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Debt Financing for Privatization of HK-listed Companies

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With the maturing of domestic capital markets in China, we are currently seeing a wave of companies controlled by Chinese investors or with significant Chinese-based assets that were previously listed in Hong Kong being taken private with the aim of returning to the domestic capital markets in China for a new listing. Most of these privatization transactions rely on debt financing, at least partially, to finance the deal. The availability of debt financing, therefore, plays a crucial role in privatization transactions.

Fangda Partners, through its Hong Kong office and Shanghai office, have recently been engaged by clients in multiple privatization financings, including:

- *Representing China Merchants Bank Co., Ltd., Hong Kong Branch as the lender in its loan financing to Zhuhai Port (Hong Kong) Co., Limited, an indirect wholly-owned subsidiary of the Zhuhai branch of the State-owned Assets Supervision and Administration Commission of the State Council, for the HK$2.11 billion privatization of Xinghua Port Holdings Ltd. by way of a voluntary conditional general cash offer.*

- *Representing China Merchants Bank Co., Ltd., Hong Kong Branch as the lender in its loan financing to Optical Alpha Limited and Optical Beta Limited for the privatization of O-Net Technologies (Group) Limited by way of a scheme of arrangement under the Companies Law of the Cayman Islands.*

- *Representing a consortium of investors in the financing of a voluntary offer to acquire all of the shares in Clear Media Limited, a company listed on the Hong Kong Stock Exchange. The consortium consists of Mr. Han, the CEO of Clear Media, at 40%, Ant Financial at 30%, JCDecaux at 23% and China Wealth Growth Fund III L.P. at 7%.*

- *Representing Bank of China, Macau branch as the arranger, lender and agent in its loan financing to CEIEC (H.K.) Limited, an indirectly wholly-owned subsidiary of China Electronics Corporation, for the HK$4.64 billion privatization of TPV Technology Limited by way of a scheme of arrangement under the Bermuda Companies Act.*

With our in-depth knowledge and experience in this space, we highlight a number of important features in debt financing arrangements for privatization transactions of which businesses should be aware.

1. Privatization of companies listed on the Hong Kong Stock Exchange (“HKSE”)

There are many ways to structure a privatization transaction in Hong Kong. These are subject to the Code on Takeovers and Mergers (the “**Takeovers Code**”) promulgated by the Hong Kong Securities and Futures Commission (“**SFC**”).

The principal pathways to take private a listed company include:

(a) a voluntary general offer (“**VGO**”);
(b) a mandatory general offer (“**MGO**”); and
(c) a scheme of arrangement.

2. Voluntary General Offer and Mandatory General Offer

The offeror of a VGO initiates the process by announcing its firm intention to make a voluntary offer to acquire all shares of the listed company (other than those shares already owned or agreed to be acquired by the offeror and parties acting in concert with it). The announcement is followed by an offer document containing the terms of the offer followed by a response document from the listed company containing a view on the offer's fairness. These are dispatched to all shareholders. Often, the offeror and the listed company issue both documents together as a composite document.

If the offeror has already announced an intention to privatize a listed company and the acceptance level of independent shareholders has reached 90% or more, the offeror will be entitled to exercise the compulsory acquisition right to acquire the remaining shares and to "squeeze out" (i.e. to remove) all other shareholders. The listing of the shares on the HKSE is then withdrawn.

A MGO is usually triggered by an acquisition of 30% or more voting shares in the listed company or an increase of more than 2% in any 12-month period if the offeror already holds between 30% and 50%. If the offeror has already announced an intention to privatize the listed company and the acceptance level reaches 90% or more, the offeror will be entitled to exercise its compulsory acquisition.

3. Scheme of Arrangement

A scheme of arrangement is a statutory procedure under the Hong Kong Companies Ordinance (or the equivalent provisions of the laws where the listed company was incorporated). The listed company asks the court to sanction a privatization proposal to cancel all the issued scheme shares of such listed company and to issue new shares equivalent to the number of shares cancelled to the offeror upon fulfilment of certain approval conditions.

Much like a general offer, the offeror and the listed company will need to publish an announcement and to dispatch a scheme document. Normally, the listed company will then need to convene a special general meeting of shareholders to approve the scheme and to apply to the local court explaining the proposed scheme of arrangement, together with a scheme document. The local court will hear the petition of the listed company and decide whether to sanction the scheme or not. If the scheme is sanctioned, the listing of the shares on the HKSE will be withdrawn.

4. Certain Funds Default

Before an offer or scheme is announced, the SFC requires a licensed financial advisor to confirm that the offeror has sufficient financial resources to complete, the offer or the scheme, at the cash consideration being offered or stated in the offer or the scheme.

If the offeror is relying on debt financing in order to finance all or a portion of the total purchase consideration, it is very important that all parties involved make certain that the debt financing will be available and funded when required. If the financing is not funded, the offeror cannot complete full payment of the total consideration being offered, which, in turn, will prevent the acquisition/privatization being completed. Such a situation will expose the offeror and the financial advisor to potential negative legal and financial consequences, such as being subject to lawsuits from the target listed company, its shareholders and the SFC.

To maximize the certainty of funding, the offeror (in its capacity as borrower) will be seeking to limit the conditionality for drawdown under the debt financing arrangements. Such limited conditionality conditions are generally known as "certain funds" provisions. Given the financial advisor's responsibility with respect to the cash confirmation letter, it is often the case that financial advisor is more incentivized than the offeror in negotiating this issue with the lender.

