GREY PAPER
insights

Maximizing value realization and increasing divestiture success for energy and chemical companies

Pilko & Associates Grey Paper

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Pilko & Associates is the industry leading operational and environmental, health, and safety risk advisory firm—working with clients in 59 countries and advising on M&A deals worth more than $600 billion.

Concise summaries of key operations/EHS and transaction risk challenges and how to increase control of risk for your project, assets and enterprise.

US +1 713 357 1000

pilko.com
700 Louisiana St. | Suite 4500 | Houston, TX 77002
info@pilko.com

BACKGROUND

Sometimes it's hard to say goodbye, even when it's the right thing to do.

Energy and chemical companies have a long history of acquiring assets for the purposes of growth, higher productivity and value creation. But when it comes to selling assets, especially those that are less relevant to the core business, many executives hang on longer than they should, leading to diminished value.

Thirty-three percent[1] of companies undertake M&A to redefine their business and operating models. Those involved in acquisition <u>and</u> divestiture create between 1.5 and 4.7 percentage points[1] higher shareholder returns than those companies mainly focused on acquisition.

Further, those who manage divestiture activities properly outperform peer companies. For example[1], best-in-class divestiture performance returned up to 37 percent higher shareholder value, in year one, while companies that divested poorly saw up to 100 percent lower shareholder value realization than peer companies in the same timeframe. This stark difference points to a need to undertake divestitures in a careful, intelligent manner to increase the probability of increased shareholder value and reduction of post-close liability risk.

THREE LEVELS OF DIVESTITURE VALUE

Divestiture-related value creation and realization isn't automatic. Value through divestiture is a function of proper planning and the right approach. There has to be a better way to increase success and reduce risk associated with divestiture activities.

Companies tend to singularly focus on the "transaction value"—the price that the asset can be sold for and the net proceeds from the sale after expenses. To be sure, this is an important metric, but not the only one that must be taken into account.

Leading companies know that every successful divestiture balances and manages three levels of business value.

1. The Transaction. The cash proceeds, net of expenses, received from the sale of the asset.

2. Accretive Shareholder Value. The growth in shareholder value realized through focus on core business activities and creation of new opportunities by reallocation of capital and lowered cost of business.

3. Minimization of Post-close Liabilities. Ensuring control of post-close exposure risks to eliminate any future liability payout in cash, resource distraction, and opportunity cost.

The most successful divestiture activities ensure attention and process that takes all three into consideration right from the start.

THE CHALLENGES

A KPMG[1] survey of more than 400 M&A professionals found that about half of corporate sellers and approximately a quarter of private equity firms believed they had failed to maximize the value of their latest sale. The leading indicated cause (>70 percent) was loss of control of the process and timeframe. There are four contributors:

First, there is a strong bias against divestiture. Less than half of companies surveyed considered divestiture as a strategic option with only 20 percent of those actually undertaking and completing divestitures.

Second, when companies consider and undertake divestitures, most often they are done in a reactive, opportunistic manner—in response to some sort of competitive or financial pressure, such as losses or debt. Unfortunately, opportunistic divestitures had a positive valuation impact only 14 percent of the time, and divestitures as a means to generate quick cash returned a positive valuation impact only 15 percent of the time.

Third, the single largest barrier to successful divestiture completion, in energy and chemical, is value disparity (33 percent of the time) between the seller and buyer. Value disparity outpaces other issues such as access to capital (29 percent), too many sellers (18 percent), commodity uncertainty (10 percent), insufficient buyer pool (5 percent), and lack of execution (5 percent).

Fourth, companies tend to depend on their "deal teams" to handle both acquisition and divestiture activities and often relying on a standardized suite of activities and processes, leading to unpredictable and non-standard results. Why is this?

IT'S ALL ABOUT LEADERSHIP

Divestitures are different than acquisitions and no single divestiture is the same as another. Each one is unique and requires leadership that drives success from the start.

Pilko's experience backs this up. We find that maximum value is achieved through strong leadership that tightly manages timelines and manages post-close liabilities through best-in-class diligence, communication and clarity.

In fact, another survey[1] highlights that strong leadership is more important than integration process when it comes to success. Also pointed out was that companies are increasingly connecting executive incentives to deal performance. So, getting it right is important!

