HKEX Guidance Letter
HKEX-GL116-23

October 2023 (~~Updated in January 2024~~Last updated in June 2024)

Disclosure of the basis of consideration and business valuations in notifiable transactions

I. Background

1. Under current Rules and guidance[1], when an issuer conducts an acquisition or disposal that constitutes a notifiable transaction, it must disclose the basis for determining the consideration and the terms of the transaction. Where the consideration (or other material terms) of the transaction is primarily based on an independent business valuation of the target (**Transaction Target**), details of the valuation must be disclosed in the transaction circular.

Published guidance on directors' duties in corporate transactions

2. In May 2017, the Securities and Futures Commission (**SFC**) issued a Guidance note on directors' duties in the context of valuations in corporate transactions[2] (**SFC Guidance Note**). The SFC Guidance Note advises directors to carry out independent and sufficient investigation and due diligence on the Transaction Targets, and provides guidance on the circumstances where the directors should consider the need to appoint an independent valuer. These include: (i) where the directors do not have sufficient experience or expertise in the target's business or in valuation; (ii) the target's business is new or still in its infancy; (iii) the information provided in respect of the target's business requires professional advice or professional scrutiny in order to properly assess the merits of the proposed transaction; (iv) the size of the target relative to that of, or its significance to, the issuer; (v) the risks involved in the transaction or the complexity or nature of the transaction; or (vi) where any director of the acquiring company has an actual or potential conflict of interest in the proposed transaction.[3]

3. In July 2019, the SFC published a Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals. The statement outlines recurring types of misconduct related to acquisitions and disposals that have given rise to concerns, including corporate transactions where the issuer either did not obtain a valuation of the Transaction Target when the circumstances suggested it would be appropriate, or the issuer relied on a valuation when reliance on the valuation was imprudent.

[1] See Main Board Rule 14.58(5) / GEM Rule 19.58(6) and ~~Frequently Asked Question Series 7, No.21.~~ FAQ11.5 – No.1.
[2] Along with the guidance to directors, the SFC also issued circulars to financial advisers and valuers in relation to the expected standard of work on valuations in corporate transactions.
[3] The SFC Guidance Note also provides guidance on considerations for engaging a valuer, including assessments on the valuer's independence and qualification, and the scope of the valuer's mandate.

II. Purpose of this guidance letter

4. In our vetting of issuers' transaction circulars, we identified cases where we were concerned that the terms of the transaction (including the consideration) may not be fair and reasonable to the issuer and its shareholders as a whole. Where the consideration was primarily based on an independent valuation, we found that the disclosure about the valuation was insufficient for investors to understand how the valued amount was derived and accordingly, the basis for the consideration. This falls short of the general standard of disclosure, which requires that the information contained in an issuer's circular must be accurate and complete in all material respects and not be misleading or deceptive, and where shareholders' approval is required, the circular should contain all information necessary to allow shareholders to make a properly informed decision[4].

5. This letter provides guidance on recommended disclosure of business valuation which forms a primary factor in the determination of the consideration (see section III(a)). It should be read in conjunction with the SFC guidance materials.

6. This letter also provides guidance on disclosure of the basis of consideration for notifiable transactions, regardless of whether an independent valuation is disclosed (see section III(b)).

III. Guidance

(a) Disclosure of business valuation which forms a primary factor in the determination of the consideration

General

7. An issuer should adequately explain the basis for determining the consideration to enable its shareholders to assess whether the terms of a transaction are fair and reasonable. When it conducts a transaction under the circumstances set out in paragraph 1, its circular should contain the valuation report of the Transaction Target or a summary that fairly presents the views and analysis of the valuer and all material factors contained in the report.

8. In general, the valuation report (or the summary of it) should contain information in line with generally accepted valuation standards (e.g. the International Valuation Standards) and include, among others:

   (i) the valuation approach(es) and method(s) used by the valuer and the reasons for their selection;
   (ii) the scope of work performed by the valuer, any limitation thereon and the reasons for such limitation;
   (iii) the nature and source of information relied upon;
   (iv) the key inputs and assumptions, and how they were determined and translated into the appraised value;
   (v) the appraised value ascribed to the Transaction Target and the principal reasons for the conclusions reached;
   (vi) the effective date of the valuation; and
   (vii) the identity, qualification and independence of the valuer.

[4] Main Board Rules 2.13 and 14.63 / GEM Rules 17.56 and 19.63.

9. In our review, we have noted that disclosure in some issuers' circulars was overly general and simplistic, particularly in disclosure about valuation methods, key inputs and assumptions used in the valuations.

Valuation approaches and methods

10. Issuers may use different valuation approaches to assess the valuations of Transaction Targets. Common valuation approaches include the income approach, market approach, cost approach and asset-based approach. Each of these approaches has different methods of application.

