M&A Market Analysis
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# Spin-offs: Review and Analysis


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Please refer to Appendix – Disclaimers and Other Disclosures on page 15.

# Spin-offs: Review and Analysis

## Executive Summary

Corporate spin-offs remained in the headlines during 2014, even amid resurgent M&A activity. Hardly a week passed without a large company announcing plans to spin off a subsidiary, often in response to pressure from activist investors to improve valuation via restructuring transactions involving non-core assets. Indeed, 2014 featured the most spin-off announcements on a global basis since at least 1990. Investor reaction to this form of corporate restructuring has been positive, which should lead to additional spin-off announcements in 2015, particularly as proactive corporate boards continue to optimize business portfolios.

A corporate **spin-off** involves the distribution of shares in a newly independent subsidiary by a publicly traded parent company to existing shareholders. The distribution is made on a pro-rata basis, with existing shareholders receiving subsidiary stock in proportion to holdings in the parent corporation (ParentCo). The distribution of shares in the subsidiary (SpinCo) occurs without cash changing hands and generally is tax-free, a primary feature of spin-offs.

The **rationale** for undertaking a spin-off transaction can include many factors, although achieving a higher valuation tends to be a primary consideration. The strong historical market performance of spin-off stocks (demonstrated in academic studies and a spin-off stock index) bolsters the case for pursuing this type of restructuring transaction. The stocks of distributing parent companies also have a positive history of shareholder returns due to the perception of value being unlocked. A spin-off can lift valuation by:

- Addressing the conglomerate discount
- Enabling SpinCo and ParentCo to trade closer to the multiples of industry peers
- Making SpinCo and ParentCo more viable takeover targets post-spin

Companies also execute spin-offs for fundamental business reasons. Spin-offs:

- Separate businesses with divergent profiles and distinct strategies
- Resolve the lack of synergy between unrelated businesses and the resulting complexity for investors
- Address a troubled business that calls for undue levels of management attention
- Stem from M&A in some situations, either in separating an acquired business that does not fit strategically or in solving an antitrust issue if the acquiror cannot buy part of the target's businesses for regulatory reasons

Company leaders evaluating spin-offs must consider the **challenges** involved in these transactions:

- <u>Operational challenges</u>: separating assets, liabilities, costs, and work orders; allocating management and determining management compensation; addressing labor-related issues; defining shared/transition services and undertaking new back-office costs; resolving business and legal conflicts; ensuring SpinCo's ability to stand alone with adequate resources
- <u>Financial hurdles</u>: the dilution of the lost earnings stream; the apportionment of debt between the two entities; the lack of monetization, although related transactions can mitigate this issue; potential claims of fraudulent conveyance if SpinCo or ParentCo becomes insolvent due to the spin-off
- <u>Equity market considerations</u>: generating investor interest in each post-spin entity; handling public company costs, regulatory filings, and financial statements for both companies; recognizing that SpinCo and post-spin ParentCo are not suitable investments for some existing shareholders; enduring the lengthy spin-off process

The **potentially tax-free** nature of spin-offs for ParentCo and its shareholders represents a critical advantage relative to divestitures, which represent the most common restructuring transaction. The tax savings versus a divestiture can be significant if the market value of SpinCo is well above its book value. In the U.S., a spin-off qualifies for tax-free treatment (for ParentCo and shareholders) if satisfying the requirements of Internal Revenue Code Section 355. Certain forms of M&A include a spin-off in order to enable a tax-free and monetizing divestiture for ParentCo.

Points of interest from our **global spin-off data set**:

- The frequency of spin-off announcements has picked up considerably in recent years, as more than half of the 720 announcements since 1990 came in the 2010-2014 timeframe
- Aggregate reported dollar volume for completed spin-offs over the past two-plus decades was $1.2 trillion
- During 2010-2014, the median value of a completed spin-off transaction was $630 million. Roughly 75% of these spin-offs were valued above $200 million, highlighting the need for SpinCo to be large enough to be a viable publicly traded company. About one-quarter of the group received an initial market capitalization of $2 billion, indicating that spin-offs are a feasible option for separating large businesses from parent companies
- Geographic representation for spin-offs was widespread. The U.S. market witnessed the most spin-off announcements (272), followed by Asia (221), and Europe (145)

## Overview of Spin-off Transactions

A spin-off involves the distribution of shares in a newly independent subsidiary by (in most cases) a publicly traded parent company (ParentCo) to existing shareholders. The distribution is made on a pro-rata basis, with existing shareholders receiving subsidiary stock in proportion to holdings in ParentCo. The distribution of shares in the subsidiary (SpinCo) occurs without cash changing hands and is tax-free in most cases, depending on certain requirements being met (as detailed later). In order for a public company spin-off to be viable, the subsidiary must be sufficiently large to be an independent publicly traded company, with its own assets and liabilities, products and/or services, customers, employees, management team, and board of directors.

Spin-offs can be executed in several different ways:

- In a standard spin-off, ParentCo distributes 100% of the stock in SpinCo to existing ParentCo shareholders in a single step. This is the most common form of spin-off
- A majority spin-off involves ParentCo distributing most of SpinCo stock to shareholders while retaining a minority interest
- An equity carve-out (IPO) and spin-off includes an IPO for a minority percentage of the voting control of the subsidiary (typically less than 20%), followed in a later step by the spin-off of the remaining interest to ParentCo shareholders

Spin-offs can occur in scenarios that are more complex than those presented above:

- In a sponsored spin-off, a financial sponsor purchases shares in SpinCo (often just after the spin-off), as pre-arranged prior to the spin-off. Such a purchase by a sophisticated investor can provide the investment community with a positive signal regarding the investment merits of SpinCo. In addition, ParentCo can receive the proceeds that are channeled through SpinCo on a tax-free basis. In order for such a purchase to be tax-free, the U.S. Internal Revenue Code restricts the sponsor investment to less than 50% of the vote and value of SpinCo stock during a two-year waiting period. Many private equity firms have the time horizon and resources needed to develop the spun-off business over the required period
- A spin-off can also occur prior to a financial sponsor or strategic acquiror investing in or purchasing ParentCo or SpinCo, with the acquisition closing immediately following the spin-off. Morris Trust and Reverse Morris Trust transactions (detailed later in report) are forms of M&A that include a spin-off in order to enable a tax-free divestiture

As detailed starting on page 8, more than 360 spin-offs have been announced since 2010 on a global basis. Below is a list of prominent spin-offs completed over the past five years. This list does not include certain large spin-offs that have not yet been completed after being announced in 2014 – for example, eBay's planned spin-off of PayPal.

