Financing a Separation Transaction: Optimizing the New SeparationCo Capital Structure

January 12, 2023

One common and important feature of separation transactions, by which we mean spin-offs or initial public offerings of a business by a parent company ("ParentCo"), is the need to put in place the optimal capital structure for the new to-be-public business ("SeparationCo"). The proceeds of the financing are frequently used to pay a dividend or otherwise distribute cash to ParentCo, which may fund a recapitalization at ParentCo in advance of the separation transaction. These financings, which are typically incurred while SeparationCo is still a wholly owned subsidiary of ParentCo, create risks for ParentCo and for potential lenders prior to the separation transaction beyond the creditworthiness of SeparationCo that the market addresses through a few common approaches.

The approaches described below include delayed draw term loan facilities and senior notes issued in Rule 144A/Regulation S private offerings with ParentCo guarantees and/or special mandatory redemption features and registration rights. These approaches are often used in tandem, with a delayed draw term loan functioning as "committed financing," but they may also be utilized separately.

DELAYED DRAW TERM LOAN FACILITIES

One common way to finance a separation transaction is through a delayed draw term loan facility. The key benefit of using a delayed draw term loan facility is that SeparationCo has certainty that the funds will be available for the separation transaction. A delayed draw term loan facility can also be used as a backstop to a bond financing, with commitments under the facility reduced dollar for dollar for any bond offering by SeparationCo. This feature again provides certainty of funding while providing flexibility to optimize the capital structure if a bond offering is able to be completed.

Typically, loans under the delayed draw term loan facility must be borrowed within a limited number of days prior to, or substantially concurrently with, the expected consummation of the separation transaction. As a result, no interest expense is incurred

in connection with a delayed draw term loan facility until SeparationCo actually borrows under the facility. Prior to closing, there will be a financial cost to the availability of the delayed draw term loan facility in the form of a commitment fee/ticking fee. These fees typically do not begin for some period of time, often 30-60 days, following entry into the facility. This can be particularly helpful if the separation transaction is expected to be completed within that period as it defers any cost until the borrowing occurs.

BOND FINANCING

Another frequent method of financing a separation transaction is a bond offering by SeparationCo. The bond financing can be used to reduce commitments under the delayed draw term loan facility, as discussed above, or it could be in addition to term loan financing. A bond offering presents its own set of challenges if it will be completed prior to the separation. From an investor perspective, SeparationCo may not have any assets at the time of the offering and therefore may not currently be able to service the debt to be incurred until the separation is completed. The concern from ParentCo and SeparationCo perspective is that the separation transaction does not occur for some reason and as a result, neither company wants the debt to remain outstanding. Unlike a bank financing, a bond offering is typically made to a broad set of investors and is not easily amended. Senior notes also include call protection for investors, with redemption during the no-call period requiring a make-whole premium, which may be prohibitively expensive for the issuer. The market has addressed these concerns in two ways—a special mandatory redemption and a ParentCo guarantee.

Special Mandatory Redemption

A special mandatory redemption feature requires the issuer, SeparationCo, to redeem the issued and outstanding bonds if the separation transaction does not occur within a specified period of time. The redemption is generally at par or at a 1% premium to par. Two key points for the special mandatory redemption feature are how the separation transaction is defined in the indenture and the date by which the separation transaction must occur. For example, if it is possible that a separation transaction that started as a initial public offering might become a spin-off (or vice versa), the definition of separation transaction in the indenture should be broad enough to capture that possibility to avoid the risk that circumstances change, a separation transaction occurs, but the bonds must still be redeemed. With respect to the relevant special mandatory redemption date, SeparationCo should ensure that it has sufficient runway to complete the transaction taking into account possible regulatory or market delays.

ParentCo Guarantee

Another common form of credit enhancement in advance of the separation transaction is to require a ParentCo guarantee to ensure repayment of the bonds if the separation transaction does not occur. The ParentCo guarantee can be used in conjunction with, or without, a special mandatory redemption feature. A ParentCo guarantee may act as a substitute for escrow arrangements, avoiding the incremental expense of an escrow agent and other disadvantages of escrow discussed below. If a ParentCo guarantee is used without a special mandatory redemption that is often because ParentCo wants to keep the debt outstanding even if the separation transaction does not occur. In that case, the ParentCo guarantee has the added benefit of allowing for reporting at the ParentCo level, which may already be a public company, rather than requiring the SeparationCo to begin reporting if the separation transaction does not occur. If a ParentCo guarantee is used with a special mandatory redemption, it is designed to ensure that the companies have the financial wherewithal to redeem the bonds if the special mandatory redemption is triggered. The ParentCo guarantee will typically automatically fall away at the time of the separation transaction.

Registration Rights

Bond financing transactions completed prior to the consummation of the separation transaction are generally structured as Rule 144A/Regulation S private offerings. If the bonds issued are below investment grade, those bonds will typically remain Rule 144A for life. However, if the bonds have an investment grade rating, investors will usually require the bonds to be registered once the separation transaction is complete, and SeparationCo becomes a publicly traded company that files periodic and current reports under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). The registration rights agreement entered into at the time of issuance will give SeparationCo a period of time, typically at least 270 to 365 or more days to exchange the existing Rule 144A/Regulation S bonds for SEC-registered bonds. The time provided to complete the exchange offer may also be tied to the special mandatory redemption date, if there is one, to ensure no registration is required until a minimum time after the financing “drop dead” date. These so-called “A/B” or “Exxon Capital” exchange offers require SeparationCo to file a Form S-4 with the SEC and conduct an exchange offer in compliance with Rule 14e-1 under the Exchange Act.

Other Considerations

Companies occasionally consider escrow arrangements for debt incurred prior to the separation transaction, but these are not used as frequently because SeparationCo and ParentCo want access to the proceeds prior to the separation transaction, and investor concerns can be addressed through the mechanisms discussed above. Placing the funds in escrow results in interest expense and escrow-related costs as well, even though the proceeds are not available to be used as ultimately intended.

Another consideration for SeparationCo is what type of reporting it will need to make during the period from the bond issuance until it is an SEC-reporting company when the periodic reports it files with the SEC satisfy the reporting obligations under the indenture. SeparationCo will want to ensure that it has a sufficient amount of time to prepare any quarterly or annual financial statements and that its reporting does not front run any planned Form 10 or Form S-1 filings in connection with the separation transaction.

For so long as SeparationCo remains a consolidated subsidiary of ParentCo, the debt incurred at SeparationCo will also be debt of ParentCo and reported on ParentCo's balance sheet. Accordingly, ParentCo should ensure that it is able to incur that debt in compliance with any negative or financial covenants in its own existing debt agreements and without any negative ratings implications for its outstanding debt.

FINAL THOUGHTS

No matter what form the financing for a separation transaction takes, it is important to maintain optionality and protect ParentCo and SeparationCo from unforeseen circumstances while achieving capital return and capital structure goals for both entities. We are available to discuss these and other considerations related to financing separation transactions.

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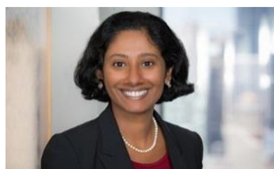
Please do not hesitate to contact us with any questions.

NEW YORK

Eric T. Juergens
etjuergens@debevoise.com

Matthew E. Kaplan
mekaplan@debevoise.com

Benjamin R. Pedersen
brpedersen@debevoise.com



Ramya S. Tiller
rstiller@debevoise.com