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Breaking Up Is Hard to Do — and to Manage

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Breakthrough Thoughts

Breaking Up Is Hard to Do — and to Manage

Three rules for ensuring that spin-offs create — and don't destroy — value.

by Chuck Lucier, Jan Dyer, and Gerald Adolph

Illustration by Lars Leetaru

Even a casual observer of the business press would have noticed over the past several months that amicable divorces have become quite the rage within large companies. Financial-services giant Citigroup Inc. is well down the path toward spinning off 20 percent of the $9 billion Travelers Property Casualty Corporation unit to shareholders by the end of this year, four years after it acquired the insurance company. Paper peddler Georgia-Pacific Corporation is also holding out a cup to investors — in this case, its $12 billion Dixie Cup unit, which it plans to spin off. Tyco International is an almost daily spin story: Earlier this year, the embattled multifaceted conglomerate announced, then withdrew, ambitious plans to divide itself into four public companies; and in April, it launched plans to spin off or sell its finance unit, CIT Group Inc., which it had acquired in 2001.

Outside the land of the giants, scores of other publicly traded companies are breaking off pieces and offering them to shareholders. Allergan Inc. is spinning off its optical medical device business, to be called Advanced Medical Optics Inc. The Goodrich Corporation is doing likewise with EnPro Industries Inc.

Others have recently taken chunks public, as the Rockwell International Corporation (since renamed Rockwell Automation Inc.) did when it completed the spin-off of its communications and avionics unit, Rockwell Collins Inc., in mid-June 2001. So common are the carve-outs and bust-ups, in fact, that specialized firms have arisen to counsel investors on the ins and outs of the spin game.

Sobering Reality

The allure of the spin-off is quite simple. Splitting a major company into two or more "pure plays" promises to unlock value for shareholders. The problem is that value can be elusive. Indeed, more often than not, it's illusory.

A Booz Allen Hamilton study of all 232 spin-offs by S&P 500 corporations during the 1990s found that "spins" are a lottery. Like a casual gambler in Las Vegas, the unwary investor is likely to lose. And if investors lose in a constrained economic environment, so may the other stakeholders — employees, managers, and the parent company, which frequently holds on to a significant cache of the spin-off's shares.

We are not criticizing spin-offs generally; the strategy, in and of itself, is neutral. To be sure, in some cases, a spin can unlock tremendous value. Within a year of the spin-off of the Cabot Microelectronics Corporation, the combined market value of the infant and its parent, chemical company the Cabot Corporation, was double that of Cabot alone, equaling $4 billion. Although both companies' shares fell afterward, in late May 2002 the companies were still worth $2.85 billion, a 45 percent premium over the unspun enterprise.

But for every successful spin, there are two that fail to live up to their potential. It's vital that boards of directors, executives, and especially senior managers of the spin-offs themselves understand the special pressures under which spin-offs labor, so that they can develop and execute growth strategies that will fulfill the promise.

If you were an investor during the 1990s, you could have done well buying into spins — but only if your pockets were deep. A shareholder who invested in every one of the last decade's 232 spins before the divestiture and held the shares for two years would have beaten the returns of the S&P 500 by 3.8 percentage points. But that figure masks a more sobering reality: While one-third of the spins generated attractive returns, two-thirds underperformed the stock market. In its first two years, the median-performing spin-off generated annual returns for shareholders that were 7.7 percentage points worse than the S&P 500. Even the mildly attractive average returns for diversified investors have a catch: They were the result of the few instances in which the extraordinary post-spin-off earnings growth of either parent or subsidiary created enormous value for shareholders.

What distinguishes the one successful spin out of three? The best place to look for success criteria is among spin-offs that yielded excellent returns for shareholders. These include the 1993 split of Marriott into the Host Marriott Corporation and Marriott International Inc.; the American Express Corporation's spin-off of Lehman Brothers Holdings Inc., which took place in 1994; Corning Inc.'s spin-off of Quest Diagnostics Inc. in 1996; and the Lennar Corporation's break-out of the LNR Property Corporation in 1997.

Three Steps to Success

In analyzing these and the few dozen other success stories, we saw clearly that a successful spin requires three steps:

1. Ensure that both parent and spin have viable business and financial structures. A company's decision to spin off a division is often triggered by the parent's poor performance. On average, companies taking the spin option underperformed the S&P 500 by 5 percentage points in the two years before the announcement. Their lagging financial performance frequently persuaded parent companies to improve their own balance sheets by burdening their offspring: Spun companies are more likely to fall into bankruptcy than the parent because the parent saddles them with excessive debt, onerous contracts, or impaired assets.

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2. Meet or exceed earnings expectations. That's crucial for all companies, of course, but even more so for a spin-off, and especially during the first two years, when Wall Street is forming its view of the quality and reliability of the newly independent company's management team. Our analysis suggests that during this critical period, an earnings shortfall has a somewhat greater effect on the stock price of a spin than on the average publicly traded company's stock.

3. Continue growth beyond childhood. The third step in a successful spin is also the stage at which most fall short. Why is growth even more of a challenge for spins than for other publicly traded companies? Mind-set. What management teams often hear from investment advisors — which admittedly may not be exactly what is said — is, "Wall Street likes pure plays. Deliver steady earnings, and value investors will be happy even if your earnings don't increase faster than the GNP." But companies whose "reliable" earnings grow along with the GNP give below-average returns to their shareholders — as most spins have done. That's not an attractive prospect for value (or any other) investors.

