

Global Corporate Divestment Study

Strategic divestments
drive value



Building a better
working world



Foreword

A note from Pip McCrostie, Global Vice Chair
Transaction Advisory Services

For many businesses, divestments are now a fundamental part of their strategy – leading companies focus on selling assets in the same rigorous way they focus on acquisitions.

Divestments were once seen as a short-term tactical tool to raise cash or pay down debt. Today, the longer-term value – and growth – that strategic selling can create is better understood. Selling assets and re-shaping portfolios can help global companies concentrate on higher-growth opportunities and create value for their stakeholders, if leading practices are applied to the process.

In times of rapid innovation, changing purchasing patterns and lower growth in the global economy, regularly reviewing the strategic core of a business is critical to achieve value. Returns from divestments are becoming increasingly important for boards and shareholders who demand strategic value.

Leading companies employ consistent practices around portfolio reviews ensuring successful divestments aligned to the strategic priorities of the business. Selling can mean a short-term dip in top-line growth, but redeploying and re-investing capital in core activities, expanding into new markets or developing new products can lead to longer-term growth and higher value.

However, even though divestments have moved up the strategic agenda and a third of global companies plan to sell a business unit in the next two years, our survey finds opportunities for companies to further optimize value. For instance, only 25% said an asset was likely to be divested if a portfolio review indicated it was non-core.

After five years of depressed M&A activity we may now see a gradual improvement in the global deal economy. Divestments are being planned and opportunistic sales will happen – around 80% of our executives are open to offers for their most prized assets and a 30% premium could seal a deal for most.

In this environment, competition for assets may increase but so could competitive positioning among would-be sellers. Within this changing deal economy, there will be even greater stakeholder scrutiny to ensure divestments are efficient, effective and executed strategically to extract maximum value and support the longer-term growth agenda of the business.

About the study

The EY *Global Corporate Divestment Study* analyzes leading portfolio review and divestment strategies and provides insights around a central thesis: strategic portfolio management leads to improved divestment outcomes.

Results are based on 720 interviews with corporate executives surveyed over September and October 2013 by FT Remark*, the research and publishing arm of the Financial Times Group.

The survey includes executives from the Americas, Asia-Pacific, Europe, the Middle East and Africa. While a broad range of industries is included, the study focuses on five key sectors: consumer products, life sciences, oil and gas, power and utilities and technology. Executives stated that they have direct knowledge of or hands-on experience with their company's portfolio review and divestment activity.

* Company-specific data, analysis and commentary provided by FT Remark



Key findings

Paul Hammes, Global and Americas Divestiture Advisory Services Leader
Transaction Advisory Services

Companies can create shareholder value by regularly assessing whether each business unit in their portfolio is contributing to strategic goals and long-term growth. In particular, portfolio reviews help companies determine:

- ▶ How to allocate capital in alignment with the core strategy
- ▶ How to effectively meet current and future market needs
- ▶ The value of each business unit on a stand-alone basis and its contribution to the entire organization
- ▶ Whether to divest or to invest additional capital in a business

Strategic divestments are key to raising capital and deploying it into a company's core business. Our latest *Global Corporate Divestment Study* found that more than half of surveyed companies have made a major divestment in the last two years.

However, companies are leaving money on the table. Only 41% of executives said that their strategic portfolio review drove their last divestment decision. This is despite the fact that 80% of those base divestment decisions on their portfolio review experienced a higher valuation multiple in the remaining business after their last divestment.

85% saw an increased valuation multiple in the remaining business following their last divestment when it was based on an updated definition of core operations

80% experienced a higher valuation multiple in the remaining business after their last divestment when they based strategic divestment decisions on their portfolio review

53% said portfolio review effectiveness could be improved if a clearer link was made between results and subsequent actions

Key findings, cont'd.

Our study reveals three leading practices for companies conducting portfolio reviews

▶ **Know your core business**

Companies need to understand their core competencies and what differentiates them from competitors. They need to analyze their core operating model regularly in order to anticipate and adapt to market changes.

Eighty-five percent of companies that updated their definition of core operations in the last 12 months saw increased valuation multiples in the remaining business following their last divestment of a non-core business.

▶ **Make better-informed decisions**

Executive boards should set the portfolio review objectives and agenda. And corporate development and other functional teams need access to more robust business unit performance data and industry benchmarks relative to that agenda. To accomplish this goal, teams with a diverse skill set need to gather and interpret market, financial, operational and stakeholder data.

Nearly half of executives said having a dedicated team would improve the effectiveness of their portfolio review process.

▶ **Take action**

Companies need to think strategically rather than opportunistically about divestments. Valuation multiples increase when companies act on portfolio review findings to divest non-core or underperforming business units.

More than half of executives said their portfolio review would be more effective if it was more clearly linked to capital allocation decisions.

Defining portfolio reviews

A portfolio review should evaluate the operating performance of an organization's segments, business units, product lines, assets, R&D or similar assets relative to the organization as a whole in order to assess whether it is the optimal owner of the assets. Our study reveals that reviewing these items twice a year helps companies better meet rapidly changing market needs and drive growth.

High performers are strategic in their capital allocation decisions

The study's empirical analysis shows that companies that follow three leading practices are more likely to initiate divestments that have a higher sale price and increase the remaining company's valuation multiples post-sale. That is, these divestments are generating significant attention from buyers and the sellers' investors.

However, these high performers account for just 12% of executives. Most companies are leaving money on the table.

Measuring divestment success



Sector watch

- ▶ **Consumer products:** The main driver for divestments is an off-trend product (58%), followed by 44% who said reduced demand or market share would make them consider divesting.
- ▶ **Life sciences:** This is expected to be the most active sector, with 41% expecting to divest in the next two years. Fifty-seven percent mentioned regulatory change as the main reason they would consider selling.
- ▶ **Oil and gas:** 63% of oil and gas executives have divested over the last two years, primarily because of technologies such as horizontal drilling and hydraulic fracturing. We see similar trends continuing globally, as sites once considered unviable are now turning into growth areas.
- ▶ **Power and utilities:** A third of companies are looking to divest. Low growth was cited as the main reason for divestment by 49% of sector executives, with 57% saying they would reinvest in fast-growth areas, such as alternative energy.
- ▶ **Technology:** 49% of sector executives said the biggest sector trend prompting them to consider divestments is big data and analytics developments, followed by cloud computing innovations (47%) and mobile devices (43%).

How to drive the greatest value from divestments

▶ Portfolio reviews should guide decision-making

Regular and thorough portfolio reviews create focused and well-defined businesses, characteristics that shareholders value. Companies use portfolio reviews primarily for identifying new growth opportunities (48%), assessing business unit performance (34%) and allocating investment and resources (32%).

All of these objectives can lead to divestments. Divesting business units that are no longer strategically aligned with the core frees up capital to reallocate to other areas that are poised for growth. One company that is achieving strong results through stringent portfolio analysis and strategic divestments is Royal Dutch Shell. Since 2010, the Dutch energy giant has divested US\$21b of assets as a result of a process ex-CEO, Peter Voser, described as “embedded” and “rigorous” portfolio management. Market speculation suggests that Shell plans to divest between US\$15b and US\$30b of further assets over the next two years as it positions itself to benefit from growth areas and to improve capital efficiency.

To achieve strategic goals, the C-suite needs to understand its current core competencies and key differentiators, as well as how the company should be positioned in the future. And their teams need to have a process in place to frequently analyze business unit information, such as pricing, industry volume changes, and customer and other stakeholder perspectives.

Companies often fail to optimize their capital allocation, despite indications that change is required. Most interviewed executives said they are not taking the appropriate actions based on their portfolio review findings; 53% said their portfolio reviews would be far more effective if they were to implement changes based on the results.

