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Divesting for growth

The value of selling non-core units

M&A volume fell by 17% in 2016, but the number of divestitures actually rose by 50%. What is driving the spike in sales of corporate business units? Four experts weigh in.

The experts:

1. Mark Brady
Global Head of M&A,
William Blair

2. Cameron Mingay
Senior partner in the
Securities Group,
Cassels Brock
Lawyers

3. Jonathan Howe
Managing Director
and Head of Mergers
& Acquisitions
Group, Wedbush
Securities

4. George Casey
Head of Global
M&A Group,
Shearman & Sterling

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How effective are divestments as part of a growth strategy?

J. Howe, Wedbush Securities

Divestitures can be an important strategic part of a company's growth strategy. Strategic divestitures are usually focused on shedding non-core operations, permitting proceeds to be re-invested in the company's core business through funding organic growth or acquisitions. In the case of public companies, a more focused strategy can often be rewarded with a higher valuation, as the companies become more "pure plays" with attendant management focus. Typically, the business being divested has less favorable valuation benchmarks, which can increase the analysts' valuation appraisal (growth rates, margins, multiples) of the remaining company.

One divestiture that Wedbush Securities advised on involved a public consumer products company. A former management team made an acquisition that it felt could leverage the company's well-known performance brand. The synergies did not prove out, as the brand equity did not transfer, and a decision was made to divest the business after a substantial impairment charge had been taken.

The analyst community supported the company's decision and the return to full focus on the company's business has been rewarded with a rising stock price.

M. Brady, William Blair

I'll use the example of Myers Industries, which we did a deal for in 2015 that is a fairly typical example of how divestments can be part of a growth strategy. We helped them divest a plastics subsidiary they had, by selling it to a private equity firm. That subsidiary was not generating any earnings for the company, but it was taking up capital in the business. The plastics business had little to no value to Myers as part of their portfolio. But they were able to sell the business for more than $100 million to create capital to put into the true growth area, their material handling business.

If an asset isn't generating earnings, or meaningful earnings, or the margins are lower than the overall corporate entity, divestment can be a pretty cost-effective way to raise capital. There are a lot of private equity firms that love to do corporate buy-out transactions.

G. Casey, Shearman & Sterling

I think it's fair to say that companies look at their portfolio all the time, and particularly when they are growing. They look at whether they want to rebalance their portfolio and sell certain assets in order to free up available resources and pursue internal growth, or to acquire assets that would help them grow. Generally speaking, I would say that divestments are a tool that almost all corporate players in the main market use in order to manage their portfolios.

C. Mingay, Cassels Brock

If divestments are done properly, they can be a powerful tool to generate value and drive growth in a company's core business. If the company isn't focusing properly on a non-core business, often someone else is quite willing to undertake that focus.

$10bn

The value of the largest North American divestment in 2016, CIT Group's sale of its commercial air unit

34%

Increase in value of divestments worldwide in 2016 to US$232bn

Source: Mergermarket

What we often find with public companies is that the market is giving no value to a company's non-core business. In a perfect scenario, the non-core business is spun out into a new public company with the original owner retaining an interest. An opportunity then exists for an additional value to accrue to the original owner in the future through the appreciation of shares in the new public company.

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What do people need to think about when considering divestment in today's business climate?

G. Casey, Shearman & Sterling

A number of considerations come to mind. One is to focus on the business strategy. What is it that the company would like to divest and why? Sometimes this means looking at whether the scope of the divestment is right for being able to sell the particular business or particular assets, so that you actually get the best value. Value is another key consideration, and to some extent it is driven both by the innate nature of the business and how the business is doing, but you also need to look at comparable businesses in the marketplace.

The equities markets have generally been volatile over the last 12 months or so. In the US right now, they are on a significant upswing, so companies need to look at the timing of the divestment, comparable companies that will be used as valuation benchmarks, whether the market is actually trading up or down, and whether the market or the economic conditions are beneficial.

The final consideration is whether the company would want to find a good strategic buyer for these assets and conduct a one-on-one negotiation or run an auction to test the market, maximize the value, and ultimately get the highest benefit out of the transaction.

M. Brady, William Blair

I think one of the biggest, most important issues for the board to think about is: What does this do

to the value of the remaining corporation? If investors are ascribing little or no value to the subsidiary they're considering divesting, you might be able to do it and generate an increase or no movement in your stock price.

