



Hong Kong

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HKEX PUBLISHES LISTING DECISION 126-2020 WITH REASONS FOR LISTING APPLICATION REJECTIONS

Lack of a commercial rationale for listing was the principal reason for the rejection of 17 listing applications on grounds of lack of suitability for listing under Guidance Letter HKEX-GL68-13A¹ in 2019 according to the Hong Kong Stock Exchange's Listing Decision HKEX-LD126-2020² (**Listing Decision 126-2020**) published in June 2020. In 2018, the Hong Kong Stock Exchange (**HKEx**) rejected 20 (6.45%) of listing applications for lack of suitability.

The latest Listing Decision 126-2020 notes that its IPO vetting process is qualitative and involves a holistic review of listing applicants' eligibility and suitability for listing. Where HKEx is concerned that the applicant is listing as a prospective shell, it pays greater attention to the commercial rationale for listing, its proposed use of the IPO proceeds and whether there is a genuine need for funds. Where a listing applicant does not demonstrate a commercial rationale for listing to the HKEx's satisfaction, the HKEx will also consider the applicant's valuation in determining suitability for listing. Listing Decision 126-2020 describes three listing applicants who were unable to substantiate their valuation due to failure to explain why their forecast price-earnings (P/E) ratios were higher than those of industry peers and their inability to justify valuations in light of their historical financial performance and profit forecasts.

HKEx notes, however, that if applicants demonstrate a commercial rationale for their use of proceeds, the HKEx will

not examine the availability of internal sources of funding or banking facilities. Applicants with healthy balance sheets and/or strong cash flows will not be disadvantaged provided they can substantiate the commercial reason for listing.

Reasons for HKEx Rejection of Listing Applications

Lack of Suitability

As noted in the Listing Rules,³ meeting the listing criteria of Chapters 8 and 11 of the Main Board and GEM Listing Rules, respectively does not guarantee an applicant's eligibility to list. HKEx must also be satisfied that the applicant and its business are suitable for listing and retains absolute discretion to reject listing applicants. Guidance on suitability for listing is set out in Guidance Letters HKEX-GL68-13⁴ and HKEX-GL68-13A.⁵

Lack of Suitability: No Commercial Rationale for Listing

Sixteen of the 18 rejected 2019 listing applicants were rejected because they failed to establish a commercial rationale for listing under the Listing Rules⁶ and were thus considered to have no genuine funding needs. A number of the listing applicants who intended to use IPO proceeds to fund their proposed expansion plans failed to substantiate their commercial basis. In other cases, listing applicants gave a

1 https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/gl6813a.pdf

2 HKEX-LD126-2020. (June 2020). To provide guidance on why the Exchange rejected certain listing applicants. Available at: https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks//d/LD126-2020.pdf

3 Main Board Listing Rule 8.01(2) and GEM Listing Rule 11.01(2).

4 https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/gl6813.pdf

5 https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/gl6813a.pdf

6 Main Board Listing Rule 2.03 and GEM Listing Rule 2.09

proposed use of listing proceeds which was not commensurate with their previous business strategies without providing an adequate explanation.

Lack of Suitability: Insufficient Support for Valuation

Listing Decision 126-2020 also describes how in the case of applicants which have not substantiated a commercial rationale for listing, the HKEx will also consider their valuation in determining suitability for listing. Three listing applicants failed to justify why their forecast price-earnings (P/E) ratios were higher than those of industry peers, the basis on which the peers were chosen and how these valuations were reasonable in light of the applicant's historical financial performance and profit forecast.

Lack of Suitability: Other Reasons

Other reasons for rejecting listing applications included failure to meet the minimum profit requirement after excluding non-ordinary course income and failure to meet the suitability of director/ person of substantial interest or controlling shareholder.

The following provides a summary of the background to the rejected listing applications.

Consumer Goods Sector Applicants

Company A: GEM Applicant Rejected for Lack of Commercial Rationale for Listing

Company A sells lighting products and provides lighting support and installation services for building construction and building renovation projects in Hong Kong. The purpose of its proposed fund raising on GEM was to:

1. acquire the supplier for a key component of emergency lighting products (the **Supplier**);
2. acquire an additional production plant; and
3. hire additional sales and marketing and procurement staff.

