

19 January 2021

Corporate and Investor Communications Department  
Hong Kong Exchanges and Clearing Limited  
8<sup>th</sup> Floor, Two Exchange Square  
8 Connaught Place  
Central  
Hong Kong

Dear sirs,

Re: Profit Requirement CP

In the consultation, the Exchange cited a number of regulatory concerns to the cause of the misalignment of the Profit Requirement with the increased Market Capitalisation Requirement (paragraph 23 of the consultation paper) and these concerns are summarized below.

1. For those Profit Requirement Applications submitted by Small Cap Issuers in 2018 with significantly higher historical P/E ratios, the Exchange suspected that their valuations were simply reverse engineered to meet the Market Capitalisation Requirement in order to manufacture potential shell companies for sale after listing given the perceived premium attached to the listing status (paragraph 22 of the consultation paper).
2. The Exchange cited that in certain cases the price discovery process may have been undermined by the possible offering of rebates to investors to entice them to take up shares, and suspected abusive behaviours such as manufacturing of an artificial shareholder base have been noticed (paragraph 23(a) of the consultation paper).
3. Despite the fact that the Exchange revised the Guidance Letter HKEX-GL68-13A in April 2018 to curb shell creation activities, the Exchange was not satisfied and had concerns that the current misalignment may result in more potential shell companies being listed (paragraph 23(b) of the consultation paper).

To rectify the above regulatory concerns, the Exchange therefore proposed to increase the Profit Requirement by 150% (Option 1) or 200% (Option 2) (the "Options") as stated in paragraph 24 of the consultation paper such that the implied historical P/E ratios of applicants meeting only the minimum thresholds under the Profit Requirement and the Market Capitalisation Requirement will be reduced to 8-10 times, similar to the level before the Market Capitalisation Requirement was increased in 2018 (paragraph 46 of the consultation paper).

The Exchange also considers that the Options will not have a material impact on the overall capital market as those companies which become ineligible for a Main Board listing under the Options can still access the capital market by listing on GEM (paragraph 10 of the consultation paper).

Having read the consultation paper, we find the reasons and rationale behind the Proposal is biased and unjust.

The regulators (both the Exchange and the SFC) have regulatory responsibilities to regulate, supervise and maintain a fair and square capital market in Hong Kong for all participants concerned, no matter they are large, small, local or with a PRC background. Whilst we fully appreciate the regulators are doing their best to prosecute the wrong doers, it is often frustrating and involved a time-consuming process. Sometimes it will take years to investigate, prosecute and conclude. It is not ideal but fundamentally, it is utmost important that all prosecution and ruling are based on fact and evidence, and not just suspicions.

Based on the reasons cited in the consultation paper, it is apparent that the main reason to increase the Profit Requirement is that the Exchange suspects many (if not all) Small Cap Issuers applied for listing just for shell manufacturing. In this regard, HKEX-GL68-13A was published to give guidance on IPO vetting and suitability for listing in relation to shell manufacturing. HKEX-LD121-2019 and HKEX-LD126-2020 were published to explain the reasons for listing applications rejected in 2018 and 2019 respectively. The reasons stated include the lack of commercial rationale for listing and insufficient support for valuation. In addition, many guidance notes and listing decisions (such as HKEX-GL104-19, HKEX-GL105-19, HKEX-LD122-2019 and HKEX-LD123-2019) were published to give guidance on the Exchange's interpretation on "reverse takeover" which is often regarded as the purpose of "shell manufacturing". Based on our best knowledge, we understand that among the cases referred to in HKEX-LD121-2019 and HKEX-LD126-2020 which were rejected on the grounds of a combination of reasons such as uncommercial business expansion plan, disproportionate use of listing proceeds, and unconvincingly high IPO valuations, many were Small Cap Issuers. On such grounds, the Exchange has already had adequate regulatory power to reject those applicants which could not demonstrate their genuine reasons for seeking a listing.

