DIVESTITURES AND SPIN OFF ALTERNATIVES

2017

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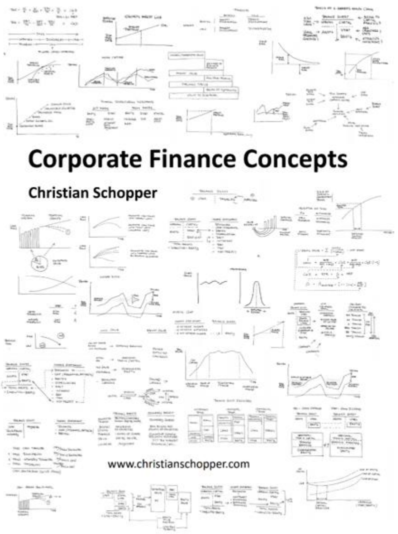

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Are You still the Best Owner of Your Assets?

McKinsey&Company

As companies rethink their portfolios for the post-crisis world, they should ask themselves if they are still the best owners of their assets

- Best owners are those companies whose distinctive characteristics enable them to create more value in a given business than other potential owners could
  - Companies may discover having lost competitive advantage in businesses they own
  - A better owner could be: A larger company, a private-equity firm, a sovereign-wealth fund, or a family, an independent listed public company, a mutual (owned by its customers), or even a government- or employee-owned entity …

- As better owners, each of these types of companies may add value to a business in a number of ways:
  - Valuable linkages with other businesses
  - Distinctive skills
  - Better governance
  - Better insight or foresight
  - Distinctive access to talent, capital, or relationships

The Best-Owner Life Cycle

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- Better ownership is not permanent or static but rather can change over the life cycle of a business
  - Too many companies don't recognize that even if their own distinctive capabilities remain the same, the needs of a business naturally change as it matures and the industry it competes in changes

- Typically, a business's founders are its first best owners
- As it grows and requires larger investments, better owner may be a VC firm
  - Specializes in helping new companies grow by providing capital, improving governance, and enlisting professional managers to handle the complexities and risks of scaling up an organization
- Eventually, the VC firm may need to take the company public
  - Selling shares to a range of investors to finance further growth

The Best-Owner Life Cycle (cont´d)

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- As the public company grows, it might find that it can no longer compete with larger corporations
  - E.g. needs global distribution far beyond what it can build swiftly
  - It may thus sell itself to a larger company that's the better owner because of an existing global distribution network, thereby becoming a product line within a division of the larger company
- As the division's market matures, the larger company may decide to focus on faster-growing businesses
  - In this case, it might sell its division to a PE firm—a better owner if the firm can eliminate corporate overhead that's inconsistent with the business's slower growth and thereby leave the division with a leaner cost structure
- Once the restructuring is done, the private-equity firm can sell the division to yet another better owner: a large company that specializes in running slow-growth brands

