

CREATING SUPERIOR VALUE THROUGH SPIN-OFFS

By Jeffrey Kotzen, Felix Stellmaszek, Jeff Gell, Danny Friedman, and Karthik Valluru

ONE OF THE BIG trends in the increasingly active market for corporate transactions has been the growing popularity of one particular type of transaction: the spin-off.

The number of spin-offs has increased dramatically in recent years. In 2015, companies closed 28 major deals worth a total valuation of \$133 billion. Among the largest were Gannett's spin-off of its publishing business, eBay's spin-off of PayPal, and Hewlett-Packard's spin-off of its PC and printer business.

Unlike selling a business to another company for cash or stock, or floating all or part of a business on the public-equity markets, a spin-off distributes shares in the new company directly to the initiating company's shareholders. Like any divestiture, a spin-off allows a company to increase its focus on the core, reduce management distraction, and improve the margin, growth profile, and valuation multiple of its remaining lines of business. Because spin-offs don't generate any cash, however, they

also have powerful tax advantages in the U.S. legal system, compared with other types of divestitures.

More important, spin-offs have a critical strategic advantage. They provide an opportunity to define—typically, for the very first time—a compelling investment thesis for the business in question and to set the new company up for success as an independent entity. And when the spin-off represents a substantial portion of the initiating company's assets, it also offers an opportunity to refocus the investment thesis and value creation strategy of the businesses that remain behind. This is especially the case in so-called splits or separations—such as Hewlett-Packard's split between HP Inc. (its PC and printer business) and Hewlett Packard Enterprise (its higher-value-added server, data-storage, networking, software, and consulting businesses) or Alcoa's recently announced separation of its upstream mining, refining, and smelting business from its downstream businesses, including auto and aerospace components.

These strategic advantages may explain why investors seem to prefer spin-offs to other types of divestitures. In an analysis of 8,000 divestitures worldwide between 1990 and 2013, The Boston Consulting Group found that from three days before the deal was announced to three days after, the companies doing spin-offs had nearly double the average cumulative abnormal return (CAR) of the companies doing trade sales or IPOs. CAR, a commonly accepted measure of how capital markets respond to a deal, is a good proxy for long-term value creation. (See *Don't Miss the Exit: Creating Shareholder Value Through Divestitures*, BCG report, September 2014.)

Not all spin-offs create superior value over the longer term, however. BCG recently analyzed 80 spin-offs that took place in the U.S. market from 2000 through 2014. We found that the median company initiating a spin-off outperformed the S&P 500 by 7 percentage points of total shareholder return (TSR) in the six months after the announcement of the move. The value creation at the median new company generated by the spin-off, however, trailed the market slightly in the six months after the close, and there was a broad spread of at least 38 percentage points between top-quartile and bottom-quartile performance.

What explains this wide gap? A spin-off is a complex transaction—the equivalent of a reverse postmerger integration (PMI). There are myriad challenges, many moving parts, and numerous situations in which things can go wrong. BCG recommends four critical steps to ensure that your spin-off ends up in the top quartile. (See the exhibit, “Successful Spin-offs Focus on Four Key Phases.”)

- *Plan for the long term—not just for the launch.* Don't just plan for day one of the spin-off. Plan for day two and beyond—by clearly defining the long-term value-creation strategy that will enable the spun-off entity to deliver strong and sustainable TSR.
- *Define the target operating model.* Understand—in advance—how the

spun-off company will operate and deliver value as a stand-alone company, and, when possible, take the time to set it up for success *before* executing the spin-off.

