

PANEL ON TAKEOVERS AND MERGERS

China Strategic Investment Limited ("China Strategic") Offers for Pacpo Holdings Limited ("Pacpo") and Hong Kong Building and Loan Agency Limited ("HKBLA")

1. Independence of financial adviser :

Internationale Nerderlanden Capital Markets (Hong Kong) Limited ("ING")

2. Chain principle offer price under Note 8 to Rule 26.1 for HKBLA

Introduction

1. The Panel met on 5 January 1993 to review two rulings made by the Takeovers and Mergers Executive in relation to the offers for Pacpo and HKBLA. These rulings related to the independence of the financial adviser to the minority shareholders of Pacpo, and the chain principle offer price applicable to the offer by China Strategic for HKBLA. ING sought a review of the Executive's decision that it was not considered to be independent to give advice to Pacpo minorities on China Strategic's offer. CEF Capital Limited ("CEF Capital"), on behalf of China Strategic, sought a review of the Executive's decision regarding the calculation of the appropriate offer price for HKBLA.

Background

2. On 8 December 1992, trading of shares in Pacpo and HKBLA was suspended at the request of the companies after Pacpo had informed the Stock Exchange that Pacific Concord Holding Limited ("Pacific Concord", whose wholly-owned subsidiary, Red Hill Company Limited ("Red Hill"), held a shareholding of 69.44% of Pacpo, had entered into a preliminary conditional agreement to sell to China Strategic its entire shareholding in Red Hill and the benefit of a shareholder's loan, at an aggregate consideration of \$170 million in cash, or \$3.82 per Pacpo share. Pacpo in turn owned as its main asset a 67.62% shareholding in HKBLA. A joint announcement was subsequently issued by China Strategic, Pacific Concord, Pacpo and HKBLA on 10 December 1992, which stated that China Strategic would make general offers for Pacpo and HKBLA upon completion of the relevant sale and purchase agreement. However, the appropriate offer price for HKBLA pursuant to the chain principle under Rule 26.1 of the Code was still being discussed with the Executive and the suspension of HKBLA shares from trading continued. At the same

time, the following appointments of financial advisers were announced : CEF Capital to China Strategic; ING to shareholders of Pacpo other than Red Hill and Pacific Concord; and Standard Chartered Asia Limited ("Standard Chartered") to the shareholders of HKBLA other than Pacific Concord, Red Hill and Pacpo.

3. The Executive ruled that ING was not considered to be sufficiently independent to give advice to Pacpo's minority shareholders on the Pacpo offer for Pacpo because ING had acted on behalf of Red Hill and Pacific Concord in relation to an offer by Red Hill for shares in Pacpo only about nine months previously. The Executive's ruling was not based on any doubts regarding ING's competence or conduct.

Code Issues Regarding Independence of Financial Adviser

4. Rule 2 of the Code is a new Rule introduced in the revision of the Code which became effective 1 April, 1992. The purpose of the Rule is to ensure that minority shareholders in both the offeror and offeree companies are provided with independent advice as to the merits of an offer.

5. Rule 2.1 addresses, specifically, the obligations which fall upon the board of an offeree company which receives an offer or is approached with a view to an offer being made. Rule 2.1 provides that, "A board which receives an offer, or is approached with a view to an offer being made, should, in the interest of shareholders, retain an independent financial adviser to advise the board as to whether the offer is, or is not, fair and reasonable.... If any of the directors of an offeree company is faced with a conflict of interest, the offeree board should, if possible, establish an independent committee of the board to discharge the board's responsibilities in relation to the offer."

6. There are a number of other paragraphs contained in Rule 2 which address particular types of transactions and circumstances. There are also some notes to the Rule which provide further guidelines. Paragraphs 2.6 and 2.7 provide examples as to the types of persons who would most likely not be suited to give independent advice. Note 1 provides some examples of possible conflicts of interest. Note 2 deals with a particular situation regarding an offer made by or with the co-operation of controlling shareholders. Paragraphs 2.6 and 2.7 and Notes 1 and 2 are set out in **Appendix 1**.

7. Rule 2 is, along with all the other Rules of the Code, subject to the overriding statement in the Introduction to the General Principles that "it is impracticable to devise rules in sufficient detail to cover all circumstances which can arise in offers. Accordingly, persons engaged in offers should be aware that the spirit as well as the precise wording of

the General Principles and Rules must be observed. Moreover, the General Principles and the spirit of the Code will apply in areas or circumstances not explicitly covered by any Rule."

Decision Regarding Independence of Financial Adviser

8. The Panel is of the view that there are two important factors in this case. First, while the Panel's decision is not based on any doubts regarding ING's competence or conduct, the Panel is of the view that it is extremely important that the advice given be perceived to be totally independent. The Takeovers Committee has placed considerable importance on the perception of independence in past cases and the Panel intends to continue to apply this approach. It is a fact that there was a relationship earlier in the year between the controlling shareholder of the offeree and the proposed adviser to the offeree's minority shareholders. In the Panel's view the minority shareholders of Pacpo could reasonably perceive a lack of independence on the part of ING. Secondly, the Panel considers it significant that there are no independent directors of Pacpo such that minority shareholders will be looking only to the independent financial adviser for advice on the offer. Accordingly, the Panel rules that it would be inappropriate for ING to act as independent financial adviser to minority shareholders of Pacpo in this case.

9. The Panel, in making its ruling, wishes to point out that in interpreting Rule 2, practitioners must always be cognisant of its main objective, which is the provision of clearly independent advice to minority shareholders.

10. Practitioners should consult the Executive before accepting any appointment if there is any possibility of a doubt about their independence which might arise. Practitioners should also bring to the attention of the Executive all information which may be relevant to the issue of independence in order that the Executive can make a fully informed decision.

