

China & Hong Kong Strategy

Increased tolerance in economic slowdown for deleveraging and structural reform

17 January 2014

CSI300: 2221.98 (-11.93% ytd); HSCEI: 9024.01 (-21.09% ytd); HSI: 20468.67 (-9.66% ytd)

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- **Head of Research Hong Kong's top pick is: K.Wah International Holdings Limited (173.HK).**
- **We underweight CSI300, HSCEI and HIS for short to medium term. 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 long term CN gov bonds, Underweight CN short term CN gov bonds and Underweight HK bonds**

The market optimism over the nation's economic recovery at the beginning of this year has faded away. Rather than bolster economic growth as the market earlier expected, the new leadership has signalled to be more determined to forgo short term growth in exchange for a long term sustainable growth through containing financial market risks and implementing structural reforms. In that spirit, the tone of monetary policy has shifted from accommodating growth to stabilizing financial system amid the government led deleveraging and economic slowdown. Therefore, we do not expect massive liquidity injection such as Reserve Requirement Rate cuts or even a large scale reverse repo operation.

China's HSBC manufacturing PMI for June reported 48.2, indicating a contraction in the nation's small and medium manufacturing businesses for a second consecutive month. Official manufacturing PMI reported 50.1, after the 50.8 reading in May. HSBC service PMI and the official non-manufacturing PMI reported 51.3 and 53.9 in June, after their respective 51.2 and 54.3 readings in May, indicating relatively weak expansion in services sector. Growth of industrial production slowed down slightly to 9.2% y-y in May, compared to the 9.3% y-y growth in Apr. Retail sales reported a growth of 12.6% y-y in May, barely changed from the 12.5% reading in Apr. YTD fixed asset investment growth slowed down to 20.4% y-y in the 5 months period through May, compared to the 20.6% y-y growth in the 4 months ended in Apr. Exports saw a sharp slowdown to 1.0% in May, compared to the 14.7% y-y growth in Apr.

CPI and PPI growths remained weak, reflecting weak economic activities. Housing market data showed that 69 out the 70 major cities saw yearly increased new home prices in May, compared to 68 cities in Apr.

In Hong Kong, exports fell by 1.0% y-y in May, after the 9.0% y-y growth in Apr. Retail sales grew by 20.7% y-y in Apr, after

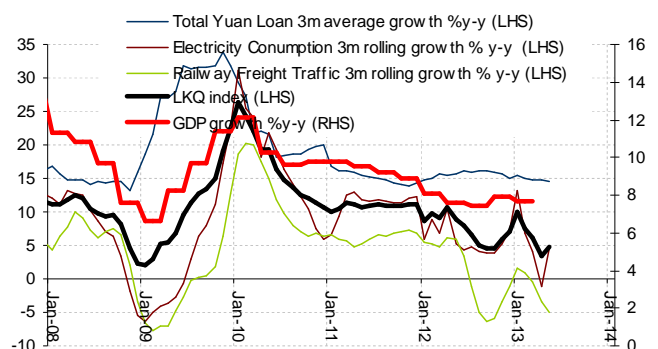
Real GDP / Inflation: 7.8% / 2.5%
2013(f) China Real GDP / Inflation: 7.5% / 2.0%

the 9.8% y-y growth in Mar. Hong Kong's housing price finally sees some monthly fall after the local government's relentless cooling policies and transaction volume contracted. Visitor arrival growth showed signs of slowdown on slower growth of visitors from mainland China. Considering the economic surgery on going in the mainland, who is Hong Kong's biggest trading partner, the city's local economy could be also lacklustre in the near future.

Back from China's traditional long holiday of Rice Dumpling Festival, China's market indices fell off cliff. In less than two week's time, CSI300 plunged by over 18% to 2023.17 at noon market close of 25th June, marking the lowest over a 4 years period. The collapse of the market sentiment is attributable to a cash squeeze as the central bank refrained from further loosening credit into banking system in an effort to curb speculative lending. The tightening liquidity may bring some small companies to bankruptcies in some over-capacity industries in the future. For the current being, though the valuations for all three indices (CSI300, HSCEI and HSI) have become very attractive due to the massive sell off, the short term uncertainty from both market sentiment and macroeconomic front is very high. Therefore we suggest our clients to hold their stake on hand and wait for stabilizing signals. We marketweight long term CN government bonds, underweight short term CN government bonds and underweight Hong Kong bonds. We have positive view on CNY and HKD.

