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EQUITY PERFORMANCE OF SPINOFFS

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ABSTRACT

Corporate spinoffs have become popular for corporations over the past two decades, and the performance of those spinoffs has been subject to much research as well. This paper looks at 36 spinoffs between 2004 and 2009 and tracks the performance of those companies relative to a competitor for -6, -12, -24 and -36 month time periods beginning on the first day of trading for the spinoff. It also looks at the growth rate of both sales and EBIT for three years after the spinoff for both the spun-off company and the competitor. The results suggest the equity performance of spinoffs is superior to their competitors over all time frames; however, the growth rate of sales and EBIT are greater over all time frames (year 0 to 1, 1 to 2, and 2 to 3) for their competitors. Given this information, it is difficult to determine the exact reason for the superior performance of the spinoffs, but it does indicate they are better investment for investors.

TABLE OF CONTENTS

Acknowledgements iii

Chapter 1 Introduction to Spinoffs 1

Chapter 2 Literature Review 11

Chapter 3 Hypothesis 16

Chapter 4 Data & Methodology 18

Chapter 5 Empirical Results 20

Chapter 6 Conclusion 24

Appendix A Internal Revenue Code Section 355 26

BIBLIOGRAPHY 28

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Chapter 1

Introduction to Spinoffs

Corporate managers are tasked with efficiently and effectively growing and expanding their businesses while taking into account all stakeholders including employees, customers, shareholders, etc. They have countless decisions to make regarding the best ways to manage their companies and one of the many options they have is a corporate spinoff. A corporate spinoff occurs when a parent company divests a smaller business, known as a subsidiary, separating the original company into two separate, independent entities operating with different management and shareholders. Investopedia.com defines a spinoff as “the creation of an independent company through the sale or distribution of new shares of an existing business of a parent company” (“Spinoff”). Spinoffs are structured such that investors of the parent company receive shares of the newly created company on a pro-rata basis; that is, proportionate with what they owned of the parent company and they have become popular as they enable corporations to accomplish many different objectives in a tax-free manner. (“Spin-Offs and Split-Offs”)

Case Studies

In 2012, two major corporations – Kraft Foods Inc. and Abbott Laboratories – spun-off subsidiary businesses which will help further illustrate the structure and potential reasoning behind corporate spinoffs. Similar to dividends, there are two major dates – the *record date* and the *distribution date* – that are very important for investors to understand. First, the *record date* is the last day for a shareholder of the parent company to be impacted by the spinoff. For example, if the record date is March 6th regarding a particular spinoff you must own shares of the parent company before closing bell on March 6th to receive the new shares of the spun-off company. If you bought shares on March 7th then you would not qualify to receive the new shares. Second, the *distribution date* is the date when shares of the new company are actually distributed to shareholders on record as of the record date.

Kraft Foods Inc. (now Mondelez International, Inc.) decided to spinoff their North American grocery business, Kraft Foods Group, Inc. (KRFT), by distributing one share of KRFT for every three shares of KFT previously owned by shareholders. In a statement to shareholders Mondelez stated, "Therefore, post-spin, you will own 1 share of Mondelez International Inc. (MDLZ) and .33 shares of Kraft Foods Group, Inc. (KRFT) for every share of Kraft Foods Inc. (KFT) that you currently own" (Spin-Off Information). As stated previously, there are numerous reasons why companies' spinoff subsidiaries (to be discussed in detail in the following section) and Kraft's reasoning dealt with the two distinctly different directions each business segment was moving in. Kraft's international segment (now Mondelez International) was rapidly growing with 5-7% expected long-term sales growth on the back of the BRIC (Brazil, Russia, India & China) nations,

whereas the North American grocery business needed to focus on innovating new products and a healthier, nutritious image. Each segment had discernibly different objectives and management felt they would be better able to accomplish these objectives as separate entities. Since the spinoff, MDLZ has returned a little more than 2% while KRFT has returned roughly 8% versus the S&P 500 which has returned approximately 7%. (Nieburg) (Watson)

Abbott Laboratories (ABT) also participated in a major spinoff in 2012 divesting their biotechnology pharmaceutical (biopharm) business which is now AbbVie Inc. (ABBV). Prior to the spinoff, the AbbVie business segment accounted for roughly half of the market value of Abbott Laboratories, and regarding share distribution, shareholders of ABT received one share of ABBV for every one share of ABT they previously owned. Similar to Kraft, the business units were moving in different directions as AbbVie's business is focused on distributing their current line of drugs, and more importantly, developing the next generation of pharmaceuticals which requires heavy research and development (R&D) expense. Abbott Laboratories now will concentrate on their medical devices portfolio (via acquisition) as well as growing their business in emerging markets. Often times R&D expense is a motivator for spinoffs because a company will have one segment that requires extensive investment while the rest of the company is more self-sustaining as was the case with Abbott. Since ABBV began trading independently on January 2nd, 2013 they have returned 6% in-line with the S&P 500 while ABT has returned 8%. (Megget) (Walker)

