CFA Society
Hong Kong

27 / January / 2021

Hong Kong Exchanges and Clearing Limited
8th Floor, Two Exchange Square
8 Connaught Place
Central
Hong Kong

Re: Profit Requirement CP

Dear Sir / Madam,

Consultation Paper on the Main Board Profit Requirement

CFA Society Hong Kong is pleased to provide you with our perspectives on areas for consideration in relation to the consultation paper issued by Hong Kong Exchanges and Clearing ("HKEX") on the main board profit requirement.

In the response, we* disagree with the proposed changes. Reasons include:

Historical profit or historical P/E is an arbitrary line, the current misalignment is a result of prior measures, the issue of "shell" should be dealt with separately from IPO requirements, market mal-practices should be handled with stronger gatekeeping, small-cap issuers are ingredients to a thriving eco-system, start-ups need fundraising platforms, Hong Kong's stock exchange should not fall behind competing platforms, the proposal can be seen as a form of financial repression, and GEM board is not a practical alternative.

For detailed elaboration, please refer to the attached questionnaire.

Should you have any question, please do not hesitate to contact me or our office staff, Mr. Ryan Lam at ryan.lam@cfahk.org / 2523 2917.

Yours faithfully,

Richard Mak, CFA
President
CFA Society Hong Kong

*"We" here represents nearly 90% of members who have come forward and provided their comments on this consultation paper.

Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below on the proposed change discussed in the Consultation Paper downloadable from the HKEX website at:
https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Consultation-Paper/cp202011.pdf

Where there is insufficient space provided for your comments, please attach additional pages.

Capitalised terms have the same meaning as defined in the Consultation Paper unless otherwise stated.

1. Do you agree that the Profit Requirement should be increased by either Option 1 (150%) or Option 2 (200%)? Please give reasons for your views.

   ☐ Yes

   ☑ No

   You may provide reasons for your views.

We* disagree with the proposed increase in the Profit Requirement for the following reasons:

One of the key reasons given for the proposed increase in the Profit Requirement is to reduce the implied historical P/E ratios of listing applicants which only just meet the minimum Profit Requirement and Market Capitalization Requirement. In our view, the Exchange may be exaggerating the importance of historical P/E ratios. A historical P/E ratio derived from the historical profit figure is only one factor among many in investment decision making. An issuer's prospects are more important to the investment decision than historical P/E ratios. Therefore, drawing an arbitrary line in relation to historical profit serves limited useful purposes, and raising the level of this arbitrary line does not improve the position.

The discussion relating to the increase in listing applications (after 2018) from Small Cap Issuers typically "in traditional industries" and with "relatively high historical P/E ratios" runs the risk of being seen as "the tail wagging the dog" or "turning a result on its head." It could be said that the increase in the Market Capitalization Requirement in 2018 caused the "misalignment" between the minimum Market Capitalization Requirement and the minimum final year profit requirement. Many small-cap, potential issuers would have wanted to list at a lower P/E ratio. If they had been successful, and with more of these small cap issuers listed under a lower Market Capitalization Requirement, then the situation would not have arisen involving "an increase in listing applications from Small Cap Issuers … [that] had relatively high historical P/E ratios". In some cases, companies have been forced into this position by the regulatory change of 2018.

The manufacture of "shell" companies in itself may not be the right focus in the context of IPOs. From a Hong Kong perspective, "shell" companies have come to carry negative connotations, some may say. However, in the investment community and from, say, the US' perspective, a listed holding company/structure (whether, for example, as a holding company, a SPAC or a “shell”) has a neutral meaning. We have long been used to seeing, and many global investors are now keen to invest in, a group of companies commonly called SPACs in the US. Moreover, the line distinguishing a “shell” company from a genuine small or medium-sized company is a fine one. Raising the bar for listing to eliminate so-called potential “shell” listings runs the risk of collateral damage. Small and medium-sized companies with solid management and earnings potential are likely to be negatively impacted. As legitimate listing candidates, they will lose a vital fundraising channel.

The discussion regarding whether allegedly “inflated valuations” genuinely reflect “expected market clearing prices” and “suspected abusive behaviours such as manufacturing of an artificial shareholder base” raises issues. We as investment practitioners would expect the Exchange, the regulators, sponsors, and other professionals to play active roles in monitoring as gatekeepers and promoters of the capital markets. In the end, of course, it is also a case of buyer beware.

