



Hong Kong

May 2021

## HKEX TO RAISE MAIN BOARD PROFIT REQUIREMENT FROM 1 JANUARY 2022

On 20 May 2021, the Stock Exchange of Hong Kong (HKEX) published its Consultation Conclusions on the Main Board Profit Requirement.<sup>1</sup> Following broad opposition to the Consultation Paper's<sup>2</sup> proposal to increase the profit requirement for companies listing on the Main Board by either 150% or 200%, the HKEX will instead raise the aggregate profit requirement over the three-financial year track record period by 60% to HK\$80 million from 1 January 2022. The aggregate profit requirement for the first two financial years will be raised to HK\$45 million (from HK\$30 million) and the profit requirement for the final financial year will be increased to HK\$35 million (from HK\$20 million). The HKEX will also grant relief from the profit spread within the track record period based on case-specific circumstances rather than the satisfaction of specified conditions as originally proposed.

In response to market comments regarding the viability of GEM as an alternative listing venue, the HKEX proposes to conduct a review of GEM.

For a summary of the original Consultation Paper's proposals, please see Charltons' November 2020 newsletter.<sup>3</sup>

1 HKEX. May 2021. "Consultation Conclusions: The Main Board Profit Requirement". Available at: [https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Conclusions-\(May-2021\)/cp202011cc.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Conclusions-(May-2021)/cp202011cc.pdf?la=en)

2 HKEX. November 2020. "Consultation Paper: The Main Board Profit Requirement". Available at: <https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Consultation-Paper/cp202011.pdf>

3 <https://www.charltonslaw.com/hkex-consults-on-proposal-to-increase-the->

### 1. Increase in the HKEX Main Board Minimum Profit Requirement

The HKEX originally proposed to increase the HKEX profit requirement by either 150% resulting in an aggregate profit requirement of HK\$125 million (Option 1) or 200% resulting in an aggregate profit requirement of HK\$150 million (Option 2). The proposal was opposed by 83% of respondents to the Consultation Paper who raised various concerns including that the increased profit requirement would prevent SMEs and traditional sector companies from listing on the HKEX's Main Board and that GEM does not provide a viable alternative listing platform for these companies. Respondents also considered the proposed timing to be inappropriate given current economic conditions and expressed concerns about the potential impact of the proposals on the competitiveness of the HKEX as compared to other markets.

The HKEX decided to adopt a smaller increase of 60% in the aggregate profit required under the Main Board's profit test, one of three financial tests for establishing eligibility to list on HKEX's Main Board. This is the first increase in the profit requirement since its introduction in 1994. The HKEX also revised the profit spread within the track record period from a 60%:40% to a 56%:44% split.

The increase in the profit requirement is intended to reduce the existing misalignment between the profit requirement and the market capitalisation requirement which resulted from the

[main-board-profit-requirement/](#)

increase in the market capitalisation requirement for applicants listing under the profit test from HK\$200 million to HK\$500 million in 2018. For listing applicants which only just meet the profit and market capitalisation requirements, this effectively increased their implied historical price-to-earnings (P/E) ratio from 10 times to 25 times<sup>4</sup> and resulted in a surge in the number of applicants with very high historical P/E ratios compared to their listed peers. As outlined in the Consultation Conclusions, the HKEX and SFC consider the existing misalignment to have resulted in inflated valuations of some listing applicants and improper conduct in the price discovery process. The 60% increase in the profit requirement will reduce the implied historical P/E ratio for applicants which only just meet the profit and market capitalisation requirements to approximately 14 times, which is in line with the average P/E ratio of the Hang Seng Index between 1994 and 2020. A comparison of the modified profit increase and revised profit spread is set out in the table below.

	Current	Modified Profit Increase	Option 1	Option 2
Proposed increase (%)		60%	150%	200%
<b>HK\$ million</b>				
In aggregate for the first two financial years	30	45	75	90
For the final financial year	20	35	50	60
<b>Total</b>	<b>50</b>	<b>80</b>	<b>125</b>	<b>150</b>
Profit Spread	60%:40%	56%:44%	60%:40%	60%:40%
Implied historical P/E ratio	25 times	14 times	10 times	8 times

The modified proposal was adopted based on the following factors:

- the proposed increase is in line with the 61% increase (2019: 60%) in the monthly composite consumer price index from September 1994 (68.6) to December 2020 (110.7);
- the modified profit increase would result in fewer profit requirement listing applicants being ineligible to list, which was respondents' most commonly cited concern. 259 (35%) of the 745 listing applicants which applied for Main Board listing under the profit test between 2016 and 2019 would have been ineligible to list under the modified profit increase with the adjusted profit spread, compared to 437 (59%) under

the HKEX's proposal for a 150% increase (Option 1) or 486 (65%) under the HKEx's proposal of a 200% increase (Option 2); and

- the aggregate profit requirement of HK\$80 million is within the range of alternatives (HK\$60 million to HK\$100 million) suggested by 27 respondents who advocated a reduced increase in the profit requirement.

