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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ABSTRACT

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.

The Board of Directors decisions and top management actions should aim at the maximization of shareholders value even though many critiques and different approaches come from academic literature and governmental bodies. According to the writer a special contribution in this debate may come from the Social Doctrine of the Church, a rich body of principles coming from Church teachings on social issues, including business and entrepreneurship. In considering the strategic opportunities to adopt in order to increase shareholders value, managers may adopt the Pentagon model[1] developed by McKinsey that, moreover, describes the role of M&A and divestment strategies as sources of value for the firm. 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. Given the potential benefits of these transactions, several times there deals are pushed by the so-called shareholder activists, a type of shareholders (or better, investors) who attempt to use their rights as a shareholder of a

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

publicly-traded corporation to bring about social change. The more common divestment strategies are spin-offs that are usually performed because of their main acknowledged benefits including enhanced business focus, appropriate capital structure for the different businesses, transparency enhancement given the distinction between the spun-off companies, divestment of a business with negative performances, effectiveness of equity-based compensation, employment of equity as a new currency to implement new mergers and acquisitions strategies. Another benefit, coming from US regulation is the tax-free treatment of spin-off if certain conditions, disciplined in Sections 355 and 368 of the Internal Revenue Code, are met in the structuring of the transaction. Spin-offs are usually performed by companies affected by the so-called conglomerate discount, a phenomenon that usually concerns firms with a highly-diversified portfolio of businesses that the market values far below peer-companies focused on a single business. According to investors, pure plays companies can be understood more easily. There is an higher level of transparency and performance measurement is easier and more consistent. Moreover conglomerate companies are considered too complex and lack the necessary focus to be managed as effectively as pure plays: this is the main reason why conglomerate companies usually underperform and command lower multiples.

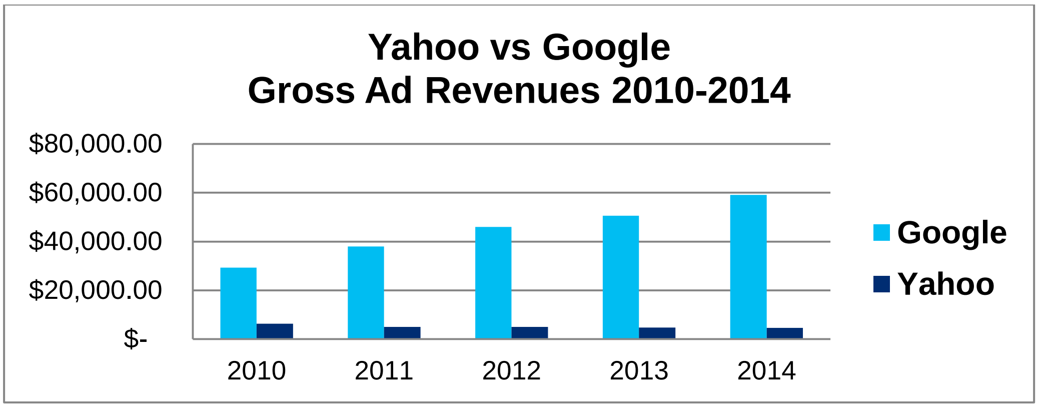
This is the case of Yahoo! Inc, one the most relevant and biggest Internet companies worldwide along with Google, Yandex, Microsoft and Baidu. Internet companies usually develop several free services and products (e.g. news, broadcasting, databases) that attract user traffic on their platforms and monetize their online audiences by providing advertising services to paying advertising and media companies who generate the big part of their revenues. 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. 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 and make the website more appealing and efficient in terms of marketing channel. A special role in the user base growth is also played by same-side network effects that is implicitly embodied in the structure of web portals and social networks. As said 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"[2]. In 2014, an year that saw an increase of 3.3% in global GDP[3], the expenses for digital advertising were nearly $145 billion with an year-over-year increase of 20%[4].

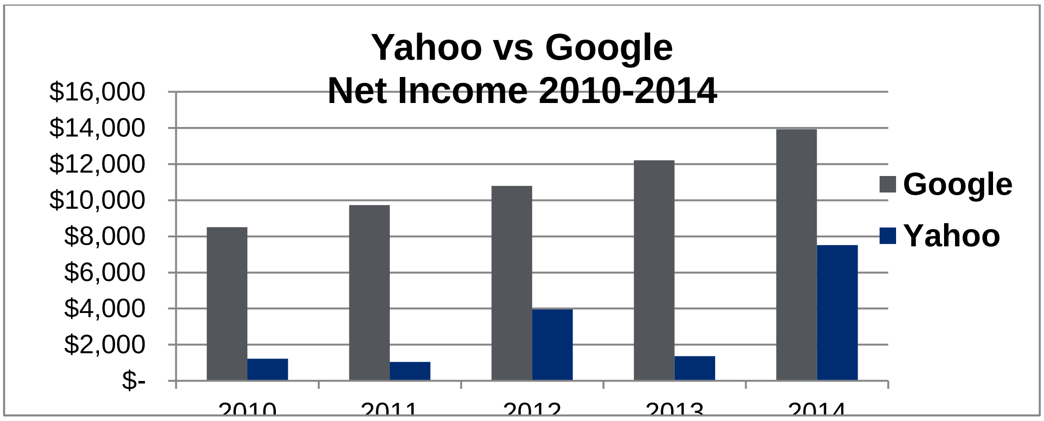
Yahoo main revenue drivers are (i) search revenues (ii) display revenues (iii) other type of revenues. Search Revenue accounted for $1,05 billion in 1H 2015 with an year-over-year increase of 20%. Yahoo offers two main products in this field that promise to increase the clients' brand awareness and the 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%[5] 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[6] 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 through non-guaranteed display advertising in which the advertisement is delivered on a preemptible basis. Other revenue include various B2B services offered by Yahoo including Yahoo Small Business (that will be spun-off along with Alibaba stake), transaction revenue,