Rationale for Spinoffs

Corporations may choose to spinoff a business segment for many reasons including: (1) absence of synergies, (2) reducing diversification, (3) increasing transparency, (4) strategic divergence, (5) legal concerns and (6) tax benefits. There are other possible reasons for a parent company to spinoff a subsidiary but these are the primary reasons. The tax laws associated with spinoffs will be discussed in the following section. ("Spin-Offs and Split-Offs")

An *absence of synergies* between two business segments is a major reason why a company might decide to spinoff one of the units, because if the two businesses do not complement each other by way of reducing costs or increasing revenue, then there is little reason for the companies to be conglomerated. For example, in 2009 Bristol Myers Squibb spun-off Mead Johnson Nutrition Company as they transformed from a healthcare conglomerate into a Biotechnology Pharmaceutical business. The company was now going to focus on their “mission to discover, develop and deliver innovative medicines to help patients prevail over serious diseases” which did not overlap with nutritional products for children. With Bristol Myers Squibb changing directions, there no longer existed synergies between the two businesses resulting in a spinoff. (Bristol-Myers)

Reducing diversification within a business has motivated many spinoffs over the last decade, especially in the financial sector post-crisis. Many of our financial institutions were growing rapidly via acquisition of non-core businesses so they could offer a larger platform of services to customers; however, after the financial crisis of 2008 many of these same institutions divested these non-core assets (sometimes by way of spinoff) to appease the government, shareholders, etc. Companies decide to

'deconglomerate' for a host of reasons but the essence is that management feels the sum of the parts is not greater than the independent businesses.

An example of this was Citigroup spinning-off their Primerica business segment in 2010. Under Sandy Weill, Citigroup amassed a conglomerate never seen before in the financial industry that unfortunately came crashing down during the financial crisis of 2008 resulting in the federal government having to step-in and bailout the bank. Following this, Citigroup decided to refocus on their core business while also deleveraging their balance sheet by divesting approximately $900 billion worth of businesses they no longer consider "core". As part of this movement, Citigroup spun-off Primerica, Inc. – a life insurance company operating in the United States and Canada – into its own publicly traded company. The spinoff of Primerica is a great example of a large corporation choosing to deconglomerate their operations, and it is often the reason for a corporate spinoff. (Guerrara)

Increasing transparency is another reason corporations may spinoff a subsidiary. Generally this stems from management and/or shareholders believing a business segment would be worth more independently than it is as part of the larger company. The idea is that as separate entities the companies will be more transparent with information and possibly have more direct competitors resulting in a higher valuation.

A great example of this in practice occurred when Liberty Media Corporation spun-off one of their Starz (a premium cable channel) holding. Many investors such as: Barry Konig (portfolio manager at Cumberland Associations), Thomas Eagan (portfolio manager at Canaccord), and Warren Buffet (Berkshire Hathaway) strongly supported this decision by John Malone, head of Liberty Media, saying, "[the sum of the parts] value is

at $125-$130 (16-21% above current levels)." In this case, Liberty Media is a holding company meaning they are a parent company that owns over 80% of voting stock in other companies giving them control of the board of directors. Essentially, they are a company that owns other companies; however, often times holding companies trade at a discount to the market because investors find it difficult to value the separate entities. If the holding company were to split up the separate companies they would likely be rewarded with a higher valuation which was exactly the argument made with Liberty Media. This ideology can be applied to other businesses that are not holding companies, but it is very popular amongst this specific group of corporations because of their tendency to trade at a discount. (Williams)

Strategic Divergence also spurs companies to spinoff subsidiaries, especially over the past few years as the emerging markets have played a larger and larger role forcing executives to make decisions they previously may not have faced. Many major conglomerates have operations internationally in countries such as: China, Russia, Brazil, India, etc. which are growing exponentially versus the United States where growth has been relatively slow. This divergence tends to results in distinctly different strategic plans regarding the best way to run the company. Some companies choose to continue operating as a conglomerate allowing their emerging markets to lead the way while the more stable geographic segments provide stability, but other companies have decided to split the two and have them operate independently.

For instance, Altria Group Inc. decided to spinoff their international segment into a separate entity that now trades as Philip Morris International, Inc. In an article describing the spinoff one of the reasons cited was, "a move designed to give the

overseas maker of Marlboros and other cigarette brands more freedom to pursue sales growth in emerging markets". An analyst at Morgan Stanley, David Adleman, stated, "Separately the businesses could be more aggressive on share buybacks, cutting costs and introducing new products." Part of the reason Philip Morris would have more freedom was the differing laws and regulations in the United States versus other countries around the world which leads to completely different marketing techniques, profit margins, products, etc. Other recent spinoffs such as: Dean Foods Co. spinning off their organic soy milk unit into WhiteWave Foods, Valero spinning off their retail unit into CST Brands, and many others are a function of management recognizing business segments moving in different directions and their belief that it can be done more effectively as independent companies. (Altria) (Jacobs) (Berk)

