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Unlocking value through divestitures: Can Indian firms seize the moment?

Divesting is a strategic capability that can add significant value. Indian companies that identify appropriate spin-offs and divestitures and execute successfully can emerge stronger from the current crisis.

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Indian companies could unlock substantial value through strategic divestitures and spin-offs, and now may be a particularly propitious time to divest. The ongoing pandemic has placed new stresses on business models and balance sheets across industries, putting portfolio rebalancing front and center on the strategic agenda. Divestitures can release capital and managerial bandwidth, enabling firms to navigate the crisis and prepare for future growth.

One challenge to divesting is that Indian companies have less experience with divestitures compared with M&A—fewer than one in six transactions in India is a divestiture. As a result, we see a large dispersion in outcomes, with some divestitures creating significant value and others destroying it. Previous McKinsey research indicates that the best-performing global companies since the last recession by total returns to shareholders (TRS) divested more than their peers during the recession.[1]

To date, Indian companies have also not taken full advantage of the growing amount of capital available from private-equity (PE) firms and strategic investors, which compensates for the decline in traditional sources of capital. Fewer than 10 percent of divested businesses are sold to PE funds.[2]

There is a battle-tested and replicable divestiture playbook. Good divestors get five critical elements right: they define the strategic rationale for the sale, thoroughly assess the buyer landscape, prepare the asset thoughtfully, orchestrate the deal process, and pay careful attention to the process of disentangling the asset from their company.

Divestitures can be a source of value creation, particularly during a slowdown or uncertainty

A recent McKinsey study of more than 200 of the world's prominent public companies found those that refreshed their portfolios by 10 to 30 percent every ten years[3] earned about 3.5 times more excess TRS compared with companies that refreshed their portfolios at a slower rate. Moreover, according to our research, companies that entered more attractive industry sectors and exited others outperformed the market by 1.7 percent, while those that remained in the "wrong" businesses underperformed the market by 0.8 percent.[4]

Divestitures are an important part of this strategy. Using a data set of 26,000 transactions across 1,100 global companies, we found that the top 20 percent of companies by TRS divested at a faster rate than other companies during the 2007–09 recession. Divestitures constituted 25 percent of total M&A activity for those firms during that period, compared with 18 percent for others.[5]

Divesting should not be perceived as offloading underperforming businesses at a discount; it is a strategic capability that can unlock significant value and a core part of the board and CFO tool kit. Selling business units that no longer fit the company strategy—but that could be attractive additions to another company's portfolio—releases capital, which can then be deployed to strengthen retained businesses or to acquire new businesses more aligned to a company's chosen direction.

Our research indicates that divestitures typically increase during economic slowdowns. As an example, across Asia, Europe, and North America, divestitures have risen by two to three percentage points of total M&A deals in slowdown years versus nonslowdown years (Exhibit 1).

Two broad reasons explain this increase in divestitures during slowdown years. First, it may be more difficult to access other funding sources, such as bank loans; divestitures release capital to be used elsewhere in the business. Second, the value of well-executed divestitures can be particularly high

