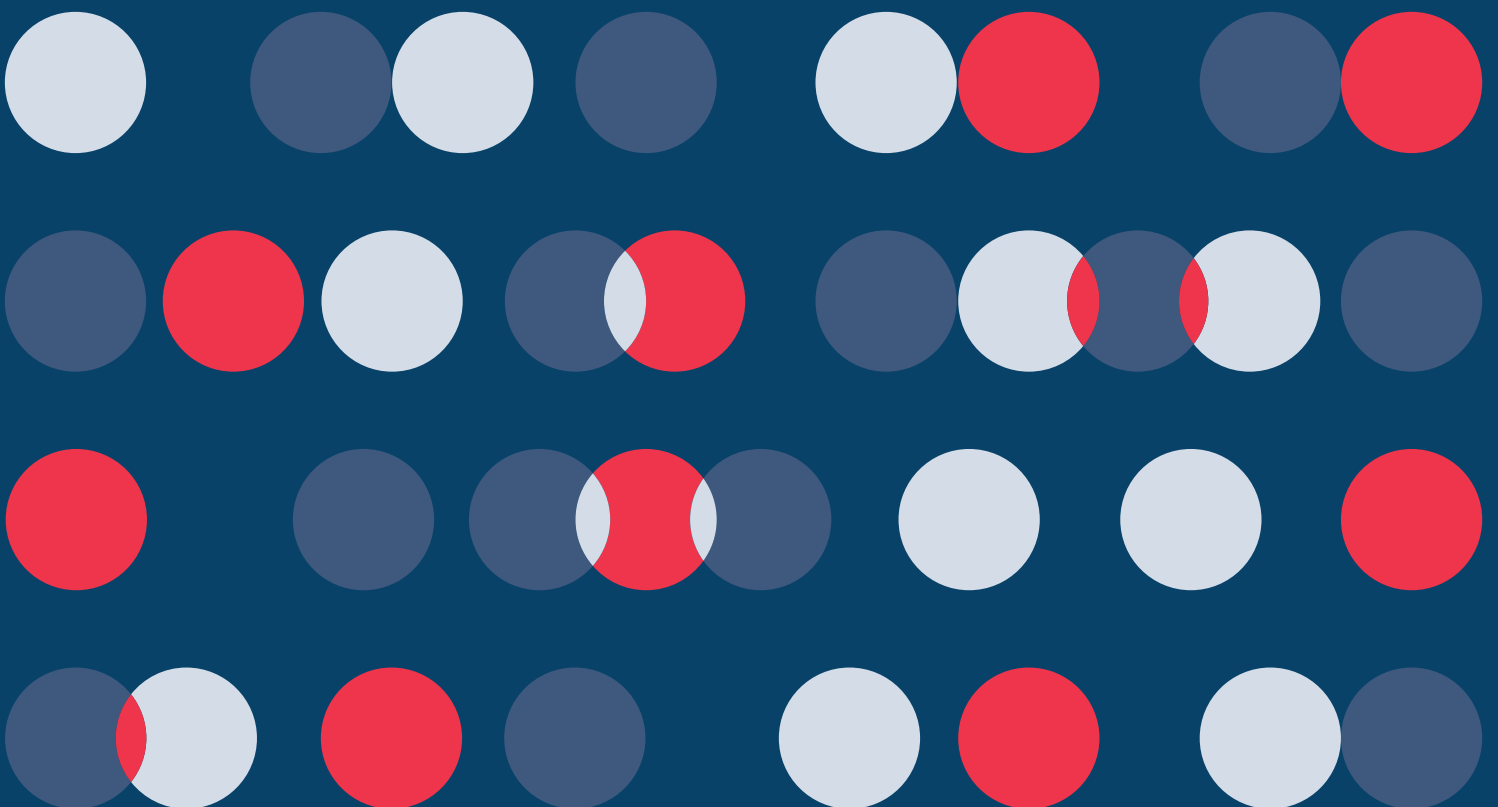


July 2016

THE MYTH OF “LOW” VALUATION OF STOCKS IN
THE HONG KONG MARKET: TRUE OPPORTUNITIES
TO INVESTORS AND ISSUERS



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EXECUTIVE SUMMARY

There has been a general perception that the Hong Kong market has lower stock valuation than the Mainland market. This is reflected by the relatively low price to earnings (PE) ratios of the blue-chip Hang Seng Index (HSI) in Hong Kong and A shares' price premium to their corresponding H shares. This may give rise to a misbelief that the Hong Kong market is less attractive to issuers for a stock offering and possibly provides less upside opportunities for investors.

However, the valuation differential between the Hong Kong and the Mainland markets at the macro level may not be the same case at the micro level. In-depth analyses found that in the Mainland market, the larger the company size of a stock, the lower the PE ratio tends to be; and in the Hong Kong market, the PE ratio is rather stock specific and no significant trend of relationship is found between PE ratio and company size. While industrial sectors may not be a crucial factor in determining stocks' PE, stocks in certain sectors, by sector nature, may tend to have higher or lower PE than other stocks in the same market. In particular, stocks in the traditional financial industry tend to have low PE while stocks in new economy industries like technology and health care tend to have high PE. Initial public offerings (IPOs) in certain industrial sectors may also obtain a higher valuation in Hong Kong than in the Mainland.

Further analysis reveals a "market norm" maintained by each market as a result of the market's characteristics including industry composition and development stage of listed companies, investor base, investor maturity and their investment behaviour. Markets with higher weighting in new economy industries would tend to have a higher weighted average PE level (e.g. Nasdaq) and markets with higher weighting in the financial industry would tend to have a lower PE level (e.g. Hong Kong). The relatively speculative trading behaviour of the dominating local retail investor population in the Mainland market results in a preference towards small-sized high-risk stocks. This is in contrary to the Hong Kong market which is dominated by international professional institutional investors whose investment decisions are largely based on stock fundamentals. Factors contributing to high stock valuation in the Mainland market also include liquidity premium and the lack of hedging/arbitrage instruments for more rational pricing strategies.

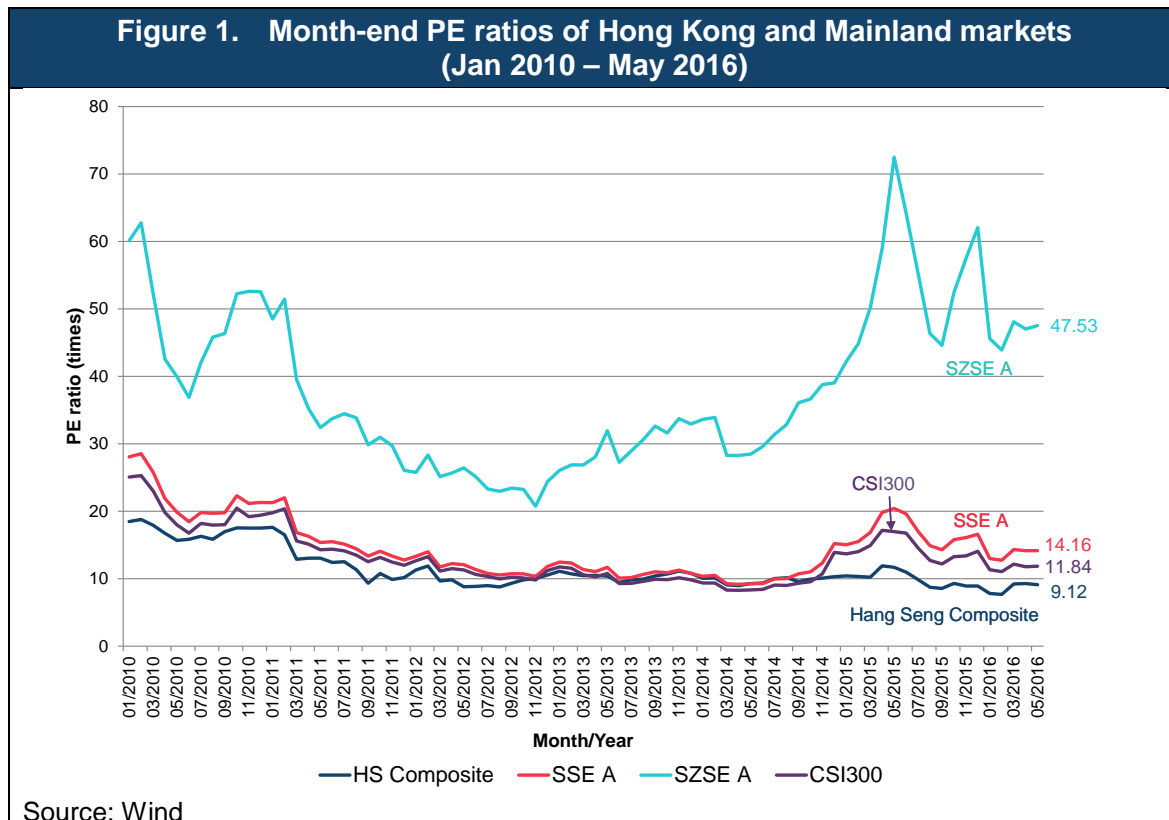
Given the price differentials between the Hong Kong and Mainland markets at the macro and micro levels, the Hong Kong market does offer opportunities to issuers and investors in respect of the lower priced H shares of AH stocks, a comprehensive range of investment tools for arbitrage and hedging and profit opportunities, possibly higher IPO pricing in certain industrial sectors, the market appetite for stocks in new economy industries and the more flexible IPO and post-listing fund-raising regime. The most important of all is the international status and global expansion opportunities offered by the Hong Kong market to Mainland enterprises.

1. GENERAL MARKET PERCEPTION ON STOCK VALUATION IN HONG KONG AND MAINLAND CHINA

The Hong Kong stock market has long been an international platform for the listing and fund raising of enterprises in Mainland China. The launch of Shanghai-Hong Kong Stock Connect in November 2014 has also opened up a formal channel for Mainland investors to invest in the Hong Kong stock market. For both issuers and investors, stock valuation in the Hong Kong market, especially relative to the Mainland market, is an important factor for making listing or investment decisions.

The price to earnings (PE) ratio is generally used as a measure of the valuation of listed stocks. The market capitalisation (MC)-weighted PE ratio of the market index is then used as the valuation measure of a stock market. Making reference to the PE ratio, it is often perceived that the Hong Kong market has low valuation and therefore less attractive fundamentally — possibly low stock pricing of initial public offerings (IPO) for issuers and possibly less upside opportunities for investors.

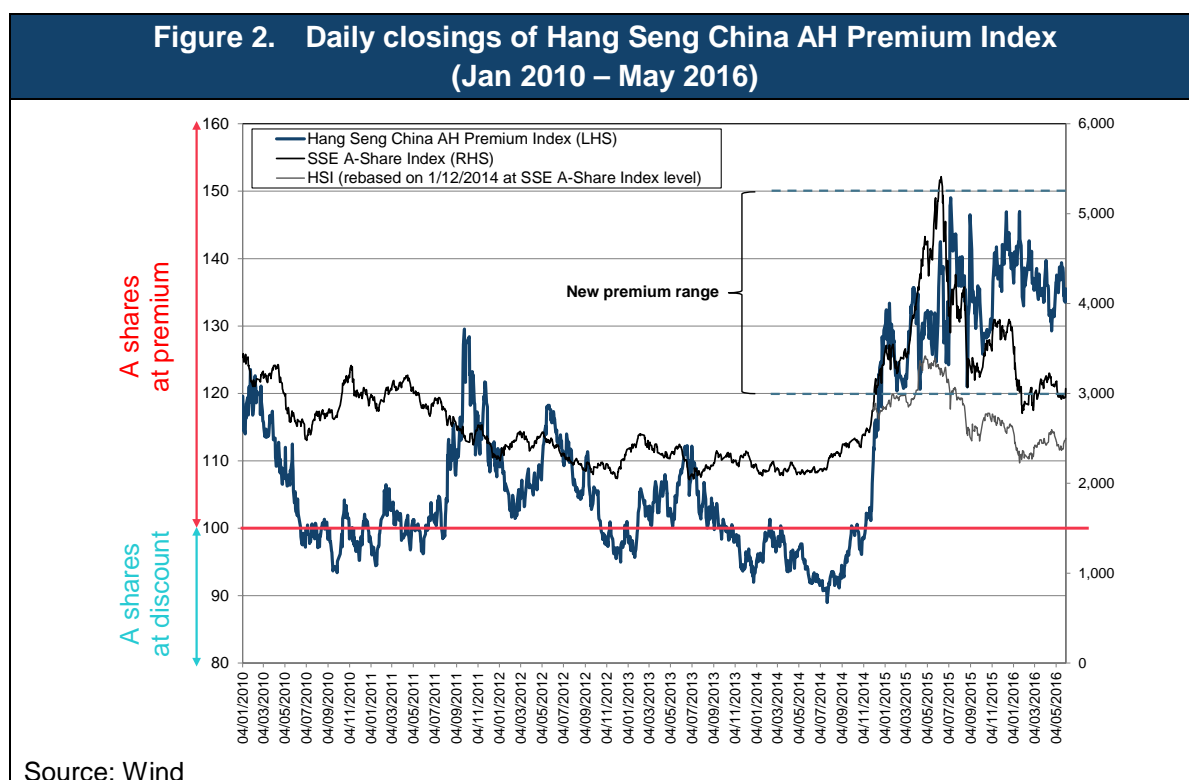
Figure 1 below shows the PE ratios of the **Hang Seng Composite Index** (which covers 95% of total MC of companies listed on the HKEX Main Board), the **Shanghai Stock Exchange (SSE)'s A-share Index (SSE A)** and the **Shenzhen Stock Exchange (SZSE)'s A-share Index (SZSE A)** which cover all their respective listed A shares. These are in comparison with the **CSI300** Index which comprises the largest and most liquid 300 A shares on the SSE and SZSE. It covers about 60% of the total market value of the two Mainland markets, with 70% weighting on the SSE and 30% on the SZSE as of May 2016¹.



