DEPARTMENT OF BUSINESS AND MANAGEMENT

Master Thesis in M&A and Investment Banking

THE CREATION OF SHAREHOLDER VALUE THROUGH SPIN-OFFS: THE CASE OF YAHOO

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Introduction

After the severe financial crisis that affected the US and then spread on all financial markets, the M&A activity saw a tremendous recovery thus leading the volumes of deals in 2014 to similar values of those achieved before the crisis in 2007. In this positive context, favoured by the low cost of money due to the unconventional expansionary monetary policies implemented by the FED first, then by the Bank of Japan and more recently by the ECB and the Central Bank of China, also divesture deals have increased in numbers. In January 2015 Marissa Mayer, the CEO of Yahoo Inc! announced the plan for a tax-free spin-off in Q4 2015 of the remaining stake in Alibaba held by the Company. Since Alibaba IPO in September 2014, Yahoo share price increased as a consequence of the performances reported by the Chinese giant but some analysts noticed the undervaluation affecting Yahoo and the conglomerate discount at which the company was trading. In this work we will critically analyse the potential impact that this transaction will have on shareholders, the criticalities of the deal and the perspectives of Yahoo after the spin-off.

In doing so we will first understand, in **Chapter 1**, why a company and its top management should focus on maximization of shareholders value, the main critiques and different approaches that academic literature adopts in studying company objectives. A special section, coming from the personal experience of the writer, will be dedicated to the Social Doctrine of the Church, a rich body of principles coming from Church teachings on social issues including business and entrepreneurship. Another part is dedicated to the Pentagon model that describes the role of M&A and divestment strategies as sources of value for the firm. The final part of the chapter will analyse the agency theory and the phenomenon of shareholders activism, that plays a key role in our case study. **Chapter 2** offers an overview on divestment strategies with a deeper analysis on spin-offs, the rationale behind such type of transactions, a special focus on conglomerate discounts and the main reasons of this penalty assigned by investors to conglomerate companies. This phenomenon is important for the purposes of our study because Yahoo itself trades at such discount. After that we will cope with a detailed analysis on the US tax-free treatment of spin-offs and the requisites to be accounted under the so-called “Section 355” in order to be tax-exempted. Finally, in **Chapter 3** we will broadly discuss on Yahoo, one of the first and most important Internet Companies in the world and the announced spin-off expected in Q4 2015. In doing so we will firstly we will understand the business model of Internet Companies and how these companies compete in the market. Then we will see how Yahoo performed and behaved in this competitive landscape since its first moves in 1996, passing by the investment in Alibaba in 2005, until the appointment of Marissa Mayer as CEO in 2012 and the new strategy that she implemented to turnaround the company from its slow but steady decline. To fully understand the difficult situation in which Yahoo was, we will compare Yahoo with Google in terms of business model, financial performance and valuation. After that, we will focus our attention on the announced spin-off of Yahoo expected for Q4 2015, on which in the last month media and the investor community have been speculating given the correspondence between the Board and the IRS for the tax-free treatment of the transaction and the probability of its incompatibility with Section 355 of the US Internal Revenue Code. Since only few details have been disclosed and given the uncertainties around the transaction, we will try to analyse the impacts that the spin-off may have on Yahoo and its shareholders with some personal assumptions that may not be true for the real future transaction. The results of our analysis will verify if the transaction will be value creating for the shareholders and the possible outcomes that the spin-off may have for Yahoo in the long-run.

Chapter 1

The creation of shareholders value

1.1. The Theory of the Firm

The theory of the firm comprises a series of economic theories that aim to explain the nature and the end of the firms, both companies and corporations. These theories aim to answer some questions:

- Why do firms exist? What is the end and the purpose of its existence?
- How can a company be distinguished from the external environment? What is the boundary between them?
- How are firms organized? Why do they adopt specific structures?
- How are relationships between different companies? Are cooperative relationships possible?
- What makes a firm profitable? What strategies should they adopt to grow?
- What evidences do we have on these theories? Are there any tests that demonstrate such theories?

Since our work wants to analyse the relationship between the creation of shareholder value and the implementation of divestment strategies and, more specifically, of spin-offs, we will briefly describe the main teleological theories of the firm that reflect on its existence and on its main purposes. These theories will provide us a clear framework that can justify the most important assumptions that we will make in our work, especially in the second part of the script, in which we will analyse the spin-off that Yahoo Board of Directors wants to perform in the 4th quarter of 2015.

The most common objective of an adequate management policy concern the maximization of returns for all those economic subjects that invested in a company. In modern economy these subjects are the shareholders (or stockholders), people who invested their own money within an organization and appointed a *corpus* of managers to run their business with the main and unique goal of making profits for them. Shareholders are the ultimate owners of the company whereas managers are the agents responsible for the achievement of the strategic objectives they had set to make the business sustainably profitable. It must be said that shareholders can also be managers of the company; this occurs in small and medium size companies and in contexts with illiquid capital market and a preferred access to funding through credit lines. In our analysis we will implicitly assume an environment where companies operate in countries where company ownership is diluted (public companies) and capital markets are liquid and developed.

1.1.1. The "Maximization of Shareholders Value" Theory

There has been a long debate among the academics about the purpose and objective of a company and a lot of theories can be found in literature. As briefly mentioned before, the most common theory that guides corporate decision makers is maximization of shareholders wealth[1]. The rationale behind this supremacy is found in the words of Freedman “in a free enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of society [...] In so far as his actions in accord with his *social responsibility* reduce returns to stockholders, he is spending their money”[2].

1.1.2. The Stakeholder Theory

In contrast with this theory there is another group of experts, whose main exponent is Edward Freeman, that affirms that a company has to focus not only on the interests of shareholders but also on the claims of the firm’s stakeholders. “Stakeholder is any group or an individual who can affect or is affected by the achievement of an organization’s purpose”[3]. Freeman believes that a company can’t do well without caring the interests of customers, suppliers, employees, or government environment because stakeholders are constituencies who play an important role in the fortunes of the company. Moreover, value can best be created by trying to maximize joint outcomes and not only the interest of a limited group of people. An important element in this theory is the identification of the main stakeholders, the creation of a map of them and the definition of their interests and claims on the company. A common classification divides stakeholders in two main groups:

[1] Ed. this is true for countries like U.S. or U.K. with a shareholder-oriented business system
[2] Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, N.Y. Times, September 13, 1970
[3] Freeman, R. Edward Strategic Management: A stakeholder approach, 1984

1. Primary stakeholders
2. Secondary stakeholders

Primary stakeholders are mainly internal stakeholders (shareholders, directors, employees) and all those subjects that engage in direct economic exchange with the business (e.g. creditors, customers, suppliers, distributors). Secondary stakeholders are, on the contrary, external stakeholders that are affected by the company or can affect it but do not engage in economic transactions with the business (e.g. local community, regulators, media, governmental tax-collecting agencies, professional associations, trade unions).

Even though these two theories are always seen in contrast, it can be said that the stakeholder theory can be conceived as an irradiation of the shareholders theory. It is Jensen[4] that states that the company can't maximize shareholder wealth if it ignores the rest constituencies. No company can create great value for its shareholders without stable growth of revenue, which comes from the relationship with customers, suppliers, banks or government and so on. Maximizing shareholder value needs satisfaction of stakeholder's interests because stakeholders are people who contribute indirectly in creating the value for the firm. Let's think for instance at customer satisfaction: without taking care of customers' needs the company will not sell anymore and profitability will turn out negative. However, defenders of Friedman view, argue that these considerations are implicitly embodied in the concept of shareholder maximization.

[4] Jensen, Michael C. 2001. "Value Maximization, Stakeholder theory, and the Corporate Objective Function," Amos Tuck School of Business, Dartmouth College Working paper No. 01-09

1.1.3. The Social Doctrine of the Church

A broader and more profound interpretation of the stakeholder theory is provided by the Catholic Church in its Social Doctrine[5]. This body of principles, who have their roots in the Gospels, assign a special value to the entrepreneurship and attributes a social function to the company and, at the same time, recognizes the importance of profitability and the economic dimension of business. In the Compendium of the Social Doctrine of the Church at number 338 it is stated that "businesses should be characterized by their capacity to serve the common good of society through the production of useful goods and services. In seeking to produce goods and services according to plans aimed at efficiency and at satisfying the interests of the different parties involved, businesses create wealth for all of society, not just for the owners but also for the other subjects involved in their activity." In this vision it is recognized the importance of efficiency, that can be translated in maximization of profits or minimization of costs, but at the same time it is affirmed that wealth does not belong only to the owners but to all parties that take part in the economic activity.

As we will understand from the next passage, the economic criteria, such as revenues at least equal to costs, is at the base of the Catholic vision of business. Again, number 338 affirms that "a business objective must be met in economic terms and according to economic criteria, but the authentic values that bring about the concrete development of the person and society must not be neglected. In this personalist and community vision, a business cannot be considered only as a 'society of capital goods'; it is also a 'society of persons' in which people participate in different ways and with specific

[5] Catholic social teaching is the body of doctrine developed by the Catholic Church on matters of social justice, involving issues of poverty and wealth, economics, social organization and the role of the state. The foundation of this doctrine can be found - a part from the Gospels - in the text of many Fathers of the Church and Doctors of the Church like Saint Augustine of Hippo or Saint Thomas Aquinas (that for the Catholic Church are part of the Deposit of Faith). However, in modern history of the Church, the Encyclical Letter *Rerum Novarum* of Pope Leo XIII is seen as the beginning of a more sophisticated doctrine concerning all aspects of human being, including business.

responsibilities, whether they supply the necessary capital for the company's activities or take part in such activities through their labour". From these words, it is clear, that the Catholic social doctrine assigns a deeper value to the stakeholder theory because, in this case, the purpose of a company is not only to satisfy the claims and interests of stakeholders, but to assure the development of the person in his entireness.

The person, his value as human being, his dignity as son of God, is at the core of all Social Doctrine. Some people believe that these theories condemn capitalism and profit. However the aim of this doctrine is to show an alternative model of capitalism in which value is not the only metric for undertaking a decision (both strategic and financial). This is evident in number 340 where it is stated that "The social doctrine of the Church recognizes the proper role of profit as the first indicator that a business is functioning well: when a firm makes a profit, this means that productive factors have been properly employed. [*However*] it is essential that within a business the legitimate pursuit of profit should be in harmony with the non-renounceable protection of the dignity of the people who work at different levels in the same company. These two goals are not in the least contrary to one another, since, on the one hand, it would not be realistic to try to guarantee the firm's future without the production of useful goods and services and without making a profit, which is the fruit of the economic activity undertaken. On the other hand, allowing workers to develop themselves fosters increased productivity and efficiency in the very work undertaken. A business enterprise must be a community of solidarity that is not closed within its own company interests. It must move in the direction of a social ecology of work and contribute to the common good also by protecting the natural environment."

1.1.4. Final Considerations

Although the debate is currently going on and many theorists keep on arguing on these themes, the creation of shareholders value as unique goal of the management policy has been preferred in management practices for many reasons:

1. It makes the management focus only on long-term strategies;
2. The satisfaction of shareholders' interests implies the fulfilment of the interests and claims of all stakeholders (e.g. debtors, suppliers, etc);
3. In case of public companies and assuming efficient capital markets[6], the capitalization of a company constantly shows the value creation and the efficiency of the actions adopted by the management

A part from these positive aspects, the shareholder theory has shown some weaknesses that we will briefly analyse in par. 1.5.

1.2. The concept of value

There are multiple ways and strategies to be adopted for managers to create value for their shareholders but they can all be summarized in the following statement and main goal: return on capital has to exceed the cost of capital. From this perspective, managers are required to implement all those projects whose returns are higher than their cost of the investment. In financial terms, managers have to undertake all those investment whose Net Present Value (NPV) is higher than zero. In order to make rational decisions and

[6] The efficient markets theory (EMT) of financial economics states that the price of an asset reflects all relevant information that is available about the intrinsic value of the asset.

given the time value of money, managers have to calculate the present value of all expected cash inflows (benefits) generated by a project using a discount rate that reflects the risk that investors have taken on, and subtract from it the incurred costs[7] for the realization of the project:

NPV = PV(benefits) – PV (costs).

If and only if a project shows a positive Net Present Value should be implemented.

When completely written out, the formula of a project evaluation is as follows:

$$\mathrm{NPV} = -\mathrm{I} + \sum_{n=1}^{\infty} \frac{FCFn}{(1+r)^n}$$

Defining:

- I: the outflow of resources used to implement the strategy
- FCF_n: the cash flows generated by the investment at time n
- r: the discount rate

The Net Present Value can be understood as a measure of the created or destroyed value of each investment decision in case both of a real or financial investment. This methodology can help managers also in the appropriate selection of the best investment among different projects given the possibility to order them from the more profitable to the less profitable in a consistent measure.

[7] Assuming that all costs are incurred at time t=0. Otherwise they should be discounted at time t=0 as the inflows

1.3. The evaluation of a company and its strategy

The previous approach, focused mainly on single projects, has been further developed by Alfred Rappaport in its paper of 1981 "*Selecting Strategies that Create Shareholder Value*" in which he enhanced the concept of Discounted Cash Flow (DCF) from a useful tool to evaluate single projects into a powerful methodology able to measure the impact of a strategy on the whole company. While in a project-based DCF the considered cash flows are only those absorbed and generated by the implementation of the project, in a strategy-based model the company is conceived as an universe of projects (Sandri, Silvi, 1995) and all the operating cash flows generated by the company are taken into account for the evaluation. The incremental cash flows generated by the new strategy are added to the company cash flows and discounted with an appropriate cost of capital. The result will show the incremental value that the strategy will add to the whole company and as a consequence, the benefit that shareholders will gain. Thanks to this approach it is also possible to evaluate how much a company is worth and, with some adjustments the intrinsic equity value.

The equity value that we refer to is not the equity book value because it represents the historic value of the investment (initial or subsequent) made by the shareholders but to its market value such as the dynamic value that equity has reached in the normal running of the business. Shareholders have residual claims on the cash flows generated by the company, given the seniority and priority of the other stakeholders (suppliers, employees, creditors, tax regulator, etc). As a result the equity value can be measured as the difference between the market value of all assets and the market value of the company's debt, or better, its Net Financial Position[8]. The assets market value is commonly called Enterprise Value because shows how much a

[8] Net Financial Position: Financial Debt – Cash and Cash Equivalents

company is worth. In its evaluation three main elements have to be taken into consideration:

i) Cash flows generated by the operating activities
ii) The terminal value.
iii) The Weighted Average Cost of Capital

1.3.1. Cash Flows generated by the operating activities

The cash flows generated by the operating activities or more commonly, the Free Cash Flows are measured as it follows:

	EBIT
	(1-t)
	Net Operating Profit After Taxes
+	Depreciation and Amortization
+/-	Change in Working Capital
+/-	Capital Expenditures
	Free Cash Flows from Operations

The Free Cash Flows from Operations (or Unlevered Cash Flows) do not incorporate the interest expenses on the debt outstanding. There is a reason behind this choice. Since we want to evaluate the cash flows available both for debt holders and shareholders, it is clear that we do not have to take into account the interest expenses on debt. However, according to tax regulations, interest expenses are not taxable whereas we are calculating taxes on EBIT, that include interest expenses. To compensate this misalignment the tax-free treatment of interests is embodied, as we will see later on, in the discounting factor adopted to discount the cash flows and the terminal value.

Free cash flows are usually projected for a 5-to-10-years investment horizon because it is assumed that forecasts over 10 years are not fully reliable. The solution to this problem is the Terminal Value, the second element for the evaluation of Enterprise Value.

1.3.2. The Terminal Value

The Terminal Value is the present value at a future point in time of all future cash flows when we expect stable growth rate forever. It is measured through two methodologies: the "perpetuity method" and the "multiple method".

The first one assumes that after the last year of the projections, the FCFO will grow at a constant rate *g*. This growth rate is set according various variables: the forecasted long-term macroeconomic fundamentals (e.g. GDP, inflation), the trends of the business in which the company runs its activities and the competitive positioning of the company. So, adopting the formula of a growing perpetuity[9] the Terminal Value will be discounted by

[9] Assuming an amount of cash D, a perpetual growth rate g and a discounting factor r, the formula for evaluating the present value of a growing perpetuity is:

$$PV = \frac{D}{r-g} \ (1)$$

The formula is justified by this demonstration:

$$\mathrm{PV} = \frac{\mathrm{D}_1}{(1+\mathrm{r})} + \frac{\mathrm{D}_1(1+\mathrm{g})}{(1+\mathrm{r})^2} + \frac{\mathrm{D}_1\,(1+\mathrm{g})^2}{(1+\mathrm{r})^3} + \frac{\mathrm{D}_1\,(1+\mathrm{g})^3}{(1+\mathrm{r})^4} + \cdots$$

Readjusting we obtain:

$$\mathrm{PV} = \frac{\mathrm{D}_1}{(1+\mathrm{r})} + \frac{\mathrm{D}_1}{(1+\mathrm{r})}\frac{(1+\mathrm{g})}{(1+\mathrm{r})} + \frac{\mathrm{D}_1}{(1+\mathrm{r})}\frac{(1+\mathrm{g})^2}{(1+\mathrm{r})^2} + \frac{\mathrm{D}_1}{(1+\mathrm{r})}\frac{(1+\mathrm{g})^3}{(1+\mathrm{r})^3} + \cdots$$

This is to be considered as a geometric series with a common ratio of (1+g)/(1+r) and can be written as:

$$\mathrm{PV} = \frac{\frac{D}{(1+r)}}{1-\frac{1+g}{1+r}} = \frac{\frac{D}{(1+r)}}{1-\frac{1+g}{1+r}}\,\frac{1+r}{1+r} = \frac{D}{1+r-(1+g)} = \frac{D}{r-g} \ (1)$$

the difference between the discounting factor (WACC) and the perpetual growth rate and then, the result of the perpetuity has to be discounted again at the valuation time (t = 0) adopting the WACC.

The second method is called the “Exit Multiple”. The assumption behind this method is that the business will be sold at the end of the projected period, for instance time t+10. At that time the Enterprise Value will be found discounting the projected cash flows. However this value can be calculated also using the relative valuation approach and more specifically all multiples that provide a valuation for the Enterprise Value (more commonly is used EV/EBITDA) . So the appropriate range of multiples to apply will be defined analysing the peers of the company. The results coming from this investigation will be multiplied to the expected EBITDA or EBIT at time t+10. Then the result will be discounted at time t_0 to be financially consistent.

In both cases the result has to be added to the discounted cash flows previously mentioned.

