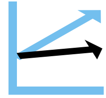
Using Divestitures to Deliver Excess Returns

BOURNE PARTNERS

Key Takeaways:



Companies which employ a mix of both M&A and divestiture strategies tend to **meaningfully outperform** versus those who do only one or the other

In a market downturn, **strategic divestitures can serve as a favorable source of financing** to support operations or purchase other assets

Hiring **an experienced advisor can help maximize value** of the divested asset or business while minimizing obstruction of day-to-day operations

Introduction:

Despite current economic conditions, the scarcity of assets in the consumer healthcare space translates into robust demand and valuations. We've recently observed the transformational spinoffs of consumer businesses by big pharma entities and have seen that strategically focused SpinCo's tend to deliver returns above what they would have expected to deliver had they remained within their prior corporate structure. Regarding consumer and wellness acquisitions of companies or legacy brands, demand remains high for quality assets. Over the past 6 months, Church & Dwight's acquisition of Hero Cosmetics (Mighty Patch), TPG's acquisition of iNova and their broad range of consumer products, and Biofarma's acquisition of Nutraskills and their supplements CDMO capabilities are just a few of the transactions that highlight the demand.

But why would a business sell itself, or a portion of its portfolio, particularly if that asset is profitable and generates cash flow? Or equally important, why wouldn't they? With that as a backdrop, Bill Koch, Bourne Partners' Director of Consumer Health Advisory, sat down to interview Emilie Feldman, Michael L. Tarnopol Professor and Professor of Management, The Wharton School, University of Pennsylvania. Emilie is a recognized expert on divestitures and recently published a new book: "Divestitures: Creating Value Through Strategy, Structure, and Implementation". The following discussion reviews some of Emilie's key findings and showcases the fundamental value of ongoing portfolio reviews and strategic divestitures.

Why Should Companies Contemplate Divestiture Strategies?

Bill: We appreciate you taking the time today to share your insights, Emilie. In my experience, many executives and corporate development folks are so growth focused they don't contemplate divestitures as part of a robust M&A strategy. Is this common?

Emilie: Yes, it's quite common. The data show that on average companies do 3-4 acquisitions for every 1 divestiture. There's a big discrepancy between acquisitions and divestitures in terms of both volume and value. Looking at the S&P 500, about 70% of companies on average fail to divest in any given year, indicating there are opportunities for divestiture that aren't being taken.

Bill: I've read research regarding revenue refresh rates. To what extent do companies who constantly refresh their revenue mix tend to outperform?

Emilie: Chapter 3 of my book looks at companies that combine M&A and divestitures strategically. What I found is that companies that do both strategically in sequence with one another typically outperform relative to companies that do one or the other on their own. I tend to look at announcement returns, how investors react on the day these transactions are announced, and then longer-term measures of shareholder value creation such as compounded monthly returns or compounded annual returns.

Bill: Companies may think they can turn around an underperforming asset and ignore the headwinds or pressures associated with that. What do you think influences that way of thinking?

Emilie: There are several factors that contribute to inertia against divestitures. Companies may say they can't divest something because it's a cash cow, or because it would result in a big tax bill, or because it would be problematic for stakeholders.

Bill: The cash cow element came up multiple times in my experience at GSK Consumer Healthcare. As did purchase accounting and goodwill associated with assets. In many cases the accounting influenced decisions since we didn't want to incur a paper loss even though everything else made sense.

Emilie: That's completely consistent with what I've seen and what I've found in my work on the topic.

Meet The Author

Emilie R. Feldman is the Michael L. Tarnopol Professor and Professor of Management at the Wharton School of the University of Pennsylvania. Emilie's research focuses on corporate strategy with a particular focus on corporate divestitures, spinoffs, and M&A. She recently published a new book ("*Divestitures: Creating Value Through Strategy, Structure, and Implementation*") which serves as a comprehensive primer on what strategic divestitures can achieve and how businesses can implement them to maximize value. Emilie graduated magna cum laude from Harvard College, where she studied Economics and French Literature, and she received her MBA and DBA in Strategy from the Harvard Business School.

