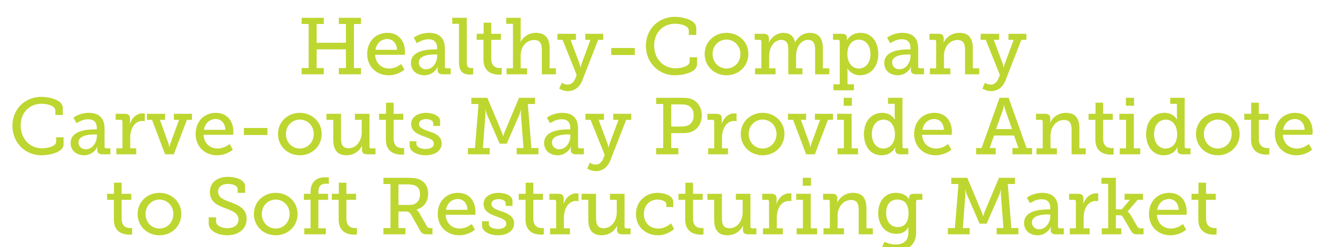

Healthy-Company Carve-outs May Provide Antidote to Soft Restructuring Market

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Turnaround managers need an antidote to the soft restructuring market. They should use their considerable skills and experience to help Corporate America generate value not just in troubled-company financial restructurings, but also in healthy-company operational restructurings.

Among various strategic options, turnaround practitioners can access private equity capital to facilitate the divestiture of their clients' noncore or underperforming assets. Practitioners can then help their clients redeploy financial resources and restructure operations to generate improved returns. They also can help strategic buyers and private equity investors execute post-acquisition performance improvement initiatives at the divested business.

Restructuring the Value-Creation Proposal

The debt markets are extremely robust—leveraged buyout (LBO) equity contributions to deals closing in the second quarter of 2013 averaged only 30 percent, versus the peak of 44 percent reached in 2009 (SunTrust). This is being driven by low default rates, low Fed funding costs (three-month Libor at 0.3 percent and 10-year Treasurys at 2.8 percent), record cash deposits by cautious equity investors (the S&P 500 is up 17 percent this year), and pressure to build net interest margin among a weak consumer lending environment (SunTrust).

Because restructurings are driven by a lack of liquidity and there is plenty of liquidity today, the turnaround community has itself faced a downturn in 2012 and 2013. In the first half of 2013, there were only 60 distressed M&A transactions in the U.S., down 25 percent year over year and down 70 percent on an annualized basis from the peak of 399 transactions in 2009 (William Blair). Continuing the down-sloping 2012 trajectory, 2013 likely will end up being a very weak year for the turnaround and restructuring business as well.

Some turnaround managers believe that a 200 basis point increase in interest rates could materially change the landscape. However, the North American economy is still growing, albeit slowly, and company valuation multiples have remained high. In its July 2013 Manufacturing Report on Business, the Institute of Supply Managers (ISM) stated that of the 18 manufacturing industries tracked, 13 reported growth. New orders, production, employment, and exports all showed positive trends.

While 2013 M&A activity is slower than in 2012, buyers are motivated by the flood of cheap debt, strong stock currency, and a mammoth buyout "dry powder" war chest. Despite the decline in the number of U.S. M&A transactions in the first half of 2013 to 5,598 (down 23 percent year over year), overall market enterprise value (EV) to EBITDA multiples have contracted by only 9 percent and, for deals in the $50 million to $250 million range, transaction multiples have remained flat (William Blair).

Further, despite the length of the current recovery, the U.S. economy still appears to be in the middle expansion

phase of the current cycle. Since World War II, typical U.S. business cycles have lasted three to five years, with expansions typically lasting 45 months. Although the economy grew in July 2013 for the 50th month, the 2009 recession was so deep and the rebound so weak that the economy does not exhibit symptoms of a late-stage expansion—commodity prices remain palatable and inflation is only 2 percent, half of the 2008 peak rates.

