Breaking up IS GOOD TO DO

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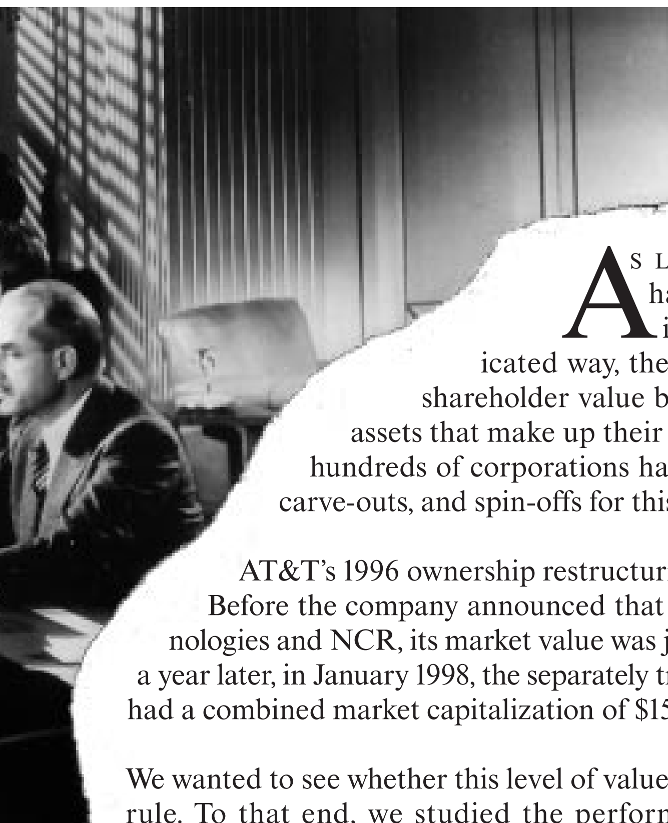
Restructuring through spin-offs, equity carve-outs, and tracking stocks can create shareholder value



As large corporations learn to handle the flow of capital and information in a more sophisticated way, they are finding it easier to boost shareholder value by restructuring the capital and assets that make up their businesses. In the past decade, hundreds of corporations have used tracking stocks, equity carve-outs, and spin-offs for this purpose.

AT&T's 1996 ownership restructuring provides a striking example. Before the company announced that it would spin off Lucent Technologies and NCR, its market value was just $75 billion. Little more than a year later, in January 1998, the separately trading AT&T, Lucent, and NCR had a combined market capitalization of $159 billion.

We wanted to see whether this level of value creation is the exception or the rule. To that end, we studied the performance of the large ownership restructurings – those in which the parent company had revenues upward of $200 million at the time of disaggregation – that have taken place in the United States during the past decade. We found that such restructurings can indeed increase shareholder value if properly carried out.

Our research looked at three ways of restructuring:

- **Tracking stocks**, also known as letter or targeted stocks, are a class of parent company stock that tracks the earnings of a division or subsidiary. Typically distributed as a dividend to shareholders in the parent company, these shares can also take the form of an initial public offering (IPO).

This article was the result of a joint effort between McKinsey's corporate finance and strategy practice and its strategic metrics initiative (SMI). SMI focuses on understanding the linkage between corporate strategy choice and local market reaction.

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- **Equity carve-outs** are an IPO of a stake in a subsidiary. The parent usually keeps majority ownership.

- **Spin-offs** occur when the entire ownership of a subsidiary is divested as a dividend to shareholders.

In the case of tracking stocks, control remains in the hands of the parent company's board; in carve-outs and spin-offs, by contrast, management reports to new and separate boards. Similarly, the assets of companies with tracking stocks are not physically separated from those of their corporate parents, though they do have to report earnings separately. In carve-outs and spin-offs, conversely, the subsidiary's assets are transferred to the new company's balance sheet.

