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# SWP 28/89 IMPROVING BUSINESS PERFORMANCE THROUGH CAPITAL DISINVESTMENT

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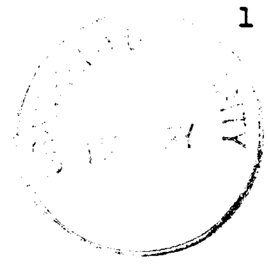

# IMPROVING BUSINESS PERFORMANCE THROUGH CAPITAL DISINVESTMENT*

## 1. Introduction

Business organisations in general appreciate that capital investment is usually necessary to increase shareholders' wealth. But the active seeking of capital disinvestment opportunities as a potential source of wealth creation seems less well understood. Whereas investment is associated with growth and success, disinvestment is often equated with decay and failure. This may help explain the reluctance of many managers to grasp profitable disinvestment opportunities. Nor is disinvestment easy, since, as Jim Slater once remarked, it is easier to turn cash into assets than to turn assets into cash.

In this article I shall discuss the types of capital disinvestment, the reasons for and against disinvesting, how to identify disinvestment opportunities and potential buyers, and the determination of the disposal price.

## 2. What is Capital Disinvestment?

In its broadest sense, capital disinvestment (or divestment) means reducing the assets (particularly fixed assets) held by a business. Capital disinvestment can be achieved in a number of ways, as shown in Figure 1.

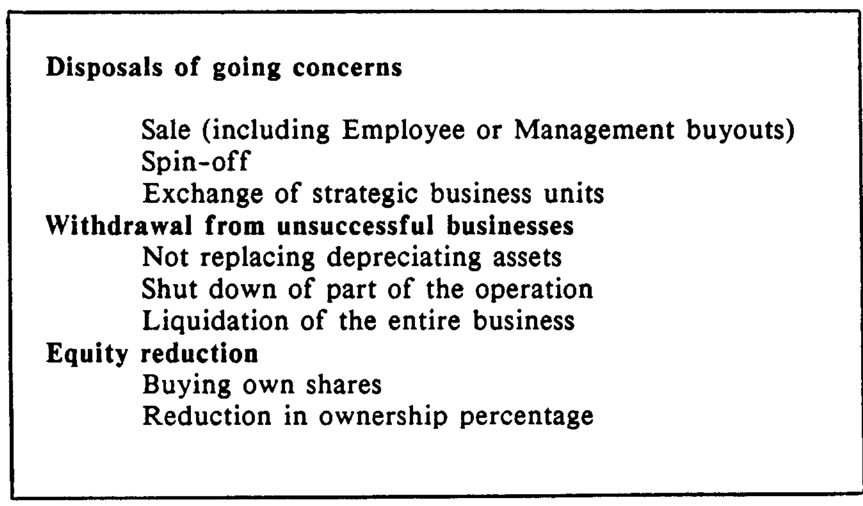


**Figure 1. Types of Capital Disinvestment**

These various forms of capital disinvestment are now discussed.

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## Sale

A business (or part of it) may be sold either as a going-concern or on an assets-only basis. Many companies sell part of their operations to other companies on a going-concern basis. For example, at the beginning of 1987 the Beecham Group sold most of its soft-drinks interests for around £130 million. The main buyer was Britvic.

An increasingly popular way for companies to dispose of unwanted and often unprofitable businesses, is through buyouts of that business activity by employees or managers. Many jobs may be retained in this way and in some instances employee shareholders may also benefit from capital growth.[1] Success in management buyouts is measured not only by the completion of a deal to the satisfaction of all parties involved. For the buyer, survival and satisfactory long-term performance also depend upon good relationships with investors, a strong management team, and the creation of a business which satisfies customer demands.[2] Last year Thorn EMI further rationalised its technology division by deciding to sell its measurement equipment interests to a group of senior managers.

Privatisations, e.g. of British Rail Hotels, are a particular form of disinvestment by sale, enabling Central Government to obtain cash whilst at the same time enhancing management's freedom and motivation, and (arguably) furthering competition. Privatisation of large organisations such as British Telecom and British Gas have also helped to achieve the government's aim of producing more shareholders.

