

Will you set the divestment pace, or try to keep up with it?

Global Corporate Divestment Study 2019
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Building a better
working world

Our perspective



Paul Hammes

EY Global
Divestment Leader

In their quest for greater value, C-suites across the globe face a myriad of forces affecting divestment plans – from shifting customer expectations, to technology-driven sector convergence, to ongoing shareholder pressure. Companies are streamlining operating models so that they can pivot more quickly in pursuit of new growth opportunities and stay competitive. In particular, they are using divestments to fund new investments in technology, products, markets and geographies.

This is keeping the appetite for divestments near record levels, with 81% of companies saying the desire to streamline the operating model will impact their divestment plans over the next 12 months. They continue to divest businesses no longer core to the portfolio or best left in the hands of another owner. As companies reshape their portfolios, they are building greater trust with stakeholders and mitigating pressure from activists.

But once companies decide to divest, the complex separation process requires far more preparation than sellers often expect. This year's *Global Corporate Divestment Study* aims to help companies understand the critical steps to increase divestment success – from weighing the merits of different deal structures to pre-empting regulatory hurdles and addressing interdependencies across their businesses – and improve the valuation of the remaining organization.

To further drive value, sellers need to prepare for a widening pool of buyers – from private equity to cross-sector – by leveraging analytics, aligning leadership around deal perimeters and building stand-alone operating models so these buyers have confidence that the business has been properly prepared for separation.

All of these critical divestment steps can help companies accelerate their pace of transformation, reposition the remaining business for future growth and, ultimately, drive total shareholder value.

About this study

The EY *Global Corporate Divestment Study* focuses on how companies should approach portfolio strategy, improve divestment execution and future-proof their remaining business.

The 2019 study results are based on 1,030 interviews with 930 senior corporate executives and 100 private equity executives. The survey was conducted between September and November 2018 by Acuris.

- ▶ Executives are from companies across the Americas, Asia-Pacific, Europe, the Middle East and Africa.
- ▶ CEOs, CFOs or other C-suite-level executives make up 85% of executives surveyed.
- ▶ Executives have knowledge of or direct hands-on experience with their company's portfolio review process and have been involved in at least one major divestment in the last three years.
- ▶ Thirty-one percent of corporate executives represent companies with annual revenues of US\$1b-US\$5b, and 44% represent companies with revenues that exceed US\$5b.

Key findings



84%

 of companies plan to divest within the next two years.

Our annual *Global Corporate Divestment Study* reveals that divestments are helping companies streamline operating models to keep pace with technological innovation, improve their agility and sharpen their focus on growth opportunities.

PAGE 4

Why are so many companies divesting?

81%

say streamlining operating models will factor into their divestment plans over the next 12 months.

60%

reinvested proceeds from their last divestment into new products, markets and geographies.

PAGE 8

How can you operationalize a divestment for success?

49%

say their last divestment was delayed or deferred because they didn't fully understand regulatory requirements.

63%

say they held onto assets too long when they should have divested them.

PAGE 14

How can you maximize value from the next wave of buyers?

38%

say involving a private equity buyer led to an increase in purchase price.

63%

say lack of leadership alignment was a challenge in developing the deal perimeter.

Lessons learned

Streamlining operating models for better agility and sharper focus

Technology accelerates the pace of transformation

Geopolitical shifts are a constant variable in the divestment equation

Active portfolio management tempers opportunistic divestments

Weigh the merits of different deal structures

Always be divestment-ready

Make tax a top consideration

Understand work stream interdependencies

Pre-empt regulatory hurdles

Don't hold onto assets too long

Expect wide price gaps

Leverage the power of private equity

Use analytics in the sales process

Build value through stand-alone operating models

Align on deal perimeter

1

Why are so many companies divesting?



The intent to divest remains at record levels – 84% of companies plan to divest within the next two years, consistent with last year’s record of 87%. Despite uncertainty from tariffs, a trade war, desynchronized growth and geopolitical concerns, the market offers sellers a resilient yet competitive environment.

Streamlining operating models for better agility and sharper focus

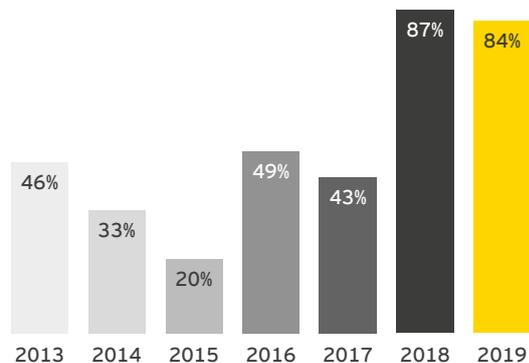
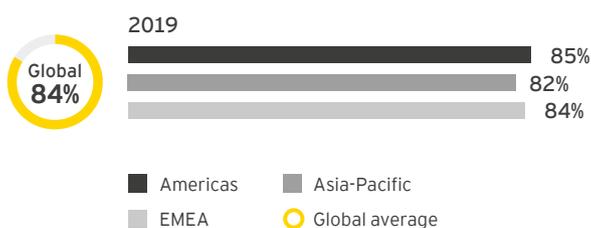
Faced with evolving sector landscapes, businesses are continuously evaluating their growth strategies and competition. They are more rigorous in portfolio management – two-thirds (66%) of companies say they review their portfolios at least every six months, according to the latest EY [Capital Confidence Barometer survey](#) – and they continue to actively dispose of underinvested assets best left in the hands of another owner. This disciplined approach to portfolio management is working. More companies are divesting for strategic reasons as opposed to because of a failure in the business: companies that cite

a unit’s weak competitive advantage as a driver in their latest divestment fell significantly to 69% from 85%.

The result is a streamlined operating model that gives companies the ability to quickly execute on their capital agendas. Eighty-one percent of companies say streamlining the operating model will factor into their divestment plans over the next 12 months, while two-thirds (67%) say this was a factor behind their most recent divestments.

Percentage of global companies that expect to initiate their next divestment within the next two years, 2013-2019.

Companies that expect to initiate their next divestment within the next two years.



The importance of portfolio reviews is further evidenced in the deconglomeration trend of the last several years, sparked in part by shareholder activism. Many companies have become increasingly complex by operating in several disparate, yet intertwined, businesses. This complexity, while often resulting in some cost savings, has come at a price. In addition to hampering agility, this conglomerate model often negatively affects market valuation. Various academic studies indicate large conglomerates often operate at a 5%-15% discount relative to the sum of their parts.

Companies that divest may redeploy proceeds in growth areas to improve shareholder value. Sixty percent of companies reinvested proceeds from their last divestment in new products, markets and geographies. Honeywell completed two spin-offs in 2017 representing US\$7.5 billion in revenue. When the divestitures were announced, CEO Darius Adamczyk commented that he was “excited” about M&A in its four businesses, and the company has made acquisitions since.

