

## 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](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.

The Group is fundamentally opposed to the proposed increases in the Profit Requirement for the following reasons.

### Profit increase will restrict Main Board listings to large cap Mainland companies

The proposed increases in the Main Board's Profit Requirement are excessive and will make the Exchange the most difficult international market on which to list, drastically reducing its competitiveness for all but the largest listing applicants which are primarily from mainland China. Either Option would give the Exchange the highest aggregate profit requirement for the three-year track record requirement of the Selected Overseas Main Markets. Not only would the actual profit figure be higher, but meeting it will be more difficult than the profit requirements of the Selected Overseas Main Markets because, unlike those markets, the Hong Kong profit test is based on post-tax (rather than pre-tax) profit and excludes the profits of entities included using the equity method of accounting and profits generated outside the listing applicant's ordinary and usual course of business. On top of that, the Hong Kong Main Board is the only market requiring listing applicants to satisfy both a profit and market capitalisation requirement. The other two major international venues for initial public offerings are New York and London. NASDAQ has minimal listing requirements. It is possible to list on its top tier Global Select Market with pre-tax earnings of just US\$11 million (HK\$85.25 million) over three years, which is considerably lower than the proposed requirements for the Main Board, without additionally having to meet a market capitalisation test. Listing on the Premium Segment of the London Stock Exchange's ("LSE") Main Market requires 75% of the listing applicant's business to be supported by three years' historic revenue earnings and the shares being listed to have an expected market capitalisation of GBP700,000 (HK\$7.75 million). With no profit test requirement, the criteria for listing on the LSE's Premium Segment are considerably less onerous than the proposed Main Board eligibility criteria. Whereas the other Selected Overseas Main Markets offer alternative tests for listing, Hong Kong's alternative

financial tests cater only for a small minority of very large companies in requiring a market capitalisation of either HK\$2 billion or HK\$4 billion in addition to HK\$500 million of revenue in the most recent financial year. As a result, just 1% of companies applying to list on the Main Board between 2016 and 2019 relied on the Market Capitalisation Revenue Cashflow test while 4% relied on the Market Capitalisation Revenue test (Consultation Paper Table 1).

The Consultation Paper notes that the adoption of either Option 1 or 2 would result in the Exchange continuing to have the second highest profit requirement for the most recent year of the track record period, after Singapore. Singapore's standalone profit test requires pre-tax profit equivalent to HK\$170 million for the most recent financial year. It is questionable whether Singapore's Main Board provides a useful point of comparison. 479 companies were listed on the SGX's Main Board at the end of November 2020 with a total market capitalisation of S\$844,749 million<sup>1</sup> (approximately HK\$4,946 billion). This compares to the Exchange's Main Board which listed 2,156 companies with a total market capitalisation of HK\$45,619 billion at the end of November 2020.<sup>2</sup> There was just one non-REIT IPO on SGX's Main Board in the year to 30 November 2020 compared to 124 on the Main Board of the Exchange in the same period. The high profit requirement for SGX's Main Board may be a circumstantial factor in the size and stagnation of the Singapore market. It is of significant concern that, as indicated in the Consultation Paper, Option 1 and Option 2 would have disqualified from listing 59% (437) and 65% (486), respectively, of companies applying for listing under the Profit Requirement between 2016 and 2019. It must be evident that many of these "Small-Cap Issuers" include Hong Kong-based issuers which, unlike mainland companies, only have access to the Hong Kong market as their domestic market. The proposals are based on the premise that large companies are necessarily better, or pose less risk, than smaller companies, which the Group considers to be mistaken. It should also be remembered that today's large cap companies were once small growth companies. The proposals will effectively close the Main Board to Hong Kong and Chinese SMEs.

Accommodation has rightly been made by the Exchange for particular types of issuer so as not to close the market to them; for example, the introduction of the capitalisation test for companies with insufficient or no profits; special arrangements for companies with weighted voting rights; mining, infrastructure, and biotech companies; and grandfathering arrangements for secondary listings of China-based companies listed on qualifying exchanges. These initiatives have primarily benefitted Chinese companies.

