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Australia

PRIVATE EQUITY

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This country-specific Q&A provides an overview of private equity laws and regulations applicable in Australia.

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AUSTRALIA
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1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

In 2022, PE raised record funds of A$9 billion to deploy in investments in Australia. During this period, 135 PE deals were completed, with take-private deals accounting for over half of the total deal value for all PE-backed transactions.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

The aim for a 'clean exit' by private equity sellers to effectively redistribute capital to investors following exit is a significant factor distinguishing deals with sponsors from those with trade sellers. While traditionally most prevalent among financial sponsor backed companies, this trend of seeking a clean exit is also becoming more prevalent among trade sellers.

Private equity sellers generally prefer the locked box pricing method for its certainty in pricing at the time of signing, whereas trade sellers, though not fundamentally against this method, may find a locked box mechanism less feasible for certain transactions that they are involved in (eg corporate carve outs).

With respect to warranties, selling sponsors typically limit themselves to fundamental warranties regarding their capacity and ownership, leaving business warranties to be provided by the management. Conversely, trade sellers will typically be required to provide both fundamental and business warranties, as management teams do not usually receive substantial benefits from these transactions. Trade sellers may additionally provide a tax indemnity. It is important to note that warranty & indemnity (W&I) insurance has become highly utilised in transactions involving both private equity and trade sellers.

Regarding non-competition or non-solicitation agreements, buyers should not expect substantial assurances from private equity sellers. On the other hand, trade sellers are expected to provide some level of post deal protection, subject to certain agreed exceptions to allow trade sellers to continue conducting any of their other existing businesses.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

Shares are transferred by the transferor and transferee of shares signing the required instrument of transfer, being a share transfer form. A proposed transfer must be approved by the board of directors of the company. The transfer will be legally effective once the company's share register is updated to reflect the transfer. A new share certificate is issued in the name of the transferee, with the share certificate(s) held by the transferor cancelled. There are no notarisation or apostille requirements.

Certain regulatory requirements may prevent shares being validly transferred until relevant regulatory approvals are obtained (eg foreign investment approvals, competition/antitrust clearance).

The transfer of shares generally will not attract stamp duty or other transfer taxes, subject to certain exceptions – most notably where the relevant company in which the shares are being transferred has freehold or leasehold interests in real property (including fixtures and fittings) that exceed certain value thresholds.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

Financial sponsors typically offer reassurance to sellers in transactions where the buyer is a special purpose vehicle by providing an equity commitment letter at the time of signing. This letter assures the seller that the sponsor's fund(s) will supply the necessary equity financing to the acquisition vehicle to cover the equity portion of the purchase price. Furthermore, it is common for sponsors to commit to compensating the seller for any damages incurred if the transaction fails to close due to a breach of the purchase agreement by the buyer.

Where a fully committed debt facility is not already in place, a debt commitment letter may be presented to demonstrate the availability of adequate debt funding for the acquisition vehicle. This is often backed by an interim facility agreement, which the debt provider is prepared to execute promptly if needed. Sponsors may utilise fund bridging facilities where available or otherwise take a strategic approach in competitive auction scenarios by initially underwriting the entire purchase price with equity at the signing stage, and then arranging for debt financing in the period between the signing and completion of the transaction.

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

In Australia, private equity funds often prefer locked-box consideration structures, where the consideration is determined before completion based on an agreed balance sheet of the target company, with safeguards against value leakage after the reference date. Pricing certainty is preferred by sponsors when both acquiring assets and on disposal of assets (particularly in a competitive sale/action process where a locked-box mechanism more readily allows like-for-like comparison of offers made by competing bidders).

Both sponsor sellers and management sellers are required to provide no leakage indemnities to a buyer.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

Warranties

The common approach for allocating risk between buyers and sellers involves incorporating warranties and indemnities into the sale agreement. In a typical private equity transaction, the sponsor sellers offer a limited range of warranties, such as those related to title and capacity, solvency, share capital, and legal compliance.

In transactions more favourable to buyers, the buyer may request warranties associated with the information provided by the seller during the due diligence process. Warranties are given at signing and repeated upon completion.

In addition to these warranties, management sellers usually offer a comprehensive set of business warranties, covering areas like financials, tax matters, assets and liabilities, intellectual property, data protection, and disputes. The sale agreement often contains a general indemnity to cover losses arising from a breach of warranty, as well as a tax indemnity addressing tax liabilities prior to completion.

