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Freeing the Captives

Current Trends in Private Equity Sponsorship of Divisional Carve-Outs and Spin-Offs

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Introduction:

The 1990's were an unforgettable time. Emerging companies, many newly formed and most in the technology sector, enjoyed astronomical valuations. Strategic acquirors enjoyed similarly high stock prices and used their stock to snap up smaller companies in acquisition after acquisition. Consolidation occurred at an unprecedented pace.

Now the party has ended. And the morning after is not pretty.

Corporate acquirors have seen their stock prices plummet. In many cases the strategic rationales underlying their acquisitions have been abandoned, and in some cases their acquisition-oriented management teams have been replaced. At the same time the acquired companies and their personnel often languish as subsidiaries or divisions of the acquiring companies. Life within many of these units is characterized by lack of strategic direction from the parent, little fit with the parent's overall strategy, equity stakes that are hopelessly underwater, serial layoffs, and a general desire to start over. Many of these business units have great technologies and products and favorable long-term prospects. This combination of factors presents a significant opportunity for private equity investors, entrepreneurial management and the owners of the units.

Market Response:

Reflecting current conditions, many recent transactions have involved spin-offs or carve outs of divisions or subsidiaries of larger companies, often with private equity sponsorship. Transactions involving corporate divisions and subsidiaries are not new to private equity investors, who have been active acquirers of corporate business units and regular sponsors of going private transactions for years. Leveraged acquisitions and going private deals have become harder to complete in the current market, however, due to the moribund condition of the debt markets and a persistent gap between the price expectations of buyers and sellers, among other factors. At the same time, many corporate parents believe that they can increase stockholder value by selling off separate pieces of their overall enterprises or making them free-standing entities through spin-offs. As the pace of more traditional transactions has slowed in this environment, alternative investment and divestiture strategies have moved to the forefront.

John LeClaire

Recent transactions involving the separation of a business unit from its corporate parent have taken a variety of forms. The simplest is a straightforward sale of the unit which the parent seeks to divest. In such a transaction the new investor typically acquires the unit or a controlling interest in the unit, employees receive new equity awards, and the parent/seller receives payment for its interest in the subsidiary. Buy-out transactions in the current market environment have increasingly involved creative forms of seller financing and/or retention of an equity interest by the parent/seller. A retained equity interest gives the parent/seller an ongoing interest in the divested unit and is sometimes coupled with an ongoing business arrangement, such as a licensing, distribution or technology development agreement. A properly structured retained equity interest can facilitate recap accounting for the transaction, which will enable the target to avoid amortization of intangibles other than goodwill for accounting purposes.

The structural possibilities for separating a division or subsidiary from its parent become richer and more diverse when the private equity investor does not seek a controlling position. Three different approaches, each geared to different types of strategic, tax and valuation considerations, are illustrative:

Investment/Spin Transactions. Private equity investors often invest in a corporate subsidiary in conjunction with a spin-off of the subsidiary to the parent's stockholders. The investor helps establish a value for the newly freestanding entity and provides institutional support and visibility for the new company with prospective underwriters, banks and other key constituencies. Spin-off transactions of this type are tax-free to the parent and its stockholders provided, among other things, the investor does not acquire 50% or more of the new company and no other acquisitions of stock occur that would result, together with the investor's purchase, in 50% or more of the new company's stock changing hands (see below). Transactions of this type usually involve a simultaneous spin-off and investment, but also can be structured as an investment in the subsidiary with a spin-off or other liquidity transaction occurring at a later date. A public equity offering sometimes accompanies or follows the spin-off.

PIPE/Spin Transactions. Parent companies sometimes develop disaggregation strategies involving spin-offs of multiple operating units and seek the participation of a private equity partner to support these strategies. In these situations the investor acquires stock (typically common stock but increasingly convertible preferred stock) of the parent in a so-called "PIPE" (private investment in public equity) investment, rather than investing directly in the smaller unit or subsidiary. The private equity investor then participates with the parent's public stockholders in each tax free spin-off. As these spin-offs occur, the investor's preferred stock preference may be reallocated among the various distributed companies in accordance with their relative values or other agreed upon criteria. Like the subsidiary spin-off strategy described above, a PIPE-related investment approach sometimes is coupled with secondary equity offerings by the new companies shortly after they are launched.

