How Hong Kong Could Maintain its Competitiveness as an International Financial Centre

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With its strong rule of law, robust financial infrastructure, and resilient capital market, Hong Kong has long been regarded as an international financial centre (IFC). Even so, Hong Kong faces significant challenges in maintaining its IFC status.

In March 2022, Long Finance and Financial Center Futures published the 31st edition of the Global Financial Centres Index (GFCI 31). Hong Kong maintains third place, with the rating dropped by one. Regarding competitiveness, Hong Kong ranks after Singapore from the perspective of the business environment and human capital in GFCI 31. Besides, Hong Kong drops six places to eleventh in financial sector development. Also, according to World Competitiveness Ranking by IMD, Hong Kong drops two places to seventh. In addition, Hong Kong has been experiencing a serious brain drain as people emigrate. Even the top market regulator in Hong Kong, the Securities and Futures Commission (SFC), lost 12% of its employees in 2021, according to Bloomberg. Moreover, investors often have concerns about the market liquidity and also expect Hong Kong to attract more new economy companies to get listed in Hong Kong.

Some macro and political factors may explain part of the challenges, such as the social unrest in 2019, the uncertainties brought by the China-US conflicts, and the relatively stringent Covid-19 social distancing measures. Besides these recent market disruptions, some deeper root causes of the challenges Hong Kong is facing to enhance its IFC status are worthwhile to be explored.

One of the important issues could be the weak corporate governance, actually for decades. The fact that almost 38% of Hang Seng Index (HSI) constituents are trading at less than the book value reflects the concern about the corporate governance issue. In this article, we first show that the low valuation problem in the Hong Kong market is prevalent and persistent. We then propose a simple model to analyze how corporate governance could be one of the culprits. We next suggest a few directions to look for solutions.

Investor protection is an anchor in any markets that fosters investor confidence and trust. Weak corporate governance could be one of the root causes challenging Hong

Kong's IFC status. We hope the analysis can draw more people's attention, and appropriate actions could be undertaken to enhance Hong Kong's status as an IFC.

Almost 38% of HSI Component Firms are Worth More Dead than Alive

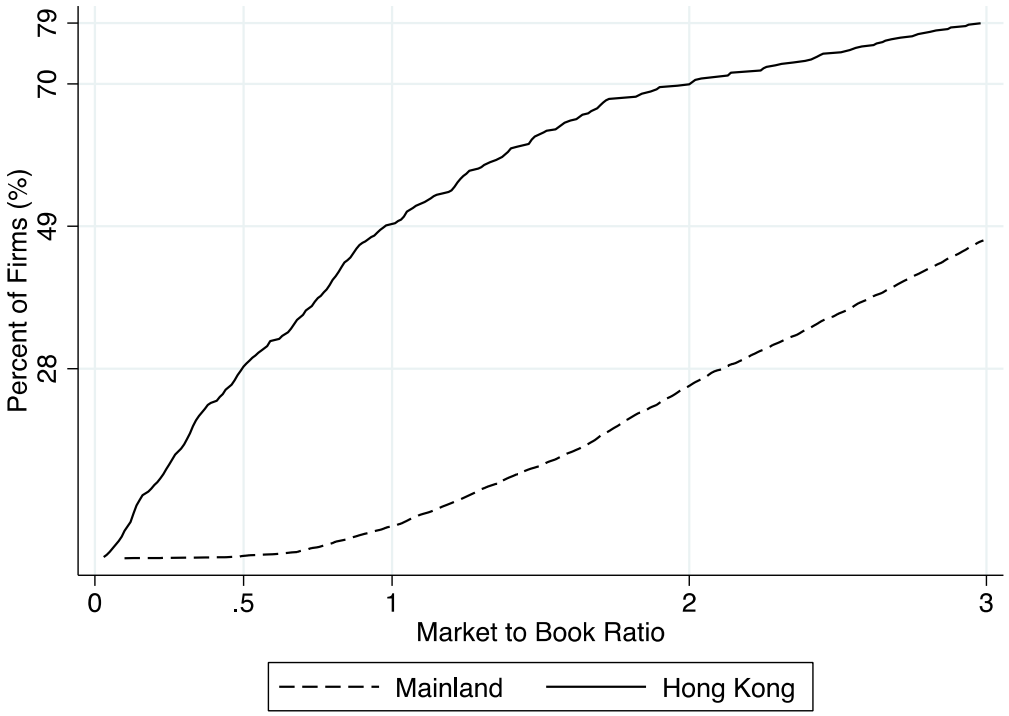
26 component firms of the prestigious Hang Seng Index (out of 69 or 37.68%) have a price-to-book ratio or market-to-book (PB, or MB ratio) below one as of 12/8/2022 (See Table 1). Among them, New World Development is 0.31, CKH Holdings 0.4, Henderson Land 0.41. If we view all firms in the index as one firm, the PB ratio is 0.83. The leading firms listed in Hong Kong as a whole are worth more dead than alive!

