Charltons - Hong Kong Law Newsletter - 13 June 2009

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# HKEx: Potential Waiver From Profit Test Requirement For Main Board IPO Applicants

## Introduction

The Stock Exchange of Hong Kong Limited (the **Exchange**) issued a News Release on 5 June 2009 setting out the circumstances in which it may grant a waiver from strict compliance with the profit test requirements under Main Board Listing Rule 8.05(1)(a), to individual IPO applicants whose profit over the track record period has been temporarily and adversely affected by the global financial crisis.

## Profit Test Requirement

The profit test, under Listing Rule 8.05(1)(a), requires an applicant to have profits of HK$50 million over a 3-year track record period, with HK$20 million in the most recent year and an aggregate of at least HK$30 million in the two preceding years. In calculating the amount of profit, any income or loss that does not arise in the ordinary and usual course of business of the applicant (or its group), should be excluded.

### Listing Decision 66-1: Exclusion of gains/losses from changes in fair value of the conversion option of the applicant’s redeemable convertible preferred shares

The Exchange recently published Listing Decision 66-1 on the question of whether a gain or loss arising from changes in fair value of a conversion option in relation to a listing applicant’s redeemable convertible preferred shares should be excluded from the computation of profit under Rule 8.05(1)(a). It was determined that they should be excluded since the conversion option changes in relation to the preferred shares were not related to activities in the ordinary and usual course of the applicant’s business activities. The decision went on to note that preferred share issues are becoming increasingly common and that the Exchange will deal with the treatment of the fair value changes in respect of them on a case-by-case basis.

The listing decision contains a useful summary of the facts to be taken into account in determining whether certain financial gains or losses fall within the “ordinary and usual course of business” of a listing applicant. A summary of the listing decision is set out in the Appendix to this note and the full text can be viewed [*here*](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld66-1.pdf).

## Waiver Applications – Relevant Factors

The Exchange has provided a non-exhaustive list of factors which it will take into consideration when assessing an application for waiver from the profit test requirements:

1. The applicant must have a minimum total profit of HK$50 million (attributable to shareholders) over the last three financial years immediately prior to its application for an initial public offering.
2. The applicant must be able to demonstrate that, had it not been for the temporary condition(s), its operating profit over those three years would have been significantly in excess of HK$50 million.
3. During the three-year track record period, at least one financial year must have ended on or after 31 December 2008.
4. There must be a positive cashflow 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 of the track record period.
5. The applicant must satisfy the Exchange that the condition(s) and circumstance(s) leading to its inability to comply with the existing profit test are temporary. Adequate disclosure must also be included in the listing document concerning:
   1. the likelihood of such condition(s) and circumstance(s) continuing or reoccurring; and
   2. the measure(s) the applicant has taken or will proceed to take to mitigate the affect of these condition(s) and circumstance(s) on its future profits.
6. The applicant must prove that it will have sufficient working capital to operate for 12 months after listing.

The Exchange encourages applicants considering a waiver application to consult, and seek informal guidance from, the Listing Division of the Exchange as to the likelihood of success of a formal waiver application.

*This newsletter provides a summary only of the Exchange’s news release dated 5 June 2009 and of Listing Decision 66-1. Its contents do not constitute legal advice and specific advice should be sought in relation to any particular situation.*

### Appendix 1

HKEx-LD66-1 (April 2009) - <http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/documents/ld66-1.pdf>

Summary

Name of Party

Company A – a Main Board applicant providing IT related services and its subsidiaries

Subject

Whether the gain/loss from changes in the fair value of the conversion option in relation to Company A’s redeemable convertible preferred shares should be excluded from the computation of profit under Rule 8.05(1)(a)?

Listing Rules

Rules 8.05(1)(a); 4.11; HKEx-LD45-2, HKEx-LD48-2, HKEx-RL3-04 and HKEx-RL23-07

Decision

The conversion option changes in relation to the preferred shares were not related to activities in the ordinary and usual course of Company A’s business. Therefore, it was appropriate to exclude them from the computation of profit under Rule 8.05(1)(a). There were an increasing number of applicants issuing preferred shares. The treatment of the fair value changes in respect of them would be dealt with case by case for Rule 8.05(1)(a).

