

TO FLOAT OR NOT TO FLOAT?

Steven Goodman, Partner, Truman Hoyle Lawyers

A brief outline of some of the key issues that require consideration before making the decision to list on the ASX.

1. WHY FLOAT?

1.1 The decision to list the shares of a company on the ASX is a significant step in the evolution of a company. It must be made after a full consideration of the objectives of the company, its management, resources and prospects as well as consideration of the available alternatives.

1.2 The main reasons a company and its existing shareholders may be considering a float are to:

- (a) raise capital to fund the company (on floatation or in the future);
- (b) exit an investment (in whole or part);
- (c) build the profile of the company with customers and suppliers; and
- (d) establish a liquid market in its shares (for employee share schemes or to fund acquisitions).

1.3 Other options which need to be considered are:

- (a) bank finance;
- (b) further investment from existing shareholders;
- (c) trade sale;
- (d) venture capital; and
- (e) management buy out.

2. IS THE COMPANY READY?

2.1 It is absolutely essential that before even starting to evaluate the alternatives a company has in place a clear and realistic business plan. Once that is in place and the objectives and prospects of the company are clear then the company will be in a position to properly evaluate whether a float is the right option.

2.2 The legal, accounting, tax and administrative affairs of the company need to be put into order in advance of commencing the float process.

2.3 The company will need to convert to a public company and adopt a share structure (only one class of ordinary shares) and constitution that comply with ASX requirements. It will also need to put in place an appropriate board (including non-

executive directors) as well as corporate governance procedures. The company should also consider putting in place an employee share ownership plan.

- 2.4 The company will also need to obtain tax advice at a very early stage of the process to ensure that the tax position of the company and its shareholders is maximised in particular in relation to Capital Gains Tax and stamp duty.

3. QUALIFICATION CRITERIA – ASSET OR PROFIT TEST AND SPREAD

- 3.1 Before a company can float it must comply with a list of requirements set out in the ASX listing rules.

- 3.2 These include (ASX listing rule 1.1):

- (a) the structure and operations of the company must be appropriate for a listed entity;
- (b) a prospectus (in some cases a Product Disclosure Statement or Information Memorandum) must be issued and lodged with ASIC;
- (c) it must satisfy the “profits test” or “assets test”; and
- (d) it must achieve a sufficient spread of shareholders.

- 3.3 The “profits test” requires the same activities and aggregate profits of at least \$1 million for the past 3 full financial years (supported by audited accounts) and profit for the 12 months prior to listing of at least \$400,000.

- 3.4 The “asset test” requires net tangible assets at the time of listing of at least \$2 million (\$15 million for investment entities other than a pooled development fund) after deducting float costs or market capitalisation on listing of at least \$10 million. There is also a requirement (other than for investment entities) that if more than half the assets are cash there must be commitments in place supported by an expenditure program consistent with business objectives to spend at least half of its cash.

- 3.5 In most floats it is not difficult to satisfy the “assets test” or “profits test”. There is an advantage in meeting the “profits test” rather than “assets test” because the escrow restrictions are less onerous for companies that are admitted under the “profits test”.

- 3.6 Achieving a sufficient spread of shareholders is often very difficult. The company must have at least 500 shareholders (this is reduced to 400 shareholders if at least 25% of shares are held by non related parties) holding shares worth at least \$2,000 (excluding restricted or escrowed securities). In most small floats (and even some larger ones) a considerable amount of time is spent trying to find sufficient shareholders to take up the offer in order to meet this requirement.

- 3.7 The shareholder spread requirement is not met if spread is obtained by artificial means (ASX listing rule 1.1 Condition 7). It is not clear exactly what this means. In practice the ASX applies this requirement by excluding more than 2 shareholders at the one address. In addition the ASX counts nominee holders as one holder only.

- 3.8 At times companies attempt to reduce the shareholder spread hurdle by structuring their new listing as a “backdoor listing”. This in essence involves selling the company into a listed shell. The difficulty with such a transaction is that the costs and risks are

normally higher due to the need to prepare a share sale agreement, appoint separate lawyers to act for the listed entity, conduct due diligence on both entities and obtain listed entity shareholder approval. Due to ASX listing rule 11.1 and ASX Guidance Note 12 the company will still in effect have to comply with all the normal listing requirements in Chapters 1 and 2 of the ASX listing rules. The only benefit then is that it may be easier to achieve shareholder spread, but this will obviously very much depend on the share register of the listed entity.