Buyers can also negotiate specific indemnities for known issues discovered during their due diligence.

Limitation of liability

Another typical way to allocate risk between buyers and sellers is by incorporating liability limitations in the sale agreement. Sellers' liability is usually capped at the purchase price for title and capacity warranties or a percentage of the purchase price for business warranties and other commitments, generally ranging from 20% to 60%. When warranty and indemnity insurance is used, the management team's remaining liability can be capped at a significantly lower amount. Business warranties and tax warranties are subject to disclosure before signing but not between signing and completion.

Liability under a no-leakage indemnity, tax indemnity, or specific indemnity is generally not capped, although sellers will attempt to limit liability for specific indemnities where the underlying risk is reasonably quantifiable. De minimis and basket provisions on claims, excluding fundamental warranties, leakage claims, or indemnities, are typical and range from 0.05% to 0.1% and 0.5% to 1% of enterprise value, respectively. Time limitations on claims are generally seven years for fundamental and tax warranties, 24-36 months for business warranties, and 3-12 months for leakage warranties. However, no limitations will apply in cases of fraud.

7. How prevalent is the use of W&I insurance in your transactions?

The use of buy-side warranty and indemnity (W&I) insurance by sponsors in private equity transactions remains strong and is often accompanied by no and/or limited recourse for the sponsor seller. De minimis thresholds usually range from 0.05% to 0.1% of the deal value, while retentions usually range from 0.5% to 1% of the deal value. Policy limits vary depending on transaction size and the parties' risk tolerance, but they typically range from 10% to 30% of the deal value.

Customary exclusions from W&I insurance policies include known risks, fraud, purchase price adjustments and earn-outs, secondary tax liabilities, environmental liabilities, underfunded pension plans (if any), and employee underpayments. The policy period typically extends up to seven years for title and capacity warranties and tax warranties, and three years for other warranties.

The pricing for W&I insurance is usually divided into four main components: (i) the premium, which generally amounts to 1% to 3% of the policy limit; (ii) underwriting fees, ranging from AUD 25,000 to AUD 50,000 (or more for larger or more complex transactions, including where multiple bidder 'trees' may be required); (iii) broker fees, which vary from 0.5% to 1.5% of the policy limit; and (iv) an applicable taxes and duties.

8. How active have financial sponsors been in acquiring publicly listed companies?

Financial sponsor attention in the Australian market is predominantly focused on private transactions, although public-to-private deals have consistently played a significant role in the market, with this trend continuing over the last two years. However, despite decreasing public market valuations and a weakening macroeconomic environment, a challenging deal landscape during 2022/2023 has seen sponsor bidders face difficulties executing certain high-profile public-to-private transactions and otherwise experiencing considerably longer completion timelines.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

There have been notable developments in the expansion of Australia's foreign investment regime, as well as the types of transactions subject to it. These developments include:

- the introduction of a new national security test, the concepts of 'national security business' and 'national security land' and the 'call in' and last resort powers for the Australian Treasurer (January 2021);
- expansion of the definitions of 'critical infrastructure asset' and 'national security business' and, in turn, the scope of transactions requiring FIRB approval (December 2021);
- changes to the threshold interest in an Australian media business that requires mandatory approval (first half of 2022);
- the doubling of filing fees for applications for foreign investment approval, increasing the maximum fee payable for a single action from A$522,500 to A$1,045,000 (July 2022);
- the indexing of the monetary screening thresholds on 1 January 2024 (as done on 1 January of each year); and
- increased reporting obligations for foreign persons on or after 1 July 2023 by notification to the ATO of certain events (whether or not such events are subject to FIRB approval) in connection with the proposed new Register of Foreign Ownership of Australian Assets.

Anticipated developments include the Treasury's increased focus on non-compliance by foreign persons with their statutory reporting obligations that may result in the increased issue of infringement notices and pursuit of civil penalties for contraventions.

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

In cases where a financial sponsor is the acquirer in a merger or acquisition, the process of obtaining merger clearance is multifaceted. It begins with comprehensive market due diligence, where the sponsor assesses potential anti-competitive concerns, such as market share and industry competition. A merger clearance strategy is then formulated, often involving decisions on whether to file pre-merger notifications with the competition regulator, the Australian Competition and Consumer Commission (ACCC). This stage is characterized by proactive engagement with ACCC, including detailed submissions and responsive communication.

