TOPIC 3 - OVERVIEW

1. OVERVIEW

1.1 What is Equity?

- Equity is evidence of part-ownership (shareholding) in a business providing a share in the profits or losses of business operations
- As there is no guaranteed return, equity is often referred to as risk capital
- Business returns depend upon a number of factors, including management effectiveness, customer demand, cost management, business systems and finance

1.2 Equity Financing

- Raising equity capital can be for a number of reasons:
  - *Start-up capital*: funds for starting a new business
  - *Expansion capital*: funds to expand a current business
  - *Recapitalization*: funds to restructure a company's capital, usually involving replacement of debt with equity

1.3 Methods of Raising Equity Finance

- Methods include:
  - *Initial Public Offering (IPO)*: raising funds from the public with the resulting shares being listed on a stock market
  - *Rights issue*: additional equity capital is raised from existing shareholders at a fixed price within a specified period of time
  - *Private placement*: shares are offered to a specific class of investors without a public offering
  - *Dividend investment plan*: existing shareholders invest their dividends in further shares providing an **ongoing source of equity finance**
  - *Equity warrants*: gives holders the right to purchase shares at a specified price within a particular period of time. Sometimes referred to as **subscription warrants**
  - *Retained earnings:* business earnings not distributed to shareholders, available to finance expansion
  - *Private equity:* equity raised from high net worth individuals or private funds where a public IPO is not feasible. Often used by **immature high-growth companies**
  - *Venture capital:* a form of private equity used to fund early stage-businesses

1.4 Why Invest in Equity?

- Equity investors want to make a financial return. Financial returns come from either dividend payments or capital gains when shares are sold for more than they were purchased

2. FUNDAMENTALS OF EQUITY SECURITIES

2.1 Initial Public Offerings

- An issuer of new equity securities must produce a detailed prospectus, reviewed and approved by The **Stock Exchange of Hong Kong** Limited
- A prospectus should provide **sufficient information** to allow investors to decide whether or not they wish to invest in the stock. Information should include the **company's financial status and prospects** and details of what the money raised will be used for
- A prospectus should include:
  - Business description, investment highlights and strategy
  - Industry analysis
  - Risks related to business and investment
  - Financial information and analysis
- IPOs do not always involve new shares; **existing shares can also be issued** thereby providing a return to the original owners

2.2 Rights Issues

- A new share issue that is offered to existing shareholders
- **Renounceable rights issues** allow shareholders to sell their entitlement to subscribe to the new issue
- **Non-renounceable rights issues** can be exercised or they will lapse if not taken up. There is no right to sell the entitlement
- The number of rights is pro-rated on the existing number of shares held – e.g. a 1 for 3 rights issue will provide one new share for every three shares currently held
- A rights issue subscription price will always be set **below the current market price**, providing existing shareholders with an incentive to subscribe
- The theoretical price that rights can be sold for is a function of entitlement and subscription, and illustrated by the following example:

Example – theoretical price of rights to a share issue

Charlie holds 200 shares worth HKD2.00 each before a 1 for 4 rights issue is announced, with a subscription price of HKD1.00 per share. That is, for every four shares held by Charlie, he is entitled to subscribe for one additional share at a price of HKD1.00 per share

Value of shares before issue	200 x HKD2.00	HKD400
Rights issue entitlement	200 shares/4	50 shares
Cost of rights issue	50 shares x HKD1.00	HKD50
Value of total shares post issue	HKD400 + HKD50	HKD450
Theoretical value of shares post issue (ex-rights price)	HKD450/250	HKD1.80
Theoretical value of rights	Ex-rights price – subscription price	HKD1.80 – HKD1.00 = **HKD0.80**

2.3 Bonus Issues

- Similar to rights issues, however there are no conditions imposed upon shareholders. That is, the shares are issued "for free", and illustrated by the following example:

  Example – theoretical price per share after bonus issue

  Charlie holds 200 shares worth HKD2.00 each immediately before a 1 for 4 bonus issue. The price per share immediately after the bonus issue is shown below.

