

95/08-Free at Last

Don't mistake a spin-off for a throwaway: Spin-off companies often outperform their parents.

By Peter Lynch

Imagine this scenario: you're a shareholder in Quaker Oats, because you think it is a good investment and you like the oatmeal. One day the mail brings free shares of Fisher-Price, a Quaker Oats subsidiary that's now being turned loose as a separate company. You call your broker to ask how Fisher-Price is doing. You find out it has been losing money for several quarters, so you think to yourself, Why keep this dog? You sell the shares as soon as they start trading, and you are happy to receive \$11 for each. After all, you got them for free.

A couple of years later, you're browsing through the stock pages, and you come across Fisher-Price. Those \$11 shares have become \$38 shares, and you wish you hadn't noticed it, because now you realize you missed a chance to more than triple your money on the giveaway, while Quaker Oats (which you still own) is up a modest 10 percent.

When a subsidiary or a division is booted out of the nest of a parent company, it's called a spin-off. Lately, we've seen a lot of these. After decades of trying to diversify or as I call it, diversify many companies are returning to their core operations. The buzzword for this is "rightsizing." If a division doesn't fit in with a company's main line of work, the company sells it or spins it off.

A spin-off happens in two stages. First, the parent company issues stock in the offspring and sells a small percentage of it in a public offering. The rest is distributed as a gift (often tax free) to shareholders of the parent. What makes these deals so intriguing is that spin-offs tend to do better than stocks in general, particularly in the first 24 to 36 months after they get their independence. On the next page is a table showing some of the most impressive performers of the 1980s and '90s.

Two Wall Street analysts are making a career out of spin-offs: Barbara Goodstein at Rothschild and Patrick Cusatis at Lehman Brothers. Cusatis says he got the idea from reading my first book, *One Up on Wall Street*, which contains a short section on the subject. I'm gratified that he paid such close attention. He traced 161 spin-offs going back as far as 1965 and made an intriguing discovery: 14 percent of these spin-offs became takeover targets and ended up as divisions in other companies, usually in the same industry.

Fisher-Price is a typical example. This liberated toy company was on its own for less than three years before Mattel snapped it up. It made no sense at Quaker Oats, but it was a fine complement to Mattel.

I look at a lot of numbers every week, but the 14 percent takeover rate made an impression. With companies in general, the odds of a takeover are only 3 to 4 percent, so the shareholders in a spin-off are three to four times more likely to benefit from one of these potentially lucrative episodes. In a takeover, the stock price is a cinch to go up.

It's no accident that spin-offs have done well. The managers no longer take orders from above and cut costs in obvious ways that the old regime overlooked (this is called grabbing the low-hanging fruit). They become more entrepreneurial. The parent company may have a financial stake in the success of the spin-off. Certainly, it has an emotional stake. The last thing a parent company wants is for one of its own projects to flop. So it tries to do everything possible to help the fledgling enterprise, from cleaning up

the balance sheet to installing good management. A company that has to jettison divisions in a fire sale to raise cash may not care about the consequences, but a powerhouse like Coca-Cola certainly does.

Coca-Cola spun off Columbia Pictures in late 1987 (keeping a 49 percent interest), and when Columbia proved to be a disappointment, Coke did what it could to turn things around. Then it found a buyer at a fancy price. In 1989, Sony acquired Columbia for \$27 a share, more than three times higher than where shares first traded.

The most complicated separation was the Baby Bells. If you owned a share in AT&T; in 1983, you got fractions of shares in seven spin-offs at once. A lot of people thought this was a nuisance, but those who held on to their fractions were well-rewarded. The Baby Bells did the easy cost-cutting and had a great six years while AT&T; languished.

In many of these spin-off situations, you've got two forces pulling at the stock price from opposite directions. On one side are the mutual funds that own shares in the parent but can't get involved with the offspring. For instance, the S&P; Index funds must sell whatever shares they get from a spin-off if the new company isn't in the S&P; 500. While the funds are dumping their holdings, so are individuals who don't want to be bothered with upstarts they know nothing about.

On the other side are buyers who understand the virtues of spin-offs and scoop up the shares at what they perceive to be bargain prices. This often results in a standoff that may last for several months, until the new company has a chance to prove itself and impress the Wall Street kibitzers. Take Gardner Denver Machinery, a manufacturer of air compressors and blowers, which emerged from Cooper Industries in April 1994. The stock was stuck in a trading rut for nearly a year until it surprised the Street with better than expected earnings. Only recently did Gardner Denver jump the rut.

Tandy is one of the champions of spinning things off, sending so many divisions out into the world that its genealogy begins to sound like the families of Levites from the Old Testament. In 1975, Tandy began Tandy Crafts and Tandy Brands, and the shareholders got free shares in both. Then, in 1976, Tandy Crafts began Stafford-Lowdon. Three years later, it began Colortile, and in 1986 it began InterTAN, one of the few losers in this crowd. Tandy Brands, meanwhile, changed its name to Bombay Company, which in 1991 began Tandy Brands Accessories. If you had invested \$5,000 in Tandy in 1975 and held on to the whole lot, you would have \$86,000 by now.

The latest trend from the boardroom is for companies with two or three giant divisions to divide themselves into equal parts. Usually, they take this action because they think investors have failed to appreciate the true value of the sum of the parts. In other words, the stock price is too low. Thus, Sears spun off Allstate, 80 percent of which will go to Sears shareholders as a tax-free gift sometime this summer.