Notifiable Transactions: An Introduction

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Listed Companies' Disclosure Obligations

- Listed companies are under duty to disseminate material information to its public shareholders in a timely manner
- Such information includes (but without limitation) financial results, results of general meetings, change of key personnel, change of corporate structure and corporate transactions
- This presentation will focus on the requirements relating to the disclosure and approval process for "Notifiable Transactions"
- This presentation only gives a general introduction of the relevant requirements. Each case is unique and other requirements outside this subject might be applicable depending on the circumstances, and if in doubt please seek expert advice on specific cases

What are “Notifiable Transactions”?

- Regulated under Chapter 14 of the Rules Governing the Listing of Shares on The Stock Exchange of Hong Kong Limited (“**Listing Rules**”)

- In general terms, “Notifiable Transactions” are transactions of listed companies that have to be disclosed to public shareholders due to the fact that the transaction size has exceeded a certain threshold

- The nature of transactions that are caught under the ambit of “Notifiable Transactions” is rather wide and it generally includes:
  (i) acquisitions and disposals of assets or shares;
  (ii) leasing of properties or machineries;
  (iii) formation of joint ventures;
  (iv) provision of financial assistance (including the provision of guarantee); and
  (v) provision of margin financing

What are “Notifiable Transactions”? (Cont’d)

- Exceptions to the definition of “transaction” include:
  - (ii) provision of financial assistance as an ordinary and usual course of business;
  - (ii) provision of margin financing as an ordinary and usual course of business; and
  - (iii) transactions of a revenue nature in the ordinary and usual course of business

- If a transaction falls within the ambit of “Notifiable Transactions”, the following factors will be taken into account before determining the mode of disclosure and/or approval process:
  - (i) asset;
  - (ii) revenue;
  - (iii) profit;
  - (iv) consideration; and
  - (v) market capitalisation

<u>What are "Notifiable Transactions"? (Cont'd)</u>

- "Size tests" will then be conducted to determine the classification of the transaction. If the transaction size has exceeded a certain threshold (by looking at the "percentage ratio"), such transaction would required to be disclosed through an ***<u>announcement</u>***

- If the transaction size is "too large", a **<u>shareholders' circular</u>** will have to be dispatched to the shareholders and the transaction will have to be approved at shareholders' meeting and, in the extreme case, by the Listing Committee of the Hong Kong Stock Exchange ("**HKEx**").

- Announcements and shareholders' circulars are regulated by HKEx and are subject to content requirements under the Listing Rules.

- Announcements and shareholders' circulars have to be disclosed officially through the website of HKEx. *<u>Press releases or methods of disclosure which do not follow with the requirements of the Listing Rules are not regarded as a proper way of disclosure</u>*

Common disclosure documents

- Announcements
- Shareholders’ circulars
- Valuation reports
- Accountants’ reports
- Technical reports
- Legal opinions

Classification of "Notifiable Transactions"

- ***share transaction*** – an acquisition of assets (excluding cash) by a listed company where the consideration includes shares and where all percentage ratios are less than 5%

- ***Discloseable transaction*** – a transaction where any percentage ratio is 5% or more, but less than 25%

- ***Major transaction*** – a transaction where any percentage ratio is 25% or more, but less than 100% for an acquisition or 75% for a disposal

Classification of "Notifiable Transactions" (Cont'd)

- ***Very substantial disposal*** – a disposal assets (including deemed disposals) where any percentage ratio is 75% or more;

- ***Very substantial acquisition*** – an acquisition of assets by a listed company where any percentage ratio is 100% or more;

- ***Reverse takeover*** – an acquisition which, in the opinion of HKEx, constitutes, or is part of a transaction or arrangement or series of transactions or arrangements which constitute, an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new IPO applicants under the Listing Rules

Size tests: what are "percentage ratios"?

