

# Tracking Hong Kong's top companies

**Almost one year after its launch, the Stars Index has outperformed the Hang Seng Index and is being re-weighted to include two new companies that meet the grade for good management. Richard Morrow reports.**

Assessing the benefit that good management and strong information disclosure can offer a company is no easy task. But almost a year after initiating the M&E BDO *Asiamoney* Hong Kong Stars Index (Stars Index), it's becoming increasingly apparent that companies capable of exhibiting such qualities do enjoy better valuations and stock performance.

In November 2013 *Asiamoney* combined with management consulting company M&E and accounting company BDO to choose and monitor a set of 18 select Hong Kong-listed companies. M&E identified these businesses by assessing them based upon a selection of publicly-available information that helped to pinpoint the strength of their management processes and their commitment to disclosure on their workings and financial performance. They were then weighted according to their respective market capitalisations, and placed into the index.

The idea was to demonstrate that companies committed to greater scrutiny of their operations, had detailed business plans and were prepared to hold themselves to higher standards, would over time outperform rivals less willing to go under the investor microscope.

Ten months later the Stars Index seems to verify this hypothesis. Since the beginning of 2011 the 17 companies in question have indeed performed better than the Hang Seng benchmark (HIS) index for Hong Kong.

The index is also growing. Once a year M&E returns to the index to consider its weightings, verify that the existing members still meet its exacting information criteria and consider whether other companies should be included. After some deliberation and information gathering from BDO, M&E decided to include three new companies to the index: AIA Group, Hong Kong and Shanghai Hotels (HKSH), and The Link Real Estate Investment Trust (Link Reit).

Bill Cox, founder of M&E, notes that both AIA and HKSH are well-run companies that have been among the top-performing stocks on the Hong Kong stock exchange. More importantly for the purposes of the index, they also demonstrate strong management performance and business processes.

"According to the M&E rating method these three companies have demonstrated solid and strong performance in their management and business processes quality," he says. "We wanted to include Link because it's one of the strongest performing Reits in the whole of Asia, and it enjoys relatively good management. Similarly, AIA is well-run and offers extra exposure to the insurance sector in addition to [existing index company] Manulife, while Hong Kong Shanghai Hotels has been doing very well in terms of performance too."

## RELATIVE PERFORMANCE

The performance of the Stars index is notable, when compared to Hong Kong's HSI benchmark.

The Stars index uses the beginning of 2011 as its analytical beginning. Judged since that date and until August this year, the index has notching up a performance rate 20 percentage points higher than the Hong Kong HSI benchmark.

It's not a bad level of outperformance at all, although on an absolute basis the index is still only 5% above where it stood two and a half years ago. Cox is first to admit that the level of outperformance is notable, but not yet stellar.

"If you notice it took us a year and a half to leave other indices behind. Good management can take some time to be amply demonstrated, but we have found in Brazil that the longer the time frame the better the outperformance."

He notes that the Brazil version of the Stars index has outperformed the underlying Ibovespa Brasil Sao Paulo Stock

Exchange Index by 66 percentage points for the period of December 2009 to August 2013. However it could take a little longer to realise such divergence in Asia, in large part because the level of information disclosure here is not as good.

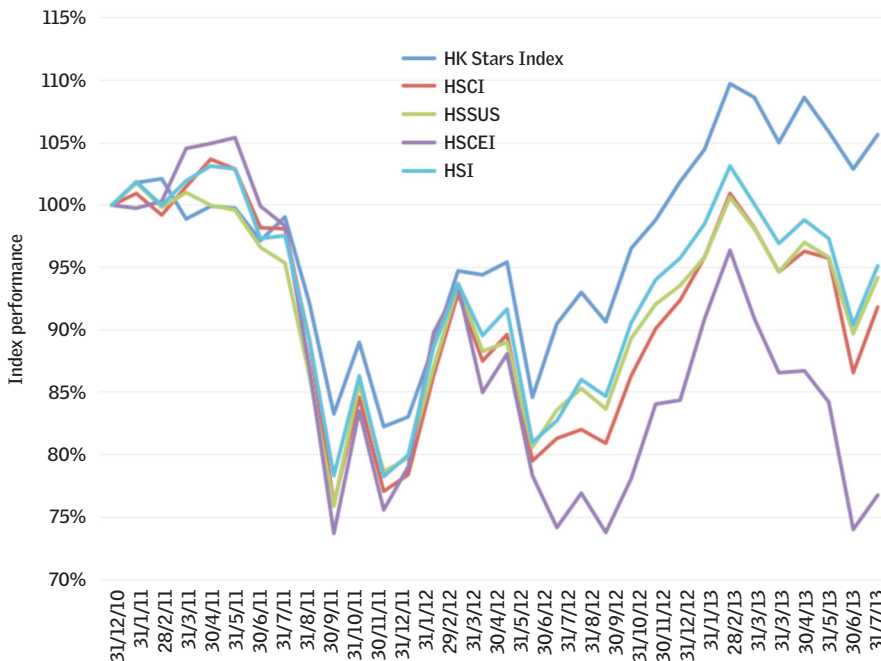
"Hong Kong reveals less information on the good management quality of its companies, so there is less of an impact on the equity prices of the companies," Cox says. "The relative lack of

