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Managing Corporate Divestiture Transactions

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The Importance of Corporate Divestiture Strategy: Pruning Divisions to Focus on High-Growth Opportunities

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Introduction

In today's competitive landscape, high-performance companies that outrun their peers will most likely have an active corporate divestiture strategy in place. These companies will not simply seek out acquisition opportunities, but they will also regularly monitor their portfolios and will shed those segments that do not have a solid business justification.

When Jack Welch was at the helm of General Electric Inc. (GE), he undertook an aggressive divestiture strategy in effort to position GE to compete successfully in the global marketplace. This strategy, in part, caused GE to demonstrate strong performance over the course of his leadership of the company. As Welch learned, while divestiture decisions are never easy and some stakeholders will resist these decisions, the results can positively affect both the parent company and the divested entity.

After making a decision to divest, a company should engage in robust pre-transaction planning. The parent should assemble a competent team of legal advisors, financial advisors, and consultants to assist with the process. In addition to readying the target for the transaction, the team should analyze the parent company's goals and assist with the identification of a transaction structure that will best meet the parent company's objectives.

Timeless Corporate Divestiture Lessons from Jack Welch's Leadership of GE

No. 1, No. 2, Fix, Sell, or Close

When GE chose Jack Welch to serve as chairman of the board and chief executive officer, Welch applied the following rigorous but simple test to determine whether to retain a business in GE's portfolio: "No. 1, No. 2, fix, sell or close."[1] The "winners of the future," he asserted, would be the companies that "search out and participate in real growth industries and insist on being number one or number two in every business they are in."[2] Though many refrain from regularly monitoring their portfolios, in

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[1] JACK WELCH WITH JOHN A. BYRNE: JACK: STRAIGHT FROM THE GUT 123 (Warner Books, Inc. 2001).
[2] *Id*. at 120.

Welch's opinion, the companies "that hang on to losers for whatever reason—tradition, sentiment, their own management weaknesses" would cease to exist.[3]

Welch announced his strategy to Wall Street early in his tenure, but analysts' reception was flat at best. Nevertheless, Welch remained steadfast in his decision to redesign GE in part by shedding underperforming assets. Drawing three circles on a page in a Venn diagram format, he divided GE's core businesses into categories: core manufacturing, technology, and services.[4] Businesses that fell outside of these three circles became the focal point for his fix, sell, or close strategy. During his first two years, Welch sold seventy-one businesses and product lines and received over $500 million in exchange that he reinvested to restructure other businesses.[5] Within four years, the number grew to 117 business units, accounting for a staggering 20 percent of GE's assets.[6]

Welch did not undertake this aggressive divestiture strategy simply to bolster GE's returns during the divestiture period, though such an approach may have been enticing. Rather, Welch prudently used the proceeds from the exit to reshape and revitalize GE's core businesses. Commenting on GE's use of proceeds from exits, Welch said, "We never put those gains into net income."[7] Instead, Welch "used them to improve the company's competitiveness. . . . We took actions to strengthen our businesses for the long haul."[8] Under Welch's leadership from 1981 until 2001, revenue multiplied fivefold to $130 billion, and GE's market value grew from $14 billion to $410 billion.[9]

Many cite corporate divestitures as a strategy for companies that come under financial pressure. However, when Welch adopted the "No. 1, No. 2, fix, sell or close" strategy, he was neither reactionary nor merely

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[3] *Id*.
[4] *Id*. at 125.
[5] *Id*. at 125, 127.
[6] Lee Dranikoff, Tim Koller et al., *Divestiture: Strategy's Missing Link*, 80 HARV. BUS. REV. 74 (2002).
[7] *See* WELCH *supra* n. 1 at 127.
[8] *Id*.
[9] Diane Brady, *Jack Welch: An Oral History*, BLOOMBERG BUSINESSWEEK, Aug. 28, 2012, http://www.businessweek.com/printer/articles/68630-jack-welch-an-oral-history.

responding to economic stress. Instead, Welch proactively sifted through GE's portfolio to ensure that GE held only the crème de la crème. Similar to "smart apple farmers [who] routinely saw off dead and weakened branches to keep their trees healthy,"[10] Welch pruned back unhealthy businesses, unlocking value for shareholders, bolstering GE's performance during his tenure, and providing the divested entity with an opportunity to flourish independently.

