HKEx LISTING DECISION
HKEx-LD37-2012 (published in September 2012)

[Withdrawn in March 2019; Superseded by HKEX-GL68-13]

Party	Company A – a GEM listing applicant
Issue	Whether Company A's deteriorating financial performance and uncertain business prospects would render it unsuitable for listing
Listing Rules	GEM Rules 2.06, 2.07, 2.09 and 11.06.
Decision	Given the concerns over Company A's sustainability, uncertainty on the prospect of the bulk sales and packaged sales businesses and to a lesser extent, the competition and reliance on its controlling shareholder, the Exchange considered that these concerns could not be appropriately addressed by way of disclosure and decided to reject Company A's application.

FACTS

1. Company A principally engaged in a processing business in the PRC with ancillary trading in raw materials.

2. Its prospectus included its financial results from Year 1 to Year 3. It submitted to the Exchange for vetting its forecast results for Year 4. It satisfied the minimum cash flow requirement under GEM Rule 11.12A(1) and submitted that it would have sufficient working capital for at least 12 months after the date of prospectus.

Deteriorating financial performance

3. Company A had recorded a continuously declining gross profit margin from over 6% to less than 2.5% from Year 1 to Year 3, with a net loss of over HK$2 million in Year 3. It projected a loss of HK$5 million in Year 4, despite revenue continuing to increase in Year 2 (60% growth) and Year 3 (10% growth). Excluding the listing expenses, there was still a decreasing trend of net profit margin from 1.5% in Year 1 to 0.2% in Year 3, and a projection of 0.1% in Year 4.

4. Raw material costs had accounted for over 95% of its cost of goods sold during the track record period. The raw materials prices which were quoted in open commodity markets had fluctuated substantially during the track record period (with a year-on-year increase of 40% and 25% between Year 1 and Year 3). Company A had not been able to fully pass the increase in raw materials costs to its customers. Previous measures to hedge raw materials prices had been ineffective and had resulted in a loss that took up about 30% of its pre-tax profit in Year 1.

5. The gross profit margin from selling its finished goods had been even lower than that from trading of its excess raw materials during the track record period (e.g. 2% compared to 4% in Year 3).

6. It had recorded significant net foreign exchange gains on financing activities in Year 2 and Year 3. Excluding these foreign exchange gains, Company A would have recorded an even slimmer net profit in Year 2 and a more substantial loss in Year 3.

7. Its interest coverage ratio declined from over 2.5 times to less than one time during the track record period, and its weighted average interest rates increased from about 2% to over 5% during the same period. Interest expenses had continued to increase during the track record period. It had also obtained substantial interest-free loans from its controlling shareholder.

8. Based on Company A's breakeven analysis, it would only be able to return to profit in Year 4 if it could secure an over 20% increase in selling price or sales quantity. However, according to its forecast, it only expected a 2% increase in revenue in Year 4.

Uncertainty over the prospects of Company A's bulk sales and packaged sales businesses

9. Company A's products were available in packaged and bulk form. During the track record period, Company A had mainly sold its products in bulk form. In view of the industry trend to shift to packaged products, Company A had begun to produce packaged products since Year 1 and planned to substantially expand the production scale going forward.

10. Certain local governments had placed restrictions on sales in bulk form since Year 2. Certain of Company A's sales during the track record period fell under these restrictions.

11. Packaged sales accounted for 1%, 1% and 2% of revenue in Year 1 to Year 3, and were forecast to increase to about 3% in Year 4. They contributed less than HK$1 million gross profit in each of Year 1 and Year 2, and recorded a gross loss in Year 3 and a forecast loss in Year 4.

12. The sponsor and Company A's directors considered that Company A's business would be sustainable after listing. They also considered that Company A's proposed expansion plan was feasible and appropriate.

APPLICABLE RULES

13. GEM Rule 2.06 states that the GEM Rules are designed to ensure that investors have and can maintain confidence in the market and in particular that, applicants are suitable for listing.

14. GEM Rule 2.07 states that the GEM Rules are not exhaustive and that the Exchange may impose additional requirements or make listing subject to special conditions whenever it considers it appropriate.

15. GEM Rule 2.09 states that suitability for listing depends on many factors. Applicants for listing should appreciate that compliance with the GEM Rules may not itself ensure an applicant's suitability for listing. The Exchange retains the discretion to accept or reject applications and in reaching its decision will pay particular regard to the general principles outlined in GEM Rule 2.06. Informal and confidential guidance may be sought from the Exchange concerning the eligibility of any proposed application for listing.

16. GEM Rule 11.06 stipulates that both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.

ANALYSIS

17. While no profit requirement is imposed on companies seeking to list on GEM, uncertainty over a company's future financial performance may cast doubt on its sustainability. Where a company's business model is believed to be unsustainable, the Exchange will consider it unsuitable for listing.

18. The Exchange took into account the following factors (and to a lesser extent competition and reliance on the controlling shareholder) when considering Company A's suitability for listing:-

Deteriorating financial performance

(a) Company A had shown a deteriorating financial performance during the track record period and there was no sign of improvement in the Year 4 forecast.

(b) It had not shown it had effective measures to manage its exposure to raw materials price fluctuation during the track record period and going forward.

(c) The gross profit margin of its manufacturing activities had been even lower than that of its trading activities. It was doubtful that Company A could sustain itself at such a gross profit margin.

(d) It had benefited from the recent appreciation of RMB against USD during the track record period. However, foreign exchange rates can fluctuate volatilely. The track record results would be worse than disclosed in its financial statements if the foreign exchange gains were excluded.

(e) It relied on borrowings to support its daily working capital, and had been subject to increasingly high borrowing costs during the track record period, even after taking into account the substantial interest-free loans from its controlling shareholder. Given the low profit margin, any increase in borrowing costs in the future could easily wipe out its net profit.

(f) It would be unlikely to return to a breakeven position based on its forecast increase in revenue.

Uncertainty over the prospect of Company A's bulk sales and packaged sales

(g) According to the management accounts for Q1 of Year 4, revenue had decreased significantly (a 42% decline based on the annualised figure for Year 4 compared to Year 3). The decrease in bulk sales had not been compensated by an increase in packaged sales as it had expected.

(h) The past and projected performance of packaged sales was even worse than bulk sales (e.g. packaged sales recorded gross loss in Year 3 and Q1 of Year 4).

(i) Packaged sales had only accounted for about 1% of its total revenue during the track record period. Company A projected its packaged sales for Year 4 would be increased to 3% of its revenue. Based on this projection, it remained doubtful how packaged sales could turn around Company A's overall financial performance or bring sufficient income going forward.

CONCLUSION

19. Given the concerns over Company A's sustainability, uncertainty on the prospect of the bulk sales and packaged sales businesses and to a lesser extent, the competition and reliance on its controlling shareholder, the Exchange considered that these concerns could not be appropriately addressed by way of disclosure and decided to reject Company A's application.

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