

HKE_x LISTING DECISION
HKE_x-LD30-2012 (published in April 2012)

Parties	Company A – a Main Board listing applicant Group – Company A together with its subsidiaries Parent Company – Company A’s controlling shareholder
Issue	Whether Company A’s financial and operational reliance on Parent Company rendered Company A not suitable for listing
Listing Rules	Main Board Rule 8.04; Paragraph 27A of Appendix 1A of the Rules
Decision	The Exchange had concern on Company A’s suitability for listing under Rule 8.04 given that (i) Company A had not yet demonstrated its operational and financial independence from Parent Company; and (ii) Company A’s significant reliance on Parent Company raised the issue of the sustainability of Company A’s business, and determined that Company A should take concrete steps to address the issue of reliance on Parent Company before the Exchange would consider any further review of Company A’s listing application.

FACTS

1. Company A was a “*Product X*” manufacturer in China. It was a subsidiary of Parent Company, a “*Product Y*” manufacturer.
2. The Group started its business as the Product X production unit of Parent Company in the year preceding the Track Record Period (comprising Year 1, Year 2, Year 3 and the first six months of Year 4), supplying Product X to Parent Company and other manufacturers. The Group made its first sales of Product X to Parent Company in the third quarter of Year 2.
3. Company A applied for listing under Rule 8.05(3) given that it was unable to meet the profit requirement under Rule 8.05(1)(a) due to net losses in Year 1 and Year 2.
4. Since the Group’s first sales of Product X in Year 2, it had generated substantial revenue from sales to Parent Company and Parent Company had been the Group’s largest customer, representing over 75% of the Group’s total sales in Year 2, Year 3 and the first six months of Year 4. The Group expected future sales to Parent Company to account for more than 50% of the Group’s total sales volume in each of Year 4, Year 5 and Year 6.
5. For Year 3 and the first six months of Year 4, the Group generated less than 25% of its revenue from sales to independent customers. At the time of the listing

application, the Group had long-term sales contracts with only 4 independent customers.

6. The Group received significant advance payments from Parent Company for the purchase of Product X, which was a major funding source for the Group to finance its operation. Such advance payment represented about 20% of the estimated sales to Parent Company, a percentage that was two to four times higher than the percentage of advance payment received from independent customers. As at the end of each of Year 1, Year 2, Year 3 and the first six months of Year 4, advance payments from Parent Company ranged from about RMB3 billion to RMB7 billion. The Group would receive a total of about RMB2 billion as advance payment from Parent Company during the working capital forecast period of 15 months for ongoing purchases.
7. Parent Company's financial performance had been adversely impacted by the continued downturn in the industry in which it operated. For the third quarter of Year 4, Parent Company recorded gross loss, net loss and had net current liabilities.
8. Company A recorded volatile operating performance and financial position over the Track Record Period (e.g. net losses in Year 1 and Year 2, net current liabilities throughout the Track Record Period and negative operating cashflow for the six months ended Year 4), and its results had been deteriorating in the second half of Year 4 due to the downturn in the industry in which it and Parent Company operated.

APPLICABLE RULES AND PRINCIPLES

9. Rule 8.04 requires that both the issuer and its business, in the opinion of the Exchange, must be suitable for listing.
10. Paragraph 27A of Appendix 1A to the Rules provides that the listing document should include a statement explaining how the issuer is satisfied that it is capable of carrying on its business independently of the controlling shareholder (including any associate thereof) after listing, and particulars of the matters that it relied on in making such statement.
11. Reference is made to Listing Decision HKEx-LD107-1 which states that "[t]here is no bright line test to determine whether an applicant's reliance on a single major supplier or customer is an extreme case which impacts on suitability for listing." In assessing a case of reliance on a single customer, the Exchange will take into account various factors set forth in the listing decision.

ANALYSIS

12. The Group's significant reliance on Parent Company during the Track Record Period gave rise to the Exchange's concern on whether the Group was able to operate independently of Parent Company, given that:-

Operational reliance

- (i) the Group's sales to Parent Company did not show a decreasing trend during the Track Record Period and the expected sales to Parent

Company would remain significant after listing. In the past, the Exchange has accepted a certain level of reliance on sales to a parent company after listing because the relevant market of the listing applicant was dominated by only a few key market players. However, the Exchange considered Company A's case different since the industry in which it operated was more fragmented;

- (ii) while the Group expected to diversify its customer base, it only had long-term sales contracts with 4 independent customers (2 contracts signed in each of Year 3 and Year 4) and the sales volume under these contracts were insignificant when compared with the Group's expected sales volume to Parent Company during the same period;
- (iii) the Group's ability to sell Product X could be further impaired by weak market demand and rapidly declining average selling price as a result of the downturn in the industry in which it operated. The average selling price of Product X dropped by more than 30% during the third quarter of Year 4 and the directors of Company A expected the decreasing trend to continue through Year 5;

Financial reliance

- (iv) the advance payment from Parent Company was significantly larger than advances received from independent customers and as such the Exchange considered that in substance the higher percentage of advance payment from Parent Company was financial assistance provided to the Group. Without the advance payment from Parent Company, the Group would likely be in a negative cash position given its current negative operating cash flow (see paragraph 8); and
- (v) Parent Company's financial performance had been adversely impacted by the continued downturn in the industry in which it operated and as a result the Group's future financial performance could be adversely affected if the financial performance of Parent Company, the Group's single largest customer, continued to deteriorate.

CONCLUSION

13. Based on the above, the Exchange considered that:-

- (i) Company A had been very reliant on sales to Parent Company during the Track Record Period. Although this reliance was expected to decline, it would still be significant after listing;
- (ii) the Group had received substantial advances from Parent Company for its sales of Product X;
- (iii) Parent Company's financial results had been adversely impacted by the continued downturn in the industry in which it operated; and
- (iv) the Group was therefore financially and operationally dependent on Parent Company, a company that had been adversely impacted in recent financial periods. Consequently, the sustainability of the Group's business was

significantly dependent on a company whose sustainability was currently very uncertain.

14. Having considered all relevant facts and circumstances, the Exchange determined that Company A had not yet demonstrated its operational and financial independence from Parent Company and that Company A's significant reliance on Parent Company also raised the issue of the sustainability of Company A's business and Company A's suitability for listing under Rule 8.04. The Exchange further determined that Company A should take concrete steps to address the issue of reliance on Parent Company before the Exchange would consider any further review of Company A's listing application.