HUTCHINSON
CAPITAL
MANAGEMENT

July 2014

INVESTMENT PERSPECTIVES:

Spinoff Success

As the second quarter was winding down, we were completing our analysis of National Oilwell Varco's (NOV) separation of its distribution business (Now Inc. or DNOW) into an independent company. NOV's disposition of DNOW is commonly referred to as a spinoff, whereby a new (and often smaller) public company is established through the separation of a business that was formerly part of a parent company. As we were working through the NOV spinoff, we noticed a couple of different acquisition announcements in the healthcare space, including former portfolio holding Medtronic Inc.'s (Medtronic) purchase of Covidien Plc (Covidien). As we will detail, Covidien was also formed through a spinoff. The NOV and Covidien spinoffs are not isolated cases, and, in fact, substantial value has historically been created through various spinoffs. For this reason, we decided to further discuss this corner of finance and how Hutchinson Capital tries to incorporate its implications into our investment process.

Medtronic/Covidien: Spinoff Outperformance Is Real News

A fair amount of the attention surrounding Medtronic's deal centered around tax policy[1] or whether or not the acquisition of Covidien's hospital supplier business was a good fit for the medical device maker. Interestingly, less attention was dedicated towards the positive returns accrued by Covidien shareholders. Covidien was actually one of three companies created when the previously acquisitive (and scandalous) Tyco International split itself during 2007. We list the names of the spinoff companies and their returns since the time spinoff. Note that the S&P 500 rose roughly 49% over the same time period:

- Covidien: +139%
- Tyco Electronics (now TE Connectivity): +87%
- Tyco International: +98%[2]

[1] While Medtronic has denied that tax savings were the primary rational behind the deal, the acquisition was one of several so-called tax inversion deals. These deals allow US companies to be re-domiciled in countries with lower tax rates than the United States, potentially lowering overall tax payments and providing more tax efficient access to cash currently residing outside the United States.

[2] In October of 2012, Tyco International actually split again into Tyco (fire protection and electronic security products), Tyco Flow Control International Ltd. and ADT (residential and small business security installation and services). Following the Flow Control spinoff, Pentair, Inc. was merged into a wholly-owned subsidiary of Flow Control with the new company named Pentair.

We will avoid a detailed discussion of Tyco's aggressive acquisition strategy throughout the 1990's as well as the shenanigans of the former CEO.[3] Instead, we would simply note that many shareholders vocally advocated for a breakup of the company for several years and the subsequent share performance has certainly proven the merits of their argument.

Spinoff Outperformance: The Academic Evidence

For years, investors have identified spinoffs as attractive places to scour for investment ideas as numerous studies have shown evidence of their outperformance. The often cited 1994 article "Some Evidence That Spinoffs Create Value"[4] examined 161 non-taxable spinoffs from 1965-1990, and found that mean matched-firm adjusted stock returns (essentially excess returns adjusted for company size) for parents/subsidiaries for the period 1, 2 and 3 years following the parent are:

- 1 Year Parent/Subsidiary: 12.5%/4.5%
- 2 Years Parent/Subsidiary 26.7%/25.0%
- 3 Years Parent/Subsidiary 18.1%/33.6%

Interestingly, the authors also found that parents and spinoff companies were five times more likely to be acquired. In a 2004 article entitled "Predictability of Long-Term Spinoff Returns,"[5] John J. McConnell and Alexei V. Ovtchinnikov looked at a larger sample of 311 spinoffs between 1965-2000 and found more sizeable industry/size matched outperformance for subsidiaries in the first year following the spin (19.4%) but less over a 3 year period (26.3%). The strong first year results suggest that investors should not wait until the often prescribed 3 or 6 month period following a spinoff to purchase shares. The McConnell/Ovtchinnikov paper also found less evidence of parent outperformance after adjusting for a single outlier (Republic Waste Industries).

