Module 3

Corporate Financial Decision-Making for Value Creation

Corporate Restructuring via Spinoffs, Divestitures and Equity Carve-outs
(Increasing value by decreasing size)

Presenter: Sean Pinder

Corporate restructuring defined

Corporate restructuring involves a transaction where a company is reduced in size by asset disposal (divestiture) or is divided into separate entities (spin-offs and equity carve-outs).

Possible reasons:

- Better alignment of interests of managers and shareholders
- Transfer assets to those that can use them better (and value them more)
- Provide sharper focus to management
- Correct strategic mistakes of management
- To highlight new information about the value of different parts of the firm to outsiders
- Mostly to unlock the **Diversification Discount.**

Empirical evidence of the “*diversification discount”*

Philip Berger and Eli Ofek published a very important research paper in 1995 titled “Diversification’s effect on firm value.”

In that paper – they examined the effects of diversification by estimating the value of diversified firms’ segments – as if they were separate firms – and then compared these values to single-segment firms in the same industry.

How did they estimate the value of individual business segments of listed multi-segment firms?

- They used accounting multiples – such as EBIT and Sales!!
- They found that multi-segment firms – relative to single segment firms - experienced a value loss of between 12.7% and 15.2% (depending on which multiple was used).

Empirical evidence of the “*diversification discount”*

They then examined reasons for the discount and found that it was linked to:

i. Overinvestment – that is investing beyond all positive NPV projects
ii. Cross-subsidization – where poor performing units are kept afloat by the star performers.

They found that the discount was mitigated when the business segments were from **related** industries.

But what about the benefits of diversification?

i. More tax shields as better debt capacity
ii. Earlier use of tax shields – as tax losses can be quickly offset against taxable income.

BUT STILL NOT ENOUGH TO OFFSET DISCOUNT!!

Divestitures

A divestiture is simply an asset sale – that involves the firm selling off a business unit for cash.

Common reasons for divestitures:

i. Management may lack the expertise to run the company in its current state
ii. It might sharpen the focus of management
iii. Can align the incentives of management and shareholders
iv. Can address liquidity issues – i.e. the firm needs the cash!!

Divestiture example

Recall that in September 2009 Kraft announced a £10.2bn bid for UK confectionary firm Cadbury.

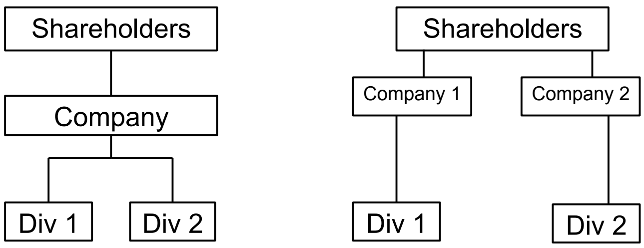
To assist in financing that deal – Kraft sold off its frozen pizza business to Swiss multinational food and beverage company Nestle for $3.7bn.

"Selling this business now not only delivers an attractive return for our shareholders, but enables us to better focus our resources on priority global brands and categories," said Irene Rosenfeld, Chairman and CEO. *"Nestle is well-positioned to continue building these powerhouse pizza brands, given its strength in frozen foods."* (Excerpt from official Kraft statement to market)

Spinoffs

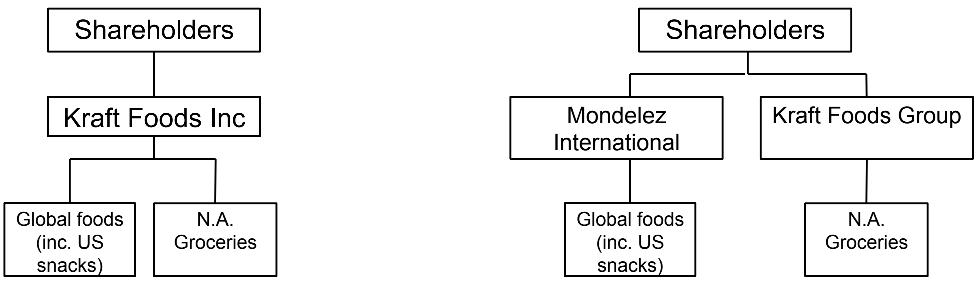
In a “spin-off” a firm will establish one of its operating units as a separate listed entity.

All of the shares in the newly established listed entity are distributed to existing shareholders on a pro-rata basis.



Spinoffs example – Kraft continued!

