CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

Divestitures

LESSONS FROM THE FIELD

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MANAGEMENT ACCOUNTING GUIDELINE | CASE STUDY

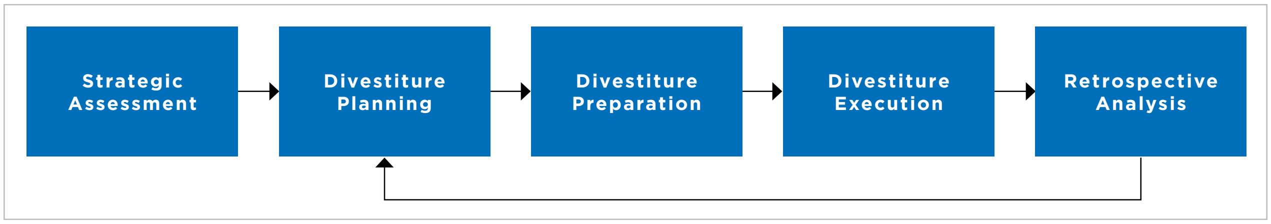
CONTENTS

The following case is based on a real organization. The names and the content have been modified for illustrative purposes.

Applying a Structured and Disciplined Process

This case study will illustrate the application of the five-step divestiture process described in CPA Canada's Divestitures guideline. Figure 1 provides a graphic overview of that process.

FIGURE 1: DIVESTITURE PROCESS MODEL



Background

The Robinson Corporation (RC) is a large, profitable, multi-division, health care information company. In the last decade, RC has focused its strategy on providing integrated solution products to health care providers in the U.S. These products have typically taken the form of software-supported databases (termed “integrated solutions” by RC) delivered on handheld devices and to the desktop of physicians, pharmacists, and nurses at hospitals, clinics, pharmacies, nursing homes, and doctors’ offices. Recent growth and profitability data for RC is summarized in the (Table 1) below.

TABLE 1: ROBINSON CORPORATION SUMMARY DATA

($ MILLIONS)	2011 ACTUAL	2012 ACTUAL	2013 ESTIMATE
Revenue	$1,002.2	$1,067.2	$1,139.8
Revenue Growth %	—	6.5%	6.8%
EBITDA	$263.6	$281.7	$302.0
EBITDA Growth %	—	6.9%	7.2%
Margin %	26.3%	26.4%	26.5%

* 2013 current year

The Healthcare Newsletter Group (HNG) is a subsidiary of RC. HNG has successfully transitioned from a print-based to an electronic newsletter business. HNG’s products, however, are not entirely compatible with RC’s strategic direction. The information-based nature of its products is not consistent with RC’s integrated solutions strategy. And, HNG’s growth potential is believed to be substantially less than benchmarks set by RC. During the most recent annual strategic planning cycle, RC’s strategic planning team — made up of business development staff and senior finance executives — identified this long-time subsidiary as a potential divestiture. Summary financial data for HNG appears below (Table 2).

TABLE 2: HEALTHCARE NEWSLETTER GROUP SUMMARY DATA

($ MILLIONS)	2011 ACTUAL	2012 ACTUAL	2013 ESTIMATE*
Revenue	$85.4	$81.4	$82.5
Revenue Growth %	—	(4.7%)	1.4%
EBITDA	$18.8	$17.1	$17.7
EBITDA Growth %	—	(9.0%)	3.5%
Margin %	22.0%	21.0%	21.5%

* Based on management accounts and includes corporate allocations; 2013 current year.

The planning team met with senior management of RC to discuss performing further assessment of HNG's strategic fit, with an understanding that a recommendation to divest the property is a possible outcome.

Responding to the challenge of assessing the future strategy of RC (and in turn, HNG) also demonstrated the need to employ some or all of the drivers of the RAISE philosophy to ensure their resilience, adaptability and innovation in the face of continuous change and disruption.

Strategic Assessment

As a follow-up to their meeting with corporate leadership, the planning team engaged in a rigorous review of HNG's historical performance and its compatibility with RC's strategic objectives. In doing so, the team posed the following questions:

- Are HNG's strategic initiatives consistent with those of RC?
- Is HNG's market expanding, contracting or stagnating?
- Does HNG's market position present any synergistic opportunities with RC's broader portfolio of businesses?