Table 1 Hang Seng Index Component Firms with Lowest Valuation

Name	Symbol	P/E	P/B
COUNTRY GARDEN	02007.HK	1.62	0.23
CHINA UNICOM	00762.HK	6.76	0.29
BANK OF CHINA	03988.HK	3.24	0.3
NEW WORLD DEV	00017.HK	59.35	0.31
CITIC	00267.HK	3.54	0.33
ICBC	01398.HK	3.53	0.37
CKH HOLDINGS	00001.HK	6.09	0.4
CCB	00939.HK	3.42	0.4
HENDERSON LAND	00012.HK	10.29	0.41
PETROCHINA	00857.HK	5.73	0.42
HANG LUNG PPT	00101.HK	15.67	0.43
SHK PPT	00016.HK	10.4	0.47
SINOPEC CORP	00386.HK	5.13	0.48
CHINA OVERSEAS	00688.HK	4.37	0.51
CK ASSET	01113.HK	9.44	0.53
WHARF REIC	01997.HK	25.93	0.55
CHINA LIFE	02628.HK	5.36	0.57
HSBC HOLDINGS	00005.HK	10.84	0.7
CHINA MOBILE	00941.HK	7.58	0.73
CNOOC	00883.HK	5.21	0.76
CHINA HONGQIAO	01378.HK	3.81	0.76
CHINA RES LAND	01109.HK	5.4	0.77
PING AN	02318.HK	6.37	0.83
LINK REIT	00823.HK	20.12	0.86
LONGFOR GROUP	00960.HK	4.41	0.87
BOC HONG KONG	02388.HK	12.8	0.99

If we look at the full universe of Hong Kong exchange (according to Compustat), 28% of listed firms have a PB ratio below 0.5, 49% with a PB ratio less than 1, and roughly 70% of companies with a PB ratio less than 2. More than 50% of companies listed on Shenzhen and Shanghai stock exchanges enjoy a PB ratio even higher than 3.

Figure 1: Distribution of Price-to-book Ratio in Mainland China and Hong Kong



In contrast, the PB ratio is 1.4 for CSI 300, 1.6 for MSCI emerging markets index, 2.9 for MSCI World index, and 4.2 for S&P500. To put these numbers in perspective, consider the current market capitalizations across stock exchanges in the world. NYSE is ranked first at 25T USD while HKEX ranked sixth at 5T, trailing Tokyo (5.2T), Shenzhen (5.3T), Shanghai (7.4T) and Nasdaq (17T). If the Hong Kong market valuation can be raised to the world average of 2.9 (as represented by MSCI World index that tracks 23 developed economies), then Hong Kong's market capitalization would increase by 3.5 times to 17 T to overtake Nasdaq. If it could be further raised to 4.2, the level of S&P 500, then Hong Kong stock exchange would beat NYSE to become ***the world's Number 1***.

