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Elephant in the room: 'Change of control' situations

What minority shareholders of Chip Eng Seng should do at the extraordinary general meeting to be held on Sept 13. BY MAK YUEN TEEN AND CHEW YI HONG

ON Oct 4, 2018, Chip Eng Seng Corporation (CES) received a trading query from SGX Regco after its share price had risen from the low 80 cents range in early September to as high as 96.5 cents on increasing volumes. Despite the query being issued at 4.27 pm, the company only requested a trading halt the following day prior to the start of trading. The sharp rise in price and volume of shares traded would seem to suggest that certain segments of the market knew of an impending corporate action.

The next day, the company announced that it had received notification from its major shareholders that they had sold approximately 29.73 per cent of the company's issued shares at S$1.08 per share. CES therefore joined the growing list of SGX-listed companies where new shareholders acquired just below 30 per cent of the issued shares from existing shareholders, without having to make a general offer to other shareholders.

The seven selling shareholders are all related and, with the exception of one, hold various senior appointments in the group. It was only three days later, on Oct 8, 2018, that the company clarified that two sisters, Lim Sock Joo and Dawn Lim Sock Kiang, would retain 1.55 per cent and 0.38 per cent of the company's shares respectively. All the other five shareholders would no longer hold any shares. Ms Lim Sock Joo is the wife of the executive chairman and group CEO, Chia Lee Meng Raymond. Ms Dawn Lim Sock Kiang would resign as executive director (ED) three days later.

The new shareholders are Celine and Gordon Tang who jointly hold 26.98 per cent of the shares, with another 2.75 per cent held by a company in which Mrs Tang is a director. The new controlling shareholders therefore have direct and deemed interests in 29.73 per cent of the shares, a whisker below the 30 per cent threshold which would trigger a mandatory general offer.

Celine Tang (left) and her husband Gordon jointly hold 26.98 per cent of CES shares, with another 2.75 per cent held by a company in which Mrs Tang is a director. The new controlling shareholders therefore have direct and deemed interests in 29.73 per cent of the shares, a whisker below the 30 per cent threshold which would trigger a mandatory general offer. BT FILE PHOTO

CHANGE OF CONTROL OR NOT?

The first General Principle of The Singapore Code on Takeovers and Mergers states that persons engaged in a takeover or merger transaction must observe both the spirit and the precise wording of the General Principles and Rules. More specifically, the fifth General Principle states that a general offer to all other shareholders is normally required where effective control of a company is acquired or consolidated by a person, or persons acting in concert.

For the purpose of the Code, effective control has been set as a holding, or aggregate holdings, of shares carrying 30 per cent or more of the voting rights. Rule 14 of the Code covers the conditions and circumstances relating to a mandatory offer.

Unless the contrary is established, a director is assumed to be acting in concert in a transaction. In CES case, Mr Chia was and continues to be a director. He did not sell his 1.78 per cent stake although his wife's stake was pared down from 3.15 per cent to 1.55 per cent.

Rule 14(6) appears especially relevant to the CES situation because it governs the partial sale by a vendor "particularly where an acquirer wishes to acquire under 30 per cent, thereby avoiding an obligation under this Rule to make a general offer".

The Code states that the Securities Industry Council (SIC) will assess if a significant degree of control exists over the unsold shares. One point the SIC would consider is a very high price being paid for the voting rights as it would suggest that control over the entire holding was being secured.

Using the average undisturbed price of 81.5 cents in August 2018, the new controlling shareholders effectively paid a premium of 26.5 cents (or about 33 per cent) to the founding family members for a controlling stake of 29.73 per cent – or a control premium of about S$49 million.

Another point mentioned by the Code is that "a significant degree of control over the retained voting rights would be less likely if the vendor was not an 'insider' ".

Ms Lim Sock Joo (wife of Mr Chia) and Ms Dawn Lim (Ms Lim Sock Joo's sister and former ED) continue to retain stakes. If either of the two sisters had not done so, the new controlling shareholders would have crossed the 30 per cent threshold.

Would the above points that we have highlighted in Rule 14(6) not apply to the CES case, such as the 33 per cent premium paid by the new controlling shareholders and the retention of stakes by the two Lim sisters?

