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The peculiar market-beating returns of Spin-offs

Some investors try to pursue a higher risk-adjusted return in their portfolios than would be offered by low-cost broad market ETFs. Most try to achieve higher returns through trading and other methods which are scientifically proven to lead to lower expected returns. A small subset seems to pursue these higher risk-adjusted returns through scientific means. The latter looks at adjusting their portfolios for well documented and proven factors that have a positive effect on expected return like the well-known value and size factors (for those interested in those I would refer to the Fama and French factor models). But there are other, maybe not as traditional, aspects to certain subsets of stocks that seemed to provide consistent risk-adjusted outperformance. In this short article, a look is taken at spin-offs.

Introduction to spin-offs

A spin-off is when a company (parent) creates a new company (called child or the spun-off company) by selling or distributing new shares of its existing business, it’s a type of divesture.

This subset of companies (both parent and child) seem to have outperformed the market consistently historically, and the child’s performance was phenomenal over the last half-century.

~10% excess return

Yearly between 1965 and 2013 for child

~18-30% excess return

Yearly averages during first three years for child

(data from Purdue University study which was renewed in 2013 and an issue from the 1993 journal of financial economics)

It was found that those child companies outperformed the market in a significant way, consistently (note that the above states **excess** returns). As noted above the excess returns are exceptionally strong during the first three years after the separation.

Knowing this it might be interesting for research-driven investors to know why this happens so consistently and how to profit from this phenomenon.

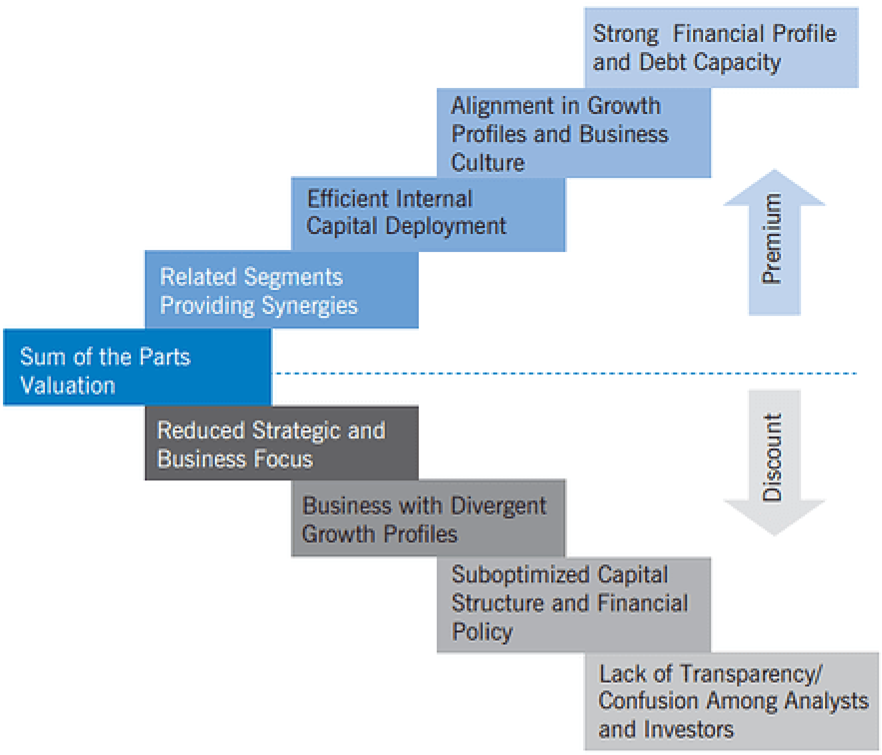
Explanation of outperformance

According to multiple papers and research articles, it seems that the Conglomerate discount is partially responsible for the outperformance.

Historically conglomerates trade at a ~10% discount to their pure-play peers (*Spin-offs: Tackling the Conglomerate Discount*). These conglomerates (except those in Latin America and Japan) trade at a discount because they tend to be more inefficient, less transparent and don't achieve all the benefits for shareholders that they could.

This largely is due to the difference in growth profiles of divisions that must compete for the limited capital within a conglomerate. Resulting in high growth divisions finding themselves at a comparative disadvantage to the larger and more established divisions within a conglomerate. In the figure below this is visualised.

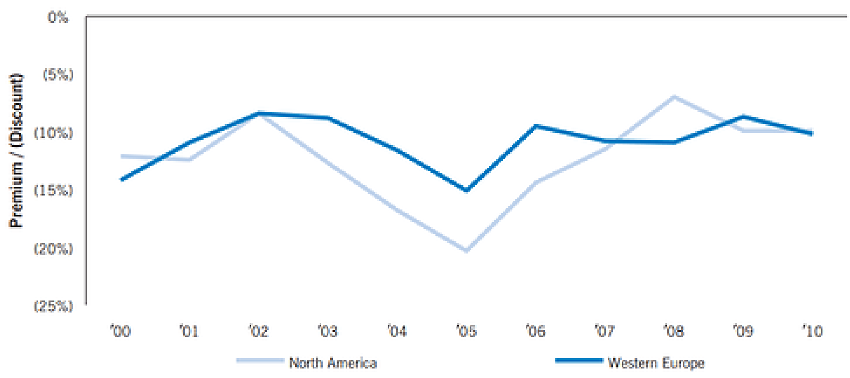
Figure 7 **Factors Differentiating Between a Premium and Discount Valuation in Conglomerates**



Source: Citi.

