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Is Hong Kong Digging Too Deep?

This memo provides a review of certain aspects of Chapter 18 of the Listing Rules of the Stock Exchange of Hong Kong Limited and the future for mineral companies wishing to list in Hong Kong. China's insatiable appetite for natural resources and the international investor base of Hong Kong provides a happy marriage whilst liquidity in Hong Kong and exposure to the Asian investor base continues to lure overseas issuers. We can look forward to more overseas issuers braving the stormy capital markets and hopefully watch the floodgates open when markets recover from the recent downturn in sentiment.

It was over a year ago (June 2010) that the Stock Exchange of Hong Kong Limited (the "Exchange") unveiled its new rules for mining and oil and gas companies. The market welcomed the revised rules with open arms. Prior to implementation, the CEO and founder of Ivanhoe Mines, Mr. Robert Friedland, tipped Hong Kong to become the "largest mining finance market in the world". A desirable goal indeed!

It remains to be seen whether Hong Kong is on track to achieve this goal. Key to this is the nature of mineral companies that are able to list in Hong Kong. Experienced market practitioners in Hong Kong supported the conservative approach that pure exploration companies should not be eligible for listing. The Listing Rules were therefore delicately crafted to ensure that mineral companies have made a meaningful discovery before they are eligible to list. Companies are also required to ensure that they have a plan to proceed to production. Resources and reserves figures must be presented in accordance with well accepted international standards and commented on by technical experts under the relevant code.

International Standards

The Exchange endorsed widely recognised international standards, requiring companies reporting mineral resources and reserves under Chinese or Russian standards to provide reconciliation to reporting standards widely recognised in Australia, Canada or South Africa. This may have seemed strange to industry outsiders, especially given that Hong Kong is a part of China, but was certainly desirable in the interests of the international investment community. The fact that the international investment community demands adherence to such standards was easily demonstrated by the historical trend of the overwhelming majority of companies listing on the Exchange presenting information on mineral resources and reserves under the Australian JORC Code. The Exchange helpfully pointed out that the difference between Chinese and Russian standards and the CRIRSCO (the Committee for Mineral Reserves International Reporting Standards) or JORC-type Codes, is that the former are focused on in-situ estimates (i.e. what's in the ground) as opposed to what is commercially extractable, the focus of the attention of the international investor.

The adoption of international standards should be applauded at a time when Hong Kong is cementing its position amongst the most successful global fundraising arenas, topping the IPO tables in 2009, 2010 and for the third year in a row in 2011, according to latest industry data. The minerals sector (including oil and gas) has been a key focus recently.

Challenges in Implementation

The challenges for companies seeking a listing lie not in the requirement to provide a reconciliation or technical report under a CRIRSCO code or satisfy the Exchange's industry experience requirements for companies not yet in production, but to meet the minimum requirements of having at least "Indicated Resources" and a plan to proceed to production.

Hong Kong differs from the main mining jurisdictions of Australia, Canada and South Africa, all of which would allow pure exploration companies to list but this is in line with requirements for the main market in London, for example. The concern, however, is that there is somewhat of an imbalance between what the rules intended to achieve and how this has been communicated to the market and is being implemented. The rules call for at least "Indicated or Contingent Resources" under a recognised code, i.e. a meaningful discovery, together with a "scoping study", which has been defined as "a preliminary evaluation of a mineral project, including an assessment of the economic viability of mineral Resources". Such studies should include production schedules and cost estimates. This requirement is at odds slightly with the wording in the "Consultation Conclusions on New Listing Rules for Mineral Companies" published by the Exchange in May 2010, which states that there must be "a clear path to commercial production". The latter threshold is only likely to be met by the presence of a pre-feasibility study, which pre-supposes the existence of mineral reserves, as opposed to resources. This in turn somehow defeats the purpose of scaling back the eligibility requirements from commercially exploitable reserves to resources or a meaningful discovery, such that development capital can be successfully raised on the Exchange.

The requirement for a meaningful discovery is well supported given the speculative nature of exploration companies and the significant retail investor base in Hong Kong, whose knowledge of the minerals industry is advancing rapidly. However, companies with meaningful discoveries that meet the eligibility requirements should be able to raise development capital without the need to demonstrate commercial viability beyond a certain doubt at the time of listing. The requirement for a meaningful discovery and an early stage scoping study should provide sufficient comfort to investors that purely speculative ventures will not meet the Exchange's eligibility requirements. Requirements over and above this in the form of pre-feasibility studies would mean that potential applicants must dig more holes in the ground prior to listing, hence digging too deep. The requirement for a technical report by experts in their field already provides comfort to investors that discoveries have been reported under conventionally accepted international standards.

As stated at the outset, the market welcomed the new listing rules for mineral companies and given Hong Kong's proximity to China and international reach, becoming the largest global centre for mining finance is a goal worth striving for. We have seen significant overseas listings in this sector in the last two years, including China Gold International Resources, Glencore, Kazakhmys PLC, Mongolian Mining Corporation, South Gobi Energy Resources, United Company Rusal and Vale. The list is impressive, including the largest iron ore and aluminium producers on a global scale. China's insatiable appetite for natural resources and the international investor base of Hong Kong provides a happy marriage whilst liquidity in Hong Kong and exposure to the Asian investor base continues to lure overseas issuers.

