



# CAPACITARTE



SUPPLEMENTARY MATERIAL

# Corporate Futures: Big Names, Big Risk<sup>1</sup>

By [Eric Fox](#) | March 29, 2010 — 2:00 AM EDT

The conventional wisdom held by the public is that [futures](#) and other [derivatives](#) are "weapons of financial mass destruction" that are a source of considerable risk for companies and investors. While there is some truth in this statement, large multi-national corporations that use these financial instruments responsibly can decrease risk in conducting business operations by protecting the value of assets, liabilities, revenues and cost inputs. (Want a solid understanding of futures contracts are, how they work and why investors use them? Check out [Futures Fundamentals](#).)



## Disney Downs Currency Risk

Many large corporations use derivatives to [hedge](#) risk because it does substantial amounts of business overseas, and are paid in currencies other than the U.S. dollar. These holdings of foreign currency are not always [repatriated](#) to the U.S. immediately, and can reach considerable size.

Let's use Disney as an example. Disney has considerable operations in Europe, Asia and other international locations and uses derivatives to hedge its exposure to the euro, the British pound, the Japanese yen, and the Canadian dollar.

Disney uses option and forward contracts to hedge its exposure out as many as five years. The company uses the gains and losses on these contracts to offset the change in the U.S. dollar equivalent of these foreign currency holdings. (Before entering this market, you should define what you need from your broker and from your strategy. Don't miss [Getting Started In Forex](#).)

## Intel's Interest Rate Risk Reduction

Many companies have assets or liabilities on its [balance sheet](#) that it wants to protect from a change in interest rates and it can do so with derivatives.

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<sup>1</sup> <http://www.investopedia.com/financial-edge/0310/corporate-futures-big-names-big-risk.aspx#ixzz4gonN4k7l>

Intel uses [interest rate swap](#) agreements to hedge its holdings of fixed-rate debt instruments that have maturities of more than six months. The company swaps its fixed rate payments into three-month U.S. dollar [LIBOR](#)-based returns.

Intel reported a \$1.7 billion notional amount of interest rate swaps as of the end of 2009.

### **Anadarko Protects Revenue**

Other companies use futures and other derivatives to hedge risk because the products they sell are [commodities](#) whose price is subject to volatile fluctuations in price. Futures and derivatives are used to fix the revenue that the company will receive for the commodities it sells.

Energy companies are heavy users of various futures and other derivatives to hedge this commodity risk. Anadarko Petroleum is one of the largest independent oil and gas companies with properties in the Gulf of Mexico, the onshore U.S, and other areas. The company expects to produce as much as 231 million barrels of oil equivalent (BOE) in 2010, and uses hedges to lock in a range of prices for the oil and natural gas it sells.

Anadarko Petroleum currently has 69% of its oil volumes hedged in 2010 at various prices. This percentage drops to 34% for 2011. Natural gas volumes are also hedged, and Anadarko Petroleum has 75% of its deliveries hedged in 2010, and 25% in 2011. (Find out how the everyday items you use can affect your investments in [Commodities That Move The Markets](#).)

Other companies are heavy users of commodities to conduct business operations. Alcoa is a major producer of Alumina and metal products, and 29% of its total refining production costs are from power generated by fuel oil or natural gas. The company uses futures and [forward contracts](#) to protect itself from unanticipated increases in these commodity prices.

### **The Bottom Line**

Futures and other derivatives are vital tools for companies to reduce risk in business operations and are used as a hedge against a change in value of assets, currencies, revenues and the cost of production inputs. There shouldn't be any worry as long as they are used to hedge and not speculate.

COMMODITIES | Thu May 11, 2017 | 3:58pm EDT

# Options bulls betting on U.S. energy stocks after oil rebound<sup>2</sup>

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- By [Saqib Iqbal Ahmed](#) | NEW YORK

Some U.S. equity options traders are betting that the recent rebound in the price of crude oil spells good news for the battered energy sector.

The S&P energy index is still down about 9.9 percent this year, making it the second worst-performing sector among S&P's tracking indexes. That contrasts against the broad benchmark S&P 500 stock index, which is up 6.9 percent for the year.

