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ABC INTERNATIONAL

ABCI SECURITIES COMPANY LIMITED

# 2H19 ECONOMIC OUTLOOK AND INVESTMENT STRATEGY

ABCI China/  
HK Equity Research

## Monetary Easing to Begin





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# Global Economic Outlook

Andy Yao



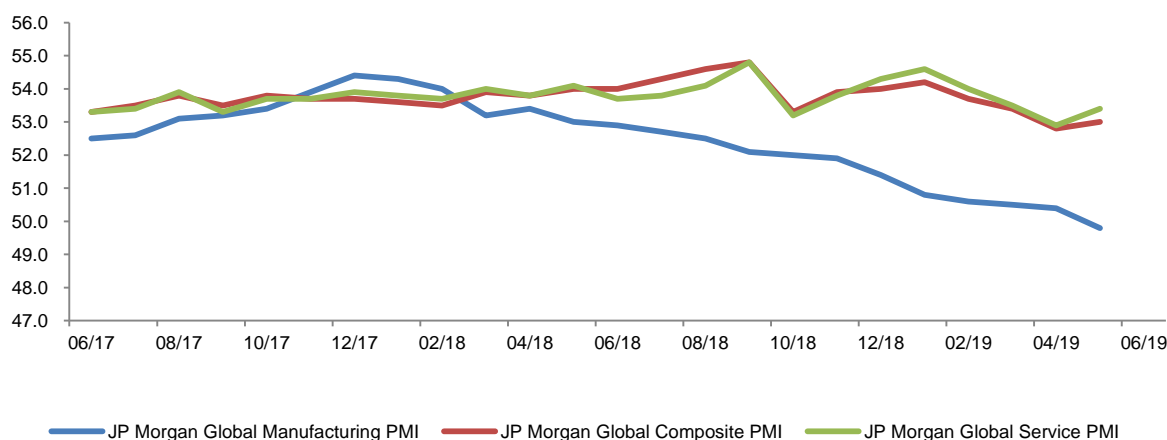
## 2H19 Global Economic Outlook

- The pace of global economic recovery has stalled since the start of 2019 on rising trade tension, heightened policy uncertainty, and ongoing declines in business and consumer confidence. Despite better-than-expected 1Q19 GDP growth for major countries, recent data for major economies point to deceleration in 2Q19
- Global inflation has been mild since the start of 2019 on anemic growth and low energy prices. Core inflation, excluding food and energy prices, was muted on weak wage growth
- Looking ahead, global economic growth is expected to slow gradually in 2H19 and 2020, mainly driven by escalating trade conflicts and heightened uncertainty on economic and political policies
- We expect economies in the US, China, Eurozone, Japan and UK to grow by 2.5%, 6.2%, 1.2%, 0.7% and 1.2% in 2019E and 1.9%, 6.0%, 1.4%, 0.6%, and 1.2% in 2020E, respectively, compared with 2.9%, 6.6%, 1.8%, 0.8%, and 1.4% in 2018

### Global growth momentum has turned frail

The pace of global economic recovery has stalled since the start of 2019 on rising trade tension, heightened policy uncertainty, as well as ongoing declines in business and consumer confidence. As shown in Exhibit 1, both the JP Morgan global manufacturing PMI and service PMI moderated in 5M19, pointing to slowing economic growth. Global trade activity revealed a waning momentum with the erection of trade barriers – the World Trade Outlook Indicator released by WTO descended to a contraction level of 96.3 in May and the sub-indicator export order index remained dismal at 96.6. In response to the abating growth impetus, investors in the capital markets have begun to reduce the proportion of risky capital holdings; major stock markets around the world have also declined since May 2019.

Exhibit 1: JP Morgan Global PMIs (%)



Source(s): Bloomberg, ABCI Securities



1Q19 GDP growth in major countries was better than expected, but these readings were distorted by various factors to a certain extent. For instance, US growth accelerated to 3.2%<sup>1</sup> in 1Q19 from 3.0% in 4Q18, but the increase was mainly due to past front-loading of imports and the build-up of inventories resulted from the ongoing trade dispute (Exhibit 2). Acceleration of Japan's GDP growth in 1Q19 was entirely driven by sharp contraction in imports of goods and services, while exports and domestic demand both deteriorated from 4Q18. In 2Q19, the data unequivocally point to decelerating momentum in major economies.

**Exhibit 2: GDP growth of global major economies (%)**

Real GDP Growth (YoY)	2018	4Q18	1Q19
US	2.9	3.0	3.2
China	6.6	6.4	6.4
Eurozone	1.8	1.2	1.2
Japan	0.8	0.3	0.9
U.K.	1.4	1.4	1.8

Source(s): Bloomberg, ABCI Securities

Global inflation has been mild since the start of 2019 on anemic growth and low energy prices. Core inflation, excluding food and energy prices, was muted on weak wage growth. In most advanced economies, core inflation failed to meet central bank targets despite substantial improvement in unemployment rate. Among the emerging economies, core inflation remained below 2% as economic activity moderates. For some, however, currency depreciation has boosted inflation, partially offsetting the downward pressure resulted from low energy prices.

Major central banks have adopted accommodative monetary policy amid subdued inflation and decelerating activity. The Fed maintained its target range for the fed funds rate at 2.25%–2.50% in 1H18; it also tapered off its program of balance sheet reduction, which will come to a halt by Sep 2019. ECB pushed back the timing of a rate hike and left interest rates at record-low levels in its June monetary policy meeting. BOJ and BOE have kept interest rates unchanged and held on to their stance of a loose monetary policy, while PBOC has relaxed the tightening bias in its neutral monetary policy.

### **Global growth to slow gradually in 2H19/2020**

Looking ahead, global economic growth is expected to slow gradually in 2H19 and 2020, mainly driven by escalating trade conflicts and heightened uncertainty on economic and political policies. In its Apr trade forecast, WTO estimates the growth of global trade in goods in 2019 will fall from 3.0% in 2018 to 2.6% before rebounding to 3.0% in 2020. According to the latest Global Economic Prospects released by the World Bank in June 2019, global economic growth is projected to decelerate to 2.6% in 2019E and 2.7% in 2020E, down from 3.0% in 2018 (Exhibit 3).

We expect the US economy to expand by 2.5% in 2019E and 1.9% in 2020E, down from 2.9% in 2018. Recent tariff increases and associated retaliatory actions are expected to hinder domestic and external demand. Fading fiscal stimulus and slowing labor force growth are likely to weigh on the economy. On the monetary front, with a weakening outlook for economic growth under the Sino-US trade conflict, we expect its interest rate to be slashed once in the remainder of 2019E and twice in 2020E if the US upholds the existing 25% tariff on \$250bn of China's imports; however, if the US decides to impose the 25% tariff on additional \$300bn of Chinese goods, we estimate the Fed would cut interest rate twice in the rest of 2019E and thrice in 2020E. On the other hand, interest rate would stay unchanged if the US reduces the tariff size or rate.

<sup>1</sup> All growth rates are year-on-year except specified otherwise



With the escalating Sino-US tension, alongside with stumbling growth in manufacturing activity and rising credit defaults, we revise down our China's 2019E/20E GDP growth to 6.2%/6.0% from the previous estimates of 6.3%/6.1%. Meanwhile, targeted RRR would be lowered twice in 2H19E and thrice in 2020E given the mild inflationary pressure and cooling economy. We expect PBOC to keep the benchmark interest rates steady in the rest of 2019E and 2020E, although interest rate cut cannot be ruled out if trade relation between US and China spirals down further.

We project Eurozone's GDP growth to slow to 1.2% in 2019E and 1.4% in 2020E from 1.8% in 2018 on weakened trade and domestic demand. According to ECB's monetary meeting in June, we expect interest rate to remain unchanged for the rest of 2019E and 2020E under the weakening economy. The ECB will provide banks with additional low-cost credit to support economic growth. Meanwhile, we expect the UK economy to grow by 1.2% both in 2019E and 2020E, down from 1.4% in 2018 due to a heightening possibility of a disorderly exit from the EU.

We forecast Japan's economic growth to slow from 0.8% in 2018 to 0.7% in 2019E and 0.6% in 2020E due to frail external demand, rising trade protectionism, as well as weaker business fixed investment. The sales tax hike scheduled in Oct 2019 may deter growth. With inflation outlook remaining low and far below the 2% target set by BOJ, we expect the country's ultra-loose monetary stance would persist in 2019 and 2020.

**Exhibit 3: GDP growth forecasts for global major economies (%)**

Real GDP Growth (YoY)	2018	2019E	2020E
U.S.	2.9	2.5	1.9
China	6.6	6.2	6.0
Eurozone	1.8	1.2	1.4
Japan	0.8	0.7	0.6
UK	1.4	1.2	1.2
World	3.0*	2.6*	2.7*

\*Denotes World Bank estimates and forecasts

Source(s): World Bank, Bloomberg, ABCI Securities estimates



# China Economic Outlook

Andy Yao



## 2H19 China Economic Outlook

- Based on the latest data, China's economy has been moderating in 2Q19
- We revise down our China's GDP growth to 6.2% and 6.0% in 2019E and 2020E from the previous estimates of 6.3% and 6.1%, considering the escalating Sino-US tension, stumbling growth in manufacturing activity, and a cooling property market. Nonetheless, a looser fiscal stance and a more accommodative monetary policy should help prevent a sharp economic downturn
- PBOC is expected to maintain a neutral monetary policy with a loosening bias to support growth. Targeted RRR would be slashed twice in 2H19E and thrice in 2020E given the mild inflationary pressure and economic slowdown. We expect PBOC to keep benchmark interest rates steady in the rest of 2019E and 2020E, although a rate cut cannot be ruled out if trade woes between the US and China worsen
- China is expected to adopt a more proactive fiscal policy to support economic growth through tax and fee reductions, infrastructure-boosting schemes, as well as specific pro-consumption measures

### Waning momentum in China

Based on the latest data, China's economy moderated in 2Q19 due to ongoing US-China trade tension, softening manufacturing activity, and deteriorating profitability in industrial sectors. Industrial production, fixed asset investment (FAI), retail sales, and exports in Apr and May were below market expectations, with figures lower than those in 1Q19.

Given low PPI and weak export growth, industrial production rose 5.4%<sup>2</sup> in Apr and 5.0% in May after growing by 6.5% in 1Q19. Electricity output expanded by 3.8% in Apr and 0.2% in May, compared with the 4.2% increase in 1Q19. PMI for manufacturing, which covers 31 industries, retreated to 50.1 in Apr and 49.4 in May from 50.5 in Mar. Profit growth of industrial enterprises entered the declining territory of -3.7% in Apr after gaining 13.9% in March.

Internal demand lost steam, as evidenced by slackened growth in both consumer spending and FAI. Retail sales expanded by 7.2% in Apr and 8.6% in May after rising by 8.3% in 1Q19, mainly attributable to consumption squeezed by a surge in residential home loans and weak car sales consequential of the tax rebate phase-out (Exhibit 1). FAI growth in urban areas also retracted to 5.7% in Apr and 4.4% in May from 6.3% in 1Q19, attributable to the slowdown in manufacturing and infrastructure investment in our view (Exhibit 2).

On the external front, both export and import growth stayed flaccid in Apr and May (Exhibit 3). Export growth was -2.7% in Apr and 1.1% in May in USD terms, slightly lower than 1.4% in 1Q19. Imports remained sluggish in Apr and May, growing by 4.0% and -8.5%, compared with -4.8% in 1Q19.

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<sup>2</sup> All growth rates are year-on-year except specified otherwise



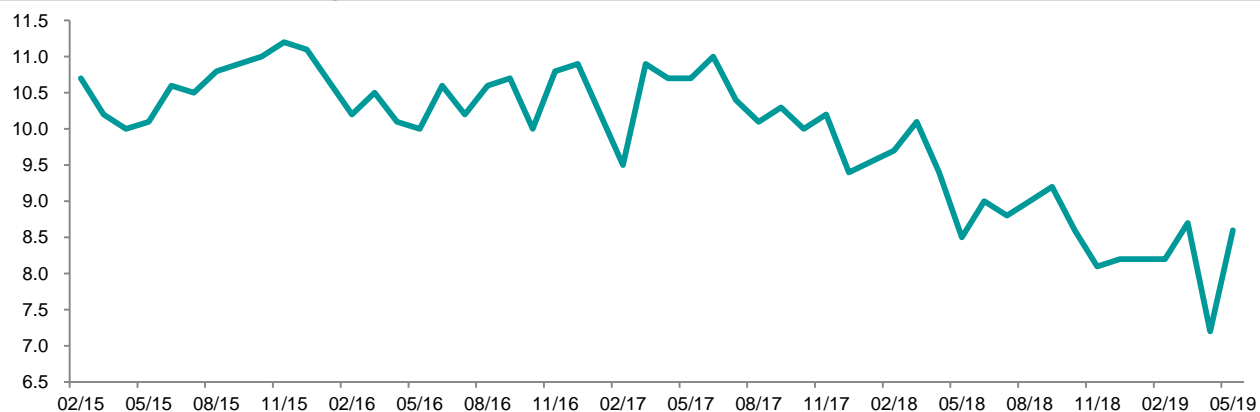


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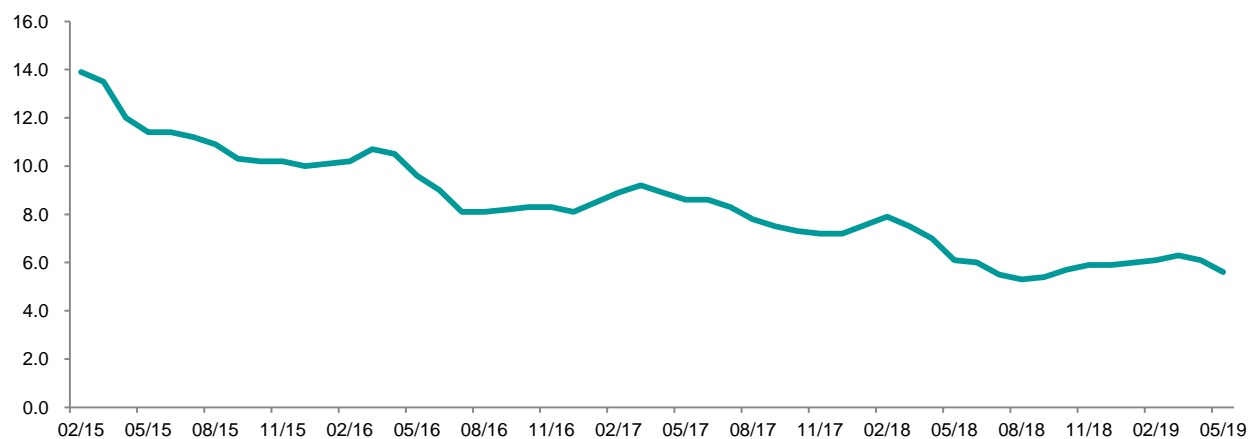
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Exhibit 1: China's retail sales growth



Source(s): NBS, ABCI Securities

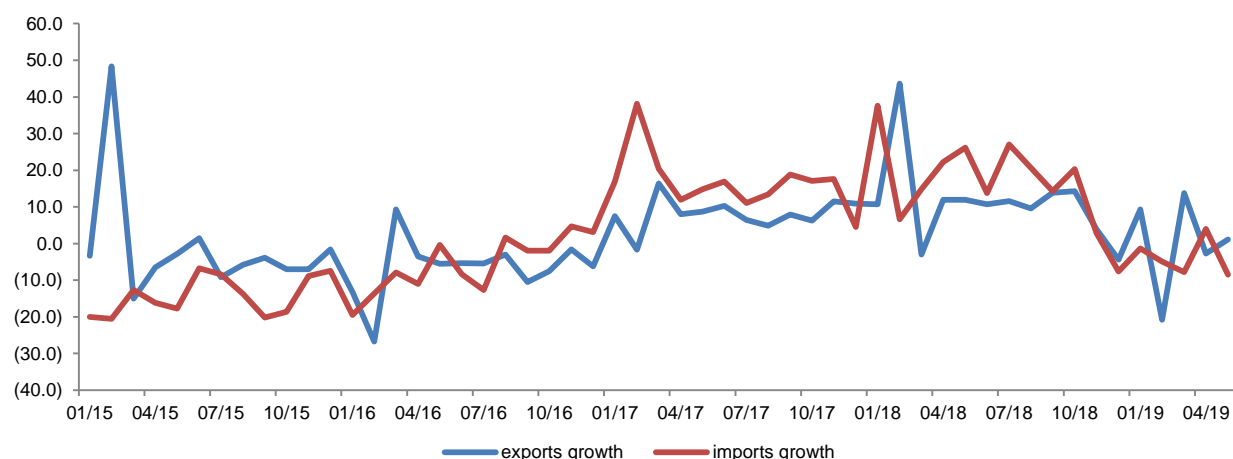
Exhibit 2: China's FAI YTD growth



Source(s): NBS, ABCI Securities



Exhibit 3: China's export and import growth



Source(s): General Administration of Customs, ABCI Securities

Inflation rebounded in Apr and May. CPI rose to 2.5% and 2.7% in Apr and May from 1.8% in 1Q as food prices were up; meanwhile, PPI rebounded to 0.9% in Apr and 0.6% in May, compared with 0.2% in 1Q due to higher prices on some products in the industrial sector.

On the monetary front, PBOC has adopted a neutral monetary policy with a loosening bias since the start of 2019. It slashed targeted RRR in Jan and May to lower financing costs for the real economy, especially for SMEs and private companies. Although the benchmark interest rates set by PBOC have stayed unchanged, yields of the government bonds, which measures market interest rates, trended downwards. Growth in broad money supply (M2) accelerated to 8.5% in May from 8.1% in Dec 2018, while total social financing – a comprehensive measure of all types of financing for the real economy, increased to RMB 10,963bn in 5M19 from RMB 8,584bn during the same period last year.

### Economic growth to moderate slightly in 2H19/2020

Despite strong 1Q19 GDP figures, we believe China's economic growth will moderate in the coming quarters.

First, the Sino-US trade dispute is likely to suppress export growth. The US has already implemented a 25% tariff on about US\$ 250bn of imports from China; it threatens to levy on another US\$ 300bn of Chinese goods. If these taxes are imposed, we estimate China's merchandise exports to the US would be reduced by ~US\$ 137.5bn per year, which accounted for 5.5% of the total exports in 2018. This calculation is based on the assumption that the commodity price elasticity of Chinese exports to the US is neutral with a price elasticity coefficient of 1. Meanwhile, 92% of China's trade surplus in 2018 came from the US – it will be hard to find another country to replace the US as a trade partner in the short term.

Second, PPI inflation is likely to moderate in coming quarters with the low-base effect fading away and commodity prices easing, which would reduce investment return and dampen investment sentiments in the manufacturing sector. Moreover, trade tension with the US and lackluster global growth would exert downward pressure on China's manufacturing output and hamper profit growth in industrial enterprises.

