China & Hong Kong Strategy

Maintain Overweight on continued economic recovery and cheap valuation

Roy Chen, Macro Analyst 28 January 2013
CSI300: 2571.67 (+1.93% ytd); HSCEI: 12001.81 (+5.77% ytd); HSI: 23580.43 (+4.95% ytd)

Phillip Securities Research Pte Ltd
2012 China Real GDP / Inflation: 7.8% / 2.5%
2013(f) China Real GDP / Inflation: 8.0% / 3.0%

- ***Head of Research China's top picks are: China Life (2628.HK) and China Lumena New Material (67.HK)); Head of Research Hong Kong's top picks are: AIA (1299.HK and HSBC (5.HK).***

- ***We continue to Overweight CSI300, HSCEI and HSI. PhillipETF recommends ChinaAMC CSI300 Index ETF (83188.HK) as a proxy for the A-share CSI300, H-Share Index ETF (2828.HK) as a proxy for the H-share HSCEI, and Tracker Fund of Hong Kong (2800.HK) as a proxy for HSI.***

- ***PhillipCFD has long/short "H Shares Index HKD5 CFD" and long/short "FTSE China A50 Index USD1 CFD"***

- ***Phillip Unit Trust Department recommends Aberdeen China Opportunities SGD and Fidelity China Focus A USD for China equity market investment.***

- ***Marketweight CN bonds & Underweight HK bonds***

In the last quarter, China's GDP grew by 7.9% y-y, exceeding the market expected 7.8% y-y pace, after the 7.4% y-y gain in 3q12. Overall, China closed 2012 with an upward surprise in GDP growth, achieving 7.8% y-y growth for the whole year, beating the average market expectation of 7.7% y-y but right on our estimate. The outperformance adds a more positive sentiment towards nation's economic outlook in 2013.

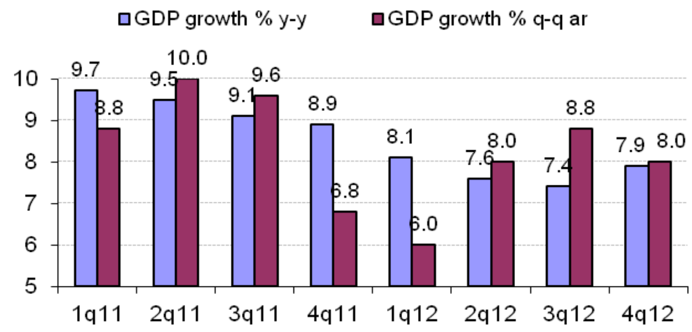
In our last CN & HK strategy report on 19 Dec 2012, we included a detailed discussion on the guidelines and tasks of 2013 economic policies set by the government during the central economic work conference held in Dec last year. To reiterate, the government is committed to forging an "efficient and quality" growth, which we believe is beneficial to a sustainable growth in the long term, rather than simply of high speed. Economic data for the past few months adds to our case of economic bottoming out in a moderate pace. Domestic demand is sound while exports could be fragile amid a EZ recession and US fiscal uncertainties. We expect no massive monetary loosening in the near term as it risks exacerbating property prices and inflation; meanwhile the continued recovery reduces the urgency of doing so. Going forward, the key growth drivers would be more about consumption and investment associated with the nation's continued urbanization process. We maintain our call for the year of 8.0% y-y GDP expansion with inflation of 3.0%. PBoC is not expected to tighten its current 6% benchmark rate as the economy is only just bottoming.

In Hong Kong, consumption and exports both are coming in above expectations for 4q12, prompting us to raise 2012 GDP growth forecast to 1.5% from 1.2%, inflation expected at 3.9%. The improvement is mainly attributable to the rising demand from China and improved retail sales in US. Property price continued to a new record, which may prompt the government to add curbs to housing market. Due to its privileged position of taking ride on China's recovery, we hold a positive outlook in Hong Kong economy, expecting growth to accelerate this year to 3%, with inflation at 4%.

We maintain our Overweight on all 3 indices: the CSI300, the HSCEI, and the HSI on attractive valuations and China's economic reacceleration, noting that all the 3 indices have cleared some resistance levels and are likely to aim higher (2700 for CSI, 12800 for HSCEI and 24000 for HSI). We marketweight China bond market and underweight Hong Kong bond market. We hold a positive outlook for CNY and negative outlook for HKD against peers in the long run.

China Economic Metrics and Growth Outlook:

Fig.1 China's GDP growth reported 7.9% y-y in 4q12, higher than the market expected 7.8% y-y pace. GDP for the whole year 2012 expanded 7.8% y-y from 2011, right at our estimation. Going forth, we expect the nation's economic recovery to continue at a moderate pace mainly on domestic demand as export is likely to remain fragile amid a Eurozone recession and US fiscal cutbacks.



Source: PSR, CEIC

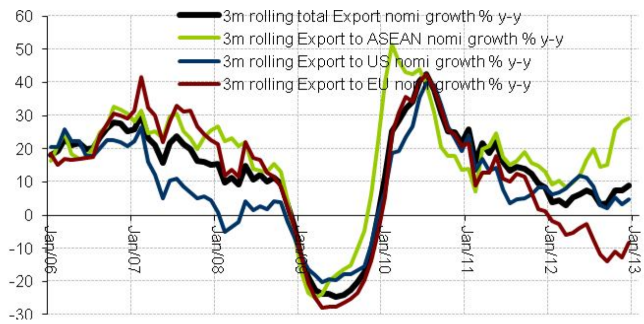
Fig.2 Retail sales has beaten market expectations for a fourth straight month, reporting 15.2% y-y in Dec, compared to consensus of 15.1% y-y growth and prior 14.9 % y-y for Nov. The continued improvement in retail sales indicates a better outlook for domestic consumption, which is also aligned with the government's long term strategy of gradually reducing the growth reliance on investment and export.

