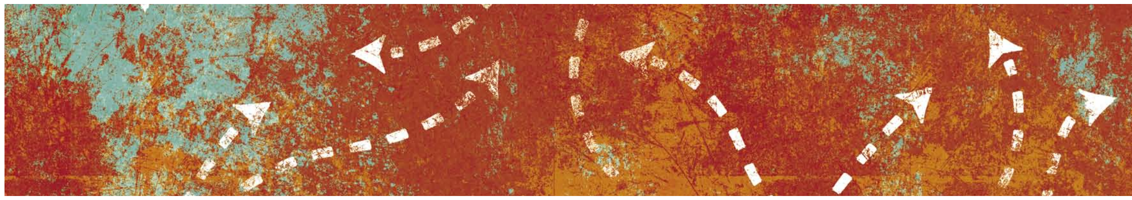
McKinsey on Finance

Perspectives on Corporate Finance and Strategy

Number 25,
Autumn 2007

McKinsey&Company



When to break up a conglomerate: **An interview with Tyco International's CFO**

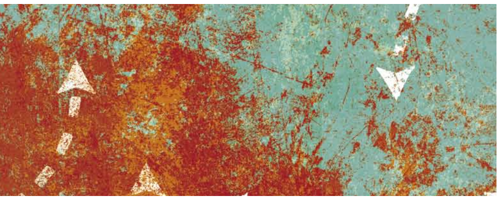
Chris Coughlin explains how spinning off some of the company's largest businesses was the key to ensuring its long-term growth.

Laura Corb and Timothy Koller

When Chris Coughlin stepped into the CFO role at Tyco International in March 2005, the conglomerate had already put its scandal-scarred history under former CEO Dennis Kozlowski behind it. The new CEO, Ed Breen, had orchestrated the departure of the entire board of directors, replacing them with new members eager to turn things around. Indeed, the company was in the midst of a rebound, with solid earnings, moderate growth, a strong capital structure, and a share price hovering just under $30—up from a low of $8.25 during the crisis several years earlier.

Investors were reassured, but Coughlin was joining a management team pondering the best way to deliver growth to the company's widely diverse businesses over the longer term. Their conclusion, announced in January 2006, was as bold as it was unexpected: spin off Tyco's health care business, now called Covidien, the world's second-biggest maker of disposable-medical products (behind Johnson & Johnson), as well as Tyco Electronics, the world's largest manufacturer of electronic connectors. Over the following 18 months, Breen and Coughlin extricated overlapping functions, contracts, and procurement agreements, appointed two new senior-management teams, addressed securities regulations, and recruited new boards of directors. The result: parent Tyco International is today a $20 billion company, half its former size, but more focused and still the world's biggest provider of security and fire protection products and services, as well as the largest maker of industrial valves.

Coughlin, 54, came to Tyco well prepared to orchestrate large transactions. He had honed his skills as CFO of Pharmacia during that company's 2000 acquisition of Monsanto, the spin-off of the Monsanto



agricultural business two years later, and Pharmacia's subsequent sale to Pfizer. At Nabisco and Interpublic, Coughlin served in both operating and CFO roles, developing perspectives on operational management that dovetailed well with the challenges at Tyco.

He recently sat down in his Princeton, New Jersey, office with McKinsey's Laura Corb and Timothy Koller to discuss the value of multi-industry companies, the strategy behind the Tyco breakup, and the challenges of conducting such large transactions simultaneously.

McKinsey on Finance: *What was behind the decision to split up Tyco into the three businesses—Tyco International, Tyco Healthcare, and Tyco Electronics?*

Chris Coughlin: By 2005 the crisis precipitated by the whole sordid history of Tyco and everything that happened in 2002 was over. The company was about where we wanted it to be in terms of corporate debt, and the businesses were thriving. At that point, we started going through our strategic-planning exercises and talking about the businesses and what it would take to really be successful over the next five to ten years and how we could grow the value of the corporation.

Early indications became apparent out of our discussions with investors. Between

Christopher J. Coughlin

Vital statistics

Born in Paterson, New Jersey; 55 years old

Married with 3 children

Education

Graduated in 1974 with BS in accounting from Boston College, Massachusetts

Career highlights

Tyco International
- Executive vice president and CFO (2005–present)

Interpublic
- Chief operating officer, member of board of directors (2003–05)

Pharmacia
- Executive vice president and CFO (postmerger of Pharmacia & Upjohn with Monsanto) (2000–03)

Pharmacia & Upjohn
- Executive vice president and CFO (1998–2000)

Nabisco (1996–98)
- President of Nabisco International (1997–98)
- Executive vice president and CFO (1996–97)

Fast facts

Serves on board of directors of Covidien and D&B

Serves on board of trustees of Delbarton School, in Morristown, New Jersey

2004 and 2005, their questions were all about the electronics business, because investors were looking at what could move within Tyco's diverse portfolio that would make earnings go up or down in a particular period. There were few questions about health care, our largest business. Investors seemed to view it simply as a solid generator of profits and cash flow.

