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How asset light approaches can help companies drive higher total shareholder returns

2020 Global Corporate Divestment Study

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The EY *2020 Global Corporate Divestment Study* reveals ways companies are streamlining operations and strengthening the valuation of the remaining organization.

As companies enter the recovery stage from COVID-19, their portfolio optimization efforts will include a review of capital allocation across the enterprise. Companies may re-evaluate ownership of non-core assets and operations, and potentially migrate to an ecosystem of strategic partners. These partners, typically "better owners or managers" of such assets, can help transition fixed costs to a variable cost structure, enhance company agility, shift resources to focus on core or critical capabilities and enhance valuation.

The asset light approach, while not necessarily new or novel, is poised to become more prevalent now with a renewed focus on supply chain resiliency. This approach has been driven by several factors over the last few years — the onset of digitization, economic downturn, shareholder activism and unprecedented levels of cash within private equity ($1.5t). Research has consistently shown that asset light companies in any sector achieve a greater total shareholder return (TSR) than their asset-intensive peers in the same sector.

Increasing value and resiliency across the enterprise

Following the crisis, companies will continue to pursue asset light objectives throughout the value chain, mainly by identifying which assets and capabilities are core to delivering value to their customer base right now. For example, sellers may find a path to greater operational agility by transitioning their manufacturing operations to a contract manufacturer rather than carving out an entire business unit and disposing of a valuable brand. Others, due to their experience with COVID-19, may look to build redundancy in key business processes but choose an asset light path including joint ventures (JVs) or other partnerships that avoid a balance sheet impact. Still other companies that are intensely focused on reducing costs may want to reduce complexity and release capital by transitioning key pieces of their support operations, such as inside sales, to an external partner.

In light of economic disruption, asset light is by no means exclusive to supply chain areas such as manufacturing, warehouses and distribution centers, reverse logistics and warranty and return services. It can help extract value from other value chain areas such as the front office, including research and development, sales and field operations, as well as more traditional back-office functions such as information technology (IT) infrastructure, procurement and other areas. Importantly, the financial benefits of becoming asset light can be significant. According to the EY *2020 Global Corporate Divestment Study*, companies that transitioned manufacturing ahead of a sale were 17% more likely to exceed expectations on the valuation multiple of the remaining business. They are also more likely to exceed expectations on the price of the divestment.

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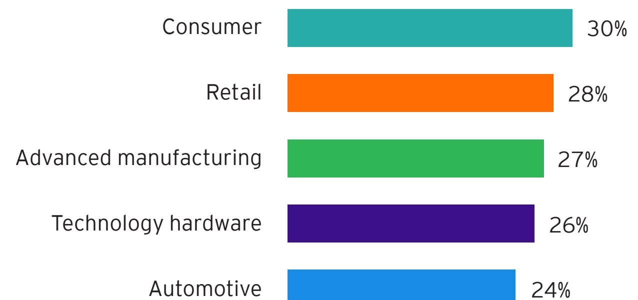
Cultivating partnerships for a more agile operating model

As they look to the future, companies can begin the journey by analyzing their products, markets and operations to determine the type of partnerships that could be appropriate. As an illustration, after reviewing transaction options to transition production to a third party, one multinational launched a sell-side auction process of a small portfolio of factories while procuring a long-term supply agreement to buy back product. Another multinational, a consumer goods company, transitioned its entire sales and distribution operations for a non-core region to a distributor-based customer interaction model. Such actions are evidenced across sectors in the EY study, with about a third of consumer (30%) and a quarter of advanced manufacturing (27%), automotive (24%) and technology hardware (26%) companies reporting that they have transitioned their manufacturing operations before putting the business up for sale.

Q Top five sectors where companies transitioned manufacturing ahead of putting a business up for sale



Lessons learned

Companies that embark on this journey with strategic partners should prepare to adopt workarounds to manage barriers.
Select lessons learned include:

Scoping and evaluation:

- Evaluate all products, businesses and geographies — no sacred cows
- Make the joint business case robust enough to withstand multiple years
- Properly weigh benefits (e.g., cash release, return on assets improvement and reduced complexity) with operational challenges and risks (e.g., quality, disconnect with customer and brand image)

Deal structuring and enablement:

- Prepare required opinions, memoranda, operating manuals, documentation and legal agreements to effectuate the new intercompany operating model
- Consider go-forward transition service agreements, take or pay arrangements and intangible asset valuations as part of divestitures

Tax and accounting:

- Consider operating model impact in asset-light environments from a tax (direct and indirect) perspective, including value-added tax, payroll registration, income tax and customs
- Evaluate accounting impacts with respect to treatment of the deal to avoid surprises with respect to go-forward reporting (i.e., unexpected balance sheet retention)
- Manage global tax considerations related to asset sales
- Structure asset sales in a tax-efficient manner - consider the degree to which the continued dependencies in the operating model (e.g., outsourced manufacturing) create "control" from a tax perspective with the associated requirements of arm's-length transfer pricing
- Check potential effects on tax attributes and their future availability (e.g., tax losses or net operating losses)
- Preserve and extend tax rates and income expectations previously obtained via rulings, advanced pricing agreements (APAs) or statutes that may have been predicated on a different operating model (e.g., ownership of manufacturing assets)

Collaboration and governance model:

- Collaborate early with your asset light partner on the future-state operating model and governance structure
- Clearly define the partner pricing mechanism and method for tracking value levers - both quantitative and qualitative
- Avoid unnecessary or redundant oversight, controls and incremental costs

Lastly, it is important to note that the strategic, financial and operational objectives for sellers and buyers may differ in a transaction. One party may be focused on improving return on invested capital and releasing capital for redeployment, whereas the other may be focused on improving overall operational efficiency and utilization of assets. Knowing what each partner's value drivers are before an arrangement not only speeds the process but helps both parties to achieve their often unique and potentially divergent desired outcomes.

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About this study

The EY *Global Corporate Divestment Study* is an annual survey of C-level executives from large companies around the world, conducted by Thought Leadership Consulting, a Euromoney Institutional Investor company.

Results are based on an online survey of 1,010 global corporate executives and 25 global activist investors pre-COVID (conducted between November 2019 and January 2020), and an online survey of 300 corporate executives and 25 global activist investors following the onset of the crisis (conducted between April and May 2020), including companies from 11 industries, with 75% of respondents holding the title of CEO, CFO or other C-level executive.

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