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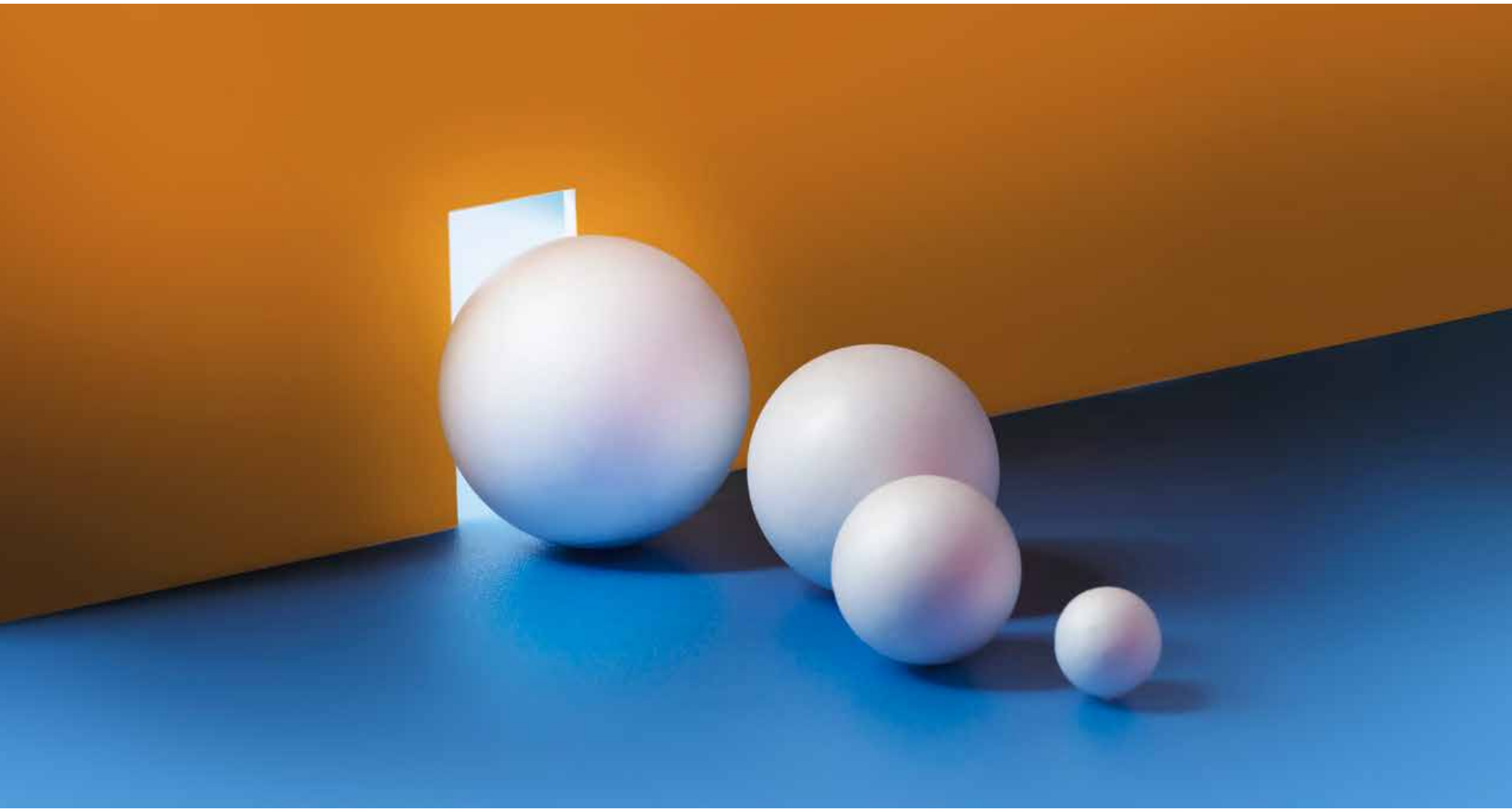
What's keeping you from divesting?

