

## **Goldman Sachs Exchanges**

### **Breaking free: The rise of corporate separations**

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**Allison Nathan:** In a world where merger and acquisition activity is still relatively subdued, companies are turning to spinoffs, sales, and divestitures. But what factors are driving this trend. And what does this trend tell us about the broader deal making environment?

**David Dubner:** There's been a change in corporate sentiment over the past decade. So, if you rewind the tape to the global financial crisis, 2008, there was a focus on portfolio diversification, consolidation, increasing complexity. That is changing and shifting sentiment towards one of simplification where there is enhanced focused across a portfolio and also unlocking some of the discounts that may exist within a portfolio.

**Allison Nathan:** I'm Allison Nathan and this is Exchanges at Goldman Sachs.

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**Allison Nathan:** A new report coauthored by Goldman Sachs and EY explains how and why companies are leaning into corporate separations. Joining us today to walk through those findings are Goldman Sachs's David Dubner, global head of M&A structuring within Global Banking & Markets and Sharath Sharma, global vice chair at EY. David, Sharath, welcome to the program.

**David Dubner:** Thank you, Allison.

**Sharath Sharma:** Thank you.

**Allison Nathan:** So, the pace of corporate separations is on the rise. More than 30 global separations were announced in 2022 alone. So, before we jump into the drivers of this big acceleration in this trend, David, can you explain to us first what corporation separations are and how they actually differ from M&A?

**David Dubner:** Sure. A corporate separation as we've evaluated in our report is essentially a capital markets separation whereby a subsidiary of a larger parent company is distributed to the parent company shareholders. So, when the dust settles, shareholders own stock in the parent company or the remain co, as well as stock in the new company called new co. In the US, that's often referred to as a spinoff. In Europe, also known as a demerger.

In terms of how it differs from other forms of M&A, a corporate separation does not require a counterparty, unlike traditional forms of M&A. And similarly, it is agnostic and not dependent on capital market conditions that exist at the time.

**Allison Nathan:** And so, these types of separations have been around for decades. Why are we seeing a rise in popularity of them today?

**David Dubner:** I think there's been a change in corporate sentiment over the past decade. So, if you rewind the tape to the global financial crisis, 2008, there was a focus on portfolio diversification, consolidation, increasing

complexity. And that, if you look across the S&P 500, they're roughly two thirds of the companies in the S&P have at least three segments with more than \$500 million of revenue.

That is changing and shifting sentiment towards one of simplification where there is enhanced focused across a portfolio and also unlocking some of the discounts that may exist within a portfolio.

There are three underlying drivers for the changing sentiment. First is the pandemic. We have emerged, or are emerging, I should say, from a pandemic where the focus was very inward. There were elevated numbers of strategic reviews that had been announced, which have caused companies to reevaluate and reimagine their business mix.

Secondly, the cost of capital is fundamentally changed. We were at near zero rates for an extended period of time. We are now in an elevated cost of capital environment. And that means it is no longer growth at any cost. Capital allocation decisions take on far greater significance. And lastly, as organic growth opportunities have slowed, there is increasingly importance being placed by management

teams and shareholders on profitability, or good old fashioned margin. And often you can think about a corporate separation as an opportunity to achieve addition by subtraction.

**Allison Nathan:** And Sharath, let me bring you into the conversation. Talk to us a little bit about where these types of separations are most prevalent.

**Sharath Sharma:** I think they're occurring in a number of industries. To the statistic that David had, a number of the S&P 500 have multiple segments. And to the comment made around COVID, the overlap between industries and adjacencies is forcing almost every industry to take another look at whether there are better shareholders for the assets they own within the company.

Right now, most of the activity is in diversified pharmaceuticals. I'd say the second sector is diversified industrial products. And as you look around the world with Alibaba announcing its intent to break into six companies. Porsche in Europe. We think this will now get into some other sectors like technology and consumer products and become more prevalent around the world as well.

**David Dubner:** I completely agree with your comments, Sharath. I think as you highlight, healthcare and industrials, I view those sectors as ones where there is a significant amount of innovation. Right? Disruption. Often technology fueled.

And when we look at sectors where you see innovation, it can also breed divergent financial profiles across a portfolio of businesses. And I think in some of those cases, you can find yourself with legacy businesses that may have a slower growth or margin profile where a corporate separation can be an attractive potential opportunity.

**Sharath Sharma:** Yeah, that's well said, David. And to the conversation around different segments, these are complicated decisions for companies to make because it's not always a straightforward separation of a business. It could be a collection of assets from different businesses.

