

## 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.

Please refer to our reply in Appenedix I attached to this Questionnaire.

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.

Please refer to our reply to above Question 1.

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.

Please refer to our reply to above Question 1. In the event that the Profit Requirement were to be increased, it is our view that the Exchange should grant temporary relief from the increased Profit Requirement due to the poor economic environment.

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.

- End -



## INTRODUCTION

For the reasons set out below, we have reservations about the Stock Exchange's proposal in the Consultation Paper entitled *the Main Board Profit Requirement* (the "2020 Consultation Paper") to increase the Profit Requirement by either 150% (i.e., Option 1) or 200% (i.e., Option 2). We are of the view that the Profit Requirement should remain at its current level under Main Board Listing Rule ("LR") 8.05(1)(a), i.e., a prospective applicant must 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 generated from activities in its ordinary and usual course of business. The following sections explain how we form our view.

### (A) Alleged Misalignment of Profit Requirement with the Market Capitalisation Requirement

Summary of Stock Exchange's arguments (paragraphs 18-25 on pages 10-14 of the 2020 Consultation Paper)

The current Profit Requirement has remained unchanged since its introduction in 1994, as it was concluded in consultation reviews in the past that it served as a good indicator of an applicant's financial performance. However, the minimum Market Capitalisation Requirement (the "MCR") was increased from HK\$200 million to HK\$500 million in February 2018, after the Stock Exchange published the 2017 Consultation Conclusions.

Given the increase of MCR from \$200 million to HK\$500 million without a corresponding change in the Profit Requirement, listing applicants would have a relatively higher valuation and historical P/E ratio (ranging from 10 times (i.e., HK\$200 million / HK\$20 million) to 25 times (i.e., HK\$500 million / HK\$20 million) as compared to those of their listed peers.

The Stock Exchange has observed that in 2018-2019, there was an increase in listing applications from issuers whose profits only marginally met the Profit Requirement but with significantly higher historical P/E ratios.



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As a number of such applicants, which were primarily Small Cap Issuers, failed in post listing to meet the profit forecasts they had projected as part of their listing applications, the Stock Exchange believes that the increase in valuation on their part was merely a response to satisfy the higher MCR (revised upwards from HK\$200 million to HK\$500 million in February 2018), instead of genuine expectation of growth, and this has led to regulatory concerns over the reasonableness of their valuations and the quality of the companies seeking Main Board listings .

## Our position

We are unable to agree with the Stock Exchange's arguments on the following grounds.

Firstly, market capitalisation depends on stock market performance, which fluctuates from time to time as a result of a variety of factors, including, but are not limited to, Hong Kong's macro-economic performance, the growth prospects of listing applicants, prevailing market sentiments, liquidity of the stock market. While the use of a mandated MCR of HK\$500 million (in relation to the listing applicant's profit level) to derive the historical P/E ratio of the listing applicant is an acceptable method of valuation, we do not believe that, contrary to what the Stock Exchange suggests in the 2020 Consultation Paper, it should be the only method used to derive a listing applicant's valuation.

Methods commonly used in the market to value an issuer's business include the market approach, the income approach and the asset-based approach. The market approach, e.g., derives the value of the listing applicant by adopting the forward price-to-earnings (the "**Forward P/E**") multiple, which measures how much investors are willing to pay based on the expected earnings of the issuer. The Forward P/E multiple is, in turn, derived by data extracted from a data provider such as Bloomberg, which is adjusted with the size premium based on the size differences between the comparable companies (i.e., those listed companies whose business nature and operations are similar to that of the listing applicant) and the listing applicant.



Since the valuation multiple derived for the listing applicant has taken into account the P/E ratios of the comparable companies, we therefore consider that the calculation of the listing applicant's Forward P/E ratio as described is a more reliable indicator of the applicant's valuation than the implied historical P/E ratio, particularly at the time of listing, listing applicants' half-yearly results are normally available for vetting by the Stock Exchange.