Additional Background Regarding Chain Principle Offer Price

11. A number of different calculations of an appropriate offer price for HKBLA were proposed by CEF Capital for discussion with the Execution. On 23 December 1992, the Executive ruled that the latest version of calculations submitted by CEF Capital was acceptable, except for a proposed upward adjustment to the book net asset value of Pacpo's food business and hence to Pacpo's net asset value. Without this adjustment, the offer price calculated by such method would have been \$17.24, which was higher than the price submitted by CEF Capital of \$15.73 per share. Standard Chartered supported the

Executive's decision.

Code Issues Regarding Chain Principle Offer Price

12. Note 8 to Rule 26.1 provides :

The chain principle

Occasionally, a person or group of persons acquiring statutory control of a company (which need not be a company to which the Code applies) will thereby acquire or consolidate control, as defined in the Code, of a second company because the first company itself holds 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 in these circumstances unless either-

- (a) the holding in the second company constitutes a substantial part of the assets of the first company; 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 such cases to establish whether, in the circumstances, any obligation arises under this Rule.

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

13. In this case, there is no dispute that China Strategic will have to make a general offer for HKBLA pursuant to the chain principle. What is in dispute is the appropriate offer price. Referring to Note 8, the Panel's approach is to determine how much the person making the acquisition of shares in the first company has effectively paid for shares in the second company.

Decision Regarding Chain Principle Offer Price

14. In a view of an Executive decision, the Panel is not bound by the ruling of the Executive or by an reasoning in connection therewith and it is open to the Panel to adopt a different approach from the Executive. This was made clear by the Executive to CEF Capital before the application for review was lodged.

15. The precedents for calculating the relevant prices under the chain principle have mainly been based on asset values. Whilst, in other situations, earnings may be more important than asset values when assessing what the appropriate price should be, the Panel concludes that, taking into account the nature of the businesses of Pacpo and HKBLA, asset values should be the basis for calculating the offer price in this case. The relevant asset values should be assessed on the information available to the offeror as at the time the transaction was entered into. In this case, the transaction entered into was a fixed-price deal with no possibility of a later adjustment to prices. The only information which was available to the offeror at the time the transaction was entered into was the publicly available information, namely the audited balance sheets of the relevant companies at 31 December 1991 as adjusted for 30 June 1992 interim results.

16. In the Panel's view, the offer price should be calculated objectively, without attempting to speculate what values should be attributed to the listing status of Pacpo or HKBLA. Accordingly, the offer price for HKBLA should be calculated as follows -

		HK\$'000
1.	Net assets of HKBLA attributable to Pacpo, For its 67.62% shareholding (\$151,077 x 67.62%)	\$102,158
2.	Divide by adjusted net assets of Pacpo as at 30 June, 1992	\$141,833
		=0.7203
3.	Multiply this fraction (0.7203) by the value of the entire issued share capital of Pacpo based on the offer price of \$3.82 per Pacpo share (total number of issued shares of Pacpo is 64,140,000)	\$245,015
		=\$176,484
4.	Divide the resulting number (\$176,484) by the number of shares held by Pacpo in HKBLA	8,639,583
		\$ 20.43
		=====

17. Accordingly, the Panel rules that, under the chain principle, the appropriate price to be offered to HKBLA shareholders is \$20.43 per share.

18. Since the advisors to the offeror and offeree companies are more fully informed on the businesses and assets of the relevant companies, the Panel believes that such advisers should make every effort to reach an agreement as to the appropriate price in consultation with the Executive in such situation.

13 January 1998

Appendix I

2.6 Persons not suited to give independent advice.

A person who has, or had, a connection, financial or otherwise, with the offeror or offeree company of a kind likely to create a conflict of interest will not be regarded as a suitable person to give independent advice.

2.7 Independent financial advisers and independent shareholders

A financial adviser will not normally be considered to be independent if he is considered to have a relationship with the offeror, the offeree company, or the controlling shareholder(s) of either of them, which is reasonably likely to affect the objectivity of his advice. If there are shareholders who are not independent because they have an interest in the proposed transaction other than their interest as a shareholder of the offeror or offeree company, as the case may be, the independent adviser should endeavour to represent the best interest of the offeror or the offeree company, respectively, by concerning itself only with the interests of the independent shareholders, i.e. those shareholders of the company who have no interest in the proposed transaction other than their interest as a shareholder of the company.

Notes

1. Conflicts of interest

A conflict of interest will exist, for instance, when there are significant cross-shareholdings between an offeror and the offeree company, when one or more directors are common to both companies or when a person is a substantial shareholder in both companies.

A financial adviser may have the opportunity to act for an offeror or the offeree company in circumstances where the adviser is in possession of material confidential information relating to the other party, for example, because it was a previous client or because of involvement in an earlier transaction. This will often necessitate the financial adviser declining to act, for example, because the information is such that a conflict of interest is likely to arise. Such a conflict will normally be incapable of resolution simply by isolating information within the relevant organisation or by assigning different personnel to the transaction.

2. Offer made by or with the co-operation of controlling shareholders.

The requirements for competent independent advice for shareholders is of particular importance in respect of offer made by or with the co-operation of controlling shareholders. An independent adviser for the independent shareholders is essential and its responsibility is reasonable. Because of this, it is all the more important that its competence and independence from the parties involved should be beyond question. In such cases, the reasons for advice are of particular importance.

The Executive will normally require the formation of an independent committee of the offeree's board of directors in these cases if it is possible for an independent committee to be formed. The responsibilities of the committee would include instructing and dealing with the independent adviser, and generally protecting the interests of the independent shareholders.