for divestiture include tax advantages, or anti-trust requirements following a merger to avoid excessive concentration of markets.

2. What is the outcome of a divestiture?

The consequence of a divestiture for the divesting parent is typically good for market returns. On average, a corporate parent that divests a business increases shareholder value. When measured in terms of a change in share price, this amounts to a low single-digit increase (typically around 2 percent) for the divesting parent. Likewise, accounting measures such return on assets (ROA), return on sales (ROS), and return on earnings (ROE) also improve for the parent.

Note that these findings do not, however, mean that a corporate parent should divest all its business, or that a strategy of divestiture will benefit every corporation that attempts it. This is because these results are mostly from a non-random sample of divested units – corporate parents divest precisely those businesses for which it makes sense and hold on to those for which it is better that they stay in the corporation.

Somewhat surprisingly, spin-offs and carve outs seem to do better than sell-offs in terms of value creation for the parent. One interpretation is that the destroying of standalone value is more of a problem (and therefore unleashes more value when solved) than missing out on the additional value a better parent can create. Alternatively, it could be that this reflects a sequential process. First there is a partial IPO and then a sell-off so that the market reactions to an IPO may already include expectations about a subsequent sell-off.

Application: ABC Sports

Lets say that you are appointed the CEO of ABC Sports, whose problem was described at the beginning of this chapter. You notice that various stakeholders are increasingly asking why ABC Sports entered footwear, and why it should continue to operate in that business. The more vocal critics ask for the footwear business to be divested. How would you reach a decision?

Step 1: The synergy test

The first step is to understand whether the footwear business is generating any synergies with the football business. (Note: we focus on operational synergies; you may also want to check for financial synergies.) The following two thought experiments may help. First, imagine that starting today, the two businesses would be moved into separate ownership and would be operated completely independently, with no communication or exchange of any kind between the two. How would the value of the businesses be affected? If there are indeed synergies between the two businesses, then the effect of such a separation should be an adverse one. Second, imagine that the ownership of the businesses would still be separated, but the business would be allowed to collaborate. In other words, if there are synergies, would those be best exploited under separate or common ownership?

To make sure that you are considering all the possible ways in which synergies might exist between the businesses, you may find it useful to use the 4C's approach outlined in Chapter 2. Recall from

Chapter 2 that operational synergies come in four types: Consolidation, Combination, Customization, and Connection. Further, these operational synergies derive from the value chain (and its underlying resources). So you could begin by drawing the value chain of the footwear business and that of the football business to make an assessment of the presence or absence of these different types of synergies.

You could also get some benchmarking data to compare how your footwear business is doing compared to other standalone footwear businesses, or those that are part of a larger corporate portfolio. But please note that you may still be passing the synergy test between football and footwear businesses even if the footwear business is doing poorly compared to its standalone peers.

If at the end of this exercise you conclude that significant synergies *do* exist between the businesses and those are hard to extract without (partial) ownership, then we have *ruled out* one option: spin-off. This is becaue a standalone valuation for the business cannot exceed what it is worth to you if there are synergies. You must still decide whether to keep footwear in your portfolio, or whether you can find a better corporate parent. If on the other hand you are *not* convinced that any synergies exist, then you have *ruled out* the option of keeping footwear in the portfolio: you must then decide between spin-off and sell-off. In other words, whether or not you pass the synergy test, you must consider the option of finding a better corporate parent.

Step 2: Finding a better corporate parent

Next, you should analyze whether other corporations are better corporate parents. You should distinguish between the following types of corporate parents:

(a) **Synergistic buyers**: Corporate parents active in the footwear business, or those who are not in footwear but who may see synergies with their existing businesses.

(b) **Financial buyers** (with limited operating synergies) who may be primarily interested in the footwear business to improve their financing structure.

Note that these are two ideal types of buyers, and in reality some kinds of buyers will fall somewhere in between; private equity firms, for instance, are sometimes seen as purely financial buyers, but this need not be true. To the extent they aim to improve the operations of their acquired companies by applying superior management skills, or by linking to the operations of other portfolio companies, then they are also synergistic buyers. You may also consider dividing up the business into pieces that are more likely to find better corporate parents. For instance there may be different takers for the manufacturing assets and for the brand and distribution assets of the footwear business.