And getting the parameter right, the equity strategy right, having a clear evaluation of what remain co would do are all complex decisions. It often can get quite emotional when you decide parameter of assets and how they get packaged.

It can also be very emotional to figure out when to do this transaction. DowDuPont took a while to figure out the right kind of assets to put into Corteva. So on and so forth.

These deals tend to generate extraordinary amounts of value to shareholders. But they are complex to make the decision in the first place.

**Allison Nathan:** And what I find interesting is that when I see think of spinoffs, I know when I think of spinoffs, I usually think of companies trying to get rid of underperforming assets. But you both have alluded to the fact that there can be opportunistic separations that can deliver and create shareholder value. So, talk to us a little bit more about opportunistic separations, David.

**David Dubner:** Yeah. I think you're spot on, Allison. All tides rise. Right? That's the intention with these transactions. We had the opportunity to speak with many executives that have executed these transactions as part of our report. Two key themes emerged as drivers of value creation. One is using a corporate separation to enable transformation across strategy and operations, both for the

parent company, as well as for the new co. And a second was risk management, which I'll combine with resiliency within an organization.

And as I think about practically how that manifests itself for a company, one is dedicated management focus on a narrower set of businesses. May be pure play. May be broader than that. But that focus breeds operational efficiencies and opportunities.

Second is having an independent capital structure. Right? The ability to allocate capital in ways that are optimized for a particular business as opposed to a broader conglomerate. Third being equity currency. How do you attract and retain talent in a competitive environment that we exist in today? And how can you use that currency to grow through M&A or other inorganic opportunities?

And lastly is the shareholder base. How can we think about migrating what may be a broader shareholder base of a conglomerate or diversified company to more of a pure play base that is focused on a particular sector with research coverage that understands and appreciates the dynamics of that sector?



**Sharath Sharma:** All of the research on this topic has been nebulous on how to measure the success of these transactions. So, Goldman and EY, our opinion is that you measure the success of these transactions at the end of the second year. Market cap of remain co and new co, compared to the market cap of the parent before the split occurred.

So why two years? We picked two years because these complex global deals, they have the interim operating models for countries where operations are a little bit more complicated to separate, like China and India. It takes some time to get it done. And transformation service agreements between the parent and new co take about two years on average. So, we like that two-year horizon.

If that was the measure, these transactions on average outperform the S&P 500 sector index in the mid single digits, which is phenomenal for shareholders.

**David Dubner:** Your point on mid single digit outperformance is an important one, Sharath. And that's a blended metric. And if you think about it from either side,

one interesting observation that we make in the piece is that new cos outperformance has the highest correlation to revenue growth. So, therefore, as we think about placing new co in the public markets for the first time, there are many aspects that ultimately will focus around optimization. But one key area of focus needs to be the growth vectors for that business and how the strategy and the equity story that they're communicating to investors supports that growth strategy.

**Sharath Sharma:** Generally, the time period between announcing and close garners a lot of attention to corporate functions, because they tend to be what's entangled. Sometimes supply chains are entangled around the world. But new co management can do a lot during the time period to get prepared for growth above market for an extended period of time with more focus, with more investments into both inorganic and organic channels.

And that's very important to get done and not get distracted with the complexities of disentanglement by focusing on what truly does drive shareholder value.

**Allison Nathan:** And if we take a step back for a moment

and we talk about the process of spinoffs, you end up with a remaining company and a newly formed company. You called it a new co, David. So, Sharath, talk to us a little bit about the parent company. How does the remaining parent company leverage the opportunities that David just mentioned, opportunistically, over the short, medium, and long term once they do this transaction?

**Sharath Sharma:** Remain co needs to transform itself, to David's point, just new co has to take advantage of all of those levers he laid out for itself. Both companies need to work on this event, if you will, to reimagine their businesses and their operations.

And so, what guiding principle are [UNINTEL]? Right? I think the parent establishing a guiding principle that says the sum of the two [UNINTEL] needs to be at or better than the current. It's a good guiding principle. And because we measured two years out, it's in everybody's best interest to think about capital allocation, sharing talent between the two companies in a way that enables success to be achieved for both sides at the end of that second year.

**Allison Nathan:** So, what kinds of things can the remain

cos do to improve their performance?

**Sharath Sharma:** So, conventionally, remain cos went after stranded costs. Stranded costs are costs they're left with because they couldn't allocate it out to the company that they're creating, if you will. Conventionally, they've gone after eliminating that expense.