Source: PSR, CEIC

Fig.3 Fixed Asset Investment grew by 20.6% y-y in the 12 month period ended in Dec, a slightly slower pace compared to the 20.7% y-y gain during the 11-month period till Nov. Despite the slight pullback, the above 20% growth should be still considered as more than decent. Going forward, the government would continue to forge a balanced growth path rather than simply speed, and we expect that average 25% growth has become a thing of the past. Nonetheless, we do not expect a major investment slowdown due to the nation's continued urbanization process.

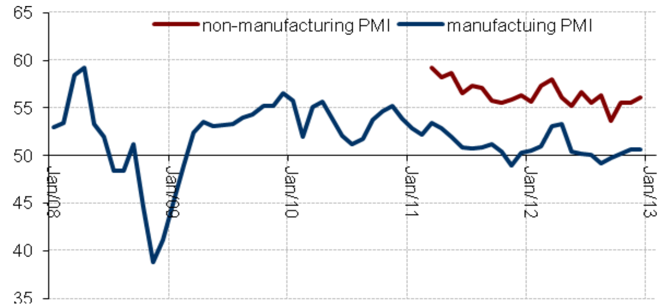
Source: PSR, CEIC

Fig.4 Export growth unexpectedly surged to 14.1% y-y in Dec, far exceeding the market expected 5.0% y-y gain, after the 2.9% y-y growth in Nov. The improvement in export is a combination of a major acceleration in demand by ASEAN, a stabilizing demand from US and a narrower contraction of demand from EU. Data of exports to ASEAN is encouraging; however the boosting effect is limited as it contributes to only 10% of China's total export, while exports to US and EU contribute around 20% each. Going forward we do not expect the Dec exports growth rate to sustain as although the global economy is in a cyclical rebound, weak demand from industrialized nations remain.



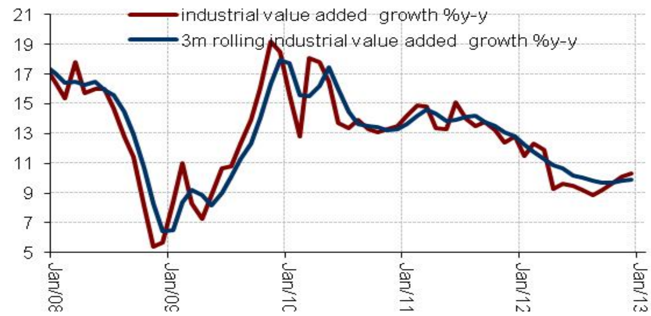
Source: PSR, CEIC

Fig.5 Official manufacturing PMI stayed unchanged at 50.6 in Dec, indicating a mild expansion in manufacturing activities. On the other hand, the 51.9 preliminary reading of Jan HSBC manufacturing PMI, beat the market's forecasted 51.7 and Dec's final reading of 51.5, reflected a faster than expected expansion in small and medium manufacturing business, the sector which bred the most concern during the slowdown due to heavy borrowing from non-traditional sources (i.e. non-bank). The fact that business has picked for SMEs allays concerns of default risk. Official non-manufacturing rose further to 56.1 in Dec, from 55.6 in Nov, indicating accelerating non-manufacturing activities; the rise contrasts to a slight drop of HSBC services PMI, from 52.1 in Nov to 51.7 in Dec, indicating a slightly slower expansion in the nation's small and medium businesses in the service sector.



Source: PSR, CEIC

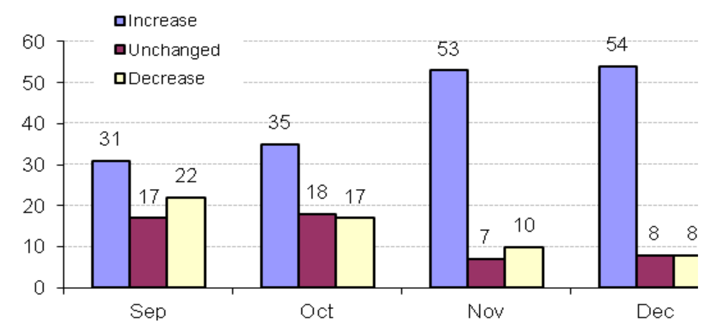
Fig.6 The growth of industrial value-added continued to improve for a fourth straight month, reporting 10.3% y-y in Dec, beating the market expected 10.2% y-y and prior 10.1% y-y pace in Nov, adding to our case of bottoming-out.



Source: PSR, CEIC

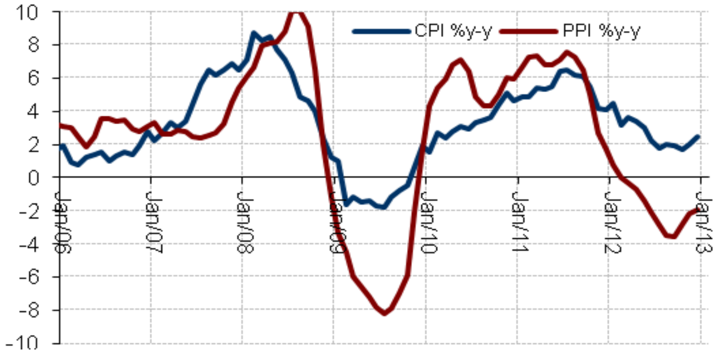
Fig.7 Along with the economic re-acceleration, risk of inflated housing price bubble revived. In Dec, 54 out the 70 major cities saw monthly increases in new residential apartment price; this compares to 53 in Nov and 35 in Oct. As the government commits a "steadfast" effort to curbing property prices, the likelihood of massive monetary loosening to is reduced in the near term. On the other hand, we do not expect an aggressive tightening measure by the government as well because it might hamper the nascent economic recovery.

monthly change in new residential apartment price



Source: PSR, CEIC

Fig.8 In Dec, inflation picked up to 2.5% on rising vegetable price due to the coldest winter in 27 years, from the 2.0% in Oct, exceeding the market expected 2.3% pace. PPI continue to stabilize, reporting a narrower y-y drop of 1.9% in Dec, after the 2.2% y-y drop in Nov, reflecting stabilizing production activities. As holiday season of Chinese New Year approaches, the increasing household demand is likely to maintain prices at a high level, which also erodes the scope of further loosening by the government.



