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STUB EQUITY: THE AUSTRALIAN REVIVAL AND EVOLUTION

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Legal Briefings – By **Andrew Rich** and **Li-Lian Yeo**

The stub equity structure has undergone a recent revival and evolution in the Australian market – re-emerging as a solution to bridge the value gap in the context of current global economic headwinds.

SUMMARY

- ‘Retained equity’ where selected target shareholders retain their holdings in the target, has developed from traditional ‘stub equity’ and has been used in two recent Australian transactions.
- This article provides an overview of the traditional ‘stub equity’ and its variant, ‘retained equity’, together with an outline of a number of recent transactions utilising the structure.

The current global economic headwinds are leaving prospective bidders and targets searching for creative new solutions to bridge value gaps. We have seen the stub equity structure return to the Australian public M&A landscape in recent times as one such solution. In this article, we examine recent Australian stub equity deals and a variant on the traditional stub equity structure. We expect to see a continued rise in the use of stub equity while target share prices remain volatile – a sweetener for those target shareholders who are suspicious of bidders taking advantage of what they view as a short term weakness in share prices.

WHAT IS STUB EQUITY?

Stub equity is the name given to scrip consideration proposed to be issued to target shareholders under a scheme of arrangement or takeover bid to enable them to participate, economically, in the bid vehicle. The key features of a typical stub equity structure include:

- **Scrip alternative**: target shareholders are offered the choice of cash, scrip in a stub equity vehicle, or both;
- **Minimum / maximum take-up**: there is usually a minimum uptake requirement which ensures that there is at least a critical mass of target shareholder participation (at least in terms of the number of shares), as opposed to having a mere handful of small minority shareholders participating in respect of a small number of shares. A maximum take-up is also usually included to ensure that the bidder retains sufficient control and economic exposure to the target;
- **Limited voting rights**: the stub equity may have limited or no voting rights; and
- **Stub equity vehicle**: the stub equity vehicle is usually an unlisted entity, although, in theory, there is no reason why the stub equity vehicle could not be listed (and indeed there are examples of this in overseas stub equity transactions). Until recently, stub equity vehicles in Australian deals have always been entities incorporated outside of Australia.

The revival of stub equity in Australia

Stub equity deals are not new to the Australian market. However, prior to the iProperty transaction (discussed below), the structure had not been used in an Australian public M&A deal for around 4 years and, where used, had always previously involved a non-Australian stub equity vehicle.

iProperty

In the iProperty Group Limited scheme of arrangement (announced 2 November 2015), REA Group offered iProperty shareholders the choice of receiving either cash or mixed consideration (comprising cash and stub equity in an unlisted vehicle).

iProperty's major shareholder, Catcha Group who held 16.7% (REA Group itself held 22.67%) publicly stated that it would vote in favour of the deal and that it would elect to receive the mixed consideration.

Rollco, the stub equity vehicle, was an unlisted Australian public company. Post-implementation, it would hold an interest in the bid vehicle, Bidco, that was dependent on the level of stub equity elections made by target shareholders. Under the structure, Rollco would have a minimum of 10.7% in Bidco (due to a maximum cash condition precedent in the scheme) and a maximum of 20% (due to a scale back mechanism). Bidco would, in turn, hold 100% of the shares in iProperty.

Patties Foods

On 2 July 2016 - not long after the iProperty transaction was implemented - the stub equity structure was deployed again in the acquisition of iconic Australian company Patties Foods Ltd by private-equity firm PEP. Patties Foods was, prior to the proposal, substantially held by its founders, the Rijs family (36.6%), and had experienced share price weakness due in part to a health scare surrounding its berry products.

Here, target shareholders were offered the choice of receiving cash or stub equity in an unlisted vehicle (with a mix-and-match facility allowing them to choose the scrip alternative in respect of 40% to 100% of their target shares).

The deal was supported by the Rijs family, who publicly stated that they would vote in favour of the deal but did not publicly state which form of consideration they would elect to receive.

