Corporate divestitures from strategy to execution

Four guiding principles to optimize value

At a glance

Amid ever-changing deal dynamics and market conditions, transaction preparation and value generation are more important than ever.

Successful corporate divestitures now demand diligent preparation. Sellers must understand all aspects of their business and address issues in advance to speed up the sales process and preserve value.

Following a few guiding principles when preparing for a sale will assist sellers in successfully exiting their business in a shorter timeframe and effectively optimize sale value.
Introduction

Buying or selling a company is a complex process, fraught with risk and uncertainty. That’s why buyers have historically used due diligence to help reveal hidden risks or opportunities that will help them negotiate a better price. The frenzied markets of the past put the seller at an advantage, because the heavy competition for business hampered buyers’ due diligence process. In a much tougher, post-downturn deal market, the smaller pool of likely buyers and increased demands from banks have heightened the need for extensive buyer due diligence and lengthened closing time frames. Now more than ever, the seller shoulders the burden of being prepared. You must know what the buyer will need to know — or risk deal failure, missed value targets, or stumbling along a protracted timeline.

While sellers may think they know their divestiture target’s operations inside out, they are usually too close to the business to look at it from a buyer’s perspective, making it difficult to clearly understand its value and viability on a stand-alone basis. This is particularly true when the target is part of a division or a product line, especially if the business has been ignored or is underperforming. Failure to see the target through the buyer’s lens increases the odds that the buyer’s diligence findings will derail the transaction, weakening the seller’s hand at the negotiating table, and destroying value while employees, customers, and stakeholders jump ship and head for safer ground.

This document provides sellers with guidance on how to successfully move through the divestiture process to prepare a business for sale. Regardless of the reason for divestiture, a robust process can help sellers successfully exit their businesses in a shorter time frame; avoid sale price erosion at the negotiating table; minimize distractions to the core business; and ultimately derive the desired value from the sale.
Appreciate current market trends and prepare accordingly

The economic slowdown has increased pressure on companies to revisit their operational strategies and business portfolio to determine if divestiture solutions are a viable response to some of their most pressing business issues. This has created a buyer’s market rich with investment opportunities. Though recent trends point toward stabilization, overall M&A activity has declined significantly domestically and abroad since the second half of 2007. Many corporate buyers continue to face a challenging economic environment. At the same time, financial buyers face much tighter lending restrictions, making it difficult for them to offer acceptable (if any) pricing for deals. These factors, combined with the weak performance of a target business and sellers’ heightened need to divest quickly to generate cash, have caused a dramatic change in market dynamics. As a result, significant gaps continue to arise between what buyers are willing to pay and what sellers are expecting to receive for a target business.

In many transactions, valuation is measured, at least in part, by an underlying performance metric, such as earnings before interest, taxes, depreciation and amortization (EBITDA). In today’s market, where deal multiples have fallen from historic levels, the underlying performance metrics of the business become even more important to determine the value the seller may receive from a divestiture. The recession of 2009-2010 ushered in a new level of skepticism in the market, elevating the onus on sellers to thoroughly prepare their business for divestiture by assessing their adequacies, leveraging their strengths and mitigating their weaknesses to achieve their deal objectives.

Pre-deal analysis and preparation add up to value. While sellers that fully understand the market value of their product are more likely to command their price, the unfortunate truth is that most business divestitures are characterized by value destruction from inception to close. Companies often fail to reap top dollar for divestitures because they fail to leverage the positives and address the negatives prior to taking a business to market. And once a business is in play, it’s often too late. Therefore, it’s paramount that sellers follow a divestiture process that moves quickly and retains value.

“Whether it is a house, or a division, it is a tough market to sell anything these days.”
When sellers don’t present a consistent and compelling business case, the bids they receive for a business are likely to be well below expectations, reflecting the issues that potential buyers claim will affect market value and future earnings. This is exaggerated in today’s uncertain market, where even the perception of unmeasured risk can derail a deal, require sellers to pursue alternative buyers, increase the time to close and reduce the price paid to the seller.

Not only does an extended deal timeline delay the receipt of critical sale proceeds, but as time elapses and target management focuses on the deal rather than business needs, other impacts also surface:

- Employee turnover increases and productivity declines as staff members speculate about their future, weigh their options, and potentially leave the company for other opportunities.

