

JUNE 2015



Shrinking to grow

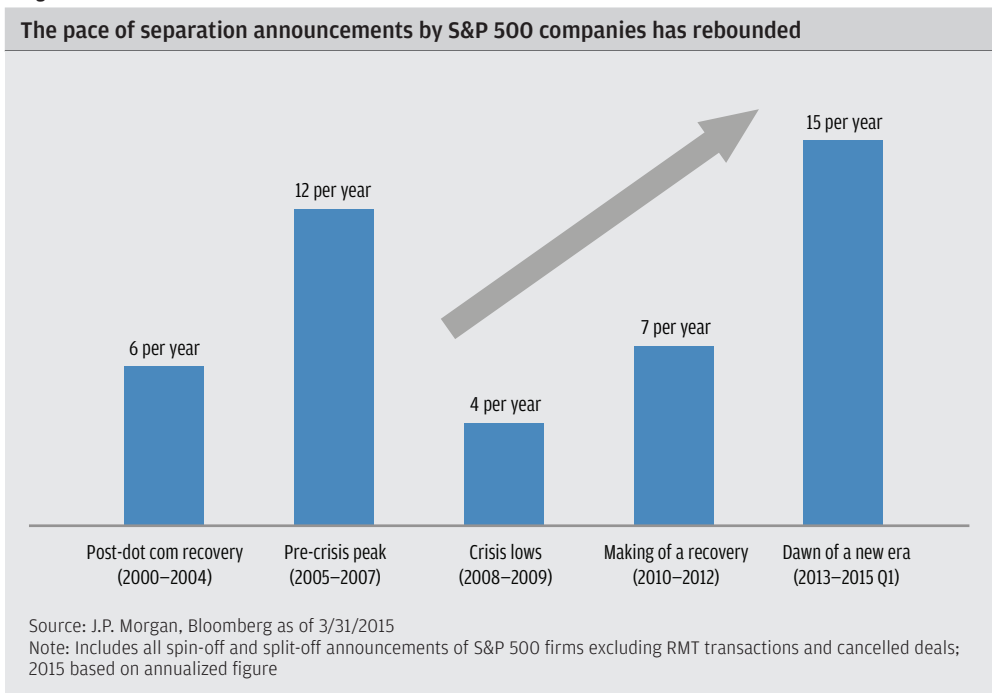
Evolving trends in corporate spin-offs

J.P.Morgan

1. Spin-offs are coming

Corporate focus is “in.” In ever greater numbers, firms have been announcing spin-offs. With historically strong balance sheets, most firms are not divesting to finance growth or reduce leverage. Rather, they are spinning off and divesting to achieve the valuation benefits commonly associated with corporate focus and clarity. The pace of corporate separation announcements has rebounded significantly since the end of the financial crisis, highlighted by recent front page announcements by blue chip firms. **The pace of separations by S&P 500 firms over the last few years has exceeded the level of any period since 2000** (Figure 1).

Figure 1



While capital markets observers recognize that the number of spin-offs has increased materially, and that investors have generally responded well to spin-off announcements, **the remarkable differences between yesterday’s and today’s spin-offs are not often well understood.** As we show in Figure 2, S&P 500 firms are now spinning off smaller, lower-rated firms and, not surprisingly, spin-off decisions are now more likely to be driven by activists than in years past. Recent spin-offs are also more likely to include innovative structures, such as Reverse Morris Trusts (RMTs), cash-rich split-offs, retained shares, etc., suggesting that senior executives leave no stone unturned in their quest to create value.

