The Risks and Rewards of Spin-Offs, Equity Carve-Outs and Tracking Stocks

In the drive to maximize shareholder value, corporate managers must constantly ask: “Are my assets optimally configured to create value?” One of the most challenging times to address this question occurs when one part of the company has significantly higher growth opportunities than the rest of the company. At this point, management should consider whether to change the ownership structure of the higher-potential entity to unlock its full value. As valuations of new economy companies skyrocket and the numbers of in-house Internet and technology divisions increase, this issue has become a consideration for more companies than ever before.

With the recent increase of spin-offs, equity carve-outs and tracking stock issues (collectively termed “equity separations”) and the market and media attention these strategies receive, boards are requiring management to carefully evaluate these opportunities. As such, we felt it timely to consider if, when, and how to implement a separation. This newsletter will:

• Profile the recent explosion of spin-offs, equity carve-outs and tracking stocks
• Outline the key areas of costs and benefits when evaluating a separation
• Review traditional methods of separation as well as some innovative variations
• Provide guidelines for selecting the best vehicle

The Separation Explosion

The recent explosion of equity separation is focused in large part on the high-technology sector, especially units related to the Internet. In 1999 alone, the U.S. technology sector completed 20 equity carve-outs and 12 tracking stock issuances. This activity equals the number of equity carve-outs completed in the previous five years combined.

Equity separation can create substantial value for the shareholders of the new entity as well as the parent company. Analysis by J.P. Morgan shows that the average spin-off and equity carve-out increased the parent’s shareholder value by 6% and 2.5%, respectively, the day after the transaction and outperformed the market by 20% and 10%, respectively, 18 months after the transaction.

A classic example of equity separation is the equity carve-out of Infinity Broadcasting (INF) from CBS. CBS sold 17% of Infinity, a network of 160 radio stations in an initial public offering in December 1998. As the figures below show, CBS market capitalization went from $20.9 billion to $28.9 billion in just a few months. Additionally, the Infinity shares offered to the public were worth an additional $3.6 billion for a total value of $32.5 billion, a 56% increase. Over the same period, a group of CBS’ peers was up 18.5%, the NASDAQ was up 15.4% and the S&P 500 was up 7.2%.

The Risks and Rewards of Spin-Offs, Equity Carve-Outs and Tracking Stocks was written by Bill Frack and Dan Schechter, Vice Presidents in L.E.K.’s Los Angeles office. Please contact L.E.K. at strategy@lek.com for additional information.
What created these superior shareholder returns? Before the equity carve-out, the market focused on the then-troubled television network, ignoring CBS’ valuable radio assets. The separation turned attention to the high-profit radio holdings, created management incentives for the new entity, reduced the inefficient cross-subsidies that drained value from radio to television, and created a new high-value stock for use as acquisition currency in the consolidating radio industry.

Analyzing the Benefits

Traditionally, many of the benefits derived from separating a business unit from its parent have been achieved through management action rather than asset restructuring. If a division required a different management culture than the parent to succeed, it could be physically relocated and communication minimized with the parent. Witness the number of automobile design studios located in California, away from corporate headquarters. If there was a desire to tie compensation more closely to the performance of a high-growth division rather than the parent, phantom stock or a long-term valuation-based incentive system would be created.

So why are shareholders now apparently better served by separate equity structures? In short, new economic developments have created more tangible, substantial benefits to separation than in the past. L.E.K. has identified six primary sources of value creation:

1. Improved Access to Equity Markets: Businesses often require significant equity capital to fund early stages of development. Historically, these investments came from the corporate treasury, where young projects competed for special funding. Equity separations enable management to access the vast capital market necessary to compete in the new business sectors. This trend is pronounced in the areas of technology where a disproportionate amount of analyst and investor attention is focused.

The CBS-Infinity Equity Carve-Out Created Significant Shareholder Value

...and Outperformed Its Peers
2. Creation of a Currency for Acquisitions: Since acquisitions can be a critical component of a high-technology unit’s capability development, a separate equity structure can provide stock whose high value makes it attractive to use as acquisition currency. Current valuation levels of technology companies require serious acquisition players in these sectors to possess currency to make stock transactions.

The media industry example below demonstrates how new online firms are valued relative to established companies on a total market capitalization-to-sales basis. By creating and owning a currency that trades on the same dynamics as the target stocks, companies can reduce the risk of heavily diluting existing shares of the parent company.

3. Stock Option Incentive Plans for Management Motivation and Retention: Creating a separate equity for a new entity enables the creation of stock option programs that can be critical to motivating and retaining management talent. While option-like incentives can be replicated with phantom stock and other mechanisms, they do not provide the tangibility or liquidity of a market–based measure of value compared to traded stock.

