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WHITE PAPER

June 2018

A Matter of Equity: ASX-Listed Companies Funding Conditional Acquisitions Through Their Shareholders

In Australia, a clear procedure does not exist for ASX-listed companies to obtain financing from their existing shareholder base for conditional acquisitions. Generally, a company will need to ensure sufficient funding is available for an acquisition that is conditional or uncertain when it is agreed and announced. Issues can arise when these entities seek to raise funds from their existing shareholders for the purpose of the conditional acquisition, including a lack of clarity regarding what to do with funds raised should the acquisition not proceed.

This Jones Day *White Paper* reviews the methods of shareholder funding of conditional acquisitions used recently by Australian listed companies, identifies the various issues that arise under each of those methods and examines whether the Canadian approach to shareholder funding of these acquisitions might work in Australia.

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Downer EDI's hostile takeover bid for Spotless announced in March 2017, and Downer's associated pro rata equity raising at the time the bid was announced, once again cast the spotlight on the issue of financing of conditional acquisitions by Australian listed entities through their shareholders. A clear and effective pathway does not exist in the Australian market to do this. It may be useful to examine the Canadian approach to this issue to see if it can be adapted for Australia.

BACKGROUND

The question of how shareholders can fund conditional acquisitions of Australian Securities Exchange ("ASX") listed companies is somewhat vexed in the Australian market. The most common current practice of equity funding acquisitions in Australia (even where an acquisition is conditional and where its closing may be some time off) is through pro rata rights issues, sometimes coupled with an institutional placement (which is generally subject to a 15 percent cap under the ASX Listing Rules). These raisings are usually announced and launched at the same time as the acquisition is announced, and the raising will generally close before closing of the acquisition. In the last three years, significant examples of this include Downer EDI's rights issue to fund its hostile bid for Spotless, Boral's raising for its Headwaters acquisition, Vocus's for Nextgen, and Transurban's for AirportlinkM7.

There are multiple related issues which arise in situations where an Australian listed company is looking to equity fund conditional acquisitions through its existing shareholder base:

- the requirement for ASX-listed companies to ensure sufficient funding is available for an agreed and/or announced acquisition, including requirements to disclose details of that funding to the market (under continuous disclosure and transaction-specific disclosure requirements). More specifically, these requirements may arise due to:
  - the acquisition contract—vendors/targets are mostly reluctant to agree to financing conditions;
  - corporate governance considerations—directors of the acquiring entity will likely feel under a fiduciary and statutory duty to not enter into agreements unless they are satisfied the acquisition can be funded; and
  - statute and regulation—for example, Chapter 6 takeover rules in Australia require a bidder to disclose details of its funding arrangements, and there may be regulatory intervention if those arrangements are considered likely to be insufficient to provide the funds required for all potential acceptances;
- the expensive and risky nature of any bridge debt financing which is to be repaid by the proceeds of an equity raising, and the negative market perception/share price issues associated with foreshadowed or anticipated equity raisings; and
- the question of what to do with the funds raised from shareholders if a conditional acquisition does not proceed, and associated market disclosure issues that arise (since that question will inevitably be asked by the market). For example, CSL conducted a large share buy-back following an equity raising to fund its acquisition of Talecris, after the acquisition fell over in 2009 due to antitrust concerns.

More generally, there is the problem arising from a lack of clarity of the investment proposition in these types of raisings. Are they an investment by shareholders in the post-acquisition company or not? Often this will turn on the extent of the conditionality of the acquisition and the perceived likelihood of those conditions being satisfied. In the Downer EDI case, that raising was not well received, because the market did not support the acquisition and there was a view (at the time) that it was likely to be unsuccessful, so the raising in effect became a proxy for the acquisition. However, the capital was being raised whether or not the acquisition was going to be successful (albeit possibly returned through a subsequent share buy-back if the acquisition did not go ahead), so there is an argument that pricing the acquisition in this manner was not efficient or rational, particularly if there was not a good understanding of the conditions of the acquisition or the likelihood of them being satisfied.

OTHER AUSTRALIAN APPROACHES

In Australia, other methods of shareholders funding of acquisitions by listed companies have included:

Convertible Securities

If convertible debt securities have been used in this context, they have colloquially been referred to as convertible unsecured loan securities ("CULS"). These have been issued on a handful of occasions but not since 2011 (most recently by

Seven West Media to finance its acquisition of Seven Media Group). Upon issue of CULS, the issuer immediately obtains the funds. As such, it immediately obtains certainty in respect of the funding of its acquisition (at least its equity component). If the acquisition does not proceed, the terms of the CULS will require repayment of the CULS principal amount, together with a premium (the amount of which can be time-scaled) to compensate holders for the use of their money.