Percentage ratios are the percentage results of the following size tests:

- ***Assets ratio*** – the total assets which are the subject of the transaction divided by the total assets of the listed company
- ***Profits ratio*** – the profits attributable to the assets which are the subject of the transaction divided by the profits of the listed company
- ***Revenue ratio*** – the revenue attributable to the assets which are the subject of the transaction divided by the revenue of the listed company
- ***Consideration ratio*** – the consideration divided by the total market capitalisation (previous 5-day average) of the listed company
- ***Equity capital ratio*** – the nominal value of the listed company's shares as consideration divided by the total nominal value of the listed company's issued shares immediately before the transaction

Classification of "Notifiable Transactions" – a summary

Transaction type	Assets ratio	Consideration ratio	Profits ratio	Revenue ratio	Equity capital ratio
Share transaction	less than 5%	less than 5%	less than 5%	less than 5%	less than 5%
Discloseable transaction	5% or more but less than 25%	5% or more but less than 25%	5% or more but less than 25%	5% or more but less than 25%	5% or more but less than 25%
Major transaction – disposal	25% or more but less than 75%	25% or more but less than 75%	25% or more but less than 75%	25% or more but less than 75%	N/A
Major transaction – acquisition	25% or more but less than 100%	25% or more but less than 100%	25% or more but less than 100%	25% or more but less than 100%	25% or more but less than 100%
Very substantial disposal	75% or more	75% or more	75% or more	75% or more	N/A
Very substantial acquisition	100% or more	100% or more	100% or more	100% or more	100% or more

Note: reverse takeover is a rather special topic and detailed discussion will follow later in this presentation

General requirements under different classifications

Transaction type	Notification to HKEx	Publication of announcement	Circular to shareholders	Shareholders' approval	Accountants' report
Share transaction	Yes	Yes	No	No	No
Discloseable transaction	Yes	Yes	No	No	No
Major transaction – disposal	Yes	Yes	Yes	Yes	Yes
Major transaction – acquisition	Yes	Yes	Yes	Yes	No
Very substantial disposal	Yes	Yes	Yes	Yes	Yes
Very substantial acquisition	Yes	Yes	Yes	Yes	Yes
Reverse takeover	Yes	Yes	Yes	Yes	Yes

Disclosure and approval process - timing

- ***Announcement*** – no later than signing of the relevant agreement (except trading is suspended to prevent leakage of price-sensitive information)

- ***Shareholders' circular*** (together with the expert reports) – no later than 21 days after publication of the announcement

- A listed company can apply for time extension if extra time is required for preparing the circular

- ***Shareholders' meeting*** – at least 14 days after the dispatch of the shareholders' circular (subject to further requirements under the listed company's Articles of Association)

- *Note: as a matter of practice a listed company should avoid publishing the transaction announcement within the 1-month period prior to the publication of financial results (informally known as the "blackout period")*

Basic content requirements for an announcement

An announcement must include the most basic information about a transaction, including:

- Nature of the transaction
- Date of the relevant agreement
- Consideration of the transaction and how it was determined
- Reasons and benefits of entering into the transaction
- Net profits (or losses) attributable to the transaction

<u>Basic content requirements for a shareholders' circular</u>

A shareholders' circular shall include the following further details of the transaction for shareholders to consider before voting at the shareholders' meeting:

- Contents of the relevant preceding announcement(s)
- Interests of the directors
- Situation of indebtedness and sufficiency of working capital
- Management discussion and analysis
- Expert reports including accountants' report, valuation report etc.

<u>General requirements for accountants' reports</u>

An accountants' report shall at least include:

- ***Profit and loss account*** – to set out turnover, cost of goods sold, investment income, interest on borrowings, depreciation, amortisation, pre-tax profit, taxation, net profit, minority interests, and dividend

- ***Balance sheet*** – to set out fixed assets, current assets, current liabilities, non-current liabilities, capital and reserve, and non-controlling interests

- Cash flow statement

- Statement of changes in equity

- Net profits (or losses) attributable to the transaction

An accountants' report has a validity of <u>*six months*</u>

<u>General requirements for valuation reports</u>

All valuation reports must contain all material details of the basis of valuation which must follow The Hong Kong Institute of Surveyors Valuation Standards on Properties or the International Valuation Standards published by the International Valuation Standards Council. It shall at least include:

- A description of each property
- Where the property is not in the process of being developed, details of rentals of the property
- A classification of the property according to the purpose for which it is held
- the effective date as at which the property was valued and the date of the valuation
- Net profits (or losses) attributable to the transaction

A valuation report has a validity of *<u>three months</u>*

General requirements for technical reports relating to natural resources assets

A so-called “Competent Person’s Report” will have to be included in circulars relating to the acquisition of natural resources assets. It shall at least include:

