

Divestiture insights

Divesting to maximize shareholder value in today's challenging market

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Foreword

With the financial markets more challenging than ever before, careful preparation has become imperative for companies looking to divest.

Buying or selling a company is a complex process, fraught with risk and uncertainty. That is why buyers have historically used due diligence to help reveal hidden risks or opportunities that will enable them to better negotiate price, whether in a competitive or exclusive situation. Over the last several years, the frenzied deal market often saw a reduced level of buyer due diligence as a result of the high competition for businesses. Now, in this much tougher deal market, with a smaller pool of likely buyers and increased demands from banks, the need for extensive buyer due diligence has increased and is expected to further lengthen deal close times. More than perhaps ever before, the burden will be on the seller to prepare for what a buyer will need to know, or risk the deal falling through, not achieving their asking price, or a much extended deal timetable.

While sellers may think they know their divestiture target's operations inside out, they are usually too close to the business to "stand in the buyer's shoes" and clearly grasp its value and viability on a stand-alone basis. This is particularly true when the target is a piece of a division or a product line, and especially if a business has been ignored or is underperforming. Failure to see the target from the buyer's perspective 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 as employees, customers and stakeholders head for safer ground.

This paper provides sellers with guidance on how to use a successful divestiture process to prepare a business for sale. Regardless of the reason for the need to divest, by using a strong divestiture process, sellers can successfully exit their businesses in as short a timeframe as possible, avoid erosion of the sale price at the negotiating table, and—ultimately—maximize their sale price.

Sellers must appreciate current market trends and prepare accordingly

Like it or not, it's been a seller's market for the last several years, and it's now over. M&A activity has declined significantly both domestically and abroad since the second half of 2007. Corporate buyers are facing difficult economic times, with many having neither the debt nor the equity capacity necessary to finance acquisitions. At the same time, financial buyers are facing much tighter lending restrictions making it difficult for them to offer acceptable (if any) pricing for deals. These factors, when combined with the weak performance of many target businesses in the current economy and the heightened need by many sellers to divest quickly in order to generate cash, have caused a dramatic change in market dynamics. As a result, deal multiples in most sectors have fallen from mid-2007 levels, with significant expectation gaps often arising 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 (e.g., EBITDA) times a multiple. In today's market, where deal multiples have fallen from historical levels, the underlying performance metrics of the business become even more important in determining the value the seller may receive from a divestiture. Further, given the recent collapse of iconic institutions that spurred the world financial crisis, buyers and their lenders are going to be even more skeptical about potential acquisitions. Bottom line: this means that today—more than ever—sellers must adequately prepare their business for divestiture by leveraging strengths and mitigating weaknesses.

Sellers beware: the damage caused by poor planning, preparation, and positioning

While a seller who fully understands the market value of his product is more likely to command his price, the ugly truth is that most business divestitures are characterized by value destruction from inception to close. Companies often do not receive 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 is often too late. In today's economic environment, where deal multiples and valuations for most businesses are lower than they were a few years ago, it is paramount that sellers follow a divestiture process that moves quickly and retains value.

When a seller doesn't present a consistent and compelling business case, the bids a seller receives for a business are likely to be well below expectations, reflecting issues that potential buyers claim will affect market value and future earnings. This case is further exaggerated in today's uncertain market where even the perception of additional risk can derail a deal or, at a minimum, increase the time to close and reduce the price paid to the seller.

While it goes without saying that an extended deal timeline delays the seller's receipt of critical sale proceeds, as time elapses and target management stays focused on the deal rather than its business, the target slated for divestiture begins to suffer in other ways:

- 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.

In addition, the impact on the price the seller actually receives after all post-closing adjustments is often dramatic.

To avoid value erosion on the sale of a business, sellers should design and implement a process that supports the rapid completion of a deal. A strong divestiture process is critical to this plan and would reveal financial, market and operations issues early in the process when they are easier to address, thereby returning some leverage to the seller.

The “three Ps” of successful divestitures

The most successful sellers in today's market are using a thorough divestiture process that includes the “three Ps” of successful divestitures: planning, preparation, and positioning.

