

BILLS COMMITTEE ON MASS TRANSIT RAILWAY BILL

PROCESS OF INITIAL PUBLIC OFFERING AND VALUATION CONSIDERATIONS

PURPOSE

This paper is submitted in response to the request made by Members of the Bills Committee on the Mass Transit Railway Bill that the Administration should provide further information on the Initial Public Offering (IPO) process and valuation considerations.

NATURE OF MTRC'S BUSINESS

2. The Mass Transit Railway Corporation (the "Corporation" or "MTRC") currently owns and operates five railway lines. This system serves on average 2.3 million passengers per day, making it one of the most heavily utilized transport systems in the world. In addition, the Corporation is currently building the Tseung Kwan O Extension, which is due for completion by the end of 2002. In line with the Government's transport development policies, the Corporation is expected to continue to play an important role in future railway development in Hong Kong.

3. Railway investments require significant upfront capital expenditure in early years and have relatively long payback periods. Therefore, the valuation of any railway investment must take into account the long-term cash flow potential of the project rather than just current earnings. Due to the long-term nature of railway investments, the Corporation currently calculates its internal rate of return over an operating period of 40 years.

4. In conjunction with railway construction, the Corporation also undertakes property development projects. As in the past, the ability to continue its role in property development is important to the financial viability of new railway projects for MTRC, thus facilitating the expansion of the railway network in Hong Kong. The Corporation also enjoys steady rental income from its own investment properties.

VALUATION CONSIDERATIONS

5. To fully capture the value of the Corporation, it is important to recognise the different components of its business. Railway is the most important component of the Corporation's business. In addition, property development and property investments also contribute to the Corporation's earnings. Each of these components needs to be assessed using separate valuation approaches.

For railway operations and property development cash flows, discounted cash flow analysis (DCF), which values all future expected cash receipts and expenditures in present terms, is the most appropriate valuation methodology because of the nature of the cash flows. On the other hand, net asset value approach, the most commonly adopted valuation methodology for property investments in Hong Kong, would be most suitable for the valuation of the Corporation's property investments.

6. The relationship between price per share and earnings per share, commonly known as the Price/Earning ratio, is a popular valuation methodology for investors in Hong Kong to determine the equity value of a business. However, this approach is not optimal at times of new railway extensions as the revenues for the new extensions require time to build up and the earnings are depressed given the effect of depreciation charges and interest expenses. For this reason, the P/E ratio may not fully capture the earnings and cash flow potential of the Corporation's investment, particularly in the early years of operation of new extensions. Furthermore, since the recognition of property development profits depends on the completion of the projects in question, the property development profit trends can fluctuate widely.

7. The valuation of the MTRC is highly dependent on the economic, equity and property market conditions of Hong Kong, as well as on the operational performance and momentum of the MTR system. The value of railway operations is driven predominantly by fare revenue, operating and financing costs, and capital expenditures. Macro factors, such as GDP growth, population growth, and inflation, also affect the operating and financial performance of the railway operations. Other factors, which can be influenced by the Government or the Corporation, include regulatory factors (such as level of competition and fare adjustment mechanism) and operational factors (such as service quality, cost efficiency, and capital expenditure). Valuation of the property development and investment operations is driven mainly by the cost of capital, return on new investment and cash flows generated by the properties. In turn, these cash flows are driven by a number of factors including property prices and the profit sharing formulas, which are negotiated between the Corporation and property developers.

OVERVIEW OF THE PROCESS OF INITIAL PUBLIC OFFERING

8. The IPO for all companies follows a broadly consistent process, but will vary depending on the unique characteristics of the business of a company. In the case of MTRC, there is an opportunity to offer investors to invest in a business with the following special characteristics:-

- MTRC is almost unique as an efficient well run urban transport system which is also profitable in its railway operations.
- The nature of MTRC's business is capital intensive, but has strong cashflows which will provide pay back on the capital invested – but over long pay back periods.
- The business also has future growth opportunities which will be attractive to investors, as well as profit contribution from its in-station property development.
- A further important feature of MTRC for investors will be the opportunity to obtain exposure to the Hong Kong economy by investment in MTRC.

