

## The Case Against Conglomerates

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Conglomerates are companies that either partially or fully own a number of other companies. Sprawling conglomerates were once a prominent feature of the corporate landscape. Vast empires, such as General Electric (NYSE: GE) and Berkshire Hathaway (NYSE :BRK.A), were built up over many years with interests ranging from jet engine technology to jewelry. Corporate hodgepodes like these pride themselves on their ability to avoid bumpy markets.

The case for conglomerates can be summed up in one word: diversification. According to financial theory, because the business cycle affects industries in different ways, diversification results in a reduction of investment risk. A downturn suffered by one subsidiary, for instance, can be counterbalanced by stability, or even expansion, in another venture. In other words, if Berkshire Hathaway's brick-making division has a bad year, the loss might be offset by a good year in its insurance business. However, both GE and Berkshire have suffered as a result of the economic downturn, providing that size does not make a company infallible. In fact, companies that diversify into areas beyond their core competencies can lead to an inefficient, poorly run company. No matter how good the management team, its energies and resources will be split over numerous businesses, which may not be “synergistic”.

For investors, conglomerates can be difficult to understand, and it can be a challenge to pigeonhole these companies into one category or

investment theme. Management may have a hard time articulating their investment philosophy to shareholders and analysts. Furthermore, a conglomerate's accounting can leave a lot to be desired and can obscure the performance of the conglomerate's separate divisions. Investors' inability to understand a conglomerate's philosophy, goals and performance can lead to stock underperformance.

### **Conglomerate Discount**

The case against conglomerates is a strong one. Consequently, the market often applies a haircut to the value of widely diversified companies. Frequently, conglomerates trade at a discount to more focused companies. The conglomerate discount gives investors a good idea of how the market values the conglomerate as compared to the sum value of its various parts. A deep discount suggests that shareholders could benefit if the company were dismantled and its divisions left to run as separate stocks.

### **Case for Spin-Offs**

The idea of getting smaller may seem counterintuitive, but corporate spin-offs can be a very attractive option for companies and their shareholders. The rationale behind a spin-off or a carveout (partial IPO) is that “the parts are greater than the whole.” These techniques, which involve the separation of a business unit or subsidiary from the parent, can help improve a company's valuation by providing powerful incentives to the people who work in the separating unit. Further, a corporate divorce can help the parent's management to focus on core operations.

Most importantly, shareholders get better information about the business unit because it issues separate financial statements. This is

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particularly useful when a company's traditional line of business differs from the separated business unit. With separate financial disclosure, investors are better equipped to gauge the value of both the parent and the spin-off.

Also, separating a subsidiary from its parent can reduce the internal competition for corporate funds. It helps alleviate internal wrangling that can compromise unity and productivity of a company.

For employees of the new separate entity, there is a publicly traded stock to motivate and reward them. Stock options in the parent often provide little incentive to subsidiary managers, especially because their efforts are buried in the firm's overall performance.

### **Spin-Off versus a Carveout**

A spin-off occurs when a subsidiary becomes an independent entity. The parent distributes shares of the subsidiary to its shareholders through a tax-free stock dividend. The newly spun-off firm is a separate legal entity with a distinct management and board. When the IPO market is healthy and valuations robust, some companies choose to carveout a subsidiary to boost shareholder value. A parent firm takes a unit public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly-listed company is created, but the parent generally keeps a controlling stake in the newly traded subsidiary. IPO carveouts are often the first step of a tax-free spin-off. For example, the parent may first sell 20% of the subsidiary to the public in an IPO. It could later distribute the 80% that it owns in a tax-free dividend. Carve-outs can also create unexpected friction between the parent and the subsidiary. Problems can arise as managers of the carved-out company must be accountable to their public shareholders as well as the owners of the parent company. This can create divided loyalties.

### **Why Invest in Spin-Offs?**

The first and foremost reason to invest in spin-offs is, of course, to make money. Numerous academic studies suggest that many spin-offs have experienced significant capital appreciation, both on an absolute and a relative basis.