Managerial Implications

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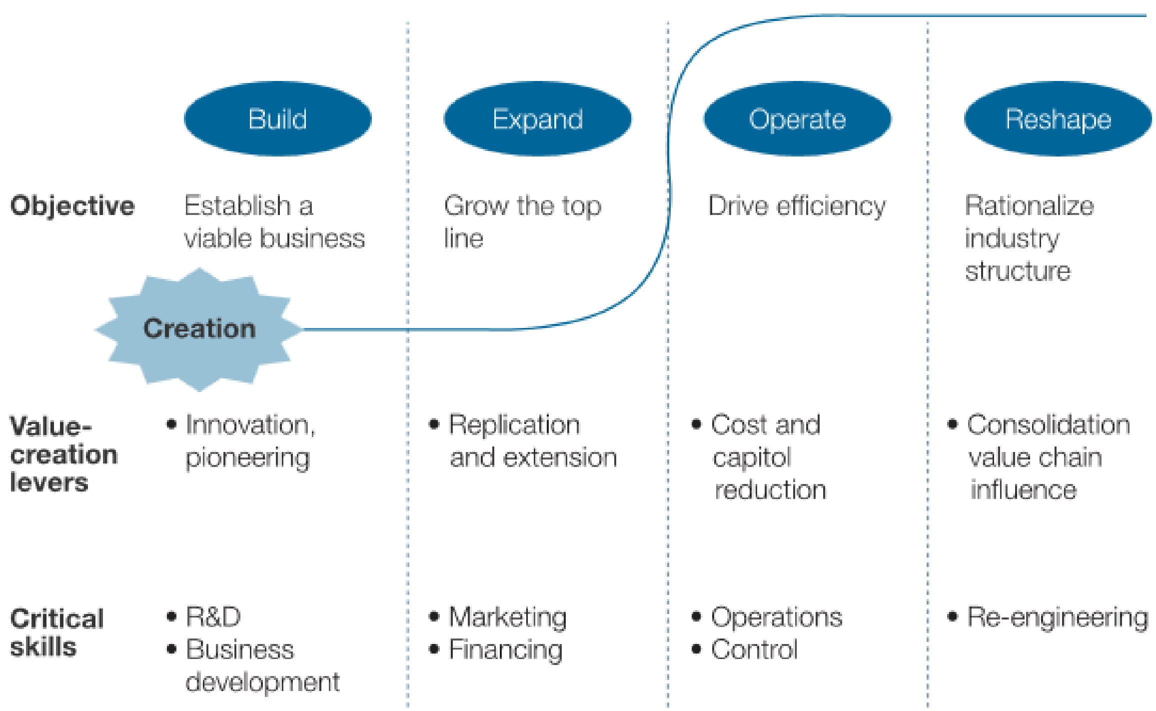
- Executives may worry that divestitures are seen as an admission of corporate failure or as a consequence of a company's relatively small size
- Yet research indicates that stock markets consistently react positively to divestitures—both sales and spin-offs



Source: McKinsey analysis

Divestitures

Reasons for Divestitures

- The divested assets may have a **higher value to the buyer** of these assets
- Immediate **cash flow needs** of the divesting firm …
  - … and less value-driven
- **Re-focus** on core activities

Divestitures vs Spin Off

Primary differences between a divestiture and a spin off

- **No cash generated** for the parent firm from a spin off
- **Division** being spun off usually **becomes an independent entity**, often with existing management in place

- As a consequence, the first two reasons given for divestitures – a buyer who generates higher value from the assets than the divesting firm and / or meeting cash flow needs – do not apply for spin offs

Reasons for Spin Offs

- Effective way of creating value, when **subsidiaries or divisions are less efficient** than they could be, and the **fault lies with the parent company**
  - … rather than the subsidiaries

- Might allow the stockholders in the parent firm to save on **taxes**

- When **problems faced by one portion of the business affect** the earnings and valuation of **other parts** of the business
  - Consider the pressure brought to bear on the tobacco firms, such as Philip Morris and RJR Nabisco, to spin off their food businesses, because of the perception that the lawsuits faced by the tobacco businesses weigh down the values of their food businesses as well

- Create value when a parent company is unable to invest or manage its subsidiary businesses optimally because of **regulatory constraints**

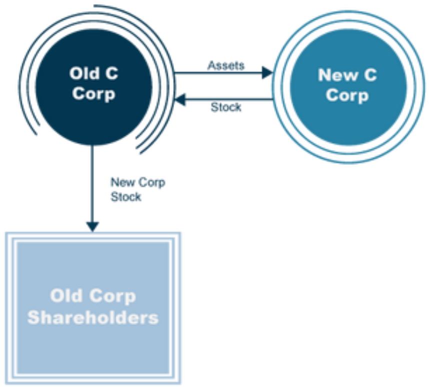
Spin Off, Split Up, Split Off

- Spin off
  - A firm separates out assets or a division, and creates **new shares** with claims on this portion of the business
  - **Existing stockholders** in the firm receive these shares in proportion to their original holdings

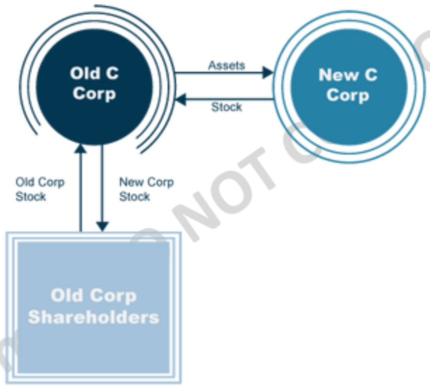
- Split up
  - Considered an expanded version of a spin off
  - **The firm splits into different business lines**, distributes these shares to the **original stockholders**, in proportion to their original ownership in the firm, and then ceases to exist

