Global Corporate Divestment Study

Volatile markets require active portfolio management
With the plunge in the price of oil during the second half of 2014, commodity volatility has become the primary driver of M&A decisions – but also the biggest impediment to completing a deal. With oil supplies likely to remain high in the near term, companies have to determine which of their assets make sense to focus on in such an environment. When the imbalance between global supply and demand does finally level out, well-financed companies able to adjust their portfolios will survive this shakeout.

Despite these economic pressures, and the close attention of activist shareholders, oil and gas companies are determined to realize the full value from asset sales. And many made it clear that if they have to, they will sacrifice speed for value. We believe this can be a false choice, and our study outlines the key strategies for successful divestments that optimize both speed and value.

Foremost among these strategies is looking at an asset's potential for sale from the buyer's perspective, and exploring the full range of alternative structures available to balance any valuation difference between the buyer and the seller. For open-minded sellers, and innovative buyers, the current environment creates ample opportunity to realize value through M&A.

Volatile oil prices are leading companies to re-evaluate their portfolio

59% of oil and gas companies say their most recent divestment was triggered by the unit’s weak competitive position in the market, the highest percentage of any sector to identify this as a divestment driver. These companies were also the most likely to say this was the most important trigger for divestment.

Oil and gas companies are divesting to refocus on core areas

44% of oil and gas companies made their last divestment because the asset being sold was not part of the core business.

38% of oil and gas executives reinvested the funds raised from their most recent divestment in their core business.

Shareholder activism is driving divestments

43% of oil and gas companies say that shareholder activism influenced their most recent decision to divest, and more than a quarter say they have been targeted by activists in the last 12 months.

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 100 in the oil and gas 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.
Oil price volatility underscores the need for effective portfolio reviews

The dramatic drop in oil prices during the second half of 2014 (crude has been down more than 50% since June) is forcing companies to re-evaluate their portfolios. Supplies in the United States and Canada are at record highs, and global supply is outstripping demand with the Organization of the Petroleum Exporting Countries (OPEC) unwilling to curtail production. As a result, the economics of some oil and gas assets have become unattractive for their current owners, creating opportunities for both buyers and sellers.

After a period of large-scale dealmaking and heavy capital investment upstream, such low and volatile commodity pricing has exposed many flaws. Some assets that made sense under different pricing assumptions are now stranded with owners who lack the cost structure or capital resources to properly operate and exploit them. Companies without strong balance sheets can divest these assets to fund capital investment in more promising areas or redirect resources to return to profitability more quickly. Oil and gas executives were significantly more likely than those in other sectors to indicate that a unit’s weak competitive position was the trigger for an asset disposition (18% said this was the most important reason, compared with 12% overall). Sellers in this sector are also most likely to be putting the proceeds back into their core business (38%).

Regulatory and political pressures also are driving some companies to divest, either to operate more effectively amid the turmoil in many regions or to address antitrust concerns, such as Halliburton’s ongoing effort to receive approval for its proposed US$35b acquisition of Baker Hughes. Upon announcing the deal, Halliburton said it would divest businesses that generate up to US$7.5b in revenues should regulators require this. Pressure by activist shareholders has also been pushing many companies to re-examine their portfolios, a trend that has been more prominent in the United States but is increasing globally. In recent years, shareholders demanding more predictable returns have led many companies to divest international and offshore assets and invest in more predictable ones onshore. Here as well, however, decisions made under different pricing assumptions may have created portfolios poorly aligned to the current pricing outlook and volatility.

Activists are now pressing for asset rationalization and exits from countries that are no longer profitable. More than a quarter of oil and gas respondents said they had been targeted by activists in the last 12 months, with 80% of these saying that activists had requested overseas exits. In the summer of 2014, for example, US-based Apache Corp. agreed to sell LNG assets and the related natural gas fields in Canada and Australia under pressure from a leading New York-based activist hedge fund to divest its international operations.

Bridge the valuation gap with alternative deal structures

One of the impediments to completing divestments successfully was the value disparity between buyers and sellers (42% of respondents). While buyers have already adjusted their valuations to take into account the changing price outlook, sellers have perhaps been slower to recognize the new pricing environment. Joint ventures (JVs), already widely used in the...
industry as a means of sharing technology, resources and risk, are one way to bridge this valuation gap. When asked what sort of structures they had considered for divestments, respondents were even more likely to cite a JV rather than a simple asset sale (63% versus 60% for division or asset sale). Looking forward to their next divestment, 53% would consider a JV, a higher percentage than for any other sector (35% overall).

Master limited partnerships (MLPs), which drove substantial activity in the energy sector last year, are also widely considered as an alternative to an asset sale (55%). In 2014, we saw some of the largest MLP creations in a decade, with initial public offerings (IPOs) continuing even into the traditionally slow winter season. Even the decision by MLP pioneer Kinder Morgan to consolidate its three MLPs in August did not slow the pace and, indeed, the Kinder Morgan transaction seems to have illustrated the successful life cycle of an MLP strategy. MLPs (and similar vehicles, such as yield companies) appeal to infrastructure investors seeking stable, low-risk returns, but also offer a lower cost of capital to companies operating in a tight market.

As Kinder Morgan demonstrated, however, the MLP structure can make sense for certain companies at certain times in their development. Companies contemplating an MLP should conduct a thoughtful and thorough analysis, with advisors bringing legal, financial and tax perspectives so that they understand the benefits and costs of such a move. Having such an analysis on hand will be even more important should it become necessary to justify the company’s decisions to activist shareholders.

