Valuation of Spin-Offs and Divestitures

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Following the frenzy of merger and acquisition activity of the last several years, the current trend is towards more spin-offs and divestitures as companies rethink the strategic benefits of consolidation. These transactions are often complicated by a variety of issues centering around the entity's transition from subsidiary status to separate company. From a valuation standpoint, these usually necessitate specific adjustments to standard metrics. Moreover, the treatment of these issues on the part of buyers and sellers can impact deal price, timing and even the success or failure of the contemplated transaction.

What Is A Spin-Off ?

A spin-off is a transaction in which at least 80 percent of the equity in a subsidiary is distributed to shareholders of the parent company. While there is commonality of ownership with the former parent immediately after the transaction, usually spin-offs contemplate a divergence of ownership interests going forward. They often involve the spin-off of a subsidiary with strong growth prospects but substantial capital requirements from a more mature, established parent company. Also, changes in the regulatory environment may necessitate the separation of a company's regulated and non-regulated operations. Differences in corporate culture and strategic vision can add to the financial, legal and tax considerations driving the spin-off. Nonetheless, in many cases the spun-off entity will continue to be dependent on the former parent for a variety of services, including sales, legal, accounting, human resources, and research and development.

What Is A Divestiture?

A divestiture is the sale, liquidation or spin-off of a corporate division or subsidiary. Thus, a spin-off is technically a form of divestiture. However, divestitures are typically referred to in the context of the sale of a subsidiary or operating division to either a third party or management of the business to be divested. Unlike spin-offs, these transactions are characterized by arm's length negotiations between buyers and sellers.

Nature of Pre- and Post-Transaction Relationship with Parent

A significant factor that must be addressed is the nature of the pre- and post-transaction relationship between the business to be divested and the parent. A business that has always operated autonomously from the parent will pose relatively fewer spin-off/divestiture specific issues. However, the majority of spin-offs and divestitures fall into one of two other categories: 1) the business will have to transition from some level of dependence on the parent to autonomy, or 2) the business will continue to be dependent on the parent for services/support post-transaction (which is more prevalent in spin-offs). The category into which the business falls largely dictates the spin-off/divestiture specific issues that must be addressed.

For businesses that will transition from dependence to autonomy, the following are important considerations in determining value:

- Is the management team capable of operating a stand-alone entity?
- Will the spin-off / divestiture be adequately capitalized?
- Will the spin-off / divestiture have access to capital?
- Are third party agreements transferable?
- How will services formerly provided by the parent be obtained?
- What is the likely business impact of the separation, including relationships with customers?

For businesses that will remain dependent on the parent, there are other considerations, including:

- Are agreements in place between the spin-off / divestiture and former parent for the use of intellectual property (including patents and trademarks), shared services, rent, and purchases from/sales to the former parent?
- What are the terms of such agreements and are they based on market rates?
- Will the former parent provide financing and, if so, on what terms?
- Who will control the business?

The answers to these questions will impact the company's growth prospects and risk profile. From a valuation standpoint, they will dictate the appropriate adjustments to income, selected market multiples and discount rates, as well as adjustments to overall valuation indications.

Pro Forma Financial Results

The single greatest impediment to most valuations for spin-off or divestiture purposes is lack of reliable pro forma financial statements. More importantly, improper or inadequate financial reporting can undermine a potential buyer's confidence in the accuracy of the represented operating results, possibly resulting in a delay of the closing of a transaction, a lower offer price, or in the extreme, termination of the transaction.

Good pro forma financial statements have two components: 1) accurate reported historical financial statements, and 2) appropriate pro forma adjustments to reflect changes in both the operating and capital structures post-transaction. Ideally, the reported financial statements will be CPA-prepared and separately identify all of the revenue and expenses, as well as assets and liabilities, of the operation to be divested. However, more often than not, the financial statements will be internally prepared and will not be a completely accurate representation of the financial results and condition of the operation to be divested.

The following are examples of typical adjustments that must be made to reported subsidiary or division level financial results to determine representative income on a post-transaction basis:

- Add back previous charges for parent overhead allocation
- Subtract estimated replacement cost for services formerly provided by parent
- Subtract royalty / license payments to parent for licensed intellectual property post-transaction
- Adjust transfer pricing for purchases from/sales to parent to a market rate
- Eliminate nonrecurring income and expenses

Other Valuation Adjustments

In addition to adjustments to income, the valuation of spin-offs and divestitures often requires adjustments to market multiples or discount rates that are used to capitalize income. Businesses that have yet to prove that they can operate autonomously carry an additional level of risk and uncertainty that may require a downward adjustment relative to the multiples of comparative companies that already operate autonomously. However, not all spin-offs and divestitures warrant such a downward adjustment. There are circumstances where the investor would assume that the unit might perform better as a separate entity because of neglect or mismanagement on the part of the parent. In such a case, a premium might be warranted.

Businesses that will remain dependent on the former parent are also generally riskier and may warrant a downward adjustment relative to the market multiples of comparative companies that are not so dependent. The magnitude of any such adjustments will depend both on the level of dependence on the former parent and the protection afforded by agreements against the loss of critical services. For example, if a unit is dependent on the former parent for the use of trademarks and/or patents for which it has no long-term license agreement, the company may be substantially more risky than a comparative company that owns its trademarks and patents.

In many divestitures, the seller will retain working capital assets such as cash and accounts receivable. If the value of the business has been determined using multiples of companies that have adequate working capital, the amount of the estimated initial working capital investment that will be required must be subtracted from the valuation indications derived therefrom. Also, consideration must be given to whether the transaction involves the sale of stock or assets (in a divestiture) and the related issue of whether contingent liabilities will remain with the parent or be assumed by the buyer.

Conclusion

Buyers, sellers and their advisors should be educated regarding the valuation impact of the myriad of issues that arise in spin-off and divestiture transactions. A proactive approach to identifying and addressing such issues can significantly increase the odds of a favorable outcome to any such transaction.