Active portfolio management can create significant competitive advantages. Still, executives routinely shy away from separations. Here are six common roadblocks and some tips for breaking through.

by Gerd Finck, Jamie Koenig, Jan Krause, and Marc Silberstein



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You've taken a close look at your portfolio and identified the assets that are no longer strategic priorities. Now what? Logic would dictate that you kick off a divestiture process—that is, you would convene a deal team to define key process steps in the separation and then market the assets in question to potential buyers.

A recent survey of business leaders, however, confirms that this process gets abandoned more often than not, for a variety of reasons—among them, senior management's perceptions that disentangling the assets will be too complicated or that there will be few interested buyers. Executives and boards often fear that divestitures will reduce the size of a company in ways that will make it difficult to replace earnings.

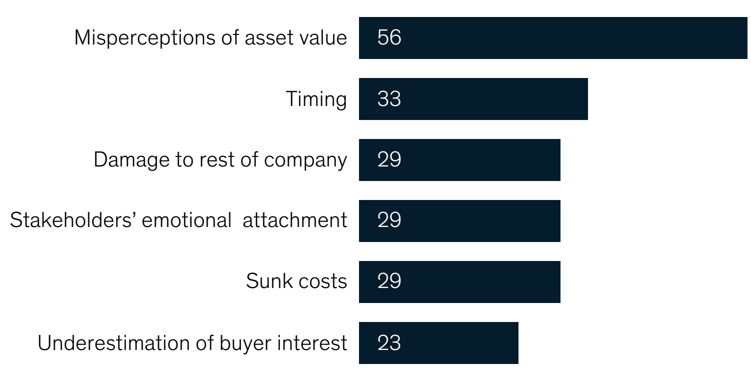
Such fears are often unfounded. In fact, research continues to mount in favor of active portfolio management, in which companies constantly redeploy their capital toward areas of the business where industry dynamics and their competitive advantages maximize returns on invested capital (ROIC). A recent McKinsey study shows that among companies in the sample, the 23 percent that regularly refresh 10 to 30 percent of their portfolios through acquisitions and divestitures outperform the others in total returns to shareholders (TRS) by an average of 5.2 percent a year.[1]

A recent survey of 128 senior business leaders helped us pinpoint the most common obstacles to divestitures. Executives said one or more of the following six concerns had prevented them from pursuing a divestiture in the past ten years: misperceptions of asset value, underestimating buyer interest, concerns about damage to the rest of the business, concerns about timing, fear of sunk costs, and emotional attachment to the asset (Exhibit 1). With 52 percent of the respondents also indicating that they expect to conduct

Exhibit 1

Executives cite six common obstacles to divestiture.

Roadblocks cited as 1st or 2nd most frequent divestiture inhibitor, % of respondents[1]



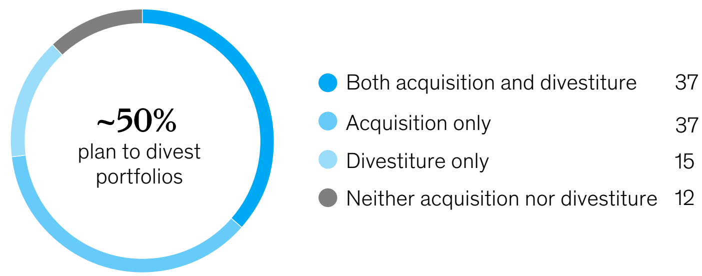
[1]Multiple answers allowed; n = 128.
Source: McKinsey survey of executives, board members, and corporate-development and -strategy leaders in June 2020

[1] This McKinsey analysis of 209 major international companies from a cross-section of industries measured average excess total returns to shareholders from 2007 to 2017. The refresh rate was defined by how much of a company's revenues came from business areas or service lines different from those ten years earlier.

Exhibit 2

A majority of surveyed companies expect to shift their portfolios in the next 18 months.

Expect company to make acquisitions or divestitures in next 18 months,
% of respondents[1]



[1]Figures may not sum to 100%, because of rounding; n = 128.
Source: McKinsey survey of executives, board members, and corporate-development and -strategy leaders in June 2020

divestitures in the next 18 months (Exhibit 2), now is the time to confront these challenges. In this article, we take a close look at each obstacle and suggest possible moves business leaders can take to overcome them.