Technology accelerates the pace of transformation

Companies must continually reformulate their capital agendas and go-forward strategies relative to their competition, particularly in light of technology-driven changes in consumer habits and supply chain. Seventy percent expect more large-scale transformational divestments within the next 12 months, up from 50% in 2018. At the same time, companies are making acquisitions that allow them to add new capabilities, such as IBM’s purchase of open source software and technology distributor Red Hat.

Sector convergence prompts divestment

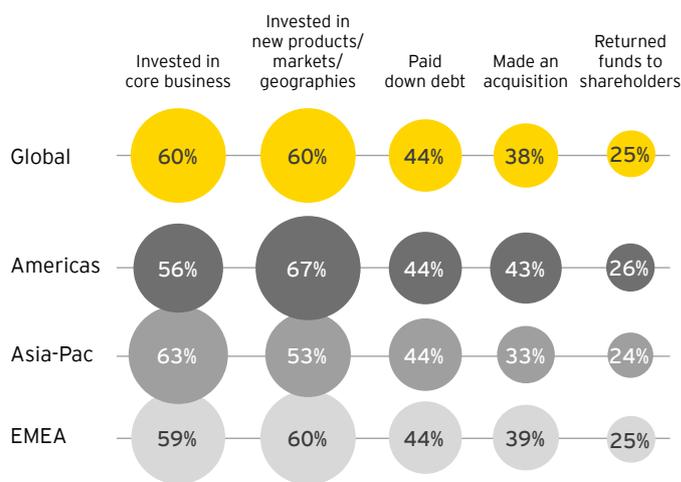
Further, 70% say sector convergence is more likely to drive their own divestment decisions, as they focus on innovation in the face of new competition from companies outside of their traditional sectors. With technology often being the catalyst of this convergence, many companies have redefined their business strategies around a narrower set of priorities and are determining the capital investments required to support technology for future growth.

Recent examples of these technology and cross-sector transformations include Philips shedding its lighting business to reposition for new technological growth in health care and GE refashioning its business through divestitures to focus on growing its footprint in renewable energy as well as its technology-driven power and aviation businesses.

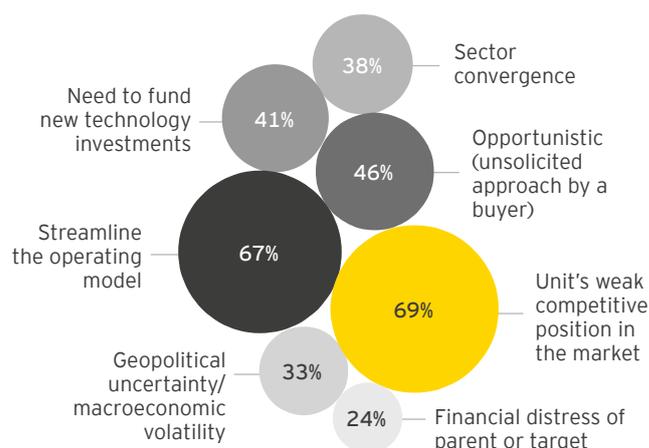
Technology-driven divestments increase

Separately, 80% of companies expect the number of technology-driven divestments to rise in the next 12 months, compared with 66% in 2018. These plans may also support the capital requirements to fund new technology investments. Further, companies that say changes in the technology landscape are directly influencing their divestment plans are more than seven times as likely as their counterparts to secure a higher price for the business sold. This may be because these companies have their eyes on the market and their portfolios, and are more prepared to address the impact technology has on their operating model.

Q What did you do with the funds raised from your most recent divestment? Select all that apply.



Q Which triggers prompted your most recent major divestment? Select all that apply.



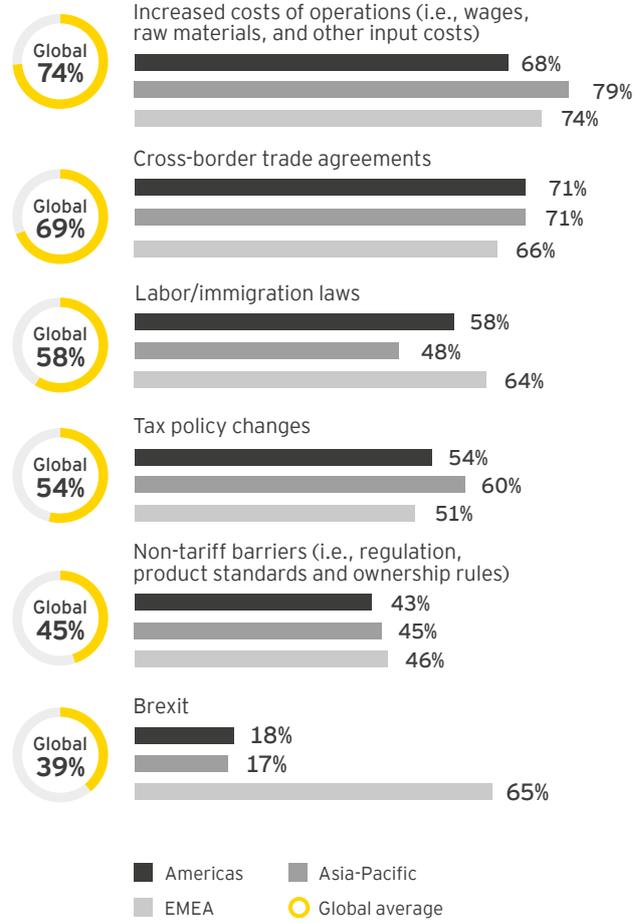
Geopolitical shifts: a constant variable in the divestment equation

Despite uncertainty within the global markets, whether driven by tariffs or trading costs, companies must continue to diligently review their portfolios. The current US administration has raised the stakes over global trade, while Brexit in the UK, the rise of populist governments in Europe and the ongoing debate over immigration add to complexity when making strategic portfolio decisions.

Companies appear to have grown more accustomed to this uncertainty over the past year: 51% of companies, compared with 62% in 2018, say that macroeconomic and geopolitical triggers will play into divestment decisions next year. Still, these factors must be weighed in the financial forecasts of companies operating in affected markets.

Almost three-quarters (74%) of companies expect these geopolitical shifts to push operating costs higher, while 69% wonder whether they can depend on existing cross-border trade agreements to remain in force. They will have to factor these rising costs into their divestment strategy and timing. Whether these factors can otherwise be addressed through vendor negotiations, price increases or cost reductions may factor into whether a company decides to divest a unit that is affected by tariffs, trade disputes or geopolitical uncertainty. One company recently entered into an earn-out agreement relative to tariffs. Knowing it is still too early to predict the full ongoing impact of tariffs, but considering its commitment to selling the business, the company took the risk of whether the earn-out will potentially pay off relative to the strategies implemented prior to the closing of the sale.

