HELIOS
Financial Group

October 2023

Helios Global Publications

Structured Success: Deal and Transaction Series

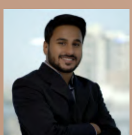
Monetizing Spin-Offs

Asad Khan
Partner, Mergers & Acquisitions

Asad is the global coleader of the HFG Global Publications, a global hub for world-class research, analysis, and collaboration in M&A productivity and performance.

Mansoor Najam
Senior Specialist, Knowledge Management, Product, Practice, and Knowledge (PPK).

Mansoor, specialist in knowledge management, dives into the stories of extraordinary transactions and deals in M&A productivity and performance.



Ammad Ahmed
Associate, Digital Intelligence, Creative & Design

Ammad, believes in all things digital, his passion for design led him to be partner Creative & Design at HFG.

Global Transactions Practice Leader: Asad Khan
Analyst: Mansoor Najam
Art director: Ammad Ahmed
Copy editor: Ammad Ahmed
Lead Reach and Relevance partner: Rehan Farooqi

Structured Success: Deal & Transaction Series is published by the Helios Global Publications, part of Helios Financial Group. The Helios Global Publications is led by Asad Khan and Imran Khan.
Helios Financial Group
Balad Technology Towers, Suite 410
Karachi, Sindh 07482
Pakistan

Preface

Welcome to "Structured Success: Deal and Transaction Series." In the world of finance, the ability to understand and navigate complex deal and transaction structures is an invaluable skill. Whether you are an experienced financial professional seeking to sharpen your expertise or someone new to the intricate world of financial transactions, this publication series is designed to be your trusted companion on this journey. The aim of this independent publication series, produced by the Helios Global Publications, is to arm public and private sector leaders with fact-based insights to guide informed decision-making.

Each article in this series is carefully curated to unpack the complexities of deal structures, presenting concepts in a clear and actionable manner. From the basics to advanced techniques, we will explore various aspects of deal structures, delving into real-world case studies, tax issues, contract issues, regulatory issues, and practical applications. Our goal is to equip you with the tools and knowledge necessary to make informed financial decisions, whether you are involved in mergers and acquisitions, real estate transactions, or any other financial deal.

The research underlying this series was run by the dedicated team of Helios Financial Group M&A practice team, led by Asad Khan, a partner. Valuable perspectives and advice were offered by a distinguished panel of academic and industry experts. Including, various articles, publications, books and research materials.

The report also benefited enormously from the contributions of HFG's global network of industry experts. It drew on HFG's indepth analytical expertise, our work with leading preferred acquirer organizations, distinguished lawyers, esteemed tax advisors and our understanding of deals space around the world.

The authors would like to thank the external and internal advisers for their contributions. In addition, the authors would like to thank Ammad Ahmed and Waqas Ahmed for their help in art directing, producing, and disseminating this report.

---

1. This report was not commissioned or sponsored in anyway by a business, government or other institution.
2. Stephen I. Glover, (2015), *Using Spin-offs to Raise Cash, Reduce Debt and Recapitalize*
3. Latham & Watkins memorandum by Ms. Birkeland, Mr. Gerstein, Mr. Stein, Ryan J. Maierson, Pardis Zomorodi, and Alexa M. Berlin, (2019), *Spin-offs Unraveled*
4. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own.

TABLE OF CONTENT

INTRODUCTION

A monetization spin-off represents a strategic maneuver wherein the Seller efficiently spins off a subsidiary with complete tax exemption while substantially reducing debt exposure. This strategic financial move optimally balances tax advantages and debt management for the Seller.

In a standard spin-off scenario, when a company spins off a subsidiary, it can transfer cash from the subsidiary to the parent company without incurring tax liabilities, or alternatively, shift debt down to the subsidiary, limited to the tax basis held in the subsidiary. However, exceeding this tax basis in cash or debt would result in taxable gains upon the spin-off's conclusion. The same tax implications apply to various methods used to deliver cash proceeds to the Seller, like a pre-spin-off secondary sale of subsidiary equity.

One aspect that garners lesser attention but significantly contributes to the attractiveness of spin-off transactions is the opportunity they offer to parent companies. Through spin-offs, parent companies can raise capital, capitalize on their interests in the companies being spun off, and strategically reduce indebtedness. Although the spin-offs themselves do not generate cash for the parent or its stockholders, astute transaction planners utilize a range of techniques to realize monetization and recapitalization objectives.

