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The big breakup: the math behind giant divestitures

Three large and complex multi-business portfolios—General Electric, Johnson & Johnson, and Toshiba—recently announced break-ups.[1] Is this a coincidence or a trend? KPMG research on value creation in complex portfolios demonstrates that financial disparities among the various businesses in a portfolio can destroy shareholder value. All three of these companies had financially disparate portfolios, making a break-up a logical path to value creation—and likely a trend that investors will actively continue to push for in the future. Leaders of large and complex multi-business portfolios should ask themselves if their company's portfolio is financially disparate and, if this disparity is not addressable through management actions, what portfolio actions (e.g. spin-offs, divestitures) could create the most value for shareholders.

When three corporate icons—General Electric, Johnson & Johnson, and Toshiba—announced plans to break themselves into smaller parts, it made headlines everywhere. If you look at the calculus behind these moves, you can draw lessons for any corporation with multiple lines of business: when corporations own businesses that differ significantly in how they use capital and earn profits, the capital market will discount the value of the whole enterprise. For investors, the whole will be less than the sum of the parts.

Indeed, when GE CEO H. Lawrence Culp announced the firm was splitting into three companies—aviation, health care, and energy—he noted the financial mismatches between the three units. As stand-alone companies, he said, they would have "more tailored capital structures and capital allocation frameworks that are aligned with each company's distinct strategies and industry dynamics."[2]

Why the market disapproves of disparities

KPMG, in collaboration with Dr. Emilie Feldman at The Wharton School, University of Pennsylvania, analyzed this phenomenon in two papers that show the cost of disparities. In our first paper, Can Your Valuation Be Improved?, our data showed that companies with business units that have different growth rates, margins, and asset intensities can suffer from a "diversification discount." The reason? Investors assume the disparate financial needs lead to sub-optimal resource allocation, especially of capital and talent. The greater the financial disparities among the businesses, the larger the diversification discount.

In our second paper, Think Like an Activist, we looked at how activists address this problem. In a two-step process, these investors demand first, that companies shed assets that utilize capital differently and second, that these companies aggressively reinvest in their cores. The data

[1] Source: Kevin Dowd, "Death To Conglomerates: GE, J&J And Toshiba All Reveal Plans To Break Themselves Up," Forbes.com, November 14, 2021

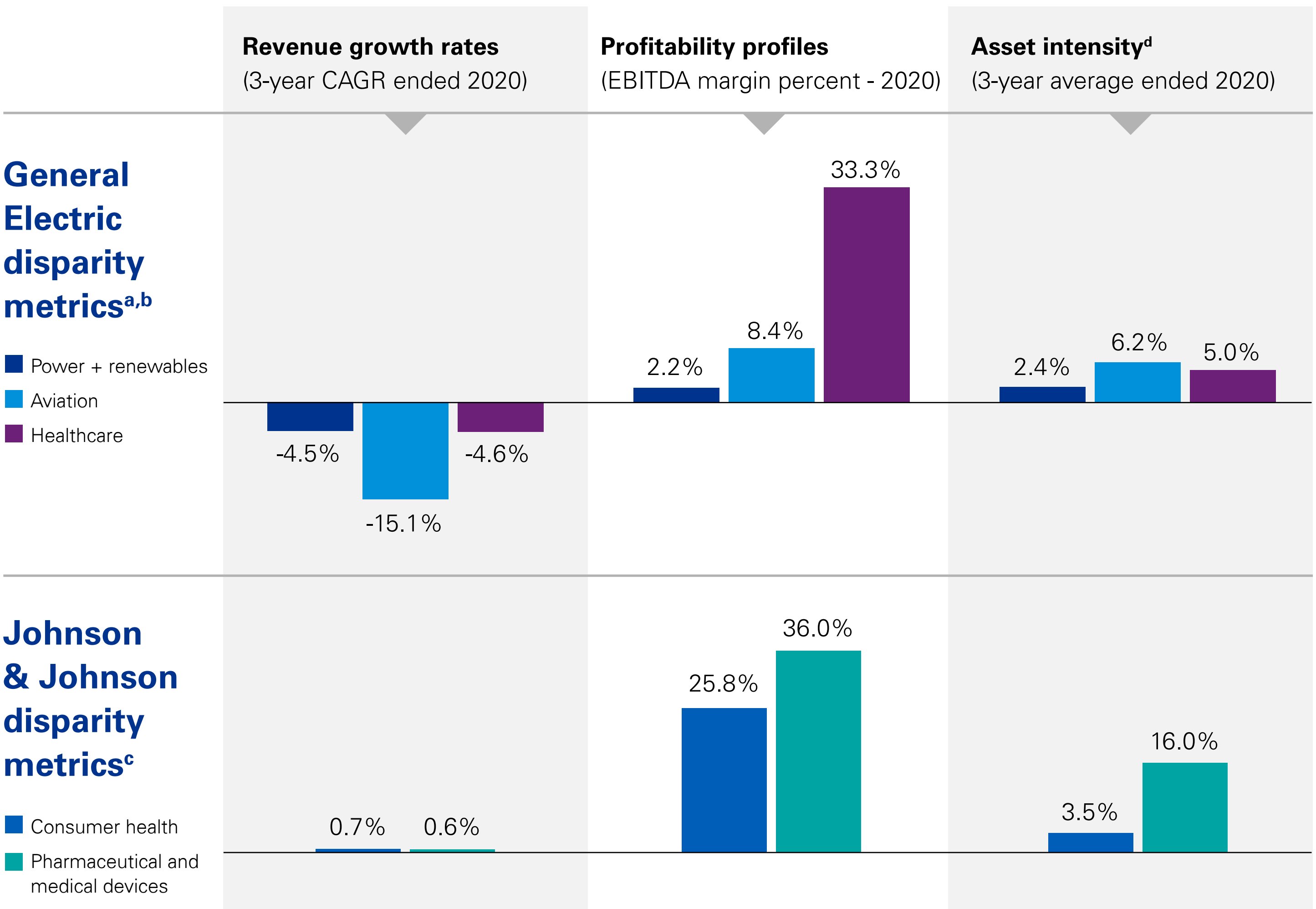
[2] Source: General Electric Co Plans to Form Three Public Companies Focused on Growth Sectors of Aviation, Healthcare, and Energy, conference call transcript, ge.com, November 9, 2021

