Strategy and tools to accelerate divestitures

Live webcast discussion

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Agenda

I. **Welcome**

II. **Divesting through a downturn**

III. **Critical path activities, levers to accelerate the divestiture timeline, key risks and considerations**

IV. **Closing and Q&A**

Recent economic uncertainties have offered an opportunity for companies to rethink traditional growth channels and shift their focus toward building resilience and driving long-term value …

… the most resilient and successful companies will be those that have shown discipline and an accelerated focus on portfolio transformation.

The EY *Global Corporate Divestment Study* reveals that divestment activity is poised for a sharp rebound as companies aim to rebalance portfolios

2020 corporate survey key findings

78%

expect to **divest within the next two years**; 57% within the next 12 months.

65%

say they will reshape their portfolio to **prepare for a post-crisis world**.

72%

say they continue to **hold onto assets too long**, up from 63% in 2019.

67%

plan to use divestment proceeds to **invest in their core business.**

2020 activist survey key findings

96%

will **recommend carve-outs** of underperforming or non-core businesses within 12 months.

76%

say slowing growth and declines in operating margins will **influence choice of new targets.**

Key considerations:

- Companies can benefit from taking bold action and exploring avenues beyond traditional sales during the downturn to ***boost longer-term total shareholder return (TSR).***
- A more aggressive rebalancing of portfolios will help companies ***free up capital to refocus on their core business and fund technology*** in response to rapidly changing customer demand.
- Emphasis on divestment preparation will be required to ***preserve value in a downturn***, with 73% of sellers reporting they would only accept a 10% or less reduction in sales price in the next 6 to 12 months.
- Companies may have only a ***short time to prepare*** for what's next on the activist agenda as recommendations for carve-outs are on the horizon.
- By communicating to key stakeholders the path to long-term value, companies can ***mitigate risk to hostile campaigns*** and the heightened activist activity set to come in the next 12 months.

An accelerated divestiture approach can help organizations unlock value and create liquidity amid today's challenges

Challenges facing organizations today

- **Rebalancing portfolios** as a result of the COVID-19 crisis[1]
- **Continued activist pressure** for more corporate focus and simplicity[2]
- **Advancement in technology** that is lowering barriers to entry and increasing the likelihood of disruption[3]
- **Rapidly changing customer demand** requiring increased investment in technology[3]

Key actions to address these challenges

- **Divest assets**
- Shut down plants and furlough employees
- Scale back on CapEx maintenance and investments
- Draw down or establish new credit facilities
- Cut costs through operational restructuring
- Scale back dividend and/or share repurchases
- Sale-leaseback agreements

Source: 2020 EY *Global Corporate Divestment Study*

[1] *Sixty-five percent of executives are rebalancing portfolios as a result of the COVID-19 crisis.*

[2] *Ninety-six percent of activists shareholders recommend carve-outs of underperforming or non-core businesses.*

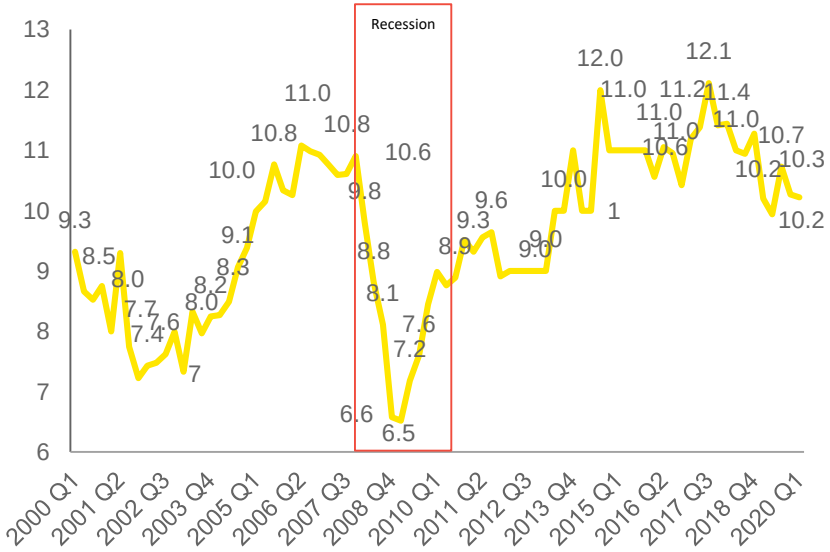
[3] *Fifty-two percent of companies say the need to fund new technology will make them more likely to divest.*

