Four Steps to a Winning Divestment Strategy

By Dan Shumate and Carter Brenneman

Consolidation in the construction industry has steadily increased over the past 10 years. In the utility construction segment, we've seen the market capitalization of the top 10 public companies grow by 65% over the past decade, with most of the growth driven by acquisition.[1]

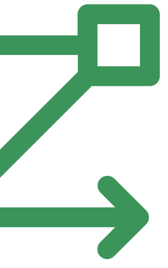
As companies grow through acquisition, there will inevitably be elements of the businesses acquired that don't align with the acquirer's strategic focus. Occasionally, these pieces can be worth more separated from the parent company than they are embedded within a larger construction company.

Divestment remains an important part of the toolkit for a corporate development team and for executives assessing how to unlock the highest value for the company. For example, one company we worked with recently held a product distribution company inside of a large specialty construction company.

As a standalone entity, that distribution company had a multiple that was almost two times the value of the larger construction company. By divesting of the company, the owners would be able to unlock the smaller business's value and then either distribute the cash or invest in the areas of the company where management was strategically focused.

By implementing a strategy that factors in not only growth through acquisition but also strategic divestment, executives can gain both operational and financial benefits that far outweigh a passive buy-and-hold approach.

[1] Source: S&P Capital IQ, Tickers for companies included are: MDU, PWR, MTZ, DY, PRIM, ARE, GVA, AEGN, MYR, MTRX



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In a business environment where 83% of E&C firms are interested in acquisitions, it pays to set your criteria, establish your team and lay down the rules of the road before jumping in.

As project sizes grow, and as the share of megaprojects rises as a percent of total construction put in place, the demand for large, technically sophisticated firms has increased. We're also seeing a continued integration of design and construction, both in terms of project delivery and business models. Combined, these trends have led large E&C players to increase their acquisition activity, especially engineering and design firms.

In FMI's recent M&A trends study, 79% of firms with over $1 billion in revenue stated that acquisitions were a current part of their strategy, compared to 42% of firms with less than $500 million in revenue. Mirroring recent deal history, engineering and integrated E&C firms indicated they were much more likely to be acquisitive in 2017, with 83% stating acquisitions were a current component of their strategy.

Similarly, of the nearly 4,000 M&A transactions FMI has tracked since 2007, roughly 5% were acquisitions by eight firms, primarily large engineering-led companies such as Stantec, WSP Global and AECOM. This trend is less pronounced on the construction side, where competitors are more fragmented, projects are delivered locally, and economies of scale are less pronounced.

Over the last few years, the ENR 400 has accounted for roughly one-third of all construction put in place in the U.S., a ceiling it has not topped since the 1970s. Despite this, we are seeing increased buyer appetite in the construction segment, especially among self-performing contractors.

In this article, we'll explore the current M&A trends, show where the challenging points are, and provide four rules of the road that all E&C firms should follow when considering and/or orchestrating mergers, acquisitions and divestitures.

Is It Worth It?

In tracking nearly 400 E&C transactions in the U.S. and Canada in 2016, FMI found activity to be roughly on pace with that of 2015 and 2014. Fast-forward to 2017, and acquisitions remain a component of most E&C firms' current strategy, with many companies prioritizing small strategic deals over major transformational acquisitions. For

those firms currently considering an acquisition, the ability to integrate effectively was identified as the most important factor in achieving a successful transaction.

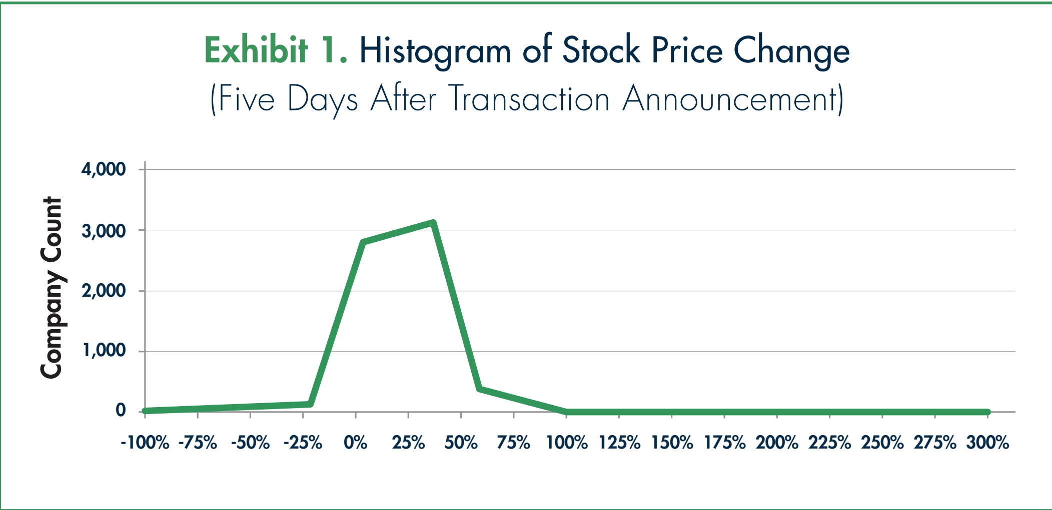
Before executing a strategy of "growth through acquisition" or "strategic refinement through divestiture," company leaders need to ask themselves this important question: Is this worth it? For acquisitive growth, this next question is: Does the risk of investing capital in a business outweigh the risk of loss or setback? And for divestitures: Do people in a division that have been with the company through the thick and thin outweigh the potential advantages that come with a focused strategy?