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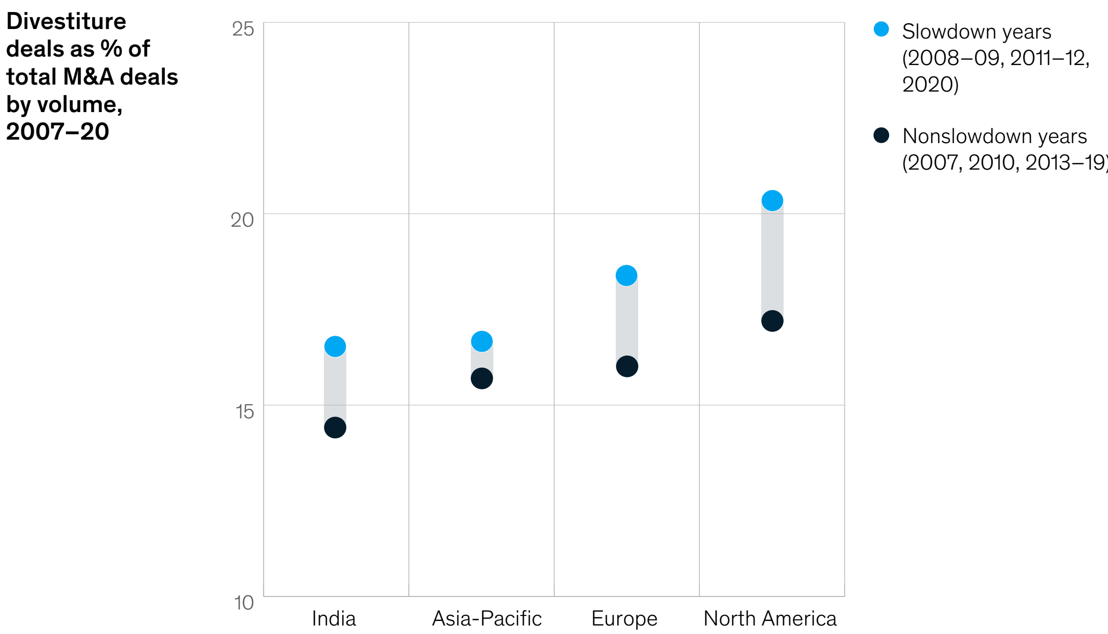
[1] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 21, 2019, McKinsey.com.
[2] S&P Capital IQ; McKinsey research covering 543 divestitures between 2008 and 2018.
[3] Sandra Andersen, Chris Bradley, Sri Swaminathan, and Andy West, "Why you've got to put your portfolio on the move," *McKinsey Quarterly*, July 22, 2020, McKinsey.com.
[4] Ibid.
[5] "Bubbles pop, downturns stop," May 21, 2019.

Exhibit 1

Divestitures in India have risen by two to three percentage points of total M&A deals in slowdown years versus nonslowdown years.



Source: S&P Capital IQ; McKinsey analysis

during—and in the immediate aftermath of—a crisis. Since 2007, companies in the top quintile by TRS were twice as likely to divest during slowdown years[6] as other companies, indicating a strong correlation between postcrisis performance and efficient portfolio restructuring.

Divestitures during slowdown years are almost 50 percent more likely to be successful than those in nonslowdown years. We analyzed divestitures by measuring excess TRS—the extent to which TRS earned by the seller over a two-year postdeal period was higher than the average TRS for the market. From 2007 to 2018, 71 percent of companies divesting in slowdown years generated above-market TRS two years after the deal, compared with 53 percent in the case of those divesting in other years.[7] Divestitures helped these companies release capital and managerial bandwidth, enabling them to focus on the retained businesses and position themselves better for postcrisis growth.

Indian companies yet to fully exploit opportunities provided by divestitures

Our analysis suggests that Indian conglomerates currently divest at a lower rate than their global peers. From 2007 to 2020, divestitures made up 2,400 of India's approximately 16,100 M&A deals (15 percent), which was lower than Asia–Pacific (16 percent), Europe (17 percent), and North America (18 percent).

This low rate of divestitures is not due to a lack of suitable assets. Our analysis of the 15 largest Indian business houses reveals that they operate in an average of 39 business verticals spread across an average of more than 100 entities. For these groups, approximately three-quarters of revenue and earnings before interest, taxes, depreciation, and amortization (EBITDA) came from their three largest businesses, while more than 40 percent of their capital was employed in the remaining businesses.[8] Carving out these business units and selling them to buyers better positioned to extract value from

[6] Based on 355 BSE 500–listed companies for which TRS data is available for 2007–19; slowdown years are defined as 2008, 2010, and 2011.
[7] Based on 246 divestitures between 2007 and 2018 for which total returns to shareholders was available for the seller two years postdeal.
[8] Prowess research; McKinsey research.

them—and therefore willing to pay a premium—would allow the parent company to release capital and resources that could be deployed in the businesses most aligned with their strategy.

