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Hong Kong Depositary Receipts: The innovation continues

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HONG KONG ATTRACTS FOREIGN ISSUERS

Innovating to stay ahead

Hong Kong relishes the role of gateway to all things China including acting as the offshore renminbi centre and of late, making Hong Kong Depositary Receipts an attractive platform for issuers to gain access to the mainland's burgeoning market as well as its potentially huge capital resources. The advent and outlook for this latest product offering for issuers was the subject of a roundtable forum, 'Hong Kong Depositary Receipts – The Innovation Continues' co-hosted by J.P. Morgan and The Asset on May 13 and attended by market intermediaries and service providers.

PARTICIPANTS:

Lawrence Fok, chief marketing officer, Hong Kong Exchanges & Clearing (HKEx)
Catherine Tsang, partner, corporate department, Paul, Hastings, Janofsky & Walker LLP
Richard Tsang, chairman and managing director, Strategic Public Relations Group
James Wong, chief executive officer, Computershare Hong Kong Investor Services
David Lau, managing director and co-head of China corporate finance, J.P. Morgan Investment Bank
King Ho, regional product manager, depositary receipts, J.P. Morgan Worldwide Securities Services

MODERATOR:

Daniel Yu, editor-in-chief, The Asset

Fok: Long term we think that Hong Kong will always be the first stop for mainland investors



Ho: The ability to raise renminbi is also important. Most companies choose HK dollars as the base currency for HDRs, but it would not require a lot of effort to add renminbi to an offering

Notwithstanding the importance of such market fundamentals as valuation and liquidity, Hong Kong's main selling point for its depositary receipts programme is the China factor.

"Foreign issuers around the world want to target China-based investors but there is no way to get into China right now. Hong Kong is the closest alternative," says King Ho, regional product manager, depositary receipts, J.P. Morgan Worldwide Securities Services. "One thing all clients and prospects mention is the China market when discussing their long-term capital goals."

Hong Kong Exchanges & Clearing's (HKEx) chief marketing officer Lawrence Fok concurs that, "China is still the ultimate target, the Hong Kong government is fully supportive of making it easier for companies to undertake dual listings."

"Issuers know for sure that they have access to big fund managers in New York," adds David Lau, managing director and co-head of China corporate finance at J.P. Morgan Investment Bank. "But in Hong Kong they gain access to big fund managers as well as capital from China, potentially helping valuations."

While valuation and liquidity underpin the basic attractiveness of listing in Hong Kong, profile raising in China's consumer and business markets has become more important to foreign issuers in recent years, according to Fok.

Starting with French cosmetics company L'Occitane International, which undertook a primary listing of its ordinary shares on HKEx in May 2010, companies have begun to see the benefits of getting closer to their main customers and markets in China.

Lau agrees that market visibility is very important to foreign issuers seeking to be closer to customers, in addition to access to capital. Brazilian iron ore miner Vale, which became the first company to issue Hong Kong Depositary Receipts (HDRs) in December 2010, sells over 30% of its output to China. The second HDR, and first to raise capital, was made by Japanese online financial service provider SBI Holdings, which is planning to expand in mainland China.

The China factor theme was likewise played out when HKEx and the Shanghai Stock Exchange held a joint conference on the development of ETFs (exchange-traded funds) and other index products for investors. In his opening remarks, HKEx chairman Ronald Arculli states, "One area we are exploring along with the Shanghai Stock Exchange is more cross-border ETFs, which would provide mainland exposure to the Hong Kong stock market, and vice versa," broadening the potential investor base which HKEx-listed companies can tap into.

HDR benefits outlined

Once foreign issuers have decided on a secondary listing in Hong Kong, there remains the choice of whether to follow an HDR route or issue ordinary shares. HKEx's Fok states that the exchange is "totally neutral between depositary receipts and ordinary shares: the company should decide".

Clearly, HDRs are preferable in the case of incompatibility between the home market's legal system and that of the listing jurisdiction. Fok remarks that "years ago, the exchange was approached by foreign companies who faced legal constraints in their home country to listing overseas". Lau adds that, "the HDR tool can solve some regulatory issues companies face".

Catherine Tsang, a partner at Paul, Hastings, Janofsky & Walker LLP, who has worked on both of the HDR listings to date – Brazil's Vale and SBI Holdings of Japan – explains that "the good thing about HDR as a product is that it allows more foreign issuers to be able to list in Hong Kong, whether raising funds or not, by eliminating some legal issues". C. Tsang notes that, as the first HDR, Vale required some additional work to get the depositary agreement (between the issuer and its depositary bank) approved by the Securities and Futures Commission (SFC) and HKEx.

