ValueInvestor INSIGHT
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Going Separate Ways

Corporate spinoff activity, today at historically high levels, has proven fertile ground for market inefficiency. Why is that so, and how can discerning investors separate the wheat from the chaff in sifting through prospects?

Bloomberg since the end of 2002 has maintained a US Spin-Off Index, which tracks the share prices of newly spun off companies with $1-billion-plus market caps for three years after they begin trading. Over that nearly 13-year period the index has increased 557%, versus a 137% return for the S&P 500.

This spinoff anomaly has been an open secret among value investors for longer than that. Early research on spinoff outperformance goes back more than 50 years. Joel Greenblatt wrote in detail on the subject in his 1997 book, *You Can Be a Stock Market Genius*. With spinoff activity near an all-time high, we examine the many structural reasons spinoffs can be mispriced and ask four experts where they're looking for such mispricing today.

INVESTOR INSIGHT

Murray Stahl
Horizon Kinetics

"The logic behind spinoffs today is often different, so the tactics of the spinoff investor might have to shift somewhat."

As a long-time student of spinoffs, you have identified what you consider an important change in the opportunity set around them in recent years. Describe it.

Murray Stahl: I'll first give credit to all the reasons people cite for why spinoffs can be interesting – big company spins off smaller one that investors don't know what to do with – because I agree with them. But there is a lot more to it than that, and it's been changing.

Historically, companies were spun off from their corporate parents because they were perpetual underperformers. The idea from the parent company's perspective was that you could get a higher valuation for your own stock if you got rid of your lowest-margin businesses. You wouldn't get a decent price if you sold them and you didn't want to pay capital gains if you did, so you spun them off.

When those businesses with low margins and low returns were on their own, they tended to be valued as if that was a permanent condition. If as an investor you could find those for which that wouldn't be a permanent condition, you could make a lot of money. On a business with 1% margins that could reasonably be 10%, which was maybe just normal, in principle you could make 10 times your money even with no organic growth. Throw a little organic growth in there from the ability to actually reinvest cash flow in the business, and you could make a tremendous amount of money even without a higher valuation.

The logic behind spinoffs today is often different. Multi-industry companies in a modern context can be less highly valued than their independent parts. So what we're seeing now are examples of profitable companies spinning off subsidiaries or divisions that have comparable profitability. Agilent Technologies, with an 18% operating margin, spins off Keysight Technologies, which has a 19% operating margin. B/E Aerospace, with a 17.7% EBITDA margin, spins off KLX, with a 16.5% EBITDA margin. Alliant Techsystems spins off Vista Outdoor, whose EBITDA margin is 300 basis points higher than Alliant's.

If one accepts the premise that low-margin businesses at least have the potential to become higher-margin businesses, but that higher-margin businesses have somewhat more trouble becoming even higher-margin businesses, one might view the current class of spinoff companies with a bit more caution. That's not to say they will be incapable of producing an adequate rate of return, but the dynamic is different. You're probably going to have to depend more on organic growth for success, which is a different proposition than a 1%-margin business getting to 10% margins.

As a result of this development, the tactics of the spinoff investor might have to shift somewhat. Historically, we've tended to discard the parent and keep the spinoff – although studies show that parents prosper after spinoffs as well – but in the current environment it's more likely that either can present opportunity.

Timing today may also be different. I used to like to focus on spinoff companies that were publicly traded for six months or so and had traded off because the parent-company shareholders didn't want them and few others were paying attention. I don't think those ideas are going away, but today with so much spinoff activity happening with activist investors involved who are looking for immediate value enhancement, if you believe the value-enhancing case is rational, it might be more logical to buy companies before the spin takes place or is even announced [*see table below*].

In sifting through potential spinoff-related ideas, what are some general characteristics you look for?

MS: Not surprisingly, one would be when a higher-margin business is spinning off a lower-margin business. It happens less often, but it can happen. Another would be when you see the CEO of the larger company decide the best place to be is with the spinoff. You don't see that a lot, but when you do I think it's a message to heed.

We also pay careful attention to capital structure. Sometimes a lot of debt goes to the spinoff, which can be a good thing or a bad thing. If it's too much, it may be a burden the spinoff can't bear and haunts it forever. But if there's debt and you believe it's manageable and can be paid down over time, those can make for excellent investments, basically like a publicly traded leverage buyout.

Another particular favorite of mine is the very small spinoff that those engaged in industrial-scale money management are unable or unwilling to own. It's rare but fascinating what you find from time to time in the sub-$100 million market cap world of spinoffs.

Don't you fall into that category of an industrial-scale manager?

