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[online version](http://www.charltonslaw.com/hong-kong-stock-exchange-publishes-listing-decision-on-whether-deteriorating-financial-performance-after-track-record-period-and-other-factors-rendered-applicant-unsuitable-for-listing/)

# Hong Kong Stock Exchange Publishes Listing Decision On Whether Deteriorating Financial Performance After Track Record Period And Other Factors Rendered Applicant Unsuitable For Listing

## Introduction

In May 2013, the Stock Exchange of Hong Kong (the **Exchange**) published a listing decision (HKEx-LD73-2013) (the **Listing Decision**) regarding whether a Main Board listing applicant’s non-compliance, uncertainties over its principal retail stores and deteriorating financial performance after the track record period rendered it unsuitable for listing on the Exchange.

The Exchange determined that the cumulative effect of the uncertainties would impact on the applicant’s future performance and that this could not be adequately addressed by disclosure in the prospectus. It therefore rejected the application to list. This seems to be a shift away from the Exchange’s professed disclosure-based approach towards a more merit-based approach.

The [Listing Decision](http://www.hkex.com.hk/eng/rulesreg/listrules/listdec/Documents/ld73-2013.pdf) [[archived copy](ld73-2013.pdf)] is available on the Exchange’s website.

## Facts

The listing applicant was a retailer and had three principal retail stores (Stores A, B and C), all of which were leased properties. The three stores accounted for approximately 80% of the listing applicant’s revenue during the track record period.

The applicant’s prospectus included financial results for Years 1 to 3 and a stub period of five months in Year 4 which met the profit test requirement under Rule 8.05(1)(a).

## Non-compliance and Uncertainty over Store A

Store A contributed over 30% of the listing applicant’s revenue during the track record period. The use of five out of six floors in Store A was not the use permitted under the occupation permit of the building and there were also unauthorized building works in Store A (the **Breach**). The applicant had been operating Store A for over 30 years and leased the premises at below the market rate for shops. The applicant surrendered three out of five floors in Store A to the landlord after the Track Record Period, since the Breach in relation to these floors was a material breach under the relevant building laws. The Directors estimated that Store A’s annual revenue would reduce by 10% as a result.

The applicant submitted an alteration work proposal (the **Proposal**) to the relevant authority to rectify the unauthorized building works on the remaining floors in Store A after the Track Record Period. The proposed alternation work would commence in the first half of Year 5 and would take six months to complete if the relevant authorities approved the Proposal. During this period, Store A’s sales were expected to reduce by 50%. Otherwise, it would need to move to another location. The renovation of the new retail store was expected to take approximately four months, and revenue to be derived from the new retail store was expected to reduce by 20% as compared to Store A during its first three months of operation.

## Deteriorating Financial Performance

The applicant’s financial performance deteriorated significantly subsequent to Year 3. The Directors attributed the decline to general economic slowdown, the closure of another two retail stores during the period and listing expenses, and considered the impact of these factors to be short term or one-off. The revenue and net profit (excluding the effect of listing expenses) in Year 4 were expected to decrease by over 10% and over 30%, respectively compared with Year 3.

## Stores B and C

The leases of Stores B and C were due to expire in the first half of Year 5. The applicant had only secured a lease renewal of Store B but had yet to commence negotiation with the landlord of Store C on renewal. Store C’s rental was expected to increase by 10% to 20% upon lease renewal.

## Applicable Listing Rules

Rule 2.03 states that the Listing Rules are designed to ensure that investors have and can maintain confidence in the market and in particular that, applicants are suitable for listing.

Rule 2.04 states that the Listing Rules are not exhaustive and that the Exchange may impose additional requirements or make listing subject to special conditions whenever it considers it appropriate.

Rule 2.06 states that suitability for listing depends on many factors. Applicants for listing should appreciate that compliance with the Listing Rules may not itself ensure an applicant’s suitability for listing. The Exchange has the discretion to accept or reject applications and in reaching its decision will pay particular regard to the general principles outlined in Rule 2.03.

Rule 8.04 states that both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.

## Decision

The Exchange concluded that the cumulative effect of the incidents of non-compliance, the substantial decline in results during the first five months of Year 4, uncertainties over the physical condition of Store A and the lease renewal of Store C would impact the applicant’s future performance. As the Exchange considered that these concerns could not be appropriately addressed by way of disclosure, it rejected the application.

### Non-compliances and uncertainty over Store A

The Exchange noted that legal and regulatory non-compliance may affect an applicant’s suitability for listing. It stated that where a substantial part of the profits are derived from operations that are in breach of law, it casts doubt on whether the applicant’s historical results is a reasonable and fair basis for assessing whether the profit requirement is met. It set out the following as factors it will take into account in determining the impact of non-compliance incidents on an applicant’s listing:

* the nature, the extent and the seriousness of the breaches, for example, whether the breaches involve dishonesty and fraud, whether the breaches involved newly established laws and regulations which may be subject to different interpretations by legal professionals;
* the impact of the breaches on the applicant’s operations; and
* the rectification and precautionary measures adopted and how promptly these measures were carried out.

The Exchange may also require the sponsor to provide the basis for its view that the applicant has adequate and sufficient procedures, systems and controls under Rule 3A.15(5) taking into consideration the non-compliances. The sponsor’s view may be required to be disclosed in the prospectus. The Exchange has expressed concerns in the past regarding listing applicants with serious incidents of non-compliance and only approved listing after these applicants had demonstrated compliance for a reasonable period of time.

The Exchange noted that the applicant had demonstrated that it could satisfy the profit test under Rule 8.05(1)(a) after adjusting the track record period’s results with market rent payable for Store A or assuming Store A had been operating without the three floors surrendered to the landlord. Yet it considered that the applicant’s future operation would be seriously affected irrespective of whether or not the relevant authority approved the Proposal in respect of the rectification work.

The conduct of the directors was also a relevant factor. The Exchange did not consider that the directors had taken sufficient steps to identify or rectify the Breach in Store A. Professionals were hired to perform inspections in Store A shortly before the listing application and a full assessment was performed only after the listing application was filed. Further, the applicant only submitted the Proposal to the relevant authority months after the Exchange had raised questions on the Breach.

While the Exchange acknowledged that premature negotiation with the landlord on lease renewal might not be in the applicant’s best interest, it noted the importance of renewing material leases for assessing the applicant’s sustainability after listing in light of the uncertainties over the continuing occupation in Store A.

### Deteriorating financial performance

The Exchange’s view was that the assessment of suitability is a continuous process and that the applicant must remain suitable for listing at the point of listing. The Exchange doubted the reliability of the track record performance for meeting the profit requirement. The Exchange noted the substantial decline in results during the first five months of Year 4 as well as the uncertainties over the physical condition of Store A and the lease renewal of Store C. Accordingly, the Exchange considered that the inclusion of a profit forecast in the applicant’s prospectus could not sufficiently address the doubt as to the applicant’s sustainability.

## Conclusion

Even where a listing applicant satisfies the profit test under Listing Rule 8.05(1), the Exchange may still reject its application to list on the grounds that it is not suitable for listing if there is uncertainty as to the 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. Less extreme cases may on the other hand be dealt with by disclosure of meaningful information regarding an applicant’s future performance in the light of a temporary deterioration of financial performance before listing.

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