HKEx considered that the applicant's proposed expansion lacked commercial sense given that:

1. the Supplier only produced key components for one type of product sold by Company A and the sales of this product only accounted for 10-20% of revenue during the track record period;
2. the annual costs saving expected from the acquisition of an additional production plant was marginal - less than 1% of Company A's estimated net profit (excluding listing expenses) of the forecast for the coming financial year; and
3. the proposed hiring of additional staff, which would almost double the number of employees in the relevant teams, was not justified based on expected industry growth.

HKEx rejected Company A's listing application because it considered that in failing to substantiate its use of the IPO proceeds, it had failed to demonstrate a commercial rationale for listing.

Company B: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing and Insufficient Support for Valuation

Company B is a motor vehicle dealer in Singapore which planned to use its listing proceeds for the acquisition of a new showroom which would be twice the size of the existing one.

The Company failed to substantiate the existence of sufficient demand for the expansion given a 5.9% decline in Singapore's automotive retail industry between 2018 and 2022. HKEx rejected the listing application for failure to demonstrate the applicant's commercial rationale for listing due to its failure to substantiate its use of proceeds.

Company C: GEM Applicant Rejected for Lack of Commercial Rationale for Listing

Company C provides commercial and industrial kitchen equipment solutions in Singapore. Already listed on the Singapore Stock Exchange, the applicant sought a dual primary listing on GEM. It planned to use 90% of its listing proceeds to set up a new product manufacturing plant in Malaysia and a significant proportion of the listing proceeds would be used to pay the company's listing expenses.

Company C could not adequately explain why it was pursuing an increase in the production of a product that had contributed to less than 5% of revenue during the trading record period.

The product also had a small market and low forecast industry growth. The company failed to demonstrate a commercial rationale for listing and its listing application was rejected for lack of suitability.

Company D: GEM Applicant Rejected for Lack of Commercial Rationale for Listing and Insufficient Support for Valuation

Company D operates three restaurants in Hong Kong and planned to use a substantial portion of its listing proceeds to open two more restaurants in Hong Kong. Company D had opened its three restaurants during its 12-year operating history. Its business performance from its existing restaurants had remained relatively flat, but proposed to expand relatively aggressively by opening two restaurants.

HKEx questioned Company D's expected valuation, even though its expected valuation was in line with its comparables. HKEx's reasons for querying the company's valuation were that: (i) the company had recorded minimal growth from its restaurant operations during the trading record period while its comparables were significantly larger in terms of operating scale and revenue; and (ii) its consultancy income, which was reflected in its valuation, was non-recurring.

Company D failed to substantiate its use of proceeds and its listing application was rejected for failing to establish a commercial rationale for listing.

Consumer Services Industry Sector Applicants

Company E: Main Board Applicant Rejected for Failure to Meet Minimum Profit Requirement

Company E is a specialty chain store retailer selling apparel and houseware products in Malaysia. The company received rental income in addition to its retail sales income. The rental income was held not to be in the Company's "ordinary and usual course of business" under the Listing Rules.⁷ Company E failed to meet the minimum profit requirement after excluding the rental income and the relevant costs of its investment properties resulting in the company's listing application being rejected.

Company F: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing and Insufficient Support for Valuation

Company F manufactures and sells cold-rolled steel bars and steel wire products, process and sells hot-rolled steel bars and trades building materials and accessories in Malaysia. It planned to set up new manufacturing facilities for steel bars and wires despite its forecast that revenue would grow just 5% in 2019, significantly lower than its 27.5% growth in 2018. It also failed to substantiate the projected increase in construction demand for steel bars and wires for which the new production facilities intended to cater. The projected increase was also contrary to the flattish industry outlook. Company F, therefore, failed to demonstrate its commercial rationale for its expansion and HKEx rejected its listing application on such basis.

Company F also failed to sufficiently support the bases for its valuation, given the significant deceleration of its profit forecast and its proposed valuation in terms of P/E ratio which was 80% above the industry peers' average P/E.

Company G: Main Board Applicant Rejected for Lack of Commercial Rationale

Company G is a supplier of optical components in Singapore. Its proposed use of listing proceeds was to fund an expansion plan that included the purchase of additional machinery, recruitment of additional staff and acquisition of manufacturer suppliers.

Company G failed to justify its expansion plan as its plan to acquire a supplier to reduce concentration risk was inconsistent with its disposal of its entire interest in a major supplier during the trading record period. It also failed to explain the reasons for and the circumstances for the change in strategy. The company was also unable to change its suppliers without prior approval from its customers and it was thus unclear why the company wanted to pursue the proposed acquisition.