Creating a Focused Strategy

Many construction companies never complete an acquisition. Instead, they are passed from generation to generation and tend to grow at a measured and predictable pace. Contrast this with a company like Quanta Services, which over the past 20 years grew its revenue from $80 million to $7.6 billion. This growth was due to a focused acquisition strategy in a segment where Quanta understood the end market and was disciplined in pricing—strategies that drove the growth of the largest power services company in the U.S.

In addition, Quanta has not simply purchased companies and held them indefinitely. Also shaping the firm's strategy and improving shareholder returns were strategic divestitures of business segments that were underperforming due to changing market dynamics. Companies that engage in both acquisition and divestitures to actively control what is in their portfolio deliver increased shareholder returns.[1]

Let's look at an analysis of the valuation and share price return of over 6,000 divestitures or spinoffs by public companies since 2000. In Exhibit 1 below, a pattern emerges that



Source: Data compiled from S&P Capital IQ and analyzed by FMI.

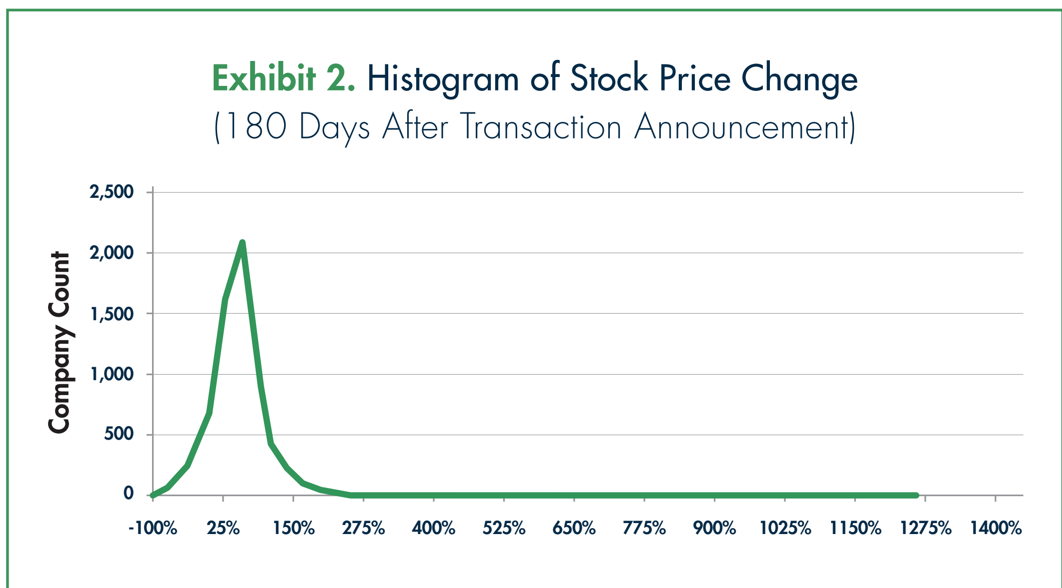
1 Dranikoff, Koller, Schneider (2002). Harvard Business Review.

persisted throughout the data: a right skewed histogram that has a very long tail on the positive end of the spectrum. We would expect the right skew because there is a natural barrier to price ($0); and if a company makes a decision that has very negative effects on the business, then there is a downside to the percentage decrease of the company's stock price. However, the magnitude of positive increase in stock price results in a notable finding, with both the short-term (5 days) and middle-term (180 days) results showing an increased chance of outperforming the market.

