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THE CHAMBER OF HONG KONG LISTED COMPANIES

5 May 2022

Dear Financial Secretary

Further to our Recommendation Paper "The 'Nasdaq of China': Opportune Time for Hong Kong SAR to Create a Listing Hub of China's Tech Companies" submitted on 23 February 2022, the Chamber of Hong Kong Listed Companies (the Chamber or CHKLC) is pleased to submit an addendum to provide additional thoughts about our Tech Board proposition.

In the following pages, we outline four areas to further illustrate the viability of our proposition, outline certain implementation details, and discuss what needs to be in place to ensure success of the Tech Board.

In addition, we received a letter from the Financial Services and the Treasury Bureau on 6 April 2022, highlighting a number of market and regulatory issues. We will take this opportunity to address them here.

The four areas that we would look at are:

1) Identifying key sectors for the Tech Board
2) Setting the right Listing Requirements
3) The need to strengthen post-listing research capabilities
4) Institutional involvement to ensure market participation

1) Identifying Key Sectors for the Tech Board

The Tech Board sets out to attract primarily quality Chinese tech companies and there is certainly no shortage of supply. China's technology industries have registered strong growth and performance for years, in particular the internet sector. In January 2022, of the world's top 10 internet companies, 3 are from China, namely, Tencent, Alibaba and Meituan. [1]

These mega Chinese companies are having a stronghold in the B2C arena, offering a range of products and services directly to end-consumers. But what we are seeing now is a fast evolution

[1] Source: https://www.value.today/world-top-companies/internet-companies-world



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of the tech industries to the B2B space. As the whole Chinese economy is on a path of transformation to become more digitalised and energy-efficient, it requires a large amount of softwares, advanced equipment and computing power to support the modernisation and automation of the manufacturing processes, flow of business and customer and consumer interaction. Technology becomes an integral part in powering this transformation. This gives rise to a significant growth in the following sectors:

- Semiconductors
- Enterprise software, SaaS, PaaS, Cloud computing
- Clean energy / e-vehicles
- Autonomous driving / AI
- Automation / Robotics

Save from semiconductors which are of a strategic nature and a listing outside of the Mainland is less preferred by the authorities, the above sectors offer high potential for the Tech Board, among which the Enterprise Software sector, which includes key services like SaaS, PaaS, Cloud computing (collectively referred to as Enterprise Software in this paper) probably carries the most potential because of its wide usage and penetration in a digitalised and web-based business environment.

China's Enterprise SaaS market has registered rapid growth in recent years. In 2020, the size of the market was about 53.8 billion yuan, increasing by 48.7% year-on-year. It was expected to grow at a CAGR of 34% in the following 3 years, outperforming the 11.35% of CAGR of the global markets. By 2022, China's Enterprise SaaS market is estimated to reach 99.1 billion yuan. (US$15.06 billion). [2]

But even that lags far behind the US market. The US Enterprise software market is estimated to reach US$120.9 billion in value in 2022, which is 8 times as much. It is generally recognised that China's Enterprise Software industry is a decade behind the US. We can foresee the Chinese Enterprise software industry will catch up rapidly and the demand for capital is huge. Now is the best time for Hong Kong to capture the listing opportunities from this sector when it is about to take leaps of growth.

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[2] Source: https://www.iresearchchina.com/content/details8_67909.html

Enterprise software companies from China have been tapping the US capital markets. The table below shows the latest situation of listings of enterprise software companies in the US.

| | No. of Companies | Total Market Cap. (US$ million) |
|---|---|---|
| All US-listed Companies | 458 | 7,698,643 |
| Chinese Companies | 23 | 24,665 |
| % by Chinese Companies | 5 | 0.32 |

Twenty-three Enterprise Software companies from China are now listed in the US – the biggest tech cluster from China. Yet, they are still a tiny fraction of the US market, only accounting for 5% in terms of number of companies, and 0.32% in terms of market capitalisation.

