



China Galaxy Securities (6881 HK) - Buy

26 June 2013

Initiation

Rating: Buy
TP: HK\$6.20

Key data

Share price (HK\$)	4.47
Target price (HK\$)	6.20
Upside potential (%)	38.7
52 Wk H/L (HK\$)	5.9/4.02
Issued share (mn)	7,537
Market cap (HK\$mn)	33,692
30-day avg vol (HK\$mn)	309.64
Major shareholding (%):	
Galaxy Financial Holdings	69.18
Auditors	Deloitte

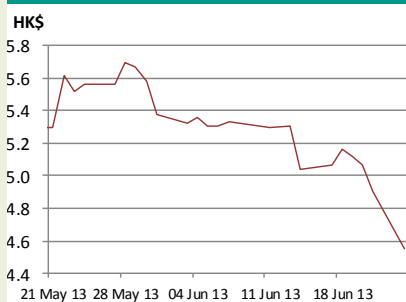
Source: Company

Revenue mix (%)

	2012
Revenue:	
Securities brokerages	68.5
Futures brokerage	8.7
Proprietary trading	6.7
Investment bank	11.5
Asset management	0.8
Private equity	0.4
Overseas	0.6
Others	2.8
Total	100.0

Source: Company

Share price performance (since IPO)



Source: Bloomberg

Analysts

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Preeminent brokerage with strong growth outlook

China Galaxy Securities (CGS) is one of the China's pioneering brokerages. It has one of the largest client bases within the sector, sustaining its high market share and ROE. We expect CGS's future earning will be driven not only by solid brokerage business, but also by innovative products and asset management business. Riding on China capital market's momentum rebound, we forecast CGS's net profit to grow by 34% CAGR in 2012-15E. We initiate coverage on CGS with a BUY rating and target price of HK\$6.2 implying a 39% upside.

Largest network with high ROE. CGS is the largest broker in China with 229 branches. Its balanced branch distribution successfully built CGS's 5.6mn customer base, which led to high brokerage revenues with 5.2% market share in 2012. We are impressed by its customer loyalty with which 82% of its customers have already been with CGS for three years and above. High efficiency reflected by top-notch revenue per branch and per staff translated into CGS's sector high ROE of 8.5% in 2012.

Two additional earning drivers. Besides CGS's solid earnings from brokerage business, fast growth in margin financing and securities lending (MFSL) and asset management (AM) would be the upcoming earning drivers. Revenue from MFSL would grow by 52% CAGR in 2012-15E, driven by increasing demand for leverage and short selling products in China as well as CGS's huge client custodian base, thus increasing profit contribution from 9.2% in 2012 to 17% in 2015E. High growth potential in AM riding on resilient China's wealth growth would achieve 89% revenue CAGR in 2012-15E.

Positive outlook on China's capital markets. Assuming that China's primary market would defrost in 3Q13 with better average daily turnover (ADT) sentiment, we forecast turnover velocity (TV) to reach 170% by 2015E. Together with continuing enhancement of non-bank loan financing sources, we expect resilient turnover growth in both equity and debt market. Ongoing sector liberalization and product developments would benefit the sector, particularly for CGS with its strong first mover track record.

Initiate with a BUY rating. We initiate coverage on CGS with a Buy rating and a target price of HK\$6.2, representing 17.9x of 2013E P/E or 1.5x 2013E P/B, or 39% upside from current price.

Risk factors: Sharp decline of capital market turnover, prolonged suspension of primary market, and slowdown of China economic growth.

Financial Summary

(FY ended Dec 31)	FY11A	FY12A	FY13E	FY14E	FY15E
Revenue (Rmb mn)	6,431	5,962	7,284	9,141	10,853
Chg (%YoY)	(24.0)	(7.3)	22.2	25.5	18.7
Net profit (Rmb mn)	1,578	1,420	1,918	2,771	3,390
Chg (%YoY)	(43.2)	(10.0)	35.1	44.5	22.3
EPS (Rmb)	0.26	0.24	0.28	0.37	0.45
BPS (Rmb)	2.67	2.90	3.32	3.63	4.00
DPS (Rmb)	-	-	0.12	0.13	0.16
P/E (x)	-	15.1	12.9	9.7	8.0
P/B (x)	-	1.23	1.08	0.98	0.89
ROAE (%)	10.3	8.5	9.0	10.5	11.7

Source: Company, ABCI estimates



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Executive summary

Five differentiating factors

China Galaxy Securities Co., Ltd. (“CGS” or the “group”) is one of the leading integrated financial services providers in China. With the largest branch network and client base, CGS provides a comprehensive set of financial services for investors. We have identified five CGS’s key differentiating factors contributing to its future success. These factors include the market leading branch network and client base, two fast earning drivers namely margin financing and securities lending (MFSL) and assets management (AM), investment bank’s defensive diversification, new business first mover advantage and higher-than-peers operational efficiency.

Largest branch network and huge client base

In 2012, CGS was the largest broker franchise in China with 229 branches, allowing the group to sustain its market leading position both in securities and futures brokerage at 5.2% net revenue market share. The group strategically balanced its branch network over different regions in China to absorb its largest client base of 5.6mn customers. We are especially impressed by CGS’s customer loyalty with half of its customer having relationship with the group over 10 years, and the cost efficiency that 80% of its total transactions were done through its online platform. This contributed to the sector high return on equity (ROE) of 8.5% in 2012.

Two fast earning drivers

Besides the solid traditional commission income, we expect two new segments would increase profit contribution to CGS in an accelerating pace. The first one is MFSL. By leveraging on strong CGS’s client base, the MFSL balance grew by 80% and 110% Y-Y in 2011 and 2012 respectively, represents 6.8% sixth-ranked market share. Contribution to the group from MFSL significantly grew to 9.2% of total revenue in 2012. We expect this segment continue to grow and would account for 17% of total revenue by 2015E.

Riding on the rapid growth of China’s wealth, AM would appear to be another fast growth segment for CGS, which benefits both from the low penetration and widening product varieties by the CSRC. Although AM business is relatively new for CGS with only 1.2% market share, liberalization of broker participation in AM business significant increased CGS’s AUM by almost 8 times in 2012. With the end of high cost phase during initiation, we expect AM to start profit contribution from 2013E.

Risk diversification by investment bank

CGS’s investment bank (IB) business contributed 15% of group profit in 2012. Given the temporary slowdown of China’s primary market development, we expect IPO activities would restart in 3Q13. In addition to CGS’s strong equity underwriting track record, the group’s first-ranked debt underwriting team could offset slack equity activities in down cycle. This was proven by the 101% growth in bond underwritten, when equity



underwritten and brokerage income dropped by 24% and 17% respectively in 2012 due to weak market sentiment.

Sector pioneer in many areas

Leveraging strong relationship with regulators and its major shareholders (Huijin and MOF), CGS is able to proactively participate in many milestone developments in China securities industry namely pilot schemes and the underwriting of new product types such as exchange-quoted bond repo, cash management products, index-based asset AM product, hybrid wealth management products, first non-performing assets securitization product and the first broker handled commercial bank sub-debt. CGS will continue to benefit from first mover advantage to build market share and expertise in innovative business.

High operating efficiency

CGS apparently achieved top ranked operating efficiency in terms of brokerage revenue per branch and per staff, beating its major comparable peers such as CITIC Securities (CITICS) and Haitong Securities (HTS). CGS is transforming its branch network to cater for more innovative business especially wealth management functions, and opening of light branches to reduce hard as majority of its customer were traded by internet. This translated into highest ROE of 8.5% in the sector, 3-7% over top five brokers in 2010-12. We believe CGS's scale advantage would enlarge if market volume increases and we forecast CGS's ROE to rise to 11.7% by 2015E, slightly higher than 2011 level.

Positive outlook on China's capital markets

We notice that China equity market momentum is picking up, with increasing average daily turnover (ADT) to Rmb240bn level in 1Q13, while we expect A-share primary market to restart in 3Q13. We conservatively forecast turnover velocity to rise to 170% by 2015E. While bond market is still at an infant stage, accounting for only 9.2% of GDP or 30% of total financings, we expect acceleration of development and availability of more bond types would lead to system debt raising size to rise by 25% in 2013E.

We forecast the business mix would change in two directions, 1) investors mix becomes more sophisticated with more institutional investor and high net worth individuals (HNWIs); 2) the profit contribution from traditional brokerage business would be lower gradually, while revenue from innovative businesses would rise. Meanwhile, with relaxation in regulations, brokers would be able to increase their balance sheet leverage and enhance ROE by higher margin business such as MFSL. Furthermore, top ten brokers currently aggregated to only 42.8% of market share, compared to 75-90% in other financial sectors. The low concentration hints at the possibility of future industry consolidation.



“One core two wings” model

CGS will focus on developing the “one core two wings” business model, by leveraging synergies between its core brokerage business and two growing segments - IB and investment management (IM). Given keen brokerage commission rate competition, the battlefield of brokers should shift to 1) explore new business opportunities with higher margin such as high-end customers business and MFSL, 2) enhance traditional brokerage transaction volume as defensive factor and take scale advantage, and 3) seek cost reduction opportunity in order to offset narrowing margin.

Initiate with a BUY rating

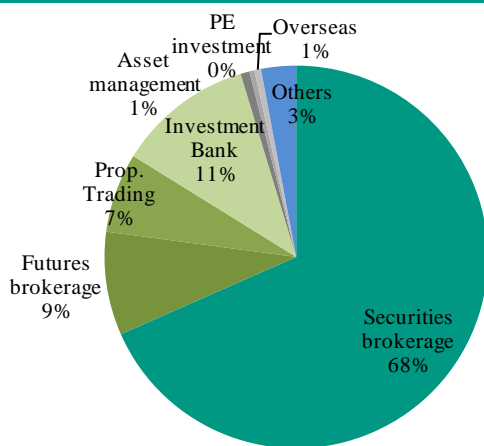
We forecast CGS’s net profit to grow by 33.7% CAGR over 2012-15E. This would primarily be supported by CGS’s sustainable brokerage income leverage on its largest network franchises, our mild economic recovery assumption and two fast growth earning drivers namely AM and MFSL. We therefore initiate coverage on CGS with a Buy rating. A three-stages DDM results in a target price of HK\$6.2, which represents 17.9x and 1.5x of 2013E P/E and P/B respectively, or implies 39% upside.

China Galaxy's differentiating factors

China Galaxy Securities (CGS) is one of the largest investment banks in China, operating in a comprehensive range of financial services such as brokerage, sales and trading (BS&T), investment banking (IB), investment management (IM). In 2012, the brokerage business including securities and futures accounted for 77% of total revenue, followed by 11% from investment banking, and 7% from its proprietary trading. CGS's investment management (IM) business including asset management (AM), private equity (PE), and overseas business in HK was relatively small due to short history.

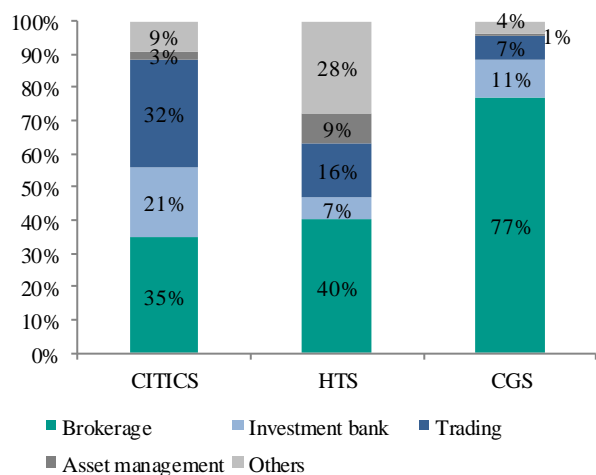
If we compare the revenue mix of CGS with that of CITICS and HTS (the other two H-share listed brokers), CGS is clearly more brokerage-driven with 77-83% of its revenue coming from its brokerage segments, while CITICS and HTS only accounted for 35% and 40% in 2012 respectively. In the following section, we have identified five differentiating factors that CGS could outperform peers under keen industry competition and financial sectors' liberalization.

CGS revenue mix (2012)



Source: Company, ABCI

Revenue mix of H-share listed brokers (2012)



Source: Companies, ABCI

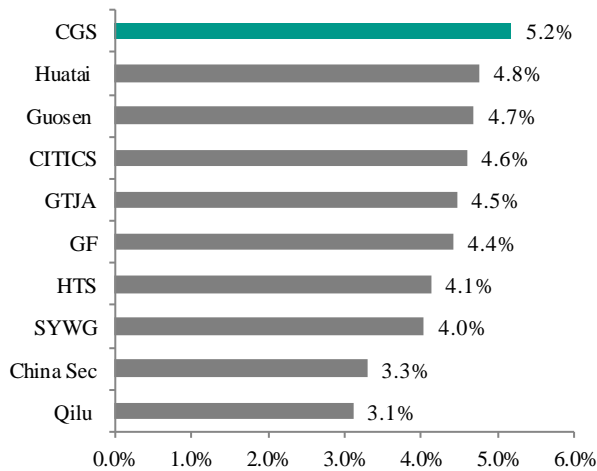
Most profitable brokerage leader

Top ranked in both securities and futures business

Apparently, CGS is the market leader in the China brokerage business demonstrated by its consistent top ranked market share in terms of securities brokerage net revenue every year from 2008 to 2012. In 2012 CGS's market share by brokerage net revenue was sustained at 5.2%, 0.4% higher than the second player. This translated into 7.5% market share in terms of market value of securities in customer accounts, which amounted to Rmb1.8tn, and 5.53% market share, or Rmb33.2bn in terms of total client account balance. Both ranked first in the industry.

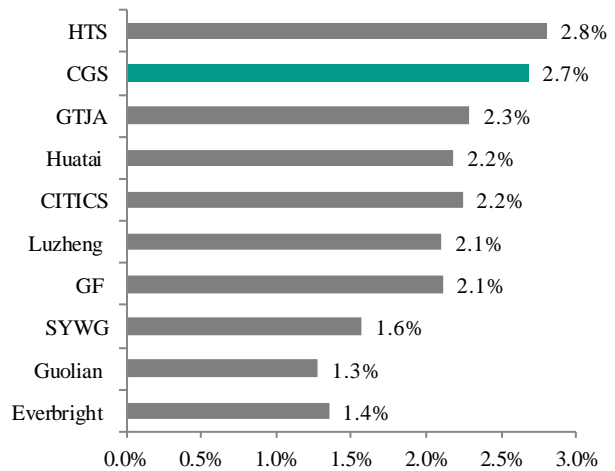


Securities brokerage net revenue market share (2012)



Source: Companies, Wind, ABCI

Futures brokerage net revenue market share (2012)



Source: Companies, Wind, ABCI

Meanwhile, CGS’s futures brokerage business was also top-notch, ranking at first both in 2010 and 2011, while second in 2012 among PRC securities firms. In terms of futures commission and fee income, CGS ranked fifth among PRC futures firms in 2012 according to China Futures Association (CFA). The securities brokerage and future brokerage segment therefore formed an integral business component of CGS and accounted for 68% and 9% of its total revenue in 2012 respectively.

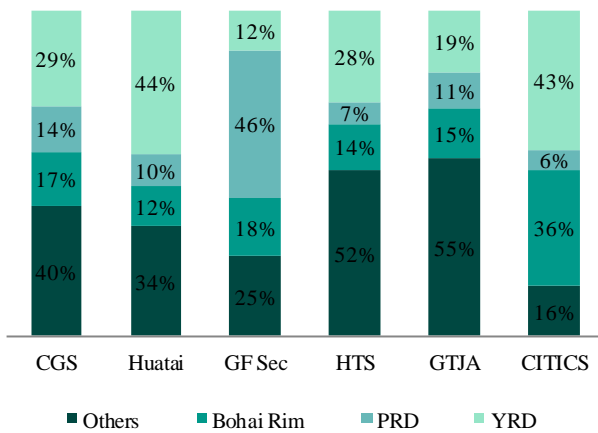
Strategic networks with the largest client base

We believe the leading market share by CGS was mainly driven by the group’s extensive brokerage network coverage, the largest among peers with 229 brokerage branches and 22 futures branches widely spreading over 30 provinces in China. CGS has a balanced mix of branch network, with two-third of its branch networks strategically located in major financial areas including Pearl River Delta (PRD), Yangtze River Delta (YRD) and Bohai Rim (BR), while the rest widely locating in other provinces of China.

Compare to other brokers, Huatai has dominant business focus of 44% of its branch network in YRD. Guangfa Securities (GF Sec) focuses 46% in PRD. HTS and Guotai Junan (GTJA) have over half of their branch networks in non-coastal areas while relatively thin franchise in PRD. CITICS puts heavy resources in YRD and BR, while only 6% and 16% in PRD and other areas in China. CGS’s balanced branch distribution therefore opened wider door to different clienteles, which not only provided CGS with top ranked market share by revenue, but also achieved the largest client bases close to 5.6mn client accounts as of December 2012, compared to 3m+ of CITICS and 4m+ of HTS.

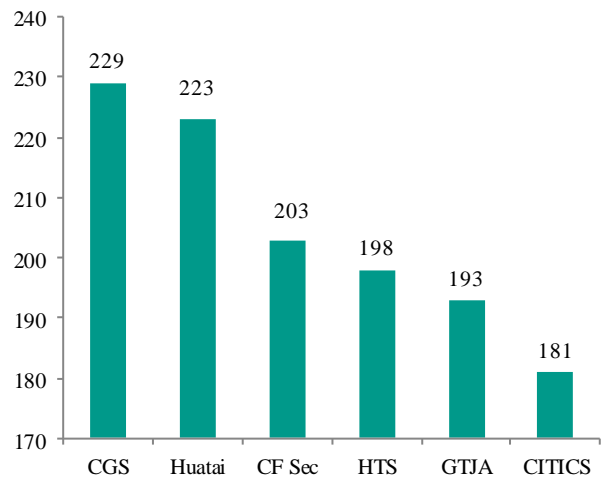


Branch network geographic comparison (2012)



Source: Companies, ABCI

No. of brokerage branch (2012)

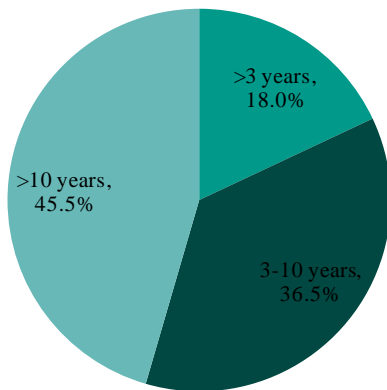


Source: Companies, ABCI

Customer loyalty supporting new business growth

CGS serves close to 5.6mn customers, including 5.5mn of securities brokerage customers and 59,000 futures customers. Among securities brokerage, 16,000 of the clients are institutional investors, 190,000 are HNWI and 500 clients are professional institution investors.

Customer account holding period



Source: Company, ABCI

CGS's client mix

Customer type	No. of customer
Retail customers	5,498,000
Institutional customers	16,000
Total securities customers	5,514,000
Futures customers	59,000
Total customer	5,573,000
Total retail customers	5,557,000
Of which:	
High-end customer	190,000
Professional investors	500

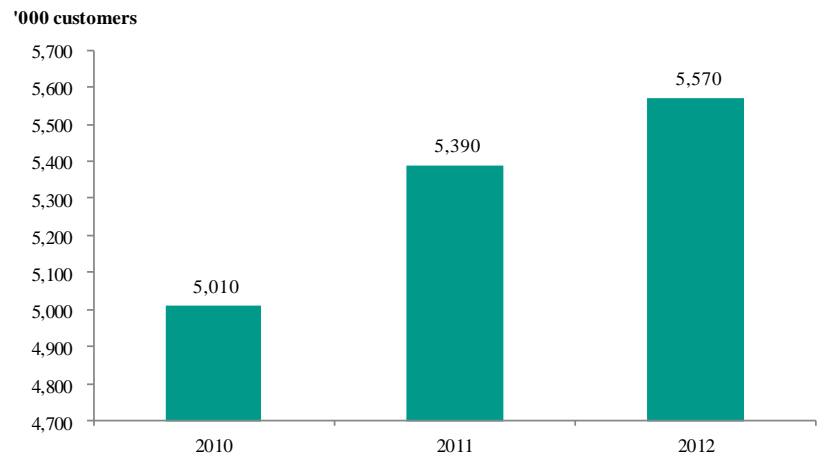
Source: Company, ABCI

We are impressed by the loyalty of CGS's 5.6mn customer base, as 82% of the accounts have already been with the group for over three years, while 45.5% of them have already been with CGS for over ten years. We expect the business focus of branches would gradually shift to wealth management, and create cross-selling opportunity on wealth management products for its retail customers.



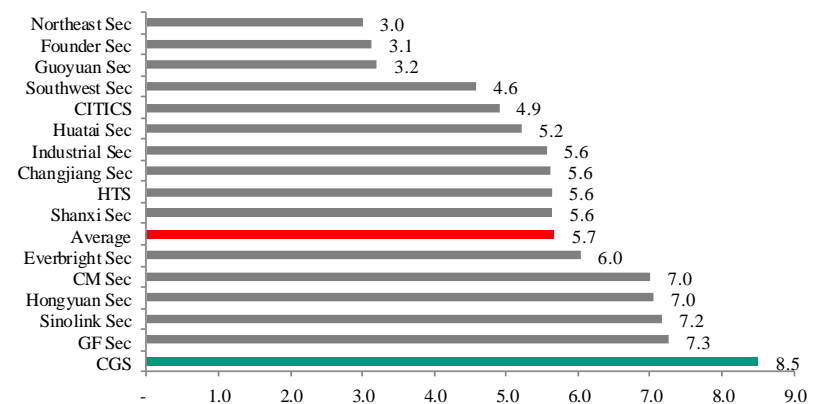
80% of CGS's brokerage transactions were done by its online trading platform in 2012 compared to our estimated 75-80% for CITICS and HTS. The strength of CGS's extensive branch networks would be to absorb new clients and enhance the growth of revenues from high-end and institutional customer through leveraging the cost efficiency from low-cost online trade.

