THOMSON REUTERS
CHECKPOINT™

May/June 2015

Valuation Strategies

After the Breakup—Valuation of Corporate Spinoffs and Divestitures

Bret Tack

Spinoffs and divestitures comprise a large portion of the overall deal market.[1] Independent valuations are often required in these transactions, for purposes that include corporate planning, fairness and solvency opinions, tax strategies, fair value reporting, option pricing, and litigation. Yet despite their prevalence, the valuation literature is practically non-existent when it comes to addressing the potential dangers for valuation professionals in performing spinoff and divestiture valuations. This article seeks to draw on the present author's experience in order to highlight some of the challenges associated with these engagements, and suggest appropriate valuation treatments.

A spinoff is a transaction in which a company distributes shares in a subsidiary to the shareholders of the parent. In a full spinoff, ownership of the spun-off entity is identical to ownership of the parent company immediately after the transaction. However, in most spinoffs it is expected that ownership of the parent and the former subsidiary will diverge on a going forward basis. This usually requires that any post-transaction business dealings with the former parent be on an arm's-length basis.

A divestiture is the sale, liquidation, or spinoff of a subsidiary or portion of the parent company's business. Thus, a spinoff is technically a form of divestiture. However, divestitures are typically referred to in the context of a full or partial sale of a subsidiary, division, business unit, or product line of the parent. Such sales are also commonly referred to as carve-outs.

Reasons for Spinoffs and Divestitures

There are many reasons that a company will spin off or divest a business unit. The number one reason is that the business is not part of the parent's core business strategy.[2] Other reasons for spinoffs and divestitures include:

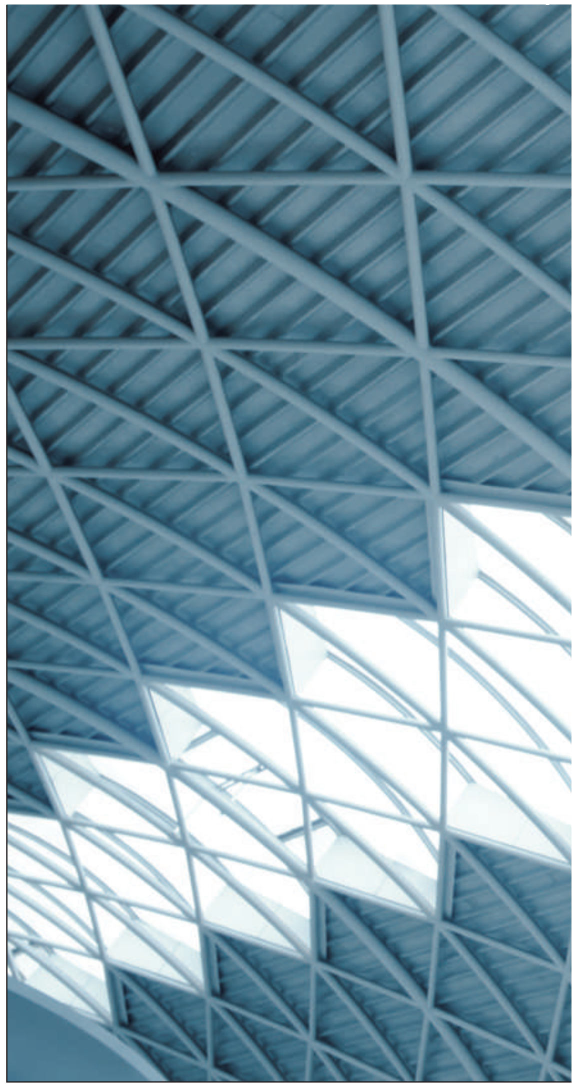
- The parent's need to reduce debt or raise capital (this was a more prevalent reason during the economic recession than it is today).
- Jettisoning an underperforming business.
- Monetizing a business that has strong growth prospects but whose current capital requirements are a drain on the parent's mature, profitable business.
- Regulatory considerations.