1.3.3. Weighted Average Cost of Capital

In Enterprise Value valuations the discount factor for cash flows and terminal value is the Weighted Average Cost of Capital (WACC), a metric able to measure the cost of capital (that reflects the total riskiness of the firm) that depends on both the financial structure of the company and the characteristics of their business. In order to embody the real weight of the two sources of financing, the WACC is measured as the sum of the products of: i) the cost of equity with respect to its weight on the financial structure of the company and ii) the cost of debt with respect to its weight on the financial structure. However because of the tax-free treatment of interest expenses, this second factor has to be readjusted, multiplying it by (1-t) where *t* stay for the marginal corporate tax rate of the country in which the company is based[10]:

$$\mathrm{WACC} = \mathrm{Ke} * \frac{\mathrm{E}}{\mathrm{D}+\mathrm{E}} + \mathrm{Kd} * \frac{\mathrm{D}}{\mathrm{D}+\mathrm{E}}(1-\mathrm{t})$$

Where:

- Ke: Cost of Equity
- E: Equity Market Value
- Kd: cost of debt
- t: marginal corporate tax rate
- D: Debt Market Value

The cost of debt (Kd) is the cost of debt financing and it is measured applying a default spread to the risk free rate.

$$\mathrm{Kd} = \mathrm{rf} + \text{default spread}$$

The risk free rate is the rate of return of an investment that does not carry the risk of financial loss. A good proxy for such type of investment are the government bond returns. However two aspects have to be taken into consideration: i) the geographical area ii) the time horizon. If a firm is based in US or in a geographical area under its economic influence, the US government bonds are the chosen proxy. On the contrary if the company we are evaluating runs its business in Europe or more in general in EMEA, the German Bund is the ideal candidate for the risk free rate. The second consideration refers to the time horizon: usually the risk free rate reflects a long term rate, usually the ten-year bond. However for single projects with a short life, the five-year bond could be a good candidate too.

[10] Edit. While calculating the cash flows from operations, we subtract the taxes from EBIT and not from EBT in order to measure the cash flows available to both debtors and shareholders. From that comes the need of integrating the tax benefit on interests into the WACC

The default spread depends on the riskiness of the financing. The lower the risk of default, the lower spread, the lower the cost of debt. In management practices the default spread is set according to the long-term rating provided by the most important rating agencies[11]. The following table shows an hypothetical scale of default spreads:

Moody's/ S&P	*Default Spread (%)*
Aaa/AAA	0.00%
Aa1/AA+	0.40%
Aa2/AA	0.50%
Aa3/AA-	0.60%
A1/A+	0.70%
A2/A	0.85%
A3/A-	1.20%
Baa1/BBB+	1.60%
Baa2/BBB	1.90%
Baa3/BBB-	2.20%
Ba1/BB+	2.50%
Ba2/BB	3.00%
Ba3/BB-	3.60%
B1/B+	4.50%
B2/B	5.50%
B3/B-	6.50%
Caa/CCC+	7.50%
Caa2/CCC	9.00%
Caa3/CCC-	10.00%

The cost of equity is measured through the Capital Asset Pricing Model (CAPM), adopting the linear relationship that the model describes as a condition for market equilibrium:

$$\mathrm{Ke} = \mathrm{rf} + \beta * (\text{Market Risk Premium}) =$$
$$= \mathrm{rf} + \beta * (\mathrm{rm} - \mathrm{rf})$$

[11] Rating agencies are companies that assign a mark to companies or governments with respect to their ability to pay back their debt. This market is dominated by three rating agencies: Moody’s, S&P and Fitch that together own the 95% of this market.

The same considerations made for the risk free rate in evaluating the cost of debt are valid for the cost of equity measurement.

The core of the CAPM is the beta, a measure that reflects the sensitivity of the stock with respect to the general movements of the market. It is measured through a linear regression that defines the relationship between the return of an asset and the return of a benchmark that in this case is the market portfolio that we are considering. Another, more common expression for beta is βe = Cov($r_{m,}$ r_a)/ Var(r_m) where r_m is the return of the market portfolio (*see later*) and r_a the return of the beta. The sensitivity of the beta is a function of the company leverage and the riskiness of the business in which the company operates. Beta has nor cap nor floor, and assumes many values according to the type of stock we are considering and the chosen benchmark. The following table gives many examples and interpretation to the value it can acquire:

$\beta < 0$	This type of assets move inversely as compared to the index	Very rare. For instance a short position
$\beta = 0$	Asset is uncorrelated with the movement of the market portfolio	Risk free assets for instance government bonds
$0 < \beta < 1$	The asset moves in the same direction as, but less than, the movement of the market portfolio	Stocks that move in the same direction as the market at large, but less susceptible to day-to-day fluctuation.
$\beta = 1$	The asset moves exactly like the market portfolio	A representative stock, or a stock that is a strong contributor to the index itself.

$\beta > 1$	Asset moves in the same direction as, but more than proportionally to the movement of the market portfolio	Stocks which are very strongly influenced by day-to-day market news, or by the general health of the economy

The final element to choose is the market portfolio. Usually it is taken the market index; for example in US the S&P 500 is considered the right benchmark for both evaluating the beta and the return of the market portfolio. The market portfolio is used to evaluate its average return over a specific time period and, as a result, the market risk premium that measures the difference between the return of the risk free rate and the average return of the market portfolio.

The main assumptions of the CAPM are that past performances can predict future performances and that all investors agree on this hypothesis. That's why in performing the linear regressions a relevant number of past observations has to be taken into consideration and also the reason why the return of the market portfolio is the average return of past performances.

1.3.4. Final Considerations

Even if a company can be seen as a universe of integrated projects, the evaluation of its strategy is more complex because there is a series of external and internal factors that can be only partially integrated within the evaluation model that we are considering[12]. We can summarize these aspects in the following points:

1. The wide effects of a new strategy

[12] The approach of real options can partially solve this problem

2. The long-term investment horizon
3. The higher level of uncertainty
4. The presence of multiple opportunities (both internal and external)
5. The presence of multiple threats (both internal and external)

The outcomes of a new strategy can be more than those expected by the management and can have positive or a negative impacts on the already existing business or businesses. For example the introduction of a new product can partially substitute the already merchandized products thus producing a cannibalization effect. Strategies usually have a longer time horizon with respect to single projects; this means that they are exposed to multiple risks for a longer time and the implementation of risk management tools to mitigate or avoid these risks is less powerful. Unexpected macroeconomic events or the introduction of a disruptive technology can affect dramatically the market and, as a consequence, the generation of cash flows for the company.

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1.4. Organic growth, inorganic growth, restructuring and the "Pentagon Model"

Business literature identifies two main ways, at corporate level[13], to create value and expand a business: organic growth and inorganic growth. Organic growth occurs when a company expands its business increasing its production in terms of output or lines of business through its own internally produced resources. On the contrary, inorganic growth is usually referred to the expansion of a business through the acquisition of another company (or more companies) that may operate in the same business or in an unrelated market (diversification). In addition to the general case of mergers and

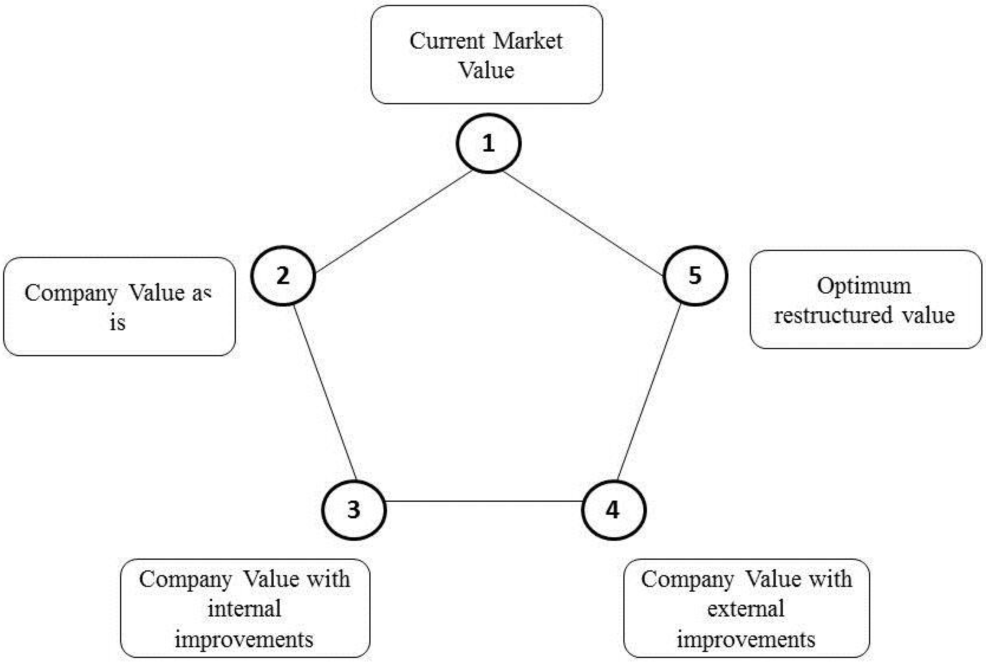
[13] Strategies can be categorized depending on which organization level at which they are implemented (entity level, division level, function level or single business unit). It is important to note that this categorization does not assign an order of importance or of efficiency because each of them can impact dramatically on the company performance.

acquisitions, there are other strategies that can be associated to inorganic growth: minority investments, outbound joint ventures, strategic alliances or contractual relationships.

However, there is another broad category of strategies that can be implemented in order to create value for shareholders but that usually is not taken into the appropriate consideration, especially by media that are mainly focused on M&A operations, such as all the divesture processes and restructuring. There are many ways in which a Board can implement a restructuring and we will analyse their characteristics and differences in detail in the following chapter.

The "Pentagon Model" developed by the strategy consulting firm McKinsey[14] incorporates these three corporate strategies in a systematic process that can help managers in the definition of a value-creating strategy. The name of the model comes from the 5 steps of the process, like the five extreme points of a pentagon. Even if the model does not assign a specific step to restructurings, in our point of view, we can associate them at inorganic growth strategies. Let us analyse the model helped by the following picture that summarizes it:

[14] Grant., R.M., *L'analisi strategica per le decisioni aziendali, 3rd Edition,* Oxford – Blackwell, 2005



1. **Current Market Value of the Company**: managers have to measure the enterprise value discounting all the unlevered cash flows generated by the operating business of the company. A historical survey on the main value drivers of the business has to be conducted in order to understand what has been contributing on the creation of the company current valuation.

2. **The Value of the Company as is:** at this stage the current market value of the company has to be compared with the perceived value by the investor community. It is possible that this perceived value is higher or, as it is in most cases, lower due to a lack in transparency and communication of the results reported by the firm or a misunderstanding of the real business of the company (as we will see later in Yahoo's case). The model assumes that some value can be delivered only through an improvement of communication with the market without modifying the composition of the business portfolio.

3. **Potential value of the Company with Internal Improvements:** At this stage managers are required to deeply analyse the business operations, individuate all the inefficiencies on the value chain and implement organic growth. They have to maximize the potential operating cash flows through strategic and operating improvements. Strategic decisions may consist for instance in a new geographical positioning or in the outsourcing of some activities. Operating gains can be translated in cost and revenue structure improvements.

   An indicator that can be adopted in measuring the operating efficiency of a business is the Return on Investments (ROI) given by *EBIT/Operating Invested Capital*. The higher the ratio, the higher the efficiency of the investment. ROI also indicates the benefits that an investor is gaining from the his investment in a certain business. DuPont Corp, a chemical and healthcare company, has identified in the 20s a method to analyse more in detail the ROI. In fact this indicator can be broken down in two elements that if multiplied will result in the ROI. These two factors are:

   - Return on Sales (ROS), that measures how much a company earns before interests and taxes from each dollar of sales (assuming we are using dollars as currency) and shows the efficiency of the cost structure,
   - Asset Turnover, that measures the efficiency of a company in using and exploiting its assets in the generation of sales.

   The previous indicators can be summarized as follows:

$$\text{ROI} = \frac{EBIT}{Operating\ Invested\ Capital} =$$

$$= ROS \times Asset\ Turnover =$$

$$= \frac{EBIT}{Sales} \times \frac{Sales}{Operating\ Invested\ Capital}$$

4. **Potential value of the Company with External Improvements:** Once managers have maximised value through organic growth (in terms of business or company as a whole) they may act in two different ways: acquire other companies or dismiss a business if the benefits coming from the divesture are higher than the net benefits associated to the maintenance of the business in the company portfolio. These decisions can modify the operating cash flows at the entity level and the overall risk of the consolidated company so the trade-off shall be considered carefully.

5. **The Optimum Restructured Value of the Company:** the last step of the Pentagon Model does not concern strategies or acquisition but focuses on the financial structure of the company. Following Modigliani-Miller theory, managers have to individuate and reach the optimum financial structure that maximizes the company value (or minimized the weighted average cost of capital).

At the end of this process the difference between the current market value of the company and its potential value (achieved through an improvement in the perception of the company, in the operating activities, in the business portfolio and in its financial structure) is the wealth that can be delivered to shareholders or the value of which a corporate raider could take advantage from in an hypothetical takeover.

1.5. The agency theory: a deviation from the shareholders' value creation

The underlying assumption of the Pentagon Model developed by McKinsey is that managers plan and execute a strategy aiming sole at the maximization of value for shareholders. However in the real world such assumption has been violated: the financial scandals that affected the US economy at the beginning of the third millennium or the Italian cases of Parmalat and Cirio are an empirical evidence.

The agency theory speculates and reflects on the issues that the separation between ownership and control arises. Given the dispersion of control in public companies, there are not subjects with a large portion of decisional power on the company. This is one reason that lead to the delegation of control to professional managers thus leading to the creation of a principal-agent relationships between shareholders (principal) and managers (agents). In general an agency relationship is defined as a contract under which a principal(s) delegates some decisional power to an agent(s) in order to benefit of her (their) services. As a result, the welfare of the principal, that will behave as passive holder, depends upon the actions successfully implemented by the agent. However this separation may lead to a misalignment between the interests of shareholders and those of the management: in imperfect labour and capital markets mangers will seek to maximize their own utility at the expense of corporate shareholders. Agents have the ability to operate in their own self-interest rather than in the best interests of the firm because of asymmetric information. Indeed, managers know better than shareholders whether they are capable of meeting shareholders' objectives.

Evidence of self-interested managerial behaviour includes the consumption of some corporate resources in the form of perquisites and the avoidance of optimal risk positions, whereby risk-adverse managers bypass profitable opportunities in which the firm's shareholders would prefer they invest.

Outside investors recognize that the firm will make decisions contrary to their best interests. Accordingly, investors will discount the prices they are willing to pay for the firm's securities.
Shareholders are interested in the increase of earnings per share (EPS) and current share prices, in a generous dividend policy, and for many of them, a greater effort of the company in social responsibility. On the contrary managers want to increase their personal wealth by paying themselves high remunerations and other benefits or for example increase their prestige and their perception in the business world.
The more common example are stock-option plans. Manager can receive shares of the company as a variable part of the salary. The underlying assumption behind this rewarding structure is that becoming shareholders makes manager focus more intensively on the company performance with respect to the investor community. However this model has led to big distortions. In fact managers implemented risky strategies with extraordinary results in the short-term, the share price went up dramatically but after their mandate the policies and actions undertaken by these managers revealed their unsustainability in the long-run thus leading the company to serious problems of profitability and competitiveness

From this perspective it seems that the agency theory would exist only in those countries where financial systems belong to the so-called outsider system (i.e. where exists a very liquid capital market, diluted ownership and, as said before, separation between ownership and control). However also in insider financial systems (i.e. where few big controlling shareholders – usually families or the State – have the power to appoint managers and directors and to exert relevant decision power over the company thanks to shareholders' agreements, as it is in all markets of Continental Europe, characterized also by lower liquidity and cross-holdings) there is a slightly different agency problem. In fact, when the ownership and the control is concentrated in the hands of a major shareholder, the conflict involves the controlling shareholder - that represents the agent - and the minority stockholders - that in this case can figure as the principal -. Majorities can extract private benefits of the control impacting on the welfare of minorities. The control of these shareholders does not come only from the relevance of stake they have in the company but also from the use of specific mechanisms, like pyramids or privileged stocks, that gives them specific rights on cash flows or extraordinary voting and decisional powers. In fact the main power they can exert is to appoint managers and directors that will very likely act as agents not of the whole company ownership but of the major shareholders. It must be noted that in all countries, several measures have been implemented in order to safeguard the rights and wealth of minorities.

1.6. Correction to management policies and a value-oriented phenomenon: Shareholder Activism

1.6.1 A brief introduction to shareholder activism

In both insider and outsider systems, a promising source of monitoring the management and balancing the related agency problems has been identified in the shareholder activism. This theme assumes a great importance for the purposes of our analysis because the decision of Yahoo to perform the tax-efficient spin-off planned for Q4 2015, the subject of our analysis, was pushed by Starboard Value Ltd, a US shareholder activist established in 2002, that entered in Yahoo in September 2014.

Shareholder activism can be defined as a way in which shareholders can assert their power as owners of the company to influence its behavior. As a result a shareholder activist is a shareholder who attempts to use his or her rights as a shareholder of a publicly-traded corporation to bring about social change. As said before it can be considered also as a source of monitoring of managers in outsider and insider financial markets and/or blockholders especially in insider financial markets (more in general in all cases of principal-agent relationship). There are three main types of activists: large shareholders, individual shareholders and the broad category of institutional shareholders like hedge funds, pension funds, banks and insurance companies.

Shareholder activism is a phenomenon that surged in the 1980s, during the "fourth merger wave", characterized by an intense hostile takeover activity and the arise of innovative financial instruments like high yield and junk bonds. At the first stage of the phenomenon, activists were pension and mutual funds that adopted a defensive and "ex-post" approach; it means that when they disagreed with managers' decisions, they reacted to protect or enhance the value of pre-existing holdings, pushing to eliminate the management decisions that according their analysis were value-destroying. They still adopt such type of approach (e.g. in chapter 3 the reaction of the two pension funds at the rejection of Microsoft tender offer of Yahoo!) The new approach arose during the second wave of shareholder activism after 2002, is the offensive shareholder activism in which specialized activists (usually hedge funds), with an "ex-ante" approach, lack a sizeable stake in the target, build up one "offensively" with the intention of actively prompt changes to maximize their investment return. The relevant difference between the two approaches is not the friendly or aggressive attitude towards the management, but the existence of a position in the target company before the decision to intervene. It can be seen that in both cases (defensive and offensive activism) the objective of their actions is to maximize their returns and the value of the firm in which they invested, with a complete alignment with the objectives of common shareholders. There is an important caveat. Even if shareholder activists want the maximization of value, their investment horizon can be in the short term in order to profit of a favorable speculative situation whereas the common shareholder base has a long term horizon. That's why sometimes managers do not take into account the suggestions coming from these actors.

1.6.2. Stages of shareholder activism

It is not easy to identify a specific process that shareholder activists apply to pursue their objectives. However the empirical evidence shows some steps that occur always:

1. **Identification of the target they want to attack**. There is a debate on what makes a firm vulnerable to activism. Activists usually look for companies whose stock returns and valuation multiples lag those of their peers.

   Another important metric adopted by activists are revenue growth perspectives: companies are more susceptible to activist interests when they are investing little in future growth prospects. It means that companies wishing to avoid activist pressure should develop credible growth plans.

   Growth plans are not enough: like for mergers, acquisitions or leverage buyouts, conservative financial strategies such as poor leverage, low payout policies and high cash balances represent an incentive for activists to take advantage from such profitable situation.