Investors were also asking about the long-term capital structure of the company. And while we felt that the health care business needed to be an A-rated kind of company, given the nature of the business, it needed that flexibility to gain access to the capital markets to make deals and to fund new technologies. So we were driving the capital structure of all of Tyco on the basis of what a company in the health care industry needed, but health care was only a quarter of our revenues. The other businesses clearly did not require that kind of a capital structure.

So in 2005, as we looked at what it was going to take to grow the health care business, we eventually concluded that it may be better off on its own. In addition to being a large group, with about $10 billion in annual revenues, it was well organized, it had integrated many of its acquired businesses, and it had a seasoned management team. And once we had reached that conclusion with the health care business, we started to look at the rest of the portfolio. Given our shareholder base, we concluded that it probably made sense to pull apart the electronics business as well, enabling that business to invest more effectively during the down cycle, which might be more difficult as a part of a multi-industry player.

McKinsey on Finance: *How did the board of directors respond to your proposal?*

Chris Coughlin: I think it surprised the board that we were thinking of something so significant so soon. The good news is they had great pride in the organization and in everything we'd achieved in bringing the company out of crisis. But I think they understood the need to look at the company's portfolio, and we put together a process to consider the proposal in greater detail. After some lively discussions, the board agreed that that strategy made sense, and in the end it was a healthy exercise.

McKinsey on Finance: *Outside of the board, did investors or anyone in management object to the split?*

Chris Coughlin: There was some initial skepticism. Some felt that we had built this great company, it was doing very well, the stock was performing very well, so why pull it apart when the profits were growing and cash flow was strong?

What surprised us was that, from the moment we announced the proposal to when we actually separated, we had virtually no shareholders express the belief that the separation was a bad idea. You know, we had some who might have been a little bit agnostic, but none of them really said, "This just doesn't make sense to us." There was concern and some confusion about how long the process would take, and some didn't fully appreciate the complexities of a spin-off on this scale. But once they saw the filings that were required—which were just massive—and the SEC review process, people started to understand how truly complex it was.

McKinsey on Finance: *In some cases, companies have done sort of an equity carve-out first to create a stock that traded before doing the final spin-out. Tyco went straight to the final spin-out. Any particular reason why? Any pros and cons?*

Chris Coughlin: We looked at a number of alternatives before we decided on just a straight dividend of shares. Obviously, one of the key drivers was size. If you look at other spin-offs that have taken place over time, most are smaller pieces of businesses. At Tyco we were divesting very large businesses, and we wanted to make sure they had the appropriate capital structures in place. We also wanted to ensure that the remaining Tyco, which was actually the smallest piece in terms of profitability, didn't need additional cash. We had very solid cash-generating businesses; we could put together a capital structure and a debt structure that were appropriate. And we didn't think that we needed to establish a market by putting out 15 percent or 20 percent in advance. We could set up the appropriate capital structures that would best support the three companies without having to move a lot of the money around.

McKinsey on Finance: *Was there any concern that once investors had shares in three different companies, they might decide they liked one and not the other two and start trading based on that?*

Chris Coughlin: Well, yes. But I had been involved in the fairly significant spin-off of the Monsanto agricultural business at Pharmacia. It was a different set of circumstances but similar in that there was a very large pharmaceutical company holding a large agriculture business. The investors were clearly pharmaceutical investors—they always wanted to be pharmaceutical investors and they didn't like this agriculture business anyway. That transaction has been just enormously successful: shares trade at $80 now, compared with $10 when Monsanto first spun off, in 2002. Clearly, in that case, the agriculture business was competing internally for funds against the pharmaceutical company that was run by pharmaceutical people.

Tyco is different: because of the scale of the business and because the remaining Tyco is smaller than the businesses we spun off, how shareholders might react is somewhat of an unknown. We recognized that there would be some churn in the stock during the first three to six months as the businesses found their natural investor bases. Clearly, health care investors are different from those that are going to look at the remaining Tyco, which is a slower growth, cash-generating kind of a business versus the more technology-driven health care business or the more cyclical electronics business. But as we have said since the first conference call when we announced the spin-off, we weren't doing this for a short-term boost in the stock price.

McKinsey on Finance: *What was the most challenging part of getting the companies ready to be independent?*

Chris Coughlin: The most challenging part was to get the management teams in place and transferring the technical knowledge from some of the corporate functions that resided at the Tyco headquarters to the two new businesses. So we set up a formal mechanism to manage the whole transition process and held reviews every month with each function.

One of the nice things about this separation is that it provided some enormous opportunities for our people. We had built some real strengths in some of the functions, so as we separated and needed, say, treasurers for all three companies, we were able to fill those positions internally. The CFO for electronics, for instance, came from inside that organization, and we appointed a new CEO from another Tyco business. In health care, we had an experienced team in place that pretty much remained in tact. There were other opportunities for people to move up many other functions including tax, treasury, and legal.