"Certain funds" provisions generally limit the conditions of funding to the following: (a) satisfaction of all conditions precedent, (b) no change of control, (c) no illegality, and (d) no "certain funds" default. The "certain funds" default is often limited to a more critical subset of the representations, warranties, events of default and undertakings in the facility agreement. Such limited "in-scope" provisions are the most important "major" provisions, that is, the lender recognizes that some other "non-major" breaches are not significant enough from a credit perspective that the lender should indirectly (by not funding) prevent the borrower from consummating its desired acquisition/privatization.

If the lender agrees to such "certain funds" provisions, it will be obliged to fund the transaction even if representations and warranties which are outside the scope of the agreed major ones are being breached on or prior to drawdown. The same goes for "out of scope" events of default which are triggered or undertakings which are being breached. So long as they do not fall within the agreed scope of the major certain funds events of default and undertakings, the lender will be obliged to fund.

With reference to provisions in the Asia Pacific Loan Market Association (APLMA) form facility agreement, the following table summarizes the typical scope of the major representations, warranties, events of default and undertakings comprised in "certain funds" provisions.

Major Representations/Warranties	Major Events of Default	Major Undertakings
Status/incorporation	Non-payment	Merger
Binding obligations	Breach of major undertakings	Acquisitions
Non-conflict with other obligations	Breach of major representations/warranties	Pari passu ranking
Power and authority	Insolvency	Negative pledge
Validity and admissibility in evidence	Insolvency proceedings	Disposals
Governing law and enforcement	Creditors' process	Loans or credit
Insolvency	Unlawfulness and invalidity	
	Repudiation and rescission of agreements	

Obviously, from the borrower's (offeror's) perspective, it wants the scope of the "certain funds" provisions to be as narrow and specific as possible, without any chance for subjectivity on the lender's part.

Typical points of contention negotiated between borrower and lender on "certain funds" provisions for privatization financings include whether:

(a) the scope of the major representations, warranties and undertakings should include the target listed company and its subsidiaries, the argument being that the offeror does not control such listed company until consummation of the privatization;
(b) the undertaking to comply with the subject acquisition/privatization documents should itself be a major undertaking, the argument being that a lender's action or non-action (i.e. not funding) can cause a breach of such undertaking; and
(c) any provision which is tied to a "material adverse effect" threshold (and therefore subject to potential lender subjectivity) should be included as a major "certain funds" provision.

Negotiation with respect to the "certain funds" provisions in a privatization transaction is often a power game between the borrower and the lender. In the case of highly competitive underwriting deals, the borrower has the power to limit the scope of such provisions to the bare minimum, which then provides more certainty in the privatization transaction as a whole.

5. Conditions precedent

In much the same context as "certain funds" default provision, as required by Takeovers Code, both offerors and financial advisors seek to minimize any uncertainty of funding by making sure that as many conditions precedent are satisfied as soon as practicable prior to, or immediately after, making an announcement of a VGO/MGO or a scheme of arrangement. As part of the application process for making such an announcement, the financial advisor will be required to issue a cash confirmation letter to the SFC. In order to issue such cash confirmation, the financial advisor in turn will be relying on the lender to issue to it a conditions precedent confirmation letter specifying which conditions precedent to the financing have already been satisfied and which ones are still outstanding. The financial advisor will also need to exercise some judgment to ascertain to some degree of certainty that the outstanding conditions precedent are all within the control of the borrower (as offeror) and will be satisfied.

There will be certain conditions precedent which are typically not possible to satisfy prior to making an announcement. Such conditions precedent typically include the delivery of the offer/scheme documents, the agreed offer acceptance level being met (in the case of a VGO/MGO) or the shareholders' resolution to formally approve the scheme in the court sanctioned shareholders' meeting being resolved (in the case of a scheme of arrangement). These are typical timetable milestones as the privatization procedure is being followed through and it is reasonable that a lender is only required to fund once such privatization process has reached a certain level of certainty.

6. Utilizations

Depending on the method of privatization chosen, the utilization mechanics under the debt financing will need to be considered and tailored.

Under a VGO/MGO, progressive consideration payments are required to be paid to shareholders as they gradually accept the offer during the specified offer period. As such, borrowers should insist on the right to multiple drawdowns with all drawdown mechanisms matching the payment arrangement required by the offer documents and the SFC.

For a scheme of arrangement, one drawdown could suffice once the actual scheme has been approved by the shareholders.

Financial advisors, borrowers and lenders are recommended to prepare a flow chart or do a dry run of the payment arrangements to ensure drawdown logistics are well planned and are aligned with the privatization transaction.

7. PRC law-related issues

If the sponsor or parent entity of the borrower is a PRC enterprise, PRC law elements are heavily involved from the following perspectives:

(a) it is common that lenders may require some form of PRC onshore security or credit support for the offshore loan. PRC security or guarantees securing offshore debt will require a "Nei Bao Wai Dai (内保外贷)" registration with State Administration of Foreign Exchange ("**SAFE**");

(b) the offshore loan may also require a filing with the National Development and Reform Commission (国家发展和改革委员会, "**NDRC**") in accordance with requirements of the *Notice of the National Development and Reform Commission on Promoting the Administrative Reform of the Recordation and Registration System for Enterprises' Issuance of Foreign Debts* (国家发展改革委关于推进企业发行外债备案登记制管理改革的通知);

(c) Overseas direct investment procedures with NDRC, the Ministry of Commerce and SAFE may also be applicable regarding the underlying privatization transaction driven by PRC sponsors; and

(d) For privatization of H-share listed companies, given the company is incorporated in China, PRC laws are relevant from many perspectives.

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