What used to be a Western-dominated market has rapidly changed

Wall Street i-banks hit by PRC firms

Local players in investment banking are stepping up, with Hong Kong coming first in terms of funds raised by initial public offering in 2016 and beating rival markets like Shanghai and even New York.

When 2016 clocked in, the Hong Kong investment banking scene took a sudden underdog storyline: Smaller local players began gobbling up more deals in equity capital markets (ECM), eating into a market previously cornered by global players. Analysts reckon this trend favouring smaller as well as mainland players will persist in 2017 due to the challenging environment that has put dominant international houses on a slump.

"The market in Hong Kong is changing rapidly. It used to be dominated by Western-oriented international and global investment banks," says **Keith Pogson**, senior partner, Asia-Pacific financial services at EY. "But this has changed quite dramatically, with both a combination of mainland players and smaller local players having a much larger share of the action and role to play."

In the ECM space, in which Hong Kong has remained as one of the most vibrant markets globally, deals are increasingly managed and underwritten by mainland or local houses. Pogson reckons this reflects China's dominance of the deal flow at the large end of the market, and the abundance of deals with local houses and boutiques at the smaller end. Global players, by contrast, have been constricted to super large deals or deals that require a wider market nexus, and they will not likely regain their dominance in the coming years.

The biggest IPO on the Hong Kong Stock Exchange in 2016 was the listing of the Postal Savings Bank of China.

"Capital markets deal flow has become more bifurcated, between the previously dominant international houses, who are generally getting a smaller slice of what was a reasonable-sized pie in 2016, versus local and mainland players who have clearly been on an upswing in terms of market share," says Pogson. "Pricing has remained tight given the dynamics and this, in the long run, is difficult to see recovering back to the richer levels historically enjoyed."

Big advantages of being small

A key theme in 2017 will be a shift in focus to seizing "smaller deals with great potential," says **Mark Chan**, managing partner at HM Chan & Co in association with Taylor Wessing, although there will be an occasional mega transaction. He notes a lack of sizeable transactions, especially in the initial public offering (IPO) space. There has also been a boom in boutique banking and financial advisory firms, which have embraced their advantage as smaller financial institutions and are gaining market share by charging lower fees and granting more flexible fee arrangements. Thus it is harder for traditional investment banking players to protect their leading market share.

With competition heating up and regulatory noose expected to tighten further, 2017 will likely test the patience and risk threshold of investment banks in Hong Kong. "2017 would be a challenging year for the investment banks as the global IPO market will be exposed to such uncertainties and volatility with major factors including the economic policies of the new US government, the pace of interest rates hikes, development of Brexit, and leadership changes in Europe," says **Wing On Chui**, partner and China-appointed attesting officer at Bird & Bird. "The Hong Kong regulators will also tighten their regulatory oversight on the investment banks in the coming year. Should the PRC authorities open the door for listing of PRC enterprises on the local exchanges, it may affect the number of China enterprises listing in Hong Kong in 2017," he adds.

Market risk is soaring, with Hong Kong regulators suing some of the bulge bracket banks in relation to their role as sponsors in previous IPO transactions. "This has definitely made investment banking a riskier business," says Chan. "Additionally, there is still a fair bit of uncertainty from the global political and economic perspectives, so this has inevitably impacted market conditions which remain challenging for industry players."

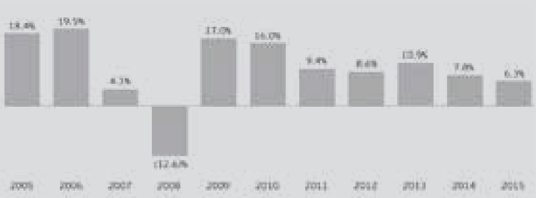
Still, despite all these uncertainties, the Hong Kong stock market remains a preferred fundraising platform in the region, which has partly improved analyst outlooks. "We are cautiously optimistic of the Hong Kong capital market given the robust position of the Hong Kong stock market with enterprises still viewing it as the first choice of fundraising platform in Asia and with the support of the mainland," says Chui. "There is also a trend of more IPOs on the growth enterprise market of the Hong Kong Stock Exchange."

Biggest deals of 2016

Hong Kong came first in terms of funds raised by IPO in 2016, pulling ahead of rival markets like Shanghai and New York, although the total funds raised in 2016 was lower than the previous year. The biggest IPO on the Hong Kong Stock Exchange in 2016 was the listing of the Postal Savings Bank of China, probably the last of China's commercial banks to do so, which raised proceeds of around US$8b. Some international investment banks were involved in the mega-deal as sponsors and underwriters, pushing through with the deal despite the string of uncertainties that have dampened market sentiment and activity, including slow global economic recovery, the US presidential election, Brexit, and rising interest rates.

"It was good to see such a large deal easily get taken by the market," says Pogson of the biggest deal of 2016 in the

Average return on equity for leading investment banks



Sources: Company accounts, EY analysis

EY says investment banks need to be more strategic

ECM space. He also highlights the steady stream of M&A deals, such as the China Chem Syngenta deal and Dalian Wanda deals, which continued to hit the market. M&A activity flourished as Chinese businesses focussed on global outbound activity, and expressed keen interest in acquiring offshore assets despite deteriorating economic conditions.

"The M&A markets have been a really positive light for the year," says Pogson, "with China dominating at the large end of the market. Deal flow has been strong though in some instances the ability to close and complete has been a large irritant, predominantly due to the speed and or lack of approval from mainland central authorities." He adds, "We will still see M&A deals still coming from the mainland. Although with mainland authorities having a tighter focus on foreign exchange (FX), these may be more focussed in terms of segments and rationale."

