The divestment premium

Shareholder returns are significantly higher for tech companies that are active divestors.

Some tech companies divest boldly and regularly, generating higher shareholder returns

A new EY analysis reveals that tech companies that divest generate substantially higher returns than companies that do not — essentially reaping a "divestment premium." The study also shows that tech companies that make the bold decision to divest more significant portions of their businesses have substantially higher returns than the companies that divest a smaller portion of their businesses.

Moreover, companies that take a focused approach and divest regularly command significantly higher multiples than peers that divest less frequently, or that do not divest at all.

What causes the divestment premium? Why don't more companies divest more actively as part of managing their portfolios? What makes some tech companies more successful divestors? We will continue to examine these questions and others in a new series focused on divestments.

About the research and analysis

With many companies in the technology sector experiencing decelerating revenue growth, rising cash balances and higher activist investor interest, it's no surprise that so many tech executives are focused on managing their portfolios, with divestments playing a key part. In fact, 82% of tech companies say that they plan to initiate a divestment within the next two years, according to the *Ernst & Young, LLP (EY) 2019 Global Corporate Divestment Study.* Accordingly, we set out to understand the impact of divestment on shareholder return.

We also wanted to understand if investors view companies that have a focused approach to divestment more favorably, and whether the divestment premium grew over time.

We analyzed the divestment activity of technology companies[1] with a market cap higher than US$5 billion (n=349). We identified 308 relevant transactions[2] by 110 unique divestors. The divestors were then segmented into the following: focused divestors (more than two divestments), opportunistic divestors (one to two divestments) and non-divestors (n=239). As slower-growth tech companies (less than 20% CAGR) were 2.3x more likely to divest compared with their faster-growing peers (greater than 20% CAGR), our study excluded large, faster-growing companies from the analysis (n=91, comprised of 76 non-divestors and 15 divestors). To compare companies, we analyzed total shareholder return (TSR) and EV/revenue and EV/EBIT multiples for divestors vs. non-divestors over corresponding 12- and 24-month periods from the divestment date.

[1] Companies classified under IT, technology hardware and equipment, and semiconductor sectors in Capital IQ with a market cap of more than US$5 billion as of September 2019.

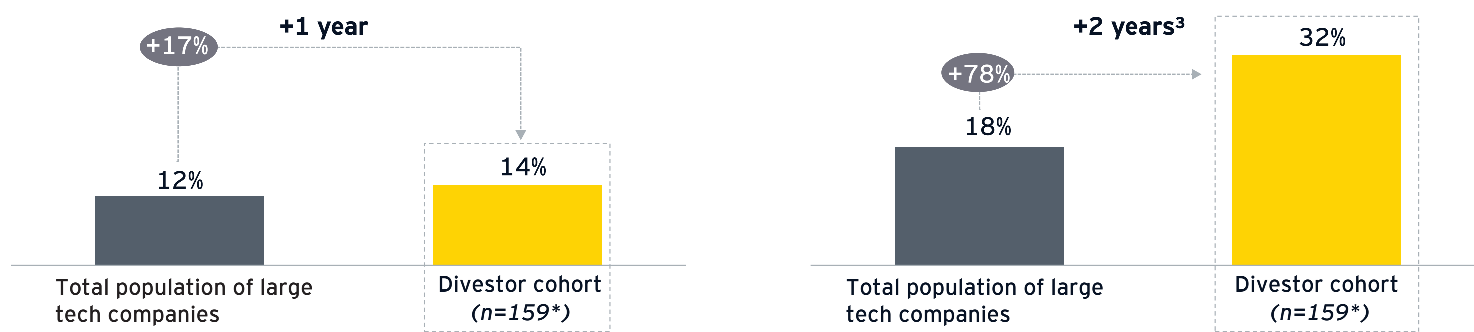
[2] Deals screened from Capital IQ included corporate divestments in the sectors of information technology, technology hardware and equipment, and semiconductors and semiconductor equipment, with an M&A announcement date of July 1, 2008 through June 30, 2018, and excluded canceled deals and public sellers with market capital less than US$1 billion and deal value less than US$1 million.

Key findings

Three key findings from our research and analysis:

1. The divestment premium is significant and improves over time: Overall, the divestor group witnessed better returns compared with the wider technology market.[5] Total shareholder return (TSR) was 17% and 78% higher 12 months and 24 months after the divestment announcement, respectively, relative to the overall large tech company universe.

Market[5] comparison of TSR: market vs. divestors



2. Size matters: Companies that divested more significant portions of their businesses generated a higher TSR over a two-year horizon.

Median seller comparison of TSR: small divestment vs. large divestment

Relative % change

1. Median seller TSR represents the change in sellers' TSR one year and two years post deal announcement and excludes fast growing companies defined as three-year revenue CAGR >20%.