   Firms with diversified business models and multiple operating segments are perfect candidates for shareholder activists given the discount that affects such type of companies (more details in the following chapters)

2. **Initial acquisition.** Activists investors take initial position in the target varying from 5% to 15%. They can reach these thresholds in one block or in more phases. It is common in this phase that share price react strongly to the presence of such type of investors in the shareholding structure because it indicates to the market that some hidden value may be present within the company.

3. **Private Correspondence with Board**. Investor seeks meetings with key management or board figures to discuss perspectives on business. Frequently they also send formal letters to the board setting out perceived short-comings in current strategy and suggested improvements. Usually activists t.ry to maintain a soft behavior and prefer to keep their engagement private

1. **Public Campaign.** It starts with the mere presence on the register, particularly for the well-known funds. If the quiet approach fails, then the activist may organize press conferences or, more likely, send open and public letters to the CEO and Board criticizing their current strategy and showing the potential value of the firm. All these activities are coordinated with approaches to other key shareholders.

2. **Requisition of an Extraordinary General Meeting (EGM).** If the relationships with the management don't take the right directions, activists manage to require an EGM seeking to place representation on the Board, remove the existing Board or requiring specific actions. The result of such actions depend on the successfulness in gaining support of majority of voting shareholders

3. **Litigation.** Much less common in European situations than in the US.

1.5.3. Objectives of Shareholder Activists

Shareholder activists can act and promote different solutions accordingly to which target they are working with. Their investment portfolio usually include many companies and it is not uncommon that an activists may suggest a combination between two or more companies that belong to its portfolio (it is the case of Starboard that pushed for a merger between Yahoo and AOL).

Looking at past cases of shareholder activism we can identify many objectives that such type of investor wants to achieve:

- influence decision making (e.g. Knight Vinke on HSBC),
- increase capital distribution (e.g. Jana Partners and D.E. Shaw Group on Philips)
- monetize other assets (e.g. Tchenguiz on Sainsbury)
- frustrate M&A (e.g. TCI and Atticus on Deutsche Borse)
- influence takeover outcomes (e.g. A-Tec on Cumerio / Norddeutsche Affinerie)
- change management team (e.g. Piedmont on Mitchells & Butlers)
- require a fair takeover compensation (e.g. Various on Wella),
- break up (e.g. Starboard on Yahoo; Knight Vinke on ENI),
- sell the company (e.g. TCI on ABN Amro)

As can be seen thanks to the list of real cases, sometimes activists act jointly in order to pursue their objectives in a more efficient and quicker manner. In fact in these cases shareholder bases are more influenced and the management team can be forced to accept the indication of the activist.

The market might not accept the management reluctance on the suggestions offered by activists and sometimes companies that don't follow the activists suggestions are penalized. However management teams know their companies better than external agents and may have relevant reasons not to follow the indications of the activists.

Yahoo's case comprises both acceptance and rejection to act accordingly activists' suggestions. At the end of our study we will be able to see if the actions promoted by Starboard Value are valuable or not.

Before studying the business case in detail it is necessary an overview on spin-offs and the benefits coming from their implementation and the reasons behind such type of transactions.

Chapter 2

Divestment strategies and spin-offs

Divestment is a form of retrenchment strategy used by businesses when they downsize the scope of their business activities. Divestment usually involves eliminating a portion of a business. Firms may elect to sell, close, or spin-off a strategic business unit, major operating division, or product line. This move often is the final decision to eliminate unrelated, unprofitable, or unmanageable operations or to enhance the creation of value for shareholders thanks to the potential benefits deriving from the strategy

After an intense period of growth, divestment is commonly the consequence. Much of the corporate downsizing of the 1990s has been the result of acquisitions and takeovers that were the rage in the 1970s and early 80s (the first M&A wave). Firms often acquired other businesses with operations in areas with which the acquiring firm had little experience. After trying for a number of years to integrate the new activities into the existing organization, no synergies were realized. The market has generally penalized these conglomerate holdings that usually trade at discount with respect to their intrinsic value. As a result many firms have elected to divest themselves of portions of the business in order to concentrate on those activities in which they had a competitive advantage. Divestment strategies are become again more common in the current business environment and often are pushed by shareholder activists that identify in such type of actions an incredible source of value.

Divestments can be grouped into two categories: (1) a sale or distribution of the stock in a new public company holding the business being separated (2) a sale to a third party of the business being separated. The decision as to which type of separation transaction to pursue depends on a variety of factors.

A sale or distribution of the stock in a new public company can often result in greater value to the parent's shareholders because:

1. the public market may place a higher value on the business than a third party;
2. a distribution of stock in a new public company can be accomplished in a manner that is tax-free to both the parent and its shareholders, whereas a sale for cash would be a taxable transaction.

On the contrary, a sale to a third party can often generate the largest amount of cash proceeds to the parent but has two weaknesses with respect to a spin-off:

1. it is a taxable transaction for the parent;
2. bears more risks because it requires a third party to execute a binding agreement for the sale and there are typically closing conditions, including, for example, regulatory approval conditions, in such agreements. Purchase agreements with third parties also often include a variety of representations and warranties about the business supported by post-closing indemnities, whereas in a spin-off the business usually is transferred on an "as-is, where-is" basis.

Let us analyze more in detail what a spin-off is, how it is realized, the reasons for a spin-off and the requirements to benefit of the tax-free treatment

2.1. Spin-offs

A spin-off involves the separation of a company's businesses through the creation of one or more separate, publicly traded companies. In a typical spin-off, all of the shares of the company being spun off are distributed pro-rata to the shareholders of the parent via an extraordinary dividend. This results in a full separation of the two entities in a single transaction. Spin-offs can be realized also through the creation of more than two entities[15].

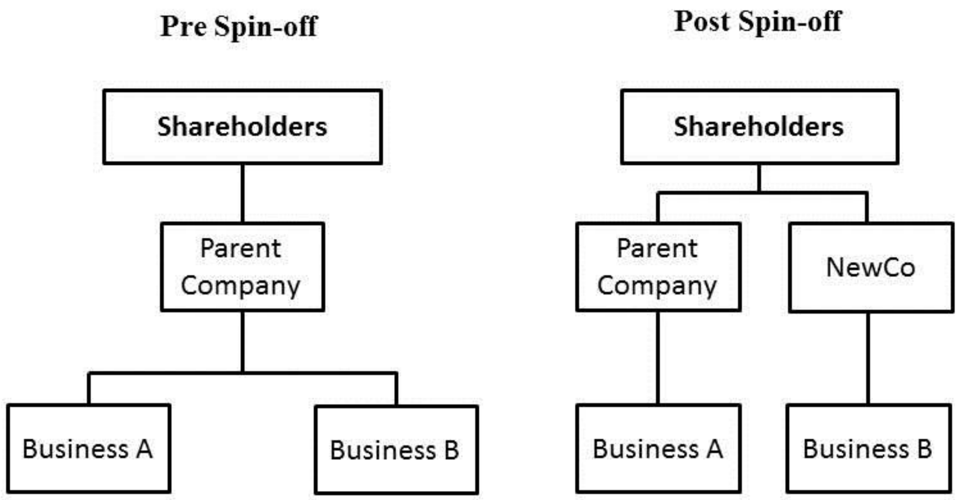


Figure 1. Corporate Spin-off (pre and post)

[15] For instance IAC/InterActiveCorp's spin-offs of Ticketmaster, HSN, Tree.com and Interval Leisure Group.

Thanks to the monetary policies adopted by Central Banks of many developed countries, especially the quantitative easing implemented by the FED and more recently by the ECB, robust debt markets have enabled companies to lock in low borrowing costs for the business being separated and monetize a portion of its value.

The process of completing a spin-off is complex and requires consideration of many of financial, capital markets, legal, tax and other factors. The issues that will arise in an individual situation will depend in large measure on the degree to which the businesses were integrated before the transaction, the extent of the continuing relationships between the businesses after the transaction, and the structure of the transaction. In case of deeply related business being spun-off that also after the separation will keep on having significant business relationships, it will take more time and effort to specify assets and liabilities, identify personnel that will be transferred, separate employee benefits plans, obtain consents relating to contracts and other rights, and document ongoing arrangements for shared services (e.g., legal, finance, human resources) and continuing supply, technology sharing and other commercial or operating agreements.

In addition to these separation-related concerns, spin-offs raise the issues associated with bringing a company public, from drafting and filing the initial disclosure documents, to applying for listing on a stock exchange, to implementing internal controls and managing ongoing reporting obligations and the public investor relations function.

In some cases, the parent may distribute fewer than all of the shares of the spin-off company. Typically, the parent would not intend to retain the remaining shares long-term, but rather would use them to generate cash proceeds though a complete disposal of the shares on the market after the spin-off believing an increase in the stock price. In this case there would be more legal issues, especially those concerning the composition of the subsidiary board, independent director approval of related-party transactions, handling of corporate opportunities and other matters.

A spin-off also can be accomplished jointly with an investment transaction in a so-called “sponsored spin-off.” In this type of transaction, the parent distributes the shares of the subsidiary benefitting of the tax-free treatment but at the same time it occurs the acquisition by a sponsor of up to 49.9% of either the parent or the company being spun off. The sponsor’s investment allows the parent to raise proceeds in connection with the spin-off without having to first go through the IPO process, and can help demonstrate the value of the target business to the market. Sponsored spin-offs raise a number of complexities, in terms of valuation, capital structuring and internal issues.

2.2. Rationale behind spin-offs

There are many reasons behind the structuring and accomplishment of a spin-off and more in general a divestment. Those most cited by companies are:

1. Enhanced business focus
2. Appropriate capital structure for the business
3. Distinction between two or more companies enhancing transparency
4. Effectiveness of equity-based compensation
5. Employment of equity as a new currency to implement new mergers and acquisitions strategies
6. Divestment of a business with negative performances
7. Reduce threats of hostile takeovers

A spin-off will allow each business to focus on its own strategic and operational plans without diverting human and financial resources from the other business. The parent will focus on its core activity whereas the subsidiary will strengthen its efficiency in terms of resources allocation and processes design.

Sometimes the company businesses portfolio includes activities that have different capital requirements that may not be optimally addressed with a single capital structure. Thanks to the spin-off managers can optimize the capital structure for each company considering the financial needs of their specific business and strategy.

A spin-off will create distinct and targeted investment opportunities in each business. A "pure-play" company may be considered more transparent and attractive to investors focused on a particular sector or growth strategy, thereby counteracting the "conglomerate discount" and enhancing the value of the business. We will discuss conglomerate discount in a specific paragraph because it is one important issue in the real case we will study in the following chapter.

Thanks to spin-offs, equity-based compensation programs can be more effective. In fact in both businesses the value of the equity compensation awarded to employees, officers and directors will be tied directly to the performance of the business for which these individuals provide services and not on an overall basis. This has a triple effect: it will motivate employees to perform better, performance can be measured more easily and more effectively and finally, employees will be rewarded for their real value added on the company.

By creating a separately publicly traded stock, a spin-off will enhance the ability of the spun-off business to effect acquisitions using this stock as consideration. This creates more opportunities for inorganic growth and increases the likelihood of higher wealth for shareholders

Lastly, spin-off allow managers to dismiss businesses that are reporting negative returns penalizing the results of the parent company. As said before, divestments occur mainly after relevant waves of mergers and acquisitions. The inability of realizing the expected synergies or the occurrence of negative synergies after the merger may induce managers to separate two businesses. In this case both businesses could be performing well, but the sum of the two businesses creates these negative synergies that, as a result, destroy value.

A part from these strategic considerations, managers focus also on financial aspects of this type of transactions. It is very common that after the spin-off, the value of the subsidiary measured through multiples valuation may be higher.

2.3. The conglomerate discount: an incentive to spin-offs

Spin-offs and other corporate restructuring are usually guided by the desire to improve the valuation of the business portfolio hold by a company. This is particularly true and achievable for firms with a highly-diversified portfolio of businesses. Indeed, these companies find themselves valued far below peer-companies focused on a single business (the so-called "pure-play companies"). This effect is commonly called "conglomerate discount".

More precisely, conglomerate discount is an economic concept describing a situation when "the market values a diversified group of businesses and assets at less than the sum of its parts. Therefore, the market penalizes a multi-division firm and attaches a lower multiple to its earnings and cash flows. There are many theories and studies on this phenomenon but three main reasons can explain it:

1. Market preferences: many critics of diversification argue that investors prefer to allocate their resources autonomously, choosing their own portfolio using companies focused on their core business, rather than investing in a fixed weigh portfolio.
2. Pure plays companies can be understood more easily. There is an higher level of transparency and performance measurement is easier and more consistent
3. Pure plays companies are better managed given their higher simplicity. On the contrary conglomerate companies are too complex and lack the focus necessary to be managed as effectively as pure

plays so they will almost always underperform and command lower multiples.

Indeed, in order to rectify this situations, company implement restructuring transactions. The first step in performing a spin-off is, generally, to evaluate if the company is traded at discount and is suffering from this market penalty.

According to many researches[16], diversified companies trade – globally - at a median discount of 5.5% with respect to their pure-play peers. In many regions, this discount is higher, as it happens in North America where it reaches roughly 10%. On the contrary in Japan or in Latin America conglomerate companies trade at premium such as, the market prefers companies with diversified portfolios.

An interesting aspect of conglomerate discount is that during periods of downturns, it tends to be lower because excess of cash of one business can offset and compensate negative performances of the other businesses hold in portfolio. On the contrary pure-play companies have to rely on external capital markets as only source of their financing.

However, as briefly mentioned before, not all conglomerates trade at discount. There are several characteristics in common among those conglomerates that trade at premium. The most important, a bit obvious, is that all the individual businesses perform better than their industry peers. The excess returns they generate are stronger than those of pure-play companies.

The second aspect is their capability to capitalize on their opportunities of growth. Growth is obtained through a strong culture of performance spread all over the company and not only in some segments of it (the so called golden boys). In addition to that growth is obtained through a well-organized distribution of capital and resources.

[16] Citigroup, Spin-offs – Tackling the conglomerate discount, April 2011; Berger and Ofek, Journal of Financial Economics, 1995; Berger and Ofek, Journal of Finance, 1996.

The third aspect in common of all conglomerates that trade at premium is the optimal capital structure of each business, a strong financial profile of the company and a high debt capacity: this allows them to successfully execute all strategic opportunities that the external and competitive environment offer in the short and long run.

The last characteristic that conglomerates that are not affected by a discount is the capability of the management to create synergies between the various business segments. These are achieved through an intense activity of strategic planning.

2.4. Sum of the parts valuation

The sum of the parts valuation, also called break up valuation, is the methodology adopted to verify if a company is trading at discount, at par or at premium. Thanks to this method is also possible to identify those businesses that are heaving more on the business portfolio and that are ideal candidate for a spin-off. The rationale behind the sum of the parts is easy: the analyst shall evaluate the intrinsic value of each business in portfolio and compare the sum of them it to the current market value of the company. If there is a value gap, there is value that the market doesn't recognize to the firm.

There are four main steps to complete the process:

1. Measure the intrinsic value of the businesses run by the company. The valuation is performed considering each business independent from the others, as it was the only business of the company.
2. The intrinsic total value of the firm. The intrinsic value of the business are summed up in order to measure the total intrinsic value of the company.

3. Determination of the implied equity value of the company. It is obtained subtracting the net debt (at market value) from the intrinsic enterprise value
4. Compare the implied equity value with the current market capitalization. If the implied equity value is higher than the market capitalization, investors are penalizing the company. On the contrary if the implied equity value is lower than the market capitalization the company is trading at premium.

2.5. The preliminary considerations before a spin-off

The initial step for a spin-off is to determine precisely the elements that will be spun off. In the case of a subsidiary that has always run as a standalone business, this may be relatively simple. The boundaries and limits of the business to be spun off will already be reasonably well defined. Even in that context, however, it may be necessary to add or remove operations from the subsidiary before the separation occurs.

After having defined the business(es) to be spun-off, the next step is to determine the capital structure of the parent and the spin-off company after the transaction, as well as the actions required to implement the desired capital structure. We have seen before that one main driver cited by companies for pursuing a spin-off is to allocate more efficiently its existing cash and debt between itself and the spin-off company. One significant complicating factor is that the parent and/or the spin-off company can be rated differently and may have different creditworthiness than, and will have (sometimes significantly) smaller assets and earnings than, the combined predecessor company. As a result, the terms (including pricing, financial and operating covenants and required guarantees and collateral support) of the credit documents of the parent and spin-off company can be dramatically different than those of the predecessor firm; therefore, such transactions can require a significant amount of new drafting, negotiation and disclosure. As stated by Watchell (2015) "it is important that early in the spin-off planning process, companies begin to identify the optimal financing structure for each of the parent and the spin-off company, begin to consider ideal terms of their debt instruments, initiate discussions with potential financing sources and rating agencies and begin to consider the timing of the financing transactions in relation to the anticipated effective date of the spin-off (especially in light of the prevailing market conditions). Indeed, the financing considerations should play a critical role in the determination of the structure for the spin-off itself, as the size of the spin-off company and the parent and their capital structures and creditworthiness (including whether or not they will receive investment-grade ratings) can dramatically affect their cost of capital and the terms of their debt."[17]

Another relevant aspect is the timing of the spin-off with reference to the debt market. In fact, if market conditions are not favorable to the issuance of new debt for the completion of the spin-off or unfavorable in the short-term thus compromising the ability of the spun-off company to recur to debt financing, the spin-off is at risk. A potential mitigation of this risk of execution could be the obtainment of financing commitment during and after the transaction.

After the financial structuring of the parent and the spun-off, management has to face relevant and tricky decisions concerning corporate governance. Because a spin-off company is typically a wholly owned subsidiary or is created as a wholly owned subsidiary of the parent, its corporate structure, charter and by-laws can be established by the parent without holding a vote of public shareholders. The parent will need to select the jurisdiction of incorporation of the spin-off company, draft its constitutive documents such as its charter and bylaws, and determine the size and composition of the board of directors, as well as board compensation and the structure of board

[17] Watchell, Lipton, Rosen, Katz, "Spin-off Guide" April 2015

committees. Identification and recruitment of the spin-off company's directors can take some time and therefore should preferably be completed not too late in the process.

Another strategic aspect that is crucial while structuring a spin-off is the creation of takeover defenses. "It is not rare that the spin-off company has more antitakeover provisions in its charter and by-laws than the parent. It is commonly acknowledged that it is desirable for the newly public company to have antitakeover provisions from the outset as the new company's board could always seek to eliminate them later, whereas a decision to add antitakeover provisions made when the company is already public may face resistance from activists or institutional investors that are less interested in long-term investments but are more interested in the short-medium term. Such resistance could, in the case of protections (such as classified boards) that can be implemented only with shareholder approval, make it very difficult to adopt such protections following the spin-off or IPO."[18] However the most important reason is that the spin-off company is potentially more vulnerable to hostile takeovers than before the transaction because of its smaller market capitalization, particularly in the period immediately following the spin-off, in which the stock price of the spin-off company is exposed to high volatility.

