

Strategy Report

HSI enhancement preview

The HSI Company will announce results of index review after market close on 26 Feb 2021. In addition to potential changes to HSI & HSCEI constituents, this review will also determine changes in HSCI constituents and in turn eligible Southbound stocks. Consultation conclusions on HSI enhancements will probably be announced too, potentially increasing the no. of HSI stocks to 80, among other changes. The enhancements may be implemented next quarter.

- **Potential new HSI constituents:** We believe **Haidilao (6862 HK)** is the most likely to be included into the HSI, while **Ali Health (241 HK)** and **Hanson Pharma (3692 HK)** are dark horses. Although some other stocks such as **JD Health (6618 HK)** have larger market caps, they do not meet listing history requirement.
- **New Southbound eligible stocks:** This quarterly review is also a half-yearly review on HSCI. As inclusion in HSCI is a prerequisite to become Southbound eligible stocks (except A-H dual-listed stocks), this review warrants extra attention given the strong inflows via Southbound trading YTD. We listed 20 stocks which could become eligible.
- **HSI enhancement 1: Expand industrial representation.** We expect: 1) Financials' weighting to decrease further with one or more existing constituents to be removed, and 2) IT, Consumer and Healthcare to enjoy meaningful increases in sector weighting and number of constituents.
- **Enhancement 2: Increase the number of constituents to 65-80.** We expect the majority of the extra 13-28 stocks to come from non-Financial sectors, in particular IT, Consumer and Healthcare.
- **Enhancement 3: Remove the minimum listing history requirement.** We believe this will undoubtedly speed up the inclusion of newly-listed mega caps, which will probably be up-and-coming tech companies.
- **Enhancement 4: Maintain a certain number of constituents classified as HK Companies.** Despite this enhancement, we believe HK companies' representation in the HSI in terms of total weighting would continue to be diluted.
- **Enhancement 5: Unify the weighting cap of individual constituent at 8%.**
- **Expected Winners:** 1) IT, Consumer, Healthcare sectors, which should have more stocks to be included into the HSI; 2) **Alibaba (9988 HK)** and **Meituan (3690 HK)**, and future WVR / secondary-listed mega-cap, which would see their weighting raised from 5% to 8%.
- **Expected Losers:** 1) Financial and Property stocks, as the weightings will be diluted more quickly, and some of the constituents may be removed from the HSI; 2) **Tencent (700 HK)**, **AIA (1299 HK)**, as their weighting cap will be lowered from 10% to 8%.

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Market Data

Hang Seng Index	30,633
52-week High / Low	31,183/21,139
3-month avg. daily t/o	HK\$194.2bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	4.0%	2.0%
3-month	15.7%	11.7%
6-month	22.0%	16.6%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

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What are the focuses in this upcoming index review?

- 1) **Potential changes in constituent stocks** of the Hang Seng Index (HSI) and the Hang Seng China Enterprises Index (HSCEI).
- 2) Changes in the Hang Seng Composite Index (HSCI) constituent stocks, which would determine **changes in eligible Southbound stocks** under Stock Connect.
- 3) **Consultation conclusions on enhancing the HSI.**

Which stocks will be included into / removed from the HSI?

In assessing potential HSI constituents, the HSI Company considers 1) Market value (MV) and turnover rank, 2) sector representation, and 3) financial performance. Potential constituents must also meet the listing history requirement shown in Fig. 2.

Figure 1: Top 10 non-HSI stocks by market value

Company	Ticker	Market Value* (HK\$ bn)	6-m avg. daily Turnover (HK\$ mn)
JD Health	6618 HK	478	1,679
NetEase	9999 HK	291	733
Smooore	6969 HK	252	1,078
Ali Health	241 HK	242	849
Longfor Group	960 HK	240	329
China Evergrande	3333 HK	224	385
Haidilao	6862 HK	220	502
Nongfu Spring	9633 HK	211	529
Hanson Pharma	3692 HK	196	172
JD	9618 HK	195	1,944

Source: Bloomberg, CMBIS; exclude IPOs in 2021

*Month-end average from Jan-Dec 2020; for secondary-listed stocks, only showing HK-registered shares