CGS's client base growth



Source: Company, ABCI

ROAE comparison (2012) (%)



Source: Companies, Bloomberg, ABCI

The China securities market is fragmental and competitive. With over 110 market participants in 2012, competition was mainly taken place through price war. Under the tough operating environment in the past several years, CGS's could still achieve a solid growing client numbers from 5mn in 2010 to 5.6mn by the end of 2012. Meanwhile with scale advantage and low cost advantage from the widely use of online trading platform, CGS were able to sustain a higher-than-peers margin. In 2012, CGS's ROE was 8.5% compared to peers' average of 5.7% with which ROE of CITICS and HTS were only 4.9% and 5.6% respectively. Based on our observation and ground checks with brokers, big brokers generally has better bargaining power for higher commission rates, attributed to their integrated services and more reliable

trading platform. With scale advantage from large transaction volumes with low handling cost and new revenue potentials driven by large client base, our earning model predicts that CGS's high ROE track record could be sustained at 9.0% in 2013E and further expanded to 11.7% by 2015E, similar to 2011 level.

Hunting with two guns

Apart from CGS's core brokerage strength, we identify in particular two business segments as the key earning drivers going forward, which are the high value-added MFSL business and assets management business riding on the surging personal wealth in China.

MFSL being the key earning driver

With the MFSL pilot program first launched by the CSRC in March 2010, CGS has kicked off the MFSL business since July 2010, by offering collateralized financing to brokerage clients who wish to increase their financial leverage while lending securities held under CGS's own account and providing short selling opportunity to their brokerage customers. In August 2012, CGS was one of the eleven China brokers allowing to carry out this business under the pilot program. Further in February 2013, CGS became the first broker to operate the securities lending business with the third party owned securities.

Discount rate for different securities

Type of securities	Discount rate
MOF bonds	95%
ETFs	90%
Non-ETF listed securities investment funds and non-MOF bonds	80%
SSE 180 index and SZSE 100 index constituent stocks	70%
Non-ST stocks	65%
ST stocks	0%

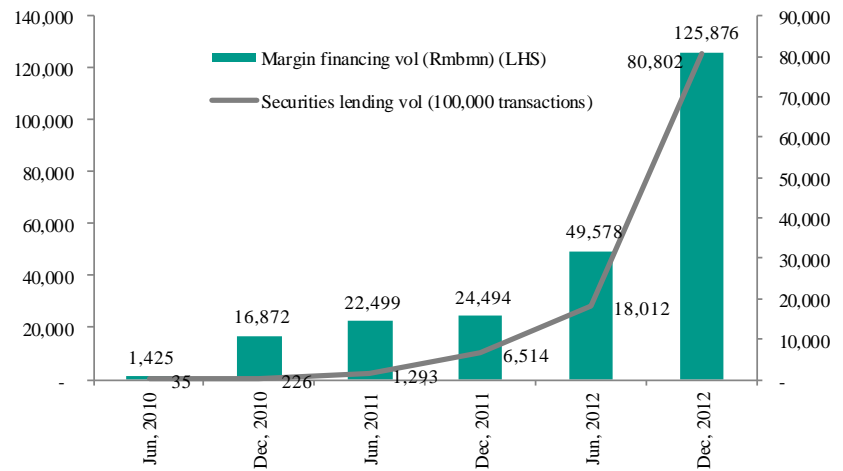
Source: Company, ABCI

The MFSL business enables brokers generate not only interest income, but also traditional commission income from transaction volume arising from brokerage business. Currently interest rate for CGS's MFSL is set at 3% and 5% above 6-month PBOC benchmark rates. Different discounts ranging from 65-95% will be applied to different collaterals.

Over the past years, system MF and SL volume rose over 270% and over 11 times respectively, when outstanding system balance MF and SL surged by 128% and 480% to Rmb85.7bn and Rmb3.8bn respectively. Further in 1Q13, the system ML balance has grown by another 74% in December 2012. Despite the fast growth, the MFSL market in China in fact only accounted for 8% of A-share market, compared to 20-40% in Taiwan, 15% in Japan and 16-20% in the US, implying the huge growth potential in this business segment. With continued liberalization by the CSRC in capital-based intermediary business including MFSL, we expect robust growth momentum of innovative businesses remains intact.



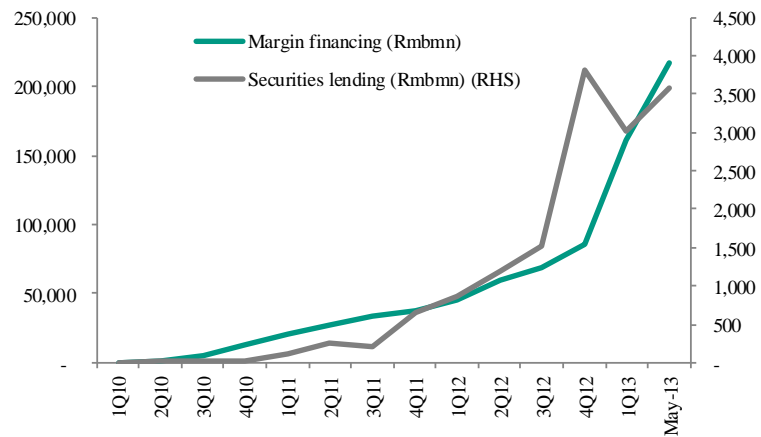
System MFSL transaction volume



Source: Wind, CSF, ABCI

In our view, the huge client base and extensive network create competitive strength for CGS to capture new business opportunities under the ongoing financial reforms in China, in particular the capital-based intermediary business like MFSL. As of December 2012, CGS's MFSL balance rose dramatically by 80% and 110% in 2011 and 2012 respectively to Rmb5.377mn by December 2012, or with 6.01% market share. Meanwhile in terms of net revenue from the MFSL business, CGS accumulated 6.8% market share, or ranked sixth among peers.

System MFSL balance

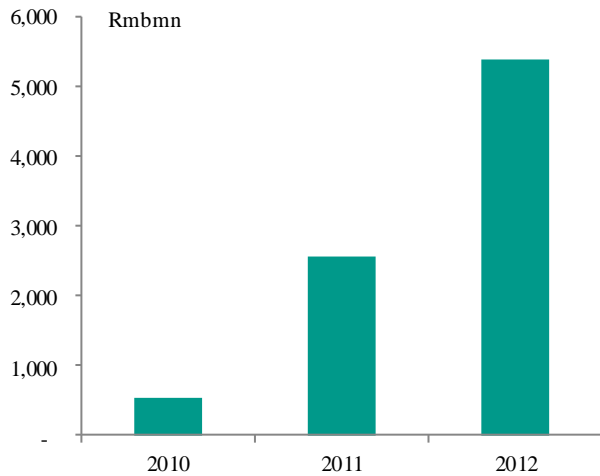


Source: Wind, ABCI

The contribution from MFSL business to total revenue has surged significantly from 3.6% in 2011 to 9.2% in 2012. We forecast CGS's MFSL income to rise by 52% CAGR over 2012-15E, after 120% Y-Y growth in 2012, driven by continued regulatory relaxation, high demand for short-selling instruments and low investor leverage in China. Revenues from MFSL therefore would account for 13-17% of CGS's total revenue in 2013-15E.

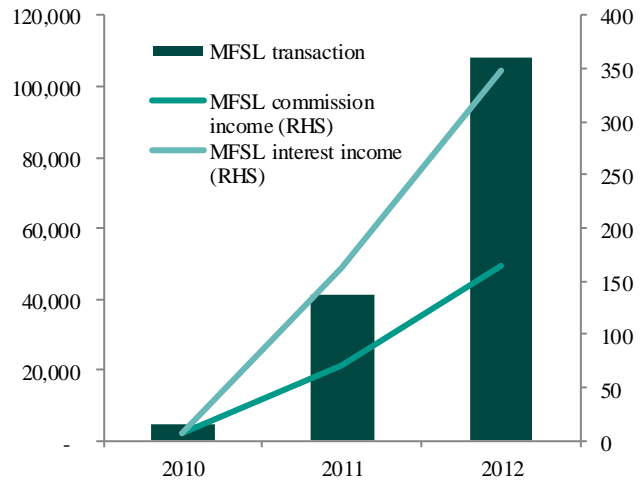


CGS's MFSL balance (end of year)



Source: Company, ABCI

CGS's MFSL transactions and income (Rmbmn)

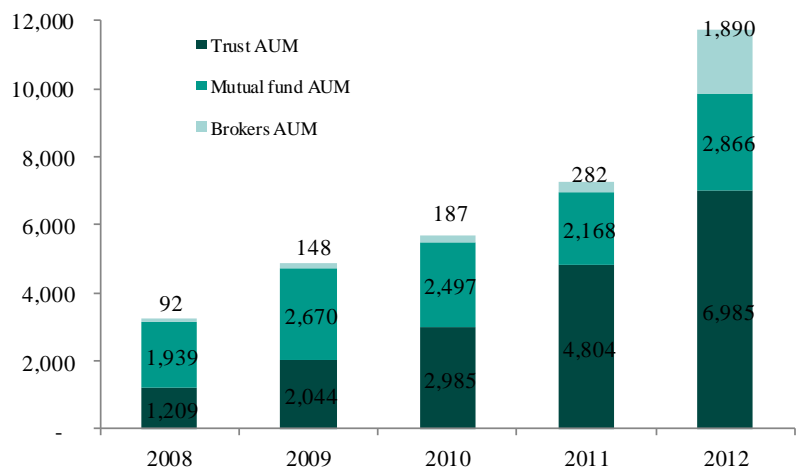


Source: Company, ABCI

Asset management massive take-off

Riding on resilient growth in personal wealth of China and the liberalization of financial markets, assets management industry has been growing fast in the past three years. According to China Trust Association (CTA), total asset under management (AUM) from trusts, mutual funds and brokers in China grew by 44% CAGR to Rmb11,741bn in 2010-12.

China assets management market growth (Rmbbn)



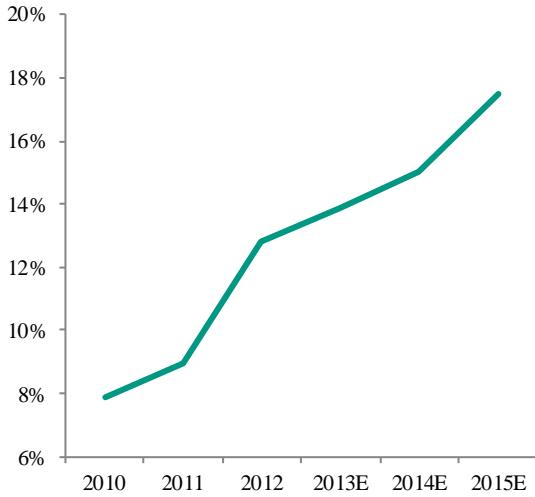
Source: Wind, CSRC, ABCI

System AUM as a percentage to system deposits has rose from 7.9% by December 2010 to 12.8% in 2012 accordingly. We forecast the share to pick up gradually to 17.5% by December 2015E. Meanwhile, the AUM by brokers saw exponential growth in 2012, which was Rmb1,890bn, or 6.7 times of 2011 total AUM. Thanks to the CSRC's continued efforts to allow more fund product varieties and enable brokers to participate in a larger extent, we expect broker's share to system AUM to rise to at least 20% of total AUM by



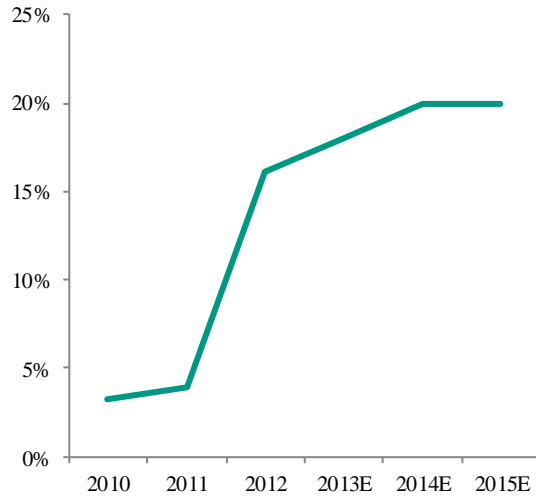
December 2015E.

China trust assets to system deposits



Source: PBOC, CSRC, Wind, ABCI estimates

Broker AUM to system AUM

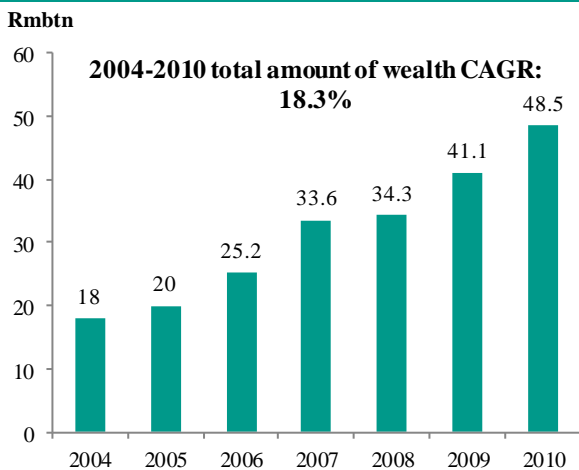


Source: Wind, CSRC, ABCI estimates

Unleashing business opportunities from surging wealth

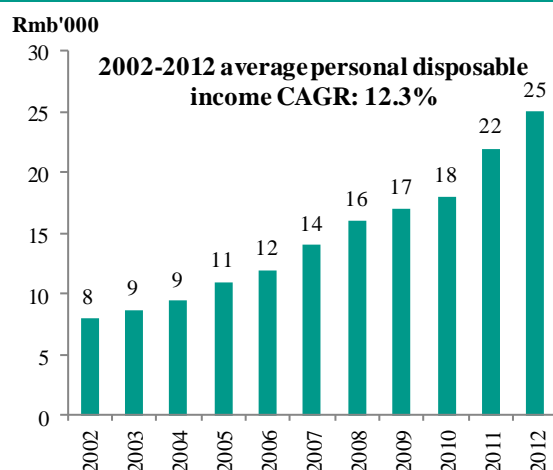
We are of the view that the growth momentum in assets management industry would continue to see a rocket surge, driven by the rapid growth of China wealth. According to the NBSC and the PBOC, China's wealth has grew by 18.3% CAGR in from 2004 to 2011 to Rmb49.5tn, when city population's disposable income grew by 12.3% CAGR over 2002-2012 to Rmb25,000. The capital market development and growth of personal wealth are in fact highly correlated, as the increase in disposable income or investible assets would mean higher investment demand in the capital markets.

China wealth growth



Source: NBSC, PBOC, ABCI

China city population disposable income

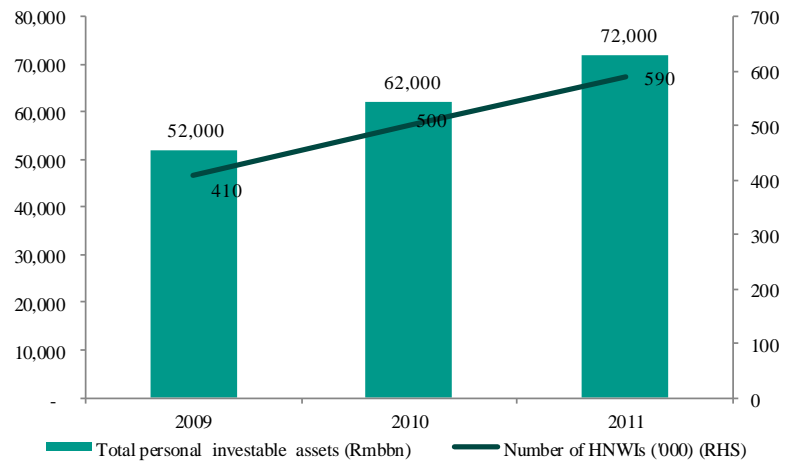


Source: NBSC, PBOC, ABCI



According to China Merchants Bank's 2011 wealth report, the number of HNWI's in China has increased from 410,000 in 2009 to 590,000 in 2011 while China's total investible assets has increased from Rmb52tn in 2009 to Rmb72tn in 2011. However, since the China's wealth management industry has only started in recent years with short history, the penetration of asset management business is still at low level.

China investible assets and no. of high net worth individual growth



Source: China Merchants Bank 2011 Wealth Report, ABCI

Significant room for growth

AM business was relatively new and insignificant to CGS as of 2012, given that the business was only established in 2009. Currently, the AM segment only carried 1.2% market share in terms of net revenue and ranked twenty-fourth among peers, which represented only 0.8% of CGS's total revenue. However, we see huge potential in this business segment given the booming wealth in China. CGS has started to transform its business strategy to enhance its branch wealth management function.

As demonstrated in 2012, besides the collective investment plan (CIP) business established in early years, CGS's business extension in targeted investment plan (TIP) had been a milestone development in 2012. CGS had entered into 22 targeted investment plan contracts in 2012, of which 10 of them had been kicked off with an AUM totaling Rmb13bn. This raised the total AUM of CGS from Rmb1.8bn in 2011 to Rmb16.1bn in 2012. With high initiate setup cost in prior years, CGS posted a segment loss of Rmb29mn for the year of 2012, partly due to a Rmb30mn impairment loss in relation to the CIP portfolio. Nevertheless, we expect CGS's AM business to accelerate and start contributing profit from 2013E.

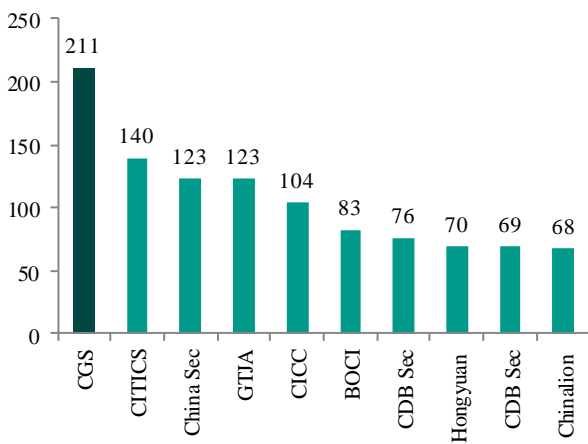


Defensive investment bank setup in down cycle

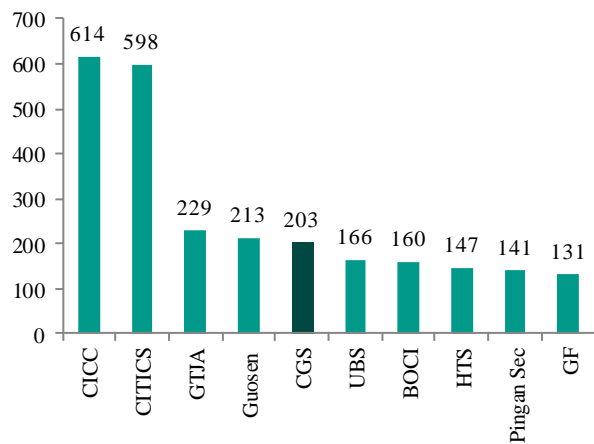
Decent underwriting business

Underwriting business has been another integral component in China securities sector. Although CGS has yet to become a market leader in this area, the group obtained a decent market share of 3% in 2012, or eleventh rank in terms of investment bank (IB) revenue, serving over 350 corporate clients. This accounted for 11% of the group’s total revenue and 15% of its net profit in 2012. In fact the IB business could be divided into two main streams, namely equity underwriting and bond underwriting.

Bond underwriting since establishment (Rmbbn)



Equity underwriting since establishment (Rmbbn)



Source: Companies, Wind, ABCI

Source: Companies, Wind, ABCI

CGS has strengths in debt underwriting business, which ranked first since its establishment. Equity underwriting of CGS ranked fifth only among peers as CICC and CITICS have dominant position in the equity underwriting business.

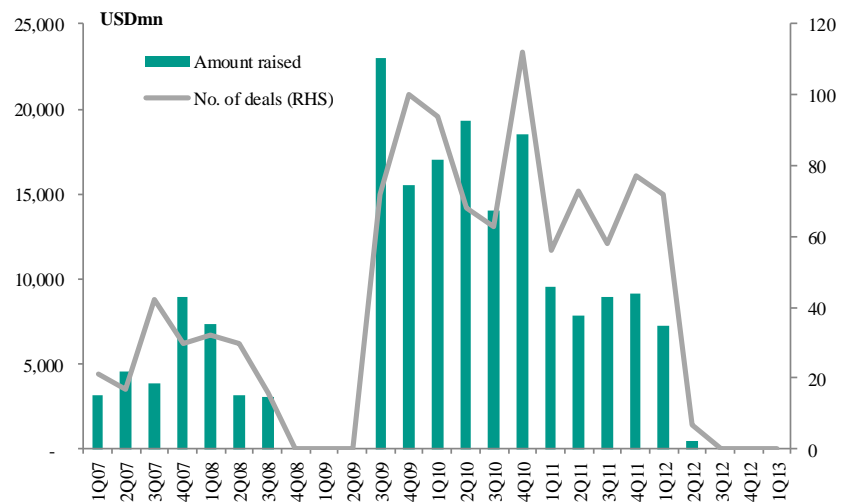
Temporary slowdown in equity primary market

Given the slowdown of China equity market in 2011 and 2012, China average daily turnover (ADT) has dropped to Rmb129bn in 2012, representing a 25% reduction from 2011 after a 23% down from 2010. Primary market was weakened accordingly from 337 deals amounted to USD69bn in 2010 to 264 deals with USD35bn in 2011 and only 79 deals for USD8bn in 2012.

IPO activities have been weak since 2Q12, given the CSRC slowed down the approval process, and subsequent suspended IPO approval in 3Q12. Similar experience could be traced back to 4Q08 when the CSRC reduced IPO approval from 2008 and suspended IPO approval since 4Q08, with the resumption in 3Q09. Apparently the prolonged suspension has provided the IPO market with extraordinary capacity in 2H09 and 2010, as companies were hunger for equity financing. Number of deals in 3Q09 was 350% higher Y-Y when total fund raised was 654% higher on a Y-Y basis.



China IPO trend



Source: Bloomberg, ABCI

Under our base case scenario, we expect the CSRC would resume the China primary market in 3Q13-4Q13, which implies that we should not expect an exciting equity underwriting outlook for 2013. Meanwhile, provided that CGS is not a market leader in equity underwriting business, we believe such a suspension would buy time for the group to strengthen their corporate clients' relationship in order to better capture future deal flows when the market rebound.

Equity business franchise leveraging on historical background

In 2012, CGS was the leading underwriter of 68 equity financings, aggregating a total fund raising of Rmb203bn, namely Rmb54.6bn in coal mining, Rmb70.9bn in financials, and Rmb308.5bn in transportation and warehouse sectors.

