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SPOTLIGHT



## Red Flag Over Hong Kong Blue Chips

*Hong Kong investors are edgy on the eve of the July 1 transfer to Chinese rule. Excess meddling could mean economic disaster for the booming metropolis, but a smooth transition could bring a big bounce to Hong Kong's markets in the fall.*

By Mark Thompson

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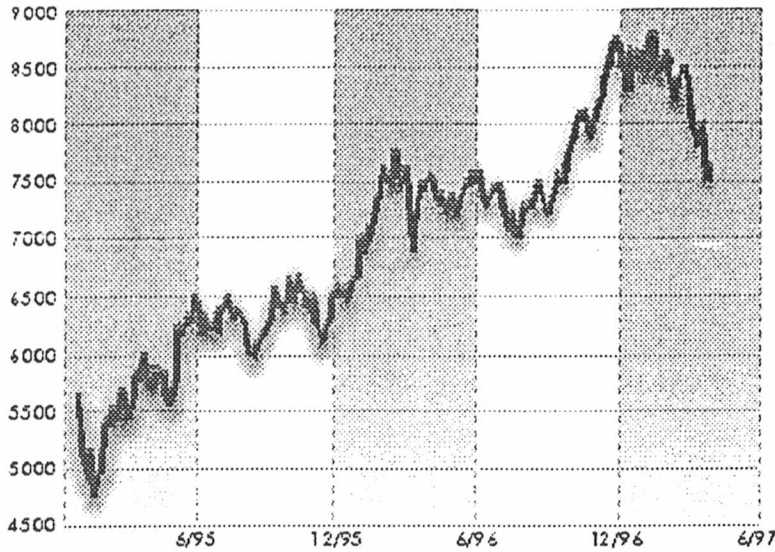
It was the sort of picture mutual fund managers in Hong Kong hope will be worth a few thousand points on the Hang Seng index by the end of the year. Carried in most local newspapers in early April, it showed multibillionaire property tycoon Li Ka-shing casually examining an F-8 jet fighter from the People's Republic of China at an aviation industry show in the Hong Kong convention center.

In less than two months, a contingent of the warplanes will be permanently garrisoned in Hong Kong, signaling the return of the erstwhile British Crown Colony to its mainland Chinese motherland. By all bullish accounts, Li and the rest of the Hong Kong business elite will take the hand-over in stride. That hope is already reflected in the Hang Seng index, which is up more than 80% since its most recent low in 1995. But many fund managers in Hong Kong are predicting further appreciation.

"A lot of attention will be focused on Hong Kong and China, and investors could end up liking what they see," observes Richard Farrell, a manager of the Guinness Flight China and Hong Kong Fund (GFCHX). He calls China "by far the most exciting investment story in Asia today" and Hong Kong the region's "co-star."

**Faith in the Motherland**

Until recently, the optimism investors feel toward the return of Hong Kong to China has resulted in a solid upward trend in the Morgan Stanley Capital International Hong Kong Index.



Source: Morgan Stanley

**Current Favorites**

1 year vs. S&P

Sun Hung Kai

New World Development

Henderson Land

Hongkong Telecom

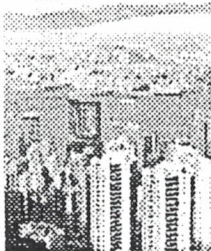
HSBC Holdings

Foreign investors will find that "political concerns about the hand-over are overblown," said Eugene Galbraith, managing director of ABN AMRO HG Asia, who expects "a good rally by the summer." Peter Churhouse, managing director of Morgan Stanley Asia (HK) Ltd., believes the Hang Seng index could double by 1999.

An amazingly smooth handover, to date at least, is just the start of the bullish Hong Kong story. What investors are expected to see after July 1 are much-improved connections between the city's shrewd, well-managed, blue-chip firms and 1.2 billion customers in China. Not only is China still in the early stages of a rebound from a period of austerity that successfully tamed inflation, but experts believe Hong Kong stocks are hardly overvalued by historical measures.

In fact, equities there are now trading at an average price/earnings ratio of around 13; optimistic local fund managers believe the stocks will be rewarded by the fall with an earnings-multiple expansion that will take the average P/E as high as 16.

To be sure, not everyone buys this rosy scenario. The few bearish stock analysts in Hong Kong are more inclined to view the photo of Li -- chairman of vast Cheung Kong Holdings Ltd. -- and the F-8 as evidence of the local economy's subservience to Beijing. The bears believe this can't be good for the free-wheeling city-state's stock market in the long run.



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Though China has promised that the people of Hong Kong can run their internal affairs as they see fit for 50 years, the PRC leadership in Beijing will call the shots on all matters pertaining to national security, a sphere of influence that even the bulls concede China will try to extend as far as it can.