Table 2 shows the median PB ratio across industries in Hong Kong and Mainland China at the end of 2018 and 2021. Across 10 different industries and both before and after the pandemic, the median PB ratio in Hong Kong is much lower than that in mainland. The low-valuation problem is not unique to real estate, but generally applies to all industries. For IT firms listed in Hong Kong, the valuation is only ¼ to 1/3 to their counterparts listed in mainland China. Healthcare firms listed in Hong Kong suffer 50%

off in their valuation. On average, the valuation in Hong Kong is about half of that in mainland. More technology-oriented sectors clearly can boost the overall valuation; however, the more first-order issue is to restore valuation for these companies within industry.

Table 2: Market-to-Book in End of 2021

	BM Ratio Median (2021)		BM Ratio Median (2018)	
Industry Name	Hong Kong	Mainland	Hong Kong	Mainland
Energy	1.64	1.77	1.34	1.36
Materials	0.70	3.03	0.84	1.85
Industrials	0.96	2.99	1.05	1.99
Consumer Cyclical	1.12	2.71	1.14	1.78
Consumer Staples	1.30	3.69	1.49	2.50
Health Care	1.85	3.51	1.27	2.39
Financials	0.51	3.50	0.91	2.42
Information Technology	1.17	4.09	1.06	2.75
Communication	1.30	3.08	1.22	2.06
Utilities	0.49	1.87	0.44	1.29
Real Estate	0.42	1.07	0.51	1.09
Average	1.04	2.85	1.02	1.95
Hong Kong-Mainland Difference	-1.8		-0.93	

Source: Compustat Global companies with headquarter (LOC) located in mainland China and Hong Kong

Figure 2 and Figure 3 show the fraction of firms with PB ratio below 1 across different industries at the end of 2021 for Hong Kong and mainland China. All 10 industries in Hong Kong have a significant fraction of firms trading below book value, ranging from a quarter for the energy industry that enjoys the highest valuation to 90% for the real estate industry. In contrast, the worst industry in mainland sees about half of its firms trading below book value, while the second worst industry (utility) has only about 15% such firms.