Q: What is your portfolio review currently used for? (Select top two)



▶ Doing nothing is no longer an option

Many companies need to be more proactive when it comes to portfolio management and divestments: they need to review their portfolios more frequently, use more robust data to make portfolio management decisions and take action based on the review findings. Doing nothing in a fast-changing world is not an option. Why?

First, the M&A boom leading up to 2008 saw companies add businesses to their portfolios, often quickly and with little consideration given to systematic integration. In addition, the original rationale for many of these deals is no longer applicable as economic assumptions were made in a different market environment. Companies should consider whether those investments are delivering the expected value or if capital could be better allocated elsewhere.

Second, with increasing investor scrutiny, companies must decide how to best allocate both time and capital resources to increase shareholder value. Many are refocusing their businesses on fast-growing segments and establishing footholds in sectors and geographies that offer long-term strategic value.

► Fortune favors the bold

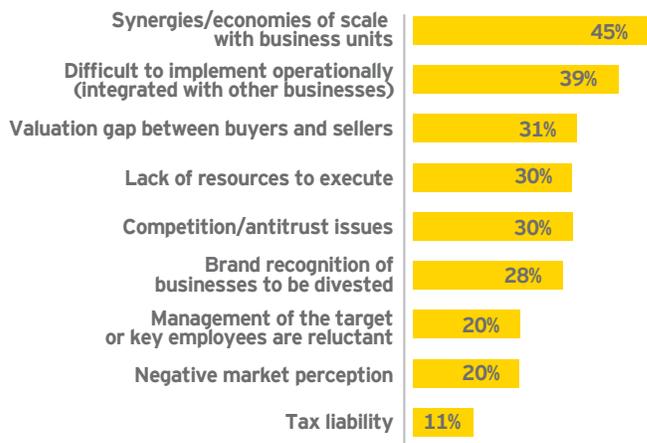
Despite the necessity for action, many companies remain cautious about selling. While a third of responding companies expect to make a divestment over the next two years, others see barriers to divestments despite having identified targets. The perceived barriers include losing synergies and economies of scale (45%), difficulties in operational separation (39%) and valuation gap between buyers and sellers (31%).

However, effective portfolio management and separation planning mean the opportunities gained from a divestment should far outstrip any perceived challenges. For example, companies can overcome operational issues by creating a road map for all business functions and thoroughly assessing stranded costs, one-time separation costs, go-forward cost structures, business continuity, tax structures, transition service agreements and transaction closing mechanisms.

Valuation gaps can be narrowed by creating a growth story tailored to how a business could fit with the bidder's business and help the bidder achieve its own strategic objectives. This story should include an M&A plan for potential investors and a view on synergy opportunities. An earn-out mechanism can also enable the seller to receive value for the performance of the business unit after it is sold, particularly when related value hasn't been realized in the business unit's historical operating results (e.g., a restructuring, closing a significant customer contract, new product introduction).

Given the positive effect that rigorous portfolio management and divestment planning can have on divestment outcomes, we will highlight what companies can do to optimize their portfolio, increase business unit sale values and enhance valuation multiples of the remaining business.

Q: For the asset that you are considering divesting, what might prevent you from actually selling it?



Three leading practices to improve your portfolio divestment strategy

1. Know your core business

Company leadership needs to assess their core business regularly and understand what differentiates the company from competitors.

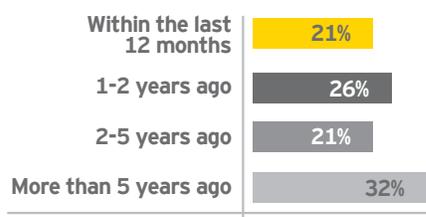
► Define the core

Three key activities can help companies validate their core competencies.

- **Meet regularly:** Internal “pulse checks” with sales teams and client-facing staff will provide insights into which products and services are best received in the market.
- **Analyze rigorously:** Formal analysis of the business’s products allows companies to better understand how they are performing on pricing, volume changes, customer satisfaction and market share. It also helps identify new trends that may impact the business and find ways of capturing market share from rivals. For example, how are your pricing trends similar to or different from the market? How does your pricing and market share compare with your three to six core competitors? How is share changing and why?
- **Look outside:** External verification with third parties can shed further light on changing market dynamics and the extent to which core products/businesses are resonating in those markets.

However, too many executives are still using dated definitions of their core businesses. More than half of executives frame portfolio reviews around outdated assessments of their core operations. Nearly a third (32%) had not redefined their core operations for at least five years, and a further 21% had not done so for between two and five years.

Q: When was the last time your company redefined its “core” operations?

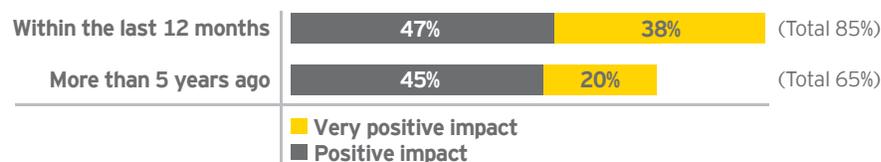


► Review strategy regularly

Companies need to revisit their strategy as market conditions change. Of the companies that had redefined their core operations in the last two years, 85% said their last divestment had a positive impact on valuation multiples of the remaining business. This compares to only 65% of executives working with a core operations model that is more than five years old.

Percentage of companies registering a positive impact on valuation multiples after last divestment

Last time redefined core operations



US multinational Dow Chemical Company has an “ongoing commitment to proactive portfolio management.” As a result, the company has recently announced plans to divest US\$5b worth of assets in its Commodities Chemicals Business, a market that Dow is now exiting. Dow Chemical CEO Andrew Liveris said that the announcement “represents a continuation of the shift of our company toward downstream high-margin products and technologies ... and to generate consistently higher returns than cyclical commodity products. We are committed to prioritize our resources such that we maximize total shareholder return.”

► Involve senior leaders early

Surprisingly, many companies fail to include senior management early enough in the process to optimize portfolio review results. Only 52% of executives said their executive board is involved in setting portfolio review goals.

Involving the executive board at an early stage in shaping a portfolio review’s direction is crucial to enhance the process, as the review’s results are more likely to inform divestment decisions.

In addition, the balance of C-suite executive participation and maintaining confidentiality while setting the portfolio review agenda and making decisions can also help prevent internal conflicts of interest. For example, board members are generally able to evaluate business units objectively and in the context of the organization’s long-term interests, whereas business unit leaders may have more of a silo view and a vested interest in their business.

Q: Who is involved in the portfolio review and at what stage?

	Setting review agenda	Collecting inputs and running analysis	Interpretation of results	Strategic portfolio decisions
Executive board	52%	25%	48%	70%
Corporate strategy	43%	51%	53%	46%
Finance and accounting	47%	59%	58%	26%
Business unit leaders	41%	50%	51%	52%
Corporate development	70%	48%	46%	27%

“One of the main issues with our current process is that the three-year rolling plan gets a wide distribution. This means that if a business unit is identified as a potential divestment, everyone knows about it pretty quickly. This can have significant implications for the business unit and those working in it, and it can also have an impact on the decision and the performance of the business. Keeping those with a vested interest in retaining the business out of the key decisions is very important.”

– Executive at US industrial products company

2. Make better-informed decisions

Companies need the right infrastructure to make effective portfolio decisions: dedicated teams with a diverse skill set and both comprehensive and accurate data.