In addition, the benefits of options are difficult to replicate in phantom stock plans because of embedded reward ceilings. This ceiling issue could be addressed by using comparable e-business multiples to establish the phantom stock value. However, companies have been reluctant to do so, in large part because of the difficulty of analytically supporting current e-valuations. Finally, phantom plans are not as easily understood and their link between pay and performance is perceived to be less reliable.¹

4. Reduced Costs from Incompatible Management Cultures: High-growth, embryonic divisions often have more than a little problem blending into more traditional corporate cultures. Frequently, extraordinary amounts of management time and resources are spent reconciling differences and providing both cultures with appropriate support. Separation can help companies circumvent potential conflicts and deploy management resources more effectively. The dress, work style, 24/7 hours, and rapid decision making found in many new businesses are often best separated structurally to encourage the unique entrepreneurial spirit that drives success.

Many people believe that toysrus.com is a business unit example that has failed to maximize its potential by remaining part of the corporate organization too long. While Toys “R” Us has been selling online since 1998, its web initiative has been fraught with problems: frequent outages, poor selection, minimal marketing, and an inadequate order-fulfillment system that caused it to remain a weak competitor to eToys and Brainplay during the 1999 holiday season. Insiders have indicated that one of the primary factors that contributed to these problems was the online group’s structure as an operating division of the parent versus as a stand-alone entity.

5. Accelerated Time to Market: New companies operating outside the parent company’s structure may be able to accelerate the time needed for innovation cycles. This ability is critical in the fast-moving e-business environment. In some market segments, first-mover advantage and/or being one of the lead players is extremely important as companies compete to make their platform the standard. Before barnesandnoble.com separated from Barnes & Noble, studies indicated that Amazon.com released three times the number of business process improvements compared to Barnes & Noble over that same period.

6. Enhanced Market Coverage and Market Value Recognition: If a company’s business unit is not being appropriately valued due to a lack of market scrutiny or understanding, equity separation forces current analysts to assess its value and may attract new ones. Equity restructuring can also encourage increased investment in the parent company, as recent valuations have shown that shareholder value rises when a sound and well-executed equity separation strategy is completed. Of course, increased visibility can be a double-edged sword. While it reveals the strength of a new business, it can simultaneously expose a weakness in the core business. If enhanced visibility is the primary reason management is considering an equity separation, a targeted investor communication program should be considered before implementing more drastic equity separation options.2

Costs of Separation

While there are many potential benefits to equity separation, there are significant costs that must be carefully assessed. Equity separations create new administrative burdens such as financial reporting, market communication, and corporate governance, which are required by every new company. Costs are also increased by the separation of shared departments such as human resources, information systems, and accounting. Separations can also divert management’s focus away from strategic and operational issues at a key juncture in a company’s development. In some situations, equity separations are executed at a discount to fair market value, effectively increasing the cost of financing. In addition, the shares of the parent company may fall when the fast-growing assets are removed from the corporate balance sheet. Other significant expenses include the legal, consulting, and investment banking fees related to implementing the separation.

Not all equity separations create shareholder value. Less publicized failures include TCI Satellite Entertainment from TCI, Aztec Technology Partners from U.S. Office Products, Midway Games from WMS Industries, and Imation from 3M. In many cases, unsuccessful separations are the result of management focusing on short-term financial engineering goals rather than long-term value creation. Leveraging the proceeds from an equity separation to pay down a parent company’s debt is consistently viewed unfavorably by the market. Separating a business unit that lacks a strong competitive advantage or strategy is another source of concern to market makers and other lead-steer investors.

Comparing Separation Methods

Once management has determined that the likely benefits of separation substantially outweigh the costs, the most appropriate separation vehicle must be selected. There are three primary ways to separate the value of a business unit from its parent: spin-off, equity carve-out and tracking stock. These vehicles vary on many dimensions, including the degree of separation, transfer of assets, capital structure, taxability of the transaction, and resulting control of the entity. Each approach has unique benefits, drawbacks, and value creation potential depending on the specific situation.

In a spin-off, the parent distributes all shares of a wholly owned subsidiary to its existing shareholders and a new entity is created with a separate governing board.

2. See Volume II, Issue 1, Market Signals Analysis.
Assets are transferred to a new balance sheet, and the separation from the parent is complete and irreversible. Generally, spin-offs are structured to be tax free, with no gain or loss realized by the parent or its shareholders. This is the purest form of separation and frees the operation to compete as an independent company. The equity carve-out is a subsidiary initial public offering and can be structured as either a primary or secondary offering of a subsidiary’s common stock. Similar to a spin-off, assets are transferred to a separate balance sheet, a separate board is established, and the parent company relinquishes control of the subsidiary to the extent that stock is offered. Typically, companies carve out less than 20% of the subsidiary in order to retain control, to preserve tax and accounting consolidation, and to enable a tax-free spin-off at a later date. Establishing a tracking stock involves issuing a second class of common stock whose value reflects the earnings of a particular division. These shares can be distributed as a dividend to shareholders in the parent company, or they can take the form of an IPO. Unlike spin-offs and equity carve-outs, the separation is only notional; the parent company’s board retains control over the division’s cash flows and assets are not transferred. While this structure allows an investor to participate or “track” the performance, the limitations around further restructuring are considerable and the inherent conflict of interest for the board has often resulted in litigation.

