

SPECIAL PURPOSE VEHICLES: HOW CORPORATE STRUCTURES CAN HELP MITIGATE RISK



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Risk mitigation and access to sufficient liquidity are two core objectives for any large corporation. Fortunately, a tool exists that enables organizations to help meet both of these challenges at once: special purpose vehicles (SPVs).

Sometimes also called special purpose entities (or SPEs), these corporate structures allow organizations to transfer or isolate risk, secure financing and meet other critical business goals.

While SPVs are well understood within the finance and real estate sectors, not every organizational leader in every space is completely familiar with the features, benefits and considerations of these structures.

In this article, we’ll learn how SPVs work, situations where they are commonly used, and any considerations of which business leaders should be cognizant.

WHAT IS A SPECIAL PURPOSE VEHICLE?

To help mitigate risk, it’s often advisable to legally separate assets or entities. Special purpose vehicles are company subsidiaries that are quarantined from the financial risks attached to their parent firms. These SPVs are legal entities that are typically created for a business transaction (or acquisition). They may also be used for funding purposes.

By creating SPVs, businesses can carve out protection for specific entities or assets that are held separately from the primary business—or any other legal structures that are associated.

These structures are a common feature of finance and real estate transactions (offices, hotels and resorts, retail developments, senior and military housing, etc). They also have substantial utility in many large lending scenarios, regardless of industry type. This is because SPVs can be used to effectively isolate risk during the financing and/or acquisition of new assets. Such assets can be securitized and held separately from the balance sheet of the parent organization.

It’s important to recognize, however, that not all SPVs feature the same structure. Within the United States, SPVs often take the form of limited liability organizations (LLCs). Under this scenario, an LLC will typically be created to purchase assets with elevated risk from its parent company. These assets are then securitized and grouped into varying tranches and sold to investors, based on risk tolerance.

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SITUATIONS WHERE SPVS ARE COMMONLY USED

Risk Management

Risk mitigation is one of the key reasons why SPVs are created. Parent organizations can legally quarantine higher-risk assets through the creation of SPVs.

Funding and Liquidity

Funding and liquidity needs are common motivators for creating corporate structures. Outside investors can assume a share of any risk after assets have been securitized. Originating institutions can also use these structures to transform illiquid, non-rated exposures into rated and liquid securities. By completing this transformation, issuing institutions create greater liquidity by expanding their funding bases and reducing the costs associated with funding.

Enable Asset Transfers

SPVs can enable asset transfers. Many permits to operate assets (such as a power plant) are difficult, or sometimes impossible, to transfer. By using a new subsidiary structure to own all assets and relevant permits, the SPV is sold as a single, self-contained package, eliminating the need to transfer permits.

Financial Engineering to Benefit Transactions

SPVs are useful in the context of financial engineering. They can be used to finance new acquisitions or transactions without increasing the debt load of the parent company or diluting existing equity held by company shareholders. Sponsors and investors can both provide needed equity, making it possible to invest in the subsidiary without investing in the parent firm. This is a common model for large infrastructure projects.

Additionally, by creating SPEs within orphan structures, regulations can sometimes be avoided. One example: Regulations requiring owners of certain assets to be registered or headquartered within particular jurisdictions can sometimes be sidestepped via SPV creation.

Investment Strategy

These structures play a role in investment strategy. By creating SPVs, organizations can test the waters before moving forward with a full investment. If the early returns are favorable, companies can push forward. If not, risk is effectively mitigated. Such a strategy is often used in the financial sector by investment firms.

Protecting Intellectual Property

SPVs can be used to protect intellectual property in situations where it may be vulnerable. For example, a new subsidiary can be created to own IP, preventing the parent company's competitors from accessing the IP through pre-existing licensing deals.

SPV CONSIDERATIONS

There are a few important things to consider before moving forward with SPV formation. Organizations should proceed carefully and be aware of all potential downsides.



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First, SPVs may not have equal access to capital (or access to the same rates) given that these structures do not have the same credit profile as the sponsor. Additionally, market-to-market accounting rules may be triggered if an asset is sold—an event that could affect the bottom line of the parent company.

It's also possible that the regulatory environment could shift, creating significant new challenges for companies using these structures.

Finally, negative public sentiment is another potential risk. Because the optics surrounding SPVs are sometimes unfavorable, companies need to consider reputational risks.

CONCLUSION

While SPVs offer a variety of powerful risk mitigation and fundraising advantages, one should first execute the proper due diligence steps. Poor risk management and an incomplete understanding of SPVs have been responsible for some high-profile failures within the corporate sector.

Because of this, it's important to have the right independent director and senior staff in place to help with risk management and ensure that **SPVs fulfill their intended purpose.**