Global Corporate Divestment Study

Regulatory change accelerates transaction activity
In the years since the financial crisis, financial services institutions have moved from a theme of globalization to “de-globalization,” and this continues to drive divestment activity. While many financial services institutions have completed divestment programs and have shifted focus to acquisitions to drive growth, further divestments are still expected in the near term; 50% of financial services companies surveyed for our latest EY Global Corporate Divestment Study expect to make a divestment in the next two years and almost 70% expect the number of both strategic and distressed sellers to increase in the next 12 months.

One of the challenges for financial services firms in deciding on potential divestments is the interconnectivity between different business lines in different regions. While some businesses might not make sense on a stand-alone basis, they may contribute to an overall balanced portfolio.

For some segments of the financial services landscape, markets (and therefore values) have been improving. Companies have to determine whether to divest and capitalize on these attractive values or instead to keep and fix these assets over time as might otherwise have been the plan. For less attractive segments, with increasing regulation and low growth, winding down and selling customer portfolios remain credible alternatives to full business divestments.

Our study highlights the importance of a regular and well-communicated portfolio review, rigorous preparation for separation of the business and tailored communications to likely buyers in order to maximize value and minimize the time and disruption associated with divestments.

### About this study

The EY Global Corporate Divestment Study analyzes companies’ top questions and concerns relating to portfolio review and divestment strategies and provides insights on how to maximize divestment success. The results of the 2015 study are based on more than 800 interviews with corporate executives, including 80 in the financial services sector, surveyed between November 2014 and January 2015 by FT Remark, the research and publishing arm of the Financial Times Group.

- Executives are from companies across the Americas, Asia-Pacific, Europe, the Middle East, India and Africa.
- 85% of executives are CEOs, CFOs or other C-level executives.
- Executives stated they have knowledge of or direct hands-on experience with their company’s portfolio review process and have been involved in at least one major divestment in the last three years.
- While nine industry sectors are represented, the study focuses on consumer products, diversified industrials, financial services, life sciences, oil and gas, and technology.
- More than half of the executives represent companies with annual revenues that exceed US$1b.
The combination of regulatory change and the shifting economic environment is leading to monumental change in the industry. A decade ago, financial services businesses scrambled to follow their customers to new markets. Now, the theme of globalization has given way to a focus on core geographies and customers that will deliver consistent, strong financial performance.

These factors have, in recent years, increased pressure on financial services companies to divest underperforming units, business lines that no longer fit the core and those that impose regulatory requirements that are deemed too burdensome relative to the unit’s contribution to the overall group.

In some locations, increasing compliance costs with local regulatory, data and governance requirements — combined with requirements to operate through subsidiaries rather than branches — no longer provide sufficient return on equity for sub-scale businesses to justify the resulting trapped capital.

Our survey responses reflected these concerns. When asked which factors they viewed as the primary reasons for considering a divestment in the future, executives cited as the most important a need to raise capital, the impact of changing regulatory capital requirements and a refocus of capital toward higher-growth opportunities.

The fintech sector has been an area of increasing focus and investment from within and outside of the financial services industry and currently attracts lofty valuations. The impact of digital web-based technology in developing direct-to-customer propositions is transforming large parts of the insurance sector, and insurance executives expect the impact of technology changes and innovation to be a significant driver of divestments (21% compared with 9% and 10%, respectively, for banking and asset management executives).

The expected impact of shareholder activism is surprisingly high given the regulated nature of financial services businesses, and particularly high for insurance company executives, for whom it is the highest expected driver of divestments (38% compared with 26% for all financial services executives). This may be due to existing group structures, whether by business mix or geography, coming under investor scrutiny given rapid market change and regulatory challenges. Furthermore, shareholder activism was expected to be a far more significant driver in the Americas and Asia-Pacific.
(35% and 38%, respectively) compared with Europe, Middle East, India and Africa (EMEIA) (13%).

Since the financial crisis, portfolio review has become a core competency for leading financial services institutions. Such companies have been proactive in communicating their criteria for assessing what is and is not core to their investors. There have been many examples, particularly among the banks, which have placed parts of their business portfolios that are no longer considered core into new, “non-core” reporting units to be divested or wound down over time.

To avoid being perceived as unprepared and unfocused by shareholder activists, all financial services institutions need to have a regular and rigorous portfolio review process that is appropriately communicated to investors.

Define transaction perimeter and deliver timely operational separation

Operational separation was considered by financial services executives to be the most important step for enhancing sale value.

