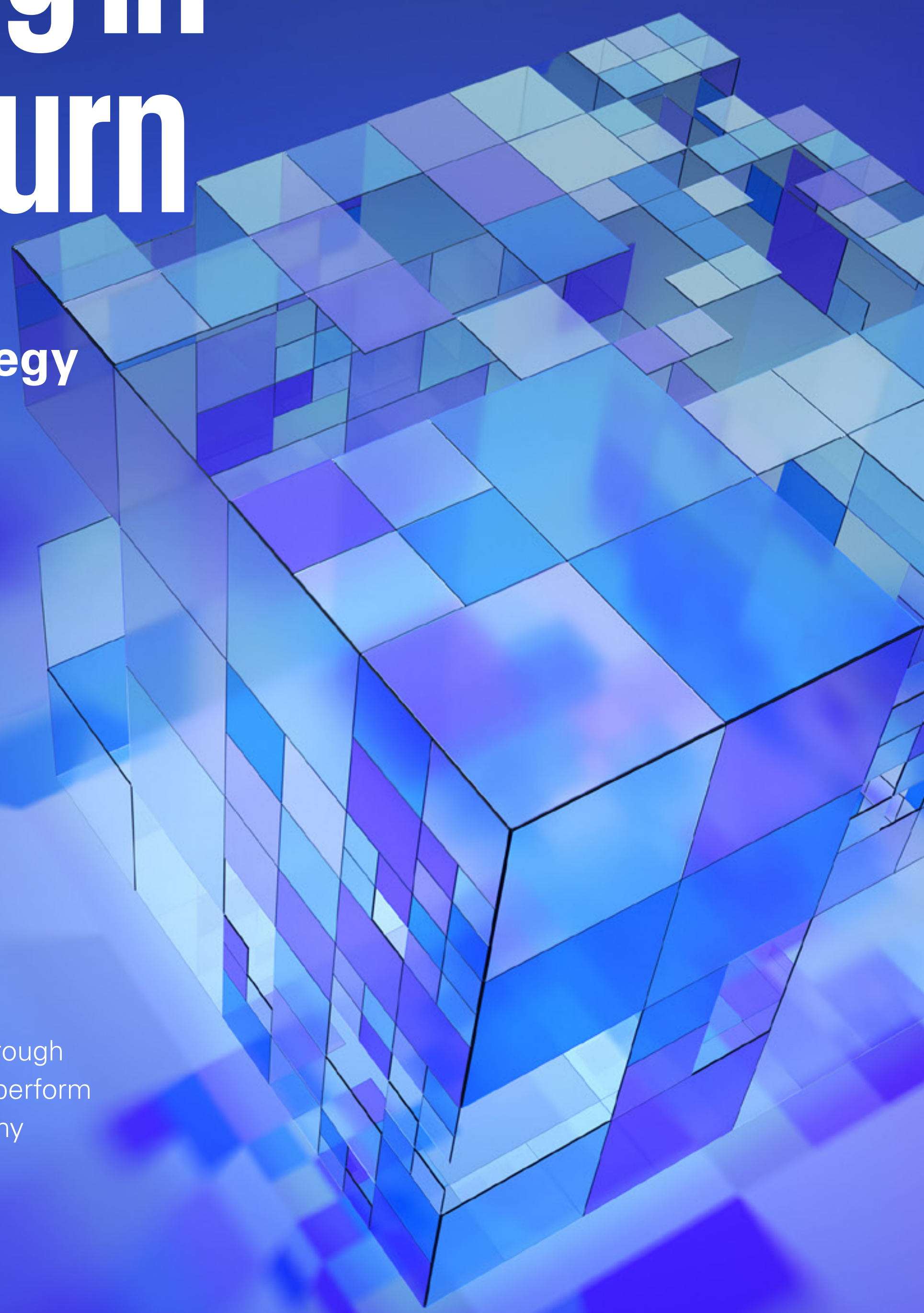
KPMG

Divesting in a downturn

Staying committed to a long-term strategy has its rewards



A deliberate focus on value creation through proactive divestitures can help you outperform in a down cycle—and help your company emerge even stronger.