Relationship with Parent

The specific valuation considerations to be addressed largely depend on which of the following categories the spinoff or divestiture candidate falls in, relating to its relationship with the parent company and their anticipated future dealings following the transaction:

- *Standalone.* A corporate subsidiary, division, or business unit that has always operated autonomously from the parent company.
- *Dependen*t. A corporate subsidiary, division, or business unit that has historically been dependent on the parent company for services, support, or financing and will continue to require some level of support from the parent post-transaction.
- *Transitioning from dependent to standalone.* A corporate subsidiary, division, or business unit that has historically been dependent on the parent company for services, support, or financing but will need to transition to full autonomy once it has been spun-off or divested.

A standalone business will pose the fewest spinoff or divestiture-specific valuation issues. If the business already has its own dedicated management team; has its own general and administrative infrastructure; owns its own intellectual property; occupies its own facilities; is self-financed; and has always had its own standalone financial statements, it is possible that no valuation adjustments specifically related to the spinoff or divestiture will be required. However,



in the present author's experience the majority of spinoff and divestiture candidates do not fall into this category. Most have historically received some level of support from the parent.

Dependent Businesses. It is common for a spinoff or divestiture candidate to continue to receive services or use the assets of the former parent post-transaction, at least for a period of time. When this is the case, the following issues need to be addressed in the valuation:

- Which services will continue to be provided by the former parent and for how long?
- Are agreements in place between the subject business and the former parent that spell out the terms by which the parent will provide such services, including management and general and administrative (G&A) services? These agreements are typically referred to as either shared services agreements or transition services agreements (TSAs). In some cases they are temporary, though there are transactions in which the shared services arrangement is expected to continue indefinitely.

BRET TACK, ASA, is a managing director at Cogent Valuation and currently manages its Los Angeles office. He has provided business valuation and related financial advisory services since 1985, managing over 1,500 valuation engagements involving businesses ranging in size from small closely held companies to multinational, publicly traded companies with revenues in the tens of billions.

- Are license agreements in place for the subject business to use intellectual property owned by the parent company?
- Are TSAs and license agreements at market rates? What are the relevant terms?
- Will the former parent provide financing and, if so, on what terms?
- How does continuing to be reliant on the former parent affect the risk profile of the subject business?
- Will the divested business use the former parent's facilities? Are there lease agreements in place?

Clean Break Scenario. An alternative scenario is one in which the subject business will be expected to make a clean break from the parent and no longer rely on it for services and support. This poses a different set of issues that must be addressed in the valuation, including:

- Is the management of the subsidiary or division capable of running the business on a standalone basis?
- Will the subject business be adequately capitalized?
- How will services formerly provided by the parent be obtained?
- What is the likely business impact of the transaction, including on relationships with customers?

Valuation Considerations

Like all businesses, spinoff and divestiture candidates are valued based on consideration of three distinct valuation approaches, each of which has multiple variants or derivative methods. These are the market approach, the income approach, and the net asset or cost approach. Primary emphasis in the valuation of operating companies is usually given to the market and income approaches.

In spinoff and divestiture valuations, specific earnings adjustments may be required to reflect changes in the financial and operating characteristics of the subject business resulting from the transaction. The transaction may also affect the subject business's risk profile and growth prospects. These factors will be reflected in the valuation professional's selection of market multiples and required rates of return. Finally, valuation indications from the market and income approaches may need to be adjusted for non-operating assets and liabilities, working capital shortfalls (or surpluses), and contingent liabilities.