**The 10 Largest Spin-offs in the Last Five Years**

| Date Closed | Spin-off Company | Parent Company | Deal Value ($ bil) |
|---|---|---|---|
| 01/02/2013 | AbbVie | Abbott Laboratories | $54.2 |
| 09/27/2012 | Kraft Foods Group | Mondelez International | 26.4 |
| 05/01/2012 | Phillips 66 | ConocoPhillips | 23.4 |
| 01/03/2011 | Fiat Industrial (nka CNH Industrial) | Fiat Chrysler Automobiles | 14.9 |
| 07/01/2011 | Marathon Petroleum Corporation | Marathon Oil Corporation | 14.7 |
| 04/30/2014 | Navient Corporation | SLM Corporation | 10.2 |
| 06/28/2013 | News Corporation | Twenty-First Century Fox | 9.4 |
| 01/04/2011 | Motorola Mobility Holdings | Motorola Solutions | 8.7 |
| 09/28/2012 | The ADT Corporation | Tyco International | 8.3 |
| 12/13/2010 | Scentre Group | Westfield Corp. | 6.0 |

Source: Capital IQ.

# Spin-offs: Review and Analysis

## Rationale for Spin-offs

While the potential tax-free nature of spin-offs is a primary feature, corporate boards must establish a clear rationale for pursuing a spin-off outside of tax considerations (discussed on page 6) when examining potential modes of restructuring. Boards should also consider the long-term interests of shareholders and other stakeholders, which have little direct say in whether a spin-off occurs.

Companies ultimately undertake spin-off transactions for many reasons, with achieving a higher valuation usually a top consideration. As shareholder activism has become widespread and more successful in achieving its goals, institutional investors are increasingly pressuring the management teams and boards of public companies to evaluate changes in corporate structure and operating strategies in an attempt to boost valuation levels. Activist shareholders often urge companies to pursue restructuring steps designed to result in value creation through optimization of business portfolios. While some of the considerations relevant to spin-offs also apply to restructuring alternatives such as divestitures, many are specific to spin-off transactions.

The strong historical market performance of spin-offs (detailed further on page 7), including those involving unwanted businesses that originally received low valuations, adds to the appeal of this type of transaction. The stocks of distributing parent companies also have a positive history of shareholder returns due to the perception of sum-of-the-parts value being unlocked in the spin-off process. A spin-off can lift a ParentCo's valuation by:

- Addressing the conglomerate discount, which reflects investors paying lower multiples for shares of a diversified public company as a trade-off for investing in unrelated businesses
- Leading to multiple arbitrage if SpinCo and ParentCo trade closer to the multiples of industry peers, which is more likely when profitability is in line with the comparables group, as pure-play companies are easier for the market to value due to greater operating performance transparency
- Making SpinCo and ParentCo more viable takeover targets, which may enhance valuations

Alternately, spin-offs can be a defense mechanism if separating from the most attractive part of the company makes ParentCo less appealing as a hostile takeover target.

Companies also execute spin-offs for fundamental business reasons. Spin-offs:

- Separate businesses requiring distinct focus due to divergent profiles that can include significant variations in operating performance, growth rates, cyclicality, capital requirements, management resources, and market opportunities.
- Resolve the lack of synergy between unrelated businesses and the resulting complexity for investors, while also allowing for greater transparency into management performance at ParentCo and SpinCo
- Address a troubled business (e.g., facing lawsuits, a declining market, or environmental issues) that draws undue levels of management attention
- Stem from M&A in some situations, either in separating an acquired business that does not fit strategically or in solving an antitrust issue if the acquiror cannot buy part of the target's businesses for regulatory reasons

Spin-offs can lead directly to improved operating performance at ParentCo and SpinCo:

- The leaders of ParentCo and SpinCo may run their business more effectively following a spin-off due to more direct alignment of management incentives (such as stock-based compensation) with company performance
- Spin-offs allow employees at both entities to focus on the individual business that they understand best
- Deconsolidation can unleash bolder actions under a more entrepreneurial management philosophy, particularly at the SpinCo level
- Once independent, management of ParentCo and SpinCo have greater focus and flexibility to pursue acquisitions, joint ventures, or other investments that would not have been practical when combined
- Unlike a divestiture, spin-offs create public currency that SpinCo can use in pursuing its acquisition strategy and stock compensation programs, along with direct access to the capital markets for financing planned projects

## CHALLENGES FACING SPIN-OFFS

Board members and company leaders evaluating a potential spin-off must consider their ability to clear the associated hurdles, which generally fall into three categories: operational, financial, and equity market considerations.

Among operational challenges that must be faced before a spin-off transaction takes place are:

- Separating assets, liabilities, costs, and work orders as part of restructuring steps needed to establish two distinct businesses; this includes indemnification for non-transferrable liabilities and determining responsibility for various tax matters. In some cases, ParentCo and SpinCo must enter into sharing or licensing agreements related to intellectual property assets such as trademarks and patents. As with apportionment of debt (discussed below), the allocation of liabilities must consider the related impact on the solvency of ParentCo and SpinCo
- Allocating company management and determining appropriate management compensation at the separated companies. Appointing SpinCo's board of directors is also necessary, with a small number of ParentCo board members often joining the SpinCo board in order to support the transfer of institutional knowledge and culture
- Addressing labor-related issues, such as employment contracts, collective bargaining agreements, and pensions
- Defining shared and transition services – particularly back-office functions such as treasury, IT, legal, and HR – temporarily provided through ParentCo (at cost or on a cost-plus basis) to enable business continuity while SpinCo builds up its operational and administrative capabilities, which often requires spending on new back-office systems
- Resolving business and legal conflicts
- Ensuring SpinCo's ability to stand alone with adequate resources to survive

Separating SpinCo from ParentCo is far less complex, risky, and time-consuming if both are already autonomous businesses with management teams in place and no customer overlap. Nevertheless, even distinct operations may be supported by consolidated functions, and disaggregating these can prove burdensome.