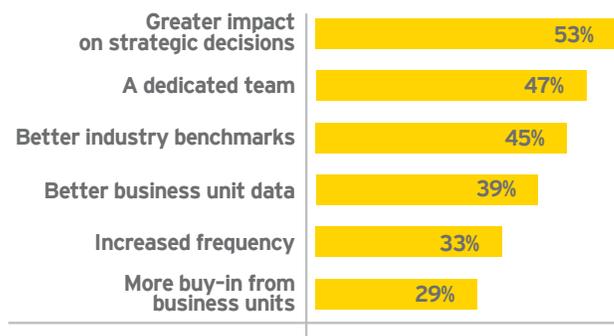
► Build the right team

Nearly half of executives believe a dedicated team would improve their portfolio review process.

The most successful teams are led by an executive with the authority to make decisions and recruit the appropriate professionals with diverse skill sets, including:

- **Strategic:** Can analyze industrial, financial and organizational information; potential candidates would be directors or vice presidents from corporate development or strategy.
- **Financial:** Work on modeling, pro forma earnings, business case development and strategic options analysis.
- **Organizational understanding:** Well-informed on the overall business, its operations and the “pulse” of the markets.
- **Sales:** A senior sales executive can offer a direct customer perspective.
- **External advisors:** Where appropriate, can provide additional operational, strategic or sector insight.

Q: What would make your portfolio review process more effective?



► Run the right analysis

Key financial metrics should be calculated to help guide the team’s strategic decisions.

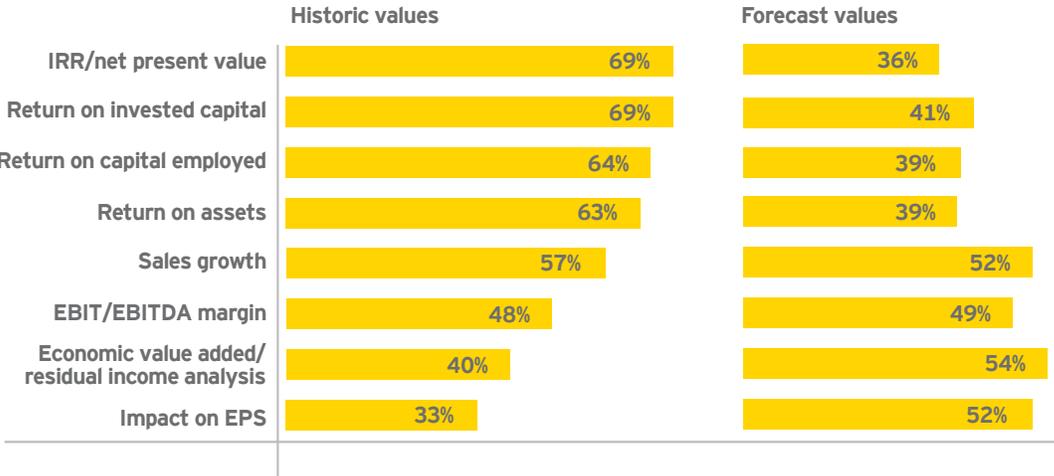
- **Return on invested capital:** To calculate return on assets and present value.
- **Sales growth and EBITDA:** Compared with internal and external benchmarks, such as: Are the unit’s sales growing faster or slower than those of competitors? Or, if EBITDA margin is low, how acceptable is it compared with other parts of the business and/or the market?
- **Economic value added:** Does the business unit strategically enhance other parts of the company?

These metrics should include both historic and forecast values, particularly in fast-changing environments where past trends may not be indicative of the future. Companies should also measure performance relative to other business units and industry benchmarks.

There is a clear need for improvement in data quality in many companies.

- ▶ Nearly half (45%) of executives would like to see better industry benchmarks.
- ▶ 39% cite the need for more robust business unit data to enhance their portfolio review process.
- ▶ Only 13% of companies allocate inter-company costs based on actual usage. Most companies potentially distort the historical cost structure when buyers are looking for a stand-alone view of the business.
- ▶ Just a fifth of executives have an accurate picture of working capital for each business unit that is being considered for divestment, which is surprising given the number of purchase price adjustment mechanisms that are based on working capital.

Q: Which financial metrics do you quantify during your portfolio review?



“By looking at historical return on investment and market growth – and how our business stacked up against competitors – we crafted heat matrices of attractiveness of each market versus our market position. We were able to categorize businesses where the market was attractive and we had a strong position in it, versus businesses where the market wasn’t very attractive and we had a weak position. So we got out of businesses where the market itself wasn’t all that interesting and our position in it also wasn’t all that good.”

– Executive at US consumer products company

3. Take action

Companies need to act strategically rather than opportunistically when divesting. And they need to act when a portfolio review considers a business non-complementary to the portfolio.

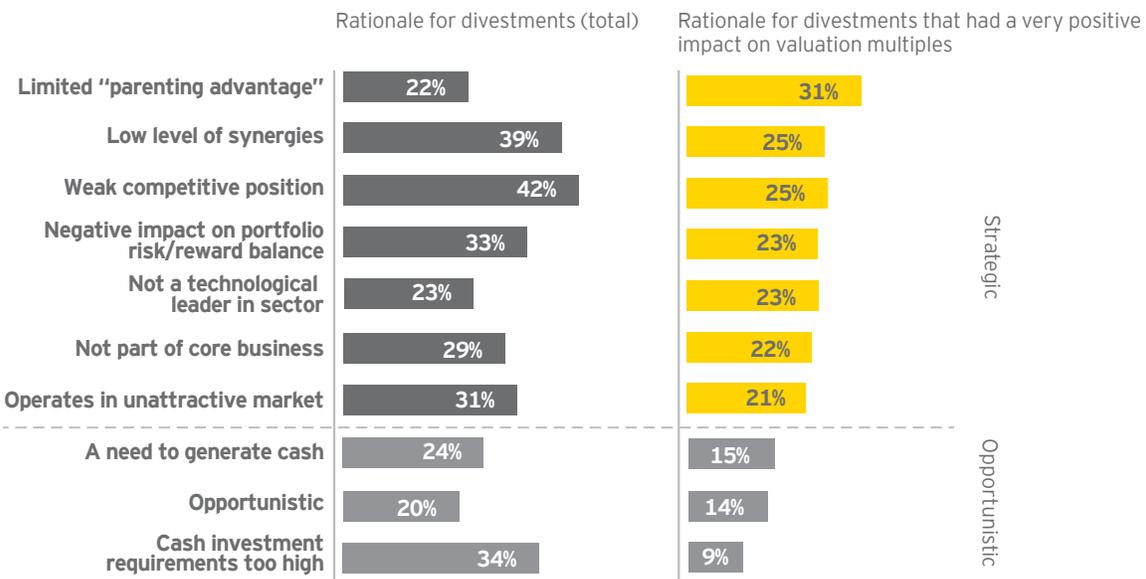
► Define criteria to drive strategic rationale

By monitoring key financial and operational metrics continuously, companies can determine potential divestments strategically rather than opportunistically.

Many companies still rely heavily on opportunistic divestments, either selling because they were approached by a buyer or because they needed fast cash. Twenty percent of companies indicated they would divest opportunistically. However, few companies succeed when taking such an approach; only 14% of recent opportunistic divestments resulted in a “very positive” increase in the valuation multiple for the remaining company.

By contrast, companies that divest for clearly communicated, long-term strategic reasons are more likely to experience increased valuation multiples for the remaining business post-sale. For example, selling a business because the parent is not the optimal owner is the rationale most highly correlated with a positive impact on valuations of the remaining business post-sale.

Q: What is the rationale for your divestments?



“Our portfolio review process is strategically driven. We examine each unit and look for those that are sub-scale. We consider divesting those areas where we cannot see ourselves gaining leadership with additional investments. And we analyze profitability, possible returns from reallocating capital and whether it is the right time to make the divestment.”

