



Hong Kong Capital Markets Overview

Creating a better future through innovation and collaboration

January 2024



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Background

In February 2024, CSRC, China's main securities industry regulator, replaced the head of its securities regulator as policymakers struggled to stabilize the country's main stock indexes after a plunge to five-year lows. The cabinet removed Yi Huiman as chairman of the China Securities Regulatory Commission (CSRC), replacing him with Wu Qing, a veteran securities regulator who had led the Shanghai Stock Exchange and served as a key deputy in Shanghai's municipal government. Yi's removal comes as Chinese markets spiral downward as institutional and retail investors scramble to cut their losses, with the sputtering economy and slower-than-expected government stimulus measures weighing heavily on confidence. Whilst China has grand plans to accelerate the maturity of its capital markets, significant challenges remain in making China's financial markets a top investment choice for global investors. This paper explores some of the existing challenges and why we are optimistic that these challenges can be overcome in the long term.

Executive Summary

The last decade has been one of unprecedented change in the global economy, leading to critical implications for the overall market and investor sentiment. Most notably, market dynamics in terms of US-China geopolitical relations are shifting, as are key macroeconomic factors such as inflation and interest rate uncertainties.

The Hong Kong capital market is under the spotlight, sparked by a liquidity crisis in Mainland China's property sector and uncertainties in the regulatory environment. Nearly nine-tenths of the foreign money that flowed into Mainland China's stock market in 2023 has already left. This has weighed down Hong Kong's Hang Seng Index and Mainland China's CSI Index. Although Hong Kong's unique legal system and investor mix set it apart from Mainland China, Hong Kong's financial system has an inextricable relationship with the rest of China.

The future remains uncertain due to factors such as a sluggish post-pandemic recovery, regulatory uncertainties, and high tensions between China and the US. Rising US interest rates and the depreciation of the Chinese yuan further encourage investors to seek less risky opportunities elsewhere. However, with its well-established financial infrastructure, international connectivity, strategic focus on technology, government support, and strengthening ties with the Middle East, Hong Kong has significant upside and advantages over other jurisdictions in the region in the long term.

With stronger collaboration with other regions and technological adoption supported by favorable regulatory policies, we are optimistic that Hong Kong will maintain its status as an international financial epicenter.

Introduction

Economic Backdrop

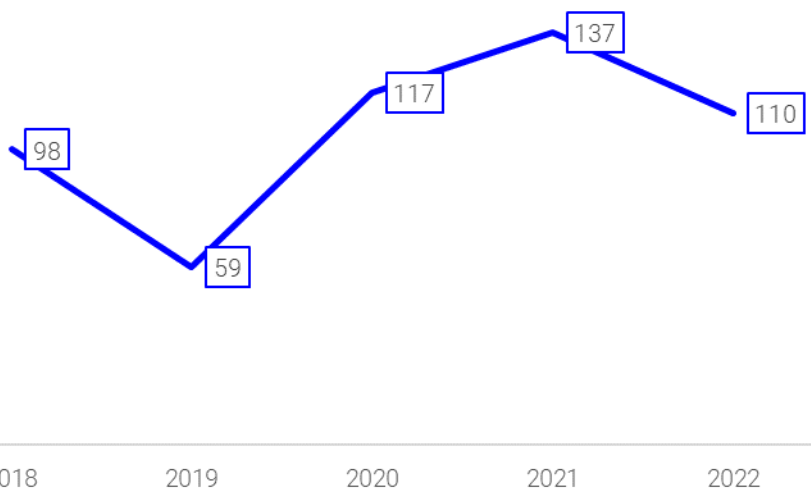
Hong Kong's financial services industry and many sectors have been significantly impacted by the COVID-19 pandemic. By the end of 2022, the total AUM of asset/wealth management in Hong Kong had decreased by 14% year-on-year. Despite much of the world returning to a more normal state by 2022, Hong Kong and Mainland China were among the last places to remove quarantine restrictions, delaying the recovery of local businesses until 2023.

