

## **Privatizing Communal Wealth: Alternative Demutualization Strategies of Australian Credit Unions**

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### *Abstract*

Credit Union demutualization can take several forms with different implications for wealth allocation among current members and transfers of wealth to outsiders. The processes can also have different implications for the future survival and structure of the business. Because current members have a financial incentive to vote for a demutualization which converts communal wealth of the credit union into private wealth, the possibility exists that demutualization will be approved even if not value adding. Three alternative demutualization strategies (share issue to members plus an external capital raising, liquidation and cash distribution to members, and merger with a listed company) recently used by Australian credit unions are analysed to highlight survival risks for the mutual form and potential problems arising in the demutualization process.

### *Keywords:*

Demutualization, Credit Unions, Privatization, Expropriation, Efficiency

*JEL Codes:* G21, G32, G34

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### *Introduction*

Credit unions were originally established as mutual organizations to provide financial services to individuals, who are member/owners, linked by a “common bond” such as employment or community. In some countries, the credit union sector is still nascent, providing relatively basic services.<sup>1</sup> In others such as Australia it has evolved to a degree where the range of financial services provided to members (including to small businesses operated by members) is little different to that offered to retail customers by banks. But noticeably, to date, there have been relatively few cases of demutualization. This contrasts with other parts of the financial sector such as insurance and building societies (savings and loans) where mutuality was common but where widespread demutualization (both in Australia and many other countries) has meant that few mutual financial organizations (other than credit unions) remain.

This does not mean that demutualization has not been widely discussed nor that there have not been some instances of credit union demutualization.<sup>2</sup> One commonly argued rationale for demutualization is that such organizational transformation is efficiency enhancing and needed to enable credit unions to remain competitive in a modern environment in which members can access financial services from a wide range of alternative providers. But an alternative argument advanced to explain interest in demutualization is based on the evolution of credit unions into organizations with large amounts of communally owned wealth. Incentives then exist for expropriation by particular stakeholders of the credit union or by outsiders, because conversion of that communally owned wealth into private wealth can be achieved by demutualization.<sup>3</sup>

Whether the *efficiency* hypothesis or the *expropriation* hypothesis best explains past demutualizations in the financial sector is open to debate, but it should be noted that they are not mutually exclusive. Key stakeholders in a mutual organization could perceive efficiency benefits arising from demutualization as well as the opportunity to enrich themselves in the process. Similarly, key decision-makers who are convinced of the

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<sup>1</sup> Sibbald, Ferguson and McKillop (2002) provide an overview of credit union development stages.

<sup>2</sup> See Davis (2007) for a discussion of demutualization experience in Australia to that time, Davis (2005) for a more general discussion of demutualization in an international context, and Wilcox (2006) and Crofton, Dopico and Wilcox (2012) for recent discussion of US experience.

<sup>3</sup> See, for example, Kay (1991)

merits of the efficiency hypothesis are confronted with the issue of how to achieve a “fair” distribution of the communal wealth and avoidance of expropriation (other than of future generations as discussed below).

There are several forms of wealth redistribution involved in a demutualization. One is through inequities in the division of the communal wealth between existing members (and outsiders who may participate in the process). It is virtually impossible to determine the relative contributions of existing members to the accumulation of the communal wealth arising from profits made by the mutual in transactions with members. The potential for inequities between current members is thus clear. But recognizing that the communal wealth has been built up over time by contributions from both past and current members identifies a potentially more important form of wealth redistribution. Current members can be viewed as having “inherited” the communal wealth from past members under an implicit contract that such communal wealth would be built upon and passed on to future members. Demutualization involves revoking the implicit inter-generational contract to the benefit of current members and the detriment of potential future members. So also does liquidating the credit union and distributing the existing communal wealth amongst current members. To the extent that past members or their heirs are excluded from participating (as is typically the case) another form of wealth redistribution occurs.

The objective of this paper is to examine three recent cases of conversion of communal wealth of Australian credit unions into private wealth of current members (and others) by demutualization, to identify sources of wealth redistribution involved.<sup>4</sup> They correspond to the alternative approaches of subscription, pure distribution and merger demutualisations analysed in Davis (2007), although the pure distribution approach considered here also involved liquidating the credit union. While intergenerational redistribution cannot be avoided, different processes may have differential implications for wealth redistribution amongst current members and outsiders. The first case (Goldfields) studied involves a demutualization by way of issuance of transferable shares to members and a simultaneous capital raising open to both members and outsiders. The second case examined (Broadway) involves liquidation of the credit union (and transfer

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<sup>4</sup> There have been two prior cases of credit union demutualisation in Australia, SunState (1997) and StateWest (2005), which are briefly discussed in Davis (2007).

of deposits, loans, and some cash to another credit union) with proceeds being distributed to current members. The third case (MyState) involved merger of the credit union with a stock exchange listed, profit oriented, company and the issue of shares in the new merged entity to existing credit union members.