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Introduction

Across industries and across the world, companies are bracing for leaner times. In the latest KPMG CEO survey, 91 percent of the 400 U.S. respondents said they expect a recession in the next 12 months, and only 34 percent thought it would be mild and short.[1]

Corporate leaders are responding with a variety of strategic initiatives, including by downsizing the workforce and by accelerating digital transformation to preserve margins and improve efficiency.

As you consider your ability to thrive in a downturn and beyond, proactive divestitures should be an important lever for consideration. But they are often not in the first-aid kit of many CEOs. Assuming the assets will not fetch a strong price due to the broader economic conditions, many are generally reluctant to divest assets in a downturn. That may be a mistake, as good assets can lead to strong transactions. And getting smaller to focus on core businesses could ultimately result in a company that is nimbler, more competitive, and better positioned for market success.

Rather than a hurdle, economic stress can serve as a useful catalyst to divest, shining a bright light on underperforming businesses for which you may not be the best owner. Prudent management teams will identify and implement a divestment strategy to achieve favorable outcomes, such as:

Reallocation of resources (including human capital, financial investments, and management focus) to enhance support for the core business (RemainCo) to deliver results in a weaker economy—and beyond.

Redeployment of capital generated from a sale of deprioritized businesses; related activities to consider include a deleveraging of the balance sheet, engagement in buy-side M&A to build on the core, and/or a boost to shareholder returns through buybacks/dividends, etc.

Mitigating diversification discounts attributed to the company due to disparate financial characteristics of the business units.

[1] Source: "KPMG 2022 U.S. CEO Outlook," October 2022

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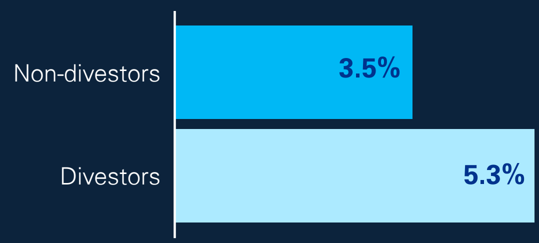
In recent KPMG research, we found that divestitures can drive greater returns in a down market. For example, during the Great Recession of 2007-2009, companies with a market capitalization of greater than $2 billion that divested a business saw median excess returns of 5.3 percent, outpacing those of non-divestors with 3.5 percent (Exhibit 1).[2] While our research focused on larger companies, we believe smaller companies could also explore this strategy to gain greater returns.

Exhibit 1. Using divestitures as a strategic move has been successful in a down market

Excess returns of divestors and non-divestors in a downturn*



*Returns from 12/1/2007 - 6/30/2009; U.S. public companies, market capitalization >$2 billion, excluding financial service companies.

Companies that activate a divestment strategy in an environment where others may be reluctant to do so can gain advantages. Those willing to take action may find fewer assets to compete with in the deal market—which can serve to attract more attention, expand the pool of interested buyers, and potentially drive up sellers' premiums. Conversely, those who try to "time the market" and wait for valuations to bounce back may miss unique opportunities to reshape and optimize their portfolio.

If you don't act, activist investors may take it upon themselves to secure board representation and pressure management teams to divest underperforming assets.[3] Recent proxy card rule changes also have made activism easier.

In this paper, we argue that it is prudent for companies to continue to assess and optimize their portfolio of assets, including potential divestment in a downturn. Simply put, management teams need to identify the biggest contributors to higher valuation, driving growth and pursuing strategic alternatives for those that hold the business back—due to relatively slow growth, challenged margins, or peripheral importance. Once companies settle on a divestment strategy, they then need to execute with a sharp focus on maximizing value during and after the transaction.

[2] Cap IQ screening was used to retrieve a list of U.S. public companies from 01/01/2007. To get to our final list for analysis, we eliminated: 1) companies with a market capitalization less than $2 billion; and 2) all financial institutions as defined by S&P's Sector Primer Series.

