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Doing the spin-out



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There are three ways to spin out a company—and many ways to get it wrong. A parent company must decide not just which method of reorganization suits it best but also how to execute its chosen plan for its own and the shareholders' benefit.

Collectively, spun-out companies and their parents have demonstrated the benefits of ownership restructuring by outperforming the market indexes. Yet individually, the picture is different: the ranks of spin-outs include as many laggards as sprinters (Exhibit 1, on the next page). A previous article¹ examined the advantages of restructuring, the methods available, and which to choose to the best advantage of parents, shareholders, and spin-outs. Here we consider how to unleash the greatest possible shareholder value by addressing the organizational challenges that these types of restructurings involve.

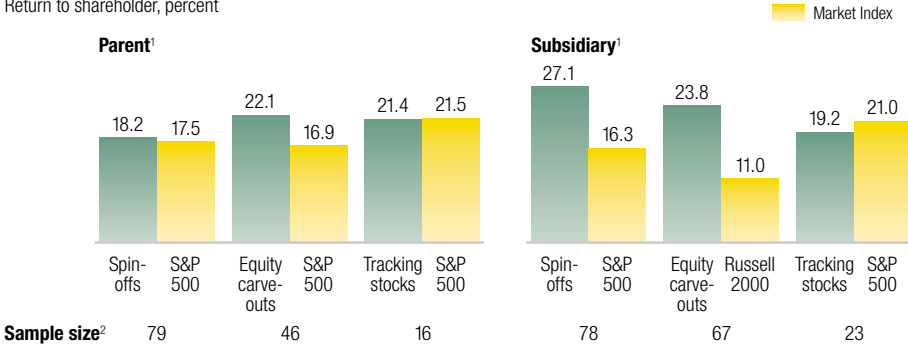
¹Patricia L. Anslinger, Steven J. Klepper, and Somu Subramaniam, "Breaking up is good to do," *The McKinsey Quarterly*, 1999 Number 1, pp. 16–27.

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EXHIBIT 1

Major spin-offs, carve-outs, and tracking stocks: 1988–96

Return to shareholder, percent

¹Total return to shareholders based on two-year compound annual growth rate.²Companies measured met the following criteria: equities were listed on US exchanges; revenues of parent company exceeded \$200 million; companies were not financial institutions; data were available through Bloomberg and Compustat.

Source: Bloomberg; Compustat; Standard & Poor's; Zacks Investment Research; McKinsey analysis

Any big corporation that wishes to grant a subsidiary some freedom to tap the power of financial markets has three choices (*see* sidebar, “Restructuring before the market speaks”). It can spin off the subsidiary by selling its entire stake to the public—usually, as a special stock dividend—and creating a new company with a separate and independent board. It can undertake an equity carve-out, issuing or selling a portion of its equity in the subsidiary to the public and (usually) keeping a majority stake in the new company, which has a separate board, assets, liabilities, and officers. Or it can create a tracking stock: a separate class of the parent company’s stock that has a claim on the cash flow generated by the tracked unit and is intended to reflect that unit’s performance. In the case of tracking stocks (also called letter or target stocks), no separate legal entity or governance structure is created.

Each type of restructuring results in the formation of new equity, owned by a fresh set of shareholders who demand a degree of accountability from the spun-out entity, which—unlike a subsidiary, cushioned within a larger corporation—is accountable to a set of shareholders, not to the parent company’s senior management. The accountability created by restructuring often improves performance, and investors also benefit from the greater visibility of the spun-out entities to analysts and the public. Even when a unit continues to be governed by its parent’s board, as with a tracking stock, the existence of a separate set of shareholders means that the cash flow and profitability of the unit are distinct from those of its parent. Recently, a large number of parent companies have decided to spin out their Internet-related businesses (Exhibit 2, on the next spread), and so far the market has responded favorably to most of these issues. How well the companies have managed the organizational challenges involved remains to be seen.

Restructuring before the market speaks

In the past, companies usually restructured in response to market pressure. Sometimes the market valuation of a company was low because it was performing poorly. Sometimes the problem was not performance as such but a lack of transparency, causing healthy subsidiaries and divisions to escape the attention of analysts and investors. But our most recent research shows that companies have begun to restructure before the market speaks. The resulting organizational changes can be a powerful part of a broader strategic plan (exhibit). Here, we examine a number of nonmarket factors that might signal a need to restructure.

A failure to attract highfliers. The best people might want to work only for businesses that dominate their preferred fields. Thus a big pharmaceutical company that has no difficulty recruiting talent for its main business could find it hard to attract people with sufficient consumer packaged-goods experience to a subsidiary selling everything from candy to personal-care products. This problem, which afflicts many conglomerates, can outweigh the synergies that a diverse group of businesses may seem to offer.