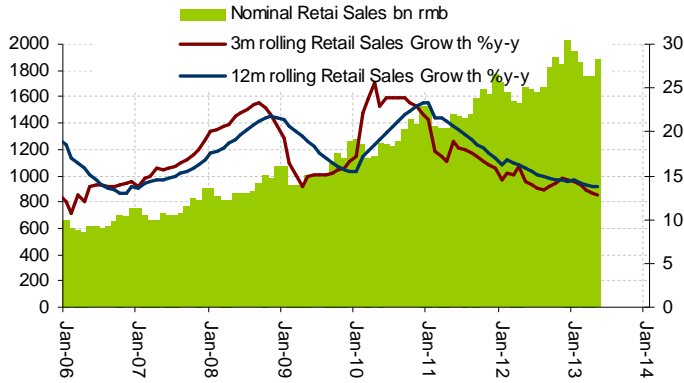
China Economic Metrics and Growth Outlook:

Fig.1 Li Keqiang Index, a good proxy for China's GDP growth, created by the Economist in the name of China's current Premier, Li Keqiang, indicates that China's economic growth would continue slowdown in 2Q13.



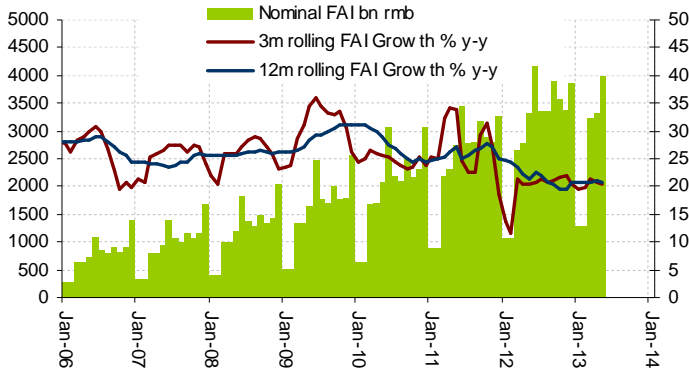
Source: PSR, CEIC

Fig.2 Retail sales, a proxy for consumption, saw a continued slowdown into May, which could be attributable to the anti-corruption campaign by China's new top leadership since earlier this year as retail sales for luxury goods is affected.



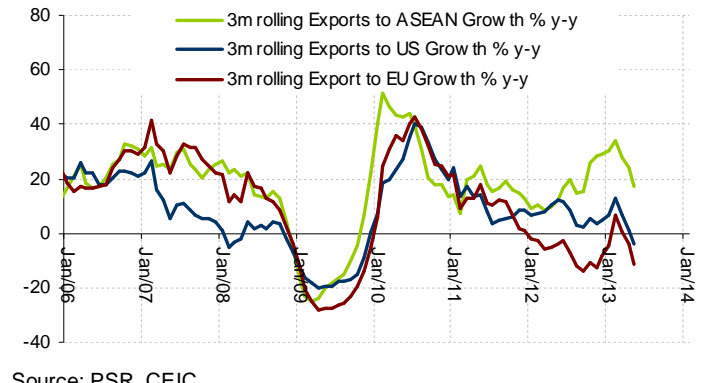
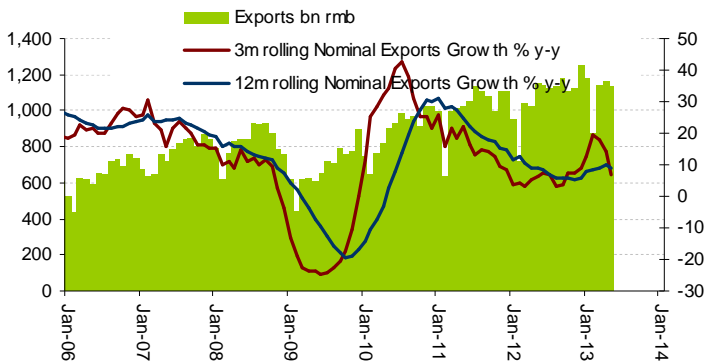
Source: PSR, CEIC

Fig.3 The growth rate of FAI, the proxy for the nation's investment, remained stable at slightly above 20%, still a relative high level. But we do not expect it to be employed by the government as a tool to boost growth since the nation has been left with over-capacity problems and financial system risks after the 4 trillion massive stimulus in 2009. In addition, the government has clearly signaled that in the current being reform rather than growth would be the focus.