Before analyzing each of three cases the next section provides a brief overview of the arguments for and against demutualization, and potential consequences for wealth redistribution.

### *1. Demutualisation Theories and Perspectives*

The “efficiency” hypothesis,<sup>5</sup> which argues that demutualisation leads to a more efficient organizational structure, is founded on a number of arguments. First, demutualization, involving a change in voting rights from one per member/owner to one per share held, increases the power of owners to discipline inefficient management and boards by exercising voting power. Second, because there are now stock market prices for the entity’s shares, capital market discipline can be exerted by threat of takeover. Third, observable share market prices enable management remuneration structures to be introduced which provide incentives via linking remuneration to share price performance.

Other arguments relate to the effects of the constraints imposed by the mutual structure which, once of limited import, have become significant impediments to competitive ability in a changed financial system. One is that the inability (or difficulty) of mutuals to raise external capital limits their ability to grow – particularly when regulatory capital requirements are imposed. Demutualisation removes the constraint of having to rely on retained surpluses to increase capital. A second argument is that the mutual structure may work well when members of the mutual are relatively homogenous, such that the degree of cross-subsidisation amongst members is relatively limited. As the membership becomes more heterogeneous such cross subsidisation acts as a disincentive for those providing the subsidisation to remain as members. This becomes particularly relevant if there is also a high degree of competition from profit-oriented entities who may be able to attract such members away from the mutual. Third, demutualization may enable the

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<sup>5</sup> See, for example, Rasmusen (1988), Masulis (1987), and Hart and Moore (1996)

institution to undertake new activities which are precluded by regulatory constraints on activities of mutual.

There are, of course, counterarguments. One group of arguments is based around the perceived negative effects of depository institutions taking on higher levels of risk. Entrenched management may be relatively risk averse to protect against risk of losing perks of office. This beneficial effect may be amplified by the absence of any owner/depositor agency problem in a mutual (since each depositor is also an owner) which can otherwise give rise to owner preferences for higher risk taking. Linking management remuneration to share prices post-demutualization may also give incentives for high risk taking. Expansion into new areas of activity post-demutualisation may involve increased risks.

A second group of arguments asserts that there are some inherent advantages arising from the mutual structure which are lost upon demutualisation. Generally, such advantages have been seen to arise from superior information about members, because of the common bond characteristic, enabling better loan assessment and monitoring. That perceived advantage diminishes as the size of the institution increases and the common bond is widened.

The alternative “expropriation” hypothesis is based on recognising that the mutual credit union creates over time a stock of communally owned wealth in the form of retained surpluses as well as the franchise value of the organisation. Davis (2001) shows how, with a one-member-one-vote governance structure, it is possible a majority vote of members to demutualise can occur, even if there are inherent advantages arising from the mutual structure, and which would be lost on demutualisation. From demutualisation, members receive as private wealth (in the form of tradable shares) some part of the communal wealth, but lose the future stream of lower cost services from the mutual. The larger is the communal wealth available to be converted to private wealth and the lower the anticipated length of membership over which advantages may be reaped, the more likely will private interest lead to a vote for demutualisation.

While demutualisation ultimately requires a vote of members, profiteers (often referred to as carpetbaggers) who are not members also have an incentive to encourage

demutualisation of well capitalised mutuals. By becoming members, if possible, they can stimulate an agenda for demutualisation, or can do so as third parties offering advisory services to the credit union. The main benefit, however, is likely to arise not simply from participating in an allocation of shares to members, but from the ability to participate in the capital raising which often accompanies a demutualisation. Because of the accumulated wealth of the credit union, purchasers of new shares can reap immediate share price gains at the expense of existing members if the issue price is below the implied value per share which has been allocated to members.<sup>6</sup>

To see this, suppose that the mutual has accumulated wealth of  $\$W$ , and  $m$  shares are allocated to members.<sup>7</sup> Without any external capital raising, the members' shares would be worth  $W/m$  each. However, suppose  $\$Z$  new funds are also raised from outside investors through the issue of  $n$  additional shares at an issue price of  $Z/n$ . After the issue there will be  $(m+n)$  shares on issue. In the absence of any additional value creation from the demutualization, the total wealth of the entity is  $\$(W+Z)$  and the post-issue share price will be  $(W+Z)/(m+n)$ . If the external shares are issued at a discount to the value of shares issued to members ( $Z/n < W/m$ ), it is straightforward to demonstrate that  $Z/n < (W+Z)/(m+n) < W/m$ . That is, the post-issue share value is above the issue price (ie "stag" profits occur for external investors) and the value of members' shares are diluted through a transfer of wealth to external investors. Note that if the valuation of shares allocated to members ( $W/m$ ) is based solely on the balance sheet figure of net assets but there is substantial "franchise" value, then even if external shares are issued at the same price ( $Z/n = W/m$ ), there will be a transfer of value to external investors.

