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Do carve-outs make sense? Yes, but not for the reasons you might think.

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Many CEOs consider equity carve-outs (Exhibit 1) too good to miss: a financial instrument that increases company stock price without sacrificing control of a valuable business unit. However, analysis we conducted of 200 major carve-outs across the world over the past ten years[1] shows that this perception is not entirely accurate. We found that the vast majority of carve-outs ultimately lead to changes in corporate control, and very few produce significant share price increases for the parent. Most actually do not create shareholder value unless the parent company follows a plan to subsequently fully separate the carved-out subsidiary.

This is not to say that carve-outs, executed wisely, are not useful tools in an executive's restructuring toolbox. They are certainly popular, with average yearly volumes of more than $20 billion between 1995 and 2000. It also cannot be denied that some high-profile carve-outs have imbued this financial device with a kind of star quality. When Kmart announced its 52 percent carve-out of Borders, Kmart stock went up 13.2 percent during the week around the announcement, generating $803 million in value for its shareholders. The same effect was evident in 3Com's 20 percent carve-out of Palm, which increased stock prices by 17.6 percent and generated $2.7 billion for shareholders.

The fact is that carve-outs can be valuable—but for reasons other than those that many have believed. Executives evaluating a carve-out for one of their business units must think beyond the question of a simple boost for their stock price. Rather, to achieve the value that carve-outs can deliver, executives must be prepared over time to give the carved-out business full independence.

Ready or not, here comes independence

The idea of maintaining indefinite corporate control over carve-outs is nearly always a fallacy. Our findings indicate that only 8 percent of carve-outs continue to exist as clearly parent-

Exhibit 1

Definitions

Carve-out: The flotation of a minority stake of usually less than 20% (in the United States) of a subsidiary's shares through an IPO for cash

Spin-off: Full flotation of a subsidiary by distributing subsidiary shares in the form of dividends to existing parent shareholders

Split-off: Full flotation of a subsidiary by offering subsidiary shares to existing parent shareholders in exchange for parent shares

Tracking stock: Special class of parent stock for which the dividends "track" a specific subsidiary's economic performance, either through an IPO for cash (tracking stock carve-out) or through a distribution to parent shareholders as dividends (tracking stock spin-off)

controlled public companies after five years, that is, where the parent owns more than 50 percent of shares (Exhibit 2). Nearly 40 percent are ultimately acquired by third parties, and an additional 31 percent see the parent stake reduced to less than a 25 percent minority.

This result should not come as a surprise. Even a minority initial public offering provides high-growth businesses with their own transaction currency for acquisitions, equity funding for internal growth, and their own shareholder and legal responsibilities, all of which lead over time to the dilution of parent company stakes. For example, Siemens's stake in its carved-out semiconductor subsidiary Infineon was reduced from 71 percent to 50.9 percent after Infineon's secondary share offering in June this year. The offering was floated to raise funding that Siemens would not provide. Siemens has since announced that it intends to further reduce its stake.

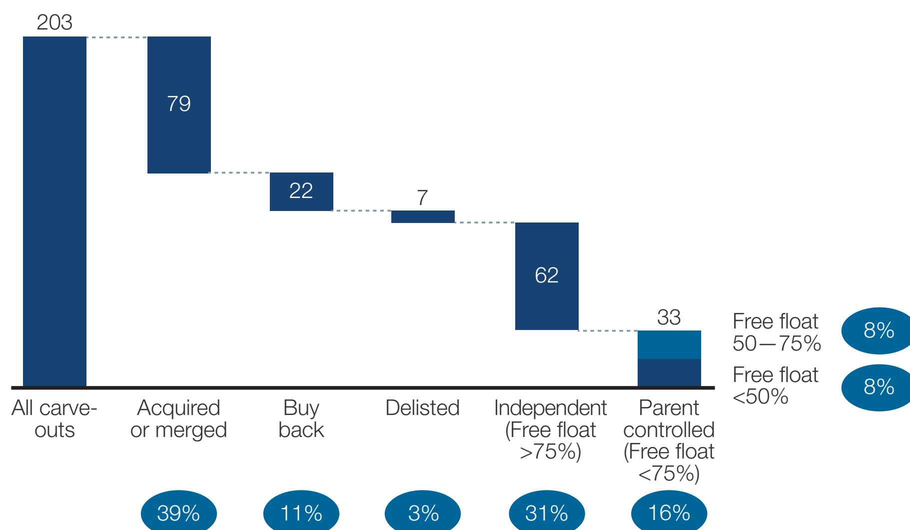
Some carve-outs are taken over by leading players in their industry that hope to realize significant synergies with their own businesses. For example, Citicorp snapped up Ford's financial services carve-out, Associates First Capital, and Morgan Stanley merged with Sears's Dean Witter Discover carve-out into MSDW.