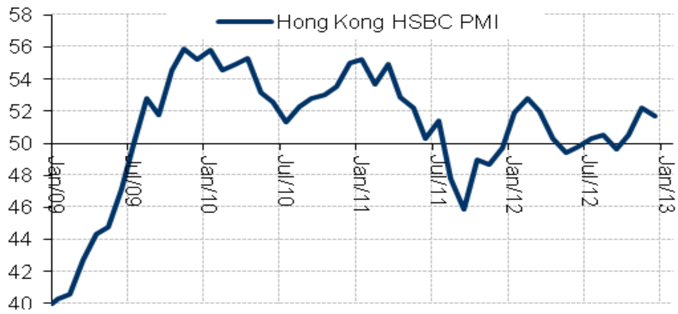
Source: PSR, CEIC

China Growth & Inflation Forecast:

- In our last CN & HK strategy report on 19 Dec 2012, we included a detailed discussion on the guidelines and tasks of 2013 economic policies set by the government during the central economic work conference held in Dec last year. To reiterate, the government is committed to forging an "efficient and quality" growth, which we believe is beneficial to a sustainable growth in the long term, rather than simply of high speed. Economic data for the past few months add to our case of economic bottoming out in a moderate pace. Domestic demand is sound while exports could be fragile amid a likely EZ recession this year and US fiscal uncertainties. We expect no massive monetary loosening in the near term as it risks exacerbating property price bubble and inflation; meanwhile the continued recovery reduces the urgency of doing so. Going forward, the key growth drivers would be more about consumption and investment associated with the nation's continued urbanization process. **We maintain our call for the year of 8.0% y-y GDP expansion with inflation of 3.0%. PBoC is not expected to tighten its current 6% benchmark rate as the economy is only just bottoming.**

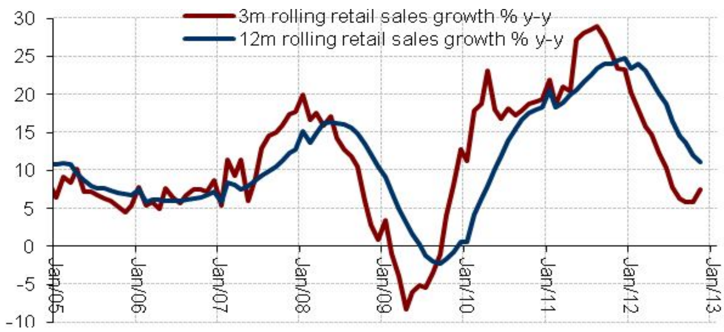
HK Economic Metrics and Growth Outlook:

Fig. 9 HSBC manufacturing PMI for Hong Kong stepped down from the 9 month high of 52.2 in Nov, reporting 51.7 in Dec, indicating a slightly slower expansion in the city's business activities. Along with China's economic bottoming out, HSBC PMI for Hong Kong has indicated expanding business activities in 5 out of the past 6 months. Going forward, we expected the re-accelerating China economy to keep lending support to Hong Kong, though the pace could be slow.



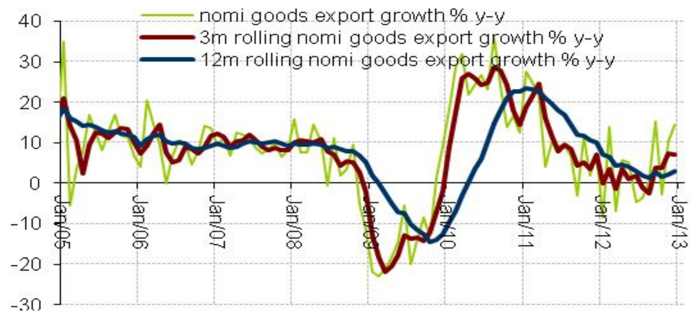
Source: PSR, CEIC

Fig.10 Retail sales rose by 9.5% y-y in Nov, beating market expected 4.2% pace after the 4.0% y-y gain in Oct, reflecting improving domestic consumption.



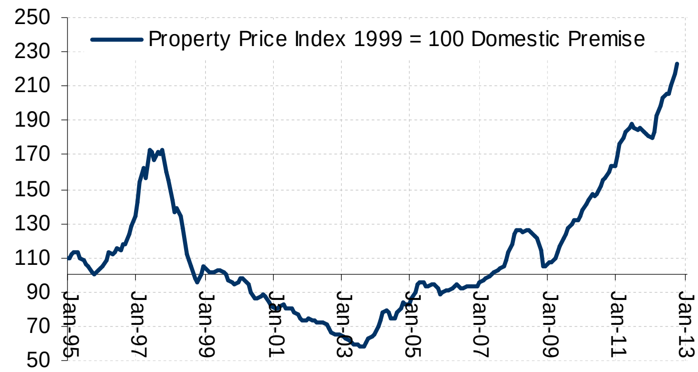
Source: PSR, CEIC

Fig.11 Growth of total export improved to approximately 7.0% y-y in the 3 month period ended in Dec, with single month y-y growth achieved double digit gains in 3 out of the past four months. The improved export is mainly attributable the rising demand from China's re-acceleration and a recent improvement in US retail sales.



Source: PSR, CEIC

Fig.12 Nov property price renewed record, reporting 30% higher than the 1997 peak where last housing price bubble burst. The price bubble is fueled by the huge influx of China mainland buyers, imported near zero percent US Fed Funds Rate, and open-ended US QE. The government has introduced a series of tightening policies such as tightening mortgage requirement and imposing 15% tax on overseas buyers and company buyers, and we expected further government intervention in housing market.



