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Hong Kong v. New York: The Competition for Chinese Tech IPOs

In September 2014, Alibaba completed the largest IPO in history, raising US$25 billion in its New York Stock Exchange (NYSE) offering. In the buildup to the high-profile offering, the Stock Exchange of Hong Kong Limited (HKEx) expressed frustration over the "loss" of the IPO to the NYSE, but Alibaba had little choice: HKEx regulations prohibit the listing of companies, such as Alibaba, that employ "differential voting structures." These structures offer additional classes of shares that provide holders greater voting rights. In August 2014, the HKEx released a "concept paper" to gauge market support for regulatory changes that would allow companies with such structures to list on the exchange. The reasons for considering such regulations are obvious: So far in 2014, 13 China-based businesses, including Alibaba, have listed on the NYSE or the NASDAQ. Of those 13 companies, 10 offer shares with differential voting rights and thus were precluded from listing on the HKEx.

Although the HKEx has led the world's exchanges in terms of funds raised through IPOs for three of the last five years and considers itself the natural listing venue for China-based issuers, a majority of China-based technology companies historically have chosen New York over Hong Kong for their IPOs. Three key factors have contributed to this trend:

- The HKEx's "profit test" makes it difficult for a company that has yet to turn a profit to be listed on the exchange's Main Board. Under HKEx rules, a Main Board listing applicant must have profits of at least HK$20 million (approximately US$2.6 million) in its most recent financial year and HK$30 million (approximately US$3.9 mllion) in aggregate in the two financial years prior, unless the applicant can satisfy either of two alternative tests introduced in 2004 — "market capitalization/revenue" (which requires HK$500 million in revenue in the most recent financial year and a market capitalization in excess of HK$4 billion) or "market capitalization/revenue/cash-flow" (which requires HK$500 million in revenue in the most recent financial year, a market capitalization in excess of HK$2 billion and aggregate positive cash flow of HK$100 million across the preceding three financial years). By contrast, both the NYSE and NASDAQ have relatively relaxed profit requirements. The less-rigorous requirements make the two U.S. exchanges more attractive for a technology company that remains in an early stage of development, a time when companies typically tend to focus more on business expansion than profit generation.
- The HKEx has had serious concerns regarding the use of "variable interest entity" (VIE) structures or contractual arrangements, which enable foreign investors to receive economic benefits from Chinese operating entities without holding any equity interest in Chinese operating entities. China's legal restrictions on foreign ownership and investment in restricted industries such as telecommunications services, however, require almost all China-based Internet companies to adopt such structures to operate key aspects of their businesses. In the past, the HKEx has taken the position that utilizing the VIE structure may make a company "unsuitable for listing." On the other

hand, U.S. regulators have taken the position that the VIE structure, risky as it may be, presents primarily a disclosure issue — it is up to the company to make appropriate disclosures and to the market to assess the risks.

- The HKEx prohibits public companies from issuing classes of shares carrying disproportionate rights — what the HKEx refers to as "weighted voting rights" and the U.S. market calls a "dual-class capital structure"; the NYSE and NASDAQ do not. The dual-class capital structure is intended to give founders and executives the ability to control the majority of the voting power with a relatively small amount of total equity in the company. Although such structures can be controversial, many technology-company founders believe that they allow strong leadership to put long-term interests first by seeing beyond the near-term financial situation.

The HKEx relaxed its rules regarding the first two issues above in 2004 and 2012-13, respectively, the latter contributing to the recent surge of Hong Kong listings by China-based Internet companies: Since the October 2013 Hong Kong IPO of the online game company Forgame Holdings Ltd., at least seven other China-based Internet companies have completed Hong Kong IPOs, including Cogobuy Group, the first business-to-business e-commerce company to list on the HKEx. However, strong opposition remains regarding the third issue, weighted voting rights/dual-class capital structures. Many observers consider it unlikely that the Securities and Futures Commission of Hong Kong (SFC), whose approval is required for any change to the listing rules, will cooperate with efforts to allow such rights in the near future.

The Hong Kong regulators' conservative approach is, in part, a product of their focus on protecting small individual investors rather than institutions. In the 1990s, the HKEx implemented rules requiring the allocation of a minimum percentage of IPO shares (from 10 to 50 percent, depending on demand for the offering) to Hong Kong public investors. In addition, Hong Kong law currently does not permit securities class actions, litigation funding or contingency-based legal fees, which significantly restricts the number of shareholder actions against listed companies and their directors, and thus has prompted Hong Kong's regulators to step into the void and apply more stringent oversight on the quality of listing applications. In the U.S. — with its robust litigation culture and sophisticated institutional investors — regulators are not bound by the same concerns as their Hong Kong counterparts and generally favor a more disclosure-based approach to risk.

The HKEx's Efforts to Compete

Even without the systemic change needed to allow weighted voting rights, the HKEx has found ways to increase its appeal. For example, all of the Internet and technology companies that have recently listed in Hong Kong have achieved superior valuations to their U.S. peers — Ourgame International Holdings Ltd., an online game company listed in Hong Kong in November 2013, has a price-earnings ratio over 20, while its peers in the U.S. trade at ratios in the low teens. Those high valuations on their own could make Hong Kong a more appealing venue for many companies. This month, CAR Inc., by far the largest auto rental company in China, also chose to list on the HKEx, despite its global peers (including Hertz, a large shareholder in CAR) mostly opting for the United States.

The HKEx also continues to demonstrate the depth of the pool of liquidity investing in China-based HKEx-listed securities. In April 2014, Hong Kong and mainland Chinese regulators announced the establishment of the Shanghai-HK Connect pilot program (Shanghai-HK Connect). Shanghai-HK Connect aims to provide a mechanism for mainland Chinese investors to trade Hong Kong-listed securities in Renminbi (RMB) through broker-members of the Shanghai Stock Exchange and Hong Kong investors to trade Shanghai-listed securities through Hong Kong-based brokers that are par-

ticipants of the HKEx. Though no fixed timetable for implementation has been set, market readiness tests are underway and it is expected to commence operation in late 2014. There is broad hope that the program will be the first step toward a greater liberalization of Chinese fund flows into the Hong Kong market.

Conclusion

Still, Alibaba's precedent-setting IPO highlights the strength and depth of the U.S. market, as well as the continuing robustness of New York as a listing venue for China-based businesses generally and technology companies in particular. The HKEx seems certain to continue to evaluate its regulations as it strives to become the exchange of choice for a majority of China-based businesses. The stage now seems set for the U.S. and Hong Kong exchanges to intensify their competition to attract promising companies from the world's second-largest economy.