Targeted stock – will it hit the mark?

Targeted shares have been used for several years in the US stock market as an alternative to traditional spin-offs by companies such as USX Corporation, General Motors, Ralston Purina and the Pittston Company, and the proposed issue by RJR Nabisco which was later withdrawn.

In Australasia the concept had been largely dormant until the announcement by Fletcher Challenge in New Zealand in October 1993 that it would be seeking shareholder approval for a pro-rata distribution to shareholders of new targeted shares linked to its solid wood plantation business.

The interest sparked by this announcement warrants an examination of the concept and its viability in the light of current market conditions and the regulatory framework in Australia.

What are targeted shares?

Targeted shares are securities issued by listed companies, usually conglomerates, with the securities' return linked directly to a particular operating unit of the company. The targeted division is not created as a separate legal entity or structurally separated from the existing group, although it has notional independence and its own notional balance sheet. The parent company's title to the assets is unchanged and lenders to the parent are still supported by these assets and the cash they generate.

Performance of the new targeted securities reflects the performance of the targeted division, rather than the group to which that division belongs. Dividend entitlements for the shares are based on the financial performance of the targeted business.

To establish the targeted share program the parent needs to define the targeted business adequately and allocate the various elements of its balance sheet and profit-and-loss statement between the targeted division and the remainder. Procedures must be established for making these allocations.

The American practice has been to set allocation policies so that financial ratios for the targeted stock mimic those ratios of companies which operate solely in the targeted industry, for example in setting the level of group debt to be allocated to the target unit.

Targeted shares are also known as "tracking stock", "alphabet stock" or "letter stock". The concept is illustrated in the diagram.

The applications

The concept could be used to cre-
ate “pure play” investment vehicles between:
- disparate business lines, as in Figure 1;
- foreign and domestic businesses — for example, a company could issue targeted shares linked to its Asian operations; or
- regulated and unregulated businesses.

The benefits

The proponents of targeted shares put forward the following arguments in favour of such programs:
- Crystallisation of value in a company for existing shareholders has traditionally been achieved by spin-offs or by selling parts of it. These deals encourage market recognition of the “free-standing” value of particular divisions.

However, targeted share programs differ in that they allow the originating company to benefit from the “sum of the parts” argument without relinquishing ownership or the benefits that go with ownership of those parts. Synergies that made conglomeration attractive to the company in the first place can be maintained.

The typical company which would consider a targeted share program would be one with an operating division whose business is clearly distinguishable from the other businesses of the parent company and whose price-earnings multiple is significantly higher or lower than that of the other businesses.

The arrangements also enable the individual business units to continue to benefit from the credit-worthiness of the consolidated enterprise in its debt-financing activities. Creditors who might oppose a spin-off because of the risks of a deterioration in the financial strength of the parent are less likely to oppose a targeted stock program. The position of creditors and providers of debt to the group is unchanged.

The share issue is generally not a taxable event for the issuing parent, since the two resulting share classes are still legally connected. There are no tax or stamp-duty implications because there has been no sale or change in structure.

In preparing a targeted stock program, issuers must ensure that the targeted shares will be considered parent stock for tax purposes. The parent would then not recognise a gain or loss in a public offering of the specified division-linked stock, nor would the parent or the shareholders recognise any gain or loss on a distribution of the stock to the parent shareholders.

The program leaves the parent with flexibility in any future restructuring. The whole transaction can be unwound into parent-company stock.

The issue of targeted stock enhances the ability of management to devise incentive plans for employees of a particular unit. Managers and employees can be motivated by the results of their particular division, rather than the overall group, over which they have little control.

Corporate taxes are still payable at the overall level and tax-loss carry-forwards from one business can shield income from the other businesses.

“Control”, for the purposes of consolidated accounts, is maintained and the parent may continue to consolidate the specified unit in group accounts.

Targeted shares should appeal to local and international investors who are seeking “pure play” shares in particular industries.

As well as providing an alternative to spin-offs, targeted shares can be used in mergers and acquisitions. They can be used to assist a low P/E company to acquire a company with a high P/E ratio. For example, General Motors used class-E stock to acquire Electronic Data Systems in 1984 and class-H stock to acquire Hughes Aircraft in 1985 (these transactions gave rise to the terms “alphabet stock” and “letter stock”). Alternatively, they might pro-

provide a takeover defence by realising the stand-alone market values for businesses that are undervalued when capitalised at the parent company’s P/E ratio and by increasing the number of voting shares.

They provide an innovative way to raise extra capital requirements for expansion or recapitalisation.

Despite these advantages, complex legal issues need to be addressed when contemplating targeted shares.

Legal rights

The key rights of targeted shares will include the following:

**Right to dividends**: Where dividends are to be paid, they will relate to, and be limited by, the income and surplus of the specific division, as determined by allocation policies.

The articles of association of the issuing company will need to be re-drafted to set out allocation and dividend policies. Payout policies for shares linked to a targeted division would typically be based on those of comparable independent companies operating solely in that sector.

It is not possible to entirely insulate the profits of the targeted division from the financial position of the rest of the group. This follows for two reasons:

**Section 201 of the Corporations Law** provides that no dividend can be paid except out of profits, including retained profits (or, in limited circumstances, out of the share premium account pursuant to section 191). Dividends cannot be paid out of capital. Accordingly, the issuing company may not distribute the profits of the targeted division to holders of targeted
shares if, for any reason, the issuing company does not itself have sufficient available profits. For example, where there are large losses in the residual division of the group and a small profit in the targeted division, target shareholders would nonetheless be precluded from receiving a dividend despite the profitability of the business to which they are linked.

