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Why Hong Kong Equity Market Underperformed over the Past Few Years

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Over the past few years, the role of Hong Kong as a gateway between the Mainland and the world has become remarkably prominent. Hong Kong no longer only provides funding and professional services to the Mainland in one direction, but also increasingly satisfies both the funding and investment needs in the Mainland in a two-way manner. Hong Kong now has become a platform for overseas companies to invest in the Mainland as well as for Mainland companies to go overseas, acting as a bridge between the Mainland and the rest of the world. As a result, the financial services industry, in particular the equity market, of Hong Kong recorded tremendous development. Over the past two decades, more and more Mainland-based companies listed in Hong Kong, greatly boosting the market capitalisation of Hong Kong equity market. Hong Kong also ranked first in terms of IPO fundraising last year. According to Bloomberg's statistics, the market capitalisation of Hong Kong amounted to US$ 3.8 trillion, just behind the US, China and Japan, indicating Hong Kong's role as an international financial centre in the region.

Sluggish performance over the past few years

Even though Hong Kong equity market recorded tremendous development over the past few years, the stock market performance continues to underperform. Comparing to the US, UK, Japan, the Mainland, and the Asian four tigers, Hong Kong's Hang Seng Index ranked sixth (out of eight selected indices) and declined 20.8% over the past year. Its performance was just slightly better than the Mainland and Japanese markets, as the former experienced a stock market bubble burst while the latter was significantly affected by the appreciation of Japanese yen. In fact, all of the selected stock market indices, except the US, declined over the past year. The poor performance is likely the result of the sluggish growth prospect around the world, the bubble-burst in the Mainland market, sharp depreciation of emerging market currencies, and the uncertainties related to Brexit, etc.

In Hong Kong, the equity market has been performing poorly for some time. In the last five years, five out of eight selected indices increased, viz, the US, UK, Japan, the Mainland and Taiwan, while the remaining three declined, viz, Singapore, Hong Kong and Korea declined 9.0%, 7.2% and 6.2% respectively. Hang Seng Index even has one of the lowest average price-earnings ratios in the world over the past five years, standing at 10.3 currently and is one-fifth lower than the second lowest one among the eight selected indices, i.e. Singapore's FTSE Straits Time Index. Nevertheless, Hong Kong equity market still could not stage a better performance and continues to underperform other markets. This report aims to explain why Hong Kong equity market has underperformed over the past few years.

Investors consider factors other than price-earnings ratio

In addition to the price-earnings ratio, investors would normally consider a number of other factors, such as future profitability of the companies, political stability, economic outlook and business environment of its operating locations, the upstream and downstream conditions of the companies, and the level of investor protection, etc, so as to determine whether the profitability of a particular company could grow sustainably, and if there are any major risk factors that would undermine their future profitability. Therefore, if the market is optimistic about a company's outlook, they are willing to pay more to acquire their shares, boosting both their price and price-earnings ratio, and vice versa. However, the market expectation on a particular company, industry or economy could suddenly change, and they could also overestimate or underestimate the intrinsic value of a company over a long period of time, which will greatly influence the performance of a particular company or the overall equity market.

Narrow industrial base of Hong Kong listed companies

Generally, companies listed on a particular stock exchange are mainly the top local companies in that economy. For example, the US companies are normally listed in the US, and the Japanese companies in Japan, etc. Therefore, the industrial base of the listed companies depends very much on the degree of diversification of the economy. Also, whether those listed companies could grow sustainably depend on the performance and size of their economy. As Hong Kong is a city-based economy, its development is not only constrained by the scale itself, but also subject to the growth potential as a developed and high-income economy. The growth trend in Hong Kong has slowed gradually over the past decades. Moreover, Hong Kong has developed into a service-oriented economy, with highly-developed financial and business services sectors based on its competitive strength. However, non-financial business and professional services companies have relatively small fundraising needs from the equity market. In addition, Hong Kong has limited manufacturing or defense-related industries, resulting in limited technological or innovative activities and a lack of innovative, technological or high-tech manufacturing companies. As a result, most of the companies listed in Hong Kong are banks, insurance companies, property developers or investors, and utility companies, signifying the narrow industrial base of Hong Kong.

