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Financial services

Global Corporate Divestment Study

Opportunism requires preparation

EY

Building a better working world

A note from financial services leadership

David Barker
EY Global Banking and Capital Markets Transactions Leader

David Lambert
EY Global Insurance Transactions Leader

Nadine Mirchandani
EY Global Wealth and Asset Management Transactions Leader

Financial services companies need to be better prepared to move when there is a receptive buyer and a strategic rationale to divest. That's one of the top messages from this year's *Financial Services Global Corporate Divestment Study*. The study also indicates that poor data is clouding value assessments for many sellers and that most companies are not seeking wider benefits from their investments in regulatory programs.

As the dust begins to settle after years of increased regulatory scrutiny, financial services firms are entering into a "new normal" and are refining their assessments of core and non-core businesses. Decision-makers are evaluating their business units' performance with a view to divestment in a balanced fashion, weighing the costs of compliance alongside opportunities to re-deploy capital elsewhere.

Against this backdrop, our study points to some clear ways that financial services firms can learn from last year and from expectations for the year ahead. Following our financial services market perspective and leading practices, you will find our full global study that includes a more robust exploration of portfolio review and divestment strategy insights. We hope you find it useful to improve the value and efficiency of your divestments.

Financial services key findings

Poor data

83% of financial services companies say poor-quality data is making it difficult to use analytics effectively in divestment decision-making

Inattention to regulatory programs

51% have not leveraged their required investments in regulatory programs

Opportunity knocks

53% pointed to opportunistic approaches as a reason for recent divestments, more than double the figure from last year (25%)

Emerging markets on the hunt

51% of companies surveyed (compared with 27% last year) expect the most likely buyer of their next divestment to be a foreign emerging market financial institution seeking global expansion

Lessons learned

Key findings

Why divest

70%
of companies are using divestments to fund growth

84%
believe their divestment created long-term value in the remaining business

Portfolio review

56%
of companies' portfolio review processes have resulted in unsuccessful divestments

49%
say access to meaningful data is the biggest portfolio review challenge

Execution

75%
more companies generate a sale price above expectations when they focus on creating value pre-sale

33%
more companies generate a sale price above expectations with an operational separation plan

49% of companies are planning to divest within the next two years

Lessons learned

Financial services highlights

Of the dominant divestment drivers in financial services identified by our study, chief among them is opportunism (responding to approaches), particularly for banking and asset manager respondents, but echoing a trend across all sectors surveyed in the study. More than half of financial services executives identified opportunism as a trigger for their most recent divestment – double the result from last year (25%) – and 42% are open to opportunistic divestments this coming year.

Opportunities may arise from unexpected places, such as sudden interest from an emerging market buyer or as a result of such market factors as improving availability of appropriately priced debt financing. Being ready to move at the right time can significantly affect the speed and price at which opportunistic divestments can be executed.

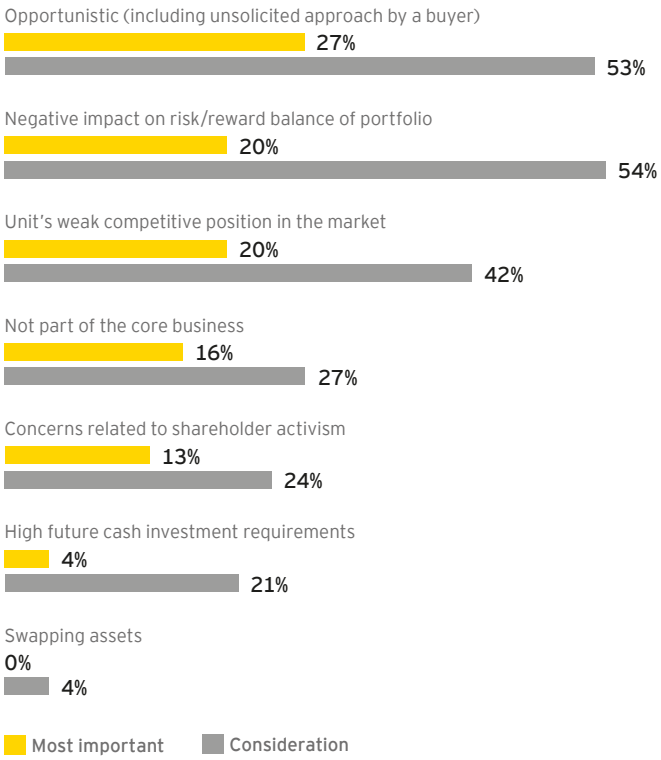
One challenge for financial services businesses is the interrelations across different businesses due to shared compliance and regulatory resources and capital usage. Understanding the value of each business, as well as the impact on value for the group of not having a business in the portfolio, is critical to assess opportunistic approaches.

Changing sentiment in equity markets has been a notable feature of 2015, such that dual-tracking of IPO and sales of businesses has been a successful tactic for a number of divestors. Management teams have been, and will continue to be, well served by being ready for both routes, depending on which offers greater value.

"The emergence of opportunism is a key observation. Being ready on business and separation issues in advance of opportunistic divestments can garner significantly more value."

Charlie Alexander, Asia-Pacific FS Transactions and FS Divestments Leader

Q What triggered your most recent major divestment?



When the portfolio review says sell, sell

Half of financial services executives say they have held on to certain assets too long. Firms have been holding on to businesses due for divestment for a number of reasons, including waiting for an improvement in the market outlook, increasing buyer appetite and underestimating the distractions of holding. Another driver has been waiting for increased availability of debt at a reasonable price, which enables private equity buyers to acquire assets such as loan portfolios.

Some firms have held on to businesses due to limited P&L capacity for losses, with the intention of improving the business, then subsequently divesting. In our experience, often improvements are not prioritized and subsequently do not materialize, leading to further losses during the extended holding period. Management also suffers the distraction and necessary time investment of running the underperforming non-core business.

In other instances, rather than divesting, firms are electing to run down certain business units. However, firms often underestimate run-off costs, whereas a more robust estimation of those costs might have supported a much earlier and sounder decision to sell.

> "We are seeing a number of financial services firms learning from past decisions and taking tougher, more proactive divestment decisions whereas in previous years, they may have held off in hopes that continuing to hold the business would yield more value."
>
> **Geoffrey Mize, Americas FS Divestments Leader**

Many executives are entering 2016 with a much greater appetite for divestment when the case is strong. The takeaway lesson for executives from this period is that indecision and procrastination usually lead to both direct and indirect costs (including people and regulatory costs), so when a rigorous portfolio review points to divestment, it's time to sell.

Invest in analytics and leverage required investments in regulatory programs

One of the challenges in analyzing financial services companies is reconciling the contrasting views from a business held at the operational level, the country level and the legal entity level. More than half (58%) of the financial services respondents said that shortcomings with their portfolio review process resulted in a failure to achieve intended divestment results. Eighty-three percent of executives said insufficient or poor-quality data made it difficult to use analytics effectively in divestment decision-making.

The need for quality analytics is greater than ever. At the same time, firms are required to produce more data than ever before to comply with their regulatory obligations, such as Solvency II, CCAR and recovery and resolution planning.

Despite this, one of the key learnings from this year's study is that many firms are failing to leverage this data and analysis. In fact, more than half of executives had not taken any steps to help their divestment efforts by capitalizing on their investments in required programs. This presents a major opportunity to extract value and improve divestment processes and results with little extra cost.

Learn to leverage by breaking down barriers

Many companies need to do more to break down the barriers – organizational and cultural – that separate their risk and regulatory arms from those business units seen traditionally as "creating value." For many large, long-established financial services firms not known for their dexterity, this can be easier said than done. Nevertheless, it is increasingly crucial in order to make the best possible divestment decisions and have the capabilities to implement those decisions effectively.

Many financial services firms have multiple and complex systems. Leading firms are investing in simple systems that capture all of the relevant information. They are also mining the information they are producing and using the learnings from the regulatory efforts to enhance their preparedness and approach to divestitures.

Examples of actions being taken include:

- Leveraging a deeper understanding of the relationships that exist across legal entities, business units and functions
- Assessing the quality and cost associated with existing service agreements and evaluating if the way services are provided today is being optimized
- Investing in simple systems that capture the relevant information from regulatory efforts so that it can be reused, and doing so outside of complex legacy systems
- Involving regulatory and risk groups earlier and more deeply in dialogues around divestments

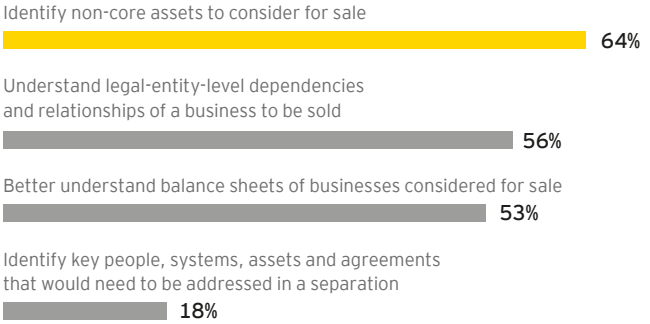
Invest in predictive analytics

Across all three financial services sub-sectors, predictive modeling has emerged as one of the most valuable tools to better assess business unit performance, and 69% of financial services executives plan to invest in this area. Particularly important will be considering the potential significant impact of new and disruptive competitors such as fintech businesses, as well as understanding the impact of different scenarios for key market assumptions such as interest rates. Further, data from regulatory programs can be used to inform predictive analytics.

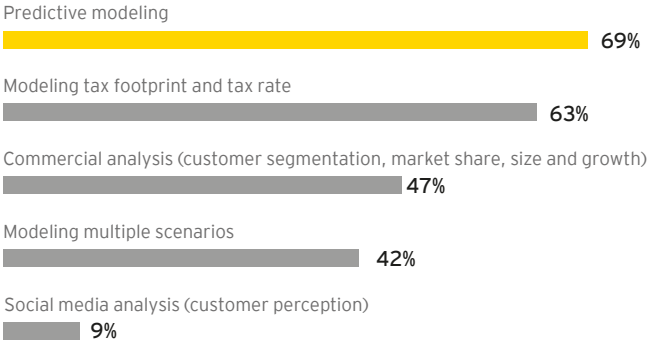
"In the European insurance context, Solvency II is providing useful insights that can inform strategic decision-making. Similar trends are evident around the world. At the same time, management teams have at their disposal a wide range of tools to improve returns, including internal reorganizations, reinsurance of certain types of risk, operational transformation and sales of portfolios or entire operations. In this environment, analytical models developed to meet regulatory requirements can help decision-makers effectively assess those various tools."

David Lambert, Global Insurance Transactions Leader

Q For those who have leveraged the required investments in regulatory programs such as CCAR or recovery and resolution planning, how have you done so to aid your divestment efforts? (Select all that apply.)



Q Which analytics capabilities do you expect to invest in within the next two years? (Select all that apply.)