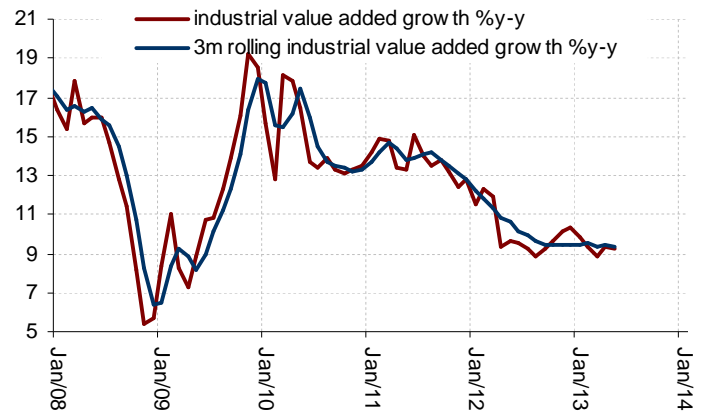
Source: PSR, CEIC

Fig.4&5 After some controversial data earlier this year, exports saw a sharp slowdown in May, reporting a tiny overall growth of 1.0% y-y. Exports growths to US, EU and ASEAN all taper off. With increasing cost of labor, China could gradually lose competitiveness to emerging ASEAN countries such as Philippines for manufacturing business.



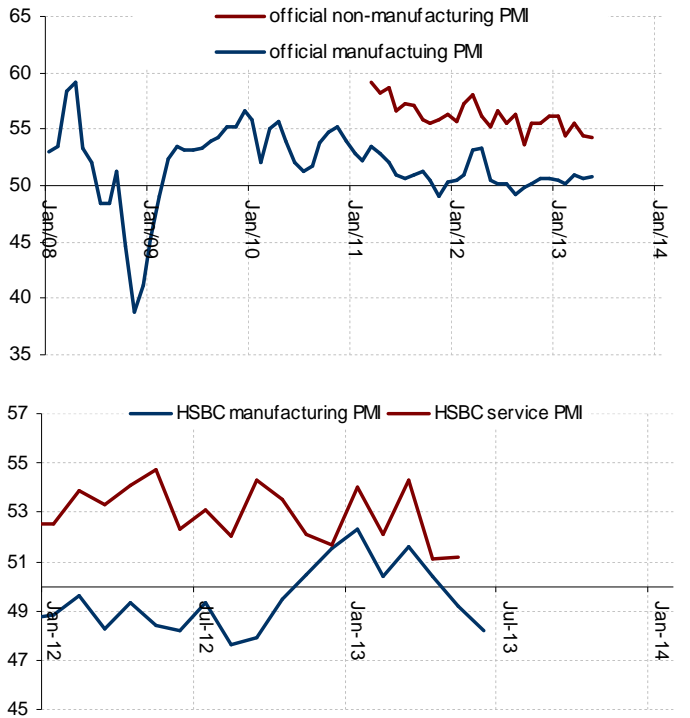
Source: PSR, CEIC

Fig.6 Industrial production continues hovering at a low level slightly above 9.0%.



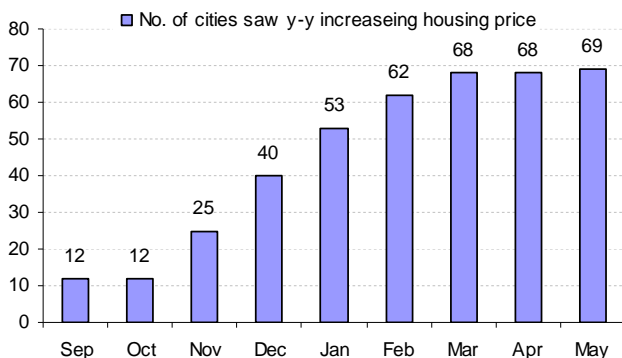
Source: PSR, CEIC

Fig.7&8 Official and HSBC PMIs indicate cooling economic activities in both manufacturing and services sectors.