clearly show that companies that embrace this kind of active portfolio management enjoy improved valuations 12 months after reconfiguration.

The GE, J&J, and Toshiba split-ups are textbook examples of how active portfolio management can enhance valuations. When Toshiba announced its split into technology and infrastructure companies, CEO Satoshi Tsunakawa explained: "It will unlock immense value by removing complexity, it enables the businesses to have much more focused management, facilitating agile decision making, and the separation naturally enhances choices for shareholders."[3]

Although J&J and its underlying businesses predominantly operate in the health care sector, the company is still often regarded as a conglomerate. Regardless of its single-industry focus, J&J suffered from the same problem of financially disparate businesses. The pharmaceutical and medical devices division had consistently higher profitability (36.0 percent) than the consumer health division (25.8 percent). The resulting overall impact to J&J was undervaluation—the Tylenol and Band Aids branded consumer health division was dragging the firm's valuation down below the pharma sector's average.[4,5]

As these examples illustrate, it's extremely hard to manage disparate businesses. Businesses with disparate financial characteristics convert revenue to cash flows at different rates, presenting capital allocation challenges that are often difficult to tackle. The following charts show the financial characteristics analyzed in this study that led to depressed valuations for GE and J&J:



Notes:
[a] At least one of the divisions to be spun off is disparate from the remaining company.
[b] Considers power and renewables businesses as one business (no adjustments made to expense items).
[c] Considers pharmaceutical and medical devices businesses as one business (no adjustments made to expense items).
[d] Asset intensity is defined according to whether business units have very different capital / asset intensities (heavy or light). To ensure alignment with industry characteristics, asset intensity for General Electric is defined as total assets over sales and for Johnson & Johnson as R&D over sales.

[3] Source: Yuri Kageyama, "Japan's Toshiba Spins off Energy, Computer Device Units," Associated Press, November 12, 2021

[4] Source: Johnson & Johnson Announces Plans to Accelerate Innovation, Serve Patients and Consumers, and Unlock Value through Intent to Separate Consumer Health Business, Investor Relations Press Release, jnj.com, November 12, 2021

[5] Source: Rebecca Robbins and Michael J. de la Merced, "Johnson & Johnson, Iconic Company Under Pressure, Plans to Split in Two," NYTimes.com, November 12, 2021

As the new year gets under way, many chief executives and C-suite teams will be reviewing strategic alternatives and wondering how to boost their valuations. Keep in mind the lessons from the recent moves by GE, J&J, and Toshiba. A key to unlocking shareholder value is to identify elements of your company's portfolio that are financially disparate—especially those relating to growth, profitability, and asset intensity—and take action. Chief executives and C-suite teams need to be aware that financial disparities may be limiting shareholder returns. At the end of the day you need to be asking yourself two questions—"What businesses are you really in? Are these the right businesses to own?"

How KPMG can help

Through proprietary solutions, leading industry perspectives, advanced data and analytics, and resources across KPMG, the KPMG Advisory practice supports clients across all stages of M&A. KPMG takes an active portfolio management approach to help optimize the composition of your firm's portfolio and, in turn, maximize strategic and financial value.

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