Companies that divested assets during the last economic recession generated excess shareholder returns compared to peers

While deal multiples were low, as there was considerable uncertainty in the market …

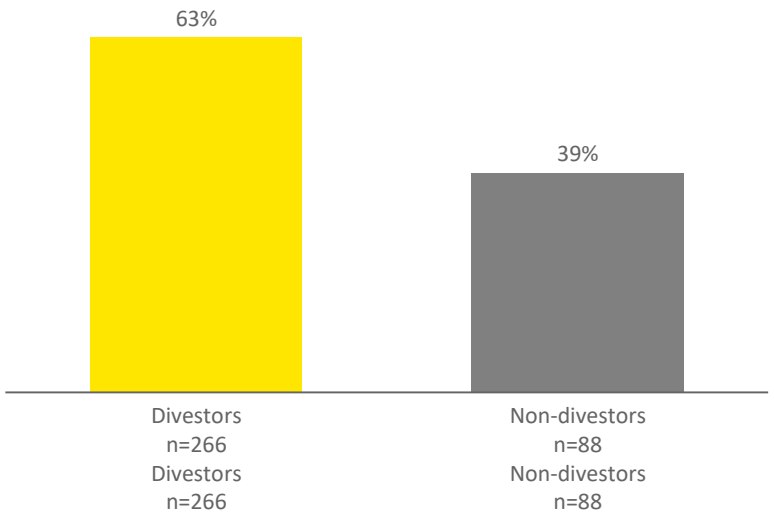
… companies that divested, using the downturn as a catalyst for change, saw their returns boosted.

Median deal multiples (2000 – Present)



Deal multiples greater than 30x and bid premium greater than 100% have been excluded from the calculation of the median.

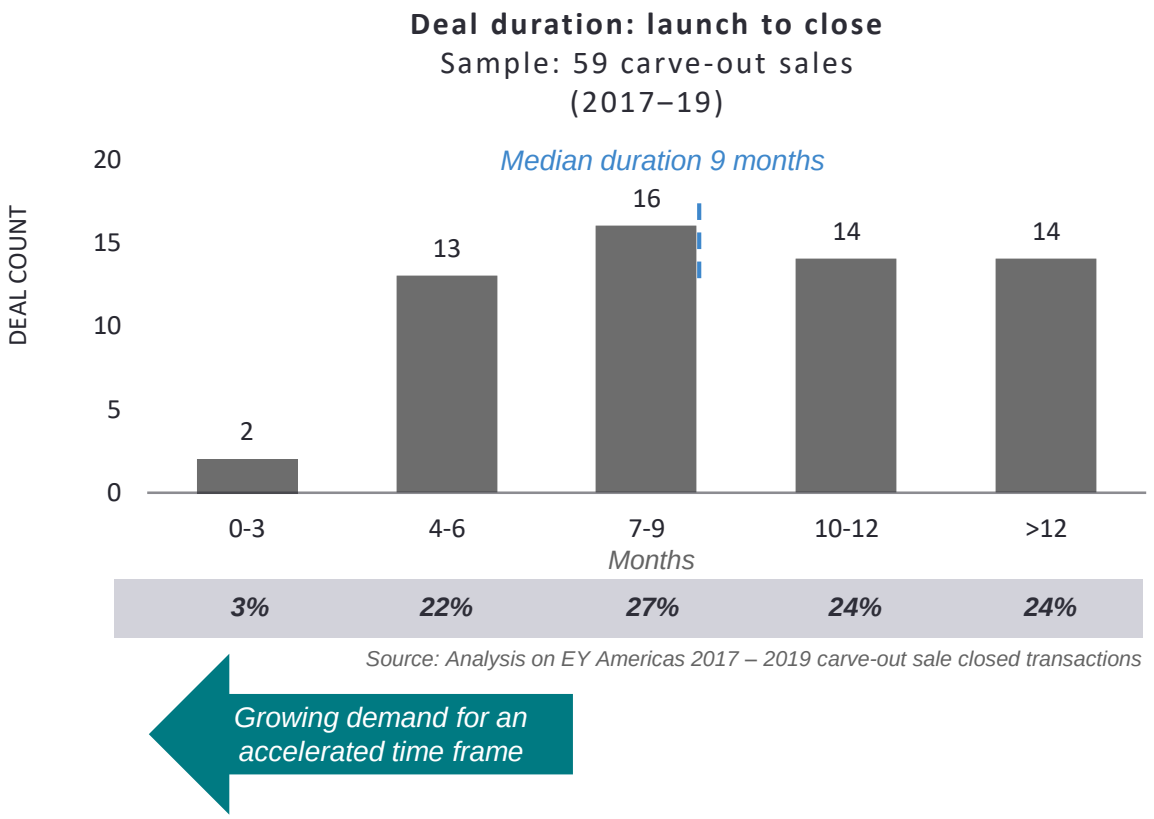
Median TSR (2010–18) for companies that made divestments in 2008–10 vs. non-divestors



