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 the Attachment.

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 the Attachment.

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.

We stated in our response to Question 1 that we believe it is not necessary and not desirable to increase the Profit Requirement. We believe that as a matter of principle, potential applicants whose financial performance has been adversely affected by the economic downturn caused by the COVID-19 pandemic should not be automatically rendered ineligible for listing merely for failing to meet the profit spread in the current Profit Requirement. We support the grant of a temporary relief to the impacted applicants subject to the conditions as set out in paragraph 55 (with the modification that references to the Profit Requirement would mean the current Profit Requirement).

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.

Please refer to our response to Question 3 above.

- End -

Attachment to Deacons' responses to Q1 & Q2 – Reasons for our views

We believe it is not necessary, and not desirable, to increase the Profit Requirement for the reasons set out below:

1. "Misalignment" of the current Profit Requirement with the increased Market Capitalisation Requirement is a misconception

We note that the major reason for the Exchange to propose an increase in the Profit Requirement is that there is "misalignment" of the current Profit Requirement with the increased Market Capitalisation Requirement, giving rise to a number of regulatory concerns described in paragraphs 4-6 of the Consultation Paper.

We note however from the 2017 Consultation Conclusions that the Exchange did not consider there being any "misalignment" as the Exchange explained in that paper as follows: *"[a]n implied historical P/E ratio of 25 times for a new applicant wishing to list on the Main Board under our proposals would only be required if the applicant met the Profit Requirement and the revised market capitalisation requirement exactly… Also, <u>the Profit Requirement and revised market capitalisation requirements are minimum standards that set the floor for the profits and market capitalisation that applicants must have if they wish to list on the Main Board</u>. It is not unreasonable to require an applicant to have a higher implied historical P/E ratio if it is close to meeting only our minimum requirements. This would indicate that, despite this, the market has a high degree of faith in the applicant's future prospects*".

This logic should still stand. We believe it is a misconception that the two requirements should be aligned. The Profit Requirement and the Market Capitalisation Requirement are two separate requirements that the listing applicants have to satisfy for Profit Requirement Applications.

2. Insufficient statistics to show a prevailing number of cases of manipulation of valuations

It appears that the Consultation Paper did not provide any statistics to demonstrate that there was a prevailing number of applicants which only marginally met the Profit Requirement ("**Marginal Applicants**") having reverse engineered their valuations to meet the increased Market Capitalisation Requirement, causing serious concerns for the overall capital market.

The Consultation Paper stated that there had been an increase in listing applications from Marginal Applicants that had relatively high historical P/E ratios as compared with those of their listed peers since 2018. Without any supporting statistics or other evidence, it would be unfair to suggest that all or most of these Marginal Applicants had manipulated their valuations for the purpose of satisfying the increased Market Capitalisation Requirement.

The only purported evidence we see from the Consultation Paper is that *some* of the Marginal Applicants failed post-listing to meet the profit forecast they had filed with the Exchange as part of their listing applications. Although manipulation of profit forecast by such applicants for the purpose of satisfying the increased Market Capitalisation Requirement may be one of the possible explanations for their failure to meet the profit forecasts, it should be acknowledged that the companies' ability (or failure) to meet their profit forecasts might also have been affected by various macroeconomic and company-specific factors.

3. Concerns of manipulation should be addressed by enhanced regulatory scrutiny

Even if there had indeed been an increased number of cases of manipulation of valuations causing serious concerns for the overall capital market, there does not appear to be any compelling reason why these concerns should be addressed by an increase in the Profit Requirement as proposed which affects all future applicants, instead of adopting a carefully targeted approach to deal with the problematic cases.

According to the Consultation Paper, only 3% (Option 1) and 2% (Option 2) of the Eligible Applications had proposed market capitalisations of less than HK$500 million. This seems to suggest that increasing the Profit Requirement as proposed and thereby significantly reducing the implied historical P/E ratios of applicants meeting only the minimum thresholds of the Profit Requirement and the Market Capitalisation Requirement would likely result in fewer cases where the Marginal Applicants may need to inflate their valuations in order to meet the Market Capitalisation Requirement.