These techniques encompass a spectrum of approaches, ranging from the straightforward, such as subsidiaries borrowing funds and distributing the proceeds to their parent before the spin-off, to more intricate maneuvers. Examples include orchestrating initial public offerings by the subsidiary before spinning off its stock or structuring sponsored spins, where a financial sponsor invests in the subsidiary at the time of the spin-off, often accompanied by a cash payment to the parent.

Moreover, more complex structures involve transactions where the spin company and the parent company engage in a debt-for-debt or debt-for-equity exchange. However, these approaches typically require extensive involvement from investment banks. Alternatively, a parent company might strategically pair a spin-off with mergers and acquisitions (M&A) transactions, coupled with monetization maneuvers utilizing "Morris Trust" or "Reverse Morris Trust" structures.

Spin-off transactions are pivotal strategic moves for companies aiming to enhance focus, streamline operations, and generate substantial value for shareholders. The potential for strategic capital raising and debt reduction further underscores the importance of spin-offs in today's dynamic business environment. Careful consideration of the diverse strategies and their alignment with the company's financial health and market conditions is essential for successful spin-off execution.

PRACTICAL CONSIDERATIONS

Strategic Business Segmentation and Alignment: In preparing for a spin-off, the initial crucial step involves defining the specific entity or business division to be spun off. When dealing with a subsidiary with a clear standalone operational history, this determination is relatively straightforward. However, adjustments to subsidiary operations may still be necessary before the spin-off. Additionally, establishing formal business relationships between the parent company and the spin-off entity, and managing shared support functions are vital aspects, considering tax implications as discussed later.

In contrast, spin-offs involving a division or segment of the parent company present greater complexities. Identifying and transferring assets and operations to the spin-off entity necessitates meticulous planning. Various corporate and tax structuring issues emerge, including determining optimal transfer mechanisms, sequencing steps, obtaining necessary consents, and managing international operations if applicable. Pre-spin internal reorganization planning should start early, aligning with a comprehensive timeline, and completion should precede the spin-off, ensuring tax and cost efficiency. However, careful consideration is needed regarding the timing to minimize risks associated with potential modifications or abandonments. This process may also require an earlier completion if financing is a pre-requisite.

In cases where the spun-off business substantially differs from the parent company's financial segments, complexities escalate. This circumstance requires extensive time for the preparation of audited financial statements and MD&A for the spin-off business, essential for the Form 10 registration statement. Notably, if the spin-off company does not align with the parent's financial reporting segments, certain regulatory provisions, such as the use of Form S-3 and Rule 144, have specific eligibility timelines post the spin-off company's Form 10 registration statement's effectiveness. These aspects should be diligently considered and addressed during the spin-off process.

Capital Structure Considerations: In preparing for a spin-off, a critical step involves shaping the capital structures for both the parent and the spin-off entity post-separation. This includes strategic allocation of existing cash and debt between the parent company and the spin-off. Additionally, there's often a need to secure extra funds or reduce existing debt.

Various techniques can be employed to achieve the desired capital structure, and the most suitable approach is usually guided by tax implications and existing debt agreements. A common method involves the spin-off entity issuing new debt, generating cash before the spin-off, and distributing it to the parent for debt repayment. This could be done through a cash distribution, share redemption, settling intercompany payables, or acquiring assets from the parent using cash.

Importantly, it's necessary to navigate complex tax implications that may arise from these strategies, particularly when distributions exceed the parent's basis in the spin-off company's assets or stock. Techniques involving the spin-off company's debt or equity can be utilized to generate value for the parent without triggering tax gains.

Furthermore, the spin-off may necessitate a range of financial transactions, including new term debt issuance by the spin-off company to fund distributions to the parent. Given the potential disparity in creditworthiness and business plans between the parent and the spin-off entity, the terms of credit agreements may differ significantly, requiring careful negotiation and disclosure.

Considering these factors, early planning is vital. Identifying the ideal financing structure, engaging with potential financing sources, and evaluating the timing of financial transactions in alignment with the spin-off date are crucial aspects. This financial planning is integral to determining the overall structure of the spin-off, considering how it influences cost of capital and debt terms for both the spin-off entity and the parent.