CULS, being debt securities, need to be offered under a prospectus. If the company is listed, a "transaction specific prospectus" can be used in reliance on ASIC Corporations (Offers of Convertibles) Instrument 2016/83, which extends the transaction specific prospectus regime to offers of securities convertible into ASX-listed securities. CULS themselves can be quoted on ASX in order to give holders some liquidity (though inevitably lower liquidity than ordinary shares), meaning ASX approval will also be required for the CULS terms of issue. Finally, CULS are unsecured notes for the purposes of Chapter 2L of the Corporations Act, so a trust deed in favour of noteholders needs to be executed by the issuer and a trustee appointed in compliance with Chapter 2L of the Corporations Act.

The benefits of CULS are that the issuer obtains upfront certain funding with the ability to return funds to holders if the acquisition does not proceed, without the need for a capital reduction or share buy-back.

CULS do have some drawbacks:

- they are not well understood in the Australian retail market;
- a prospectus is required (there is no ability to do a "low-doc" issue, contrary to the position for pro rata offers of listed shares);
- a trustee is required for the purposes of Chapter 2L of the Corporations Act; and
- CULS are unsecured, and the funds subscribed become general funds of the company following issuance, so holders are taking (pre-acquisition) credit risk on the issuer.[1]

Convertible equity securities (eg. convertible redeemable preference shares) have been even less common than CULS in this context. A fundamental issue for companies redeeming preference shares is that the Corporations Act requires the redemption to be funded either from profits or the proceeds of a fresh issue of shares made for the purposes of funding the redemption.

Unpaid Shares

An alternative equity instrument is partly paid or unpaid shares, with the unpaid amount to be called upon the acquisition closing. This also has complications:

- the company will rely on the shareholders, or possibly an underwriter, to satisfy the calls in order to obtain the funds needed to close the acquisition, which could become questionable if market sentiment turned against the company or the acquisition, or the situation became otherwise distressed (eg. Brisconnections);
- uncalled amounts on shares can be called upon in an insolvency scenario, even where the terms of the instrument allow for the call to be made by the company only on satisfaction of certain conditions (ie. the same conditions do not bind the liquidator, who can call upon unpaid amounts on shares under statute); and
- cancelling uncalled capital is a reduction of capital, so the capital reduction rules in the Corporations Act must be followed.

Conditional Equity Raising

Depending on the timetable for the acquisition, it may be possible for a company to raise capital by obtaining upfront investment commitments with settlement (ie. issue of the shares against payment of subscription amounts) to occur only once the acquisition becomes certain. This would likely work only where the timetable for satisfaction of the acquisition conditions was relatively short. The longer the timeframe, the more likely that pricing and underwriting terms for the company would be worse given there would be no ability to trade the shares until settlement.

One other thing to bear in mind is if the acquisition is conditional on shareholder approval by the acquirer, then any pro rata or other entitlement issue undertaken where completion of the issue is conditional on satisfaction of the acquisition conditions (where one of those conditions includes the

1 Tax considerations are beyond the scope of this article.

approval of shareholders) will need to have a record date (ie. the date for determining entitlements under the entitlement issue) which comes after the date of the shareholders meeting (due to ASX Listing Rule 7.15, which will not be waived by ASX except in unusual circumstances). This means that trading in the company's shares on ASX will occur with (or, using ASX terminology, *cum*) entitlement during the period from announcement of the offer until that time—an entitlement issue structure that is tended to be avoided in the Australian capital market, particularly for extended periods.

Back-End Equity Raising

Another alternative that has been used, although rarely, is an equity raising offer conducted only after completion of the acquisition becomes certain. Southern Cross Media's raising in 2011 to fund its Austereo acquisition is an example of this, which it conducted after reaching 90 percent acceptances on its takeover offer and was used to repay a bridge facility. Again, the issue here is pricing for the issuing company, as the market will expect detail on how the acquisition will be funded at the time the acquisition is announced. If the company flags, or does not rule out, that it will undertake an equity raising at a later time when the acquisition is more certain, this may have a downward impact on its share price as the market reacts to the impending issue. This can create a feedback loop, because as the price goes down, the number of shares required to be issued to raise the necessary funds increases, which in turn puts more pressure on the share price. Furthermore, the requirement for funding certainty when the acquisition is agreed and announced will make the need for bridge debt financing more likely in this case.

SHOULD AUSTRALIA CONSIDER THE CANADIAN APPROACH?

