



Hong Kong

November 2020

HKEX CONSULTS ON PROPOSAL TO INCREASE THE MAIN BOARD PROFIT REQUIREMENT

On 27 November 2020, the Stock Exchange of Hong Kong (**HKEx**) published a consultation paper¹ outlining a proposal to increase the Main Board HKEx Profit Requirement (the **HKEx Profit Requirement or Profit Requirement**) (the **HKEx Profit Requirement Consultation Paper**). If adopted, the proposal would impact the market considerably, with the HKEx's impact study assessing that 59% (437) and 65% (486) of companies making HKEx Profit Requirement Applications between 2016 and 2019 would have been ineligible for listing under Option 1 and 2, respectively.

The HKEx proposes to either increase the HKEx Profit Requirement by either:

- 150%, based on the percentage increase in the Market Capitalisation Requirement in 2018, which will increase the minimum amount of profit attributable to shareholders (i) from HK\$20 million to HK\$50 million in the most recent financial year prior to listing and (ii) from HK\$30 million to HK\$75 million in aggregate in the two preceding financial years; or
- 200%, based on the approximate percentage increase in the average closing price of the Hang Seng Index from 1994 to 2019, (i) from HK\$20 million to HK\$60 million in the most recent financial year prior to listing and (ii) from HK\$30 million to HK\$90 million in aggregate in the two preceding financial years.

The HKEx is of the view that there is currently a misalignment of the HKEx Profit Requirement with the increased Market Capitalisation Requirement, which the HKEx believes has raised regulatory concerns surrounding the quality of companies seeking Main Board listings. The HKEx states that there has been an increase in listings by Small Cap Issuers marginally meeting the HKEx Profit Requirement but with relatively high historical P/E ratios in comparison to their listed peers.

Through increasing the HKEx Profit Requirement, the HKEx also aims to enhance the distinction between a Main Board and GEM listing in Hong Kong, offer issuers clearer choice and investors greater clarity.

The consultation period ends on 1 February 2021.

1. HKEx Current Main Board Minimum Profit Requirement

Main Board Rule 8.05(1)(a) currently prescribes that a new applicant must have a minimum amount of profit attributable to shareholders 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 Minimum HKEx Profit Requirement was introduced in September 1994 and has remained unchanged through two public consultations and two reviews by the Listing Committee conducted between 2002 and 2017 on the basis that it continued to be a good indicator of an applicant's performance and that it was on par with the main markets of selected

¹ <https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Consultation-Paper/cp202011.pdf>

overseas exchanges. Meanwhile, the Market Capitalisation Requirement (Main Board Rule 8.09(2)), which an applicant relying on the HKEx Profit Requirement must also meet, was increased in February 2018 from HK\$200 million to HK\$500 million. Since this increase, the HKEx states that there has been a significant increase in applications from issuers marginally meeting the HKEx Profit Requirement, but having relatively high proposed market capitalisations.

A majority of Main Board applicants (82%) between 2016 and 2019 relied on the HKEx Profit Requirement (51% of which were Small Cap Issuers), which compares to only 1% relying on the Market Capitalisation Revenue Cashflow Requirement, 4% relying on the Market Capitalisation Revenue Requirement and 13% relying on others, which include listing applications under Listing Rule 8A.06, Chapter 18, Chapter 18A, Chapter 19C, Chapter 20 and Chapter 21.

The HKEx outlines that since the increase of the Market Capitalisation Requirement in 2018, the HKEx has seen an increase in listing applications from Small Cap Issuers (defined as companies with a market capitalisation of less than or equal to HK\$700 million) that marginally meet the HKEx Profit Requirement but had relatively high historical P/E ratios as compared with those of their listed peers. For example, the HKEx notes that the average historical P/E ratio of the HKEx Profit Requirement applications from 2016 to 2019 was 14 times, however the proportion of HKEx Profit Requirement applications with historical P/E ratio above 15 times increased significantly in 2018 following the increase in the Market Capitalisation Requirement. While these Small Cap Issuers justified their higher valuations by reference to potential growth, the HKEx states that a number failed to meet their profit forecasts post-listing, calling into question the reasonableness of their valuations.

Further, the HKEx cites concerns that Small Cap Issuers may have been inflating their valuations in order to manufacture shell companies to sell post-listing. The HKEx states that this impacts not only the quality of Main Board listings but also the market overall owing to potential losses investors face and the resultant impacts to investor confidence.

2. Proposed Increase in the HKEx Main Board Minimum Profit Requirement

In view of the HKEx's observations and concerns, the HKEx proposes to increase the Main Board Minimum Profit Requirement. The options are as follows:

	Option 1*	Option 2**
Proposed Increase (%)	150%	200%
	HK\$ million	
In aggregate for the first two financial years	75	90
For the last financial year	50	60
Total	125	150
Implied historical P/E ratio (based on the Market Capitalisation Requirement)	10 times	8 times

* based on the percentage increase in the Market Capitalisation Requirement

** based on the approximate percentage increase in the average closing price of the Hang Seng Index from 9,541 in 1994 (when the HKEx Profit Requirement was introduced) to 27,569 in 2019.

3. Expected Impact of the HKEx Main Board Minimum Profit Requirement

a. Number of Applicants Eligible for Listing

The HKEx performed an impact analysis and outlined the results in order to demonstrate the expected effects of the increased HKEx Profit Requirement.