It is reasonable to expect a very slow restructuring market for some time to come. Generous deal multiples, ample and low-cost debt capital, and slow but continuing economic growth are not prescriptives for a turnaround in the turnaround business. The antidote is to embrace a wider arena of value creation in the middle market. Turnaround managers can package their established expertise in financial restructurings with their well-developed administrative and operating skills to help nondistressed clients critically assess their businesses, perform strategic reviews, and restructure operations to improve financial performance.

Addition by Subtraction

Despite peak levels of stock price performance in this slow-growth environment, shareholders and many public company boards remain motivated to maximize value. And, at least in publicly held companies, the pressure is tangible—the executive search firm Russell Reynolds observes that "investors are expecting boards to play a greater role in ensuring that shareholder value is maximized... [P]rivate equity['s]...acquisition and management of large companies has made this more acute, forcing boards to measure their own performance and decision making against that of a theoretical (or sometimes very real) private equity purchaser."

In a throwback to the 1980's proxy battles, aggressive shareholder activism is back in vogue. There are at least 60 investment funds with an activist strategy (13D Monitor), including leading activist groups such as Icahn Capital, JANA Partners, Pershing Square, Relational Investors, Third Point, and Trian Fund. These funds seek to increase the value of equity stakes they acquire in corporations by placing pressure on management to change corporate policy, change financing structure, and implement cost cutting initiatives.

According to Goldman Sachs, activists have more than $200 billion of levered fund capacity, which has grown at a 20 percent-plus compound annual growth rate (CAGR) over the last four years. There were 47 publicly disclosed activist situations at companies greater than $500 million in the first half of 2013, up from 63 situations for all of 2012 and only 26 such cases in 2009. The title of an August 2013 *Forbes* article sums it up well: "The Golden Age of Activist Investing."

Maximizing value in slow-growing companies frequently involves a divestiture or "carve-out." In his 1989 article (revised in 1997), "Eclipse of the Public Corporation," Michael Jensen, the Harvard Business School corporate governance and mergers and acquisitions expert, described corporate divestitures and spin-offs, including LBOs, as the means to maximize value to shareholders of slow-growing public corporations. He presciently described divestiture opportunities arising in situations "where long-term growth is slow, where internally generated funds outstrip the opportunities to invest them profitably, or where downsizing is the most productive long-term strategy."

Jensen's observation that the low-growth or declining industries of "steel, chemicals, brewing, tobacco, television and radio broadcasting, wood and paper products..." and also" industries such as aerospace, automobiles and auto parts, banking, electric power generation, food processing, industrial and farm implements, and transportation equipment" would continue to provide divestiture opportunities remains true today.

An example of carve-outs as transformative strategy is Dow Chemical. Driven by onshoring trends, fueled by a fracking boom, and supported by improved demand in housing and automotive, the U.S. chemicals industry is undergoing a renaissance. However, Dow and many other companies with exposure to China and Europe have lagged in stock price performance. As a result of its underperformance, Dow's management is realigning its portfolio and has divested noncore businesses representing approximately $8 billion in revenue between 2009 and 2013.

Activist shareholder activity in chemicals has been rampant—Trian with DuPont, JANA with Agrium and Rockwood Holdings, Quinpario in Zoltek and Ferro, and Starboard in Calgon Carbon. Since JANA took a position in Rockwood in late 2012, Rockwood sought to divest three units in February 2013 and sold its clay business for $635 million in July 2013. One investment bank is tracking approximately 50 potential chemical divestitures.

In its January 2013 "Divestiture Survey Report," Deloitte & Touche observed that "as the U.S. economy strengthens, divestitures are becoming more a matter of strategy than survival. During the challenging economic conditions of the last few years, many divestitures were driven by the need to reinforce balance sheets, raise capital, and improve financial performance. While the ups and downs of the economy and market conditions will likely still play a big role in 2013 decision making, divesting is becoming an important tool for implementing corporate strategic goals and making a statement in the marketplace."