Figure 2: Hong Kong Valuation by Industry

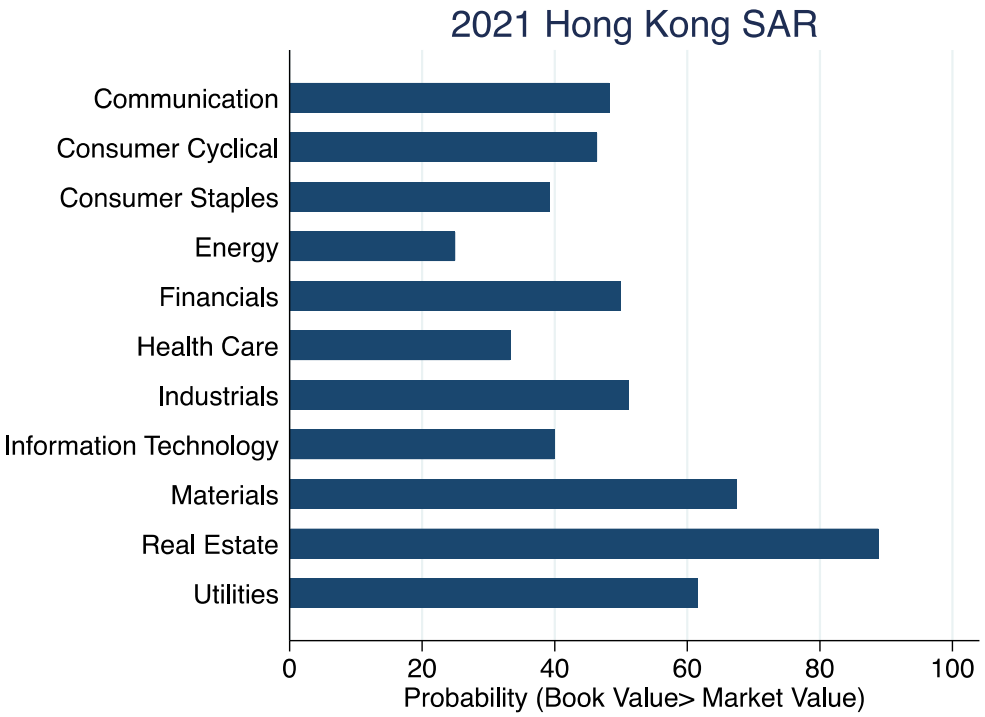
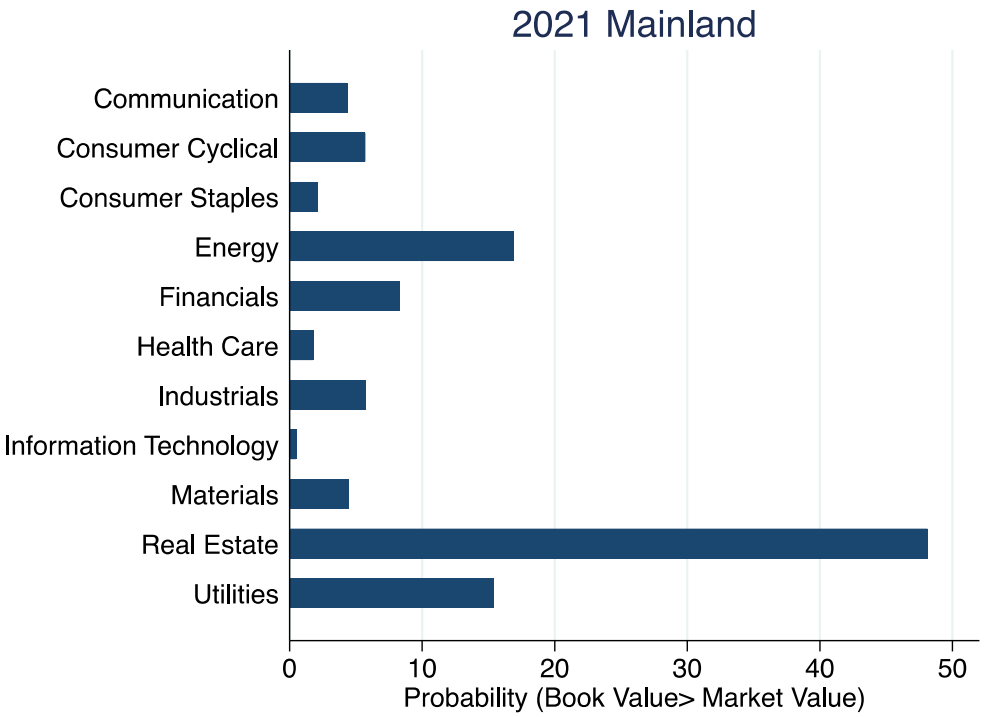


