



1 February 2021

By Email: response@hkex.com.hk
Corporate Communications Department
Hong Kong Exchanges and Clearing Limited
8th Floor, Two Exchange Square
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Hong Kong

Dear Sirs,

Response to HKEx Consultation Paper on The Main Board Profit Requirement (“the Consultation”)

Terms and expressions used in this Submission shall have the meanings under the Consultation unless being specified otherwise.

About Us

We are a specialty service provider, which is rendering company secretarial, compliance and corporate governance as well as risk management services to listed companies and IPO cases of over 250 companies. From 2014 and up to now, we are the leading corporate services provider in IPO market in rendering the above services.

Our views

We oppose the Exchange’s proposal for increasing the Profit Requirement. We genuinely believe that this proposal does “more harm than good” to the market. Local small and medium enterprises (“SMEs”), being deprived of their opportunities to list on the Main Board as a result, could hardly access the local equity capital market as GEM is not a real alternative (see below). The proposal will distort the eco-system of the capital market where the local corporate finance industry sector, who relies on SMEs for IPO and corporate actions, will be marginalized. Details of our views will be elaborated below.

GEM is not a real alternative for local SMEs seeking listing

The Exchange stated in the Consultation that Options 1¹ and 2² would have resulted in 59% (437) and 65% (486) of the Profit Requirement Applications being ineligible for listing³. Presumably, local

¹ Option 1 is a proposed increase of 150% in the Profit Requirement, which requires a post-tax profit of HK\$75 million in aggregate for the first two financial years and HK\$50 million for the last financial year during the 3-year track record period.

² Option 2 is a proposed increase of 200% in the Profit Requirement, which requires a post-tax profit of HK\$90 million in aggregate for the first two financial years and HK\$60 million for the last financial year during the 3-year track record period.

³ Per paragraph 28 of the Consultation

SMEs having genuine needs to raise funds for development through an IPO on the Main Board will be mostly affected by the proposal. Stated in the Consultation, the Exchange “*is mindful though that the proposed increase in the Profit Requirement will affect companies at an early development stage or small or mid-sized companies..... These companies can still access the capital market by listing on GEM..... that are not able to meet the Main Board eligibility requirements*”⁴. However, obviously, the reality is that GEM is not a real alternative given:

- its historical thin trading performance and post-market activities self-speak for the lack of investors’ interests. As of 31 December 2020, there were 368 GEM listed companies, represented 14.5% of total listed companies in Hong Kong by numbers but their market capitalization only constituted 0.28% of the total market capitalization. The average daily turnover of GEM issuers only represented around 0.23% and 0.27% respectively of daily turnover of Hong Kong securities market in 2019 and 2020. Despite the significant rebound of a 151% increase in post-IPO funds raised by Main Board issuers in 2020, it saw a further decrease of 9.32% of post-IPO funds raised by GEM issuers in the same year;
- A shrink in IPOs and fund raising for GEM is evident of the negative view of SMEs on this “going public” avenue ever since the position of GEM as a stepping stone to the Main Board being ripped out in 2018. The number of new listings in GEM decreased largely from 75 in 2018 to 15 in 2019, and further decreased to only 8 in 2020. The IPO fund raised in GEM also decreased significantly from HK\$5,060 million in 2018 to HK\$970 million in 2019 and HK\$554 million in 2020 respectively; and
- further to the above statistics, GEM has probably been stereotyped as potential shell-making venue. Back in 2017, when the Exchange proposed the removal of GEM streamlined listing process to Main Board, it expressed its concerns that the GEM streamlined listing process was an opportunity for regulatory arbitrage between the Main Board and GEM which potentially impacted the overall quality of the Hong Kong market and alleged that such process was exploited by certain companies to access the Hong Kong capital markets for the premium attached to a listing status (rather than to develop their businesses) and this might have led to an increase in the number of potential shell companies listed on GEM⁵. It is also noted that many fund managers are mandated not to trade on GEM stocks.

As such, SMEs who are ineligible to list on the Main Board after the heightened Profit Requirement would hardly accept GEM as an alternative listing venue. Not only that they might not be able to raise the necessary funds through GEM, they might also been associated with a “shell-maker” rather than a “decent” corporation with improved corporate image and prospects of increased business after going public. This proposal will end up barring local SMEs from successfully getting listed in Hong Kong. According to Census and Statistics Department, there were over 340,000 SMEs in Hong Kong as at September 2020 which accounted for more than 98% of the total number of enterprises and provided job opportunities to more than 1.2 million persons, about 44.5% of total employment.

⁴ Per paragraph 47 of the Consultation

⁵ Per paragraph 12 of consultation conclusion on “Review of the Growth Enterprise Market (GEM) and Changes to the GEM and Main Board Listing Rules” published in December 2017

Restricting their accessibility to the local equity capital market will certainly be harmful for their development and cause indirect harm to the local economy.

Existing listed companies will also suffer

The more stringent Profit Requirement will make spin-off proposals harder to proceed with. Holding companies would find it harder to unlock values of their subsidiaries by spin-offs.

On the other hand, the Exchange now challenges companies facing deteriorated financial performance due to business downturns with Listing Rule 13.24 of insufficient operations. The more stringent Profit Requirement makes it harder for these companies to demonstrate to the Exchange that they could re-comply with the listing requirements. Delisting of these companies as a result will be grossly unfair to their shareholders.