In fact, corporate restructuring after 2009 has resulted in 300 new corporate entities (73 percent were LBOs, and 27 percent were spin-offs), and divestiture volume has risen to more than 40 percent of overall M&A, a five-year peak (Goldman Sachs). Also, while U.S. private equity buyers represented only 13 percent of divestiture buyers in 2006-2008, they represented 26 percent of divestiture buyers in 2011-2013 (Deloitte).

Carving Out Opportunities

Now is an ideal time for turnaround practitioners to market the full breadth

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of their corporate renewal abilities in helping drive carve-outs and operational restructuring to accelerate corporate growth. Corporate cash balances have built up to a five-year peak of more than $1 trillion; however, a frothy stock market and a reduced ability to raise quarterly earnings are keeping CEO confidence at mid-2009 levels (The Corporate Board). Economists forecast only a 1.4 percent real GDP growth rate in 2013, down from 2.8 percent in 2012 (Wells Fargo). Being long on cash and short on growth is not a long-term tactic for maximizing shareholder value.

In a survey of corporate development executives conducted in 2012 by Deloitte & Touche, only 40 percent of executives surveyed reviewed their portfolios for potential divestitures on a routine basis. This presents an opportunity for turnaround practitioners to add assessment of potential divestitures into their performance improvement approach when advising nondistressed clients.

The divestiture analysis should include reaching out to a colleague at a private equity firm on a confidential, no-names basis to get a market estimate of value for the potential divested unit. The analysis should contemplate potential costs and other considerations involved in separating a business, especially when it is well-integrated into other parts of the seller's business. Strategic and commercial implications, such as the effect of intellectual property that is being divested on revenues and market competitiveness of the remaining business, should be carefully analyzed.

Another opportunity for turnaround practitioners is to assume a temporary corporate development role to administer the separation of the business being divested. Once an entity is identified for divestiture, many company executives and private equity owners underestimate the level of work involved in the execution of the carve-out. They tend to oversimplify the situation, think that divestitures are easy, and frequently misjudge the level of planning and operational resources needed.

This is particularly true when a carve-out is highly integrated into the parent, lacks a management team, is undergoing a turnaround, involves a global operation, or needs a back office. Furthermore, corporate development executives shy away from divestiture work because divestitures are often viewed as failures. Corporate development executives want to take credit for good acquisitions, sharing in compensation rewards caused by adding scale to the enterprise.

Deals typically fail post-acquisition primarily because of a lack of qualified human resources dedicated to the investments.

Sellers can also engage turnaround managers to undertake seller-provided operational and financial diligence. This is a common practice outside the U.S., but it is becoming more common here. In divestiture situations, this can be particularly useful, as many separation and transition issues can be identified during diligence prior to engaging with potential buyers. Seller-provided diligence can help eliminate uncertainties in getting a deal done and can help to ease the transition for both seller and buyer. These reports can be especially helpful in cross-border transactions. Out of 2,482 global divestitures year-to-date (Deloitte), approximately 80 percent of the transactions involved non-U.S. targets.

Finally, turnaround practitioners can work with the client to redeploy assets into the core business, improving returns. Once the divestiture closes, turnaround practitioners can provide the needed interim senior-level resources to ensure asset redeployment strategies are realized and can also assist management with cultural and organizational change processes to ensure that successes achieved in unlocking asset value are sustained.

Filling the Execution Gap

The list of qualified funds able to undertake complex or underperforming carve-outs and then orchestrate a highly successful investment is short. More than $328 billion of private equity dry powder is currently available for investment by 17,000 funds (PitchBook). However, there are only 351 funds based in the U.S. and Canada that identify themselves as firms that focus on complex situations, special situations, and turnarounds. Although these funds control a total of $170 billion (52 percent of total dry powder), only $17.8 billion (5 percent of total dry powder) is controlled by 38 funds that are oriented to small and mid-sized companies and have $250 million to $1 billion of available capital (Preqin).