Insurance perspective

Insurers were focusing on their core businesses in 2015. In this highly competitive sector, with margins under ongoing pressure due to high levels of legacy costs and very low investment yields, insurers should continue to focus on key competencies rather than expending capital and precious management time on peripheral activities.

This is especially the case as business models continue to diverge, with an increasing divide between legacy insurance businesses and forward-looking new businesses using digital customer interaction, technologically enabled pricing and product design, and streamlined processing and settlement in a way that has not previously been possible. This increasing disconnect between the old and new is likely to drive divestment of back books or entire legacy operations in 2016.

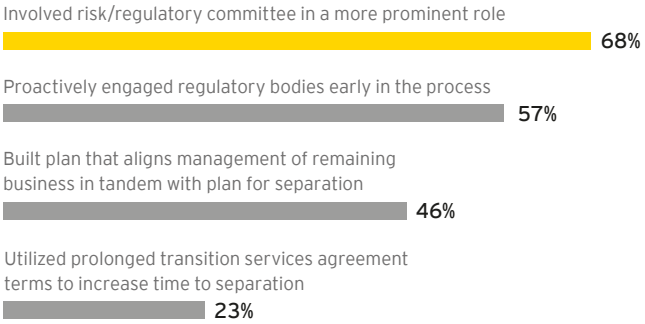
Interestingly, many insurers stated that they are not planning to divest, but that they would be open to opportunistic approaches. There is clearly a large market for insurance businesses and portfolios, with substantial capital being deployed by industry consolidators, reinsurers, Asian investors, major private equity players and others.

Fully integrate risk and regulatory capabilities into deals

Financial services firms are beginning to recognize that risk and regulatory capabilities need to play a greater role in deals from start to finish. Leading practices are:

- **Integrate from start to finish**
  It is no longer sufficient to bring regulatory committees aboard early in the process; those committees need a fully integrated role. Many divesting firms need to have regulators on board before they can sell a business to the market, and having an integrated regulatory committee can help keep regulators on their side. At the very least, this can help ensure data arising from required investments in regulatory programs is fully utilized throughout the portfolio review process.
- **Bulk up on risk and regulatory expertise in deal steering committees**
  Previously, regulatory arms of firms might command one seat on a deal steering committee. The trend now is – or should be – toward several seats. Expanded resources on this front can help clarify the value of a deal, particularly in terms of its capacity to free up capital for deployment elsewhere. It can also give comfort and encouragement to buyers who are increasingly nervous about tail-end risks relating to compliance functions and the ongoing impacts of previous breaches.

Q In executing a recent divestment, have you altered your traditional approach in any of the following ways? (Select all that apply.)



Banking perspective

With countless headlines about large fines in the banking sector, legacy issues have been a major factor affecting deals. And the inability of some buyers to get comfortable with those risks has often caused early exits from deal processes. Legacy issues, such as claims for mis-selling products, have been dealt with in a number of ways, including via asset sales, pricing adjustments and providing indemnities (for 30%, 29% and 22% of bank respondents, respectively). These findings reinforce the need for early and continued engagement with risk and regulatory teams, and to proactively address such issues ahead of a divestment process.

Consider all potential buyers

The study shows foreign emerging market financial institutions seeking expansion are seen as the most likely buyers for upcoming divestments – at a level that has almost doubled over the past year.

Given the economic strains in a number of emerging markets, we consider it likely that, in reality, large and well-capitalized financial institutions from some of the more established Asian economies, such as China and Japan (itself a developed economy), may lead the acquisition charge in European countries and the US. This would be consistent with the strong growth from 2014 to 2015 in the value of financial services acquisitions by Chinese and Japanese firms in Europe and the US, of 374% and 291%, respectively.

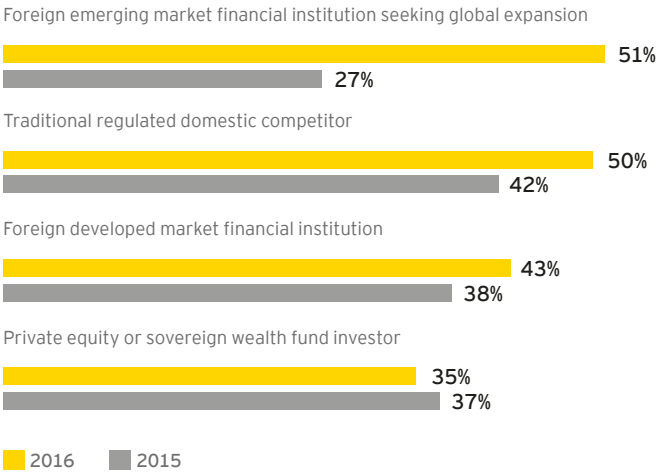
Major players in emerging markets have been burned by attempts to establish greenfield capabilities in developed markets, and they are also facing declining growth and returns in their own markets. As a result, a number of potential emerging market buyers are new entrants; divesting to these buyers may give rise to a new market "entry premium."

Considering the full range of potential acquirers, including emerging market institutions, will be important in order to maximize value. Adapting the divestment process (for example, analyzing buyers' ability to execute a deal and engaging proactively with regulators to understand their appetite for a possible buyer) and tailoring buyer information provided for the full range of likely buyers will be important to both value and speed of divestment. Tailored buyer information may include extended commercial-vendor due diligence or greater insights into the regulatory environment.

"Over 2015, major Asian buyers, particularly from China, Japan and Singapore, have seen increasing appeal in certain European assets. As the wealthy population increases and barriers to money transfer recede, Asian buyers are looking particularly at opportunities to invest in European and also US banks and asset managers."

Chris Locke, EMEIA FS Divestments Leader

Q Who would you view as the most likely buyer for your next divestment? (Select all that apply.)



Conclusion: opportunism requires preparation

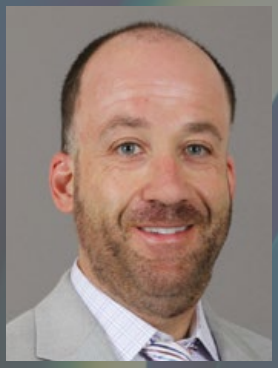
Financial services firms are continuing to refine their portfolios in the wake of significant regulatory changes since the financial crisis, and this will continue to lead to a significant number of divestments across the industry. Sixty-six percent of financial services respondents expect to see an increase in the number of willing strategic sellers in 2016, and 62% expect an increase in the number of distressed sales. Further, 56% of financial services companies expect to divest in the next two years, including 43% within the next year.

There will likely therefore be many financial services acquisition opportunities to choose from. So for potential divestors, being clear about what is core and non-core, being prepared and having a well-executed divestment process will be critical to success in the future.

Findings from across all sectors

Global Corporate Divestment Study

Learning from private equity: experts at extracting hidden value



Paul Hammes

EY Global Divestiture Advisory Services Leader

Roughly half of the companies surveyed for our *Global Corporate Divestment Study* are considering a divestment in the next two years. Yet many of these companies will struggle to generate maximum value from their divestments. This is all the more reason to share leading practices now – particularly those of organizations that excel in finding value.

Private equity (PE) firms are skilled value-finders. They are serial buyers and sellers, expert at locating hidden upside in companies. They often exit at a multiple that is many times the original purchase price. As key board members, they have an innate understanding of their portfolio companies' inherent value and whether to continue to invest or if it is time to divest.

While corporations have a different core mission from PE firms, they can learn lessons from PE on how to maximize shareholder value. Corporates face particular challenges in maximizing value from divestments: some companies may be too opportunistic, reacting to an interested buyer rather than thinking strategically about who might be the best acquirer. Many are reluctant to invest management time in an asset they plan to sell, or they may be unwilling to allocate scarce capital to such businesses. Yet by failing to properly prepare assets for sale, companies only make them less appealing to the next owner.

This year's *Global Corporate Divestment Study* focuses on the critical lessons corporations can learn from PE to increase divestment success. Our findings are based on interviews with 900 global corporate C-suite executives and 100 private equity executives, as well as external data from nearly a decade's worth of divestments.

Steve Krouskos

EY Global Deputy Vice Chair, Transaction Advisory Services

For the M&A markets, 2015 was the biggest year on record – and divestments were a significant part of that story. The divestment of non-core or underperforming businesses is now widely seen as a key way for companies to fund the next phase of growth.

So what comes next? As we look ahead to 2016, an M&A slowdown appears unlikely. Global economic and policy conditions mean that companies are likely to continue with aggressive moves to protect revenue and market share while boosting margins and profitability. While acquisitions are companies' most likely response, strategic divestments should also be a top priority.

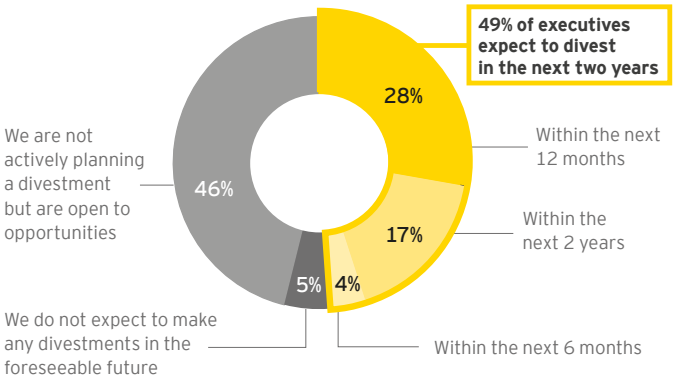
Moreover, many potential buyers are sitting on large war chests of cash to fund bold acquisitions. Nonfinancial corporates in the S&P Global BMI currently hold more than US$5.4t in cash and equivalents on top of US$1.2t of dry powder from private equity funds. In short, now is an especially good time to evaluate businesses for potential sale or spin-off.

1 Are companies achieving their divestment goals?

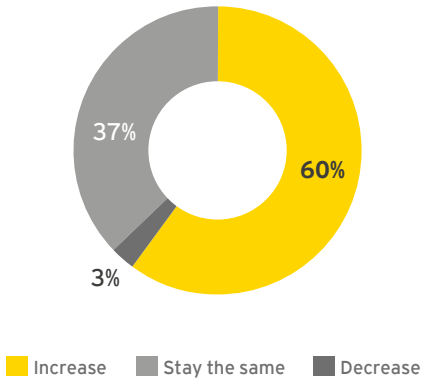
Considering that all of our study respondents already made a major divestment in the past three years, it is remarkable that nearly half expect to divest again in the next two years. This is an indication of how deeply embedded divestments have become in corporate strategy. Moreover, 60% expect the number of strategic sellers to increase in the next year alone.

Yet despite the anticipated growth in divestment activity, many companies continue to take a tactical approach to their transactions: 52% say their last divestment was opportunistic, and the greatest portion (46%) say their next asset sale, if any, will likely be opportunistic as well. This is a major shift from previous editions of the *Global Corporate Divestment Study* that saw companies making divestments more strategically – proactively selling assets, often strong ones, that were no longer core to their business.