Source: PSR, CEIC

Fig.13 Hong Kong's underlying inflation stayed unchanged at 3.8% in Nov. The recent hiking inflation in mainland China would likely export inflation to Hong Kong, and the city's price is also vulnerable to the inflation pressure introduced by QE in the long term. Going forward, we expect a slight pickup in Hong Kong's inflation.

Source: PSR, CEIC

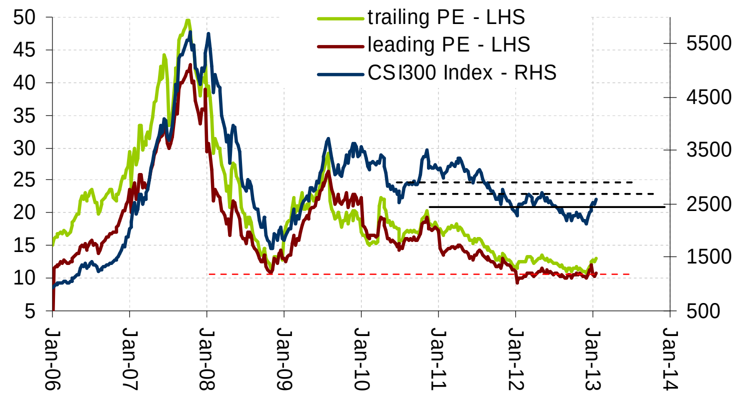
Hong Kong Growth & Inflation Forecast:

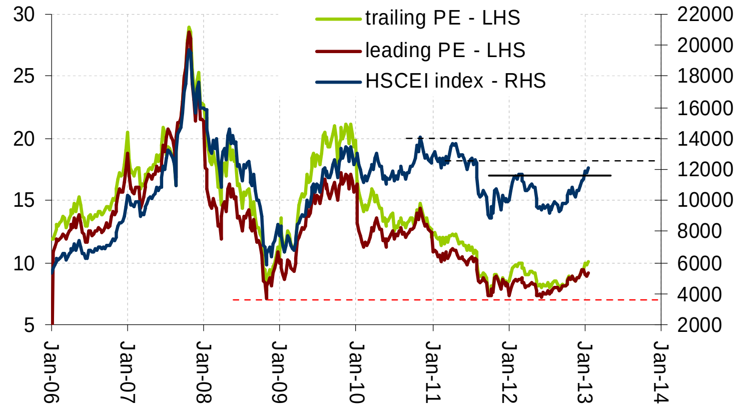
- **Due to the recent upside surprise in retail sales and exports data, we adjust our 2012 forecast of Hong Kong's GDP growth upward from 1.2% to 1.5% (3.9% inflation) and maintain a preliminary call of 3.0% GDP growth and 4.0% inflation for 2013 in consideration of the effects from a rebounding China economy and importing open-ended QE and low interest rates from US.**

Asset Strategy

- **Stock Market: We maintain our Overweight rating (since 22nd Oct 12) for all 3 indices**. P/E ratios for CSI300 (12X), HSCEI (9.5X) and HSI (12X) are all residing near the lower end of their respective historical ranges, indicating still cheap valuations despite recent rallies and therefore continued attractive buys from a long term perspective. HSI and HSCEI have displayed nice upward trends since 2nd half of last year, driven by the nascent signs of China's economic bottoming and subsequent US QE3, while the A-share CSI300 index has been sluggish until the start of last December, from which we observed a strong rally, triggered by economic policy meeting held by China's new central politburo. Since then, CSI300 index has rallied by 23%, and along the way positive economic data such as PMI, retail sales and industrial production contribute further to the improved sentiment in China's A share market. In our 19 Dec strategy report, we said the CSI300 was aiming at the resistance level near 2500, which has already been cleared and turned into a support level within the last one month. Backed by the improving macro data and still cheap valuation, the current sentiment is unlikely to reverse despite a possible consolidation in the near term, which we view as gathering strength to challenge the strong resistance level at 2700. HSCEI has also stood upon the 12000 target level of in our 19 Dec report. Presently the HSCEI is consolidating at the 12000 level after breaking through and is likely to turn it into support, it could then aim for the resistance level near 12800. While for HSI, the nice upward trend is unbroken, and is grinding through the massive resistance region between 23000 and 24500.

Fig.14 All 3 indices have PE ratios near their respective historical low at Lehman Meltdown, indicating attractive valuations.





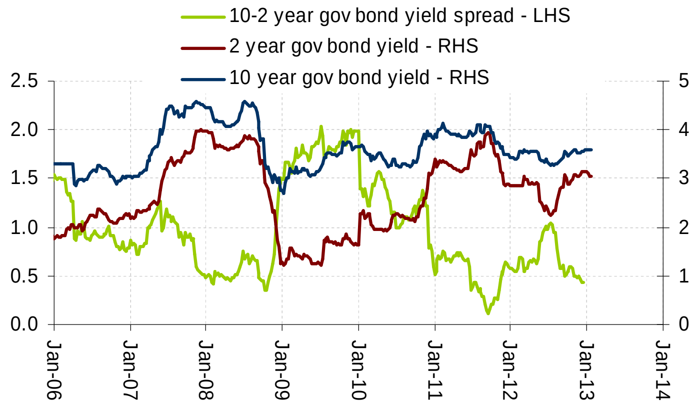
Source: PSR, Bloomberg

- **We recommend the physically backed ETF, ChinaAMC CSI300 ETF (83188.HK) as a proxy for A-share CSI300 index. For HSCEI we recommend H-Share Index ETF (2828.HK) as a proxy. And we recommend 2800.HK as a proxy for HSI.** CSI300 contains 300 major big cap Chinese companies listed in Shanghai and Shenzhen exchange and the CSI300 ETF is denominated in CNY. HSCEI contains all the Chinese enterprises listed in Hong Kong market and the corresponding 2828.HK ETF is denominated in HKD. HSI contains 49 largest companies listed in Hong Kong and the constituent companies also have significant business exposures in China. The corresponding index ETF 2800.HK is denominated in HKD. In the long run, we see 3 indices tracking each other well as the indices are all highly correlated with the well-being of China's economy. Nevertheless there could be short term discrepancies in the 3 indices due to the different constituent companies and differences in market sentiments of buyers. The majority of CSI300 constituent stock buyers are mainland domiciled while HSCEI and HSI is open to international investors.