CGS's major investment bank customers

Year	Company name
2010	Agricultural Bank of China Limited
	Hangzhou Songcheng Tourism Development Co. Ltd
	Guangzhou Haige Communications Group Incorporated Company
	Chongqing Water Group Co. Ltd
	State Grid Corp. of China
2011	Zhejiang Semir Garment Co. Ltd
	Shanxi Coal International Energy Group Co. Ltd
	Dailian Port (PDA) Company Limited
	Zhongshan Broad-Ocean Motor Co. Ltd
	Changzhou Urban Construction Co. Ltd
2012	Elec-Tech International Co. Ltd
	China National Petroleum Corp.
	Beijing Philisense Technology Co Ltd
	Changzhou Wujin Urban Construction Investment Co. Ltd
	Jinan City Construction Investment Co. Ltd.

Source: Company, ABCI



CGS's historical background would become a catalyst to enhance its equity business franchise. CGS was established in 2000 by consolidating the securities divisions of Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China, China Life Insurance and China Economic Development Co. with the 78.57% and 21.43% shareholding by Huijin and MoF in CGS's holding company respectively (Galaxy Financial Holding owned 69.2% stake in CGS after H-share IPO). We expect CGS to leverage on its strong relationship with major financial institutions in deal sourcing and capture new business opportunities from other Huijin and MoF related companies.

China's top 10 IPO

Rank	Issuer	Amount (Rmbbn)	Industry
1	Agricultural Bank of China	68.5	Banking
2	China National Petroleum	66.8	Oil and gas
3	China Shenhua	66.6	Coal
4	China Construction Bank	58.1	Banking
5	China State Construction	50.2	Construction
6	Industrial and Commercial Bank of China	46.6	Banking
7	Ping An Insurance	38.9	Insurance
8	China Pacific Insurance	30.0	Insurance
9	China Life	28.3	Insurance
10	China Coal	25.7	Coal

Source: Wind, ABCI

Therefore, we expect system equity fund raising to drop by 50% in 2013E to Rmb153bn and rebound by 40% and 20% in 2014E and 2015E to Rmb218bn and Rmb263bn respectively, given the uncertain timing of the primary market resumption. CGS's equity underwriting business would shrink by 50% in 2013E and we conservatively assume only 40% and 20% rebound in 2014E and 2015E accordingly. This would translate into 50% drop in equity related fee in 2013E, followed by 43% and 22% growth in 2014E and 2015E.

Debt underwriting strength being a defensive factor

Nevertheless, CGS did especially well in its debt underwriting business, in particular for enterprise bonds issuance. CGS ranked first both in terms of enterprise underwritten amount and fees for three consecutive years from 2009 to 2011, while ranked second in 2012. According to Wind, the group has underwritten Rmb308.5bn of debt issuances, or 178 projects in 2012. CGS has strong State-owned enterprises (SOE) client franchise given its shareholders and historical background, especially covering infrastructure, transportation, construction, power and energy sectors.

In our view, the scale of China bond market is still relatively small, accounting for only 9.2% of GDP. This is because China enterprises and corporates relied heavily on bank loans and equity financing as the core funding source to support their business developments in past years. According to the PBOC statistics, under the continuous reforms of China financial sectors, the reliance of bank loan has been significantly reduced from 80% of total social financing in the beginning of 2012 to below 40% by the end of 2012, substituting by the use of alternative financing sources namely corporate bonds, which rose from 5% of total social financing in January 2012 to as high as 24% in July 2012.

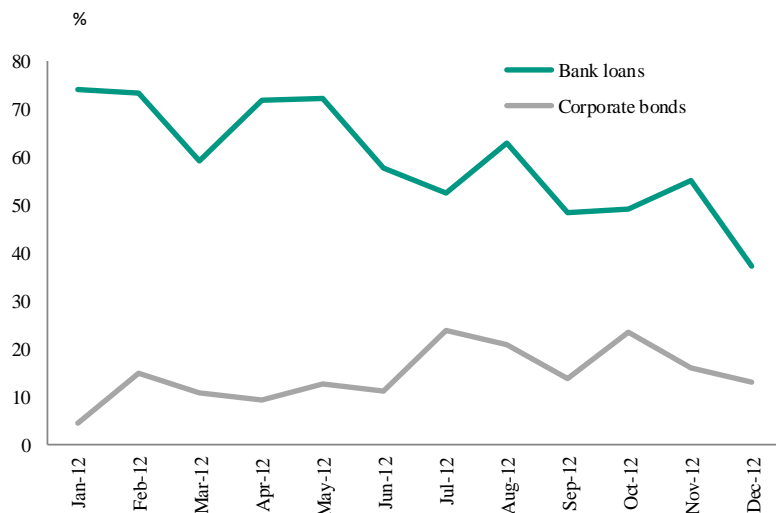


Major long term enterprise bond customers

1. Ministry of Railways
2. State Grid Corp. of China
3. China Southern Power Grid Co., Ltd.
4. China National Petroleum Corp.
5. China Petroleum & Chemical Corp.
6. Beijing Capital International Airport
7. China Guodian Corp
8. China Huadian Corp
9. China Power Investment Corp
10. Sinohydro Group Ltd
11. China Poly Group Corp
12. Legend Holding Ltd
13. Tsinghua Holding Co. Ltd
14. Beijing Infrastructure Investment Co. Ltd
15. Hebei Construction & Investment Group Co. Ltd
16. Shanghai Guosheng Group
17. Dalian Port (PDA) Company Ltd

Source: Company, ABCI

Component of total social financing



Source: PBOC, ABCI

This hints at the ongoing development trend of China bond market and we believe regulators would continue to enrich bond varieties and improve the bond market structure in order to support the organic growth driven by the shift of funding demand within the banking system. That said, CGS’s strong position and expertise in the debt underwriting business would allow the group to outperform in this business segment.

Besides huge market potential, we firmly believe that CGS’s strong debt underwriting franchise could effectively diversify its business risks in different stages of financial cycle, as bond investments are always defensive investments in volatile and down market. A strong debt business foundation therefore could offset the slack primary equity market activity and slow securities turnover during bad time. This has been proven in 2012 when total bond underwritten grew by 101%, while equity underwritten amount and securities brokerage revenue dropped by 24% and 17% Y-Y respectively under weak market sentiment.



Obvious all-rounded sector pioneer

Pioneer track record leveraging on strong relationship

With proactive business strategy and experienced management team, CGS is able to maintain close relationship with regulators and take pioneer move in many new policies and product developments.

First mover track record

Brokerage	Investment bank	Asset management	Others
Participate in MFSL pilot scheme	First broker qualified to conduct IB business	Join Asset Management association of China as fund rating agency	Pioneer in ETF market making and create model to provide liquidity for ETFs
Offer exchange-quoted bond repo	Lead underwriter for the first non-performing asset securitization product	Receive fund XBRL data from CSRC	
Enjoy reduced regulatory requirement on bond repo business	First broker act as lead underwriter for commercial bank subordinated bonds	Offer cash management products on pilot basis and launch first cash management product - "Galaxy Mercury I"	
Offer securities-based lending product on pilot scheme	First broker act as lead underwriter for the first municipal construction project bond	Launch first index based asset management product	
Conduct in OTC trade		Launch first hybrid wealth management product	

Source: Company, ABCI

As demonstrated in the table, CGS was the early bird in most of its major business units. Besides being first batch broker to conduct OTC trade and IB business as well as enjoy liberalized regulatory requirements, CGS was selected to participate in different pilot scheme such as MFSL business and securities-based lending product, reflecting its strong relationship with regulators.

Major participant in China securities industry development

Meanwhile CGS's management are dedicated to explore new revenue sources and created many milestone achievements in the China securities industry. CGS has taken the opportunity to be the first issuer of various products such as exchange-quoted bond repo, cash management product (Galaxy Mercury I), index based asset management product (Galaxy 99 Index) and hybrid wealth management product (CCTV Balanced 50). Moreover, CGS held responsible to be the lead underwriter in certain new products, such as the first non-performing asset securitization product and the first broker handling commercial bank subordinated bonds.

The outstanding first mover track record demonstrated that CGS is a major participant in the development of China securities industry and the unbreakable relationship and foundation indicates that CGS would continue to benefit from the early bird advantage in new business development.

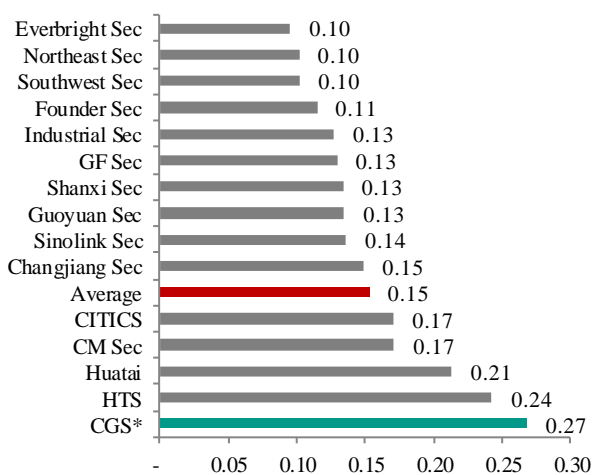
High operating efficiency from scale advantage

Scale advantage from competitive edges

It is clear that the extensive branch network and the huge client base of CGS have become a competitive advantage for the group. The market leading position in brokerage thus provides CGS with massive transaction volume, which was transformed into scale advantage, especially with 80% of CGS's brokerage transactions were done through its online platform (Compare to CITICS and HTS of 75-80%). The scale advantage efficiency has been evidenced through brokerage revenue per employee and branches. If we divide CGS's 2012 result by half to compare with other broker's 1H12 results, CGS's brokerage revenue per employee was top ranked, with Rmb270,000 per staff, much higher than sector average of Rmb150,000 per staff. HTS and Huatai ranked second and third with Rmb270,000 and Rmb210,000 respectively. Another market leader CITICS ranked fifth with Rmb170,000 per staff.

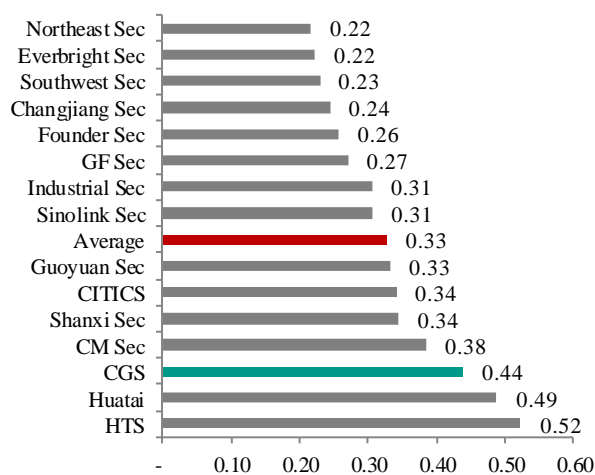
Apparently the ranking of top three players are stable as the brokerage market shares are not substantially fluctuated over time due to existing branch networks and clientele foundation. If we observed the 2011 data, CGS, HTS and Huatai were at top three with slight ranking swapped.

Brokerage revenue by employee (1H12) (Rmbmn)



Source: Companies, Bloomberg, ABCI

Brokerage revenue by employee (2011) (Rmbmn)



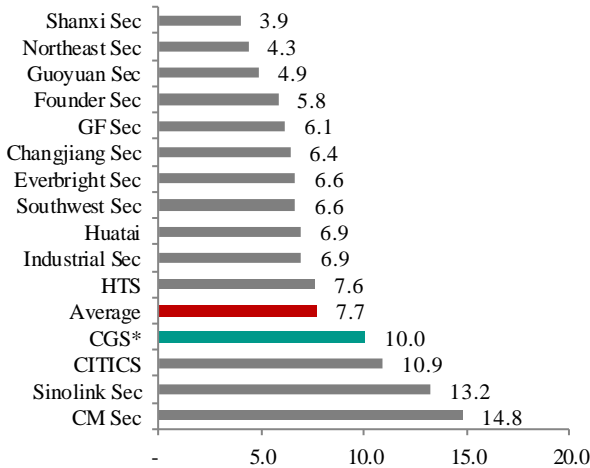
Source: Companies, Bloomberg, ABCI

Looking at per branch brokerage revenue, as CGS has the largest branch network and widely distributed over China, some of the branches may not generating as much revenue as coastal area branches, therefore diluting revenue per branch. For both period in 2011 and 1H12, CGS's brokerage revenue per branch was stable at fourth rank at Rmb23.2mn and Rmb10mn



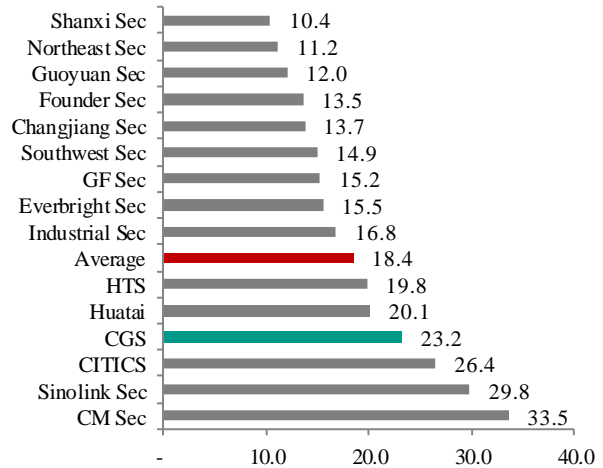
respectively. China Merchants Securities was the most efficient one in terms of branch, and CITICS ranked third for both periods.

Brokerage revenue by branch (1H12) (Rmbmn)



Source: Companies, Bloomberg, ABCI

Brokerage revenue by branch (2011) (Rmbmn)

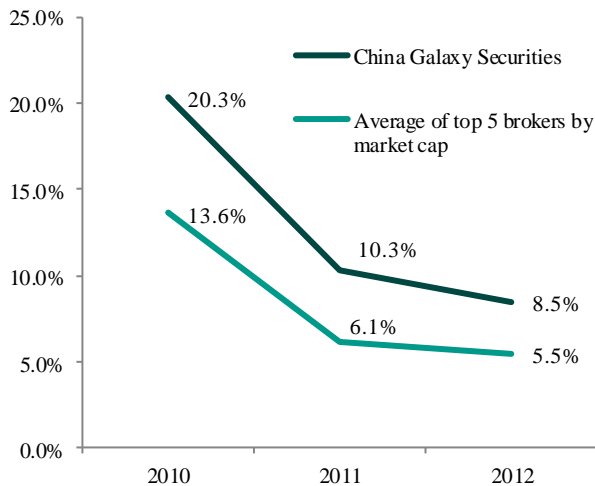


Source: Companies, Bloomberg, ABCI

Top-tier profitability outlook

CGS was able to position itself above average for both performance indicators in both periods, maintaining at top three in terms of number of employee and top fourth in terms of branch. The high operating efficiency has been converted into higher-than-peers profitability outlook, with CGS's ROE spreading over the average of top five brokers by 3-7% over 2010 to 2012. Interestingly, we believe the operating efficiency could widen the spread with surging market turnover due to scale advantage.

CGS's ROE vs top 5 brokers ROE



Source: Companies, ABCI

ROE peer comparison (2012)



Source: Companies, Bloomberg, ABCI

In 2012, if we compare the ROE among listed brokers in A-share and H-share markets, CGS sustained at top place ROE of 8.5%, 1.2% higher than the



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second place, Guangfa Securities and 2.8% higher than the sector average of 5.7%. Regarding CGS's ongoing development direction to enhance trade automation with more light branches, we forecast CGS's ROE to sustain at 9.0% in 2013E and steadily increase to 10.5% in 2014E and 11.7% in 2015E.



Positive outlook on China's capital markets

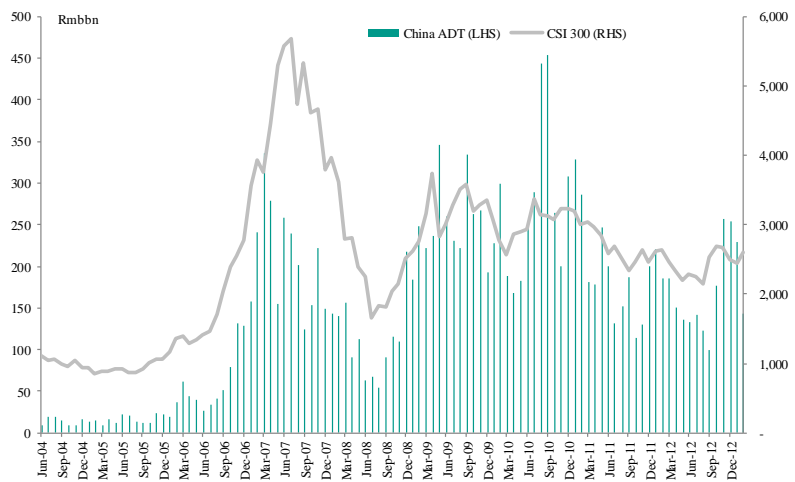
The rocket age of capital market

Equity market momentum to resume

The China stock market has undergone a fast development since 2005. The number of listed companies in Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) has surged dramatically from 1,381 in 2005 to 2,494 in 2012, representing a CAGR growth of 8.8%. The total market cap grew by 32.3% CAGR over the same period from Rmb3.2tn to Rmb23tn, and became the second largest capital market in terms of both market capitalization and total trading turnover in 2012.

China stock market's average daily turnover (ADT) jumped significantly in 2Q07 and 3Q07 to Rmb132bn and Rmb270bn respectively, or 145% and 105% Q-Q growth, when the Shanghai composite index surged by 42% and 35% Q-Q over the same period, driven by not only a 23% nominal GDP growth in 2007, but also the Rmb1tn re-launch of new mutual fund by CSRC and the non-tradable share reform since May 2005. The record of Rmb335bn in May 2007 was later exceeded in November 2011 with ADT of Rmb454bn, according to Wind.

A share ADT vs CSI300



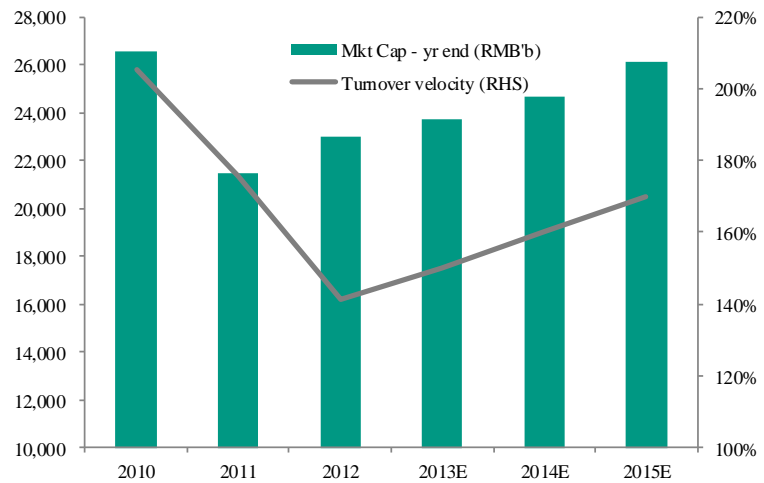
Source: Wind, Bloomberg, ABCI

Market turnover and velocity analysis

However equity market ADT was shrinking since then, with ADT reduced from previous November 2011 peak to only Rmb99bn in November 2012, when the Shanghai composite index dropped from 3,137 to 2,140. This was the key reason of profit declines in the China broker sector. Nevertheless, we saw signals that the market turnover momentum has been resumed from 4Q12. China ADT was bottomed in November 2012 and subsequently rose back to the mark of Rmb247bn in 1Q13 and sustained over Rmb205bn in May 2013 after a slight reduction to Rmb143bn in April.



China market capitalization and turnover velocity



Source: Wind, Bloomberg, ABCI estimates

Based on our calculation with Bloomberg and Wind data, the turnover velocity (i.e. annual trading volume/average market capitalization) has been reduced from 206% in 2010 to 196% and 2011 and 137% in 2012, despite the CSI300 rose by 8% in 2012 with China market capitalization up by 7%. Our ABCI chief economist, Banny Lam, expects economic rebalancing remains intact in 2H13 with GDP growth in 2H13 outperforming 1H13 while inflation would be well under control between 2.5% and 3%. With economic recovery on track, we are of the view that the recent rebound and A-share ADT is sustainable.

Under our base case assumptions, we forecast CSI300 to rise by 3-6% each year in 2013-15E, i.e. to reach 2,600-2,800 over 2013-15E. On the back of better turnover momentum, we project the turnover velocity to rise back to 150%, 160% and 170% level in 2013E, 2014E and 2015E respectively. This would trigger a 10-12% higher ADT for the A-share market. Having said that we believe this set of assumptions is fairly conservative as our forecasted Rmb179bn ADT by 2015E is still far below the previous peak of Rmb225bn in 2010 and Rmb270bn in 2Q07.

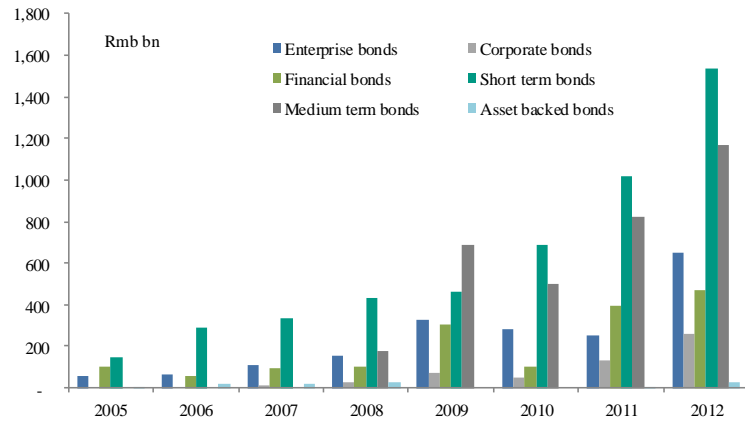
Bond market still at infant stage

Meanwhile the China bond market has picked up dramatically since 2005 due to high demand for direct financing in China. The total proceeds of China bond issuance from 2005 to 2012 has grew by 44.3% CAGR, of which corporate bonds grew the fastest by 87.7% CAGR over 2005-2012.

In addition to the current bond types, China regulators are close to complete their research phrase to launch private corporate bond placement with more flexible issuance process and regulatory requirements, and extend the bond issuance to SMEs. We believe the new bond types would fuel up another positive earning driver to overall bond market.