If the capital raising enables investment in positive NPV projects or the demutualization itself creates value, then the total wealth of the entity will exceed  $W+Z$ , moderating or offsetting any such wealth transfer. It thus becomes important to assess both the terms of such a capital raising as well as the prospects for a demutualization and capital raising to involve value creation.

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<sup>6</sup> Crofton, Dopico and Wilcox (2012) discuss how these concerns influenced the evolution of US regulatory determinations on allowable methods of demutualisation.

<sup>7</sup> This wealth value should include any "franchise" value as well as the accumulated financial wealth recorded in the balance sheet.

## 2. *Goldfields: A “standard” demutualization*

A common approach to demutualization for both credit unions and other financial institutions has been to link the demutualization to the raising of new capital, as in the example just discussed. In this approach members will be allocated some number of shares (free of charge), and will have, as may outsiders, the opportunity to subscribe for extra shares. This was the approach adopted by Goldfields Credit Union when it demutualized in May 2012, and listed on the Australian Stock Exchange under the name *Goldfields Money*.

In the prospectus, dated 14 February 2012, (Goldfields Credit Union (2012)) it was advised that individuals who were members as at 30 March 2012 would, subject to approval of the demutualization by a vote of members at that date, be eligible to receive an allocation of free shares in the credit union and make priority applications to subscribe for new shares in the company. The intention to demutualize, including that members would receive free shares worth approximately \$2,000 had been announced much earlier on November 4, 2010<sup>8</sup>. No new members were admitted after the announcement. There were 2,675 members at June 2011, and membership had previously been on a declining trend (at June 2008, membership was 3,370).

In the prospectus, each of the assumed 2675 members would receive 2,303 shares for a total issuance of 6,160,525 shares of \$1 par value each. Investors (including members who were to have priority allocation) were invited to subscribe for 9 million extra shares at a price of \$1 each. For every two shares purchased, investors would also receive, for no extra cost, an unlisted option to purchase additional shares at an exercise price of \$1.50, anytime over the subsequent seven years, with each option valued by the company at \$0.407 each.<sup>9</sup> Table 1 sets out an extract from the pro-forma financial statements and information (from the prospectus) about share capital.

Total costs of the demutualization and capital raising of \$9 million were estimated in the prospectus to be \$1.86 million with \$0.7 million attributable to the demutualization and

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<sup>8</sup> Goldfields Credit Union and Patersons (2010)

<sup>9</sup> The valuation was made using a binomial model with an assumed volatility of 50 per cent p.a. and risk free rate of 3.4 per cent p.a. (Future dividends were stated in the 2012 Annual Report as being assumed to be zero for purposes of the valuation). The prospectus outlines how the terms of the options would be adjusted for rights and bonus issues.

\$1.16 to the capital raising. The capital raising was underwritten by Patterson stockbrokers and passed on to a number of individuals and institutions as sub-underwriters.

In the event, the allocation of shares was as shown in Table 2, with 2,643 members receiving the free allocation of 2,303 shares each, and with the top 20 investors holding 31.6 per cent of the shares (with an average of around 250,000 shares each).

**TABLE 1: PROFORMA FINANCIAL STATEMENT: GOLDFIELDS CREDIT UNION**

	Pre Demutualization	Post Demutualization	
Assets	58.2	66.5	
Deposits	54.4	52.4	
Equity	5.8	14	
Share Capital			Accounting Treatment
Members shares	10700	-	
Shares issued free to members		6160525	valued at \$6,160,525
Shares issued to subscribers		9000000	valued at \$7,169,400
Shares granted to CGU Community Trust		580000	not included
Unlisted Options issued to subscribers		4500000	unlisted option reserve \$1,830,600

**TABLE 2: INITIAL SHARE DISTRIBUTION: GOLDFIELDS CREDIT UNION**

Range of Holdings	Number of Holders	Number of shares	Average Holding
<1000	0	0	n.a.
1001-5000	2631	6,238,823	2,371
5001-10000	53	409,946	7,735
10001-100000	102	4,160,757	40,792
100001+	19	4,857,829	255,675

