

# Hong Kong Capital Markets Update

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## New guidance on IPO vetting and suitability for listing

In the guidance letter [HKEX-GL68-13A](#) (the “New GL”) published by the Hong Kong Stock Exchange (“the Exchange”) on 3 June 2016, the Exchange recognised a number of listed issuers whose controlling shareholders have either changed or gradually sold down their interests in the listed issuers shortly after the lock-up arrangements expired.<sup>1</sup> The Exchange indicated that one possible reason for such a change or sell-down is the perceived premium attached to the listing status of such issuers, which is considered to be more “attractive” than continued development of the underlying businesses.

The Exchange expressed concerns over such activities, as they may be structured in such a way that the associated issues are not tackled by the existing rules on reverse takeovers ([HKEX-GL78-14](#)) and cash companies ([HKEX-GL84-15](#)).

There have also been concerns that the size of such newly listed companies (the “Target Companies”) and their prospects may not justify a listing status. In its review of new listings between 2012 and 2015, the Exchange identified certain characteristics of those Target Companies. These characteristics, together with the additional analysis or disclosures required of the applicants with these characteristics and their sponsors, are discussed in the New GL. The New GL only summarises part of the suitability assessment by the Exchange, and applicants and their advisors may refer to guidance letter [HKEX-GL68-13](#) (Appendix 1) which contains detailed guidance on suitability for listing.

### Characteristics identified

According to the empirical data gathered by the Exchange, Target Companies exhibit one or more of the following characteristics:

- (i) small market capitalisation
- (ii) meeting of the listing eligibility requirements on a marginal basis
- (iii) size of fundraising disproportionate to listing expenses (i.e. a high proportion of the listing proceeds were used to pay listing expenses)
- (iv) pure trading business with a high concentration of customers
- (v) asset-light business where a majority of the assets are liquid and/or current assets
- (vi) superficial delineation of business from the parent; and/or
- (vii) little or no external funding at the pre-listing stage.

Listing applicants which have one or more of the above characteristics raise concerns on listing suitability and should therefore be subjected to a more focused review by the Exchange. The Exchange noted that there is no prescribed bright-line test to identify the characteristics, and the list is not exhaustive. The Exchange emphasises that it will take into account the facts and circumstances of each case, and may exercise its discretion to reject the applicant’s listing on the grounds of suitability.

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<sup>1</sup> According to the Main Board Listing Rules 10.07/GEM Listing Rules 13.16A, an issuer’s controlling shareholder is prohibited from disposing of, or entering into any agreement to dispose of or otherwise create any options, rights, interests or encumbrances in respect of (i) all their shares of the issuer within six months from the listing date, and (ii) their shares which resulted in the cessation as a controlling shareholder within 12 months of the listing date.

Additional analysis or disclosures

If an applicant exhibits one or more of the identified characteristics, the Exchange expects the applicant and its sponsor(s) to provide a **robust** analysis in the following areas to substantiate its listing suitability:

Areas of focus	Analysis	Other matters to note
<b>(i) Use of proceeds</b>	Disclosure of specific use of proceeds commensurate with the applicant's past and future business strategy and observed industry trends.	The applicant is expected to explain the commercial rationale for the listing. The Exchange has indicated that the following generic descriptions of use of proceeds would not be accepted: (a) brand building (b) potential acquisitions without identified targets and specific selection criteria; and/or (c) expansion through an increase in headcount.
<b>(ii) Future objectives and strategies</b>	A comprehensive analysis to demonstrate that the applicant has a detailed strategic plan for its business operations and growth.	In <a href="#">HKEX-GL68-13</a> , the Exchange outlines some factors which cause them to consider a business model unsustainable. These factors include: (a) significant and recent changes in the revenue model such that its track record is not representative of its past performance (b) changing regulatory environment and industry outlook (c) deteriorating financial performance during the track record period and no sign of improvement in the forecast period and beyond (d) one-off windfall profits unlikely to be recurring.
<b>(iii) Profits and revenue growth</b>	A comprehensive analysis to substantiate business sustainability when the applicant: (a) has experienced declining or low profit and revenue growth; and/or (b) will record declining or low profit and revenue growth after listing.	The Exchange is likely to reject the listing application if sustainability issues are not addressed to their satisfaction.
<b>(iv) Potential sunset industries</b>	Proof of ability and resources available to the applicant to modify its business in order to respond to the changing demands of the market and to demonstrate the returns from the business justify the cost of listing.	



KPMG China's observations

As noted in the Exchange's recently published [Listing Committee Report 2015](#), there have been a number of reported market commentaries about trading and creation of shell companies in Hong Kong which, in the opinion of the Exchange, would have a negative impact on the quality and reputation of the Hong Kong capital market. While the New GL does not specifically refer to "shell companies", it sends a clear message to the market on the "shell creation activities", and that it remains the priority of the regulators to maintain the quality and reputation of the Hong Kong market. Prospective listing applicants that exhibit one or more of the identified characteristics set out in the New GL should carefully consider the potential impact of the new requirements.

If you have any questions about the matters discussed in this publication, please feel free to contact the following partners in our Capital Markets Advisory Group.

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## Appendix 1

### Summary of Guidance Letter HKEX-GL68-13

Guidance Letter [HKEX-GL68-13](#) provides guidance on factors that the Exchange would consider when assessing whether an applicant and its business are suitable for listing under Main Board Rule 8.04 (GEM Rule 11.06).

The Exchange states that there is no bright-line test for determining the suitability for listing, and it will evaluate each application based on its own facts and circumstances.

Certain factors that the Exchange would focus on include:

#### (1) The suitability of the director and controlling shareholders

While having a past non-compliance record or conviction does not necessarily mean that a person cannot be accepted as a director of a listed company, it should be considered whether such matters raise serious concerns about the individual's integrity and whether the individual is likely to exert substantial influence on the applicant after listing even if he/she is not formally appointed as a director. There may also be concerns about the applicant's suitability for listing, as well as the suitability of the individual to act as a director.

#### (2) Non-compliance

The Exchange considers that systematic, intentional and/or repeated breaches of laws and regulations by an applicant may affect its suitability for listing. In determining the impact of non-compliance, the Exchange will consider (i) the nature, extent and seriousness of the breaches; (ii) the reasons for the breaches; (iii) the impact; (iv) the rectification measures adopted; and (v) the precautionary measures put in place to avoid future breaches.

#### (3) A deteriorating financial performance

The Exchange is of the view that the listing applicant must remain suitable for listing at the time of listing, taking into account the actual performance after the track record period, the profit forecast and such other projected information submitted by the listing applicant in relation to its business and financial position after listing. Deteriorating financial performance subsequent to the track record period may be a strong indicator of a fundamental deterioration of commercial or operational viability.

#### (4) Reliance on parent group/connected persons/major customer

There would be serious concerns about the applicant's suitability if the degree of dependence is excessive.

Other factors the Exchange would consider when assessing an applicant's suitability for listing include business involvement in gambling, contractual arrangements, reliance on unrealised fair value gains to meet the profit requirement, and an unsustainable business model.

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