

18 August 2017

Hong Kong Exchange and Clearing Limited
12/F One International Finance Centre
1 Harbour View Street
Central
Hong Kong

Dear Sir

Re: Consultation Paper on Review of the Growth Enterprise Market (GEM) and changes to the GEM and Main Board Listing Rules

We refer to the Consultation Paper published by the Exchange in June 2017 regarding the captioned matter. We would like to submit our comment below. Unless otherwise defined, capitalized terms have the same meanings as in the Consultation Paper.

GEM Board

Reasons for the rule change

- To increase its admission requirement with the aim of improving the overall quality of GEM listings
- To re-position GEM as a stand-alone board for small to mid-sized companies

Proposed rule change

1. Cashflow requirement:
 - Increase to HK\$30million
2. Minimum market capitalization and public float value requirement:
 - Increase minimum market capitalization at the time of listing to HK\$150million
 - Increase minimum public float value at the time of listing to HK\$45 million
3. Post-IPO Lock-up period on controlling shareholders:
 - Controlling shareholders cannot sell shares for the first year after listing
 - For the second year after listing, controlling shareholders may sell shares but should retain control
4. Offering mechanism:
 - Mandatory public offering of at least 10% of the total offer size and the allocation of offer shares between the public and placing tranches and the claw back mechanism to be consistent with those in Practice Note 18 to the Main Board Rules
5. Placing to selected individuals:
 - Align with Main Board Rules where waiver/consent of the Exchange are required
6. Transfer mechanism:
 - A sponsor must be appointed & issue "Prospectus-standard" listing document
 - Must have published at least two full financial years of financial statements after GEM listing and no disciplinary investigations for serious or potentially serious breaches 24 months before transfer

Factors supporting the rule change

1. Cashflow requirement:
 - Improve the overall quality of GEM by attracting applicants with stronger cash flow performance
 - 70% of Selected GEM Issuers recorded aggregate operating cash flow before changes in working capital of HK\$30 million and above

2. Minimum market capitalization:
 - The current market capitalization requirement was introduced almost nine years ago
 - The average market capitalization at the time of listing of Selected GEM Issuers was HK\$274 million
 - 88% (107 of 121) of Selected GEM Issuers had market capitalization of HK\$150 million or above at the time of listing
3. Post-IPO Lock-up period:
 - Avoid market manipulation, insider trading and unnecessary volatility in the market post-listing
 - Require controlling shareholders to have a longer commitment period to the applicant
 - Address the issue on the creation of potential shell companies
4. Offering mechanism:
 - Avoid insiders from controlling the supply and allocation of GEM stocks, which in turn makes GEM more prone to manipulation
 - Solve the problem of high shareholding concentration at listing
5. Placing to selected individuals:
 - Increase the level of safeguards to GEM shareholders
 - Avoid sharp movements in the share prices of GEM issuers
6. Transfer mechanism:
 - Address market concerns on the extent of due diligence to be performed on GEM Transfers
 - Provide more clarity on the financial condition and operation of the GEM Transfer applicants
 - The 99 successful GEM Transfer Applicants were listed on GEM for an average of 5.4 years
 - 78% (62 out of 79) of the GEM issuers that were transferred to the Main Board from the second half of 2008 to 2016 had been listed on GEM for two full financial years or longer before their transfers

Our View

Minimum cash flow requirement

The guiding principle given by the Exchange in the Consultation Paper to increase the minimum cash flow requirement which is defined as the aggregate operating cash flow before changes in working capital at the time of listing ("GEM Cash Flow") from HK\$20 million to HK\$30 million is to improve the overall quality of the GEM listings. However, based on our analysis, we do not find conclusive empirical evidence that companies with HK\$30 million GEM Cash Flow are of better quality compared to those with less than HK\$30 million GEM Cash Flow.

