

Four reasons why RemainCo transformation should run parallel to spin-off execution

According to the EY 2020 Global Corporate Divestment Study, nearly one out of every three companies say the need to streamline operating models will make them more likely to divest over the next 12 months. However, many companies often focus resources on the company being separated, not on the remaining organization (RemainCo). EY analysis shows companies that transform RemainCo during a significant spin-off can drive higher value than those that do not.

Our analysis of 129 US spin-off transactions from 2009 - 2018 reveals that the market forms a different perception about the SpinCo and RemainCo and rewards them differently. On average, after the first, second and third year following the spin-off, SpinCos outperformed the S&P 500 by 7.3%, 11.4% and 17.9% more than the RemainCo, respectively, based on total shareholder returns (TSR). This was especially relevant when the business being spun had one or more of the following characteristics:

- ▶ SpinCo was a substantial portion of total revenue (25% or more)
- ▶ SpinCo contributed substantially to the overall profitability of the total business (25% or more)
- ▶ SpinCo owned key capabilities that RemainCo had to rebuild post-spin (IP, talent, customers, etc.)

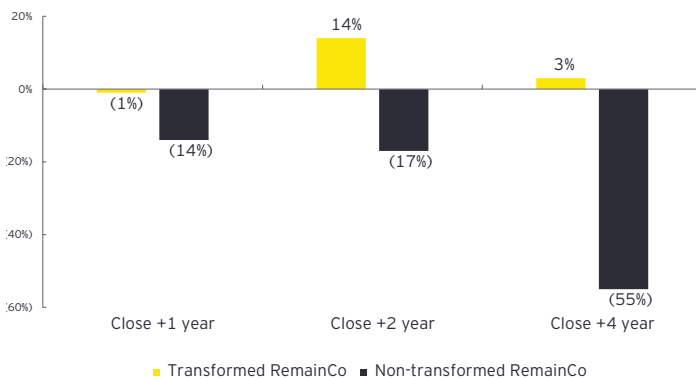
As a leading practice, operational streamlining in significant tax-free spin-offs should encompass both the divested entity and RemainCo. The EY findings support four reasons why business leaders should not leave RemainCo transformation to after spin-off execution: a deliberate focus on RemainCo transformation in parallel to spin-off execution creates substantial value for the remaining business.



Reason 1: Companies that transform RemainCo during a spin-off perform better than those that don't

We analyzed 51 recent major spin-offs², where SpinCo's revenue was more than 25% of total company revenues. Of the 51 spin-offs, 31 companies carried out major transformation efforts of RemainCo and 20 companies did not take any action during or after the spin-off to transform RemainCo. Tracking the performance of RemainCo for four years clearly shows that transformed RemainCos substantially outperformed non-transformed RemainCos.

Figure 1: Transformed RemainCo return over S&P 500 return



Among the spins analyzed, the most common areas of transformation included:

- ▶ Evaluating strategic alternatives to improve top-line growth
- ▶ Creating a streamlined structure with fewer layers of management
- ▶ Saving operational costs by reducing headcount
- ▶ Exiting non-core businesses
- ▶ Realigning geographic presence
- ▶ Outsourcing to reduce costs on non-core operations

Furthermore, a common characteristic observed among the 31 outperforming companies was clear and regular guidance about their transformation efforts to the market throughout the spin-off process. This gave the market confidence that the company was taking steps to minimize value erosion from the spin-off.

How successful companies communicate the value of their transformation to the market²:

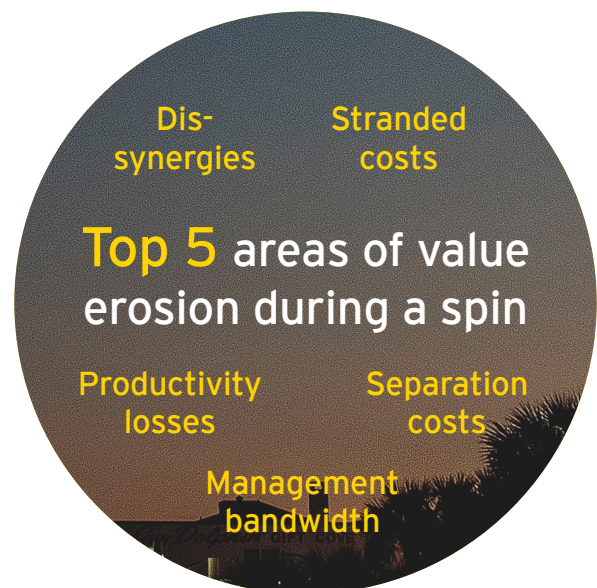
"\$15 million to \$20 million in savings alone will more than offset the dis-synergies ..."

"Restructuring will target a minimum 10% operating margin by the end of the year ..."

"We expect to achieve the full \$120 million in run-rate savings by the end of calendar year ..."

Reason 2: RemainCo can be impacted negatively by a spin-off, and may not get the right attention from management during the process

Separation of a major portion of the business can bring disruptive operating model changes to RemainCo, such as the loss of critical capabilities, reduced customer base, brand dilution, loss of intellectual properties and cost dis-synergies of scale. These dis-synergies and stranded costs can have major long-term financial implications if not managed proactively. For example, in our analysis, we looked at selling, general and administrative expenses (SG&A) variance among RemainCos from t³-90 days and found that SG&A costs as a percent of revenue tend to increase in the months following a spin-off, due to dis-synergies, stranded costs and other inefficiencies caused by the spin-off. In certain industries, it may take up to a year for companies to bring SG&A back to the original level. In other industries, companies may take a longer time to recover or may not be able to recover at all.