- **Bond Market:** We observe a mild pickup in the yields of especially the 10 yr government bonds as China's bond market is gradually losing favour to stocks due to the nation's economic recovery. However, considering the higher yields against peers, the relatively tame inflation and the positive long term outlook for CNY, we still like China bonds. The reported acceleration in Dec property price and inflation is likely to deter the yields from going lower but do not erase the possibility as the yet economic recovery might still need support from a relatively weak borrowing cost environment. So on balance **we maintain our marketweight rating for China bond market.**

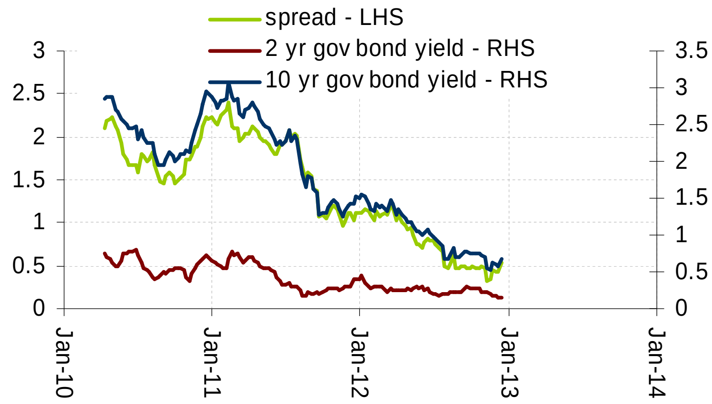
- **We assign an underweight rating to Hong Kong's bond market** as the yield is already so low and there is not much room to going down further.

Fig.15 China Government 2y/10y bond yields and spread



Source: PSR, Bloomberg

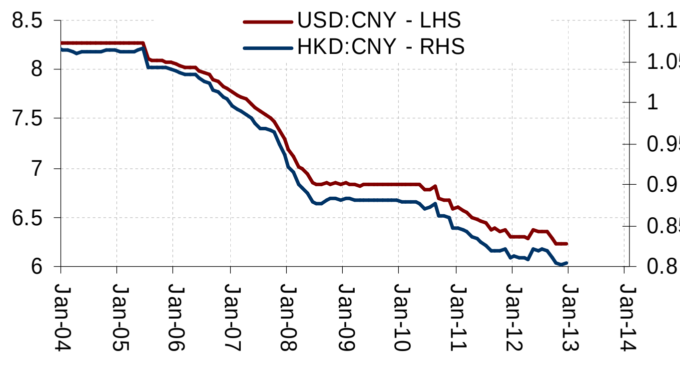
Fig.16 Hong Kong Government 2y/10y bond yields and spread



Source: PSR, Bloomberg

- **Currency Outlook:** We hold a positive outlook for CNY against major trading currencies in the long term as CNY is still moderately undervalued. For the near term, there are competing forces. On one hand, the recovery of China's economy would likely induce fund inflow to China (i.e. CNY appreciation) to take advantage of China's bottoming out. On the other hand, the government has an incentive to maintain a stable or weak CNY to bolster the nation's faltering export growth. Therefore, we assign a neutral rating to CNY against major trading currencies in the near term. To sum up, **we expect CNY exchange rate to remain relatively stable in the short term, but continue to appreciate in the long run. As for HKD, which is pegged to USD, the open-ended QE by FED would likely depreciate HKD against other major trading currencies.**

Fig.17 USD:CNY, HKY:CNY exchange rates



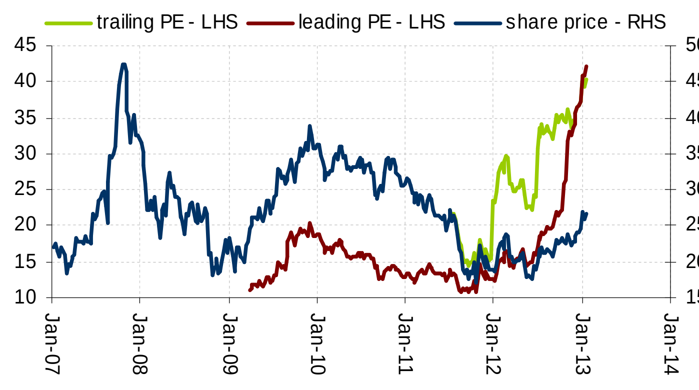
Source: PSR, Bloomberg

STOCK PICKS:

- **Head of Research China top picks are: *China Life (2628.HK) and China Lumena New Materail (67.HK)***

China Life (2628. HK)

Fig. 18 China Life



Source: PSR, Bloomberg

- According to the data from CIRC, the premium incomes of China Life (or the Group) reported RMB298.772 billion in Nov 2012, 0.81% lower from year ago. The premium incomes has been decreasing since Feb 2012, but the recent contractions have narrowed;

- The Group's total assets increased significantly by 12.6% y-y to RMB1.78 trillion as end of 2012, equivalent to BVPS of RMB7.50, 10.7% higher than that of 2011;

