Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

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Federal Divestiture Myths & Realities

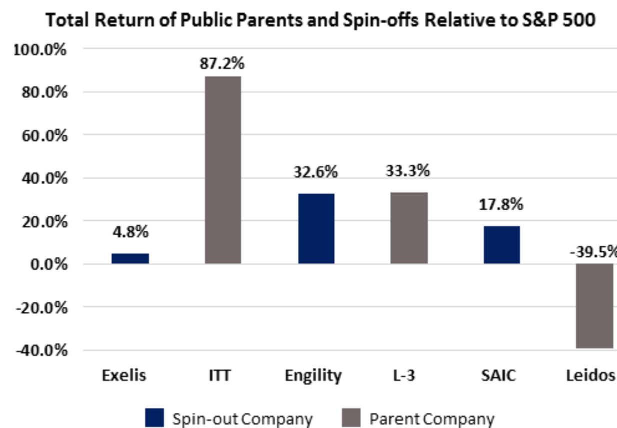
1. ***Myth: Divestitures enable constrained subsidiaries to flourish once freed from parental restrictions***
2. ***Reality: Many spin-offs are ill-equipped to stand on their own and results post-closing have varied widely***
3. ***Myth: Legacy capabilities translate well to new markets and create untapped opportunities for divested companies***
4. ***Reality: Orphans often lack the means to displace established players in adjacent markets***
5. ***Myth: Spin-offs offer outsized opportunities for cost savings***
6. ***Reality: Buyers should expect to make sizeable post-closing investments***
7. ***Myth: Breaking up larger companies is the key to unlocking shareholder value***
8. ***Reality: Returns have been mixed, with some shareholders benefitting far more than others***
9. ***Myth: Continued spin-off activities portend a strengthening M&A market***
10. ***Reality: Recent deals have been borne primarily of company-specific needs***

Black Friday Shopping: Federal Market Divestitures

- Much recent federal M&A activity has been the result of divestitures – both the initial spin-offs and the subsequent tie-ups of spun entities
- Sellers have been motivated to eliminate OCIs, focus their portfolios, and exit shrinking and/or underperforming business segments
- Buyers have been drawn by the opportunity to liberate subsidiaries from excessive parental costs and artificial governors on growth
- Results have varied widely, with some divestitures flourishing and others foundering, with company-specific, not macro market causes
- Many spin-offs lack clear differentiation, with buyers disappointed to find forecasted "white space" occupied by entrenched competitors
- These corporate orphans are fueling a wave of M&A activity as they seek to fill in the gaps in their competitive positioning and infrastructure

Doorbuster Sale – Deals and Disappointments

In recent years, federal sector management and boards have focused significant energy executing divestitures and tax-free Section 355 spin-offs. Lockheed (The SI) and Northrop Grumman (TASC) led the way, followed shortly thereafter by ITT (Exelis), L3 (Engility), and Leidos (SAIC). ITT just spun off Vectrus and now there are rumors of another wave of properties preparing to spin, including HP, CSC, and others. Organizational Conflicts of Interest have played a role in the decision to divest, but cost pressures, exiting shrinking market segments, and reinvesting in growth areas have also been factors. Many larger firms are at a cost disadvantage relative to smaller competitors because of indirect expense inertia and bloated overhead. Divestitures have become a popular way to quickly reset cost structures and reposition portfolios. While press releases and portfolio theory provide myriad divestiture motives, additional scrutiny is required before declaring these properties a "splurge" or a "steal."



For divestitures through FY14, Wolf Den analyzed stock performance above or below S&P 500 returns over the same period for each parent and spin-off pair.
Source: Wolf Den Analysis

Deals of the Century or Dead Inventory?

Lurking behind the well-scripted talking points are a host of seller-friendly motives. Sellers have generally unloaded assets to shed underperforming business units and exit shrinking markets. Many recently-divested businesses competed in support-side markets reeling from funding tightness, grinding small business pressures, and a dearth of new program starts. Additionally, many divested businesses have been hampered by "free gifts with purchase" – grab bags of assets with little or no connection to the primary divested business unit. Amid all these moving parts, returns have been mixed and a few cases of buyer's remorse are reminders that *caveat emptor* is an eternal truth.

Expert Personal Shopper Required

The mixed performance of many of these deals may have surprised buyers who bought into seller strategic rationale or relied too heavily on due diligence rooted in top-down examination of the market. For example, Booz and TASC ostensibly compete in similar segments of the market, yet experienced disparate outcomes. Smart buying decisions require program-level situational awareness around competitive positioning and asking the right strategic due diligence questions. Does the divested entity have the contract vehicles, IP or repeatable methodologies, and strong customer relationships required to drive sustainable differentiation? Is the qualified pipeline real and actionable enough to hit organic growth targets? What BD infrastructure investments are required post-closing to convert that pipeline into bids? Can they hit prevailing market price points? While the Federal budget draws the bulk of diligence and subsequent blame, company-specific issues determine outcomes and are largely predictable.

Cyber [Merger] Monday

Divested businesses are often leaned-out entities with big growth dreams but limited Day One organic growth capacity. Post-closing, key hires, targeted BD enhancements, and talent investments are urgent requirements. As seen in the recent couplings of QinetiQ North America with Vencore (The SI) and TASC and DRC with Engility, comprehensive M&A strategies are required to satisfactorily answer the competitive positioning questions raised above. As this next wave of post-Black Friday merger activity continues into the Holiday season, look for divested federal businesses to continue their buying spree to round out their offering and check the organic growth drivers off of their M&A wish lists.

8280 Greensboro Drive
McLean, VA 22102
wolfdenassociates.com

Dave West
(917) 657-4525
dave@wolfdenassociates.com

Rick Tossavainen
(703) 327-4383
rick@wolfdenassociates.com

John Descalzi
(908) 591-7853
john@wolfdenassociates.com