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DUAL FILING UPDATE

A newsletter to help market participants better understand the Dual Filing arrangements

Cases handled

During the year ended March 2012, we received 191 listing applications via The Stock Exchange of Hong Kong Ltd (SEHK), including nine applications for transfer to the Main Board by companies listed on the Growth Enterprise Market. We commented on 168 of the listing applications, and deferred commenting on nine cases because of fundamental issues or serious deficiencies in the initial submissions, which required substantial improvements to be made to the draft listing documents. Our average response time was seven working days [1].

Highlights

During the period under review, the Securities and Futures Commission (SFC) continued to note in a number of cases that the listing application materials were not up to the expected standard. Areas of concerns during the period under review include:

- Assertions of critical importance in some listing application materials were based on assumptions that were apparently at odds with observable facts.
- The initial listing application materials in some cases were apparently incomplete and not ready for regulators' review.
- Many draft listing documents failed to provide meaningful disclosures on the listing applicants' risks, historical financial performances and future plans for investors to make an informed assessment of the applicants' businesses and prospects.

The deficiencies highlighted above not only caused unnecessary delays in the vetting process, but, in some cases, also resulted in eventual suspension of the applications.

Failure to substantiate assertions of critical importance with objective analyses

Investors would reasonably expect listing documents to provide information on how a listing applicant can sustain its business if it is facing significant risks of business discontinuation. We noted in two extreme cases that the applicants claimed their operations to be sustainable based on assumptions that were apparently at odds with observable facts.

In one case involving a property developer outside Hong Kong, the listing applicant had net operating cash outflows during the track record period and significant investment commitments and borrowings falling due within one year. To demonstrate its working capital sufficiency, the applicant submitted a forecast predicting strong cash flows from its property sales based on forecast average selling prices that were approximately 30% higher than the historical average. However, the regulators' enquiries revealed that the actual cash flows for the first two months of the forecast period were much lower than the forecast

1 From April 2010 to March 2011, the SFC received 201 listing applications and commented on 160 cases. Please refer to Dual Filing Update Issue No. 4 January 2011 and Dual Filing Update Issue No. 5 August 2011 for background statistics.

because of exceptionally poor property sales in the traditional peak season. The regulators' enquiries also revealed that the applicant subsequently initiated a substantial price-cut for one of its property projects amidst widespread media reports of expected downturn in the property market. Despite the material adverse changes, the applicant revised upwards the forecast cash flows without offering any plausible explanation. It was questionable whether the forecasts were prepared on reasonable grounds and after careful consideration.

In another case, the listing applicant was a media products distributor with negative equity, which was expected to continue after listing. Despite its long operating history of over 10 years, the applicant has never reported any operating profit since establishment. To justify its viability, the applicant asserted that it would be profit making two years later assuming it managed to acquire and distribute more media products then. The listing application materials provided no objective information to demonstrate how the applicant would be able to turnaround in practice. On the contrary, the regulators' enquiries revealed that the applicant had only a patchy track record in acquiring commercially successful media products and that gross profits from some of its products could not even cover the corresponding amortisation and distribution costs. The application did not proceed after the regulators raised concerns on the bases of the optimistic assertions.

Liquidity problems or insolvency poses significant risks to the sustainability of a listing applicant. In cases where an applicant has experienced serious cash strains or continuing operating losses, the listing application materials should provide a balanced analysis of pertinent facts relating to the applicant's business and industry environment to demonstrate that the applicant and its business can continue as a going concern.

Listing application materials not ready for review

The relevant listing requirements in the Stock Exchange Listing Rules set out the minimum information and documents that should be provided when a listing application is submitted. However, the initial listing application materials in some cases were apparently incomplete and not ready for regulators' review.

In one case involving a listing applicant established in a newly recognised overseas jurisdiction, the initial listing application materials lacked a number of documents expressly required under the relevant listing requirements. In the absence of further submissions, the application ultimately did not proceed.

In two cases, the listing applicants relied on external investment managers to manage their investment portfolios and were required under the relevant listing eligibility requirements to demonstrate that their investment managers had the relevant investment experience. However, the initial draft listing document in one case did not contain the required disclosure whereas the draft in the other case stated that the proposed investment manager did not have any relevant experience in the field of the applicant's target investment. Both cases did not proceed after the regulators expressed concern on the qualifications of the investment managers.

In a few other cases, the initial draft listing documents submitted to the regulators contained not only due diligence questions requesting information from the listing applicants regarding their customers or directors, but also obvious errors and inconsistencies that were attributed to "inadvertent typos" when queried. In all these cases, substantial subsequent amendments needed to be made to the draft listing documents.

Submission of incomplete listing applications inevitably prolongs the vetting process at the expense of applicants. In order to facilitate efficient vetting, a listing application should enclose a substantially complete draft listing document and all other requisite supplementary documents under the relevant listing requirements.

Failure to provide meaningful disclosures on risks, historical financial performances and future plans

Investors rely on complete and relevant information in listing documents to make an informed assessment of applicants' businesses and prospects. We noted that many draft listing documents failed to provide meaningful disclosures on the listing applicants' risks, historical financial performances and future plans.

