VOICES

VIEWPOINT

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Have Spinoffs Spun Out of Control?

THOUGH spinoff companies are not a new phenomenon, never before have so many been created.

Thirty-three publicly traded spinoffs were completed in 1995, with a total market value of $48 billion, up from $27 billion in 1994, according to the Securities Data Company. Spinoff transactions worth more than $80 billion have been announced and are waiting to be completed.

By comparison, there was $11 billion in spinoff activity in 1988, a level that would fall precipitously into the early 1990's, along with other forms of deal-making, and was not surpassed again until 1993, when the current record-setting pace began in earnest.

Why the sudden surge? For some companies, spinoffs have become a vehicle to unlock value and to refocus and renew the entire corporation. But in part, the activity appears to be simply fueling itself, based on data that suggest — though not entirely accurately, perhaps — that these transactions increase value for shareholders.

Could it be that some shareholder groups are misguided in their euphoria over spinoffs and their potential for gains?

At first glance, the evidence would appear to say no. Data from J. P. Morgan indicate that spinoffs outperform the stock market by an average of 20 percent in the first 18 months of independent operations. The parent companies' stocks also outperform the market, as well they should, according to valuation theory. And the spinoffs tend to have higher growth rates, operating income and capital expenditures than the market as a whole.

In a study of 162 spinoffs from 1965 to 1990, it was found that shares of parent companies had risen by 67 percent, on average, three years after the spinoff and that those of the offspring had risen by an even more impressive 76 percent.

But the study, by J. Randall Woolridge and James A. Miles, professors at Penn State University, and Patrick Cusatis of Lehman Brothers, also found that spinoffs were about five times more likely to be taken over than other companies were. With the takeover targets factored out, stock performance was flat for the group.

What does this mean for investors? When the current bull market ends and mergers and acquisitions subside, there may be a safer harbor in diversified companies.

Because a spinoff has a strategic rationale, its ultimate success or failure is harder to assess than a pure financial deal. In the latter, buyers have a simple motive: unlock the equity potential in the target company by leveraging it, selling certain assets to reduce debt and finally offering equity to the public at a substantial gain. Approached by a buyer, a company's board has to determine the fairness of the price to stockholders, a decision uncomplicated by strategic considerations.

In a spinoff, there is more to consider. The process generally starts with the recommendation of the parent company's management, usually supported by the opinion of an investment banker. These bankers, joined by institutional investors, start from the premise that companies must have a strategic focus to command a higher market multiple.

Additional factors may support the recommendation. A spinoff, for example, may eliminate conflicts between the businesses of the parent and its subsidiary, rid the parent of a business that the market currently disfavors, or, conversely, allow the parent to focus on a business that is in favor. The spinoff may also provide easier access to capital, separate a regulated business from an unregulated business or permit the parent or subsidiary to compete more effectively because of legal or regulatory changes.

In any case, assessing management's recommendation for a spinoff brings into play all of a director's business judgment skills.

A threshold issue for directors is whether the company being spun off is a "dog" or has long-term potential and is too valuable to let go.

In the latter case, perhaps a "spinout," in which the parent retains more than 50 percent of the equity and controls the board, would be more desirable. When the current business cycle ends, a spinout may generate more favorable returns for shareholders over the long term.

The board must also ask whether human factors are behind management's recommendation. In an analysis of 24 spinoffs over the last three years, two-thirds were found to have been initiated by chief executives in their "retirement zones," meaning they were aged 58 or older. One might wonder whether the outcomes would have been different had the executives been at the peaks of their careers, when they might have been more concerned about the long term. And there are reports that chief executives may use spinoffs to reward or get rid of top executives who want to replace them. It is also common for companies to spin off a few corporate directors to the new entities.

THE board should also ask whether management has given undue weight to the urgings of Wall Street.

Is the spinoff recommendation, for example, prompted by investment bankers and analysts, who may not be completely objective? And boards should question whether the trend toward breaking up diversified businesses makes sense for their companies in light of alternative scenarios. The stocks of some well-managed diversified concerns, like General Electric and Allied Signal, sell at the current market multiple for the Standard & Poor's 500-stock index, equivalent to a sum-of-the-parts valuation. Despite current market skepticism about conglomerates, diversification can provide for synergies and offer a hedge against a recession.

Finally, directors must examine the impact of breaking apart so-called soft assets, like intellectual property, which have grown in importance both on and off the balance sheets of corporate America. Boards should ask whether keeping these assets might bring a better long-term return than spinning them off for transitory market reasons.

Though the data suggest positive potential from spinoffs for the parent and offspring, there is no guarantee. To protect shareholder value, boards should address these tough questions before voting to approve spinoffs.

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