

# **CORPORATE DEALMAKER**

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## **PREPARING FOR A DIVESTITURE**

**When it comes to selling a business, planning is everything. In the first of a two-part series, an experienced divestor explains some of the major issues.**

**by David G. Monderer**

Many companies have made acquisitions and feel comfortable with their acquisition process. But many of those same acquirers have never done a divestiture. When it comes to divesting, experience in buying is useful, but not sufficient. After all, a buyer enters the typical acquisition process possibly months after the seller began its preparations.

With the economy softening, some of these knowledgeable buyers may soon need to become knowledgeable sellers. That means getting up to speed on the planning they need to do and the questions they must answer before making the first phone call to a prospective buyer.

The most obvious question -- should I divest this business? -- must be answered within the context of a given company's strategy. But for every company, that first question will be closely connected to a second one, which is: When is the best time to divest this business? The answer here is that sooner is often better than later.

True, many companies will find it difficult to sell a business when it's producing healthy earnings. But divesting a healthy business and replacing it with one that has better long-term potential may be easier and more profitable than waiting until the business has peaked and you have a declining or even failing business. I have seen a growing, profitable business that is being divested for strategic reasons bring buyers who are literally competing in adjacent conference rooms, while failing businesses have taken up to two years to divest, with the seller having to infuse capital in order to get buyer interest.

And remember: Since a typical divestiture process can last eight months or more, you need to allow for what will happen with the business during this period and begin early enough so that it isn't deteriorating while you're showing it to buyers.

Not every disposal will involve a full-fledged business. So another early question may be whether a project is really a divestiture, and who needs to be involved to get it done? A division manager will wonder whether he or she needs to bring in the corporate or group M&A people or whether the division's purchasing or contracts people can handle the task. If an operation is to be shut down and a supply agreement with an outside vendor is to be negotiated for similar services, there's probably no reason for expert M&A help. But if you're transferring assets, people and/or contracts to a third party, the transaction starts to look like a divestiture, with all the complications inherent in selling any business. In this case, M&A experts, whether internal or

external, can keep you from missing important considerations and help you avoid problems that can arise long after closing.

The same logic applies to the question of whether to hire investment bankers. Although bankers are perceived as expensive, much of their fee is often paid on a contingency, which minimizes risk for the seller. You need to ask yourself several questions. First, do you know who the prospective buyers are? Remember, they're not just companies now in the business, but also companies that may want to expand into it, as well as financial sponsors that may have an interest.

Even if you can identify all the buyers, do you have the staff and ability to call everyone and do the handholding necessary to develop a strong list of first-round bidders? Are you able to write an offering memorandum that's a positive, yet truthful, marketing tool? Will you need a fairness opinion for your board of directors? Do you have knowledgeable and experienced negotiators, outside of the business being divested, who can negotiate a myriad of agreements intended to sell the business and protect you, the seller, after the closing?

My recommendation is to generally use investment bankers in the front end of the process -- that is, to prepare the offering book, to help identify and call prospective buyers and to filter the buyers down to those who would proceed into due diligence. However, once you're down to a few buyers, it's better to maintain control of the process yourself and use experts in their respective fields to handle the detailed issues that arise.

The help you'll need will usually include your M&A team, internal functional experts and deal and specialist attorneys, and perhaps other external advisers and consultants as well. The bankers stay involved as advisers and can help understand the buyers' concerns and be a go-between if necessary. But negotiations should be handled by internal experienced negotiators if available or by external negotiators whose only concern is to do the best job for the seller.

Other experts will be required along the way; who they are will largely depend on what ends up being transferred in the sale. Which leads to the next part of the planning process: determining what's for sale and, just as important, what is not for sale. This can be one of the most difficult steps in the divestiture process as well as one of the most contentious issues within the selling company.

The organizational structure of the business being divested is the biggest factor here. If the unit is a stand-alone subsidiary of the parent company, then it can often be sold as is, either in a stock or asset sale. But even then, you must address questions as to what, if anything, is retained by the parent company or provided by it. For example, is all intellectual property owned by the parent company and licensed to subsidiaries? Or if the IP is owned by the sub, will the parent company get a license before the sale?

These questions could produce friction between parent and subsidiary management and should be considered early and clearly explained in the offering memorandum. Wholly owned subsidiaries often depend on the parent company to provide them with many services. These can include tax, accounting, human resources and licensing, to name just a few. You must consider whether these will be offered as transitional services to the buyer, and under what terms. And

they must also be clearly identified so the buyer can account for them in analyzing the financial statements and determining an offer price.

A far more difficult analysis is necessary when the unit being divested is a division or business within a larger entity. The "carve-out" work that's involved -- determining what goes with the sale and what stays behind with the parent -- can be considerable. Computer systems, for example, will be a major and potentially expensive issue for both sides. Corporations using large enterprise systems may not have the ability to run the divested entity on its own.