So, we're advocates for the company to do more than that. Back to the discussion we were having on how to generate outperformance for both companies. It's a rare opportunity for the parent to understand all the detailed wiring of the business when they're trying to separate a business. So, taking advantage of the learnings from that to simplify their back office functions, often called general and administrative expenses, or G&A is very important. It gives them a hard look into their procurement expenses and supply chain, which is a major category within their P&L to renegotiate their vendor contracts.

And then at the end of the day when they separate systems, they have a real clean look at the data that's available, which is a powerful accelerator of value as they find out how to do more with analytics and automation and

so on and so forth within the remain co. That, I think, is the opportunity for remain co to use this moment to think about all of those operational and tactical items, but also to move up the value chain, if you will, and take another look at whether their segments should change, whether their peers have changed, and if the structure of their leadership team needs to change.

It's a rare moment for them to be able to do all that in a very short period of time.

**David Dubner:** And the average timeline, from announcement to closing by a separation transaction is, call it, nine to 13 months. I think the point you're making is important to highlight, which is we would encourage remain cos or parent companies to use that time to their advantage. Not just adopt a clone and go approach to a separation, but rather think about how during that period, not only are they appropriately setting up new co to be a first time public company. But they're reimagining what the remain co can be, both in terms of their processes, their people, their growth opportunities, and all of the points that you made.

**Sharath Sharma:** It's a very good point, David. There is no correlation we've observed between the time it takes to get the deal done between announce and close and excess returns. However, speed is important because of the ambiguity and the need to move forward and separate the businesses so that they can operate as quickly as possible.

Conventionally, companies have tended to do exactly what David said, clone and go, in the interest of speed. But we're at a different time now. We're advocates for new co to do more improvements as they separate. And for remain co to in parallel launch several mini transformations so that both companies can be at a better place at the time of the transaction.

**Allison Nathan:** David, do you have anything to add?

**David Dubner:** Ultimately, every situation is bespoke, right? These transactions are not one size fits all. So, as we think about engaging in one of these transactions, you want to carefully consider at the outset before you make any decision whether or not to move forward how entangled is the new co business from the parent company? What is involved operationally in that separation? And that

includes all aspects of the organization. For example, IT, IP, HR, tax. A host of various considerations. You also want to think about up front contractual and other legal implications that arise in the context of the separation.

And what I'm really driving at is before you embark, you want to think about showstoppers and you want to plan appropriately, recognizing that inherently issues will arise during the pendency of the transaction. And management teams and their advisors will work through those issues as they arise.

**Allison Nathan:** Some of your advice focuses on talent and the necessity of training that talent to operate and execute in the new co. Your advice really touches on two factors, announcing a leadership team decisively and early. And then picking that new management team incredibly carefully. Why is that so central?

**David Dubner:** We want both the remain co, as well as new co, to hit the ground running. Now, that is operationally, but that is also vis-à-vis their management team. And therefore, as you say, Allison, we spend time in the report exploring that it is oftentimes optimal and more

often occurs in practice to bring a management team CEO, CFO in earlier in that process so they can begin to hone their messaging, their understanding of the strategic objectives and go forward strategy for the company. They can begin to prepare and advance separating agency presentations, IR days, and equity roadshows to be in the best position to be in a mentality of what I would call beaten race, right, as opposed to the alternative. And that's, ultimately, where we want these companies to be.

**Sharath Sharma:** If I can add to that. I think the decade old wisdom on this topic was let's wait and announce the leadership team of new co about a quarter before the roadshows begin. And I think that in the earlier days of these types of transactions, right, a decade ago, that thinking was because they didn't want disruption within the company on who gets to make what decisions.

Our opinion is to do the reverse of that. To David's point, to announce the leadership team early enough for the management team to be trained in their individual jobs. And also, to come together as a team. A little over 80 percent of the CEOs of new cos come from within the organization. A little over 70 percent of the CFOs come



from within the organization. And those are the statistics.

We're also advocates for bringing new talent into the leadership team so that it is well balanced from knowing the business and then knowing how to operate a business standpoint. And we're also advocates for more diversity in the leadership team.

At the end of the day, bringing them all together and giving them enough time to work together as a team is a critical success factor for new co to out perform. Here, again, if you contrast this with what are the parents' responsibilities, it's to help them get trained, to David's point. Let the CFO come to earnings calls. Let the CEO attend board meetings. Help train them, I think, is very important.

**Allison Nathan:** And another vital key to success is communication. That seems obvious. But given the complexity of these transactions and given all of the different participants and parties that are involved, we have customers, employees, shareholders, how has communication played a role in the success? And what are some examples where communication was done well and was a large contributor to the success?