However, it is important to note the overall effect of the proposal is a significant drop in the number of eligible listing applications (according to the Consultation Paper, Option 1 and Option 2, on average, would have eliminated 62% of the Profit Requirement Applications and might be expected to have a similar impact on future potential applications). As explained in the paragraphs below, we do not agree with the Exchange's proposition (in paragraph 10 of the Consultation Paper) that this does not have a material impact on the overall capital market.

Instead of adopting the proposal which we believe would have adverse impacts on a number of aspects (we will elaborate below), we believe the regulators should focus on making efforts to enhance their targeted scrutiny and gatekeeping functions to tackle the regulatory concerns of cases of manipulation.

We have noted that the Exchange has already adopted a heightened vetting approach and heavily scrutinised the commercial rationale for listing and the reasonableness of P/E ratios of Small Cap Issuers as well as the independence and *bona fides* of placees in IPOs. We have also noted from the Listing Decisions that a number of listing applications were rejected in the last two years on the ground that the applicants concerned failed to justify the commercial rationale for listing and/or why the forecast P/E ratios were higher than those of industry peers, the basis on which the peers were chosen; and how such valuations were reasonable in light of the applicant's historical financial performance and profit forecast.

The regulators should also monitor the post-listing performance of all applicants, in particular whether they are able to meet their profit forecasts in a material respect. If applicants fail to justify the deviations from their profit forecasts, the regulators should consider taking appropriate actions against them on a case-by-case basis. Any enforcement / disciplinary decisions and other guidance materials should be published by the Exchange in a timely manner in order to send a clear message to potential applicants and market participants that the profit forecasts must be carefully and properly prepared.

We believe that after more rigorous regulatory scrutiny has been in place for some time, it would be clear to the market that companies which are not able to justify their forecast P/E ratios will have no prospect to achieve or maintain a successful listing on the Main Board, and over time, the market will see much less attempts that would raise the regulatory concerns.

4. Are applicants that can meet a higher Profit Requirement necessarily of better quality?

The Exchange suggested in the Consultation Paper that the proposal will "*improve the overall quality of Main Board issuers, which will be conducive to promoting post-listing liquidity*".

We do not entirely agree with this proposition. We believe historical profitability is just one of the many factors that measure the quality of companies. Some other factors, such as prospects of growth and corporate governance / culture, may also be important considerations.

Further, applicants that can meet a higher Profit Requirement does not necessarily mean that their stock will have a higher post-listing liquidity or they will have better post-listing performance.

Take the ability to meet profit forecasts as an example. The Consultation Paper contains an analysis comparing the proportion of applicants in the Eligible Applications meeting or exceeding their profit forecasts with those applicants in the Ineligible Applications. This analysis illustrates that among the Profit Requirement Applications in 2016-2019, a higher proportion of applicants having high profits (i.e. those in the Eligible Applications) met or exceeded their profit forecasts, as compared to less profitable applicants (i.e. those in the Ineligible Applications). However, as mentioned above, companies' ability (or failure) to meet profit forecasts may be affected by various macro-economic and company-specific factors. The phenomenon illustrated by the aforesaid analysis in respect of the past applications in recent years should not form the sole basis for concluding that raising the Profit Requirement would necessarily result in a higher proportion of applicants meeting their profit forecasts in future cases. It should also be noted that 40% of issuers of Eligible Applications under Option 1 failed post-listing to meet their profit forecasts. Although this proportion is lower than that of the Ineligible Applications, this is not an insignificant proportion.