Source: ASX initial holdings disclosure

Was the allocation policy a fair one? It is important to note that the market value of the equity of an organization is not necessarily equal to the accounting (book) value of its equity. *Franchise value*, which is the ability of the entity to generate income in excess of



the required return of shareholders, also needs to be considered. That franchise value could reflect past profitable investments, or future profitable growth opportunities. Unfortunately, in the absence of a stock market price pre-demutualization, it is difficult to assess the likely market value. It is partly for this reason that Davis (2005) argues that demutualization (if it is to occur) and capital raising should be undertaken as a two step process. By first demutualizing and gaining information about the overall value of the credit union from the resulting market prices at which shares trade, it is then possible to determine an appropriate price for making a share issue to external investors and existing shareholders to raise additional capital. While it is typically the case that such secondary issues will be made at some discount to the market price, and thus involve some transfer of value from existing shareholders to investors in the offer, there is less risk of excessive transfers of value. More generally, such a process transfers all of the current value of the entity to existing members via the first stage allocation of shares to members.<sup>10</sup>

One possible way to examine how much value is transferred from existing members to subscribers to the issue (many of whom may be members) is to compare the stock market value of the company after demutualization and stock exchange listing to the book value of equity immediately after the demutualization. The difference represents the original franchise value plus the value created by demutualization and the capital raising. If it is assumed that the capital raising was not value creating (an extreme assumption), then value transferred to investors equals the number of shares they receive multiplied by the difference between the post-listing share price and the par value of shares.

In the case of Goldfields, the share price on the first day post listing ranged between \$1 and \$1.02 versus a \$1 par value. This suggests virtually no transfer of value to investors, nor any significant net value added created by the injection of capital by those investors.<sup>11</sup> That conclusion does not, however, take into account the issue of 4.5 million “free” options to investors which were valued in the prospectus at \$ 0.407 each,

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<sup>10</sup> This is equivalent to the “free distribution” model proposed but abandoned by US mutual thrift and credit union regulators discussed in Crofton, Dopico and Wilcox (2012)

<sup>11</sup> In the first ten days after listing 1.36 million shares (or around 9 per cent of total shares on issue) were traded. While the share price increased to \$1.29 over the next two weeks, it had reverted to around \$1 within four weeks

presumably at an assumed share price of \$1 (the par value).<sup>12</sup> The market value of the options, post listing, although unobservable, needs to be considered as part of the net gain to investors. At the prospectus valuation of \$0.407 this amounts to a \$1.8 million unrealized gain. Thus external investors appear to have made a gain of \$1.8 million on an investment of \$9 million or 20 per cent.<sup>13</sup>

How did the members fare? Most received only the free allocation and thus an initial communal wealth of \$5.8 million was converted into 6.16 million shares worth approximately \$1.00 each, or a total value of \$6.16 million. Their implied gain was thus \$0.36 million, or \$0.94 million if the 580,000 shares allocated to the CGU Community Trust are also included. Thus most (over two-thirds) of the net benefits from demutualization accrued to the outside investors. Is this appropriate? The answer depends on how much of the apparent value creation reflected the inherent “franchise value” of the credit union (which arguably should accrue to current members) versus the creation of new profitable opportunities due to the increase in size from outside investor injections of equity capital (which arguably should accrue to those investors). Unfortunately it is not possible to determine the relative importance of these two factors given the absence of a market price for the credit union equity prior to the contributions of the external investors.

In addition to the private gains to external investors and members, there were substantial expenses involved in the demutualization (\$0.7 million) and raising of capital (\$1.16 million). These amounts (which suggest that the process was a high cost exercise) can be interpreted as a third form of private gains from the demutualization process in the form of fees accruing to the corporate advisors managing the process – although expenses incurred by them in the process would reduce the net gain.

A further complication arises from the existence of unused franking credits in the company’s franking account balance.<sup>14</sup> At June 2011, the balance was \$2.37 million. As a mutual, there was no way for these tax credits to be distributed to members.

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<sup>12</sup> Precise details of the option value calculation are not provided in the prospectus.

<sup>13</sup> Because the options were not listed, there is no market price available for them, and the prospectus valuation is used in this calculation.

<sup>14</sup> Australian companies are able to distribute tax (franking) credits, arising from company tax payments, to shareholders when cash dividends are paid.

Demutualization makes distribution possible through payment of dividends. Estimating the net benefit to shareholders of this change is however problematic.

It has already been noted that most members received only their free allocation, with the top 20 investors being allocated around 250,000 shares on average. Members were to have priority in the allocation process, so some of these are likely to have been members – although information on the allocation process is not publicly available. And in the official register of holdings of the top 20 investors provided by the ASX, most of the investors are not individuals – but self managed superannuation funds or private companies.<sup>15</sup> Notably, the four non-executive directors of the credit union post-demutualisation were reported in the notification to the ASX of initial holdings of directors as each holding between 20 and 55 thousand shares.<sup>16</sup> They did not participate substantially in the share subscription, indicating that this was not a case of insiders expropriating the communal wealth.

