

HKEX LISTING DECISION

HKEX-LD108-2017 (published in June 2017) (updated in October 2019
(amendments to the reverse takeover Rules) and withdrawn in January 2024)

[Streamlined and incorporated into the guidance letter GL104-19 (Guidance on application of the reverse takeover Rules).]

Parties	Company A – a Main Board issuer Target – a company that Company A proposed to acquire from Company B Company B – the owner of the Target
Issue	Whether Company A's proposed acquisition of the Target constituted a reverse takeover or an extreme VSA
Listing Rules	Main Board Rule 14.06B
Decision	The proposed acquisition was a reverse takeover

FACTS¹

1. Company A was principally engaged in trading business.
2. Company A proposed to acquire the Target from Company B. It would pay for the acquisition by issuing consideration shares to Company B. Upon completion of the acquisition, Company B would become a substantial shareholder of Company A (25% of the enlarged issued shares).
3. The acquisition would be a very substantial acquisition based on the size tests. With an asset ratio of about 8 times and a revenue ratio of about 50 times, the Target was significantly larger than Company A.
4. The Target was principally engaged in coal mining. It owned two coal mines (**Target Mines**) which had been under commercial production for a few years. The information provided by Company A showed that there were changes in the business model of the Target:
 - During the track record period, the Target had been selling mixed coal by mixing the coal extracted from the Target Mines with different types of raw coal purchased from other coal mines owned by Company B (**Other Mines**). In light of the recent change in market conditions, the Target intended to sell coal produced from the Target Mines without mixing with raw coal from the Other Mines after completion of the proposed acquisition.

¹ Time reference is the time to date of the decision.

- It was also noted that the Target's coal products were mainly sold to Company B who then sold the products to ultimate customers at a mark-up price. Sales to Company B accounted for about 50% of the Target's revenue in the first year of the track record period, and over 90% in the last two financial years.

Company A explained that historically Company B had performed the sales and distribution functions for coal products from the Target Mines and the Other Mines for the purpose of centralized management and planning. A few months ago, the Target had already set up its own sales and distribution team for selling its products directly to the ultimate customers.

5. Company A submitted that the Target could meet the profit requirement for new listing applicants under Rule 8.05(1) and the acquisition should be treated as an extreme VSA as stated in Guidance Letter GL78-14. It sought the Exchange's confirmation that the acquisition would not constitute a reverse takeover.

APPLICABLE LISTING RULES

6. Rule 14.06(6) defines a "reverse takeover" as "... *an acquisition or a series of acquisitions of assets by a listed issuer which, in the opinion of the Exchange, constitutes, or is part of a transaction or arrangement or series of transactions or arrangements which constitute, an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new applicants set out in Chapter 8 of the Exchange Listing Rules...*". This is a principle based test.
7. Rule 14.54 states that "*The Exchange will treat a listed issuer proposing a reverse takeover as if it were a new listing applicant. The enlarged group or the assets to be acquired must be able to meet the requirements of rule 8.05 and the enlarged group must be able to meet all the other basic conditions set out in Chapter 8 of the Exchange Listing Rules. ...*"
8. The Exchange Guidance Letter (HKEX-GL78-14) on reverse takeovers (**RTO**) explains that Rule 14.06(6) is an anti-avoidance provision designed to prevent circumvention of the new listing requirements. Paragraphs 7 and 8 of the guidance letter states that:-

"7. If a transaction falls outside the bright line tests, the Exchange will apply the principle based test to assess whether the acquisition constitutes an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for new listing. The

transaction would be treated as a RTO under the principle based test if the Exchange considers it is an 'extreme' case taking into account the following criteria:

- *the size of transaction relative to the size of the issuer;*
 - *the quality of the business to be acquired—whether it can meet the trading record requirements for listings, or whether it is unsuitable for listing (e.g. an early stage exploration company);*
 - *the nature and scale of the issuer's business before the acquisition (e.g. whether it is a listed shell);*
 - *any fundamental change in the issuer's principal business (e.g. the existing business would be discontinued or very immaterial to the enlarged group's operations after the acquisition);*
 - *other events and transactions (historical, proposed or intended) which, together with the acquisition, form a series of arrangements to circumvent the RTO Rules (e.g. a disposal of the issuer's original business simultaneously with a very substantial acquisition); and*
 - *any issue of Restricted Convertible Securities² to the vendor which would provide it with de facto control of the issuer.*
8. *A transaction would be treated as an extreme very substantial acquisition (extreme VSA) where the Exchange considers it "extreme" by reference to the criteria set out in paragraph 7, but the assets to be acquired can meet the minimum profit requirement under Rule 8.05 (the positive cash flow requirement under GEM Rule 11.12A) and circumvention of new listing requirements would not be a material concern. Extreme VSAs are presented to the Listing Committee for its decision."*

(The reverse takeover Rules were amended on 1 October 2019. See Note 1 below.)

9. Paragraph 2 of Practice Note 3 provides that

"...In all cases the trading record period of a new applicant must enable the Exchange and investors to make an informed assessment of the

² **Restricted Convertible Securities** are highly dilutive convertible securities with a conversion restriction mechanism (e.g. restriction from conversion that would cause the securities holder to hold 30% interest or higher) to avoid triggering a change of control under the Code on Takeovers and Mergers.

management's ability to manage the applicant's business and the likely performance of that business in the future...".