A successful divestiture process will ensure that sellers develop a divestiture plan for the most effective interaction and negotiation with buyers. They will utilize experienced professionals to advise in the preparation of financial information for prospective buyers and positioning the business for sale in the most favorable way consistent with sound accounting principles. A successful divestiture process often

identifies potential “deal killers” early in the process and in time for the seller to take appropriate steps before buyer due diligence begins.

The components of the three Ps of a successful divestiture process are as follows:

Planning

Careful planning will be critical to a successful divestiture and the planning process should include:

- **Clarity around 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 a buyer can ultimately leverage to their advantage later in the process. This is not to suggest that some very successful deals don't involve variables that provide buyers with flexibility, but sellers who don't have a firm going-in position often lose value as the process unfolds.

Additionally, for some sellers, a divestiture may involve considering a dual track strategy of both divestiture (sale) and spin-off.

- **Developing a “Divestiture Project Plan”**—Sellers should create a managed divestiture project plan with a clearly defined team that has sound project management experience, including a well laid out transaction timeline. Sellers need to be realistic about the demands on—and capabilities of—their people. Depending on the scope and objectives of the transaction, a company may need third party assistance to deliver on the plan. Too many divestitures drag on and see value erosion solely due to the lack of resources able to respond quickly to buyer requirements throughout the process.
- **Determining the implications of what's left behind**—Divestitures often result in unexpected stranded costs being left behind with the seller which indirectly erode the value received from the transaction. Planning for these costs includes committing to any restructuring decisions that may be required. Unfortunately, however, this is too often an afterthought.

Preparation

The seller will need to be prepared for the rigorous due diligence that buyers and their lenders will be requiring in the current tight financial market. Sellers should understand any critical issues with their target

business and also be well-armed with the upside opportunities their business provides. Critical areas requiring preparation include:

- **Identifying operational issues and opportunities**—Many divestiture target businesses, particularly in the current market environment, are underperforming management expectations. In these circumstances, sellers should consider fully reviewing their operations prior to putting the business up for sale in order to identify and address issues such as non-recurring costs impacting earnings, working capital investment, plant efficiency, excess back office costs, and restructuring options prior to any presentation to potential buyers. This process is sometimes referred to as “seller due diligence” and is a vital aspect of divesting in today's market. Quite often, early identification of an issue and its intended resolution will neutralize the issue as a negotiating point.
- **Describing 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. It also involves anticipating buyer requirements and preparing for timely and thorough responses.
- **Addressing the potential need for carve-out financial statements**—Many transactions will involve buyers who, for financing or SEC reporting purposes, will 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 address this issue up front to ensure it doesn't become a negotiating item later in the transaction.

Positioning

While the planning and preparation are vital, it all comes down to execution. The following are key aspects to the positioning of information to facilitate the sale:

- **Revisiting the historical presentation of financial information**—The historical results of a target business often need to be adjusted in order to reflect its true post-sale economics, and this can often present a better story for prospective buyers.

Adjustments identified in the “seller due diligence” process need to be positioned properly.

- **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. In today’s market, a company’s ability to fully defend its target business forecast is critical, including its ability to speak to downside risks and mitigating factors.
- **Developing a tailored contract that protects the seller**—Sellers should 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 what the adjustment mechanism should be based upon (i.e., working capital, net assets, etc.) and what benchmark (i.e., historical date, forecast amounts, average of various dates, etc.) is most appropriate, as well as what accounting policies and GAAP deviations may need to be disclosed.
- **Drafting of transition service agreements**—Moving expeditiously from signing to close is critical, and explicit plans for transitioning vital 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.

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 today’s shrinking pool of increasingly skeptical buyers.

Critical steps to a successful divestiture

A successful divestiture process is often a multipart process through which the seller would develop the information needed to present a business in a manner that is compelling, consistent and accurate. While there are multiple stages to the process, to achieve the fastest possible close date and preserve deal

value, the execution must often be parallel rather than sequential—with several stages being executed simultaneously at any one time. The following provides a deeper dive into how the “three Ps” can be aligned with the steps to a successful divestiture.