### 3. *Broadway: Liquidation and Distribution*

In November 2008, the deposits and loans (and some cash) of Broadway Credit Union were transferred to Gateway Credit Union in a partial transfer of engagements, after which Broadway Credit Union was liquidated and remaining assets (cash) of around \$22 million distributed to the approximately 1,100 members (around \$22,000 each).

The terms of the acquisition were reported in Gateway's 2009 Annual Report as shown in Table 3. The Board of Gateway perceived it as being a good transaction in that the value of assets received exceeded the value of liabilities taken on by \$400,000. It also meant a significant increase in the size of the credit union. However, the effect was to reduce the capital ratio of Gateway, since only the \$400,000 would be counted as capital, while around \$42 million of assets were added to the balance sheet.

#### **TABLE 3: GATEWAY CREDIT UNION ACQUISITION OF BROADWAY ASSETS AND LIABILITIES**

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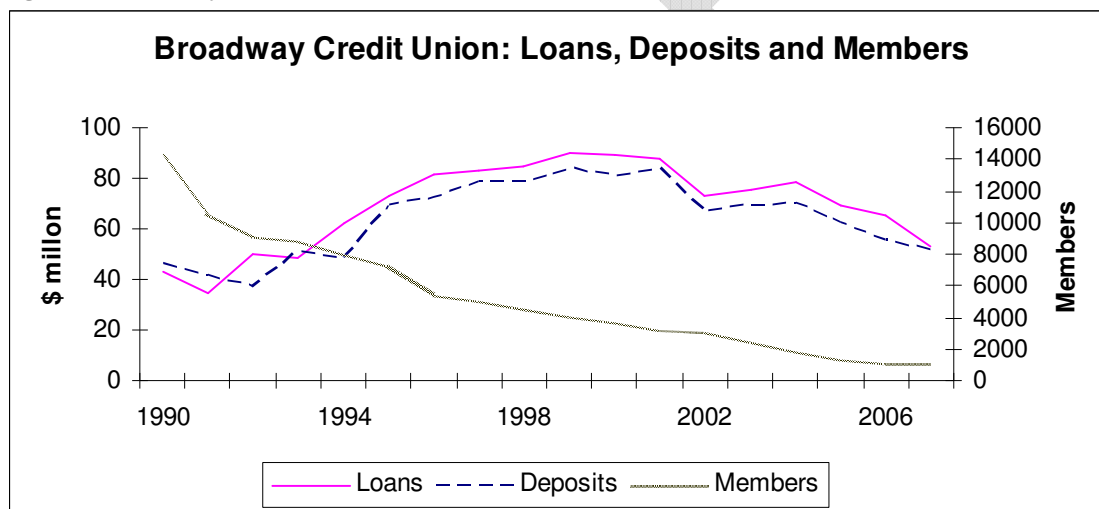
<sup>15</sup> The official register indicates that none of the top 20 investors previously held shares in the company, suggesting that none were members (who each received the free allocation) although this is likely to be either a reporting error or resulting from member/investors having the shares registered in an alternative name.

<sup>16</sup> Two other directors resigned after the demutualization and before ASX listing.

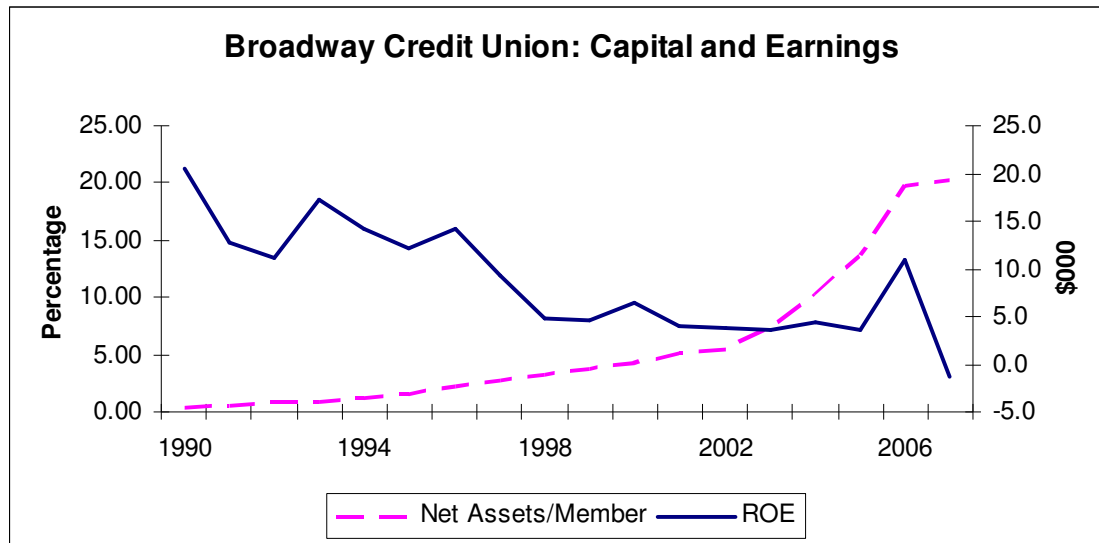
	\$'000
Cash	11,882
Loans and advances	30,214
Deposits	-41,691
Payables	-3
Member shares	-2
Fair value of net identifiable assets and liabilities	400
Purchase Price	-
Discount on acquisition	400

Broadway Credit Union had experienced a declining membership since the start of the 1990s but had grown substantially in terms of total assets until around 2000, after which assets and deposits had declined. See Figure 1.