Financial hurdles related to spin-offs include:

- The dilution of the lost earnings stream for ParentCo. The existing credit agreements of ParentCo might restrict its ability to spin off a subsidiary that contributes meaningfully to its earnings
- The apportionment of debt between the two entities, with solvency considerations and possibly higher interest rates due to reduced size and earnings diversification. Debt apportionment could include SpinCo issuing debt securities to ParentCo, followed by ParentCo exchanging the securities with external parties to retire existing debt
- A spin-off does not directly provide ParentCo cash that can be used to pay down debt. The low interest rate environment of recent years may have diminished the importance of debt reduction, leading to more spin-offs
- To monetize a spin-off transaction, ParentCo can push debt down into SpinCo or have SpinCo borrow to fund a tax-free dividend to ParentCo before the spin-off occurs. Such attempts to extract value are limited by ParentCo's basis in SpinCo's assets (any amount above this basis is taxable) and SpinCo's ability to service added debt
- Creditors can make claims of fraudulent conveyance if SpinCo declares bankruptcy due to debt taken on to pay a dividend to ParentCo, or if ParentCo becomes insolvent due to the spin-off. Bankruptcy filings by companies excessively burdened by a spin-off have resulted in litigation for former parent companies. Given the exposure to potential claims related to dividend distributions and debt authorizations, boards may seek third-party assessments and an overall solvency opinion in an attempt to mitigate risk

Equity market considerations for corporate boards:

- Generating sufficient investor interest in each post-spin entity by crafting a shareholder communications strategy for the targeted investor base of SpinCo as well as ParentCo. Recently, building investor demand for each entity has been facilitated by the strength in the equity markets. Given the benefits of positive investment sentiment, the extended equity market rally suggests spin-off activity will remain high in the near term
- Shouldering the burden of public company costs, SEC filings and regulations (for U.S.-based companies), and financial statements for both companies. Information statements with relevant SpinCo details must be filed with the SEC before the transaction can close, and preparing disaggregated data can be difficult and time-consuming. Providing pro forma financial information on ParentCo is beneficial for educating investors on its post-spin profile
- Recognizing that SpinCo may not be a suitable investment for some existing shareholders of ParentCo, particularly institutional shareholders focused on a certain investment style. The selling pressure related to this factor, along with forced selling by index funds that hold a shrunken ParentCo, dampens performance for ParentCo and SpinCo stocks soon after spin-offs occur, often followed by stronger performance as orphaned stocks eventually find homes with investors increasingly attuned to the outperformance of spin-offs and remaining companies
- Accepting timing considerations, as executing on spin-offs can be a lengthy process, partly due to the need to establish an investor market for ParentCo and SpinCo

## Alternative Restructuring Transactions

Companies and corporate boards have several options when contemplating a corporate restructuring. Among potential restructuring transactions involving corporate subsidiaries, alternatives to a spin-off include:

- Divestitures
- Split-offs
- Equity carve-outs

The sale of a subsidiary or assets to another company or a private equity firm through a divestiture is far more common than the completion of a spin-off transaction. More than 4,600 corporate divestitures were announced by public companies on a global basis in 2014, versus 97 announced spin-offs. Company leaders have several reasons to choose the divestiture route:

- Divestitures have the advantage of generating consideration (usually cash) that can be used to reduce debt, invest in the remaining business, repurchase shares, make acquisitions, or pay a special dividend. Accordingly, a highly leveraged company would generally select a divestiture over a spin-off that would not generate cash
- The purchase price in a trade sale may reflect a premium that incorporates the buyer's anticipated synergies, resulting in value that may not be captured by the seller in alternative transactions.
- Divestiture transactions can be completed more quickly than the alternatives, although it should be noted that divestiture proceeds are received only after a period of negotiations that lead to a deal agreement and closing. In contrast, the primary discussions with outside parties for a spin-off are pre-transaction meetings with potential post-spin investors
- Divestitures are particularly attractive for smaller subsidiaries that would not be viable as a standalone public company

The feasibility of a divestiture is largely a function of the strength of the M&A environment, as well as the quality and quantity of offers by potential suitors when the selling parent company canvasses the market. Spin-offs represent an alternative to a divestiture when the direct sale of part of a business to a strategic or financial buyer is not optimal or practical. In addition, spin-offs generally are tax advantaged relative to divestitures, whose proceeds are subject to corporate taxes if the divested business was sold for above book value.

In a split-off transaction, the parent corporation offers its shareholders shares in newly created stock in its subsidiary in exchange for ParentCo shares. Key attributes of a split-off:

- The offer might incorporate a premium that motivates ParentCo shareholders to accept the exchange. If the offer is over-subscribed due to this premium, shares are exchanged on a pro-rata basis. In the case of an under-subscribed offer, the remaining subsidiary shares are distributed via a spin-off
- Although not directly leading to monetization, the share exchange effectively serves as a share repurchase program, helping offset earnings dilution related to the split-off
- As with a spin-off, a split-off is tax-free if meeting certain requirements, such as distribution of 80% or more of the stock in the subsidiary
- Split-offs have occurred less frequently than spin-offs (i.e., less than 10 per year), possibly due to greater complexity

An equity carve-out consists of an IPO for a minority percentage of the voting control of the subsidiary (often less than 20%). Important aspects of an equity carve-out:

- Results in monetization for ParentCo when the IPO proceeds are directed to ParentCo rather than the carved-out business
- Can take place before a planned split-off or spin-off in order to establish a market value for the stock of the subsidiary. The remaining shares held by ParentCo could also be sold to new shareholders via a follow-on offering
- Generally requires an environment of relatively low volatility and higher equity valuations, in line with the overall IPO market
- As with split-offs, equity carve-outs are uncommon (usually a handful per year), reflecting the complexity and lengthy cycle of a transaction that ultimately requires multiple steps for the intended benefits to be realized

In all of these types of corporate restructurings, the assets and liabilities of the subsidiary must be separated from those of the parent. Although more complex and time-consuming, a multi-track process that allows ParentCo to gauge the market's interest in multiple alternatives and to allow for varying market conditions can be undertaken as a means of maximizing the value of the assets being separated.