In determining whether to pay a dividend, and its amount, the directors must consider the interests of the company as a whole. Where directors consider that a particular distribution of profits to target shareholders would not be in the interests of the company as a whole, that distribution may be reduced or cancelled, regardless of the profitability of the division to which the targeted shares are linked.

In addition, the parent will remain subject to overall restrictions on dividends imposed by law, debt instruments, and other contracts.

Voting rights: In most instances the targeted stock and the parent's ordinary stock will vote together as a single class. However, provision may be made, through the articles of association, for different voting rights for the different classes of shares.

The articles might provide that the voting rights attached to targeted shares are "weighted" according to a formula—for example, the market value of targeted stock relative to the market value of the other class of share at a specified time.

It is also possible for the enabling documentation for the program to set out additional or exclusive class votes on particular matters; eg, a vote on the use by directors of proceeds derived from the sale of a portion of the targeted division for another business segment of the parent.

It is possible for the parent to retain a part-interest in the targeted division for the benefit of holders of the reclassified original ordinary shares. Where this happens, there is a question of whether the retained interest is to have any voting power and, if so, how and in what circumstances this is to be exercised.

Rights on a winding-up: Targeted shares provide no direct ownership of the assets in the targeted division. They are securities in the parent which merely reflect the performance of a particular segment. They provide no insulation from risk emanating from elsewhere in the group.

Creditors are creditors of the group, not creditors of the targeted division, and they will have access to assets of the targeted division as security.

This is a difficulty with the targeted share concept. In a winding-up, a liquidator would be at liberty to deal with the assets of the issuing company, including the assets of the targeted division, subject to preferred rights. It is possible that the targeted subsidiary, or the assets of that subsidiary, could be disposed of by a liquidator before the disposal of other assets.

In some circumstances, anomalous situations could arise. For example, if the issuing company has a negative net worth on a winding-up, the holders of targeted stock would not be entitled to any payment from the company, even if the targeted division itself had surplus of assets over liabilities.

Implementation

An issue of targeted stock can be made either by a bonus issue or by a share split with a share reclassification. The mechanics of the issue will differ depending on which route is followed and may require shareholder approval for changes to the articles of association.

Generally, given the innovative nature of any new targeted stock proposal, it would be prudent to discuss the proposal confidentially with the Stock Exchange before any announcement, to ensure that it presents no difficulties. The exchange should also be consulted about the specific rights to be attributed to the targeted stock and residual shares. A detailed information memorandum on the activities of the targeted division and the share structure should be distributed to shareholders before any meeting at which approval would be sought.

Management issues

To ensure that as far as possible the value of the new stock is related to the value of the targeted subsidiary, it will be essential to consider including rules or guidelines in the articles of association to insulate the targeted subsidiary or division from the fortunes of the rest of the group. This is likely to be one of the most difficult issues in determining the terms of the targeted shares.

The establishment of this "ring fence" might involve ensuring that dealings between the targeted division and the rest of the group are at arm's length. This would encompass any transfer pricing or any internal lending or use of surplus funds.

Right of shareholders to complain:
The issue of targeted stock involves the creation of a new class of shares where the interests of the holders may diverge significantly from the interests of the holders of residual equity. This will increase the risk of shareholders complaining about particular decisions of the directors.

Takeovers:
In normal circumstances, each dollar invested in a company buys the same voting power. The takeover legislation does not contemplate a situation other than one vote for one share. However, the result of linking voting rights to market value is that the same holding of "voting shares" (be they targeted or residual shares) can give different voting rights. Depending on special rights set out in the articles, a shareholder who holds targeted shares, where the market value of those shares exceeds the market value of the same number of residual shares, will have more voting power than if he held only residual shares.

A potential acquirer of a targeted division could not achieve control by purchasing the shares relating to that unit unless the purchaser also gained control of the parent.

Unwinding the program

In designing a targeted stock program, it would be prudent to provide for a possible later decision to reverse the creation of the targeted shares or to sell the assets of the targeted division. Ways in which target stock can be extinguished, so that the company can return to a conventional capital structure, include:

Redeemable targeted shares:
Targeted shares could be issued on terms under which the company may redeem them as the board of directors determines. To follow this course, the issue of targeted shares must be made as an issue of preference shares.

Since changes to the tax legislation in 1987, redeemable preference shares can sometimes be unattractive from a tax viewpoint. Any dividend paid on these shares may be classified as a "debt dividend" and taxed in the hands

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of shareholders as interest income, while the company will be unable to
claim the dividend as deductible inter-
ests expense.

Convertible target stock: Another
possible type of issue for targeted stock
is that the company may, at its option
after a specified future date, convert
fully paid-up shares of its capital into
fully paid-up shares of another de-
nomination, eg. targeted stock into
residual shares. This avenue has positi-
tive tax implications, as it may be pos-
sible to avoid a “disposal” in terms of
the capital gains regime. However,
such a provision may put at risk one of
the underlying benefits of target shares
— the “pure play” nature of the stock.

Will targeted shares succeed
in Australia?
The success of targeted share pro-
grams in Australia will depend on
whether the market accepts what these
schemes are attempting to achieve: attributing
the equity characteristics
of shares in an independent company,
operating solely in a specified indus-
try, to the shares of an issuing company
which are linked to a particular
division of that company.
The market will have to be sold on
the integrity of the allocation proc-
esses and comforted about the global
nature of liabilities. There must be no
perception in the market that there is
a possibility of the targeted division
being dragged down by the residual
company.

Nevertheless, as US experience has
shown, for companies seeking to max-
imise the value of their equity, tar-
gested shares are a potentially attrac-
tive option.

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