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Valuation Insights

Greater China Edition

SECOND QUARTER 2019

INSIDE

HKEX New Listing Regime – Checking In One Year Later

It has been one year since the Hong Kong Stock Exchange first permitted the listing of pre-revenue biotech companies and new economy companies with non-standard share structures. In that time, HKEX's aim – to increase Hong Kong's attractiveness as a capital-raising hub for groundbreaking companies – has largely been achieved.

A look at the numbers bears this out.

Over the twelve-month period ended 30 April 2019, a total of 40 new-economy companies have gone public under the new listing regime,[i] raising about HK$150.4 billion in the process. These new listings constitute about half, or 53%, of all IPO funds raised in Hong Kong in that period.

Biotech companies have also benefited from the new listing regime, with nine such companies (including seven pre-revenue biotech firms) raising HK$ 32.3 billion, over six times more than what biotech IPOs raised in Hong Kong a year earlier.[ii]

The numbers reflect the impact of the most important change to Hong Kong's listing regime in 25 years. But the potential of these changes has yet to be realised – and future economic developments may influence their outcome.

Chinese companies responded to the new regime, but IPOs from elsewhere in the world have so far not responded to the new rules. "There are many tech companies in the U.S., Israel and Singapore that need to raise funds," the Hong Kong lawmaker Kenneth Leung Kai-Cheong told the South China Morning Post. "The HKEX should encourage these companies to list here, to diversify our source of listing beyond just mainland China."[iii]

Competition from other China-based bourses – Shenzhen and Shanghai key among them – may also come into play. The Shanghai Stock Exchange, for one, accepted applications from 89 biotech companies as opposed to Hong Kong's nine. But the HK$ 32.3 billion raised from biotech IPOs in Hong Kong far surpasses equivalent amounts raised in Shanghai,[iv] making Hong Kong the second-largest biotech hub worldwide.

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Greater Bay Area:
China's Newest Hotspot for Biotech, Healthcare and Technology

On 18 February 2019, China's central government unveiled its Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area. The ambitious blueprint encapsulates China's overall vision for the Pearl River Delta (PRD): to pivot the area's strengths from manufacturing to world-class services and innovation.[i]

The Greater Bay Area (GBA) covers a total area of 56,000 sq. km. with a combined population of over 70 million at the end of 2017. Its constituent cities include the Special Administrative Regions (SARs) of Hong Kong and Macao, along with Shenzhen, Guangzhou and seven other cities in Guangdong Province.[ii]

The Plan will increase the synergy between the major metropolises in the GBA: combining Hong Kong's strengths as a financial center, Shenzhen's startup culture, Guangzhou's manufacturing and logistics capacity, and Macau's appeal as a leisure and tourism hub.

"The Greater Bay Area is meant to work as an integrated value chain," Witman Hung, liaison officer for the Qianhai Authority, told the South China Morning Post. "In the future, research results from a Hong Kong lab will be made into a prototype by a Shenzhen company, and sent back to Hong Kong for the design. Factories in Dongguan will then start production, and the products will be shipped overseas immediately."[iii]

Hong Kong and Biotechnology

The GBA Plan considers biotechnology to be one of its pillar industries, and Hong Kong has lost no time encouraging its development.

About 250 to 300 biotechnology-related companies have already set up shop in Hong Kong,[iv] attracted by the ready availability of funding, laws safeguarding IP rights, and near-seamless transportation to the rest of the PRD.[v]

Many new biotech companies have also been drawn in by listing rule reforms in 2018 that allow them to list on the Hong Kong Stock Exchange once they attain a minimum HK$1.5 billion market valuation, circumventing Main Board financial eligibility tests.[vi]

Efforts by both the regional and national government will make Hong Kong even more attractive to biotech investors. The biotech industry was identified as a key area for innovation by the Hong Kong Government budget.[vii] The Innovation and Technology Fund has supported about 495 biotech-related projects to the tune of US$125.5 million in 2018, and the National Government has pledged greater access to national research and development funding for Hong Kong laboratories.[viii]

Shenzhen and High Tech

The **healthcare industry** is also expected to flourish under the GBA Plan, with Hong Kong and Shenzhen taking the lead.

Thanks to the Closer Economic Partnership Agreement (CEPA) between Mainland China and Hong Kong,[ix] Hong Kong-based medical professionals' qualifications are recognized in the mainland. Stronger links have since been forged across the border, with the University of Hong Kong and the Chinese University of Hong Kong establishing their own medical facilities in Shenzhen.[x]

Healthcare will benefit from the complementary strengths of Hong Kong and Shenzhen – the former for its world-class medical facilities and training, the latter for its innovation and R&D. These may translate to smart hospitals and e-health systems developed by healthcare professionals from both sides of the divide.

Shenzhen's strengths in **technology** are already apparent in the businesses that call this city home. The high-tech hub of the GBA already counts tech giants like Tencent, DJI and Huawei as the most prominent of the three million businesses that use Shenzhen as their base.

The city invested 4% of its GDP (about US$14.9 billion) into research and development in 2018, comparable to the 4.2% invested by Israel and South Korea in 2016.[xi] These investments are expected to increase even further under the GBA Plan, using the Qianhai Free Trade Zone as an engine for development and platform for cooperation.

In the long run, the entirety of the GBA – not just Hong Kong and Shenzhen – stands to benefit from the Plan. China Center for International Economic Exchanges (CCIEE) CEO Zhang Xiaoqiang expects the GBA's GDP to hit US$4.62 trillion by 2030, tripling its current figure and leapfrogging rivals Tokyo (US$3.24 trillion) and New York (US$2.18 trillion).