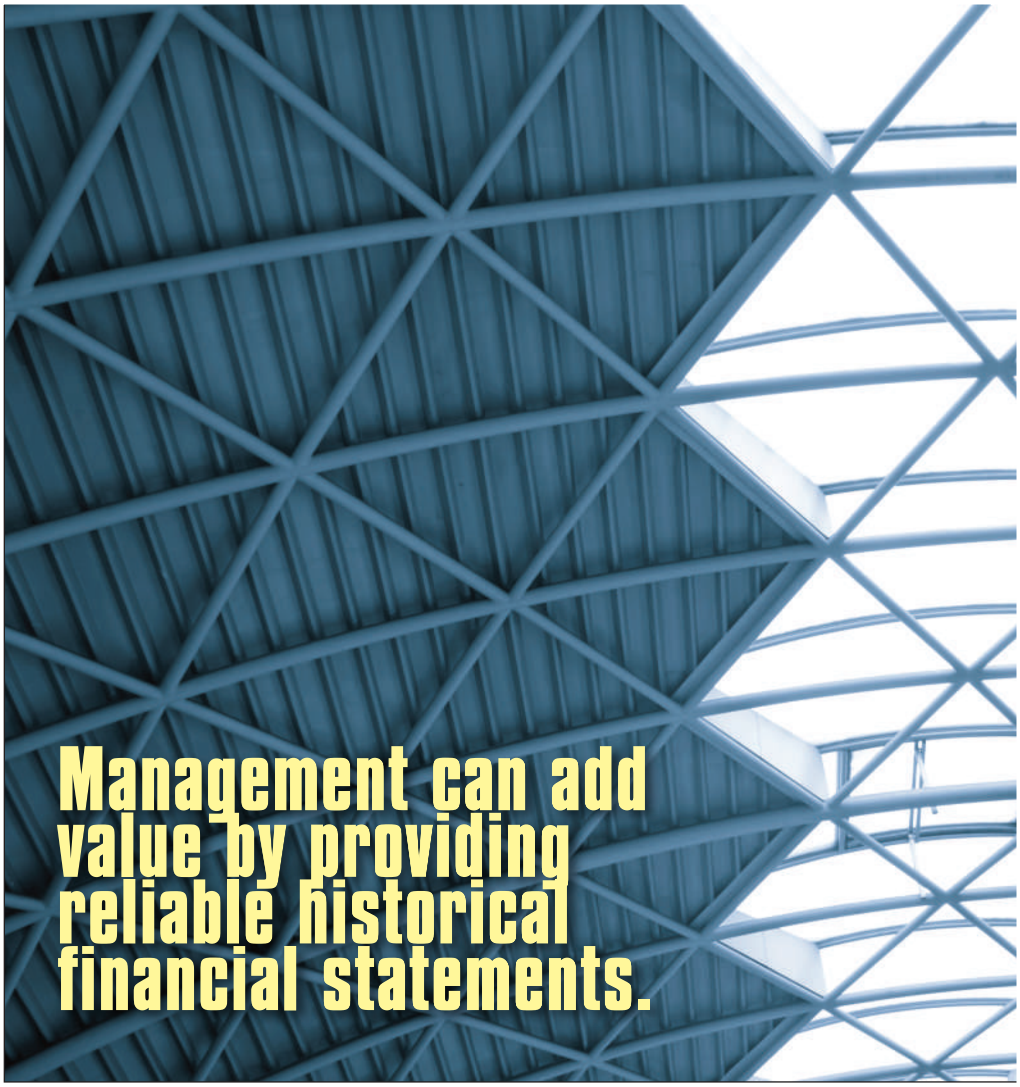
In order to identify specific valuation considerations relating to the spin-off or divestiture, the areas of investigation discussed below should be covered in the valuation professional's due diligence.

Intellectual Property. Often the business being spun-off or divested will have been using intellectual property owned by the parent. This may include trademarks and trade names; patents and technological know-how; copyrights; software code; or proprietary data and content. During the time that the business was a subsidiary or division of the parent, there may not have been any license agreements in place covering the usage of the intellectual property by the business and no license fees being charged by the parent. The valuation professional must first assess who will own the intellectual property used by the subject business post-transaction. If ownership will be retained by the parent (as is common when the parent also uses the same intellectual property), he or she should determine whether license agreements will be in place post-separation from the parent and, if so, on what terms.