Already there have been signs of possible Chinese government meddling in the economic affairs of Hong Kong. One example: Next Media, a Hong Kong publishing company whose controlling shareholder, Jimmy Lai, has been an outspoken critic of China's rulers. The company had to shelve plans to go public in April when the underwriter – who had agreed to sponsor the offering – mysteriously pulled out at the last minute.

And so-called red chips, Hong Kong-domiciled companies controlled by mainland Chinese interests, have displayed a knack for winning big public works contracts over seemingly more attractive bids from politically less correct firms

Check out Investor's  
exclusive interview with  
Marc Faber

Moreover, Hong Kong's astounding prosperity in recent decades stems largely from an historical accident, the bears assert. The city was practically the only functional bridge between the rest of the world and China when that nation emerged from decades of Maoist isolation, notes super-bear Marc Faber, a Swiss-born investment newsletter publisher and fund manager who has lived in Hong Kong since 1973.

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With more centrally located Chinese cities such as Shanghai fast catching up, the former Drexel Burnham Lambert (HK) Ltd. managing director says he believes Hong Kong will "become again an economically insignificant little city on the coast."

WEBS Hong Kong  
performance vs. the  
S&P

American investors don't have to watch this debate from the sidelines. Most China region funds are waist-deep in Hong Kong blue chips, a number of which are also traded directly on the New York Stock Exchange or over the counter in the United States through American Depository Receipts, or ADRs.

Americans can also invest in Morgan Stanley's Worldwide Equity Benchmark Shares, or WEBS. A unit-investment trust traded on the American Stock Exchange, the WEBS Hong Kong Index (EWK) closely tracks the performance of the Morgan Stanley Capital International Hong Kong Index. That index is somewhat broader in scope than the better-known Hang Seng index, but like the Hong Kong market as a whole, has about 40% of its capitalization in real-estate stocks.

Here is a look at some of Hong Kong's leading publicly traded companies, with an eye toward their prospects for the future in the Hong Kong Special Administrative Region of the PRC.

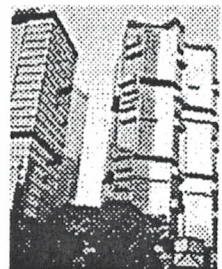


## REAL ESTATE

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Real estate stocks account for a third of the Hong Kong market's capitalization. So it was no surprise that an anonymous letter to a Chinese language newspaper in early April and its immediate aftermath delivered a significant jolt to the stock market. The letter railed against exorbitant housing costs, emphasizing the point with an enclosure: a packet of poison, which the writer threatened to administer to the Hong Kong housing minister if the government didn't act.

Tung Chee-hwa, the shipping tycoon who is designated to be Hong Kong's chief executive after the hand-over, promptly announced measures to curb real estate speculation, starting with a demand that Hong Kong developers put more apartments on the market earlier than they might like. The developers subject to the demand include four of the biggest, most widely held stocks in Hong Kong: Cheung Kong (CHEUY), Sun Hung Kai Properties Ltd. (SUHJY), Henderson Land Ltd. (HLDCY) and New World Development Ltd. (NDVLY). Together they constitute a fifth of the assets of many Hong Kong funds, as well as a big chunk even of some China funds.



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The fortunes of these companies have rested heavily in the past on the sort of news that cheered Cheung Kong's investors a few days before the poisoning threat: There were 77 applicants for every one of the apartments in the most recent batch put up for sale. The average price would bring an apartment with 600 square feet of floor space the equivalent of \$500,000 in the United States.

With real estate prices already so lofty, "comparisons in the next three to five years will be very difficult," concedes Douglas Eu, investment manager of the Jardine Fleming China Region Fund (JFC), who has about 20% of the portfolio in Hong Kong real estate companies. But Eu remains very bullish on the developers anyway. "I buy them despite the fact that they are real estate companies," he says, explaining that they have spent the decade leading up to the handover feverishly diversifying.

In China, they are building everything from luxury housing and shopping malls to roads and ports, with the bankroll to match the demand. "In China you need to bring a lot of money to the table," says Eu. "They have so much capital that the Chinese are willing to give them good terms."

Churchouse, of Morgan Stanley, concurs that the richest developers are the best buys. He says Sun Hung Kai, New World and Henderson Land all should deliver higher-than-market earnings growth this year and should also be key beneficiaries of any shift in assets from U.S. and European markets to Asia.

There is truly a limited supply of housing in the crowded city, with only 19,000 flats released last year in the face of demand for 50,000 to 60,000 new residential units a year. The demand was fueled by an influx of legal immigrants from the mainland. "It's not going to be a straight line. It never is," concludes Churchouse. "But we see very significant upside potential" for

the property companies and the Hong Kong market as a whole.

## TELECOMMUNICATIONS

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China set out a couple years ago to boost the number of phone lines in the country from 3 per 100 to 10 per 100 by the end of this decade. Plug the Chinese population into that equation and you end up with a figure of 60 million new phone lines in five years. It's a figure that has caught the fancy of the world-class telecommunications companies in Hong Kong, where it seems every third pedestrian is hugging a cellular phone to his or her ear.

