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Valuation for Corporate Spin-Offs

Companies use spin-offs for a lot of reasons: to enhance shareholder value, to move a new technology into a better environment for development, or to deal with a regulatory issue. But, whatever the reason, the company driving the spin-off needs good legal, accounting, and valuation advice to complete the process without problems.

Challenge

A company spun-off a product line to substantially increase its value.

The board of directors of a Silicon Valley video advertising management and monetization company faced a dilemma. Nearly $25 million had been invested over four years and the company was showing promise; some marquee customers had been signed and the products were generating first revenues. But product development had gone in two, different directions: a patented video indexing or “fingerprinting” technology; and video advertising serving software with an advertising network business. The board knew that over time it would strain the ability of such a small company to continue with both lines of business because they served different customer bases and needed separate development teams and sales forces.

The board performed a “market test” and approached several of the most likely corporate buyers in the space. Many of them indicated an interest – but only in one business line or the other, not both – and none would pay much more than invested capital. Based on this and other factors, the board decided to separate the two businesses into two companies with a spin-off so that each technology could be financed and developed independently.

This created several challenges, among them: How should the transaction be structured for tax efficiency? How should the liquidation preferences of preferred stock be allocated between the two companies? And how should employee equity incentives be restructured in the two companies?

Solution

Teknos had previously prepared valuations of common stock to support stock option issuance in compliance with IRC §409A and ASC 718 for the company, so we were retained to provide valuation support for the proposed spin-off.

(See the Teknos whitepaper *How Changes in Regulation Have Driven Stock Option Prices*).

Selection of Transaction Structure

We quickly developed estimates of the standalone value of each of the two businesses. These estimates were used by management and tax counsel to select a transaction structure which was appropriate to the situation. In this case, the indexing product line was determined to have the smaller value of the two, so the assets for it were placed in a subsidiary and then the shares of that subsidiary were distributed as a dividend to existing shareholders to complete the spin-off. Treating the transaction as a dividend worked in this case, because the parent company had a large reserve of net operating losses, because many of the venture capital shareholders were tax-exempt entities, and because the tax basis of the indexing product line was low. Another transaction structure and tax treatment might be more appropriate in different circumstances.[1]

Although selecting the right structure was important, there were other significant problems to be solved, including how to allocate the liquidation preferences and how to set stock option strike prices.

Reallocation of Preferred Stock Liquidation Preferences

Each of the companies – call them Oldco and Newco – would be taking some portion of the liquidation preferences of the existing preferred stock. But this could not be accomplished by simply splitting the preferred stock in two or even assigning a dollar weight to each entity in line with the relative values of Oldco and Newco. The situation was complicated because the existing series of preferred stock (Series A, B, and C) were not pari passu and because they had different participation rights with different "caps." The economic effects of these and other terms had to be considered in determining how to allocate the liquidation preferences between the two companies and in determining how to set new "caps" and other features.

This process is analogous to how debt is allocated in a spin-off transaction by a large, publicly traded company (because preferred stock behaves like debt in a company's capital structure, at least until the value rises to a level at which the preferred stockholders convert to common stock in order to realize the full potential of any liquidity event). Just like with debt, there might later be claims of fraudulent conveyance[2] and/or parent company directors might face personal liability under the laws of the state in which the company is incorporated, if the transaction is not structured appropriately.[3] If counsel believes that these questions are relevant, a solvency opinion might be in order.[4]

Resetting of Stock Option Strike Prices

In a similar vein, the spin-off has an effect on the stock options of the company. Under the requirements of IRC §409A, stock options must be priced at or above the fair market value of the underlying common stock of the issuing company. Our client had been following this regulation for years, but now the fair market value of the underlying common stock was about to be radically adjusted down to reflect the movement of value in the spun-off unit.

How should the strike prices of existing stock options be modified? What should be the strike prices of new options at both Oldco and Newco? And should employees of Oldco be given options exercisable into stock of Newco as part of the spin-off process?

