Exchanges at Goldman Sachs

Changes at the Top: Spinoffs,

Separations and Restructurings

Ben Snider, senior strategist, U.S.

Portfolio Strategy macro team,

Goldman Sachs Research

David Dubner, global head of M&A

Structuring, Investment Banking

Division, Goldman Sachs

Allison Nathan, Host

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Allison Nathan: The economy is slowing, interest rates are rising. Markets are volatile, and geopolitical tensions are high. For corporations, that's a recipe for shrinking revenue and profits.

Ben Snider: Companies are dealing with incrementally higher input costs, and the key question for investors is going to be whether companies will be able to sustain these record profit margins as growth slows but those input costs continue to rise.

Allison Nathan: I'm Allison Nathan and this is

Exchanges at Goldman Sachs.

A challenging macroeconomic backdrop is putting pressure on companies' bottom lines, so how are management teams responding? Many companies are looking to create value for shareholders through spinoffs, separations, and carve outs. In this episode, we'll dig into the outlook for corporate profits, the landscape for corporate restructuring, and what this all means for deal making. To do that, I'm joined by Ben Snider, senior strategist on the US portfolio strategy team and Goldman Sachs Research, and David Dubner, global head of M&A structuring within the investment banking division. Ben, David, welcome to the program.

Ben Snider: Thanks, Allison.

David Dubner: Great to be here. Thank you, Allison.

Allison Nathan: Ben, first just give us a sense of the macro headwinds that US companies are facing today and how they are beginning to navigate them.

Ben Snider: It's definitely been a volatile macro environment to start the year, and I think the headwinds are pretty clear. Growth is slowing. If you look at our economic forecasts or the consensus of economic forecasts, it's pretty clear that growth is slowing. And at the same time, inflation is running hot so the Fed is tightening monetary policy. And that is a very different environment than companies have been used to operating in the last couple years where growth has been very, very strong Just to give you some context, earnings are right now running at a pace that is 25% above pre-COVID levels. And profit margins -- the dollar a company makes relative to their revenues -- are also running at record highs. So in addition to being a difficult environment, it's a changing environment and that's always a challenge for companies.

Allison Nathan: And we hear so much about valuations, especially coming into this year, stretched valuations in the equity space. You know, what has been the impact of some of these macro headwinds on valuations?

Ben Snider: Valuations have definitely declined. If you look at the S&P 500 PE -- price to earnings multiple, which is the most common our investor clients look at --

it's currently around 19 times for the S&P 500. Last year, it was at 22 times. So it's below the highs, but, relative to history, 19 times is still very elevated. And I think you can attribute that, in part, to the slowing of growth that I mentioned earlier, but mostly I think that's due to the fact that the Fed is now tightening monetary policy and interest rates are rising pretty quickly.

Allison Nathan: So if you think about this on a sector basis, though, are there some companies -- or sectors, I should say -- that are looking more stretched than others? Or is it really a uniform situation where valuations are still quite elevated relative to the past?

Ben Snider: Of course there's a wide distribution, but I think it's fair to say that really across the market valuations are elevated relative to the past. I think what's interesting though is, if you dig into the market and you look across companies, we can find patterns of which companies are expensive or cheap based on their corporate fundamentals. So for example, over the last few years, investors have really been focused on revenue growth, on which companies are growing the most quickly, and those companies have, therefore, become the most expensive. I

think what's interesting is, in the very recent past, that dynamic has started to shift. And as inflationary pressures have built and as expected growth has slowed, the market has shifted a little bit towards focusing more on profitability with high profit margin companies commanding an incremental valuation premium relative to their lower profit margin peers.

Allison Nathan: So we're about to head into the earnings season in the US, so what are you watching? What are investors most focused on right now?