Secondly, the Stock Exchange asserts in paragraphs 21 and 22 on pages 11-12 of the 2020 Consultation Paper that a number of the Small Cap Issuers in 2018 failed to meet the profit forecasts filed with the Stock Exchange under LR 11.17 as part of their listing applications, which gave rise to the Stock Exchange's concerns that they were not genuinely listed to raise funds for business development and that their valuations were reverse engineered to meet the MRC in order to manufacture shell companies for sale after listing given the perceived premium attached to the listing status. The Stock Exchange further asserts in paragraph 23(a) on page 12 of the 2020 Consultation Paper that

*the inflated valuations discussed in paragraph 21 raise the regulatory concern of whether the IPO offer prices genuinely reflect the expected market clearing prices. 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. (Our emphasis)*

While there is no denying that there have been clearly egregious cases of this kind, the Stock Exchange's assertions appear to us to be too dismissive of the relevant Small Cap Issuers. The force of the Stock Exchange's arguments for an increase in the Profit Requirement is also reduced by the apparent failure of the Stock Exchange to provide sufficient details and evidence to support its claims in the 2020 Consultation Paper. Without such information, the Stock Exchange's assertions might turn into sweeping generalisations.

Accordingly, we have identified and examined two listing decisions ("LD"), namely, LD121-2019 and LD126-2020, which rejected listing applications (i) based on inflated valuations; and (ii) in 2018 and 2019, which were the time periods in which the Stock Exchange claims in the



2020 Consultation Paper that some of the Small Cap Issuers failed their profit forecasts, thus giving rise to worries over the reasonableness of their valuations.

Of the 42 rejections in total set out in the two LDs, seven rejections (16.6%) were valuation-related and only one of the listing applicants, namely, Company D in LD121-2019, was rejected based solely on unsupported valuation. The two other listing applicants<sup>1</sup> in LD121-2019 and the four listing applicants<sup>2</sup> in LD126-2020 were rejected based on a combination of unsupported/insufficient support for valuation and lack of commercial rationale. Disregarding the lone GEM listing applicant, i.e., Company D in LD126-2020 (GEM listing applications are not part of the coverage of the 2020 Consultation Paper), only 14.3% of the listing applicants in the two LDs were rejected due to questionable valuations. Given that (i) the total number of valuation-related rejections of listing applications was relatively small; and (ii) the curbing measures against shell creation and sale activities adopted by the regulators have been effective (see below), we have doubts on the urgency for any proposed change in the Profit Requirement now.

It should be emphasised that the Profit Requirement (i) has been in existence for over a quarter of a century; (ii) its support base remains strong;<sup>3</sup> and (iii) Option 1 or Option 2 would result in the Stock Exchange having the highest profit requirement on an aggregated basis for the three years of a track record period (“TRP”) as compared with being third under the current Profit Requirement (lower than NYSE and NASDAQ) and continue to have the second highest profit requirement for the final year of the TRP (lower than SGX), as well as, on average, eliminate 62% (462) of a total of 745 Profit Requirement Applications, which, according to the Stock Exchange, might be expected to have a similar effect on future listing applicants.<sup>4</sup>

<sup>1</sup> Company H and Company M in LD121-2019. There was no mention in the LD that whether Companies D, H and M were Main Board or GEM applicants.

<sup>2</sup> Main Board applicants, namely, Company B, Company F and Company H and GEM applicant, viz. Company D.

<sup>3</sup> For example, in the 2017 Conclusions, 56% of the respondents supported the retention of the Profit Requirement, and 77% of them agreed that the current level of profit under the Profit Requirement should be preserved.

<sup>4</sup> Paragraphs 44 and 45 on pages 21 and 22 of the 2020 Consultation Paper.