Originating a proprietary divestiture investment opportunity typically involves years of building a successful investment track record and relationships with potential corporate sellers. Sellers typically care about speed to close, certainty to close, and price. Hence, public companies and their financial advisors involved in divestitures typically only want to transact with credible suitors—logical strategic buyers or financial buyers with a strong brand of closing complex deals. Because their engagement success is often centered on successfully closing a transaction, turnaround practitioners involved in corporate carve-outs should be familiar with the capabilities and reputations of the various buyout funds positioned as potential buyers.

What typically drives success in the private equity investing business has changed over time. In a February 2008 study of private equity value creation, Boston Consulting Group identified the 1980s as a "leverage era," the 1990s as the "multiple expansion era," the 2000s as the "earnings growth era," and the 2010s as the "operational improvement era." These 2010-era operational improvements are driven mostly by improved management capabilities, but also by add-on acquisitions. In its study of 2006-2012 EBITDA growth at private equity portfolio companies, EY observed that 44 percent was driven by organic revenue growth, 26 percent was driven by bolt-on acquisitions,

and 30 percent was driven by cost reductions or other initiatives.

While a deal may look great on paper, only the successful funds allocate proper attention to the carve-out and stabilization processes—that is, how the deal will actually be executed once the purchase and financing documents are signed. Deals typically fail post-acquisition primarily because of a lack of qualified human resources dedicated to the investments. Turnaround practitioners are well-positioned to provide the critical interim senior manpower needed both to navigate the difficult first 100 days of an acquisition and also in driving operational performance improvement.

Turnaround practitioners who possess the ability to drive real change in the carved-out entity's performance provide significant value to investors in divested businesses. Typical performance improvement is focused on operating strategy, core business systems, operations performance improvement, and revenue enhancement. And, as mentioned earlier, a divestiture typically adds complexity to human capital, customer and supplier relationships, back-office functions, IT systems, and potentially to transition service agreements (TSAs). Many successful carve-outs and turnarounds benefit from an introduction of advanced business systems for strategy and for management of employee development. Goal Deployment, Voice of Customer, Toyota Production System, Lean, and the Management by Objective process are a few examples.

Three-Way Partnership

The economy and deal activity are both slow, and bankruptcy and restructuring activity leaves a lot to be desired. The outlook for an upturn in restructurings is bleak, and any uptick in activity is likely a long way off, as the business cycle is still expanding. Turnaround practitioners have the skills and experience, forged in distressed situations, applicable to a wider ecosystem of services, broadly defined as good old-fashioned, long-term stakeholder value creation. Jensen presciently advocated in 1989 that the logical place to look for value creation is in Corporate America and that divesting noncore or underperforming units hiding within consolidated accounting segment reports and/or overshadowed by a frothy stock market is a key strategic lever to unlock significant added value. Jensen pointed out that private equity firms are common buyers of noncore assets, and this remains true today.

In public companies, activist shareholders are increasingly serving as catalysts for change, driving carve-out strategies. The formula to achieve successful outcomes includes a three-way partnership among a committed corporate seller; an experienced in-house or independent turnaround practitioner to identify and execute performance improvement strategies, including carve-outs; and a private equity firm with a track record of closing successful corporate carve-out transactions.

Michael Teplitsky (top photo) is a vice president and **Duncan Bourne, CTP,** is a managing director with Wynnchurch Capital, a private equity investment firm headquartered in Chicago. Teplitsky has more than a decade of experience in private equity investing and corporate finance involving turnaround, corporate carve-outs, underperforming companies, and restructurings. Bourne has more than 30 years of experience in turnarounds, financial restructurings, operational performance improvement, and investing in special situations. In addition to being a CTP, he is also a CIRA.