# WHO IS SPIN-OFF ADVISORS, L.L.C.?

Spin-Off Advisors, L.L.C. is an investment research boutique who provides independent research on information poor, inefficiently priced spin-off situations. The firm was formed as an Illinois limited liability company in August 1998 and provides proprietary investment research for the investment professional focused on restructuring situations. Money managers, mutual funds, banks, pension funds and hedge funds subscribe to the firm's proprietary research product **"*Spin-Off Research*"** which has been published since March 1997. ***Spin-Off Research*** is an extensive, monthly, institutional**,** advisory report, featuring continuous research on corporate spin-off activity. ***Spin-Off Research*** is edited by Joe Cornell, CFA, and author of the book **"*Spin-Off To Pay-Off: An Analytical guide to Corporate Divestitures*"** (McGraw-Hill). Annual subscriptions are $30,000.

## Founder of Spin-Off Advisors

### Joe Cornell, CFA

Mr. Cornell is President and controlling principal of Spin-Off Advisors, L.L.C., and the author of "***Spin-Off To Pay-Off***" **-An Analytical Guide To Investing In Corporate Divestitures**. He has published "***Spin-Off Research"***, an advisory service featuring current information on spin-offs since March of 1997. His insight and commentary on spin-off situations have been featured in various media such as: Barron's, Business Week, Bloomberg, CNBC, Forbes, Money Magazine. Joe is has been a Forbes contributor for over ten years on corporate spin-off situations. Joe graduated from Loyola University of Chicago in 1986 with a BS in Economics & Finance, and in 1991 received a MBA in Finance from Loyola University. In addition, he earned the Chartered Financial Analyst (CFA) designation in September 1997. He has worked exclusively in the investment industry since graduating from college, and has extensive investment management, trading and analytical experience.

## General Thesis

### "The Sum Of The Parts Is Greater Than The Whole"

Spin-Offs often result in a higher aggregate value for the constituent pieces. Many diversified companies are electing to spin off parts of their business, finding that this restructuring technique can create significant value for shareholders. Some of the reasons for spinning-off a company include a parent's decision to withdraw from an industry or market due to lack of synergies or related core competencies, unsatisfactory performance of the spun-off entity, or superior margins of the spun-off entity. Newly independent companies are no longer constrained by the overall strategic direction of their former parent. This independence forces them to develop their own roadmap for success. Spin-Off situations can be very rewarding. Investors can often achieve superior investment performance from spin-offs for a variety of reasons. Institutional investors often shy away from spin-offs. Sometimes the spin-off does not meet the investor's portfolio requirements. For example, the market capitalization may be too small, a comparable company may already be represented in the portfolio, or the fund may be constrained by indexing requirements. This lack of initial sponsorship often creates a vacuum of downward pressure on the share price not attributable to business fundamentals. In effect, there is a temporary inefficiency that can be

captured by astute investors. When one reconstitutes that parent and spin-off after a one to two year period, often outstanding overall returns are observed.

## Why Spin-Offs Prosper

Much of the impressive performance comes from the altered dynamics of the spun-off business and its parent. Spin-Offs do well partly because when a business and its management are freed from a large corporate parent, pent-up entrepreneurial forces are unleashed. The combination of accountability, responsibility and more direct incentives take their natural course. Managers have greater freedom to pursue new ventures, streamline production, and pare overhead. After the spin-off, stock options can more directly compensate management. This often leads to improved operating performance.

## Other Points To Consider:

1.) Spin-off pricing inefficiency, where it can be accurately identified, holds the potential for above average investment returns over time. Nevertheless, factors such as timing of the initial purchase, length of the holding period, and selectivity are critical to successful spin-off investing.

2.) Unlike IPO's (roadshows and post IPO syndicates) analyst coverage on new spin-offs is severely limited leading to a lack of institutional sponsorship. Therefore, spin-offs don't get "talked up", hiding their inherent value. Spin-Offs are in effect new issues, but there is no underwriter or promoter telling the investment community what the company is worth.

3.) Investment Advisors often recommend that their clients sell the spin-off shares indiscriminately because it often doesn't fit within the Advisor's financial planning framework. This works to the advantage of the astute investor.

4.) Parent companies many times become acquisition targets after they complete a spin-off. This can be very lucrative.

5.) Structural selling of spin-offs happens due to index fund selling (because the spin-off is not in the index), lack of yield, odd-lot selling and limited liquidity.

6.) Many uninformed shareholders receive shares in a spin-off that they have not chosen to receive and think have no reason to keep, prompting them to sell them in a knee-jerk fashion.

7.) Spin-offs are five times more likely to be acquired.

8.) Spin-offs provide a means for the spun-off entity to secure better access to expansion capital.