We then checked whether each company had divested or not during the first year of an economic downturn (12/01/2007-11/30/2008). While retrieving this data, we filtered for "Corporate Divestiture" to capture when a seller's wholly owned subsidiary, division, or operations line was divested (this feature is not applicable if the target is a real estate property/real estate holding company). Excess returns were calculated for the start (12/01/2007) to the end of the recession (06/30/2009). Excess return is defined as company return less Russell 3000 return during this period.

[3] Source: Stephen Gandel, "Activist Investors See Opportunity in Rocky Markets," New York Times, October 19, 2022

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Do you have businesses for which you are not the best owner?

A diverse portfolio of businesses can entail a high degree of complexity driven by a variety of factors, including differences in the business model, operating structure, tax structure, and reporting considerations. Downturns can expose such complexity by creating unanticipated performance issues or dividing leadership's attention when companies can least afford to do so. Our research has shown that financial disparity between a company's portfolio businesses can arise from differences in growth trajectory, margins, or asset intensity. This disparity is significantly correlated with "a diversification discount" relative to the sum of the values of its parts.[4]

What is active portfolio management?

For companies with a complex portfolio of businesses, active portfolio management answers the critical question of what businesses to operate, buy, or sell. Management teams can arrive at the best move for each business by relentlessly posing these questions:

Such an approach is even more relevant heading into a downturn because investors can more easily identify companies carrying a portfolio that bundles together businesses with financial disparity—and penalize them with a greater market discount. Divestitures, however, can proactively address disparities among businesses in a portfolio.

[4] Source: "Can your valuation be improved?," KPMG, 2018

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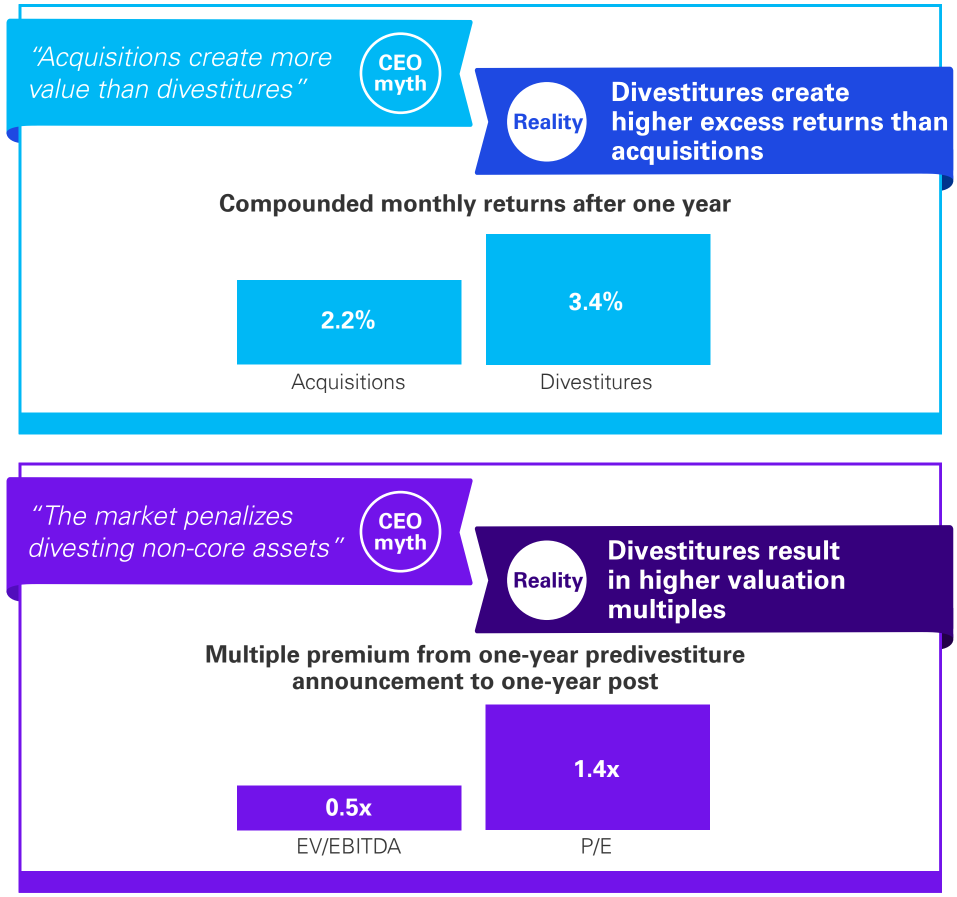
Selling businesses for which you are not the best owner can unlock value and free up both financial and human capital to drive growth of the core business. High-performing management teams consistently assess businesses with a focus on strategic fit. This approach will support an ongoing environment of fixing/buying-for-scale-and-capabilities/selling. In addition, the deliberate adjustments can prevent a mixed portfolio for which you may or may not be the best owner for all the businesses and, ultimately, value destruction. In our earlier paper, *Think Like an Activist*, our research and market data showed that companies applying active portfolio management (see "What is active portfolio management," page 4) can actually create more value through divestitures than through acquisitions, and their market valuations tend to be higher 12 months after a divestiture announcement (Exhibit 2).[5] A prudent approach to active portfolio management is key in all economic cycles—downturns are no different.

