strategy+business

ISSUE 72 AUTUMN 2013

The Secret to a Successful Divestiture

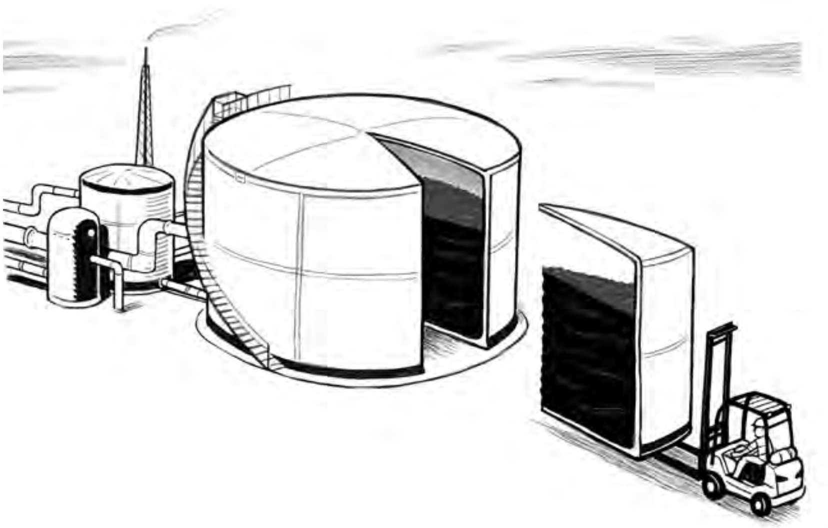
When you are selling part of your company, don't just offer buyers a potential asset; give them the capabilities to gain value from it.

BY EDUARDO ALVAREZ, STEVEN WALLER,

AND AHMAD FILSOOF

REPRINT 00208

This article was originally published by Booz & Company.



The Secret to a Successful Divestiture

When you are selling part of your company, don't just offer buyers a potential asset; give them the capabilities to gain value from it.

by Eduardo Alvarez, Steven Waller, and Ahmad Filsoof

A major North American oil and gas company had formulated the straightforward part of a deal—deciding to sell one of its refineries and a group of its gas stations—a few months earlier. Now, as part of its business strategy in preparing these assets for sale, the company was diving into the details of divestiture, and the capabilities that would be affected by the deal. This exercise was going to be almost as complex as a typical merger or acquisition; certainly it would be more complex than the company's leaders had expected.

The decision to divest these assets was part of a new M&A strategy—one that would have the oil and gas company concentrate on its higher-margin energy businesses, including refineries that produced diesel and other heavy forms of fuel. The deal was also a first step in getting out of the service-station business altogether—part of a broader industry trend in which major energy businesses had moved away from the idea of being "fully integrated," with positions in drilling, refineries, and gas stations. This oil and gas company (which is real, but will remain unnamed) was in the early stages of fine-tuning its strategic focus.

Business strategy is always intertwined with capabilities. A capability is the combination of processes, tools, knowledge, skills, and organizational design needed to deliver a specified outcome. Thus, although most M&A departments spend much more time thinking about the sale price, attention to capabilities can make a major difference in a deal's outcome.

For example, when you sell major assets, you can often maximize the deal price by identifying buyers with capabilities systems of their own that are a good fit. Such buyers can make the best use of the capabilities (including skills and technology) associated with the assets being divested. They are often willing to pay big premiums to complete the deal—and with good reason. Deals that leverage a buyer's existing capabilities typically fare well (*see "The Capabilities Premium in M&A," by Gerald Adolph, Cesare Mainardi, and J. Neely,* s+b, *Spring 2012*).

But maximizing price is only one of four major goals in a divestiture. The others are minimizing any disruptions to your retained businesses, keeping capabilities away from particularly strong competitors (which might mean turning down a deal that is favorable in other respects), and handing the buyer something that can be operated successfully from Day One. Your motive is not altruistic; in M&A, it is generally in a seller's interest to minimize the length of entanglement, and to establish a reputation as a good partner for making deals.