The Company had made minimal additions to its plant and machinery and stated that this was due to a lack of financial resources. It was, however, clear that the company did have sufficient financial resources as it consistently generated operating cash flows during the trading record period and it would only take six months to generate sufficient funding for its proposed expansion plan. Lastly, the company failed to explain why it needed to increase its technician workforce by around 80% to devise new testing plans and equipment calibrations for new equipment. The new testing plans and equipment calibration should not require substantial manpower once set up.

⁷ Main Board Listing Rule 8.05(1)(a)

Company G failed to demonstrate its commercial rationale for listing and its listing application was rejected.

Company H: Main Board Applicant Rejected for Lack of Commercial Rationale and Insufficient Support for Valuation

Company H is a subcontractor for electrical and mechanical engineering services for building service systems in Hong Kong. Its listing proceeds were proposed to be used to: (i) procure systems to allow for direct supply to its customers to replace subcontractors, which had been the practice during the trading record period; and (ii) to acquire equipment and hire additional staff to enhance its internal capabilities.

The company failed to show sufficient demand for its expansion plan. It did not have a strong contract backlog and there was a downward trend in the value of new projects obtained during the trading record period. It was also unable to substantiate the projected cost savings from procuring the systems itself as compared to its practice during the trading record period. Lastly, the company's valuation was not supported by its profit forecast, which projected a decline in adjusted net profit and its forecast P/E ratio was higher than that of its peers.

Company I: Main Board Applicant Rejected for Lack of Commercial Rationale

Company I formulates, develops and supplies polymer materials used in the manufacturing of specialty cables in Southeast Asia.

The company had a stable supply of polymer compounds as it had long term relationships with upstream compounders. The company planned to use its listing proceeds to invest in an upstream compounder and to establish an in-house product development centre.

During the trading record period, the company's sales of the relevant product were low - less than 200 tonnes - relative to the 6,000 tonnes production capacity of the proposed investment, and was forecasted to decline. The company had operated for over 18 years without its own in-house development centre and could not substantiate the material benefits of having one. It therefore did not have commercial rationale to invest in an upstream compounder and to establish an in-house development centre and its listing application was rejected on that basis.

Company J: GEM Applicant Rejected for Lack of Commercial Rationale for Listing

Company J provides container depot management services and container maintenance services in Hong Kong and the PRC.

The company proposed to use its listing proceeds to replace machinery, recruit additional staff and establish a new depot in a city in the PRC, increasing the company's capacity in the existing depot in that city by 100%. However, the company failed to demonstrate that there would be sufficient demand for the new depot and it was also able to fund its expansion through deployment of its then-available cash or bank borrowings.

The HKEx considered that the company had failed to show a commercial rationale for listing and rejected the listing application.

Property & Construction Sector Applicants

Company K: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing

Company K rents and sells construction equipment in South East Asia and planned to use 22% of its listing proceeds for the construction of integrated premises in Singapore.

The company failed to justify its business needs for the integrated premises in light of declining revenue and the scale of the integrated premises was expected to be 70% larger than the existing premises, while it only planned to expand its rental fleet by 12-13%. The increase in aggregate depreciation and amortisation resulting from the integrated premises would also be higher than the existing rental expenses borne by the company.

Company L: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing

Company L is a main contractor focusing on public civil engineering projects in Singapore and planned to use its listing proceeds to expand its operations by acquiring new machinery and equipment, hiring additional labour and to pay for performance bonds.

Its expansion plan was not supported by demand. During the trading record period, the company's revenue grew at a compound annual growth rate of less than 3% and its gross profit margin had remained relatively stable. The average

project size of the contracts secured by the company over the trading record period had also decreased. The company had not secured any new projects since the end of the latest financial year and its backlog of work had decreased by around 40% over the course of the trading record period. The HKEx considered that it had failed to show a commercial rationale for listing and rejected the company's listing application.

Company M: GEM Applicant Rejected for Lack of Commercial Rationale for Listing

Company M is a supplier of fixtures and furniture and decoration materials in Hong Kong. It planned to use its listing proceeds to establish a showroom, to expand into the PRC and to cover the payment of upfront costs for some projects.

The Company claimed that the new showroom could increase the sales of a product, but sales of the product had previously been increased without the new showroom during the trading record period. The company's PRC expansion plan was not supported by any customer feasibility study. It also consistently generated cashflows, but was unable to explain why it required funding for payment of upfront costs of projects that had already commenced.

The company failed to show commercial rationale for listing and its listing application was thus rejected.

