

Corporate Finance

HKEX proposes to increase the profit requirement for a Main Board listing

Introduction

On 27 November 2020, The Stock Exchange of Hong Kong Limited (the “**Stock Exchange**”) issued a consultation paper on the proposed changes to Rule 8.05(1)(a) (“**Rule 8.05(1)(a)**”) the Rules Governing the Listing of Securities on the Stock Exchange (Main Board unless otherwise stated) (the “**Listing Rules**”) by increasing the profit requirement for listing on the Main Board (the “**Consultation Paper**”). The consultation period will end on 1 February 2021.

Current Profit Requirement

In order to be qualified for listing on the Main Board, a listing applicant must satisfy the profit test in Rule 8.05(1) (the “**Profit Test**”), the market capitalisation/revenue/cash flow test in Rule 8.05(2) or the market capitalisation/revenue test in Rule 8.05(3) of the Listing Rules.

Out of the three tests set out in Rule 8.05 for qualification of listing on the Main Board, Profit Test is the most commonly used test under which an listing applicant can satisfy the listing qualification. Under the current Profit Test, it requires a listing applicant to have a minimum amount of profit attributable to shareholders (the “**Profit Requirement**”) of (i) HK\$20 million in the most recent financial year and (ii) HK\$30 million in aggregate in the two preceding financial years (the “**Current Profit Requirement**”).

Reasons for raising the Profit Requirement

The Consultation Paper indicates that the minimum profit requirement under Rule 8.05(1)(a) has not been changed since its introduction in 1994. In 2018, the minimum market capitalisation requirement under Rule 8.09(2) of the Listing Rules was increased from HK\$200 million to HK\$500 million (the “**Market Capitalisation Requirement**”) while the Current Profit Requirement remained unchanged.

The Consultation Paper explains the reasons for the proposed increase in Profit Requirement is that there has been an increase in listing applications from issuers that marginally met the Profit Requirement and the Market Capitalisation Requirement (the “**Small Cap Issuers**”) but had relatively high historical P/E ratios as compared with those of their listed peers. These Small Cap Issuers usually justified their valuations by reference to potential growth, however a number of them failed post listing to meet the profit forecasts filed with the Stock Exchange in their listing applications.

The Consultation Paper also raises regulatory out concerns about whether the Small Cap Issuers were genuinely listed with the intention to raise funds for the development of their underlying businesses or to manufacture potential shell companies for sale after listing, given the perceived premium attached to the listing status.

It also says 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 after listing.

Proposed Profit Requirement

The Consultation Paper suggest that the problems mentioned above is partly attributable to the misalignment of the Current Profit Requirement with the Market Capitalisation Requirement which was increased five-fold from HK\$100 million in 1994 to HK\$500 million in 2018. As such, the Stock Exchange proposed two options (the “Proposed Profit Requirement”) for the increase in the Current Profit Requirement as follows:

1. **Option 1:** Increase the Current Profit Requirement by 150% which is the percentage increase in the Market Capitalisation Requirement from HK\$200 million to HK\$500 million in 2018 so that the minimum amount of profit attributable to shareholders would be HK\$50 million in the most recent financial year and HK\$75 million in aggregate in the two preceding financial years and the implied historical P/E ratios of Small Cap Issuers to 10 times, in line with that prior the change of the Market Capitalisation Requirement in 2018; or
2. **Option 2:** Increase the Current Profit Requirement by 200% based on the approximate percentage increase in the average closing price of the Hang Seng Index from 9,541 in 1994 when the Profit Requirement was introduced to 27,569 in 2019 so that the minimum amount of profit attributable to shareholders would be HK\$60 million in the most recent financial year; and HK\$90 million in aggregate in the two preceding financial years, thus reducing the implied historical P/E ratios of Small Cap Issuers to 8 times.

The Consultation Conclusion acknowledges that both Option 1 and Option 2 will result in the Stock Exchange having the highest profit requirement when compared with the profit requirements of the global main markets on an aggregated basis for the three years of a track record period.

Temporary relief from the Profit Requirement

Considering potential listing applicants’ financial performances may have been adversely affected by the COVID-19 pandemic and the uncertainties arising from the economic and

political frictions between the United States and China, if the Proposed Profit Requirement is adopted, the Stock Exchange further proposed to give certain temporary reliefs from the profit spread in the Increased Profit Requirement if an applicant is able to meet the following conditions:

1. its aggregate profit during the track record period meets the minimum aggregate profit in the track record period under the Proposed Profit Requirement;
2. 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;
3. it demonstrates that the conditions and circumstances leading to its inability to meet the profit spread in the Profit Requirement are temporary;
4. track record period must have at least consecutive six months that fall within the calendar year 2020; and
5. adequate relevant disclosure is made in its listing document.

An applicant seeking a temporary relief from the Proposed Profit Requirement will be required to submit an application to the Exchange for consideration on a case-by-case basis.

Transitional Arrangements

To minimise the impact of the Proposed Profit Requirement on potential applicants which may have commenced plans to apply for listing on the Main Board relying on the Current Profit Requirement (the “Potential Applicants”), the Stock Exchange proposed the following transitional arrangement:

1. The effective date of the “Proposed Profit Requirement” will not be earlier than 1 July 2021 (the “Proposed Effective Date”); and
2. Main Board listing applications will be assessed under the Current Profit Requirement if they are submitted before the Proposed Effective Date and remain active as of the Proposed Effective Date. Such applications will be allowed to be renewed once after the Proposed Effective Date for continued assessment under the Current Profit Requirement.

Given the above measures, Potential Applicants should therefore have sufficient time to prepare their listing applications under which they can rely on the Current Profit Requirement.

Conclusion

As stated in the Consultation Paper, the consultation period will end on 1 February 2021. Members of the public and market practitioners are invited to submit their responses to the Consultation Paper by 1 February 2021.

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Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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