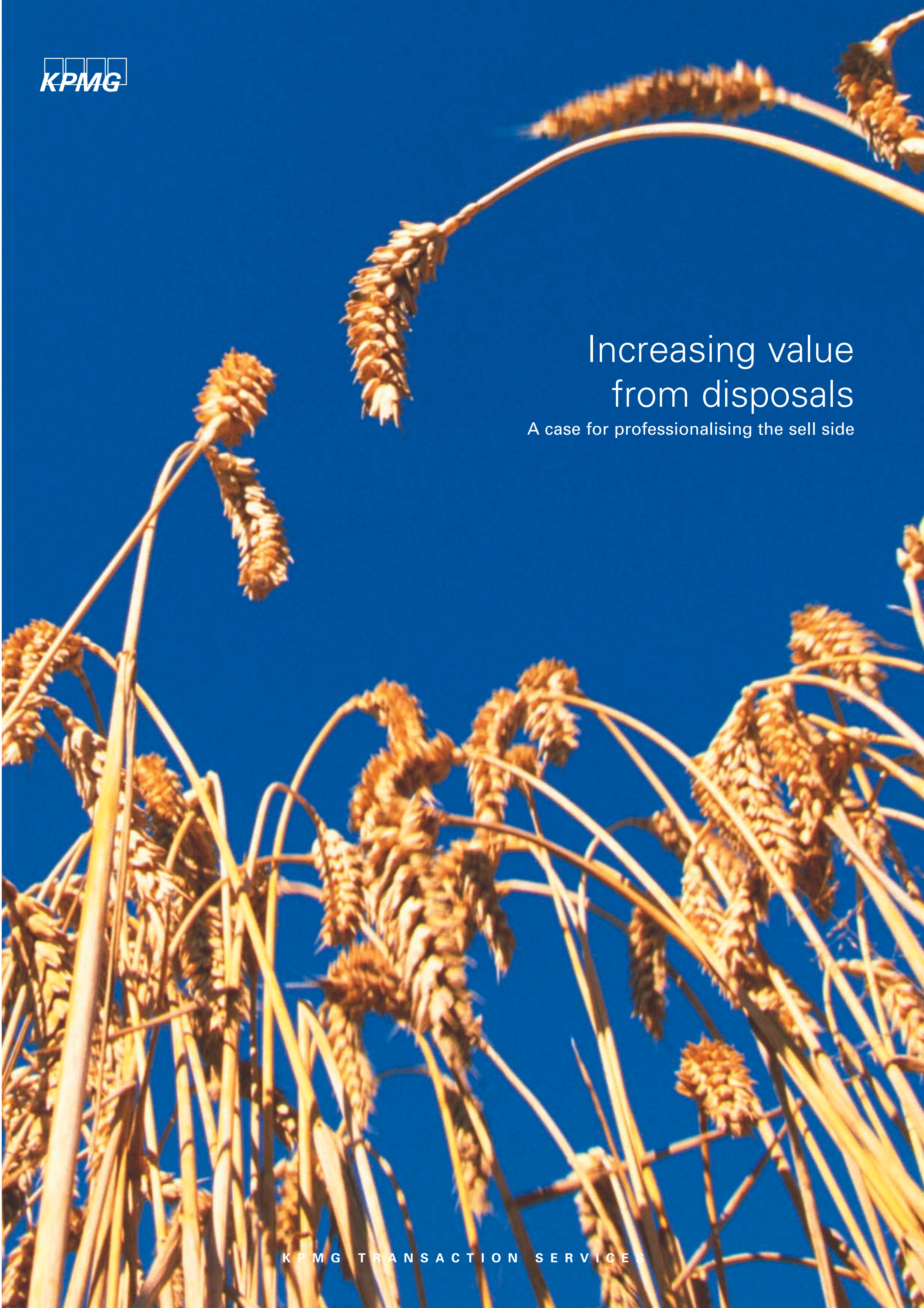


Increasing value from disposals

A case for professionalising the sell side

KPMG TRANSACTION SERVICES

Key insights

Recent years have seen a widespread improvement in the acquisition processes of purchasers. Our *Beating the Bears* survey in 2003 suggested that 31 percent of deals reduced shareholder value, a considerable drop from 53 percent in our 1999 survey. The increasingly sophisticated approach by purchasers, the prevalence of private equity (PE) buyers and the recent difficult mergers and acquisitions (M&A) market all place increased demands on vendors and make achieving a successful sale more challenging. How have deal-makers upgraded their sales processes in response and how can they deliver better disposals?

This survey investigates disposal practices in Europe and highlights a number of areas for possible improvement.

The majority of corporate decision-makers now regard disposals as an integral part of corporate strategy and are increasingly adopting the portfolio approach long practised by PE houses. Indeed 43 percent of those surveyed predicted that the annual number of disposals in Europe would increase over the next two years.

A common misconception, however, is that buyers face most of the challenges in a transaction. In fact, divesting a business is as complicated and resource-intensive for the seller as the acquisition is for the buyer. Vendors often have only one chance to get it right, as once the selling process has started, businesses can frequently become destabilised.

The majority of our respondents outlined some degree of formal process to support their disposals activity but this process often appears to be ill-defined or inconsistently applied. Areas where the approach to disposals can be improved include the importance of the vendor identifying issues in the business prior to prospective purchasers, the need to commit sufficient and appropriate resource to the process, the need to try to ensure the value in the business is not eroded by rumour and uncertainty and above all, setting a detailed and realistic timetable for the disposal process.

This survey confirms the consequences of failing to rise to the challenge. Over a third of respondents suffered value leakage by a reduction in bid price during the disposal process. In fact, 35 percent of our respondents completed their most recent disposal at a price significantly below (20 percent on average) their own valuation and expected selling price. The results show that value erosion is closely associated with delays in the process – and decision-makers acknowledged that delays were one of the most common problems they faced when implementing a disposal.