Rules cannot prevent crime totally. We believe there were cases that the Exchange might genuinely believe that the applicants were shell manufacturing but could not find irrefutable evidence to reject these listings. In the consultation paper, the Exchange did not indicate the number of these “suspicious” Profit Requirement Applications among the 745 Profit Requirement Applications between 2016 and 2019. In any case, we consider it is unfair and unjust for the Exchange to propose to increase the Profit Requirement in order to avoid the listing of these suspected cases and make 59% to 65% of the Profit Requirement Applications which were eligible for listing becoming ineligible for listing. It is unjust to penalise the market because there are suspicious cases that the regulators may fail to catch. We note that Small Cap Issuers accounted for 51% or 382 (in terms of numbers) of the Profit Requirement Applications. Under the Options, only 30 or 9 of the Small Cap Issuers under Option 1 and Option 2 respectively would have been eligible for listing. Small Cap Issuer is defined as “an issuer that applies to list on the Main Board pursuant to the Profit Requirement with a proposed market capitalisation at the time of listing of equal to or less than HK\$700 million”. What it means is that under the Options, over 90% of the listing applications (even if they are genuinely seeking listing for business expansion) with proposed market capitalisation at the time of listing of equal to or less than HK\$700 million which is 40% higher than the minimum market capitalisation requirement of HK\$500 million will be deprived of the righteous opportunity to seek listing. This is not fair and the cost to the market far out-weighs the Exchange’s intended objective of “improving the overall quality of Main Board issuers” as stated in the consultation.

In 2017 Consultation Conclusion, the Exchange concluded that they would maintain the Profit Requirement but to increase the minimum market capitalisation requirement at listing for Main Board applicants to at least HK\$500 million. The Exchange were then of the view that an implied historical P/E ratio of 25 times for a new applicant wishing to list on the Main Board would only be required if the applicant met the Profit Requirement and the revised market capitalisation requirement (ie HK\$500 million) exactly and it is not unreasonable to require an applicant to have a higher historical P/E ratio if it is close to meeting only the minimum requirements, which would indicate that, despite this, the market has a high degree of faith in the applicant’s future prospects (paragraph 119 of the 2017 Consultation Conclusion). We consider such conclusion is still correct and applicable under the current circumstances.

Under the current consultation, the Exchange cited that “the Profit Requirement Applications submitted by Small Cap Issuers in 2018 recorded significantly higher historical P/E ratios, which the Exchange believed was in response to the increased Market Capitalisation Requirement. Whilst these Small Cap Issuers typically justified their higher valuations by reference to potential growth, a number of them failed post listing to meet the profit forecasts they had filed with the Exchange as part of their listing applications, which gave concerns about the reasonableness of

