The growing acceptance of backdoor listings

Raising capital through an initial public offering on the ASX is becoming more difficult. **RICHARD KUO** and **NICK HUMPHREY** consider the key commercial, structural and regulatory issues in relation to backdoor listings.

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The deterioration of equity capital markets has made it difficult for companies to raise capital through initial public offerings ('IPO') unless they are a potential ASX200 company or in a strong industry sector.

Companies seeking to go public, whether to increase shareholder liquidity, gain increased access to capital or for other strategic objectives, must now consider other ways in which to achieve listing.

Backdoor listings ('BDL') are becoming increasingly popular as a cost-effective and flexible option for listing on the ASX. They are, however, not without their pitfalls, and this article considers the key commercial, structural and regulatory issues associated with backdoor listings.

Market conditions

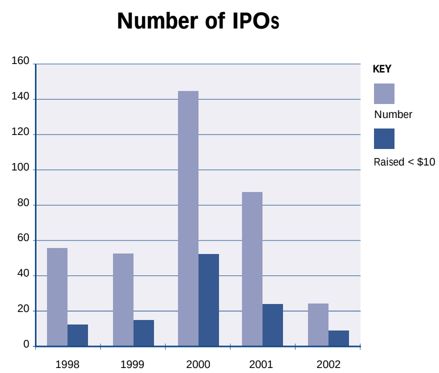
The convergence of a number of capital markets trends has significantly increased the viability of backdoor listings as an option for listing, in particular:

- the difficulty of raising capital through an IPO, particularly for smaller cap companies (under ASX 200); and
- the large number of small companies currently listed on the ASX which have failed to meet their original objectives and are seeking to create value for their shareholders.

In the IPO boom of 2000 and 2001, 147 companies were listed on the ASX in the year to 30 June 2000 and 91 were listed in the year to 30 June 2001. In the year to 30 June 2002, only 25 companies successfully listed on the ASX by way of an IPO.

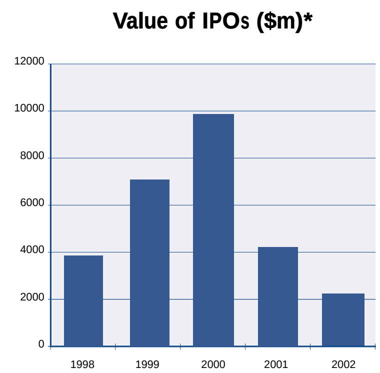
Importantly, the average amount raised in an IPO in the 2002 year was approximately $98 million, substantially more than the $50 million in 2001 and $65 million in 2000. IPOs are currently the domain of large companies. The graphs below demonstrate the number (Figure 1) and value (Figure 2) of IPOs over the last five years.

FIGURE 1



Source: ASX Annual Returns 2001, 2002

FIGURE 2



*Value excludes Second Tranche of Telstrra

Source: ASX Annual Returns 2001, 2002

The IPO boom enabled a large number of early stage companies without a profit history or proven business model (many in the internet and technology sectors) to go public and raise significant capital. A number of these companies are now languishing and:

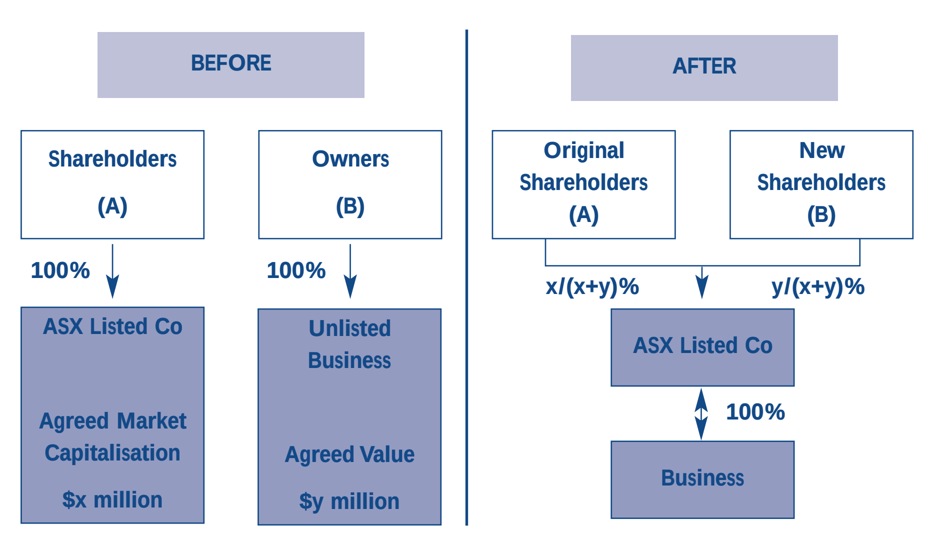
- have vastly reduced market capitalisations;
- cannot access new capital as:
  - brokers and institutions are focused on the ASX 200;
  - their current shareholders are disappointed with management performance;
- have poor operating track records and now lack critical mass to execute their business objectives.