Source: HKEx

### Summary of Facts

* In the first year of the track record period, Company A issued redeemable convertible preferred shares to strategic investors.
* The material terms and conditions of the preferred shares included:
  1. Company A must redeem all preferred shares on maturity (6-year term) unless earlier redeemed or converted;
  2. Holders of the preferred shares were entitled to a fixed cumulative dividend per annum of the principal amount payable quarterly since the first year;
  3. Holders were also entitled to convert the preferred shares into ordinary shares at the initial conversion rate of 1:1, subject to adjustment for anti-dilution protections from time to time; and
  4. The preferred shares issued were denominated in Hong Kong dollars, while Company A’s functional currency was RMB.
* Under Company A’s HKFRS accounting policies, the financial instrument for the preferred shares were made up of:
  1. the derivative component (i.e. the conversion option for the preferred shares), and
  2. the liability component
* The entire financial instrument for the preferred shares was designated as a financial liability or financial asset at fair value through profit or loss on initial recognition and at each balance sheet date.
* The fair value changes from the derivative component of the preferred shares (the **Conversion Option Changes**) did not arise in the ordinary and usual course of business for Rule 8.05(1)(a). If the Conversion Option Changes were excluded from the computation of profit, Company A could satisfy the minimum profit requirement under Rule 8.05(1)(a).

### Precedent Cases

Precedent cases from Listing Decisions HKEx-LD45-2, HKEx-LD48-2 and Reject Letters HKEx-RL3-04 and HKEx-RL23-07 set out the Exchange’s analysis in relation to the determination of whether income can be counted towards satisfaction of the profit requirement of Rule 8.05(1)(a). The basic criteria is that the Exchange must be satisfied that the income was derived from the ordinary and usual course of business, i.e. it was actively derived from the applicant’s principal business, and not from a source incidental to it. In addition, the timing of the income must not be arbitrary and dependent, to a large extent, on the discretion of the applicant’s directors.

In HKEx-LD66-1, the Exchange provided three examples to illustrate how the fair value gains/losses on an applicant’s income statement would be considered under Rule 8.05(1)(a).

In determining whether the Conversion Option Changes should be excluded for the profit requirement under Rule 8.05(1)(a), the Exchange considered the following factors:

### Factors favouring the inclusion of the Conversion Option Changes

* Company A contended that it used the net proceeds from the preferred shares to develop and expand its business. They were used primarily in acquiring IT related companies/businesses which were relevant and complementary to its core business of providing IT related services. There was therefore some connection between the Conversion Option Changes and Company A’s ordinary course of business.
* Companies often seek external financing and the issue of preferred shares as a means of raising finance does not differ materially from financing via bank borrowings. As the finance costs from bank borrowings are normally included when assessing an applicant’s compliance with the minimum profit requirement, it would be inconsistent to exclude the related expenses (including the Conversion Option Changes) from the issue of the preferred shares.

### Factors favouring the exclusion of the Conversion Option Changes

* Besides providing finance to develop and expand its business, Company A’s issue of the preferred shares had a very limited connection to its business operation. Issuing the preferred shares, which required obtaining shareholders’ approval to amend Company A’s constitution, was different from bank borrowings. These factors indicated that the issue was not in the ordinary and usual course of Company A’s business.
* The Conversion Option Changes were mainly affected by the price and volatility of Company A’s shares and were determined on the basis of professional valuation at the respective balance sheet dates. There was no actual cash flow movement and the Conversion Option Changes had little correlation with how Company A’s business was conducted. The more the price of Company A’s shares exceeded the conversion price, the greater the loss from the Conversion Option Changes and the harder it would be for Company A to satisfy the minimum profit requirement under Rule 8.05(1)(a). Once the preferred shares were issued, Company A’s directors would have limited discretion/control over the Conversion Option Changes and this distinguished this case from HKEx-LD45-2.
* If Conversion Option Changes were included, the negative correlation between the Conversion Option Changes with the price performance of Company A’s shares would distort the Company’s net profit figures as an indicator of its past performance over the track record period.
* The financial impact of the Conversion Option Changes depended largely on the price and volatility of Company A’s shares. In determining the computation of profit under Rule 8.05(1)(a), Company A would ordinarily exclude positive Conversion Option Changes in the second year of the track record period on the basis that the gain was not actively derived from its principal business. It followed that Company A should also be entitled to exclude negative Conversion Option Changes for the first year of the track record period.

### The Decision

Having considered the above, the Exchange decided that the Conversion Option Changes were not related to Company A’s ordinary and usual course of business and should therefore be excluded from the computation of profit under Rule 8.05(1)(a).

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