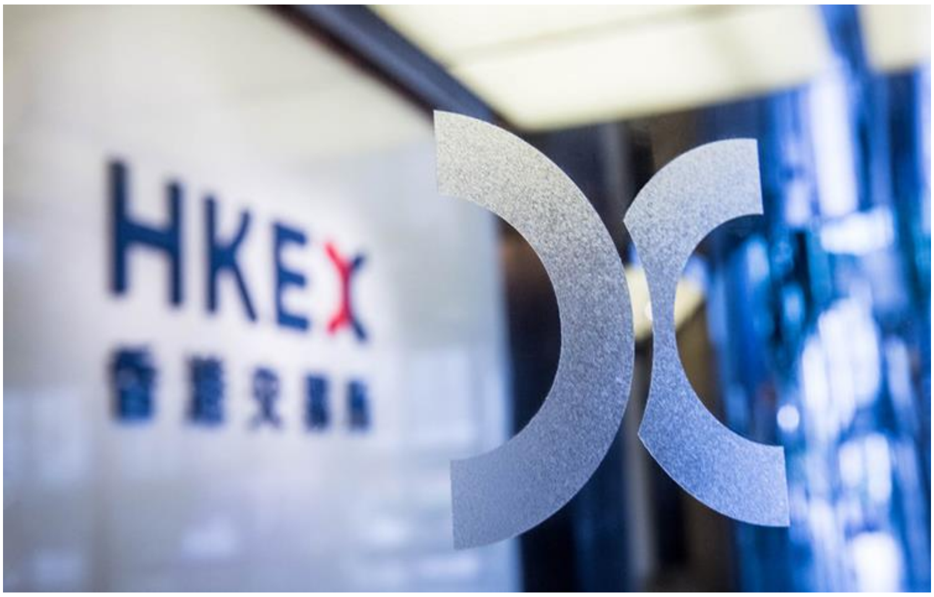
HKEx Proposes to Increase the Main Board Profit Requirement



by Selwyn Chan, Sing Tam, Jack Li, Anson Lam and Ryan Lo on 25 January 2021

Introduction

On 27 November 2020, The Stock Exchange of Hong Kong Limited (the "**Stock Exchange**") published a consultation paper inviting public comments on its proposal to (i) increase the profit requirement for listing on the Main Board of the Stock Exchange (the "**Proposed Profit Requirement**"); and (ii) introduce temporary conditional relief from the Proposed Profit Requirement. It is proposed that the Proposed Profit Requirement, if adopted, will come into effect no earlier than 1 July 2021.

Current profit requirement

Under Rule 8.05 of the Rules Governing the Listing of Securities on the Stock Exchange (the "**Listing Rules**"), a listing applicant may be considered qualified for listing on the Main Board by satisfying, among other things, (i) the profit test; (ii) the market capitalisation/revenue/cash flow test; or (iii) the market capitalisation/revenue test.

Under the current profit test, a listing applicant is required to have a minimum amount of profit attributable to shareholders of (i) HK$20 million in the most recent financial year; and (ii) HK$30 million in aggregate in the two preceding financial years (the "**Current Profit Requirement**").

Reasons for change of profit requirement

The Current Profit Requirement was first introduced in 1994 and was maintained after several public consultations and reviews in the past. Meanwhile, the minimum market capitalisation requirement (the "**Market Capitalisation Requirement**") under Rule 8.09(2) of the Listing Rules was increased from HK$200 million to HK$500 million in 2018.

Since the Market Capitalisation Requirement was increased in 2018 without a corresponding increase in the Current Profit Requirement, the Stock Exchange has noted an increase in listing applications from issuers with a proposed market capitalisation at the time of listing of equal to or less than HK$700 million ("**Small Cap Issuer**") that marginally met the Current Profit Requirement but had relatively high historical P/E ratios as compared with those of their listed peers.

Whilst these Small Cap Issuers usually justified their higher valuations by reference to potential growth, a number of them were unable to meet their profit forecasts submitted to the Stock Exchange in their listing applications after listing. It therefore raised the regulatory concerns over the reasonableness of their valuations, in particular, whether their valuations were supported by genuine expectation of growth, or merely reverse engineered to satisfy the Market Capitalisation Requirement amended in 2018 in order to manufacture potential shell companies for sale after listing.

Proposal to increase the profit requirement

In response to the abovementioned regulatory concerns, the Stock Exchange has proposed solution of increasing the Current Profit Requirement by one of the following options:-

- **Option 1**: increasing the Current Profit Requirement by 150%, based on the percentage increase in the Market Capitalisation Requirement in 2018, which will increase the minimum amount of profit attributable to shareholders (i) from HK$20 million to HK$50 million in the most recent financial year prior to listing; and (ii) from HK$30 million to HK$75 million in aggregate in the two preceding financial years; or

- **Option 2**: increasing the Current Profit Requirement by 200%, based on the approximate percentage increase in the average closing price of the Hang Seng Index from 1994 to 2019, which will increase the minimum amount of profit attributable to shareholders (i) from HK$20 million to HK$60 million in the most recent financial year prior to listing and (ii) from HK$30 million to HK$90 million in aggregate in the two preceding financial years.

Details of the two proposed options are set out below:-

	Current	**Option 1**	**Option 2**
Proposed increase	N/A	150%	200%
In aggregate for the first two financial years (HK$ million)	30	75	90
For the last financial year (HK$ million)	20	50	60
Total (HK$ million)	50	125	150
Implied historical P/E ratio (based on Market Capitalisation Requirement)	25 times	10 times	8 times

Impacts of the proposed options

Based on the impact analysis performed by the Stock Exchange, if Option 1 and Option 2 were adopted between 2016 and 2019, they would have resulted in 437 (59%) and 486 (65%) out of the 745 Main Board listing applications relying on the Current Profit Requirement submitted during such period being ineligible for listing, respectively. However, it is worth to note that approximately 30% of these ineligible applications under both options had proposed market capitalisation of less than HK$500 million and therefore would not have been eligible for listing under the current Market Capitalisation Requirement.