Third, property investment and property sales are likely to slow amid intensified tightening measures, which in turn would curtail home renovation in retail sales growth. In fact, growth in new home sales, as measured in floor space area and value, descended to -5.5% and 0.3% in May, as compared with 1.2% and 14.1% in Apr.



With the escalating trade tension, stumbling growth in manufacturing activity, and a cooling property market, we revise down our China's GDP growth to 6.2% and 6.0% in 2019E and 2020E from the previous estimates of 6.3% and 6.1% (Exhibit:4). However, a looser fiscal stance and a more accommodative monetary policy should help prevent a sharp economic downturn.

On the monetary front, PBOC is expected to maintain a neutral monetary policy with a loosening bias to support growth. PBOC is likely to keep liquidity abundant to support loan growth for private firms and SMEs. Targeted RRR would be slashed twice in 2H19E and thrice in 2020E given the mild inflationary pressure and economic slowdown. We expect PBOC to keep the benchmark interest rates steady in the rest of 2019E and 2020E, although a rate cut should not be ruled out if trade woes between the US and China worsen. Regarding the exchange rate, we expect spot USD/CNY rate to approach 6.8000 at end-2019E and 6.7000 at end-2020E with the potential US interest rate cuts.

The Chinese government is expected to adopt a more proactive fiscal policy to support economic growth through tax and fee reductions, supportive schemes for infrastructure investment, and specific pro-consumption measures. The central government announced on June 10 that proceeds from local government special bonds can be used as equity capital for selected key infrastructure projects. In addition, NDRC announced a pro-consumption package for autos and home appliances on June 6.

**Exhibit 4: Economic forecasts**

Economic indicators	2018	2019E	2020E
Real GDP growth, %	6.6	6.2	6.0
FAI growth, %	5.9	5.4	5.1
Retail Sales growth, %	9.0	8.2	8.0
Export growth in USD terms, %	9.9	2.0	1.0
Import growth in USD terms, %	15.8	3.0	2.0
Industrial Production growth, %	6.2	5.7	5.5
CPI, %	2.1	2.4	2.0
PPI, %	3.5	0.3	0.5
M2 growth, %	8.1	8.5	8.5
New Aggregate Financing, RMB bn	19,260	21,000	23,000
New Yuan Loans, RMB bn	16,170	17,500	19,000
Spot CNY per USD, End-year	6.8785	6.8000	6.7000

Source(s): NBS, PBOC, ABCI Securities estimates



# Investment Strategy

Philip Chan



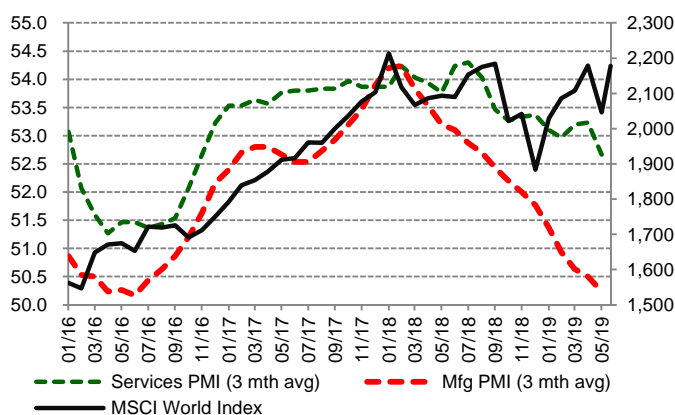


## 2H19 Investment Strategy

### Interest rate cycle to Reverse - Be Prepared

**Rally of stock market on weakening economic fundamentals is mainly driven by liquidity flow and speculations of new fiscal or monetary stimulus measures.** MSCI World Index has rallied by ~15% YTD and S&P GSCI Spot Index by ~13% YTD; in contrast, global manufacturing PMI and services PMI have weakened since early 2018. The rising indices reflect bullish expectations that governments in major developed countries will implement various fiscal or monetary expansion measures to support growth. Risks of corrections in the global equity and commodity markets will heighten in 2H19 and 2020 if the expected fiscal or monetary stimulus measures are postponed or milder than expected.

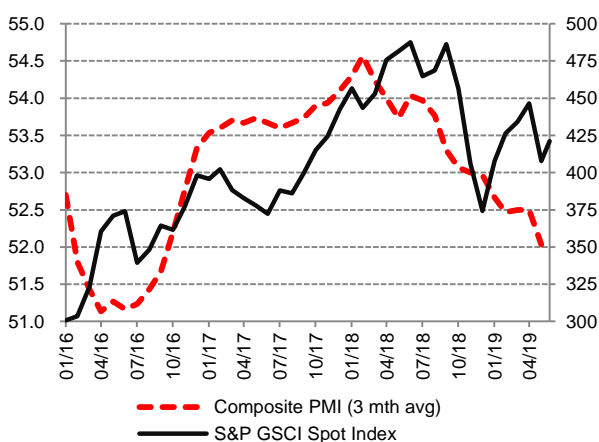
**Exhibit 1: Global Mfg & Services PMI (LHS) vs. MSCI World Index (RHS) - Mfg PMI & services PMI is trending down while MSCI World Index is going up**



Remarks: We apply the 3-mth moving average of PMI to illustrate the trend

Source(s): Bloomberg, IHS Markit

**Exhibit 2: Global Composite PMI (LHS) vs. S&P GSCI Spot Index(RHS) - Composite PMI is trending down but commodity index is not**



Remarks: We apply the 3-mth moving average of PMI to illustrate the trend

Source(s): Bloomberg, IHS Markit

**Boosting the services sector to cushion off slowdown in manufacturing sector could be one of the effective ways to stabilize economic risk.** High statistical correlation of manufacturing PMIs in major industrial nations indicates global manufacturing supply chains are highly integrated. Prolonged Sino-US trade conflict and the mounting trade friction of the US with Europe and Japan will adversely affect manufacturing industry worldwide. On the contrary, global non-manufacturing industries are less correlated. We expect governments of major economies, including China, will strengthen contribution of services industry on economic growth to offset downside risk at the manufacturing front. Outlook of services industry in 2019-20 is more favorable than the manufacturing one. We expect China to encourage investments in tertiary industry such as education, sports & leisure, healthcare, railway and expressway transportation, and more.



**Exhibit 3: PMI correlations of major economies - High correlations in manufacturing industry but low correlations in non-manufacturing industry**

Mfg PMI	US	PRC	Euro	Japan	UK	Non-mfg PMI	US	PRC	Euro	Japan	UK
US	1.00	0.47	0.60	0.74	0.35	US	1.00	0.26	0.25	0.32	0.07
PRC	0.47	1.00	0.77	0.63	0.61	PRC	0.26	1.00	0.52	0.32	0.27
Euro	0.60	0.77	1.00	0.79	0.66	Euro	0.25	0.52	1.00	0.38	0.53
Japan	0.74	0.63	0.79	1.00	0.54	Japan	0.32	0.32	0.38	1.00	0.20
UK	0.35	0.61	0.66	0.54	1.00	UK	0.07	0.27	0.53	0.20	1.00

Remarks: Correlations based on 36-mth data till May 2019

Source(s): Bloomberg, NBS, IHS Markit, Caixin, ABCI Securities

**Exhibit 4: China's PMI correlations - Low correlations between manufacturing and non-manufacturing industries**

		NBS PMI							Caixin PMI	
PMI	Industries	Mfg	Large enterprises	Medium enterprises	Small enterprises	Non-mfg	Services	Construction	Mfg	Services
NBS	Mfg	1.00	0.88	0.70	0.59	0.57	0.49	0.37	0.73	0.09
	Large ent	0.88	1.00	0.34	0.28	0.51	0.46	0.37	0.76	0.09
	Med ent	0.70	0.34	1.00	0.46	0.39	0.37	0.11	0.36	0.03
	Small ent	0.59	0.28	0.46	1.00	0.42	0.26	0.42	0.35	0.10
	Non-mfg	0.57	0.51	0.39	0.42	1.00	0.86	0.49	0.42	0.16
	Services	0.49	0.46	0.37	0.26	0.86	1.00	0.09	0.38	0.13
	Construction	0.37	0.37	0.11	0.42	0.49	0.09	1.00	0.33	0.17
Caixin	Mfg	0.73	0.76	0.36	0.35	0.42	0.38	0.33	1.00	0.30
	Services	0.09	0.09	0.03	0.10	0.16	0.13	0.17	0.30	1.00

Remarks: Correlations based on PMI data from Jan 2014 to May 2019

Source(s): Bloomberg, NBS, IHS Markit, Caixin, ABCI Securities

**Exhibit 5: China's FAI in tertiary industry, (YoY) - Tracking capital flow to identify sectors that may outperform**

	2018	5M2019
<b>Secondary industry</b>	<b>6.2%</b>	<b>3.2%</b>
Pharma manufacturing	4.0%	8.1%
<b>Tertiary industry</b>	<b>5.5%</b>	<b>7.1%</b>
Road transportation	8.2%	6.2%
Railway transportation	(5.1%)	15.1%
Cultural, sport & leisure	21.2%	20.0%
Education	7.2%	15.4%
Health & social work	8.4%	5.2%

Source(s): NBS

**Growth gap between China and the US/Eurozone will widen, motivating global fund to increase asset allocation to China.** The China-US GDP growth gap narrowed from 5.4ppt in 2Q16 to 3.2ppt in 1Q19. The narrowing growth difference over the last 11 quarters has weakened the attractiveness of the Chinese market from the US investor's perspective. We expect the China-US GDP growth gap to rebound to over 4.0ppt in 4Q19 as the Fed expects GDP growth to slow to 2.1% in 4Q19; meanwhile, the World Bank predicts China-US growth gap will expand from 3.7ppt in 2019 to 4.4ppt in 2020. China-Eurozone growth gap has widened from 3.9ppt in 4Q17 to 5.2ppt in 1Q19 due to weakening economic growth in the Eurozone, enhancing the appeal of the Chinese market to Eurozone investors. World Bank predicts the China-Eurozone growth gap to be 5.0ppt in 2019 and 4.7ppt in 2020.



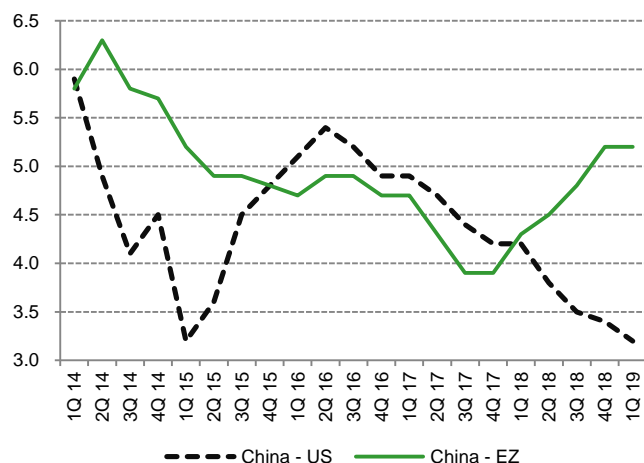


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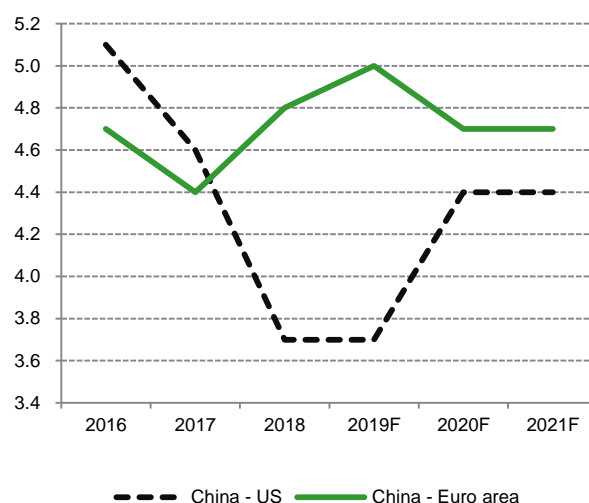
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**Exhibit 6: China's quarterly real GDP growth relative to the US's and Eurozone's (ppt): China-US GDP growth gap is narrowing while China-Eurozone GDP growth gap is widening**



Source(s): Bloomberg, NBS

**Exhibit 7: China's quarterly real GDP growth relative to the US's and Eurozone's (ppt): Narrowing trend in China-US GDP growth gap halts in 2019 and is expected to reverse in 2020**



Source(s): NBS, World Bank

**A new round of monetary easing in sight.** Due to weakened economic impetus, monetary policies in the US and Eurozone are expected to loosen in 2H19 or 2020. The Fed has dialed down its pace of balance sheet reduction since May and will halt such downsizing in Sep 2019. At the same time, ECB has planned to launch a new series of targeted longer-term refinancing operations (TLTRO III) from Sep 2019 to Mar 2021. Liquidity supply in the US and Eurozone will begin to increase in 4Q19, and positive effects on the capital market will be apparent in 2020-21. In Asia, Japan will increase sales tax from 8% to 10% in Oct 2019, but further monetary stimulus policy is expected in 2020 to offset some of the resultant negative impacts; meanwhile, China will maintain its money supply growth in line with nominal GDP growth.

**Exhibit 8: Change of total assets in major central banks - Global economies suffer from downsizing or slowing growth of balance sheets by major central banks in 2018 and 1H19**

Central bank	End 2017 (YoY)	End 2018(YoY)	May 2019 (YTD)
PBOC	5.6%	2.6%	(3.6%)
Federal Reserve	(0.1%)	(8.4%)	(5.7%)
ECB	22.1%	4.4%	0.4%
BOJ	9.4%	5.9%	2.7%

Source(s): Bloomberg, PBOC, the Fed, ECB, BOJ, ABCI Securities

**The downtrend in global interest rate cycle will begin in 2H19.** We believe declining inflation risk is one of the prerequisite conditions for a downward interest rate cycle to take place. Core inflation rates in China, the US, and Eurozone went down in 5M19, which will provide room for major central banks to lower nominal interest rates in 2H19. In June, the Fed indicated current fed fund rates are in line with the longer-run target rate of 2.5%, which implies that the interest rate cycle has peaked and will soon enter the downward cycle. The upcoming TLTRO III in Eurozone will reduce upside risk of interest rates in the region. In China, the 2019 Government Work Report also hinted at lowering real interest rate to support economic growth. Therefore, any internal or external political policy errors (such as global supply chain interruption, escalation of import tariffs, etc.) that leads to sharp rebound in core inflation rates in 2H19 or



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2020 can significantly reduce the central banks' ability to lower nominal interest rates. Non-financial corporates in the US have aggressively leveraged up since 2014. Net debt/EBITDA ratio of non-financial corporates in S&P 500 Index increased to 1.9x in May 2019 from 1.6x in Dec 2018 and 1.5x in Dec 2017. Since expected slowdown of economic growth in the country in 2019-20 will elevate financial risks, these corporates would much prefer an earlier and larger reduction in lending interest rates.

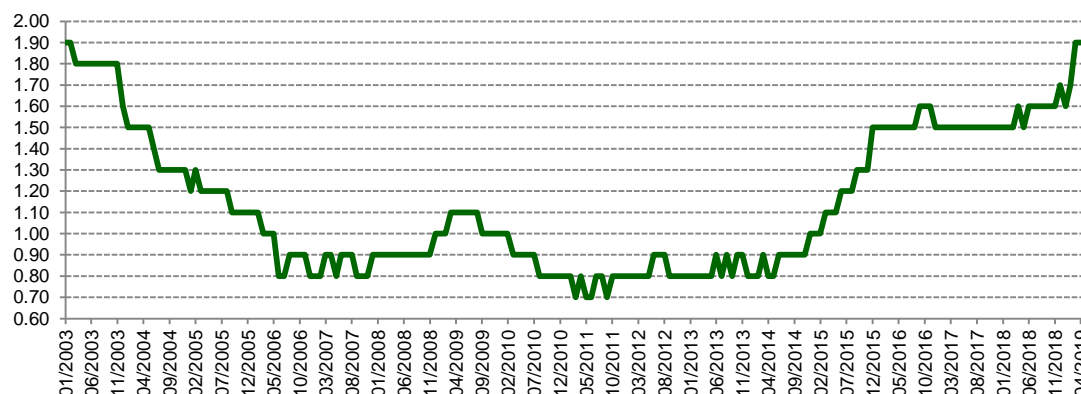
**Exhibit 9: Core inflation rate (excluding fuel and food), (%YoY) - Falling core inflation rate provides a more favorable condition for central banks to loosen monetary policies**

	6/2018	12/2018	5/2019
China	1.9	1.8	1.6
US	1.95	1.95	1.57*
Eurozone	1.0	0.9	0.8

\*Apr 2019 data

Source(s): Bloomberg, NBS, Bureau of Economic Analysis, Eurostat

**Exhibit 10: Net Debt to EBITDA Ratio of S&P 500 Index Non-financial companies- Current financial risk of the US corporates is higher than the crisis in 2007-08, driving them to lobby the US government or regulatory bodies to lower lending interest rates. Expected slowdown in US economy in 2019-20 could be a catalyst of another financial crisis**

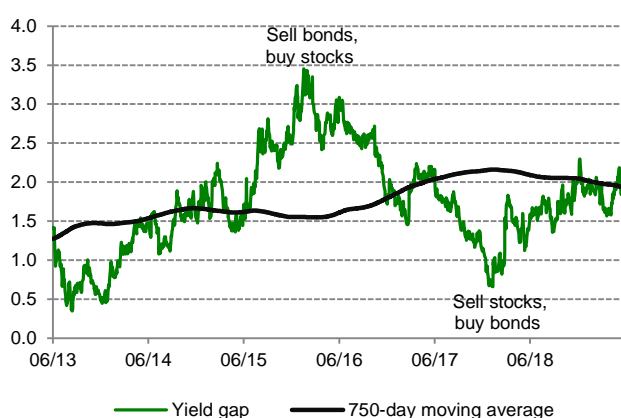


Source(s): Bloomberg, S&P 500 Ex-financial Index

## Hong Kong Stock Market Outlook

**Relative valuation:** Yield investors should consider accumulating blue chips if the yield gap (HSI dividend yield minus Hong Kong government bond yield) exceeds 2.5ppt. Currently, the yield gap is ~1.8ppt, in line with the 750-day yield gap average. Est. 2019 P/E of the index is at 32% discount to 2019E P/E of DJIA Index. The lower valuation of HSI is a result of weakened EPS growth. Market expects EPS of HSI to decline by ~2% YoY in 2019E; on the other hand, EPS of DJIA Index is estimated to grow by ~3% YoY. The low profit growth of blue chips in 2019E will encourage investors to reduce holding of risky assets.