Exhibit 2. Costly myths: CEOs still believe that acquisitions create more value than divestitures and that markets penalize companies that divest assets



Note(s): Compounded monthly returns after 12 months, estimates based on Research by E. Feldman; average of manufacturing and services industry; in a CEO survey (n=50) conducted by KPMG with GLG, 72% of CEOs agree that acquisitions have created more value than divestitures over their careers and will do so in the future

Source(s): Research by E. Feldman, based on KPMG analysis, KPMG CEO survey, and CEO discussions

[5] Source: "Think Like an Activist," KPMG, 2020

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How do you determine which assets to sell?

Start with an evaluation of your portfolio management process to see if it challenges businesses to innovate and if it is aligned with your customer base, strategy, and values, including environmental, social, and governance (ESG) objectives. Critically review the portfolio to assess whether the company is trading at a discount due to certain businesses in the portfolio. If a path to reverse this discount through operational or capital investment can't be developed, these businesses should be considered for divestiture.

Corporate leaders can be emotionally attached to businesses, whether they are legacy assets that the company was founded on or past acquisitions that no longer have a strategic rationale. You can, however, counter this emotional attachment by asking:

- What unique value does your company bring to the business (and vice versa)?
- Why is your company the best owner for this business?
- How can your company fight the effects of the financial disparity this business creates in your portfolio?

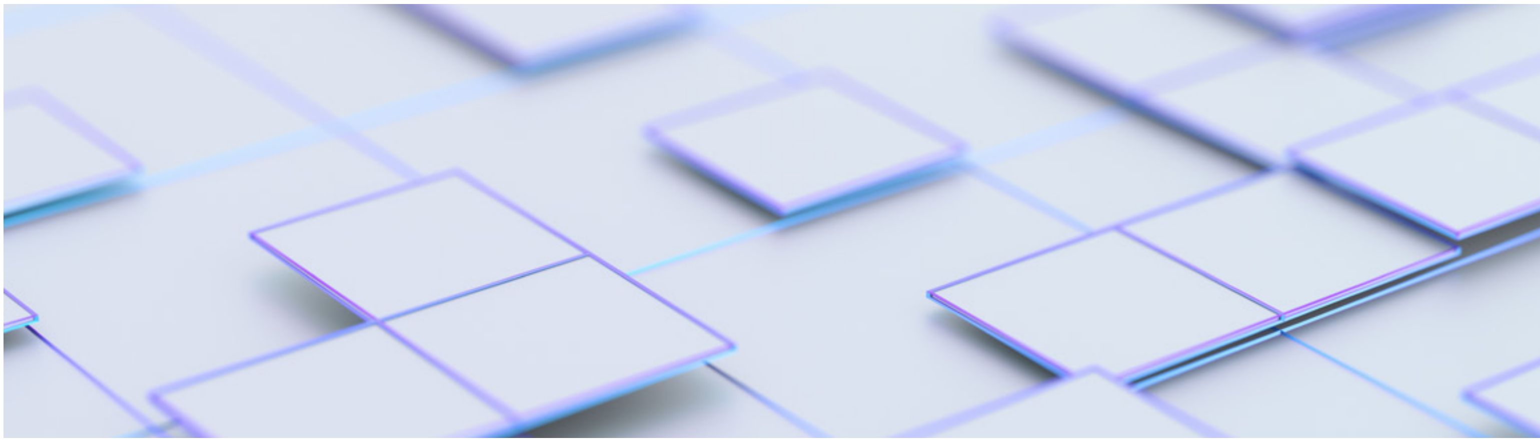
Divestitures are a proactive means to optimize the portfolio, not an admission of failure. Assets that can find better owners usually yield strong returns in any market. Slower deal activity in a downturn can create pent-up demand for good assets, providing an opportunity to sell at premiums, if you can articulate their value story.