Asset value

Business leaders often decline to part with an asset because they believe that its value is far greater than what anyone would be willing to pay for it. That belief is frequently rooted in unrealistic growth expectations for the asset—the traditional hockey-stick projection[2]—which fail to come to fruition year after year. So even when executives perform high-level valuation analyses and flank them with trading multiples, that might not be a sufficient fact base to address biases in management's business plan or to consider realistically how valuable the asset might be to different types of buyers.

A better approach is to build a detailed outside-in valuation model that factors in different business and market scenarios, under current and other ownership. The executive team of a diversified utility company did just that: it established an outside-in perspective on the value of a business unit it had considered parting with, looking at the unit from the perspective of different potential buyer groups (competitors, private-equity firms, infrastructure funds, and so on). In parallel, the team comprehensively reviewed the business unit's internal business plan and challenged the viability of its strategic initiatives.

Through this review, the executive team learned two things. First, there was a potentially strong market for the business unit among private-equity buyers and infrastructure funds, which could bring greater agility, focus, and flexibility to the asset. Second, the existing plan of the business unit did not reflect the significant capital investments and other resources that would be necessary for its strategic initiatives to succeed. Once the executive team factored in significant near-term cash needs, the picture looked very different. The team decided to divest now rather than await cash flows that would be unlikely to materialize—and it prepared its

[2] See Chris Bradley, Martin Hirt, and Sven Smit, "Eight shifts that will take your strategy into high gear," April 2018, McKinsey.com.

marketing materials in a way that would point out the value-creation opportunities for financial buyers, among others.

Buyer interest

In our experience, executives tend to limit the universe of potential buyers for an asset to the usual suspects or those already active in the industry. This, of course, leaves out a wide swath of potential suitors. One European utility sold its majority position in the operator of a electricity-transmission system to a consortium of more than a dozen infrastructure funds and life, pension, and health-insurance companies. The buyers had no previous exposure in the electricity sector but were attracted by the system operator's stable cash flows.

Business leaders seeking to divest should consider potential buyers within adjacent industries and geographies, new market entrants and disrupters, and financial sponsors, among others. These groups may be looking for new integration, cross-selling, or expansion opportunities. Executives may even want to consider alternative transaction structures—joint ventures or asset swaps, for instance—to entice parties that may not be in a position to acquire an asset outright.

An agricultural-equipment company seeking to exit production sites in several locations believed that antitrust authorities would block any sale of those sites to competitors. It abandoned its hopes of divestiture and began to assess shutdown costs. A further assessment of the situation, however, showed the executive team that the production sites held significant value for companies (even some financial sponsors) that did not have operations in the region. Given the expanded range of potential buyers, the agricultural-equipment company decided to divest and took initial steps to determine how best to tailor its marketing messages to different types of buyers.

Damage to the rest of the company

Business leaders commonly believe that divestitures create too much upheaval for the rest of their companies: that it's too complicated to disentangle divested assets from the rest of a business and will take too much time, diminish economies of scale, and result in stranded costs. In our experience, however, the operations of a company can actually become more efficient as its portfolio is streamlined. As former Oppenheimer Value Fund executive Laton Spahr put it, "Split the worm in half, and it grows two new heads. Now we've got two great companies."[3]

Rather than assume that the divestiture process may negatively affect the rest of the company, its leaders should review the possible effects systematically. First, they should formally document and assess the links or entanglements between the asset being divested and the rest of the business. Second, they should quantify the benefit of any links and entanglements and the value that could be lost by breaking them. Executives can use hard data on procurement, revenues, and margins to assess whether any losses in value could be offset or mitigated. Finally, they should evaluate the true effort required to disentangle the asset in question. A seemingly complicated divestiture process may actually be simplified by, for instance, redefining the scope of the separation or hammering out long-term commercial or manufacturing supply agreements.

It can also be helpful to draw a separation road map that captures all the activities associated with divesting an asset, the teams and functions affected, and the intended goals and milestones.[4] One manufacturing company, for instance, wanted to sell off three assets. By conducting a detailed assessment of the potential effects on the company, the leadership discovered that some production lines associated with two of the assets would need to be shared 50/50 with any buyer. Under these

[3] Jen Wieczner, "Activist investors love spin-offs: Here's why you should, too," *Fortune*, June 29, 2015, fortune.com.
[4] Jamie Koenig, Anthony Luu, and Steve Miller, "Three degrees of separation: How to successfully execute divestitures," June 2020, McKinsey.com.

conditions, the manufacturing company would need to restructure its production footprint significantly, which could take years. The company decided not to divest these two assets. However, the process revealed that the third asset was operating on a stand-alone basis, with its own logistics network, procurement contracts, and IT systems. This made it a prime candidate for sale to a financial sponsor as a new platform company.