## Spin-off

A spin-off establishes part of the business as a separate company and distributes the shares in that company to the shareholders of the holding company. In this way the spin-off company is set free to operate under its own management without interference (or help) from the group holding company. Spin-offs are not common and usually result from court orders. Standard Oil of New Jersey and Transamerica Corporation have been involved in court order disinvestments. The announcement in April 1988 that Racal Electronics is to float off its Racal Telecommunications operations does not amount to a spin-off, because Racal will continue to hold a majority stake in Racal Telecommunications.

## Exchange of strategic business units

Two businesses wishing to disinvest part of their activities may achieve mutual satisfaction by exchanging business units. In 1982 for instance, BP Chemicals swapped its PVC business for ICI's low density polyethylene interests, in a virtually cashless deal.

## Buying own shares

The buying of a company's own shares reduces its equity and its cash. This is much more popular in the United States than in the UK where it has only recently become legal. Ford Motor Company amongst others have bought their own shares in order to support the share price since the October 1987 stock market crash. In the UK GEC have bought their own shares in recent years. The result is less equity and less cash. Although fixed assets themselves have not been immediately reduced, the capacity to acquire more fixed assets has.

## Reduction in ownership percentage

The reduction in percentage ownership of a subsidiary company, and the subsequent possible relinquishing of control is often associated with the foreign investments of multinational companies, and sometimes where the host government wishes to localise business control.[3] It is achieved by the disinvestor selling his shares in the subsidiary company. During 1987 General Motors sold 40% of its ownership in its Bedford Van operation in Luton to the Japanese company Isuzu. The responsibility for managing the operation was also passed on to Isuzu.

## Not replacing depreciating assets

By not replacing depreciating assets a business can gradually reduce its investment. It might be necessary, however, for some minor investment to be made just to keep the business in operation until the major fixed assets have ceased to be effective. In historical cost accounts, the balance sheet amount of fixed assets needs to increase from one year to the next in order to maintain the "real" level of fixed assets, because of increasing prices. With current cost accounts, the cost of asset acquisitions needs to match CCA depreciation in order just to "stand still."

The British (and other countries) shipbuilding industry have disinvested by not reinvesting in fixed assets.

## Shut down of part of the operation

Some business operations are shut down because they are considered not worth continuing and because an acceptable buyer has not been found. Last year Golden Wonder closed its factories at Broxburn, West Lothian and Long Buckby, Northants. in order to improve efficiency and job security in the remaining business.

If significant, the financial and human costs of closure may well delay the closure date. For instance, coal mines eventually reach a point where they are exhausted or become uneconomical to mine. The often high level of redundancies, however, tends to provoke resistance to closures.

## Liquidation of the entire business

When things have turned particularly bad for a company the best alternative may be (voluntary) liquidation of the entire company. This enables creditors to be paid and possibly allow return of some cash to shareholders. Liquidation is more prominent amongst smaller businesses which don't have a long track record of profit growth and where the political consequences of liquidation are minor compared to those for larger companies.

Figure 2 shows the range of activities and capital that might be disinvested.

