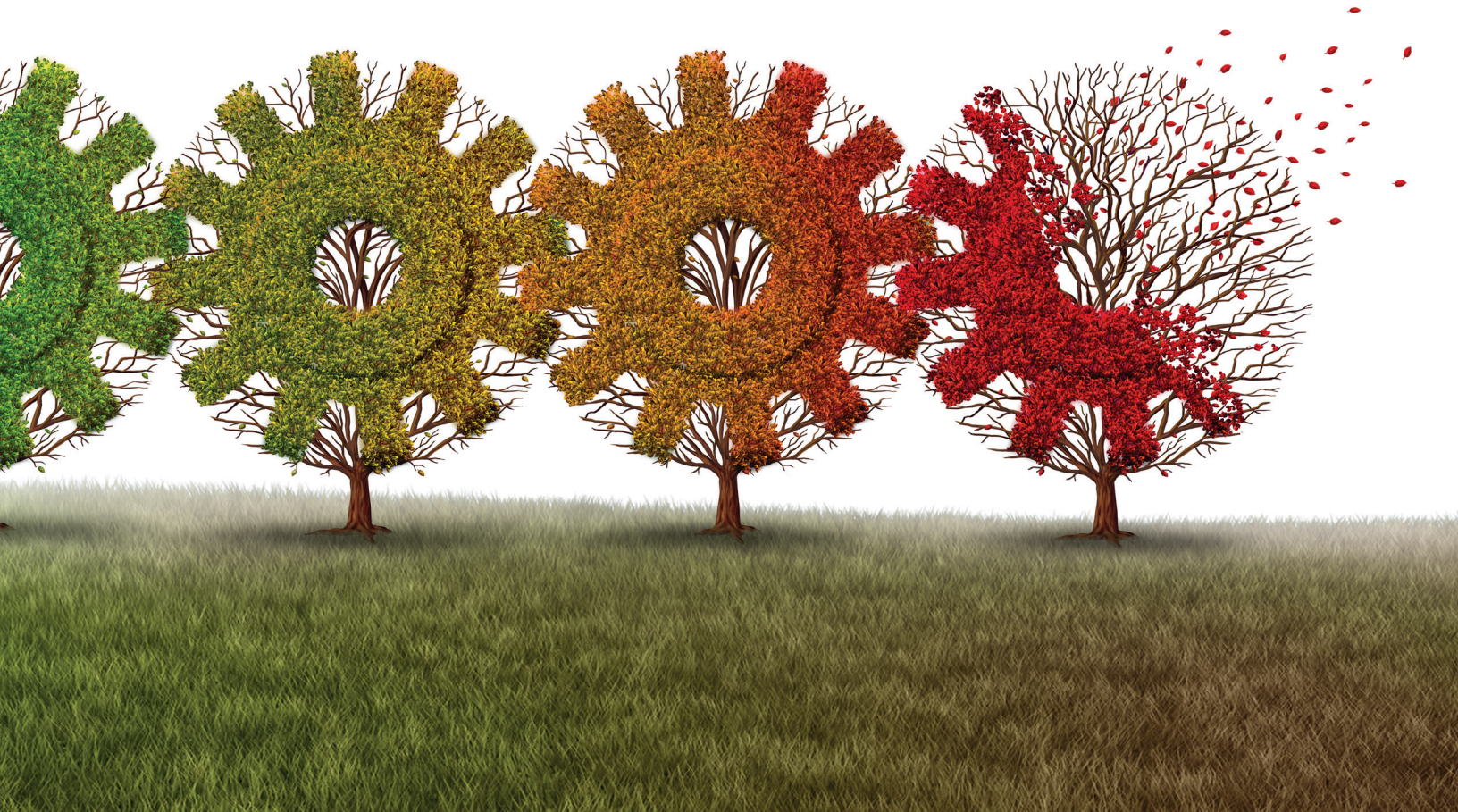


Understanding how US tax reform will affect divestitures

Lower rates will motivate companies to consider selling assets that lack scale for spinning off, and will make some complex deal structures less attractive.

Obi Ezekoye, Jannick Thomsen, and Andy West



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Research shows that companies that actively and regularly reevaluate their assets and portfolios can end up being worth twice as much as their less agile counterparts.¹ Yet for years some US companies resisted dynamically reshaping their portfolios—in part because of the tax consequences of active divestitures.