### Equity Separation Comparisons

<table>
<thead>
<tr>
<th>Description</th>
<th>Spin-Off</th>
<th>Equity Carve-Out</th>
<th>Tracking Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Degree of Separation</td>
<td>Parents distributes shares of subsidiary to existing shareholders</td>
<td>IPO of subsidiary</td>
<td>Parent issues shares representing ownership of the earnings of</td>
</tr>
<tr>
<td>Reversible</td>
<td>No</td>
<td>Generally partial</td>
<td>Notional</td>
</tr>
<tr>
<td>Cash Proceeds</td>
<td>Yes (upstream dividend)</td>
<td>Yes</td>
<td>Yes (with offering)</td>
</tr>
<tr>
<td>Taxability</td>
<td>Generally tax-free</td>
<td>Potential capital gains</td>
<td>Tax free</td>
</tr>
<tr>
<td>Mechanics of Borrowing Costs</td>
<td>Pro rata distribution</td>
<td>IBO Could increase borrowing costs of spin-off</td>
<td>Pro rata stock dividend</td>
</tr>
<tr>
<td></td>
<td>Could increase borrowing costs of spin-off (depends on capital structure)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consolidation</td>
<td>No Consolidation</td>
<td>Full tax consolidation if sell less than 20%</td>
<td>Tax consolidation</td>
</tr>
<tr>
<td>Asset Transfer to New Company</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parent Control of New Company Cash Flows</td>
<td>No</td>
<td>No (generally)</td>
<td>Some</td>
</tr>
<tr>
<td>Board of Directors</td>
<td>Separate</td>
<td>Separate</td>
<td>Status Quo</td>
</tr>
</tbody>
</table>

### Benefits and Drawbacks of Equity Separation Methods

<table>
<thead>
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<th>Spin-Off</th>
<th>Equity Carve-Out</th>
<th>Tracking Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefits</td>
<td>- Flexibility</td>
<td>- Greater flexibility</td>
<td>- No taxable gain</td>
</tr>
<tr>
<td></td>
<td>- Facilities culture change</td>
<td>- Culture changes more likely</td>
<td>- Separate out volatile earnings stream</td>
</tr>
<tr>
<td></td>
<td>- Stock useful for incentives/acquisitions</td>
<td>- Stock useful for incentive/some acquisitions</td>
<td>- No separate board</td>
</tr>
<tr>
<td></td>
<td>- Volatile earnings stream separated out</td>
<td>- Volatile earnings stream separated out</td>
<td>- Stock somewhat useful for incentive/ pricing for acquisition likely to be substantially discounted</td>
</tr>
<tr>
<td></td>
<td>- Complete freedom</td>
<td>- Consolidation if &lt;20% is carved out</td>
<td></td>
</tr>
<tr>
<td>Drawbacks</td>
<td>- Greater administrative cost</td>
<td>- Minority interest</td>
<td>- Limited flexibility</td>
</tr>
<tr>
<td></td>
<td>- Separate board review</td>
<td>- Possible taxable gain</td>
<td>- Culture differences may continue</td>
</tr>
<tr>
<td></td>
<td>- Cannot unwind</td>
<td>- Difficult to unwind</td>
<td>- Two classes of shareholders/potential lawsuits</td>
</tr>
<tr>
<td></td>
<td>- Can be bought like any other company</td>
<td>- Capital flow of constraints</td>
<td>- Duplication of administrative costs</td>
</tr>
<tr>
<td>Best Use</td>
<td>- Business units strong enough to stand on their own</td>
<td>- Potential tax issues</td>
<td>- Capital flow constraints</td>
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<td></td>
<td>- No shared assets</td>
<td></td>
<td>- Potential analyst of investor confusion</td>
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<td></td>
<td>- Substantial business potential with parent's competitors</td>
<td></td>
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<td></td>
<td>- Heavy capital requirements that the parent unwilling/unable to fund</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>- If the parent of the subsidiary has net operating losses that can be used to offset profits from the other and hence reduce taxes</td>
<td></td>
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<tr>
<td></td>
<td>- Strategic/marketplace benefit but not ready to spin off (time to separate assets, management experience etc)</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>- The parents and subsidiary share substantial assets, and thus the company does not have to divide assets</td>
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Evaluating the Approaches

Determining the best separation method requires careful evaluation of the financial and strategic consequences. While there are no hard and fast rules, spin-offs are generally most appropriate when the parent is seeking to de-conglomerate, the business unit is strong enough to stand on its own, and there are minimal shared assets. An equity carve-out is more appropriate if the entity has high growth potential and its management and operations require additional maturation and capital before being released as a spin-off. Tracking stocks are most appropriate when asset sharing is substantial and difficult to separate even over time.