McKinsey on Finance: *How about recruiting new board members?*

Chris Coughlin: It was easier than we expected. Typically, recruiting 1 board member can be a challenge, but how do you find 20? We went through a very rigorous process to identify skill sets that we needed on each of the boards; we also decided to have nonexecutive chairmen at the two new companies because neither CEO had led a public company before. Given the scale of these companies and the market-leading positions they have, we were surprised that the process actually attracted very many qualified people. But not having to go on to an existing board where people might have been working together for years and not having to worry about fitting in, that ended up being a real plus.

Interestingly, one of the decisions of the existing Tyco board was not to split itself up—which is different from what's happened in a number of other major spin-offs. I think what drove that decision was that our board came in together shortly after the previous board had stepped down. They saw the advantage of a new full team building a strong working relationship. So although you might ask if it wouldn't be better to have some of the board that was experienced in overseeing some of the businesses, I think they felt that the best approach was to attract completely new members.

McKinsey on Finance: *You obviously played a very important role in the whole process. What would you say to CFOs who are trying to play a more strategic role, rather than just dealing with the technical issues. How do they go about doing that?*

Chris Coughlin: The way the world is today, I can't imagine the CFO *not* playing a strategic role, particularly in a business as large and diverse as this one. A critical part of the strategy is allocating capital across the businesses—where are we going to invest, what are we going to do with the cash flow between acquisitions and with our dividend policies, and so on. With the capital markets being what they are and with investor expectations of CEOs as well as CFOs, these two positions have to be very closely linked. The more complex the business model, the more CFOs just have to play a strategic role. To do that, you have to have extremely strong technical finance functions behind you. At Tyco we never would have been able to execute this kind of a transaction, nor could I have spent the time that I needed on both the strategy and managing the overall separation process if we hadn't had world-class experts in the controller, treasurer, and tax roles. It's unbelievable what they did.

McKinsey on Finance: *Now that the spin-offs are complete, have they done things that they wouldn't have done if they were still part of a bigger company? Has the experience been positive?*

Chris Coughlin: It's still early, having just completed the separation six weeks ago, but I think that there are some clear indications of good things. For example, I think the health care business has made very significant strides in attracting new talent that more than likely would not have been attracted to the old Tyco. They now see Covidien as a health care company with a very defined strategy, where people can advance while remaining in health care and playing a very significant role.

'It's very difficult to manage a broad base of businesses in ***a single portfolio,*** *and to argue that that's the right way to do it becomes more and more difficult'*

Additionally, each of the three companies is moving aggressively toward changing their portfolios. We indicated at the time we separated that all three companies still had to make changes to their portfolios that include making strategic acquisitions as well as divesting certain businesses.

And I think they're each more nimble now, as separate companies with their own management teams, M&A groups, tax groups, accounting groups, and so on. And with all the complexity of going through such transactions, we can actually do more in a shorter period of time. For example, the health care business has already announced that they're getting out of their retail business; Tyco International is exiting its infrastructure services business, Earth Tech, and Tyco Electronics has announced that it's getting out of its power systems business.

I also think that allocation of capital has become much more defined and much more focused, so we're seeing more transactions in each of the three companies in bringing businesses and technologies in, as well as divestitures.

McKinsey on Finance: *So now the deals are done and you're the CFO of a much smaller company. Any regrets?*

Chris Coughlin: No. There aren't many multi-industry players that last for a very long time. They get to a certain size, and their business units get to a certain size, where the value of being part of a single company declines—depending on the type of businesses and the diversity of the portfolio. For example, we have a very large service component in our ADT and SimplexGrinnell businesses. These businesses require a very large and very different kind of workforce than in health care. Well, how much synergy are you going to have moving people from the health care business into a home or business security business?

If you're buying small companies and can add management expertise and processes and competencies that maybe smaller companies don't have, that's one thing. But when they become $10 billion–plus organizations with tens of thousands of employees around the world, I think you have to honestly look at what value is created by adding to a corporation. It's very difficult to manage a broad base of businesses—such as heavy manufacturing, service businesses, and technology-driven companies—in a single portfolio, and to argue that that's the right way to do it for a long period of time becomes more and more difficult. The world obviously changes and it's incumbent on management to continue to take a very hard look at its portfolio of businesses, the value that's being added, and whether they are truly better off being a part of the same large company.

On the personal side, it is a pretty big deal to say, "Hey, look, I'm the CFO of a $40 billion company with 250,000 employees and there aren't many companies around like that." But the reality is that my job is to organize and help manage the company, to drive the financial and capital structure of the company, and to drive the benefit to our shareholders. Tyco International remains a very complicated business, and there's still much work to do in making our company more efficient. These businesses were never deeply integrated, so we believe there's significant value yet to be captured. So there's as much challenge now, although it's different than it was before—and we're still a $20 billion company with 100,000 employees. MoF

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