In turn these companies may have:

- disgruntled shareholder bases which are seeking strategic changes to restore the value of their investment; or
- controlling shareholders who have recognised the futility of pursuing their original objectives and are conserving capital raised under the original IPO to implement a new strategy (these companies may be called a 'cashbox').

These companies provide ideal entities for backdoor listings.

FIGURE 3 **WHAT IS A BACKDOOR LISTING?**



What is a backdoor listing?

A backdoor listing essentially involves the merger between a listed company (commonly referred to as a 'shell') and an unlisted company ('target'), after which the shareholders in the target control the shell.

While technically it is the shell which is acquiring the shares or assets of the target, in practical terms the shareholders in the target are 'acquiring' a controlling stake in the shell by transferring their business into the shell (hence the US terminology of 'reverse takeover' or 'pacman takeover').

Why backdoor list?

The primary objective of a BDL is for an unlisted business to list on the ASX as a strategic step towards the creation of shareholder value (by, for example, creating liquidity or increasing access to capital). An IPO may not be the most appropriate listing alternative for the business for a number of reasons, including prevailing market conditions, size and structure of the business, timing constraints and cost considerations. Transferring the business into an already listed entity may be the most effective way to list the business on the ASX.

Advantages of being listed

A BDL provides most of the benefits and detriments arising from listing through an IPO. The key issue to bear in mind is that the relative pros and cons of being listed vary significantly depending on the size of the company.

In general, the smaller the company the more likely that the costs of being listed will outweigh the advantages. Small cap companies are unlikely to have much liquidity nor to get significantly enhanced access to institutional capital (particularly in the current market).

To compound the issue, the aggregate cost of being listed (such as annual listing fees, annual reports and registry fees etc) are 'stepped fixed' costs and are relatively greater for small cap companies.

The key benefits of being listed include:

- Access to capital: Providing greater access to the equity capital markets and therefore the ability to raise funds more easily.
- Liquidity: Providing a market and liquidity for shareholder interests (although founders and promoters may be restricted from disposing of their interests for a certain period of time after listing).
- Acquisitions: Acquisitive companies can use their scrip as consideration for acquiring other companies.
- Profile: Providing a higher profile and greater credibility for the business for customers, suppliers, debt providers, investors and other stakeholders. For example, you may be able to negotiate more favourable terms with your debt financiers once listed.
- Employee retention: Giving employees the ability to have equity in the company through employee share or option schemes which in turn assists employee retention and motivation.
- Employee attraction: Being able to recruit management from a wider pool of executives.

Disadvantages of being listed

- Continuous disclosure: Compliance with the continuous disclosure regime which is not only expensive but allows competitors to access detailed information about your business.
- Executive focus: Applying for listing is a time consuming process and often distracts management from operations. Once listed, management may also be distracted by enquiries from investors, journalists, brokers and regulators.
- Expensive: Significant expenses in applying for listing, including underwriters' fees, legal and accounting fees, listing application fees and printing expenses.
- Restrictive: Compliance with ASX Listing Rules, which contain restrictions on capital structure and governance (such as maintaining spread, shareholder approvals, expert reports etc).
- Ongoing costs: Ongoing expenses such as annual listing fees, share registry fees and the administrative burden of complying with continuous disclosure.

TABLE 1 ASX POLICY INDICATING WHEN A PROSPECTUS IS REQUIRED

	No change in scale or nature		Change in scale or nature	
	Capital raising	No raising	Capital raising	No raising
Prospectus	No	No	Yes	Information memorandum

Examples

Notable examples of backdoor listings include:

- Ambri through Optecom Limited
- Cockatoo Ridge Wines through Adelaide Share Investments Limited
- Ellex Medical Lasers through Gemstone Corporation of Australia Limited
- Davnet through Golden Hill Minerals N.L.
- Prima Biomed through Prima Resources Ltd
- Rivkin Financial Services through Kurnalpi Gold N.L.

Advantages and disadvantages of BDLs

BDLs are often thought to be cheaper, easier and faster to list than IPOs. A key assumption underlying these claims is that no prospectus will be required. However, the ASX Listing Rules may require a prospectus to be issued if the shell is substantially changing the nature or scope of its activities through the BDL.