While it is not suggested that the Profit Requirement is cast in stone and cannot be changed, any attempt to successfully challenge and replace it with a comparatively unattractive proposition, namely (iii) above, must, in our view, be supported by compelling reasons for change, which we do not believe the reasons cited by the Stock Exchange in the 2020 Consultation Paper (i.e., corresponding change in the Profit Requirement following a change in the MCR in 2018) could amount to.

Finally, we agree with the Stock Exchange's adoption<sup>5</sup> of a heightened vetting approach (i.e. heavy scrutiny of the commercial rationale of listing and P/E ratio of Small Cap Issuers, revision of HKEX-GL68-13A to curb shell creation activities) and a more robust application of LR 13.24 to suspension and delisting of issuers that have a low level of operations or business of no substance, in an effort to arrest the drop in overall quality of the Main Board Listings caused by the listings of shell companies.

In our opinion, the quality of issuers may be improved and the shell creation and sale activities may be curbed, not so much by increasing the Profit Requirement as by implementing (i) a comprehensive due diligence process; (ii) robust prospectus disclosure requirements; (iii) vigorous examination of the reasonableness of the profit forecasts of the Small Cap Issuers to confirm their valuations; and (iv) heavy scrutiny of the book building process. Any listing applicant which fails to meet the above tests would be rejected.

The Stock Exchange's due diligence efforts as described above together with that of the SFC,<sup>6</sup> are, in our judgment, sufficiently potent to curb shell creation and sale activities, which show no signs of getting out of control following the above-mentioned curtailing measures taken by the regulators. With a strong handle over the shell creating and selling activities, the Stock Exchange has, in our view, little urgency in calling for an increase in the Profit requirement, which as mentioned before, has been in existence for 27 years. If anything, the proposed increase in the Profit Requirement might indirectly contribute to a revival of such activities given that the premium on selling existing shell companies will become higher in light of short supply in the market, something which the Stock Exchange may wish to avoid from happening.

<sup>5</sup> See paragraph 23(b) on pages 12-13 of the 2020 Consultation Paper.

<sup>6</sup> See, e.g., the SFC's statement titled "Statement on the SFC's Approach to Backdoor Listings and Shell Activities" dated 26 July 2019.



## (B) Limited choices offered by Option 1 and Option 2

In our view, the 2020 Consultation Paper seems to present a “foregone” conclusion that raising the Profit Requirement to align with the recently increased MCR is in the interest of the “overall market”. Little effort, however, seems to have been made to evaluate whether the Profit Requirement should be retained – instead the focus is on accepting either Option 1 or Option 2. However, as explained in the following paragraphs, we consider that neither Option 1 nor Option 2 present sufficient choice to the market for consideration.

The Stock Exchange claims in paragraph 46 on page 23 of the 2020 Consultation Paper that Option 1 and Option 2 would reduce the implied historical P/E ratios of applicants meeting only the minimum thresholds under the Profit Requirement and the MCR to 8-10 times, similar to the level before the MCR was increased in 2018.

We are not aware of the rationale of using the implied historical P/E ratio of 10 times and question its value as a reference. A substantial number of companies listed on the Stock Exchange are also noted to have a P/E ratio below 10 times. Hence, the fact that 10 times was the implied historical P/E ratio before the MCR was increase in 2018 does not mean or follow that an implied historical P/E ratio after a change in the Profit Requirement should be similar to it. Instead, we believe that it would be more realistic for the implied historical P/E ratio to be at a similar level as the historical P/E ratio implied by the Hang Seng Index (“HSI”) between September 1994, when the Profit Requirement was introduced, and the end of November 2020, when the 2020 Consultation paper was published, which was approximately 14.02 times.<sup>7</sup>

Accordingly, the implied historical P/E ratio of 10 times suggested by the Stock Exchange seems to be inconsistent with the market P/E ratio of 14.02 times, which would result in a profit of approximately HK\$35.6 million,<sup>8</sup> for the last financial year in the TRP, representing an increase of 78% from the current HK\$20 million, but still lower than Option 1’s HK\$50 million by approximately 29%, and Option 2’s HK\$60 million by approximately 40.6%.