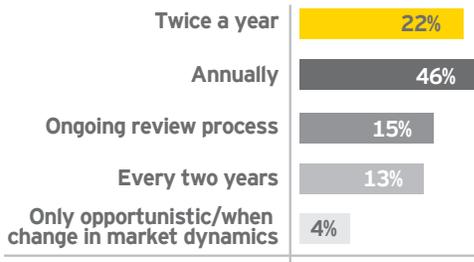
– Executive at a UK-based pharmaceutical company

► Use frequent reviews to create opportunity

Divesting for long-term growth requires an ongoing portfolio review process. Two-fifths of executives who conduct reviews twice a year registered a very positive impact on their company's valuation multiples after their last divestment.

Many companies are not reviewing their portfolios with sufficient frequency. Two-thirds of companies said they did this only annually or even less frequently. Further, not a single executive that conducted reviews opportunistically registered a very positive impact on the valuation multiples of their remaining business after their last divestment.

Q: How often do you conduct a strategic review of your portfolio of businesses?



Percentage of companies registering a **very positive** impact on valuation multiples after last divestment

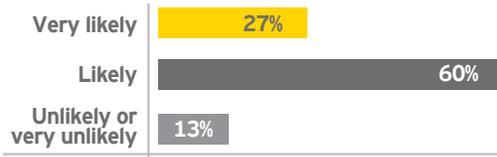


► Decisive action maximizes value

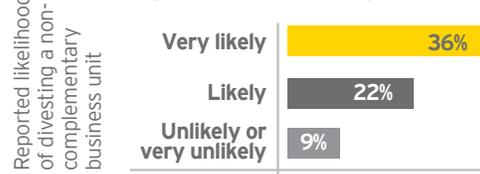
Portfolio reviews may identify changes that need to be made, but too often companies fail to dedicate the effort and resources required to turn analysis into action.

- 53% of executives said there needed to be more of a link between review results and action.
- Just 27% said a business found to be non-core was very likely to be sold. This group of high performers rate their review process as more effective and make divestments that are better received by investors.

Q: If your portfolio review indicates that a business unit is not complementary to your performance or strategy, how likely is it to be divested?



Percentage of companies registering a **very positive** impact on valuation multiples after last divestment



Consumer products

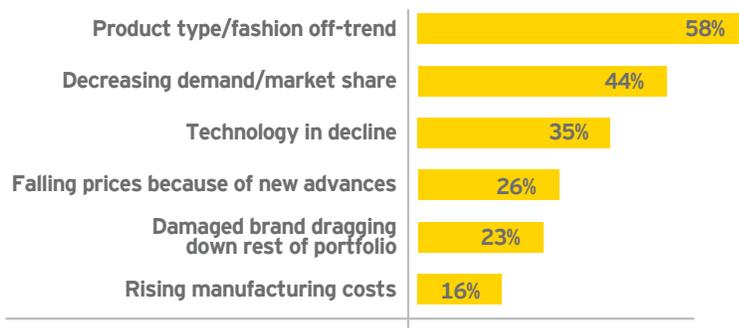
Profitable brands flourish when non-core brands are shed

Consumer businesses have historically found it hard to let go of brands, but rapid changes in consumer tastes and fashions are prompting the sector to reassess its portfolios more strategically. A laser-sharp focus on profitability and return on capital means executives can no longer afford to cling to brands in decline, regardless of the legacy associated with those brands. Further, companies that have delayed divesting weak brands often realize a significant discount in sale value.

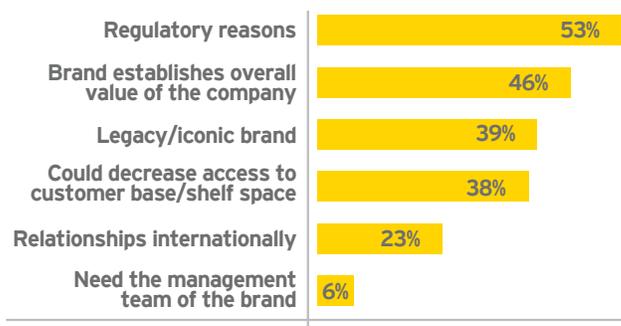
Many companies now recognize divestment as a valuable tool for focusing resources on core categories and premium performers. The study found that 58% of executives would consider divesting a brand if it was found to be off-trend. More than 40% would consider selling if demand for a product was decreasing or it was losing market share.

And there are plenty of recent examples. In order to focus on faster-growth products, Campbell Soup Company sold its European soups and sauces division, which had slowed in recent years, to CVC Capital Partners. GlaxoSmithKline sold its Lucozade and Ribena brands to Japan's Suntory Beverage & Food as a result of the products not being as well-recognized in the emerging economies that GlaxoSmithKline wants to focus on. Unilever has been one of the most active sellers: it has divested lower-growth food brands, such as Skippy peanut butter and Wishbone dressings, to focus on its higher-growth personal care and developing markets businesses.

Q: What factors have motivated you to consider a divestment?



Q: What factors might limit your desire to divest a brand?





▶ **Conduct frequent portfolio reviews to keep pace with market changes**

Portfolio reviews should be conducted regularly in order to determine the strategic path forward and whether markets shifted sufficiently to warrant a divestment.

However, despite the strategic benefits, executives remain reticent about brand divestments when they need to generate revenue growth. As a result, many consumer products companies allow less-favored brands to die off slowly, rather than monetize what could be valuable assets for a buyer prepared to invest.

One key concern centers on how a divestment might affect the overall value of the parent, cited by almost half (46%). More than a third (39%) said they would be very reluctant to sell an iconic or legacy brand.

Many are nervous about selling assets without a replacement earnings stream already lined up. Executives also fear that selling even declining, low-margin businesses may be earnings dilutive at a time of low interest rates, particularly if the business has been de-levered in recent years. While these are valid concerns, establishing a regular portfolio review process allows companies to address them effectively and take long-term, proactive decisions on which brands deserve further investments and which should be divested. Embedding this process as part of the company's strategic planning enables executives to anticipate trends and assess individual brand performance over a period of time. This approach will also improve communication with investors and other stakeholders, who will place value on well-chosen divestments if the strategic justification is clear and well-stated.

Consumer products divestment successes

Percentage of companies achieving higher valuation multiples for their remaining business following their last divestment



81%

when it was based on a definition of core operations that had been updated in the last 12 months

64%

when they based their recent strategic divestment decision on their portfolio review

77%

when they conducted portfolio reviews twice a year

Consumer products, cont'd.

▶ **Act quickly to maximize value**

Once the portfolio review provides compelling insight, management should not hesitate to act on it. Investors in companies that choose to sell non-core units in a low-growth category or with a weak competitive position view such decisions positively. Even if a disposal is earnings dilutive in the short term, these assets are usually starved of both capital and management attention. Delaying a sale will therefore likely erode value; by contrast, acting early to maximize value and reinvest capital in areas where it can be most effective often pays off over the long term.

For example, in December 2013, Mondelez announced plans to sell a controlling interest in its SnackWell's cookie and cracker business to Brynwood Partners, a private equity firm that specializes in revitalizing consumer products companies' faded brands. The deal seemed to be driven by Mondelez's cost-cutting efforts and an initiative to have another owner invest in the brand while continuing to keep some financial stake in the business's future success. Letting go of a brand is often far from easy. Holding on to it too long can be harder still.

“Any businesses that are a drag on revenue growth and gross margins (and hence dilutive to the group) are candidates for divestment; the strategic factor for our last divestment was that the business had limited international exposure. There is scope to improve our portfolio review process, by providing more lead time to prepare for divestments and hence retain value.”

– Executive at a UK-based consumer products company

Divestment dialogues: multinational beverage company

“We operate in different geographies and have a number of product lines across different subsidiaries,” observes the EMEA-based Chief Strategy Officer. “So it is important for us to keep strategic reviews of our portfolio as an ongoing process.”

