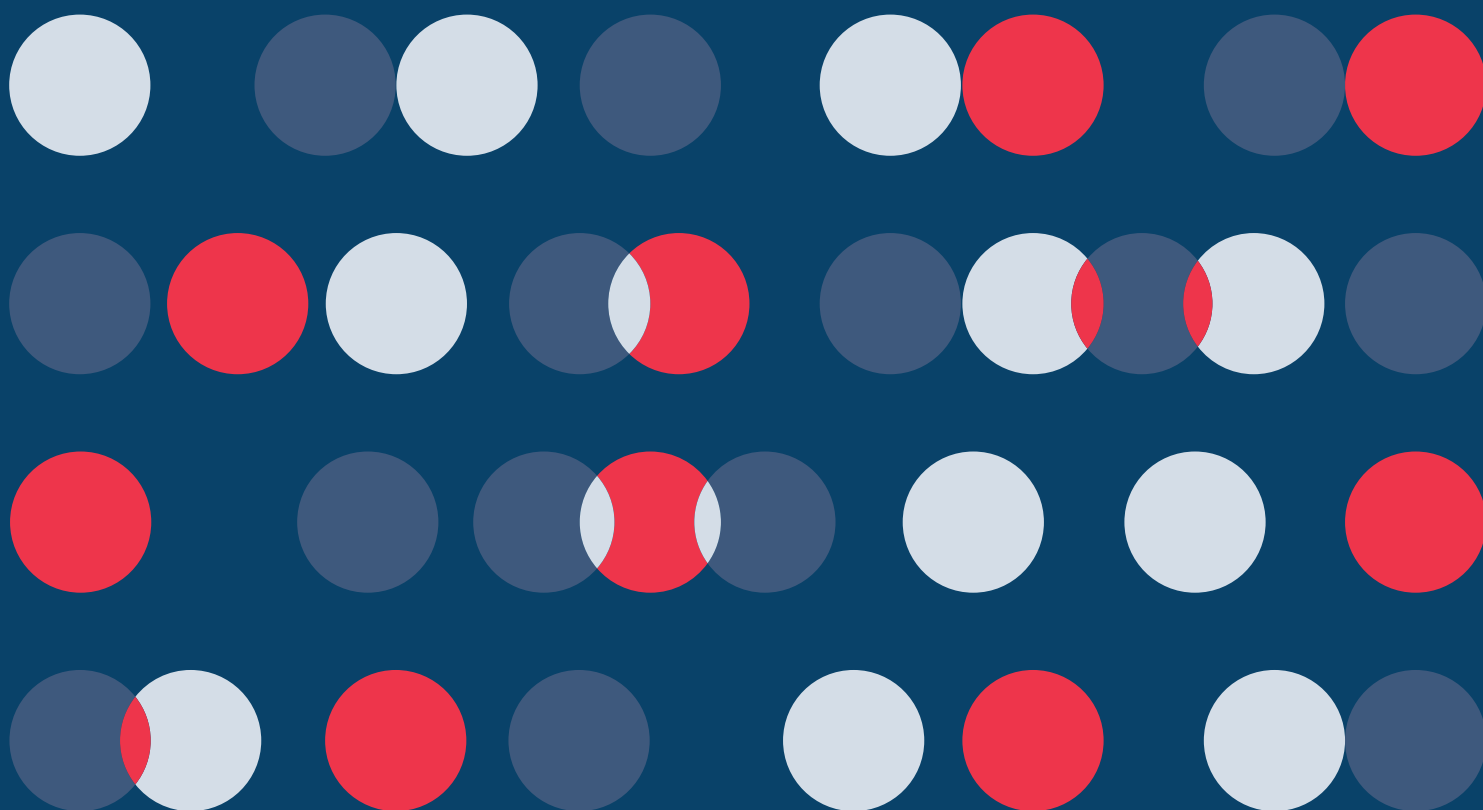


June 2019

RESEARCH REPORT

HONG KONG'S ROLE IN SUPPORTING THE  
FUND-RAISING OF MAINLAND PRIVATE ENTERPRISES



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## SUMMARY

Mainland private enterprises (MPEs) have contributed tremendously to China's economic growth over the past four decades of economic reform and will continue to assume a significant role in the current round of economic transformation into a new economy driven by innovation and entrepreneurship. MPEs' contribution is well recognised and encouraged by China's leadership through providing long-standing policy support. However, MPEs are still experiencing difficult times in getting sufficient financing in the onshore market. Major reasons include direct financing channels not offering enough support such that their share of enterprise funding is still low, the recent rebound in the leverage of MPEs that worsens their bargaining power in getting further funding and the intense competition with state-owned enterprises (SOEs) for both equity financing and bond financing as well as bank loans. As a result, the shares of equity financing and bond financing to MPEs came to their recent lows and MPE funding through shadow banking channels (e.g. share pledges) has been tightened. MPEs are desperately in need of more funding support.

Among the Mainland authorities' policy support to MPEs is the promotion and encouragement of their offshore financing through stocks and bonds. In this regard, Hong Kong has been the largest offshore funding centre in equity financing and bond financing for Mainland enterprises. This is especially beneficial to MPEs given their domestic funding difficulties. Compared to the Mainland market, the Hong Kong market offers more certainty of funding timing, market-driven valuation and the reach of global investors. These contribute to a level-playing field for fund-raising by MPEs and other Mainland enterprises, irrespective of the enterprise's sector and ownership. In respect of equity financing, the majority share of funds raised by initial public offerings (IPOs) and secondary offerings by Mainland enterprises in 2018 fell onto MPEs. Moreover, the Hong Kong market implemented a listing regime reform in April 2018 to allow the listing of companies with weighted voting rights (WVR) and biotechnology companies which are not yet in profitable stage. These would be new-economy companies, including many MPEs. In respect of bond financing, Mainland enterprises issued dim sum bonds and foreign currency-denominated bonds in Hong Kong, with lower funding costs than in other offshore centres. As a leading centre of offshore financing for Mainland enterprises, the Hong Kong market provides a wide spectrum of offshore RMB risk management tools for their exchange rate risk management in the light of the currency mismatch.

Besides, the global liquidity channelled through the Stock Connect and Bond Connect schemes helps boost the domestic liquidity of the onshore stock and bond markets. This would support domestic financing activities of Mainland enterprises, including MPEs. The enhanced foreign access to the Mainland stock and bond markets has increased global recognition of the markets and facilitated the inclusion of Mainland securities into global benchmarks, which further drives up foreign participation and domestic liquidity. The global connectivity offered by the Hong Kong market gateway provides strong support to funding for all Mainland enterprises. This is particularly important to MPEs which have been facing obstacles in obtaining financing through domestic means.

Complementary to the Mainland market, the Hong Kong market will continue to exhibit its roles in supporting the offshore financing of Mainland enterprises, including MPEs.

## 1. THE ECONOMIC SIGNIFICANCE OF MAINLAND PRIVATE ENTERPRISES AND THEIR CURRENT FUNDING LANDSCAPE

### 1.1 Economic significance of Mainland private enterprises

Mainland private enterprises (MPEs) have been playing an increasingly significant role in China's economic development ever since the country's economic reforms that started four decades ago. A number of central policy documents had been issued over time, including the State Council guidelines issued in 2005<sup>1</sup> and 2010<sup>2</sup>, to encourage market entry of MPEs into various sectors to enhance industry productivity. By 2018, MPEs had contributed more than 50% of tax revenues, 60% of gross domestic product (GDP), 70% of technological innovation, 80% of urban employment and 90% of job creation and number of new enterprises<sup>3</sup>.

Comparing to state-owned enterprises (SOEs), MPEs have been more innovative in grasping economic growth opportunities. MPEs have their business decisions driven more by market conditions and are more flexible to adapt to the fast changing economic environment. Owing to these, new business ideas or visions can be pursued more efficiently in the private sector, rendering MPEs a source of innovation for the Mainland economy. This is especially important strategically in this new-economy world.

Given the economic significance of MPEs, China's leadership re-assure their support. In an open letter undersigned by President Xi Jinping in October 2018, MPEs' contribution to economic development was highly recognised and continuous support to MPEs was expressed<sup>4</sup>. On 1 November 2018, President Xi convened a symposium with Mainland officials and representatives from the private sector, including Baidu and Tencent<sup>5</sup>. The aim of the symposium was to "boost the confidence" of private enterprises and to reiterate that "encouraging, supporting and guiding" the private economy "has not changed". During the symposium, President Xi pledged to find new ways to protect the business of private enterprises that may include substantial tax cuts for the private sector, more encouragement to banks for lending to the private sector and to "conduct necessary financial rescues of private businesses with good business prospects" by local governments.

Notwithstanding the supportive policies, the financing of MPEs has been in difficult situation, affected by the market structure and macroeconomic environment. This is discussed in detail in the following sub-sections.

### 1.2 Relatively low direct financing for the corporate sector

Bank loans are still the main source of funding for non-financial sectors and the share of direct financing through the capital market is still low. According to the statistics from the People's Bank of China (PBOC), bank loans accounted for about 68.2% of total social financing outstanding as of end-2018 (see Figure 1). Net financing from bonds issued by non-financial corporates accounted for about 10.0%. Equities accounted for only 3.5%. Other financing

<sup>1</sup> *Certain Opinions on Encouraging, Supporting and Guiding the Development of Non-Publicly-Owned Economy such as Sole Proprietors and Private Enterprises* (《國務院關於鼓勵支持和引導個體私營等非公有制經濟發展的若干意見》), issued by the State Council, 25 February 2005.

<sup>2</sup> *Certain Opinions About Encouraging and Guiding the Healthy Development of Private Investments* (《國務院關於鼓勵和引導民間投資健康發展的若干意見》), issued by the State Council, 13 May 2010.

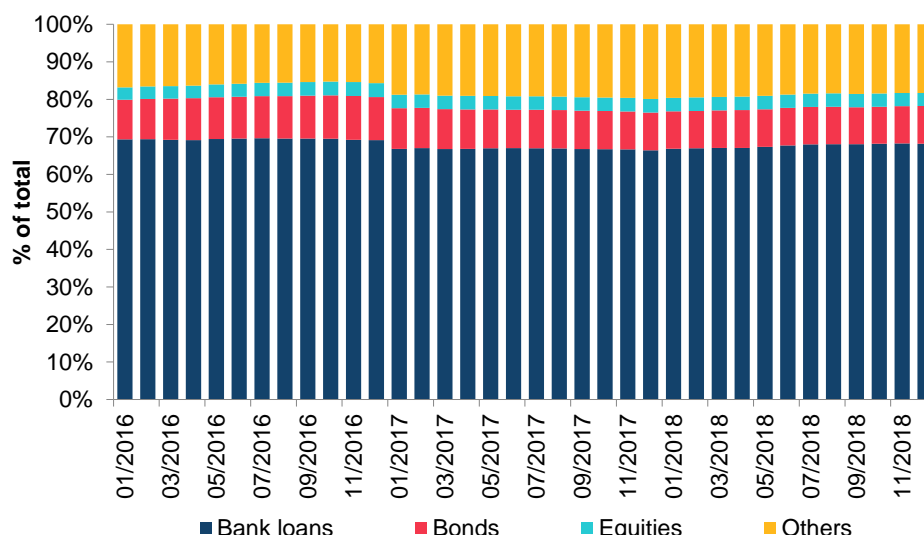
<sup>3</sup> Source: 〈劉鶴：所謂「國進民退」的議論既是片面的也是錯誤的〉("Liu He: The discussions on so-called 'the state sector advances, the private sector retreats' are partial and incorrect"), *Xinhua News*, 20 October 2018. ([http://www.xinhuanet.com/politics/leaders/2018-10/19/c\\_1123583752.htm](http://www.xinhuanet.com/politics/leaders/2018-10/19/c_1123583752.htm))

<sup>4</sup> Source: 〈習近平給「萬企幫萬村」行動中受表彰的民營企業家的回信〉("Xi Jinping's reply letter to the praised private entrepreneurs in the 'Business to Help Village' campaign"), *Xinhua News*, 21 October 2018. ([http://www.xinhuanet.com/politics/leaders/2018-10/21/c\\_1123590760.htm](http://www.xinhuanet.com/politics/leaders/2018-10/21/c_1123590760.htm))

<sup>5</sup> Source: 〈習近平：在民營企業座談會上的講話〉("Xi Jinping: The speech at the symposium with private enterprises"), *Xinhua News*, 1 November 2018. ([http://www.xinhuanet.com/politics/leaders/2018-11/01/c\\_1123649488.htm](http://www.xinhuanet.com/politics/leaders/2018-11/01/c_1123649488.htm))

channels, including shadow banking, accounted for about 18.3%. In other words, direct financing (comprising equity financing and bond financing) was about 13.5%, not so far behind the 20% of bank loans. Compared to the results of an earlier study<sup>6</sup> which showed that direct financing was only one-ninth of bank loans in China, the share of direct financing has improved, but was still relatively low (the same study showed that direct financing had an equal share as bank loans in many countries).

**Figure 1. Distribution of total social financing outstanding in the Mainland (Jan 2016 – Dec 2018)**

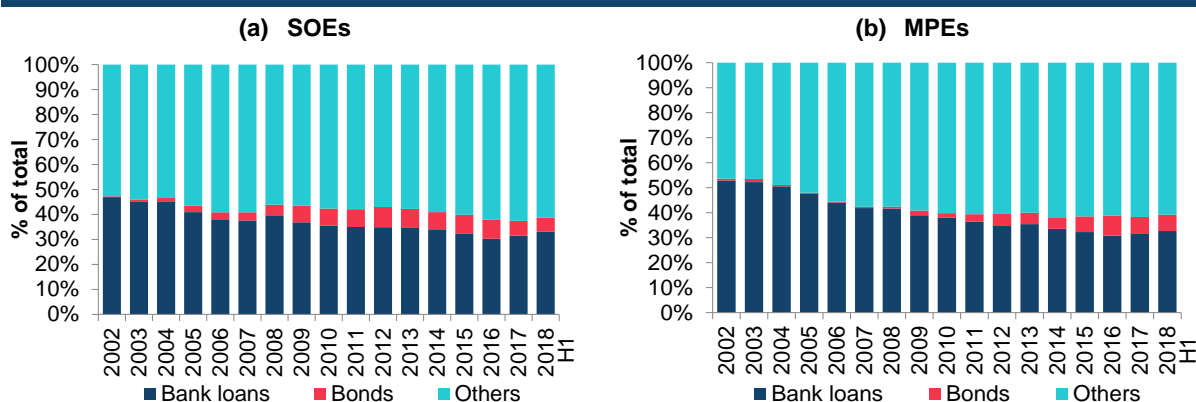


Note: "Others" include entrusted loans, trust loans, bank acceptances and other financing.