"Frozen Preferred"/Distribution Transactions. Each of the investment strategies described above usually involves a tax free spin-off under Section 355 of the Internal Revenue Code. A third approach for separating a subsidiary business unit from its parent company involves a taxable spin-off of the unit. In this type of transaction, the subsidiary first issues the parent preferred stock having a liquidation preference equal to some or all of the current value of the subsidiary's business, in exchange for a contribution of the business. The parent then distributes to its stockholders common stock representing any additional enterprise value at the time of the spin-off plus the right to all future appreciation in the value of the business. The investors who participate in the spin-off often include one or more private equity firms. The transaction is taxable but the parties expect that taxes will be minimized because most of the subsidiary's value arises after the spin-off. This type of spin-off was used widely in recent years by companies seeking to establish separate market capitalizations for their internet operations, but has since been adapted to other uses.

Opportunities and Challenges:

Creating a freestanding business unit from within a larger corporate enterprise presents a number of challenges. Carve out and spin-off transactions generally are more complex than stand-alone investment or acquisition transactions, particularly in the area of tax planning. These transactions also present operational hurdles that must be anticipated and managed for the investment to succeed.

Most importantly, the sponsor of the transaction must seek to align the interests of all stakeholders, including those of the selling parent, management and the investors. Specific operational and strategic issues which the sponsor must address include the following:

Kevin Dennis

1) Can historical financials be recast to draw meaningful conclusions?
2) Is the business divisible from a physical, management and systems standpoint?
3) Does the parent do business with the division as a customer or supplier of materials?
4) When senior parent company management has risen through the ranks of the division, does the sponsor want to try to attract them with equity incentives?
5) Are there any real services provided by the parent for which a corporate allocation is charged?
6) Is the management team entrepreneurial? Is it broad and deep enough, or does it need to be supplemented?
7) If a minority investment is contemplated, are adequate protective rights available?
8) If the parent will not provide warranties and indemnification relating to prior operations, will the investor be comfortable relying on management warranties? How can the interests of the sponsor and management be aligned?
9) Can the sponsor identify specific ways in which it can add or create value after the deal has been closed?
10) Can the sponsor identify and feel comfortable with at least two possible exit strategies?

Investors who sponsor carve out or spin-off transactions must be mindful that the culture and operations of the target business as a stand-alone company will differ from its culture and operations as a unit of a larger enterprise. In this regard, it is important that a seasoned and entrepreneurial management team be in place from the start. A company that has been part of a larger enterprise often retains its key technical personnel, but may lack executive leadership and entrepreneurial management. In some cases investors join with the unit's original founders or managers as their management partners, to supplement or replace incumbent management of the subsidiary or division.

The tax and legal issues associated with spin-off transactions can be complex. A spin-off transaction will not give rise to tax for the distributing corporation or the subsidiary to be distributed if, among other things:

• the business to be spun-off has a five-year history as an active trade or business;

- the business to be spun-off has not been acquired in a taxable transaction in the past five years (companies recently acquired in stock-for-stock exchanges, therefore, may be spun-off but companies acquired in acquisitions involving cash payments may not);
- the parent must distribute all of the subsidiary's stock that it owns, and such stock must represent at least 80% of the subsidiary's voting stock;
- there cannot be a 50% change of ownership of either the distributing company or the spun-off subsidiary, including any "planned" issuances of stock (as defined under very detailed Internal Revenue Code rules); and
- the spin-off must have a substantial business purpose.

These rules can substantially affect a spin-off transaction. For example, if a company wishes to spin-off a subsidiary on a tax-free basis, an investor cannot acquire a 21% voting interest in the subsidiary in advance of the spin-off, because the parent will be unable to distribute 80% of the subsidiary's voting stock. Similarly, an investor cannot acquire 49% of a subsidiary following a tax-free spin-off in conjunction with a plan to have the newly independent company issue stock in an acquisition or public offering, because this would violate the 50% change of ownership requirement under Section 355. To avoid these limitations, private equity investors contemplating a spin-off transaction often limit the amount of stock they acquire or use taxable structures such as the "frozen preferred" approach described above.

Conclusion:

Investments in conjunction with spin-off and other divestiture transactions present opportunities for operating companies, private equity investors and entrepreneurial management. For corporate parents, these transactions provide an opportunity to divest non-core operations, raise cash (depending on the structure), and provide stockholders with a separate asset having a separate market valuation, often on a tax-free basis. From the perspective of management, these transactions create an opportunity to gain direct equity ownership of their business at a favorable price and reestablish an entrepreneurial environment. And for private equity investors, corporate divestitures and spin-offs provide an important source of deal flow. When these objectives coincide, a new company can be launched, captives can be freed, and a new beginning can occur.

Behrman Capital, a private equity firm with $1.8 billion of capital under management and offices in New York and San Francisco. Darryl Behrman, a Founder and Managing Partner of the firm, passed away unexpectedly in February 2002.

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