However, if the 'shell' is not raising any capital, then a prospectus may not be required—ASX policy provides an exception for companies which have not raised capital and do not intend to raise capital for three months preceding and following the BDL. The ASX has a discretion on this exception and may still require a prospectus to be issued.

Table 1 summarises these provisions.

Advantages of BDLs

The main advantages of a BDL include:

- Access to cash: An appropriate 'shell' is likely to maintain a net cash balance, which substantially reduces or dispenses with the need to raise additional equity capital. This is particularly important in the current environment where access to quality equity capital is extremely limited, especially for companies with market capitalisations of less than $150 million.
- Regulatory: Generally reduces the regulatory prerequisites for listing. As a BDL involves an already listed ASX company, all admission requirements have previously been met. The requirement for spread (400 unrelated shareholders with a minimum holding of at least $2,000) can be difficult to obtain for small companies —brokers can charge as much as $100 a name to achieve spread.
- Timing: Generally reduces the time to list a company compared with an IPO. The shorter time frame arises through the reduced amount of due diligence and regulatory procedural issues, and avoiding the lengthy capital raising period.
- Rollover relief: Capital Gains Tax rollover relief is now available on the disposal of shares if at least 80% of consideration paid for the shares in the unlisted business is paid in shares in the ASX Listed Company. CGT liability is deferred until the shares in the ASX company are ultimately disposed of.

Disadvantages of BDLs

The disadvantages of a BDL include:

- Hidden liabilities: The shell can have contingent liabilities such as unpaid creditors, non-performing assets, employee liabilities and on-going contractual liabilities to service existing projects. For example, if the shell is currently a mining entity, it may have environmental liabilities.
- Tired share register: A BDL typically involves merging with a dormant shell that has failed to meet its original objectives, hence often has a group of disgruntled minority shareholders and no institutional support. In turn these minorities may be problematic in seeking the required

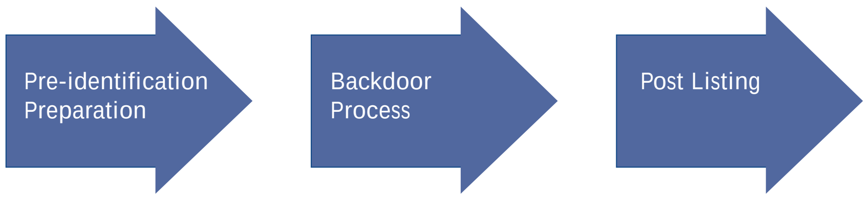
shareholder approvals, or will be sellers into the market after the BDL, thereby weakening the share price performance in early months. Furthermore the shell may have no research or broker relationships (as there is insufficient activity and potential brokerage to justify the effort).

- Reduced profile: BDLs have historically been associated with the speculative end of the market and some investors consider that BDLs are only for those companies unlikely to succeed in an IPO. While most experienced investors will assess the fundamental value proposition, a BDL lacks the 'marketing event' associated with an IPO and usually does not gain the profile and attention which is afforded to IPO companies.
- Premium: The 'price' of the shell may be greater than its net tangible assets (particularly its cash balance) and therefore the owners of the unlisted business may suffer material dilution in their resulting shareholding.
- Approvals: Any BDL requires approvals from the shareholders in the shell. Subject to the structure of the BDL, material information including a detailed information memorandum and, in certain circumstances, an independent expert's report, will be required. If a prospectus is also to be issued to raise capital, the 'regulatory process' can become time consuming and expensive in terms of required resources and can extend the market risk impacting on the transaction after the BDL process is announced to shareholders and the market.

TABLE 2 **DILUTION THROUGH A BDL**

BEFORE BDL	
ASX Company	
Issued Ordinary Shares	50 million
Agreed Share Price	10 cents
Agreed Market Capitalisation	$5 million
Unlisted Business	
Agreed Value	$10 million
Number of Ordinary Shares Issued	100 million
AFTER BDL	
Capital Structure After BDL	
Issued Ordinary Shares	150 million
Unlisted Business shareholders interest	66.7%
Original ASX Co Shareholders interest	33.3%
IF ADDITIONAL CAPITAL IS TO BE RAISED	
Additional Equity Capital	5 million
Issue Price of Shares	8 cents
Number of Shares	62.5 million
Resulting Capital Structure	
Issued Ordinary Shares	212.5 million
Unlisted Business shareholders interest	47.1%
Original ASX Co Shareholders interest	23.5%
New Equity Investors	29.4%