Other important takeover defense is a classified board structure that many managers consider one of the most powerful especially as a defense in the event of hostile attempts to acquire board control. This measure provides the board with time to adequately consider a bid. Because only one-third of the board is up for election in any given year, a hostile acquirer or shareholder activist who runs a proxy fight to replace board members with its nominees would need to obtain shareholder support in two election years to replace a majority of the board members. There are many benefits descending from a classified board structure:

[18] Watchell, Lipton, Rosen, Katz, "Spin-off Guide" April 2015

- Top management will have no pressure to make decisions with a short-term horizon, in contrast with activist shareholders perspective and will run the business adopting strategies that look at the long-term interests of the company.
- It enables the company to require that directors may only be removed for a right cause.

It should be noted, however, that shareholder activists are critical of classified boards and have submitted declassification proposals to numerous companies.

There are many other antitakeover provisions including:

1. no right for shareholders to call a special meeting;
2. no right for shareholders to act by written consent (or a requirement for actions to be adopted by unanimous written consent);
3. blank check preferred stock authorization;
4. inclusion of “fair price” provisions;
5. advance notice provisions for shareholders seeking to make director nominations or otherwise bring business before a shareholders’ meeting;
6. limitation on shareholders’ ability to amend bylaws;
7. no exemption from state antitakeover statutes.

2.6. Other divestment strategies

A part from spin-offs, many companies may choose alternative structures of divestments. This paragraph aims to describe briefly their differences and the objectives of these transactions that can differ significantly from those expected by a spin-off.

For instance, a parent can structure a separation transaction through an initial public offering (an “IPO”) just with a portion of the common stock of the company to be spun-off followed by a distribution of common stock to shareholders of the parent. Thanks to the IPO, the subsidiary is able to sell a portion of its shares to the public in an underwritten offering, with the proceeds either retained by the subsidiary or distributed to the parent. An IPO allows the formation of a natural investor base for the subsidiary in advance of distributing the remainder of the parent's stake in a spin-off. In this case the shareholders of the new company should be really interested in investing in the company whereas through the spin-off shareholders are potentially forced to receive their shares and only later on can sell them on the market (if the spun-off is public). Creating an investor base in advance of a spin-off may be helpful because the shareholders of the parent on the record date for the spin-off dividend may or may not wish to hold shares of the spin-off company. In addition, an IPO not only allows for an additional means for the parent to raise capital, but it also allows for a trading market and market valuation of the spin-off company to be established before the distribution of the spin-off company stock to the parent's shareholders. For the subsequent spin-off to qualify as tax-free, the parent must generally retain at least 80% of the voting power of the shares of the subsidiary after the IPO, because the tax rules require the parent to distribute "control" (generally 80% of the voting stock) of the subsidiary. An IPO followed by the distribution of the offering proceeds to the parent is generally tax-free to the corporations involved, provided the amount of cash distributed is less than the parent's basis in the stock of the subsidiary and certain other requirements are met. If the distribution of proceeds exceeds the parent's aggregate tax basis in the stock of the subsidiary, the excess would generally be includible in income of the parent either when the distribution occurs or when the parent divests the subsidiary. Issuing low-vote stock to the public may preserve the ability to spin off the subsidiary in a subsequent step if the parent wants more than 20% of the value of the stock of the subsidiary to be issued to the public. However, the US IRS[19] (also "IRS") no longer issues rulings regarding the tax consequences of a spin-off in which such a high-

[19] IRS stands for Internal Revenue Service. It is the US National Agency responsible for tax collection and the administration of the Internal Revenue Code such as the federal statutory law in United States

vote/low-vote structure is put into place in anticipation of the spin-off. Accordingly, under current IRS practice, any such spin-off would have to be done on the basis of an opinion of counsel, rather than an IRS private letter ruling. If the parent desires to sell to the public more than 20% of the stock of the subsidiary, while preserving the ability to spin-off its remaining interest in the subsidiary subsequently in a tax-free manner, an alternative to the traditional high-vote/low-vote structure is to structure the subsidiary as an "Up-C." An Up-C structure generally has the following characteristics:

- the business to be separated is contributed to an operating company that is a limited liability company or limited partnership (and is treated as a partnership for tax purposes);
- the public purchases low-vote stock in a newly formed corporation that holds a minority economic interest in the operating company and a majority of the vote and control over the operating company;
- the parent holds both non-economic high-vote stock in the newly formed corporation giving it control over the corporation and at least a 50% direct economic interest in the operating company. When the parent subsequently spins off its remaining interest after the IPO, the operating company merges with the corporation.

The Up-C structure allows the parent to sell up to 50% of the economics of the business being separated and, until it spins off the remaining interest, receive cash distributions from the operating company on a tax-efficient basis. Distributions can be received on a tax-efficient basis because the operating company is a partnership for tax purposes rather than a non-consolidated corporate subsidiary. The main downside of the structure is that the parent may pay tax on the upfront proceeds from the IPO of the corporation. As with the traditional high-vote/low-vote structure, the IRS no longer rules on spin-offs of corporations that have issued low-vote (or high-vote) stock in anticipation of the spin-off. Some companies determine not to pursue a carve-out IPO because of the additional costs (such as underwriting fees), complications and uncertainty involved in an IPO. The timing of an

IPO will depend in large part on market conditions, which could significantly delay the completion of the transaction. An IPO also raises governance issues because the parent continues to control the subsidiary between the time of the carve-out IPO and the later spin-off, resulting in fiduciary duties to the subsidiary's public shareholders. Examples of carve-out IPOs followed by spin-offs are the Sunoco/SunCoke Energy, Motorola/Freescale Semiconductor transactions and GE's planned spin-off of the rest of Synchrony Financial following its IPO.

Another potential structure is the so-called Split-Off. In a split-off, the parent makes an offer to its shareholders to exchange their parent stock in exchange for all or a portion of the shares of the spin-off subsidiary. It is equivalent to a share buyback of the parent's stock using stock in a subsidiary as the consideration instead of cash. A split-off is typically done after the spin-off company has been taken public as a result of an IPO, so that the established trading value of the spin-off company's shares can be used in pricing the split-off exchange ratio. In a split-off, the parent typically offers to purchase the parent stock at a premium relative to the trading price of the spin-off company's shares. Because the parent's shareholders elect whether to participate in a split-off, ownership of the spin-off company following the transaction generally is not proportionate (unlike a spin-off, in which shareholders receive a proportionate number of shares of the spin-off company), and the transaction must be registered under the U.S. Securities Act of 1933 (the "Securities Act") because it involves an investment decision by the parent's shareholders. A split-off is also an issuer tender offer under the U.S. Securities Exchange Act of 1934, and, therefore, the parent must comply with the tender offer rules.

A split-off can also be used to reacquire stock, generally from a large stockholder, in a transaction that is referred to as a "cash-rich split-off." In this type of transaction, the parent company creates a new subsidiary and contributes an "active trade or business" (i.e. an operating business that the parent has owned and operated for five years or more) to that subsidiary as well as cash. The active trade or business must comprise at least five to ten percent of the subsidiary's enterprise value, and the subsidiary cannot contain more than 66% in cash or other investment assets. Assuming other tax requirements are satisfied, such as having a valid business purpose for the transaction, the parent can then exchange stock in the new subsidiary for the parent's stock held by the large stockholder in a transaction that is tax-free.

2.6. The Tax-free Treatment of Spin-offs

In order for a spin-off to qualify as tax-free to both the parent and its shareholders for U.S. federal income tax purposes, it must qualify under Section 355 of the Internal Revenue Code. Section 355 aims to provide tax-free treatment to transactions that separate two operating businesses and not to transactions that resemble either (1) distributions of cash or other liquid assets or (2) corporate level sales.

Under Section 355, the parent must distribute "control" of the spin-off company (generally, stock representing 80% of the voting power and 80% of each non-voting class of stock) and must establish that any retention of stock or securities is not pursuant to a tax avoidance plan. In the spin-off, the parent can distribute stock or stock and securities of the spin-off company, and the distributees can be shareholders or shareholders and security holders. In addition, the parent and the spin-off company must each satisfy a five-year active trade or business test (i.e., immediately after the spin-off, each of the parent and the spinoff company must be engaged in an "active trade or business" that was actively conducted throughout the five-year period before the spin-off, with certain exceptions). Further, the spin-off must be carried out for one or more corporate business purposes and not be used principally as a "device" for the distribution of the earnings and profits of the parent, the spin-off company, or both. Whether the spin-off is a "device" turns on whether the spin-off encompasses planned sales or exchanges of stock of the parent or spin-off company, or other transactions the effect of which would be to permit the distribution of corporate earnings without a dividend tax. This standard as to sales and exchanges may, in some cases, involve seeking representations by greater than five percent holders to the effect that such sales, exchanges or other distributions are not planned.

The "business purpose" standard requires that a real and substantial nontax purpose germane to the business of the parent, the spin-off company or both in fact motivated, in whole or substantial part, the spin-off. A shareholder purpose, such as increasing shareholder value, will not in and of itself suffice, although the IRS has held in published advice that a spin-off motivated by the desire to increase the stock price satisfies the business purpose requirement where that stock will be used to make acquisitions or compensate management. If more than one spin-off is to occur, each spin-off must be supported by its own business purposes. Business purposes that can support a spin-off include demonstrably improving intended access to capital markets for the parent or the new company (including enhancement of an initial carve-out IPO), allowing the parent or the new company to have a "single line of business" or a higher value public stock needed to make desired acquisitions, allowing the parent or the new company to have a "single line of business" or a higher value public stock to attract or retain employees, improving credit terms or enhancing "fit and focus."

A company planning a spin-off must determine whether to proceed solely on the basis of an opinion of tax counsel or whether to seek a private letter ruling from the IRS. A private letter ruling provides a high degree of assurance as to the tax results of the issues ruled upon, which may include aspects of internal restructuring steps that precede a spin-off or split-off. Depending on the complexity of the transaction structure, the preparation of a ruling request could take several weeks or months as the ruling request includes detailed information regarding the entities and businesses involved. Typically, seeking IRS rulings as to numerous internal pre-spin restructuring steps slows the process of preparing the ruling request and obtaining the ruling once the request has been submitted as compared with seeking only rulings on the spin-off itself. The IRS will generally grant a request for expedited handling for rulings pursuant to Section 355. If expedited handling is granted, IRS guidelines state that a ruling will typically be issued within ten weeks of submitting the ruling request. However, depending on the complexity of the request, the process of obtaining a ruling may take approximately six months, regardless of whether expedited handling has been requested. Typically, supplemental submissions in addition to the initial submission of the ruling request are required, both to respond to questions and issues raised by the IRS and to update the IRS with respect to the status of the relevant transactions and any changes in the transaction structure. The IRS has strict and sometimes unpredictable ruling guidelines. There is generally no assurance that a favorable ruling can be obtained, although a pre submission conference with the IRS, as well as discussions with the IRS while the ruling request is pending, provide feedback. The IRS has over time limited the scope of spin-off related private letter rulings that it will grant. The IRS will no longer rule broadly on whether a transaction as a whole satisfies the requirements for tax-free treatment, but instead will only rule on “significant issues” embedded in the transaction. Furthermore, the IRS will not rule on whether the “device” and “business purpose” requirements have been satisfied or whether the spin-off is part of a “plan” that includes a post-spin acquisition. Moreover, the IRS will no longer issue private rulings with respect to certain structures that had previously been utilized regularly in spin-off transactions, including debt-for-debt or debt-for-equity exchanges where the parent’s debt is issued in anticipation of the spin-off and certain high-vote/low-vote structures at the company to be spun off. In connection with obtaining an IRS ruling, the parent will be required to make certain representations with respect to the transaction under penalties of perjury. An opinion of tax counsel will similarly rely upon representations made by an officer of each of the parent and the company to be spun off.

Under current law, a spin-off coupled with a tax-free or taxable acquisition will cause the parent to be taxed on any corporate-level gain in the spin-off company's stock if, as part of the plan (or series of related transactions) encompassing the spin-off, one or more persons acquires a 50% or greater interest in the parent or the spun-off company. Acquisitions occurring either within the two years before or within the two years after the spin-off are presumed to be part of a plan or series of related transactions with the spin-off. IRS regulations include facts and circumstances tests and safeharbors for determining whether an acquisition and spin-off are part of a plan or series of related transactions.

Generally, where there have been no "substantial negotiations" with respect to the acquisition of the parent or the spinoff company or a "similar acquisition" within two years prior to the spin-off, an acquisition of the parent or the spin-off company for acquirer stock after the spinoff will not jeopardize the tax-free nature of the spin-off. Substantial negotiations generally require discussions of significant economic terms. In general, an actual acquisition is "similar" to another potential acquisition if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business assets as the potential acquisition would have. Post-spin equity transactions that are part of the plan remain viable where the historic shareholders of the parent retain a greater than 50% interest (by vote and value) in the parent and the spin-off company after the merger transaction. Thus, a spin-off followed by a merger with a smaller company is feasible even if it is part of a plan or series of related transactions with the spin-off and has been the format of a number of significant recent transactions. Where the merger partner is larger than the parent or spin-off company to be acquired, it may be possible to have the merger partner borrow funds to redeem or otherwise shrink its capitalization prior to the merger transaction. Because post-spin transactions can cause the spin-off to become taxable to the parent corporation (and potentially its shareholders), it is not uncommon for tax matters agreements to impose restrictions with respect to such transactions and to allocate any corporate tax liability resulting from the spin-off to the corporation the acquisition of whose stock after the spin-off triggered the tax.

Chapter 3

Case study: the spinoff of Yahoo announced for Q4 2015

"*Yahoo! is the world's largest start-up, which means that we move fast and always let our users lead the way. Founded in 1994 by two Stanford PhD candidates, we've grown into a company that helps you find what you're looking for on any Internet-connected device. Our employees are rewarded for curiosity and we celebrate explorers, relying on our passionate and transformative talent to do what's right for our users*[20]": this is the definition that Yahoo! gives of itself on its corporate website.

Yahoo! Inc. (usually styled as Yahoo!) is an American multinational technology company headquartered in Sunnyvale, California. It is globally known for its Web portal, search engine Yahoo! Search, and related services, including Yahoo! Finance, Yahoo! Directory, Yahoo! Mail,

[20] https://info.Yahoo!.com/about-us

Yahoo! News, Yahoo! Answers, advertising, online mapping, video sharing, fantasy sports and its social media website. Yahoo! was founded by Jerry Yang and David Filo in January 1994 and was incorporated on March 1, 1995. Given its presence worldwide, Yahoo! itself claims it attracts more than half a billion consumers every month in more than 30 languages. Yahoo! is currently the Internet’s fourth most visited website in the world after Google, Microsoft and Facebook and it is the leading web portal by number of visitors in the USA.

3.1 The Business Model of Internet Companies and the competitive environment

Internet companies usually develop and operate several free services and products (e.g. news, broadcasting, databases) that attract user traffic on their platforms and monetize their online audiences by providing advertising services to paying advertising and media companies who generate the big part of their revenues. Not only free services are offered by internet companies, but also paid products or contents but they do not contribute massively on the revenues generation.

The greatest objective of companies like Yahoo! is to maximize user traffic on their web portals in order to boost their value as a marketing channel for advertisers. The larger the user base, the more attractive the platform is to advertisers, the more they will be willing to pay for an ad space on the platform. As a result, the introduction of new technologies and products on web platforms (horizontal diversification) or the penetration in other geographical areas (geographical diversification) have the ultimate goal to widen the user base. A special role in the user base growth is also played by same-side network effects that occur quite independently from internet companies actions especially on social networks. In the case of websites the same-side effect can be explained as follows: the webpage is more useful and interesting for its visitors when the number of users grows, so an increase of users makes the website more appealing for more potential users that as a result will be attracted and will take part into the user base and so on, thus generating a virtuous circle. This effect is one of the main reasons that justifies the success of social networks like Facebook or Tumblr (the latter owned by Yahoo!) as marketing channels.

In 2014 the number of Internet users was 2.92 billion and in the last 10 years has nearly tripled. Although the great number, the average global internet penetration rate in 2014 stays at 40.4% because the greatest part of the global population is still not reached by internet technologies: in Africa only 19% of the population accesses regularly on the Internet. The country with the greatest user base is China but its penetration rate is one of the lowest in the world and that makes China one of the most profitable and promising markets for Internet companies.

As mentioned before, Internet Companies generate revenues mainly selling their ad spaces to advertisers. It follows that their business is strictly correlated to global advertising spending that in turn, is very exposed to macroeconomic changes and industry-specific business cycles. According to Xerfi Global "advertising expenses tend to respond more than proportionally to economic fluctuations both upwards and downwards"(Xerfi Global,2015). In 2014, an year that saw an increase of 3.3% in global GDP[21], the expenses for digital advertising were nearly $145 billion with an year-over-year increase of 20%

The competitive landscape of Internet Companies is very complex: in the last years the competition has been increasing dramatically, especially given the new trends. The continuous need of innovation creates very high entrance barriers because of the high costs of R&D. Additionally, even in periods of economic slowdown, these companies have to invest in R&D. In fact, the continuous emergence of new innovations and the booming of Internet-enabled devices such as tablets or smartphones has created and

[21] IMF Research 2014

keeps on creating new market opportunities but bears also big risks. It also forces companies to adapt quickly to changing technologies and user habits, requiring heavy and constant investment in hi-tech infrastructures, software development and key personnel.

It is important to note that innovation has not the unique aim of attracting new users thanks to new products or contents, but in the last years is having a crucial role also in the acquisition of advertisers. Internet companies develop for their clients new marketing tools that can attract and reach more efficiently the web traffic. The main example - that will be relevant for the purposes of our investigation - is the great effort that all Internet companies are lavishing in the mobile segment that is seen as a big opportunity of business. In fact, mobile devices are increasingly becoming the main channel to access the Internet: since 2014, the majority of Internet access was coming not from desktop computers but from mobile devices. In the world there are 6.6 billion mobile-cellular subscriptions and more than one third of them is a broadband-enabled mobile contract (Xerfi World, 2015). At the same time mobile ad revenues more than doubled in 2013 and reached $24 billion in 2014 (eMarketer)

Yahoo! has been less successful in exploiting the booming online market opportunities compared to its main rivals, and reported constant reductions of revenues and earnings, the latter preserved only through an ongoing process of cost reduction and massive layoffs. Before looking at Yahoo! More in detail, how the new management is currently running the business, the strategies that have been implemented by new CEO Marissa Mayer and the next moves, it will be extremely useful a general overview on Yahoo!'s history in order to understand what had lead Yahoo! in its actual positioning in the Internet companies landscape.

3.2. The History of Yahoo! Inc

3.2.1. The first moves of Yahoo! and the launch on the Stock Market

Yahoo! was founded in 1994 by two Stanford students, David Filo and Jerry Chang. In 1995 Yahoo! was incorporated and in the same year the company saw the entrance of Sequoia Capital that invested in two rounds nearly $3 million. The Internet was at the beginning of its capillary diffusion in the whole world and search engines and web directories were becoming very popular across Internet users. Yahoo! became soon the market leader of search engines: the increasing number of daily access on the website and the adoption of Yahoo webpage as homepage of all computers, promised a glorious future and priceless opportunities for this company.