## Tax Considerations

The potentially tax-free nature of spin-offs for ParentCo and its shareholders represents a critical advantage relative to certain alternatives. The tax savings versus a divestiture can be significant if the market value of SpinCo is well above its book value.

In the U.S., a spin-off qualifies for tax-free treatment (for ParentCo and its shareholders) if satisfying the requirements of Internal Revenue Code Section 355. The requirements include:

- Both ParentCo and SpinCo must have engaged in an active trade or business for five years prior to the spin-off
- Neither ParentCo nor SpinCo were acquired in a taxable transaction in the preceding five years
- Following the separation, ParentCo and SpinCo must continue operating actively in their trade or business
- ParentCo shareholders must own at least 80% of the vote and value of all classes of the stock in the subsidiary (SpinCo) prior to the spin-off and must hold less than 80% of the vote and value of SpinCo stock after the spin-off
- The spin-off must have a valid business purpose, rather than simply serving as a tax-free means of distributing subsidiary earnings as dividends. The IRS might accept improved focus, regulatory relief, and better access to debt or equity financing as viable purposes
- Shareholders of ParentCo must retain continuity of interest in both parent and subsidiary for a four-year period beginning two years before the spin-off by maintaining 50% equity ownership interest in both companies. A change in control of either ParentCo or SpinCo during this period could trigger a tax liability for ParentCo

A Morris Trust transaction is a form of M&A that includes a spin-off in order to enable a tax-free and monetizing divestiture for ParentCo by satisfying the last requirement listed above. The pre-acquisition spin-off involves the assets to be acquired remaining with ParentCo and the unwanted assets going with SpinCo. Immediately after the spin-off, the acquiror purchases ParentCo. This transaction represents a tax-free reorganization if ParentCo shareholders control more than 50% of the voting rights and economic value of the ParentCo/acquiror combination (e.g., via a stock deal that provides ParentCo shareholders 50%+ ownership of the acquiror).

A Reverse Morris Trust is another form of transaction intended to allow a tax-free and monetizing divestiture through the use of a spin-off. In this scenario, the spun-off subsidiary (SpinCo) merges with a smaller external company immediately following the spin-off of the assets wanted by the merger partner. As with the regular Morris Trust, the principal requirement for tax-free status is that ParentCo shareholders (who are also SpinCo shareholders) receive more than 50% of the vote and value of the newly merged company.

Morris Trust transactions can be central to a more complex series of transactions that also involve debt-for-debt or debt-for-equity swaps that involve additional investors. All else equal, a regular Morris Trust is more tax-efficient when ParentCo wants to monetize the transaction through debt issuance but is limited in its ability to use SpinCo for this purpose due to a low tax basis in SpinCo. Otherwise, a Reverse Morris Trust is generally preferred.

In 1997, the U.S. Congress restricted the feasibility of many spin-off/M&A combinations by enacting Internal Revenue Code Section 355(e). Under Section 355(e), a spin-off is taxable to ParentCo if 50%+ of the vote or value of ParentCo or SpinCo is acquired as part of a “prohibited plan” with the spin-off. Since this change, Morris Trust and Reverse Morris Trust transactions have occurred much less frequently, with about two per year over the past decade (according to Thomson Reuters), as finding a viable buyer with less value than the targeted assets (to satisfy the 50%+ requirement) represents a major challenge.

Regarding majority-stake acquisitions involving ParentCo or SpinCo, an acquisition occurring less than two years before or less than two years after a spin-off would generally be considered part of a “prohibited plan” and therefore would cause the spin-off to be a taxable event. However, acquisitions that fit within certain regulatory safe harbors are not prohibited within the first two years following a spin-off. Such safe harbors require the absence of any agreement or substantial negotiations regarding a potential M&A transaction during a specified black-out period following the distribution date of the spin-off, with the length of the black-out period ranging up to two years depending on the safe harbor.

Spin-offs that do not qualify for tax-free treatment result in taxes at both the ParentCo level (capital gain on the difference between SpinCo’s market value and its basis for ParentCo) and the shareholder level (ordinary income equal to SpinCo’s market value). If SpinCo is acquired following a spin-off in violation of Section 355(e), the M&A transaction represents a taxable event for ParentCo, but the spin-off is not taxable at the shareholder level.

Boards of directors considering a spin-off will want a tax analysis and/or legal opinion to be provided, likely by an outside firm, to determine the taxable status of the prospective transaction. ParentCo’s board should also seek a private letter ruling from the IRS providing guidance regarding tax-free treatment for the transaction, recognizing that the IRS recently expanded the list of spin-off related issues for which it will not provide such a ruling.