However, value erosion does not end with agreement of the final price. Post-transaction problems are common, with almost 60 percent of our respondents claiming that they had significant value issues to deal with after the deal had completed. Managing the post-disposal transition, unforeseen warranty and indemnity claims, tax consequences and higher than expected deal costs were top of our respondents' lists.

The survey also highlights some interesting differences between corporates and PE houses, most notably that PE houses place greater importance on providing bidders with information on the future opportunities of the business to be sold. This may explain a significantly higher percentage of PE houses than corporate respondents claiming to have achieved a higher price at the preferred bidder stage than the initial valuation.

This survey's findings provide a clear case for further professionalising each stage of the disposals process to respond to the increasing effectiveness of purchasers' acquisition processes.

The survey

The purpose of the survey was to identify current approaches and practices adopted during the disposals process, highlight problems commonly encountered by decision-makers and outline potential strategies. The survey's findings are based on telephone interviews with M&A decision-makers in 155 leading European corporate organisations and 50 PE houses. We supplemented this research with a selection of in-depth qualitative interviews. All the research was carried out by TNS Financial & Professional Services. We are very grateful to all who participated.

Summary of findings

Attitudes to disposals

- The majority of decision-makers regard disposals as an integral part of corporate strategy with almost two-thirds of corporate respondents and over 80 percent of PE respondents asserting that disposals are given the same priority as acquisitions.
- Improving profitability and emphasising core business were the main reasons given by corporate decision-makers for considering disposals. The main reason among PE houses was, not surprisingly given their business model, the opportunity to achieve returns on the most favourable terms possible.
- Two-thirds of both corporate and PE respondents had considered alternatives to divestment. Restructuring was the most favoured alternative for corporates, while the preference of PE houses was refinancing.

Perceived success factors

- Both corporates and PE houses emphasised the importance of finding the right purchaser, maintaining control over the process and minimising value leakage.
- While the majority of respondents said that it was important to have a process to manage these objectives, and stated that such a process existed in their organisations, there was little consistency on what it should comprise of or how it might be applied.

Disposals performance

- 35 percent of respondents completed their most recent disposal at a price significantly below their own valuation and selling price.
- Delays in the process were the principal problem encountered by both corporate and PE vendors. Despite this, only 39 percent of corporate respondents and 34 percent of PE respondents regarded minimising the time-frame of the transaction as extremely important.
- Managing the post-disposal transition was identified by almost 40 percent of corporates as the most likely problem to arise following completion of the deal. Perhaps surprisingly, given that M&A activity is a core part of their business process, over 60 percent of PE houses identified higher than expected deal costs as the biggest problem.

Differences between corporates and PE houses

- The two groups had very similar attitudes in terms of the goals pursued through the deal and belief that the transaction should be supported by a process.
- PE houses appear to perform better than corporates in realising the upside on disposals, with 42 percent claiming to have achieved a higher price on their initial valuation at preferred bidder stage, compared with only 19 percent of corporates. This may reflect their status as serial deal-makers and the clear focus on maximising investment return, not least given the personal stake the key deal-makers may have in the business being sold.
- There is a much stronger consensus view of the key motivating factors, risks and opportunities of the disposal process among PE respondents to our survey than among the range of corporate respondents. While this, no doubt, in part reflects the wider range of business models and strategic imperatives among our corporate respondent base, the apparent higher success of PE vendors to realise value upside suggests that corporate vendors can learn from PE houses in managing and packaging businesses and people to deliver successful disposals.

Attitudes to disposals

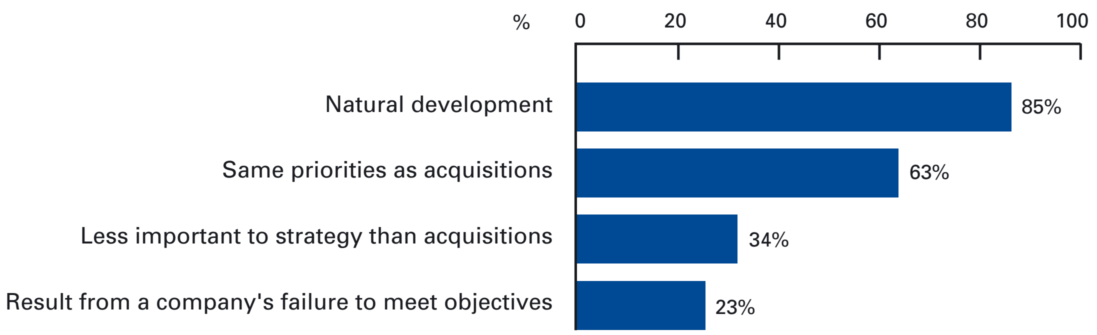
An integral part of corporate strategy

The majority of corporate decision-makers surveyed regard disposals as an integral part of corporate strategy, rather than as a consequence of the business failing to deliver results for the group:

'They tend to fit in with a plan rather than being ad hoc. We aren't in the business of buying and selling companies. We will sell something only if we think that it doesn't fit strategically.'

A significantly higher proportion of PE respondents (82 percent) than corporates (63 percent) said that disposals received the same priority as new investments. This is not perhaps a surprise given the business model of PE houses but the quantum may, in our view, be a reflection of PE houses' need to work harder to achieve exits given current market conditions.

Attitudes to disposals – corporates



Rationale behind the decision

Disposing of marginal, unprofitable or strategically incompatible businesses, increasing shareholder value and improving competitive position were the goals cited as most important to the corporate decision-makers participating in our survey:

'We have a very clearly defined programme to dispose of non-core assets, having identified what our core strategic assets were and our strategic direction.'

'The overall strategy is focusing on the core areas. That means freeing up capital and making use of it to invest in core areas.'

Not surprisingly, the most important reason quoted by PE respondents reflected the requirement to exit and achieve realisations on the most favourable terms possible.