Mismatched business models. After buying Unigraphics—a CAD/CAM software business—from McDonnell Douglas in 1991, EDS realized that its new subsidiary was operating on the basis of a software business model different from its own. Its new subsidiary's research-and-development and sales-and-marketing expenses, for example, exceeded 45 percent of revenue—a far higher proportion than EDS was accustomed to spending in these areas. After a few years, EDS carved out Unigraphics.

More efficient decision making. The headquarters

people who make capital-budgeting decisions depend on the often-inflated representations of division managers in a way that capital markets almost never do. By spinning off a division, a parent hands this problem to the market. Indeed, in the two years following a restructuring, the leading spin-offs and tracking-stock issues of the past decade enjoyed an average increase in return on invested capital of more than 50 percent.

Can't keep up with the Joneses. Senior management sometimes neglects business units or functions because they are not as efficient or value-creating as their independent counterparts. These, too, can be good candidates for carve-outs.

Subsidiary needs wings to grow. Because the health care information industry was consolidating, AMBAC, a financial-services firm, saw that its subsidiary, HCIA, would have to grow larger. AMBAC didn't want to make any acquisitions itself, however, since the gap between its stock's multiple and that of the typical health care information provider made any such transaction highly dilutive. So it carved out HCIA in the expectation that its stock would achieve a higher price-to-earnings ratio, making it a more powerful currency with which to finance the acquisition of another provider.

EXHIBIT

The trend to strategic restructuring

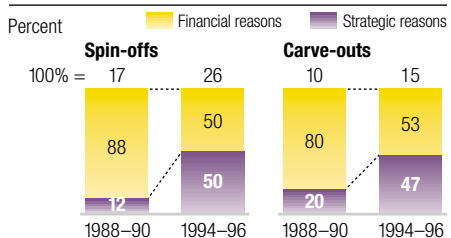


EXHIBIT 2

E-commerce spin-offs, carve-outs, and tracking stocks: August 1988–July 1999

	Parent	Subsidiary	Parent's retained ownership, percent	Market capitalization, \$ million
Spin-offs	Pittway	Penton Media	Not applicable	373 / 591
	Stac Software	Hi/fn	Not applicable	130 / 432
Carve-outs	Reuters Group	TIBCO Software	64.4	881 / 6,957
	Toronto-Dominion Bank	TD Waterhouse Group	88.8	6,540 / 9,000
	Medical Manager	CareInsite	73.0	1,252 / 3,793
	Barnes & Noble	barnesandnoble.com	41.0	450 / 2,857
	CMGI	Engage Technologies	81.6	690 / 2,533
	Carso Global Telecom	Prodigy Communications	49.6	885 / 1,759
	CBS	MarketWatch.com	38.3	200 / 660
	True North Communications	Modem Media.Poppe Tyson	52.9	80 / 620
Tracking stocks	Donaldson, Lufkin & Jenrette	DLJ Direct	84.0	1,700 / 1,796
	Ziff-Davis	ZDNet	84.0	1,359 / 1,796

¹As of November 24, 1999.
Source: Hoover's Online; Bloomberg; McKinsey analysis

Whatever may be the chosen method of restructuring, the parent and the new entity alike must establish fresh relationships, both between themselves and with their employees and the stock market. The former subsidiary must learn to stand separately—but not so separately that it can threaten the parent—and must develop its own performance culture; the parent must create new incentives to motivate the former subsidiary's new management team.

Motivating the spin-out: Incentives and team structure

One of the main reasons for restructuring is the desire to motivate management, not only with a new strategy, but also with equity-based incentives. High-technology industries offer particularly meaty rewards. A review of 15 carve-outs undertaken in the sector since 1996 revealed that, on average and irrespective of market capitalization, each company's CEO and senior management team were collectively awarded options worth \$8 million to \$10 million.

When Case Corporation was carved out of Tenneco, in June 1994, Tenneco gave Case's top management options representing 1.8 percent (worth \$9.8 million) of Case's outstanding shares as part of a long-term incentive plan. This amounted to little more than 1 percent of the \$780 million value of Case's IPO, but by the end of 1996 the top five executives had pushed up the stock price so far that their compensation reached \$70 million. Among carve-outs in general, teams whose units outperformed the relevant market indexes earned an average of almost \$1.7 million a year from options—approximately twice the \$860,000 earned by teams whose units underperformed.

Incentives of this order must of course go to the right team. Many corporate parents retain subsidiary-level management when they should be recruiting executives with experience at public companies. Even long-standing managers of a privately held subsidiary can be unprepared for the challenge of managing a newly public company and dealing with shareholders and their expectations. Lucent Technologies accomplished this by making Henry Schacht—the longtime chairman and CEO of Cummins Engine and a board member of Lucent's former parent, AT&T—its first CEO and charging him with the task of mentoring the telecom equipment maker's heir apparent, Chief Operating Officer Rich McGinn, over two years.