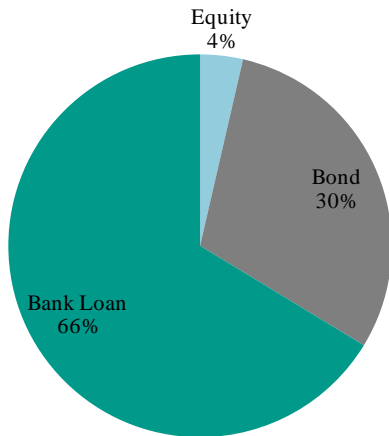
China bond market growth by category



Source: Wind, ABCI

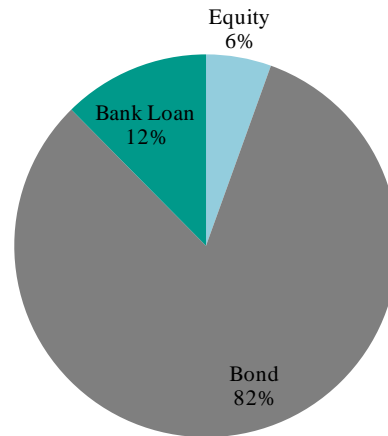
Despite the robust growth in China equity and bond markets, the current issuance level is in fact at low level compared to developed economies such as the US. In 2012, only one-third of the total financing in China were supported by capital markets compared to 88% in the US while China's total market capitalization to nominal GDP and total corporate bond issuances to GDP were at 46.6% and 9.2% respectively, much lower than 103.5% and 34.6% respectively in the US. These indicate that the bond and equity market in China still has room for further development.

China proportion of total financing - 2012



Source: Wind, SHSE, SZSE, ABCI

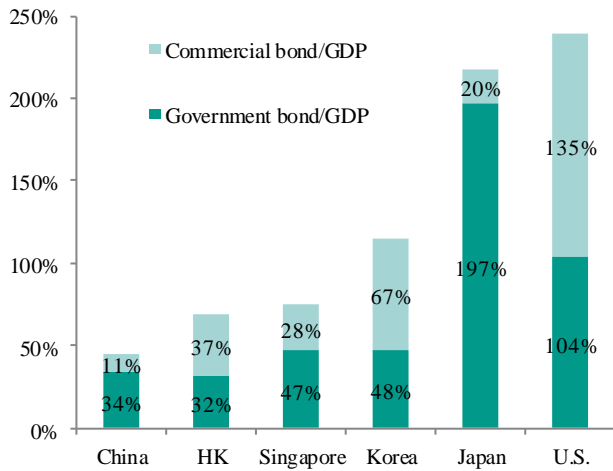
US proportion of total financing - 2012



Source: WFE, US Fed Res Board, ABCI

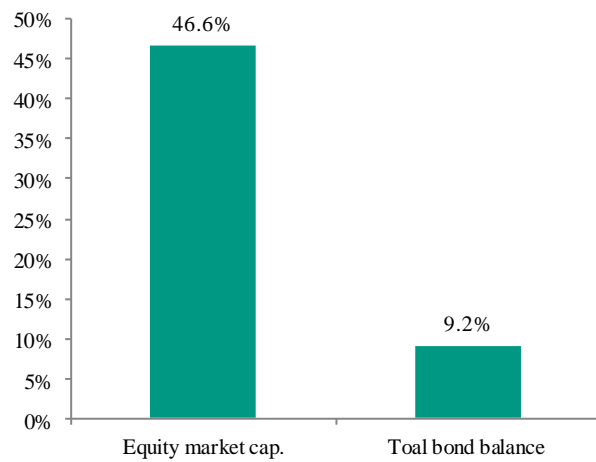


Bond market comparison by country (2012)



Source: Wind, SHSE, SZSE, ABCI

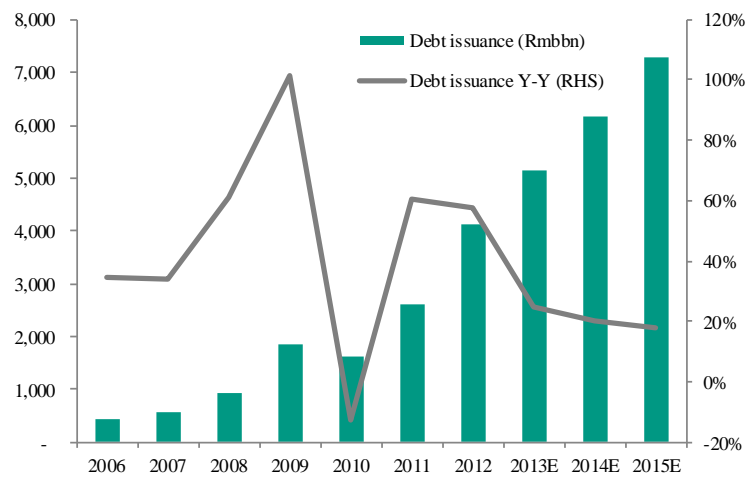
China capital market size nominal GDP (2012)



Source: Wind, ABCI

Under the roadmap of 12 five-year plan, the financial reforms in China are on top agenda, especially the bond market. The key agenda is to 1) simplify approval process, disclosure requirement and regulatory framework, 2) expand the size of bond market and develop innovative product, and 3) strengthen the bond market infrastructure and system. In our opinion, these would create a continuous bond market growth in the next decade. Therefore under our base case assumptions, we forecast the total debt issuance in China to grow by 18-25% each in 2013E to 2015E.

China debt issuance and Y-Y growth



Source: Wind, ABCI estimates

Exciting futures market developments

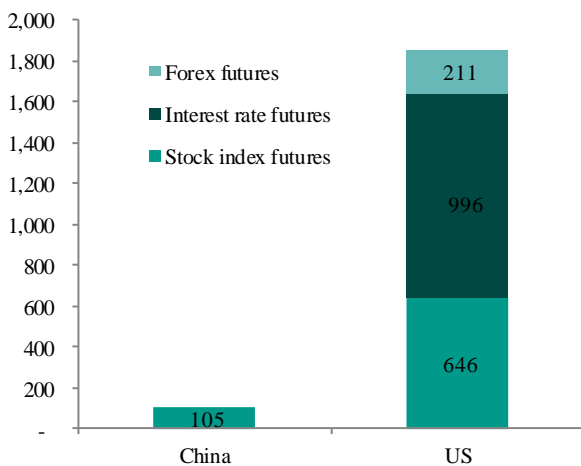
The China futures market has a pretty long history. Shanghai Stock Exchange (SHSE) began to trade government bond futures since 1992. At first the bond futures was only open for institutional investors and later extended to retail



investors. In 1995, the China bond future market was the largest in the world with turnover of Rmb5tn in 1995. At that time, due to loose regulation, the government ended the bond futures experiment in May 1995 due to the market manipulation of underlying bonds. This resulted in a highly cautious stance on future market development.

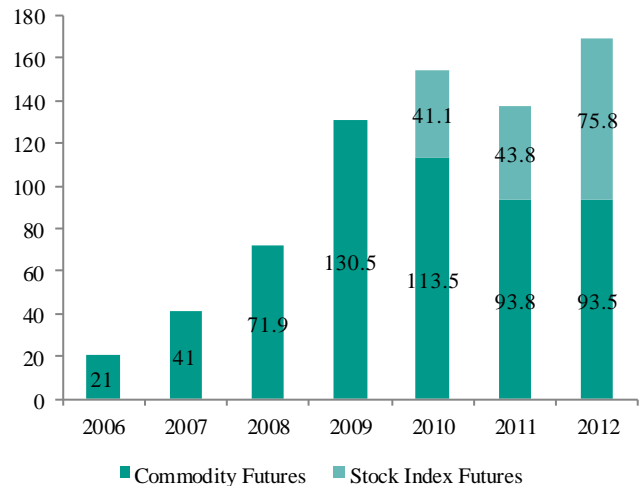
Trading momentum from futures market was regained in 1H11, after the launch of stock index future in April 2010. Currently futures trading are conducted through China Financial Futures Exchange, Shanghai Futures Exchange, Zhengzhou Commodity Exchange and Dalian Commodity Exchange, with product covering mainly commodities and stock index futures. We notice that they grew significantly in past several years, According to the CSRC, trading volume (single side) of the overall China futures market grew eight-folds from Rmb21tn in 2006 to Rmb171tn in 2012, or 41.8% CAGR. In particular the commodity futures market has become one of the largest commodity future markets in the world while the stock index future has successfully increased its popularity with Rmb75.8tn turnover in 2012, or over 240% of the China stock market turnover in 2012.

Financial futures contract (mn) outstanding in 2012



Source: WFE, ABCI

China futures market volume (Rmbtn)



Source: CFA, ABCI

The limited product varieties in China futures market have been the major barrier of sustainable development. We believe expansion of futures product varieties would create a new growth driver for brokers. Some new futures products are already on the pipeline and pending regulatory approval such as crude oil futures and MOF bond futures, which would be released in the near future. If we compare the situation in China and US, the World Federation of Exchanges (WFE) statistics shows that only 105.1mn stock index future contracts were outstanding in China in 2012, compared to 646mn, 995.7mn and 210.7mn of outstanding stock index futures, interest rate futures and foreign exchange futures contracts respectively in US. According to the CFA, the trading volume split between commodities futures and stock index futures was 55% vs 45% in 2012 when the contribution of stock index futures rose significantly from 27% of total trading volume in 2010. With more brokers' participating in this business, we expect a higher growth of 16-25% of system stock index futures trading volume each year in 2013-15E, compared to



relatively stable 5% growth in commodities futures each year in 2013-15E, which is a more sophisticated user market than investor market. In sum, we expect total futures trading volume to grow by 11-14% each in 2013-15E.

Emerging capital market structure

Reduction of retail market dominance

Going forward, we believe China's capital markets will emerge in two major directions, namely the change of investor mix with more sophisticated investors, and the slowdown of traditional brokerage income offsetting by surging innovative businesses revenues. Currently, 84.5% of China market participants are individual investors. The percentage of professional investors' trading turnover has increased from 10.4% in 2007 to 14.4% in 2011. On the rise of personal wealth and more foreign investors' involvement in China market, we expect the investor mix to be modified from the current retail investor dominant market to a balanced market with more sophisticated participants such as institutional investors, HNWI and professional investors.

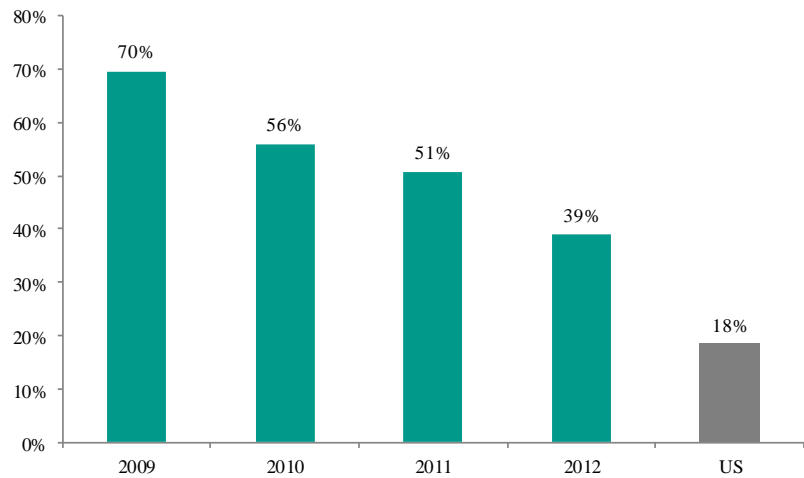
We notice that some key developments could lead to greater institutional investors' participation in China market. CIRC's relaxation of insurers' equity investment restriction in July 2012, SAFE's extended QFII and RQFII quota to US\$37.4bn and Rmb67bn in December 2012 and surging amount of the corporate pension funds (1% to China's GDP vs OECD countries average of 68%) would increase share of institutional investors within the investor mix. The transforming of participant mix would increase market diversity and induce the need of more sophisticated financial products. In addition, the ongoing policy developments would enhance the matured level of market infrastructure and regulation, which could attract more foreign and institutional investors to participate in the market. However, for the roadmap of next two to three years, individual investors remain as primary participants in the market. We believe this change of investor mix in long run is positive to the China's capital markets.

Lowering traditional brokerage mix

To cater for increasing demand from more sophisticated investors, we see the need for the industry to widen product varieties. Innovative products therefore are of paramount importance for China brokers to maintain high growth as they could offset the keen competition in traditional brokerage business. These include but not limited to the launch of stock index futures, MFSL business, bond repo, OTC trading platform, and new types of wealth management and bond products. With all these new products, we notice that the system securities brokerage income as a percentage to total income has gradually reduced from 70% in 2009 to only 39% in 2012, compared to only 18% in the US.



Securities brokerage revenue to total revenue in China vs US



Source: CSRC, SHSE, SZSE, Bloomberg, ABCI

Traditional brokers have started to prepare for the transformation of business. We notice that CGS has gradually upgraded its branch network with more wealth management functions in order to grab the business opportunities, while proactively participating in new product issuance and pilot scheme to enjoy early bird advantage in new segments. In the new era of competition under emerging market, we believe big player with solid client base and branch networks are at a beneficiary position towards sustainable growth.

Low leverage set to grow

Room for growth with leverage

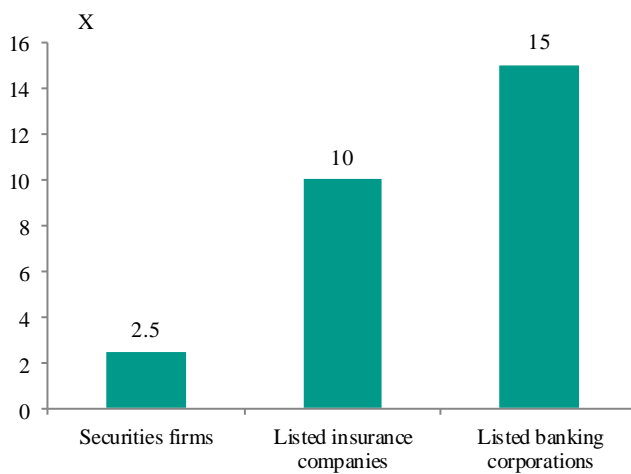
It is interesting to know that the China securities industry is currently operating at relatively low leverage (i.e. total asset/total equity) of 2.5x compared to 21.1x in US. This low leverage structure is due to strict regulation in the industry with which brokers are not allowed to take overly aggressive leverage position on its balance sheet. Although recent economic crisis in the US and Europe may raise questions on whether China should let brokers increase their leverage, it also indicates a potential room for fast growth in the industry if the regulators relax the operation environment.

Cautiousness in sight

In our opinion, the issue rests on how to liberalize the financial sector with cautiousness. It is inevitable for the financial sector to conduct reforms and the experience from western economies should act as a lesson for China. The key focus of market liberalization is to monitor market behavior and increase market participant's self-discipline when they engage in innovative businesses. Apparently, with many pilot schemes and test run of previous new products, we feel comfortable regarding the high risk management awareness of the regulators and brokers.

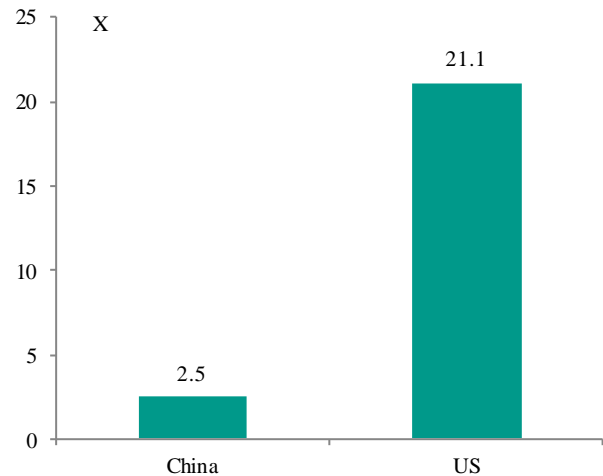


Leverage ratio of China financial sectors (2012)



Source: CFA, Wind, ABCI

China vs US brokers leverage (2012)



Source: CFA, Bloomberg, ABCI

Driver for higher ROE

Besides regulatory factors, lack of sustainable and profitable income channel and low cost funding source were the barriers to support high leverage business model, leading to the low industry leverage and limiting the upside on return on equity (ROE). With the relaxation of regulations, capital based intermediary and capital investment business should have more room for faster growth.

These regulatory measures being relaxed included the CSRC's proposal to replace the current net capital ratios with the new core net capital ratio to total assets ratios in January 2012. In April 2012, CSRC announced to lower the weighting factors used for the calculation of risk capital reserve for broker's proprietary trading, asset management and brokerage business, open up leverage business such as margin financing and securities lending (MFSL) and allow brokers to extend low cost funding through the issuance of debt instruments. We expect the ongoing loosening in regulatory requirements would lead to surging industry leverage, which drive up sector profitability.

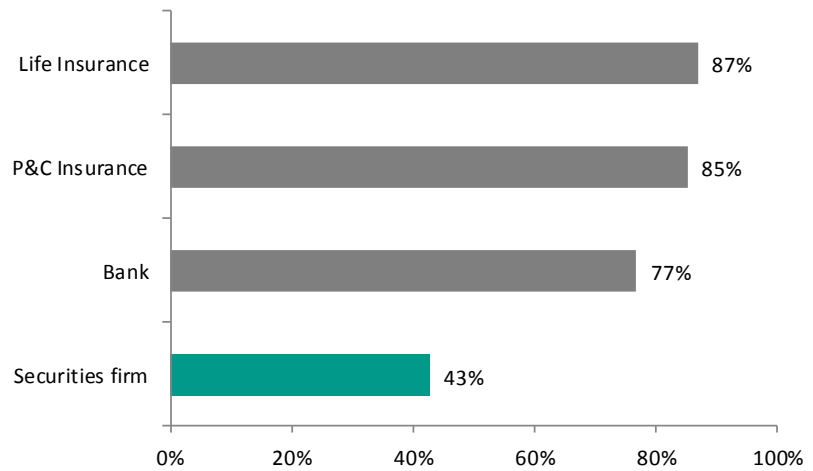
Potential industry consolidation amid low concentration

A fragmental industry

According to the SAC, the China brokerage sector is a fragmental industry with currently 114 securities brokers in 2012. This is different from other financial sectors such as banks and insurance with which their market concentrations were much higher than that of the brokerage sector. Top ten brokers by revenues aggregated only 42.8% of market share while other financial sectors in China such as top ten banks, life insurers and P&C insurers accumulating 76.9%, 86.9% and 85.2% market share respectively.



Top 10 player aggregated market share of financial sectors



Source: Wind, ABCI estimates

Potential catalyst from industry consolidation

The expansion of China brokers' industry could be taken place through M&A activities. Leading players with sufficient capital base could acquire smaller brokers for their client bases and branch networks, which are one of the most efficient ways to increase market share, and enhance operating synergies and pricing powers. Potential synergies are evidenced by the fact that large securities firms usually have more stable and better fee rates compared to niche players. Therefore big names such as CGS, CTICIS, and HTS are at better position to act as buyers. Although we believe these kinds of industry consolidation activities would provide the sector with positive catalysts, we do not factor into any potential increase in market share in our earning model given low visibility.



Business model analysis

Business strategy – “One core two wings”

Going forward, CGS would operate with the model of “One core two wings”, with the core securities and futures brokerage business as integral business component, leveraging on its big volume trading business to support the growth of two developing wings, i.e. investment bank (IB) and investment management (IM) segments.

One core two wings model



Source: Company, ABCI

This business strategy intends to achieve inter-segmental synergies: 1) IM could leverage on strong brokerage client base to develop multi-layer, new products on the back of increasing wealth management demand driven by surging personal wealth. 2) IB could leverage on the core strength in distribution channel to obtain new business from high quality customers.

The core brokerage component

The brokerage business of CGS has long been the core revenue driver for the group, contributing to a total of 77% and 86% of revenue and net profit in 2012 respectively. With the strong strength in scale, network coverage and

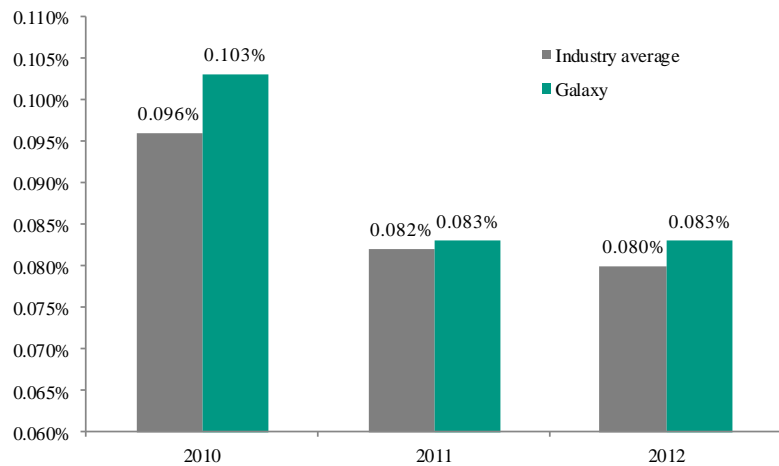


client base as well as the rising of innovative businesses, we expect the brokerage segment will continue to serve as the core business component for CGS with the revenue mix maintaining at 77-78% level over 2013E to 2015E. We expect CGS to maintain its leading position in securities brokerage with 5.3-5.4% market share.

Unfavorable commission rate trend

It is noted that the sector commission rate has narrowed in the past several years as industry average commission rate reduced from 0.096% in 2010 to 0.080% in 2012. CGS apparently has competitive advantage in commission pricing, with the rate narrowing less dramatically during the same period from 0.103% to 0.083% while 1Q13 commission rate posted a slight rebound to 0.085%. It is also worth noting that CGS's brokerage rate had been stable over 2011 and 2012, when industry commission rate dropped by 0.002%.

Brokerage commission rate trend



Source: Wind, CSRC, ABCI

Nevertheless, the commission rate in China securities sector would continue to face pressure on the back of keen competition, and we believe the continued narrowing in commission rate would ultimately drive out weak market players. Yet in our opinion, market leaders are relatively defensive from pricing competition and the room for substantial narrowing in commission rate is limited. Therefore we factor into another 0.003% narrowing in CGS's commission rate in 2013E, and it would remain flat until 2015E.