Given its widespread business usage and application, the usage of enterprise software correlates to the size of the economy. According to IMF estimates, in 2022, the GDP (in Purchasing Power Parity) of China is estimated to be US$30.18 trillion. This exceeds the US$25.35 trillion projected for the US. By logic, China's enterprise software will only grow in proportion to support China's economic activities surpassing that of the US. [3]

Judging from the growth potential of the industry we have just discussed, enterprise software companies from China are only scratching the surface of the capital markets and Hong Kong stands to gain a big share of their future fund-raising activities.

When it comes to financing growth and expansion, one characteristic we observe of Chinese entrepreneurs is that they have a stronger desire to seek funding via a public market listing far more so than their US counterparts who are open to both IPOs and mergers and acquisitions. A public listing would give Chinese entrepreneurs a stronger sense of autonomy and a control of destiny. Such a preference mean that they would welcome earlier opportunities for a listing if the conditions are right, which brings us to our next area of discussion.

2) Setting the Right Listing Requirements

In order to attract tech stocks to Hong Kong for listing, the Tech Board needs to devise the right

[3] Source: https://en.wikipedia.org/wiki/List_of_countries_by_GDP_(PPP)

listing requirements that cater to their growth characteristics.

Hong Kong is not without competition in this regard. In the past two years, STAR, the market of Shanghai Stock Exchange for high-tech industries, has grown from 25 listed companies to more than 350 with market capitalisation increasing from US$113 billion to US$976 billion. [4]

However, the STAR market's listing process is sometimes thought to be arduous, uncertain and subject to policy shifts. This gives Hong Kong an advantage if we can offer a listing process that are clearly laid out, transparent, predictable and largely based on numerical measurements rather than subjective interpretation.

As in our recommendation, the Tech Board is intended for earlier-stages and fast-growing tech companies, many of them have commenced business operation, generating sales revenue but are yet to reach the stage of profitability, and this is rather common for the enterprise software industry.

An accepted way of valuing enterprise software companies for listing in the US is using Price-to-sales multiple, and this should be adopted for the Tech Board. According to market observation, a typical established enterprise software company in China would generate annual sales anywhere between 100 million yuan to 700 yuan million and above, with the majority within the 200 million yuan to 400 million yuan bracket.

We recommend setting the minimum listing requirement at 200 million yuan (HK$250 million) in annual sales in the most recent audit financial year. This allows the Tech Board to capture the majority of the more sizeable companies in the market. Companies at this level should pocess an established business and stable customer base. On top of this, listing candidates can be required to demonstrate recurring sales in the immediate past years with healthy sales forecasts to support a positive growth trajectory.

In 2021, most enterprise software companies in the US were listed at an average Price-to-sales multiple of 12 times. Applying this to the Tech Board, for a listing candidate with HK$250 million revenue, projecting a 35% sales growth (as referred to earlier) forward one year, we arrive at a market capitalization of HK$4 billion.

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[4] Source: https://www.csis.org/blogs/trustee-china-hand/two-years-how-does-star-market-measure

Below table shows comparison of listing requirements using "Revenue with Capitalisation" between the Tech Board and a number of other exchanges and market boards:

| | Revenue | Market Capitalisation |
|---|---|---|
| Proposed for HK Tech Board | HK$250 million | HK$4 billion |
| STAR market Option 4 | 300 million yuan (HK$360 million) | 3 billion yuan (HK$3.6 billion) |
| Nasdaq Global Select Market Standard 3 | US$90 million (HK$700 million) | US$850 million (HK$6.6 billion) |
| HKEX Main Board - The market capitalisation/revenue test | HK$500 million | HK$4 billion |

At this level, the Tech Board will offer a competitive option for companies that have a relatively smaller business but commanding a higher valuation. By rough estimates, there are roughly 100-200 mainland enterprise software companies that could meet the proposed Tech Board's "Revenue with Capitalisation" requirements in the next 24 months.

