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BY HAND

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RE: Profit Requirement CP

27 January 2021

Dear Sirs,

Consultation Paper - The Main Board Profit Requirement (the "Consultation Paper")

We are writing in response to the Consultation Paper. Unless otherwise defined, terms used in this letter have the same meaning as defined in the Consultation Paper.

A. Introduction

After reviewing the Consultation Paper, we are of the view that the proposals set out therein warrant further consideration and review.

We acknowledge the Exchange's comments that since the Market Capitalisation Requirement was increased in 2018 without a corresponding increase in the Profit Requirement, it has resulted in a misalignment between the two requirements. We believe this misalignment was a direct result of the disproportionate increase to the Market Capitalisation Requirement in 2018. This misalignment has since given rise to an increased number of listing applications from issuers that marginally met the Profit Requirement but had relatively high historical P/E ratio as compared to their listed peers.

However, while safeguarding the overall quality of the Main Board listings and Hong Kong as an international financial centre, we believe, in our humble opinion, the Exchange should i) bear in mind its corporate social responsibility in supporting and enabling the development of financial markets and society as a whole; and ii) balance all interests and perform its duty to facilitate access to market for all businesses including companies of different sizes and in different industries, rather than just focusing on companies with large market capitalisation or from the new economy. A drastic increase in the Profit Requirement, as suggested in both Option 1 and Option 2, will not only limit the number of quality small and medium sized companies ("**SMEs**"), which can satisfy the Market Capitalisation Requirement but may fail to satisfy the revised Profit Requirement, from listing on the Exchange, but at the same time seriously dampens the economic growth prospects and reputation of Hong Kong as a human capital centre of legal, accounting, corporate finance and other professionals.

Accordingly, we are against both Option 1 and Option 2. We strongly encourage the Exchange to put on hold the current proposals and undertake a holistic review of the market structure. Should the Exchange intend to position the Main Board as the main market to attract sizeable companies, it should only do so after there is a viable alternative for SMEs. As explained later, GEM at its degraded present form is not a viable alternative listing venue for SMEs.

On a separate note, in view of the COVID-19 and the challenging economic environment, we urge the Exchange to consider granting certain form of relief from the existing Profit Requirement.

B. Our Responses

We refer to the Consultation Paper and its corresponding questionnaire and set out below our responses.

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.*

   We do not agree that the Exchange should increase the Profit Requirement by either Option 1 or Option 2. Our disagreement to such proposals is based on the following reasons:

   (a) Reducing the opportunities for quality SMEs to gain access to the capital market in Hong Kong

   The proposed increase in the Profit Requirement by either Option 1 or Option 2 will make the Main Board's Profit Requirement on an aggregated basis for the three years track record the highest of the Selected Overseas Main Markets. Such action will reduce the opportunities for quality SMEs to gain access to the capital market in Hong Kong as the proposed changes will make the Main Board the most difficult to list amongst the Selected Overseas Main Markets.

   Although it was stated in the Consultation Paper that the aggregate market capitalisation at the time of listing of all Ineligible Applications under Option 1 that have been listed accounted for only 3% of the aggregate market capitalisation of Main Board issuers newly listed between 2016 and 2019 at the time of their respective time of listing and that number may represent a very small portion of the Exchange's new listing business or may contribute very little to the Exchange's strive to become a global leader in terms of the amount of new funds raised from IPOs. However, we would like to gently remind the purpose and the values of the Exchange, as stated in its website.

   Whilst we support the vision of the Exchange in becoming the global markets leader in the Asian time-zone, we would humbly ask the Exchange to keep in mind that, being the monopoly stock exchange in Hong Kong, it should also facilitate access to market for all businesses, including quality SMEs. This is integral to the promotion and progress our financial markets (being Hong Kong financial markets) and the communities (being Hong Kong communities). Setting a high threshold through the proposed increase in the Profit Requirement will inevitably deny quality SMEs the opportunity to raise funds on the Main Board for expansion or simply to list for liquidity purpose. This negates the purpose of the Exchange, and additionally it may also dampen the economic growth prospects and reputation of Hong Kong as a human capital centre of legal, accounting, corporate finance and other professionals.