Though Welch oversaw GE mostly in the eighties and nineties, recent research suggests that Welch's active divestment approach still rings true today and is timeless. The companies that best prepare themselves to compete for tomorrow in a challenging, global marketplace not only plan for acquisitions, but also promptly exit businesses that no longer have a solid business justification. The benefits of an intelligently designed, carefully planned divestiture strategy are hard to dispute. A global divestment study released by Ernst & Young in 2013 surveyed 567 executives of companies in the United States, Asia, Europe, the Middle East, and Africa in fourteen industry sectors.[11] The study concluded that the majority of high-performance companies have adopted a carefully considered divestiture strategy and actively manage their portfolios.[12] More specifically, the study states that "55% of high performers have a structured process and reviewed their portfolio regularly."[13] According to the study, these companies regularly review their portfolios to determine whether they should continue status quo because it is serving them well, or whether they ought to change course and make modifications.[14]

Overcoming Resistance from Stakeholders

Some companies may avoid divestiture decisions knowing that a decision to divest a business segment could be fraught with controversy. When companies make such significant decisions, typically, there is no shortage of

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[10] *See Dranikoff supra* n. 6 at 76.
[11] Pip McCrostie, *Global Corporate Divestiture Study: Maximizing Divestment Success in an Uncertain Economy*, http://www.ey.com/GL/en/Services/Transactions/Global-corporate-divestment-study---Strategic-divestments-are-no-longer-optional---Overview 3 (EYGM Limited 2013).
[12] *Id*. at 3.
[13] *Id*.
[14] *Id*.

skeptics and naysayers who view the proposed course of action as unnecessary, ill advised, and even harmful to the enterprise. Inevitably, some will publicly question and challenge corporate executives who decide to exit a business. While there is a possibility the decision will be well received, there is also a chance that the decision to divest will anger employees in both the core and non-core businesses and incite questioning from analysts, stockholders, the media, and others.

Welch himself experienced substantial pushback when he executed his divestiture strategy. As he quickly learned, stakeholders have their own independent thoughts about the best way to lead a company forward. GE's stakeholders were vocal, and some sent angry letters accusing him of taking steps that had the potential to lead to the demise of the company. Commenting on the resistance, Welch has said, "The turmoil, the angst and confusion were everywhere. The causes were the goal to be No. 1 or No. 2, the three circles, the outright sale of businesses, and the cutbacks."[15]

In fact, so many criticized Welch's approach that *Newsweek* named him "Neutron Jack" in mid-1982 while he was in the middle of making these controversial decisions. The severe internal conflicts had taken on such great momentum that they became exposed for the entire public to see. Nevertheless, executives can learn from Welch because he continued to make tough calls despite the outcry. Defending his approach, he stated, "Making tough-minded decisions about people and plants is a prerequisite to earning the right to talk about soft values, like 'excellence' . . . . Soft stuff won't work if it doesn't follow demonstrated toughness. It works only in a performance-based culture."[16]

Not only will some executives shy away from divestitures out of concern they will be viewed as "Neutron Jacks," some may also be uneasy about executing on divestiture strategy out of fear that exiting a business signals weakness and failure. If the individual participants had been successful with the business segment, there would not be a justifiable rationale for exiting.

However, as Lee Dranikoff, Tim Koller, and Antoon Schneider state in an article published by the *Harvard Business Review* entitled "Divestiture:

[15] *See* WELCH *supra* n. 1 at 135.
[16] *Id*. at 139.

Strategy's Missing Link," "divestiture is not a symbol of failure; it's a bade of smart, market-oriented management."[17] Contrary to their perception, corporate boards and executive officers are more apt to fail when their nervousness and fear cause them to slow their decision making down so much that when they do exit, they find themselves in a disadvantaged position. When these companies delay, they run the risk of backing themselves in a corner, causing them to believe they must exit because they have no other defensible alternatives. When they finally execute, outsiders (and prospective buyers) view the decision as a sign of desperation, potentially causing the divestiture target to lose leverage if the company divests through a negotiated sale to another party.[18]

Some companies also have difficulty making the decision to divest a business segment when the divestiture target's performance demonstrates strength in certain areas. Not all business segments ripe for divestiture are dramatically underperforming, financially or otherwise. At the surface level, certain targets identified as divestiture candidates seem to be a fit, are profitable, and help with earnings predictability. However, when corporate executives peel back the layers and conduct a close analysis, they may discover opportunity costs and realize that these businesses are actually detracting from greater growth potential in core business segments.

