Paul | Weiss

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Private Equity Digest

Quick Takes

As we head towards the last quarter of 2022, we continue to see mixed private equity deal levels. While total deal value was up globally and in the U.S. (after falling off recent highs in April/May), deal counts dropped. Overall deal sizes reflect these trends, with a corresponding move towards larger deals. Not surprisingly given the state of the equity markets, IPO exits are down. We are also seeing continuing (and evolving) regulatory scrutiny of established business and M&A, not to mention de-consolidation trendlines and tight credit markets.

In recognition of current market dynamics and private equity in search of deployment opportunity, we thought we would take a dive into the "sponsored spin" – an investment that may be ripe for further exploration in this environment.

Sponsored Spins

In recent years, as more money has flowed into the alternative investment space, sponsors (including traditional private equity sponsors, credit fund sponsors and hybrid capital sponsors) have increasingly looked for new and evolving ways to deploy capital. For example, private capital regularly financed the PIPE component of de-SPAC transactions, though such opportunities are now much less frequent as SPAC transactions recede to pre-pandemic levels. In the search for creative capital deployment opportunities, we believe there may be opportunities for private capital to provide financing as deconsolidation trends appear to be accelerating. In particular, sponsored spin-offs (or split-offs) may provide a new avenue for private capital to be deployed in structured transactions.

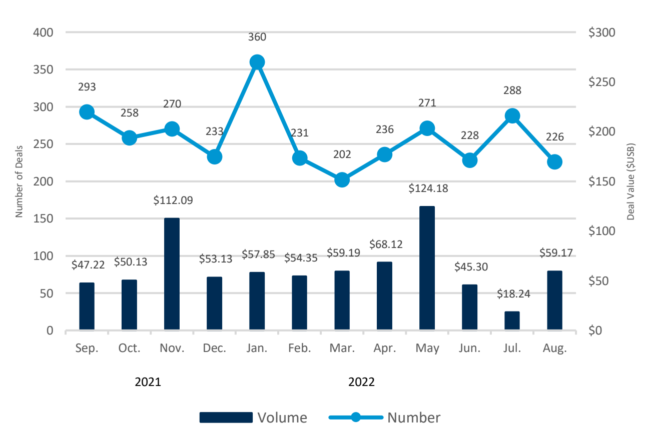
What is a Sponsored Spin-off and Why Now?

A sponsored spin-off is identical to a traditional spin-off, except that a sponsor invests in the company to be spun off ("spinco").[1] A sponsored spin provides the parent company ("remainco") with the opportunity to reallocate its capital structure via the spin-off transaction, with a potential to raise additional cash for spinco or remainco. The sponsored spin-off structure allows for flexibility of form (i.e., common vs. preferred equity, both of which may be coupled with warrants) and timing (i.e., investment prior to, concurrently with or after the spin-off), similar to what might be available with a SPAC investment. The sponsored spin-off may,

Global Sponsor-Related M&A Activity

Source: Cortex[2]

U.S. Sponsor-Related M&A Activity



Source: Cortex[2]

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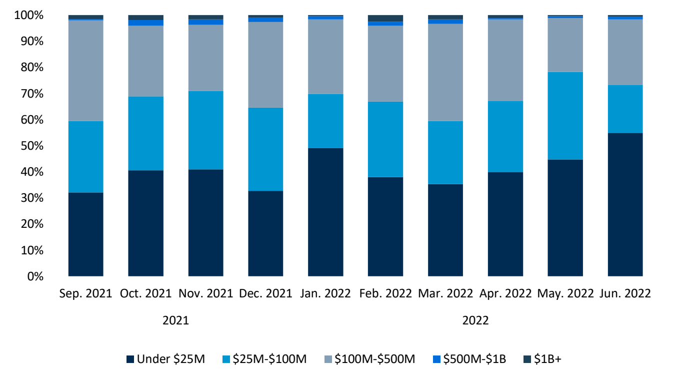
however, allow the sponsor to invest in a more established business like a traditional PIPE, since spinco has often had significant historic operations as part of a mature public company ecosystem. Spin-offs are, however, subject to specific tax rules that do not apply to SPACs or PIPEs that need to be carefully navigated as we discuss below.