However, these concerns should not be used as the basis for disadvantaging small-cap companies. A functioning capital market should offer access to a diverse range of issuers. Big cap, small cap, new economy, old economy, high tech sectors, traditional sectors, value stocks, growth stocks are ingredients of a thriving eco-system. Business cycles in an environment of “new normal” can be volatile. When the internet bubble burst in 2000, high tech stocks were stocks to be avoided. Then, mining companies became popular because of their asset values. Fads come and go. What we as investment practitioners would like to see is diversity in the offering. Financial investors could add value to the capital market (and society) as a force who can recognize value. We can help raise market efficiency by allocating resources from one segment of the economy to another. However, if the Exchange only offers “big cap” or “new economy” companies, investors will have no choice but to chase the current winners. As to what happens when the fads subside, to quote Mr. Warren Buffett, “only when the tide goes out do you discover who’s been swimming naked”.

Hong Kong is a small but open economy. In recent years, there have been many start-ups. Not all of these are “new economy” companies. We are concerned that while the government, the business sectors, venture capital/private equity funds and the public are keen to promote start-ups who are by definition, small companies, the Exchange is unwilling to provide them with access to a fundraising platform.

To support these start-up initiatives and cater for non-start-up, small companies that are growing their businesses, the Exchange should consider lowering or even removing the Profit Requirement. Its removal would just put the Hong Kong Stock Exchange on par with some of the more developed western markets. We also notice that the STAR board in China has not adopted a similar unofficial cap of historical P/E ratio (23x) commonly believed to be used in the Shanghai Stock Exchange. This is regarded by many investors as a regulatory progress, removing unnecessary barriers in the IPO process. So, in this respect, we would expect the Hong Kong Stock Exchange to be at least on par with, not behind, these other exchanges. Driving out issuers may reduce the competitiveness of Hong Kong as an international financial centre and benefit competing platforms.

Raising the Profit Requirement can be seen as regressive rather than progressive. It could be seen as a form of “financial repression” in that one segment of the society is systemically disadvantaged. Given that the Exchange has a different listing requirement for biotech companies (which have no revenue, let alone profit) and mining companies, one may wonder if the playing fields are tilted. We do not believe that anyone has a crystal ball that can reliably or consistently predict business fortunes. The best we can hope for is that we create an eco-system in which information is transparent, the disclosure requirements are stringent, and policing and penalties are effective. Too many pre-conceived barriers and subjective judgments will only result in a regulatory regime that consistently produces ad hoc rulings in response to prior or current faults or misalignments.

While the GEM board is cited in the consultation paper as an alternative for Small Cap issuers if the profit requirement is raised, it is commonly perceived that GEM is not a well-functioning board. Over the years, the GEM board has essentially been relegated to a lesser quality board subject to numerous criticisms and even stigmas. Low liquidity, inferior quality, high listing expense (as a proportion of funds raised), and higher or equally stringent listing requirements (other than as to profit and market Capitalization) compared to the Main Board, are just some. So while on paper, an alternative platform exists, in practice, without a major revamp, issuers/their backers do not see GEM as a practical solution.

2. Besides the proposed increase in the Profit Requirement, is there any other alternative requirement that should be considered? Please give reasons for your views.

☑ Yes

☐ No

You may provide reasons for your views.

We consider that the Exchange should take a holistic approach to the reform of its structure and stratifications, and consider the practical solutions to allow the listing of small and medium-sized companies and start-ups raised in our response to Question 1 above.

The issue of shell companies should be regulated separately from the listing or IPO process.

The IPO process and responsible parties should be regulated according to a high standard under a disclosure-based regime.

3. Do you agree that the Exchange should consider granting temporary relief from the increased Profit Requirement due to the challenging economic environment? Please give reasons for your views.

☐ Yes

☐ No

You may provide reasons for your views.

Not applicable

4. If your answer to Question 3 is yes, do you agree with the conditions to the temporary relief as set out in paragraph 55? Please give reasons for your views.

☐ Yes

☐ No

You may provide reasons for your views.

Not applicable

Remarks:
* "We" here represents nearly 90% of members who have come forward to the Society and provided their comments on this consultation paper. The remaining ones support the proposal by citing that the change in Q1 is a reasonable compromise between profit requirement and investor protection, hence the temporary relief measures proposed in Q3 and Q4.

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