Carve-outs have assumed a prominent place in US equity activity. In the past ten years, the US stock market has seen an average of almost 50 carve-outs a year, or about 10 percent of all IPOs.* One recent example of a substantial carve-out is DuPont's IPO of Conoco, in October 1998. DuPont raised $4.2 billion for a 30 percent stake in its subsidiary.

The level of spin-off activity has also been high recently: more than 300 spin-offs took place in the United States between January 1988 and September 1998. A notable example of a spin-off was the 1995 breakup of ITT into three businesses – diversified industrial, insurance, and hotels and gaming.

By contrast, tracking stocks are few and far between. Since General Motors issued the first of them with its acquisition of EDS in 1984, a total of 23 have been listed in the United States. Several more have been announced and subsequently canceled, and a few others are pending.

Creating value for shareholders

Companies that elect to restructure usually have one goal in mind: creating value for shareholders. Empirical evidence in the form both of price-to-earnings (P/E) multiples and total return to shareholders (TRS) – the combined capital appreciation and dividend yield of an equity – demonstrates that, on average, each form of restructuring creates value.

Gains in stock prices flow from four changes. First, there is an increase in coverage by analysts. This seems to support investment bankers' claims that floating equity in business units not previously exposed to the market makes their operating performance more transparent and raises shareholder returns by revealing hidden value. This transparency, however, comes not from a

* Unless otherwise indicated, data in this section are from the US Securities and Exchange Commission.

RELATED RESEARCH

The many corporate ownership restructurings carried out through equity carve-outs, spin-offs, and tracking stocks may be closely related to the broader forces of disaggregation studied in a separate McKinsey & Company research effort: "Creating and leading corporations of the future." Begun in 1996, it aims to understand the design and conduct of the corporations that will succeed over the coming decade. The project combines empirical studies, and casework in particular, with research into the theory of organizational economics, which has provided a number of important concepts.

Among the conclusions the study reached is the prominent role disaggregation can play in helping the world's biggest companies to deal with such challenges as deregulation, globalization, technological change, and increasing pressure from financial markets. Disaggregation – the devolution of decision-making authority within and beyond the organization – makes its controlled economy more like a market.

Many chief executives recognize the impact that market pressures can have on the performance of managers. By devolving decision making, these chief executives seek to harness market forces to increase autonomy and accountability, to boost entrepreneurialism, to enhance the flexibility of companies, and to improve access to opportunities. The most important effect is to put decisions in the hands of the managers most familiar with the business.

Markets at their purest emphasize motivation and entrepreneurialism. Hierarchies emphasize coordination and common control. All organizational forms fall somewhere between these two extremes. Corporations can be disaggregated internally or externally. Internal and external disaggregation can be interpreted as shifts away from hierarchy toward a more market-oriented mentality. Choosing among organizational forms requires balancing the trade-off between market autonomy (personal initiative) and common control (enforced cooperation).

Companies that disaggregate themselves internally devolve decision making authority to managers of business units, but the capital structure does not change, and full ownership of assets rests with the corporation. For some companies, internal disaggregation alone may suffice, but many find themselves pushing up hard against its constraints: unreliable performance measures, a blurred stock market "story," and a politicized capital allocation process.

For a fuller treatment of this material, *see* Jonathan D. Day and James C. Wendler, "The new economics of organization," *The McKinsey Quarterly*, 1998 Number 1, pp. 4–18.

