Building a better working world

Divestments and working capital management

Sellers are leaving money on the table

"Cash is king," as the saying goes. It's echoed by business school professors and business owners around the world, but how quickly people forget. Companies are routinely leaving cash on the table when they don't consider working capital improvements prior to a divestment. Instead, they gift an often sizable and readily accessible value-creation opportunity to the buyer. Others often act too late to fully implement the operational improvement needed to release cash and positively affect valuations. Here we explore this apparent paradox and suggest an approach for seizing this opportunity.

Big numbers

It is not news to claim that sustained working capital improvement initiatives enhance business value, whether measured in terms of discounted cash flows, EVA or even EBITDA. They generate cash to fund growth, pay down debt or enhance shareholder distributions. Additionally, the process and policy actions required to sustain improvements invariably have a positive impact on productivity, eliminate cost and are accretive to earnings.

The numbers are compelling. According to EY's *Working Capital Management Report 2014*, the leading 2,000 US and European companies have up to US$1.3t of cash unnecessarily tied up. This amount is equivalent to nearly 7% of their combined revenues. In other words, for every US$1b in revenues, the opportunity for working capital improvement averages US$70m. Our experience is that in non-core businesses frequently being disposed, cash-release opportunities can exceed 10% or even 15% of revenues.

The paradox of inaction

Despite the benefits, most sellers do not take action to improve performance ahead of a sale. Based on interviews with more than 800 corporate executives, the *2015 EY Global Corporate Divestment Study* revealed that only 35% of executives seek to extract working capital prior to divestment (Chart 1 on the following page).

Paradoxically, while this was the least frequent way for companies to add value to their business pre-sale, it was the **most** frequently identified action that the companies did not take but believed they would have benefited from the most (Chart 2 on the following page).

In non-core businesses frequently being disposed, cash release opportunities can exceed 10% or even 15% of revenues.

Chart 1
Which of the following pre-sale value-creation initiatives did you undertake?

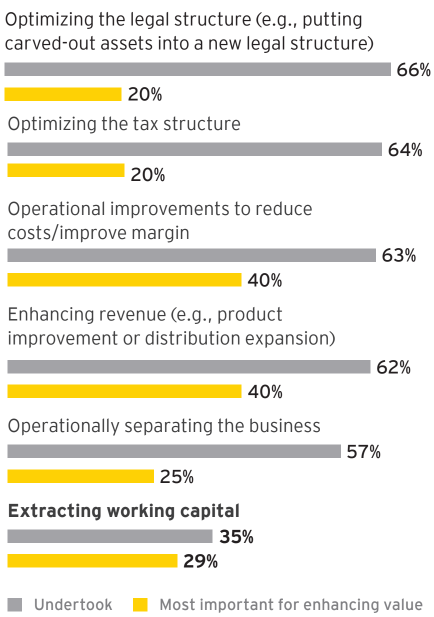
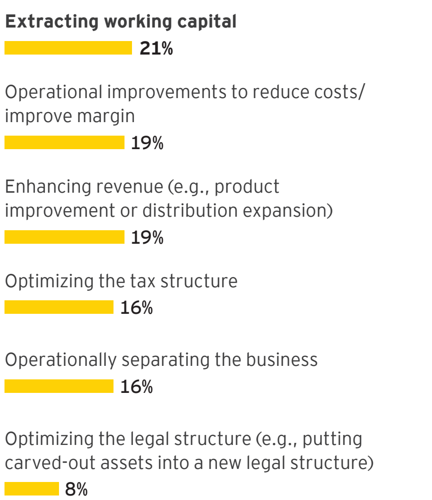


Chart 2
Which step did you not do but now feel you would have benefited from the most?



Why wait?

A number of factors explain companies' inaction, the most common being that management is either insufficiently aware of or insufficiently interested in the scale of the opportunity to be motivated to act. This is most frequently observed in non-core operations or those lacking sufficient scale, i.e., those assets routinely subject to divestment.

Even when management understands the opportunities, they may delay action because of competing deal priorities and perceived implementation difficulties. However, these excuses rarely prevail under even modest scrutiny.

Perceived challenge	Reality
Working capital optimizations provide a benefit only over the long term.	Though certain benefits from structural working capital optimization changes take time to realize, opportunities for quick wins abound. Even if realized within 12 months of a sale, a well-developed story line can lend support in negotiating a lower working capital peg, which would otherwise be challenged during diligence.
Increased payment terms can be a barrier to negotiating better pricing for procured goods.	By rationalizing and consolidating suppliers, the increased volume and spend with fewer suppliers enable better negotiating leverage – for both cash and cost. Also, a rationalized supplier base, especially with private equity buyers, eases the NewCo separation effort and set-up.
Inventory reductions target lower production requirements and, accordingly, lower overhead absorption rates.	The quickest win in inventory is rebalancing the mix, typically by finessing the underlying logic for stocking and replenishment decisions to better align with demand. A better mix can support larger sales and production volumes with a lower inventory balance and, at the same time, improve margins by reducing overtime, order expediting and obsolescence write-offs.
Post-sale, there is little or no value to RemainCo of any optimization performed for NewCo.	Deal fatigue might prevent the seller from leveraging separation work efforts after a time-consuming and expensive divestment – the organization seeks to transition to newer strategic and operational opportunities. However, during the sale process, the seller should identify and rationalize contracts and suppliers for the divested entity. This momentum provides a natural opportunity for RemainCo to capitalize on work efforts already conducted for separation purposes, in addition to initiating other working capital transformation efforts.