¹ Source: China Securities Index Co., Ltd (CSI) website and CSI300 Fact Sheet, May 2016.

From Figure 1, the PE ratio of the Hong Kong market remained below the PE ratios of the Mainland markets since late 2014. For the Shanghai market where most of the Mainland big-cap companies are listed, the PE ratio premium over Hong Kong was not as big as for the Shenzhen market where the listed companies are mostly medium to small-caps². Although the PE ratios of the Shanghai market and the major Mainland index, CSI300, were almost at the same level as the Hong Kong PE ratio for most of the time during 2013 and 2014, the market price levels in the recent year has given the perception of a persistent low valuation of Hong Kong stocks.

Eliminating the factor of different stock bases, the difference in stock valuation is more effectively represented by the price premium/discount between A shares and the corresponding H shares for companies with listed H shares in Hong Kong and A shares in the Mainland (either in Shanghai or in Shenzhen). The trend is tracked by the **Hang Seng China AH Premium Index**, depicted in Figure 2 below. For most of the time, A shares were traded at a premium over their corresponding H shares. The premium had been at a higher range level than before since 2015. In fact, the trend follows the upsurge trend in the SSE A Index during the period, which the Hong Kong market did not follow suit.



However, the perception imposed by the above observations is rather superficial. Factors like the degree of market maturity, industry composition and investor base need to be taken into account. More in-depth examination of stock pricings in the Hong Kong and Mainland markets can give a better understanding of the full picture. This is elaborated in sections below.

² The average MC per stock on the SSE was RMB 22,595 million compared to RMB 11,279 million on the SZSE (RMB 11,196 million on the SME Board and RMB 9,363 million on ChiNext) as at the end of May 2016 (source: Monthly statistics of SSE and SZSE on their respective websites). This compares to the average MC per stock of HK\$14,857 million (~RMB 12,632 million) on the HKEX Main Board.

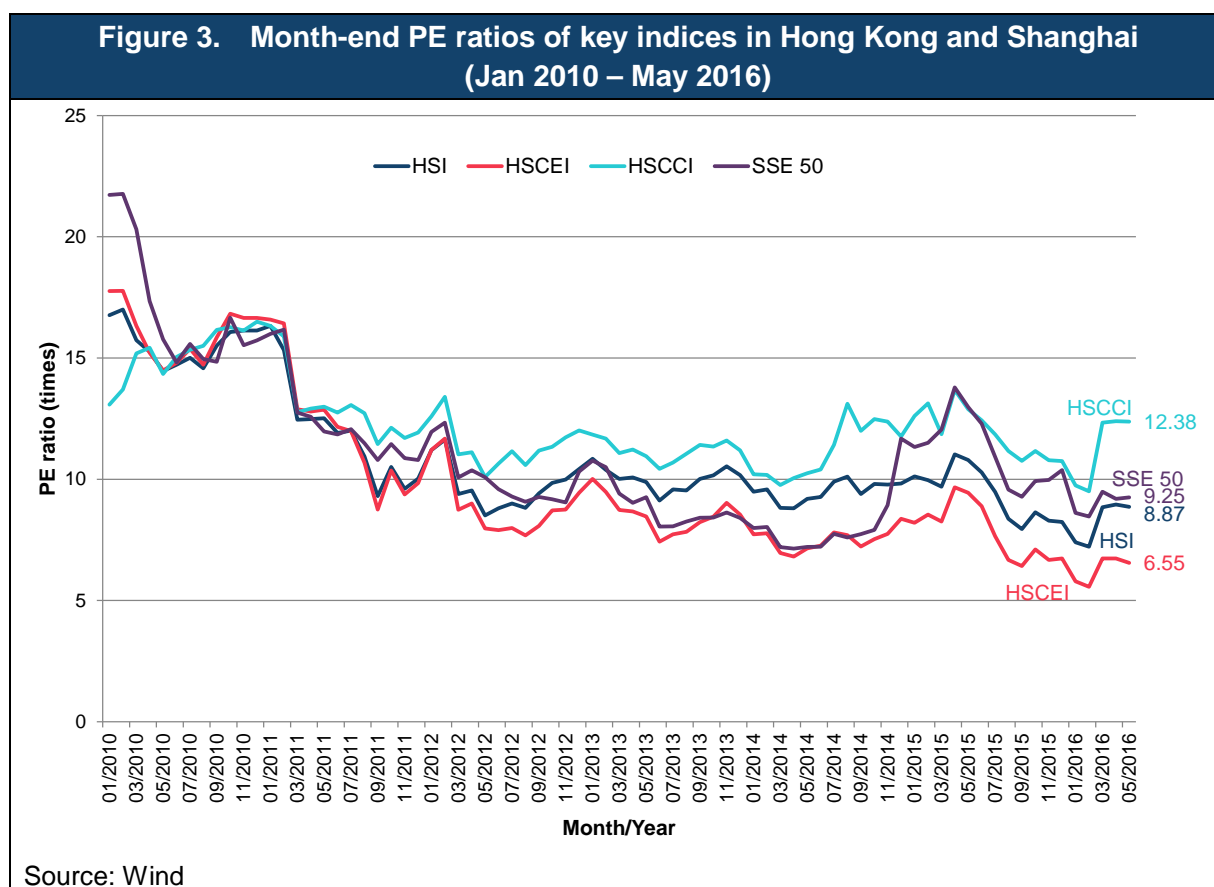
2. PRICE DIFFERENTIALS IN THE SECONDARY MARKET

2.1 Differentials across indices in a market

The key Hong Kong market indices include the following³:

- **Hang Seng Index (HSI)** — comprising 50 constituents which are the largest and most liquid stocks listed on the HKEX Main Board, covering 57% by market value and 54% by market turnover of the Main Board as of May 2016;
- **Hang Seng China Enterprises Index (HSCEI)** — comprising 40 constituents, covering 81% by market value and 30% by market turnover of all H shares on the Main Board as of May 2016;
- **Hang Seng China-Affiliated Corporations Index (HSCCI)** — comprising 25 largest and most liquid red chips, covering 17% by market value and 13% by market turnover of the Main Board as of March 2016.

In the Shanghai market, the counterpart of HSI would be the **SSE 50 Index** which comprises the 50 largest and most liquid stocks on the SSE. A comparison of the PE ratios of the different Hong Kong market indices with SSE 50 Index is shown in Figure 3.

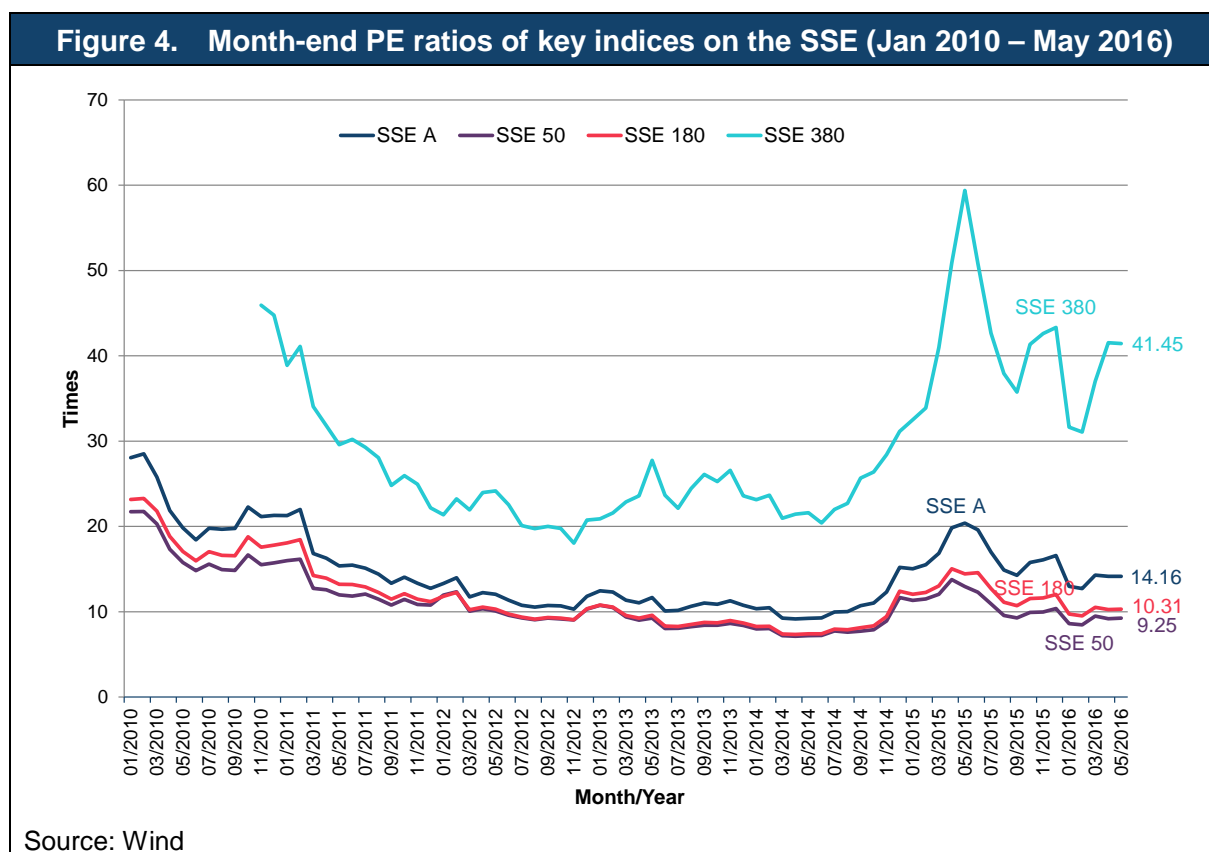


³ Source of market coverage data: Factsheets on the respective indices, Hang Seng Indexes website (<http://www.hsi.com.hk>).

Since 2015 up to May 2016, HSI and HSCEI (which have 9 H shares as common constituents, constituting 24% weighting in HSI) had lower PE ratios than SSE 50. However, HSCCI had a higher PE ratio than SSE 50 for most of the time since 2011. This shows that ***the valuation of different Mainland stocks varies, not only across markets but also within the same listed market.***

Looking at the Shanghai market alone, this valuation differential is apparent across indices tracking different stock segments, compared to the all-shares SSE A Index:

- **SSE 50 Index** — comprising the most representative 50 stocks in size and liquidity on the SSE, selected from the constituents of the SSE 180 Index;
- **SSE 180 Index** — comprising the most representative 180 A shares on the SSE, embracing constituents of, and smaller stocks beyond, the SSE 50 Index;
- **SSE 380 Index** — comprising 380 stocks with modest scale, high growth and profits potential, representing the segment of emerging blue chips outside the SSE 180 Index on the SSE.

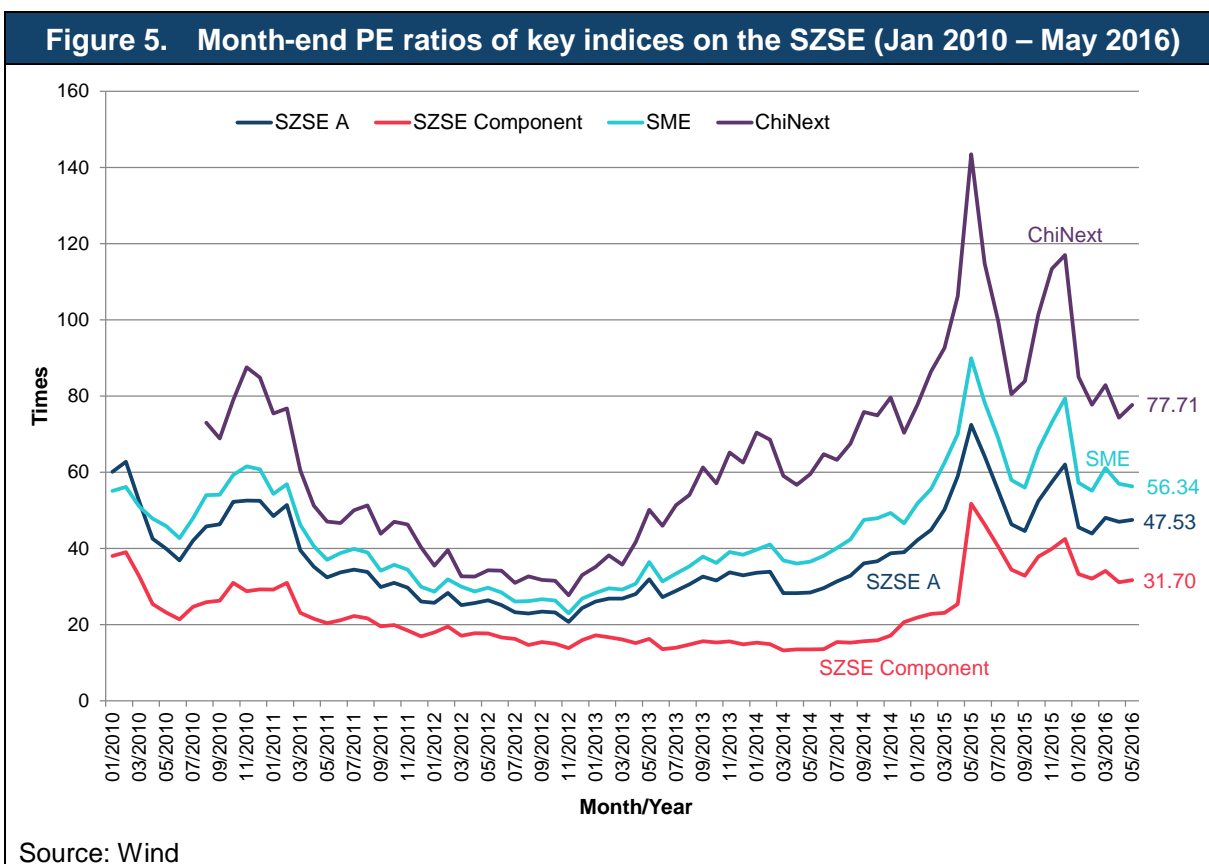


As observed from Figure 4, SSE 380 has a PE ratio much higher than SSE 180 which in turn has a somewhat higher PE than SSE 50. This implies that ***the more smaller-sized stocks are included in an index, the higher the index's PE ratio tends to be.***

Looking at the Shenzhen market alone, similar valuation differential is observed across the following indices, compared to the all-shares SZSE A Index:

- **SZSE Component Index** — comprising the 500 most representative stocks in size and liquidity on the SZSE, covering nearly 60% by value of all A shares on the SZSE;

- **SME Composite Index** — comprising all listed shares on the SZSE SME Board;
- **ChiNext Composite Index** — comprising all listed shares on the SZSE ChiNext.