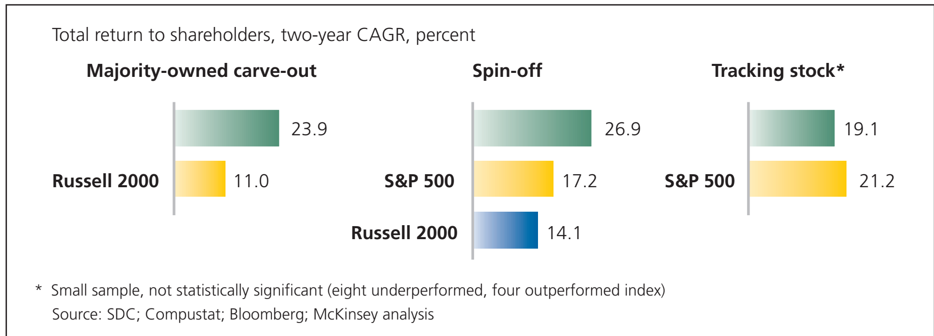
greater quantity of information provided by the company – it can freely provide more information about business units without restructuring ownership – but from an improvement in the quality of analysts' coverage.

Second, the restructured subsidiaries attract new investors. Indeed, there is little overlap between people who invested in a parent company and those who invest in its subsidiaries after a restructuring. Third, the restructuring of ownership usually improves a subsidiary's operating performance through such means as new incentives to management. Finally, restructuring can improve corporate governance and increase strategic flexibility.

Our research on large restructurings of ownership shows that the announcement of tracking-stock deals or spin-offs tends to raise the price

Exhibit 1

Market value created by restructuring

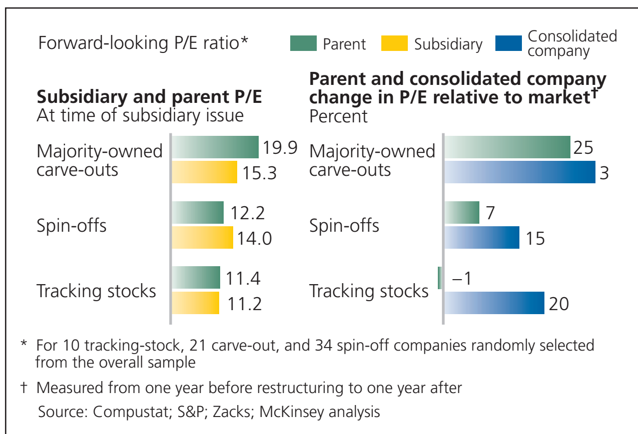


of the parent company's stock by 2 to 3 percent. When we analyzed recent announcements of majority-owned equity carve-outs, however, we found that they had no positive effect on the parent company's stock.*

In the longer term, equity carve-outs in which the parent company retains majority ownership easily outperform the Russell 2000 index, with an average annual TRS in the two years after issue of 24 percent as compared with 11 percent (Exhibit 1). We chose to concentrate on majority-owned carve-outs, since they are more common than those involving minority stakes.

Exhibit 2

Boost in P/E multiples created by restructuring



Spin-offs also substantially outperform the market, showing a two-year annualized TRS of 27 percent, compared with 14 percent for the Russell 2000 and 17 percent for the S&P 500. Large-cap spin-offs actually lag the market; it is the spin-offs with lower market capitalization – less than $1 billion – that account for this performance.

Tracking stocks, by contrast, tend to trail the market, with a TRS of 19 percent as against 21 percent for the S&P 500. Yet benchmarked against industry peers, they kept pace. Too few tracking-stock deals have been done in the past 15 years to support any general conclusions.

* Academic researchers using a sample that includes smaller carve-outs found positive 2 percent abnormal returns – in other words, an increase beyond that of the broad market; *see* Katherine Schipper and Abbie Smith, "A comparison of equity carve-outs and equity offerings: Share price effects and corporate restructuring," *Journal of Financial Economics*, Volume 15, 1986, pp. 153–86.

How does the corporate parent fare? Overall, the average improvement for all three options in the P/E multiple of the consolidated parent and subsidiary was 21 percent relative to the market (Exhibit 2). The increases show that when new equity is issued, the market's expectations both of the parent and the subsidiary change.