> The sheer scale of value being discarded should prompt sellers to rethink how and when to act.

Timing is everything

While working capital efficiency may be valued differently by financial versus strategic buyers, any material improvements realized within 12 months of sale are likely to be discounted to some extent, and those delivered within 6 to 9 months of the transaction may be challenged as unsustainable balance-sheet dressing. For a typical cash release initiative, >50% of the identified opportunities may be realized within the first 12 months, with benefits starting to flow within the first 3 to 4 months from the start. Accordingly, companies should act within 18 to 24 months of an asset being contemplated for sale for the seller to retain the full value of those improvements.

The research presented in EY's *Working Capital Management Report 2014* found the opportunity fairly evenly split between the primary working capital drivers — accounts receivable (35%), inventory (30%) and accounts payable (35%). Given the speed at which cash flow improvements can be driven from payables and receivables in particular (for example, through differentiated collections strategies or supplier payment policies), sellers should be optimistic about chances of extracting value at a sufficiently compelling return prior to a transaction.

Even the most forward-looking companies have imperfect portfolio review disciplines, and even those that do have a strong review discipline may not have a formal methodology for optimizing divestment value. While companies may act too late to fully capture excess cash, there is still value in defining the opportunity and developing the story line for the buyer.

Where to start

Success requires planning — ideally as a routine part of the portfolio review process — and a practical approach to execution that prioritizes speed-to-value. Companies that do this well start early and follow a sequence of activities, including:

- Benchmarking key working capital ratios against peers and across business units to select candidates for improvement and further analysis
- Conducting granular analysis to narrowly define the opportunity and required actions
- Focusing on actions that will drive improvements in the near term
- Establishing clear goals and operational metrics to track progress
- Aligning management incentives to those goals
- Developing a compelling story line for all potential improvements, whether delivered or not

For the best outcome, companies should align the oversight and execution of these activities to those related to planning and executing the divestment, allowing for story line consistency.

Summary

Companies that plan for working capital release ahead of a divestment significantly improve the total economic return from the deal. The best results are a one-time cash release, improved productivity ratios and increased asset valuations. Even where there is insufficient time to fully execute the improvement plans, forward projections backed by a strong, fact-based narrative can provide support for a lower working capital peg at sale.

The opportunity costs of inaction are significant. Companies should follow the lead of private equity owners who aggressively manage working capital throughout the holding period. If a seller doesn't optimize working capital pre-sale, the buyer will do so and reap the rewards.

How EY can help

EY's dedicated divestment and working capital transformation professionals can help clients improve portfolio management, divestment strategy and deal execution.

As clients evaluate strategic divestment opportunities, we help them position the business to be divested in order to maximize transaction speed and value. Specifically related to working capital in the context of a divestment, we can assist with:

- Establishing working capital requirements at NewCo
- Valuing post-spin working capital improvements
- Developing sell-side narrative for working capital peg and future improvement opportunities
- Identifying and executing working capital improvement opportunities pre- and post-sale
- Designing working capital improvement services in TSAs

Contacts

For a conversation about your divestment and working capital strategy, please contact us:

Global

Paul Hammes
EY Global Divestiture Advisory Services Leader
paul.hammes@ey.com
+1 312 879 3741

Steven Waller
EY Divestiture Advisory Services Partner
steven.waller@ey.com
+1 312 879 5336

Americas

Rich Mills
EY Americas Divestiture Advisory Services Leader
rich.mills@ey.com
+1 404 817 4397

Ed Richards
EY Americas Working Capital Leader
edward.richards@ey.com
+1 212 773 6688

Asia-Pacific

Stephen Lomas
EY Asia-Pacific Divestiture Advisory Services Leader
stephen.lomas@au.ey.com
+61 3 9288 8441

Wayne Boulton
EY Oceania Working Capital Leader
wayne.boulton@au.ey.com
+61 3 9288 8016

EMEIA

Martin Hurst
EY Europe, Middle East, India and Africa Divestiture Advisory Services Leader
martin.hurst@de.ey.com
+49 6196 996 27365

Jon Morris
EY Europe, Middle East, India and Africa Working Capital Leader
jmorris10@uk.ey.com
+44 20 7951 9869

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