As noted, there has been a consistent flow of spin-offs in recent years, with a significant increase in 2021. According to Deal Point Data, 35 spin-offs were announced in 2021 compared to 26 in 2019 and 17 in 2020. In 2022, deconsolidation continues to be a buzzword around the boardroom, likely leading to a steady pipeline of spin-offs going forward. This, of course, is a function of spin-offs being considered an alternative to sales or other traditional M&A transactions due to, among other things, (i) the increasingly complex and stringent antitrust and other merger clearance regimes in the U.S. and abroad and (ii) volatility in public market valuations.

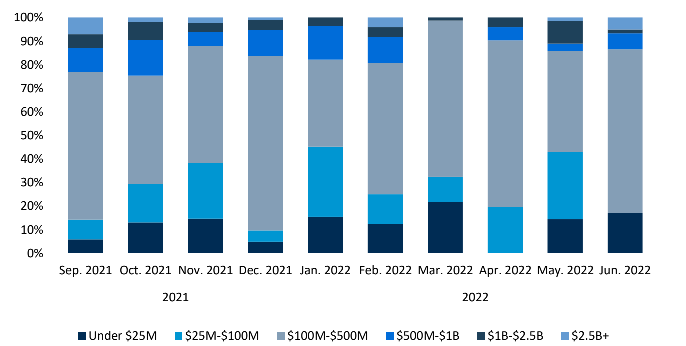
In many ways, sponsored spin-offs are similar to PIPE investments in SPACs. Sponsored spin-offs provide the sponsor with flexibility and potentially attractive valuations like those of SPAC investments because financial terms can be negotiated in private and finalized before an announcement. Private equity investment may also yield benefits for the spinco and remainco through, among other things, reputation, cash and governance. For example, equity participation by a well-known sponsor may lend more credibility to a spinco. This could decrease post-spin shareholder turnover and boost market valuations after distribution, especially if the private investment signals an anticipated valuation. Sponsored spin-offs may also provide up-front cash proceeds to the remainco, allowing for deleveraging at either the remainco or spinco level (depending on how the deal is structured), especially since certain types of equity investments will not be considered debt-like in the view of credit rating agencies. Lastly, a private sponsor may be able to provide a certain expertise to spinco after it goes public as it would for other portfolio companies, such as having (i) active board participation and management oversight from an experienced sponsor and (ii) guidance based on its expertise.

U.S. Sponsor-Backed M&A by Size



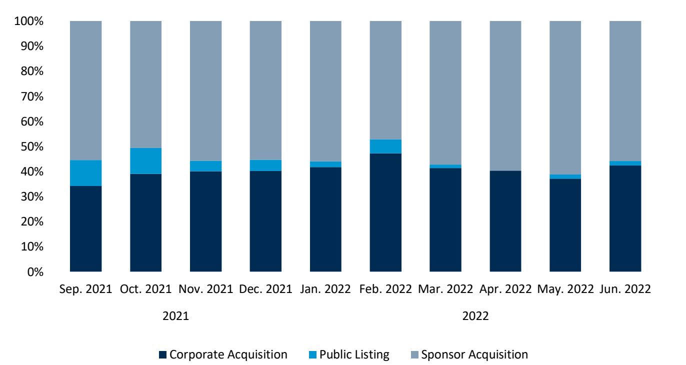
Source: PitchBook Data, Inc.[3]

U.S. Sponsor-Backed Exits by Size



Source: PitchBook Data, Inc.[3]

U.S. Sponsor-Backed Exits by Type



Source: PitchBook Data, Inc.[3]

In other ways, sponsored spin-offs differ from PIPE and SPAC investments. Sponsored spin-offs may not be as susceptible to market volatility as de-SPAC transactions, as there may be other synergies captured in a spin-off (e.g., unlocking value in the spinco, allowing focus on the core business at remainco). Spinco may also have more experience and knowledge than a de-SPAC target when it comes to public company practices, both disclosure and internal controls, due to its prior affiliation with a public parent company.