Further study has demonstrated that over longer time intervals, excess returns for companies that complete divestitures averaged 4.4% globally.[2]

Exhibit 2 illustrates not only the right skew, but also the significant long tail that can occur, resulting in outsized shareholder return. The average stock price return over 180 days was 10.9% alongside a median of 4.5%. Additional analysis by other firms produces similar results. In a study written by Bain consultants for HBR, "An investment of $100 in the average company in 1987 would have been worth approximately $1,000 in 2007, but a similar investment in the 'best divestors' would have been worth more than $1,800."[3]

While the divestiture can be a boon for a shareholder, many of these transactions actually produce limited returns. The reason for the divestiture, strategy moving forward and the financial changes after close all



Source: U.S. Census Bureau, July 3, 2017

[2] Restructuring and Repackaging Corporate Assets, May 9, 2008, Citigroup Global Markets. Excess return is defined as: Actual Return – (β x Market Return).

[3] Mankins, Harding and Weddigen (2008). Harvard Business Review.

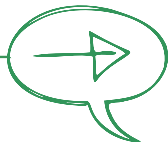
impact the likelihood of success. Reasons for a divestiture can vary widely from operationally focused to financially focused. Common reasons include:

Operations Focus

Strategic Focus:
Management aligns the business with its primary strengths.

Operational Improvement:
Management exits from low growth and profitability segments.

Highlight Growing Business:
Rather than focus efforts on underperforming groups, management can highlight a business unit by divesting of others that do not meet the same expectations.



Financial Focus

Capital Structure Change:
Management can reduce leverage, improve credit rating and increase financial flexibility.

Increase Cash:
Management increases cash to allow for acquisition or significant capital purchases.

Market Timing:
Management determines that a business segment is overvalued by buyers and exits that business.

The Four Rules of the Road

Acquisitions and divestments do not come without risk. Many of the best-in-class acquirers have dedicated teams to select the appropriate companies and then integrate those firms into their organizations. Employee turnover and risk management impact operations while capital structure, distributions, investor profile and credit impact the financial decisions.

We reviewed the work on "how the best divest" for application to the construction industry to determine the four rules of divestment.[4] Here they are:

Rule 1: Establish a dedicated team. Whether determining to complete a major spinoff such as Babcock and Wilcox from McDermott or selecting whether to keep a division in place, a team of individuals dedicated to the analysis of the fit and opportunity of business units within a company is critical. For smaller companies with limited resources, management should take on the role of reviewing business units and service offerings annually.

Rule 2: Set your criteria. While market timing is stated as a potential financial reason for divestment, timing the market is incredibly challenging in practice. It's important to establish a set criterion to effectively determine whether a division or subsidiary should be a candidate for divestment. For example, a division's return on investment must meet a three-year average of 15%, or that division could become a candidate. The specific values should be highly focused

[4] Mankins, Harding and Weddigen (2008). Harvard Business Review.

on the individual market and industry; however, the criteria can prevent hasty decisions or market-timing mistakes.

Rule 3: Dig into the details before pulling the trigger. Removing components of a business can be as impactful as incorporating new ones. Management should select the people who will be involved in the divestment and assess the associated impact on existing operations. For a materials company that can easily separate an individual quarry's people and operations, this can be straightforward. However, the decision to sell the service division of a large commercial electrical company can be much more difficult. Often, the service division of the company will have similar estimators, dispatch and controllers, and be a component of active contracts held in the construction division. The best divestors have a strategy of de-integration before making the decision to go to market.

Rule 4: Articulate the benefit to a potential buyer and motivate employees to stay on board. The last rule is a requirement of any acquisition or divestiture in the engineering and construction space. Without the people involved in the transaction, there is no transaction. Therefore, it is important that you clearly articulate the potential benefit to an acquirer of the division or subsidiary that is being placed on the market. This process helps ensure the divestment does not fail or receive a poor valuation. In addition, it's crucial to retain key employees to facilitate the successful divestment of a unit. A champion within the division can be very helpful for selling the concept internally and presenting the asset for sale. Incentivizing the unit's management team with compensation, and providing select management with knowledge of the eventual sale, can also positively impact the outcome.

As the E&C industry becomes increasingly dotted with mergers, acquisitions and divestitures, the success rates for these deals will depend heavily on the teamwork, legwork and due diligence that take place long before any documents are signed. Utilizing divestments to illuminate value, create liquidity and flexibility, and improve operations has a clear valuation benefit. In both the short term and the long run, companies that align their acquisition and divestment strategy with the core competencies of their business can outperform their peers.

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