Figure 3: Mainland Valuation by Industry

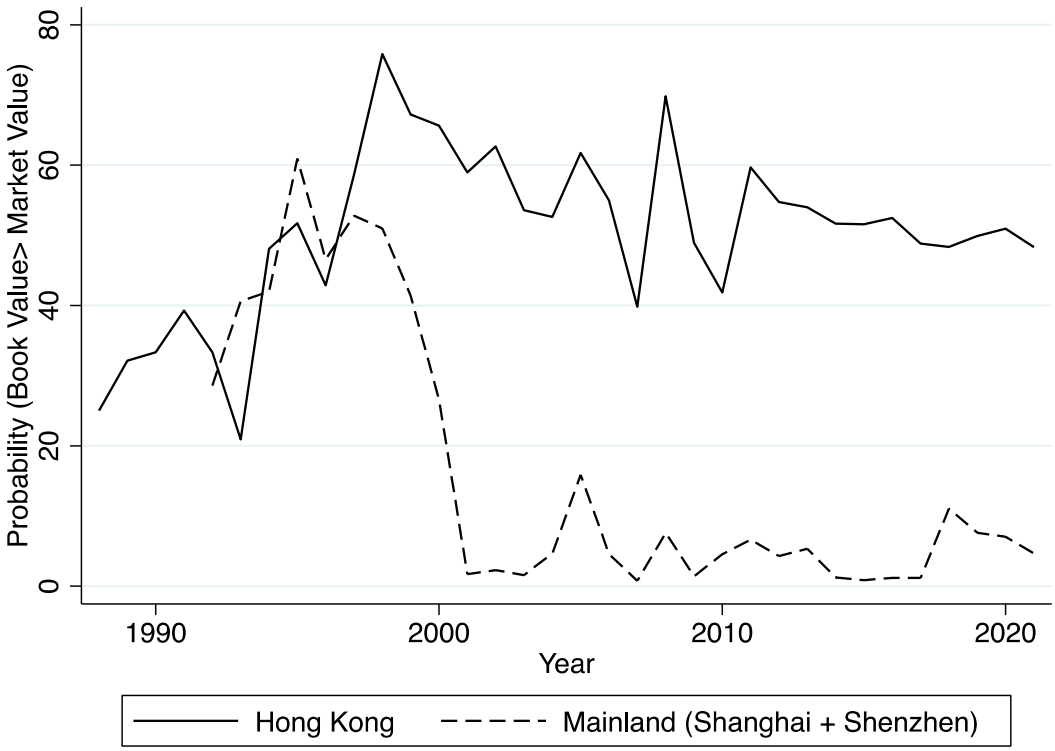


Investment Opportunities or Traps?

How to read these low valuation metrics for Hong Kong firms? Are the stocks in the Hong Kong market undervalued by the moody Mr Market, the pessimistic animal spirit, or the irrational fear? If so, value investors should get greedy while others are most fearful. Alternatively, does the low valuation originate from certain structural defects in the Hong Kong market and thus represents room for improvement for Hong Kong as an international finance centre?

Our research has swayed us more towards the latter. One way to distinguish the two hypotheses is to look at the persistence of the pattern. We have shown that the fraction of firms in Hong Kong trading below book value has been above 50% most of the time in the past two decades (see Figure 4) while the counterpart for the mainland market is typically below 10%. Almost at any point since 2000, half of the firms in Hong Kong are worth more dead than alive.

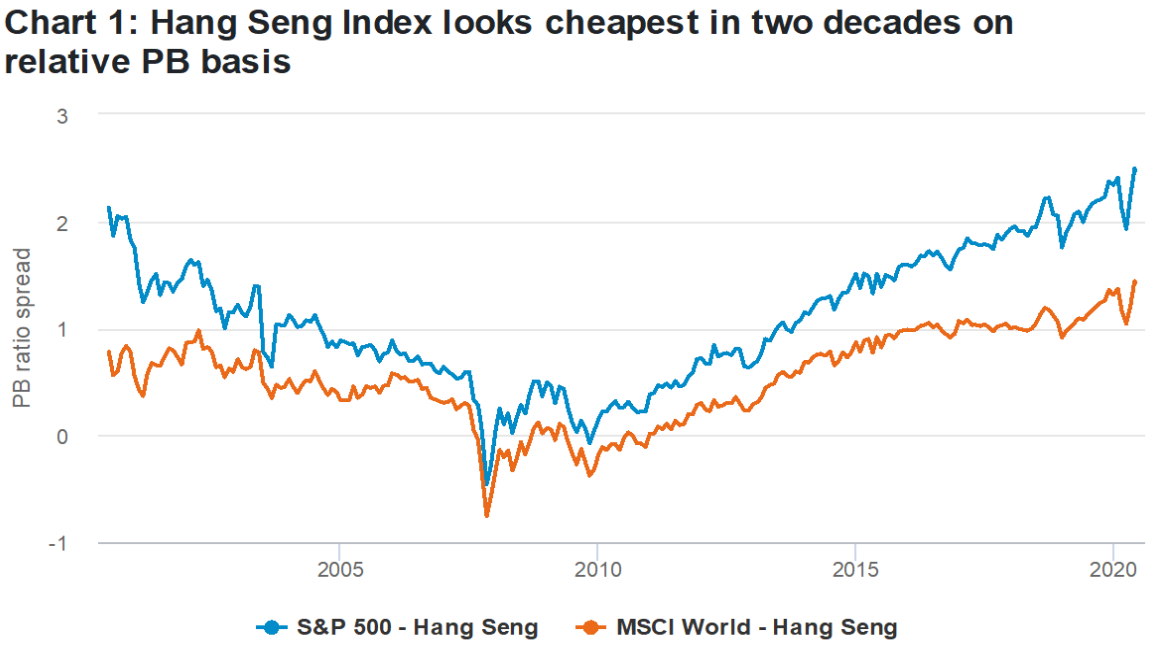
Figure 4: The Faction of Companies with Book Value Higher than Market Value



