Forbes

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Analyzing spin-offs is my business.
10/8/2013

Addition By Subtraction: The Art Of The Spin-Off

In the entertainment world spin-offs are the offspring of hit shows. Television shows take popular characters and give them their own programs. Thus “Friends” gave birth to “Joey”. Unlike on network TV, where series spin-offs rarely distinguish themselves, on Wall Street the stocks of spun-off companies as a group consistently score hits.

The Guggenheim Spin-Off exchange-traded fund (ticker: CSD) has climbed 39.8% year-to date versus a total return of 19.62% for the S&P 500 (through October 3). This ETF invests in companies that have been spun-off within the past 30 months, but not in spin-offs that are less than six months old. It has roughly 24 holdings. The outperformance of spun-out stocks is no fluke. A Credit Suisse study last year found that over the prior 17 years, spin-offs beat the S&P 500 by some 13 percentage points in the year following their liberation.

English: National Oilwell Varco headquarters (Photo credit: Wikipedia)

The outsized returns from owning spin-offs have been so attractive and consistent over the years that, in theory, they should not exist. Market anomalies with a good track record tend to go away as opportunity-seeking investors adapt and squeeze out any inefficiencies. Yet for structural and behavioral reasons, the spin-off advantage abides.

Spin Mechanics

In a typical spin-off, a diverse parent company distributes to its own shareholders new shares in a stand-alone unit. The idea is that the division’s value is not fully reflected in the parent valuation, so splitting the businesses allows the market to properly value each part. The mechanics often mean that the spun-off company is orphaned at first, its shares lacking analyst coverage or handed to investors who never chose to buy them and often to index funds which are forced to sell the spin. The type of selling can create excellent opportunities for the astute investor to uncover good businesses at favorable prices.

Often, post spin, freed from a large corporate parent, pent up entrepreneurial forces are unleashed. Independence motivates management of the subsidiary to run the business more efficiently. The management team is often incentivized with stock and options and an independent stock price which should reflect the capital market’s assessment of management performance. The combination of accountability, responsibility, and more direct incentives typically show up in the operating performance once liberated.

Spin-offs are often the offspring of established companies. You take a division and turn it into a free-standing public company. Thus Abbott Laboratories ABT +0.27%, a diversified healthcare firm, spawned AbbVie ABBV -0.94%, a pharmaceutical company. Pfizer PFE -0.93%, a large drug company, sired Zoetis ZTS +0.31% (animal healthcare). Pfizer is even in the process of dividing its existing businesses into new divisions, and that seems to be the writing on the wall that its growth operations and legacy operations could see future spin-off announcements.

The idea behind a spin-off is very simple. Either a unit or operation of a company does not fit in with the broad effort, or the aim is to unlock value for shareholders. Investors like focused companies to diversified ones. Financial engineers like them because they are more tax-efficient than straight sell-offs, avoiding a capital-gains tax. So Far this year there have been 25 spin-offs (U.S.) completed. The spin-off calendar continues to grow as another 30 spin-offs have been announced thus far in 2013.

More Spins Announced

Four more tax-free spin-offs where announced in September. Measurement equipment maker **Agilent** (NYSE: A) announced that it will spin-off its electronics measurement business. **National-Oilwell Varco** (NYSE: NOV) announced plans to spin its oilfield production equipment distribution unit, which accounts for three-quarters of sales. Transmission-and-bearings firm **Timken** (NYSE: TKR) will spin-off its steelmaking unit. **Noble Corp**. (NYSE: NE) intends to spin-off its older oil rigs, primarily jack-ups in 2014. Noble plans to do a "two-step" spin-off. They hope to carveout part of the spin in an IPO first, and then spin the rest tax-free to Noble's shareholders.

More Spins Completed: United Online to Spin-off FTD on November 1

United Online Inc. (NASDAQ: UNTD; $7.98, Market Cap $739 million) is a provider of services over the internet. UNTD claims to have attracted a total audience of more than 100 million registered accounts worldwide. This is broken up in a hodge-podge group. Its FTD segment is into floral-related products and services via FTD, Interflora, Flying Flowers and Flowers Direct. United Online's Content & Media segment consists of Classmates and StayFriends, the online loyalty marketing via MyPoints, and also in its primary Communications segment of Internet access via NetZero and Juno, and even 4G mobile broadband via NetZero Wireless.

On November 1, 2013, United Online shareholders will receive one share of FTD common stock for every five shares of United Online common stock they hold, but then there will be a one-for-seven reverse split for the new United Online stock. The spin plan has unlocked significant value and should add operational and strategic flexibility for both FTD and United Online while further enhancing stockholder value. The spin plan was announced on August 1, 2012. **United Online's stock has soared 88% since the split was announced ten months ago.**

We believe the sum-of-the-parts are worth $8.50 per share (or $779 million), implying a modest 7% upside from the current market price of $7.97. In this case the spin-off, FTD accounts for most of the consolidated value (65% or about $506 million). We value the other assets at $273 million as a standalone.