Spin-Offs

Finding Buried Treasure in Corporate Discards

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Kirr, Marbach & Company, LLC ("KM") attempts to uncover investment opportunities where we can buy one dollar of intrinsic value for 50 cents. We look for stocks with limited Wall Street recognition or sponsorship or that are otherwise out of favor with the institutional investing crowd.

We have had success investing in spin-offs, post-bankruptcy reorganizations and other corporate restructurings. Our experience has been that these restructuring events often create market inefficiencies that allow us to buy at a significant discount to our evaluation of intrinsic value.

This paper explains what a spin-off is and discusses reasons companies elect to spin-off subsidiaries. In addition, we will present evidence that spin-offs have significantly outperformed the overall market and offer reasons why spin-offs have been a very inefficiently priced sector of the market.

Many investors look at spin-offs as corporate waste, an orphan pushed to the side to let the parent company shine. We see it as the exact opposite. Spin-offs have gained popularity recently, with companies completing over $115.8 billion in spin-offs in 2011, more than double the $53.8 billion recorded in 2010, according to Dealogic.

We have found buried treasure among these corporate discards for decades. We expect to have the opportunity to exploit this market inefficiency for the benefit of our clients going forward.

A spin-off can come in many different shapes and sizes, but the end result is the same: a parent company distributes all or most of its ownership of a subsidiary to the parent's shareholders. In the process, a new, independent company emerges. Following the spin-off, the parent company has effectively removed itself from the management and ownership of the subsidiary. There is no inflow of capital to either the parent company or the spin-off in this transaction, as the share distribution is considered a non-taxable stock dividend.

There are many reasons why a company may choose to spin-off a subsidiary. The first is that unrelated businesses can be separated and thus better understood and valued by the market. The best way to look at this is that a spin-off creates parts with a combined market value greater than the present whole. For example, a corporation with health care and energy businesses can separate and become more valuable to investors that want to invest in either health care or energy, but not both.

Spin-offs can also accomplish the task of separating a "bad" business from a "good" business. The "good" business can stand on its own merits and hopefully be valued appropriately by the market. The "good" business' management team no longer has to be concerned about trying to save the "bad" business. Concurrently, the "bad" business' management team can focus solely on improving their business, unshackled from the constraints of the combined entity.

Additionally, a company may try to make itself a more attractive acquisition candidate by spinning-off a subsidiary. Similarly, a buyer may want a company to spin-off a subsidiary. Also, the parent may want to rid itself of some debt by larding it on the spin-off (subject to the parent's loan covenants).

Finally, as a spin-off is generally the most tax-efficient way to divest assets, it may be the best way to maximize value for shareholders. If the spin-off meets certain qualifications from the IRS, neither the parent company nor its shareholders incur a tax liability upon the distribution. If the parent company were to choose a cash sale of the subsidiary as opposed to the spin-off, it would face a taxable gain (assuming the proceeds exceeded the cost basis of the subsidiary). Shareholders would incur taxes if any part of the proceeds were distributed.

> "…a spin-off creates parts with a combined market value greater than the present whole"

Now that you know how spin-offs work, let's look at why they work…

Knee-jerk selling leads to pricing inefficiencies

Once a subsidiary's shares are distributed to the parent company's shareholders, they are typically sold immediately, with little regard to price or intrinsic value. Think back to our example of the company with two unrelated businesses, health care and energy. Assume health care is the company's primary business and the reason most shareholders own the stock. If the company spins-off the energy subsidiary, would you hold or automatically sell your shares in the spin-off? In many cases, uninformed shareholders who receive shares in a spin-off find it more expedient to sell the shares rather than take the time and effort to understand and value the business they view as having been dumped on them.

There is a structural aspect to this, as well. Unlike an initial public offering, there is often little or no coverage by Wall Street analysts of impending spin-offs. This makes the process of understanding and valuing much more challenging.

Institutional investors receive shares of the newly separate company as a *byproduct* of owning shares of the parent company. The spun-off company is generally much smaller than the parent. The market value of the new shares received is typically dwarfed by the market value of the shares of the parent company owned. Thus, institutional investors tend to dismiss the spun-off shares as irrelevant to the overall portfolio and not worthy of research.

