Acquisitions of Controlling Interests in Hong Kong-Listed Companies Through Primary Issuances

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Acquisitions that result in a change of control of a Hong Kong-listed company — defined as 30 percent or more of the voting power — trigger a mandatory general offer to all shareholders of the company. AcquisitionsThe Hong Kong Securities and Futures Commission (SFC) will typically waive the general offer requirement in situations where a primary issuance of new shares has been approved in an independent vote at a shareholders' meeting. In 2015, there was increased scrutiny by the Hong Kong Stock Exchange (HKEx) on primary issuance acquisitions that result in a change of control. A relatively large number of the deals announced in 2015 were aborted or restructured due to failure to address one or more regulatory issues raised by the HKEx and/or SFC.

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Under the Hong Kong Listing Rules, if a transaction constitutes a reverse takeover, the HKEx treats the company like a new listing applicant, requiring a Hong Kong prospectus, appointment of a sponsor and a full vetting process with the HKEx's Listing Division, all of which carry cost and timing implications. The HKEx has wide discretion to deem a transaction a reverse takeover, with acquisitions of assets that constitute "a very substantial acquisition" (see sidebar) resulting in such a designation.

However, a new investor can acquire a controlling shareholder stake without triggering a reverse takeover if the deal involves a cash subscription of new shares (or a combination of new shares and convertible securities). Many primary issuance acquisitions in the last few years have relied on this structure, which in most cases effectively removes the risk of the transaction being deemed a reverse takeover. We believe investors and listed companies will continue to structure change-of-control transactions through primary issuance acquisitions, as structuring an acquisition in this manner will not require the relevant investors to launch a mandatory general offer to all company shareholders. Companies and investors that do so should consider the following issues that may arise.

Cash Company

Under Hong Kong Listing Rule 14.82, if for any reason the assets of a listed issuer (other than an "investment company" as defined in Chapter 21 of the listing rules) consist wholly or substantially of cash or short-dated securities (less than one year to maturity), it will not be regarded as suitable for listing and the HKEx may request that it suspend trading. Once it is considered a cash company, the listed issuer must apply for resumption of trading, an application that the HKEx scrutinizes as it would a new listing applicant. As a result, most third-party investors abandon the transaction if the HKEx determines that a listed issuer will, upon consummation of the primary issuance, become a cash company.

The HKEx issued a guidance letter in December 2015 on the cash company rules. The HKEx has indicated that there are no quantitative criteria to define a cash company and that the assessment is a qualitative test. AcquisitionsHistorically, transactions that result in the company having 90 percent or more of its assets in cash or short-dated securities

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Notifiable Transactions Explained

Under the Hong Kong Listing Rules, transactions of a listed issuer are classified into different categories depending on their "size" relative to the listed issuer. For this purpose, Hong Kong-listed companies are required to calculate five size test ratios to determine the category. They are:

Assets Ratio
The total assets that are the subject of the transaction divided by the listed issuer's total assets.

Profits Ratio
The profits attributable to the assets that are the subject of the transaction divided by the listed issuer's profits.

Revenue Ratio
The revenue attributable to the assets that are the subject of the transaction divided by the listed issuer's revenue.

Consideration Ratio
The consideration divided by the listed issuer's total market capitalization.

Equity Capital Ratio
The number of shares to be issued as consideration divided by the total number of the listed issuer's issued shares immediately before the transaction.

If one or more of these ratios equals 25 percent or more, shareholders' approval is required. A "very substantial acquisition" is an acquisition (or a series of aggregated acquisitions) through which one or more of these ratios equals 100 percent or more.

immediately after the transactions typically have triggered the designation. However, the guidance letter clarifies that under the rules, companies with less than half their assets in cash as a result of a fundraising exercise typically would not be regarded as having assets consisting wholly or substantially of cash.

A number of companies have in the past tried to address cash company concerns by providing further details about their business plans and signing agreements to commit the use of the cash proceeds. The HKEx clarified in the letter that such actions would not reduce the cash proceeds for the purpose of the cash company rules, as the cash company assessment is made based on a company's cash balance as a result of the fundraising and the pertaining situation at the date of fundraising completion.

To decrease the risk of the listed issuer being deemed a cash company, the parties can reduce the amount of cash the issuer receives from the third-party investor. However, this runs the risk of attracting HKEx scrutiny if the discount to the prevailing market price is too large and the dilution on existing shareholders too significant.

Share Price Extremity

When a primary issuance acquisition provides the third-party investor a significant discount to the then-prevailing market price of the listed issuer's shares, the HKEx may require a share consolidation (*i.e.*, a reverse stock split). The HKEx will calculate the theoretical trading price of the shares based on the market capitalization of the listed issuer, discount and expected dilution. If that price is below HK$0.1, it may be difficult to convince the HKEx that there is no share price extremity issue.

Should the HKEx take that view, the listed issuer will need to include a proposal at the shareholders' general meeting for a consolidation of its shares as a condition of the transaction. Shareholders almost always vote in favor of share consolidation, as the failure to do so may cause the HKEx to suspend trading. The share consolidation could result in a capital reduction, requiring a special resolution and resulting in a potentially longer notice period to convene a general meeting. The HKEx has indicated that the listed issuer should address this issue pre-emptively instead of taking a wait-and-see approach.

Public Float

As a general rule, the HKEx requires all listed issuers to have a public float — shares held by the public and excluding those held by any "core connected person" such as a director, chief executive or substantial shareholder — of at least 25 percent. The HKEx has the right to suspend trading of the shares until appropriate steps have been taken to restore the public float.

If a proposed primary issuance acquisition involves a third-party investor who is seeking to acquire close to 75 percent of a company's issued share capital, the shares held by directors, chief executives, substantial shareholders and their respective close associates must be factored into the public float calculation. One challenge is that information on this type of shareholding may not be available at the time the agreement is signed, in which case an amendment to the agreement may be required, or the third-party investor may sell down its shareholding in order to restore public float and resume trading.

Shareholders' Vote

Third-party investors often enter into share subscription agreements with the listed issuer and one or more of the largest shareholders and/or directors. Sometimes the third-party investor will negotiate representations and warranties relating to the issuer's business and operations. However, once a shareholder becomes a party to the share subscription agreement, it is "involved in" the transaction and, as such, is unable to participate in the independent shareholders' vote. A third-party investor seeking to acquire control in a listed company should weigh the benefit of having representations and warranties given by a major shareholder against the inability to participate in the independent shareholders' vote. Two or more shareholders becoming party to the share subscription agreement may also lead the SFC to conclude that such shareholders are acting in concert and recognize them as a group for the determination of voting right changes and the obligation to make mandatory offers.

Conclusion

The regulatory environment for primary issuance acquisitions has changed significantly in 2015, with the HKEx taking a more conservative approach on a number of issues, including those raised above. Specifically, with the new guidance letter on the cash company rules, it is important that investors and companies structure their transactions carefully to fit within the rules. The HKEx has wide discretion to interpret the listing rules, and interpretations may change from time to time. As such, companies should seek legal advice before structuring an acquisition of a controlling interest in a Hong Kong-listed company.