

# McKinsey on **Finance**



## **Perspectives on Corporate Finance and Strategy**

Number 4, Summer  
2002

### **Divesting proactively 1**

Most companies wait too long to divest. They should sell off businesses long before they become a burden.

### **What makes your stock price go up and down? 7**

Identifying and understanding important individual investors can help corporate executives predict the direction of share prices.

### **Who's afraid of variable earnings? 13**

Many companies waste effort smoothing short-term earnings. They would be better off focusing on long-term profit and return on capital.

### **Viewpoint: Stock options—the right debate 18**

Reformers want companies to treat executive stock options as a cost. The real question is whether shareholders are getting what they pay for.

# Divesting proactively

Most companies wait too long to divest. They should sell off businesses long before they become a burden.

*Lee Dranikoff, Timothy M. Koller, and Antoon Schneider*

**B**reaking up, it turns out, really *is* hard to do. For many executives, the prospect of selling a business triggers a vague sense of dread. Perhaps the sale will seem like a tacit admission of failure or evidence of poor management. In some close-knit corporate cultures, it may even smack of treason.

It should not be surprising, then, that when executives do divest, it is nearly always in response to pressure—maybe the divested business is suffering heavy losses, the parent has a suffocating debt burden, or Wall Street analysts have turned negative. Among 50 of the largest divestitures completed over the past four years, we found that more than three-quarters were completed under pressure, most of them only after long delays when problems became so obvious that action was unavoidable<sup>1</sup> (Exhibit 1). Furthermore, in our study of the 200 largest US corporations during the 1990–2000 period, fewer than half divested three or more substantial businesses—those with a disclosed worth of at least \$100 million. Only one in five divested more than a half dozen substantial businesses. Taken as a group, the companies we studied bought 40 percent more businesses by number of transactions than they sold.<sup>2</sup>

We believe that such a bias against divestitures serves companies poorly and that most CEOs can boost performance by thinking about divestiture more proactively. Prior research

by McKinsey colleagues demonstrates that companies that create the most shareholder value are those that actively acquire and divest their portfolios.<sup>3</sup> Indeed, a hundred dollars invested in the average active corporate portfolio manager in January 1990 would have been worth \$459 by the end of the decade, but would have grown to only \$353 if invested in the average passive portfolio. Companies that tilted toward acquisition lagged significantly behind those that balanced their acquisitions with divestitures.

## Holding on can be costly

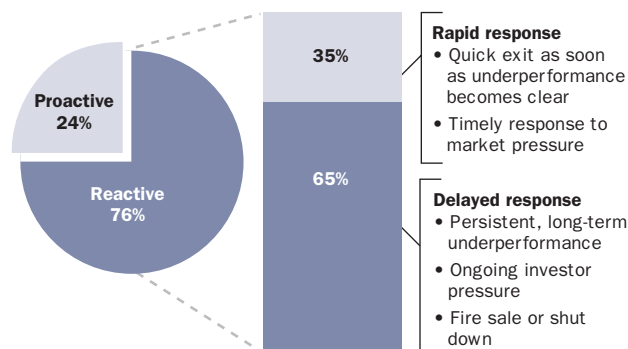
Of course, the desire to hold onto businesses, particularly successful ones, is strong. A unit may provide strong cash flow. It may deliver marketplace advantages through its relationships with key customer groups. Or it may represent a sentimental attachment for employees or other stakeholders, forming an important component of a company's identity.

But holding onto a unit too long also imposes costs—both on the entire corporation and on the unit itself. These costs often far outweigh the benefits of keeping the business and can include the following:

*Costs to the corporation.* The stability that well-established, profitable businesses provide is a mixed blessing. True, stable businesses can produce cash and help keep earnings smooth

**Exhibit 1. Most divestitures are reactive, in response to pressure on the parent or the unit**

100% = 50 divestitures



Source: McKinsey analysis

and predictable. But they can also dampen a company's impulse to create new, high-growth businesses. Determined business building often springs from a sense of crisis—a clear and pressing need for growth. The sense of comfort that surrounds seemingly stable businesses can temper any sense of urgency, causing a company to stagnate.

A stagnant portfolio of stable businesses can also drain precious resources and hinder exploration of new opportunities. Specialty-packaging-products provider Pactiv reviews the role of each business unit every year, as part of the overall company's strategic-planning process, and sees divestiture as a powerful way to free up resources. In 1999 the company sold its aluminum business despite its strong cash flow. Says CEO Richard Wambold: "It was using resources and management time we could use better elsewhere, and its cyclical nature [made Pactiv] more difficult for investors to understand. It did not offer the same potential as the other businesses."