Yahoo! Inc. was listed on April 12, 1996 on NASDAQ, by selling 2.6 million shares at the opening bid of $13 each, raising $33.8 million. The same day the share price reached $33 and the market capitalization rose up at $85.8 million. At that time the CEO was Timothy Koogle who remained in charge until 2001 and that seated in the Board of the Company until 2003. In those very first years the web portals (i.e. Yahoo!, MSN, Lycos, Excite) were growing rapidly along with all the dot-com companies and the stock prices started to reflect the enormous potentials that the World Wide Web could offer. It was only during the late 1999 that Yahoo! stock price increased tremendously and on January 3, 2000 it marked its historical maximum price at $118.75: it was the dot boom. Just a year later Yahoo! share price dropped down at $8.11 on September 26. Nevertheless, Yahoo! was one of the surviving companies at the bursting of the dot-com bubble that, ultimately, had created several profitable situations for them. In fact, Yahoo! implemented an aggressive acquisition strategy of undervalued companies, including HotJobs (February 2002) Inktomi (March 2003), Overture Services, Inc. and its subsidiaries AltaVista and AlltheWeb (July 2003) in order to exploit all the synergies and to increase its user base.

3.2.2 The eastward expansion: the investments in Yahoo! Japan and Alibaba

Since the beginning of its life, Yahoo! founders and top managers looked with interest at the Asian economies, especially at Japan, given their fast-growing pace, the poor presence of competitors in the web sector and the high relevance of new technologies in that specific geographical area that had made these markets just another step forward the growth of the business. That's why, Yahoo! and SoftBank formed Yahoo! Japan in January 1996 to build up the first Japanese web portal, that was opened on April 1, 1996. Yahoo! Japan went public on JASDAQ in November 1997. In January 2000, at the top of the irrational dotcom bubble, Yahoo Japan became the first stock in Japanese history to trade for more than ¥100 million per share. The company was listed on the Tokyo Stock Exchange in October 2003 and became part of the Nikkei 225 stock market index in 2005. This Japanese company runs its business in Internet advertising, e-commerce and members services and represents an important asset for Yahoo! Inc that currently owns its 35.5%.

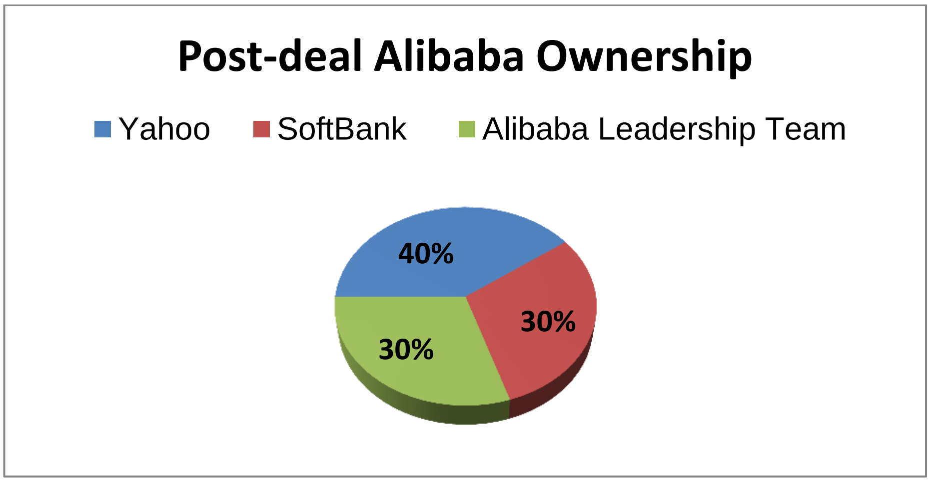
For the purposes of our study, it is crucial the expansion that Yahoo! made towards the Chinese market that started in 1999 with the launch of Yahoo! China, as a translation of U.S. contents into two Chinese languages. In 1999, nearly 5 million people were accessing the Internet in China, but that figure would have doubled in each of the coming years until China became the largest country of Internet users by the end of 2005[22]. At the early stages the organic growth had helped Yahoo! to stay competitive into that market, but by 2002 Yahoo! was not getting the traction that other local Chinese

[22] Xerfi, Internet Companies, March 2015

Internet companies were seeing, revenues were flat and the user base was not growing at satisfactory levels. The management believed that the solution was to acquire a local company that was strong in the market and with a proven local management. After a long period of search and due diligence the target firm to purchase was identified in “3721” whose acquisition was closed in January 2004 for $120 million. However this acquisition quickly turned out into a failure for many reasons, especially because of control issues and management style differences that forced Yahoo! to focus on internal issues and internal processes instead of improving operations and services offered to the user base to gain market power against the competitors (Google and Baidu) that on the contrary, were gaining share and monetizing their investments in the Chinese market. Surely, thanks to the acquisition of 3721, Yahoo! was in a stronger market position than before the transaction but the need for another acquisition or partnership with a local firm was clear to the management that started to study the landscape carefully and with a deeper knowledge of Chinese business culture and a greater understanding of the market thanks to the prior attempt.

The Yahoo! management team came to know Jack Ma, who founded Alibaba in 1999, a privately held company owned by its management, venture capitalists and SoftBank (that had already partnered with Yahoo! in Japan). Alibaba was based in the South of China, had about 2400 employees and was showing good results in terms of profitability and seemed to have enormous growth potentials. Their business is deeply linked with the economic growth of China and its role of exporter. Tmall, the name of their business, consisted in offering an online platform in which, Chinese companies could interact and merchandise with international distributors or foreign acquirers. In 2004 Alibaba had generated more than $4 billion in merchandise sales through its platform and reached 50 million of revenues. Moreover it was launching two new lines of business that were offered for free and that could have surely increased Alibaba user base: Alipay, a payment system like Paypal and Taobao, an auction site where people could buy and sell anything they wanted.

After two months of intense negotiation and deal structuring, the final agreement was reached and it established that Yahoo! would have owned the 40% of Alibaba, Softbank the 30% and the Alibaba Team Leadership the remaining 30% but Ma and its team retained the control on the company.



On 11 August 2005, Yahoo! paid $1 billion cash and gave in exchange also its Chinese Assets (Yahoo! China) that at that time were valued $700 million. The entire value of the deal was estimated at around $4 billion.

3.2.3 After the dot-com bubble: a period of increasing competition, missed opportunities and flat decline

The acquisitions made at the end of the dot-bubble, both in US and all around the world, were extremely necessary given the increasing competition among Internet Companies as a result of the space left in the market after the bubble. Obviously, Yahoo!'s main competitor remained Google that was acquiring market share day by day, becoming the first search engine in the world when, in the early 2004, 84,7% of all searches in the World Wide Web started from its web page. Moreover, thanks to the new capital injection coming from its IPO[23] in August 2004, when it raised $1.9 billion, Google began a powerful horizontal diversification strategy, widening its offer for the user base with more sophisticated and innovative tools. In that period Yahoo! was a complete follower of Google's moves and was in need for a new strategy. Both companies were performing a lot of acquisitions and were partnering with main player of the technology market like AOL and Microsoft. In that period (2004-2005) Yahoo! share price was quite steady and far below the values seen at the beginning of the III millennium, in a range of 34-35 dollars. On the contrary at the end of 2005 (30/12), Google share price registered an increase of 313,45% since the IPO, reaching $207,64 per share.

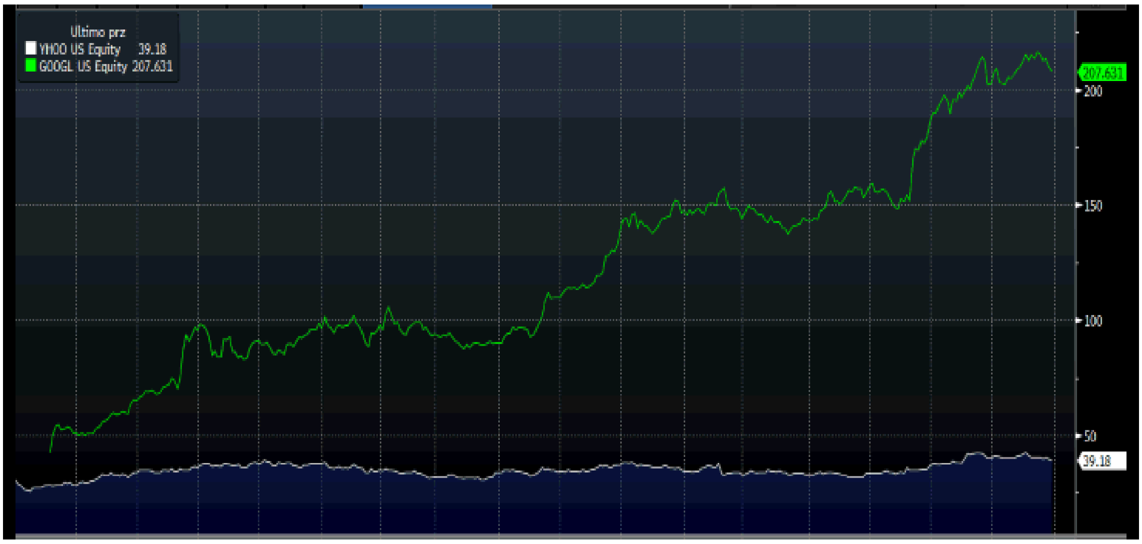


Figura 2 Bloomberg. Yahoo Share Price vs Google Share Price (01/08/2004 -31/12/2004)

[23] Google's IPO is considered a disastrous deal. In fact, Google decided to hold a Dutch auction, a method in which everyone who wants a share put in a bid. The lowest successful bid becomes the price that everyone gets their shares at, even if they bid a higher amount. This method guarantees that the initial offering price is set to sell all of the shares at a price that conservatively reflects the market. The Dutch auction method was meant to give individual investors a chance at the IPO instead of the usual bystander's role, watching from the side-lines as major investors and houses bought up all the shares. It worked, but it left the underwriters and the companies who usually profit from their mutual deals fuming. "Why Dutch auction didn't work? Because Wall Street came to believe that it was a bad idea to leave pricing up to the masses. Far better to price to (theoretical) value of the company, the Street concluded" (Bob Pisani, CNBC, August 18, 2014)

It is during 2005 that Microsoft approached Yahoo! and pursued the first merger discussions: it believed that the creation of a strong competitor of Google, the eternal rival of Microsoft, with a wide product offer and user base, was necessary. Google was incessantly increasing its dominant position in the market, revenues were increasing year by year and more products in his range were overlapping those offered by the other market players (Gmail vs Hotmail vs Yahoo! Mail; Google Chrome vs Internet Explorer; Google Earth vs Windows Live Local). After several friendly takeover offers, on February 2008 Microsoft made an unsolicited takeover offer of $44.6 billion in stocks and cash. Yahoo! rejected the offer and started to study other alternatives like a merger with Google or a transaction with News Corp (owner of Myspace.com) because, according to the Board, Microsoft offer was undervaluing Yahoo!'s brand and the growth potentials. This decision was not accepted by several shareholders (especially two pension funds of Detroit[24]) who considered the response to Gates' company as a measure against the real duty of their mandate such as creating value for shareholders. After frequent correspondence between the two boards and the threat of Microsoft to undertake a hostile takeover, Yahoo! admitted that was not against the merger but required a worthy offer. After that request, Microsoft offered to raise its offer by $5 billion, $33 per share while Yahoo! demanded $37 per share. The parties did not reach the agreement and the hypothesis for a hostile takeover was over because, according to Microsoft's managers, the CEO and founder Yang would have surely put in place a poison pill to make the deal as difficult as possible. On November 20, 2008, almost 10 months after Microsoft's initial offer of $33 per share, Yahoo!'s stock dropped to a 52-week low, trading at only $8.94 per share[25]. Given this sign of weakness perceived by the market, Microsoft offered $20 billion for a part of Yahoo!, its search and advertising business, but also this offer was rejected by Yahoo!'s Board.

[24] http://usatoday30.usatoday.com/tech/products/2008-02-22-435052336_x.htm

[25] NASDAQ (November 20, 2008). "YHOO stock quote - Yahoo!! Inc. stock price - NASDAQ.com"

After 2008, Yahoo! kept on acquiring small companies while revenues reported a negative evolution, mainly because of the severe crisis that was affecting the world, especially the USA, but net income showed an important increase thanks to the new strategy implemented by new CEO, Carol Bartz, appointed at the beginning of 2009 that cut operating costs for nearly $1billion.

(in thousands)	2008	2009	Delta (%)
Revenues	$7,208,502	$6,460,315	-10.38
Net Income	$ 418,921	$ 597,992	42.75
EPS(diluted)	$0.29	$0.42	44.83

Table 1: Data from Consolidated Financial Statement 2009

However a flat decline in revenues continued in 2010 and 2011, that's why on September 2011 Carlo Bartz was removed and three months later replaced by Scot Thompson, former President of PayPal. His mandate did not last too much for his biography was found incorrect and the Board and some shareholders pushed towards his replacement. While in 2009-2011 several CEOs changed and moved for several reasons, Yahoo! share price remained flat within the range of $17-$15 while its main competitors were growing fast and were cannibalizing its user base.

3.2.4. The Marissa Mayer era: a period of turnaround

A new season for Yahoo! was welcomed when Marissa Mayer was appointed as new CEO in July 2012. Mayer had joined Google after graduating in 1999 and worked soon as executive on several projects and held key roles in crucial business functions. She was protagonist of the impressive growth of Google and was considered the ideal candidate for the revamping of Yang and Filo's company. On July, 18 2012 the day after

Mayer’s appointment, Yahoo! stock price was at $15,70. The main focus of Mayer’s strategy[26] would have been:

- a massive acquisition programme of small high-tech companies not only for their products but also for their know-hows and for those talented people that had found them or were working there;
- the focus on the mobile segment in which Yahoo! would have become strong in 2015;
- the personalization of Yahoo! customer experience;
- the increase of advertisement sales and the improvement of advertisement tools.

Finally, since her appointment and the implementation of her strategy the market capitalization of Yahoo! saw a true and constant increase. This increase could be explained by various aspects, for example, because profits began to grow thanks to another wave of layoffs and operating costs reductions; unfortunately the main reason are found outside Yahoo!’s profitability and management capabilities but in the relevance that the stake in Alibaba and Yahoo! Japan were acquiring[27]: the former because of the rumours of a near IPO and the appreciation of its equity valuation thanks to the astonishing performances it was reporting, the latter thanks to the good operating performance and cash flows.

Between 2012 and 2014, right after the appointment of Marissa Mayer, Yahoo! reduced its participation into Ma’s company especially because of its incoming IPO on the New York Stock Exchange (NYSE) and the need of cash to perform the acquisition plan wanted by the Mayer. As stated in the 2012 Annual Report, “on September 18, 2012 (the “Repurchase Closing Date”), Alibaba Group Holding Limited (“Alibaba Group”) repurchased (the “Initial Repurchase”) 523 million of the 1,047 million ordinary shares

[26] http://www.businessinsider.com/here-is-the-plan-marissa-mayer-just-announced-to-Yahoo!-employees-2012-9?IR=T
[27] http://www.bloomberg.com/news/articles/2014-03-18/Yahoo!-s-alibaba-cash-enables-tumblr-sized-deals-real-m-a

of Alibaba Group ("Shares") owned by Yahoo!. The Initial Repurchase was made pursuant to the terms of the Share Repurchase and Preference Share Sale Agreement entered into by Yahoo! Inc. and Alibaba Group. Yahoo! received $13.54 per share, or approximately $7.1 billion in total consideration, for the 523 million Shares sold to Alibaba Group. Approximately $6.3 billion of the consideration was received in cash and $800 million was received in Alibaba Group preference shares. This Initial Repurchase resulted in a pre-tax gain of approximately $4.6 billion for the year ended December 31, 2012. On the repurchase closing date, Alibaba Group paid also $550 million in satisfaction of certain future royalty payments under the existing Technology and Intellectual Property License Agreement (IPLA) with Alibaba Group. In addition, certain existing contractual limitations on the ability to compete in the People's Republic of China were terminated"[28].

This important transaction brought a huge amount of cash into Yahoo! but resulted in the decrease of ownership in Alibaba at nearly 22% from the 40% of 2005. This liquidity injection was used to buyback a considerable number of Yahoo! shares for an amount of $3.65 billion. This decision was very welcomed by the market given the benefits that shares repurchase plans usually produce for the shareholders: increase of the share price, return of value for those selling their stake, signals of management confidence in the future performances of the company, increase of earnings per share given the reduction of the float (all else equal). As stated before, the important amount of cash was not only used to implement and pursue the buyback but also to perform another wave of M&A that most importantly lead Yahoo! to acquire Flickr and Tumblr. The acquisition of these two companies was considered extremely strategic because signed the entrance of Yahoo! in the social network industry: Flickr offers a storage and sharing service for its customers of all kind of pictures whereas Tumblr is a micro-blogging

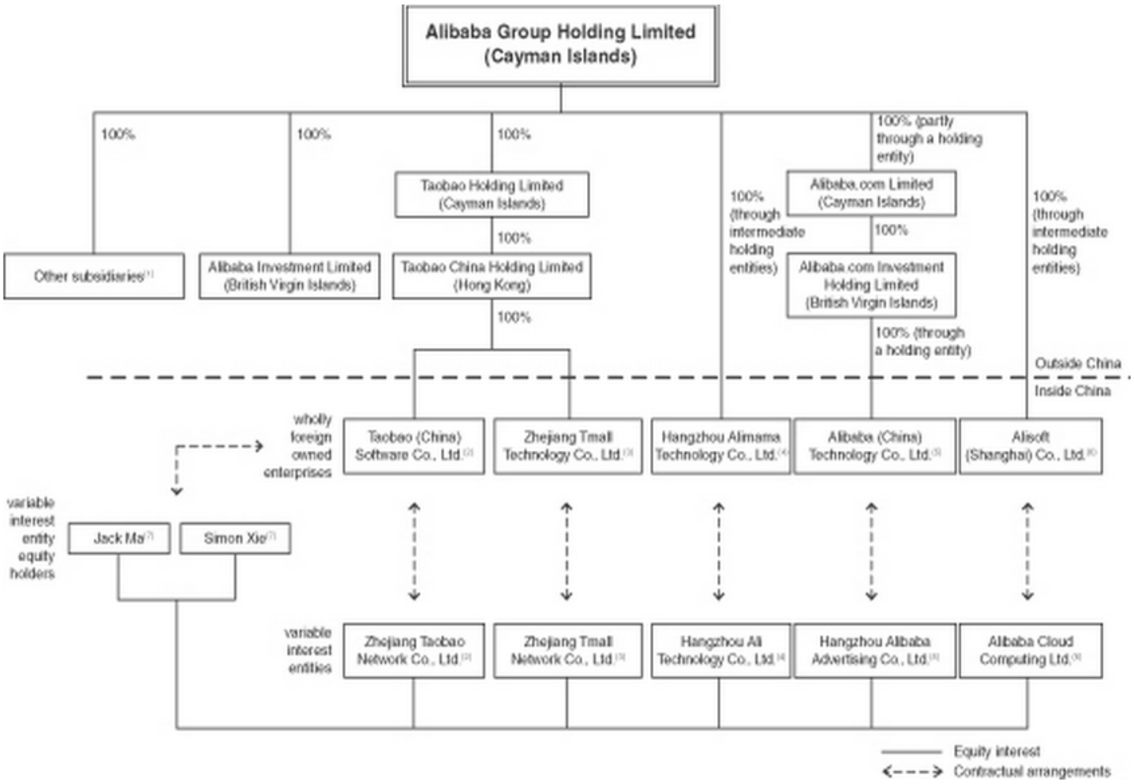
[28] 2012, Yahoo! Annual Report (www.investor.Yahoo!.net/annual)

platform that allows its users to post all kind of media contents and share them with the web.