For specific businesses to divest, leaders can take a deceptively simple, structured approach to identify them. The key issues to address include:

- Which businesses are you really in? If you looked at your businesses as a collection of "sellable units," what would they be? To answer, disaggregate your portfolio around business models and financial characteristics. Ultimately, a collection of sellable units can look very different from how they are run along business segments or product lines.
- Why are you the best owner for these sellable units?
- Which of these sellable units have an accretive standalone value trajectory (based on forward-looking growth, margin, capital intensity, and multiples), and which don't?
- Are there others that would make better owners for your sellable units? For these potential owners who are likely to regard these assets highly, what is the value story?

If your portfolio assessment points toward divestiture, you should move decisively and align your management team around the transaction strategy. As Emilie Feldman of the Wharton School notes, companies are often indecisive. But waiting to act only delays achievement of the benefits the divestiture strategy can yield.

> **"Research shows that companies can wait 18 months longer than they should once the rationale to divest becomes clear."**
>
> – Emilie Feldman, Professor of Management, Wharton School, University of Pennsylvania



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Setting yourself up for success

Companies tend to be better buyers than sellers. Many companies don't have extensive experience selling nor the infrastructure to appropriately prepare and execute a divestiture. With proper preparation and resources, you can ensure that both RemainCo and the business being divested (CarveCo) are transaction ready, and operationally optimized. The result is a value-driven divestiture process that is primed to be executed with purpose, speed, and precision.

A variety of factors will determine the direction your process takes, but all divestitures start with these three decisions:

1. Define a clear (and potentially flexible) transaction perimeter—what is being divested?
2. Decide on a preferred transaction structure—will you sell, spin, joint venture, or consider other structures?
3. Identify the buyer pool—who are likely the better owners for this business, and what will be their value priorities?

Considering the realistic answers to these questions will drive the evolution of the divestiture from a concept to a program, and ultimately to a reality.

Transaction perimeter

For many sellers, the transaction perimeter is easily identified and articulated. It can take many forms, but will often be: (a) a business segment; (b) a product line; (c) a geography—and/or combinations thereof. At times, however, drawing a line around the perimeter is more difficult due to operational and financial reporting entanglements. While this may mean taking a scalpel through the operations and financials, it is important to do so to avoid creating execution risk and value leakage.

As the transaction perimeter is defined, sellers need to ensure that the value story for the business remains viable, attractive, and can be clearly articulated. In addition, successful sellers maintain flexibility in the transaction perimeter to enable a response to suitor preferences and demands as the process unfolds.

Will a suitor require a fully stood-up and operationally independent business, or will it simply seek a business to be bolted on to an existing infrastructure? The seller will need ready access to key management team members, historical and forecast performance data (at a granular level), an understanding of the key functional support needs, and operational key performance indicators to draft a flexible business plan. In a downturn, the need for this flexibility is magnified as suitors may apply different lenses to the acquisition opportunity and request (if not require) the seller pivot to address their transaction preferences.

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Preferred transaction structure

As transaction value and strategy are assessed, a preferred transaction structure will often emerge. In determining the structure, the seller will need an informed view of the various markets that may be likely landing spots for the business, including public markets (via an initial public offering or spin-off transaction), strategic acquirers, and financial sponsors.[6] During this stage, conversations with and selection of an investment banker and tax adviser can provide salient insights to the seller.