5. The local bourse's competitiveness and attractiveness could be harmed if the proposal is adopted

In the 2017 Consultation Conclusions, the Exchange concluded that no change to the Profit Requirement was necessary in view of market respondents supporting the current threshold be maintained for the main reason that it was on par with a majority of the main markets of the other overseas exchanges. According to the Consultation Paper, among the Selected Overseas Main Markets, we currently have the third highest profit requirement on an aggregated basis for the three years of a track record period (lower than NYSE and NASDAQ Global Select Market).

If the Profit Requirement is increased as proposed, either Option 1 or Option 2 will result in the Exchange having the highest profit requirement on an aggregated basis for the three years of a track record period, which is significantly higher than NYSE and NASDAQ Global Select Market (being ~34% *(in the case of Option 1)* or ~61% *(in the case of Option 2)* higher than that of NYSE; and ~47% *(in the case of Option 1)* or ~76% *(in the case of Option 2)* higher than that of NASDAQ Global Select Market), and even more significantly higher than SSE (Main Board) (being ~3.57 times *(in the case of Option 1)* or ~4.29 times *(in the case of Option 2)* of that of SSE (Main Board).

The local bourse has been facing increasing competition from other exchanges. Making our financial eligibility requirements more stringent will harm our local bourse's competitiveness and attractiveness *vis-à-vis* other exchanges.

According to the Consultation Paper, Option 1 and Option 2, on average, would have eliminated 62% of the Profit Requirement Applications and might be expected to have a similar impact on future potential applications. If such companies are prevented from seeking a listing on the Main Board, and they do not consider GEM as a preferred venue (as GEM stocks are perceived to be more susceptible to high market volatility and low liquidity), they will choose to list on other exchanges. We note from the Consultation Paper that a large proportion of these companies have relatively low market capitalisation. However, we should not underestimate the impact of letting go the listings of these companies. We should not rule out that such companies, albeit smaller at the moment, may nevertheless be of good quality and potential, and may grow bigger with the ability to raise funds from the capital markets.

It is possible that the Exchange could at this moment have identified a promising number of potential listing applicants which are eligible under the increased Profit Requirement. However, given the uncertainties caused by, among others, the pandemic and the geopolitics, there is no assurance that their listing plans will proceed as proposed. There is also no assurance that there will continue to be a healthy pipeline of eligible and interested companies in the coming years. The deal flows could be significantly reduced if smaller companies that originally want to pursue a listing here but become ineligible to do so as a result of increase of the Profit Requirement and some of the eligible companies postpone or cancel their plans to list here for whatever reasons. If the Exchange is to stay competitive, it should take a more prudent approach in assessing the impact of losing out the listings of a significant number of companies on our local bourse's deal flow and competitiveness *vis-à-vis* other exchanges in the long run.

6. Exchange should not shut the door on listings of smaller (local) companies and companies in traditional industries on the Main Board

We note the Exchange's objective of positioning the Main Board as the main market to attract sizeable companies, and it is also encouraging to see that it has successfully attracted listings of quite a few new economy giants in recent years. However, we believe the Exchange should not only be interested in sizable companies or new economy companies and shut the door on listings of smaller companies and those in traditional industries on the Main Board.

Smaller companies may be of good quality and potential. It is not in the interest of the Exchange to turn away such companies. Further, as Hong Kong's only stock exchange, it would just be fair that the Exchange should allow smaller local companies to tap the local stock market to raise funds for growth of their businesses.

Companies in traditional industries should also not be unfairly disadvantaged or prejudiced. It is in the interests of the Exchange as well as the investing public for the Exchange to maintain and promote a diversified market, rather than merely focussing on new economy companies.

The Exchange suggested in the Consultation Paper that companies that will no longer be eligible to list on the Main Board as a result of the proposed increase in the Profit Requirement can still access the capital market by listing on GEM. However, considering the general perception that GEM stocks are more susceptible to high market volatility and low liquidity, and the market has also seen a trend of very significant decline in the number of new GEM listings in recent years (75 in 2018; 16 in 2019 and 8 in 2020), it is questionable if listing on GEM is indeed an attractive or viable alternative.