HEIDRICK & STRUGGLES
CEO & BOARD PRACTICE

Building a spin-off board: Are you ready?

A new era of corporate splits, spins, and separations raises the stakes on making a bad board appointment. Here's how thoughtful parent companies avoid them when turning one board into two.

Every day seems to bring news of another corporate spin-off, split-off, or equity carve-out — or of investors clamoring for one. In the event, the parent company must form a board for the new entity and reconfigure its own board, all under great time pressure. Filling one board seat is difficult enough. Filling as many as ten or more is downright daunting. The complexities multiply and so do the risks of making mistakes — mistakes that a company and its shareholders may have to live with for a long time. A closer look at how thoughtful parent company boards avoid them suggests five guidelines that other boards can follow to best ensure that their new — and existing — boards are ready for a more focused future.

Get ready for spin-offs

In 2014, more companies pursued spin-offs than in any other year in the past decade, and the number of such deals already announced for 2015 is expected to maintain that rapid pace. In many cases, leaders of diversified companies see separations as an opportunity to create more value by allowing management to focus on its core business, monetize undervalued assets, and separate businesses that are out of phase with each other and drag down the stock price.

More vocal shareholders, especially activist investors, are also increasingly pushing for spin-offs. Major recent calls to action include Carl Icahn urging eBay to spin off PayPal, Elliott Management calling for EMC to spin off VMware, and Daniel Loeb pushing both Dow Chemical to spin off its petrochemicals business and Sony to split off its entertainment division.

Managing complexity and reducing risk

As a result of this increased push for separation by management and shareholders alike, nominating and governance committees are more likely than ever to find themselves facing the task of board building for a new company. The challenges are formidable: the parent company must determine a comprehensive, strategic profile of the board-to-be, identify non-conflicting candidates for each seat, and successfully recruit the finalists, all within the 12 months or less that typically elapse between announcement of a separation and its completion. The demanding time frame, the number of roles to be filled, and the necessary considerations of board composition and culture create a level of complexity — and risk — that requires both careful attention to detail and an eye on the big picture.

In the absence of a well-structured process that combines care and speed, companies are at risk of winding up with a spin-off board of ill-assorted personalities, skills, and degrees of ability — and a parent company board that is weaker. In our experience, we have found that companies can avoid the manifold pitfalls of the challenge, create the optimal board for taking the new company forward, and maintain the strength of the parent company board by adhering to the following guidelines.

Plan to temporarily expand the board prior to the split

Building the new company board entirely separate from the existing board is possible, but it can be difficult and risky. Difficult because candidates hesitate to join a board on which all of the independent members are new to the company. And risky because a board consisting of all new directors faces a steep learning curve. In an ideal scenario, it is helpful to temporarily expand your existing board far in advance of the spin-off and then allocate directors appropriately between the parent company and the new company at the time of separation. This way, directors can attend the parent company board meetings before the split and thus gain better institutional knowledge.

For example, we recently worked with a large technology company that used this approach in its spin-off. The board, originally consisting of twelve members, was temporarily expanded to twenty in the six months prior to the spin-off. Of the eight new members who were added, some were recruited with an eye to the spin-off board and some to replace parent company directors who would leave to join the new board. At the time of separation, six of the new recruits and two of the parent company directors went to the new company, leaving two of the new recruits and ten original directors on the parent company board.

For entirely new directors who ultimately join the board of the new company, temporary expansion of the existing board provides valuable experience prior to the split. Among other things, they are able to:

- Familiarize themselves with the new company's business, industry, competition, customers, suppliers, strategy, capital structure, and anticipated shareholder base as well as any other material third-party relationships

- Get to know the management team that will run the new company and begin to develop relationships with each of them

- Assist with decisions on related party transactions, assets, debt, and other costs between the separated companies

- Develop a clear understanding of the relationship and arrangements between the two companies (potential service agreements, tax-sharing arrangements, and transfer costs) as soon as possible so that they may act accordingly and with urgency after the separation

- Acquire a thorough understanding of the new company's governance structure, documents, and processes as well as any unusual aspects of state corporate law to which it will be subject

- Begin to develop working relationships with their peers, including parent company directors who will be joining the new board, bringing valuable experience and institutional memory

- Participate in informed and timely decisions about the allocation of members to the new company board

As a result of these experiences, the new board can hit the ground running at the time of separation due to its dynamics and culture already taking shape. The board's preparation in governance and its grasp of the business not only help ensure a successful launch but also promise long-term oversight of exceptional quality. Meanwhile, new directors who remain with the parent board after the split will gain similar knowledge and experience with regard to the parent company, its directors, and its management. While expanding the board temporarily is not always possible, it provides many benefits to the transition process.

Begin recruiting new directors as soon as the separation is announced

The lead time for recruiting even a single director can be as long as a year or more. Recruiting six to eight directors in that time span vastly increases the pressure. In our experience, companies that conduct successful, orderly recruitment of new directors begin the process almost as soon as the company announces a split or spin-off. Ideally, an efficient process should bring new members onto the temporarily expanded board in time to get two or three meetings under their belts before the separation.

