China Equity Strategy

Could CDRs encourage a return home for tech giants and unicorns?

Equity Strategy

China

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CDRs—a new channel for A-share listing

The China Securities Regulatory Commission (CSRC) is planning to allow overseas-listed tech companies and unicorns (unlisted start-ups valued over US$1bn) to list on the A-share market via the newly introduced Chinese Depositary Receipt (CDR), according to a Reuters report. Some Hong Kong- or US-listed tech giants have reportedly been selected for a pilot programme later this year—including Tencent, Sunny Optical, Alibaba, JD.com, Weibo, Ctrip and NetEase. The CDR launch could: 1) drive a potential re-rating for these tech giants; 2) pressure A-share market liquidity in the short term; and 3) reduce the positive impact of HKEX's recent weighted voting right (WVR) reform. While the CDR offers a new channel for Chinese companies in new-economy sectors to list, we believe it is unlikely to completely change the current IPO system.

The best way to bypass existing listing obstacles

Similar to an ADR, a CDR is a type of depositary receipt traded in the A-share market, which represents securities of a company incorporated outside of mainland China. The CSRC believes it could be the best approach to allow overseas-listed Chinese companies and unicorns to list on the A-share market since it can bypass existing restrictions, such as: prohibition on variable interest entity (VIE) structures and multiple share classes, requirement for a profitability track record, and a long approval process. We believe the CDR could be enforced in two possible ways, either by an "offering" or a "listing" facility. The former allows overseas-listed companies to refinance by issuing new shares (CDRs) to onshore investors (secondary offering), while the latter issues no additional shares and acts as an onshore trading derivative, backed by overseas-listed shares.

Potential re-rating for overseas listed companies; pressure on A-share liquidity

By issuing CDRs we believe overseas-listed tech companies will be able to: 1) generate sufficient proceeds to support operations/expansion; and 2) enjoy a valuation re-rating since onshore investors have a preference for growth stocks in new-economy sectors (A-share scarcity value). However, we consider these positives to be a double-edged sword since refinancing needs (if any) would increase the supply of stocks, putting pressure on A-share liquidity and sentiment. For example, if top 4 Internet giants in China issued an additional 5% of existing shares as CDRs, we estimate Rmb373bn (US$59bn) could be diverted from the A-share secondary market. This is a sizeable amount, considering total IPO/secondary offering proceeds of Rmb1,722bn in 2017. Enabling onshore investors to access high-quality growth names more easily could also result in a potential increase in the market's risk appetite and potentially cause a sell-off in overvalued ChiNext stocks, in our view.

Reduces positive impact of HKEX's WVR reform

On 23 February, HKEX released a consultation paper aiming to attract more companies in emerging/innovative sectors to list in Hong Kong: 1) permit listing of biotech companies that do not meet Main Board financial eligibility tests; 2) permit listing of companies with WVR structures; and 3) establish a new concessionary secondary listing route for Greater China and international companies. We believe the launch of CDRs and the loosening of A-share IPO restrictions for unicorns could cast a shadow over the positive impact brought by HKEX's reform, given: 1) overlap of the targeted companies; 2) approval of CDRs also implies the CSRC's implicit acceptance of WVR and VIE structures; and 3) A-shares could warrant higher valuations than H-shares due to the scarcity of new-economy names, hence benefitting the issuers more.

Introducing CDRs to the A-share market

According to a 5 March report from Reuters, the CSRC is planning to allow overseas-listed technology giants to list on the A-share market through Chinese Depositary Receipts (CDRs), a new approach to listing that is similar to an American Depositary Receipt (ADR).

CDR has been widely mentioned by the regulators

"Using the CDR approach is more suitable for overseas-listed companies to list in domestic equity markets", said Qingmin Yan, CSRC vice chairman, during the annual Two Sessions meetings, according to Caixin. Jianjun Wang, general manager of Shenzhen Stock Exchange (SZSE), mentioned the exchange had been studying the topic for some time. Preparation of CDR issuance has basically been completed and pilot launches should be ready this year, according to the Reuters report.

Many overseas-listed companies are interested in applying

Meanwhile, founders and CEOs of overseas-listed tech giants have expressed willingness to list on the A-share market via CDRs, during the Two Sessions, according to Caixin. JD.com's CEO Qiangdong Liu said the company is more willing to list on domestic exchanges. And William (Lei) Ding, CEO of NetEase, also expressed willingness to consider the CDR approach.

What obstacles do companies face in listing on the A-share market?