Figure 2

The spin-off landscape has evolved considerably in recent years

	2010–2012	2013–2015 Q1	
Percentage of deals in which activists were catalysts	14%	36%	↑
Percentage of deals with an innovative structure ¹	10%	25%	↑
Median size of SpinCo ²	\$4.0bn	\$2.5bn	↓
Percentage of SpinCos included in the S&P 500 ²	57%	6%	↓
Percentage of SpinCos that are investment grade rated ²	38%	22%	↓

Source: J.P. Morgan, Bloomberg, CapitalIQ, FactSet

¹ Innovative structures include Reverse Morris Trust (RMT) transactions, cash-rich split-offs, carve-outs, retained shares structures

² Throughout this report, SpinCo refers to the spun-off company and RemainCo refers to the entity remaining after the spin-off

Many factors have driven this major shift in the nature of spin-offs, but they all arise from the current low interest rate environment. Low rates are leading to more and smaller spin-offs due to the following factors:

- The cost of capital benefits of investment grade capital structures are currently less pronounced than they have been historically (except in commodity-oriented sectors)
- Non-investment grade capital markets offer debt at record-low cost
- Investors have an appetite for both yield-driven equity (e.g., REITs, MLPs, high dividend stocks) and growth stocks; spin-offs often provide an opportunity to target investor clienteles
- Firms enjoy strong access to capital markets and do not need to sell assets to reduce leverage
- Activist hedge funds present attractive investment alternatives in low-rate environments like today and, with their ever increasing assets under management, often pressure firms to spin off their non-core divisions

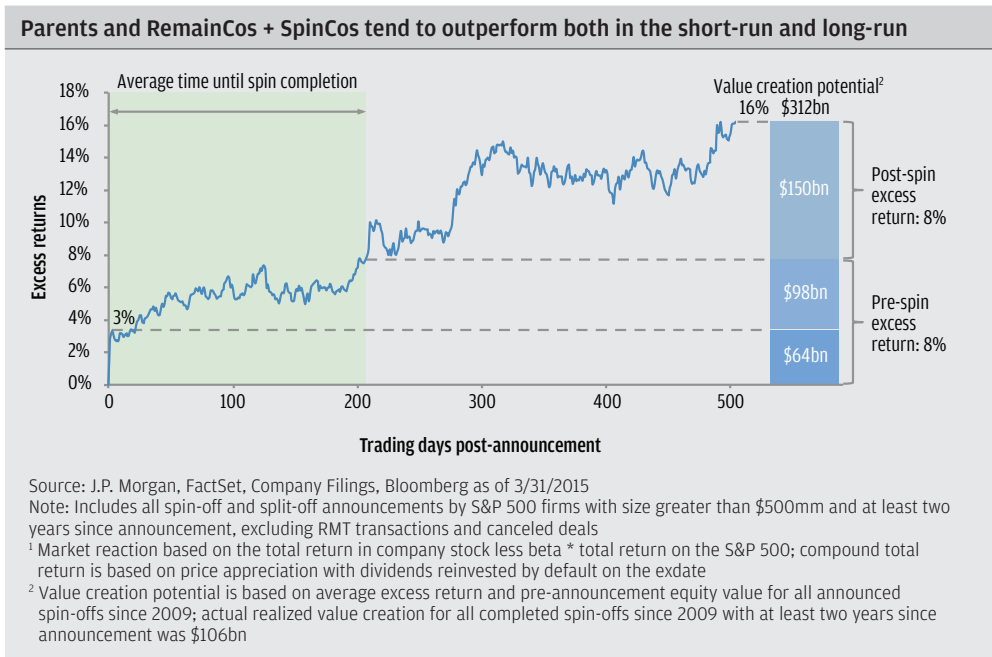
EXECUTIVE TAKEAWAY

Spin-off activity has rebounded significantly since the financial crisis. Supportive capital markets and activist investors seeking new value-creation alternatives have been catalysts for this revival. In contrast to prior periods, today's spin-offs are smaller, more likely to be non-investment grade and less likely to be in the S&P 500 index than previously. With this backdrop, boards and senior decision-makers are encouraged to be proactive in evaluating the attractiveness of a separation or the opportunity to acquire recently spun-off firms. While spin-offs have undoubtedly created shareholder value, a careful cost-benefit analysis is still necessary before a spin-off decision is made.