Included 354 companies with a market capitalization greater than US$1b located in Europe and North America from the life sciences, consumer and industrials sectors
*Company TSR adjusted for currency and benchmarked against global sector indices to calculate excess returns

A shifting activist agenda and recent economic conditions have increased demand for an accelerated divestiture timeline

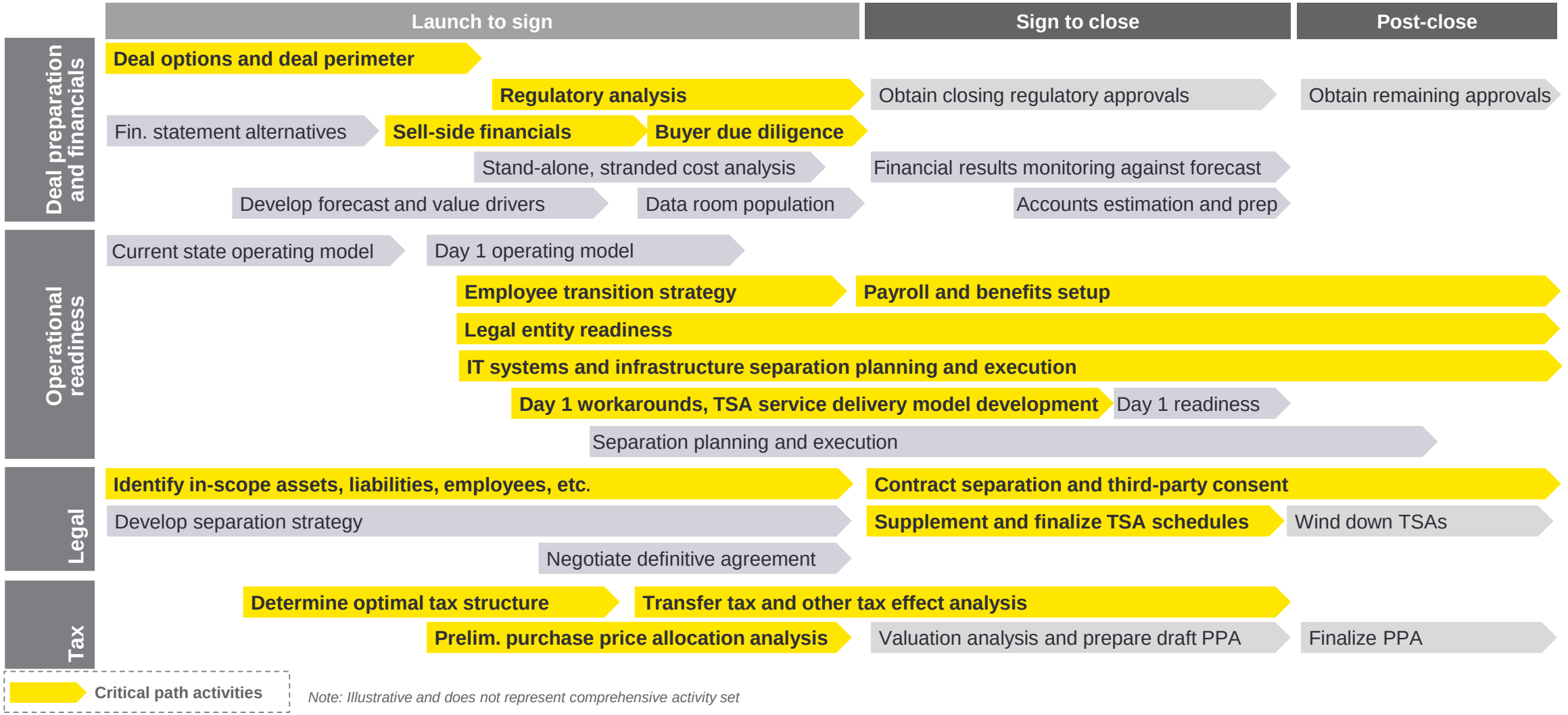
- Divestitures are complicated and can often take nine or more months to complete.
- Pre-crisis, **36%** of activists said the expectation was that a divestment should take place within six months.
- Today, **84%** of activists expect a six month divestiture timeline, with a focus on divesting non-core and underperforming assets.