Existing obstacles to listing include: VIE structure, multiple share classes, requirements on financials and regulatory approvals

Currently, only companies incorporated in mainland China are eligible to list on domestic exchanges (ie, an A-share listing). Many Chinese tech companies received investment from foreign funds before they underwent an IPO and, as a result, many of them were incorporated outside mainland China with a variable interest entity (VIE) structure, which is not permitted for A-share listings. Multiple share classes are also not permitted for companies listing on the A-share market. And there are numerous requirements for companies' financials, such as demonstrating a track record of profitability.

Only a few of China's technology giants that are listed overseas can meet all the existing A-share listing requirements. We believe this challenge is unlikely to be overcome, unless China's company law is amended. Even if an overseas-listed company has amended its ownership structure and taken efforts to meet all requirements, it will still need to wait to get the regulators' approval (which can take a long time).

Loosening IPO approval for unicorns

In order to attract more "unicorns" (unlisted start-ups valued over US$1bn) in new-economy sectors to list in the A-share market, securities regulators have recently accelerated the approval process and loosened certain listing requirements for qualified companies, as seen in Foxconn's recent A-share IPO (it was approved in little more than a month, according to a 5 March report from Bloomberg).

Nevertheless, overseas-listed tech giants are not able to list on the A-share market given the abovementioned obstacles.

What is a CDR and what is its purpose?

China's version of an ADR

A Chinese Depositary Receipt (CDR) is a type of depositary receipt traded in China's domestic A-share market that represents securities of a company incorporated outside of mainland China. A CDR can be viewed as China's version of an American Depositary receipt (ADR) as they share a similar working mechanism.

CDR was originally proposed to help HK-listed Chinese companies list A-shares

The CDR concept was first proposed by the Hong Kong securities regulator and was designed to help Hong Kong-listed Chinese companies list on the A-share market. China Mobile, which listed in Hong Kong in 1997 as a "red chip", expressed its willingness to list on the A-share market at various times in the early 2000s. A CDR was proposed as a means for China Mobile to list on the A-share market, although the issuance plan was later dropped.

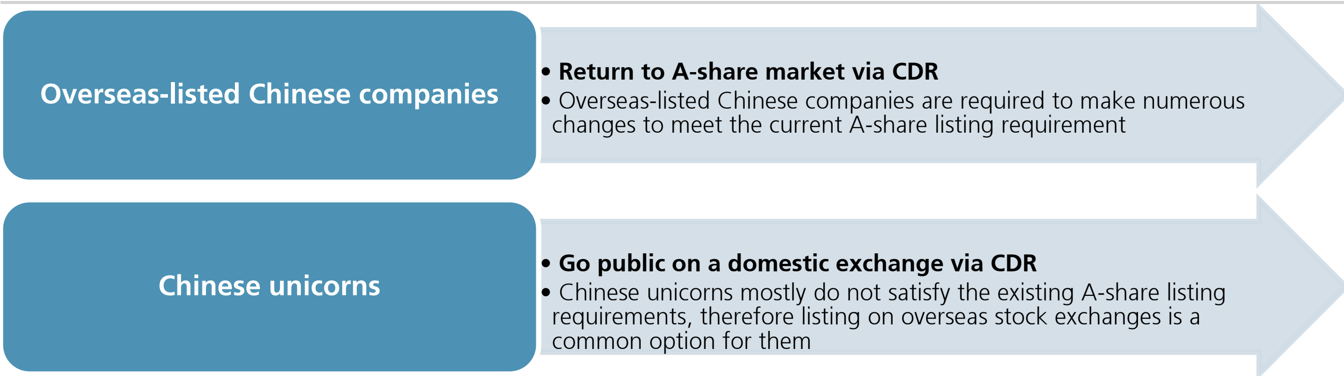
Now China wants to attract overseas-listed tech giants to the A-share market

Now, China is targeting overseas-listed Chinese tech companies to encourage them to list on the A-share market—and 'return home'. Companies that do not comply with current A-share listing requirements will reportedly be allowed to apply for a CDR without, for example, changing their ownership structure.

Also a potential route for unicorns' onshore IPO

CDRs can also offer a new option for unicorns in new-economy sectors to list on the A-share market, by bypassing the listing requirements under company and securities laws. Furthermore, the Shanghai and Shenzhen stock exchanges are competing with the Hong Kong stock exchange to attract IPOs of unicorns (please refer to Figure 2 for a list of unicorns in China).