Capital Outflows

After COVID restrictions were removed, there has been an increasing and interconnected capital outflow in both Mainland China and Hong Kong. Hong Kong recorded a large-scale outflow of HK\$140 billion out of the Hong Kong stock market in February 2023, while its accumulated foreign capital outflows reached HK\$1.05 trillion. In September 2023, China suffered US\$75 billion of capital outflows after a US\$42 billion flight in August, which is the largest since 2016. According to Goldman Sachs, foreign funds sold US\$2.1 billion of Chinese stocks in mid-September, taking the six-week outflows to a record US\$15 billion. In October 2023, China and Hong Kong experienced a combined \$3.1 billion net outflow from active long-only funds, the third consecutive month of net selling exceeding \$3 billion. Foreign funds further sold US\$5.1 billion out of the onshore stock market. Generally, Hong Kong and Mainland-listed companies suffered a decline in their stock prices, driving valuations down. For example, Alibaba Group, e-commerce rival JD.com, food delivery platform operator Meituan, and Tencent all declined by more than 30% in 2023. The continuous capital outflows have reduced Hong Kong's aggregate balance and pushed the interbank rates to 14-year highs, further draining cash to the lowest level in two years.

Foreign Direct Investment (FDI) Inflow

US\$ billions



Source: HKTDC

Key Drivers of Capital Outflow

The main drivers of the capital outflows are two-fold, namely the poor sentiment towards China's business and economic recovery outlook and the rising US interest rates. The bankruptcy of real-estate giant Evergrande, the arrest of senior banking executives, and new regulations across technology, gaming, and education sectors have further fueled investors' worries over investing in China. These factors led to foreign companies (primarily US-based firms) scaling back their operations in China and diversifying their supply chains in other regions of Asia, such as India and Southeast Asia. Additionally, widening interest-rate differentials and significant depreciation of the Yuan against the US dollar have contributed to the capital outflow, particularly from high-net-worth individuals and families. Large capital outflows have hindered the ability of fast-growing companies and startups to raise capital and find cornerstone investors to support IPO listings.

Market Headwinds

Capital Markets Landscape

Sluggish IPO Activity Despite Strong Pipeline

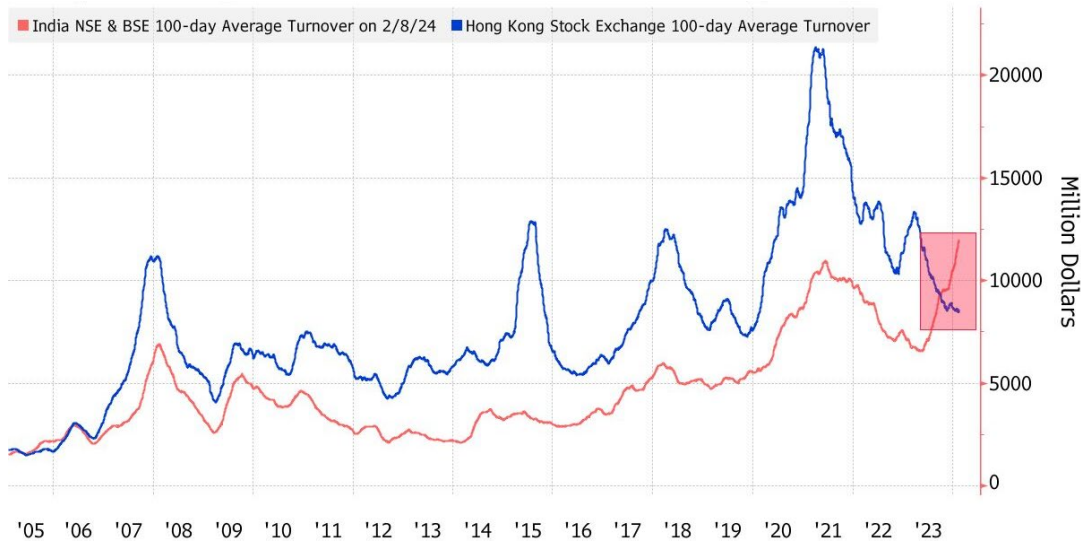
A recent report by KPMG about the IPO landscape in Q3 of 2023 revealed sluggish IPO activity, causing Hong Kong's position in the global rankings to drop to 8th globally. The first three quarters of 2023 revealed a 65% fall in deal count and a 15% decrease in proceeds compared to the same period last year. Shanghai and Shenzhen Stock Exchanges also saw a decline in the funds raised compared to the first three quarters by 42% and 43% respectively. However, there seems to be a sliver of hope, given the 110 active IPO applicants, that could potentially allow Hong Kong to achieve a position in the top 5 by the end of 2023 if market conditions recover.