At the same time, there are certain industries where companies are not only pre-profit but even pre-revenue; companies that are committing high Capex in R&D and production but still in pre-delivery stage. E-vehicles is one such industry. These companies are however heavy in assets and deep in shareholders' equity. The Tech Board may capture them by offering alternative listing options based on Assets and Equity, similar to Nasdaq Global Select Market Standard 4 listing requirements.

China's electrical vehicle industry is booming, backed by advanced technology and a huge market. The three main players NIO 蔚來汽車 (NIO.US), Lixiang 理想(LI.US) and XPeng 小鵬 (XPEV.US) are listed in the US (two are dually-listed in Hong Kong) and their market capitalisation in the US are comparable to Rivian Automotive (RIVN.US), a company seen to be a major competitor to Tesla. This demonstrates Chinese e-vehicles companies are well-received by international investors.

Apart from leading players like them, there are other up-and-coming e-vehicle manufacturers that could be attracted to a listing in Hong Kong. Besides, the e-vehicles industry commands a long production value chain. Underneath each manufacturer is a huge network of Tier 1 and

Tier 2 suppliers who supply anything from traditional mechanical parts to technology-laden components. These suppliers are an integral part of the e-vehicle industry and are set for high growth in tandem. They would be fit for a Tech Board listing with the right set of listing requirements.

As mentioned above, the listing requirements of the Tech Board should be as transparent as possible and less subjective consideration is preferred. However, in exceptional circumstances where a listing candidate does not meet established listing requirements but can demonstrate strong business potential, an Expert Panel may be formed to assess its suitability, in which case, the following factors might be taken into consideration:

- Quality of anchor investors
- Quality of business or alliance partners
- Amount of secured contacts/Projection of verifiable future sales
- Scalability of business model
- Number of patents and industry accolades held
- Percentage of R&D spending as a percentage of sales or Capex

When developing the listing requirements, we recommend that the Exchange proactively approach the top 5 to 10 companies from the targeted sectors for a possible listing on the Tech Board and discuss how their funding needs can best be met. This can be a good learning process for the Exchange to understand the characteristics of different industries and capital cycles, and how the listing requirements and related rules can be fined-tuned.

An early engagement with potential listed companies can help secure their eventual listing. Success breeds success. The ability to attract winners of the industry to list on the Tech Board on the get-go will attract other quality companies to follow and investors to come.

3) <u>The Need to Strengthen Post-listing Research Capabilities</u>

The success of the Tech Board relies on the development of the whole eco-system, not least strong post-listing research capabilities. In our Recommendation Paper, we stated our belief that institutional investors would be willing to consider investment opportunities in earlier-stages, fast-growing tech companies. But to fully engage them and getting them on board, there needs to be high-quality post-listing research, at both macro and micro levels, to assist them in understanding company performance and market outlook. Levels of information dissemination and transparency are key consideration for investors.

To this end, Hong Kong can leverage on the research resources built up in the mainland securities market. Through the years, strong analyst capabilities covering Chinese tech stocks listed in the A shares and overseas markets as well as their US comparables have been developed in leading Chinese brokerage houses such as CICC, CITIC Securities, Haitong Securities, Huatai Securities, to name a few. Such knowledge allows analysis and comparison to be made across markets in business performance, growth potential and trading velocity, providing good reference for investors when making investment decisions.

The mainland research expertise should be engaged early-on in the planning of the Tech Board, allowing sufficient research resources to be allocated to Hong Kong or developed locally ahead of time.

4) Institutional Involvement to Ensure Market Participation

Given the fact that earlier-stages tech companies carry a certain level of risks arising from the business uncertainty and technology viability, our Recommendation Paper suggested that the Tech Board be opened to institutional investors and professional asset managers only, at least in the beginning.

While the geopolitical tensions between China and the US may inhibit the level of participation of US investors, we believe investment managers from other regions such as Europe and SE Asia would show keen interest in the growth opportunities from China's tech sectors.

