## PART B Consultation Questions

**Question 1. Do you agree that the Profit Requirement should be increased by either Option 1 (150%) or Option 2 (200%)? Please give reasons for your views.**

**Answer 1. NO**

**We disagree with and object to the proposed options to increase the Profit Requirement. Our reasons are set out below**

1. The Consultation Paper noted that either option of increase in the Profit Requirement can effectively address the issues which the Hong Kong market is facing[1]. Such issues being the (i) high implied historical P/E ratio of 25 times; (ii) shell companies manufacturing; and (iii) rebates to IPO investors and manufacturing of an artificial shareholder base. Such issues do not appear to be prevalent in the Selected Overseas Main Markets and yet, these markets do not operate high profit requirement regime. Therefore, there may be alternative means to address the purported issues other than implementing Option 1 or Option 2. We are concerned about the far reaching impact on the financial industry in Hong Kong if Option 1 or Option 2 were implemented.

**Magnitude of increase in Profit Requirement would limit Main Board listing to non-Small Cap applicants and put Small Cap applicants at a disadvantage**

2. Option 1 and Option 2 would render 437 (59%) and 486 (65%) of the listing applications between 2016 and 2019 as Ineligible Applications, respectively[2]. Even if we only consider applications that met the current HK$500 million Market Capitalisation Requirement, Option 1 and Option 2 would have rendered 296 (39%) and 343 (46%), respectively, of the listings applications between 2016 and 2019 as Ineligible Applications. Even on this more stringent basis, given that there were 2,170 companies listed on the Main Board as at 31 December 2020, as an approximation, applying Option 1 and Option 2 would exclude 13.6% and 15.8% of the companies from listing on the Main Board, respectively[3].

3. Either option would make Hong Kong the hardest international main market to list on with the highest total profit requirement over the three-year track record period among the Selected Overseas Main Markets. Furthermore, "profit" in the Profit Requirement in Hong Kong refers to profit attributable to shareholders generated in the ordinary and usual course of business whereas "profit" in the Select Overseas Main Markets, which have a profit requirement invariably refers "profit" (i) to pre-tax profit; (ii) generated not restricted to ordinary usual

[1] Paragraph 46 of the Consultation Paper.
[2] Paragraph 30 of the Consultation Paper.
[3] For fairness and reasonableness, this approximation has taken into consideration of the net effect of (i) not all applications will be successful (over-estimation of the percentage) and (ii) applications submitted and successfully listed in the year ended 31 December 2020 (under-estimation of the percentage).

course of business; and (iii) allowing the inclusion of certain profit recognised using equity method. Therefore, the barrier of entry imposed by Option 1 and Option 2 are in fact substantially higher than the purported headline comparative "profit" figures. As regards the benchmarking of the final year profit with the Selected Overseas Main Markets, noticeably, on the surface the SGX Main Board's requirement of HK$170 million equivalent is about three-fold higher (albeit pre-tax) than the propositions in Option 1 and Option 2. However, we need to read into the context that the SGX Main Board only has 479 listed companies with a total market capitalisation of S$851,129 million (HK$4,962 billion) as at 31 December 2020[4] compared with the Exchange's Main Board which has 2,170 listed companies with a total market capitalisation of HK$45,619 billion as at the same date[5]. In the year ended 31 December 2020, only five IPOs took place on the SGX Main Board whereas there were 124 IPOs on the Exchange's Main Board. For completeness, in the year ended 31 December 2020, there were 6 and 8 IPOs on SGX Catalist and the Exchange's GEM, respectively. Circumstantially the high profit requirement of the SGX Main Board may have contributed to the stagnation in the Singapore IPO market. Furthermore, the high entry barrier to the main market in Singapore has not induced a vibrant second board by driving Small Cap applicants to the SGX Catalist.