Declining Liquidity in Capital Markets

The Hong Kong Stock Exchange (HKEX) is one of the world's leading capital-raising venues that attracts global investors to its primary market. However, in the secondary market, Hong Kong lags behind other countries. In 2022, the average daily turnover in the Hong Kong stock market declined to \$124.9 billion, 25% lower than the \$166.7 billion in 2021.

In 2022, Hong Kong scored 76.4% in turnover liquidity, which is the value traded relative to the overall market capitalization. This turnover was significantly higher than that in 2019, yet still far behind the US, which had a turnover velocity of 109%. The relatively low liquidity in Hong Kong is due to its distribution of investors. Institutional investors, the less active traders, dominate the Hong Kong cash market, accounting for 56.4% of turnover in 2020, compared with high-volume traders, including market makers, high-frequency traders (HFTs), and quantitative funds, accounting only for 28.1%.

Daily trading value in India overtakes Hong Kong



Source: Bloomberg

On 23 January 2024, India overtook Hong Kong to claim the fourth position in the global equity market rankings by market capitalization. According to Bloomberg data, India’s market cap reached \$4.33 trillion, beating Hong Kong’s \$4.29 trillion market cap. While the US leads the global stock market, China, with a market cap of \$8.44 trillion, and Japan, at \$6.36 trillion, lead India in second and third place, respectively. However, we believe India only surpassed Hong Kong temporarily, given Hong Kong stocks are heavily oversold as of February 2024 with an average P/E ratio < 10 while India is trading at a P/E ratio of > 20.

HKEX has abundant market makers and Exchange Traded Products (ETP) to provide investors with secondary liquidity. Over 30 Securities Market Makers (SMMs) and Designated Specialists (DSs) provide market liquidity and price efficiency. ETFs generate liquidity as market makers are required to constantly trade the underlying securities when they create or redeem a unit of the fund or undertake rebalancing to reflect a change in the index. In Hong Kong, 56% of the day’s short-selling was accounted for by major ETPs. However, ETFs accounted for only 4% of the stock trading in Hong Kong, leading to relatively low secondary liquidity.

Hong Kong Investor Base

Hong Kong's Asset Management Industry Overview

Despite recent capital outflows, Hong Kong's \$22 trillion asset management industry remains diversified and healthy. According to SFC data, more than 60% of asset and wealth management businesses are from non-Hong Kong investors, amounting to \$19,011 billion as of 31 December 2022. Despite the poor sentiment, the percentage of foreign investment has remained stable over the past five years.