Direction of new brokerage competition

We are of the view that the upcoming competition in the brokerage industry would point to three directions. Firstly, the brokers aim at exploring new business opportunities with higher margin such as high-end customers business and MFSL. We notice that CGS's future organic growth will focus on increasing its high-end customers and institutional clients market share driven by enhancing the company's wealth management functions in branches, better serving its approximately 190,000 high-end customers and



making use of the cross-selling synergies from its investment bank division and asset management division. Meanwhile CGS will leverage on its huge client base and first-ranked customer securities custodian balance to boost its high margin MFSL business.

Secondly, brokers aim at enhancing traditional brokerage transaction volume as a defensive factor and further exploring scale advantage. This will be mainly achieved through branches' expansion in order to widen the geographic coverage for new clientele, especially in the form of light branches. With the Supervisory Provisions on Branches of Securities Companies (Draft for Public Commentary) issued by the CSRC in January 2013, new branch setup requirements will be relaxed on a gradual basis, allowing CGS to grow its largest branch networks while transforming them with more wealth management functions.

Last but not least, brokers continue to seek cost reduction opportunities in order to offset narrowing margin. Cost control will be one of the most critical factors towards the future success. We believe CGS could achieve this by leveraging on its scale advantage from trading volume, encouraging the use of alternative trading platform and integrating middle and back office functions. In 2012, 80% of CGS's brokerages were done through their online and mobile platform, compared to our estimated 75-80% for CITICS and HTS respectively, while number of staffs has been reduced from 12,104 in 2011 to 8,601 in 2012 though branch networks were expanded. This was clearly a proactive move of CGS to improve the cost efficiency.

High value added MFSL

MFSL has become the major growth driver on the ride of financial market liberalization, with 9.2% revenue contribution to CGS in 2012 from almost zero two years ago. Given high entry barrier, MFSL are especially for institutional and high-end investors which are well-fitted for the hedge fund development in China. CGS's MFSL balance has grown rapidly by 380% and 110% in 2011 and 2012 respectively, in line with market growth rate. We believe CGS will achieve a high growth rate through further expansion of margin business and we factor into 70-90% Y-Y growth for system MFSL balance each in 2013 and 2014E amid its infant stage.

Margin financing and securities lending assumptions

Rmbmn	2011	2012	2013E	2014E	2015E	Growth			
						2012	2013E	2014E	2015E
MFSL revenue	233	513	922	1,397	1,808	120%	80%	51%	29%
Balance of MFSL	2,558	5,377	11,389	19,651	25,546	110%	112%	73%	30%
Average balance	1,546	3,968	8,383	15,520	22,598				
Effective interest rate	15%	13%	11%	9%	8%				
MFSL market share	6.70%	6.01%	6.70%	6.80%	6.80%	-0.7%	0.7%	0.1%	0.0%
System MFSL	38,179	89,468	169,988	288,980	375,674	134%	90%	70%	30%

Source: Company, Wind, ABCI estimates

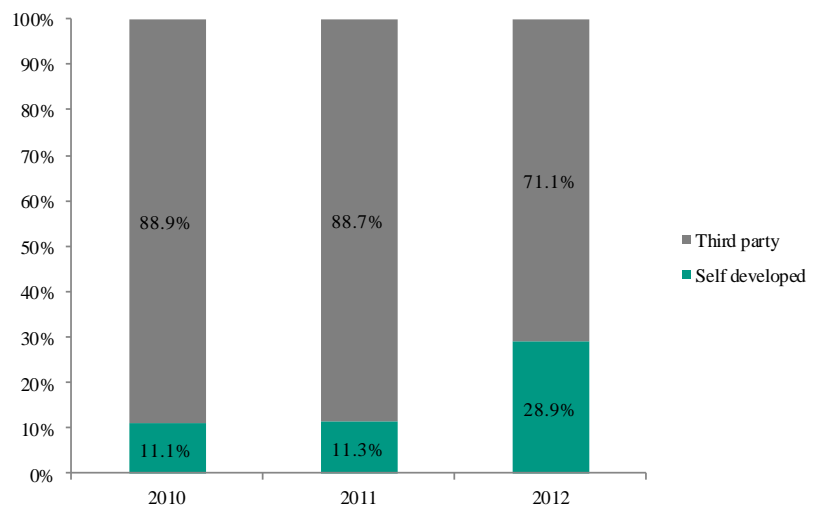
In view of CGS's core strength in client base, we expect CGS's market share in MFSL to increase to 6.8% by 2014E. Currently interest rate charge to client in margin financing and securities lending are both floating between 3% and 5% above 6-month PBOC benchmark rate, or effectively 8.6% for margin financing and 10.6% for securities lending in 2012. Based on our calculation with average MFSL balance, CGS's effective interest rate on



MFSL was 13% in 2012. Given that more market participants enter this battlefield, we assume overall effective interest rate of the MFSL business would come down to 8-11% over 2013-15E.

As of December 2012, 116,500 of CGS's customers were eligible to open margin account but only 26,200 (0.47% of total customers or 22.5% of eligible customers) had opened margin accounts with CGS, justifying the high growth potential of this business line in coming years. Given the group's dedication to develop MFSL business, we factor into 112% and 73% balance growth in 2013E and 2014E respectively, followed by 30% in 2015E which will translate into 52% revenue growth CAGR in 2012-15E and account for 13-17% revenue contribution to CGS.

CGS's wealth product mix



Source: Company, ABCI

Wealth management products to unleash potential

In addition to MFSL, wealth management products are another bright spot supporting the overall brokerage business, given low wealth management penetration in China and the increasing needs for wealth management products. The market value of wealth management products selling through CGS grew by 75% CAGR over 2010-12 to Rmb6.26bn, with which only 28.9% of the products sold were self-developed by CGS. Although it had increased from 11.1% in 2010, there are plenty of rooms for further expansion. As new regulation on agency sales of financial products was issued in December 2012, CGS, being the market leader in retail businesses, became one of the first China brokers qualified to engage in such business, opening up business opportunities for CGS to provide more variety of products to customers.

Market turnover forecasts

Brokerage revenues are highly co-related with market turnover trend. Combined the fact that China market ADT has dropped by 23% and 25% respectively in 2011 and 2012 to Rmb129bn, and market capitalization was down from Rmb26,542bn in 2010 to Rmb23,036bn in 2012, majority of



Chinese brokers saw profit decline in 2012.

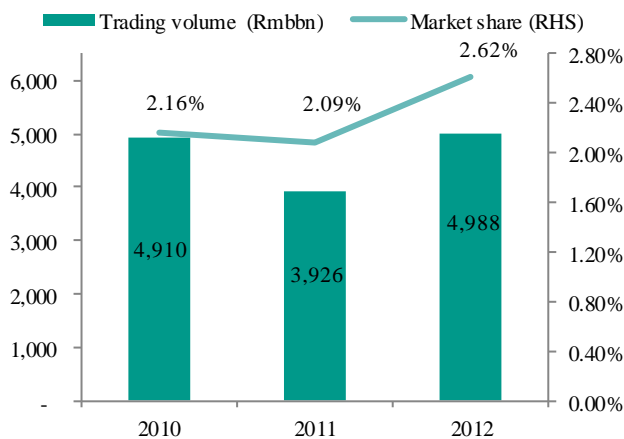
China stock market turnover assumptions

Rmbbn	2011	2012	2013E	2014E	2015E	Growth			
						2012	2013E	2014E	2015E
Avg. daily turnover	172,807	129,493	144,927	160,011	178,545	-25%	12%	10%	12%
Annual trading volume	42,165	31,467	35,072	38,723	43,208	-25%	11%	10%	12%
Mkt Cap - yr end	21,476	23,036	23,727	24,676	26,157	7%	3%	4%	6%
Weighted avg. mkt cap	24,009	22,256	23,382	24,202	25,416	-7%	5%	4%	5%
Turnover velocity	176%	141%	150%	160%	170%				
CSI 300	2,346	2,523	2,599	2,703	2,865	8%	3%	4%	6%
Average CSI 300	2,737	2,434	2,561	2,651	2,784				

Source : Wind, Bloomberg, ABCI estimates

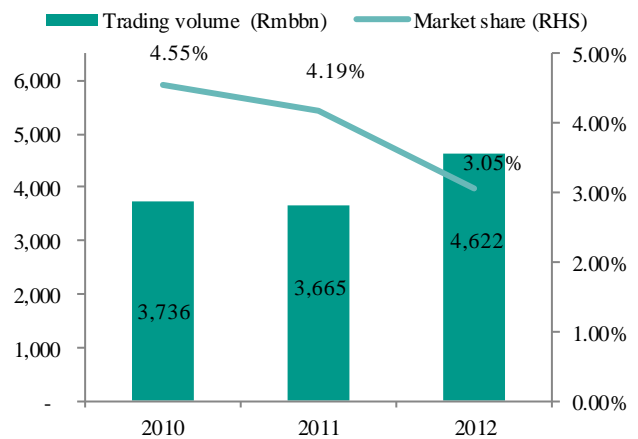
According to our calculation, China market velocity has reduced from 206% in 2010 to 176% in 2011 and 141% in 2012. Given the recent market turnover trend with daily turnover around Rmb140bn, we take a conservative stance to forecast CSI300 to reach only 2,600-2865 in 2013-15E, and market velocity to steadily rise back to 170% by 2015E though we believe the A-share market turnover is going to improve in the coming two years. This would result in Rmb145bn, Rmb160bn and Rmb179bn ADT for 2013E, 2014E and 2015E respectively, or 10-12% increase in ADT each year in 2013-15E.

CGS's commodity futures trend and market share



Source: Company, CFA, ABCI

CGS's stock index futures trend and market share



Source: Company, CFA, ABCI

As of December 2012, CGS had 59,000 futures customers, reaching 29.8% CAGR in 2010-12, which drove futures brokerage revenue to grow by 31.5% CAGR in 2010-12. As we expect regulators to allow more futures products in the market, we forecast futures brokerage to continue to contribute 7-8% of total revenue over 2013-15E.



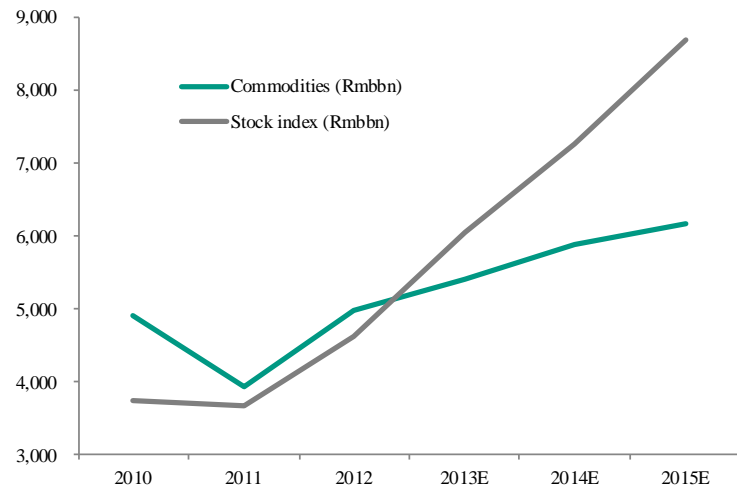
農銀國際

ABC INTERNATIONAL

ABCI SECURITIES COMPANY LIMITED

China Galaxy Securities Co., Ltd.

Futures handled by CGS



Source: Company, Wind, ABCI estimates

Brokerage business assumption and forecast

Rmbbn	2011	2012	2013E	2014E	2015E	Growth				
						2012	2013E	2014E	2015E	
Securities revenue	4,895	4,055	5,037	6,290	7,556	-17%	24%	25%	20%	
- securities brokerage	3,626	2,680	2,935	3,302	3,684	-26%	9%	12%	12%	
- MFSL	233	513	922	1,397	1,808	120%	80%	51%	29%	
- other brokerage	1,036	862	1,179	1,592	2,064	-17%	37%	35%	30%	
Securities commission rate	0.083%	0.083%	0.080%	0.080%	0.080%	0.00%	0.00%	0.00%	0.00%	
Other commission rate	0.055%	0.021%	0.023%	0.025%	0.027%	-0.03%	0.00%	0.00%	0.00%	
Futures revenue	383	517	573	658	744	35%	11%	15%	13%	
Futures commission rate	0.005%	0.005%	0.005%	0.005%	0.005%	0.00%	0.00%	0.00%	0.00%	
Galaxy Securities handled (Rmbbn)										
Stocks	4,369	3,230	3,669	4,127	4,605	-26%	14%	12%	12%	
Warrants	81	-	-	-	-	-100%	na	na	na	
Funds	52	59	72	89	107	15%	22%	23%	20%	
Bonds	1,743	4,117	5,056	6,278	7,539	136%	23%	24%	20%	
Futures	7,591	9,610	11,459	13,151	14,873	27%	19%	15%	13%	
- Commodities	3,926	4,988	5,397	5,877	6,171	27%	8%	9%	5%	
- Stock index	3,665	4,622	6,062	7,274	8,702	26%	31%	20%	20%	
Total	13,835	17,016	20,256	23,646	27,123	23%	19%	17%	15%	
Market share										
Stocks	5.2%	5.2%	5.3%	5.4%	5.4%	0.0%	0.1%	0.1%	0.0%	
Warrants	11.7%	0.0%	0.0%	0.0%	0.0%	-11.7%	0.0%	0.0%	0.0%	
Funds	4.3%	3.8%	3.8%	3.9%	4.0%	-0.5%	0.0%	0.1%	0.1%	
Bonds	4.6%	5.7%	5.6%	5.7%	5.8%	1.1%	-0.1%	0.1%	0.1%	
Futures										
- Commodities	2.1%	2.6%	2.7%	2.8%	2.8%	0.5%	0.1%	0.1%	0.0%	
- Stock index	4.2%	3.1%	3.2%	3.2%	3.3%	-1.1%	0.2%	0.0%	0.1%	
System turnover (Rmbbn)										
Stocks	84,012	62,106	69,222	76,427	85,279	-26%	11%	10%	12%	
Warrants	693	-	-	-	-	-100%	0%	0%	0%	
Funds	1,198	1,558	1,901	2,281	2,668	30%	22%	20%	17%	
Bonds	37,885	72,228	90,285	110,148	129,974	91%	25%	22%	18%	
Futures	275,303	341,925	389,331	437,214	484,080	24%	14%	12%	11%	
- Commodities	187,828	190,374	199,893	209,887	220,382	1%	5%	5%	5%	
- Stock index	87,475	151,551	189,439	227,326	263,698	73%	25%	20%	16%	
Total	399,090	477,817	550,739	626,069	702,002	20%	15%	14%	12%	

Source: Company, Bloomberg, Wind, ABCI estimates



Assuming that stable market share of 5.3-5.4% and commission rate at 0.08% will be sustained by CGS in 2013-15E, overall securities brokerage commission should see 9-12% growth each in 2013-15E. For other business lines under brokerage segment including funds, bonds, and futures, we factor into stable market share and fee rates for CGS over 2013-15E. We expect funds, bonds and stock index futures to grow by 16-25% Y-Y each in 2013-15E, while only 5% growth each year for commodity futures given its relatively matured nature in China. In sum, these brokerage segments will generate revenue growth of 30-37% Y-Y each in 2013-15E.

Despite we do not expect significant upside potential from CGS's traditional securities brokerage business, the robust growth of other innovative business within the brokerage segments including MFSL and wealth management products would offset the weakness of traditional business. We forecast overall securities brokerage segment revenues to grow by 23% CAGR in 2012-15E. Combining it with future brokerage segment will account for 76-78% of total revenues which are similar to that of 2012.

The two growing wings

Under the "One core two wings" business strategy, IB segment currently accounts for 11% of group revenue or 15% of group net profit while IM segments including the AM and private equity (PE) just account for 1% of total revenue.

Balanced investment bank franchise

There are two major components within the IB segment of CGS namely equity and debt underwriting. We are impressed by CGS's business mix between equity and debt underwriting, which protects CGS from revenue volatility in different stages of financial cycle. This was obviously evidenced in 2012 when the debt market in China became more active along with the acceleration of financial reform. Total bond underwritten grew by 101% in 2012, when the equity underwritten amount dropped by 24% due to weak equity market. This is a normal behavior that investor will shift to fixed income market for capital protection when equity market turns volatile or inactive, vice versa.

Under the "One core two wings" strategy, synergies between the IB and the brokerage segments were mainly taken place through the sharing of quality clients, i.e. corporate customers from brokerage division and investment bank division. According to CGS's management, future development in business will be more diversified and the group will dedicate more efforts in SME client coverage and project execution as CGS's previous equity financing experiences were strong in big IPOs in China rather than small IPOs (i.e. only three small IPOs were done in 2012)



IPO to resume in late 2013

Equity market has been weakened since 2010, not only in terms of market turnover, but also the activities in primary market with which total equity fund raising has dropped by 43% and 38% in 2011 and 2012 respectively. In October 2012, A-share listing was basically suspended, leading to profit decline of China securities sector in 2012. For CGS, equity underwriting fee has dropped by 56% in 2012.

Under our base case assumptions, we forecast in a prudent way that the China primary market to resume earliest in 3Q13. Therefore we factor into another 50% reduction both in system equity fund raising and CGS's underwritten amount in 2013E, followed by a 40% rebound in 2014E and 20% in 2015E after a prolonged suspension. This would translate into 50% decline in equity underwriting fee income in 2013E and a 43% and 22% rebound in 2014E and 2015E respectively given an improving market share to 3.4-3.5% and average fee rate to 1.35-1.4% over 2013-15E.

Optimistic organic growth of debt market

The liberalization of debt market is expected to result in robust growth in the debt underwriting business. Bonds issuances have only become active since 2009, thus distracting funding sources from over-reliance in bank loans. We can reasonably expect that bond market will continue to develop and become one of the major components of the China direct financing market.

Investment bank segment forecasts

Rmbmn	2011	2012	2013E	2014E	2015E	2012	Growth		
							2013E	2014E	2015E
Revenue	682	685	758	1,078	1,246	0%	11%	42%	16%
Equity underwritten									
System equity raised	507,307	312,754	156,377	218,928	262,713	-38%	-50%	40%	20%
Average fee rate (%)	4.474	4.311	4.400	4.400	4.400	-4%	2%	0%	0%
Underwritten amount									
Lead	11,596	9,184				-21%			
Co-lead	296	-				-100%			
Sub-underwriter	449	139				-69%			
Total	12,341	9,323	4,662	6,526	7,832	-24%	-50%	40%	20%
Fee amount									
Lead	280	125				-55%			
Co-lead	0	-				-100%			
Sub-underwriter	1	0				-71%			
Total	282	125	63	90	110	-56%	-50%	43%	22%
Assumptions									
Market share by amount	2.4%	3.0%	3.4%	3.5%	3.4%	1%	0%	0%	0%
Average fee rate	2.28%	1.34%	1.35%	1.38%	1.40%	-1%	0%	0%	0%
Debt underwritten									
System debt raised	2,610,000	4,117,000	5,146,250	6,175,500	7,287,090	58%	25%	20%	18%
Underwritten amount	34,940	70,211	92,633	123,510	145,742	101%	32%	33%	18%
Fee amount	297	503	695	988	1,137	70%	38%	42%	15%
Average fee rate	0.85%	0.72%	0.75%	0.80%	0.78%	-16%	5%	7%	-3%
No. of deal	23	43				87%			
Market share	1.3%	1.7%	1.8%	2.0%	2.0%	0%	0%	0%	0%

Source: Company, Wind, Bloomberg, ABCI estimates



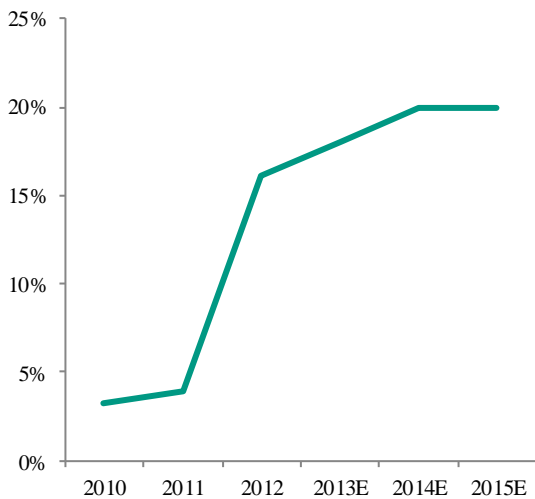
As a result, we expect CGS to leverage on its leading position in enterprise bond financing market and expand its business into other available forms of bond financings. We project the system debt raising in China to rise by 18-25% each year in 2013-15E, after the 58% growth in 2012. By stepping efforts to explore underwriting business in different types of bonds, we forecast CGS's bond underwriting size to rise by 32-33% each in 2013-14E and slow down to 18% in 2015E. Assuming that the fee rate stabilizes at 0.75-0.8%, the debt underwriting fee income will see 31% CAGR over 2012-15E. By combining equity and debt business, IB segment will see 22% CAGR growth in 2012-15E.

Fast IM growth on low base

The IM business of CGS is divided into two business segments namely AM and PE investment and both of them are having relatively short history (starting from 2008-09). Given the infant stage and high initiation cost, the two segments accounted for only 1% of group revenue in 2012. A net loss and small profits were reported in asset management and private equity respectively.

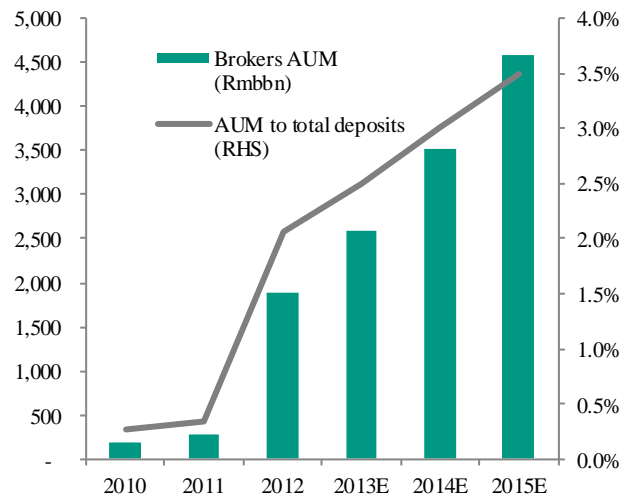
Given low penetration of China asset management industry, we conservatively project system AUM to grow by 25% CAGR in 2012-15E, representing 13-18% of system deposits. As we believe that the importance of asset management products distribution within the China securities industry continues to increase, we expect brokers' AUM as a percentage to system AUM to reach 20% by 2015E.