3.2.5. Alibaba's IPO and its implications on Yahoo

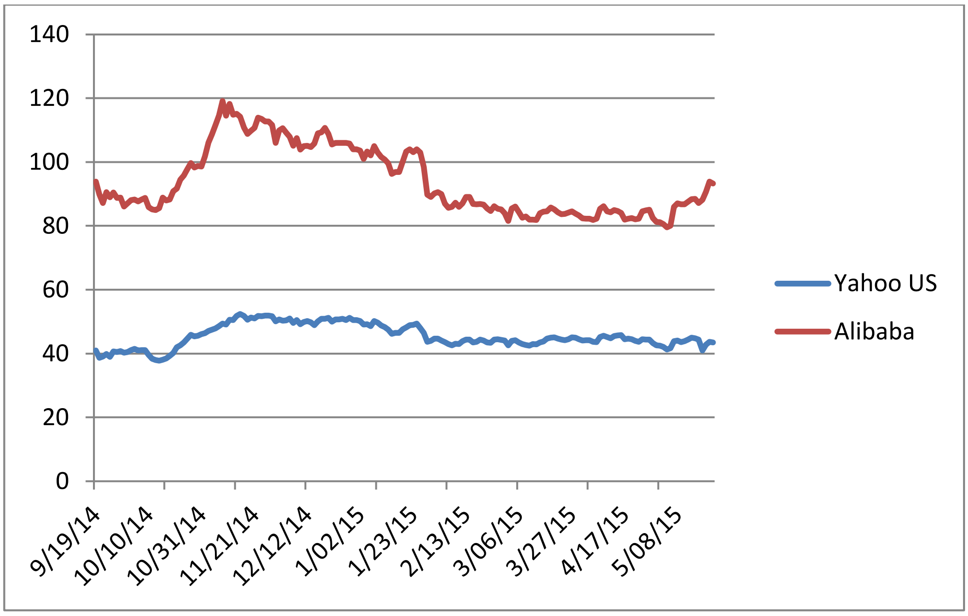
A historic moment that most significantly affected Yahoo! and saw him as one of the main protagonists was the Initial Public Offering ("IPO") of Alibaba (ticker "BABA") on the NYSE on 18 September 2014, that, markets closed, resulted in the biggest IPO in history surpassing the IPO of Agricultural Bank of China in 2010 when the lender raised $22.1 billion. Alibaba raised up nearly $25 billion and the stock began trading with a bang, soaring 38% and closing at $93,89. At the end of its first day, the market capitalization of BABA was approximately $242 billion, just smaller than Wal-Mart, being out of the S&P500's top 10 for only 3 billion. Alibaba's IPO was a very complex transaction especially in legal terms given the severe restrictions of Chinese Laws that don't allow foreign investors to own Chinese strategic assets like communication and media as in Alibaba's case. To get around this constraint, Alibaba adopted a structure29 called "variable-interest entity" who basically gave the investor the ownership on "Alibaba Group Holding Ltd", a company based in Cayman Island that had a binding contract with the Chinese Alibaba (who would have kept on managing and controlling the assets), establishing its entire control over profits generated by the PRC-based assets.

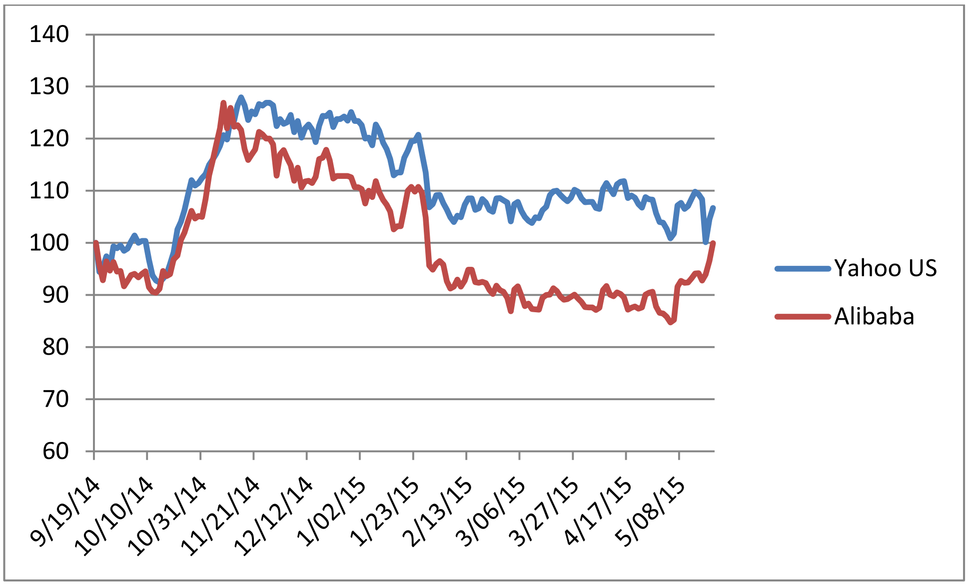
[29] http://www.sec.gov/Archives/edgar/data/1577552/000119312514333674/d709111df1a.htm



In this context, Yahoo! gained of several benefits thanks to the investment made in 2005, as stated in the 2014 Annual Report: “on September 2014, Alibaba Group closed its initial public offering (“IPO”) of American Depositary Shares (“ADSs”). Each Alibaba Group ADS represents one ordinary share of Alibaba Group. Yahoo! Hong Kong Holdings Limited (“YHK”), our wholly owned subsidiary, sold 140,000,000 Alibaba Group ADSs in the IPO at an initial public offering price of $68.00 per ADS. We received $9.4 billion (net of underwriting discounts, commissions, and fees of approximately $115 million) in cash for the 140 million Alibaba Group ADSs sold. We recorded a pre-tax gain of $10.3 billion (including a $1.3 billion gain reflecting our proportionate share of the IPO proceeds) for the year ended December 31, 2014, which is included in other income, net on the consolidated statements of income. The after-tax gain was approximately $6.3 billion. Following completion of the sale in the IPO, we retained 383,565,416 ordinary shares of Alibaba Group, representing approximately 15 percent of Alibaba Group's outstanding ordinary shares. As a result of the IPO, we no longer account for our remaining investment in Alibaba Group using the equity method and no longer record our proportionate share of Alibaba Group's financial results in the consolidated financial statements. We reflect our remaining investment in Alibaba Group as an available-for-sale equity security on the consolidated balance sheet and adjust the investment to fair value each quarterly reporting period with changes in fair value recorded within other comprehensive income (loss), net of tax. Also in connection with the IPO, each of Yahoo! and YHK entered into a lock-up agreement with the underwriters restricting the sale of its remaining ordinary shares of Alibaba for a period of one year, subject to certain exceptions".

As briefly mentioned in par 4.3.4. since 2012 Yahoo! Share price has been strongly influenced by its investment in Alibaba even before the IPO. However, since the Chinese company went public it is possible to see the strict correlation and dependence that Yahoo share price has on BABA's performances. Some investors strongly affirm that Yahoo has become a tracker of Alibaba.





The two charts above show that a strong correlation exists but the performance of Alibaba is now highly affected by the economic and financial crisis that is interesting China. Yahoo's performance is protected against BABA's by Yahoo Japan that is reporting good results and cash generation.

3.3. Yahoo! Business Model and Q2 2015 results

Yahoo! is one the most relevant and biggest Internet companies worldwide along with Google, Yandex, Microsoft and Baidu (excluding social networks like Facebook, Linkedin or Instagram). As seen from the previous brief historical digression and the last graph showing the stock price of Yahoo since August 2014, despite the great transformation of these last three years with Mayer's guidance, Yahoo is not performing at the levels expected by the Board and by financial analysts.

Before looking at some figures, let us understand the main revenue and cost drivers and the different channels that Yahoo adopts to attract users on its websites.

Yahoo main revenue drivers are:

- Search Revenues
- Display Revenues
- Other type of revenues

Search Revenue accounted for $1,05 billion in the H1 2015 with an year-over-year increase of 20%. Yahoo offers two main products in this field that promise to increase the clients' brand awareness and the diffusion of their products: Yahoo Gemini and Bing Ads that. Both generate revenue on a per-click base: every time a user clicks on paying advertisers' websites links found through Yahoo web portal and search engine, Yahoo receives money. This business is implemented both on displays (i.e. display and laptop computer) and mobiles. To increase its user base, on November 19, 2014 Yahoo signed an agreement with Mozilla to become the default search engine of Firefox, the web browser developed and distributed by Mozilla that has a market share of 19.55%[30] among web browser. Even though this agreement boosted Yahoo revenues in the first half of the year, it has impacted also on TAC that will be paid to Mozilla. In Q2 TAC[31] reached $200 million with an YoY increase of 345,5%.

Display revenue is generated from the display of graphical and non-graphical advertisements. Advertisers pay fixed amount to Yahoo for a fixed ad contract in which the size and the duration of the ad display is decided with the advertiser (premium display ad). Yahoo makes revenues also

[30] Source: eMarketer March 2015

[31] "TAC refers to Traffic Acquisition Costs. TAC consists of payments to third-parties entities that have integrated Yahoo's advertising offerings into their websites or other offerings and payments made to companies that direct consumer and business traffic to Yahoo Properties" (YAHOO Q2 '15 Financial Highlights, Board of Directors). Yahoo enters into agreements that usually last one year or five years. These agreements two main economic structures: fixed payments based on a guaranteed minimum amount of traffic delivered, which often carry reciprocal performance guarantees from the Affiliate, or variable payments based on a percentage of Yahoo revenue or based on a certain metric, such as number of searches or paid clicks. (2012 Annual Report)

through non-guaranteed display advertising in which the advertisement is delivered on a preemptible basis. Non-premium advertising also includes native advertising[32] for which revenue are recognized only when a user clicks on a native advertisement.

Other revenue include various B2B services offered by Yahoo including Yahoo Small Business (that will be spun-off along with Alibaba stake), transaction revenue, royalties coming from joint-ventures, and fees revenue for all those fee-based services for both customers and businesses.
In 2015 Q2 Yahoo reported $1,243 million gross revenues[33], with a YoY increase of nearly 15% that added up at the Q1 revenues totalize 2,5 billion revenues for the first half of the year. These revenues can be split in the several segments we have seen before, as showed in the following table:

	2Q		1H	
	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2015	2014	2015
Search revenue	428.418,00	521.126,00	873.185,00	1.052.792,00
YoY		*21,6%*		*20,6%*
Display revenue	436.053,00	500.376,00	889.277,00	964.109,00
YoY		*14,8%*		*8,4%*
Other revenue	219.720,00	221.763,00	454.459,00	452.334,00
YoY		*0,9%*		*-0,5%*
Total revenue	1.084.191,00	1.243.265,00	2.216.921,00	2.469.235,00
YoY		*14,7%*		*11,4%*

Tabella 1: Yahoo Q2 2015 Earnings Report. All values in thousands

To understand Yahoo business model the performance can be split also in the two main channels that attract users: solid display and mavens (mobile, video, native and social). Solid display refers to all access made on Yahoo and its affiliates from computers (both business and consumer) whereas

[32] Native advertising is a form of online advertising that matches the form and function of the platform on which it appears. For example, an article written by an advertiser to promote their product, but using the same form as an article written by the editorial staff. The word "native" refers to the content's coherence with other media on the platform.
[33] GAAP compliant

mavens indicates all revenues from mobile (smartphones, tablets and watches), video ads and video ad packages, native ads, and Tumblr ads and fees, where Yahoo is very focused given the market trends in this area. In the 2Q, Yahoo reported the following results in the two segments:

	Q2 2014	Q2 2015
Mavens revenue	$ 249,00	$ 399,00
YoY		*60,2%*
Non-Mavens revenue	$ 742,00	$ 725,00
YoY		*-2,3%*
Total traffic-driven revenue	$ 991,00	$ 1.124,00
YoY		*13,4%*
Non-traffic-driven revenue	$ 93,00	$ 119,00
YoY		*28,0%*
GAAP revenue	$ 1.084,00	$ 1.243,00
YoY		*14,7%*

Tabella 2: Yahoo Q2 2015 Earnings Report split by segment. All values in millions

As can be easily understood, the mavens segment is increasing with interesting growth rates but they still are a small part of the total revenues (nearly 35%).

It important to understand Yahoo positioning by geography. Nearly $992 million are generated in the Americas that represent the 80% of Yahoo’s market. Americas are followed by APAC (13%) and EMEA (7%). Like all Internet Companies, despite the global scale of its business, the bulk of Yahoo’s revenues comes from its domestic market. The split by region is performed according the location of the advertising customer. The concentration of revenues in domestic markets hence means that Internet Companies are very exposed to local market conditions, but also shows a strong potential to leverage international activities for further revenue growth.

However in the last quarter Yahoo saw a dramatic growth of costs: as stated before TAC grew on a YoY base at 345,5% passing from $44 million to

$200 million that impacted on EBIT and net earnings thus reporting a total loss of $22 million, corresponding to -$0.02 per share

The controversial results that Yahoo reported in Q2 are only another piece in the series of deceiving performances that the company has been performing for the last years. The poor performance of Yahoo can be shown if compared to those reported by Google, Yahoo's main competitor.

Google core business model is similar to Yahoo's one: it is an Internet Company that was born in 1998 as a search engine, it's based in United States and offers online products for both users and advertisers that ideally can overlap those offered by Yahoo (search engine, email, finance). Let us analyze the results reported in the last years by these two companies:

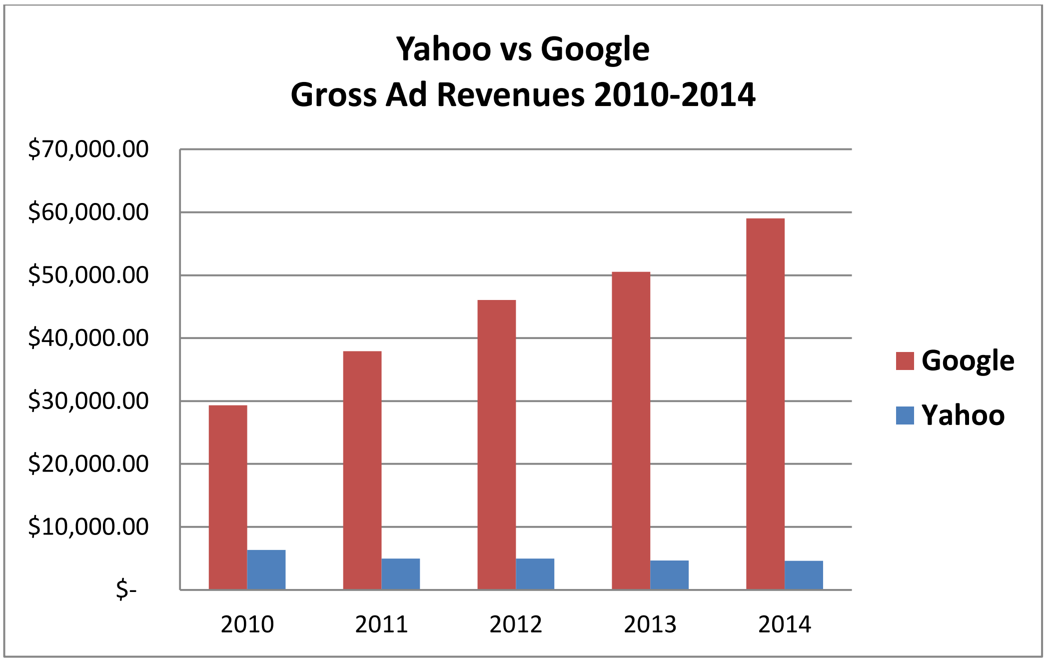


Tabella 3 source: company data. Values in million

Gross Ad Revenues 2010-2014					
	2010	2011	2012	2013	2014
Yahoo	$ 6,324.60	$ 4,984.20	$ 4,986.60	$ 4,680.30	$ 4,618.10
yoy		*-21.19%*	*0.05%*	*-6.14%*	*-1.33%*
Google	$ 29,321.00	$ 37,905.00	$ 46,039.00	$ 50,547.00	$ 59,055.90
yoy		*29.28%*	*21.46%*	*9.79%*	*16.83%*

Tabella 4. Source: company data. Values in million

	Google 2013	Google 2014
Search	43.251,90	49.679,60
on total revenues	85,6%	84,1%
Display	3.798,80	4.587,30
on total revenues	7,5%	9,1%
Youtube	3.496,30	4.789,00
on total revenues	6,9%	9,5%
Total	50.547,00	59.055,90

	Yahoo 2013	Yahoo 2014
Search	1.949,80	1.868,00
on total revenues	41,7%	39,9%
Display	1.741,80	1.792,90
on total revenues	37,2%	38,3%
Other	988,80	957,20
on total revenues	21,13%	20,45%
Total	4.680,40	4.618,10

Source: Company Data.

While Yahoo reported a continuous decline in revenues, Google kept on growing with an yearly growth of 19% on average. Google main source of revenue is the search advertisement business that in 2014 accounted for $50billion (84% of total revenues) against the $1.8 billion of Yahoo (40% of total revenues). The product offered for advertisers in the search advertising channel is AdWords. AdWords enables advertisers to display an advertising copy based on selected keywords taped by users in their search on Google. As for Yahoo search business, advertisers pay Google on a per-click base: when a user clicks the link-ad that appear after the research operated by the user to visit the advertiser's site, Google receives a fee. The reason of the divergent results between the two companies can be found in the strategy adopted by Google. During the years it maintained the same webpage with the search bar only, in order to show its focus on the search engine function and to qualify itself as the best search engine that provides the best results for users' queries. This has led Google to become the market leader, owning *de facto* a monopoly position given its 88% of market share of searches performed on the Internet[34]. On the contrary Yahoo has always been a web portal with multiple services in the same webpage, with a lower specialization in the search channel that in 2014 accounted for only 40% of its total revenues against the 80% of Google.

