

# COMBINATION DEMERGER: A NOVEL ALTERNATIVE TO THE DEMERGER VS DIVESTMENT DECISION

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Legal Briefings - By **Kam Jamshidi, Toby Eggleston** and **William Kunstler**

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As the dual themes of specialisation and consolidation continue to fire, particularly for companies with excess franking credits, the interest in the combination demerger is expected to increase. We examine a novel deal structure that enables listed acquirers to use scrip in carve-out transactions by listed sellers, effectively combining a scrip acquisition with a demerger.

## IN BRIEF

- The 'combination demerger' has been used on two recent Australian public market transactions - the first of their kind globally.
- A 'combination demerger' is a novel structure, whereby a listed seller divests a division or assets to a listed acquirer in exchange for scrip in the acquirer, which is then distributed to the seller's shareholders.
- For acquirers, this enables the use of scrip in carve-out deals, which avoids the need to raise capital to fund cash consideration and can have other benefits, such as increasing the number of shareholders and 'free float' of shares in the acquirer.
- For sellers, as well as increasing the bidder pool for an asset by allowing scrip acquirers, this has all the advantages of a demerger with the added benefits of reducing valuation uncertainty, not having to establish a separate group / functions to support the business and enabling shareholders to share in any post-transaction available synergies.

- We expect interest in the use of this structure to increase as the dual themes of specialisation and consolidation continue to fire, particularly for companies with excess franking credits, will generate sufficient franking credits on disposal on the sale of the asset to the buyer to fully frank the dividend component or otherwise has a large bank of accumulated losses, in which case the distribution may be able to be treated as a return of share capital.

## **BACKGROUND**

A 'combination demerger' transaction is a novel structure, whereby a listed seller divests a division or assets to a listed acquirer in exchange for scrip in the acquirer that is then distributed to the seller's shareholders.

We recently advised on the first combination-demerger transaction to be announced in the Australian market; BHP's combination of its petroleum business with Woodside Energy. Shortly after this transaction, Humm announced a similar transaction structure with Latitude financial in respect of its "buy now sell later" business.

To our knowledge, the structure has never been used anywhere else globally.

## **DRIVERS OF THE COMBINATION DEMERGER**

The use of this structure is being driven by the same themes that we see driving increased demerger activity, including:

1. providing shareholder choice on asset exposure;
2. allowing greater focus on performance both by managers and investors; and
3. divergences in valuations, such as in growth relative to stable businesses.

For listed sellers, the combination demerger presents all the benefits of a traditional demerger listed above, but with the following additional benefits:

1. reducing valuation uncertainty, by having the listed scrip consideration as a reference point for the value of shares held by shareholders after the transaction;
2. not having to incur the cost and burden of establishing a separate listed group / functions to support the business being divested; and

3. enabling shareholders to share in any post-transaction available synergies associated with the asset combination component of the transaction.

The combination-demerger can also appeal to a broader group of potential acquirers, as it allows them to use scrip to acquire divisions or assets held by listed sellers. This can be particularly attractive in circumstances where a capital raising to acquire a division or assets for cash is not feasible (for example, because the raising is too large or would need to be done at an unacceptable discount). It also has other benefits, such as increasing the number of shareholders and 'free float' of shares in the acquirer, which can be useful where the listed acquirer has a concentrated shareholder base.

Since the introduction of the demerger rules in the *Income Tax Assessment Act 1997* in 2005 up to 2013 the ATO had allowed a company to spin out the shares in a subsidiary entity to its shareholders in a tax free distribution and then an acquirer would acquire the shares of the original company for either cash in scrip (see, for example, the Talon/Texon Petroleum transaction). However, in 2017 the ATO flagged a change of approach which ultimately resulted in Taxation Determination TD 2020/6, effectively putting an end to these types of multi-faceted transactions. The 'combination-demerger' structure does not utilise the demerger rules so the tax impact on the seller and shareholders need to be factored in.

