



Creating value through demergers



FW moderates a discussion on creating value through demergers between Sanjay Thakkar, Ina Kjaer, Jonathan Boyers, Nicola Longfield, and Caroline Bott at KPMG.

Marco Schwartz, Naveen Sharma, Jeremy Welch and Matt Watkins also assisted on the production of content.



Sanjay Thakkar

Head of Deal Advisory
KPMG in the UK

T: +44 (0)20 7311 1000

E: sanjay.thakkar@kpmg.co.uk

Sanjay Thakkar is a partner and a member of the executive committee of KPMG in the UK. He is head of deal advisory which advises clients to buy, sell, fund, fix and partner. In a career spanning 26 years, Sanjay has worked across the globe in both emerging and developed markets including London, Frankfurt, San Jose and India. He is a banking and telecoms market recognised partner and has extensive experience advising global funds.



Ina Kjaer

Partner
KPMG in the UK

T: +44 (0)20 7311 8901

E: inayara.kjaer@kpmg.co.uk

Ina Kjaer is a partner within KPMG's integration & separation team in the UK. A Brazilian native with over 15 years' experience of managing cross-border integrations & separations, she has broad and extensive M&A advisory experience, having advised on financial, commercial and integration issues on numerous cross-border acquisitions and disposals. Additional areas of expertise include identifying, delivering and tracking revenue and cost synergies and complex cross-border integrations and separations.



Jonathan Boyers

Partner
KPMG in the UK

T: +44 (0) 161246 4136

E: jonathan.boyers@kpmg.co.uk

Jonathan Boyers is the KPMG partner who leads the firm's corporate finance practice in the UK. Jonathan also oversees KPMG's wider deal advisory business across the North region, which comprises corporate finance, valuations, debt advisory, transaction services and infrastructure advisory, and also involves M&A tax, consulting services and legal services. He has advised hundreds of companies regarding strategy and corporate finance transactions, with deal sizes ranging from £1 to £600 million.



Nicola Longfield

Partner
KPMG in the UK

T: +44 (0)20 7311 4383

E: nicola.longfield@kpmg.co.uk

Nicola Longfield is a partner and head of KPMG's deal advisory consumer markets team in London. She has over 15 years' experience with KPMG as a transaction services specialist, advising corporate and private equity clients on sell-side, buy-side and refinancing projects. Nicola has worked on a wide range of transactions within the consumer markets sector, including acquisitions, disposals, IPOs, refinancing and sell-side support.



Caroline Bott

Partner
KPMG in the UK

T: +44 (0)20 7311 8371

E: caroline.bott@kpmg.co.uk

Caroline Bott is a partner and leads KPMG's valuation services group in the UK. Caroline has specialised in commercial valuations since moving to KPMG corporate finance in 2004. She has experience of a full range of commercial valuations for both public and private companies in the context of mergers and acquisitions, joint ventures, fund valuations, restructuring, disputes, expert determinations, fairness opinions, reorganisations and tax and accounting valuations. She also leads KPMG's consumer and healthcare valuations businesses.

FW: How would you describe general demerger activity in the current market? What factors are driving this trend?

Thakkar: Our economies have been operating in a low return environment for a number of years. Lower yields are prompting shareholders to assess whether they are receiving adequate returns for the level of risk and amount of capital invested. This ongoing hunt for scarce returns is ultimately what is driving deal activity. Where a shareholder believes that someone else can extract greater value from a business, it makes absolute sense to crystallise this by divesting this business. The term 'demerger' itself is too narrow as it is simply a mechanism through which a shareholder is able to monetise future value, in the same way that divestments, joint ventures and strategic alliances can.

Boyers: Activity is driven by a desire to continually refine and drive portfolios. There has probably never been a better time to sell a high-quality business than over the last six to 12 months. The amount of private capital that has been raised in order to buy businesses is phenomenally high and we are also seeing enormous interest from US, Far East and Middle East corporate buyers thanks to the devaluation of sterling. Put these two factors together and sellers are achieving multiples above anything people can remember – certainly several turns higher than two or three years ago. The fact that a large number of private equity houses have been exiting over the last year or two demonstrates the buoyancy of the market.

“ Successful deals are ultimately defined by strong business fundamentals rather than being defined by sector or geography ”

Sanjay Thakkar
KPMG in the UK

If a corporate feels it needs to slim down its focus on a smaller number of businesses, and therefore exit a particular area, now is as good a time as ever to achieve full value.