[2] Internet Companies World – market analysis, 2015-2018 trends, Corporate Strategies, Xerfi Global, 2015
[3] IMF Research 2014
[4] Internet Companies World – market analysis, 2015-2018 trends, Corporate Strategies, Xerfi Global, 2015
[5] Source: eMarketer March 2015
[6]"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).

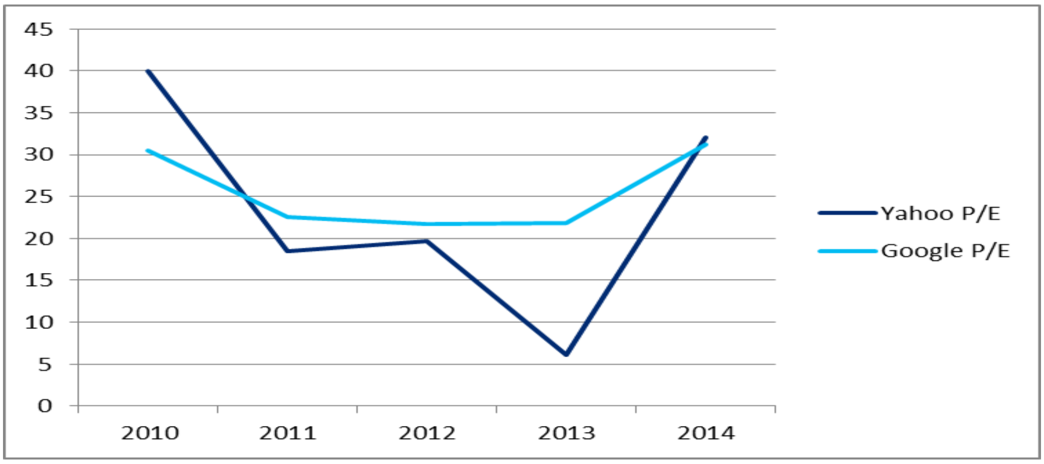
royalties coming from joint-ventures, and fees revenue for all those fee-based services for both customers and businesses.

In terms of financial results, in 2Q 2015 Yahoo performance was below consensus and costs grew dramatically: 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).





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 the appreciation of Alibaba stake in Yahoo portfolio after the IPO but it is not due by Yahoo performances and by the management capabilities.

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. The main topic of the letter was the suggestion of a tax-efficient sale of Alibaba and Yahoo Japan stakes given the enormous conglomerate discount that was affecting the company, in order to unlock hidden 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 tax-inefficient sales of Alibaba stocks (2012 and 2014) - note that in 2014 disposal, Yahoo incurred in a tax liability of $3.1 billion – and completely wrong timing.

As noted by shareholder activist Starboard Value LP and several analysts, Yahoo was and still is affected by a relevant conglomerate discount. 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. In addition to that, it is reasonably to presume that the 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 precedent disposal of Alibaba stakes.

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 and will consist in the creation of a new entity, a new closed-end management, independent, publicly traded, investment company that will be named "Aabaco Holding, Inc" whose assets will consist in the 15,4% stakes in Alibaba Group Holding Limited and the 100% of 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"[7]. As stated in Form N-2, Yahoo 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. The performance of Aabaco Holdings will be strictly correlated, or better,

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

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[8] and is expected to generate revenues for $12 billion in 2015 and $16 billion in 2016 but its growth pace is slowing down given the Chinese crisis that massively affects Alibaba since it is its first market (90% of revenues)[9]. The type of holding companies like Aabaco usually trades with a discount of 7%[10]. 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 discount at which Aabaco may trade 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.

Yahoo after the spin-off can be measured through a DCF 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

8 As of 12/08/2015
9 Alibaba Annual Report 2014
10 Liberty Trip Advisor Holdings/Liberty TripAdvisor, Liberty Broadband/Charter & TWC, Comverse/Verint

analysis (JP Morgan, Morgan Stanley, Pivotal, RBS). This assumption is also fostered by the inefficient cost cut that Yahoo is implementing. The marginal tax rate is fixed at 40%, as suggested by Damodaran[11] 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 of 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%

Discounting for the WACC, we obtain the following intrinsic valuation:

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 include 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:

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

- 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. 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. The more reliable scenario for Aabaco is the first one because is more in line with current Alibaba capitalization, given 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 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. 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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