Source: Analysis on EY Americas 2017 – 2019 carve-out sale closed transactions

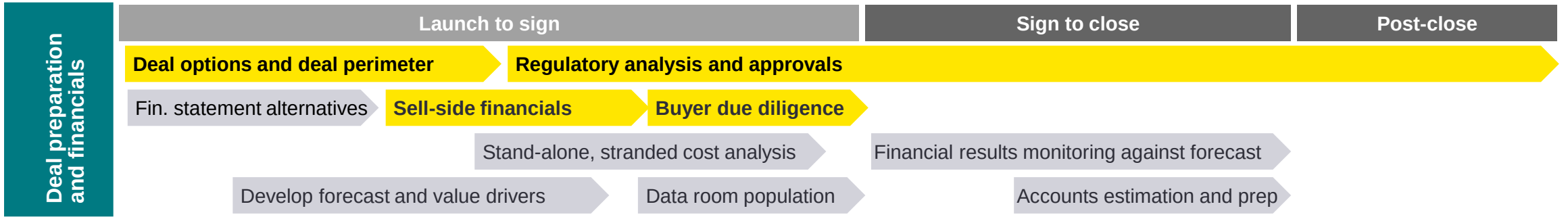
Companies must prepare for investor discussions that focus on how they are responding to the crisis and proactively develop an approach to accelerate the deal timeline.

Critical path activities across functions need to be understood and addressed to accelerate divestiture timelines and balance risks



Note: Illustrative and does not represent comprehensive activity set

Critical path activities and levers to accelerate timelines and balance risks: *deal preparation and financials*