Recent trading in the options market, however, shows traders putting on bullish bets in both options on exchange traded funds exposed to the energy market and individual stocks.

"The commodity has sort of turned and bounced off the low around \$46 and with that you've had an obvious bid to the upside," said Jim Strugger, MKM Partners derivatives strategist said about the price for a barrel of crude oil.

Brent, which fell to a five-month low of \$46.64 last week amid concern over slowing demand, a rising U.S. dollar and increasing U.S. crude output, has recovered some ground.

Large drawdowns in U.S. inventories and growing support for continued output cuts by the Organization of the Petroleum Exporting Countries boosted confidence that a seemingly insurmountable glut might finally diminish.

Strugger pointed to the United States Oil Fund LP, VanEck Vectors Oil Services ETF and Energy Select Sector SPDR Fund, as energy-related funds where the options market was showing a bullish bias.

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<sup>2</sup> <http://www.businessinsider.com/r-options-bulls-betting-on-us-energy-stocks-after-oil-rebound-2017-5>

For the United States Oil Fund, there are 1.1 calls open for every open put, the most since late March, highlighting traders' bullish bias, according to data from options analytics firm Trade Alert.

"If oil rises to the top end of its recent range or even stabilizes within this range, the energy sector could do a little bit better," Strugger said.

Bullish options on individual stocks have also been in demand.

EnSCO Plc, Nabors Industries Ltd, Patterson-UTI Energy Inc, Encana Corp, Diamond Offshore Drilling Inc and Superior Energy Services Inc are some stocks that have drawn near-term upside positioning, Christopher Jacobson, derivatives strategist at Susquehanna Financial Group, said in a note on Thursday.

"There are a lot of incredibly burned-out energy names that could be good for a real bounce," MKM's Strugger said.

The Organization of the Petroleum Exporting Countries meets on May 25 and will discuss extending its agreement forged with a number of its rivals, including Russia, late last year to cut output by 1.8 million barrels per day in the first half of 2017.

(Reporting by Saqib Iqbal Ahmed; Editing by Daniel Bases and Lisa Shumaker)

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# Why Hedge Funds Are Not Living Up to Their Return Hype<sup>3</sup>

By [Andrea Travillian](#) | November 2, 2015 — 12:10 PM EST

Bring up the topic of [hedge funds](#) at a cocktail party and the first thing to pop into most people's minds may very well be their performance, exclusivity and protection from market downturns. But those impressions may have little to do with reality. Hedge funds, as a group, don't produce better returns than [index funds](#) or protect your investment any better than a well-balanced [asset allocation](#). In reality, not



having access to this exclusive investment or choosing to avoid it all together is saving you money. Let's dive in and look at exactly what hedge funds are supposed to do and why they just don't live up to the hype of a great investment.

## Purpose of a Hedge Fund

The original purpose of a hedge fund was to minimize the [risk](#) of long-term investment positions, while at the same time trying to maximize profits. It originally began as a [long/short strategy](#) with some [leverage](#) added in. This is how they came to have the name hedge funds — they were [hedging](#) the risk out of the investment. (For more, see: [A Brief History of the Hedge Fund](#).)

Over the years as the funds produced great profits for those that ran them, more and more money managers were attracted to starting a hedge fund. As more hedge funds were created the emphasis on hedging investment losses became second priority to providing aggressive high returns

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<sup>3</sup> <http://www.investopedia.com/articles/financial-advisors/110215/why-hedge-funds-are-not-living-their-return-hype.asp#ixzz4gpKrEjq3>

through [illiquid](#) and risky investments. With the move away from the original purpose and the increase in funds, performance began to decline.

Here are some of the reasons these funds are not making the money they should or preserving capital.

### **High Fees**

Most hedge funds charge a 2% management fee plus 20% of the profits that they create, without sharing in the downside when there are losses. While these fees have come down in recent years with increased competition, they are still higher than you would pay in other investments. Even with some funds offering deals where there are [clawback](#) provisions, where you get some money back when there is a loss, there are still a lot of fees to overcome. (For more, see: Hedge Funds: [Higher Returns or Just High Fees?](#))

Overcoming fees is one of the hardest thing for any investment to do. The higher that number the harder it is to give your investors returns. If you make 10% and have fees of at least 2% then you really only made 8%. Where this really hurts is when the funds are not doing as good as the indexes. If an index returns the same 10%, you are underperforming by a full 2%.