Improving coverage by analysts

Small divisions or subsidiaries within a large company may find that their growth prospects are not fully appreciated by securities analysts. An analyst specializing in the chemical industry, say, may track as many as 30 companies. This leaves little time to get to know the complexities of a small pharmaceutical subsidiary, whose valuation may suffer as a result. Slight differences in growth expectations can dramatically alter the value analysts place on the subsidiary. When companies launch tracking stocks, equity carve-outs, or spin-offs, they receive more attention from analysts. For all three restructuring options, the combined parent and subsidiary receive 25 percent more coverage in the two years after a transaction. By contrast, the overall number of US equity analysts rose by just 2 percent a year in the 1990s.

The increase in attention comes mostly in the form of new coverage of the subsidiary by analysts who specialize in its industry. After the 1996 spin-off from AT&T, Lucent picked up coverage from 24 telecom equipment analysts; previously, only two of them had covered AT&T. The parent, whose remaining analysts can focus on it more closely, benefits as well. Greater coverage from analysts is one reason many high-tech companies undertake carve-outs. Safeguard Scientifics, for instance, confirms that the several carve-outs it has executed have sparked new interest among analysts.

Attracting new investors

In theory, the market values a company as the sum of its parts, analyzing the growth prospects of each of the separate businesses and using the market view of predicted cash flows to determine the price of the stock. In practice, the market consists of many investors with their own individual criteria for making a purchase. The trouble is that investors who find a particular division of a company attractive might reject the stock of the corporate parent because, for example, it competes in a less attractive line of business or has slower growth prospects.

Take U S West. In 1995, it was a regional Bell operating company that also owned cable and cellular operations. An investor seeking the comparative stability of a utility stock would also be purchasing the volatility inherent in an emerging growth division. Another investor, wishing to benefit from the capital appreciation potential of the cable and wireless business, would be frustrated by the relatively slow earnings growth of the telecommunications utility. Neither of these investors would be entirely satisfied.

Seeking to win over two kinds of investors with different risk and reward profiles, U S West therefore created a Media Group tracking stock. While U S West's Bell operating company continued to pay stable quarterly dividends, the Media Group offered an opportunity for high capital appreciation but paid no dividends. Just a year after the launch of the Media Group, new investors owned more than 86 percent of its stock.

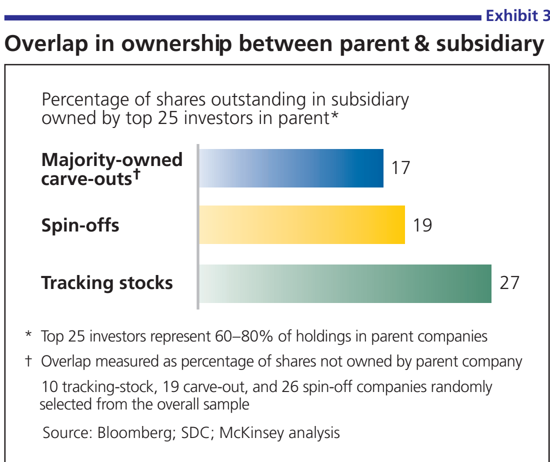
To see if this pattern applied to ownership restructurings in general, we took 55 recent examples of all three types and compared the top 25 shareholders of the parent and the subsidiary. On average, ownership overlapped by only 17 to 27 percent (Exhibit 3). Clearly, ownership restructurings can attract new investors.

Improving operating performance

If we examine the operating performance of newly traded subsidiaries during the two years from the time of issue, we see, on average, substantial increases in the return on invested capital (ROIC) both in the tracking stocks and the spin-offs, while the ROIC of carve-outs dips slightly (Exhibit 4). Carve-outs instead enjoy high revenue growth in the two years after they begin trading, with an average annual gain of 32 percent. The corresponding figure for the S&P 500 from 1990 to 1997 is just 7 percent. Carve-outs thus unleash value through top-line growth rather than cost efficiencies.