Our example is an energy company, but it could just as easily have been in healthcare, media, or financial services. The leaders of any company divesting assets must deal smartly with capabilities issues or risk having the deal fall short.

Differentiating Divestiture

As a seller, you should begin your divestiture process by identifying the desired end state for the important capabilities involved: those you

Illustration by Lars Leetaru

will still need after the deal is done, those you won't need, and most importantly, those that both you and the buyer will need (*see Exhibit 1*). In each group, some capabilities are "table stakes"—every company in the industry needs them—whereas others are truly differentiating. The latter can distinguish your company in the market and give you an advantage over competitors. These capabilities require the most attention during a divestment, and you should seek to keep them intact while enabling the buyer to benefit from the deal in every other way (*see Exhibit 2, page 3*).

In practice, most sellers, facing the pressure of time, end up having to choose which capabilities to focus on. Your goal is to keep the process moving without sacrificing the quality of your decision making or jeopardizing the outcome.

There are certainly divestitures in which the buyer is known from the beginning, but it is not uncommon for a company to decide to divest something just because it no longer fits strategically, announce this plan publicly, and then search for a buyer. In these cases, major portions of a divestment plan must be executed before a buyer has been identified, and certainly before the transaction has taken place. This adds to the challenge.

There are also partial divestitures (such as that in the oil and gas company example in this story), in which only some assets of a given business or parts of an asset are sold. A partial divestiture is often more complicated from the standpoint of capabilities, because of the seller's need to hold on to some people, processes, and technologies that it could let go of if it were selling an entire business or product line.

To make the process of divestiture more manageable, we recommend five steps. Each step gains its power from how it builds on previous steps, helping sellers during the critical period—usually lasting up to 18 months—when they are readying assets for sale. Note that these steps focus only on the analyses and business process changes that are relevant to managing the capabilities you are divesting. How to identify a buyer, manage a road show, negotiate price, and execute post-deal service agreements—all critical activities—are outside our focus here.

Step 1: Capability Scoping

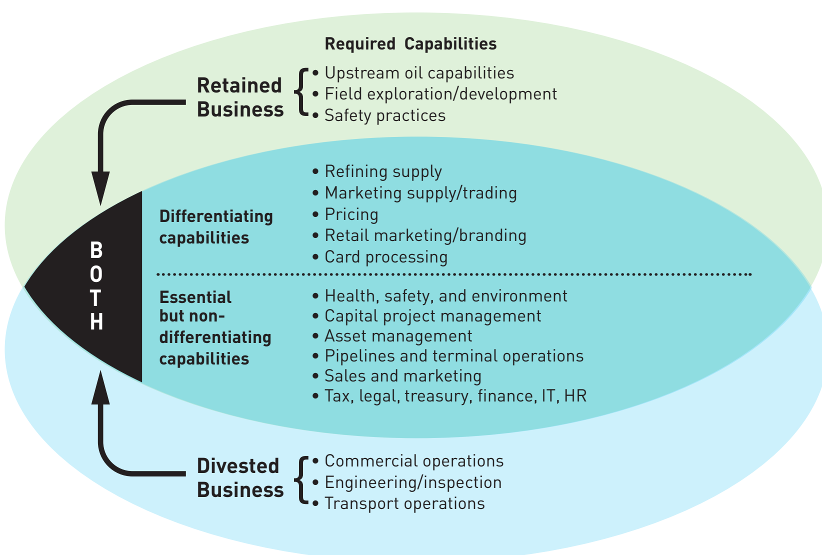
In the first step, you set the overall strategy for the divestment—including the assets you want to sell, when you want to sell them, and to whom. This takes place through an exercise called "capability scoping," in which you take stock of the most important capabilities associated with the assets you are putting on the block. Often what's up for sale is not a stand-alone business unit but (as in our oil and gas example) a product, service, or asset that sits within that business unit. It likely draws on capabilities that are centralized within the company or that are used by other parts of the business unit (and therefore can't be offered as part of the deal). This step usually precedes the identification of a buyer and should be done before any transaction-related activity, such as planning an auction.