Of course, as long as the parent has majority control, it can usually block any undesirable takeover such as a direct buy by a head-to-head competitor. By carefully planning a carve-out's trajectory, parent companies can ensure that a business unit has the opportunity to prove its viability in the market before exposing it to the full brunt of market forces and susceptibility to takeover.

However, parent companies that obstruct carve-outs on their way to independence and use their majority stake to exercise managerial control in the long run risk eliminating the very benefits the carve-out was intended to deliver. They also risk precipitating further conflict as subsidiary executives formally pursue the best interest of their own company and shareholders. Consider US oil exploration and production (E&P) company Vastar, which was carved out by ARCO in 1994. At one point, Vastar found itself bidding against ARCO for the same E&P projects. ARCO resolved this potential conflict not by preventing Vastar from bidding but rather by shifting its own focus to international projects and leaving the US market for its subsidiary.[2]

Exhibit 2

Carve-out dynamics—typical trajectories



Source: McKinsey analysis

Such conflicts can easily intensify over time as the distance increases between parent and carve-outs, especially since carve-outs often operate in different, higher-growth industries than their parents do. In our sample, revenues for carve-outs grew at an average annual rate of about 13 percent for the first two years after the IPO, compared with around 5 percent for their parents.

When carve-outs make sense

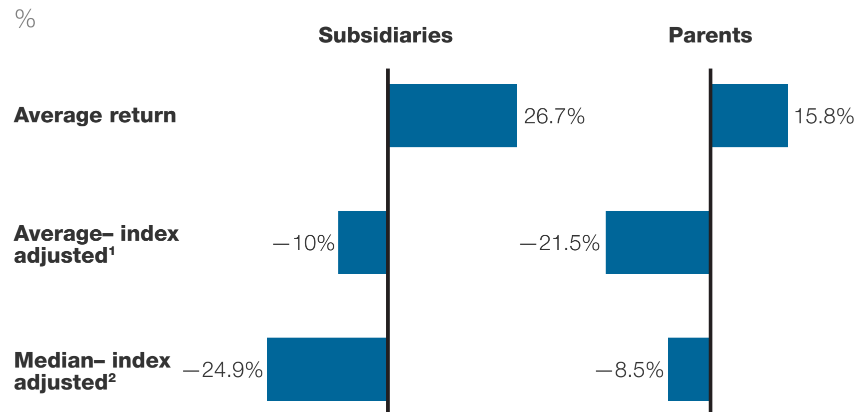
Another chimera associated with carve-outs is that they routinely deliver big boosts in share price. Our research shows that in the short term only 10 percent of carve-outs resulted in a share price increase of more than 12 percent for the parent. Over the long term, most carve-outs actually destroy shareholder value, as shown by negative, risk-adjusted performance measures (Exhibit 3).

Shareholder value typically increases only when both parent and subsidiary perform better as independent companies, and only when parent companies aim for full separation of the subsidiary—through a subsequent spin-off or full public offering of subsidiary shares. Carve-outs can create value for shareholders from enhanced strategic freedom and access to independent funding. As part of a parent group, subsidiaries are often restricted in choosing customers, suppliers, funding, and transaction opportunities. For example, prior to its carve-out and subsequent spin-off, one telecom equipment provider had virtually no access to customers for its hardware products that were competitors of its parent. Similarly, Palm was in a better position to close strategic alliances with AOL, Nokia, and Motorola after its carve-out from 3Com. These strategic and funding benefits can be fully captured only when parent companies are prepared to reduce control over time.

Furthermore, carve-outs can create value through better alignment of managerial incentives and more streamlined decision making within the carved-out business. As management is freed from the parent's decision process, decision making in

Exhibit 3

Cumulative two-year post-transaction TRS



[1]Benchmark index is S&P 500 for U.S. companies and Datastream's European Market index for European companies.
[2]Benchmark index is median estimated S&P 500 index for all companies.
Source: McKinsey analysis

the subsidiary can become less complex and more effective. Moreover, listing equity publicly enables management to provide high-powered incentives in the subsidiary through stock and stock option plans, which make up a significant part of total compensation to carve-out executives.[3]

In the best cases, parent company executives anticipate and plan full independence for carve-outs. In the United States, a carve-out followed by a spin-off usually also enables a parent company to divest a subsidiary without incurring the capital gains taxes that it would typically face in a trade sale or full IPO. For example, the carve-outs Guidant, Palm, and Lucent were subsequently spun off by parents Eli Lilly, 3Com, and AT&T, respectively, in tax-free distributions to the parents' shareholders. Indeed, carve-outs that eventually become independent from their parents as a result of a subsequent full spin-off or public offering of the parent's remaining stake have significantly outperformed the stock market as a whole in the first two years after their flotation (Exhibit 4).

