The New York Times
nytimes.com

November 5, 2006

INVESTING

Profiting When Companies Split Up

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BIG-NAME corporate spinoffs have garnered considerable attention this year, starting in January when CBS split off from its parent, Viacom, and resumed trading on the Big Board. Early last month, 155-year-old Western Union became a separate company again when it split off from First Data. And late last month, Altria said it was moving closer to spinning off its giant food subsidiary, Kraft.

Investors drawn to the reemergence of marquee names like these may be onto something: investing in spinoffs can be very profitable. Nearly two-thirds of the companies spun off over the last three years have beaten the Standard & Poor's 500-stock index this year, according to figures from Spin-Off Advisors, a Chicago research firm.

Timing such investments can be tricky. While shares in spun-off companies often decline in their first weeks of trading, they tend to rebound — sometimes substantially. Spinoffs with the best performance are generally found among small and midcap companies, several studies show.

In 1999, a 10-year McKinsey study found that shares of spinoffs trounced the S.& P. 500 over comparable two-year periods by 10 percentage points. Spinoffs also beat so-called carve-outs or partial spinoffs, in which the parent keeps a majority stake in the company, by three percentage points, the study showed.

In February, a Lehman Brothers report looking at spinoffs from 2000 to 2005 told a similar story. It found that the average two-year gain of spinoffs was 45 percent higher than the S.& P. during the period.

Often the best time to buy shares in a spinoff is weeks or months after the company goes public, after the stock price has drifted lower. At that point, the shares may have been put under pressure for reasons that have nothing to do with the merits of the company. Institutional investors will often dump a spinoff when it does not pay a dividend, or otherwise fails to meet the criteria for its portfolio, according to a 1993 study by Keith C. Brown, a business professor at the University of Texas at Austin.

Investors may sell the shares because their stake in the spun-off company is too small to bother with, or the company does not fit their asset allocation or is not included in an index. Demand for shares may be particularly weak for small and midcap spinoffs, the McKinsey study noted, since such companies may not find an immediate following among analysts or investors. So a flurry of shares being sold into the market may find few ready buyers.

“It might drift down 10 to 15 percent over the first few months making for a good entry point at the end of that time,” said Mark T. Keeley, vice president for marketing and research at Keeley Asset Management, which invests in spinoffs.

Finding spinoffs worthy of an investment can take time and energy. First, there are limited opportunities. A good year might have 30 spinoffs, including carve-outs. Last year, there were 26 and this year, just 15 through October. Spinoffs at Verizon and Halliburton are ready for this month, while deals at Altria and Tyco are likely by early next year.

And evaluating spinoffs, which can be less transparent than a typical public company, can also be challenge. “Investing in spinoffs is something of a black box allocation,” said Stuart C. Gilson, a professor at the Harvard Business School. “You don’t know how it will do without the parent’s support.”

Spinoffs may share potential liabilities with their ex-parent. There are also tax concerns. Spinoffs must be careful about making significant acquisitions, for example. The I.R.S. may question the spinoff’s tax-free status — a big reason for doing a spinoff instead of selling a division — if it believed a takeover was being financed with funds not paid to the government in taxes.

Conglomerates — companies made up of disparate businesses — are a big source of spinoffs. Investors often give such amalgams a “conglomerate discount” because of the view that corporate managers may lack the skill to get the most profit out of many different units.

“No one is good at managing half a dozen different businesses,” says Hemang A. Desai, a business professor at Southern Methodist University. If you allow someone who knows a business well to run it independently and give them the right financial incentives, “you’ll see its operating performance improve,” Professor Desai said.

SARA LEE appears to have learned that lesson. After gobbling up brands like Jimmy Dean sausages, Kiwi shoe polish, Coach handbags and Hanes underwear over two decades, the company has decided to focus on food, beverages and household products.

Hanesbrands is the latest to be spun off. After floundering for a few weeks, the stock took off, rising more than 20 percent since trading began in August. Hanesbrands might prove to be similar to another former Sara Lee unit, the handbag maker Coach, said Joseph W. Cornell, president of Spin-Off Advisors. Coach has expanded dramatically since being spun off six years ago and its shares are up about 1,500 percent.

Realogy, the little-known parent for familiar real estate brands like Century 21, has no such glamorous antecedents. What it does have is a spinoff's classic J-curve start since trading began in July. The company, made up of the real estate holdings of the former Cendant Corporation, was spun off this summer. Its shares fell 22 percent from late July to early September but have since risen 27 percent — an impressive feat given the slowdown in the housing market.

Wyndham Worldwide, a collection of midmarket hotel chains spun off from Cendant about the same time, has not fared as well. Its shares have dropped 9 percent amid a slowdown in travel.

Mueller Water Products, the dominant producer of hydrants, values and pipe fittings for municipalities, was carved out of Walter Industries, another conglomerate, in May and its stock has languished ever since. Mr. Cornell said he liked its prospects, though, especially once Walter distributes its remaining shares as expected by the end of the year.

With America's aging infrastructure in need of fixing, Mueller, a solid moneymaker, would appear to be well positioned to handle its business alone, without having to share profits with a parent. That would be good for Mueller's shareholders, which is the whole point of a spinoff, after all.