## Practice Note 19 (PN 19) – Chain principle offer price

There may be instances where, as a result of acquiring statutory control of a company (which need not be a Code company), a person or group of persons may in turn obtain or consolidate control over a second company because the first company holds 30% or more of the voting rights of the second. In such cases, Note 8 to Rule 26.1 provides that the acquirer of the first company may trigger an obligation to make a mandatory general offer for the other company. This is known as a chain principle offer.

The Executive has from time to time been consulted about how to determine the offer price where a chain principle offer has been triggered. Practice Note 19 provides guidance on this issue.

### *The chain principle*

Note 8 to Rule 26.1 provides that "*[o]ccasionally, a person or group of persons acting in concert acquiring statutory control of a company (which need not be a company to which the Takeovers Code applies) will thereby acquire or consolidate control, as defined in the Codes, of a second company because the first company itself holds, either directly or indirectly through intermediate companies, a controlling interest in the second company, or holds voting rights which, when aggregated with those already held by the person or group, secure or consolidate control of the second company. The Executive will not normally require an offer to be made under this Rule 26 in these circumstances unless either: -*

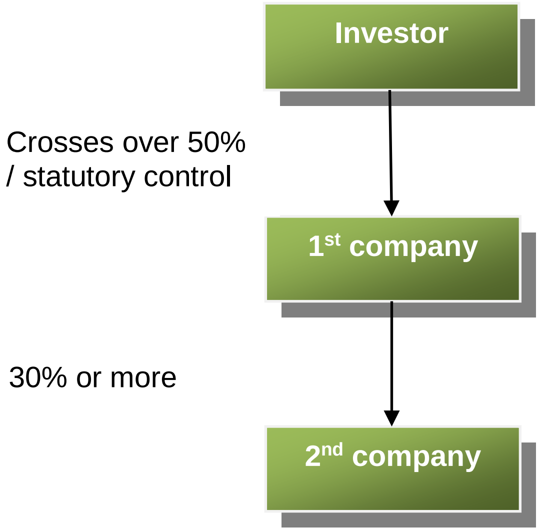
*a) the holding in the second company is significant in relation to the first company. In assessing this, the Executive will take into account a number of factors including, as appropriate, the assets and profits of the respective companies. Relative values of 60% or more will normally be regarded as significant; or*

*b) one of the main purposes of acquiring control of the first company was to secure control of the second company.*

*The Executive should be consulted in all cases which may come within the scope of this Note to establish whether, in the circumstances, any obligation arises under this Rule 26.*

*"Statutory control" in this Note means the degree of control which a company has over a subsidiary."*

***Trigger***




Under the chain principle, if an investor acquires statutory control of the first company, typically by acquiring or increasing its shareholding to over 50%, it will trigger a chain principle offer for the second company if the criteria under either the substantiality test as set out in (a) above or the purpose test as set out in (b) are met.

***Calculation of the chain principle offer price***

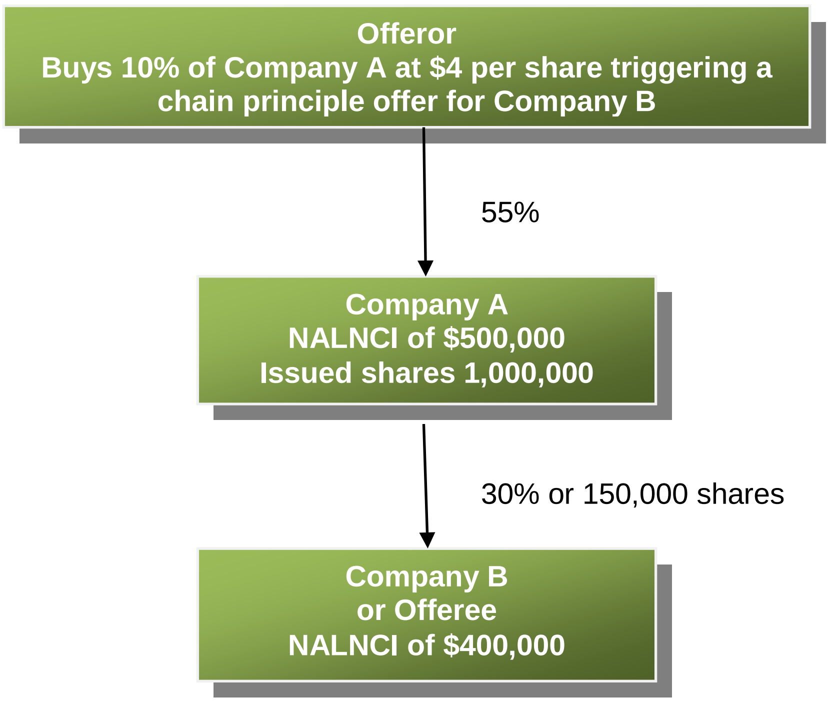
The offer price should be calculated objectively taking into consideration the transacted price for shares in the first company and the relative value of the second company. The objective of the exercise is to establish how much of the price paid for the first company is attributable to its holding in the second.

