# Ex-chaos trading: Zhongtian proves point

***27th January 2011***

Zhongtian International Ltd (**Zhongtian**, 2379) yesterday provided us with a classic and timely demonstration of why shares should not be allowed to trade ex-entitlements until shareholders have approved any necessary resolutions in general meeting. Timely, because after Webb-site has raised this point several times with regulators over the years, they are finally doing something about it, in the form of a consultation paper published by HKEx on 17-Dec-2010 (announcement here). But they need to do more, in two other areas we once again raise - the treatment of passive shareholders, and the discount on open offers.

## Zhongtian case study

On the evening of Sunday 19-Dec-2010 (but dated 17-Dec-2010), Zhongtian announced a proposed rights issue of 10 new shares for every share held, at $0.03 per share, a 96.7% discount to the previous market price of $0.90. The deal was underwritten by chairman Chen Jun (**Mr Chen**) who owns 62.79% of Zhongtian.

The prior market capitalisation was just HK$162.8m. The stated reason for the rights issue, which would raise HK$54.26m gross, was 40% for "general working capital" and 60% "to finance the Group in establishing a new line of business in trading of precious metals and coal", with no acquisitions planned. Being larger than 1 for 2, the issue was subject to independent shareholders' approval. There was a circular dated 10-Jan-2011 convening a meeting for yesterday, 26-Jan-2011.

There was no particular reason for such a massive discount. The interim report shows net tangible assets at 30-Jun-2010 of CNY95.58m (then HK$109.6m), or about HK$0.606 per share. So this was not a bubble stock, and was trading at a modest premium to NTAV which reflected its potential as a back-door listing shell at only HK$53.2m over book value - much less than shells are worth these days.

That NTAV included CNY50.4m of vacant investment office properties in Qingdao, CNY27.5m of cash, and CNY34.1m of equity investment, being a 2.14% stake in unlisted Qingdao Huafeng Rural Cooperative Bank Ltd. There were no borrowings. We note that the front cover has a photograph of a grade-A office tower and hotel in Pacific Place, Admiralty, Hong Kong, with which Zhongtian has no connection.

Turnover in the stock picked up substantially on the news, with the shares rising to a daily high of $2.16 on 3-Jan-2011, as shown by our market data. We should note that it was very volatile intra-day during that period. On 18-Jan-2011, the day before it went ex-rights, the stock closed at $1.71. So the theoretical ex-rights price (**TERP**) was ($1.71+10*$0.03)/11=$0.183. In theory, the bulk of the value of each share in the company, $1.527 per share, had been transferred to the 10 nil-paid rights which had yet to be distributed. The pro forma net asset value was $0.082 per share.

When the stock went ex-rights on 19-Jan-2011, trading volume exploded, with the price ranging from $0.315 to $0.96, closing at $0.88 with a volume-weighted average of $0.708. Turnover that day was 69.96m shares, or 104% of the free float of 67.29m shares. The closing price of $0.88 was a gain of 380% over the TERP. Clearly, some investors were betting that the rights issue would not proceed, otherwise, they were paying almost 5 times the previous day's adjusted price, and 10.7x the pro forma net asset value. Volume the next day was 51.93m shares, with the price averaging $1.331 and closing at $1.50.

At the EGM yesterday, held in Qingdao at 10:00, independent shareholders vetoed the rights issue by 71.2% to 28.8%, with a turnout of 35.7% of the free float shares eligible to vote. Consequently, the rights issue is cancelled. Mr Chen was prohibited from voting, because rights issues larger than 1 for 2 require independent shareholders' approval. Zhongtian could have done a 1 for 2 right issue at $0.60 to raise exactly the same proceeds, without the requirement for a shareholder meeting, but it did not.

With the rights issue cancelled, the stock rose this morning, closing for lunch at $1.45, up 26.1%.

During the 5-and-a-bit trading days ex-rights, the average price was $1.017, trading in a huge range from $0.315 on 19-Jan to $1.52 on 20-Jan. The investor who sold at $0.315 probably thought he was doing well to get a premium to the TERP, but in fact he suffered an 81.6% discount to the previous day's closing price. Those who bought during the ex-rights trading last week, at the average of $1.017, are up 42.6% this morning.

Previous examples of rights issues which were vetoed after ex-rights trading include a rights issue by Tai Shing International (Holdings) Ltd (8103), 2 for 1 at $0.10, an 84% discount to the cum-rights price of $0.62. The stock went ex-rights on 30-Jun-2009, and the deal was vetoed by independent shareholders on 7-Jul-2009.

## Ex-entitlement trading

The Zhongtian case provides a perfect example of the chaotic trading that results when a share starts trading ex-entitlements before the meeting to approve the entitlement, whether it is a capital distribution, a regular dividend, a demerger, a rights issue or anything else that affects the value of the shares.