Of the HKEx Profit Requirement Applications between 2016 to 2019, Option 1 and 2 would have resulted in 59% (437) and 65% (486) being ineligible for listing respectively. Under both options, 46% of ineligible applications were Small Cap Issuers with proposed market capitalisations between HK\$500 million and HK\$700 million, none of which were "new economy" companies, and a median historical P/E ratio of 14 times. Comparatively, 10% (under Option 1) and 3% (under Option 2) of eligible applications had proposed market capitalisations between HK\$500 million and HK\$700 million, with median historical P/E scores of 8 times.

22% (under Option 1) and 25% (under Option 2) of ineligible applications were non-Small Cap Issuers with proposed market capitalisations exceeding HK\$700 million, with median historical P/E ratios of 27 times (under Option 1) and 26 times (under Option 2) and 87% (under Option 1) and 95% (under Option 2) of eligible applications were non-small Cap Issuers with market capitalisations exceeding HK\$700 million, with a median historical P/E ratio of 16 times (under Option 1) and 15 times (under Option 2).

Applicants with market capitalisations of less than HK\$500 million would not have been eligible under the current Market Capitalisation Requirement even if the HKEx Profit Requirement is not increased.

b. Early Development Stage Companies and SMEs

The HKEx is mindful that an increased HKEx Profit Requirement would affect companies at an early development stage or SMEs seeking listing on the Main Board of the HKEx. The increased HKEx Profit Requirement would not however preclude these companies accessing the Hong Kong capital markets as they may alternatively pursue listings on GEM. This aligns with the HKEx's goal of further differentiating between Main Board and GEM listings in an effort to improve the overall quality of Main Board issuers, thereby strengthening Hong Kong's position as an international finance centre.

c. HKEx in Comparison to Overseas Markets

Currently, the HKEx has the third highest profit requirement when compared to selected overseas main markets (ASX, LSE (premium segment), NASDAQ Global Select Market, NYSE, the Main Board of the SGX and the Main Board of the SSE). An increase in the HKEx Profit Requirement (either Option 1 or Option 2) would result in the HKEx having the highest profit requirement when compared with the profit requirements of selected overseas main markets on an aggregated basis for the three years of a track record period. However, there are alternative eligibility tests available for companies that may not meet the increased HKEx Profit Requirement of the Main Board and the HKEx considers that the increased HKEx Profit Requirement is justified in order to tackle the issues facing the Hong Kong market.

4. Proposed Temporary Relief from the Increased Profit Requirement

The current HKEx Profit Requirement requires, at minimum, the aggregate profit for the first two financial years and

the most recent financial year prior to listing to account for 60% (HK\$30 million) and 40% (HK\$20 million) of the Aggregate Profit Threshold of HK\$50 million respectively.

If the proposed increase is adopted, the HKEx proposes to introduce temporary conditional relief from the increased HKEx Profit Requirement in order to facilitate the listing of quality companies whose financial results have been temporarily and adversely affected by COVID-19 and the corresponding economic downturn.

If an increased HKEx Profit Requirement is adopted, in order to qualify for the temporary relief from the spread of profit between the first two financial years and the most recent financial year, an applicant must meet the following conditions:

- i) its aggregate profit during the track record period meets the Aggregate Profit Threshold (HK\$125 million under Option 1 or HK\$150 million under Option 2);
- ii) 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;
- iii) it demonstrates that the conditions and circumstances leading to its inability to meet the profit spread in the HKEx Profit Requirement are temporary. The HKEx will assess the profitability in the last financial year / period as a means of whether the applicant has recovered or is recovering from the adverse market conditions;
- iv) the track record period must have at least six consecutive months that fall within the 2020 calendar year; and
- v) adequate disclosure is made in its listing document, including:
 - the likelihood of continuance or recurrence of the circumstances leading to the inability to meet the profit spread in the context of an increased HKEx Profit Requirement;
 - measures which were taken or will be taken by the applicant to mitigate the impact of those circumstances on future profitability; and

- a profit forecast covering the period up to the forthcoming financial year end date after the date of listing with detailed bases and key assumptions.

In any case, an applicant seeking temporary relief must submit an application to the HKEx for consideration on a case-by-case basis.

5. Transitional Arrangements

In view of the fact that companies may have commenced plans to apply for a Main Board listing based on the current HKEx Profit Requirement, the HKEx proposes to introduce transitional arrangements to minimise the impact on potential applicants.

It is proposed that the increased HKEx Profit Requirement will, if adopted, take effect no earlier than 1 July 2021 (the **Effective Date**). Main Board listing applications (including GEM transfers) submitted before 1 July 2021 and that remain active (i.e. the application has not lapsed, been withdrawn, rejected or returned) as at 1 July 2021, will be assessed under the current HKEx Profit Requirement. Such applications may be renewed once after the Effective Date for continued assessment under the current HKEx Profit Requirement, if the renewal is made within three calendar months from the date on which the previous application lapsed. Any subsequent renewals shall be assessed under the increased HKEx Profit Requirement.

As for GEM Transfer applications processed under the transitional arrangements set out in Appendix 28 to the Listing Rules (i.e. those made by GEM Eligible Issuers between 15 February 2018 and 14 February 2021), they will no longer be entitled to the transitional arrangements if such applications lapse after 14 February 2021 and they will be required to comply with the current HKEx Profit Requirement and Market Capitalisation Requirement, among others. The above outlined transitional arrangements will however apply.

Applicants will not be permitted to withdraw a listing application prior to its lapse in order to resubmit shortly thereafter before the Effective Date such that the application will be assessed under the current HKEx Profit Requirement for a longer period.

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