Augmenti Consulting

UNLOCK VALUE IN YOUR BUSINESS WITH SELECTIVE CARVE-OUTS

Avoid leaving money on the table.

Every management team is aware that, regardless of methodology, the official valuation does not reflect the full value of their businesses. There are always unidentified niches of value that can be monetized to increase shareholders' returns. In order to avoid leaving money on the table, high-performing CEOs routinely carve out portions of their companies.

The case for unlocking value

Value unlocking is a prevalent practice in an array of industries. To sustain growth, a chemical company, for instance, deleveraged its balance sheet by separating out non-core operations such as housing complexes and supply pipelines. In another case, to increase its return on equity, a mining conglomerate carved-out and sold minority shares of its logistics subsidiaries. In a third example, a vertically integrated steel producer carved out its port operations and brought investors in to sell unused capacity to clients in adjacent industries.

There are two common reasons for the added value of carve-outs.

First, the valuation of publicly traded companies does not account for all business lines. In other words, equity analysts typically examine only the primary business in their valuation models, ignoring smaller business units that also have intrinsic value. In the preceding mining example, the incremental cash flow generated by the logistics subsidiary was not reflected in the overall valuation of the company.

In addition, many investors discount the value of diversified conglomerates, arguing that smaller side businesses are a "distraction" to management and confound their analysis of the company's strategy and results.

Secondly, some businesses would command higher multiples if valued as independent entities. In the same mining example cited above, the primary mining business had a median EV/EBITDA multiple of 6-7x, while the logistics company had a multiple of 10x. By carving it out from the primary business, the management got an additional 3 to 4 times EV per EBITDA.

Carving out unvalued portions of your business makes perfect business sense, but there are no one-size-fits-all solutions for releasing value.

A Roadmap to Unlock Value

To maximize the release of value, the potential actions are contingent on three factors: value, timing, and purpose. Let's examine them with the aid of the flowchart below:

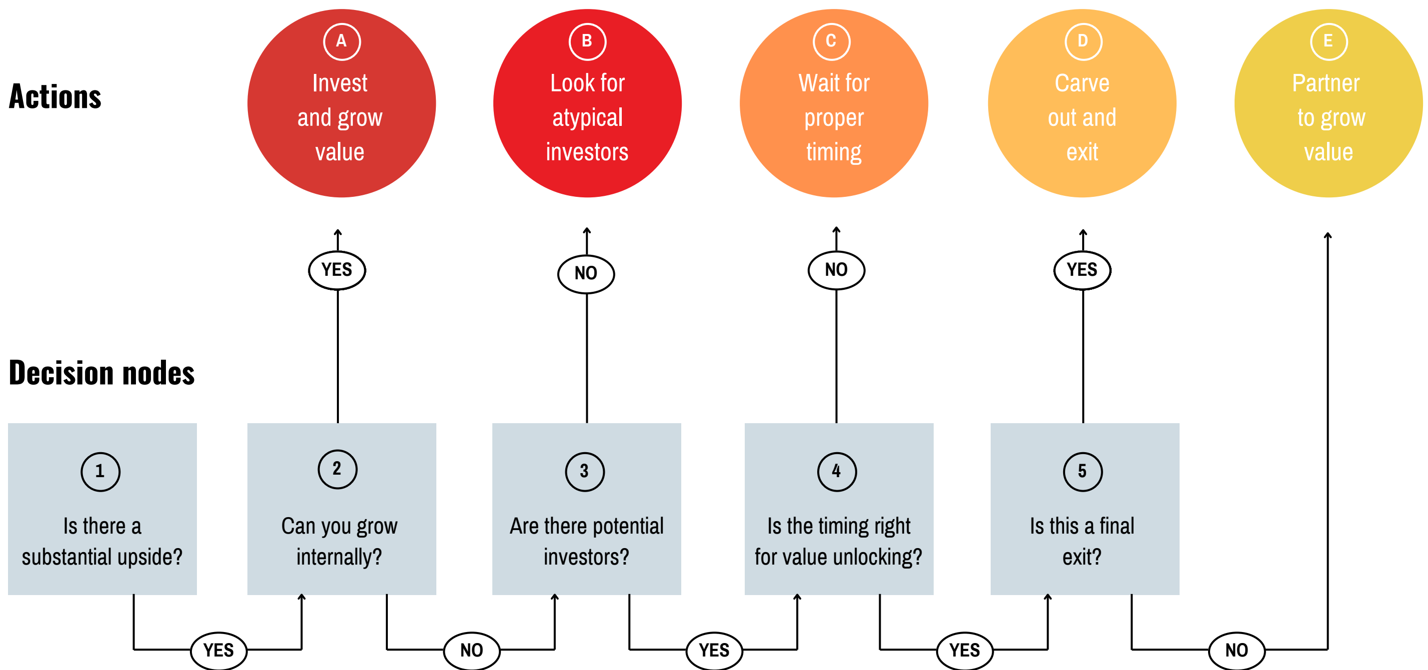

Figure 1 – Action and decision nodes to maximize value unlocking.

The decision nodes start with the value component:

1. Has your asset reached its maximum potential? If not, carving it out too early would imply forgoing future benefits.

2. Can you grow value by yourself? If you bring external partners, you will have to split the upside with them. The optimal course of action would be to invest internally and get all of the upside yourself (A).

3. Are there investors who recognize the value and would be willing to pay for it if the price is right? This might not happen, for instance, with investors unwilling to invest in captive (e.g., unable to diversify demand risk) or out-of-fashion (like greenhouse gas-polluting) assets. If the answer is no, these assets should be deprioritized (B) until non-traditional potential investors appear on the radar (e.g., businesses with atypical business models).

After value is established, the next question concerns timing:

4. Is the market condition favorable for deals that maximize your value? In adverse economic cycles, investors will likely submit proposals that undervalue your asset. The wisest action at this time would be to wait (C) for more favorable market conditions, unless there is an immediate need to raise funds.

The final inquiry relates to the purpose of the carve-out:

5. For the specified asset, are we seeking a full exit or a partner who will assist us in maximizing the asset's value to its full potential? The full exit scenario is a typical carve-out and sale (D) of non-core assets with residual value for the seller. The second case entails a search for investors who will also become partners in the new growth venture (E).

Once a comprehensive list of potential investors has been compiled, several tools are available to enable the planned unlocking of value.

Options for value realization

The nature of the business, the size of the transaction, the seller's desire for control, and whether the investor needs non-financial benefits (such as new capabilities) all have an impact on the choice of the suitable financial vehicle to unlock value.

The most prevalent options are initial public offerings, private placements, and the formation of joint ventures. They are briefly summarized in the table below.

Type	Profile	Overall characteristics
Joint-Venture	The asset is segregated in a joint venture, whose management is shared with other investors.	Sellers can surrender control. Investors can also provide non-financial benefits, such as new capabilities and access to markets.
Private Placement	Raise funds from private parties like such as large financial institutions and pension funds.	More flexible than IPOs and applicable to portions of the main entity, such as business units.
Initial Public Offering (IPO) or Secondary Public Offering (SEO)	Raise capital with a large pool of investors, ranging from small individual investors to large institutional investors.	Sellers maintain control of the venture and agree to adhere to financial regulations and quarterly reporting.

Table 1 – Examples of financial instruments to unlock value

In general, joint ventures are the most common occurrence due to their flexibility to tailor the deal to discrete operating assets, such as a water treatment plant or an industrial air separation unit, in which the operating control is transferred to a third party alongside a long-term supply contract. In addition, they can be tailored for the collaborative development of market niches through the pooling of cash, operating assets, and intellectual property.

Private placements are relatively common with large institutional investors, like pension funds and global asset managers. Investors are minority shareholders with no operational responsibilities. A mining company, for instance, sold 13 percent of one of its business units for $3.4 billion under the pledge of allocating it to strategic energy transition initiatives. In addition, the investors earned a seat on the board of directors of this now autonomous business unit.

Finally, due to their complexity and relatively high cost, initial and secondary public offerings are less frequent. In addition, sellers must submit quarterly financial reports and adhere to stringent financial regulations.

Conclusion

Avoid leaving cash on the table. Look for opportunities, and if they're worthwhile, unlock them!

François Santos
is the Managing Director of Augmenti Consulting.

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