Benchmarking Hong Kong with the advanced markets shows a similar pattern. The PB ratio of Hong Kong has been trailing that of S&P 500 and MSCI World Index in the past two decades except the period of 2008-2010 (see Figure 5 created by Fidelity International). The 2008 financial crisis brought down the valuation in the United States and other countries more than in Hong Kong and thus reduced the gap.

However, since then the gap has been steadily increasing and has reached the highest level ever.

Figure 5: Hang Seng Valuation Relative to S&P 500 and MSCI World



Source: Bloomberg, Fidelity International, June 2020

Overall, we conclude that the low valuation problem has been both prevalent and persistent in the Hong Kong market. It indicates that there are systematic factors that investors are concerned about.

Corporate Governance Could be the Culprit

We propose a simple model to organize our discussion about the possible cause of the persistent low valuation. Call our protagonist John. John started a company with 25 million of his own capital, raised 75 million from the market, and thus controlled 25% of the firm. The book value of the firm was 100 million. The firm issued 1 million shares and thus the book value per share was 100. The market value of the stock would depend not only on the 100 million cash in the bank account, but also on investors' expectations and assessment of the firm's future activities. Suppose John changed his mind after raising the capital (or it could be his original idea). Instead of making best use of the cash to maximize shareholder value, John kept the cash in the firm's bank account and sent implicit messages, gradually, to investors that he would never return any money to them. Investors receiving the messages assess their credibility and adjust the prices accordingly. The stock price plummeted to 80 first and then to 60, with a screaming PB ratio of 0.6. Long-term value investors started to notice. More

and more brave souls got in as the valuation became ever lower. It continued to slide to 50, 40, 30 and even 20 in the next few years.

After the share price fluctuated around 20 for a year, John made the following announcement: "Our company is one of the greatest ever and has a promising future. Regrettably the capital market has persistently failed to recognize the gold buried in the sand and the stock price has been depressed for too long. The management, committed to protecting our shareholders' interest, has proposed to take the firm private at the price of 30 per share, a 50% premium over the average price in the past year." Board of directors supported the deal and carried out all the due diligence. The independent directors praised the proposal as enhancing shareholder value by pointing out the 50% premium over the prevailing stock prices. The financial advisor and legal adviser developed hundreds of pages of financial analysis, reaching the conclusion that the price of 30 per share is fair and reasonable. On this basis, the board approved the deal and sent it to a special shareholder meeting in which the majority voted favourably. The deal was completed.

We have assumed that John kept the assets in the form of cash to avoid complicated valuation issues. One otherwise might argue that the low PB ratio could be justified by the inflated book value. The moral of the story is exactly the same if the assets were stocks of other listed firms, or any other real assets.

Assuming cash assets also makes it crystal clear the benchmark shareholder value maximization solution: at the minimum, John could have liquidated the firm to return the 100 dollar per share to other investors if he were truly "committed to protecting our shareholders' interest."

The culprit for the persistently low valuation in our model world is the corporate governance. Valuation could be viewed as the product of the so-called fundamental (real assets) and corporate governance. When corporate governance stops working, the link of valuation to the fundamental value is attenuated or even severed. The low PB ratio, however low or persistent it might be, is ultimately a trap, even though it seemed an incredible investment opportunity in light of the 100 dollar cash asset. Even though the fundamental value (the 100 dollars per share cash asset) was for real, the valuation could be as low 20 dollars as the corporate governance factor that connects the fundamental value to the shareholder value has broken down.