Source: Wind.

**The low share of bond financing is evidenced for both SOEs and MPEs.** As estimated from the financial statements of non-financial companies with A shares listed in the Mainland, bank loans accounted for a much higher share than bonds. For Mainland-listed SOEs, bank loans accounted for about 33.1% of total liabilities as of the end of the first half of 2018 (2018H1), which was 5.9 times the share of bonds at 5.6% (see Figure 2a). For Mainland-listed MPEs, the share of bank loans was about 32.7% of total liabilities as of the end of 2018H1, which was about 5 times the share of bonds at 6.5% (see Figure 2b).

**Figure 2. Breakdown of total liabilities for Mainland-listed enterprises (2002 – 2018H1)**



Note: The enterprise type of bond issuers is identified using Wind's definitions.

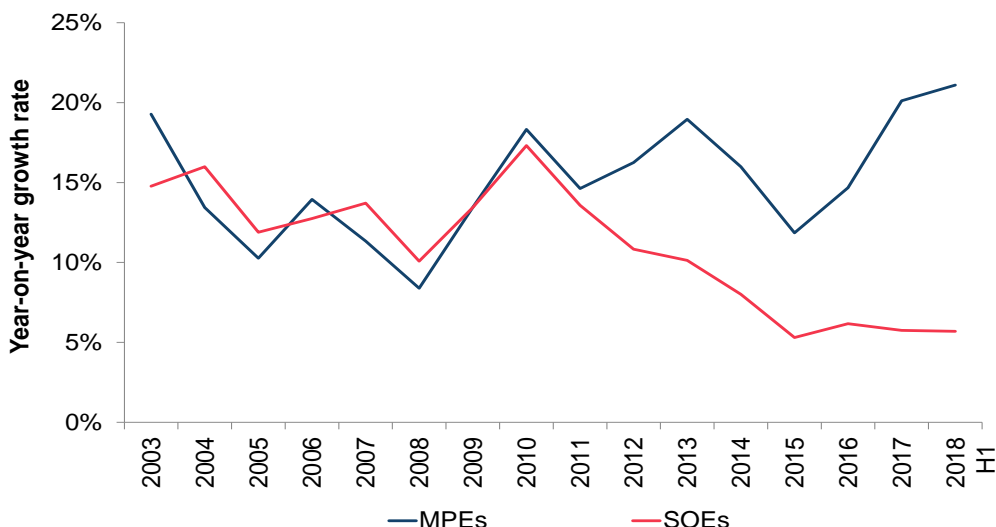
Source: Wind.

<sup>6</sup> See Peng, S. (2010) "Macro-Economic Reform", Chapter 3 in Li Tiejing (eds.) *Reforming China: International Comparisons and Reference*, pp.107-152. Enrich Professional Publishing.

### 1.3 Rebound in the leverage of MPEs

**MPEs have faster growth in debt than SOEs.** The median growth rate of total liabilities of Mainland-listed MPEs outpaced that of Mainland-listed SOEs. As of the end of 2018H1, the total liabilities grew by 21.1% year-on-year in median terms for MPEs, compared to 5.7% for SOEs (see Figure 3).

**Figure 3. Median growth of total liabilities of Mainland-listed companies (2002 – 2018H1)**

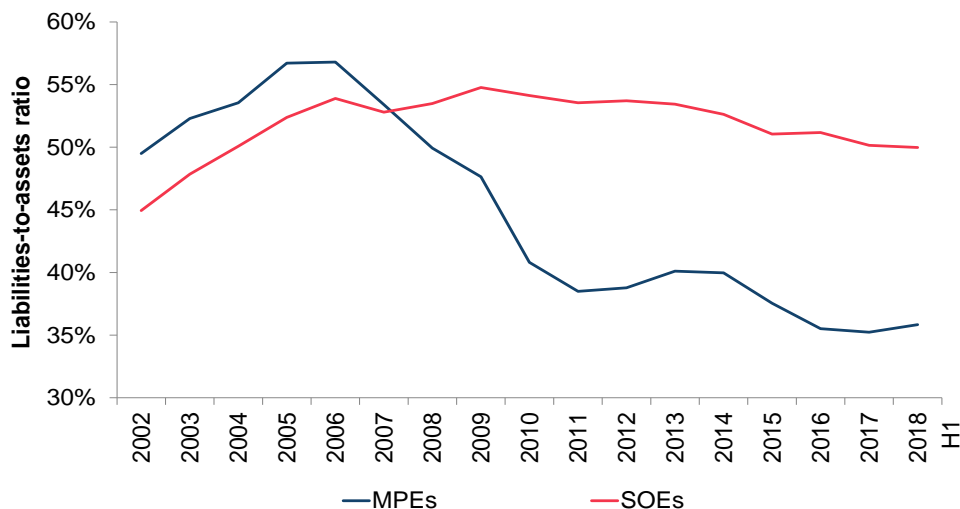


Note: The data are calculated using the information of Mainland non-financial A-share companies and the enterprise type is identified using Wind's definitions.

Source: Wind.

**MPEs have had lower leverage than SOEs since 2008.** However, the leverage rebounded somewhat by the end of 2018H1 — the median liabilities-to-assets ratio (or leverage ratio) of MPEs rose to 35.8% by the end of 2018H1, which was the highest since 2016 (see Figure 4). In contrast, the median leverage ratio of SOEs declined to 50.0% by the end of 2018H1, which was the lowest in more than a decade.

**Figure 4. Median liabilities-to-assets ratio of Mainland-listed A-share companies (2002 – 2018H1)**



Note: The data are calculated using the information of Mainland non-financial A-share companies and the enterprise type is identified using Wind's definitions.

Source: Wind.

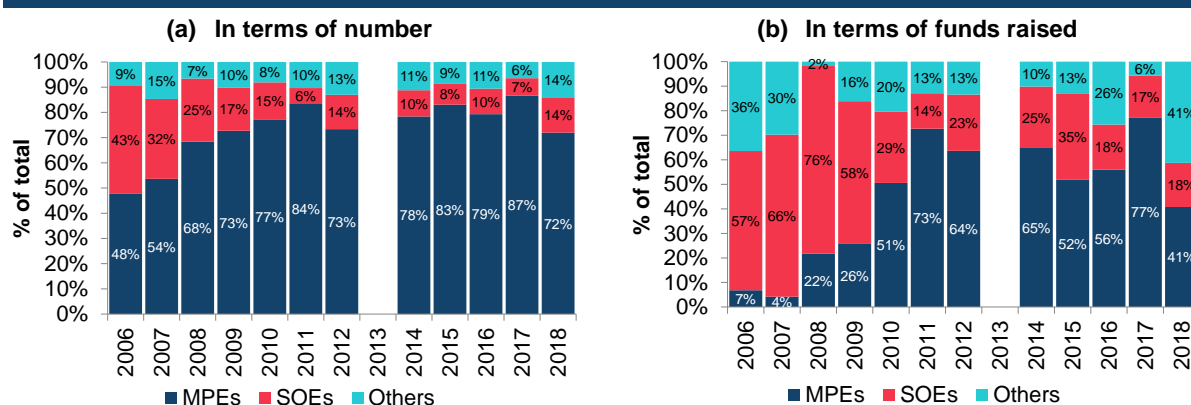
**The increase of leverage for MPEs is not a sign for economic recovery.** In a scenario of economic recovery, a company decides to borrow more for investments, leading to increases in both assets and liabilities. However, the results of a study<sup>7</sup> showed that both assets and liabilities of MPEs contracted during 2018H1 and that the liabilities decreased by 0.3% on tight funding conditions and the assets fell to a greater extent by 7.8% on weak business performance. As a result, the increase of leverage was not accompanied by asset expansion but more uncertainties of future earnings. These contributed to the rising number of bond defaults for MPEs<sup>8</sup>.

#### 1.4 Intense competition for domestic funding resources

MPEs have been facing intense competition with SOEs in multiple financing channels, including equity and debt financing, as discussed below.

**In respect of equity financing,** the Mainland stock market has been supporting the funding of MPEs. However, **the share of MPEs' initial public offerings (IPOs) fell to a recent low in 2018.** During 2014 to 2018<sup>9</sup>, MPEs accounted for more than 70% of the total number of IPOs but the share fell to a 5-year low of 72% in 2018 (see Figure 5a). The share of funds raised also declined to a 5-year low of 41% in 2018 (see Figure 5b).

**Figure 5. Breakdown of IPOs in the Mainland by enterprise type (2006-2018)**



Note: Enterprise types are determined using Wind's definitions. "Others" comprise public enterprises, collectively-owned enterprises and foreign enterprises. IPOs were suspended during December 2012 to December 2013.

Source: Wind.

**As for debt financing,** despite the fact that the private sector contributed 60% of GDP, a study noted that only one-third of all corporate debt in the Mainland fell on to MPEs<sup>10</sup>. These include bank loans, bonds offerings and other types of debt financing (e.g. shadow banking).

**In respect of bond financing, MPEs have a much smaller amount than SOEs.** According to a research by Pengyuan, the issue amount of MPE bonds accounted for only 9.5% of the total issue amount of credit bonds<sup>11</sup> during 2010 to August 2018 while that of SOE bonds accounted for 85.9%<sup>12</sup>. The same research also observed that the average yield at issuance

<sup>7</sup> See 〈民企槓桿不降反升背後：如何突圍高槓桿之困〉(“Behind the rising but not falling leverage of private enterprises: How to address the issue of high leverage”), *Securities Times*, 20 September 2018.

<sup>8</sup> See 〈民企紓困六題〉(“Six questions on reliefs to private enterprises”), *China Economic Weekly*, Vol. 40, 15 October 2018.

<sup>9</sup> The IPO listings in Mainland markets are suspended during December 2012 to December 2013.

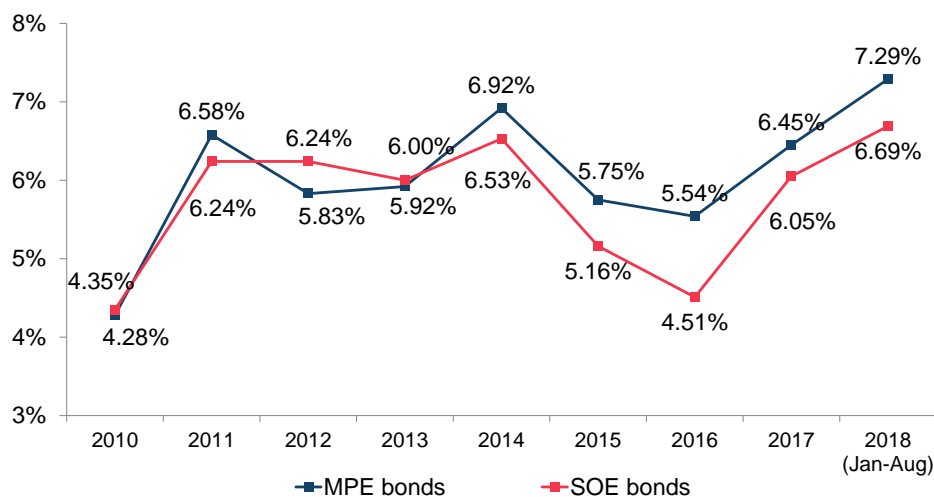
<sup>10</sup> See H. Handley, “Debt in China and Its Implications for the Private Sector”, *China Briefing*, 12 May 2017. (<http://www.china-briefing.com/news/debt-china-implications-private-sector/>)

<sup>11</sup> Credit bonds comprise enterprise bonds, corporate bonds, medium-term notes, commercial papers, convertible bonds and asset-backed securities.

<sup>12</sup> Source: Pengyuan Research. 〈2010-2018年8月民營企業與國企債券融資對比分析〉(“Comparative analysis on bond financing of MPEs and SOEs during 2010-August 2018”), 18 October 2018.

of MPE bonds was higher than that of SOE bonds, indicating higher cost of debt for MPEs; and that the average tenor of MPE bonds was about 2.27 years, compared to 2.87 years for SOE bonds (see Figure 6).

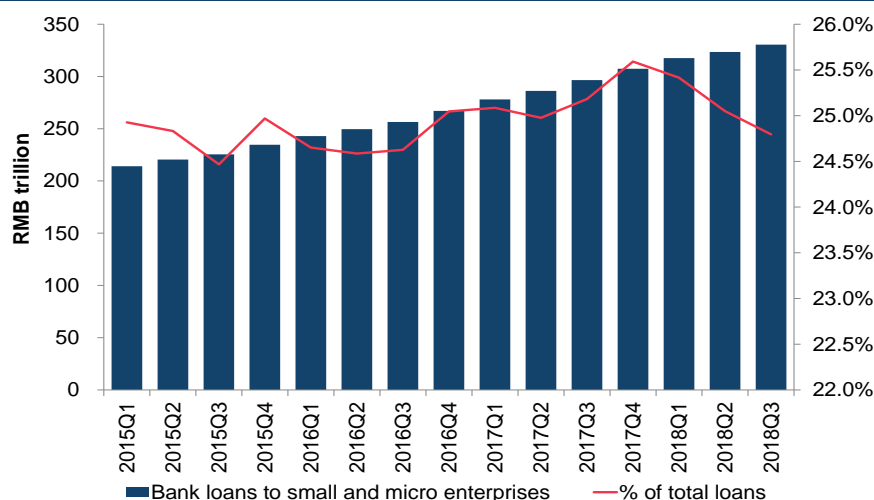
**Figure 6. The average yield at issuance of MPE and SOE bonds (2010 – August 2018)**



Source: 〈2010-2018年8月民營企業與國企債券融資對比分析〉(“Comparative analysis on bond financing of MPEs and SOEs during 2010-August 2018”), Pengyuan Research, 18 October 2018.