Brokers AUM to system AUM forecast



Source: Wind, CTA, SAC, ABCI estimates

China capital market size nominal GDP



Source: Wind, CTA, SAC, ABCI estimates

Turnaround AM story from 2013E

CGS's assets management operation became active since 2009, leading to a substantial early stage setup cost in 2010 and 2011. The business strategy started to pay off in 2012 when AM operation posted 44% Y-Y revenue growth to Rmb45mn with approximately 29,000 customers. Regarding the



cost side, there was a provision of Rmb30m for the collective assets management plan due to weak market performance. We expect the setup phrase has been finished with which profit contribution from this segment will start in 2013E.

AUM of CGS expanded 8 times from Rmb1,994mn in 2010 to Rmb16,060mn in 2012. The rise was contributed by two major categories of products namely CIP and TIP. CIP refers to one investment plan handling a bunch of customers together, while TIP is a tailor-made investment plan for one single client, which CGS started to develop in 2012.

By the end of 2012, CGS had eleven outstanding CIPs, aggregating an AUM of Rmb2.9bn with Y-Y growth of 62%. They covered different types of plans such as equity linked plans, quantitative plans, index-based plans, money market plans, fund of funds and hybrid plans. Meanwhile CGS entered into twenty-two TIP plans in 2012, with which ten of them recorded an outstanding AUM of Rmb13.1bn.

We notice that TIP has been increasingly used by China banks as an off-balance sheet lending tool to counter the LDR requirement set by the CBRC. Banks inject capital as an investor to the TIP established by brokers, which with sole purpose to finance their projects of a specific corporate customer. Although the CBRC's announced new regulation in March 2013 to control bank's investment channel of wealth management products (WMPs) may slow overall WMPs growth, brokers could continue to develop non-bank cooperating WMPs on the back of fast China wealth growth. Hence we forecast the growth of TIP AUM to stay at 40-52% each year in 2013-15E.

Asset management segment forecasts

Rmbmn	2011	2012	2013E	2014E	2015E	Growth			
						2012	2013E	2014E	2015E
Revenue	31	45	135	211	303	44%	202%	56%	44%
CIP	1,802	2,912	4,659	7,222	10,110	62%	60%	55%	40%
TIP	-	13,148	19,966	27,927	40,410	na	52%	40%	45%
Total AUM	1,802	16,060	24,625	35,149	50,521	791%	53%	43%	44%
Average fee rate	1.64%	0.50%	0.55%	0.60%	0.60%				
Rmbbn									
System trust assets	7,254	11,741	14,401	17,574	22,964	62%	23%	22%	31%
AUM for brokers	282	1,890	2,592	3,515	4,593	570%	37%	36%	31%
Total deposits	80,937	91,756	103,684	117,163	131,223	13%	13%	13%	12%
System AUM to deposits	8.96%	12.80%	13.89%	15.00%	17.50%				
Broker to system AUM	3.9%	16.1%	18.0%	20.0%	20.0%				
Market share	0.64%	0.85%	0.95%	1.00%	1.10%				

Source: Company, Wind, Bloomberg, ABCI estimates

Combined with 40-60% AUM growth in CIPs each in 2013-15E, we aim to see CGS's overall AUM to arrive at Rmb50bn by 2015E, representing 1.1% market share, while average fee rate will stay healthy at 0.5-0.6%. Total revenue from assets management thus should grow by 89% CAGR over 2012-15E, partly due to low base.



More time is needed for PE

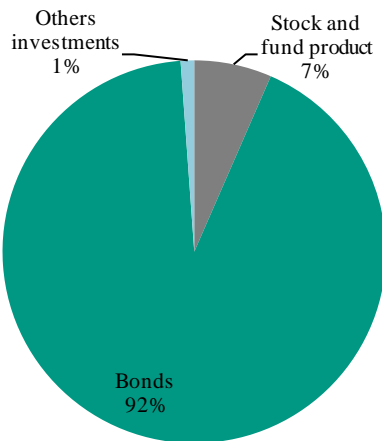
The PE business of CGS has started since October 2009. As of December 2012, CGS has invested in eight investments, with the total investment of Rmb442mn, covering manufacturing, consumer goods, telecommunications, cultural and mining sectors. None of the projects has exited so far. We expect CGS to increase the investment size by 10% each year from 2013E to 2015E and the total investment hence will reach 588mn in 2015E.

Other business segments

Proprietary trading

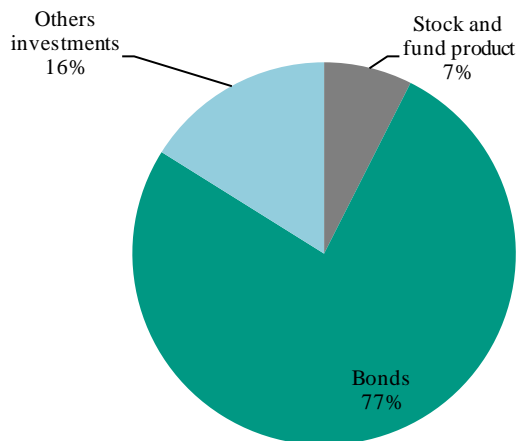
Proprietary trading of CGS was relatively small, attributing to only 7% of revenue or 13% of profit in 2012. With limited spare funds, total investment amount was only Rmb5.7bn by December 2012. The group adopted a conservative investment strategy by having higher bond mix of 77%, thus posting a 238% revenue growth when the bond market outperformed the equity in 2012.

Proprietary trading portfolio 2010



Source: Company, ABCI

Proprietary trading portfolio 2012



Source: Company, ABCI

The large bond portfolio was partly used to support the group’s innovative product, ‘Daily Profit’. This product aims at raising short term funding from customers by pledging CGS’s bond investment for borrowings at higher than bank deposit interest rates. We do not expect a dramatically change in CGS’s investment mix. Overall investment portfolio should see 13% increment each in 2013E and 2014E, and 11% in 2015E which will result in 15% revenue CAGR in 2012-15E. This represents a steady investment yield at 5.7-6% over 2013-15E.



Proprietary trading portfolio forecasts

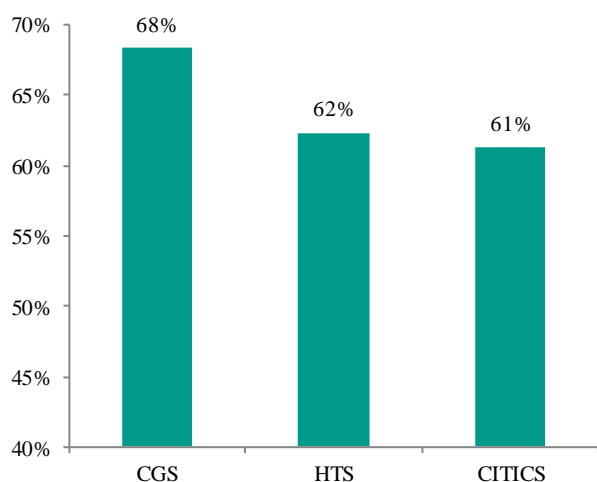
Rmbmn	2011	2012	2013E	2014E	2015E	2012	Growth		
							2013E	2014E	2015E
Revenue	119	401	487	552	610	238%	21%	14%	10%
Stock and fund product									
Investment amount	729	424	508	610	701	-42%	20%	20%	15%
Net revenue	(126)	(6)	10	18	35	-95%	-277%	80%	92%
Annualized return	-17.2%	-1.4%	2.1%	3.0%	5.0%	16%	3%	1%	2%
Bonds									
Investment amount	4,022	4,347	4,781	5,259	5,680	8%	10%	10%	8%
Net revenue	174	294	325	347	358	69%	10%	7%	3%
Annualized return	4.3%	6.8%	6.8%	6.6%	6.3%	2%	0%	0%	0%
Others investments									
Investment amount	453	915	1,144	1,396	1,675	102%	25%	22%	20%
Net revenue	22	36	51	63	67	65%	42%	22%	7%
Annualized return	4.8%	4.0%	4.5%	4.5%	4.0%	-1%	1%	0%	-1%
Total investments									
Investment amount	5,204	5,685	6,433	7,265	8,056	9%	13%	13%	11%
Net revenue	71	325	387	428	460	359%	19%	11%	7%
Annualized return	1.4%	5.7%	6.0%	5.9%	5.7%	4%	0%	0%	0%
Other trading services	48	77	100	125	150	60%	30%	25%	20%

Source: Company, Wind, Bloomberg, ABCI estimates

Net profit forecast

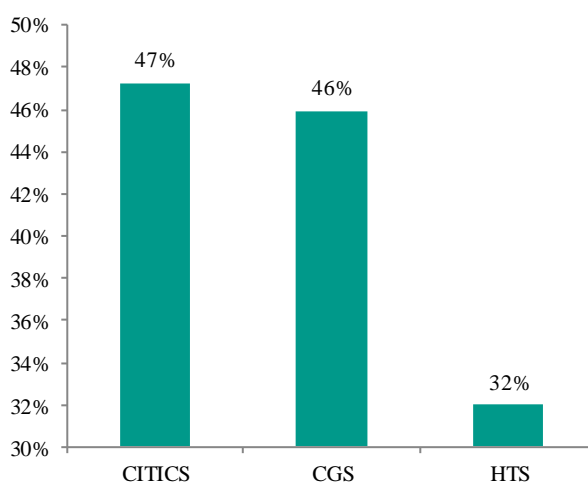
As the broker business is driven by human capital, the most valuable assets in the firms are their staffs and client bases. Staff cost to total expenses hence will be higher than that of other industries. If we compare the share of staff cost within the total expenses between CGS, CITICS and HTS in 2012, CITICS and CGS had higher ratio of 47% and 46% respectively against HTS's 32%. HTS and CITICS were operating with a higher efficiency than CGS given that their cost to income ratio (CIR) were 62% and 61% respectively compared to CGS's 68%.

CIR comparison (2012)



Source: Companies, ABCI

Staff cost to total expenses comparison (2012)



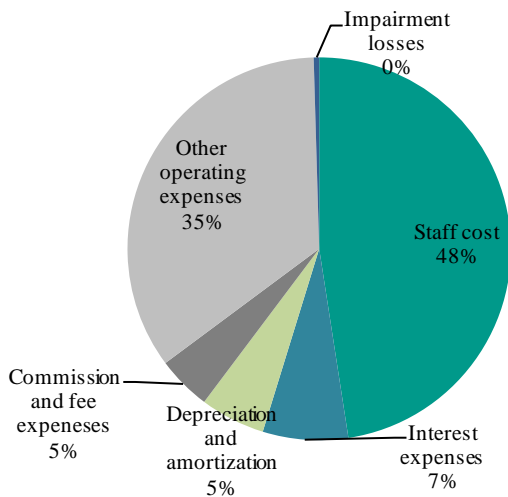
Source: Companies, ABCI



CGS's staff cost accumulated to 43-48% of total expenses in 2010-12 and we expect this ratio to sustain at 42-45% over 2013-15E, with 15-16% total expenses growth each in 2013-15E. This factored into a one-off listing expenses in 1H13 amounting to Rmb278mn. We do not expect staff cost to become a burden to CGS, as majority of the group's staffs is on performance-based and surging costs reflect the increase in revenues accordingly.

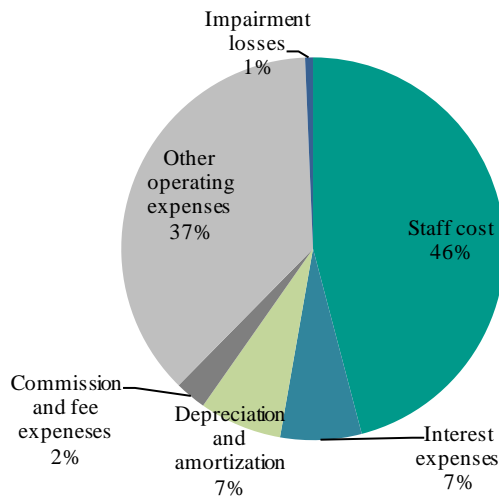
We forecast CGS's net profit to grow by 35%, 45% and 22% in 2013E, 2014E and 2015E respectively, on the back of 1) higher brokerage income from better market momentum, 2) increasing profit contribution from MFSL business, 3) turnaround of AM segment driven by high growth, 4) rebound of IB profit in 2014E with the resumption of primary market and 5) better asset deployment and utilization of leverage. This will sustain CGS's industry high ROE at 9.0% in 2013E and further improve to 11.7% by 2015E.

CGS's operating cost mix 2010



Source: Company, ABCI

CGS's operating cost mix 2012



Source: Company, ABCI



BUY on low valuation and fast growth

We initiate coverage on CGS with a Buy rating and a target price of HK\$6.2. This implies 17.9x 2013E target P/E and 1.5x 2013E target P/B, or 39% upside from current price. Under the expectation of an improving market sentiment and lower policy risk on the back of mild economic recovery and stable inflation assumptions, our base case scenario points to a turnover velocity of 150%, 160% and 170% in 2013E 2014E and 2015E respectively. Future earnings will be driven by broadening innovative products and increasing balance sheet leverage. Key concerns remain on short term market volatility, prolonged suspension in A-share primary market and slowdown of China economy.

Company value by three-stages DDM

We value CGS with three-stages dividend discount model (DDM), as we believe DDM is an appropriate and traditional valuation method used for brokerage sector and stocks exchanges. Besides, DDM can reflect the high growth rate in near term given that the resilient development of China capital markets under the ongoing liberalization shall unleash the growth potential. This will be consistent with CGS's leading brokerage business and developed franchise in other segments to sustain future dividend payments.

We expect CGS to maintain its payout ratio of 35% over 2014-15E after a special dividend around Rmb500mn being paid to pre-IPO shareholders, benchmarking to peers' range of 30-60%. This will be supported by the strong net capital to net assets ratio at 80% in 2012, far above regulatory requirement at 40%. For the three stage DDM, we factor into 25% first stage growth (2016-18), 20% second stage growth (2019-21), 15% third stage growth (2022-26) and 6.0% long term growth. Our cost of equity (COE) of 13.6% is calculated by 3.4% risk free rate (10 years China government bond yield), 1.2 stock beta referencing to the two H-share listed brokers CITICS and HTS, and equity risk premium of 8.5%.

High quality choice in the H-share universe

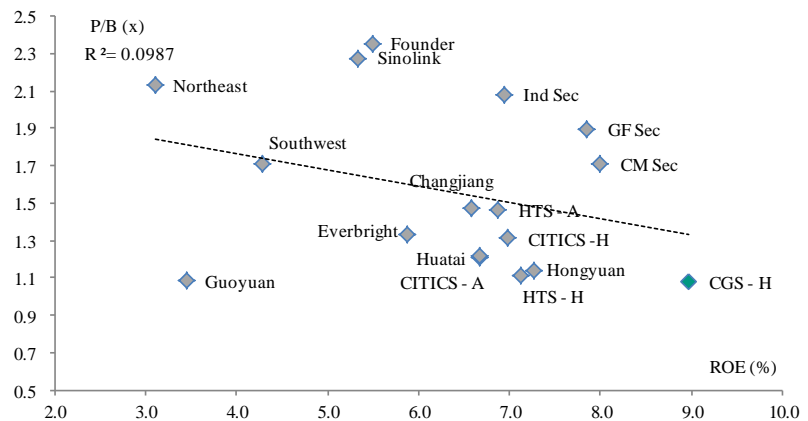
China brokers listed both in A-share and H-share markets. However we notice a divergence between the two markets. Currently there are nineteen brokers listed on A-shares and only two of them (CITICS and HTS) are dual listed in HK. CGS is one of the rare high quality choices in the H-share universe for China brokers as it has clear retail strength with the largest branch network and customer base as well as the highest ROE within the sector.

A/H shares valuation divergence

According to Bloomberg consensus, the China brokerage sector (A-shares) is currently trading at an average 2013E P/E and P/B of 35.3x and 1.68x respectively, while the H-share brokers including CITICS and HTS are trading at an average of 18.4x and 1.16x 2013E P/E and P/B respectively. The high A-share valuation is partly distorted by some outlier brokers such as Founder Securities and Northeast Securities with which their high P/E are the consequence of their low ROE.

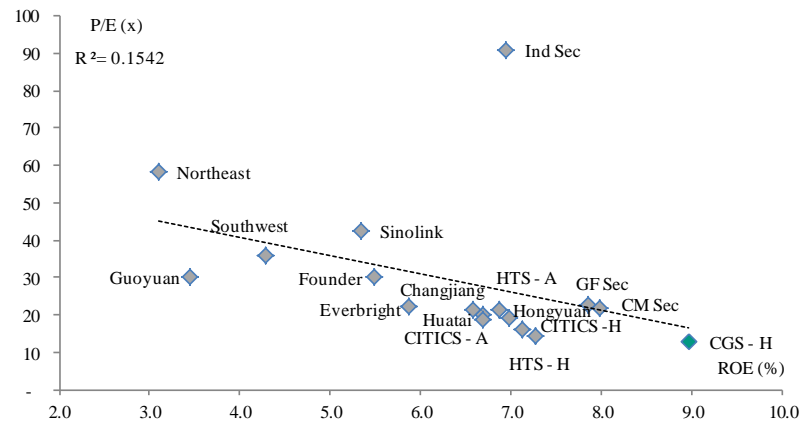


China brokers P/B valuation comparison (2013E)



Source: Bloomberg, ABCI

China brokers P/E valuation comparison (2013E)



Source: Bloomberg, ABCI

We also notice another interesting phenomenon between A and H-share valuations. If we use the two dual-listed brokers, CITICS and HTS, as an example, below table demonstrates that the share price of CITIC's H-share is trading at premium to its A-share while HTS's share price shows different outlook with H-share trading at discount to A-share. We believe this reflects the investor preference of the two markets where H-share investors prefer market leader in investment bank (CITICS) for better profitability potential, while A-share investors prefer well-established retail franchise (HTS) due to their high recognition in domestic brand. Meanwhile H-share investors appear to be more bullish than A-share investors given that H-share EPS growth consensus are 4.6-17.6% higher than A-share.

Although CITICS and HTS's 2013E P/E and P/B are higher than CGS's (12.9x 2013E P/E and 1.08x 2013E P/B) at 16.0x-21.6x and 1.11x-1.46x respectively, we believe its H-share valuation is undervalued given CGS's sector leading ROE and fast growth potential driven by its MFSL and AM businesses and CGS should be re-rated with continuous ROE improvement.



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A and H valuation comparison for CITICS and HTS (2013E)

	Share price (Lcy)	P/E (x)	P/B (x)	EPS growth (%)	ROE (%)
CITICS - A	10.00	20.20	1.21	30.26	6.68
CITICS - H	13.50	19.22	1.31	47.89	6.98
A over H	-7%	5%	-8%	-17.63	-0.30
HTS - A	9.38	21.56	1.46	31.82	6.87
HTS - H	9.01	16.02	1.11	36.36	7.13
A over H	30%	35%	32%	-4.55	-0.26

Source: Bloomberg (closing price as of 25 June 2013), ABCI

Global valuation comparison

Name	BBG code	Total mkt cap (USDmn)	Price (Lcy)	P/E		P/B		EPS gr	ROE		Payout		Div yield
				2012	2013	2012	2013	2013	2012	2013	2012	2013	2013
China													
CITICS - A	600030 CH	18,057	10.00	26.32	20.20	1.26	1.21	30.26	4.98	6.68	78.95	55.96	2.77
HTS - A	600837 CH	14,082	9.38	28.42	21.56	1.49	1.46	31.82	6.40	6.87	36.36	35.63	1.65
GF Sec.	000776 CH	10,670	11.08	29.95	22.70	1.93	1.89	31.89	6.67	7.86	40.54	na	na
CM Sec.	600999 CH	7,681	10.13	28.69	21.93	1.79	1.71	30.84	6.67	7.99	40.22	28.14	1.28
Huatai Sec.	601688 CH	7,142	7.84	27.18	18.62	1.25	1.22	45.93	5.12	6.68	51.99	35.63	1.91
Everbright Sec.	601788 CH	5,416	9.74	33.59	22.39	1.47	1.33	50.00	5.37	5.87	31.72	36.09	1.61
Founder Sec.	601901 CH	5,676	5.72	62.04	30.11	2.42	2.35	106.07	3.93	5.49	na	na	na
Hongyuan Sec.	000562 CH	5,622	8.70	17.40	14.43	1.12	1.14	20.60	9.48	7.27	140.00	na	na
Industrial Sec.	601377 CH	3,845	9.09	41.32	90.90	2.30	2.08	-54.55	5.56	6.94	54.55	130.00	1.43
Southwest Sec.	600369 CH	2,966	7.85	52.33	36.01	1.73	1.71	45.33	3.06	4.29	66.67	87.16	2.42
Changjiang Sec.	000783 CH	3,017	7.82	26.97	21.25	1.49	1.47	26.90	6.72	6.58	68.97	na	na
Guoyuan Sec.	000728 CH	2,732	8.55	41.29	30.32	1.11	1.09	36.19	2.47	3.46	48.29	35.46	1.17
Sinolink Sec.	600109 CH	2,438	11.58	42.26	42.42	2.34	2.28	-0.36	5.19	5.34	na	na	na
Shanxi Sec.	002500 CH	2,342	6.00	100.00	66.67	2.38	2.14	50.00	2.36	na	na	na	na
Northeast Sec.	000686 CH	2,571	16.15	80.75	58.30	2.14	2.13	38.50	5.47	3.10	100.00	72.20	1.24
Pacific Sec.	601099 CH	1,383	5.14	119.53	46.73	na	na	155.81	na	na	na	na	na
Average				47.38	35.28	1.75	1.68	40.33	5.30	6.03	63.19	57.36	1.72
HK													
CITICS - H	6030 HK	18,057	13.50	28.42	19.22	1.38	1.31	47.89	4.90	6.98	78.95	39.50	2.06
HTS - H	6837 HK	14,082	9.01	21.84	16.02	1.18	1.11	36.36	5.82	7.13	36.36	36.44	2.28
CGS - H	6881 HK	4,344	4.47	15.11	12.86	1.23	1.08	16.67	8.49	8.97	-	42.54	3.36
GTJA Int'l	1788 HK	637	2.86	15.21	12.22	1.38	1.28	24.47	9.28	10.64	53.19	44.02	3.60
Haitong Int'l	665 HK	570	3.22	11.51	16.10	1.04	na	-28.54	9.30	6.10	48.35	39.50	2.45
SYWG HK	218 HK	164	2.39	41.93	34.14	1.06	1.03	22.81	2.53	3.10	26.32	27.14	0.79
First Shanghai	227 HK	110	0.61	na	na	0.34	na	na	na	na	na	na	na
Emperor Cap.	717 HK	107	0.32	13.11	na	0.64	na	na	6.27	na	31.15	na	na
Bright Smart	1428 HK	124	0.93	10.94	na	1.38	na	na	10.23	na	20.18	na	na
Average				19.73	18.41	1.07	1.14	19.94	7.10	7.06	36.81	36.46	2.28

Source: Bloomberg, ABCI

*closing price as of 25 June 2013



Risk factors

Price risk

The growing competitiveness of China securities sector might bring pressure to the sector's profitability. In addition to the 114 brokers in China, other financial institutions such as commercial banks and insurance companies present a greater challenge to the securities industry through both directly and indirectly competition with brokers. Price competition persists under this challenging environment as market participants may sustain market share by price war. CGS's commission rate, especially the brokerage commission rate, has been under pressure in recent years. Moreover, the asset management fees, financial advisory fees, and underwriting fees have also been subject to downside pressure.