4. It is also worth highlighting that none of the Selected Overseas Main Markets require listing applicants to satisfy at the same time both (i) a profit requirement as well as (ii) a market capitalisation requirement. On the other hand, the combination of Profit Requirement together with Market Capitalisation Requirement is the most common listing criteria opted by the majority of Main Board listing applicants thus making the eligibility to list on the Main Board more onerous than the Selected Overseas Main Markets. The Alternative Requirements which do not make reference to profit, namely the Market Capitalisation + Revenue + Cashflow Requirement test and the Market Capitalisation + Revenue Requirement test, only accounted for 1% and 4% of Main Board applicants, respectively, between 2016 and 2019, are again only catering for a small minority of very large companies.

5. Option 1 and Option 2 will result in the consolidation of the Main Board by marginalising Small Cap as well as local applicants which is against the grain of creating a comprehensive and diversified market to increase inclusiveness and coverage. We need to be mindful that small and medium enterprises ("**SME**") make up of a significant proportion of the economy in Hong Kong as well as the Mainland. According to the Support and Consultation Centre for SMEs, there are over 340,000 SMEs in Hong Kong. They account for more than 98% of the total number of enterprises and provided job opportunities to more than 1.2 million people, approximately 44.5% of the total employment in Hong Kong (excluding the civil service) as

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[4] Singapore Stock Exchange. (December 2020). Market Statistic Report. https://api2.sgx.com/sites/default/files/2021-01/SGX%20Monthly%20Market%20Statistics%20Report-Dec-2020_FA4.pdf

[5] HKEx. (December 2020). HKEx December Monthly Highlights https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Statistics/Hong-Kong-and-Mainland-Market-Highlights?sc_lang=en#select3=1&select2=11&select1=30

at September 2020[6]. While in the Mainland there are 18 million SMEs according to the Fourth National Economic Census. They account for more than 99.8% of the total number of enterprises and provided job opportunities to more than 233 million people, about 79.4% of total the employment in the Mainland in 2018. Increasing the Profit Requirement to the proposed extent will put the Main Board beyond the reach of SMEs not only of Hong Kong but also of the Mainland.

6. Under the current eligibility criteria, the Exchange has successfully attracted numerous auspicious non-Small Cap Mainland companies to list on the Main Board and its global position is beyond dispute while at the same time allowing Small Cap applicants to co-exists on the Main Board. The Exchange has made adaptations from time to time to accommodate topical market requirements by making provisions for certain types of companies to apply for listing, for example, under Chapter 8A (Weighted Voting Rights), Chatper18 (Mineral Companies), Chapter 18A (Biotech Companies), Chapter 19C (Secondary Listing of Qualifying Issuers) of the Listing Rules. Flexibility on revenue and profit are afforded to mineral and biotech companies. Provisions are afforded to Grandfathered Greater China Issuers for secondary listings. These measures largely benefited large Mainland companies. Opportunities for SMEs especially those which are homegrown in Hong Kong should not be neglected. Option 1 and Option 2 stretch the distance further between aspiring SMEs and the Main Board.

**The "implied historical P/E ratio" as defined in the Consultation Paper skewed the implied historical P/E ratio**

7. The implied historical P/E ratio of 25 times cited in the Consultation Paper based on the current minimum Profit Requirement and Market Capitalisation Requirement was derived on a post-money basis hence portraying a skewed perception. In order to present a fair and reasonable comparison between the price and the earnings, we consider deriving the implied historical P/E ratio on a pre-money basis to be more appropriate. On the assumption that a Small Cap applicant achieving the (i) minimum Market Capitalisation Requirement of HK$500 million with (ii) minimum public float of 25% of the issued ordinary share capital and (iii) minimum Adjusted Net Profit of HK$20 million in the latest financial year of the track record period, the pre-money market capitalisation could arguably be valued as HK$375 million (HK$500 million × 75%) therefore the implied historical P/E ratio is 18.75 times (HK$375 million ÷ HK$20 million). In other words, the implied historical P/E ratio cited in the Consultation Paper was overstated by 33%. Pre-money basis is appropriate in this context because the subject matter is the implied "historical" P/E ratio and the "historical" Adjusted Net Profit was generated without the benefit of the availability of the proceeds from the share offer (assumed to be HK$125 million) during the latest financial year of the track record period. Pre-money basis enables a like-with-like comparison between the pre-money market capitalisation and

[6] Trade and Industry Department of Hong Kong Government. (2020). Support and Consultation Centre for SMEs. https://www.success.tid.gov.hk/english/aboutus/sme/service_detail_6863.html

the historical Adjusted Net Profit without exaggerating the implied historical P/E ratio. Please refer to paragraph 17 below for further discussions on the P/E ratios anomaly caused by the Market Capital Requirement.