If a fund is limited to owning companies within a certain index, it is highly likely that the spun-off company will not be contained in that index. In this case, the spun-off stock *must* be sold immediately. It's very likely that if a company included in the Standard & Poor's 500 Index decided to spin-off a subsidiary, the shares of the spin-off would be the subject of a large amount of indiscriminate selling.

All in all, the spin-off process is a fundamentally inefficient method of distributing stock to the wrong shareholders. This leads to a market inefficiency that can be exploited. This inefficiency, if accurately identified, holds the potential for significant outperformance, over time.

Entrepreneurial Forces are Unleashed

Once a spun-off company is granted its independence, the new management team is free to run its own show. The concept of accountability takes on a whole new meaning for them. Incentive awards tied to the performance of the parent company and/or its stock may not mean much for managers of the subsidiary. However, as soon as that subsidiary has independent financial results and its own stock price, that all changes. The stock price that affects their incentives now reflects the market's assessment of their performance. Compensation is now more directly related to their performance, furthering the motivation to make the company succeed.

That success might also be easier to find as an independent company. Parent companies often have large and diverse operations, which can prevent them from providing the kind of management, financial, and resource support each subsidiary needs for growth. Once spun-off, the new management team can focus on *its* specific needs and maximizing value for *its* shareholders.

Academic Studies Support Our Thesis

We've had success investing in spin-offs, so there is anecdotal evidence that spin-offs can outperform. Fortunately, there is also a body of academic study that shows spin-offs significantly and consistently outperform the overall market.

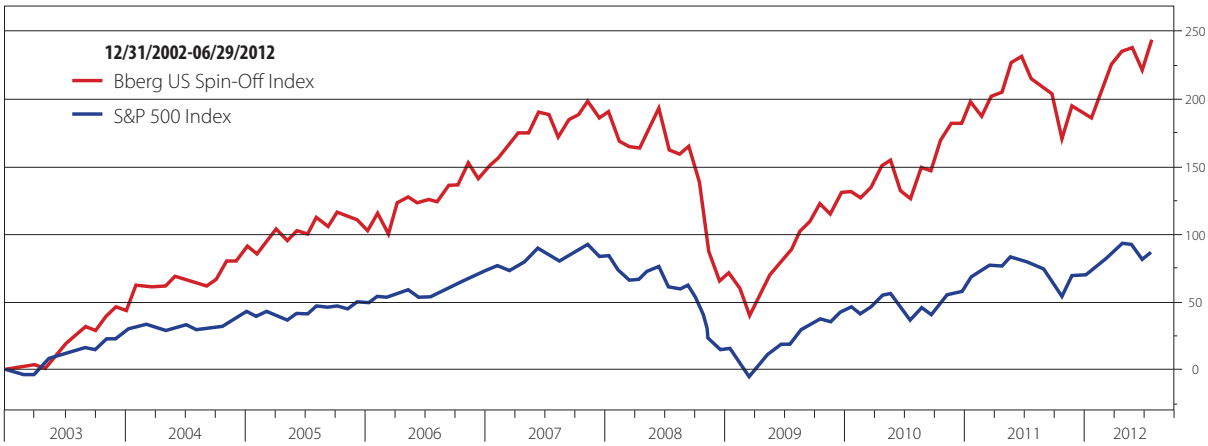
A study published in 1994 by the Journal of Applied Corporate Finance titled "Some New Evidence that Spinoffs Create Value" examined 161 non-taxable spin-offs from 1965-1990. The study found evidence that "strongly suggested that spinoffs are accompanied by substantial improvements in operating performance and profitability." They found that the spin-offs outperformed "matched-firm adjusted stock returns" (MFARs—relative to industry- and size-matched companies) for periods 12-months from the date of the spin-off (+4.5%), 24-months (+25.0%) and 36-months (+33.6%). Importantly, the study also found parent firms and their spinoffs were *five times* more likely to be taken over than other companies.[1]

John McConnell and Alexei Ovtchinnikov from the Krannert School of Management at Purdue University expanded this research 10 years later. There were 311 spin-offs undertaken by 267 parents between January 1965 and December 2000. Those spin-offs outperformed their industry- and size-matched companies by 19.40%, 24.37% and 26.32% for the 12-, 24- and 36- month periods, respectively, following the spin-off.[2]

