The appeal of the equity carve-out

Here is what a carve-out does to help companies exploit growth opportunities and increase shareholder value.

BY PATRICIA ANSLINGER, DENNIS C. CAREY, AND CHRIS GAGNON

THE PURPOSE of a corporate center is to do for the subsidiaries what they cannot do effectively for themselves. Many structures serve this purpose: operating companies, multibusiness companies, holding companies, conglomerates, and even investment firms such as Berkshire Hathaway — all are different ways for a single, central parent to deliver value to its business units. The newcomer to the list is the equity carve-out.

Like its predecessors, the carve-out enables a subsidiary to draw on the wisdom, experience, and practical assistance of the executive center. But it also offers something new: a degree of independence that appears to foster innovation and growth.

An equity carve-out is the sale by a public company of a portion of one of its subsidiaries' common stock through an initial public offering. The decision on how much to carve out will depend on accounting and tax advantages. If the parent retains 80% it can be consolidated for tax purposes and subsidiary dividends are fully deductible. A stake greater than 50% allows a consolidation for accounting reasons. The parent or subsidiary can receive the proceeds of the IPO.

Each carved-out subsidiary has its own board, operating CEO, and financial statements, while the parent provides strategic direction and central resources. As in any other corporate structure, the parent can provide executive management skills, industry and government relationships, and employee plans, and perform time-consuming administrative functions, freeing the subsidiary's CEO to concentrate on products and markets. What is different is the way in which the role of the corporate center is clearly spelled out in contractual agreements.

Patricia Anslinger is a partner in McKinsey & Co.'s corporate finance practice. **Dennis Carey** is vice chairman of Spencer Stuart U.S. and co-founder of the Wharton/Spencer Stuart Directors' Institute. **Chris Gagnon** is managing director of Blue Capital, an investment firm focused on administering operational and strategic improvements in companies it owns.

Striking results

A number of companies have chosen to spin off a single subsidiary in this manner. A smaller group, including Thermo Electron, Enron, Genzyme, Safeguard Scientifics and, more recently, The Limited, have chosen the carve-out as their basic organizing structure, repeatedly selling stakes in their business units. The results are striking.

We examined the performance of U.S. equity carve-out subsidiaries from 1985 to 1995, in cases where 50% or more of each subsidiary's shares were retained by the parent. (We were interested only in those companies where the parent remained an operating center, not a loosely affiliated holding company, and had annual revenues of at least $200 million.) Over a three-year period, the subsidiaries in this sample of 119 carve-outs showed average compound annual returns of 20.3%, which was 9.6% better than the Russell 2000 Index. Those companies that repeatedly sold stakes in subsidiaries fared even better. Three years after the carve-out, their subsidiaries showed annual returns of 36.8%. The parent companies themselves experienced average annual returns of 31.1%.

The results suggest that equity carve-outs are an effective way for companies to exploit growth opportunities and increase shareholder value. Safeguard Scientifics, for instance, has spawned six new companies since 1985, with revenue growing from $66 million then to $1.9 billion in 1996.

So what is it about a carve-out that promotes such growth? The answer appears to lie in the changed relationship between the corporate cen-

ter and the business unit, and the effect this has in three important areas: corporate governance, human resources, and finance.

Corporate governance

• *More value from the corporate center.* Many corporate centers often do little more than shadow-manage business units; and frequently they sub-optimize the plans of individual business units in the search for intracompany synergies. Carve-outs prevent these abuses. The agreements between parent and subsidiary are communicated to the subsidiary's shareholders through the offering prospectus. If the cost of the services the parent provides (typically 1% to 2% of revenue) is not deemed worth the benefits, then the subsidiary's board has a responsibility to minority shareholders to renegotiate the agreement or bring the services in-house.

The corporate center is therefore forced explicitly to add value by answering to an outside constituency of shareholders. No transaction will be tolerated, either between the subsidiary and its parent or the subsidiary and another business unit, that is not in the economic interests of all concerned.

• *Stock market scrutiny.* Business units that are 100%-owned are the sole responsibility of their parents, and are thus the subject of countless corporate reviews, meetings, and reports. Carve-outs, however, are under the direct scrutiny of investors and analysts who constantly measure them against other companies. Far from fearing such attention, CEOs of carve-outs welcome it as a means of monitoring (and improving) performance.

Human resources

• *High motivation.* Linking pay and business unit performance is one of the most difficult issues corporate boards face, and they seldom provide the kind of incentives that encourage outstanding performance. In carve-outs, however, corporate boards can use the market to align pay closely to performance, awarding managers stock in their own carved-out units rather than cash bonuses and/or parent company stock.

The payback is clear: increased entrepreneurialism, which benefits the parent company, the subsidiary, and top managers alike. As Victor Poirier, CEO of Thermo Cardiosystems (a carve-out from Thermo Electron), points out: "What you do is represented in the stock price." In fact, many of the subsidiary CEOs we interviewed saw their compensation more than double during the first year of independent operation.

Money is not the only incentive. The carve-out structure also responds to the psychological need of high-performing executives to be autonomous. Business unit presidents are no longer bit players in a billion-dollar company — they are CEOs.

•*Talent retention.* Companies sometimes lose their most talented people because they cannot offer them enough independence. Spencer Stuart discovered that out of 41 CEO assignments over an eight-month period, 65% were filled by executives who were number two in their previous companies and who were motivated by a desire to run their own companies.

