# Suitability for Listing

The Stock Exchange of Hong Kong Limited (the Exchange) issued a Guidance Letter on 3 June 2016 in relation to the issue of suitability for listing and the related Initial Public Offering (IPO) vetting considerations.

The Exchange notes that there have been a number of listed companies in which their controlling shareholders either changed or have gradually sold down their interests shortly after the minimum regulatory lock-up period of 12 months following a new listing. Although these are just normal share transactions when viewed on a stand-alone basis, such activities could lead to opportunities for market manipulation, insider trading and unnecessary volatility in the market post-listing, none of which is in the interest of the investing public. Accordingly, the Exchange has concerns in respect of listing applicants whose size and prospects do not appear to justify the costs or purpose associated with a public listing. These issues also raise questions regarding the reasons and justification for their listings.

The Exchange's concerns have led to a review of all new listings on the Main Board and Growth Enterprise Market between 2012 and 2014, together with selected companies in 2015, with the aim of identifying the characteristics of companies with suitability issues. Based on the review, the Exchange has identified in the Guidance Letter that such listings are associated with one or more of the following characteristics:

(i) small market capitalization;

(ii) only marginally meeting the listing eligibility requirements;

(iii) the fundraising being disproportionate to the listing expenses (ie a high proportion of the listing proceeds being used to pay the listing expenses);

(iv) pure trading businesses with a high concentration of customers;

(v) asset-light businesses, where the majority of the assets are liquid and/or current assets;

(vi) a superficial delineation of the business from the parent, whereby the applicant's business is artificially delineated from the parent by geographical area, product mix or different stages of development; and/or

(vii) having little or no external funding at the pre-listing stage.

These characteristics call into question whether such companies are suitable for listing and whether they should be subject to a more focused review by the Exchange.

 

In this regard, the Exchange expects that when a potential IPO applicant exhibits some of the seven aforementioned characteristics, the IPO application should provide a robust analysis to substantiate that the applicant is suitable for listing. In particular, special consideration should be given to the following areas:

(i) Use of proceeds – disclosure is required concerning the specific uses of proceeds which are commensurate with the applicant's past and future business strategy and observed industry trends. A commercial rationale for listing needs to be stated.

(ii) Future objectives and strategies –comprehensive analysis should be provided to demonstrate that the applicant has a detailed strategic plan for its business operations and growth.

(iii) Profit and revenue growth – where an applicant (a) has experienced decreasing or low profit and revenue growth; or (b) is expected to record decreasing or low profit and revenue growth after listing, a comprehensive analysis is required to substantiate that the applicant's business is sustainable.

(iv) Potential sunset industries – where an applicant is in a potential sunset industry or in an industry that has declining market prospects, the applicant must be able to demonstrate that it is feasible and that it has both the ability and resources to modify its business to respond to the changing demands of the market. The applicant should also demonstrate that the returns from the business justify the cost of listing.

The Exchange will take into account the facts and circumstances of each applicant and may impose additional requirements or conditions on applicants with the characteristics mentioned above. As such, a potential IPO applicant is always recommended to consult with the IPO professionals, such as reporting accountants, lawyers and sponsors, to get clarity on any potential issues in the early stage of an IPO process.

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