Q When do you expect to initiate your next divestment?



Q What do you expect to happen to the number of willing strategic sellers over the next 12 months?

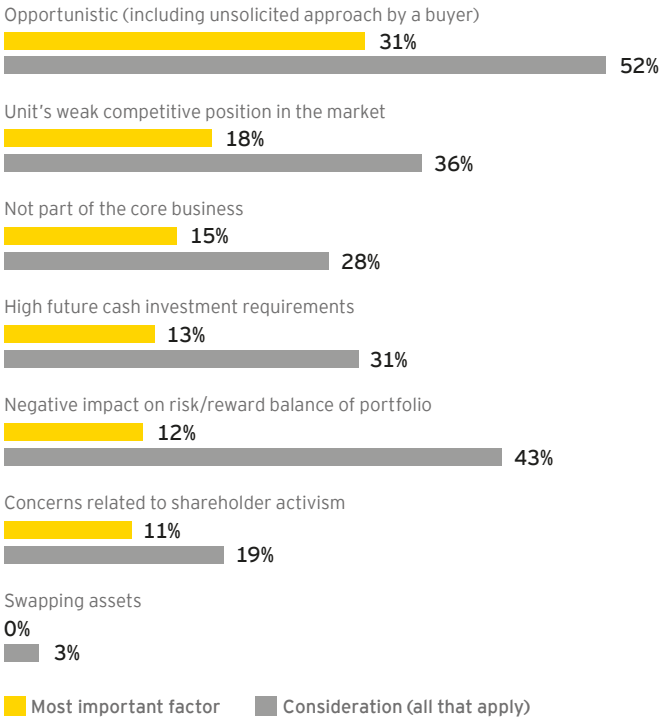


A successful divestment meets three criteria:

- Has a positive impact on the valuation multiple of the remaining company
- Generates a sale price above expectations
- Closes ahead of timing expectations

Only 19% of sellers in our survey meet all three key success criteria. What sets these high performers apart? They take the time to prepare well in advance of a divestment, they understand the potential buyer pool and the buyers' needs, and they communicate the value of the transaction to internal and external stakeholders.

Q What triggered your most recent major divestment?



Even as corporates are taking a more opportunistic approach to divestment in this more-active M&A market, the vast majority are satisfied that making the divestment in the first place was the right move. Among companies that completed a divestment, 84% said they believe it created long-term value in the remaining business. But there is room for improvement – our survey also reveals that these divestments may not have met the full range of success criteria (see box above), indicating there is still value to be captured.

Why the private equity perspective on exits is important

Our survey is based on interviews with both corporate and PE executives. The corporate responses we received suggest there is much companies can learn from expert buyers and sellers – private equity firms – regardless of whether they consider PE a likely buyer of their business.

Over the past three years, PE firms have exited companies at nearly 1.5 times the rate at which they've acquired them; in fact, the 20 largest PE firms have each sold an average of eight companies per year. Moreover, they are very good at what they do:

- Over a 10-year period, US PE firms outperformed public markets by 62%.[1]
- Only 1% of PE firms that responded to our study say their last exit did not meet timing expectations.

This section focuses exclusively on the overall divestment rationale and performance of our roughly 900 corporate respondents. And the next two chapters focus specifically on what portfolio-review and divestment-execution lessons companies can learn from PE in order to improve overall transaction success.

Corporations have clearly bought into the idea of selling, yet their results to date have been mixed. Given the high expectations corporates have for their divestment activity over the next couple of years, we strongly recommend that future corporate sellers look to the PE buy- and sell-side perspectives to improve their divestment processes.

[1] *Private Equity Growth Capital Council Performance Update Report*, March 2015. Cambridge Associates U.S. Private Equity Index® (excluding venture capital) versus S&P 500 Index® (including dividends).

In depth

Market data shows positive effect of corporate divestments

Nearly a decade of deal-market data tells us a great deal about divesting — both its potential and its limitations. Based on market data from nearly 800 deals globally since 2006,[2] we have found that strong companies use strategic divestments to improve earnings and increase shareholder value at a greater pace than the market. Moreover, larger divestments seem to have a greater positive impact on the remaining company post-sale. However, for underperforming companies, while divestments often improve their value relative to the market, a divestment on its own does not tend to fix systemic weaknesses, especially in companies that are not performing in line with peers.

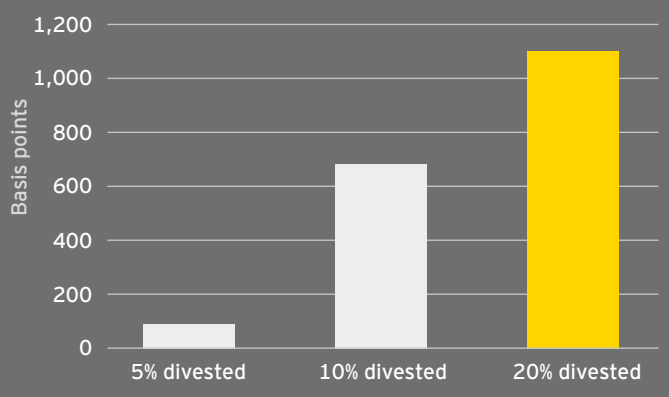
The market likes a big deal

Investors tend to reward companies for transformational divestments. For strong companies — those that outperform their respective index — generally, the more transformational the divestment, the greater their stock price outperforms the index in the year following the sale (comparing post-close performance versus the year before). For example, since 2006, companies that divested 5% of their business outperformed by 91 basis points more in the year post-divestment. However, companies that divested 20% of their business increased their outperformance by 1,104 basis points during the same time period.

These figures may even understate the case. In the above measurement, the one-year performance period pre-sale includes a period of roughly three to six months between when a company announces a deal and when it closes. During this period, the company's stock price will already begin to reflect the market's perception of the potential transaction, and some of the increased value may already be recognized pre-close. This fact only enhances the potential effect of divestment: it implies that outperformance versus the benchmark could be even greater than what is reflected in the post-close performance.

Difference in median outperformance one year post-sale versus one year pre-sale (2006–15)

Stock price versus MSCI World Index price



Recent deal trends — the effect of divesting 10% of a company

We have also seen a number of trends recently among more sizable deals — companies that divested at least 10% of their total enterprise value within the last five years.[3]

Stock price performance

Strong companies tend to outperform the public index at an even greater rate once they divest. These companies outperformed the public index by 612 basis points more than they did in the one-year period pre-sale. Similarly, while a divestment is not a quick fix, even underperforming companies were able to get 235 basis points closer to their benchmark's growth rate.

Effect on EBITDA multiple

Strong companies are able to unlock shareholder value with their divestments. The median growth rate of their EBITDA multiple one year after their divestment was 24.3%, compared to 6.1% for underperformers. In sum, while there is a large dispersion between outperformers and underperformers, on average, companies generally experience a positive effect on their EBITDA multiple post-sale. This is the effect of increased investor confidence in the remaining company that stems from an increased focus on the core business and improved growth prospects.

Effect on revenue growth

For strong-performing companies, divesting generally has — perhaps ironically — a positive effect on revenue growth. The median revenue growth for outperforming companies the year after their divestment was 4.5% (versus -0.9% the year before the sale); for underperformers, the increase the first year after sale was 0.8% (versus -1.8% the year before). This revenue growth is likely the result of companies shedding slower-growth or underperforming businesses and using divestment proceeds more aggressively to grow their core business or pursue new markets.

[2] S&P Capital IQ and EY analysis. Divestments completed between 1 December 2006 and 1 December 2015, comprising at least 5% of parent company total enterprise value, where parent company revenue was greater than US$250 million; sample size of 788.

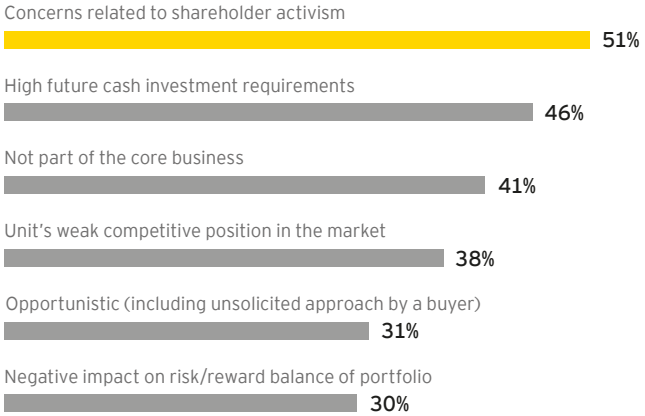
[3] Sample of 241 companies that divested between 1 December 2010 and 1 December 2015.

What can corporates do to improve divestment performance?

Don't wait for a buyer — make a move before you're forced to act

The increased popularity of opportunistic divestments is likely the result of the more active M&A marketplace, filled with a myriad of eager and proactive buyers, as well as the opportunity this deal market provides companies to raise fast cash. However, our research shows that opportunistic divestments are among the least likely to positively affect the remaining company's valuation multiple post-sale. Among respondents who achieved a high-performing deal, those triggered by opportunism make up one of the smallest proportions, whereas those triggered by shareholder activism concerns or future cash requirements include much larger percentages of the high performers (51% and 46%, respectively).

Percentage of high-performing deals for each strategic trigger (measured by impact on valuation multiple of remaining business post-sale)



There are numerous potential reasons for such varying success between divestments driven by shareholder activist concerns and opportunistic divestments:

Trigger	Activism-fueled divestments	Opportunistic divestments
Management focus	Confronted with a real or perceived activist threat, a company may need to sharpen focus on its core strategy, review its portfolio and create shareholder value.	An opportunistic divestment may mean an external party is paying more attention to a business than the actual owner. The owner is likely to undervalue its own business and/or not take the time to prepare a proper value story for the buyer.
Investor perception	Investors are likely to react positively if they hear that an activist shareholder — one with a reputation for creating value — has an eye on a company. Activists often coalesce a strong message about what needs to get done in a company, and the market responds to the perception of future value creation.	Opportunistic divestments can be confusing to investors — its not a strong story when a company that had previously considered a business to be core suddenly sells because it was approached by a potential buyer who found more value in the company's business than the company itself was able to identify.