MS: Yes, but my feeling has always been that if I'm walking down the street and see a $20 bill on the sidewalk, I don't leave it there just because it's not going to have a material impact on my net worth. I'm going to pick it up.

On the Docket?

These companies make up the latest "Radar Screen" list from Horizon Kinetics' *Spin-Off Report*. Reasons why: "a similar company may have recently announced a spinoff, the company may be under investor pressure to consider strategic alternatives, or the company's current segments may not be proving a synergistic fit and as a result the stock trades at a discount to its closest peers."

Company	Ticker	Market Cap ($Bill)	Price@ 11/27/15	52-Week Price Change	Why on Radar Screen?
Actuant	ATU	1.46	24.44	(-14.7%)	Separation of mini-conglomerate's operating segments could improve underlying performance
Advanced Micro Devices	AMD	1.84	2.33	(-12.7%)	Split in two could allow it to better compete with rivals and/or make it more attractive to acquirers
Allegheny Technologies	ATI	1.36	12.42	(-62.2%)	Following Alcoa's lead, could realize value from spinning off "High Performance Materials" segment
AIG	AIG	78.77	63.68	17.0%	Under pressure from investors Carl Icahn and John Paulson to simplify by breaking up
Chemed	CHE	2.60	154.08	40.0%	Disparate businesses – a hospice operator and Roto-Rooter – don't logically go together
DuPont	DD	58.80	67.09	(-0.6%)	Persistent activist pressure to improve management focus and accountability
Exelon	EXC	25.40	27.62	(-23.8%)	Could consider separating regulated and unregulated assets, which are valued differently by the market
Forestar	FOR	0.45	13.52	(-10.6%)	Complex portfolio of assets could be better understood by separating real estate and energy businesses
Gap	GPS	11.05	27.36	(-30.6%)	Fitness and lifestyle brand Athleta would likely garner high stand-alone valuation
Griffon	GFF	0.84	18.27	48.7%	Whole trades at a discount to the multiples awarded peers of its three disparate businesses
LSB Industries	LXU	0.14	6.23	(-80.2%)	Keeping chemicals and climate-control units together provides few synergies and dampens valuation
Merck	MRK	150.74	53.96	(-10.8%)	Ongoing internal review may lead to further divestitures that increase therapeutic focus
Nationstar Mortgage	NSM	1.48	13.48	(-53.5%)	Value of Solutionstar real estate services business could be better recognized as an independent company
Pitney Bowes	PBI	4.15	21.06	(-12.5%)	Could face pressure to separate businesses thought to be in secular decline from faster-growing assets
Stanley Black & Decker	SWK	16.33	109.06	16.6%	Separation of security business, as others have done, could add shareholder value
Tredegar	TG	0.50	15.39	(-13.8%)	Recent management shakeup could trigger an array of value-unlocking transactions
Vector Group	VGR	3.08	25.16	22.0%	Disparate tobacco and real estate operating units could both be valued more highly if separate

Sources: The Spin-Off Report, Horizon Kinetics, LLC; other publicly available information

Are there any old-school, low-margin spinoffs attracting your attention today?

MS: There have been recent spinoffs more of the historical cast as media companies have split off their traditional print-publishing businesses. There's no guarantee they're going to work, but these are deals more like what used to happen. E.W. Scripps and Journal Communications merged their broadcast assets and spun off their newspaper businesses into Journal Media Group [JMG]. News Corp. split in two, with its newspaper assets, including *The Wall Street Journal*, staying under the News Corp. [NWS] name. Gannett [GCI] now runs its newspapers under its name and its television assets are in a separate company called Tegna. In all these cases the publishing businesses are lower-margin and struggling, and the question is whether they can reorient themselves in a way that allows them again to prosper.

The case can be made that as local newspaper businesses evolve into information-services businesses, mostly delivered online, that in the fullness of time there will be a cost structure and demand environment, both from readers and advertisers, that will allow these companies to perform much better than they do now. It's going to take time, but eventually I believe it will work. What's problematic is that you want to invest in low-margin businesses when you think they're not subject to further margin pressure, and it's not clear that's the case today with newspapers. The most likely scenario is that they struggle for the first couple of years and then eventually find their way.

Do you expect the spinoff calendar to remain robust?

MS: Spinoff activity always waxes and wanes, and will continue to do so, but I think the level will stay high for the foreseeable future. It's hard to imagine interest rates will go any lower, ending the valuation lift many companies have enjoyed since the financial crisis. That puts even more pressure on big companies with multiplicities of divisions to look for ways to earn the valuation they believe they deserve. Spinning off a low-margin business, a more cyclical business and even a high-margin business can justifiably serve that purpose. I don't think we're close to exhausting what can be done in the world of large companies and spinoffs.

Disclosures