These three steps toward a successful spin might seem a tad obvious. The trick for managers and investors alike is to use them in a preliminary analysis of a spin-off's viability. Consider, for example, the plan by the pharmaceuticals giant Merck & Company Inc. to spin off its Merck-Medco Managed Care LLC subsidiary, a pharmacy benefits management business. Merck, the second-largest U.S. drugmaker, is offering a portion of Merck-Medco's shares to investors this year, preparatory to a sale of the rest within 12 months. The spin comes nine years after Merck's $6.6 billion purchase of Medco Containment Services Inc.

At first glance, Merck's spin-off of Merck-Medco appears to follow the common pattern. The pharmaceutical behemoth is coming off a difficult year. Because of patent expirations of several blockbuster drugs (Vasotec and Prinivil for hypertension, Pepcid for ulcers, and Mevacor for high cholesterol) and increases in competitive intensity for some of Merck's most profitable drugs (e.g., Zocor against AstraZeneca's expected release of Crestor), Merck announced lower-than-expected earnings in 2001, and indicated that earnings would be flat in 2002. As a result, the company's total returns to shareholders in 2001 (including both the change in stock price and dividends) was about 25 percentage points below the S&P 500's.

However, Merck has a superb finance staff and a strong balance sheet. That's one indication the Merck-Medco spin-off is predicated on strength, not weakness. And industry conditions augur well for Merck-Medco, which seems to be well positioned for reliable earnings growth in the infancy of its forthcoming independence, when it will be renamed MedcoHealth Solutions Inc. From their origin as processors of claims in the 1970s, pharmacy benefits managers (PBMs) like Merck-Medco are now at the hub of $15 billion of rebates from pharmaceutical manufacturers and retailers. PBMs can influence the brand of drug that a consumer receives, through participation in benefit design and the structures of both drug formularies (the list of drugs eligible for reimbursement) and co-payments by consumers. A PBM's ability to influence drug choice is even greater within the approximately 14 percent of prescriptions filled by mail — where Merck-Medco is especially strong — since mail order gives the PBM sufficient time to call physicians and inform them that an alternative medication is preferred by the plan or available at lower cost for the patient.

Of course, the evolving role of PBMs in the health-care value chain is inviting competition, with other players beginning to match PBMs' efficiencies, creating margin pressures for companies like Merck-Medco. Large health plans, for example, are increasingly insourcing high-margin activities, such as the design of formularies and reimbursement tiers. Pharmaceutical companies, learning that rebates make far more sense on some products than they do on others, are increasingly linking the rebates they pay to demonstrated changes in the market share of their drugs.

There remains an upside for PBMs, though. They are contracting directly with employers for

Growth is a greater challenge for spins than for other publicly traded companies. Why? Mind-set.

pharmacy benefits, as Merck-Medco did recently with United Airlines Inc. They are entering the market for distribution of specialty products, which is expected to be one of the fastest-growing segments in the health industry. Most important, it's quite possible that Medicare drug benefits will be administered through PBMs. The P/E ratios of Merck-Medco's three principal competitors — 42 for AdvancePCS, 33 for Express Scripts, and 45 for Caremark, all on trailing earnings — imply that investors are bullish about the growth prospects of PBMs. During the last five years, Merck-Medco has grown revenues at a steady 23 percent per year and (segment) profit at 26 percent. It certainly seems capable of meeting or exceeding earnings expectations after its spin is done.

But turning that capacity into a reality will require Merck-Medco's management to think differently than it has in the past, no matter how well run the company has been. Here's the reason: As part of a large company, management is always sheltered from the stock market as well as constrained by the parent in effecting a growth strategy. After the spin, both the shelter and the constraints are gone. Accelerating growth in this newly unshackled environment involves a different mind-set.

Positioned well in terms of the three steps of a successful spin, Merck and Merck-Medco seem to be traveling down the path toward superior returns. For others in the spin game, though, understanding this casino's special characteristics will help minimize the risk — and create strong companies that contribute to the economy as well as to stakeholders' well-being. Our guidance is aimed at three constituencies:

- **For investors**, know that spins during the 1990s were a high-return/high-risk investment, and there's no reason to believe that will change in this decade. Investors can minimize the risk by diversifying, investing in all spins. However, it's best to avoid spins in which either the parent or the subsidiary holds an excessive debt burden. The best time to invest is just before the spin-off. Listen for growth stories from both the parent and the subsidiary. Make sure the stories sound like nonfiction.

- **For corporate management prior to the spin**, you must realize that executing a spin is a lottery, and most parents and subsidiaries hold losing tickets. Investors can diversify their risk and thus benefit from the positive average returns; however, the inside stakeholders can't diversify, and they face two-to-one odds against success. The spin has positive results only when the parent or subsidiary is able to significantly accelerate growth in earnings. Executives must ask whether they can stimulate such growth without doing the spin.

- **For management following the spin**, the odds are against you. The experience of the 1990s was that only one-third of companies outperformed the market and the risk of bankruptcy tripled. There is no choice: You've got to grow faster. The time to start is Day One.

Divorce can be difficult. But let's remember: With vision and strength, it's possible to flourish. +

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