Figure 2: Listing history requirement for HSI candidates

MV Rank by Review Cut-off Date	Minimum Listing History
Top 5	3 Months
6 – 15	6 Months
16 – 20	12 Months
21 – 25	18 Months
Below 25	24 Months

Note: MV Rank refers to average of month-end MVs for the past 12 months

Source: HSI Company

Among the top non-HSI stocks by market value listed in Fig. 1, JD Health (6618 HK), Netease (9999 HK), Smooore (6969 HK), Nongfu Spring (9633 HK) and JD (9618 HK) DO NOT meet listing history requirement. Longfor (960 HK) and Evergrande (3333 HK) are unlikely to be added since property sector is already well-represented.

We believe **Haidilao (6862 HK)** is the most likely to be included into the HSI, while **Ali Health (241 HK)** and **Hanson Pharma (3692 HK)** are dark horses. Ali Health's short history of positive profits (i.e. less sound financial performance) and Hanson's relatively thin turnover make them not as likely to be included as Haidilao, in our view.

If there is any removal from the HSI, then **Hang Lung Properties (101 HK)** is the most likely one, in our view, given that it ranks among the lowest in terms of both market cap and turnover.

Which stocks will become eligible Southbound stocks?

This quarterly index review is also a half-yearly index review on the Hang Seng Composite Index (HSCI). That will determine most of the changes in Southbound eligible stocks too, because to be eligible for Southbound trading, a stock has to be:

1. **Constituent of the HSCI, with 12-month average market cap over HK\$5 bn, or**
2. H-shares of A-H dual listed companies.

In Fig. 3, we listed some stocks that may be included into the HSCI, and thereby become eligible Southbound stocks effective from 15 Mar 2021.

Figure 3: Potential ADDITIONS into Southbound trading

Company	Ticker	Sector	Market Cap (HK\$ mn)*
Evergrande Property Services	6666 HK	Property management	96,649
CR Mixc Lifestyle Services	1209 HK	Property management	82,056
Sunac Services	1516 HK	Property management	44,538
Shimao Services	873 HK	Property management	33,350
S-Enjoy Service #	1755 HK	Property management	15,403
KWG Living	3913 HK	Property management	12,362
Jinke Services	9666 HK	Property management	8,002
Simcere Pharma	2096 HK	Healthcare	24,146
Everest Medicines - B	1952 HK	Healthcare	18,260
Ocumension - B	1477 HK	Healthcare	14,638
Antegene - B	6996 HK	Healthcare	11,118
CStone Pharma - B	2616 HK	Healthcare	10,478
RemeGen - B	9995 HK	Healthcare	9,362
JHBP - B	6998 HK	Healthcare	9,204
Henlius Biotech - B	2696 HK	Healthcare	7,405
Pop Mart	9992 HK	Consumer discretionary	114,048
Blue Moon	6993 HK	Consumer staples	87,701
HKTv	1137 HK	Consumer staples	6,890
Joy Spreader	6988 HK	Internet	7,767
Cathay Edu	1981 HK	Education	9,041

Source: Bloomberg, CMBIS

*Month-end average from Jan-Dec 2020

S-Enjoy Service may be included into HSCI only if the HSI Company believes there is no longer an issue of high concentration of shareholding (HKSF warned of this issue on 2 Apr 2019)