The company uses portfolio reviews principally to set unit-level targets. This gives an unbiased impression of subsidiaries’ performance down the line, and it helps the company achieve its overall objectives.

“We particularly look to quantify sales growth during the portfolio review process as it compares to market growth overall,” the CSO adds. The company also looks at strategic factors such as current and future attractiveness of the markets in which subsidiaries operate, units’ positions within different markets and how important different units are within the core businesses.

A portfolio review process influenced the company’s last divestment, which generated a sale price 20% higher than expectations and improved the company’s valuation multiples. Even so, the CSO says increasing the frequency of the review process, and working off better industry benchmarks, could improve the process further.

Successful divestments boost pharmaceutical share prices

Investors in life sciences are attracted to companies that allocate capital to drive shareholder value. Companies need to reposition themselves for growth in a sector hit by global austerity, patent expirations, rising R&D costs and extensive regulatory change.

► Focus on the core

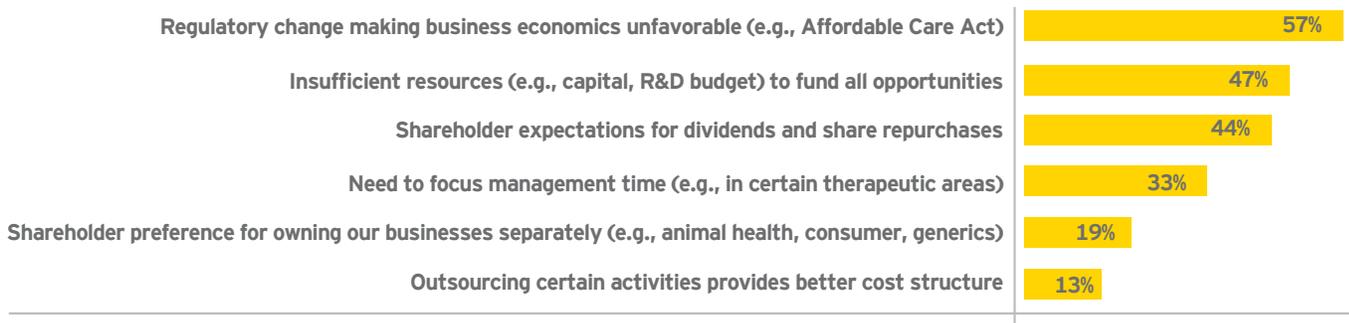
Leading players are refocusing their businesses around their most profitable and fastest growing units. Some companies now have a number of non-core assets resulting from expansion into new therapy areas, adjacent businesses and new territories. To remain competitive, these companies need to identify divestment candidates that are less profitable but demand a large amount of capital and/or management time. Those divesting non-core and less profitable business lines are being rewarded by shareholders for doing so. One of the largest recent examples of this was Abbott's US\$54.5b spin-off of its research-based pharmaceuticals business, AbbVie, announced in October 2011. More recently (in May 2013), Pfizer agreed to spin off its animal health business, Zoetis, in a deal that valued the business at US\$12.4b.

What's driving this trend toward divestment? Regulatory change is by far the most common rationale for divestments in the sector: 57% of executives identify it as a major factor. For example, the Affordable Care Act has catalyzed consolidation among health care providers. Companies need to manage costs and quickly attain the skills and technology required for success in this new environment.

Insufficient resources (e.g., capital, R&D budget) to fund all opportunities are identified by 47% as a factor encouraging divesting. This is a clear indication that divestments can enable growth, as disposing of tail brands (e.g., off-patent products) and non-core assets can raise capital for investment in higher-growth areas.

Other key drivers include a desire to fund dividends and share repurchases through divesting (44%) and a need to focus management time on core business areas (33%).

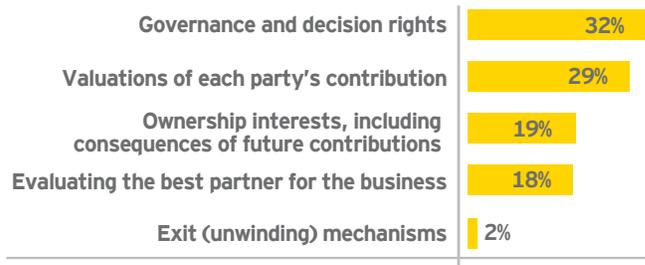
Q: What are the major factors encouraging you to consider divesting a product or business?



However, the study suggests that life sciences companies are not taking action based on their portfolio review results. Just 27% of executives in the life sciences sector state that their portfolio review was the main factor behind their last divestment, which compares to 41% across all sectors.

The primary perceived barriers to a successful divestment are issues around governance and decision rights (32%) and the valuations of each party's contribution to a joint venture (29%).

Q: When considering divesting into a joint venture or similar structure, what is the primary barrier to a successful transaction?



Life sciences, cont'd.

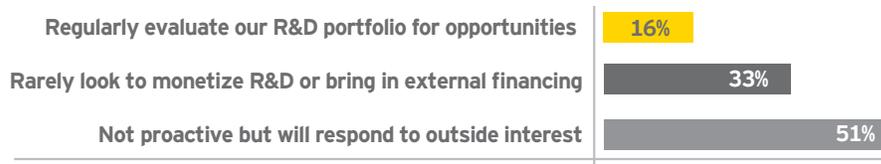
► Monetize non-core R&D projects

Companies can extract value from under-exploited assets through a joint venture or licensing.

Yet most companies are not proactive in identifying ways of monetizing their R&D projects: more than half of executives react only to expressions of outside interest and a third said they rarely look to monetize R&D or bring in external financing for projects.

Meanwhile, just 16% indicate that they regularly evaluate R&D portfolios for monetization opportunities. This population will gain the greatest benefit from successful divestments as they are most likely to be serial dealmakers who are accustomed to monetizing under-utilized assets and, therefore, will not “leave money on the table.”

Q: What is your approach to monetizing R&D projects or securing third-party financing?



► Consider and target most-likely investors

Success in divestments requires a clear and accurate picture of each unit's contribution in order to identify where opportunities exist. To achieve this, firms need to allocate costs and profitability effectively and, when potential deals are identified, they should act promptly to prevent value erosion. Early preparation and decisive action are key to generating maximum revenue from divestments.

Considering the needs and perspectives of potential buyers should be integral to a divestment strategy. Private equity firms, for example, will need to carry out in-depth due diligence and see attractive IRR forecasts before committing to an acquisition. Preparation is vital to achieving a successful sale. Most executives (69%) calculate IRR figures historically, but only 31% of pharmaceutical companies calculate IRR forecasts during their portfolio review.

Divestment dialogues: South Korea-based life sciences company

The head of finance at a life sciences firm based in South Korea says that reviews are conducted continuously to identify local and international trends.

Frequent reviews enable the company to keep track of policies, risks and opportunities in different business units. In the process, “EBITDA is one of the most important aspects, as it assesses our company’s profit margin,” the head of finance notes. “It also indicates that our company is able to keep our earnings at a reasonable level. In terms of strategic elements, identifying subsidiaries that are technological leaders is fundamental to our long-term success.”

“A proper strategic review is required to assess the portfolio,” he adds, “so that we can make the right divestment decision.”

The company’s most recent divestment saw a six-month gap between signing and closing due to new, necessary corporate structures, including new legal entities and necessary trading permits. Ultimately, the divestment had a better-than-expected effect on the company’s valuation multiples.

When it comes to improving his company’s portfolio review process, the head of finance says areas that could be enhanced include obtaining better industry benchmarks, establishing a dedicated team and ensuring findings have a bigger impact on strategic decisions.

Overall, he believes that divestments are becoming increasingly important for life sciences companies. “Life sciences is entering a period of consolidation, global expansion, and a period of off-shoring R&D and clinical trials,” the head of finance says. “It is more important than ever for companies to monetize their R&D portfolios and maximize shareholder value. In order to do that, companies must regularly review their existing portfolio.”