Given that a significant portion of CGS's revenue is generated by its securities brokerage business, there is a potential risk that price competition will post negative impact on revenues and profits. According the CGS's commission rate sensitivity analysis, every 0.005% decrease in commission rate in 2012 would reduce its revenue by 3% or net profit by 9%, vice versa.

CGS's commission rate sensitivity

Rmbmn	2010	2011	2012
Increase by 0.005%	282	221	164
Decrease by 0.005%	-282	-221	-164
Revenue	8,460	6,431	5,962
Impact of +0.005% in commission rate to revenue	3%	3%	3%
Net profit	2,777	1,578	1,420
Impact of +0.005% in commission rate to net profit	8%	11%	9%

Source: Company, ABCI

Market risk

By considering the business nature of a broker, CGS is exposing to inherent risks associated with the securities industry, including market volatility of asset prices, market turnover driven by investment sentiment and market liquidity. Downturns in economic conditions and unfavorable market conditions in China may result in a decline of ADT and slower financing and investment activities in the market, which would adversely affect both CGS's securities brokerage and underwriting revenues.

CGS's market rate sensitivity

Rmbmn	2010	2011	2012
Price of investments			
Increase by 10%	84	172	156
Decrease by 10%	-84	-172	-156
Revenue	8,460	6,431	5,962
Impact of 10% increase in asset prices to revenue	1%	3%	3%
Net profit	2,777	1,578	1,420
Impact of 10% increase in asset prices to revenue	2%	8%	8%

Source: Company, ABCI



Regarding the proprietary trading business, CGS trades equity, fixed income securities, and derivatives. These asset classes are highly subject to risks in relation to market volatility. Since China derivatives market is still developing, CGS does not have enough channels to fully hedge against price volatility. According to CGS's market rate sensitivity analysis, any 10% decrease in asset prices would reduce CGS's 2012 revenue by 3% or net profit by 8%, vice versa.

Legal risk

China brokers not only primarily expose to policy risk under the regulations set by the CSRC but also are affected by policies of other regulators such as the PBOC, CBRC, CIRC and so on. Therefore any changes in regulations and policies may have impact on CGS's core business. Changes may lead to new competition, suspension of business segment, or new business opportunities. In addition, regulators may introduce new laws and regulations to tighten operating requirements, impose additional restrictions, or even terminate any part of CGS's existing business or operations.

Interest rate risk

CGS is exposed to interest rate risk associated with interest income, interest payment, and fixed income securities. Currently CGS's interest income mainly comes from deposits with banks and other financial institutions, margin financing and securities lending as well as financial assets held under resale agreements. Interest incomes generated from these sources are directly linked to the prevailing market interest rate. CGS also makes interest payments on deposits held on behalf of customers, short-term borrowings and repo transactions. The change of these interest incomes and expenses are positively correlated with the movement of market interest rates.

Another type of interest rate risk facing CGS comes from the fixed income securities in its investment portfolio. The change of market value of fixed income securities is negatively correlated with the movement of interest rate, hence affecting CGS's investment return. In sum, according to CGS's interest rate sensitivity analysis focusing on both types of interest rate risks, any 100bps increase in market interest rate shall reduce its 2012 revenue by 2% or reduce its net profit by 6%.

CGS's interest rate sensitivity

Rmbmn	2010	2011	2012
Increase by 100bps	-33	-45	-117
Decrease by 100bps	33	45	117
Revenue	8,460	6,431	5,962
Impact of 100bps increase in interest rate to revenue	0%	-1%	-2%
Net profit	2,777	1,578	1,420
Impact of 100bps increase in interest rate to net profit	-1%	-2%	-6%

Source: Company, ABCI



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Dilution risk

Upon the completion of CGS's H-share IPO, CGS plans for its A-share listing of 1.7bn shares (approximately 22% of post H-share IPO share capital or approximately 18% of post A&H IPO share capital) in order to further support its continued development in capital based intermediary business. This implies a potential dilution risk to existing shareholders' earnings per share subject to the final size of such fund raising activity. However due to the uncertainty facing the resumption of A-share IPO market, we do not factor into such potential equity issuance into our model.



Financial statements projection

Consolidated income statement forecasts (Rmbmn)

Year Ending Dec	2010	2011	2012	2013E	2014E	2015E
Fee and commission income	6,869	4,664	3,831	4,718	6,052	7,237
Interest income	1,243	1,629	1,699	2,123	2,590	3,057
Investment income	314	104	395	402	453	511
Other income	34	33	38	41	45	49
Revenue	8,460	6,431	5,962	7,284	9,141	10,853
Operating costs	-4,319	-3,914	-3,827	-4,448	-5,152	-6,026
Operating EBITDA	4,142	2,517	2,135	2,837	3,989	4,827
Depreciation	-251	-256	-248	-261	-274	-287
Operating EBIT	3,891	2,261	1,886	2,576	3,715	4,540
Profit before tax	3,891	2,261	1,886	2,576	3,715	4,540
Tax	-1,100	-676	-454	-644	-929	-1,135
Profit after tax	2,790	1,585	1,433	1,932	2,786	3,405
Minority interests	-13	-7	-13	-14	-15	-15
Reported net profits	2,777	1,578	1,420	1,918	2,771	3,390
Growth (%)						
Revenue	na	(24.0)	(7.3)	22.2	25.5	18.7
Operating EBITDA	na	(39.2)	(15.2)	32.9	40.6	21.0
Operating EBIT	na	(41.9)	(16.6)	36.6	44.2	22.2
Net profit	na	(43.2)	(10.0)	35.1	44.5	22.3
Per share data(Rmb)						
EPS	0.46	0.26	0.24	0.28	0.37	0.45
BVPS	2.41	2.67	2.90	3.32	3.63	4.00
DPS	0.20	-	-	0.12	0.13	0.16
Operating performance (%)						
Operating EBITDA margin	49.0	39.1	35.8	38.9	43.6	44.5
Operating EBIT margin	46.0	35.2	31.6	35.4	40.6	41.8
Net margin	32.8	24.5	23.8	26.3	30.3	31.2
Effective tax rate	28.3	29.9	24.1	25.0	25.0	25.0
Dividend payout	43.2	-	-	42.5	35.0	35.0
ROAE	na	10.3	8.4	8.4	9.4	10.6
ROAA	na	2.1	2.3	2.7	3.4	3.7
Dividend yield	-	-	-	2.9	3.2	3.9
Revenue By Business Segments	2010	2011	2012	2013E	2014E	2015E
Securities brokerages	6,868	4,918	4,081	5,063	6,320	7,590
Futures brokerages	304	388	521	577	662	748
Proprietary trading	323	119	401	487	553	610
Investment bank	740	682	685	758	1,078	1,247
Asset management	61	31	45	135	211	303
Private equity investment	27	28	25	29	42	43
Overseas	-	4	33	50	75	98
Other income	136	261	169	185	199	215

Source: Company, ABCI estimates



Segmental income statement forecast (Rmbmn)

2013E	Securities brokerage	Futures brokerage	Prop. Trading	IB	AM	PE	HK	Others	Elim.	Total
Revenue	5,037	573	487	758	135	23	50	181	0	7,243
Revenue - inter-segment	5	0	0	0	0	0	0	0	(5)	0
Other income	22	4	0	0	0	5	0	10	0	41
Segment revenue	5,063	577	487	758	135	29	50	190	(5)	7,284
Operating expenses	(3,097)	(412)	(199)	(484)	(89)	(27)	(77)	(329)	5	(4,708)
Profit before tax	1,967	165	287	274	47	2	(27)	(139)	0	2,576
Growth %										
Fee and commission income	24	11	21	11	202	14	50	8	0	22
Revenue - inter-segment	(24)	0	0	0	0	0	0	0	(24)	na
Other income	10	5	0	0	0	10	0	10	0	9
Segment revenue	24	11	21	11	202	13	50	8	(24)	22
Operating expenses	18	15	21	20	20	16	12	(10)	(24)	16
Profit before tax	35	1	21	(3)	(262)	(20)	(24)	(27)	na	37
2014E	Securities brokerage	Futures brokerage	Prop. Trading	IB	AM	PE	HK	Others	Elim.	Total
Revenue	6,290	658	553	1,078	211	36	75	195	0	9,096
Revenue - inter-segment	6	0	0	0	0	0	0	0	(6)	0
Other income	24	4	0	0	0	6	0	11	0	45
Segment revenue	6,320	662	553	1,078	211	42	75	206	(6)	9,141
Operating expenses	(3,592)	(474)	(241)	(605)	(106)	(31)	(86)	(296)	6	(5,426)
Profit before tax	2,728	188	312	474	105	10	(11)	(90)	0	3,715
Growth %										
Fee and commission income	25	15	14	42	56	54	50	8	0	26
Revenue - inter-segment	25	0	0	0	0	0	0	0	25	na
Other income	10	5	0	0	0	10	0	10	0	9
Segment revenue	25	15	14	42	56	46	50	8	25	25
Operating expenses	16	15	21	25	20	16	12	(10)	25	15
Profit before tax	39	14	9	73	123	553	(59)	(35)	na	44
2015E	Securities brokerage	Futures brokerage	Prop. Trading	IB	AM	PE	HK	Others	Elim.	Total
Revenue	7,556	744	610	1,246	303	37	98	211	0	10,804
Revenue - inter-segment	8	0	0	0	0	0	0	0	(8)	0
Other income	26	4	0	0	0	6	0	12	0	49
Segment revenue	7,590	748	610	1,247	303	43	98	222	(8)	10,853
Operating expenses	(4,167)	(550)	(294)	(786)	(125)	(36)	(96)	(266)	8	(6,313)
Profit before tax	3,423	198	316	460	178	7	2	(44)	0	4,540
Growth %										
Fee and commission income	20	13	10	16	44	2	30	8	0	19
Revenue - inter-segment	20	0	0	0	0	0	0	0	20	na
Other income	10	5	0	0	0	10	0	10	0	9
Segment revenue	20	13	10	16	44	3	30	8	20	19
Operating expenses	16	16	22	30	18	15	11	(10)	20	16
Profit before tax	25	6	1	(3)	70	(32)	(120)	(51)	na	22

Source: Company, ABCI



Consolidated balance sheet forecasts (Rmbmn)

Year Ending Dec	2010	2011	2012	2013E	2014E	2015E
Fixed assets	609	584	516	541	568	580
Goodwill	223	223	223	223	223	223
Other intangible assets	322	353	363	381	400	412
Investment securities	324	391	743	854	983	1,032
Other non-current assets	462	305	174	140	112	89
Total non-current assets	1,940	1,857	2,019	2,140	2,286	2,336
Cash & equivalents	55,585	42,264	36,607	39,536	35,582	35,938
Advances to customers	533	2,549	5,439	11,503	19,847	25,801
Trading securities	6,515	5,011	4,622	5,454	6,108	6,597
Investment securities	2,015	642	6,739	8,518	9,426	10,254
Other current assets	27,677	6,892	8,870	10,666	11,818	12,619
Total current assets	92,325	57,358	62,277	75,677	82,782	91,210
Total assets	94,265	59,215	64,296	77,816	85,068	93,546
Accounts payable	76,795	41,231	39,746	43,720	47,218	50,995
Other liabilities	2,925	1,857	6,991	8,888	10,257	12,140
Total liabilities	79,720	43,088	46,737	52,609	57,475	63,135
Net current assets	12,605	14,270	15,540	23,068	25,306	28,075
Issued share capital	6,000	6,000	6,000	7,537	7,537	7,537
Reserves	4,956	5,683	6,268	11,283	11,847	12,439
Retained profit	3,504	4,321	5,162	6,188	7,989	10,193
Total shareholders' fund	14,460	16,004	17,430	25,008	27,373	30,169
Minority interest	84	123	129	200	219	241
Total equity	14,545	16,127	17,559	25,208	27,592	30,411
Growth (%)						
Advances to customers	na	378.3	113.4	111.5	72.5	30.0
Investment securities	na	(68.1)	949.9	26.4	10.7	8.8
Total assets	na	(37.2)	8.6	21.0	9.3	10.0
Accounts payables	na	(46.3)	(3.6)	10.0	8.0	8.0
Total liabilities	na	(46.0)	8.5	12.6	9.3	9.8
Total equity	na	10.9	8.9	43.6	9.5	10.2
Financial strength						
Total assets/equity (%)	6.5	3.7	3.7	3.1	3.1	3.1
Current ratio (x)	1.2	1.3	1.3	1.4	1.4	1.4

Source: Company, ABCI estimates

Appendix I – Company background

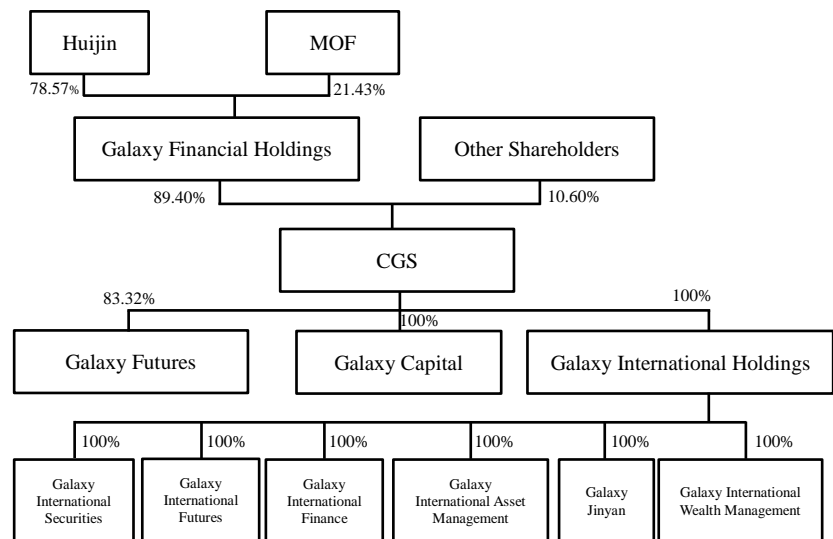
Company Business Description

CGS provides a comprehensive range of financial services including securities brokerage, securities investment consulting, financial advisory for securities trading, and securities investments, securities underwriting and sponsoring, securities proprietary trading and securities assets management.

Shareholding structure

CGS currently has 2 groups of major shareholders, including 89.4% equity stake held by China Galaxy Financial Holdings Company Limited (“CGF”), which is ultimately held by Central Huijin Investment Limited (78.57%) and China Ministry of Finance (21.43%), and the rest of 10.6% equity interest held by 37 shareholders. Each of them has less than 2% shareholding in CGS and these shareholders include Shougang Corporation, Chongqing Water, Zhejiang TianLang Investment Management Company Limited, CNBM, another 30 corporates and 3 individual shareholders.

CGS’s corporate structure (pre-IPO)



Source: Company, ABCI

Meanwhile CGS has 3 subsidiaries, namely Galaxy Futures Company Limited (“GFC” or “Galaxy Futures”), Galaxy Capital Management Company Limited (“GCM” or “Galaxy Capital”), and China Galaxy International Financial Holdings Limited (“GIH” or “Galaxy International Holdings”).

GFC conducts business in commodity futures brokerage, financial futures brokerage, futures investment consulting, and asset management which CGS holds 83.32% of equity stakes in GFC. GFC was established under the name of Dalian Zhongbei Futures with a registered capital of Rmb30mn in May 1995. It was later renamed as Galaxy Futures Brokerage (“GFB”) and became

the first Sino-foreign joint venture futures company in China. CGS then acquired the 49.99% equity stakes of GFB from China Galaxy Securities Company Limited (“Galaxy Limited”) in 2007. GFB was renamed as GFC in August 2010.

GCM was incorporated in October 2009 with a registered capital of Rmb1bn, which is primarily engaged in asset management, project investment, and investment management business and is a wholly-owned subsidiary of CGS.

GIH was incorporated in Hong Kong in February 2011, which is a wholly-owned subsidiary of CGS, with issued share capital of HK\$600mn. GIH provides comprehensive services in securities and futures brokerage, research, investment banking, and money lending in Hong Kong through its wholly-owned subsidiaries.

CGS's subsidiaries

Name	Date of Incorporation	Equity Holding Structure		Registered Capital	Business Description
Galaxy Futures	August 6th, 2010	83.32%	China Galaxy Securities	Rmb600mn	Financial futures brokerage, futures investment consulting, and asset management
		16.68%	RBS Asia Futures Limited		
Galaxy Capital	October 21st, 2009	100%	China Galaxy Securities	Rmb1bn	Asset management, project investment, and investment management
Galaxy International Holdings and subsidiaries	February 9th, 2011	100%	China Galaxy Securities	HK\$600mn	Securities and futures brokerage, research, investment banking, and money lending

Source: Company, ABCI

Company History

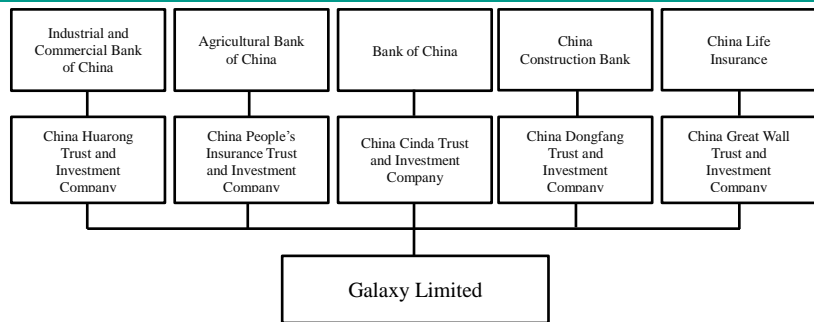
CGS was established in January 2007 with a registered capital of Rmb6bn. Upon establishment, CGF provided around Rmb5,993mn as registered capital and held 99.98% of CGS's shares. The rest of minority shareholders collectively contributed approximately Rmb7mn of the registered capital and held 0.11% of its stake.

Galaxy Limited

Galaxy Limited was established in August 2000 with a registered capital of Rmb4.5bn. Business scope coverage includes issuer and issuing agent of marketable securities, proprietary trading and trading agent for various marketable securities, depository agent, authentication and transfer of marketable securities, distribution agent for equity interest including debt repayment, interest payment and dividend distribution, fund and asset management, corporate restructuring, merger and acquisition, investment consulting and financial advisory. It was a wholly state-owned securities company formed by the consolidation of China Huarong Trust and Investment Company, China Great Wall Trust and Investment Company, China Dongfang Trust and Investment Company, China Cinda Trust and Investment Company, and China People's Insurance Trust and Investment Company. These companies were the trust and investment companies wholly-owned by Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank, and China Life Insurance respectively.



Galaxy Limited Formation



Source: Company, ABCI

Acquisition of Assets from Galaxy Limited

In 2005, the State Council approved the restructuring of Galaxy Limited with Huijin and the MOF established Galaxy Financial Holdings, which later established the CGS in 2007. Within the year of 2007, CGS acquired the securities brokerage business, investment banking business, and related assets of Galaxy Limited together with 49.99% equity stake in GFC with the total amount of acquisitions at Rmb1.1bn. These acquisitions helped CGS to gain the leading position in China securities industry.

Acquisitions of Assets from Galaxy Limited

Assets	Business
Securities Brokerage	Trading agent of various marketable securities, depository agent, authentication and transfer of marketable securities, distribution agent for various interest including debt repayment, interest payment and dividend distribution, and agent of QFI's domestic securities brokerage, together with related assets
Investment Banking	Share and bond underwriting, listing sponsorship, investment consulting, financial advisory, corporate restructuring and merger and acquisition, together with related assets
Galaxy Futures (49.99% of equity interest)	Commodity futures brokerage, financial futures brokerage, and futures investment consulting

Source: Company, ABCI

Cornerstone investors in H-share IPO

Upon the completion of CGS' H-share IPO, the company has introduced seven cornerstone investors as below. Total number of share allocated to these investors accounted for 48.04% of total IPO issued shares, or 7.03% of total share capital of CGS. Cornerstone investors are subject to a six months lockup period from the IPO date (i.e. will be unleashed on 18 November 2013).