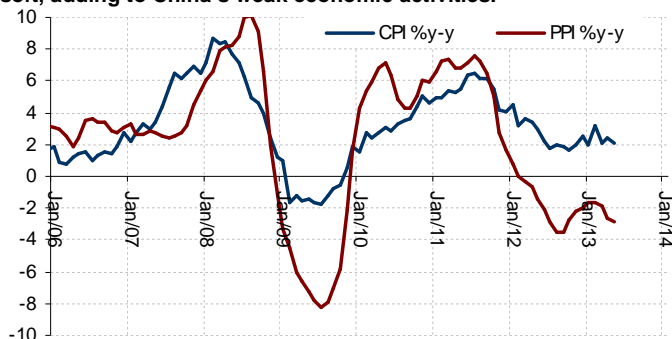
Source: PSR, Bloomberg

Fig.9 Out of the 70 major cities in China, 69 saw yearly increased new home price in May, though sporadic cities saw monthly drops.



Source: PSR, CEIC

Fig.10 Inflation stayed tame, reporting 2.1% in May, and PPI remained soft, adding to China's weak economic activities.



Source: PSR, CEIC

Policy Review and Growth Forecast

- We have been tracking closely Chinese government's policies since the new leadership took over the reins. Clients are referred to our CN-HK strategy reports on 19/12/2012 and 24/04/2013 for more details of some major policies. Along with the policy provisions so far, the government has clearly indicated in different occasions its increased tolerance in growth slowdown during the transition period of economic reforms. The government's determination and perseverance in reforms have been tested by the recent credit crunch in the banking system, where inter-bank overnight interest rate is pushed to as high as 30% at the peak on 20th June, due to the central bank's reluctance in providing further credit loosening. Even though the inflation has been tame, the increasing home prices in major cities would still impede interest cut in the near term unless crisis does occur and the government has to take action to support the economy.
- Relentless government-led investment and credit loosening is not a sustainable way to achieve high speed in the long run and changes in such regime have been expected to come someday. Now reform has really come, accompanied by uncertainties in the economy. We can clearly sense the change of tone from China's President Xi Jinping's saying that officials should not be solely focused on growth, following which we expect local

government to have less incentives to pursue economic growth regardless of cost.

- **We downward adjust China's 2013 GDP growth forecast from earlier projected 8.0% to 7.5%, just the government's growth target, and still caution that there is even possibility that the government may fail to meet the target.** We forecast a full year inflation of 2.0% in consideration the weak economic growth.

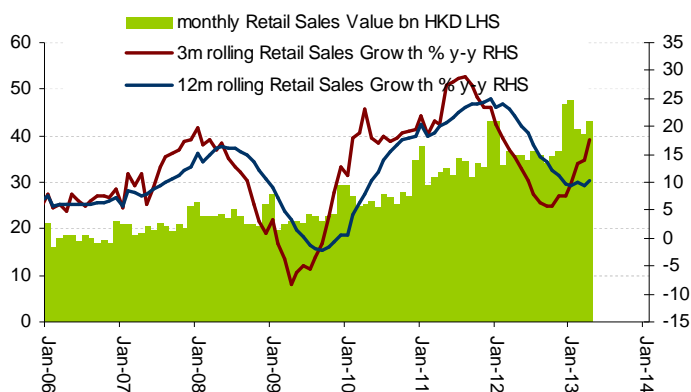
HK Economic Metrics and Growth Outlook:

Fig.11 HSBC PMI reported 49.8 in May, a second consecutive month of reading below 50, indicating a contraction in the city's economic activities. With a slowdown of China, Hong Kong's biggest trading partner, we do not expect much catalyst in the city economy from China.



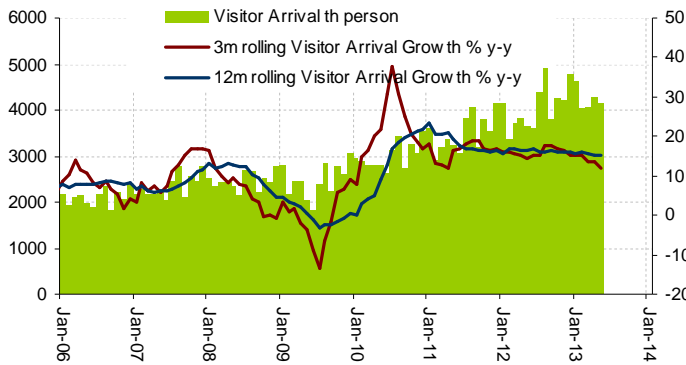
Source: PSR, Bloomberg

Fig.12 Retail sales growth unexpectedly picked up to 20.7% y-y in Apr, which is less likely to sustain amid the backdrop of China slowdown.