US tax reform—specifically the reduction of the top corporate federal income tax rate from 35 percent to 21 percent—will change companies’ portfolio agility and boost their willingness to pursue separation and divestitures.²

Companies have traditionally hesitated to sell non-core assets because the gains and losses on divestitures are taxable as ordinary income. The consequences of selling off assets can be

significant—even in those cases where the business no longer seems to be the best owner of an asset, or when an asset no longer fits the company’s strategic portfolio.

As new tax laws take effect, however, valuations are likely to go up in most industries, as lower taxes have a positive effect on cash flows, resulting in greater returns for sellers.³ Moreover, the tax liability associated with the sale of an asset will likely be about 40 percent lower. For instance, in the theoretical sale of a \$1 billion business with a \$200 million tax basis, after-tax proceeds would increase by 23 percent, given the changed tax rate and increased valuation (exhibit).

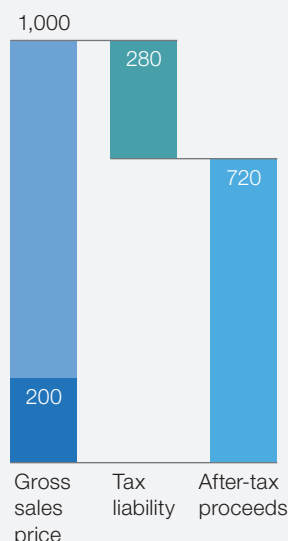
Once the decision to initiate a divestiture is made—whether to improve the balance sheet, refocus

Exhibit

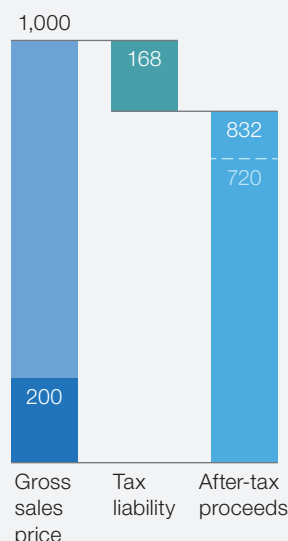
In the sale of a business, after-tax proceeds will increase, due to the changed tax rate and increased valuation.

Theoretical sale of a business, \$ million

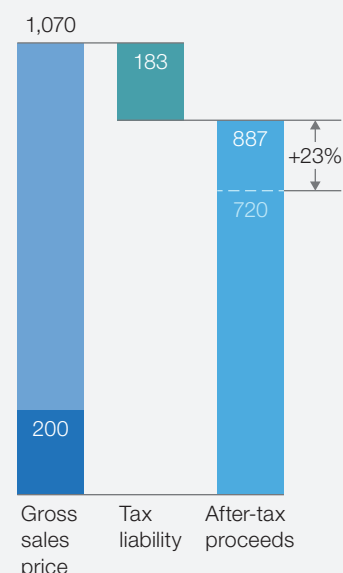
\$1 billion business with a \$200 million tax basis and 35% tax rate



Increase in net proceeds because of change in tax rates



Increase in valuation because of increased after-tax cash flows



senior management, return cash to shareholders, or otherwise benefit the organization—businesses must still consider how precisely to let go. The revised tax law will affect the way companies execute this separation. Complex deal structures—for instance, joint ventures, master limited partnerships, and real-estate investment trusts—may be used less often if, as many expect, the tax benefits from these deal types become less attractive.

Changes to the US tax code are ushering in a period of increased divestiture activity and more dynamic resource reallocation. Companies that were previously hesitant to reallocate resources with greater frequency will have an opportunity to capitalize on this trend. Specifically, they will have more incentive to sell noncore assets or businesses that distract senior management and that do not have the scale to be considered for a tax-free spin-off into a publicly listed entity. Additionally, companies will have more flexibility to divest large businesses and use the proceeds to invest in new businesses that are more in line with the company's strategy and core capabilities.

What shouldn't change, however, are some fundamentals of good portfolio management. Companies should aim to evaluate their portfolios on a rolling basis, not just once or twice a year. They should develop a systematic process for deciding who the best owner of assets or businesses should be (without bias or false inferences). And they should not be afraid to make both big and small moves to continually reshape their portfolios. ■

¹ Yuval Atsmon, "How nimble resource allocation can double your company's value," August 2016, McKinsey.com.

² The benefits will be conferred to US companies as well as the US operations of non-US companies.

³ Note that this also depends on how much is passed on to consumers, which will vary from industry to industry.

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