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Part of the Horizon Scanning series

HONG KONG PUBLIC M&A REVIEW: H1 2020

CONTENTS

I INTRODUCTION

Welcome to our Hong Kong Public M&A Review for H1 2020, where we look back at Hong Kong public company M&A activity from the first half of 2020 and discuss what we see as the key trends and developments.

M&A, both public and private, declined sharply during H1 this year across Asia Pacific, with total deal value down 17% year-on-year. M&A in the Greater China region fell in line with Asia Pacific as a whole. Public company takeovers on the other major global exchanges have suffered sharp declines – in the US, public M&A deal value is down 78%; in the UK, the number of offers has more than halved.

Defying these trends, Hong Kong public M&A enjoyed a strong first half to 2020.

The number of offers announced in H1 2020 for Hong Kong-listed companies increased against the same period last year, from 21 offers to 24. The total value of those offers increased over fourfold, driven by some high-profile privatisations such as Wheelock & Company and Li & Fung.

We have remained extremely busy with public takeovers work since the end of H1, as well as capital markets transactions, and remain cautiously optimistic that factors underpinning the Hong Kong market's attractiveness will continue through the remainder of H2.

For now, please see inside our view of the first half, and feel free to get in touch to discuss any aspects.

Chris McGaffin
Partner
Editor

We are a tier 1 international law firm for Corporate and M&A in Hong Kong and China in the 2019 and 2020 editions of Chambers Asia-Pacific, Legal 500 Asia Pacific and IFLR1000 Asia-Pacific. We are in the top tiers of the league table legal advisory rankings for M&A published by Bloomberg, Mergermarket and Refinitiv.

Highlights of our experience on announced transactions in H1 2020 include advising in relation to:

- Lai Sun Development's offer for Lai Fung Holdings Limited (HKSE: 1125)
- The consortium offer for Li & Fung Limited (HKSE: 494)
- The consortium offer for Clear Media Limited (HKSE: 100)
- China Huadian Corporation on the proposed privatisation of Huadian Fuxin Energy Corporation (HKSE: 816)

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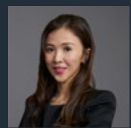

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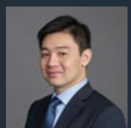

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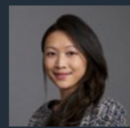
Global anti-trust



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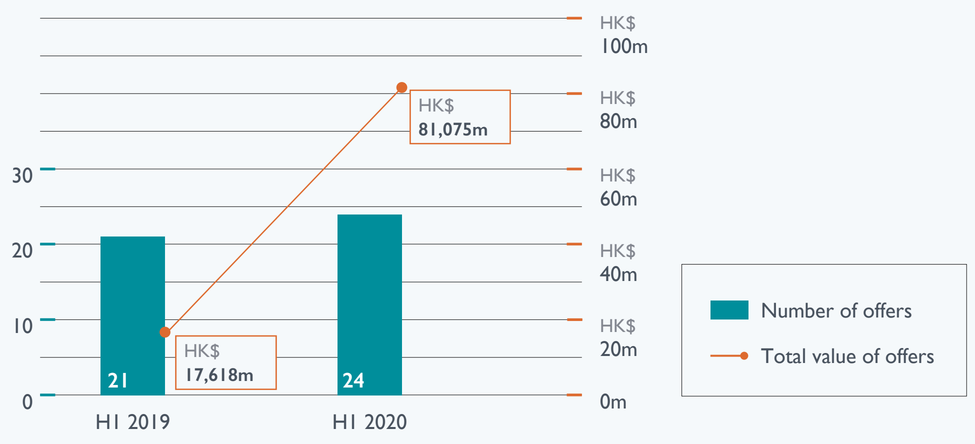
3 HI 2020 IN STATISTICS

1. State of the market: a busy half for public M&A

Hong Kong public M&A enjoyed a strong first half to 2020, defying a global slowdown in both public and private M&A.