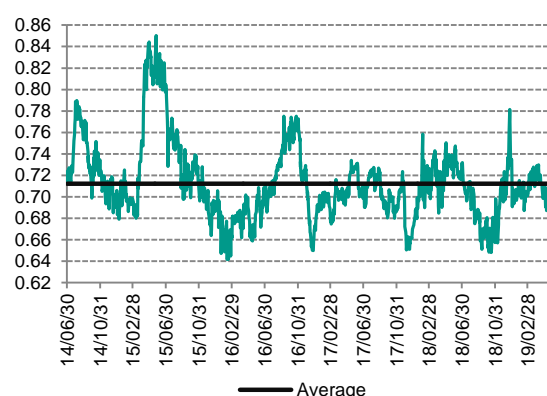
**Exhibit 11: HSI dividend yield minus 10-yr Hong Kong gov't bond yield, (%) - Current yield gap not wide enough to lure yield investors to substantially increase holding of blue chips**



750-day avg: 1.817%

Source(s): Bloomberg, ABCI Securities

**Exhibit 12: HSI est. P/E / DJIA Index est. P/E - The deeper the discount, the lower the relative valuation of Hong Kong blue chips against the US blue chips**

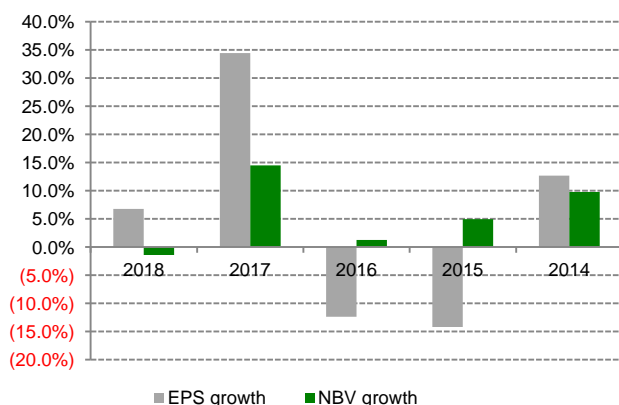


5-yr avg: 0.712

Source(s): Bloomberg, ABCI Securities

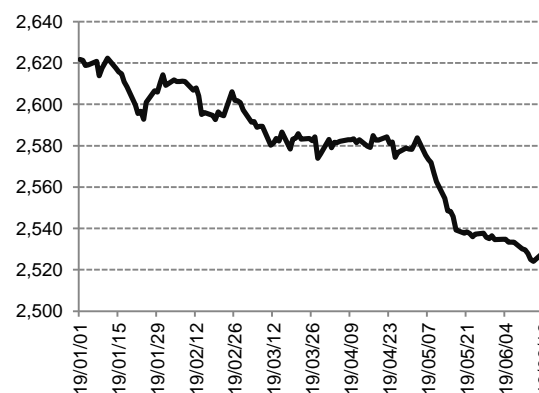
**Earnings Outlook:** Market is revising down the earnings outlook of blue chips in HSI, DJIA Index and Euro Stoxx 50 Index. Downward revisions of earnings outlook for 2019 indicate capital market believes the expected negative factors would persist for an extended period.

**Exhibit 13: HSI EPS and NBV, (%YoY) - Opposite changes in EPS and NBV increased investment risk for value-driven investors**



Source(s): Bloomberg, ABCI Securities

**Exhibit 14: HSI consensus 2019E EPS (HK\$) - Market keeps revising down earnings outlook of HK's blue chips**



Source(s): Bloomberg, ABCI Securities



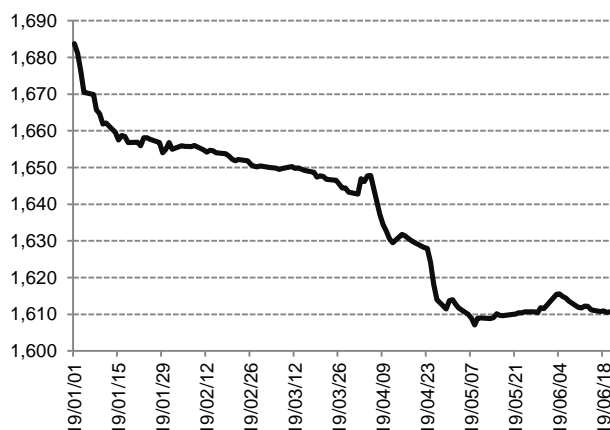


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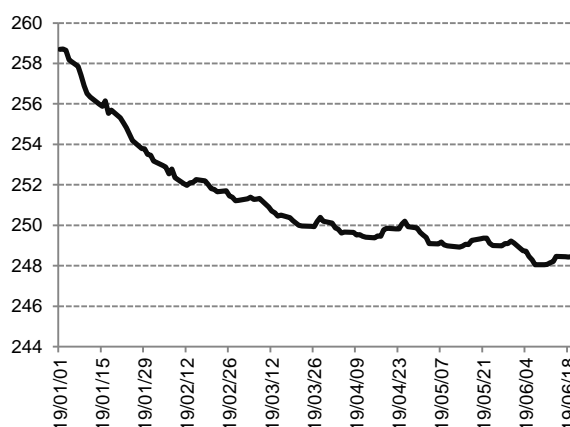
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**Exhibit 15: US DJIA Index consensus 2019E EPS (US\$)**  
Market keeps revising down earnings outlook of US blue chips



Source(s): Bloomberg, ABCI Securities

**Exhibit 16: Euro Stoxx 50 Index consensus 2019 EPS (Euro)** - Market keeps revising down earnings outlook of Eurozone's blue chips



Source(s): Bloomberg, ABCI Securities

### Hang Seng Index (HSI)

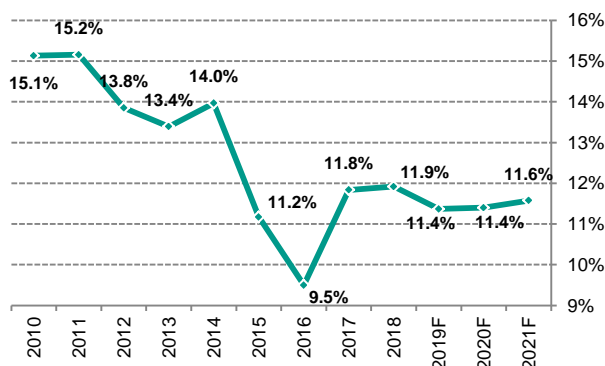
In 1H19, HSI was traded at 24,896.87-30,280.12, which was within our 2019 forecast at 24,488-31,637 (please refer to 2019 Economic Outlook and Investment Strategy Report published in Dec 2018). We assume stagflation risk (i.e. low economic growth but high inflation) would be minimal and major central banks would be able to fine-tune their monetary policies to cushion off downside risk in 2H19-2020. In view of the latest earnings outlook of blue chips and projected return rate of average equity in coming years, we set the high end of HSI at 12.0x 2019E EPS and the low end of the index at 1.0-1.05x 2019E net book value. We adjust our HSI trading range forecast for 2H19 to 24,259-30,411. Our 2020E forecast for HSI was 24,839-32,788. Major downside would be the surge in stagflation risk caused by policy errors and supply interruption (e.g. trade discord, oil crisis, etc.). Conversely, major upside risk may arise from monetary expansion policies that are more potent or enforced earlier than expected by major central banks, which could result in an oversupply of liquidity.

**Exhibit 17: HSI projections for 2H19E-2020E**

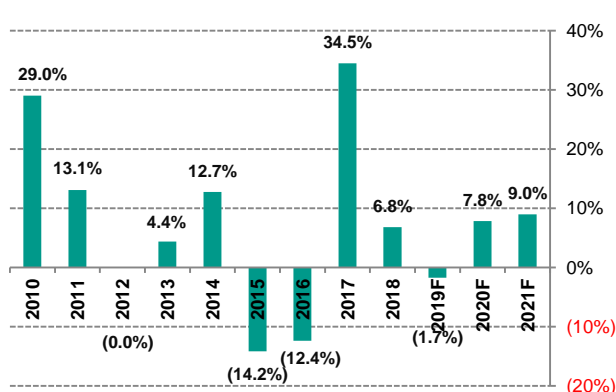
Period: 2H 2019	High	Low	Year end
Index	30,411	24,259	29,144
Implied 2019 P/E (x)	12.00	9.57	11.50
Implied 2019 P/B (x)	1.32	1.05	1.26
Implied 2019 yield	3.41%	4.28%	3.56%
Period: 2020	High	Low	Year end
Index	32,788	24,839	30,056
Implied 2020 P/E (x)	12.00	9.09	11.00
Implied 2020 P/B (x)	1.32	1.00	1.21
Implied 2020 yield	3.37%	4.45%	3.68%

Sources: Bloomberg, ABCI Securities

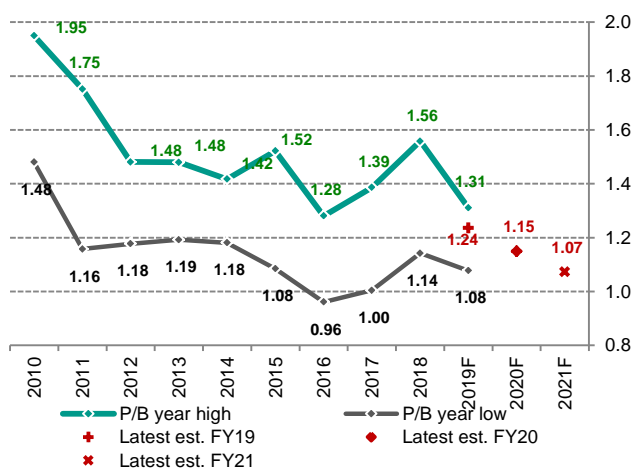
## Hong Kong Stock Market

**Exhibit 18: HSI ROAE**


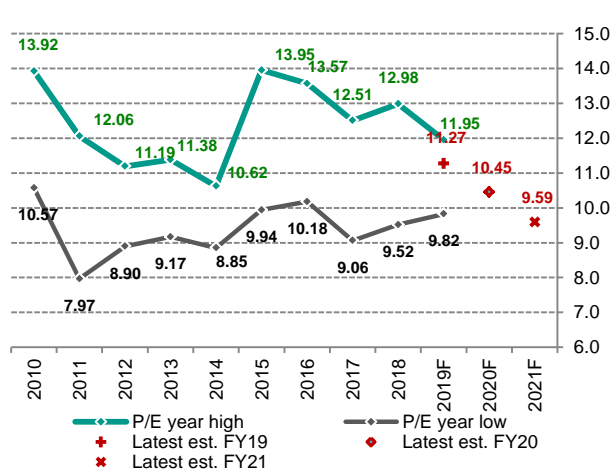
Source(s): Bloomberg

**Exhibit 19: HSI EPS Growth**


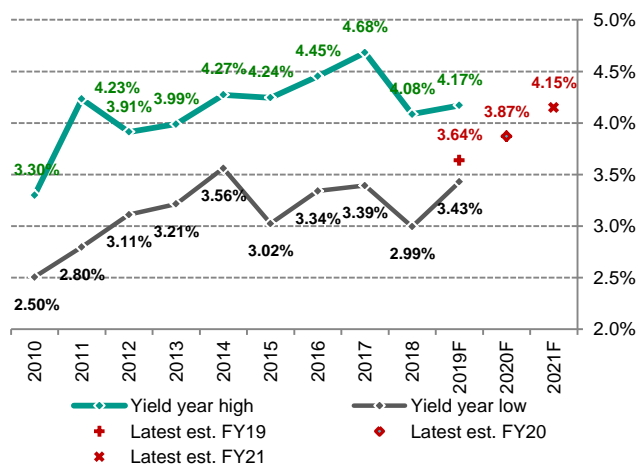
Source(s): Bloomberg

**Exhibit 20: HSI P/B band (x)**


Index at 28550. Source(s): Bloomberg

**Exhibit 21: HSI P/E band(x)**


Index at 28550. Source(s): Bloomberg

**Exhibit 22: HSI Dividend yield**


Index at 28550. Source(s): Bloomberg



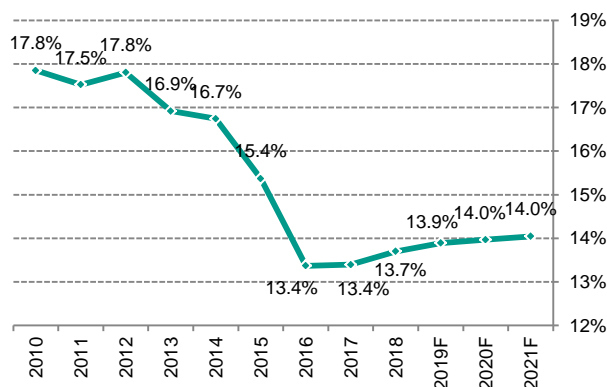
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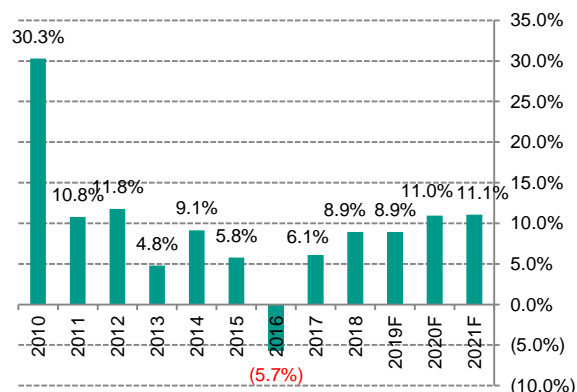
## China Stock Market

Exhibit 23: SSE50 Index ROAE



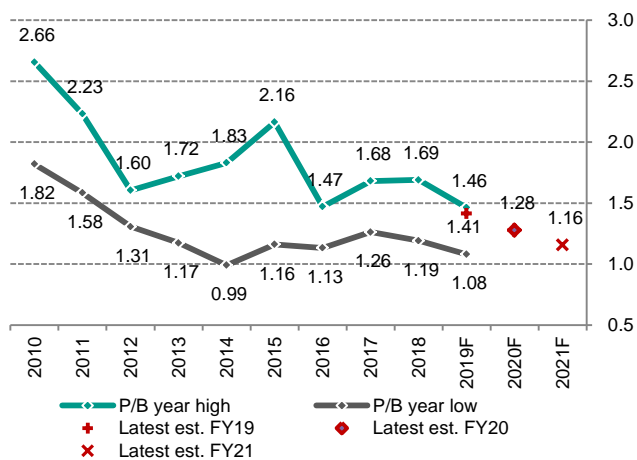
Source(s): Bloomberg

Exhibit 24: SSE50 Index EPS Growth



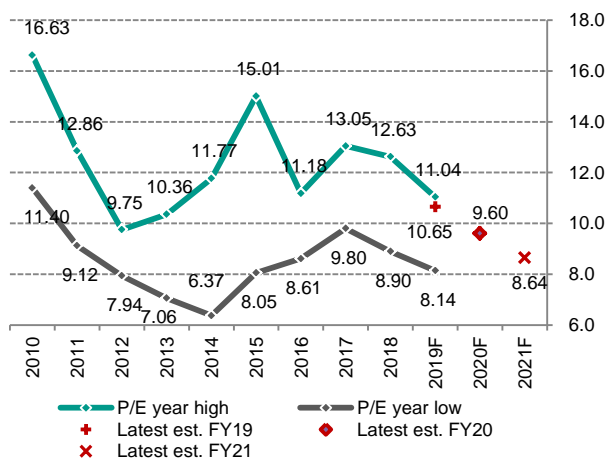
Source(s): Bloomberg

Exhibit 25: SSE50 Index P/B band (x)



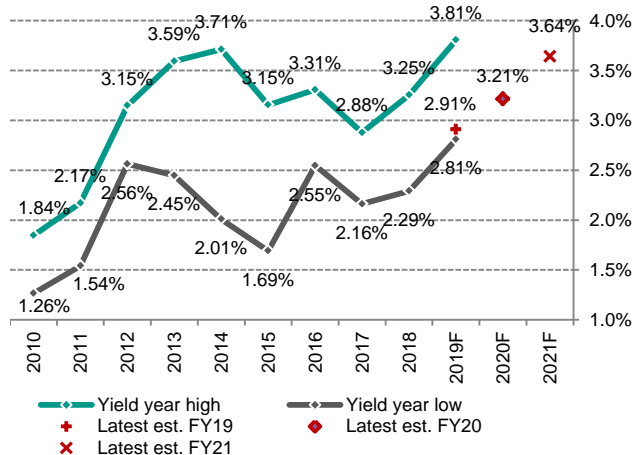
Index at 2943. Source(s): Bloomberg

Exhibit 26: SSE50 Index P/E band (x)



Index at 2943. Source(s): Bloomberg

Exhibit 27: SSE50 Index Dividend yield



Index at 2943. Source(s): Bloomberg





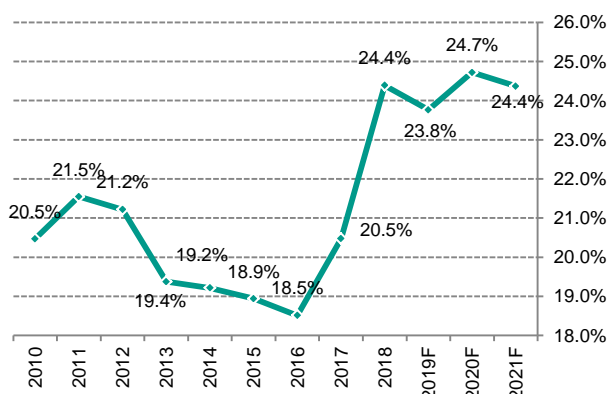
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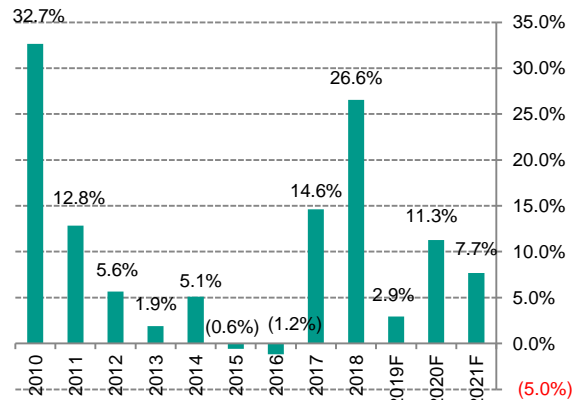
## US Stock Market

