Classifying joint venture arrangements (LR 10.1.3R)

When a listed issuer with a premium listing enters into a joint venture, it must classify this transaction under LR 10. We would expect the issuer to classify both sides to the transaction, so that both the disposal into the joint venture and the acquisition of an interest in the joint venture are classified.

To illustrate the approach, here is a basic example:

Listed issuer (L) intends to set up a joint venture with partner (P). Both L and P will transfer a subsidiary to a new company (newco) in return for a 50% interest in newco. The disposal of a subsidiary to newco should be classified by L in the normal way by applying the profits, gross assets and consideration to market capitalisation tests. As the disposal will result in deconsolidating the subsidiary from L’s accounts, the profits and gross assets tests must be run on a 100% basis.

Separately, L should also classify the acquisition of a 50% interest in newco. If this interest will not be consolidated into L’s accounts, the only tests applicable would be the gross assets test and the consideration to market capitalisation test.

We recognise that this is a simple example and, in reality, joint venture arrangements can be complex. The classification will depend on the facts of each case, including the value added by each partner and further funding commitments etc. As such, we would urge issuers and their advisers to contact us to discuss the correct application of the class tests to their specific transaction.

Please note that, as this is effectively one transaction, we would not expect these two sets of class tests to be aggregated, but the highest result from the tests will determine the overall classification of the transaction.

Classifying company/assets being acquired out of administration (LR 10 Annex 1)

It is often the case, where a business is acquired from liquidators or out of administration, that the company has not prepared accounts for some time and it may be unclear whether the issuer is acquiring a business or just assets. The issuer normally faces two problems: what numbers to use for the purposes of the class tests and which of the various class tests are relevant.
Relevant class tests depend on what the company is acquiring. If the issuer is acquiring a business then all tests are relevant. However, it is less clear when the issuer acquires assets, as often with an asset acquisition the profits test would not be relevant as there is not a relevant profit stream to measure.

The issuer and its advisers may need to consider the type of assets being acquired and whether or not on a look-through basis the issuer has effectively acquired the business. Often, for tax reasons, sales are structured as asset purchases despite the intention being for the issuer to operate the newly acquired entity as a business. In such circumstances it may be appropriate for the transaction to be treated as an acquisition of a business. Indications that the company is acquiring a business might be, for example, employee transfer and the transfer of contracts and licences. However, this is not an exhaustive list and we would encourage issuers to fully consider the substance and commercial reality of the acquisition, regardless of the strict legal form.

With regards to the financials to be used as a basis for the class tests, issuers should use figures obtained from the most recent set of accounts available for the target. Where these are significantly out of date, we would be happy to discuss alternative sources and the appropriateness of the tests where the results are considered anomalous. However, advisers are reminded that we would often consider the best indicator of the size of the business to be the accounts immediately before the company going into administration. In addition these accounts are often audited and considered to be more reliable than management information.

We would suggest that in circumstances where issuers are acquiring businesses or assets out of administration that they contact us as early as possible to discuss the issue.

**Assessing whether an item is exceptional a one-off cost for the profits test (LR 10 Annex 1 4R)**

Paragraph 4R in LR 10 Annex 1 sets out the methodology to calculate the profits test and clearly states that profits mean profits after deducting all charges except tax (profits before tax or PBT). Therefore generally the figure should be used when calculating the profits test. Therefore, adjusting the profit figure used for calculating the profits test by removing one-off costs is a modification of the applicable Listing Rule. As such, issuers and their advisers should always consult us before relying on such an adjusted figure except where the Listing Rules expressly state that they are not required to do so.

To help issuers and their advisers, including sponsor firms, we set out below our approach to assessing whether the profit figure used to calculate the profits test may be adjusted. Premium listed issuers and their sponsor should also take these matters into consideration when deciding whether the issuer may rely on the Listing Rules’ concession to modify the figures used to calculate the profits test in paragraph 13R in LR 10 Annex 1 without having to consult us first. Paragraph 13R of LR 10 Annex 1
1 permits a premium listed issuer to make certain adjustments to the profits figure without prior consultation with us. Issuers relying on this concession will need to obtain guidance from a sponsor under LR 8.2.2R because the transaction is or could amount to a class 1 or reverse takeover.

