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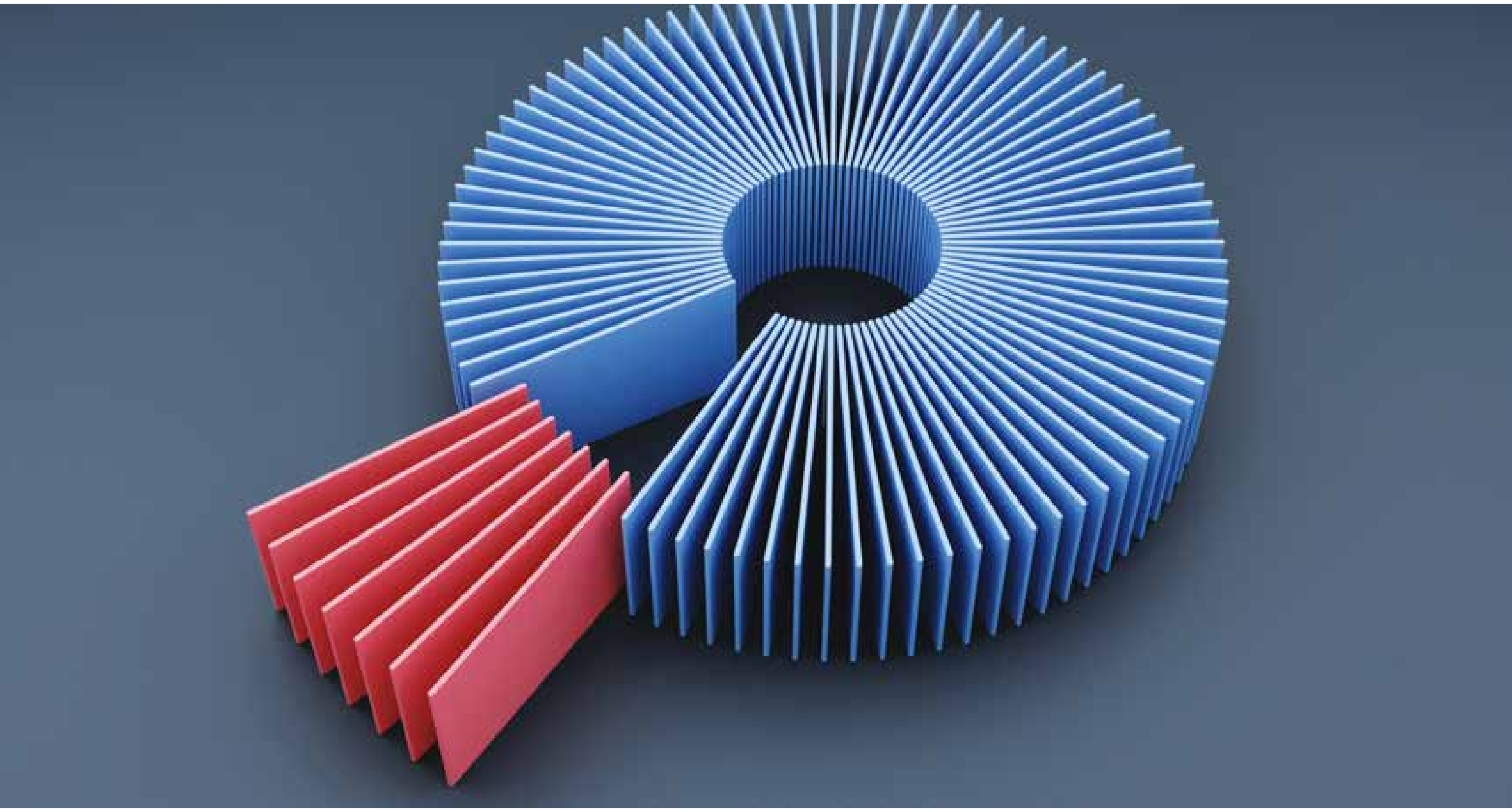
# Three degrees of separation: How to successfully execute divestitures

The seller's focus on three key interrelated activities—defining, marketing, and disentangling—can help expedite the transfer of divested assets and increase total deal value.

*by Jamie Koenig, Anthony Luu, and Steve Miller*





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**The decision to divest a business unit** or other asset can be painstaking and protracted: leaders ruminate about sunk costs, the size and scope of their portfolios, and the status of their strategic objectives. But once all sides have been heard and the choice is finally made, leaders face an even more daunting challenge—executing the divestiture.

