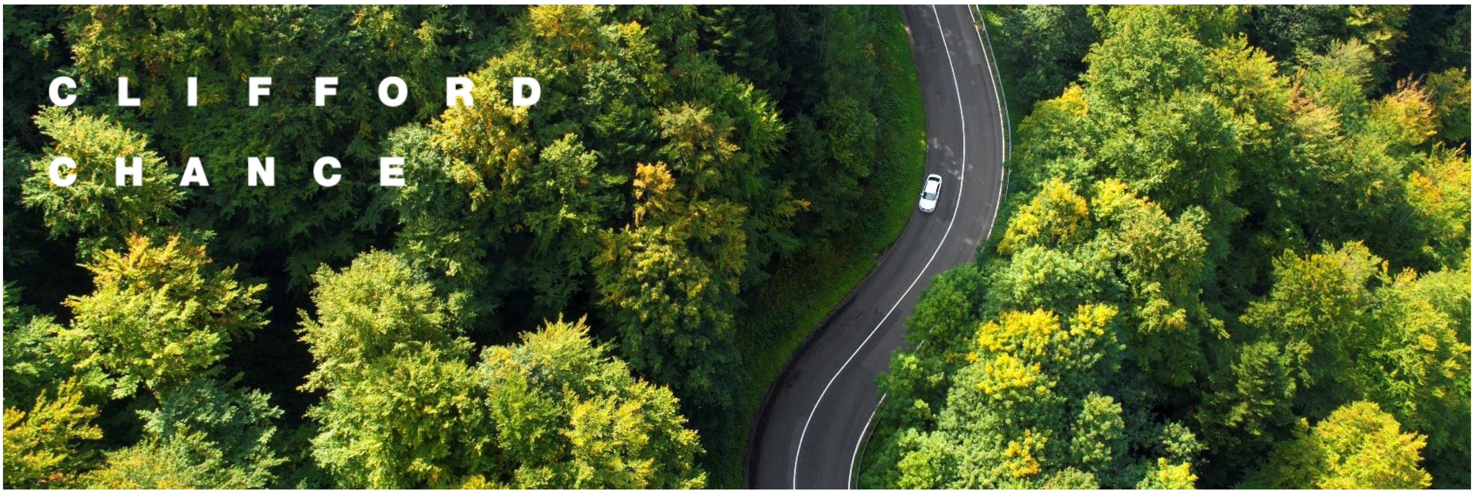

STUB EQUITY: A DIFFERENT ROUTE TO CONTROL

Overview

In "take private" transactions, while cash is usually king, there are a range of non-cash forms of consideration that can be used to get a deal across the line. As we move through a more challenging part of the economic cycle during which reaching consensus on valuations may be harder to achieve and raising capital on favourable terms is less straight forward, one of the trends we expect to see is for bidders to consider alternative forms of consideration to cash.

For unlisted bidders (e.g. private equity and financial investor bidders), the most common non-cash consideration offered is stub equity. In contrast, listed companies have the option of offering their own listed securities in addition to, or instead of, cash. While the form of consideration, shares, is the same, the outcome for target shareholders and the regulation of an offer of stub equity is quite different in practice from the offer of quoted securities in a listed company.

In this article we focus on stub equity in the context of private equity and other financial investor offers and include a couple of brief case studies in respect of take private transactions where stub equity has formed part of the offer.

Key issues

- The inclusion of stub equity as a form of consideration under a take private transaction can assist to meet the commercial requirements of key stakeholders, including substantial shareholders and the senior leadership team.
- Stub equity is a highly flexible instrument, with the bidder having broad discretion about offer terms, but it can add significant complexity to a deal.
- Thoughtful structuring is required to optimise the benefits of offering stub equity and to ensure that the intended commercial outcome is successfully achieved.

What is stub equity?

Stub equity is an offer to target shareholders of unlisted securities in the acquirer's bidding vehicle or its holding company (the "**Bidder"**). Most commonly, the offer to target shareholders is structured as a cash offer, with eligible target shareholders having the choice to elect to receive equity in the Bidder in lieu of some or all of the cash consideration being offered. The terms of stub equity offers are highly transaction specific and are customised to address identified concerns of key target stakeholders and to meet specific Bidder needs.

