



金利豐財務顧問有限公司  
KINGSTON CORPORATE FINANCE LIMITED

1 February 2021

BY HAND AND  
BY FAX (2524 0149)

Hong Kong Exchanges and Clearing Limited  
8th Floor, Two Exchange Square  
8 Connaught Place  
Central  
Hong Kong

**Re: Profit Requirement CP**

Dear Sirs,

We refer to the Consultation Paper on The Main Board Profit Requirement (the "Consultation Paper") published by The Stock Exchange of Hong Kong Limited (the "Exchange").

We welcome and appreciate the Exchange's efforts in reviewing and, where necessary, updating Hong Kong's regulatory regime in order to ensure that the quality and efficiency of the Hong Kong market is maintained and enhanced. There will be different views as to how those objectives are best achieved, but whatever the outcome, the market will undoubtedly benefit from the discussion. We appreciate this chance to provide comments to the Exchange with regard to the Consultation Paper.

We set out below our responses and observations to the Consultation Paper. Unless otherwise stated, the capitalised terms used herein have the same meaning as defined in the Consultation Paper.

1. We do not agree that the Profit Requirement should be increased by either Option 1 or Option 2. Our reasons are as follows.

**A. Market capitalisation and quality of issuers**

As stated in paragraph 48 of the Consultation Paper, the increase in the Profit Requirement is in line with the Exchange's objective of positioning the Main Board as the main market to attract sizeable companies that can meet high market standards and the proposal will therefore improve the overall quality of Main Board issuers. We neither agree that the size of an issuer is correlated to its overall quality or ability to meet high market standards.

Companies that have a large market capitalisation and are profitable before listing may still post losses afterwards and are not guaranteed to meet their profit forecasts

subsequent to listing. While a higher proportion of Small-Cap Issuers failed to meet the profit forecasts as compared to non-Small Cap Issuers, as discussed in paragraph 39(b) of the Consultation Paper, a significant proportion of 39% of non-Small Cap Issuers with Eligible Applications under Option 1 (with median market capitalisations of HK\$3,876 million, as stated in paragraph 38 of the Consultation Paper) at the time of listing still failed post-listing to meet the profit forecasts they had filed with the Exchange as part of their listing applications, as set out in Table 4 of the Consultation Paper.

On one hand, the Exchange now proposes to increase the Profit Requirement to attract sizeable companies that can meet high market standards and improve the overall quality of Main Board issuers; on the other, the Exchange has introduced alternatives to accommodate the listing on the Main Board of issuers which have not yet generated profit including, for example, (i) the Alternative Requirements in Listing Rules 8.05(2) and 8.05(3) for companies with insufficient or no profits; (ii) waivers for the Profit Requirement and Alternative Requirements pursuant to Listing Rule 8.05B(2) for infrastructure companies; and (iii) alternative listing requirements pursuant to Chapters 18, 18A and 19C of the Listing Rules for the listing of mineral companies, biotech companies and secondary listings of China-based companies, respectively, which are unable to satisfy the Profit Requirement or the Alternative Requirements. There is no discussion in the Consultation Paper why traditional industry issuers who are able to satisfy the existing Profit Requirement are of lower quality or have higher investment risk than pre-profit or pre-revenue companies listed pursuant to the alternative requirements mentioned in points (i) to (iii) above, regardless of their size.

It is further noted that, as at closing on 1 February 2021, 778 (or approximately 36%) of issuers listed on the Main Board had market capitalisations of less than HK\$500 million, according to the database of historic market values of Main Board primary-listed shares published on Webb-site.com. Such Main Board issuers with market capitalisations of less than HK\$500 million are still presumed to be suitable for listing on the Main Board as long as they continue to meet the relevant corporate governance and disclosure requirements under the Listing Rules. As an international financial centre, it is critical to enhance the standard of corporate governance and compliance with disclosure requirements in order to improve the overall quality of listed issuers.