During the oil company's first capability-scoping exercise, its senior executives identified almost a dozen capabilities that needed to be bundled with the refinery and service stations it was selling. These capabilities—including logistics and scheduling at the refinery, and a way of managing the service stations' customer data that was built into their distinctive software system—would inevitably end up in the buyer's hands.

Some of the other capabilities that the oil and gas company ini-

Exhibit 1: **Anatomy of the Capabilities in a Major Oil and Gas Divestiture**

The top oval represents capabilities that are of more value to the seller, and the capabilities in the bottom oval have more value to the buyer. The seller, in deciding which capabilities in the middle group to put on the market, can influence how both companies will compete in the future.



Source: Booz & Company

Exhibit 2: **Divesting Capabilities: The Buyer's vs. the Seller's View**

SELLER'S PERSPECTIVE ↓ / BUYER'S PERSPECTIVE →	**Differentiating** (competitive advantage)	**Competitive necessity** ("table stakes")	**Nonessential**
Differentiating (competitive advantage)	IN DEMAND Both sides need the skills and technologies. This situation is most common in a partial divestiture, and the terms may depend on the seller's need for cash.	MUTUAL GAIN, WITH MORE AT STAKE FOR SELLER Both sides should exercise caution; otherwise, buyer may end up overpaying, while the seller risks losing essential staff or technologies.	UNLIKELY DEAL Neither seller nor buyer has reason to proceed.
Competitive necessity ("table stakes")	MUTUAL GAIN, WITH MORE AT STAKE FOR BUYER Both sides should exercise caution, or seller may end up retaining too much, and the buyer may not gain everything it needs.	MUTUAL GAIN, WITH FRUGALITY During the sale, both sides should think about the investment required and whether to begin arrangements for outsourcing. The two sides might even collaborate to share operations and expenses after the deal.	BUYER BEWARE The buyer has little or no interest in these capabilities, but the seller may use this as an opportunity to reduce its ongoing costs by selling off some of its operations.
Nonessential	MUTUAL GAIN Potentially a good deal for both sides; make sure the buyer gets every aspect of these capabilities and the products and services associated with them.	BUYER'S BARGAIN OPPORTUNITY The buyer gains from these capabilities, and should not have to pay very much for them.	BOTH SIDES BEWARE Both sides have an interest in making sure that they don't end up with these capabilities and the activities associated with them. Explore selling to a third party.

Source: Booz & Company

tially planned to look at were capital project management, asset management, and activities that fell under the heading of health, safety, and environment.

Often, the seller realizes there isn't time to address every capability on its list, and it must set some priorities. As the scoping exercise at the oil and gas company went on, the company focused on four capabilities that would matter significantly after the deal was completed: the pricing expertise and proprietary algorithms of its refineries, an advanced system for understanding its inventory positions, a unique approach to credit card processing, and brand development. These four capabilities worked together (along with others) to allow the enterprise to be a low-cost producer and attract price-conscious consumers, many of whom went out of their way to drive to one of the company's gas stations. These four capabilities would also remain critical to the seller after the deal, since the seller planned to continue to operate other refineries and service stations.

Undoubtedly there is a set of analogous activities at your company, drawing on people and technologies that are dispersed throughout the organization. A scoping exercise in and of itself isn't a plan for divesting assets—it doesn't answer the question of how to ensure the integrity of differentiating capabilities. But it does lead to a hypothesis of what will have to be accounted for, and either added to or carved out of an asset, in the months leading up to a divestiture.

Step 2: Baseline Analysis

This step involves understanding the components of key capabilities and how they come together to enable products and services to be successful. The idea is to break down those activities into their constituent parts—what the activities consist of, who performs them, where in the company they are performed, how long they take, what technologies make them possible, and what problems are associated with them.