Exhibit 28: DJIA Index ROAE



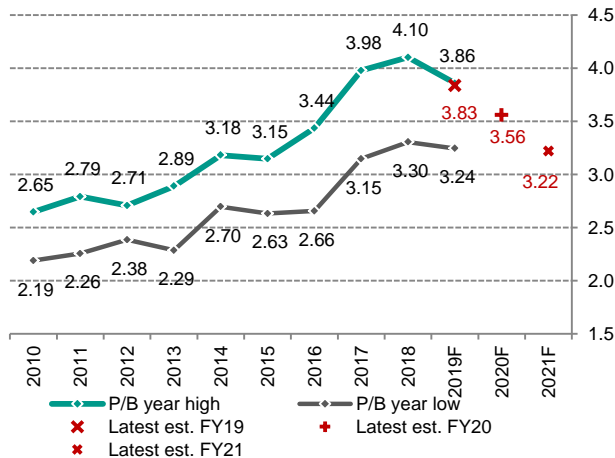
Source(s): Bloomberg

Exhibit 29: DJIA Index EPS Growth



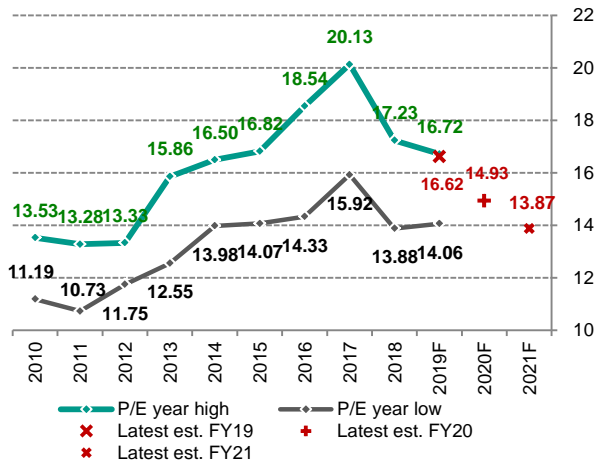
Source(s): Bloomberg

Exhibit 30: DJIA Index P/B band (x)



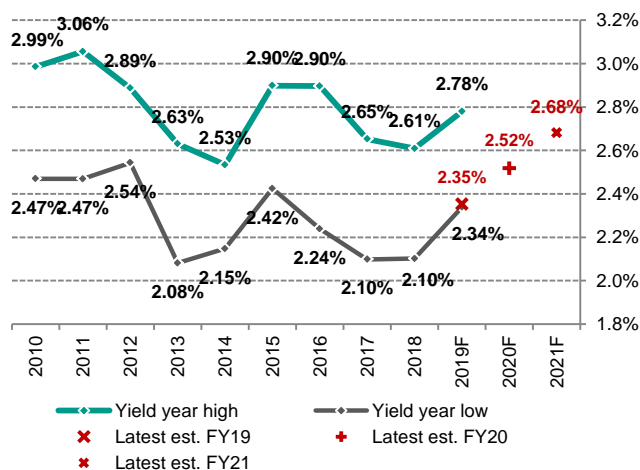
Index at 26753. Source(s): Bloomberg

Exhibit 31: DJIA Index P/E band (x)



Index at 26753. Source(s): Bloomberg

Exhibit 32: DJIA Index Dividend yield



Index at 26753. Source(s): Bloomberg

## Hong Kong IPO Market

### Financials regained top position

- In 5M19, Hong Kong IPO market has raised US\$ 5.6bn with an average deal size of US\$105mn. The Chinese investment banks accounted for seven of the top 10 underwriters by volume
- In terms of industry mix, the top four industries are financials, healthcare, consumer discretionary, and energy, accounting for 40%, 16%, 15%, and 9% of IPO volume, respectively, in 5M19
- With the lack of large technology IPO in 5M19, financials stock has regained its top position in the IPO market, accounting for 40% of total IPO volume

In 5M19, total volume of Hong Kong equity IPO amounted to US\$ 5.6bn. A total of 53 IPOs were issued in 5M19, with an average issue size of US\$ 105mn each. In terms of underwriting volume, seven out of the top 10 underwriters were Chinese investment banks in 5M19.

With the lack of large-scale technology IPO in 5M19, financials stocks reclaimed its top position in the IPO market, accounting for 40% of the total IPO volume. This is followed by healthcare (16%), consumer discretionary (15%), and energy (9%). Overall, the four industries jointly contributed to 80% of total IPO volume.

Technology stocks, which accounted for 21% of IPO volume in 2018, only took up 2% of total IPO volume in 5M19. This is due to lack of sizeable technology/new-economy IPO after Xiaomi (1810 HK) and Meituan (3690 HK). The share of technology IPO, however, may increase in coming months should Alibaba seek for dual-listing in Hong Kong.

**Exhibit 1: 5M19 Hong Kong IPO Overview**

Industry	Volume (US\$ mn)	Avg deal size (US\$ mn)
Financials	2,218	246
Health Care	899	225
Consumer Discretionary	830	52
Energy	489	163
Telecom	482	96
Others	649	41

Source(s): Bloomberg, ABCI Securities



# Sector Outlook

ABCI Analysts



## OVERWEIGHT

### China Banks Sector –Stable outlook, with diverging fundamentals Johannes Au

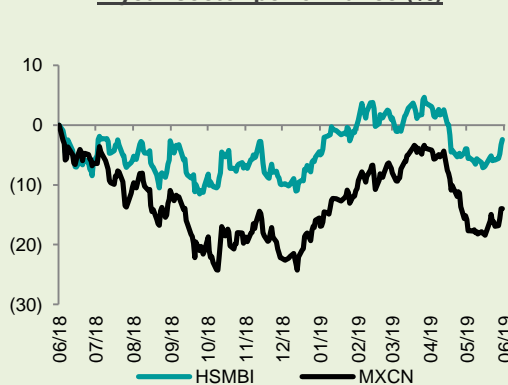
Key Data		Sector Performance (relative to MXCN)	Absolute (%)	Relative (%)
Avg. 19E P/E (x)	4.74	1-mth	2.38	0.43
Avg. 19E P/B(x)	0.60	3-mth	(3.91)	4.14
Avg. 19E div yield (%)	5.03	6-mth	(8.27)	(2.00)
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities		
<ul style="list-style-type: none"><li>➤ Banks' NIM would be defended by solid loan demand, improved liquidity, and stable lending yield</li><li>➤ Large provisions would persist to strengthen risk buffers</li><li>➤ Increased use of alternative capital tools to support balance sheet growth</li><li>➤ Prefer big banks for defensiveness and promising dividend yield</li></ul>				

1-year sector performance (%)

Month	HSMBI (%)	MXCN (%)
06/18	0	0
07/18	-5	-5
08/18	-10	-10
09/18	-5	-15
10/18	-10	-25
11/18	-5	-20
12/18	-10	-25
01/19	-5	-15
02/19	0	-10
03/19	5	-5
04/19	0	-5
05/19	0	-20
06/19	0	-20

Source(s):Bloomberg, ABCI Securities

1-year sector performance (%)



Source(s):Bloomberg, ABCI Securities

**NIM defended by solid loan demand and stable lending yield.** Clear government policies supporting MSE and private enterprise lending and reducing social financing cost have extended to recent quarters. In particular, explicit targets have been set for the Big 5 Banks (ICBC [1398 HK], CCB [939 HK], ABC [1288 HK], BOC [3988 HK] and BoCom [3328 HK]) to increase their MSE loan balance by 30% and reduce average lending yield of MSEs by 1ppt in 2019. This would increase the proportion of MSE loans in the banks' loan mix and consequently, the higher lending yield would support NIM. While a lower market interest rate may affect income, improved liquidity in the banking system should help offset some of the impacts by aiding loan growth. The two RRR cuts announced in early 2019 have improved liquidity outlook, as reflected by the downtrend in SHIBOR; meanwhile, solid loan growth was evident in 5M19, with new loan aggregating to 45.8% of our full-year loan target of RMB 17.5tr. We expect two more targeted RRR cuts to take place in 2019E to release liquidity for MSEs and private enterprises. According to PBOC, average loan yield rebounded mildly by 5bps QoQ to 5.69% in Mar 2019. The proportion of loans priced above benchmark rates also rebounded by 2.62ppt QoQ to 68.88% in Mar 2019. According to CBIRC data, system NIM in 1Q19 was down 1bp QoQ to 2.17%, while system net profit grew 9.4% YoY for the period. While we expect a mild decrease in market interest rate, robust loan demand would partially offset the pressure on NIM. We forecast system NIM to be stable over 2019E-20E; by category, JSBs and district banks may have a higher NIM upside given their clientele strength in MSEs and private enterprises.

**Lower NPL ratio; higher risk buffer indicators.** System NPL ratio gradually fell from 1.87% in 3Q18 to 1.8% in 1Q19 on increased NPL handling. By category, average NPL ratio of the big banks reduced the most by 9bps QoQ to 1.32% in 1Q19, while JSBs stayed flat QoQ at 1.71%. Average NPL ratio of city commercial banks and rural commercial banks increased by 9bps QoQ each to 1.88% and 4.05% as of Mar 2019. We expect overall asset quality would stay benign, with system NPL ratio remaining stable or edging down in 2Q19-4Q19, under the assumption that no unforeseeable global factors resulting in pervasive damage to China's macro outlook would occur. Nonetheless, banks are dedicated to strengthen their risk buffer towards potential economic downturn – system provisioning ratio and provision coverage ratio improved to 3.45% and 192.17% as of Mar 2019, up 4bps and 5.86ppt QoQ. For the big banks and JSBs, their average provisioning ratios increased by 7bps and 8bps QoQ in 1Q19, while average provision coverage ratio rose 20.36ppt and 4.77ppt QoQ. We estimate the two risk buffer indicators would continue to improve over 2Q19-4Q20 on large provisions.

**Balance sheet growth induces higher capital need.** Continuous balance sheet growth has been a primary reason driving up capital need. According to CBIRC, total assets and total liabilities growth of commercial banks accelerated to 9.2% and 8.9% YoY in Apr 2019 from 6.8% and 6.4% YoY in Dec 2018. System average CT1 and CAR, therefore, decreased 8bps and 2bps QoQ to 10.95% and 14.18% as of Mar 2019, among which city commercial banks recorded the greatest balance sheet growth – total assets and total liabilities grew by 12.1% and 12.0% YoY in Apr 2019. For big banks and rural commercial banks, both total assets and total liabilities growth were in the range of 8.0%-8.6%; JSBs showed the slowest growth of 6.2% for total assets and 5.7% for total liabilities. Obtaining capital from the equity market has been harder in recent years given the increased no. of listed banks in both A-share and H-share markets. Although most banks have maintained a sufficient CAR as required by the capital rule, we expect more alternative capital tools, such as the issuance of preference shares and perpetual bonds, will be utilized in coming quarters by banks to improve capital position amid balance sheet growth.

### Long-term Outlook

Policy risk remains to be the largest overhang in the China Banks sector. We believe a highly regulated and disciplined business environment is essential to strengthen industry fundamentals. Meanwhile, we are cautious against long-term impacts of prolonged Sino-US dispute.

### Short-term Outlook

Although we believe the enforcement of new policies in the sector is beneficial in the long run, uncertain timing and details of the implementation would weigh on the sector in the near term due to reduced risk appetite. This is especially true for smaller banks less defensive to policy risk. In contrast, promising dividend yield of big banks may draw interest from yield investors.

### Stock Recommendations

We reiterate our **OVERWEIGHT** rating for the China banks sector on undemanding valuation and stable improvement in fundamentals. Big banks, with promising dividend yield and high degree of business diversification, have repeatedly demonstrated defensiveness against policy risks and high adaptability to macro changes. Regarding valuation, the average P/Bs of the Big 5 Banks are slightly below their historical mean. Our sector top picks are **ABC (1288 HK)** for its outstanding risk buffer and solid fundamental improvements; the bank is also the major beneficiary of policies supporting inclusive finance and Sannong. We like **CCB (939 HK)** for its persistence in prudent practices and high degree of business diversification. Among the JSBs, we are positive on **CMB (3968 HK)** for its above-peer growth and high profitability, but its high valuation at present indicates limited upside potential.

District banks, with a smaller balance sheet, are more sensitive to impacts of macro and policy compared to banks in other categories despite higher operational flexibility. Since regulators have paced down approval for A-share bank IPOs, district banks, with relatively fast growth and high capital needs, would need to explore alternative capital sources. Also, investors should remain cautious against their low trading liquidity.

### Risk Factors

1) Radical change in business environment induced by heavy-handed supervision and policies; 2) Increasing competition from non-bank financial institutions; 3) Sharp deterioration in asset quality in specific regions; 4) Sharp decline in loan demand; 5) Policy risk in new and fast-growing businesses.

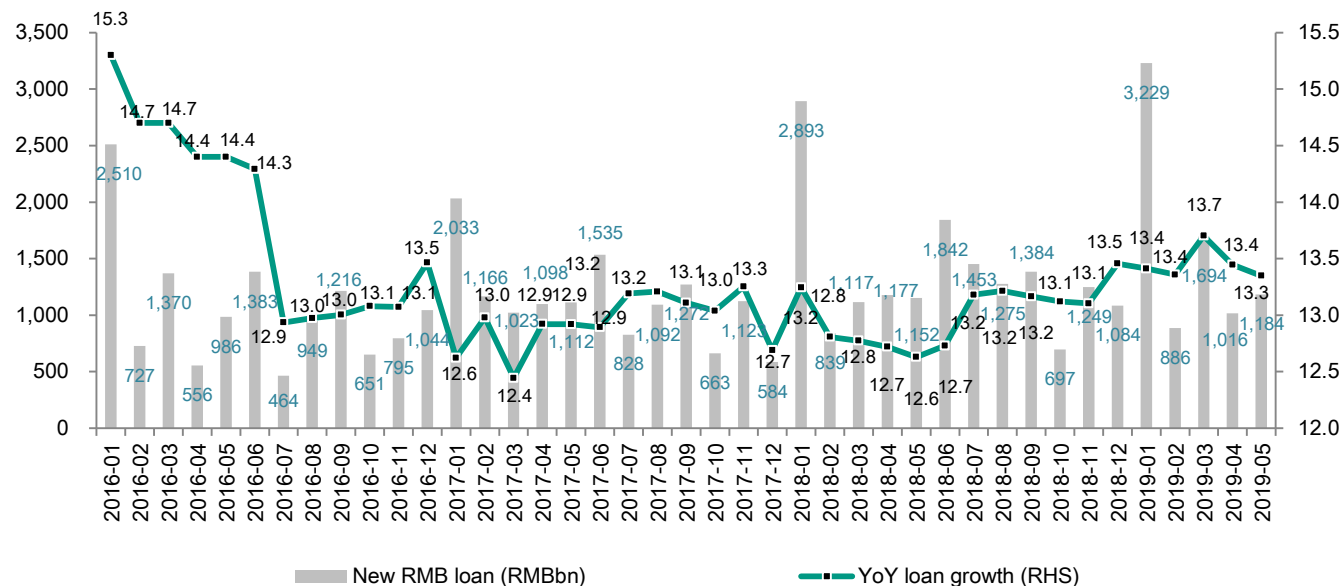


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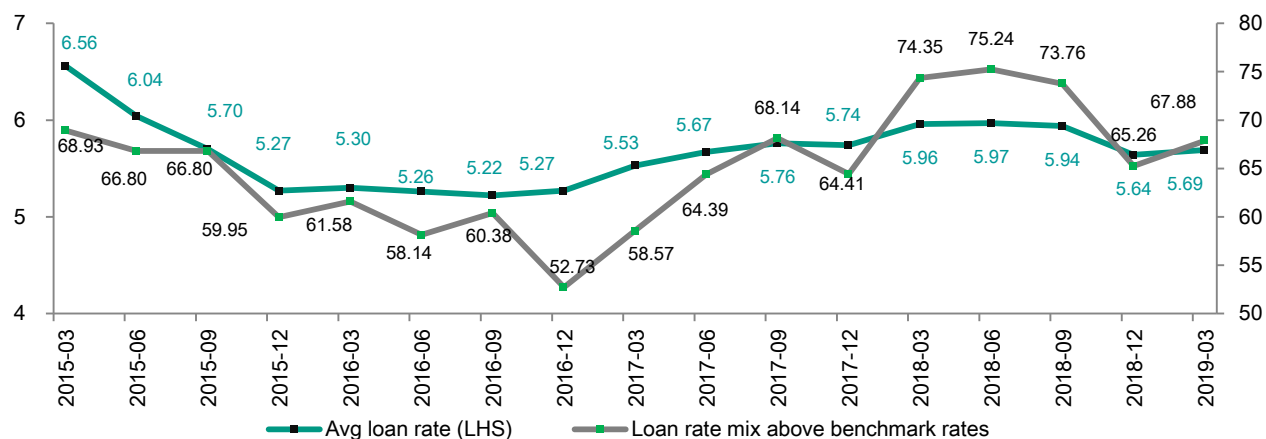
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Exhibit 1: Monthly new loans (RMB bn) and YoY growth (%)



Source(s): PBOC, ABCI Securities

Exhibit 2: Average loan yield vs. proportion of loans with above-benchmark rates (%)



Source(s): PBOC, ABCI Securities



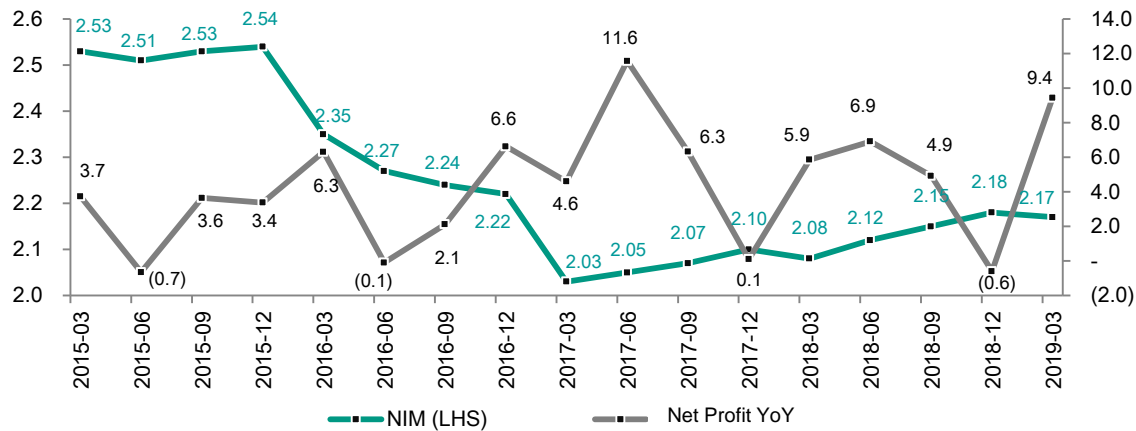


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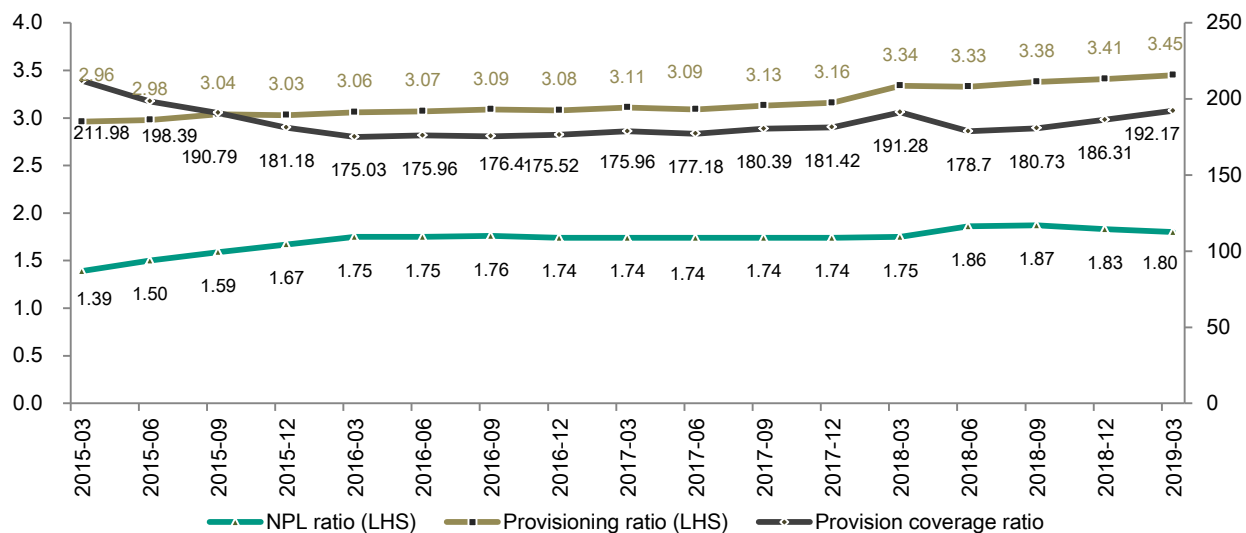
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Exhibit 3: System NIM and system net profit YoY (%)