- A short 18 months after acquiring Cadbury, Kraft announced to the market its plans to spinoff the North American Groceries part of the business as the Kraft Foods Group.
- For each share held in the pre-spinoff Kraft company, shareholders received 3 shares in the new Kraft Foods Group.
- The parent company – which retained control of the Global snacks business - was subsequently renamed Mondelez.



(Excerpt from official Kraft statement to market)

Reasons for Kraft spinoff

An argument that the two parts of the business were not natural complements to each other:

- North American Groceries: Stable, low growth prospects, mature
- Global Snacks: High growth, requiring lots of investment.

Highlighted by reports that valuations of Kraft vs Mondelez were 8x vs 13x EBITDA respectively.

Kraft Chair and CEO Irene Rosenfeld stated at the time:

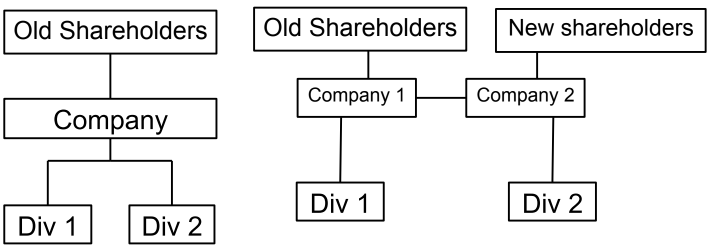
"*The differences of those two businesses allows us to create two very effective selling capabilities that will optimise the performance of both parts… We've never been able to get credit for the tremendous snacking portfolio that we have within the company,"* she claimed. *"The opportunity as we separate these two businesses for that to be much more visible and for investors to see the incredible profile that our global snack business has will serve us well.."* (Interview with Just-Food.com, 4 August 2011)

Equity Carve-outs

A company establishes a new listed entity – like spin-offs – but shares in the new entity are sold off to the market.

Parent company typically maintains a significant shareholding in the new entity.

Pre Carve-out **Post Carve-out**



Equity Carve-outs

Rationale:

- Provides cash to the firm – an alternative to selling the business unit outright
- Often precedes a subsequent spinoff of the newly established entity.

e.g. In March 2014 mass media company CBS announced that it had carved out its outdoor advertising business – CBS Outdoor –

successfully raising $560m by listing for sale 19% of the shares in the firm at $28 per share...
It closed 9% higher… It completed the spinoff 4 months later…

Summary

- Corporate restructuring is often motivated by a desire to “unlock” the **diversification discount.**
- Diversification discount is in the order of 13-15% for multi-segment firms.
- Three key methods of restructuring:
  1. Divestitures
  2. Spin-offs
  3. Equity carve-outs.

How successful are management in creating value through M&A or corporate restructuring?

THE UNIVERSITY OF MELBOURNE

Source list

Slide 6:
Quote from Kraft Foods media release, republished as Kraft Foods announces agreement to sell pizza business to Nestlé (http://ir.mondelezinternational.com/releasedetail.cfm?ReleaseID=736433). Accessed 03/06/2015.

Pizza - out of the oven! by Cheryl [CC BY-SA 2.0 (https://creativecommons.org/licenses/by-sa/2.0/)] (https://flic.kr/p/5bmJFr)

Money Hand Holding Bankroll Girls February 08, 20117 by Steven Depolo [CC BY 2.0 (https://creativecommons.org/licenses/by/2.0/)] (https://flic.kr/p/9htwiK)

Paul A. Young Marmite Dark Chocolate XO Bar Breaking by Lee McCoy [CC BY-ND 2.0 (https://creativecommons.org/licenses/by-nd/2.0/)] (https://flic.kr/p/83Q46K)

Source list

Slide 9:
Fortune Most Powerful Women 2012 (https://flic.kr/p/dgbmnf) by Fortune Live Media. Licensed under Creative Commons [CC BY-ND 2.0 (https://creativecommons.org/licenses/by-nd/2.0/)].

Quote from interview – Best, Dean, 'US: Kraft CEO Rosenfeld outlines benefits of spin off', *Just Food* 4th August 2011 (http://www.just-food.com/news/kraft-ceo-rosenfeld-outlines-benefits-of-spin-off_id116207.aspx). Accessed 02/06/2015.

Slide 11:
ArtPrize '09 (https://flic.kr/p/71kKyM) by John Eisenschenk. Licensed under Creative Commons [CC BY 2.0 (https://creativecommons.org/licenses/by/2.0/)].