The mechanism for pricing chain principle offers may differ depending on the circumstances of each case. For companies that are asset-based, asset values are normally used to determine the chain principle offer price. Where there are non-controlling interests, the Executive will generally take the asset values to be the net assets less non-controlling interests (ie, equity attributable to owners of the company). In other situations, earnings may be a more important or relevant consideration. Parties and advisers should take into account all relevant factors, such as the nature of the businesses and assets involved, in determining a chain principle offer price and consult the Executive when in doubt.

*Pacpo formula*

In 1993, the Takeovers Panel considered the pricing mechanism of a chain principle offer by China Strategic Investment Limited for the shares of Pacpo Holdings Limited and Hong Kong Building and Loan Agency Limited. The Panel adopted a step-by-step approach which is commonly referred to as the "Pacpo Formula".

Set out below is an example of an offeror triggering a chain principle offer for an asset-based company:




An Offeror acquires a 10% interest in Company A, increasing its shareholding from 45% to 55%. Company A holds 30% of Company B (ie, 150,000 shares). Both Company A and Company B are engaged in property development and investment.

The acquisition price is $4.00 for each share in Company A. The net assets less non-controlling interests (if any) **(NALNCI)** of Company A is $500,000 and that of Company B is $400,000. The total number of issued shares of Company A and Company B is 1,000,000 shares and 500,000 shares respectively.

Steps to calculate the chain principle offer price for Company B:

1. <u>Determine the ratio reflecting the relative values of Company A and Company B</u>

   (a) The value of Company B attributable to Company A is calculated by multiplying the NALNCI of Company B by the percentage shareholding of Company A in Company B:

   $400,000 x 30% = $120,000

   (b) A relativity ratio of 0.24 is obtained by dividing the value of Company B attributable to Company A (as a result of step (a) above) by the NALNCI of Company A:

   $120,000 / $500,000 = 0.24

2. <u>Determine the implied market capitalisation of Company A</u>

   Based on the acquisition price of Company A's shares of $4.00 per share, the implied market capitalisation of Company A is:

   $4.00 x 1,000,000 = $4,000,000.

3. <u>Apportion the implied market capitalisation of Company A to Company B</u>

   This is determined by multiplying the relativity ratio obtained in Step 1 with the implied market capitalisation of Company A obtained in Step 2:

   0.24 x $4,000,000 = $960,000.

4. <u>Translate into a per share price for Company B</u>

   The implied market capitalisation of Company B obtained in Step 3 relates to the total number of shares held by Company A in Company B (ie, 150,000). The price for each Company B share is therefore:

$960,000 / 150,000 = $6.40 per share.

The offer price for the chain principle offer for Company B is $6.40 per share.

In summary, the Pacpo Formula calculates a chain principle offer price as follows:

$$\frac{\boxed{\text{NALNCI of }2^{nd}\text{ company} \times 1^{st}\text{ company's \% shareholding in }2^{nd}\text{ company}}}{\boxed{\text{NALNCI of }1^{st}\text{ company}}} \times \frac{\boxed{\text{Transacted price of }1^{st}\text{ company} \times 1^{st}\text{ company's total issued shares}}}{\boxed{\text{No. of }2^{nd}\text{ company's shares held by }1^{st}\text{ company}}}$$

It is noted that the Pacpo Formula essentially arrives at the chain principle offer price of the second company by applying the same premium or discount to NALNCI at which the offeror is acquiring the first company.

30 September 2019