Regardless of the initial motivation behind a spin-off transaction, two studies showed newly spun-off companies tend to handily outperform the general market. One study, completed at Penn State, covering a twenty-five year period ending in 1988, found that stocks of spin-off companies outperformed their industry peers and the Standard & Poor's 500 by about 10 percent per year in their first three years of independence (Patrick J. Cusatis, James A. Miles, and J. Randall Woolridge, "Restructuring Through Spin-Offs," *Journal of Financial Economics*, June 1993). In their study, the parent companies also managed to do fairly well--outperforming the companies in their industry by more than 6 percent annually during the same three-year period.

Another study by Lehman Brothers of 88 spin-offs between 2000 and 2005 found that they beat the S&P 500 by an average of 45% in their first two years as independent companies. The group evaluated contained only spinoffs (no carveouts) and was drawn from the top 1,500 companies in the stock market. A larger group, dating back to 1990, topped the benchmark average by 18%.

Spin-off pricing inefficiency, where it can be accurately identified, holds the potential for above-average investment returns over time. Nevertheless, factors such as the timing of the initial purchase, length of holding period and selectivity are critical to successful spin-off investing. Once removed from the parent, these newly independent spin-offs frequently undergo significant internal and external changes, which can create major investment opportunities and problems in spin-off analysis and investment.

Often spin-offs are viewed as damaged goods initially by investors and discarded indiscriminately. Some of these discarded stocks have been outstanding investments. We have chosen to review some of the ground rules for spin-off investing in an effort to establish a general framework for evaluating and trading spin-offs situations.

Spin-offs can take many forms but the end result is the same: A corporation takes a subsidiary,

division, or part of its business and separates it from the parent company by creating a new, independent, free-standing company. In most cases, shares of the new entity are distributed to the parent company's existing shareholders or sold. There are numerous reasons why a company might choose to separate itself from the business to be spun off. **Unrelated businesses may be separated so that the market can better appreciate the spin-off.** For example, a diversified company may have a fast growing business that is largely ignored or not valued by the market because it is a small part of a large company. The fast growing division would likely garner a richer valuation (P/E multiple) as a stand-alone business. Highly diversified companies (conglomerates) often trade at a discount, (reflecting the "forced" purchase of unwanted businesses). Thus, the spin-off of such a business could enhance the total value of the parent shareholders' holdings, since it might be valued at little or nothing as part of the current corporate whole. In spinning off a more desirable unit, management may see a stock market opportunity where pure plays in specific sectors are highly prized by investors

**Sometimes, the motivation for a spin-off comes from the desire to separate a "poor" or under performing business so that an untarnished "good" business can shine through to investors.**

The benefits of separating problem operations from the parent's relatively untroubled businesses are self-evident. For the parent company, perhaps the principal benefit of spinning off a troubled operation is that the market value of the presumably profitable remaining businesses may be enhanced by the elimination of the under performing assets. Parent company management may have lost its patience or ability to deal with the unit's problems. Some of these problems include lawsuits, environmental issues, mature or declining markets, overly large fixed cost structures, and a general history of poor management. In general, the "bad" business may be an undue drain on management time and focus. As separate companies, a focused management group for each entity has a better chance of being effective. Ironically, some of these "bad" spin-offs turn out to be rewarding investments.

A spin-off may solve a strategic, antitrust, or regulatory issue, paving the way for other transactions or objectives. In a takeover, sometimes the acquirer does not want or cannot for regulatory reasons, buy one of the target company's businesses. A spin-off of that business to the target company's shareholders prior to the merger can provide a solution. In some instances, a bank or insurance subsidiary may subject the parent company or the subsidiary to unwanted regulations. A spin-off of the regulated entity can solve this problem.

**Compelling Tax Advantages**

Spinning off subsidiary corporations has become an increasingly popular way to create shareholder value while taking advantage of tax laws. A spin-off distribution can be made tax-free to the parent corporation and the receiving shareholder. This can represent significant savings to the parent company, relative to selling the division outright, if the subsidiary is carried on the books at a large discount to current market value. A sale would generate a big capital gain tax. If at least 80% of a subsidiary's equity is distributed to existing shareholders, a spin-off lets a company avoid the potentially large capital gains tax liability that a straight sale would incur. Spin-offs are the most tax efficient mechanism to separate a division. The parent firm restructures the subsidiary as an independent company with its own stock, then gives those shares to current investors of the parent company. Under Internal Revenue Service rules, to qualify for a spin-off, the company being spun (among other things) must have been in business for at least five years to obtain tax-free status. The Securities and Exchange Commission also requires three years of audited financials.