Further, divestitures have just as much potential to add value in India as they do elsewhere; the top quintile of BSE 500 companies by TRS were twice as likely as other companies to have divested during the previous crisis.[9]

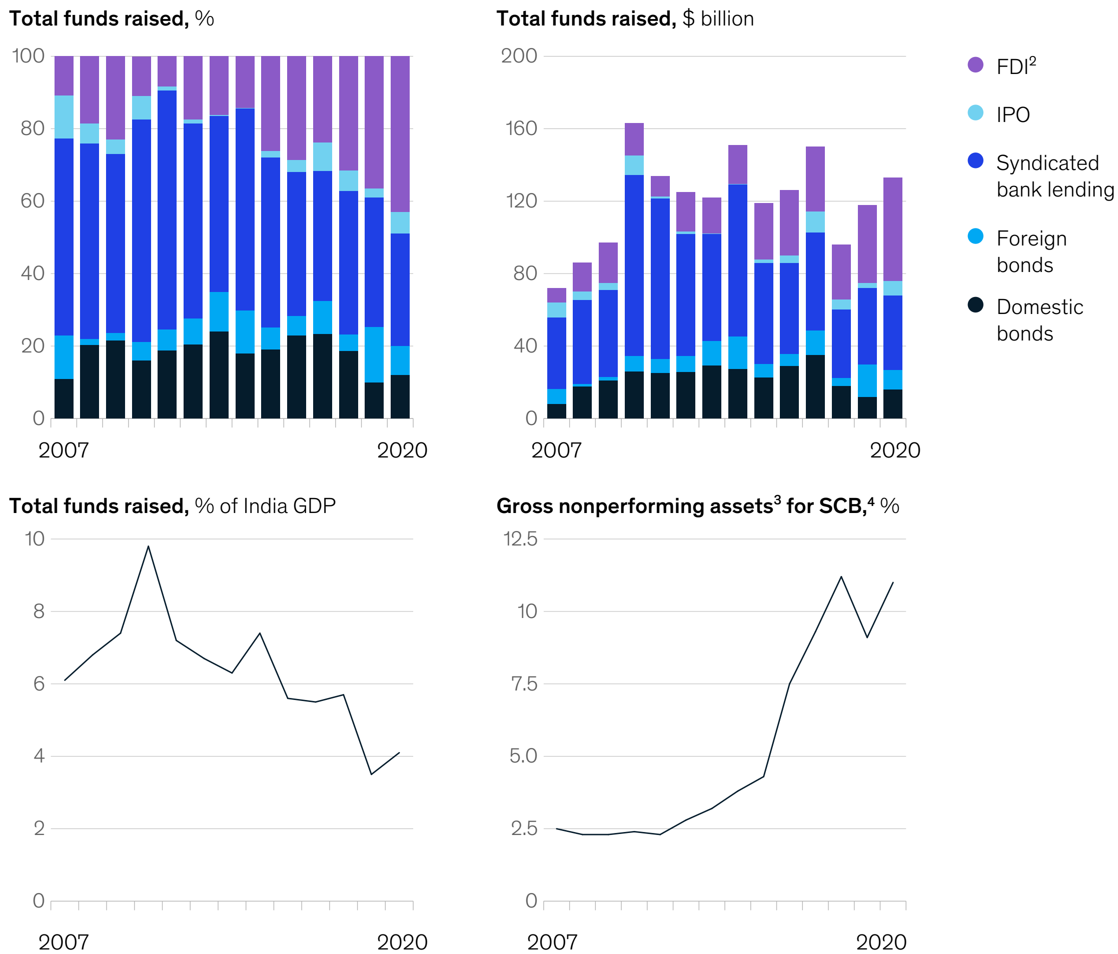
The current economic climate in India is a clarion call for boards and CFOs to unlock value through divestitures

Credit availability is likely to be constrained in India in the coming years, which means that divestitures could provide an invaluable source of capital. Funds from major sources such as foreign direct investment (FDI), IPOs, syndicated lending, and foreign and domestic bonds have declined considerably, from 10 percent of GDP in 2010 to 4 percent in 2019 (Exhibit 2).

Exhibit 2

Divestitures could provide an invaluable source of capital in the coming years.

Trends in primary capital raised in India through key sources[1]



[1]Trends in primary capital raised in India through key sources (corporate bonds, syndicated debt, IPOs, and foreign direct investment).
[2]Foreign direct investment.
[3]Average of early estimates from RBI and S&P Global.
[4]Scheduled Commercial Banks.
Source: Dealogic; RBI data; McKinsey analysis

[9] Twenty-three percent of top quintile (by total returns to shareholders) BSE 500 companies made at least one divestiture during slowdown years (2008, 2011, and 2012); for other companies, this proportion was 11 percent.