Spin-offs complete the separation immediately, while both equity carve-outs and tracking stocks should be viewed as intermediate solutions. A J.P. Morgan study found that equity carve-outs in which the parent announced that there would be a later spin-off attracted a more favorable market response than those in which the parent did not.3

This is because over time, the circumstances that initially validated the separation will change. Strategies that best suit the parent and the new entity are likely to be hindered by complex financial structures. Eventually, management should expect to spin off fully or reacquire when performing an equity carve-out.

Tracking stocks have exhibited variable performance in recent years. To illustrate, as of March 3, 2000, CarMax and DLJ Direct were down 92% and 38%, respectively, from their initial IPO offering prices, while Liberty Media had risen 100% and Sprint PCS was over 380%. It should be emphasized that the structure of tracking stocks is inherently exposed to litigation between classes of shareholders over the allocation of capital and earnings by shares. General Motors, the pioneer of tracking stocks, has faced shareholder litigation regarding both of its major tracking stocks, EDS and Hughes.

New Twists in the New Economy

L.E.K.’s client work in e-business has uncovered new twists to equity separation frameworks. Specifically, the rapid new economy evolution has led companies to combine equity separation with creative partnering strategies to achieve two benefits:

• Accessing additional capabilities critical to the ultimate success of the separated entity

• Simplifying and accelerating the separation process which can take up to 12 months to implement

The following table lays out three approaches that have been recently implemented:

**Combined Asset Spin-Off and Joint Venture**

The combined asset spin-off and joint venture with an online entity is a more recent business solution. In this transaction, the off-line company offers non-monetary investments such as brand recognition, customer databases, promotional services, marketing capability, entertainment content, investor credibility or existing operating assets in return for substantial equity in an online venture. Thus, through creative partnering, management is able to leverage its core non-monetary assets and create a competitive business entity with equity separation potential.

3. CFO, March 1999, “Take Part of Me”
**Combined-Asset Spin-Off and Joint Venture**

**Established Corporation**
- Nascent division
- Promotion, advertising
- Brand equity
- Content
- Marketing organization
- Market credibility

**Private Online Company**
- Promising concepts
- Strategic focus
- Small but loyal customer base
- Online technical and marketing expertise

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**Benefits**
- Realize large returns after IPO
- Obtain cheap equity
- Capitalize on Internet market valuations
- Create effective control position in high-value company that can raise money and further strategic objectives of parent (online platforms)
- Requires only modest cash investment, if any, with cash-efficient option

**Issues**
- High uncertainty: Online
- Business may not be viable
- In the long run
- May or may not allow control
- Need a non-cash currency

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**CBS-SportsLine**: A success story using this creative vehicle is the creation of CBS-SportsLine, where CBS invested mostly non-cash currency in a leading sports website. CBS was attracting large amounts of Internet traffic to events like the NCAA March Madness basketball tournament. Its inferior web site, however, was resulting in disappointed viewers. SportsLine was an Internet startup with excellent sports statistics and infrastructure but with limited promotion capabilities. At that time, both companies were at a major disadvantage compared to ESPN’s SportZone. The graphic below summarizes the initial deal.

Through this transaction, CBS created a stand-alone entity, with talented e-management, in which it had a major interest. It avoided heavy additional internal investment and management distraction. Through subsequent, similarly structured transactions, CBS has increased its stake in CBS-SportsLine to 18% – worth $160 million as of February 2000.

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**Look Before You Leap**

The new economy has more value creation reasons to consider separation, but the costs and risks are just as real. Before falling into the “me too” trap, there are several purported benefits from separation by adjusting the organization and compensation structure, rather than radically restructuring the organization. It’s the difference between arthroscopic “small hole” surgery and invasive “crack the ribs” heart-lung transplant surgery.

- Determine which separation method – spin-off, equity carve-out or tracking stock – is most appropriate for the targeted entity. This decision requires careful assessment of the difficulty of asset separation, the maturity of the new entity, the capabilities of the management team to run a public entity, the competitive implications, and the funding requirements.

- Have a clear vision of the ultimate disposition of any partially separated entity – normally a set of criteria for a full spin-off or reintegration.

Because the necessary financial analysis requires a careful and unbiased assessment of the costs and benefits, many of our clients have depended on L.E.K. to serve as an honest broker between the champions and the skeptics. This objective, third-party analysis has also served as a valuable tool in communicating decisions to internal stakeholders, potential external partners and the market at large.
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