Figure 1: Broadway Credit Union: Measures of Size



The credit union had been profitable over this period with retained surpluses leading to growth in its net assets (members funds) as shown in Figure 2. Return on equity (ROE) declined as the capital/assets ratio of the credit union increased from around 10 per cent at the start of the 1990s to around 16 per cent at 2000 to almost 30 per cent just prior to demutualization. Net assets per member increased markedly during the 2000s as membership declined to around \$20,000 just prior to the demutualization, creating significant private incentives to convert this communal wealth into private wealth.

**Figure 2: Broadway Credit Union Capital and Earnings**

The proposal to do so, by way of a transfer of loans (and cash) and deposits to a third party and subsequent liquidation, was put to members in an information statement in late 2006 (Broadway Credit Union (2006)). That proposal envisaged a transfer of loans and deposits to Savings and Loans Credit Union, which had been selected based on an evaluation of expressions of interest and tenders in response to an Information Memorandum. The proposed transfer involved Savings and Loans taking on deposit liabilities from Broadway valued at \$55.965 million and loan assets valued at \$61.756 million and paying the difference (\$5.791 million) to Broadway. Ultimately, the transfer was to Gateway Credit Union and involved significantly lower loan and deposit amounts (due to a decline in Broadway's balance sheet size) plus a cash transfer from Broadway to Gateway (see Table 3).<sup>17</sup>

The transfer of \$42 million of assets was only a partial transfer of the total assets of Broadway. At June 2007 (latest figures accessed) total assets of Broadway were \$75.6 million, deposits were \$51.6 million and net assets (equity) were \$22.3 million. Assuming that at November 2008 deposits and assets had both shrunk by around \$10 million (and \$41 million of each transferred), there remained some \$22 million of net assets communally owned by members of the credit union. At June 2007 there were

<sup>17</sup> Negotiations between Broadway and Savings and Loans broke down, and Gateway was instead chosen to receive the transfer of business.

1,104 members or around \$20,000 of net assets per member. In the subsequent liquidation, these funds were distributed to the members. This took the form of a liquidating dividend (paid in two tranches – the 2006 Information Memorandum proposed an initial distribution of \$15,455 to each member of which \$6,869.75 would be franked.<sup>18</sup>

The wind-up of Broadway Credit Union achieved the outcome of converting the communal wealth into private wealth of existing members with no leakage to outsiders other than the expenses of the process which were estimated in the Information Statement to be \$1.768 million. The rationale for the wind-up of the Credit Union was the declining membership and concerns about future profitability. While return on equity (roe) over the past decade at around 5 per cent had been low by industry standards, this needs to be considered in the context of the low leverage of the credit union. Return on Assets (roa) had averaged in the region of 0.7 – 0.8 per cent, which was no worse than the credit union industry average for the period.

The declining membership, in conjunction with the growing communal wealth created conditions conducive to members voting for a wind-up of the business, despite current profitability, rather than alternative strategies such as merger with another credit union. The small number of remaining members profited handsomely from the distribution of funds. Notably, there was no distribution made (or proposed) to past members, whose transactions with the credit union had contributed to the build-up of communal wealth since its establishment in 1963. While it is not known how many of the remaining members were long term members and how many relatively new, it is worth noting that around \$15 million of the net assets of the credit union had been built up by 2000, when membership was still around 4,000. While legally, current members were able to vote to wind-up the entity and the directors able to recommend a distribution of net assets to current members only, a moral case could be argued that past members warranted some share in the distribution of net assets.

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<sup>18</sup> Under Australia's dividend imputation tax system, a franked dividend has tax credits attached to it (reflecting past company tax payments by the company). Dividend recipients on a marginal tax rate of 30 per cent (equal to the company tax rate) would pay no tax on the dividend, those on lower tax rates would receive an offset against any other tax liabilities (or a tax refund). Those on higher tax rates would be liable for some additional tax payments. For example, because of the tax credits, a recipient on a marginal tax rate of 45 per cent would pay tax at a rate of around 20 per cent on the cash amount received.