As one of the values of the Exchange is to promote diversity, it should have the obligation to service all types of companies and not simply focus on companies with large market capitalisation, unicorns or companies engaging in the new economy. There has been a false perception that companies with large market capitalisation are better, however, when it comes to risk, large pre-revenue or pre-profit companies, including those companies listed via Chapter 8A, 18 or 18A of the Listing Rules, present significant risks to investors and they are not necessarily having better quality than SMEs.

We are mindful that SMEs can also access the capital market by listing on GEM. However, as we will explain in the later part of our reply, GEM is not a viable alternative.

(b) Valuation of companies upon listing should be market driven

The Consultation Paper notes that since the adoption of the increased Market Capitalisation Requirement, there were a higher portion of Small Cap Issuers that had recorded significantly higher historical P/E ratios, i.e. higher than 15 times and the Exchange raised concerns about the reasonableness of their valuations. However, the Consultation Paper also notes[1] that non-Small Cap Issuers that had recorded significantly higher historical P/E ratios were even higher than that for Small Cap Issuers during the period from 2016 to 2019. One can therefore deduce that the valuation of a company upon IPO is not determined so as to meet the Market Capitalisation Requirement but is determined by market demand.

Furthermore, since 2018 and the issuance of the updated Guidance Letter HKEX-GL68-13A, the Exchange has already adopted a more stringent approach to scrutinise the commercial rationale for listing and the reasonableness of P/E ratios of Small Cap Issuers. The Exchange has rejected listing applications[2] on the basis of lack of commercial rationale for listing or unsupported valuation. Therefore, the Exchange already has the authority to determine whether an applicant is suitable for listing and can reject an application if it is unsatisfied that the applicant is suitable for listing on the basis of insufficient support for valuation. In that regard, there is no need to

[1] Charts B and C of Appendix III of the Consultation Paper
[2] See, for examples, Listing Decision HKEX-LD121-2019 and HKEX-LD126-2020

change the current Profit Requirement to address the misalignment between the Market Capitalisation Requirement and the current Profit Requirement.

(c) Not all Small Cap Issuers are de facto shell companies

We note that the Consultation Paper appears to characterise Small Cap Issuers as de facto shell companies and question the genuineness of the purpose of their listing. Without debating whether such characterisation is reasonable or not, the Exchange already has the tools to combat the problem of shell companies. In its Guidance Letter HKEX-GL68-13A, the Exchange has already laid down seven criteria that a listing applicant needs to fulfil in order to be suitable for listing and such criteria were laid down with a key objective to prevent people from creating shell companies through the IPO process. Furthermore, the Exchange has also implemented more stringent rules through the revision of certain provisions under Chapter 14 of the Listing Rules with the aim of discouraging back-door listing via shell companies. In that regard, we believe the current regulatory framework adequately deals with this issue and there is no need for the Exchange to raise the threshold in the Profit Requirement to provide itself with an additional tool to stop the creation of shell companies.

(d) Small does not necessarily equate to bad

The Consultation Paper points out a number of misconducts surrounding the Small Cap Issuers that were listed after the Market Capitalisation Requirement came into effect in 2018, such as reporting inflated profit forecasts at the time of IPO to justify their high P/E ratio while failing to meet them afterwards.

We would like to point out that missing of profit forecast, which is submitted as a supporting document, can be interpreted as the uncertainty involved in the preparation of a profit forecast and should not be concluded as an intentional inflation of profit forecast to justify the valuation to meeting the Market Capitalisation Requirement. Citing table 3 on page 17 of the Consultation Paper for post-listing performance of Ineligible Applications, it seems like the real problem was stemmed from those companies that had a market capitalisation at the time of listing of less than HK$500 million, in which their percentage of meeting or exceeding profit casting was only 22%. Comparing that number to the other two segments, such percentage has jumped to over 40%. If taking into account the less than 30% shortfall figure, the HK$500-700 million segment for Ineligible Applications even outperformed the Eligible Applications (i.e. 89% versus 86%).

If the Exchange has concern on the efforts, prudence and accuracy that the listing applicants, the sponsors and the reporting accountants have put into the profit forecast submitted together with a listing application, we respectfully suggest that the Exchange can request the listing applicant to include the profit forecast figure into the prospectus so that directors and parties involved in the preparation of the prospectus will be liable to the accuracy of such profit forecast figure.