Figure 4: Potential REMOVALS from Southbound trading

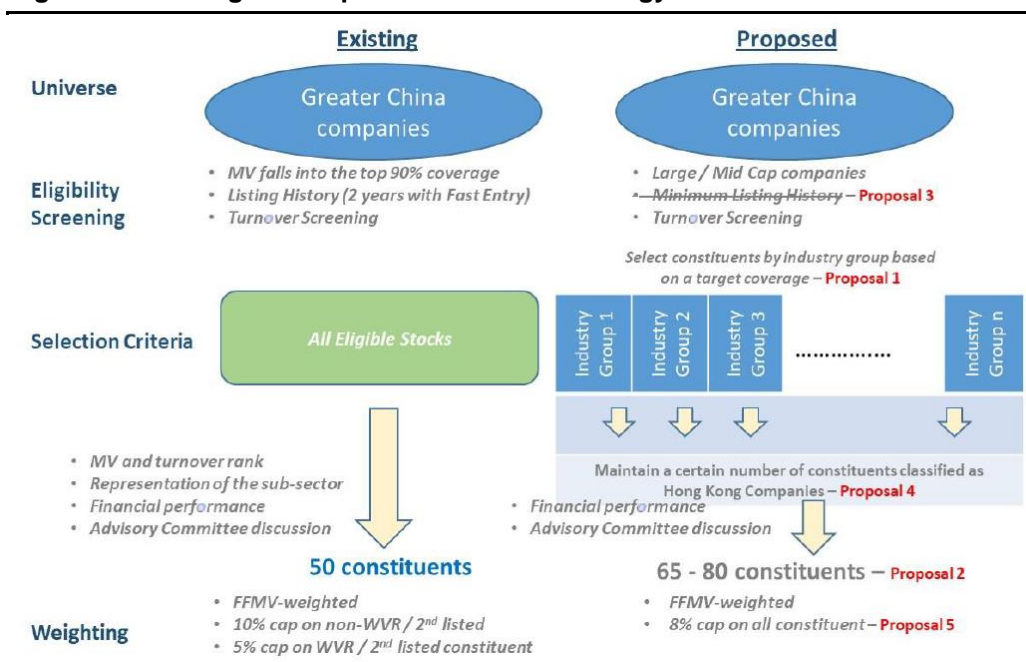
Company	Ticker	Sector	Market Cap (HK\$ mn)*
Minsheng Edu	1569 HK	Education	4,734
China Aircraft Leasing	1848 HK	Leasing	4,729
Shineway Pharm	2877 HK	Healthcare	4,557
IMAX CHINA	1970 HK	Consumer discretionary	4,364
JNBY	3306 HK	Consumer discretionary	4,139
Kasen	496 HK	Industrial	1,784

Source: Bloomberg, CMBIS

* Month-end average from Jan-Dec 2020

What are the proposed enhancements of the HSI and their impact?

On 22 Dec 2020, the HSI Company issued a Consultation Paper, proposing to enhance the HSI in five ways. They intend to announce the consultation conclusions in Feb 2021, probably on 26 Feb in a separate note from the quarterly index review.

Figure 5: Existing vs. Proposed Index Methodology of the HSI

Source: HSI Company

■ Enhancement 1: Expansion in industrial representation

By selecting constituents by industry group (e.g. consolidate the current 12 industries into 6 groups) and based on a target coverage for each industry group.

CMBI comment: the rationale of this change, according to HSI Company, is to ensure a more balanced representation for the major industries, and alleviate the weight concentration issue for certain industries (i.e. Financials which currently has 41% weight).

Expect: 1) Financials' weighting to decrease further with one or more existing constituents to be removed, and 2) IT, Consumer and Healthcare to enjoy meaningful increases in sector weighting and number of constituents.

■ **Enhancement 2: Enlargement in market coverage**

By **increasing the number of constituents to 65-80** (from 52 currently).

CMBI comment: The rationale is to achieve a more balanced and diversified industry representation. Since the HSI is now overly dominated by Financials, **we expect the majority of the extra 13-28 stocks to come from non-Financial sectors, in particular IT, Consumer and Healthcare.**

■ **Enhancement 3: Prompt inclusion of sizeable new listings**

By **removing the minimum listing history requirement** for eligible candidates.