Figure 1: Purposes of the introduction of CDRs



Source: UBS-S

Figure 2: China's "unicorns"

Company	Valuation ($B)	Country	Industry	Select Investors
Didi Chuxing	56.0	China	On-Demand	Matrix Partners, Tiger Global Management, Softbank Corp.,
Xiaomi	46.0	China	Hardware	Digital Sky Technologies, QiMing Venture Partners, Qualcomm Ventures
Meituan Dianping	30.0	China	eCommerce/Marketplace	DST Global, Trustbridge Partners, Capital Today
Lu.com	18.5	China	Fintech	Ping An Insurance CDH Investments, Bank of China
Toutiao	11.0	China	Digital Media	Sequoia Capital China, SIG Asia Investments, Sina Weibo
DJI Innovations	10.0	China	Hardware	Accel Partners, Sequoia Capital
Lianjia	5.8	China	eCommerce/Marketplace	Tencent, Baidu, Huasheng Capital
EasyHome	5.7	China	Retail	Alibaba Group, Boyu Capital, Borui Capital
Ele.me	5.5	China	On-Demand	Sequoia Capital China, Alibaba Group, Horizons Ventures
United Imaging Healthcare	5.0	China	Healthcare	China Life Insurance, China Development Bank Capital, CITIC Securities International
NIO	5.0	China	AutoTech	Baidu Venture Capital, Capital Today, GIC
Meizu Technology	4.6	China	Hardware	Telling Telecommunication Holding Co., Alibaba Group
Kuaishou	3.0	China	Social	Morningside Venture Capital, Sequoia Capital, Baidu
Royole Corporation	3.0	China	Hardware	Warmsun Holding, IDG Capital Partners
Maoyan-Weiying	3.0	China	eCommerce/Marketplace	Tencent Holdings, Enlight Media Group
VANCL	3.0	China	eCommerce/Marketplace	Ceyuan Ventures, QiMing Venture Partners, Temasek Holdings
Mobike	3.0	China	On-Demand	Tencent Holdings, Sequoia Capital China, TPG Capital
Ofo	3.0	China	On Demand	GSR Ventures, Matrix Partners China, Didi Chuxing
e-shang Redwood	2.8	China	Real Estate	SK Group, GF Investments, China Minsheng Banking Corp.
Meicai	2.8	China	Food & Grocery	Tiger Global Management, Blue Lake Capital, ZhenFund
Huimin	2.0	China	On-Demand	Zheshang Venture Capital, GP Capital, Western Capital Management
Trendy Group International	2.0	China	Clothing & Accessories	L Capital Partners
Weiying	2.0	China	eCommerce/Marketplace	Tencent, iDreamSky Technology, GGV Capital
LaKala	1.6	China	Fintech	China Continent Property & Casualty Insurance, China Renaissance Capital Investment, China Taiping Life Insurance
CAOCAO	1.6	China	On Demand	People Electrical Appliance Group China, Zhongrong International Trust
DouyuTV	1.5	China	Internet Software & Services	CMB International Capital, Nanshan Capital, Tencent Holdings
Pindouduo	1.5	China	eCommerce	Tencent Holdings, Banyan Capital, Cathay Innovation
Vipkid	1.5	China	Edtech	Sequoia Capital China, Tencent Holdings, Sinovation Ventures
GuaHao	1.5	China	Healthcare	Tencent, Morningside Group
Tujia	1.5	China	eCommerce/Marketplace	GGV Capital, QiMing Venture Partnersl
SenseTime	1.5	China	Computer Vision/ AI	Star VC, IDG Capital, Infore Capital
Tuandaiwang	1.5	China	Fintech	Beihai Hongtai Investment, China Minsheng Investment, Yisheng Innovation
Koudai Gouwu	1.4	China	eCommerce/Marketplace	New Enterprise Associates, Tiger Global management, Tencent
URWork	1.3	China	Real Estate	Ant Financial Services Group, Dahong Group, Sequoia Capital China
NetEase Cloud Music	1.2	China	Internet Software & Services	China International Capital Corporation, Hunan TV & Broadcast Intermediary, Shanghai Media Group
Jiuxian	1.1	China	eCommerce/Marketplace	Sequoia Capital China, Rich Land Capital, Merrysunny Wealth
Cambricon	1.0	China	Chips & Semiconductors	Alibaba Entrepreneurs Fund, CAS Investment Management Co., Lenovo Ventures Group
Yuanfudao	1.0	China	Edtech	Tencent Holdings, Warbug Pincus, IDG Capital
Liepin	1.0	China	HR & Workforce Management	China Mobile, Matrix Partners China, Warbug Pincus
Yixia	1.0	China	Social	Sequoia Capital China, Sina Weibo, Kleiner Perkins Caufield & Byers, Redpoint Ventures
Apus Group	1.0	China	Mobile Software & Services	Redpoint Ventures, QiMing Venture Partners, Chengwei Capital
Fanli	1.0	China	eCommerce/Marketplace	QiMing Venture Partners, Steam boat Ventures
Mogujie	1.0	China	Social	IDG Capital Partners, QiMing Venture Partners, Banyan Capital
BeiBei	1.0	China	eCommerce/Marketplace	Banyan Capital, New Horizon Capital, IDG Capital Partners
Panshi	1.0	China	Adtech	WI Harper Group, Fang Fund Partners, NewMarging Ventures
Zhaogang	1.0	China	eCommerce/Marketplace	K2 Ventures, Matrix Partners China, IDG Capital
iTutorGroup	1.0	China	Ed Tech	QiMing Venture Partners, Temasek Holdings, Silverlink Capital
Dt Dream	1.0	China	Internet Software & Services	Alibaba Group, China Everbright Investment Management, Yinxinggu Capital
Dada	1.0	China	eCommerce	Sequoia Capital China, DST, Greenwoods Asset Management
Mia.com	1.0	China	eCommerce/Marketplace	Sequoia Capital China, ZhenFund, K2 Ventures
Xiaohongshu	1.0	China	eCommerce/Marketplace	GGV Capital, ZhenFund, Tencent
iCarbonX	1.0	China	Healthcare	Tencent, Vcanbio
Mofang Gongyu	1.0	China	Facilities	Warburg Pincus, Aviation Industry Corporation of China
UBTECH Robotics	1.0	China	Robotics	CDH Investments, Goldstone Investments, Qiming Venture Partners
HuJiang	1.0	China	Edtech	China Minsheng Investment, Baidu, Wanxin Media
Guazi	1.0	China	eCommerce/Marketplace	Sequoia Capital China, GX Capital
Zhihu	1.0	China	Internet Software & Services	Tencent Holdings, Sinovation Ventures, Qiming Venture Partners
51Xinyongka	1.0	China	Fintech	GGV Capital, JD.com, Meridian Capital China
YH Global	1.0	China	Supplychain/ logistics	Co-Energy Finance, Grandland
Tongdun Technology	1.0	China	Cybersecurity	Advantech Capital, Temasek Holdings Ltd., Tiantu Capital Co.
Face++ (Megvii)	1.0	China	AI / Facial Recognition	Ant Financial Services Group, Russia-China Investment Fund, Foxconn Technology Company
XiaoZhu	1.0	China	eCommerce/Marketplace	Morningside Ventures, Capital Today, JOY Capital
17zuoye	1.0	China	EdTech	DST Global, Temasek Holdings