Being detrimental to Hong Kong capital market eco-system

Notwithstanding many of the local SMEs will become ineligible to get listed on the Main Board after the more stringent Profit Requirement and be effectively deprived of the opportunities to go public in Hong Kong, Option 1 and Option 2 which will result in the Exchange having the highest profit requirement on an aggregated basis for the three years of a track record period and the second highest profit requirement for the final year of the track record period⁶ undermined the competitiveness of the Exchange in attracting overseas companies to list. Besides, the reduction of new IPOs will naturally result in reduction of post-listing compliance services. Based on the aforesaid statistics for a potential reduction of about 60% of companies to be listed on the Main Board after the heightened Profit Requirements, this proposal will drive away substantial amount of businesses and strike a deadly blow to the entire corporate finance value chain, including sponsors, financial advisers, compliance advisers, lawyers, accountants, valuers, investor and public relations professionals, etc., in particular to local firms mainly serving local SMEs, causing severe unemployment. When these local firms and professionals are being driven out of the market, local SMEs will find less professional support for accessing the capital market as historically international firms of investment banks, lawyers and accountants do not eagerly serve them after balancing their own interests. It's a vicious circle. We believe that the Exchange, being the monopoly stock exchange in Hong Kong, has the duty to facilitate access to market for all quality businesses, not only big businesses. Every business also starts from small and grows to large and possibly grows through stages by obtaining bank and debt financings, investments from venture capital funds, and accessing to equity capital markets. This is how the capital market eco-system works. By lifting the Profit Requirement, many small businesses are denied access to access funds through listing on the exchange, thus their investment values will be reduced if not minimal in the eyes of venture capital funds; the increasing difficulties in raising capitals might increase funding costs, resulting them in a more disadvantageous position when competing with big businesses.

⁶ Per paragraph 44 of the Consultation

Wrong assertion that small-cap issuers are of lower quality and no inherent mistake for a higher P/E

The Exchange said that this proposal was to improve the overall quality of Main Board issuers⁷, stating, inter alia, in the Consultation that “*the Exchange has seen an increase in listing applications from Small Cap Issuers that marginally met the Profit Requirement but had relatively high historical P/E ratios as compared with those of their listed peers. ... While 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 rise to concerns about the reasonableness of their valuations...*”⁸ It continued that “*the inflated valuations also 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.*”⁹

From the above citation, it might have implied that the Exchange considers that small-cap issuers are problematic of more misconduct issues and cause lowering of market quality. However we believe that there is vast number of small-cap issuers with good profitability, business and growth prospects, and corporate governance. Quality of a listed issuer should not be determined purely with reference to its market capitalisation.

We made reference to statistics published by the Exchange in December 2020¹⁰, the rate of full compliance with all code provisions in the Corporate Governance Code and Corporate Governance Report was improving over the years, and the compliance rate and trend of small-cap issuers was not largely varied compared with those of the mid-cap or large-cap issuers. When it comes to misconducts, sizeable companies are equally susceptible to misconducts only that they could result in more severe harms to the market and investors. An example was a recent case which SFC commenced proceedings against Tianhe Chemicals Group Limited and its executive director for defective prospectus and to seek compensation orders for investors in September 2020. IPO Proceeds of approximately HK\$3.52 billion was raised in 2014 based on a prospectus alleged to have contained materially false or misleading information regarding its sales revenue and profits for its track record period.

We also wish to stress that there is no inherent mistake for a higher P/E. Different industries and different markets have different P/E ratios and it only reflects investors’ appetite but not an indicator of something right or wrong. We made reference to a comment made by the Exchange’s own publication in December 2017¹¹, “*an 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. In practice, most*

⁷ Per paragraph 48 of the Consultation

⁸ Per paragraph 4 of the Consultation

⁹ Per paragraph 6 of the Consultation

¹⁰ Per paragraph 57 of “Analysis of 2019 Corporate Governance Practice Disclosure” published by the Exchange in December 2020

¹¹ Per paragraph 119 of consultation conclusion on “Review of the Growth Enterprise Market (GEM) and Changes to the GEM and Main Board Listing Rules” published in December 2017

new applicants achieve profits and have market capitalisations that exceed our requirements by varying degrees. So, most applicants could list with an implied historical P/E ratio of less than 25 times. Also, 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. 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." Nevertheless, the Small Cap Issuers who are classified as Ineligible Applications only had their median historical P/E ratios of 14 times¹², which does not largely deviate from the average P/E ratio of Main Board issuers of 17.55 times in 2020 (2019: 13.28 times). The statistics have proven itself that the Exchange's concern of a high theoretical P/E of 25 times or more for Small Cap Issuers is not a real threat. Actually, the market's self-monitoring still functions well. A higher P/E for some issuers does reflect investors' faith in their future prospects, similar to the faith to those pre-revenue biotech companies.

It is the issuer's and Sponsor's responsibility to ensure that the disclosures in the prospectus are complete, true and accurate and we believe that the Exchange plays an important gate-keeper role to have the content of the prospectus (including profit forecasts and valuations) scrutinized prior to approval of listings. The Exchange should never dictate the price discovery process by pre-determining what is the right P/E ratio but let the market operate on its way. Even if there is clear evidence of market misconduct which we believe to be of a tiny minority, our view is that the Exchange should invoke disciplinary actions or refer cases to authorities for prosecution on an individual case basis instead of increasing the Profit Requirement for the benefits of nobody but for the sake of improving the overall quality of Main Board issuers which might or might not be achieved by doing so.

Should you have any questions, please contact the undersigned at [REDACTED] or [REDACTED]

Yours faithfully,
For and on behalf of
SWCS Corporate Services Group (Hong Kong) Limited

¹² Per paragraph 32 of the Consultation