The team concluded that HNG's business strategy was diverging from that of RC and that the actual and potential synergies between it and other RC subsidiaries were extremely limited. Furthermore, the team concluded that HNG's growth potential was also limited and would be a drag on the overall corporation's growth. The team presented their financial analysis to RC's CEO. A summary of these findings appears in Table 3.

TABLE 3: RC PROJECTED GROWTH AND PROFITABILITY ANALYSIS: WITH AND WITHOUT HNG

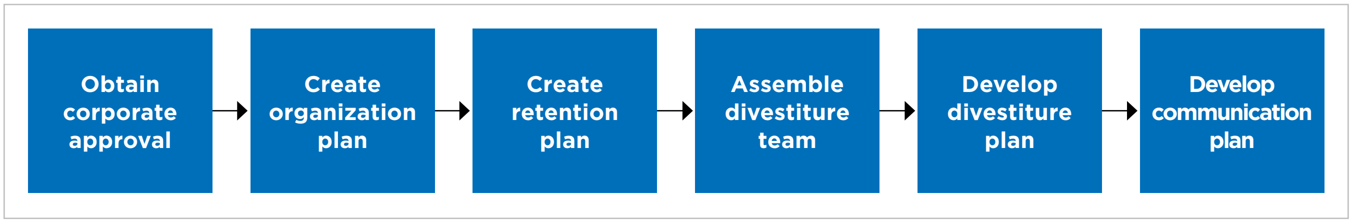
($ MILLIONS)	2013 ESTIMATE	2014 FORECAST	% GROWTH	2015 FORECAST	% GROWTH
Revenue with HNG	$1,139.8	$1,216.2	6.7%	$1,296.4	6.6%
Revenue without HNG	$1,057.3	$1,131.3	7.0%	$1,211.6	7.1%
EBITDA with HNG	$302.0	$322.8	6.9%	$346.1	7.2%
EBITDA without HNG	$284.3	$305.3	7.4%	$328.8	7.7%
Margin % with HNG	26.5%	26.5%	—	26.7%	—
Margin % without HNG	26.9%	27.0%	—	27.1%	—

Although it is estimated that in 2013 HNG would contribute over $80 million in revenue and approximately $18 million in EBITDA, HNG was projected to have a dilutive impact on RC's overall revenue and EBITDA growth and margins. Based on the strategic assessment and this analysis, the team recommended divestiture of HNG (representing the resilient and adaptive drivers of the RAISE philosophy). RC's CEO concurred and directed the team to proceed with a formal detailed recommendation to present to the board.

Divestiture Planning

The planning step of the divestiture process was made up of the following sequence of tasks:

FIGURE 2: DIVESTITURE PLANNING TASKS



Obtain corporate approval. The planning team drafted a document requesting approval to proceed with the divestiture, citing the lack of potential synergies between HNG and the other RC businesses and its lack of long-term growth potential. The document also included the following:

- A description of alternative approaches to divestiture that were considered, specifically further investment or changes in management;
- A detailed analysis of the accretive effect of the divestiture on RC's EBITDA margins;
- A description of the anticipated structure of the transaction (an outright sale of the business), a valuation range ($100 to $175 million), an estimate of disposal costs ($12 to $15 million), and estimated book and tax gains on the transaction;
- A timeframe for the planning, preparation, and execution of the transaction, as well as how it would be managed; and
- The identification of the divestiture team leaders, namely the senior vice-president of business planning and the CFO, who would have day-to-day responsibility for managing the transaction.

RC's CEO presented the document, along with her endorsement, to the board. The board approved, which initiated the following planning tasks:

Create organization plan. The first step to developing an organization plan was the meeting of team leaders, RC's CEO, and HNG's chief executive, who held the title of general manager (GM). The GM was informed of the planned divestiture and was assured that he would be offered a generous retention incentive for his cooperation and support. He then assisted the divestiture team leaders in analyzing operations, infrastructure, and staffing, and identifying those products functions, facilities, and personnel that would logically comprise HNG's ongoing business.

Create retention plan. As part of the organization plan, the GM identified key HNG executives — those who should remain with the company throughout the transaction to help stabilize the business and assist in the selling process. In addition, other key employees who were critical to the ongoing operation of the business were identified. The complete list of key personnel included the GM and his six direct reports, as well as a senior manager in the systems and technology department and the director of product development. Retention plans for these individuals were structured and negotiated as follows:

- **GM.** HNG's GM would receive 140% of annual salary, broken down as follows: 40% for retention (remaining with HNG through finalization of the transaction); 50% for performance (attaining budgeted revenue and profitability goals for the remainder of the current year); and 50% for successful sale (prorated from 90% to 110% of targeted valuation of $165 million).