Sample Capitalization Table: Before and After a Spin-off Transaction

To illustrate the complexity of this sort of change, consider the following simplified example. Oldco has 1 million options at $0.01 per share, 5 million options at $0.10 per share, and 3 million options at $0.20 per share. Each strike price was based on the fair market value and the capital structure of the company at the time that series of options was issued. Part of that value on each of those dates was access to the future potential of both product lines and another part of that value was the burden of preferred stock liquidation preferences and participation features. Change either or both of these and, clearly, the option strike prices also should change in the interest of fairness to the employees.

After the spin-off, the capitalization table of Oldco might include 1 million options at $0.01 per share (this strike price is so low that it does not merit readjustment), 5 million options at $0.07 per share, and 3 million options at $0.12 per share (there often is a non-linear relationship between the Oldco options going from $0.10 to $0.07 per share and from $0.20 to $0.12 per share because of the non-linear effects of the preferred stock liquidation preferences and other variables in the Black-Scholes option pricing model). In a similar vein, the capitalization table of Newco might include 2.5 million options at $0.03 per share and 1.5 million options at $0.05 per share (again a non-linear relationship with the Oldco strike prices because of the Black-Scholes model).

IRC §409A and its cousin, IRC §422, are clear that stock option prices cannot be adjusted down without adverse tax consequences, except under certain limited circumstances. Fortunately, the corporate change created by a spin-off is one of those circumstances.

Part of the answers to these and similar questions depend on tax regulations and the individual facts of a company's situation, so be sure to work closely with counsel.[5]

Outcome

In the case of the video advertising and monetization company, there was a happy outcome to the whole process. The indexing technology company (Newco) was acquired about four months later by a well known Silicon Valley Internet company for more than $20 million. And the advertising network technology company (Oldco) was acquired about 10 months later by another well known Silicon Valley software company for approximately $120 million. The total proceeds to shareholders from the two transactions were far more than was ever contemplated during the "market check" of just one year before – in large part because the two product lines had been successfully separated.

Teknos Associates provides valuation services for emerging growth companies and their venture capital backers. Clients rely on our financial expertise, knowledge of technology markets, and high standards to deliver relevant and timely valuation reports and fairness opinions.

***Special Note**: From time to time, Teknos Associates has been retained by the Internal Revenue Service to perform valuation services. However, nothing in this communication may be taken to represent the official position or policy of the IRS. The opinions expressed herein are those only of Teknos Associates.*

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[1] It is important to note that if a spin-off is being structured so that it is non-taxable, the IRS requires that the transaction be motivated, in whole or in part, by one or several business purposes – beyond a planned sale of the spun-off entity. Under the provisions of IRC §355(e), it is not permissible to avoid corporate-level tax for dispositions of 50% or more of the stock involved in the spin-off. The tax regulations contain a presumption that a sale is part of the plan that includes the spin-off if a sale of the spun-off entity occurs within two years of the spin-off transaction.

[2] If the parent company receives less than equivalent value for the transaction and either the parent company or the newly spun-off company is rendered insolvent (i.e., if liabilities exceed assets) , if the parent company or the newly spun-off company is left with unreasonably small capital to operate, or if the parent company or the newly spun-off company is left with debts that exceed its ability to pay those debts as they come due.

[3] If the "dividend" of the spin-off transaction is found to be unlawful because the parent company lacked enough capital to make such a "dividend" or if the parent company is rendered insolvent in the process of the transaction.

[4] See http://www.teknosassociates.com/index.php/services/solvency/.

[5] For example, IRC §422 does not allow granting incentive stock options to anyone who is not an employee of the company, so it may be difficult to grant Newco incentive stock options to employees of Oldco unless the grant is timed to take place before the spin-off is completed (i.e. while Newco still is a subsidiary of Oldco). Or it may be better to use non-qualified stock options instead.