**In respect of bank loans, MPEs accounted for a smaller share but incurred higher funding costs than SOEs.** An example is bank loans to small and micro enterprises, most of them are MPEs. The share of bank loans to these enterprises decreased in 2018 (see Figure 7). This may be attributed to the relatively long approval period for short-term loans, limited amount of approved loans, high collateral requirements and high borrowing rates<sup>13</sup>. The borrowing costs of MPEs can be higher than those of SOEs by up to 2 percentage points, attributable to additional costs on guarantees, assessment, registration and approval<sup>14</sup>.

**Figure 7. Bank loans to small and micro enterprises in the Mainland (2015Q1 – 2018Q3)**



Source: Wind.

Moreover, as noted in some studies, the large state-owned commercial banks have a strong preference of lending to large SOEs<sup>15</sup>. As a result, **shadow banking has become an**

<sup>13</sup> See 〈民企紓困六題〉(“Six questions on reliefs to private enterprises”), *China Economic Weekly*, Vol. 40, 15 October 2018.

<sup>14</sup> Ditto.

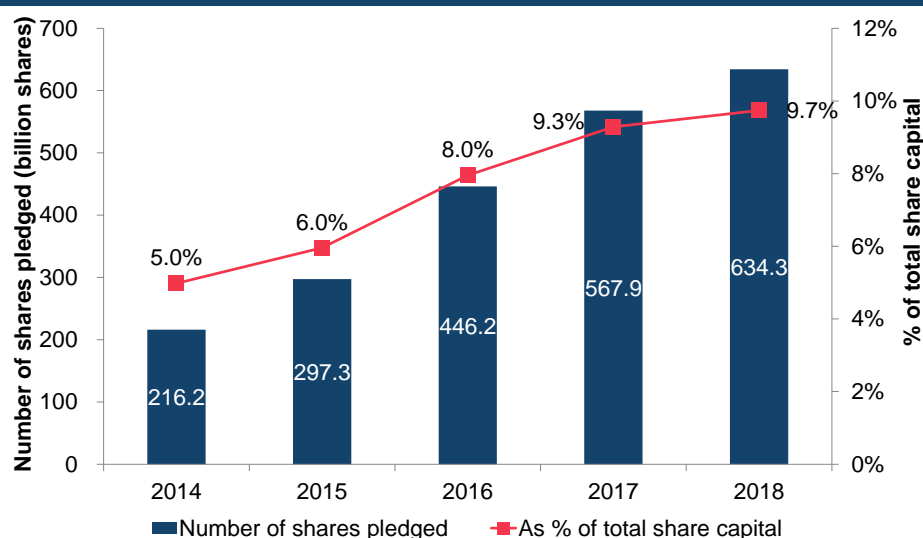
<sup>15</sup> See Song, Z., K. Storesletten, and F. Zilibotti. (2011) “Growing like China”, *The American Economic Review*, No. 101, Vol. 1, pp 196-233.



**important funding source for MPEs<sup>16</sup>.** Empirical evidence showed that firms with access to bank loans tend to grow faster and a dominant share of financing of small and medium enterprises (SMEs) was conducted through informal channels since their access to bank loans was limited<sup>17</sup>.

An example of informal funding channels is stock pledging (see Figure 8). Some MPEs pledged their stocks to borrow money through different channels, including brokers and their asset management plans as well as banks' wealth management products and trust products. The multiple stock-pledge agreements of many companies created a chain of debt, increasing the risk of contagion across the companies as their exposure to each other's debt increases.

**Figure 8. Shares pledged for borrowings (2014 – 2018)**



Source: Wind.

## 2. THE NEED FOR MORE MPE FUNDING SUPPORT

### 2.1 Tighter domestic funding conditions since 2018

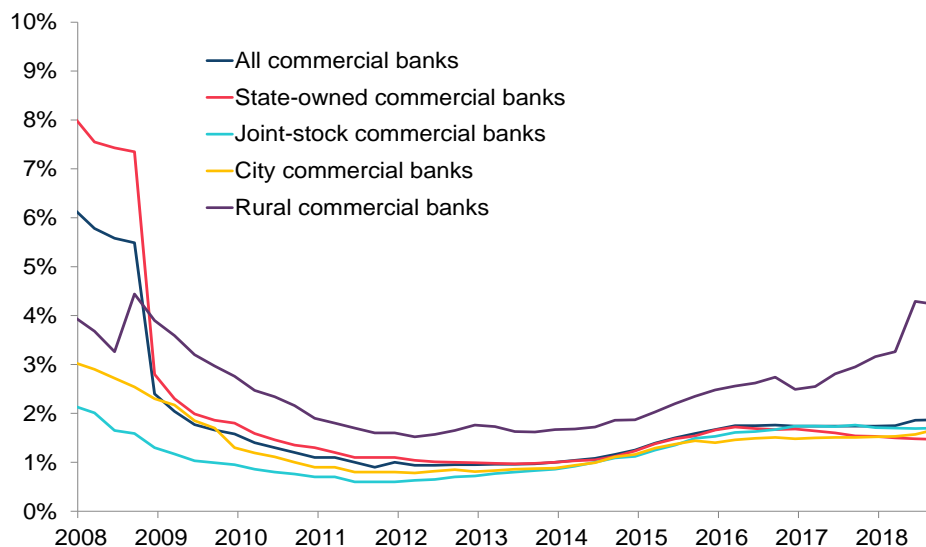
**More uncertain global economic outlook and continued financial deleveraging result in greater difficulties for MPEs to get new funding.** The Sino-US trade tensions remained unresolved and lenders in the Mainland financial market have become more cautious. Meanwhile, the Mainland authorities continue their efforts of financial deleveraging, especially on curbing shadow banking. Since 2018, MPEs have been facing tighter funding conditions not only for bank lending, but also for stocks, bonds and other channels.

**For bank lending,** given the economic difficulties faced by enterprises, the non-performing loan ratios of Mainland banks climbed to a decade-high level in 2018 (see Figure 9). Banks may become more cautious and selective in lending.

<sup>16</sup> Ehlers, T., S. Kong and F. Zhu (2018) "Mapping shadow banking in China: structure and dynamics", Bank for International Settlements (BIS) *Working Paper*, No. 701, February 2018.

<sup>17</sup> See examples quoted in Ayyagari, M., A. Demirgüç-Kunt and V. Maksimovic. (2010) "Formal versus informal finance: Evidence from China", *The Review of Financial Studies*, Vol. 23, No. 8, pp. 3048-3097.

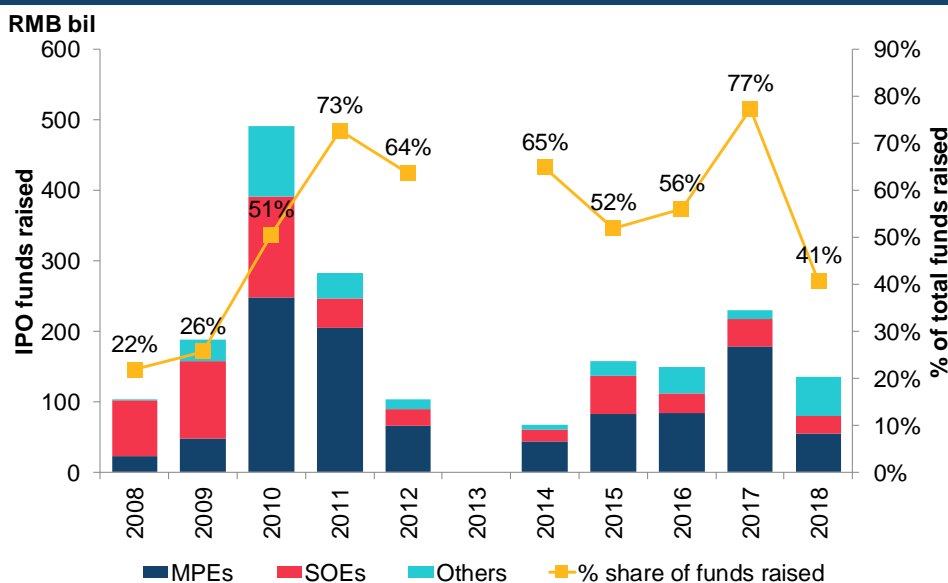
**Figure 9. Non-performing loans ratio of Mainland commercial banks (as % of total loans) (2008 – 2018Q3)**



Source: Wind.

**For financing through the onshore stock market, the IPO funds raised of MPEs contracted significantly in 2018 to RMB 55.2 billion, which was less than one-third of the RMB 177.9 billion in 2017 (see Figure 10). This compared to RMB 24.4 billion and RMB 55.9 billion respectively for SOEs and other enterprises in 2018.**

**Figure 10. Annual IPO funds raised in the Mainland by enterprise type (2008 – 2018)**



Note: Enterprise types are determined using Wind's definitions. "Others" comprise public enterprises, collectively-owned enterprises and foreign enterprises. IPOs were suspended during December 2012 to December 2013.

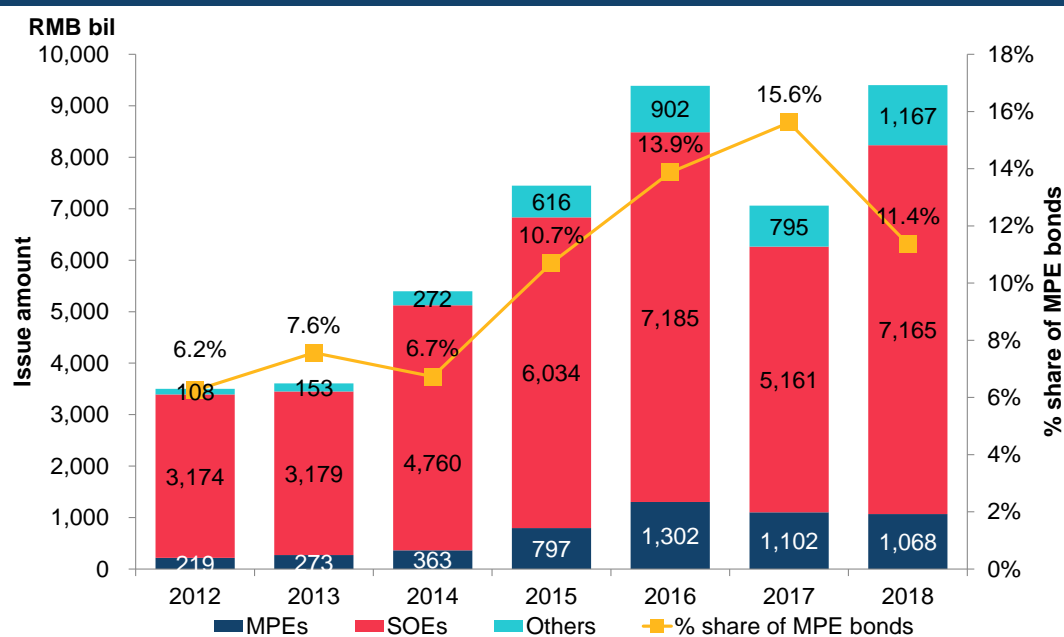
Source: Wind.

**Moreover, certain non-market-driven characteristics of financing by stock issues in the Mainland pose concerns to enterprises.** Firstly, the timing of stock issues may not be able to match the market conditions and the enterprises' funding conditions under the current

approval-based system<sup>18</sup>. The timing of IPOs depends on the approval by the China Securities Regulatory Commission (CSRC). Secondary offerings are also subject to relevant authorities' approval. It was reported that it takes about one year for processing secondary offerings in the onshore market<sup>19</sup>; and that some sectors are subject to stricter requirements for a listing, for example, educational services, catering, agricultural, high pollution industries, real estate as well as new-economy companies with weighted voting rights<sup>20</sup>. Furthermore, Mainland IPOs are usually priced at a price-to-earnings (PE) ratio not to exceed 23 times<sup>21</sup>.

**For bond financing, the gross issuance of credit bonds by MPEs had decreased in the recent two years, dropping to RMB 1,102 billion in 2017 and further to RMB 1,068 billion in 2018. Their market share had also declined to 11.4% in 2018, the lowest since 2015 (See Figure 11).**

**Figure 11. Issue amount of onshore credit bonds by issuer type (2012 – 2018)**



Note: Enterprise types are determined using Wind's definitions. "Others" comprise public enterprises, collectively-owned enterprises and foreign enterprises.

Source: Wind.

Given the economic difficulties against the macro backdrop, more onshore bond defaults of MPEs are observed (see Figure 12). Therefore, onshore investors would have become more inclined to invest in high-quality MPEs.

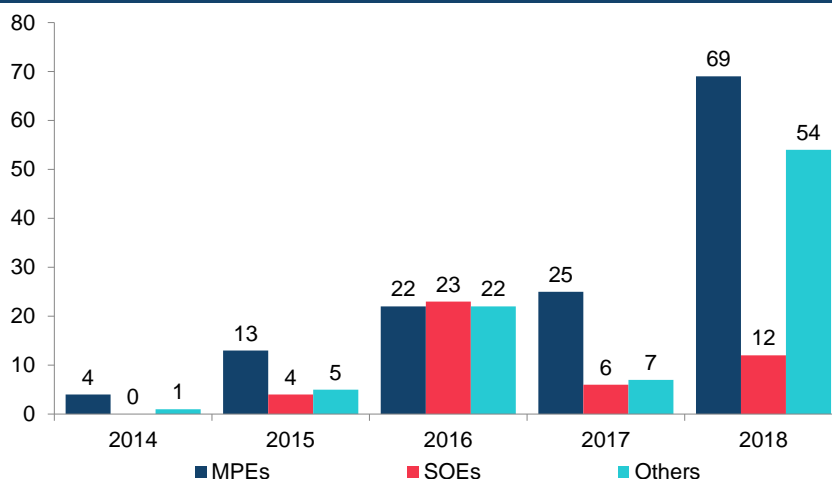
<sup>18</sup> A registration-based regime for listings was introduced on the Science and Technology Innovation Board of the Shanghai Stock Exchange (see 《科創板首次公開發行股票註冊管理辦法(試行)》 released by the CSRC on 1 March 2019), It remains uncertain about the timing for the regime's implementation on other segments of the Mainland market.