Valuations are attractive and the existence of trailblazers eases the regulatory costs of other applicants. Moreover, the Exchange seems committed to providing a secondary listing regime which continues to embrace international regulatory standards but provides concessions to companies already listed elsewhere, to avoid duplication. It is worth noting however, that if the secondary listing route is followed, a fundraising is preferred by investors in Hong Kong, which generates significant interest from the retail sector and may provide the added attraction of cornerstone investors who will take fixed allocations at IPO price before the launch of an offering. Listings by way of introduction (where no funds are raised at IPO) are often followed by limited trading and liquidity in Hong Kong.

The Exchange's paternal approach towards the minerals sector may not be surprising given the strong retail investor element in Hong Kong and the speculative nature of exploration companies. Market practitioners and investors have also proven to be cautious and would ideally like to see some production on hand. Recent events such as the Lehman

"mini-bonds" fiasco have heightened the need to protect investors from a bad investment, not that there is or ever could be agreement that investors with full knowledge of investment risks should be provided such protection. It is nevertheless sensible to have certain requirements in place to protect investors from purely speculative ventures, at least for the moment and until the market for mineral companies in Hong Kong develops further.

Cash is King

The Listing Rules may increase the funding requirements for early stage mineral companies that already have significantly high rates of cash burn. Sufficient funding must be in place so enough digging can be done to meet the eligibility requirements and to help demonstrate a viable development plan. The rules require a buffer of 25% over existing working capital requirements but this is not significant in the grand scheme and provides a suitable buffer for cost over-runs. It is important, however, to bear in mind the Stock Exchange's guidance on pre-IPO investments. The rules require that the issuing and marketing of securities is conducted in a "fair and orderly manner" and that holders of securities are treated "fairly and equally". Investments in a private company are invariably conducted on different terms than those in a public company, for a number of reasons, including the fact that a holding in a private company is generally more difficult to dispose of. There is an expectation that Pre-IPO investments are concluded (i.e. funds are received by the listing applicant) either (a) at least 28 days before a listing application is submitted or (b) 180 days before the first day of trading.

Aside from the timing of investments, investment terms will need to be carefully crafted. Private equity investments often come with a number of favourable terms for the investors but potential listing applicants should be mindful of steering clear of possible adjustments based on stock price performance on or after listing. Such adjustments are likely to offend the equality of treatment principle. Potential applicants issuing convertible securities should also be aware of the expectation that specific rights afforded to holders of convertibles must be relinquished on conversion so they sit in the same position as other shareholders. Nevertheless whilst they are bondholders, they may be afforded certain customary rights for investments of that nature, e.g. rights to vote on the declaration of dividends and rights to restrict the creation of new security.

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The future is bright for overseas miners that are looking to raise capital in Hong Kong, especially with the knowledge that China imports over 60% of its resources requirements. Australian and Brazilian iron ore is in high demand, with iron contents of above 60% for some projects. South African iron ore also boasts iron contents of above 60% and one can easily foresee that greater amounts of South African exports will arrive on Chinese soil, to complement the country's exports of platinum, silver and precious stones. Canadian projects typically contain between 30 to 40% of iron, which also compares favourably with Chinese domestic ore. Transportation costs for overseas issuers provide some with a competitive edge over others. Exports from India should not pose a significant threat in 2012, as the Indian government reigns in exports in favour of domestic consumption. However the environment remains challenging, given Europe's fiscal concerns and recent Chinese austerity measures aimed at controlling inflation. Few see a return to prices of $190 a ton seen for high quality iron ore in early 2011 but a Reuters poll indicated that prices are expected to average $150 a ton for 62% iron ore in 2012. At this price, many projects should remain profitable.

We can look forward to more overseas issuers braving the stormy capital markets and hopefully watch the floodgates open when markets recover from the recent downturn in sentiment. We hope the Exchange is pragmatic in its approach, whilst continuing to maintain the well regarded standards that have been put in place to protect investors, and may provide valuation upside for issuers. Despite China's recent measures aimed at curbing inflation, the Asian growth story continues and China is still tipped to become the world's largest economy in the next ten to twenty years. The Chinese

government's efforts should be commended as inflation does seem under control for now, whilst growth continues, albeit at a more modest rate to what the world has become accustomed to.

Mineral or oil and gas companies are not the only ones that may profit from a listing in Hong Kong, by raising their profiles in Asia and moving closer to their customer base. The consumer goods sector should continue to grow in tandem with the Chinese consumers' purchasing power. Listings from the likes of L'Occitane, Prada and Samsonite are just the beginning of this growth story, as international luxury brands look for greater brand recognition in Asia, coupled with attractive valuations and deep liquidity. It's difficult to see the downside but of course sentiment must first reach the light at the end of the tunnel.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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