Again, in a downturn, the need for this strategic approach to the transaction is amplified, as market volatility will often impact appetite for the transaction and ultimately the value achieved. But, while the headline price may be the most obvious indication of value, an informed management team should remain keenly aware of other value attributes, including opportunity cost, redeployment of resources, etc.

Buyer pool

Viable buyers will often inform the seller's transaction structure and can also have a material influence on the transaction preparation process. A best practice is to maintain options deep into the process. In tandem with the flexibility in the transaction perimeter, the ability to market the business to a variety of suitor classes allows the seller to drive competitive tension in a process—a factor that is likely to enhance value.

A dual-track path is the best means to facilitate this approach. This is a strategy in which the seller runs parallel efforts toward different transaction outcomes, perhaps to prepare simultaneously for a spin-off and a sale, or for a sale to a strategic and financial sponsor.

The importance of a view on the likely buyer pool and the potential for market-driven changes to the pool are magnified in a downturn. But well-prepared sellers with well-articulated value stories are best positioned to pivot, if required, and mitigate execution risk.

[6] Source: For more on carve-outs and spin-offs, see "Dissecting public carve-outs: What are the dynamics of a successful transaction?," KPMG, 2020; and "Successful corporate spins," KPMG, 2022

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Executing with excellence for CarveCo

The current economic environment creates additional challenges for standing up a carved-out organization with a new owner. For example, there is great uncertainty with respect to topline forecasts, impacts of inflation on costs, supply-chain disruption, and employee recruiting and retention. Add to this a Federal Reserve tightening cycle, geopolitical events, increased ESG responsibility, and you have an unusually challenging transaction environment for divestitures. However, a focused and disciplined approach can still yield success in the execution phase of your divestment. Take a holistic view to address the challenges, with enhanced focus on commercial and operational diligence.

Smart commercial diligence is paramount. The past performance of a business as support for forecasts is unreliable and brings diminishing returns as the operating environment changes. A downturn can change the landscape of customer demand, product pricing, and competitive dynamics. A detailed commercial diligence, focused on customer engagement and using bespoke data, can provide the insights needed to support forecast assumptions. These will need to be thoroughly vetted to help your management team convey a business plan with confidence.

Beyond the top line, the business plan must present a thoroughly vetted cost structure to support the target operating model of the business being divested. Sellers will need to develop a keenly optimized operating model prepared with the transaction in mind, specifically incorporating input from the functional leads that will manage the business and own the forecast in the post-separation period. These people will have the requisite insights into the most current market dynamics that the operating model and corresponding business plan will need to address, including but not limited to inflationary and supply-chain risks. In taking this approach, consider the most recent and relevant impacts of current economic conditions and the alternative strategies for the management team to implement to drive project performance and mitigate downside risk.

Also important to get right is human capital strategy—who goes and who stays? In an already uncertain environment, how you communicate the

answers is as important as the answers themselves. Clear communication from business leaders will drive employee confidence in both the selling company and the divested business. In a weak economy, it is critical that employees can focus on delivering results without worrying about losing jobs and with conviction that the transaction will cause minimal disruption. Sellers need to carefully consider the people needs assumed in the target operating model, as well as the in-house talent that may address the standalone personnel needs of the divested business.

Executing with excellence for RemainCo

So how does the divestiture impact RemainCo? There's always a risk of stranded costs, as operations are split up in a carve-out. But in a recession, sellers must be even more vigilant to ensure the RemainCo business continues to operate seamlessly and deliver on market expectations. The windfall of cash that a divestiture may deliver needs to be tightly managed to drive the intended business objectives (e.g., investments, deleveraging, shareholder payouts, etc.).

The transaction often provides the seller the opportunity to restructure RemainCo. Management teams should recognize the importance of continually assessing available resources against their real, and perhaps now different, needs of RemainCo. Reap the rewards of a robust divestiture program with a thoroughly active portfolio management process. This is where good management teams can become great—even in the midst of unusual economic pressures.