9. However, the explanation and marketing of these features must be subject to the stringent IPO process of HK law, which will be described below – all of which will also have impact on the Corporation's valuation.

10. In addition, it is necessary, indeed vital, to establish a clear and predictable framework within which MTRC is to operate so that all of the Stakeholders in MTRC's operations can be confident the Corporation can provide continuing high levels of service and generate continuing profits on its operations – as well as being able to finance its future growth opportunities for the benefit of the people of Hong Kong.

Clear Regulatory Framework is Critical

11. It is important to clearly define the relationships between the Corporation and other key stakeholders, including the Government, the Legislative Council (LegCo), passengers, employees, MTRC's shareholders and the regulators.

12. There are two groups of stakeholders, those concerned with the regulation of MTRC – addressing questions such as performance, safety, service and the right of MTRC to operate and expand its rail system; and those with commercial interests in the Corporation – primarily users, investors and employees.

13. The primary regulatory instrument is the Mass Transit Railway Ordinance (MTRO) which will establish the framework for regulation of the Corporation and is enacted by LegCo. The principal objective of the MTRO is to create the MTRC's franchise, to establish performance and safety standards, to make appropriate provision for termination of the franchise – if this becomes necessary, to reserve certain powers to the Chief Executive and to provide

certain operational statutory powers that can be exercised by MTRC. Beyond this, the detailed operational arrangements of MTRC is dealt with in the MTRC's Operating Agreement with the Government.

14. The Operating Agreement provides for the detailed operating terms of the MTRC's franchise. The key headings have been shown previously to Members on 23 November 1999. They cover issues such as extension of franchise, railway design, passenger services, new lines, performance standards, safety, new projects and fare setting arrangements. These are issues typically found in other similar franchise documents.

15. The third key regulatory arrangements are to be found in the investor protection regulation of the Securities and Futures Commission and the Stock Exchange of Hong Kong. As a proposed listed company, MTRC will be subject to all of the regulatory requirements routinely enforced to protect investors and ensure transparency of operations of typical listed companies.

16. The commercial stakeholders in MTRC have differing but equally important interests in a privatised MTRC as follows:-

- Passengers – One of the most important stakeholders requires both value for money and a safe and reliable system. Passengers as a group are not so concerned with the profitability of the Corporation – if things are not going well, they will use the buses, and this is the major discipline for MTRC. If MTRC cannot deliver value for money, it will lose ridership.
- Investors – Both the Government and public as investors will be seeking to get a good return from their investment. But as with any investors, they will also wish to be confident that MTRC is running a good business to minimise the risk of losing their invested money. Therefore, a good management, and good regulatory framework, including access to both revenues and growth opportunities will be important.
- Employees – The employees, like investors have several objectives in their relationship with MTRC. They will wish to continue to be well paid and well treated. It will also be important that the Corporation continues to operate profitably to secure, as far as possible, their continued employment.

Key Components of an IPO Process and Timetable

17. An IPO for privatisation would typically require three to four months to complete following the passage of the legislation, and the appointment of the Global Coordinator by the Government.

18. The Global Coordinator is usually the listing sponsor to the stock exchanges for the company. It prepares and files documentation with these stock exchanges and relevant authorities on behalf of the Corporation. The Global Coordinator is also responsible for developing an effective positioning and marketing strategy to maximise investor demand. Other third party professionals, including legal counsels, auditor, printer, receiving banks and share registrar, will also be appointed in preparation for the IPO. In a large offering like MTRC, consultants, experts and public relations firm would be engaged as well.

19. Key components of a typical IPO process include the following:

- a) Due Diligence and Prospectus Drafting;
- b) Valuation and Marketing Review;
- c) Documentation and Filings with Relevant Authorities; and
- d) Marketing

20. These components are critical in ensuring there are no misleading issues in the public offering, and that the valuation of the Corporation is properly determined by the market, having regard to all the relevant information. It is important to understand that the IPO process fundamentally involves the preparation of a company for sale to the public, but the sale can only proceed if the Vendor's view of value (in this case the Government) and the market's view are within the same range. However, this range can only be finally determined when all the relevant processes have been completed. We will now look briefly at those processes.