FIGURE 4 **THE BDL PROCESS**



• Identify Tax Issues • Prepare Information • Prepare Forecasts • Determine Value Criteria • Clean Capital Structure • Prepare for Due Diligence	• Identify Listed Companies • Negotiate Valuations • Determine Board and Management • Structure Transaction • Documentary Preparation • Marketing • Shareholder Approvals	• Integrate Business • Investor Liaison • After-Market Support • Achieve or exceed Business Expectations

Key structural issues

Pricing and valuation

In most cases, negotiating and agreeing respective valuations for the shell and target is the key commercial issue for the parties. While the 'shell' will have a market value for its equity from its trading share price, this value may not properly reflect the value the board of the company considers appropriate. The fundamental value of the 'shell' will be calculated based on:

- net cash backing;
- net realisable tangible asset backing; or
- cashflow or earnings ratios (although unlikely to be present in an appropriate 'shell').

It is likely that the board of the shell will seek a premium to be paid on the fundamental value for both:

- recommending shareholders approve the transaction (a premium for passing control); and
- to acknowledge the 'value' inherent in providing an ASX Listed Company.

This premium varies with, among other things, the quality of the 'shell', the demand for the 'shell' from other interested parties, the expectations of the board and shareholders of the 'shell' and prevailing market conditions.

The valuation for the unlisted business must be made on a fundamental basis, usually on traditional valuation techniques such as EBIT or cashflow multiples.

Few directors of 'shells' or investors are likely to value unquantifiable potential of a business in the current environment, except in exceptional cases such as biotechnology where other sector specific factors are considered appropriate.

Importantly, the price and valuation of both the 'shell' and the unlisted business, once the BDL is complete, must result in a level of pricing which:

- provides fundamental value for investors when compared to peer companies listed on the ASX; and
- if capital is to be raised, provides appropriate pricing and valuations to support the equity capital raising.

Goodwill

Almost all structural alternatives in a BDL are acquisitions of some form and therefore give rise to goodwill. As the goodwill arising from the transaction will be amortised, the 'headline' profitability of the company will be reduced.

Although equity analysts and sophisticated investors will 'normalise' and disregard the goodwill amortisation charge, unsophisticated investors and some media commentators will not.

Dilution

The real 'price' of a BDL is the dilution in ownership to both the owners of unlisted business and the shareholders in the shell. Dilution in ownership occurs through two main events:

- by 'merging' the unlisted business with the shell, thereby consolidating the ownership of two separate enterprises into one; and
- by raising additional equity capital.

An illustration of the effect of this dilution is set out in Table 2.

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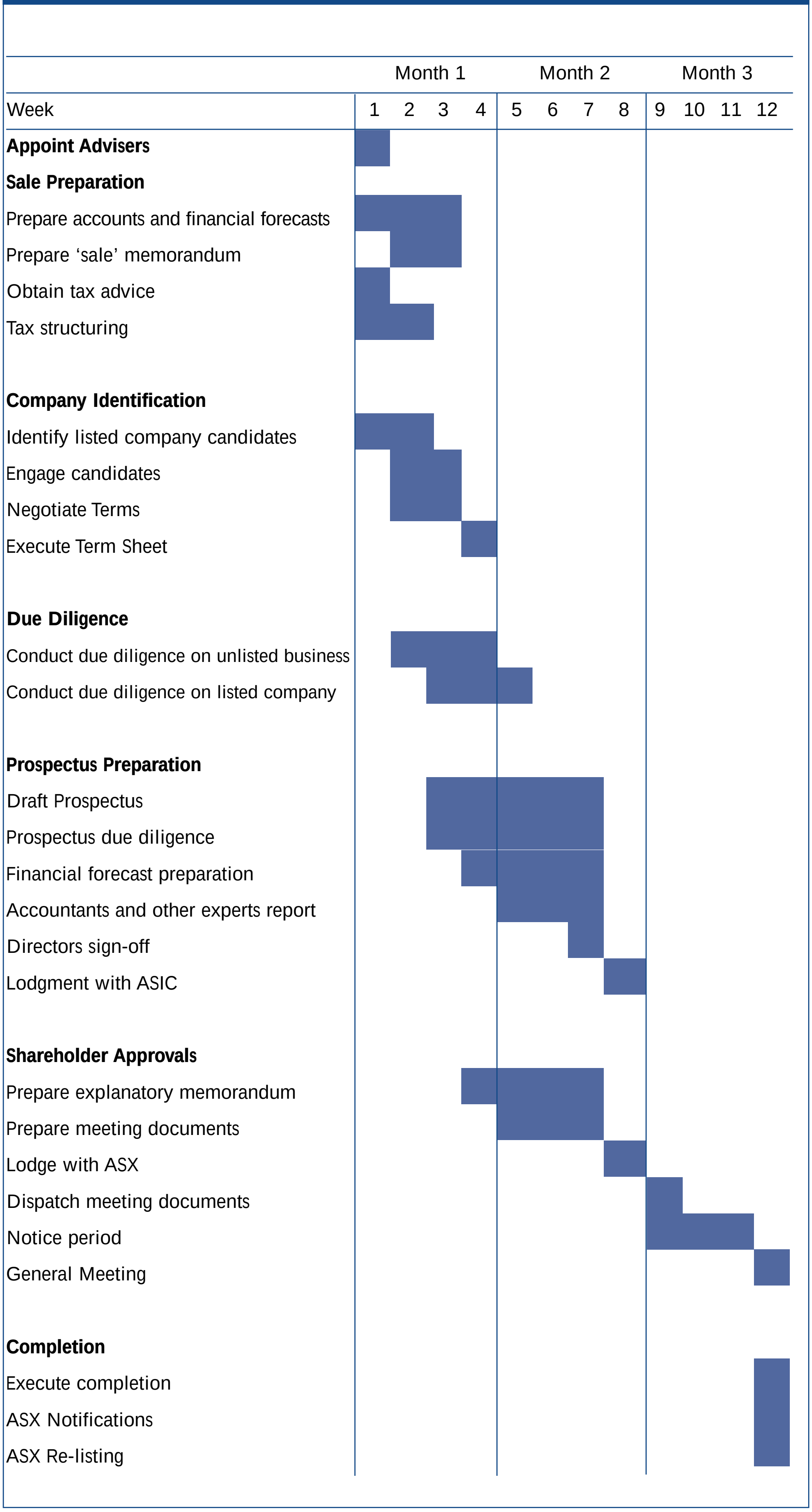
APPENDIX A **INDICATIVE BACKDOOR TIMETABLE—EXCLUDES CAPITAL RAISING**