### **Replicating Passive Investments**

Recent studies have shown that an overwhelming majority of hedge funds are not engaging in real [active management](#) to obtain a higher return. They are instead replicating many passive investment strategies such as traditional indexes or [smart beta strategies](#). Australia's Monash University recently published a [paper](#) that showed this phenomenon. It even showed that those hedge funds that were actually using active management to try and outperform indexes were performing worse than the hedge funds that were more passive. So those that were actually running like a hedge fund were bad at it. (For more, see: [What's the Difference Between Alpha and Beta?](#))

### **Lagging Returns**

Now that hedge fund investors are paying for passive returns it becomes even more painful to learn that the hedge funds are doing no better than a standard [balanced fund](#) that has an allocation of 60% stocks and 40% bonds at protecting them from risk in the market. Vanguard did a [study](#) that showed that hedge funds had the same downside protection of this balanced group of mutual funds during the 2008 market crash.

From November 2007 to February 2009 hedge funds were down from an average monthly rate of -2% to 1.3%. At the same time, a portfolio of 60% stocks and 40% bonds was down 2.3%, while the overall market was down an average monthly rate of 4.2%. When you add in fees, those in the hedge fund have to have a greater return to get back to zero than those in the balanced portfolio. (For more, see: [6 Reasons Hedge Funds Underperform.](#))

Even after the comeback in the markets, hedge funds are consistently underperforming the [S&P 500](#). The Barclay Hedge Fund Index showed a 2.88% gain in 2014 when the S&P 500 returned 13%. Not exactly the return you think you will be getting.

### The Bottom Line

It may sound like a great idea to get into hedge funds, especially when they seem like they are the hot thing to do with your investments. The poor performance of hedge funds are not worth the extra fees you have to pay just to be in them. Your money would be better served finding a good [index fund](#) and keeping your asset allocation properly balanced. (For more, see: [Hedge Fund Due Diligence.](#))



# How Hedge Funds Held Argentina for Ransom<sup>4</sup>

By MARTIN GUZMAN and JOSEPH E. STIGLITZ

APRIL 1, 2016

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<sup>4</sup> [https://www.nytimes.com/2016/04/01/opinion/how-hedge-funds-held-argentina-for-ransom.html?\\_r=0](https://www.nytimes.com/2016/04/01/opinion/how-hedge-funds-held-argentina-for-ransom.html?_r=0)



PERHAPS the most complex trial in history between a sovereign nation, [Argentina](#), and its bondholders — including a group of United States-based hedge funds — The resolution was excellent news for a small group of well-connected investors, and terrible news for the rest of the world, especially countries that face their own debt crises in the future.

In late 2001, Argentina defaulted on \$132 billion in loans during its disastrous depression. Gross domestic product dropped by 28 percent, 57.5 percent of Argentines were living in poverty, and the unemployment rate skyrocketed to above 20 percent, leading to riots and clashes that resulted in 39 deaths.



Unable to pay its creditors, Argentina restructured its debt in two rounds of negotiations. The package discounted the bonds by two-thirds but provided a mechanism for more payments when the country's economy recovered, which it did. A vast majority of the bondholders — 93 percent — accepted the deal.

Among the small minority who refused the deal were investors who had bought many of their bonds at a huge discount, well after the country defaulted and even after the first round of restructuring. These kinds of investors have earned the name vulture funds by buying up distressed debt, then, often aided by lawyers and lobbyists, trying to force a settlement.

The companies involved included some of the best-known vulture funds, including NML Capital, a subsidiary of Elliott Management, a hedge fund co-led by Paul Singer, a major contributor to the Republican Party, as well as Aurelius Capital and Dart Management. NML, which had the largest claim in the Argentina case, was the lead litigant of a group of bondholders in New York federal courts.

For a long time, Argentina refused to pay the holdouts. The funds tried all sorts of ways to change the country's position, including, at one point, having an iconic Argentine ship seized in Ghana.

