

Taking Off on Their Own

**A RISING STRATEGY, SPIN-OFFS OFFER
VALUE TO PARENT AND OFFSPRING**

It's not just the big players — more mid-caps are taking divisions public.



When Rockwell International Corp. (ROK) announced in July 1998 the spin-off of its semiconductor business, Conexant Systems, it hatched a plan to ensure a successful launch.

Clearly, Conexant was a suitable candidate. While Rockwell was a stable, slow-growth business, its semiconductor branch was, in contrast, a much faster-growing but cyclical business. The division was dragging its parent

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down. With its high fixed costs, the semiconductor business lost money on an operating basis and caused Rockwell's revenues to drop. "It was shareholder value maximization that drove [Rockwell] to sell off the semiconductor business," says Bala Iyer, Conexant's senior vice president and chief financial officer.

In the subsequent months, Rockwell recruited executives to key positions not typically needed for a company division. It created a top-notch board of industry experts and developed a manufacturing strategy that relied more heavily on subcontractors.

The company then attracted coverage from the research community. "We set up a full-blown road show typical of an IPO and went to New York, Europe, Boston and the Midwest," says Iyer. Its efforts paid off. By the time public trading started in early January, seven analysts covered the newly formed Conexant Systems (CNXT).

Conexant has thrived with its independence. Its stock has risen from \$15 to a mid-September high of \$78. Iyer attributes this success to a re-energized workforce in a company that can now attract top talent, "a priority in the competitive semiconductor business. People would rather work for a pure-play company than for a division of a defense and electronic conglomerate."

It's been profitable for Rockwell as well. Without Conexant, a leaner Rockwell has an operating margin of 17% on sales of almost \$7 billion, say analysts. Prior to the spin-off, Rockwell traded at \$40 and is now close to \$60. Investors that held both stocks had a 140% return in one year.

As 1999 draws to a close, companies continue to bank on the increasingly fashionable financial strategy of the spin-off. *The McKinsey Quarterly* reports that the level of spin-off activity has been high recently: more than 300 spin-offs took place in the U.S. between January 1988 and September 1998. "Spin-offs are more frequently used [as a strategy] now than in the past," says Mark Minichiello, vice president of Chicago-based Spin-Off Advisors, an independent research firm. "We followed 45 spin-offs in 1998, and we're already up to 35 as of September of this year."

Minichiello cites AT&T's 1996 divestiture, when it spun off Lucent Technologies and NCR, as the hallmark case. Before

the announcement, its market value was \$75 billion. In January 1998, the three independent companies had a combined market value of almost \$160 billion. Now, it is more than \$200 billion. "The Lucent spin-off brought to life that

this is an efficient way to create value for shareholders," says Minichiello. "It proves that the sum of parts is quite often far greater than the whole," he says.

Spin-Off Advisors is recommending the upcoming spin-off of Aerial Communications (AEROL) by Telephone & Data Systems (TDS). VoiceStream Wireless (VSTR) will acquire Aerial for a stock and cash deal equaling \$2.1 billion. "The sale of Aerial may be the catalyst that shareholders have been waiting for," Minichiello says.

In another action, Kansas City Southern Industries (KSU) may consolidate its financial holdings into one company, Stillwell Financial, which would include subsidiary Janus Capital Corp.

The overall outlook may be positive for spin-offs, but the strategy itself has undergone a distinct change. The spin-off fervor encompassing big conglomerates, big surprises, and huge returns, evident in the early 1990s, has tapered in the past few years. Though the number of spin-offs has increased, the volume of each individual deal has decreased, according to Rick Escherich, managing director of J.P. Morgan in New York.

"While the technique remains popular, the most obvious large spin-offs have already happened. What we're seeing are about the same number of spin-offs, but from smaller, mid-cap companies. Indeed, the Conexant spin-off is more the norm today than an AT&T divestiture. But the volume is still there." Escherich says that more than \$80 billion in spin-offs closed in 1998, the second highest total ever.