The obvious PE differentials across different market segments on the SZSE are clearly presented in Figure 5 above. The small growth enterprises listed on ChiNext have the highest PE ratios while the largest stocks represented by the SZSE Component Index have the lowest ratios.

It appears that, in the Mainland, indices tracking blue-chips would have lower PE ratios while indices tracking smaller sized stocks would have higher PE ratios.

2.2 Differentials across company size

The valuation differentials across the indices are highly related to the nature of the constituent stocks. Among the influential factors is the company size which reflects to a certain extent the maturity of the company and its further growth prospects. To investigate this factor, analyses were done to examine the relationship between the MC and PE ratio of stocks listed in Hong Kong Main Board (MB) and GEM and A shares listed in Shanghai and Shenzhen. As stocks tend to cluster at the low end of MC, appropriate MC grouping was performed to classify companies into small and large-sized groups (see Table 1) for further analysis to give a better illustration of the broad picture. Results are shown in Figures 6 and 7.

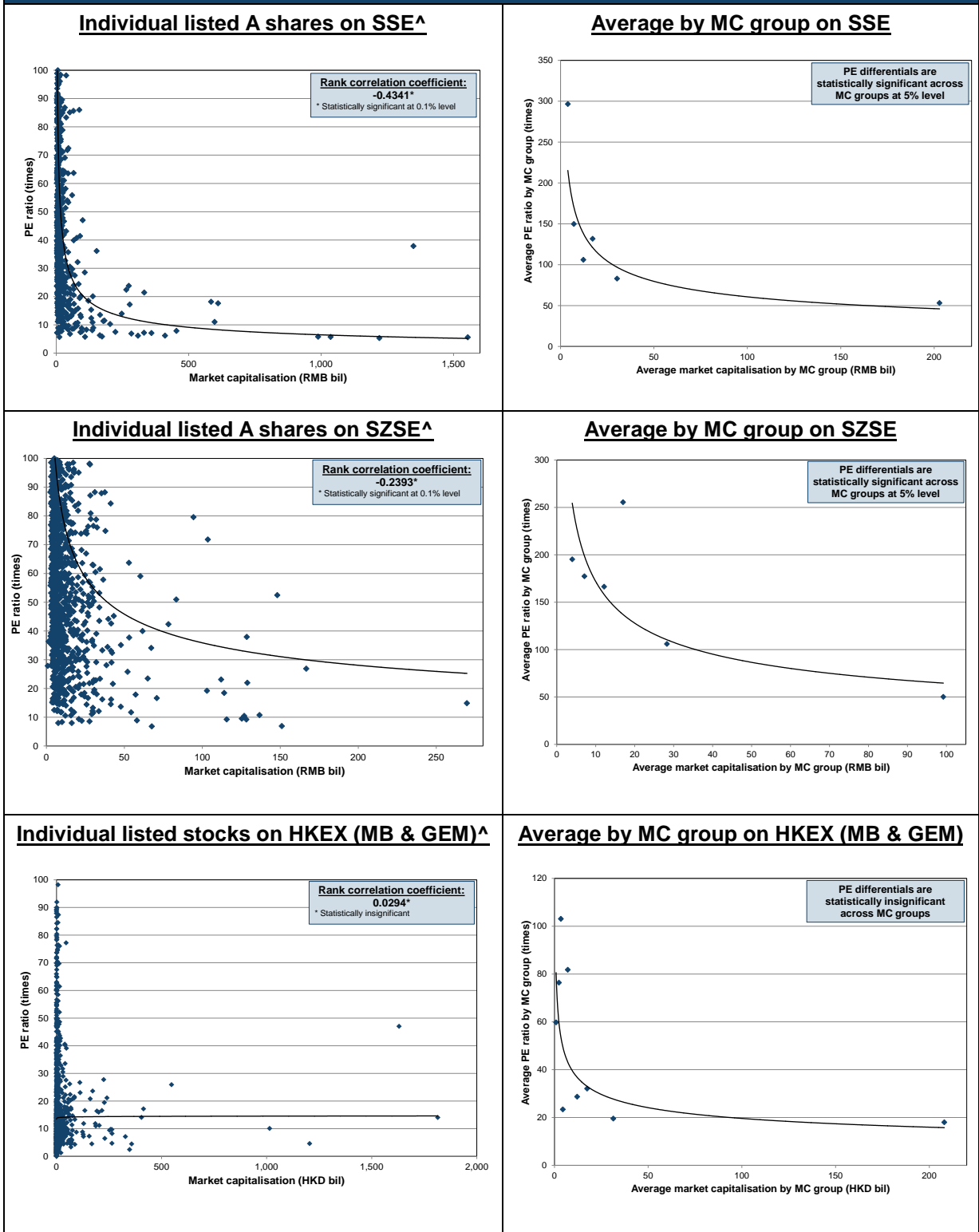
**Table 1. MC grouping of A shares on SSE and SZSE and stocks on HKEX
(as of 31 May 2016)**

MC group (Mainland)	No. of stocks		No. of stocks by MC grouping for HKEX				
	SSE	SZSE	MC group	Market	MB	MC group	GEM
Up to RMB 5bil	200	373	Up to HKD 2bil	570	485	Up to HKD 0.5bil	57
						>HKD 0.5bil – 1bil	13
						>HKD 1bil – 1.5bil	7
						>HKD 1.5bil – 2bil	8
			>HKD 2bil – 3bil	111	108	>HKD 2bil – 5bil	7
			>HKD 3bil – 4bil	79	75		
>HKD 4bil – 5bil	42	42					
>RMB 5bil – 10bil	302	654	>HKD 5bil – 10bil	164	161	>HKD 5bil	4
>RMB 10bil – 15bil	155	237	>HKD 10bil – 15bil	67	66		
>RMB 15bil – 20bil	82	113	>HKD 15bil – 20bil	44	44		
>RMB 20bil – 50bil	126	162	>HKD 20bil – 50bil	95	95		
>RMB 50bil	87	34	>HKD 50bil	75	75		
Total	952	1,573	Total	1,247	1,151	Total	96

Note: Excluding stocks with negative earnings.

Source: HKEX analysis based on data from Wind for SSE and SZSE, HKEX market data for HKEX

**Figure 6. PE ratio vs MC of listed stocks in Hong Kong and Mainland China
(31 May 2016)**

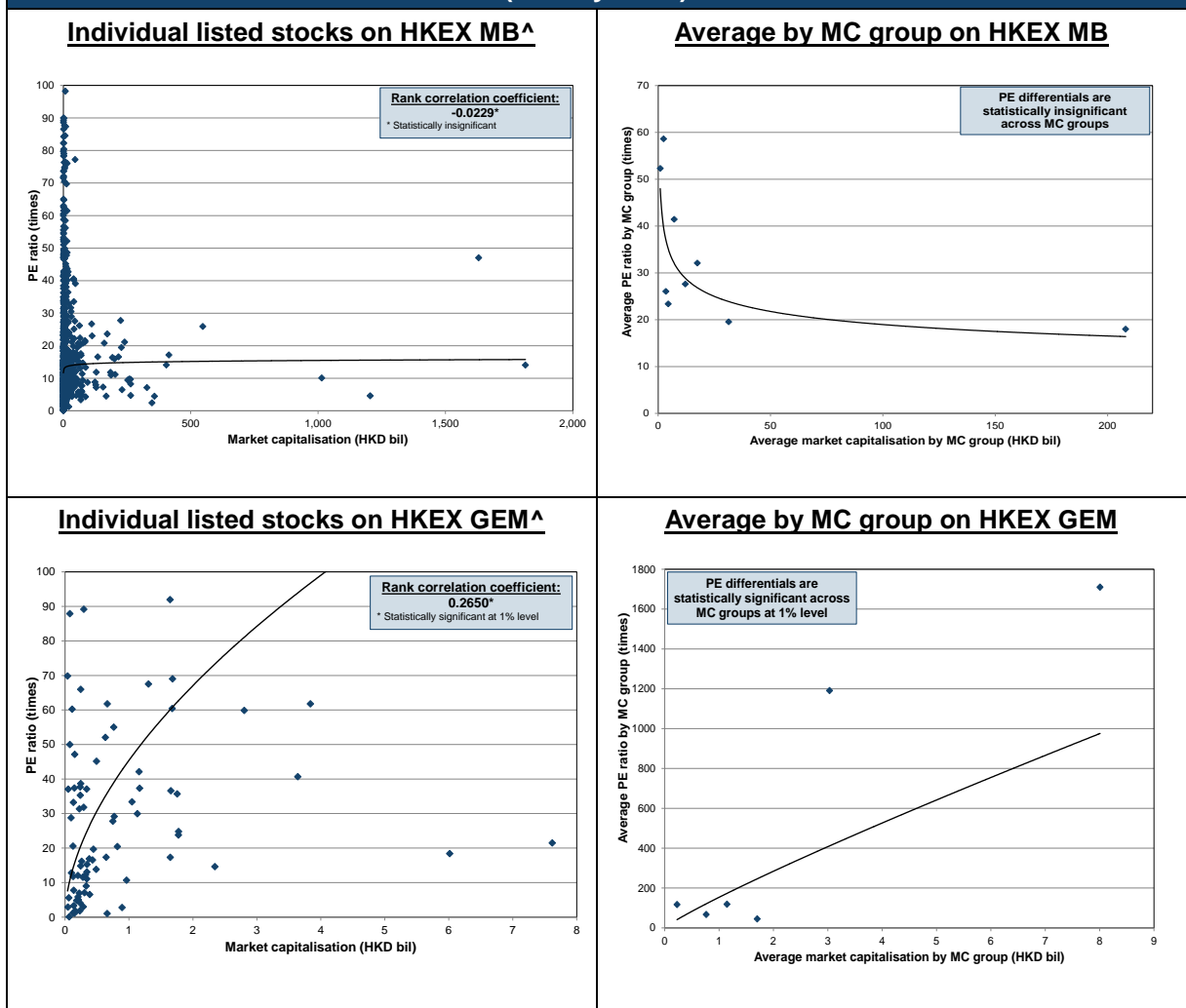


^ Cases with PE ratios > 100 times are not plotted in the charts but included in the correlation analysis.

Source: HKEX data analysis based on data from Wind for SSE and SZSE, HKEX market data for HKEX.

Analysis results found that there is a statistically significant inverse relationship between the PE ratio and the MC of A shares listed in the Mainland markets. On the left-hand-side (LHS) column in Figure 6 are the scatterplots of PE ratio against MC of individual stocks while the right-hand-side (RHS) column shows a clear inverse relationship of the average PE ratio against the average MC across MC groups. **PE differentials across MC groups are found to be statistically significant for A shares listed on the SSE and SZSE — the larger the MC, the smaller the PE ratio tends to be.** However, for the overall Hong Kong market, the relationship is statistically insignificant. Since the Hong Kong stock market consists of two market segments — MB and GEM where MB comprises relatively more mature companies and GEM comprises emerging companies, separate analyses for MB and GEM were performed to see if the relationship is different between them. Figure 7 shows the results.

Figure 7. PE ratio vs MC of listed stocks respectively on HKEX MB and GEM (31 May 2016)



^ Cases with PE ratios > 100 times are not plotted in the charts but included in the correlation analysis.

Source: HKEX analysis based on HKEX market data.

For the relatively more mature companies on the Hong Kong MB, there is statistically insignificant relationship between the PE ratio and MC. For the emerging companies on GEM, there is some positive relationship between the PE ratio and MC at statistically significant level. By observation from the scatterplot, the distribution of PE ratios is more disperse at higher MC levels across stocks on GEM than stocks on MB, i.e. GEM stocks with higher MC may have high or low PE ratios. Nevertheless, the MC variation of stocks on GEM is rather narrow and the PE differential is considered to be rather stock-specific, albeit a statistically significant mild positive relationship between MC and PE was found for GEM stocks.

The above analyses found that in the Mainland market the larger the company size of a stock, the lower the PE ratio tends to be; and in the Hong Kong market, the PE ratio is rather stock specific and no significant trend of relationship is found between PE ratio and company size.

2.3 Differentials across industrial sectors

To examine the PE ratios of stocks across different industrial sectors, listed stocks in the Hong Kong and Mainland markets were classified into 10 industrial sectors in accordance with the Global Industry Classification Standard (GICS)⁴. Table 2 below gives the number of stocks under study by sector for each market or index segment.

