

HKEx LISTING DECISION
Cite as HKEx-LD51-1 (March 2006)

Summary	
Name of Parties	Company A - a Main Board listing applicant and its subsidiaries (the ‘Group’) Parentco - Company A’s controlling shareholder and a state-owned enterprise
Subject	Whether Company A’s reliance on its parent for certain aspects of its operations rendered Company A not suitable for listing?
Listing Rules	Listing Rule 8.04; Part A of Appendix 1, Paragraph 27A; General Principles On Land Title Requirements For PRC Mainland Properties
Decision	The Exchange determined that Company A was suitable for listing and the issues arising from its reliance on its parent could be dealt with by way of disclosure in the prospectus.

SUMMARY OF FACTS

1. Company A was principally engaged in the manufacture of Product X in its production plant.
2. For the purpose of listing Parentco transferred the core businesses in relation to the manufacture of Product X to Company A. These included the injection of financial management capabilities, research and development facilities, sales and purchase operations, and the transfer of staff. However, Parentco retained, amongst other things, the utilities plant (for energy supply), social and ancillary facilities (such as schools, hospitals and miscellaneous equipments); land and factory premises under its own name.
3. A review of Company A’s listing application necessitated a review of the extent of Company A’s reliance on Parentco. In particular, the following aspects were considered by the Exchange:
 - a. that utilities and social and ancillary services retained by Parentco and utilities expenses accounted for approximately 10% of the costs of goods sold for the last financial year of the track record period;
 - b. that approximately 50% of the land and 60% of the properties that Company A occupied for its operations were owned by and leased from Parentco;

- c. that products were sold to and purchase from Parentco;
 - d. that common management existed between Company A and Parentco – with five out of six executive directors of Company A having executive roles in Parentco; and
 - e. that Company A was financially dependent on Parentco.
4. In response to the Exchange’s review, the following submissions of the sponsor were noted:

Regarding reliance on Parentco’s utilities and social and ancillary services

- a. that Parentco was a stable supplier of quality utilities at reasonable price. Although it was possible to seek independent suppliers, the executive directors of Company A considered that it would be commercially sensible to continuing using such services and facilities;
- b. that Company A had the exclusive right to terminate the supply and service agreements and Parentco agreed to indemnify Company A against its losses being suffered as a result of unexpected supply disruption caused by Parentco;

Regarding reliance on land and properties held by Parentco

- c. that leased agreements were entered into on fair and reasonable terms. The sponsor and the property valuer had confirmed that the rents were determined with reference to the prevailing market rates;
- d. that it would not be commercially viable for Company A to acquire the land and properties from Parentco as the substantial cost would have an adverse impact on the IPO share price, the profit and the return on equity;
- e. that Company A did not consider the leased properties were crucial to the operations of the Company A as the production lines could be relocated easily. The time required for the relocation would be two to three months, and the relocation costs would not be significant. In addition, Parentco would bear all the relocation expenses if Company A was required to move out of the relevant land and properties within five years after listing;
- f. that additional measures were put in place to protect the interests of Company A. For example:
 - Company A could terminate and renew the agreements unilaterally and had an option to buy the relevant land and properties;

- the terms of any renewal of lease agreements would be decided by the independent non-executive directors of Company A. Any decision to acquire the leased land and properties from Parentco would be considered by the board of directors of Company A and the independent non-executive directors;
- Parentco undertook to use its best endeavour to honour its obligations under the lease agreements. The directors believed that Parentco being a state-owned enterprise, the possibility of Parentco not honouring its obligation would be extremely remote;

Regarding the purchases and sales of products from and to Parentco

- g. that the auxiliary materials to be purchased from Parentco were low-end products and third party suppliers could be found easily; and
- h. that the materials sold to Parentco were mainly fuel, coal and industrial chemical products required by both Company A and Parentco in their operations. Prior to the reorganisation, such purchases were made through the internal material department of Parentco, which became part of Company A after the reorganisation. The directors of Company A considered that it would be more cost effective for this department to buy in bulk, and to resell part of the materials to Parentco;

Regarding common management

- i. although they shared common management they were not afflicted by any conflict of interest issues as they did not operate competing businesses;
- j. that the executive directors were prepared to devote most of their time and attention to the management of Company A as the remaining businesses of Parentco would not demand significant management time and effort; and

Regarding financial dependence

- k. that before listing, all the relevant guarantees provided by Parentco would be released or replaced by Company A's own guarantees and all non-trade balances with related companies would also be fully settled.

THE ISSUE RAISED FOR CONSIDERATION

- 5. Whether Company A's reliance on its parent for certain aspects of its operations rendered Company A not suitable for listing?

APPLICABLE LISTING RULES OR PRINCIPLE

6. Listing Rule 8.04 states that:

Both the issuer and its business must, in the opinion of the Exchange, be suitable for listing.

7. Part A of Appendix 1, Paragraph 27A of the Listing Rules requires:

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' in the listing document.

8. Reference is made to Listing Decision HKEx-LD42-1, paragraph 7 states that:

when interpreting the requirements under Part A of Appendix 1, Paragraph 27A of the Listing Rules, the Exchange normally requires an applicant to take into account the following:-

- a. financial independence;
- b. independent access to sources of supplies/raw materials for production;
- c. independence of production/operation capabilities; and
- d. independence of access to customers and independent management.

9. HKEx News Release entitled 'Clarification on Requirements for Land Use Title of Properties situated in the Mainland of the People's Republic of China' published on 25 March 1998 states the requirements as to when land use right certificates and/or building ownership certificates in relation to properties situated on the PRC mainland must be obtained for new listing applications:

Where the listing applicant is an infrastructure project company or property company, the requirement is strict. A listing applicant which is neither an infrastructure project company nor a property company would also be expected to have the relevant long-term land use right certificate and/or building ownership certificate for a mainland property where the property is crucial to its operations.

THE ANALYSIS

10. Listing Decision HKEx-LD42-1 categorised the ways in which an applicant might be dependent on its controlling/substantial shareholders and in each category the degree of dependence of an applicant on its controlling/substantial shareholders might be higher or

lower. Where the degree of dependence is excessive, this would translate into a concern on suitability for listing. When reviewing the reliance issue, the Exchange ordinarily would take into account the particular facts and circumstances of an applicant.

11. The Exchange noted that it is common amongst H-share companies previously part of large state-owned enterprises that they rely, to a certain extent, on the facilities provided by their controlling shareholder. In the present case, the Exchange considered the following factors:
 - a. there were sound commercial reasons for continuing the arrangements with Parentco, and these arrangements were common amongst other H-share listed companies;
 - b. the background to and details of the arrangements and the risks thereof had been highlighted in the prospectus;
 - c. the continuing arrangements with Parentco were designed to ensure Company A's access to such facilities and services on a long-term basis at Company A's discretion; and
 - d. based on the submissions of the sponsors, the Exchange was satisfied that the leased land and properties were not crucial to the operations of Company A that it should obtain ownership thereof.
12. In light of the above, the Exchange determined that Company A was not reliant on Parentco to an extent that would render it not suitable for listing under Listing Rule 8.04.

THE DECISION

13. Based on the facts and circumstances of the case and the Exchange's analysis of the Listing Rules, the Exchange determined that Company A was suitable for listing and the issues arising from its reliance on Parentco could be dealt with by way of disclosure in the prospectus.