HONG KONG PUBLIC OFFERS: A STRONG MARKET

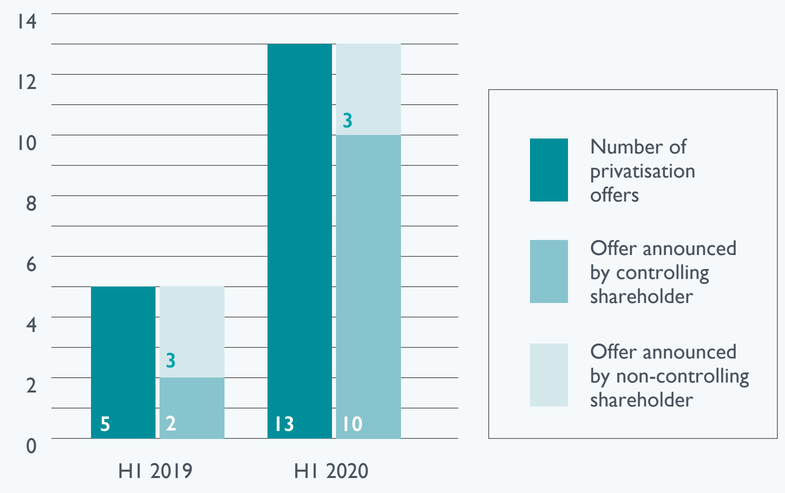


The value of offers announced also increased, up more than fourfold on the same period last year, driven by some headline transactions such as the privatisations of Wheelock & Company, and Li & Fung. The privatisation of Wheelock & Company alone accounted for HK$48bn of HI 2020's total offer value of HK$81bn. The number of offers announced increased by 14% (HI 2019: 21; HI 2020: 24).

2. Deal rationale: privatisations on the rise

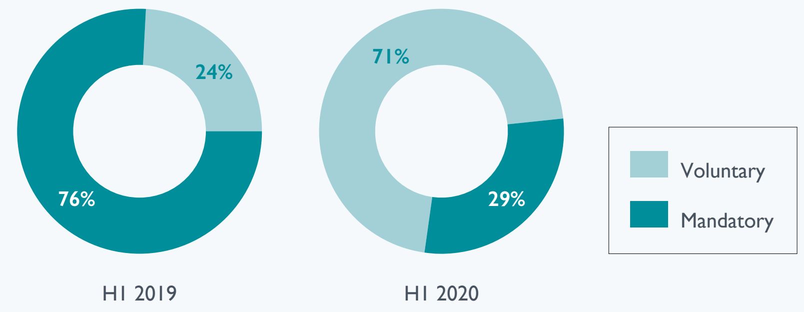
There has been a dramatic increase in the number of privatisations, driven by offers from controlling shareholders. The number of offers seeking privatisation more than doubled year-on-year (H1 2019: 5; 2020: 13), with controlling shareholders accounting for the bulk of these. Overall, privatisation offers by controlling shareholders comprised over 40% of all transactions (H1 2019: 10%).

PRIVATISATIONS ON THE RISE:
CONTROLLING SHAREHOLDERS LEAD THE WAY



The number of mandatory offers (which often entail significant risk of not privatising) dropped sharply.

BUYERS STEER CLEAR OF TRIGGERING MANDATORY OFFERS



3. Deal structures: schemes increase in popularity

Perhaps partly because they may offer a more straightforward route to privatisation, we saw an increasing number of deals done by way of scheme of arrangement as opposed to tender offers. The proportion of deals structured as schemes of arrangement increased from 19% in H1 2019 to 33% in H1 2020.

4. Consideration: cash remains king

The proportion of offers where the consideration was cash remained broadly steady, at 92% (H1 2019: 86%).

5. Friend or foe: rare hostile offers

H1 2020 saw 2 hostile offers (H1 2019: 0), historically rare in the Hong Kong market. As is usual, the remaining 22 deals were recommended.

4 REGULATORY UPDATE
Rule Changes

There have been relatively few changes to public M&A regulations in H1 2020. For practitioners, the more material developments have been the SFC: (1) clarifying which lenders enforcing security over shares can rely on the exemption from making a mandatory offer, and (2) clarifying the treatment of right-of-use assets under the Takeovers Code.

Mandatory offers – SFC clarifies the requirement to make a mandatory offer where a stake is acquired due to the enforcement of security – *March 2020* – The SFC has clarified when a lender may be required to make a mandatory offer pursuant to Rule 26 of the Takeovers Code as a result of enforcing its security over shares in a listed company. Lenders would often seek a waiver in reliance on Note 2 on dispensations from Rule 26, which allows for a waiver where the shareholding was charged to a bank or lending institution on an arm's length basis and in the ordinary course of business.

The SFC has stated that it will interpret "bank or lending institution" narrowly: although an authorized institution within the meaning of the Banking Ordinance will normally fall within the definition, the holding of a money lender's licence is unlikely of itself to suffice (see also our notes on the mandatory offer for Zhongchang International, overleaf).