When to Consider Divestitures

Bill: How often do you think a business should conduct a portfolio review to identify potential divestiture candidates?

Emilie: It's hard to give an exact number, but more frequently than it's already done. I tell my MBA students you should be continuously scouting opportunities externally for M&A and expansion, but you should also be continuously scouting internally for potential divestiture candidates.

Bill: Once an asset has been identified for divestiture, your research indicates it's often too late, correct? Particularly in terms of maximizing value.

Emilie: That's exactly the problem. By the time the "problem business" that needs to be divested is identified as such, the situation is often worse than it could have been. Had you been more proactive, you could have gotten a better valuation. Even worse, there's the opportunity cost of what you could have done with your portfolio that you didn't do because you were investing in non-strategic assets. And it's not only a monetary cost, but also an opportunity cost of time, attention, and other company resources. There is also a positive impact on effective capital investment in the remaining business post-divestiture.

Bill: And managerial bandwidth too, right?

Emilie: Absolutely. That's as critical, if not the most critical resource.

Bill: So, to get ahead of that, what criteria should an executive or management team consider when evaluating their portfolio?

Emilie: I'd argue there is probably some industry specificity but in in general terms I'd say big ones are existing and forward-looking industry conditions, competitive landscape, and resource consumption. What does it take to continue running that business? Most importantly, what is the fit? Why are we the best owner for this asset relative to other companies? What are we adding in terms of value that other companies couldn't?

Industry or Asset Specific Considerations

Bill: Bourne Partners' advisory focus is Pharma, Pharma Services and Consumer Healthcare. Does your research differentiate between industries?

Emilie: My research is generally industry agnostic, but many of the factors that drive and create value from divestitures are likely to be at play in the context of Pharma and Consumer Health. Companies that operate diverse portfolios of businesses or assets are often ones where we see divestitures creating a lot of value. When these companies do these kinds of transactions, value is created because they reallocate resources, drive management focus, clarify perceptions of strategy, etc.

Bill: Is there a distinction between types of assets? Whether it's a non-strategic business segment versus a non-strategic product portfolio?

Emilie: That is something that I've teased apart, and we do see similar results and patterns of outcomes regardless of asset type.

Divesting in an Economic Downturn

Monetize non-strategic assets and apply proceeds to core business

Bill: Now that we're coming out of the pandemic, have you seen any changes in the landscape over the last couple of years?

Emilie: We don't see nearly as much variance in divestiture activity or outcomes as we do for M&A. We see a ton of cyclicality in M&A, less so for divestitures. The economic environment we're in is going to put pressure on companies. I think this will likely encourage divestitures. You have a finite number of resources, and you must make choices. What better way to achieve focus than by using divestitures so that you can focus on those core areas? A lot of times, divestitures get used as a solution for problematic, underperforming, or even failing assets. As the economic environment tightens, are we going to see more of those types of transactions that aren't the proactive type we've been discussing? I think those factors will accelerate over the next six months to a year.

Bill: Then we get into the circular conundrum of, once I've identified an asset to divest, I may think it's not the time to capture the highest multiples. You recently wrote about divesting in a downturn. Could you expand on that a bit?

Emilie: This is where I think companies can get themselves into trouble. There's that element of, "oh the conditions aren't right, let's hang on." The market conditions might improve but at the same time, the value of the asset may have deteriorated, especially to the extent that you're not the right owner of it. Does the potential for higher multiples in a better market offset the deterioration of the asset, and/or cause inefficient allocation of resources during that time? It's difficult to make a general statement but that would be the pathology.

Bill: Simply put, if I divested today, I could put those proceeds to use in the same down market, right?

Emilie: Correct. Markets may be weak, other assets may be cheaper, and now you have excess cash that you generated from a divestiture, to acquire new assets to further advance your core strategy. I think it's all about opportunity cost.

When to Engage an Expert

Bill: When we're tracking deal activity, we analyze whether an advisor was engaged and if so, in what capacity? I've seen this issue before with middle market companies. They tend to approach divestitures alone. Have you observed any differentiation between the outcomes for companies that engaged an advisor versus those that tried to go at it alone?

