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Strategic Divestiture with Retained Minority Equity: Have Your Cake and Eat It Too

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Large players in the defense and government service market are consistently exploring ways to optimize operations and enhance shareholder value. This is often done through acquisitions and outright sales of larger divisions. A less often utilized - but no less accretive strategy - is a targeted carve-out divestiture with a retained minority equity position. This approach offers a multitude of benefits, allowing large defense and government services companies to streamline focus, appease regulators, and capitalize on potential future upside opportunities to achieve maximum value creation.

Streamlining Focus, Eliminating Risk, and Generating Liquidity: Divesting a non-core asset is used as a strategic move for large defense and government companies seeking to sharpen focus on core competencies and reduce debt in the new (and possibly here to stay) high interest rate environment. Shedding non-core assets also eliminates potential financial, operational, or (increasingly greater) customer funding risks -- running a business is hard enough, why retain these risks if a business line is not part of a core strategy? Finally, divestitures help optimize the allocation of resources and management attention to areas that drive a company's competitive advantage.

Regulatory Considerations: Beyond many obvious financial advantages, selling non-core businesses may also serve as a hedge to a regulatory environment that is increasingly critical of defense and government contracting mergers and acquisitions (M&A). For much of the past three decades, the industry experienced dramatic consolidation with little scrutiny from antitrust agencies. Recent antitrust challenges by federal regulators (e.g., Lockheed Martin / Aerojet Rocketdyne and Booz Allen Hamilton / EverWatch) suggest larger defense consolidators will continue to face stricter oversight around M&A activities. Companies that embark on a proactive campaign to divest non-core assets now, may find this creates more favorable regulatory dynamics for future strategic acquisitions.

Retaining Minority Equity for Maximum Value Creation: Keeping equity means companies can participate in the potential upside of the divested business' success. As the divested business continues to grow and thrive through the focus and capital investment that new ownership provides, a retained equity position offers the parent company an opportunity to realize additional financial gains without committing substantial resources. This is where industry-focused private equity buyers like Bluestone often emerge as ideal partners. In addition to fresh capital, a defense and government focused private equity firm can bring M&A and operational expertise, as well as strategic insights into the divested entity, accelerating its growth trajectory. Private equity sponsorship also provides an opportunity for the leaders of the divested business to be empowered and incentivized to grow the business more so than they could have under a more expansive corporate strategy where the business is not considered core.

So why is this strategy underutilized? Well one hesitation corporate development teams often have about non-core divestitures is the potential for negative value arbitrage. If the business' standalone market valuation is below that of the parent company's trading multiple of earnings before interest, depreciation, and amortization (EBITDA), why bring the asset to market? Again, this is where the private equity model employed by industry-focused firms like Bluestone can make up for and exceed this valuation gap. By rolling over some equity at the initial transaction with the private equity sponsor, the divesting company can capture greater valuation upside after the sponsor has successfully built and transformed the divested business in way that attracts a higher multiple at the sponsor's exit. Thus, when proceeds from both the initial and sponsor exit transactions are viewed in aggregate, the resulting multiple for the divested business can exceed any initial valuation gap. This is not just theory, but the core value proposition of the private equity model. At Bluestone, we have a track record of investing in defense and government services assets that ultimately return double digit multiples of EBITDA for sellers through a combination of initial transaction proceeds and the appreciation of rollover equity.

In today's market, divestitures with a retained equity component offer a compelling strategy for companies aiming to enhance shareholder value and focus strategic efforts on core competencies. By choosing an industry-focused private equity partner, companies can both execute these deals efficiently and achieve maximum value creation. As businesses continue to evolve, a strategic divestiture with a retained minority equity position should be seen as an additional tool for creating value and maintaining flexibility or put a better way -- having your cake and eating it too.