Asset and Wealth Management Business – Assets from non-Hong Kong Investors (\$29,791 billion)

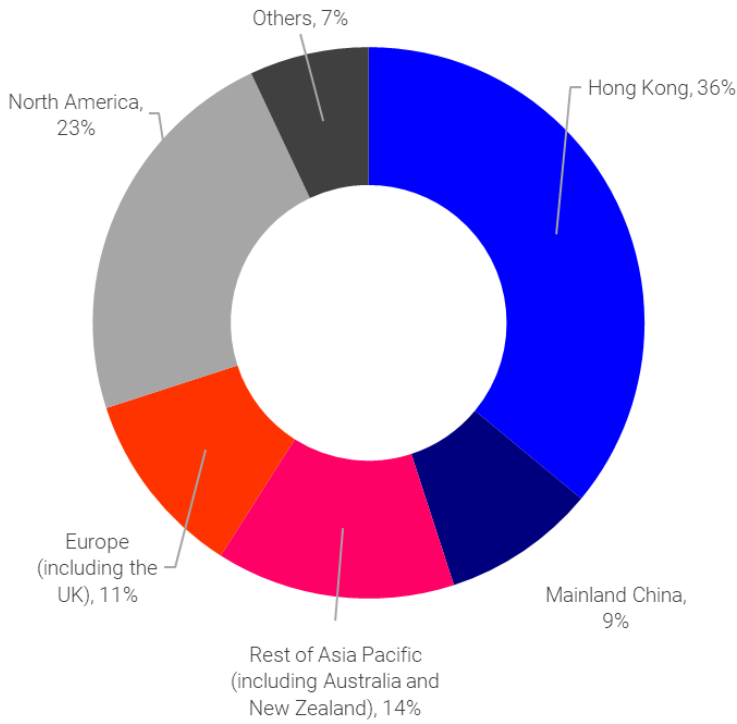


Source: HKSFC 2023

Lack of Investors from the Middle East

Hong Kong's investor base is diversified – amongst the non-Hong Kong investor base, North America ranked first with 23%, followed by the Rest of Asia-Pacific and Europe with 14% and 11%, respectively. As diplomatic tensions drove US and European investors away, Hong Kong must look for new capital sources. The lack of investors from the Middle East, Africa, and South America suggests weak investor penetration from these regions and room for growth. Middle East investors, particularly, are keen to allocate more resources to high-tech industries and fast-growing companies to diversify their risks from traditional natural resource industries. Hong Kong can build stronger diplomatic relations with OPEC and BRIC countries to attract foreign investments.

Asset and Wealth Management Business – by Investor Base (\$29,791 billion)



Source: HKSFC 2023

In fact, the Hong Kong SAR Government has already carried out High-level meetings with the Qatar Investment Authority, subsidiaries of Saudi Arabia’s Public Investment Fund, and the Abu Dhabi Investment Authority to explore trade opportunities. These meetings highlight the deepening economic and diplomatic ties between China and the Middle East, a region traditionally part of the US sphere of influence.

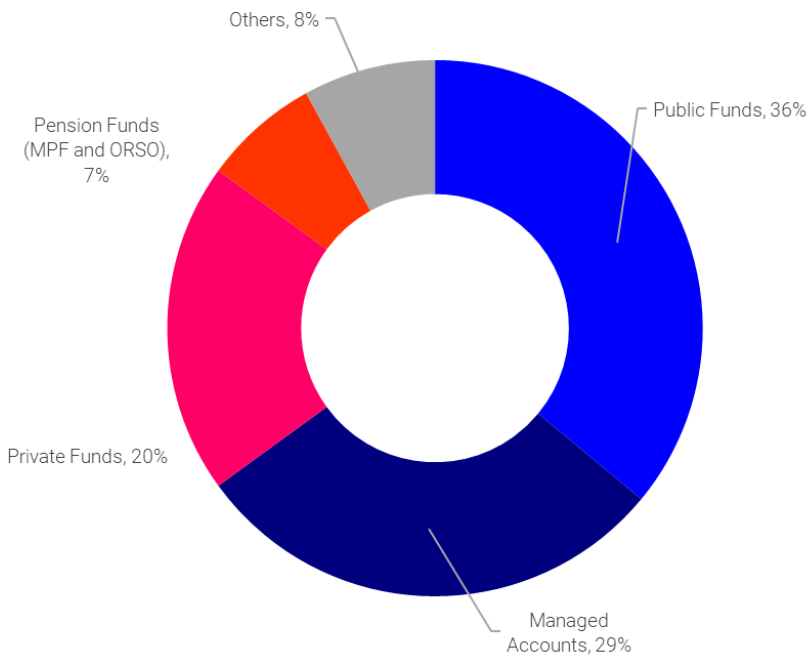
While big US investors such as Texas Teachers’ Pension and California State Teachers’ Retirement System have cut exposure to Chinese equities in the past year, Chinese companies’ valuations have become increasingly attractive. According to Wong Kok Hoi, CIO at Singapore-based APS Asset Management, the Middle East believes that China is cheap and wants to diversify away from US-centric investments. In the long term, the strategy of Middle East investors to increase their exposure to non-dollar assets should not change much. China and the Middle East have broad prospects for future cooperation in areas including sustainable development, high-end manufacturing, and healthcare.