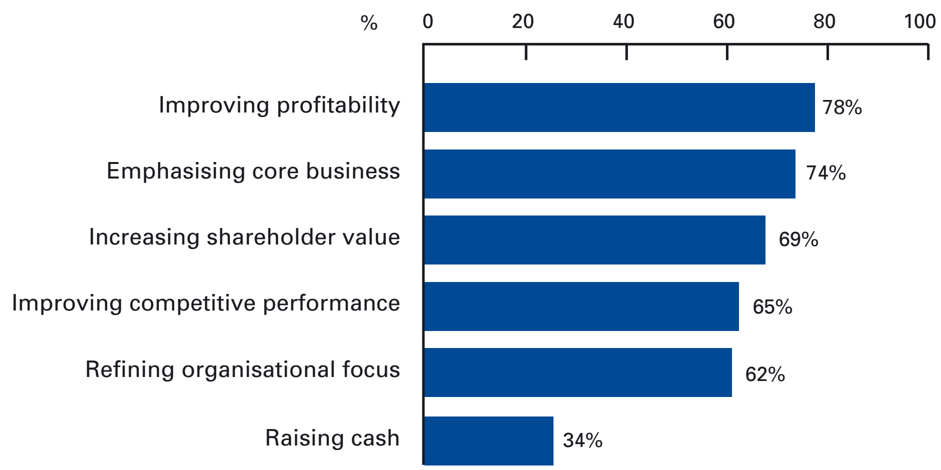
Interestingly, attitudes to disposals among both corporates and PE houses appear to be converging. Corporates are increasingly adopting the portfolio approach long practised by PE houses and fund managers. Even where such an approach has not been formalised, many corporates are now regularly looking at how the businesses within the group fit together strategically; some go so far as to set targets for portfolio renewal or replacement each year:

'It's part of normal business planning, not an unusual event. There's a greater emphasis on portfolio management and trying to cut out the tail performers, and doing that on a consistent basis across the organisation.'

'Disposals are a fundamental part of managing the portfolio of businesses. There is a continuous process of regenerating the portfolio, reinforced by the capital allocation process.'

The greater upside value achievements claimed by our PE respondents suggest, however, that corporates have not yet necessarily extended this convergence to the point of effectively grooming businesses for potential future disposal.

Strategic disposal objectives – corporates



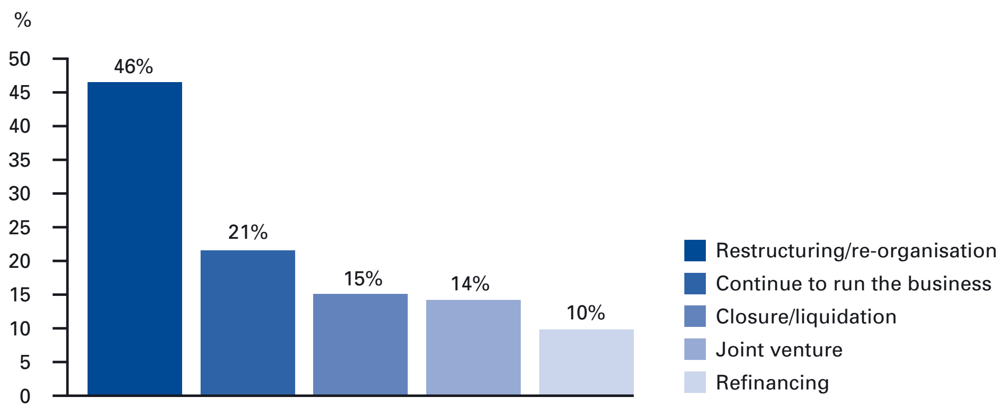
Alternative options

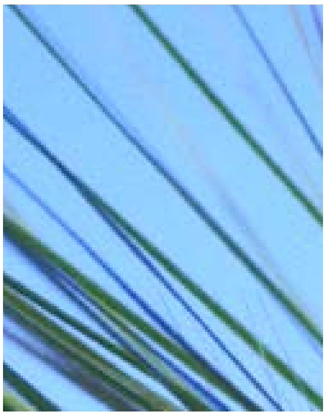
Two-thirds of both corporate and PE house respondents have considered alternatives to divestment. Among corporates, restructuring is the most favoured possibility. Among the PE respondents, 52 percent identified refinancing as the main alternative if a straight exit was not a viable option.

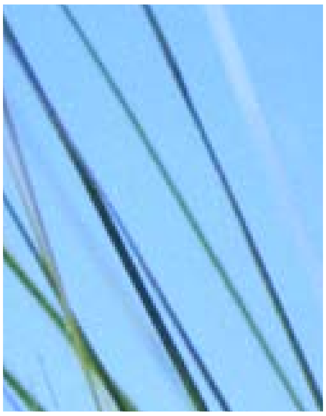
The extent to which alternatives are considered may depend on expectations of the number of likely buyers. Decision-makers may pay more attention to potential alternatives if they believe that obstacles could lie in the path of a successful disposal:

'If you are selling an asset in a liquid market and you know there's going to be 20 buyers lined up, you won't spend much time on alternatives. If we're concerned there may not be many buyers, then we may be evaluating the alternatives in more depth.'

Alternative options to disposal – corporates







Confirming the decision

Decision-makers will take into account a number of factors before pressing ahead with a disposal. These include making a candid assessment of whether the profit and growth figures are realistic, what the maintainable earnings of the business are, how much the business is likely to be worth to potential bidders and whether the business will attract sufficient interest at the right price:

'We always look at what it's worth to us and if anyone else could replicate the infrastructure that we've got to make that asset worth that much. We don't sell unless we think there's a very good chance of getting the right price.'

In our experience this is a critical phase. Once started, a disposal process is very difficult to stop. In this context vendors correctly focus on identifying the right potential bidders and keeping the competitive tension going. However, they sometimes spend less time focusing on the detail that buyers need to value a business:

'Once you have started the selling process the business gets destabilised. If the sale falls through you could end up in a worse position than you were before. So you really want to make sure that you look at the market and that you think there are buyers and that it is a good time to sell. Otherwise it may be worth waiting and not spreading the news that you are considering selling the business, and wait for better times.'