Exhibit 3

Overlap in ownership between parent & subsidiary



* Top 25 investors represent 60–80% of holdings in parent companies

† Overlap measured as percentage of shares not owned by parent company

10 tracking-stock, 19 carve-out, and 26 spin-off companies randomly selected from the overall sample

Source: Bloomberg; SDC; McKinsey analysis

Issuing any of these new equities makes it possible for a company to offer managers incentives tied to the market performance of the divisions they run. John England, of the compensation firm Towers Perrin, says, "With carve-outs, companies have a once-in-a-lifetime opportunity to develop a new executive and board compensation program. They can clearly indicate to investors, executives, and other employees that performance, ownership, risk, and reward are bound together."*

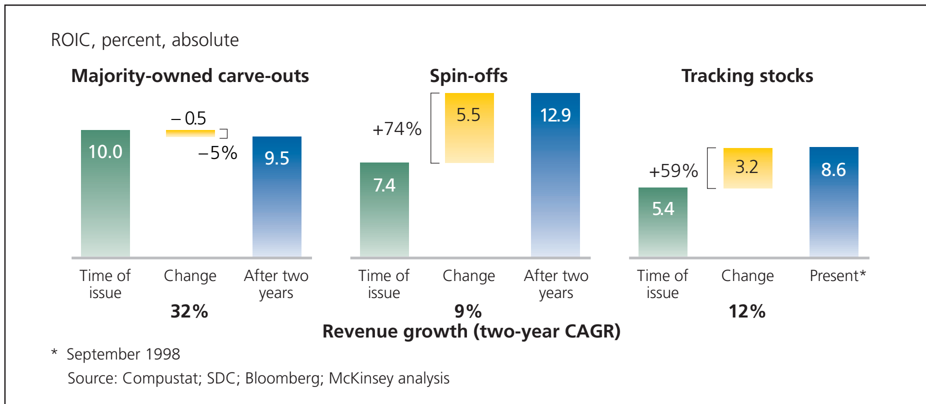
Increasing strategic flexibility

The restructuring of ownership permits a company to push management accountability deeper into the organization. For a subsidiary that is newly exposed to the market, greater scrutiny by investors and analysts creates a

* *See* Patricia L. Anslinger, Dennis Carey, Kristin Fink, and Chris Gagnon, "Equity carve-outs: A new spin on the corporate structure," *The McKinsey Quarterly*, 1997 Number 1, pp. 165–72.

Exhibit 4

Increase in subsidiary ROIC after restructuring



* September 1998

Source: Compustat; SDC; Bloomberg; McKinsey analysis

"second board" to which management must respond. Operating performance generally improves as a result. For management in poorly performing businesses, the new accountability becomes tangible through lower compensation when the stock falters.

Both tracking stocks and equity carve-outs increase strategic flexibility by facilitating mergers and acquisitions. In our sample, 22 percent of the tracking stocks were issued for use as acquisition currency. Four carve-outs between 1988 and 1998 were undertaken primarily to raise capital for future acquisitions. Four spin-offs were motivated chiefly by this aim, and an additional five were carried out to eliminate strategic conflicts that prevented the parent or its subsidiary from completing a merger or an acquisition.

Spin-offs can increase the strategic flexibility of businesses by allowing a subsidiary to form relationships with companies that do not want competitive information to flow to its parent. After being spun off from AT&T, Lucent was better able to do business with international telecommunications companies that perceived its parent as a rival.

Common concerns

Sometimes a company hesitates to use these restructuring tools, despite their evident advantages, because it is worried about the new entity's stability or fears that costs and complexity will rise.

Stability

In the case of tracking stocks and carve-outs, some companies have expressed fears that a subsidiary might be taken over by their rivals or that analysts could exert pressure to spin it off completely. In the case of spin-offs, the corporate parent may doubt the ability of an enterprise to survive independently.

A look at the survival rate of new equities over the past decade should allay such concerns. Of the 23 US-listed tracking stocks issued since 1984, 19 are still trading as tracking stocks. Just two have been sold (Ralston Purina's Continental Baking Group and USX's Delhi Group) and two spun off (the Media Group from U S West and EDS from GM).