**Regulatory changes in recent years have already made shell companies manufacturing a futile pursuit**

8. Following the increase in the minimum Market Capitalisation Requirement effective from February 2018 and Guidance Letter GL104-19 as well as LR14.06B of the Main Board Listing Rules effective from October 2019 to deter circumvention of new listing requirements through injection of material assets after a change in control, the manufacturing of shell companies for the perceived premium of their listing status has become a futile pursuit. The effects of the October 2019 rules changes may not be fully reflected in the statistics in the Consultation Paper, which has the period under review between 2016 and 2019. However, the Consultation Paper still considers this is an issue the market in Hong Kong is facing, and it remains a justification for implementing Option 1 or Option 2. In actual fact, the shell market has largely collapsed. The shell companies manufacturing issues appeared to be recycled in the Consultation Paper as one of the justification for positioning the Main Board as the main market to attract sizable companies that can meet high market standards. The presumptions of non-Small Cap companies are of better "quality" and Small Cap companies are shell-manufacturing-until-proven-innocent are sweeping generalisations. By further raising the barrier of entry to the Main Board as advocated in the Consultation Paper is counter-intuitive as it is likely to have the inadvertent effect of reviving the "perceived premium of the listing status" of existing Main Board listed companies. Arguably, it is the high eligibility requirements creating the barrier of entry to the Main Board that gives rise to the perceived premium, which is not prevalent in the Selected Overseas Main Markets.

**Generalisation of rebates to IPO investors and manufacturing of an artificial shareholder base**

9. Instead of making generalised assumptions and pre-emptively penalising all Small Cap applications, regulators should consider exercising enforcement measures where such illegal practices are noticed in order to deter such practice.

**The Consultation Paper positions GEM further in limbo**

10. The Consultation Paper is silent on a holistic roadmap on the future strategy for GEM to dovetail into the Exchange pursuing the objective of positioning the Main Board as the main market to attract sizable companies that can meet high market standards. The Consultation Paper noted that there was an increase in the number of Main Board listing applicants which only marginally met the Profit Requirement following the February 2018 increase in the Market Capitalisation Requirement. In practical terms, it is only reasonable for potential listing applicants to take the commercial decision to grow their business enough to meet the eligibility requirements of the Main Board, albeit marginally, before applying to list in Hong Kong, given

that (i) the listing application process, cost (excluding underwriting fees) and timetable are very much the same between GEM and the Main Board; and (ii) the GEM Listing Rules changes which took effect in February 2018 raised the GEM admission criteria, required a mandatory share offer tranche and removed the streamlined transfer process to the Main Board. We fail to understand and the Consultation Paper is silent on how the 150% and 200% increase in historical track record period profit to meet Option 1 and Option 2, respectively, would improve the quality of issuers and post-listing liquidity. The disclaimer – past performance is no guarantee of future results is an all too familiar cliché. Through the vetting process carried out by the regulators before granting listing approval to an applicant, the regulators should be satisfied that the applicant had met the required quality standards and was suitable for listing. Good governance post-listing has little to do with historical profit before listing. The provisions of Chapter 18 and Chapter 18A shows that Profit Requirement to be not a be-all end-all quantitative measurement of suitability for listing.

11. Without a holistic roadmap, the implementation of Option 1 or Option 2 will create more uncertainty for SMEs and dampen the desire to access the capital market by applying for listing on GEM. Besides quantitative eligibility requirements, in order to distinguish between the Main Board and GEM to position GEM for SMEs, the application procedure, vetting process, share offer / placing requirements and continuing obligations of GEM (e.g. quarterly financial reporting along with the corresponding black-out periods and double-length lock-up periods) should be suitably streamlined to reflect GEM as a market for SMEs.