Key to this process are those provisions within transaction agreements which outline relevant regulatory clearance conditions precedent, required efforts for clearance and deadlines. Where competition concerns are identified, the financial sponsor may propose remedies, such as divestitures, to mitigate these issues. Throughout, the involvement of legal and financial advisors specializing in competition law is crucial, providing guidance on regulatory compliance and assisting in strategic planning.

11. Have you seen an increase in (A) the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside; and (B) 'continuation fund' transactions where a financial sponsor divests one or more portfolio companies to funds managed by the same sponsor?

Most PE transactions involve control investments, however there has been a recent increase in interest for minority investments or co-investments to assist financial sponsors in managing market risk. Minority investments of this nature are typically structured as equity investments, although, depending on the size, scale and nature of the activities of the target company, down-side protections are often included – typically through the issue of equity carrying preferred rights on a liquidity event.

When a financial sponsor takes a minority position, they may have less control over the selection of the acquisition structure. Nevertheless, the primary factors influencing the choice of acquisition structure include:

- tax considerations for the financial sponsor, the target company, the sellers, and/or the management team;
- requirements of lenders financing the transaction, such as structural subordination; and
- the target company's size, industry, assets, and liabilities.

In a minority position, financial sponsors might also explore co-investment or consortium structures with one or more other institutional investors.

12. How are management incentive schemes typically structured?

In Australia, management teams are often incentivised through an employee equity scheme, which allows for the issuance of shares or options to acquire shares in the target company.

In an Australian private equity transaction, the management team is typically allocated an equity share ranging from 5% to 20% of the target company's total equity. A higher allocation is common when the management team is instrumental in driving the business's growth and success. Time-based vesting is frequently used, with vesting periods generally spanning between two and five years. Moreover, performance-based vesting can be introduced, often tied to financial objectives like revenue or EBITDA growth, or operational benchmarks. Good leaver and bad/early leaver regimes apply in almost all cases.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

Participants in equity incentive schemes typically face taxation on revenue account based on the difference between the market value and the value of their options or shares. However, if certain conditions are met, the tax liability may be deferred to a later date. Generally, the participant bears the income tax consequences, and no withholding applies.

Alternative structures, such as 'loan-funded shares' or 'premium-priced options' are commonly used in private equity. If structured correctly, the 'employee share scheme' rules should not apply to these interests, and they will be held on capital account.

Phantom or shadow equity is not frequently used in Australia, as payments under a phantom equity plan are generally treated as salary and wages, with associated withholding and superannuation obligations.

When management rolls over into a new acquisition structure, consideration must be given to the availability of capital gains tax 'rollover relief' (ie the deferral of tax liability on disposal of equity currently held). Managers should ensure the transaction does not inadvertently trigger an unfunded Australian tax liability, particularly when no cash component is available to fund any such liability during the rollover. Where managers sell their interests and do not reinvest in a new structure, relevant Australian tax considerations include determining whether the gain is taxable on capital or revenue account and whether a capital gains tax discount is available (eg 50% of the amount of any gain is not subject to tax where the seller is an individual or trust that has held such interest for at least 12 months prior to disposal).

14. Are senior managers subject to non-competes and if so what is the general duration?

In the event that a shareholder agreement contains non-compete or non-solicit clauses, these provisions must not impose an unreasonable restraint on trade. As such, they need to be reasonable, serve to safeguard a legitimate business interest and otherwise not be contrary to public interest. Australian courts have the authority to modify overly broad non-compete or non-solicitation provisions, effectively “reading down” these terms to render them enforceable.

With respect to duration, what is considered reasonable will depend on the relevant circumstances, although restraint periods apply during the period that the manager holds shares or options and for up to 24 months following disposal for key/senior management and between 6 to 12 months for other management.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

The financial sponsor will typically have veto and/or specific approval rights over all material and/or non-ordinary course matters in relation to the business, allowing sponsors to influence material business decisions if required. However, when a financial sponsor holds a minority position, their veto rights are restricted to more critical decisions that affect the company and protect the value of their investment. Examples of such decisions include changes to share capital, mergers and acquisitions, alterations to the company’s dividend policy, changes in key management, modifications to the budget or business plan and changes to the leverage policy of the company.

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

Management pooling vehicles (MPVs) may be employed when there are numerous employee shareholders. MPVs serve to streamline the shareholding structure by consolidating multiple individual employee shares into a single entity. This consolidation not only simplifies certain transactions, such as acquisitions, but also aligns the interests of employee shareholders.