Ben Snider: It's two key questions that we're focused on and that investors are invested on and, frankly, other analysts are focused on as well. First is: How much is growth slowing? As I mentioned, our forecasts are for growth to slow. I think most clients have this view. Most economists have this view. The question is: How much is it going to slow? Especially because the consumer is 70% of the US economy, and the consumer is losing a lot of support that they've had in the past from fiscal stimulus and now because prices are rising quickly and that also reduces consumer spending. So we'll be watching very closely both the actual first quarter reports, but I think

even more importantly what companies are telling us about their expectations to get a sense of that path going forward.

And the second key issue, again, is this profit margin issue, where profit margins are at record highs. Companies are dealing with incrementally higher input costs. And the key question for investors is going to be whether companies will be able to sustain these record profit margins as growth slows but those input costs continue to rise.

Allison Nathan: And are companies taking any action? I mean, what are they doing to try to sustain those higher margins right now?

Ben Snider: Today, there's two approaches they're taking. One is on the fundamental side, which is pulling the usual levers that companies always pull. So if you can cut costs elsewhere, companies are doing that. If you can improve efficiency or increased productivity, companies are doing that. And if you can just raise prices, companies are doing that. That's the definition of inflation, right? It's higher prices, so companies are clearly doing that.

And the other thing is get a little more active and a little more creative in terms of corporate structure. And so we're seeing an increased focus on potential M&A and, in particular, increased focus on splits and spin outs. You know, last year, we had over 30 companies announce splits. We had over $100 billion in executed splits. That's over twice the 5-year average. In our view, that trend is just going to continue as companies have to find new creative ways to sustain their growth and sustain their profitability.

Allison Nathan: And so by splits, you mean companies just breaking up into various parts. And spinoffs are just spinning out, like, one aspect of their business.

Ben Snider: Absolutely. Taking a structure and saying, "Maybe I can carve out a part of this business and make each part better as a result."

Allison Nathan: David, let me turn to you. You actually advise companies on these types of transactions, so what does the landscape for splits, spin outs look like today? And what activity are you really seeing the type of activity that Ben just mentioned?

David Dubner: Yeah, so I would agree with Ben, Allison. At the beginning of the pandemic, we put out a thought piece predicting a super bloom of separation activity. And I'd say, sitting here today, that activity is in full bloom. Ben mentioned last year alone we saw on a global basis more than 30 completed spin offs. And again, as Ben said, a spin off is effectively a stock dividend. You're distributing a subsidiary business to your shareholders such that a shareholder now has two pieces of paper instead of one. We saw 30 of those announced and more than 30 of those complete on a global basis.

If you think about what that means in terms of overall M&A volumes, that's running at roughly 5-10% of global M&A volumes over the past several years. And if you look at it just this year alone, Q1, we've had ten announced separation transactions, spin off transactions, as well as seven completed. One of those transactions being completed was north of $100 billion separation transaction. So these transactions and structures are very much topical and very much being evaluated in many board rooms and by many managing teams.

Allison Nathan: And Ben gave his thoughts on what's driving that activity. Do you have any incremental thoughts in terms of why this type of activity is really taking off right now?

Speaker: Sure. I'd say for the past, you know, 18 months, we've had many companies inwardly focused. Focused on their strategic priorities, their growth vectors against the backdrop, as Ben described, of a changed operating and competitive environment coming out of the pandemic. That has led to an increase in the amount of strategic reviews, with strategic reviews often being a precursor for a separation transaction or the like. That's the first.

The second is we have seen companies become more segmented, more complex, more diversified. And that has pros and cons. On the cons, it can create capital and operating inefficiencies, and a separation transaction can be one tool to address those inefficiencies. So for example, when companies announce a separation, you will very often hear them talk about management focus and attention. Can a management team focused on one business or one purpose be more fit for that purpose to drive growth?

Secondly, you'll often hear about capital efficiencies and capital allocation priorities. If I have multiple businesses each demanding capital, am I allocating those across each three? Or am I perhaps favoring one over the other? And similarly, as I think about attracting the optimal shareholder base and research coverage, do I have the appropriate structure and business mix to do that? Or can I perhaps unlock incremental value and attract an appropriate or more appropriate shareholder base and research coverage through a separation transaction?

