



# Hong Kong

Look for slower but steady growth through the year end in both the IPO and M&A markets

## Current Environment

Hong Kong saw GDP growth of 5.6 percent in the first half of 2007, a fall of 1.3 percent compared to the 2006 growth rate of 6.9 percent. Growth has fallen somewhat short of the market's expectation due to comparatively weaker investment spending and exports. Whilst Hong Kong's exports surged by 10 percent in January and February, in response to shipments in advance of the Chinese New Year holiday, the Hong Kong Trade Development Council expects Hong Kong exports to only grow by a modest 6 percent for the whole of 2007 (compared to 9 percent in 2006). This is due to decreasing US demand and changes in Mainland China's processing trade regulations (covering a reduction in VAT rebates and a tightening of environmental regulations), together with Guangdong province's industry relocation measures (including measures to restrict the growth of resource-intensive industries).

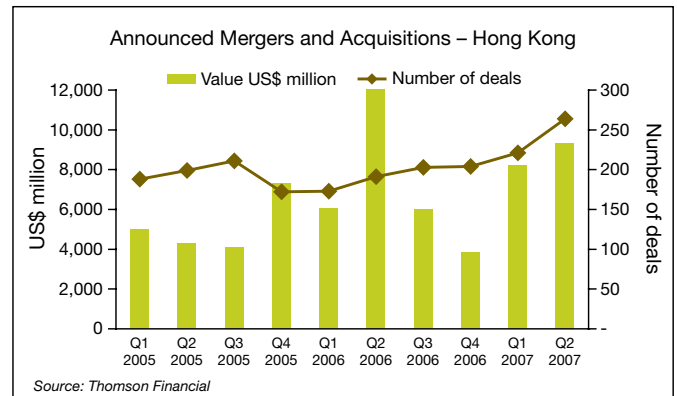
On the plus side, any effects from the downturn in the US economy are being partially offset by demand for digital products and the continuing shift of US and EU clothing orders to China. The weakness of the Hong Kong dollar should also support Hong Kong's external trade. In addition, despite the appreciation of the Renminbi by over 7 percent against the US dollar since China's exchange rate reform in July 2005, the effect on China's production costs (in reality, most of Hong Kong's manufacturing industry and production costs are on Mainland China) appears to have been relatively low.

Despite a blip in early 2007 when volatility in Chinese stock markets impacted on Hong Kong stocks, the Hang Seng Index reached record highs of over 21,500 in June 2007, with daily securities market turnover values of over US\$13 billion. These record highs were propelled by the continuing influx of foreign capital and news of possible Chinese A share listings of PetroChina, China Mobile and China Construction Bank. The China Banking Regulatory Commission announced on 11 May that the scope for investment instruments under the Qualified Domestic Institutional Investor (QDII) scheme would be broadened to include stocks. As a result, analysts expect the volume of investments in Hong Kong from Chinese QDIIs to increase as Hong Kong regulators are currently the only ones to have signed Memoranda of Understanding with Chinese regulators.

Following the SARS crisis in 2003, buyers and investors have returned to the Hong Kong property market in droves. Economic growth continues to drive up property prices, although the volume of property deals still has some way to go to reach the record 1997 levels.

The labour market has also continued to improve on the back of sustained economic growth. Unemployment has reduced to 4.3 percent, the lowest rate for over eight years. There were improvements across many sectors, including construction, restaurants and real estate.

## Deal Activity



The deal market in Hong Kong remained strong in the first half of 2007. Deal values increased by 79 percent to US\$17.6 billion, compared to the second half of 2006. The number of announced deals also increased to 485.

US\$12.6 billion was raised on the Hong Kong stock exchange in the first half of 2007. This appears low when compared to the US\$29 billion raised in the second half of 2006. However, the latter includes US\$21.9 billion raised by the Industrial and Commercial Bank of China (ICBC) in the world's largest ever IPO. Excluding this, funds raised increased by US\$5.5 billion in the first half of 2007.

The increase was driven by the world's largest IPO this year: China CITIC Bank's April dual listing in Hong Kong and Shanghai, which raised a total of US\$5.4 billion (US\$4.2 billion in Hong Kong). Shares in China CITIC bank rose 17 percent on their Hong Kong debut, a strong performance in line with forecasts. China CITIC became the second company to make a dual Hong Kong-Shanghai listing behind ICBC.

Other successful listings included the Chinese real estate group Country Garden Holdings, which raised US\$1.9 billion on its April listing, and Chinese shoe retailer Belle International, which raised US\$1.3 billion in May. Shares in Country Garden increased by 37 percent as investors ignored efforts by Mainland state authorities to dampen booming house prices. Shares in Belle International increased by 36 percent on their debut due to strong investor interest in Chinese retail stocks, but even this was short of the expected 40 percent increase predicted by analysts.