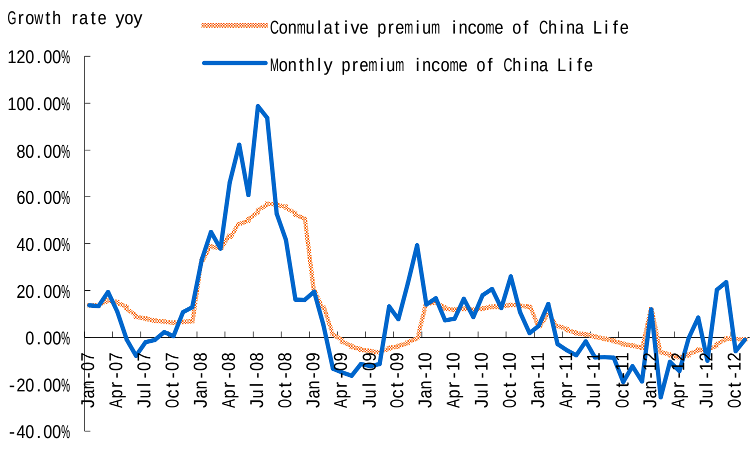
- As of end of Sep 2012, accumulated net profits of China Life reached RMB7.428 billion, 55.57% lower compared to a year ago and also much lower than our expectation. This was because of the significant increase in impairment losses, which reported RMB29.024 billion, i 3.84 times the reading of a year ago;

- Due to much slower-than-expected profit growth in the first three quarters of this year, we reduce our previous profit estimation, and forecast the Group's net profits would decrease approximately by 38% y-y to RMB11.4 billion with the EPS of RMB0.40 in 2012;

- However, recently there was news that CSRC would approve domestic insurance companies to open retail fund management business in future, which may help insurers to expand the businesses through more diversified investment channels. Therefore we believe the insurers' incomes, especially the investment incomes, would rebound significantly due to such businesses and improvement of market environment in future;

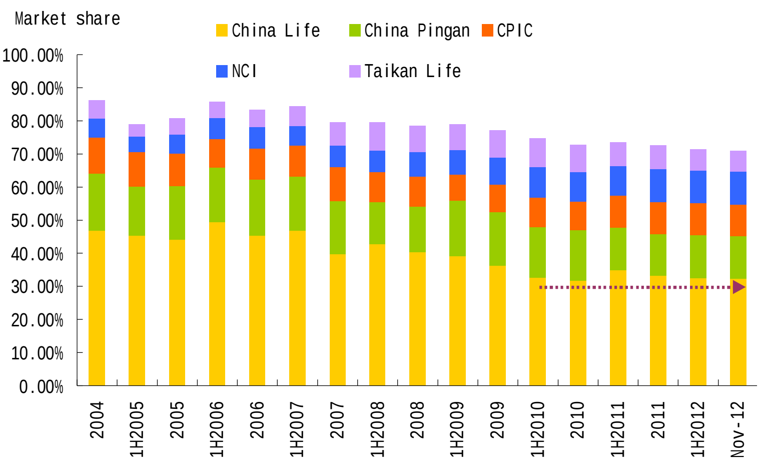
- We believe the profits of the Group would increase significantly in the next two years, and we hold optimistic views for its future performance. We increase the 12-month target price to HK$31.66, as its share price had reached our previous target price recently. The new target price is around 17.25% higher than the latest closing price, and equivalent to 2013P/E34.9x and P/B3.4x respectively. Maintain Buy rating.

Figure 19. Growth of the premiums of China Life



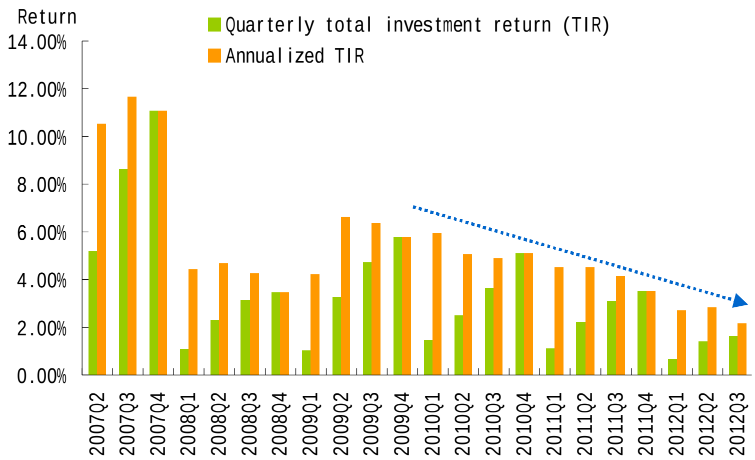
Source: CIRC, Phillip Securities

Figure 20. Changes of main insurers' market shares in terms of life insurance premiums in China



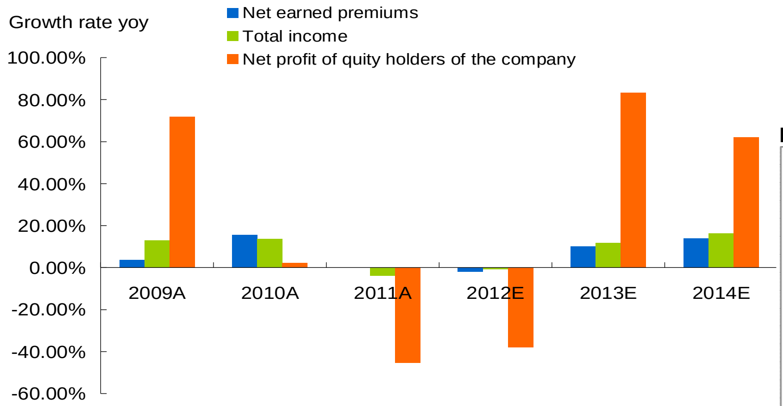
Source: CIRC, PSR

Figure 21. Annualized TIR of China life



Source: Company report, PSR

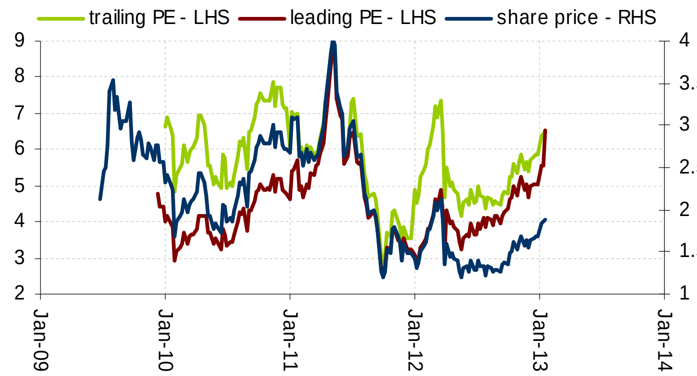
Figure 22. Estimation of China Life's profit growth



