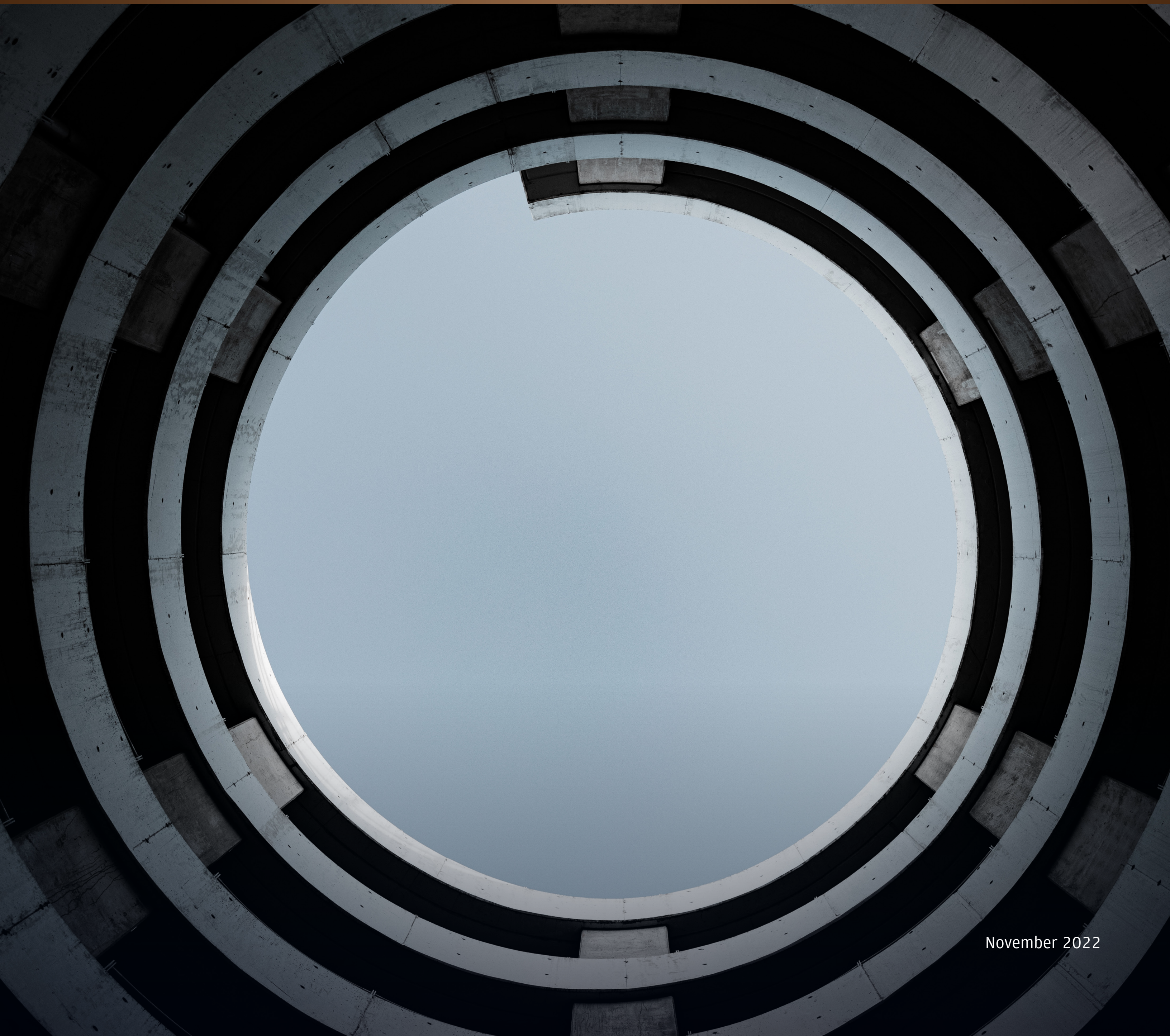
J.P.Morgan

TREASURY GUIDE

Steps to a successful spin-off: How Treasury can get it right



November 2022

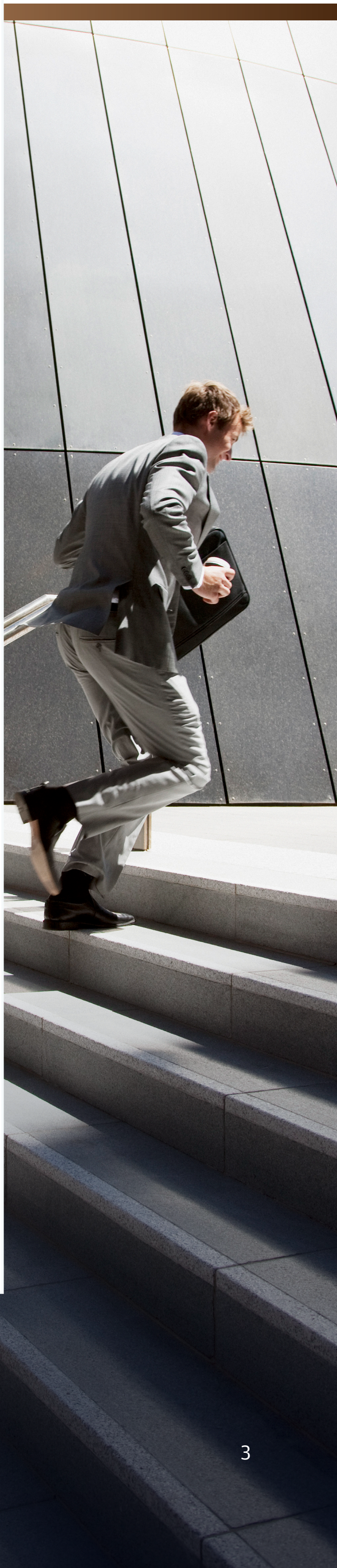
Tough trading conditions are prompting companies to look inwards to determine what their priorities are – leading to the rise of spin-offs as a corporate action. Learn how and ways J.P. Morgan is aiding Treasury teams to successfully execute a spin-off.

The time companies spend re-evaluating their strategic direction has led to the embrace of spin-offs as a corporate action – one which allows firms to create a leaner more streamlined structure, which suits their goals and mission, while also boosting cash resources.

Pressure from a new generation of highly focused, tech-based companies, that often dominate a niche is also causing strategic investors to re-evaluate the conglomerate model.

Once a spin-off is complete, the remaining company is free to focus on its main activities, while the spun-off company's profile and value is often bolstered by allowing it to stand alone as a separate entity.

However, the success of a spin-off relies heavily on optimizing the operating model, re-engineering the processes, and ensuring there is an efficient infrastructure for movement and utilization of capital. This places treasury teams in a crucial position for both the Remain Co and Spin Co.



Challenges for treasury

Spin-offs differ significantly from mergers and acquisitions. Treasurers often find spin-offs challenging and pressured in terms of time, as the company being separated has to operate from the onset as a new, standalone entity with segregated and independent money flow.

Setting up new legal entities, establishing a new banking account structure, re-routing accounts for concentration, reconciling transactions, and ensuring staff are on board and aligned with the changes all require know-how and careful planning to execute well and to deadline.

Despite the challenges, there are also great opportunities for treasury teams to transform their organization, using it as a fresh start to upgrade technology, improve processes and enable greater integration. With that in mind, we look at what corporate treasurers need to know to successfully navigate a corporate spin-off.

Treasury guide – 3 key phases of spin-off

1. Do your due diligence