<sup>19</sup> Source: 〈港股「再融資」是這次市場的風險嗎?〉, Gelonghui.com, 28 February 2018.

<sup>20</sup> Source: 〈香港成 IPO 最熱市場之一 機會、風險全解讀〉, *People's Daily*, 28 May 2018.

<sup>21</sup> Source: 〈取消新股首日漲停限制 監管須有效跟上〉, *Securities Times*, 17 January 2019.

**Figure 12. Number of onshore bond defaults (2014 – 2018)**

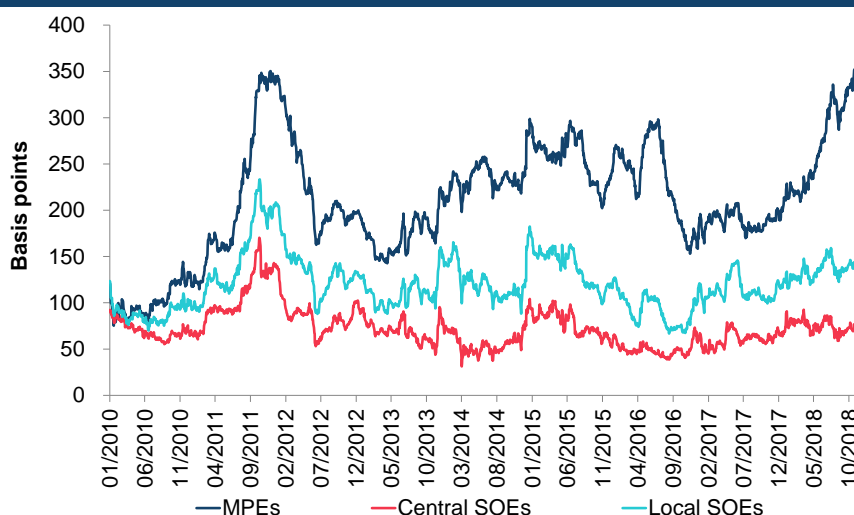


Note: Enterprise types are determined using Wind's definitions. "Others" comprise public enterprises, collectively-owned enterprises and foreign enterprises.

Source: Wind.

**In fact, yield spreads have become increasingly widened for MPE bonds.** According to the Industrial Bank, the median yield spread of corporate bonds across industrial sectors relative to benchmark riskless policy bank bonds increased to a record high of about 360 basis points as of end-2018 for MPEs, compared to about 80 basis points for central SOEs and about 120-130 basis points for local SOEs (see Figure 13). Lenders' preference towards state-owned borrowers (see section 1.4) reduces the demand for bonds issued by MPEs, particularly lower-quality MPEs. The lower demand and the possibly higher proportion of low-quality MPE bonds at times of precarious economic conditions have contributed to the increase in yield spreads for MPE bonds. Larger yield spread implies higher costs of bond financing for MPEs.

**Figure 13. Median yield spreads of corporate bonds issued by industrial enterprises by enterprise type (2010 – 2018)**



Note: The median yield spread of bonds for an enterprise type is the median of the credit spreads of corporate bonds issued by enterprises of that type, as compiled by the Industrial Bank. The credit spread of a corporate bond is the bond's yield minus a policy bank bond with the same tenor, where the reference policy bank bonds are bonds issued by the China Development Bank.

Source: Wind.

**Furthermore, the funding through shadow banking was tightened after the new asset management rules<sup>22</sup> became effective since April 2018.** The new rules aim to regularise banks' wealth management businesses and the investment activities of wealth management products in the capital market. Measures introduced include prohibiting implicit guarantees against investment losses, putting caps on product leverage for tranches sold to the public, banning the use of capital pool to roll over bad credit and requiring stress tests to control risks. There is a transition period for market institutions to comply with the new rules by end-2020. Although the PBOC and the China Banking and Insurance Regulatory Commission (CBIRC) allow further issuance of existing products to invest in new assets that may include non-standard credit assets<sup>23</sup> during the transition period<sup>24</sup>, the channeling of funds to MPEs through these products is expected to tighten.

**Another informal channel of MPE funding — borrowing by stock pledging, is also being squeezed.** Major shareholders of listed companies may face increasing pressure of forced unwinding of stock-pledged borrowings at times of a downside market. According to Wind, the total number of shares pledged of listed companies on the Shanghai Stock Exchange and the Shenzhen Stock Exchange was about 634.5 billion shares (9.83% of the total number of issued shares) as of end-2018, compared with 624.9 billion shares (9.90% of the total number of issued shares) as of end-June 2018. Despite a similar volume of pledged shares, the market value of shares pledged declined by 23% to RMB 4,233.6 billion in December 2018 from RMB 5,472.2 billion in June 2018. For shares pledged by major shareholders, the number was 607.4 billion shares (6.75% of the total number of issued shares) in December 2018, compared with 593.0 billion shares (7.05% of the total number of issued shares) in June 2018. However, the corresponding outstanding market value of shares pledged fell by 44% to RMB 1,089.9 billion as of end-December 2018 from RMB 1,954.5 billion as of end-June 2018.<sup>25</sup> In other words, the major shareholders are facing a high pressure of repayment.

## 2.2 Supportive Mainland policy measures

The significance of MPEs in China's economic reforms and development is well recognised by China's leadership. Over the years, various policies and measures have been introduced by the Mainland authorities to support the development of MPEs. Back in the 1990s, MPEs have been allowed to seek listing and funding overseas according to new measures issued by the CSRC<sup>26</sup>. Since early 2000s, the improvement in the financing of SMEs has been included in the central policy for economic reform<sup>27</sup>. As mentioned in section 1.1, the State Council issued guidelines in 2005 and 2010 to encourage market entry of MPEs. These guidelines opt for expanding direct financing channels, including having the same treatment as SOEs for the listing of MPEs, improvement of the SME Board and the then Agency Share Transfer System<sup>28</sup> and promoting the overseas listing of qualified MPEs. Another policy document was issued by the CSRC in 2012<sup>29</sup> to offer further support to the share issuance, listing and refinancing of

<sup>22</sup> 《關於規範金融機構資產管理業務的指導意見》，issued by the PBOC, the CBIRC, the CSRC and the State Administration of Foreign Exchange (SAFE) on 27 April 2018.

<sup>23</sup> Non-standard credit assets refer to credit assets that are not traded on exchanges or the China Interbank Bond Market.

<sup>24</sup> See 《關於進一步明確規範金融機構資產管理業務指導意見有關事項的通知》，issued by the PBOC on 20 July 2018; 《商業銀行理財業務監督管理辦法》，issued by the CBIRC on 28 September 2018.

<sup>25</sup> Source for all statistics quoted here on stock pledging: Wind.

<sup>26</sup> In July 1999, the CSRC issued the *Notification about Issues concerning Overseas Listing of Enterprises* (《關於企業境外上市有關問題的通知》). Since then, possible candidates for overseas listing have been expanded from mainly SOEs to include collectively-owned and private enterprises.

<sup>27</sup> *Decisions about Investment System Reform* (《國務院關於投資體制改革的決定》), issued by the State Council in 2004.

<sup>28</sup> The Agency Share Transfer System was discontinued in 2014 and replaced by the National Equities Exchange and Quotations System (NEEQ) (the so-called New Third Board).

<sup>29</sup> *Notification About Work Focus for Implementing the "State Council's Certain Opinions About Encouraging and Guiding the Healthy Development of Private Investment"* (《關於落實〈國務院關於鼓勵和引導民間投資健康發展的若干意見〉工作要點的通知》), issued by the CSRC, May 2012.

MPEs. In 2017, specific guidelines<sup>30</sup> were issued to put forward a series of measures and initiatives to resolve the institutional obstacles for the development of private investments, for them to offer significant support in developing China into a strong manufacturing country. Specifically for small and micro enterprises, policy decisions have been made by the State Council in 2011 to provide financial and fiscal policy support for the development of these enterprises<sup>31</sup>, followed by a series of supportive measures issued since then. More recently at the close of the 2019 National People's Congress Plenary Session, Premier Li Keqiang highlighted the policy initiative of a further cut in the funding cost of small and micro enterprises in 2019 by 1 percentage point from the levels of 2018<sup>32</sup>. It is followed by a guideline issued in April 2019<sup>33</sup> by the Communist Party of China Central Committee and the State Council to call for more measures to relieve small and medium-sized enterprises' financing difficulties that include broadening the funding channels and more supportive direct financing through capital market.

In the light of the tightened funding conditions faced by MPEs since 2018 (see section 2.1), new supportive policies and measures have been introduced by the Mainland authorities to encourage MPE financing through bank loans and the issuance of stocks and bonds. The key measures are presented in Table 1.

Table 1. Recent key measures introduced by the Mainland authorities for supporting MPE financing	
Measures	Details
PBOC measures (Jun-Dec 2018) <sup>34</sup>	<ul style="list-style-type: none"> <li>• Cut the reserve ratios for financial institutions that lend to small and micro-enterprises, private enterprises and innovative enterprises</li> <li>• Increased the total relending and rediscount quota for bank loans supporting small and micro enterprises and MPEs</li> <li>• Introduced Targeted Medium-term Lending Facility (TMLF)</li> <li>• Combo measures in the areas of credit loans to small and micro enterprises, support facility for bond and equity financing of MPEs</li> </ul>
CSRC measures (Jul & Oct 2018) <sup>35</sup>	<ul style="list-style-type: none"> <li>• Encourage private equity financing through regional equity rights markets</li> <li>• Encourage funding through the issuance of specialised corporate bonds, to be provided with a green approval channel</li> </ul>
SSE measures (Oct & Nov 2018) <sup>36</sup>	<ul style="list-style-type: none"> <li>• Reform the exchange's bond market to support bond financing by</li> </ul>

<sup>30</sup> *Guiding Opinions about Driving Forward the Strategy of a Strong Country in Manufacturing through Promoting Private Investments* (《關於發揮民間投資作用推進實施製造強國戰略的指導意見》), issued by 16 government authorities including the PBOC, the CBRC and the CSRC, 21 November 2017.

<sup>31</sup> Decisions were made at the State Council Standing Committee meeting on 12 October 2011.

<sup>32</sup> See 〈李克強：讓小微企業融資成本在去年的基礎上再降低 1 個百分點〉(“Premier Li: Further reduce the corporate funding cost of small and micro enterprises from the base levels of last year by 1 percentage point”), *Xinhua News*, 15 March 2019.

<sup>33</sup> *Guiding Opinions about Expediting the Healthy Development of Small and Medium-sized Enterprises* (《關於促進中小企業健康發展的指導意見》), issued by the General Office of the Communist Party of China Central Committee and the General Office of the State Council, 7 April 2019.

<sup>34</sup> See 〈央行再次較大範圍「定向」降準·旨在釋放流動性及置換到期 MLF〉(“The central bank cut targeted reserves ratios with a broader scope to release liquidity and rolling over the maturing Medium-term Lending Facility (MLF)”), China International Capital Corporation (CICC), 7 October 2018; 〈央行創設定向中期借貸便利 支持民營和小微企業貸款〉(“The central bank introduced Targeted MLF to support loans to MPEs and small and micro enterprises”), *Xinhua News*, 19 December 2018; 〈中國央行行長易綱：「三支箭」讓資金流向民企緩解融資難〉(“PBOC Governor Yi Gang: ‘Three arrows’ to let capital flowing into private enterprises to relieve the difficulties in financing”), 《中國新聞網》, 6 November 2018.

<sup>35</sup> *Guidelines on Information Submission of Regional Equity Rights Market (Trial Implementation)* (《區域性股權市場信息報送指引(試行)》), issued by CSRC on 12 February 2018 and effective on 1 July 2018; 〈建「綠色通道」審核紓解民企融資困境及股票質押風險專項債〉(“Construct ‘Green Channel’ for dedicated bonds to relieve the financing difficulties of MPEs and the risk of share pledges”), *Xinhua News*, 26 October 2018.

<sup>36</sup> See 〈深化債券市場功能·助力民營企業健康發展〉(“Deepening the function of bond market to assist the healthy development of MPEs”), SSE website, 26 October 2018; 〈上交所推出信用保護工具試點 支持民營企業債券融資〉(“SSE launched Credit Protection Tools pilot program to support the bond financing of MPEs”), SSE website, 2 November 2018.



Table 1. Recent key measures introduced by the Mainland authorities for supporting MPE financing	
Measures	Details
	<p>MPEs: (1) introducing specialised corporate bonds; (2) enhancing the bond financing mechanism and review approval system; and (3) introducing credit support tools</p> <ul style="list-style-type: none"> <li>• Launch a pilot programme on credit protection instruments</li> </ul>
SZSE measures (Dec 2018) <sup>37</sup>	<ul style="list-style-type: none"> <li>• Launch private enterprise bond financing supportive instruments</li> </ul>
CBIRC's targets for bank credit to support small and micro enterprises (Nov 2018) <sup>38</sup>	<ul style="list-style-type: none"> <li>• "One-Two-Five" targets: (1) at least one-third of large-sized banks' new corporate loans; (2) at least two-thirds of small and medium-sized banks' new corporate loans; and (3) at least 50% of all new corporate bank loans after three years</li> </ul>
National Development and Reform Commission (NDRC) measures (Nov 2018) <sup>39</sup>	<ul style="list-style-type: none"> <li>• Actively support the bond issuance of high-quality MPEs for uses on national key strategies and key sectors</li> <li>• Encourage the issuance of credit-enhanced collective bonds by large and medium-sized enterprises, the proceeds of which will be entrusted to banks for relending to small and micro enterprises with good prospects</li> <li>• Support the issuance of venture capital enterprise bonds that will be used for entrepreneurial growth enterprises not yet listed</li> <li>• Coordinate all efforts to mitigate and handle bond default risks and help resolve temporary financing difficulties of key MPEs</li> <li>• Coordinate with other financial regulators to implement the support facilities for bond financing and equity financing of MPEs</li> </ul>
Local governments and branches of State-owned Assets Supervision and Administration Commission (SASAC) (as of Nov 2018) <sup>40</sup>	<ul style="list-style-type: none"> <li>• Dedicated relief funds for MPEs amounted to about RMB 256 billion</li> </ul>
Market institutions (as of Nov 2018) <sup>41</sup>	<ul style="list-style-type: none"> <li>• Securities companies' asset management plans with a total amount of at least RMB 70 billion for funding MPEs</li> <li>• Insurance products of about RMB 86 billion dedicated to provide funding to MPEs</li> </ul>
Central government's policy document (Feb 2019) <sup>42</sup>	<p>Policy directives to strengthen direct financing of MPEs include:</p> <ul style="list-style-type: none"> <li>• Streamlining the regime of IPO and secondary offering to speed up the approval for applications of MPEs;</li> <li>• Expanding the scope and scale of private convertible bond placements by MPEs as well as expanding the pilot issuance of innovative entrepreneurial corporate bonds;</li> <li>• Speeding up the launch of the Science and Technology Innovation</li> </ul>

<sup>37</sup> See 〈以市場化方式緩解民企融資難 滬深交易所民企債券融資支持工具落地〉("Using market-based ways to relieve the financing difficulties of MPEs, Shanghai and Shenzhen stock exchanges launched bond financing supporting tools for MPEs"), *Shanghai Securities News*, 15 December 2018.