We've made this point several times to regulators. There was a consultation in 2009 on the timing of rights issues and open offers, and we published an article, conducted an opinion poll, and made a submission with the results. Although that consultation did not cover ex-entitlement trading, we included the point and in the poll we asked readers whether trading ex-entitlement before meetings to approve entitlements should be banned. The opinion of 206 respondents was 174 in favour, 20 against, and 12 undecided. That's **overwhelming support, from 90% of those who expressed a view**, with 10% opposed.

The consultation paper published on 17-Dec-2010 proposes that there should be at least one day of trading after a shareholder meeting before shares start trading ex-entitlement. We support that, because it provides the market an opportunity to establish the market value of the shares after the uncertainty of the shareholder meeting has been removed. This is important in determining the fair adjustment to the terms of convertible bonds and share options resulting from the discount in the rights issue or open offer.

## Other problems with HK rights issues and open offers

Please refer to the sections of our article of 7-Sep-2009, titled "You snooze, you lose" (on rights issues and open offers) and "Dilution damage calls for discount limit" (on open offers). We won't repeat the details here, but HKEx has still not addressed these problems.

If the Zhongtian rights issue had gone ahead, then any shareholder who failed to take up their rights or sell them would have seen a massive dilution in their share value, from $1.71 (the day before ex-rights) to the TERP of $0.183, a loss of 89.3%. The beneficiaries would have been those active shareholders who applied for "Excess Rights" in the issue. **Hong Kong must end this unfair way of treating passive shareholders, and instead require that unsubscribed shares be sold in the market after the issue closes, and any premium over the issue price should be paid to the holders of those entitlements rather than confiscated**. That is the way to run a fair market, not penalising people who, for whatever reason, do not subscribe their entitlements. The shareholder may be ill, on holiday, dead, in jail, or simply not hear about the issue. The regulators have a duty to protect passive shareholders from expropriation of their shareholder value.

The "Excess Rights" system is also something which is wide open to abuse by controlling shareholders and directors. They are in a position to know, from the registrar, how many applications for excess rights have been received, and to scale up their own applications just before the closing deadline in order to get an extra allocation of unsubscribed shares at a big discount to market. Also, some investors may own as little as 1 share and make applications for millions of excess rights, which are allocated proportionate to the application size rather than to the number of shares held. It is far fairer to sell the unsubscribed shares in the market and pass the premium to holders of those entitlements.

**For the same reason, open offers should be limited to a discount of 10%, as they are in the UK under Listing Rule 9.5.10, because shareholders have no opportunity to sell their entitlements.**

Again, when we polled on those two points in 2009, there was over whelming support. 83% of those who expressed a view said that the premium on sale of unsubscribed entitlements should be paid to their holders. 90% of those who expressed a view said that there should be a discount limit on open offers. 87% said the discount limit should be 10%. It is disgraceful that HKEx has yet to address these points.

This article, with the poll results of 2009, constitutes our submission to HKEx on these points and on the very narrow consultation on ex-entitlement trading. **Readers: please support our efforts by writing to response@hkex.com.hk**.

# Poll results: Rights issues & open offers

| | |
|---|---|
| Current time: | 21:33:20 28-Jan-2011 |
| Closing time: | 18:00:00 25-Sep-2009 |
| Time remaining: | **Poll closed** |

**1. Do you agree that there should be a discount limit on open offers, to reduce dilution?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 181 | 87.4% |
| No | 21 | 10.1% |
| Undecided | 5 | 2.4% |
| Total | 207 | 100.0% |

Crosstab with question: 2 Submit

**2. If so, then what should the discount limit be?**

| Answer | Responses | Share |
|---|---|---|
| 10% (UK limit) | 166 | 87.4% |
| 20% | 17 | 8.9% |
| More than 20% | 7 | 3.7% |
| Total | 190 | 100.0% |

Crosstab with question: 1 Submit

**3. Should we keep at least 7 business days to sell shares before they go "ex" an open offer?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 185 | 90.2% |
| No | 12 | 5.9% |
| Undecided | 8 | 3.9% |
| Total | 205 | 100.0% |

Crosstab with question: 1 Submit

**4. After a rights issue or open offer closes, should any net premium from sale of unsubscribed entitlements be paid to their holders?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 154 | 75.1% |
| No | 32 | 15.6% |
| Undecided | 19 | 9.3% |
| Total | 205 | 100.0% |

Crosstab with question: 1 Submit

**5. Should HKEx allow trading "ex" an entitlement even before shareholders have approved it?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 20 | 9.7% |
| No | 174 | 84.5% |
| Undecided | 12 | 5.8% |
| Total | 206 | 100.0% |

Crosstab with question: 1 Submit