Value creation through divestitures

Interdependency assessment is the starting point

Divestitures are in vogue. Companies divest operations for a variety of reasons. A company may decide to refocus its strategy on selected core operations and, as a result, certain businesses no longer make sense for the company's long-term future. Other companies may choose to monetize assets in order to redeploy that investment in other opportunities or pay down debt. The assets to be divested (DivestCo) may not be underperforming or lack-luster, but simply no longer fit with the seller's business and may have more value in someone else's portfolio of operations.

However, as anyone who's been through the process can attest, deciding to divest and actually executing a divestiture are very different things. Meticulous, purposeful planning is absolutely critical to maximizing the value for all stakeholders. One of the critical early steps in the divestiture process is to carefully understand how broadly and deeply the DivestCo is embedded within the seller's organization. While each divestiture is unique, many of the fundamental execution issues and questions are fairly common.

Common questions around divestitures

1 Financial statement implications

- **Current cost allocations** – What are the existing cost allocations by the seller's corporate functions or affiliates to DivestCo for service provided, and to what extent does this represent the actual level of service and cost? *In many cases, broad-brush allocations are made that may not reflect that actual level of effort to provide such services (e.g., allowed under SAB No. 55). Potential buyers typically require more specificity to properly understand the underlying effort to provide such services. This is required in GAAP-compliant financial statements.*
- **Stand-alone costs** – What would be the stand-alone costs to operate DivestCo once it is no longer part of the seller's organization? *The answer may differ if the potential buyer is a corporate acquirer that may be able to provide such services through existing infrastructure or a private equity firm in which such corporate functions may need to be replicated or outsourced. Stand-alone costs might be reflected in pro-forma financial statements provided by the seller.*

2 Transition services agreements
What interim support will DivestCo need to properly function in the near-term post-close period? *It may be unrealistic to believe DivestCo could function on its own on the day of closing. So, what support is the seller willing to provide to the buyer, at what cost, and for what period of time? In addition, depending on the nature of the transaction, there could also be reverse transition services agreements (TSAs) whereby a buyer may provide certain services back to the seller. This particular scenario is not uncommon.*

3 Separation issues
What are the separation issues that will need to be addressed to make Day One a success? *This often includes physical separation, logical separation, commercial agreements that need to be in place between the seller and DivestCo at closing, separation of data and systems, transition of third-party agreements, etc. Yes, it becomes quite complicated.*

4 Stranded costs
How will the seller's cost structure need to be addressed post-closing, once transition support has run its course? *In most cases, the seller can no longer afford to retain the same cost structure in a smaller organization.*

In too many cases, sellers underestimate the complexities of the challenge and/or do not have a sufficient understanding of the specific ways the DivestCo is connected to the broader corporate organization and/or its affiliates. Best practice suggests the seller be proactive in these areas in order to obtain the greatest possible value from a potential transaction.

With this in mind, we recommend a common starting point—the interdependency assessment—for any company looking to undertake a divestiture.