Even though companies know there are going to be value erosions, often they underestimate the impact of dis-synergies and stranded costs. In addition, companies often continue to execute internally based on historical projections and estimates. Limited to no time is spent within specific functions and capabilities to identify efficiency/effectiveness opportunities. The result is misaligned priorities and missed targets.

² Source: Restructuring charges in public financials, companies' communication to the market regarding restructuring effort through market calls, quarterly earnings reports and investors' meetings

³ t is defined as the day of spin-off, also known as Day 1

Reason 3: If RemainCo says unlocking value is the spin-off rationale, the market expects leadership to walk the talk

In many spin-off announcements, we find that the primary spin-off rationale provided by management includes opportunities to further improve RemainCo. The following are the three most common opportunities cited by leadership:

- ▶ Increasing focus on RemainCo's core strength
- ▶ Eliminating conglomerate discount
- ▶ Developing a business-appropriate capital structure for RemainCo

When companies communicate such commitment to ensure success for both SpinCo and RemainCo, the market reacts positively. The same analysis shows company stock prices experience an increase on the day of announcement 78% of the time, with an average share price increase of 3.5%¹.

However, as a spin-off progresses and the negative impact on RemainCo starts becoming more evident, the market becomes increasingly inquisitive about RemainCo's future. Shareholders seek guidance from management in every interaction, formally and informally, to confirm that the management is aware of challenges and has a clear plan to identify and execute value creation initiatives.

An analysis of market calls, investor meetings, analysts' reports and news coverage of spin-offs⁴ reveals that in almost every interaction, questions were asked about RemainCo's future and management's plan to transform the business. The most common questions asked were related to:

- ▶ Dis-synergies
- ▶ Stranded costs
- ▶ One-time separation costs
- ▶ Capital structure impact
- ▶ RemainCo transformation road map

The analysis also revealed that the market becomes more anxious about RemainCo as the spin-off date approaches.

Based on market expectations and the original intent of a company to protect RemainCo's interests, it is imperative for management to walk the talk and take steps to ensure RemainCo's success. Failure to do so not only disappoints the market, but also makes it more difficult for management to bring about big changes later in the process.

What some companies say about RemainCo when announcing a spin rationale⁴:

"... we will significantly simplify our business, eliminating more than 50 manufacturing sites worldwide and creating an opportunity to focus even more."

"... we are going to have a stronger balance sheet and available liquidity to provide the flexibility and optionality that we want going forward."

"... this results in 2 even more focused companies that can create greater opportunities for employees and customers as well as drive additional value for shareholders."

Reason 4: If separation decisions made during a spin-off are managed carefully, it can substantially help reduce value erosion for RemainCo

One of the biggest reasons companies don't restructure RemainCo is the fear of overburdening the organization with the parallel activities of executing a major spin-off and undertaking a substantial restructuring effort. However, critical separation decisions related to the spin-off can have a substantial negative impact on RemainCo, making the spin-off the most appropriate time to stabilize and restructure RemainCo. Specifically, there are five critical junctures in any spin-off process with which RemainCo should align.

1

Operating model decisions:

The proposed changes to SpinCo's operating model on Day 1 and future state can impact RemainCo's operating model. If needed, the RemainCo operating model should be redesigned at the same time to reduce value erosion.

2

Organizational design and talent selection:

Management should ensure there is no cherry-picking of talent, and both SpinCo and RemainCo are staffed with the right talent to ensure future success.

3

Transitional services agreement (TSA) structure:

While TSAs can allow RemainCo to postpone some stranded costs, it also ties up RemainCo with people and other resources providing these services, thereby delaying any transformation effort. The right balance should be achieved.

4

Communication:

Spin-offs can create uncertainty among various stakeholders (employees, customers, investors) for both SpinCo and RemainCo. Companies cannot afford to communicate with only one side and not another.

5

Day 1 execution:

Due to substantial changes in the operating model, the disruption to the business can be high on the day of close for both SpinCo and RemainCo. Leadership on both sides should closely monitor and manage any risk to business continuity on Day 1.

And how some analysts follow up on those corporate statements⁴:

"Do you have a feel for any potential dis-synergies ..."

"Do you think you can sustain that kind of mid-single-digit growth ..."

"Can you talk a little bit about the timing of the restructuring ..."

"Any thoughts on expected capital structure for the RemainCo ..."

⁴ 129 spin-off transactions over 2009-2018. Source: Capital IQ, Forms 10, press releases, media reports, analyst reports

Conclusion

When companies spin off a substantial portion of their business, their intention is always to make both SpinCo and RemainCo successful. However, the pressure to complete the spin-off on time and the complexity involved may result in leadership waiting too long to focus on RemainCo. Companies should realize that critical decisions taken to separate SpinCo can have a substantial impact on RemainCo, making the spin-off the most appropriate time to plan for RemainCo restructuring. Furthermore, the market, albeit apprehensive about potential stranded costs and dis-synergies from a spin-off, demands clear guidance regarding RemainCo's future. Companies that leverage the momentum built to execute a major spin-off can rally its people to execute the RemainCo transformation in parallel, which will often be richly rewarded by investors.

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