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Why Stapled Securities?

FRDP 2012 – 3

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Australia is relatively unique internationally in permitting business entities to issue stapled securities, which are used by many A-REITS and Infrastructure Funds. In this FRDP the merits of such structures are examined, reasons for Australia being an international outlier in permitting such structures considered, and the question posed of whether that is an appropriate regulatory approach.

Introduction

Stapled Securities involve the stapling together of separate securities such as a share in a company and a unit in a trust which cannot be traded separately. This type of structure, of which there are many variants, has been used quite intensively in Australia by A-REITS (real estate investment trusts) and infrastructure funds.[1]

At the end of 2011, 15 out of 18 listed infrastructure funds and 28 out of 49 listed A-REITs had stapled security structures. The major banks have also previously utilised stapling in the construction of non-innovative tier one (NIT-1) capital instruments, such as StEPS (issued by ANZ), PERLS (CBA), SPS (Westpac) and NIS (NAB).

But stapling is relatively uncommon in the rest of the world. In mid 2011 the Canadian authorities introduced new tax legislation to prevent emerging use of stapled structures by REITs, and the USA has prevented such structures since 1984. There are few instances of stapling to be found internationally, although a number of Malaysian banks had used stapling to create NIT-1 capital instruments, and there is some emerging interest in stapling in Asia. In 2011 HKT was spun out of PCCW on the Hong Kong exchange as a stapled structure, while in May 2012 there were media reports that Formula One is to undertake an IPO on the Singapore exchange using stapling.

Stapling of securities is not, at first glance, a value adding activity, because it reduces investor choice. Investors should prefer non-stapled securities which can be traded separately, enabling them to choose the combination of the securities which best meets their individual preferences - including tax positions. (This is sometimes referred to as a “clientele” effect).

[1] More detail on stapled securities can be found in Kevin Davis “Stapled Securities: Antipodean Anomaly or Adaptable Innovation”, which can be downloaded from the ACFS web site.

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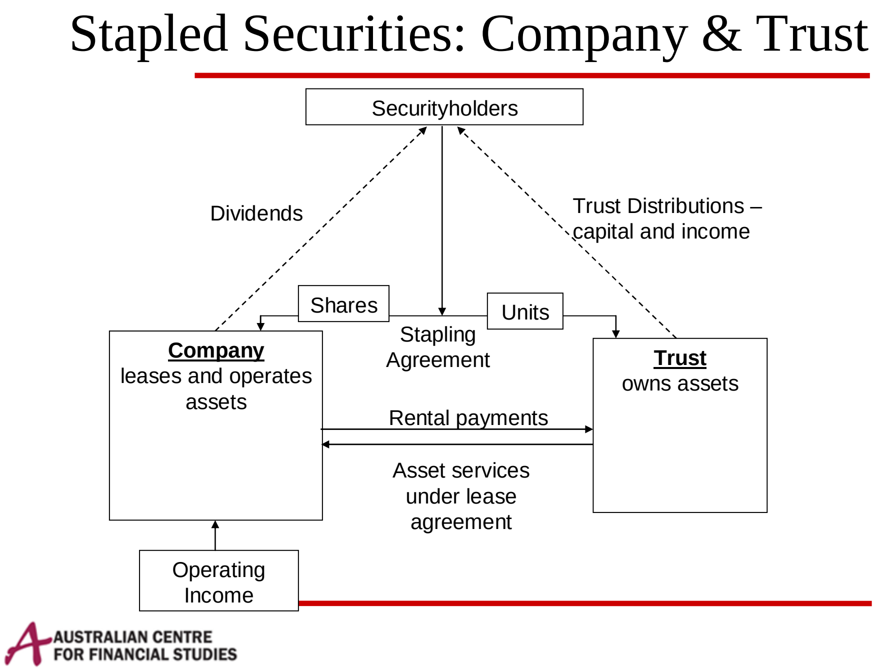
Hence, it needs to be asked how stapling of securities might create value, and why the Australian authorities are willing to allow stapling in contrast to most of their overseas counterparts.

Value creation by stapling

Stapling of securities requires some form of contractual relationship between the entities whose securities are being stapled. At the simplest level, the securities could be issued by the one entity, such as the debt security (loan note) and equity structure used in the spin-off of Envestra from Boral in 1997. Another possibility is for one security, such as a preference share, to be issued by a parent company and the other, such as a loan note, by a subsidiary, such as in the creation of NIT-1 stapled securities by the Australian banks. A third approach is for contractual operating agreements between a company and a "related" trust (or several trusts) to underpin the stapling of the securities. In that latter form, the trust might own physical assets and lease them to the company for use in generating income. Figure 1 illustrates.