Fortunately, Hong Kong benefits from being an international financial centre serving the Mainland, attracting a large number of Mainland-based companies to raise funds and list in Hong Kong. Currently, Mainland-based companies account for over 60% of the market capitalization of Hong Kong. The diversified industrial base of the Mainland companies can supplement Hong Kong's narrow industrial base. Moreover, the major state-owned companies in the Mainland still have a dominant position in their respective industries. Those major state-owned companies are far larger in size, compared to other private sector companies. As such, the stock index performance will be highly sensitive to those major state-owned companies after their inclusion. Nevertheless, the issue of narrow industrial base of Hong Kong equity market cannot be completely resolved by an increasing number of Mainland-based companies listed in Hong Kong.

According to the Global Industry Classification Standard developed by the MSCI and Standard & Poor's, all the companies around the world are classified into 67 different industrial sectors. There are 50 components in Hong Kong's Hang Seng Index, but they only represent 21 industrial sectors, less than one-third of the total 67 sectors. The industrial base of Hang Seng Index is one of the narrowest among the eight selected indices, save the Singapore's FTSE Straits Time Index's number of industrial sectors at 17. It could be explained by the fact that both Singapore and Hong Kong are city-based economies. Although the economic structure of Singapore is somewhat more diversified than Hong Kong, with a higher presence in manufacturing industry, Singapore's financial and business services sectors remain better developed than manufacturing. In addition, Singapore could not attract as many Mainland-based companies to list as could Hong Kong, resulting in an even narrower industrial base. On the other hand, the Dow Jones Industrial Average in the US only has 30 components, but they represent 24 industrial sectors, higher than the 50-component Hang Seng Index. The remaining five selected stock indices are even more diversified, representing over 40 industrial sectors.

Furthermore, limited sectoral representation is not the only issue, as the companies from its pillar industries also represent a high proportion of its equity market. Banks, insurance, property development and management are the top three industrial sectors of Hang Seng Index, representing 28.14%, 12.80% and 10.49% respectively for a total of 51.43%. Similarly, the FTSE Straits Time Index has an even higher industrial concentration, with its top three industrial sectors, namely banks (34.11%), property development and management (13.14%) and integrated telecommunication services (13.14%), accounting for 60.39%. On the other hand, even though the Dow Jones Industrial Average only has 30 components, its industrial concentration is not as high as that of Hong Kong and Singapore. Its top three industrial sectors are information technology services (8.74%), aerospace and defense (8.69%) and pharmaceutical (8.29%), with a total of 25.72%. Obviously, the economic diversity of the US is much higher than that of Hong Kong and Singapore. Even though Hong Kong has attracted a large number of Mainland companies to list here, the issue of narrow industrial base remains. As a result, the performance of Hong Kong and Singapore equity markets are more likely to be affected by the boom and bust of a particular industry.

In addition to narrow industrial base and concentration of pillar industries, Hang Seng Index is also distorted by some mega-sized companies. The top three companies of Hang Seng Index are Tencent Holdings, HSBC Holdings, and AIA Group, representing 10.21%, 9.30% and 8.32% respectively, and a total of 27.83%. The top three companies of FTSE Straits Time Index even accounted for a much larger share of 37.63%, with Singapore Telecommunications, OCBC Group, DBS Group representing 13.14%, 12.28% and 12.21% respectively. Given two of the top three companies are banks, Singapore equity market is likely to be highly affected by the banking sector performance in both Singapore and its Southeast Asian counterparts. On the other hand, the top three companies of the Dow Jones Industrial Average account for just 18.10%, while other selected indices also have a similar proportion. As a result, because Hong Kong and Singapore stock markets have the highest industrial and company concentration among all the selected indices, their performance would be sensitive to a particular company or industry.

Industrial structure affected equity market performance

With the abovementioned industrial and company structure of Hong Kong equity market, its sluggish performance could likely be explained by the following factors.

1. **Limited growth prospects of local companies in Hong Kong.** As mentioned above, Hong Kong has become a highly developed economy and only maintained moderate growth since the global financial crisis. Its economy even slowed further since 2H last year, with tourism, retail and property markets all in correction. The economy of Hong Kong is likely to grow rather slowly this year and the next. Together with the limited economic size of Hong Kong, the market is not that optimistic about the growth prospect of the local companies in Hong Kong, particularly when most of their businesses are still concentrated in Hong Kong (except Cheung Kong and Hutchison group) with modest exposure to the Mainland and other geographical locations. Therefore, with limited breakthrough of Hong Kong economy or unremarkable overseas development by those companies, the market might have reservations about the growth prospect of the local companies in Hong Kong. Their share prices and price-earnings ratios are likely to stay low persistently.

