The Skinny on Spin-Offs

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STOCKS BY ANNE KATES SMITH

ANYONE who has watched *Better Call Saul* or *Frasier* is familiar with the spin-off concept, in which characters from an existing series branch off in a new show with a different story line. It works sort of the same way in corporate America, when firms split off a part of their business into a new, publicly traded company, usually via a tax-free distribution of the stock to shareholders of the original firm. The idea: Capitalize on a sum-of-the parts strategy, in which an undervalued business unlocks value under a new, simplified structure.

Stock spin-offs had a strong 2022, although momentum has slowed some this year. Last year, U.S. companies announced 44 spin-offs and completed 20, totaling $61 billion in market value, according to Goldman Sachs. So far this year, through mid July, nine U.S. spin-offs have been completed, according to financial information provider Dealogic.

In theory, spin-offs should be rewarding. Managers of the new company are unfettered by the old organizational chart and are often motivated by performance incentives in a way that was impossible in a bigger company. And the market may assign a higher valuation to businesses that are less complex and easier to understand, whereas conglomerates can be penalized.

In truth, performance is mixed. GE HealthCare Technologies is up 39% since it began trading on January 4. But ZimVie, a dental and spinal treatment offshoot of medical-devices giant Zimmer Biomet, has lost 64% of its stock value since March 2022. "Spin-offs are not a sure bet," says Jim Osman, founder and chief executive of The Edge Group, a firm specializing in fundamental analysis of spin-offs and other special situations.

Yet, he says, because spin-offs are smaller firms that are underfollowed by analysts, investors have more chances to uncover index-beating returns. And spin-offs can be bargains. In a spin-off distribution to parent-company shareholders, "investors gain these shares by default and sell them in the open market pretty much immediately, often making them cheap companies that no one is looking at," says Osman. "It's at this point where X marks the spot and you should start digging."

A number of high-profile spin-offs are expected later this year.

COURTESY OF 3M

3M will spin off its health care division. The new company will be focused on wound care, health care IT, oral care and filtration products used in the biopharma industry.

Osman likes the chances for a few and suggests buying the parent company, pre-spin-off. Among them are ***3M (symbol MMM, $112)***, which will spin off its health care division. The new company will be focused on wound care, health care IT, oral care and filtration products used in the biopharma industry. ***Danaher (DHR, $255)*** is shifting toward becoming a pure health care player, so it is spinning off its Environmental and Applied Solutions division, with businesses aimed at protecting resources, including global food and water supplies. ***Kellogg (K, $67)*** will split in two, separating its snack and plant-based food business (including Cheez-It and MorningStar Farms) from its North American cereal unit (Frosted Flakes, Special K).

For a diverse portfolio of companies that have already been spun off, consider exchange-traded fund ***Invesco S&P Spin-Off (CSD, $60)***, with an expense ratio of 0.65%. The portfolio adds spin-offs with at least $1 billion in market value and holds them for four years. It uses a modified market-cap weighting, which skews the portfolio a bit toward larger holdings without allowing assets to concentrate in only the biggest names. The fund's one-year gain of 10.6% ranks it within the top 21% of mid-cap blend funds. K

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