**Societal impact on the finance and ancillary industries in Hong Kong**

12. If we take Option 1 as the conservative case, it would have rendered 437 Profit Requirement Applications (59%) ineligible for listing between 2016 and 2019 as noted in the Consultation Paper. If we assume conservatively, the typical IPO listing expenses (excluding underwriting fees) of HK$25 million per case, fees of HK$10.9 billion over four years, which averages to HK$2.7 billion per year, would have vapourised from the value chain of the professional working parties before taking into consideration the impact on underwriters and brokers. Besides affecting the front-line professionals namely the regulators and exchange, lawyers, accountants, and corporate finance advisers during the listing application process, such professional parties would also lose out on the provision of on-going services to the otherwise listed clients. Organisations providing ancillary advisory and other services such as high-street banks, share registrar, financial printers, translators, valuers, search agents and the travel and hospitality industries (providing food and beverage, accommodation and conferencing facilities) would also be affected significantly.

13. As an indication of activities level, in 2020, 30 sponsor firms have completed Main Board listings for issuers with market capitalisation of not more than HK$700 million (i.e. classified as Small Cap applicants according with the Consultation Paper)[7]. Among these 30 sponsor firms, there are 202 responsible officers and 430 representatives licenced under the SFO to

[7] Paragraph 9(a)(ii) of the Consultation Paper.

provide advice on corporate finance as at 19 January 2021. The proposed increase in Profit Requirement would not doubt put jobs at risk. Subsequent to the social unrest in 2019 and the ongoing pandemic since early 2020, the Hong Kong economy and job market had taken a severe beating. Further restrictive policy measures which undermine economic activities and job opportunities are untimely.

**The Exchange's monopoly position in Hong Kong**

14. The Exchange, a wholly owned subsidiary of the Hong Kong Exchange and Clearing Limited, holds the monopoly to operate stock exchanges in Hong Kong. Analogous to a for-profit utility company, besides the fiduciary duty to shareholders, we believe the Exchange should have a service obligation to provide non-Small Cap and Small Cap home-grown companies alike, an equitable platform to access the capital market through listing. By moving the Profit Requirement goal post, most home-grown companies will be relegated to apply for listing on the second board or otherwise forced to seek listing overseas. Since the spell of successful listings or dual listings of sizeable and auspicious international companies in the mining, industrial materials and luxury goods sectors on the Main Board around 2011, listings in Hong Kong of similar international companies were few and far between. By increasing the Profit Requirement to the extent of Option 1 or Option 2, it is likely that only non-Small Cap Mainland companies would list on Main Board narrowing its diversity. The Exchange should be mindful of its social obligation to the community and the home-grown companies of Hong Kong.

**Question 2. Besides the proposed increase in the Profit Requirement, is there any other alternative requirement that should be considered? Please give reasons for your views.**

**Answer 2. YES**

15. As explained in our response to Question 1 above, we have set out our reasons for disagreeing to the proposed options to increase the Profit Requirement. Alternative requirements which may facilitate the Exchange's objectives are set out below.

**Reduce the Market Capitalisation Requirement to reduce the implied historical P/E ratio**

16. Our calculation of the implied historical P/E ratio is 18.75 times on a pre-money basis, based on the current Main Board eligibility requirements, which is approximately 33% less than the historical implied P/E ratio the Exchange considered as excessively high. The most effective way to reduce the implied historical P/E ratio would be to adjust the Market Capitalisation Requirement downwards, which, to a certain extent, created the notion of the "high" implied historical P/E ratio in the first place.