Q Which of the following geopolitical shifts may affect your plans to divest? Select all that apply.



Active portfolio management tempers opportunistic divestments

Through more active portfolio management, companies have sharpened their focus on agility and improved their ability to respond to new opportunities both inside and outside of their sector. They have become better at identifying assets ripe for divestment and are starting to prepare their assets to maximize the potential for success when receiving an unsolicited bid. To capture full value, opportunistic divestors need a solid understanding of their earnings power, net assets and working capital, both historically and projected. It is no longer enough to focus on pro forma historical performance. Sellers have to understand and credibly portray – using analytics and sophisticated tools – the drivers of forecasted performance for potential buyers.

Opportunistic divestments by the numbers

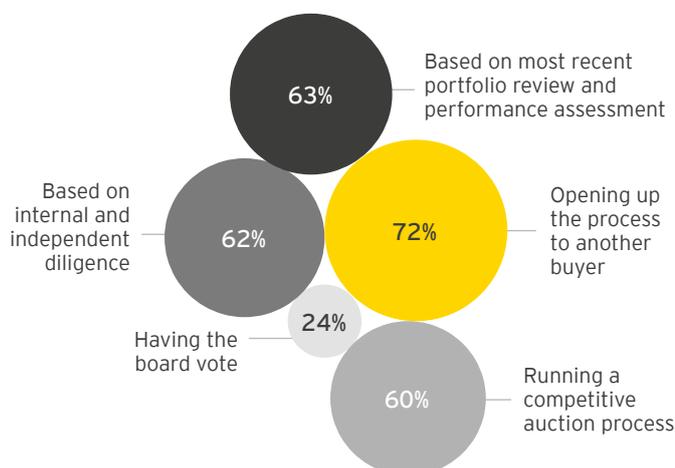
65% of those reporting an opportunistic divestment say they had already started considering a sale and therefore completed some level of preparation when the unsolicited bid was made. They were also four times more likely than their counterparts to meet or exceed their expectations for both price and timing in the divestment, demonstrating that preparation for a possible divestment as a result of portfolio reviews pays off when the asset is divested.

46% of sellers describe their last divestment as opportunistic, down from 71% in 2018. While every business may be for sale in whole or in part, active portfolio management may mean that companies have fewer assets remaining that they are willing to part with, even if a buyer appears.

72% of companies opened their opportunistic divestment process up to at least one other buyer to create competitive tension and validate the price offered. Companies can maximize value by taking the appropriate steps in the best interest of shareholders.

34% of companies say they are not confident they would be able to accurately value their businesses were they to receive an unsolicited bid today, underscoring the need to regularly conduct portfolio reviews with an eye toward the value of a business to different types of potential buyers.

Q How did you determine whether the price being offered was reasonable? Select all that apply.



When opportunistic divestments present themselves, success is by no means guaranteed. Unplanned divestments are four times less likely than planned divestments to achieve expectations on price and improve the valuation of the remaining company.

With a more active approach to portfolio management, companies can begin to prepare a compelling value story for an increasingly diversified pool of buyers. This is an essential step in closing the widening price gap between buyers and sellers.



How can you operationalize a divestment for success?



Ongoing pressure from shareholders has created a new normal of frequent and disciplined portfolio reviews, with companies more actively identifying assets for disposal. However, companies that don't prepare for a transaction early enough risk holding onto assets too long and losing value once they've launched the monetization process. Nearly 40% of companies say their last divestment did not meet timing or price expectations.

Weigh the merits of different structures

Seventy-nine percent of companies say their most recent divestment took the form of a carve-out sale, but other deal structures (e.g., joint ventures, tax-free spins, full enterprise sale) can sometimes support greater return to shareholders, or align better with the long-term goals for the remaining organization.

In Europe, for example, joint ventures have grown in popularity as part of the divestment landscape, with companies more often contributing assets to these deals. This structure is helping some companies tackle innovation-related challenges by bringing in a partner with capital, experience and technological expertise. Examples include Swiss engineering group ABB's joint venture with Hitachi to tackle new markets in energy infrastructure, and the two-year Arlanxeo JV between chemicals maker Lanxess and Saudi Aramco to support product innovation that recently led to a buy-out. These arrangements may help companies accelerate growth more quickly than a buy-or-build strategy.

In the US, even with major tax reform, tax-free spin-offs (i.e., demerge a business to existing shareholders) remain an effective strategy for creating shareholder value and deleveraging by moving debt to SpinCo while restructuring the remaining organization. This structure is effective in distributing to shareholders a business with a low tax base that may otherwise result in taxable gains and a large tax bill. In addition, tax-free spin-offs can help a divested business achieve its desired value, especially if the target price cannot be realized through a traditional sales process. Further, as a separately traded public company, SpinCo may now more effectively manage its strategic objectives and capital agenda, thereby achieving a valuation more appropriately reflecting its value.

Q What were the causes of value erosion in your last divestment? Select all that apply.



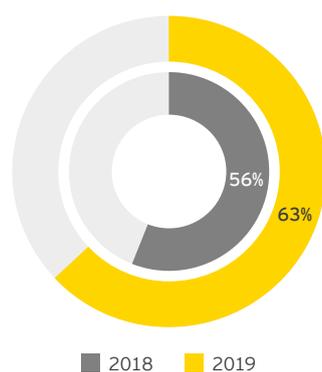
Be flexible to improve your outcome

Thirty-two percent of companies indicate that optimizing the legal structure was the most important factor in enhancing value in their last divestment. Conversely, 57% of companies say lack of flexibility in the sale structure caused value erosion. To maximize value, companies may need to evaluate structures ultimately through greater flexibility in the deal perimeter. This allows room to optimize according to market conditions, tax efficiencies, timeline, anti-trust considerations or net proceeds.

In some cases, morphing to another deal structure may be the only way to get the deal done. For example, a low valuation for an outright asset sale may result in a shift to a joint venture structure that entices a buyer to participate in the upside of the business with the seller. Another option is dual tracking deal structures, which can maximize the likelihood of achieving your divestment goal – though it's worth noting that fewer than one in 10 businesses took this approach in their last divestment. Companies considering dual tracking a tax-free spin and an outright sale should proceed with caution. For example, if more than 50% of either SpinCo or RemainCo is sold within two years of a spin-off, the US tax rules contain provisions that can cause a tax-free spin-off to become a taxable transaction. Therefore, companies must consider the US tax safe harbor rules during any dual tracking process to understand the impact on future plans.

When one manufacturer dual tracked a full enterprise sale alongside a planned initial public offering, a strategic buyer quickly moved on the opportunity to capture synergies from product design to production. Ultimately the cash-rich offer led to a transaction accretive to buyer earnings in the first year while preserving the seller's entire workforce.

Companies that say they held onto assets too long when they should have divested.



