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STUBS AND SPIN-OFFS



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Regina Pitaro is a Managing Director of Gabelli Asset Management Company. Prior to her 17 year career at Gabelli, she worked for Lehman Brothers in New York. Ms. Pitaro holds an MBA in Finance from Columbia University Graduate School of Business. Ms. Pitaro is also the Author of Deals . . . Deals . . . and More Deals published by Gabelli University Press.

We thought we would share with you the following article, which appeared in the April 2001 issue of Cigar Aficionado.

Investing in Fragments of a Company Can Sometimes Pay Off Handsomely

In past articles, we have shown that there are more ways to earn a return than just buying a stock. We have discussed absolute returns, relative returns, even returns from announced mergers and acquisitions (risk arbitrage). In this article, we zero in on another approach: investing in stubs, spin-offs and liquidations.

Stubs are created through the leveraged buy-out process. As the name implies, leveraged buyouts (LBOs) are transactions in which the buyer uses debt to fund the acquisition of a company. Usually, the LBO group will buy all of the target company's publicly traded equity. However, occasionally it will leave a small portion (usually 10 to 15% of the float) in the public market to avoid having to book "goodwill" (purchase price in excess of book value), which eventually must be written off against earnings. Shares of this small portion of equity remaining in public hands are called stubs.

Because we analyze securities in much the same way as LBO specialists—looking for undervalued assets and focusing on how much free cash flow a company generates—many of our portfolio holdings have been targeted by LBO groups. We have our cake in the form of premiums paid by LBO groups to buy portfolio companies. Every now and then, we get to eat it too, by holding on to stubs that allow us to participate, along with the LBO group, in realizing a portfolio company's full upside potential. Our risk arbitrage operations—buying deal stocks at a modest discount to the purchase price to earn respectable annualized returns when the deal closes—also give us the opportunity to take advantage of fundamentally attractive stubs.

The Power of the Stub

Let us give you an example from the Gabelli files. On January 23, 1997, Amphenol, a leading electrical equipment manufacturer, announced that the prominent LBO group Kohlberg Kravis Roberts & Co. (KKR) was purchasing 90% of its equity for \$26 per share in cash. The remaining 10% would remain in public hands—a classic stub. We thought the deal price was a little skinny, valuing Amphenol at around 15 times earnings, when its competitors were trading at 17 to 18 times earnings in the market. Believing we might see a better bid from a competing suitor and/or KKR, we bought Amphenol stock at \$25.50. At this price, we could earn a modest 6% annualized return on our investment even if no higher bid materialized. We also had the option of holding on to all or part of our Amphenol position via the stub. Either way, the downside risk was limited and the upside potential appeared attractive.

Other shareholders saw value in the stub, and approximately 9 million shares (about 20% of the publicly held equity) were not tendered for cash. The deal was then pro-rated, requiring the remaining shareholders to tender half their position for cash and retain half of their shares in the stub, which within one year was trading at \$61 per share. We earned a 6% annualized return on the half of our position we were forced to tender and 139% on the half that remained in the stub. So, the one-year total return on our Amphenol investment was 72%. Behold the power of the stub.

Spin-Offs and Liquidations

A spin-off is when a company creates a separate publicly traded stock for one or several of its businesses. Stock of the company being spun off is distributed free of charge to shareholders of the parent company, which generally will retain a substantial position in its now publicly traded child.

Businesses are spun off for a variety of reasons. In many instances, the parent company wants to highlight the value of the businesses it is spinning off, believing the market will value the sum of a company's parts greater than it has valued the whole company. Prior to last year's technology stock massacre, many "old economy" companies spun off "new economy" businesses to bring out their value. These kinds of spin-offs tend to be priced rather too richly for value investors' tastes.

Companies will also spin off non-core businesses to clean up their images in the marketplace. This is often perceived as a convenient way to dispense of underperforming businesses, and these spin-offs are generally not treated particularly well in the market. However, independence from a parent that has failed to provide the capital or management focus to nourish these businesses can substantially improve their prospects within their industries and turn a bargain-priced investment into a big winner.

We'll provide two examples of our recent spin-off investments—one of which is now largely history and another (a spin-off/liquidation) that is still very much alive. In March 2000, media company Ziff Davis (ZD) announced a recapitalization and the spin-off of its events (trade show) business. For each share of ZD, shareholders received 0.57 shares of ZD Net (an already publicly held tracking stock of the parent's Internet business); a \$2.50 cash dividend; and 0.5 shares of Key3Media, which upon completion of the parent company's reorganization would be an independent publicly traded company, with additional shares being brought to market via an initial public offering (IPO).

By buying one share of ZD for \$11.50, shorting shares of richly valued ZD Net and covering the short as soon as the reorganization was completed and pocketing the \$2.50 per share cash dividend, we were effectively purchasing one share of Key3Media for \$2.32. This was the equivalent of paying just 6 times trailing free cash flow for a very good, albeit not terribly sexy, business whose competitors (Penton Media and Primedia) were trading at 14 to 15 times free cash flow in the market. Sure enough, the Key3Media IPO shares came to market at \$6 per share and the stock traded at \$12 per share within a month, delivering a 417% return on our original investment in the parent company stock. Behold the power of the spin-off.

Harbor Global

Ready for a spin-off you can take advantage of? You may want to consider Harbor Global Co. (OTC; HRBG), a recent spin-off from the merger of Pioneer Group and UniCredito Italiano. Harbor Global is managed by the former president and senior vice president of Pioneer Global Investments, a division of Pioneer Group.

This spin-off is also a liquidation, in that management's mandate is to liquidate all of Harbor Global's assets within five years. Liquidations are the sale of all of a public company's assets, with the net proceeds being paid directly to shareholders. Liquidations generally occur when companies have assets worth more to buyers of businesses than they are ever likely to be to public market investors.

As compensation, in addition to salaries, Harbor Global's management will pocket 10% of the value of all asset sales. These assets consist of approximately \$35 million in cash, about \$25 million (book value) of Russian investments and real estate, around \$5.6 million (book value) of Polish venture capital investments, \$12.5 million in timber inventory and equipment, \$7.5 million (book value) in assorted tag-end assets and \$4.5 million in net cash coming from the sale of Pioneer Group's gold-producing properties. All this adds up to \$90.1 million in assets. Backing out \$7.8 million in management compensation (including the 10% commission on asset sales) and \$12 million in operating costs over the next five years, we estimate total net assets are \$70.3 million. Divided by Harbor Global's 5,397,918 shares, this comes to approximately \$13 of net assets per share. As we write, Harbor Global stock is trading at about \$4.50 per share—about a 40% discount to the cash and cash receivables currently on the books. This is an old-fashioned Graham & Dodd “net/net”—a security selling below the value of the cash on the books.

Why so cheap? First, assets like Russian real estate and Polish venture capital investments aren't easy to evaluate. We have taken what we believe to be a conservative approach, valuing these assets at book. They may be worth considerably more. Second, with a market capitalization (total shares multiplied by share price) of just \$21.6 million, no one on Wall Street is paying any attention to this stock. Finally, HRBG is a “bulletin board” stock. It isn't listed on NASDAQ and isn't actively traded. Harbor Global stock may never be “discovered,” and consequently, may languish at or around its current \$4.50 price for the next five years. However, if all goes according to plan, when the liquidation is completed, shareholders should be receiving checks for \$13 per share or more. That translates into a 288% return or better over five years.

For more information, visit our website at:

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