*Costs to the unit.* Every corporate parent has different skills and resources. Some, like

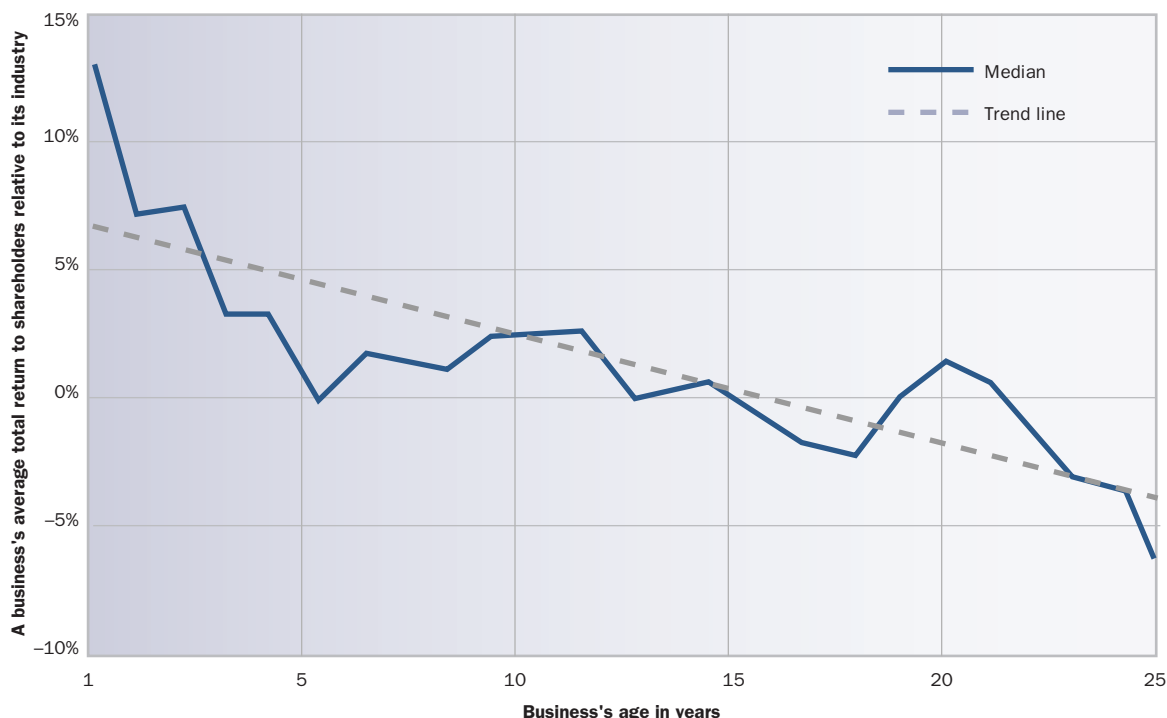
strong venture capital firms, understand how to seed a business, providing important capabilities in such areas as product development, sales and marketing, and alliance creation. Some excel in growing businesses, offering expertise in, for example, operational planning and capital management. Others know how to manage mature businesses, providing assistance in making operations more efficient or helping them to better manage costs.

Rarely does a parent have the expertise required to help a business through every stage of its life cycle. When a corporate parent stops adding distinctive value, it is no longer the natural owner of a unit and should consider selling it or spinning it off. That is what Wambold did with Pactiv's polyethylene-packaging business. Although the unit was the largest player in its market, the polyethylene industry remained highly fragmented. Wambold saw that Pactiv did not have the resources to lead further industry consolidation. As a result, Pactiv was not best positioned to take the unit to the next level of performance. So in January 2001, Pactiv sold the unit to Tyco, which wanted to expand its polyethylene business. As Wambold explains, "You have to know what business you are good at and let someone else manage the rest."

*Depressed exit price.* Postponing divestitures can exact another cost through direct impact on shareholder returns. As with acquisitions, a well-timed divestiture can contribute to shareholder value, and a poorly timed one can destroy value.

Naturally, timing the market perfectly is impossible. But we find that a company's timing can improve considerably by using a simple rule of thumb: *sell sooner* (Exhibit 2). In the vast majority of divestitures we have

## Exhibit 2. Time is the enemy of business



Source: McKinsey analysis

studied, it is clear that selling earlier would have generated much higher returns. Why? Downward adjustments of business valuations by outsiders or capital markets typically lag behind any decrease in true value of a business as it matures and generates lower economic performance and/or growth because outsiders have incomplete information. That asymmetry of information can give companies a window of opportunity to sell a business at an attractive price once it becomes evident internally that growth and performance are on the decline.