It is also noted that both Option 1 and Option 2 will result in the Stock Exchange having the highest profit requirement when compared with the profit requirements of selected overseas main markets on an aggregated basis for the three years of a track record period.

Although the Proposed Profit Requirement will largely affect companies at an early development stage or small or mid-sized companies which intend to list on the Main Board, the Stock Exchange noted that these companies may still list on GEM with lower financial eligibility criteria, which in turn further distinguish between issuers listed on GEM and the Main Board and improve the overall quality of Main Board issuers.

Temporary relief from the profit requirement

In view of the backdrop of COVID-19 pandemic and general economic downturn in 2020, the Stock Exchange further proposed to grant certain temporary relief from the Proposed Profit Requirement, if the potential applicant is able to meet the following conditions:

- its aggregate profit during the track record period meets the aggregate profit threshold (i.e. HK$125 million under Option 1 or HK$150 million under Option 2);

- it had a positive cash flow generated from operating activities in the ordinary and usual course of business before changes in working capital and taxes paid in the last financial year during the track record period;

- it demonstrates that the conditions and circumstances leading to its inability to meet the Proposed Profit Requirement are temporary;

- the track record period must have at least six consecutive months that fall within the calendar year 2020; and

- adequate disclosure is made in its listing document.

A potential applicant seeking a temporary relief from the Proposed Profit Requirement will be required to submit an application to the Stock Exchange for consideration on a case-by-case basis.

Transitional arrangements

In order to minimize the impact of the Proposed Profit Requirement on potential applicants who may have already commenced plans to apply for listing on the Main Board based on the Current Profit Requirement, the Stock Exchange has proposed certain transitional arrangements before the adoption of the Proposed Profit Requirement.

The Stock Exchange proposed that the Proposed Profit Requirement, if adopted, will come into effect no earlier than 1 July 2021 (the "**Effective Date**"). For Main Board listing applications that are submitted prior to and remain active as of the Effective Date, they will be reviewed under the Current Profit Requirement and will be allowed to be renewed once after the Effective Date for continued assessment under the Current Profit Requirement, provided that such renewal is made within three calendar months from the date on which the previous application has lapsed. Any subsequent renewals will then be assessed under the Proposed Profit Requirement.

Our views

If the proposals are adopted, it is believed that the Proposed Profit Requirement will correct the misalignment of the Current Profit Requirement (which has remained unchanged for the past 26 years) with the revised Market Capitalisation Requirement and address the regulatory concerns regarding the overall quality of Main Board listings, especially for Small Cap Issuers. It will also further differentiate between the Main Board and GEM issuers and may attract more sizeable companies for Main Board listings.

However, the Proposed Profit Requirement may have unjustifiably ruled out the opportunity for companies from the "new economy" or high growth industries which had a relatively lower profit in the track record period to list on the Main Board, even though they appropriately justify a higher valuation given by the public market and expect a strong growth after listing. It also calls into question whether implementing the Proposed Profit Requirement would effectively prevent listing applicants who are engaging in potential shell manufacturing activities from seeking a potential listing on

Main Board, as the Stock Exchange principally only inhibits such activities from Small Cap Issuers with relatively lower profit. There seems to be no evidence in the market suggesting that these Small Cap Issuers are more likely to engage in potential shell manufacturing activities than those that are able to satisfy the Proposed Profit Requirement.

In addition, the success of the Hong Kong capital market has been largely attributable to the market economy system with a wide variety of choices of investments as well as funding opportunities. Investors from across the globe were attracted to capital markets in which they have choices to freely invest and divest in the shares of listed companies so long as there is high transparency for the investors to make informed decisions. It is anticipated that after the Proposed Profit Requirement is implemented, the number of listing applications in the Main Board will be significantly reduced. Arguably, the variety of the capital market investment products will be narrowed and investors will have more limited choices of investment. Furthermore, following the reform of GEM in December 2017, GEM has been repositioned as a "stand-alone board" and considered by some businesses and investors as a less attractive alternative to the Main Board with its lowered status, image and financing function as compared to its "stepping stone" position before the reform, as demonstrated by the reduced market value and trading volume of the GEM listed companies. As such, it may be disadvantageous to various stakeholders in the community to redirect those marginally ineligible issuers with genuine growth potentials to seek for listing in GEM after the reposition of GEM. Potential quality issuers with relatively lower profit may as a result of the proposed changes seek for listing in other overseas market and investors who often invest in small and middle cap listed companies may consequently consider to invest elsewhere. In turn, this will undoubtedly undermine the overall attractiveness and competitiveness of the Hong Kong capital market.

Considering that the financial performances of many potential applicants are continuously and severely impacted by the prolonged situation of COVID-19 and market downturn in 2020, it also gives rise to concerns regarding the necessity, prominence and timing to introduce the Proposed Profit Requirement under the current market sentiment. Although potential applicants may be able to benefit from a temporary relief from the profit spread in the Proposed Profit Requirement, it only applies to those relatively sizeable companies as potential applicants are still required to have attained, among others, an aggregate profit of at least HK$125 million or HK$150 million during the track record period, which is still significantly higher than the Current Profit Requirement.

In any event, potential applicants who are considering to apply for listing on the Main Board shall be mindful of the potential impact of the Proposed Profit Requirement that may have on their eligibility and current timetable for listing, regardless of whether they will be able to rely on the proposed temporary relief and transitional arrangements.

Members of the public are invited to submit their responses to the proposals before the public consultation period ends on 1 February 2021.