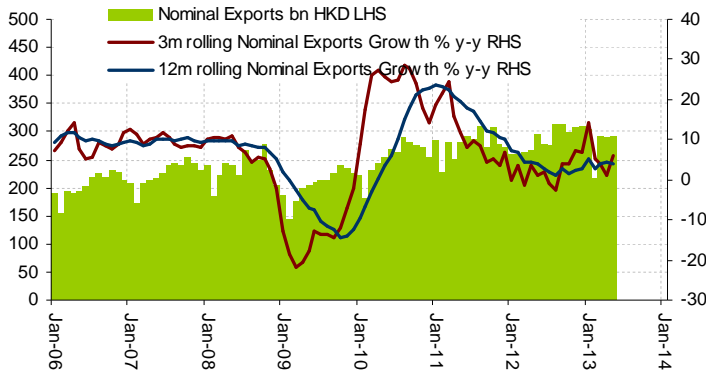
Source: PSR, CEIC

Fig.13 Staying at above 15% for the past year, the growth of visitor arrivals finally slows down on weaker growth of visitors from China. As tourism is associated with about 10% of the city's GDP, the slowing trend of visitor arrivals could have negative effect the city's outlook.



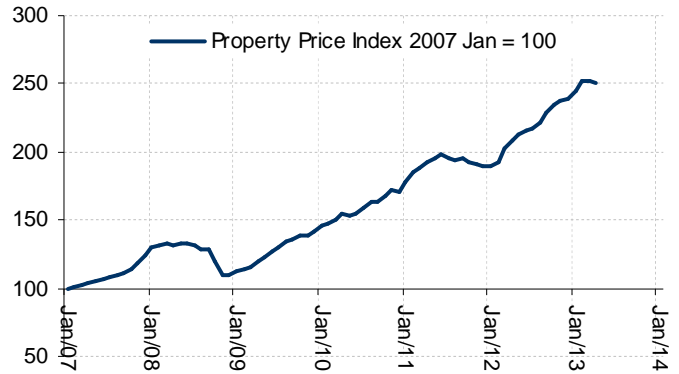
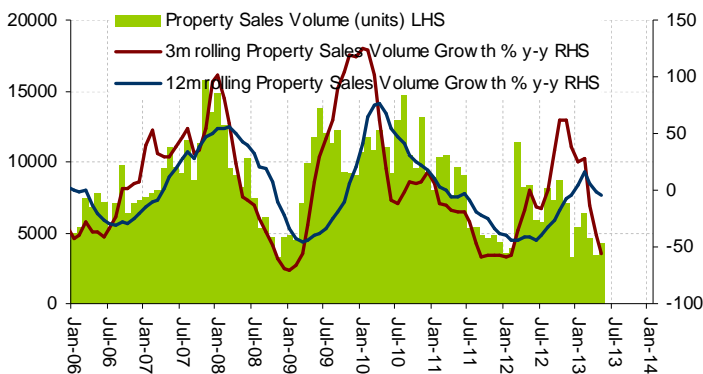
Source: PSR, CEIC

Fig.14 Exports growth remained volatile, hovering near the level around 5% y-y. Hong Kong's exports could be under pressure from a slowdown of China and the still not so clear economic environment of western world.



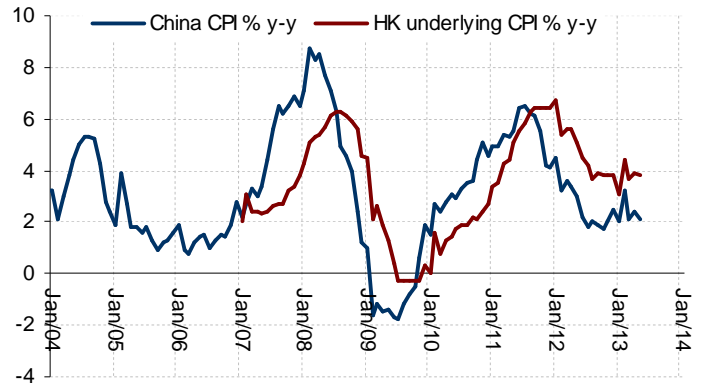
Source: PSR, CEIC

Fig.15&16 After relentless policy tightening by Hong Kong government, we see the transaction volume of residential houses brought down and the momentum of rising housing prices finally contained. With a potential withdraw of FED QE3 and a slowdown of China economy, the factors that keep pushing Hong Kong property price previously would gradually wane.



