**HKEx LISTING DECISION**
**HKEx-LD73-2013 (published in May 2013)**

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| **Parties** | Company A – a Main Board listing applicant |
| **Issue** | Whether Company A's non-compliances, uncertainties over the principal retail stores and deteriorating financial performance subsequent to the Track Record Period would render it unsuitable for listing |
| **Listing Rules and Regulations** | Main Board Rules 2.03, 2.04, 2.06 and 8.04 |
| **Decision** | The Exchange considered that the cumulative effect of the number of uncertainties would impact Company A's future performance which could not be adequately addressed by disclosure in the prospectus. Company A was considered not suitable for listing for the time being. |

## FACTS

1. Company A was a retailer and had three principal retail stores (Stores A, B and C), all of which were leased properties. The three stores contributed around 80% of Company A's revenue during the Track Record Period. Company A's prospectus included its financial results from Year 1 to Year 3 and a stub period of five months in Year 4 which met the profit test requirement under Rule 8.05(1)(a).

2. The Exchange noted the following material issues in its listing application:

*Non-compliances and uncertainty over Store A*

3. Store A contributed over 30% of Company A's revenue during the Track Record Period. The use of five out of the six floors in Store A was not the ones permitted under the occupation permit of the building and there were also unauthorized building works in Store A (the "**Breach**"). Company A had been operating Store A for over 30 years and was leasing Store A at below the prevailing market rate for shops.

4. The Breach relating to three out of Store A's five floors was regarded as a material breach under the relevant building laws. Company A surrendered these three floors to the landlord after the Track Record Period. The Directors estimated that Store A's annual revenue would reduce by 10% as a result of the surrender of the three floors.

5. Company A submitted an alteration work proposal (the "**Proposal**") to the relevant authority for the rectification of the unauthorized building works on the remaining floors after the Track Record Period. Pending approval of the Proposal by the relevant authorities, the proposed alteration work would commence in the first half of Year 5 and would take six months to complete. During this period, Store A's sales was expected to reduce by 50%. If the Proposal were rejected, Store A 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*

6. Company A's financial performance deteriorated significantly subsequent to Year 3, recorded a net profit of HK$1 million during the first five months of Year 4 and forecasted a full year net profit of approximately HK$9 million in Year 4. The Directors explained that the decline was due to general economic slowdown, the closure of another two retail stores during the period and listing expenses, and considered that 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 comparing with Year 3.

7. The Directors confirmed that Company A would have sufficient working capital for at least 12 months after the date of the prospectus.

*Others*

8. The leases of Stores B and C were due to expire in the first half of Year 5. Company A only secured a lease renewal of Store B but had yet to commence negotiation with the landlord of Store C on renewal. Company A estimated that Store C's rental would increase by 10% to 20% upon lease renewal.

## APPLICABLE LISTING RULES

9. 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.

10. 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.

11. 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.

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

## ANALYSIS

*Non-compliances and uncertainty over Store A*

13. The Exchange considers that breaches of laws and regulations may affect an applicant's suitability for listing. 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 profit requirement is met. The Exchange takes into account the following factors in determining the impact of non-compliances on an applicant's listing:-

a. 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;

b. the impact of the breaches on the applicant's operations; and

c. the rectification and precautionary measures adopted and how promptly these measures were carried out.

14. The Exchange may request the sponsor to provide the basis of 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 Exchange may request the sponsor's view be disclosed in the prospectus.

15. The Exchange has expressed concerns over listing applicants with serious non-compliances and only approved listing after these applicants had demonstrated compliance for a reasonable period of time.

16. The Exchange noted that Company A 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 involving the Breach. However, the outcome of Company A's Proposal remained uncertain. Company A's future operation would be seriously affected irrespective of whether the relevant authority approved the Proposal or not (see paragraph 5).

17. Directors' conduct was also a factor for consideration. During the previous lease terms of Store A (more than 30 years), the Exchange did not consider that the Directors had taken sufficient steps to identify or rectify the Breach. 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, Company A submitted the Proposal to the relevant authority only towards the end of Year 4, months after the Exchange had raised comments on the Breach.

18. While the Exchange acknowledged that pre-mature negotiation with the landlord on lease renewal might not be in the best interest of Company A, the Exchange noted the importance of renewing material leases for assessing Company A's sustainability after listing in light of the uncertainties over the continuing occupation in Store A.

*Deteriorating financial performance*

19. The Exchange is of the view that the assessment of suitability is a continuous process and an applicant must remain suitable for listing at the point of listing. Even if an applicant satisfies the profit test under Rule 8.05(1), if its results decline after the track record period or is very likely to decline substantially after listing, the applicant must explain and justify the reasons for the decline.

20. With the information provided which normally includes a profit forecast memorandum submitted to the Exchange for this purpose, the Exchange will be able to understand whether there is a continuing concern that affects suitability for listing, and assess the applicant's sustainability with a greater degree of reliability. This is particularly the case

where the financial year following the end of the track record period is well advanced when a listing hearing takes place.

21. In Company A’s case, the Exchange noted substantial decline in results during the first five months of Year 4. This coupled with the uncertainties over the physical condition of Store A (had it been operating under the Proposal or relocated) and the lease renewal of Store C (both of which had contributed significantly to Company A’s revenue during the Track Record Period) cast doubt on the reliability of the track record performance for meeting the profit requirement.

22. Accordingly, the Exchange considered that the inclusion of a profit forecast in Company A’s prospectus could not sufficiently address the doubt on sustainability, while the Exchange may consider this method acceptable in less extreme cases by providing meaningful information about an applicant’s future performance in light of a temporary deterioration of financial performance before listing.

**CONCLUSION**

23. The Exchange considered that the cumulative effect of the number of uncertainties would impact Company A’s future performance and these uncertainties could not be adequately addressed by disclosure in the prospectus. Company A was considered not suitable for listing for the time being.