CMBI comment: Currently, a security must have a minimum listing history of 3 months - 24 months (the larger market value, the short history required; see Fig. 2) to be considered for inclusion into the HSI. This enhancement will undoubtedly **speed up the inclusion of newly-listed mega caps, which will probably be up-and-coming tech companies.**

■ **Enhancement 4: Representation of Hong Kong companies to remain intact**

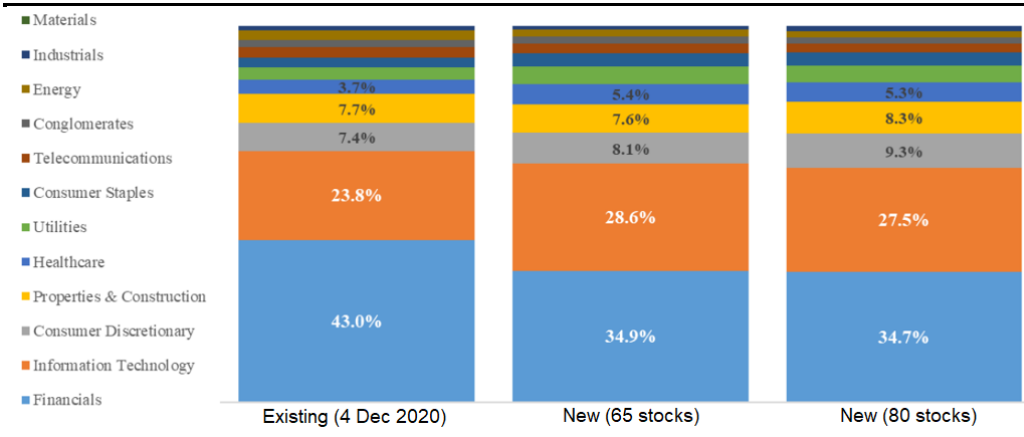
By **maintaining a certain number of constituents classified as HK Companies** (around 25 under the current situation).

CMBI comment: Currently, there are 24 constituents classified as HK companies, taking up 42% weight. Since there is no minimum weighting on individual constituent, merely maintaining a certain number of HK companies in the HSI won't make much difference. After all, putting AIA, HSBC and HKEX aside, each HK constituent has only 0.9% weight on average, and some of them (Wuxi Bio, WH Group, Budweiser APAC, Sands China, Galaxy Ent) are not even normally considered as HK company in terms of source of revenue. In short, **HK companies' representation in the HSI in terms of total weighting would continue to be diluted despite this enhancement.**

■ **Enhancement 5: Enrichment in constituent weighting distribution**

By unifying the weighting cap of individual constituent at 8%.

CMBI comment: Currently, the weighting cap is 10%, while that of WVR and/or secondary-listed constituents is 5%. **Tencent (700 HK)** and **AIA (1299 HK)**, the only two stocks capped at 10%, will see their weight down to 8%. On the other hand, **Alibaba (9988 HK)** and **Meituan (3690 HK)**, the two WVR stocks capped at 5%, will enjoy a lift in weight to 8%.

Figure 6: Existing vs. Simulated HSI sector weightings

Source: HSI Company, CMBIS

Expected Winners:

1. **IT, Consumer, Healthcare sectors**, which should have more stocks to be included into the HSI, boosting their sector weightings.
2. **Alibaba (9988 HK)** and **Meituan (3690 HK)**, as weighting cap on WVR and/or secondary-listed stocks will be raised from 5% to 8%. **Xiaomi (1810 HK)**, another WVR constituent with a 4% weight currently, may benefit in future if its market cap expands much further. Other non-constituent (e.g. **NetEase (9999 HK)**) or future WVR and/or secondary-listed mega-caps might benefit from this enhancement too in the long run.

Expected Losers:

1. **Tencent (700 HK), AIA (1299 HK)**, as their weighting cap will be lowered from 10% to 8%.
2. **Financial and Property stocks**, as the weightings will be diluted more quickly as more new constituents will be included faster post-enhancement, and some of the constituents from these sectors may even be removed from the HSI.

When will the enhancements be implemented?

How many of the above-mentioned enhancements will be implemented remains to be seen in the consultation conclusions. While the HSI has not specified a date, we believe **any enhancement changes to be announced in Feb 2021 will be implemented starting from the May 2021 quarterly index review** (effective in early Jun 2020), assuming the same practice as in the previous consultation.

In the consultation on Eligibility of Weighted Voting Right Companies (“WVRs”) and Secondary-listed Companies for inclusion in the HSI and HSCEI, consultation conclusions were announced in May 2020, and changes were implemented starting from the August 2020 index review.

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