Table 2. Number of stocks by sector for each market/index segment (as of May 2016)														
GICS sector	HK market		HSI		HSCEI		FTSE A50		SSE		SZSE		CSI300	
Financials	378	[278]	23	[23]	21	[21]	26	[25]	120	[97]	91	[67]	59	[57]
Industrials	319	[206]	5	[5]	4	[4]	9	[8]	288	[234]	466	[375]	61	[55]
Consumer Discretionary	462	[277]	4	[4]	3	[3]	4	[3]	202	[171]	285	[221]	40	[35]
Information Technology	224	[130]	2	[1]	—	[—]	2	[2]	83	[72]	335	[282]	28	[25]
Materials	170	[79]	—	[—]	2	[2]	1	[0]	199	[122]	313	[235]	32	[22]
Energy	54	[22]	5	[5]	4	[4]	3	[3]	41	[19]	31	[17]	15	[12]
Consumer Staples	101	[62]	4	[4]	1	[1]	1	[1]	78	[67]	109	[81]	17	[17]
Health Care	86	[64]	—	[—]	1	[1]	1	[1]	75	[67]	141	[128]	24	[24]
Utilities	47	[41]	5	[5]	3	[3]	2	[2]	54	[51]	38	[32]	22	[22]
Telecom Services	17	[13]	2	[2]	1	[1]	1	[1]	2	[2]	3	[1]	2	[2]
Total	1,858	[1,174]	50	[49]	40	[40]	50	[46]	1,142	[902]	1,812	[1,439]	300	[271]
[] No. of stocks with valid PE ratio														
Source: HKEX analysis based on data from Bloomberg														

⁴ The GICS is an industry classification system developed by MSCI and Standard & Poor's in 1999, which consists of 10 industrial sectors. The GICS sector of each stock under study was obtained from Bloomberg.

Figure 8 presents the **MC-weighted average PE ratio**⁵ by sector for the different segments as of 31 May 2016. Among the industrial sectors, the Hong Kong overall market had similar MC-weighted PE ratios as the SSE stocks in the relatively mature industries of Financials and Utilities. When comparing PE ratios of the blue-chip indices in Hong Kong and the Mainland, the Hong Kong HSI had a higher MC-weighted PE than the FTSE China A50 Index in Financials, Consumer Discretionary, Information Technology⁶ and Utilities, and their MC-weighted PE ratios were similar in Consumer Staples. Hong Kong listed H shares (represented by the HSCEI) had a higher MC-weighted PE than the Hong Kong blue chips (represented by the HSI) in the Industrials and Energy sectors but a lower MC-weighted PE in other sectors where both had constituent stocks for comparison. The SZSE market, which consists of mostly small growth companies, had the highest MC-weighted PE across almost all industrial sectors (except Health Care where the only one stock in A50 had an exceptionally high PE).

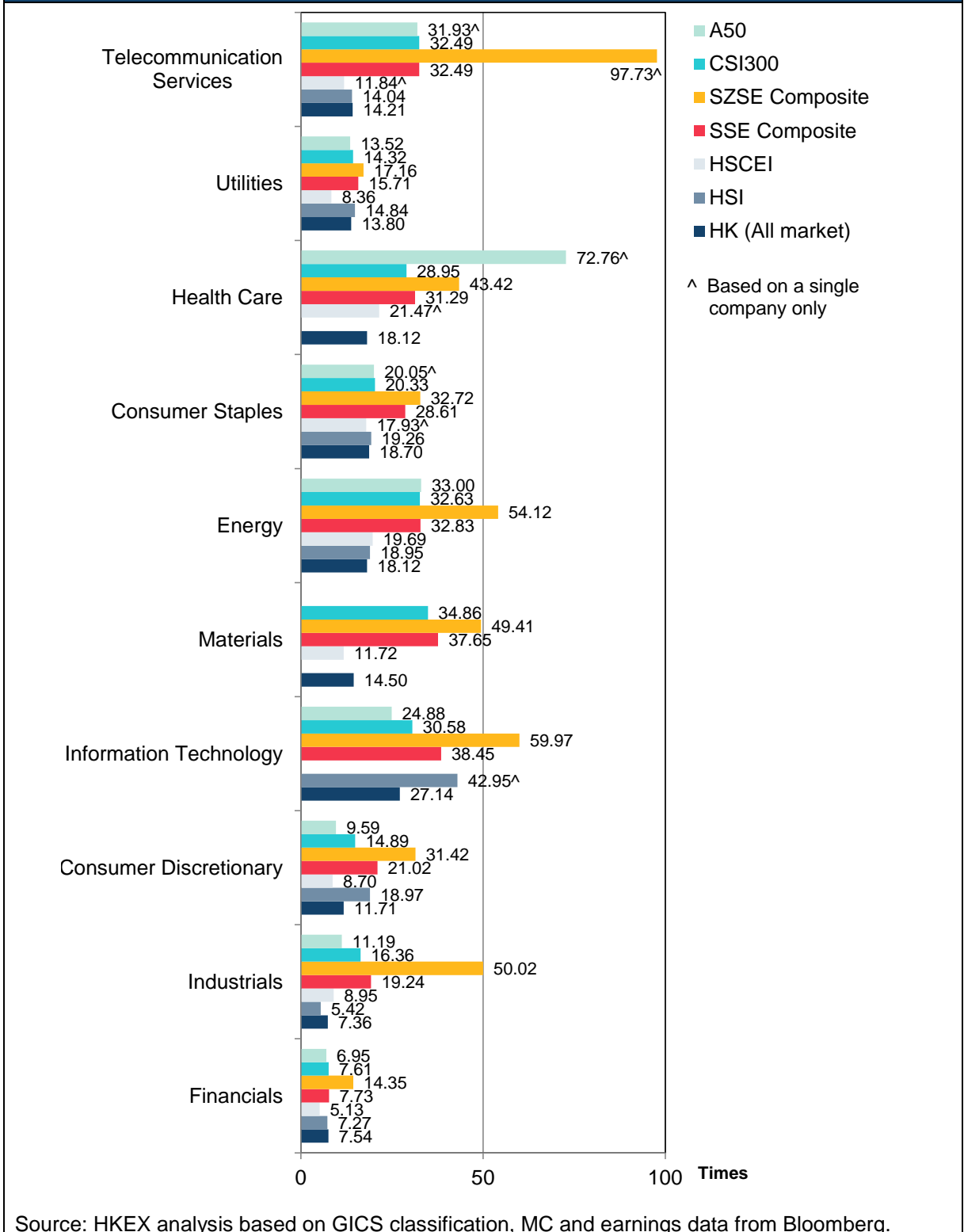
When analysing the difference in PE ratios of individual stocks across sectors within the same market (as of 31 May 2016), no statistically significant difference was found in the PE of individual stocks between most sectors in both the Hong Kong and Mainland market, with some exceptional cases below (see Appendix 1 for details):

- For Hong Kong market: *stocks in the Financials sector had lower PE* (a simple average of 24 times) than stocks in Industrials (a simple average of 67 times);
- For Shanghai market: *stocks in Financials had lower PE* than stocks in IT, Consumer Staples, Consumer Discretionary and Materials; *stocks in IT had higher PE* than stocks in Utilities; and stocks in Consumer Staples had higher PE than stocks in Utilities but lower PE than stocks in Health care;
- For Shenzhen market: Stocks in Industrials had higher PE than stocks in Health Care.

⁵ MC-weighted average PE ratio is calculated by dividing the aggregated MC of the stocks under study by the aggregated 12-month earnings of the stocks as obtained from the data source, excluding stocks with negative earnings.

⁶ Based on only one company in this sector in HSI.

Figure 8. MC-weighted PE ratio by sector in Hong Kong and Mainland (31 May 2016)



In fact, wide variance in PE of stocks within the same sector was found. ***The findings imply that industrial sectors may not be a crucial factor in stocks' PE but stocks in certain sectors, by sector nature, may tend to have higher or lower PE than other stocks in the same market.***

2.4 Differentials across A-H stocks

The price differential between stocks with dual listing of H shares in Hong Kong and A shares in the Mainland (either SSE or SZSE) (referred to as “A-H stocks”) was examined to see if the above factors — MC and industrial sector — did matter in PE ratio.

Figure 9 gives scatterplots of the A-share price premium over H-share against MC for A-H stocks. A significant negative relationship was found between the price premium and MC. On the other hand, the price premium differentials of A-H stocks across industrial sectors were found to be statistically insignificant (see Figure 10).

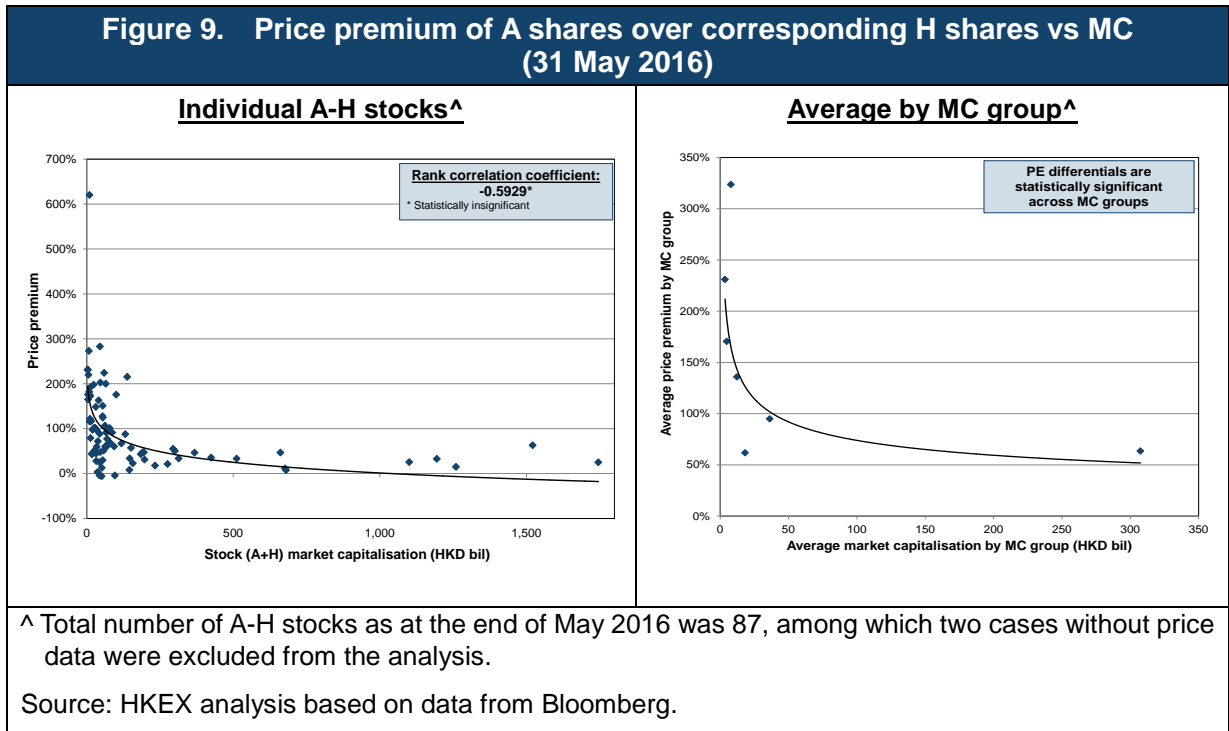
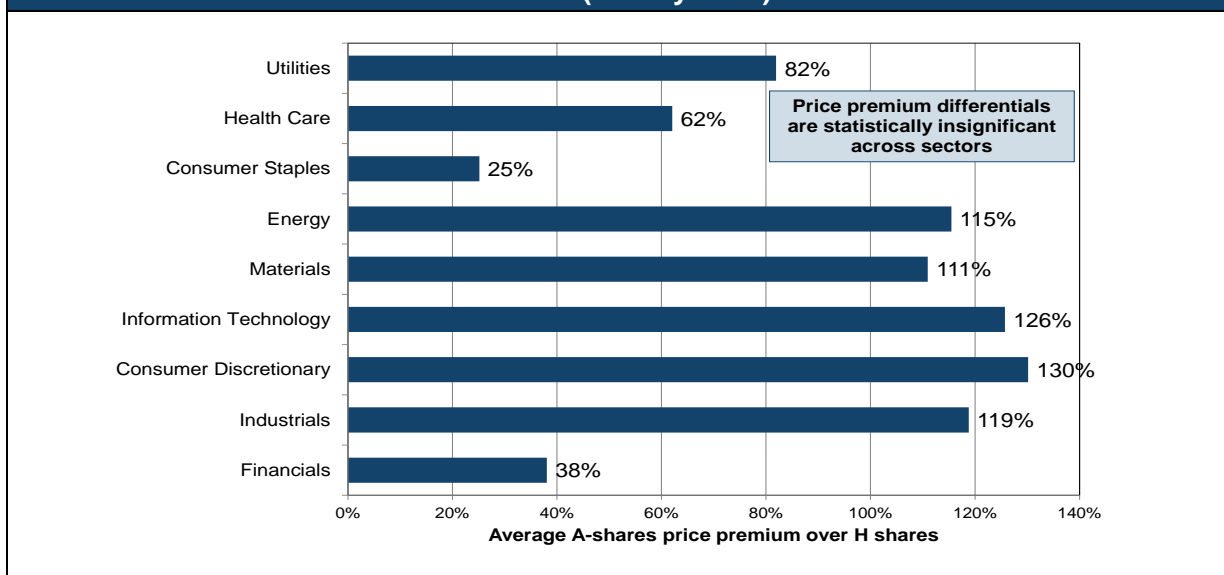


Figure 10. Price premium of A shares over corresponding H shares across industrial sectors (31 May 2016)



Note: Total number of A-H stocks as at the end of May 2016 was 87, among which two cases without price data were excluded from the analysis.