Spin-off transactions typically have short, strict timelines, during which the deal team needs to identify and allocate all assets and liabilities between the remaining company and the spun-off company. Therefore, focused, intensive planning, and disciplined project management is required to progress efficiently.

During this due diligence phase, having a comprehensive understanding of the current state including accounts, processes and systems and available resources are vital. Effective partnership with other internal teams such as IT, tax, and legal, as well as external banks, will be critical. Decisions such as whether the spin-off will be approached as a replication of the current organization, or an opportunity to optimize will need to be made, along with the choice of a bank partner that will support the transition.

Critical success factors: Due diligence

- Partnership with technology and bank resources
- Validation and documentation of existing structure

2. Start to ring-fence

Once you have a clear understanding of the current state of your business, the 'ring-fencing' stage is the time to internally outline and prepare to have the spin-off company ready to operate as a separate company.

With all of your key company operating information on hand, you have to decide what the spin-off company's detailed structure is initially going to be. Begin setting up new legal entities with a clear view on their capital structure and bank account framework. Close partnership with the chosen bank is important as treasury takes stock of required documentation for full ownership transfer.

Critical success factors: Start to ring-fence

- Project management cadence to guide implementation
- Simplified approach to bank structure, connectivity and documentation

3. Test and operate a parallel run, before the official spin date

Now that treasury has set up the new legal entities and bank account structures required for the Spin Co, you're ready to run a parallel operation of the soon-to-be independent company. Some companies, under time pressure choose to skip this parallel operation phase, opening the door to issues and friction post-deal close.

To ensure the Spin Co's treasury team is ready for the full transfer at the spin date, there needs to be rigorous testing of all processes and services, and coordination between treasury, IT and bank resources to hammer out any issues.