- Critical investments and new products are often put on hold.

- Competitors use the opportunity to attack the target on its most vulnerable points, raising doubts among key customers, and making it harder to attract new business.

Finally, the impact on the price sellers receive after all post-closing adjustments can be dramatic, further reducing the divestiture’s value.

One way to avoid value erosion is to design and implement a process that supports rapid deal completion. The process should reveal financial, market and operations issues early in the deal, when they are easier to address, thereby restoring some leverage back to the seller.

The four guiding principles of a successful divestiture

Most successful sellers in today’s market use a thorough divestiture process that follows the four guiding principles of successful divestitures: planning for all aspects of the divestiture process, presenting financial information tailored to the deal, preparing thoroughly and positioning for the exit and execution.

Savvy sellers tap tenured deal professionals who bring to the team experience and capabilities beyond those of legal and banking professionals. These deal professionals can advise on the preparation of financial information for prospective buyers and the positioning of the business for a favorable sale, using consistent and sound accounting principles. An independent point of view that is not tied to the deal’s success helps identify potential deal killers or, at the very least, highlights likely challenges buyers will face early in the process, giving the seller time to take appropriate steps before buyer due diligence begins.

The four guiding principles of a successful divestiture process are explained in the following pages.
1. Plan for all aspects of the divestiture process

Careful planning is critical to a successful divestiture. It should include:

- **Clarity regarding the scope, goals and objectives of the transaction** — A seller needs to clearly outline the parameters surrounding the assets to be disposed. This includes determining what is included and excluded within the scope of the transaction, the expectations about structure and issues related to employees. Too many transaction processes begin with far too much ambiguity — ambiguity that buyers can ultimately leverage to their advantage later in the process. While some very successful deals don’t involve variables that provide buyers with flexibility, sellers that don’t have a firm position going in often leak deal value as the process unfolds.

Additionally, for some sellers, a divestiture may involve a dual-track strategy of a corporate divestiture or a spin-off transaction to existing shareholders. Such cases can carry the added complexities of regulatory and reporting considerations.

- **Developing a divestiture project plan** — A critical first step to a successful divestiture is to create a managed divestiture project plan with a clearly defined team that has sound project management experience and a well laid out transaction timeline for all functions and responsibilities. At this stage it’s important to avoid oversimplifying the plan. Having a realistic view about the demands on — and capabilities of — the internal team, as well as the scope and objectives of the transaction, is key. Too often, value erodes when divestitures drag on, solely due to the lack of resources able to respond quickly and capably to buyer requirements throughout the process.

“*Every M&A transaction is different and requires its own strategy. We use a sliding scale based roughly on the size and nature of the property under consideration. Is it a technology? A license? A patent? A segment of a business unit? A whole unit? The strategies, tools, people, and resources are vastly different for each thing.*"
“Price versus timing versus ease is a set of variables that we think about. But then it’s finding the resources internally to package it ... it is the trade-off between price and ease of getting a deal done.”

- **Determining the implications of what’s left behind** — Divestitures often result in unexpected stranded costs being left behind with the seller. These indirectly erode the value received from the transaction. Planning for these costs includes committing to any restructuring decisions that may be required.

2. **Present financial information tailored for the deal**

As each transaction is different and each potential buyer is different, presenting financial information tailored to the transaction will help guide a more efficient divestiture process:

- **Evaluate information requirements and articulate a "bridge"** — Given the myriad scenarios for divestitures in today’s environment, sellers should carefully consider what information will be needed by potential buyers, what information is available, and how to best present it. While generally accepted accounting principles (GAAP) financial statements and deal-basis financial statements often vary significantly, both can be important to many buyers. Sellers may lose value by presenting only GAAP financial statements, but they may also be unable to complete a transaction by presenting only deal-basis financial statements. Presentation of both sets of financial statements may be preferred; if so, it’s important to bridge the differences between the two. Multiple sets of data that cannot be reconciled or bridged can erode buyer confidence.
“There is a level of additional due diligence that will be necessary on the part of the company’s management to ‘scrub’ the carve-out data to ensure that headcount, assets, and liabilities assigned to the divested businesses are complete and accurate. ...This effort often adds valuable time to an already strained timeline.”