9.) Wall Street likes to apply a premium to "pure plays" which spin-offs represent.

10.) Academic studies have confirmed that spin-offs on average have outperformed the general market (S&P 500) and that spin-offs many times improve the market performance of the parent company as well.

## Citations:

1.) "Restructuring through spin-offs, equity carve-outs, and tracking stocks can create shareholder value. In the longer term, equity carve outs in which the parent company retains majority ownership easily

outperform the Russell 2000 index, with an average annual total return to shareholders (TRS) in the two years after issue of 24% as compared with 11%. Spin-offs also substantially outperform the market, showing a two-year annualized TRS of 27%, compared with 14% for the Russell 2000 and 17% for the S&P 500." Tracking stocks returned 19%. Overall, the average improvement in the P/E multiple of the consolidated parent and subsidiary outperformed the market by 21%.

—Study of the performance of 168 large ownership restructurings-- those in which the parent company had revenues upward of $200 million at the time of disaggregation--that have taken place in the United States during the time period 1988-1998. The study was published in *The McKinsey Quarterly*, 1999 Number 1, pp. 16-27

2.) A 1998 working paper from Pennsylvania State University examined 83 equity carve-outs done between 1981 and 1990, and found that carved-out companies had significantly higher revenue and asset growth, higher earnings, and higher capital spending than the industry average during the first three years after the carve-outs. A similar study by J.P. Morgan & Co. which examined 101 carve-outs between 1986 and 1997, documented that, on average, the share price of the parent rose between 3-4% in the 90 days following the announcement of a carve-out. In the case of 12 carve-out companies in which the parent announced there would be a later spin-off, the share price of the carve-out performed 11% above the market 18 months after the initial public offering.

—*CFO Magazine*, March 1999, pp. 97-98

3.) A sample of 174 spin-offs, followed by Professors James Miles and Randall Woolridge of the Smeal School of Business at Penn State University between 1965 and 1994, returned an average of 18% in the first year, 51% in the first two years and 76% in the first three years outpacing the S&P 500 by 31%.

—*Bloomberg Personal Finance*, September 1999, p. 27 and *Spin-Off to Pay-Off, An Analytical Guide To Investing In Corporate Divestitures* by Joseph W. Cornell, CFA, p. 32

4.) “Over the two-year period prior to the spin-off, the stock price of the average parent company outperforms the stock market by 35% on average. After the spin-offs, stock returns of both the parent and the spin-off outperform the market, on average. Over the entire three-year period, assuming portfolio rebalancing, we find a compounded raw return of 106.6%, which corresponds to a compounded annual return of 27.4%. The largest returns come between one and two years

after the distribution month. "

—*"Some New Evidence That Spin-Offs Create Value"* by professors James Miles and Randall Woolridge of Penn State University, and Patrick Cusatis of Lehman Brothers. (See "*Spin-Off to Pay-Off, An Analytical Guide To Investing In Corporate Divestitures*" by Joseph W. Cornell, CFA, pp. 33, 35)

5.) A J.P. Morgan study of 231 spin-offs and carve-outs between 1985 through 1998 found that during the first 18 months of trading, straight spin-offs beat the S&P 500 by 11.3% vs. 10.1% for carve-outs.

—*Business Week*, December 13, 1999 p. 198

6.) "Spin-Offs create opportunity through inherent neglect."

—*Andy Graves, Portfolio Manager for Brandywine and Brandywine Blue Funds*

7.) Spin-Offs with promising longer-term fundamentals should be purchased no later than six months after the spin-off. Price performance suggests that this is typically an optimal period to selectively buy this class of security. Buying at this time would have yielded the maximum price appreciation over the ensuing 12 to 18 months.

—*Spin-Off to Pay-Off, An Analytical Guide To Investing In Corporate Divestitures* by Joseph W. Cornell, CFA, p. 66

8.) These studies demonstrated that the announcement of a corporate spin-off or carve-out is associated with positive stock price movements in the parent's stock.

—*Schipper and Smith, 1986* (carve-outs), *Hite and Owers, 1983, Miles and Rosenfeld, 1983* and *Schipper and Smith, 1983* (spin-offs)

9.) A J.P. Morgan study of 77 spin-offs from 1985 through 1995 shows that spin-offs outperform the stock market by more than 20% on average during the first 18 months after the transaction. The same study found that parent companies outperform the overall stock market by 5 to 6%, on average, between the spin-off announcement date and the actual spin-off. There is considerable academic research on spin-offs that suggests that they outperform the general market by a considerable margin. *Hite and Owers, Shipper and Smith, and Miles and Rosenfeld* document a mean abnormal spin-off announcement return of approximately 3%.

