STOCK EXCHANGE CALLS FOR ADEQUATE DISCLOSURE ON BASIS OF TRANSACTION CONSIDERATION

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In October 2023, the Stock Exchange of Hong Kong Limited (the "Stock Exchange") issued a new guidance letter (HKEX-GL116-23) directing Hong Kong listed issuers to disclose adequate information concerning their basis of consideration for notifiable transactions, particularly where the consideration was based primarily on an independent business valuation.

> "The Stock Exchange drew attention to the need for disclosure of adequate and objective information with quantitative inputs and analysis to substantiate how the consideration for the notifiable transaction was determined."

Pursuant to Main Board Listing Rule 14.58(5)/GEM Listing Rule 19.58(6) and related guidance materials, when a Hong Kong listed issuer conducts a notifiable transaction, it must disclose the basis upon which the consideration was determined. Where the consideration of the transaction is primarily based on an independent business valuation of the transaction target (the "Target"), details of the valuation would need to be disclosed.

The Stock Exchange has recently noted cases where disclosures on the basis of consideration were overly general and simplistic, falling short of the general standard required. In particular, it noted that disclosures on independent valuations were insufficient for investors to understand how the valued amount was derived.

The Stock Exchange drew attention to the need for disclosure of adequate and objective information with quantitative inputs and analysis to substantiate how the consideration for the notifiable transaction was determined.

WHERE BUSINESS VALUATION IS A PRIMARY FACTOR IN THE DETERMINATION OF THE CONSIDERATION

When a listed issuer conducts a notifiable transaction where consideration is primarily based on an independent business valuation of the Target, its circular should contain the Target's valuation report or a summary that fairly presents the valuer's views and analysis and all material factors contained in the report.

Guidance was provided on the disclosure of valuation approaches/methods, key inputs and assumptions. Please see below a summary of the key requirements set out in HKEX-GL116-23:

Required disclosures on valuation approach

For any of the adopted approaches, the valuation report (or its summary) should include valuation methods, key inputs and assumptions used in the valuations, comprising (among other things):

• the valuation approaches and methods selected and reasons for their selection;
• the key inputs and assumptions, and how they were determined and translated into the appraised value;
• if appraised value is different from the base value computed from the valuation method, a reconciliation of such difference; and
• where more than one valuation approach and method are used, the process in analysing the values derived from the different valuation approaches and methods and how they contribute to the final appraised value.

Required disclosures on valuation key inputs and assumptions

Market approach

Disclosures are required as to:

• key inputs such as financial information about the Target, the pricing multiples used and its rationale;
• a list of market comparables and its bases, including the selection criteria (including quantitative benchmarks) and bases for excluding those that meet the selection criteria;
• details of the selected market comparables (e.g. nature and location of their business and financial information); and
• any adjustments made for differences between the Target and the market comparables and how they were determined.

Disclosures considered to be **insufficient**:

• a generic description of the selection criteria – e.g. comparable companies were selected on the basis that they are "mostly" or "mainly" engaged in certain businesses, without providing any quantitative benchmark such as the percentage of revenue or profits attributable to the relevant business segment; and
• limited explanation as to exclusions of certain companies that met the selection criteria from the list of market comparables – e.g. certain companies were excluded as their price earnings multiples were "significantly higher or lower than" the other comparables, without disclosing the identities and price earnings multiples of those companies to support the basis for exclusion.

Required disclosures on valuation key inputs and assumptions	
Income approach	Disclosures are required as to: • all key, specific assumptions underlying the financial projections, in particular quantitative assumptions and the supporting rationale; • key inputs to the valuation and how they were determined; • a narrative of the discounted cash flows (DCF) model that describes how the key inputs are applied to the financial projections to arrive at the base value of the Target and (if any) a reconciliation of the difference between the final appraised value and the base value; • computation process showing how the financial projections and the key inputs are translated into the base value of the Target; and • a sensitivity analysis if changes in any key assumptions or inputs are likely to materially affect the valuation. Disclosures considered to be **insufficient**: • making assumptions about the general accuracy of the estimates made in the profit forecast, or matters which the directors are best able to take a view in or are able to exercise control over; and • disclosing only the definition of the DCF method and the formulae used, and generic assumptions made for the financial projections, and providing limited information about the key quantitative inputs such as the discount rate and the terminal growth rate (if a terminal value is applied to the cash flows beyond the forecast period), and the specific assumptions in respect of the Target.
Cost approach	Disclosures are required as to: • quantitative inputs used to determine the gross current replacement or reproduction cost; • amount of depreciation adjustment made to the gross current replacement or reproduction cost to account for the physical and economic obsolescence and any technical deficiency; and • computation process for the final depreciated replacement or reproduction cost.
Asset-based approach	Disclosures are required on: • key quantitative inputs and assumptions used in the calculations of these appraised values and the computation process, and where applicable, provide separate valuation reports for these assets; and • explanation on the material differences between the book values and appraised values (if any).

WHERE NO INDEPENDENT VALUATION IS DISCLOSED

When a listed issuer conducts a notifiable transaction without obtaining an independent valuation, the listed issuer is required to disclose sufficient and objective information with quantitative inputs and analysis to substantiate how the consideration was arrived at.

Please see below a summary of the key disclosure requirements as set out in the guidance letter:

Bases or factors on or with which consideration (or material terms) are determined or taken into account	Required disclosures
Historical performance and future prospects of the Target	• Adequate and relevant information (both quantitative and qualitative) of the underlying performance of the Target, e.g. its expected financial and operational performance (such as its revenue growth rate, gross profit/ EBITDA margin, sale volume, market share and production capacity and efficiency).
Pricing multiples derived from market comparables	• Relevance of such pricing multiples and the selection criteria for the market comparables (see above).
A forecast on the Target's net profits or losses	• Key assumptions (including quantitative assumptions) for the forecast and the supporting rationale, with details and in specific terms (see above).

It is also expected that the same principles and guidelines are applicable to notifiable transaction announcements as well as connected transactions under Chapter 14A.

Please feel free to reach out to us if you have any queries regarding this newsletter.

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