“ The timing of selling assets is important and we have held onto assets for longer than required. Argentina faced economic challenges, and we weren't getting desired returns from the sale. Divesting earlier would have saved us from the magnified losses that we faced during the economic drought. ”

CFO of a power and utilities company in Argentina

Always be divestment-ready

Companies today are broadly better at identifying assets that should be divested, but are increasingly slower in launching the process. In fact, 63% of companies say they held on to assets too long, up from 56% in 2018. A well-defined portfolio strategy, coupled with the right resources and expertise to effectuate the divestment, should give companies more confidence in their ability to act when the time is right. Sellers who say they did not hold on to assets for too long are twice as likely to secure a better price from the transaction.

Companies may underestimate how lack of preparation impacts their deal timeline and total shareholder return. The majority (51%) of companies report their divestment took five months or longer from sign to closing, far beyond the three-month close that shareholders have come to expect. Deferred closings, increased transitional service agreements (TSAs) and other obligations can plague the remaining organization when appropriate time is not invested in preparing the business for sale. Lack of preparation is a critical factor for the 41% of companies that say their last divestment did not meet expectations in impacting the valuation multiple of the remaining business.

Companies are increasingly pursuing a “carve-out platform” approach to make businesses divestment-ready. Under this approach, systems, processes and even legal entity separation work begin before the deal process starts. Initiating this work before a buyer is known helps accelerate the separation and stand-alone timeline and minimize TSAs. For example, 32% of companies reported that an optimized legal structure was the most important step in enhancing sale value. Sellers may also negotiate reimbursement for the related separation and stand-up costs because buyers receive control of the divested business sooner.

Make tax a top consideration

Tax is a central consideration during the carve-out process, and work should align with the portfolio review process. Far too often, a decision to divest is made without appropriately considering tax implications. In fact, two-thirds of companies say a lack of preparation in dealing with tax risk was a major cause of value erosion in their last divestment.

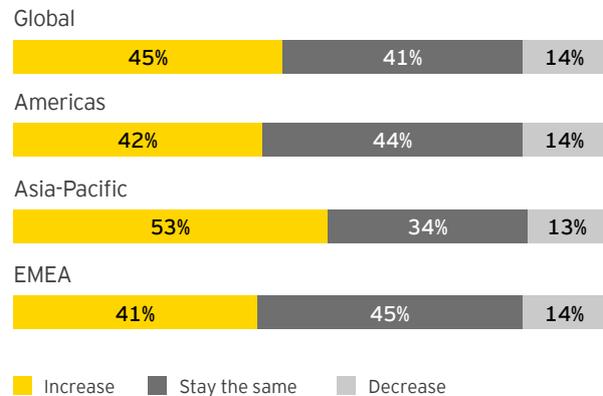
Sales processes often stall when sellers fail to recognize that potentially skeptical buyers may have a completely different view of the risks associated with tax-efficient structures implemented historically.

Sellers should start by asking:

- ▶ How should the transaction be structured to minimize tax exposure on the deal?
- ▶ What does the most efficient tax operating model look like for the carve-out business?
- ▶ How do we manage the potential tensions between tax efficiency on exit for the seller and the ongoing tax profile of the carve-out business for the buyer?
- ▶ Can we build a forecast model that underpins this work with hard data?
- ▶ How can we start executing tax structuring changes to accelerate exit while minimizing tax costs?

Companies must also consider country-by-country requirements. As tax reform initiatives continue to roll out around the globe, 45% of companies say they expect an increase in tax challenges as they execute deals.

Q Did the impact of tax challenges on the ease of executing deals over the last 12 months increase, decrease or stay the same?



Understand work stream interdependencies

Businesses built on years of acquisitions, complex systems consolidation or shared service centers are intertwined at functional levels, including finance, tax, supply chain, treasury, procurement, legal, technology, human resources and sales. More than half (56%) of companies say lack of understanding around work stream interdependencies – and the critical path to disentangle them – derailed or delayed the closing of their last carve-out. And 50% of companies say failure to present the business as a stand-alone “scared off” potential buyers, eroding value in their last divestment.

Companies can evaluate how to disentangle the business for sale before the formal process by:

- ▶ **Appointing leaders to oversee each function** from the start of the process and establishing clear lines of communication. For example, one global original equipment manufacturer established a project board to drive the timeline based on a cross-functional interdependency assessment, allowing for precise tracking and steering that mitigated divestment delays and disruptions.
- ▶ **Reviewing revenue streams** to allocate costs within the asset to be divested and avoid stranded costs, from things like long-term vendor contracts or shared personnel or services between work streams – 65% of companies say they tried to identify and mitigate stranded costs before the asset was put up for sale in their latest divestment. For example, the management team of a chemicals company proactively shifted select support functions from a group level to the respective businesses, ultimately reducing stranded costs from their divestment.
- ▶ **Developing the post-transaction operating model** for the parent company as well as the carve-out business, with work streams clearly defined.
- ▶ **Devising the optimal short- and long-term tax strategy** as part of the separation strategy and operating model. Companies should think in terms of what the tax implications will be on the separation transaction itself (e.g., will it be taxable or tax-free) and what will create a tax-efficient operating model for both DivestCo and RemainCo going forward. For example, to make the carve-out tax-free, the tax-structuring team might want to assign operations to entities in one country. If the operations group decides separately to divest or move those operations to a different country, it could cause the spin-off transaction to be taxable in the initial country or to the shareholders. Further, it could shift operations from a low tax jurisdiction to a higher tax jurisdiction increasing the operating cash effective tax rate. Hence, a company needs to understand the tax implications of its separation strategy and operating model design and changes.

Tackle highly entangled areas first

Areas with a high degree of interdependencies that consistently cause divestment delays:

- ▶ IT – shared ERPs and other applications have long lead times and are expensive to separate
- ▶ Shared legal entities – commingled business activity such as shared customers and vendors require communications and/or negotiations that can be disruptive if not properly handled
- ▶ Shared services – centralization of business processes means commingled transaction data that can be difficult to identify and require separation

- ▶ **Minimizing transitional services agreements (TSAs)** where possible. TSAs can saddle sellers with unwanted responsibilities and disrupt the more streamlined operating model. More than a third of businesses (39%) say they had between 26 and 50 TSAs in their last divestment – 19% had more than 50. While this range is normal, sellers are not in the business of providing services to the divested entity, particularly beyond 6-12 months. Such ongoing entanglement requires staffing and accounting and often delays the ultimate mitigation of stranded costs.

Mapping out interdependencies early and creating an ongoing dialogue between cross-functional teams drives transaction governance and ultimately value for all stakeholders in terms of timing and net proceeds. In a recent divestment, a seller’s preferred buyer – also with the highest bid – walked away during the diligence process because of obvious entanglement issues. This resulted in the seller accepting another bid 20% below that of the first and more complicated public financing requirements.