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and look forward to further consultation with ASIC on this matter.

ASIC Australia-wide roadshow

The Institute once again facilitated a nation-wide FSRA Update forum over October and November on the subject of getting an Australian Financial Services Licence. ASIC is keen to encourage the industry to transition early, well before the deadline of 31 March 2004. Participants were able to question ASIC representatives and industry practitioners about the law and the application process.

Accreditation for 2003 and beyond

The Institute's postgraduate award courses were all reassessed for Australia-wide delivery during August and October by all the relevant state agencies, led by the NSW Department of Education and Training. The overall outcome was positive, with compliments on:

- the strength and professionalism of the application;
- the subject room facility;
- the quality of the learning product and its applied nature; and
- the observation of due process and accreditation procedure.

Subject to final and formal approval being received, the Institute has approval for these courses to run from the beginning of 2003 until the end of 2007.

To deliver open-entry accredited courses, the Institute is obliged to maintain its status of Registered Training Organisation. A self-assessment report submitted on 30 June 2002, demonstrated how the Institute meets the newly released Australian Quality Training Framework of standards. This having been completed, the Institute is also able to offer the training package qualifications which have been newly introduced for 2003:

- Advanced Diploma of Financial Services (Financial Planning);
- Diploma of Financial Services (Financial Planning); and
- Diploma of Financial Services for Stockbrokers.

The Diploma of Mortgage Lending, along with its Certificate IV version, is in the final stages of reaccreditation by the Vocational Education & Training Accreditation Board (NSW), a decision that will subsequently be recognised by all other jurisdictions, thereby allowing national delivery of these courses for up to three years. The Diploma of Financial Markets is also still awaiting a final decision as this edition goes to press. J

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Conclusion

While an IPO remains the favoured route for a public offering for companies with well established profit histories, backdoor listings offer a cost-effective and flexible alternative for smaller companies seeking to go public.

Historically BDLs have been seen as the 'poor cousin' of IPOs, however they are gaining acceptance as a viable alternative in the current market environment. Investors generally welcome strong businesses which are seeking a listing and which have been appropriately priced and structured.

From a regulatory process perspective, BDLs can be significantly cheaper and easier to implement than an IPO if a capital raising is not required and/or the shell is in the same industry. Care needs to be taken in selecting the appropriate 'shell' to ensure there are no contingent liabilities, that the 'shell' is appropriately valued (and the premium can be justified) and the shareholder register provides a suitable foundation going forward.

To help ensure a successful ASX listing, the complex transactional issues and subtle investment community issues must be addressed thoroughly and thoughtfully (see Table 3). Owners of businesses contemplating a backdoor listing need to appoint appropriately experienced corporate, legal and tax advisers to execute these transactions. J