Spin-offs are one of three basic ways to separate a subsidiary. The other two methods are sell-offs (usually for cash, where the subsidiary is sold to another corporation or to the divisions' management in an LBO) and carveouts (also known as partial public offerings.) In a carveout some or all of the subsidiary's stock is offered directly to the public in the form of an IPO. From a shareholder standpoint, the spin-off, based on distribution of stock in a subsidiary to

create a new public company is usually the most attractive restructuring alternative. Spin-offs that qualify under IRS Section 355 Code are the only way to spin-off assets on a tax-free basis.

### **Requirements for a Tax Free Spin-Off**

In order to effectively execute a spin-off, complex rules must be followed to ensure that the unit will be able to operate independently, that the transaction is tax-free, and the financial reporting requirements are satisfied. Particular care must be paid to capital structure, IRS rules and financial reporting requirements. If a spin-off fails to meet all of the IRC Section 355 requirements, the company can be liable for the full taxes on the separation without receiving the cash that could be used to pay the tax bill. In addition, shareholders will be taxed on the receipt of an ordinary income dividend.

To be tax-free, among other things, the spin-off must be undertaken for a bonafide, non-tax “corporate business purpose” (i.e. to save costs other than federal taxes, to enhance the profitability of the new company or to enhance management focus on each business). The parent must “control” the subsidiary to be spun-off immediately prior to the spin-off, and the parent must distribute “control” of the subsidiary to the parent’s shareholders. The shareholders of the parent corporation must maintain a “continuity of interest” in both the parent corporation and the spun off subsidiary. Finally, the parent corporation and the spun-off subsidiary must actively conduct a trade or business immediately after the spin-off, and the business must have been actively conducted throughout the five-year period ending on the date of the spin-off.

**To avoid taxable consequences, the transaction must be structured carefully to abide to the rules of Section 355, which are summarized as follows:**

#### **CONTROL**

The parent company must have “control” of the subsidiary immediately prior to the spin-off and must disburse to the shareholders a controlling amount of subsidiary stock. Normally, the parent is required to distribute all of its stock in the

subsidiary. Control is defined as stock possessing at least 80% of the voting power and at least 80% of each class of nonvoting stock.

#### **ACTIVE BUSINESS**

Section 355 also requires that both the parent and subsidiary be engaged immediately after the spin-off in an active trade or business in which each has actively operated for at least five years prior to the divestiture.

#### **MAY NOT BE USED AS A DEVICE TO AVOID TAXATION**

Under the code, the transaction must not be used as a device to distribute earnings of a company. Basically, this means that the transaction may not be used simply as a means of escaping dividend taxation rules by converting ordinary income into capital gains.

#### **CONTINUITY OF INTEREST**

This rule requires that the shareholders of the parent maintain a significant continuing interest in both the parent and the subsidiary following the transaction.

#### **BUSINESS PURPOSE**

This requirement for a tax-free spin-off is that the transaction has a substantial business purpose. This is typically the most rigorous and uncertain prerequisite. Through the years, a business test has evolved through Internal Revenue Service rulings and court cases. This test requires the spun-off company have a real and substantial business purpose separate from avoiding federal income taxes. Commonly, a spin-off must bring about material and quantifiable cost savings or other benefits to one or more of the businesses involved.

### **Commonly Accepted Business Purposes for Rationalizing a Spin-Off**

#### **Equity Financing**

The company indicates that a spin-off will allow the parent or a subsidiary to trade at a higher valuation than the current stock price. Again, the IRS is unlikely to accept that simply increasing the stock price enhances the business per se, unless a stock offering to raise capital to be used

in the business will follow. Consequently, the IRS will request a letter from an investment banker stating the case for the spin-off as a technique of affecting a more successful stock offering. The IRS will demand a representation that an offering will take place within a year after the spin-off.