**Discriminatory to industry sectors that have low P/E ratios**

17. Respondents to the 2017 Consultations Paper had pointed out that the Market Capital Requirement would lead to discrimination against industry sectors that have low P/E ratios. Instead of increasing the Profit Requirement to rectify the anomaly created previously, we suggest to consider reducing the Market Capitalisation Requirement instead. For illustrative purpose, Table 1 below sets out the P/E ratios of Main Board listed companies in various industry sectors as at 31 December 2018 and 2019 and 20 January 2021. P/E ratios vary from sector to sector. The Market Capitalisation Requirement created the high implied historical P/E ratio to Small Cap applicants marginally meeting the Profit Requirement in order to qualify for listing. The sector P/E ratios may vary substantially during the course of a listing application process due to economic cycles and sector specific market sentiments. The historical P/E ratios of such Small Cap applicants could be well conforming with their industry sectors norms and yet fall short of you meeting all the eligibility requirements. Not meeting the implied historical P/E ratio does not objectively demonstrate such Small Cap applicants are not of suitable "quality". Under the current listing requirements, the Market Capitalisation Requirement implicitly favours industry sectors with high P/E ratio where companies marginally meeting the Profit Requirement would have no implied historical P/E ratio concern. Consequently, this leads to more listing of new economy companies and makes it harder to list traditional businesses (e.g. industrials and manufacturing) which may have solid businesses with longer operating history and consistent profitability, however, immersed in low profit margin and low P/E industry sectors. In other words, the regime filters industry sectors that may list on the Main Board, depriving investors the opportunity to select the investments that they judge to be suitable for their portfolio.

**Table 1: Historical P/E ratios of Main Board listed companies by industry sectors**

| Industry sectors[1] | Historical P/E ratios as at 31/12/2018[2] | 31/12/2019[2] | 20/1/2021[2] | Fluctuations 31/12/2019 v. 31/12/2018 | 20/01/2021 v. 31/12/2019 |
|---|---|---|---|---|---|
| Communication Services | 19.6 | 29.0 | 24.1 | 47.9% | -16.9% |
| Consumer Discretionary | 16.8 | 18.4 | 34.3 | 9.8% | 86.4% |
| Consumer Staples | 20.7 | 26.0 | 34.5 | 25.6% | 32.6% |
| Energy | 15.7 | 14.2 | 13.5 | -9.4% | -5.1% |
| Financials | 13.3 | 17.1 | 13.8 | 29.0% | -19.7% |
| Health Care | 36.8 | 41.9 | 53.3 | 13.8% | 27.1% |
| Industrials | 19.3 | 16.9 | 26.0 | -12.0% | 53.5% |
| Information Technology | 28.0 | 25.7 | 61.5 | -8.0% | 139.1% |
| Materials | 15.8 | 40.4 | 26.6 | 156.4% | -34.2% |
| Real Estate | 15.3 | 16.0 | 21.8 | 4.6% | 36.5% |
| Utilities | 23.8 | 14.8 | 16.3 | -37.8% | 10.1% |
| Miscellaneous[3] | 145.1 | 147.7 | 13.5 | 1.8% | -90.9% |
| Average[4] | 19.3 | 21.8 | 29.8 | 13.1% | 36.6% |

**Source**: Bloomberg.
**Notes**: **1.** Industry sectors classification is based on the Global Industry Classification Standard (GICS).; **2.** Trailing P/E; **3.** The "Miscellaneous" sector accounted for only 7, 6 and 36 companies as at 31 December 2018 and 2019 and 20 January 2021, respectively; and **4.** Average of the listed companies with valid P/Es.

### Only to increase the final year Adjusted Net Profit

18. Only the Adjusted Net Profit of the latest financial year of the track record period is relevant to the determination of the implied historical P/E ratio currently under scrutiny. If the Exchange is to proceed with increasing the Main Board Profit Requirement in any event in order to reduce the implied historical P/E ratio, one alternative requirement to consider is only to amend the threshold of the minimum Adjusted Net Profit of the latest financial year of the track record period. Proportionally increasing the Adjusted Net Profit of the outer years as set out in Option 1 and Option 2 do not affect the implied historical P/E ratio and yet are prejudicial to fast growing businesses.

**Level of increase to the Profit Requirement**

19. In the event that the Exchange is to proceed with increasing the Main Board Profit Requirement regardless, we suggest the increase should be to a lesser extent. Taking reference to the 2017 Consultation Conclusions when the GEM Cashflow Requirement was increased by 50% from HK$20 million to HK$30 million, a more progressive increase of a smaller magnitude appeared to be more palatable to the market practitioners. We suggest the Profit Requirement should be increased by no more than 50% in the latest financial year of the track record period (i.e. from HK$20 million to no more than HK$30 million) and there should be no increase to the outer years (i.e. to remain at HK$30 million in aggregate).