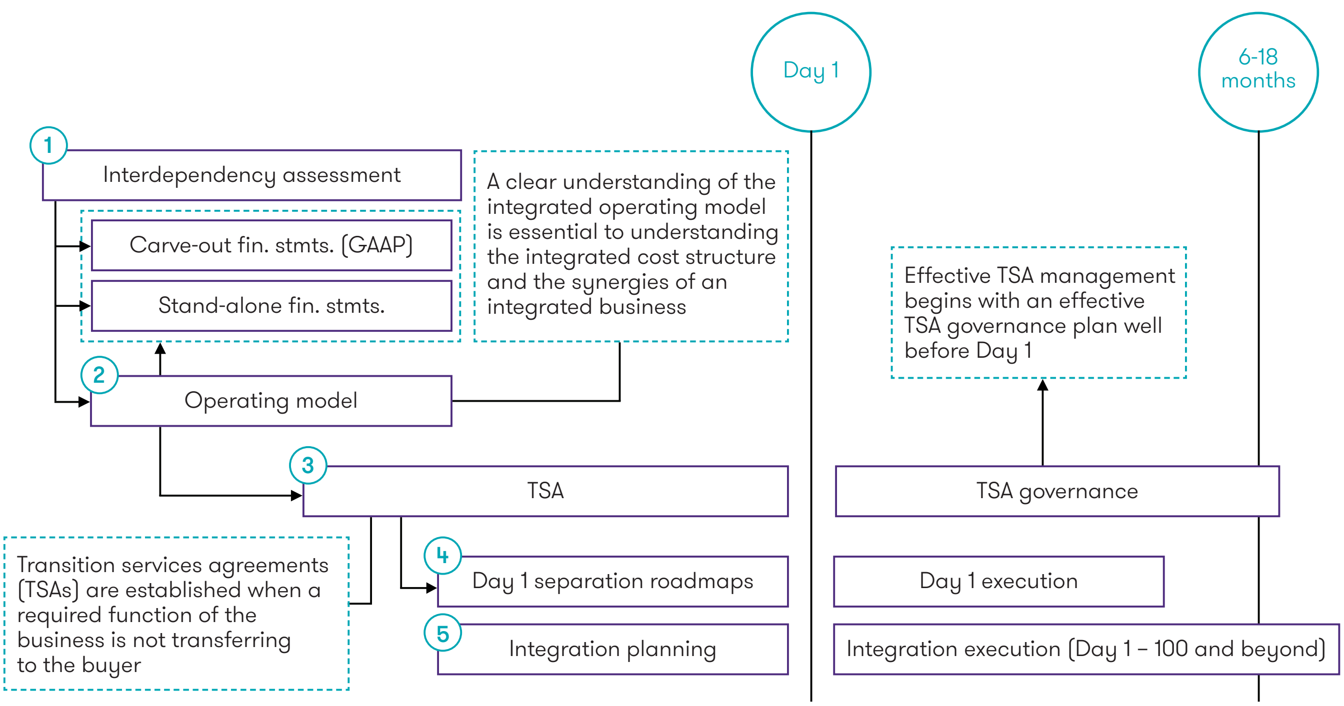
Planning the separation

Simply put, the objective of the interdependency assessment is to examine the degree to which DivestCo is dependent upon the seller's organization and determine how to address this in light of a potential buyer stepping in to take over the operation. As simple as that statement sounds, it proves to be a fairly complex, challenging process—but a necessary first step in realizing value for the transaction and keeping the seller in control of the process.

A seller also needs to consider the buyer's perspective—namely, how much it will cost for DivestCo to be supported by the seller on an interim basis, as well as once the transition support period has expired.

Figure 1 provides some perspective. First, interdependencies between DivestCo and the seller's organization may exist

Figure 1: Separation planning & execution
Five areas of work to effective buy-side separation, leading to efficient integration



across each functional area, from corporate shared services to commercial agreements. Second, DivestCo benefits from being part of the seller's collective group, of which such advantages may not exist post-closing when DivestCo is separated out (e.g., corporate purchasing leveraging with favorable pricing). Third, the assessment must always consider people, processes used, assets and facilities involved, legal contracts and technology.

Through the interdependency assessment, the exact nature of the services received by DivestCo can be clarified, profiled and prioritized, along with the true associated costs to provide such services (people, facilities, equipment, outside contracts, technology, etc.). The costs can then be compared with the historical allocation for such services (if any) to determine if adjustments would be needed to the GAAP-based financial statements that are presented. The goal would be to develop a fully loaded cost analysis that will ultimately inform the pricing of necessary transition services.

Understand stand-alone costs

In traditional GAAP financial statements, allocations of shared corporate costs are generally included. In order to be accurate from a GAAP perspective, such costs should reflect underlying levels of effort and the allocation method (percentage of revenue, number of employees, etc.) should be reflective of this effort. However, a seller may wish to develop a stand-alone cost analysis, which would be of interest to a potential buyer. For example, assume for a moment DivestCo depends on the seller for shared accounting services, including accounts payable processing. Also assume that the level of effort the seller makes on DivestCo's behalf is the equivalent of three accounting clerks—approximately one-third of the department's resources—with oversight by a supervisor. Accordingly, stand-alone costs would likely equate to three full-time clerical equivalents plus a full accounts payable supervisor (versus the allocation that is likely for one-third of the supervisor's time). Fractional people are the largest challenge in any separation or stand-alone cost analysis.