Source: PSR, CEIC

Fig.17 Due to the lackluster economic outlook for China and the repatriation of funds from emerging market to US due to the potential withdraw or reduction of scale of QE, we expect inflation to slightly slow down in Hong Kong.



Source: PSR, CEIC

Hong Kong Growth & Inflation Forecast:

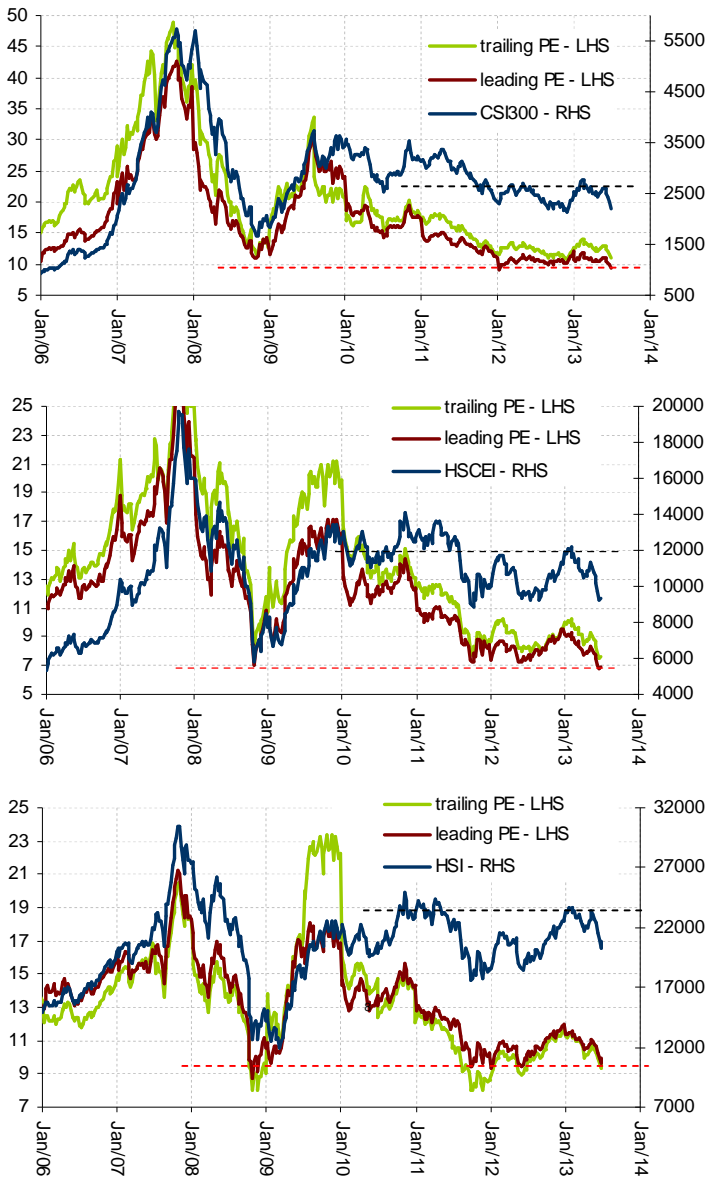
- Consider the impact of the growth slowdown in China, we lower our 2013 forecast for Hong Kong GDP growth to 2.8% from earlier projected 3.0%. Inflation forecast is downward adjusted to 3.8% from 4.0%.

Asset Strategy

- **Stock Market:** Back from China's traditional long holiday of Rice Dumpling Festival, China's market indices fell off the cliff. In less than two week's time, CSI300 plunged by over 18% to 2023.17 at noon market close of 25th June, marking the lowest over a 4 years period. The collapse of the market sentiment is triggered by the recent liquidity crunch, which is interpreted as a sign of the central bank's intention of weaning the financial market from overly loose liquidity in an effort to curb speculative lending. And the sudden upshot of interbank overnight interest rate also adds to this case though later PBoC announced it had provided funding to some major financial institutions to ensure market stabilization. Going forward, we expect it to get increasingly difficult for some small enterprises, especially those in over-capacity industries, to get loans and some may be forced to

bankrupt. Even though the valuations for the 3 market indices have been very attractive by P/E ratios (CSI300 at 9.5X, and HSCEI at 7.5X, both below their previous historical low post 07/08 financial crisis; HSI below 10.0X, near historical low), there is significant uncertainty arising from the weak sentiment of recent market turmoil in the very near term and also the risk associated with the government-led reforms that would extend to mid term. Despite the very cheap valuations, the heightened uncertainty is likely to cap the upside of the market in the medium term, thus we downgrade our overweight to **underweight China market for the near to mid term** and suggest our clients avoid adding stakes until the above specified uncertainties wane.