[34] Source: eMarketer March 2015

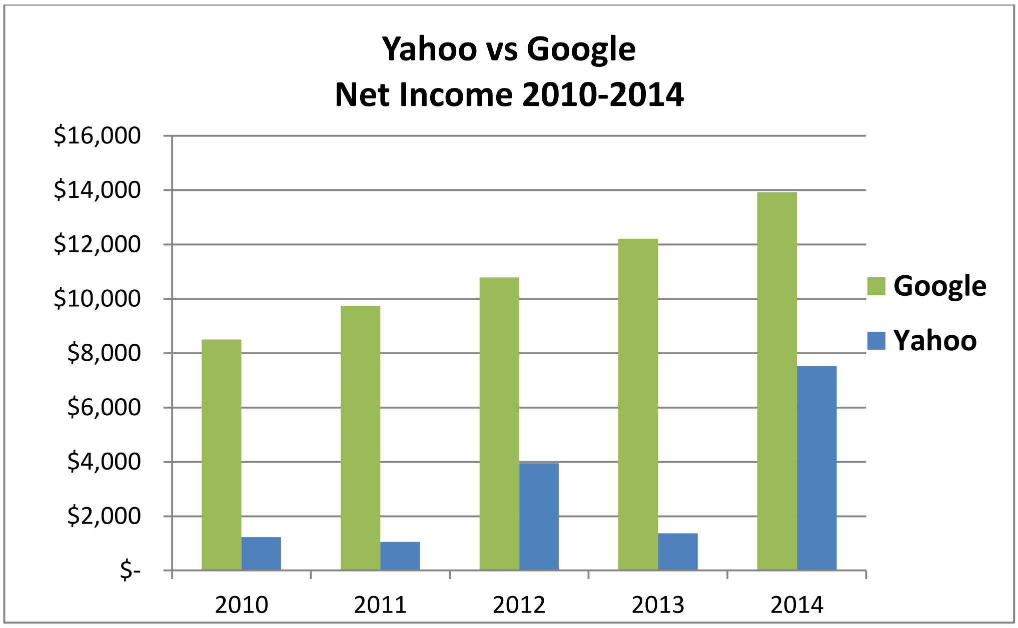
AdSense is the second product in order of importance offered by Google: it places advertisement of every type (images, videos, texts, interactive tools) on partner websites, the so-called Google Network (Youtube, Gmail, Blogger and Maps are the main players in the network) that receive a rebate from Google in case they are not owned but only business partners. The costs for advertisers are on a per-click or on a per-impression basis[35].

Another interesting aspect that deeply differentiate Google from Yahoo is its geographical breakdown of revenues. Like the majority of Internet Companies (Yandex in Russia, Alibaba in China), Yahoo generates the bulk of its revenues from their domestic market (as seen before 80% of revenues). On the contrary Google revenues come on average (2012-2015) 45% from US and for the remaining 55% from the rest of the world. Given the strict correlation between Internet-companies performances and the macroeconomic environment, Google's geographical diversification reduces its exposure on economic downturns and allows it to benefit from the global growth instead of being too linked to US economy.

Google has implemented an aggressive acquisition strategy (more than 180 companies since 2001) focused on high-tech startups and solid promising companies. However the outcome is opposite with respect to Yahoo. While Yahoo hasn't yet monetized the acquisitions performed in the last years that cost for more than $1.3 billion, Google has shown outstanding results. The main example is Youtube that was acquired in 2006 for $1,65 billion and reported revenues for $3.5 billion in 2013 and $4.8 billion in 2014. In 2014 Youtube revenues were higher than those performed by Yahoo itself in the same year. The estimates for 2015 forecast an increase from Youtube revenues of 38.1% and, in general, for Google advertising business a 6.5%[36] *yoy* increase.

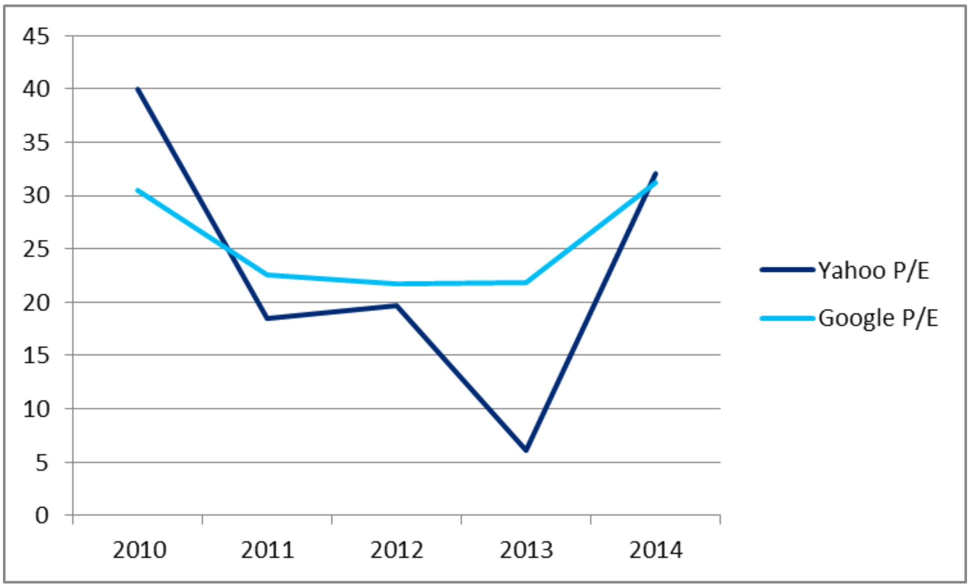
[35] Advertisers pay each time an ad is displayed. It can be also in terms of cost-per-thousand impressions where the amount paid is established for every thousand impressions
[36] Source: Morgan Stanley Research estimates as of April 2015

A part from the flat revenues reported in the last years, another problem for Yahoo are the increasing operating costs: in terms of margins Yahoo reported in 2014 an EBITDA margin of 30.9% (from 35.3% in 2013) with a projected negative trend in the following years given the increasing Traffic Acquisition Costs due to the agreement with Mozilla, whereas Google shows an EBITDA margin for 2014 of 48.9% that will remain constant in the next five years. The evidence of this consideration comes from the net income reported by the two companies:



Net Income 2010-2014					
	2010	2011	2012	2013	2014
Yahoo	$ 1,231.00	$ 1,049.00	$ 3,945.00	$ 1,366.00	$ 7,522.00
yoy		*-14.78%*	*276.07%*	*-65.37%*	*450.66%*
Google	$ 8,505.00	$ 9,737.00	$10,788.00	$12,214.00	$13,928.00
yoy		*14.49%*	*10.79%*	*13.22%*	*14.03%*

The level of Yahoo's net income in 2012 and 2014 is due to the partial disposal of Alibaba stake. These sales have covered the poor performances that the core business has been performing. It is clear, on the contrary, the constant growth rate of Google net income that has led to an incredible valuation of Google as shown by the following graph that compares Yahoo and Google P/E



The increase of Yahoo Multiple in 2014 was mainly driven by the new management team and the appreciation of Alibaba stake in Yahoo portfolio after the IPO.

In this context of uncertainty for the future profitability of Yahoo, right after Alibaba's IPO, a turning point for Yahoo plans occurred with the entrance of Starboard Value LP in the shareholder base in September 2014.

3.4. The reasons behind the spin-off of Yahoo

3.4.1. The entrance of Starboard Value LP in Yahoo

The entrance of shareholder activist Starboard Value LP in the ownership of Yahoo and their public letter sent to the CEO and President of Yahoo's Board on September 26th, 2014 led the market to put again the eyes on Yahoo. Starboard Value LP is a New York-based shareholder activist that was founded by Jeffrey C. Smith in 2002. It invests in deeply undervalued companies, publicly traded in U.S and actively engages with management teams and boards of directors to identify and execute on opportunities to unlock value for the benefit of all shareholders.

Before Alibaba's IPO and the activist's letter, some analysts were criticizing the equity valuation that Yahoo was reporting and stated that the company was traded with a consistent conglomerate discount[37]. In September 2014 Starboard, in line with those analysts, estimated a value gap between the total intrinsic value of Yahoo and its market-based EV value of $17,834 billion. The main topic of the letter was the suggestion of a tax-efficient sale of Alibaba and Yahoo Japan stakes in order to unlock value for shareholders. According to Starboard and its CEO , these stakes not only had to be sold or distributed to shareholders but a tax efficient structure was mandatory given the previous sales of Alibaba stocks (2012 and 2014) that had been inefficient in terms of taxation - note that in the sale of 2014 Yahoo incurred in a tax liability of $3.1 billion – and completely wrong in timing. Moreover, Starboard suggested the Board:

1. to exploit the rich cash injection coming from Alibaba's IPO for a potential combination with AOL that according their analysis was able to generate $1 billion of synergies thanks to the reduction of corporate overhead and the revenue growth opportunities given the broader user base and enhanced relationship with advertising agencies
2. to stop the wave of acquisitions of startups that had costed $1.3 billion since Q2 2012 and in turn were not generating value to shareholders but were absorbing cash and not impacting on revenues
3. to focus on the already existing businesses and try to realize cost efficiency.

The Board of Yahoo refused all Starboard's proposals except the complete monetization of Alibaba stake.

[37] Matt Levine, "How can Yahoo be worth less than zero?", www.bloombergview.com, 17/04/2014

3.4.2. Yahoo undervaluation

As noted by shareholder activist Starboard Value LP and several analysts, Yahoo was and still is affected by a relevant conglomerate discount. As mentioned in the previous chapter, the market penalizes companies that run different businesses because considers them unable to manage a diversified portfolio of activities as efficiently as focused companies with only one core business or related ones.

The most straightforward method to verify if the company is trading at discount is to compare the valuation of the stakes in Alibaba and Yahoo Japan with respect to Yahoo market capitalization. At the moment, as shows the following table, the sum of the two stakes at market value is worth more than the market capitalization of Yahoo: it means that the advertising business of Yahoo is valued zero, or worst, less than zero.

	n of sharers	Price	xchange ratio	Mkt Value
Alibaba Stake	383.56	$ 64.04		$ 24,563.18
Yahoo Japan Stake	2,021.70	¥480.00	¥123.75	$ 7,841.59
				$ 32,404.77
Yahoo Market Cap	938.44	$ 31.52		$ 29,579.63
Value Gap				$ (2,825.14)
Conglomerate Discount				*-8.72%*

source: FactSet as of 09/09/2015

The reason could be in the belief of the investment community that Yahoo's core business will report only losses that will be offset by the dividends distributed by the Asian Companies or, more reasonably, by the total or partial sale of the two stakes. However Yahoo is not reporting negative EBITDA, and the projections for the following years are not in negative field, so the negative valuation is not justified. According to our analysis, there is a strong mismatching between the intrinsic value of Yahoo and the value attributed by the investors that is worth nearly $3 billion.

The method adopted by activist Staboard Value is a bit different. It measures the value gap by subtracting the current enterprise value (EV) from the sum of the intrinsic values of Yahoo core and the relevant assets within the portfolio. In Yahoo's case the elements to sum are three: i) the advertising business that comprises the display business, the search business and the other small services offered to other companies, ii) the stake in Alibaba, iii) the stake in Yahoo Japan. The following table shows the deep undervaluation at which Yahoo is traded:

Sum-of-the-parts valuation *all values in millions (except share prices)*

Alibaba Stake, valued at market	Share price:	$ 64.04		
	n° of shares	383.56		
			$	24,563.18
Yahoo Japan Stake, valued at market	Share price:	¥480.00		
	n° of shares	2,021.70		
	USD/JPY**	¥123.75		
			$	7,841.59
Core Business EBITDA (2015E)[1]		993.00		
Peers NTM EV/EBITDA multiple *(at discount)*[2]		9x		
Core Business Value			$	8,937.00
Yahoo's Total Intrinsic Value			$	41,341.77
Yahoo Market Cap	Share price:	31.52		
	n° of shares	938.44		
				29,579.63
Net Cash and Investments				7,380.00
Current Enterprise Value				**22,199.63**
Value Gap				**19,142.14**
conglomerate discount				*-46.30%*

[1] Broker Consensus, as of 09/09/2015

[2] the multiple is at discount for conservative purposes, given the poor results reported in 1H2015

source: Company Data and FactSet, as of 09/09/2015

The following table shows the next twelve months EV/EBITDA multiple of Yahoo's comparable firms. In the previous analysis we adopted a conservative multiple below the average and the median of the peers especially because, in contrast with its comparable that are seeing important margins of growth, Yahoo published a deceiving EBITDA in the second quarter.

	NTM EV/EBIT
Google	17.24
Baidu	16.43
Yandex	7.91
Iac	14.39
Average	13.99
Median	15.41

source: FactSet, 14/09/2015

In addition to that, it is reasonably to presume that the deep undervaluation of the stock is not only due to the conglomerate discount but also because the market is discounting the likelihood of an inefficient sales of the remaining stakes in the two Asian Companies as occurred with the two disposal of Alibaba stakes.

So, a part from the pressure coming from the shareholder activist, it seems appropriate and necessary for Yahoo to perform the spin-off.

3.5. The announcement of the spin-off and the structure of the deal

On January 27th, 2015 the execution of a tax-free spinoff of the remaining 15,4% stakes in Alibaba was announced by the CEO Marissa Mayer. The completion of the transaction was expected to occur in the fourth quarter of

2015 after the expiration of the one-year lock-up agreement on the Alibaba shares entered into in connection with the IPO.

On July 17th, 2015 the Board officially filed to the Security and Exchange Commission (SEC) the N-2 form for the spin-off of its remaining stake in Alibaba. The form N-2 provides some general details about the structure of the deal that, according to previous releases, is planned for the 4Q of the year. The new entity will be a new closed-end management[38], independent, publicly traded, investment company that will be named "Aabaco Holding, Inc". The assets of the company will consist in the 15,4% stakes in Alibaba Group Holding Limited and the 100% ownership interest in Aabaco Small Business (former Yahoo Small Business) that "operates a cloud-based services platform that enables small business entrepreneurs to start, build and grow their businesses"[39]. The shares exchange ratio is not defined yet but Yahoo stated that Aabaco Holding's shares will be distributed pro rata as a dividend to each Yahoo shareholder and cash will be distributed in lieu of fractional shares of the Fund's Common Stock. The Spin-Off is intended to be tax-free to Yahoo stockholders, except for cash received in lieu of fractional shares.

The fund's investment objective is to seek returns for its stockholders primarily through the ownership of Alibaba Shares that will always consist of at least the 80% of its total assets and the performances of Aabaco Small

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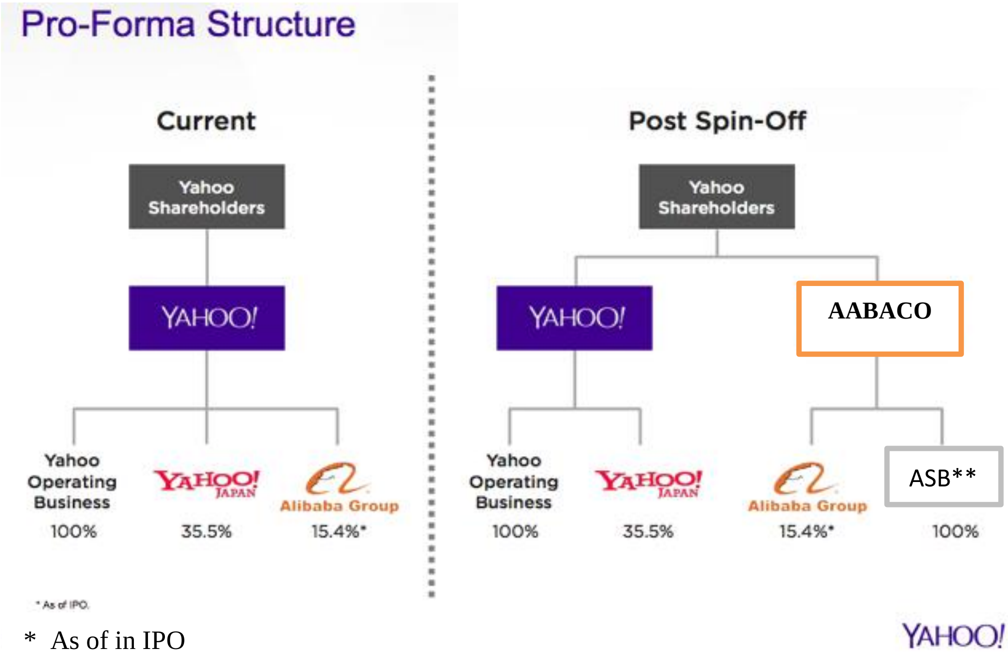
[38] The Fund is a non-diversified, closed-end management investment company (commonly referred to as a closed-end fund) with no operating history. Closed-end funds differ from open-end funds (commonly referred to as mutual funds) in that closed-end funds generally list their common stock for trading on a stock exchange and do not redeem shares of common stock at the request of the stockholder. This means that if you wish to sell your shares of common stock of a closed-end fund you must trade them on the stock exchange like any other stock at the prevailing market price at that time. In a mutual fund, if the stockholder wishes to sell shares of the fund, the mutual fund will redeem or buy back the shares at net asset value per share. Also, mutual funds generally offer new shares on a continuous basis to new investors and closed-end funds generally do not. The continuous inflows and outflows of assets in a mutual fund can make it difficult to manage the fund's investments. By comparison, closed-end funds are generally able to stay more fully invested in securities that are consistent with their investment objectives and also have greater flexibility to make certain types of investments and to use certain investment strategies, such as financial leverage and investments in illiquid securities. (Yahoo, N-2 Form to SEC, July 17th 2015, p. 51)

[39] Yahoo, N-2 Form to SEC, July 17th 2015

Business. Moreover it is stated that the Fund may temporarily lend its Alibaba Group Holding shares to generate income for working capital purposes or to repurchase the Fund's common stock if and only if authorized by the Board.

Following the spin-off, Aabaco Holding and Yahoo will be two independent companies that will operate independently of each other and neither will have any ownership interest in the other.

The final result of the spin-off can be represented as follows:



* As of in IPO

**Aabaco Small Business

In Form N-2 the Board stated some necessary conditions for the completion of the spin-off among which the most relevant concerns the qualification of the transaction under Section 355 of the Internal Revenue Code that treats the tax-free treatment of business separations. When in May 2015 the Internal Revenue Service announced that the tax treatment of spin-offs in US could have changed in the near future, some people saw this pronouncement as directed to Yahoo thus causing some uncertainties around the effective implementation of Yahoo's spin-off whose main aspect understood and appreciated by the market is the tax efficiency. Yahoo replied to the investor community that the plan would have been compliant with the US Internal Revenue Code to benefit for the special tax treatment and reaffirmed the conviction to complete the transaction in Q4 2015. Even if in the N-2 Form the final verdict of the IRS is seen as a constraint for the deal, the Board keeps on stating its commitment for the deal even if a negative pronouncement would arrive from the US Tax Body and reassuring the market for the positive tax treatment to both the parent company and its shareholders.

3.6. The results after the spin-off

The main objective of the planned spin-off is to deliver value for Yahoo's shareholders that have been asking for greater efforts in that sense. The pressure of shareholder activist Starboard Value LP and his threats of aggressive measures against the Board (letter of January from Starboard to Yahoo) have played a crucial role in this story. But will the spin-off create value for shareholders only in the short-term or will it effectively allow Yahoo to focus on its core business and create the prerequisites for a sustainable growth of the Company in the medium and long term? Will the sum of the two companies be higher than the actual valuation attributed by the market to this conglomerate Yahoo?