Source: Company report, PSR

China Lumena (67.HK)

Fig. 23 China Lumena



Source: PSR, Bloomberg

- Since the unit price of thenardite is stable, CLNM's thenardite business will be steady. Thanks to its business advantages, the negative effect from external competition pressure will be low.

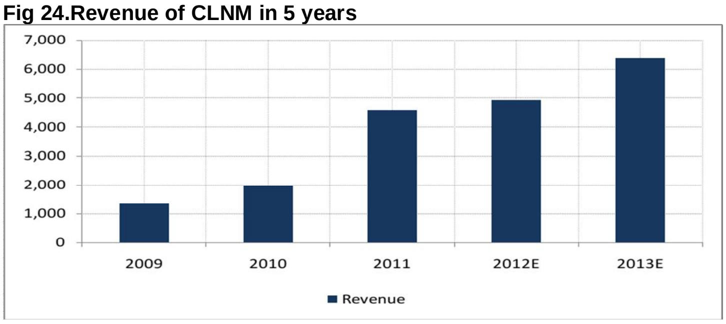
- The unit price of thenardite in the 2HY of 2012 is in low range, therefore there is higher probability of increases compared to the odds in 2011. The potential rising price will benefit thenardite business.

- Both the market demand and unit price of PPS products has been increasing, which would likely improving operating results.

- CLMN had finished the refinance of 250M senior notes, reflecting a good financial position which contributes to the ability of further business expansion.

- The EPS in 2011 is CNY 0.23. The increase of issued share results in a lower nominal EPS. We estimate that the operation results of the 2H will be improved. With the adjustment of business structure, the growth in medium and long term will be stable. We estimate that the EPS in 2012 and 2013 will be CNY 0.24 and 0.39 respectively. Considering the current market condition, the target price in next 5 months is HKD 2.45, equivalent to 5X PE according to our estimation. The rating is BUY.

Fig 24.Revenue of CLNM in 5 years

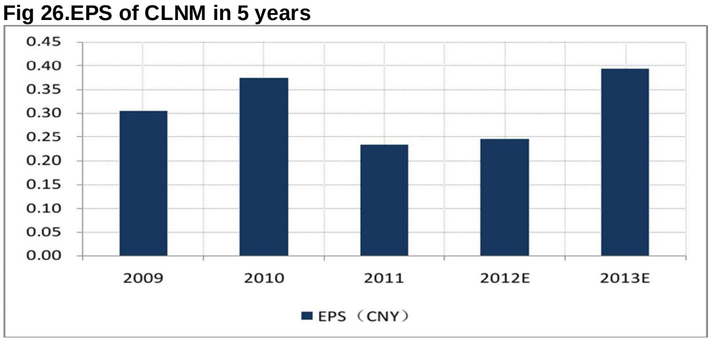


Source: Company report, PSR

Fig 25.Net Profit of CLNM in 5 years

Source: Company report, PSR

Fig 26.EPS of CLNM in 5 years



Source: Company report, PSR

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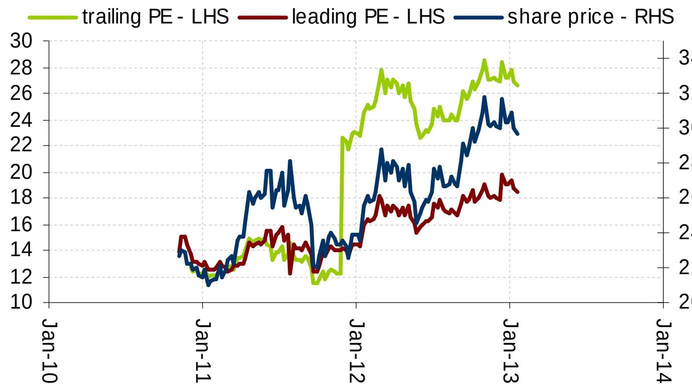
AIA (1299.HK)

Fig. 27 AIA



Source: PSR, Bloomberg

- The Group announced to acquire ING insurance business in Malaysia. The consideration to be paid is Euro $1.336 billion (equivalent to US$1.73 billion). The acquisition has yet to be approved by the local and Netherland's regulatory authorities. Reviewing the ING Malaysia business, its market share is around 13.5% by the earned premiums in 2011, which is the third largest in Malaysia (AIA is the fourth largest insurance company). It serves 1.6 million customers and employing 9200 insurance agents. Its bancassurance services are the second largest in Malaysia. The annualized new premiums accounted for 18% of the market share. 65% of the annualized new premiums were come from the agent, and the rest was from the bancassurance business. Reviewing its results in the last year, net profit was US$ 91 million; the embedded value was US$ 952 million. Using approximately 19x P/E and 1.8x embedded value multiple, the consideration is reasonable. In addition to the profit margin of the value of new business of only 25.4%, comparing to the AIA Group's up to 41.4%, synergies are significant to enhance the profit margin of ING Malaysia business after acquisition.