4. ESCROW ISSUES

- 4.1 The ASX rules impose certain escrow requirements. In general terms these are imposed on persons that have some connection with the entity in order to prevent them floating the entity and then cashing out immediately thus protecting the integrity of the market. The escrowed securities are referred to as restricted securities and they cannot be sold during the restriction period.
- 4.2 The rules are set out in Appendix 9B of the ASX listing rules in the form of a table setting out the restriction period periods of 12 months or 24 months depending on the class of person or the transaction. The classes of persons covered include seed capitalists, vendors of classified assets, promoters, professionals and consultants and persons under an employee incentive scheme.
- 4.3 Due to ASX listing rule 9.1.3 certain restrictions in the table do not apply to an entity admitted under the profits test. The only restrictions that apply to such an entity are related party vendors or vendors that end up holding more than 20% equity who are escrowed for 12 months.
- 4.4 There is also a significant exemption for seed capitalists. In effect the number of shares they could have purchased at the float price with the money they actually paid for their shares will not be escrowed.
- 4.5 There is also an anti avoidance provision in ASX listing rule 1.1 Condition 10 which is designed to prevent promoters or related parties from extracting cash via a listing from a company with intangible assets and no record of profitability. It provides that if in the 2 years before application to be listed the company acquired a classified asset (mining interests, intangible property not profitably exploited for at least 3 years or assets which cannot be readily valued) from a related party or a promoter then the consideration must have been restricted securities.
- 4.6 This anti avoidance provision will not apply if the consideration was reimbursement of expenditure incurred in developing the classified asset or if under ASX listing rule 9.1.3 the entity is not required to apply the restrictions in Appendix 9B (if the entity is admitted under the “profits test” or has a record of profitability or revenue acceptable to ASX or has in the opinion of ASX a substantial proportion of its assets as tangible assets or assets with a readily ascertainable value).

5. THE FLOAT TEAM

- 5.1 One of the most important steps is establishing the float team at the commencement of the process and clearly defining roles at the outset. The company should make sure that each member of the team provides an engagement letter and fee quotes or estimates at an early stage.

- 5.2 The following will generally be required:
- (a) lawyer;
 - (b) tax advisor;
 - (c) independent accountant;
 - (d) financial advisor;
 - (e) underwriter;
 - (f) broker/s;
 - (g) public relations consultant, designers and printers;
 - (h) share registry;
 - (i) other experts.
- 5.3 The roles of Financial Advisor and Underwriter are often performed by the same company. In addition, some floats are not underwritten and in that case there is obviously no need for an underwriter.
- 5.4 The key to managing the costs and timing of a float (and hence to some degree its success) is to carefully select and control this team making sure there is no overlap in roles and that there is effective co-ordination. This management role can be performed by the company itself, the financial advisors or the lawyers. This will involve establishing a program of tasks, responsibilities and due dates.
- 6. THE PROSPECTUS AND DUE DILIGENCE PROCESS**
- 6.1 Under Section 710 of the Corporations Law a prospectus must contain all the information that investors and their professional advisors would reasonably require to make an informed assessment of:
- (a) the assets and liabilities, financial position and performance, profits and losses and prospects of the company; and
 - (b) the rights and liabilities attaching to the shares being offered.
- 6.2 The prospectus must include all relevant information actually known or which should reasonably have become known (through making enquiries) to any of a wide range of persons including the company, directors, underwriter and other persons named in the prospectus which will include accountants, lawyers and experts.
- 6.3 The need to include what should have become known as well as the defence provided in S.731 of the Corporations Act for persons that can prove they made all reasonable enquiries and believed on reasonable grounds that the statement or omission was not misleading or deceptive gives rise to the common practice of conducting extensive due diligence.
- 6.4 The process is to first establish a due diligence committee consisting of the following persons:

- (a) one or more company representatives (the chairman of the company to be listed will normally chair this committee);
 - (b) lawyer;
 - (c) independent accountant;
 - (d) financial advisor; and
 - (e) underwriter.
- 6.5 This committee should be relatively small and focused so that the normal business of the company can continue to be managed by others.
- 6.6 A due diligence memorandum is then prepared (usually by the lawyer) which sets out a planned process including allocation of responsibilities and regular meetings. The lawyer is normally responsible for legal due diligence, the investigating accountant for financial due diligence and the company representatives for commercial due diligence. The memorandum will also set out how materiality will be determined as well as who will be responsible for drafting the prospectus and the process for conducting verification of the prospectus.
- 6.7 The lawyer will conduct an extensive legal due diligence process commencing with an information request and ending with a legal due diligence report which is presented to the due diligence committee. The lawyer will also normally be required to provide an opinion letter (usually on the day the prospectus is issued and lodged with ASIC) regarding prospectus compliance and the adequacy of the due diligence review.
- 6.8 The Independent Accountant will prepare a report which is usually included in the prospectus immediately following the Financial Information section.
- 6.9 Verification is a time consuming part of the due diligence process which in essence involves checking the accuracy of every statement in the final draft of the prospectus. Every statement needs to be verified back to a reliable external source or be within the knowledge of a reliable person and written sign offs need to be obtained and kept in a verification folder. This process is usually co-ordinated by the lawyer.
- 6.10 In drafting the prospectus there are two areas that have consistently caused difficulties. These are:
- (a) financial forecasts; and
 - (b) use of proceeds.
- 6.11 Special care and attention needs to be taken with these sections of the prospectus. This should include consideration of relevant ASIC policy statements and Information Releases (in particular PS 170 and IR 05-34).
- 6.12 Prior to lodging a prospectus the company will need to obtain a number of consents including the consent of every director and proposed director (Section 720 Corporations Act) as well as consents of all other persons to whom statements are attributed (Section 716 Corporations Act). There are also a number of specific content requirements set out in Section 711 of the Corporations Act relating to disclosing the

