

Rebalancing Hong Kong's management benchmark

The Hong Kong Stars Index has undergone a re-weighting that has led to the inclusion of Melco Crown and Prudential, while China Life and Smartone have been dropped. Richard Morrow investigates why.

The fortunes of companies can wax or wane, depending upon both market circumstance and the consequences of their own actions. A combination of both factors has led to the inclusion of Macau-based gaming company Melco Crown and insurer Prudential at the expense of China Life and Smartone in the M&E BDO *Asiamoney* Hong Kong Stars Index.

The Stars index is based upon 21 Hong Kong listed stocks from 13 different industries, with 18 of the companies being Hong Kong-based and three headquartered in China. The index measures the management processes, transparency and financial strength in each of the included companies. Its purpose is to combine a selection of well-managed and financially successful companies, which are as a result more likely to see their stock valuations outperform.

Twice a year, M&E and BDO decide on whether other companies have improved in their processes to merit inclusion into the index. At the end of this year's analysis, two companies were deemed worthy of joining, while two underperforming existing index members were dropped.

Index newcomer Prudential makes for an obvious new participant, given that it immediately ranks as the index's eighth strongest company upon its accession, based upon a management value score of 56.5 out of 100. Melco Crown enters at the lower end of the index spectrum at 20th place, with a management value score of 44.5.

The management value score is the culmination of over 300 data points, and a score closer to 100 denotes companies with better information disclosure, management processes and risk management considerations.

NEW ENTRANTS EXPLAINED

The inclusion of new companies is down to the work of M&E and BDO in seeking out other candidates for inclusion.

"M&E and BDO regularly monitor the management performance of existing Index components and search the market for worthy additions," says Bill Cox, founder of M&E. "We want to include companies with strong compliance, good management practices and a consistently strong financial performance while improving the diversification of the index. That sometimes requires removing some previous participants and replacing them with other, better-performing companies."

This can be a complex process, as M&E adapts the data points that it uses to assess each sector. Cox notes that risk management, for example, is more important in the insurance sector than it is in a hotel company.

He adds that Prudential was included into the index after its strength became evident during his research into the best Asian insurance companies for *Asiamoney's* December/January edition. It ranked second among

10 leading insurers at the time, whereas China Life sat at ninth place with a management value score of 41.1.

"If you take three or four insurance companies and assess them you might not see the complete range of strengths and weaknesses in the sector. But comparing 10 companies offers far more insight," Cox says.

He adds that Prudential boasts a mixture of a broad product base and presence through Asia-Pacific, together with return on assets of 3.52%, good for insurance companies, and a strong, UK-style governance structure.

Melco Crown is the beneficiary of another surge of capital in China's economy into the gaming sector. Casinos in Macau took in HK\$45bn (\$5.77bn) more in 2013 than in the previous year, and account for seven times the annual revenues of the Las Vegas strip. Casinos have spread beyond Macau too, into Singapore, the Philippines and Australia.

Melco Crown is one of the leading players, within the Macau gaming space and increasingly beyond. It has joint ventures in Australia, the Philippines and Macau, and Cox notes that this nets it some diversification benefit.

Additionally, the company's shares are listed on Nasdaq as well as Hong Kong, meaning that Melco Crown has to live up to the Sarbanes Oxley information disclosure rules, which are far more rigorous than those in Hong Kong.

"Melco was a client of BDO's a few years ago and we helped with its compliance and readiness; we can see it has potential," adds Vivian Chow, manager of risk advisory services at BDO. "It's listing on Nasdaq means its transparency in these areas is top notch versus the other Macau casinos that are listed in Hong Kong."

Melco's relative transparency benefits its management value score too. Plus the company recently declared a new corporate social responsibility programme.

Why put them in the index now? Cox says it's in large part to do with the fact it was the right time.

"Melco wasn't even listed in Hong Kong when we started compiling the Hong Kong Stars index," he says. "But the US SEC's (Securities Exchange Commission) reporting requirement to file a 20F form is probably the best annual form in terms of data, so Melco's disclosure standard is very high."

THE LOSERS

Prudential's replacement of China Life might seem surprising, given that the Chinese insurance industry is rapidly expanding at the behest of Beijing. However, part of this push has been to let foreign insurers enter the onshore market via joint ventures, while the Chinese Insurance Regulation Commission has been increasing its supervision of the industry.

"This is all ultimately good news for China's insurance companies and should mean their management value ultimately improves, but in the short term it could lead to some confusion and volatility," says Benson Ngan, senior associate at BDO. "China Life may go through a rollercoaster ride in the coming years, and it could well have become one of the riskiest companies in our index."

The decision to remove Smartone was similarly down to a realisation that the company's market

MANAGEMENT VALUES OF THE TOP 5 COMPANIES IN THE HONG KONG STARS INDEX

Company	M&E management value factor	Market cap 31 Jan 2014 (HK\$)	Management value (HK\$)
1 Standard Chartered	0.649	400,519,897,470	259,937,416,458
2 CLP Power	0.638	148,049,999,547	94,455,899,711
3 HKEx	0.600	141,591,990,223	84,955,194,134
4 Power Assets	0.598	124,427,452,800	74,407,616,774
5 HSBC	0.592	1,524,332,690,775	902,404,952,939

SOURCE: M&E; BDO

position has deteriorated since the index was originally conceived and put together.

"Smartone's sales increased over double between the 2011 and 2012 financial years but the market competitiveness is rising and we don't think Smartone will do as well as some other mobile companies in Hong Kong," says Ngan.

