Spinoff Stock Investigator

All You Need to Know about Reaping the Rewards of Spinoffs

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FREE REPORT

Spinoff Stock Investigator:

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SPINOFFS UNLOCK HIDDEN VALUE

One of the ways a company can try to unlock its own hidden value is by creating a separate company out of a subsidiary. The parent company can either sell stock in the new company to the public, or spin it off—hand the stock out to its own investors. In the past few years, it has become common to do both.

Often, the parent company starts by selling a portion of the new company to the public, to establish a market and a following among investors. That way, by the time of the spin-off, stock in the new company may be liquid enough to be sold relatively easily, or retained with some confidence as a worthwhile investment.

In our experience, and in most academic studies of the subject, this helps the parent and the spin-off. Both generally do better than comparable companies for at least several years after the spin-off takes place.

Spinoffs are the closest you'll get to a "sure thing"

We can say without reservation that, in investing, spinoffs are the closest thing you can find to a sure thing. It all comes down to the incentives.

When a company carries out a spinoff, it sets up one of its subsidiaries or divisions as a separate company, then hands out shares in the new company to its own shareholders. It may hand out the shares as a special dividend, or give its shareholders an opportunity to swap shares of the parent company for the shares of the newly established spinoff.

Study after study has shown that after an initial adjustment period of a few months, spinoffs tend to outperform groups of comparable stocks for several years. (For that matter, the parent companies also tend to outperform comparable firms for several years after a spinoff.) The above-average performance of spinoffs makes sense for a couple of reasons.

First, company managers naturally prefer to acquire or expand their assets, not get rid of them. Getting rid of assets reduces a company's total potential profit. This cuts into the funds available to pay managers, and reduces their opportunities for career advancement. The management of a parent company will only hand out a subsidiary to its own investors if it's nearly certain that the subsidiary, and the parent, will be better off after the spinoff than before.

Second, spinoffs involve a lot of work and legal fees. The parent will only spin off the unwanted subsidiary if it can't sell the stock for what it feels it's worth. That's why companies only have an incentive to do spinoffs under two sets of favourable conditions: When they feel it isn't a good time to sell (which often means it's a good time to buy); or, when they feel the assets they plan to spin off will be worth substantially more in the future, possibly within a few years.

Quite often, a big company will spin off a small subsidiary because it feels the subsidiary is a tiny gem, but that it's too small to make an impact on the much larger financial statements and market capitalization of the parent.

With new issues, the situation—and our advice—is largely the opposite

In spinoffs, the incentives work in your favour. This is easier to understand if you contrast spinoffs to one of the least desirable investments, new stock issues, where the incentives all work against you.

New issues (also known as Initial Public Offerings or IPOs) come to market when it's a good time for the company or its insiders to sell. That's not necessarily—and often isn't—a good time for you to buy. In addition, the underwriting brokerage firms try to spark investor interest in the new issue. They hire public relations firms to get the media interested. They also pay extra commission (double the regular rates or more) to spur their salespeople to sell the new issue.

This tends to create a high-water mark in the price of the issue. After it hits the market and the hype dies down, its price may languish for months or years.

Some new stock issues—so-called "hot new issues"—begin moving up as soon as they hit the market. Some hot new issues even "gap upward" on their first day of trading; that is, their first public trading takes place well above the new issue price. This possibility attracts buyers who fail to appreciate how rare it is, not to mention how unlikely it is that they will get to buy a hot new issue at the new issue price.

After all, the underwriting brokers can generally tell when a new issue is going to be "hot", based on the reaction of their biggest clients (who of course get first pick on all new issues), and the media. Brokers reserve most of their allotments of hot new issues to their biggest and best clients. New clients and occasional new issue buyers may get to buy token amounts of a hot new issue, if any.

Your best course as an investor is to stay out of most new issues, even those that seem to have serious appeal. It's better to hold off on buying until a new issue has been trading for a few months if not years, and has shown some of the potential that the initial hype promised.

We've had great success with spinoffs

We've had great success with a number of spun off stocks over the years. That's especially true of the many spinoffs we have recommended that have gone up after they began trading, and have later attracted a takeover bid at a substantial premium over the market price.

