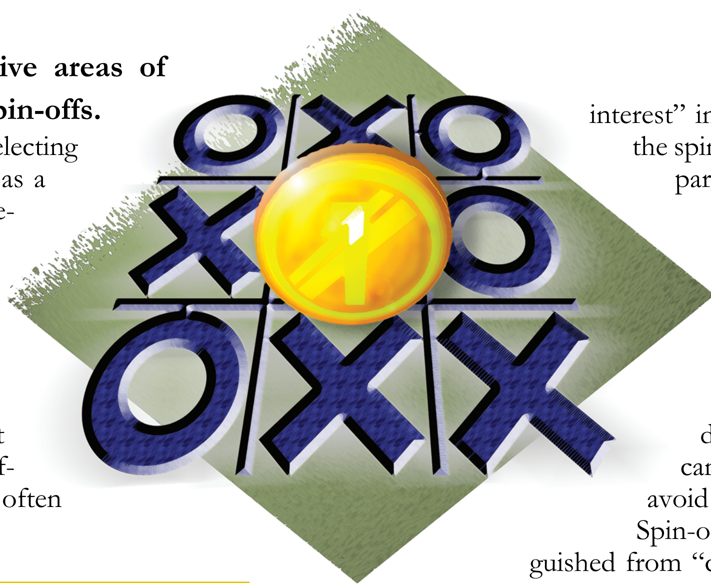
To Find Small Caps, Don’t Neglect the Large: Spin-offs for Fun and Profit

By John E. Deysher

One of the most lucrative areas of investing in recent years is spin-offs.

Many diversified companies are electing to spin off parts of their businesses as a tax-efficient way of enhancing shareholder value. Once freed from the parent, managers have greater freedom to pursue ideas to drive operating performance and higher share prices.

A spin-off often fits into the small- or mid-cap stock category. Yet many small- and mid-cap investors often overlook them, since spin-offs often originate with large companies.



What Is a Spin-Off?

A spin-off occurs when the parent company distributes (spins off) shares of a subsidiary company to the shareholders of the parent company.

Typically, the spin-off is a non-core business that can be easily jettisoned as a stand-alone entity. The hope is the stock market will value the two companies at a higher value than the parent alone had commanded. The spin-off shares then trade freely on their own and are typically deemed a tax-free distribution by the IRS.

To be tax free, the spin-off must occur for legitimate, non-tax business purposes—to enhance profitability or management focus for example. The parent must “control” the subsidiary immediately prior to the spin and must distribute “control” of the subsidiary to the parent’s shareholders. Shareholders of the parent must maintain a “continuity of interest” in both the parent and the spin-off. Finally, both the parent and the spin must be engaged immediately after the spin-off in the same business each was engaged in for at least the five years prior to the divestiture. Companies can’t be spun off just to avoid taxes.

Spin-offs should be distinguished from “carve-outs” where the parent carves out a portion (or 100%) of the subsidiary, which it then proceeds to sell to the public as an initial public offering. This is usually preceded by a “road show” to institutional investors accompanied by investment banking hype that usually results in the carve-out shares being efficiently priced. After the initial offering, the parent will sometimes sell additional shares in a secondary offering.

The Spin

There are a number of features that make spin-offs attractive prospective investments. These include:

- They may have better valuations than other new issues without the hype surrounding the typical initial public offering issuance.
- They are usually smaller companies that result in secu-

Table 1. Spin-Offs and How They Fared: 1999 Through 2003

	No.	Annualized Return (%)
Acquired	11	3.7
Still Trading	82	36.6
Worthless/Delisted	8	-81.3
All Spin-Offs	**101**	**25.1**
S&P 500	**—**	**0.1**
Russell 2000	**—**	**8.3**

rities with smaller market caps which fall under the radar screens of institutional portfolio managers and analysts. Many spins are too small to justify analyst coverage or the purchase by institutions.

- They are often "dumped" immediately and trade down initially, as index funds and other institutions owning spin-off shares sell them—providing an attractive purchase price. A large spin-off ratio (i.e., one share for 10 shares) can intensify selling pressure.
- The spin-off is often accompanied by voluminous disclosure documents, which discourages investors from proceeding any further to see what they are getting. Individuals often receive odd lots, which clutter the portfolio and prompt an immediate sale.
- They are usually of mature businesses with solid sales and profits, seasoned management, strong financials and good cash flow. Any restructuring or cost reduction has usually been done pre-spin to improve the probability of success.
- They are often focused, "pure play" businesses that make attractive takeover bait.
- The spin-off allows the management of the new firm, for the first time, to direct capital, manpower and operating initiatives as they see fit—without the parent's consent or input.
- The spin-off also allows management to be properly motivated with stock options on publicly traded shares and other incentives leading to improved operating performance. Sometimes management will play down the company's prospects pre-spin in order to have their initial options struck at the lowest price possible.

Spin-Cycle: How Have They Fared?

Table 1 shows the results of a study of 101 spin-offs that occurred over the last five years (1999 through 2003).

The average spin-off that occurred during this time period produced a return of 25.1%, solidly beating the S&P 500's 0.1% annualized return and the Russell 2000's 8.3% annualized return over the five-year time period.

