

A periodic newsletter to help participants in Hong Kong's financial markets better understand the Codes on Takeovers and Mergers and Share Repurchases

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.

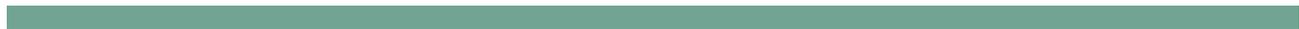
The chain principle

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.

Highlights

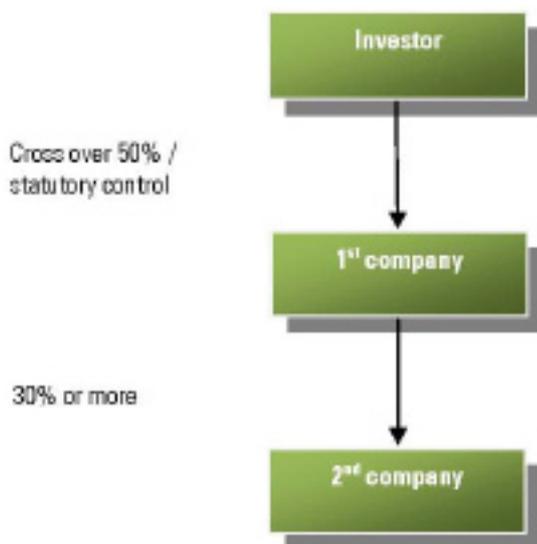
- Practice Note 19 – Chain principle offer price
- “No comment” fax not a confirmation of compliance
- Quarterly update on the activities of the Takeovers Team for the period ended 30 June 2012



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) is met.

Calculation of the chain principle offer price

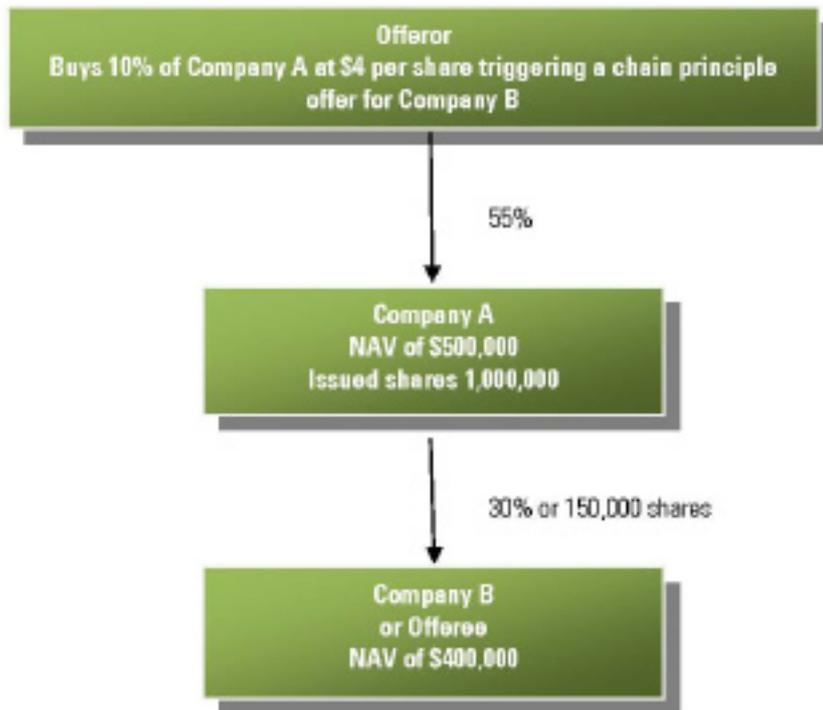
The offer price should be calculated objectively taking into consideration the transacted price for shares in the first company and the relative value of the second company. The objective of the exercise is to establish how much of the price paid for the first company is attributable to its holding in 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. 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 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. 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 asset value (**NAV**) 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 chain principle offer price for Company B:

1. Determine the ratio reflecting the relative values of Company A and Company B

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

$$\$400,000 \times 30\% = \$120,000$$

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

$$\$120,000 / \$500,000 = 0.24$$

2. Determine the implied market value of Company A

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

$$\$4.00 \times 1,000,000 = \$4,000,000.$$

3. Apportion the implied market value of Company A to Company B

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

$$0.24 \times \$4,000,000 = \$960,000.$$

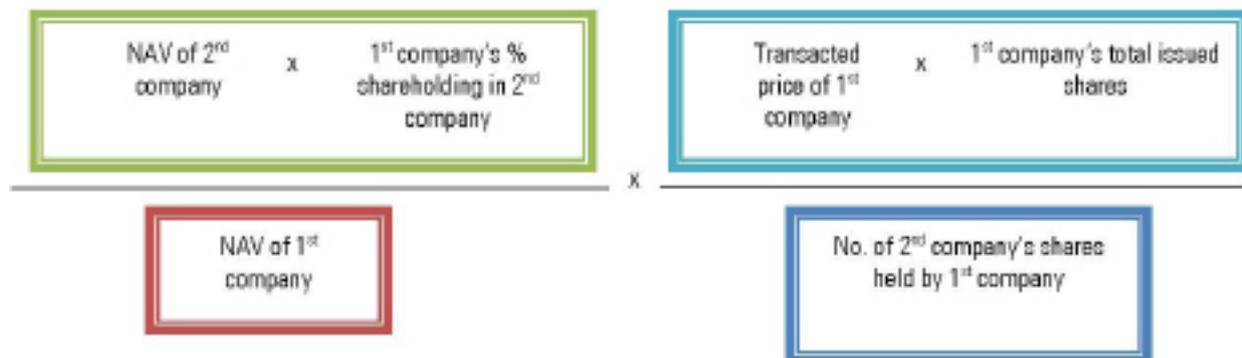
4. Translate into a per share price for Company B

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

$$\$960,000 / 150,000 = \$6.40 \text{ per share.}$$

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:



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

“No comment” fax not a confirmation of compliance

Rule 12.1 of the Takeovers Code requires all Code-related announcements and documents (other than announcements appearing in the Post-Vet List) to be “*filed with the Executive for comment prior to release or publication and must not be released or published until the Executive has confirmed that it has no further comments thereon*”. Once a draft announcement or document has been submitted to the Executive, the commenting process begins and the Executive will raise issues identified by it until such issues are resolved.

As a matter of practice, the Executive will issue a “no comment” fax at the end of the commenting process to indicate formally that it has no further comments on the draft announcement or document and that the announcement or document can be released or published. The issuance of the “no comment” fax by the Executive should therefore not be taken as anything other than for that purpose only.

Most importantly, the “no comment” fax should not be taken as a confirmation from the Executive that the announcement or document fully complies with the Codes or any other laws and regulations that might be applicable to that announcement or document. Parties and their advisers who are involved in Code transactions are reminded that, as provided in Note 2 to Rule 12, “[t]he Executive’s role in the commenting process is no more than a consulting role where the Executive provides assistance in resolving any Code issues raised by the Executive or identified by the parties and their advisers”.

Parties who issue Code-related announcements and documents should be aware that they are ultimately responsible for the information disclosed as well as for compliance with the Codes and any other applicable laws and regulations.

Update on takeovers-related cases

In the three months ended 30 June 2012, the Executive dealt with 14 takeovers-related cases (including privatisations, voluntary and mandatory general offers and off-market and general-offer repurchases) and nine whitewashes. The Executive also received 68 ruling applications.

The Executive referred one case to the Takeovers Panel for a ruling during the quarter as particularly novel, important and difficult points were at issue.

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