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FOCAL POINT |
Investing in Divesting: Value Drivers Prior to Exit

Higher Portfolio Returns Through Well-Prepared Divestitures

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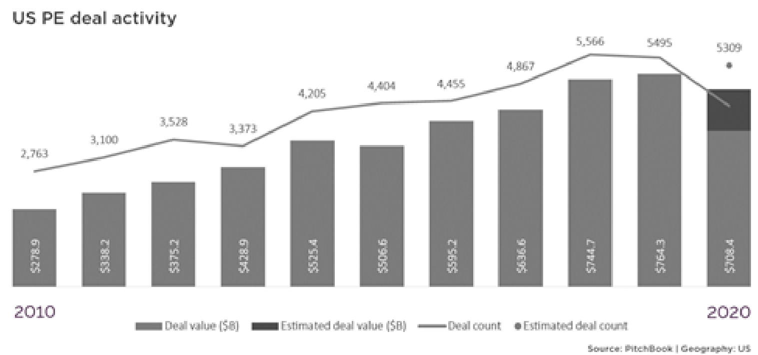
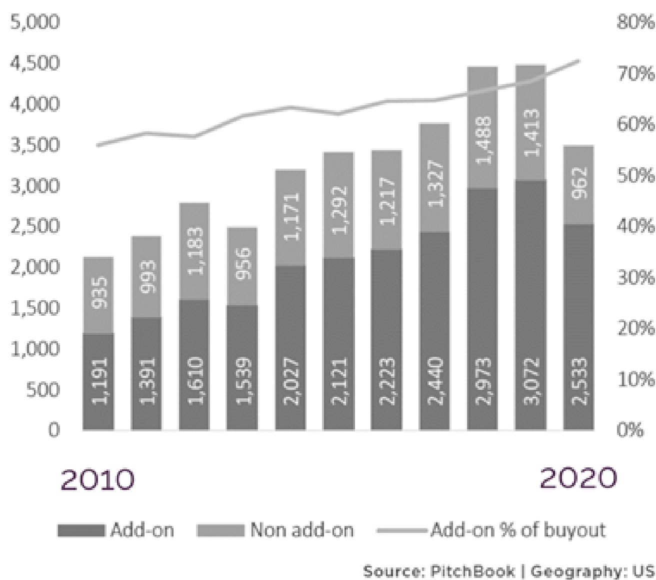
Looks like the strong Private Equity M&A environment still has legs. Debt options abound and pricing is plentiful. Over-equitized deals with dry powder can create easily built structures for close. Value through add-ons is going to stay in vogue. Platform multiples continue to be high and rare. Interestingly, subtraction to gain continued addition may provide compelling long-term growth.

High multiples for platforms not too long ago were perceived as having plenty of lower cost add-ons to blend down the acquisition multiple. While that approach is still relevant in 2021, it may not blend down as far as initially thought. For instance, acquiring smaller supply chain participants may be easy and come cheap, but they may not move the top line substantially. Add-ons providing core needs such as products & services, synergistic sales organizations, and geographical expansion may be expensive. Thoughtful add-ons aligned with your prevailing value creation thesis may tick 80% of the boxes in a meaningful, yet expensive, way.



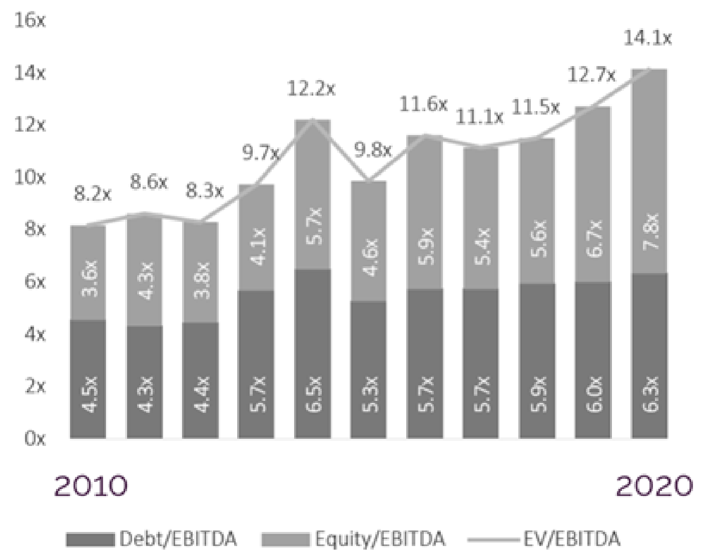
When thinking about divesting as a way to free up capital to reinvest in higher returning investments, these questions can pop up:



- Why not rapidly drive value through the integration of the 80% with "good portfolio fit" and sell off the other 20%?
- Can divesting assets dragging down results increase value and focus resources better for organic or acquisitive growth?
- Has the last year forced recent add-ons to look less accretive to earnings due to the changes in the COVID economy or changes in the firm's microeconomic conditions?

