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December, 2002

Clean Break - Divestitures and Demergers

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Divestitures and Demergers

Clean Break
Divestitures and Demergers

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This article was published in Charter magazine, the Journal of the Australian Institute of Chartered Accountants in December 2002, pages 65 to 67.

Over recent years there have been some high profile demergers and divestments with this trend likely to continue. Implementing a demerger requires significant effort and resources with the tasks required dependent on the mode of divestment and the current integration across businesses. There are actions management can take to smooth what can be a very disruptive process.

Divestitures and demergers are currently receiving significant press. Goodman Fielder has been implementing a divestiture program, Onesteel was demerged from BHP Billiton and Amcor spun off Paperlinx. Mayne is currently examining the alternatives of divesting it’s Logistics business via trade sale and demerger and analysts are calling for the demerger of Coles Myers food and non-food businesses.

Companies divest subsidiaries, business units and departments for many strategic reasons. However, breaking up can be hard to do. Preparing both the parent organisation and the to-be divested organisation for split often involves substantial effort and many difficult decisions.

While many divestitures are performed to improve management focus, ironically the divestiture process often diverts management focus. The work often continues after the divestiture has taken place and can have substantial impact on the remaining part of the company and the people within it.

The tasks involved in pre-divestiture preparation and post divestiture clean up can differ substantially depending on the role of the divested entity in the group, the level of integration across business units and the method of divestiture. In fact, demergers can be one of the most difficult divestment methods, especially when the demerging businesses are intertwined prior to separation.

This article outlines some of the critical operational tasks involved in the split, indicates the complexity of different divestment methods and provides suggestions to successfully manage a divestment/ demerger.

Reasons for Divestiture and Divestiture Methods

As indicated in Table 1, there are many reasons why senior management may elect to divest a part of the business.

<table>
<thead>
<tr>
<th>Table 1. Strategic reasons for divestiture</th>
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<tbody>
<tr>
<td>❑ Refocus business on core activities</td>
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<tr>
<td>❑ Enable divested division to supply parent competitors</td>
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<tr>
<td>❑ Raise capital</td>
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<tr>
<td>❑ Exit a non-performing business</td>
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<tr>
<td>❑ Gain from overvalued market</td>
</tr>
<tr>
<td>❑ Avoid future capital expenditure</td>
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<tr>
<td>❑ Greater synergies with another owner.</td>
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There are also many ways that management can divest a business unit. These include:

❑ Trade sale to another company,
❑ Spin-off of a separate company and either giving shares in the spin-off to parent shareholders (demerger) or selling all or a portion of shares to the public,
❑ Management buy-out,
❑ Establishment of a joint venture with another industry participant,
❑ Closing down the business.

The appropriate divestment method in any circumstance will be influenced by whether parent management seeks to retain any power or influence over, or economic interest in, the divested unit. For example, where the divested entity is a major supplier of the parent, the parent may wish to retain some influence over supply, especially if the supply market is limited. Management may also seek to retain some interest if they believe that the divested unit has significant growth prospects and they decide to retain some exposure to investment gains.

Other factors affecting the divestment method selected include the size of the business unit, buyer interest, level of potential synergies with other owners, current market values, potential staff redundancies, the need for funds and taxation impacts.
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Preparation for Divestment

Once management has elected to divest a business unit and the method of divestment the serious work of preparation begins.

Depending on the degree of integration between the business unit and the rest of the parent and the method of divestiture significant work is often required to ring fence the operations of the to-be divested business unit and establish required capabilities.

Some of major steps that may need to be performed in preparation for divestment are:
1. Establish to-be divested entity,
2. Determine assets, liabilities and people to be included in divested entity,
3. Build capabilities of the to-be divested firm,
4. Establish contract management and purchasing capabilities in the parent,
5. Commercialise relationships and processes between entities,
6. Develop service level agreements for corporate services to be provided on an interim basis by the parent.

These tasks are discussed below.

Establish to-be Divested Entity

Establishing the to-be divested entity may include setting up an independent board of directors and establishing a legal entity and new name for the spin-off. This is unlikely to be necessary for a trade sale to another company.

Determine Assets, Liabilities and People to be Included

Where the unit to be divested is a separate stand-alone subsidiary it can appear quite clear which assets liabilities and people are likely to be included in the sale. However, in many cases the business unit being sold may not have previously recorded a full balance sheet or profit and loss, with assets, debt and some costs recorded by head office and arbitrary cost allocation to business units.

Often people and assets are shared between business units, especially where shared corporate services are provided. Placing staff can also be difficult due to many organisations and jurisdictions having employee agreements and laws providing employees with the choice of staying with the parent, moving with the divested unit or accepting redundancy.

Often there is a balance required in ensuring both organisations have the required assets and skills to go forward and are not strangled by debt. Often as a result of ensuring both entities are competitive, a number of redundant assets and people are identified that need to be shed.

Build Capabilities of To-Be Divested Unit

Where an independent entity is being spun out a number of capabilities may need to be built to enable the new company to operate on a stand-alone basis. This may include new leadership, developing a new strategy, putting commercial services in place and implementing new IT systems and business processes.