While the Exchange's success in attracting the listings of some of China's most successful companies is to be applauded, the Exchange should not neglect SMEs and smaller tech and other innovative companies which play a significant role in the economies of Hong Kong and mainland China. According to the Trade and Industry Department, there were more than 340,000 SMEs in Hong Kong as at June 2020 providing jobs for more than 1.2 million people, around 45% of total employment excluding the civil service.<sup>3</sup> According to China's official statistics, medium-sized, small and micro enterprises made an important contribution to the country's economic development between 2014 and 2018. At the end of 2018, China's SMEs and micro enterprises reportedly accounted for 99.8% of all legal entities and 68.2% of company revenues.<sup>4</sup> Denying these SMEs access to the Exchange as a fund-raising platform is ill-advised, both from Hong Kong's own perspective and that of China, given that Hong Kong is tasked with playing an important fund-raising role for enterprises in the Greater Bay Area. It also seems perverse that, instead of encouraging or accommodating Hong Kong based issuers, the Listing Rules are to be changed to disadvantage companies which are engaged in activities that account for a large portion of our local economic activity, such as hotels, tourism,

manufacturing through factories located to the north, finance, shipping and logistics, trading, retail, and property and construction. At the same time, smaller tech and other innovative companies have no viable venue for listing in Hong Kong.

### Inadequacy of GEM

The Consultation Paper appears to suggest that the GEM market offers an alternative for smaller companies. In practice this is not so. The GEM market is over-regulated (being more stringently regulated than the Main Board), not specifically designed for traditional economy companies, and its lengthy and costly application process is a considerable disincentive to listing on it. The cost of listing on the Exchange increased significantly following the introduction of the sponsor regime in 2013 due largely to the extensive due diligence sponsors typically conduct to meet the broadly drafted and imprecise requirements of Paragraph 17 of the Code of Conduct. The sponsor regime is unique to Hong Kong with no other international market imposing anything close to this level of due diligence. Since the introduction of the 2013 sponsor regime there have been no significant international listings on the Exchange and this is likely to persist. The resulting increase in the cost of listing has proved a particular burden for GEM listing applicants which, as SMEs, typically raise a relatively small amount. It then adds insult to injury when GEM listing applicants are rejected as unsuitable for listing because a high proportion of the listing proceeds will be used to pay the listing costs (under Guidance Letter 68-13A), when the high cost of listing is substantially caused by the listing requirements and the Exchange itself.

That GEM does not provide a viable alternative market is apparent in the declining numbers of companies listing on GEM each year. Eighty companies listed on GEM in 2017, the last full year before higher requirements for admission to GEM and for the transfer of GEM-listed companies to the Main Board were introduced in February 2018. GEM listed just 15 companies in 2019, and 8 companies in the first 11 months of 2020. GEM's dwindling performance over the past two years is particularly concerning given the record IPO fundraising activity seen on the Main Board over the same period. For the GEM market to be developed as a viable alternative for smaller companies, its listing process and procedures will require a radical overhaul. As this does not appear to form part of the Exchange's proposals, the implementation of the proposals in their present form is likely to needlessly close the Hong Kong market to many smaller Hong Kong and China-based businesses. This not only adversely affects these potential issuers but also the local legal practices, accounting firms and financial advisers who act for them, and to the extent fewer issues take place, it will adversely affect others such as printers, translators, caterers and hotels. Taking the 437 Profit Requirement Applications that Option 1 would have rendered ineligible for listing between 2016 and 2019 by way of example, assuming average IPO listing expenses (excluding underwriting fees) of HK\$25 million, fees of HK\$10.925 billion over four years (an average of HK\$2.73 billion per year) would have been wiped out from the value chain of the professional parties, before taking into consideration the effect on underwriters and brokers. This would have far-reaching societal effects and a significant impact on the corporate finance industry in Hong Kong. Given the Exchange's monopoly status, it is surely incumbent on it to provide a capital raising platform for Hong Kong SMEs as well as larger established companies. As Hong Kong's only domestic market, the Exchange must ensure that it serves Hong Kong companies and the local market.

## Hong Kong needs to provide a comprehensive and diversified market

In contrast to Hong Kong, the New York and London exchanges offer domestic issuers of every size ready access to an effectively functioning capital market. NASDAQ's Global Market and Capital Market have much lower entry requirements than Hong Kong. The LSE is a diverse market providing a listing venue for a broad range of companies on the three different segments of its Main Market: the Premium Segment (discussed above), the Standard Segment and the High Growth Segment. The LSE's AIM market further offers SMEs and growth companies early access to the capital markets and currently lists 819 companies with a combined market capitalisation of GBP131 billion<sup>5</sup> (HK\$1,390 billion). The New York and London exchanges will also list companies from a broad range of countries, something which the Hong Kong Exchange has singularly failed to do in recent years, which has left it heavily reliant on mainland Chinese companies. Meanwhile China has taken steps to implement a multi-level capital market with Shenzhen's ChiNext board providing a fund-raising platform for innovative growth companies and start-ups.