Company N: GEM Applicant Rejected for Lack of Commercial Rationale for Listing

Company N sells and leases out real estate in Japan and planned to use its listing proceeds to expand its real estate portfolio.

Real estate investment is capital intensive in nature and Company N claimed that the listing would significantly enhance its capital base and financial position. However, as the net listing proceeds would represent only a 4% increase of the book value of Company N's property portfolio, the company could not substantiate its claim that the listing would substantially enhance its capital base and financial position. The Company could not demonstrate its commercial rationale for listing and its listing application was rejected.

Company O: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing

Company O provides property management services in Macau

and planned to use 41% of its listing proceeds to renovate certain existing car parks.

Company O could not provide a reasonable explanation for the renovation as the relevant concession agreement did not require Company O to undertake the renovation and none of the tenders it had won during the trading record period required any renovation. The company was also able to increase parking tariffs without the renovation. The renovation thus did not appear to materially benefit the company by increasing its chances of renewing its concession agreements, applying for parking tariff increments or increasing its overall competitiveness. The company was therefore unable to show a commercial rationale for listing and its listing application was rejected.

Company P: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing

Company P is a contractor providing fitting-out and alteration and addition services in Macau. It planned to use 60% of its listing proceeds to acquire a mechanical and electrical works contractor (the **Acquisition**) as well as to acquire additional machinery and equipment.

The Acquisition would enable the company to change its business model and strategy from a project manager to a labour intensive role of mechanical and electrical works contractor. The company could not demonstrate how the benefits of the Acquisition outweighed the costs of outsourcing or developing a mechanical and electrical work practice internally.

The Company also failed to demonstrate the need to acquire machinery and equipment since the utilisation rates of the same type of machinery and equipment it already owned were low and it subcontracted work that required such machinery and equipment.

HKEx considered that the company had failed to demonstrate its commercial rationale for listing and rejected the listing application for that reason.

Company Q: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing

Company Q provides pavement supply and lay services, mainly for infrastructure projects and sells asphalt premix products in Singapore. It planned to use about 25% of the

listing proceeds to invest in a new asphalt plant and to acquire machinery and equipment and 65% of the listing proceeds to repay bank loans.

The company had a short operating history and had commenced operations only shortly before the trading record period. During that period, a substantial portion of its revenue was derived from a large-scale non-recurring project which was approaching completion. The company had not secured contracts of similar size after the trading record period.

Further, as a result of an industry slowdown, fewer projects were being tendered and the value of the new projects secured after the trading record period had been decreasing steadily. Therefore, the company did not expect its revenue and profit to grow in the near future due to limited projects in its project pipeline.

Company Q failed to show a commercial rationale for listing and its listing application was thus rejected. Its need for capital for business expansion was uncertain and its business prospectus would depend on whether the company could secure potential projects.

Company R: Main Board Applicant Rejected for Lack of Commercial Rationale for Listing and Lack of Directors' Suitability

Company R develops and sells residential properties in the PRC.

During the trading record period, the company defaulted on a number of short-term intercompany loans. The inter-company lender then assigned the defaulted loans to a distressed asset lender with no discount on the principal. The distressed asset lender could only purchase distressed debt which was already in default. Substantially all of the company's borrowings during the trading record period was accounted for by the financing arrangements with the distressed asset lender.

The company explained that it was only able to obtain financing from the distressed asset lender when it first commenced operations. It failed to explain why it continued to turn to the distressed asset lender when its business became more established and it could be financed by other financial institutions. As borrowing from other financial institutions did not require an associated default, there would be no adverse impact to the company's credit in that respect.

The company failed to show that the distressed asset lender provided better terms than other commercial lenders nor that the distressed asset lender was the only available lender. Loans from the distressed asset lender actually incurred higher interest rates and additional financial advisory fees.

Company R failed to explain the commercial rationale for the financing arrangements, which did not seem to benefit the company and seemed engineered to allow the distressed asset lender to acquire the debts at the expense of the company. The company therefore lacked commercial rationale for listing and its listing application was rejected.

The above issues also raised concerns as to the suitability of the directors and whether they had acted in the best interests of the company and its shareholders when seeking financing for the company.

Conclusion

The Listing Decision sheds light on the HKEx's IPO vetting approach and highlights reasons for the rejection of recent IPO applications. Potential listing applicants should review their business expansion plans and their intended use of listing proceeds and consult the professional parties involved on their listing to ensure that they can demonstrate a commercial rationale for listing.

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