Addressing existing debt is also essential, necessitating a review of debt allocation based on intended business structures and tax implications. Obtaining consents for debt covenants may be necessary, and in cases where existing debt terms pose challenges, issuing new debt at the spin-off level can offer a solution.

However, it's important to acknowledge that the need for new financing introduces risks, potentially delaying or even jeopardizing the spin-off if market conditions or other factors impede debt issuance. Mitigating these risks involves securing financing commitments during the planning phase or arranging debt agreements well in advance of the spin-off, albeit with careful consideration of associated risks and costs.

In summary, meticulously planning the capital structures, financial maneuvers, and debt strategies is fundamental to ensuring a smooth spin-off process, navigating the complexities of taxation and financial implications effectively.

Allocation of liabilities: In the process of organizing a spin-off, it's essential to strategically distribute not only debt but also other liabilities, like contingent ones, among the parent and spin-off companies. These allocations involve a careful analysis of which liabilities naturally align with each business and addressing legacy liabilities that may not be connected to any current business of the parent. Additionally, it's vital to account for general corporate or shared liabilities, such as those related to shareholder litigation, which may not pertain specifically to either entity.

The liabilities in question could already be appropriately assigned to their respective legal entities in some instances. However, in other cases, careful consideration is required to ensure the right entities assume these obligations. Typically, the allocation of liabilities is formalized through indemnities outlined in the separation and distribution agreement or other relevant transaction documents. These indemnities serve as protection, but their effectiveness might be limited if the obligated company is financially insolvent or bankrupt when the indemnity payment is due.

Moreover, part of this process involves the mutual release of liabilities between the parent and the spin-off company. It's worth noting that customary mutual releases are generally considered suitable and enforceable, as confirmed by the Delaware Court of Chancery.

Solvency and Surplus: When orchestrating a spin-off, prudent handling of debt and liabilities is critical to ensure the financial health and viability of both the parent company and the spin-off entity. This includes a thoughtful approach to allocating debt, other liabilities, cash, cash equivalents, and financial instruments like derivatives.

Spin-offs usually entail dividend payments, such as distributing the spin-off company's stock to the parent company's shareholders or making cash payments from the spin-off company to the parent before or after the spin-off. However, such dividend transactions can face legal challenges if it's later deemed that the paying entity was insolvent at the time of the distribution. To mitigate this risk, companies often seek solvency opinions from valuation firms for either or both the parent and spin-off companies. Although these opinions may not conclusively settle insolvency disputes, they help in establishing solvency, especially when backed by relevant market data and demonstrating the board of directors' prudent consideration of the matter.

In most jurisdictions, corporate laws stipulate that a company can distribute to shareholders only from surplus or earnings, ensuring solvency after the distribution. This assessment of surplus must take into account asset appreciation not reflected in book value and contingent liabilities not on the balance sheet. Expert opinions, along with the company's management, can aid the board of directors in determining surplus availability. Some states' laws provide a safety net for directors relying on the company's financial statements to confirm sufficient surplus for distributions.

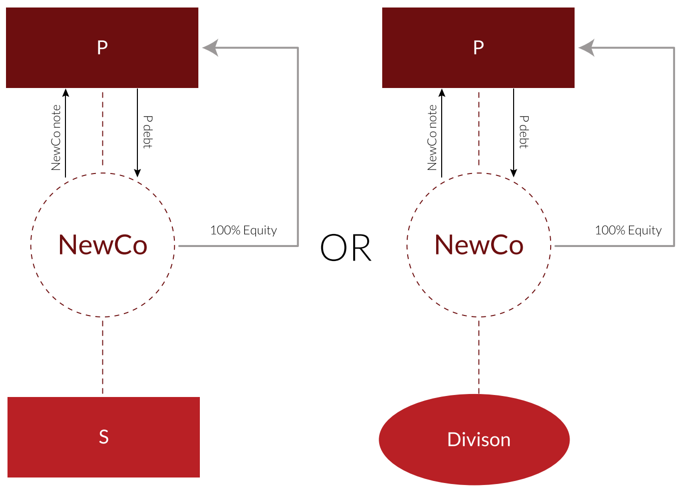
MODEL DEAL STRUCTURE

BUILDING THE STRUCTURE

Outlined below is a concise, guideline on the general steps of the partnership dynamics between an buyer and seller in a Monetinzng Spin-off deal structure :