Rather than attempt to diversify the Hong Kong market by offering a listing venue for smaller and growth companies and for companies from a wide variety of jurisdictions, the Exchange's proposals risk limiting the Main Board to only the most substantial Chinese companies capable of meeting the financial tests of Chapter 8 or eligible for listing under Chapters 8A and 18A. While that strategy may work in the short-term, the Exchange needs to be cognizant of increasing competition for Chinese listings from the mainland stock exchanges. Hong Kong's existing profit test is already higher than that for the Shanghai Stock Exchange's Main Board. The adoption of a higher profit requirement for the Main Board would thus risk losing the IPOs of Chinese SMEs to the A-share markets. It is notable that the Shanghai Stock Exchange significantly outperformed the Exchange in terms of IPO funds raised in the first three quarters of 2020 and ranked as the world's largest IPO fund raising exchange in that period.<sup>6</sup> When China opens its securities markets to foreign investors, either directly or through an arrangement similar to Stock Connect, the attractiveness of the Exchange as a listing venue for mainland companies may be diminished.

The Exchange's ultimate objective must surely be to enhance the market's diversity and competitiveness by increasing its inclusiveness and coverage. The Exchange's proposals for the Main Board cannot be considered in isolation and must be looked at in conjunction with their implications for the companies they will exclude from the Main Board. The Group therefore advocates a holistic review and radical reorganisation of the Exchange's markets with a view to ensuring that the Exchange provides a comprehensive and diversified market capable of listing Hong Kong and overseas issuers whatever their size. Potential reforms to achieve this might include segmenting the Main Board into a premium and standard segment where the premium segment would list very large companies and the standard segment would adopt the existing profit requirement and a reduced market capitalisation requirement. The Main Board is already segmented in providing different entry criteria for weighted voting rights companies, pre-revenue biotech companies and mineral companies (among others). The Exchange should also consider repositioning GEM as an attractive SME board and potentially establishing a new board open to start-up and growth companies whatever their jurisdiction of incorporation. With regard to overseas issuers, Hong Kong should aim to take advantage of the opportunities arising from the Belt and Road and Greater Bay Area Initiatives and other Central Government initiatives as well as the opportunity to list companies incorporated in ASEAN countries.

## Taking the Opportunity to Rejuvenate GEM

Broad changes which might usefully be considered in order to rejuvenate GEM include:

- Simplifying the listing requirements so as to make listing on GEM more efficient and less costly. This should focus in particular on avoiding the uncertainty surrounding the issue of “suitability”, the interpretation of which has become needlessly subjective;
- Removing quarterly reporting which is expensive and time-consuming for GEM companies. It is anomalous to have a higher obligation than for the Main Board, especially in view of the obligation to release price sensitive information promptly and continuously. Quarterly reporting also increases the black-out period for connected shareholders, bringing the restriction on dealing for such shareholders, often an important source of liquidity – one of the major needs of GEM – to 5 months in the year; and
- Restoring the “light touch” means of “promotion” to the Main Board. GEM companies which are able to meet the Main Board’s financial tests should not need to issue a further prospectus.

### Over-emphasis on “shell company” listings

The stated rationale for the proposed increase in the Main Board profit requirement is the Exchange’s concern that Small Cap Issuers list not *“to raise funds for the development of their underlying businesses”* but to *“manufacture potential shell companies for sale after listing given the perceived premium attached to the listing status”* (paragraph 5 of the Consultation Paper).

The 2018 increase in the market capitalisation requirement, taken together with the changes to the Listing Rules and guidance letters on reverse takeovers, have almost certainly made the creation of a listed shell as the sole or a dominant reason to list a pointless endeavour. The Exchange has also revised the Listing Rules to make an injection of material assets into a listed company following a change of control virtually impossible. The Consultation Paper’s apparent concern with a perceived need to crack down further on the market for shell companies is misguided – the market has largely collapsed. Ironically, it is the artificial barriers to listing created by the Exchange’s imposition of high listing eligibility requirements that gives value to listed shells in the first place. Indeed, there is every likelihood that its proposals, by introducing higher profit hurdles, would revive the market for existing listed shells.

Further, the effort to root out the creation of potential shell companies through the listing process should not have the unintended consequence of disadvantaging perfectly acceptable SMEs, which wish to list for legitimate reasons. The Exchange’s vetting criteria for GEM listing applicants and smaller Main Board applicants appear to have become significantly more stringent compared to those applied to large companies raising substantial funds, particularly in its application of Guidance Letter 68-13A and the requirement that applicants should demonstrate a commercial rationale for listing. The Exchange’s suggestion in the Consultation Paper that only listings which raise funds for the development of issuers’ underlying businesses should be regarded as “genuine listings” is misplaced. While raising funds for business expansion is undeniably one reason for listing, it is by no means the sole reason.