65% of companies say they tried to identify and mitigate stranded costs before the asset was put up for sale in their latest divestment.

Can you deliver a business with zero TSAs?

Outlining a TSA strategy early can help companies determine what can be done to minimize or avoid TSAs altogether. Start by gauging the complexity of the divestment. Is the business multinational? Are you integrating with another business or effectively “standing up” another public company? Are you working toward a joint venture, or outsourcing core functions? Do you have IT or operational projects currently in progress?

Shared overhead functions (e.g., payroll and benefits), intermingled accounting and reporting (e.g., general ledger, cash pooling, AR/AP), joint IT systems (e.g., internet, data center, ERP, infrastructure, application maintenance) and operations (e.g., logistics, sourcing, warehousing, supply chain) typically drive TSA needs and volume.

To manage the process, companies should take the following steps.

1. Examine each functional area based on:
 - ▶ Separation or integration complexity
 - ▶ Acquirer capacities
 - ▶ Stand-alone resource requirements
 - ▶ Options to outsource processes
2. Discuss initiatives with functional experts to avoid transitional services
3. Detail and sequence activities to reduce TSA needs

When required, companies should price TSAs at cost-plus, add escalation clauses, cap them at 12 months and manage them in relation to stranded costs.

While it’s often difficult to avoid TSAs altogether, companies can turn to managed services to provide a more structured, zero-TSA approach when committing to a specific carve-out timeline to deliver a stand-alone business. One company that was forced to divest as part of an acquisition outsourced IT, finance, HR and procurement to develop a stand-alone backbone for the divested business. This “carve-out platform” approach enabled day one readiness and zero TSAs while allowing the remaining organization to focus on its own priorities.

Mitigate stranded costs

Identifying potential stranded costs early can allow sellers the opportunity to develop mitigation plans. Companies often minimize the effort required and the time pre- and post-closing to complete those plans. We often hear from companies, “This can only be done close to closing” or “We know the costs included in the deal, so this will be easy.” However, many costs in the deal are often shared or allocated in nature. Accordingly, companies need to examine shared costs across business units, including those charged to the carve-out. Corporate allocations, business charge-ins and charge-outs, services provided with no, under-, or over-allocated costs, shared people and facilities are all key inputs relative to stranded costs. There are several sources of stranded costs and related key considerations – knowing these can save precious time while preserving value going forward for the seller.

Cost type	Sellers should take these into consideration by:
Allocated cost: Amount currently allocated to entity considered for separation	Mapping these allocations to the actual costs to be ultimately transferred is paramount – they often represent fractional time for people, facilities, research and development, sales and marketing.
One-time or transition costs: Costs related to the transfer of operations (e.g., cloning a computer system)	Knowing that while these costs are typically borne by the seller, they are often subject to negotiation.
TSA cost recovery: Some of the stranded costs can be covered, for a time, by charging for ongoing services under TSAs	Minimizing TSAs, particularly given that they often defer the ultimate mitigation of stranded costs. TSA exit terms and conditions could impact the stranded cost mitigation plans (e.g., early termination of services) and should be considered when developing TSA pricing methodology.
Loss of leverage costs: Additional costs incurred under vendor contracts due to lost volume or other incentives	Assessing the potential impact from vendor and other agreements as soon as practical in order to be able to begin negotiations well before the separation date.

Pre-empt regulatory hurdles

Sellers need to identify regulatory requirements in every jurisdiction to set clear work stream timelines. Forty-nine percent of companies say their divestment was delayed or deferred because they didn't fully understand regulatory requirements.

Widely varying country-specific requirements, along with insufficient time to capitalize and operationalize a legal entity, can delay the buyer from being able to effectively operate in a jurisdiction. Forty-three percent of sellers say capitalizing and operationalizing a legal entity was a challenge in their most recent divestment. In many countries, sellers may face a 60-, 90- or 120-day review requirement to be met before they can put capital into a local entity. Regulatory requirement can include antitrust approvals, business licenses, capitalization of new legal entities, registration of products, labor requirements and obtaining various tax IDs. Many of these activities must occur in a specific sequence, can be lengthy and can change based on rule-making bodies in each country and even locality.

Delayed closings pose operational and administrative burdens to sellers post-close and often delay their receipt of cash. They also delay the buyer from implementing the changes required to achieve value capture goals. Overall, these issues are suboptimal for buyers and sellers.

Actions taken in successful divestments include:

- ▶ Identifying key regulatory requirements in every current and anticipated jurisdiction by leveraging local subject-matter experts.
- ▶ Prioritizing the countries of significant importance based on a combination of size and criticality to the day one operating model (i.e., location of key facilities).
- ▶ Building out the proper timeline to address activities such as product registration, product labelling, business licenses, tax IDs, labor requirements and contracting with third-party service providers.

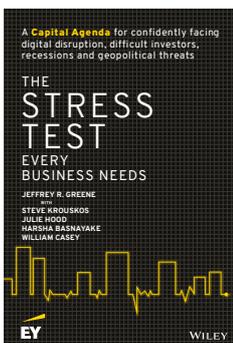
In summary, identify long lead time regulatory requirements early in the divestiture process and start developing country-specific plans to minimize delays and transition cost overruns.

Case study: Don't let details delay your divestment

On a recent divestiture, a buyer formed a new legal entity to purchase the assets and operations of a divested entity in Brazil. Unfortunately, they failed to understand the different facility, legal entity and product licensing requirements at the municipality, state and federal level. As a result, they were not licensed to operate the business in every state and municipality where the divested business had operations – resulting in a delay of several months in the deal closing.

49% of companies say their divestment was delayed or deferred because they didn't fully understand regulatory requirements.

43% of sellers say capitalizing and operationalizing a legal entity was a challenge in their most recent divestment.



Further reading on divestment execution

In the new EY book, *The Stress Test Every Business Needs: A Capital Agenda for confidently facing digital disruption, difficult investors, recessions and geopolitical threats*, the EY authors explore how companies can better manage capital, execute transactions, and apply corporate finance tools to strategic and operational decisions.

In particular, the book takes a deep dive into the most critical aspects of planning and executing a divestment to maximize value and minimize disruption to the remaining business. Learn more at www.ey.com/capitalagenda.

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How can you maximize value from the next wave of buyers?



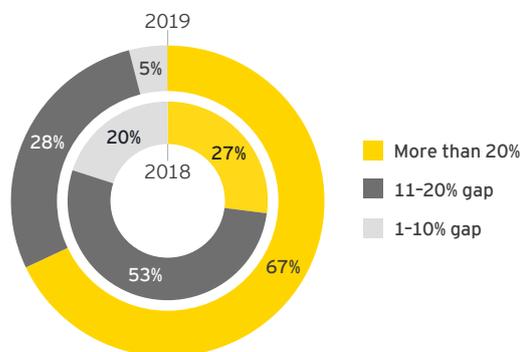
In a volatile marketplace driven by high valuation expectations, sector convergence and an abundance of capital – both private equity and corporate – who will be your next buyer? How will you anticipate the needs of different buyers and maintain competitive tension? What tools do you need in your negotiation playbook?