The tenet of corporate governance is that shareholders are the most vulnerable group of stakeholders. A firm is a nexus of contracts among independent stakeholders who voluntarily participate in the entity to pursue their own best interests. All other stakeholders make their contribution to the firm and receive their payoffs from the firm through contracts, and they are further protected by the relatively frequent renegotiation of their contracts with the firm. In contrast, shareholders provide capital

upfront, but both the amount and the timing of their payoff are not contractually specified. The amount is the residual after all other parties have been paid, and the timing of the payoff is not legally stipulated.
Corporate governance arises as a response to address this concern of shareholders who otherwise will be reluctant to join the firm. The central purpose of corporate governance is to protect shareholders' interest against the exploitation by all other stakeholders. In the United States where ownership is most dispersed, the main threat to the shareholders' interests come from the management who has the power to change the payoffs to all other parties. In contrast, firms in Hong Kong markets often have concentrated ownership and, as a result, corporate governance should be designed to protect minority shareholders against expropriation by controlling shareholders.

Shareholders may sell their shares in the secondary markets to cash out, and capital appreciation (as opposed to dividends) is often the main component of investors' returns on the stock. They can vote with their feet. However, collectively, the payoffs to shareholders have to derive from the firm in the form of dividends or liquidation.

What Went Wrong?

Now let us analyze the model to discuss how the dismal outcome for shareholders in our model world could have been different.

First, John, the owner/manager in our model world, has control over the firm that is disproportionately larger than his economic interest, laying the background for the wealth transfer from other shareholders to controlling shareholders. In Hong Kong, companies with concentrated ownership are common and family-controlled firms are widespread. However, some shareholders with less than 50% equity interest seem to have substantial control as well.

Recall that a firm is a collection of individuals who voluntarily participate in the coalition to pursue their best interest. It is exactly what John did (even though he was apparently not performing his fiduciary duty to other shareholders in his capacity of a board director and senior manager). The question is that what check-and-balance do we have in the system to counter balance John's power over the firm? A number of corporate governance measures are designed explicitly to protect the minority shareholders' interest against the appropriation by controlling shareholders, including representation on the board of directors and specifically by independent directors, the mandatory use of independent financial and legal advisor, and the recusal system in the shareholder meeting. However, these systems may just look impressive on the paper.

Second, the obvious firm value maximization solution is to liquidate the firm. At the price of 20 dollar per share, liquidation increases the firm value by 500%. It is a blatant breach of fiduciary duty when the board of directors fails to pursue such avenues. In the real world, firms do not necessarily have to take such extreme corporate actions as liquidation, but there are many alternatives. For example, firms can pay out special dividends or aggressively buy back their own shares.

An often-heard counter argument to generous pay-out policy is that firms need capital to expand or grow "for a better future." We shall briefly answer this objection. The first lesson students learn in corporate finance that corporate decisions are made to maximize the firm's value. The second lesson we preach to students is the NPV rule for investment decisions. The core of the NPV rule is the expected future cash flows discounted by the firm's cost of capital, which is defined as the opportunity cost of the firm's funds. The new investment should yield a risk-adjusted return that is not smaller than that by all other alternative opportunities. When a firm's stocks are trading at 20 cents on a dollar of book value, one dollar pay-out generates an immediate risk-free rate of return for shareholders of 500%. It is a bar too high for almost any firm.

Third, a strong corporate governance often involves external disciplines, including the corporate control market (hostile takeover) and critical media. In our model, when the stock price traded at 20 cents on a dollar, where were the "barbarians at the gate"? What prevented activist investors from building up a position and then launch a proxy fight to increase corporate pay-out? When John proposed the privatization at $30 per share, how difficult was it for other investors to enter the race with competing offers? What prevented initial investors who acquired the shares at 100 per share from suing the company in the court? What were the media's coverage and analysis of such transactions?