- a) We have reviewed the latest published audited results of the Selected GEM Issuers as at 11 August 2017 and note that 33 of the Selected GEM Issuers recorded a loss (before listing expenses). Among these loss-making Selected GEM Issuers, 20 of them had GEM Cash Flow of HK\$30 million and above and 13 of them had GEM Cash Flow of less than HK\$30 million; and
- b) We note that among the 99 GEM Transfers, 36 out of these 99 GEM Transfers are those companies having GEM Cash Flow of less than HK\$30 million, representing approximately 36.4% of the GEM Transfers. This percentage is higher than the approximate 29.8% (36 out of 121) of the Selected GEM Issuers with GEM Cash Flow of less than HK\$30 million, which means a relatively higher percentage of the GEM companies with GEM Cash Flow of less than HK\$30 million successfully achieving the GEM Transfers after they got listed on GEM. In our opinion, to be able to meet the Profit Requirement and complete the GEM Transfer at least demonstrates that these GEM companies were able to grow and had better profit quality than the other GEM companies. As such, there is no evidence to support the argument that the quality of GEM Issuers with GEM Cash Flow of HK\$30 million or above is necessarily better than that of the smaller GEM Issuers with GEM Cash Flow of less than HK\$30 million.

In summarizing points (a) and (b) above, we do not find that by increasing the minimum GEM Cash Flow to HK\$30 million will improve the overall quality of the GEM listings.

Minimum market capitalization

To reflect the growth of the Hong Kong market, we agree to the proposed increase in the minimum market capitalization to HK\$150 million and the minimum public float value to HK\$45 million at the time of listing.

Transfer mechanism

Whilst we see the rationale behind to position the GEM as a stand-alone board from the Main Board, we do not understand why we should penalize those GEM companies which meet the Main Board listing requirements and are able to qualify for the Main Board listing from a relatively simple transfer mechanism as available currently under the Main Board Listing Rule Chapter 9A. Therefore, we propose that the current Main Board Listing Rule Chapter 9A should still be made available to those GEM companies which have continued to engage in the same business activities and have not changed its controlling shareholders and have retained substantially its management since their GEM listings. In all other cases, a sponsor will be appointed and a "Prospectus-standard" listing document is required.

In terms of when a GEM Transfer is allowed, we agree that GEM companies will only be allowed to seek a GEM Transfer after they have published and distributed at least two full financial years of financial statements after GEM listing and no disciplinary investigations for serious or potentially serious breaches 24 months before the GEM Transfer.

Main Board

Reasons for the rule change

- To ensure that there is a clear distinction between issuers listed on GEM and the Main Board
- To reinforce the Main Board's position as a market for larger companies

Proposed rule change

1. Minimum market capitalization requirement:
 - Increase minimum market capitalization at the time of listing to HK\$500 million
 - Increase minimum public float value at the time of listing to HK\$125 million
2. Post-IPO Lock-up period on controlling shareholders:
 - Controlling shareholders cannot sell shares for the first year after listing
 - For the second year after listing, controlling shareholders may sell shares but should retain control

Factors supporting the rule change

1. Minimum market capitalization:
 - The average size of listed companies is doubling since the minimum market capitalization requirement was introduced in 2004;
 - Significantly reduce the percentage of Selected GEM Issuers that could have met the Main Board requirement. Only 9% of Selected GEM Issuers would have been able to meet a HK\$500 million market capitalization requirement, compared with 71% of Selected GEM Issuers that could meet the current HK\$200 million requirement. However, increasing this figure above HK\$500 million would not have much further effect, as 7% of the Selected GEM Issuers could meet a requirement that was as high as HK\$900 million;
 - It would have excluded only 13% of direct listing applicants to the Main Board from 2010 to 2016 and 33% of GEM Transfers to the Main Board. This means the Main Board would remain available as a listing venue for a majority of larger companies (providing benefits to them such as eligibility for Hang Seng Indexes) and GEM would continue to be available for excluded companies; and
 - Position the Main Board closer to some of the Selected Overseas Main Markets (i.e. Nasdaq Global Select Market, NYSE and SGX) with regards to their expected market capitalization requirements

2. Minimum public float value:

- The requirement on the minimum public float value of securities will need to be increased proportionally with the minimum market capitalization requirement

Our view

We consider that the proposed HK\$500 million minimum market capitalization is not justified based on the Hong Kong market's own characteristic for the following reasons:

1. The Main Board profit test requires a listing applicant to demonstrate HK\$20 million profit in the last year of its three years track record period. The proposed minimum HK\$500 million market capitalization would effectively mean an implied P/E (price to earnings ratio) of 25 times. This 25 times implied P/E is higher than the average P/E of all the HK market constituencies indexes, as stated below:

| Index | P/E ratio |
|---|-----------|
| Hang Seng Index | 14.77 |
| Hang Seng China Enterprises Index | 8.74 |
| Hang Seng Finance Sub-index | 11.85 |
| Hang Seng Utilities Sub-index | 19.38 |
| Hang Seng Properties Sub-index | 8.94 |
| Hang Seng Commerce & Industry Sub-index | 22.17 |
| Hang Seng Red Chip Index | 12.41 |
| Hang Seng LargeCap Index | 14.40 |
| Hang Seng MidCap Index | 17.14 |
| Hang Seng SmallCap Index | 11.76 |
| Average (simple average) | 14.16 |