While directors of the credit union benefited from the wind-up in their capacity as current members, there is no evidence of insider gains from the process. The wind-up resolution involved approval of redundancy payments to the directors totaling only \$73,000 (and distributed amongst the four directors on the basis of years of service). With many credit unions of comparable size paying total annual directors fees of the same order of magnitude, this does not appear unreasonable.

#### *4 The MyState-Perpetual Trustees Merger*

In September 2009, MyState Financial Credit Union (with 117,000 members) merged with the ASX listed Tasmanian Perpetual Trustees (TPX), with the merged entity named MyState Limited trading on the ASX under that name (and code MYS) from 24 September 2009. Shareholders in TPX received one share in MYS in exchange for each TPX share held, while each member of MyState received 387 shares. MYS was structured as a holding company with the credit union activities and the trustee company activities initially operating as subsidiaries. The Tasmanian State Trustee legislation had been amended to limit the maximum beneficial shareholding in MYS to 10 per cent (although plans for Federal legislation to subsume State legislation would see this limit increase to 15 per cent – which would be consistent with provisions of the Banking (Bank Shareholdings) Act.

The proposed merger had been announced on 10 October 2008, although the terms were not finalised until June 2009 and announced in MyState Financial (2009).<sup>19</sup> Members of My State Financial voted to approve the merger in August 2009, although a previous attempt to demutualise one of the predecessor credit unions (Connect) which had been merged into MyState had failed in 2003. Connect and Island State Credit Unions merged on 1 July 2007 to form My State. The main arguments advanced by MyState management in support of the merger were based around increased strength and scale of

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<sup>19</sup> New members of MyState joining after October 10, 2008 were not eligible to receive shares in the merged entity.

the merged organization, although the consequences for each member of receiving approximately 380 shares in MYS was highlighted.<sup>20</sup>

The independent experts (PKF) assessed the value of MyState Financial to be \$117.3 million, and the consideration to be received by members (67.5 per cent of the merged entity as having value of \$139.2 million). At June 2008, MyState had net assets of \$120.2 million. The valuation method adopted by the independent expert was to apply a multiple of around 10 (based on comparables) to a sustainable earnings stream around \$12 mill (which was the profit figure for 2006-7, while it was \$13.8 mill for 2007-8). This implied a net tangible assets multiple of approximately unity – lower than for comparables.

TPX had a market capitalization of \$65.5 million and net assets of \$33 million at the end of 2008. Prior to the merger announcement TPX shares traded at \$3.75 on 9 October 2008. In June 2009 they were trading at \$2.70. In 2007-8 profits were \$7 million, down from around \$7.5 million in the previous two years. Just under 22 million shares were on issue. The independent experts arrived at a valuation of TPX close to the current market capitalization, by applying a multiple of around 12 to maintainable earnings of over \$4 mill and determining that there were approximately \$14 million of surplus assets. This involves a multiple to NTA of approximately 2 compared to that for MyState of around unity. While there may be grounds for this disparity, and the non-realizability of the MyState value without demutualization is argued by the independent experts to be such a reason, this disparity seems large.

Following the merger there would be 67.5 million shares on issue, 22 million held by former TPX shareholders and 45.5 million held by MyState members. By adding a premium to the consolidated value for expected synergies of between \$20-25 million, the independent experts arrive at a total valuation of \$200 million plus such that the approximately 2/3 share of the total held by MyState members meant a premium relative to the assessed value of MyState of between 17.6 and 19.6 per cent. (Of course, if a similar NTA multiple had been used for both, the net effect would have been a discount).

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<sup>20</sup> While the information memorandum did not place a dollar value on the 380 MYS shares to be received, the fact that each TPX share, then trading at around \$2.70, would convert to one MYS share indicated a value of around \$1,000.



In the event, MYS shares commenced trading at around \$3.00 which is close to the value per share assessed by the independent experts.

Alternative approaches could be used to consider the merits of the terms of the merger. One would be a comparison of the expected contribution of each entity to the total profits of the merged entity. With MyState profitability at around \$12 million p.a. and TPX at around \$7 mill p.a., an outcome giving MyState members approximately 2/3 of the combined entity seems reasonable. Using market capitalization of TPX of \$65.5 million and book value capitalization (net assets) of MyState of \$120 million also would suggest that a 2/3 share is not inappropriate – although the validity of such a comparison requires the assumption of an implied market/book ratio for MyState of around unity.

MyState Financial had available some \$37.5 million of franking credits which could not previously be distributed to members, but which the merger would make available for distribution to shareholders. Placing a value on these is difficult, since the value depends upon the marginal tax rate of shareholders. However, the value seems unlikely to exceed \$8 million (and may be less)<sup>21</sup> hence ignoring them in the valuation process (or incorporating them as part of the projected “synergies”) is not unreasonable.