While the subject business may receive a royalty-free license from the parent as part of the spinoff or divestiture, often it will be required to pay a license fee for the use of the parent-owned intellectual property. The valuation professional may be called on to determine a market royalty rate for the intellectual property if establishing an arm's-length basis for the license fee is important. If the subject business's historical financial statements do not include a license fee, historical earnings should be adjusted to deduct agreed upon license fees (typically as a per-

1 According to Global Finance magazine, spinoffs and divestitures accounted for 47% of worldwide M&A activity in 2012. See Platt, "M&A: Record Spin-Offs Boost Global M&A," Global Finance (February 2013). It has been estimated that almost $600 billion worth of spinoffs and divestitures were completed in the U.S. in the first nine months of 2014. See Dealogic, M&A Review (September 2014).

2 This was cited as the number one reason for divesting a business by 62% of respondents in Deloitte's Divestiture Survey 2013.



centage of revenues) when calculating representative earnings. The valuation professional should also make sure that the company's financial projections include the license fee. The present author has been involved in spinoff and divestiture valuations where the company-provided financial projections did not include the royalty payments.

It is also important to understand the breadth of the license for the intellectual property as an assessment of both the business's risk and its growth potential. The narrower the license—in terms of either product line, customer population, or geographic territory—the more limited the ability of the business to expand into new areas using the intellectual property. Another consideration is whether the business's rights to the intellectual property will be exclusive within its licensed fields or territories and whether there is a significant risk of the subject business losing its rights to it in the future (for example, for failing to hit minimum sales targets). These are all factors that could affect the market multiple and required rate of return selections for the subject business. Finally, the valuation professional should understand whether there are any restrictions on transferring the license agreement to a subsequent buyer, which could limit the marketability of the business.

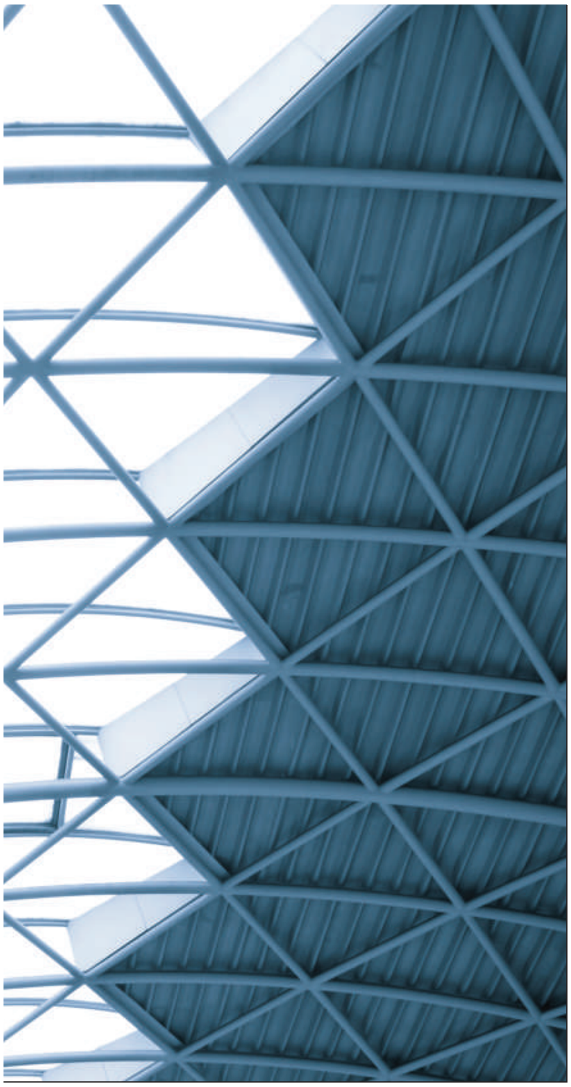
Management Services. The quality and depth of management is an important consideration in any business valuation but it is especially so in spinoffs and divestitures, because these often involve a change in how the business is managed or how it is to be charged for management services. It is common that many of the high-level management functions of the business to be spunoff or divested will have historically been provided by parent company employees that devote only a portion of their time to the subject business. Often, the subject business will not have been charged for these services.