Source: Bloomberg, 11 August 2017

If the Hong Kong market is currently not a market commanding a P/E valuation of 25 times in average, we consider that it is neither fair to assume all listing applications be able to commend such valuation at listing nor just to exclude those companies which are able to meet the minimum Profit Requirement but can only commend a lower (than 25 times) P/E at listing on the Exchange.

2. If we assume the average P/E of 14.16 times as demonstrated in the above table, it effectively means that a listing applicant will need to achieve a profit of HK\$35.31 million in the last year of its track record period before listing, which is higher than the current requirement of HK\$20 million and is not consistent with the conclusion made by the Exchange on paragraph 14 in Chapter 5 of the Consultation Paper that "...we do not propose any change in the level of profit under the Profit Requirement."
3. The guiding principle (the "Principle") of the Exchange's proposal to increase the minimum market capitalization at listing from HK\$200 million to \$500 million is "to preserve the distinctiveness of the Main Board and its position as a market for larger companies that can meet Hong Kong's highest market standards" (paragraph 23 in Chapter 5 of the Consultation Paper). However, we do not see conclusive empirical evidence that companies with higher market capitalization will be larger companies, which can meet the Hong Kong's highest standards, compared to those with lower market capitalization. "Size" and "quality" of a company can be determined by many factors such as profitability, asset value, intrinsic value, development and future prospects, level of corporate governance and etc. To illustrate this point, we note that:
 - a) There was a total of 345 newly listed Main Board issuers (the "Selected Main Board Issuers") from 2013 – 2016. Based on their latest published audited results as at 11 August 2017, we note that 62 of the Selected Main Board Issuers reported a loss (before listing expenses). Among them, 12 had market capitalization of less than HK\$500 million at the time of their listings; 35 had market

capitalization of HK\$500 million or more but less than HK\$2 billion at the time of their listings; and 15 had market capitalization of HK\$2 billion and above at the time of their listings; and

- b) There was a total of 60 Main Board listed companies, the trading of these companies' shares were suspended either for more than three months as at 31 July 2017 (source: HKEx website) or during 1 June to 11 August 2017 due to various non-compliance issues other than insufficient public float or in the course of a privatisation. 48 out of these 60 companies had market capitalization of more than HK\$500 million at the time of suspension.

Based on the above observation, we conclude that there is no direct correlation between market capitalization and "size" or "quality" of a company. As such, we do not agree that to increase the minimum market capitalization requirement at listing will be able to meet the Principle.

4. We consider that the current Profit Requirement under the Main Board Listing Rules and the three years track record requirement already position the Main Board as a market for companies with stronger profit history, more mature and stable profit and business track record as compared to GEM. If a GEM company can meet the minimum market capitalization requirement of the Main Board but cannot meet the Profit Requirement, it still cannot transfer its listing from GEM to the Main Board. On the contrary, if it can meet the Profit Requirement, we should encourage them to seek a transfer. We do not see that the market will mix up the characteristic of Main Board with GEM if the Exchange allows more GEM Transfers because these GEM companies are able to meet the Profit Requirement. In our opinion, it only benefits Hong Kong's reputation as a major financial center if more GEM companies are able to grow and become more mature and be able to qualify for the Main Board listing.
5. Despite the fact that we do not agree to increase the minimum market capitalization to the proposed HK\$500 million, we would still propose a higher minimum capitalization to reflect the growth of the Hong Kong market since 2004. We propose to increase the minimum market capitalization to HK\$300 million. Based on the minimum HK\$20 million profit in the last year of the profit track record period, our proposed minimum market capitalization of HK\$300 million implies a P/E of 15 times which is comparable to the average implied P/E of the Hong Kong market.
6. If the minimum market capitalization is increased to HK\$300 million, the minimum public float value will correspondingly be increased to HK\$75 million at the time of listing.

Should you have any questions or require any further information to assist you in your consideration of our comment in this letter, please contact our Mr. Alex Lau at [REDACTED].

Yours faithfully,

[REDACTED]

Alex Lau
Managing Director

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