Critical success factors: Parallel operations

- Defined testing scope
- Sufficient time for parallel operations
- Coordination between treasury, IT and bank resources to address issues

Considerations for a successful execution

As the strategy is carried out, good advice, great project management, and strong communication between treasury, tax, legal and all other involved parties can help to ensure great execution. The following are a few key actions to deliver a smooth transition:

1. Decide and build your organizational structure early on

A new treasury team needs to be established for the Spin Co as soon as possible. Allowing six months as a minimum will allow the spin-off to operate independently from the start, and to identify issues while the separating corporates are working on ring-fencing and running parallel operations. It's important to be sensitive to the needs of the existing personnel and team structures, timing personnel and team re-structuring announcements carefully to protect morale. New treasury hires must often be made, as roles are split between the Spin Co's new treasury department and the existing organization.

2. Question whether existing governance policies can be improved

There is a perception that spin-off companies can simply 'lift' the rules and policies of their former parent company, only making changes as and when a problem occurs. It's true that many spin-offs simply 'port' existing policies and procedures, but with this new independence, it's an opportune time to make major or minor improvements, revise, simplify or tailor treasury policies to better suit the Spin Co's needs going forward. One important note: remember that any new treasury policies will need to be approved by the new Spin Co board. This can be time-consuming, so it is important to ensure any changes are ready to be assessed and approved as soon as the new board is finalized.

3. A strong understanding of capital structure by every party involved is essential

Creating the best capital structure for the Spin Co and its subsidiaries is one of the most strategically important tasks of treasury – one which should be built upon cash flow and growth profile. Reviewing the terms of the outstanding debt can help minimize disruption in execution, as well as costs. This is particularly important when considering clauses such as MAC (material adverse change). When considering cash flow, assess currency, jurisdiction, and how the historical liabilities will be split – as well as what the sufficient working capital needs are.

4. Have a clear step-plan for critical cash movements with firm and committed deadlines

Working with one bank globally can make this easier to coordinate. Having a clear step plan helps mitigate potential business, operational, financial and tax impediments. Treasury's role includes ensuring the appropriate bank structure for the Spin Co, setting up overdraft facilities to move cash globally, planning for the new Spin Co capital structures, and ensuring a clear step plan can be followed with detailed cash movements and dates.

5. Liquidity should be reviewed both from the bottom up and the top down, to get to target cash levels

Liquidity structures should be moved to three tier cash pools, so that the top tier can be moved during parallel operations. Doing a bottom-up analysis for the new companies using cash positions of the worst cash flow quarter, as well as top-down analysis using 'Value at Risk' analysis, will help determine the target cash levels of both the Remain and Spin Co's.

The Separation and Distribution Agreement for the transaction should also clearly define the post-spin cash settlement, in relation to target cash levels, depending on the last quarter's cash flows. Separately, regional treasuries should also be expected to lead the effort to set-up bank accounts and replicate cash pools, if appropriate.

6. Take stock of all contingent liabilities and determine the strategy post separation

Know what and who each liability should be assigned to and include this as a clause with your legal team involved. For outstanding Remain Co guarantees, treasury teams need to be prepared to re-negotiate them to the fullest extent feasible. If guarantees cannot be re-negotiated, this should be covered in the Separation and Distribution Agreement – with appropriate FIN 45 disclosure requirements.

For bank guarantees and letters of credit, each need to be analyzed to ensure that the right business is the issuer of the guarantee post-separation. Including the 'assignment' clause for all contingent liabilities and intercompany loans can help with the legal assignment transfer.

7. Review with regulators early regarding the impact of the spin-off

Unexpected regulatory restrictions or requirements can derail the spin-off and cause delays, so it is important to evaluate the implications in all jurisdictions, especially when setting up new legal entities. For example, if there are special treasury licenses and incentives for a specific market, activating early discussions with relevant regulatory authorities are a must to minimize any disruption.

While recent inflation-linked and geopolitical volatility has created uncertainties in the market, we expect meaningful levels of spin-off activity to continue. Ensure your treasury is equipped with the skills and knowledge to make the most of this trend, calling on trusted partners if necessary to help if needed.

Transition Service Agreement

In a fast-moving spin-off transaction, if a complete separation is not feasible, the Remain Co and the Spin Co may come to an agreement to help manage day-to-day operations during the separation period to ensure business continuity. This Transition Service Agreement (TSA) includes key terms such as services that will be supported for an agreed time period, roles and responsibilities of the two companies including any service level agreements, and associated costs of providing the services.

While a TSA can provide some important benefits such as ability to meet spin-off close deadline, reduced transition cost, stability in systems and processes, it is important to note that a TSA acts only as a bridge to help the transition and it not a permanent option.

