Practice Note 19 (PN 19) – Chain principle

1. 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 of the Takeovers Code 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 chain principle

2. 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 and, where both companies are listed, their respective market capitalisation. 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.

   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.

   Where any calculation of the relative values of assets and profits under paragraph (a) may produce an anomalous result or is otherwise inappropriate, the relevant parties should provide further calculations by reference to at least the three most recent audited financial periods for the

3. 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 any of the two tests are met:

(a) **Substantiality Test** – The assets and profits of the first company and the second company are compared in deciding whether the holding in the second company is significant in relation to the first company. Where both companies are listed, their respective market capitalisation will also be compared.

(b) **Purpose Test** – Whether one of the main purposes of acquiring the first company was to secure control of the second company.

The Substantiality Test

<u>Assets and profits</u>

4. When assessing the Substantiality Test, relative values for all appropriate line items for assets and profits, including total assets and net assets, gross profit and net profit, for the relevant companies should be calculated. ,Thism

5. Calculations of relative values of assets and profits should normally be based on the figures reported in latest published financial statements.

Market capitalisation

6. Where both the first company and the second company are listed, the relative value based on their respective market capitalisations will normally be taken into account when assessing the Substantiality Test.

7. Reference dates for market capitalisation comparison should be appropriate having considered the facts and circumstances of each case. Normally, the Executive would accept the latest available market capitalisation data to be appropriate.

Comparing relative values and anomalous results

8. Relative values of 60% or more will normally be regarded as significant. All relevant values calculated for assets, profits and market capitalisation would be taken into account. No single figure would by itself be determinative.

9. When either the first company or the second company is in a net liability position, has made a net loss, or breaks even, the Substantiality Test may produce an anomalous result. For example, if the first company broke even on a consolidated basis, and the second company made a nominal net profit. In this situation, the relevant ratio from comparing net profit would be "infinity" arithmetically, implying t bk (t)4 (se)4 pe ( )hi 4.03 0 Td [(t)2 (hat)2 (4.03 nn (d)-10[(pr)7 (nT
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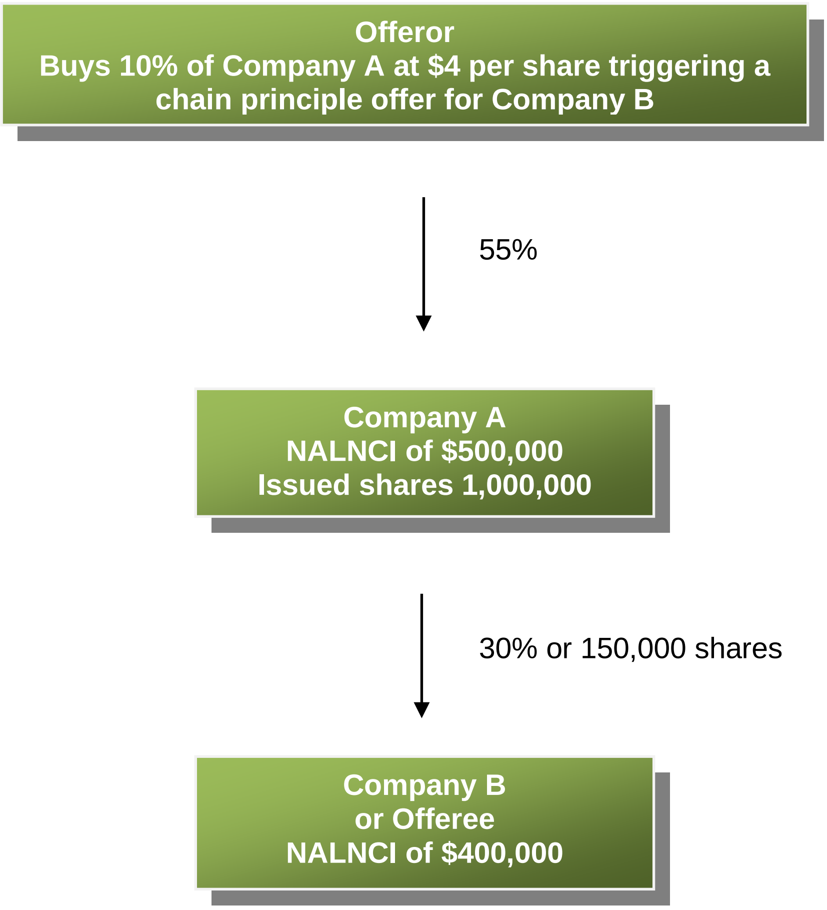
17. Set out below is an example of an offeror triggering a chain principle offer for an asset-based company:



An Offeror acquires a 10% interest in Company A increasing its shareholding from 45% to 55%. Company A holds 30% of Company B (ie, 150,000 shares). 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 assets less non-controlling interests (if any) (**NALNCI**) 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.

18. Steps to calculate the chain principle offer price for Company B:

1. <u>Determine the ratio reflecting the relative values of Company A and Company B</u>

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

   $400,000 x 30% = $120,000

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

   $120,000 / $500,000 = 0.24

2. <u>Determine the implied market capitalisation of Company A</u>

   Based on the acquisition price of Company A’s shares of $4.00 per share, the implied market capitalisation of Company A is:

   $4.00 x 1,000,000 = $4,000,000.

3. <u>Apportion the implied market capitalisation of Company A to Company B</u>

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

   0.24 x $4,000,000 = $960,000.

4. <u>Translate into a per share price for Company B</u>

   The implied market capitalisation of Company B 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 per share.000 =Ѓ7$960 ianf(ned)1(.)T2 (C)6 (o)10 (m)-5 T

19. In summary the Pacpo Formula calculates a chain principle offer price as follows:

$$\frac{\boxed{\text{NALNCI of } 2^{nd} \text{ company} \times 1^{st} \text{ company's \% shareholding in } 2^{nd} \text{ company}}}{\boxed{\text{NALNCI of } 1^{st} \text{ company}}} \times \frac{\boxed{\text{Transacted price of } 1^{st} \text{ company} \times 1^{st} \text{ company's total issued shares}}}{\boxed{\text{No. of } 2^{nd} \text{[2]}}}$$

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

29 September 2023