- **Describe the business in a clear and cohesive manner** — Avoiding inconsistencies in the data provided to buyers and communicating credible, supportable forecasts are critical to obtaining top value for a business and accelerating the divestiture process. This means making sure that the data provided for offering memorandums, management presentations, data rooms or other related uses are accurate and consistent prior to delivering them to buyers. It also involves anticipating buyer requirements and preparing for timely and thorough responses.

- **Address the potential need for carve-out audited financial statements** — Many transactions involve buyers who, for financing or regulatory reporting purposes, require carve-out audited financial statements. Depending on the complexity of the carve-out, preparation of these statements can be extremely complicated and time-intensive. Sellers should understand the demographics and audit requirements of their potential buyers as early as possible in the divestiture process to keep this from becoming a negotiating item later in the transaction.
“We not only assess the monetary cost of an independent audit, but also the cost and stress on internal resources while balancing the day-to-day core operations and managing the sale process.**”

**3. Prepare, prepare, prepare**

“You can’t diligence yourself enough; preparation is key. It’s impossible to overprepare.**”

After prepping the dataroom and financial presentations, the next step is to prepare for the rigorous due diligence process that buyers and their lenders may undertake. Proactive sellers use this stage to understand any critical issues with their target business and to be well armed with the upside opportunities the business provides potential suitors.

Critical areas of preparation include:

- **Identifying operational issues and opportunities** — Many divestiture target businesses, particularly in a challenging economic environment, which are performing below management expectations. Under these circumstances, it’s important to fully review operations prior to putting the business up for sale. This enables the seller to identify and address crucial issues prior to any presentation to potential buyers: non-recurring costs impacting earnings, working capital investment, delayed capital expenditure (CAPEX) spending, plant efficiency, excess back-office costs and restructuring options. This process is referred to as preparatory or sell-side due diligence; it’s a vital aspect of divesting in today’s market. Early issue identification and its intended resolution can help neutralize the issue as a negotiating point.

- **Anticipate questions and requests** — Delays in transactions can often lead to lost deal value. Preparation and thorough sell-side due diligence enables sellers to anticipate requests and questions from potential buyers. Being prepared for these matters expedites the buyer’s due diligence and inspires confidence for the buyer and the acquisition’s management team, bolstering value retention.

- **Plan for key terms in the purchase agreement** — Sell-side due diligence presents an excellent opportunity to think through the entire transaction, including contractual terms and negotiation strategies. Typical areas of negotiation include purchase price adjustment mechanisms (e.g. working capital, indebtedness and restricted/trapped cash); representations and warranties; indemnities; and transaction scope (included or excluded assets). Proactive sellers take the lead in drawing up key contractual terms, including the rules for presenting financial information and the nature of post-closing adjustment mechanisms. This entails giving careful consideration to the basis for an appropriate adjustment mechanism (e.g. working capital, net assets) and the benchmark (e.g. historical date, forecast amounts, average of various dates), as well as what accounting policies and GAAP deviations may need to be disclosed.
• Validate forecast assumptions —
Pressure testing the business unit’s forecast assumptions is a significant focus of buyer due diligence. Consequently, sellers in the preparation stage of a transaction should be sure to: analyze forecast assumptions with a degree of skepticism; anticipate buyer concerns and areas of focus for the assumptions included in the forecast; and prepare adequate support for those assumptions (e.g. historical performance versus forecast and third-party forecast assumptions). Sellers today face particular challenges in demonstrating forecasting accuracy, given the recent economic and market volatility and its implications for future outcomes based on historical results.

• Bridging historical results to forecasts — For buyers to become comfortable with management’s plans for the future, there must be a clear, consistent link between historical and forecasted results. This involves laying out key actions that drive enhanced profits, and addressing likely concerns over synergies and stand-alone costs in a way that makes sense to the buyer. Buyers expect that sellers have the ability to support its target business forecast, including the ability to speak to downside risks and mitigating factors.