While focused on selling, successful value creation through divesting tends to borrow skills and approaches from buy-side Add-On and Corporate Development functions. Strong sellers think about buyer interests and how they can articulate ways the company will flourish under new ownership. We know it's a delicate balance of investing in an existing portfolio firm with enough magnitude necessary to make an impact but not so much expenditure that it cuts too deeply into your buyout multiple. In the spirit of investing in divesting, nine ideas to consider:

1 | *Empower Value Creation Operating Teams* - PE firms must have strong alignment to the CXOs of the firm's portfolio companies. Over the past decade, add-on acquisitions have become the major source of growth for PE-held assets. However, in many instances, acquired assets are not fully integrated into the platform due to financial, human capital, information systems or market segmentation reasons. Over the last year, it has become apparent some of the "roll up" strategies within platform companies have assets that may be more of a drag on earnings than accretive. The sooner possible divestiture candidates can be quantified, the better the platform can utilize its resources more efficiently to drive its investment thesis and accelerate EBITDA. Hence, it requires flipping the Corporate Development function to the opposite side. It requires a simultaneous view of measuring and driving equity value creation and thinking like a sell-side banker, assessing the fit within the portfolio, and what firm capabilities can be synergistic or a value creator for the acquirer. The firm needs to be clear on what activities drive value creation and, early on from acquisition, have clear, consistent criteria defining what does and does not add enough growth. Devoting time to an ill-fitting business should not be second guessed. The longer the PE firm tries to force a fit with a straggler, the more resources are used which, in turn, delays value creation speed and impact for the total portfolio.



2 | *Assess Divestiture of Underperforming Assets* - this drives multiple opportunities for a portfolio company. First, it frees up capital, both financial and human, to focus on the execution of the value creation plan applied to higher returning investments. It also may allow the portfolio company to focus its freed-up resources on accretive add-ons. Furthermore, the path to value creating add-ons involves a critical resource – skilled, experienced, talented people - who possess the ability to effectively integrate technologies and cultures to assimilate the asset seamlessly into the portfolio company.

3 | *Capture Corporate Development Best Practices* - they are critical to value creation when evaluating an add-on and divestiture list. Focus on key new business capability developments and industry value creation drivers is the basis for investment thesis implementations over time. As markets change, the accumulated market intelligence will drive portfolio value further. The firm begins to develop a collective wisdom on day-to-day organic growth but also accrues lessons learned through corporate purchases and asset sales. Portfolio company leadership, PE firm direction and, if the development knowledge is not in-house, third-party consultants and advisors may fill the gaps in identifying and executing on the most valuable acquisition practices and divestiture strategies.

4 | *Extend Executive Leadership's Reach* - leadership has multiple draws on its time during this process, especially during the first years of entering a PE firm's portfolio. If this is the first institutional capital injected into a company, existing or newly placed executive leadership must focus the organization on shorter-term cash flow and return on investment metrics versus the typical longer-term horizons of former founder-led or corporate carve-out assets. Drinking from a firehose is a cliché but it's apt here. Executing an add-on strategy in the near-term not only can improve EBITDA, but it can also shorten holding periods as the portfolio company grows its top and bottom lines faster. The most important variable with this strategy, however, is the add-on's integration into the platform. As we suggested earlier, integration can soak up significant human capital and system resources. It is also important to have a data-backed sense of when an acquired asset may be a drag on earnings and other critical resources. This alarm signaling too much tied up capital (human, systems, financial) without commensurate return to the platform should

focus management to question the path they are on and even the "goodness of fit" of the asset in the future.

5 | *Ramp Up Communication* – messaging during the divestiture process throughout the organization and with the sponsor is, without question, extremely important. Retaining revenue, talent, and intellectual property of the carve-out candidate must be top of mind in order to not rapidly lose value. Thoughtful consideration of a TSA (Transition Services Agreement) is instrumental in keeping management of the carve-out focused on its future. If extending it allows for a deal to get done at the valuation desired, it is a good lever in the deal structure. Buyer diligence of the carve-out Financials, Separation Assessment and TSA will help the transaction. Working with the acquirer's program management and value creation plan could provide some new best practices and an easier deal closure. If the goal of the divesting platform is to free up human capital and financial resources, an extended "through the eyes of the acquirer" sensibility can be invaluable. The timeliness of acquiring, integrating, and divesting allows for greater value creation of the overall platform company and will lead to a higher risk-adjusted EBITDA, greater operational efficiency, and perhaps, greater clarity of the gaps needing to be filled through the next add-on.