Diverse Wealth Management Products

Hong Kong’s assets under management are highly diversified across fund products. Public funds and managed accounts contributed to most of the assets under management (AUM), with 36% and 29%,

respectively. While hedge funds, private equity, and venture capital occupied a comparatively smaller share at 20% combined, Hong Kong’s private equity funds’ AUM of \$212 billion was the second highest in Asia after Mainland China.

Asset and Wealth Management Business – by Product Type (\$29,791 billion)

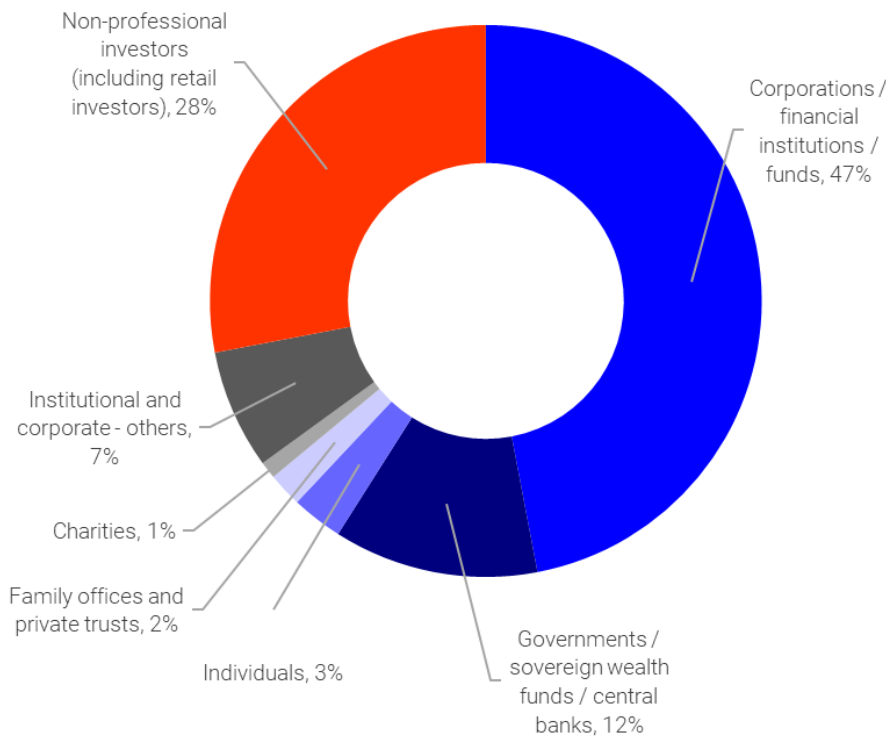


Source: HKSF 2023

Room for Family Offices to Grow

More than 70% of Hong Kong’s investor base are professional investors, with the majority of the AUM being invested by corporations, financial institutions, and government-related funds. The Hong Kong SAR Government has consistently been working towards strengthening Hong Kong’s position as a family office hub. In mid-2020, the Hong Kong SAR Government introduced the family office tax concession regime to attract and support more family offices to set up in Hong Kong. While the number of family offices has grown by more than 7% in 2023, the percentage of investment from family offices and private trusts investing in Hong Kong ranks among the last at 2% of the total AUM.

