How European companies can increase resilience through divestments

2021 Global Corporate Divestment Study

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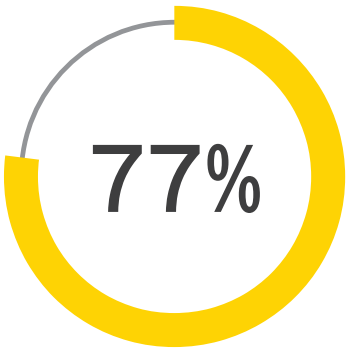
Greater portfolio agility can equip European companies to tackle changing customer needs, rising operating costs and technology requirements.

For European companies the COVID-19 global pandemic has proven to be a powerful catalyst for honing portfolio strategy and using divestments to build greater resilience. The 2021 EY *Global Corporate Divestment Study* reveals that they need to take bolder stances on non-core businesses. An increasing majority (78%, up from 72% a year ago) concede that they should have divested assets instead of holding onto them for too long.

Similarly, 77% of European companies anticipate accelerating their divestment plans because of the pandemic's continuing impact. Only a few (6%) expect to delay these due to the crisis.



of European companies anticipate accelerating their divestment plans because of the global pandemic's continuing impact.

This suggests that European companies' trend toward greater portfolio agility will continue. With the need for business models to adapt to changing customer needs and behavior, as well as increasing operating costs and new technology requirements, this is likely to drive a re-balancing of portfolios and the resulting capital allocation strategy.

The COVID-19 pandemic has galvanized European companies' shortcomings in their portfolio review processes. More than three-quarters (78%) admit to these challenges, ahead of Asia-Pacific peers (65%) but behind the Americas response of 87%.

The majority also recognize a need to work more on RemainCo. European CEOs often struggle with formulating a strategy for the remaining organization: 47% report this, compared to 43% globally. Nearly two-thirds of European companies (64%, ahead of the global score of 63%) wish they had placed the same emphasis on RemainCo as on preparing their last divestment. Many (58% versus 55% globally) judge that they could have used the transaction as an opportunity to reimagine RemainCo.

This may reflect a slower engagement with the post-divestment operating model. Nearly a third of European companies (29%) only start working on this when the divestment is signed or later, compared to 24% globally.

Technology provides a new lens on portfolio management

Clearly, the global pandemic has increased the use of technology and European companies' dependence on it for both internal collaboration and interactions with customers and suppliers. It has also underscored the cost benefits of a technology-centric approach (most obviously in the near elimination of travel costs).

As a result, divestment proceeds are used to invest in core capabilities. Three-quarters of European companies used funds raised from their latest divestment to invest in technology — slightly ahead of investing in new products, markets or geographies.

However, despite the depth of technology's importance in achieving strategic goals, the need to fund new technology investments is not the key trigger for most European companies. Capital returns, profit, market positioning and growth opportunities are the predominant factors driving portfolio turnover. This is reflected by 71% of European companies who say that suboptimal return on capital from a specific business prompted their most recent divestment.

Ninety-two percent of European companies say that changes in the technology landscape, and therefore the competitive landscape, are directly influencing their divestment plans — up from 55% pre-pandemic. They are increasingly recognizing the need to divest businesses that are not technology-driven, or at least relocate them to more conducive parts of their enterprise.

Q Which triggers prompted your most recent divestment?

ESG grows in importance when assessing divestments

While not yet a main driver for divestments, environmental, social and governance (ESG) considerations are increasingly of focus in Europe. Evidence of this significant shift in priorities in recent years includes larger corporates with compliance programs embedding a carbon footprint KPI in senior management's balanced scorecards.

Forty-three percent of European companies say that ESG and sustainability challenges, as well as other social issues and policies, are directly influencing their divestment plans — compared to only 14% of companies in the Americas and 84% in Asia-Pacific.

Companies will increasingly need to assess the impact of their carbon footprint and embed related performance metrics into their reviews and planning. This will give them visibility of how their carbon footprint is improving after they have sold an asset.

ESG is such an important consideration for C-suite, shareholders and other stakeholders alike. Compromising on the sales price can be worth it, if it means achieving environment and social balance by improving the company's carbon footprint and social policies, including diversity and inclusion.

Steps to enhance value ahead of a transaction

For sectors not under pressure from the pandemic, equity valuations remain at peak levels with significant liquidity (PE "dry powder," for example) still available in the market to pursue corporate carve-outs. For companies that are not forced sellers, this creates an appealing opportunity to pursue value-creation strategies ahead of divestments.

This is reinforced by the relatively narrow gap between buyers' and sellers' price expectations. European companies see this gap as no greater than 20%, while a majority put it as low as from 1% to 10%.

Ideally, companies would be taking action 12 to 24 months before the divestment to achieve the best possible price. But even for divestments already in the pipeline and due in 6 to 12 months, they can seek to harness several value-creation opportunities. Examples include working capital improvements through measures such as altering inventory thresholds.

This kind of thinking reflects a change in European companies' approach to value creation. While the corporate context may restrict freedom of action in some areas compared to financial investors, companies are increasingly looking to replicate the PE playbook by working to enhance value before they put businesses into the market.

Three-quarters of European companies report that focusing on the quality of DivestCo's management (78%) and optimizing its working capital (74%) were sources of value in their last divestment. These areas, as well as reorganizing the supply chain, also stand out as priorities where companies will place greater focus in their next divestment.

Progress on these points should reduce the number of companies who report disappointment in divestment prices achieved (78% say these did not meet expectations) and the impact on RemainCo's valuation multiple after divesting businesses (61% say this did not meet expectations).

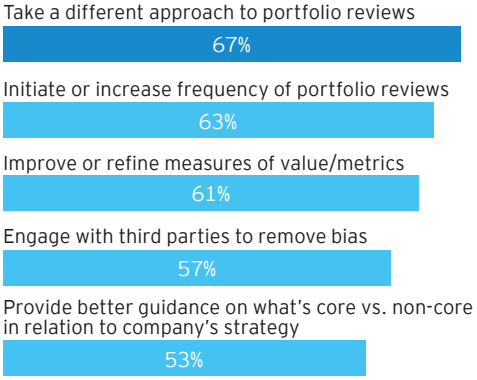
Activist campaigns build momentum

While their capacity to influence European boards and management teams depends largely on shareholder structure, activist investors are exerting notable pressure for change in some European companies. Such campaigns are triggering more discussion around portfolio management and optimization.

Of the European companies surveyed, 38% report that activism in their sector has prompted them to review strategic alternatives in the past 12 months.

CEOs, even those who do not feel pressured by investor demands, will factor this growing activist momentum into their own approaches. One way they can do this is by bringing greater rigor to their portfolio review process, where a majority of European CEOs see scope to do better in all areas.

Q **What specific actions could CEOs take to enhance identification of a divestiture candidate?**



Base = 114 CEOs

This is reinforced by more than a third (37%) of European CFOs having not changed the ranking of their top portfolio performance KPIs in the past three years.

Recommendations

- Aim for even greater portfolio agility and decisiveness on optimization
- Bring investor-style rigor to portfolio reviews or risk gaining unwanted attention from activists
- Enhance the value of your divestment 12 to 24 months ahead of the sale process to achieve desired deal outcomes
- Seize the opportunity that divestment presents to reimagine RemainCo, starting this important work early in the process
- Look to your strategy to define your technology capability requirements and verify that your divestment decision-making reflects these goals

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