Due Diligence and Prospectus Drafting

21. Due diligence is an important step in the IPO process and allows the Global Coordinator and the Vendor to understand the company's business in detail and identify risk factors that investors should be aware of in the prospectus. In a typical due diligence process, the Global Coordinator would visit the company's sites, interview with the company's senior management and government officials, analyse the company's financials, and address necessary legal issues and other relevant matters.

Valuation and Marketing Review

22. Valuation is an ongoing process throughout an offering. Prior to formal marketing, a valuation discussion is held among the Government, the Corporation and the Global Coordinator to agree on an indicative price range that will be used for marketing to investors. This discussion will take place only after the due diligence work has been completed including all necessary verification. It is important to understand that valuation range may vary from time to time depending on a range of factors including the market outlook, industry performance, the Corporation's growth prospects and operational performance. All of these factors must be taken into account in determining the Vendor's valuation range. It will be the market perspective of the same factors and their impact on the Corporation that will determine the ultimate valuation of the Corporation.

Documentation and Filings with Relevant Authorities

23. Listed companies are required by the stock exchange and relevant securities authorities to file a prospectus and other legal documents. The preparation of the prospectus requires a thorough understanding of the company's business, legal requirements in terms of disclosure as well as awareness of investors' interest and concerns. The prospectus is also used as a primary marketing document during the marketing process to investors. In Hong Kong, the Listing Rules of SEHK set forth numerous rules and disclosure requirements for information contained in the prospectus to provide protection for all parties involved. A prospectus comprises many sections, the more significant of which include:

- a) Business description
- b) Risk factors/investment considerations
- c) Management's discussion and analysis of financial conditions and operations
- d) Capitalisation and financial statements
- e) Industry overview
- f) Principal shareholder arrangements, and
- g) Sections related to the offering such as description of shares, underwriting, etc.

These are designed to ensure that investors have a good understanding of the company they are being provided with an opportunity to invest in.

Marketing

24. A well-planned marketing programme is critical to achieve a successful offering. Coupled with an appropriate positioning strategy, the Corporation would be able to target the right universe of investors and result in maximum demand for the shares. The key components of the marketing programme include:

- a) *Pre-marketing* – Pre-marketing is used to introduce the offering in the marketplace while providing the Global Coordinator and the Corporation with an understanding on the current market sentiment and key investor concerns in advance of the actual launch of the offering. The pre-marketing process would also assist potential investors in familiarising themselves with MTRC’s story.
- b) *Roadshow* – The roadshow is a series of group presentation and one-on-one meetings with potential institutional investors around the world. It is an optimal forum for the company’s senior management, the Government, and underwriters to communicate effectively the investment “story” and address investor’s concerns. In MTRC’s case, an extensive public relations campaign would be launched to maximize awareness for Hong Kong retail investors.
- c) *Bookbuilding* – Bookbuilding is a process whereby the Global Coordinator would build a “book” indicating the investor demand for the offering during the pre-marketing period which accelerates towards the end of roadshow. Investors submit indications of interest at different price levels.
- d) *Pricing/Allocation* – Through the bookbuilding process, the Global Coordinator determines an optimal pricing level and allocates shares to investors. The goal is to maximise IPO proceeds, enhance the quality of investors and ensure strong aftermarket performance. Trading of the shares would commence shortly after the pricing and allocation.

MTRC – The Opportunity

25. As outlined above, the IPO process involves a complex series of steps designed to create an environment where a good sense of MTRC can be communicated to the market, in a way which will ensure the Vendor can realise full value for the assets being sold. It is important, however, that in the process that sight of the tree is not lost by the forest, or in the idiom of the committee the egg by the chicken.

26. That is, MTRC is a fine company with many strong attributes including:

- Efficient and profitable railways
- Experienced management with a proven record
- Future growth opportunities
- A well-recognised name
- An excellent track record in safety
- A strong financial profile

All that is required is a clear and predictable regulatory framework and the opportunity can then be provided for Hong Kong investors to participate in this company.

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