In reaching a conclusion, respondents emphasised the need to be as objective as possible:

'It is important to perform a very dispassionate evaluation, which is why we do it from the centre rather than in the business, such that we are being realistic with our forecasts and not over- or under-cooking it.'

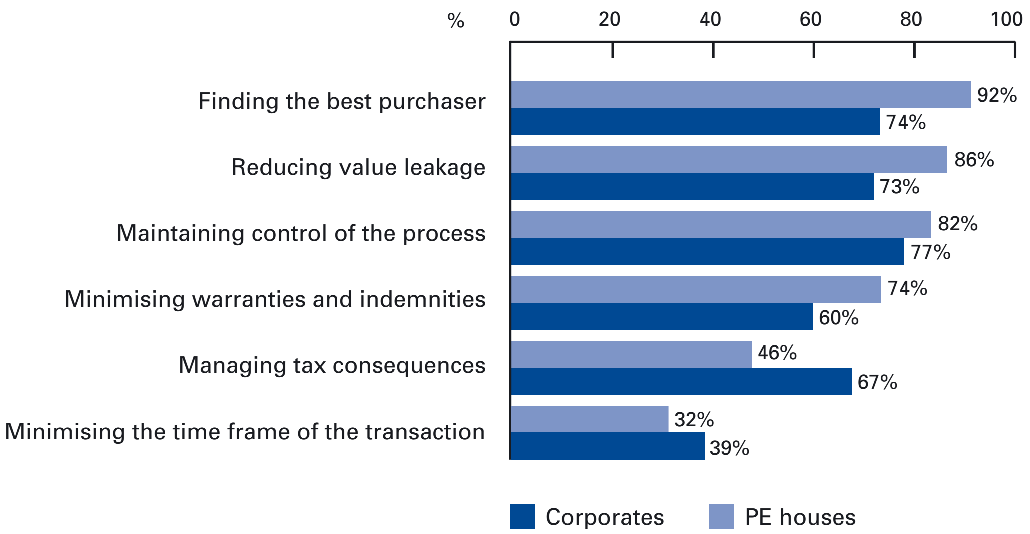
Perceived success factors

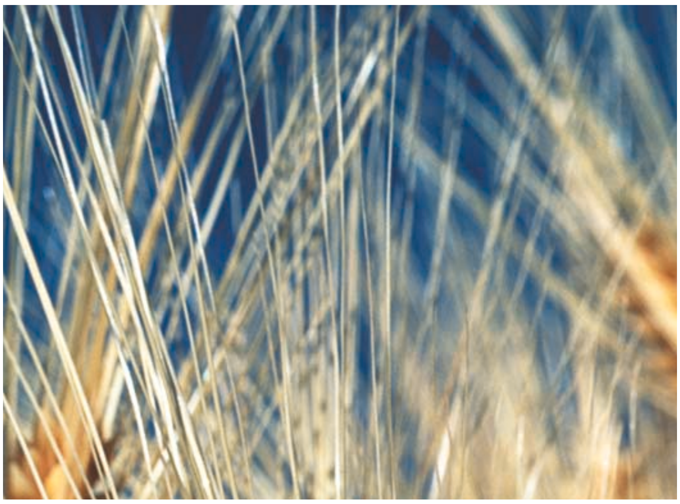
Tactical goals

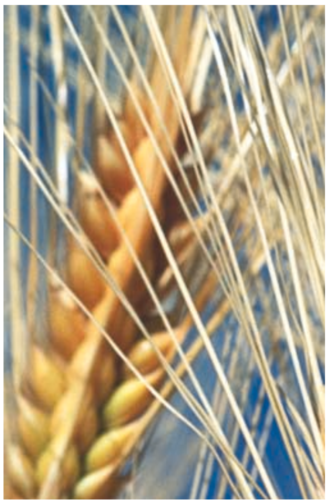
After a disposals strategy has been agreed, objectives for the actual process must be set. Our survey identified the most important tactical goals for both corporates and PE houses as finding the right purchaser, minimising value erosion and maintaining control over the process. The findings of the survey support our belief that disposing of a business is a complicated process; there are a number of important steps which the vendor needs to get right to ensure a successful outcome.

KPMG's UK PE team suspect that the low priority given to managing tax consequences by PE houses reflects the fact that potential tax issues will on the whole have been considered at the time of the acquisition to try to ensure there is a clean exit.

Tactical goals







Survey participants were also asked to what degree various activities in the disposal process presented an opportunity or risk for financial or strategic advantage. The results show an interesting difference between corporates and PE respondents. While both agreed that 'identifying potential purchasers' and 'negotiation' presented the best opportunity for financial or strategic advantage, PE houses thought these opportunities to be significantly higher than did corporates.

PE houses also identified the valuation phase as providing more of an opportunity for financial or strategic advantage than corporates. In our experience PE houses require significant amounts of information to enable them to build up a detailed valuation model for the business. As such they recognise the importance of this to purchasers when they are disposing of investments in their portfolio:

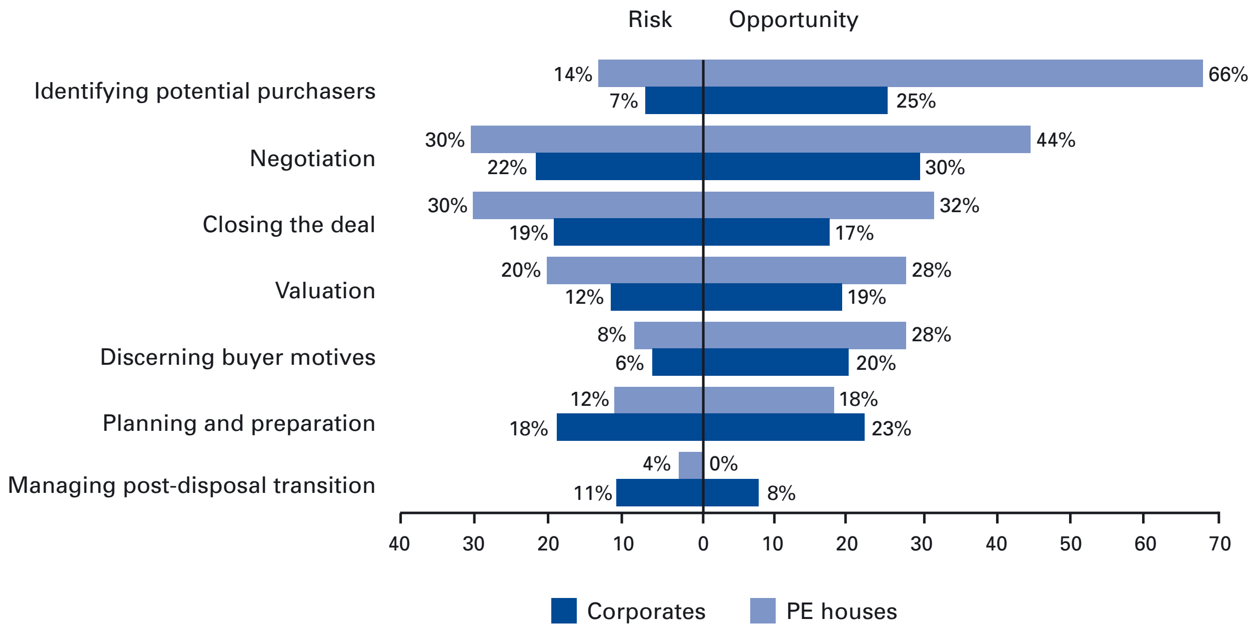
'If you have a poor, sloppy or uninformative valuation, then you're going to have a real problem because you're setting expectations either too high, and the deal will not happen as it should happen, or you're going to leave a lot of negotiation around the table.'

'If you [the vendor] don't do due diligence well, you're going to have assumptions in your valuation that could be way off – or you're going to go to market with a deal that has problems that you don't know about until the buyer brings it up – and that's going to hurt.'

The higher importance placed on the planning and preparation phase by corporates may reflect the sales process starting immediately following the decision to exit, compared with the longer-term exit planning possible for PE houses. It may also reflect previously limited group management focus on a non-core or geographically remote subsidiary business.

Interestingly, two of the three principal opportunities of the disposals process (i.e. negotiation and closing the deal) also represented the greatest risk in the process. This supports our view that disposing of a business is a finely balanced process in which it is critical that the vendor achieves its objectives at all stages of the transaction.

Opportunity and risk



Approach to the process

Respondents believe that having a process for managing disposals imposes valuable disciplines:

'There really is an effort here to create a consistent process around the [disposal] programme.'

'If you don't have a formalised process, too much can go wrong and things can slip through the cracks.'

However, while the majority of respondents claim to have a process in place, the definition of process and its applications varied significantly between (and within) organisations. For example, some companies applied a process only for deals above a certain threshold. In others, the process was mandatory for some business units, but voluntary for others. The process may or may not involve an auction or the use of external advisers, and may or may not be formally documented:

'This area of expertise here in central M&A is not imposed on businesses. It's a voluntary relationship.'

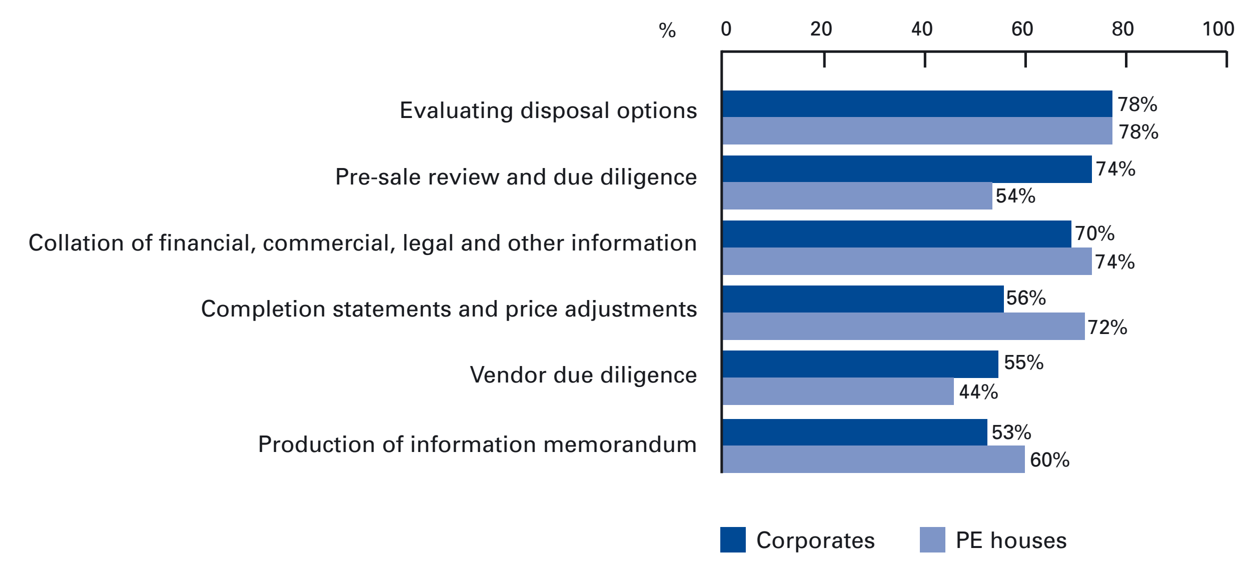
'You can always improve the process. One area that I don't know if there is always sufficient independent challenge to is the valuation.'