### **Regulatory Relief**

An example of a business purpose based on regulatory rules is a divestiture required by a governmental agency. The spin-off may follow an acquisition whose approval by the Federal Trade Commission or Department of Justice may be contingent on divestiture of a certain businesses. Regulatory relief can be among the more difficult situations to document to the satisfaction of the IRS. Many times, a government agency has not mandated a spin-off take place. Usually, private counsel has advised the acquiring company that a spin-off could help avoid certain regulatory restraints. If the divestiture has not been mandated by regulators, a legal opinion may be required to convince the IRS that the spin-off will lead to that desired outcome.

### **Debt Financing**

This business purpose establishes that the company's ability to borrow will be enhanced as a result of the separation of the parent and the subsidiary. The focus would likely be on circumstances affecting the company's credit rating.

### **Fit and Focus**

This purpose often involves a business identified by management as non-core. Many spin-offs have received IRS approval based on the parent's ability to show that the needs of one business for management direction and access to capital markets would be greatly improved through separation from one or more other businesses.

### **Why Spin-Offs Could be Misvalued**

#### **OWNERSHIP CHANGES RAPIDLY**

In a pure spin-off, shareholders receive shares that they have not chosen to buy and, often, have no interest in keeping. In addition, there is often "structural" selling associated with spin-off situations. For example, if the parent company

is in a major index (S&P 500), and the subsidiary that is spun-off is not, index managers will be forced to sell the spin-off without regard to the prospects of the business if it wishes to mirror the index it is designed to mimic. This generally will place selling pressure on newly spun-off firms.

#### **INADEQUATE OR PARTIAL INFORMATION**

For a variety of reasons, there is often an absence of adequate financial information. Management is typically reluctant to provide sufficient information to perform financial analysis due to uncertainties over spin-off effects on earnings. Less research is done until more complete information is available. This leads to spin-offs being underfollowed by Wall Street analysts.

#### **UNCERTAIN EARNINGS OUTLOOK**

Since many spin-offs are often made up of underperforming assets to begin with, it is difficult to target appropriate valuation parameters. It is difficult to precisely project new expenses the spin-off will incur as a freestanding company, which adds to the difficulty of forecasting earnings and appropriate valuations. In addition, there may be a lack of comparable public companies to provide acceptable valuation comparisons, which compounds these problems.

#### **LITTLE STREET RESEARCH**

The lack of street coverage initially for spin-offs can create excellent opportunities for investors. There is little economic motivation for large brokerage firms to initiate coverage of spun-off companies. Remember that the shares are given to shareholders, therefore Wall Street cannot make any fees on the distribution (versus a big payday with an IPO). In addition, usually the spin-off is small to mid-cap in size; this will further inhibit Wall Street's interest. Further, management (in the new spin-off) is often ill equipped to deal with investor relations at a sophisticated level. Often, the staff is without adequate, experienced personnel to convey the

company's message to investors.

**STRUCTURAL SELLING EFFECTS** For example, if the parent company is included in a major stock index and the spin-off is not, index fund selling usually generates selling pressure on the divested company. A large spin-off ratio (one for 10 or greater, for example) will intensify selling pressure as investors who are not interested in keeping small or odd lot positions in an unfamiliar company. Lack of a dividend may push income-oriented investors out of the spun-off stock. A spin-off of a small capitalization stock from a large capitalization stock may prompt large cap managers to sell due to liquidity concerns. Many institutional portfolio managers are forced to realign their portfolios to meet preset investment criteria. In other words, if the spin-off does not fall within the manager's investment parameters (size, yield, industry, etc.), it may be necessary to sell the shares without regard for the prospects for the spin-off. This typical structural selling often pushes spin-offs to price levels, which are not reflective of the long-term outlook for the company. Savvy investors can take advantage of this temporary decline in prices by accumulating shares on the cheap.

**ENLIGHTENED SELF INTEREST** Some companies would rather have their stock price decline after the distribution. Yes, it is true. Upper management is often "incentivized" with stock options whose strike price is determined by some average number of days trading after the spin-off. It is to management's benefit to have their options strike at low prices rather than higher prices. Therefore, management may not communicate with the investment community initially (who presume there is nothing good to discuss and bailout on the spin-off).

