

Hong Kong Capital Markets Update

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HKEX's consultation on the Main Board profit requirement

On 27 November 2020, the Stock Exchange of Hong Kong Limited (the "Exchange") published a [consultation paper](#) ("Consultation") seeking the market's views on the proposals to increase the Main Board profit requirement ("Profit Requirement") and introduce temporary conditional relief from the Profit Requirement if the proposal to increase the Profit Requirement is adopted. The deadline for submissions is 1 February 2021.

Highlights

- The Exchange proposes two options to increase the current Profit Requirement of HK\$50M during the track record period either:
 - (i) by 150% to HK\$125M ("Option 1"); or
 - (ii) by 200% to HK\$150M ("Option 2").
- If the above proposal to increase the Profit Requirement is adopted, the Exchange proposes to have a temporary conditional relief from the profit spread in the increased Profit Requirement for listing applicants with financial performance adversely affected by the market conditions in 2020.
- The Exchange will introduce transitional arrangements for listing applications submitted before the effective date of increased Profit Requirement.
- The deadline for submitting responses to the Consultation is 1 February 2021.

Background

Since the minimum market capitalisation for Main Board listing under the Profit Requirement was increased from HK\$200M to HK\$500M in February 2018, the Exchange has seen an increase in Main Board listing applications from issuers with a proposed market capitalisation at the time of listing of equal to or less than HK\$700M ("Small Cap Issuers") that marginally met the current Profit Requirement but had relatively high historical P/E ratios as compared with those of their listed peers.

These Small Cap Issuers were typically small and mid-sized companies in traditional industries. While these Small Cap Issuers typically justified their higher valuations by reference to potential growth, a number of them failed post listing to meet the profit forecasts they had filed with the Exchange as part of their listing applications.

It gave rise to regulatory concerns on whether these Small Cap Issuers were genuinely listed with the intention to raise funds for the development of their underlying businesses as stated in the profit forecasts, whether their valuations were simply reverse engineered to meet the increased minimum market capitalisation requirement in order to manufacture potential shell companies for sale after listing given the perceived premium attached to the listing status, and whether their IPO offer prices genuinely reflect the expected market clearing prices.

When the valuation achieved by an issuer upon listing is not genuinely supported by the market, it could result in losses to investors and hurt investors' confidence in the potential for price appreciation of the relevant shares. Inadequate market demand may also lead to thin trading and low liquidity of the shares, making the relevant shares more susceptible to speculative trading and excessive market volatility post listing. It is not in the interest of the investing public and will affect the overall quality of the Main Board listings.

Therefore, in order to address the issues above, the Exchange proposes to increase the Profit Requirement, which has remained the same level for the past 26 years since 1994.

Proposal to increase the Profit Requirement

The Exchange proposes to increase the current Profit Requirement of HK\$50M during the track record period, which comprises of (a) HK\$20M in the most recent financial year and (b) HK\$30M in aggregate in the two preceding financial years, with two options:

Option 1 - 150% (i.e. HK\$125M) - based on the percentage increase in the minimum market capitalisation from HK\$200 million to HK\$500 million. This will increase the minimum amount of profit attributable to shareholders to (a) HK\$50 million in the most recent financial year and (b) HK\$75 million in aggregate in the two preceding financial years, and reduce the implied historical P/E ratios of listing applicants meeting only the minimum Profit Requirement of HK\$50M in the most recent financial year and the minimum market capitalisation of HK\$500M to 10 times, in line with that before the change of the minimum market capitalisation requirement in February 2018.

Option 2 - 200% (i.e. HK\$150M) - based on an approximate percentage increase in the average closing price of Hang Seng Index from 9,541 in 1994 when the Profit Requirement was introduced to 27,569 in 2019. This will increase the minimum amount of profit attributable to shareholders to (a) HK\$60 million in the most recent financial year and (b) HK\$90 million in aggregate in the two preceding financial years, and will reduce the implied historical P/E ratios of listing applicants meeting only the minimum Profit Requirement of HK\$60M in the most recent financial year and the minimum market capitalisation of HK\$500M to 8 times.

The Exchange believes either of the proposed options to increase the Profit Requirement can effectively address the issues while not having a material impact on the overall capital market. It is also in line with Exchange's objective of positioning the Main Board as the main market to attract sizeable companies that can meet the high market standards. The proposal will therefore improve the overall quality of Main Board issuers, which will be conducive to promoting post-listing liquidity, and will increase investors' confidence in the market and strengthen Hong Kong's position as an international financial centre.

The Exchange is mindful though that the proposed increase in the Profit Requirement will affect companies at an early stage development or small or mid-sized companies, which intend to list on the Main Board. These companies can still access the capital market by listing on GEM, which is intended to be a capital raising platform for early stage development companies and small or mid-sized companies that are not able to meet the Main Board eligibility requirements.

Temporary conditional relief from the increased Profit Requirement

Due to the COVID-19 pandemic and other uncertainties in the global economy in 2020, many companies' businesses have been adversely affected. Therefore, subject to the adoption of the proposal to increase the Profit Requirement in this Consultation, the Exchange proposes to introduce temporary conditional relief from the profit spread in the increased Profit Requirement to facilitate the listings of quality companies that are temporarily affected by the market downturn in 2020, when the listing applicant is able to meet the following conditions:

- (i) its aggregate profit during the track record period meets HK\$125M (Option 1) or HK\$150M (Option 2);
- (ii) it 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;
- (iii) it demonstrates that the conditions and circumstances leading to its inability to meet the profit spread in the Profit Requirement are temporary (i.e. the applicant has recovered or is recovering from the adverse market conditions);
- (iv) the track record period must have at least six months that fall within the calendar year 2020; and
- (v) adequate disclosure is made in its listing document, including:
 - the likelihood of continuance or recurrence of the circumstances leading to the applicant's inability to meet the spread of the increased Profit Requirement;
 - measures which were taken or will be taken by the applicant to mitigate the impact of those circumstances on future profitability; and
 - a profit forecast covering the period up to the forthcoming financial year end date after the date of listing with detailed bases and key assumptions.

Transitional arrangements

To minimise the impact of the proposal to increase the Profit Requirement on companies that have commenced plans to apply for Main Board listing relying on current Profit Requirement, the Exchange proposes transitional arrangements for Main Board listing applications that are submitted before the effective date of the proposed increased Profit Requirement (“Rule Amendment Effective Date”).

The Rule Amendment Effective Date will not be earlier than 1 July 2021, which allows potential applicants that are now preparing or planning to apply for listing on the Main Board to have enough time to prepare and submit their listing application before the Rule Amendment Effective Date.

Under the transitional arrangements, for those Main Board listing applications (including GEM Transfer applications) that are submitted before, and remained active on, the Rule Amendment Effective Date, the eligibility for Main Board listing will be assessed in accordance with the current Profit Requirement. Such listing application will be allowed to be renewed once after the Rule Amendment Effective Date for the application to continue to be assessed in accordance with the current Profit Requirement. For any subsequent renewal, the application will be assessed in accordance with the increased Profit Requirement.

If you have any questions about the matters discussed in this publication, please feel free to contact the following capital markets partners and directors.

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