- Summary of assets
- nature and extent of any rights to explore and extract resources
- the methods employed for exploration and/or extraction with details of any potential geological risk
- Discussion on any social and/or environmental issues

A Competent Person’s Report has a validity of *six months*

General considerations for a shareholders' meeting

- Notice period
- Choice of venue
- Ascertaining attendees – cut off time
- Quorum – minimum attendance
- Chairman's script
- Proxies
- Anyone needs to abstain from voting?
- Ordinary vs. Special Resolutions
- Mode of voting – by show of hands or by poll?
- Q&A session
- Media attendance
- Security

How do HKEx regulate the whole process?

- ***Vetting*** – HKEx inspect the contents ("vetting") of the announcements after publication (except for those for very substantial transactions which require pre-vetting) and, as for shareholders' circulars, clearance has to be obtained from HKEx before bulk-printing and dispatch

- ***Making enquiries*** – HKEx will issue enquiries to listed companies in case there are unusual price and/or volume movements, and will discuss with listed companies (or their representatives) about whether trading should be suspended before the publication of the transaction announcement

- ***Sanctions*** – actions will be taken against listed companies and their directors (often together with the Securities and Futures Commission and/or the Commercial Crimes Bureau) in case there are false / misleading information or material omission in the disclosure documents or other acts of market misconduct.

Indicative timetable for typical transactions

Time	Action item(s)
T-13 week	• Initial discussion between the parties • Engagement of professional parties
T-12 week	• Sign non-binding letter of intent (Note: announcement is required to disclose the insider information) • Start preparing statement of indebtedness
T-12 week to T	• Due diligence • Preparation of expert reports for inclusion in shareholders’ circular
T-3 week to T	• Preparation of transaction agreement and negotiations • Preparation of announcement and shareholders’ circular
T	• **Signing of transaction agreement** • **Publication of announcement**
T to T+3 week	• Responding to HKEx’s comments on the shareholders’ circular • Bulk-printing and dispatch of the shareholders’ circular
T+3 to T+5 week	• Preparation for shareholders’ meeting • Responding to shareholders’ queries (if any)
T+5 week	Shareholders’ meeting
T+6 week onwards	Handling of final approval procedures and completion

Practical differences between various classifications

- Discloseable transactions / share transactions – announcement
- Major transactions – shareholders' circular plus shareholders' approval (by way of physical meeting or, if no shareholder is required to abstain from voting, by written consent of shareholder(s) holding 50% interests or more)
- Very substantial acquisitions / disposals – similar to major transactions but physical shareholders' meeting must be convened. They are also subject to more stringent content requirements (e.g. requiring the inclusion of business trends and management discussion and analysis) and vetting process
- Reverse takeover – the transaction will have to go through IPO vetting process whereby the listed company will have to engage a sponsor for the due diligence process and, on top of shareholders' approval, the transaction needs to be approved by HKEx's Listing Committee

What constitutes a reverse takeover?

- The rules relating to reverse takeover are designed to prevent “backdoor listing” whereby listed companies could achieve listing status for their businesses / assets that are otherwise not eligible for listing. HKEx refer to the following “bright-line tests” when determining whether a transaction constitutes a reverse takeover:

  (i) an acquisition of assets constituting a very substantial acquisition where a change in control (i.e. introduction of a new shareholder with a shareholding of 30% or more) will happen; or

  (ii) acquisition of assets from a new controller within 24 months of gaining control which constitutes a very substantial acquisition

- However, the above “bright-line tests” are by no means exhaustive and HKEx will also consider a range of factors to determine whether a listing company is avoiding the IPO requirements. These factors include:

  (i) the size of the acquisition relative to the size of the listed company;
  (ii) whether the acquired business meets the IPO eligibility criteria;
  (iii) the nature and scale of the listed company business before the acquisition (i.e. whether it is a “shell” company); and
  (iv) any fundamental change in the listed company’s principal business

Points to note when doing size tests

- ***Assets*** – must refer to the relevant figures in the latest annual report or interim report (as the case may be) and take into account of transactions that are completed between the relevant financial report and the transaction date

- ***Profits*** – must refer to the relevant figures in the latest annual report

- ***Revenue*** – must refer to the relevant figures in the latest annual report

- ***Consideration*** – the figure should be the higher of the *total* contractual amount and the fair value of the assets concerned. It should also take into account the amount of liabilities to be discharged or assumed

<u>Points to note when doing size tests (Cont'd)</u>

- ***Loss-making*** – the listed company shall consult HKEx in the event losses were recorded in the financial reports. As a matter of practice, the listed company will have to do "alternative tests" as a substitute.