Our ever-changing *legal* system also contributes to corporate spinoffs. Again this became a larger issue following the regulations that stemmed from the financial crisis, namely the Dodd-Frank Wall Street Reform and Consumer Protection Act. While this document spurned many changes in the financial industry, the separation of banks from proprietary trading was most relevant to spinoffs with investment banks like Goldman Sachs, Morgan Stanley and J.P. Morgan being forced to rid themselves of any proprietary trading. Specifically, Morgan Stanley intends to spinoff their quantitative Process Driven Trading unit into PDT Advisors (Fioravante). Legal issues can also urge spinoffs if a subsidiary is facing certain legal issues that management does not want to subject the rest of the company too such as a lawsuit. ("Spin-Offs and Split-Offs")

Tax Benefits of Spinoffs

The favorable tax laws are another major reason why corporations spinoff subsidiary businesses versus selling the company outright or any other type of divestiture. When a corporation spins-off a subsidiary business it is considered a stock dividend which is tax-free according to the Internal Revenue Code Section 355. For example, if a company decides to sell a business segment to another company then they are required to pay capital gains tax on the appreciated value of the business. This is similar to a retail investor in that when they sell stock in a company, they are required to pay tax on any capital gains received from an increase in share price from when they originally purchased the stock. A spinoff is tax-free meaning the neither the parent company nor the shareholders are responsible to pay taxes on any gains attributable to the spinoff. While this tax-exemption has been in place since the 1950's, previous to the Tax Reform Act of 1986 when the General Utilities Doctrine was repealed, corporations were forced to pay tax on any gains from property of the subsidiary. To put in perspective the impact this change had, in the 1980's the total value of spinoffs in the United States was less than $5 billion versus $16.6 billion in 1992 (six years after the change) and $85.3 billion in 1996 (ten years after the change). (Reference for Business)

There are specific requirements that a company must meet in order to qualify for the tax-exemption outlined in section 355 which can be found in Appendix A.

SEC Form 10-12B

The Security and Exchange Commission (SEC) is the standing entity responsible for regulating the securities market via monitoring corporate actions. When a corporation is involved in a spinoff they must file the SEC Form 10-12B. Investopedia.com defines this as, "a filing with the Securities and Exchange Commission required when a public company issues a new class of stock through a spin-off" (SEC Form 10-12B). It is a very important filing because it outlines a lot of relevant information for investors such as: reason for the spinoff, risks facing the new company, possible strengths and weaknesses and other specific details pertinent to investors.

Capital Market Implications

The capital markets are separated into debt and equity which are the two vehicles corporations can use to access capital. When a company needs to raise money for whatever reason, they have access to the capital markets to go about doing so. This capital comes at a cost as a function of the perceived risk of providing this capital, and when a corporation goes through a spinoff the perceived risk of providing capital can change quite dramatically for the two companies. For example, if a company is spinning off a very steady business because the parent company wants to focus on higher growth ventures, then the cost of capital for the parent company might rise. Vice versa, if the parent company is spinning-off a subsidiary that is small and relatively unstable, the cost of capital for the newly created company might be significantly higher. Also, if the capital structure (debt-to-equity) of the two companies changes drastically then the cost of capital would probably also change accordingly. (Spin-Offs and Split-Offs)

Goals and Objectives

In writing this paper, I intend to determine whether or not equity investors can attain superior returns by investing in spinoffs rather than their competitors. I will also try to determine if the performance of spinoffs aligns with the growth rate of their sales and EBIT. That is, if their equity returns are superior to their competitors, are their growth rates of sales and EBIT also superior. To complete this analysis, I will look through all 10-12B filings between 2004 and 2009 to find a list of spinoffs. From this, I will track the equity performance over -6, -12, -24 and -36 month time periods for both the spinoff and a competitor beginning on the first day of trading for the spinoff. For sales and EBIT growth rates, I will look at the growth rate for year 0 to 1, 1 to 2 and 2 to 3 for both the spinoff and the competitor. Finally, I will take the mean performance of the spinoffs and competitors to determine which generated higher returns, and I will take the median growth rate of both sales and EBIT to determine which generated a higher growth rate.

Chapter 2

Literature Review

The performance of spin-offs has been studied in various forms over the years as researchers have been trying to determine if spinoffs produce superior investment returns, and if so, what the rationale for it is. This section will outline several papers previously dedicated to this topic as well as provide some analysis of their findings.