Asset and Wealth Management Business – by Investor Type (\$29,791 billion)



Source: HKSFC 2023

The Hong Kong SAR Government can consider policies encouraging family offices to invest and support Hong Kong-listed companies and local startups.

Lack of Foreign Retail Investor Base

While retail investors take up 28% of assets, most of these investors are local. Foreign retail investors face numerous challenges when investing in the Hong Kong Stock Market:

- **Language and Cultural Barriers:** Hong Kong operates predominantly in English and Chinese languages. Foreign retail investors unfamiliar with these languages may face challenges in accessing information, understanding disclosures, and communicating with market participants. Language barriers can create difficulties in conducting research, analyzing company reports, and staying updated with market developments.
- **Regulatory Complexity:** Hong Kong has a well-regulated financial market, but the regulatory framework may be complex and unfamiliar to foreign retail investors. Navigating through regulatory requirements, understanding listing rules, and complying with disclosure obligations can be challenging for investors who are accustomed to different regulatory environments.
- **Limited Access to Information:** Foreign retail investors may face limitations in accessing timely and comprehensive information about Hong Kong-listed companies. Complex disclosure requirements, language barriers, restricted access to certain research reports, and limited availability of financial data in a structured format can hinder the ability to make informed investment decisions. This lack of information transparency may make it challenging to conduct thorough due diligence.
- **Trading and Settlement Differences:** Retail investors may encounter differences in trading and settlement practices compared to their home markets. Different trading hours, settlement cycles, and trading conventions can create logistical challenges and require adjustments in investment strategies.

The Importance of Cornerstone Investors

Cornerstone and anchor investors have become increasingly significant in Hong Kong, playing a crucial role in elevating IPO valuations and providing endorsement for public offerings. Cornerstone and anchor investing are more common and popular in Hong Kong than in other markets outside Asia. These investors are typically individuals or groups that can influence market sentiment toward a given investment.

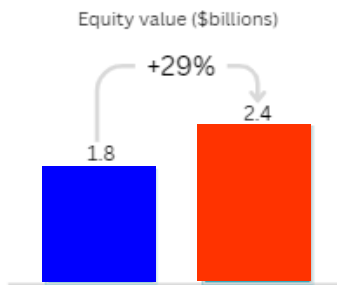
Cornerstone investors are allocated shares after the IPO process has been initiated but before the formal book building. On the other hand, Anchor investors are allocated the shares before the IPO Process is undertaken. Both types of investors are subject to a lockup period after an IPO.

Cornerstone investors play a key role in driving positive investor confidence as their presence signals a robust due diligence process towards the issuing company. Cornerstone investors can also drive higher equity valuation.

Increased Equity Valuation Derived from Cornerstone Investors

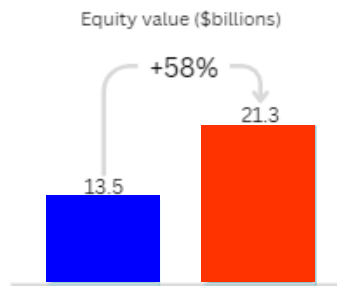
Financial Investors

- Company: Laureate Education’s IPO
- Investors: Apollo, Abraaj Group
- Acquire 20% of stake



Strategic Player

- Company: Tencent Music Entertainment
- Investors: Spotify
- Acquire 9% of stake



Source: BCG Analysis

Between 2010 and 2018, cornerstone investing played an increasing role in the Hong Kong IPO market due to favorable regulatory and market conditions. However, in recent years, the dwindling IPO market has caused a fall in overall investor confidence and has comparatively reduced the extent of cornerstone investing.