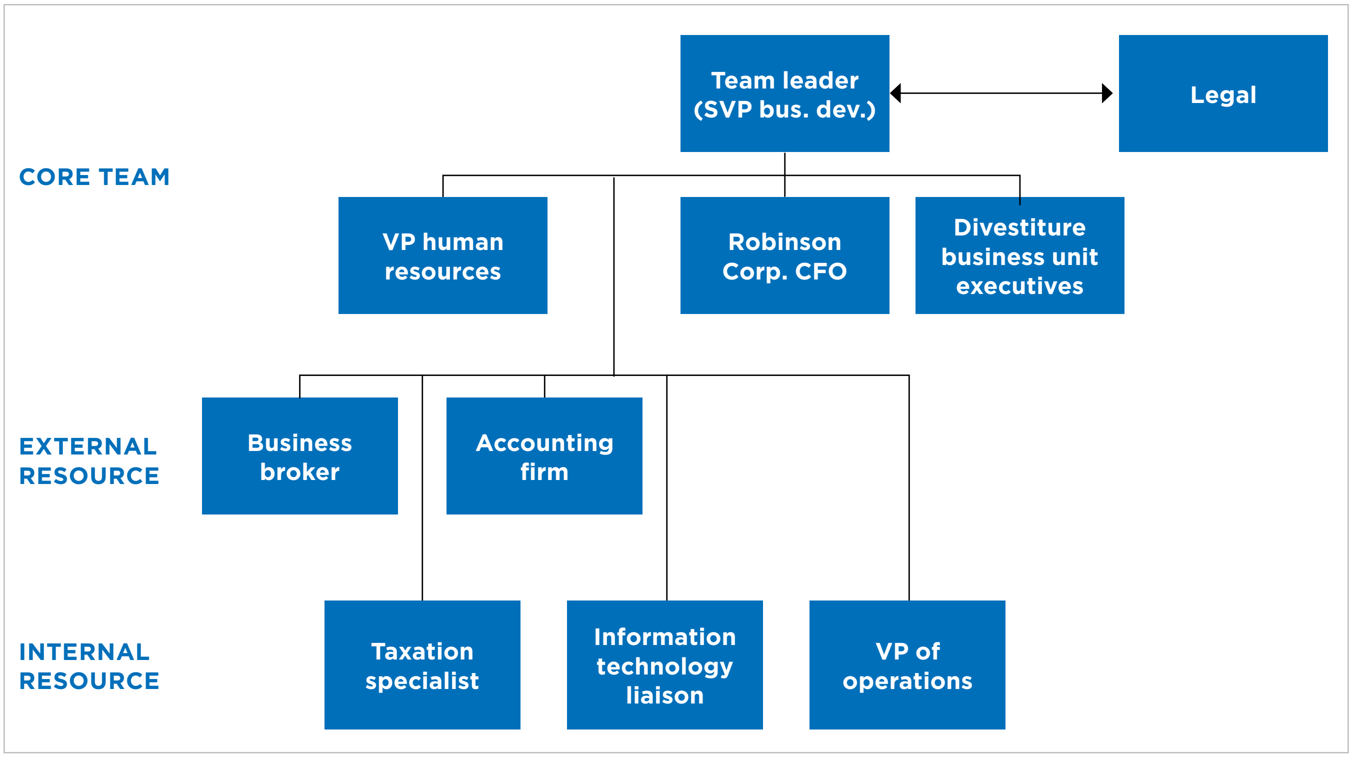
- **Senior vice-presidents.** Six senior executives would receive 100% of annual salary, one-third each to be awarded for retention, performance and success (also prorated from 90% to 110% of the targeted valuation).
- **Technology manager and product development manager.** The technology and product managers would receive an award of 40% of annual salary for retention through the finalization of the transaction.