- After acquisition, the combined customer base will become 2.6 million and the number of agents will increase to 16,000. It will become the Group's fourth-largest contribution region of net profit, contributing nearly 13% of the Group's profit. We expect AIA to become the market leader in that region after the acquisition of the business and market share will be doubled to 25%, result in higher revenue weight on its banking insurance business.

- Coupled with launching Islamic insurance products last year, the Group effectively expanded its market share in that region. The management expects the acquisition to be paid by internal cash or debt financing. The Group are financially strong and has healthy balance sheet, we don`t see the equity financing needs. The Group is expected to use US$55 million to integrate the business within three years, and the synergies generate US$24 million at the end of 2015. Therefore, we are optimistic about the operation prospects of that region.

- The Group's annualized new premiums, and the value of new business rose steadily. As we expected in the report on first quarter results, 1H2012 annualized new premiums in the emerging market region, including Vietnam, Indonesia, Philippines and other markets reached US$ 260 million, rose by 28% yoy, marking the best region in the Group. We estimate that with the sustained economic growth in the three emerging countries (Vietnam, Indonesia, the Philippines), the value of the new business and the annualized premiums growth are expected to outperform the Group's average, becoming the growth engine of the Group in the future.

Assumption for H Model:
Dividend in 1H FY12 =$0.1233 HKD
Long term Average Growth rate = 6.3%
Short-term Average Growth rate = 9%
Required Return = 7.5%
Length of high growth period= 7 years
Source: PSR

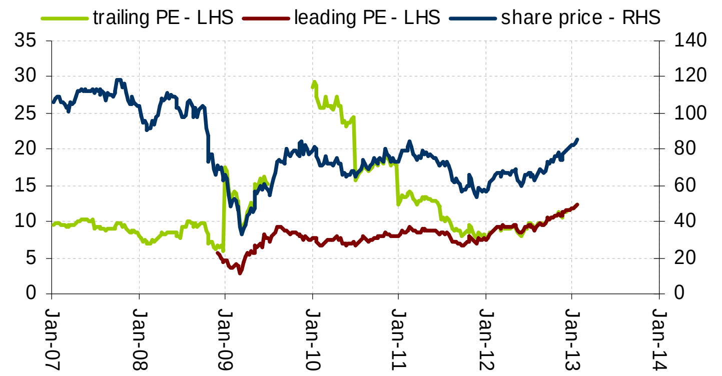
- We expect that the Group to grow at 9% annually in the first seven years ahead and at 6.3% annually afterwards. e. The Group distributed dividend of HK$12.33 cents per share in the first half of 2012, slightly higher than last year's HK$11 cents. In addition, earnings per share rose by about 9% yoy to US$0.11.

- By H model, we calculated the intrinsic value per share to be HK$ 34. Corresponding to P/B rate about 2 times and P/E ratio about 18.88 times, embedded value multiples of the new business is around 19 times.

- Operating performance was slightly better than we have expected before, so we raised our valuation of the Group accordingly. Beyond the significant synergies from Group's acquisition of the ING's Malaysian business, a positive impact is expected on the Group's overall operations. As we have yet to see any improvement in the operations in Korea, we only increased our target price and valuation modestly.

HSBC (5.HK)

Fig. 28 HSBC



Source: PSR, Bloomberg

- On 11th May 2011, group's strategy day, the senior management presented future target of group as below:
  - Maintain the return of equity 12-15%
  - Before 2013 Cut cost US$ 2.5-3.5 billion, cost efficient rate achieved 48-52%
  - Maintain target dividend payout ratio 40-60%
  - Restructure the global business
  - Actual Operating performance in Q3
  - ROE about 10%
  - Cut cost US$ 3.1 billion, cost efficient rate achieved 57.5%
  - Maintain target dividend payout ratio 40-60%
  - Sold and exit 41 non-core businesses

- In first month of 2013, our Quarter target price 85 HKD was achieved, mainly due to strong market conditions. However, we recommended clients to be more cautious as the current prices of HSBC fully reflected the value of its fundamentals. We expect the results of HSBC to improve comprehensively in mid of 2013. However, as the market is likely to be affected by news on U.S. debt ceiling and China enterprises` performance of last year, we recommend investors to be more cautious

- The operation of HSBC has gradually improved; we maintained our profit forecasts of the group for this year and next year, at HK$8 and HK$9.34 respectively. We project earning growths at 11.7% and 16.75% yoy. Expected P/E are about 10.625X and 9.1X, while forecasted P/B are 1.2X and 1.124X respectively in 2012 and 2013. EPS is expected to reach HK$8, and HK$3.6 would be paid out as dividend; the dividend payout ratio can be sustained at 45%. Our forecast is conservative, considering the good cost control and the potential improvement in operating performance in 1H2013; we raise the target price to HK$95, and maintain "accumulate" rating. If the situation is as good as we expect, the target price can be achieved in 1Q2013. To be more optimistic, the share price may reach HK$100 in the first half of 2014.

- We expected the performance of HSBC to be driven by good cost control in the next year. First of all, HSBC has continued to cut costs and improve the cost-effectiveness ratio since the strategy day in 2011. According to the results of the third quarter of this year,

- However, the cost-efficient ratio has been deteriorating, mainly because of the extraordinary spending of US$ 1.2 billion in the Q3 of this year, including restructuring costs of US$ 660 millions, compensation to British customers of about US$ 1.7 billion, a provision of US$ 1.5 billion to the U.S. anti-money laundering investigation. In total, the extraordinary spending was nearly US$ 4 billion.

- As these costs are likely to be one time and are not related to core operations, we expected a better profit margin in the years ahead.

- The current P/B of HSBC is about 1.2X, close to the five-year average. The Group's cost-efficient ratio is slightly higher than its peers. However, with the on-going global business restructuring and an improving global market, we expect double-digit growths in EPS during 2012 and 2013. We maintain "accumulate" investment rating, and raise target price to HK$ 95.

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