

# ACUMINOUS

2020 THIRD ISSUE

## MAIN BOARD PROFIT REQUIREMENT CONSULTATION

On 27 November 2020, The Stock Exchange of Hong Kong Limited (the “**Exchange**”) has published a consultation paper on the increase in the minimum requirement in the profit attributable to shareholders for new listing applicants (the “**Profit Requirement**”) for new Main Board applicants (the “**Consultation Paper**”). The new requirement is expected to negatively impact small-to-medium enterprises who wish to get listed on the main board of the Exchange. In this issue, we will go through the key proposals of the consultation.

### Executive Summary

In the Consultation Paper, the Exchange proposed the following key amendments:-

- **Increase the Profit Requirement** by either 150% or 200%.
- **Introduce temporary conditional relief** from the Profit Requirement which will facilitate the listings of quality companies that are temporarily affected by the pandemic and the current economic downturn if the proposal to increase the Profit Requirement is adopted.
- The **effective date** of the increased Profit Requirement is proposed to be on or after **1 July 2021**. Main Board listing applications submitted before and remain active as of such effective date will be assessed under the current Profit Requirement.

The regulators are concerned whether small caps listed companies were genuinely listed with the intention to raise funds for the development of their underlying businesses as stated in the profit forecasts, or whether their valuations were simply reverse engineered to meet the revised Market Capitalisation Requirement introduced in 2018 in order to manufacture potential shell companies for sale after listing given the perceived premium attached to the listing status.

### Increase the Profit Requirement

As the key theme of the Consultation Paper, the Exchange proposed to increase the Profit Requirement by either (i) 150%, based on the percentage increase of the Market Capitalisation Requirement (“**Option 1**”); or (ii) 200%, based on the approximate percentage increase in the average closing price of the Hang Seng Index from 9,541 in 1994, when the Profit Requirement was introduced, to 27,569 in 2019 (“**Option 2**”).

Set out below are the key effects of the two options:-

|   | Existing | Option 1 | Option 2 |
|---|----------|----------|----------|
| Profit for the most recent financial year during track record period (HK\$' mil)  | 20       | 50       | 60       |
| Aggregate profit for the two preceding financial years during track record period (HK\$' mil)   | 30       | 75       | 90       |
| Implied historical P/E ratios of applicants meeting the minimum thresholds under the Profit Requirement and the Market Capitalisation Requirement | 25 times | 10 times | 8 times  |

### Analysis of impacts of the proposed options

In the Consultation Paper, the Exchange highlights the impact each proposal will have on the 745 applications fulfilling the Profit Requirement submitted between 2016 and 2019 (the “**Profit Requirement Applications**”). The key findings are as follows:-

- Option 1 and Option 2, on average, would have eliminated 62% (462) of the Profit Requirement Applications (the “**Ineligible Applications**”) and might be expected to have a similar impact on future potential applications.
- The aggregate market capitalisation at the time of listing of all Ineligible Applications under Option 1 that have been listed was approximately HK\$184 billion which only accounted for 3% of the aggregate market capitalisation of Main Board issuers newly listed between 2016 and 2019 (both inclusive) at the time of their respective time of listing, as compared to HK\$2,675 billion for eligible applications under Option 1 (38%).

- Profit Requirement Applications that were listed as of 30 June 2020 and which have published their annual financial results post listing, a higher proportion (60%) of the eligible applications under Option 1 met or outperformed the profit forecasts they had filed with the Exchange as part of their listing applications, as compared to Ineligible Applications under Option 1 (37%).

Such increase in the Profit Requirement will result in it being one of the most stringent financial eligibility tests compared to the profit requirements of other major overseas main markets.

### Temporary relief

Due to the backdrop of the COVID-19 pandemic and the uncertainties arising from the economic and political tensions between the US and China, many companies' businesses have been adversely affected. Therefore, subject to the adoption of the proposal to increase the Profit Requirement, the Exchange proposes to introduce a temporary conditional relief from the increased Profit Requirement, which will facilitate the listings of quality companies that are temporarily affected by the pandemic and the current economic downturn.

The key conditions for such relief are as follow:

- The listing applicant's aggregate profit during the track record period meets the minimum aggregate profit in the track record period under the Profit Requirement for Option 1 or Option 2;
- The listing applicant had a positive cash flow generated from operating activities in the ordinary and usual course of business before changes in working capital and taxes paid in the last financial year during the track record period; and
- The listing applicant must demonstrate that the conditions and circumstances leading to its inability to meet the Profit Requirement are temporary.

### Transitional arrangement

The effective date of the increased Profit Requirement is proposed to be on or after 1 July 2021. Accordingly, Main Board listing applications (including applications to transfer from GEM to Main Board ("**GEM Transfers**")) will be assessed under the current Profit Requirement if they are submitted before and remain active as of such effective date.

Transitional arrangements adopted for GEM Transfers as a result of the reform of GEM in 2018. For GEM Transfer applications submitted by GEM issuers who are entitled to such transitional arrangements on or before 14 February 2021 but which lapse thereafter will have to comply with the Market Capitalisation Requirement of HK\$500 million, among other things, whereas the current Profit Requirement will still apply to such applicants so long as the GEM Transfer applications are submitted before and remain active as of the effective date of the increased Profit Requirement.

### Conclusion

These proposals are a clear indication of the Exchange of its determination to clamp down potential listed shell companies manufacturing activities and to restore investors' confidence in the Hong Kong equities market. Companies at an early development stage or SMEs which intend to list on the Main Board will likely be affected. These companies will be forced access the capital market by listing on GEM. The increased Profit Requirement will separate the position and liquidity within the GEM and the Main Board. However, given the higher investment risks associated with GEM, new listing applicants which are unable to meet the Profit Requirement may be deterred from the Hong Kong equities market and may consider listing in other jurisdictions with easier access to quality capital.

The consultation will end on Monday, 1 February 2021.

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