<sup>7</sup> Calculated from figures extracted from Hang Seng Indexes Company Limited, which operates the HSI.

<sup>8</sup> A slightly lower figure of HK\$30 million was suggested in Response No. 17, reply to question 13 in respect of the Responses to the 2017 Consultation Paper.





## (C) More GEM listings

The Stock Exchange maintains in paragraphs 47 and 48 on page 23 of the 2020 Consultation Paper that companies at an early stage of development or small or mid-sized companies which fail to satisfy the proposed increase in the Profit Requirement to list on the Main Board may still be able to access the capital market by listing on GEM, which is intended to be a capital raising platform for such companies.

Moreover, the increase in the Profit Requirement will further distinguish between issuers listed on GEM and the Main Board and is in line with the Stock Exchange's objective of positioning the Main Board as the market of choice for sizeable companies that can meet high profit requirement. The proposal will therefore improve the overall quality of Main Board issuers, which will be conducive to promoting post-listing liquidity, increasing investors' confidence in the market and strengthening Hong Kong's position as an international financial centre.

While it is laudable that the Stock Exchange has dedicated GEM as a market for Small Cap Issuers to raise funds and arguably absorb the listing applications which might not meet the increased Profit Requirement and choose to list on GEM as a result. GEM's performance as a venue for fund raising, however, leaves much to be desired.

According to a recent report by an international financial newspaper,<sup>9</sup> GEM returns have been drab. An investment of US\$1,000 in the S&P/HKEX GEM index – the biggest 55 GEM stocks by market capitalisation – in late 2000 would be worth about US\$23 today. The same amount put in the NASDAQ, including dividends, would be worth over US\$3,000. The newspaper article further said that professional investors in Hong Kong attributed GEM's poor performance to its thin liquidity and an absence of sell side research. A Hong Kong-based former executive at major American investment banks was quoted by the article as saying that GEM encouraged companies with lesser quality financials to list there, but institutional money requires high quality financials.

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<sup>9</sup> See David Shane, "Hong Kong's Nasdaq' GEM Market Fails to Sparkle", <https://www.ft.com/content/7e48e97c-06ea-11ea-a984-fbbacad9e7dd>.



In similar vein was a recent interview a Chinese language online newspaper conducted with the capital markets partner of a Big Four audit firm on the occasion in which the audit firm published its annual review of Hong Kong's capital market performance in 2020. The partner was quoted as saying<sup>10</sup> that there was no correlation between an increase in the Profit Requirement and a surge in the number of GEM listees. Big institutional funds would not find GEM an attractive venue in which to park their investments due to GEM's thin liquidity, regardless of whether the Profit Requirement would be increased. Even if the Profit Requirement were to be increased, it would not necessarily result in any increase in GEM listings. Hence, prospective companies for IPO are likely to shun GEM and move to other overseas markets for listing, which, however, is not a very attractive option as investors in overseas markets are not familiar with companies from Hong Kong and are likely to make a discount on the Hong Kong companies' valuations at the time of listing.

If the Stock Exchange is determined to grow GEM as a stock market for Small Cap Issuers, it is imperative that GEM be revamped to shed its image as a second-tier market with low liquidity. However, before this revamping process is complete, which might take a number of years, we do not believe that the Stock Exchange should use the increased Profit Requirement as a hurdle to prevent the approximately 62%,<sup>11</sup> or as high as 80%,<sup>12</sup> of future listing applicants from being listed on the Main Board even if they meet other listing requirements. Instead, as long as these companies can otherwise meet the listing criteria, they should be permitted to list on the Main Board notwithstanding their failure to comply with the increased Profit Requirement, since the latter is not in our view a comparatively reliable indicator of the listing applicants' future profitability after listing (see section D below).