However difficult the decision to divest, companies that are not a textbook fit because of strategic reasons or otherwise can have a significant adverse impact on related entities.[19] Those that are laggards may quash the desire of executives to build and develop high-growth companies, as complacency and stagnation in these divisions could potentially spill over into the company's culture.[20] While some might suggest that companies in this position should solve the issue primarily through talent management—by bringing in new talent and parting ways with current underperformers—these low growth businesses may have a difficult time attracting high performers who are drawn to positions that will provide the greatest opportunity to thrive.[21] Potential candidates may be concerned that these

[17] *See Dranikoff supra* n. 6 at 77.
[18] *Id*.
[19] *Id*. at 79-80.
[20] *Id*.
[21] *Id*.

units will have risk-averse cultures that dampen entrepreneurial spirit, making it so that the best and the brightest, the most creative and driven talent, may refuse to consider these opportunities, regardless of whether proposed compensation packages offer above-market terms.[22] As one chief executive officer of PerkinElmer who confronted this issue when he took over the reins said, "We knew recruiting talent for the senior ranks would be a challenge given PerkinElmer's steady-as-she-goes reputation."[23] Many of the best candidates will only bet their career on an underperformer if they perceive that there is real potential for them to turn the business around in a meaningful way and that, once they have done so, they will have the chance to sit at the helm.

Unlocking Value for the Divested Enterprise

In addition to dragging down the growth of a parent, attachment of a division to an unfit parent has the potential to hinder the growth and development of a segment that is ripe for divestiture. Welch, for example, found that his strategy of selling businesses that failed to align with GE's growth strategy benefited not only GE, but also unlocked significant value in the divested entity that otherwise may have been stifled had the divested business remained a part of the conglomerate.

In one instance, Welch sold an unprofitable air conditioning business to Trane Co., a market leader in the industry at the time.[24] Air conditioning seemingly was a core operation, but the market share this company captured was a weak 10 percent, far less than GE's other divisions. Competitors with a greater percentage of the market beat GE on several metrics (they had relationships with the best distributors and independent contractors), so Welch sought to shed GE's position.[25]

Initially, Welch received backlash from employees who believed that this air conditioning business was central to GE's core. However, the decision to divest proved to be the right one, both for GE and for the divested segment. After the transaction closed, Welch called one of GE's prior

[22] *Id*.
[23] *Id*.
[24] *See* WELCH *supra* n. 1 at 126.
[25] *Id*.

general managers who joined Trane Co. after the sale. Discussing the transaction, the general manager told Welch the move benefited both companies, stating, "Jack, I love it here. When I get up in the morning and come to work, my boss is thinking about air-conditioning all day . . . . Every time I talked to you on the phone, it was about some customer complaint or my margins. You hated air conditioning, Jack, today we're all winners and we all feel it. In Louisville, I was the orphan."[26]

If Welch would have retained this business, it is quite possible, and perhaps likely, that the value of the enterprise would never have been unlocked. In these types of situations, the parent company may not understand the business or possess the necessary expertise to grow the business to its greatest potential. If left unchanged, the parent company's weakness in these areas has the potential to hamper the development of the business or causes the business to be an outsider that does not receive sufficient attention or resources.

Execution of the Divestiture Transaction

Transaction Timing Considerations

Though companies should have an active, ongoing divestiture strategy in place and regularly review their portfolios, this is not to say that the timing is always right to consummate a transaction. Timing considerations are critically important to ensuring a successful outcome. If the company structures the transaction as a sale, the company should consider the likely buyers, the degree of competition for the target, whether any factors exist that could adversely impact valuation, whether the divested business has any contingent liabilities that could drive down valuation, and the long-term impact the divestment will have on the overall enterprise.[27] As PricewaterhouseCoopers noted in a recent study, "sales processes are very disruptive to the core businesses—so any divestment decision should not be taken lightly."[28]

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[26] *Id*.
[27] Pricewaterhouse Coopers, *Strategies for Managing a Successful Corporate Divestiture*, (Feb. 2012), at 7, http://www.pwc.com/en_US/us/transaction-services/assets/ Corporate_ development_roundtable_insights.pdf
[28] *Id*.