Allison Nathan: And when we think about spin offs and carve outs, I often think about activist investors. This is a favorite tool of theirs. Are companies engaging in this kind of activity in order to thwart activist attacks on their companies? Do you see that as a motivation?

David Dubner: I would agree that, as we look at activist campaigns over several years, a breakup thesis or M&A thesis is often a component, in particular on some of the more diversified targets. But if you think about what the driver is for those activist campaigns, it is to unlock shareholder value, right? Often a potential proceeds some of the parts discount. At the same time, boards and

management teams have been focused on and thinking about portfolio and portfolio rationalization since the beginning of time, also with a focus on driving long-term shareholder value creation. So I don't necessarily view this as a competition for ideas or thwarting an activist campaign. Rather, I view this as a healthy dialogue where boards and management teams, as I noted earlier, are looking inwardly, thinking about their portfolio against a host of other potential alternatives that are available to them, and very often may announce a separation transaction in advance of an activist coming into a register, while an activist is in a register. But I wouldn't necessarily say, in my experience, that's thwarting. In my view, it's all aligned around a similar objective, which is creating value.

Allison Nathan: Are there other factors contributing to this level of activity today?

David Dubner: Yes, Allison. I would say that the level of dry powder, capital that is sitting on the sidelines in the form of private equity funds, venture capital funds, and SPACs, is also fueling the level of activity that we have seen to date that is in part because the amount of public-to-private opportunities for a private equity fund will be

limited relative to the opportunity for a fund to deploy capital in a corporate carve out. And what I mean by that is investing in a minority or majority position in a corporate subsidiary. That type of dialogue and in bounding to strategics only fuels this level of thinking and this type of activity ahead.

Allison Nathan: Right. So it's just another instance of a lot of cash.

David Dubner: They're getting in bound -- or clients are being in bounded. They're not only hearing from activists, they've got financial sponsors are calling saying, “Hey, I'd like to buy 30% of your business.” Everyone is in on the game and looking for these opportunities. And very often, that may precipitate, “Let's review this. We're hearing it from a lot of different places. Let's think about this. Is this appropriate? Maybe we engage in a strategic review. Maybe we don't do the sponsor, we just spin.”

Allison Nathan: And how do you actually structure these deals? Give us a little insight under the hood about what these deals really look like.

David Dubner: Sure. I would say, Allison, no one deal is the same. Every situation is bespoke. But what I would guide to at the beginning is, while we focus on the separated business, it's as much of the re-IPO of the remaining company as it is a spin off or a separation of a new company. And therefore, we are hyper focused on ensuring the -- I'll call it -- long-term shareholder value creation for both businesses.

What that means, first and foremost, is, as EBITDA -- meaning earnings before interest, taxes, depreciation, and amortization -- leaves one system, right? Leaves the parent company and shifts to the spun off company, do we have an appropriate capital structure? So first and foremost, we start with proceeds. Do we need or should we consider an alternative to what would be a typical transaction or 100% spin off where you distribute all of the subsidiary to your shareholders? Instead, we can at times see our companies engage in a first step IPO where they bring incremental investment dollars which can allow them to deleverage or engage in other general corporate purposes. They can bring in anchor investors such as financial sponsors and/or SPACs. And those are ways to generate

incremental proceeds and right size capital structures.

They can also think about coupling a separation transaction with more traditional M&A. For example, you will often hear the term “spin merger.” What that means is a company separating out a subsidiary and immediately and simultaneously merging it, generally with another publicly traded company. That type of spin merger transaction can be an attractive way to generate incremental synergies relative to a stand-alone separation. It can also provide public company infrastructure that comes with combining with the public company counterparty.

Allison Nathan: You mentioned 30 transactions last year. 10 I think you said so far this year. Are there specific sectors or areas of the economy where these transactions have been more prevalent?