<sup>38</sup> See 〈郭樹清：初步考慮對民企貸款要實現“一二五”的目標〉("Guo Shuqing: Initial consideration to implement 'One-Two-Five' targets of loans to private enterprises"), China's *Financial Times* (中國《金融時報》), 8 November 2018.

<sup>39</sup> See 〈五大措施支持民企發債融資〉("Five key measures to support private enterprises' bond financing"), *People's Daily*, 16 November 2018.

<sup>40</sup> See 〈券商險資政府聯手 逾5000億紓困資金加速支持民企〉("Cooperation between brokers, insurers and local governments; more than RMB 500 billion of relief funds to accelerate support to private enterprises"), *The Economic Daily* (中國《經濟日報》), 29 November 2018.

<sup>41</sup> Ditto.

<sup>42</sup> *Certain Opinions About Strengthening Financial Services for Private Enterprises* (《關於加強金融服務民營企業的若干意見》), issued by the Chinese Communist Party Central Committee and the State Council, 14 February 2019.

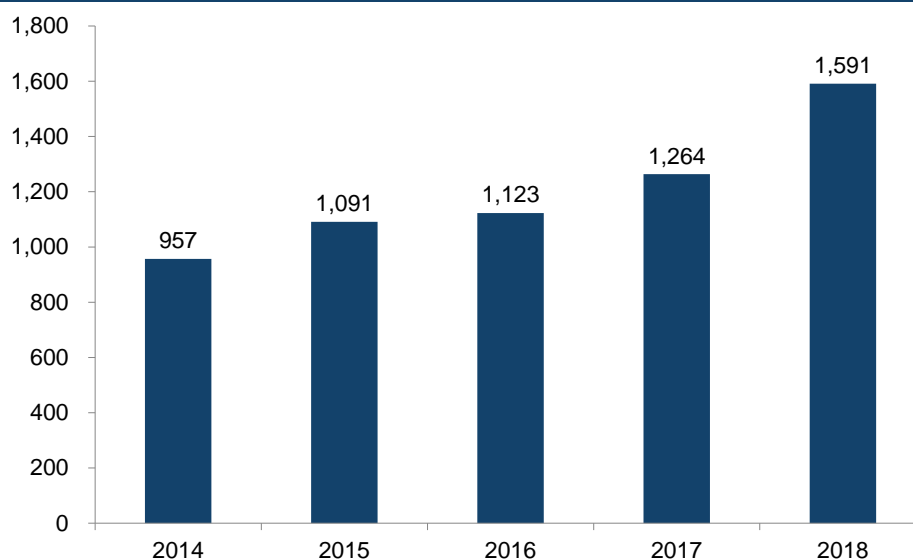
**Table 1. Recent key measures introduced by the Mainland authorities for supporting MPE financing**

Measures	Details
	Board (Sci-Tech Board) on the SSE <sup>43</sup> , piloting with a registration-based regime; supporting financing of innovative small and micro MPEs through the New Third Board

Apparently, domestic channels would not be sufficient to meet the rising needs of MPE financing so far and especially under the current tough market conditions as discussed above.

**Overseas financing channels would be of paramount importance to MPEs.** This has been well recognised by the Mainland authorities, with related supportive measures introduced. In fact, the authorities have been promoting MPEs' financing through offshore markets, mainly Hong Kong. In 2012, a central policy document was issued to promote offshore investments by MPEs<sup>44</sup>. The set policies not only encouraged tax incentives and more credit from onshore banks to MPEs, but also promoted the overseas listing of MPEs and the issuance by MPEs of bonds denominated in RMB and foreign currencies in the offshore markets.

Riding on such policy support, Hong Kong has been the largest offshore financing platform for Mainland enterprises, including MPEs. More than a half of Mainland's foreign direct investments came from Hong Kong. The number of Mainland enterprises which have set up operations in Hong Kong has grown from 957 enterprises in 2014 to 1,591 enterprises in 2018 (see Figure 14). These enterprises can tap into the Hong Kong capital market with global participation, attracting funding from all over the world.

**Figure 14. Number of Mainland enterprises with operations set up in Hong Kong (2014 – 2018)**

Source: Hong Kong's Census and Statistics Department.

<sup>43</sup> The full set of rules and measures for the operation and regulation of the Sci-Tech Board were issued by the CSRC, the SSE and the China Securities Depository & Clearing Corporation (CSDC) on the 1st and 3rd of March 2019, ready for the launch of the board.

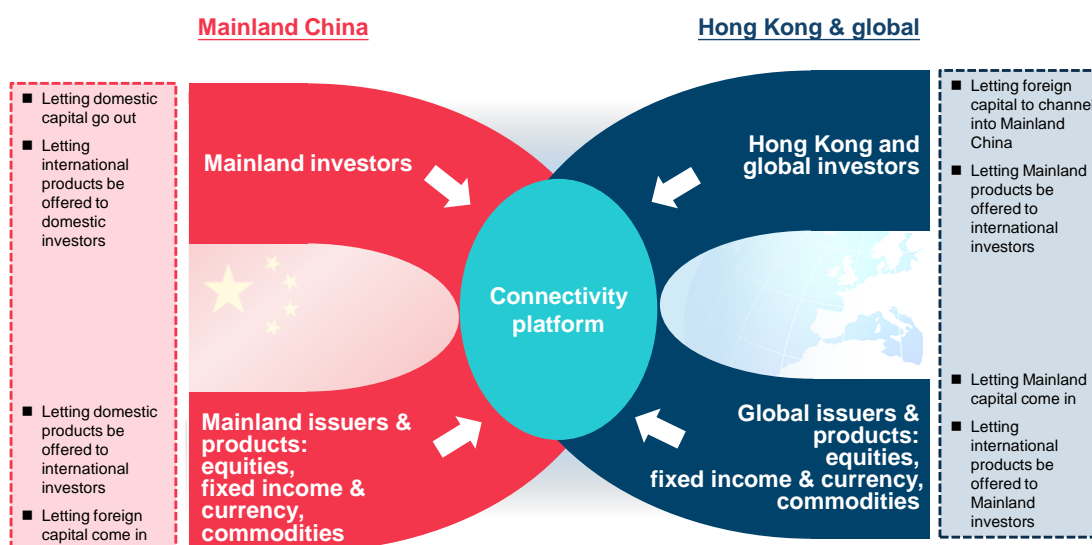
<sup>44</sup> *Implementation Opinions About Encouraging and Guiding Private Enterprises to Actively Engage in Foreign Investment* (《關於鼓勵和引導民營企業積極開展境外投資的實施意見》), issued by 13 government authorities including the National Development and Reform Commission, the PBOC, the CSRC and the then China Banking Regulatory Commission (CBRC), 29 June 2012.



### 3. THE HONG KONG MARKET'S SUPPORTIVE ROLE FOR MPE FINANCING AND DEVELOPMENT

Hong Kong has been the most important offshore fund-raising centre for Mainland enterprises, especially for MPEs. The Hong Kong market saw MPE listings and fund-raising back in 1998, not to say back-door MPE listings which were much earlier, while the first MPE listing on the New York Stock Exchange (NYSE) was reportedly to be in December 2015<sup>45</sup>. Bond financing in Hong Kong by Mainland enterprises is also as active as equity financing. The efficient and market-based model with global connectivity for funding through the Hong Kong market has been an optimal choice for direct financing of Mainland enterprises, complementary to the Mainland market. This is illustrated in Figure 15 and further elaborated in sub-sections below.

**Figure 15. The Mainland-global connectivity provided by the Hong Kong market**



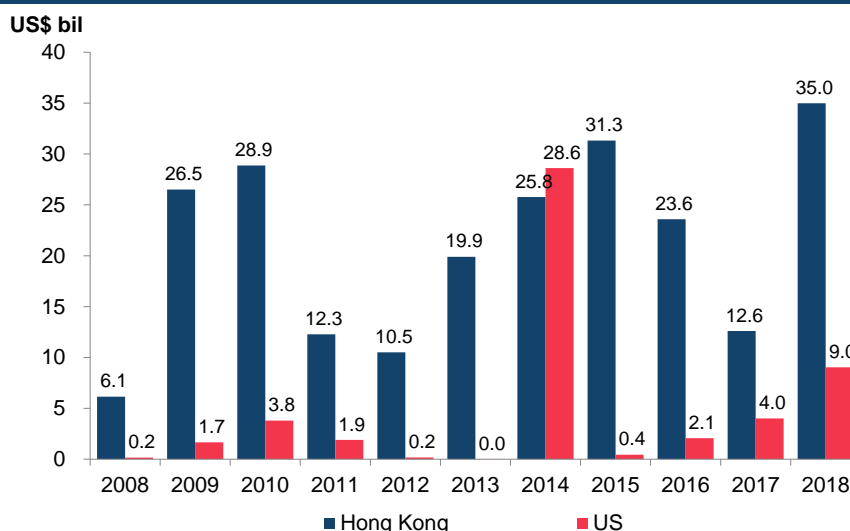
#### 3.1 The largest offshore equity financing centre for MPEs

**The Hong Kong market is one of the most active IPO markets in the world and is the offshore listing venue most preferred by Mainland enterprises.** Hong Kong ranked 1<sup>st</sup> on IPO funds raised in 2018 with an amount of US\$36.5 trillion, followed by US\$26.3 trillion for NYSE and US\$22.3 trillion for NASDAQ<sup>46</sup>. For offshore IPOs of Mainland enterprises, Hong Kong also topped the list. The amount of funds raised by Mainland enterprises in Hong Kong had been higher than that in the US in each year of the past decade, except in 2014 when Alibaba did its IPO in the US. The amount reached an 11-year high in 2018 at US\$35.0 trillion in Hong Kong, compared to a combined total of US\$9.0 trillion for NYSE, NASDAQ and AMEX in the US (see Figure 16).

<sup>45</sup> Suntech Power Holdings Co., Ltd (無錫尚德) was reported to be the first MPE listing in the form of American Depositary Receipt (ADR).

<sup>46</sup> Source: World Federation of Exchanges (WFE).

**Figure 16. IPO funds raised by Mainland enterprises in Hong Kong and the US (2008 – 2018)**

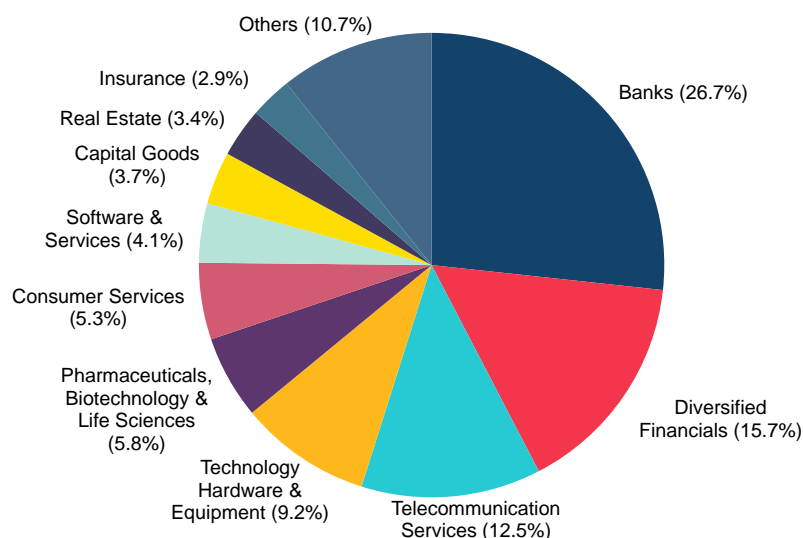


Note: Mainland enterprises comprise H shares, red chips and MPEs. The amounts of IPO funds raised in Hong Kong are converted into US dollars based on the exchange rate available in Wind. The Mainland enterprises in the US are identified as companies with China as the country of risk according to Bloomberg's definition. IPOs in the US refer to IPO listings on the NYSE, NASDAQ and AMEX.

Source: HKEX, Bloomberg and Wind.

During 2016 to 2018, the IPO activities in Hong Kong not only serve the financing needs of Mainland enterprises in the traditional sectors but also those in the new-economy sectors. Banks and diversified financials accounted for 42.4% of the total IPO funds raised in Hong Kong by Mainland enterprises. These sectors provide funding through credit intermediation to the real Mainland economy (see Figure 17). The other sectors in the top 5 were new-economy growth drivers — telecommunication services (12.5% of the total), technology hardware and equipment (9.2% of the total) and biotechnology (5.8% of the total). This sectoral breakdown of IPO funds raised in Hong Kong is different from that in the Mainland market (see Figure 18). While Mainland real estate companies faced more difficult funding conditions in 2018, it is worth noting that these companies' IPOs in Hong Kong ranked 9<sup>th</sup>, accounting for 3.4% of the total. In other words, the equity financing through the Hong Kong market is complementary to the Mainland market in funding the Mainland's real economy.