Source: CBInsights, UBS-S

CDRs—two possible modes

Opening a new channel

In our view, while the CDR offers a new channel for overseas-listed Chinese companies and Chinese unicorns to list on the A-share market, it is unlikely to completely change the current A-share market IPO mechanism. Most companies will still need to go through the traditional A-share IPO approval process. We also believe the programme is designed for Chinese companies rather than foreign companies, since the renminbi is not yet freely convertible

There might be a pilot programme

According to the CSRC, a CDR pilot programme may be launched later this year, initially targeting high-quality Hong Kong-listed and US-listed Chinese tech companies. We expect only a few qualified blue chips would be eligible to apply for a CDR listing. However, whether or not such overseas-listed companies decide to list on the A-share market via CDR would be determined by the market itself.

We believe the CDR could be enforced in two possible ways, either by an "offering" facility or a "listing" facility. The former allows overseas-listed companies to refinance by issuing new shares (CDRs) to onshore investors (secondary offering), while the latter issues no additional shares and acts as an onshore trading derivative, backed by overseas-listed shares.

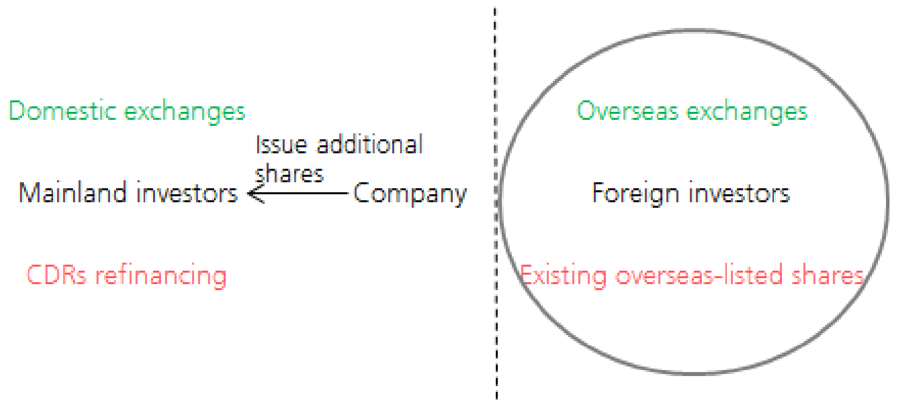
Mode 1: "offering" facility

Refinance by issuing new shares (CDRs)

Under the "offering" facility, which is the mainstream mode in the global equity market, overseas-listed companies would be able to refinance by issuing new shares (CDRs) to mainland investors. This mechanism is similar to a secondary offering, although most of the shares are still listed overseas and only part of the shares (CDRs) will be listed onshore.