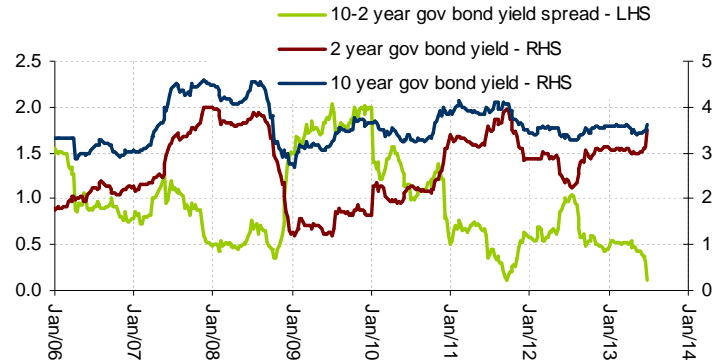
Fig.18 Despite the very attractive valuation in all 3 indices, we suggest our clients to hold their stake on hand until uncertainties in the near/mid term wane.



Source: PSR, Bloomberg

- **Bond Market:** Despite the recent short term liquidity crunch, we do not expect China's economic outlook to be much affected, therefore we **keep marketweight on China's long term government bonds**. But the tightening liquidity would have an upward pressure on short term interest, therefore we **underweight China's short term bonds**.

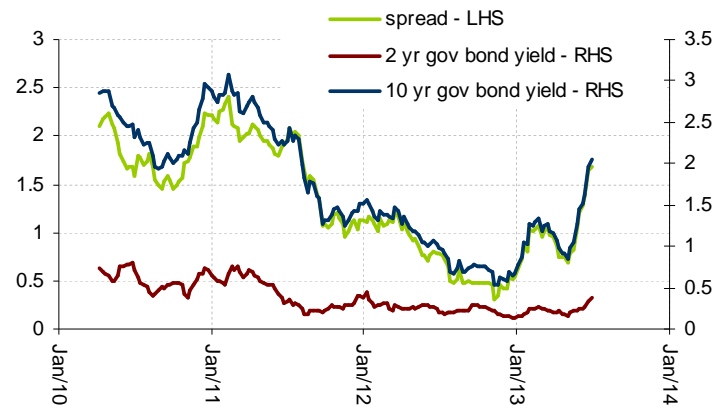
Fig.19 China Government 2y/10y bond yields and spread



Source: PSR, Bloomberg

- We keep **underweighting Hong Kong's government bond** due to the possible rising yield associated with the potential reduction or even withdrawal of QE by FED.

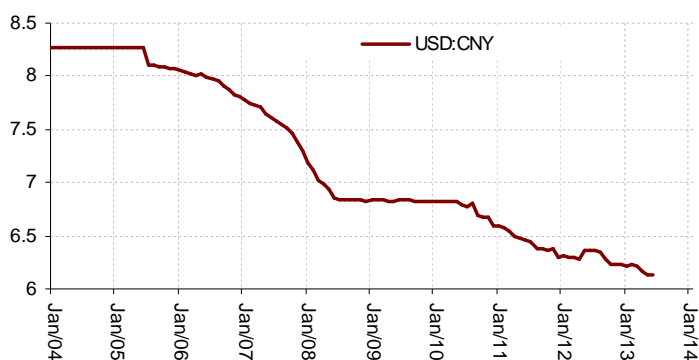
Fig.20 Hong Kong Government 2y/10y bond yields and spread



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 and still has scope for further appreciation. But in the near term, potential reduction or even possible withdraw of FED QE and the associated fund repatriation back to US might induce a stronger USD. We **change our view on HKD from neutral to positive** due to its pegging to USD.