With the help of your corporate development team, you can make a list of companies under each category. You could look at trade journals, or ask your investment bankers to quietly ask around and get a sense of what the market might be like. You could also look for private equity firms that have been active in the past in related sectors, and see if your footwear business fits the profile of the kinds of deals they have done – in terms of the operational performance relative to peers, or financing structure, for instance. For the synergistic buyers, you could use the same kind of analysis you did in Step I, to see if their value chains would generate stronger synergies with your footwear business than you do between footballs and footwear. In particular, you should look closely at those potential buyers that are in the footwear business, as they may have significant Consolidation/Combination synergies with your footwear business.

At the end of this exercise, you must be able to answer the following question: is it likely that you can realize a valuation from these other buyers that will leave you with a gain if you were to sell your footwear business to them? What you do next depends on combing this information with the results of your synergy test in Step I, as shown in Figure 7.3.

Step 3: Implement

If the analysis leads to an indication that sell-off or spin-off is indeed appropriate for the footwear division, then you now have a clear rationale for your decision. Consider also the possible dependencies between your retained business and the divested business, **particularly in the case of sell-off when you are still passing the synergy test** – one of the units may still need to provide some inputs or services to the other. This is equivalent to realizing $D_m[B]$ not at one time, but over a period of time in the divestiture test (see Box 7.1). These should be contractually specified and agreed upon with the buyer, and possible transactional hazards should be considered (see Chapter 3 and also Chapter 8 on outsourcing).

You will also need to prepare your footwear (and indeed football division) employees for the divestiture. The rationale for the divestiture, how it will ultimately create value for shareholders, and what guarantees you have obtained from the buyer about the care of your employees once transferred to them, all need to be communicated clearly to the relevant constituencies.

If, on the other hand, you choose to retain footwear in the portfolio, you now have a clear rationale for this – including a more detailed statement of synergies than you probably started with, and a sense of how other corporate parents might value the business. Next time you are asked why the footwear business is part of ABC Sports, you know what to respond: because ABC Sports can create more value from the footwear business than if it were standalone, and no one else can replicate it!

Common mistakes to avoid

Be proactive, not reactive: Divesting when you can, and not when you have to is usually preferable; distress sales rarely turn a profit. It's hard to let go of businesses, and it is something that does not come naturally to many corporate managers. Hence, for divestitures to happen management often seem to need to be pushed into action, e.g., by activist investors, bad performance, new incentive plans, or even replacement of the CEO. However, from the divestiture test, it is clear that divestitures might be sensible even if a business is doing well. In other words, a proactive attitude is useful, which is at the core of what a corporate strategist as the manager of a portfolio of businesses must cultivate.

Consider the consequences for the retained organization: Sometimes divesting a business might still mean that your remaining business are dependent on them, or vice versa – for inputs (as in the case of outsourcing) or to share infrastructure. Think about how these dependencies will be managed once ownership changes hands. Transaction service agreements (TSAs) are contractual means of recognizing such dependencies and stipulate how the buyer can continue to receive certain services from the seller for a period after the divestiture (and possibly the other way round). These should be part of the divestiture negotiations in the case of sell-offs, and may also influence the valuation of the assets. A more subtle form of dependency lies in the fact that your own employees will evaluate you as an employer based on how the divested employees fare in their new parent corporation. A transparent and fair process for transitioning employees to the new parent is therefore not just ethically important but it is also good business sense.

Frequently asked questions

1. Another corporate parent wants to buy one of my businesses. We think the other parent is a better owner, but we can't agree on a price. What should we do?

Here it appears that both sides see benefits from a deal. One possibility is to do a partial IPO (i.e., equity carve out), followed by a sell-off. The market price after the IPO then becomes a reference price for the negotiation. This is especially useful when it is difficult to value a business (e.g., uncertainty about future growth rates, intangible assets).

2. I understand the importance of identifying the best corporate parent for divestiture decisions. Is this also relevant for the diversification decision when buying a company in a business in which you are currently not active?

Yes and no. When you buy a company, it's important to understand if you can create more value than the current owner and other bidders, i.e., if you are a better parent. If you cannot create more