As target shareholders who elect to receive stub equity will become shareholders in the Bidder, it is customary for a shareholders' agreement to be put in place to regulate the governance of the Bidder going forward. Electing shareholders become party to the shareholders' agreement by operation of the privatisation scheme or as a condition of the stub equity offer. Common terms in these agreements include agreed exit provisions with tag and drag along rights, as well as governance reserved matters and director appointment rights. As part of the negotiation of a recommended deal, the target board will typically review and negotiate the terms of the shareholders' agreement for the benefit of any electing shareholders. The full form of the shareholders' agreement, along with a summary of the material terms of the shareholders' agreement, are included in the scheme booklet or bidder's statement (as applicable).

Why offer stub equity?

The most common scenarios where stub equity offers are made include:

- the target company has founder or management shareholders that hold a meaningful stake in the business and whose ongoing participation in equity ownership is desired or required; or
- it is known (or suspected) that a shareholder or group of shareholders wish to retain ongoing economic exposure to the target business or may even want to increase their exposure to the business once it is taken private as they have high conviction on the prospects for the target business.

Less commonly, we have seen stub equity being used as a way to partially fund a take private transaction as it results in the Bidder needing less cash to fund the acquisition.

An offer to all eligible target shareholders?

Generally, the offer of stub equity is made to all eligible target shareholders. There are two main reasons for doing this:

- first, if the offer is under a scheme of arrangement, and the stub equity alternative is made available to only selected target shareholders, then the total shareholder group will need to be divided into at least two classes and each class of shareholders will need to approve the scheme of arrangement by the requisite thresholds[1]. Generally, Bidders and target companies try to avoid multiple classes as it raises the prospect of a small group of shareholders being able to block a transaction; and
- second, the offer is often structured as an offer to all shareholders so that those shareholders who do elect to take stub equity, can obtain Australian capital gains tax rollover relief. As a commercial matter, the availability of rollover relief is critical and so it is important for the Bidder and its legal and tax advisers to work closely on this aspect of transaction structuring.

To the extent that the transaction is to be implemented by way of takeover bid, it is not possible to offer different consideration to particular shareholders as all shareholders need to be treated equally and accordingly an issue of stub equity as part of a takeover bid must be made to all shareholders.

[1] A scheme of arrangement requires approval by a vote of shareholders with at least (i) 75% of votes cast in favour of the scheme, and (ii) a majority by number of all target shareholders present and voting (in person or by proxy), voting in favour of the scheme.

CLIFFORD CHANCE

Other key considerations

Stub equity is flexible but can also be complex. There are a range of other matters that need to be considered as part of structuring an offer of stub equity.

Place of establishment of stub equity vehicle	*Australian Bidders* In 2020, ASIC introduced a new regulatory instrument, ASIC Corporations (Stub Equity in Control Transactions) Instrument 2020/734 ("**Stub Equity Instrument"**) and associated guidance on stub equity offers. Because of the Stub Equity Instrument, if the Bidder is an Australian company, it must be a public company to make an offer of stub equity. The Stub Equity Instrument also permits the use of a custody arrangement by a Bidder that is an Australian public company to ensure that the number of shareholders on the Bidder's register post implementation will not exceed 50 and will therefore not be subject to Chapter 6 of the Corporations Act (i.e. the takeover provisions). *Offshore Bidders* A non-Australian entity can also make an offer of stub equity and that entity will not be subject to the Stub Equity Instrument. Through the disclosure documents for the offer the Bidder is required to ensure that the nature of the securities being offered is described in detail, along with a description of the applicable governance and takeover regimes that will apply.
Minimum election threshold	Stub equity offers generally have a minimum election threshold, such that if there is insufficient take up, the stub equity will not be issued and all shareholders will receive cash. The level of the minimum election threshold is highly transaction specific with the range in practice to date being from 3% to 35%.
Maximum election cap	To ensure that the Bidder retains control, a cap on elections is also typically specified. The level of the cap is contingent on the transaction with the range generally extending to up to 49%.
Scrip scale backs	Where a maximum election cap is applied it is necessary to include a mechanism to scale back elections where the cap is exceeded. The terms of the scale back must be set out in the terms of the offer and shareholders should be treated equally.
Mix and match facilities	Some stub equity structures have also included a "mix and match facility" whereby shareholders who are particularly keen can subscribe for any of the "left over" stub equity after the initial elections have been satisfied. In this way, a target shareholder can increase its total holding in the Bidder and its overall exposure to the target business.
Minimum election condition precedent to the transaction	If a Bidder is using stub equity to reduce the total amount of cash that it requires to pay upfront for control or wishes to ensure that certain target shareholders elect to receive stub equity, the Bidder can specify that a condition precedent to the transaction is acceptances of the stub equity offer achieving a specified minimum threshold.
Target board recommendation	Historically, target boards have not provided a recommendation in relation to stub equity elections. Stub equity is complex and may not necessarily be suitable for all shareholders. In such cases, it may be difficult for a target board to make a general recommendation about which election a shareholder should make. In the Explanatory Statement supporting the Stub Equity Instrument, ASIC said that it was best practice for boards to make a recommendation on the stub equity component of the offer. We have seen no evidence of an emerging practice for target directors to make recommendations in relation to the stub equity alternative.