**Question 3. Do you agree that the Exchange should consider granting temporary relief from the increased Profit Requirement due to the challenging economic environment? Please give reasons for your views.**

**Answer 3. YES**

20. We disagree with increasing the Profit Requirement. However, if an increase is inevitable, relief measures are justified amidst the current economic environment.

21. Given that there is a need to contemplate the granting of temporary relief, it begs the question whether the present is the appropriate time to implement such increase especially when the increased Profit Requirement may become effective as early as July 2021 according to the Consultation Paper. Hong Kong has suffered back-to-back from the social unrest in 2019 and the pandemic since early 2020. Besides, tourism, travel, hospitality and retail businesses, various service industries are also affected by government social distancing directives in order to contain the pandemic in 2020. As far as the pandemic is concerned, the impact is likely to persist into 2022.

22. If the Exchange proceeds with any form of increase in Profit Requirement regardless, in the place of temporary relief, we advocate to adopt a similar transitional period time line as the GEM reform in 2018 which provided a transition period between 15 February 2018 to 14 February 2021. Based on our experience as sponsor, companies invariably start to contemplate listing a couple of years before the end of the track record period. The transition period proposed in the Consultation Paper appears to assume companies would only, as well as all of a sudden, start to plan for a listing towards the end of the track record period. Main Board listed companies who are contemplating a spin-off have landed themselves in an even more peculiar situation, where, without a meaningful transition period, within the matter of months, not only the spin-off group, but also the parent group excluding its interest in the spin-off group, would have to satisfy individually the increased Profit Requirement. In other words, based on the conservative scenario of Option 1, their new profit requirement in total would have been increased by 300% (150% each). This would inevitably scupper their spin-off plan. A three-year transition period would absorb the need for temporary relief arrangements and allow companies who have started to contemplate listing on the Main Board make and attempt on their listing plan under the current regime.

**Question 4. If your answer to Question 3 is yes, do you agree with the conditions to the temporary relief as set out in paragraph 55? Please give reasons for your views.**

**Answer 4. NO**

23. We disagree with the following aspects of paragraph 55.

24. Paragraph 55(a): Merely gave some flexibility to reallocate the required Adjusted Net Profit in the latest financial year of the track record period to the outer years. The overall Profit Requirement over the track record has not reduced. We consider, if relief were to be given, it should be more generous.

25. Paragraph 55(b): Due to government directives on social distancing in Hong Kong, certain sectors such as travel, tourism, hospitality, food and beverage, entertainment, recreational and beauty related are among the hardest hit and may not turn a positive operating cashflow in the ordinary and usual course of business before working capital changes and taxes. Thus, this clause is retracting the extent of the relief.

26. Paragraph 55(d): The negative market conditions started when the social unrest began in 2019 while the effect of the pandemic is likely to persist into 2022. Therefore, the validity window of the relief should be widened to cover 2019 to 2021 and to be reviewed from time to time.

27. Paragraph 55(e)(iii): At present, the disclosure of profit forecast is voluntary except for when a waiver is granted for the strict compliance with Main Board Listing Rules 4.04(1) which requires the inclusion in its accountants' report its consolidated results for each of the three financial years immediately preceding the issue of the listing document. The disclosure of profit forecast covering the period up to the forthcoming financial year end date after listing especially during uncertain times like the present may not be insightful to potential investors. If the forthcoming financial year end date after listing is close to the listing date, the forecast is likely to be more certain. The contrary holds true if the forthcoming financial year end date after listing is distant from the listing date. Therefore, potential investors cannot assume a standardised level of certainty when reading into disclosures of profit forecasts should they become mandatory when transition reliefs are granted. Applicants have to submit profit and cashflow forecast memoranda to the regulators for vetting as a matter of course. The regulators already have the documentation for pre-listing and post-listing regulatory purposes. Profit forecast as an expressed requirement attached to the transition relief may give potential investors a false sense of certainty and reliance despite the disclosure of detailed bases and key assumptions.

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