Before Thermo Electron embarked on its carve-out strategy, several key executives were lured away by venture capitalists who promised them the chance to exercise their entrepreneurial talent by running their own operation with their own board of directors. Since then, not a single key executive has been lost.

Subsidiary carve-outs serve as breeding grounds for candidates who might succeed senior executives in the parent company.

Equity carve-out structures actually offer executives a nice trade-off between risk and reward. The CEO who is lured away by a venture capital firm to start a new company probably faces a tougher initiation than the CEO of a subsidiary carve-out who has strong support from the parent company.

• *Succession planning.* Subsidiary carve-outs serve as breeding grounds for candidates who might succeed senior executives in the parent company. Here, subsidiary CEOs get the chance to prove their business acumen and ability to work with their own board of directors. In discussions with GTE and SmithKline Beecham, we learned that they consider board experience important in identifying internal candidates for succession.

Finance

•*Funding for new ventures.* The stock market's close scrutiny of margins and earnings can inhibit investment in growth, which means new ventures within corporations are sometimes underfunded. Equity carve-outs give parent companies the chance to fund projects that might otherwise drain earnings. While the parent company includes the subsidiary's equity on its balance sheet, the income statement contains only a proportion of the subsidiary's expenses (51% ownership by the parent would record 51% of the subsidiary's expenses).

"Subsidiary carve-outs allow us to develop new businesses we would not otherwise have developed," states John Wood, CEO of Thermedics, a quality assurance and inspection product company. Wood

spun out Thermo Cardiosystems, which makes implantable heart-assistance devices, in 1989. Cardiosystems has since achieved compound annual returns for shareholders of 66%.

•*New investors.* Because carve-outs enable investors to buy shares in distinct businesses, they can attract a new constituency of shareholders. Investors can own shares in food company Nabisco, a carve-out of RJR, without owning shares in the parent tobacco company, for example. Boise Cascade, an integrated paper and forest products company, attracted 26 major new institutional investors when it offered a minority interest in Boise Cascade Office Products, a direct supplier of branded and private-label office furniture and supplies.

The carve-out structure responds to the psychological need of high-performing executives to be autonomous.

Carve-outs can also increase analysts' coverage of the parent company and its various subsidiaries, which in turn can increase demand for stocks. Safeguard Scientifics says carve-outs have prompted new interest in the company from top-tier, international market analysts, and that it now receives more requests for company literature in a month than it previously did in a year.

•*New capital at attractive prices.* Traditional financial theory suggests the market will value a project or business the same, irrespective of whether the parent or the subsidiary is raising funds. Many CEOs we interviewed, however, felt the subsidiary could offer stock at more attractive prices. Although we cannot test this opinion empirically, it is possible that when a subsidiary does an IPO, analysts take the time to evaluate its growth and profitability fully, whereas when the parent goes to the market, its performance overshadows the smaller unit's potential.

Equity carve-outs for everyone?

Any company undertaking an equity carve-out should realize that the act itself is no guarantee of success. The median compound annual return of our sample group was only 6.6%, compared with 12.2% for the Russell 2000 over a three-year period. In other words, while some companies do extremely well from carve-outs, others do not.

In analyzing the also-rans, we discovered that not all the carve-outs were done to spur performance: some parent companies wanted to distance themselves from slower-growing businesses. Others carved out units but failed to give them the strong management teams they needed; still others simply failed to take advantage of the new structure, applying the same old compensation and management practices as before.

Corporations must also realize that an equity carve-out will not suit everyone. It makes sense only under certain circumstances, when subsidiaries can be separated easily from the parent and other business units without creating huge transfer-pricing issues, and when the subsidiary has good prospects.

Companies also have to be prepared to deal with extra complexity and costs. Contractual agreements mean that transfer pricing, co-marketing, and technology sharing between the subsidiary and the parent or other subsidiaries have to be scrutinized by each board, which can be difficult and time-consuming. In addition, a carve-out duplicates administrative costs, and the cost of a subsidiary's debt is likely to rise once its assets and liabilities are separated from the more secure parent.

Successful equity carve-outs also require subsidiary management teams to work cooperatively with the corporate center. "The best, most secure management teams will always take advantage of all the help they can get," says Dave MacLachan, CFO of Genzyme. "Weaker, more insecure managers will always push for more independence than they are ready for."

Finally, it has to be remembered that an equity carve-out is not a substitute for selling a business unit that should be discarded. It is instead a way of keeping businesses together that can create value together, but under a new, more vital structure.

Done properly, and under the right conditions, carve-outs offer an exciting opportunity to increase returns to shareholders. In the 1990s, innovation and growth are increasingly tied to specific employees who are mobile, and who demand a considerable share of the value they help create. To perform well in an environment of specialization, increased competition, and diminishing product life cycles, those individuals need the power to act quickly and independently. At the same time, globalization and shared resources such as reputation demand a degree of coordination.

Carve-outs can help address all these issues. They foster many of the performance advantages found in independent, agile businesses, but they do not forfeit the opportunity to profit from synergies among business units or from the wisdom and experience of the executive center.

©1997 McKinsey & Co. The authors published an additionally detailed analysis of equity carve-outs in *The McKinsey Quarterly* (1997, Vol. 1), from which this article has been adapted.