To maximize value and minimize deal timelines, potential buyers must have a clear view of what they would be buying, and 55% of executives cited defining the perimeter as an important step for improvement in their next transaction.

Based on the defined perimeter, sellers identify and evaluate the interdependencies between the businesses being retained and divested, and how these will be managed during the transaction.

Shareholder activism, while once considered a rare issue for financial services institutions, has become a very real factor in certain geographies. Successful companies should go on the offensive rather than waiting and finding themselves unprepared.

The separation work required can be a key challenge for financial services businesses when divesting because they have to unwind all aspects of integration that they have historically pursued to optimize their operating model. More than just a required action, operational separation of the divested entity was actually considered by executives to be the most important step for enhancing their sale value.

Sellers have to employ both segregation and separation in order to enable a smooth and timely transition of the divested entity. There is no standard solution; each case needs to be assessed based on the intricacies of the legacy operating model and the readiness and capabilities of the buyer. Only in respect of property was there a clear preference for making it stand-alone for Day One, with all other factors split fairly evenly between these two choices.

Across financial services, the executives identified data segregation and separation as the most common challenging aspect of operational execution, with 77% of them having to address this issue as part of their most recent divestment. This can be materially affected by whether it is a share or asset deal, because of the added complexities that arise if historical data needs to be carved out and made available to the buyer.

The leading area where segregation and separation work was required did differ within sectors, with the main area being data for banks (80%), clients for wealth and asset managers (80%), and IT systems and infrastructure for insurers (88%).

Given the integrated nature of financial services institutions, it is not uncommon for both a transition services agreement (TSA) to be required for services provided by the seller to the buyer and a “reverse TSA” for services provided by the buyer back to the seller. Such mutual reliance can aid the TSA negotiation process as each party is a provider and recipient of services under the same terms, but it also means that...
both parties have obligations to comply with local regulatory guidelines on outsourcing. This is an area under scrutiny by regulators that have a strong interest in understanding how the recipient’s board will continue to discharge its responsibilities when material services are outsourced, and how the outsourced services will be managed if contingency or recovery and resolution plans need to be invoked.

A number of jurisdictions now require banks to conduct recovery and resolution planning. This process is proactively resulting in operational restructuring that not only allows for resolution, but also for more thoughtful divestments. This is challenging banks to consider in detail their relationships with group service companies and the concept of service “life boats,” and may lead to accelerated operational separation planning and deal executions in the future.

Identify buyers early and tailor communications

In recent years, the number and type of buyers available for financial services businesses have expanded significantly. While this is good news for sellers, it can make it problematic to prepare the business for sale effectively and ensure buyer communication is effective and targeted. Where once likely buyers of a financial services business were mainly local competitors, the universe has expanded to include a full range of private equity firms, large Asian funds and global institutions. All have different perspectives on the relative attractiveness of assets and information they see as critical, and they also have different tax considerations.

While a traditional regulated domestic competitor was viewed as the most likely buyer of assets, with 42% saying this, foreign acquirers from developed markets and private equity and sovereign wealth funds were not far behind, with 38% and 37%, respectively. Financial institutions from emerging markets were also cited as important buyers by 27%.

More than half (58%) of financial services executives developed a value creation roadmap for buyers, considered to be one of the most important initiatives for enhancing value.

In your most recent asset or equity divestment, which of the following did you segregate and provide under a TSA or make stand-alone for Day One?

| Third-party supplier contracts | 5% | 14% |
| Property                      | 15% | 41% |
| Data                         | 38% | 39% |
| IT systems and infrastructure | 43% | 30% |
| Legal entities               | 29% | 33% |
| Employees                    | 38% | 35% |
| Third-party commercial/distribution agreements | 38% | 28% |
| Clients                      | 36% | 28% |

Deal activity by private equity and sovereign wealth funds has noticeably increased in the last two years. Executives agreed, with 18% of this year’s executives identifying this buyer category as the most likely acquirer of future divestments, compared with a mere 3% in our 2014 Global Corporate Divestment Study. Considering the needs of private equity and sovereign wealth fund buyers is becoming increasingly important in divestments of financial services businesses. Private equity firms often have higher expectations regarding the depth of diligence compared with corporate acquirers.

From a regional perspective, traditional domestic buyers were considered to be the most important for the Americas (43%) and, while also important in EMEIA and Asia-Pacific, the most likely buyers in those regions were considered to be foreign developed-market financial institutions (50% in EMEIA) and private equity and sovereign wealth funds (50% in Asia-Pacific). Foreign acquirers from developed markets were seen as more likely buyers in the insurance sector (50%) than banking (32%) and asset management (40%).
Whom would you view as the most likely buyer for your next divestment?