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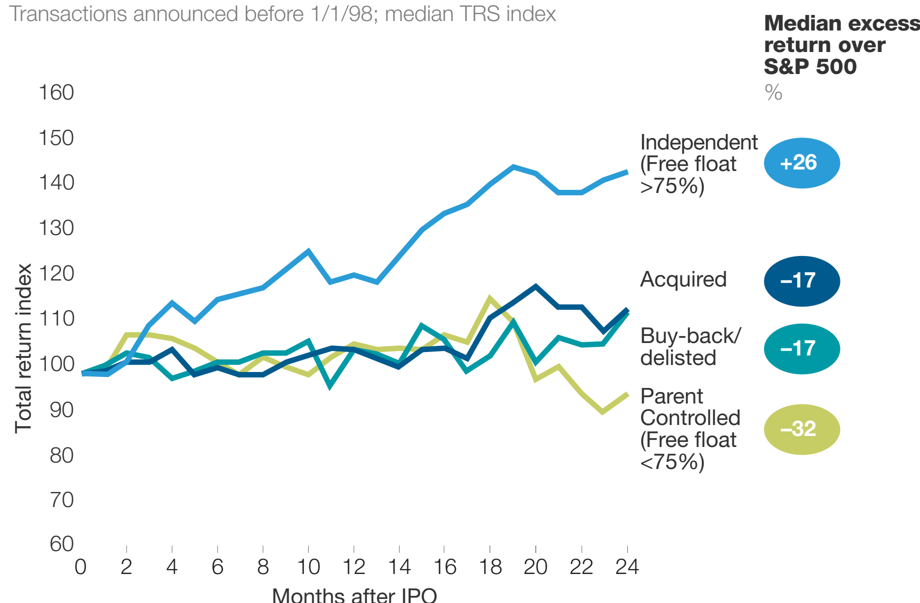
Exhibit 4

Long-term TRS of carve-outs varies by trajectory



Source: McKinsey analysis

You can't go home again

A carve-out is not likely to be a good option if there are still operating or strategic synergies with the parent group. Most synergies between parent and subsidiary will be lost after a carve-out as the two entities operate at the requisite arm's length. Legal protections for the public minority shareholders typically demand that all transactions with the parent company take place at fair market terms and conditions as if it were between two independent entities. This greatly reduces the flexibility and ease with which parent and carve-out can cooperate to capture any synergies.

Although many parent executives anticipate that they still have a "strategic option" to buy back the public minority stake if the carved-out business is successful, the facts show quite the opposite. Carve-outs that were bought back by their parent companies show very low long-term stock market performance. Buying back a minority stake to recover significant synergies between parent and subsidiary, or to compensate for lagging subsidiary share prices, can also prove expensive for the parent. In one example, after US biotech company Genzyme carved out its testing division, IG Laboratories, Genzyme realized that it was still very dependent on IG Laboratories to test its products. When it found IG to be less and less willing to accommodate its needs, Genzyme ultimately had to buy back the public stake in IG from the capital market.[4] In another example, following its 1997 carve-out of Hertz, Ford revised its corporate strategy to focus on becoming the global leading consumer company for both automotive products and services.[5] Under the revised strategy, Ford considered Hertz to be one of the world's strongest automotive service brands and an integral part of this strategy. To enhance the operating flexibility between itself and Hertz, Ford bought back the public stake in Hertz at a 46 percent premium

over the $24.25 September 20, 2000, share price, reflecting a $224 million acquisition premium over Hertz's stand-alone value.

Carve-outs remain a useful financial tool. But corporate executives need to avoid illusions about what carve-outs can deliver. Carving out even small stakes of subsidiaries is likely to lead to complete and practically irreversible separation. Companies that do not plan for such complete independence for their carved-out subsidiary or even try to reverse the carve-out are likely to end up destroying shareholder value.

[1] Source: *Securities Data Corporation* global database. Transactions analyzed were those exceeding $50 million between January 1990 and May 2000.
[2] Patricia Anslinger, Sheila Bonini, and Michael Patsalos-Fox, "Doing the spin-out," *McKinsey Quarterly,* 2000 Number 1, pp. 98–105.
[3] Patricia Anslinger, Sheila Bonini, and Michael Patsalos-Fox, "Doing the spin-out," *McKinsey Quarterly,* 2000 Number 1, pp. 98–105.
[4] Patricia Anslinger, Sheila Bonini, and Michael Patsalos-Fox, "Doing the spin-out," *McKinsey Quarterly,* 2000 Number 1, pp. 98–105.
[5] Ford Chief Financial Officer Henry Wallace, December 2000.

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