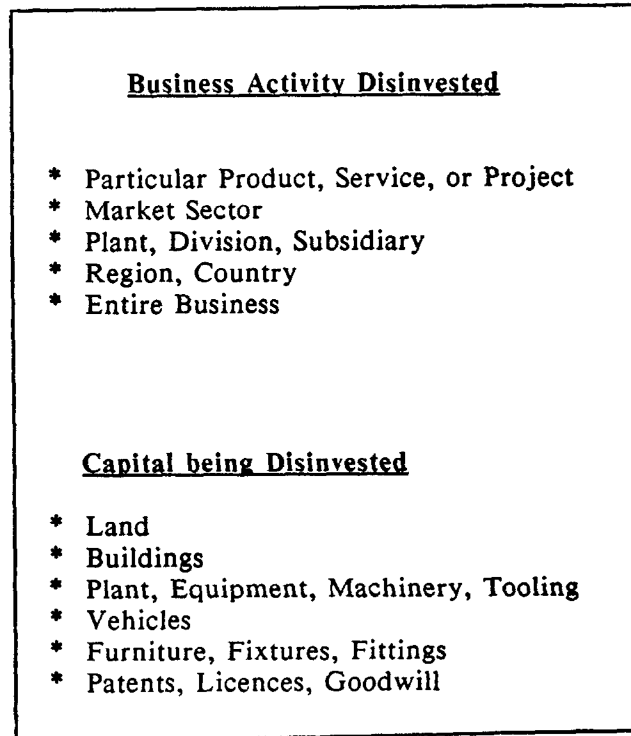


**Figure 2. Disinvested Activities and Capital**

In liquidation circumstances, the value of land and buildings will often far outweigh the disposal worth of the other capital items in Figure 2. For going-concern businesses the future business prospects count more than book values.

As a consequence of a reduction in fixed assets there may also be a reduction in current assets, particularly stock and debtors. In some instances the current assets disposed may exceed the fixed assets. For example, Standard Chartered Bank's decision to sell Union Bank, its Californian subsidiary, involved substantially more debtors than fixed assets.

## 3. Why Disinvest?

Businesses choose to disinvest for a number of reasons, only some of which are financial.[4] The financial reasons for voluntary disinvestment relate to cash needs, business performance and the financial environment. These are identified in Figure 3. In addition to financial reasons, other reasons for choosing to disinvest relate to the market place, management, technology, business environment and business strategy. These reasons are detailed in Figure 4.

(a) Cash related

(i) Need for cash - survival, better re-investment opportunities, to reduce gearing (thereby reducing interest charges and risk, and improving the credit rating of the business).

(ii) Owners of a closely-held corporation selling their shares.

(iii) Voluntary liquidation of the business, not only to obtain cash but also to avoid the cash needs for any substantial new investment required to continue on a profitable basis.

(b) Performance related

(i) Unsatisfactory (actual or forecast) profit level on assets being disinvested.[5]

(ii) Selling off failed acquisitions and fringe activities to focus efforts in order to increase share values.

(iii) Rationalisation of resources to achieve cost reductions and avoid duplication or uneconomic scale of operation.

(iv) Project nearing end of profitable life.

(v) Corporate sales and profit growth objectives not met.

(vi) Present value of cash flows is greater for disinvestment than retention or expansion of business.

(c) Financial Environment

(i) Increasing interest rates pushing up financing costs.

(ii) Increasing rate of inflation which cannot be compensated for by price increases.

(iii) New restrictions on funds transfer from foreign country to home country (of multinational company).

(iv) Adverse tax changes.

**Figure 3. Financial reasons for voluntary disinvestment**

(a) Market related

(i) Declining industry with permanent reduction in customer demand to an inadequate level.

(ii) Market share continuing too low, or inability to penetrate a new market.

(iii) Business location badly situated in relation to markets and distribution means.

(iv) Commercial difficulties, risks and uncertainties.

(v) Competition increased to severe level.

(b) Management

(i) Better use can be made of limited management and other skilled resources.

(ii) Inadequate management knowledge.

(iii) Conflict between foreign local management, local trade unions, host government or foreign partners and multinational head office regarding objectives, policies (e.g. trading policy), management style, expansion, staffing, research and development; plus language and cultural problems.

(iv) Lack of any specific competence.

(c) Technological

Obsolete technology in the businesses products or processes.

(d) Environmental Factors

New legislation, anti-trust laws, restrictions on new technology, removal of incentives, possibility of involuntary disinvestment, risks and uncertainties, (e.g. the greater political pressures and uncertainties currently relating to South Africa).

(e) Strategic

Change in business strategy.

