Response to HKEx Consultation Paper June 2018
on
Backdoor Listing, Continuing Listing Criteria and Other Rule Amendments
(“RTO Consultation”)

Of all the tightening proposed in the RTO Consultation, most are codification of practice of the Listing Department and the Listing Committee, and therefore considered minimal disruptions. Even the three-year “cool down” period (increased from two years) between a change in control, an asset acquisition and an asset disposal under the proposed changes to Rule 14.06(B) Note 1(f), can be acceptable, so long as the Listing Department follows the new rule (which is a big question mark though).

We aim to focus only on one of the most significant changes proposed in the RTO Consultation – Rule 14.54(2), and its impact on listed issuers having insufficient operations (in the eyes of the Listing Department). Following is an analysis on how the new Rule 14.54(2) would affect listed issuers.

Companies not having sufficient revenue may be considered by the Stock Exchange as having insufficient operations under Rule 13.24 (“13.24 Companies”). Therefore, it is important for listed issuers to have significant revenue, which is equivalent to “operations” in the eyes of the Stock Exchange.

The proposed addition of Rule 14.54(2) is in our view onerous for 13.24 Companies trying to bring themselves back to scale to comply with Rule 13.24 through a reverse takeover (“RTO”).

13.24 Companies can seek to comply with Rule 13.24 by increasing its revenue.

13.24 Companies can increase revenue by one of the following methods:–

i. 13.24 Companies can undertake organic growth, through an increase in sales by selling more products or services to customers, which require more human resources, more working capital investments, and more importantly – time. In terms of Stock Exchange’s approval, so long as 13.24 Companies can show significant increase in revenue (operations) and some profits (sustainability), we believe the Stock Exchange would likely consider them compliant with Rule 13.24.

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Therefore, the revised Rule 13.24 and the new Rule 14.54(2) would have minimal or no impact on 13.24 Companies trying to comply with Rule 13.24 via organic growth. However, one must understand that it is not easy to significantly grow revenue within a short period of time, and the proposed 12 months transition period is too short for 13.24 Companies to even report the revenue growth in the subsequent financial reporting.

ii. 13.24 Companies can also make acquisitions in its existing line of business, or even new business. But because of the low base in revenue of 13.24 Companies, any acquisition would most likely constitute a very substantial acquisition ("VSA").

Under the existing Listing Rules, 13.24 Companies intending to acquire a profitable business ("Target Business") through a VSA, Rule 14.06 treats the Target Business as an RTO, then Rule 14.54 applies to require only the Target Business <u>or</u> the enlarged group to comply with the three-year profits requirement equal to a new listing application ("IPO Profits").

Under the proposed introduction of the new Rule 14.54(2), 13.24 Companies undertaking an RTO not only must have the Target Business meet the IPO Profits, the Target Business <u>must cover all past losses of the listed companies in the past three years in computing the IPO Profits</u> to be approved for an RTO. Therefore, even if the Target Business can meet the IPO Profits, so long as the 13.24 Company made a loss in any of the past three years, the 13.24 Company still cannot acquire the Target Business.

Fortunately, paragraph 73 on page 27 in the consultation paper states that the Stock Exchange will disregard past losses of 13.24 Companies in an RTO <u>IF</u> the 13.24 Companies discontinue the existing business at the same time as they undergo an RTO type of acquisition. In other words, 13.24 Companies discontinuing or liquidating existing business would also be not so much affected by the new Rule 14.54(2). Though paragraph 73 is not being incorporated in the new Rule 13.24 or 14.54(2), it still gives some hope to 13.24 Companies so long as they cease or liquidate their existing business upon implementation of an RTO.

<u>What is left behind</u> are 13.24 Companies intending to both continue its existing business, and to acquire a new business. This type of 13.24 Companies would be <u>most adversely affected</u> by the new Rule 14.54(2) because the new Target Business <u>not</u> only must have IPO Profits (an aggregate of HK$30 mln for 2015 and 2016, plus HK$20 mln in 2017), the Target Business must have IPO Profits in past three years profit <u>after</u> covering the 13.24 Companies past three years losses.

To illustrate the difficulty, if a 13.24 Company had an aggregate accounting loss of HK$50 mln in 2015 and 2016, and an accounting loss of HK$100 mln in 2017, the Target Business must have an aggregate profit of HK$80 mln (30+50) in 2015 and 2016, and a profit of HK$120 mln (20+100) in 2017. The new Rule 14.54(2) makes rescuing almost impossible for 13.24 Companies who want to continue its existing business while at the same time undergo an RTO with a new Target Business.

By a rough estimate, there are about 100 issuers at present not fulfilling Rule 13.24, or on the verge of failing it. Under the current Listing Rules, if they acquire a Target Business that satisfies IPO Profits, they can save themselves from delisting. Under the proposed changes, 90% of them would be delisted even after an RTO of a Target Business that fulfills the IPO Profits.

Based on the above analyses, we urge the Stock Exchange not to introduce the new Rule 14.54(2).

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For and on behalf of
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