Assemble divestiture team. Once organization and retention plans were in place, the structure of the divestiture team was flushed out by the team leaders and RC's CEO. The team consisted of three general components:

1. The core team, led by RC's senior vice-president of business development, and assisted by its vice-president of human resources, its CFO, and outside counsel from a firm used by RC for merger and acquisitions (M&A) transactions and the divestiture business unit executives;
2. External resources, consisting of a financial advisor/ business broker and an independent accounting firm, both of which would be engaged just prior to the preparation step of the transaction; and
3. Internal resources, including a member of RC's tax department, a senior manager from its systems and technology department, and its vice-president of operations. Other department heads were also put on notice that members of their teams may be called upon periodically to assist in the process.

An illustration of the divestiture team's composition appears in Figure 3.

FIGURE 3: DIVESTITURE TEAM STRUCTURE



Develop divestiture plan. The divestiture team developed a detailed plan that identified major tasks, deliverables, and milestones for the preparation and execution of the transaction, as well as those individuals with primary responsibility for their execution (fulfilling the resilient driver of the RAISE philosophy). An overview of the plan appears in Figure 4.

FIGURE 4: HNG DIVESTITURE TIMELINE AND PLAN OVERVIEW

MONTH	1	2	3	4	5	6	7
PREPARATIONS							
Select business broker (core team)		→	→ → →	→ → →	→ → →	→ →	
Select accounting firm (Robinson CFO)	→ →	→ → →	→ → →	→ → →			
Create prospectus (business unit executives and broker)			→	→ → →			
Identify potential buyers (core team and broker)			→ → →	→			
Develop management presentations (business unit executives and broker)			→	→ → →			
Prepare data room (core team and broker)				→ → →	→		
Assemble disentanglement team (core team)			→ → →	→			
Execute disentanglement plan (core and disentanglement teams)			→	→ → →	→ → →	→ →	
EXECUTION							
Announce intent to sell (core team and corporation management)				→			
Solicit bids (broker)				→ →			
Manage due diligence (broker)					→ →	→	
Accept winning bid (corporation management)						→	
Structure terms (legal, team leader, CFO)						→ →	→
Comply with reg. requirements (legal)							→ → →
Close (legal, team leader, CFO)							→

Develop communication plan. Although the announcement of the prospective sale of HNG would not be made until the transaction entered the execution step of the transaction, the team recognized that the development of a communication plan well in advance of the announcement was extremely important. Accordingly, messaging and plans to manage its delivery were developed during the planning step. The core elements of the messaging were:

- The announcement of the intent to sell HNG.
- The divestiture rationale—that HNG no longer provided synergies with other RC businesses.
- That this lack of synergy in no way diminished the fundamental attractiveness of HNG, i.e., that it was a highly successful and profitable business in its own right.
- The identification of the financial advisor that would be managing the transaction.
- An indication of the anticipated timing of the transaction.

With respect to the logistics of the announcement, the team scheduled and assigned the following deliverables:

- A target date for the announcement (announcement day) was set by the team and RC's CEO.
- A memo from RC's CEO announcing the divestiture to all employees was prepared by the VP of HR to be distributed on announcement day.
- The divisional VP, to whom HNG reported, prepared a presentation he would make to HNG employees on announcement day.
- The VP of HR assembled materials for distribution to HNG employees that addressed their obvious questions and concerns (such as "What does this mean for me?", "Is my job in jeopardy?", "What will happen to my benefits?", "How will the selling process unfold?").
- A press release to be distributed on announcement day was prepared by the VP of human resources and approved by the corporate media relations department.
- The team prepared reassuring talking points (of which the central theme was "business as usual") that addressed the divestiture for the sales and customer service departments of all of the corporation's business units and for those individuals who dealt with suppliers.

Once the communication plan was assembled, the process moved to the preparation step of the transaction.

Divestiture Preparation

The team attacked the preparation stage in the process on two tracks: the sales preparation track and the disentanglement or business separation track. The sales preparation track consisted of:

- The engagement of external resources, namely, an accounting firm and a financial adviser;
- Determination of the sales process;
- Development of selling materials;
- Preparation of a data room.

Simultaneously, the team initiated the disentanglement process by setting up a cross-functional team that was assigned responsibility for identifying inter-company dependencies and developing recommendations for resolving them so as to present the financials of HNG as a stand-alone business.

Sales Preparation

Engage external resources. The team first focused on selecting an accounting firm. Previous experience informed them that a carve-out audit, the audit of internal use statements for the business, would be necessary given the size of the transaction and the resulting need to satisfy the requirements of potential buyers and/or the entities financing the purchase. They knew that the audit would take several months under the best of circumstances, so the team chose RC's auditor for the engagement, believing correctly that this would reduce start-up time and significantly reduce the slope of the learning curve associated with the effort.