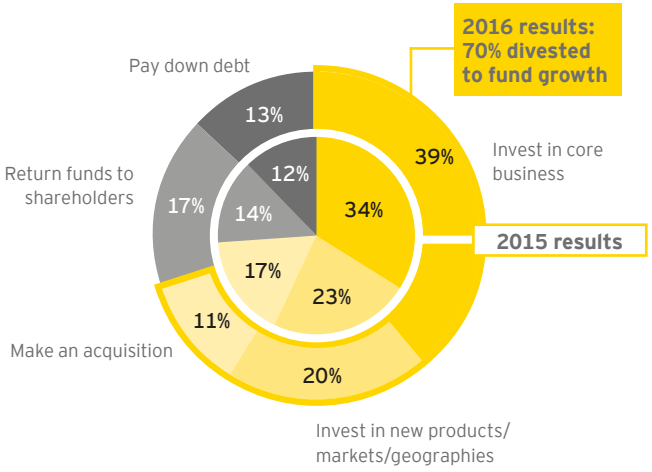
Companies are much more likely to improve the value of a business over the long term if their divestment decisions are consistent with their announced strategy. In other words, they should think like an activist before there is any concern about being forced into action.

Use divestment proceeds for an acquisition

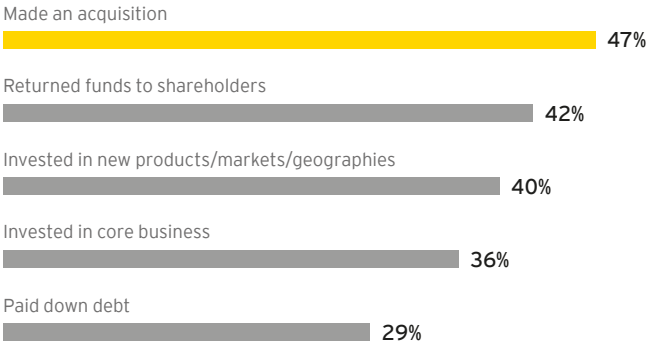
A key to divesting successfully is not only to plan for the sale, but also to consider how to use the proceeds. Seventy percent of our respondents used the funds from their previous divestment to grow their core business, through investing in new products/markets/geographies or acquiring a complementary business.

On the whole, compared with last year, companies are more focused on investing in organic growth and less on using divestment funds for an acquisition or pursuing new markets. For example, compared with last year, 35% fewer companies are planning to make an acquisition with divestment proceeds (11% versus 17%). Those who did use their previous divestment to fund an acquisition were 62% more likely to have experienced a higher-than-expected valuation multiple on the remaining business post-sale than a company that used the funds to pay down debt (47% versus 29%).

Q What did you do with the funds raised from your last major divestment?



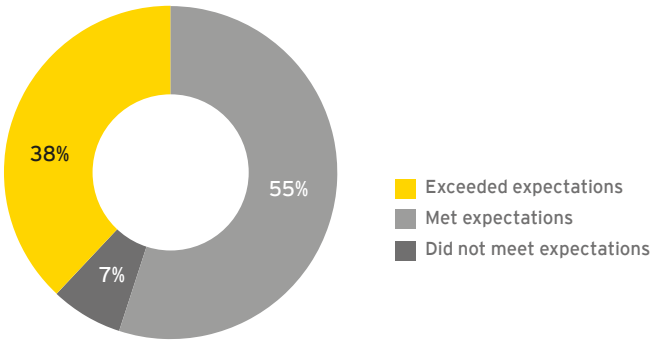
Percentage of high-performing deals for each use of divestment funds (measured by impact on valuation multiple of remaining business post-sale)



Prove divestment value to your investors

In order to have a positive effect on valuation multiple, it's not enough to achieve a good sale price and close the deal on schedule. Sellers must communicate the deal's alignment with future strategic direction – why they are divesting, how they define their core business and how they will use divestment proceeds. In our survey, just over one-third of companies succeed in this regard: 38% said their most recent divestment exceeded expectations in terms of its effect on the valuation multiple of the remaining business. More than half (55%) said their divestments were in line with expectations.

Q How would you assess the valuation multiple of your remaining business after your last divestment?

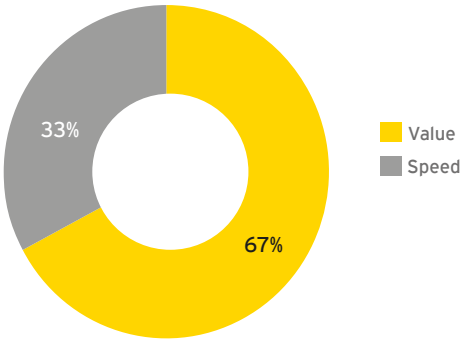


Less need for speed: big change over last year

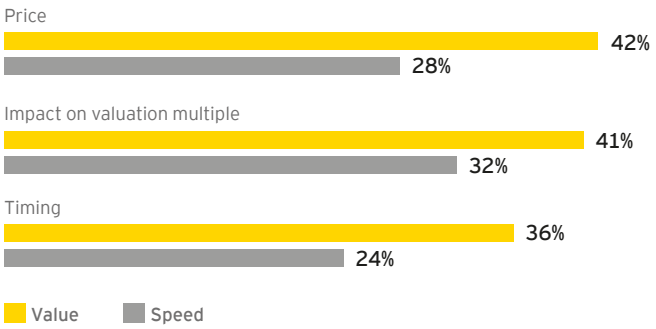
Two-thirds of companies now place greater emphasis on value rather than speed. This is another significant shift from last year's divestment study, which found a 50/50 split between speed and value. This change reflects the focus on overall shareholder value. And sellers know that strong availability of capital means greater competition for good assets and potentially higher bid prices.

Perhaps unsurprisingly, companies that prioritized value were more successful at all three divestment success criteria: price, speed and valuation multiple post-sale. The likely reason for this much stronger performance is that companies prioritizing value are often well-prepared for the separation process and buyer communications. However, those that prioritize speed often take shortcuts with buyer information and operational separation planning, which ends up lengthening the process and eroding value.

Q What was your main priority in your last divestment?



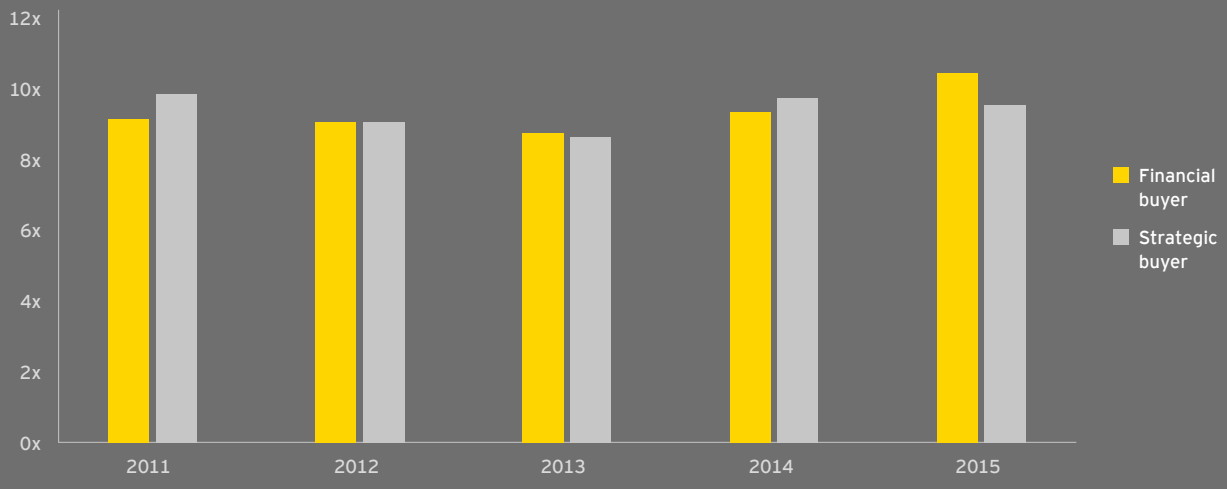
Percentage of high-performing deals by priority during last divestment (speed versus value)



Consider all potential buyers

Only 11% of executives surveyed sold to private equity buyers in their most recent major divestment. One key reason is that sellers think strategic buyers will pay a higher multiple. But that isn't necessarily the case. Private equity buyers are often more creative in their evaluation of potential acquisitions. Corporate buyers, by contrast, are often unwilling to pay for synergies. Market data shows that strategic and financial buyers pay similar multiples for businesses, and there is no clear pattern of one buyer type consistently paying more than another.

Median implied EV/EBITDA multiples paid for global transactions



Source: S&P Capital IQ, EY analysis, 1 January 2011 to 1 December 2015. Includes all transactions globally (4,341) where the buyer took a majority stake in the business and the target businesses had positive EBITDA multiples.

2 Portfolio review: think frequent and flexible

Most companies believe they run effective portfolio reviews, but they are often slow to pivot as market conditions change. The value of non-core businesses under a corporate umbrella can erode when there is no divestment imperative. In extreme cases, inaction can leave companies vulnerable to shareholder activism or hostile bids.

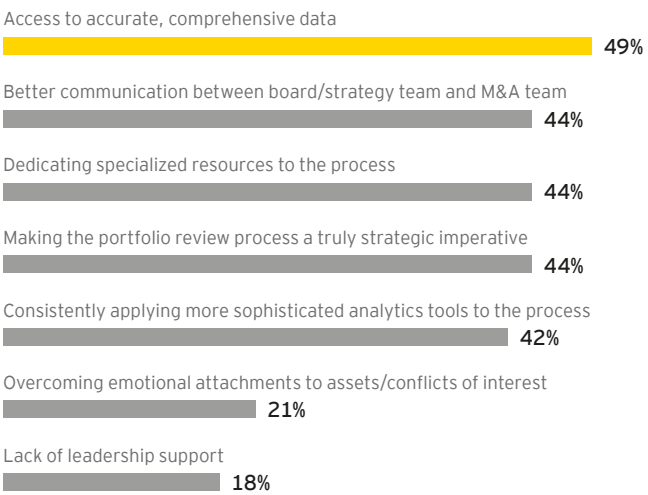
In our survey, 56% of corporate respondents say shortcomings in the portfolio review process resulted in failure to achieve intended divestment targets. There are many challenges – not least getting access to accurate, comprehensive data, and communication shortcomings between the board or strategy team and the M&A team. And nearly half of companies (44%) say one of their most significant challenges is making the portfolio review a strategic imperative.

PE owners, on the other hand, tend to place their investee businesses under constant review, such that they can use their influence to change strategic direction quickly. PE firms also use aggressive industry benchmarks and advanced analytics to assess capital performance. This means they are acutely aware of when and how to grow, fix or exit a business, and they largely avoid crisis management and fire sales.

53%

say they have held on to assets too long when they should have divested them

Q What do you consider to be the main challenges associated with portfolio reviews? (Select top three.)



Lessons learned from private equity

Frequency: make reviews a habit, not an event

Private equity firms make portfolio reviews an ongoing activity, more so than their corporate peers. For example, more than one-quarter of PE firms carry out portfolio reviews quarterly, compared with just 7% of corporates; in all, nearly half of PE firms conduct reviews at least twice a year as a matter of course.