Source(s): CBIRC, ABCI Securities

Exhibit 4: Key asset quality indicators (%)



Source(s): CBIRC, ABCI Securities



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Exhibit 5: Valuation of sector top picks (Data as of June 21, 2019)

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
ABC	1288 HK	BUY	5.28	60.98	4.36	3.89	0.60	0.54	6.95	7.65
CCB	939 HK	BUY	9.48	44.29	5.10	4.54	0.69	0.63	5.90	6.59

Source(s): Bloomberg, ABCI Securities estimates



## NEUTRAL

### China Securities & Brokerage Sector –Sector fundamentals are solid

Steve Chow

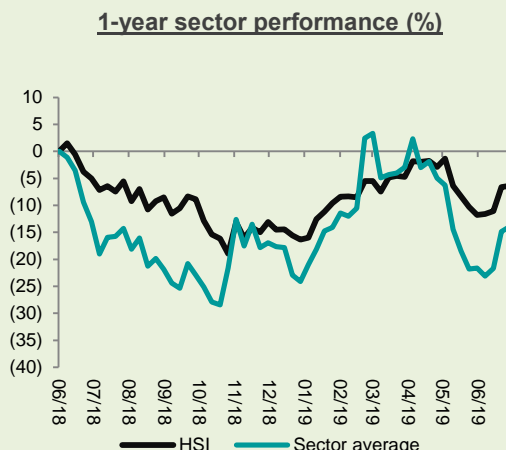
Key Data		Sector Performance (relative to HSI)		
			Absolute (%)	Relative (%)
Avg. 19E P/E (x)	10.1	1-mth	5.5	(1.9)
Avg. 19E P/B(x)	0.7	3-mth	(16.9)	(13.2)
Avg. 19E div yield (%)	3.5	6-mth	20.8	5.6
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities		
<div>➤ Market sentiment might start to moderate in the near term amid ongoing dispute between US and China</div> <div>➤ We believe the market fundamentals are healthy and policy environment remains supportive</div> <div>➤ We like <b>CSC (6066 HK)</b> and <b>SWHY (6806 HK)</b> for their high ROAE in recent years</div>				

### 1-year sector performance (%)

Date	HSI (%)	Sector average (%)
06/18	0	0
07/18	-10	-20
08/18	-5	-15
09/18	-10	-25
10/18	-15	-30
11/18	-10	-15
12/18	-15	-20
01/19	-10	-25
02/19	-5	-15
03/19	0	-5
04/19	-5	-10
05/19	-10	-25
06/19	-5	-15

Legend: HSI (black line), Sector average (teal line)

Source(s):Bloomberg, ABCI Securities



**Momentum to moderate amid trade discord.** Overall, A-share monthly ADT has improved significantly from RMB 266bn in Dec 2018 to RMB 898bn in Apr 2019. Margin financing and securities lending (MFSL) balance increased from ~RMB 0.76tr at end-2018 to ~RMB 0.97tr at end-Apr 2019. Market momentum, however, has moderated since May 2019 amid ongoing Sino-US trade dispute, with monthly ADT retracting to RMB 496bn and MFSL balance falling to RMB 0.94trn at end-May.

**Overall market condition is healthy.** Despite the near-term uncertainties, we believe the market fundamentals are healthy. E.g., A-share total market cap/M1 ratio is at 0.8x at present, in line with the historical average of 0.8x, significantly lower than the peak level of 1.3x during the bull market in 2015. In addition, MFSL balance currently accounts for 2.4% of total A-share market cap, significantly lower than the 5% peak in 2015, indicating a reasonable leverage level in A-share market.

**Policy support.** Government policy remains supportive for the industry. E.g., the introduction of “technology innovation board” would bode well for brokers’ investment banking business. To mitigate pledge share risk, a total of 28 Chinese brokerages have committed RMB 41bn to an asset management scheme to support listed firms. In addition, the government has launched measures to encourage listed companies to buy back shares.

**Undemanding valuation.** Major H-listed securities companies are currently trading at an average 0.8x 2019E P/B, still significantly below the level (> 2x) during the last bull market in 2015 and the 1.2x historical average. In our view, sector valuation is undemanding.

**Commitment on industry reform.** We believe the Chinese government is committed to industry reform over the long run. China will increase the contribution of direct financing in the economy through the development of a diverse, multi-layered capital market while promoting product innovations such as high-yield bonds, hybrid financing, and more. In our view, such developments will be supportive to the investment banking business. Overall, direct financing only accounted for 15% of the aggregate financing in the economy in 2018 vs. 50% in US (2015), implying ample room for growth.



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## Sector Outlook

In our view, market sentiment could continue to moderate in the near term despite trade dispute between China and the US. Overall, we expect average A-share ADT to increase by 50% YoY to RMB 555bn in 2019E while MFSL balance to rise to RMB 907bn, implying a 20% YoY growth.

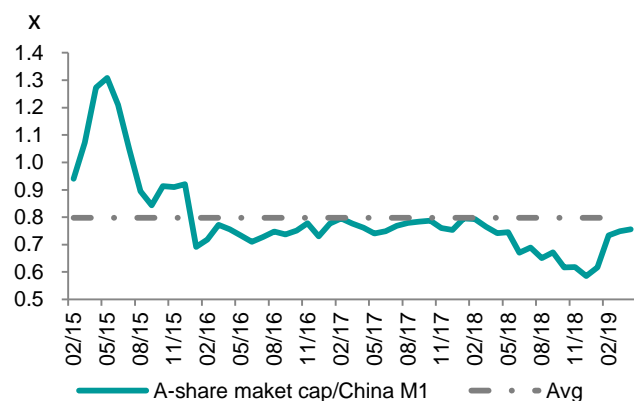
## Stock Recommendations

Among our covered brokerage stocks, we like **CSC (6066 HK)** and **SWHY (6806 HK)** for their high ROAE throughout the market cycle.

## Risk Factors

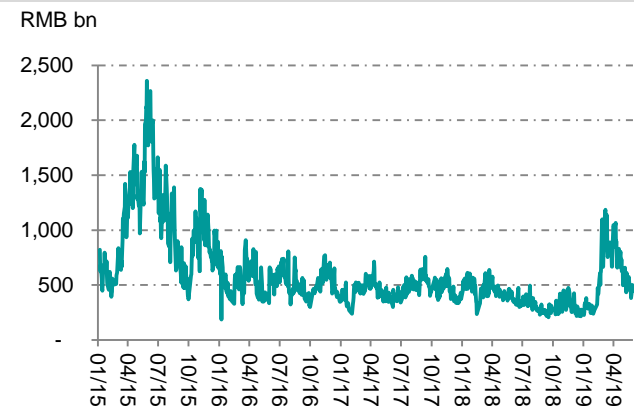
1) Market risk of financial assets; (2) Credit risk associated with bond investments and lending business; (3) Volatility in market turnover; (4) Penalties on misconduct or staff malpractice in securities firms; (5) Regulatory changes in direct financing; (6) Spill-over impact from deleveraging in the financial sector; (6) Intensifying competition after the relaxation of foreign ownership in the industry; (7) Intensifying competition between banks and securities companies in direct financing business.

Exhibit 1: A-share market cap/China M1



Source(s): Bloomberg, ABCI Securities

Exhibit 3: A-share ADT



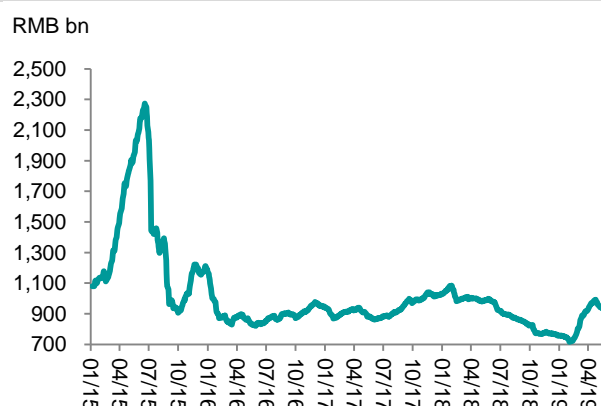
Source(s): Bloomberg, ABCI Securities

Exhibit 2: MFSL balance/A-share market cap



Source(s): Bloomberg, ABCI Securities

Exhibit 4: MFSL Balance



Source(s): Bloomberg, ABCI Securities



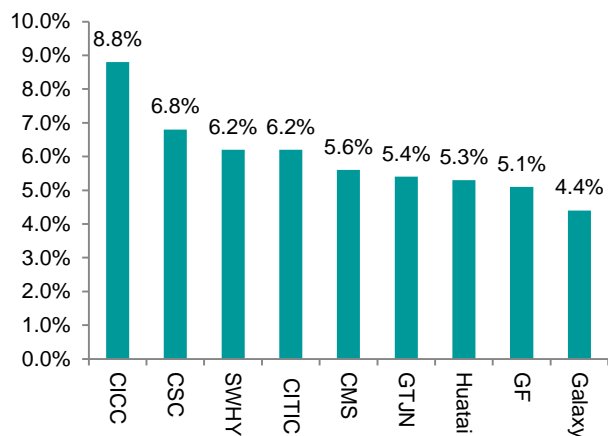


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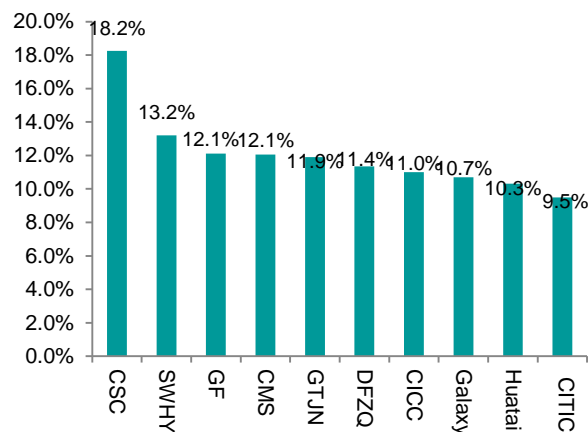
Exhibit 5: ROAE (2018)



CICC (3908 HK), CSC (6066 HK), SWHY (6806 HK), CITIC (6030 HK), CMS (6099 HK), GTJN (2611 HK), Huatai (6886 HK), GF (1776 HK), Galaxy (6881 HK)

Source(s): Companies, ABCI Securities

Exhibit 6: ROAE (2014-18 average)



CSC (6066 HK), SWHY (6806 HK), GF (1776 HK), CMS (6099 HK), GTJN (2611 HK), DFZQ (3958 HK), CICC (3908 HK), Galaxy (6881 HK), Huatai (6886 HK), CITIC (6030 HK)

Source(s): Companies, ABCI Securities

Exhibit 7: Valuation of sector top picks (Data as of June 21, 2019)

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
CSC	6066 HK	BUY	7.6	30%	8.5	8.1	0.8	0.8	3.6	3.9
SWHY	6806 HK	BUY	3.65	19%	10.4	8.5	0.8	0.8	2.4	2.4

Source(s): Bloomberg, ABCI Securities estimates



## OVERWEIGHT

China Property Sector – Cash-rich property management companies are defensive

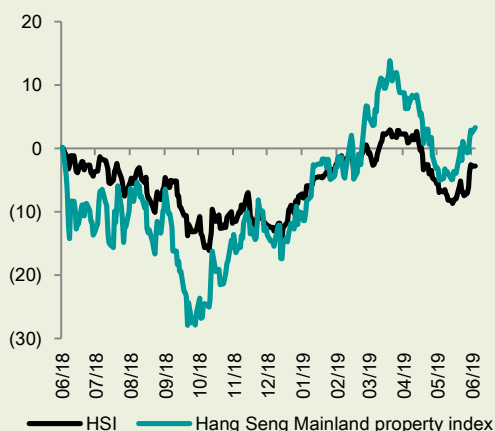
Kenneth Tung

Key Data		Sector Performance (relative to HSI)	Absolute (%)	Relative (%)
Avg. 19E P/E (x)	6.04	1-mth	5.71	3.24
Avg. 19E P/B(x)	1.15	3-mth	(2.98)	0.20
Avg. 19E div yield (%)	8.44	6-mth	18.68	8.12
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities		
<ul style="list-style-type: none"><li>➢ Relaxation on residency curbs will attract population to major tier-2 cities over the long run</li><li>➢ Exchange rate risk is still a major overhang for developers</li><li>➢ Concerns on margin for property management eased as employers' contribution rate to social insurance has been slashed to 16% from 20% in May 2019</li><li>➢ We prefer Greater Bay Area (GBA) players over national players. <b>Aoyuan (3883 HK)</b> is our top pick among Chinese developers given its impressive 5M19 contracted sales performance (+35%YoY) and expertise in urban redevelopment in GBA. <b>A-Living (3319 HK)</b> is our top pick among Chinese PMCs for above-peer growth in managed GFA growth and attractive valuation</li></ul>				

**1-year sector performance (%)**

Source(s):Bloomberg, ABCI Securities

1-year sector performance (%)



Source(s):Bloomberg, ABCI Securities

### Sector Outlook

#### ■ Developers:

**Relaxation on residency curbs will attract population to major tier-2 cities.** In Apr, NDRC announced to relax residency curbs on domestic migrants for type I cities (with population of 1-3mn) and type II cities (3-5 mn), which should boost property demand for tier-2 cities in the long run. We expect population will be drawn to tier-2 cities from lower tier ones, hence driving up housing demand in the former. Overall, residential sales momentum has continued to recover – May contracted sales was up 20% YoY (Apr: +23%YoY; Mar: +21%YoY; Feb: +2%YoY; Jan: -13%YoY); for 5M19, contracted sales rose 11%YoY. Sales of Country Garden (2007 HK) and Evergrande (3333 HK), which have substantial exposure in lower tier cities, declined by 13%YoY and 9%YoY respectively. With tightened monetary compensation for shantytown projects, we believe sales performance of these players is unlikely to recover substantially in near future.

**Exchange rate risk is still a major overhang.** Given a significant portion of debts among the Chinese developers are denominated in USD, currency fluctuation could result in FX losses. In turbulent time, investors may prefer to invest in industry with a solid financial position. Listed PRC developers, with an average net gearing of 76% as at Dec 2018, may fall short of appealing to more conservative investors.

#### ■ Property management companies (PMCs):

**Concerns on margin eased.** Starting from Jan 2019, the State Tax Administration will replace Ministry of Human Resources and Social Security to become the authority for social security collection. Previously, the market was concerned that labor-intensive sectors, including property management services, would suffer from higher payment on social securities (if they have not been complying fully with the regulation previously). Fortunately, the working report of the State Council announced in Mar 2019 provides some relief: (1) Local authority will not

demand recovery on historical arrears;(2) Share of enterprise contributions to urban workers' basic aged-care insurance has been reduced from 20% to 16% starting on May 1, 2019, which we believe would reduce the financial pressure for the PMC sector. In fact, average gross margin and net margin of HK-listed PMCs rose 0.9ppt YoY and 2.0ppt YoY in 2018, driven by 1) faster growth in value-added services (VAS) business, which usually allows for higher pricing power; 2) newly added projects from parent groups with higher management fee rate than existing ones. Management fee rate of newly development projects has risen following the uptrend in property price in recent years. New projects, with higher margins, will partially offset the cost pressure on existing ones.

**Listing of less competitive PMCs may drag down valuation.** Since 4Q18, five PRC PMCs (including, Xinchengyue (1755 HK), Kaisa Property (2168 HK), Ever Sunshine (1995 HK), Aoyuan Healthy Life (3662 HK) and Binjiang Services (3316 HK), have completed their listing in HK; meanwhile, three other PMCs have filed prospectus with HKEx and relevant listing procedures are now pending. In our view, most sizeable players, such as Country Garden Services (6098 HK) and A-living has already been listed. The latecomers yet to be listed are usually smaller companies with less competitive clout. We estimate a significant valuation discount may be applied for these players; consequently, the sector valuation could be dragged down. Nonetheless, we still regard the PMC sector as defensive amid the volatile market environment given its cash-rich nature and secure growth outlook with support from parent companies.

### Stock Recommendations

#### ■ **Developers:**

**GBA players to benefit from rising property demand.** We prefer the GBA players over the large national players as economic growth in the region will outpace the national average on supportive policies from the government. Among the GBA developers, **Aoyuan (3883 HK)** is our top pick given impressive 5M19 presales (+35% YoY vs. peer average of 10% YoY) and expertise in urban redevelopment projects in the region.

#### ■ **PMCs:**

**A-Living (3319 HK) is our top pick** for its fast managed GFA growth, above-peer margins and large net cash balance. In 2018, A-Living had the highest net margin among peers at 23.7%, up 7.3ppt YoY, driven by growth in VAS revenue. With superior margins and contracted GFA growth, we believe the counter's valuation at 14.5x 2019PE (vs. sector avg: 19x) is unjustifiably low.