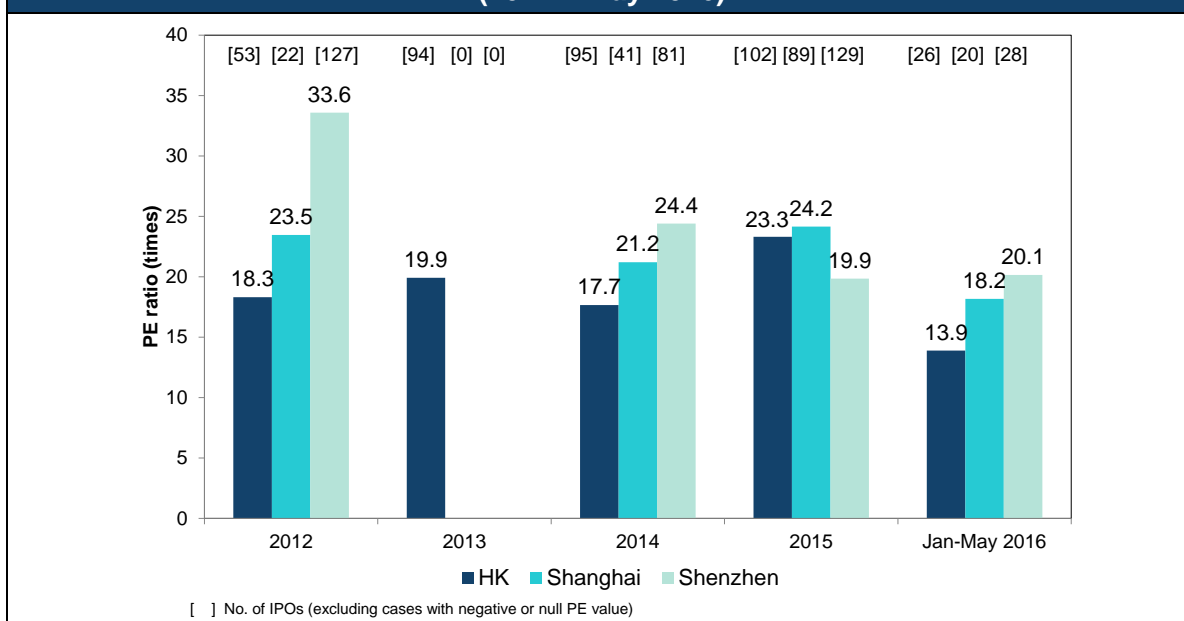
Source: HKEX analysis based on GICS classification and price data from Bloomberg.

In other words, ***the larger the company size, the smaller the A-H price premium irrespective of the industrial sector.*** As the stock valuation in the Hong Kong market is relatively independent of the company size, such observation is believed to owe to the negative relationship between stock valuation and MC for stocks listed in the Mainland markets (see findings in above section on “*Differentials across company size*”).

3. PRICE DIFFERENTIALS IN THE PRIMARY MARKET

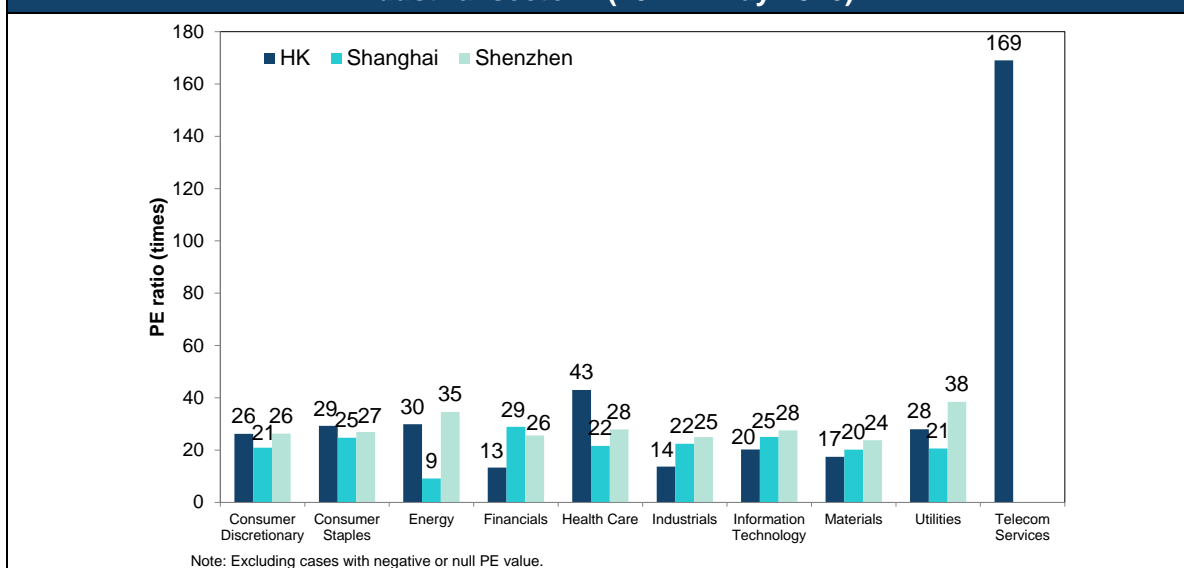
During 2012 to May 2016, the PE ratios at the offer price of IPOs in Hong Kong were on (MC-weighted) average somewhat lower than in the Shanghai and Shenzhen markets (see Figure 11). However, as shown in Figure 12, the stock valuation differentials for IPOs varied across industrial sectors. For the full period, IPOs in Hong Kong had higher valuation than IPOs in Shanghai in a number of sectors — Consumer Discretionary, Consumer Staples, Energy, Health Care and Utilities — and also higher valuation than IPOs in Shenzhen in some of these sectors.

Figure 11. MC-weighted PE ratios of IPOs in Hong Kong and the Mainland by year (2012 – May 2016)



Source: HKEX analysis based on IPO raw data from Bloomberg.

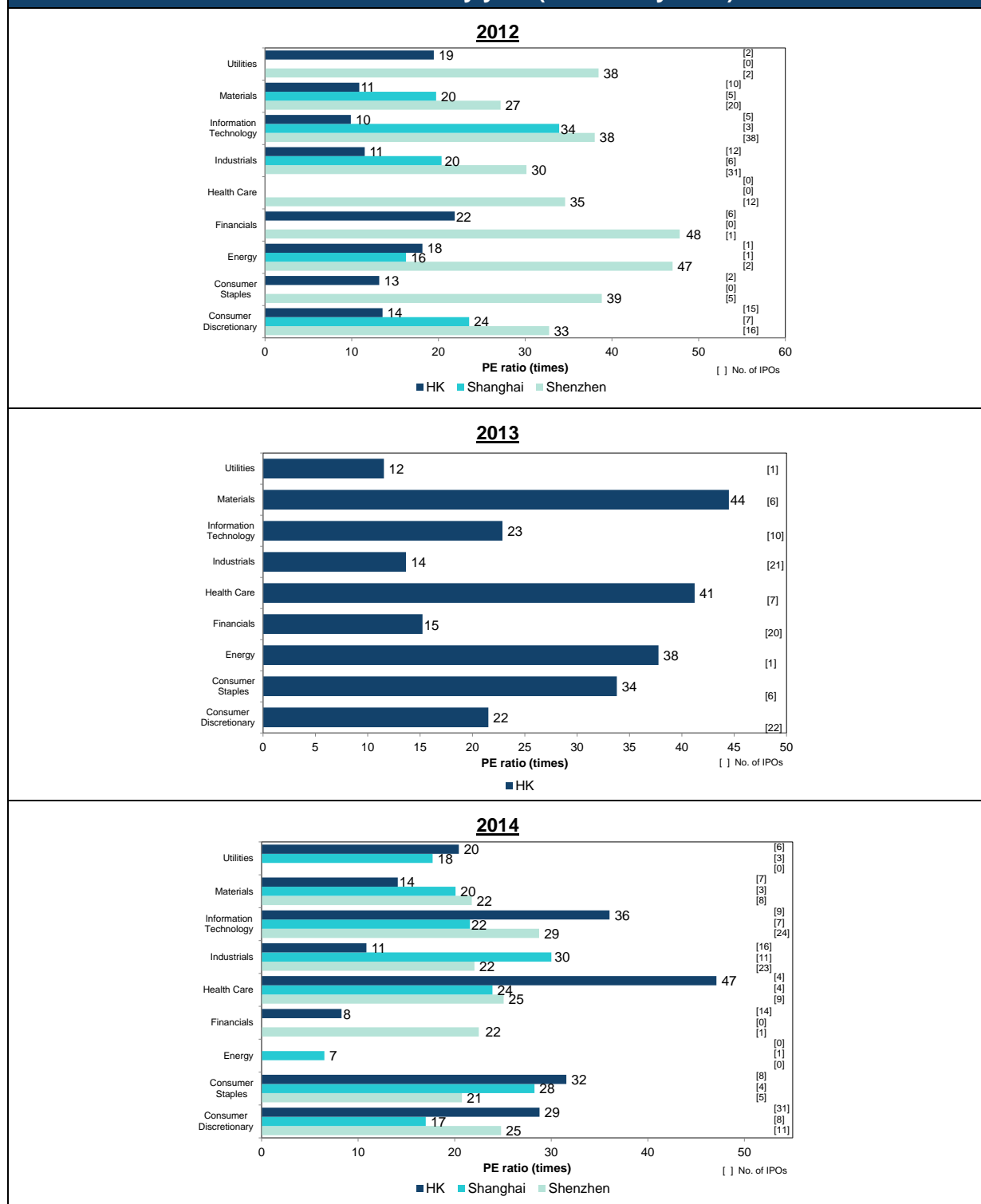
Figure 12. MC-weighted PE ratios of IPOs in Hong Kong and the Mainland by industrial sector (2012 – May 2016)



Source: HKEX analysis based on IPO raw data from Bloomberg.

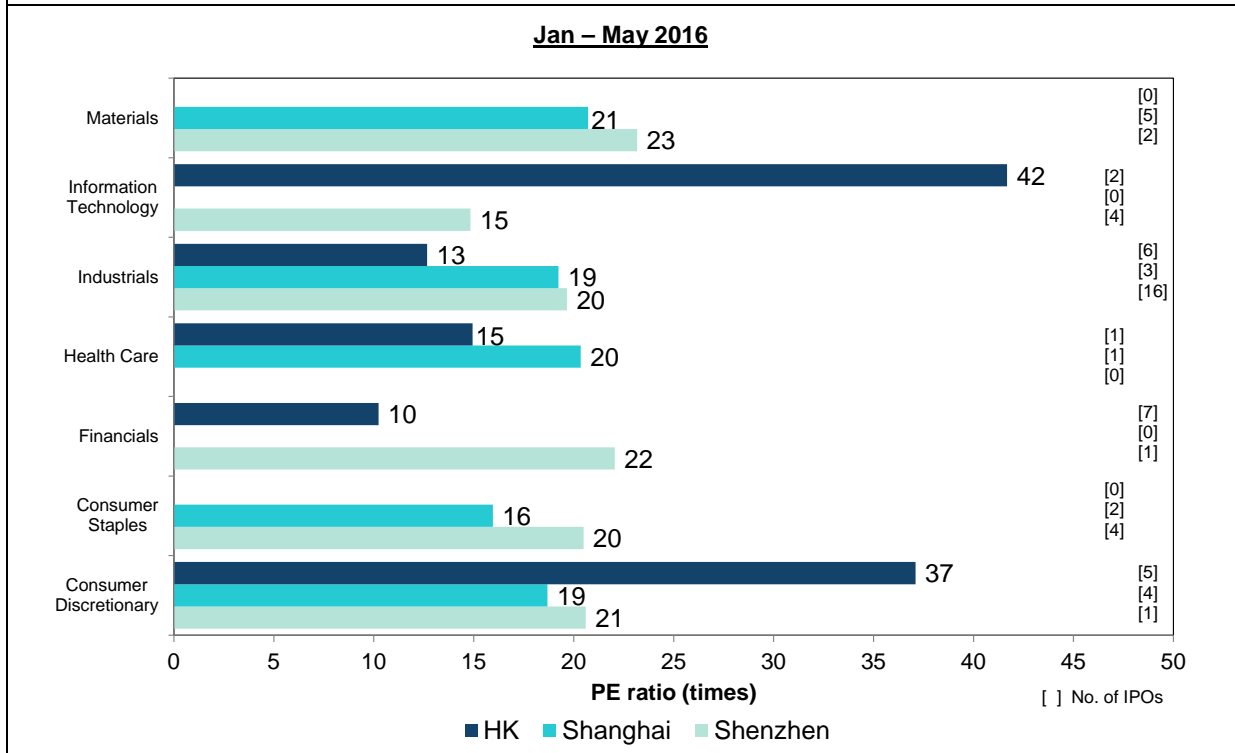
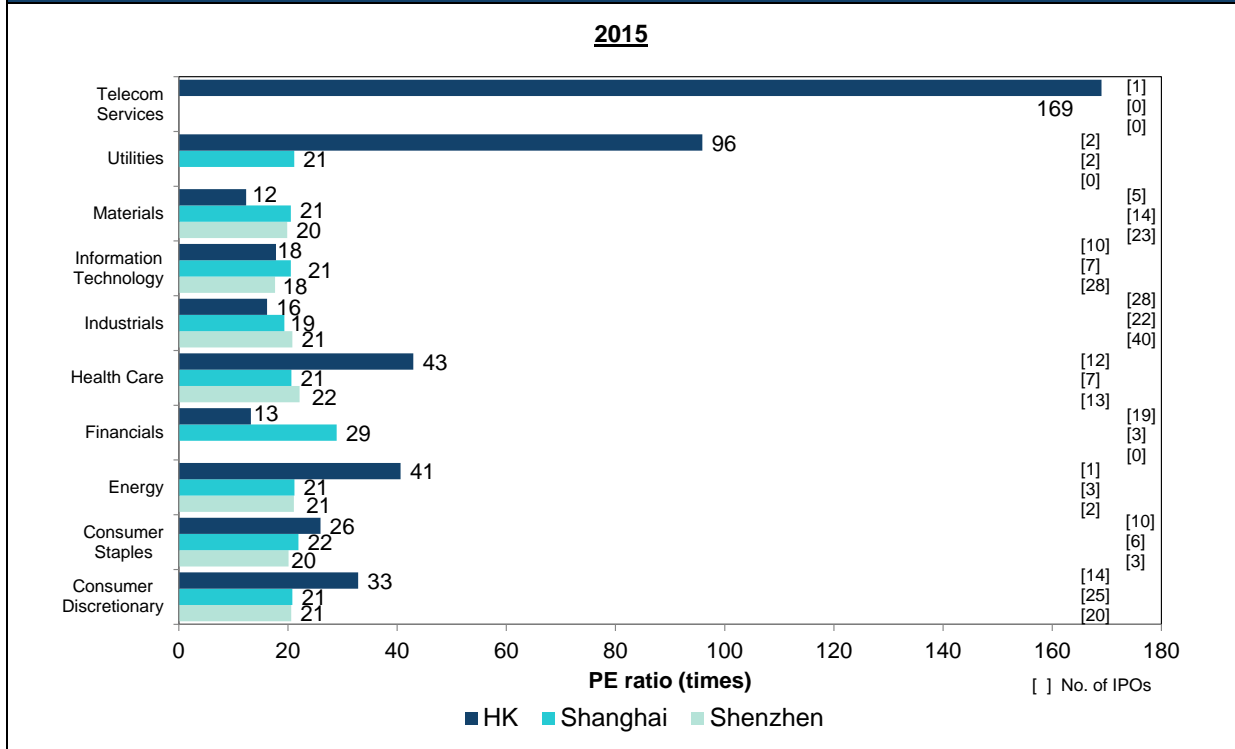
Further examination by year reveals that IPOs in Hong Kong were offered at higher PE ratios than in the Mainland for a number of sectors in each year since 2014 up to May 2016 (i.e. in the period after CSRC approval of IPOs had resumed in the Mainland following a suspension in 2013). (See Figure 13.) In 2014, IPOs in Hong Kong had a higher MC-weighted PE ratio than in the Mainland for the sectors of Consumer Discretionary, Consumer Staples, Health Care, IT and Utilities. For 2016 up to May, the Hong Kong MC-weighted IPO PE differentials against the Mainland remained positive for the sectors of Consumer Discretionary and IT.