Stage 1: An in-depth business review of the divestiture target’s financial information

In the initial phase of a divestiture process, sellers should critically evaluate the integrity of the financial information of the business to be offered for sale, whether performed with internal corporate resources or external accounting specialists. This “seller due diligence” process is likely to include visits to target locations to identify both financial and operating “soft spots.” It will also include identifying issues associated with carving a division away from its corporate parent and preparing an analysis of earnings quality. This review should be completed before any information is presented to potential buyers. This gives the seller the opportunity to develop a credible portrait of the business and confront potential negatives, before the buyer tries to use them as negotiating leverage.

Seller management will usually have a strong opinion on what a business is worth. Part of the job of this assessment is to challenge these views, offering a frank assessment of what a buyer would be likely to conclude, and playing the “devil’s advocate” in reviews of financial information. This may include conducting mock Q&A sessions to prepare the seller and the divestiture target for the tough questions they will inevitably face in buyer due diligence and subsequent negotiations, and providing an unbiased assessment of how buyers are likely to regard the quality of the divestiture target’s management team. The most important output of this initial phase is the financial information that will be presented to prospective buyers. The divestiture process should aim to present the business in the strongest possible light, and generally will include a number of potential adjustments to the historical results that support this position. Such adjustments typically include:

- **Nonrecurring or one-time costs**—Obvious examples include adjustments for restructuring provisions, legal settlements, and losses on sales of assets, but a careful review may reveal other relevant items. For example, on one deal, the impact of nonrecurring transition costs resulting from the consolidation of two plants caused a significant erosion of gross margins. Rather than presenting only the historical results and later explaining the issue to potential buyers, the impact of this one-time issue was added back and the results were presented on an “as adjusted” basis.

The treatment of this issue was fully disclosed in the offering memorandum and was also supported by detailed computations in the data room. The decision to present the issue in this manner added direct value to the deal, as the bids from the group of perspective buyers were all based on the “as adjusted” numbers.

- **Balance sheet movements**—The divestiture process should include a review of balance sheet reserves that focuses on both their adequacy and the timing of any provisions. Such reviews often reveal that certain periods have been unfavorably affected by a “true up” of shortfalls attributable to prior periods. When reserve movements that are largely judgmental in nature adversely affect more recent income statements, the seller should consider adjusting the information to be presented to potential buyers, even though the historical treatment of such data is valid under GAAP.

For example, a seller's pre-deal analysis revealed that a significant charge had been recorded in the current year to increase inventory reserves of the target business. However, further investigation revealed that the associated inventory had actually been on hand, with little or no movement, for several years, but was written down in the current year after the company reviewed it in detail and declared it obsolete. For purposes of the offering memorandum, the charge was removed from the current period and reflected in earlier years when, arguably, the inventory write down should have been accounted for, with complete documentation presented in the dataroom.

- **Parent company allocations**—In any carve-out situation, allocating parent company costs to the target and determining their basis is largely a judgment call. Such costs include general corporate allocations as well as reimbursement for direct services provided and intercompany purchase and sale agreements. Quite often, the historical practices followed are not the most meaningful for a stand-alone business. Also, sellers and their advisors must consider and address any areas where the parent maintains balance sheet reserves for the divestiture target, or does not charge it for certain items. Often, there are different possible options to what actually gets presented and the GAAP answer may differ from the most relevant to potential buyers.
- **Historical charges that do not reflect future costs**—Quite often, GAAP requires charges for items that are not indicative of prospective costs. One example includes amortizing components of pension and postretirement costs, which often

represent adjustments from a deal context. Specifically, while GAAP accounting for these costs requires the smoothing of gains and losses, the amortization of these items technically relates to prior years, and arguably should not affect the current or forecasted earnings or cash flow from a buyer's perspective. Also, adjustments for the income statement impact of retained liabilities that the seller will retain—such as the interest cost associated with retired employees' benefit obligations—should be considered.