At the same time, the Tech Board should tap into the deep pool of investment funds of the Mainland. As of the end of 2020, China's Social Security Fund (SSF) held 2.92 trillion yuan of assets under management and its portfolio include domestic and international assets in advanced manufacturing, strategic emerging industries and technology innovation, which are the same types of stocks that would be listed on the Tech Board. SSF's participating in the Tech Board will not be inconsistent with the national objective of directing funds to support key strategic industries and sectors.

We suggest a feasibility study be made to include stocks on the Tech Board in the existing Stock

Connect Programme or a new sub-programme through which mainland institutional funds, including the SSF and corporations' pension schemes, can invest in stocks on the Tech Board within their bounds of risk exposure. Their participation will create greater market depth and also insulate stock prices from undue exposure to geopolitical tensions

To achieve this, there may need to be senior level governmental discussion between Hong Kong and Beijing, involving key regulatory agencies of the Mainland, such as the China Securities Regulatory Commission and China Banking and Insurance Regulatory Commission. This shall be a strategic priority in the whole scheme of the Tech Board development.

**Market and Regulatory Issues**

The above looked at key areas concerning the preparation of the Tech Board that would help ensure its success. The following sections will discuss a number of market and regulatory issues.

1) Positioning of Tech Board vs GEM

GEM was set up in 1999 as a listing platform for growth enterprises that do not meet the Main Board listing requirements. Such a channel is still needed today. In our view, Tech Board is not to replace GEM, nor is it a revamped version. It is designed as a stand-alone board with a distinct identity, targeting a specific group of companies and institutional investors. Creating the Tech Board is to have a brand-new platform without any legacy or pre-existing perception and which can begin operation quickly.

We support HKEX's plan to reform GEM to make it truly fulfil its objectives of serving the fund-raising needs of SMEs and other growth enterprises of wider industry backgrounds. To provide these companies with better access to funds is to nurture their growth and help them succeed. This in turn will encourage more entrepreneurs to start their own business, knowing their endeavours will be met with the financial support they need. Entrepreneurship is not confined to the tech sector but takes different sizes and forms. It can be found in other streams of business that have social demands and economic value. The spur of entrepreneur spirit will inject fresh ideas and new vitality to our economy which will bring long term social and economic benefits to Hong Kong. The Chamber is happy to share our views in reforming GEM in a separate discussion.

2) Price Discovery Mechanism for Tech Stocks

We believe that the traditional way of price discovery during IPO roadshows where investors' orders are taken and tabulated can work as a good indicator of the stock's accepted value by the market. This is still applicable to tech stocks as there are comparables already listed in the home or overseas exchanges that can provide a benchmark for the IPO price ranges. In case there is no comparable for a stock, pre-deal enquiry with interested investors is widely accepted as a way of price discovery, and is widely practiced by the investment community.

3) Market Integrity Under a More Disclosure-based Regime

When we advocated in our Recommendation Paper for a more disclosure-based regime for the Tech Board, we were not forsaking quality and certainly not neglecting investor risks. The Tech Board targets companies with real business with substance and genuine market demands, and as suggested earlier, the top 5-10 companies of the targeted sectors shall be proactively approached for listing. This in a way ensure the quality of the Tech Board companies. All investments carry risks and the Tech Board is no exception. But the risk here is more related to business rather than misconduct. Since the Tech Board is opened for institutional and professional investors who would be capable for risk detection and mitigation, the chance of market-wide risks brought about by the Tech Board is small.

As this is a professional market, investors should be discerning enough to tell strong companies from weaker ones. Sufficient, prompt and accurate information disclosure is required under more disclosure-based regime. We support enhancing the level of information provided by companies, including providing longer term profit forecasts of up to three years to provide better guidance to the market. Companies will be held accountable for their actions and the quality of information disclosed. Ill- performed companies will be punished by the market with falling share prices and limited access to market funding in the future. On the contrary, good companies will be rewarded. It will be a case of the market self-regulating itself.

Conclusion

Since submitting our Recommendation Paper, the Chamber has continued to speak to market organisations that have a role to play in Hong Kong's capital markets and technology development and we are pleased to have received widespread support.