A comprehensive study on the performance of spinoffs was done by J. Randall Woolridge and James Miles for 199 companies during the period of 1965 to 1996. They tracked the -6, -12, -18, -24 and -36 month performance of these spinoffs to determine whether or not spinoffs produced a materially different return relative to an industry peer group. Their hypothesis was that operating efficiency should increase for spun-off companies as agency costs would decrease from the reduction in bureaucratic interruption associated with large conglomerates. With greater operating efficiency the newly created companies could justifiably have greater returns. They also suggested that (1) once a company is spun-off management may be more focused as they are more in-tune with the actual operations, (2) business segments of a large corporation might not receive the talent they could potentially attain as an independent firm and (3) capital allocation should be more efficient as the market would determine this as opposed to management. (Miles and Woolridge)

Woolridge and Miles found that the performance of spun-off companies is strongest between the 12 to 24 month period and overall, they are better investments over

the long-term than competitors as well as the market as a whole (S&P 500). They also noticed that many of the companies – 113 of 199 – were no longer publicly traded after three years as a function of either being acquired or going out of business. Those that were acquired most likely produced a superior return due to the control premium paid in an acquisition, while those that went out of business obviously had an inferior return. Woolridge and Miles concluded companies formed as a result of a spinoff provide superior returns over a three year period, and they attributed this to *elevated operating performance* and *corporate restructuring activity.* (Miles and Woolridge)

April Klein and James Rosenfeld (2008) completed a study comparing the performance of conventional spinoffs to sponsored spinoffs using 57 firms as their sample size of sponsored spinoffs, and 182 as their sample size for conventional spin-offs from 1994 to 2005. A conventional spin-off occurs when a parent company distributes a minimum of 80% of their shares in a subsidiary to their current shareholders, whereas a 'sponsored' spin-off is "when the subsidiary to be divested sells an equity stake to an outside investor before going public, thereby receiving a substantial capital infusion." The major reason for this study was that Klein and Rosenfeld felt companies were "increasingly seeking substantial equity infusions from outside investors" so they wanted to compare whether these spin-offs produced a higher return than traditional spin-offs. They also compared the performance of both sponsored and conventional spin-offs to the S&P 500. (Klein and Rosenfeld)

Their hypothesis was that sponsored spinoffs would produce superior returns to conventional spinoffs because previous papers concluded returns were greater for companies that received a capital infusion (spinoff or not), and they felt this would also

apply to spinoffs. However, their findings suggested that sponsored spin-offs underperform the market as a whole over one-, two- and three- years while conventional spin-offs do not. Specifically, the one-, two- and three- year alphas convert to negative abnormal returns of -15.69%, -38.64% and -54.22% indicating that sponsored spin-offs significantly underperform in the long-run. Alternatively, the one-, two- and three- year alphas of conventional spinoffs are “positive but statistically insignificant at conventional levels.” (Klein and Rosenfeld)

Ranjan D’Mello, Sudha Krishaswami and Patrick Larkin’s (2004) study was based on the assumption that spinoffs do produce superior returns than normal with a focus on the reason why. In Woolridge and Miles’s study the superior performance was attributed to an increase in operating performance, but D’Mello, Krishaswami and Larkin analyzed another possible rationale, a lower cost of equity. Cost of equity is the focus because, empirically, for a stock to increase in price the present value of all future cash flows must increase which is calculated by taking all levered future cash flows from current time into perpetuity and discounting them by the cost of equity. Thus, the stock price will increase if future cash flows increase or if the cost of capital decreases (or both). They believed that the cost of equity should be lower citing four reasons: (1) “as manager-shareholder agency costs decrease following spinoffs, we would expect an associated decrease in the cost of equity” (2) “restructuring through spinoffs leads to efficient redeployment of the assets and improvement in investment efficiency… to the extent that this alters the systemic risk (beta) we would expect the cost of equity to change” (3) “debt is reallocated and capital structure is altered… which may cause a change in the financial risk” and (4) “lower information asymmetry and increased

transparency following spinoffs." Given this, D'Mello, Krishnaswami and Larkin believe a decreased cost of equity could be partially responsible for the superior performance of spinoffs. (D'Mello and Krishaswami and Larkin)

D'Mello, Krishnaswami and Larkin used a data set consisting of 200 companies between 1979 and 1995. They look at the equity betas of the companies before the spinoff and after the spinoff to test whether or not the cost of equity had decreased. Their findings indicated there was no decrease in the betas of the companies that were spun-off and thus, there was no decrease in the overall cost of equity. (D'Mello and Krishaswami and Larkin)

John McConnell and Alexei Ovtchinnikov (2004) did a study analyzing the effects of a buy and hold strategy when applied to companies that have been spun-off. Their study was quite extensive in that it covered 36 years of data which included 311 spinoffs during the period of 1965 and 2000. They originally began with 1,459 companies but narrowed it down to 311 by excluding companies that were: "all taxable or mixed taxation distributions (576), distributions classified as a return of capital (144), involuntary distributions (19), and distributions for which no information on the nature of the distribution is available in *CCH Capital Changes Reporter* (184). This filtering leaves 536 nontaxable distributions for which full information on their nature is available. We further exclude 31 distributions that were trading prior to the announcement of the spinoff, and 194 distributions for which no return data is available on *CRSP*." Lastly, they compared the performance of these spinoffs to two separate benchmarks: (1) An "industry and size-matched benchmark" where the market capitalization of the industry competitor resided within 25% of the spun-off company, and (2) "size and book-to-

market benchmark [which] comprises of all companies that in the same book-to-market quintile and the same size-quintile as the subsidiary." Performance was recorded as the difference between the subsidiary and the two benchmarks. (McConnell and Ovtchinnikov)