- ***Aggregation*** – HKEx are entitled to aggregate a series of transactions and treat them as a single transaction if they are all completed within a 12-month period or otherwise related. Factors to consider include:

  (i) whether the transactions are entered into by the listed company with the same party or with parties connected or otherwise associated with one another;

  (ii) whether the transactions involve the acquisition or disposal of securities or an interest in one particular company or group of companies;

  (iii) whether the transactions involve the acquisition or disposal of parts of one asset; and

  (iv) whether the transactions together lead to substantial involvement by the listed company in a business activity which did not previously form part of the listed company's principal business activities

Points to note when doing size tests (Cont'd)

- ***Attribution of interests*** – the value of the entity's total assets, profits and revenue is to be multiplied by the percentage of the equity interest being acquired or disposed of by the listed company

- ***Consolidation and segregation*** – 100% of the entity's total assets, profits and revenue will be taken as the value of the total assets, profits and revenue, irrespective of the size of the interest being acquired or disposed of, if:

  (i) the acquisition will result in consolidation of the assets of the entity in the accounts of the listed company; or

  (ii) the disposal will result in the assets of the entity no longer being consolidated in the accounts of the listed company

- ***Deemed disposals*** – allotments of shares by a subsidiary of a listed company may result in a reduction of the percentage equity interest of the listed company in such subsidiary. Such allotments give rise to deemed disposals and size tests will have to be done to determine the transaction classification

Other practical matters to note

- ***Signing of transaction agreement*** – after market close so as to facilitate the publication of the announcement
- ***Qualified property transactions*** – acquisition of land or property development projects by listed companies engaging in property development (as a principal business activity) from HK / PRC governmental organisations through public auction or tender can be exempted from shareholders' approval
- ***Accountants' report*** – it is advisable to discuss with the accountants on how profits are to be recognised at an early stage
- ***Status of indebtedness*** – preparation of indebtedness statement should start at an early stage as it could take an exceptionally long time to prepare

Other practical matters to note (Cont'd)

- ***Experts' consents*** – consent letter of experts should be obtained before including their reports in the shareholders' circular

- **Change of resolutions** – a listed company should give ample time for their shareholders to consider the resolutions to be approved at the shareholders' meeting, and because of this the timetable might have to be delayed if the listed company wishes to add further resolutions for the shareholders' meeting

- **Termination of transactions** – an announcement must be published immediately if the transaction is terminated for any reason

Case study – major transaction of China Electronics Corporation (0085.HK) in 2013

- China Electronics Corporation is a company that engages in the design, research and development and sale of integrated circuits and it entered into an agreement to acquire information technology industrial parks on 7 July 2013. The following are a list of factors (amongst many others) considered when running the transaction:

  (i) Choice of assets to be acquired and classification of the transaction?

  (ii) The agreement is signed by shareholders might reject the transaction at the subsequent shareholders' meeting. Any issues?

  (iii) Timing of announcement – before or after the interim results? "Blackout period"?

  (iv) Consideration – cash or cash plus shares?

  (v) Accountants' report – is recognition of profits an easy task?

  (vi) Queries from shareholders – how to handle unreasonable queries?

Summary

- Before entering into a transaction, a listed company must consider whether the transaction falls within the ambit of “Notifiable Transactions”
- If the transaction falls within the ambit of “Notifiable Transactions”, the listed company should apply the size tests and determine which classification it falls into
- The listed company shall publish the announcement no later than the signing of the transaction agreement (after market close)
- The listed company shall also dispatch the shareholders’ circular to its shareholders if the transaction is classified as a major transaction, a very substantial transaction or a reverse takeover, which is subject to shareholders’ approval
- HKEx are entitled to treat a transaction as a reverse takeover if it is, in HKEx’s view, designed to circumvent the requirements relating to new listing application, and in addition to shareholders’ approval, it will have to go through stringent vetting process as well as HKEx Listing Committee’s hearing

Q & A