## MANAGEMENT VALUES OF THE TOP 10 COMPANIES IN THE HONG KONG STARS INDEX

Company	M&E management value factor	Market cap 31 July 2013 (HK\$)	Management value (HK\$)
1 Standard Chartered	0.649	430,186,791,723.00	279,357,105,130.32
2 CLP Power	0.638	162,450,779,361.00	103,645,289,633.87
3 HKEX	0.600	139,054,884,261.00	83,366,914,599.10
4 Power Assets	0.598	148,651,327,458.00	88,921,249,407.71
5 HSBC	0.592	1,624,663,643,746.00	962,491,132,807.59
6 Swire	0.591	136,894,204,292.00	80,876,178,765.72
7 Henderson	0.575	129,883,999,545.00	74,671,375,196.46
8 The Link*	0.552	87,698,258,839.95	48,451,349,459.33
9 HSH*	0.547	17,545,630,945.00	9,597,626,753.01
10 Wharf Holdings	0.529	202,234,299,077.00	106,909,788,730.97

\* NEW HK STARS INDEX COMPONENTS EFFECTIVE AUG 2013. SOURCE: M&E

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



SOURCE: M&E

best company in the index, with a score of 0.649. It is followed by CLP Power at 0.638 and then HKEx, the company that runs the Hong Kong bourse, at 0.6.

Interestingly, both the Link Reit and HKSH rank among the top 10 stocks in the index, according to their management value factor, or a single score that represents their level of management quality and business processes. A score of over 0.5 reflects relatively good processes, and The Link scored 0.552 while HKSH was slightly lower, at 0.547. The average score for the index is 0.524.

Break down some of the individual areas a little further and some variance emerges. For example HSBC only ranked 5th in the index, yet it enjoyed the highest compliance rating with 78.4%. HKEx followed at 77.5% and Chinese computer manufacturer

information disclosure here in Hong Kong means that the impact of good or bad management on the respective performance of stocks is not as strong. However the impact is still notable and I'm confident that the Stars index will continue to do better than the HSI over time."

**TOP PERFORMERS**

One of the reasons for creating this index is to reveal the importance of information disclosure on the stock price and hence market valuation of genuinely well-run companies.

Each company in the Stars Index is assigned one single numerical ranking between zero and one, with one representing perfect management and business processes.

In practice Asia's companies do not rank anywhere close to the ideal rank, in large part because information disclosure levels in Hong Kong are a great deal lower than in some other markets, such as the US, Europe or Brazil, the latter of which M&E also covers via an index.

Nevertheless, as of August some corporates still stood out for their relative quality. Standard Chartered currently stands as the

trader Lenovo, MTR Corp. and Standard Chartered were joint-third with 76.6%.

According to M&E, each company bears its own relative risks too, which can greatly impact the performance of their respective share valuations. Lenovo is deemed riskiest with a risk score of 79%, due to its debt position and cost of financing this burden. Manulife followed due to concerns over its productivity and net income predictability.

These risk scores do not necessarily indicate major problems with these companies, but variables in their business models that add a greater chance of negatively impacting their share performance.

**SHINING A LIGHT**

For the coming year the biggest focus of Cox at M&E and BDO will be to bang the drum for more information disclosure from Hong Kong-listed companies, whether they be included on the list or not.

"What we think the index performance demonstrates is that companies that are willing to be held to scrutiny, are open about their business models, their risks and their processes to overcome them, will be better rewarded by shareholders," says Cox. "I continue to hope that this message is one that the companies in Asia understand, and that this index goes some way to making this point clear."

He hopes that more companies understand the index's message that transparency, effective management and good processes pays. In times of turbulence and uncertainty, companies that can demonstrate sound leadership, good management principles and transparency will inevitably be seen as the safest bets.

Hopefully more companies will take this heartening message on board. ▲

**THE TOP FIVE RISKIEST COMPANIES IN THE HONG KONG STARS INDEX**

Company	Risk score (volatility of performance)	Riskiest areas
1 Lenovo	79.0%	Interest expense, debt position
2 Manulife	77.0%	Net income, productivity
3 Cathay Pacific	56.0%	Dividends
4 The Link	51.0%	Financing costs
5 Wharf Holdings	50.0%	Financing costs

SOURCE: M&E