2. Firms executing spins typically outperform in both the short- and long-term

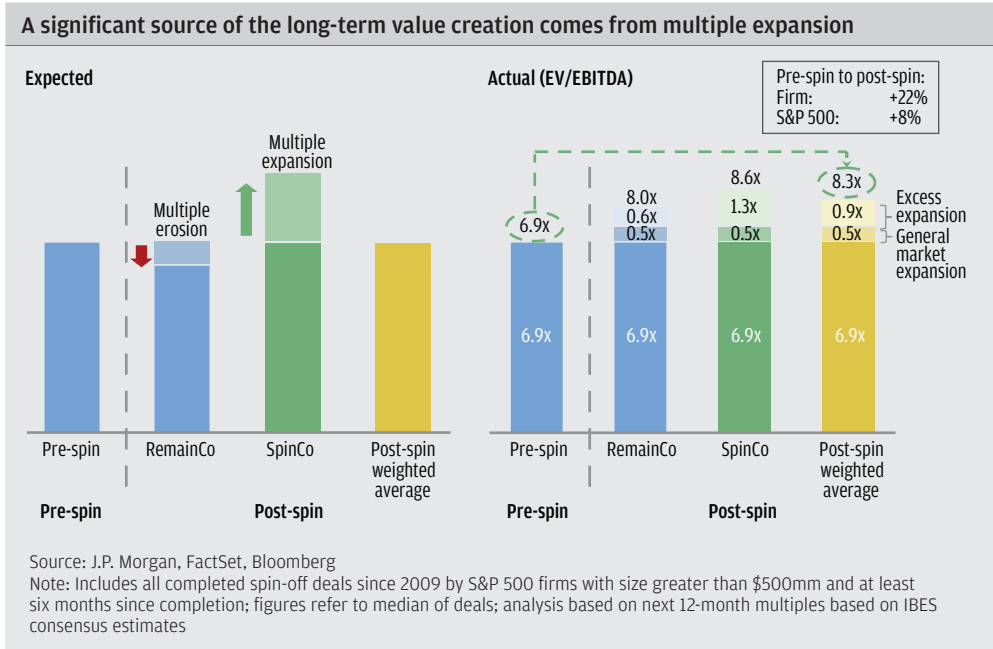
Anticipating the potential benefits of corporate separations, investors have historically rewarded companies announcing spin-offs. These firms have experienced positive reactions across sectors and company size. More importantly, these announcements are well-received both over the short- and long-term. Upon announcement, the market-adjusted reaction is a 2-4% upswing for the parent company. Intriguingly, this figure (measured post-spin as the combined return of the RemainCo and SpinCo) rises to **15%-20% over the subsequent two years (Figure 3)**. These numbers suggest that the recent wave of separation announcements has the potential to create value of approximately \$300bn, approximately 2% of the market capitalization of all U.S. firms. This outperformance is in addition to any pre-announcement rise in stock price due to investor anticipation of such a transaction (for example when the market hears either through rumor or by a formal statement that a firm is examining the pros and cons of a separation). Note that while the initial reactions are material, on average they are a fraction of the eventual long-term value creation. The market may not fully price in all the advantages accruing from the spin, either because of insufficient information or due to a lack of confidence in the successful execution of the spin-off and the harvest of its potential benefits.

Figure 3



A common misperception of separations is that the value creation comes from the independence of high-growth subsidiaries. One would, therefore, expect that the separation of a high-growth subsidiary would lead to a decline in the valuation multiple of the RemainCo relative to the parent company (Figure 4, left panel). This intuition does not, however, play out in practice. We find that **the valuation multiples of both RemainCo and SpinCo increase relative to the pre-spin company (Figure 4, right panel)**. We estimate the uptick in valuation multiples post-separation to be over 20%. Admittedly, broader market multiples also increased during that period, but after controlling for this general uplift in multiples, we still find the difference to be material, remaining in the 10%-20% range.

Figure 4



Several factors may explain this multiple expansion, including:

- Increased business line transparency
- Enhanced growth expectations
- More attractive acquisition currency (or more attractive target)
- Clearer alignment of management incentives
- Growth/risk/capital allocation profile tailored to differing investor preferences and clienteles

This last point has become particularly important because the ongoing low interest rate environment has driven investors to yield-oriented equity securities. The increasing trend of firms spinning off REITs and other yield-oriented entities is one example of how this phenomenon has manifested itself.