Longfield: We are certainly seeing a lot of global businesses really think about their portfolios and focus on what they see as strategically important, which has led to a number of sizeable disposals or demergers, across various sectors. The consumer and life sciences sectors are two particular examples. The aim is often to free up large amounts of capital to then focus on areas they see as absolutely core in the future. In addition, financial institutions are continually having to assess shareholder returns in light of increasing pressure from regulators to strengthen their capital base. Banks in particular are having to reassess their portfolios and different businesses attract different levels of regulatory capital.

FW: Are there any regions or sectors where demergers appear to be occurring with particular frequency – and if so, why

Boyers: There has been strong activity across a number of sectors. We have seen high levels of activity in food and drink, both in the UK and globally, where a number of businesses are looking at reshaping their portfolio of brands to more specialist groups. There has also been quite a bit of activity in media, technology and, more widely, in gambling and gaming with a consolidation of players in this sector. Power – both its distribution and retail – is the other area to mention as one primed for activity. We have already seen a number of independent electricity companies emerge on the back of government policy for switching, and reports suggest the independent power sector could go from 2 percent of the market in 2013 to something closer to 30 percent in 2019. I think a number of those independent power companies will start to consolidate, and that will spur activity among the 'Big Six', which will offload non-core products across distributed power, combined heat and power, and renewable energy, which in turn will be snapped up by private equity or specialist businesses.

Thakkar: Nevertheless, divestments are not confined to a particular region or sector. Successful deals are ultimately defined by strong business fundamentals rather than being defined by sector or geography. Other key drivers of deals include the disruptive forces caused by technology, innovation and geopolitics.

FW: Could you provide an overview of the benefits a demerger can bring to a business?

Kjaer: Demergers and divestments can deliver huge savings through simplification. Some of these businesses are very bureaucratic, really complex beasts and ultimately, that can be expensive. Take out that complexity and you actually have an enormous amount of cost savings in a much more straightforward, more focused business which is able to concentrate on what it is good at. We often find that demerged businesses are more agile and fleet of foot in their operations and also that decisions are made with closer proximity to the customer. Demergers are less successful when they fail to shrug off legacy bureaucracy and business culture.

Boyers: I would add that from a commercial perspective, sellers can also enjoy a corporate finance arbitrage if they sell for more than their own investors thought it was worth.

FW: What fundamental characteristics of a business typically make it a sound proposition for a successful demerger process?

Bott: In a lot of the disposals we see, corporates describe the business as 'non-core'. I think it is important that when businesses describe a unit that way, they do not infer that this business is underperforming, because that is often the assumption made. Often it is more a case of a business lacking strategic alignment or sufficient scale for the parent, but actually having significant growth potential.

Boyers: Once a company has decided on strategy of divestment it needs to make sure the assets in question are in a position where they can be marketed. Can they stand alone? Can they be stripped out of central overhead structures, central reporting structures or head office structures? Do they have an independent business plan that can be sold to buyers? Is its own management team strong enough? These questions have to be addressed if the seller wants to get on the front foot and achieve full value and attract plenty of interest. There is nothing worse than a business deciding to sell, publicly starting a process and then failing to complete it.

FW: What strategic considerations does a business need to make when evaluating a potential demerger? What are the key risks and possible downsides?

Longfield: Deciding where the company wants to play in future is probably the most strategically important point, as is identifying where something that might be non-core to the business could be core for somebody else. That is how you create value. Scale is an interesting issue. Decisions might be delayed because management considers 'bigger is better', where in reality the ability to reinvest the capital from a business that has been sold represents a greater opportunity. Lastly, I would say there is always 'execution risk'. There is a lot of work that needs to go into separating a business. Making sure sufficient work has gone into the process is really important.

Kjaer: The most common mistake we see is an underestimation of just how complex separating a business is. Generating realistic numbers is the first struggle. Businesses are extremely difficult to carve out because they have never really existed on their own before. So you have to estimate how much it would cost to create a standalone IT department, for example. And you need those numbers because, eventually, you are going to IPO or sell this to somebody else and the first thing everyone wants to know in order to value the business is how realistic your numbers are.

FW: Could you highlight any examples of demergers which illustrate the value creation aspects of the process? To what extent can they be used as a tool to boost shareholder returns?