Indeed, the Exchange's own marketing materials ("Listing in Hong Kong: A Quality Market") once noted that "*Companies list their shares for reasons that are unique to the particular circumstances of each company, its owners and its management. A company may seek a listing because its owners would like to realise part of their investment, or because it lacks the funds to expand its business operations*". Despite previously acknowledging owners' desire to realise their investment as a legitimate reason for listing, the Exchange now effectively discourages offers for sale when they are specifically permitted under the Listing Rules. This has the effect of forcing all new issuers to raise new equity funds through the initial public offer process, whether they need them or not. We do not consider that potential issuers should be effectively prevented from being listed through an offer for sale of existing shares only and ask that the Exchange reconsider its policy in this regard. There are many perfectly valid reasons to list apart from raising new funds to finance the expansion of a business. These include, as noted in the Exchange's publication referred to above:

- Higher profile and visibility in the market may result in increased business, greater assurance among the company's customers and suppliers, and an improved corporate image;
- Increased corporate transparency to gain recognition from institutional funds and the investing public;
- Improved corporate governance as a result of listing requirements will help improve management efficiency and information flow; and
- Greater employee commitment resulting from the grant of employee share options as part of the compensation package to encourage the senior management to grow with the company.

The Consultation Paper notes an increase in the number of Main Board listing applicants which only marginally met the Profit Requirement following the February 2018 increase in the market capitalisation requirement. However, this should not be surprising since it is only reasonable that potential listing applicants should grow their business into a Main Board marginal case before applying to list given that: (i) the listing application process, cost and timetable are virtually the same for GEM and the Main Board; and (ii) the GEM Listing Rule changes which took effect in February 2018 raised the GEM admission criteria and removed the streamlined transfer process to the Main Board.

The Group would also note that, while Hong Kong has continued its campaign against shell companies, other international markets have encouraged the listing of special purpose acquisition companies ("SPACs"), which are simply shell companies by another name. It believes the Exchange should also be open to listings of this kind.

The Consultation Paper's suggestions that there have been arrangements to rebate investors or to create the appearance of attracting more subscribers than genuinely subscribed for shares in an initial public offer (at paragraphs 6 and 23(a) of the Consultation Paper) are unparticularised. If such actions are being employed to give the appearance of a more successful issue than is actually the case, they should be properly investigated and those involved suitably sanctioned. These unfounded allegations should not be used to promote changes to the Listing Rules which will disadvantage potential issuers from raising capital in their domestic market.

The Exchange's policy of delisting companies which fail to lift the suspension of trading in their shares within eighteen months (twelve months for GEM) and the treatment of companies whose accounts are qualified or disclaimed has already greatly increased the risks of investing in smaller listed companies, which is likely to be reflected in the volatility of their share prices. The imposition of much higher profit requirements is also likely to influence how the sufficiency of operations are to be assessed under Listing Rule 13.24 in the future. This too is likely to affect the valuations of such companies and the volatility of their traded share prices, particularly if they start to operate at a loss.

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.

As noted in the response to Question 1 above, the Group disagrees with the Exchange's proposed increase in the Main Board profit requirement. For the reasons discussed below, the Group suggests that consideration should instead be given to reducing the minimum capitalisation requirement which is the cause of the problem and is now disadvantaging so many potential issuers based in Hong Kong and mainland China.

In relation to the profit requirement, the Group's preference would be to retain the existing requirement. If there is to be an increase in the profit requirement, it suggests increasing the final year's requirement to no more than HK\$37.5 million and the aggregate requirement for years 1 and 2 to between HK\$40 and HK\$50 million.

#### Need to consider reducing Main Board market capitalisation requirement

The Group agrees that there is a "disconnect" between the minimum market capitalisation of HK\$500 million and the minimum most recent financial year earnings figure of HK\$20 million. However, in addressing this disconnect, we hope the Exchange can keep an open mind and allow for the possibility that the HK\$500 million market cap has proved, with hindsight, to be too high. As was noted by some members of the Group in responding to the Exchange's June 2017 proposal, market capitalisation is subject to market conditions. Thus, a minimum market capitalisation of HK\$500 million may preclude many companies from listing during a poor market. Those Group members therefore suggested that if the Main Board market capitalisation requirement was to be raised, it should be to no more than HK\$300 million. The Group considers that reducing the minimum market capitalisation should be on the table when considering potential solutions.