The SFC has further stated that, although independent administrators and liquidators are not required to make an offer under Rule 26, as they will often be looking to dispose of the secured assets, this may lead to a change of control of the offeree thereby giving rise to a possible offer and an obligation to publish a Rule 3.7 announcement.

Valuation of property assets – SFC revises PN7 to clarify treatment of right-of-use assets in light of IFRS 16 – *March 2020* – The SFC has revised Practice Note (PN) 7 to clarify the treatment of property assets for the purposes of valuations under Rule 11.1(f) of the Takeovers Code. Pursuant to Rule 11.1(f), the offeree (and sometimes offeror) must provide a valuation of its property interests if they exceed 15% of its consolidated total assets and if the offeror is an interested party.

PN7 now clarifies that while right-of-use (ROU) assets such as operating leases are treated under IFRS 16 as assets, ROU assets should not normally be regarded as property assets under the Takeovers Code, and are therefore excluded for the purposes of determining whether a company has significant property interests under Rule 11.1(f).

4 REGULATORY UPDATE

The Rules in Practice

1 PCCW: a rare use of a partial offer (Rule 28)

A partial offer is an offer to buy a proportion only of the shares of other shareholders, as opposed to a full takeover whereby 100% of the shares would be sought. In August, Richard Li made a partial offer for PCCW Ltd (HKSE: 8) to acquire 2% of the offeree's share capital, which if successful will bring his stake to 30.93%. This deal, on which we advised, shows how partial offers – not commonly seen in the market – may be used as a means to mitigate some of the negative consequences for the listed company of the mandatory offer regime contained in Rule 26 of the Takeovers Code.

- A person is required to make a mandatory offer under Rule 26 if they acquire 30% or more of the voting rights of a listed company. Prior to the partial offer, due to Mr Li's 28.93% stake, PCCW had been unable to undertake share repurchases opportunistically without potentially triggering a mandatory offer obligation by increasing Mr Li's stake to 30% or more.

- However, under Rule 28, a person may make a partial offer which would result in them crossing the 30% threshold without making a mandatory offer, provided the partial offer receives the approval of shareholders holding a majority of the independent shares.

- If successful, following the partial offer, Mr Li would only be required to make a mandatory general offer if PCCW's share repurchases cause his shareholding to increase by more than 2% over a 12-month period. This would give PCCW greater flexibility to manage its capital structure.

Says Jing Chen, who was advising on the transaction

2 Zhongchang International: a timely reminder that a lender enforcing security over a controlling stake may be required to make a mandatory offer for the remainder of the company (Rule 26)

Given the recent increase in the number of such cases of enforcement, China Cinda (HK)'s offer for Zhongchang International Holdings (HKSE: 859) is a timely reminder to lenders - in particular, alternative lenders such as asset managers or private equity firms - who provide secured finance to controlling shareholders, of the risk that an obligation to make a mandatory offer for the remainder of the listed company's shares may arise upon enforcement.

- A bank or lending institution who enforces security over shares comprising 30%+ of a listed company will not normally be required to make such a mandatory offer, provided that the security was obtained at arm's length, in the ordinary course of business as security for a loan, and at a time when the lender had no reason to believe that enforcement was likely (Note 2 on dispensations from Rule 26).

- However, in April, China Cinda (HK) announced a mandatory offer to acquire Zhongchang International, having failed to obtain a waiver from the SFC from making a mandatory offer following its enforcement of its security over the controlling shareholder's 74.98% stake in the listed company.

- China Cinda (HK) is an asset management company primarily engaged in distressed asset management and a licensed money lender registered under the Money Lenders Ordinance. While the reason why China Cinda (HK)'s waiver application was not granted was not disclosed in the offer documentation, the SFC has recently clarified (see page 7) that it construes "bank or lending institution" narrowly, and that the holding of a money lender's licence is unlikely to be adequate.

Says Chris McGaffin

3 Chain principle mandatory offers and restructuring of state-owned enterprises (SOEs) (Note 8 to Rule 26.1)

Subject to certain exceptions, when a buyer acquires statutory control (generally, more than 50%) of any company (whether or not listed in Hong Kong), it will be required to make a mandatory offer for its Hong Kong-listed subsidiary if it has indirectly acquired control (generally, more than 30%) of that listed subsidiary (the chain principle; Note 8 to Rule 26.1).