- Traditional regulated domestic competitor: 14% (Top factor), 28% (Second factor)
- Foreign developed-market financial institution: 17% (Top factor), 21% (Second factor)
- Private equity or sovereign wealth fund investor: 18% (Top factor), 19% (Second factor)
- Foreign emerging market financial institution seeking global expansion: 16% (Top factor), 11% (Second factor)
- Non-regulated domestic financial institution: 14% (Top factor), 9% (Second factor)
- Management team spin-out: 9% (Top factor), 6% (Second factor)
- Closed/run off book consolidator (insurance): 9% (Top factor), 5% (Second factor)
- Wind-down: 3% (Top factor), 1% (Second factor)

While a number of global financial services institutions have been refocusing on their core businesses, this has given rise to regional bank acquirers that already have a significant local presence. Another theme, running counter to the re-focus on core strategy of many firms, has been sector pure-plays selectively expanding into other financial services sectors, with insurance companies acquiring asset managers and banks acquiring wealth managers.

Seventy-nine percent of financial services executives presented synergy opportunities for each likely buyer and, of these, 52% said this was the most important buyer communication initiative for value enhancement. More than half (58%) said they developed a value creation roadmap for buyers, which is considered to be the second most important (by 28%) initiative for enhancing value.

Considering the potential buyers and tailoring information to their likely needs is important, according to one respondent, a CFO of a financial services institution in Asia-Pacific: “We were exiting the market and divesting a business to a player that had relevant product and industry experience, so ensuring we provided tailored analysis and information to their likely areas of interest was key to limiting the timeline of negotiations and safeguarding deal value.”

Conclusion

Financial services institutions recognize the importance of the portfolio review process, as evidenced by the 64% that divested businesses that were not meeting the required performance criteria, compared with only 37% for all sectors. Executives indicate that sellers need to carry out regular portfolio reviews and be proactive in communicating appropriately the outcomes with investors.

Financial services institutions have greatly enhanced their approach to planning and executing divestments, thanks to the experience from a large number of divestments made in the industry in recent years. For any seller, value will always be one of the most important issues and the valuation gap has been a significant barrier to many potential divestments since the financial crisis. However, 63% of financial services executives identified speed as being more important than value. To maximize both the value and speed of future divestments, sellers will need to deliver timely separation of businesses to be divested, identify likely buyers and be proactive in communicating a tailored value story to those buyers.
Top divestment questions
companies across sectors are asking

Do we have the right information to make good portfolio decisions?

Access better data for individual business units
56% say access to industry performance benchmarks would make their portfolio review more effective, and many say they would also benefit from profit/cash flow forecasts and cost allocations at the business unit level.

Develop analytical tools to measure the impact of your decisions
Strong business analytics for both financial and non-financial metrics are the single most important way companies say they could improve their portfolio reviews.

Build regular portfolio reviews into your business
58% say greater frequency would improve the review process. Frequent reviews help companies make better decisions faster, while infrequent reviews can trigger uncertainty internally.

What value creation lessons can we learn from private equity?

Drive sustainable top-line growth
PE knows that buyers look for long-term sustainable growth, not just cost-cutting opportunities. 38% of companies did not enhance revenue through product improvement, distribution expansion or other pre-sale initiatives.

Extract working capital before the sale
PE often extracts working capital to reinvest in growth areas before a sale because buyers won’t pay for it. Companies often neglect this step. Only 35% extracted working capital to enhance pre-sale value.

How can we improve divestment execution?

Define the perimeter of the business early on
This affects all other carve-out work streams. Companies that address this are 56% more likely to close on a sale price that exceeds their expectations.

Prepare early and rigorously manage the execution timeline
Companies that do so are 56% more likely to complete their divestment within their expected timeline.

Optimize your tax structure
Tax structuring affects your decision to divest or not. Sellers can make the divestment process more efficient and enhance deal value by assessing tax issues early.

Plan for the complexity of IT separation
50% say they could do a better job planning for IT separation, and most say this operational area needs the most significant improvement.

Tell a targeted value story from the buyer’s perspective
Developing a value creation roadmap for potential buyers and helping them identify synergies are some of the most important initiatives sellers can take to generate value.

Are we striking a balance between speed and value?

Speed
When companies focus solely on time, they often take shortcuts and release incomplete or inaccurate information.

Value
Companies need to tell a credible value story and weigh the opportunity costs of waiting too long for the right price.
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