Expect wider price gaps

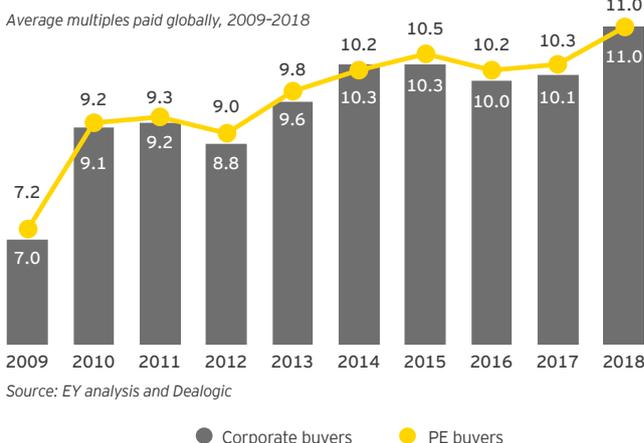
The price gap between what buyers and sellers expect has risen sharply over the past year. Sellers of quality businesses often value assets through a combination of improvements and projected earnings power, while buyers are inclined to calibrate against historical earnings to discount for short-term or unquantified risks while balancing their desire to stay in the deal process.

Two-thirds (67%) of sellers say the price gap between what they expect to receive for an asset and what buyers are willing to pay is greater than 20%. In 2018, only a quarter noted such a significant gap. Now, more than ever, it is critical for sellers of quality businesses to build a credible value story with supporting data and start the related preparation early to achieve their desired valuation.

Q How wide do you consider the price gap between what sellers expect versus what buyers are offering?



It is a fallacy that PE consistently pays less for businesses. In fact, average multiples paid by corporate and PE buyers are very competitive.



“High purchase prices and the fluency with which PE can close a deal are highly positive factors that increase the value of the deal. They are efficient deal makers with the ability to align the loose ends of a deal and keep a diligent check on execution.”

Director of Mergers & Acquisitions at a technology business in the UK

Leverage the power of private equity

Appealing to private equity buyers sometimes requires significant time and effort, but these bidders can also bring sharper focus on value, increased competition and potentially higher multiples to the sales process.

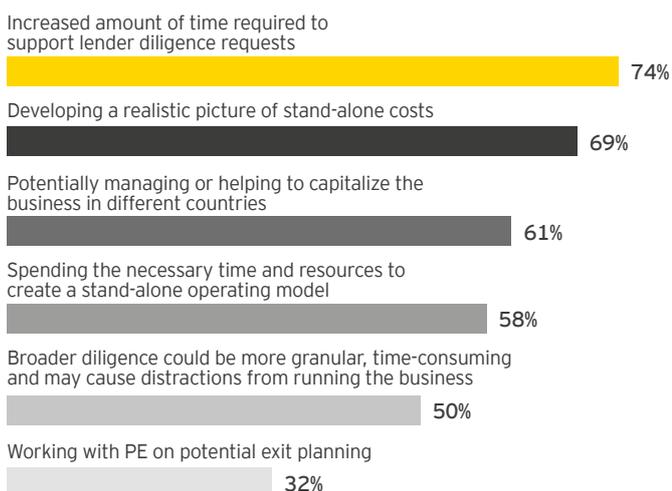
Unlike corporate buyers, PE may not necessarily have a portfolio company in which to integrate the business being sold. In the absence of synergies, sellers may find PE diligence demands to be more granular, and therefore time-consuming. Seventy-four percent of sellers say the increased amount of time for PE diligence requests was a challenge. But fulfilling these exacting requirements during negotiations can support a faster closing once the deal is signed. Forty-nine percent of sellers say that PE's involvement in the divestment led to a reduced time to close. Reasons for a faster closing may be that PE firms require fewer regulatory disclosures; they may already have expertise relative to a particular business based on ownership experience with an existing portfolio company; or their clarity relative to the exit strategy and related time sensitivity speeds up the process. There are other benefits, too: 38% say working with a PE buyer led to an increase in purchase price.

Sellers should take the following steps to maximize PE participation in a competitive process:

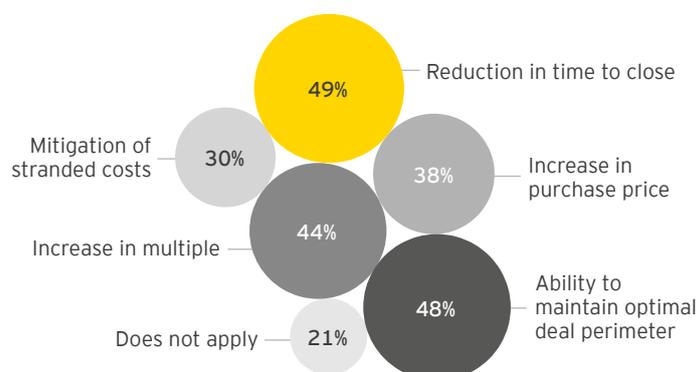
- ▶ **Build a compelling picture of the asset as a stand-alone business:** one quarter of PE firms say a well-thought-out stand-alone case and related cost model are key to keeping them in the sales process. Sellers may need greater flexibility in financial reporting systems as a first step in developing an accurate picture.
- ▶ **Keep an eye on operational performance:** missed forecasts concern potential buyers, particularly if the business misses forecasted performance outlined in marketing materials. More than a third (39%) of private equity bidders cite this as the most likely reason they would drop their price or walk away.
- ▶ **Help PE "see" the exit strategy:** the nature and timing of an exit is of ultimate focus to PE. Sellers should articulate their perspective around potential monetization strategies early in the process.
- ▶ **Be prepared to generate granular data:** half of PE firms say access to granular data was a key factor in their decision about whether to stay in an auction process. The seller may need to have historical and projected information down to transactional and SKU-level detail, often monthly, and for as many as 10 years.
- ▶ **Tell a consistent story** about financial forecasts, growth opportunities, capital requirements, the management team and the overall business going forward. These are focus areas to PE as they drive the financial and operational business models as well as the exit strategy.

Keeping PE engaged in the process can be vital to a successful deal. For example, a fifth of businesses say their last divestment ultimately lost value because they failed to maintain competitive tension throughout the deal process. Not articulating a clear value story, lack of adequate preparation for diligence requests and not fully understanding the buyer pool's requirements (e.g., operational, regulatory, financing) can contribute to the loss of bidders in the sales process.

Q What do you see as your biggest challenges in working with PE as a potential buyer? Select all that apply.