But which spin-offs performed the best? A 2008 study by International Strategy & Investment (ISI) indicated that small- and mid-capitalization spin-offs performed the best. This supports the point earlier that institutions may disregard a spin-off because of market capitalization and/or position size considerations. In spin-offs from 1993-2007, relative performance (vs. stocks in same market capitalization category) one year from the date of the spin-off date were +13.7% for small-cap ($25 million-$1 billion), 17.2% for mid-cap ($1 billion-$5 billion) and -7.8% for large-cap (>$5 billion). Similar to the first referenced study, ISI also found that acquisitions after spin-offs were common. They noted 65 spun-off companies (27% of the sample) were subsequently acquired, on average 4 ½ years after the date of the spin-off and provided absolute cumulative returns of 80% from spin-off date to acquisition date.[3]

> "Spinoffs are accompanied by substantial improvements in operating performance and profitability"

This performance "anomaly" persists to this day. For the period ending June 29, 2012, Bloomberg's US Spin-off Index had a cumulative excess return (vs. the S&P 500) of 25.70% for 36-months, 18.19% for 60-months and 156.12% for 114 months (inception of the US Spin-off Index).



Index	Price Appreciation	Total Return	Difference	Annual Eq
Bloomberg Spin-Off Index	197.42%	243.47%	156.12%	13.87%
S&P 500	54.82%	87.36%		6.83%

The Bloomberg US Spin-Off Index is a modified market capitalization weighted index that contains equities that were spun-off from the top US companies. Equities remain a member of the index for a three year period from the first trading date.

Example #1 ▪ Discovery Holding/Ascent Capital Group

Discovery Holding Company (DHC) owned 100% of Ascent Media Group and a 66-2/3% interest in Discovery Communications. On December 13, 2007, DHC and Advance/Newhouse Programming Partnership (a privately held company that owned the rest of Discovery Communications) announced their intent to combine their interests in Discovery Communications to form a new public company. DHC shareholders and Advance/Newhouse would now be shareholders of the new company, Discovery Communications, Inc.

A confusing wrinkle to the transaction was added. Along with the combining of its stake in Discovery Communications to form a new company, DHC also announced it would spin-off to its shareholders the networks and creative services businesses of Ascent Media Group. DHC would distribute one share of Ascent Capital Group, the soon-to-be holding company of Ascent Media Group, for each 20 shares of DHC stock outstanding.

The reason for the wrinkle did not become clear until seven months later. In July 2008, Ascent Capital Group filed its Form 10 with the Securities and Exchange Commission. The Form 10 is the document that contains the most relevant information about a subsidiary that will be spun-off. It can run to hundreds or even thousands of pages, which is why many investors don't take the time to do the research.

DHC's Form 10 indicated the only way the Discovery Communications transaction could be completed was if DHC spun-off Ascent Media Group. DHC stated that "the spin-off resolved differing views with respect to the value of Ascent Media Group." Further, the board of directors of DHC determined the Discovery Communications transaction was in the best interests of DHC, but it wouldn't happen on terms acceptable to DHC without the spin-off. DHC wanted to keep Ascent Media, but not enough to sacrifice making Discovery Communication the world's leading provider of non-fiction programming.

At the time of the spin-off announcement, Ascent Media Group had a weak operating performance track record. It had incurred losses in three of the last five fiscal years, with the last year being the most brutal. As you may recall, in November 2007 the Writers Guild went on strike, affecting script writing for television shows and films. The strike lasted four months and had a significant adverse effect on the revenue generated by Ascent Media's creative services business. For 2007, Ascent Media Group posted a net loss of $132 million, or $9.42 per share.

Despite these losses, the new board of Ascent Capital Group saw the spin-off as an opportunity to turn Ascent Media around. No longer would Ascent Media's assets be overshadowed by DHC's interest in Discovery Communications. They would also be able to incentivize their personnel by granting equity awards based directly on the performance of Ascent Media. Adding Ascent Capital Group's plan to be opportunistic acquirers and grow internationally, we thought this spin-off had tremendous investment potential.