But she emphasizes that, "Subsequent deals shouldn't have to go through as extensive a procedure. In the first case, it was necessary to ensure that the depositary agreement was sufficiently robust" in terms of protecting stakeholder rights, a key concern of Hong Kong's regulators due to the relatively high level of retail investor participation in the market. In contrast to ordinary shares, HDR holders are not direct shareholders. Their rights are derived from the depositary agreement: when it comes to voting, for example, HDR holders can ask the depositary bank to vote yes or no for them but cannot vote directly.

An additional factor in favour of HDRs is the speed at which shares can be moved between markets. Ho explains that normally with a dual listing, shares are moved between two markets. This requires shares to be de-registered in London, for example, and re-registered in Hong Kong – a process that can take one week to 10 days. "With a depositary receipt, a framework is set up that is as efficient, if not more so, than moving shares across borders," according to James Wong, chief executive officer, Computershare Hong Kong Investor Services.

The number of depositary receipts or ordinary shares avail-

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Wong: *More foreign issuers are now interested in this product*



able for trading in a secondary market can be crucial. Ho continues, “it can be difficult to hold liquidity in a market where only 2% of a company’s market capitalization is traded”. Consequently, companies are strongly recommended to seriously consider embarking on a fund raising exercise, which creates immediate trading liquidity and helps maintain it over time.

Lau adds that we have “made clear the need for clients to undertake fund raising to generate liquidity, with greater retail participation helping to further build trading liquidity”. According to Ho, “a company needs at least 15-20% (of its market capitalization) in the market to keep liquidity from flowing back to the home market where investors may get a better spread”.

While fund raising may be beneficial in terms of generating liquidity, some companies do not have a need to raise new funds. In the case of Vale, remarks Ho, they had a lot of cash reserves and did not want to dilute existing shareholders. “But now, they have a platform ready if they need to raise funds in the future.” Fok illustrates this point with an analogy: “When people buy a piece of property, they may keep it vacant until one day they may want to rent it out (to raise capital).” In this context, a Hong Kong-listed DR provides issuers with a prime piece of real estate.

In Lau’s view, the relatively low level of liquidity witnessed in HDR trading to date is a “temporary issue”. When companies need to raise funds from China-based investors “the liquidity issue will go away”. Ho adds that, when “listing by introduction (without fund raising), a company needs time to build trading liquidity...when attracting one investor at a time it’s difficult to generate liquidity”.

Unlike Vale, SBI Holdings raised funds with its HDR offering. It was the Japanese company’s first listing outside its home market, and it took the opportunity to set the HDR ratio, resulting in a more acceptable HDR price level for retail investors. SBI Holdings’ HDR was issued at a price of HK\$80.23, a ratio of ten HDRs to one ordinary share. In contrast, dual listed ordinary shares are adjusted for the exchange rate only, since they must be issued at the ratio of one-to-one, driving away investors who may find the price too high compared to other Hong Kong-listed stocks.

Vale has gained a good deal of experience in overseas listings: its American Depositary Receipts (ADRs) are traded on the New York Stock Exchange (NYSE) and cross-listed on NYSE Euronext in Europe.

Preparing for issuance

Richard Tsang, chairman and managing director, Strategic Public Relations Group (SPRG), advises that “once a foreign issuer has a plan to list in Hong Kong: come and visit early and come often”. He adds that issuers “need to understand the characteristics of retail investors”. A notable characteristic of Hong Kong’s stock exchange is the relatively high degree of retail investor participation. HKEx’s Fok remarks that “in some other markets, such as London, most trading – up to 90% – is by institutional investors. Hong Kong trading is 26% retail”. This has implications for investor relations practitioners as well as the regulators.

R. Tsang continues, “While institutional investors have access to senior executives within the company, retail investors have no access, they rely on the media.” In preparing for a listing, he opines that investor education is key: “companies from foreign countries need to highlight their strengths via the media”. On the one hand, this is getting easier, as companies from a broader range of sectors are represented on HKEx, raising awareness among investors. On the other, “HDR is an additional tool for investors, so companies should stay focused on communicating their fundamentals.” R. Tsang’s recommendation is for executives “to spend more time here – talk to commentators and the media – and come as frequently as possible”.

Since the primary listing of Tsingtao Brewery in 1993, the stock exchange’s development has been focused on facilitating access to international capital for mainland Chinese companies, notes Fok. There are “two pieces lacking to complete the picture”: overseas companies and mainland investors. He adds that, at the time of Tsingtao’s listing, China’s foreign exchange reserves were US\$20 billion and “Hong Kong had a role in raising capital”. Now China’s reserves are US\$3 trillion. “Long term we think that Hong Kong will always be the first stop for mainland investors,” remarks Fok.