By that time, "our bay area will become the world's advanced manufacturing center, innovation center, as well as the finance, trade and shipping center," explained Mr. Zhang.[xii]

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China Commits to Fully Open Banking and Insurance Sectors to Foreign Capital

China will enact measures to further open its banking and insurance sectors to foreign capital, declared the Chairman of the China Banking and Insurance Regulatory Commission (CBIRC) on 1 May 2019.[i]

Mr. Guo Shuqing explained that the ongoing liberalisation of China's banking industry was essential to the nation's economic and financial development. Encapsulated in a set of new measures announced by Mr. Guo, the relaxed rules are intended to encourage participation by market players, attract more foreign investment, and improve the management and competitiveness of the Chinese financial industry.

The implementation of the new measures follows the principle of **equal treatment between domestic and foreign parties:** entry requirements and restrictions on foreign entities participating in China's banking and insurance industries will be lifted or relaxed to near parity with their China-based counterparts, effectively diversifying channels for foreign investors to access China's financial sector.

Foreign investors entering the **banking sector** will benefit from the following new measures:

- Removal of the ceiling on shareholding for a single Chinese-funded bank or a single foreign-funded bank in a Chinese commercial bank, abolishing a shareholding restriction of 20% mandated by a 2018 CBIRC circular;[ii]
- Removal of a US$10 billion total assets requirement for foreign banks establishing foreign-funded corporate banks and removal of a US$20 billion total assets requirement for foreign banks establishing a China branch;
- Removal of an approval requirement for foreign-funded banks opening renminbi (RMB)-related businesses, while allowing foreign-funded banks to open and operate RMB-related businesses after commencing operations (abolishing a previously established one-year waiting period).

China's **insurance sector** will be opened up to foreign entities, with the implementation of the following measures:

- Permission for foreign financial institutions to make equity investments in insurance companies in China;
- Removal of a requirement that foreign insurance brokerage companies in China must have been in operation for 30 years with total assets of no less than US$200 million;
- Permission for foreign-funded group companies to establish insurance institutions (subject to qualification requirements for Chinese-invested insurance group companies).

Other financial sectors will be opened up to foreign institutions with the implementation of the following measures:

- Removal of the total assets requirement of US$1 billion for offshore financial institutions making equity investments in trust companies;
- Loosening of entry policies for Chinese-invested and foreign-invested financial institutions investing in and establishing consumer finance companies.

In the wake of these new measures, foreign financial institutions are already taking stock. Netherlands-based ING Groep NV became the first foreign firm to take a majority stake in an onshore retail bank (taking Bank of Beijing Co. Ltd. as its local partner).[iii]

Others have followed suit: the UBS Group AG won approval to raise its ownership in a local securities venture to 51% late last year pending the new measures, and JPMorgan Chase & Co. already has a pending application for majority ownership in China securities ventures.[iv]

No timetable has yet been set for concrete implementation of the measures, though CBIRC spokesperson Mr. Xiao Bao assured stakeholders that regulations on the administration of foreign-funded banks and foreign-funded insurance companies "have been revised and are intended to be implemented in the near future."[v]

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Nine Months after FIRRMA Approval, Several Key Trends Emerge

As the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) was signed into law on August 13, 2018, John Cornyn, a key Senate sponsor of FIRRMA, announced that the new law would help the Committee on Foreign Investment in the United States (CFIUS) “focus on modern-day national security risks without hindering U.S. investment or trade efforts.”[i]

Nine months after FIRRMA’s enactment – and six months after its Critical Technology Pilot Program took effect[ii] – several key trends have emerged that help us assess whether FIRRMA meets the expectations set by Senator Cornyn (and investors in general).

Expect Extended Timelines. The implementation of FIRRMA will not reduce the U.S.’ overall openness to foreign investment, but the new regulatory environment will add a layer of procedural complexity to the filing process, extending timelines significantly for a greater number of cases.

Changes in processing times extend CFIUS timetables for reviews from 75 days to up to 105 days.[iii] All told, changes to the CFIUS review will add about four to six months to any deal timelines for entire process, from drafting pre-filing to revisions.[iv] Any parties should incorporate the extended timetable in their preparations, and plan in advance to streamline their CFIUS reviews.

Concerns About China Underpin Changes in CFIUS Process. While outright bans on Chinese investment are off the table, CFIUS under FIRRMA will increase scrutiny over equity investments that may be seen to affect U.S. competitiveness against China.

Several investment types may face a particularly disadvantageous process under CFIUS. These include “critical technologies” as defined in the Pilot Programs,[v] and sectors prioritized by the Made in China 2025 plan.[vi] The latter was cited as a threat to U.S. interests in a critical Section 301 report created by the Office of the U.S. Trade Representative (USTR).[vii]

Parties involved in any such investments should be prepared for CFIUS to begin from a position of increased skepticism – and address or mitigate that skepticism.

Few Takers for Short-Form Declarations Under Pilot Program. Transactions covered by the Critical Technology Pilot Program may either submit a short-form, five-page declaration, or formally file using the longer joint voluntary CFIUS notice. The former offers the shortest route to approval (up to 45 days between signing and closing).

Transaction parties are concerned that the new FIRRMA-empowered CFIUS process encourages a more conservative outlook that favors risk-averse outcomes. Short-form declarations might be met with a request for a lengthier notice due to national security concerns, delaying the review process even more.

Thus, out of an abundance of caution, few transaction parties have invoked the rights to a shorter declaration, with the majority preferring to file the longer CFIUS notice instead.

Regulatory Uncertainty. CFIUS is required to implement FIRRMA by February 2020. By that time, CFIUS will need to implement regulations that define certain key terms, including core jurisdictional definitions for terms like "U.S. business", "foreign person" and "foreign entity"; define CFIUS' scope of jurisdiction; and set timelines for processes like the short-form filing and enforcement.

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