Emilie: There is absolutely a difference and I'll go a step further. We talk about this a lot in academic research. Can companies learn to get better at doing certain types of transactions? It's a core question that many people are interested in. On the M&A side, it's more straightforward for companies to do these types of transactions in-house. We do end up seeing a positive correlation, especially when companies start to do a lot of transactions. The problem with companies running their own divestitures is that they don't do them frequently enough, if at all, so they don't get the opportunity to build expertise. To quote a corporate colleague with whom I was recently discussing my book, "every divestiture is equivalent in terms of workload to five M&A deals."

Meet The Interviewer

William Koch joined Bourne Partners in 2022 as a part of the firm's investment banking team, with a focus on Consumer Healthcare. Prior to Bourne, Bill spent several years as an independent M&A, licensing and valuation consultant. His background includes 12 years in Worldwide Business Development, Corporate Development and Strategy with GSK Consumer Healthcare. In addition to an operating perspective, Bill brings a wealth of consumer health transaction experience including divestitures, M&A, and licensing.

“Research has shown that … by leveraging the experience of an advisor, companies can achieve better outcomes.”

Emilie: Research has shown that when companies engage external advisors, there is an improvement in the performance of these transactions. Further, external advisors that are highly experienced with those types of transactions tend to create even more value. We call this ‘renting’ divestiture experience. By leveraging the experience of an advisor, companies can achieve better outcomes.

Bill: As a follow-on, some folks in a corporate setting might look at divestitures as simply M&A in reverse. If you look at the corporate buyside M&A process, engagement of subject matter experts within the company occurs during a finite period in the process. They don’t need to engage on planning for it and ramping up the workload until it the deal gets traction. On the divestiture side, you need to have the planning and material prep work done upfront to make this turnkey by the time you even announce that you’re ready to go. There’s a ton of effort, particularly if assets are shared in the corporate structure. What are some of the challenges companies may face when they undertake a divestiture?

Emilie: I couldn’t agree more. This all relates to chapters 9, 10, and 11 of my book. People may think it’s the reverse of M&A, but it’s not. Certainly, from a timing perspective, but also which parties are involved. Divestitures have a much different tone and perception. There’s more work to do up front. From defining the asset perimeter, ensuring the correct resources that are associated with it go with it, managing any shared resources with other assets in the business, properly assigning liabilities and expenses, etc. Another issue that people don’t recognize enough is stranded costs. The overall cost structure of an organization needs to be adjusted downward proportionally. All of this is incredibly complex and companies struggle managing it on their own. And the process isn’t just backward looking to unwind the asset. There’s also the forward-looking portion of setting up the RemainCo for the future. What are you going to do in terms of focusing your strategy, identifying and pursuing future opportunities, and addressing investors’ perceptions? Preparing for the future is an important and time-consuming step that I think is often overlooked or underestimated.

Conclusions and Bourne Partners’ Perspective:

This discussion highlights the empirical evidence supporting implementing an active divestiture process, in that the performance of a focused RemainCo post-divestiture could be better positioned to deliver growth going forward. Whether that’s through better allocation of capital, managerial focus on the core business(es), ability to monetize a non-strategic asset and apply those proceeds to core areas, or a combination thereof.

The research is focused on public company disclosures and data availability, but we believe the logic applies to public and private entities alike. Whether that’s a private equity firm looking to best position a portfolio company for exit, or a founder-owned business positioning itself for sale. It’s not necessarily just a multiple of scale in terms of revenues or EBITDA. Taking the interim steps via divestitures to demonstrate a focused business is likely to impact marketability, and ultimately value.

An internal assessment of resources and capabilities with respect to divestitures is also critical. Evidence shows that the time, effort, and complexity of divestitures differs from what a corporate development team experiences on the M&A buy-side.

Bourne Partners has over 20 years’ experience in advising public and private companies on sell-side transactions in the pharma, pharma services and consumer healthcare sectors, comprising over $10B in value. We hope you found these perspectives useful and would welcome a discussion to learn more about your business, aspirations, and where we can potentially assist you in the journey.

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