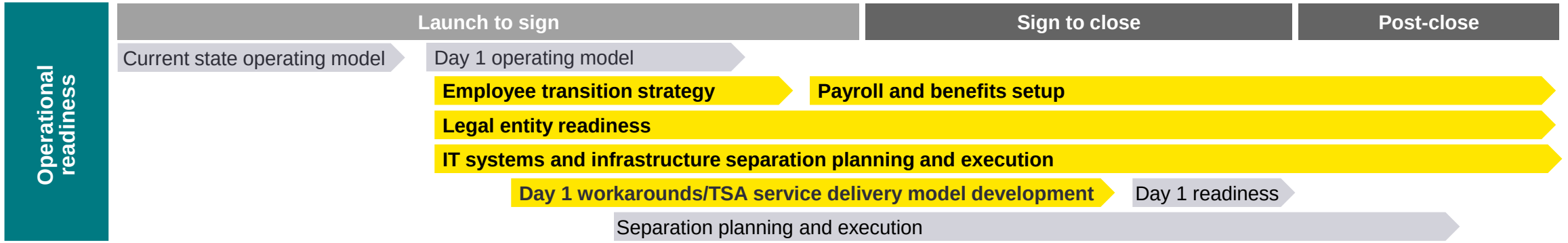


Critical path activities	Interdependency			Levers to accelerate timeline
	Ops	Legal	Tax	
Consider **deal options and define the deal perimeter early** to avoid time consuming iterations.	✓	✓		▪ Involve key decision-makers early to finalize and set deal perimeter ▪ Select assets that are easy to carve-out and identify buyers with readily available financing ▪ Define the method of allocating resources to the deal perimeter early ▪ Determine treatment of patents and other critical IP ▪ Identify and assess treatment of shared assets, contracts and services early
Regulatory approvals can be time-consuming and complicated by seller and buyer industry dynamics.		✓		▪ Selectively target a buyer pool that would limit antitrust concerns (e.g., due to industry concentrations), work councils or other local jurisdiction concerns
Sell-side financials could be subject to time-intensive carve-out audit requirements.	✓			▪ Prioritize smaller, digestible assets to not trigger an audit; evaluate significant subsidiary test ▪ Prepare focused outside-in financials that support the value story around quality of earnings and key trends
Buyer due diligence requires significant time to understand business interdependencies, cost structure and allocations.	✓	✓	✓	▪ Invest time to detail out the operating model (shared vs. dedicated capabilities), cost allocations and a future state stand-alone cost model ▪ Consider reducing the pre-sign period by allowing post-sign flexibility, such as with a “grab bag” approach

Critical path activities

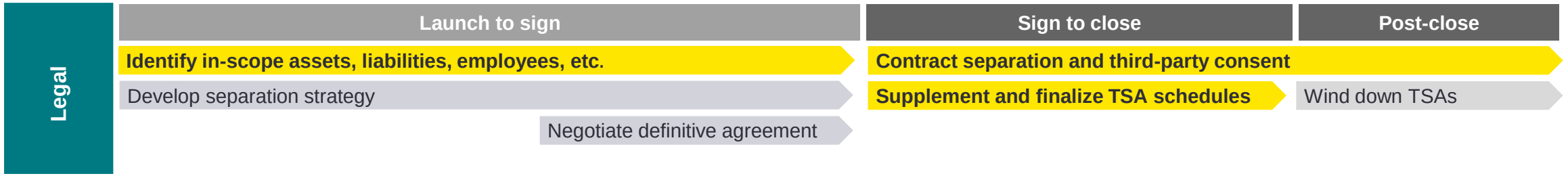
Note: Illustrative and does not represent comprehensive activity set

Critical path activities and levers to accelerate timelines and balance risks: *operational readiness*



Critical path activities	Interdependency			Levers to accelerate timeline
	Fin.	Legal	Tax	
Employee transition can be delayed due to labor relations (e.g., European Works Councils) approval.		✓		▪ Initiate notice periods and negotiations as soon as possible ▪ Utilize professional employer organizations (PEOs) or employee leasing agreements to avoid delayed country closings ▪ Determine the stranded cost of severing in-scope employees not transferring to buyer
Payroll and benefits setup requires significant lead time and is difficult for a buyer to merge into their own plans or outsource.		✓		▪ Amend the employee matters agreement and enable the buyer to establish programs
Creating step plans to form and operationalize **legal entities** requires cross-functional input.	✓	✓	✓	▪ Prioritize setup of legal entities and identify legal regimes with long lead times ▪ Establish Day 1 workarounds with incentives for prompt post-close transfer ▪ Develop efficient acquisition structures to minimize transfer and other taxes
IT systems and infrastructure separation complexities can prevent business continuity.	✓			▪ Minimize systems and infrastructure separation; use TSAs where necessary ▪ Wall off the separated business from general IT access; establish security protocols for employees
Day 1 workarounds and TSAs must be identified early and a delivery model planned to prevent disruption to business, as well as to limit ongoing entanglement.		✓		▪ Identify potential TSAs as the operating model is developed ▪ Leverage TSA inventory during buyer discussions ▪ Assess buyer reliance on TSA support and required post-closing resources

Critical path activities and levers to accelerate timelines and balance risks: *legal*