6 | *Build a Future Revenue Roadmap (Thinking About Buyers)* – everyone respects revenue growth – especially potential buyers. Make it easy for potential buyers to understand the business development functions and efficacy a firm has by documenting "current state" Business Development functions such as prospecting capabilities & responsibilities or any existing voice of the customer (VOC) programs sharing insights into current products & services offerings. If possible, assure potential buyers the firm has a customer relationship management system filled with qualified leads, knows target markets intimately, and has a path to retain current relationships beyond the divestiture. If the firm has any stand-out marketing capabilities or integrated, productive content management programs, make sure potential buyers know how these play into current and future customer conversion rates. Share a plan for retaining key Sales talent with incentives and retention programs already in place. If the team has pricing optimization opportunities or even a process or team to improve pricing yields, get credit for this on-going revenue builder as well.

For "future state" Business Development functions, let potential buyers know where the team is on their improvement trajectory and what they still need to get accomplished. Essentially, the divesting team wants to get potential buyers to dream about the next big revenue sources on the horizon. Sharing this aspiration around what the new buyer could get accomplished may involve pulling back the curtains a bit on innovation and experimentation support within the firm, research & development processes with promising projects underway, internal knowledge management systems (KMS) that may help share revenue-generating opportunities, and most certainly intellectual property examples (patents and trademarks) with further monetization potential. Incorporate "current state" capabilities and "future state" potential into reasonable revenue projection models backed up with a tangible roadmap of what the firm's functional divisions (Sales & Marketing, Operations, Finance, and Human Resources) need to stop, start, or continue to meet revenue goals.

7 | *Get Information Sources Reliable and Crisp (Thinking About Buyers)* – sell-side experts must acknowledge the buy-side frustration of not having reliable data and employing spotty information to decide on a fair buying price. Why not make it easier for a potential buyer to know what's under the covers? Provide a compelling way to document and share the current data sources flowing through the tech stack and culminating in usable, reliable operational & financial reporting capabilities. Document on-going software licensing requirements. Provide a snapshot of the what the firm's technology ecosystem looks like today (tech partners, make vs. buy software, internal capabilities, etc.) to allow potential buyers to know what hardware and software expenditures may be incurred on their watch. The firm may even have servers overflowing with social media datapoints that can be analyzed for demand-sensing cues or customer experience temperature checks to take into consideration. If Marketing is not set up to analyze this type of data, then build a process or team to do so.

Share a view of how the data sources are analyzed and applied by Management to make day-to-day decisions. If Management cannot articulate KPI trending that matters to the business or performance analysis & reporting is weak, then invest in building up the team's analytical capabilities. If information is reliable and crisp, then potential buyers have less room to discount the selling price due to lurking variables and unknown risks.

8 | **Create Operational Playbooks (Thinking About Buyers) -** document how the company runs day-to-day with processes, procedures, and training content. Share roles and responsibilities tied to the current organizational chart. Create instructions for how the new buyer could open up new locations or expand e-commerce capabilities. Provide a detailed summary of the "current state" supply chain and procedures for key components such as procurement practices, inventory controls, transportation sources, and warehousing models. If the firm has a project management office (PMO) in place, there may be value in boosting the selling price by sharing extant project artifacts, lessons learned summaries, or even risk mitigation strategies that worked in the past and will be relevant in the future. Create a plan for any necessary separation strategies or service level agreements after the sale. Aspire to making it clear for potential buyers to see where operational synergies may reside if they sign. Make it easier to see where future operational improvements could, or should, be enacted.

9 | **Build A Foundation for Culture & Talent Retention (Thinking About Current and Future Teams) -** share an overview of the current internal communication structure and how a buyer might be able to plug into the communication channels for change management upon ownership. Highlight any talent management processes, compensation clarity measures, or training and development processes in place that will help maintain cultural consistency and customer service levels. Odds are some Managers will be replaced and some folks will leave under the new buyer's influence. Assure potential buyers that the business is built on systematic operational excellence and not just fleetingly residing in the hearts and minds of a few key employees who may bolt when the deal is done.

It's an open secret that Private Equity teams are masters of buying and selling. Yet, there's still room for improvement when sell-side talent stops to consider what their buy-side counterparts hold dear. Applying these nine ideas not only boosts firm management's effectiveness in the near-term but may also increase the eventual selling price.

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About The Authors |

Steven Koinis

Steve leads the Private Equity Practice for Catalyft LLC, a practitioner-led, boutique operating partner firm focused on strategy implementation and operational improvements in Middle Market businesses acquired by Private Equity, investment firms and Family Offices. Steve has held several senior executive positions with the sovereign wealth fund Abu Dhabi Investment Company, Huron Consulting Group, and as C-level executive and Board member of private firms in the US, Europe and Middle East. He earned his MBA from Harvard Business School and has two Bachelor of Science degrees in Mechanical and Materials and Metallurgical Engineering from University of Michigan, Ann Arbor. Steve speaks conversational Greek, German and Arabic.

John Bova

John is a is a Transformation and Operational Excellence Leader in Private Equity Firms and Portfolio Companies. John has played many roles in the private capital space over 30 years Including senior executive to fast growing middle market companies, Independent Sponsor, PE and Family Office Advisor and Consulting Practice Leader. John has a BA in Economics from Fairfield University and his MBA from Pace University.