However, a parent company board should not sacrifice quality for the sake of speed. We have seen numerous instances where spin-off board seats are hastily filled, regardless of whether the appointees possess the right skills or the new board will have the right dynamics to be effective. In the absence of a structured, well-timed process for selection, a parent company board may find itself at the eleventh hour forced to make rushed decisions, sometimes poor ones. While a well-established board may be able to manage around an ineffective or ill-suited member, a spin-off company at the crucial moment of its launch cannot afford the luxury of even one such member, much less several.

For example, a parent company board that waited many months before starting the recruiting process wound up with a spin-off board of eight white males, all with similar backgrounds. The spin-off thus began life with a problem of public perception and, more important, a board deprived of the business benefits of gender and ethnic diversity as well as diversity of thinking.

> *"A parent company board should not sacrifice quality for the sake of speed."*

In another case, the parent company's failure to promptly begin recruiting resulted in a spin-off board without a full complement of members. Directors on the new board were spread thinly on committees and spent much valuable time searching for additional members to fill out the board — time that could have been better spent getting the new company off to a fast start.

Establish a structured timeline and project plan

In addition to beginning almost immediately, the parent company board should put in place an efficient, disciplined process for managing the many moving parts involved in recruiting multiple candidates. Following are the keys to success in implementing such a plan.

A small set of decision makers

This helps to ensure speed and efficiency in managing the complex series of decisions required. Those decisions include which candidates to consider, to interview, to vet, and to recommend. Though the full board will of course make the final decisions on appointments, the many prior decisions are best handled by a small group, whether the nominating and governance committee or a special search committee designated by the board. In the absence of a small group with clear authority to conduct the initial screening, the process is likely to bog down in conflicting advice from many sources and result in an unmanageable number of candidates and a potentially damaging delay.

A crisp articulation of the decision-making process

Who will meet the candidates? Who has veto power? What role will the existing and new CEOs play? Because there are so many moving parts in a process of recruiting as many as eight or more new directors, all of these questions should be answered at the outset and the plan committed to paper. We have found that best practices include having all of the members of the small group directing the process (including the CEOs of the parent company and the new company) meet all of the candidates who emerge from the initial screening. That approach reduces the possibility of a poor choice and produces the consensus necessary to keep the process moving forward.

A weekly or biweekly communications plan

These regular communications, usually through a standing conference call (ideally weekly) and with supporting material, should include progress reports, next steps, and, when the interviewing stage is reached, an interview schedule.

A commitment to responsiveness

Interviews with candidates should take place as soon as possible after the candidate has been contacted. Queries and communications from candidates should be answered immediately. Few things sour potential candidates more than long lapses of silence after they have expressed interest in a board seat.

No shortcuts

Do not forgo referencing, interviews, and assessments and simply recruit people with outstanding resumes or well-known names. No matter how good a candidate looks on paper or in the press, he or she should be thoroughly referenced and interviewed face-to-face by the decision makers in the selection process. In addition, the search firm should work — either individually or in conjunction with members of the current board — to conduct formal and informal references on the candidate. Finally, we recommend that the board enlist a neutral third party to conduct a thorough background check on the candidate's legal and educational history. The consequences of cutting corners can range from the embarrassing to the disastrous. In one instance, a high-profile CEO was appointed to the board of a spin-off company that too closely resembled the company he still served as chief executive. To avoid conflicts of interest he frequently had to recuse himself from board discussions. So frequently, in fact, that he resigned his seat only a few months after the launch of the spin-off. In another case, a board that neglected to do a background check found shortly after making an appointment that the new director was facing a Wells notice from the SEC.

Holistically approach board composition through a board planning matrix

A board seeking to fill a single vacancy need only fit the skill set and style of one new member into the already well-known skills and culture of the current board. There are, in effect, only a few variables. But when the skill sets and styles of all of the board members for a spin-off must be identified and made to fit into a coherent whole, multiple variables must be worked out almost simultaneously. Before embarking on multiple searches, the board should therefore undertake a planning exercise designed to determine the mix of competencies that both the new board and the parent board will need following the split. The exercise should answer the following questions:

- What are the key strategic imperatives for both companies as you look forward three to five years?
- Based on your strategic priorities, what skills and experiences might need to be added to each board over time to assist the CEO and management team in addressing these opportunities and challenges?
- What skills and qualifications are top priorities for each board?
- How can you best seize the opportunity to achieve diversity?

The competencies and qualifications that emerge for the spin-off board should then be treated as a portfolio of skills that could be satisfied in a variety of ways but that in the aggregate represent the ideal mix. You can then begin the process of solving for the right mix through various combinations of candidates (see figure).