The story is much the same for carve-outs and spin-offs. Fully 77 percent of the majority-owned equity carve-outs created between 1988 and 1993 were still trading as independent companies five years after issue. Similarly, 76 percent of the 129 spin-offs survived at least five years. Of those that are no longer trading, 25 were taken over and 6 delisted after filing for bankruptcy.

Although the business press sometimes views tracking stocks as a poor alternative to complete spin-offs, we found that analysts seldom exert any pressure to spin off these divisions. On the whole, analysts' reports mention a company's tracking-stock status only in passing, if at all. Those who discuss it tend to regard it favorably; they do not treat it as the prelude to an inevitable spin-off. Our research suggests that companies considering any of the three forms of ownership restructuring should regard them as stable tools for creating shareholder value.

Rising costs and complexity

Senior managers at companies contemplating a tracking-stock or carve-out structure must consider the greater complexity brought by new equities. For one thing, the board of directors will have to be responsive to more than one set of shareholders. Moreover, the creation of equities to attract different types of investors places a burden on senior management to communicate effectively and consistently with each group.

The need to share resources within a tracking-stock or carve-out structure adds another layer of complexity: R&D costs, for example, may need to be divided between the income statements of the parent and the subsidiary. Ownership restructuring also creates the potential for conflicts of interest between the two entities. A parent and a subsidiary may, for example, find themselves on opposite sides of a regulatory issue, such as those that bedevil the telecommunications industry. Or a subsidiary that is vertically integrated with its parent might want to pursue business with its parent's competitors. The SABRE Group, for instance, provides reservation systems not only for American Airlines, its parent, but also for some of American's rivals.

Companies incur transaction and overhead costs, too. The direct transaction costs associated with raising new capital in the market through an equity carve-out can represent 2–5 percent of the transaction's total value; for a spin-off or tracking stock, the figure is around 2 percent. The higher percentage for carve-outs may reflect the fact that their offerings often come in the form of

an IPO and not a stock distribution. On top of these transaction costs, companies giving thought to restructuring must take into account the costs of dual governance structures and additional reporting requirements.

These expenses, both direct and reckoned in management time and attention, must be weighed against the substantial benefits that ownership restructuring brings to many companies and their shareholders.

When to restructure . . .

By posing a series of simple questions, senior executives can determine when it might be appropriate to disaggregate by means of a new equity issue, and which option to choose. Those who answer "yes" to most of the following questions should seriously consider an ownership restructuring:

- Do parent and subsidiary operate in different industries?
- Is the subsidiary growing much faster or slower than its parent?
- Do analysts seldom mention the subsidiary's future growth and earnings prospects?
- Are high-performing managers or key technical staffers being lost to smaller competitors, or is there a risk that this might happen?

. . . and how

Once a company has determined that restructuring may be advisable, it must select one of the three options below.

A spin-off may make the most sense if the following conditions prevail:

- The parent company is no longer in the best position to create the greatest value from its business through skills, systems, or synergies; in other words, it has ceased to be the natural owner of the business. One reason for the 1996 spin-off of EDS from GM was the desire to free EDS from constraints that prevented it from pursuing certain deals.
- The strategic interests of parent and subsidiary conflict. When U S West issued tracking stock for its Media Group in 1995, it expected the telecom services and cable businesses to converge. But when the expected synergy did not materialize, parent and subsidiary found themselves in opposite camps over regulatory issues. The Media Group was spun off as MediaOne in June 1998.

A majority-owned carve-out is the most appropriate choice in three circumstances:

- When the parent or the subsidiary needs better access to capital. In general, companies that take the carve-out approach are more highly leveraged than their peers and perform less well, so they are more likely to suffer capital constraints. Carve-outs allow companies to raise capital at a fair price and to fund projects that might otherwise depress earnings.