When considering whether to accept arguments that one-off costs should be excluded from profits, we make our decision on a case-by-case basis and take into account the specific circumstances of the issuer. Our decision-making process is informed by an understanding of whether or not the item in question is a genuine one-off cost and the sponsor’s view on whether, under the circumstances, the item should be treated as such.

In assessing whether the item is a genuine one-off cost, we may consider how the item has been presented in the accounts. However, just because an item has been presented as a one-off cost in an issuer’s accounts does not mean we will agree that it should be adjusted for in the profits test.

We will consider if the cost appeared in previous profit and loss accounts and whether there will be a similar charge in the following year’s profit and loss account. We are unlikely to consider items that are a reoccurring feature of an issuer’s business or are in the ordinary course of business as a genuine one-off even if they appear in the issuer’s accounts as an exceptional or extraordinary item. For this reason, we are very unlikely to accept arguments that it is appropriate to adjust for goodwill and impairment charges. If an issuer wishes to adjust for items associated with restructuring they, and where applicable their sponsor, will need to satisfy themselves that the cost is genuinely a ‘one off’ and not part of an ongoing restructuring strategy. Costs incurred in a restructuring that spans more than one financial period may not be one-off.

Sponsors should address each of the above issues when making a written query about the appropriate measure of profit, particularly when asking us to agree that a transaction is a class 2 transaction that would be a class 1 transaction if PBT were the profit figure used.

**Waiving the consideration to market capitalisation test (LR 10 Annex 1 paragraph 5R)**

We have regarded a company’s market capitalisation as significant in assessing the size and importance of a particular transaction. We are generally not minded to allow enterprise value to be used as a substitute test – the key reasons are:

a. the market capitalisation test is the primary indicator of a listed company’s size as at the date of the transaction;

b. it is the only test which does not use historic financial information;

c. if the company was to be sold or become the subject of a takeover offer, the market capitalisation is the starting point for valuation; and

d. arguments that market capitalisation is anomalous are inherently flawed as, if the
market is valuing companies incorrectly, this would suggest full information is not in the market.

We will continue to assess each request as it arises; however, we believe that our general approach continues to be appropriate.

**Class tests – figures used to classify assets and profits (LR 10 Annex 1 paragraph 8R(3))**

LR 10 Annex 1 paragraph 8R(3) states the class test numbers must be adjusted, where applicable, for transactions completed during the relevant financial period (i.e. the period used as the basis of calculation for the class tests) and for subsequent completed transactions for the issuer and the target. These adjustments are required for transactions which are class 2 or larger. We would not for instance expect adjustments to be made for transactions which have been announced but not yet completed.

To illustrate our approach, here is an example:

Listed issuer A is considering acquiring company B. A’s latest published annual audited accounts are to 31 December 2011 and B has a year end of 31 March 2012. A completed a class 2 acquisition of target C, after its year end, in February 2012. The figures for A must be adjusted before the class tests are performed so that the latest audited 12 month profit and asset figures for C are added to the profits and assets of A as extracted from the 31 December 2011 audited accounts.

If, however, A had disposed of C after its year end we would expect A’s financial information to be adjusted so that 12 months of profits and assets for C are deducted from A’s profits and assets before the class test is performed.
If B had disposed of its subsidiary D, prior to its year end, the profits for B must be adjusted by removing all profits for D from the full year profits for B to 31 March 2012. B’s year-end balance sheet will already reflect this disposal and no further adjustment needs to be made.

However, if B had acquired E before its year end those profits for E that have already been consolidated should be subtracted from B’s figures and the latest audited 12 months profits for E should be added back. B’s latest balance sheet will already reflect this acquisition and no further adjustment needs to be made.