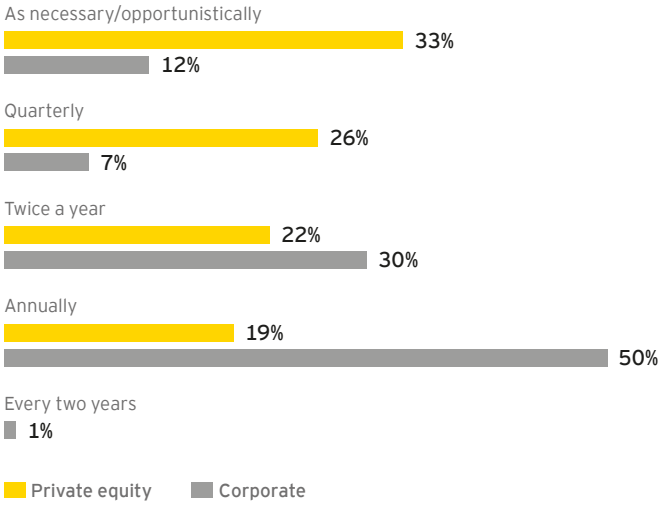
This PE approach should serve as a model for all enterprises, particularly as the digital revolution, big data and activist investors are impacting everyone's business model and forcing companies to review performance more often. Specifically, we believe corporates should carry out three key types of reviews:

- **In-depth portfolio review.** These reviews should be conducted once or twice a year.
- **Quarterly performance review.** Every quarter, public companies should understand in detail performance against plan, macro market dynamics and competitor actions, and accordingly, whether any changes are required to their capital allocation and structure.
- **Use analytics for real-time insight.** Companies should use internal and external analytics to stay closer to their businesses and ideally have real-time access to meaningful granular performance data in order to make faster and more precise decisions.

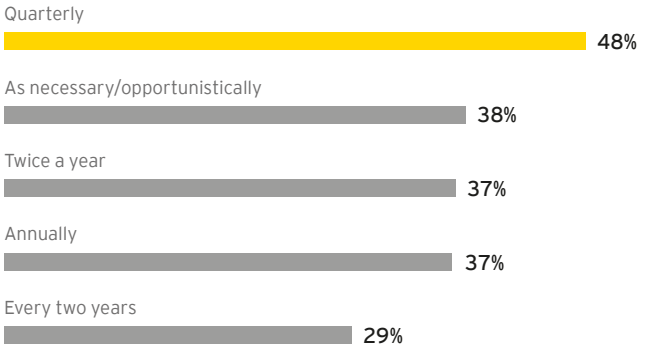
Our survey shows a clear link between frequent portfolio reviews and divestment success. Among the respondents who experienced high-performing deals, 48% carried out reviews quarterly and 37% annually – a 30% difference in likelihood of success.

There are other implications of infrequent portfolio reviews. Shareholder activists tend to get involved when the market perceives that a company does not appreciate the inherent value in its portfolio of businesses and is slow to act. This is becoming a widespread problem: 78% of executives expect the same or an increased number of unsolicited or hostile bids within the next year.

Q How frequently do you assess your portfolio to determine business units/brands to grow or divest?



Percentage of high-performing deals by frequency of portfolio review (measured by impact on valuation multiple)



Shareholder activism in the US

- The number of activist campaigns increased by 17% between 2010 and 2014 – and 2015 is set to outpace 2014 (annualized 644 campaigns in 2015 versus 518 in 2014).
- Divestments are the second most frequent change activists are pushing, behind governance – which can also result in a divestment.
- Technology, consumer products and retail, and life sciences have been the most targeted sectors over the last five years (455, 322 and 265, respectively).

Source: Shark Repellent and EY data analysis.

Data: good decisions don't come from bad information

Nearly half of corporate executives say access to accurate, comprehensive data is a significant portfolio review challenge. Businesses are often burdened with unclear cost allocations, onerous intracompany pricing policies and lack of dedicated balance sheet responsibility. This makes a business's contribution to the portfolio, as well as potential stand-alone performance, difficult to determine.

Below are suggestions to help better understand portfolio performance and create a better value story for a buyer.

- **Produce more granular data.** PE firms empower their information systems to provide a deeper dive into business unit financials. The costs of this effort are not inconsequential but should be recouped through incremental shareholder value over the long term
- **Set benchmarks like an outsider.** Align the key performance indicators used for portfolio reviews with those that are typically looked at by external investors

Data causes divestment dilemmas

- **81%** say poor-quality data makes it difficult to use analytics effectively.
- **46%** of PE buyers say availability of sufficient granular data is the most important factor in staying in an acquisition process (e.g., gross margin, cost of sales, working capital).
- Conversely, **44%** of PE buyers say lack of confidence in information is the most significant factor that causes a PE firm to reduce its offer price or walk away from a deal.

- **Stress-test the data.** Empower a portfolio management team comprising people from different functional areas to make sure the data is accurate and supportable
- **Understand business complexity.** Consider the extent to which each business unit is integrated with the remaining company (e.g., overlap in customers, vendors, facilities, shared services)

Analytics: critical for performance measurement

The use of analytics isn't just about tools. It's about taking advantage of a proliferation of data that is now accessible both to a company and its outside influencers. The last thing companies want is for a third party (e.g., a shareholder activist, a potential buyer) to uncover something about the company that its leadership didn't know because they hadn't fully considered all potential sources of available data.

Companies need to make sure their analytics provide answers to critical questions like these:

- What are the true drivers of historical and forecast performance (financial and nonfinancial)?
- What are probable future outcomes for the portfolio under various assumptions, and how could this affect a deal as well as the remaining organization?
- What strategic options offer the most value-creation potential?
- What are the risk and return characteristics of each business in the portfolio, and what is the overall effect of their relationships and interdependencies?

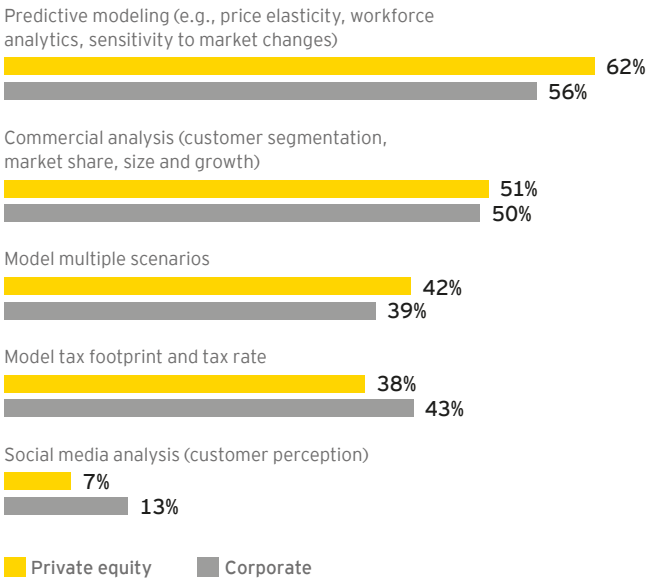
42%

of executives say they need to apply more sophisticated analytical tools to their process

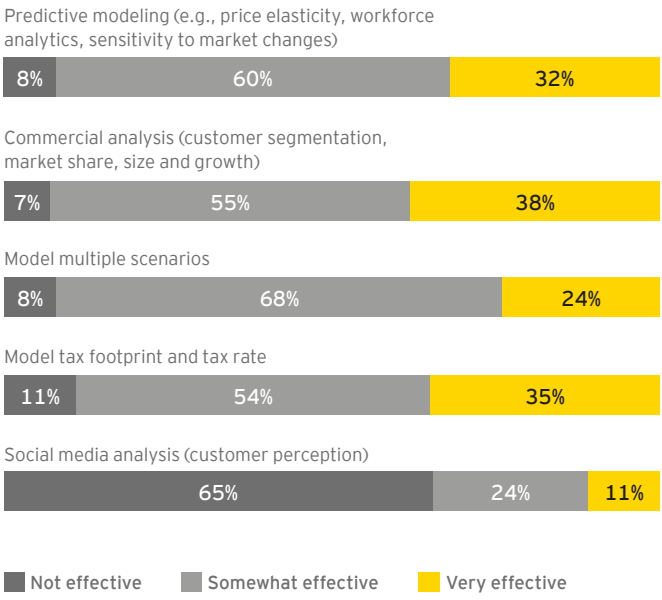
Priority analytics capabilities are not areas of strength

Sixty-two percent of PE executives say that they find predictive modeling most important to assess business performance, compared with 56% of corporates. PE firms are also slightly more likely to use commercial analysis and to model multiple scenarios. While corporates are placing increasing importance on analytics, few believe they have advanced analytics capabilities.

Q Which analytics do you find most important to assess business unit performance?

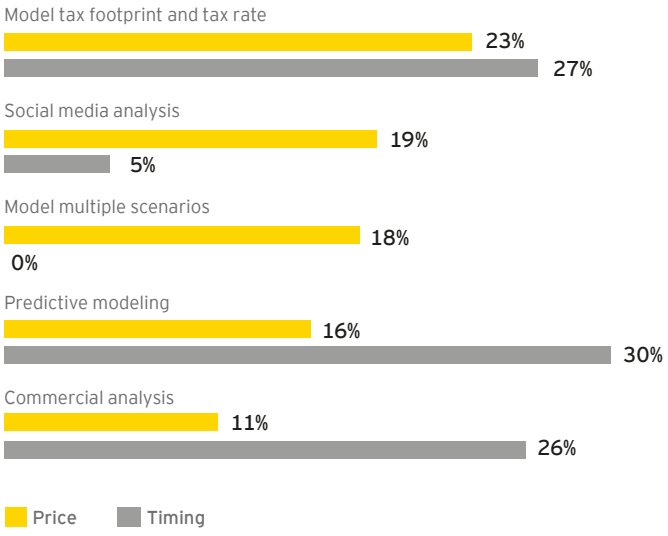


Q How effective are your analytics capabilities?



Companies that do rate their abilities as very effective are more likely to carry out divestments that exceed expectations, likely because robust forecasts support the equity story, and therefore the diligence process.

Increase in likelihood of strong sale price and timing performance if analytic capability is rated as very effective

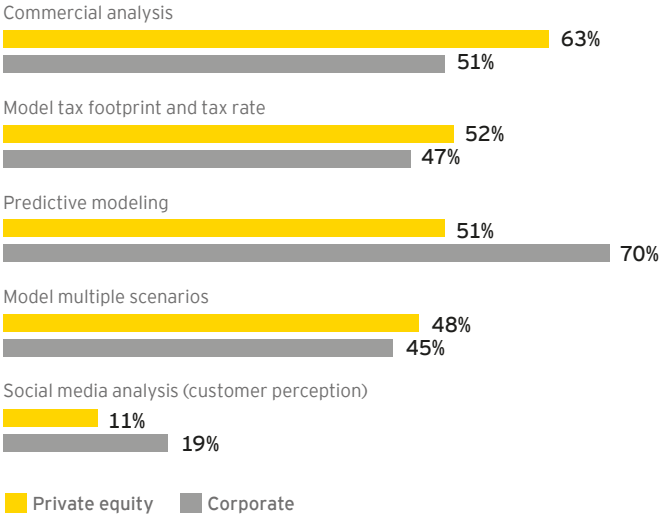


The potential buyer of a manufacturing company asked for 20 years of insurance claims data. The buyer wanted the data to use as a basis to predict future costs. The seller had the data but had never analyzed it before, so they hadn't considered how it would affect the bidder's view of the business.