- When decision-making power in an organization must be devolved to the people who know it best.* In companies with centralized capital budgeting, for instance, division managers have an incentive to overstate their investment needs and to waste time lobbying for bigger budgets. Carved-out businesses, by contrast, can gain direct access to capital markets – a key advantage for fast-growing enterprises that might otherwise struggle to win funds. At Thermo Electron, for instance, managers of carve-outs assume primary responsibility for financing and investment decisions.

- When subsidiaries can readily be separated without problems over the price of the transfer. Both boards will have to review contractual agreements, including those establishing transfer prices. Other issues include the sharing of R&D, sales and marketing, and manufacturing resources. If the split can be made without extreme complexity, equity carve-outs are an attractive option.

Equity carve-outs may also be preferable to tracking stocks when shareholders are expected to react adversely to a tracking-stock deal. Carve-outs on average have the strongest TRS performance of any restructuring option, while their effect on P/E multiples is roughly comparable to the effect of the other possibilities. In addition, carve-outs are much more common than tracking stocks, so the market understands carve-outs better.

Either an equity carve-out or a tracking stock can create value in the following circumstances:

- When equity is needed for use as an acquisition currency, especially if the acquisition target is not interested in the parent company's shares. GM issued tracking stock when it acquired EDS in 1984. As EDS began trading, its forward-looking P/E was 38, as compared with 5 for GM. When U S West issued Media Group tracking-stock shares in 1995, they traded at P/E multiples of 76, as compared with 17 for the parent company, and were used in the following year to acquire Continental Cablevision.

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* For more on the use of disaggregation in devolving decision-making authority within and beyond an organization to boost personal initiative and entrepreneurialism, *see* Jonathan D. Day and James C. Wendler, "The new economics of organization," *The McKinsey Quarterly*, 1998 Number 1, pp. 4–18.

◆ When a subsidiary could take advantage of its parent company's capital structure to borrow at lower cost. USX and Circuit City both chose tracking stock in part to maintain the ability of the disaggregated entities to borrow at the debt rating of the consolidated company.

◆ When the margins and growth of a subsidiary are on a par with or better than those of its pure-play peers. If its operating performance lags the industry average, a carve-out or tracking stock probably will not create value and may even destroy it. (By contrast, companies may choose to spin off their poorly performing subsidiaries to improve their performance, even if the subsidiary falters.) Ralston Purina's Continental Baking Group was issued as a tracking stock in 1993 to provide an incentive for management to turn the unit around. By the time the group was sold in 1995, the stock had sunk to one-third of its original value.

Tracking stocks, in two situations, are likely to be better than either carve-outs or spin-offs, since both require at least some separation of assets:

◆ If the parent or the subsidiary of a US company has net operating losses that can be used to offset taxable profits. More than 50 percent of the companies that have issued tracking stocks take advantage of the parent's or the subsidiary's net operating losses in this way.* Genzyme has used the losses flowing from the high R&D expenses of its Tissue Repair tracking stock to reduce taxes at the corporate level.

◆ If restructuring seems to be attractive, but the parent and the subsidiary share synergies or use similar business systems. The Delhi Group of USX operated gas-processing plants jointly with Marathon Oil. A spin-off would have required what at that time was an unnatural division of these assets, but the Delhi tracking stock, which began trading in 1992, eliminated the need for a separation.

Companies that restructure their ownership can often improve the performance of business units by exposing them to the market and thus attracting a more focused analyst community and new investors. More important, such companies can improve their operating performance by providing incentives for managers and increasing their strategic flexibility. Used judiciously, spin-offs, equity carve-outs, and tracking stocks are important tools that help corporate management increase value. Q

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* US tax law also allows consolidation for tax purposes in equity carve-outs whose parent companies maintain more than 80 percent ownership. In these cases, net operating losses in one division can be used to offset taxable profits in another.