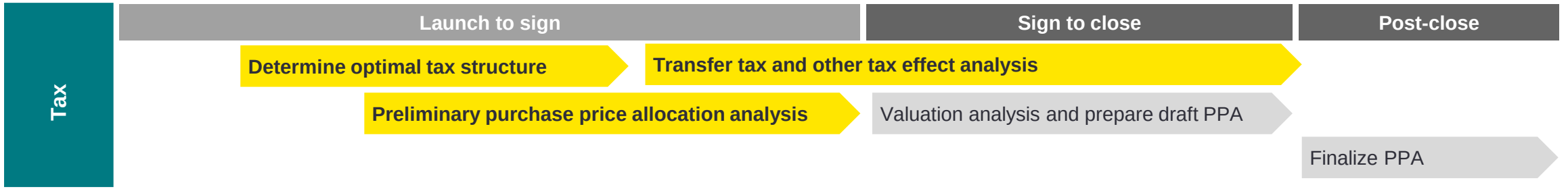


Critical path activities	Interdependency			Levers to accelerate timeline and balance legal risks
	Fin.	Ops	Tax	
Identifying and producing **all in-scope assets** requires cross-functional input.	✓	✓		▪ Consider trade-offs in using categorical descriptions (e.g., primarily related or exclusively used in) vs. a specific listing approach ▪ Consider a "grab bag" approach to shorten pre-signing buyer diligence period ▪ Reduces certainty and creates an additional process; potentially impacts stranded costs (e.g., procurement contracts)
Contract separation may not occur until post-close, but planning should start early to minimize post-closing entanglement.		✓		▪ Contract terms can dictate the separation strategy and timing ▪ Include proper incentives to minimize cost and burden of extended subcontracting arrangements post-close (e.g., drop-dead date, tax gross-ups, liability transfer)
TSA scope negotiations should balance speed and certainty.		✓		▪ Avoid creating a backdoor closing condition by delaying TSA negotiations ▪ Create a transition team to lead TSA negotiations with an escalation path that allows disputes to be addressed quickly ▪ Allow buyer flexibility but negotiate "guardrails" upfront to protect the seller, including a clear end date ▪ Ensure "at-cost" calculations are sufficiently broad to incentivize the seller ▪ Impose pricing increases for renewals and extensions

Critical path activities

Note: Illustrative and does not represent comprehensive activity set

Critical path activities and levers to accelerate timelines and balance risks: *tax*

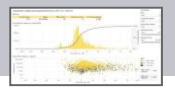


Critical path activities	Interdependency			Levers to accelerate timeline
	Fin.	Legal	Ops	
Identify the **seller's optimal tax structure** and calculate baseline tax savings.	✓	✓		▪ Identify baseline tax cost for the seller's optimal tax structure so that the seller can negotiate for additional consideration to compensate for any lost tax savings due to a buyer-preferred structure; consider NPV of the buyer's basis step-up ▪ Allow the buyer flexibility to change the structure post-signing but provide for a tax-gross up for taxes exceeding the baseline
Identify asset and liability location to determine potential **transfer tax** and other tax costs of divestiture.	✓	✓		▪ Split transfer taxes 50/50 to incentivize parties to develop structures to minimize transfer tax costs
Develop a mutually agreeable **allocation methodology** for purchase price allocation.	✓	✓		▪ Engage early on allocation methodology in complicated divestitures to limit post-close disputes and significant changes to purchase price allocations

Critical path activities

Note: Illustrative and does not represent comprehensive activity set

EY teams bring several accelerators to help divestors achieve faster timelines

	Critical path activities	EY Capital Edge	Op model workshops	Embedded data analytics	Functional cost baseline tool	EY org and Talent Hub	Managed services	Separation planning workshops
								
Deal preparation and financials	Consider **deal options and define the deal perimeter early** to avoid time-consuming iterations.	✓			✓			
	Regulatory approvals can be time-consuming and complicated by seller and buyer industry dynamics.	✓						
	Sell-side financials could be subject to time-intensive carve-out audit requirements.	✓		✓	✓			
	Buyer due diligence requires significant time to understand business interdependencies, cost structure and allocations.	✓		✓	✓			
Tax matters	Tailor the **transaction structure** to account for all tax considerations.	✓						
Operational readiness	**Employee transition** can be delayed due to labor relations (e.g., works councils) approval.	✓	✓			✓	✓	✓
	Payroll and benefits setup requires significant lead time and is difficult for buyers to merge into their own plans or outsource.	✓	✓			✓	✓	✓
	IT systems and infrastructure separation complexities can prevent business continuity.	✓	✓		✓		✓	✓
	Creating step plans to form and operationalize **legal entities** requires cross-functional input.	✓	✓	✓			✓	

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