### Risk Factors

#### ■ **Developers:**

1) Slowing contracted sales performance due to moderating economic growth; 2) Weakening property demand in lower tier cities due to scale-back of shantytown development ; 3) FX risks due to currency volatility amid Sino-US trade dispute

#### ■ **PMCs:**

1) Substantial related-party transactions between PMC subsidiaries and parent developers; 2) Reliance on shareholders for new projects for non-independent PMCs; 3) Potential margin erosion caused by M&A; 4) increasing number of PMC IPOs may drag down sector valuation



Exhibit 1: 5M19 presales of major listed PRC developers

		Stock code	Amount RMBbn	YoY %	5M19		ASP RMB/sqm	YoY %	2019 Target RMBbn	% Achieved
					GFA 000 sqm	YoY %				
1	Powerlong	1238 HK	22.5	86%	1,391	54%	16,187	20%	50	45.0%
2	Beijing Capital	2868 HK	24.8	57%	1,004	31%	24,721	20%	80	31.0%
3	Yuxiu	123 HK	28.9	53%	1,247	32%	23,154	16%	68	42.5%
4	Sino-Ocean	3377 HK	43.4	41%	2,015	30%	21,525	8%	140	31.0%
5	Shimao	813 HK	72.0	40%	4,027	25%	17,869	12%	210	34.3%
6	CR Land	1109 HK	90.4	37%	4,887	25%	18,487	9%	242	37.3%
7	COLI*	688 HK	123.5	36%	6,708	9%	18,408	25%	299	41.3%
8	Aoyuan	3883 HK	38.3	35%	3,782	42%	10,132	-5%	114	33.6%
9	CIFI	884 HK	66.1	30%	3,934	20%	16,800	9%	190	34.8%
10	Times	1233 HK	25.1	23%	1,670	38%	15,054	-11%	75	33.5%
11	Poly-A	600048 CH	189.0	22%	12,268	20%	15,402	2%	na	na
12	Logan	3380 HK	34.4	20%	2,542	79%	13,548	-33%	85	40.5%
13	Agile	3383 HK	45.5	19%	3,096	8%	14,687	10%	113	40.2%
14	Yuzhou	1628 HK	21.4	16%	1,412	3%	15,153	13%	67	31.9%
15	Sunac	1918 HK	163.4	12%	11,245	26%	14,528	-11%	550	29.7%
16	Vanke	2202 HK	267.6	12%	16,608	5%	16,113	7%	na	na
17	KWG	1813 HK	28.5	11%	1,617	9%	17,617	2%	85	33.5%
18	Longfor	960 HK	84.2	11%	5,252	9%	16,030	1%	220	38.3%
19	Greentown	3900 HK	37.0	5%	1,410	-8%	26,241	15%	139	26.5%
20	R&F	2777 HK	44.2	2%	3,794	10%	11,658	-8%	160	27.6%
21	Jinmao	817 HK	54.5	-4%	2,572	64%	21,171	-41%	150	36.3%
22	Evergrande	3333 HK	231.5	-9%	21,549	-11%	10,745	3%	600	38.6%
23	Country garden	2007 HK	292.2	-13%	30,995	-12%	9,426	-1%	na	na
Total			2,028	11%	145,027	5%	13,985	5%	3,638	35.2%

\* in HKD

Source(s): Companies, HKEx, ABCI Securities

Exhibit 2: Hong Kong IPO of China PMCs since 4Q18

Listing date	Company	IPO proceeds raised	IPO price	Share price performance
		HK\$mn	HK\$	since listing
6 Nov 18	Xinchengyue (1755 HK)	638	2.90	178%
6 Dec 18	Kaisa Property (2168 HK)	328	9.38	23%
17 Dec 18	Ever Sunshine (1995 HK)	741	1.78	96%
15 Mar 19	Binjiang Service (3316 HK)	532	6.96	3%
18 Mar 19	Aoyuan Healthy Life (3662 HK)	737	3.66	24%

Source(s): HKEx, ABCI Securities



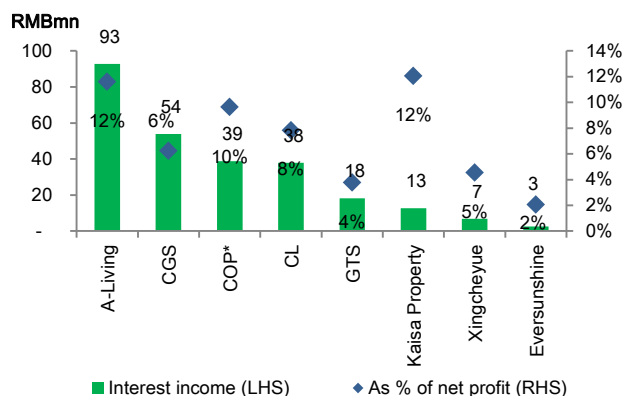


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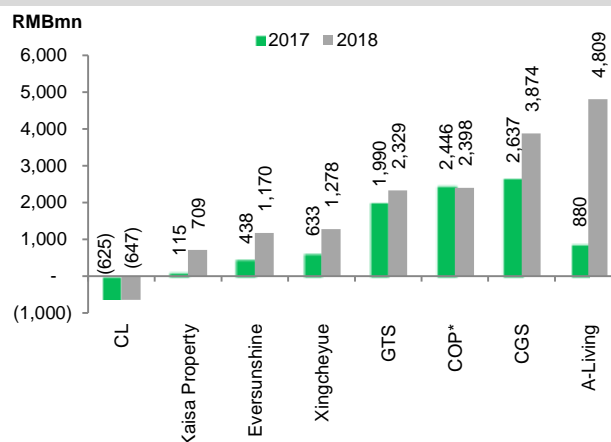
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**Exhibit 3: Interest income as a percentage of net profit for PMCs (2018)**



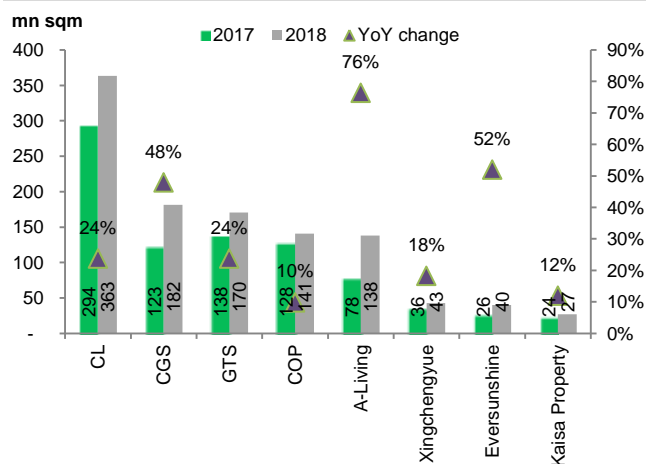
Notes: CGS= Country Garden Services (6098 HK); COP= China Overseas Properties (2669 HK); CL= Colour Life (1778 HK); GTS= Greentown Services (2869 HK)  
Source(s): Companies, ABCI Securities

**Exhibit 4: Net cash/(debt) level of PMCs**



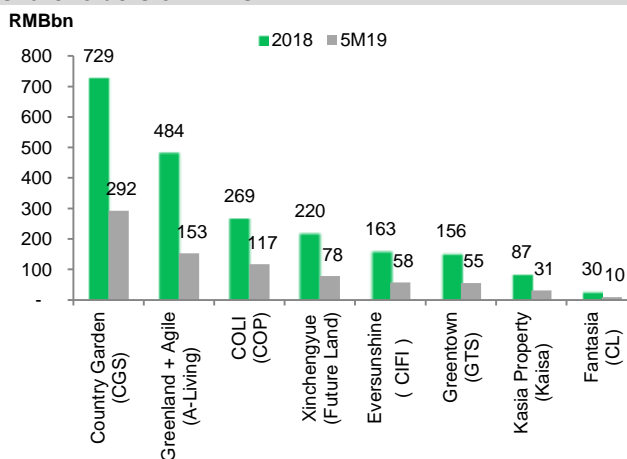
\* in HK\$  
Notes: CL= Colour Life (1778 HK); GTS= Greentown Services (2869 HK); COP= China Overseas Properties (2669 HK); CGS= Country Garden Services (6098 HK)  
Source(s): Companies, ABCI Securities

**Exhibit 5: Managed GFA of PMCs**



CL= Colour Life (1778 HK); CGS= Country Garden Services (6098 HK); GTS= Greentown Services (2869 HK); COP= China Overseas Properties (2669 HK)  
Source(s): Companies, ABCI Securities

**Exhibit 6: Contracted sales of parent/ major shareholders of PMCs**



Source(s): Companies, ABCI Securities

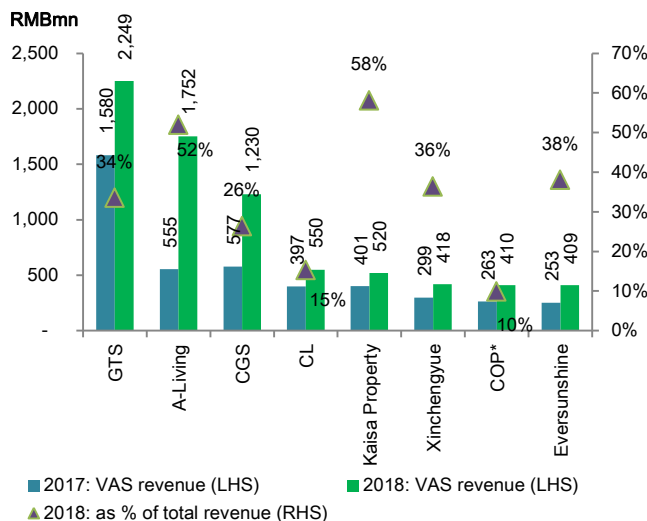


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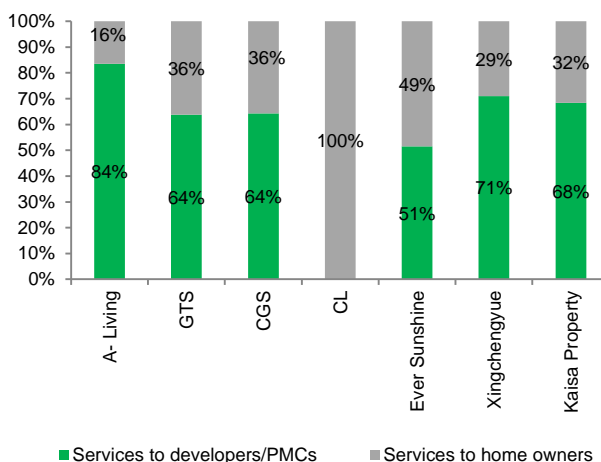
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Exhibit 7: VAS revenue of PMCs



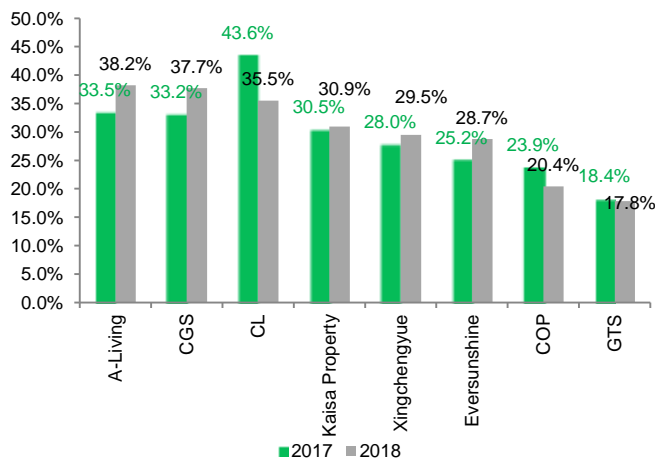
GTS= Greentown Services (2869 HK); CGS= Country Garden Services (6098 HK); CL= Colour Life (1778 HK); COP= China Overseas Properties (2669 HK)  
Source(s): Companies, ABCI Securities

Exhibit 8: VAS revenue breakdown (2018)



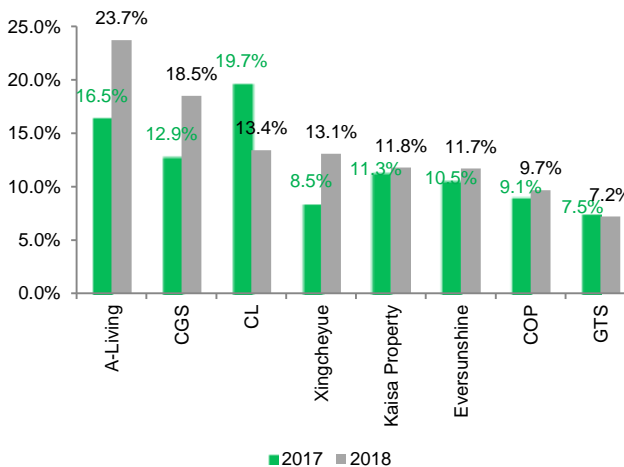
GTS= Greentown Services (2869 HK); CGS= Country Garden Services (6098 HK); CL= Colour Life (1778 HK)  
Source(s): Companies, ABCI Securities

Exhibit 9: Gross margin of PMCs



CGS= Country Garden Services (6098 HK); CL= Colour Life (1778 HK); COP= China Overseas Properties (2669 HK); GTS= Greentown Services (2869 HK)  
Source(s): Companies, ABCI Securities

Exhibit 10: Core net margin of PMCs



CL= Colour Life (1778 HK); COP= China Overseas Properties (2669 HK); CGS= Country Garden Services (6098 HK); GTS= Greentown Services (2869 HK)  
Source(s): Companies, ABCI Securities

Exhibit 11: Valuation of sector top picks (Data as of June 21, 2019)

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
A-Living	3319	BUY	18.6	44.4	14.5	11.1	2.6	2.2	2.6	3.4
Aoyuan	3883	BUY	14.1	36.1	6.3	3.9	1.7	1.4	6.5	10.3

Source(s): Bloomberg, ABCI Securities estimates



## NEUTRAL

### China Alternative Energy Sector – Wind power to enter a subsidy-free era

Kelvin Ng

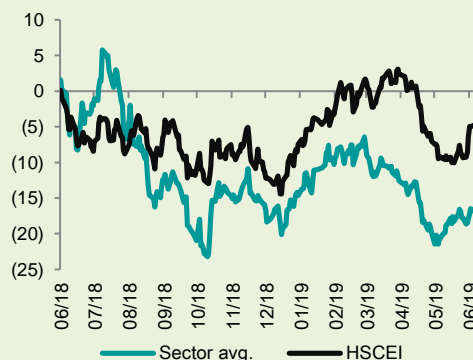
Key Data		Sector Performance (relative to HSCEI)	Absolute (%)	Relative (%)
Avg. 19E P/E (x)	7.10	1-mth	4.8	1.8
Avg. 19E P/B(x)	0.77	3-mth	(7.8)	(2.6)
Avg. 19E div yield (%)	3.05	6-mth	2.3	(5.8)
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities		
<ul style="list-style-type: none"><li>➤ Wind power will soon enter the subsidy-free era; operators located in prime regions with lower operating cost, net gearing and financing cost; higher utilization hour would be winners</li><li>➤ Nuclear power operators would continue to enjoy strong output growth in the next few years based on the low contribution to overall energy output at present</li><li>➤ China's wind power and nuclear power outputs are likely to expand at 12%/15% CAGRs in 2018-20E as energy structure shifts from coal-fire sources to greener alternatives</li><li>➤ <b>CGN Power (1816 HK)</b> is our preferred nuclear power play based on its leading position in China and key assets located in Guangdong province. <b>Longyuan Power (916 HK)</b> is our top pick in the wind power sector given its prime asset quality conducive to higher utilization hour and stronger cash flow.</li></ul>				

**1-year sector performance (%)**

Month	Sector avg. (%)	HSCEI (%)
06/18	0	0
07/18	5	2
08/18	0	-5
09/18	-10	-10
10/18	-20	-15
11/18	-15	-10
12/18	-10	-15
01/19	-5	-5
02/19	-10	0
03/19	-15	5
04/19	-20	0
05/19	-15	-10
06/19	-10	-5

Source(s):Bloomberg, ABCI Securities

1-year sector performance (%)



Source(s):Bloomberg, ABCI Securities

**Wind power: Entering a subsidy-free era.** National Energy Administration (NEA) announced on Jan 10, 2019 that it would encourage the construction of subsidy-free projects for wind and solar power. Several key supportive policies have been proposed, which include 1) reducing unreasonable fee; 2) granting green certificates; 3) grid companies to help reduce curtailment; 4) aid from financial market. We believe these subsidy-free projects are a prelude to the eventual cancellation of subsidies to alternative energy sector.

On May 21, 2019, National Development and Reform Commission (NDRC) announced that the government will no longer subsidize onshore wind power facilities approved before end-2018 but cannot be completed by end-2020; no subsidy will be given to onshore wind power facilities approved between Jan 1, 2019 and end-2020 that cannot be completed by end-2021. Starting from Jan 1, 2021, no subsidy will be provided to newly approve onshore wind power facilities. We believe the subsidy-free policy would urge wind power operators to ramp up competitiveness.

**Wind power: Offshore capacity is a rising trend.** China's key wind power resources are located in inland areas (e.g. Inner Mongolia and northwest region) while key demand for wind power comes from the coastal regions (e.g. Shanghai and Guangdong). Limited capability to transmit large amount of wind power from distant regions resulted in power curtailment in early years. Constructing offshore wind power capacity, however, could help resolve the issue because 1) close proximity of offshore facilities to power demand regions would reduce the need for distant transfer; 2) higher wind speed of offshore facilities is conducive to higher utilization hour; 3) greater offshore turbine size indicates lower all-in unit cost. We believe wind power operators will expand their offshore wind power capacity in the future.



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**China wind power to grow at 12% CAGR during 2018-20E.** China's wind power output has maintained a robust growth in the past decade to reach 366bn kWh in 2018 - a 27-time jump from 13bn kWh in 2008, representing a 40% CAGR in 2008-18. We believe wind power output would maintain an uptrend, with operators constructing more power turbines before the subsidy-free policy is set in motion (wind power facilities installed before end-2020 could still enjoy subsidy; after that, no subsidy on tariff will be provided). We believe nationwide wind power output would expand at 12% CAGR for 2018-20E.

**Nuclear power: Subsidy-free policy has limited impact on nuclear power industry.** We believe nuclear power would be China's major alternative energy source in the future due to its clean nature. Average production cost of nuclear power is ~RMB 0.31/kWh ex. VAT, close to that of coal-fired power (RMB0.30/kWh ex. VAT). Since feed-in tariff subsidy does not apply to the nuclear power industry the subsidy-free policy will have limited direct impact on operators.

**Nuclear power: Low contribution to overall energy structure suggests ample room for growth.** We believe China's switch to alternatives (e.g. wind, solar, and nuclear) will continue. Nuclear power accounted for only 4% of China's overall power output in 2018, far lower than the ~30% in developed countries. We believe the government would construct more nuclear power plants in the long run.

**China nuclear power: Power output to expand at 15% CAGR in 2018-20E.** China's nationwide nuclear power output jumped 300% from 69bn kWh in 2008 to 294 bn kWh in 2018, representing a 10-year CAGR of 16%. 5M19 nuclear power output was up 24.3% YoY, indicating a persisting uptrend. We believe China's strong capacity growth in nuclear power with high utilization hour would elevate output to 391bn kWh by end-2020E, representing a 15% CAGR in 2018-20E.

### Long-term Outlook

We believe both nuclear power and wind power sectors would undergo robust growth in the next two years as China aims to reduce air pollution and decrease reliance on coal-fired power.

**Wind power:** We believe competition in the wind power industry would intensify when subsidy is withdrawn in China. Wind power operators with the characteristics of 1).lower unit operating cost 2).lower net gearing ratio and finance cost 3).higher utilization hour 4).better locations would outperform.