## LEGAL CONSIDERATIONS

The following key legal matters need to be considered when structuring a combination-demerger:

- **Shareholder vote:** The listed acquirer will typically need to have a shareholder vote because of ASX listing rules 7.1 (which effectively places a 15% limit on share issuances, subject to certain exceptions which would not apply to a combination demerger). The listed seller may also need to have a shareholder vote under the ASX listing rules if the transaction is to make a significant change to the vendor's nature or scale of activities.
- **Scheme of arrangement:** The distribution of the listed acquirer's scrip may give rise to a need for a scheme of arrangement, depending on the company's constitution and steps required to be taken. However, the decision to proceed with a scheme of arrangement should be carefully considered, given the scheme process will add complexity and time to the transaction.
- **Capital reduction:** As with a demerger, there will in most instances need to be a capital reduction either due to a lack of retained earnings to complete the distribution of the listed acquirer's scrip by way of dividend. The ATO will need to be consulted via the class ruling process to ensure that to the extent the distribution of shares is treated as a return of share capital, it is not deemed to be an unfranked dividend. A capital reduction will need the listed seller to obtain shareholder approval, typically an ordinary resolution.

- **Disclosure:** The listed acquirer will likely need to issue an explanatory memorandum as part of obtaining shareholder approval that sets out all information considered material to deciding whether to vote in favour of the transaction or not. An Australian prospectus, which has a higher disclosure standard, and can therefore be more costly and time consuming to produce, is typically unlikely to be required, provided a cleansing notice is released by the listed acquirer. The listed acquirer may be required to produce a prospectus or similar in other jurisdictions depending on the shareholder composition and any listings being pursued, among other reasons.

The BHP Petroleum-Woodside transaction was effected by dividend without a scheme of arrangement nor a capital reduction and required Woodside shareholder approval, but not BHP, shareholder vote. Conversely, the Humm-Latitude transaction involved a scheme of arrangement and capital reduction as part of distributing the Latitude shares to Humm shareholders.

## **TAX CONSIDERATIONS**

The tax considerations for the listed seller's shareholders will be important to assessing the transaction. The following tax considerations are often key when structuring a combination demerger:

- **Roll-over relief:** It is not possible to get roll-over capital gains tax relief for a combination-demerger transaction and then use the demerger rules to spin out the buyer's shares in a tax free manner. Accordingly, there may be little point in the seller seeking scrip for scrip rollover relief if the distribution will otherwise be an unfranked distribution for the shareholders.
- **Capital reduction:** The Australian Tax Office will typically expect that if a portion of the distribution is structured as a capital reduction it does not exceed the average share capital per share. If the company has a large reserve of accumulated losses, then the distribution may be able to be structured fully as a return of share capital, which will generally only reduce a shareholder's cost base.
- **Dividend component:** The dividend component of the distribution will be taxed as income received by the listed seller's shareholders. Franking credits can also attach to the income component of the distribution. While the franking credits distributed are valuable to Australian shareholders that can use them, the availability of franking credits for alternate uses, such as ordinary course dividends and off-market buy-backs, should be assessed by the listed seller.

The BHP-Woodside transaction involved a fully franked in specie dividend by BHP, whereas the Humm-Latitude transaction was to be an in specie distribution that was part franked dividend and part capital reduction.

Given these considerations, we expect that companies interested in these types of transactions will be either companies with excess franking credits, will generate sufficient franking credits on disposal on the sale of the asset to the buyer to fully frank the dividend component or otherwise have a large bank of accumulated losses, in which case the distribution may be able to be treated as a return of share capital.

## **CONCLUSION**

The combination demerger transaction structure provides a third, hybrid, option relative to the traditional demerger vs divestment considerations faced by listed sellers of divisions or assets, with the potential to deliver material benefits to shareholders of both seller and acquirer.

We expect interest in the use of this structure to increase as the dual themes of specialisation and consolidation continue to be pursued.



## 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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