## Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below on the proposed change discussed in the Consultation Paper downloadable from the HKEX website at:
https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Consultation-Paper/cp202011.pdf

Where there is insufficient space provided for your comments, please attach additional pages.

**Capitalised terms have the same meaning as defined in the Consultation Paper unless otherwise stated.**

1. Do you agree that the Profit Requirement should be increased by either Option 1 (150%) or Option 2 (200%)? Please give reasons for your views.

   ☐ Yes

   ☐ No

   You may provide reasons for your views.

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   |---|
   | Please refer to our response in the attached letter. |

2. Besides the proposed increase in the Profit Requirement, is there any other alternative requirement that should be considered? Please give reasons for your views.

   ☐ Yes

   ☐ No

   You may provide reasons for your views.

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   |---|
   | Please refer to our response in the attached letter. |

3. Do you agree that the Exchange should consider granting temporary relief from the increased Profit Requirement due to the challenging economic environment? Please give reasons for your views.

☐ Yes

☐ No

You may provide reasons for your views.

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| Please refer to our response in the attached letter. |

4. If your answer to Question 3 is yes, do you agree with the conditions to the temporary relief as set out in paragraph 55? Please give reasons for your views.

☐ Yes

☐ No

You may provide reasons for your views.

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| Please refer to our response in the attached letter. |

- End -

Deloitte.

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[redacted]

29 January 2021

Corporate and Investor Communications Department
Hong Kong Exchanges and Clearing Limited
8th Floor, Two Exchange Square
8 Connaught Place
Central
Hong Kong
**Re: Profit Requirement CP**

Subject: Response to Hong Kong Stock Exchange Consultation Paper, *The Main Board Profit Requirement*

Dear Sir/Madam,

On behalf of Deloitte Touche Tohmatsu, it is our pleasure to submit our response to *The Main Board Profit Requirement* Consultation Paper of the Hong Kong Stock Exchange.

This response comprises an overview of Hong Kong's capital market status and developments, observations and suggestions on the contents of the Consultation Paper, other observations, and our thoughts on the timing of the new Profit Requirement.

## Overview

Over many decades, the Hong Kong Stock Exchange (the Exchange) has helped create and sustain Hong Kong's status as an international financial centre, and as an initial public offering (IPO) venue in particular. We applaud its efforts and reforms to protect the rights of investors and uphold a high-quality Main Board (MB) for issuers and investors.

As stock exchanges elsewhere continue to reform and transform, it is important that the Exchange also continues to adjust and evolve. As Hong Kong is a core city in the Greater Bay Area (GBA) and will be a key engine driving development of the GBA, it is vital that when reforms are planned, including this proposed revision to the Profit Requirement, the Exchange's overall positioning, the GBA blueprint, and long-term strategy for the development of Hong Kong's capital market, be taken into account.

No market is immune to problems, unqualified entities, wrongdoing or irregularities. Whether it is necessary to increase the Profit Requirement as a front-loaded regulatory approach to supervise and correct market issues, such as shell companies, inflated P/E ratios, and post-listing deteriorations in business performance, remains an open question. This approach has the potential to reduce listing opportunities for many smaller and traditional businesses, and make Hong Kong's capital market less diverse. New, more focused measures, and enhancements to existing mechanisms would be better answers to the abovementioned issues.

With its longstanding success and reputation as an IPO hub, it is crucial that the Exchange continues to expand the opportunities for companies to go public, regardless of their development stage, size, scale or industry sector. These listing opportunities ensure companies are able to find the right listing thresholds and a viable market to fulfil their fundraising and listing needs. This will help extend the financing benefits of Hong Kong's listing platform to the wider business community and continue to support our capital market as an international financial centre.

## Our observations and suggestions

In general, we appreciate the reasons for the Exchange to propose making a change to the Profit Requirement thresholds. However, we suggest the Exchange refer to the following factors when considering the change:

i. While the Exchange has proposed to reduce the implied historical P/E ratios of applicants and use the overall increment in the Hang Seng Index in revising the Profit Requirement, it is important to consider the existing price performance of issuers in the secondary market.

   According to market information on the P/E ratios of issuers that went public in the recent two years, median P/E ratios calculated based on their offer prices and closing prices on 31 December 2020 were considerably more than 10 times, with some even ranging from 20-30 times. The *Hong Kong and Mainland Market Highlights* published on the Exchange's website show that the average P/E ratio of MB companies was about 17.6 times as of 31 December 2020 and 15.9 times as of 30 October 2020. These figures are all higher than the implied historical P/E ratio of 10 times mentioned in the Consultation Paper.

ii. Over the years, the Exchange has put substantial efforts into attracting more diverse issuers from a wider range of industry sectors, pre-revenue businesses, corporations with different voting rights, and a large number of jurisdictions, to list in Hong Kong. These efforts include April 2018's largest reform of the listing regime since the introduction of H share listings. As a result, Hong Kong has emerged to become the world's second largest listing venue for biotech companies in 2019.

   While we now accept issuers without any profits from fast-growing segments, such as companies in the new economy and biotech, especially the investment community, we should also be open to issuers with high potential growth that meets the existing Profit Requirement thresholds, so long as they meet the other listing and disclosure requirements.

