Perspective

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Seven Reasons Divestitures Are Harder Than You Think

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Seven Reasons Divestitures Are Harder Than You Think

As the merger wave rolls on, it is clear that many companies are taking this opportunity to divest noncore businesses. After all, we're in an active market and there are plenty of buyers—financial and strategic—sitting on hordes of cash and looking for attractive deals.

However, before moving to cash in on businesses you think will be attractive, it is worth taking a hard look at the process of divestiture. Whether it's an outright sale or even a spin off to shareholders, in today's business environment splitting off pieces of a business is much harder than it appears. It can have an impact on not only the divested entity, but the seller itself.

In some ways, the difficulty of breaking up is directly related to how well an organization's businesses have been integrated in the first place. Company-wide information technology initiatives, shared support services, aggressive outsourcing, and the advantages of scale all work against the divestiture process. That's not to say divestitures should be abandoned. The point is this: It is critical to fully understand the major impediments to unraveling a business unit before making the decision to sell.

Our analysis has found there are seven key hurdles to successful divestitures.

1. IT integration efforts make divestitures difficult.
ERP (enterprise resource planning) applications like SAP have become ubiquitous in large organizations today. The promise is business process simplification, enhanced productivity, and seamless information transfer. However, these applications also require that businesses be wired together, typically through a single, unified database and other infrastructure. This, of course, means individual businesses are far more difficult to separate.

For example, when Pfizer divested its Adams and Schick units, significant effort went toward figuring out how to separate data of the entities while blocking access to each other's information.

2. Support services and facilities are hard to unravel.
Achieving scale through shared support services and joint facilities is a broad trend in the business community. The more successful a company has been at this, the greater difficulty it will face unwinding these collaborations.

One big part of this is staff allocation. The trend toward shared support services has extended through general and administrative functions, call centers, accounts payable and receivable, payroll administration, and compensation and benefits plan management. Carving out pieces of these integrated functions carries real challenges.

3. Outsourcing adds third-party issues to divestitures.
Not only are organizations centralizing, they are outsourcing as well. In some ways, this may ease the process of separation as the organization no

longer owns the employees, systems, and processes. Outsourcing firms are also very good at splitting workflow. If only it were that simple.

In addition to accumulating numerous—perhaps hundreds of—vendor relationships, outsourcing generally involves processes that are critical to a company's core businesses. Therefore, divesting a unit with significant outsourcing substantially increases the need for a rigorous review of service agreements to understand change-of-control provisions and to assess how service will continue going forward.

4. The divested business may require long-term support.
Until the divested business is prepared to stand on its own or is fully supported by the buyer, it likely will need support from its former parent. Establishing clear service-level agreements (SLAs) between buyer and seller is critical. For highly integrated global businesses, this can lead to country-by-country agreements, each involving dozens of services such as facilities management, back-office support, and sales and manufacturing.

Conflicting interests can complicate the SLA process. For example, depending on the situation, the selling organization may have incentive to either prolong or limit the time frame in which these services will be provided.

5. Disruption threatens both seller and divested entity.
Like a merger in reverse, a divestiture done right requires a plan detailed across every function, carefully monitored and adjusted as execution unfolds. This is a major project.

Developing the separation plan often requires a three-way collaboration between the seller and its remaining businesses, the divested unit itself and, in some cases, the buyer. The complexity of managing this separation planning across every function of the business and across the globe can rapidly absorb all the attention of the businesses. The real danger here is underestimating just how much effort this will require.

6. The divestiture can impact the seller's cost structure.
Once the seller has carved out the divested business, it may well need to take another look at its own cost structure.

In some cases, there can be loss of scale in areas where work was combined with the divested business. In the earlier Pfizer example, customer service employees who had supported the divested Adams businesses were rationalized because the buyer, Cadbury Schweppes, did not require their services. However, this did not fully make up for the loss of scale. It took additional work with the customer service model—automating orders and other improvements—to get the cost structure back in line.

In other cases, the remaining business may face "stranded costs" that cannot easily be eliminated. Typical examples include excess building space or other fixed infrastructure costs that were previously allocated to the divested unit.

7. Regulatory requirements can force your hand.
Regulatory requirements, on both local and global levels, often create additional complexities. For example, divestitures may be required to resolve antitrust concerns for a merger transaction. In these situations an organization may have to give up capabilities it would otherwise not elect to relinquish.

As part of the Linde-BOC merger, regulators required that the North American business be divested and operate as a stand-alone business, forcing Linde-BOC to part with both capabilities and people it would otherwise want to retain. Similarly, in divestitures with European components, negotiating with works councils on a country-by-country basis can lengthen the divestiture process and create additional constraints.

* * *

Does all this mean divestitures are a bad idea? Of course not. In many cases, they are absolutely the right thing to do. The trick is to be aware of the seven challenges in advance—and all seven are equally valid for divestitures of every size—and use that knowledge when assessing any proposed transaction.

There are many assessments to be made. How much of the business to sell? Could a strategic buyer more appropriate than a financial buyer? Which is better, a divestiture or a spin-off? Truly understanding the answers to these questions can help a seller get the very best deal—in the broadest sense of the term.

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