offer terms, interests and fees of people involved with the offer, fees and benefits, quotation, the expiry date, lodgement with ASIC and other information required by the corporations regulations.

- 6.13 ASIC does not review prospectuses prior to lodgement although it does conduct selective post lodgement vetting of prospectuses and it can issue stop orders if it discovers any defects in the prospectus.
- 6.14 Once a prospectus is lodged with ASIC there is a requirement to lodge a supplementary or replacement prospectus if relevant new information comes to light or if clarification is required (Section 719 Corporations Act).
- 6.15 Once the prospectus has been lodged it will be necessary to apply to the ASX for admission to the official list and quotation of securities by completing and lodging Appendix 1A to the ASX listing rules. Obviously, given the relative complexity of this process it will be necessary for the company and in particular its lawyers to work closely with ASX through the whole listing process.

7. COST AND TIMING

- 7.1 The costs both in financial terms and time commitment are significant. The costs and time taken to achieve a listing will obviously depend on the size and complexity of the business, pre-float process work required as well as the amount of funds being raised and whether the raising is underwritten.
- 7.2 As a general guide the underwriting fee and broking fees range from approximately 2% to 8% of the amount raised. Other fees (including ASX fees, legal, accounting, experts, registry and printing) normally range from approximately \$300,000 to \$800,000 in total depending on the size of the business and the extent of pre-float restructuring work required. Very complex floats can involve other fees in excess of \$1 million.
- 7.3 In terms of timing most floats take between 6 months and 1 year to complete.
- 7.4 It is also worth noting that there are a number of time constraints imposed by the Corporations Act and the ASX listing rules. Most notably due to Section 724(b) of the Corporations Act the application for admission to quotation must be made within 7 days after the date of the prospectus and the shares must be admitted to quotation within 3 months after the date of the prospectus. If this is not achieved then the company will be required to repay application monies or give investors the option (by issuing a supplementary prospectus and giving 1 months written notice) of withdrawing applications and being repaid.

8. PRICING AND MARKETING

- 8.1 Correctly pricing and marketing the float are absolutely critical to success. These issues need to be carefully considered and planned at an early stage.
- 8.2 The price may be a fixed price specified in the prospectus or it could (normally only in large floats) be an open price involving a "book build" process. It may also be fixed for some investors (retail) and open for others (institutions).

- 8.3 There are significant restrictions on publicising the float before the prospectus is lodged. The only advertising or publicity allowed is a tombstone type advertisement that complies with Section 734(5) of the Corporations Act. Those restrictions basically fall away after the prospectus is lodged as long as any advertisement or publicity contains a reference to the prospectus in the prescribed terms set out in Section 734(6) of the Corporations Act.
- 8.4 The company may present information about the company and the float (including a draft prospectus – Section 734(9) Corporations Act) to sophisticated or professional investors. This is a key aspect of successfully marketing a float.

9. LIFE AS A LISTED ENTITY

- 9.1 Of course becoming listed is only the beginning of life as a listed entity. There are obviously benefits in being a listed entity including in particular the ability to raise further amounts relatively quickly and cheaply by making private placements in reliance on the exceptions contained in Sections 708(8) for sophisticated investors and Section 708(11) for professional investors. This can be done without shareholder approval for up to 15% of the equity in the company in any one year under ASX listing rule 7.1.
- 9.2 However, a considerable amount of time, effort and cost needs to be devoted to complying with the additional corporate governance and disclosure requirements including the continuous disclosure requirements in Chapter 3 of the ASX listing rules.
- 9.3 For this reason it is very important to carefully consider all of the relevant issues identified above before making the decision to list.

Steven Goodman
Partner
Truman Hoyle Lawyers
sgoodman@trumanhoyle.com.au
Tel: (02) 9226 9888
Fax: (02) 9226 9899

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