Q In what ways did you experience an increase in value based on PE's involvement in your divestiture? Select all that apply.



Case study: Stress test through a buyer's lens

One global consumer company preparing to divest used analytics to test revenue forecasts relative to customer churn and product pricing. While the company was confident in its revenue projections among top-tier customers, analytics revealed how price increases had impacted the bottom tier of customers, driving 40% of gross profit. This lower-tier customer base was turning over on average every three years and therefore needed to be continually replaced – clearly a risk to potential buyers. In uncovering this issue early, the company was able to illustrate its success in managing such turnover given the overall market potential.

Use analytics in the sales process

When faced with widening interest from more diverse buyer pools – from PE to cross-sector corporates – sellers may benefit by leveraging analytics in the negotiation process. Advanced analytics can produce greater insight for buyers on the historical and future performance of a business while allowing sellers to tailor and strengthen their value story for different buyers. Only 39% of sellers say they used analytics during buyer negotiations, but 52% say it's a step they should have taken. In doing so, sellers and buyers alike can avoid surprises leading to loss of value or cause the deal to fail.

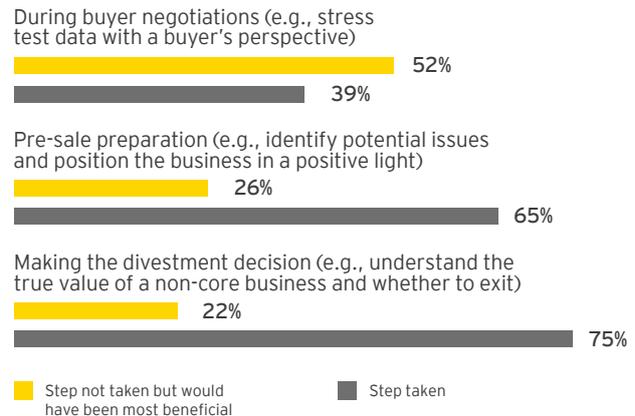
Further, companies that use analytics in negotiations are three times more likely to achieve a higher sales price and increase valuation in the remaining business, as well as to close the deal faster, than those that do not. Additionally, use of analytics during negotiations can reduce the workload of the management team by anticipating buyer's questions before they arise. This success can be attributed to providing buyers with the appropriate level of granular data that both satisfies their diligence requests and supports the value story. Also, use of analytics minimizes surprises and avoids additional time spent on negotiations relative to matters the company should have been aware of at the start of diligence.

Tools to support the negotiation playbook

Divestment tools can help sellers save time and make more informed decisions during the negotiation process by streamlining access to data across business functions. These specialized deal tools can be loaded with commingled financial and operational information. Then, using specified parameters, sellers can isolate transactions and information specific to the business being divested. This becomes the basis not only for generating financial statements and financial analytics to support diligence, but mapping fixed assets, intangibles, SKUs, inventory, vendors, customers and employees to support operational separation. Companies then have better insights on the deal perimeter impact to working capital, legal entities, operations, supply chain, HR and tax. Even more importantly, sellers will have a better, faster understanding of how the slightest change in perimeter may impact the target financial forecasts across the business.

For example, a multinational automation company was forced to divest parts of a business during an acquisition process. Without having time to complete full diligence on the assets, a small yet strategic and high-value part of the business had been included in the deal perimeter. The seller realized this late in the process and wanted it removed. However, the bidders knew their market, saw the importance of this business and wanted it left in the perimeter. In the end, it was removed and the deal value dropped, with time and money lost, as well as delays to the sales process.

Q In which of the following areas of your most recent divestment did you leverage analytics? And where would it have been most beneficial?



Build value through stand-alone operating models

In carve-outs, buyers may recognize greater value by presenting a stand-alone operating model. In fact, sellers that present a business as a stand-alone are twice as likely to achieve a higher price and complete their deal faster than those electing not to do so. Buyers have confidence in the operating model and know that the business has been properly prepared for sale, with a comprehensive separation plan. Further, significant time is saved post-signing by not having to take these steps, long ago completed. This is critical to PE – 51% of PE buyers say it's required for them to stay in a purchase process for corporate assets – as they often do not have the infrastructure or personnel to support a stand-alone business unless there is a match with an existing portfolio company.

The benefits also extend to sellers by:

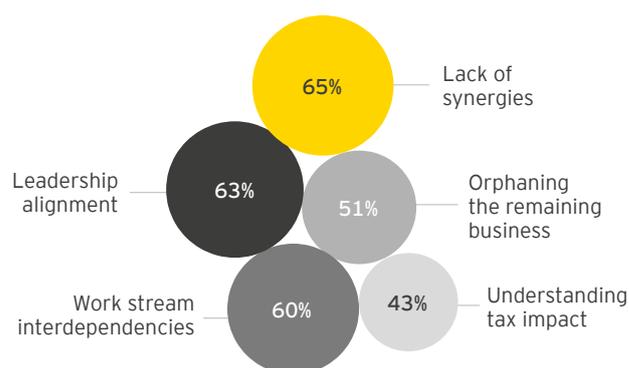
- ▶ Enabling them to easily understand the impact of potential deal perimeter changes in “real time” – to make the business more attractive to a buyer
- ▶ Assisting with TSAs, one-time costs and stranded cost remediation, which impacts the deal model for both the buyer and seller
- ▶ Serving as key input into and aligning with the stand-alone cost model that drives deal economics
- ▶ Building the foundation for the seller's separation planning and the buyer's integration planning, both of which will be greatly accelerated
- ▶ Allowing for proper planning relative to capitalization and regulatory requirements, which avoids delayed or deferred closings

Align on deal perimeter

Companies often ask us, “The deal perimeter simply reflects the business – why are we spending so much time on this?” The business to be divested is often defined differently by executives and functions within the organization. Too often, deal models are prepared utilizing historically generated system data that contains improperly allocated costs, excludes certain costs and does not reflect the business to be ultimately transferred. Accordingly, alignment on the deal perimeter across all functional areas, with a clear line of site to the deal model for each buyer, is critical.

Leadership alignment around the deal perimeter – across RemainCo and DivestCo – is essential, but this is a challenge for 63% of companies. One common deal perimeter issue for sellers is deciding on the disposition of commingled manufacturing and production facilities. For example, one life sciences company was looking to carve out a business that shared manufacturing facilities with other businesses in the portfolio. The seller’s supply chain leaders pushed to remove the divested business from all commingled locations around the globe to pursue new growth opportunities. Buyers immediately recognized this as costly and highly disruptive to the business, thereby eroding value and requiring lengthy negotiations to reach a compromise. Sellers can improve alignment in deal perimeters by involving leadership early in the portfolio management process with the right data to inform decision-making.

Q What are some of the biggest challenges you’ve faced in developing the deal perimeter? Select all that apply.



