HERBERT SMITH FREEHILLS

2018 AUSTRALIAN IPO REVIEW: IPO OR DEMERGER?

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Legal Briefings – By **Baden Furphy**

A divestment of a business division can be structured in a number of ways, including by way of a demerger or initial public offering. There are some key considerations to keep front of mind when deciding on the preferred form of divestment.

INTRODUCTION

A listed company considering divesting a business division has a number of options open to it, including a trade sale, a demerger or an IPO.

A trade sale may not be a viable option for a number of reasons, including if the natural acquirers of the business face competition law or other impediments to undertaking the acquisition, or if the business being divested is too large to be acquired by a single buyer.

A demerger and an IPO both involve separating the divestment business and listing it on the public markets, but there are important differences that need to be considered, that are summarised below.

WHAT IS THE DIFFERENCE BETWEEN A DEMERGER AND IPO?

A demerger involves the parent company distributing equity in the demerged entity on a pro rata basis to existing shareholders of the parent company and separately listing that entity on the stock exchange. Parent company shareholders essentially receive a direct shareholding in an entity that owns the business in which they previously held an indirect interest.

An IPO involves retail and institutional shareholders acquiring shares in the entity that owns the business being divested, and the listing of that entity on the stock exchange. This can be effected by the parent company selling existing shares in the IPO entity, or the new IPO issuing new shares, or a combination of each.

KEY CONSIDERATIONS

When deciding between a demerger and an IPO, these are some considerations to keep front of mind:

DOES THE PARENT COMPANY NEED TO RAISE CASH?

- An IPO can generally be structured so that the parent company receives some or all of the proceeds of the IPO. This may be important, for example, if one of the objectives of the divestment is to reduce the parent company's leverage or to raise cash for the parent to invest in acquisition or development opportunities.
- In a demerger, unless a capital raising is built in to the process, no money is raised. Notwithstanding this, in a demerger, it is possible for some of the parent company's debt to be allocated to the demerging entity (either directly or via the demerging entity raising new debt as part of the demerger and applying the proceeds to acquire assets/entities from the parent company). So the removal of a business that contributes to the parent company's earnings can be coupled with a commensurate reduction in the parent company's debt levels.

DOES THE PARENT COMPANY WANT TO CRYSTALLISE THE VALUE OF THE UNDERLYING BUSINESS?

- An IPO involves the parent company selling its underlying business to new investors for cash, and so crystallises the value of the underlying business (subject to any shareholding that is retained by the parent company). In a demerger, shareholders in the parent company retain equity in the underlying business, and there is no sale to external parties.
- A demerger may therefore be preferred if there is a concern that the divestment is occurring at the bottom end of a commodity price cycle for example, or if there is significant upside for the business being divested (especially if that upside is difficult to quantify and "sell" to new investors in the context of an IPO). It avoids the risk of directors of the parent company being criticised later on for selling the relevant business too cheaply.

HOW WILL MARKET VOLATILITY IMPACT THE DIVESTMENT?

- As recent experience demonstrates, execution of an IPO involves significant exposure to market risk and equity market conditions. Generally the outcome of an IPO (including whether it proceeds and its pricing) is not known until relatively late in the process and volatile markets can cause significant disruption.
- By contrast, because a demerger does not involve raising capital, it can generally be executed even in difficult market conditions, provided those market conditions do not undermine the fundamental viability of the demerged entity. In assessing a demerger, the focus is on whether the demerged entity is better off being separated from the parent company and likely to perform better as an independent company, rather than the absolute trading value of shares in the demerged entity.

WHO IS BEST PLACED TO OWN THE UNDERLYING BUSINESS?

- In a demerger, existing shareholders in the parent company automatically receive shares in the demerged entity if the demerger is implemented – they don't need to pay for those shares or take other action. In an IPO, only those investors that are attracted to the entity and investment characteristics of the relevant underlying business will apply for and receive shares in the IPO entity.
- There are two main issues to consider in this context. First, there is a risk of a demerger giving rise to flow-back, ie shareholders choosing (in the short term) to sell shares in the demerged entity. Flow-back will be more significant if the demerged entity is small relative to the parent company (and so is not included in key stock exchange indices) or its business is not part of the core business of the parent company. Second, in an IPO, especially a large scale IPO, there is a risk of inefficient recycling of capital if there is large degree of overlap between the shareholders in the parent company and the investors to whom the IPO is being marketed.

IS CAPITAL GAINS TAX RELIEF AVAILABLE?

- Generally speaking, capital gains tax relief is likely to be available in a demerger where a number of tests are satisfied (for example, the parent company must distribute at least 80% of its holding in the demerged entity). No similar relief is available for an IPO.
- Demerger relief provides roll-over for the Australian parent company shareholders, but

also exempts the parent company from Australian capital gains tax on the divestment of the demerged entity.

IS A FULL EXIT IMPORTANT?

- In most Australian IPOs, the vendor retains a shareholding in the IPO entity, which is typically escrowed for the period of the financial forecast included in the prospectus for the IPO. Typically an escrow is not required under the ASX Listing Rules, but is considered desirable for the purposes of marketing the IPO, as new investors look for the vendor to keep some “skin in the game”. Therefore a full exit may not be possible in an IPO.
- On the other hand, most demergers in Australia have involved a full exit by the parent company (the recent demergers of Coles from Wesfarmers was an exception – in that case, Wesfarmers retained a 15% shareholding in Coles).

IS SHAREHOLDER APPROVAL REQUIRED?

- A demerger may be effected in a number of ways, including by capital reduction, dividend or scheme of arrangement. Most large scale Australian demergers have involved a capital reduction and/or a scheme of arrangement (although the 2015 demerger of South32 by BHP was an exception), and therefore parent company shareholder approval has been required.
- On the other hand, it is generally possible to effect an IPO of an underlying business without shareholder approval, provided that business is not the main undertaking of the parent company. The ASX Listing Rules do regulate divestments of businesses by way of public listings, but usually the relevant rules can be accommodated relatively easily (eg by including in the IPO a priority offer for parent company shareholders).

TRANSACTION SPOTLIGHT

Herbert Smith Freehills recently acted on the demerger of Coles from Wesfarmers. The transaction was the largest demerger in Australian corporate history. Key features of the demerger included the following:

- the demerger was effected by way of scheme of arrangement, and was overwhelmingly supported by Wesfarmers shareholders;
- Wesfarmers retained a 15% shareholding in Coles, and has a nominee on the Coles board; and
- Coles is an ASX top 30 company and employs over 100,000 team members.

SUMMARY

- A demerger involves a parent company giving shares to existing shareholders, while an IPO involves selling shares to new investors.
- There are a range of considerations to take into account to determine whether an IPO or demerger is the preferred transaction.
- It is possible to pursue both an IPO and a demerger in parallel, and it is also possible to undertake a transaction that includes both IPO and demerger elements.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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