The second consideration is having some realistic thoughts on what that division might be worth. Thinking about the value prior to undertaking a divestment process, particularly one which gets announced publicly, is an important step. You do not want to be in the position where you find that the bids come up short of what the expectations were because the expectations weren't realistic to begin with. If you get yourself in that scenario, as a board, there can be a lot of pressure to complete a deal that may not be the best thing to do for the company, or at least as good a deal as it would have been if you did the work to set a realistic value at the beginning.

The third consideration is that when you're selling off a division, unless it's truly a pure, separate subsidiary, it's quite likely you need to be prepared for some level of engagement, like a shared services agreement, with the buyer for some period of time after the deal. As an example, if you sell a division to a private equity firm and that division doesn't have its own payroll function, or its own HR function, they will likely need to contract with you for a period of time in order to keep access to those functions.

When we're advising a company that's selling a division, through our due diligence, we can start to understand how much that division relies on the overall corporate entity. If they have a lot of systems tie-in, and they've got IT support that otherwise isn't going to be there, and payroll, insurance, finance, or any of those functions, we're going to know that when we get into diligence. We would then prepare the client for that and charge for those services. It's not going to be free, but they're going to need to be able to provide some support to that division for a period of time after the sale. This isn't necessarily the case when you sell an entire entity.

C. Mingay, Cassels Brock

Management teams need to think about changing business conditions, primarily, and about why it might be an effective time to do a spinout. Often changes have occurred in the regulatory environment, or there is economic or political uncertainty in a sector. In this context, a divestment can be quite advantageous if done properly, because a company that is in a business often sees things that others don't and therefore may be more aware that the future is not quite as rosy as it appears.

J. Howe, Wedbush Securities

Evaluation of possible divestment of a business requires careful consideration prior to undertaking the strategy, as well as significant planning once the decision to divest is made. Senior management evaluation of a potential divestment must consider factors such as: Are there likely buyers that will pay an attractive price? Will the company and the divested business share customers, and what are the implications if the process doesn't go smoothly? Which management members will comprise the "go team" with the divested business, and how integral or replaceable are they to the remaining company? What are the tax and financial accounting implications in terms of cost basis and potential gain or loss?

If the above and other factors lead senior management to conclude that a divestiture is the correct strategic decision, a number of tactical considerations come into play, such as preparing the business for sale – including separating it from the core business as much as possible, preparing a reasonable business plan as it would have been under current ownership, identifying strategic benefits available to buyers, and developing a marketing plan, among others. They would also want to develop a strategy for dealing with common customers and suppliers as the situation requires. Planning must be undertaken regarding use of the divested operation's branding if it is shared with the remaining company. As Mark mentioned, planning for shared services for an interim period is also critical if the divested business is currently integrated into the company's core operations.

> **"It's been such a strong M&A market that people who are thinking of selling assets will find those businesses are worth more today than they were a year and a half ago."**
>
> **Mark Brady, William Blair**

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What trends in divestment activity have you seen in the market this year, and what do you think is driving such activity?

M. Brady, William Blair

I don't know that it's a trend, but it's been such a strong M&A market as a whole that people who are thinking of selling assets, whether it's a corporate divestiture of a division or subsidiary, or a private equity firm looking to sell something they own, they'll find those businesses are worth more today than they were a year and a half ago. There's just more activity.

There are a lot of stand-alone private equity firms that want to focus on divestitures, and there seem to be more of those because divestitures are much more complicated than a straight sale. One of the complications is the shared services that I

mentioned. The other is having the patience to deal with a large corporate seller for whom this asset isn't really material or meaningful. Sometimes, those deals can move at a pace that could be frustrating to most buyers, so some private equity firms have really developed a specialty in this. I think that's a real trend in the market.

J. Howe, Wedbush Securities

Wedbush Securities has been actively involved assisting middle-market public and private companies evaluate and implement divestiture strategies over the last few years. We have seen divestitures as part of growth strategies, as a source of cash for companies suffering from difficult times, and as a way to undo poor acquisitions, among other reasons.

There is an increasing number of private equity firms that focus on divestitures as an investment strategy. They view divested businesses as often undermanaged, underfunded by prior ownership and "orphans" that did not receive proper attention. These factors lead them to see divestitures as undervalued, with a visible path to value creation. Private equity firms are also attracted to the transaction dynamics, as once the divestiture strategy has been undertaken, the selling company is not emotionally attached, as is the case with privately held companies. Wedbush Securities has had significant private equity interest in most of its divestiture transactions.

G. Casey, Shearman & Sterling

The M&A market in 2016 was slower than in 2015. The sell-side activity has been slower, partially because of the volatility in the equities market I mentioned previously, which was particularly high over the summer. There were also challenges in the financing market early in the year. But having said that, there are plenty of divestments that have been done this year – from very small businesses and very small assets to very significant transactions.