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10 See 翟梓謙, “香港 IPO 集資全球排名第二 安永：明年有望重奪一哥之位”, [https://www.hk01.com/article/564506?utm\\_source=01appshare&utm\\_medium=referral](https://www.hk01.com/article/564506?utm_source=01appshare&utm_medium=referral).

<sup>11</sup> This is the approximate percentage of future listing applicants estimated by the Stock Exchange which might be deterred from applying for listing on the Main Board due to the increased Profit Requirement. See paragraph 45(a) on page 22 of the 2020 Consultation Paper.

<sup>12</sup> This is the percentage of listing applicants estimated by the interviewees recorded in an *Hong Kong Economic Journal* article. See <https://www1.hkej.com/dailynews/finnews/article/2694341>.



## (D) Inappropriate timing

The case presented by the Stock Exchange in the 2020 Consultation Paper seems to be that if the listing applicant fails to meet the increased Profit Requirement, it should and will not get listed on the Main Board and be relegated to GEM. The small and medium-sized companies which fails to comply with the increased Profit Requirement might think that the Main Board does not exactly welcome their listings on it.

As compared to other indicators such as sustainable business model and competent staff, the ability of a listing applicant to meet a mandated profit requirement may not reliably indicate a listing applicant's profit potential. It is trite that companies which make good profits before listing may lose their earnings post listing because of, among others, poor investment decisions having been made. Likewise, companies earning little profits before listing may become highly profitable after being listed owing to the nature of their businesses. This may explain why the Stock Exchange permits infrastructure, mineral exploration and biotech companies which make little or no profits before listing to get listed.

Given that (i) compliance with the Profit Requirement does not necessarily indicate and ensure the listing applicant's future earning potential; and (ii) the Stock Exchange is not hesitant to exercise its discretion to exempt companies in certain industries from the Profit Requirement, we do not believe it to be fair for the Stock Exchange to subject listing applicants which are engaged in other types of businesses than those mentioned above to the Profit Requirement. Even if the Stock Exchange insists that listing applicants, apart from those exempted ones, should meet the Profit Requirement for the purpose of listing, we do not see, as explained above, any cogent reasons to increase the Profit Requirement now. Accordingly, we are of the view that as long as listing applicants can comply with the disclosure and governance requirements set by the Stock Exchange, fulfil the Profit Requirement and meet the rest of the listing criteria, they should be allowed to list on the Main Board, which will offer more choices to investors to buy their shares. In the final analysis, it is our view that a liquid and diverse stock market comprising both large companies and small and medium-sized enterprises is in Hong Kong's best interest as an international financial centre.



Moreover, the Stock Exchange acknowledges in paragraph 46 on page 23 of the 2020 Consultation Paper that the proposed increase in the Profit Requirement would result in it being one of the most stringent financial eligibility tests compared to the profit requirements of the Selected Overseas Main Markets. As noted before, approximately 62% of future listing applicants will be denied listing on the Main Board due to their failure to comply with the increased Profit Requirement even though they are otherwise eligible for listing. However, there is no alternative liquid stock market in Hong Kong on which these listing applicants could seek to be listed (see above section C) and they might move to overseas markets for listing as a result. Hence, the Stock Exchange proposed increase in the Profit Requirement might only result in a reduction of Hong Kong's attractiveness and competitiveness as an international finance centre of choice.

At the end of 2020, Hong Kong's economy continued to suffer from the ravages brought on by the Social Movement since the second half of 2019 and the Covid-19 pandemic in 2020. In a market profile on Hong Kong<sup>13</sup> dated 28 January 2021, the Hong Kong Trade Development Council said, among others:

- Hong Kong's economy contracted by 3.5% year-on-year in real terms in the third quarter of 2020, after a fall of 9.0% (year-on-year) in the preceding quarter.
- For year 2020 as a whole, real GDP fell by 6.1%.
- The value of retail sales, in nominal terms, decreased by 4.0% year-on-year in November 2020 over the same month a year earlier, compared with a year-on-year decrease of 8.7% in October 2020.
- The labour market remains under significant pressure. The seasonally adjusted unemployment rate now stands at 6.6% which is a 16-year high.<sup>14</sup>

<sup>13</sup> See Samantha Yim, "Economic Trade Information on Hong Kong" 28 January 2021, <https://research.hktdc.com/en/article/MzlwNjkzNTY5>.