McConnel and Ovtchinnikov's hypothesis was that spinoffs did indeed produce superior returns, but they wanted to conduct a study that they felt dug deeper than previous studies. Their results showed spun-off subsidiaries actually produced returns over 20% relative to their benchmarks, and more specifically, the best period is during the first twelve months (contrary to the Woolridge and Miles study which found the 12 to 24 month period was best). They conclude investors' portfolios will produce superior returns if they include spinoffs as opposed to if they did not. (McConnell and Ovtchinnikov)

Chapter 3

Hypothesis

Intuitively, there are several reasons that justify superior results for companies that are spun-off by a larger conglomerate: (1) management incentives, (2) acquisitions, (3) deployment of cash, and (4) multiples expansion. First, the new management team is generally provided with compensation incentives highly correlated with share performance which encourages them to run a more efficient business resulting in stronger operating metrics and thus, a greater valuation. Second, many of the companies that are spun-off are small, niche businesses that are very attractive as takeover targets. While one parent company may no longer wish to have that subsidiary as part of their conglomerate, another may be eager to add it. Again, the parent company is better off to spinoff the subsidiary rather than sell it because of the tax benefits associated with spinoffs. Third, subsidiaries that operate as part of a larger corporation do not have control over their cash deployment. That is, the cash they generate is managed by the parent company so many times if a subsidiary is generating strong cash flow, the parent company will take that cash and use it for other things. When the subsidiary is spun-off into a separate entity they can deploy their excess cash in ways that are most beneficial to them such as: reinvesting in the business for growth, dividends, stock buybacks, etc. Lastly, large conglomerates generally are not rewarded with as high of multiplies as their streamlined counterparts due to lack of transparency and the overall difficulty of valuing so many

businesses. Thus, when a subsidiary is spun-off they will often benefit from a greater multiple, especially if they are a high growth type of business.

On the contrary, there are also two major reasons that could possibly produce inferior returns: (1) reduction of synergies and (2) immediate selloff by certain Funds. First, the subsidiary might be benefitting from certain synergies that they will no longer have access to as a separate entity, specifically cost synergies such as: technology, finance, marketing, etc. Second, many index Funds are required to own companies that have certain attributes like: paying out a dividend, member of the S&P 500, certain market capitalization, etc. The index Fund may be forced to sell shares of the newly created company if they do not meet the requirements of the Fund's prospectus which could create downward pressure on the stock price.

While there are arguments to be made on either side, overwhelmingly the research on this topic and the above reasoning advocate spinoffs should produce superior returns relative to their peer group, partially due to more efficient operations.

Chapter 4

Data & Methodology

This study analyzes the equity performance as well as the growth rates of two operating metrics for thirty-six companies that were spun-off between 2004 and 2009 for a three year period. That is, if they were spun-off in 2005, their performance was tracked until 2008. The operating metrics used were sales and earnings before interest and taxes (EBIT) to determine if the stock performance was related to superior operations. Eleven of the companies did not report an EBIT so the sample size was 25 for this metric. Each spinoff was paired with a competitor that was in the same industry and of similar market capitalization. The market capitalization guidelines applied were: (a) under $1 billion paired with under $1 billion, (b) $1-5 billion paired with $1-$5 billion, (c) $5-15 billion paired with $5-15 billion and (d) >$15 billion paired with >$15 billion. Obviously there are no exact competitors for any company but ensuring market capitalizations were similar (micro-cap, small-cap, mid-cap, large cap) and that the companies were in the same industry resulted in the best competitor set. Basic statistical analysis was applied to both equity performance returns and growth rates to determine if the results were statistically significant.

Equity performance was calculated (assuming a buy and hold strategy) by tracking the performance of the spinoff for -6, -12, -24 and -36 month periods and then doing the same with the competitor starting on the date the spinoff went public. The mean return was then taken for each time frame for both the spinoff and the competitor

followed by calculating the matched-firm-adjusted return (MFAR) which was simply the difference between the spinoffs' return and the competitors' return. Under the efficient market assumption the difference should be zero as neither set should outperform the other on average.