Who the buyer is will also have an impact on the process. It was generally agreed that financial buyers take a lot longer to do their due diligence and that the information requirements are different. For example, financial buyers, who are likely to be raising debt finance as well as making an equity investment, may require more detailed information around cash flows to enable them to 'bank' the deal:

'If you're a strategic buyer, you can just make the call. You'll just slot it into your business. If you're a financial bidder you need to understand the sales force requirements, the routes to market etc. The two processes can be very different.'

An added complexity is that given the current environment the information requirements of corporate buyers are increasing, both to meet the demands of debt providers in leveraged transactions and, in the case of SEC registrants, to enable them to meet their internal control and reporting requirements.

Critical elements in the disposals process



When respondents were asked to identify critical elements in the process a less clear picture emerged, although both corporates and PE houses agreed on the importance of clearly evaluating the disposal options.

Corporates identified pre-sale review and due diligence as more important than did PE houses. In our opinion this reflects in part the fact that PE houses are preparing for the exit from the time of the initial investment and are more likely to have an understanding of, and deal with, many of the likely disposal issues well in advance of the 'sale' or 'auction' process. In contrast to this, corporates may be disposing of non-core or overseas subsidiaries; as such, group management may not have a clear understanding of the likely risks and opportunities at a detailed level, inherent in disposing of the business.

Over half of corporate respondents thought vendor due diligence was a critical element in the disposal process. However there were mixed views on the benefits vendor due diligence provides:

'Vendor due diligence ensures you take the business to market with no surprises.'

'I think that it is a flawed concept. The buyer may be buying the business for different reasons to what the seller thinks.'

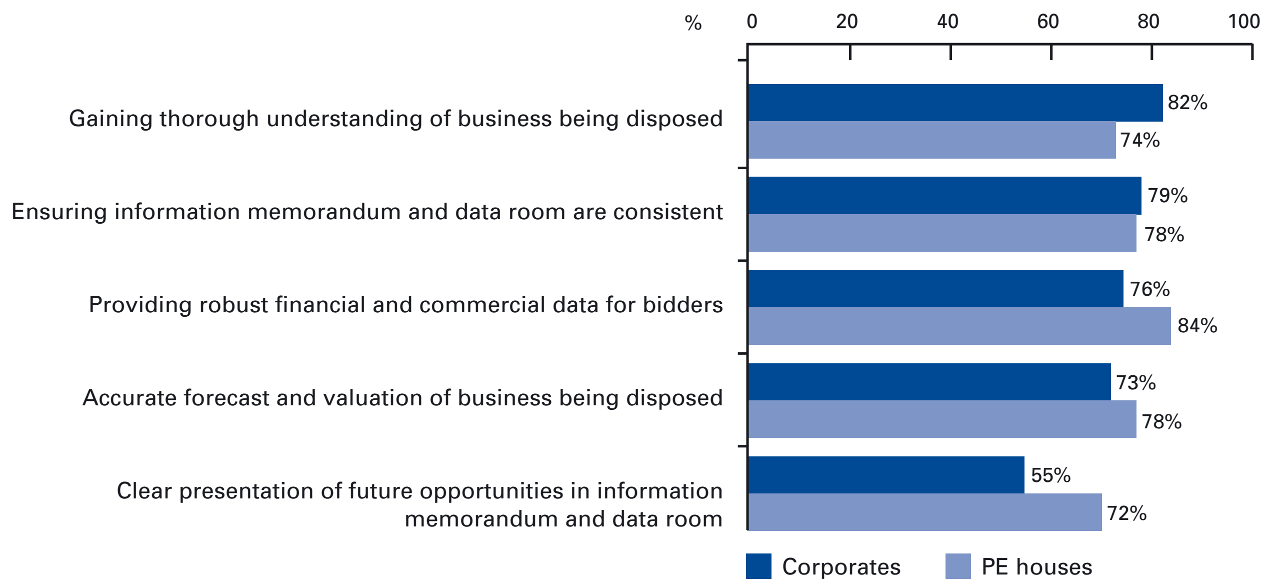
In our experience vendor due diligence is a useful tool in certain disposal situations. The key benefits to the vendor are the ability to remain in control of the process, have an early warning of issues likely to cause concern to bidders and to maintain maximum competitive tension. Vendor due diligence can also provide vendors with a mechanism to corroborate key value messages.

Corporates and PE houses had substantially consistent views on the most important aspects of the disposals process when considered with the benefit of hindsight.

However, PE houses placed greater importance than corporates on the need to provide bidders with information on the future opportunities in the business. This may help to explain why PE houses appear more successful at realising the upside in deals; 42 percent of PE house respondents claimed to have achieved a higher price at preferred bidder stage than at the time of the initial valuation, as opposed to only 19 percent of corporates. However, this is also likely to reflect that the key deal-makers in PE houses often have personally invested in the company being disposed and therefore a clear incentive for maximising the proceeds achieved.

Our experience accords with these findings. Vendors should assess bidders' due diligence requirements, and collect, or if necessary create, a set of data that can clearly address these issues. For example, if the budget or projections include the launch of a new product or entry into a new market, objective market research or information from external sources could be included to support this. If synergies are critical, it would be important to work out which areas would be relevant and provide information or analysis to allow bidders to quantify both the benefits that may accrue and the costs that must be incurred to realise the benefits.

Important aspects of disposals process with the benefit of hindsight



Disposals performance

Problems during the sales process

We asked corporate and PE respondents to identify the problems they had experienced during the sales process.