- Split off
  - Like in a spin off creates **new shares** in the undervalued business line
  - In this case, however, the existing **stockholders are given the option to exchange their parent company stock for these new shares**, which changes the proportional ownership in the new structure

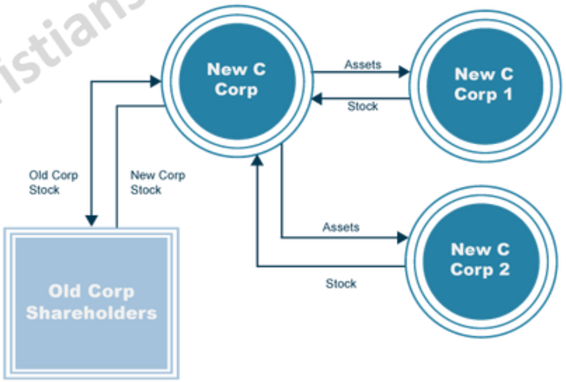
Spin Off, Split Up, Split Off (cont´d)



Spin-Off



Split-Off



Split-Up

Equity Carve Outs (ECOs)

- A firm **separates out assets or a division**, creates shares with claims on these assets and **sell them to the public**

- In contrast to a spin off, the sale **brings in cash** into the firm

- In **general**, the **parent company retains control** of the carved out unit, though some equity carve outs are accompanied by spin offs or the issue of tracking stock

Reasons for Equity Carve Outs

- ECOs bring in **cash** either to the parent company or the subsidiary
  - Much likely to use an equity carve out for a division that has both high growth opportunities and significant investment needs
  - The cash raised from the equity carve outs can be utilized to meet these needs
- Parent company usually retains **control** after the spin off
  - Hence, some of the operating improvements that follow after spin offs, that result from separation from the parent company, may not occur in equity carve out

Tracking Stocks

- Creation of shares in divisions or subsidiaries that track the performance of just these units …
- … without holders having a claim on the assets of the division or the parent company
  - The **parent company usually retains complete control** over the units
  - All revenues and expenses of the applicable division are separated from the parent company's financial statements and bound to the tracking stock
- The firm **may receive cash** from issuing tracking stock, but the transaction can also be cash-free

Reasons for Using Tracking Stocks

- Allow investors to invest in a particular portion of a business …
- … while the company maintains overall control
- Investors receive dividends relating to the performance of the associated portion of the business regardless of the overall performance of the business as a whole
- Eliminates the need for the company to create a separate business or legal entity
  – Removes need for the creation of additional management teams and shareholders as would occur when establishing a new legal entity, such as with the creation of a spinoff

Choosing among the Alternatives

Common Objectives

- All of these actions serve to highlight the **undervaluation**
- All of these actions might also result in **additional information** being provided to markets on the operations of the separated units
- Firms that are interested in a market estimate of the value of different portions of the business will gain by using all of these actions

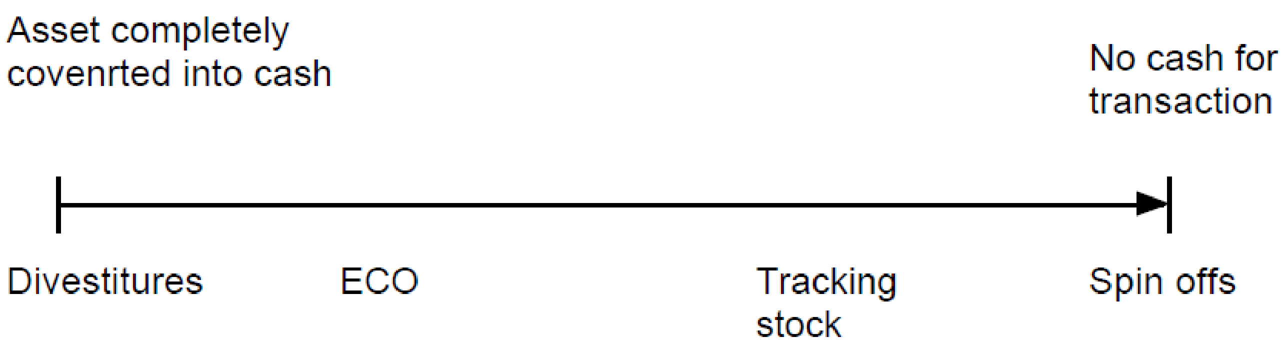
Key Differences

- Effect on **Cash**
- Effect on **Control**
- Effect on **Taxes**
- Effect on **Bondholders**

