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Delve deep to find the good spin on spun-off companies

Whitney Tilson
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The deal machinations many companies put themselves through, while certainly a bonanza for investment bankers, can confound the typical investor.

A Cendant or a Tyco, say, spends billions of dollars to grow by acquisition only to reverse course a few years later and break itself up. The quest for synergy and economies of scale gives way to a desire for focus and flexibility – all, of course, in the name of creating shareholder value.

As wasteful as all this can be, the breaking-up process can provide fertile ground for investment – an experience confirmed by numerous studies. This is particularly true in the case of spin-offs, in which one or more corporate divisions that are no longer deemed to fit together are spun out to existing shareholders as separately traded entities. Among many recent examples: First Data, which separated from Western Union; Viacom breaking out CBS; InterActive Corp spinning off Expedia; and Realogy, which was spun off from Cendant.

While all spun-out companies will clearly not be winners, there are built-in inefficiencies in the process that can work to the benefit of savvy investors.

Shares of spin-offs often face immediate selling pressure, as the new company may not have the market capitalisation required by a big fund's charter or must be immediately sold because it is not in a particular index. In addition, growth companies often spin off cyclical or low-growth divisions, which the growth investors who own the parent company stock immediately sell, irrespective of price.

A final reason spin-offs can perform so well is basic capitalistic motivation. Famed investor Joel Greenblatt puts it well in his classic book, *You Can Be A Stock Market Genius*: "When a business and its management are freed from a large corporate parent, pent-up entrepreneurial forces are unleashed. The combination of accountability, responsibility and more direct incentives take their natural course."

All of these dynamics were at work when Motorola spun off Freescale Semiconductor in mid-2004. When the stock price languished in the mid-teens, smart investors such as Greenlight Capital's David Einhorn pounced. He believed the business would be run very differently as a stand-alone company.

In particular, he expected Freescale's lousy historical margins to dramatically improve as the company stopped spending money on large-scale capital spending projects that might have made sense in a broader Motorola context, but certainly would not for an independent company.

Einhorn and other early Freescale shareholders (ourselves included) were paid handsomely for looking beyond past performance: After engineering a tremendous turnround in its business, Freescale sold itself last year to a consortium of private-equity buyers for $40 a share.

What spin-offs look appetising today? We own two: Western Union, which was spun off by First Data in late September and on which we already have a healthy gain, and Mueller Water Products, which was spun off by Walter Industries in May.

Western Union provides money- transfer services worldwide, primarily through a network of 285,000 agent locations in more than 200 countries and territories. It is an extraordinary business, with 30 per cent operating margins and virtually infinite returns on capital. At first glance, with earnings down slightly in 2006 and projected to be flat in 2007, the stock appears fully valued at just over 20 times 2007 earnings estimates, but we think the company has plenty of growth left in it and we are willing to pay a high multiple of earnings for a business of this quality. If the stock drops below $20, from today's level of nearly $23, we'll likely be adding to our position.

Mueller is the leading North American provider of water infrastructure and flow control products – things such as fire hydrants, valves, pipes, fittings and couplings. While this is no doubt a mundane business, it is also an excellent one.

Mueller has a strong competitive position, with one of the largest installed bases in the US and 74 per cent of sales coming from products with number one or two market positions.

Adjusted for one-time charges, its operating margin was 14 per cent in its latest fiscal year and revenue, earnings before interest, tax, depreciation and amortisation and operating income grew 11 per cent, 30 per cent and 42 per cent, respectively. Future growth prospects are excellent, as the crumbling US water infrastructure – the American Society of Civil Engineers gave US drinking-water and wastewater infrastructure a grade of "D-" in 2005 – will require billions of dollars of new investment during the next few decades.

So what is Mueller worth? Using three different valuation methodologies – private market value, peer public company multiples and a sum-of-the-parts analysis, we think Mueller shares are worth in the mid-$20s, versus under $15 today. We think that is plenty cheap for a stable, high-quality business and have been buying aggressively at today's prices.

Whitney Tilson is a money manager who co-edits Value Investor Insight and co-founded the Value Investing Congress. E-mail: feedback@tilsonfunds.com