David Dubner: I would say, first and foremost, we are seeing this across all sectors, all geographies, and all size companies. So there is not a one-size-fits-all approach. I would key off Ben's comment that financial metrics matter, right? To some extent, this can be viewed

as addition through subtraction. And as I look at my growth forecast, my margin profile, when growth is coming down and margins may be more constrained, how do I think about a separation transaction? So to be responsive, Allison, I'd say looking at more diversified companies is where we would often see separation activity as opposed to a company that's engaged in a single activity.

You would also look at increasingly global companies. This is a cross-border trend. And we'll often see companies engage in geographic carve outs. Do they have the sufficient size and scale in a specific geography? Or might they be better focusing on one versus the other through a separation transaction?

Allison Nathan: Ben, I see you nodding. Do you have anything to add on that?

Ben Snider: Exactly to David's point, I've been shocked at the sector diversity that we've seen. This isn't just a story of consumer companies or health care companies or financials. It's really across every sector in the market. You can find some commonalities, right? It's larger companies almost by definition have something to

spin off. And generally speaking, the companies with the best growth and best profit margins are incentivized to think about their corporate structure in these ways. But it's really that sector diversity that has been so stunning and gives us confidence that this is a trend that is going to continue for the foreseeable future.

Allison Nathan: At the end of the day, companies are implementing these transactions because they think they are creating shareholder value. Ben, what have you found? Is that really the case over the longer term? Is there value to be gained that prove these types of transactions?

Ben Snider: We've looked at hundreds of these over the last 20-25 years in a report earlier this year that we updated, and of course there's a very wide distribution. Some companies generate value, some do not. And on average, it's about a coin flip, about 50/50 chance. So not much there for those playing the odds.

I think at the end of the day it really comes down to executions relative to expectations. What we found is, for companies with very low valuations where growth expectations are very low and where expected profitability

is very low, the likelihood that the company exceeds those expectations is pretty high. And those tend to be the companies that do best after these kind of transactions.

David Dubner: Yeah, I'd add to that, Ben, we have, on the banking side, looked at similar data. You know, roughly close to 300 spins since the beginning of 2000. And what we're driving at, is this financial engineering, right, Allison? To your question? Or are we creating long-term shareholder value? And when we look at these transactions on a blended basis -- meaning, let's compare the whole company prior to the separation to the combination of the remaining company in the spun off company and we look at that over time, do we see value creation? And our data is clear that we do. And the way we look at that is, if we look at operating metrics, in particular, do we see enhanced margin? Do we see improved ROIC? The answer is yes. Do we see positive multiple re-rating over time? The answer is yes. And do we see, on a blended basis, enhanced total shareholder return? The answer is yes. And this is over a wide swath of transactions, but I think it's important to reinforce Ben's point. This is not always the right answer for a company. There can be dissynergies. There can be stranded costs.

There can be other frictions that take away or detract from value creation, which is why it isn't always the right and appropriate answer for a particular company.

Allison Nathan: And so just to close, just to reiterate, we've seen this surge in activity. Both of you seem to think it's likely to continue. Maybe Ben, some last thoughts from you. And last thoughts from you, David.

Ben Snider: Unfortunately, from a macroeconomic point of view, it's unlikely that the growth environment gets much better in the near future. It seems like the profit margin headwinds we were talking about earlier are here to stay, at least for a little while. So I do think this kind of transaction will continue. And as David highlighted, it really comes down to companies to make sure that those are accretive for value and the best choice for shareholders as well.

David Dubner: I would agree with Ben. I think these transactions, separations, spin offs, de-mergers will continue across geographies, and ultimately it comes down to: Can I re-rate a parent company and a spin off company in excess of where I trade today, thereby creating

shareholder value? And as we have both discussed, the management focus that can come through a separation and renewed or different capital allocation priorities will continue to fuel this type of activity in our view.

Allison Nathan: Ben, David, thank you for joining us today and breaking down what's happening in the corporate restructuring landscape.

Ben Snider: Thanks very much.

David Dubner: Thanks, Allison.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs.

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