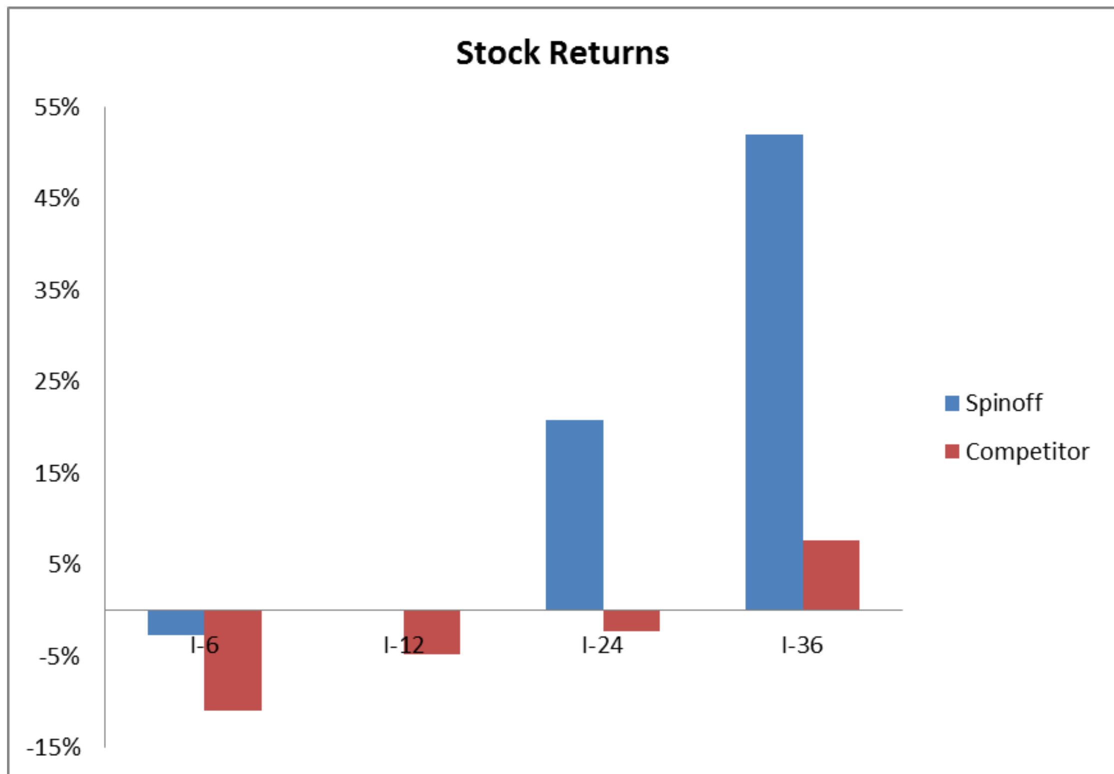
The growth rates of sales and EBIT were calculated to determine if there was a difference in equity performance, could it be attributed to stronger operating results. Again, each spinoff was paired with a competitor (the same one as performance) and the growth rate in sales and EBIT were calculated for years 0 to 1, 1 to 2 and 2 to 3. Year 0 to 1 is the least relevant because many times this would not include a full twelve month period for the spinoff. This was calculated for both the spinoff and the competitor, and then the median-industry-adjusted number was computed as the difference between the median growth rate for spinoffs and the median growth rate for competitors. The sample size for sales was 36 and the sample size for EBIT was 25 as eleven of the companies did not report an EBIT number.

Chapter 5

Empirical Results

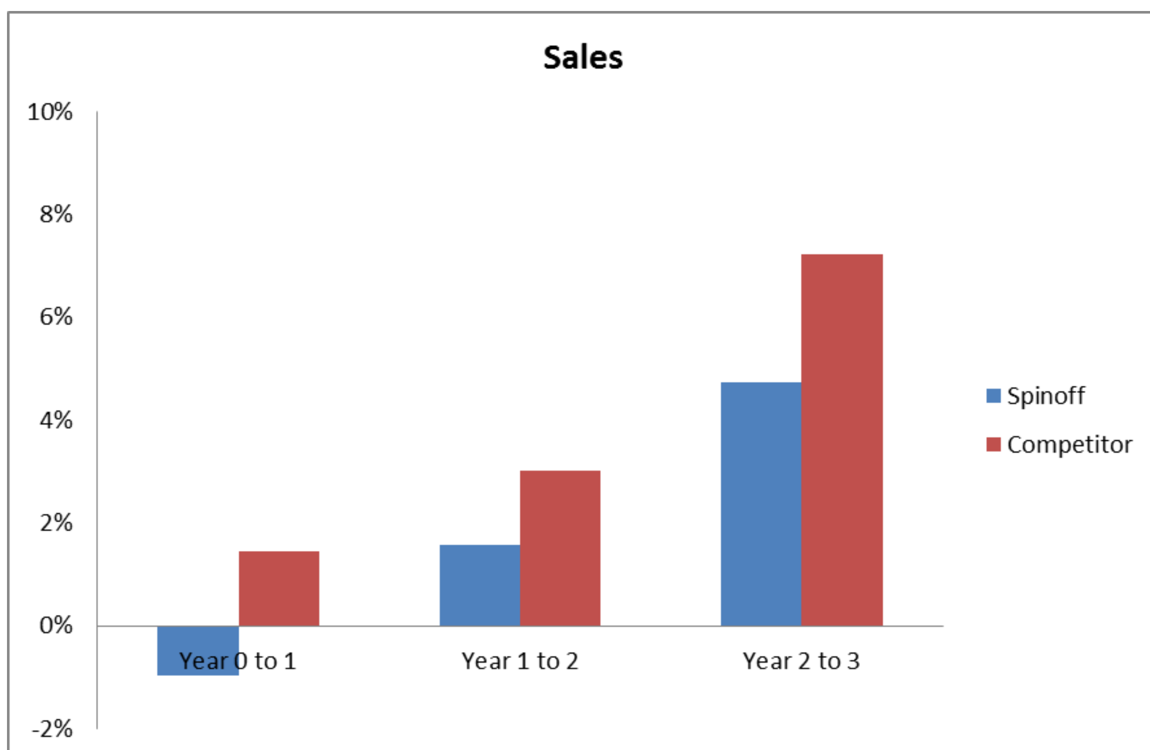
The above analysis produced results suggesting the equity performance of spinoffs is superior to the performance of their competitors over the -6, -12, -24 and -36 month time periods tested. Spinoffs outperformed their competitors by 8.2%, 4.8%, 23.0% and 44.4% respectively. These results were significant for the 24 and 36 month time frames at a 10% level. On a raw returns basis, spinoffs returned -2.7%, 0.1%, 20.8% and 52.0% over those time frames while the competitors returned -10.9%, -4.7%, -2.2% and 7.6% respectively. Below is a table and graph summarizing the results stated above.