The stub equity vehicle, Holdco, was an unlisted Australian proprietary limited company[1] that was the holding company of the bid vehicle. A scale back mechanism was also included which resulted in target shareholders being able to hold a maximum 39.3% of Holdco.

THE EVOLUTION OF STUB EQUITY – ‘RETAINED EQUITY’

Earlier this year we saw a variant of the stub equity deal develop – the ‘retained equity’ deal.

A ‘retained equity’ transaction involves a public M&A transaction under which certain target shareholders, some or all of whom are unrelated to the bidder, retain their existing direct shareholding in the target company. This effectively causes the target to become an unlisted joint venture company following implementation of the transaction.

The key variance from the ‘traditional’ stub equity structure is who the opportunity to take scrip is offered to. In the case of traditional stub equity, the offer is made to all shareholders. In the case of ‘retained equity’, the opportunity is provided only to selected shareholders.

Ausenco

The first instance of this structure being used in Australia was the Ausenco Group Limited scheme of arrangement, which was announced on 14 June 2016.

Under the scheme, Resource Capital Funds, a mining-focused private equity firm (**RCF**) would acquire all the shares in Ausenco other than shares held by Duro Felguera (a substantial Ausenco shareholder) and certain of Ausenco's directors and key management personnel. RCF and the other holders of the retained equity held approximately 40% of the Ausenco shares. Prior to the scheme being implemented, RCF held approximately 5% of Ausenco and all of its secured debt.

Simonds Group

On 30 August 2016, Simonds Group Limited announced that it had entered into a scheme implementation agreement with a bid vehicle jointly held by Simonds Family Office Pty Ltd (**SFO**) and Roche Holdings Pty Ltd.

Under the terms of the proposed scheme of arrangement, the bid vehicle would acquire all the shares in Simonds other than those held by SFO or its associates. Post-implementation, it is proposed that Simonds Group would be delisted and SFO and Roche would hold 51% and 49% respectively.

ISSUES TO KEEP IN MIND

Some of the issues that should be kept in mind when devising these structures include:

- **Disclosure**: a prospectus level of disclosure on the entity issuing the stub equity will be required in the scheme booklet or bidder's statement. As the stub equity is often a special class share issued in an unlisted entity, prominent disclosure in relation to its illiquid nature is also important, together with other risks of holding the scrip;

- **Board recommendation**: target boards will need to consider whether they are in a position to make a recommendation on the stub equity alternative. While target boards are required to make a recommendation in relation to whether or not to vote in favour of a scheme of arrangement or accept a takeover bid, a target board is not required to make, and may form the view that it is not able to make, a recommendation in relation to stub equity;

- **Stub equity vehicle**: Australian stub equity bidders previously tended to prefer to incorporate their stub equity vehicles in jurisdictions outside of Australia, though this has changed in the more recent transactions. If the stub equity vehicle is an Australian entity and ends up with more than 100 members, one of the consequences is that it will be subject to periodic financial reporting requirements and continuous disclosure obligations. If the stub equity vehicle is an Australian proprietary company, it will also need to consider workarounds if it will have more than 50 non-employee shareholders. In addition, if the Australian stub equity company has more than 50 members, it will be subject to the takeover provisions in Chapter 6 of Australia's Corporations Act; and

- **Tax:** as always, tax considerations (such as the availability of roll-over relief for holders of stub equity) will also need to be considered in the early structuring phase.

CONCLUDING REMARKS

Stub equity and its variant, retained equity, are likely to remain a possible 'go to' structure in Australian public M&A transactions where there is a value gap between the bidder and target.

We also expect the deal technology to continue to evolve, with one possible future structure being a combination of the two structures – where 'retained equity' is offered to all target shareholders under a scheme of arrangement, with a maximum take-up limit, coupled with a scale-back mechanism.

** Herbert Smith Freehills acted for iProperty, Ausenco and Simonds Group on the transactions discussed above.*

ENDNOTES

1. If there would be more than 50 members in the bid vehicle, the shares in the bid vehicle would be held on bare trust by a nominee on behalf of those former target holders electing to receive scrip in the bid vehicle. This is because Australian proprietary limited companies must not have more than 50 non-employee shareholders.

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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