There was, however, considerable diversity in how these spin-offs fared. Nine spin-offs had annualized returns of over 100%, while on the downside, 26 spin-offs had annualized losses. You can see from the Top 10 list on page 19 that the overall market environment played a big role; spin-offs that have occurred more recently fared much better than those early on. In addition, the 11 spin-offs that eventually were acquired returned an average 3.7% annually, while those still trading returned an average 36.6% annually. Only eight of the 101 became worthless or were delisted.

Spin-offs took several forms.

Most parents had single spins only. But some parents had multiple spins—Delta Woodside spun off Delta Apparel and Duck Head Apparel; Varian Associates spun off Varian Semiconductor and Varian Corp.

Others split themselves into parts with no parent surviving—Canadian Pacific spun off CP Rail, CP Ships, EnCana, Fairmont Hotel and Fording; Allegheny Teledyne became Allegheny Tech., Teledyne Tech. and Water Pik.

Finally, some spins went on to have spins themselves like Rockwell International's spin of Conexant, which then spun off Mindspeed Tech., or Lynch Corp.'s spin of Lynch Interactive, which spun off Sunshine PCS.

How Do You Find a Spin-off?

Most major spin-off announcements are carried by Barron's, the Wall Street Journal, Investor's Business Daily and other major newspapers.

Another way to find spin-offs is to search the SEC Web site (www.sec.gov) or other EDGAR sites for SEC Registration Statement Form "10-12B" which a company contemplating a public spin-off usually files. Typically, an initial filing is made containing a description of the business and the most recent financials for several months prior to the spin. This may be amended several times before the spin, reflecting subsequent financials or other changes.

You can also search Yahoo! Finance and other Internet search engines using the keyword "spin-off."

The only Wall Street research report that focuses on spin-offs, the Spin-Off Report, published by PCS Securities, is expensive and marketed to large, institutional investors.

What to Look for

Needless to say, not all spin-offs are worth your investment dollars. What characteristics make a spin-off appealing?

You should apply the same type of security analysis to a potential spin-off as you would to any other security. Evaluate the firm's main lines of business, its history and prospects, major customers and competitors, depth of management, financial condition, barriers to entry and the amount of director and executive participation in company ownership.

Avoid highly leveraged spin-offs.

Often the parent will load up the spin with lots of debt in order to improve its own financial condition. Of the spin-offs that subsequently failed, the majority were highly leveraged initially. If the parent is deleveraging via the debt-laden spin-off, perhaps look at the parent company instead.

Avoid spin-offs where the parent is just getting rid of a collection of unrelated, underperforming businesses it doesn't want anymore. They will usually continue to underperform.

Spin-offs will normally trade down initially as institutions and individuals jettison the shares, so it's sometimes best to see where the shares settle before buying. You may even want to set buy and sell triggers for appropriate entry and exit prices.

You'll notice in Table 1 that spin-offs that were subsequently acquired fared worse than those still trading. I believe this occurred for two reasons. First, the acquirer pounced quickly before the shares could appreciate over several years. Second, some firms were spun off near the bubble's peak at ridiculous valuations, settled back to earth and were then acquired at more reasonable valuations.

The lesson? Valuations matter! Analyze each spin independently and invest in only those that meet your criteria for long-term investing.

Spin-Offs 1999-2003

The Top 10

Spin-Off	Parent	Spin Date	Annualized Return** (%)
Cavco	Centex	6/03	371.4
Mindspeed	Conexant Sys	6/03	304.0
Gen-Probe	Chugai	9/02	219.4
Texas Genco	CenterPoint Egy	12/02	252.7
Brookfield Homes	Brookfield Prop	1/03	195.1
Citadel Sec	CT Hldgs	5/02	176.8
Hudson Highland	Monster WW	3/03	174.7
Medco Health	Merck	8/03	110.9
VoiceStream*	Western Wireless	5/99	100.7
Marine Products	RPC	2/01	86.1

Most Recent: Last Six Months of 2003

Spin-off	Parent	Spin Date	Initial Price ($)
Brillian	Three Five Sys	9/03	8.00
Cavco	Centex	6/03	12.70
Genesis HealthCare	Genesis Hlth Ven	11/03	15.50
Levitt	BankAtlantic	12/03	16.00
Medco Health	Merck	8/03	22.60
MI Development	Magna Intl	8/03	17.65
Mindspeed	Conexant Sys	6/03	2.05
PalmSource	Palm One	10/03	28.40
Piper Jaffray	US Bancorp	12/03	42.50

**Acquired.*
*** Returns are annualized except for spin-offs carried out within the past year.*

Conclusion

Spin-offs can offer unique investment opportunities in good markets and bad. There are often tremendous bargains, especially among smaller, under-followed spin-offs.

However, not all spin-offs are created equal and, as always, you must do your homework to separate the attractive from the mediocre. Spin-offs can and do go bankrupt so perform your analysis carefully. Don't forget to look at the condition of the parent post-spin, there may be an opportunity there instead. Also, spin-offs have been around awhile and, due to their stellar performance, are attracting more attention than 20 years ago when they were fairly new.

Caveat emptor. ➤

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