2. **Market is still concerned about the downside risk of Hong Kong property market.** Hong Kong residential property market entered a correction since September last year after 12 years of rapid growth. Based on the current economic, interest rate, housing supply conditions, and government policies, no sharp correction in Hong Kong residential property market is expected, barring any unforeseen economic or financial crisis. However, the market (in particular equity analysts) remains rather pessimistic about Hong Kong property market outlook. Some of them are even of the view that the property market will repeat its sharp plunge after the Asian Financial Crisis, which will not only hurt the revenue and profit of the property developers but also lead to valuation loss or impairment. Therefore, even though many property-related companies are now trading at price-to-book ratios of 1 or below, some equity analysts still do not recommend property-related companies, resulting in low share prices and price-earnings ratios of those companies.

3. **The fast growing phase of the banking sector might have passed.** Since the global financial crisis, the global economy and financial markets have been continuously affected by a number of events, such as the sub-prime mortgage crisis in the US, collapse of Lehman Brothers, historic downgrade of the US credit rating, several rounds of euro debts crisis, significant correction of international commodity prices, sharp depreciation of emerging market currencies, Mainland economic slowdown and increasing RMB depreciation pressure, as well as the uncertainties related to Brexit, etc, restraining the performance of those global or major financial institutions. In addition, the regulatory environment of financial institutions are

being tightened further, in particular targeting those that are of globally systemic importance by imposing stringent capital and liquidity requirements, controlling high-risk trading activities, and implementing macro-prudential measures, etc, in a bid to ensure steady growth of credit activities and financial stability. In light of this, the market is increasingly pessimistic about the performance of those global or major financial institutions. In addition, the market also worries about the rise in bad debts and provisions since 2H last year when the global and Mainland economic outlook dimmed further. As a result, the performance of financial institutions weakens further. HSBC Holdings accounts for around 10% of Hang Seng Index, and it dragged down the index performance most in the past one and five-year period.

4. Major state-owned enterprises are affected by recent Mainland economic performance. As mentioned above, Hong Kong attracted a large number of Mainland-based companies to list in Hong Kong over the past two decades, including four largest national commercial banks, Bank of Communications, two largest insurance companies, four resource-related companies and China Mobile (Hong Kong), etc. However, most of those state-owned enterprises are affected by different factors which restrain their performance in the near term. For example, banking shares are affected by the concern over Mainland economic slowdown and the resulting increase in bad debts. Insurance shares are affected by the decline in investment income after the stock market bubble burst last year. Resource-related shares are affected by the decline in international commodity prices and over-capacity issues in a number of industrial sectors. Moreover, China Mobile (Hong Kong) might have also passed its rapid growth phase and will perform more like a utility share ahead. Given the Mainland A shares have not fully recovered, and the connecting mechanism between Hong Kong and the Mainland equity markets has yet to allow arbitrage, the companies listed in Hong Kong still could not benefit from the higher trading multiples in the Mainland.

5. The number of new economy stocks is limited. Over the past year, Tencent Holdings, CLP Holdings and the Link REIT contributed the most to the Hang Seng Index, while Tencent Holdings, AIA Group and China Mobile (Hong Kong) contributed the most in the last five-year period. Among them, CLP Holdings, the Link REIT and China Mobile (Hong Kong) can be considered utilities or high dividend shares. Many investors purchase those companies mainly because of their high-yield rather than growth potential, given the current low interest rate environment. Meanwhile, Tencent and AIA could be considered the few growth or new economy stocks in Hong Kong. Tencent is one of the largest internet software and services companies in the Mainland. With the relatively closed internet market environment in the Mainland, Tencent could capture a very large part of the internet market rapidly and further expand its businesses to different areas. Meanwhile, AIA benefits from the increasing insurance and investment demand from the Mainland. Yet, other than Tencent and AIA, Hang Seng Index does not have many other new economy or growth stocks, which likely restrains Hong Kong equity market performance.

6. High shareholding ratio of majority shareholders creates difficulty for market forces to push for reform. Both local companies like property developers and state-owned enterprises are mostly controlled by its majority shareholders. Even though the market believes the company has underperformed continuously, market forces, such as investment funds, could not acquire enough shares to get control of the company or to be represented in the board of directors so as to introduce reforms to enhance the company's performance. As such, this might also be one of the reasons why a company can consistently trade below its intrinsic value.