MPVs are also advantageous for efficiently administering equity incentive schemes, offering a centralized approach to managing shares or options. Additionally, they can provide tax efficiency, though this depends on their specific structure and the tax circumstances of the employees involved. In exit scenarios, MPVs facilitate smoother ownership transfers, handling transactions at the entity level rather than with each individual shareholder.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

Debt finance for funding private equity transactions primarily comes from international and domestic banks, as well as private credit, non-bank, and institutional lenders in recent times. Acquisition financing packages usually comprise an amortising Term Loan A, bullet Term Loan B, a revolving facility for working capital, and occasionally, capital expenditure/acquisition facilities when needed. Syndicates of financiers often provide larger loans.

The syndicated loan market experienced a new record in 2022, with AU$140 billion in loans, as Australian sponsors significantly favoured syndicated loans over corporate bond issuances. Mezzanine loans are frequently included in larger acquisition financing packages, with the mezzanine funding typically positioned at a higher level than the borrower or obligor group for senior loans.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

The Corporations Act prohibits a Company from financially assisting a person to acquire shares in the Company, without having first obtained shareholder consent, subject to certain exceptions (including a material prejudice test).

Financial assistance requiring shareholder consent is most commonly seen where banks are lending to the purchaser to fund the acquisition of shares in the company and require security over the target company and its assets following completion of the acquisition.

To deal with this, a shareholder approval/’whitewash’ procedure is undertaken and requires the shareholder approval by the target company and its holding company. Explanatory memoranda are required to be prepared and lodged with the Australia’s corporate regulator, ASIC, before being dispatched to shareholders, with a mandatory minimum 14 day period required before shareholders may vote on the relevant resolution. Where the target company is a subsidiary of a listed company, approval by the shareholders of the listed company approval is required.

The typical approach is for the whitewash procedure to be undertaken post-transaction, meaning that the relevant financiers will not have security over the shares or assets of the target company. Banks can usually be persuaded to accept these arrangements, with sponsors establishing their acquisition structures to consist of multiple holding entities interposed between the target company, with security provided over the holding structure for the interim period. In the other cases, the whitewash will need to be done as a condition precedent to financial close.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

While there is not a universally standardised credit agreement for financings, industry-standard templates are commonly used as starting points. The extent and materiality of negotiations on these agreements vary greatly, influenced by the transaction's complexity and size, the parties' nature and bargaining power, market conditions, the industry in which the target company operates and the specific risk profile of the deal. Larger, more complex transactions, or those involving well-established entities, often see more extensive negotiations, particularly on key terms such as covenants, interest rates, and repayment schedules.

Additionally, prevailing market trends and legal and regulatory requirements play a crucial role in shaping these negotiations. Agreements are typically customized to meet the specific needs and objectives of the transaction, requiring adjustments to standard templates. Given these variables, the level of negotiation can be significant, with parties frequently engaging legal, financial and credit advisors to ensure that the credit agreement is not only tailored to the transaction but also complies with Australian financial laws and aligns with optimal financial structuring.

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

Key areas of negotiation between borrowers and lenders have been predominantly shaped by evolving economic conditions. A central point of these negotiations has been the interest rate on loans. Borrowers, facing a fluctuating economic environment, have actively sought to negotiate lower interest rates, leading to significant reductions and consequent savings on repayments. Another major area of negotiation has revolved around the flexibility of loan repayment terms. Given current financial uncertainties, borrowers have increasingly pursued options for more lenient repayment schedules or deferred repayments (including PIK repayment arrangements). This trend reflects a growing need among borrowers for adaptable loan structures that can accommodate changes in financial circumstances.

These negotiations have been reflective of both the broader economic climate and individual borrower circumstances, with a mutual effort from both borrowers and lenders to find workable solutions amidst changing market conditions.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

The private credit market has emerged as an essential source of debt financing, offering flexibility and customisation. Loans from private lenders often deliver a higher quantum and more flexible terms compared to the syndicated bank market. This growth in private credit has led to the emergence of alternative financing packages, such as unitranche loans, which combine senior and subordinated loans into a single loan and have gained popularity.

Rising demand has prompted alternative lenders, institutional investors, and credit funds to allocate capital to private debt strategies, further driving growth in the acquisition financing market.

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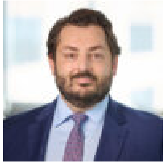

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