Risks

It is not uncommon that initial draft listing documents contain only boiler-plate risk warnings, which fail to explain clearly the relevance, significance and likelihood of the risks disclosed.

In one case involving a company that managed entrusted properties in return for rental income, the initial draft listing document disclosed that the applicant might incur significant losses because it had agreed to provide very high guaranteed rates of return to its clients. However, the document failed to disclose a meaningful analysis of the possible losses, such as a comparison of the market rent trend and the guaranteed returns for the various properties under the entrustment arrangements.

In another case, the listing applicant operated various non-profit entities that were prohibited by law from distributing dividends. To allow for dividend distribution, the entities must be converted into for-profit enterprises, which would operate under a different business model and tax regime. However, the initial draft listing document failed to disclose clearly the risks associated with such conversion and the different business model following conversion. The application did not proceed, leaving the issues unresolved.

Many draft listing documents cited as a risk factor that the applicants might not be able to obtain necessary government approvals for their development projects. However, the risk disclosures often failed to explain the risk in the context of the applicants' businesses, such as the materiality and nature of the applicants' projects that were pending government approvals at the time of listing.

Historical financial performances

The management discussion and analysis (MD&A) sections in many cases merely recited figures from the financial statements in narrative form with little or no meaningful explanation of the events causing the fluctuations in the applicants' financial performance. This issue is particularly common in the discussion of changes in gross profit margins and fair value gains.

Changes in gross profit margins

In one extreme case, the initial draft listing document merely stated that the decrease in the applicant's gross profit margin was because "[the] rate of increase in cost of sales was faster than the rate of increase in revenue." In another case, the initial draft listing document only stated that a decrease in the gross profit margin of one principal business segment was due to "differences in product varieties caused by changes in customer preferences". The specific reasons for the changes in product varieties and customer preferences were disclosed only after the regulators' enquiries.

Significant fair value gains

For some businesses, fair value gains may contribute a significant part of the profits. The initial draft listing documents in a number of cases failed to provide sufficient information for investors to understand the reasons for the significant fair value gains during the track record period and the bases and assumptions used in the estimation of the gains.

In a case involving a property developer outside Hong Kong, the estimated fair value of the applicant's investment properties was said to have more than doubled over the track record period although the applicant failed to lease out a substantial portion of the units and an industry report suggested that there was a severe over-supply of similar units in the market. However, the initial draft listing document failed to provide any meaningful explanation for the significant appreciation in the estimated capital value of the applicant's properties notwithstanding the unfavourable market conditions.

In one case, the applicant recorded a gain on certain biological assets acquired in the latest financial year. The initial draft listing document was silent on the fact that some of the biological assets had been infected with disease and that the fair value was estimated based on a "constant yield" assumption, contrary to the decreasing yield of the biological assets in reality. Upon regulators' further enquiries, the assumption was revised to take into account the expected decrease in yield over time, resulting in a reduction in the fair value gain.

In another case, the initial draft listing document disclosed that the fair value of the applicant's biological assets was estimated by an independent expert. Only upon the regulators' enquiries was it revealed that the expert had not conducted any physical count to ascertain the condition or quantity of an entire class of biological assets, which accounted for over 30% of the total fair value of the applicant's biological assets. The case did not proceed after the regulators enquired further into the bases of the valuation.

Future Plans

A number of initial draft listing documents provided very limited disclosures on the applicants' future plans, making it difficult to understand the justifications for and the feasibility of the plans, which might use up a significant portion of the listing proceeds.

In one extreme case, the use of proceeds was substantially revised after the regulators enquired about the details of the future plans, which raised concern on whether the original future plans were determined after careful consideration. Initially, the listing applicant allocated most of the net listing proceeds for expanding its existing business into China and other Asian countries. Upon queries, the applicant allocated most of the proceeds for diversifying into another business in China, because its existing business was strictly prohibited in China and it had not studied the feasibility of expanding into other Asian countries. The case did not proceed after the regulators expressed concern on the viability of the applicant's future plans and other critical issues, including the sustainability of the applicant's business.

In another case, the applicant intended to almost double its production capacity with most of its listing proceeds on the directors' belief that market demand would grow rapidly. However, the initial draft listing document failed to reconcile the directors' belief with the widespread media reports about weakening market demand. The draft also failed to provide meaningful justifications for the aggressive expansion plan given the historically low utilization rates of its production facilities and oversupply in the industry.

Investors rely on risk disclosures, management discussion and analysis and future plans to understand the specific events or factors driving the changes in a listing applicant's financial performance historically and going forward. The listing document should provide sufficient information tailored to the specific circumstances of the applicant for investors to make an informed assessment of the applicant.

The Dual Filing Update is available under 'Speeches, Publications & Consultations' – 'Publications' of the SFC website at http://www.sfc.hk.

Feedback and comments are welcomed and can be sent to dualfiling@sfc.hk.

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