**Nuclear power:** Due to its high stability and low production cost, nuclear power is likely to become a core alternative energy source, especially since it took up only 4.0%of overall power output in China.

### Short-term Outlook

**Wind power operators:** We believe high account receivables would be the key risk. Given the high debt ratio in local governments, subsidies to wind power operators could be delayed, which may affect cash flow.

**Nuclear power operators:** Public concern on safety issue would be the key risk. Any nuclear and radiation accidents will result in public panic and affect the development pace of nuclear power.

### Stock Recommendations

#### ■ Wind power operators:

**Longyuan power (916 HK) is our top pick.** We believe wind power industry would continue to enjoy robust growth in the next few years since its current contribution to China's overall power output is still low. With the subsidy-free policy commencing by end-2020, we advise investors to select operators with assets in prime locations, facilities with higher utilization hours, and a history of strong cash flow. **China Longyuan Power (916 HK)** is our sector top pick.



### ■ Nuclear power operators:

**CGN Power (1816 HK) is our top pick.** CGN is the sole nuclear power operator listed on HKEx and the largest nuclear power operator in China controlling ~60% of the country's existing operating nuclear power capacity. Around 65% of CGN's existing operating capacity is located in Guangdong province, one of the most economically vibrant regions in China. Prime locations of facilities also guarantee higher utilization hours and strong cash flow.

### Risk Factors

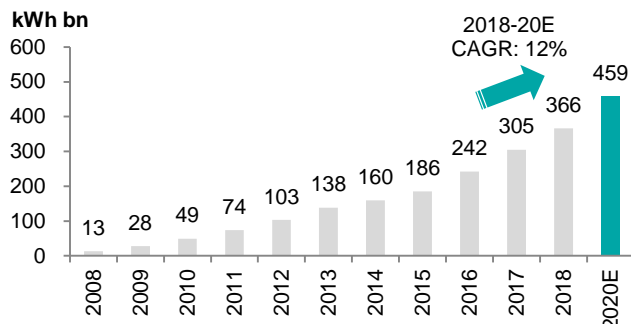
#### ■ Wind power operators:

1) Power curtailment risk; 2) Wind resources risk; 3) Tariff risk; 4) Construction risks; 5) Fundraising risk 6) Government policy to deleverage may constrain growth

#### ■ Nuclear power operators:

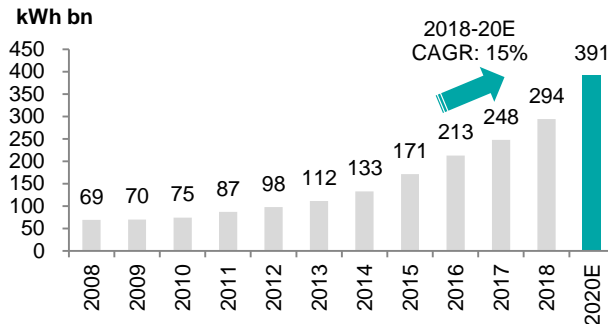
1) Operation safety risk; 2) Construction risk; 3) Fuel cost risk; 4) Tariff risk; 5) Currency and interest rate risks; 6) Fundraising activities for M&A.

**Exhibit 1: China's wind power output outlook**



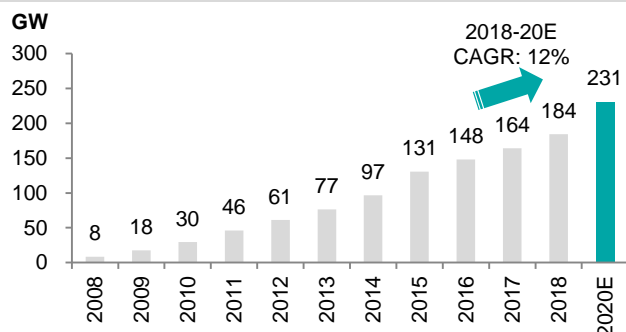
Source(s): NEA, CEC, ABCI Securities estimates,

**Exhibit 2: China's nuclear power output outlook**



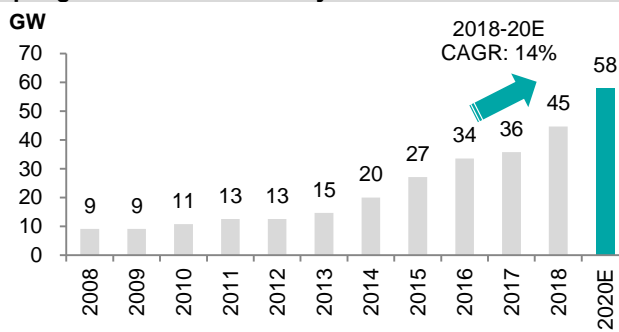
Source(s): NEA, CEC, ABCI Securities estimates,

**Exhibit 3: China's wind power capacity outlook**



Source(s): NEA, CEC, ABCI Securities estimates,

**Exhibit 4: China's nuclear power capacity outlook: rapid growth in the next few years**



Source(s): NEA, CEC, ABCI Securities estimates,

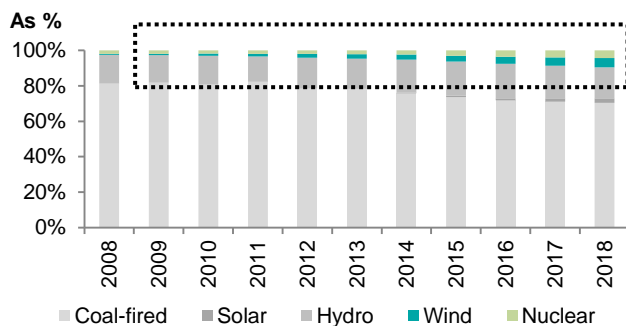


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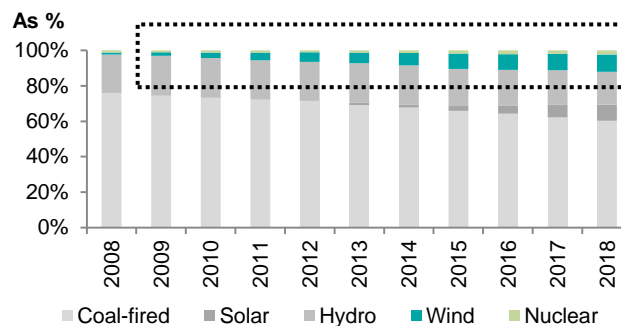
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**Exhibit 5: Contributions of wind and nuclear power will expand in China (by power output)**



Source(s): NEA, CEC, ABCI Securities

**Exhibit 6: Rising contributions of wind and nuclear power in China (by power capacity)**



Source(s): NEA, CEC, ABCI Securities

**Exhibit 7: Valuation of sector top picks (Data as of June 21, 2019)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
Longyuan	916	BUY	7.50	49.4	6.8	6.2	0.7	0.6	2.9	3.3
CGN Power	1816	BUY	2.50	12.1	9.2	7.9	1.1	1.0	3.6	4.2

Source(s): Bloomberg, ABCI Securities estimates



## OVERWEIGHT

### China Environmental Protection Sector – Incinerators are set to grow

Kelvin Ng

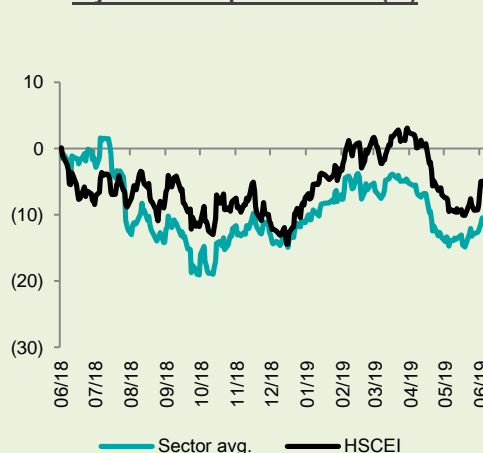
Key Data		Sector Performance (relative to HSCEI)		Absolute (%)	Relative (%)
Avg. 19E P/E (x)	8.49	1-mth		3.6	0.6
Avg. 19E P/B(x)	1.33	3-mth		(3.9)	1.2
Avg. 19E div yield (%)	3.53	6-mth		4.6	(3.6)
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities			
<div>➤ Solid waste produced per capita maintains an uptrend on increasing O2O activities</div> <div>➤ Low penetration rate in urban areas would support growth. Waste incinerated in urban areas was up 19% CAGR in 2017-20E</div> <div>➤ Nationwide wastewater treatment volume would expand at 5% CAGR in 2017-20E since current penetration has already reached 94%</div> <div>➤ <b>China Everbright Int'l (257 HK)</b> is our preferred pick for its leading position in a growing industry</div>					

### 1-year sector performance (%)

Month	Sector avg. (%)	HSCEI (%)
06/18	-5	-5
07/18	-10	-10
08/18	-15	-15
09/18	-18	-18
10/18	-20	-20
11/18	-15	-15
12/18	-10	-10
01/19	-5	-5
02/19	0	0
03/19	5	5
04/19	10	10
05/19	-10	-10
06/19	-15	-15

Source(s):Bloomberg, ABCI Securities

1-year sector performance (%)



Source(s):Bloomberg, ABCI Securities

**Incineration: Solid waste produced per capita maintains an uptrend on increasing O2O activities.** China's solid waste produced per capita has declined from 1.44kg/day in 2003 to 1.11kg/day in 2013, equivalent to -2.6% CAGR during the period. The trend, however, has reversed since then, with the figure rebounding to 1.20kg/day by end-2017. We believe the increase is driven by rising online-to-offline (O2O) activities. According to iResearch data, O2O sales in China grew from RMB 1.9tr in 2013 to RMB 6.3tr in 2017 (35% CAGR in 2013-17). We believe the change in lifestyle has increased the amount of solid waste produced; in particular, O2O shopping usually involves the use of large amounts of packaging materials. We expect solid waste produced per capita would rise at 0.5% CAGR in 2017-20E on the back of growing O2O activities.

**Nationwide penetration rate is still low at 34%.** According to Ministry of Housing and Urban-Rural Development (MOHURD), incineration rate in urban area of China is low, especially in inland provinces. In 2017, only Jiangsu province had 70% of its residential solid waste treated via incineration; six provinces (Zhejiang, Anhui, Fujian, Shandong, Yunnan and Hainan) achieved an incineration rate between 50%-70% while 14 provinces had an incineration rate lower than 30%. The average penetration rate in coastal provinces is higher than that of inland ones (49% vs. 28%), suggesting opportunities in the latter regions. China targets to boost nationwide incineration rate to 50% by end-2020, hence we believe incineration facilities would continue to expand in coming years. In addition, incineration operators would enter the inland provinces for further development opportunities.

**2017-2020E outlook: waste incinerated in urban areas would increase at 19% CAGR.** In 2007-2017, total volume of solid waste treated via incineration in urban area increased from 14mn ton in 2007 to 93mn ton by end-2017, representing a 21% CAGR. We believe increasing urbanization, rising solid waste produced per capita, and the government's intention to raise incineration ratio in urban areas would drive up the application of such waste treatment over the next few years. National Development and Reform Commission (NDRC) estimates urbanization to reach 60% by end-2020E, representing an addition of 57mn people in urban areas, while solid waste produced per capita would increase by 0.5% CAGR in 2017-20E on robust O2O activities. We expect waste treated by incineration in urban areas to jump from 93mn ton in 2017 to 159mn ton in 2020E, suggesting a 70% increase or 19% CAGR for the period.



**Wastewater: China's urban wastewater treatment rate was expected to reach 95% by end-2020.** According to MOHURD, as of end-2017, wastewater treatment rate in urban areas reached 94%, close to China's target of 95% by end-2020. We believe the target is highly achievable based on current progress.

**Urban wastewater produced per capita would grow at 0.7% CAGR in 2017-20E.** China's wastewater produced per capita in urban areas increased from 85m<sup>3</sup>/ppl/year in 2007 to 91m<sup>3</sup>/ppl/year in 2017, up 7% or representing a 0.7% CAGR during the period. Due to the increase in hygienic standard, we expect wastewater produced per capita to rise at 0.7% CAGR during 2017-20E.

**Modest 5% CAGR growth in urban wastewater treatment volume in 2017-20E.** Assuming rising urbanization (4% CAGR in urban population in 2017-20E) and improved living standard would support demand for wastewater treatment in urban areas, we estimate China's wastewater treatment volume to expand at 5% CAGR in 2017-20E.

#### **Public-Private Partnership (PPP): from wax to wane**

Public-Private Partnership (PPP) was first introduced by the Chinese government in 2016 to attract private capital into urban utilities sector. However, as reported cases of substandard projects and scams increase, approval for new PPP projects has slowed. It is unlikely that PPP would catalyze development in the wastewater treatment industry until effective monitoring policy and regulations are in place.

**Water environment services business as growth area but cash collection will be a concern.** We believe water environment services (rivers, lakes and underground water protection and remediation) will be the new growth spot as environmental awareness increases; growth in urban wastewater treatment is limited since penetration rate now stands at 94%. Unlike urban wastewater treatment services, the expenses of water environment services are solely borne by the governments. We believe cash collection would be a major overhang especially in regions where the local governments are financially stretched.

#### **Long-term Outlook**

**Incineration:** We believe China's urbanization will continue for decades, supporting demand for solid waste treatment. Low penetration of incineration in urban areas (2017: 34%) means rooms for growth is plentiful.

**Wastewater treatment:** Since penetration rate of wastewater treatment in urban areas is already high, we believe wastewater treatment operators would expand their existing services to more rural regions and enter the water environment market. As usual, we expect players would compete for facilities in prime regions with steadier cash flow and lower default risk.

#### **Short-term Outlook**

Incineration operators will benefit from rising urbanization and rising solid waste produced per capita. Solid waste incineration in urban areas would continue to grow over 2019E-20E. For wastewater treatment operators, more focus will be on BOT (Build-Operate-Transfer) projects rather than Engineering, Procurement and Construction (EPC) projects. Funding through PPP is unlikely to increase.

#### **Stock Recommendations**

**China Everbright International (CEI, 257 HK) is our top pick.** We expect volume of solid waste treated through incineration in China's urban areas to grow at 19% CAGR in 2017-20E. CEI, as a market leader in China's incineration industry controlling 12% of the country's incineration capacity in 2017, is set to benefit from the strong growth.





## Risk Factors

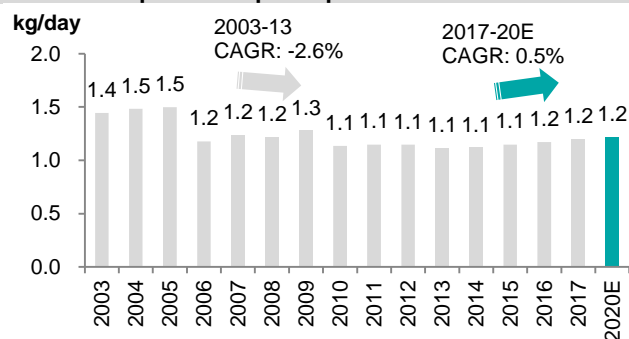
### ■ Incineration operators:

1) Slower-than-expected capacity growth; 2) Default risk; 3) Policy risks; 4) Surge in maintenance costs; 5) Public resistance to incinerator construction.

### ■ Wastewater treatment operators:

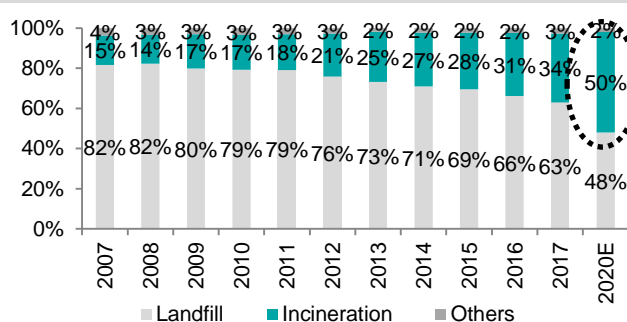
1) Slower-than-expected capacity growth; 2) Default risk; 3) Policy risk; 4) High net gearing ratio; 5) Negative cash flow.

