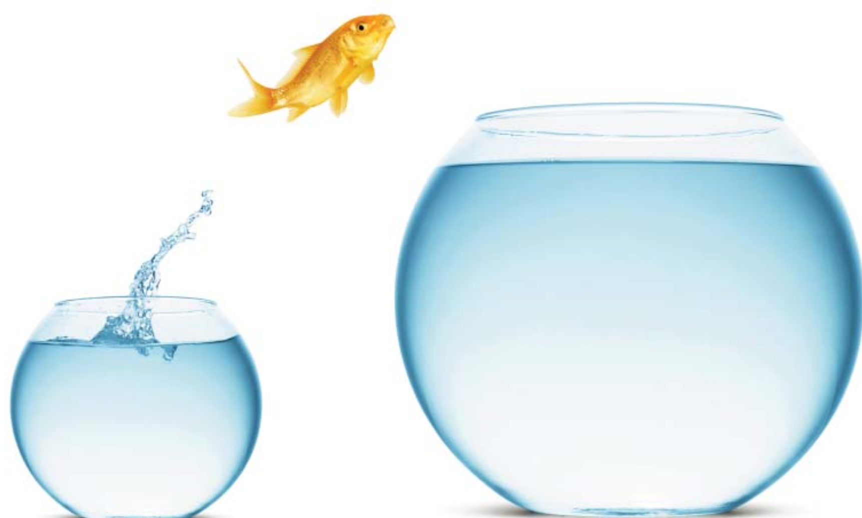
Deloitte.

CFO insights:
Divestitures and Carve-outs: Becoming a Prepared Seller

Given the uncertainty and conflicting data around the economic recovery, one of the leading trends we're seeing among CFOs today is evaluating and rebalancing the organization's business unit portfolio. And as CFOs review their portfolio of businesses, they should consider not only which businesses to grow, but also which businesses to shed. Divesting non-core assets not only increases strategic and financial flexibility but also allows sellers to focus their attention on the core business and maximizes overall shareholder value.

During the credit crisis, many divestitures were put on hold as asset values plummeted and sellers took offerings off the market to wait for better valuations. Many potential buyers also found it difficult to raise financing or chose to conserve cash in uncertain times. Today, as credit conditions ease and valuations increase, companies are turning to divestitures to free up cash, pay down debt, finance other growth initiatives, and optimize their portfolio of businesses. In fact, Deloitte's Divestiture Survey found 87% of executives polled expected a divestiture in the next three years, and divestitures are likely to increase substantially in the coming year.[1]



In these changing times, the CFO's role in a divestiture is also changing. Gone are the days of simply preparing the target company's financial statements and shepherding the transaction. Today, the CFO plays a vital role in ensuring that back-office processes, sales forces, and shared services are seamlessly transitioned, that transition services are optimized, and that the costs that should logically disappear, in fact, do.

The following article outlines some of the major challenges and surprises that a CFO may face as part of a divestiture. It also outlines some leading practices en route to becoming a prepared seller to maximize transaction and enterprise value.

Challenges and Surprises

To the novice, divestitures appear like a merger in reverse – but to the expert, they are rife with their own unique challenges and issues. Five of the top challenges and pitfalls for a CFO to avoid include:

1. **Separating Tightly Integrated Businesses** — Over the past twenty years, advances in information systems such as ERPs have enabled integration across different business operations. The tighter the integration, however, the more difficult and costly it becomes to decouple. The divested entity will likely rely on the ParentCo post-transaction close until they can stand alone or plug-in to their buyer, which is a relationship that is fraught with challenges. Another key challenge in facilitating a quick sale of a highly integrated business is the "lack of a single voice" representing the transaction to the buyer. There may be many individual managers focused on product lines, customers, etc., but there may not be a single CEO/CFO type that can serve as the voice of the overall business during the sale process. This may increase the buyers' costs to gather critical information.

2. **Providing Transitional Services** — As discussed above, the complexity and increasingly accelerated timelines for divestiture transactions often require the parent to provide transitional services to the divested unit for a period after transaction close. These transition service agreements (TSAs) are, too often, utilized as the default option without questioning whether there are quicker, cheaper options. Because neither the seller nor the buyer is typically in the service-providing business, the result can be expensive, underperforming service for both parties. Organizations should view TSAs as necessary evils with accurate costs, defined service levels and specific exit plans.

3. **Avoiding Stranded Costs** — Shedding peripheral businesses can leave the seller with a disproportionate cost structure relative to its new size. The CFO should be wary of loss of scale and duplicate corporate capabilities and keep a keen focus on controlling costs. Even if the need for cost reduction is apparent, management commonly fails at execution. The inability to deal with competing priorities during a time of transition, insufficient resources to execute, and a failure to follow through tend to plague CFOs in their bid to avoid saddling the parent with unnecessary costs.

4. **Confronting Varied Disruptions** — As with any breakup, divestitures can be disruptive internally, as employees have to perform their day-to-day jobs along with separation activities, which can stretch resources to the breaking point. Externally, both the parent and the spin-off risk making transitional mistakes that can jeopardize market standing and business continuity. Developing a robust Day One plan for all functions can help mitigate these challenges — and an equally coherent end-state plan can help focus energy on the core business that remains.

5. **Managing Multiple Parties and Divergent Agendas** — Typically there are several different parties involved in any divestiture transaction, and their agendas are usually not aligned. Parent organizations, spin-offs, and buyers all pursue different agendas, but each puts value at risk if the divestiture isn't handled properly. Sometimes this conflict manifests as the parent company tries to position the business in the most favorable light while those in the business unit work to accomplish the opposite.