Needless to say, things don’t always work out this well. Spinoffs and their parents do sometimes run into unforeseeable woes. But on the whole, in investing, spinoffs are the closest thing you can find to a sure thing.

Spinoffs also tend to attract big takeover offers

We also sift through thousands of stocks, digging deeply to discover which are ripe for spinoffs—and which spun off stocks may be in line for takeovers.

When an acquiring company makes a bid to assume control of a target company, it often pays a high price to buy a majority stake. Takeovers consistently offer a windfall to investors holding the shares of the target stock.

Both spinoffs and parents experience an unusually high incidence of takeovers, according to *Journal of Financial Economics* study.

We have created an exclusive proprietary rating system—our *Takeover Target Rating*—that will alert you to these rare but highly profitable opportunities.

To give investors advance notice of the possible takeover of a recent spinoff, or its former parent, we zero in on 13 factors that enhance its appeal to potential buyers. Here are three:

• *Operates in a consolidating industry, which enhances its appeal for competitors seeking economies of scale.*

• *The company has good management/industry experts that the buyer can put to more profitable use.*

• *Profit margins are lower than industry norms. That leaves room for the buyer to cut costs and improve profits.*

Here’s a classic example:

Fording Canadian Coal Trust was one of five spinoffs from the original Canadian Pacific Railway Ltd. When we recommended it in January 2008, it was trading at $47. We liked its prospects as a major metallurgical coal producer for steelmaking, and its steady cash distributions to shareholders. And we liked its appeal as a takeover candidate.

Not long after we recommended it, Teck Cominco (now Teck Resources) launched a takeover bid that pushed *Fording’s shares up 162.3% in five months*!

Activist involvement is often a plus

We also carefully monitor the market for stocks that have drawn the attention of activist investors.

Typically, activist investment firms buy large numbers of a company's shares often to obtain seats on the company's board and effect a major change in the company. When activists take hold, new growth is often in store—and we alert investors to the benefits ahead.

Activist investing has surged in the past decade, led by a relatively small but powerful group of activist hedge funds. They follow different strategies, but all have the same goal of wringing the greatest possible profits from the company's assets.

For example, **Mentor Graphics** is a company that makes systems to improve the design and speed the development of electronic products (with many clients in the auto industry). It also fit the criteria of an appealing takeover candidate.

In October 2016, a year after we made it a buy, Mentor jumped 7% after activist investor group Elliott Management Corp. revealed that it had doubled its stake in the company. Elliott had a record of coaxing smaller firms into the arms of bigger ones.

And just a month later, German conglomerate AG Siemens bid for Mentor, and completed the all-cash takeover in April. *In the brief period between the bid and the takeover, the stock jumped 50.8%.*

OUR SPINOFF RECOMMENDATIONS

Here are some spinoff stocks (and their former parents) that we still think have gains ahead. As well, we look at a spinoff ETF.

✓ **Conagra Brands Inc. $33** (New York symbol CAG; Shares outstanding: 416.5 million; Market cap: $13.7 billion; http://www.conagrabrands.com/) makes packaged foods, including Chef Boyardee canned pasta, Hunt's tomato sauce, Peter Pan peanut butter, Orville Redenbacher popcorn and Reddi-wip whipped cream.

In November 2016, the company spun off Lamb Weston (see below) as a separate firm. Under the terms of the spinoff, Conagra investors received one Lamb Weston share for every three shares they held.

If you exclude costs related to the spinoff and other unusual items, Conagra earned $0.37 a share in its fiscal 2017 fourth quarter, ended May 26, 2017. The latest earnings are up 15.6% from $0.32 a year earlier. Sales in the quarter fell 9.3%, to $1.86 billion from $2.05 billion. If you adjust for unfavourable currency rates and the sale of some non-core operations, Conagra's sales fell 3.6% in the quarter.

