A case for restructuring before spin-off

Making big operational changes before spinning off assets can be daunting, but our research indicates that doing so can dramatically improve the odds of deal success.

by Obi Ezekoye and Anthony Luu
The goal of most executives leading large spin-offs is to establish two (or more) successful and focused companies instead of just selling off noncore assets. Such transactions represent opportunities to create more value for shareholders. Since eBay spun off PayPal in 2015, for instance, PayPal has become one of the largest payments companies in the world and has been able to grow its base of active users, potentially exceeding 300 million accounts by the end of 2019—up from 169 million active accounts in 2015.¹

But as many managers can attest, such transactions are always highly disruptive. Management teams on both sides of the deal must address all stakeholders’ concerns—assuaging employees, customers, suppliers, and regulators—while protecting their base businesses and managing the market’s perceptions of their companies. What’s more, performance in such deals varies widely, especially in larger, more complex transactions.

Because the process is so daunting, managers are often reluctant to make improvements to business units or other assets ahead of spin-off. Better to wait until the deal closes, they think, and then focus on making any big changes. Our research suggests just the opposite is true: companies that undertake significant restructuring prior to spin-off tend to outperform those that don’t.

Exploring the differences
We examined spin-offs with a value greater than $10 billion that occurred between 2008 and 2017, in a range of industries. Specifically, we looked at the restructuring charges the companies in these deals incurred two years prior to separation all the way up to two years after separation.

The sample size is small but still instructive. The companies that had higher restructuring charges in the eight quarters prior to divestiture tended to produce greater total shareholder returns than did those companies that invested more in restructuring after separation.² The companies that restructured prior to close also outperformed those that did not in terms of revenue growth, gross-margin change, and EBITA³-margin improvement in the two years leading up to the spin-off (exhibit).

Exhibit

Companies that restructure business units or assets prior to spin-off outperform those that do not.

<table>
<thead>
<tr>
<th>Performance after spin-off¹</th>
<th>Restructured after spin-off (n = 17)</th>
<th>Restructured prior to spin-off (n = 14)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue growth 2 years</td>
<td>–4.6</td>
<td>1.5</td>
</tr>
<tr>
<td>after divestiture, %</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in gross margin 2 years</td>
<td>–4.6</td>
<td>1.1</td>
</tr>
<tr>
<td>after divestiture, %</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in EBITA² margin 2 years</td>
<td>–2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>after divestiture, %</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average total returns to shareholders after closing, %</td>
<td>–7.8</td>
<td>1.3</td>
</tr>
</tbody>
</table>

¹ Large divestitures with value >$10 billion in 2008–17.
² Earnings before interest, taxes, and amortization.
³ Earnings before income, taxes, and amortization.

Source: Expert interviews; McKinsey analysis
In the rush to separate quickly, companies can create orphaned entities and inefficient systems and processes, which can lead to extra costs.

The numbers suggest that the companies that restructured prior to separation were able to build and sustain momentum for transformation within both the parent company and the spin-off once the deal closed. By contrast, the companies that did not restructure ahead of separation were likely bogged down by the need to manage stranded costs and misaligned strategies, creating an overall drag on business performance in both the parent company and the spin-off.

Lessons learned

These findings and our experiences in the field point to a few lessons for companies seeking maximum value from spin-offs:

— **Activate the new business strategy as soon as possible.** Spin-offs and separations can create significant value that accrues to the bottom line, but only if companies emphasize strategic and operational improvements at the outset. Timing is everything. For example, a diversified industrial company spun off one of its commodity businesses. Well before close, the executive team in the divested business unit began operating with a leaner mind-set—for instance, reducing its general and administrative expenses, moving toward a flatter organizational structure, and improving its management of working capital. By the time the deal had closed, the divested unit was ready to stand on its own and was already realizing positive earnings.

— **Don’t forget about the long-term implications of short-term decisions.** It’s true that speedy separations create more value than do those that lumber along. However, in the rush to separate quickly, companies can create orphaned entities and inefficient systems and processes, which can lead to extra costs. That was the case at one pharmaceutical company. It created unnecessary and redundant legal entities to house the assets being divested: senior leaders thought doing so would allow the company to close the deal more quickly. However, the way the deal was structured forced the company to take on extra IT, legal, financial-reporting, and other costs, which proved to be a huge drag on the pharma company’s postclose earnings and on its ability to launch its new strategy.

— **Identify and manage leveraged costs ahead of separating.** Corporate functions need to be managed in a way that sets up both the parent company and the divested entity for success. Before finalizing organizational structures, management teams from both the parent company and the divested business unit should perform rigorous benchmarking of their cost structures, looking at operating models used by "target" peers rather than the parent company’s peers. While time consuming, this exercise can uncover areas of inefficiency and highlight new ways of working. In a large industrial spin-off, for instance, senior manage-

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**“Going, going, gone: A quicker way to divest assets,” August 2018, McKinsey.com.**
ment boldly announced cost targets associated with the separation and, to help meet those targets, implemented significant changes to back-office functions at both the divested company and the parent company ahead of separation. The spin-off became the catalyst for increased productivity in both organizations.

Our research cuts through the complexities of deal making to reveal one critical point: forward-thinking business leaders can achieve outsized performance from their divestitures, spin-offs, and separations simply by considering opportunities for improvement before deals close and then acting on them.

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