THE LISTING DECISION BY THE STOCK EXCHANGE OF HONG KONG LIMITED ON REASONS FOR THE REJECTION OF CERTAIN LISTING APPLICATIONS IN 2018

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On 22 March 2019, The Stock Exchange of Hong Kong Limited (the "**Hong Kong Stock Exchange**") published a listing decision (LD121-2019) to provide guidance on the reasons for rejecting 24 listing applications in 2018, an eight-fold increase from 3 in 2017. Such increase in the number of rejections of applications is due to a heightened level of scrutiny exercised by the Hong Kong Stock Exchange in its assessment of suitability of listing applicants, and the exercise of its discretion to determine whether there are facts and circumstances to form a reasonable basis to believe that the applicants are likely to invite speculative trading upon listing or to be acquired for their listing status.

The Hong Kong Stock Exchange has emphasised that a greater level of scrutiny is now placed on the applicant's (1) commercial rationale for listing and whether there was a genuine need for funding, and (2) valuation and the methodology used, when vetting the listing applications.

The factors considered by the Hong Kong Stock Exchange in rejecting the listing applications are summarised below.

Suitability

1. *Lack of commercial rationale for listing and thus no genuine funding needs* – 15 applicants failed to:
    - substantiate the commercial basis for the proposed expansion plans, and the proposed expansion plans were not commensurate with their previous business strategies and financial performance;
    - explain how their application of the IPO proceeds makes commercial sense, and where the applicants intended to apply the proceeds from IPO to acquire land or property for use as a showroom, office premises or retail outlets, and the cost savings derived from owning as opposed to leasing the properties was noted to be immaterial; or
    - demonstrate a genuine funding need as the applicants had previously relied upon internally generated funds to finance their operations during the track record period (the "**TRP**") and would be able to fund the proposed expansion plans with internal resources and/or debt financing.
2. *Unsupported valuation* – 3 applicants failed to justify:
    - why the forecasted price-earnings ratios were higher than those of industry peers;
    - the basis on which the peers were chosen; and
    - how such valuations were reasonable in light of the applicant's history and profit forecasts.
3. *Packaging* – An applicant failed to demonstrate that the various companies recently restructured under the proposed listing group had operated as a single economic unit during the TRP, leading to the view that the applicant's reorganisation had been done solely to meet the eligibility requirements

of the Hong Kong Listing Rules.

4. *Deterioration of financial performance* – One applicant had showed a significant deterioration in its financial performance during the TRP and there was insufficient basis to believe that its diversification into a new segment would improve its financial condition as this was a recent development and long term prospects of the new business were uncertain.
5. *Suitability of director or person of substantial interest or controlling shareholder* – 3 applicants' director(s) or person(s) of substantial interest or controlling shareholder(s), who had significant influence on the operations and management of the applicants during the TRP, had previously been convicted of offences relating to dishonesty, thus rendering the applicants unsuitable for listing.
6. *Sustainability of business* – One applicant's revenue during the TRP was derived from a separate business operated by its controlling shareholder. The following concerns have led to the question of whether the applicant's business is sustainable:
   - the delineation of the applicant's business from its controlling shareholder did not conform with industry norms;
   - the arrangements with the controlling shareholder were not on normal commercial terms; and
   - there was uncertainty whether arrangements with independent customers would generate a similar amount of sales.

Eligibility

1. *Failure to meet the minimum net profit requirements after excluding non-ordinary course income* – One applicant engaging in development and sale of residential and commercial properties in the PRC derived income from the gain on the disposal of a training institute (which was developed and operated using a one-off government subsidy). Such income was excluded for the purposes of determining the applicant's net profits and thus whether it satisfied the minimum net profits requirements under the Hong Kong Listing Rules on the grounds that:
   - the subsidy, the construction of the training institute and the subsequent disposal did not form a part of the applicant's ordinary course of business and were non-recurring; and
   - the subsidy and the gain on the subsequent disposal were accounted for differently from the rest of the applicant's developments.
2. *Failure to meet the qualification requirements for transfer from GEM to Main Board* – One applicant had been a subject of a disciplinary investigation by the Hong Kong Stock Exchange in relation to serious breaches of the GEM Listing Rules for the past 12 months prior to its application to transfer to the main board, rendering it unqualified for the transfer from GEM to the main board.

Others

Failure of the sponsor to satisfy the independence requirement –One applicant's sole sponsor in the applicant's application to transfer from GEM to the main board was also the sole sponsor and the compliance adviser of the applicant's previous main board listing application. Since the sole sponsor's role in the transfer application will involve the review of the applicant's compliance records during the period when it acts as the applicant's compliance adviser, such relationship will lead to a perception that the sole sponsor may not objectively assess the applicant's compliance records.

The above rejected applications reflect the change in the Hong Kong Stock Exchange's IPO vetting process and the new initiatives of the Hong Kong Stock Exchange shown in recent developments such as the GEM Listing Rules amendments in February 2018 and the Consultation Paper regarding Backdoor Listing published in June 2018. Against the backdrop of speculative trading commonly seen in the securities of new applicants, it is expected that the Hong Kong Stock Exchange will continue to step up its efforts and take a stringent approach in the IPO vetting process in order to avoid listing of new applicants involving shell creation activities.