The CES deal seems to tick a number of the "precise wording" boxes and arguably the spirit of the Code, but no general offer is required because the 30 per cent threshold was not crossed. Under what situations would the acquisition of a stake of less than 30 per cent trigger a mandatory general offer?

Further, the share sales triggered a change in control under the company's note covenants (which specifies 25 per cent as the threshold). Together with wholesale changes to the board, we believe it would appear crystal clear to most market participants that "effective control" has been achieved by the new controlling shareholders.

BOARD COMPOSITION

On Oct 11, 2018, Mrs Tang was appointed non-executive chairman and two EDs related to the former controlling shareholders resigned. The appointment of Lock Wai Han as independent director (ID) and the cessation of Mr Chia as chairman (who remains as CEO) also took place on the same day.

In a Sept 5 BT article "*Corporate governance: more teeth, and substance needed*", we detailed certain observations relating to the corporate governance practices of CES. One of the key issues discussed was the board composition of CES, including the independence of the independent directors.

The independence and competencies of the board of directors become particularly critical where there are corporate actions involving significant divergence between the interests of controlling and minority shareholders, such as privatisation, change of control, large share issues and interested person transactions (IPTs) – some of the types of corporate action that CES is involved in.

The board now consists of a non-executive chairman, two EDs and four IDs. On paper, it is more than compliant with the Code of Corporate Governance 2018, with a separation of non-executive Chairman and CEO, and a majority of IDs. But are the IDs equipped for what is to come?

One of the IDs has been on the board since 2003, a former MP with more than 30 years of estate management experience. Another ID was a former minister, with a public sector background. The third is a corporate lawyer, who prior to his appointment as ID in February 2018 had served as the joint company secretary of CES from as early as 2004. The fourth ID is the ED and CEO of SGX-listed OKH Global Ltd, which is controlled by the new CES controlling shareholders.

Not only are there questions about the independence of most of the IDs, there are also questions about whether they have the competencies to oversee the corporate transactions that CES is undertaking. The IDs do not appear to have the financial backgrounds necessary to oversee these corporate transactions. Merely relying on management, advisers and intermediaries may not adequately safeguard the interests of minority shareholders.

A SPEEDY RIGHTS ISSUE

On Aug 22, 2019, CES announced a renounceable underwritten 1-for-4 rights issue at an issue price of 63 cents per share.

The terms of the rights issue include:

a) irrevocable undertakings by the new controlling shareholders to subscribe for their pro-rata entitlement to the rights shares;

b) the new controlling shareholders to sub-underwrite any shares not subscribed for under the rights issue by UOB, the manager and underwriter of the rights issue; and

c) a whitewash waiver of the obligation to make a mandatory general offer under the Singapore Code on Takeovers and Mergers.

The company stated that the independent financial advisor, SAC Capital, has been appointed to advise on the whitewash waiver. Within seven days, on Aug 29, the company issued a notice for the EGM to approve the proposed rights issue, proposed payment of the sub-underwriting commission to the controlling shareholders, and proposed whitewash resolution, together with the circular to shareholders.

The circular shows that all the material related to the rights issue were finalised and sent for printing on Aug 22, 2019. In other words, the irrevocable undertaking, management and underwriting agreement, sub-underwriting agreement and the IFA letter were all ready by the date of the announcement of the rights issue.

The EGM is to be held on Sept 13 – exactly 14 clear days between the date of notice and date of meeting, the minimum notice period required under SGX rules.

The rights issue and the haste in executing it surprised us. This has to be one of the fastest executions of a rights issue, and the need for speed may well be explained by the rather unconvincing justification and unattractive terms of the rights issue.

JUSTIFICATION AND TERMS OF THE RIGHTS ISSUE

First, the directors highlighted that the company's net debt-to-equity has risen to about 1.8 times and that the latest issue of the company's 3-year fixed rate notes was priced at 6 per cent per annum. It is common for companies involved in property development to have higher leverage during the early stages of its project developments and for leverage to ease off as the projects are completed. For example, CES had gearing of 0.97 times in FY2013, which then fell to 0.56 times by FY2015. The leverage of the group is higher now, but this is mostly due to its portfolio of investment properties and hotels that are generating recurring income.