their valuations". In our opinion, one failed to meet the forecast filed at the time of its listing application may well be due to reasons and circumstantial factors that can be genuinely and reasonably explained. It is definitely not conclusive that IPO valuations were deliberately inflated if the listing applicants failed post listing to meet their profit forecasts they had filed with the Exchange as part of their listing applications. All listing applications are subject to the Exchange's vetting. All listing applications are required to submit a cash flow forecast which includes a profit forecast for the current financial year. All listing applications are also required to prepare Form M-111 to justify their proposed valuations as compared to their peers already listed on the Exchange or overseas markets. In our experience, the Exchange would critically question the reasonableness of the proposed IPO valuations and the forecast. If the Exchange has serious doubt on the reasonableness of the proposed IPO valuations or the forecast, the Exchange would not have approved the listings of these applications. In this consultation paper, the Exchange hinted that some Small Cap Issuers had artificially inflated their forecasts at the time of their IPO applications to justify their IPO valuations. However, there are also many other genuine post listing reasons which could not be predicted accurately at the time of the listing applications causing the Small Cap Issuers or other listing applicants failed to meet their forecasts. We particularly noted that the worsening Sino-US trade relationship, the Hong Kong social movement in 2019 and the COVID-19 pandemic in 2020 have all had adverse impact on the economy, which are un-precedented and would not be reasonably predicted in advance. Events such as these events will definitely have had adverse impact on the forecasts made by the Small Cap Issuers and other listing applicants in 2018 and 2019. Under such circumstances, we would expect the Exchange to further analyse and disclose in the consultation paper the number of Small Cap Issuers which failed to achieve their profit forecasts (i) due to artificially inflated forecasts at the time of their listing applications; or (ii) due to and explained by post listing events which could not be expected to be reasonably predicted in advance at the time of their listing applications. The mere fact that some Small Cap Issuers failed to meet their forecasts post listing (without analysing further why they failed to meet the forecasts) did not justify the Exchange's concerns about the reasonableness of IPO valuations of these Small Cap Issuers. There is also lack of evidence showing the IPO valuations achieved by the Small Cap Issuers were based on profit forecasts which were often not disclosed to the market at the time of listing. They were submitted to the Exchange with the purpose of proving the working capital sufficiency post listing as required under the Listing Rules instead of commitment of future profits nor does it support the Exchange's conclusion that the valuations were not genuine and were only achieved in response to the increased Market Capitalisation Requirement. Therefore, the Exchange's implied statement that the Small Cap Issuers were mainly shell manufacturing and the IPO offer prices did not genuinely reflect the expected market clearing prices (paragraph 23 of the consultation paper), as explained above, is biased and unjust. In fact, there are already rules and published guidance notes and listing decisions explaining to the market that the regulators could base on certain qualitative evaluation (such as business model, growth

prospect, profit trend etc., apart from the profit requirement) to reject any listing applications if the listing applicants cannot demonstrate to the Exchange's satisfaction that their listing purpose are genuinely for business consideration. We do not agree that the market should be penalised and deprived of the righteous opportunity to raise capital for business expansion/development just because the regulators fail to catch ALL possible shell manufacturing suspicious listing applicants. Under the current proposal to increase the Profit Requirement, the Exchange estimated 59% to 65% of the 745 Profit Requirement Applications during 2016 – 2019 which were eligible for listing becoming ineligible for listing. We do not agree that it is a fair proposition to the market.

To further demonstrate if it is imperative and fair to the market as a whole to increase the Profit Requirement just because there were some (and we don't know how many) suspected shell manufacturing listing applications (the "Suspected Cases") that the Exchange failed to catch, we have conducted a research to identify these Suspected Cases.

If a listed issuer, soon after its listing and as permissible under the Listing Rules, has its controlling shareholders changed and conducted certain activities to circumvent the regulatory scrutiny under Rules 14.06B to 14.06E, the Guidance Letters HKEX-GL104-19 on reverse takeovers, and HKEX-GL105-19 on large scale issues of securities, it is generally regarded as a "shell manufacturer". The primary goal of "avoiding reverse takeover" or "conducting large scale issues of securities" is to inject or conduct a new line of business activity(ies) which become the principal business activity(ies) but such new business activity(ies) is(are) not required to comply with the new listing requirements under the Listing Rules (i.e. circumvention of new listing requirements).

Based on the following criteria,

- (a) there is change in control after listing; and
- (b) there are changes in the principal business activities after the listing as demonstrated by the fact that 50% or more of the revenue based on the information as disclosed in the latest annual/interim report were derived from business activity(ies) that is/are different from that/those business activity(ies) as described in the prospectus,

we have identified **three** Suspected Cases among the Small Cap Issuers during 2016-2019, which were successfully listed and met the above criteria. These Suspected Cases were suspected to be shell manufacturing but we stress that we have had no hard evidence to confirm that they were in fact shell manufacturing at the time of their listing applications. Given the small number of Suspected Cases, it is apparent that the Exchange is able to curb the circumvention to the

reverse takeovers rules based on the current rules and regulatory power, which makes shell creation less meaningful and attractive. As such, we disagree that it is a fair proposition to the market that 59% to 65% of the 745 Profit Requirement Applications during 2016 – 2019 which were eligible for listing will be disallowed a righteous opportunity for listing (even if they are genuinely seeking listing for business expansion) just because the regulators failed to identify or reject a small number of Suspected Cases at the time of their listing applications.

