Predictive Attribute Update: Spin-Offs

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In 1996, Horizon Asset Management published a study titled "Spin-Offs Revisited: A Review of a Structural Pricing Anomaly." This report examined the long-term returns provided by tax-free spin-offs, as well as the correlation of their performance with that of the broader equity market. Our findings were consistent with those of the few other published papers on the topic at the time: as a class, tax-free spin-offs appear to provide relative returns well in excess of the S&P 500 Index ("S&P"), while also providing diversification benefits, as measured by the correlation of their returns with those of the S&P. A follow-up study we published in 2010 reaffirmed these findings, as well as noted that the shares of parent companies to spin-offs also fared well against the market during the observed periods.

As part of our qualitative analysis of potential investments, we attempt to assess whether companies exhibit any attributes which we believe to be predictive of long-term outperformance. Of these attributes, owner-operator management is the one we have discussed most frequently in recent periods. However, as supported by the studies referenced above, spin-offs may be considered predictive of long-term investment results as well—whether the company in question originated through a spin-off or has the potential to engage in a future spin-off transaction. Of course, we do not simply invest in all spin-off securities. Rather, this is one of many structural disciplines that may impact our investment decisions.

We believe in the merits of spin-off transactions for many reasons, most ostensibly the fact that such actions have the potential to unlock shareholder value that has been obscured by a dysfunctional corporate structure. While operating as a unit of a parent or holding company, for instance, a business unit may be subject to revenue targets and other corporate planning that incentivize short-term initiatives at the cost of long-term competitive advantage. These entities may also be saddled with excessive overhead costs from the parent organization, or cede control of their cash flow to the parent. Consequently, the true economics of the underlying business may be shrouded and even suppressed by the operations of larger business segments. A spin-off has the potential to enable management to make more rational long-term operational and financial decisions, and allows investors the freedom to invest in the portion of the business that they believe offers greater investment potential. In particular, these structural, operational and categorization (as when the spin-off represents a different industry, market capitalization or investment style category than the parent company) anomalies tend to inhibit effective research coverage and valuation by the broader investment community.

Over the past year, we have observed an uptick in the number of spin-off transactions. This recent increase in activity, as well as the substantial number of announced prospective spin-offs, suggests that companies are increasingly turning to this type of corporate action as a way to create value for shareholders. This is likely in response to their unduly undervalued equity—both relative to the current yields in fixed income investments and historical equity values. Some of the more notable transactions of late are found below[1]. Even in those cases where a positive rate of return has yet to materialize (i.e., WPX Energy and AMC Networks), we believe that these spin-offs represent the potential for

[1] Some, but not necessarily all of these spin-offs, may be holdings of Funds or accounts managed by adviser subsidiaries of Horizon Kinetics. In addition, other spin –offs not mentioned below may be held in Funds/accounts managed by adviser subsidiaries of Horizon Kinetics.

considerable future outperformance.[2] Statistically, spin-offs as a class realize the greatest share price returns in the 2nd and 3rd years following their distributions.

Madison Square Garden Company (MSG US): 1st Trade Date (1st day exchange-traded) - January 25, 2010
MSG US Annualized Total Return: 29.07%
S&P 500 Annualized Total Return: 12.39%
Annualized Excess Return: 16.69%

Howard Hughes Corporation (HHC US): 1st Trade Date - November 5, 2010
HHC US Annualized Total Return: 35.15%
S&P 500 Annualized Total Return: 10.18%
Annualized Excess Return: 24.97%

AMC Networks Inc. (AMCX US): 1st Trade Date - June 16, 2011
AMCX US Annualized Total Return: 8.90%
S&P 500 Annualized Total Return: 11.41%
Annualized Excess Return: (2.52)%

Brookfield Residential Properties (BRP US): 1st Trade Date – April 1, 2011
BRP US Annualized Total Return: 11.40%
S&P 500 Annualized Total Return: 6.19%
Annualized Excess Return: 5.21%

Fortune Brands Home & Security (FBHS US): 1st Trade Date - September 16, 2011 (<1 year)
FBHS US Total Return: 100.79%
S&P 500 Total Return: 18.15%
Excess Return: 82.63%

TripAdvisor Inc. (TRIP US): 1st Trade Date - December 7, 2011 (<1 year)
TRIP US Total Return: 21.82%
S&P 500 Total Return: 13.35%
Excess Return: 8.48%

WPX Energy Inc. (WPX US): 1st Trade Date - December 12, 2011 (<1 year)
WPX US Total Return: (18.96)%
S&P 500 Total Return: 15.59%
Excess Return: (34.55)%

[2] Past performance is not an indication of future results and the value of the investments and the income derived from them may increase or decrease.

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<u>Rouse Properties, Inc. (RSE US): 1st Trade Date - December 28, 2011 (<1 year)</u>
RSE US Total Return: 16.42%
S&P 500 Total Return: 14.24%
Excess Return: 2.17%

<u>Post Holdings Inc. (POST US): 1st Trade Date - January 27, 2012 (<1 year)</u>
POST US Total Return: 10.76%
S&P 500 Total Return: 8.32%
Excess Return: 2.44%
Source: Bloomberg, data as of 8/31/2012. Past performance is not an indication of future results and the value of the investments and the income derived from them may increase or decrease.

In addition to the completed transactions discussed above, the current pipeline of spin-off transactions appears to present attractive opportunities, as can be seen in the examples below.