The baseline analysis identifies exactly what you can let go of and what you need to keep—and illuminates where a new owner might be left with a gap.

Not all buyers have gaps. Some may have capabilities systems that are a better fit for the assets you're selling than your own capabilities are. In other cases, the ability of your activities to fill the buyer's gaps becomes a point of negotiation in the deal—factoring into the price, the time to completion, or the transition services that you must provide. If no buyer has yet been identified, this is your chance to formulate a clear picture of the value that your divested assets might hold for someone else.

Completing a baseline analysis of your capabilities is more difficult than it might seem. The problem is that most people in a company—even, and sometimes especially, those with special talents or important functional roles—have a narrow view of what underpins a business's success. The salespeople will describe the differentiating capabilities in one way, the marketing people in another, and the product development people in a third. From up close, and amid the competing perspectives, it can be hard to tell which activities truly make a difference. You may need to weigh all these inputs dispassionately—and pull back to get a wider perspective.

Step 3: Option Analysis

In this step, having identified one or more potential buyers, you look closely at the buyer's capabilities needs and how your assets can help fill those gaps. This enables you to maximize the value of the deal.

At the oil and gas company, pricing emerged as one of the obvious gaps—a capability too valuable to simply hand over. Energy is a dynamic market, with prices that change continuously throughout a trading day; a refinery's ability to take market information and know what to bid for a given set of deliveries is crucial to its ability to make a profit. Yet this was not a capability the oil and gas company felt it could cut loose. After all, it was keeping other refineries, and they also drew on this capability.

The seller identified two main options for dealing with this dilemma. The first was sharing its pricing capability with the buyer—letting the buyer tap into the systems and processes that the seller already had in place. The second option was providing the buyer with the mechanical part of its pricing capability (the hardware and basic software) after stripping out the algorithms and the bulk of the system's intelligence. And of course it was possible that the buyer would have a sophisticated pricing capability of its own, and not need any part of what the seller had to offer.

The seller could not assume that this would be the case, however, so it analyzed the relative impact of each option. This is a key part of this step. Sharing the pricing system was going to be very complicated, both in terms of the technology and from a regulatory perspective, since the owners would be operating refineries in different states within the U.S., with different environmental laws. Dividing up the system was going to be an equally big job, and would leave the buyer having to fill in many software blanks and recreate processes that were already locked down. Ultimately, though, the oil and gas company determined that the second option, dividing up the system, was better; it would eliminate a link that could interfere with both companies' business processes later on. The information it got from the analysis was instrumental in helping the oil and gas company start the preliminary work of dividing the system—even before it found a buyer.

The information uncovered during this step may prompt you to revisit a previous step. For instance, one of the oil and gas company's tests had to do with the amount of time it would take for a buyer to bring the financial systems of the divested gas stations, including the credit card system, into full operation. It was clear that this couldn't be implemented on the day the deal went through. So the seller returned to Step 2 to understand the impact of a delay. Some iteration of this sort is to be expected as new information and possibilities emerge.

Step 4: Transition Planning

Having identified the gaps and decided how to fill them, you as the seller now must start carving out the asset and making sure it has the capabilities it will need. This involves the creation of detailed project plans—perhaps one for each of the major capabilities involved—and of work teams.

Where to begin? At this stage, there is still no guarantee of who the buyer will be. Focus on activities that need to be conducted for any buyer. This forces you to tend to the *known* things first, as opposed to doing what comes more naturally and tending to the *biggest* things first. This approach can speed a sale once a buyer has been identified—and even if you don't sell the asset, in the end, you won't regret the planning effort.

The oil and gas company knew it wanted to cordon off parts of its pricing capability, no matter who bought the refinery. Identifying and stripping out its proprietary algorithms was one of the "no regrets" projects it embarked on. By contrast, another technology issue—

Some buyers may have capabilities that are a better fit for the assets you're selling than your own capabilities are.

how to turn over customer data for its divested retail business—though clearly a major undertaking, wasn't knowable. The company identified several ways to do this, but didn't start working on any of them, because it recognized that the buyer might have its own ideas about how to handle this.