Then a 2012 ruling by Judge Thomas Griesa of the United States District Court for the Southern District of New York threw the game in the vulture funds' favor, ruling that Argentina had to pay them back at full value, a cost to Argentina of \$4.65 billion. NML, for example, would get a total return of 1,500 percent on its initial investment, according to our calculations, because of the cheap prices it paid for the debt and because of a "compensatory" interest rate of 9 percent under New York law.

The ruling, which became effective in 2014, did something else: Judge Griesa issued an injunction blocking Argentina from paying *anything* to the creditors who had accepted the deal until it had paid the vultures *in full*.

The judge gave the vultures the weapon they needed: Argentina had to either pay them off or renege on the default they had negotiated, ruining the country's credit in the future and threatening its recovery.

On Thursday, Argentina finally settled for something close to the terms that Judge Griesa set. NML Capital will receive about half of the total agreement — \$2.28 billion for its investment of about \$177 million, a total return of 1,180 percent. (Argentina also paid the legal fees for the vultures.)

This resolution will carry a high price for the international financial system, encouraging other funds to hold out and making debt restructuring virtually impossible. Why would bondholders accept a haircut if they could wait and get exorbitant returns for a small investment?

In some ways, Argentina was an outlier. It fought aggressively for the best terms from the initial set of bondholders, setting the stage for a spectacular recovery: From 2003 to 2008, until the global financial crisis intruded, the country grew 8 percent per year on average, and unemployment declined to 7.8 percent from more than 20 percent. In the end, the creditors who had accepted the initial restructuring got the principal value in full and even 40 percent more.

Most countries are intimidated by the creditors and accept what is demanded, with often devastating consequences. According to our figures, 52 percent of sovereign restructurings with private creditors since 1980 have been followed by another restructuring or default within five years. Greece, the most recent example, restructured its debt in 2012, and only a few years later it is in desperate need of more relief.

It's common to hear the phrase "moral hazard" when looking at countries that face crushing debt, like Greece or Argentina. Moral hazard refers to the idea that allowing countries (or companies or people) to renegotiate and lower their debts only reinforces the profligate behavior that put them in debt in the first place. Better that the debtor faces disapproval and harsh consequences. But the Argentina deal reversed the moral hazard by rewarding investors for making small bets and reaping huge rewards.

# Mergers and acquisitions are starting to look a lot like they did just before the financial crisis<sup>5</sup>

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- Wolf Richter, Wolf Street
- Apr. 2, 2017, 1:04 PM  
Reuters/Eric Thayer

“Announced” global volume of Mergers & Acquisitions – “announced” in quotes for a reason, more in a moment – has breached the \$700 billion year-to-date for the first time since the crazy pre-collapse year 2007. This includes 125 deals of over \$1 billion, totaling \$455 billion. Three industries are at it with the most vigor: oil & gas, healthcare, and technology.

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<sup>5</sup> <http://www.businessinsider.com/mergers-and-acquisitions-are-starting-to-look-a-lot-like-they-did-just-before-the-financial-crisis-2017-3>

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This surge in M&A “has been driven by cross-border acquisitions, which have doubled in the last 5 years to \$288 billion in 2017 YTD,” according to [Dealogic](#). They’re now also at the highest level since 2007.

US-based companies are on top of the heap of cross-border deals, with \$95.8 billion in announced acquisitions so far – “the highest YTD level on record.”

What caused this surge in M&A? According to [Dealogic](#): “Strong equity markets and valuations – which have soared to the highest level on record.”

These “valuations” are measured in EBITDA (Earnings Before Interest, Tax, Depreciation, and Amortization), a metric that reflects the target company’s operating performance by removing non-operating expenses.

For the first quarter, “14 times EBITDA is what the Dealogic figures show as the median EBITDA multiple,” explained Dealogic’s head of M&A Research, Chunshek Chan. “That’s something we really haven’t seen over the course of the data that we have. Historically, we’ve been bouncing between 10 and 12 times, sometimes even 13 times. So 14 times EBITDA is certainly a premium to pay for acquisitions.”