He notes that China Mobile has made strides at the expense of Smartone, with the Chinese company having used its exclusive distribution of the iPhone in mainland China to build its market position there and then invest into other territories such as Hong Kong.

"China Mobile has a huge customer base in China, which helps to mitigate its risks. Successful telecom businesses come down to its top-line [revenues] and the cost of sales, which benefits it. In contrast Smartone has very limited customer sales and if the cost of sales rises it could prove very damaging for its business. And, somewhat worryingly, Smartone has experienced several recent complaints in the media about its service."

LEVEL OF RISK

Cox notes that Power Assets tends to be the lowest risk when it comes to the financials and topline costs of the stocks in the index. In large part this is down to the steadiness of its revenue and income streams of the asset, along with a generally stable client base.

"Clients with their own secure situation and client base would always be the least risky and volatile, whereas companies that are high growth or have large amounts of debt have among the highest risk," he says.

Melco Crown is a good example of the latter, notes Ngan. It has seen its revenues turn around from a topline loss in 2010 to profit in 2012 as its investments into gaming began to pan out, and its revenues and profits rose even more during 2013. Added to this, it has the high transparency factor of its US listing.

However, "the reason it's the bottom of the chart is because the company has had quite volatile revenue growth, and it's not entirely stable in terms of its revenue outlook".

Cathay Pacific is another name that has seen a sizeable risk attached to it, in large part because it has been affected by its exposure to rising oil prices, which it failed to manage as well as some rivals, along with rising competition from regional and budget airlines.

Computer maker Lenovo, meanwhile, is considered relatively risky because it has spent a great deal on M&A investments, including IBM's x86 server business for \$2.3bn and then Motorola's mobile handset business for \$2.91bn, respectively. The acquisitions have left it with a much bigger but also more indebted business.

"The return on assets and return on equity of Lenovo are its biggest risk factors," says Ngan.

IMPROVING SCORES

The good news for most of the companies in the Stars index is that their scores are generally rising. Cox says this is in large part a reflection of the fact that when the index was being conceived in 2011-2012, market risks stood a great deal higher, leaving sizeable concerns when it came to the potential management of debt or foreign currency exposures, for example.

PRUDENTIAL AND MELCO'S MANAGEMENT STRENGTHS

New component company	Total score	Compliance score	Performance score	Risk score	Comments (strengths)
Melco Crown	0.445	0.6	0.5917	0.5722	Compliance, rapid growth in recent years
Prudential	0.565	0.68	0.684	0.34	Compliance, cash & cash equivalents, revenues, management of interest revenue

SOURCE: M&E: BDO

"Since the global financial crisis there has been huge volatility in the debt of debt. However market conditions have eased since and as a result risk scores of these companies are continuing to drop, meaning that their overall management value scores are rising on average," Cox says.

He adds that a number of companies have made investments earlier in their business cycles that initially increased their risk but have gradually generated cash flows, adding to their top line and ultimately bottom line profitability, which has also helped improve their scores.

Going forward, Cox believes further re-balancings of the index will lead to even more new entrants as more companies see their post-global financial crisis performance improve and management quality rise.

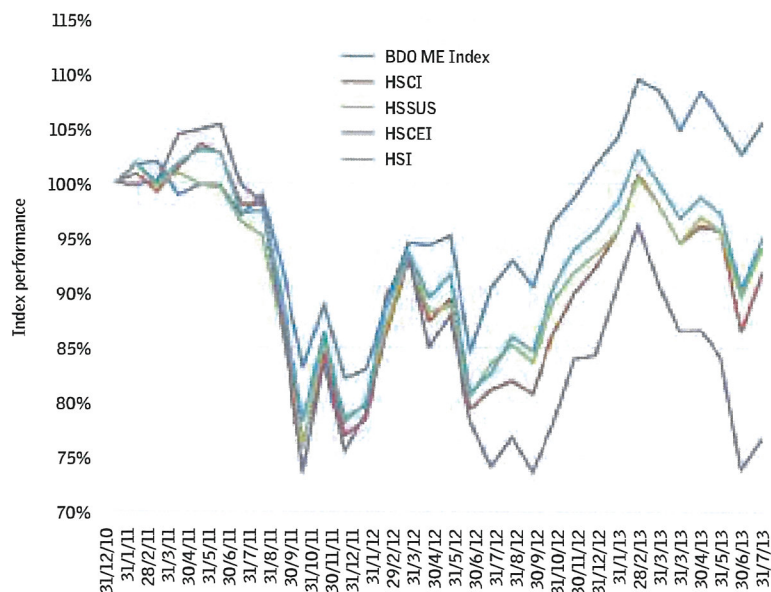
Lastly, he anticipates Hong Kong companies continuing to improve on their transparency, either voluntarily or as a result of greater demands from the exchange.

"Following any crisis there tends to be a demand for higher transparency and stronger listing governance requirements. I hope to see the level of information coming out of Hong Kong-listed companies continuing to improve over the next year or two," he says.

If Cox is right, the Stars index could see more new entrants in the coming year or two. Companies eager to burnish their credentials for integrity and transparency would do well to volunteer more information about themselves.

Good times come and go, but investors will always appreciate and favour companies that don't act like they have a lot to hide. ▲

PERFORMANCE OF HONG KONG STARS INDEX VERSUS OTHER HONG KONG BENCHMARK INDEXES



SOURCE: M&E: BDO