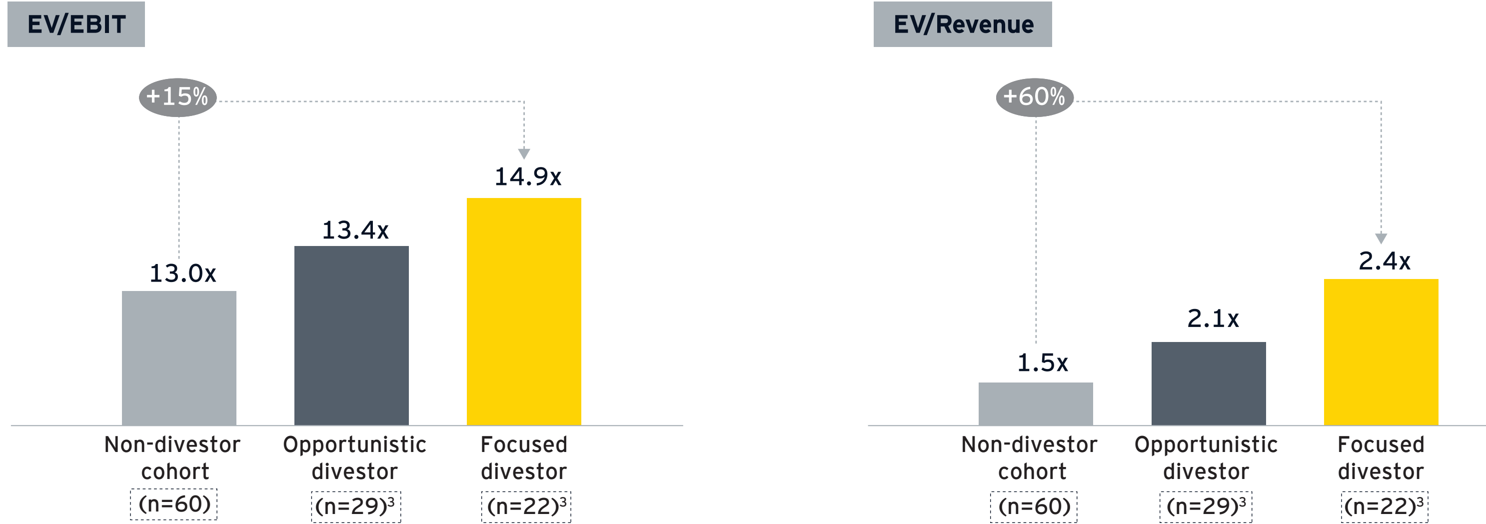
2. Deal classification is based on deal value as a percentage of market capitalization. Small deals are considered those up to 1% of market capitalization, while large deals are >1% of market capitalization.

3. For 2017 and 2018 deals that have not been completed in the two years since deal announcement, TSR (two-year) is calculated from the announced date of the deal through September 6, 2019.

4. To avoid double counting divestment premiums, we grouped divestments by the same company within a two-year time frame and used the largest transaction from that group, giving us 159 unique transactions for our analysis.

5. Market is defined as the universe of large technology companies with slow to medium growth.

3. Investors value a focused approach to divestments: Focused divestors have traded at higher valuation multiples, with EV/EBIT of 14.9x and EV/revenue of 2.4x compared with moderate divestors with 13.4x and 2.1x, respectively.



1. EV/EBIT and EV/Revenue multiple excludes fast growing companies defined as three-year revenue CAGR >20%, EV/EBIT multiple >50, EV/Revenue >5, not meaningful "NM" multiples and outliers with inconsistent/volatile numbers across 10 years.
2. For every group, calculated average multiple for individual year and then calculated median for 10 years.
3. Focused divestor: two divestments; opportunistic divestor: one to two divestments.

The research demonstrates a divestment premium. We will explore the following hypotheses and why the divestment premium exists in future papers.

Divestments drive investor confidence in management:

Portfolio pruning and proactive selection of the right asset(s) to divest is a signal that the management team is better prepared to take action, is thinking about shareholder return and is actively preparing for longer-term sustainability, competitive positioning and profitability. Investors take notice and reward such behavior.

Divestments signal increased likelihood of capital being returned to shareholders:

Investors perceive divestments as a signal that management is more likely to return capital to shareholders, either in the form of dividends or buybacks.

Larger divestments are a powerful signal of transformational intent:

The delineation in the divestment premium between larger and smaller divestments may be due to larger divestments providing a clearer statement of intent with respect to transforming for growth. Investors reward this with higher growth, margin and competitive positioning expectations, and higher valuations. Very large divestments may meaningfully improve overall profitability.

Focused divestors are able to execute better and extract more value than opportunistic divestors:

Seasoned divestors are viewed as being better able to maximize the value of their divestments relative to more casual or opportunistic divestors that don't have the organizational "muscle memory" or know-how to successfully maximize value.

Proactive divesting may lessen the probability of shareholder activism:

Divestment of non-core or under-performing assets is one of the top priorities for activist investors. Actively managing the portfolio may help companies stay ahead of activist investors by identifying under-performing assets more quickly and having a plan to divest.

Conclusion

With the divestment premium so clearly evident, tech companies need to frequently evaluate and align their portfolios with an ever-evolving growth strategy to stay competitive. Portfolio reviews are even more critical for mature companies experiencing slowing revenue growth. With a bolder approach to divestments, tech companies can sharpen their focus and improve their ability to respond to new threats and opportunities both inside and outside their sectors. As our findings suggest, tech companies that actively reshape their portfolios for innovation and resilience can help enhance the overall capital efficiency of the company and inspire higher investor confidence.

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