If the former parent will continue to provide management services to the subject business after the spinoff or divestiture, the valuation professional should understand the parameters under which such services are being provided and whether they will be memorialized in a management service agreement. Key issues include the amount of time former parent company employees will devote to the subject business; how the business will be charged for management services; and the duration of the agreement. An adjustment to earnings may be required if the new arrangement results in a change in how management services are charged to the subject business.

If the subject business will be transitioning away from any reliance on the parent for management services, consideration should be given to whether the management team at the division or subsidiary level is capable of running the business on a standalone basis. Any perceived gaps in managerial talent should be treated as either a risk factor to be reflected in the market multiple and required rate of return selections or an adjustment to earnings to reflect the additional expense that will be required to procure such talent. At the same time, any previously allocated expenses for parent company management services that will no longer be provided should be added back to reported earnings.

An alternative scenario is one in which management of the subsidiary or division perceives that parent company management is adding minimal value and may even be a hindrance to the subject business realizing its full potential. Indeed, management of the subsidiary or division may be better positioned to identify growth opportunities and unlock potential value than parent company management, that may be distracted tending to core operations. This is borne out by the many studies showing that publicly traded spinoffs generally outperform their former parents. When this is viewed to be the case, the valuation professional should consider whether the subsidiary or division-level management team is properly incentivized to remain with the business post-transaction.

Sales, General, and Administrative Services. Prior to the spinoff or divestiture, the subsidiary or division was most likely obtaining G&A services from the parent, including accounting, strategic and financial planning, legal services, human resources, information systems, insurance, and shared office space. It may also have been relying on the parent company's sales force to market its prod-



ucts. The issue of how the subject business will procure these services post-transaction and the effect that it will have on its cost structure should be addressed in the valuation.

In some instances, the parent may have provided overhead services for a subsidiary or division for which it was either not charged or it was undercharged relative to the true cost of such services, resulting in the subsidiary or division's historical earnings being overstated. In other situations, the subject business was being unduly burdened by corporate overhead charges that were either excessive or unnecessary resulting in the subsidiary or division's historical earnings being understated. In either case, historical earnings should be normalized to substitute the parent-allocated overhead expense with the estimated post-transaction cost of such services.

If G&A services will continue to be provided by the former parent, the valuation professional should determine whether shared service agreements will be in place post-separation from the parent, and understand their terms. If such services will no longer be provided by the former parent, the valuation professional should investigate how the subject business plans to perform G&A functions in the future.

Intercompany Sales. Often the business to be spun-off or divested has been a supplier to (or customer of) the parent. The transfer pricing used in such intercompany transactions is typically dictated by where the parent wants profits to appear. However, once the business is spun-off or divested market pricing is likely to prevail. When the market price is materially different from the transfer price formerly used for intercompany sales, one of two things will happen: either (1) the sales will cease because the business cannot compete when the arrangement is subjected to market competition, or (2) sales will continue but under a new pricing structure. In either case, an adjustment to reported earnings should be made to reflect either the loss of revenues (and cost of sales) or the new market pricing.

Legal and Tax Considerations. When subsidiary stock is transferred either in a spinoff or in a stock sale, generally all of the subsidiary's assets and liabilities, including contingent liabilities, will be indirectly assumed by the buyer. Thus, the valuation professional should inquire about the nature and potential financial effect of any significant contingent liabilities. If the contingent liability is material, the liability may need to be quantified and subtracted from the valuation indications resulting from the market and income approaches. Sometimes the company or its accountants will have made a determination as to the magnitude of the contingent liability, which the valuation professional will be able to rely on. In rare cases, the valuation professional may be required to value the contingent liability as part of his or her analysis (which could be the subject of an entire separate article).