Wing On Chui

Mark Chan

Keith Pogson

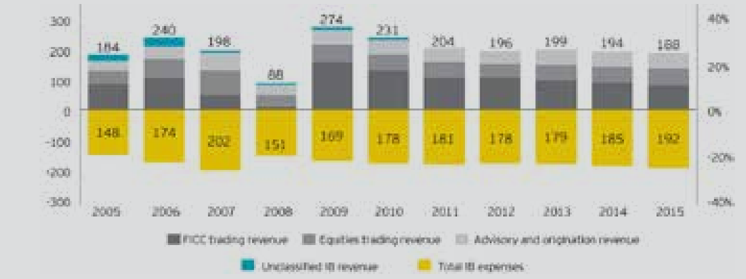
Major trends

Looking back at 2016, analysts identified some major trends that shaped dealmaking activity. The debt capital markets (DCM) underwent big changes, says Pogson, and has become dominated by long-term relationship bankers, enabling mainland commercial banks to capture a larger market share. The Panda bond market and the RMB market both matured, although they will need more time to develop.

Another noticeable trend has been the use of internal deal teams by serial acquirers from the PRC. "This has given these players a focus, speed, and execution capability unseen before in the region," says Pogson, "but has also taken large chunks of potential fees away from the banks, with the banks left in these situations to support difficult regulatory situations or providing financing."

Analysts are keeping a close eye on the gradual re-acceleration of the Chinese domestic stock markets, and how this may challenge the Hong Kong market in the long run. Pogson explains that Hong Kong has long provided a quick solution for those desperate to list from

Investment banks operating performance (in US$b)



Sources: Company accounts, EY analysis

the PRC, but this unique advantage could erode soon. "I think we will see a continuing relaxation of the pipeline constraints on the mainland exchanges. This will continue to raise challenges for the Hong Kong exchange in terms of longer term volumes and proposition."

The opening of the Shenzhen-Hong Kong Stock Connect in the end of 2016 is also viewed by some as a possible game-changer, but whether it will drive up listing interest in the territory remains to be seen. "We have yet to see how the launch of the Shenzhen-Hong Kong Stock Connect, which together with the Shanghai-Hong Kong Stock Connect, could expand the investment base and improve investor sentiment in the Hong Kong market and attract more enterprises to come to list in Hong Kong," says Chui.

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Global challenges

In EY's report *"Capital Markets: Building the investment bank of the future,"* it says the investment banking industry continues to face an uphill struggle to deliver sustainable returns to investors. "Investment banks have been in reactive mode, making incremental and tactical changes, often in response to the urgent demands of regulators. The short-term focus of the regulatory agenda has constrained their ability to make discretionary strategic choices, and their long-term vision has been impaired," says EY.

The report cites investment banks' multiple strategy reviews since the crisis. "They've been preoccupied with scaling back their business; withdrawing from geographies, asset classes and customer segments; and reducing their workforce. Despite this downsizing, the average return on equity (ROE) for the top 14 global investment banks was just 6.3% in 2015," notes EY.

Although some managed to post ROEs greater than 10%, EY says performance across the industry is forecast to decline further, with regulatory pressures continuing to drive up costs and prudential rules driving up risk-weighted assets. "In particular, banks are challenged by the fundamental review of the trading book, rules around counterparty credit risk, credit valuation adjustment, and capital requirements (especially as a result of total loss-absorbing capacity and leverage ratio proposals)."

As a result, EY believes that without any cost restructuring or capital optimisation, industry ROE could fall below 5%. It says banks must become more strategic and more sharply focussed on transforming their businesses in order to meet the challenges.

SINGAPORE VIEW

Will 2017 see the "great adjustment"?

If investment banks in Singapore had a hard time coping with the flurry of challenges and changes in 2016, then 2017 will provide a much-needed breather, especially for banks that have started shaping up their operations. Analysts forecast a thrilling year ahead marked by an improving outlook as well as opportunities to collaborate with financial technology firms. Consolidation, innovation, and compliance will be the key themes in 2017.

"The winners in this environment will be investment banks that restructure successfully and develop a sharp focus on the things they do best and embrace innovation," notes Liew Nam Soon, ASEAN managing partner, financial services at Ernst & Young Solutions LLP. Liew says investment banks face a slew of hurdles that are driving down return on equity (ROE).

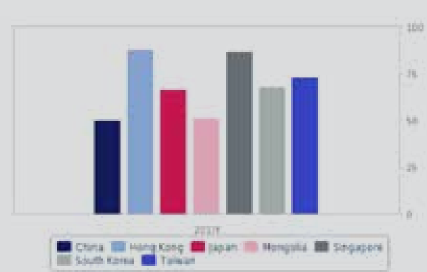
Business restructuring

Not only is economic growth slowing, but revenue for fixed income, commodities, and currencies is on the decline. Banks must also contend with new tax and compliance regulations that impose tougher penalties. As a result, ROE amongst investment banks has declined in the past years, forcing some to restructure their businesses. Liew says EY has been working with investment banks to restructure operations and implement new models to optimise business, taking into consideration legal entity structures and transfer pricing.

"We have seen a lot of downsizing in the past couple of years for investment banking and I think that has resonated across many financial institutions," says Ow Kim Kit, deputy head of banking and finance practice, RHTLaw Taylor Wessing LLP. "The result is that many senior level people have been displaced, most of them very experienced, having seen through several market cycles." She reckons the wave of restructuring was a survival necessity, preparing financial institutions for the opportunities this year.

"I saw the second half of 2016 as a time when investment banking players regrouped and built the backdrop for what may be a very exciting 2017," says Ow. "The markets will assimilate into the new set of circumstances and a positive outlook should soon emerge within the first quarter, barring any severe and unexpected situations."

Strong banking and investment environment



Note: 100 - lowest risk; 0 - highest risk
Source: BMI Trade and Investment Risk Index