This mode could be expanded to other unlisted companies, such as overseas-incorporated unicorns, hence allowing them to list on domestic exchanges. This would be similar to the IPOs of Chinese ADRs in the US market.

Figure 3: Possible mode 1 – CDR "offering" facility



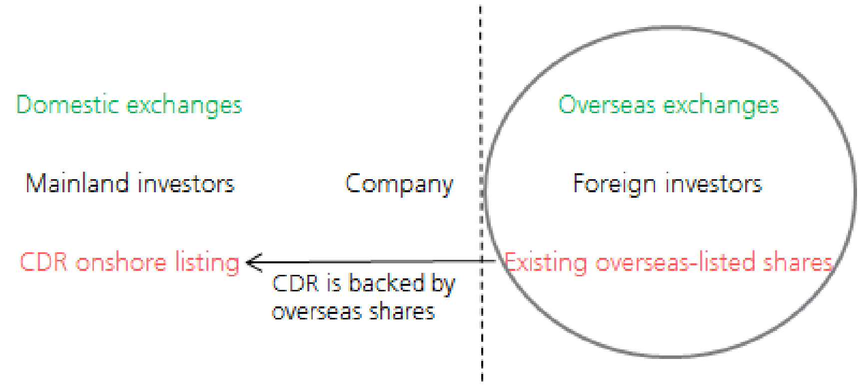
Source: UBS-S

Mode 2: "listing" facility

Existing shares to be floated on domestic exchanges and no additional shares issued

Companies without funding needs can list their CDRs on domestic exchanges, via a "listing" facility. No additional shares will be issued, while the onshore CDRs will mainly come from the existing overseas-listed ordinary shares. In other words, the CDR is like an onshore listed derivative backed by overseas-listed shares. Its working mechanism is similar to the single stock version of the Stock Connect Scheme, except there is a financial instrument named CDR and listed on domestic exchanges.

Figure 4: Possible mode 2 – CDR "listing" facility



Source: UBS-S

Can CDRs be converted into overseas shares?

In global markets, depositary receipts (DRs) can be converted into overseas listed shares. For the "offering" facility, it is unclear whether CDRs will be able to do the same as conversion will involve cross-border capital flows.

If conversion is not allowed, a CDR/overseas share premium may arise (similar to the “A/H premium” between A-shares and H-shares) since the onshore market is separated from the overseas market. If conversion is allowed, arbitrage activities will eliminate the pricing differences, while how will the regulators deal with cross-border capital flows and floating number of CDRs/shares remains unknown. In our view, a quota system is more likely to be included in the conversion framework.

For the "listing" facility, we think CDRs will be able to be converted into overseas listed shares, as the CDR is a financial instrument backed by overseas-listed shares and no additional shares are issued.

Figure 5: Comparison of possible CDR modes

Possible mode	For company	Mechanism	"Analogy"	Conversion allowed?	Other comments
"Offering" facility	Re-financing	Issuing new shares (CDRs)	Secondary offering to mainland investors	Unclear. If no, there might be a CDR premium to overseas shares. If yes, how regulators deal with cross-border capital flows and floating number of CDRs remains unknown	Can be expanded to unicorns' IPOs
"Listing" facility	No additional shares would be issued	Existing shares to be floated on domestic exchanges	Onshore listed derivative backed by overseas-listed shares	Yes	Two possible modes can be combined into one multi-level system

Source: UBS-S

The two possible modes are not mutually exclusive. Taking the ADR as a reference, there is a multi-level ADR system in the US. Companies can choose from different types of programmes or facilities, depending on how much effort and other resources they are willing to commit. In our view, a multi-level CDR system could expand the scope of application.

Investment implications

1) Overseas-listed Chinese companies: potential valuation re-rating

Refinancing, valuation re-rating

Under the "offering" facility, overseas-listed companies could refinance by issuing additional shares (CDRs) on the onshore equity market. As A-share investors have a strong preference for growth stocks in new-economy sectors, we believe the newly issued CDRs would be warmly welcomed. As a result, the valuation of the CDRs could be higher than the overseas-listed shares at the initial stage. The issuer would not only get sufficient proceeds to support operation or expansion, but also enjoy a potential valuation re-rating since the rich valuation of onshore-listed CDRs could indirectly boost the trading multiples of its overseas-listed shares.