COVID-19 is provoking deeper and longer economic uncertainty than witnessed in recent decades—India's GDP declined by 24 percent year on year in the second quarter of 2020, and a GDP contraction of 7.3 percent was estimated for fiscal year 2021 as a whole.[10] The credit squeeze could be particularly pronounced in the banking sector, as the pandemic exacerbates the stress on the balance sheets of commercial banks: the Reserve Bank of India (RBI) anticipates that the gross nonperforming-asset (GNPA) ratio of commercial banks, which was already at the comparatively high level of 7.5 percent in September 2020, could rise to 13.5 to 14.8 percent by September 2021.[11]

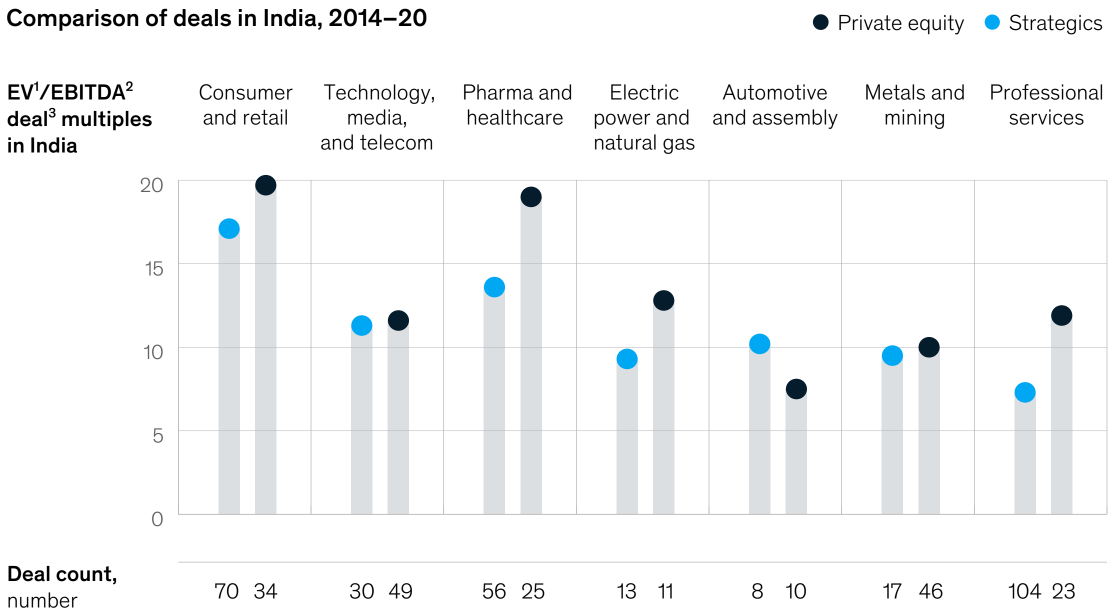
The crisis may make traditional buyers less willing to invest, but PE firms are currently flush with resources, and that could constitute an attractive market for prospective divestors. Globally, unallocated capital increased to more than $1.5 trillion at the end of 2020.[12] PE investment in India also increased steadily from $9 billion in 2015 to $23 billion in 2020, an annual growth rate of 15 percent since 2015.[13] Despite slowdown in economic activity due to the pandemic, PE investment has been buoyant on the back of marquee deals in the technology, healthcare, and retail sectors.

In addition, PE firms have historically paid higher enterprise value (EV) to EBITDA multiples than strategic buyers during the 2014–20 period, though this varies by sector (Exhibit 3). The ability of PE owners to attract top talent, undertake transformations, and employ better capital discipline may explain their ability to underwrite higher value over their holding period.

Exhibit 3

Private-equity firms have historically paid higher enterprise value to EBITDA multiples than strategic buyers during the 2014–20 period in India.

Comparison of deals in India, 2014–20



[1]Enterprise value.
[2]Earnings before interest, taxes, depreciation, and amortization.
[3]Deals with EV/EBITDA multiple > 50 excluded as outliers.
Source: S&P Capital IQ; VCCEdge; McKinsey analysis

[10] Amy Kazmin, "India's economy contracts 24% during coronavirus lockdown," *Financial Times*, August 31, 2020, ft.com; "Provisional estimates of Annual National Income, 2020-21 and Quarterly estimates (Q4) of Gross Domestic Product, 2020-21," Press Information Bureau, Government of India, May 31, 2021, pib.gov.in.
[11] *Financial stability report*, January 2021, Reserve Bank of India, rbi.org.in.
[12] Preqin research.
[13] AVCJ research; VCCEdge research; McKinsey research.