Figure 13. MC-weighted PE ratios of IPOs in Hong Kong and the Mainland by industrial sector by year (2012 – May 2016)



Source: HKEX analysis based on IPO raw data from Bloomberg.

Figure 13. MC-weighted PE ratios of IPOs in Hong Kong and the Mainland by industrial sector by year (2012 – May 2016) (cont'd)



Source: HKEX analysis based on IPO raw data from Bloomberg.

Notes:

1. Cases with negative or null PE value are excluded.
2. Sectors without IPOs in Hong Kong and the Mainland in the year are not shown in the chart.
3. There were no IPOs in the Mainland in 2013.

In other words, *IPOs in certain industrial sectors may obtain a higher valuation in Hong Kong than in the Mainland, bearing in mind that the PE at offer would be rather stock-specific.*

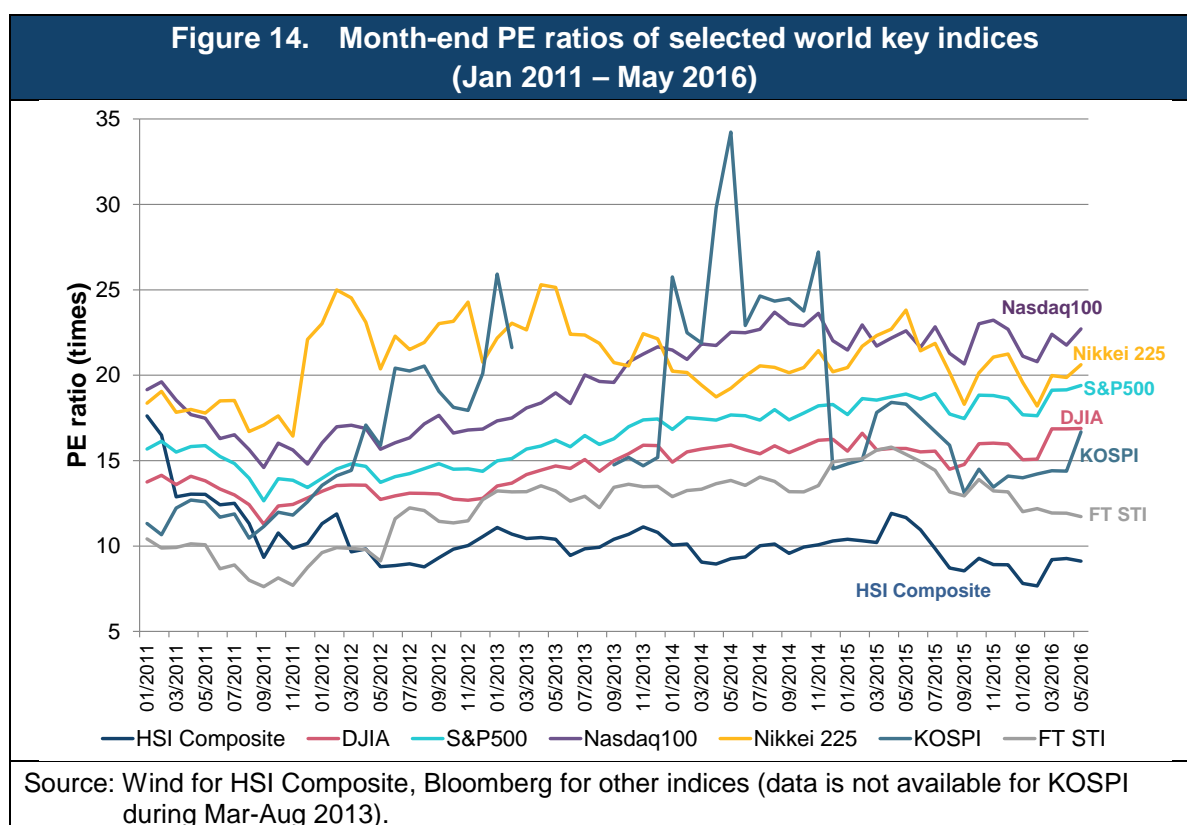
4. SOURCES OF DIFFERENCE

The valuation differentials across markets originate from a number of factors including macro factors of the market and micro factors of the individual stocks. These factors are discussed below.

(1) Market norms of PE ratio

Each stock market in the world, irrespective of the degree of openness, tends to maintain its “normal” level of PE ratio during a period of time — **the market norm**, which is the result of the market’s characteristics including industry composition and development stage of listed companies, investor base, investor maturity and their investment behaviour. This market norm will tend to remain unless the market fundamentals have changed upon which a new norm will be achieved.

Figure 14 shows the PE ratios of the Hong Kong market in comparison with key indices in the US — Dow Jones Industrial Average (DJIA), S&P 500 and Nasdaq 100, and the Asia markets — Nikkei 225 in Japan, KOSPI in Korea and FT Strait Times Index (FT STI) in Singapore. While the Japan market has a PE market norm level comparable to the US market, the Singapore market has a PE market norm level between the US market and the Hong Kong market in the recent few years. The Korean market is a special case where the PE ratio of its composite index fluctuated a lot, yet its norm level in the recent year was between the US market and the Singapore market.



Attempts were made below to explore the market fundamentals that affect the PE norm level of a market.

(2) Industry composition of listed companies

As examined in section 2.3 above, certain industries tend to have a relatively lower or higher PE. The “traditional” financial industry tends to have a lower PE and new economy industries like technology and health care which appeal to investors with high growth prospects tend to have a higher PE. Therefore, **markets with more weighting in new economy industries would tend to have a higher weighted average PE level and markets with more weighting in the financial industry would tend to have a lower average PE level.** In this context, the Nasdaq market, which comprises about 66% in technology and health care sectors, is an example of high-PE market; and the Hong Kong market, which comprises over 40% of financial stocks, is an example of low-PE market. (See Figure 15.)

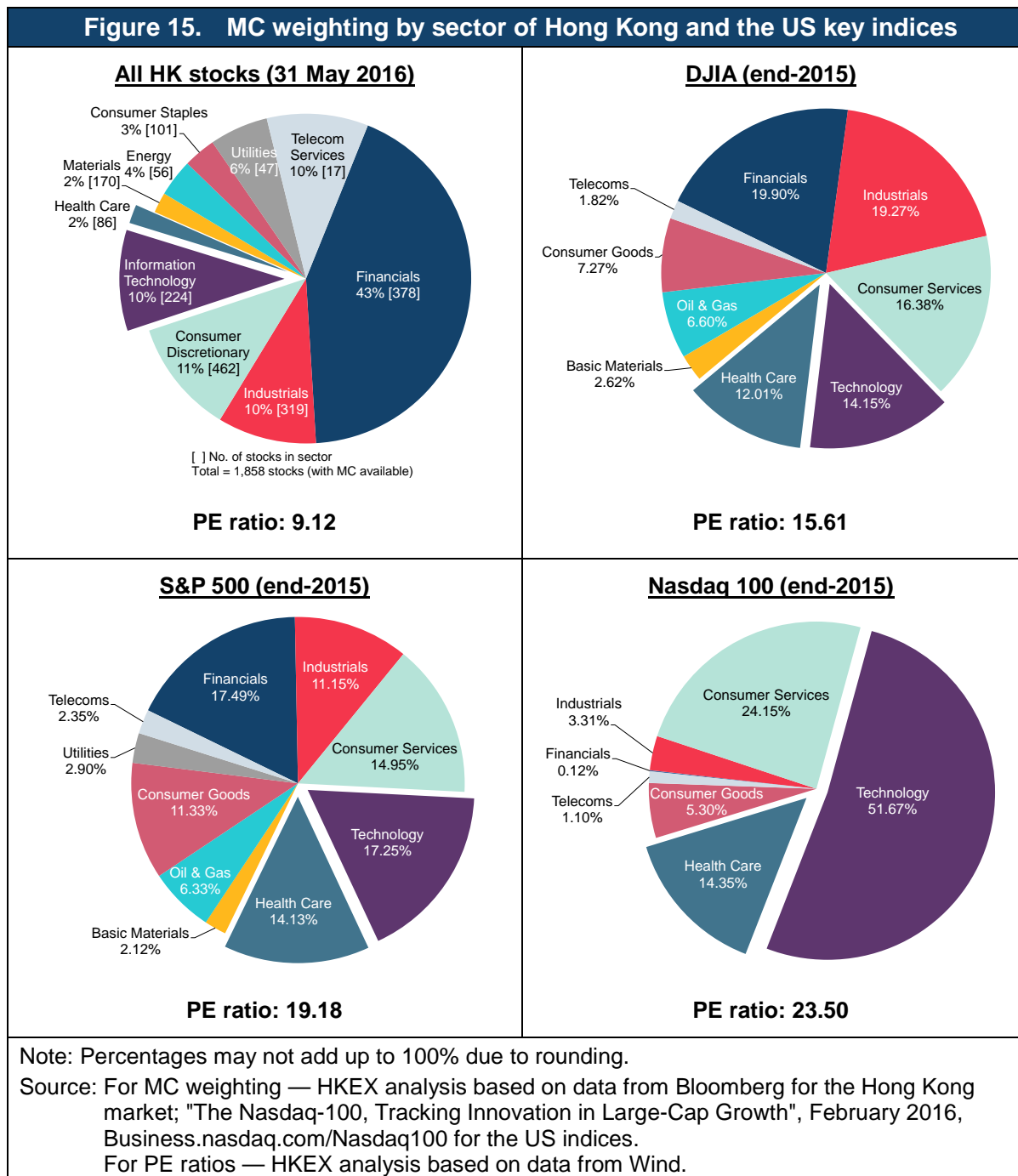
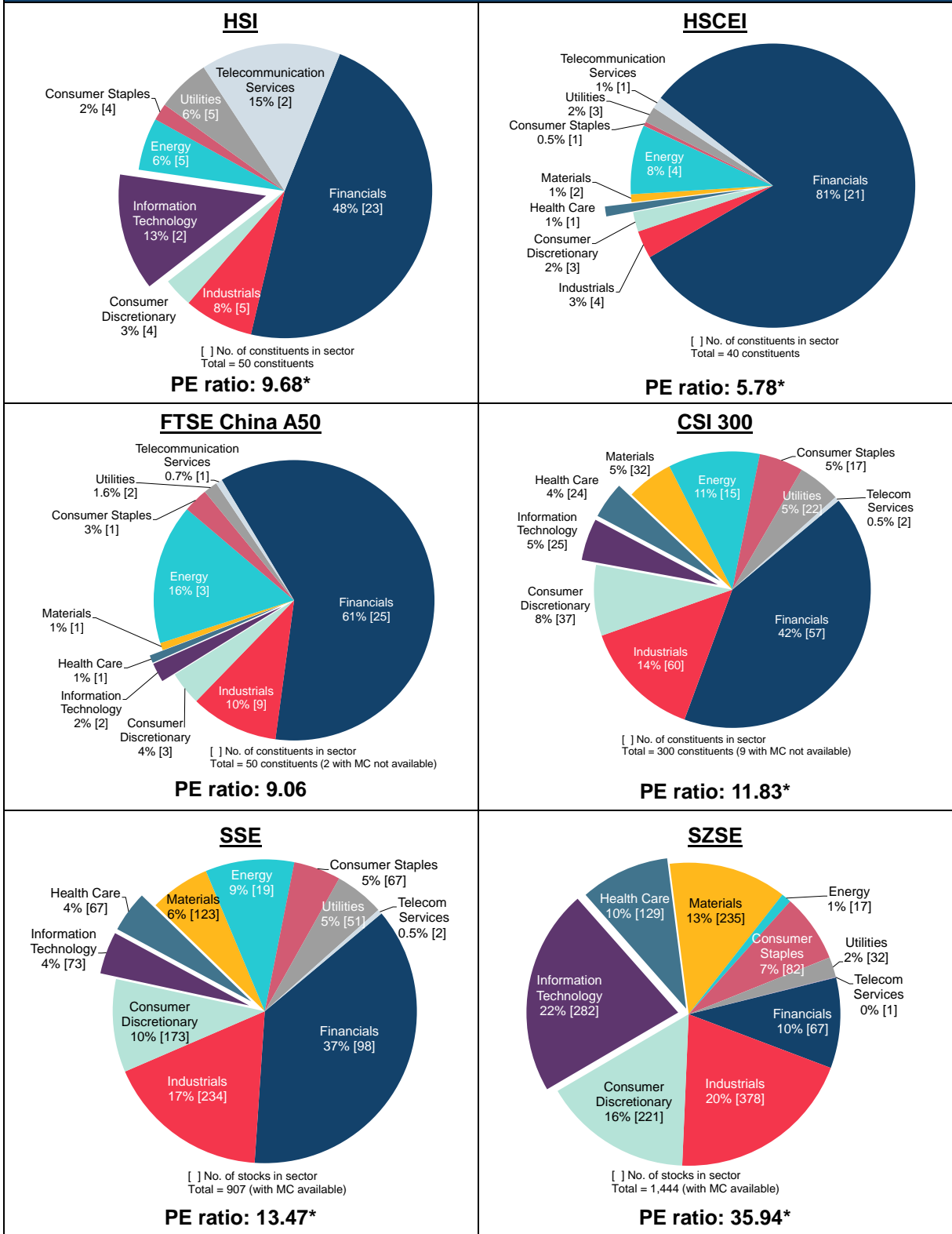