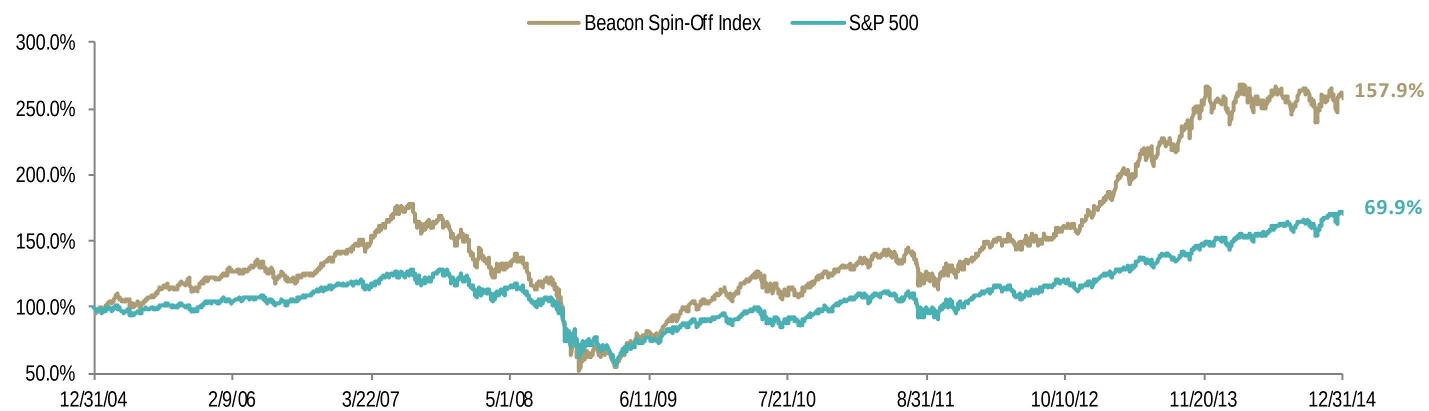
## STOCK PERFORMANCE

The strong historical market performance of spin-offs, including some unwanted businesses that originally received low valuations, adds to the appeal of this type of transaction. Academic studies and a spin-off stock index have highlighted the outperformance of spin-offs relative to the S&P 500, with the stock performance of ParentCo often improving as well.

Academic research conducted over various periods in past decades has demonstrated positive investor response to spin-offs, in terms of both SpinCo stock and ParentCo shares, with outperformance typically lasting two to three years. As noted previously, spin-offs can raise valuations by eliminating the conglomerate discount, lifting multiples closer to those of industry peers, and making SpinCo and ParentCo more viable takeover candidates. In addition, each management team comes away from a spin-off in better position to pursue distinct strategies and growth initiatives that may not have been possible previously, potentially leading to better operating results.

The outperformance of spin-off stocks can be seen through the recent gains of a stock index focused on spin-offs. The Beacon Spin-Off Index (created by Beacon Trust Company) includes the stocks of certain companies that have been spun-off from larger corporations within the preceding 30 months. As indicated in the chart below, the Beacon Spin-Off Index dramatically outperformed the S&P 500 over the past 10 full years, a period that included the last substantial market decline.

**Spin-off Index Stock Performance**




Source: Capital IQ.

The index does not include spin-offs that are less than six months old, likely due to the potential for initial underperformance related to selling by existing shareholders more interested in ParentCo, forced index selling, uncertain earnings outlooks for unseasoned standalone companies, and low levels of equity research sponsorship for SpinCo stocks in the early stages. The pressure placed on spin-off stocks by such challenges eventually draws the interest of other investors familiar with the longstanding outperformance of spin-offs.

The stocks of parent companies involved in spin-offs also have generated excess returns. For parent companies, strong relative stock performance generally begins with the announcement of a spin-off. According to our analysis of spin-offs announced over the past five years, the mean return (relative to the S&P 500) for parent companies was 3.4% in the week following the announcement and remained at 3.4% on 30-day basis. As noted above, academic research has also demonstrated stock outperformance for parent companies following the completion of spin-off transactions.

In a recent example, Procter & Gamble stock increased 2.3% (adding $5+ billion in market capitalization) on the day that it announced plans to spin off its Duracell business. Although P&G ultimately decided to sell Duracell to Berkshire Hathaway for $4.7 billion rather than execute on the spin-off, the sizable gain reflected investors seeing the spin-off announcement as evidence of P&G making progress on simplifying its business portfolio by creating value from an underperforming brand.

### DATA ON SPIN-OFF TRANSACTIONS

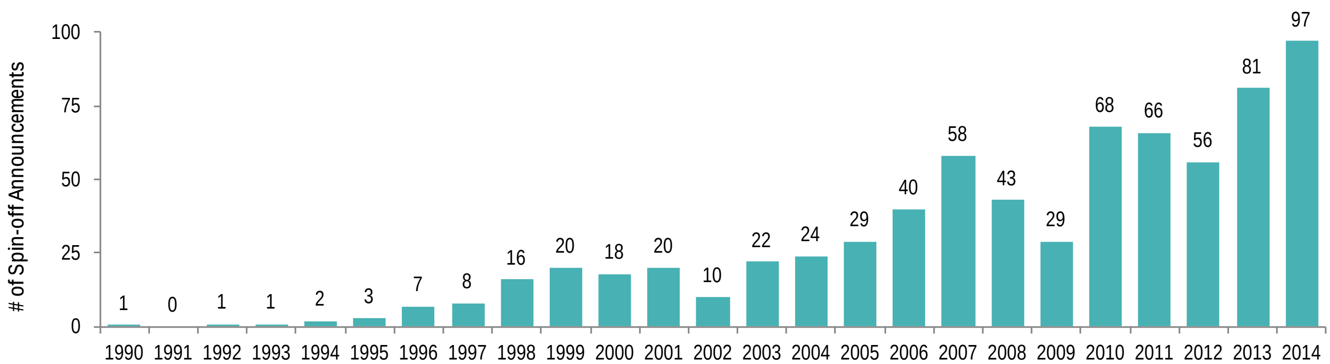
This section presents analysis of more than 700 corporate spin-offs that have been announced since 1990. Of this group, more than 500 spin-offs have been completed. The aggregate value of completed spin-offs (with a disclosed value) was $1.2 trillion.

Before providing further detail on our data set, we note the following:

- Data is provided back to 1990, the earliest year of transaction data available through Capital IQ, our source for spin-off transaction data
- We excluded transactions with a ParentCo market capitalization below $50 million or a SpinCo market capitalization below $25 million
- Of the 546 completed spin-offs, Capital IQ provided a transaction value for 447; the aggregate spin-off value of $1.2 trillion applies to this group of 447 spin-offs

Our data set includes 720 spin-off announcements since 1990. As indicated below, the frequency of these announcements has picked up considerably in recent years. Indeed, more than half of the spin-offs were announced in 2010-2014. Note that many of these spin-offs are yet to be completed, and some will never take place as planned.

**Spin-off Announcements by Year**




Source: Capital IQ.