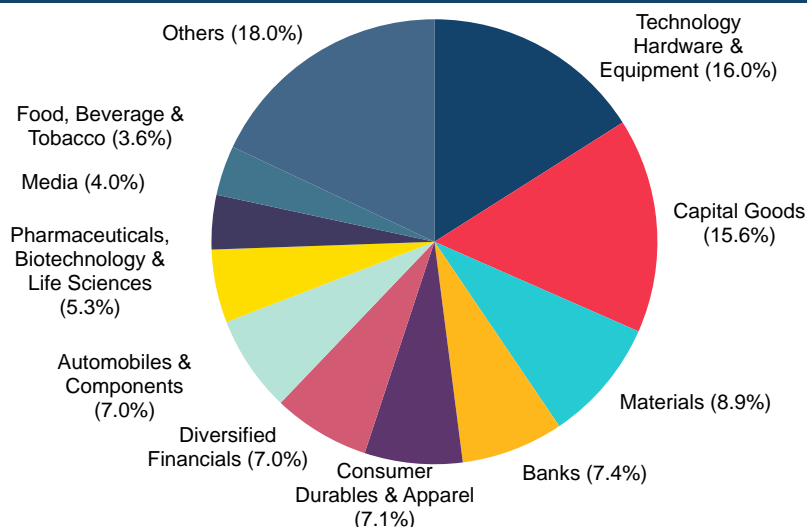
**Figure 17. Breakdown of IPO funds raised by Mainland enterprises in Hong Kong by industry sector (2016 – 2018)**



Note: The industry classification is based on Wind's definitions.

Source: Wind.

**Figure 18. Breakdown of IPO funds raised in the Mainland by industry sector (2016 – 2018)**

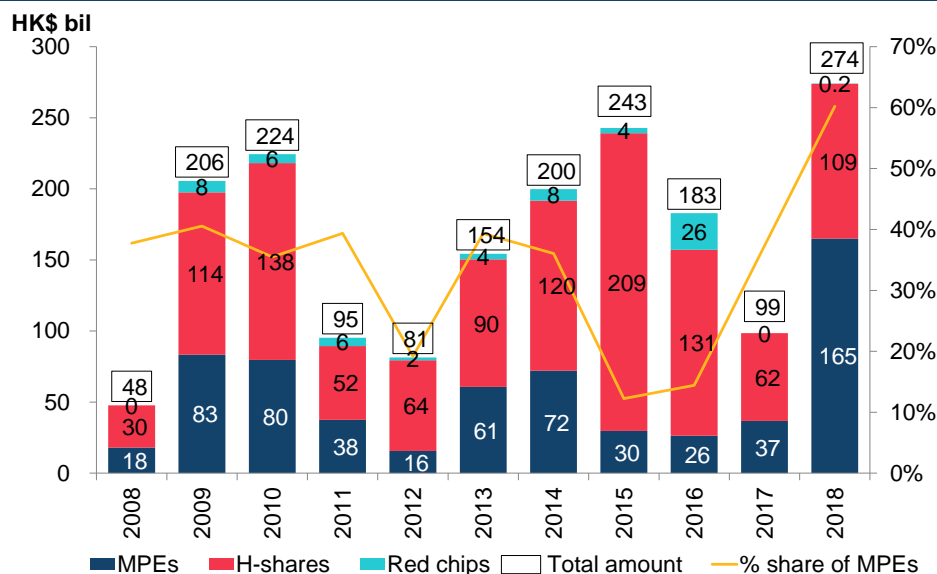


Note: The industry classification is based on Wind's definitions.

Source: Wind.

**The amount of IPO funds raised by Mainland enterprises in Hong Kong rose to a record high in 2018, with the majority (60%, HK\$165 billion) went to MPEs (see Figure 19).**

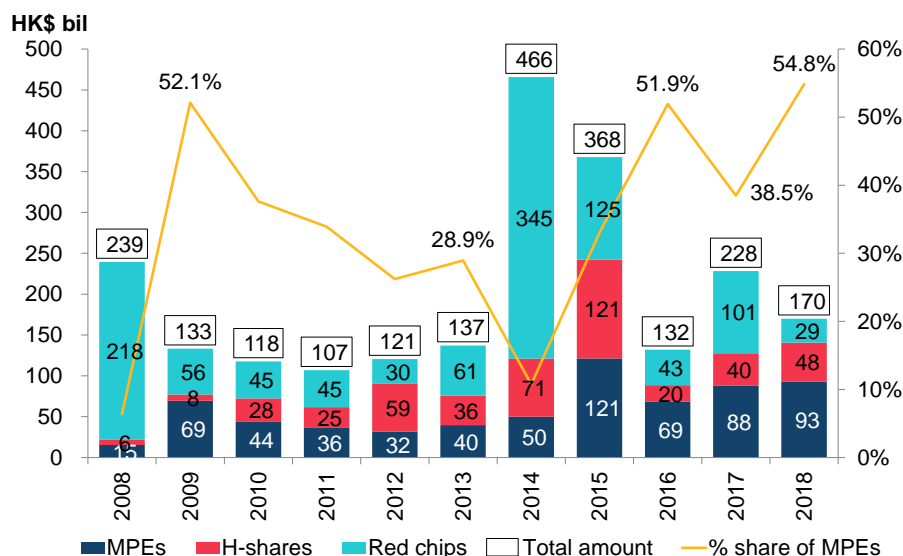
**Figure 19. IPO funds raised by Mainland enterprises in Hong Kong (2008 – 2018)**



Source: HKEX.

**Post-listing secondary offerings in Hong Kong are also important source of equity financing by MPEs.** In 2018, MPEs accounted for 54.8% (HK\$93 billion) of total post-listing funds raised by Mainland enterprises in Hong Kong, compared to 28.0% for H shares and 17.2% for red chips (see Figure 20).

**Figure 20. Post-listing equity funds raised by Mainland enterprises in Hong Kong (2008 – 2018)**

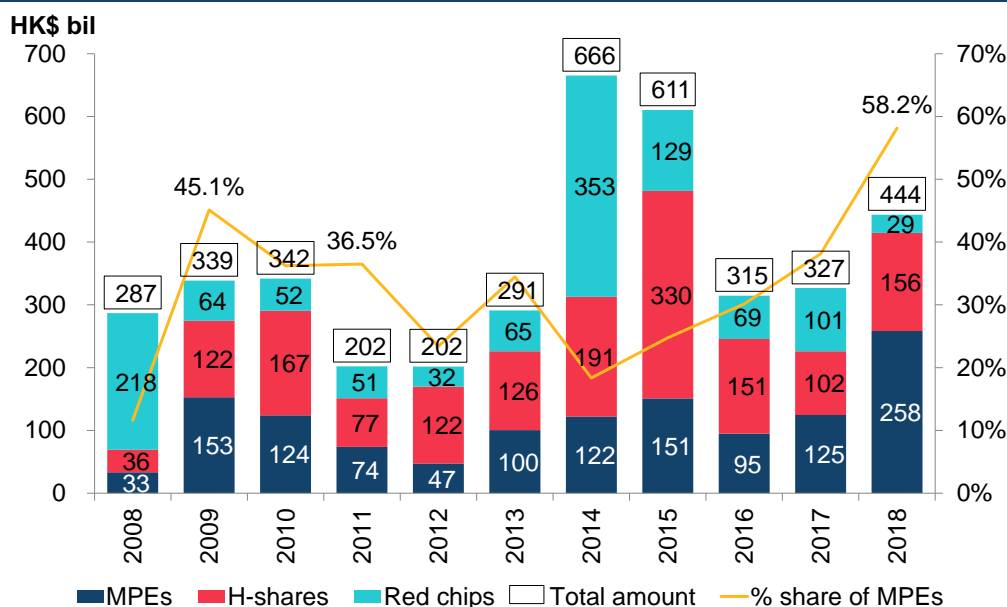


Note: Post-listing equity funds raised refer to funds raised by secondary offerings which include rights issues, placements and other forms.

Source: HKEX.

Combining IPO funds raised and post-listing equity funds raised, the equity financing of MPEs in Hong Kong rose to a record high of HK\$258 billion and the highest market share (58.2%) among Mainland enterprises in 2018, exceeding those of H shares and red chips respectively (see Figure 21).

**Figure 21. Total equity funds raised by Mainland enterprises in Hong Kong (2008 – 2018)**



Source: HKEX.

**The attractiveness of the Hong Kong market to Mainland enterprises for equity financing lies very much on its market-based system of international standards as well as the global reach.** The listing of enterprises in Hong Kong follows market principles and is subject to a registration-based listing regime. Listing status will be granted as long as the applicant fully meets the requirements stipulated in the Listing Rules of the Stock Exchange of Hong Kong (SEHK). Seeking a listing in Hong Kong might be more efficient and cost-effective

than in the Mainland, particularly for MPEs which are facing more obstacles than SOEs for funding in the Mainland:

- **More certainty of timing for IPOs:** Unlike the two layers of approval of listing system in the Mainland, the listing system in Hong Kong provides for more efficient processing of listing applications. Applications of listing (together with IPO) are required to be made to a single authority, the Listing Division of the HKEX, for processing and final approval by the Listing Committee. The Securities and Futures Commission (SFC) reserves the power of gatekeeping for listing in case of any concern under the Securities and Futures (Stock Market Listing) Rules (SMLR)<sup>47</sup>. In comparison, the process in the Mainland involves the CSRC for the approval of IPOs and the stock exchange for the approval of shares listing. Moreover, service pledge is made by the HKEX Listing Division in listing processing such that the time taken for the listing approval process is more or less predictable<sup>48</sup>, and so will be the timing of the IPO, as long as the applicant (and its sponsor) has well prepared the required information. As of secondary offerings, an issuer can apply for the offering after 6 months from the date of first listing of shares or securities<sup>49</sup>.
- **No specific selective requirements on sectors and ownership:** The Hong Kong market welcomes the listing of enterprises irrespective of their sectors and types of ownership. A level-playing field is offered to all kinds of enterprise, the successful listing of any enterprise is hinged on market acceptance — the global investor base in Hong Kong supports the fair assessment of an enterprise undergoing an IPO and listing process based on market-based factors including sectoral outlook and company fundamentals. In the Mainland, however, certain sectors and kinds of enterprise may be at comparative disadvantage in the priority queue of candidates for IPO and listing<sup>50</sup>. For example, MPEs in educational services sector is heavily exposed to policy risks which can make the approval for onshore listing more difficult<sup>51</sup>. Statistics showed that more MPEs in education services chose to list in Hong Kong than in the Mainland, including 6 MPEs in Hong Kong but none in Mainland during 2018<sup>52</sup>.
- **Market-driven IPO valuation:** The valuation of an IPO in the Hong Kong market depends on the enterprise's fundamentals, industry benchmarks and market conditions. The PE ratios at IPO of Mainland enterprises listed in Hong Kong have a wide spectrum across sectors, with an average of about 34.7 times in 2018 compared to 21.5 times in the Mainland and -26.1 times in the US (see Appendix). Besides, Hong Kong's new listing regime allows the listing of new-economy companies in innovative sectors (see section 3.2).
- **Global reach of investors, with professional intermediary support:** The Hong Kong market is highly liquid, attracts investors from all over the world and is supported by high-quality market professionals. Compared to the Mainland market which has limited foreign investor participation, the Hong Kong market has a strong global investor base which would

<sup>47</sup> See *Memorandum of Understanding governing Listing Matters*, jointly signed by SFC and HKEX, 28 January 2003

<sup>48</sup> For example, in 2018, the Listing Department took an average of 18 business days to issue the first round of comments from the date of acceptance of a listing application.

<sup>49</sup> See SEHK Main Board Listing Rules 10.08 and GEM Listing Rules 17.29.

<sup>50</sup> In the Mainland, certain sectors of strategic importance for economic development objectives may be offered preferential support vis-à-vis other sectors. For example, the CSRC offers fast-track approval processes (refer to as green channel) for the IPOs of enterprises traded on the NEEQ in poor provinces (including Tibet and Xinjiang) (see *Opinions on capital market to play the role in serving national poverty alleviation strategy* 《關於發揮資本市場作用服務國家脫貧攻堅戰略的意見》, issued by the State Council and CSRC, 9 August 2016). Separately, it was reported that the CSRC also offers a green channel for innovative companies in biotechnology, cloud computing, artificial intelligence and advanced manufacturing sectors in March 2018 (see 〈四行業獨角獸 IPO 綠色通道開啟 雲計算板塊備受關注〉, *China.com.cn*, 2 March 2018 (<http://finance.china.com.cn/roll/20180302/4557205.shtml>)).

<sup>51</sup> See 〈監管收緊超預期 教育股風險驟增〉 (“Regulations tightened more than expected, the risk of educational services sector rise sharply”), *Hong Kong Economic Journal*, 22 November 2018.

<sup>52</sup> Source: Wind.

appeal to Mainland enterprises seeking global funding and global branding. Compared with other international markets, the Hong Kong market has a strong base of market professionals and intermediary service providers who are highly knowledgeable about the Mainland economy, industries and enterprises to offer the necessary support to Mainland issuers and global investors.

### 3.2 An attractive offshore listing venue for Mainland new-economy companies

The Mainland economy is undergoing structural reform and is in transition to a new economy with economic growth to be driven more by the new-economy sectors of innovative, technology and network industries mostly comprised of MPEs.

**To cater for the expectedly immense funding needs of new-economy sectors and to provide for the investment desires of global investors, the Hong Kong market implemented a listing regime reform in April 2018.** The new listing regime in Hong Kong allows the listing of innovative companies with weighted voting rights (WVR) structure and biotechnology companies not yet in profitable stage, as well as the secondary listing of overseas-listed Mainland enterprises. Since the listing regime reform became effective on 30 April 2018, a total of 137 IPOs raised HK\$264.4 billion in Hong Kong market up to the end of 2018. Out of these are seven new-economy companies — two WVR companies and five biotechnology companies, which raised HK\$94.2 billion in aggregate. Table 2 shows the list of new-economy companies newly listed in Hong Kong in 2018 under the new regime, which are mostly MPEs. There were reportedly over ten biotechnology companies in the pipeline for listing in Hong Kong and Hong Kong has become the most preferred listing place with low listing costs (e.g. up to 60%-80% lower for accounting costs)<sup>53</sup> for Mainland and overseas biotechnology companies.