Fourth, investors were scared by the messages from John before he actually took any actions to divert the assets. They lack "confidence" in the firm's corporate governance in safeguarding the firm's assets and returning the assets to them. Even though there is an elaborate web of rules and regulations that are designed to stop John from keeping the assets within the firm forever, investors believe that the corporate governance system will succeed in protecting their interest with a slim chance of 20%, as revealed by the stock price at 20 cents on a dollar of book value.

Hong Kong SFC has the power to intervene in corporate cases at an early stage when it is reasonable to believe that a proposal contravened the principle of maximizing shareholder value.

Intervention in corporate governance by regulators, however, is different. In our model, the reason that pushed down the stock price was John's messages that he wouldn't return the assets to shareholders. Since he didn't actually carry out any

tunnelling activities, it would take a fearless and, probably, reckless regulator to intervene in this early stage. Without being able to address this root cause, all other interventions would be complicated and futile. By the time the privatisation proposal was put on the table, it had become even more difficult for the regulator to intervene. The proposed price represented a 50% premium over the average price in the past year, all the other gatekeepers, including the independent directors and financial and legal advisors, had provided their professional fairness opinion, and, more importantly, shareholders themselves have voted in favour of the proposal.

Moreover, the expropriation by the controlling shareholders can take forms other than privatizations. These other forms are often even more difficult for regulators to intervene. A classic example is excessive perk consumption, such as club membership and luxurious corporate housing. Extravagant pay would be another example to eventually drain the firm's coffer. Yet another example is to hire family members and make the firm an extended family.

Thus, we have got into a vicious cycle. When investors do not have confidence in the corporate governance and thus pushes down the stock price in the first sight of any corporate trouble, regulators find it more difficult to intervene, which further pushes down the stock price and justifies the initial concerns of investors.

Finally, reputation and repeated transaction serve as a critical deterrent in corporate governance. If John expected to return to the capital market frequently in the future to raise capital for new investment opportunities, he would have a second thought before sending the messages to drive down the stock price. Corporate governance thus is often weaker in firms in declining or mature industries and with managers who have a shorter career horizon.

The Governance Problem in Hong Kong May Get Worse

We believe that the corporate governance problem laid out above can get a lot worse in the near future if no substantive actions are taken to address the problem. The stars are being aligned to exacerbate the problem.

First, at the macro level, the economy of mainland China and Hong Kong becomes more mature, and thus the growth prospect for many firms is likely to diminish. As a result, the controlling shareholders will shift their focus from enlarging the size of the pie more to the division of the pie.

Second, many Chinese private firms, which has been the growth engine for the economy and the backbone for the group of high-valued firms, are facing the succession problem as the first generation of founders and entrepreneurs started to age or failed to catch up with the time. They are likely to pass their control to their

own offspring. If and when they do so, the next generation of controlling shareholders are, on average, less motivated and capable in creating a larger pie. When they focus on the division of the pie, the corporate governance problem becomes even less tractable.

Finally, a large number of Chinese firms currently listed in America are expected to migrate to Hong Kong in the next few years. Their corporate governance in the near future could be a disaster for four reasons. The two reasons discussed above apply equally here. These firms are facing a much slower growth than expected even just a few years ago, and their founders are gradually exiting the firms. Moreover, most of these firms employ a variable interest entity (VIE) structure that has a built-in corporate governance weak spot. Finally, the value of the assets of these firms lies mainly in intangible assets, making it much easier to divert.

Suggestions

We don't have a silver bullet to cut through the problem of corporate governance. After all, it is truly a trillion-dollar question. We hope that our analysis of the problem could convince more people that not all things are right in Hong Kong's corporate governance system and that we need serious efforts to improve it before it's too late. With this first step of acknowledgment, our analysis has offered a few places to look for solutions. We trust that the corporate governance could improve in stride with the determination and calibre of policymakers. As a result, Hong Kong's status as an IFC would be even more prominent.