Thakkar: PE absolutely loves disposals from a value-creation perspective. Often a business might be the unloved second cousin as part of the seller group, and so management are not incentivised, the business is underinvested, the business has not been a core focus, costs are likely not to have been optimised, and potentially the business would be looking to new ideas – markets, customers, products and opportunities – to rekindle growth and incentivise management. In these cases, there would be a detailed business review for value creation and this would drive a heightened culture and more focus on KPIs and delivery of those. The reason PE likes a 'primary' deal from a corporate is often there is more low-hanging fruit available than in a business that has been owned two or three times by PE already. From a seller's point of view, you need to consider a few things. First, the type of demerger – is it a complete sale, a full listing, partial IPO or sale? Second, the key reasons for the demerger – is it non-core? Is the division not valued properly by the market as part of the overall group? Is large investment required to grow or fix the business? Is the business underperforming? Third, who is driving this sale - this could be management as part of overall portfolio management, activist shareholders agitating change, other shareholders or potentially the need for cash to fund another acquisition.

Kjaer: This is actually relatively straightforward in the US if the new entity is going to be listed. When a company is the result of a demerger, it is given a 'signal' and this can be tracked separately. We tracked a number that were demerged maybe a year and a half or two years ago, and interestingly, in that time all these companies delivered around twice the value of the wider stock market. Unfortunately, that is much harder to do in Europe. The tracking is more difficult and there are fewer spin offs.

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Nicola Longfield
KPMG in the UK

I am pretty sure that you would see similar levels to those in the US though. Why? Well, you can create value by simplifying a company, such as having a simpler back office and prioritising one product category, for example. So you create value in the revenue side because you give priority and value to cost savings, because you can create a much more simple business than the previous one.

FW: How much of today's demerger activity is as a result of shareholder activism? How would you characterise the extent of the influence activists wield over the separation of business entities?

Thakkar: Shareholder activism is on the rise and the majority of activist investors and their funds originate in the US. Their interest and influence in Europe has been growing as these US funds seek new opportunities. Their direct influence on demerger activity is difficult to quantify but where they have agitated as a shareholder, they have contributed to changes to, or scrutiny of, company strategy. Some high-profile situations have caused management to publicly defend or justify their strategy, or in M&A situations, they have contributed towards seeking better terms, or stopping a deal altogether.

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KPMG in the UK

It has also had a ripple effect as management teams not yet dealing with an activist investor might proactively scrutinise their strategy and portfolio to mitigate the danger of attracting the attention of an activist.

Boyers: Somebody can take a position, vote themselves onto the board, and then start to dictate strategy. The result is often a total change in strategy rather than a short-term transaction, but the latter does happen, particularly in the middle-market. In the larger corporates, the level of governance means that an active investor can only work at a certain pace, so often you end up with a change of strategy rather than a forced sale of a business.

FW: What essential advice can you offer to companies on planning and executing a demerger that successfully delivers value for shareholders?

Kjaer: I think companies should start early, really early, as soon as an idea comes up. Decide what is in and what is out of scope from the outset. Say you are demerging a desserts business, does that include your ice cream unit? Baked goods too? It is surprising how many businesses fail to answer those kind of questions. And do not underestimate the work involved in generating realistic projections. I see a lot of demergers from the buy side and most of the time we get numbers that simply are not credible. They are not well-prepared and that complicates valuations. Start planning for the actual separation straight away because it is a lot of work and it takes an enormous amount of energy. But the shareholder value you will create as a result makes every hour worth it.

“ Do not underestimate the work involved in generating realistic projections. ”

Ina Kjaer
KPMG in the UK

Boyers: You need to understand clearly the different stages involved. The first is to get the core strategy right: making sure the business understands exactly what the future focus is and the resources it needs to achieve that goal. It is then a case of reviewing and properly understanding the market in which the divested business will be sold. That might be a process that you have to repeat several times if you are selling several businesses. Each one needs to tick boxes: a strong management team; the ability to stand alone; a clear business plan for its own growth; and making sure it has an identity that works for the appropriate kind of investor, whether that be private equity or investors in an IPO. Also, are you targeting a straight listed demerger, or marketing the business towards particular strategic buyers? Whichever route you go down, you need to do so in a way that maximises competitive tension

FW: In your opinion, what is the outlook for demerger activity in the months ahead? Do you expect this strategic option to gather momentum?

Thakkar: We see a buoyant deal market which will continue over the next few years. While executives tend to crave certainty and stability, experience tells me it is actually volatility and uncertainty that inject impetus into deals – and the one thing I do not see coming down the track over the months ahead is calmness and tranquillity.

Longfield: We are going to see a continuation of this type of activity because a number of businesses either have quite wide portfolios or have been looking to shift their portfolios over time, whether that be in terms of segments or brands.

Bott: We expect divestments to pick up further. There is a lot of market uncertainty at the minute, but the fundamentals that are driving disposal and demerger activity – shareholder activism – is not going away. I think we will see continued activity throughout 2018 which will probably be up on last year.

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This article was repurposed from Financier Worldwide's [‘Creating value through demergers’](#).

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