**Table 2. IPOs of Mainland new-economy enterprises under the new listing regime in Hong Kong up to end-2018**

Listing date	Company name	Nature	IPO funds raised (HK\$ bil)	Applicable listing chapter
2018/07/09	Xiaomi	MPE	42.61	Weighted Voting Rights
2018/08/01	Asclepis Pharma	MPE	3.14	Biotechnology
2018/08/08	Beigene	MPE	7.08	Biotechnology
2018/09/14	Hua Medicine	MPE	0.89	Biotechnology
2018/09/20	Meituan Dianping	MPE	33.14	Weighted Voting Rights
2018/10/31	Innovent Biologics	MPE	3.80	Biotechnology
2018/12/24	Shanghai Junshi Bioscience	H share	3.54	Biotechnology
<b>Total</b>			<b>94.21</b>	

Note: The individual funds raised do not sum up to the total due to rounding.

Source: Wind.

New-economy companies are different from traditional companies in terms of business cycle and risk-return profile. The riskiness of new-economy investments can be potentially much higher than that in traditional sectors. Apart from a suitable listing regime, **the market-based listing process and valuation model in Hong Kong would also be particularly attractive to new-economy companies from the Mainland.**

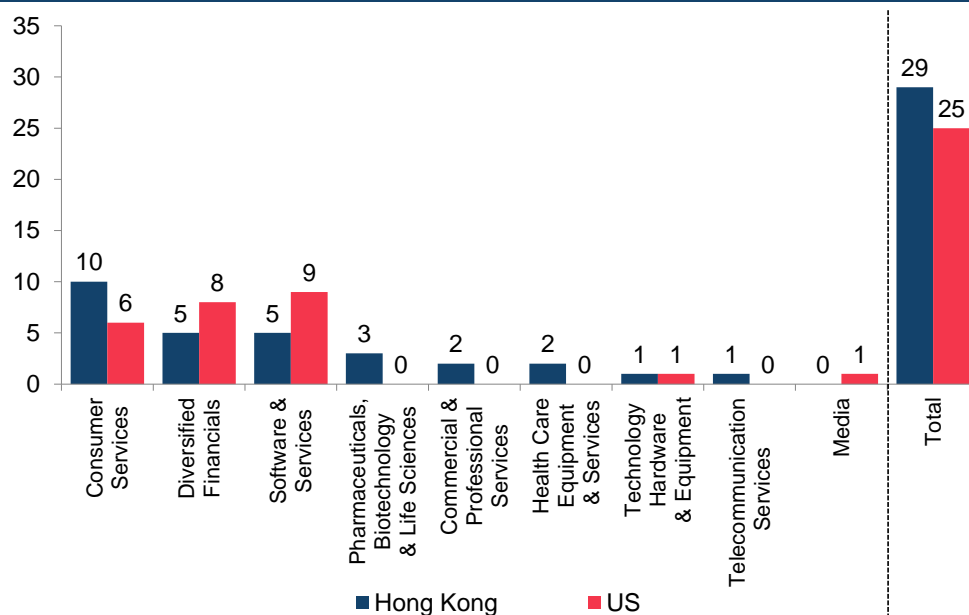
Statistics also showed that more Mainland new-economy companies from a wider spectrum of industries came to list in Hong Kong in 2018 than in other offshore markets like the US — 29

<sup>53</sup> See 〈巴曙松：新經濟企業赴港上市將保持高位〉(“Ba Shusong: New economy enterprises listings in Hong Kong will stay active”), Tai Kung Pao, 13 November 2018.



IPOs (out of a total of 210 IPOs) in Hong Kong, compared to 25 IPOs in the US (see Figure 22).

**Figure 22. Number of IPOs of Mainland new-economy companies in Hong Kong and the US (2018)**



Note: The Mainland companies listed in Hong Kong are identified based on Wind's classification. The Mainland companies listed in the US are identified as companies with China as the country of risk according to Bloomberg's definition.

Source: Wind and Bloomberg.

### 3.3 The largest offshore bond financing centre for Mainland companies

As discussed in Section 2.2, MPEs are encouraged to seek offshore financing, whether through equity or bond issuance. For bond financing, the NDRC introduced a registration-based system for offshore bond issuance in September 2015 to replace the case-by-case pre-approval system<sup>54</sup> and in January 2017 the SAFE relaxed the repatriation of offshore bond proceeds under a neibaowadai (内保外贷) structure<sup>55</sup> (a loan structure where an onshore company's offshore arm borrows money from an offshore bank and an onshore bank provides guarantee for the offshore borrowing). The proceeds from such offshore bond issuance can be used for offshore investments to support the Belt-and-Road Initiative (BRI) and for investments in the development of the Mainland-Hong Kong-Macao Greater Bay Area (GBA).

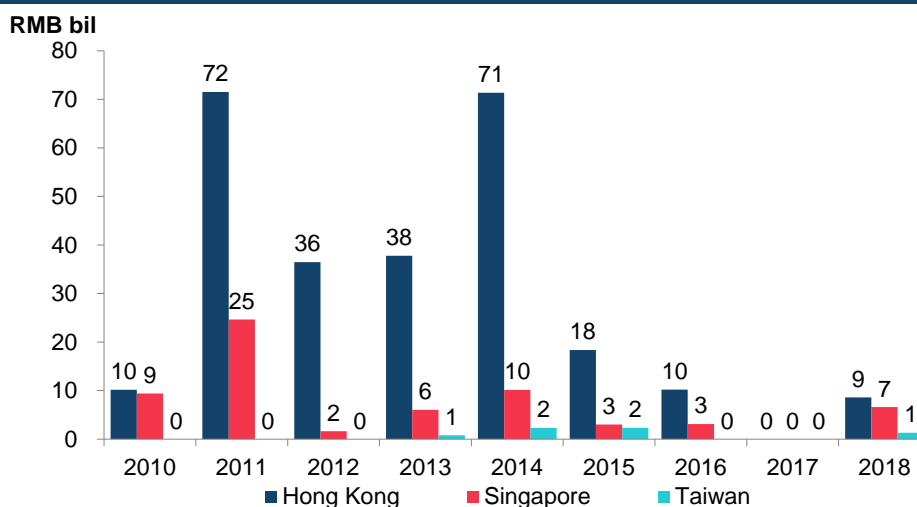
**With the support of Mainland policies, the Hong Kong market has been an alternative source of bond funding for Mainland companies.** To this end, the Hong Kong authorities have introduced initiatives to lower the cost of bond issuance in Hong Kong. The Pilot Bond Grant Scheme (PBGS) was launched to subsidise first-time issuers for offshore bonds issued and listed in Hong Kong. In the light of the growth of green bond issuance in the Mainland and Hong Kong, the Green Bond Grant Scheme was launched to subsidise the cost of certification for green bonds issued and listed in Hong Kong. These policies facilitate the growth of offshore bond issuance of Mainland companies in Hong Kong, including offshore RMB bonds (dim sum bonds) and offshore US dollar (USD) bonds. Figure 23 shows the relative

<sup>54</sup> See *Notice of the National Development and Reform Commission on Promoting the Administrative Reform of the Filing and Registration System for Enterprises' Issuance of Foreign Debts* 《關於推進企業發行外債備案登記制管理改革的通知》, issued by the NDRC on 14 September 2015.

<sup>55</sup> See *Notice of the State Administration of Foreign Exchange on Further Promoting the Reform of Foreign Exchange Administration and Improving the Examination of Authenticity and Compliance* 《國家外匯管理局關於進一步推進外匯管理改革完善真實合規性審核的通知》, issued by the SAFE on 27 January 2017.

dominance of Hong Kong in the issuance of dim sum bonds by non-financial issuers compared to the other major offshore Renminbi (RMB) centres of Singapore and Taiwan.

**Figure 23. Gross issuance of dim sum bonds by non-financial issuers in Hong Kong, Singapore and Taiwan (2009 – 2018)**

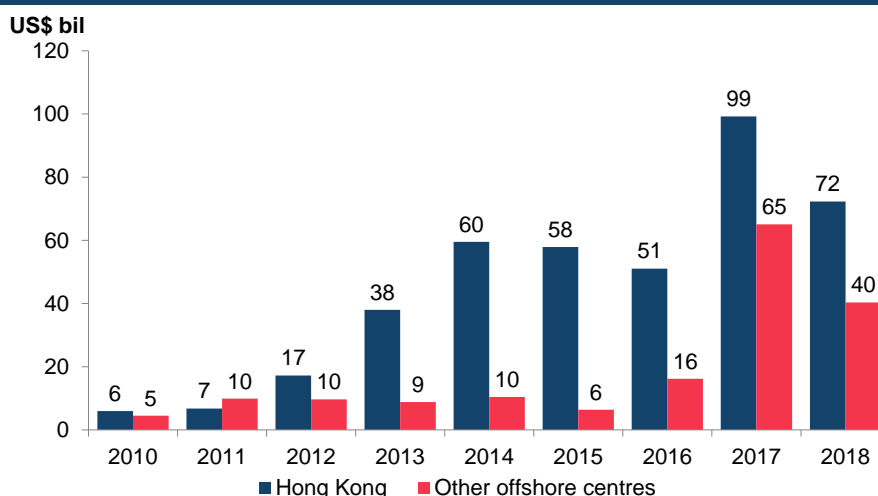


Note: These include not only Mainland issuers, but also issuers from the global market.

Source: Wind.

**In respect of USD bond issuance, Hong Kong had the highest amount issued by non-financial Mainland companies among offshore centres over the past 9 years.** The issue amount reached a record high at US\$99.3 billion in 2017 (see Figure 24) when the issuance of onshore credit bonds by non-financial companies contracted (see section 2.1). The issue amount in 2018 was about US\$72.3 billion for Hong Kong, 79% more than the US\$40.3 billion in aggregate for other offshore centres. At times of funding difficulties, the Hong Kong market could become an important funding source for MPEs. This occurred to the real estate sector in the Mainland: when the onshore financing to real estate developers was tightened in recent years given the on-going financing deleveraging, a number of listed Mainland real estate developers were able to raise funds through bond issuance in Hong Kong.

**Figure 24. Gross issuance of USD-denominated bonds by non-financial Mainland companies in Hong Kong and other offshore centres (2010 – 2018)**



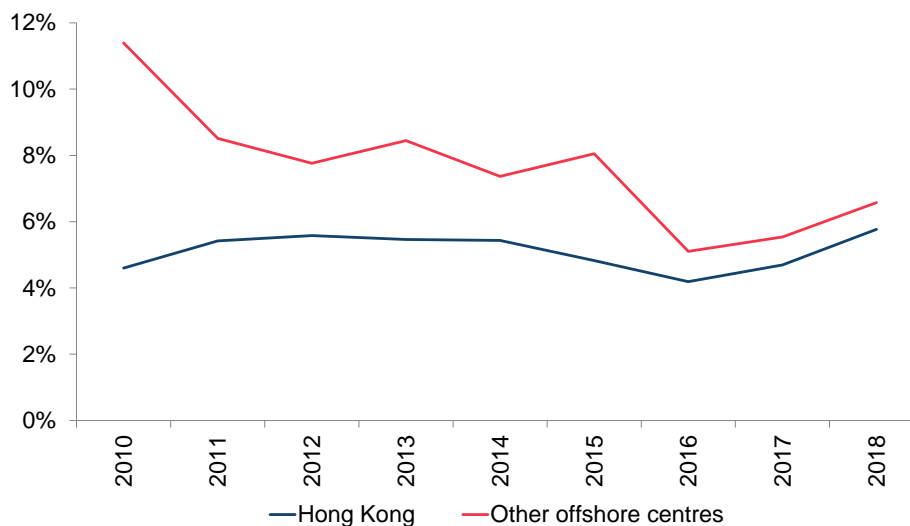
Note: These would include the cases where non-financial companies used their financial subsidiaries (excluding banks and brokers) for offshore issuance. Other offshore centres comprise the US, the UK, Singapore, Ireland, Malaysia, Taiwan Province of China and other unspecified offshore markets.

Source: Wind.



Moreover, the funding cost has been lower than other offshore centres over the past decade — the average coupon rate of USD bonds issued by Mainland non-financial companies in Hong Kong were lower than the average of those in other offshore centres (see Figure 25).

**Figure 25. Average coupon rate of USD-denominated bonds by non-financial Mainland companies in Hong Kong and other offshore centres (2010 – 2018)**



Note: These would include the cases where non-financial companies used their financial subsidiaries (excluding banks and brokers) for offshore issuance. Other offshore centres comprise the US, the UK, Singapore, Ireland, Malaysia, Taiwan Province of China and other unspecified offshore markets.

Source: Wind.

With sound institutional framework and supportive policies, the Hong Kong market serves as a choice of preference for offshore bond issuance by Mainland enterprises. This would be especially advantageous and convenient for Hong Kong-listed Mainland enterprises to do so as they would have already established their international recognition through a listing in Hong Kong. Funding through offshore bond issuance, in complementary to offshore equity financing, could further enhance their corporate image and expand their international investor base.

### 3.4 An offshore RMB risk management centre for Mainland enterprises

The funds raised in Hong Kong by Mainland enterprises can be denominated in Hong Kong dollars (HKD), USD, RMB as well as other foreign currencies. If a Mainland enterprise wants to repatriate the funds back for use in the Mainland, it may need to convert the proceeds in foreign currencies into the RMB at the end of the fund-raising process and upon approval by the regulator, thereby exposing itself to exchange rate risk. RMB currency products would help them hedge the exposure. For enterprises with offshore operations, which are on the rise under the “going out” initiatives, would have revenues and expenditures denominated in foreign currencies. While some may have natural hedge with investment and revenue in the same currency denomination, most could make use of foreign exchange (FX) products to hedge against their currency exposure, so as to achieve more stable corporate earnings. Thus, **offshore RMB risk management is a significant tactic to go with offshore financing and business development of Mainland enterprises.**

RMB risk management has become particularly important to enterprises with RMB exposure as the RMB has become much more volatile after the exchange rate mechanism reform on 11 August 2015, which has given more flexibility in the RMB's exchange rate movement and provided a more market-based mechanism in determining the central parity rate.