Establishing new systems may be costly and time consuming, greatly affecting purchase price and time to closing. Can the entity be absorbed into the buyer's existing systems? Are off-the-shelf systems available to handle a relatively simple business? Or does the buyer need to hire a major systems firm to design all new systems to handle a diverse multinational business? At the other end of the spectrum, I have even recommended pencil and paper to handle the systems on an interim basis for a relatively simple business with a limited product line and few sales in a given period. After all, how did we handle accounts before personal computers and mainframes? It may not be the best way to run the operation, but if it means getting to closing faster, it can be worthwhile.

Carve-outs can also raise major intellectual property battles within both the parent company and entity being divested. The entity, of course, has no IP rights of its own, since it is not a separate company. Everything is owned at a higher level within the parent organization. Therefore, you must determine what gets transferred to the entity upon sale and what gets licensed.

If licenses will be granted, does the divesting entity have control of them in any way? How will it protect itself from infringers? Can it sublicense others, and what is the parent company allowed to do in the future? These questions will spark much debate among senior managers at the seller, and the answers to them will affect the interest level and bidding decisions of prospective buyers. They'll also affect the potential future businesses of both sides.

Licenses and permits are other assets that must be considered early in the process. Again, these are likely not held by the entity being divested and often can't be transferred. You may need to apply for new permits well in advance of closing. For example, environmental permits can often take a long time to get for a new company.

Licenses, even for simple desktop software, may need to be negotiated with the vendors. Software licenses are generally not valid for even the provision of short-term transitional services after the sale. Be prepared to pay handsomely to software vendors for the right to transfer or extend licenses, as vendors know you often have no choice but to pay their fees.

Employee issues are a major part of any divestiture and can become very complicated in a carve-out situation. Dedicated employees are an obvious inclusion for the list of who goes to the seller. But in most situations there are many shared employees who work with multiple organizations or employees supporting the entity from corporate functions such as finance or human resources. Will any of these employees be moved into the entity or offered to the buyer?

If traditional defined-benefit pension plans are involved, you must decide whether pension

obligations and assets are being transferred and whether the transfer is based on benefits to date or projected benefits. You may have to hire actuaries to run pension calculations, and you should expect extensive negotiations with the buyer -- who will hire his own.

Decisions about the handling of other employee benefits must be made as well, and even issues as mundane as how to handle healthcare reimbursement submissions must be decided. These are just a few of the decisions regarding what is for sale, but even after careful consideration of the issues, buyers will have their own ideas. The flexibility to consider alternative wishes of the buyers will be important to getting a deal done.

Financial statements can be particularly difficult in a carve-out. You likely won't have audited financial statements for a carved-out unit, which could eliminate some potential buyers. But even creating pro forma statements will be difficult, if not impossible, when the unit is heavily integrated into the parent company. Asset lists will be a must, since this will be a key schedule to the purchase and sale agreement.

A pro forma income statement, leaving out (yet identifying) the cost of services supplied by the parent may be relatively easy to create, but a balance sheet and cash flow statement may be impossible when receivables and payables commingle with other company groups. In this case, you must decide who will handle them as of closing and the impact this may have on price and the need for the buyer to raise working capital.

The preparation of the data room for buyer due diligence also requires considerable time and attention. Proper disclosure of information is important to prevent costly issues from cropping up after closing, and the early discovery of potential problems will help you avoid surprises and properly position these issues with the buyers. When collecting data-room material, you should put yourself in the position of the buyers. They will certainly have due diligence request lists to which you will need to respond. I have seen request lists consisting of only a few pages of questions, but they can exceed 100 pages.

Be prepared for the latter. Use a more detailed request list, and answer all the questions by collecting the responsive materials. If you have nothing pertinent to a particular question, just answer "none." The point is that a more exhaustive list will help ensure that you have searched for everything pertinent to the business.

Each document should then be reviewed, not only by unit management but by the corporate legal department and/or the M&A group. You should answer the following questions for every document: Should it be disclosed? Are there confidentiality restrictions and, if so, how should you disclose the information without violating confidentiality? Is there anything that can hurt us competitively? Is there any information that should be redacted? Can it be copied? Can disclosure be an antitrust issue?

If, during your investigation, you find any bad surprises, remember: It's much better that you found them before the buyers' discovery. You now have the opportunity to disclose the bad news in a way that you deem appropriate. Sometimes, bad news can be positioned as a great opportunity for the buyer. Or maybe the problem can be fixed before the buyer sees it. In any case, first discovery by the buyer will have only one of two results -- either he'll walk from the

deal or use it for price leverage. So thorough due diligence is of critical importance in preparing for the deal.

The other due diligence question, a new one in the past few years, is whether to use an electronic data room. It is certainly the wave of the future and offers the opportunity to have many more buyers in the process at the same time. Buyers are now beginning to expect electronic data rooms, so you will likely need to enlist the help of a third-party provider. It does, however, mean less document control than a physical data room and fewer opportunities to interact with the buyer's representatives. So be sure to consider the impact that sharing your documents off-site may have on your business.

These are just a few of the many questions and issues you will need to confront when preparing for a divestiture. In the next issue, I will address dealing with management, both that of the unit being divested as well as corporate management, employee and public communications, the impact on employees and maintaining the business during the sale. - *David Monderer*

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