Reasons for spin-offs being announced more commonly in recent years include:

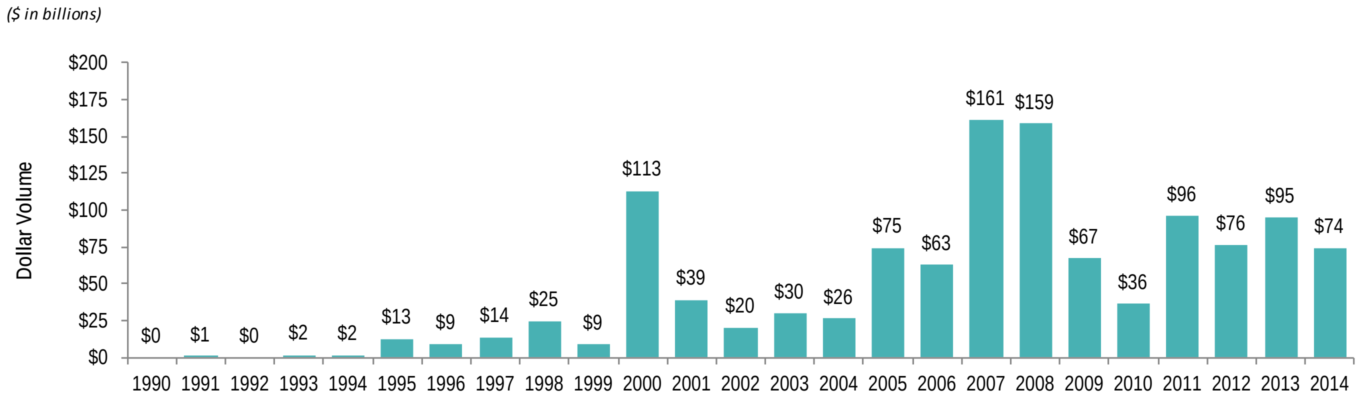
- Increased levels of shareholder activism
- Strong equity markets
- Low interest rates, reducing the relative appeal of monetization via alternatives such as divestitures
- Investors rewarding focused companies amid better economic conditions, contrasting with the prior period of economic recession/crisis, when the market valued the safety net provided by larger scale and greater diversity

With these factors still relevant in early 2015, we anticipate continued strength in spin-off activity over the near term.

# Spin-offs: Review and Analysis

Aggregate dollar volume for completed spin-offs over the past two-plus decades was approximately $1.2 trillion. Dollar volume by year is lumpy due to the impact of the largest spin-offs. Note that the value of spin-offs announced in 2014 will largely be reflected in 2015, as most of these have yet to be completed.

**Spin-off Dollar Volume by Year**

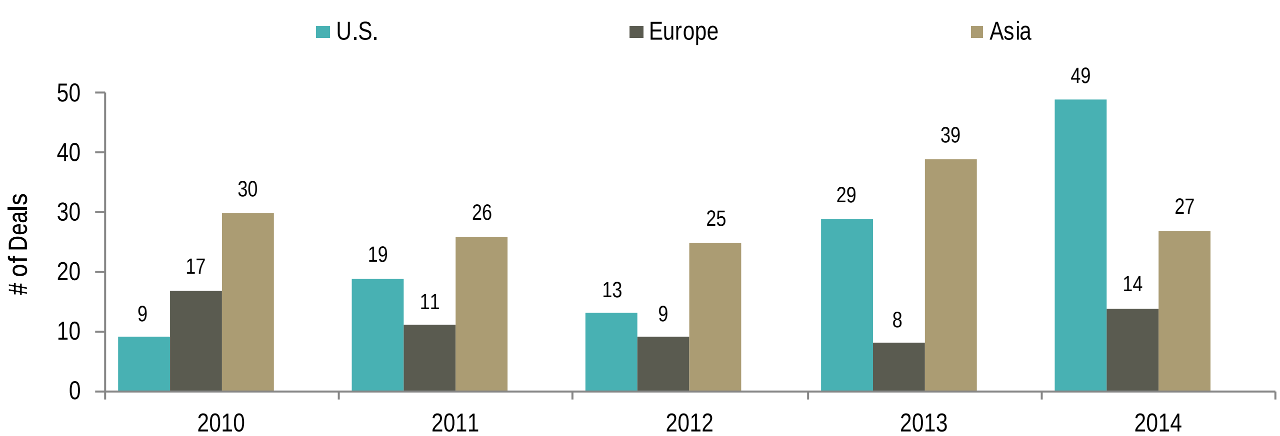



Source: Capital IQ. Each year's volume includes only transactions closed during the year indicted; in some cases, spin-offs were announced `in a prior year.

During the 2010-2014 period, the median value of a completed spin-off transaction (i.e., the market capitalization of SpinCo immediately post-spin) was $630 million. Roughly 75% of the spin-offs in 2010-2014 were valued above $200 million, highlighting the need for SpinCo to be large enough to be a viable publicly traded company. About one-quarter of the 2010-2014 group received an initial equity value of $2 billion, indicating that spin-offs are a feasible option for separating large businesses from parent companies.

Geographic representation for spin-offs was widespread. The U.S. market witnessed the most spin-off announcements (272), followed by Asia (221), and Europe (145). As indicated below, 2014 was a peak year for spin-off announcements in the U.S. However, Asia registered the most planned spin-offs over the past five years.

**Geographic Mix of Spin-Off Announcements**




Source: Capital IQ.

# Spin-offs: Review and Analysis

The size of completed spin-offs has varied widely across geographies. The U.S. has featured the largest spin-offs (on average), with a median market capitalization during 2010-2014 exceeding $1.3 billion and with 75% of completed spin-offs initially trading at a market capitalization above $400 million. The spectrum of market capitalizations for spin-offs in Europe nearly matched global figures, while Asia's spin-offs generally had a smaller profile.

**Spin-Off Value Breakdown**

| Region | Median ($mil) | 25th Percentile Value ($mil) | 75th Percentile Value ($mil) |
|---|---|---|---|
| Global | $630 | $212 | $2,005 |
| U.S. | $1,341 | $416 | $3,453 |
| Europe | $637 | $254 | $2,171 |
| Asia | $283 | $109 | $988 |

Source: Capital IQ.

Spin-offs have been completed for companies in a diverse group of industries. Only three sectors – Consumer Discretionary, Industrials, and Financials – accounted for more than 10% of spin-off announcements, and none of these represented as much as 15% of the total. Spin-offs have been more prevalent in sectors such as Industrial and Consumer, where conglomerates are more commonplace.