While engaging in this analysis is important, executive teams should be cautious about being overtaken by "analysis paralysis." For example, some executives lament over the timing for a sale, believing that holding an asset will lead to a higher future valuation. This approach is even more understandable, given the current state of the economy and potential macroeconomic events that could slow down or derail a transaction. In the context of an exit via a negotiated sale transaction, given that the United States is still climbing its way out of a recession, many prospective sellers have expressed concern that a hiccup arising from the Euro Zone crisis or another "fiscal cliff" type of situation in Congress could cause buyers to become more hesitant to complete a deal. Buyers who are nervous about current and future macroeconomic events may attempt to renegotiate the purchase price or walk away from the deal altogether.

However, these considerations are only one aspect of the analysis, and the best companies balance them against the possibility that holding onto certain assets for too long a period may hinder growth objectives. Indeed, there may be hidden costs associated with waiting to divest. Time, energy, and capital allocated to a business that is unfit only detracts from the core, which (if identified correctly) is a high-growth opportunity and has greater upside potential. As one industrial products executive noted in the study conducted by PricewaterhouseCoopers, "You always wonder whether holding onto an asset a little longer would have enabled you to grow it or even achieve a higher valuation . . . But you really have to weigh that against the opportunity costs of having monetized the asset for other purposes. In addition, if that asset is already attracting less capital as part of the resource allocation process, then it will be difficult to fund any kind of growth."[29]

Pre-Transaction Planning

Once a decision to divest is made, a company should engage in robust pre-transaction planning, focusing on readiness of the target, optimal transaction structuring, and impeccable execution. While this approach is necessary no matter the health of the economy, thoughtful preparation is even more crucial in the current economic climate. Though the US economy is recovering in earnest from the 2008 financial crisis, deal activity still has not reverted back to pre-recession levels and may not for some

[29] *Id*. at 5.

time. Because of the state of the economy, divestitures involving a sale to a third party may encounter more hurdles and take longer to complete.

Promptly after identifying a target, the company should assemble a team of legal advisors, financial advisors, and consultants to assist with the process. The team will need to decide which assets to sell and which to retain and will need to carefully oversee the decoupling of the enterprises. The divestiture target may not have detailed financial statements and, if this is the case, the company should take steps as early on in the process as practicable to prepare these financial statements for the transaction.

This team of advisors should also review the target closely to identify any problems with the divestiture target and prepare a plan to resolve those issues that can be remedied. The team should help the company to craft the story of the divested business, making sure to present the business in the best possible light. If the divestiture is completed through an outright sale, a seller should expect that the parties to the transaction—the buyer and financing sources—will invest considerable resources to conduct due diligence. Failure to address known issues could unnecessarily give a buyer leverage in a transaction, allowing the buyer to carefully and methodically chip away at purchase price during negotiations.

After engaging in robust planning, the best teams take steps to adequately prepare both organizations (the parent and the divestiture target) for the exit and then execute quickly to maximize price. An elongated transaction timetable can be harmful, particularly if safeguards are not put in place. Some employees who learn of the transaction may exit the business once they learn of the divestiture plan (unless they enter into retention agreements). In addition, during the time when management teams are contemplating the transaction, they often place future growth plans on hold. As a result, if the transaction is not completed, the divested entity could suffer because the company's executives are no longer focusing on taking steps to develop the business. The parties have the ability to minimize these risks if they work quickly toward an outcome.

Potential Transaction Structures

Much of this chapter has analyzed corporate divestiture transactions in the context of a sale, but the structure of a transaction can take a variety of forms. The strategies that corporate and tax lawyers and financial professionals devise are often as creative as they are complex, and this chapter provides a high level overview of only a few potential options that tend to be the most common approaches.

As referenced above, one potential transaction structure is to sell the divestiture target to a third party. If the divestiture target is being sold in a negotiated transaction, the company should assess the merits of prospective purchasers, considering in particular whether the company should sell to a private equity fund or a strategic buyer. Private equity funds may have the ability to execute transactions at an accelerated pace, but, unlike financial sponsors in some instances, strategic buyers might be willing to pay more because they will be in a position to realize post-closing synergies.

Instead of selling to a third party, a parent company may instead choose to spin off a subsidiary by distributing the subsidiary's stock to the parent company's stockholders. A spin-off allows the subsidiary to have complete independence from the parent company. Initially, the parent company's stockholders own the stock of the spin-off entity until the stockholders decide to sell. Typically, spin-off transactions can be completed in approximately six months. Tax considerations may drive this structure, as spin-offs may be eligible for treatment as a tax-free distribution under Section 355 of the Internal Revenue Code if certain requirements are met.