The Exchange cited that the Profit Requirement Applications submitted by Small Cap Issuers in 2018 recorded significantly higher historical P/E ratios, which the Exchange believe was in response to the increased Market Capitalisation Requirement and suggested the Options to reduce the implied historical P/E ratios to 8-10 times. We have summarized below the average historical P/E ratios of Main Board listed company with market capitalisation of HK\$700 million or below (ie the same definition as the Small Cap Issuers) in different industry sectors based on GICS classification as of 31 December 2020:

<u>Historical P/E ratios:</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
Healthcare	18.5	29.3	27.3	15.4
IT	23.9	19.3	18.6	14.4
Financial	12.5	17.3	14.3	15.6
Industrials	17.3	16.5	18.8	15.1
Materials	20.4	22.4	16.5	14.7
Real Estate	11.9	14.5	10.4	11.5
Utilities	11.9	16.4	22.3	20.2
Communications Services	19.0	14.8	15.3	12.5
Energy	22.8	6.2	13.7	13.5
Consumer Discretionary	16.4	20.2	20.3	14.5
Consumer Staples	19.7	29.8	28.5	14.5
Overall	17.5	18.8	18.7	14.4

Note:

1. The Historical P/E ratios represent the simple average P/E ratios (excluding those over 100 times)
2. Global Industry Classification Standard (“GICS”) was developed by MSCI and S&P Dow Jones indices in 1999. According to MSCI’s website, GICS is widely adopted in the globe by many market participants including asset managers, brokers, custodians, consultants, research teams and stock exchanges as the standardised industry definitions designed to apply to companies globally.

*source : Bloomberg and Ballas research*

Valuation is a product of a number of factors such as industry characteristics, growth potential, company's market positioning, business sustainability, assets/cash flow levels etc. Some industries (such as the new economy) and some companies in their respective industry (such as a market leader or ones with more advanced technologies or superior business track record) command higher valuation because investors generally trust they have a more sustainable business model and can achieve a higher growth in future, for instance. Although the proportion of Small Cap Issuers with historical P/E ratio above 15 times increased significantly in 2018, after the Market Cap Requirement was increased as illustrated in Chart B in Appendix III of the consultation paper, the consultation paper did not further analyse these cases with high valuation such as (1) how their valuations compared to their industry average and comparable companies; (2) the market sentiments at the time of their IPO launch; and (3) whether the listing applications of these cases had been approved or rejected (as we understand that some listing applications were rejected due to unreasonably high valuation). As illustrated in the table above, the historical P/E ratios of different sectors under the GICS classification during 2016-2019 fluctuated. Average historical P/E ratios during 2016-2019 were approximately 17.5 times, 18.8 times, 18.7 times and 14.4 times respectively. Some sectors achieved relatively higher P/E ratios at different time during the review period. For instance, healthcare, consumer discretionary and consumer staples sectors achieved relatively higher historical P/E ratios in 2017 and 2018 whereas IT and communication services sectors achieved relatively higher historical P/E ratios in 2016. There are many reasons to support a valuation and it is overly broad when the Exchange concluded that the Profit Requirement Applications submitted by Small Cap Issuers in 2018 recorded significantly higher historical P/E ratios was only or mainly because of the misalignment of the Profit Requirement with the increased Market Capitalisation Requirement (paragraph 23 of the consultation paper). Similarly, based on the same logic, before the Market Capitalisation Requirement was increased from at least HK\$200 million to HK\$500 million in 2018, it is also not fair to conclude that the Profit Requirement Applications recorded a lower historical P/E ratios in 2016 and 2017 (Chart B in Appendix III, the consultation paper) was because the underwriters were able to push down the valuations to better manage their underwriting risks in view of the then relatively lower Market Capitalisation Requirement, which would have made the Hong Kong capital market less competitive and attractive due to the lower valuation that the Hong Kong market could achieve as compared to other international capital markets.