If only the "listing" facility is allowed for the CDR program, valuations of the overseas-listed shares could still expand as additional onshore mainland funds could access the CDRs backed by overseas shares. This would happen in particular if CDRs were convertible to overseas-listed shares.

According to Caixin (5 March 2018), eight Hong Kong or US-listed tech companies have been selected for the upcoming CDR pilot programme later this year, including Tencent, Sunny Optical, Alibaba, JD.com, Weibo, Ctrip and NetEase.

Figure 6: Comparative valuations – potential participants in a CDR pilot programme

Reuters		Mkt cap	Trading		Price	Price	Upside	PE (x)		P/BV (x)		ROE (%)		EPS grth (%)		Div. yield (%)	
Code	Name	(US$m)	currency	Rating		target	to target	2018E	2019E	2018E	2019E	2018E	2019E	2018E	2019E	2018E	2019E
BABA.N	Alibaba	489,678	USD	Buy	188.41	240.00	27%	35.9	28.1	6.8	5.4	21.9	21.3	42.6	27.6	-	-
0700.HK	Tencent	551,565	HKD	Buy	463.60	525.00	13%	39.4	30.0	10.7	8.0	31.3	30.6	38.2	31.0	0.3	0.4
CTRP.O	Ctrip	23,089	USD	Buy	48.78	57.26	17%	30.2	16.6	3.2	2.8	11.0	17.7	51.4	81.4	-	-
JD.O	JD.com	63,054	USD	Buy	44.32	50.00	13%	52.2	31.0	6.7	5.5	13.7	19.5	53.4	68.7	-	-
WB.O	Weibo	28,670	USD	Buy	131.13	155.00	18%	46.8	33.6	9.7	7.2	29.8	25.1	53.3	39.3	-	-
NTES.O	NetEase	41,134	USD	Neutral	311.62	300.00	-4%	18.7	15.8	4.5	3.7	26.8	25.7	9.2	18.3	1.1	1.3
2382.HK	Sunny Optical	19,634	HKD	Neutral	143.30	126.50	-12%	28.0	21.6	11.4	8.1	48.6	43.7	57.9	29.3	0.7	1.1

Note: Data as of 14 March 2018. Source: Reuters, UBS and UBS-S estimates

2) A-share market: short-term liquidity pressure

Pressure on market liquidity in the short term; negative for some overvalued ChiNext stocks

If the CDR programme adopts the "offering" facility, the refinancing of overseas-listed companies will increase the supply of stocks in the A-share market, which could put some pressure on market liquidity and sentiment. Our scenario analysis in Figure 7 shows that if top 4 Internet giants in China were to issue an additional 5% of their total existing shares, Rmb373bn (US$59bn) would be diverted from the A-share secondary market. This compares with the total amount raised via A-share IPO or secondary offering in 2017 of Rmb1,722bn.

Figure 7: Scenario analysis: amount potentially to be raised by top 4 Internet giants via CDR refinancing (US$bn)

Additional CDR offering	Total
Total market cap (US$bn)	1180.8
1%	11.8
3%	35.4
5%	59.0

Note: Data as of 9 March 2018.
Source: Thomson Reuters, UBS-S estimates

Moreover, we believe some overvalued stocks on the ChiNext exchange with rich valuations but low earnings might face strong selling pressure since mainland investors would be able to access more high-quality growth names after the introduction of the CDR programme.

Further opening up of A-share market

From a long-term perspective, the listing of quality overseas-listed companies, especially the well-known technology giants, could raise the market's risk appetite, while the launch of CDRs could further help China open up its domestic capital markets.

We expect regulators would launch a pilot programme first, for some high-quality overseas-listed blue-chips, potentially by the end of this year, before gradually expanding the CDR programme. In our view, while CDRs open up a new route for onshore listing, they are unlikely to completely change the current IPO mechanism. Whether an overseas-listed company decides to list in the A-share market via CDR will be determined by the market itself.

3) H-share market: reduce positive impact of WVR reform

HKEX's reform to attract companies from new-economy sectors

On 23 February 2018, HKEX released a consultation paper aiming to attract more companies in emerging/innovative sectors to list in Hong Kong. Three major areas are touched on in this reform (for details see Figure 10):

- Permit listing of **biotech companies** that do not meet any of the financial eligibility tests of the Main Board
- Permit listing of companies with **weighted voting right (WVR) structures**
- Establish a new concessionary **secondary listing route for Greater China and international companies** that wish to make a secondary listing in Hong Kong

HKEX expects the new listing rules will become effective in late April 2018 and listing applications will also begin at that time. According to Reuters (30 January 2018), Xiaomi could be the first new-economy company to list in Hong Kong after the reform. If more new-economy companies list in Hong Kong overall market turnover could increase, theoretically benefiting HKEX.