## 2. More Flexible Relief from the HKEX Profit Spread Requirement

The HKEX has also amended its proposal for the grant of relief from the profit spread requirement. The original proposal was that the HKEX would grant relief to listing applicants meeting the aggregate profit requirement for the track record period subject to their meeting a fixed set of conditions. The conditions included that the listing applicant should: (i) have positive cash flow for the final financial year; (ii) be able to demonstrate that the conditions and circumstances resulting in its inability to meet the profit spread requirement are temporary; and (iii) include in its listing document a profit forecast for the period ending on the next financial year end date. The proposal to provide relief was supported by 62 respondents, while the proposed conditions received support from 27 respondents.

The HKEX has decided to grant relief from the profit spread requirement to companies able to meet the increased aggregate profit requirement of HK\$80 million. However, relief will be granted based on case-specific circumstances rather than on satisfaction of a set of fixed conditions. In considering whether to grant a waiver from the profit spread requirement, the HKEX will:

- consider the listing applicant's business nature and the underlying reasons for its inability to meet the profit spread (e.g. growth stage companies and companies whose businesses have been severely affected by the COVID-19 pandemic and current economic downturn); and
- assess the applicant's profit forecast memorandum and the reasonableness of its P/E ratio.

The HKEX may also require disclosure of the listing applicant's profit forecast in the listing document if it considers this necessary to enable investors to make an informed decision on the position and prospects of the company. It may also make enquiries as to how the IPO price was determined with reference to the book-building process.

<sup>4</sup> Consultation Paper at paragraph 3

### 3. Cooperation between the HKEX and SFC in Combating Regulatory Issues

The HKEX will continue to work closely with the SFC to combat various regulatory matters discussed in the Consultation Paper and the Consultation Conclusions.

#### Review of Estimated Valuations of HKEX Listing Applicants

The HKEX notes that the increase in the market capitalisation requirement for listing applicants in 2018 was followed by a surge in the number of listing applicants that just met the profit requirement and only managed to fulfil the market capitalisation requirement with very high historical P/E ratios (as compared to their listed peers). These listing applicants typically justified their high valuations by reference to potential growth which they supported with profit forecasts, but many of them failed to meet their profit forecasts and/or experienced falls in their share prices and market capitalisation post-listing. The HKEX is thus concerned that applicants' valuations were artificially inflated to meet the market capitalisation requirement.

According to the Consultation Conclusions, the HKEX and the SFC will continue to critically review listing applicants' estimated valuations, particularly those of applicants with relatively high historical P/E ratios compared to those of their listed peers. In particular, the HKEX will critically assess, among other things, listing applicants' profit forecast memoranda to evaluate the reasonableness of their valuations and, in appropriate cases, will require applicants to disclose their profit forecasts in their listing documents. In the case of applications to transfer from GEM, the HKEX will consider any unusual increase in the applicant's share price during the track record period. If the listing applicant and its sponsor are unable to provide a satisfactory explanation for the increase, the HKEX may reject the application for transfer to the Main Board.

#### SFC/HKEX Joint Statement on IPO-related Misconduct

##### *SFC/HKEX Regulatory Concerns*

The HKEX and the SFC also published a Joint Statement on IPO-related Misconduct<sup>5</sup> on 20 May 2021 which describes in more detail the regulatory concerns referred to in the Consultation Paper and