Companies plan to invest in the highest-impact analytics

To their credit, many companies recognize this structural weakness and are planning to address it. Successful companies are increasingly seeing the benefits of using predictive analytics to provide early visibility to the expected performance of each business, as well as greater insight into the expected value of a sale, including associated synergies. A greater percentage of PE firms expect to ramp up their commercial analysis capabilities (63%) than their corporate counterparts. These capabilities could help companies better understand their competitive positioning and customer trends to better inform valuation and transaction decisions. Predictive analytics, commercial analysis and scenario modeling can also help executives identify what attributes of a deal might attract a broader group of owners willing to pay more for an asset, and when and why they would be willing to pay more.

Q Which analytics capabilities do you expect to invest in within the next two years?



Social media is being overlooked

Every day, more than 500 million opinions, comments and suggestions are posted on Twitter, with countless more appearing on reviews, blogs and other online forums. These real-time, unfiltered opinions contain a treasure trove of intelligence that can help companies track market trends and extract insight for portfolio reviews.

For example, social media analysis helps executives understand sentiment changes about a division, product or service and benchmark them against various business units, specific competitors or entire industries. In addition to traditional metrics, these findings can serve as indicators of future business prospects. Social media analytics can even help companies understand investor opinions if the company becomes an activist shareholder target.

Many companies are already leveraging social media analytics for product development. Ideally, these analyses should expand beyond individual business units and into wholesale portfolio reviews, which will help companies compare potential growth across business units and help inform decisions on whether to invest in a business or sell it.

Critical analytics capabilities that can provide objective and actionable insights

Capability	Benefit
Commercial analysis	
Customer segmentation and churn	Helps inform the enterprise on customer base, how to influence buying patterns and related impact on forecast
Stakeholder sentiment	Supports the value story and ongoing revenue and EBITDA
Predictive modeling	
Cost analytics	Drives value creation road map relative to buyer synergies; allows for benchmarking on a pro forma combined basis
Price elasticity	Reveals potential implications of future price changes
Workforce analytics	Identifies productivity drivers and go-forward impact on EBITDA/value creation
Working capital analytics	Optimizes working capital; assists in setting closing working capital peg/value creation
Tax analytics	Details tax cost both pre- and post-close
Scenario modeling	Tests the impact of various drivers on deal value

In depth

Communication: poor information-sharing hinders divestment success

Improving communication between the board/strategy team and M&A team

Forty-four percent of executives say they need better communication between the board or strategy team and the M&A team. Here are some leading practices to improve the dialogue:

- Establish portfolio review protocols so that it is clear which businesses are on a watch list
- Develop appropriate models, timelines and milestones relative to pending transactions to allow time for value enhancement
- Develop related stakeholder communications, including communiqués directed to equity analysts
- Align internal functional work streams and service providers

Appoint a project leader to manage the portfolio review process

Forty-four percent of corporate executives say dedicating specialized resources to the process is a significant portfolio review challenge, and nearly one in five companies (18%) say they lack leadership support. A key way to resolve these issues is to enlist a project leader who is sufficiently senior and experienced in the organization to have the C-suite's ear. This person is empowered to secure the smartest functional leads — colleagues who aren't always readily available — and to make them accountable. No external advisor can do that.

Managing internal conflicts of interest

One in five companies (21%) says that overcoming emotional attachments to assets or other conflicts of interest is a significant portfolio review challenge. Here, we outline some key ways to overcome it.

During the portfolio review process:

- Define objective evaluation criteria
- Discuss portfolio review findings regularly in board meetings to support objective decision-making
- Involve the business stakeholders in the process so that they understand performance expectations, and the review feels less like an event — or a threat

Once the decision has been made to divest:

- Listen to employee concerns early and explain the vision for the separated business
- Involve business stakeholders in discussions with external advisors so they understand potential opportunities, both for the parent company and for the target
- Incentivize key executives to effectuate a successful transaction (e.g., retention payments, stock options, performance bonuses)

A company publicly announced the timing of a spin-off without alignment among the deal team. During the separation, the company discovered several regulatory hurdles in numerous countries that delayed the transaction by six months. The stock lost more than 20% of its value post-announcement and did not recoup its losses until after separation.

3 Deal execution: fail to prepare, prepare to fail

With boards under constant scrutiny to build shareholder value, sellers of corporate assets need to answer three critical questions: What drives the business's purchase and valuation decisions? How can the seller develop a value story tailored to individual bidders in order to maximize value? What impact will the divestment have on the remaining business?

Sellers who can answer these questions make an asset easy to buy and create competitive tension. The value story should clearly articulate the future value of the separated business, which often deviates from the current operating model under the current corporate umbrella.

And yet, just over one-third (36%) of companies have developed consistent execution procedures across their divestments. Corporates continue to point to deal execution as a divestment area ripe for improvement.

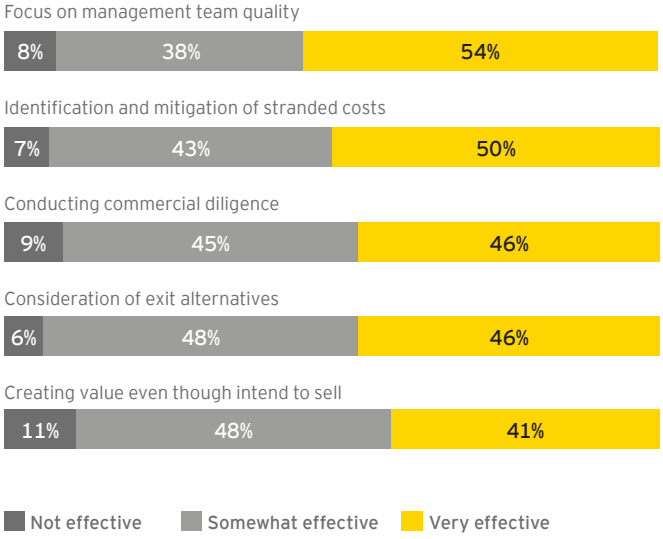
Lessons learned from private equity

It's still your business: don't ignore it until it's off your books

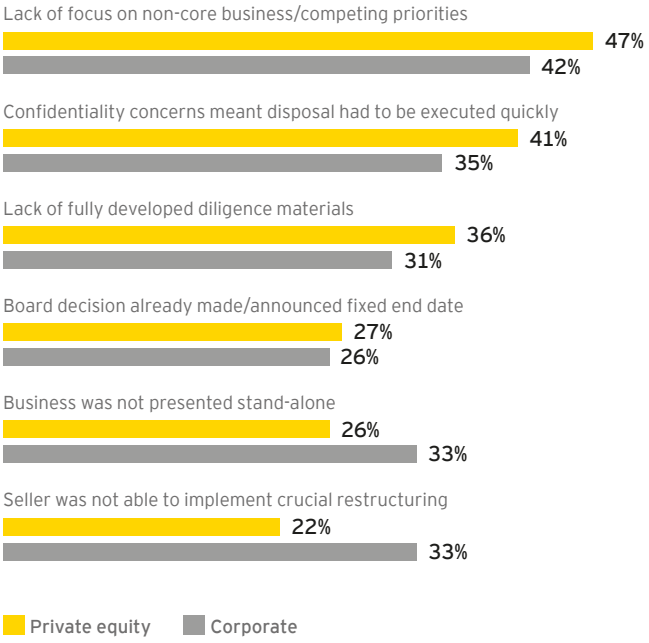
Only 41% say they are very good at continuing to create value in businesses they intend to sell, an area where PE excels. Corporate and PE executives agree that most companies sacrifice value due to pressure to allocate time and resources to their core businesses (42% and 47%, respectively).

This short-sightedness is challenging to deal execution results. Our research shows that those who continue to create value in a business targeted for divestment are 75% more likely to receive a higher-than-expected price and 59% more likely to experience a higher-than-expected valuation multiple post-sale. Sellers must therefore continually evaluate the potential returns from continuing to optimize the business's attractiveness to buyers.

Q In your last major divestment, how would you rate the effectiveness of each of the following steps?



Q What do you see as the main causes of value erosion in corporate divestments?



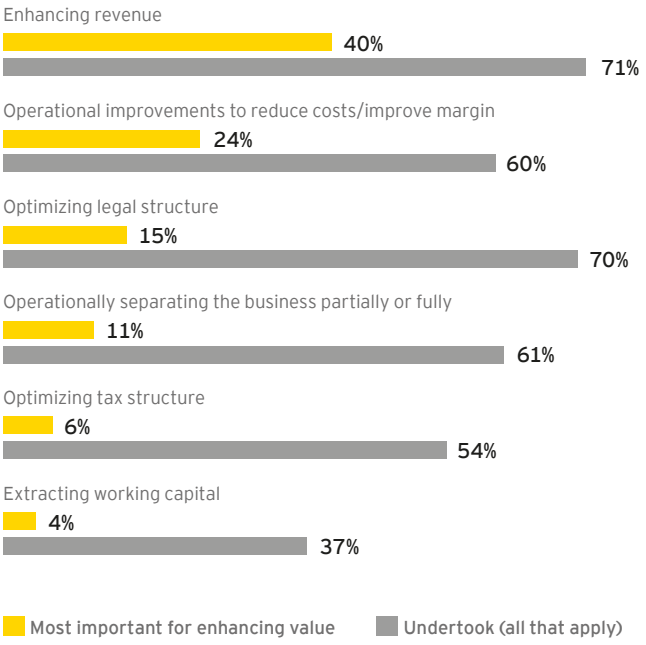
Operational separation: vital to value creation, often neglected

One of the most effective ways to create value pre-sale is to present a compelling vision to a potential buyer of how the business will be operationally separated and how it would fit into the buyer's organization. This initiative comes up most frequently when corporates are asked about the step they did not undertake on their most recent divestment, but wish they had.