Despite their promise, divestitures can be difficult to execute successfully

Divestitures are not without risk; they may, if not carefully executed, destroy value. Divesting in India can be particularly challenging, as low deal volume means there is a broad lack of divestiture experience. Our data suggests that from 2007 to 2018, 47 percent of Indian deals with a value of more than $10 million failed to generate above-market TRS. Losses were sometimes of significant magnitude; almost one in five of these deals[14] led to a decline in TRS, compared to market, of more than 25 percent (Exhibit 4).

Companies looking to divest profitably will need to guard against three major risks: organizational inertia, insufficient planning, and overemphasis on negotiation.

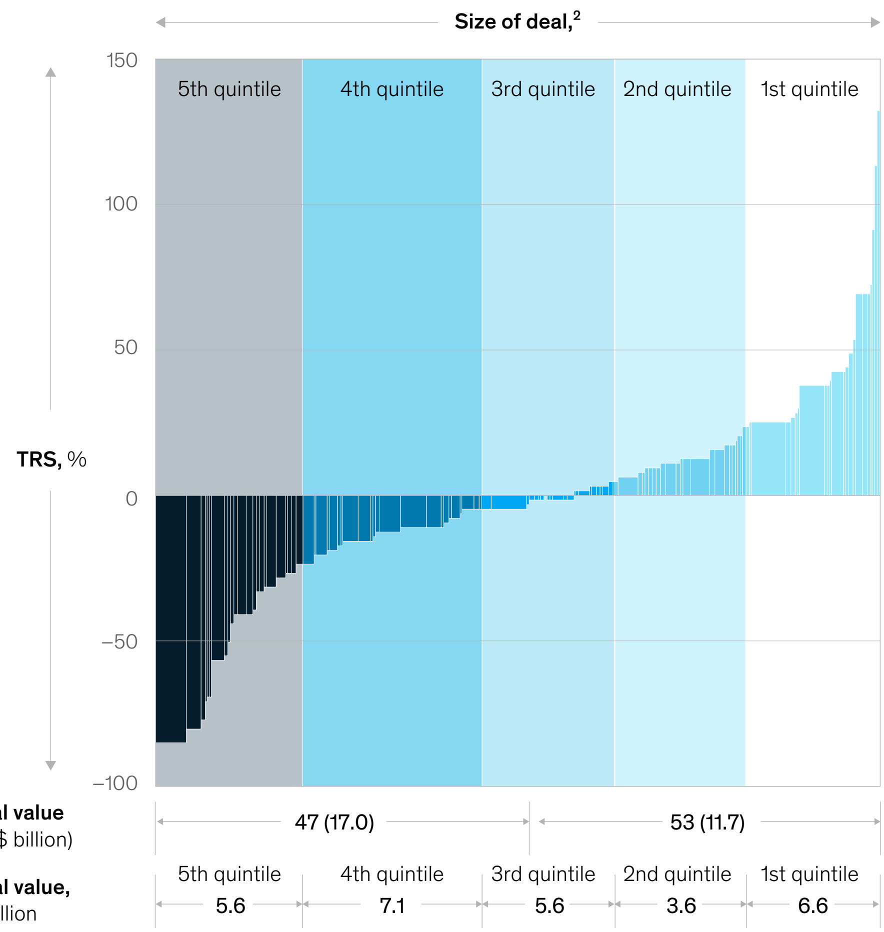
Organizational inertia due to technical and emotional roadblocks

Even after a business is identified for divestment, it is often difficult and time consuming to get all stakeholders aligned. This lack of consensus can delay the deal, which can lead to value destruction. A recent McKinsey survey of more than 120 senior business leaders found that typical technical roadblocks include a misperception of asset

Exhibit 4

Divesting in India can be particularly challenging, as low deal volume means there is a broad lack of divestiture experience.

