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Primary Market Technical Note

Classification tests

The information in this note is designed to help issuers and practitioners interpret our UK Listing Rules, Prospectus Regulation Rules, Disclosure Guidance and Transparency Rules, and related legislation. The guidance notes provide answers to the most common queries we receive and represent FCA guidance as defined in section 139A FSMA

Rules

UKLR 7.2.9R and UKLR 7 Annex 1

Classifying joint venture arrangements (UKLR 7.2.9R)

When a listed issuer with a listing in the equity shares (commercial companies) category or closed-ended investment funds category enters into a joint venture, it must classify this transaction under UKLR 7 (unless it is a transaction in the ordinary course of business or, in the case of a closed-ended investment fund, within the published investment policy of the issuer). UKLR 7.2.9R requires 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. However, the two sets of class tests must not be aggregated and the highest result from the class tests will determine the overall classification of the transaction, as this is effectively one transaction.

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 gross assets and consideration to market capitalisation tests. As the disposal will result in deconsolidating the subsidiary from L's accounts, the gross assets tests must be run on a 100% basis.
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> Separately, L should also classify the acquisition of a 50% interest in newco.

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 sponsor to contact us to discuss the correct application of the class tests to their specific transaction.

Classifying company/assets being acquired out of administration (UKLR 7 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 with an asset acquisition the gross capital test would not be relevant.

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 issuer 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 from the most recent set of financial statements available for the target. Where these are significantly out of date and an issuer wishes to seek individual guidance from the FCA in relation to the same, we would be happy to discuss with the issuer's sponsor alternative sources and the appropriateness of the tests where the results are considered anomalous. However, we would often consider the best indicator of the size of the business to be the financial statements immediately before the company going into administration. In addition, these financial statements 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, and an issuer wishes to seek individual guidance from the FCA in relation to the same, that they contact us via their sponsor as early as possible to discuss the issue.

Waiving the consideration to market capitalisation test (UKLR 7 Annex 1 paragraph 4R)

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:

- the market capitalisation test is the primary indicator of a listed company's size as at the date of the transaction;
- it is the only test which does not use historic financial information
- 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

- 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 (UKLR 7 Annex 1 paragraph 7R(3))

UKLR 7 Annex 1 paragraph 7R(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 subsequent completed transactions where any percentage ratio was 5% or more at the time the terms of the relevant transaction were agreed. 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 2022. After its year end, in February 2023, A completed an acquisition of target C where any percentage ratio was 5% or more. The figures for A must be adjusted before the class tests are performed so that the latest audited asset figures for C are added to the assets of A as extracted from the 31 December 2022 audited financial statements.
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> If, however, A had disposed of C after its year end we would expect A's financial information to be adjusted so that assets for C are deducted from A's assets before the class test is performed.