### Real estate sector

Despite macro-economic control policies and tax measures such as Land Appreciation Tax, aimed at slowing down the apparently overheating property market in China, investment by Hong Kong-listed property developers in Mainland China is expected to increase in 2007. Kowloon Development Co Limited and Hang Lung Properties Limited have both announced plans to invest in significant Chinese real estate



projects. In addition, Hong Kong-listed Shenzhen Investment Limited announced in May 2007 that it would invest US\$75 million for majority stakes in five other Shenzhen investment companies.

Real Estate Investment Trusts (REITs) fell out of favour with investors in 2006, as trusts attempted to use financial structures to enhance the sales of low-yielding buildings. However, in February 2007, Hong Kong's Regal Hotels International Holdings Limited revived a spin-off of five hotels through a property trust, valued at US\$1.6 billion. The announcement came two months after the failure of a rival IPO, Henderson Land's Sunlight REIT. The company has applied to list the Regal REIT on the Hong Kong Stock Exchange.

Following a failed bid to take Henderson Investment Limited private in 2006, Henderson Land Development announced in March 2007 that it would pay US\$1.5 billion for most of Henderson Investment Limited's assets in an effort to unlock value for investors in the group.

### Telecoms sector

Hong Kong's telecoms market, and in particular its mobile phone market, continues to surprise analysts with its resilience. Penetration rates are in excess of 130 percent, but analysts maintain that Hong Kong offers investment and growth opportunities, especially in high-speed internet and additional mobile services. However, the competitive environment is forcing some operators to take their companies private in order to reduce administrative costs and focus on business development. Hong Kong-based Asia Satellite Telecommunications Holdings Limited announced that its major shareholder would take it private to relieve the administrative burden of the company's dual listing in the US and Hong Kong. In addition, Hong Kong-listed TOM Group, owned by billionaire Li Ka-Shing, announced it would buy out its Beijing-based internet arm TOM Online Inc, for US\$300 million, in response to falling profits resulting from tough new regulations on the Mainland.

Hong Kong-based operators also made moves to buy overseas providers in 2007. In February, First Pacific Co Limited announced that it would bid for Philippine Long Distance Telephone Company (PLDT), matching a bid of US\$520 million made by Singapore-based Parallax Venture Fund, taking First Pacific's effective interest in PLDT from 23 to 29 percent. Also, Connect Holdings announced in January that it would make an offer of US\$140 million for US-listed Pacific Internet. Connect currently owns 100 percent of the Asia Netcom Corporation Limited group.

In one of the largest deals of the year, Vodafone won a bid in March 2007 to buy Hutchison Essar, the Indian arm of Hutchison Telecommunications International Limited (HTIL), itself a subsidiary of Hong Kong conglomerate Hutchison Whampoa. Vodafone has agreed to pay US\$11.1 billion in

cash for a 67 percent stake in Hutchison Essar and will assume US\$2 billion of its net debt. The transaction is Vodafone's largest ever acquisition.

### Other deals of note

Other significant deals announced in the first half of 2007 included the proposed acquisition of a majority stake in Hong Kong-listed Pacific Century Insurance Holdings Limited by Belgian financial service provider Fortis for US\$430 million. Pacific Century Insurance is 45 percent owned by Singapore-based Pacific Century Regional Developments Limited, itself 75 percent owned by Richard Li, the son of Li Ka-Shing.

In February, Hong Kong-based Rotary Vortex made an offer of US\$812 million for China's largest meat processor, Henan Shuanghui Investment and Development Co Limited. In addition, Hong Kong-based Easyknit Enterprises Holdings Limited proposed a merger with US-based mining firm Wits Basin Precious Minerals, Inc, for a consideration of US\$600 million.

Finally, the chairman and chief executive of Techtronic Industries Co Limited made a general offer for the remaining shares they do not already own, via their jointly owned company Cordless Industries Inc. (BVI). The consideration is expected to be US\$814 million.

## Outlook

The Hong Kong government sees the slower than predicted growth rate as being more in line with the mature economy. Official estimates put growth at between 4.5 and 5.5 percent for 2007/8 and unemployment is expected to fall to 3.5 percent by the end of 2007. Given the improvement in the unemployment rates, together with stable interest rates, property firms expect residential house prices to increase by 5 to 10 percent over 2007. Having said this, continuing price increases may act as a disincentive for investors, as they seek to switch to Mainland China and its huge growth potential.

However, Hong Kong faces certain risks. Changes in the Mainland's processing regulations could have a significant impact on Hong Kong manufacturers, particularly in terms of use of technologies, sources of raw materials, production costs and manufacturing locations.

In addition, the EU and US are both reviewing trade protection instruments, in order to improve anti-dumping measures in relation to China. It is expected that protectionism in the US will increase as a result of the Democrat-dominated Congress.

The state of the US economy will also have an effect on Hong Kong exports. Uncertainties over the rate of the expected US slow-down, driven by the US housing market, persist. A faster than expected slowdown could lead to a loss of consumer confidence, with knock-on effects to world financial markets.