To successfully part with an asset, management teams must choreograph a range of critical tasks and consider the perspectives of dozens of internal and external resources and advisers—potential buyers, current employees, boards of directors, and so on. And they need to do these things quickly: McKinsey research reveals that, on average, separations completed within 12 months of announcement deliver higher excess total returns to shareholders (TRS) than those that take longer.[1]

In most cases, however, business leaders allocate more time to the question of *whether* rather than *how* to divest. So, when they get the green light from the board, many find themselves stuck in neutral—unsure about where to put their energy, which decisions to make first, and which tasks to prioritize. Meanwhile, delays can diminish an asset's value or scuttle deals altogether. Our research and experience in the field suggest that, to get unstuck, business leaders need to break the divestiture process down into three interdependent but distinct activities: defining, marketing, and disentangling the asset in question (see sidebar, "Parting words and deeds: Critical separation activities"). For instance, a company that wants to sell a business unit must identify key characteristics of the asset in question so it can consider how to disentangle it from others in the company's portfolio while simultaneously deciding on the valuation story to tell potential buyers.

Segmenting the separation process in this way can help business leaders better understand where to begin and where to focus their efforts—thereby increasing the odds of divestiture success.

## Where to begin

Once they get permission from the board to pursue a divestiture, business leaders tend to go right to the marketing activity. They engage a deal team, retain an investment bank to support the sale process and evaluate the potential universe of buyers, and develop a ten- to 20-page document outlining investment highlights. Of course, this approach will work if the asset in question is a stand-alone entity with a strong track record—for instance, if it is a distinct business unit within a larger conglomerate that overlaps minimally with other businesses in the portfolio.

For most divestitures, though, there's a better way: start by fully defining the asset in question—particularly the financials involved—and considering potential disentanglement issues *before* launching

**Separations completed within 12 months of announcement deliver higher excess TRS than those that take longer.**

[1] See Obi Ezekoye and Jannick Thomsen, "Going, going, gone: A quicker way to divest assets," August 6, 2018, McKinsey.com.

## Parting words and deeds: Critical separation activities

Business leaders must manage the separation of assets through three interrelated but distinct activities.

**Defining the asset:** The company must convene a cross-functional working group to define what is actually being divested—for instance, confirming deal boundaries, carve-out financials, and legal structures.

**Marketing the asset:** The team needs to build a narrative that takes the buyer's point of view of the potential value they may gain from the asset being divested. McKinsey research shows that risk premiums decrease and valuations increase when sellers take this approach. The team should define the universe of potential buyers and prepare marketing materials that tell a consistent story.

**Disentangling the asset:** The team needs to assess the risk from the separation to the various stakeholders, processes, and functions. It must consider the scope and timing of the transition while incorporating different financial and buyer scenarios.

any marketing efforts. In doing so, sellers are less likely to leave money on the table or to introduce skepticism among buyers about the information being provided about the asset, which could kill a deal.

The leaders of a complicated aerospace divestiture went straight to the marketing task before fully evaluating the upside potential and sources of value for an asset on the block. In its marketing materials, the seller provided an estimate for the cost of transitioning the asset to potential buyers. Days after the offering memorandum was released, a round of deeper financial analyses revealed that the corporate allocations used to generate that estimate were deeply understated. By then, it was too late. Sophisticated bidders quickly discovered the error, and the seller was left at a disadvantage during negotiations on the transition service agreement. The seller learned from this mistake, however: This was the first in a string of planned divestitures, so the corporate-development team made sure to validate and adjust historical allocations before bringing other assets to market.

By contrast, the executives at one software company developed an ambitious yet attainable value-creation plan for a business unit that the company intended to carve out. The plan included shedding lower-margin, slower-growth products associated with the carve-out, particularly those linked to other business units at the software company, and shifting sales and marketing resources toward newer products and services. Executives subsequently were able to focus their marketing efforts on the potential financial upside of the deal—an expected EBITDA[2] expansion of more than 25 percent as well as aggressive growth targets. This led to a substantially higher valuation of the asset at sale.

## What to focus on

Even the most experienced business leaders and divestiture teams can have trouble determining when and how to deploy limited resources in high-pressure deal situations. Here, again, a focus on the three core activities—with recognition of how they inform one another—can help cut through much of the noise and external pressures. It will be

[2] Earnings before interest, taxes, depreciation, and amortization.

most critical to establish the deal perimeter (defining the asset), build upside into the valuation (as part of marketing the asset), and draw a road map for separation (disentangling the asset).