## **Evaluating Spin-Offs**

### **Timing: When Should You Invest in Spin-Offs?**

There are three periods during which an investor can get involved with a spin-off. Each period presents different investment opportunities and

analytical problems. Since many spin-offs are often made up of underperforming assets to begin with, it is difficult to target appropriate buying or selling points based on traditional valuation parameters. The difficulty in accurately projecting new expenses the new spin-off can expect to incur as a freestanding company adds to the difficulty of forecasting earnings and appropriate valuations.

### **The "Pre-Spin-Period"**

The pre-spin period occurs after a spin-off is announced. The decision to buy stock in the corporate parent may be desirable if it enables the investor to purchase both entities at a lower combined price than the two separate post-spin companies. But, this can be difficult without definitive knowledge of the spin-off's balance sheet, asset base and normalized earnings power. Typically, the market reacts positively to announcements of spin-offs. Often there will be an initial jolt to the price of the stock, as investors anticipate increased operating efficiencies that are consistent with these transactions. This positive announcement effect is attributable to Wall Street participants embracing the idea that a divestiture will be a catalyst in unlocking value inherent in the business. As the initial euphoria subsides, the stock often settles into a narrow trading range until the actual spin-off takes place. This can be as long as a year or more, depending on the firm seeking IRS, SEC, and final board approval. This can be an attractive time to get involved with the spin-off if one is patient, and believes both parts are attractive investments.

### **The Initial Trading Period**

The initial trading period occurs when the spin-off begins when-issued or regular-way trading, and continues for a period of several weeks to several months. Institutional holders normally are not very active in "when-issued" trading, preferring to take physical receipt of their shares. Thus, if you wish to play the percentages (spin-offs often drop initially), or believe the spin-off's prospects are poor near term, this can be a good window for investors to sell shares. As previously discussed, newly spun-off shares are often subjected to a downward selling pressure

due to “structural” issues. If the parent is included in a major index and the spin-off is not, index fund selling generates downward pressure on the spin-off. A large spin-off distribution ratio (i.e., one for 20) can intensify selling pressure. Some investors are not interested in holding small or fractional positions in an unfamiliar company. A spin-off of a small capitalization stock from a large capitalization stock may prompt large cap managers to bail out on the spin-off. For these, as well as other reasons, spin-offs often face significant selling pressure when initially freed from its corporate parent. Therefore, those who are adept traders may wish to consider selling as soon as possible, then repurchase the shares as the selling subsides.

### **The Seasoning Period**

The seasoning period starts from the moment the spin-off is announced and can last up to several years. The better the spin-off is understood and perceived, the faster the seasoning period. During this time more information becomes available, management tells its story to Wall Street, and more realistic appraisals of the company’s prospects can be made. Depending on how much structural selling the spin-off endured, this period can have the greatest mispricing of a given stock as well as the best opportunity to profit from that market inefficiency. One must be patient and selective when sorting out attractive spin-offs.

### **The Dangers of Buying Too Soon**

In the past, buying most spin-offs in the early weeks of trading, due to the intensity of artificial selling pressures, was generally the best strategy. Now, greater patience and selectivity is important in ferreting out attractive spin-offs. Spin-offs tend to trade at higher initial prices than in the past, due to the stellar price performance of some earlier spin-offs; more attention is being paid to spinoff situations. Consequently, there is now a greater initial interest in spin-offs as portfolio managers try to identify bargains, and less likelihood of grossly mispriced spins relative to their inherent value. Newly spun-off companies are often subjected to a variety of new and unexpected internal and external pressures. These pressures can have a major effect on its ability to meet initial short-term earnings targets and thus match earnings expectations. If

disappointments occur, investors can prove less patient with a company that is suddenly viewed as having no long-term operating record and an uncertain future. The lack of a long-established “sponsorship” with the understanding and willingness to take a longer-term point of view can also hurt the stock price.

### **Breaking up is Good to Do**

We have published “Spin-Off Research” continuously since 1997. Over that period, we have tracked and analyzed over 450 U.S.-based spinoff situations. Our unique perspective has lead us to believe that spin-offs often result in a higher aggregate value for the constituent parts (i.e., the sum of the parts is generally greater the whole). When one reconstitutes the value of the parent and the value of the spinoff after a one to two year period, often outstanding overall returns are observed.