Number of shares before issue		200
Value of shares before issue	200 shares x HKD2	HKD400
Bonus issue entitlement	200 shares/4	50 shares
Number of shares post issue	200 + 50	250 shares
Price per share post issue	HKD400/250	**HKD1.60**

Net effect is an increase in number of shares held and a proportionate decrease in share price

3. THE STOCK MARKET

- An intermediary platform allowing the **efficient allocation of equity capital** from those with surplus funds (investors) to those with a need for funds (corporations)
- To be liquid and active, the stock market needs **a fully informed and transparent trading environment** with a wide range of issuers and investors
- **Dealing costs** include: brokerage commission, stamp duty and levies payable to regulators (e.g. SFC)

3.1 Stock Market Indices

- Represents the average price level of a sample of shares traded on the stock market
- A useful tool for comparing current market levels with historical levels, giving an indication of whole market performance
- Examples of stock market indices include:
  - **Dow Jones** Industrial Average (DJIA) in the US
  - Financial Times Stock Exchange (**FTSE**) 100 Index in the UK
  - **Hang Seng** Index (HSI) in Hong Kong
  - **Nikkei 225** Stock Average in Japan
- **MSCI Inc**. provides international, regional and sectoral benchmarks widely used by institutional investors (e.g. **MSCI EAFE** Index covering markets in Europe, Australasia and the Far East)

3.2 The Stock Exchange

- The term “stock exchange” refers to the **actual infrastructure** allowing the trading of stocks. It can be physical and/or electronic
- For shares to be traded on a stock market, they must first be listed. There are **two types of listing**:
  - **Main board listing**: publicly listed companies with proven profitability records and size that justify a listing (Main Board of the SEHK)
  - **Secondary board listing:** smaller companies that do not qualify for a main board listing (GEM)
- **Advantages** of being listed:
  - Potential to increase capital base
  - Access to a liquid secondary market with instant pricing
  - Increased corporate profile
  - Enhanced employee loyalty, with share offerings as part of remuneration
- **Disadvantages** of being listed:
  - Spread of ownership
  - Onerous reporting requirements
  - Increased administrative costs

3.3 Bull and Bear Markets

- A **bull** market is one that is expected to **increase** in value
- A **bear** market is one that is expected to **decrease** in value

4. PRIVATIZATION OF GOVERNMENT-OWNED COMPANIES

- The alteration of the legal and management structure of a government-owned company or statutory body to permit private ownership
- The resulting shares may be sold to private entities or listed on a stock exchange, in part or in full
- **Government objectives** in privatizing companies include:
  - ➢ Improving competitiveness and economic efficiency
  - ➢ Reducing levels of public debt/increasing public revenue
  - ➢ Broadening share ownership
  - ➢ Encouraging shareholder scrutiny of management
- Privatization can **benefit an economy** by:
  - ➢ Improving economic competition and efficiency
  - ➢ Guiding idle private sector savings into productive investments
  - ➢ Creating new finance sources for companies
  - ➢ Moving government assets to the private sector where they can be managed more efficiently
- Privatization of a government monopoly will involve industry restructuring to make it work
- Examples of Hong Kong government privatizations are the listing of the MTR Corporation in October 2000 and the Link Real Estate Investment Trust (The Link) in November 2005

5. THE HONG KONG EQUITY MARKET

5.1 Development of the Hong Kong Equity Market

- The first stock exchange was formalized in 1891 and was named the Hong Kong Stock Exchange in 1914
- Three more exchanges were established as the Hong Kong equity market grew: the Far East Exchange in 1969; the Kam Ngan Stock Exchange in 1971; and the Kowloon Stock Exchange in 1972
- The above four stock exchanges were replaced by the Stock Exchange of Hong Kong (SEHK) which became fully operational in 1986

5.2 Structure of the Stock Market

- Since 30 April 2018, SEHK permits pre-profit/revenue companies to list on the Main Board, subject to certain criteria in the MBLR
- As at August 2019, 2,392 companies were listed on the Main Board with a market capitalization of HKD30 trillion
- **Types of securities** listed on the SEHK include:
  - ➢ Equity securities (ordinary, preference and equity warrants)
  - ➢ Debt securities (government and HKMC)
  - ➢ Derivatives (derivative warrants, CBBC)
  - ➢ Trusts and funds (ETFs and REITs)
- HKEx entered into a **Pilot Programme** in May 2000 whereby a number of securities listed on NASDAQ and the NYSE are also listed on the SEHK
- **Naked short selling** is prohibited by the Securities and Futures Ordinance
- **The Hang Seng Index** was publicly launched on 24 November 1969 with 100 being set as at 31 July 1964
- As at July 2019, the HSI comprised **50 stocks** which accounted for 56.6% of total market cap
- The Growth Enterprise Market (**GEM**) offers small and mid-sized companies an avenue to raise capital. Companies are not required to have a record of profitability, however they must have a positive cash flow of at least HK$30 million in aggregate for the two preceding financial years. GEM caters for professional and sophisticated investors, operating on the basis of buyer beware
- **Securities margin financing** is a common Hong Kong practice whereby finance is provided to purchase securities using existing securities as collateral