Since many of the factors that have made spin-offs popular investments in years past have waned, market reaction to spin-offs has turned cautious. According to a July 1999 study by J.P. Morgan's Escherich, there are several factors now evident that did not exist a few years ago. "First is [that] with the high past volume and fewer candidates, the market has intensified its focus on likely split-up candidates."

Thus, he says, when announcements are finally made, they

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are less of a surprise than in the past. "A second factor is that in some cases, spin-offs have been announced in conjunction with poor operating performance or other disappointing news. This leads to a mixed/negative reaction."

Nonetheless, the J.P. Morgan research reveals that parent companies' spin-offs outperform the market by an average of over 10% in the first 18 months of independent operation. Parent companies, meanwhile, outperform the market by a total of about five percent on average, following the announcement of a spin-off. The size of the spin-off also impacts market reaction. The larger the spin-off, the more positive the parent's stock price. This is particularly evident in the first month or so immediately following the announced spin-off.

Spin-offs themselves continue to beat the market. Researchers from Penn State studied 161 spin-offs from 1961 to 1990, and determined that profits and sales at the new companies increased 15% faster than at their peers during the first three years of independence. During the same period, stock returns were 33% higher than those of their peers, the study concluded. J.P. Morgan's more recent study finds that once independent, spin-offs in its 130-company sample have outperformed the market by about 10% in the first 18 months post-spin-off.

Barbara Goodstein, an analyst with Rothschild in New York, says spin-offs will continue to improve performance for several months after independence. "It's like a parent-child relationship when the parent stops the child from growing, strangling it a bit. It can only grow if you let it go," she says. "You often have the mid-level manager who used to run the division before the divestiture being given the opportunity to run it as he or she sees fit," says Goodstein.

"There is a lot of house cleaning, and most spin-offs go through a huge amount of restructuring. That's what we look at. First, the management, and second, what changes they will make [in order] to perform. But," she notes, "there is no prototypical formula for investing in spin-offs. It's always a unique situation," she says.

"The new management of a spin-off is hugely

motivated to turn a profit as soon as possible," says Robert Topping, a general partner of the Chicago-based Vintox Fund. "For the first couple of months they're getting their ducks in a row," he says.

The new ownership situation forces a higher degree of management accountability. With this new and increased exposure to the market and higher scrutiny by investors and analysts, managements must respond. But they tend to be motivated, says Topping, and results happen. "I always like to look at spin-offs because of the initial supply situation," he says. "Sometimes after a couple of months the supply lasts and that's a good opportunity as well."

Topping says he's been keeping an eye on Too (TOO), as in The Limited, Too, which was spun off from The Limited in August 1999. "That's what comes to mind as the best opportunity right now." In that transaction, The Limited (LTD) distributed 100% of the shares of Too, receiving one share for every seven shares of Limited. The newly independent Too focuses on young fashion-aware girls, considered now to be the highest growth area in the sluggish specialty retailing arena.

Vintox Fund's Topping continues to consider these and other spin-offs good investment opportunities. "You get these sleepy

SPIN-OFF COMPANIES RANKED BY CONSENSUS ANALYST RATING*

| Rank | Ticker | Company | Analysts | Consensus Estimate |
|------|--------|---|----------|--------------------|
| 1 | VARI | Varian | 4 | 1.3 |
| 2 | VSTR | VoiceStream Wireless Corp. | 18 | 1.4 |
| 3 | INF | Infinity Broadcasting Corp. | 17 | 1.4 |
| 4 | GENZ | Genzyme General | 13 | 1.4 |
| 5 | DPH | Delphi Automotive Systems Corp. | 11 | 1.4 |
| 6 | PPE | Park Place Entertainment Corp. | 15 | 1.5 |
| 7 | CNXT | Conexant Systems | 13 | 1.5 |
| 8 | CVG | Convergys Corp. | 12 | 1.5 |
| 9 | FOX | Fox Entertainment Group | 12 | 1.5 |
| 10 | MIPS | MIPS Technology | 6 | 1.5 |
| 11 | AZX | Azurix Corp. | 8 | 1.6 |
| 12 | CARI | CareInsite | 8 | 1.6 |
| 13 | MKTW | MarketWatch.com | 5 | 1.6 |
| 14 | TURF | iTurf | 5 | 1.7 |
| 15 | COC.A | Conoco | 18 | 1.8 |
| 17 | PHCC | Priority Healthcare Corp. | 6 | 1.8 |
| 18 | LPNT | LifePoint Hospitals | 11 | 1.9 |
| 19 | VSEA | Varian Semiconductor Equipment Associates | 7 | 1.9 |
| 20 | HIFN | Hi/fn | 4 | 1.9 |