Achieving a healthy separation

Separating a business from its parent can create a strategic conundrum, so it is advisable for a subsidiary to define its strategic focus before a restructuring. Lucent, for example, agreed to stay out of public-switched services, one of AT&T's core operations. But Vastar, an oil exploration-and-production business of which ARCO, its parent, carved out a 17.7 percent interest, risked strategic conflict when it bid against ARCO for projects in the same territories. To give Vastar space to grow, ARCO decided to focus its business units on international opportunities and let Vastar concentrate on the United States.

Although the strategies of a parent and its former subsidiary may be separate, their activities often remain entangled. In cases where each party sells goods and services to the other, for example, pricing these transfers becomes the most critical issue in the relations between the two companies. When General Motors spun off EDS (a data-processing company) in 1996, GM was contributing about 35 percent of its revenues—such a large portion that its market valuation depended on the transfer prices. To resolve the concerns of shareholders, EDS negotiated a preferred-customer price contract with a ten-year term. In general, prices must be set at levels that are fair to each party and its shareholders. Industry benchmarks, such as the forward price of gas, which Enron uses to set prices between itself and the carved-out company Enron Oil and Gas, are helpful. An independent audit committee of the board of directors, appointed to oversee purchase agreements, can be as well.

But beware. If the level of interaction is high because technologies, services, and brands are shared, these agreements can become so complicated that there may be little value in separating. Indeed, extra costs can outweigh the carve-out's benefits, which in any event accrue mostly to the subsidiary. Between 1987 and 1994, ARCO, for instance, undertook three equity carve-outs, requiring in all at least 26 separate agreements to delimit the boundaries of the various businesses. "It became prohibitively expensive to create

all the appropriate tracking mechanisms,” says one person close to the negotiations. “ARCO became exhausted by all of this.” Although these carve-outs did improve ARCO’s performance, the cost of the extra complexity ate into this improvement.

Retaining influence and managing risk

Although spinning out is intended to promote independence, a parent should retain enough influence over the subsidiary to ensure that the two continue to work in harmony. Genzyme struggled with this issue in its first carve-out—that of its testing division, IG Laboratories, in 1990. Even after the carve-out was completed, Genzyme continued to rely heavily on IG to test prototype drugs. Because IG became increasingly unwilling to accommodate the needs of its former parent, in 1995 Genzyme decided to repurchase the outstanding shares. The right to act in this way—either at the parent’s discretion or only in particular situations—must be disclosed to prospective shareholders.

Most parent companies aim to preserve their influence by nominating some of their executives for membership on the carve-out’s board, though that body has a legal duty to act in the interest of all shareholders. Executives of parent companies serve on the boards of almost all US majority-owned carve-outs. In 65 percent of these, an executive of the parent is the subsidiary’s chairman, and in more than 60 percent, three or more representatives of the parent sit on the boards, which have an average of seven directors.

Links between parent and subsidiary are closest if office-holders fill executive positions in both, though only 40 percent of the majority owners of US carve-outs exercise influence in this way. When they do, parents most often appoint their own executives as the chief executive officers or chief financial officers of the carve-outs. On carving out Genzyme Transgenics, Genzyme filled not only the CEO and CFO positions but also the chairmanship with its own executives. Harcourt General went even further, appointing its own managers as chairman and CEO, CFO, and COO of its subsidiary Neiman Marcus, which it recently spun off without making any changes in the top management of either company. To review the issues that arise when executives serve both parent and subsidiary, many parent companies set up board compensation committees whose tasks include setting levels of compensation that reflect the executives’ performance in these dual roles.



Wielding influence in this fashion can have important benefits for the parent: close links can help improve operational coordination as well as prevent

carve-outs from acting in ways that could damage their parents. Such benefits must not, however, be gained at the new company's expense. According to an executive of a less successful carve-out, its parent company believes that it exists only to support the parent. Thus, although the carve-out desperately needs greater liquidity to make acquisitions, the parent insists on maintaining no less than an 80 percent share for its own tax purposes; meanwhile, the industry is consolidating quickly.

Once the parent has worked out its relationship with the carve-out, it must consider the minority shareholder, a burden the parents of wholly owned subsidiaries don't have. The common-law systems of the United States and the United Kingdom are committed to protecting shareholders, particularly minority shareholders. A parent that repurchases shares in its subsidiary for too high a price, for example, risks a suit filed by its own shareholders, and a parent that pitches the price too low risks a suit from the subsidiary's. When Royal Dutch/Shell attempted in 1984 to repurchase the part of Shell Oil it did not already own, minority shareholders rejected Royal Dutch/Shell's offer and sued under the laws of the State of Delaware, where Shell Oil was incorporated, for a fairness opinion. To settle the suit, Shell agreed to pay all outstanding shareholders an additional \$2 a share.

The voting rights of minority shareholders of tracking stocks must likewise be taken into account. When Georgia-Pacific issued tracking stock in its timber business, it linked the voting rights of the tracking stock's shareholders to the stock price of the timber business. As that business grew to represent a larger proportion of the parent's total market capitalization, holders of the tracking stock gained additional voting rights. *MQ*