After engaging the accounting firm, the team "auditioned" several financial advisory firms. The candidates ranged from investment banking arms of major financial institutions to boutique business brokers with M&A expertise and good contacts in HNG's market. All candidates demonstrated a thorough understanding of HNG's business, its market, and the divestiture process. All agreed that the valuation range developed by the team was reasonable based on their knowledge of the market and multiples of revenue and EBITDA for recent, comparable transactions.

The team was particularly impressed with one of the business brokers, Burke, Clarke & Associates (BCA), which had managed transactions for RC in the past. That experience combined with the belief that BCA could optimize the transaction price because of its in-depth market knowledge and strong industry relationships made BCA its choice.

Determine sale process. The team leaders and BCA first focused their attention on the size and nature of the potential buying entities and the optimal method of sale. A dozen potential, serious bidders for the business were identified, pretty evenly split between financial buyers (private equity firms) and strategic buyers (existing businesses that had a presence in or adjacent to HNG's market). The group agreed that a preemptive bid by one of these entities, if it were to materialize, was likely to be far less attractive than the results of a competitive auction involving a substantial number of interested parties. Experience had shown that an auction under these circumstances would quickly narrow the field but would also be likely to generate a premium price for the business.

Develop selling materials. Because the sale would involve a competitive auction, the team set to work on developing the selling materials that would be utilized in the execution step of the process. The broker drafted a teaser based on information provided by the team. This was a several page description and an abbreviated financial profile of the business outlining the market opportunity that an acquisition would provide a buyer. It would be distributed with the intent of inviting expressions of interest by potential bidders. The core team members and the broker then met for two days to discuss the creation of a more comprehensive offering document, or prospectus, which would be distributed to qualified respondents to the teaser. That document was drafted over the subsequent two weeks. Finally, they developed a management presentation that paralleled the contents of the offering document (OD) and would eventually be delivered by the HNG executives to a limited number of bidders, those deemed most attractive by the team and BCA.

Prepare data room. The next task in the process was the creation of a data room that would house the underlying documentation of the representations made in the selling materials and would ultimately be reviewed by selected bidders as part of their due diligence. A decision was made to utilize a virtual data room (as opposed to a physical site housing hard copy of the information). This would provide the team and BCA with the benefits of greater control over the due diligence process, as well as the ability to enable simultaneous access to multiple bidders and the ability to measure usage of the various information sets reviewed. A vendor specializing in this area was engaged, and BCA and the team then agreed on the breadth and depth of the information to be provided. Each team assigned an individual to work with the vendor to manage its processing.

Disentanglement

Create a cross-functional team. Around the same time the preparation for the selling process started, the divestiture team leaders created a cross-functional disentanglement team. To maintain confidentiality until the prospective sale was announced, the team was formed in two stages. Initially, and in advance of the announcement, RC managers from operational areas likely to be affected by the divestiture were assembled and informed of their participation. The group consisted of representatives from the finance, human resources, information technology, and facilities management functions, and was led by a VP from the finance department. In addition, the team included an associate of the legal firm assisting in the transaction who would provide legal guidance on relevant issues and who quickly advised the group of the importance of keeping information of the prospective sale confidential until the announcement was made. Once the prospective sale was announced, the team was complemented by the addition of HNG managers from the relevant functional areas who then helped refine the findings of the RC managers. The participation of HNG managers was particularly important in maintaining a balanced approach to disentanglement decisions and ensuring that the interests of HNG were protected.

Resolve interdependencies. The team identified all functional areas for which RC provided support, all vendor and customer contracts associated with HNG to which RC was a party, and all intellectual property rights which benefited HNG but were owned by RC or one of its other affiliates. The team then began to unwind these relationships and, in the process, identified infrastructure gaps that resulted at HNG. The material gaps identified fell into the areas of human resources, finance, and information technology. More specifically, the exercise identified the need for a human resource VP and a benefits manager, a CFO and one mid-level accountant, and two information technology professionals. The fully loaded cost to fill these positions was estimated to be $600,000. A decision was made to not fill these positions, but rather to reflect their cost in the pro forma financials presented in the offering document and the management presentation.