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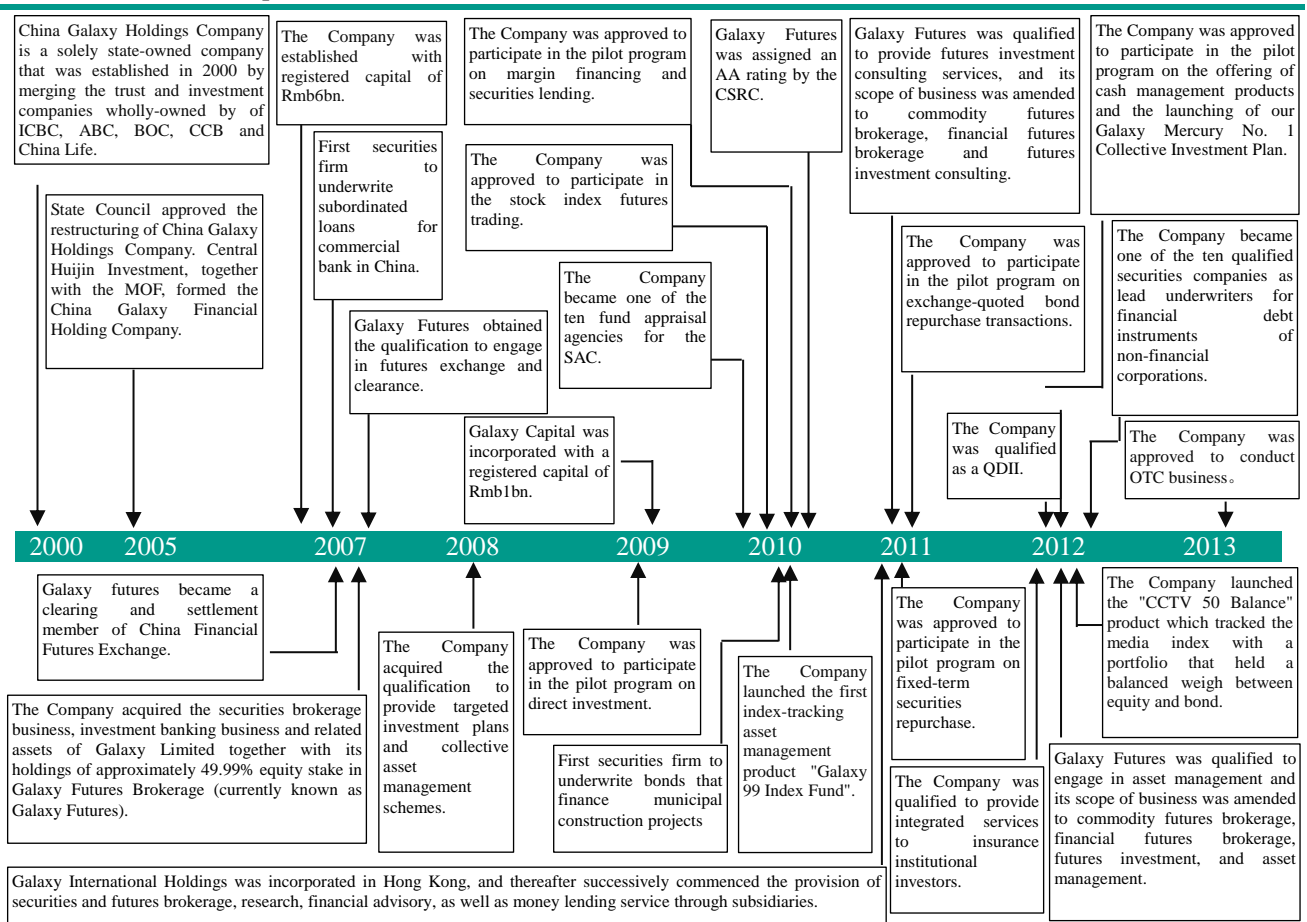
China Galaxy Securities Co., Ltd.

CGS's cornerstone investors

Company Name	No. of share allocated	Percentage to total sh-cap
AIA	73,221,500	1.0%
China Life	43,933,000	0.6%
Cinda Asset Management	29,288,500	0.4%
Genertec HK Ltd	43,933,000	0.6%
Khazanah Nasional Berhad	146,443,000	2.0%
Sino Life Insurance	73,221,500	1.0%
Sinopec Century Bright Capital	117,154,500	1.6%

Source: Company, ABCI

CGS's milestones development



Source: Company, ABCI

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China Galaxy Securities Co., Ltd.

Appendix II – Management team

Management Profile

Executive Director				
Name	Current Position	Date of Appointment	Responsibility	Background
Mr. Gu Weiguo	Deputy Chairman, Executive Director and President	August 19, 2011	Overall management and operations of the Company	Mr. Gu joined the Company since January 2007, and was chairman of the Company's labor union from October 2008 to July 2010, Vice President of the Company from September 2009 to March 2010, and chairman of Galaxy Capital from April 2010 to October 2010.
Mr. Wu Chengming	Executive director, joint company secretary	August 19, 2011	Daily affairs of the board, and Company information disclosure and information submission	Mr. Wu served as director of Galaxy Financial Holdings from June 2009 to July 2012, and director of Galaxy Investment from May 2011 to July 2012.
Senior Management				
Name	Current Position	Date of Appointment	Responsibility	Background
Ms. Chen Jing	Vice President	August, 2007	Settlement management and information technology	Ms. Chen has also been chairman of the labor union committee since October 2012 and a member of the executive committee of the Company.
Ms. Huo Xiaoyu	Vice President	August, 2007	Overseas business	Ms. Huo has been a member of the executive committee of the Company since December 2012 and chairman and director of Galaxy International Holdings since June 2011.
Mr. Wang Liuqi	Chief Officer of Equity Financing Business	March, 2012	Investment banking business including equity financing, mergers and acquisitions, and restructuring.	Mr. Wang also holds position as general manager of the investment banking head office since February 2012 and has been a member of the executive committee of the Company since December 2012.
Mr. Dai Xu	Chief officer of Fixed Income Business	March, 2012	Fixed income business	Mr. Dai has been a member of the executive committee of the Company since 2012. From November 2004 to March 2012, he consecutively served as deputy general manager of investment banking head office of Galaxy Limited, deputy general manager of investment banking head office of the Company, and managing director of debt financing department of the company.
Mr. Yin Yanwu	Chief Officer of Asset Management Business	March, 2012	Asset business management	Mr. Yin was Acting Chief Business Officer of Asset Management Business from November 2011 to December 2012.
Ms. Zhu Ruimin	Chief Financial Officer	December, 2012	Business affairs of the Finance and Planning Department and Investment Management Department	Ms. Zhu has been a member of the executive committee of the Company since December 2012. She is a senior accountant recognized by Beijing Senior Professional Qualifications Committee in May 2011.
Mr. Wu Jianhui	Chief Human Resources Officer	November, 2011	Human resources affairs	Mr. Wu served consecutively as general manager of human resources department in the Company and secretary to the board of the Company from July 2010 to August 2012.
Mr. Li Shuhua	Chief Compliance Officer and Chief Risk Officer	November 2011	Compliance and risk management affairs	Mr. Li has been Chief Compliance Officer of the Company since April 2010 and Chief Risk Officer as well as Chief Compliance Officer of the Company since November 2011.

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China Galaxy Securities Co., Ltd.**Joint Company Secretary**

Name	Current Position	Date of Appointment	Responsibility	Background
Ms. Yung Mei Yee	Joint Company Secretary	2013	Corporate governance, regulatory and compliance affairs	Ms. Yung has over 20 years of experience in the company secretarial field and has worked for various sizable and reputable Hong Kong Main Board listed companies.

Non-executive Director

Name	Current Position	Date of Appointment	Responsibility	Background
Mr. Chen Youan	Chairman, Non-executive Director	August 19, 2011	N/A	Mr. Chen is currently the deputy general manager of Huijin.
Mr. Xu Guoping	Non-executive Director	August 19, 2011	N/A	Mr. Xu has been serving as director and deputy general manager of Galaxy Financial Holdings since August 2005 and June 2011 respectively.
Mr. Li Chenghui	Non-executive Director	August 19, 2011	N/A	Mr. Li has also been serving as director of Galaxy Financial Holdings since August 2005.
Mr. Shi Xun	Non-executive Director	August 19, 2011	N/A	Mr. Shi has been serving as independent non-executive director of Zhejiang Xianju Pharmaceutical Co., Ltd since December 2007.
Ms. Qi Xiaoli	Non-executive Director	November 20, 2012	N/A	Ms. Qi has also been serving as deputy supervisor of the working committee of China Financial Industry Labor Union set up under Galaxy Financial Holdings since June 2007, deputy chairman of the Company's labor union since October 2008, and supervisor of President's office of the Company since January 2012.

Independent Non-executive Director

Name	Current Position	Date of Appointment	Responsibility	Background
Mr. Wang Shiding	Independent Non-executive Director	August 19, 2011	N/A	Mr. Wang also serves as a researcher in Institute of Fiscal Science of Ministry of Finance.
Mr. Liu Feng	Independent Non-executive Director	August 19, 2011	N/A	Mr. Liu has been adjunct professor at the Management School of McGill University, Canada since January 2006.
Mr. Zhou Ruijin	Independent Non-executive Director	January 25, 2013	N/A	Mr. Zhou served as independent non-executive director, chairman of remuneration committee and chairman of nomination committee of Branding China Corporation since April 2012.
Mr. Wu Yuwu	Independent Non-executive Director	January 25, 2013	N/A	Mr. Wu is a professor of accounting at the School of Accountancy of the Chinese University of Hong Kong since January 2002.

Supervisor

Name	Current Position	Date of Appointment	Responsibility	Background
Mr. Yu Wenxiu	Chairman of Supervisor Committee	August 19, 2011	N/A	Mr. Yu was elected as supervisor in December 2005, and he has been supervisor and Chairman of the supervisor committee of the Company since January and February 2007, respectively.
Mr. Zhong Cheng	Supervisor	August 19, 2011	N/A	Mr. Zhong was elected as supervisor in December 2005, and has been Supervisor of the Company since January 2007.
Mr. Gu Shulin	Supervisor	November 20, 2012	N/A	Mr. Gu has been serving as supervisor of work inspection office and deputy chairman of the labor union committee of the Company since August 2010 and October 2012.

Source: Company, ABCI

Appendix III – China securities industry regulatory framework

CGS's capital position

We notice that CGS has a strong capital based, which is an essential factor to support CGS's future growth. Looking at major capital indicators, CGS has well-positioned far above regulatory requirements. For instance, CGS's net capital to risk capital reserve ratio was 662.6% in 2012, six times of required 100%, while net capital to net assets was 77.9% in 2012, compared to the required 40%.

Company net capital and key regulatory risk control indicators comparison

	As of December 31,			Warning level	Minimum/Maximum level
	2010	2011	2012		
Net capital (in millions of RMB)	11,316.0	12,664.3	13,508.3	≥240.0	≥200.0
Net capital/total risk capital reserves (%)	298.3%	436.2%	662.6%	≥120%	≥100%
Net capital/net assets (%)	78.8%	79.5%	77.9%	≥48%	≥40%
Net capital/total liabilities (%)	399.2%	740.9%	199.6%	≥9.6%	≥8.0%
Net assets/total liabilities (%)	506.9%	932.3%	256.3%	≥24.0%	≥20.0%
Value of equity securities and derivatives held ⁽¹⁾ /net capital (%)	5.3%	8.0%	9.9%	≤80.0%	≤100.0%
Value of fixed-income securities held/net capital (%)	72.4%	37.9%	76.4%	≤400.0%	≤500.0%

Note:

- (1) The warning level is set by the CSRC according to the Risk Control Indicator Measures. If an indicator is required to stay above minimum level, the warning level is 120% of the minimum requirement, and if an indicator is required to stay below a maximum level, the warning level is 80% of the maximum requirement.
- (2) Net capital equals net assets minus risk adjustments of financial assets minus risk adjustments of other assets and contingent liabilities plus/minus other adjustments determined or authorized by the CSRC
- (3) Risk capital reserve is a statutory reserve for PRC securities firms to cover any loss that securities firms may incur in their ordinary course of business and in the process of setting up subsidiaries and branches. Such reserve is calculated based on a securities firm's net capital.
- (4) Total liabilities exclude the accounts payable to brokerage customers.

Source: Company, CSRC, ABCI

China's regulatory framework

In China, the scope of brokerage business covers the operation of brokerage, trading and investment advisory, proprietary trading, asset management, underwriting and sponsorship, and other securities related businesses. All of these business activities are principally regulated on a legal perspective, under the PRC Investment Fund Law, PRC Securities Law, and the Regulation on Supervision and Administration of Securities Companies.

The China securities market has three regulators as the gatekeepers: 1) China Securities Regulatory Commission (CSRC) is in charge of drafting and enforcing laws and policies for the securities and futures market and the regulatory oversight of market participants; 2) Securities Association of China (SAC), which is a self-regulatory organization, is responsible for formulating industry practice standards and codes of conducts, and supervising professional qualification exams, and the registration of licensed practitioners; 3) Stock Exchanges oversee listing procedures and trading activities and monitor their members and listed companies.

CSRC has long been focused on the internal control and risk management of securities firms. By assessing individual firm's risk management capabilities, competitiveness and the status of regulatory compliance, the authority



classifies securities firms into five categories and 11 sub-levels (e.g. Class A (AAA, AA, A), class B, (BBB, BB, B), Class C (CCC, CC, C), Class D and Class E. A securities firm's risk capital reserves, review frequency, resource allocation, and ability to obtain licenses for new businesses and branches are not immune from the influences posted by the rating system mentioned above. To better protect investor interests, China Securities Investor Protection Fund Corporation established an investor protection fund to cover any default risk from brokers, while brokers have to pay a fund according to the rating given by CSRC.

Broker classification by CSRC

A	Highest risk management capability across the industry, able to manage risk in new business and new products
B	Relatively high risk management capability in the industry, able to management risk of expansion in changing market environment
C	Risk management capability well match with current business area and scale
D	Relatively low risk management capability, potential risk could exceed acceptable level of the company
E	Risk realized, CSRC has adopted risk control measures to the company

Source: CSRC, ABCI

Capital requirements

CSRC requires market participants to satisfy certain financial indicators. Major components in relation to these ratios are net capital and sum of risk capital reserves, which are calculated based on asset liabilities management, business segments and resource allocation of each company.

Capital requirement ratio

Capital requirement indicator	Minimum regulatory level (%)
Net capital to total risk capital reserves	>100
Net capital to net assets	>40
Net capital to total liabilities	>8
Net assets to total liabilities	>20
Value of equity securities and derivatives held to net capital	<100
Value of fixed income securities to net capital	<500
Cost of holding one equity security to net capital (Ranked top 5)	<30
Market value of one equity security in the portfolio/its total market cap (Ranked top 5)	<5
Scale of margin financing for one customer to net capital (Ranked top 5)	<5
Scale of security lending for one customer to net capital (Ranked top 5)	<5
Holding in one security to market capitalization of that security (except underwriting reason or approved by CSRC)	<20

Source: CSRC, ABCI

Net capital

A company's liquidity level is reflected on net capital, which can be calculated by discounting assets and liabilities from the net assets of the parent level of an investment bank. The calculation is based on assigning different adjusting factors to different asset classes. Non-current assets, including long-term investment, investment in subsidiaries, and other assets, fixed assets and intangibles that are not easy to convert into cash, are fully



excluded from the calculation. Investments that are sensitive to market volatility will be assigned with higher adjusting factors. Contingent liabilities and commitments from guarantees are deemed as potential risk and are fully deducted from net assets.

Calculation of net capital

Items	Deduction rate (%)
Net assets	
Less: Risk adjustment of financial assets	
1. Equity ⁽¹⁾	
- SSE 180 index, SZSE 100 index, CSI300 index components	5
- Other listed equity	10
- Restricted shares	20
- Total holding >5% of market capitalization	40
- ST shares	50
- *ST shares	60
- Delisted but available to sell by agent	80
- Delisted but not available to sell by agent	100
2. Money market fund	0
3. Securities investment fund ⁽²⁾	1
4. Fixed income securities ⁽³⁾	
- Government bond & Central bank papers	0
- Financial bond & Municipal bond	1
- Trust bond - AAA rating	2
- Trust bond - below AAA rating, above (including) BBB rating	4
- Trust bond – below BBB rating	20
5. Convertible bond	5
6. Trust investment product ⁽⁴⁾	80
7. Collective asset management	
- Investment in other company's collective asset management plan	5
- Investment in the company's collective asset management plan (No upfront guarantee of loss sharing)	10
- Investment in the company's collective asset management plan (With upfront guarantee of sharing)	15
8. Targeted asset management and special purpose asset management accounts managed by other security company or fund management company ⁽⁵⁾	10
9. Investment in other financial products ⁽⁶⁾	*
Less: Risk adjustment of derivatives	
1. Equity related	20
2. Asset resulted from interest rate swap fair value change	100
3. Others derivatives ⁽⁷⁾	
Less: Risk adjustment of other assets	
1. Lending to financial institutions (within contract period)	0
2. Margin financing	2
3. Securities lending ⁽⁸⁾	5
4. Repo agreement (not overdue)	0
5. Interest receivable	0
6. Deposits	
- Trading deposits	0
- Commitment deposits	10
- Futures deposits ⁽⁹⁾	100
- Other deposits	
7. Long-term equity investment (excluding listed companies)	
- Investment in subsidiaries	100
- Investment in subsidiaries with fund management and futures business ⁽¹¹⁾	100
- Investment in subsidiaries in other industry ⁽¹⁰⁾	100
- Investment in overseas subsidiaries	100
- Strategic equity investment ⁽¹¹⁾	100

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	- Other equity investment ⁽¹²⁾	100
8. Investment properties		100
9. Fixed assets		
	- Properties	100
	- Other fixed assets	100
10. Intangibles		
	- Trading license	50
	- Other intangibles	100
11. Goodwill		100
12. Deferred tax assets		100
13. Dividend receivable		0
14. Receivable from margin financing and securities lending		100
15. Account receivable		
	- ≤1 year	10
	- 1-2 years	50
	- >2 years	100
	- Receivables from shareholders & associate companies	100
16. Acting underwriting securities		0
17. Receivable from bond settlement on behalf of third party		0
18. Receivable on underwriting costs		100
19. Pledged assets		100
20. Deferred expenses		100
21. Others ⁽¹³⁾		100
Less: Risk adjustment on contingent liabilities		
1. Guarantee for third party (excluding counter-guarantee for the company itself)		100
2. Guarantee for subsidiaries in securities business		100
3. Other contingent liabilities ⁽¹⁴⁾		
Less: Other adjustment items specified by CSRC⁽¹⁵⁾		
1. Assets cannot be liquidated		100
2. Other items		
Add: Other adjustment items specified by CSRC⁽¹⁵⁾		
1. Subordinated debt ⁽¹⁶⁾		
2. Guarantee from parent company		
Net capital		

Note:

- (1) Equity fulfilling 2 or more classification, highest deduction rate applies.
- (2) Trust investment products according to assessment by CSRC on their rating, maturity and guarantee.
- (3) Adjust according to prudence guideline publish by CSRC.
- (4) Currently this only applies to subsidiary running direct investment business.
- (5) Strategic investment includes only authorised investment in financial industry.
- (6) Includes all unauthorised equity investment.
- (7) For investment without loss sharing commitment, amount calculated by 10% of net shares minus net invested capital. For investment commit to loss sharing, 50% of shares minus invested if investment dropped below par value, otherwise same calculation applies.
- (8) Higher of 20% of contingent liabilities amount or potential loss.
- (9) Items allowed by CSRC in the calculation of net capital

* Deduction rate subject agree by CSRC

Source: CSRC, ABCI

Risk capital reserve

Risk capital reserve is another major component from the compliance perspective. It is calculated by applying certain percentages (based on the company's CSRC rating) to different business segments. Derivatives and equities are generally considered high risk products. Fixed income products are the least risky for proprietary trading and underwriting businesses. Other factors, such as reserves for branches and previous year operating expenses, are also considered in risk capital reserve calculation.



Calculation of risk capital reserve

Items	Required reserve by classification (%)				
	"A" rating >3yrs	A	B	C	D
1. Brokerage business					
Total client money in relation to transactions	0.4	0.6	0.8	2	4
2. Proprietary trading business					
(1) Derivatives					
Warrants	4	6	8	20	40
Long position in index futures ⁽¹⁾	4	6	8	20	40
Short position in index futures ⁽¹⁾	4	6	8	20	40
Interest rate swap ⁽¹⁾	4	6	8	20	40
(2) Equity securities and related products					
Equity	3	4.5	6	15	30
Equity fund	3	4.5	6	15	30
Mixed fund	3	4.5	6	15	30
Collective asset management product	3	4.5	6	15	30
Trust investment product	3	4.5	6	15	30
Others	3	4.5	6	15	30
(3) Fixed income					
Government bonds	1.6	2.4	3.2	8	16
Corporate bonds	1.6	2.4	3.2	8	16
Bond fund	1.6	2.4	3.2	8	16
Others	1.6	2.4	3.2	8	16
(4) Hedged proprietary investment in equity securities and related derivatives ⁽²⁾					
Equity securities	1	1.5	2	5	10
Short position in stock and index futures ⁽¹⁾	1	1.5	2	5	10
(5) Hedged proprietary investment in fixed income securities and related derivatives					
Fixed income securities	1	1.5	2	5	10
Interest rate swap ⁽¹⁾	1	1.5	2	5	10
3. Underwriting business					
Equity underwriting re-finance	6	9	12	30	60
IPO	3	4.5	6	15	30
Corporate bonds ⁽³⁾	1.6	2.4	3.2	8	16
Government bonds ⁽⁴⁾	0.8	1.2	1.6	4	8
4. Asset management business					
Special purpose asset management	0.4	0.6	0.8	2	4
Collective asset management	0.4	0.6	0.8	2	4
Limit-specific asset management	0.2	0.3	0.4	1	2
Targeted asset management	0.2	0.3	0.4	1	2
5. Margin financing and securities lending					
Margin financing	1	1.5	2	5	10
Securities lending ⁽⁵⁾	2	3	4	10	20
6. Branch indicator (Rmbmn)					
Branch number ⁽⁶⁾	20	20	20	20	20
Sales office number ⁽⁶⁾	3	3	3	3	3
7. Operating risk					
Last year operating cost ⁽⁷⁾	10	10	10	10	10
8. Others					
SME private placement bond ⁽⁸⁾	3	4.5	6	15	30
Sum of risk capital reserves (total of item 1-8)					

Note:

- (1) The investment scale of equity index futures and interest rate swap is calculated as 15% of the contract value and 3% of the contract value respectively.
- (2) If equity indexed futures and interest rate swap are hedged according to "Corporate Accounting Principles 24 – Hedging", their risks is considered hedged.
- (3) Corporate bond includes corporate bonds, convertible bonds, short-term financing bills, and medium-term notes issued by corporations.
- (4) Government bond is issued by the government.
- (5) The scale of security lending business is calculated as the market value at initiation.
- (6) The risk capital reserve of each branch and sales office is RMB 20 million and RMB 3 million respectively.
- (7) Operating cost equals the sum of sales and administrative expenses, asset impairment provision, and other business related costs.
- (8) When securities firms participate in underwriting and proprietary trading of SME private placement bonds, the risk capital reserve equals to 15% of the amount of involved bonds.

Source: Bloomberg, ABCI

Disclosures

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