Sponsored spin-offs are, however, subject to technical and specific tax restrictions, including a cap on sponsor ownership of 49.9% of the spinco (if the investment is made after the distribution), and generally 19.9% (if made before the distribution), and additional restrictions on business changes after distribution. The nature of the tax restrictions and whether the tax-free status of the spin-off can be maintained is driven by a number of parameters, including how the cash proceeds from the sponsor are used. Accordingly, there are a number of highly particular decisions to be made when considering whether to pursue and how to structure a sponsored spin-off, which will require significant input from tax advisors.

What Are Some Key Considerations for Sponsored Spins?

There are several considerations when deciding whether to execute a sponsored spin-off. These factors are similar to considerations undertaken in approaching a SPAC or PIPE investment and include the below:

- Economic Terms. The economic terms of structured investments can vary significantly, including with respect to the form (PIK vs. cash) and rate of return, minimum returns, conversion terms and redemption features. It is important to note in equity transactions that the cash available to satisfy dividend and redemption requirements may be limited by applicable law. A sponsor may also want to consider commitment fees, original issue and similar discounts and expense reimbursement.

- Size and Form of the Investment. In a sponsored spin, sponsor ownership is capped at 49.9% if effected post-spin-off, or, as described below, at 19.9% if effected before (absent additional structuring including potentially making the investment in remainco and participating in the spin-off or implementing of a high-vote/low-vote share structure at spinco). In any case, there can be no plan or intention to increase ownership to 50% or above. The investment may be made in common stock, preferred stock (including convertible preferred stock) or some combination of the two, and may or may not be coupled with warrants. A preferred stock investment may provide the flexibility of debt-like treatment of the investment, depending on the terms of the security. Similarly, the terms of the preferred stock, or the inclusion of warrants, can provide the upside of a common equity investment. While sponsored spin-offs provide flexibility in deal structure, the appropriate choice may vary according to entity type, the existing pro forma capital structures of remainco and spinco, and the desired use of the cash proceeds.

- Timing. Investing in the spin-off prior to the distribution provides for flexibility in negotiating terms, but is less common due to, among other IRS requirements, the requirement that remainco distribute at least 80% of the shares in spinco to its shareholders in the spin-off. Investment in the spinco immediately post-spin of up to 49.9% may be permitted consistent with prior IRS rulings. However, large investments in spinco following the distribution may require a shareholder vote pursuant to stock exchange requirements.

- Governance. There are a series of governance factors that require consideration, including board or committee representation and whether the sponsor will have voting or consent rights, veto rights, information rights and preemptive rights. As is typical in any minority investment, the scope of the sponsor's governance rights will be dictated in large part by the size and nature of the investment, market practice and other business considerations.

- Lock-ups and Standstills; Registration Rights. Remainco and spinco will likely request that the sponsor be subject to potential lock-up and standstill provisions, which should be considered in light of the overall transaction terms. Relatedly, depending on the size of the investment and governance terms, a sponsor may require registration rights in order to facilitate its ultimate disposition of the acquired securities.

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[1] Another structural alternative is a split-off, which is similar to a spin-off except the public shareholders are given the option to exchange their shares in remainco for shares in the split-off subsidiary, rather than all shareholders owning a pro rata interest in both companies without any action by the public shareholders. In this deal structure, the sponsor may be able to invest directly in remainco and receive its shares of the subsidiary in the split-off.

[2] Sponsor categorization determined by Cortex; as of September 12, 2002. Deal volume by dollar value is calculated from the subset of deals that include a disclosed deal value. Paul, Weiss has not reviewed data for accuracy.

[3] Sponsor and exit type categorization determined by PitchBook Data, Inc.; as of June 30, 2022. Sponsor-backed M&A includes buyouts and private equity growth investments. Includes only completed deals and exits (not rumored or announced transactions), and excludes exits in which the only sponsor backing was a PIPE. Data includes deals of undisclosed sizes distributed proportionally within buckets that are less than US$1 billion. Paul, Weiss has not reviewed data for accuracy.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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