- With the current PRC government's drive for restructuring its SOEs, the market has continued to see major mergers and restructurings of SOE groups in H1, some of which include subsidiaries listed in Hong Kong. Such deals could in principle require a mandatory offer for any Hong Kong-listed subsidiary under a strict application of the chain principle.
- During H1, we have continued to successfully apply for waivers from making a mandatory offer under the chain principle, or confirmation that the principle does not apply, in these circumstances. However, we note that, following the Takeover Panel's decision in relation to the mandatory offer for Maanshan Iron and Steel last year, it is not safe to assume that a waiver will always be granted for nil-paid transfers of indirect controlling stakes in Hong Kong-listed companies between SASAC-owned companies, especially if this is between Central SASAC and a provincial SASAC. Detailed analysis of the relationship between the two SASAC bodies would have to be made if the listed company is significant to the target which is being transferred.
- On potentially relevant deals, consultation with the SFC is recommended - although this is not always possible if the decision is made top-down by the PRC government, resulting in questions on whether a Rule 3.7 announcement has to be made urgently.

Say Benita Yu and Lisa Chung

5 OUR THOUGHTS

1. Buying back the family silver: privatisations surge

The number of offers whose stated aim was privatisation almost tripled in H1 2020, with 13 privatisation offers announced compared with 5 in the same period last year. This has been driven primarily by controlling shareholders, who were responsible for 10 of the 13 attempted privatisations this half (compared with 2 of 5 privatisations in H1 2019). As a result, privatisations by controlling shareholders accounted for over 40% of all deals announced.

In some cases, low share prices battered by the effects of COVID-19 and its countermeasures incentivised controlling shareholders to privatise, or provided an opportune time to proceed with pre existing plans that would be more effectively executed off the public markets.

For example, property companies such as Wheelock & Company (HKSE: 20), and Allied Properties Limited (HKSE: 56) noted that their shares traded at sharp discounts to NAV. For Allied Properties, it felt unable to raise equity capital, and therefore the rationale for maintaining a listing (and the associated costs) was undermined. For Li & Fung (HKSE: 494), the company was anticipating a restructuring to address structural challenges to the retail sector posed by digitalisation, and headwinds created by the pandemic. It argued that maintaining a public listing would create challenges to that process because of the execution risks associated with it and the longer time-frame required to see returns.

In the first half we have also seen SOEs listed in Hong Kong being privatised in connection with larger restructurings of their respective businesses, as part of the PRC government's recent drive to restructure its SOEs. At least four SOE-related privatisations and delistings were announced or completed in H1, two of which we advised on.

Although share prices for some companies and in certain sectors have rebounded from their H1 lows, there remains significant volatility and a number of companies and sectors are trading at historically low levels, and the drive for SOE restructurings continues. Similar considerations may well therefore lead to a further spate of privatisations in H2.

2. Conditionality and MAC clauses

The pandemic radically altered the outlook for many companies almost overnight, and with it, the commercial rationale for many transactions. As a result, market commentary around the world questioned whether material adverse change (MAC) clauses could allow buyers to walk away from deals.

For private M&A, whether a buyer can rely on a MAC clause will depend heavily on its drafting and, in general, the threshold for a court to permit the invocation of a MAC clause is high. Since the beginning of the pandemic, there have been several highly public incidences of litigation involving MAC clauses, and of renegotiations following disputes over the alleged occurrence of a MAC.

Conditions in public M&A must pass an extra hurdle in order to be invoked. Note 2 to Rule 30.1 of the Takeovers Code states that a condition to a public offer should not be invoked unless the circumstances which give rise to the right to invoke it are of material significance to the offeror in the context of the offer.

In practice, this has been an extremely high bar to the invocation of offer conditions such as MACs, and we are not aware of any cases of a MAC condition being successfully invoked in a Hong Kong offer. In H1 2020, an attempt to do just that was made under the UK's takeovers regime, which operates on similar principles to that in Hong Kong. Moss Bros plc, a high-street menswear chain, was the target of an offer that was announced and priced before the commencement of lockdown caused a substantial deterioration in its trading position. Despite the business' decline, the UK Takeover Panel prevented the offeror from invoking its MAC condition on the basis of the UK's equivalent rule.