Focus on capital allocation leads to robust dealmaking

Capital allocation is paramount for oil and gas companies that have to make long-term investment decisions against a global backdrop of fluctuating commodity prices, shifting energy politics, and both changes in supply and demand and the wider capital markets. Companies are constantly assessing what geographies, asset types and areas of the value chain offer the best opportunities. This is reflected in robust levels of M&A activity. The total reported deal value for oil and gas transactions in 2013 was US\$336b, according to EY's *Global Oil and Gas Transactions Review 2013*, which draws on data from IHS Herold, Inc.

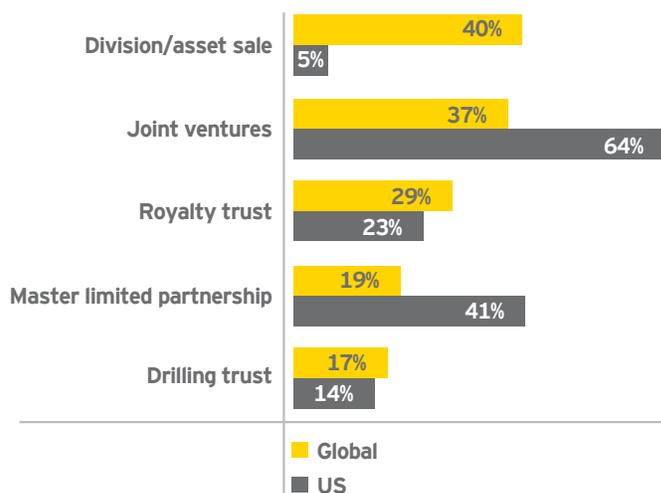
This dynamism makes portfolio management a core activity for most businesses in the sector. Almost two-thirds (63%) of oil and gas executives have made a major divestment in the last two years – the highest proportion of any sector (compared with 55% overall).

In many regions, oil companies have been seeking to sell off downstream operations and focus on potentially more lucrative upstream plays. In other parts of the world, market demographics are encouraging downstream investment, highlighting the range of strategic options available in just one area of the value chain.

Meanwhile, new financial structures, such as master limited partnerships, have aided divestment execution in the US. Forty-one percent of US executives surveyed have considered this type of divestment. These high-yield products have experienced a huge surge in popularity as a result of the low interest rate environment.

With many oil and gas projects operating as joint ventures, successful companies in the sector need to be as adept at managing relationships with parties as diverse as state-sponsored to private, niche regional technology specialists as they are at managing their portfolio of businesses and assets.

Q: Over the past year, what structures/transactions has your executive board reviewed with respect to a divestment or spin-off?



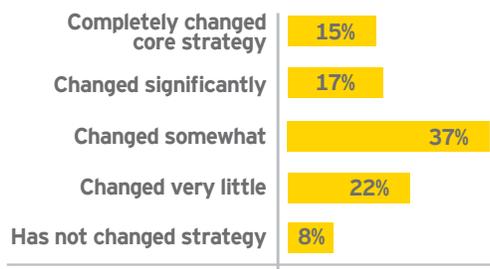
► Embrace technological change

Evolving technology has become a major consideration in the portfolio review process. Nearly a third (32%) of executives say technological change has completely or significantly changed their core strategy, with a further 37% saying their strategy has changed somewhat.

The successful application of horizontal drilling and hydraulic fracturing technologies, for example, has transformed the US energy market. The US has moved from major importer to potential exporter of natural gas in less than a decade. The impact of these technologies has seen oil field service companies base M&A strategies on securing a competitive advantage in new technology. Half of firms in the US, where new drilling technologies are well-established, have produced a new model of their core business in the last 12 months, compared with just 21% of oil and gas firms in total.

Other regions could undergo a similar transformation to the US and, as the use of technology becomes more widespread, multinationals need to consider how this will affect which assets they should be investing in and which should be considered for divestment. Many oil field service companies base their M&A strategies on securing a competitive advantage in new technology and/or applying technology in new geographies.

Q: How much have technological changes in the oil and gas industry affected how you define your strategy?



Oil and gas, cont'd.

► Overcome challenges

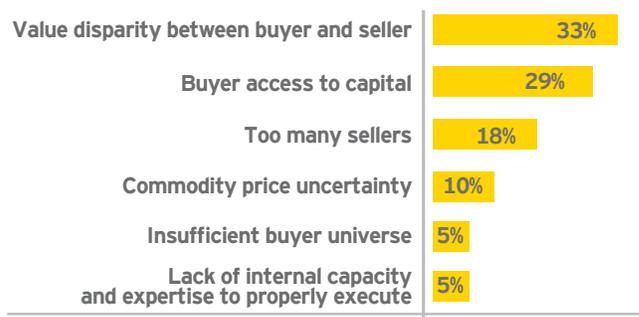
The two key challenges identified by oil and gas companies undertaking strategic divestment are pricing gaps between buyers and sellers and access to capital.

A third of oil and gas executives see value disparity between vendor and buyer as the main obstacle to completing a divestment. Commodity price is a key factor in this and natural gas prices, in particular, continue to have wide regional variations. However, oil prices have been trading in a narrow band close to US\$100 during the last 18 months – a level of pricing stability that the industry has not seen for 15 years.

Any uptick in volatility could in fact be a contributor to increased transaction activity, with such an environment conducive to private equity investors and also triggering distress-driven transactions, particularly in stretched parts of the supply chain and for projects with high break-even points.

For 29% of executives, buyer access to capital is the greatest challenge when divesting an asset. Increasing capital markets activity could see buyers with good balance sheets expand acquisition activity, possibly exploiting the competitive advantage over less well-funded peers. The IPO window reopening has also provided a credible alternative to divestment.

Q: What do you see as the greatest challenge in successfully completing a divestment in the current market?



Relatively stable oil prices and recovering capital markets mean that oil and gas companies have plenty to be optimistic about as they consider future investment. A strong focus on portfolio management and long-term strategy remains crucial as companies in the sector determine which non-core businesses or assets to divest.

Industry players who can execute their strategy successfully will be best placed to take advantage of the uncharted territories of this constantly shifting environment. It is perhaps surprising that only 5% of executives viewed ability to execute as a challenge to success.

Divestment dialogues: Americas-based oil and gas company

There are few industries that have undergone as much dramatic change as the oil and gas sector, says the Chief Financial Officer of an Americas-based company operating in the industry. “Horizontal drilling and fracking have made previously unprofitable deposits profitable,” the CFO notes. “These technologies are responsible for the drilling booms happening across the US and Canada, as drillers are now able to access oil and gas deep under layers of rock in these countries.”

Accordingly, the CFO has been involved in a transformation of his business that has seen it completely revamp its core business to keep pace with developments in horizontal and fracking technology. “We consider some units that are based on outdated technologies, and are therefore no longer economically viable,” he says. “This is occurring throughout the industry, as companies seek to rebalance their portfolios to keep up with technological developments.”

As companies navigate the revolution in the oil and gas industry, the portfolio review process has come to the fore. Reviews have proven a valuable tool for identifying acquisitions, growth opportunities and subsidiaries for divestment.

In its most recent divestment, the company’s annual portfolio review process was the main driver, says the CFO. The company relies on the review to “... quantify the current and future attractiveness of subsidiaries’ markets, units’ competitive positions, cost synergies with other parts of the business and whether or not subsidiaries are part of our core business.”