There may be legitimate reasons behind the relatively higher historical P/E ratios in 2018 (but not in 2019 [emphasis]) after the Market Capitalisation Requirement was increased in 2018. It is too simplistic and dangerously erroneous to solely rely on the summary of the data collection (as illustrated in Chart B in Appendix III, consultation paper) and concluded straight away that the higher P/E ratios in 2018 was because of the misalignment of the Profit Requirement and the increased Market Capitalisation Requirement, and hence it is justified and reasonable to

increase the Profit Requirement as suggested in the consultation paper.

To retain the current Profit Requirement, we in fact will be able to support companies in high growth industries with lower profit track record, which are able to command a higher P/E ratio in meeting the minimum Market Capitalisation Requirement to tap into the market for capital funding. To allow so, the regulators have not relinquished their regulatory power in scrutinizing the suitability of listing of all listing applicants.

Finally, the Exchange considers that the Options will not have a material impact on the overall capital market as those companies which become ineligible for a Main Board listing under the Options can still access the capital market by listing on GEM. However, it is an agreed market consensus that GEM is not a recognised alternative capital market to Main Board for fund raising purpose. GEM has often been neglected by the Exchange and it was not promoted by the Exchange as a springboard or a viable alternative to the Main Board. The Exchange aborted the GEM Streamlined Process (as defined in the 2017 Consultation Conclusion) from its 2017 Consultation Conclusion. Due to the lack of promotion and poor investors perception, the fund raising ability of GEM is far less attractive than the Main Board. In our opinion, not unless the image of GEM is vitalized, GEM cannot be regarded as a recognised alternative capital market to Main Board. Therefore, it is again an unfair proposition to those companies which are eligible for Main Board listing under the current Profit Requirement becoming ineligible for Main Board listing under the Options to seek listing on GEM as a viable alternative solution.

#### Question 1

For the reasons as stated above, we do not agree that the Profit Requirement should be increased.

#### Question 2

If the Exchange finally decide to increase the Profit Requirement, we propose to:

1. increase the profit for the last financial year to HK\$30 million, implying a historical P/E ratio of approximately 16.7 times based on the minimum Market Capitalisation Requirement of HK\$500 million. This is in line with the 4-year average historical P/E ratio of approximately 17.4 times of all the Main Board listed companies with market Capitalisation of HK\$700 million or below under the GICS classification. The GICS classification is widely adopted in the globe by many market participants including asset managers, brokers, custodians, consultants, research teams and stock exchanges, as the standardised industry definitions and therefore it is fair to assume that companies seeking listing on the Main Board can on average command a similar P/E ratio and those companies with the last financial year profit



of not less than HK\$30 million should be able to meet the minimum Market Capitalisation Requirement and hence should be allowed to seek listing on the Main Board; and

2. increase the profit in aggregate for the first two financial years to not less than HK\$40 million.

### Question 3

If the Profit Requirement is increased, we agree but it should not be a waiver but a written rule that companies meeting the temporary relief should be allowed to apply for listing. This will avoid unnecessary subjective judgement and make the rules fair to all concerned.

### Question 4

If the Profit Requirement is increased as proposed in the consultation, GEM listed companies which can meet the increased Profit Requirement demonstrate that they have matured substantially in terms of profits and should be encouraged to transfer their listing from GEM to the Main Board. Under the current rules, GEM Transfer is required to go through a new listing process, which is a costly exercise and totally un-necessary (as they are listed already). Therefore, we propose the Exchange should re-install the GEM Streamlined Process (as defined in the 2017 Consultation Conclusion) to facilitate the GEM Transfer.

Yours faithfully

For and on behalf of

Ballas capital Limited

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