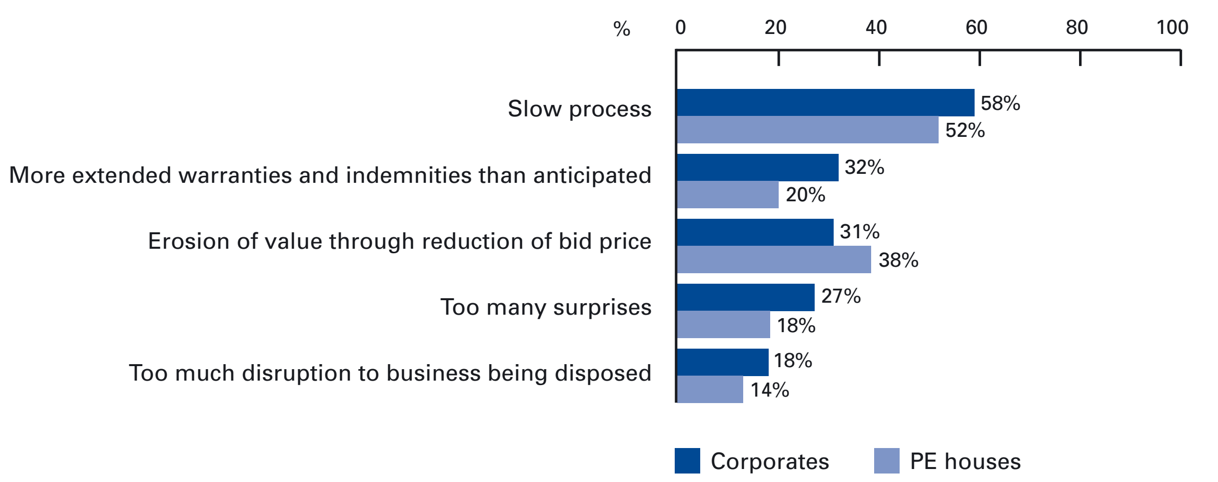
Perhaps the most important finding here is that, if corporates and PE houses are taken together, over a third of respondents suffered value erosion by a reduction in bid price during the disposal process. In fact, 35 percent of our respondents completed their most recent disposal at a price significantly below (an average of 20 percent) their own valuation and expected selling price.

The survey also suggests that a loss of control over the timetable will often lead directly to value leakage. Given this correlation it might seem surprising that only 39 percent of corporate respondents and 34 percent of PE respondents regarded minimising the time-frame of the transaction as extremely or very important. However, this accords with our experience where often the importance of keeping tight control of the timetable can be overlooked in favour of other less important areas.

So why do such issues arise? In our view buyers have become increasingly sophisticated in their approach to M&A. They often have a host of advisers to give tactical and strategic advice and carry out due diligence. Needless to say, these advisers will have hundreds of questions about a business.

Unless these questions are addressed at the outset vendors can lose control of the selling process. For example, we were recently brought in to assist in resolving a sale which had already been running for nearly eight months (and was eventually resolved after 14 months). The corporate vendor had pulled together data from the management accounts and assumed this would be sufficient to support a deal, but did not understand the (financial) buyer's requirement for additional information to support bank financing. It took time to convince management that this information was needed, and they then had to go back to collect information from the subsidiaries being sold. The impact of the delay and uncertainty, and identification of key issues late in the

Problems identified during the sales process

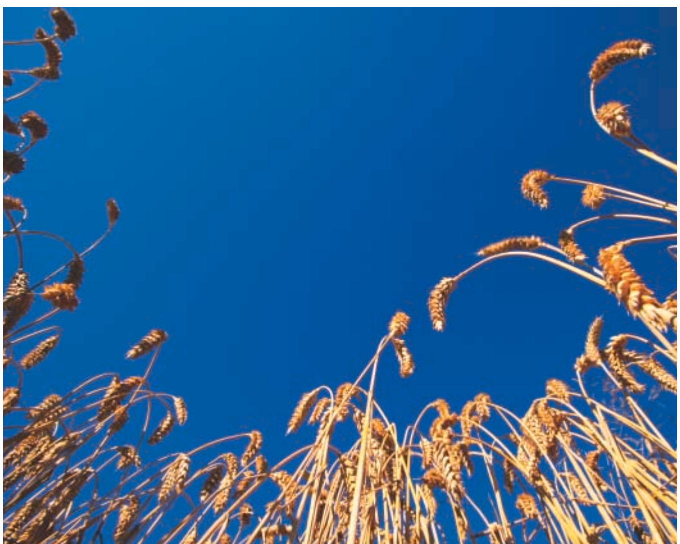


process, significantly impacted the price achieved. A disposals process which becomes unduly extended is likely to destabilise the business, as a result of reduced management focus, employee demotivation and customer insecurity. For example, a cultural split can occur internally when parts of the business know they are being sold. It can also lead to buyers starting to question the quality of the information they are receiving. Taken together, extension of the deal timetable can only undermine the vendor's negotiating position.

In addition to the importance of thorough planning and preparation, restricting information is rarely, in our opinion, a good approach. Clearly there is a balance to be struck between confidentiality concerns and achieving full value through early disclosure. The purchaser's advisers will take the most pessimistic view if they do not have all the information – so if possible it is better to show the real position early in order that it is factored into bids when competitive tension is strongest:

'Try and do as much prep upfront as possible. Do not underestimate the value of doing all your internal due diligence first and the amount you'll learn and understand about your business. Get all your bad news out upfront. Don't pretend it's not there because it's going to come out.'

A relevant example of this is pension funding – increasingly a significant issue. Vendors are often silent on their proposed treatment of this at the outset. The likely result is that each bidder proposes a different approach and the vendor sacrifices the initiative. Instead, bidders should be told from the start what the pensions funding position is and how it will be dealt with in the contract, the aim being to push more bidders to assess the value in a similar way, and as far as possible remove the issue from the discussion.



Problems after completion of the sales process

Factors which may reduce the value of the disposal to the vendor also arise in the post-transaction phase. We asked the same group of respondents which problems they had experienced following completion of the transaction.

In some areas the erosion of value arising from these issues is difficult to quantify – such as disruption to group management or loss of reputation. However, several of the issues identified during the post-transaction phase, including higher deal costs, unforeseen warranty or indemnity claims and tax consequences, are likely to have adverse financial consequences.