**Establish the deal perimeter**

A common mistake among sellers is launching into due-diligence processes and negotiations with buyers without fully understanding what they are selling. Sellers should instead take the time to assess both the buyer landscape and the value-creating aspects of the asset in question. In this way, they can gain a better sense of the marketing messages that will attract potential buyers as well as the effort that may be required to transition an asset.

The divestiture team must set a perimeter around the deal—drawing clear lines around the operations (manufacturing sites or equipment, for instance) products (SKU lists), intellectual property (patent rights), and commercial capabilities (sales force) associated with the asset in question. The team should explore critical questions such as which products, geographies, and groups of personnel are in scope for the deal; which contracts will be reassigned; how shared intellectual property will be managed (transferred entirely or licensed); and which systems will remain with the divested asset (Exhibit 1).

Of course, the divestiture team should ensure that it is using complete and up-to-date information during this asset review. The deal team at one global pharmaceutical company realized too late that SKU records in the company's enterprise-resource-planning (ERP) system were dated. The team had failed to validate the data with local market leads before sharing the information and agreeing to a transaction with a buyer. This led to some difficult conversations with the buyer during the sign-to-close phase, as some of the SKUs included in the deal were no longer being manufactured or marketed. The two sides entered into protracted negotiations that could have been easily avoided.

**Build upside into the valuation**

Corporate-development teams must ensure that all the technical requirements associated with the sale of the asset can be met. Just as important, they must ensure that the company is getting the best price for the asset. To do so, deal teams must take a fresh look at the performance of the business unit or asset to be divested. They must prepare a thorough assessment of the upside opportunities embedded in the valuation model and, ideally, push buyers toward a deal price that is based on a multiple of management's adjusted EBITDA.

In the case of the software company mentioned earlier, for instance, the team identified and shared with all potential buyers the full range of value-creation opportunities from the deal, with typical levers like growth and cost improvements. It went a step further, however, in highlighting for specific buyers how the deal could expand their profitability through, say, different market positioning, improved technological capabilities, or the compatibility of the asset in question with other businesses in their portfolios. The team also prepared detailed plans for how each buyer could seize those opportunities. With such a compelling valuation story, the team was able to help buyers understand how they could tap into new profit pools as a result of the deal—

Exhibit 1

**Divestiture teams must clarify the key requirements for any potential deal.**

| Critical | Necessary | Nice to have |
|---|---|---|
| • Products (SKU lists) | • Facilities | • Non-key assets |
| • Core operating assets (manufacturing sites, equipment) | • Key contracts | • G&A[1] personnel |
| • Commercial capabilities (sales force) | • Key systems | • Non-key systems |
| • IP[2] (patent rights) | | |

[1] General and administrative.
[2] Intellectual property.