If the subsidiary is a C corporation, any unrealized gain in the company's assets will remain with the subsidiary. The treatment of unrealized gains is controversial in the valuation community and it is beyond the scope of this article to advocate for any specific treatment of the issue. Nonetheless, the valuation professional should be aware of whether a substantial unrealized gain exists in order to determine whether any valuation adjustment is warranted.

Often the business to be divested will be a division or an operating unit whose assets and liabilities are not held in a separate legal entity. Thus, the contemplated sale will be an asset sale rather than a stock sale. In an asset sale, the valuation professional should review the asset purchase agreement in order to understand which assets and liabilities will be sold as part of the transaction and which will be retained by the parent. For example, it is common in such agreements for the subject business's cash and debt to remain with the parent. Pro forma adjustments to the subject business's historical balance sheet may be required to reflect any assets and liabilities to be retained by the parent.

Name on Key Agreements. Often the subject business's key agreements will be in the name of the parent. The valuation professional should inquire as to the timing and potential hurdles involved with transferring or assigning such agreements to the buyer. This issue often causes significant delays in the close of the transaction.

Financial Statements. The quality of the subsidiary's or division's financial statements can be one of the most problematic issues for spinoffs and divestitures. In many cases, the parent has never deemed it necessary for the subject business to have accurate, standalone financial statements because the business has historically been viewed as an integrated part of the whole company. Yet the parent's inability to present potential buyers with reliable financial statements for the divested business can have several undesirable consequences. At a minimum, it could delay the closing of the transaction because of the buyer's need to perform more intensive due diligence on the business's financial results and condition. More significant consequences include lower offers than would otherwise be forthcoming if potential buyers had more confidence in the financial statements and, in the extreme, disengagement by potential buyers (this has been observed by the present author). The valuation professional can add value by emphasizing to parent company management and its advisors the importance of reliable historical financial *(Continued on page 47)*

Spinoffs

(Continued from page 25) statements for the business to be spun-off or divested.

The considerations with respect to historical financial statements are twofold:

1. Are the subject business's financial statements an accurate representation of its historical financial results and condition?
2. Are appropriate pro forma adjustments being made to the historical financial statements to present a fair representation of what the subject business is going to look like post-transaction, as differentiated from what it has looked like in the past?

The first issue will fall largely outside of the scope of the valuation professional's role in the transaction. In fact, the prudent valuation professional should always include language in the valuation opinion that he or she has relied, without independent verification, on the financial statements provided as accurately representing the financial results and condition of the business for the time periods covered. Nonetheless, the quality of division-level financial statements varies widely and the valuation professional should inquire as to whether the business's financial statements were prepared in accordance with generally accepted accounting principles (GAAP) and whether such statements capture all of the revenues and expenses, as well as assets and liabilities, associated with the business to be spun-off or divested. Often such statements will be missing allocations of certain operating costs.

The second issue is a primary responsibility of the valuation professional providing an opinion related to a spinoff or divesture transaction. If pro forma financial statements giving effect to the proposed transaction have not been prepared by the company or its accountants (as is most often the case), the valuation professional should make the appropriate adjustments to historical financial statements to reflect anticipated changes in the subject business resulting from the transaction. The following is a summary of some of the more common pro forma adjustments to the income statement:

- Eliminating revenue and costs associated with product lines or customers that will be retained by the parent company.
- Adding back parent company overhead allocation charges that will not continue.
- Adding back parent company management fees that will not continue.
- Subtracting replacement costs for services formerly provided by parent.
- Subtracting license fees for intellectual property that will be licensed from the former parent.
- Reversing related party transfer charges for goods and services and substituting market rates or contracted rates going forward.
- Eliminating interest expense on debt retained by the parent company.

