Using operating models to capture divestment value

Help enhance divestment value by building a targeted, tailored operating model.

Building a better working world

Divestitures are an important play in the corporate playbook, allowing companies to trim non-strategic assets and raise capital to fuel future growth. One underutilized tactic for helping to enhance divestment value is optimizing the target operating model.

By developing a bespoke/customized operating model for the target business, companies can articulate the business's capabilities and value. This, in turn, allows buyers to visualize (and quantify) the potential of the future state and how it fits into their strategy.

The seller's comparatively small up-front investment in defining and optimizing the target operating model has been demonstrated to dramatically increase value. It also serves as a basis for developing operational separation plans.

What is an operating model?

An operating model provides a framework to describe how the target business is run today and how it will change in the future. It is a snapshot of key organizational capabilities and how those capabilities are (or can be) organized to achieve strategic objectives. More specifically, the operating model provides insight into the people, organization, processes, technology and other components that make up the business (see Figure 1).

Usually depicted graphically, operating models provide an easy-to-digest picture of the target's operations at a point in time. They can be designed for the current state of the business, for day one (what it would look like upon the deal close), as well as for a desired future state. With respect to achieving divestiture value, the latter two models are most important.

Once completed, the operating model becomes the one source of truth for the disposition. In addition to providing clarity around the target business operations, the operating model serves several other purposes:

- Allows sellers to easily toggle deal perimeter options — adding some assets or excluding others — to make the target more attractive to a buyer.
- Informs transition service agreement (TSA) requirements, one-time costs and stranded cost remediation, all of which will impact the deal model for either the buyer or seller or both.
- Serves as key input into and aligns with the stand-alone cost model that feeds the deal economics
- Builds the foundation for the seller's separation planning and the buyer's integration planning, both of which will be greatly accelerated by having a well-defined operating model.
- Provides a comprehensive assessment of potential stranded costs.

Operating model components

Increasing the value of the sale

In a market where sellers frequently see price gaps greater than 10% between seller expectations and buyer offers[1], the operating model can help the seller identify additional sources of value and communicate them to the seller. This happens in a few ways:

Increase EBITDA

The most overt way that operating models add deal value is to increase the deal price itself. By evaluating the optimal stand-alone business via the operating model, the deal model can reflect the optimized (i.e., more profitable version) of the carved-out business, rather than the business as it exists today. In a recent deal, we helped our client use effective operating model design to reduce stand-alone costs and increase the target EBITDA by $40m. This resulted in an increase of $250m in deal value after the transaction multiple was applied, on an eventual $4.2b sale price. A cost-benefit model that links business improvements to valuation increases can help you determine the right investments to make.

Reduce one-time and stranded costs

Operating model analysis can also help to reduce value-eroding costs that occur when performing a divestiture. On the same deal mentioned above, we helped our client reduce one-time costs by $100m by streamlining the target operating model, resulting in simplified IT requirements.

Reduce buyer risk

The visibility that the operating model provides the buyer into the workings of the target business reduces its risk — which should create value in and of itself. For example, operating models lend credibility to the target business leadership team. When these leaders come together and give buy-in on the operating model, they are more likely to come across as a cohesive, well-prepared team during discussions with the buyer. The operating model provides the buyer with greater granularity about the target's operations than it would get with traditional financial diligence alone.

Speed to close

If time is money, then preparing up front to lay out the target operating model pays dividends. Presenting a well-defined operating model to the buyer can speed up both negotiations as well as the time from sign to close.

Getting started

Operating models should be created at the onset of the divestment process and refined over time as the buyer pool narrows. Data within or outside your company can provide a solid foundation for designing the operating model for the business to be divested. Between organizational charts, policies and process documentation, you can identify the capabilities of the business, employees, systems, assets, etc., that make up the current state operating model.

From there, the operating model should be tailored in a cost-competitive manner, fit-for-purpose for the target and aligned with the strategy and needs of a specific buyer. Private equity buyers, for example, often have different buying priorities than a corporate buyer. While corporate and PE buyers come in different stripes, the guidelines below can help sellers begin to tailor the operating model for the carved-out business.

Private equity

Buying priorities ...	Operating model should demonstrate ...
► Low complexity of separation, with the seller completing the majority of stand-up activities	► Target is stand-alone and as self-sufficient on Day 1 as possible (minimal TSAs)
► Understanding of cost reduction opportunities and organic growth prospects	► Target is scalable and can support rapid growth
► A strong management team	► Management understanding and buy-in for the future state operating model

Corporates

Buying priorities ...	Operating model should demonstrate ...
► Elimination of unnecessary overhead and other costs	► Target is lean and could easily be plugged into another corporate parent
► Ownership and flexibility in the integration process	► TSAs that can bridge the gap between the close date and such time as the buyer can take over provision of corporate services

[1] EY 2017 Global Divestment Study: 60% of respondents indicated that they considered the price gap between what sellers expect and what buyers are offering to be 11% or greater.

Of course, some PE buyers will aim to integrate the target with another portfolio company, and some corporate buyers will aim to leave the target as a stand-alone entity. It is important for sellers to understand the deal rationale for each potential buyer. Once the seller has anticipated the needs of the buyer, it can toggle the deal perimeter and make other operating model decisions to suit those needs. Think of it as tailoring your resume to the job you want: make the target look as attractive as possible to each potential suitor.

To ensure cost competitiveness, the operating model should be benchmarked against competitors and industry-leading practices, analyzing opportunities to reduce cost to serve, from sourcing to distribution; making buy vs. build decisions; and optimizing the way the business goes to market across geographies (direct presence or through distributors based on each market's characteristics).

Once the target future state is defined, the leadership team must define day one guiding principles and disposition strategies and define how the business will be conveyed to a buyer when the deal closes. Is the intent to rebuild corporate functions on top of the carved-out business? Rely on heavy TSAs? Lift and shift existing functions and capabilities? With this guidance, specific functional teams can decide how to separate the business.

Operating model design in the 21st century

Little in the corporate playbook has gone untouched by technological advances, and the same is true for operating model design. Deployment of technologies, such as analytics, artificial intelligence, automation and blockchain, enables the seller to improve analyses, communicate them more effectively to buyers and accelerate the time to close. Below are just a few examples of how sellers can leverage technology to unlock additional value from their divestment:

- Instruct machine learning algorithms to analyze system and workflow process data faster and isolate key transition dependencies.
- Apply process automation to key transition processes to accelerate stranded cost removal and simplify TSA requirements.
- Deploy data lakes and data visualizations to rapidly consolidate and syndicate critical data to buyers, regulators and transition planning teams for decision-making.
- Implement a blockchain to provide "digital continuity" and the trust needed to streamline TSA processes and eliminate duplicative and error-prone transactions during the TSA period.

In closing

Companies around the globe are becoming more disciplined about creating value before the sale. Creation of detailed operating models should be a key part of that discipline. Making the relatively small up-front investment to build this targeted, tailored operating model can help you realize more value from your divestment.

How EY can help

EY's dedicated, multifunctional divestment professionals can help you improve portfolio management, divestment strategy and execution. Related to operations, EY's propriety operating model design methodology and tools aid sellers in analyzing, designing, communicating and executing the optimal operating model for a given divestment.

Using advanced analytics, we first help you understand the current state of the to-be-divested business and its attractiveness to different buyer pools. We then help you evaluate options for unlocking additional value from the divestment via strategic operating model design, working with you to become an informed negotiator.

Our work with corporate and private equity clients includes a variety of divestment types, including sales of entire companies/subsidiaries, carve-outs, spin-offs and joint ventures.

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