This serves as a reminder to buyers of listed companies quite how high the threshold for invoking a MAC condition in Hong Kong public M&A will be. In relation to the impact of COVID-19, with the pandemic now a known issue, it is difficult to conceive of circumstances where a buyer would be permitted to invoke a MAC condition to lapse an offer.

3. Shareholder activism

Public M&A in Hong Kong has historically been left relatively untouched by formal interventions from activist investors, possibly because most Hong Kong-listed companies have a controlling shareholder holding more than 30% (and often more than 50%) of the company's shares.

Interestingly, H1 saw Aimia, Inc., a Canadian investment holding company, acquire a slightly greater than 10 per cent. stake in Clear Media Limited (HKSE: 100), then subject to an offer by a consortium of investors including Ant Financial Services Group and JCDecaux. This enabled Aimia to block any squeeze-out of minority shareholders under Bermuda company law and the Takeovers Code.

Post M&A arbitrage (often referred to as "bumpitrage"), whereby an activist investor acquires a blocking stake in a company subject to a takeover offer so as to force the offeror to increase the price, has been a feature of the US and European public M&A markets for some time. Notable examples include Elliott Management's acquisition of stakes in SABMiller and Poundland in the UK, Norbert Dentressangle in France, and NXP in the US.

Aimia's actions so far don't resemble the classic case of "bumpitrage" that we might see in the US or EU. To date, Aimia has made no statement that it is seeking to increase the offer price. Instead, its stated objective is to capture the long-term value generated by a "blue chip" consortium and "a highly skilled management team".

With Asia increasingly a target for activist investors (Japan is now the most targeted jurisdiction outside of the US), it is possible that Hong Kong-listed companies may find themselves targeted by activists more often than in the past, including in M&A situations, and the risk should be borne in mind by the parties when putting deals together.

4. SAMR and PRC regulatory review

With mainland companies making up a significant proportion of the Hong Kong stock market, merger review in the PRC by the State Administration for Market Regulation (SAMR) can often be a relevant consideration on takeovers in Hong Kong.

Despite the increasing uncertainty surrounding regulatory reviews around the world, merger reviews by SAMR appear to be "business as usual" in H1, with some key transactions being cleared in this period, including Elanco's acquisition of Bayer Animal Health unit, a joint venture between Coca-Cola and China Mengniu Dairy, Danaher's acquisition of GE's biopharma business and Infineon Technologies' acquisition of Cypress Semiconductor (the last two were cleared with remedies).

In the current climate, SAMR is conducting particularly detailed reviews and closely scrutinising transactions in certain key industries, including pharmaceuticals and semiconductors.

In April 2020, one of the cases published by SAMR under the simplified review procedure (and which was subsequently cleared) involved a shareholder with a variable interest entity (VIE) structure. Control under a VIE structure is derived from contractual arrangements rather than via ownership of shares, and such structures are frequently used as a means of enabling foreign ownership of PRC businesses in restricted or prohibited sectors, thereby enabling them to list in Hong Kong via a so-called "red-chip" listing. By way of example, at the end of Q3 2019, VIEs listed on global exchanges had a total market capitalisation of almost $2 trillion.

While use of the structure is well-established, SAMR had previously refused to review transactions involving VIE structures, leading to significant uncertainty for parties involved in relevant transactions. This development indicates that, going forward, M&A transactions involving VIE structures may be capable of being subject to at least SAMR review in PRC.

5. Transaction structuring: consortia deals to grow in popularity?

H1 2020 saw 2 high profile consortium offers (H1 2019: 1), for Clear Media and Li & Fung, both of which we advised on. We anticipate that the use of consortia to effect transactions may become a more common feature of Hong Kong public M&A.

We see 3 main reasons for our view. First, a consortium structure allows the offerors to reduce their risk exposure on valuations and the amount of funding each is responsible for. Secondly, private equity is sitting on a record $2.6 trillion of dry powder, and has shown an increasing willingness to participate in club deals and consortia since their decline in popularity following the GFC. Consortia and teaming up with controlling shareholders is a natural next step, as we saw in GLP Pte Ltd's partnership with the founders of Li & Fung, and China Wealth Growth Fund III L.P.'s participation in the consortium to acquire Clear Media. Thirdly, controlling shareholders will often need to obtain outside funding to make a bid, particularly if they are seeking privatisation (discussed above). They may turn to consortia with sponsors and other investors where they are unable to fund transactions alone or with bank lending.

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All transactional data in this material has been taken from public transaction announcements and documentation themselves.

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