Hang Seng Index has no doubt continuously underperformed other selected indices. The reasons include narrow industrial and company bases, high concentration of pillar industries, poor global, Mainland and Hong Kong economic performance, correction of Hong Kong property market, more stringent regulatory environment of financial institutions and the concern of bad debts, etc. Some of these factors could only improve after the recovery of the global and Mainland economies. Moreover, the Mainland economy is now upgrading its industrial structure and a new batch of fast growing companies are likely to be nurtured through the "China 2025" and "Internet +" initiatives. Together with an increasing number of the Mainland companies going out to expand their businesses, and the further implementation of the "Belt and Road initiative", the geographical coverage of the Mainland companies will expand further to different places around the globe. Leveraging on the advantages of the "one country, two systems", Hong Kong's role as an international financial centre serving the Mainland will be strengthened, with increasing number of diversified Mainland-based companies to be listed in Hong Kong. Hong Kong equity market will benefit greatly from the further expansion of those Mainland-based companies.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2014**	**2015**	**2015/Q4**	**2016/Q1**
總量(億元) GDP($100 Million)	21,946	22,464	6,448	5,904
升幅(%) Change(%)	2.6	2.4	1.9	0.8
二. 對外貿易 External Trade	**2014**	**2015**	**2016/5**	**2016/1-5**
外貿總值(億元) Total trade($100 Million)				
港產品出口 Domestic exports	553	469	35	166
轉口 Re-exports	36,175	35,584	2,880	13,393
總出口 Total exports	36,728	36,053	2,915	13,559
進口 Total imports	42,190	40,464	3,177	15,101
貿易差額 Trade balance	-5,463	-4,411	-262	-1,542
年增長率(%) YOY Growth(%)				
港產品出口 Domestic exports	1.7	-15.2	-18	-16.6
轉口 Re-exports	3.2	-1.6	0.2	-4.3
總出口 Total exports	3.2	-1.8	-0.1	-4.5
進口 Imports	3.9	-4.1	-4.3	-6.6
三. 消費物價 Consumer Price			**2016/6**	**2016/1-6**
綜合消費物價升幅(%) Change in Composite CPI(%)	4.4	3	2.4	2.7
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數(宗) No. of agreements	81,489	76,159	6,033	26,571
年升幅(%) Change(%)	15.6	-6.5	-24.5	-39.1
五. 勞動就業 Employment			**2016/3-2016/5**	**2016/4-2016/6**
失業人數(萬人) Unemployed(ten thousands)	14.95	12.2	13.5	13.6
失業率(%) Unemployment rate(%)	3.2	3.3	3.4	3.4
就業不足率(%) Underemployment rate(%)	1.5	1.4	1.4	1.4
六. 零售市場 Retail Market			**2016/5**	**2016/1-5**
零售額升幅(%) Change in value of total sales(%)	-0.2	-3.7	-8.4	-10.8
零售量升幅(%) Change in volume of total sales(%)	0.6	-0.3	-9	-10.2
七. 訪港遊客 Visitors				
總人數(萬人次) arrivals (ten thousands)	6,084	5,931	445	2,287
年升幅(%) Change(%)	12	-2.5	-6.4	-8.4
八. 金融市場 Financial Market			**2016/4**	**2016/5**
港幣匯價(US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.6	775.1	775.6	776.8
貨幣供應量升幅(%) change in Money Supply(%)				
M1	13	15.4	11.1	6.5
M2	9.5	5.5	3	2.1
M3	9.6	5.5	3	2.1
存款升幅(%) Change in deposits(%)				
總存款 Total deposits	9.7	6.7	4.8	3.6
港元存款 In HK$	9.3	10.7	2.8	1.3
外幣存款 In foreign currency	10.1	3.1	6.8	6
放款升幅(%) in loans & advances(%)				
總放款 Total loans & advances	12.7	3.5	1.9	2.1
當地放款 use in HK	12.1	3.5	3.8	3.8
海外放款 use outside HK	14.2	3.6	-2.2	-1.8
貿易有關放款 Trade financing	-1.4	-16.3	-11.9	-17.4
最優惠貸款利率(%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恒生指數 Hang Seng index	23,605	21,914	21,067	20,815