Thanks to the company's plan to focus on its more-profitable products, as well as a successful cost-cutting plan, its gross margin improved to 29.0% in the latest quarter from 27.7% a year earlier. (Gross margin is the gross profit on sales divided by the total sales; the higher the better.) Conagra expects to expand its gross margin to 32.0% in fiscal 2020.

The company also recently raised its quarterly dividend by 6.3%. Investors now receive $0.2125 a share instead of $0.20. The new annual rate of $0.85 yields 2.5%.

Conagra Brands is a BUY.

✓ **Lamb Weston Holdings Inc. $45** (New York symbol LW; Shares outstanding: 146.2 million; Market cap: $6.6 billion; http://www.lambweston.com/), sells frozen potatoes and other vegetable products to restaurants and prepared-food makers.

Lamb Weston's sales in its fiscal 2017 fourth quarter, ended May 28, 2017, rose 7.1%, to $832.5 million from $777.0 million a year earlier. (Those earlier results are pro-forma figures provided by the company.) Rising prices and volumes drove the increase.

If you disregard costs related to the spinoff and other unusual items, Lamb Weston earned $0.51 a share in the latest quarter. That's down 10.5% from $0.57 a year earlier, mainly due to higher interest costs on existing debt.

In fiscal 2018, Lamb Weston will probably earn $2.40 a share. The stock, which has gained over 30% since the spinoff, trades at 18.8 times that estimate. That's a reasonable p/e in light of the company's high market share—Lamb Weston has roughly 40% of the North American frozen-potato market. The $0.75 dividend yields 1.7%.

Lamb Weston is a BUY.

✓ **Yum! Brands Inc. $76** (New York symbol YUM, Shares outstanding: 344.8 million; Market cap: $26.2 billion; www.yum.com) spun off its Chinese operations—Yum China Holdings (see below)—as a separate company on November 1, 2016.

Investors received one share of Yum China for each Yum Brands share they held. They won't have to pay capital gains tax on those shares until they sell them.

Yum Brands now operates 43,992 restaurants in over 135 countries. Its main banners are KFC (fried chicken), Pizza Hut and Taco Bell (Mexican food). Franchisees operate 94% of those outlets. The company plans to increase that figure to 98% by the end of 2018.

In the three months ended June 30, 2017, Yum's overall sales fell 4.0%, to $1.45 billion from $1.51 billion a year earlier.

If you disregard the contribution of the 174 new stores Yum opened in the quarter, overall same-store sales rose 2%. Same-store sales at KFC (up 3%) and Taco Bell (up 4%) offset a 1% decline at Pizza Hut. The company plans to boost Pizza Hut's sales with several new initiatives. Those include upgrading restaurant equipment, hiring more delivery drivers and launching a new loyalty rewards program.

Earnings per share jumped 21.4%, to $0.68 from $0.56 a year earlier. These figures exclude costs related to the spinoff and other unusual items.

Yum's shares are up 24% since the spinoff and now trade at 27.0 times the company's 2017 projected earnings of $2.78 a share. That's a high p/e, but still reasonable, in light of Yum's well-known brands and improving earnings outlook. The $1.20 dividend yields 1.6%.

Yum Brands is a BUY.

✓ **Yum China Holdings Inc. $36** (New York symbol YUMC; Shares outstanding: 383.3 million; Market cap: $13.8 billion; www.yumchina.com), operates 7,685 fast-food outlets in China, mainly under the KFC, Pizza Hut and Taco Bell banners. The company owns about 80% of those outlets, while franchisees and affiliates own the remaining 20%.

For its second quarter, ended May 31, 2017, Yum China opened 90 new restaurants. Even so, its overall sales for those three months were flat at $1.59 billion.

Overall same-store sales rose 3%. That reflects a 4% gain at KFC, which offset flat sales at Pizza Hut.

The new company earned $0.27 a share in the quarter, up 42.1% from $0.19.

The improved earnings are mainly because China's recent financial reforms have cut the company's tax bill. Yum China also continues to benefit from its new loyalty programs (altogether, they now claim over 100 million members) and its expanded home delivery and mobile payment options.