The stocks of most spin-offs trade weakly at the outset, due to the indiscriminate selling we described earlier. Ascent Capital Group's experience was no different. Its stock began trading at $33.95, but fell to $17.86 after only three months. It has since rebounded to almost $50, a 280% gain.

Ascent Capital Group

Example #2 ▪ IAC/HSN

In November 2007, InterActiveCorp (IAC), an operator of diversified Internet businesses, announced its plan to spin-off four of its subsidiaries to create five publicly traded companies. The "Spincos," as IAC called them, would be HSN, Inc., Interval Leisure Group, Inc., Ticketmaster and Tree.com. The transaction was targeted to take place in August 2008. For brevity, we will only discuss the HSN spin-off.

HSN, Inc. owns and operates HSN, a retailer and interactive lifestyle network offering products through television home shopping programming. It also owns the Cornerstone Brands collection of catalogs and related websites, including Frontgate, Ballard Designs and Garnet Hill. According to IAC's 2007 Annual Report, the retailing portion of its business (which would become HSN) accounted for just under 50% of IAC's revenue. While most spin-offs result in a large parent company spinning off a smaller subsidiary, HSN, Inc. would be the largest company remaining among the four "Spincos" and IAC.

Even though this made the IAC spin-off atypical, the reasons behind the transaction were similar to most others. Barry Diller, Chairman and CEO of IAC, said in the spin-off announcement that "each (company) will benefit from standing on its own, with its own capital structure, its own currency which will enhance its ability to attract and retain superior talent and make acquisitions, and a focused story investors can clearly understand and buy into".

In its Form 10 filing, IAC stated its belief that the common stock of the five publicly traded companies would have a higher aggregate market value than would IAC if it were to remain in its current configuration. IAC would be free to become a truly integrated Internet conglomerate. HSN would become a leading "pure play" retailer.

> "…each (company) will benefit from standing on its own"

The separation of IAC in to five different companies made for a confusing distribution of shares. Each share of IAC was entitled to receive one-fifth of a share of HSN, Inc., Interval Leisure Group and Ticketmaster and one-thirtieth of a share of Tree.com.

True to form, HSN's shares (HSNI) began trading at $10.90 and had plummeted to $1.44 in four months. HSNI closed at $40.35 on 6/29/12, a 2,700% gain from the low. As is also the case in many spin-offs, the shares of the parent company also performed well. On the day before the spin-off, IAC's shares (IACI) closed at $16.58. IACI closed at $45.60 on 6/29/12. IAC's decision to spin-off its subsidiaries clearly unlocked a great deal of value for shareholders.

HSN, Inc.

Conclusion

As Joel Greenblatt said in his excellent book, You Can Be a Stock Market Genius, "The facts are overwhelming. Stocks of spin-off companies, and even shares of the parent companies that do the spinning off, significantly and consistently outperform the market averages."[4]

If this is both true and widely known, how can this performance "anomaly" persist? First, there will always be numerous holders of the parent company's shares that will indiscriminately sell shares they receive in the spin-off, regardless of the spin-off's operating fundamentals or valuation. Second, it's the same reason value investing continues to outperform growth even though investors "know" this to be the case. It's not easy. By definition, you're buying something that has been discarded and is out of favor. You may seem clueless for an extended period of time. In addition, it can take a lot of time to dig through a Form 10.

However, if you have the stomach and psyche for investing in spin-offs and are willing to do the work, there is indeed treasure buried in corporate discards.

1. Patrick Cusatis, James A. Miles and J. Randall Woolridge, "Some New Evidence that Spinoffs Create Value," *Journal of Applied Corporate Finance* 7.2 (1994).
2. John J. McConnell and Alexei V. Ovtchinnikov, "Predictability of Long-Term Spinoff Returns," (2004)
3. Chris Senyek and Adam Calingasan, "Corporate Actions: Do Spin-offs Still Produce Alpha?," *International Strategy and Investment* (2008).
4. Greenblatt, Joel. *You Can Be a Stock Market Genius: Uncover the Secret Hiding Places of Stock Market Profits.* New York: Simon & Schuster, 1999.

"'Stocks of spin-off companies…significantly and consistently outperform the market averages'"