**Figure 4. Other reasons for voluntarily disinvesting**[6]

Not all disinvestment is voluntary. Involuntary disinvestment may result from government decree, expropriation, nationalisation, localisation or liquidation. Multinational organisations operating in foreign countries are particularly prone to involuntary disinvestment, as are those companies operating in socialist countries.[7]

4. **Barriers to Disinvestment**

Although there are many reasons for disinvesting, there are also many "barriers to exit" which might make any disinvestment less desirable than it first appears.[8] Exit barriers may relate to one or more of the following:

(a) Financial.

(b) Strategic.

(c) Managerial and emotional.

(d) Government and Social.

(e) Information.

These barriers are covered in detail in Figure 5.

(a) **Financial Barriers**

- (i) Long-lasting specialised assets (fixed assets and working capital special to the business, company or location), where the proceeds from sale may be much less than the economic value of continuing operations.
- (ii) High cost of exit (labour redundancy settlements, employee relocation and retraining, reduced productivity, management time required, continuing availability of spares, cancellation penalties for long-term contracts, customer and supplier reactions).
- (iii) Effect on company profitability in the short-term (due to asset writedowns and additional costs).
- (iv) Tax penalties on disinvestment (e.g. capital gains tax, grant repayments).
- (v) Exchange controls preventing remittance of proceeds.

(b) **Strategic barriers**

- (i) Interrelatedness of activity being disinvested with those being retained.
- (ii) Vertical integration concerns (i.e. where the business being considered for disinvestment is a supplier to, or customer of, the remaining business).
- (iii) Effect of disinvestment on access to financial markets.
- (iv) Effect on company image, public relations, customer relations and competitor position).

(c) **Managerial and emotional barriers**

- (i) Managerial resistance due to disinvestment being equated with failure, sentiment towards project or people, adverse effect on own job prospects or rewards, resistance to change.
- (ii) Irreversibility of disinvestment.
- (iii) If surplus funds already exist, disinvestment is not necessary!

(d) **Government and social barriers**

- (i) Legislation (e.g. Employment Protection Act), ... but this may also discourage "investment" in the first place.
- (ii) Government reluctance to disinvest poorly performing state industries.
- (iii) Pressure from central and local governments, trade unions and other interest groups.

(e) **Information barriers**

- (i) Lack of detailed performance knowledge.
- (ii) Belief (perhaps false) that the project can be made profitable.
- (iii) Acceptance of myths - loss leaders are OK, a full line of products is necessary, all overheads are fixed in the long term, employees will lose heart and give up.

**Figure 5. Barriers to Disinvestment**

## 5. Identifying disinvestment opportunities

We now need to establish how to identify possible disinvestment opportunities. Sometimes it will be obvious that disinvestment is essential. On many occasions further detailed analysis will be needed to determine which disinvestment options should be pursued.[9]

Important aspects in identifying opportunities for disinvestment relate to:

(a) finance,

(b) the market, and

(c) information and motivation factors.

(a) Financial indicators suggesting disinvestment.

- (i) Losses (or zero accounting profit) being incurred.
- (ii) Return on Investment below required standard.
- (iii) No actual or expected positive cash flow.
- (iv) Disposal value is greater than the NPV of retention alternatives.
- (v) Wages as a proportion of selling price becoming too high.

(b) Market indicators suggesting disinvestment.

- (i) Product in decline position on product life cycle.[10]
- (ii) Cessation in growth of sales and profits.
- (iii) Declining industries or products, in which the company has no specific strengths.
- (iv) Market position (e.g. low market share and low growth. Low market share and high growth products should also be reviewed).

(c) Information and Motivation Factors

- (i) Require that a disinvestment study also be carried out when considering capital investment proposals.
- (ii) Management Information System needs to facilitate a routine disinvestment review procedure.
- (iii) Management compensation plans might be designed to encourage management to suggest and support disinvestment proposals.

6. Identifying potential buyers for going-concern businesses

When disinvestments take place with excessive haste a 'distress' price may be all that is obtained by the seller. Whilst the releasing of cash and management resources by a prompt sale is highly desirable, this must be set against the loss of cash by selling at too low a price. If the seller is under no pressure to sell he might delay selling until circumstances allow a good deal to be agreed.