From a treasury perspective, key activities to consider for inclusion in a TSA are:

- Funding of payments
- Procure-to-pay/order-to-cash including reconciliations
- Cash visibility/forecasting
- Provision and access to historical business data
- Bank account management including ownership transfers
- Management of payroll

It is important to include all the activities that will be provisioned to ensure there is no business disruption for customers, suppliers and employees.

Treasury should also document all services that will not be included under the TSA and provide clarity on services that are not intended to be covered. Other important elements include specifying the banking partners and third parties that will support the transition, outlining the indemnification needs for associated risk, describing the issue management process, scoping out geographic coverage, and being clear about costs and charging methods.

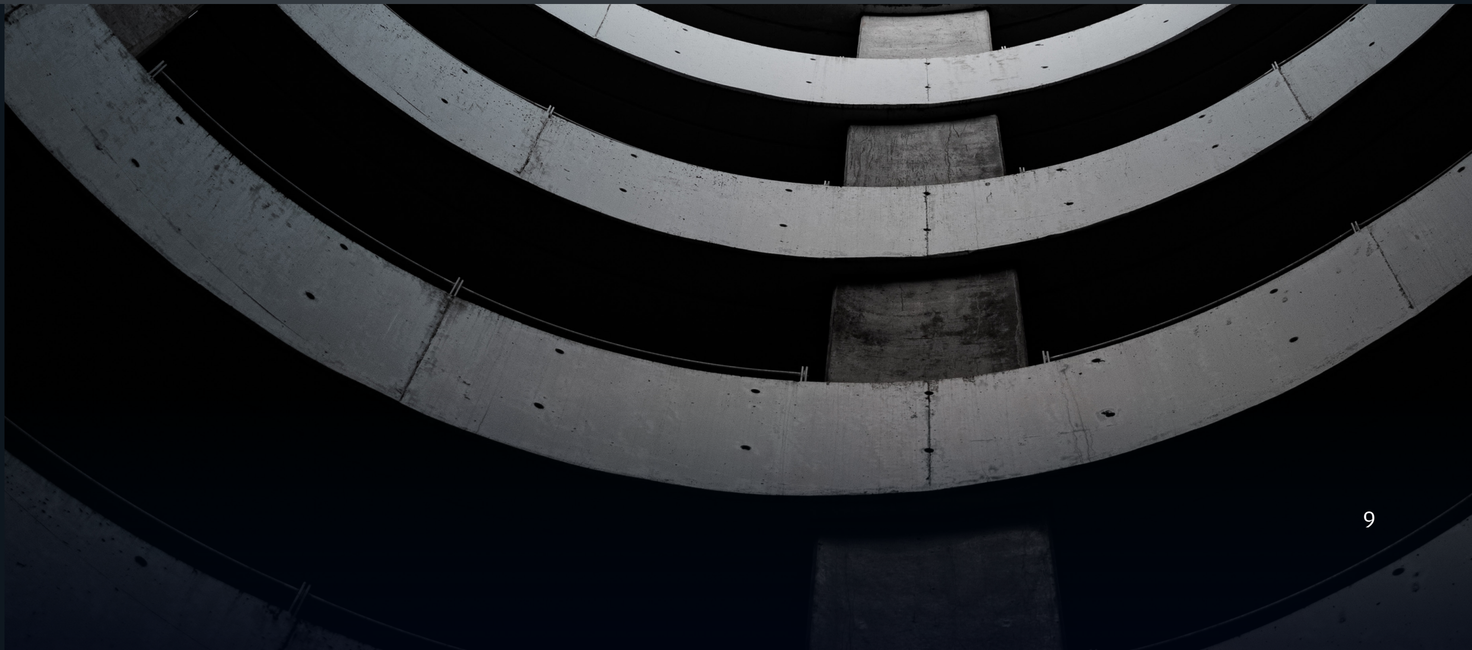
As the treasury team develops the step-plan, ensure this is aligned to the TSA for a proper stand-up of functions and processes. Be realistic in what the organization can do versus cannot do and remember third party processes that needs to be unwound, with estimated timeline and costs understood by all parties.

Achieving a successful spin-off

Leveraging all the resources and partners you have at hand is critical in ensuring the desired outcomes are achieved for a corporate spin-off. J.P. Morgan is uniquely qualified and experienced to support corporates to be fully functional and standalone treasury operation from initiation.

As a trusted partner in Payments, we assist treasurers to overcome strategic and operational considerations to ensure an effective and prosperous spin-off.

To learn more about how we can support your business, please contact your J.P. Morgan representative.



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