#### Estimated P/E of 25 is incorrect

The assumption that a minimum market capitalisation of HK\$500 million and minimum earnings of HK\$20 million equates to a P/E ratio of 25 times (at paragraph 3 of the Consultation Paper) is not comparing like with like. Nearly all small/medium cap IPOs

involve the raising of new capital. Indeed, the majority satisfy the 25% public float requirement entirely by the issue of new shares. A minimum market capitalisation of HK\$500 million at IPO is therefore likely to be made up of: (i) a business valued at HK\$375 million; and (ii) new money raised of HK\$125 million (i.e. 25%). Since the new money contributes nothing to the last audited earnings of HK\$20 million, it is fair to compare the earnings with the pre-money valuation of the group of HK\$375 million, i.e. the implied P/E is about 18 times, not 25 times. On this basis, if a “fair” P/E, as the Consultation Paper suggests, is 10 times, the maximum amount to which the earnings for the most recent financial year should be increased would be HK\$37.5 million (i.e. HK\$375 million divided by 10). The Group opposes such a substantial increase. It also fundamentally opposes the Consultation Paper’s proposed new minima, which at HK\$50-60 million, are in the Group’s opinion significantly too large.

Increase in most recent year’s profit should not automatically trigger increases in years 1 and 2

The Group does not accept the assumption that an increase in the most recent year of the track record period should automatically trigger the same percentage increase for the sum of years 1 and 2. In the case of a fast growth company, the proposed year 1 and 2 aggregates of HK\$75-90 million could be more difficult to satisfy than the minimum for the most recent year. The Group doubts whether this is intentional or desirable. It proposes instead that the aggregate for years 1 and 2 should remain unchanged or, if increased, increased only modestly.

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.

The Group opposes the proposed increase in the Profit Requirement. As regards the proposed temporary relief arrangements to counteract the impact on the financial performance of many potential issuers as a result of the coronavirus pandemic, the fact that relief arrangements of this kind are being proposed, indicates strongly that now is not the right time to increase the financial requirements for listing. If there is to be a review of the listing requirements, it should be delayed until there is reasonable certainty that the most affected sectors of the economy are well into a recovery to levels seen before the pandemic.

If, however, the Exchange ultimately proceeds with its proposals (or revised proposals to raise the financial eligibility criteria), the Group would support granting temporary relief.

However, the Group believes that the relief arrangements should not simply be confined to the effects of the pandemic during 2020. For potential issuers in the most affected sectors, problems started to arise in 2019 with the civil unrest in Hong Kong which had a particularly



marked adverse impact on the hotel and retailing sectors. Also, the difficulties caused by the coronavirus pandemic are expected to continue into 2021 and potentially beyond.

With regard to the proposed transitional arrangements set out in Chapter 3 of the Consultation Paper, the Group advocates a three-year transitional period – the same as the transitional period allowed for the transfer of GEM companies to the Main Board following the February 2018 Listing Rule amendments. This would provide relief for companies which at the date of the Consultation Paper were making preparations to list on the Main Board within the next few years.

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.

The proposed temporary relief measures will require potential issuers to show that they generated a positive cashflow during 2020 (paragraph 55(b)). This would appear to exclude automatically potential issuers from the hardest hit sectors such as airlines, cruise lines, hotels, restaurants, cinemas, casinos and the entertainment sector generally.

The Group further considers that the profit requirements should remain unchanged until the economy has recovered from the pandemic and disagrees with the proposed condition under paragraph 55(a). Given that the pandemic's impact is extending into 2021, paragraph (d) should be revised to refer to six months of the track record period falling within 2021 rather than 2020.

The Group disagrees with the proposal to require a profit forecast to be included in the listing document (paragraph 55(e)(iii)) which will need to be reported on by the company's auditors and subject to a sponsor confirmation as required by the Listing Rules. The accuracy of profit forecasts is particularly questionable in the current economic climate. The Group therefore doubts that sponsors will be willing to give the required confirmations on profit forecasts given the degree of risk.

With regard to profit forecasts in general, while the Group opposes the proposed increase in the profit requirement, it suggests that if the profit requirement for the most recent financial year is increased substantially, then the current financial year of the prospectus should be allowed to qualify (on a permissive not mandatory basis) as the "most recent" if a formal profit forecast for that year is included, and reported on, in the prospectus.

- End -

## Endnotes

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