Furthermore, the recent trade friction and macro conditions have intensified the situation<sup>56</sup>. While onshore RMB currency derivatives may not have enough variety or may be costly to use (e.g. the PBOC raised the reserve requirement to 20% on forward positions in August 2018 for the sake of financial stability<sup>57</sup>), offshore RMB FX products would be attractive alternatives for Mainland enterprises to hedge their RMB currency risks.

**In fact, the Hong Kong market offers the largest spectrum of offshore RMB products<sup>58</sup>, including a wide range of FX derivatives for RMB risk management.** These include deliverable USD/CNH futures and options as well as cash-settled CNH futures against USD, euro, Japanese yen (JPY) and Australian dollar (AUD). These products provide cost-effective means for offshore hedging of RMB currency risk within a controllable environment that will not significantly affect onshore RMB exchange rates. Hong Kong's USD/CNH futures are the world's first deliverable RMB futures in the offshore markets and its turnover is among the largest in the world<sup>59</sup>. The USD/CNH option is complementary to the USD/CNH futures with continuous quotation and high capital efficiency<sup>60</sup>. These factors contributed to the record-high turnover volumes of the USD/CNH futures and options in August 2018 when the RMB exchange rate weakened.

### 3.5 The key gateway to connect onshore markets with global investors

As discussed above, the Hong Kong market has played an important role in providing offshore financing to Mainland enterprises which come to make offerings of shares and/or bonds to global investors. **It also facilitates the channelling of global liquidity into the Mainland market to reach domestic companies and potentially lower their funding costs.** This is particularly beneficial to MPEs which are facing strong competition from SOEs for domestic funding but their vivid business prospects, especially for those in new-economy sectors, would be attractive to global investors. The increased flow of global liquidity onshore is effected by way of the Stock Connect and Bond Connect schemes that provide convenient ways for offshore investors to invest in onshore stocks and bonds respectively through the Hong Kong market infrastructure that is linked to the Mainland market infrastructure (see more about this below). As a result, the investor base in Mainland, especially the institutional investor base, has been broadened which brings in not only global liquidity, but also international perspective and professional securities valuation model. This consequentially would promote further development of the Mainland securities market towards more mature market operations.

As a result, there is greater acceptance of the Mainland market by the global investor community. **The market accessibility offered by the Connect schemes is one of the significant factors contributing to the inclusion of onshore securities into global benchmarks.** These include MSCI's inclusion of A shares into its Emerging Markets Index since 31 May 2018<sup>61</sup>, to be followed by a further increase of inclusion factor effected from May 2019; and Bloomberg Barclays' inclusion of Chinese bonds into its Global Aggregate Indices from April 2019<sup>62</sup> after certain key refinements were made to the Bond Connect scheme in late 2018. With these inclusions, there will be growing volumes of passive global investments being allocated to Mainland stocks and bonds. Such strong investment demand would further

<sup>56</sup> See HKEX research report, "RMB exchange rate movements amid global trade friction and RMB exchange rate risk management tools: CNH Futures with multiple currency pairs and tenors", published on the HKEX website, 14 January 2019.

<sup>57</sup> See 〈準備金率調整為 20%有關問題答記者問〉("Q&As for the Press related to Reserve Requirement adjusted to 20%"), issued by the PBOC, 4 August 2018.

<sup>58</sup> See HKEX research report, "Offshore RMB products and risk management tools – Hong Kong's ecosystem nurtured by the Connect Schemes", published on the HKEX website, 29 November 2018.

<sup>59</sup> Ditto.

<sup>60</sup> See HKEX research report, "The HKEX USD/CNH Options Contract — A RMB currency risk management tool", published on the HKEX website, 18 August 2017.

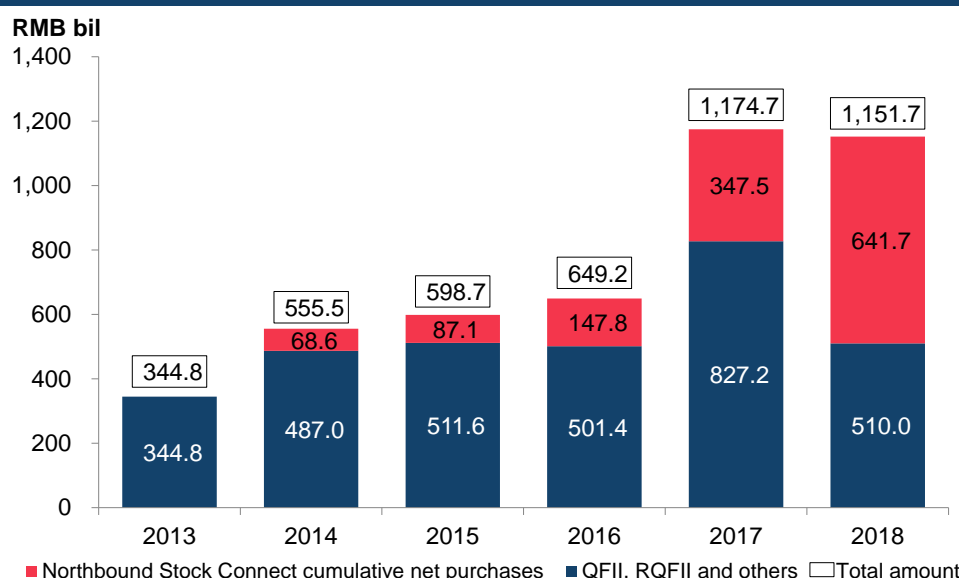
<sup>61</sup> See MSCI, "Conclusion of the Consultation on Further Weight Increase of China A Shares in the MSCI Indexes", February 2019.

<sup>62</sup> See Bloomberg, "Bloomberg to Add China to the Bloomberg Barclays Global Aggregate Indices", 23 March 2018.

boost the liquidity of onshore markets as well as the availability of funding to Mainland enterprises, benefiting especially the MPEs.

**For the onshore stock market**, the investment amount in A shares through Northbound Stock Connect since the launch of the Shanghai-Hong Kong Stock Connect (Shanghai Connect) in November 2014 and subsequently the Shenzhen-Hong Kong Stock Connect (Shenzhen Connect) in December 2016 has been on the rise over the years. The cumulative purchases of A shares through Northbound Stock Connect reached RMB 641.7 billion as of December 2018, overtaking the holdings through QFII, RQFII and other schemes (Figure 26). In 2018 when the onshore market performance was weak, there was still a net increase of RMB 294.2 billion of foreign A-share holdings under Stock Connect, compared to a net decrease of RMB 317.2 billion under other channels. The strong liquidity under Stock Connect was catalysed by a number of enhancements during the period, including the removal of aggregate net purchase quota in August 2016 and quadrupling the daily net purchase quota in May 2018.

**Figure 26. Year-end total foreign holdings of Mainland onshore stocks (2013 – 2018)**



Note: The amount of QFII, RQFII and others is calculated as the difference between the total foreign holdings in onshore stocks and Northbound Stock Connect cumulative net purchases.

Source: Wind.

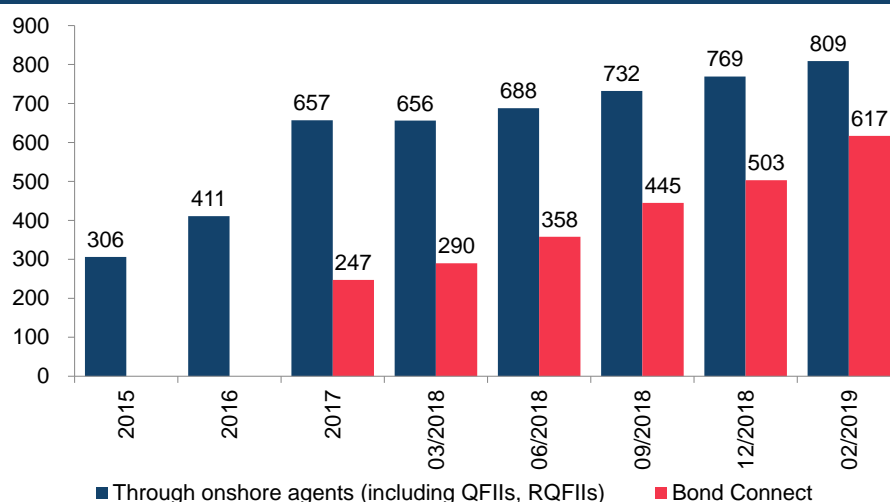
Enhanced secondary market liquidity would offer strong support to enterprise funding in the primary market. However, global investors cannot participate through Stock Connect in domestic IPOs and secondary offerings of Mainland companies yet. Given the growing appetite of global investors for Mainland A shares, the potential demand for their participation in Mainland primary market shares offering through Stock Connect is expected to be very high. The introduction of Primary Equity Connect would not only help drive forward the Mainland's capital account opening but also be directly beneficial to onshore funding by Mainland enterprises<sup>63</sup>. Nevertheless, operational enhancements to the Stock Connect schemes, such as block trading mechanism, that could further support liquidity would be beneficial.

**As for the bond market**, offshore institutions can participate in both secondary market trading as well as in subscription of new issues of onshore bonds in the China Interbank Bond market (CIBM) through Northbound Bond Connect. The number of global investors investing in Mainland bonds through Northbound Bond Connect has been increasing, reaching 503

<sup>63</sup> See HKEX research report, "Primary Equity Connect — A breakthrough opportunity for Mainland-Hong Kong Mutual Market connectivity and RMB internationalisation", published on the HKEx website, 28 August 2017.

institutional investors across 24 jurisdictions by the end of 2018 (Figure 27). The primary issuance through Bond Connect to offshore investors amounted to RMB 4.1 trillion by the end of 2018 since the launch of Bond Connect in July 2017<sup>64</sup>, and an average daily turnover of RMB 3.58 billion was achieved in 2018<sup>65</sup>. In fact, the amount of foreign holdings of onshore bonds has more than doubled to RMB 1,729.9 billion as of end-2018 from RMB 842.5 billion in June 2017. Since January 2019, Bond Connect can be accessed via Bloomberg in addition to Tradeweb, drawing in a wider group and spectrum of international investors to Mainland bonds. With stronger liquidity and direct primary market participation from a growing global investor base, Bond Connect offers strong support to bond financing by Mainland enterprises.

**Figure 27. Number of offshore institutional investors in the CIBM (2015 – Feb 2019)**



Source: Xinhua08.com (for the number through onshore agents) and Bond Connect Company Limited (for the number using Bond Connect).

In summary, the global connectivity offered by the Hong Kong market gateway provides strong support to onshore equity and bond financing by Mainland enterprises. This is particularly important to MPEs which have been facing obstacles in obtaining financing through other means such as bank loans.

#### 4. CONCLUSION

MPEs are integral to the real economic growth in the Mainland, especially during the current transition to a new economy. Despite the long-standing support by China's leadership, MPEs have been facing difficulties in getting funding from domestic channels. Offshore channels, particularly Hong Kong, are important to MPEs.

The Hong Kong market has been the largest offshore fund-raising centre, whether in respect of equity financing or bond financing, for Mainland enterprises, especially for MPEs. It provides a level-playing field and market-based platform for fund-raising by enterprises through stocks and bonds, irrespective of the enterprise's sector and type of ownership. New-economy companies seeking a listing in Hong Kong, which would be mostly MPEs, would benefit from the more certainty of funding timing, market-driven valuation and global reach like other Mainland enterprises. To help Mainland enterprises hedge the currency mis-match in offshore financing, the Hong Kong market is an offshore RMB risk management centre offering the widest spectrum of exchange rate risk management tools. The onshore equity and bond financing of Mainland enterprises is further supported by additional global liquidity

<sup>64</sup> Source: "Flash Report for Bond Connect – December 2018", Bond Connect Company Limited (BCCL) website, 3 January 2019.

<sup>65</sup> Source: "Happy New Year – Over 500 Investors Joined Bond Connect at the End of 2018", BCCL website, 28 December 2018.

channelled through Stock Connect and Bond Connect schemes, particularly after the inclusion of onshore securities into global benchmarks.

Complementary to the Mainland market, the Hong Kong market will continue to exhibit its roles in supporting the offshore financing of Mainland enterprises, including MPEs.

## APPENDIX. PE RATIOS OF MAINLAND COMPANIES' IPOS IN 2018 IN HONG KONG, MAINLAND AND THE US

Sector	Hong Kong (times)	Mainland (times)	US (times)
Commercial & Professional Services	767.7	21.3	
Food, Beverage & Tobacco	210.1	21.2	
Telecommunication Services	93.5		
Real Estate	26.3	23.0	
Capital Goods	21.3	23.0	
Diversified Financials	18.7	21.4	38.1
Automobiles & Components	18.0	21.6	-26.4
Food & Staples Retailing	15.7		-22.6
Materials	13.0	21.8	
Banks	11.1	7.8	
Energy	11.0		
Pharmaceuticals, Biotechnology & Life Sciences	10.0	23.0	
Consumer Durables & Apparel	9.4	23.0	
Utilities	9.1	21.3	
Software & Services	7.2	23.0	-258.6
Technology Hardware & Equipment	-7.3	21.0	757.6
Consumer Services	-13.7	22.2	295.9
Transportation	-15.2	22.5	
Health Care Equipment & Services	-67.2	23.0	
Household & Personal Products		23.0	
Insurance		8.9	
Media			209.5
Retailing		21.2	-245.1
Semiconductors & Semiconductor Equipment		20.7	
<b>Average</b>	<b>34.7</b>	<b>21.5</b>	<b>-26.1</b>
<b>Average (excluding loss-making companies)</b>	<b>57.8</b>	<b>21.5</b>	<b>267.4</b>

Note: The sector of each company is identified with reference to the Level 2 industry classification from Wind.

Source: Wind.

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