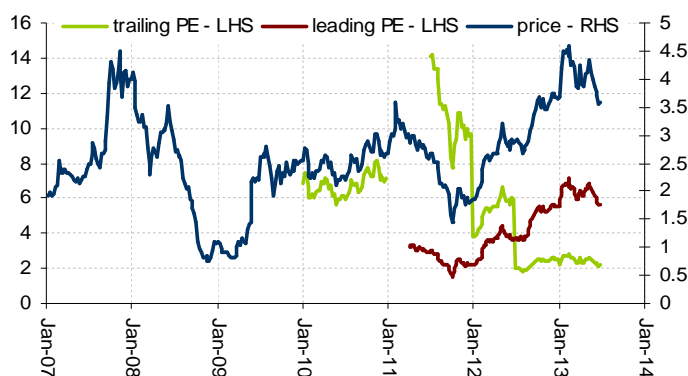
Fig.21 USD:CNY exchange rate



Source: PSR, Bloomberg

STOCK PICKS:**Head of Research Hong Kong's top pick:*****K. Wah International Holdings Limited (173.HK)***

Fig.22 K. Wah International Holdings Limited



Source: PSR, Bloomberg

- K.Wah International Holdings Limited is an integrated property developer and investor. KWIH has a presence in HK, Shanghai, Guangzhou and Southeast Asia, property portfolio including residential, Grade A offices, hotels, serviced apartments and retail spaces. KWIH's JV projects in HK include Marinella, Providence Bay and The Coronation. KWIH's property development projects are mainly located in the first-tier China cities such as Shanghai and Guangzhou.
- The Group reported strong growth in 2012. Core earnings increased 2.4 times y-y to HK\$4.127b. DPU was HK\$15 cents, an increase of 50% yoy, mainly driven by HK sales, including Providence Bay, Providence Peak and Marinella. We expect 2013 focus will shift to the projects in Shanghai and Guangzhou, such as The Palace, Upstream Park in Shanghai and Le Palais, J Metropolis in Guangzhou.
- Chinese government is committed to dampen speculative demand and has introduced harsher regulation rules, such as strictly levying 20% personal income tax from home sales, qualification check on

second home mortgage borrowers and the ban on the third home loans. We expect these policies have more impact on demand for high-end properties. Fortunately, first phase of The Palace in Xuhui District, a traditional luxurious residential area, has already recorded sales over 60%, which will be booked in 1H2013. The projects in GZ are for lower end market which is less affected by recent policies.

- The Group actively acquired sites in 2012, including 3 sites in HK for total HK\$5.162b (including joint ventures), 1 site in Pudong District in Shanghai for RMB671m and 1 site in Xihu District in Dongguan for RMB657m. The Group's gearing ratio was healthy at 21% in 2012, down 8% from 2011. We expect the Group will continue to seek opportunities to increase its land bank.

Mainland properties sales progressing well but may slow down by policies

- In Guangzhou, the Group launched Le Palais and J Metropolis, with ASP of approximately RMB9,000 psm and RMB8,200 psm respectively. Le Palais sold more than half of total 303 units. J Metropolis, launched earlier this year, only sold about 20-30% of total 564 units. The progress is slower than we expected.
- In Shanghai, first phase of The Palace in Xuhui District, a traditional luxurious residential area, has already sold more than 60% of the units with ASP of around RMB100,000 psm and the sales will be recognized in 1H2013. Upstream Park in Minhang District has 1,424 salable units and has already sold more than 70% of the total with ASP of approximately RMB17,000 psm. In addition, the Group said it would launch Grand Summit at the end of 2013 or early 2014.
- The Group's sales progress in mainland is at satisfactory level, but it is expected to slow down due to the policies. We remain optimistic and expect after the market consolidate the impact from the policies. The Group has its competitive edge in mainland from its well-known brand.
- We raised 2013 NAV per share estimate to HK\$9.5 to reflect the higher valuation of Galaxy Entertainment Group (27.HK), in which the Group has 3.9% interest. With expected slower properties sales due to policies, we assign a higher discount to NAV. Using the long-term historical average discount of 53.6%, we give an "Accumulate" rating, with target price at HK\$4.40, slightly lowered by 3.5% from previous target price.
- Major risks include harsh policies by the government, weak demand from a deteriorating China economy, uncertainty in home prices

Fig.23 2013 Dec NAV Estimate

2013 Dec NAV Estimate

Item	HKD mn	HKD per share	% of GAV
Investment properties	5,134	2.0	17.6%
HK development properties	7,680	3.0	26.3%
Shanghai development properties	6,423	2.5	22.0%
Other projects	3,211	1.2	11.0%
3.9% holding on Galaxy Entertainment (27.HK)	6,703	2.6	23.0%
Total gross asset value	29,151	11.3	100.0%
Net debt	-4,634	-1.8	
Net Asset Value	24,517	9.5	

Source: Company report, PSR

Fig.24 Historical discount/premium to NAV



Source: Company report, PSR, Bloomberg

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