3.6.1. Aabaco Holdings, Inc

As stated in Form N-2, shareholders will be given Aabaco Holding shares pro rata with respect to their current ownership in Yahoo in order to not dilute the ownership in the new company. This will be the quickest way for shareholders to have some returns. The performance of Aabaco Holdings will be strictly correlated, or better, will depend on the performance of Alibaba. Immediately after the spin-off Aabaco Holdings will be formed by more than 95% of Alibaba shares. As a result the market price and net asset value of Aabaco will be impacted by the market price of Alibaba Shares which depend on the results of its operations and financial condition.

Alibaba is currently trading with a 1YR FW P/E of 30x[40] and is expected to generate revenues for $12 billion in 2015 and $16 billion in 2016 but its growth pace is slowing down. The results published on August 12, 2015 confirmed this negative trend: revenues were at 3.27 billion below an expected $3.39 billion[41]. The main reason of such decline is that Alibaba operates mainly in China (90% of revenues) that in 2015 is reporting its lowest GDP growth rate in 25 years at 6.8% (IMF estimates), especially due to internal demand contraction and decrease of investments that together drive Alibaba's business. However analysts are unanimously convinced that Alibaba can exploit the positive results coming from its mobile segment that in in the last quarter have accounted for the 51% of all revenues. This increase shows the monetization of the investment made in the last years with the acquisition of several companies that enhanced Alibaba's mobile services. The target price of Alibaba is set at $100 with a range of $77 up to $120, that was the max price reached by the company in November 2014. Alibaba Holding stock price will be also sustained by the stock repurchase announced by the Board that plans to buy back $4 billion over a period of two years, primarily to offset dilution that occurred mainly to share-based compensation programs.

Coming back to Aabaco, there are two main aspects to take into account that could affect its shareholders:

1. The discount at which the type of investing companies like Aabaco or Alibaba Holding itself trade
2. An active trading market for Aabaco might not develop

Quite often shares of closed-end management investment companies trade at a discount from net asset value. This is because investors would prefer to

[40] As of 12/08/2015
[41] Thomson Reuters

buy directly Alibaba shares rather than through the indirect vehicle of Aabaco. This would not be the case if Aabaco Small Business, the remaining part of Aabaco Holdings – spun-off with Alibaba stake in order toobtain the tax-free treatment - will show positive performances and result so as to induce investors to invest in the holding, but this seems an unrealistic scenario. The type of holding companies like Aabaco usually trades with a discount of 7%[42]. In order to quantify the potential value of Aabaco we have to consider: i) the value that the stake in Alibaba will have in the future ii) the discount that will affect Aabaco. Since we don't know what will be Aabaco shares outstanding we can't give a realistic value per shareholder. However assuming that the distribution ratio will be 1:1, let us hypothesize the following scenarios:

	Scenario 1	Scenario 2	Scenario 3
Alibaba	$ 60.00	$ 88.00	$ 120.00
n° shares held by Yahoo (in million)			383.56
Alibaba Stake	$ 23,013.60	$ 33,753.28	$ 46,027.20
Aabaco market cap	$ 21,402.65	$ 31,390.55	$ 42,805.30
Yahoo shares outstanding (in million)			994.6
Aabaco share price	**$ 21.52**	**$ 31.56**	**$ 43.04**

source: Facset as 09/09/2015

The potential absence of an active market on Aabaco, also cited in the N-2 Form among the risks of the transaction, will increase the likelihood for a greater discount on Aabaco shares because an illiquid market will require higher returns given the potential threat and risk of being unable to liquid the stakes. However this discount could be an incentive for Alibaba to acquire Aabaco in such a way that operate a stock buyback without the use of cash but using its own stocks with an advantageous ratio and giving Aabaco shareholders the underlying in which the invested through Aabaco.

[42] Liberty Trip Advisor Holdings/Liberty TripAdvisor, Liberty Broadband/Charter & TWC, Comverse/Verint

3.6.2. Yahoo post spin-off

The most interesting part of the deal will be the valuation and the future of Yahoo after the spin-off.

The first consideration must be done on the tax treatment of the spin-off. After many conflicting voices since May 2015, the doubts concerning the potential tax-free treatment of the spin-off seem to be come to an end. In July, even if stated differently in N-2 Form, the Board had assured the completion of the spin-off even without the qualification of the transaction under Sections 355 and 368 of the IRS Code. In that case the spin-off would result in significant tax liabilities on Yahoo but not on its shareholders. Finally on September 2, 2015, the IRS notified Yahoo's counsel that it had determined, in the exercise of its discretion, not to grant the requested ruling. At the same time, the IRS indicated that it had not concluded that the proposed spin-off transaction was taxable and therefore was not ruling adversely on the request. Following receipt of such notification, Yahoo withdrew its request for a ruling on September 2, 2015. The decision has had a negative impact on Yahoo share price and on the likelihood that the spin-off will be effectively performed in the terms and accordingly the structure previously announced but it is equally important for the purpose of our study to measure the different impact that a tax-free treatment would have on shareholders.

Assuming a tax rate of 38%[43] the two scenarios would be the following:

			Pre-Tax	Post-Tax	Delta
Alibaba Stake	Share price:	$ 64.04			
	n° of shares	383.56			
			$ 24,563.18	$ 15,229.17	$ 9,334.01

source: FactSet as of 09/09/2015

[43] Starboard Value LP applied this tax corporate rate in its official analysis

The difference of value would be of nearly $9 billion. Dividing the delta by Yahoo shares outstanding (994.6 million shares), the potential value freed up through the tax-efficient structure would be ca. $8.9 per share.

The risk of the occurrence of a huge tax liability has to be taken into account not only before the spin-off but also in the following years. As seen in the previous chapter, Section 355 of the Code establishes that a tax liability would occur at both corporate and shareholder level if acquisitions on the companies implementing the spin-off were performed within two years after the spin-off because it would violate the criteria for being categorized under Section 355 and 368.

Leaving this tax-related aspect of the spin-off, we can evaluate Yahoo core business after the transaction adopting the discounted cash flow analysis.

For our analysis we will use:

- Estimates provided by UBS in its Equity Research published on April 21, 2015;
- Public data available on Bloomberg;
- Public information released on Yahoo corporate website;
- "Worldwide Ad Spending Q1 2015 Complete Forecast" published by *eMarketer*, the leading independent market research company that provides insights and trends on digital marketing, media and commerce.

Internet Companies like Yahoo base their projections on the researches and forecasts released by this type of companies. Market research companies have developed quantitative and qualitative approaches to evaluate the trends on various markets. They usually gather data from government agencies, company reports and other research firms and finally publish revised projections periodically.

Since Yahoo and its peers forecast their financials through these types of researches, we will first analyze the trends for global digital advertising expenditures in the next five years:

Digital Ad Spending Worldwide, 2013-2019

	2013	2014	2015	2016	2017	2018	2019
Search	59.16	70.18	81.59	93.82	105.88	118.81	130.58
growth rate YoY		*18.6%*	*16.3%*	*15.0%*	*12.9%*	*12.2%*	*9.9%*
Display	49.01	61.72	75.50	89.93	104.24	118.27	132.21
growth rate YoY		*25.9%*	*22.3%*	*19.1%*	*15.9%*	*13.5%*	*11.8%*
Other	12.10	13.10	13.77	14.42	15.08	15.65	16.21
growth rate YoY		*8.26%*	*5.11%*	*4.72%*	*4.58%*	*3.78%*	*3.58%*
Digital Ad Spending	120.27	145.01	170.85	198.18	225.19	252.72	279
growth rate YoY		*20.6%*	*17.8%*	*16.0%*	*13.6%*	*12.2%*	*10.4%*

Source: eMarketer March 2015 *all values in billion and in $*

Digital Ad Spending will increase in the following years with positive growth rates. Even though the trend is declining (from 18% y-o-y to 10%) we can assume that eMarketer adopts a conservative approach given the high level of uncertainty of the industry and the many unpredictable disruptive technologies that may affect dramatically the market. However these forecasts guarantee that Yahoo core business will not know slowdowns. In addition, the another trend that has to be carefully considered is the greater importance that mobile ad spending will acquire in the next few years, as shown in the following table:

Digital Ad Spending Worldwide, 2013-2019

	2013	2014	2015	2016	2017	2018	2019
Non Mobile Ad Spending	101.07	102.38	102.16	96.81	91.45	86.09	83.45
growth rate YoY		*1.3%*	*-0.2%*	*-5.2%*	*-5.5%*	*-5.9%*	*-3.1%*
% of Digital ad spending	*84.0%*	*70.6%*	*59.8%*	*48.8%*	*40.6%*	*34.1%*	*29.9%*
Mobile Ad Spending	19.2	42.63	68.69	101.37	133.74	166.63	195.55
growth rate YoY		*122.0%*	*61.1%*	*47.6%*	*31.9%*	*24.6%*	*17.4%*
% of Digital ad spending	*16.0%*	*29.4%*	*40.2%*	*51.2%*	*59.4%*	*65.9%*	*70.1%*
Digital Ad Spending	120.27	145.01	170.85	198.18	225.19	252.72	279
growth rate YoY		*20.6%*	*17.8%*	*16.0%*	*13.6%*	*12.2%*	*10.4%*

Source: eMarketer March 2015 *all values in billion and in $*

The majority of Ad spending will not be directed anymore on the “display channel” (i.e. advertising that appears on desktop and laptop computers) but by the end of 2019, 70% of advertising spending will be targeted on the mobile segment. In this context the strategy implemented by Yahoo seems to be a winning strategy. Moreover the acquisition of Polyvore, the leading US social shopping site announced on July 31, 2015 and completed on September 2, 2015 will strengthen Yahoo’s presence and growth acceleration on mavens segment through its strong and high-profile offerings in social, native, and mobile. The acquisition presents some characteristics equal to the Google acquisition of Youtube: in fact Polyvore is a company that has already shown strong results and promising growth rates, becoming an important player in the online fashion shopping segment thanks to its social networking element that differentiate its business. It also represents a diversification from Yahoo core business, more focused on search and display advertisement, into the e-commerce sector.

However Yahoo is not the only Internet Company that is putting its efforts on that channel, but its competitors too are shifting their resources to boost and enrich the mobile segment. Google reported solid Q1 2015 results driven by its mobile search that constituted 45% of total search paid clicks while Yahoo is at 30% of total revenues coming from mobile in the first quarter.

After this environmental analysis, we can focus on the Discounted Cash Flow developed in order to define a realistic intrinsic value of Yahoo’s core business. The previous analysis can justify the assumptions that we will adopt in the model. Given the current performance of Yahoo and industry trend for the following years, we assumed a conservative growth rate of Yahoo’s EBIT for the next 5 years, below UBS estimates adopted to develop the model, but also lower than the majority of consulted research analysis (JP Morgan, Morgan Stanley, Pivotal, RBS). This assumption is also fostered by the inefficient cost cut that Yahoo is implementing: the reduction of operating costs will be completely offset by the increasing

Traffic-Acquisition Costs due to Mozilla according the agreement signed on November 2014.

The marginal tax rate is fixed at 40%, as suggested by Damodaran[44], for United States whereas D&A, Change in WC and CAPEX are extrapolated by UBS estimates. The perpetual growth rate is fixed at 1.5% as the long-run GDP growth rate for US plus a spread given by the potentials shown by the internet advertising industry.

		2013	2014	2015	2016	2017	2018	2019	2020
EBIT		935	755	419	362	462	520	570	602
g					-13.6%	27.6%	12.6%	9.6%	5.6%
t	40%								
NOPAT		561	453	251.4	217.2	277.2	312	342	361.2
D&A		699	607	592	536	492	465	449	449
Change in WC				-3311	32	-21	-36	-38	-38
CAPEX				-433	-444	-407.5	-385.2	-372	-372
FCFO				-2900.6	341.2	340.7	355.8	381	400.2
								TV	5077.538
								g	1.50%

Table 2 Yahoo post spin-off DCF

Discounting the cash flows by the Weighted Average Cost of Capital we find the present value of all cash flows, then we sum up the present value of the Terminal Value and finally we get the intrinsic value of Yahoo core business according our estimates:

[44] http://pages.stern.nyu.edu/~adamodar/

PV FCFO	$	(1,514.09)
PV Terminal Value	$	3,227.53
Yahoo Core Business	$	1,713.44
Net Cash	$	5,183.00
Stake in YHOO JP	$	8,200.99
Teoretical Yahoo Price	$	15,097.43
post-spin	$	16.09

As we can see, as a consequence of the spin-off, the share price of Yahoo will not retain anymore the stake in Alibaba but will keep on considering the stake in Yahoo Japan. According to our analysis, the cash generated by Yahoo Core Business is poor and is dramatically affected by:

- the relevant tax liability that Yahoo has to pay to the US Government as a consequence of the sell-off of its stake in Alibaba on the IPO and
- the inability to offset such absorption of cash with a real rationalization of expenses

Yahoo core business valuation accounts for ca. $1.5m whereas the stake in Yahoo Japan is worth $8.2bn. Even if Yahoo valuation is poor, it is surely more than the valuation below zero that the market is currently assigning to the conglomerate spin-off.

Narrowing our analysis on Yahoo core business, the highest amount of value comes from the Terminal Value such as the projections in the long-run. This may have a positive and a negative meaning. The positive aspect is that in the future Yahoo is expected to generate cash but in this case, the positive attribution to the evaluation of Yahoo core business comes only from the Terminal Value. This may not be appealing for investors and shareholders that now more than in the past are looking for returns in the short run.

3.6.3. The combined value for shareholders

Yahoo spin-off will allow current shareholders to potentially diversify their investment. This is an acknowledged benefit that comes in every spin-off or split-off. The implicit benefit however concerns the value that this transaction will deliver for shareholders.

The combined value for shareholders can be easily measured through the sum of the prices that hypothetically the two stocks will have the day after the spin-off.

It is important to remember that in our analysis we adopted a prudential methodology and that estimates have been considered in a prudent perspective below the estimates of analysts. The more reliable scenario for Aabaco is the first one because is more in line with the current Alibaba capitalization, recently affected by the poor results that the Chinese company is reporting as a consequence of the Chinese financial and economic crisis. The following table summarizes the results of our analysis:

	Yahoo Pre Spin Off	**Yahoo Post- Spin-off**		
YHOO	$ 31.52	$ 16.09	$ 16.09	$ 16.09
AABACO	$ -	$ 21.52	$ 31.56	$ 43.04
		scenario 1	*scenario 2*	*scenario 3*
Total	$ 31.52	$ 37.61	$ 47.65	$ 59.13
Delta (pre vs post)		19.32%	51.17%	87.60%

The enhancement of value is evident in all scenarios. We have not considered in this valuation the impact that a taxed transaction would have. Assuming a tax rate of 38%, Yahoo would incur in a tax liability of $9billion that would consist in a weigh on its share price of $8.95 per share. In this case the spin-off would create value only if the tax liability would be compensated by an increase in Aabaco share price (as a reflection of Alibaba share price), for instance, approaching to the target value that brokers have estimated. Again, the main driver of the success of this transaction seems to be Alibaba and his performance.

Conclusions

The case study on Yahoo and its equity investment in Alibaba is an empirical evidence that, under certain conditions, spin-offs are a source of value creation. The history of Yahoo has shown that management may not pursue the real interests of shareholders and many times for reasons well-explained by the agency theory, opportunities to deliver value for shareholders – the real objective of a management team- are missed (e.g. the tender offers received from Microsoft).

According to our results the spin-off of Yahoo is not one of these missed chances of profit. Indeed, our analysis supports the theoretical thesis on the effectiveness of restructuring transactions as a source of wealth for shareholders and the sustainable profitability of a company. Yahoo is a corporate that has been losing competitiveness, focus and a clear strategic direction. Financial data, an attentive analysis and benchmarking with Yahoo's peers show the dramatic and distressed situation in which Yahoo is at this stage of his life. The figures obtained through our model show an increase of value in a range from 19% to 88% but in our opinion these results have to me furtherly discussed.

The recent declaration of the IRS and the decision of the Board to withdraw its request for a ruling under Section 355 have increased the uncertainty on the transaction and the execution itself is at risk. The Board is still committed to perform the disposal of Alibaba stake in a tax-efficient manner and the open answer given by the IRS does not preclude that the announced transaction will not occur. Moreover Yahoo's tax counsel *Skadden, Arps, Slate, Meagher & Flom LLP* said the IRS' decision would not affect its ability to render an opinion that the currently proposed spinoff would satisfy all of the requirements for tax-free treatment.

Assuming that the tax-free treatment will be obtained, it is doubtless that the implementation of the spin-off is an answer to the requests of shareholders asking for returns on their investments. However in our view the real purpose of the spin-off, more than a strategic decision aimed at the revamping of Yahoo performance, seems to be an attempt to please shareholders with a short-term horizon. In fact, the results obtained in our analysis are controversial.

The most remarkable effect that will likely come is the higher valuation that the market should attribute to Yahoo core business given the higher transparency that the transaction will permit, in contrast with the current valuation that sees Yahoo with values below zero (as it is affected by a conglomerate discount of 9%). At the same time our analysis has shown again that the greatest part of Yahoo share price post spin-off will be still attributed to the stake held in Yahoo Japan and the cash remained after Alibaba's IPO ($1.7bn of Yahoo vs 8.2bn of Yahoo Japan).

All else equal, the poor valuation of the core business shows the weak potential that the company has in itself. The increasing supremacy of Google and the small market shares that has left to its competitors, the inability of Yahoo to make strategic investments and to monetize those already performed, the insufficient cost restructuring strategy and the lack of innovative products weight on the future performances of the company. This situation is a process that began in the past and with the current conditions of the competitive environment make recovery and growth very difficult.

The recent rumors of the spin-off of the remaining stake held in Yahoo Japan raises other questions. Without this crucial asset, Yahoo would have such a poor value in itself that would be the ideal target for any strategic acquirer. However, after having spun-off Alibaba and Yahoo Japan - a solution that in the short-run is the unique way to deliver value for shareholders - the idea of a merger with another market player seems to be the ideal solution with a long-run perspective, exploiting the high liquidity in Yahoo portfolio for new investments and the potential synergies that could come from combined user bases, cost reductions, wider product offer.

The mission to turnaround the company entrusted to Marissa Mayer three years ago was a very complex task. In three years Yahoo saw a dramatic increase in its valuation, but the main drivers come from wise (lucky?) investments made in the past. The core business of the company has been facing many challenges mainly driven by a fierce competition in the competitive environment. The spin-off of Alibaba equity investment (and potentially Yahoo Japan) is the sole way for Yahoo to deliver somehow value to shareholders but the impact would be only in the short run.

The results of our study testify that spin-off can have positive impacts in the short run with any doubt, delivering higher value given the higher transparency of the two businesses. However in the long-run the results depend on the capability of the two or more business to generate value. In Yahoo’s case, the situation is very complex: the core business may potentially deliver value but the results lead the writer to believe that, considering the industry dynamics, a merger with another player could be the best solution. If competitors don’t anticipate Yahoo and cannibalize it.

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