— *Hite and Owers,* "Security Price Reactions Around Corporate Spin-Off Announcements," *Journal of Financial Economics,* 1983, vol. 12(4), pp. 409-436; *Schipper and Smith,* Effects of Restructuring on Shareholders Wealth: The Case of Voluntary Spin-Offs," *Journal of Financial Economics,* 1983, vol. 12(4), pp. 437-468; and *Miles and Rosenfeld,* "The Effect of Voluntary Spin-Off Announcements on Shareholder Wealth,"

*Journal of Financial Economics,* 1983, vol. 38, pp. 1597-1606—each documents a mean abnormal spin-off announcement return of approximately three percent.

# Types of Spin-Offs

## Pure Spin-Offs

In a pure spin-off, a parent company distributes 100% of its ownership interests in a subsidiary operation as a dividend to its existing shareholders. After the spin-off, there are two separate, publicly held firms that have exactly the same shareholder base. This procedure stands in contrast to an initial public offering (IPO), in which the parent company is actually selling (rather than giving away) some or all of its ownership interests in a division. The spin-off process is a fundamentally inefficient method of distributing stock to people who may not necessarily want it. For the most part, investors were investing in the parent companies business. Once the shares are distributed, often they are sold without regard to price or fundamental value. This tends to depress the stock initially. In addition, institutions typically are sellers of spin-off stocks for various reasons (too small, no dividend, no research, etc.). Index funds are forced to sell the spin indiscriminately if the company is not included in a particular index. This type of selling can create excellent opportunities for the astute investor to uncover good businesses at favorable prices. Often, after the spin, freed from a large corporate parent, pent-up entrepreneurial forces are unleashed. The combination of accountability, responsibility, and more direct incentives (stock options) typically shows up in the operating performance post spin.

## Carve-Outs (Partial Spin-Off)

In this case, the parent corporation sells to the public an interest of less than 20% in the new subsidiary in a SEC registered public offering (IPO) for cash proceeds. Often, an IPO in which the parent company retains a majority interest in the new company, may be a prelude to a spin-off of the remaining interests to existing shareholders. Companies utilize a partial spin-off strategy for a number of reasons. Sometimes a corporation may need to raise capital. Selling off a portion of a division while still retaining control may be an attractive option for a company. At other times the motivation for pursuing a partial spin-off is to highlight a particular division's true value to the marketplace. Its value may be masked when buried among the parent company's other businesses. A separate stock price for the division enables investors to value the division independently.

## Stubs

Partial spin-off transactions occur when a corporation distributes shares in a subsidiary to the public while retaining partial ownership. After a subsidiary becomes publicly traded, it is possible to determine the market value of the parent company's investment in the subsidiary. By subtracting the subsidiary's per-share value from the parent company's per-share value, we will be able to isolate the implied value of the parent company's core businesses— known as the "stub". The stub's trading value can be at times less than its intrinsic value because the true business value of the stub becomes obscured. We try to identify stub situations where the value is significantly in excess of its current implied value. It is possible to synthetically

create a stub investment by purchasing the parent company's stock and shorting its underlying subsidiaries (the carve-out). This methodology allows investors to capture the unrealized value of the stub, while simultaneously hedging market risk.

## Tracking Stocks

Companies create these stocks to track the fortunes of one or more of their subsidiaries. We view tracking stocks as distant cousins to spin-offs. Unlike a spin-off where a division is separated from the parent, goes public, and has complete autonomy financially and managerially from the parent company- tracking stocks represent shares that are still joined at the hip to the parent (there is no legal separation of the assets or liabilities). The parent and tracking stock operate under one management team and one board of directors, even though the tracking stock's finances are reported separately from the parent. Companies issue tracking stocks to hopefully unlock value in their underlying subsidiary. Tracking stocks have some advantages (to the issuer) over spin-offs. Issuing tracking stocks is always a tax-free procedure and if either of the two units were losing money, the earnings from one would offset the losses of the other for tax purposes. Borrowing costs for the tracker are usually lower because it relies on its parent's higher credit rating. Overhead costs are lower than if the two were separate. If synergies exist between the parent and the tracker, there are added benefits. As with spin-offs, the biggest reason for issuing tracking stock is the potential to goose the parent's stock price. Companies often feel that Wall Street analysts and investors incorrectly value captive subsidiaries that are overshadowed by the parent. So investment bankers tell them that the creation of a tracking stock highlights "pure-plays" that can be valued higher by the market. This may prompt separate analyst coverage and entice a different set of shareholders for the company. Tracking deals are our least favorite restructuring technique. Tracking stocks have inferior shareholder rights and the potential for serious conflict of interest issues.

We believe the biggest drawback with tracking issues is that they are immune from takeovers. From an investor's point of view, we would prefer to "own the thing that owns the thing".

For more information, please visit our web site at www.spinoffresearch.com.