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FEATURE **CONTRIBUTED ARTICLE**

Hein Marais, a partner at PricewaterhouseCoopers, discusses how a different approach is needed to successfully divest assets in an economic landscape much changed.

RETURN ON DIVESTMENT: SELLING NON-CORE ASSETS IN A DOWNTURN

The business of divesting an asset or part of a company has changed a great deal over the last year or two and companies are grappling with a new environment where new skills, knowledge and approach are needed to make a successful sale.

Whereas diversification was a boon for companies in the early and middle years of the last decade, many businesses are now facing pressure from shareholders to focus on core competencies.

Businesses are thirsty for cash, access to finance on favourable terms has dried up and immediate prospects look no better. Shareholders also understand that diversification can take businesses away from what they do best and makes companies more vulnerable in hostile takeover situations. All of this makes the sale of non-core assets an attractive prospect.

Groups such as Rio Tinto, Anglo American and ConocoPhilips have either announced or are already running large portfolios of non-core assets for divestment and other companies have made clear their intentions to do the same. But achieving sales has become immensely more complex. The luxury of one seller, one asset, one buyer, one lender, now seems like a distant dream.

Buyers are now often forced to group together in consortium due to borrowing constraints (and the need to maximise leverage) and they regularly need a vast array of lenders to close a deal. One major deal last year saw a buyer reliant on 25 banks, where two or three would have been used before.

M&A and strategy directors (and those running disposal processes at companies) need to supercharge their learning curves to operate in this new, highly complex environment. There is also a big role for investment banks and organisations such as PwC

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to help companies navigate through these new waters.

Recently bidders have been clubbing together to buy and then separate the assets themselves at a later date, or they may need information on the impact of selling parts of a division immediately, post-acquisition, to pay down bridging finance.

Some bidders may offer to buy only parts of the asset for sale, leaving the seller with the remainder, others may want to buy the asset as a whole then implement their own sub-separation plan to open up future exit options for their investment.

The key to success is to maintain maximum flexibility by planning for every potential realistic outcome. The absence of sufficient leverage available to buyers means that divisions often need to be presented for sale with the built-in option of sub-separating into two or more smaller units, which has happened a number of times in recent divestments.

These demands put the responsibilities for diligent planning and preparation on the sellers. If the information isn't readily available to bidders, the sales process could grind to a halt while the analysis is being prepared, which could cause a loss of momentum. Or, as we have seen last year, bidders might offer substantially lower pricing to reflect the increased uncertainty associated with the outcome of sub-separation or even walk away.

Breaking up is hard to do

How the issue of IT is approached in complex divestment programmes is often decisive as to whether they are successful or not. The order in which divestments take place in the current market is largely outside the control of those running the disposal process. Changes in the order of disposals have the potential to play havoc with separation planning.

In just about every carve-out, IT is the key driver of timescale, complexity and therefore cost. Ask any IT director and they will tell you the nightmare scenario for complex separation programmes is a request to sub-separate IT systems not previously planned for, or to change the order or timing of the individual IT separation projects.

Yet this is almost inevitable when divesting in a downturn. IT separation planning needs to become more modular and agile. IT during complex divestment programmes is like turning an oil tanker, it takes a long time to change course. Changes in the order of separation or timing can have a knock on impact on IT projects that are unrelated to the separation(s), causing implementation delays, write-offs and additional costs being incurred.

The ability of support functions, often in the shape of shared services, to meet the needs of the divestment programme has become a critical factor in a scenario where sub-separation arises or where multiple assets are being divested. Vendors may even need to consider the establishment of a separate support organisation for a portfolio of divested assets, which could itself be spun off at a later date.

One thing that helps here is effective and extensive scenario planning, the management tools and methodologies of which were first developed around the oil crisis in the 1970s and are now, appropriately enough, being dusted off at a time of further economic stress.

Transitional service arrangements (TSAs)

The provision of transitional services by the seller (typically for a six to 12-month period to enable the purchaser to replace support services previously provided by the parent) becomes a lot more complex in this environment. Sub-separation means that, in addition to seller and buyer, a third party is often introduced – the buyer of a sister entity or former parent division. This leads to situations where the bidder now needs to get comfortable that a third party, often a private equity fund, will become the provider of key support services.

The perceived execution risk associated with transitional services is also much higher in a portfolio divestment scenario. In the old world the ability of the seller to provide these transitional services was rarely questioned, but when assets are being offered to multiple buyers of sub-divisions the ability of the seller to deliver on these commitments can be cast into doubt.

I am aware of two potential deals last year where the bidders walked away just before deal signing because of the perceived inability of the seller to provide transitional support, and I am sure that there were many more.

As another indication of how much things have changed, it is interesting to observe that, previously, lending banks rarely came to separation planning meetings during the due diligence phase. They were thought of as having only operational significance. Now they are often chairing these meetings. That is how central these issues have become.

Further complexity is added because TSAs may need to become longer than the typical six to 12 months, due to the inability of the seller to provide the required migration support to come off the transitional services, and may involve services being provided both ways (to and from the assets being divested) to balance the delivery risk.

We have seen instances where TSAs have worked well for the time allotted, but coming off these agreements has been difficult for both parties. These arrangements can often be extended, but at large premiums, and for the seller this scenario can represent a big distraction as well as a reputational and legal risk.

Stranded costs and migration support

Stranded costs are the people, processes and property that will no longer be required by the seller at the end of the TSA period. How do you keep people working and motivated in a job that is certainly going to end?

Attention to detail on the HR side is essential. Retention plans often include incentives and bonuses tied to the completion of the project. Interestingly, bonuses in these situations are paid for knowledge as much as performance. It is often the "old hands" who know legacy and heavily customised IT systems inside-out who are most valuable and need to be kept on.

A further point of consideration in a complex divestment scenario is the potential impact on the rest of the seller's business. Significant parts of shared service centres or other support functions may eventually become redundant or impossible to reassign to "business as usual" growth requirements.

Inevitably, this leads to redundancy programmes during or immediately after the TSA period, which further increases the risk of retaining key staff involved in providing the TSAs, or the migration support required by the buyers to come off the TSAs.

Finally, if the divestment in aggregate is large, it may impact the viability of the seller's remaining function. Multiple asset sales can make a particular aspect of the seller's business or operating model obsolete, precipitating an internal restructuring that can involve anything from outsourcing to consolidating operations across the globe. Again this has the potential to impact the seller's migration support to the buyer(s).

Conclusion

There are no predictions for liquidity to improve in the short term. Also, no return to the relatively straightforward "one-on-one" strategic purchase is predicted anytime soon. Outcomes are more unpredictable than ever and each possibility needs to be anticipated.

Should you ask those who have recently managed complex divestment programmes, they are likely to tell you that these ended up very differently than expected. In this business environment it is important that sellers engage in earlier and deeper scenario planning to extract the best terms from a transaction. In the model that we are going to have to work with over the coming years, complexity needs to be addressed and embraced by those seeking to survive and grow.