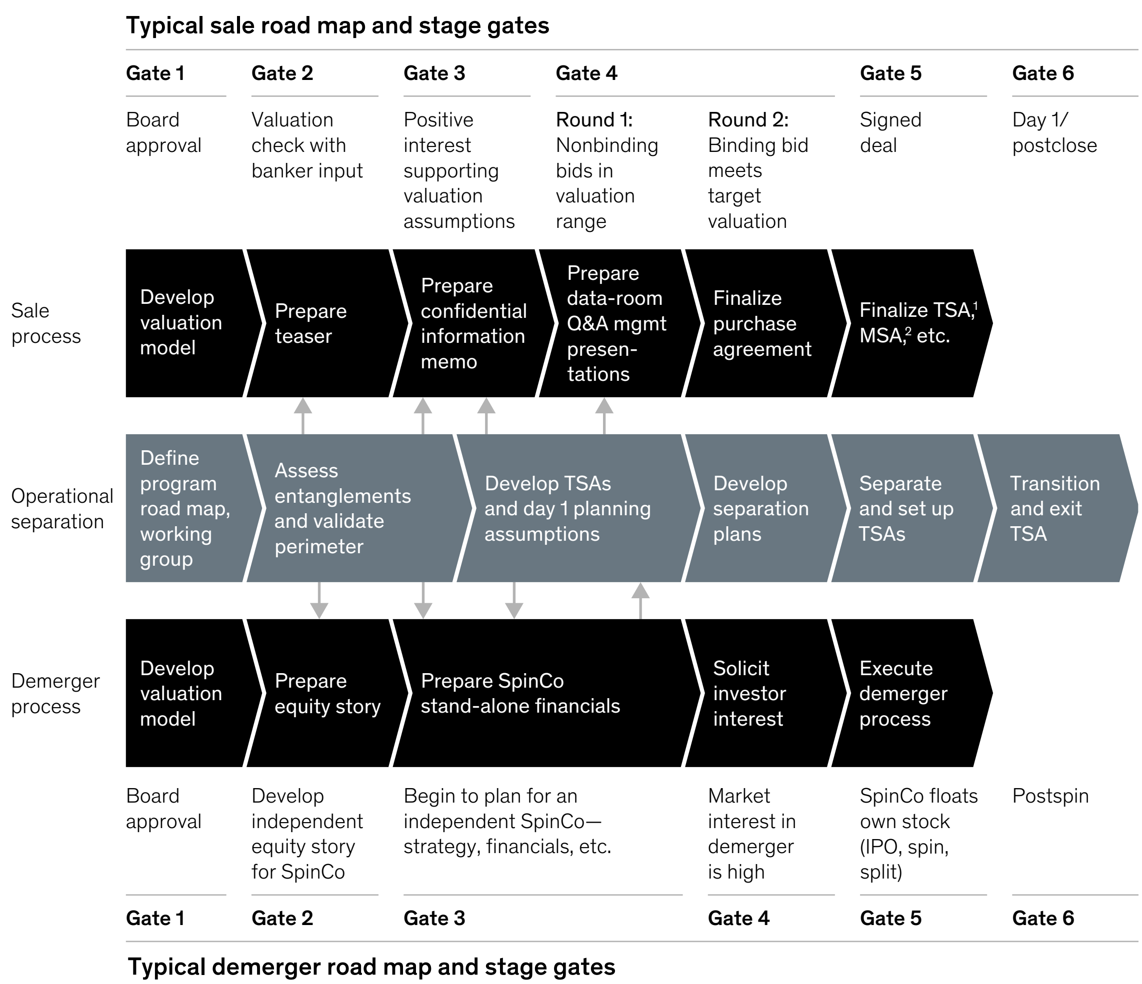
for instance, gaining access to new innovations that lead to new revenue streams, or bringing on an experienced management team with a proven track record of execution.

**Draw a 'separation road map'**

One of the biggest roadblocks to successful separations is executives' failure to anticipate all the dependencies and interdependencies associated with the asset in question. A comprehensive "separation road map" can help them address such disentanglement issues. The road map should capture all activities as well as the sequencing of functional and cross-functional work streams associated with the divestiture. It should clearly link the intended goals and milestones for the separation with the related deal process steps. For instance, the separation tasks of "build a census of transferring employees" and "develop day 1 planning assumptions" should correspond with the deal process step of "prepare confidential information memo" (Exhibit 2).

Exhibit 2

## To properly disentangle divested assets, companies need to draw a road map.




[1] Transition service agreement.
[2] Master service agreement.

Divestiture teams will, of course, need to be aware of the time frames required to execute all the steps in their road maps. Some business entanglements, like shared manufacturing, IT systems, and facilities, are more complicated than others and can take more time to resolve. To better pace their investments and minimize business disruption, deal teams may want to build stage gates into their road maps—triggers that allow for companies to discontinue separation activities if designated thresholds are not met.

An agricultural company was uncertain about whether it could attract enough interest in an asset it was putting up for sale. Senior management believed there would be a dearth of buyers able to support an acceptable valuation given high consolidation in the market. Investment banks and some board members felt otherwise, however. There were lingering questions as well about whether the costs and investments required to separate the asset's operations would outweigh the benefits of a potential sale. The divestiture team addressed these concerns by building into its separation road map a series of stage gates, one at each phase of the sale process. In this way, senior management and the board could conduct frequent cost–benefit analyses and formally consider whether to proceed with or halt any disentanglement activities—and, in fact, the separation was put on hold after the initial bids for the business failed to meet predefined valuation thresholds at a certain stage gate.

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Divestitures can be challenging for the teams tasked with executing them. But by defining the assets in question, marketing them effectively, and anticipating the complexity of disentangling them from the existing business, executives can keep the focus on creating the most value for buyers and sellers alike.

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