11. The valuation approaches and methods selected by the valuer and the reasons for their selection should be clearly disclosed and discussed in the valuation report. For example:

    - When applying the discounted cash flows (**DCF**) method to value a start-up target company, the issuer should explain how the use of the DCF method was appropriate in the absence of a historical track record to substantiate the forecasts.

    - When applying the market approach to value a target company engaging in a novel or innovative industry, the issuer should explain how the use of the market approach is appropriate in the absence of similar or comparable companies.

12. If the appraised value is different from the base value computed from the valuation method selected by the valuer, the report should include a reconciliation of such difference[5].

13. Where more than one valuation approach and method is used by the valuer, the report should also include the valuer's process in analysing the values derived from different valuation approaches and methods and how they contribute to the final appraised value.

Key inputs and assumptions

14. To assist shareholders to understand the valuation, the issuer should explain, with detail and in specific terms, the key assumptions and valuation inputs.

Market approach

15. Where the market approach is used, the valuation report should contain sufficient information on the criteria used to select market comparables[6]. This would include:

    - the key inputs such as the financial information of the Transaction Target, the pricing multiples (e.g. revenue/ earning/ EBITDA/ book value multiples) used in the computation process and the rationale for using these pricing multiples;

    - a list of market comparables and the bases for compiling this list. The report should set out the selection criteria (including quantitative benchmarks) for the comparables and the reasons for using those criteria. If any companies or transactions that meet the selection criteria are excluded, the bases for such exclusion should be justified and clearly stated;

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[5] For example, the discount applied to the base value of the Transaction Target for lack of marketability, or the discount for lack of control in an acquisition of a non-controlling interest of the Transaction Target (or conversely, the control premium).

[6] They can be publicly-traded comparables or comparable transactions.

- relevant details of the market comparables selected (e.g. the nature and location of their principal businesses and financial information such as revenue, profits, net asset value and market capitalisation/transaction consideration) to reflect that the selection criteria were consistently applied and the market comparables are appropriate and exhaustive; and

- any adjustments made for differences between the Transaction Target and the market comparables and how they were determined.

16. Set out below are some examples of cases reviewed where the disclosure was inadequate and could not demonstrate that the selection bases were appropriate:

    - The description of the selection criteria was generic. For example, the report disclosed that 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.

    - There was limited explanation as to why certain companies that met the selection criteria were considered as outliers and excluded from the list of market comparables. For example, the report simply disclosed that certain companies were excluded as their price earnings multiples were “significantly higher or lower than” the other comparables. There was no disclosure of the identities and price earnings multiples of those companies to support the basis for excluding them from the list of market comparables.

Income approach

17. For a DCF valuation, the Rules specifically require, among others, disclosure of all the principal assumptions upon which the underlying cash flow forecast is based.[7] As a general principle, the assumptions must be specific rather than general, and they should draw the shareholders’ attention to, and where possible quantify, those uncertain factors which could materially disturb the ultimate achievement of the forecast. It would not be acceptable to make assumptions about the general accuracy of the estimates made in the profit forecast, or matters which the directors, by virtue of their particular knowledge and experience in the business, are best able to take a view in or are able to exercise control over.[8]

18. In some cases reviewed, the valuation report disclosed the definition of the DCF method and the formulae used, and generic assumptions made for the financial projections. There was 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 Transaction Target. As a result, shareholders cannot properly assess the fairness and reasonableness of the terms of the transaction.

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[7] Under Main Board Rule 14.61 / GEM Rule 19.61, any valuation of assets (except for property interests or businesses) acquired by an issuer based on discounted cashflows or projections of profits, earnings or cashflows is regarded as a “profit forecast”. Main Board Rules 14.60A, 14.66(2) and Paragraph 29(2) of Appendix D1B / GEM Rules 19.60A, 19.66(10) and Paragraph 29(2) of Appendix D1B require (i) a report from the issuer’s auditors or reporting accountants on their review of the accounting policies and calculations for the profit forecast; and (ii) a confirmation from the directors or the financial advisers that the forecast has been made by the directors after due and careful enquiry.

[8] Main Board Rule 11.19 / GEM Rule 14.31

19. We consider that the disclosure should include, among others:

- the key, specific assumptions underlying the financial projections, in particular quantitative assumptions (including, without limitation, revenue growth rates, the gross profit or EBITDA margins, changes in major expenses of the Transaction Target during the forecast period and its plan for capital expenditure) and the supporting rationale. It would not be sufficient to include merely qualitative or narrative statements without specific quantitative disclosures of the relevant figures;

- the key inputs (e.g. the discount rate and terminal growth rate) to the valuation and how they were determined;

- a narrative of the DCF model that describes how the key inputs are applied to the financial projections to arrive at the base value of the Transaction Target. Where the final appraised value is different from the base value, the report should also include a reconciliation of such difference;

- where appropriate (for example, where the Transaction Target's income statement items are projected to be significantly improved compared to its historical trend or the Transaction Target's projected profit margin is significantly higher than that of the industry peers), the Exchange has the discretion to request the issuer to explain the rationale behind the assumptions with basis and disclose the key projected figures such as projected revenues, operating costs and profits. The issuer should also disclose the computation process showing how the financial projections and the key inputs are translated into the base value of the Transaction Target; and

- a sensitivity analysis if changes in any key assumptions or inputs are likely to materially affect the valuation.