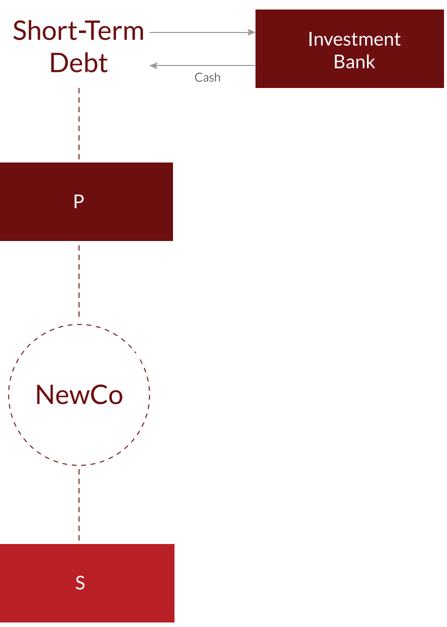
1 NewCo Formation and Strategic Contribution

- P initiates the process by contributing S (or the relevant division) to NewCo, the entity slated for a public offering. In return, P receives 100% ownership of NewCo's equity and a NewCo Note
- NewCo has the flexibility to take on P's debt, up to P's tax basis in the contributed assets. Alternatively, it can secure borrowing and provide cash to P through a dividend of a matching amount.
- The overall debt assumed by NewCo, inclusive of the NewCo Note, P debt assumption, and/or incurring new debt, is capped by NewCo's debt capacity.
- The contribution of S to NewCo fulfills the criteria for a reorganization. This strategic arrangement enhances the maneuverability to retire short-term debt during the spin-off and simplifies the retirement of P debt using the NewCo Note.



2 Short-Term Debt Transaction and Exchange Plans

- An investment bank acquires P's short-term debt (like P's commercial paper) for cash through the secondary market.
- At the time of this acquisition, the investment bank and P have a prearranged plan, though not yet a binding contract, to engage in two types of exchanges involving NewCo:
  - A debt-for-equity exchange involving NewCo shares
  - A debt-for-debt exchange involving the NewCo Note
- The investment bank is required to retain this debt for a specific duration (e.g., 14 days) before formalizing the Debt/Equity and Debt/Debt Swaps.
- Current IRS guidelines permit the exchange agreement to be executed after 5 days, with pricing determined 9 days following the agreement.

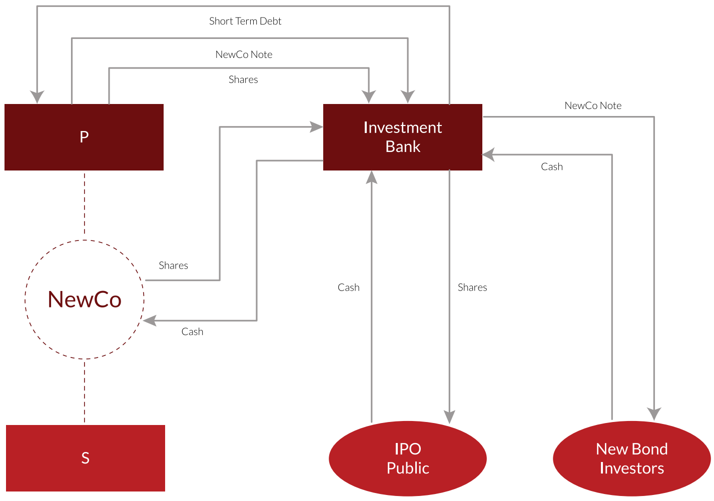


3 Implementation of Debt-for-Equity and Debt-for-Debt Exchanges

- An investment bank initiates a public offering of NewCo shares. A part or the entirety of these shares is acquired by the bank from P, essentially retiring a portion of P's short-term debt. Subsequently, the bank sells these shares to the public. Alternatively, NewCo might directly issue any remaining shares (after the retirement of P debt) in a primary share offering facilitated by the investment bank.

- Another approach involves the investment bank selling the shares as part of a demand event for the subsidiary's equity, not necessarily a public offering. For instance, this could be triggered by the subsidiary's admission to the S&P 500 or its merger into a larger public company.