The stock has jumped 40% since the company's spinoff from Yum Brands. It now trades at a high 24.7 times the $1.46 a share Yum China will likely earn in 2017.

That's still a reasonable p/e as expanding prosperity in China makes the company's products more affordable. As well, it has built up its own distribution networks and warehouses in the 30 years since Yum Brands first began operating in China. That gives Yum China an advantage over other fast-food chains.

Yum China is a BUY.

✓ **FirstService Corp. $83** (Toronto symbol FSV; Shares outstanding: 34.6 million; Market cap: $2.9 billion; www.firstservice.com), set up its commercial real estate business, Colliers International Group (see below), as a separate company on June 2, 2015.

Investors received one Colliers share for each FirstService share they held.

With the spinoff completed, FirstService has carried on with its residential property management and its commercial and residential property improvement services.

In the second quarter, ended June 30, 2017, the company's revenue rose 12.9%, to $434.9 million from $385.1 million a year earlier (all figures except share price and market cap in U.S. dollars).

Excluding one-time items, earnings per share for the quarter climbed 17.3%, to $0.61 from $0.52 a year earlier. The big gain was the result of cost savings as well as the higher revenue.

With the April 2017 payment, FirstService raised its quarterly dividend by 11.4%, to $0.1225 U.S. from $0.11 U.S. The stock yields 0.7%.

The company's outlook remains strong. However, FirstService trades at a high 34.6 times the $1.92 U.S. a share the company will likely earn in 2017.

FirstService is a HOLD.

✓ **Colliers International Group Inc. $62** *(Toronto symbol CIGI; Shares outstanding: 37.5 million; Market cap: $2.3 billion; www.colliers.com)* is one of the top three commercial real estate firms in the world. It offers a range of commercial services in the U.S., Canada, Europe, Australia, New Zealand, Asia and Latin America.

The company has 15,000 employees operating from over 500 offices in 68 countries.

In the three months ended June 30, 2017, Colliers's revenue rose 12.8%, to $544.2 million from $482.5 million a year earlier (all figures except share price and market cap in U.S. dollars). Excluding one-time items, earnings per share rose 20.6%, to $0.76 from $0.63.

Colliers continues to grow worldwide by acquisition. Its latest buy was WelshCo LLC. The company has yet to reveal the terms of the deal. WelshCo has 240 professionals operating in the greater Minneapolis-St. Paul area of Minnesota and provides lease brokerage, property management, facilities management and architecture services.

The outlook for Colliers is positive, but for the stock to climb, it needs global real estate markets to move higher. Meanwhile, it trades at 21.8 times the $2.28 U.S. a share Colliers will likely earn in 2017.

Colliers International Group is a HOLD.

✓ **Broadridge Financial Solutions Inc. $77** (New York symbol BR; Shares outstanding: 116.5 million; Market cap: $9.0 billion; www.broadridge.com), began trading on April 2, 2007, after former parent Automatic Data Processing handed out Broadridge stock to its own investors as a special dividend.

This financial company serves the investment industry in three main areas: investor communications, securities processing and transaction clearing. It processes 85% of all proxy votes in the U.S.

Investor communications makes up 72% of Broadridge's revenue. Securities processing and transaction clearing make up the remaining 28%.

In the fiscal 2017 fourth quarter, ended June 30, 2017, revenue jumped 38.1%, to $1.3 billion from $974.5 million a year earlier. The big increase reflects the contributions of the North American Customer Communications business of DST Systems; Broadridge paid $410 million in cash for that business in July 2016.

Excluding one-time items, the company earned $204.0 million, or $1.71 a share, in the quarter. That's up 15.9% from $176.0 million, or $1.45 a share, a year earlier.

The stock trades at 20.8 times Broadridge's projected fiscal 2018 earnings of $3.71 a share. That's reasonable considering the company's strong growth prospects. It plans to raise its quarterly dividend by 10.6% with the October 2017 payment, to $0.365 from $0.33. The shares now yield 1.9%.

Broadridge is a BUY.