Figure

Getting tactical: Map skills to candidates using a planning matrix

Candidate or board member who is ethnically or gender diverse

Desired criteria	Parent company: Existing board members	Parent company: New recruits	Spin-off: Existing board members	Spin-off: New recruits
1. Sitting or recently retired CEO	Parent company board members		Parent company board members	Retail CEO; Tech CEO
2. Qualified financial expert	Parent company board member	Private equity executive; Wealth management executive	Parent company board member	Former CFO; Technology CFO
3. Data analytics experience	Parent company board members			Chief data officer, large auto manufacturer; Chief information security officer, global software company
4. Cybersecurity expertise		Cybersecurity executive; Former cybersecurity director, FBI		Chief information security officer, financial company

For example, a CEO who is also a former CFO and has extensive experience globally might satisfy several criteria at once: general management experience, financial expertise, and knowledge of emerging markets. Meanwhile, another candidate might bring the regulatory experience and knowledge of technology that will be critical for the spin-off's success. The competencies of parent company directors who are moving to the new board will also figure into how you solve the overall equation, both for the new board and for the board of the reconfigured parent company. Juggling all of the possible permutations that could satisfy the portfolio is far from easy, but the effort pays off with a spin-off board that comes as close to the ideal mix as possible and a parent company board that is ready for a new future as a more focused company.

Don't neglect board culture

The dynamics and culture of a board can make all the difference between an effective board and a dysfunctional one. In addition to taking into account how the competencies and qualifications of director candidates fit together, you should also assess how candidates for the spin-off board fit with its desired culture and how candidates for the parent board fit with its existing culture.

In our work with spin-offs, for example, we employ a cultural profile approach to define the cultures of both boards. This profile is then used to inform the candidate assessment and selection process. During that process we use two key dimensions in the cultural relationship between candidates and the board — values and leadership styles — to assess how candidates and the board might interact. The goal is to enhance the interviewing and referencing of candidates, surface compatibility gaps that could disrupt board dynamics, avoid potential cultural land mines, and create a board whose dynamics are tuned to the demands of the business.

Ensuring that a spin-off outperforms the market

Research by Bain & Company suggests that the combined equity returns of spin-offs, on average, do not outperform the S&P after the first eighteen months following separation. And for one-third of the companies doing spin-offs, the combined market cap of the new companies eighteen months after separation is 40% less than the pre-spin value. Further, according to a study conducted by consulting firm The Edge and accounting firm Deloitte, 56% of spin-offs had negative returns one month after separation from the parent company, 47% after three months, and 38% after one year. Parent companies also run considerable risks — 37% of the parent companies in the study saw share-price declines in the year after a spin-off.

However, the top one-third of separations generate significant value, with the combined market cap of the new businesses after separation exceeding the pre-spin value by more than 50%. In fact, these stellar performers make the aggregate numbers appear quite strong. While the success of the clear winners may stem from many factors — operational, strategic, and commercial — we believe that high-performing boards play a significant role in helping sustain success for those spin-offs over time, just as they do for other successful companies. And the roots of that success lie in the care with which parent companies approach their board-building responsibilities.

About the authors

Bonnie W. Gwin is vice chairman and managing partner of Heidrick & Struggles' Board of Directors Practice in North America; **John T. Thompson** is vice chairman of Heidrick & Struggles' global CEO & Board of Directors Practice.

CEO & Board Practice

Heidrick & Struggles' CEO & Board Practice has been built on our ability to execute top-level assignments and counsel CEOs and board members on the complex issues directly affecting their businesses.

We pride ourselves on being our clients' most trusted advisor and offer an integrated suite of services to help manage these challenges and their leadership assets. This ranges from the acquisition of talent through executive search to providing counsel in areas that include succession planning, executive and board assessment, and board effectiveness reviews.

Our CEO & Board Practice leverages our most accomplished search and leadership consulting professionals globally who understand the ever-transforming nature of leadership. This expertise, combined with in-depth industry, sector, and regional knowledge; differentiated research capabilities; and intellectual capital, enables us to provide sound global coverage for our clients.

Leaders of Heidrick & Struggles' CEO & Board Practice

Americas

Bonnie Gwin
New York
bgwin@heidrick.com

Jeff Sanders
New York
jsanders@heidrick.com

EMEA

Will Moynahan
London
wmoynahan@heidrick.com

Asia Pacific

Karen Choy-Xavier
Singapore
kchoy@heidrick.com

George Huang
Beijing
ghuang@heidrick.com

Fergus Kiel
Sydney
fkiel@heidrick.com

Harry O'Neill
Hong Kong
honeill@heidrick.com

Graham Poston
Singapore
gposton@heidrick.com

Heidrick & Struggles

Heidrick & Struggles is the premier provider of senior-level executive search, culture shaping, and leadership consulting services. For more than 60 years we have focused on quality service and built strong relationships with clients and individuals worldwide. Today, Heidrick & Struggles' leadership experts operate from principal business centers globally.

www.heidrick.com

WE HELP OUR CLIENTS CHANGE THE WORLD, ONE LEADERSHIP TEAM AT A TIME™

Copyright © 2015 Heidrick & Struggles International, Inc. All rights reserved. Reproduction without permission is prohibited. Trademarks and logos are copyrights of their respective owners.

Cover photography: © hxdyl/iStock/Thinkstock