Theoretically, the buyer will still need to have DivestCo use the common accounts payable system; however, a separate instance would likely need to be created to segregate the operations of DivestCo. This is but one example of the considerations associated with separation.

Information technology is generally one of the most challenging and critical areas for a separation. Not only will the major systems need to be separated (enterprise resource planning, material requirements planning, accounting processes, etc.), but data will also need to be separated between the seller and DivestCo. In certain cases, the amount of historical data may need to be considered as well, such as maintenance records and specific purchases associated with replacements. In addition, there are generally smaller ancillary systems, such as those for recording OSHA incidents and environmental compliance, all of which DivestCo will likely need on a stand-alone basis.

HR issues can also be complicated. Which employees are moving with DivestCo or which need to be transferred? Is their payroll already resident with the legal entities that will be divested? How will shared benefit plans and pension plans (both assets and liabilities) be separated? How will incentive compensation plans be handled post-separation? Some plans are often based on total company performance, which will need to be addressed. If the company is publicly traded, any incentive compensation based on equity will also need consideration, since DivestCo will likely no longer be part of the public entity. Thus, separation issues associated with people can be easily magnified.

Commercial agreements, often less formal prior to separation, are also frequently ripe with complexity, as these examples illustrate.

- A company desired to sell a refinery, yet all of the refined product still had to pass through a terminal that was being retained by the seller.
- A third-party benefits provider was divesting its absence management business, yet still wanted to retain the services in the offerings it provided to customers.
- A quick-service restaurant conglomerate with multiple brands was divesting one concept, whereas its foreign headquarters in one country was situated on the land of the concept to be divested without any formal agreement.
- A service organization of a major electronic goods manufacturer had centralized all procurement contracts and the entity to be divested was enjoying significant purchasing benefits.

All of these are examples of areas that need to be addressed pre-closing; a seller should be proactive in order to retain its favorable commercial terms, albeit the contracts may now be split between multiple operations.

Establish transition service agreements

All of the entanglement issues described above point to transition service agreements that may be required. Commercial agreements may also be needed. Each of these, when identified, should be included with the development of a Day One separation checklist so that all these entanglement issues can be addressed. Transition services can run both ways, depending on which people and capabilities remain with the seller and which will go with DivestCo as part of the transaction.

The seller's cost to provide such services plus the reliance of DivestCo on these services help define what transition support may be required. Again, best practice suggests that the seller should be proactive in identifying what services DivestCo will need, determine those for which the seller would be willing to support DivestCo on a transition basis, and develop a framework agreement to be presented to a potential buyer. How long will services be provided? Will there be a provision for extensions or early termination? Will the price be escalated for each extension? In order to properly manage post-close operating ambiguities and risk, we recommend they should be significantly escalated to provide an incentive for the buyer to quickly reduce dependence on the seller's organization. Getting such interim support properly framed at the outset benefits both the seller and the potential buyer, while at the same time allowing the seller to remain in control.

Address separation issues

Each of the issues noted above will likely also need to be addressed in terms of separation. For example, data will need to be separated, instances of software applications will need to be replicated, shared office space will need to be physically separated, treasury structures will need to be established, etc. While the interdependency assessment is being completed, a list of these separation issues can be compiled and a master checklist developed to prepare for the eventual separation when a buyer steps in and becomes responsible for DivestCo's operations.

Eliminate stranded costs

One of the greatest challenges for a seller will ultimately be analyzing and addressing the issue of stranded cost. Consider, for example, a specialty paper manufacturer selling one of two divisions, representing 45% of total revenue. Post-closing, the company is now only 55% of its former size, yet generally retains 100% of the corporate overhead structure. So, in connection with divestiture planning, some consideration must be given to this disproportionate overhead burden. First and foremost, the potential buyer should be willing to take on certain parts of the overhead structure (e.g., research and development, safety, etc.), which will lessen the impact. Some of the cost associated with this excess capacity will be covered by reimbursement by the buyer to the seller for transition support services. However, at the same time, the seller must consider how the overhead structure can be reduced and right-sized in proportion to the remaining organization.