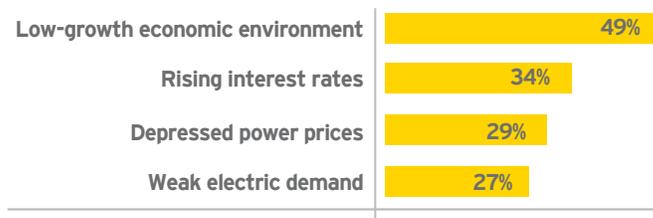
Power and utilities

Sector leaders rationalize portfolios in a challenging market

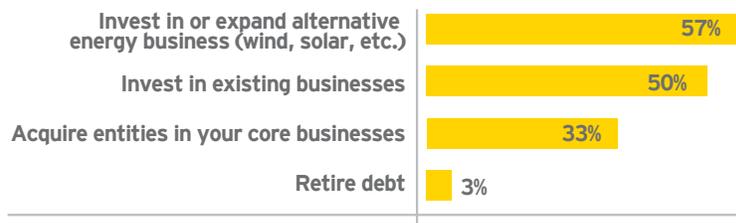
Power and utilities companies globally are dealing with a range of new challenges. Declining demand, customer price elasticity and the growth of distributed generation are threatening conventional business models. With low wholesale prices and surplus generation capacity in many developed markets, and network investment now plateauing after many years of strong growth, utilities are actively investigating ways to preserve market share and leverage existing skills, experience and capital.

These trends have spurred divestment and transactional activity, as nearly half of executives in the sector (49%) cite low economic growth as the main driver of divestment activity.

Q: What power and utilities sector trends have motivated you to consider a divestment?



Q: What will you do with the money you raise from your divestment?



Much of the current appetite for divestments in the developed utilities sector reflects core themes of rebalancing and reform.

We expect continued outbound investment from utilities in the US and Europe into the emerging markets. We also expect utilities to continue to diversify into upstream and downstream parts of the supply chain, such as energy services, in order to retain current market share and target growth opportunities. This follows low wholesale energy prices and customer awareness and elasticity of retail pricing in Europe and North America.

We also expect continued activity as a consequence of reform. Divestments, acquisitions and investment follow clear signaling by governments that private sector capital can play a strong part in the future of markets. The Japanese government's intention to liberalize its electricity market, for example, has potential new entrants considering their options and awaiting critical future announcements about market frameworks. Announcements in Australia regarding private sector financing of network investments and selling government-owned generation are also gaining strong interest. We expect divestment and transactional activity to follow these themes in 2014.

▶ **Capitalize on new revenue streams**

Demand reduction, new technologies and customer price sensitivity are driving power and utilities companies toward new revenue streams elsewhere in the supply chain and new regions. Most executives (57%) plan to allocate divestment proceeds toward investing in alternative energy businesses, such as wind and solar power, in order to capitalize on the strong growth in those markets and hedge against reductions in revenue from more traditional sources of generation capacity. This is particularly the case in Europe and the United States, where utilities are responding to declining revenues domestically by out-bounding investment to developing markets in Africa and South America.

US gas and electricity utility provider Duke Energy, for example, recently shifted capital from traditional utilities to alternative energy when it completed a \$600m sale of telecom division DukeNet Communications to Time Warner, following a couple of earlier acquisitions: a solar project from Recurrent Energy and a Chilean hydropower generator from CGE Group.

▶ **Seek out regional growth opportunities**

Divestments are also financing expansion into emerging and developing geographies with strong growth prospects. Europe-based companies hit hard by the regional economic climate are looking to emerging markets for growth.

Turkey's electricity grid privatization, for example, has boosted acquisition activity in the power and utilities sector over the past few years, a trend that is set to continue as expected government plans to sell the country's generation assets come on line. Africa is also becoming one of the most popular target destinations among global acquirers.

Power and utilities, cont'd.

▶ **Reallocate capital to the core business**

Power and utilities businesses are also reallocating capital freed up from divestments to focus on and reinforce their core business: 50% expect to invest in their existing business, and a further 33% are planning to use sale proceeds to make acquisitions for their core business.

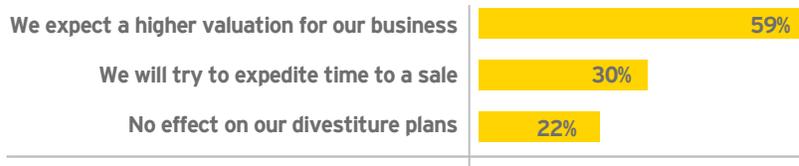
Germany's E.ON is leading this trend, having exceeded its disposal target of €15b (US\$20.5b) by over €4b (US\$5.5b). For example, E.ON netted \$1.75b on the sale of its stake in Slovakian gas company SPP to Czech energy company EPH and signed an agreement for the sale of German network operator E.ON Mitte.

Divestment is a key element of E.ON's strategy, enabling it to expand its core power generation activities, reduce its network carbon intensity and expand outside Europe.

▶ **Target financial buyers**

Private equity and sovereign wealth funds are showing increased interest in power and utility assets, in particular network assets with predictable, often regulated, revenue streams. As a result, 59% of executives expect to receive a higher valuation for their business in the near future than currently, while 30% have expedited their sale plans. Early preparation and an understanding of where the value lies for particular financial investors are key to executing a successful sale.

Q: How has the increase in private equity and sovereign wealth fund investors affected your divestment plans?



Divestment dialogues: Australia-based utilities company

“We divested a unit when its IRR, EBITDA margin and return on invested capital were not as expected,” the CFO says. “The unit also was not aligned to our overall strategic goals, which gave us a limited parenting advantage. On top of that, this particular unit was not a technological leader in its space.”

This divestment helped the company free up cash for investment in faster-growing areas, as the tough market climate for power and utilities companies remains a pressing concern.

Forward planning identified in the portfolio review process proved key for the success of this divestment. In particular, regulatory clearance added time between signing and closing. “With most of our transactions, applying for licenses and getting clearance in a timely way simply has never happened,” the CFO notes. “This can have a major effect on deals – time delays can ruin them entirely.”

The company conducted a portfolio review of its various subsidiaries annually, but the process was not a “static” one: “We are always looking to increase our understanding of business unit performance and the broader industries in which subsidiaries operate.”

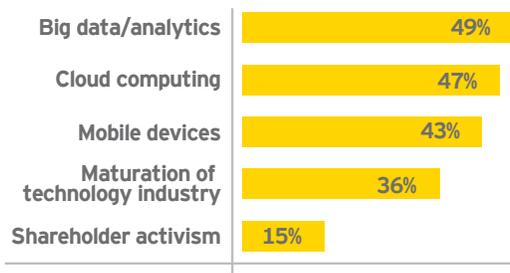
Rapid innovation drives strategy shifts

Few industries can both create and take advantage of disruptive innovation like technology. Rapid developments in big data, the cloud and mobile computing are transforming the sector. Technology companies need to carefully manage their portfolios to keep pace given their cost of capital and potential for higher returns.

Technology executives clearly recognize this. Almost half (49%) of the sector's executives surveyed said the big data trend had motivated them to consider a divestment. Rationalizing portfolios and positioning their businesses to benefit from new growth areas have become crucial strategies for the industry's leading companies to adapt to change and drive value for investors.

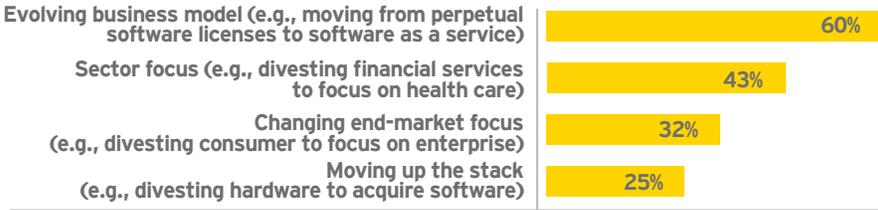
And 47% cited cloud computing as a driver of their divestment agenda. For example, Nokia sold off its mobile phone arm to Microsoft so it could refocus on its core telecommunications equipment business. Others are looking to refine their strategy. This is true of Symantec, the security software provider, which has come under pressure from activist investors to sell its storage and server-management division to focus on faster-growing cloud solutions.

