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## Hong Kong Stock Exchange Proposes to Increase the Main Board Profit Requirement

***The consultation paper proposes to increase the Main Board Profit Requirement by 150% or 200%.***

The Stock Exchange of Hong Kong Limited (the Exchange) has published a Consultation Paper on the Main Board Profit Requirement (the Consultation Paper) proposing to increase the profit requirement to align with the market capitalisation requirement for Main Board applicants. Since the introduction of the profit requirement in 1994, the Exchange has maintained the profit requirement despite amendment to other requirements such as the increase in market capitalisation requirement from HK\$200 million to HK\$500 million in 2018. When introduced in 1994, a new applicant was required to have a minimum amount of profit attributable to shareholders of HK\$20 million in the most recent financial year and HK\$30 million in aggregate in the two preceding financial years (the Profit Requirement). The Exchange's 27 November 2020 proposal is intended to align the Profit Requirement with the revised market capitalisation requirement (which was increased five-fold from HK\$100 million in 1994 to HK\$500 million in 2018). A more detailed summary of the Consultation Paper is set out below. The consultation period ends on 1 February 2021.

### Background

In 2017, the Exchange proposed changes including increasing the market capitalisation requirement from HK\$200 million to HK\$500 million for Main Board applicants. This was detailed in the consultation paper on the review of the Growth Enterprise Market (GEM) and changes to the GEM and Main Board Listing Rules in June 2017 (the Consultation Paper — Review of GEM). One of the key areas addressed in the Consultation Paper — Review of GEM was to re-position GEM as a stand-alone board, and in order to improve the quality of GEM applicants the minimum market capitalisation requirement for GEM applicants was proposed to be increased from HK\$100 million to HK\$150 million. The proposed amendments to the GEM Listing Rules meant that the GEM listing requirements would be close to or exceed the equivalent requirements of the Main Board and in order to preserve the Main Board's position as a market for larger companies, the Exchange proposed increasing the market capitalisation requirement for Main Board applicants from HK\$200 million to HK\$500 million. The proposal to increase the market capitalisation requirement of Main Board applicants to HK\$500 million became effective from 15 February 2018.

The Exchange observed that the increase in the market capitalisation requirement without a corresponding increase in Profit Requirement has resulted in the following:

- An increase in listing applications from issuers that apply to list on the Main Board pursuant to the Profit Requirement with a proposed market capitalisation of equal to or less than HK\$700 million (Small Cap Issuers) that marginally meet the Profit Requirement but have relatively high historical price to earnings (P/E) ratios
- A number of the Small Cap Issuers failing post-listing to meet the profit forecasts they had filed with the Exchange
- Increasing concerns of Small Cap Issuers inflating valuation and reverse engineering in order to meet the market capitalisation requirement

## Proposals

To address the concerns arising from the misalignment of the Profit Requirement and the market capitalisation requirement, the Exchange proposed two options to increase the Profit Requirement:

### Option 1

- Increase the Profit Requirement by 150% to reflect the percentage increase in the market capitalisation requirement (which increased from HK\$200 million to HK\$500 million in 2018)
- This would increase the minimum profit attributable to shareholders to (i) HK\$50 million in the most recent financial year and (ii) HK\$75 million in aggregate in the two preceding financial years
- Reduce the implied historical P/E ratio (based on the market capitalisation requirement) meeting only the minimum thresholds under the Profit Requirement and the market capitalisation requirement to 10 times

### Option 2

- Increase the Profit Requirement by 200% to reflect the percentage increase in the average closing price of the Hang Seng Index from 1994 to 2019
- This would increase the minimum profit attributable to shareholders to (i) HK\$60 million in the most recent financial year and (ii) HK\$90 million in aggregate in the two preceding financial years
- Reduce the implied historical P/E ratio (based on the market capitalisation requirement) meeting only the minimum thresholds under the Profit Requirement and the market capitalisation requirement to 8 times

## Temporary Relief From the Proposed Profit Requirement

Various external factors, in particular the COVID-19 pandemic and uncertainties arising from the economic and political tensions between US and China, may have adversely affected the businesses of many listing applicants.

To give consideration to the market conditions in 2020, the Exchange will consider granting temporary reliefs from the increased Profit Requirement if an applicant is able to meet the following conditions:

- Its aggregate profit during the track record period meets the aggregate profit threshold (i.e., HK\$125 million under Option 1 or HK\$150 million under Option 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
- It demonstrates that the conditions and circumstances leading to its inability to meet the profit spread in the Profit Requirement are temporary
- The track record period must have at least six consecutive months that fall within the calendar year 2020 as such relief is for applicants whose financial results during the track record period had been adversely affected by the negative market conditions in 2020
- The company makes adequate disclosures in its listing document, including:
  - The likelihood of continuance or recurrence of the circumstances leading to the applicant's inability to meet the spread of the increased Profit Requirement
  - Measures that were taken or will be taken by the applicant to mitigate the impact of those circumstances on future profitability
  - 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 order to benefit from such temporary relief, applicants must submit an application to the Exchange for its consideration on a case-by-case basis.

## **Transitional Arrangement**

As some companies may have commenced plans to be listed on the Main Board on the basis of the existing Profit Requirements, in order to minimise the impact of the proposed increase of the Profit Requirement to such companies, the Exchange will introduce the following transitional arrangements:

- The date on which the proposed rule amendment set out in the Consultation Paper becomes effective (the Rule Amendment Effective Date) will not be earlier than 1 July 2021.
- Main Board listing applications (including GEM transfer applications) will be assessed under the current Profit Requirement if the applications are submitted before the Rule Amendment Effective Date and remain active (i.e., not lapsed for more than three months, been withdrawn, rejected, or returned) as of the Rule Amendment Effective Date.
- Such application will be allowed to be renewed one time after the Rule Amendment Effective Date for continued assessment under the current Profit Requirement. For any subsequent renewals, the application will be assessed under the increased Profit Requirement.

- Before the Rule Amendment Effective Date, a new applicant will not be permitted to withdraw its listing application and resubmit shortly thereafter in order that the application would be assessed in accordance with the existing Profit Requirement for a longer period.

## Conclusion

The Exchange acknowledged that the increase in the Profit Requirement will further distinguish between issuers listed on GEM and the Main Board and 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. The proposals are intended to improve the overall quality of Main Board issuers, which will be conducive to promoting post-listing liquidity. The proposals will not affect the early development stage companies in the biotech sectors who meet, amongst other requirements, the suitability and eligibility requirements and the relevant minimum market capitalisation requirement to be listed under Chapter 18A of the Listing Rules. Potential applicants that are in the process of commencing plans to be listed on the Main Board must take into account: the potential impact that the proposals may have on the applicant's eligibility to be listed on the Main Board, whether or not the applicant will be able to benefit from the proposed temporary relief measures and transitional arrangement, and how all these factors fit together with the applicant's current timetable for its potential listing application.

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