However, the potential launch of CDRs and the loosening of A-share IPO restrictions for unicorns could cast a shadow over the positive impact brought by the recent HKEX reform, given: 1) overlap of the targeted companies; 2) approval of the CDR programme implies CSRC's implicit acceptance of WVR and VIE structures; and 3) scarcity of new-economy A-share names could warrant a higher valuation premium than H-shares, hence benefiting the issuing companies.

Companies reportedly in the first batch of a CDR trial approval list: Tencent, Sunny Optical, Alibaba, JD.com, Weibo, Ctrip and NetEase. If any of these overseas-listed new-economy companies decide to list on the A-share market via CDRs, we believe their interest in conducting secondary listings in Hong Kong will wane.

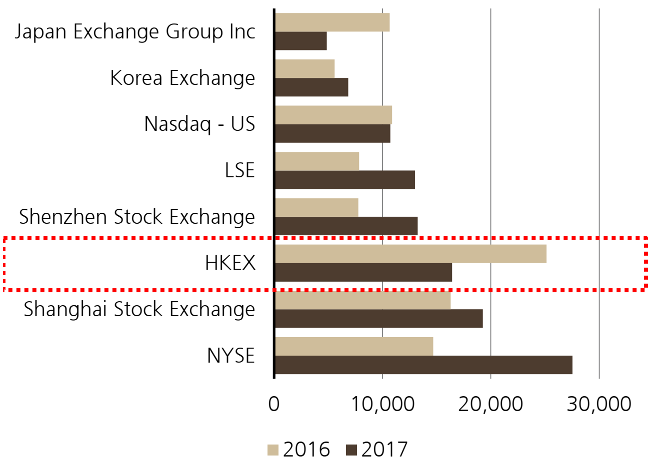
The launch of CDR might have limited immediate impact on existing H-share trading landscape

We expect the launch of CDRs and unicorn IPO reform will have only a limited near-term impact on the H-share market given:

- In **international fund flows**, investors already have free access to Hong Kong and overseas-listed ordinary shares, hence they are likely to have only limited interest in investing in CDRs (except for unicorn stocks).

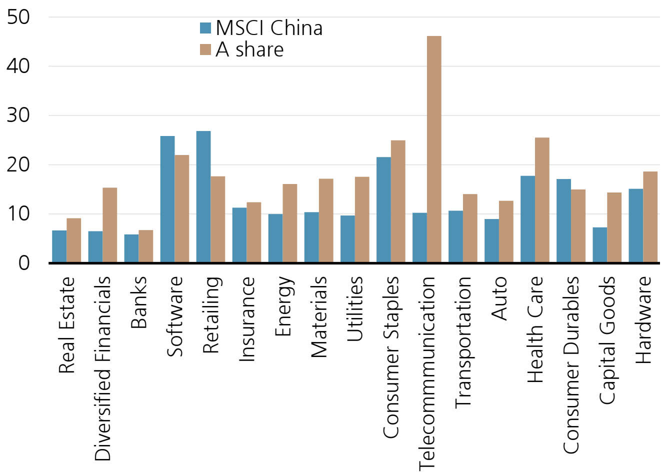
- **For southbound flows**, momentum from onshore institutional investors' asset allocation demand should remain strong, and attractive A/H-share valuation gaps will likely continue to drive inflow. Meanwhile, the Stock Connect programme will become an important tool for onshore investors to arbitrage the pricing differences between the Hong Kong-listed new-economy ordinary shares and their CDRs.

Figure 8: Comparison of IPO equity funds raised (US$m)



Source: HKEX

Figure 9: MSCI China vs A-share 2018E PE ratio, by sector (x)



Note: Data based on MSCI China sector indices versus Wind GICS indices and SW Indices. Source: Go-goal, Datastream, UBS-S estimates