Alternatively, a parent may consider a split-off transaction, a split-up transaction, or to offer a certain percentage of shares in an initial public offering. In a split-off transaction, the parent's stockholders have the opportunity to exchange their shares of stock in the parent company for shares of stock in the subsidiary entity. In a split-up transaction, the parent dissolves after distributing its subsidiaries' stock to its stockholders. Or, the parent company may instead choose to offer shares of the target divestiture's securities to the public through a partial initial public offering that only covers a small percentage of the target's stock. This transaction structure allows the parent to experience a liquidity event, yet retain control while developing the target's independent identity and brand prior to completely separating. If the entity grows but the parent has retained equity, the parent will continue to benefit from the financial upside of this entity.

These are only a few of the potential transaction structures available, and the company should collaborate with its team of advisors to ensure it selects the transaction structure that best allows it to meet its objectives.

Conclusion

Research suggests that companies benefit from actively managing their portfolios. Jack Welch demonstrated this when he undertook to transform GE and made divestitures a focal point of his strategy. Welch came under pressure for making some controversial divestiture decisions, but GE grew dramatically under his watch. Current research performed by Ernst & Young continues to validate the importance of divestitures to the growth of core businesses. Nevertheless, the decision to divest should not be undertaken lightly, and companies should engage in a careful analysis before moving forward with exiting a particular business.

Once a company undertakes to divest a business, the company should engage in a robust pre-transaction planning process to prepare the company for a sale or other transaction (depending on parent's goals and the recommendations of the advisors). Particularly in the context of a sale to a third party, this process can help the seller retain its leverage in the transaction and maximize value. Pre-transaction planning in a sale transaction is especially crucial in a slow growth economy so that the seller does not inadvertently empower the buyer to scale back purchase price by failing to remedy issues with the divestiture target.

After a company reaches a decision to sever ties with a segment, the company's advisors should consider the optimal transaction structure to accomplish the seller's goals. If the parent chooses to sell the divestiture target, the parent should take steps to ensure the transaction proceeds rapidly so that it closes before issues arise that cause the buyer to consider walking away and terminating the deal altogether. On the other hand, for tax, branding, or numerous other reasons, the company may determine that another transaction structure is a better approach—for example, a spin-off, a split-off, a split-up, an initial public offering of the divested entity's shares or other alternatives.

Key Takeaways

- To best prepare to compete in the global marketplace, companies should not only plan for acquisitions, but also promptly exit businesses that no longer have a solid business justification.
- Executives should not consider divestiture as a symbol of failure, but rather see it as smart, market-oriented management. Failure is more apt to come when executives let fear and nerves slow their decision making. Delay can cause executives to back themselves into a corner that makes an exit their only justifiable option. This can cause outsiders to view the exit as a sign of weakness and desperation, potentially eroding the company's leverage if the target is sold to a third party.
- Dramatic underperformance is not always the only sign that a business segment is ripe for divestiture. On the surface, divestiture targets can appear fit and profitable. Companies should conduct a close analysis to study opportunity costs and determine if the business actually detracts from greater growth possibilities in core business segments.
- Companies should expend extra effort and care in pre-transaction planning and readying the target. Optimal transaction structuring and impeccable execution are even more integral to success in a divestiture in the current economic climate. Sales may take longer to complete, and swiftness in the transaction is essential to maximize the price. Delay in the timetable can be harmful, especially if safeguards have not been established. This is because employees may leave once they learn about the plan to divest and plans for growth can be put on hold. Executives are no longer focused on the growth of the business and this can lead to stagnation or detrimental effects in the business entity. Companies can minimize the risk of damage by working quickly toward an outcome.
- Invest in assembling a team of legal advisors, financial advisors, and consultants to assist with preparing for the transaction. This team should analyze the situation closely to determine the best transaction structure. In the context of a sale, the team should assess the target to identify any problems and prepare a plan to resolve all issues that can be remedied. Potential buyers will

naturally conduct due diligence, and discovering unknown issues or issues that were not addressed will grant the buyer leverage in the transaction. Additional transaction structures that advisors may consider are spin-offs, split-offs, split-ups, and an initial public offering of a portion of the divestiture entity's shares, among a variety of other alternatives.

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