Tailwinds for Growth

Catalysts for Hong Kong

Investor confidence serves as the cornerstone of any thriving financial market, and Hong Kong is no exception. The trust and belief in the transparency, efficiency, and regulatory framework of a market attracts domestic and international investors, fostering capital flows and paving the way for sustainable economic growth.

As Hong Kong looks towards revitalizing its position as a premier investment destination, there are several key factors that must be addressed to restore investor confidence. This section outlines the key drivers and opportunities for Hong Kong. It presents potential strategies to rebuild trust, foster stability, and create an environment that attracts investors from around the globe.

Restoring Investor Confidence

To enhance stock market liquidity, the government established the Task Force on Enhancing Stock Market Liquidity in 2023 to comprehensively review key internal and external factors affecting stock market liquidity, including the listing regime, market structures, and trading mechanisms.

The Task Force also explores how to broaden the sources and flows of funds, attract high-quality listings, enhance price discovery mechanisms and trading efficiency, etc. Moreover, there are enhancements on Stock Connect. With the introduction of block trading under Stock Connect, offshore investors can conduct block trades via Northbound trading on both the Shanghai and Shenzhen stock exchanges; investors from Mainland China will be able to conduct manual trades via Southbound trading on Hong Kong's stock market. Manual trades and block trading are important trading mechanisms that allow investors to conduct negotiated transactions, further enhancing trading efficiency and offering more choice and liquidity.

Go Green

Environmental, social, and governance (ESG) considerations have become increasingly important for Hong Kong's secondary market investors. According to a survey conducted by the HKMA, 82% of institutional investors in Hong Kong consider ESG factors in their investment decisions. This reflects a shift in investor preferences towards sustainable and responsible investments. Green investing offers a new and attractive choice for investors, which boosts their confidence and sentiment, improving the secondary liquidity in Hong Kong.

The issuance of green bonds showcases Hong Kong's commitment to sustainable development and can attract high-quality investors. The Government launched the Government Green Bond Programme (GGBP) in 2018 with a ceiling borrowing of HK\$100 Billion, which will be used to finance

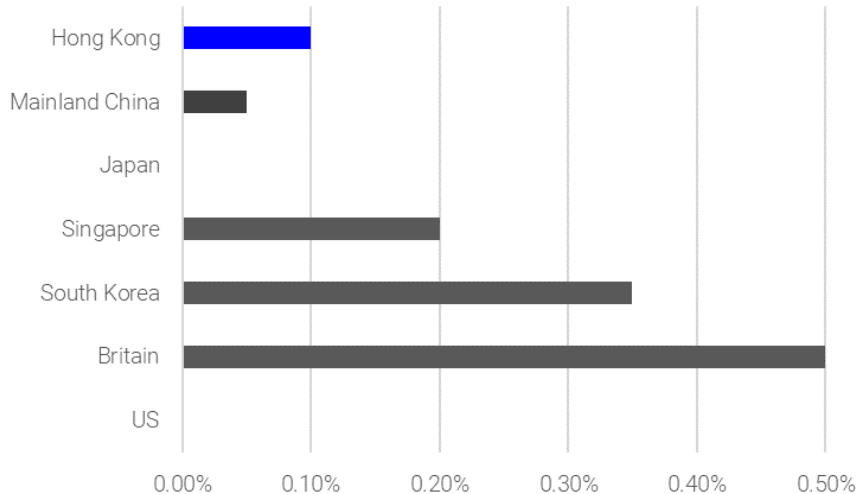
projects that provide environmental benefits and sustainable development for Hong Kong. The issuance of green bonds equivalent to around US\$10 Billion under GGBP since 2019, covering the US dollar, euro, renminbi, and Hong Kong Dollar, and a four times increase in the sustainable debt issuance has further helped Hong Kong's green and sustainable market experience major growth. These initiatives have attracted the global investment community and affirmed investors' confidence in Hong Kong's commitment to tackling climate change. Fifty green, social, and sustainable bonds were added to the HKEX market, raising HK\$172 Billion as compared to forty-two listings and HK\$123.4 billion in the corresponding period of the previous year. Around 90% of green and sustainable bonds issued in Hong Kong come from the private sector, with real estate developers and financial institutions being the major contributors. The availability of green bonds may attract new investors to the equities market, potentially increasing demand for green-focused companies and projects. The government's green bond program and the increasing use of renewable energy sources further demonstrate Hong Kong's dedication to becoming an international green finance hub and achieving carbon neutrality by 2050.