All things being equal, Hongkong Telecommunications Ltd. (**HKT**), the largest communications company in Hong Kong with the largest market capitalization, might win a big chunk of the China action. It has accumulated cash reserves of \$1.2 billion, but things won't necessarily be equal in the new Hong Kong.

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HKT's problem is that Britain's Cable & Wireless, or C&W, holds a 59% interest in the company, a reminder of the colonialist past that many analysts and fund managers fear could keep the company on the sidelines. That is, unless C&W confirms long-standing rumors and sells part of its stake to a mainland government-owned enterprise. These fears, along with fierce competition in telecommunications and the disappointing performance of other Asian telecom stocks, explain why Hong Kong Telecom under-performed the Hang Seng Index by 28% last year.

That might make it a good buy, a few analysts say, though many fund managers are more comfortable with Hutchison Whampoa Ltd. (**HUWHY**). The company, which is 49% owned by Li Ka-shing, has extensive real estate and hotel holdings in Hong Kong. But like its peers in that sector, it has branched out, with tentacles as far afield as food processing, retailing, shipping, telecommunications and cellular phone service. Perhaps most reassuring of all, the company has extensive joint-venture ties with Chinese government-controlled entities, including container-shipping terminals in southern China and a satellite television enterprise.

## BANKING

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The most impressive multinational corporation in Hong Kong is the parent company of the city's flagship Hong Kong Shanghai Bank, HSBC Holdings Ltd. (**HSBHY**) The company is the top stock in Fidelity's Hong Kong and China Fund (**FHKCX**) and in Templeton's China World (**TCH**) and Dragon (**TDF**) funds.

Its Hong Kong operation is heavily dependent on the mortgage business, which the bulls will tell you is healthy. But the company's holdings range far afield from Hong Kong, with asset management, securities trading, insurance, leasing and shipping businesses conducted in offices in 71 countries. The company's main U.S. holding is the Buffalo, N.Y.-based Marine Midland Bank.



Bin Shi, the Shanghai-born portfolio manager of U.S. Global Investor Inc.'s China Region Opportunity Fund (USCOX), one of the best-performing Asia-Pacific funds recently, is rare among his peers in having a higher percentage of his fund's assets in China stocks (more than 40%) than in Hong Kong companies (35%). Still, HSBC is his top stock.

At this point "it is still very much undervalued," Shi says. Moreover, HSBC has broad exposure in booming emerging markets, which account for about 30% of its earnings, considerably higher than at any other world-class bank. Yet the stock has "excellent liquidity," Shi says.

## DIRECT CHINA PLAYS

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Despite their names, a number of China fund managers actually give China stocks quite a wide berth. There's a virtual laundry list of classes of Chinese shares available to foreign investors: B shares traded in Shanghai and Shenzhen, H shares traded in Hong Kong and N shares traded in New York. Virginia Dutkin, manager of investor relations at Fidelity Investments in Hong Kong, said her firm believes Hong Kong stocks beat them all "hands down." They have "better management, better disclosure, better liquidity and a better track record." Besides, she adds, they're "all China plays in one way or another."

For those wishing to invest directly in China, a handful of Chinese companies have listed so-called N shares on the New York Stock Exchange. The best of them include Huaneng Power International Inc. (HNP), and Guangshen Railways Inc. (GSH), operator of high-speed train lines between Hong Kong and the booming southern Chinese city of Guangzhou.

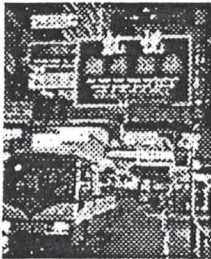
But about the best that can be said for these Chinese equities is that their share prices haven't collapsed, a fate that befell many issues on China's exchanges after a series of scandals of insider trading and questionable use of funds.

The U.S. market "doesn't understand N shares very well," observes Shi. "Trading is not very active. They don't move, even after the company announces favorable news."

So the growing consensus among Chinese companies is that despite the prestige and riches of the U.S. stock market, the best way for them to raise foreign capital is with a listing in Hong Kong.

Faber, the rare bear, sees this as a sign of bad times ahead for the city's stock market, as a steady flood of new issues soaks up limited capital. But the bulls believe the trend — strengthening the city's key role as China's Wall Street — bodes well for the Hong Kong stock market.

It certainly ensures that the People's Liberation Army will have a different attitude toward foreign capital than the Chinese army that rolled into Shanghai in 1949, expropriating everything in sight. The army and other PRC government



Chinese government officials are expected to do everything in their power to keep the bull market alive and well.

entities have a big stake in many of the Chinese enterprises that are hoping to raise capital in the Hong Kong market. Chinese government officials are expected to do everything in their power to keep the bull market alive and well.

Photos courtesy of Julie Wong



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