Independent expert report	ASIC has stated that it is best practice for the independent expert's report to include a valuation and opinion on the stub equity. Market experience since 2020 is that where stub equity is offered, independent expert's reports do contain an assessment and opinion on the stub equity offer.
Jurisdictions into which the stub equity offer can be made	As securities are being offered to retail investors, it is necessary to analyse the share register of the target to ensure that an offer of stub equity can be made into jurisdictions in which any non-Australian shareholders are located. Depending on the composition of the register, as well as the applicability of foreign securities laws, a decision may be made to exclude certain non-Australian target shareholders from the stub equity offer.

Recap

While public M&A is highly regulated, Bidders do have flexibility with respect to the form of consideration that may be offered to target shareholders. In certain circumstances, a well-structured stub equity offer might assist a Bidder to acquire control by meeting the requirements of key stakeholders. Stub equity can also reduce the funding burden and secure management's continued participation in the business.

***

Please contact David Clee or Nicole Backhouse if you would like to discuss further.

Case studies

Capilano Honey

While the Capilano Honey scheme of arrangement was the immediate precursor to the ASIC Stub Equity Instrument and therefore was undertaken before the current guidance was in place, it is a good example of a complex stub equity offer, where the stub equity was used to reduce the overall cash funding requirements of the Bidder (i.e. the proceeds of the stub equity offer were used to partially fund the cash consideration paid to target shareholders).

Bravo Bidco Pty Ltd ("**Bravo Bidco"**) made an offer to be implemented by way of scheme of arrangement pursuant to which it proposed to acquire all of the issued shares in Capilano Honey Limited (an ASX listed company) (**Capilano**). The consideration offered comprised:

- **Cash consideration** of $20.06 for each Capilano share. This was the base and default offer to shareholders;
- **Scrip consideration** of one Bravo HoldCo Pty Ltd ("**Bravo Holdco"**) (being the holding company of Bravo Bidco) share for each Capilano share. To receive the scrip consideration, a shareholder was required to elect receive this consideration and return the election form to Capilano by the election time; and
- **Bravo HoldCo Share Offer** which was only available to Capilano shareholders who validly elected to receive scrip consideration as part of the scheme. Under this share offer, an electing Capilano shareholder was able to subscribe for 0.5 Bravo HoldCo shares for every Capilano share they held at the scheme record date at a subscription price of $20.06 cash for every Bravo HoldCo share. The subscription form and subscription funds needed to be given to Capilano on or before the scheme consideration election time, which was before the scheme meeting date with the subscription funds being held in a trust account operated by Capilano pending disbursement in accordance with the scheme.

The scheme was subject to a condition precedent that there was a 15% minimum acceptance of the stub equity offer and that the maximum stub equity that could be issued (under both the scheme consideration offer and the Bravo Holdco Share Offer) was capped at 49.9% so that the scheme proponents would maintain no less than 50.1% of the diluted share capital of Bravo Holdco. Scale back arrangements were included in the document to the extent that there was an over election of Bravo Holdco shares.