Cost approach

20. We identified insufficient disclosure about key valuation inputs in some cases reviewed. We consider that the report should contain: (i) the quantitative inputs used to determine the gross current replacement or reproduction cost (i.e. costs that would be required to replace or reproduce the assets of equivalent utility e.g. material and labour costs, and other associated costs such as transportation and installation costs); (ii) the 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 (iii) the computation process for the final depreciated replacement or reproduction cost.

Asset-based approach

21. Where the asset-based approach is used, the valuation report sets out the appraised value for each asset and liability of the Transaction Target, their book values and the differences between the two. The report should disclose the key quantitative inputs and assumptions used in the calculations of these appraised values and the computation process, and where applicable, it should provide separate valuation reports for these assets. Where there are material differences between the book values and appraised values, the report should also explain the differences.

(b) Disclosure of the basis of determining the consideration regardless of whether an independent valuation is obtained

22. An issuer should provide an adequate explanation of the basis for determining the consideration by disclosing in the transaction announcement sufficient and objective information with quantitative inputs and analysis to substantiate how the consideration was arrived at. For instance, where the consideration is not primarily based on an independent valuation, it would not be sufficient if the issuer simply disclosed that the consideration is determined with reference to the historical performance and future prospects of the Transaction Target. The issuer should provide adequate and relevant disclosure (both quantitative and qualitative) of the factors that are key to the determination of the consideration. Examples include the historical and expected financial and operational performance of the Transaction Target such as its revenue growth rate, gross profit/ EBITDA margin, sale volume, market share and production capacity and efficiency.

23. Further, the explanation should also include disclosure of quantitative inputs and assumptions referencing, where applicable, our guidance in part (a) above. For example:

- where the consideration of a transaction is determined with reference to, among others, pricing multiples derived from market comparables, the issuer should make adequate disclosure on the relevant pricing multiples, why such pricing multiples were relevant and the selection criteria for the market comparables (see paragraphs 15 and 16); or

- if an issuer discloses a forecast on the Transaction Target's net profits or losses to support the basis for the consideration or other terms of the transaction, it should disclose, with detail and in specific terms, the key assumptions (including quantitative assumptions) for the forecast[9] and the supporting rationale (see paragraphs 17 to 19).

IV. Glossary

"appraised value" – an opinion of the value of an asset or a business at a specified date given by a valuer

"asset based approach" – a valuation approach which estimates the value of a business as its adjusted net asset value, i.e. after adjusting each asset and liability of the business to their respective appraised values

"base value" – the value of an asset or a business directly computed from a valuation method. A valuer would apply valuation premiums, discounts and/or other adjustments (where appropriate) to the base value to arrive at the appraised value

"cost approach" – a valuation approach which estimates the value of an asset or a business by calculating its gross current replacement or reproduction cost and subtracting the estimated depreciation to reflect its physical deterioration and other forms of obsolescence

"discount rate" – the rate at which the financial projections are discounted to their present values. It should reflect the time value of money and the risks associated with the financial projections and future operations of the asset or business

[9] Main Board Rules 14.60A, 14.66(2) and Paragraph 29(2) of Appendix D1B / GEM Rules 19.60A, 19.66(10) and Paragraph 29(2) of Appendix D1B also require (i) a report from the issuer's auditors or reporting accountants on their review of the accounting policies and calculations for the profit forecast; and (ii) a confirmation from the directors or the financial advisers that the forecast has been made by the directors after due and careful enquiry.

"income approach" – a valuation approach which estimates the value of an asset or a business by reference to the value of income, cash flows or cost savings generated by the asset or business based on discounting future cash flows to present value

"market approach" – a valuation approach which estimates the value of an asset or a business by comparing it with comparable assets or companies for which price information is available

"terminal value" – where an asset or a business is expected to generate cash flows beyond the forecast period, the value of the asset or business at the end of that period, i.e. the sum of present values of its expected future cash flows beyond the forecast period, valued at the end of the forecast period

"valuation approach and method" – a valuation approach generally refers to the manner in which the valuation task is undertaken in order to determine the value of an asset or a business, while a valuation method generally refers to the particular procedure of technique applied or used