#### B. Valuation of issuers

It is noted from the Consultation Paper that, from 2016 to 2019, the proportion of non-Small Cap Issuers with historical P/E ratios of 20 times or above was significantly higher than that of Small Cap Issuers. As set out in Chart C in Appendix III, 40%, 48%, 47% and 43% of non-Small Cap Issuers in 2016, 2017, 2018 and 2019, respectively, had historical P/E ratios of 20 times or above. In comparison, only nil, 2%, 13% and 7% of Small Cap issuers had historical P/E ratios of 20 times or above during the same years, as set out in

Chart B in Appendix III. Furthermore, as set out in paragraphs 33 and 38 of the Consultation Paper respectively, the non-Small Cap Issuers with (i) Ineligible Applications had median historical P/E ratios of 27 times and 26 times under Option 1 and Option 2, respectively ("**Median Ineligible non-Small Cap Valuation**"); and (ii) Eligible Applications had median historical P/E ratios of 16 times and 15 times under Option 1 and Option 2, respectively ("**Median Eligible non-Small Cap Valuation**"). In comparison, as stated in paragraphs 32 and 37 of the Consultation Paper respectively, issuers with proposed market capitalisations between HK\$500 million and HK\$700 million with (i) Ineligible Applications had median historical P/E ratios of 14 times under both options ("**Median Ineligible Small Cap Valuation**"); and (ii) Eligible Applications had median historical P/E ratios of 8 times and 7 times under Option 1 and Option 2, respectively ("**Median Eligible Small Cap Valuation**"). While as stated in paragraph 37 of the Consultation Paper, the Exchange considers that, for Small Cap Issuers with proposed market capitalisations between HK\$500 million and HK\$700 million, those with Eligible Applications had "*more reasonable*" P/E ratios than those with Ineligible Applications, we note that a significantly higher proportion of non-Small Cap Issuers have a higher historical P/E ratio as compared to Small Cap Issuers, as discussed above.

Considering (i) the Exchange commented in paragraph 119 of the 2017 Consultation Conclusions with respect to the implied historical P/E ratio of 25 times that "*it is not unreasonable to require an applicant to have a higher implied historical P/E ratio if it is close to meeting only [the Exchange's] minimum requirements. This would indicate that, despite this, the market has a high degree of faith in the applicant's future prospects*"; (ii) one of the general principals of the Listing Rules is "*that potential investors are given sufficient information to enable them to make a properly informed assessment of an issuer*" as set out in Listing Rule 2.03(2) and reiterated in Guidance Letter HKEX-GL86-16 in February 2016 which sets out guidance on producing simplified listing documents; and (iii) the listing documents published by the applicants should be in compliance with the relevant Listing Rules, the implied historical P/E ratios of issuers (including those who marginally met the minimum thresholds under the Profit Requirement and the Market Capitalisation Requirement at the time of listing) should indeed be a genuine reflection of investors' confidence in the issuers' prospects made after properly informed assessments.

### C. Review and regulation of shell company activities

The Exchange states, in paragraphs 22 and 23 of the Consultation Paper, that there is a regulatory concern of whether "*Small Cap Issuers were genuinely listed with the intention to raise funds for the development of their underlying businesses*" or whether "*their valuations were simply reverse engineered to meet the Market Capitalisation Requirement in order to manufacture potential shell companies for sale after listing*" and

that the key underlying cause of this was due to the *“misalignment of the Profit Requirement...with the increased Market Capitalisation Requirement.”*

The Exchange has implemented various measures to directly regulate and deter shell company creation and related activities, including (i) the issue of Guidance Letter HKEX-GL68-13A in April 2018 setting out guidance regarding suitability of listing applicants; (ii) the adoption of a heightened vetting approach and scrutiny in assessment of the suitability for listing taking into account, among others, an applicant’s commercial rationale for listing and the reasonableness of the valuations such as that described in Listing Decision HKEX-LD121-2019 of March 2019 and Listing Decision HKEX-LD126-2020 of June 2020; (iii) the adoption of a robust approach on application of Listing Rule 13.24 to delist existing issuers that have a very low level of operation and/or carry on businesses with little substance; and (iv) the Rule amendments to Chapters 13 and 14, among others, effective 1 October 2019 which codified the guidance with respect to backdoor listing in Guidance Letter HKEX-GL78-14. These direct intervention measures implemented by the Exchange are already effective deterrents to shell company activities. By increasing the Profit Requirement as a general deterrent to shell company creation, the Exchange will be disadvantaging numerous Small Cap Issuers genuinely intending to be listed on the Main Board to raise funds for the development of their underlying businesses.