Figure 1: Stapling – A Simple Example



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The most obvious rationale for stapling is tax arbitrage. If stapling reduces the total tax bill paid on income generated by a particular business activity, stakeholders (other than government) benefit. Figure 1 provides a simple illustration of how this can work. Because the trust is a "pass-through" entity for tax purposes, income it receives is not subject to company tax as long as paid out to unit holders. Consequently lease payments by the company reduce its taxable income and company tax paid, and increase the income of the trust on which company tax is not paid.[2]

In the case of the Australian banks, the structures were designed to reduce company tax paid to foreign governments, via tax deductibility of interest payments issued by the subsidiary. While consequently higher company tax was paid in Australia, this also generated offsetting franking (tax) credits for investors.

Other potential sources of value creation result from possible market imperfections or investor behavioural biases. Constraints on companies paying dividends when unprofitable may mean that trusts are better able to distribute available cash flow to investors. Attaching franking credits to stapled securities which are more "debt-like" may appeal to low tax rate investors who do not want increased equity exposure. Higher leverage might be possible through the use of "internal" debt provided via stapled securities without creating owner-creditor agency problems, and high pay-out ratios may reduce owner-manager agency problems by preventing managers squandering free cash flow.

The ASX practice of measuring market capitalization by the aggregate value of stapled securities rather than the equity component alone also means that size of the business is overstated relative to a similar entity with separate equity and debt. This can bring advantages where fund managers invest primarily in larger capitalization stocks.

But the possibility that such structures are established by the sponsors of the business involved to extract wealth from investors and consolidate their control over the business should not be discounted. Virtually all such structures are opaque and complex, and result in governance arrangements which give investors limited control rights. Sponsors of the business (such as investment banks) can generate fee income streams as the responsible entity for the trust and from providing external management and other services for the operating company, and may profit from selling assets into the structure.[3]

Unfortunately investors, and advisors, do not appear to fully understand the nature of the cash flow streams which they receive from such structures. Typically some part of that cash flow will

[2] Similar effects could be achieved by the trust making a loan to the company, which buys the assets, with interest payments from the company to the trust reducing company tax paid. There are a number of complicating factors in design of such arrangements including efficient use of depreciation tax shelters. The imputation tax system used in Australia also complicates the analysis – as discussed later.

[3] Details of external management agreements and fee structures between the controlling entities and the stapled structure are generally not available.

be a return of capital – but the total cash flow is generally described as a “yield”, causing stapled securities to appear to be high (and stable) yield investments. This exploits a well known behavioural bias of investors of unwillingness to consume out of capital rather than income. And this is amplified by the unusual practice, accepted by the ATO, of referring to the capital return component as “tax deferred income” – rather than as a return of capital.

Why is Stapling a predominantly Australian phenomenon?

The rationale for preventing stapling in most other countries is straightforward – to prevent tax arbitrage which reduces company tax collections. However, Australia operates a dividend imputation tax system. If shareholders are Australian residents, the payment of company tax is “washed out” by tax (franking) credits attached to dividend payments and which reduce tax paid at the investor level.

Consequently, the dividend imputation tax system means that the incentive for the Australian government to legislate against such structures is much reduced.[4] The main cost to government tax revenue arises from distributions to foreign shareholders – where otherwise the franking credits arising from company tax would not reduce individual tax.

And, paradoxically, given the popularity of stapling in Australia, the imputation tax system should also reduce the incentives for Australian business entities to adopt such structures in order to avoid company tax. But if overseas investors are a significant clientele, there may be some tax arbitrage involved.[5]

Whether the Australian government should review whether stapled security structures should be allowed is an open question. It is possible that tax revenue is adversely affected, although details on foreign ownership of stapled securities are not easy to come by. But as an example, assume a ball-park guesstimate of distributions on stapled securities of $5 billion p.a. which has largely avoided payment of corporate tax. If foreign investors receive $2 billion of that amount, there is $0.6 billion of company tax avoided, which would not have been offset at the investor level by use of attached franking credits.[6]

Operators of stapled structures would no doubt argue that there are real efficiencies associated with stapling. But whether any such perceived benefits are truly social benefits, private benefits at the expense of taxpayers, or involve wealth transfers to operators of such structures and insiders at the expense of third party investors, has not been rigorously investigated. While most listed infrastructure funds have used stapling (and some of which have exited the

[4] There has been more interest in preventing the attachment of franking credits to the NIT-1 stapled securities by banks, but that appears to be more related to the “debt-like” nature of those securities.
[5] For business activities with large up-front capital and depreciation costs and finite lives, the timing of overall tax cash flows is affected by stapling, and risks of franking credits being “trapped” in a corporate structure may be reduced.
[6] Withholding tax arrangements are also relevant here.

market), only around 60 per cent of A-REITS do so. The apparent ability of non-stapled A-REITS to compete suggests that stapling is not a necessary condition for efficient operations.

Since: (a) there may be some erosion of the tax base where foreign investors are involved; (b) there is no obvious tax cost to domestic investors from un-stapling, (c) real efficiency benefits from stapling are unproven; and (d) stapling increases the opportunities for financial engineers to exploit investor biases and inadequate information to redistribute wealth to themselves, further investigation and consideration of the merits of permitting stapling would seem warranted.

This FRDP was prepared by Kevin Davis, Research Director of the Australian Centre for Financial Studies.

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