When a spinoff is on the board's agenda

Directors have distinctive strategic and board composition decisions to make when involved with a spinoff.

BY DENNIS C. CAREY, CHARLES M. ELSON AND RALPH S. SAUL

THE MID-1990S have witnessed a new surge in corporate restructurings. Of those restructurings, only spinoffs allow the affected business unit to create its own board of directors and place all of its stock in the public marketplace. Never before in corporate history have so many new spinoff companies been created. All are justified in the name of "enhancing shareholder value." Others have additional justifications, ranging from dealing with emerging strategic business conflicts such as the case at AT&T, Electronic Data Systems, and Baxter International, changing the "mix" of shareholders such as at Dun and Bradstreet, to (although not publicized as such) reversing failed acquisitions made during the 1970s and '80s. Spinoffs have become for some companies a vehicle to refocus and renew the entire corporation.

According to J.P. Morgan & Co., a close tracker of spinoff activity and a leading adviser on spinoff transactions, 41 spinoffs were completed in 1996, with a total value of $94 billion. Twenty of those spinoffs each had a value over $500 million, a marked indication of the sizable nature of this activity. This dollar volume of 1996 spinoffs is up dramatically from 1995 (itself a record year), when some 33 spinoffs with a value of $51 billion were completed.

In its fundamentals, a spinoff is set up as a standalone business with ownership given to the parent's existing shareholders through a distribution of common stock in the new business. The typical spinoff is designed to be a tax-free transaction for the shareholders, since they already own the business through their ownership of the parent company's stock.

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— Dennis Carey

Market outperformers

Spinoffs are not a new phenomenon. The literature contains references to the performance of spinoff companies dating back to 1965. The data show $11 billion in spinoff activity in 1988, a level from which spinoffs declined precipitously into the early 1990s (along with other forms of dealmaking) and not surpassed again until 1993, when the current record-setting pace began in earnest.

Why the sudden surge? In part, the activity is fueling itself, based on data suggesting that these transactions actually do increase value. J. P. Morgan's tracking finds that spinoff companies are outperforming the market by an average of 20% in the first 18 months of independent operations. The parent company's stock also outperforms (as well it should according to valuation theory), and the greatest response comes from spinoffs of large and profitable operations, the kind done by ITT (with ITT Industries and ITT Hartford), General Motors (with EDS), Sprint (with 360 Communications), 3M (with Imation), and other major players. Most spinoff companies tend to have higher growth rates, operating income, and capital expenditures. And, predictably, shareholder groups have pushed for spinoffs.

Unwarranted euphoria?

Could it be that some shareholder groups are misguided in their euphoria over spinoffs and their impact on shareholder value? Perhaps. In a study of 162 spinoffs from 1965 to 1990, professors J. Randall Woolridge and James A. Miles of Penn State University and Patrick Cusatis of Lehman Brothers found that, on average, shares of parent companies had risen 67% three years after the spinoff, and the offspring rose an even more impressive 76%. However, the study also found that parents and subsidiaries were

approximately five times more likely to be taken over than other companies. With takeover possibilities factored out, stock performance was flat for the group.

One conclusion that might be drawn is that when the current bull market ends, acquisition activity, which hit a record last year, will likely fall off, bringing average returns to spinoffs as well. As Andrew Osterland observed in a *Financial World* article last year, "When a downturn arrives, shareholders again will pine for the cushion diversification brings, and while many spinoffs will continue to do well, it won't be because they were spun off so much as because they are good businesses anyway."

Bondholders may share a similar concern since they bought bonds on the assumption that a company is diversified. In the RJR Nabisco spinoff case, S&P placed a credit watch on the bonds to reflect the uncertainty of the spinoff vote, and Moody's Investors Service announced it, too, would review RJR's short- and long-term debt for a possible downgrade.

Because a spinoff has a strategic rationale, its ultimate success or failure is harder to assess than a pure financial deal. In the 1980s, financial buyers had a simple motive — unlock the equity potential in the target company by first leveraging it, then selling off certain assets to reduce debt, and finally offering equity to the public at a substantial gain. The board of a company targeted by a financial buyer is focused primarily on the fairness of the price to stockholders — a decision uncomplicated by strategic considerations.

The starting premise

A spinoff starts with the recommendation of management of the parent company, usually supported by the opinion of an investment banker hired by management. Investment bankers, joined by institutional investors, start from the premise that companies must have a strategic focus to command a higher market multiple. Additional reasons may support the spinoff recommendation, e.g., eliminating conflicts between the businesses of the parent and its subsidiary; divesting a business which the market currently favors or disfavors; separating a regulated business from an unregulated business; or permitting the parent or subsidiary to compete more effectively because of legal or regulatory changes.

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Assessing management's recommendation for a spinoff brings into play all of the directors' business judgment skills and acumen. Here are some of the issues that directors must wrestle with in evaluating management's recommendation.

A threshold issue is whether the company being spun off is, indeed, a non-strategic asset or, conversely, has long-term potential and is too valuable to let go. In the latter case, perhaps a "spinout" would be more desirable, where the parent retains more than 50% of the equity and controls the board. This approach has worked well for Thermo-Electron, which remains one of only a few companies doing true spinouts in America. There is the possibility that when the current business cycle ends that a spinout will over the longer term generate more favorable shareholder returns.