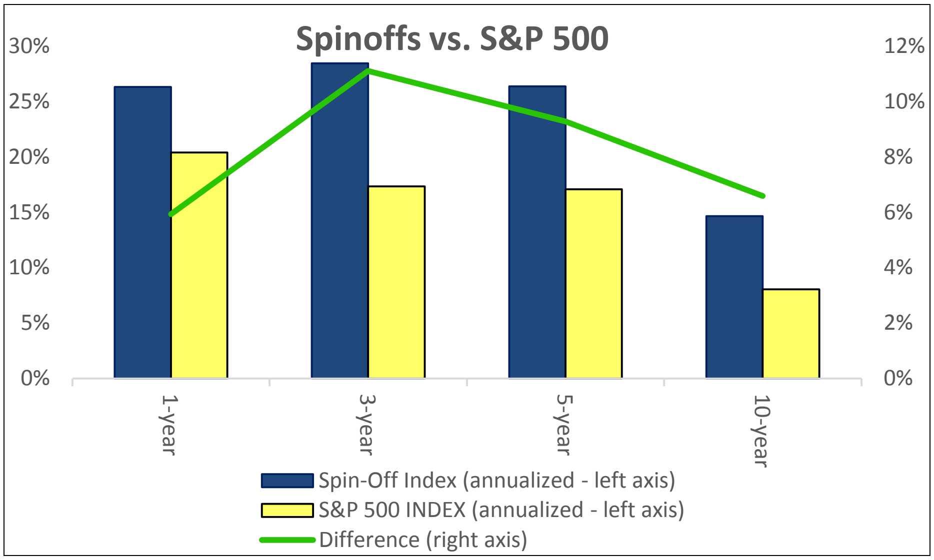
So after boring you with academic references, we also include a chart showing the Bloomberg Spinoff Index[6] returns versus the S&P 500 over the past 1, 3, 5, and 10 years. In summary, spinoffs often work.

[3] Dennis Kozlowski was CEO of Tyco from 1992-2002, leaving amid scandals regarding his compensation and Tyco funded reimbursements of personal items (including a reported $6,000 shower curtain). In 2005, Kozlowski was convicted of grand larceny and conspiracy, falsifying business records and violating general business law. After spending more than 8 years in prison, Kozlowski was granted parole in December 2013.

[4] Patrick Cusatis, Lehman Brothers, James A. Miles and J. Randall Woolridge, Journal of Applied Corporate Finance, 1994, vol. 7, issue 2, pages 100-107.

[5] Journal of Investment Management, Vol. 2 No.3, (2004), pp. 35-44.

[6] The Bloomberg Index is a market weighted index of spinoffs (excluding tracking stocks) with a market capitalization of at least $1 billion. Stocks are added when trading starts post-spin with companies remaining in the index for 3 years following the spinoff. Clearly, index results would be different if spinoffs are equally weighted or held for more/less time than 3 years following the spin.



No Single Reason For Spinoff Outperformance

But why? There is not a single satisfactory explanation. Sometimes newly spun companies find it easier to pursue growth opportunities, and the management teams are rewarded based upon the share price of the new company rather than having compensation tied to other business lines within a larger company. Other times, investors are simply more willing to ascribe higher multiples to certain lines of business and spinoffs allow re-ratings. Furthermore, many spinoffs initially have little or no Wall Street research coverage, with covering firms generally waiting several weeks or months following the spinoff to assume coverage (if ever). This period of limited coverage can allow investors to purchase shares before other analysts highlight a new company's investment merits.[7] Additionally, this quiet period is often accompanied by indiscriminate selling from either index investors who cannot own a new company that is not part of an index or from institutional or retail investors who simply don't want to own or to follow a small lot position.

Certainly, not every company with multiple operating segments needs to pursue separations. Berkshire Hathaway shareholders have done very well operating as a conglomerate over the years. Generally, however, we find Berkshire to be more the exception than the norm. In our experience, companies are typically less effective at simultaneously managing multiple different businesses, as one or possibly more often distract attention away from a core competency. In our July 2013 quarterly letter entitled *Measuring Management*, we noted that analyzing management teams was far from a straightforward exercise based upon a single ratio or a single measure of shareholder performance over some arbitrary time-frame. Instead, judgments needed to be based on a series of actions, including multiple capital decisions on acquisitions, divestitures, and share repurchases/dividends. Certainly, not every well-managed company will spinoff particular divisions to shareholders and, noting Berkshire, we stated that several have been competent in pursuing acquisitions while avoiding divestitures. We do believe, however, that strong management teams

[7] This is far from an absolute rule. In the case of National Oilwell's spinout DNOW, JP Morgan actually picked up research coverage of DNOW prior to its official trading debut, complicating our efforts to purchase shares.

will often *consider* a spinoff if it is in the best interest of shareholders. For this reason, we often find that we either own companies that are considering or pursuing spinoffs or we find ourselves looking at other spinoffs for possible future investments.