#### D. Competitiveness of the Exchange

As stated in paragraph 44 of the Consultation Paper, increasing the Profit Requirement under Option 1 or Option 2 will result in the Exchange having the highest profit required on an aggregated basis for the three years of a track record period (**“3-year Aggregate Profit Requirement”**) among the Selected Overseas Main Markets; and the Exchange will continue to have the second highest profit requirement for the final year of a track record period (**“Final-year Profit Requirement”**) (lower than SGX) among the Selected Overseas Main Markets.

It is important to note that as set out in Table 7 of the Consultation Paper, (i) the 3-year Aggregate Profit Requirement under the existing Profit Requirement will be increased significantly from approximately 59% and 54% of the relevant requirements of NASDAQ Global Select Market and NYSE, respectively, to approximately 147% and 134%, respectively, pursuant to Option 1 and approximately 176% and 161%, respectively, pursuant to Option 2; and (ii) the existing Final-year Profit Requirement of the Main Board will also be significantly increased from approximately 118% and 125% of the relevant requirements of NASDAQ and NYSE, respectively, to approximately 294% and 313%, respectively, pursuant to Option 1 and approximately 353% and 375%, respectively, pursuant to Option 2, despite the proposed Final-year Profit Requirement would remain the second largest Final-year Profit Requirement after SGX. However, it

may be worthwhile to note that SGX does not have any 3-year Aggregate Profit Requirement.

In effect, the proposed increase in Profit Requirement will significantly increase the barrier to entry to the Main Board far above the Selected Overseas Main Markets which may reduce the Exchange's competitiveness and attractiveness as an international listing venue.

In view of the above, in particular that (1) size is not correlated with the quality or investment risk of an issuer; (2) a significant proportion of 39% of non-Small Cap Issuers with Eligible Applications under Option 1 still failed post-listing to meet their profit forecasts; (3) a significantly higher proportion of non-Small Cap Issuers have a higher historical P/E ratio as compared to Small Cap Issuers; (4) the implied historical P/E ratios of issuers (including those who marginally met the minimum thresholds under the Profit Requirement and the Market Capitalisation Requirement at the time of listing) should be a genuine reflection of investors' confidence in the issuers' prospects made after properly informed assessments; and (5) the measures already implemented by the Exchange to directly regulate and deter shall company creation and related activities, we invite the Exchange to consider (I) why the relatively lower valuations of Small Cap Issuers would, in general, raise regulatory concern and lead to the Exchange's proposal to increase the Profit Requirement; and (II) whether increasing the Profit Requirement will reduce the Exchange's competitiveness and attractiveness as an international listing venue.

2. As stated above, we do not agree that there should be an increase in the Profit Requirement. However, as noted from paragraph 23 of the Consultation Paper, the Exchange considers that there is a misalignment of the existing Profit Requirement with the increased Market Capitalisation Requirement. We invite the Exchange to now consider whether the HK\$500 million Market Capitalisation Requirement introduced in 2018 is too high and, in addressing this "misalignment," consider reducing the Main Board Market Capitalisation Requirement instead.

For example, issuers with Eligible Applications who had proposed market capitalisations between HK\$500 million and HK\$700 million, and above HK\$700 million, had median historical P/E ratios ranging from 7 to 16 times under both Option 1 and Option 2, as stated in paragraphs 37 and 38 of the Consultation Paper. With reference to the high-end of the range of median historical P/E ratios of 16 times, the Market Capitalisation Requirement may be capped at HK\$320 million based on the existing Profit Requirement for the most recent finance year of HK\$20 million.

We would be happy to discuss any part of this response with the Exchange or to answer any questions that the Exchange may have. Please feel free to contact us by telephone at [REDACTED] or facsimile at [REDACTED]

Yours faithfully,  
For and on behalf of  
**Kingston Corporate Finance Limited**