Stock Performance				
Holding Period	**I-6**	**I-12**	**I-24**	**I-36**
Mean Spinoff Return	-2.7%	0.1%	20.8%	52.0%
Mean Competitor Return	-10.9%	-4.7%	-2.2%	7.6%
Matched-Firm-Adjusted Return	8.2%	4.8%	23.0%	44.4%
***t*-statistic**	1.34	0.81	1.73*	1.93*
N	36	36	36	36


Stock Returns
55%
45%
35%
25%
15%
5%
-5%
-15%
I-6
I-12
I-24
I-36
Spinoff
Competitor

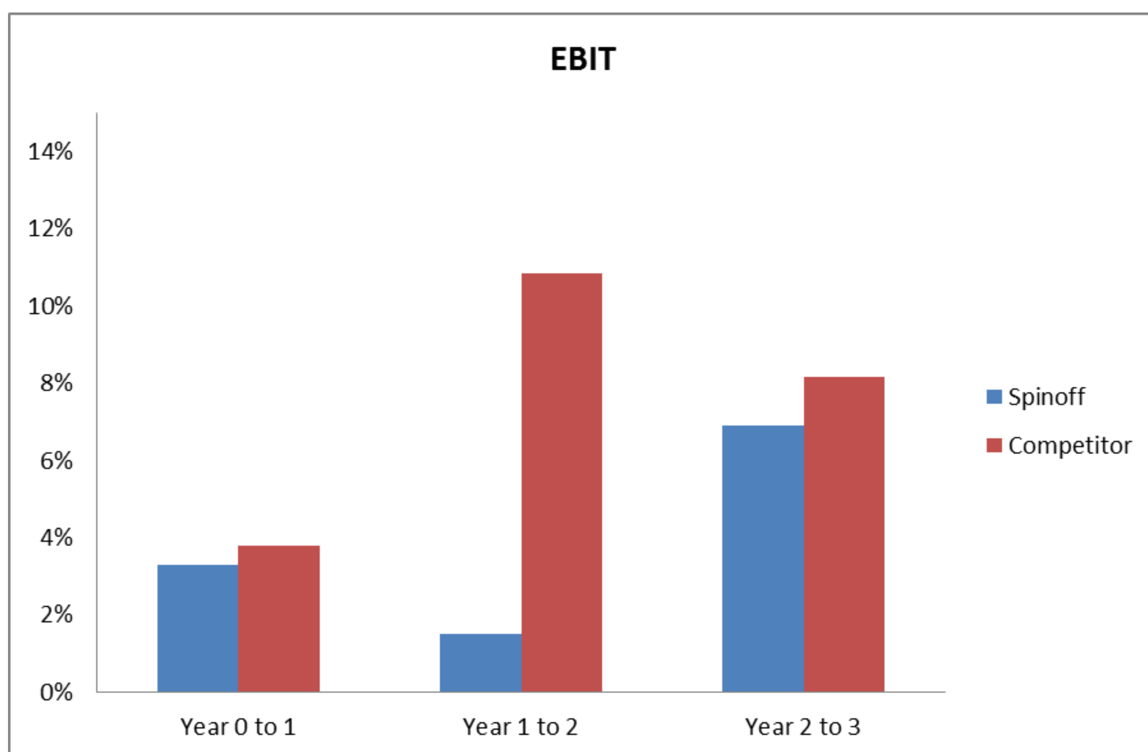
The result of the growth rate for sales was somewhat surprising, especially given the results of the equity performance. For sales, the spinoffs' growth rates were less than their competitors over all three time periods (year 0 to 1, year 1 to 2 and year 2 to 3) by -2.4%, -1.4% and -2.5% respectively. On a raw percentage change basis, the median growth rate for sales of spinoffs' was -1.0%, 1.6% and 4.7% while competitors reported 1.5%, 3.0% and 7.2%. These results were not significant at any statistical level.