Other features of the deal included:

- **Shareholders' deed**: electing shareholders' agreed to be bound by a shareholders' deed and would be treated as minority shareholders for the purposes of that deed. The scheme booklet highlighted the differences between holding unlisted shares in a proprietary company as against holding shares in a listed company and included both summary of the shareholders' deed as well as the full form shareholders' deed in the scheme booklet;
- **Director appointment rights**: under the shareholders' deed any former Capilano shareholder who held more than 25% of Bravo Holdco's shares was entitled to appoint one director, whereas the consortium who put forward the offer had a right to appoint three directors so long as they held 45% of Bravo Holdco's shares; and
- **Custodian**: electing shareholders agreed to have their shares in Bravo Holdco held by a custodian in the event that there was going to be more than 50 members, such that the majority shareholders would hold their shares directly in Bravo Holdco and minority shareholders would hold their shares indirectly via a custodian who would hold the shares on bare trust for that shareholder.

Bingo

In 2021, the MIRA consortium (part of Macquarie Asset Management) put forward a proposal to acquire Bingo Industries Limited (**Bingo**) by a scheme of arrangement. The proposal involved a complex stub equity component. This scheme was approved in July 2021 and was undertaken following the release of ASIC's Stub Equity Instrument.

At the time of the scheme, Bingo's two largest substantial holders, were Daniel Tartak (**Tartak**) and Ian Malouf ("**Malouf"**) and both were on the Bingo board and the independent board committee ("**IBC"**) that was formed to consider the proposal from MIRA. There was a unanimous IBC recommendation in favour of the scheme in the absence of a superior proposal and both Tartak and Malouf indicated that they intended to elect to receive the mixed consideration.

Under the scheme Bingo shareholders could choose:

- **all cash consideration** of $3.45 in cash per Bingo Share; or
- **mixed consideration** comprising cash and unlisted scrip in a public company that was the ultimate Australian holding company for the bidder entity ("**RollCo"**). The mixed consideration had a notional value of $3.30 per Bingo share, comprising:
  - cash of $1.32 per Bingo share; and
  - unlisted scrip in RollCo, comprising one Class B Share, one Preference Share and one Class C Share with an aggregate issue price of $1.98 per Bingo share. Each Class C Share entitled the holder to receive an earn-out dividend of up to $0.80 per Class C Share, subject to certain conditions based on Bingo's future financial performance.

A condition precedent to the transaction was that Bingo shareholders holding no less than 30% of the total issued capital elected to receive the mixed consideration. This condition would be satisfied solely by Tartak's and Malouf's mixed consideration election.

The maximum number of RollCo shares that could be offered under the scheme was capped at 40% and to the extent that there was an over-election, scale back terms would be applied.

Other key features of the deal included:

- **Shareholders' deed**: electing shareholders were required to enter into a comprehensive shareholders' deed;
- **Director appointment rights**: under the shareholders' deed any Class B shareholder who had a Qualifying Interest (being 5% of RollCo's shares) was entitled to appoint one director; and
- **Custodian**: in the event that RollCo would have more than 50 shareholders, Class B shareholders who were not Qualifying Shareholders (i.e. they held less than 5% of RollCo shares) would be required to hold their shares indirectly via a custodian, with all other shareholders holding their shares in RollCo directly.

It is important to note that:

- Tartak's and Malouf's decision to elect to receive the mixed consideration;
- the director appointment rights in the shareholders' deed for shareholders with a "Qualifying Interest"; and
- the differential treatment of shareholders who did not have a Qualifying Interests from a custodian perspective,

did not disqualify either Tartak or Malouf from being members of the independent board committee that considered the offer, nor did it mean that they needed to form a separate class from other shareholders for the vote on the scheme proposal.

CLIFFORD
CHANCE

CONTACTS

David Clee
Partner

T +61 2 8922 8575
M +61 424 181 692
E David.Clee
@cliffordchance.com

Nicole Backhouse
Counsel

T +61 2 8922 8058
E Nicole.Backhouse
@cliffordchance.com