

Practice Note 7 (PN7) – Treatment of certain assets for the purpose of Rule 11.1(f)

Rule 11 of the Takeovers Code provides that when valuations of assets are given in connection with an offer, details of the valuations must be included in the relevant document and should be properly supported by the opinion of a suitably qualified independent valuer. This helps ensure that shareholders are provided with sufficient information to reach an informed decision on an offer as required by General Principle 5 of the Codes.

Some aspects of Rule 11 are unique to Hong Kong insofar as it imposes an obligation on a company to obtain an asset valuation in certain circumstances. There is no such requirement in the UK Takeover Code. The obligation to require an asset valuation arises under Rule 11.1(f) which provides that “... a valuation will be required of the properties of (i) the offeree company if it has **significant property interests**; and (ii) in the case of a securities exchange offer, the offeror if it has **significant property interests**” (emphasis added). This requirement was introduced into the Codes to reflect the relatively high concentration and volatility of property companies listed in Hong Kong at the time.

Rule 11.1(f) provides further guidance on the meaning of “significant property interests”:

“As a general guide, a company has “significant property interests” if the book value of its consolidated property assets **exceeds 15% of its consolidated total assets**” (emphasis added).

Some market practitioners had voiced concerns that strict compliance with Rule 11.1(f) may in some circumstances be unduly burdensome. They suggested that certain assets should not be regarded as property assets for the purpose of calculating the 15% threshold even though they may be listed on a company’s balance sheet as “buildings” or “plant and buildings”. For example, it has been suggested that account should not be taken of properties of a mining company which are used for smelting or storage purposes or infrastructure such as roads at the mining sites.

The Executive agrees that in some circumstances the strict application of Rule 11.1(f) may be unduly burdensome and should be decided on a case-by-case basis.

With regard to right-of-use (ROU) assets as defined under International Financial Reporting Standard 16 (IFRS 16) 'Leases'¹, although IFRS 16 treats the right to use the asset under a lease as an asset on the company's balance sheet, the lessee does not have legal ownership of the underlying leased asset as it remains with the lessor. ~~Given this, ROU assets should not normally be regarded as a company's property assets for the purposes of the Takeovers Code. It follows that the values of these ROU assets should normally be excluded when determining whether a company has significant property interests of 15% and 50% under Rule 11.1(f)~~Depending on the nature and terms and conditions of the lease (such as whether the lessee has unilateral right to transfer, sublet, mortgage or otherwise dispose of the leasehold interest without the consent of the lessor), a property valuer may or may not ascribe a commercial value to the company's leasehold interest. To mitigate the impact of IFRS 16 on the operation of Rule 11.1(f), we normally permit exclusion of the book value of these ROU assets from both the denominator (i.e. "consolidated total assets") and the numerator (i.e. "consolidated property assets") of the percentage calculations under Rule 11.1(f), unless the ROU assets relate to leasehold interests that are analogous to ownership in property (such as long-term land leases granted by the HKSAR Government).

If parties or their advisers are in doubt as to whether certain assets should be taken into account for the purpose of calculating the relevant thresholds, they should consult the Executive at the outset of the transaction. The Executive may request to see a list of the assets including a detailed description of their nature and purpose, location, size, book value, salient lease contract terms, and any other characteristics or relevant information which would assist in its consideration of the matter.

¹ ~~The~~Or its equivalent of Hong Kong Financial Reporting Standard 16 (HKFRS 16) 'Leases'.

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