

ACUMINOUS

2021 THIRD ISSUE

INCREASE IN MAIN BOARD LISTING PROFIT REQUIREMENT

On 20 May 2020, The Stock Exchange of Hong Kong Limited (the “Exchange”) published its conclusion (the “Consultation Conclusion”) to its consultation (the “Consultation”) on the proposed increase in the profit requirement (the “Profit Requirement”) for Main Board listing applicants. This is a major overhaul of the profit requirement which has been in place since 1994 and we will go through the key points of the Consultation Conclusion and the relevant changes to the Listing Rules in this issue.

Executive Summary

The Exchange received an overwhelming number of responses to the Consultation from institutions, professional bodies and individuals. Even though a majority of the respondents were not supportive of the quantum of the proposed increase in the Profit Requirement and did not see an urgency to implement such a drastic proposal in 2021, the Exchange decided to adopt the follow changes to the Profit Requirement in pursuit of market quality improvements:-

- a 60% increase in the aggregate profit required under the Profit Requirement, resulting in **an aggregate profit threshold of HK\$80 million**, with the aggregate profit requirement for the first two financial years to be raised to HK\$ 45 million and HK\$ 35 million for the final financial year (the “**Modified Profit Requirement**”).
- The Modified Profit Requirement will become **effective on 1 January 2022**.
- Set out below is the summary of the increase in the Profit Requirement:-

	Current	Modified Profit Requirement
	HK\$ million	
In aggregate for the first two financial years	30	45
For the final financial year	20	35
Total	50	80
Profit Spread	60%:40%	56%:44%
Implied historical P/E ratio	25 times	14 times

Figure 1 – Summary of the Modified Profit Requirement

Basis of the Modified Profit Requirement

The Exchange considered the feedback from the market and consulted with the Securities and Futures Commission (the “SFC”). Their rationale for such decision was based on,

among others, the following key factors:-

- the proposed increase is in line with the 61% increase in the monthly composite consumer price index (a common inflation measure) from September 1991 (68.6) to December 2020 (110.7); and
- the aggregate profit threshold of HK\$80 million is within the range of the alternatives of the increase in profit requirement (HK\$60 million to HK\$100 million), and the percentage increase of 60% is not significantly different from the average 53% increase proposed by some respondent.

In view of the regulatory concern relating to high implied historical P/E ratio of certain listing applicants which only marginally meet the profit requirement, the Exchange decided to adjust the current profit spread from 60%:40% to 56%:44%, which in the view of the Exchange would be more conducive to attracting companies of desired business scale and growth. As a result, the aggregate profit requirement of the first two financial years will be HK\$45 million and HK\$35 million for the final financial year. Based on the minimum profit requirement, the implied historical P/E ratio for a listing applicant will be 14 times, which is higher than the five-year average P/E ratio of 12.42 times for the Hang Seng Index between May 2016 and May 2021.

Impact of the Modified Profit Requirement

Based on the analysis made by the Exchange in its Consultation Conclusion, a total of 745 listing applications relied on the Profit Requirement for its application to list on the Main Board between 2016 and 2019 (only 463 were subsequently listed as of 30 June 2020).

With the Modified Profit Requirement, 259 (35%) of the 745 Profit Requirement applications would have been ineligible to list on the Main Board, of which, 98 had a market capitalisation of less than HK\$500 million and 124 had a market capitalisation of between HK\$500 million and

HK\$700 million, all being small capitalisation listed companies.

	Modified Profit Requirement
No. of eligible applications	486
No. of ineligible applications	259
<i>Market cap. above HK\$700 million</i>	37
<i>Market cap. between HK\$500 million and HK\$700 million</i>	124
<i>Market cap. less than HK\$700 million</i>	98

Figure 2 – Impact of listing applications submitted between 2016 and 2020 by applying the Modified Profit Requirement

Out of 463 companies listed between 2016 and 2020 by complying with the Modified Profit Requirement, 141 (30%) would have been ineligible to list on the Main Board, of which 68 had a market capitalisation of less than HK\$500 million and 54 had a market capitalisation of between HK\$500 million and HK\$700 million, all being small capitalisation listed companies.

	Modified Profit Requirement
No. of eligible applications	322
No. of ineligible applications	141
<i>Market cap. above HK\$700 million</i>	19
<i>Market cap. between HK\$500 million and HK\$700 million</i>	54
<i>Market cap. less than HK\$700 million</i>	68

Flexible Relief for profit spread requirement

Relief may be sought from the Exchange on the profit spread requirement. The Exchange will consider each application for relief based on case-specific circumstances. The Exchange will also take into account the nature of the listing applicant's business and underlying reasons for its inability to meet the profit spread (e.g. adverse effect from the COVID-19 pandemic and current economic downturn). Additional conditions (e.g. additional disclosure relating to the listing applicant's profit forecast in the listing document) may be imposed by the Exchange on listing applicants as it deems appropriate.

Implementation of the Modified Profit Requirement

The Modified Profit Requirement will take effect on 1 January 2022. It will apply to all Main Board listing applications (including renewals of previously submitted applications or applications to transfer from GEM) submitted on or after 1 January 2022. A listing applicant will not be permitted to withdraw its listing application before it lapses and re-submits it before 1 January 2022.

For enquiries related to this newsletter, please get in touch with the following person or your usual contacts in Asian Capital.

Catherine Wang

T (852) 2869 8861

E acuminous@asiancapital.com.hk

Going forward

Despite opposition, the Exchange decided to proceed with implementation of the Modified Profit Requirement. Such a significant increase in the Profit Requirement may deter many small and medium-sized enterprises from seeking a listing in Hong Kong. While GEM is supposedly meant to be a viable alternative listing venue to the Main Board, it is often categorised as being "buyers beware" market and not as attractive to sophisticated investors. Only time will tell whether such a drastic change will actually improve market quality in the Hong Kong's IPO market or drive potential listing applicants to other jurisdictions with easier access to quality capital.

Companies wishing to go public in Hong Kong should seek financial advice from experience professionals at an earlier stage to avoid regulatory issues.