While Australia has perhaps not developed a "go-to" solution for shareholder funding of conditional acquisitions by listed companies, there would seem to be no good reason for it not being able to do so. One effective method of doing this might be to leverage off the Canadian approach, where there is a very well-established mechanism. In Canada, listed companies that wish to equity fund conditional acquisitions most commonly issue "subscription receipts". They typically have the following features:

- Issued under a Canadian prospectus, investors receive a subscription receipt upon payment of a specified subscription amount.
- Each receipt is evidence of a right to receive a share in the company on satisfaction of certain "escrow conditions" (such conditions being tied to whether the acquisition goes ahead or not) or to otherwise have the subscription amount returned if those conditions are not satisfied by a certain time.
- The funds subscribed are held in escrow in a separate trust account by a third-party escrow agent (often a share registrar's trust company) pending satisfaction of the escrow conditions, at which time they are released to the company. At the same time, the shares in respect of the subscription receipts are issued by the company to the investors.
- If the escrow conditions are not satisfied by the required time, or if they earlier become incapable of satisfaction, the funds are returned to the investors and the subscription receipts cancelled.
- Subscription receipts can be listed on a stock exchange (typically the Toronto Stock Exchange) to allow trading in these instruments.
- Practice varies, but subscription receipt holders can sometimes be entitled to payments equal to the amount of dividends the company pays on its shares during the period the receipts are on issue.
- Funds in escrow are invested by the escrow agent (conservatively, usually in government-backed securities). Any gain or loss on investment is borne by the company or the investors, depending on who becomes ultimately entitled to the funds. However, while the funds are in escrow, they are held by the escrow agent on behalf of the subscription receipt holders and are therefore not subject to general creditor claims on the company.

HOW WOULD THIS WORK IN AUSTRALIA?

Analysing how subscription receipts would be regulated in the Australian context is not a straightforward exercise. Like CULS, the funds in subscription receipts offerings are subscribed upfront against the issue of an instrument convertible into shares. However, the subscription monies are held, and invested, by an escrow agent on behalf of the investors until the escrow conditions are satisfied (and do not become general funds of the company immediately). This puts the investors in a preferable position to CULS, as they are not taking credit risk on the company while they hold the receipts (and for that reason, subscription receipts would probably not be considered debt instruments under the Australian law).

Given the trust arrangement, there is also a similarity to managed investment schemes as defined in Australia's Corporations Act. However, in Canada the subscription receipt is an instrument issued by the company to the investor (and not by the third-party trustee/escrow agent typically used in this structure), unlike with managed investment schemes ("MIS"), where the trustee is the issuer of the interests in the MIS.

Below we set out some specific legal and regulatory considerations in Australia that would need to be worked through if subscription receipts were to be used here:

- Would subscription receipts be securities (subject to Chapter 6D disclosure requirements) or other financial products, such as managed investment products or derivatives (subject to Part 7.9 disclosure requirements), for the purposes of the Corporations Act? Assuming some form of regulated disclosure document would be required, ideally "transaction specific" disclosure relief that ASIC has issued would be available (if not the "low-doc" regime for rights issues).
- What Australian financial services licensing implications may arise for the company issuing "subscription receipts"? Would it be an MIS which required registration under Chapter 5C of the Corporations Act? What about the position of the escrow agent (it seems certain this role would require an Australian financial services licence at the very least), assuming such an agent was used?
- What requirements would ASX impose in order to list these instruments on their market (listing these would seem to be a highly desirable feature)? As they are convertible into shares, subscription receipts would be equity securities for the purposes of the ASX Listing Rules, meaning that ASX would need to consider their terms to be "appropriate and equitable".
- Should subscription receipt holders have any say on whether the conditions to the acquisition were waived by the acquirer/bidder? While this question is relevant for any type of acquisition, it could be particularly acute in takeover bids where the takeover offer has a minimum acceptance condition. In those instances, bidders may consider waiving the minimum acceptance condition so as to build bid momentum. Debt financiers of takeover bids will usually have a veto over whether that condition can be waived so as to ensure they do not need to fund the bidder in circumstances where it ends up owning less than 100 percent of the target entity. It would be possible to grant equivalent rights to subscription receipt holders, who are investing on the basis that the acquisition will proceed successfully (ie. to acquisition of 100 percent of the target). However, granting these rights may have the effect of even more significantly reducing bidder flexibility (compared to a debt financier veto) because consent to the waiver would be practically more difficult to obtain from subscription receipt holders.

None of these issues would appear to be insurmountable.

CONCLUSION

On the question of shareholders funding conditional acquisitions by ASX-listed companies, we would suggest that it can be very useful to see how various issues are grappled with in other jurisdictions. Canada has a well-established mechanism for listed companies to equity fund conditional or uncertain acquisitions, which avoids many of the pitfalls encountered in the various Australian approaches. The Canadian approach also clarifies the investment proposition in these scenarios—subscription receipts are an equity investment in the post-acquisition entity only and otherwise a very safe investment with a stable return if the acquisition has not closed by a specified deadline. It would seem worthy of consideration for both the private sector and the regulators to see if this approach could work in Australia and lead to greater efficiency in Australian capital markets.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Mark B. Crean
Sydney
+61.2.8272.0710
mcrean@jonesday.com

Isaac C. West
Brisbane
+61.7.3085.7070
iwest@jonesday.com

Robert F. Speed
Sydney
+61.2.8272.0519
rspeed@jonesday.com