More Spinoffs Coming

Among current portfolio holdings, Valero spun out its gas stations (CST Brands Inc.) in May of last year and then distributed its pipelines and terminal facilities, so called midstream assets, (Valero Energy Partners) via an initial public offering in December of last year. Liberty Interactive Corporation will be separating its QVC business from its other internet assets in the third quarter of this year. Meanwhile, Liberty Media Corporation will soon have two tracking stocks, with Liberty Broadband Group holding the interest in Charter Communications Inc. and Liberty Media retaining the majority stake in Sirius XM Holdings Inc. And as previously mentioned, National Oilwell Varco recently separated its distribution business. Admittedly, we do not agree with capital allocation decisions of every existing holding. Considering the merits/historical track record of spinoffs, we wish certain holdings would consider possible separations. For example, are Bing/Xbox really core assets for Microsoft? Is there any real synergy between Bank of New York Mellon's asset servicing businesses and its asset management business? We'll save these discussions for another day.

Spinoffs: Selective Additions, Not Noah's Ark

Of course, investing rarely involves absolutes. Collectively, spinoffs have posted strong returns and are often the result of thoughtful capital allocation decisions. While we generally consider most spinoff opportunities, we do not blindly purchase every spinoff. Sometimes a spinoff occurs in an industry outside our area of expertise. Other times, the spinoff occurs at an unattractive valuation. More recently, we have found that several spinoffs may have had less initial selling pressure, possibly due to some of the pockets of money allocated towards purchasing all spinoffs. Just as there is not a perfect way to assess a management team's effectiveness, there is not a single test as to determine which spinoff opportunities are superior to others. Of course, the beauty of our concentrated value strategy is that we do not need to generate 100 different ideas. Instead, we identify 15-25 names that we thoroughly understand and feel comfortable holding for an anticipated 3-5 year period. We believe, however, that focus improves the odds for investment success, and therefore we think future spinoffs will likely offer numerous investing opportunities for Hutchinson to pursue in the years ahead.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of June 30, 2014, Hutchinson Capital Management (HCM) held:
113,005 shares of National Oilwell Varco (NOV)
248,155 shares of Now, Inc. (DNOW)
600 shares of Medtronic (MDT)
250 shares of Covidien LTD (COV)
250 shares of TE Connectivity LTD (TEL)
250 shares of Tyco International LTD (TYC)
3,168 shares of Berkshire Hathaway Class B (BRK.B)
160,275 shares of Valero Energy Corporation (VLO)
31,321 shares of CST Brands Inc. (CST)
0 shares of Valero Energy Partners (VLP)
374,964 shares of Liberty Interactive Corporation (LINTA)
69,752 shares of Liberty Media Corporation (LMCA)
0 shares of Charter Communications (CHTR)
0 shares of Sirius XM Holdings, Inc. (SIRI)
543,066 shares of Microsoft Corporation (MSFT)
256,226 shares of Bank of New York Co. (BK)
59 shares of Pentair (PNR)

As of June 30, 3014:
National Oilwell Varco (NOV) closed at $82.35
Now, Inc. (DNOW) closed at $36.21
Medtronic (MDT) closed at $63.76
Covidien LTD (COV) closed at $90.18
TE Connectivity LTD (TEL) closed at $61.84
Tyco International LTD (TYC) closed at $45.60
Berkshire Hathaway Class B (BRK.B) closed at $126.56
Valero Energy Corporation (VLO) closed at $50.10
CST Brands Inc. (CST) closed at $34.50
Valero Energy Partners (VLP) closed at $50.31
Liberty Interactive Corporation (LINTA) closed at $29.36
Liberty Media Corporation (LMCA) closed at $136.68
Charter Communications (CHTR) closed at $158.38
Sirius XM Holdings, Inc. (SIRI) closed at $3.46
Microsoft Corporation (MSFT) closed at $41.70
Bank of New York Co. (BK) closed at $37.48
Wal-Mart Stores Inc. (WMT) closed at $75.07
MRC Global (MRC) closed at $28.29
Pentair (PNR) closed at $72.12

As of June 30, 2014, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	6/30/2014 Closing Price
JOHNSON CONTROLS INC	6.9%	49.93
MICROSOFT CORPORATION	6.4%	41.70
WELLS FARGO & CO	6.1%	52.56
GENERAL MOTORS CORP	5.8%	36.30
MARKEL CORP COM	5.7%	655.64
CVS CAREMARK CORPORATION	5.6%	75.37
LEUCADIA NATIONAL	4.9%	26.22
ARCOS DORADOS HOLDINGS	4.3%	11.20
MERCK & CO. INC	3.8%	57.85
CHUBB CORPORATION.	3.7%	92.17

For a complete list of holdings, please see our most recent 13F filing on the following SEC website: http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

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