Human factors

The board must also ask whether there are "human factors" that may lie behind management's recommendation to spin off a company. For example, Pacific Telesis's spinoff of Air Touch Communications was pushed by the Pacific Telesis CEO who wanted to run an independent cellular business and is now doing so at Air Touch as a competitor to the former parent. It is also interesting to note that in an analysis of 24 spinoffs over the past three years, over two-thirds of spinoffs were initiated by CEOs in the "retirement zone." One might wonder if the outcome would have been different had they been in the peak of their career. After all, spinoffs are as much about giving away long-term strategic assets and intellectual property as adding value. And, there are reports that CEOs may use spinoffs to either "reward" or "get out of the way" top executives who want to be a CEO. Further, it is common to "spin off" a few corporate directors to the new entity as well.

The board under certain circumstances should ask whether management has given undue weight to the urgings of Wall Street. Is the spinoff recommendation prompted in large part by investment bankers and analysts who may not be completely objective? Boards should question whether the current trend to-

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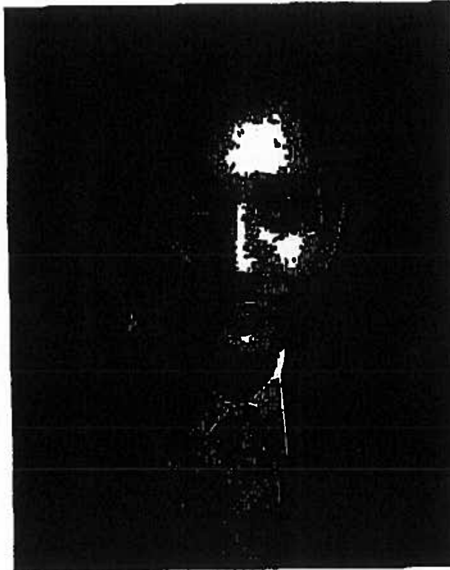
ward breaking up diversified businesses and spinning off their components is justified in this particular case. Some well managed diversified companies sell at the current S&P market multiple or at the sum of the parts valuation (e.g., General Electric and AlliedSignal). Despite the long-standing market skepticism about conglomerates, diversification can offer some hedge against a recession just as a diversified investment portfolio can produce better returns over the longer term.

Giving away assets

One of the most complex issues in dealing with a spinoff recommendation is the impact upon the parent and its shareholders of giving away soft assets such as licenses, patents, and other intellectual property. These assets have grown in importance on the balance sheets of corporate America. It would be unfortunate for a board to spin off an asset that might over the longer term have enormous strategic value for the parent. Boards should question whether under different strategic scenarios these assets might bring better returns to shareholders than spinning them off for transitory market reasons.

Boards of directors exploring spinoffs and those which inherit new spinoff companies need to be mindful of their duty of care and duty of loyalty requirements spelled out in corporate governance law. For new boards being formed for the spinoff company, care must be given to ensure that shareholder interests are protected. As these companies make their move to the public market, each must form a new board of directors. Little has been written on this issue and even less focus given to this question by shareholders and governance watchers.

While a close reading of state laws of incorporation is needed on any board matter, the minimum mandates on board composition to be traded on the NYSE or NASDAQ (where the majority of spinoffs trade) are not onerous. Each self-regulatory organization calls for at least two independent directors. The trend, fortunately, is for a company to have a board composed mostly of outsiders, with only one or two insiders. Frequently, the CEO of the spinoff company is the only insider.



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Distinctive decisions

Spinoff companies have distinctive board composition decisions to face. Unique to spinoffs is that they have a prior history with and are still subject to the oversight of the parent company while the spinoff process unfolds. Several governance issues are special to these companies, including:

- *Who should determine the composition of the "new" board?* The parent CEO? The parent board? The CEO designate of the spinoff? We believe the CEO designate should drive the process.

- *How big should the board be and how often should it meet?* Ideally, start-up boards should be no larger than seven to nine, with no more than two insiders. To aid in the recruitment process, the board should have no more than four to six regular meetings, with telephonic meetings beyond that if needed.

- *How many, if any, of the parent board directors should join the spinoff board?* On this point, should the CEO or CFO of the parent (assuming the spinoff was not done to avoid strategic business conflicts in the first place) be considered? And, are there certain parent company directors who can add value based on their interest or expertise in the spinoff business? To date, most new boards are being pollinated with two or more parent company directors who bring special talents and insights to the table. However, it may be inappropriate to have the CEO of the parent or certain directors serving on both boards. The CEO of the spinoff must have latitude in breaking away from parent company objectives and strategies as quickly as possible. And, to assure the proper alignment of shareholder and board interests, each director should be compensated primarily in company stock.

- *When should the new board be formally convened?* The current practice is to convene the new directors as an advisory body prior to the company being incorporated and publicly launched. In this way, they get to know each other and the issues that will confront them early on. For example, one issue they should deal with is the data suggesting they are five times more likely to be taken over than other companies.

A yellow flag

Boards of the parent and the spinoff companies being formed have to ask the tough questions to ensure their respective companies stay on track and benefit shareholders. Although the data suggest positive potential with spinoffs for the parent and offspring as well, there is still no compelling data to suggest that the act of the spinoff itself is of value to shareholders. As spinoffs continue to gain momentum, perhaps now is the time to raise a yellow flag. Boards must, in the end, be accountable for doing the right thing for shareholders. Although no one knows for sure in every case what is best for them, we must at least be convinced that the right questions are being asked before the actions are taken.