- **Modification of accounting policies**—Often, there is more than one acceptable accounting treatment and the seller can choose the one that works best from a deal perspective. An example would be the decision to use LIFO versus FIFO for the recording of inventory. Buyers typically bid based on the financial results presented in the offering memorandum, which, where appropriate, should be adjusted for any such issues. A reconciliation between the reported results of the business and the adjusted results should also be presented in the back of the memorandum along with a description supporting each adjustment. This approach can lead to higher opening bids that can ultimately lead to higher deal value when the transaction is completed. Since buyers will scrutinize any adjustments, it is critical that sellers prepare supporting documentation for the prospective buyers. It is also important for sellers to identify issues that buyers are likely to raise, and propose solutions. A key takeaway here is that the historical GAAP answer may not always be the most relevant, which often requires clear explanation and bridging of the reported to “as adjusted” information to ensure any such adjustments survive buyer due diligence.
- **Structuring**—The structure of a transaction can also affect the value the seller receives, and this is another area where the seller should consider seeking professional support. For example, one seller sent out an offering memorandum asking potential buyers how much additional value they would offer if a deal were structured as a stock sale with an IRC Section 338h-10 election, as opposed to a straight stock sale. The seller was able to offer the 338h-10 election, in which the buyer can treat a stock purchase as an asset acquisition and deduct goodwill for tax purposes, without incurring any incremental cost in the transaction. After evaluating several responses, the ultimate buyer paid a significant premium for the 338h-10 alternative, which added substantially to the value received by the seller.

Stage 2: Planning for separation and transition

Separating infrastructure can be complex and present significant challenges, particularly when core operations of the business to be divested are commingled with the parent. Sellers often wait too long before starting the work of separation, increasing the likelihood of uncovering surprises late in the deal process which result in closing delays and value erosion.

Sellers should perform an early evaluation of shared processes, systems, data, contracts, and facilities, among others. Care must be taken in deciding what will stay and what will go, and detailed plans should be developed to ensure effective and timely separation execution. Of course, planning the degree of separation is dependent on the potential buyers, each with their own particular infrastructure needs and requirements. Sellers are best served by adequately preparing for each probable buyer scenario and positioning itself to address them. Savvy sellers also identify and prepare for potential trade-offs between buyers. Though preparation requires a significant level of effort by the seller, it places the seller in a better position at the negotiating table and increases the likelihood for timely transaction closing and sustained deal value.

As part of the separation planning process, sellers should also prepare for the terms and costs of likely Transition Service Agreement (TSA) well in advance. Again, history has shown that sellers often wait too long before identifying and documenting TSA details and often get caught on the wrong end of the bargaining table. As each day passes, TSA details are more commonly developed and negotiated in a way to simply get the deal done, leading to “Day One” difficulties for both parties and often resulting in value erosion for the seller. Early TSA planning areas to consider include service level descriptions and delivery, pricing and cost allocation methodology, duration and termination provisions, and tracking, invoicing, and payment processes.

Stage 3: The offering memorandum

Investment bankers skilled in describing a business often prepare the offering memorandum. However, they often need guidance on how best to present the financial information to tell a compelling story. Sellers should ensure that experienced accounting professionals are involved in advising management on how to describe the story behind the numbers in the offering memorandum. This can involve helping management develop the “management’s discussion and analysis” section of the memorandum, such that the document highlights positive attributes identified

during the review. The seller and their investment bankers should make sure the historical financial information (including any “adjusted” numbers as discussed previously), as well as the forecast, will hold up under intense buyer scrutiny. This means analyzing all reported financial information, cross-checking internal references, and ensuring that all of the documents to be provided in the data room will ultimately support the numbers in the offering documents. An offering memorandum prepared on this basis will present the positive story while addressing potentially negative issues effectively. Our experience suggests that, while interest may be strong upon initial delivery of the offering memorandum, many deals falter when the offering memorandum is not properly supported—or when actual results begin to fall short of the forecast during the buyer’s detailed due diligence phase.

Stage 4: Data room preparation and management presentations

Data rooms have become a common element of transactions, particularly when deals are conducted through an auction process. Although sellers typically make each relevant functional area within an organization responsible for a particular “chapter” in the overall data room “book,” our experience suggests there is often little coordination to ensure that all internal groups disclose consistent information. At this stage, sellers and their advisors need to protect against value leakage by making sure that all the information holds together during the buyers’ due diligence phase. Team members should ensure that data room materials are presented in the way buyers expect, and that the story is clear, complete and consistent from beginning to end. This process involves reviewing all relevant materials to be included in the data room, including those related to finance, operations, tax, legal and employee benefits—particularly for areas where the information cuts across various disciplines within the organization. Many buyers can cite cases in which the legal or employee benefits sections of the data room revealed issues with financial consequences that were not disclosed or properly reflected in the financial information. Deals often undergo a significant reduction in value simply because the data room highlights inconsistencies with the information presented in the offering memorandum.