EXECUTIVE TAKEAWAY

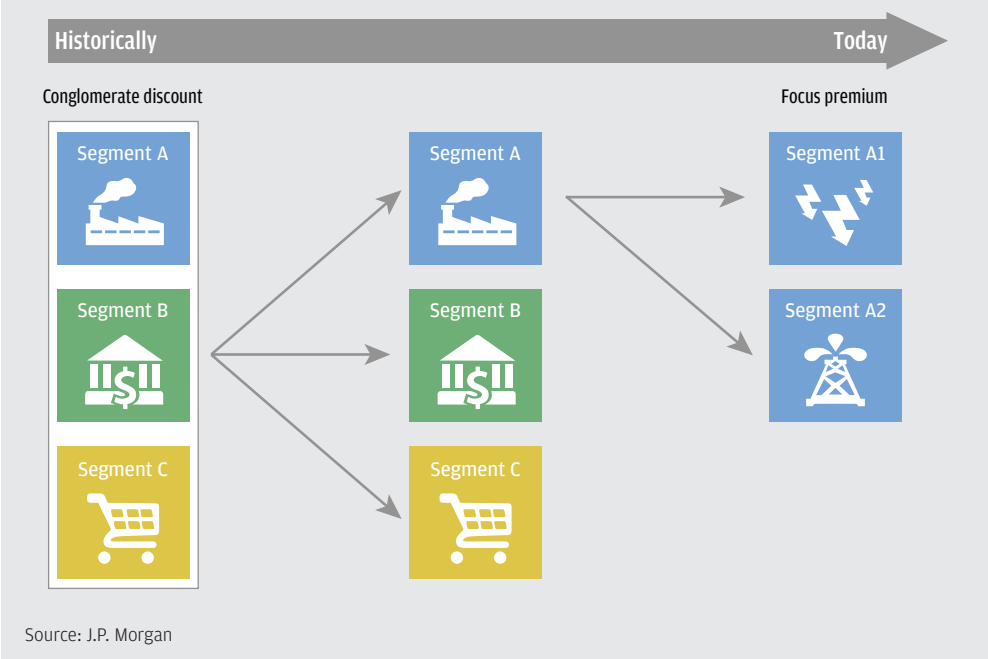
Investors continue to embrace firms announcing separations, not only in the short-term but also over the long-term. The returns are largely attributable to the higher valuation multiples that both the RemainCo and SpinCo command after the spin-off. There is dispersion in the data, however, and firms announcing separations should have clear plans with a credible execution strategy to maximize investor reception to the transaction. In our experience, where such a strategy was not available, firms have typically declined to pursue spin-offs as an avenue for creating value shareholder.

3. From conglomerate discount to focus premium

Firms with operations spanning disparate sectors (such as energy, banking and retail) have historically traded at a discount to stand-alone peers. This discount has been referred to as the “conglomerate discount” and has been well-documented. Interestingly, the nature of the **valuation differential has evolved in recent years to now encompass firms operating in segments in the same general sector** (such as operating in various subsectors within technology or branded food). With greater investable wealth and more technological resources, today’s investors tend to seek greater optionality in portfolio creation. As a result, investors now place a premium on firms targeting narrower subsectors within a broader industry. We refer to this preference as the “focus premium” (Figure 5).

Figure 5

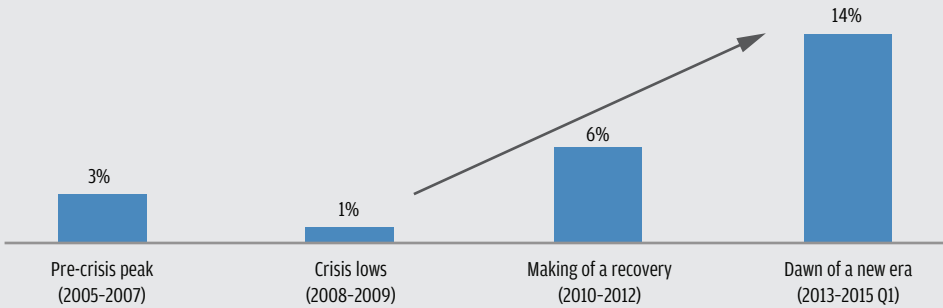
Evolving investor preferences give rise to a “focus premium”