Bonus Recommendation: a Spinoff ETF

The **Guggenheim S&P Spinoff ETF $48** (New York symbol CSD; Units outstanding: 3.95 million; Market cap: $189.6 million; www.guggenheimfunds.com), aims to track the S&P U.S. Spin-off Index. The ETF's MER is 0.65%.

The S&P U.S. Spin-off Index consists of 62 companies that have been spun off within the past four years. They must also have a market capitalization (or the total value of a company's outstanding shares) of at least $1 billion U.S.

S&P defines a spinoff as any firm resulting from either of the following events: a parent company's distribution of shares in a subsidiary to its own shareholders or "partial initial public offerings," in which a parent company sells a percentage of a subsidiary's shares to the general public.

The ETF's top holdings include Synchrony Financial (spun off from General Electric), Hewlett-Packard Enterprises (Hewlett-Packard Co.), PayPal Holdings (eBay), Fortive (Danaher), CDK Global (Automatic Data Processing), Chemours Co. (DuPont), Liberty SiriusXM Group (Liberty Media), Gaming and Leisure Properties (Penn National Gaming), Allegion PLC (Ingersoll Rand), and Keysight Technologies (Agilent Technologies).

The Guggenheim S&P Spinoff ETF is a HOLD, but only for aggressive investors.

Who is Pat McKeough?

A professional investment analyst for more than three decades, Pat has developed a stock-selection technique that has proven reliable in both bull and bear markets. His philosophy puts an emphasis on safety, yet generates growing and often spectacular gains for his subscribers. He focuses on stocks that provide exceptional quality but whose hidden value is often overlooked. Many savvy investors consider it the most powerful stock-picking method ever created.

Pat is the editor and publisher of our five investment advisories:

1. ***The Successful Investor*** – Pat McKeough's flagship advisory is for conservative investors who want growing gains with reduced risk, mainly in Canadian stocks. Click here to learn more.

2. ***Power Growth Investor***—If you like the idea of "a conservative approach to aggressive investing", this advisory has Canadian and U.S. stocks with escalating growth potential. Click here to learn more.

3. ***Wall Street Stock Forecaster*** - An advisory that focuses on conservative portfolio investing in U.S. stocks, with an emphasis on finding hidden value on the U.S. market. Click here to learn more.

4. ***Canadian Wealth Advisor*** - An advisory reporting "safe money" strategies on well-established Canadian dividend stocks, Real Estate Investment Trusts (REITs) and Canadian and international exchange-traded funds (ETFs). Click here to learn more.

5. ***TSI Dividend Advisor*** – Our newest advisory helps assure your financial future with dividend stocks. Whatever success you have had with dividend stocks, you can now expect to have much more. We have developed powerful new proprietary ratings that will help you unlock the full power of dividend stocks. Click here to learn more.

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Pat McKeough's Inner Circle is Pat's exclusive service for investors who want more personal attention and interaction with their investments, plus access to all of Pat's publications. Inner Circle membership gives you the opportunity to ask Pat your personal investment questions and includes his commentaries as he answers questions posed by other Inner Circle members. As a member, you get access to all four newsletters, our full library of special reports and much more. Click here to learn how you can become a member of Pat McKeough's Inner Circle (note: membership is strictly limited).

Successful Investor Wealth Management: If you are already familiar with Pat McKeough and his long history of profit-making advice, you can imagine how well your portfolio might do if Pat managed it for you. That's what you get when you become a Successful Investor Wealth Management Inc. client. For complete information, please click here or call us toll-free at **1-888-292-0296**. We'll send you a FREE information kit and answer any questions you may have.

Information about all of these comprehensive services is available at TSI Network (www.tsinetwork.ca).

Successful Investor Wealth Management

Pat McKeough offers personal portfolio management advice to a number of individual investors, his Successful Investor Wealth Management clients.

Before becoming our clients, many followed Pat's advice through our investment newsletters. Others were referred to us by satisfied portfolio management clients. All benefit from the fact that this service is free of the conflicts of interest that distort so many other sources of investment advice.

A strong team of experts contribute an enormous amount of time and research to the Successful Investor Wealth Management service. But Pat personally approves every transaction in every portfolio.

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