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[online version](http://www.charltonslaw.com/stock-exchange-publishes-listing-decision-in-relation-to-suitability-for-listing-of-applicants-with-deteriorating-financial-performance-and-uncertain-business-prospects/)

# Stock Exchange Publishes Listing Decision In Relation To Suitability For Listing Of Applicants With Deteriorating Financial Performance And Uncertain Business Prospects

## Introduction

In September 2012, the Stock Exchange of Hong Kong (the **Exchange**) published a listing decision (HKEx-LD37-2012) (the **Listing Decision**) regarding whether a GEM listing applicant’s deteriorating financial performance and uncertain business prospects made it unsuitable for listing on the Exchange.

This Listing Decision suggests that the Exchange will consider the sustainability of the applicant’s business when determining whether to grant listing approval or not. If, in the opinion of the Exchange, the business is not sustainable and the Exchange’s concerns cannot be addressed by way of disclosure, it will reject the application. This seems to be a shift away from the Exchange’s professed disclosure-based approach towards a more merit-based approach.

The Listing Decision is available at on the [Exchange’s website](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld37-2012.pdf) ([see archive](ld37-2012.pdf)).

## Facts

The listing applicant met the minimum cash flow requirement under GEM Rule 12.12A(1) and submitted that it would have sufficient working capital for at least 12 months after the date of its prospectus.

## Deteriorating Financial Performance

The applicant had recorded a continuously declining gross profit margin from Year 1 to Year 3, with a net loss of over HK$2 million in Year 3. It also projected a loss of HK$5 million in Year 4. There was also a decreasing trend of net profit margin from Year 1 to Year 3. Significant revenues came from net foreign exchange gains on financing activities in Year 2 and Year 3. Excluding these gains, the applicant would have recorded a slimmer net profit in Year 2 and a more substantial loss in Year 3.

Raw material costs had accounted for over 95% of the applicant’s cost of goods sold during the track record period. The raw materials prices fluctuated substantially in open commodity markets. The applicant had not been able to pass the increase in raw materials costs to its customers. Previous measures to hedge raw materials prices had been ineffective and had resulted in a loss that took up 30% of its pre-tax profit in Year 1.

## Uncertainty Over The Prospects Of The Applicant's Business

The applicant’s major business was bulk sales. In view of the industry trend, the applicant had also begun to engage in packaged sales business. However, certain local governments had placed restrictions on sales in bulk form since Year 2. Also, the newly developed packaged sales business only accounted for 1%, 1% and 2% of revenue in Year 1 to Year 3.

## Applicable Listing Rules

GEM Rule 2.06 states that the GEM Rules are designed to ensure that investors have and can maintain confidence in the market and in particular that, applicants are suitable for listing.

GEM Rule 2.07 states that the GEM Rules are not exhaustive and that the Exchange may impose additional requirements or make listing subject to special conditions whenever it considers it appropriate.

GEM Rule 2.09 states that suitability for listing depends on many factors. Applicants for listing should appreciate that compliance with the GEM Rules may not itself ensure an applicant’s suitability for listing. The Exchange retains a discretion to accept or reject applications and in reaching its decision will pay particular regard to the general principles outlined in GEM Rule 2.06. Informal and confidential guidance may be sought from the Exchange concerning the eligibility of any proposed application for listing.

GEM Rule 11.06 states that both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.

## The Decision

The Exchange stated that uncertainty over a company’s future financial performance may cast doubt on its sustainability. Where the Exchange considers a company’s business model to be unsustainable, it will consider it unsuitable for listing.

The Exchange considered that the applicant’s business model and financial performance were uncertain and unsustainable. As the Exchange considered that these concerns could not be appropriately addressed by way of disclosure, it rejected the application.

### Deteriorating financial performance

In particular, the Exchange identified that the applicant did not have effective measures to manage its exposure to substantial fluctuations in raw materials, both during the track record period and going forward. The gross profit margin of its manufacturing activities had been even lower than that of its trading activities. The Exchange doubted whether the applicant’s gross profit margin was sustainable in the long run.

Much of the applicant’s revenue was derived from the recent appreciation of RMB against USD during the track record period. Foreign exchange rates, however, can fluctuate volatilely. Moreover, the applicant had supported its daily working capital through borrowings with increasing borrowing costs during the track record period, even after taking into account the substantial interest-free loans from its controlling shareholder. The Exchange considered that, given the low profit margin, further increases in borrowing costs could cancel out the company’s net profit completely.

### Uncertainty over the prospect of the applicant’s business

The Exchange stated that the significant fall in the applicant’s bulk sales business had not been compensated by its expansion in the packaged sales business. Moreover, the growth of the applicant’s packaged sales business had been sluggish. During the track record period, the business only accounted for less than 3% of the total revenue each year. Therefore, the Exchange doubted that the applicant’s future financial performance could be improved and its business sustained.

## Conclusion

The Listing Decision seems to suggest a shift away from the disclosure-based approach towards a more merit-based approach when the Exchange considers listing applications. Moreover, the Exchange seems to interpret ‘suitability for listing’ as stipulated in the Listing Rules to be its judgment as to an applicant’s business sustainability and future prospects. If the Exchange concludes that an applicant’s business is unsustainable or uncertain, the Exchange will not approve the application even if the relevant issues are fully disclosed in the listing document.

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