We therefore suggest the Exchange consider the average market P/E ratios and the existing Market Capitalisation Requirement when considering whether it is necessary to increase the Profit Requirement thresholds. We also suggest the Exchange determine the adjustment in the Profit Requirement with reference to the analysis of the Profit Requirements used by the Main Markets of other major international exchanges that are stated in paragraph 43 of the Consultation Paper. Despite having a more stringent basis for determining the profit component, the analysis in paragraph 43 shows that Hong Kong Main Board's requirements of three years profit in aggregate is the third highest and its final year profit is the second highest among the Selected Overseas Main Markets.

## Other observations

*Shell companies*

There are also concerns raised in the Consultation Paper about the shell company issue. Our observation of the Hong Kong IPO market over recent years indicates that this issue has been largely addressed since GEM reform was introduced in February 2018, an enhanced delisting framework became effective in August 2018, guidance on IPO vetting and suitability for listing was introduced in April 2018, and revised guidance on reverse takeovers became effective in October 2019.

The Securities & Futures Commission has taken an active role in front-loaded regulatory measures. Instead of raising the bar for listings to regulate and guard against this potential issue, which was addressed not long ago, we believe existing regulatory mechanisms could be enhanced, such as the delisting framework and disciplinary procedures for listing applicant irregularities.

Rather than focusing on whether the implied historical P/E ratios of some listing applicants were inflated to meet the Market Capitalisation Requirement, we would suggest the Exchange leave the issue of implied historical P/E ratios to the market. While doing so, it might consider requiring applicants to enhance disclosures in their IPO prospectuses, such as valuation details and bases for their historical P/E ratios, and prospective P/E ratios. For those with high historical P/E ratios, the Exchange might require them to disclose their associated risk factors.

The Exchange could also develop more targeted oversight measures for these issuers, rather than using a new Profit Requirement as a general approach, which might affect most potential MB listing candidates. We also suggest the Exchange apply post-listing measures focused on potentially problematic issuers. These could include requiring such issuers to explain why their market capitalisations have dropped below the required level, and additional enforcement over issuers that are found to have significant issues related to their IPO valuations, profit forecast bases and assumptions in the applications that they submit to the Exchange.

*Market diversity*

Nevertheless, with the Exchange having initiated the new listing regime in 2018 to open up the stock market of Hong Kong to pre-revenue biotech companies and innovative businesses with operations in Greater China and primary listings in the US or UK, successfully diversifying Hong Kong's stock market, we submit that it should pay the same attention to serving smaller businesses with high potential growth and those from other more traditional segments, so long as they comply with the listing rules of Hong Kong that enable investors to make an informed investment decision. Ongoing enforcement actions suggest that the scale of a business often makes no difference when it comes to misconduct. As an international financial centre and IPO hub, Hong Kong should reinforce these positions by developing its capital market with breadth and depth that would appeal to investors with different appetites.

*GEM*

Following the GEM reform in February 2018, and the launch of the new listing regime in April 2018, the appetite for GEM listings has declined sharply. GEM has lost its attraction and function as a viable alternative for businesses that cannot meet the MB's listing requirements. As such, GEM needs to be reformed further to re-establish its status as one of the key listing platforms in Hong Kong and be enhanced to become a standalone market for small and mid-sized companies. This is particularly important to continue to develop and support smaller local businesses in Hong Kong and the region.

Hong Kong continues to nurture its innovative and technology businesses. We suggest that the Exchange consider this direction and Hong Kong's role in the GBA to further refine and enhance the functions of the GEM.

*To consider*

Given the above, we would like to put forward two other proposed measures for the Exchange's consideration:

i. While the Exchange could continue to consider the appropriateness of the current Profit Requirement thresholds, it might also look into measures to stimulate GEM as a priority, so that more companies, especially those unable to fulfil any new Profit Requirement, can consider this market as a listing option.

ii. Key stock exchanges across the world embrace diversity and inclusion to develop the breadth and depth of their capital markets. An overall strategy has to be considered to address market issues. In the US, minimum market capitalisation was set as one of the requirements for companies to remain listed, backed by active multi-tier markets and a clear delisting mechanism.

    We, therefore, think the Exchange could consider splitting the Main Board market into two tiers – a premium and a standard board – so that the rise in listing thresholds can be applied to potential premium issuers while other smaller and medium-sized candidates, which dominate the market, can remain subject to the existing Profit Requirement for listing on the standard board. In this way, the Exchange can continue to attract companies of different sizes and sectors.

    The Exchange could also consider how post-listing measures can help better sustain the Hong Kong capital market. This includes maintaining a minimum market capitalisation as a requirement for companies to remain listed, which the US is applying to existing issuers.

Timing of new Profit Requirement

In the current economic environment, which has been hit hard by the ongoing pandemic, businesses might struggle to meet the existing Profit Requirement.

Given the above, we suggest that rather than doing so immediately, the Exchange introduce the new Profit Requirement when global businesses, especially those in Hong Kong, start to show signs of picking up. Otherwise, the number of businesses able to fulfil the new Profit Requirement would be less, hampering the Exchange's capability and function as a fundraising platform for businesses.

That said, regardless of the magnitude of adjustment in the Profit Requirement, if any, the Exchange would eventually adopt, in general we agree with the proposed conditions for temporary relief measures that are outlined in the Consultation Paper. These relief measures should be able to help many eligible businesses continue to raise funds from the capital market. However, a preparation of profit forecasts amid the ongoing pandemic might be challenging for issuers.

We express our gratitude for having such a valuable opportunity to express our views on this proposed reform. We look forward to seeing these suggestions considered, together with recommendations and perspectives from other market stakeholders, and a positive outcome of this reform for all.

Yours faithfully,

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