*Companies With More Than 4 Analysts 1=Strong Buy 5=Strong Sell

old subsidiaries that don't do much under the parent. Give them some independence and then they get going," he says.

In the past, investors grabbed spin-off stocks at a discount after the stock would have been blown out of a portfolio.

"There is an oversupply initially, but this is such a known phenomenon now that it isn't such a big factor anymore," says Goodstein. "If there's an index issue, then you can see somewhat of a stock depression, but there are enough savvy buyers out there. My clients and I are not focused on the discount. They are not traders trying to get a buck or two, but value-oriented investors wanting to make an investment."

Undoubtedly, it's a strategy that will continue to thrive. Ill-advised mergers of today become tomorrow's spin-offs, says Goodstein. "It's a well-accepted strategy once bigger companies discover that smaller would be better." Goodstein, who has watched the performance of "cast-off" companies since 1990, says it's often a savvy strategic decision for corporations. "If the stock is lagging and the company does an internal assessment as to why it's under-performing, they look to spin-offs, particularly if they are in multiple businesses with difference synergies. Part of the benefit of the spin-off is the tightened coverage of industry analysts and the exposure to institutional investors."

Analytical coverage increases significantly after a spin-off for the newly formed company, whereas the parent company

preserves about the same number of analysts. In the 1997 spin-off of Tricon from PepsiCo, for instance, the total number of analysts increased from 30 before the divestiture to 49 one month after the spin-off. "It was the spin-off, Tricon, that picked up the new coverage," says J.P. Morgan's Escherich. This, again, leads to higher value.

"Analysts that specialize in each of a firm's major businesses typically can do a better job providing the market with information and insight, reading the company. Evaluating the pieces," he says, "analysts can provide the market with a much clearer picture of a firm's prospects, opportunities and risk."

Research is the key to whether or not some institutional investors will look at spin-offs.

"We really don't deal with spin-offs any differently than other investments," says Jack Fraser, an associate with Friess Associates, which runs the Brandywine Funds. "We always look at the management and the liquidity situation and see what research is out there."

The question analysts and investors ask today, however, is as more people recognize the potential in spin-offs, will the positive effect diminish? "We are seeing more companies use them, both large and small," says Spin-Off Advisors' Minichiello, "You can't neglect the continued good results and the number of opportunities." ■

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DOT-COM SPIN-OFFS PROLIFERATE

IT'S NO SURPRISE that a large proportion of spin-offs in the past year have involved Internet companies. "Internet subsidiaries are ideal spin-off candidates," says Mark Minichiello, vice president of Chicago-based Spin-Off Advisors. "Dot-com companies are valued on revenues and not on earnings because they're so hot right now. Their parent companies, however, are typically valued on earnings." The companies can get more bang for their buck by spinning off the Internet subsidiaries because they can then see the performance of both, says Minichiello.

Internet divestitures differ from traditional spin-offs. Instead of casting off underperforming divisions or ones that

are inconsistent with core businesses, parent companies are spinning off the divisions with the best growth potential. Because Internet companies have seemingly endless opportunity, yet require huge capital infusions, often while operating at losses, some turn to this strategy. Barnes & Noble, for instance, recently sold a minority stake in its online business in a partial spin-off, collecting \$100 million. Other such divestitures include PeopleSoft's Momentum Business Applications, CBS's MarketWatch.com and Ziff-Davis' ZD Net Group.

Spin-Off Advisors reports several others in the works, including Nordstrom's new Internet unit, Nordstrom.com, and Perfumania's online sales arm, Perfumania.com. ■