<sup>5</sup> HKEx and SFC. May 2021. "Joint statement on IPO-related misconduct". Available at: [https://www.hkex.com.hk/-/media/HKEX-Market/News/News-Release/2021/210520news/IPOJointStatement\\_e.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/News/News-Release/2021/210520news/IPOJointStatement_e.pdf?la=en)

how the regulators will use their powers to reject or object to listing applications in appropriate cases. The Joint Statement raises awareness of the orchestration of "ramp-and-dump" schemes which more commonly involve newly listed stocks where issuers marginally met the market capitalisation requirement with very high historical P/E ratios at IPO. It suggests that, in some cases, the perpetrators might have used the placing tranche to allocate shares to controlled accounts in order to: (a) artificially satisfy the initial listing requirements under the HKEX Listing Rules, creating a false market for the shares; or (b) corner the shares to enable market manipulation after the listing of the shares. There was information suggesting that these accounts were financed in part by funds diverted from unusually high underwriting commissions and other listing expenses paid. The regulators are concerned that these practices artificially inflated the IPO price and valuation resulting in a substantial fall in the share price on the first day of trading to a level which more closely reflected the company's true market value, causing substantial losses to investors.

#### *Heightened Regulatory Scrutiny of HKEX Listing Applications*

As explained in the Joint Statement on IPO-related Misconduct, the HKEX and the SFC will apply heightened scrutiny to listing applications displaying one or more of the following features:

- a) the listing applicant's market capitalisation only just meets the HK\$500 million minimum requirement under the HKEX Listing Rules;
- b) a very high P/E ratio taking into account the listing applicant's fundamentals, including its profit forecast, and the valuations of its peers;
- c) unusually high underwriting or placing commissions or other listing expenses; or
- d) shareholding is highly concentrated in a limited number of shareholders, particularly where the value of the public float is small and the spread of shareholders only just meets the Listing Rules' minimum requirements for at least 300 shareholders (or 100 for GEM).

In these cases, the regulators will make additional enquiries to determine whether there is sufficient genuine investor interest in the listing applicant and its shares, and an adequate spread of shareholders to enable an open, fair and orderly market following listing.

## SFC's Regulatory Framework for Book-Building and Placing Activities

The SFC proposes to increase its focus on the supervision of intermediaries involved in book-building and placing activities in IPOs with a view to identifying malpractices and misconduct. Intermediaries involved in IPOs possessing any of the features identified in the Joint Statement (as discussed above) may be subject to more in-depth inspection to assess their compliance with the applicable legal and regulatory requirements.

## Enhancements to the HKEX's Disciplinary Powers and Sanctions

The HKEX published its Consultation Conclusions on Review of Listing Rules Relating to Disciplinary Powers and Sanctions<sup>6</sup> on 20 May 2021 setting out changes to its disciplinary regime which will take effect from 3 July 2021. The Listing Rule changes will increase the range of reputational sanctions the HKEX can impose and enable disciplinary action to be brought against a wider range of individuals, including members of senior management, if they cause or knowingly participate in a breach of the Listing Rules.

<sup>6</sup> HKEx. May 2021. "Consultation Conclusions: Review of Listing Rules Relating to Disciplinary Powers and Sanctions." Available at: [https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/August-2020-Disciplinary-Powers/Conclusions-\(May-2021\)/cp202008cc.pdf](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/August-2020-Disciplinary-Powers/Conclusions-(May-2021)/cp202008cc.pdf)

The HKEX proposes to increase its focus on holding individuals accountable for breaches of the HKEX Listing Rules.

## 4. HKEX to Conduct GEM Review

Many respondents to the consultation did not consider GEM to be a viable alternative listing venue for companies unable to meet the proposed increased profit requirement. The HKEX proposes to launch a review of GEM and to consider feedback from respondents, particularly in relation to GEM's positioning and the market perception of GEM. If the HKEX concludes that changes to the GEM Listing Rules are required, it will issue a consultation paper on its proposed reforms.

## 5. Implementation of Revised HKEX Listing Rules

The amendments to the Main Board Listing Rules will take effect on 1 January 2022. The revised profit requirement will apply to all Main Board listing applications, including renewals of previously submitted applications and applications to transfer from GEM, submitted on or after 1 January 2022. Listing applicants are prohibited from withdrawing their listing applications before they lapse and re-submitting them before 1 January 2022 to enable the application to be assessed under the current profit requirement.

# CHARLTONS

**Boutique Transactional Law Firm of the Year 2020  
Asian Legal Business Awards**

---

**This newsletter is for information purposes only.**

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at [unsubscribe@charltonslaw.com](mailto:unsubscribe@charltonslaw.com)

---

**Hong Kong Office**  
Dominion Centre  
12th Floor  
43-59 Queen's Road East  
Hong Kong  
**Tel:** + (852) 2905 7888  
**Fax:** + (852) 2854 9596

[www.charltonslaw.com](http://www.charltonslaw.com)