LEADERSHIP-DRIVEN DIVESTITURES

Pilko has a rich history of solving the leadership challenge for divestiture activities. Our thoughtful approach directly contributes to value maximization for both buyer and seller delivering the best due diligence, achievement of timelines, clear communication and minimization of post-close liabilities.

We've identified three proven success factors that corporate officers and board members should consider when undertaking and completing divestiture activities:

1. Prepare and start early. Know the value of each area of the business and prepare detailed due diligence packages.

2. Create a comprehensive transition team. This should be a cross-functional group that assumes leadership for and completion of the divestiture from "cradle to grave."

3. Focus on core processes. Prioritize processes that add value, create positive outcomes, and drive to successful divestiture completion.

To accomplish these strategies, divestiture leaders have the following tactical characteristics.

- Take the buyer's perspective. Understanding the buyer's motivation, business need, strategic direction and desired operational and business value should a buy-side transaction be completed.

- Know your core business. Define and evaluate all assets with a clear understanding of core business characteristics to ensure the proper asset carve out occurs and mistakes are avoided.

- Align divestiture choices to business strategy. Ensure that any considered divestitures align with your business strategy and positively contribute to strategy achievement.

- Tightly integrate senior leadership and board members. Divestiture activities require the input, analysis and decision making of senior leaders of the company to increase probability of successful outcomes.

- Assemble the best, dedicated team. One study showed that corporate officers believed that a dedicated team improved portfolio review process, carve out, analysis, negotiation, and close. Ensure you have the right experts in strategy, finance, organization and culture, sales and key external advisors to bring objective third-party views and expertise.

- Analysis, analysis and analysis. Any divestment decision must undergo rigorous analysis of return on capital, EBITDA, economic value add and organizational/cultural impact.

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- Define the reasons. Determine the rationale, both strategic and tactical, for the divestiture. Be ruthless in the definition around issues of leadership, risk/reward, synergies, market conditions, asset condition and the like. Leaders have a good, business-based reason for divesting, not simply as a mechanism for quick cash.

- Take action. Once a decision is made, set into motion the ancillary decisions, project plans and activities, metrics and resources needed to make the divestiture happen in a manner that drives up the greatest value to the company.

ACCELERATING DIVESTITURE VALUE

Even if leaders have the right value strategies and activities, there are still two more areas that increase value realization.

- Preparing the asset for sale. Often companies will carve out an asset and lower any future operational investment. "Starving" an asset by reducing investment and lowering operational and EHS performance diminishes the asset value to the selling company.

  Leading companies prepare the carved-out asset by ensuring operational and EHS effectiveness, thereby reducing risk of value loss or incident.

- Controlling post-close liabilities. Leading companies identify, quantify, prioritize and communicate post-close liability possibilities. These become a key and integral part of controlling risk through clear representations, warrants and liability limitation activities in areas such as due diligence information and disclosures, environmental and safety, personnel, regulatory and compliance and legal and financial.

Leaders that are tempted to be hasty, cut corners or have a strategy of non-disclosure increase risk exposure and diminish long-term divestiture value. This can be avoided by integrating a third-party, independent advisors for additional accountability and structure for success.

ENSURING DIVESTITURE SUCCESS

Our experience over the past 38+ years and $600B in deal volume drives our company to work with clients to increase success and value maximization of divestitures prior to, during and after closing. Pilko increases your success by increasing your control of divestiture preparation, discovery, negotiation, close and post-close liability limitation.

Start by putting Pilko & Associates on your divestiture team—right away. You'll get best practices, experience, third-party objectivity, resource, skill and a track record of divestiture success that will immediately increase control of risk and maximize value creation and realization.

Our clients have discovered that Pilko & Associates is the key to divestiture leadership and outcome success and difference between success and failure.

Are you ready for your next success? We are.

Grey Paper Author: Sven Royall, Managing Director

[1]Sources: KPMG 2017 M&A Predictor; E&Y: Global Corporate Divestment Study (2014); PwC 2017 M&A Integration Survey; McKinsey "Divestitures: How to Invest for Success (2015);

ABOUT PILKO & ASSOCIATES

Pilko & Associates provides industry-focused advisory services in three core areas –Transactions, Operational Excellence and Governance & Assurance –to enhance value for our clients and their stakeholders in the chemical and energy sectors. We deliver innovative solutions for publicly and privately-held companies, helping them to identify, understand and manage their Operational Risk and Environmental, Health & Safety needs. For more information, visit www.pilko.com.

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