Overall, while the potential exists for outsiders to receive a significant part of the credit union value through demutualization by way of merger, the MyState demutualization process appears to have avoided such an outcome. This assessment can be checked by examining whether TPX shareholders made abnormal gains through share price changes as a result of the merger – although the length of time between announcement and completion of the merger makes it difficult to disentangle effects of the merger from other exogenous influences on share prices. From the date of the merger plan announcement in October 2008 (when TPX shares were trading at around \$3.75), the share price fell much in line with the ASX Financials Index for around 6 months,

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<sup>21</sup> The franking credits can only be distributed attached to cash dividends. Consider, for example an injection of \$1 into the company by a shareholder which is returned as a \$1 franked dividend. The tax payable or rebate amount would be  $(t_p - t_c)/(1 - t_c)$  where  $t_p = 0.30$  is the company tax rate and  $t_p$  is the investor's marginal tax rate. If, for example, all shareholders had a marginal tax rate of 0.15, the value of the \$37.5 million franking tax credits when distributed would be  $\$37.5 (0.15/0.7) = \$8$  million. Some shareholders would be on a zero tax rate and others on higher rates, suggesting the overall value of the released tax credits is unlikely to be higher than this figure and possibly lower. The present value would also be less due to the likely time lags involved in their distribution.

subsequently underperforming somewhat to reach \$2.70 in June 2009 when the Information Booklet was released. Taking that latter figure as a benchmark, exchange of a TPX share into a MYS share which commenced trading at around \$3.00 gives a benefit to TPX shareholders of around 10 per cent, which on a market capitalization of around \$65 million equates to a gain of around \$6.5 million. This could reasonably be interpreted as an upper bound estimate<sup>22</sup> and is only around 5 per cent of the pre merger net assets of MyState.

Thus, the MyState demutualization appears to have avoided significant value transfer to outsiders at the expense of current members. However, it did not obviate the wealth transfer to current members from past and/or future members through the conversion of communal wealth passed on by past members for the benefit of current and future members into private wealth of current members.

#### 5. *Conclusion*

The three examples of credit union demutualization discussed here illustrate both the risk to survival in the mutual form faced by mutuals which accumulate significant communal wealth, as well as the potential for expropriation of that communal wealth into private wealth by both insiders (current members) and outsiders.

The Goldfields demutualization (issuing shares to members in conjunction with an external capital raising) provides an example of the problem that unless the true market value of the organization is established before an external capital raising is made, there can be a significant transfer of value to outsiders through the underpricing of shares issued via the capital raising. In the Goldfields case, the underpricing was not reflected in the listing price of the shares, because of the provision of “free” options to the external investors. But whether the net gains to outside investors reflected a transfer of value (due to inherent “franchise value” not being reflected in the book value of equity, or only arose from the injection of new capital enabling future potential expansion, cannot be determined.

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<sup>22</sup> However, the possibility should not be discounted that the share price of TPX would have fallen further in the absence of the merger proposal, thereby increasing the value of the merger to TPX shareholders.

The Broadway demutualization (by way of partial transfer of business and liquidation) highlights the incentives for current members to agree to closure of a profitable business (albeit one which was facing business challenges) when there is substantial personal gain available. While current members undoubtedly contributed, through their patronage of the business, to some part of the accumulation of communal wealth, their moral entitlement to the whole of that wealth is certainly open to debate. This case study provides a good example of the dilemma examined in Davis (2001) where private wealth acquisition incentives could lead to members voting to wind up a profitable mutual or convert it to a joint stock form (thereby converting communal into private, transferable, wealth) even if that involves a loss of operating efficiencies.

The demutualization by way of merger with a joint stock company undertaken by MyState Financial appears to have avoided the transfer of significant value to outsiders. The reason for this result is that the process involved a valuation of both participating entities (MyState and TPX) and allocation of shares in the merged entity to the owners of each based on the relative value contributed by each entity. Regardless of whether the rationale for the merger – that economic benefits would result – was valid or not, the private wealth gains for members if the merger was approved no doubt helped induce a vote in favour.

Perhaps the most fascinating aspect of these three demutualisations is that insiders in the form of directors and management did not appear to obtain excessive direct financial benefits from the process.<sup>23</sup> There do not appear to have been significant excessive payouts to retiring directors or staff, nor significantly above average allocations of shares to them. However, for executives and directors with ambitions to expand the scale and scope of their entities operations, the private member wealth benefits from demutualization undoubtedly made gaining member/shareholder approval for such expansion plans significantly easier. Whether the conversion of communal wealth to private wealth involved in these demutualization processes was morally appropriate or value adding from a social perspective (by enabling more efficient operations as a joint

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<sup>23</sup> However, external advisers and managers of the demutualization processes received significant fees.

stock firm or, in the case of Broadway, closing down an entity perceived to have poor future prospects) is another question.

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