Step 5: Buyer Engagement

Once you have a definite buyer and a signed contract, you can flip the switch on all the plans you have been making in Steps 1 through 4. Begin by sharing your thinking with the buyer, including which capabilities you see as most important and what your plans are for transferring them. Describe how you will deliver a fully functioning business to the buyer. The buyer has its own market strategy, quite possibly different from yours, and may have a different view of which capabilities are important. These differences sometimes lead the buyer to ask for something you don't expect. That's another reason not to start on this stage prematurely: That early work might have to be discarded.

In the oil and gas company divestiture, the operation of the gas stations was a major issue. These assets couldn't simply be handed over, with the seller washing its hands of them—the buyer wouldn't have had the personnel or the knowledge to operate the assets successfully. Although the parties initially discussed a commercial services agreement, in which the seller would have operated the retail assets for the buyer indefinitely, they ultimately settled on a technical service agreement, which had the advantage, in both parties' eyes, of spelling out a clear end date. The seller began laying the groundwork to fulfill that agreement.

Preparation, Skills, and Pride

Divestitures can be some of your company's most complex transactions. They require strategic thinking, a massive amount of contingency planning, and—once a certain point is reached—the simultaneous management of multiple work streams and projects. You will need to be flexible and ready for the unexpected. This checklist can help you get ready for the process:

1. Do you have a clear sense of what you'd like to sell, what you think it's worth, and what capabilities might be involved?

2. Do you know when you'd like to complete a transaction, and do you have a rough sense of the time line leading up to that?

3. Do you have a list—if not by name, then by type of company—of who might be interested in your assets?

4. Do you have a clear sense of how the sale will affect capabilities you'll need for your retained businesses or assets?

5. Do you have a dedicated transaction team, and if so, does the team have a clear set of priorities?

6. Do you have measures in place to track your progress? Do you have clear measurements for the success or failure of the transaction?

The skills you develop during this process aren't relevant just to divestitures. They can also be used to reduce risk; create value; and improve the outcomes of acquisitions, spin-offs, and portfolio restructurings. Your work on divestitures can span organizational boundaries, geographies, business units, and functions, and thus help you develop the structures and communications links you need for other complex initiatives. The focus on capabilities involves accounting for factors that are often overlooked. It can help you avoid the tunnel vision that often accompanies a singular focus on financial matters during major transactions—and that can keep you from seeing the broader strategic impact of your decisions in general.

Many companies pride themselves on their ability to use acquisitions to drive inorganic growth. It's far more rare to find a company that prides itself on the way it divests a business or asset. That's understandable; by their nature, divestitures focus on businesses or assets that once seemed promising but no longer fit with where the seller is heading. It isn't surprising that there would be a mind-set of "the sooner, the better" and a narrow focus on the price. If you use the filter of capabilities, the divestiture might take a little longer, but it can leave your company better off in the ways that matter most. +

Reprint No. 00208

Eduardo Alvarez
eduardo.alvarez@booz.com
is a Booz & Company partner based in Chicago. He leads the firm's global operations practice and is an expert in business process transformation and technology-enabled transformation.

Steven Waller
steven.waller@booz.com
is a Booz & Company principal based in Chicago. He specializes in technology strategy and the development of new operating models for energy and financial-services companies.

Ahmad Filsoof
ahmad.filsoof@booz.com
is a Booz & Company senior associate based in Chicago. His focus is on operations, business process transformation, and technology-enabled transformation in the energy industry.

strategy+business magazine
is published by PwC Strategy& Inc.
To subscribe, visit strategy-business.com
or call 1-855-869-4862.

For more information about Strategy&,
visit www.strategyand.pwc.com

• strategy-business.com
• facebook.com/strategybusiness
• http://twitter.com/stratandbiz
101 Park Ave., 18th Floor, New York, NY 10178

strategy&
Formerly Booz & Company