Annualized excess TRS[1] over BSE 500 index, 2-year postdeal (n = 115, 2007–18)



[1]Total returns to shareholders. Percentage points of excess TRS over BSE 500 index.
[2]Width of the bar is proportionate to the size of the deal.
Source: S&P Capital IQ; McKinsey analysis

[14] In 21 cases out of 115, postdeal total returns to shareholders for the seller was more than 25 percent below market.

value (generally related to unrealistic growth expectations), underestimates of market interest due to an overly narrow definition of potential buyers, and (often unfounded) concerns about damage to the rest of the business. Common emotional roadblocks include emotional attachment to the asset, fear of sunk costs (for example, a reluctance to walk away from previous investments in the business), and a desire to "time the market."[15]

In a recent example, an Indian company had initial interest from a number of foreign buyers, but the sale was delayed for almost three years as the board debated whether the offers were high enough. By the time they were ready to make a deal, many of the players had already entered the Indian market and were no longer willing to pay a premium for market access. As a result, the final price fell significantly.

Insufficient planning

Delayed planning generally leads to a protracted and unstructured deal process and can result in the late emergence of unforeseen issues. In particular, it is vital that companies recognize critical linkages—such as shared back-office functions—between the business that they are selling and the rest of the portfolio, and then implement postdeal transitional service agreements (TSAs) to minimize operational disruptions.

Planning-related delays have been a feature of a number of recent Indian divestitures. In one case, a basic materials company failed to address regulatory barriers, resulting in a 12-month delay; crucial operating licenses were not transferable to the new owner, which meant the deal had to be restructured. For another company, lender approvals did not come through as expected, which resulted in the deal being canceled after a buyer had been found and a price agreed to.

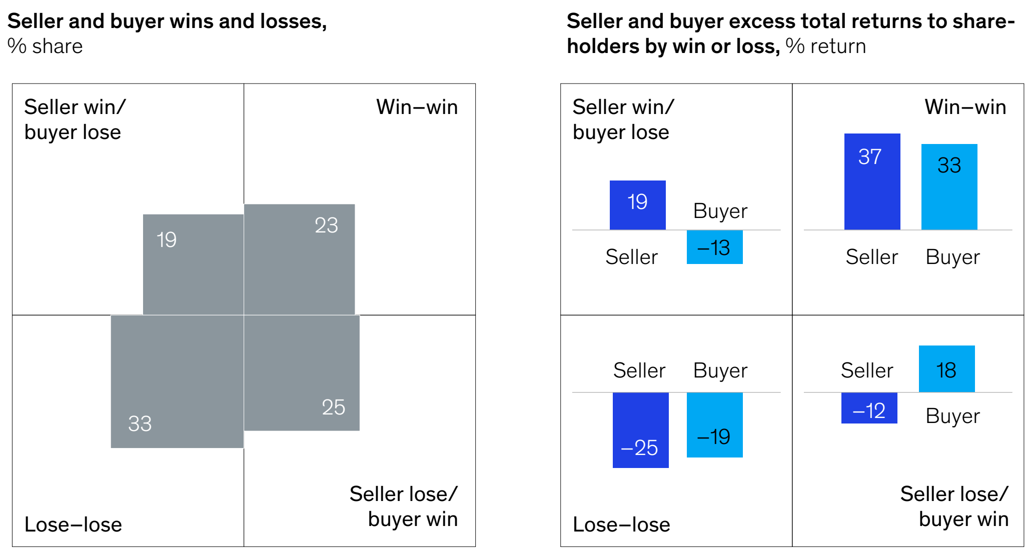
Overemphasis on negotiation

We analyzed corporate divestiture deals from 2007 to 2018 and classified a deal as a "win" for the seller or buyer if their two-year postdeal exceeded market returns over the same period. Our research shows that returns are disproportionately higher when both parties win—excess TRS for sellers was 94 percent higher and for buyers 83 percent higher when both parties had successful outcomes (Exhibit 5).

Exhibit 5

We analyzed corporate divestiture deals in India from 2007 to 2018, and we found that returns are disproportionately higher when both parties win.

Seller and buyer performance[1] by deal archetype (n = 93,[2] 2007–18)



[1]Performance improvement measured as annualized percentage-point excess TRS relative to market in the 2-year period postdeal.
[2]Analysis for 93 deals for which both the seller and the buyer were listed.
Source: S&P Capital IQ; McKinsey analysis

[15] Gerd Finck, Jamie Koenig, Jan Krause, and Mark Silberstein, "What's keeping you from divesting?," September 18, 2020, McKinsey.com.