A thorough review of the data room, with these issues in mind, is essential to ensuring that potential buyers maintain the initial value estimates they developed from reading the offering memorandum. This review should include a “dry run” in which the divestiture team stands in the shoes of the buyer, anticipating

their questions and requests for additional information.

Stage 5: Negotiation of sales contract and purchase price adjustments

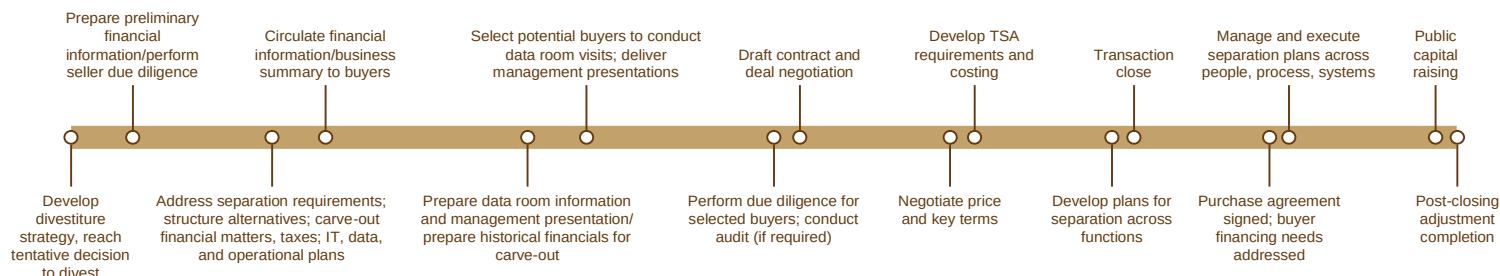
Quite often, a seller's first draft of a sales agreement is a cut and paste from some earlier deal. Our experience suggests that each deal is different and requires unique consideration of the contract terms. A strong divestiture process is designed to identify issues for consideration and develop appropriate contract language tailored to each transaction.

Such issues include sellers' representations and warranties, areas for indemnification, and the basis of adjustment mechanisms. It is also important to weigh the costs and benefits of offering any audited accounts of the target business to the buyer. Sellers must be proactive in developing and negotiating contract terms.

A reality of the deal world is that, while buyers often base their offer on a company's earnings and cash flow, they often seek adjustments based on the closing day's balance sheet. This is because most contracts include a post-closing balance sheet adjustment clause that measures the change in the

balance sheet from some interim date to the day of close in order to protect both parties from changes during that period. Sellers must examine the balance sheet for any issues that the buyer might raise after the deal closes, and address these issues early in the process. Often there is a solution that can preserve value, however it must be raised and addressed early to avoid a post-closing surprise. Too many buyers today use the post-closing adjustment mechanism clause to get a "second bite at the apple," often resulting in prolonged disputes and post-closing price concessions. As many sellers have learned the hard way, most arbitrators give more weight to GAAP than consistency, unless the purchase agreement specifies otherwise. The basis of accounting in a contract need not always conform to GAAP, and in many situations it is advantageous to specify other accounting methods. Sellers can use the information gathered throughout the investigative process to help develop tailored sales contract language that protects the seller's interests and minimizes the likelihood of negative surprises on or after the day of close.

Typical Divestiture Process Timetable



The big picture

It is 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, but many companies fail to recognize that they need a comparable process when separating a business. Value can begin to erode long before a deal is consummated. In today's market, companies must work to avoid this outcome by adopting a disposal process that includes:

Planning—Outlining the seller's objectives for the transaction and the key value drivers and risks.

Preparation—Identifying critical issues and upside opportunities, and preparing the financial and operational information necessary to support the asking price in the offering memorandum.

Positioning—Showing financial information for the target business in the most compelling light appropriate, thereby taking a proactive stance to effectively manage the divestiture process—including the key terms to be negotiated in the purchase agreement.

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

Divestiture Insights is a PricewaterhouseCoopers publication and provides strategic thinking on a wide range of divestiture issues that affect the deal community. For more information on the topics discussed in this issue, contact **Mark Ross** at (305) 375 7386 and **Gregg Nahass** at (213) 356 6245