Major stock indices are hovering near all-time highs, he said. Hence the high volume and the all-time record premium.

“This is really a translation of the exuberance in the equities market,” he said. This merger boom is “really driven by valuation.”

In other words, higher stock prices beget even higher premiums that acquirers are eager to pay. Over the longer run, M&A rarely produces positive results except for the stockholders of the acquired companies, executive bonuses, and Wall Street investment banks that manage these deals and extract their fees. Many mergers turn into abysmal operational failures, followed by layoffs and often enough, ironically, spin-offs (Wall Street wins again).

Companies are struggling with the tough environment beyond cheap credit and sky-high stock prices. They’ve been stuck in an earnings quagmire for years. Combined earnings of the S&P 500 companies in Q4 2016 [were back where they’d been five years earlier, in Q4 2011](#).

Even after financial engineering is applied with all its might via share buybacks and other strategies, and even by using Wall Street’s favorite most hyped liar-metric, ex-bad-items “adjusted” earnings per

share, the combined “adjusted” earnings per share of the S& 500 companies [are back where they’d been in January 2014](#).

In this environment, Corporate America cannot come up with earnings growth – despite or because of the huge wave of M&A. So what’s the solution? More M&A, at record prices and record multiples.

But there’s an additional kink in the equation: the collapse of “announced” merger deals. These mergers were announced with great fanfare. Their huge premiums were hyped with glowing words. They fired up the entire sector and even stock markets for a few days, as analysts were pronouncing the next potential targets, whose shares then jumped.

But then the proposed mergers run afoul of regulators who are worried belatedly about monopolies or oligopolies. Or the proposed mergers run into the buzz saw of other issues. And suddenly the merger collapses and is withdrawn,

Just on Wednesday, the \$14-billion merger between two stock exchanges, the London Stock Exchange and the Deutsche Börse, was withdrawn after regulators had a hissy-fit. This brought the total of withdrawn mergers in Q1 to \$271 billion, according to [Dealogic](#), the second largest amount of withdrawn mergers ever in a first quarter, behind only Q1 2007.

If pre-collapse year 2007 keeps popping up, it may be for a reason.

This quarter included the second largest withdrawn merger ever. It was proposed, shrugged off, and revoked within a couple of days in February: Kraft Heinz Co.’s \$155 billion bid for London-listed Unilever. It’s behind only Pfizer’s \$160-billion effort to acquire Ireland-based Allergan, which collapsed in April 2016, after the US government started targeting “inversion” deals that were primarily engineered to dodge US income taxes.

Last year had already seen the highest withdrawn deal volume since 2008, in total 769 deals for \$842 billion, “partly reflecting heightened regulatory pressure,” as [J.P. Morgan](#) put it.

And J.P. Morgan had an additional explanation for the merger boom, beyond the crazy stock market valuations: “Buyers capitalize on low cost of funding.”

Cash deals – funded by borrowing money, rather than issuing shares – accounted for 62% of the deals in 2016, up from 54% in 2015. And this year, despite rising rates, “the cost of capital is unlikely to be *substantially* impacted (emphasis added), and we do not think any increases will impede M&A activity.”

So full steam ahead. Overpaying is a virtue. Bugged down earnings, no problem. Record debt levels and leverage are signs of corporate health and confidence, as Wall Street likes to say. Exuberance reigns. Eerie sounds of 2007.



# Comparing Spin-offs, Split-Offs and Carve-Outs<sup>6</sup>

By [Elvis Picardo, CFA](#) | September 7, 2015 — 9:54 PM EDT

A [spin-off](#), [split-off](#) and [carve-out](#) are different methods that a company can use to divest certain assets, a division or a [subsidiary](#). While the choice of a specific method by the [parent company](#) depends on a number of factors as explained below, the ultimate objective is to increase [shareholder value](#). We begin by citing the main reasons why companies choose to divest their [holdings](#). (For more, see: [Parents and Spin-offs: When to Buy and When to Sell.](#))

## Putting a positive spin on spin-offs and carve-outs

When two companies merge, or one is acquired by the other, the reasons cited for such M&A activity are often the same (e.g., strategic fit, synergies, [economies of scale](#)). Extending that logic, when a company willingly splits off part of its operations into a separate entity, it should follow that the reverse would be true, that synergies and economies of scale should diminish or disappear. But that's not necessarily the case, since there are a number of compelling reasons for a company to consider slimming down, as opposed to bulking up through a [merger](#) or acquisition.

