Tighter ADR regulations: A boost for Hong Kong

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Tighter regulatory scrutiny on Chinese ADRs, amid re-escalating US-China tensions, will accelerate the dual-listing trend into the Hong Kong market. The price impact on existing Chinese ADRs may however be surprisingly muted.

The US Senate passed the Holding Foreign Companies' Accountable Act on 20 May 2020, tightening regulations on American Depositary Receipts (ADRs). The Act requires companies listed on any of the US securities exchanges to certify that they are not under the control of a foreign government. Companies can also be suspended or delisted if they are unable to comply with the audits by the Public Company Accounting Oversight Board (PCAOB) for three consecutive years.

US listings have been a popular way for China's technology companies to raise capital given the strict restrictions at home. The Act, if it gets passed through Congress and signed by President Trump, could result in Chinese ADRs being delisted from the US stock exchanges as Beijing currently prohibits the PCAOB from inspecting the audit records of China and Hong Kong headquartered companies.

NO SURPRISE

The Act should not come as a surprise since discussions on increased disclosure requirements were already underway since last year. The rising US-China geopolitical tensions ahead of the US elections (and post the coronavirus outbreak) as well as the recent accounting scandal at US-listed Luckin Coffee are further catalysts.

A number of US-listed Chinese companies, such as Alibaba, had already turned to secondary listings in Hong Kong last year to broaden their investor bases and reduce risks. The recent passing of the Act in the Senate is likely to compel other companies to do likewise.

MUTED IMPACT

There are currently 233 Chinese ADRs listed in the US (primary listings only), with an aggregate listed market capitalisation of USD 1.03 tn. This represents 3.3% of US equity market capitalisation and 8% of all-China market capitalisation.

Among the ADRs, there are about 11 state-owned companies[1] which would be impacted if the

Source: [1]US-China Economic Security Review Commission in 2019.

proposed legislature passes. However, even if some of China's large state-owned companies such as Petrochina, Sinopec and China Life Insurance are forced to withdraw their ADR listings, the impact is likely to be muted for these companies.

Petrochina's ADRs, for example, only account for about 1.9% of its outstanding shares with its Hong Kong listing making up for 52.1%. Likewise, for China Life, its ADRs account for only 1.1% of its outstanding shares while its Hong Kong listing makes up 41.3%.

The price impact on the ADRs could also be relatively moderate. It is estimated that US investors hold about USD 350 bn worth of Chinese ADRs, which translates to about one-third of the ADR universe.

Hypothetically, it would take more than 200 days for US investors to fully liquidate their ADR exposures[2]. If the bill becomes law, there could be a 3-year transition period starting from the date of enactment for affected companies to come into compliance. This transition period could further mitigate the liquidity impact on the market and share prices.

The price impact for some of the state-owned ADRs, could be even more limited given their light trading volumes. Over the past 30 days, for example, the trading value for China Life's and PetroChina's ADRs averaged USD 5.6 mn and USD 5.5 mn per day respectively. In contrast, over in Hong Kong for the same duration, the daily trading value for China Life and PetroChina averaged USD 75 mn and USD 36 mn respectively[3].

That said, the delisting could pose greater problems for selected technology companies whose US listing accounts for a large percentage of their market capitalisation. Given the potential 3-year transition period, these companies which were listed in 2018 may still have time for potential negotiation/adjustments among related parties.

A BOOST FOR HONG KONG

Tighter regulatory scrutiny on Chinese ADRs, against a backdrop of re-escalating US-China tensions is likely to accelerate the dual-listing trend into the Hong Kong market. High profile listings of new economy companies could also lift trading activity. For example, while Alibaba's Hong Kong listing only account for 0.3% of Hong Kong's total market capitalisation, it has contributed to 3-4% of the market's total turnover in the past 90 days[4].

It was also announced earlier this week in Hong Kong, that the benchmark Hang Seng Index will for the first time admit companies with secondary listings and multiple classes of voting rights. These reforms, the largest in 14 years, will allow companies such as Alibaba to be included in the index, helping to make Hong Kong a more attractive listing destination for US-listed China technology companies going forward.

The dual-listing trend would be a boost for Hong Kong as the number of Initial Public Offerings (IPOs) has fallen significantly this year. 2020 marks the first time in six years where Hong Kong did not rank among the top three centres globally for IPOs. This may be about to change.

Sources: [2]Goldman Sachs. Assuming that US investors account for 1/3 of the ADRs' ADT. [3]As of 22 May 2020. [4]As of 22 May 2020.

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