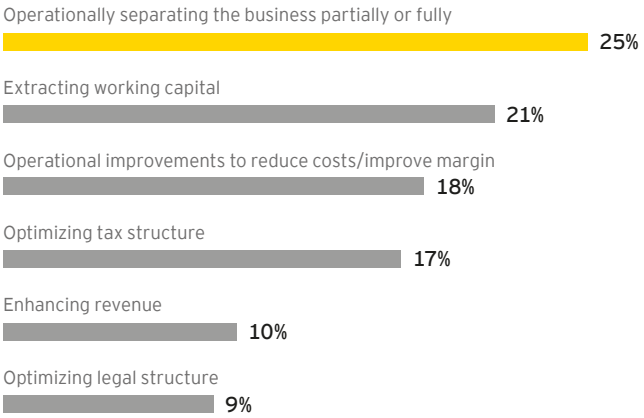
Sellers should be able to ensure that:

- Stand-alone financials can withstand diligence
- Assets, liabilities and operations within the perimeter of the deal have been vetted
- Separation activities, particularly long lead-time items, have already commenced. Sellers are often reluctant to implement these measures until a buyer has been identified and appropriate personnel are cleared because they can generate significant work and cost. But waiting for buyer agreement can cause delays and increase transaction execution risk. Ideally, a seller will begin separation as part of its preparation process – developing a clear view of what is included in the deal and preparing a detailed separation road map. This plan details timelines, costs and transition arrangements, which enhances buyer confidence and adds certainty to negotiations.

Q Which value creation initiatives did you undertake before your last divestment?



Q Which step did you not do but now feel you would have benefited from the most?



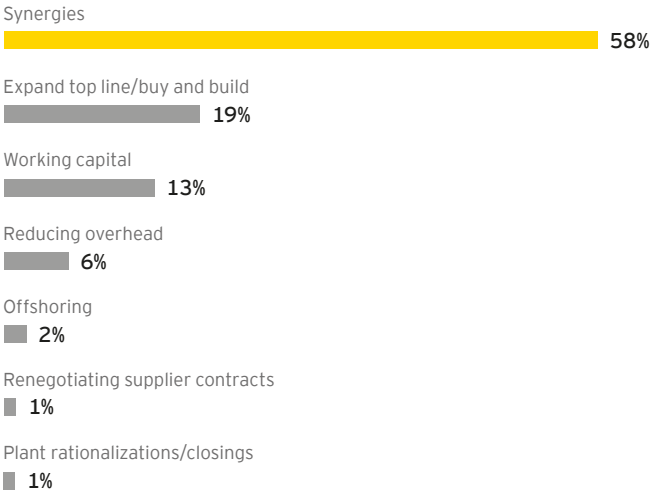
Increase in likelihood of high performance on each metric if value creation initiative is carried out

Communicate synergies: take back the buyer's upside

Most PE firms (58%) said synergies were the source of their greatest upside. This suggests that corporate sellers should be much more rigorous in how they identify, communicate and value potential synergies for each potential buyer. It may also suggest that PE is good at building scale through acquiring platform companies and subsequently bolting on acquisitions. In essence, they are finding synergies and are thereby able to create an efficient cost base and a more efficient organization overall.

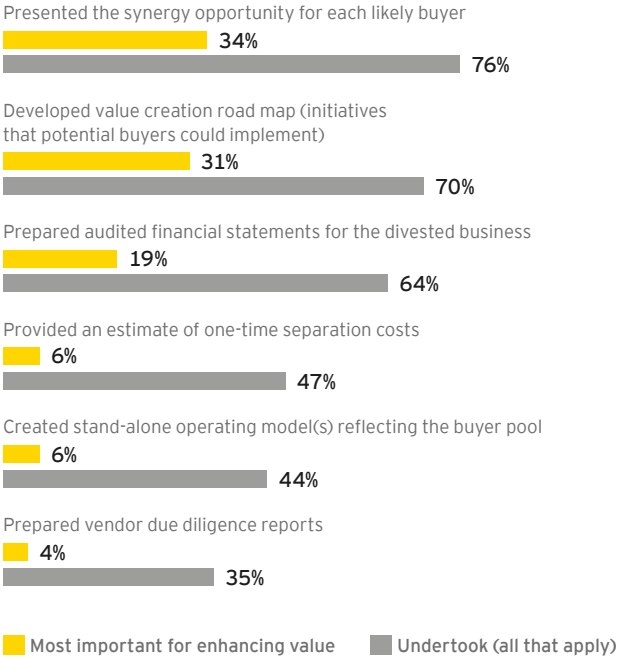
Similarly, presenting each likely bidder with its own tailored synergy opportunity was the buyer communication initiative found to have the most significant impact on overall success.

Q for PE buyers Where did you find the most upside in your most recent corporate acquisition?

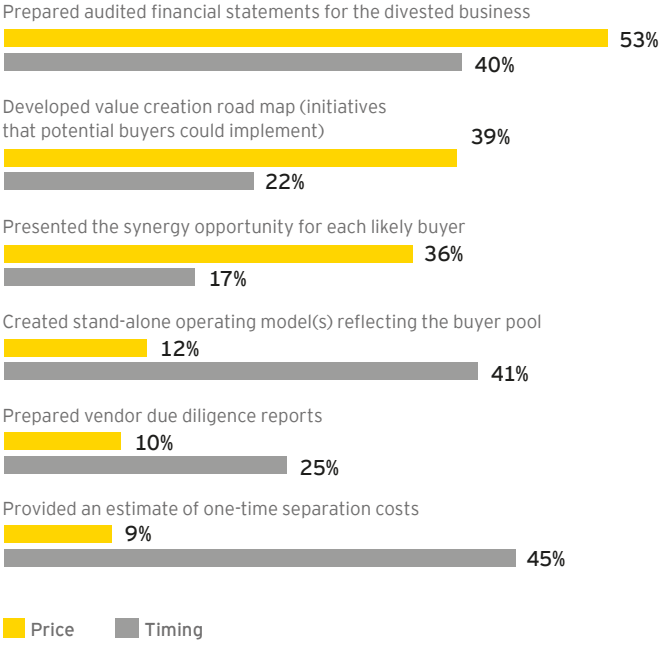


A potential buyer was very focused on understanding stand-alone costs. The seller refocused the conversation on market, functional and country overlap. Leadership convened staff across functions to crunch numbers and determine the value the buyer could extract relative to synergies. The seller ultimately identified US$32 million in synergies, representing US$208 million in value based on the sale's 6.5x multiple.

Q Which of the following buyer communication initiatives did you undertake?



Increase in likelihood of high performance on each metric if buyer communication initiative is carried out



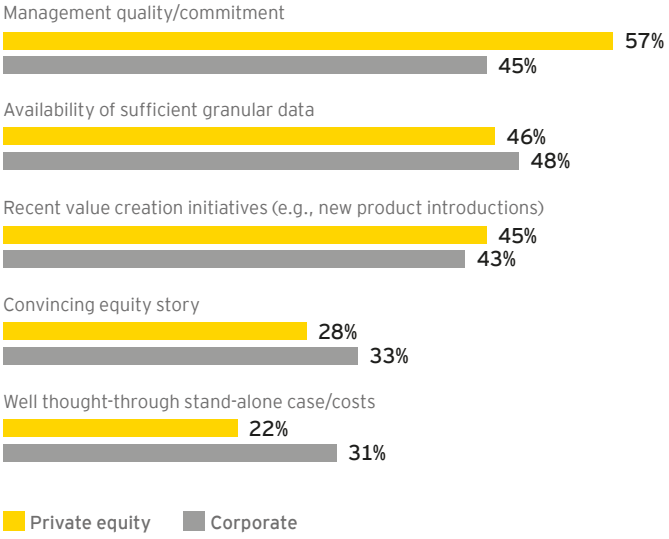
Keep a buyer in it to win it: management quality and commitment

PE firms say management quality and commitment are the factors they prioritize most when deciding to stay in an auction process. If a PE firm does not have confidence in who will run the business and deliver on plan, they will seek out their own team.

Corporates, like PE, should give sufficient focus to the management factor while also keeping in mind that, at some point in the sales process, management loyalty will shift from the current owner to the potential new owner. Therefore, sellers should establish rules and incentives to keep demarcation lines clear until a sale is concluded.

PE firms seeking add-on acquisitions and strategic buyers might use the existing business's management or choose which management team they prefer. Regardless of a buyer's intentions regarding current management, a business with a strong management team is much more likely to be run well and use strong data for both its decision-making and the sale process.

Q What do you think are the two most important types of information a PE buyer requires to stay in an auction or purchase process for corporate assets?



Provide the right details: keep buyer's needs in mind

PE buyers, in particular, have an eye for detail. But sellers should be able to provide the following to any smart buyer:

- Explanations of margin development and cost pass-through, including detailed value creation bridges and a clear view to the forecast
- Clarification if the business will be stand-alone , and sufficient details regarding stand-alone consequences
- Links between performance of the business and the markets in which it operates
- Future plans and opportunities for the business, including additional upside potential that is not reflected in the current-state business

On a recent complex carve-out transaction, a seller circulated 20 targeted-buyer presentations, but the information did not explain clearly what was actually included in the deal.

The result: more than 70% of the potential buyers declined, and the remaining six dropped out early in the diligence process. One potential buyer said, "Far too much time would be required of us to purchase this business."

Most important financial factors for buyers

More than half of PE respondents (56%) say growth potential is the financial factor they most prioritize, followed by potential EBITDA multiple and internal rate of return (IRR). It is therefore incumbent upon sellers to employ data analytics (e.g., social media, predictive analytics) as well as traditional commercial diligence to help buyers understand the growth potential. As for EBITDA, value creation bridges are critical to helping buyers identify efforts that can be undertaken to drive value post-close (and therefore the EBITDA multiple they are willing to pay).

What makes a buyer walk away from a deal

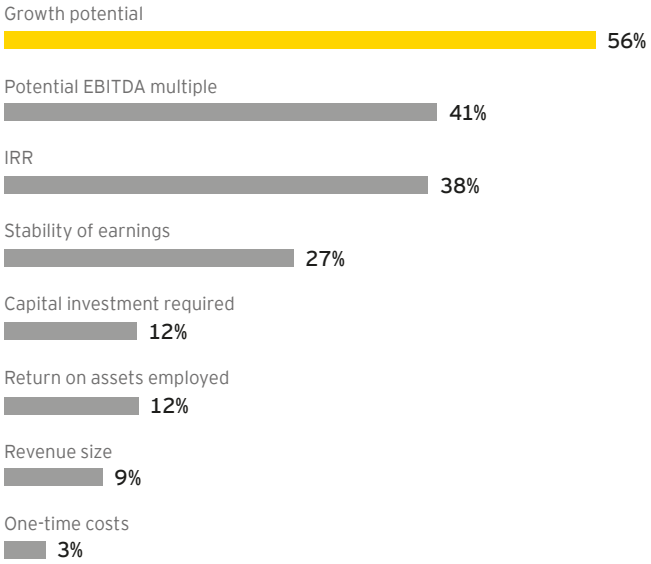
Companies should understand how to create a compelling story for experienced buyers. Particularly among PE buyers, there is often a stark difference between what sellers think causes a reduction in offer price or a bidder dropout and what PE firms say actually drives them away.