With regards to upcoming HDRs, Fok remarks that the first four months of 2011 have seen 27 or 28 foreign companies mentioned in the media. “Hopefully, this is the tip of the iceberg. There may be another 3 to 4 times that number.”

All participants agreed that the first hurdle for foreign issuers has been overcome and the first batch of HDRs appears to have breached the dam. Ho remarks that, “When we talked to foreign issuers in 2009 (when the idea of HDR was first proposed), they always asked: ‘Is there any DR listed yet?’ At that time the answer was no. Now, several HDRs have been introduced and proven to be a workable solution.”

C Tsang: *The good thing about the HDR as a product is that it increases the number of issuers who can come to Hong Kong*



Lau: *Companies think, 'If I can't go to Shanghai, Hong Kong is a good choice', but the two options are not mutually exclusive*

Outlook for HDRs

"More issuers are now interested in this product" remarks Wong, with reference to HDRs. Despite rosy prospects, Lau cautions that, "HDRs are still at an early stage. I can only say that there will definitely be more HDRs to come. There are two right now and it is very likely that there will be more to come."

Ho explains that, before the HDR regime was launched, foreign companies that wanted to list their ordinary shares on HKEx had to maintain an ordinary share register in Hong Kong and appoint a registrar, recognized by HKEx, to manage it. A number of jurisdictions do not allow companies (listed in their jurisdiction) to maintain an offshore ordinary share registrar, including Brazil, India, Japan, Russia and South Korea. The HDR resolves this problem. Further, "When a listing applicant comes from a new jurisdiction, HKEx requires a comparison of regulations between Hong Kong and those of the issuers' jurisdiction." Thus, Vale and SBI Holdings have paved the way for companies with primary listings in Brazil and Japan respectively to offer HDRs in Hong Kong.

Lau adds that there is a lot of interest in HDRs from private and listed companies in the EU and the US. "They see the merits of coming to Hong Kong. They see the valuation and profile benefits."

Further, the benefits of a presence on HKEx have been on the rise. Apart from its traditional role as a gateway to China, Hong Kong also benefits from its lack of restrictions on the movement of capital in and out.

"The ability to raise renminbi is also important," adds Ho. "Most companies choose HK dollars as the currency for HDRs, rather than US dollars which are also available as an option, but it would not require a lot of effort to add renminbi to an offering."

Currency convertibility is a major factor in Hong Kong's positioning against Shanghai, which is developing an International Board to attract foreign companies to list there. Fok remarks that, "Hong Kong and Shanghai are working well together. We believe that we complement each other: they have major domestic companies listed on their exchange and we are the more international side."

Lau remarks that some clients ask, "Can I go to Shanghai?"

J.P. Morgan explains the International Board concept but also that the timetable and rules are not yet known and that very big companies will be the first to list. Lau adds that, "Companies think, 'If I can't go to Shanghai, Hong Kong is a good choice', but the two options are not mutually exclusive."

Once the rules and timetable for Shanghai's International Board are known, companies will still need to consider the currency factor. "I don't think that the problem of not being able to move funds out (of China) is one that can be solved in two to three years" notes Ho. "If the objective is to raise and use funds in China then this is not a problem. If not, compatibility in currencies and fungibility in shares is required... Hong Kong is still at least a few years ahead, although more innovation is needed to keep the lead, like renminbi-denominated IPOs."

Additionally, there are extra features that will be added to improve the HDR product over time. Ho comments that, "Some (DR) features offered in New York and London are not yet available in Hong Kong, although more features will be added in the next three to six months." A high priority is the introduction of a feature to speed up the creation and cancellation of HDRs, for example.

Further, as more and more HDRs are issued, it may be possible to formulate a standard set of waivers (from the listing rules). Lau remarks that it would be more efficient if the rules were changed, so that "certain rules don't apply for a secondary listing", rather than each company having a specific, individual set of exemptions. This would be "similar to the difference between listing on the Growth Enterprise Market (GEM) and the Main Board a few years ago".

C. Tsang adds that, at present, certain exemptions are granted because, "these compliance matters are already covered" where the company has its primary listing. "The company is complying with this type of rule already. If a list of express exemptions could be identified, and stated to apply where certain conditions are met, this would be a big plus since the waiver application and granting process is extremely time consuming." Thus, while early HDR pioneers have gained the profile-enhancing status of being first, later issuers stand to benefit from more efficient processes as further gains are realized. ■

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