Companies should therefore focus on crafting win–win propositions rather than becoming fixated on zero-sum negotiations.

In a recent divestiture deal, a large pharmaceutical company focused almost exclusively on negotiating the price of its respiratory portfolio instead of working out a postdeal business model that would be mutually beneficial. The resulting deal destroyed value for both the buyer and the seller.

The recipe for success: Good divestors get five key elements right

Our analysis of PE exits suggests a divestiture playbook that can help companies guard against the major risks. The following five key elements distinguish companies that execute successful divestitures from the rest of the pack:

1. *Define the strategic rationale*
   Companies need to incorporate proactive portfolio management as part of their strategy and to regularly reevaluate their ownership of each business in their portfolio. For a business to be retained, it must be both financially attractive and fit within the overall strategic direction of the business. Even if a business unit has high potential, selling to a better-positioned owner may accrete value, provided that the valuation is attractive.

   For example, a large Indian pharmaceutical company sold its profitable consumer-health business to a major fast-moving consumer-goods (FMCG) player that had the strong sales and marketing capabilities to increase its revenues. The divesting company gained a hefty divestiture premium, which it invested into R&D to strengthen their product-development pipeline. This reinvestment drove higher returns on invested capital for the company as a whole.

2. *Understand the buyer landscape*
   For each potential divestiture, companies could conduct a big-picture, in-depth assessment of the buyer landscape, including domestic and international competitors, other strategic buyers, and financial sponsors. This process can help executives better understand the rationale for each buyer category and position the asset strategically, targeting buyers for whom the strategic value may be higher.

   Sellers that are better able to articulate an asset's value story to the targeted buyer category are able to extract more value. The pharmaceutical player in the deal described above, for example, identified and targeted both India-focused and global consumer-product players, as well as buyout-focused PE firms. By broadening the scope of potential buyers, they were able to extract greater value from the sale.

3. *Optimize and prepare the asset*
   Companies need to ensure that their asset is as attractive as possible before going out to potential buyers. This exercise requires considerable planning. For a conglomerate selling a business unit, it can include operational improvement, putting in place structures and processes to enable that unit to be easily separated from the rest of the business and absorbed by the buyer with minimal disruption. PE firms typically begin developing plans to enhance predeal value 18 months in advance of the planned sale date and run parallel processes for strategic and financial investors. They are also more likely to invest in assets that can be run independently and have a built-in managerial layer to oversee day-to-day business operations.

   For example, one PE fund looking to sell an IT-services business went through an extensive program of preparation with the company's management. It created an entry plan for adjacent markets and articulated the potential upside for the next owner. This in-depth preparation encouraged bidders to accept a higher valuation for the company.

4. *Orchestrate the separation process*
   This process—and the one that follows—may be best run through a capable and independent separations-management office (SMO), which is responsible for planning the separation, identifying entanglements and risks, and managing the end-to-end deal process. For

example, a major Indian conglomerate has a centralized group-strategy office to oversee all major inorganic initiatives, and it plays the SMO role in acquisitions and divestitures done by portfolio companies. This approach enables the conglomerate to embed experience and learnings from across deals as a core strength of the organization.

Once a priority bidder has been identified, the buyer and seller should immediately work together to develop a clear divestiture road map that lays out key timelines, responsibilities, and milestones. Frequent and transparent communication with all stakeholders is vital throughout the process to manage anxiety and ensure continued business momentum.

5. *Disentangle to support the business*
   Interlinkages between the business being sold and the remaining portfolio companies could be identified early, enabling TSAs to be designed in a way that preempts postdeal complications. Working closely with the buyer is generally the best way to guarantee a smooth handover process. For instance, a large Indian IT-services company delivered 25 percent excess TRS over market by collaborating closely with the buyer to ensure they reached a detailed agreement around people, assets, and postdeal commercial arrangements.

COVID-19 has created unprecedented challenges for many companies globally. The road to recovery may be particularly challenging for India, due to a lack of available capital. Indian companies must, therefore, carefully evaluate whether divesting might be an important source of fundraising, as well as a strategic opportunity to refresh and reorient their portfolios to ensure they are well positioned to thrive in the next normal.

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