**Top 10 Sectors for Spin-offs**

| Sector | Deal Count |
|---|---|
| Consumer Discretionary | 100 |
| Industrials | 96 |
| Financials | 92 |
| Information Technology | 60 |
| Materials | 54 |
| Energy | 41 |
| Healthcare | 27 |
| Consumer Staples | 26 |
| Utilities | 18 |
| Telecommunications Services | 11 |

Source: Capital IQ.

# Case Study: Kimball International, Inc.'s Spin-off of Kimball Electronics, Inc.

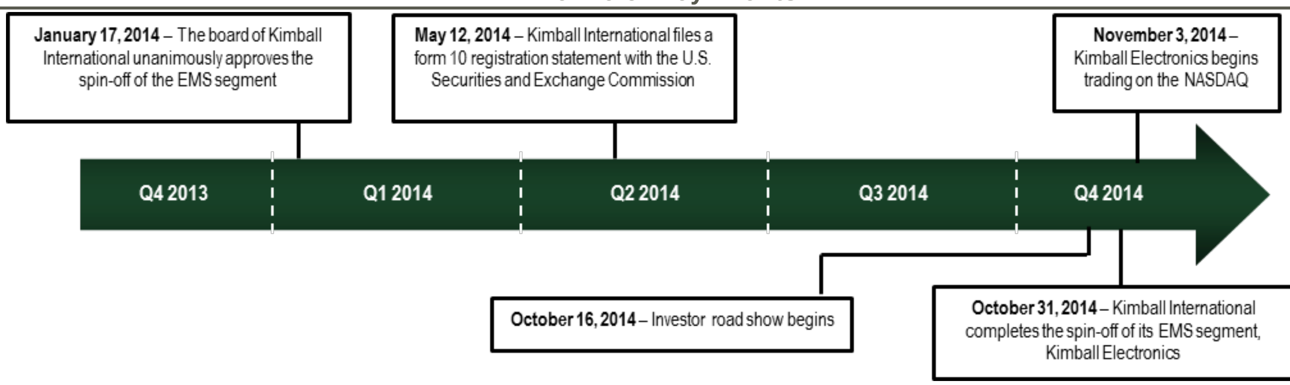
Kimball International

Kimball Electronics
Lasting relationships. Global success.

## Pre-Spin-off Overview

- Kimball International entered 2014 as a publicly-traded corporation with two major segments: furniture and electronics manufacturing services (EMS)
- Kimball and Baird discussed a potential spin-off of the EMS segment
    - The combined company traded at a discount to both the EMS and Furniture peer groups
- Baird advised Kimball that a spin-off of the EMS segment would address the conglomerate discount, although a discount related to its small market capitalization would likely persist
    - EMS would be a pure-play, small-cap electronics design and manufacturing business
    - The remaining company would consist solely of the furniture business
- Factors that lowered execution risk for a spin-off:
    - Seasoned management team
    - No customer/functional overlap among subsidiaries
    - No capital transfer or allocation needed
- The spin-off was expected to accomplish important objectives for Kimball, including:
    - Permitting focus on the remaining company
    - Establishing pure-play valuations to lift overall multiple
    - Increasing certainty of 100% disposition that is tax-free to the parent company
    - Executing a transaction that is not as dependent on the stock market as an IPO
    - Giving shareholders the first opportunity to retain upside in EMS stock or generate liquidity through the sale of distributed stock in the EMS business

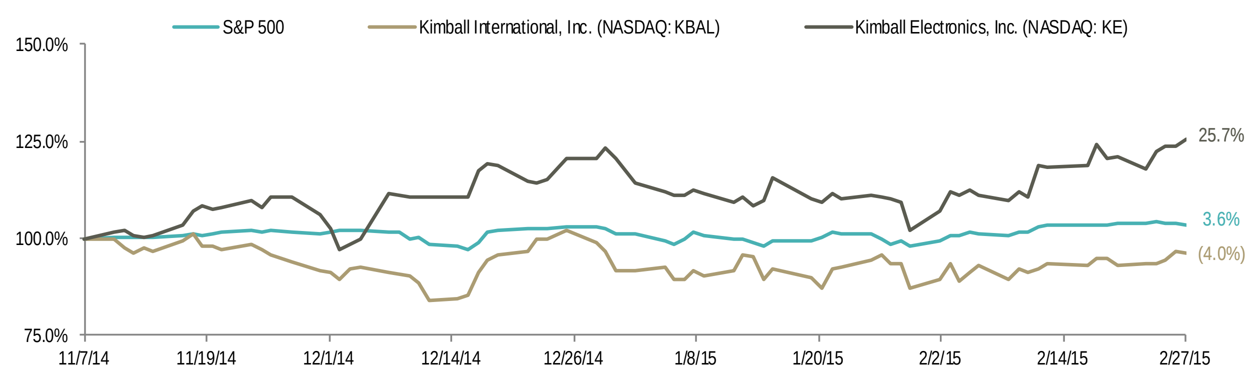
## Timeline of Key Events




## Outcomes Summary

- Baird served as the exclusive financial advisor to Kimball International in the spin-off of Kimball Electronics, assisting in evaluating the merits of a spin-off, developing an investor communications strategy, composing public marketing materials, and selecting a stock exchange
- Baird and Kimball management conducted a two-day road show in mid-October 2014
- Kimball Electronics, Inc. rose 25.7% from 11/7/14 to 2/27/15, far outpacing the S&P 500
- Kimball International, Inc. declined slightly during the same period
- Combining ownership of both, total shareholder returns since the spin-off were 8.4%, exceeding the S&P 500 performance
- Combined market cap of $629 million 30 days post-spin

## Stock Performance Since Spin-off




Source: Capital IQ. Chart excludes the first week of trading for KE and standalone KBAL due to unusual price swings during this period.