Figure 10: Summary of HKEX's listing framework reform

1) Biotech companies: Permit listing of biotech companies that do not meet any of the financial eligibility tests of the Main Board	
Listing eligibility	- **Product:** At least one core product beyond concept stage; ie, pharmaceutical, biologics, medical devices and other biotech products - **R&D:** Primarily engaged in R&D of its core products for a minimum of 12 months - **IPO:** Primary reason for listing is to raise capital for R&D to bring its core products to commercialisation - **Patents:** Durable patents, registered patents, patent applications and/or IP in relation to its core products - **Sophisticated investors:** Received meaningful investment for at least 6 months before IPO (which must remain at IPO)
Listing requirement	- **Market cap:** ≥HK$1.5bn - **Track record:** In its current line of business for at least 2 financial years; substantially the same management - **Working capital:** 125% of the group's costs for at least next 12 months (after taking into account the proceeds of the IPO) which must substantially consist of: (a) general, administrative and operating costs; and (b) R&D costs
Additional requirement	- **Cornerstones** will not count towards minimum initial public float requirement at listing or during 6 months lock-up - **Fundamental change of principal business** will require consent from the Exchange. - **Stock marker "B"** at the end of its stock name
2) Weighted voting right (WVR): Permit listing of companies with WVR structures	
Listing eligibility	- **New applicants only:** Only apply to innovative company for which success of core business is attributable to (1) new technologies; (2) innovations; and/or (3) a new business model, which also serves to differentiate the company from existing players - **R&D** is a significant contributor of its expected value and constitutes a major activity and expense - **Intangible assets:** Has an outsized market capitalisation / intangible asset value relative to its tangible asset value; success is demonstrated to be attributable to its unique features or intellectual property. - With **track record of high business growth** - Value of the company is largely attributable or attached to **intangible human capital** - **External validation:** Received meaningful third-party investment from at least one sophisticated Investor (which must remain at IPO).
Listing requirement	- **Market cap:** ≥HK$10bn; requires at least HK$1bn in revenue, if market cap is <HK$40bn
WVR beneficiaries	- **Individuals only**: materially responsible for growth of the business. - **Directors only**: at listing and afterwards - **Shareholding**: Collectively hold ≥10% and ≤50% at listing - **Transfers prohibited**: With natural sunset; allow trusts and legitimate tax planning
Additional requirement	- **No increase in proportion** of WVRs after listing - Share-based WVR only with **maximum 10x voting power** vs. ordinary shares - Non-WVR shareholders must have **10% of voting power** - **Fundamental matters** voted on a **"one-share, one-vote" basis** - **Stock marker "W"** at the end of its stock name
3) Secondary listing for Greater China and international companies: Establish a new concessionary secondary listing route for Greater China and international companies that wish to make a secondary listing in Hong Kong	
Listing eligibility	- **Listed on qualifying exchange**: NYSE, NASDAQ & LSE's Main Market - With **at least 2 financial years** on qualifying exchange
Listing requirement	- **Market cap**: ≥HK$10bn with ≥HK$1bn in revenue if less than HK$40bn - **Non-Greater China Issuers** can list with ≥HK$10bn market cap only
Additional requirement	- Greater China Issuers that are primary listed on a Qualifying Exchange **before 15 December 2017 will be exempted** from HKEX's proposed WVR structures and VIE structures requirements - Greater China Issuers that are primary listed on a Qualifying Exchange **after 15 December 2017 will need to comply** with HKEX's proposed WVR structures and VIE structures requirements - **Non-Greater China Issuers**: Can secondary list with their existing WVR structures and VIE structures intact; no need to comply with WVR safeguards

Source: HKEX

Valuation Method and Risk Statement

We use a variety of valuation approaches for stocks we cover across industries in the Hong Kong and mainland China stock markets, including DCF, Gordon growth model analysis and relative valuation analysis using various multiples such as PE, EV/EBITDA and P/BV.

We think the risks facing China's equities include a hard landing for the property market, a capital exodus associated with currency depreciation and slow progress in structural reform. In our view, improper government policies to address these risks could shock the market. For example, an overdose of stimulus policies could threaten to derail the transition from an investment- to a consumption-driven economy and swell the debt of government and state-owned-enterprises.

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12-Month Rating	**Definition**	**Coverage[1]**	**IB Services[2]**
Buy	FSR is > 6% above the MRA.	46%	27%
Neutral	FSR is between -6% and 6% of the MRA.	39%	24%
Sell	FSR is > 6% below the MRA.	16%	13%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 December 2017.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS:Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Alibaba Group[7, 16b, 22]	BABA.N	Buy	N/A	US$188.41	13 Mar 2018
Ctrip.com International[16b]	CTRP.O	Buy	N/A	US$48.78	13 Mar 2018
JD.com[7, 16b, 22]	JD.O	Buy	N/A	US$44.32	13 Mar 2018
NetEase[16b]	NTES.O	Neutral	N/A	US$311.62	13 Mar 2018
Sunny Optical Technology[2, 4, 5, 16a]	2382.HK	Neutral	N/A	HK$146.50	13 Mar 2018
Tencent Holdings[16a, 22]	0700.HK	Buy	N/A	HK$462.80	13 Mar 2018
Weibo Corp[16b]	WB.O	Buy	N/A	US$131.13	13 Mar 2018

Source: UBS. All prices as of local market close.
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