Mutual Market (Stock Connects)

- Launched in November 2014, the “Stock Connect” allows eligible investors in Mainland China to trade shares listed on the SEHK, known as the **Southbound link**, and investors in Hong Kong to trade A shares listed on the Shanghai Stock Exchange (“SSE”), known as the **Northbound link**.
- The **Shenzhen-Hong Kong Stock Connect** was launched on 5 December 2016

- **Home market rules apply to all trades**. Orders are placed through local securities firms, however trading and clearing is subject to the rules and procedures of the exchange where the securities are listed.
- Hong Kong Securities Clearing Company Limited (**HKSCC**) and China Securities Depository and Clearing Corporation Limited (**ChinaClear**) deal with the clearing, settlement and provision of depository, nominee and other services for their respective market participants and investors
- **All Hong Kong persons** and overseas investors able to trade on the SEHK can participate in the Northbound links.
- **Shares eligible for the Shanghai Northbound trading link** are all constituents of the SSE 180 Index and SSE 380 Index and all SSE-listed companies which have issued both A and H shares
- **Shares eligible for the Shenzhen Northbound trading link** are all constituent stocks of the Shenzhen Stock Exchange (SZSE) Component Index and the SZSE Small/Mid Cap Innovation Index with a market capitalization of not less than RMB6 billion
- **Mainland China persons** who are able to participate in the Southbound link include institutional investors and individuals with Rmb500,000 in cash and securities
- **Shares eligible for the Southbound trading link** are all constituents of the Hang Seng Composite LargeCap Index and Hang Seng Composite MidCap Index and shares of all companies that are listed on both SSE and SEHK
- There are **daily quotas** for the value of shares traded on both the Northbound and Soutbound links of Stock Connect. The quotas are expected to be expanded as the program evolves.
  - The current **Northbound trading link quota** is:
    - daily quota of Rmb52 billion; and
  - The current **Southbound trading link quota** is:
    - daily quota of Rmb42 billion
  - Daily quotas are calculated on a **"net buy" basis**
    - **Sell trades increase the available quota**. Investors are always allowed to sell their cross-border securities. The daily quota is reset to zero at the beginning of each trading day
    - **Buy trades are subject to availability** in the respective quotas
- HKSCC and ChinaClear have agreed on **two key principles** to mitigate any new risks from the Clearing Links arrangement:
  1. **Application of home risk management regime** as much as possible
  2. **Insulation against risk spill-over** across markets

5.3 Types of Equity Securities

- The most common form of equity is ordinary shares, with some forms being referred to as hybrids, such as preference shares, convertible notes and equity-linked instruments (ELI). Details follow
  - ***Ordinary shares***: represent company ownership with voting rights at AGMs and EGMs. Entitled to a share of company profits in the form of dividends and, in the event of a company being liquidated, a final payment after all other creditors have been fully paid

    To attract good quality and high growth companies to list in Hong Kong, innovative companies with a **weighted voting right (WVR)** structure are permitted to list on the Main Board, as long as they meet certain requirements from 30 April 2018. WVR shares are not permitted to confer more than ten times the voting power of ordinary shares
  - ***Preference shares***: have priority over ordinary shares for dividend payments and liquidation proceeds. No voting rights but usually a right to a fixed dividend. Other forms include: participating, cumulative and convertible
  - ***Equity warrants***: like options, a call (put) warrant gives the holder the right to buy (sell) the underlying equity security at a specified price. Traded on the SEHK and are usually American style
  - ***Convertible notes***: a combination of debt and equity. Fixed interest securities issued by a company which give holders the option of converting the loans into ordinary shares in the issuing company. If not converted, they can be redeemed for cash on maturity
  - ***Company options***: usually issued under a stock option scheme by a company to provide an incentive to senior executives to maximize company share price
  - ***Exchange-traded funds***: funds designed to track the performance of a benchmark, such as the HSI, and traded on the SEHK. Give investors exposure to the whole equity market for a relatively low investment. Tracker Fund is the major Hong Kong ETF. Dividends are paid
  - ***Real estate investment trust***: a fund that invests in a portfolio of income-generating real estate properties. Large majority of income is distributed by way of dividend. At the end of August 2019, there were ten REITs listed in Hong Kong
  - ***Structured products***: exotic products created by combining different types of basic derivatives. Two traded on the SEHK are Callable Bull and Bear Contracts (CBBC) and Equity Linked Instruments (ELI). There are three different types of ELIs: bull, bear and range
  - ***Stapled securities***: an arrangement where two or more different securities of the same issuer are listed as if they are legally bound together and cannot be transferred or traded separately. There will be a single SEHK price quotation for a stapled security and no price quotation will be given for the individual components. An example would be a company share combined with a unit in a trust