• Provide stand-alone cost estimates — Stand-alone costs can often be a point of contention during transactions. We recommend that sellers carefully consider all stand-alone costs and allocated costs, and prepare support for these assumptions, such as proposed transition services agreement terms or costs for physical resources to replace the allocated costs. Historical cost allocations are often not an appropriate proxy for third-party service costs, and insufficient preparation for these discussions can lead to significant delays in transactions.

“Doing diligence on your internal model before sharing it with the prospective buyer is critical.”
“A strong pro-forma model that the buyer can use to model its own future expectations and anticipated stand-alone results is key.*”

4. Position for the exit and execute

While the planning, presentation, and preparation stages of a divestiture are vital, value realization all comes down to execution. The following are key aspects to position information for facilitating the sale:

- **Managing the process** — Sellers that actively manage the transaction process experience fewer delays and retain more value than those that allow potential buyers to dictate the process and timeline. Careful planning, presentation, and preparation will allow the seller to provide all buyers with the same information and answers they require, promoting a much smoother transaction process.

- **Drafting of transition service agreements** — Moving expeditiously from signing to close is critical, and explicit plans for vital transitioning services, systems, supply agreements and back-office operations to the divested business often drive this outcome. Too often, such arrangements are mere afterthoughts that lead to value deterioration, closing delays or Day One difficulties for both parties.

- **Tax structuring** — Understanding different tax structures for transactions and their potential costs and benefits can help the seller leverage additional value from potential buyers. Sellers should consider these structures and be positioned for sale based on the option that can provide the most value for the buyer and the seller.

- **Maintaining a competitive process** — While this may appear to be a simple concept and is key to maximizing value for the seller, maintaining a competitive bidding situation is often challenging. Sellers should consider the volume of potential bidders and when (and if) it’s necessary to enter into an exclusivity agreement.

Given buyer skepticism in today’s volatile markets, smart sellers have every incentive to do their homework on a business they’d like to sell, so they can present it in a way that is both accurate and compelling. A company that engages an objective third party to rigorously evaluate a business as soon as its sale is contemplated and resolves any issues early will have a far better chance of commanding full price when it goes to market. This has never been more important, given constraints on the pool of buyers.

“Transition service agreement needs should be considered early in the process; an activity-based cost analysis should be performed and it should be assumed that the transition will consume substantial resources.*”
Typical divestiture deal continuum

Transaction planning
- Reach tentative decision to divest
- Prepare preliminary financial information
- Address carve-out issues, benefits plans, taxes, structure

Sale process
- Prepare data room materials
- Circulate financial information to buyers
- Select potential buyers, provide access to data room
- Detailed due diligence for selected buyers
- Contract drafting/ negotiation/ transition service contracts
- Signing and closing
- Post closing adjustment and separation

Spin-off process
- Prepare and audit carve-out financial statements, pro forma statements and other financial information
- Prepare and file regulatory documents with the SEC, IRS and other applicable bodies
- Regulatory review and approvals
- Spin-off effectiveness and separation
Realizing value in a corporate divestiture

It's a well-known fact that buyers must implement a sound due diligence and integration process if they hope to capture the value of an acquisition. Ironically, many companies fail to recognize that a comparable process is vital when divesting a business if they hope to realize value on the sell side of a corporate divestiture. Value erosion begins long before a deal is completed, making it imperative for sellers to prepare well before they identify a buyer.

Apply the four guiding principles of corporate divestiture to meet your transaction objectives. Be sure you:

*Plan for all aspects of the divestiture process* — Outline transaction objectives and the key value drivers and risks.

*Present tailored financial information for the transaction* — Show financial information for the target business in a compelling, yet appropriate, light that builds buyer confidence in the process.

*Prepare, prepare, prepare* — Identify critical issues and upside opportunities and prepare financial and operational information in support of the asking price in the offering memorandum; perform preparatory or sell-side diligence before marketing the deal.

*Position for the exit and execution* — Actively manage all aspects of the divestiture process to support healthy competition, an efficient process, and a timely closing.

Conclusion

A thorough divestiture preparation process is crucial to a successful divestiture in today's market. Such a process arms a seller with the critical information needed to present the business most effectively, address deal issues early on, answer challenging questions and boost value for the assets in play.
End note

* This statement was made by a participant at a recent PwC Corporate M&A Roundtable event on corporate exit strategies.
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