<sup>14</sup> See [https://www.censtatd.gov.hk/press\\_release/pressReleaseDetail.jsp?charsetID=1&pressRID=4815](https://www.censtatd.gov.hk/press_release/pressReleaseDetail.jsp?charsetID=1&pressRID=4815).



Quoting government statistics, a recent article<sup>15</sup> in a local English-language newspaper said Hong Kong's economy shrank by 6.1% in 2020, which was the biggest contraction on record, as the Covid-19 pandemic hammered key drivers of growth such as tourism and consumption.

In light of (i) Hong Kong's current economic situation; (ii) the lack of urgency of increasing the Profit Requirement given that only 16.6% of the listing applicants (14.3% if the lone GEM listing applicant is disregarded) were rejected in 2018 and 2019 due to unsupported/insufficient valuations; and (iii) the satisfactory measures undertaken by the regulators to curb shell creation and sale activities, we consider that it would not be appropriate for the Stock Exchange to propose an increase in the Profit Requirement now when most businesses in Hong Kong are forced by the Covid-19 pandemic to downsize their operations and generate much less profits in the running of their businesses than before.

## (E) Further reflection

In the penultimate part of our submission, we respectively invite the Stock Exchange to further reflect on the following issues before it publishes the Consultation Conclusions.

On its website, the Stock Exchange sets out its purpose as one "to promote and progress our financial markets and the communities they support for the prosperity of all".<sup>16</sup> The Stock Exchange may well ask if part of its mission is to facilitate small and medium-sized enterprises, armed with sustainable business models, quality management staff, genuine needs for fund-raising, commitment to fully observe good corporate governance practices and strong emphasis on compliance, to access the public markets in Hong Kong and to become success stories (maybe becoming large companies in the future).

<sup>15</sup> See Kanis Leung, "Hong Kong economy suffers biggest annual contraction on record, shrinking 6.1 per cent as coronavirus hammers tourism, local spending" 29 January 2021, <https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3119795/hong-kong-economy-suffers-biggest-annual>.

<sup>16</sup> See [https://www.hkexgroup.com/About-HKEX/About-HKEX/Our-Purpose-Vision-and-Values?sc\\_lang=en](https://www.hkexgroup.com/About-HKEX/About-HKEX/Our-Purpose-Vision-and-Values?sc_lang=en).



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If the Stock Exchange concludes that listing on the Main Board is reserved for only those large companies which can comply with the increased Profit Requirement and that small scale but thriving enterprises which can only meet the current Profit Requirement level do not deserve this fund raising opportunity, it seems to contradict the Stock Exchange's another claim that it "has a robust IPO regime that has helped issuers of all sizes successfully raised ... HK\$ 2.4 trillion of funds in 2010-2019."<sup>17</sup>

Finally, the Stock Exchange may need to seriously consider how it can attract companies to list on it if all it has to offer is increased Profit Requirement for the Main Board as proposed in the 2020 Consultation Paper and GEM in its present state? Once the flow of larger companies seeking listing on the Stock Exchange begins to dry up, one might well ask what would the Stock Exchange's game plan be?

## CONCLUSION

All things considered, we have reservations on the Stock Exchange's case for increasing the Profit Requirement now, and are unable to support it for the reasons stated above.

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<sup>17</sup> See paragraph 17 on page 6 of HKEX's Concept Paper entitled *Modernising HK IPO Settlement Process*, November 2020.