Even the most difficult divestiture obstacles can be overcome through extensive preparation. Becoming a prepared seller can help maximize shareholder value and reduce the risk, not to mention headaches, often associated with divestitures.

Becoming a Prepared Seller

Deloitte's experience suggests that becoming a prepared seller may boost the value of a transaction. A prepared seller can quickly close a transaction and focus on the remaining core business operations. For the buyer, the prepared seller's assets are more valuable because they are able to quickly execute the transaction and immediately focus on synergy capture. To become a prepared seller, CFOs should plan and execute a divestiture process in advance of the transaction close. Both transaction and separation readiness are key elements in preparing for a sale and must often be executed in parallel.

Transaction Readiness

- **Selecting a portfolio optimization strategy.** CFOs should work with CEOs and Boards to decide what businesses to keep or divest. Once units are targeted for divestiture, it is important to consider any legal or regulatory constraints to the divestiture. The impacts of the separation on existing and future consumers, markets, revenues and shareholder value should also be evaluated to maximize portfolio value.

- **Preparing financial statements and offering documents.** As part of the divestiture process, sellers need to prepare financial statements for the entity being divested. Thorough and clear financial statements enhance the seller's credibility with buyers, enabling quicker transactions and often higher deal valuations. A prepared seller can add value to buyers by providing a clear understanding in offering documents of future cash flows and business continuity at the close of the transaction.

- **Planning for tax efficiency.** Divestitures can give rise to a number of different tax issues based on the context of the divestiture. Tax planning in advance can enable more tax efficient divestitures.

- **Establishing TSAs.** To facilitate divestitures, the parent company often has to support ongoing services to the divested entity. A prepared seller is clear, at the outset, regarding what services they are willing to provide and understand the cost of the services. While TSAs allow a company to meet its divestiture deadline, even when critical services cannot be separated in time, they are not a cure-all, and should not be used as a crutch to avoid tough decisions to end specific services.

- **Establishing a voice of the business.** The companies that get a higher price have people that can pull everything together and discuss revenues, customers, margins, five-year plans, etc. Prepared sellers thus establish a voice for the sale that facilitates the communication of critical information coherently to prospective buyers.

Separation Readiness

- **Establishing a clear separation strategy.** By establishing a strategic framework by which to manage the separation, seller and buyer can align against key milestones, deliverables and interdependencies. Developing a separation roadmap, establishing joint meetings/working sessions and developing a common set of tools and accelerators will ensure a smooth transition.

- **Assessing functional impacts.** This includes determining what functionality will be migrated to the divested entity and the need to replace that functionality. Clearly defining the functional carve-out strategies and end-state blueprints is an effective method for preventing organizational roadblocks. It's important to define not only how the newly carved-out business will operate at close, but also the future state of ParentCo and SpinCo, including corresponding organizational and financial implications.

- **Eliminating stranded costs.** When a unit is divested the parent company can be left with a number of stranded costs – costs previously incurred in serving the divested unit. Planning to eliminate stranded costs can help the company execute a disciplined program for cost reduction. This requires setting targets for cost reduction post divestiture and following through with specific initiatives in a given time frame to reduce costs.

- **Establishing day one readiness teams.** On Day One, or the date the transaction closes, both ParentCo and SpinCo should experience uninterrupted operations. To ensure a smooth close and business continuity it is imperative to establish a Day One Readiness team and air-tight Day One readiness plans. A robust, pre-tested Day One readiness plan is "earthquake insurance" against disruption and uncertainty at the moment of truth. By prioritizing objectives for each function, organizations can ensure business continuity, reduce employee tension, and minimize customer defections.

Engaging all of the above considerations in advance of a divestiture can enable a company to become a better prepared seller. These considerations, among others, can also help frame a robust separation plan so that business continuity is achieved both in the parent and the divested entity on Day One.

Excellence in Execution

Value is gained through the transaction itself; however, it is unlocked through seamless and rapid execution. As a CFO, a rigorous focus on planning, communicating and executing should help maintain business continuity for customers, employees, stakeholders and shareholders. By becoming a prepared seller in advance of transaction execution, CFOs are likely to realize better deal values, a shorter time to close, and quicker elimination of stranded costs. Shorter and more effective execution of transactions also permits the CFO and the ParentCo managers to conserve and refocus their attention toward improving the performance of the remaining businesses in the ParentCo portfolio.

Primary Contacts

Jeffery M. Weirens
National Managing Principal, Divestiture Services
Deloitte Consulting LLP
jweirens@deloitte.com

Jeffrey Bergner
Partner, M&A Transaction Services
Deloitte & Touche LLP
jbergner@deloitte.com

This Deloitte CFO Insights article was developed with the assistance of Craig Oberg, Manager, Deloitte Consulting LLP and Dr. Ajit Kambil, Global Research Director, Deloitte CFO Program.

Deloitte's CFO Program harnesses the breadth of our capabilities to deliver forward-thinking perspectives and fresh insights to help CFOs manage the complexities of their role, drive more value in their organization, and adapt to the changing strategic shifts in the market.

For more information about Deloitte's CFO Program visit our website at www.deloitte.com/us/cfocenter.

Endnotes

[1] "A Closer Look at Carve-Outs," Deloitte, 2009.

This publication contains general information only and is based on the experiences and research of Deloitte practitioners. Deloitte is not, by means of this publication, rendering business, financial, investment, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Copyright © 2010 Deloitte Development LLC. All rights reserved. Member of Deloitte Touche Tohmatsu Limited.