Potential buyers include:-

(a) employees or management

(b) partners (in joint ventures)

(c) public or private companies

(d) entrepreneurs

(e) competitors

(f) suppliers or customers

(g) the public

Buyers who can make best economical use of the disinvested business and have ready access to the necessary cash are good candidates. Competitors may be acceptable buyers, providing the seller's remaining business operations are not jeopardised by the sale. Monopoly (or anti-trust) restrictions may, however, prevent some buyers from being able to complete the purchase. A recent well-known example is the Football League Management committee's prevention of Elton John selling his stake in Watford Football Club to Robert Maxwell.

In addition to the seller identifying suitable candidates assistance may also be sought from bankers, consultants, accountants or other advisors. Advertising for a buyer is another possibility, (e.g. the Financial Times 'Businesses For Sale' columns). Sometimes a potential buyer takes the initiative by making an unsolicited offer.

In the event that no satisfactory buyer can be found, voluntary liquidation might be considered.

7. **Establishing the Price**

From the disinvestor's view the disposal proceeds should normally exceed the expected present value of continued operation. It is important to beware of the shortcomings of comparing the potential disposal proceeds with the book value of the assets. This may mislead management into continuing with an operation that is best disinvested, or selling a business too cheaply. To use book values is to focus on the past and the short-term future, especially the current financial year's performance. Top management must be able to convince shareholders and lenders of the longer-term value of major disinvestments.

The value of the disinvested business should also be considered from the buyer's viewpoint. What is the business worth to somebody else? If the value of the disinvested business is thought to be worth considerably more to the potential buyer than it is to the seller, the seller may substantially improve his shareholders' wealth

by this disinvestment. The buyer also expects to gain from this win-win transaction. Buyer and seller values of the disinvested business might differ due to:-

(a) greater synergy with the buyer's total business than with the seller's,

(b) differences in the discount rate used in determining present values (perhaps because of real or perceived differences in cost of capital or risk),

(c) differences in forecasts of future currency exchange rates and opportunities,

(d) tax implications, e.g. buying a UKbusiness to take advantage of unrelieved Advanced Corporation Tax,

(e) differences in management motivation and behaviour.

The agreed price may be for cash on transfer of assets, cash at a later date, interest-bearing loans to, or shares in the buying company.

## Conclusion

During the 1960's and early 1970's when organic growth and acquisitions were commonplace and satisfactory profits more readily attained, some unsuccessful operations could more easily be tolerated.[11] With the highly competitive business environment nowadays, poor performers cannot be carried for long. Management, therefore, needs to be more alert to disinvestment opportunities that may significantly improve business performance.

Consideration of possible disinvestments is often hampered by management's desire to get on and manage what they have. Too often a "fire-fighting" attitude prevents an objective review of how management and financial resources might better be used in future. Time needs to be given periodically to this longer-term view of the business which will assist in more profitable disinvestments conducted at the seller's initiative, rather than in forced-sale circumstances or not at all.

It seems quite common after acquisitions for the buyer to quickly dispose of any peripheral activities acquired. Such disposals are likely to be less traumatic than selling off poor performers to "concentrate on core businesses".

Many companies may need to update their management information systems and routines to enable periodic review of disinvestment opportunities. In addition to reviewing business profit performance, periodic analysis of past and forecast future operating cash flows will highlight poor performing activities. If remedial action fails to lift performance then consideration should be given to finding a buyer or, at worst, planning for closure.

Motivation systems may also need to be changed to encourage management (and maybe other employees) to positively seek out and implement good disinvestment opportunities. Management buyouts are perhaps the best example of how managers might be motivated to seek out disinvestment opportunities and, of course, successfully follow through.

Disinvestments viewed by shareholders and the market as a good logical deal are likely to cause the company's share price to rise on announcement of the disinvestment news.[12] And share price growth is a major factor is measuring the success of a business and its managers.

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