

## The Two Reasons for Spinoffs

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Special situation investing involves participating in variety of corporate actions like buyback, rights issue, spin-offs, asset sales, etc. These are low-risk arbitrage opportunities which can act as a significant source of generating alpha in an investor's portfolio. In my Best Ideas 2018 presentation, I am going to focus on spin-offs.

Spin-offs happens for two broad reasons:

1. Due to conglomerate nature or historical diversification steps, company could be operating in two completely different areas of businesses. Spin-offs can help to get better valuation (no more holding company or conglomerate discount) and unlock parent company's value. It also gives focused management bandwidth to each business to grow and scale up.
2. Sometimes, parent company might be struggling with debt, which holds back the core operating performance of the company. Hence, the management sandbag one of its divisions with debt and spin them off. This will liberate the other operating company from the debt and help them to achieve better valuation in the market, especially if their underlying sector is currently in fancy.

This second category is the one I will be presenting at Best Ideas 2018. It is a typical case of how value migrates to the equity side from the debt side as deleveraging kicks in driven by sale of richly valued assets which are obscured from investors' view due to the prominently visible high debt of the spun-off entity. It will also be a real-life application of the valuable vicarious learnings obtained over the years from the writings of Joel Greenblatt and Seth Klarman as elaborated below.

Joel Greenblatt in [You Can Be a Stock Market Genius](#):

"Believe it or not, far from being a one-time insight, tremendous leverage is an attribute found in many spinoff situations. Remember, one of the primary reasons a corporation may choose to spin off a particular business is its desire to receive value for a business it deems undesirable and troublesome to sell. What better way to extract value from a spin-off than to palm off some of the parent company's debt onto the spin-off's balance sheet? Every dollar of debt transferred to the new spinoff company adds a dollar of value to the parent. The result of this process is the creation of a large number of inordinately leverage spinoffs. Though the market may value the equity in one of these spinoffs at \$1 per every \$5, \$6 or even \$10 of corporate debt in the newly created spin-off, \$1 is also the amount of your maximum loss. Individual investors are not responsible for the debts of a corporation. Say what you will about the risks of investing in such companies, the rewards of sound reasoning and good research are vastly multiplied when applied in these leveraged circumstances. Tremendous leverage would magnify our returns if spinoff turned out, for some reason, to be more attractive than its initial appearances indicated."

Seth Klarman in [Margin of Safety](#):

"The behavior of institutional investors, dictated by constraints on their behavior, can sometimes cause stock prices to depart from underlying value. Institutional selling of a low-priced small-

capitalization spinoff is one such example. Many parent-company shareholders receiving shares in a spinoff choose to sell quickly, often for the same reasons that the parent company divested itself of the subsidiary in the first place. Shareholders receiving the spin-off shares will find still other reasons to sell: they may know little or nothing about the business that was spun off and find it easier to sell than to learn; large institutional investors may deem the newly created entity too small to bother with; and index funds will sell regardless of price if the spinoff is not a member of their assigned index. There is typically a two to three month lag period during which the spin-off company's financials have not been entered into financial databases and there will be very few analysts covering it. Thus, the stock could be the cheapest stock in the world during this time."

I look forward to participating at Best Ideas 2018 alongside a group of like-minded individuals and actively engage in collaborative learning through the sharing of ideas, insights and personal experiences.