Present the financials of HNG as a stand-alone business. The audited financials from the carve-out audit provided the basis for the pro forma statements that portrayed HNG as a stand-alone entity. These audited statements were adjusted based on the findings of the disentanglement team and other factors, specifically: corporate allocations for support services and severance costs for a senior VP terminated the prior year. The adjustments that bridged the audited profit and loss (P&L) to the pro forma P&L for the last full fiscal year are summarized in Table 4.

Upon completion of the preparatory work done to position HNG for sale, the team proceeded to the execution step of the transaction.

TABLE 4: HNG BRIDGE SCHEDULE 2012

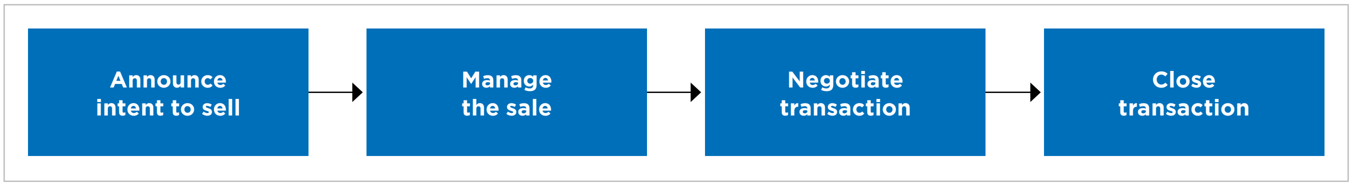
($ MILLIONS)	REVENUES	EXPENSES	NET INCOME
Audited carve-out income statement	$81.4	$64.3	$17.1
LESS: Internal cost allocations for services provided by parent company(1)	—	-$.2	+$.2
ADD: Estimated costs to provide services on a stand-alone basis(2)	—	+$.6	-$.6
+/- Non-recurring or unusual items(3)	—	-$.2	+$.2
Pro-forma income statement on a stand-alone basis	$81.4	$64.5	$16.9

(1) Allocations for human resource, accounting, and information technology support.
(2) Annual, fully loaded costs for human resource, accounting, and IT personnel.
(3) Severance costs associated with terminated senior VP.

Divestiture Execution

The execution step of the transaction consisted of the formal announcement of RC's intention to sell HNG, the management of the auction that would be used to identify the buyer, the negotiation of the details of the transaction, and the finalization of the sale. These tasks are illustrated in Figure 5.

FIGURE 5: DIVESTITURE EXECUTION



Announce intent to sell. Up until this point in the process, most of the planning and preparatory activity had been conducted by a relatively small team in a confidential setting. On announcement day that changed substantially. Announcements were made internally to employees of both HNG and RC, as well as to external constituents, as planned. The primary vehicle for the announcement to the outside world took the form of a press release (Figure 6).

Manage the sale. As agreed by RC and BCA, the selling technique to be used was a competitive auction. The auction took the following form:

- **Soliciting initial bids.** Initial bids were preceded by the distribution of the teaser to 32 companies. Approximately 20 companies responded with expressions of interest. These respondents were required to execute a non-disclosure agreement (NDA), an agreement not to disclose proprietary aspects of the transaction or to solicit employees of RC and HNG. This requirement weeded six potential bidders out of the respondent population, leaving 14 companies to receive the ODs and a description of how the bidding process would be managed.

- **Qualification of bidders.** Those that received ODs were then required to make non-binding bids for HNG within two weeks of receipt. Those who chose to bid had their bids evaluated by the team leaders and the broker based on the bidders' perceived credibility, their ability to finance the transaction, and their commitment to closing the deal.
- **Invitation to proceed.** Six bidders cleared the qualification hurdle. The field consisted of three strategic buyers and three financial buyers. All were invited to conduct preliminary due diligence, consisting of presentations by and discussions with members of the HNG management team, access to the data room, and a tour of HNG's facilities. At this point in the due diligence review, certain customer and product development information was redacted, with the understanding that there would be full disclosure of this information to the winning bidder.
- **Final bids.** These six participants were then asked to make their best and final offer for HNG. In addition, they were given a preliminary draft of the purchase agreement, which had been prepared by RC's legal advisor. They were required to return their marked-up copy with their offer, with the understanding that the extent of the markup would be a consideration in the choice of the winning bidder.
- **Selection of a buyer.** Two of the finalists, both strategic buyers, submitted bids that were close in value. The high bid was $170 million, $2 million more than its closest competitor. In addition, both were deemed to have A+ credit, obviating any possibility of the deal unraveling as a result of difficulty in obtaining financing. However, the purchase agreement markups by the high bidder were considered excessive and the bidder's reputation for intransigence in prior deals involving BCA caused the team to accept the bid of the other finalist. The winning bidder was given the opportunity to perform final confirmatory due diligence and, having been satisfied with the result, advanced to contract negotiation.