5.4 Participants in the Equity Market

- The following are participants in the Hong Kong equity market

Issuers

- **Commercial organisations** issue equity by selling new shares
- **Fund houses** issue Exchange Traded Funds by selling fund units to investors
- Real estate investment trusts are issued by business trusts
- Investment banks issue derivatives, warrants and other exotic structured products

Investors

- Two main categories:
  - *Institutional investors:* banks, insurance companies, fund managers and others. At December 2018, this group accounted for 55% of Hong Kong cash trading, with 35% being foreign institutions (mainly US and Mainland China)
  - *Retail/private investors:* individuals who make up approximately 16% of Hong Kong cash trading
- Foreign investors are attracted to the Hong Kong market as there is no capital gains tax levied on share trading. However, stamp duty is payable to the government

Dealers and Traders

- Any entity dealing in securities must be licensed by the SFC
- **Dealers** execute orders on behalf of clients; **traders** trade for profit on behalf of their principals
- Some licensed dealers are also authorized **market makers**, providing market liquidity

Custodians and share registrars

- A **custodian** holds and safeguards the assets of an individual, a financial institution or corporation
- A share registrar is appointed by a listed company to maintain a register of shareholders, providing the following services:
  - Distribution of dividends and bonus shares
  - Mailing of financial reports
  - Share transfers
  - Issuing share certificates
  - Distributing share certificates
- A list of share registrars can be obtained from the SEHK

Regulators

- SFC is responsible for supervision of the Hong Kong securities and futures markets
- HKEx supervises the operation of listed companies on the SEHK, ensuring the efficient and fair operation of the stock exchange

Government of the Hong Kong Special Administrative Region

- In August 1998, the Hong Kong Government acquired a significant portfolio of shares on the Hong Kong market to defend an attack on the local currency during the Asian financial crisis
- In October 1998, Exchange Fund Investment Limited was established by the government to advise on the disposal of the portfolio in an orderly manner
- In June 1999, the government launched the Tracker Fund of Hong Kong (TraHK) as a vehicle to sell off its surplus equity holdings

5.5 Trading and Settlement Systems

Trading

- Trading on SEHK is conducted in both morning and afternoon sessions, as follows:
  - Pre-opening session from 9.00am to 9.30am
  - Morning session from 9.30am to 12.00pm (extended session from 12.00pm to 1.00pm)
  - Afternoon session from 1.00pm to 4.00pm
  - Closing auction session (CAS) from 4.00pm to 4.10pm
- CAS allows trades to be executed at the closing price
- Trading on the SEHK is conducted via computer terminals at the exchange participants' premises
- The trading system used by the SEHK is the **Orion Trading Platform** (OTP-C) (introduced in February 2018). OTP-C replaced the third generation of Automatic Order Matching and Execution System (AMS), which was introduced in October 2000
- **OTP-C** aims to offer a scalable, flexible and high performing cash equity trading platform, based on open systems technology
- The **Volatility Control Mechanism (VCM)** was launched on 22 August 2016 for safeguarding market integrity from extreme price volatility arising from trading incidents. If a stock price deviates by more than 10% from the last traded price within 5 minutes, a 5-minute cooling off period will be triggered wherein trades can only be priced within the reference range

Settlement

- Physical share certificates, although used in some circumstances, are being replaced by electronic registration of securities transactions
- Clearing and settlement of securities traded on the SEHK is processed through the Central Clearing and Settlement System (**CCASS**), which is an electronic book entry system overseen by Hong Kong Securities Clearing Company (**HKSCC**)
- Securities traded on the SEHK are settled on a **T+2** basis