**Sharath Sharma:** To the earlier conversation about the complexity of these deals and the emotional attachment to doing these deals in the first place, it's not a decision you take lightly.

And that brings a lot of emotional attachment to this deal for our people, for our suppliers, for our customers.

Regulators around the world want to understand what this is about. So, the way out of this we have observed in our paper is to communicate proactively, often, effectively. And to make the decisions that you're communicating transparently and in advance of when the decision is due. That kind of clarity allows us to dispel ambiguity. It allows us to get trust back in the process to new management teams. They all now know when decisions are being done. They know who's going to make these decisions. And it's very clear on when you're going to communicate the impact of these decisions to all of those stakeholders.

This is a very important point for creating those excess returns that we talked about.

**David Dubner:** Yeah, I completely agree with that. And

culture matters, right? Every organization, much like our own, have their own unique cultures. It's important to have that early, often, and continuous dialogue with your employees as this is a period of significant uncertainty, both in terms of equity-based comp arrangements, their own workplace financial planning, understanding how that will be addressed in the context of a separation is important.

And then Allison, you mentioned shareholders.

Shareholders is a key consistency that companies need to consider in these transactions. As I alluded to earlier, a key is ensuring that the shares of new co migrate to their natural home. Therefore, we treat these transactions as if we were IPOing new co. We're not actually raising new capital, generally speaking or placing the shares. But we treat that engagement process through roadshows and investor day similarly to how we would if we were raising fresh capital for the business. Because, again, we want to ensure that natural shareholder base exists and is available and opportunistic in their migration into the register.

**Sharath Sharma:** I think that's a very important point. The

peer groups are going to be different for new co. Very likely they're going to be different from parent co. So, it's an important moment in time to take another look at who these peers are and what performance indicators differentiate both companies after this transaction. And how you cascade those metrics to the rank and file and incentivize the right kinds of behaviors.

And the approach to communicate the value proposition of both companies to shareholders, strategy for strategy. You know? It's equity [UNINTEL]. It's an equity strategy. And those are two different threads. Strategy, conventionally, is to grow a company and to take another look at the portfolio. But this is different from that. Right? This is very clear articulation of why this business is going to be an outperformer. And it's different than conventional strategy to the point David was making.

**Allison Nathan:** We discussed at the beginning that this process in terms of corporation separations is accelerating. We're seeing so many of them. How should we think about these transactions as a feature or a harbinger of M&A activity and deal volume more generally in what has been, as we said, a more subdued M&A environment?

**David Dubner:** First, I think some of these transactions fit within what I would call a shrink to grow thesis, which is it can be difficult to grow all parts of the diversified organization simultaneously. If I can separate out pieces, much like some of the transactions, Sharath, you mentioned earlier, then I may be able to more effectively optimize and grow this business. So, I think we certainly expect to see more corporate separations announced.

Secondly, in the context of regular way M&A, two companies merging, we are more commonly seeing an acquirer say that there may be certain parts of that portfolio that are less strategic for their objectives. And therefore, we're seeing separations coupled with regular way M&A.

Third, we see an increased incidence of change of control transactions on the part of the remain co, as you termed it, Allison, or the new co. It's a higher level of M&A than you see across the broader market defined.

And the last harbinger would be bolt-ons. A new co has, for the first time in its existence, its own independent equity

currency. And we see them using that currency to engage in M&A.

**Sharath Sharma:** If I can add a couple of data points. So, historically, of all the deals the team has studied in this paper, remain co has returned 67 percent of capital to shareholders. The pace with which industries are changing and opportunities available for companies to outperform, we're advocates for using some of that capital for acquisitions moving forward for these types of deals.

For new co, 45 percent of capital was used for organic and inorganic investments, M&A to David's point. We're advocates for doing more of that. And I want to tie this back to tenure, because I think it's an important lens through which to view the acceleration of these deals and the acceleration of economic cycles themselves.

The average tenure of a CFO or a COO or a CIO is now at about four years in the S&P 500. That's a rapid amount of C suite turnover. The CEOs tend to be about seven to eight years. So, there's not a lot of time to come up with, design, and execute in one's tenure. And so, M&A, as well as organic investment plans, we see acceleration of those

cycles and we're advocates for both sides to do more of this with their own currency, to use the phrase David used.

**Allison Nathan:** Sharath, David, thank you so much for joining us.

**Sharath Sharma:** Thank you.

**David Dubner:** Thank you, Allison.

**Allison Nathan:** Thanks for joining us for another episode of Exchanges at Goldman Sachs recorded on Thursday, March 30th, 2023. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode.

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