Key Differences among the Alternatives

Effect on Cash

- Divestitures, equity carve outs and tracking stock result in cash proceeds, whereas spin offs do not generate cash for the parent company



Key Differences among the Alternatives (cont´d)

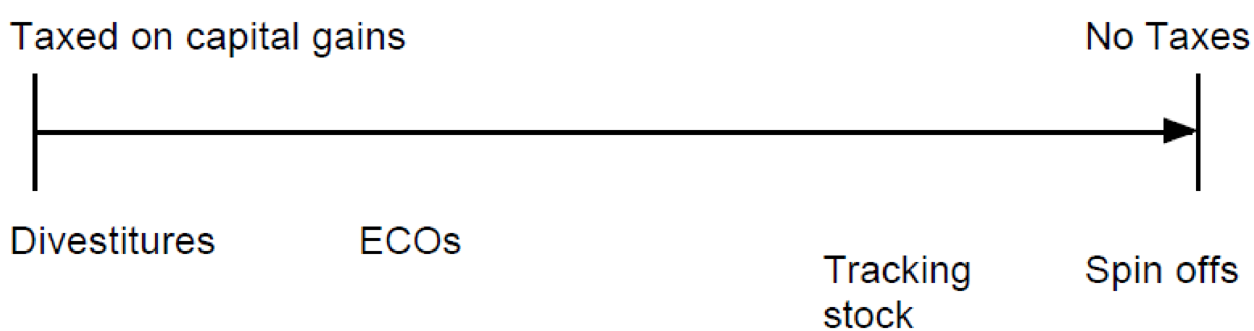
Effect on Control

- In a divestiture, the divesting company has no control over the assets once they are divested
- At the other extreme, when tracking stock is issued, the parent company usually retains complete control over the tracked unit, and stockholders in the unit get no voting right

Key Differences among the Alternatives (cont´d)

Effect on Taxes

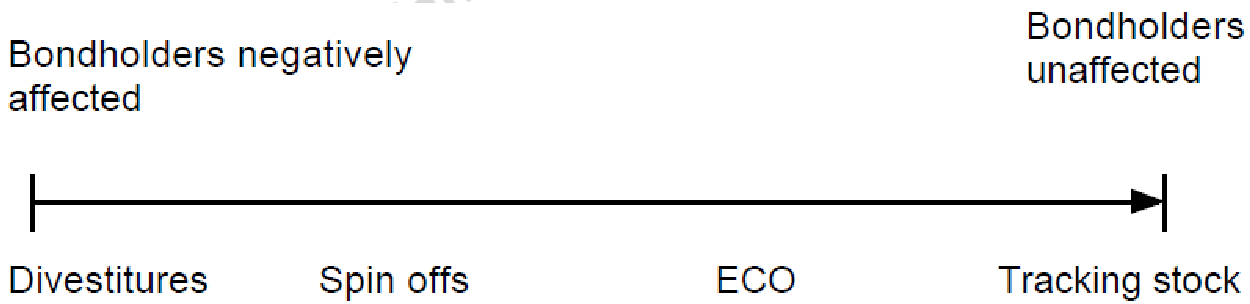
- Spin offs and tracking stock generally create no tax obligations for the stockholders of the parent company
- Divestitures, on the other hand, create a capital gain for the parent company, on which taxes are due



Key Differences among the Alternatives (cont´d)

Effect on Bondholders

- The bondholders in the parent company have no claim on the assets that are divested
  - If the cash from the divestiture is paid out as a special dividend or used to buy back stock, the bondholders will be worse off
  - Bondholders can also be negatively affected by spin offs, since the parent company has only a minority interest in the spun off units



Rationale between the Alternatives

- **Divestitures** should be the preferred course of action for firms that **need** the **cash** proceeds to pay off outstanding debt or to make investments in other businesses

- A **spin off** makes the most sense for firms that have **sufficient cash** on hand to meet their investment needs, and do not need additional cash

- An **equity carve** out will add the most value for firms that **need** the **cash** from the carve out

- Issuing **tracking stock** makes sense for firms that want to retain complete **control** over the unit or assets being separated, but still want to **highlight** their **value**

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