- Evolving into "[pure play](#)" businesses: Splitting up a company into two or more component parts enables each to become a pure play (a publicly traded company focused on only one industry or product) in a different sector. This will enable each distinct business to be valued more efficiently and typically [at a premium](#) valuation, compared with a hodgepodge of businesses that would generally be valued [at a discount](#) (known as the [conglomerate discount](#)), thereby unlocking shareholder value. The sum of the parts is usually greater than the whole in such cases.
- Efficient allocation of capital: Splitting up enables more efficient [allocation of capital](#) to the component businesses within a company. This is especially useful when different business units within a company have varying capital needs. One size does not fit all when it comes to [capital requirements](#).
- Greater focus: Separation of a company into two or more businesses will enable each one to focus on its own game plan, without the company's executives having to spread themselves

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<sup>6</sup> <http://www.investopedia.com/articles/investing/090715/comparing-spinoffs-splitoffs-and-carveouts.asp#ixzz4fTHMaq4M>

thin in trying to grapple with the unique challenges posed by distinct business units. Greater focus may translate into better financial results and improved profitability.

- Strategic imperatives: A company may choose to divest its "[crown jewels](#)," a coveted division or [asset base](#), in order to reduce its appeal to a buyer. This is likely to be the case if the company is not large enough to fend off motivated buyers on its own. Another reason for [divestment](#) may be to skirt potential [antitrust](#) issues, especially in the case of serial [acquirers](#) who have cobbled together a business unit with an unduly large share of the market for certain products or services.

While the potential loss of synergies between the parent company and subsidiary can be a drawback of spin-offs and carve-outs, in most cases where a separation is being considered, such synergies may have been minimal or non-existent. Another drawback is that both the parent company and the spun-off subsidiary may be more vulnerable as [takeover](#) targets for friendly and hostile [bidders](#) because of their smaller size and pure play status. But the generally positive reaction from [Wall Street](#) to announcements of spin-offs and carve-outs shows that the benefits outweigh the drawbacks.

### **What is a spin-off?**

In a spin-off, the parent company distributes shares of the subsidiary that is being spun-off to its existing shareholders on a [pro rata](#) basis, in the form of a [special dividend](#). The parent company typically receives no cash consideration for the spin-off. Existing shareholders benefit by now holding shares of two separate companies after the spin-off instead of one. The spin-off is a distinct entity from the parent company and has its own management. The parent company may spin off 100% of the shares in its subsidiary, or it may spin off 80% to its shareholders and hold a [minority interest](#) of less than 20% in the subsidiary. A spin-off in the U.S. is generally tax-free to the company and its shareholders if certain conditions defined in [Internal Revenue Code](#) 355 are met. One of the most important of these conditions is that the parent company must relinquish control of the subsidiary by distributing at least 80% of its voting and non-voting shares. Note that the term "spin-out" has the same connotation as a spin-off but is less frequently used.

Example: In 2014, Healthcare company Baxter International, Inc. ([BAX](#)) spun-off its biopharmaceuticals business Baxalta Incorporated ([BXLT](#)). The separation was announced in March, and was completed on July 1. Baxter shareholders received one share of Baxalta for each share of Baxter common stock held. The spin-off was achieved through a special dividend of 80.5% of the [outstanding shares](#) of Baxalta, with Baxter retaining a 19.5% stake in Baxalta immediately after the distribution.



Interestingly, Baxalta received a takeover offer from Shire Pharmaceuticals ([SHPG](#)) within weeks of its spin-off; Baxalta's management rebuffed the offer saying it [undervalued](#) the company.