However, even though the market is volatile, divestment activity will continue as part of the strategic rebalancing of portfolios for large corporations, and also as part of the exit strategies for private equity funds looking to divest portfolio companies. The activity driven by private equity funds this year has been slower, but these market participants always look at opportunities to sell.

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Do you see a correlation between the pressure for digital transformation and divestment activity?

C. Mingay, Cassels Brock

I think the rate of change is more dramatic than perhaps at any time in the past, generally as a result of technology. Companies are using divestments to fund expensive digital transformation and innovation. Beyond that, however, technological disruption is causing companies to re-define their core value propositions. For example, the blockchain is bringing in a whole new host of interesting

"Companies are using divestments to fund expensive digital transformation and innovation. Beyond that, technological disruption is causing companies to re-define their core value propositions."

Cameron Mingay, Cassels Brock

developments in the fintech area, and businesses that don't know how to adapt will find erosion of even their core business segments. It may sound a little harsh, but the speed of change is quite dramatic.

M. Brady, William Blair

I do think there is a correlation. We did a deal a couple of years ago, selling the largest envelope manufacturer in North America. Because of the digital transformation, electronic communications, and mobile communications on your smartphone, that company made 33 billion envelopes in one year, and the next year, they'd make 31, and the next year, 29. They were slowly being ground to death by the digital transformation you're talking about. In those cases, it's very important to be sure that when you do this divestiture, you are getting ahead of the curve, because by the time the decline in production is obvious to everyone, there usually are not a lot of buyers.

Printing is another example. Because of the digital transformation that has occurred, there is a massive excess of capacity in the printing industry because there just isn't the demand for it. Even printing magazines has become a brutally difficult business, so there are a lot of people who would like to sell. It's true all across the landscape of businesses that have been impacted by more technologically sophisticated approaches to what they do. Oftentimes, what you see is a lot of people interested in selling those legacy businesses that are affected, but there is limited demand.

> **"In the course of digital transformation, companies may find that functions and strategies once core to the business are no longer useful or viable, which can lead to evaluating potential divestitures."**
>
> **Jonathan Howe, Wedbush Securities**

G. Casey, Shearman & Sterling

It likely depends on the industry and the particular business. In some cases, there is definitely a correlation, especially if the company wants to focus on more high-end technology assets and access more technologically advanced businesses. But, in my mind, it depends on the specific company and industry.

J. Howe, Wedbush Securities

Digital disruption is a trend that is impacting many businesses and industries as participants take

advantage of developing technologies to improve business processes, go-to-market strategies, customer experiences, supply chain management as well other parts of enterprises' core functions. Since every industry has competitors that are more technologically advanced than others, companies lagging behind are forced to quickly adopt digital strategies to remain competitive.

In the course of digital transformation, companies may find that functions and strategies once core to the business are no longer useful or viable, which can lead to evaluating potential divestitures. As digital transformation continues and accelerates, there is likely to be more divestiture activity as companies redefine their core competencies and operations. We anticipate that more companies with strong core digital competencies are likely to be acquired as established industry participants attempt to incorporate these efficiencies and offerings to compete for more demanding customers.

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Do you believe this increase in strategic divestments will continue into 2017?

M. Brady, William Blair

This question revolves around whether the conglomerate or the pure play is popular at the moment. I've been doing this for 20+ years, and have experienced both environments. Right now, the pure play is the more popular, with a higher multiple. The theory is that investors want to allocate across different industries themselves, so they aren't as interested in buying a company that's one-third health care, one-third technology, and one-third consumer, because they want to make the decision whether to allocate their investment dollars a third, a third, a third, or something else. So we're in an environment right now where the pure play is more popular, and if you believe that will persist, then yes, divestments will continue. If the world goes back to loving the conglomerate again, the environment would change.

J. Howe, Wedbush Securities

We believe the momentum for divestitures will continue. Private equity firms have record amounts of uninvested funds and continue to see divestitures as an attractive source of deploying them. Debt financing is readily available at attractive rates, terms and leverage ratios. Strategic acquirers see divestitures as a way to fulfill strategic objectives in terms of sources of supply, access to technology, new products and other imperatives. The stock market and merger and acquisition comparable multiples are near record highs. Combined, these factors show a ready source of demand for divestiture businesses.

On the supply side, we believe corporations will continue to rationalize their businesses and look at underperforming or non-strategic assets as a source of funds to invest in more attractive activities. Potential tax law changes could increase the attractiveness of divestitures at the margins. With valuations near all-time highs, corporations will seek to pursue strategies that will take advantage of market conditions to maximize shareholder value, and divestitures should remain a viable strategy to do this.

