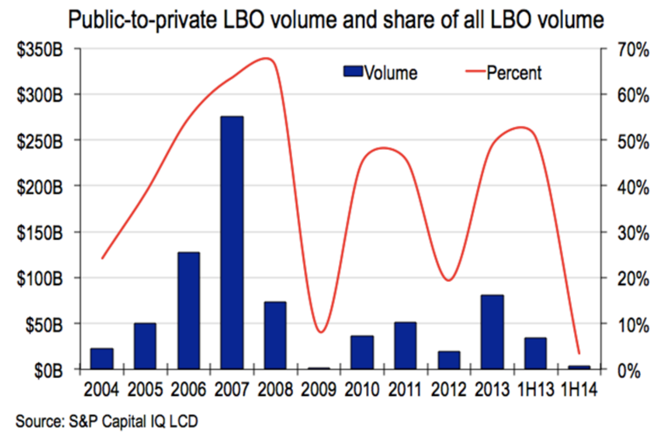
QUALIFYING THE IMPLICATIONS OF SPIN-OFFS FOR BONDHOLDERS

INTRODUCTION: THE RESURGENCE OF THE SPIN-OFF

Over the past 18 months, the Corporate bond market has seen the trend of "event risk" grow increasingly important. By event risk, we mean unforeseen actions taken by corporate management teams meant to enhance shareholder value to the detriment of creditors. One such event that has surged in the last year is spin-off transactions, or the distribution of ownership of a subsidiary to existing shareholders through a stock dividend.

While historically public-to-private leveraged buyout transactions (LBOs) have been a dominant source of event risk, the equity bull market of the past five years has made LBOs an increasingly unattractive strategy for private equity investors. As a result, the public-to-private share of total LBO volume fell to 3.5% in the first half of 2014, the lowest level on record. With the depressed levels of LBO activity in the investment grade space, spin-offs have emerged as the dominant form of event risk in the high-quality Corporate space.

Thus far in 2014 (through September), there have been 57 spin-off transactions announced by nonfinancial corporations in the U.S. This is up substantially from 44 transactions in all of 2013 and just 33 in 2012. There is no doubt that the rise of activist shareholders has created a strong tailwind for spin-off transactions, as management teams are pressured to find imaginative ways to generate "shareholder value." As activist firms have enjoyed success and attracted significant capital, they are increasingly targeting larger, more complex investment grade companies.



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WHAT ARE THE MOTIVATIONS FOR SPIN-OFFS?

The most frequently mentioned motivations for spin-off transactions include:

- ***To separate one or more disparate businesses, allowing management to be more focused on executing a specific business strategy*** For example, eBay (a recent spin-off announcement) may manage its online eBay business and PayPal payments business very differently.

- ***To address valuation discrepancy between two different business lines*** A separation theoretically allows the market to assign different valuation multiples to each specific business.

- ***To jettison a business that is facing industry headwinds or outright secular decline*** Recent examples here include media conglomerates that have been spinning-off newspaper/magazine businesses, *e.g.,* News Corp and Time Warner.

- ***To take advantage of tax benefits*** Spin-offs can often times circumvent state and federal tax liabilities that would otherwise arise if the business was sold outright. Rather than selling a company outright and paying taxes on the gains, companies can spin off shares directly to their shareholders. This spin off is not a taxable event for the parent company, and only becomes taxable for their investors when the spun-off shares are sold.

- ***To properly align capital structures with the underlying business*** A recently popular theme is the "GrowthCo, YieldCo" approach. In this example, business lines are separated into two new companies: one that is an under-levered, growth-orientated company that retains most of its earnings, the other that is slower growth but more profitable business that is able to take on more leverage while returning the majority of cash flow to shareholders.

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WHAT IS THE IMPACT OF SPIN-OFF TRANSACTIONS ON CREDIT?

Spin-offs can often benefit shareholders at the expense of creditors by weakening the credit profile of either the parent, spun-off entity, or both. By transferring assets to a new entity, a parent company is reducing its cash flow generation; so, unless cash proceeds from the spin-off are used to repay parent debt, cash flow-based credit metrics will deteriorate. In extreme cases, some companies have used spin-offs as a junkyard for bad assets. The parent company may be able to load up a spin-off entity with unwanted assets and excessive debt while improving its own balance sheet. One of the most famous examples of this outcome is Viacom's spin-off of debt-laden Blockbuster in 2004 which resulted in a dividend of more than $700 million back to Viacom. After being valued at more than $5 billion at its peak, Blockbuster was liquidated in bankruptcy seven years after its spin-off. Lastly, one of the rating agencies most frequent concerns about spin-off transactions is the reduction in business diversity. Specifically, there is concern that a less diversified revenue base could result in more volatile cash flows and thus a weaker credit profile. While a number of other factors, including an uncertain capital structure, influenced their decision, one of the primary reasons Moody's cited regarding their decision to place Hewlett-Packard (HPQ) on review for downgrade after the announced spin-off of the Personal Systems business from the Enterprise business was that the resulting business would be "smaller and less diverse and consequently will have a weaker business profile," according to Moody's Richard Lane.

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WHAT PROTECTIONS DO CREDITORS HAVE?

Investment grade creditors have a tendency to be more susceptible to damaging spin-offs because higher-rated issuers typically have weaker covenant packages. Some possible protections for creditors that are common in bond indentures include restricted payments, limitations on the incurrence of debt and restrictions on asset sales. There may also be a limitation on sales of equity interests in wholly-owned subsidiaries, which can potentially block an attempted spin-off. Unsurprisingly, management teams have been creative in navigating bond holder defenses. One common workaround is for the spin-off company to issue new debt in exchange for cash before the spin-off, and distribute such cash to the parent, which the parent may then use to retire its existing debt. Noble Corporation, an offshore oil driller, recently spun-off its oldest drilling rigs into a new company, after which the spin-off company issued approximately $1.7 billion of new debt used to pay an "intercompany loan" owed to Noble. We note that the new entity, Paragon Offshore, is rated four notches below the parent by S&P.

THE RATINGS HISTORY OF SPIN-OFF TRANSACTIONS

S&P recently published a retrospective analysis of parent and spin-off companies back through 2005. During that time period, spin-off transactions were concentrated in five key sectors (media, oil and gas, consumer products, technology, and healthcare), which accounted for more than 60% of the announced transactions. Surprisingly, the credit quality of spun-off companies has remained remarkably stable, with 77% of S&P ratings on spin-offs remaining the same or higher after the close of the transactions. Some possible explanations for this financial stability include better incentivized management, as well as the reduction of unnecessary expenses associated with larger corporate bureaucracies. Interestingly, parent company credit ratings have not fared quite as well, with 40% of parent issuers involved in spin-offs are now rated lower than they were before announcing the transaction. We would attribute these results to the rating agencies' focus on the risk associated with a narrower business profile. We also suspect that spin-off transactions may be biased towards parent companies that are looking for creative ways to confront fundamental headwinds in their core business.

CONCLUDING THOUGHTS

Given the benign conditions in the credit markets and continued popularity of activist investment strategies, we anticipate that spin-off volume will continue at a historically elevated pace. We believe there is value in focusing on avoiding management teams that take an aggressive approach to shareholder returns and prioritize the interests of shareholders over bondholders, and that spin-offs that have been unfairly (based on historical performance) punished by the bond market may offer opportunities for high grade corporate bond investors.

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