Highlight

November 2023

HKEX Guidance Letter on Disclosure of the Basis of Consideration and Business Valuations in Notifiable Transactions

In view of more notifiable transactions that occurred, the Hong Kong Exchanges and Clearing Limited (the “HKEX”) has issued a guidance letter (the “Guidance Letter”) on 20 October 2023 regarding the disclosure of the basis of consideration and business valuations in these transactions to remind the responsibilities of directors and valuers.

It focused on improving transparency around business valuations used in "notifiable transactions" – major acquisition or disposal deals requiring shareholder's approval. When an independent valuation serves as the basis for determining the consideration, companies are expected to provide more details.

With respect to the Guidance Letter, you can notice that HKEX has paid more attention to the valuation methodology employed for the target company and the parameters adopted for determining the consideration. Thus, the requirement of disclosure should be aware, and we would like to share it with you in the industry.

Key highlights mentioned by the Guidance Letter include:

- Thorough explanation of the applied valuation approaches and methods.
- Specific inputs, assumptions, projections, e.g. quantify revenue growth rates, margins, discount rates, etc.
- Disclose selection criteria of comparable companies clearly, including quantitative benchmarks, justification of the outliers.
- Provide a clear narrative walkthrough discounted cash flow (“DCF”) model, illustrating how projections contribute to the valuation.
- Sensitivity analyses if key assumptions could materially affect the value.

Purposes of the Guidance Letter:

- Set out the disclosure gaps identified from HKEX review; and
- Provide guidance on disclosure of the basis of consideration for notifiable transactions where no independent valuation is disclosed.

WeValue Advisory Limited is a professional valuation advisory company. We provide valuation and valuation support for a variety of applications to business owners, senior management as well as other professional parties. Our valuation analysis serves different purposes, including financial reporting, corporate development transactions, strategic planning, tax planning, dispute support, etc.

The issuers 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. In general, the valuation report should contain the following information in line with generally accepted valuation standards (e.g. the International Valuation Standards):

- Valuation approach(es) and method(s) used by the valuer and the reasons for their selection;
- Scope of work performed by the valuer, any limitation thereon and the reasons for such limitation;
- Nature and source of information relied upon;
- Key inputs and assumptions, and how they were determined and translated into the appraised value;
- Appraised value ascribed to the transaction target and the principal reasons for the conclusions reached;
- Effective date of the valuation; and
- Identity, qualification and independence of the valuer.

The issuers may use different valuation approaches to assess the valuations of transaction targets. 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.

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.

Where more than one valuation approach and method 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.

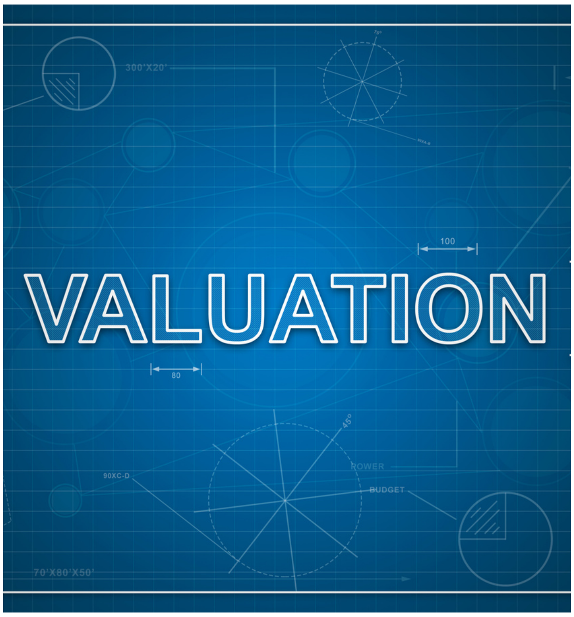
Cost approach	Asset-based approach
The report should contain: • The quantitative inputs used to determine the gross current replacement or reproduction cost (i.e. costs that would be required to replace or reproduce the assets of equivalent utility e.g. material and labour costs, and other associated costs such as transportation and installation costs); • 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 • The computation process for the final depreciated replacement or reproduction cost.	When using the asset-based method, the valuation report should provide asset/liability valuations of the transaction target, together with its book values. The report should disclose quantitative assumptions / inputs adopted for these appraisals and the calculation process. If material differences exist between the book and appraised values, the report should explain the differences. Separate asset valuation reports, where relevant, should also be provided.

Market approach	Income approach
Where the market approach is used, the valuation report should contain sufficient information on the criteria used to select market comparables. This would include:	For a DCF valuation, the listing rules specifically require disclosure of all the principal assumptions upon which the underlying cash flow forecast is based. As a general principle, the assumptions must be specific, and they should draw the shareholders' attention to those uncertain factors which could materially disturb the ultimate achievement of the forecast. We consider that the disclosure should include, among others:
• 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) and the reasons for using those criteria. If any companies or transactions that meet the selection criteria are excluded, the bases of exclusion should be justified and clearly stated; • Relevant details of the market comparables selected (e.g. the nature and location of principal operation) 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.	• Key, specific assumptions underlying the financial projections, in particular quantitative assumptions and the supporting rationale. It would not be sufficient to include merely qualitative or narrative statements without specific quantitative disclosures of the relevant figures; • 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, the HKEX 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.

Transactions where no independent valuation is disclosed

For any notifiable transaction, issuers must clearly explain how the consideration is computed. The announcement should provide sufficient objective data using quantitative factors and analysis to present a well-founded rationale.

Regardless of whether an independent valuation is obtained for a notifiable transaction, the 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 primarily based on the historical performance and future prospects of the transaction target, the issuer should provide adequate and relevant disclosure (both quantitative and qualitative) of the underlying performance that are key to the determination of the consideration.



Circumstances where the directors should consider appointing an independent valuer

According to the guidance note on directors' duties in the context of valuations in corporate transactions issued by Securities and Futures Commission (the "SFC"), the guidance note advises directors to carry out independent and sufficient investigation and due diligence on the transaction target, and provides guidance on the circumstances where the directors should consider the need to appoint an independent valuer:

- Directors do not have sufficient experience or expertise in the transaction target's business or in valuation;
- The transaction target's business is new or still in its infancy;
- The information provided in respect of the transaction target's business requires professional advice or professional scrutiny in order to properly assess the merits of the proposed transaction;
- The size of the transaction target relative to that of, or its significance to the issuer;
- The risks involved in the transaction or the complexity or nature of the transaction; or
- Any director of the acquiring company has an actual or potential conflict of interest in the proposed transaction.

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