More curiously, the company estimated its cost of equity at 5.88 per cent, obtained by taking the last dividend of 4 cents per share and dividing by the closing price of 68 cents. This is a highly simplistic computation of the cost of equity.

The company stated in the same breath the 5.88 per cent cost of equity and the 6 per cent cost of borrowing, seeming to hint that the company's cost of equity is cheaper than its cost of debt – which may in turn support the use of a rights issue to raise more capital. However, a fundamental principle in corporate finance is that cost of equity is higher than the cost of debt as equity holders are compensated for taking on more risk since they only have residual claims. This is rarely invalidated, if ever. A quick Bloomberg check shows that the estimated cost of equity for CES is 9.8 per cent. Further, if the cost of those two sources of finance is to be compared, the after-tax cost of debt should be used as there are tax benefits on the interest payments.

Second, the subscription price of 63 cents – five cents below the closing price of 68 cents on the day of the announcement – is unattractive in our view. At a 5.97 per cent discount to the theoretical ex-rights price of 67 cents, it was not priced to encourage shareholders to exercise their subscription rights. According to the IFA report, the discount of 5.97 per cent is less generous than all but one of the 14 comparable rights issues completed in the last 12 months. The mean and median discounts were 24.77 per cent and 24.98 per cent respectively.

The day after the announcement, the share price closed at 64.5 cents and continued to trend downwards, closing at 62.5 cents on Sept 2, 2019. Coupled with the state of the property market, the arguably muted prospects of the group and the lack of clarity on the use of the proceeds, there is little incentive for shareholders to subscribe for the rights issue at 63 cents.

Third, given the above, it is more likely than not that the controlling shareholders will consolidate their control in the company to more than 30 per cent. With their undertakings and the sub-underwriting agreement, it is not unreasonable to expect that the rights issue will help them achieve that.

We wonder if the independent directors and the financially trained professionals questioned management on the justification and terms of the rights issue.

SUB-UNDERWRITING AGREEMENT

The company also stated that the controlling shareholders will receive a sub-underwriting fee of 1.5 per cent of the underwritten rights shares. Our reading of the circular suggests that about S$1 million will be paid as a sub-underwriting fee to the controlling shareholders even if minority shareholders take up their rights fully.

Therefore, if the EGM resolutions are passed, the controlling shareholders stand to receive about S$1 million to carry out this rights issue that will likely allow them to increase their shareholdings beyond 30 per cent without triggering the mandatory general offer. This seems like a case of having your cake and eating it too.

The company has disclosed that the underwriter would not underwrite the rights issue without the sub-underwriting agreement and that the sub-underwriting arrangement was proposed by the manager and underwriter and not by the controlling shareholders. Perhaps the IDs should have insisted that the company consider appointing a different underwriter. The underwriter is essentially getting a risk-free "underwriting commission spread" of S$338,000 to pass on the "risk" to the controlling shareholders.

WHITEWASH WAIVER

Clearly, those involved recognise that it is likely that the controlling shareholders will increase their stake following the rights issue, and have therefore included a whitewash waiver as one of the resolutions to be put to shareholder vote.

SIC granted its approval on July 26, 2019, for, inter alia, a waiver of the obligations of the new controlling shareholders and parties acting in concert to make a mandatory general offer subject to standard conditions imposed on companies seeking a whitewash waiver. It required the Whitewash Resolution to be separate from other resolutions. Under the listing rules, the company is also required to seek specific shareholders' approval "by way of a separate shareholder resolution" for the payment of the sub-underwriting commission to the controlling shareholders.

Technically speaking, CES has made both the sub-underwriting commission and the whitewash waiver separate resolutions. However, all three resolutions are inter-conditional.

While the company may reason that this is to ensure the success of the rights issue, there is no doubt that it will further strengthen the control of CES by the new controlling shareholders. Is this in the spirit of making the sub-underwriting and the whitewash waiver resolutions "separate from other resolutions"?

Mr Chia has given an irrevocable undertaking to vote in favour of all three resolutions. We cannot comprehend why he is considered independent of the offer and not a concert party.

CES minority shareholders should vote against all the resolutions at the coming EGM to send a clear message to the controlling shareholders that they are dissatisfied with the rights issue and the sub-underwriting arrangement and believe that a general offer should have been made.

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