ANALYSIS

10. In this case, the Exchange applied the principle based test to assess whether the proposed acquisition would constitute a RTO under Rule 14.06(6). When applying the principle based test, the Exchange would consider all the criteria set out in Guidance Letter GL78-14 to assess whether, taking the criteria together, a proposed acquisition would constitute an attempt to achieve a listing of the assets to be acquired and a means to circumvent the Exchange's new listing requirements.
11. When making the assessment, the Exchange noted that:
 - a. Company A's existing business had a small scale of operations. Based on the size tests for the proposed acquisition, the Target was significantly larger than Company A.
 - b. The proposed acquisition would result in a fundamental change in Company A's business. The Target was engaged in coal mining which was different from Company A's existing trading business.
 - c. Although Company A submitted that the Target would meet the profit requirement under Rule 8.05, the Exchange was concerned that the Target's historical financial information were not representative of its future performance due to the significant changes in its business model, including the type of coal sold and the sales and distribution arrangements. In particular, the Target's products were mixed with Company B's products and sold through Company B. The Target only developed its own sales functions for the purpose of selling its own products recently. As these changes only took place recently, the Target's trading record could not provide sufficient information to allow investors to make an informed assessment of the management's ability to manage the Target's business and the likely performance of that business in the future. The Exchange was concerned that Company A could not satisfy the new listing requirements under Paragraph 2 of Practice Note 3.
12. Based on the above, the Exchange considered that the proposed acquisition was an extreme case and constituted a RTO under Rule 14.06(6).
13. The Exchange disagreed with Company A's view that the acquisition should constitute an extreme VSA. As set out in the RTO guidance letter, an extreme VSA applies in situation where the assets to be acquired can meet

the minimum profit requirement under Rule 8.05 and circumvention of new listing requirements would not be a material concern. In this case, the Exchange did not consider that the acquisition could fall into the situation of an extreme VSA under the guidance letter given its concern over the Target's ability to satisfy the new listing requirements as discussed in paragraph 11c above.

CONCLUSION

14. The proposed acquisition constituted a reverse takeover for Company A under Rule 14.06(6).

Notes

1. *The reverse takeover Rules were amended on 1 October 2019.*
 - *Under the new Rule 14.06B (which incorporates former Rule 14.06(6) with certain modifications):*
 - *A “reverse takeover” is defined as an acquisition or series of acquisitions by a listed issuer which, in the opinion of the Exchange, constitutes, or is part of a transaction and/or arrangement or series of transactions and/or arrangements which constitutes, an attempt to achieve a listing of the acquisition targets and a means to circumvent the requirements for new applicants as set out in Chapter 8 of the Listing Rules.*
 - *Note 1 to Rule 14.06B sets out the factors that the Exchange will normally consider in assessing whether the acquisition or series of acquisitions is a reverse takeover, including:*
 - i) *the size of the acquisition or series of acquisitions relative to the size of the issuer;*
 - ii) *a fundamental change in the issuer’s principal business;*
 - iii) *the nature and scale of the issuer’s business before the acquisition or series of acquisitions;*
 - iv) *the quality of the acquisition targets;*
 - v) *a change in control (as defined in the Takeovers Code) or de facto control of the listed issuer (other than at the level of the subsidiaries); and/or*
 - vi) *other transactions or arrangements which, together with the acquisition or series of acquisitions, form a series of transactions or arrangements to list the acquisition targets.*

- *Note 2 to Rule 14.06B contains two specific forms of reverse takeovers involving a change in control (as defined in the Takeovers Code) of the listed issuer (other than at the level of the subsidiaries) and an acquisition or a series of acquisitions of assets from the new controlling shareholder and/or its associates at the time of, or within 36 months from, the change in control.*
- *Rule 14.54 (as amended) requires that in the case of a reverse takeover, the acquisition targets must meet the requirements of Rule 8.04 and Rule 8.05 (or Rule 8.05A or 8.05B), and the enlarged group must meet all the new listing requirements in Chapter 8 of the Rules (except Rule 8.05). Where the reverse takeover is proposed by an issuer that does not meet Rule 13.24, the acquisition targets must also meet the requirement of Rule 8.07.*
- *The Exchange also added a new Rule 14.06C to (i) codify the “extreme VSAs” requirements in Guidance Letter GL78-14 and rename this category of transactions as “extreme transactions”; and (ii) impose additional eligibility criteria on the issuer that may use this transaction category.*

Under Rule 14.06C, an “extreme transaction” is defined as an acquisition or a series of acquisitions of assets by a listed issuer, which individually or together with other transactions or arrangements, may, by reference to the factors set out in Note 1 to Rule 14.06B, have the effect of achieving a listing of the acquisition targets, but where the issuer can demonstrate to the satisfaction of the Exchange that it is not an attempt to circumvent the requirements for new applicants set out in Chapter 8 of the Listing Rules and that:

- (1) (a) the issuer must have been under the control or de facto control of the same person(s) for a long period (normally not less than 36 months) and the transaction will not result in a change in control or de facto control of the issuer; or (b) the issuer must operate a principal business of substantial size; and*
- (2) the acquisition targets meet the requirements of Rule 8.04 and Rule 8.05 (or Rule 8.05A or 8.05B) and the enlarged group meets all the new listing requirements set out in Chapter 8 of the Listing Rules (except Rule 8.05).*

2. *The Rule amendments would not change the analysis and conclusion in this case.*