Operating Performance: Sales			
Time Period	**Year 0 to 1**	**Year 1 to 2**	**Year 2 to 3**
Median Spinoff Percentage Change	-1.0%	1.6%	4.7%
Median Competitor Percentage Change	1.5%	3.0%	7.2%
Difference (Spinoff - Competitor)	-2.4%	-1.4%	-2.5%
Z-statistic	-0.33	-0.66	-0.05
N	36	36	36



The result of the growth rate for EBIT was also surprising as the spinoffs' growth rates again were less than their competitors over all three time periods (year 0 to 1, year 1 to 2 and year 2 to 3) by -0.5%, -9.4% and -1.2% respectively. On a raw percentage change basis, the median growth rate for sales of spinoffs' was -3.3%, 1.5% and 6.9% while competitors reported 3.8%, 10.9% and 8.2%. The results for year 1 to 2 were significant at the 10% level.

Operating Performance: EBIT			
Time Period	**Year 0 to 1**	**Year 1 to 2**	**Year 2 to 3**
Median Spinoff Percentage Change	3.3%	1.5%	6.9%
Median Competitor Percentage Change	3.8%	10.9%	8.2%
Difference (Spinoff - Competitor)	-0.5%	-9.4%	-1.2%
Z-statistic	0.36	-1.82*	1.09
N	25	25	25



Chapter 6

Conclusion

The results of this study indicate that the stock returns for spinoffs are in fact superior to their competitors over the -6, -12, -24 and -36 month time periods while the growth rates of both sales and EBIT are less than their competitors over years 0 to 1, 1 to 2 and 2 to 3. The original hypothesis stated spinoffs should produce superior returns as a function of (1) management incentives, (2) acquisitions, (3) deployment of cash, and (4) multiples expansion. The idea behind management incentives is that management will have more efficient operations so as to increase operating metrics like sales and EBIT leading to a higher share price which intern will result in them getting paid more money. The results of this study do not support that hypothesis because the sales and EBIT growth rates were actually inferior for the spinoffs. This study did not account for acquisitions because it only looked at spinoffs that are still currently traded. Acquisitions would not have impacted this study because they were not a part of the data set. Deployment of cash is one explanation for why spinoffs produced superior returns despite having smaller growth rates. If the spun-off companies used their cash to pay out a dividend or buyback shares it would not be accounted with the growth rates used. If the company was putting that money back into operations it should be seen in increased sales and EBIT numbers, but dividends and buybacks are not accounted for. Lastly, multiples expansion refers to companies receiving a higher valuation as a separate entity as

opposed to being a part of a larger conglomerate. This study does not test for that, but it could certainly be another reason the spinoffs performed better.

Overall, while the exact reason for the superior performance of spinoffs is unknown, investors would obtain a higher return by investing in spinoffs rather than their competitors.

Appendix A

Internal Revenue Code Section 355

(1) "*Control*. Immediately before the distribution, the parent corporation must control the subsidiary corporation whose shares are being distributed. The term "control" is defined to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all classes of stock. Section 355(a)(1)(A)."

(2) "*Active Trade or Business*: Both the parent distributing corporation and the controlled corporations must be engaged in the active conduct of a trade or business both before and after the distribution. This requirement is satisfied only if the trade or business was actively conducted throughout the five year period ending on the date of distribution and was not acquired within the five year period in a taxable transaction. A corporation is considered to be actively engaged in the conduct for trade or business if it carries on activities, including the collection of income and payment of expenses for the purpose of earning a profit. Managing income from passive assets such as investment securities does not qualify as an active trade or business."

(3) "*Distribution of all Controlled Stock.* The distributing corporation must distribute either all of the stock and securities in the controlled corporation or enough stock to meet the 80% control test and to satisfy the Secretary of the Treasurer that the

retention of some of the stock in the controlled corporation was not for the principal purpose fo avoidance of federal income tax. Section 355(a)(1)(D)."

(4) "The Treasury Regulations under Section 355 state that a change in the trade or business during the five year period by adding new or dropping old products, or making changes in production capacity, etc., would not violate the five year rule. In particular, iuf a corporation engaged in a particular trade or business during the give year period purchased another trade business in the same line of business, the acquisition would likely be treated as an expansion of the original business and not be a violation of the five year rule."

(5) "*Not a Device.* The transaction must not be used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation or both. This is determined from all the facts and circumstances."

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