Figure 16. MC weighting by sector of key indices in Hong Kong and the Mainland (31 May 2016)



* The PE ratios of the respective indices do not equal the data point in the time series presented in Figure 1, 3 to 5 due to different bases and data sources. This does not affect the comparability across markets in this Figure with data on the same calculation basis — sum of MC / sum of earnings for stocks in the applicable index or market (excluding companies with negative earnings).

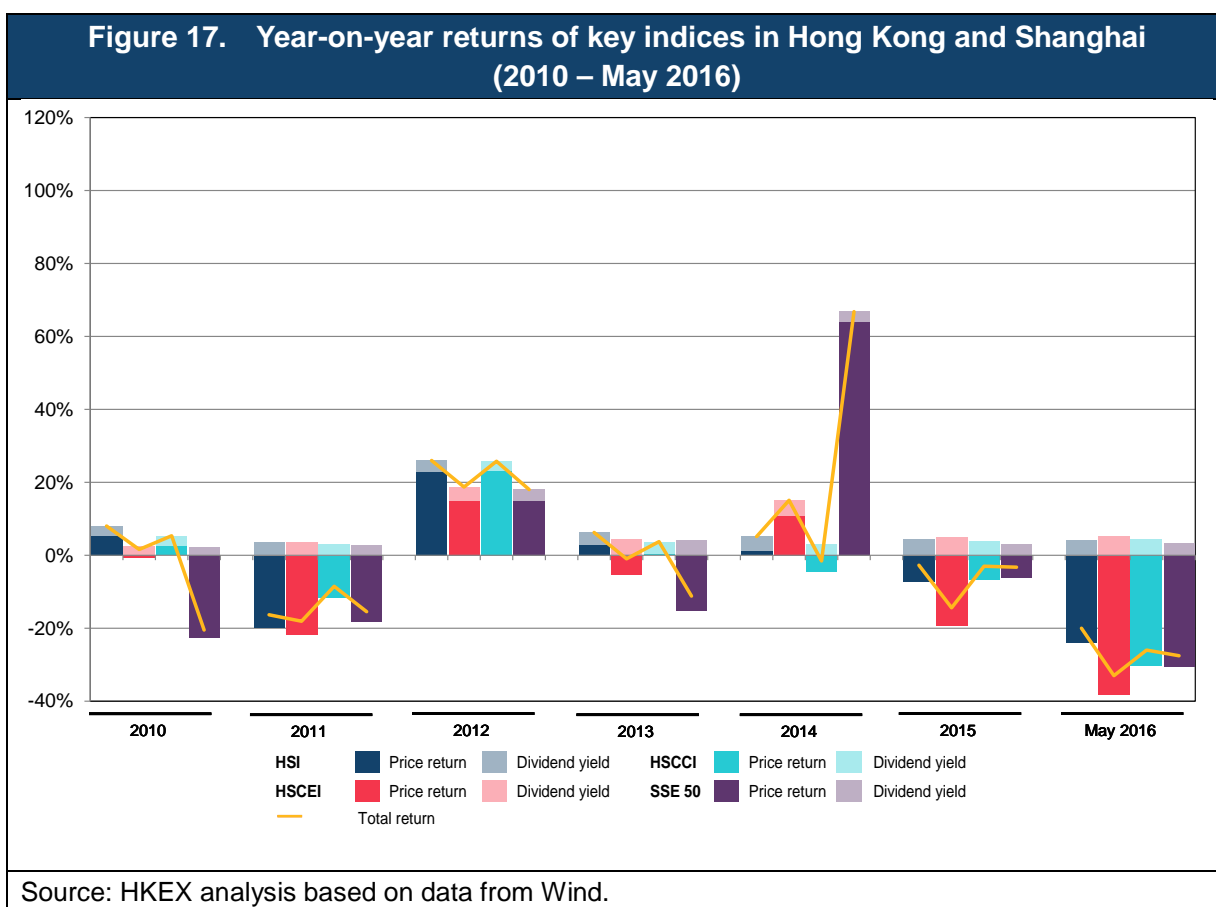
Note: Percentages may not add up to 100% due to rounding.

Source: HKEX analysis based on price and earnings data from Bloomberg.

In Hong Kong, the relative PE levels of different indices also differ — HSCEI tends to have a lower PE than HSI (see section 2.1 above). One reason would be the fact that HSCEI has a much heavier MC weighting in low-PE Financials — 81% vs 48% for HSI. In comparison, the key indices of the Mainland market (Shanghai and Shenzhen combined) — FTSE China A50 Index and the CSI300 Index — also have a high weighting in Financials, but the CSI300 has a relatively diverse industry composition and alongside a higher PE than the HSI. The SZSE market, in particular, has a significant MC weighting (32%) in new economy industries of IT and Health Care. Accordingly, the SZSE market has the highest PE among the indices. (See Figure 16 above.)

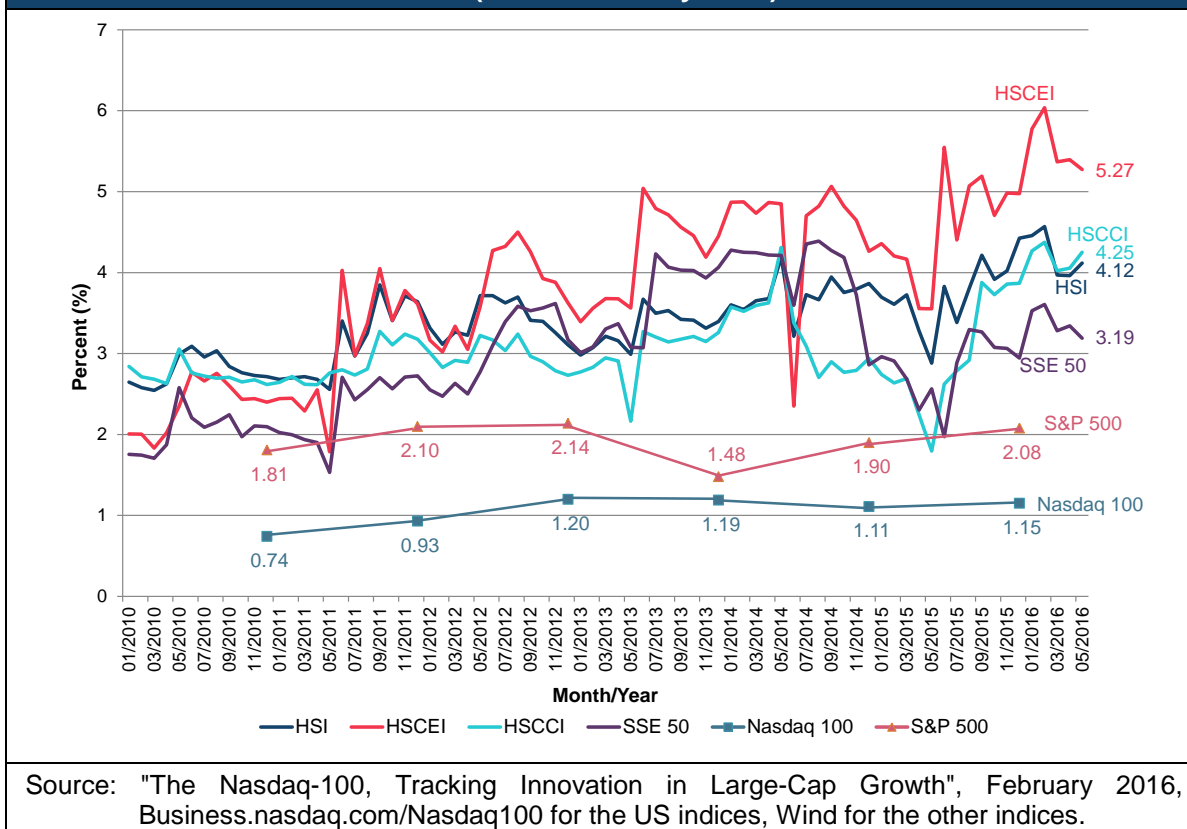
(3) Dividend yield as part of stock valuation

The value of stock investment to investors consists of capital gain — the gain or loss in stock price changes, and dividend payments during the holding period. The price level measured by the PE ratio reflects the capital gain only. The total return should be assessed by taking into account the dividend yield. Figure 17 shows the year-on-year total return on the key indices in Hong Kong and Shanghai and its composition into price return and dividend yield. For most of the years, HSI had a higher or less bad total return than the SSE 50 Index. While the HSCEI might have performed less good, the HSCCI outperformed the SSE 50 Index for most of the time.