Particularly problematic are fractional people who remain with the seller. For example, in the case of the paper company, there was a single environmental engineer who supported both organizations. It is extremely difficult to reduce the cost of this engineer by 45% because of the divestiture (the fractional person issue). In this case, two possible alternatives might exist. Outsource environmental compliance post-closing, post-TSA period could be one option. In this particular case, there was a compelling reason for DivestCo to take the environmental engineer, which would then allow the seller to leverage services from DivestCo during the transition. Again, there are numerous complexities that would need to be addressed and alternative scenarios developed. The seller simply cannot afford to retain the disproportionate overhead structure for any extended period of time.

Importance of the interdependency assessment in divestiture planning

As we've seen, it's impossible to overstate the importance and value of performing a proper interdependency assessment. It will help the seller have greater accuracy in the separate financial statements of DivestCo. Not only are such financial statements critical to the due diligence process, there may also be a requirement to include them in a public filing (e.g., Form 8-K). Based on the complexities examined above, historical statements are generally not reflective of stand-alone financial statements. Thus, the seller may wish to also prepare pro-forma statements that consider what DivestCo might look like if all the resources required to maintain operations were included and no assistance was provided by the seller. This could have a significant bearing on many areas, including the valuation of a potential transaction where significant incremental cost may be required.

In addition, the seller will need to properly identify transition services that will likely be required and properly price these on the actual cost to perform such services. These costs are not just incremental payroll costs. Often they will include, among other things, employee benefits and an allocation of incentive compensation, reimbursement for buildings leveraged, adequate compensation for information technology hardware and software utilized, and other costs properly included as part of supporting the potential buyer.

Day One is when the transaction closes and separation needs to be official. So, it is important to the transaction being concluded for the seller to understand what will need to be separated and terminated (e.g., insurance policies covering DivestCo) or separated and supported through TSAs (accounting, human resources, etc.). It behooves the seller to take a position on such matters. Otherwise, an astute buyer will try to leverage every opportunity to have the seller pay for certain costs. A prepared seller is in a better position to resist the buyer's attempts to pass costs back.

Finally, because sufficient cost analysis will be performed around shared people, processes, assets, technology and contracts associated with DivestCo, the seller can begin to plan how it will reduce such costs once the organization is no longer required to provide transitional services. Thus, a targeted cost reduction number can be established and planning for such a reduction can be done in advance. The sooner such planning is completed, the sooner the seller can make the necessary reductions and not materially impact overall profit and loss by carrying excessive costs for any longer than necessary.

Complex and fraught with risks

Divestitures are generally a highly complex process, fraught with myriad risks. And, unlike many other types of cross-functional initiatives, a divestiture is a "point-in-time" opportunity tied to a defined timeline, and we have one shot to "get it right." The astute seller will develop an overall plan and perspective surrounding the implications of the divestiture in order to maintain control over the negotiations and avoid potential negative consequences post-transaction. There is an adage regarding the devil being in the details, which is certainly the case with divestitures. Too many sellers generally do not realize the level of interdependencies that exist between its organization and DivestCo. Both formally and many times informally, there are little tentacles between the two. All need to be addressed, whether severed at the date of sale, addressed through TSA or addressed through a commercial agreement. The point is that nothing can really be left to chance if the seller truly wants to capture the full potential value associated with the contemplated transaction.

	Buyer	Seller
What are the allocations by the seller's corporate functions or other affiliates to DivestCo for services provided? In many cases, broad-brush allocations are made that may not reflect that actual level of effort to provide such services. Potential buyers will want more details.	✓	
What would be the stand-alone costs for such services when DivestCo is no longer part of seller's organization? The answer may differ if the potential buyer is a private equity firm or a corporate aquirer.	✓	
What interim, post-closing support will DivestCo need in order to properly function? It may be unrealistic to believe DivestCo could function on its own on the day of closing. So, what support is the seller willing to provide the buyer, at what cost, and for what period of time?	✓	✓
What are the separation issues that will need to be addressed immediatly at closing? This includes physical separation, commercial agreements that need to be in place between the seller and DivestCo at closing, separation of data and systems, transition of third-party agreements, etc. Yes, it becomes quite complicated.	✓	✓
How will the seller's cost structure need to be addressed post-closing, once transition support has run its course? In most cases, the seller can no longer afford to retain the same cost structure in a smaller organization.	✓	✓

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