C. Mingay, Cassels Brock

Yes, I think we're about to see the impact of digitalization, disruption and new technologies, and a lot of the traditional institutions that couldn't be challenged will be impacted adversely if they're not agile. We see that, for example, with the Canadian banks. Our banks have 95% of market share and so they're very focused on trying to understand what the disruptive actions are. They are trying to figure out how a whole generation of young people will never go into a bank and will just do all their transactions from their mobile devices. That's just beginning, and in this country that's a huge change. We were the only country that really didn't suffer a downturn in 2008 with the financial meltdown, so while those institutions did a great job of behaving conservatively, now they've got to turn around and do the opposite and behave in a more aggressive manner.

> **"Overall, I think that 2017 will probably see a strong M&A market. Simply having more stability in the market will help divestments.**
>
> **George Casey, Shearman & Sterling**

G. Casey, Shearman & Sterling

This is a bit like looking into a crystal ball. Overall, I think that 2017 will probably see a strong M&A market. I say this because there was a slowdown in M&A activity in 2016, when people were anticipating what was going to happen with the Brexit vote and the US presidential election. Other global political and economic factors also drove slower M&A activity. Simply having more stability in the market will help divestments. We will still have a number of European countries going through elections in 2017 that will influence M&A activity, including divestments. But overall there should be a positive market and positive market dynamics for divestments to continue in the new year.

Jeffrey Riback, President of Toppan Vite New York, on divestment activity

In an era of fast-moving change in the way that companies do business, divestments are becoming an increasingly useful tool for adapting to new conditions. This is reflected in the divestment data for 2016, when both the volume and value of corporate asset sales went up by a sizable margin (see p.1-2 for the figures). Throughout the year, major brands made use of divestments to raise capital and sell off non-core assets, such as in GE's sale of its appliances unit for US$5.6bn to China-based Qingdao Haier and Thomson Reuters' sale of its Clarivate Analytics division to a consortium of private equity funds for US$3.5bn.

Geopolitical change could speed up the pace of divestments as well. Companies with assets in the UK may re-assess those units' prospects with Brexit approaching. And if the new US Congress makes regulatory changes in sectors such as financial services and energy, firms in those industries will be re-evaluating their strategic positions.

Markets often reward companies for undergoing renewal through divestitures, and for good reason. The process allows sellers to re-focus on what they do best and invest in their core. And with more private equity firms than ever seeking acquisitions – the number of buyouts worldwide reached a record high of nearly 2,900 in 2016 – there will almost certainly be eager buyers for the assets.

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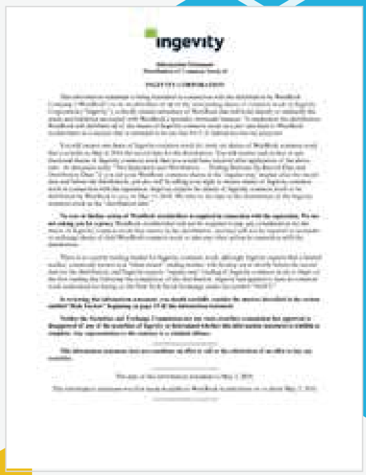

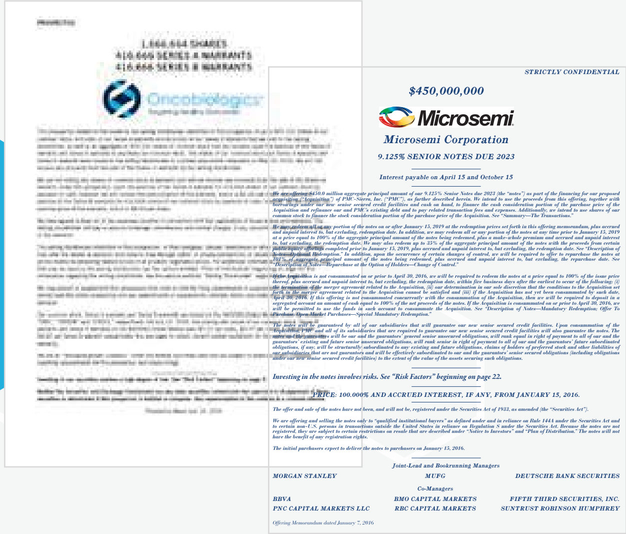

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212. 596. 7747 | marketing@toppanlf.com | 747 Third Avenue, 7th floor, New York, NY 10017