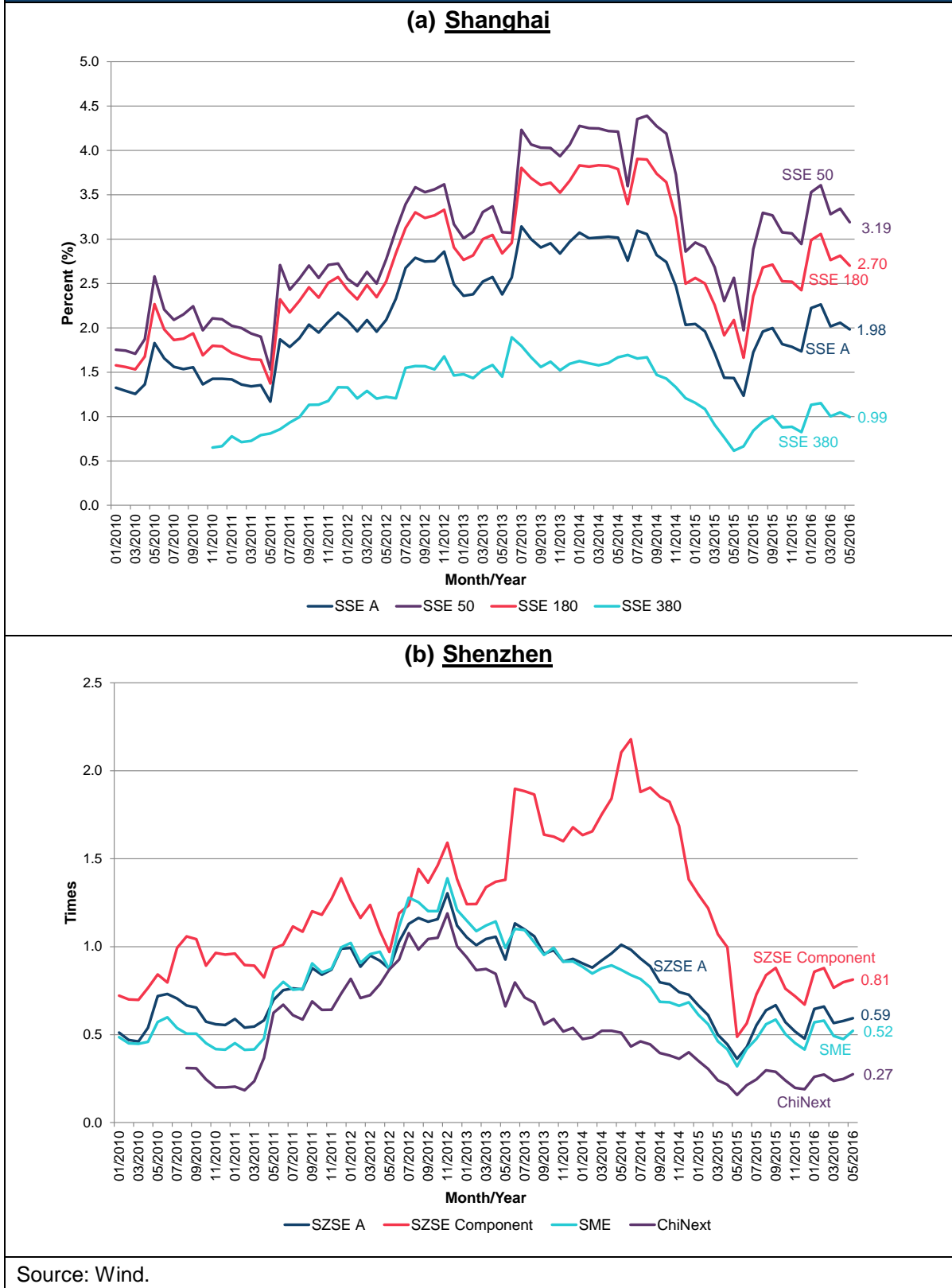
In fact, as shown in Figure 18, the SSE 50 Index was found to have a lower dividend yield than the HSI for most of the time during the past 5 to 6 years and the HSCEI was found to have the highest dividend yield among the Hong Kong indices and SSE 50 for most of the time since 2011. In comparison, while Nasdaq 100 had a relatively high PE ratio, its dividend yield was the lowest. An examination of the dividend yields of the various SSE and SZSE indices also shows that **indices having a higher PE ratio tend to have a lower dividend yield and vice versa** (see Figure 19 below and Figures 4 and 5 above). This is probably due to the nature of the constituent stocks — mature companies in traditional industries with stable business and income stream tend to have higher dividend distributions but low growth prospects and therefore lower PE; emerging companies with high growth prospects tend to have higher PE but low or no dividend distributions due to unstable income stream or even no earnings yet.

Figure 18. Month-end dividend yield of key indices in Hong Kong, Shanghai and US (Jan 2010 – May 2016)



Source: "The Nasdaq-100, Tracking Innovation in Large-Cap Growth", February 2016, Business.nasdaq.com/Nasdaq100 for the US indices, Wind for the other indices.

Figure 19. Month-end dividend yield of key indices in Shanghai and Shenzhen (Jan 2010 – May 2016)



(4) Investor preference

The investor composition in the Hong Kong and Mainland markets are very much different. Over 50% of cash market trading in Hong Kong was contributed by institutional investors and over 30% by overseas institutional investors; local retail investors contributed about 20% only.⁷ On the contrary, the majority of trading in the Mainland market came from local retail investors. Developing the institutional investor base has been a long-term market development strategy of the Mainland authorities. The investment behavior of retail and institutional investors differs a lot. Large international institutional investors make investment decisions based on sophisticated stock valuation models and risk-adjusted portfolio management techniques. The large majority of retail investors are non-professionals who in general invest on self-preference which may be of a speculative nature. The valuation of stocks in a market with a high degree of participation of international institutional investors would tend to align with stock fundamentals. On the other hand, ***the valuation of stocks in a market with predominant participation of retail investors would be an aggregate result of the investors' self-preferences.***

Given the short history of the modern stock market in Mainland China, retail investors are still not very mature and sophisticated. Much investor trading in the Mainland market is of a speculative nature. These investors prefer small-sized and high-risk stocks for higher potential gains. As a result, in the Mainland market, the smaller the company size, the higher the PE ratio. In the highly internationalised Hong Kong stock market which has gone through cycles of boom and bust in its centenary history, even retail investors are relatively mature. Given the sophisticated investor structure in Hong Kong, company size is not a determinant of stock price valuation. (See section 2.1 above.)

(5) Liquidity premium

In addition to the risk premium that investors would ask for in stock valuation, ***investors would also be willing to pay more for stocks with higher liquidity — the liquidity premium***, i.e. the premium paid to be easier to sell out the stock. Mainland listed stocks generally have a much higher turnover velocity than stocks in Hong Kong — 449% on SSE and 521% on SZSE vs 106% on HKEX in 2015⁸. For A-H stocks, the aggregate turnover velocity of A shares is 286% compared to 131% for the corresponding H shares in 2015.⁹ Among the 87 A-H stocks, only 15 stocks (or 17%) had a higher turnover velocity than their corresponding A shares.

⁷ Source: HKEX Cash Market Transaction Survey 2014/15.

⁸ Calculated by dividing the annual stock turnover value by the year-end total market capitalisation of listed stocks on the respective markets (source: monthly statistics of the respective exchanges on their websites). For the Mainland markets, the turnover ratios based on negotiable market capitalisation were considerably higher — 513% for SSE and 713% for SZSE.

⁹ Based on data of year-end closing price and outstanding shares and the annual turnover value of the A-H stocks as obtained from Thomson Reuters.

Although a partial connectivity channel is opened between the two markets upon the launch of the Shanghai-Hong Kong Stock Connect in November 2014 (the Shenzhen-Hong Kong Stock Connect is still underway), the flow of investment across the markets to level out the liquidity differential is still limited because of the imposed regulatory restrictions like trading quota and Mainland investor eligibility criteria.

(6) Availability of investment instruments for flexible portfolio management and hedging/arbitrage

The Mainland securities market currently offers equities, investment funds including exchange traded funds (ETFs), and bonds for investment. Structured products like derivative warrants and Callable Bull/Bear Contracts (CBBCs) in Hong Kong are not available. Short selling facility is also limited. Stock index futures were firstly launched on the China Financial Futures Exchange (CFFEX) in April 2010 with only one product — CSI300 futures — until 5 years later in April 2015 when CSI 500 Index futures and SSE 50 Index futures were introduced. ***The narrow range of derivatives and structured products in the Mainland deprives investors of more flexible portfolio management and arbitrage and hedging opportunities in stock investment.*** This results in a uni-directional investment behavior of investors, with investment monies chasing similar investment targets, thereby pushing up the price level.

5. OPPORTUNITIES OFFERED BY THE HONG KONG MARKET

As discussed above, due to the differences in market characteristics and investor structure between the Hong Kong and Mainland markets, the price differential at the macro level between the two markets — higher PE in the Mainland market — is expected to continue for a considerable period of time. Nevertheless, a reverse price differential — higher PE in the Hong Kong market — does exist at the micro-level. The Hong Kong market offers the following opportunities to issuers and investors under both the macro and micro situations:

(1) Taking advantage of the lower priced H shares of AH stocks

For AH stocks where H shares are traded at a discount to A shares, investors would benefit from buying in the lower priced H shares and receiving a higher dividend yield than holding A shares of the same company. The capital gain return on the stock would be comparable since the stock fundamentals are the same for the same company.¹⁰

(2) Taking advantage of the comprehensive range of investment tools

Compared to trading in the Mainland market, investors trading in the Hong Kong market would benefit from the availability of a wide range of equity derivatives and structured products for hedging and arbitrage with stock investment. These investment tools would provide a dampening effect under volatile market conditions. Investors would therefore have enhanced capability to cope with risky market conditions and be exposed to more profit opportunities than in the Mainland market.

(3) Taking advantage of the higher IPO pricing in certain industrial sectors

IPOs in certain industries like consumer goods, energy and health care were offered in Hong Kong with a higher PE ratio than in the Mainland. This reflects that at the micro level of individual stocks, potential issuers falling in the right appetite of investors in the Hong Kong market would be able to get a better pricing than in the Mainland.

(4) Taking advantage of the market appetite for stocks in new economy industries

The current industry composition of the Hong Kong market has been too much concentrated in the financial industry. There is plenty of room for an increased weighting in new economy industries like IT and health care. Potential issuers in these industries would be attractive to investors. Moreover, past Hong Kong IPOs in the health care sector were offered at a much higher PE than those in the Mainland (see section 3 above).

¹⁰ For reference, the year-on-year returns of H shares of the 87 A-H stocks as at the end of June 2016 had a simple average of -30.4%, compared to -31.1% for A shares.

(5) Taking advantage of the more flexible IPO and post-listing fund-raising regime

Compared with the Mainland market, the new shares issuance regime in Hong Kong is less restrictive and more flexible. The time to market for an IPO application in Hong Kong would be shorter as the application queue is much shorter than in the Mainland. An IPO and any post-listing fund raising action is a commercial decision made solely by the issuer. There is a range of methods allowed for post-listing fund raising for choice at the discretion of the issuer, provided that the action is taken in accordance with the relevant Listing Rules. Such flexibility and market-driven approach could highly benefit the issuers to time their shares issuance in accordance with business needs and the prevailing market conditions.

(6) Taking advantage of the international platform for a listing

The Hong Kong stock market is completely open for the participation of global investors and its operation is consistent with international practice and regulatory standards. Issuers listed on this platform can easily reach out to international professional institutional investors and global monies. In particular, issuers would be able to attract international cornerstone investors. An international listing status offers abundant opportunities for companies with an international perspective to expand their business worldwide through branding, global mergers and acquisitions and corporate restructuring. The international status, fund raising capacity and flexibility offered by the Hong Kong platform would be the preferred choice for Mainland enterprises to support their corporate development and expansion strategies.

6. CONCLUSION

The differentials in stock valuation between the Hong Kong and the Mainland markets originate from a number of factors, including the difference in market characteristics, industry composition of listed companies, investor structure and investor preference. The Mainland market appears to have positive valuation differentials at the macro level but the Hong Kong market may also have positive valuation differentials at the micro level of individual stocks and industries.

While the valuation differentials at the macro level may exist for a considerable period of time given no significant change in the underlying factors, issuers and investors may still benefit from the opportunities offered by the Hong Kong market arising from such differentials. These opportunities include better dividend yield from H shares of AH stocks, better arbitrage and hedging opportunities, better IPO pricing in certain industries of market appetite and the more flexible fund-raising regime. The most important of all is the international status and global expansion opportunities offered by the Hong Kong market to Mainland enterprises.

* * *

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APPENDIX 1. STATISTICAL TESTS ON SIGNIFICANT DIFFERENCE BETWEEN PE RATIOS OF STOCKS ACROSS INDUSTRIAL SECTORS

(A) Hong Kong stocks

() Simple average of PE ratios [] No. of stocks

Sector	Financials	Industrials	Consumer Discretionary	Information Technology	Materials	Energy	Consumer Staples	Health Care	Utilities	Telecom Services
Financials (24x) [278]		*	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Industrials (67x) [206]			n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Consumer Discretionary (72x) [277]				n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Information Technology (79x) [130]					n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Materials (39x) [79]						n.s.	n.s.	n.s.	n.s.	n.s.
Energy (49x) [22]							n.s.	n.s.	n.s.	n.s.
Consumer Staples (55x) [62]								n.s.	n.s.	n.s.
Health Care (53x) [64]									n.s.	n.s.
Utilities (21x) [41]										n.s.
Telecom Services (26x) [13]										

*** Statistically significant difference at 0.1% level
 ** Statistically significant difference at 1% level
 * Statistically significant difference at 5% level
 n.s. No statistically significant difference

(B) SSE stocks

() Simple average of PE ratios [] No. of stocks

Sector	Financials	Industrials	Consumer Discretionary	Information Technology	Materials	Energy	Consumer Staples	Health Care	Utilities	Telecom Services
Financials (50x) [97]		n.s.	*	***	*	n.s.	**	n.s.	n.s.	n.s.
Industrials (106x) [234]			n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Consumer Discretionary (158x) [171]				n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Information Technology (126x) [72]					n.s.	n.s.	n.s.	n.s.	***	n.s.
Materials (146x) [122]						n.s.	n.s.	n.s.	n.s.	n.s.
Energy (228x) [19]							n.s.	n.s.	n.s.	n.s.
Consumer Staples (196x) [67]								*	**	n.s.
Health Care (82x) [67]									n.s.	n.s.
Utilities (54x) [51]										n.s.
Telecom Services (33x) [2]										

*** Statistically significant difference at 0.1% level
 ** Statistically significant difference at 1% level
 * Statistically significant difference at 5% level
 n.s. No statistically significant difference

(C) SZSE stocks

() Simple average of PE ratios [] No. of stocks

Sector	Financials	Industrials	Consumer Discretionary	Information Technology	Materials	Energy	Consumer Staples	Health Care	Utilities	Telecom Services
Financials (78x) [67]		n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Industrials (178x) [375]			n.s.	n.s.	n.s.	n.s.	n.s.	*	n.s.	n.s.
Consumer Discretionary (122x) [221]				n.s.	n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Information Technology (279x) [282]					n.s.	n.s.	n.s.	n.s.	n.s.	n.s.
Materials (195x) [235]						n.s.	n.s.	n.s.	n.s.	n.s.
Energy (147x) [17]							n.s.	n.s.	n.s.	n.s.
Consumer Staples (101x) [81]								n.s.	n.s.	n.s.
Health Care (101x) [128]									n.s.	n.s.
Utilities (59x) [32]										n.s.
Telecom Services (98x) [1]										
*** Statistically significant difference at 0.1% level ** Statistically significant difference at 1% level * Statistically significant difference at 5% level n.s. No statistically significant difference										