This existence of this discount has persisted and thus seems to support that conglomerates invest more inefficiently but have potential value to be unlocked. Although a ten year time period is very short for financial research it's plausible that this conglomerate discount has existed for longer. This discount being priced out would explain some of the outperformance during the initial three years after the spin-off.

Figure 4 Persistence in the Conglomerate Discount



Source: Worldscope, FactSet, and Citi.

Fun fact: Spin-offs lead to an improved valuation multiple for the parent as well
(I'm very funny at parties)

All the above gives strong indications that spin-offs tend to have large excess returns, however, there seem to be certain factors within spin-offs that have positive effects on expected returns.

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*He will **win** who knows **when to fight** and when **not** to fight.*
Sun Tzu

A special subset of spin-offs
Research conducted by Matthew Semandeni and Alber Cannella found that continued ownership by the parent firm has a negative effect on the child firm market performance. This is an interesting finding as management's importance is often underestimated by investors.

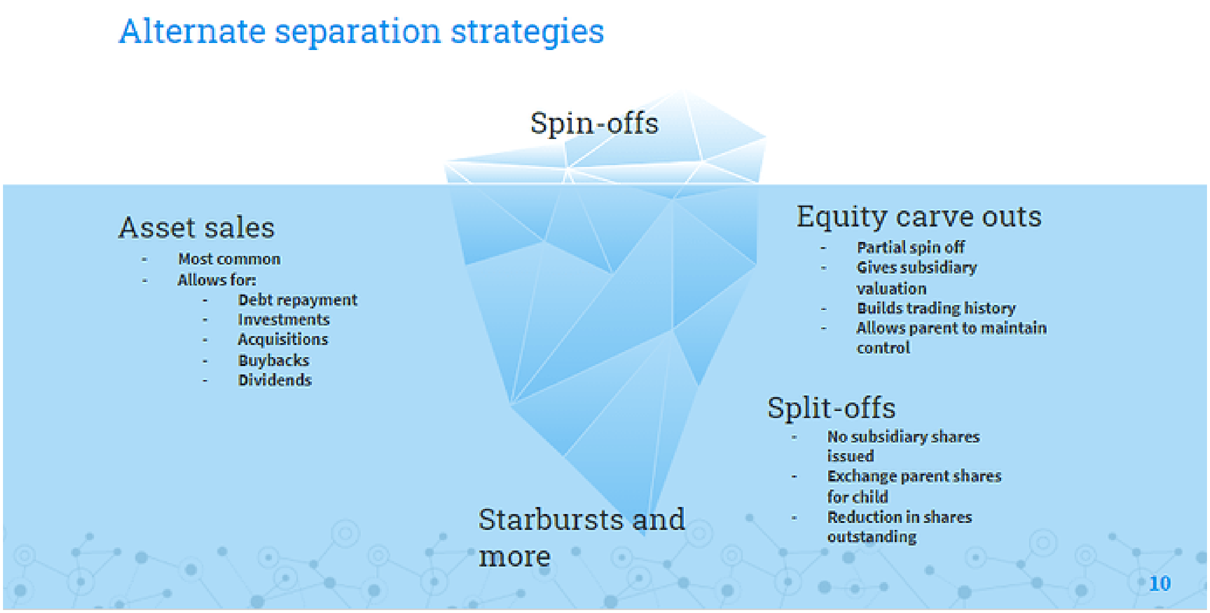
The parent retains ownership because it believes the child's stock will appreciate and therefore it has an interest in the child's success, leading to a positive relationship between parent ownership and performance. In reality, the parent often retains some ownership to exert continued control over the child, this continued control would negatively affect performance as proved by M. Semandeni and A. Cannella.

Another interesting finding is that having either a board member or a chairman of the board from the parent firm has essentially the same positive effect on the child firm's market performance. But having both a board member and chairman from the parent has a negative effect.

The above seems to indicate that control by the parent firm affects performance negatively, however that's not the entire story. It seems that a little bit of control from the parent spurs better performance but more has a negative result as the management environment *doesn't change much*.

Also having ties from the parent when previously being vertically integrated or horizontally related seems to have a positive effect on the child's performance.

Just so you know:
Horizontal: same industry and at the same stage of production
Vertical: same industry but different production stage



There are many routes that could be taken when separating businesses, as quickly highlighted in the slide (from presentation to Investment Committee) above, if you're interested in the other procedures of divestitures I would suggest you read Spin-offs: Tackling the Conglomerate Discount (Ajay Khorana, Anil Shivdasani, Carsten Stendevad, Sergey Sanzhar, Citi) or find more research going into more depth on your topic of interest!

Academic sources

Spin-offs: Tackling the Conglomerate Discount (Ajay Khorana, Anil Shivdasani, Carsten Stendevad, Sergey Sanzhar, Citi)

Examining the performance effects of post spin-off links to parent firms: should the apron strings be cut? (Matthew Semadeni Albert A. Cannella JR)

Spin-Off Performance: A Case of Overstated Expectations? (Carolyn Y. Woo, Gary E. Willard and Urs. S. Daellenbach)

Drivers of spin-off performance in industry clusters: Embodied knowledge or embedded firms? (Guido Buenstorf, Carla Costa)

Non-academic sources:

How Spinoffs Shares Outperform the Market Index