

Hong Kong Capital Markets Update

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HKEX's consultation conclusions on the Main Board profit requirement

On 20 May 2021, the Stock Exchange of Hong Kong Limited (the "Exchange") published the [conclusions](#) of its consultation on proposals to increase the Main Board profit requirement ("Conclusions"). The proposed changes are summarised below:

Way Forward

Modified Profit Increase - 60% Increase in 3-Year Minimum Aggregate Profit

	Current	Modified Profit Increase
Total 3-year minimum aggregate profit	HK\$50M	HK\$80M (60% increase)
1st & 2nd financial years (in aggregate)	HK\$30M	HK\$45M (50% increase)
3rd financial year	HK\$20M	HK\$35M (75% increase)
Profit spread (1st & 2nd years : 3rd year)	60% : 40%	56% : 44%

Profit Spread Relief

- The **profit spread relief of the Modified Profit Increase** will be **granted on case-specific circumstances** instead of through a set of fixed conditions set out in the Consultation Paper to provide flexibility.

Effective date

- The **Modified Profit Increase** will be **implemented on 1 January 2022**.
- Any **listing applications (including renewals of previously submitted applications)** **submitted on or after the Effective Date** will be **assessed** under the **Modified Profit Increase**.

Others

- The Exchange and the Securities and Futures Commission ("SFC") will continue to **combat regulatory issues** through robust review of listing applications and heightened scrutiny on cases displaying features in the [Joint Statement on IPO-related misconduct](#).
- The Exchange will also launch a **review of GEM** covering positioning and market perception.

Background

The Profit Requirement is one of the three pivotal financial eligibility tests for a Main Board listing. It has remained at HK\$50M since 1994. After the minimum market capitalisation for Main Board listings under the Profit Requirement was increased to HK\$500M (the "Market Capitalisation Requirement") in February 2018, the Exchange experienced an unexpected surge in Main Board listing applicants that marginally met the Profit Requirement and only managed to fulfil the Market Capitalisation Requirement with very high historical P/E ratios at their IPOs compared with their listed peers.

While these Main Board listing applicants typically justified their higher valuations by reference to potential growth supported by optimistic profit forecasts they had filed with the Exchange as part of their listing applications, a number of them failed to meet these profit forecasts post-listing. This gave rise to regulatory concerns about whether the valuations of these listing applicants were reverse-engineered to fulfil the Market Capitalisation Requirement when there was no sufficient public interest from the market for their securities at such price, which in turn called into question the listing applicant's suitability for listing, a fundamental listing principle under the Listing Rules.

The Exchange and SFC have also become aware of other instances of misconduct following the misalignment between the Profit Requirement and the Market Capitalisation Requirement, and therefore calling for re-evaluation of whether the current Profit Requirement is at an appropriate level taking into account the market positioning of the Main Board and the Exchange's role in upholding the quality of the market.

In light of the above, the Exchange published a [consultation paper](#) in November 2020 proposing an increase to the Profit Requirement (the "Consultation Paper") by either 150% to HK\$125M ("Option 1") or 200% to HK\$150M ("Option 2"). (See our [Capital Markets Update Issue 2020-08](#) for a summary). While the Exchange's pursuit of market quality has been acknowledged, the majority of respondents indicated that the Exchange should consider alternative requirements, such as a smaller increase. After considering all feedback, the Exchange decided to modify the original proposals as follows:

- (1) **Modified Profit Increase** - A smaller increase in the Profit Requirement of 60% with the profit spread amended;
- (2) **More flexible profit spread relief** - Prepared to grant relief from the profit spread under the Modified Profit Increase on case-specific circumstances to provide flexibility, rather than through a set of fixed conditions; and
- (3) **Effective date** - The Modified Profit Increase will be implemented on 1 January 2022.

In addition to the above, the Exchange will continue to work with the SFC to combat regulatory issues identified in the Conclusions and the Exchange will launch a review of GEM covering its positioning and market perception.

Modified Profit Increase

The Exchange concluded that it is appropriate to increase the Profit Requirement by 60%, resulting in an increase in minimum aggregate profit for the three-year track record period from HK\$50M to HK\$80M, and to amend the profit spread from 60%:40% split to 56%:44% split.

Under the Modified Profit Increase, the minimum aggregate profit required for the first two financial years of the three-year track record period will be increased from HK\$30M to HK\$45M while that for the final financial year will be increased from HK\$20M to HK\$35M. The implied historical P/E ratio based on the final financial year profit will be approximately 14 times, which is in line with the average P/E ratio of the Hang Seng Index between 1994 and 2020.

According to the Exchange, the Modified Profit Increase was decided primarily based on the following factors:

- (a) the proposed increase is in line with the 61% increase in the monthly composite consumer price index (which is a commonly used measure of inflation) from September 1994 to December 2020;
- (b) the Modified Profit Increase would result in fewer listing applications being ineligible to list on the Main Board, which is the concern raised by a majority of the respondents; and
- (c) the minimum aggregate profit of HK\$80 million for the 3-year track record period is within the range of the alternatives (HK\$60M to HK\$100M) and the percentage increase of 60% is not significantly different from the average 53% increase proposed by some of the respondents.

The Exchange and the SFC will continue to monitor the situation after the implementation of the Modified Profit Increase and may revisit the Profit Requirement at a later time if circumstances warrant a review.

More flexible profit spread relief

Instead of imposing a set of fixed conditions as proposed in the Consultation Paper, the Exchange is prepared to grant relief to Main Board listing applicants from the profit spread under the Modified Profit Increase on case-specific circumstances provided that they meet the Modified Profit Increase of HK\$80M.

In this respect, the Exchange will ordinarily, among other things:

- (a) evaluate the listing applicant's business nature and the underlying reasons for its inability to meet the 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
- (b) impose conditions where appropriate, including disclosure of the listing applicant's profit forecast in the listing document.

In considering an application for a waiver from the profit spread under the Modified Profit Increase, the Exchange (i) will critically assess the need to include a profit forecast in the listing document to enable investors to make an informed decision on the position and prospects of the listing applicant; and (ii) may make enquiries on how the listing applicant's IPO price was determined with reference to the book-building process.

Effective Date

The Modified Profit Increase will be implemented on 1 January 2022 (the "Effective Date"). 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. A listing applicant will not be permitted to withdraw its listing application before it lapses and resubmit the listing application shortly thereafter before the Effective Date such that the listing application will be assessed in accordance with the current Profit Requirement for a longer period.

Combating regulatory issues

In addition to the above, the Exchange will work with the SFC in combating the regulatory issues identified in the Conclusions, such as unreasonably high valuations, through robust review of listing applications and heightened scrutiny on cases displaying features described in the Joint Statement on IPO-related misconduct. There will also be an increased emphasis on holding individuals accountable in relation to Listing Rules breaches, including those who participate in the problematic behaviours described in the Joint Statement on IPO-related misconduct.

Review of GEM

In response to market feedback on the Consultation Paper about GEM, the Exchange will launch a review of GEM and carefully consider the matters raised by respondents, including comments relating to the positioning and the market perception of GEM, and seek further market feedback on appropriate reforms if it is concluded that changes to the GEM Listing Rules are necessary.

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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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