Invest in required analytical and management resources

Effective analytics have always been vital to success in the oil and gas sector, and the sector has developed a strong culture of sharing data and technology. In the current challenging environment, the ability to invest in more innovative and
proprietary data technology will be a differentiator, especially the ability of companies to generate full value from the divestment process. In no other sector do respondents express such a clear preference for value over speed — 61% versus an even split of 50% overall. Key to realizing full value is the ability to produce a robust analysis of business units and assets (22% of respondents in oil and gas said business analytics tools were most needed for their portfolio reviews). As one respondent noted, “Better analytics tools would help our business to invest in the best regions and also reduce the burden of losses when the industry goes through a downturn.” Ideally, this analysis would go beyond engineering and geological models to include soft data such as political and tax considerations, regulatory time frames and risks, and the complexities of IT separation.

Sellers should also devote adequate management resources to the transaction. Divestments in oil and gas can take a long time, given the need for engagement with a variety of stakeholders, including regulatory bodies and commercial partners. Companies often underestimate the time and effort involved in successfully executing a divestment. Consequently, management often underallocates resources on both the front end and in the actual sale process. Indeed, a lack of resources was one of the biggest factors preventing a divestment from taking place in the sector, cited by 54% of respondents (compared with 46% for all sectors).

To be a seller, think like a buyer

The same commodity volatility that is sending companies to market can also hinder the divestment process (58% of respondents in oil and gas cited it as the greatest challenge in completing a sale).

In such a volatile environment, the best way to divest successfully is to prepare, and the best way to prepare for a sale is to think like a buyer. The available exit routes have changed, especially for upstream assets. For example, deep-pocketed national oil companies (NOCs) were once ready buyers, but now NOCs are undergoing their own portfolio reviews. Sellers need to understand the full universe of potential buyers, including sovereign wealth funds, private equity and, in the downstream space, infrastructure investors. Understanding who the likely buyers are for a particular asset – their priorities and return objectives – will allow a seller to select and position the right asset for sale based on what the market wants to buy right now (even if it’s not the asset at the top of the seller’s own list). Buyers currently have many options and to get the best value, sellers need to understand what else is available in the market and tailor their divestments accordingly.
Conclusion

While divestments in the sector can be complex, those able to sell successfully report highly positive outcomes. Oil and gas topped the sectors for a major divestment having had a very positive impact on the company valuation, with 17% saying this compared with just 11% across the sample.

Furthermore, almost 90% of respondents in oil and gas said that their most recent divestment had met or exceeded valuation expectations, the highest figure for any sector except financial services.

Our survey does suggest that sellers are becoming more open-minded about selling or otherwise monetizing assets using alternative structures when the market is ready. When asked what premium would persuade them to consider a deal for an asset they did not intend to sell, respondents in oil and gas were the most likely to say they would be willing to consider a relatively low price, with 57% indicating that a premium of 20% or less would be persuasive. In no other sector did more than 50% of respondents say they would agree to 20% or less. Oil and gas respondents were also among the least likely to say that they would not sell a strategically important asset at any price (only 13%, compared with 19% overall).

Which of the following governance steps should you improve in your next transaction?

- Coordinating all the business functions involved in the separation: 47%
- Identification and mitigation of stranded costs (those which remain with parent following divestment): 46%
- Determining IT separation requirements: 46%
- Managing the execution timeline: 44%
- Determining employees transferring with the business and transition requirements: 42%
- Defining perimeters of the business for sale: 42%
- Starting preparation on time: 33%

At what premium would you consider selling an asset you had no intention to divest?

I would not sell an asset that was strategically important to me at any price: 13%
- 50% +: 2%
- 40%-50% premium: 10%
- 30%-40% premium: 6%
- 20%-30% premium: 12%
- 10%-20% premium: 48%
- Up to 10% premium: 9%
Top divestment questions
companies across sectors are asking

Read the full Global Corporate Divestment Study to learn about how to improve your portfolio strategy and divestment practices.

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

<table>
<thead>
<tr>
<th>Access better data for individual business units</th>
<th>Develop analytical tools to measure the impact of your decisions</th>
<th>Build regular portfolio reviews into your business</th>
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<tr>
<td>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.</td>
<td>Strong business analytics for both financial and non-financial metrics are the single most important way companies say they could improve their portfolio reviews.</td>
<td>58% say greater frequency would improve the review process. Frequent reviews help companies make better decisions faster, while infrequent reviews can trigger uncertainty internally.</td>
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What value creation lessons can we learn from private equity?

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<th>Drive sustainable top-line growth</th>
<th>Extract working capital before the sale</th>
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<tr>
<td>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.</td>
<td>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.</td>
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How can we improve divestment execution?

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<th>Define the perimeter of the business early on</th>
<th>Plan for the complexity of IT separation</th>
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<td>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.</td>
<td>58% say they could do a better job planning for IT separation, and most say this operational area needs the most significant improvement.</td>
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<td>Prepare early and rigorously manage the execution timeline</td>
<td>Tell a targeted value story from the buyer’s perspective</td>
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<tr>
<td>Companies that do so are 56% more likely to complete their divestment within their expected timeline.</td>
<td>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.</td>
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<tr>
<td>Optimize your tax structure</td>
<td></td>
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<tr>
<td>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.</td>
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Are we striking a balance between speed and value?

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<th>Speed</th>
<th>Value</th>
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<tr>
<td>When companies focus solely on time, they often take shortcuts and release incomplete or inaccurate information.</td>
<td>Companies need to tell a credible value story and weigh the opportunity costs of waiting too long for the right price.</td>
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Contacts

Andy Brogran
EY Global Oil and Gas
Transaction Advisory Services Leader
abrogan@uk.ey.com
+44 20 7951 7009

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

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

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

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

Kenneth G. Smith
Japan Divestiture Advisory Services Leader
kenneth.smith@jp.ey.com
+81 3 4582 6400

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