### **What is a carve-out?**

In a carve-out, the parent company sells some or all of the shares in its subsidiary to the public through an [initial public offering](#) (IPO). Unlike a spin-off, the parent company generally receives a cash inflow through a carve-out. Since shares are sold to the public, a carve-out also establishes a net set of shareholders in the subsidiary. A carve-out often precedes the full spin-off of the subsidiary to the parent company's shareholders. In order for such a future spin-off to be tax-free, it has to satisfy the 80% control requirement, which means that not more than 20% of the subsidiary's stock can be offered in an IPO.

Example: In February 2009, Bristol-Myers Squibb Company ([BMY](#)) sold 17% of the shares in its subsidiary Mead Johnson Nutrition Company ([MJN](#)). By December 23, 2009, the Mead Johnson IPO was the best performing one on the [New York Stock Exchange](#), with the shares increasing nearly 80% from the IPO issue price.

### **What is a split-off?**

In a split-off, shareholders in the parent company are offered shares in a subsidiary, but the catch is that they have to choose between holding shares of the subsidiary or the parent company. A shareholder thus has two choices: (a) continue holding shares in the parent company, or (b) exchange some or all of the shares held in the parent company for shares in the subsidiary. Because shareholders in the parent company can choose whether or not to participate in the split-off, distribution of the subsidiary shares is not *pro rata* as it is in the case of a spin-off. A split-off is generally accomplished after shares of the subsidiary have earlier been sold in an IPO through a carve-out; since the subsidiary now has a certain [market value](#), it can be used to determine the split-off's [exchange ratio](#). In order to induce parent company shareholders to exchange their shares, an investor will usually receive shares in the subsidiary that are worth a little more than the parent company shares being exchanged. For example, for \$1.00 of a parent company share, the shareholder may receive \$1.10 of a subsidiary share. The benefit of a split-off to the parent company is that it is akin to a [stock buyback](#), except that stock in the subsidiary is being used rather than cash for the buyback; this offsets part of the share [dilution](#) that typically arises in a spin-off.

Example: In November 2009, Bristol-Myers Squibb announced the split-off of its holdings in Mead Johnson in order to deliver additional value to its shareholders in a [tax-advantaged](#) manner. For each

\$1.00 of BMY common stock accepted in the exchange offer, the tendering shareholder would receive \$1.11 of MJN stock, subject to an upper limit on the exchange ratio of 0.6027 MJN shares per share of BMY. Bristol-Myers owned 170 million Mead Johnson shares, and accepted just over 269 million of its shares in exchange, so the exchange ratio was 0.6313 (i.e., one share of BMY was exchanged for 0.6313 shares of MJN).

### **How to invest in spin-offs**

2014 was a bumper year for spin-offs, with close to 50 deals announced in the U.S. over the year. A number of these deals involved the spin-off of a "YieldCo" (yield company) by utilities and solar energy companies. A typical YieldCo carries a portfolio of operational energy projects. Investors like such dividend-rich YieldCos because they have stable [cash flows](#) through long-term power purchase agreements, and are not exposed to other, riskier businesses of the parent company.

In Canada, leading retailers such as Loblaw Companies, Ltd. ([L.TO](#)) and Canadian Tire Corp, Ltd. ([CTC.TO](#)) spun-off their substantial property holdings into [real estate](#) investment trusts ([REITs](#)) in 2013.

Spin-offs have generally outperformed the broad market. As of August 10, 2015, the Bloomberg U.S. Spin-Off Index had [total returns](#) of 625% since its inception on December 21, 2002, compared with the S&P 500's 136% return over this period.

So how does one invest in spin-offs? There are two alternatives: invest in a spinoff exchange-traded fund ([ETF](#)) like the [Guggenheim Spin-Off ETF \(CSD\)](#), which has had [average annual returns](#) of 8.43% from its inception on December 15, 2006, up to June 30, 2015; or invest in a stock once it announces a divestment through a spin-off or carve-out. In a number of cases, the stock may not react positively until after the spin-off is effective, which may be a buying opportunity for an investor.

### **The Bottom Line**

A spin-off, split-off or carve-out are three different methods of divestment with the same objective—to increase shareholder value. One can invest in the potential upside of spin-offs either through a specialist ETF, or by investing in a stock that has announced plans for a divestment through a spin-off or carve-out.

*The author of this article owns shares in Bristol-Myers Squibb and Mead Johnson.*



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