<u>Liberty Media Corp. (“Liberty”)</u>
Liberty has undergone many transformations, dating back to its inception in 1991 as a vehicle to hold the television-content assets of cable operator Tele-Communications, Inc. Owner-operator and Chairman John Malone has overseen these multiple transformations and has been very effective at creating shareholder value while incurring the lowest tax burden possible. The current incarnation of Liberty is the result of the November 2011 combination of Liberty Capital, primarily an investment vehicle, and Liberty Starz, primarily a premium television network operator. The combined entity has an equity stake in Sirius XM (which it is in the process of fully acquiring) worth over $6.5 billion, as well as Starz LLC, which generates over $400 million in adjusted operating income before depreciation and amortization (OIBDA) per year.

Liberty’s management believes that these assets are neither being properly valued by the market nor being optimally utilized within a combined entity. Accordingly, the company has announced the intention to spin off all assets *not* related to Starz LLC through a tax-free dividend. The remaining Starz business will retain $1.5 billion of debt, which is considered an appropriate level of leverage for a company with such robust cash flow, while the “new Liberty Media” will be free to complete its acquisition of Sirius XM. We believe that Starz LLC will command a substantially higher valuation as a standalone entity and will be an attractive acquisition candidate for several media operators. Meanwhile, the “new Liberty Media” is expected to formalize its acquisition of Sirius XM and, once in control, to utilize the high cash flows generated by the company to fund share repurchases, debt repayment, and additional strategic acquisitions to build value for Sirius XM shareholders.

This transaction is expected to close in late 2012 and is a prime example of an owner-operator creating value through corporate actions—as a combined entity, the cash flows generated by a fully-consolidated Sirius XM and Starz LLC would not be effectively utilized. We expect both entities to command significant premiums to current valuations once separated.

<u>Brookfield Asset Management (“Brookfield”)</u>
Brookfield is a large asset management company based in Canada; however, both the domicile and the name of the company are somewhat misleading. While Brookfield is in fact an asset management

company that earns investment management fees, the company is also one of the largest asset operators in the world, with a portfolio of premier real estate, infrastructure, and renewable energy assets. Although a Canadian company by domicile, with the preponderance of its revenues and assets in North America, Brookfield is truly a global company, with assets such as a coal terminal in Western Australia and a robust commercial real estate portfolio in Brazil. The diversity and complexity of the company often causes certain of its assets to be underpriced or even ignored within the Brookfield complex. However, management (which owns approximately 10% of the company) has proven its ability to extract value through strategic asset combinations and spin-offs (examples are Brookfield Infrastructure Partners in 2008 and Brookfield Renewable Energy Partners in 2011).

More recently, Brookfield announced its intention to distribute 10% of its property portfolio to shareholders by a special dividend into a separately listed and managed company, Brookfield Property Partners. The new entity will hold over 250 million square feet of commercial real estate in North America, Europe, Australia, and Brazil, and will include stakes in Brookfield Office Properties, General Growth Properties, and Canary Wharf Group. Brookfield Property Partners will not be formed as a real estate investment trust for tax purposes, but will still aim to maintain a 4% dividend yield and to pay out 80% of its funds from operations. This new structure is expected to attract a different type of yield-oriented investor, and the potential appreciation of the shares should increase the net asset value of Brookfield Asset Management.

The strategy of focusing assets into niche companies under the overall Brookfield umbrella has been very successful in the past, and we anticipate similar results from the Brookfield Property Partners transaction.

Sears Holdings Corp. ("Sears")
Sears is one of the most misunderstood positions held in various Horizon Kinetics strategies. The recent price dislocation has presented management (owner-operator Chairman Edward Lampert) with the opportunity to create significant shareholder value through corporate transactions. Sears has undergone many transitions under the stewardship of Mr. Lampert. For example, in January 2012, the company spun off Orchard Supply Hardware, a regional chain of home improvement stores. More recently, in May 2012, Sears announced its intention to spin off part of its equity interest in Sears Canada. These transactions have had the intended benefit of highlighting the positive operations of these specific units to investors, while permitting Sears to focus on its core business and portfolio of real estate and consumer brands.

In September 2012, Sears is expected to complete a rights offering to its shareholders, granting the holders the right to purchase an equity stake in Sears Hometown and Outlet stores. This is effectively a spin-off transaction that allows investors to decide whether or not to participate. The newly formed entity will own 1,238 Sears specialty stores, including Sears Hometown, Sears Hardware, Sears Home Appliance, and Sears Outlet. These locations each have different operating characteristics, and are typically smaller and more focused than the core big box retail locations with which Sears is widely associated. This unique rights offering will benefit both Sears and its shareholders–Sears expects to raise approximately $350 million from the rights offering and will receive a $100 million dividend from Sears Hometown and Outlet. This additional $450 million of liquidity will increase the financial flexibility of Sears as the company continues its retail renovations. The transaction itself will highlight the operating

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characteristics of the smaller Hometown and Outlet unit, which may prompt investors to recognize the profitability potential of properly sized and efficiently managed Sears locations.

The new entity also appears to be an attractive opportunity for shareholders of the distributed rights—at a $15 strike price plus the $100 million dividend to Sears, Sears Hometown and Outlet is expected to have an enterprise value of approximately $450 million. Past results from this segment, coupled with encouraging year-to-date operations in 2012, lead us to believe that the company can generate over $100 million of EBITDA per year—this translates to an Enterprise Value to EBITDA multiple of 4.5x, which is extraordinarily low. Accordingly, Mr. Lampert (personally, as well as through the entities that he controls) has expressed the intention to exercise any rights that shareholders do not, essentially guaranteeing that the available 23,100,000 rights will be exercised at $15. Sears Hometown and Outlet appears to be a unique opportunity for shareholders to inexpensively purchase a mature, albeit stable, retail business with a strong balance sheet.

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