Case study: Don't miss out on hidden gems

A US-based service provider sold a series of comparable businesses across the globe. A performance analysis of these initial carve-outs uncovered two steps the company failed to take in the sales process to help support a higher deal price. In their next divestment, they addressed the analysis by delivering buyers a detailed separation plan and providing a vendor due diligence report. As a result, they increased the EBITDA multiple by 17%.

52% of companies say their lack of flexibility on the perimeter scared off buyers or delayed closing on their last divestment. Flexibility is critical in an ever-changing regulatory, economic and competitive market.

Leading practices in the negotiation process

- Articulate and support the value story:** ensure product pipeline and business strategy supports revenue growth projections. Develop a target operating model that identifies potential cost and revenue synergies available from combining the asset to be divested with the businesses of potential buyers as well as other value creation opportunities, such as changes to the country go-to-market strategy.
- Involve leadership teams:** bring the management of the business into the process at an early stage to increase divestment success. Seek their views on potential buyers, upsides that can be incorporated into the forecast and value story, risks likely to be discovered during diligence and how to deal with them, the likely go-forward operating model and how to anticipate buyer concerns. Consider “boot camps” that include executives and experienced deal professionals from outside the organization that have “been there and done that” to prepare management for successful meetings with buyers.
- Communicate the tax upsides:** evaluate how different divestment structures impact the business value from the buyer perspective and factor this into negotiations. Clearly identify and specify tax assets already available or triggered upon the divestment to allow the buyer to evaluate impact on the financial model and cash taxes.
- Demonstrate deal flexibility:** understand how different deal structures and perimeters may appeal to different buyers and consider dual tracking if necessary.
- Share analytics and necessary diligence materials:** make sufficient diligence materials available to prospective buyers who may otherwise identify opportunities to pay less.
- Develop a negotiation matrix:** evaluate each key point in the negotiation process, its impact on the remaining organization and stakeholder value, and also determine “how far you are willing to go.”

Conclusion

84% of companies are considering a divestment in the next two years. How can you maximize value on your sale and your remaining business?

Streamline for agility

A streamlined operating model gives companies the agility to seize growth opportunities in a competitive climate that is rapidly changing under the forces of technology and sector convergence. The trend toward deconglomeration, driven in part by shareholder activists, necessitates regular portfolio review to identify underinvested or non-core assets.

Be prepared yet flexible

Preparing a business for a potential divestment makes it more likely to meet price and timing expectations when an opportunity presents itself. Consider the extensive interdependencies among functional areas and systems, legal entity separation and related regulatory issues and tax implications before a buyer emerges. Be prepared to flex to a different deal structure in order to get the deal done.

Develop a value story for all potential buyers

Sellers must be able to present a compelling valuation story to many different types of buyers. PE could offer the best price but may require more information on how the business can operate as a stand-alone than would a corporate buyer. Meanwhile, sector convergence means that sellers need to understand the needs and value story for a widening range of buyers from different industries.

EY Capital Edge for divestitures: a better, faster way to separate a business and drive value

EY Capital Edge is a real-time data and analytics platform that provides a broad view of your divestiture life cycle. Designed for any size transaction – and any level of divestment experience – this web-based, secure technology helps you to collaborate across three often siloed functional areas: program management, finance and operations.

EY Capital Edge helps teams:

- ▶ Track day-to-day milestones and develop shared processes while automating administrative tasks
- ▶ Develop the deal perimeter with flexibility and help drive insights through integrated financial and tax data
- ▶ Meet tight transaction timelines by creating deal-basis and auditable financial statements based on multiple deal perimeters
- ▶ Seamlessly operationalize legal entities across the globe by tracking sequential milestones and regulatory requirements
- ▶ Manage interdependencies and milestones with real-time reporting to quickly make decisions, resolve issues and support day one readiness

With EY Capital Edge, teams can improve focus and make more informed divestiture decisions to accelerate value while minimizing disruption to the remaining business. Request a demonstration today.

How EY can help

Our dedicated, multifunctional divestment professionals work with corporate and private equity clients on sales of the entire company, carve-outs, spin-offs and joint ventures. We help companies evaluate their strategy, manage the portfolio, improve divestment value and grow their remaining business.

Evaluate corporate strategy and help manage the portfolio:

- ▶ Identify strategic opportunities to help drive growth
- ▶ Understand business performance compared to peers and contribution to the rest of the portfolio, including assessing the quality of information and developing more reliable data for the evaluation
- ▶ Evaluate priorities around which businesses to divest, and when
- ▶ Stress test divestiture hypotheses, evaluating different deal perimeters and estimating impact to EBITDA and operations
- ▶ Understand dis-synergies and one-time costs that may result from a potential divestment
- ▶ Help determine where capital can be released and reallocated toward growth and digital innovation

Improve divestment value:

- ▶ Identify and help execute opportunities to help create value in the assets to be divested
- ▶ Become an informed negotiator through use of advanced analytics
- ▶ Support the development of a clear value story and help guide you through preparation and execution – removing any potential bumps in the road before buyers get involved
- ▶ Assist in designing a tax structure to benefit buyer and seller, to help optimize working capital, design a communication plan, evaluate forecasted performance or provide a complex global separation and stand-up plan

Grow the remaining business:

- ▶ Understand the remaining company's cost structure, and help identify opportunities for the company to invest in the core business with a focus on top-line growth
- ▶ Identify areas of leverage to improve working capital or return value to shareholders

Connected Capital Solutions

Whether you're preserving, optimizing, raising or investing, our Connected Capital Solutions can help you drive competitive advantage and increased returns through improved decisions across all aspects of your Capital Agenda.



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Enabling fast-track growth and portfolio strategies that help you realize your full potential for a better future



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Enabling better decisions around financing and funding capital expansion and efficiency



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Enabling strategic growth through better-integrated and operationalized acquisitions, joint ventures and alliances



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Enabling strategic portfolio management, and better divestments to help you maximize value from a sale



Reshaping results

Helping you transform or restructure your organization for a better future by enabling business-critical and capital investment decisions



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- ▶ Life sciences
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- ▶ Technology

Contacts

To learn more and to have a conversation about your divestment strategy, please contact us:

Paul Hammes

EY Global Divestment Leader
paul.hammes@ey.com
+1 312 879 3741

Carsten Kniephoff

EY Europe, Middle East, India and Africa Divestment (EMEA) Leader
carsten.kniephoff@de.ey.com
+49 4036 132 17664

Paul Murphy

EY Asia-Pacific Divestment Leader
paul.murphy@au.ey.com
+61 421 052 872

Rich Mills

EY Americas Divestment Leader
rich.mills@ey.com
+1 404 817 4397

Shinichi Ogo

EY Japan Divestment Leader
shinichi.ogo@jp.ey.com
+81 90 4736 0279

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EYG no. 000310-19Gbl
BSC No. 1808-2831826
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