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Conclusion

Great management teams prove their mettle across all economic cycles. They don't try to time the market but remain focused and determined in executing their stated strategy. There is little appetite to accept the status quo, particularly amid economic uncertainty and volatility. As one strategy leader for a Fortune 500 company has stated, a portfolio of products and services can never achieve an "end state," but rather must continually evolve to address the changing needs and demands of its customer base. An economic downturn does not contradict this fact—accordingly, active portfolio management, inclusive of divestiture considerations, must continue undeterred.

Activist investors have shown that the path to the highest market returns is through a combination of portfolio actions and reinvestment in the core.

Corporate leaders can take the same lens to long-term value creation. At a time of economic stress, divesting businesses for which you are not the best owner creates an opportunity to reevaluate the operating model of RemainCo from the perspective of commercial models, functional costs, systems, and processes. The result will be more growth and resilience for your core business when the economy rebounds.

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How KPMG can help

KPMG Deal Advisory professionals help organizations and executive teams change, grow, adapt, shape, and respond to disruptive forces. We support organizations in defining their ambition and executing innovative strategies to redefine "where they play" and "how they win."

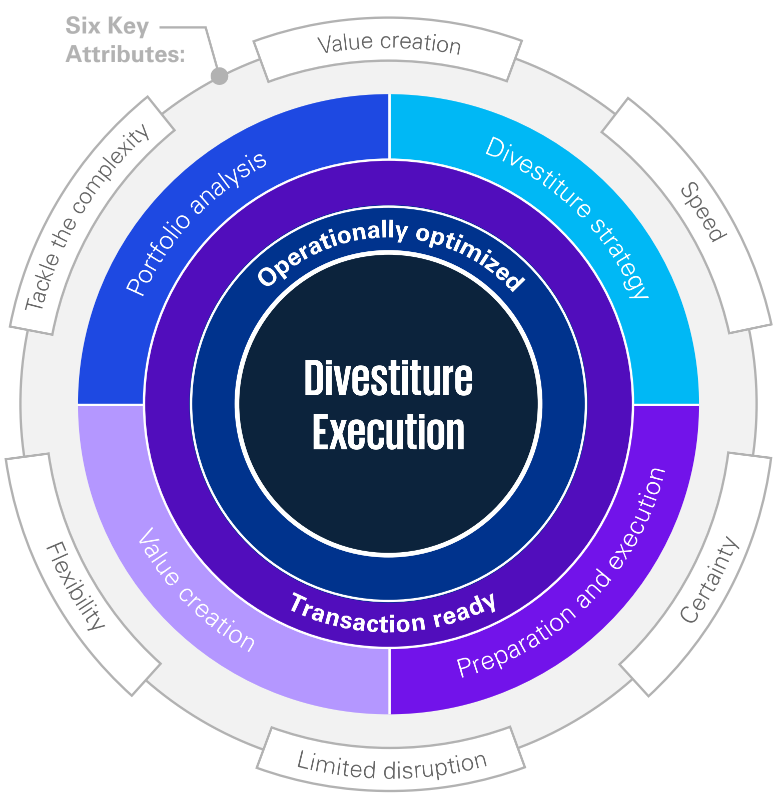
To help you succeed in divestiture deals, we set our goals to ensure you are **operationally optimized** and **transaction ready**. We do this by developing an actionable readiness plan for smooth Day 1 separation and identifying transaction perimeter and value levers for sustainable value creation.

Portfolio analysis

Through our portfolio analysis, we can help identify where to divest and how to best position those assets for sale in the marketplace. Companies should develop an unbiased view to disaggregating your portfolio of businesses and understanding valuation- enhancing businesses for which you are the best owner.

Value creation

We help identify and plan value-creating opportunities in the post-sale period. Starting with a cash proceeds deployment plan, we can support the development of your performance improvement plan and a path to your strategic objectives.



Divestiture strategy

We help you apply the right divestment strategy based on the assets identified to sell. Whether it is a sale or tax-free spin-off, we can assist in assessing each approach to determine and target appropriate buyers or how your shareholders can gain optimal benefits.

Preparation and execution

We can help prepare the asset as a standalone entity with the right delivery model. Based on CarveCo's strategic objectives and evaluating current RemainCo support, we help stand up the right support structure.

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