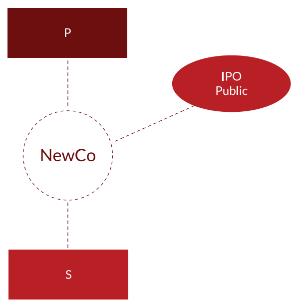
- In this scenario, the investment bank also conducts an exchange with P, where the outstanding portion of P's short-term debt is exchanged for the NewCo Note. The NewCo Note is then re-marketed to new bondholders of P.



4 Monetization and Value Extraction

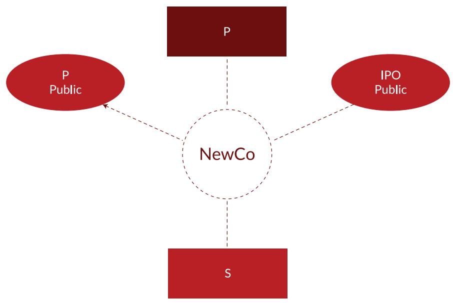
- P has successfully monetized S by employing strategic financial maneuvers. NewCo assumes P's debt or channels new financing proceeds to P. P's short-term debt is retired through a debt-for-debt exchange. Additionally, P's short-term debt is retired by engaging in a debt-for-equity swap.

- Utilizing these advanced financial strategies, P can extract value equating to over 50% of the enterprise value of the subsidiary that is slated for the spin-off..



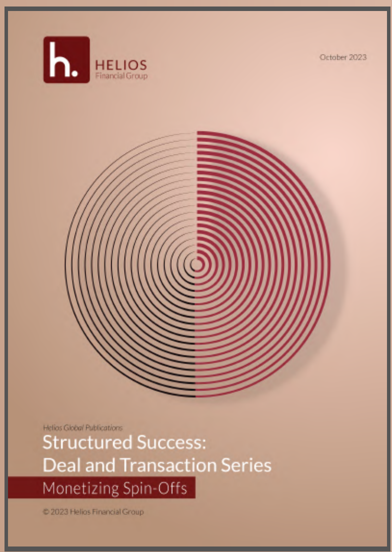
5 Public Spin-Off of NewCo

- P spins off remainder of NewCo common shares (representing at least 80% of the voting interest in NewCo) to the public shareholders of P



Empowering the global transactions community with essential data and insights.

RELATED PAGES



Deal and Transaction Series
Monetizing Spin-Offs

Read now

Deal and Transaction Series
Mixing Bowl

Read now

Deal and Transaction Series
Leveraged Partnership

Read now

HELIOS
Financial Group

Learn More

For more information, please contact:

Asad Khan
M&A | Transactions,
Helios Financial Group
+92 312 240 3989
ak@heliosfinancialgroup.com

Imran Khan
Financial Services | Transactions,
Helios Financial Group
+92 333 776 1334
Imranullah.khan@heliosfinancialgroup.

Farooq Akhtar
Transactions| Transformations,
Helios Financial Group
+1 312 879 3680
farooq.akhtar@heliosfinancialgroup.com

Endnotes

1. Stephen I. Glover, (2015), *Using Spin-offs to Raise Cash, Reduce Debt and Recapitalize*
2. Latham & Watkins memorandum by Ms. Birkeland, Mr. Gerstein, Mr. Stein, Ryan J. Maierson, Pardis Zomorodi, and Alexa M. Berlin, (2019), *Spin-offs Unraveled*
3. Based on HFG's own consultative experience of working with clients on Mergers & Acquisitions.
4. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own.

HELIOS
Financial Group

Advisory | Strategy & Transactions | Tax | Consulting

About Helios Financial Group

Helios Financial Group stands as a leader of excellence in financial advisory, tax, strategy, transaction, and consulting services on a global scale. Our steadfast commitment to delivering unparalleled insights and top-tier services fosters trust and confidence within the international capital markets and economies. Through our relentless dedication, we nurture exceptional leaders who collaborate to fulfill our commitments to all stakeholders. This vital undertaking positions us as catalysts in constructing an improved working world, benefiting our people, clients, and communities alike.

For more information about our organization.

please visit www.heliosfinancialgroup.com