Corporates think that lack of confidence in the management team and level of capital investment required are the most likely factors. For PE respondents, the management team is indeed important, but so too are inconsistent or declining financial performance and commercial factors.

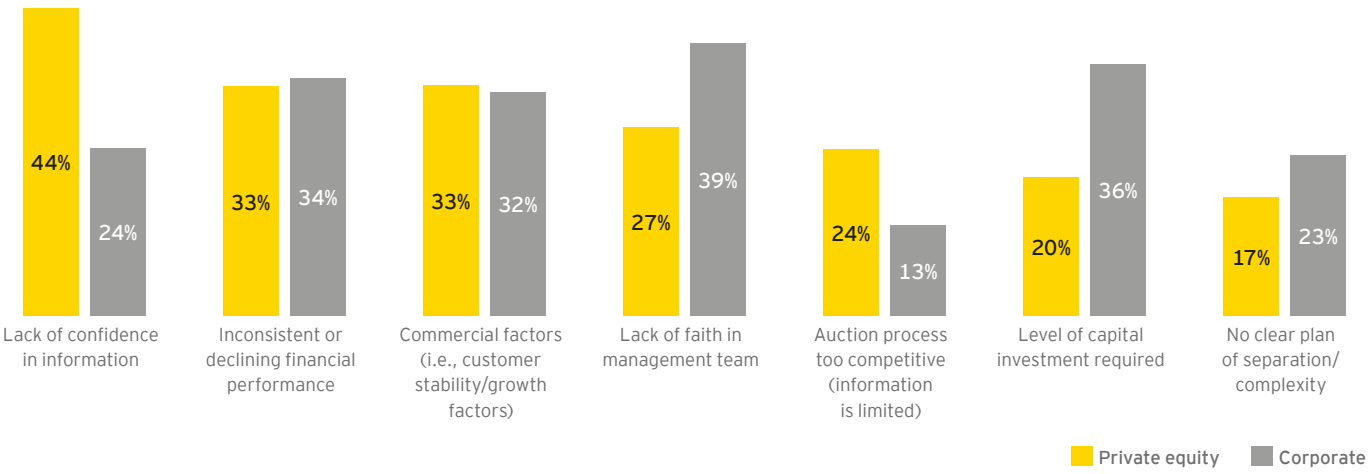
We draw two major conclusions from these responses:

- **Corporate executives may need to focus on different priorities.** Early in the process, PE wants strong management in place. But while this will make them interested in the asset, PE buyers also want confidence in the financials. This means sellers must gather sufficiently granular data to support the equity story
- **Sellers must provide credible information to buyers.** Nearly two-thirds of corporate executives say they prepare audited financials – and yet, lack of faith in information is the leading cause of PE buyers discounting a deal. Any potential buyer needs to understand the deal-basis financials (e.g., how the company is being run, how it has performed, what cash flow looks like on a pro forma basis)

Q for PE buyers What are the two most important financial factors your company requires to stay in an auction or purchase process for corporate assets?



Q What factors do you think are most likely to make a PE buyer reduce its offer price or drop out of the bidding process?



Conclusion

Looking forward: since you're likely to divest

Nearly half of companies plan to divest in the next two years, and another 46% are open to the possibility. For example, life sciences companies often divest to fund new opportunities, financial services companies continue to react to regulatory changes, consumer products companies are better at predicting or reacting to customer preferences, and technology companies are keeping pace with fast innovation and activist shareholders.

Unless you're part of the 5% that does not plan to divest over the next two years, now might be the ideal time to start considering if you have the right infrastructure and teams in place to decide what, when and how to divest.

Evidence from this study clearly shows that companies that divest strategically – including preparing assets for sale and carefully considering how to use sale proceeds – are much more likely to execute divestments that positively affect their remaining business over the long term. Private equity firms have proven to be successful buyers and sellers. They are not the end-all, but they transact more often than corporates and their 10-year performance is impressive.

With limited resources and time, companies should re-examine which practices are shown here to have the greatest correlation with success, and which aspects of the value story are most important to discerning buyers.

Related thought leadership

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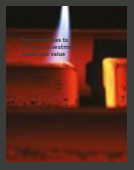

Tax strategies to increase divestment speed and value
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About this study

The EY *Global Corporate Divestment Study* focuses on the critical lessons corporations can learn from private equity relating to portfolio review and divestment strategy and execution. The results of the 2016 study are based on more than 900 interviews with corporate executives, including 187 financial services executives, and 100 private equity executives. The survey was conducted between September and November 2015 by FT Remark, the research and publishing arm of the Financial Times Group.

- Executives are from companies across the Americas, Asia-Pacific, Europe, the Middle East, India and Africa.
- CEOs, CFOs or other C-level executives make up 82% of executives surveyed.
- Executives stated they have knowledge of or direct hands-on experience with their company's portfolio review process and have been involved in at least one major divestment in the last three years.
- While nine industry sectors are represented, the study primarily focuses on consumer products, financial services, life sciences and technology.
- One-third of corporate executives represent companies with annual revenues of US$1b–US$5b, and 27% represent companies with revenues that exceed US$5b.
- Private equity executives represent firms that have US$1b or more in assets under management; 40% exceed US$5b.
- This year's study also incorporates external data from select divestments that were closed between December 2006 and December 2015.

Produced in association with
FT Remark
Research from the Financial Times Group

How EY can help

EY's dedicated, multifunctional divestment professionals can help clients improve portfolio management, divestment strategy and execution.

First, we help each client understand the performance of its business relative to peers and the rest of the portfolio, including assessing the quality of information and developing more reliable data for the evaluation process. We then help clients decide where capital can be released from underperforming or non-core activities and reallocated toward higher-growth areas.

We then work with clients to prepare them for a divestment and become an informed negotiator. Our work with corporate and private equity clients includes 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. Furthermore, 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 can 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.

Global contacts

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

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

Paul Hammes
EY Global Divestiture Advisory Services Leader
paul.hammes@ey.com
+1 312 879 3741

Rich Mills
EY Americas Divestiture Advisory Services Leader
rich.mills@ey.com
+1 404 817 4397

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

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

Peter Wesp
Japan Divestiture Advisory Services Leader
peter.wesp@jp.ey.com
+81 3 458 26400

Financial services contacts

David Barker
EY Global Banking and Capital Markets Transactions Leader
dbarker@uk.ey.com
+44 20 7951 2005

David Lambert
EY Global Insurance Transactions Leader
dlambert@uk.ey.com
+44 20 7951 9848

Nadine Mirchandani
EY Global Wealth and Asset Management Transactions Leader
nadine.mirchandani@ey.com
+1 212 773 0090

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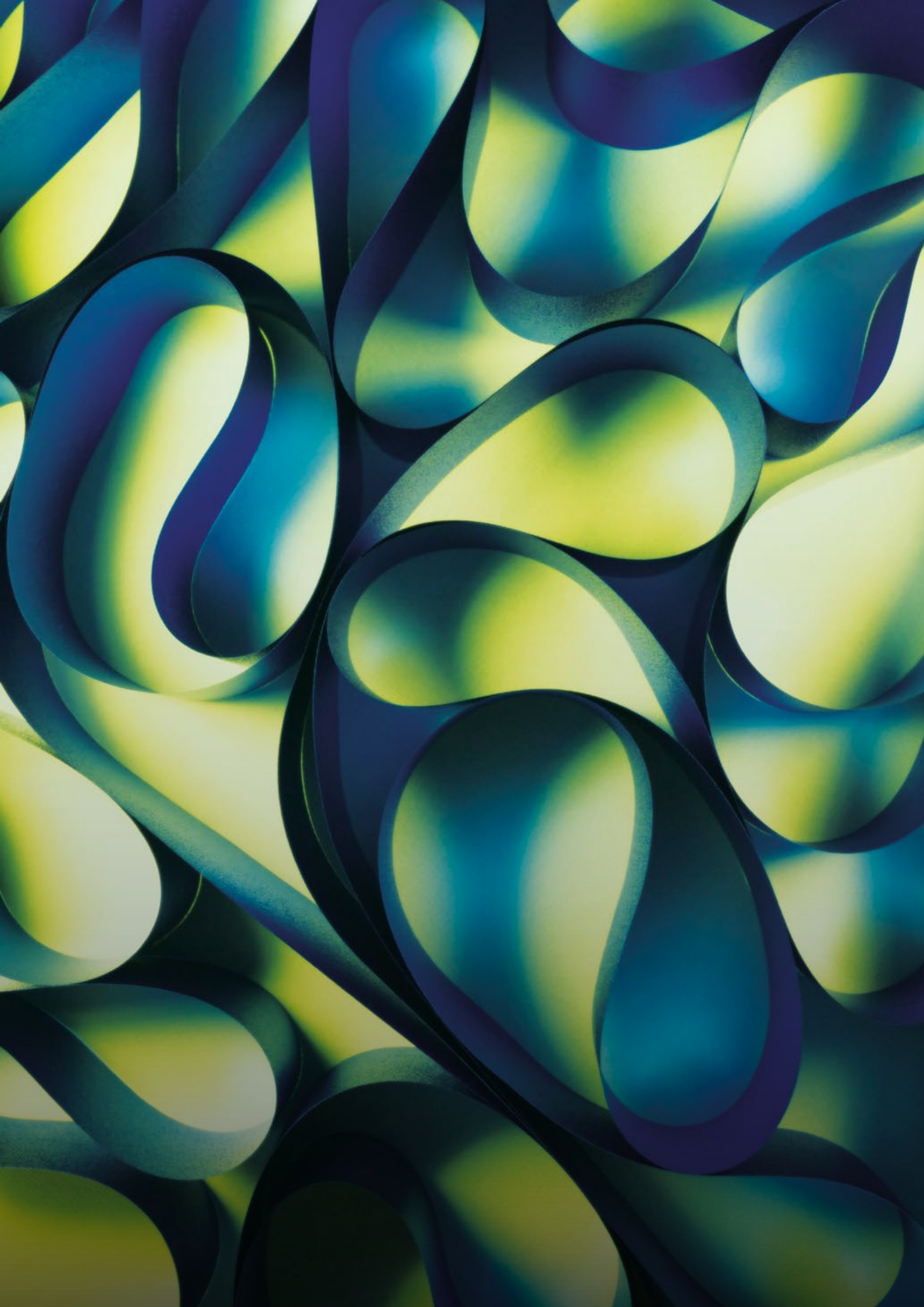

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About EY's Transaction Advisory Services
How you manage your capital agenda today will define your competitive position tomorrow. We work with clients to create social and economic value by helping them make better, more informed decisions about strategically managing capital and transactions in fast-changing markets. Whether you're preserving, optimizing, raising or investing capital, EY's Transaction Advisory Services combine a unique set of skills, insight and experience to deliver focused advice. We help you drive competitive advantage and increased returns through improved decisions across all aspects of your capital agenda.

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