The focus premium captures the valuation benefit attributed to firms, even those wholly in a particular sector, with a more concentrated focus. We compute it as the percentage difference in the median P/E ratios between firms with 1-3 segments and those with 4+ segments (as illustrated in Figure 6). As expected, the focus premium is generally correlated with spin-off activity. **Spin-off activity and the focus premium have been elevated in recent years, indicating that firms proactively contemplating separations can benefit from investor preferences.**

Figure 6

The focus premium indicates strong investor appetite for corporate clarity



Source: J.P. Morgan, Bloomberg, FactSet

Note: The focus premium is computed, for S&P 500 firms, as the % difference in the median EV/EBITDA ratios between firms with 1-3 and 4+ "key" segments. "Key" segments are those that: (i) do not have the word "other" in their name and (ii) have at least \$1bn in revenue or 10% of total revenue

EXECUTIVE TAKEAWAY

Firms operating in what traditionally seem to be related areas and hence unaffected by the conglomerate discount are now turning to spin-offs as a method to capture the focus premium. This premium has risen sharply in the past few years, suggesting that investors currently reward corporate clarity more than they have in the past.

4. Structural innovations continue to evolve

As firms have continued to embrace the theme of corporate clarity, separation strategies have generally become more sophisticated and innovative, with Figure 7 illustrating a few popular approaches. For example, **Reverse Morris Trust (RMT) transactions**, essentially a spin-off coupled with a merger, have doubled, reflecting the positive trends in both corporate clarity and M&A.

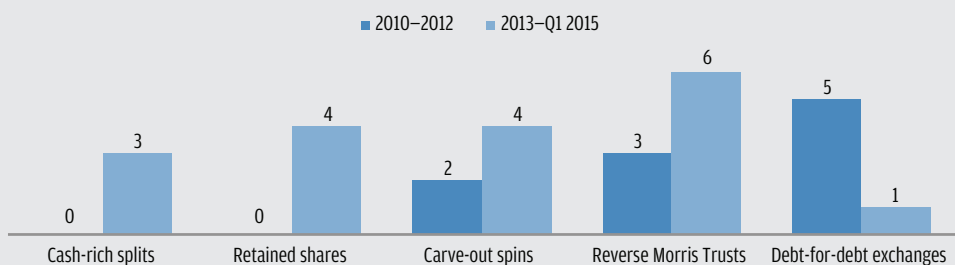
Similarly, **carve-outs**, where firms first “IPO” the entity to be subsequently spun or split off to shareholders, have also seen an uptick in popularity. This approach provides RemainCo with additional firepower to maximize benefits arising from the focus premium. **Retained shares** structures, whereby firms keep a stake in the SpinCo equity for later sell-down have emerged as a common alternative to the carve-out structure, without much of the associated market timing and risk associated with an IPO. **Cash-rich splits**, whereby firms contribute assets and cash to a subsidiary which is subsequently exchanged for shares of the parent company, effectively resulting in a buyback of parent company shares, have also been more frequent.

Not all structures have seen a significant pick-up in activity, however. **Debt-for-debt exchanges**—whereby firms may tax-efficiently monetize an asset in a spin-off above tax basis—have declined from five in 2010–2012 to just one since. This trend has been driven by a 2013 IRS proclamation that significantly complicates debt-for-debt transactions.

There are many tools that provide firms contemplating separations with additional flexibility to raise funds, optimize their capital structures, and seek strategic and valuation benefits in conjunction with greater corporate clarity. The evolving use of these structures underscores the willingness to pursue more complex strategies to maximize shareholder value creation.