FIGURE 6: PRESS RELEASE

The Robinson Corporation (RC) announced today that it intends to sell its subsidiary, Healthcare Newsletter Group (HNG).

RC plans to initiate discussions with potential buyers shortly, and a transaction is expected to be completed by the first quarter of 2014.

We continue to refine our strategy in the healthcare market to enable us to meet the changing needs of our customers and strengthen our market position," said Patricia Smith, president and CEO of RC.

While HNG has established an outstanding reputation and is noted for its product excellence, it does not provide the synergies needed to advance our growth strategy. With this sale, we will streamline our offerings and sharpen our focus on becoming the leader in our core healthcare provider markets with integrated workplace solutions."

RC has retained Burke, Clarke & Associates as its financial advisor for the sale.

Negotiate and close transaction. Agreement on price and most major terms of the sale having been reached, the parties began negotiation of the finer details of the purchase agreement and the associated disclosure schedules. The major sticking points related to non-competition provisions and indemnification conditions and terms.

RC pushed for a narrowly defined non-compete ("the electronic health care newsletter business whose target market was health care providers") for a period of one year. The buyer pressed for a non-compete that was more broadly defined ("any referential information products whose target market was health care professionals") and a term of five years. Differences were ultimately resolved by defining the business as "the delivery of health care clinical and business information in all media" but specifically excluded database and software supported information products from the non-compete. In addition, a term of three years was agreed.

Disagreement on indemnification for breach of representations, warranties, and covenants centered on the buyer's wish to have any claims against the seller survive indefinitely. RC's initial position was a two-year survival period on all claims other than ownership and title which would have an indefinite survival period. Resolution was reached with agreement that the survival period would be three years, except for tax and environmental representations, which would survive for the statute of limitations, and incorporation, ownership, and title to assets, which would survive indefinitely.

Once final agreement was reached, separate dates were set for signing and closing. Closing was scheduled for a month subsequent to signing. Due to the size of the transaction, governmental approval was required to ensure compliance with anti-trust statutes. Upon receipt of government approval, the transaction closed and ownership officially transferred.

Retrospective Analysis

Two weeks after the sale closed, key members of the team (exclusive of HNG's management team) reassembled for one day to perform a post-mortem on the transaction. The review consisted of an evaluation of the performance of team members, recommendations for process improvement for future transactions, and dissemination of the lessons learned during the transaction.

Evaluation of team performance. The key points noted during the evaluation were:

- The broker performed well and was instrumental in optimizing the results of the transaction. It was further noted that the broker was the right "fit" for this size and type of transaction and should be considered for future transactions of this size and scope.
- The creation and distribution of the sales materials (specifically, the offering document and management presentation) was briefly delayed by the length of the carve-out audit and development of the pro forma financial statements. The inherent length of the process confirmed the wisdom of using RC's auditor for the carve-out. Although this reduced the timeline for the development of financial information for the OD, improvements in the process (such as the assignment of a senior member of the finance department to actively oversee and expedite the engagement) and earlier initiation of the audit should be considered for future transactions.
- Internal support during the transaction was uneven and could be significantly improved upon with training. A training program for key managers was recommended to executive management. This would take the form of a one- or two-day seminar annually conducted by business development

and finance executives and attended by those operational managers deemed most likely to participate in future divestiture and acquisition transactions.

Creation of a feedback loop. To ensure that the findings of the group were properly disseminated, the team leader created a formal report with the team's observations and recommendations. The report was archived with the transaction documentation (i.e., the approval document, the selling materials, and the purchase agreement and disclosure schedules) and distributed to RC's CEO and relevant managers in RC's business development and finance departments.

Taken together, the divestiture transactions demonstrated both the resilient and adaptive drivers in the RAISE philosophy as they are meant to be strategic and long-lasting, able to withstand and adapt to the disruptive and ever-evolving demands of the marketplace.

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