# THE HONG KONG STOCK EXCHANGE'S CONSULTATION: CONCLUSIONS ON THE MAIN BOARD PROFIT REQUIREMENT

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**Hong Kong Capital Markets Alert**

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On 20 May 2021, The Stock Exchange of Hong Kong Limited (the Exchange) published conclusions (Consultation Conclusions) to its consultation paper on 27 November 2020 (the Consultation Paper). The Consultation Paper relates to the proposal to substantially increase the profit requirement for listing on the Exchange's Main Board under the Exchange's Main Board's profit test, one of the three financial tests for establishing eligibility to list on the Exchange's Main Board (Main Board). The other two financial tests, namely the market cap/revenue test and the market cap/revenue/cashflow test remain unchanged.

The key concerns in the market mainly surround the impact of the Consultation Paper on the ability of small-to-medium sized enterprises (SMEs) and companies in traditional industries to list in Hong Kong. After careful consideration of all feedback, the Exchange has decided to:

- adopt a 60 percent increase in the profit requirement from the current aggregate profit of HK$50 million for the three immediate preceding financial years, to HK$80 million (Modified Profit Increase) and amend the profit spread to HK$45 million for the first two financial years of the track record period and HK$35 million for the final financial year (Revised Profit Spread);
- implement the Modified Profit Increase and the Revised Profit Spread on 1 January 2022; and
- provide flexibility by granting relief from the Revised Profit Spread on case-specific circumstances.

This alert will examine the Exchange's decision to increase the profit requirement, outline present concerns in the market regarding this decision, and propose a way forward.

## CONSULTATION ON INCREASE OF THE PROFIT REQUIREMENT

Under Rule 8.05(1)(a) of the Main Board Listing Rules, the current minimum amount of profit attributable to shareholders of a new applicant is HK$20 million for the most recent financial year and HK$30 million in aggregate in the two preceding financial years (Profit Requirement).

In the Consultation Paper, the Exchange proposed to increase the Profit Requirement by either 150 percent or 200 percent, and also sought the market's views on:

- whether there is any other alternative requirement that should be considered for the increase in the Profit Requirement;

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- whether the Exchange should consider granting a temporary relief from the profit spread of the increased Profit Requirement due to the challenging economic environment; and
- the conditions for temporary relief.

## MARKET CONCERNS

The majority of respondents to the Consultation Paper did not support the quantum of the proposed increase in the Profit Requirement or the urgency to implement such a proposal in 2021. The respondent's key concerns included:

- the impact on the ability of SMEs and companies in traditional industries to list in Hong Kong, and the potential negative effect on Hong Kong's economy if too many of these applicants are denied access to the capital market;
- the Growth Enterprise Market (GEM) not being considered a viable alternative to the Main Board as a listing venue. Listing on GEM and the subsequent compliance (including quarterly reporting) are costly. Additionally, the number of GEM listings, as well as the level of liquidity and trading volume, have also been reduced;
- the appropriateness of the timing of the change in light of the current economic conditions;
- compromising the Exchange's competitiveness vis-à-vis other major overseas exchanges which have lower and less stringent profit requirements; and
- increasing the Profit Requirement not being the right approach to address the shell manufacturing issue and the valuation issue, given that a stringent and comprehensive post-listing regulatory regime was already in place. The valuation issue results from the increase in the market capitalization requirement in 2018, resulting in an unexpected surge in listing applicants that marginally met the Profit Requirement and only managed to fulfil the market capitalization requirement with very high historical P/E ratios (as compared to those of their listed peers) at their IPOs.

## WAY FORWARD

After careful consideration of the respondents' feedback, in consultation with the Securities and Futures Commission, the Exchange has decided to modify the proposal as follows:

### A Smaller Increase in the Profit Requirement

The Exchange has decided to increase the Profit Requirement by 60 percent, resulting in an aggregate profit threshold of HK$80 million. It also has decided to amend the profit spread to a 56/44 percent split such that the minimum aggregate profit required for the first two financial years of the track record period will be HK$45 million and that for the final financial year will be HK$35 million. This translates into an implied historical P/E ratio of approximately 14 times, which is in line with the average P/E ratio of the Hang Seng Index between 1994 and 2020.

### Implementation Date

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The Modified Profit Increase and the Revised Profit Spread will become effective on 1 January 2022. Any Main Board listing applications (including renewals of previously submitted applications or GEM transfer applications) submitted on or after 1 January 2022, will be assessed under the Modified Profit Increase.

Any Main Board listing applications submitted before 1 January 2022 will still be assessed under the current Profit Requirement. However, a listing applicant will not be permitted to withdraw a listing application it has submitted within six months before it lapses and resubmit the listing application shortly thereafter before the effective date of the Modified Profit Increase, such that the listing application will be assessed in accordance with the current Profit Requirement for a longer period.

### Flexible Relief from Revised Profit Spread

The Exchange has indicated it is prepared to grant temporary relief from the Revised Profit Spread, but will only do so on a case-by-case basis, provided the listing applicant meets the Modified Profit Increase. It will not adopt a check-the-box approach or enumerate a fixed set of conditions precedent. Factors the Exchange has indicated it will consider include, among other things:

- the nature of the listing applicant's business and the underlying reasons for its inability to meet the Revised Profit Spread (e.g., growth stage companies and companies whose businesses have been severely affected by the COVID-19 pandemic and current economic downturn); and
- may make enquiries on how the issuer's IPO offer price was determined with reference to the book-building process.

### Review of GEM Listing Rules

In response to market feedback about GEM, the Exchange will also launch a review of GEM Listing Rules and carefully consider the matters raised by respondents to the Consultation Paper, including comments relating to GEM's positioning and the market perception of GEM. If this review concludes that changes to the GEM Listing Rules are necessary, the Exchange will publish a consultation paper to seek market feedback on appropriate reforms.

## TAKE-AWAYS

Main Board listing applications that are new or have previously submitted, as well as GEM transfer applications should take note of these newly issued Consultation Conclusions, as the increased profit requirement will have a direct impact on the success of their listing applications.

Should you wish to discuss anything in or related to this alert, please contact our Hong Kong capital markets team members.

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