Figure 7

Separation transactions have increasingly used various structural innovations



Source: J.P. Morgan, Bloomberg as of 3/31/2015

Note: Includes all spin-off and split-off announcements of S&P 500 firms; cash-rich split defined as split co-asset value consisting of at least one-third cash

EXECUTIVE TAKEAWAY

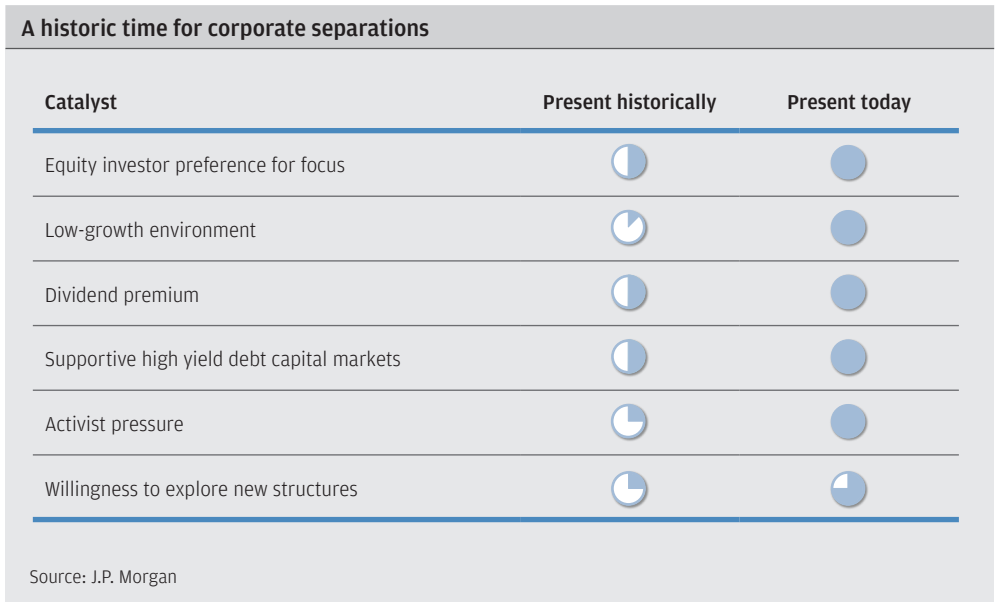
Firms evaluating potential separations have numerous tools at their disposal to maximize both the strategic and monetization potential of separations. The evolving use of these techniques suggests firms are more willing to subject themselves to modestly greater complexity to create more shareholder value.

5. Strike the iron while it’s hot

A confluence of economic factors is driving the resurgence in separation activity today: primarily a sluggish growth environment, low interest rates and attractive capital markets (Figure 8). In addition, the focus premium is at an all-time high, drawing the attention of both traditional and activist investors. Accordingly, management teams, even of firms that operate in one general sector, should continue to assess the value-creation potential from spin-offs. Assuming value can be ascertained, these senior decision-makers should then actively discuss the pros and cons of a separation with their boards.

We caution, however, that not all spin-offs are created equal. **Despite investor pressures for more spin-off activity, boards and management teams, in conjunction with their financial advisors, should continue to consider both the short-term and long-term value benefits of separations.** Separations are associated with friction costs, and if the value benefits are low or short-lived, the decision not to separate may create more long-term value. In cyclical sectors, a return to more volatile capital market environments may make spin-offs less attractive. In those sectors, it is important to evaluate the benefits of a spin-off through the economic cycle.

Figure 8



Investors today understand that economic factors are uniquely conducive to separations and expect companies to take advantage of these conditions. This environment indicates that at the very least, firms should explore whether some of their businesses would perform better, or at a minimum be valued more, on a stand-alone basis. Potential operating and financial synergies of combined businesses, whether across or within sectors, are often smaller than expected. When that fact pattern is present, it can be worth capitalizing on supportive economic and corporate finance conditions while simultaneously satisfying investor expectations. Further, decision-makers should also ensure that a separation guarantees value creation in both the short and long run. This is imperative because separations are associated with friction costs, and not all possible separations are created equal.

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