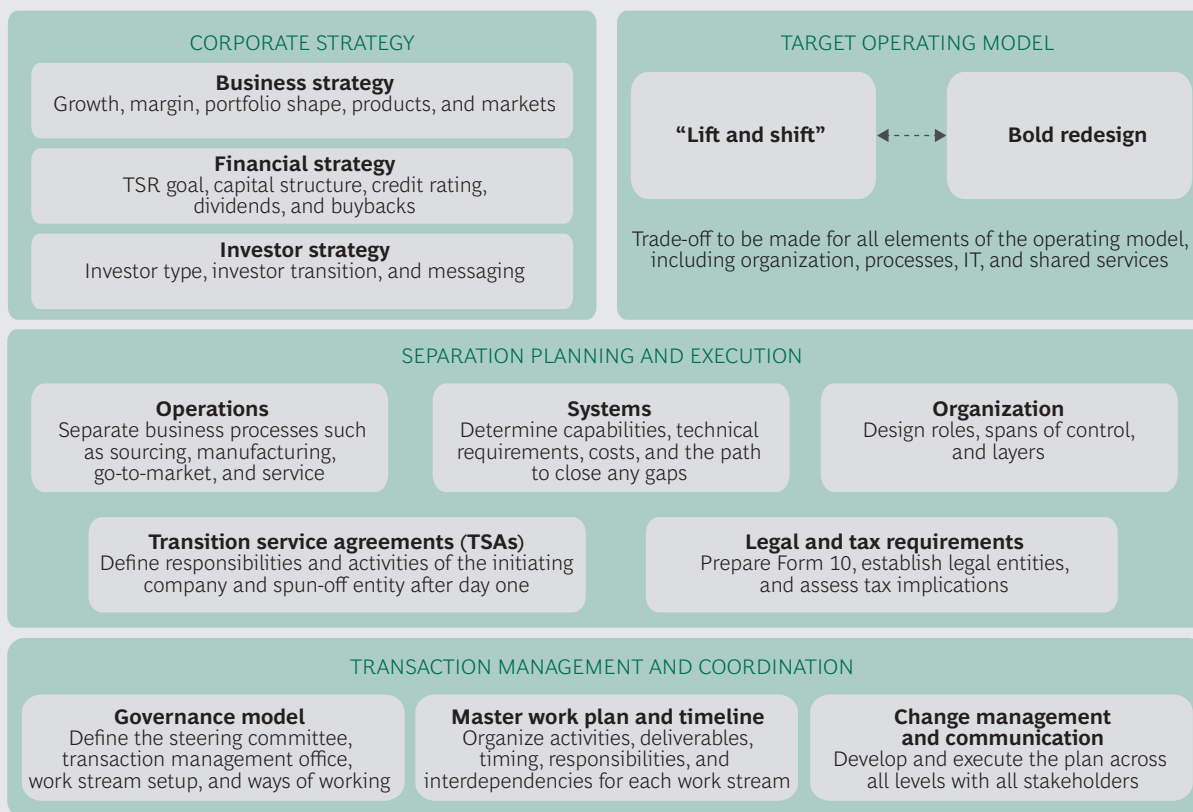
- *Focus on the critical path.* In any spin-off, there is usually a limited set of critical-path issues that, if not resolved before day one, risk delaying the launch of the new company and damaging credibility with investors as a result. Focus the lion's share of managerial time and attention on these issues.
- *Manage the hard side and the soft side of change.* Change management is a critical part of any spin-off—both the “hard side” of formal governance and the “soft side” of building a new culture for a new company. Stay on top of this change process by establishing a strong transaction-management office to lead the effort.

Plan for the Long Term

By the time a company decides to conduct a spin-off, the senior management team has typically put a great deal of thought into why spinning off the business in question makes strategic and financial sense for the initiating company. But only rarely does it have an equally clear understanding of how the spun-off entity will create value in the future. Instead, once the decision to spin off is made, executives tend to focus tactically on day one—when the new company goes public—rather than strategically, on what happens after it is independent.

An overly tactical focus, however, will leave a lot of value on the table, because it doesn't set up the new company for long-term success. After all, a spin-off isn't usually a company's star business. Almost by definition, it doesn't fit well with the rest of the portfolio (which is why the company is spinning off the business in the first place). Unless the senior management team of the initiating company addresses the new entity's long-term value-creation strategy in advance, the spin-off is unlikely to be as successful as it

SUCCESSFUL SPIN-OFFS FOCUS ON FOUR KEY PHASES



Source: BCG analysis.

should be—which could harm the initiating company’s relationship with its dominant investors.

Therefore, before spinning off a business, make sure to answer the following questions:

- What is the investment thesis that will make this new company attractive to investors? What can the company accomplish on its own that it could not do as a wholly owned division or subsidiary?
- What combination of business, financial, and investor strategies will allow the new entity to be successful and deliver strong and sustainable TSR?
- Will the separate valuations of the spun-off entity and the remaining business be greater than the sum of the parts of their combined valuation?

It’s especially important to establish in advance a three-to-five-year TSR target that is both ambitious and achievable. This target will be a key part of the investor communications and road show that precede the launch of the new company. Finally, in situations where the spun-off business represents a significant portion of the initiating company’s revenues, all these questions should also be asked about the company’s remaining portfolio of businesses.

Define the Target Operating Model

In addition to setting a strong foundation by defining the new company’s value-creation strategy, it is equally important to decide how the spin-off is going to operate to deliver on that strategy.

An important task here is making a fundamental choice about how to prepare the spun-off entity for its future as an independent company. Specifically, are you going

to “lift and shift”—that is, take an existing organization with its current operating model and simply make it independent with relatively few changes? Or, alternatively, are you going to go for a “bold redesign”—creating a fundamentally new operating model *before* the spin-off occurs?

This is a critical trade-off. The former option is certainly faster. But, depending on the value creation strategy, the latter may be necessary in order to ensure that the spin-off is successful. For example, when the organization to be spun off has too many layers or an uncompetitive cost structure, it is usually better to fix things first (or, at a minimum, to have a clear transformation plan in place that is ready to be executed once the spin-off closes). In fact, the decision to spin off can be used internally as “air cover” to push through difficult changes that may be hard to implement in a business-as-usual environment.