### Making it happen

Most coordinated divestiture programs happen as a result of a change in a company's leadership. Indeed, more than 50 percent of all significant divestitures take place within two

years of the appointment of a new chief executive. Fresh to the role, the incoming CEO can assess the situation without bias, make decisions without fear, and take the hard actions necessary to unload businesses.

But incumbent CEOs can achieve the same results. By following a rigorous, carefully managed five-step process, companies are more apt to get a proactive divestiture program off the ground, build support for it throughout the ranks, and ultimately make it a core element of their corporate strategies (Exhibit 3). Two of these steps—structuring the deal and communicating a difficult decision—are likely to be familiar and intuitive, similar to components of any important strategic transaction. The other three we will examine more closely here.



---

**Exhibit 3. Five steps of proactive divestiture**

<b>Prepare the organization</b>	<ul style="list-style-type: none"><li>• Explain to employees the rationale for the divestiture and why it is essential to the corporation's health.</li><li>• Introduce forcing mechanisms to ensure that managers actively consider divestiture.</li></ul>
<b>Identify candidates</b>	<ul style="list-style-type: none"><li>• Establish concrete criteria for determining candidates, including a unit's impact on the rest of the corporation, the corporation's impact on the unit, the unit's ability to meet or surpass market expectations, and the optimal portfolio for the company.</li><li>• Analyze the practical issues (such as taxes, availability of buyers, and so forth) to narrow the list of candidates.</li></ul>
<b>Structure the deal</b>	<ul style="list-style-type: none"><li>• Identify buyers and determine how best to structure the sale (for example a simple sale for cash, a spin-off to shareholders, or complex structures involving two-step transactions and contingent compensation).</li><li>• Ensure that employees are not distracted during the sale process, perhaps by offering them additional incentives.</li></ul>
<b>Communicate the decision</b>	<ul style="list-style-type: none"><li>• Hold off on the sale announcement until the completion of the deal seems likely.</li><li>• Communicate the reason for the sale concisely and simply.</li></ul>
<b>Create new businesses</b>	<ul style="list-style-type: none"><li>• Reinvest the funds, management time, and support-function capacities in attractive new growth opportunities.</li></ul>

Source: McKinsey analysis

---

## Prepare the organization

Because the stigma surrounding divestiture is so strong, people will naturally resist it, at least initially. It is critical, therefore, that senior managers rigorously communicate the rationale for divestiture and why it is essential to the corporation's health. PerkinElmer's leadership team, for instance, prepared the ground for its divestiture program<sup>4</sup> by talking directly and repeatedly with people throughout the organization. CEO Greg Summe held regular "town hall" meetings with each of his businesses, explaining the company's strategy and divestiture's role in it. In time, as a company begins to enjoy the results of proactive divestiture, the stigma should fade, and divestiture should become an expected event in a business unit's life cycle. Until then, though, management will have to assure employees that divestiture is not a sign of failure but an emblem of strategic strength.

When a company is in the early stages of building its divestiture skills, it can be useful to introduce some formal forcing mechanisms to ensure that divestiture is routinely considered. A company might, for instance, impose limits on portfolio size, set fixed ratios of divestitures to acquisitions, or hire people with trading mind-sets to sit on boards or fill key roles. Or, as private equity firms have done for years with strong results, a company can "date stamp" all its businesses. The idea is not to force any divestiture by a specific date but rather to ensure that divestiture is seriously considered at regular intervals.

## Identify candidates

Perhaps the biggest shift in embracing a proactive approach to divestiture is thinking about selling off good, profitable businesses. That can be quite a shock to many people, even in the most senior management ranks. It

is important, therefore, to establish concrete criteria for analysis and apply them objectively to every unit. Four factors, in particular, should be weighed:

*The business unit's impact on the rest of the corporation.* What effects, positive and negative, does the business unit have on other units and on the corporation as a whole? A cultural audit, for example, can help assess whether a unit's culture clashes with the parent corporation. Examining the CEO's calendar can identify units that consume a disproportionate share of management time. Interviews with unit managers and a review of denied capital spending requests can identify opportunities that have not been explored because of competitive conflicts. Conversely, a review of each unit can reveal whether it offers ongoing synergies in terms of growth options or valuable benefits such as shared R&D resources.

*The corporation's impact on the business unit.* Any evaluation of a business unit should be two-way. What value does the parent corporation add to the business unit, relative to other potential owners? relative to what other owners bring to similar units at competitors? Analysis of matching skills, cultural fit, and synergies then have to be compared with what another owner could offer the unit in order to assess the premium another owner might pay to acquire it.