(e) The increase in threshold of the Profit Requirement is too drastic

The increment in the threshold of the Profit Requirement is too drastic and draconian for any potential issuers seeking to list on the Main Board, especially those quality SMEs. We understand that there are other eligibility tests available, but they are designed and geared toward sizeable and/or new economy companies, which in a way is prejudicing those smaller companies engaging in traditional industries.

Paragraph 38 of the Consultation Paper states that the median historical P/E ratio for the majority of Eligible Applications of non-Small Cap Issuers were 16 times (Option 1) and 15 times (Option 2). Therefore, we believe that the proposed Option 1 (150%) or Option 2 (200%), which would result in a historical P/E ratio of 10 times and 8 times, respectively, are drastic changes and presents unrealistically difficult thresholds for any potential issuers seeking to list on the Main Board, especially those SMEs.

(f) GEM is not a viable alternative

The Exchange has suggested that companies unqualified for the Main Board under the new Profit Requirement can seek a listing on GEM, but in our view that is not a viable option. As of November 2020, there were only 372 companies listed on GEM with a daily average turnover value of HK$536 million while there were only 8 new listings on GEM for the year ended 31 December 2020. In the past, many companies chose to list on GEM because of the availability of a simplified mechanism to transfer to the Main Board upon meeting the Profit Requirement, such mechanism will no longer be available to eligible GEM listed companies, after the transitional period of three years ending on 15 February 2021. To make things worse, since the change in GEM Listing Rules, there exists a general market perception that GEM companies lack growth potential and are of little investment value. With such degradation, GEM does not have the traction to attract companies and investors and has all but dwindled in the past few years.

The positioning of GEM is also ambiguous. At the very beginning, GEM was established as a market to cater for emerging companies that was engaging in the technology industry with strong growth potential but lacking profitability to mimic the NASDAQ in the US. Throughout the years, GEM has gradually become a board consisting of ultra small cap issuers with low daily turnover and limited fund raising capability. Most of the better quality companies that were originally listed on GEM and were able to meet the Profit Requirement have subsequently transferred to the Main Board after their listing. In such circumstances, any company that can demonstrate a track record of profitability would be hesitant to list on GEM. In other words, companies that have a three-year profit of at least HK$50 million but less than HK$125 million will not have a suitable board to be listed on.

(g) Current Profit Requirement is on par with the majority of the Selected Overseas Main Markets

In the consultation conclusion to the 2017 consultation published in December 2017, a majority of respondents agreed to retain the current Profit Requirement threshold for Main Board listings as such level was on par with the majority of the Selected Overseas Main Markets. It is our understanding that none of the Selected Overseas Main Markets have increased their minimum profit requirements since the consultation conclusion, therefore, the current Profit Requirement is still on par with the majority of the Selected Overseas Main Markets and nothing has changed.

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.*

Further to our reply to Question 1 above, we recommend the Exchange to put on hold the current proposals and undertake a holistic review of our market structure. The Main Board's Profit Requirement can only be revised upward when there is a viable alternative for local SMEs. GEM at its degraded present form is not an alternative listing venue for quality SMEs. The Exchange should look into developing a genuine tiered-market structure to provide real solutions to quality SMEs wishing to come to the stock market in Hong Kong.

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.*

Referring to our reply to Questions 1 and 2 above, we do not agree with the proposal for the increased Profit Requirement. In view of the COVID-19 and the adverse economic situation, we believe the Exchange should instead consider granting temporary relief to the **existing** Profit Requirement as many companies' businesses, especially SMEs, have been adversely affected.

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.*

Please refer to our reply to Questions 1 and 2 above.

This response represents the views of Howse Williams. We confirm that we are happy for the name of our firm and the contents of this letter to be made publicly available as part of the consultation process.

If you have any questions in relation to this submission, please contact [redacted].

Yours faithfully,

[redacted]

HOWSE WILLIAMS

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 paragraph B.1 of the attached letter for our response.

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 paragraph B.2 of the attached letter for our response.

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 paragraph B.3 of the attached letter for our response.

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 paragraph B.4 of the attached letter for our response.

- End -