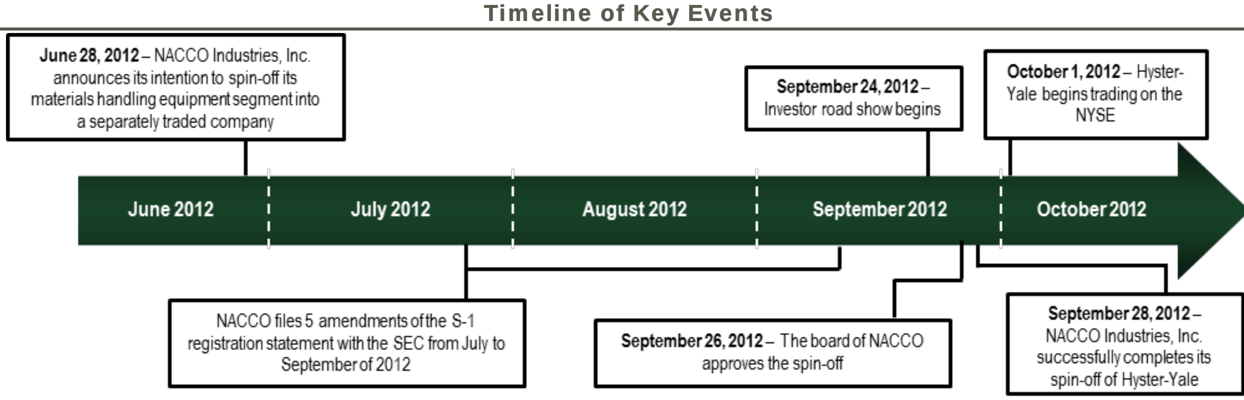
# Case Study: NACCO Industries, Inc.'s Spin-off of Hyster-Yale Materials Handling, Inc.

NACCO Industries, Inc. | HYSTER-YALE MATERIALS HANDLING

## Pre-Spin-off Overview

- NACCO entered 2012 as a publicly-traded conglomerate with businesses in material handling equipment, coal mining, home appliances, and specialty retail
- NACCO and Baird discussed a potential spin-off of its materials handling group (Hyster-Yale) in response to NACCO trading at a substantial discount to the industrial universe, largely reflecting the conglomerate discount
  - Hyster-Yale represented 76% and 60% of NACCO's pre-spin net sales and operating income, respectively
- Baird advised NACCO that a spin-off of Hyster-Yale could unlock significant value
  - Hyster-Yale expected to trade closer to lift truck peers, with substantial multiple arbitrage anticipated based on favorable investor reaction to industrial spin-offs and stock offerings, as well as varied valuation analyses
  - Post-spin NACCO seen as maintaining its trading profile
- Several attributes of Hyster-Yale reduced execution risk:
  - Independent business with global scale and resources
  - Experienced management team
  - No customer/functional overlap with other subsidiaries
  - No capital transfer or allocation required
- The spin-off was expected to accomplish important objectives for Hyster-Yale, including:
  - Create flexibility to pursue strategic growth opportunities
  - Improve ability to respond to changing market conditions and to pursue growth opportunities
  - Enhance access to equity/debt capital markets
  - Strengthen alignment of senior management incentives with needs and performance of the company
  - Provide more focused investment option for investors

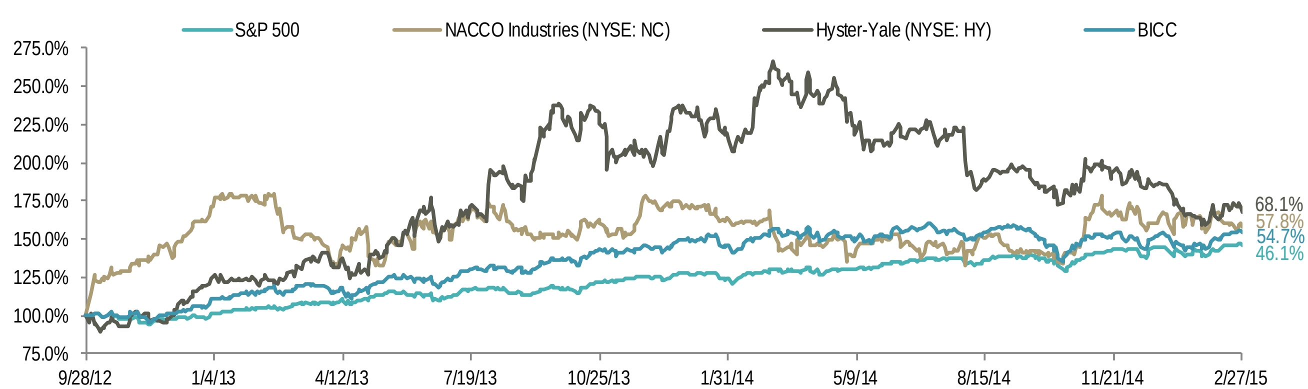
## Timeline of Key Events




## Outcomes Summary

- Baird was NACCO's lead financial advisor in the spin-off of Hyster-Yale, assisting in evaluating the merits of a spin-off, developing an investor communications strategy, authoring public marketing materials, and selecting a stock exchange
- Baird and Hyster-Yale management conducted a five-day road show that included 50 institutions
- From the completion of the spin-off on 9/28/12 to 2/27/15, Hyster-Yale's stock increased 68.1%, outperforming the S&P 500 and the Baird Industrial Company Composite index
- NACCO Industries' stock rose 57.8% over the same period, also outperforming broad indices
- Combined market cap of $1.9 billion 30 days post-spin

## Stock Performance Since Spin-off




Source: Capital IQ. Baird Industrial Company Composite ("BICC") represents 517 companies which Baird views as indicative of the publicly traded industrial company universe.

# Baird's Spin-off Transaction Experience

## BAIRD ADVISED ON TWO RECENT SPIN-OFF TRANSACTIONS

**Baird Spin-Off Transactions**

$281,200,000*

Kimball International

Spin-off of

Kimball Electronics Group

$662,900,000*

NACCO Industries, Inc.

Spin-off of

Hyster-Yale Materials Handling, Inc.

The above transactions represent select Baird transactions. Please visit www.rwbaird.com/investment-banking for a list of all Baird transactions.
*Approximate market capitalization of the spun-off company 30 days after the spin-off.

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