*The unit's ability to beat market expectations.* Do the capital markets currently overvalue or undervalue the business? This analysis can be difficult—management needs to estimate the unit's value based on future expectations for performance and compare that number to the unit's implied market value embedded in the stock price. Difficult? No question. But this

---

**Divestiture is not an end in itself  
but rather a means to building a  
company that can grow and prosper  
over the long haul.**

---

analysis is essential because it will show executives whether the unit can realistically create future value for the company's shareholders. When the analysis reveals that existing businesses are overvalued by the capital markets, executives will tend to be much more aggressive in selling off units to outsiders who lack in-depth information into true business performance and growth prospects.

Sometimes, the divestiture candidates pinpointed by this analysis even include cash cows. Why sell cash cows? Because they are likely to be in mature industries and have limited potential for achieving growth beyond the market's expectations. Cash cows benefit companies by providing protection during downturns, for example, or being a source of funding for new investments. But they usually contribute little to shareholder value. They can also be risky to hold if they lose market share, which is virtually inevitable among high-market-share businesses, because their market value will likely decline sharply.

*The corporation's overall portfolio.* If the previous steps identified candidates for divestiture, it is this final step that must determine which divestitures to push forward. Only a sound portfolio strategy can determine what is the best combination of businesses for the company to hold, the critical size for the organization, and the desired market

perception. By examining the portfolio that would remain if different sets of divestitures occurred, it is possible for a CEO to see the impact on the overall company and evaluate how the remaining portfolio fits with the company's long-term strategy. This analysis must be forward looking; a business unit that does not fit with a company's portfolio today might fit exactly with the portfolio it intends to develop.

It is important to note that no one type of portfolio is best for every company. The purpose of a divestiture strategy should not be simply to transform a diversified, multi-business company into a focused, single-business company. In fact, the capital markets actually reward a moderate degree of diversification. Between 1980 and 2000, moderately diversified companies delivered shareholder returns that were at least as strong as, and in some cases stronger than, those of focused companies and consistently stronger than those of highly diversified companies.<sup>5</sup>

These four analyses will highlight attractive candidates for divestiture. Management can then apply practical considerations—tax implications, availability of buyers, market reaction, payment mix, use of divestiture proceeds, and dilution of earnings—to narrow the list and set timing. Some executives would argue that the practical issues are so important that they should be considered first. We disagree. Many corporations overemphasize the practical issues and thus presume that divesting is impossible. By focusing on more strategic considerations at the outset, companies build momentum for divestiture and look at the practical constraints as problems to be overcome rather than as roadblocks to action—an important distinction.

## Create new businesses

Divestiture is not an end in itself but rather a means to building a company that can grow and prosper over the long haul. Wise executives divest businesses in order to create new ones and expand existing ones. All the funds, management time, and support-function capacity that are freed up through a divestiture should therefore be reinvested in creating shareholder value. In some cases, this will mean returning money to shareholders. But more likely than not, it will mean investing in attractive growth opportunities. In companies, as in the marketplace, creation and destruction go hand in hand; neither flourishes without the other. **MoF**

**Lee Dranikoff** (Lee\_Dranikoff@McKinsey.com) is an associate principal, **Tim Koller** (Tim\_Koller@McKinsey.com) is a principal, and **Antoon Schneider** (Antoon\_Schneider@McKinsey.com) is a consultant in McKinsey's New York office. Copyright © 2002, McKinsey and Company. All rights reserved.

<sup>1</sup> See also, D. Ravenscraft and F.M. Scherer, "Mergers, sell-offs, and economic efficiency." The Brookings Institution, 1987, pp. 167, which found that divested units had below-average operating profits for seven years prior to being sold.

<sup>2</sup> See also, Constantinos Markides, "Diversification, refocusing, and economic performance." Massachusetts Institute of Technology, 1995, pp. 62, which found that large companies completed 34 percent more acquisitions than divestitures during the 1980s.

<sup>3</sup> Jay Brandimarte, William Fallon, and Robert McNish, "Trading the corporate portfolio." *McKinsey on Finance*, Number 2, Autumn 2001, pp. 1–5.

<sup>4</sup> The company completed 11 acquisitions and 6 divestitures over 3 years between 1998 and 2001.

<sup>5</sup> Neil Harper and Patrick Viguerie, "Beyond focus: Diversifying for value." *McKinsey on Finance*, Number 3, Winter 2002, pp. 1–5.