Working Capital. Because certain working capital assets may be retained by the parent, it is possible that the subject business will have a working capital deficiency post-transaction. As previously mentioned, often the business's cash on hand will be retained by the parent. Although less common, accounts receivable and other working capital assets may also be retained by the parent, requiring the new owners to make an additional investment in working capital post-transaction. In order to determine whether there is a working capital deficiency, the post-transaction level of net working capital (accounts receivable, inventory, prepaid expenses, and other working capital assets, less accounts payable, accrued expenses, and other working capital liabilities) should be compared to both the subject business's historical levels of net working capital and the guideline companies' net working capital levels (generally as a percentage of revenues). If it is determined that the business will have a working capital deficiency requiring a capital infusion immediately post-transaction, the valuation indications from the market and income approaches may need to be adjusted downward for the amount of the deficiency (though to avoid double counting, beginning working capital in the discounted cash flow model should be adjusted to a normal level of working capital).

Access to Financing. It is likely that the subject business's financing needs have historically been met by the parent, either in the form of direct loans or loan guarantees. The valuation professional should inquire as to how financing needs will be met post-transaction. The financing issue is particularly relevant in the case of start-up companies with ongoing losses that have heretofore been funded by the parent.

Financial Ratio Analysis

A component of the market approach is a financial ratio analysis, wherein the subject company is compared to the guideline companies based on such financial measures as size, growth, profitability, leverage, liquidity, and activity. In spinoff and divestiture transactions, the subject company's financial ratios should be adjusted as follows:

- Profitability ratios should be based on pro forma earnings and include the earnings adjustments mentioned above.
- Leverage ratios should exclude any debt that will be retained by the parent and include any new debt resulting from the transaction (if the valuation is on a post-transaction basis).
- Liquidity ratios should exclude cash and other working capital assets and liabilities to be retained by the parent.

Conclusion

This article has sought to demonstrate that there are many nuances to spinoffs and divestitures, and the risk of overlooking important issues and missing necessary valuation adjustments is high for the uninitiated valuation professional. On the other hand, this can provide an opportunity to add value by alerting clients and their advisors to the need to address spinoff and divestiture-specific issues early in the process. In particular, the need for reliable financial statements for the subject business should be emphasized. Not only will this make for a better supported valuation, but it may also help facilitate the closing of the transaction. ●

Bret Tack is a Managing Director at Cogent Valuation, and currently manages its Los Angeles Office. Providing business valuation and related financial advisory services since 1985, he has managed over 1,000 valuation engagements involving companies ranging in size from small closely held companies to multinational, publicly traded companies with revenues in the tens of billions.

Mr. Tack has extensive experience in corporate transactions, including resolving highly complicated securities design and equity allocation issues. He has also dealt with the Internal Revenue Service on dozens of valuation matters for income, gift and estate tax purposes with overwhelmingly positive results. He has provided expert testimony in various courts, including United States Tax Court.

Mr. Tack holds a Bachelor of Science in Business Administration from the University of Southern California and is an Accredited Senior Appraiser with the American Society of Appraisers in Business Valuation. He has written and spoken extensively regarding valuation issues, often for MCLE or CPA credit.

cogent valuation

Cogent Valuation is a nationally recognized full service business valuation firm that has provided inde-pendent valuation and financial advisory opinions in thousands of situations since 1991. These include the valuation of companies ranging from small closely held businesses to those with market values in the tens of billions, covering almost every industry and all types of transactions.

With the collective backgrounds of our managing directors and professional staff, Cogent Valuation brings substantial large deal experience to bear on our middle market transaction opinions. Cogent Valuation utilizes proprietary research, intensive due diligence, and the experience and insights of its professionals to produce thoughtful, well-documented opinions that have consistently withstood the scrutiny of clients and their advisors, investors, regulators, and courts.

For additional information and/or questions, please visit our website at www.cogentvaluaton.com or contact Mr. Tack at tack@cogentvaluation.com.

Los Angeles
21700 Oxnard Street
Suite 1080
Woodland Hills, CA 91367
Phone (818) 905-8330
Fax (818) 905-8340

Orange County
650 Town Center Drive
Suite 1200
Costa Mesa, CA 92626
Phone (714) 668-0272
Fax (714) 668-0137

San Francisco
601 California Street
Suite 800
San Francisco, CA 94108
Phone (415) 392-0888
Fax (415) 392-7070