Timing

The reality is that the right time to begin the process of divesting an asset is the moment you recognize that it no longer supports your strategic objectives.[5] Business leaders who wait expectantly for market conditions to change often risk a continued decline in the asset's performance, accompanied by an increased need to divest, but now at potentially lower purchase prices.

In our experience, even significant changes in market conditions (for instance the collapse of credit markets or COVID-19's humanitarian and economic crises) rarely warrant abandoning divestiture plans. At worst, the sale process is put on hold for a few months, until conditions stabilize. Under these conditions, sellers can make it easier to complete deals by looking at alternative structuring arrangements—for instance, purchase-price earn-outs, staple-on financing, staggered payments, or two-step acquisitions. Executives should remember that divestitures typically take 12 to 18 months, from concept to deal close; today's challenges will look different by the time a deal is completed.

Sunk costs

After investing millions into a business or asset, executives often don't want to admit that they aren't the right owner to turn it around once performance declines. Rather than pull back when signs of significant financial or operational weakness appear, individuals and teams are inclined to escalate their commitment to losing courses of action.[6] By holding on, though, they are just delaying the inevitable.

To counteract this emotional bias, executives should change the way they evaluate their portfolios. For instance, during regular portfolio reviews, it can be helpful to have teams present conflicting opinions—the case for and against divestiture—as a counterweight to arguments about sunk costs. The head of one industrial company convened red and blue teams to explore whether it was still the best owner of two lagging business units. One team explored the argument for divestiture, the

The right time to begin the process of divesting an asset is the moment you recognize that it no longer supports your strategic objectives.

[5] Richard Dobbs, Bill Huyett, and Tim Koller, "Are you still the best owner of your assets?," November 1, 2009, McKinsey.com.
[6] Tim Koller, Dan Lovallo, and Zane Williams, "Bias busters: Pruning projects proactively," February 6, 2019, McKinsey.com.

other options for retention. Both consulted with internal and external experts. Both made presentations to the executive leadership team and the board. Through this process, executives discovered that it made good sense to divest one of the business units and to spin off the other as a joint venture. The latter deal ended up creating significant value for the company—value it would have foregone if it had continued to hold on to the unit because of sunk costs.

Stakeholder attachment

A range of stakeholders—boards, employees, shareholders, business partners, regulators, and policy makers—are affected by and can have adverse reactions to divesting assets.

In our experience, business leaders seeking a divestiture will need to have a consistent message about it—for instance, "We are doing this because this business unit is exposed to different cycles, markets, and customers and would therefore fare better as a stand-alone company." Once this rationale is established, business leaders can tailor the message for each stakeholder group.

For example, they can remind **the executive team and the board** that, rather than damage the entire company, a divestiture will free up limited capital to reinvest in critical or new strategic priorities. The forms of analysis described earlier can be used to gather the important data required to make this case. Any board discussions should focus on the creation of long-term value rather than possible reactions of short-term investors during the quarters immediately after divestiture.

Since the decision to divest will have outsize effects on **employees**, business leaders should be transparent about what it means for employees personally and what it means for the company's future. Let them know, for instance, about the additional growth opportunities each stand-alone business will be able to pursue if it doesn't have to compete for resources with other, disconnected businesses.

In addition, ensure that **shareholders** understand the value-creation opportunities from divestiture, the intended outcomes of the process, the potential resources required, and the planned timing. Ultimately, divestitures are intended to create incremental value for shareholders, so make sure you bring them along on the journey.

Most business leaders understand the need—now more than ever—for active portfolio management. Yet delivering on the promise of divestitures remains a challenge for many. By taking a pragmatic and structured approach to evaluating divestiture candidates and opportunities, executives can greatly improve their odds of success and shift their portfolios into a higher gear.

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