The biggest issue identified by corporates was managing the post-disposal transition. This is not surprising given that it did not feature in the tactical goals identified at the outset and was identified by only eight percent of respondents as presenting an opportunity for financial or strategic advantage. In our experience this is an area that is not given sufficient attention at the outset and is often left to the negotiation phase before being given any detailed focus.

An example of this might be the shared service agreements often required in the transition period. Ideally a draft of the proposed agreement would be provided to bidders during the data room phase to ensure all bidders have a clear understanding of what is being proposed so they can factor this into the bid process. However, this is frequently left to the completion phase and results in lengthy negotiations, at which time the vendor may have lost the negotiating advantage it had gained earlier on in the process.

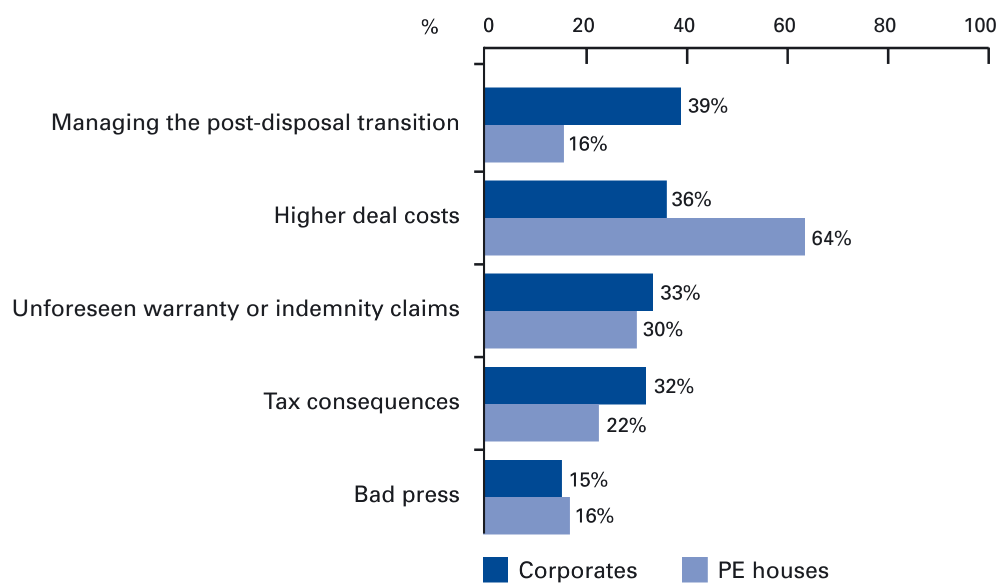
Indeed, we have often seen the details of transition arrangements deferred beyond signing the sale and purchase agreement or even completion, frequently presenting the purchaser with a further opportunity to negotiate additional, and sometimes significant, value from the transaction.

A third of corporate respondents have experienced unforeseen warranty or indemnity claims. This frequently arises when the warranties and indemnities as drafted were not supported by sufficient due diligence by the vendor or were too wide in their scope; disclosure may have been inadequate or limitations on warranties were not effective.

In our view, time and effort spent during the negotiation phase in identifying and addressing potential contractual issues is always more cost-effective than the potentially lengthy, and costly process of dispute resolution after completion of the transaction.

Such results may also reflect the existence of 'aggressive' buyers in the market-place. We have had experience of both corporates and PE houses using or attempting to use warranties, completion accounts and price adjustment mechanisms to alter the deal price retrospectively in their favour.

Problems experienced after completion of the sales process



Measuring success

Our respondents generally saw a successful disposal as one that had achieved its target valuation:

'It's pretty simple. Have you met the target for the cash raised?'

'There isn't a formal process [for measuring success]. Basically as long as you've got a price that's above our keep value and we've actually gone ahead and sold, that in itself is a success.'

But apart from the price paid, there are a number of other factors that were looked at when measuring success. These include speed, avoiding value erosion, disposal costs and managing reputation:

'I think with our experience now, we pretty much know how much these things cost and have that well managed. Speed on the other hand is something that every time we do a deal, we remember how important speed is and sometimes we don't do it as fast as we could.'

'At the micro level, the indicators are time, value and cost. Assessment is made in relation to the initial project predictions.'

This rather haphazard measurement contrasted with the increasingly professional approach adopted by acquirers. In *Beating the Bears*, we found that 79 percent of acquirers set financial and strategic criteria to evaluate whether the deal would meet strategic objectives.

Increasing value from disposals

Agenda for action

Organisations that are successful in making disposals a cornerstone of corporate strategy give these transactions the same attention as they would mergers or acquisitions. In our opinion key areas of focus to professionalise disposals include:

Strategic assessment

- Validate the selling opportunity and likely market for the target before commencing the process.
- Conduct a pre-sale review and carry out sufficient due diligence on the business.
- Assess alternative options to the disposal process and the pros and cons for each of these.

Preparation and planning

- Establish a realistic timetable and set clear objectives by which success can be measured.
- Assess bidders' requirements up front and, allowing for commercial sensitivities, provide as much information as possible to allow bidders to put a value on any upside in the business plan or potential synergies.
- Produce a credible and dispassionate valuation which can be substantiated with detailed information.
- Consider HR aspects including how to keep employees motivated/incentivised throughout the process.
- Give early consideration to drafting of shared service arrangements including the establishment of transitional management arrangements to protect the vendor's interests.

Value preservation

- Keep tight control of the process and the timetable.
- Package bad news up front, in order that bidders value it in the same way.
- Monitor the value and timing of a disposal at board level – it is not a process that can be delegated.

Completion

- Be aware of what can go wrong after the deal is signed and incorporate this into the drafting of the sale and purchase agreement.
- Perform sufficient due diligence on warranties and indemnities to be provided.

Post transaction

- Conduct a formal review of the process to determine whether objectives have been met and capture key learning points for future disposals.



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