That said, bold redesign is not necessarily always the way to go. There are many situations in which not much needs to be changed at the business to be spun off or in which managerial attention and appetite just aren’t strong enough to do the heavy lifting that a bold redesign would require. There is no one best way; rather, it is a matter of balancing the trade-offs depending on the situation. Whatever approach the initiating company takes, however, it must define a clear target operating model for the spun-off business—in advance of the spin-off’s announcement and execution.

Focus on the Critical Path

Only when a company has thoroughly addressed questions about the value creation strategy and target operating model are executives in a position to focus on the myriad tactical issues associated with implementing a spin-off. This is the crucial phase of separation planning and execution.

A typical spin-off will include work streams across the full range of corporate activities—among them operational separation, IT, corporate reporting, finance, HR, legal, tax, and treasury. All these work streams

are important, but they are not necessarily created equal. In any spin-off, there will be a limited number of “long poles in the tent”—critical issues that, if not resolved before day one, risk delaying the spin-off’s execution and damaging credibility with investors.

Precisely what those issues are will vary depending on the situation. For example, IT can often end up being the make-or-break priority in a spin-off, one that can become a black hole for added costs and resources if not managed carefully from the very beginning of the process. In other cases, the main challenge will be financial reporting—defining the new entity’s P&L and consolidating financial information. In still other cases, legal and regulatory issues or the challenges of operational separation in a complex global manufacturing network will loom especially large. It is important to identify as early as possible the critical-path issues that could seriously delay the momentum of the spin-off execution plan and to focus the lion’s share of managerial time and attention on them.

When it comes to orchestrating the actual organizational separation, drawing the boxes on a formal organization chart is one thing, but the real challenge is filling the boxes with the right people. Leaders need to pay close attention to how they deploy talent between the spin-off and the initiating company, recruit to fill critical gaps, and retain the best people through what can be an intense and high-stress transition. There are also countless HR basics that must be addressed and managed over time—for example, titles, salary levels, and pensions. Given the importance of these tasks, HR will need to be ready to play a central role in the spin-off process.

Another important focus of the execution plan will be negotiating any transition service agreements, or TSAs, which govern interactions between the new entity and its former parent. In most spin-offs, the initiating company ends up being the provider of certain critical services—typically, back-office shared services such as IT and payroll—to the new entity. These arrange-

ments are temporary, but in some cases they can last a number of years. Usually, this service-provider role is new for the organization, and managers within the initiating company must plan for the time and personnel required to deliver against these new commitments.

An important principle here is to pay as much attention to defining the “spirit” of the collaborative relationship between the two organizations as to specifying the actual “letter” of the contractual agreement. No formal agreement can foresee all eventualities. So make sure you have established an atmosphere of continuous collaboration to address whatever issues may arise.

Manage the Hard Side and the Soft Side of Change

Like PMI, executing a spin-off is an exercise in change management, one that will start as much as one year before the close of the deal and continue for at least the equivalent amount of time after it.

Some of that change will be “hard”—for instance, the many technical issues specific to the spin-off transaction model that must be anticipated and managed, such as avoiding so-called stranded costs (expenditures that made sense when the spun-off business was still part of the initiating company’s business portfolio but no longer make sense after the spin-off), figuring out how to share intellectual property (and negotiating the necessary nondisclosure agreements), and defining the TSAs.

But a great deal of the necessary change will be “soft.” Senior executives initiating a spin-off often find, to their surprise, that it can be a highly emotional process. Frequently, the unit being spun off is a legacy business of the initiating company, one that looms large in the corporate culture and identity. The spin-off may make perfect sense from a strategic and financial perspective but still prove to be personally difficult, not only for the executives who are leaving the company to form the new entity but also for those who stay behind.

What’s more, just as a PMI creates a single corporate culture out of two, a spin-off requires creating two distinct cultures, each facing its own specific challenges. At the same time, it is critical that the two organizations work well together, especially in the early period of the spin-off, when the new entity cannot stand completely on its own. In our experience, even something as seemingly trivial as the name of the new company or the design of logos and other elements of brand identity can be disruptive. In one spin-off that we worked on, disagreements about what to name the new entity caused delays that led to nearly missing the scheduled closing date.

Finally, all this work takes place in an environment where there is a complex set of stakeholders whose interests must be taken into account. There are not only internal stakeholders such as managers and other employees (both those who will be leaving with the new entity and those who will be staying) but also external stakeholders such as customers, suppliers, investors, bankers, accountants, lawyers, and regulators.

For all these reasons, it is important that structures and practices be in place to manage the change process. We recommend that any company planning a spin-off establish a strong transaction management office to oversee the spin-off process. A “TMO with teeth” that actively manages the key work streams in the spin-off and communicates frequently with all the relevant constituencies is critical to ensuring buy-in, good governance, and efficient stakeholder management.

NONE OF THESE tasks is easy, but getting them right will likely be the difference between a spin-off that creates superior value and one that does not. As the corporate transaction market continues to heat up, spin-offs are likely to become even more popular. When companies take these four steps, they will go a long way toward ensuring that their spin-off delivers the kind of value that investors expect—both at the newly spun-off business and at the initiating company.

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