Building capabilities is likely to be a greater task where the to-be divested unit is heavily integrated in the parent and does not have its own commercial services. For example, finance, human resources and legal capabilities may need development. Sometimes, the business unit will be spun out prior to the completion of this capability work and arrangements will be made for the ex-parent to continue to provide services for an interim period.

Where the unit was previously predominantly an internal supplier to the parent and other business units with little external sales, it is likely that sales and marketing capabilities will need to be put in place in the spun-out unit.

Much less effort is generally put into building the capabilities of a unit that is to be sold to another company. The business unit is likely to be integrated into the buyer’s infrastructure in order to achieve synergies. In this case, investment by the buyer is unlikely to be recovered through a higher selling price. A trade sale is likely to result in a negotiation over the assets, liabilities and staff transferred.

Establish Capabilities in the Parent

Often organisations run into difficulties when they continue to informally manage relationships with what was previously an internal business unit. Where the ex-business unit continues to supply the prior parent, often staff need to be put in place to manage contracts and purchasing between the units and the cost structure of the parent.

Commercialise Relationships

Where the divested unit is a major supplier of the unit, commercial arrangements often need to be put in place. This includes commercial contracts at appropriate prices, arm’s length ordering and contract management and monitoring processes. It is important to note that the terms of the ongoing supply contract can have a significant impact on the value of the to-be divested unit and the on-going cost structure of the remaining entity.

Develop Service Level Agreements for Interim Services

Where capabilities are not fully built in the divested unit at the time of divestment it may be necessary for the now separated unit to continue to acquire services from the ex-parent for a period after separation. Likewise, after a trade sale it can take many months for the new buyer to move the newly acquired onto its existing systems and processes, requiring interim services from the ex-parent.

Identifying the cost of the services provided and establishing service level agreements for each of the services can be a time consuming exercise.

After the Deal

So now you can relax, right? Wrong! Often the parent organisation is left with oversized corporate services and redundant property and equipment. Significant effort is often required to reduce the costs associated with corporate services and to dismantle some of the bureaucracy; property rentals often need to be “made good’ and efforts made to sub-lease or pay exit

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penalties; excess equipment and owned property needs to be sold; and relationships with the ex-business unit need to continue to be managed on a commercial basis.

**Comparison of Effort Across Divestment Methods**

Some divestment methods are more resource intensive under different circumstances. Figure 1 indicates that spinning-off a business unit to create an independent business (eg a demerger) generally creates greater divestiture effort than a trade sale to another company. This is due to the need to build a viable spin-off entity.

As Figure 1 suggests, there is also more work where the separating entities are integrated either through the provision of corporate services or through inter business unit supply of goods and services.

**Improving the Divestment / Demerger Process**

Divestments can involve significant effort and change for many people inside and outside of the organisation. Impact on the ongoing businesses can be reduced by:

- Understanding People Issues: many staff will be affected by changing responsibilities, lay-offs and uncertainty, and their responses can range from the excitement of a new challenge to despair, all of which impact on the performance of the ongoing business.
- Communicating with stakeholders; use communication strategies to reduce uncertainty for staff, show a clear strategic direction to shareholders and clarify the impact on customers, pre-empting rumours from competitors.
- Establishing a focused divestment team: it is vital to have a responsible, dedicated project team charged with ensuring that critical divestment tasks are performed and that the remaining management teams focus on maintaining the profitability of both remaining businesses.
- Utilising a rigorous program management framework in order to prioritise projects, allocate resources, ensure projects are completed on time and budget issues are addressed.

**Figure 1. A comparison of typical preparation tasks for divestment under alternative divestment methods and different pre-divestment integration**

<table>
<thead>
<tr>
<th>Method of Divestiture</th>
<th>Divestiture / Trade Sale</th>
<th>Spin-Off / Demerger</th>
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</table>
| **Significant Business Between Business Units** | • Determine assets, liabilities and people  
• Establish capabilities in parent,  
• Commercialise relationship between entities | • Establish to-be divested entity  
• Determine assets, liabilities and people  
• Build capabilities of to-be divested unit  
• Establish capabilities in parent,  
• Commercialise relationship between entities |
| **High Level of Centrally Provided Corporate Services (eg Shared Services)** | • Determine assets, liabilities and people  
• Develop Service Level Agreements for interim services  
• Downsize parent corporate services | • Establish to-be divested entity  
• Determine assets, liabilities and people  
• Build capabilities of to-be divested unit  
• Develop Service Level Agreements for interim services  
• Downsize parent corporate services |
| **Independent Subsidiary** | • Determine assets, liabilities and people | • Establish to-be divested entity  
• Determine assets, liabilities and people |

**Conclusions**

Divestments can be used to further the strategic goals of both the parent and the divested unit. Do not underestimate the people process and technology effort involved with separating the divested unit, building commercial relationships and moving to reduce costs of the parent company. Divestiture can improve focus in the medium to long term but can often divert management and employee focus in the short term.

Demergers, where a separate stand-alone company is created, can be the most complex type of divestiture especially where the businesses are integrated prior to separation. The businesses need to be separated, capabilities built in each business and excess resources shed.
Divestitures and Demerger

A divestment or demerger can impact many stakeholders. Negative impacts on both businesses can be reduced through a strong communications program, moving to retain key staff and the establishment of a focussed divestment project team and structure program management framework.

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Updated Author Details (March 2014)
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