Despite being nascent, Hong Kong's green bond market creates a broader ecosystem that encourages domestic and foreign investment portfolios to tap into greener investing opportunities in Mainland China. Green investing also contributes to liquidity in the secondary market by attracting a growing number of ESG-themed funds globally. These funds focus on companies and projects that meet specific environmental, social, and governance (ESG) criteria. The Hong Kong Investment Funds Association reports that the total assets under management (AUM) of sustainable funds in Hong Kong reached USD 6.6 billion in June 2021, representing a significant increase compared to previous years.

Stamp Duty Reduction

To stimulate capital market activity and boost investor confidence, a series of measures have been implemented by regulators. On 17 November 2023, the stamp duty on HKEX stock transactions was reduced from 0.13% to 0.1%. After this reduction, the stamp duty in Hong Kong will drop to levels on par with Singapore and South Korea.

Comparison of Stamp Duty Across Jurisdictions



Opportunity to grow Foreign Retail Investor Base

The Hong Kong Stock Exchange can promote the use of technology to address the challenges faced by foreign retail investors and attract more inflows to boost liquidity. For example:

- Build a 24/7 automatic trading platform to support pre-market and post-market trades to bridge the differences in trading hours for foreign investors
- Leverage natural language processing (NLP) technology to translate Chinese disclosures to English, especially for Mainland-based company announcements
- Standardize reporting workflows and provide financial and ESG data in a structured format that is easily and freely accessible for investors
- Remove board lot trading requirements to reduce the price barrier for retail investors to buy stocks and boost liquidity

Attracting Cornerstone Investors

Hong Kong can consider offering incentives to attract cornerstone investors. These incentives could include tax breaks, reduced trading fees, or access to exclusive investment opportunities. By providing tangible benefits, Hong Kong can differentiate itself from other markets and make itself more attractive to cornerstone investors. Hong Kong should actively engage with potential cornerstone investors through roadshows, conferences, and other promotional activities. These initiatives provide an

opportunity to showcase investment opportunities, highlight the benefits of investing in Hong Kong, and address any concerns or questions that investors may have. Building strong relationships with cornerstone investors requires ongoing communication and engagement efforts to showcase the strong growth potential of Hong Kong companies and startups.

Conclusion

We are optimistic about the opportunities that lie ahead. The future success of Hong Kong's capital markets relies on the collective efforts of stakeholders to boost investor confidence and enhance liquidity. Building stronger ties with other regions, promoting cross-border collaborations, and adopting technology are key to restoring investor confidence, attracting capital inflows, and enhancing market stability. Moreover, the global trend towards sustainable finance offers Hong Kong various opportunities to attract investors seeking environmentally responsible investment. Hong Kong can establish itself as a leader in sustainable finance by actively taking part in issuing green investment products. Hong Kong should continue to promote transparency, fair practices, and strong enforcement. Finally, Hong Kong should address geopolitical issues to reassure investors of its stability and dedication to the rule of law. While US-China tensions continue weighing down investor sentiment and capital flows, Hong Kong must carefully navigate the complex geopolitical environment while minimizing risks and keeping communication open with all parties involved.

Times have changed - Hong Kong cannot rely on the status quo to succeed. We must explore new means through investor diversification and technological advancement to reverse the tide and uphold its reputation as a thriving and robust worldwide financial epicenter.

About the Authors

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