Q: Which key industry trends have motivated you to consider a divestment?



Whether pressure is exerted by new innovations or activist shareholders, firms cannot afford to be complacent about the composition of their asset portfolios. And it's here that divestments can really add value. For example, many companies (60%) are moving their business model from perpetual software licenses to services, among other changes. Companies are also focusing on different sector customers (43%), such as divesting financial services-focused businesses to serve health care customers. And many (32%) are also changing their end-market focus, such as switching to business clients from consumer products.

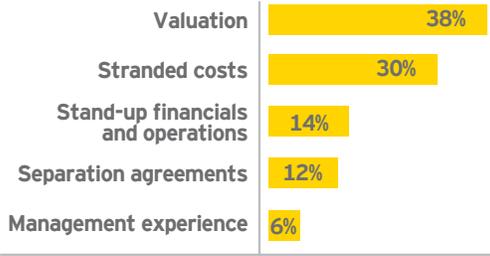
Q: What are the primary strategic reasons for you to consider a divestment?



► Search for hidden value in your portfolio

Despite the benefits, valuation ranks as the biggest divestment challenge: technology firms regularly use their parent company’s market value, rather than that of the underlying asset, as a basis for valuation. Further, many technology companies are sitting on hidden gems: selling unfashionable units can unlock hidden value that analysts may not see. For example, many slower-growth companies own assets with the potential to be valuable to buyers as new innovations come to light, and many “industrial” companies are finding assets that, if packaged and prepared as technology companies, could be sold at technology sector multiples. Selling these assets can offer companies a more efficient route to monetization than developing them internally.

Q: What is the biggest challenge you need to overcome with your divestment?



Technology, cont'd.

► Look beyond operational challenges

Operational challenges can also prevent technology businesses from being bold in their divestment strategies, even if their portfolio review concludes the need to sell a business unit. “Our company is a highly integrated, complex organization with many legal entities,” explains one technology executive. “The challenges posed by carve-outs are the high costs and the risk they will be more trouble than they are worth.”

Stranded costs are also cited by executives as one of the biggest challenges to overcome for their next divestment (30%). However, effective planning for business separations, including conservative time estimates, consideration of resource issues at the parent and asset level and evaluating the value potential buyers may see in an asset, can help alleviate those issues.

If slower-growing technology assets are well carved out for sale, the divestment process should not prove too distracting at board level. The assets are usually highly attractive to the right buyers: they offer high margins and substantial cash flows with little need for further R&D. Technology companies serious about focusing on fast-growing markets need to look closely at sending deals their way.

“Crises in small, non-core businesses were becoming a distraction for management. They prompted a major project to understand where we made our money. We had around 150 businesses and found that the top 15 were providing 60% of the profit. The next 10 gave us another 25%. There were maybe 75 businesses where the net profit was zero.”

– Executive at a US technology company

Divestment dialogues: Germany-based technology company

Portfolio reviews “help manage the company’s investment tools, while keeping a proper record of different elements that contribute to an effective portfolio,” says a corporate development executive.

The company’s continuous portfolio reviews consider financial and strategic factors, but the main focus is sales growth, “the major financial concern, as it so closely impacts the running of the business,” he says.

The company’s thorough portfolio review process played a role in its last major divestment. “The strategic factors we examined when considering this divestment concerned its low levels of synergies with other parts of our business and its dissimilarity from our core business,” the executive explains. “It also was not a leader in its operating space, and the market in which it operated was not an attractive one for us.”

Despite its recent successes, the corporate development executive anticipates some challenges relating to IT separation, regulatory clearance and stranded costs. The executive also notes that the market is likely to see an uptick in divestments over the next year.

Conclusion

In light of rapid technological advances, regulatory changes, increased shareholder scrutiny and customer purchasing power and demand shifts, strategic portfolio reviews are the most important tool to optimize capital allocation. Decisions regarding which assets to invest in or sell off will drive a company's competitive advantage and long-term growth.

Frequent and effective reviews help companies avoid some symptoms of portfolio inertia that negatively impact business performance:

- ▶ Lack of alignment between capital allocation and the strategic value of portfolio components
- ▶ Neglecting market trends, resulting in investment gaps and missed opportunities
- ▶ Reactive postures that result in lower-quality investment options and wasted effort in evaluating non-strategic options

An effective portfolio review agenda is based on an up-to-date definition of the core business – that is, a clear model of where the company should be focusing its capital to reach current and future market needs. The review itself should then analyze whether each business unit fits within that core strategy.

Performing this assessment regularly – ideally, every six months – should reveal divestment candidates as those business units that are under-performing or non-core to strategic goals, as well as those that may have greater value for another owner or as a separate entity. But portfolio review results are only effective if companies dedicate resources to implement suggested changes and divest units that are a poor strategic fit.

Companies are realizing that divestments are a growth tool, similar to acquisitions. Those that adopt leading practices are completing divestments that achieve higher sale prices and are rewarded by investors through stronger valuation multiples on the remaining business. These high performers, just 12% of executives, are in a better position to adjust to changes within their sector and in the economy as a whole.

Respondent demographic

- ▶ 80% of executives are CEOs, CFOs or other C-level executives.
- ▶ Executives are from companies across the Americas, Asia-Pacific and Europe, the Middle East, India and Africa.
- ▶ More than eight industry sectors are represented.
- ▶ More than half of the executives represent companies with annual revenues that exceed US\$1b.
- ▶ Executives stated they have knowledge of or direct hands-on experience of their company's portfolio review process and divestment activity.

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How we can help

EY's dedicated, multifunctional divestment professionals can help clients improve portfolio management, including:

- Developing a clear strategy
- Updating it frequently to stay relevant to the market
- Understanding available capital
- Deciding where that capital can be released from current activities and reallocated toward higher-growth areas

We then help clients prepare for a divestment and become a more informed negotiator. We work with corporate and private equity clients on a variety of divestments, including sales of the entire company, carve-outs, spin-offs and joint ventures.

For carve-outs, in particular, we advise on which businesses are worth investing in and which may be worth more to another owner. Our sector-focused teams can also help clients understand the effect a divestment could have on the remaining company's growth, brand and stakeholders.

Further, we can help maximize transaction value by guiding you through preparation and execution and removing any potential bumps in the road before buyers get involved. For example, we create a compelling value story by analyzing the growth opportunity, assessing underlying trends and identifying hidden value in earnings, corporate allocations, real estate, working capital, human resources, IT, operations and tax. Finally, we assist with negotiations, Day One readiness and helping your company manage its remaining cost structure and focus on future growth.

For a conversation about your capital strategy related to divestments, please contact us

Pip McCrostie

Global Vice Chair
Transaction Advisory Services
pip.mccrostie@uk.ey.com
+44 20 7980 0500

Steve Krouskos

Deputy Global Vice Chair
Transaction Advisory Services
steve.krouskos@uk.ey.com
+44 20 7980 0346

Paul Hammes

Global and Americas Divestiture
Advisory Services Leader
paul.hammes@ey.com
+1 312 879 3741

Martin Hurst

Europe, Middle East, India and
Africa Divestiture Advisory
Services Leader
martin.hurst@de.ey.com
+49 6196 996 27365

Stephen Lomas

Asia-Pacific Divestiture Advisory
Services Leader
stephen.lomas@au.ey.com
+61 3 9288 8441

Kenneth G. Smith

Japan Divestiture Advisory
Services Leader
kenneth.smith@jp.ey.com
+81 3 4582 6400

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