**Exhibit 1: Increasing O2O activities would increase solid waste produced per capita**



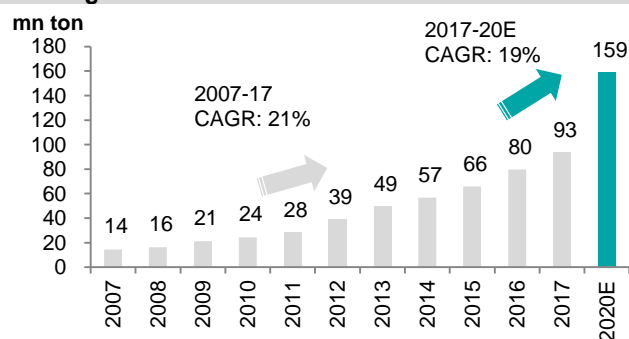
Source(s): MOHURD, ABCI Securities estimates

**Exhibit 2: China will increase the proportion of waste incinerated in 2020E**



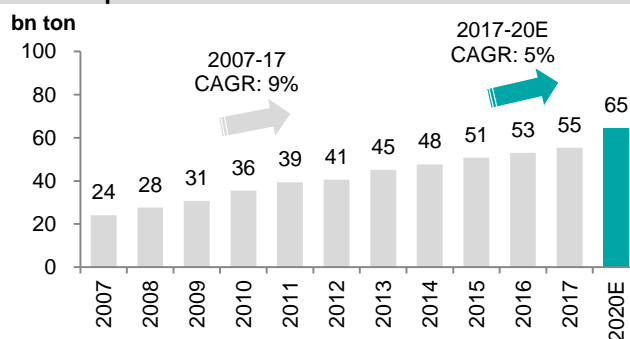
Source(s): NDRC estimates, ABCI Securities

**Exhibit 3: Waste incinerated in urban areas would see robust growth in 2017-20E**



Source(s): MOHURD, NDRC, ABCI Securities estimates

**Exhibit 4: Nationwide wastewater treatment volume would expand at 5% CAGR in 2017-20E**



Source(s): MOHURD, NDRC, ABCI Securities estimates

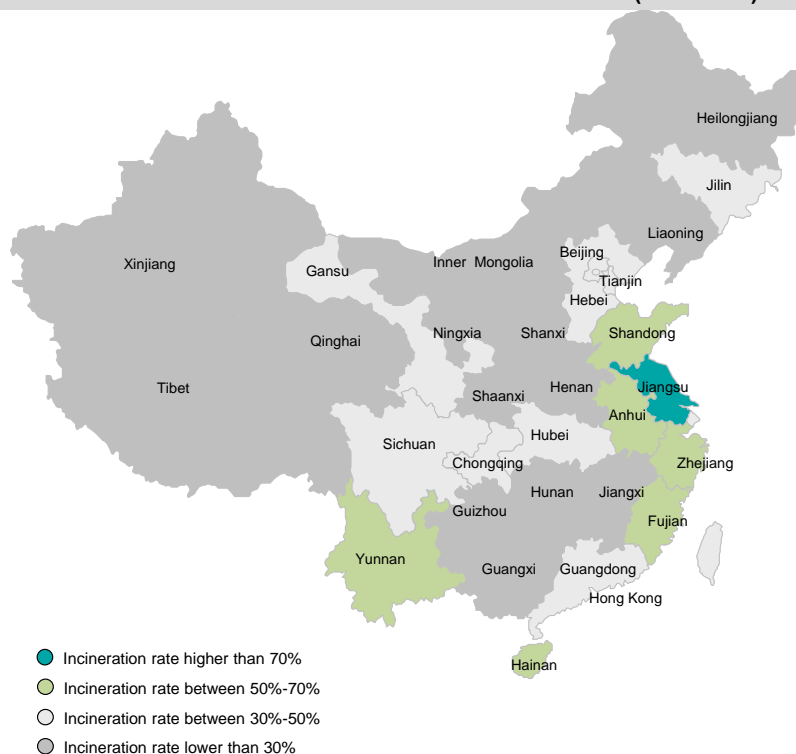


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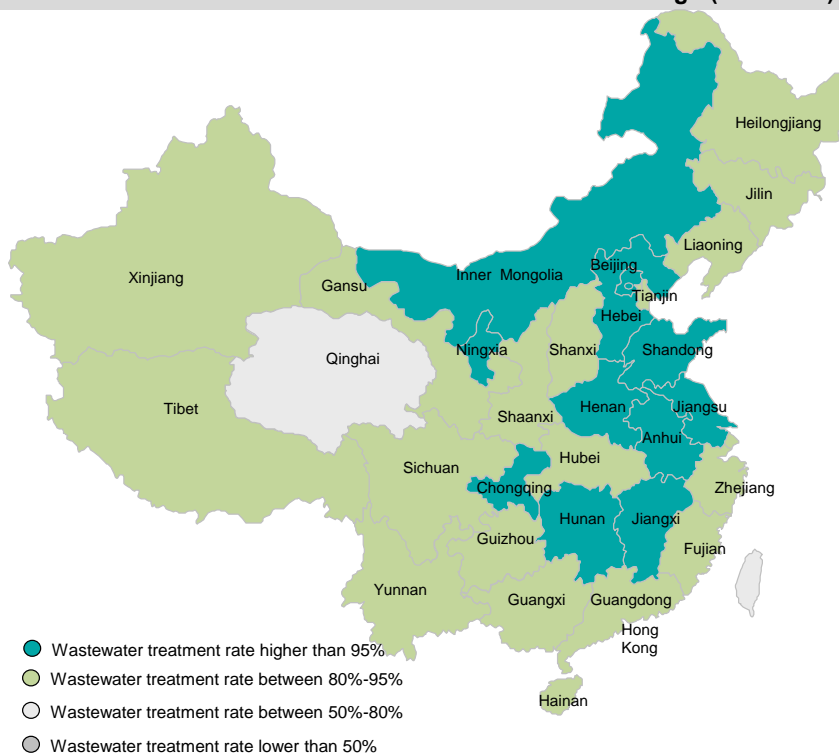
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**Exhibit 5: Penetration rate of incineration in China remains low (2017 data)**



**Exhibit 6: Penetration rate of wastewater treatment in China is high (2017 data)**



**Exhibit 7: Valuation of sector top picks (Data as of June 21, 2019)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
CEI	257	BUY	8.90	20.6	8.6	7.5	1.2	1.1	3.5	4.0

Source(s): Bloomberg, ABCI Securities estimates



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## OVERWEIGHT

Internet Media and Consumer Commerce – Online shopping is the strongest fort  
Steve Chow

Key Data		Sector Performance (relative to MXCN)		Absolute (%)	Relative (%)
Avg. 19E P/E (x)	27.6	1-mth		11.9	4.1
Avg. 19E P/B(x)	28.7	3-mth		(1.6)	4.5
Avg. 19E div yield (%)	4.1	6-mth		25.0	10.2
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities			
<div><div>➤ We believe the rise of short videos has diluted users' share of time spent on other forms of online entertainment including online games.</div><div>➤ Online sales growth has remained resilient in recent months despite weakened macro environment.</div><div>➤ <b>Alibaba (BABA US)</b> is our top pick for the sector</div></div>					

1-year sector performance (%)

Date	MXCN (%)	Sector average (%)
06/18	0.0	0.0
07/18	-5.0	-2.0
08/18	-10.0	-5.0
09/18	-15.0	-10.0
10/18	-18.0	-15.0
11/18	-25.0	-20.0
12/18	-20.0	-15.0
01/19	-22.0	-18.0
02/19	-15.0	-10.0
03/19	-10.0	-5.0
04/19	-5.0	-2.0
05/19	-10.0	-5.0
06/19	-20.0	-25.0

— MXCN    — Sector average

Source(s):Bloomberg, ABCI Securities

**Intensified competition on users' time spent.** According to mobile big data service provider JiGuang (JG US), the average no. of mobile apps installed per mobile user has trended up to 52 in 1Q19 vs. 34 in 3Q17; meanwhile, average daily time spent on mobile apps per mobile user has remained largely stable at 4.2hrs. In our view, this implies competition on users' time spent among mobile apps has intensified.

**The rise of short videos is stealing popularity from other forms of online entertainment.** According to the big data service provider QuestMobile, market mobile users have increased their time spent on short videos from 2.0% in June 2017 to 8.3% in Dec 2018. In our view, this would inevitably reduce the share of users' time spent on other form of online entertainment such as instant messaging, long videos, and online games.

**Online gaming - not out of the woods yet.** According to QuestMobile, mobile users have reduced their share of time spent on online games from 10.1% in Mar 2018 to 8.2% in Mar 2019. Although the government has resumed the approval for new online games since late-2018, the no. of approved mobile games dropped significantly by 62% YoY to 728 in 1Q19. In our view, the tight regulatory environment would inevitably disrupt game developers' new game pipeline, further reducing the attractiveness of online gaming as a form of entertainment. This could prompt users to migrate to emerging forms of online entertainment.

**Online advertising – the emergence of strong competitor.** In 1Q19, Tencent's online advertising revenue growth slowed to 25% YoY vs. 38% YoY in 4Q18. In our view, the online advertising segment is facing rising competition from Douyin, which has been ramping up its advertising business in recent quarters. Indeed, according to QuestMobile, ByteDance (the parent company of short video platform Douyin and news and information content platform Toutiao) has already commanded an online advertising market share of 11% in 2018, approaching Tencent's 13%.

**Online shopping is still resilient.** Despite a softening macro outlook, China's online sales of physical goods grew 22.2% YoY in 4M19, accounting for 18.6% of total retail sales during the same period, according to NBS. On a monthly basis, online sales of physical goods were up 25% YoY in Apr 2019.



### Short-term Outlook

We expect online gaming to face regulatory headwinds in the near term given the decline in approved new games. Online shopping, on the other hand, should remain resilient.

### Long-term Outlook

Online gaming is facing structural challenges from other forms of online entertainment, including short video platforms.

### Stock Recommendations

**Alibaba (BABA US)** is our preferred pick among the large-cap internet stocks based on our positive view on online shopping and the Group's leading market position in the domain. In addition, Alibaba has been reporting higher revenue growth than JD.com (JD US) in recent quarters, implying ongoing market share gains.

For Tencent (700 HK), the Group experiences broad-based slowdown across major business segments including online gaming, online advertising, and FinTech. We do not expect any positive catalysts in the near term at this point.

### Risk Factors

1) Tightening regulation on internet finance, mobile game and online payment; 2) Entry of foreign competitors such as Facebook (FB US) and Google (GOOGL/GOOG US); 3) Slowdown in ecommerce and internet finance; 4) Lifecycle of mobile games.

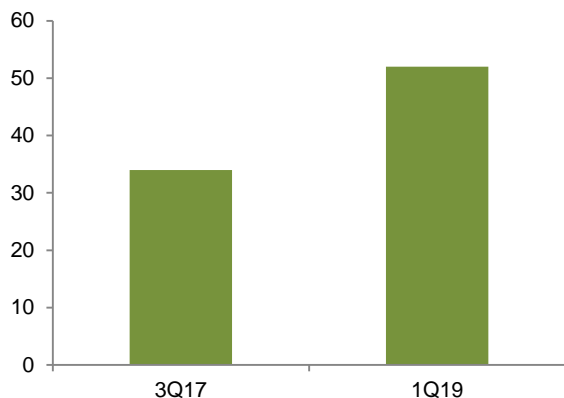


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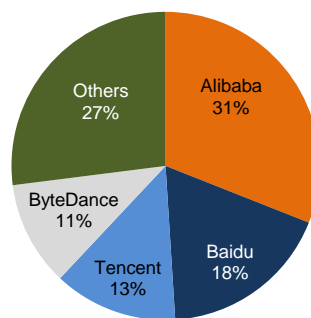
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Exhibit 1: No. of installed apps per mobile user



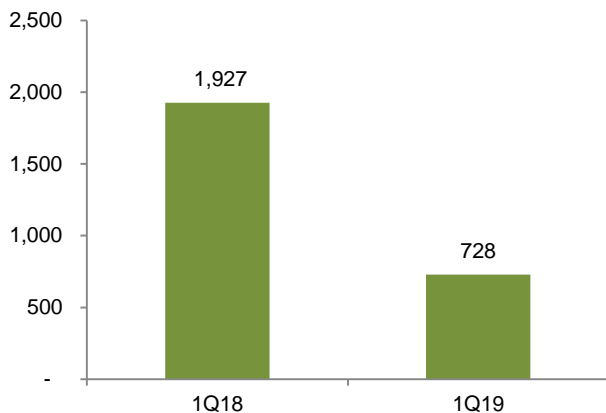
Source(s): JiGuang, ABCI Securities

Exhibit 2: Online advertising market share in 2018



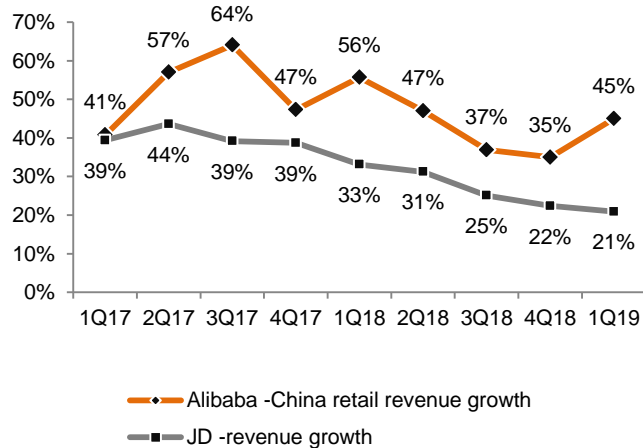
Source(s): QuestMobile

Exhibit 3: Number of approved new online game



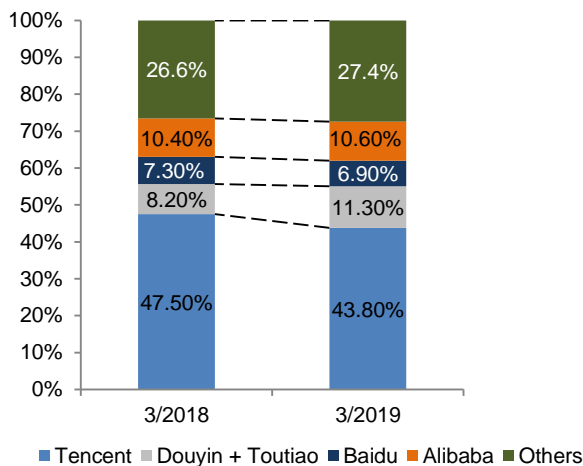
Source(s): QuestMobile, ABCI Securities

Exhibit 5: Revenue growth – Alibaba vs. JD.com



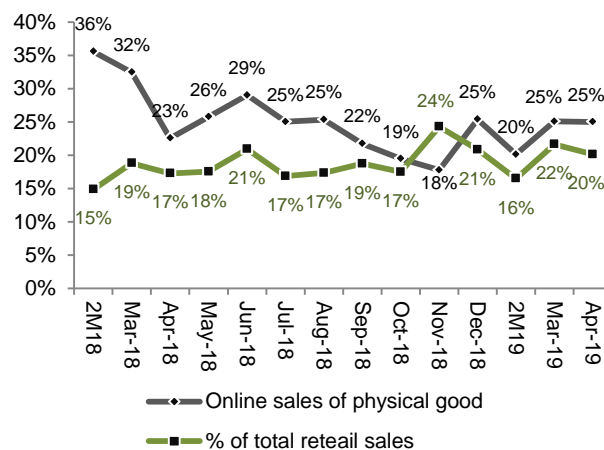
Source(s): Companies, ABCI Securities

Exhibit 4: Share of user time among major online platforms



Source(s): QuestMobile, ABCI Securities

Exhibit 6: Online sales of physical goods



Source(s): NBS, ABCI Securities



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**Exhibit 7: Valuation of sector top picks (Data as of June 21, 2019)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
Alibaba	BABA US	BUY	183	10.2%	17.4	18.5	30.0	25.3	NA	NA

Source(s): Bloomberg, ABCI Securities estimates

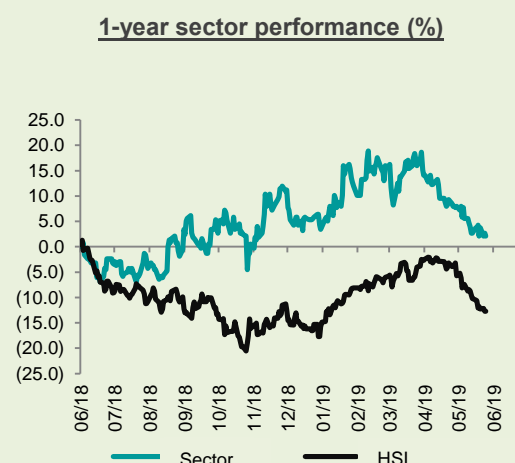


## OVERWEIGHT

### China Telecom Sector– Growing 4G user penetration rate

Ricky Lai

<u>Key Data</u>		<u>Sector Performance</u> (relative to HSI)	<u>Absolute</u> (%)	<u>Relative</u> (%)
Avg. 19E P/E (x)	22.6	1-mth	(9.2)	(3.7)
Avg. 19E P/B(x)	1.3	3-mth	(6.7)	2.9
Avg. 19E div yield (%)	2.3	6-mth	(12.7)	(14.8)
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities		
<ul style="list-style-type: none"><li>➤ In June 2019, MIIT granted the official 5G operating licenses to China Mobile (941 HK), China Unicom (762 HK), China Telecom (728 HK) and China Broadcasting Network Corporation Ltd</li><li>➤ We expect telecom operators to increase CAPEX for 5G network development in 2020E</li><li>➤ The Speed upgrade and Tariff Reduction policy will affect telecom operators' ARPU but will also stimulate data usage and mobile user growth.</li><li>➤ <b>China Mobile</b> is our top pick for its high dividend yield, healthy balance sheet, and dominant position in China's mobile business</li></ul>				



**We forecast 4G user penetration in China to reach 79.0% in 2019E and 85.0% in 2020E.** MIIT has announced slashing telecom operators' mobile service tariff by 20% and broadband tariffs for SMEs by 15% to boost internet penetration and improve network coverage in 2019. We forecast mobile ARPU to be affected by the lower data service fee. Downward pressure on mobile data tariff, however, have stimulated users' data usage – average mobile data per user reached over 7.32GB in Apr 2019, up 110.2% YoY. China's mobile users reached 1.59bn in April 2019, up 7.3% YoY. China's overall mobile internet users exceeded 1.34bn in Apr 2019, which accounted for 84.3% of total mobile users. According to MIIT, as of Apr 2019, 4G users reached 1.21bn, representing 76.1% of total mobile users in China. We expect 4G penetration rate to further increase and reaching 85.0% in 2020E, driven by migration of low-end users (from 2G/3G platforms to 4G), widespread use of dual SIM cards smartphones, and lower mobile service tariff. As of Apr 2019, 4G market share of China Mobile, China Unicom, China Telecom were 59.4%, 19.2%, and 21.4%, respectively.

**5G network will start commercial launch in 2H19.** In June 2019, MIIT granted the official 5G operating licenses to China Mobile, China Unicom, China telecom and China Broadcasting Network Corporation Ltd. Telecom operators are building a small-scale 5G network for testing and preparing for the commercial launch in 2H19. Several cities (e.g. Guangzhou, Shanghai, and Suzhou) will become the pilot areas for 5G network in China. The launch of 5G network will raise demand for telecom towers and equipment. Driven by stronger demand for network coverage by telecom operators and the introduction of discount rate for tower co-sharing, China Tower (788 HK)'s tenancy ratio reached 1.56 in Mar 2019. We forecast its tenancy ratio to reach over 1.70 in 2020E with the emerging 5G network.

**Wireline broadband user penetration rate to reach over 92% by 2020E.** We expect China's wireline broadband market in 2019 to grow steadily with better network speed and IPTV utilization rate. According to MIIT, wireline broadband users reached 426mn in Apr 2019 while fiber to the home (FTTH) users hit 387mn, or 90.8% of total wireline users. We forecast China's FTTH users to reach over 92% in 2020E, driven by demand from IPTV, online games, and high-quality videos.





**Global smartphone shipments showed the sixth consecutive quarter of decline.** According to IDC, global smartphones shipments were 310.8mn in 1Q19, down 6.6% YoY, marking the sixth consecutive quarter of decline, affected by longer phone replacement cycle, little innovative features for new smartphones, and increasing penetration rate. We forecast growth in global smartphone shipments to be sluggish for 2020E due to weak demand and unstable economic environment. On the contrary, smartphone ASP would increase on rising disposable income, consumption upgrade, and consumer preference for quality smartphones.

### Long-term Outlook

We expect telecom operators to increase CAPEX for 5G network development in 2020E since commercial launch would require more base stations and wider fiber network coverage. 5G network, with higher transmission rate and lower latency compared to 4G, will increase high-end user penetration rate. Reduced tariff of mobile data service has affected revenue growth, but telecom operators have launched various value-added services, IPTV, and video contents to boost adoption.

### Short-term Outlook

The Speed upgrade and Tariff Reduction policy will affect telecom operators' ARPU but will also stimulate data usage and mobile user growth. We forecast moderate growth in mobile service revenue in 2019E due to growth in data usage (+107.3% YoY) and mobile user growth (+6.8% YoY). Telecom operators are focusing on emerging businesses such as cloud computing, industrial internet, and smartphone applications with more value-added services to boost adoption. We expect mobile data traffic consumption to grow with higher demand for video transmission and longer smartphone surfing time.

### Stock Recommendations

**China Mobile (941 HK) is our sector top pick.** Thanks to its network advantage with better coverage and customer loyalty, China Mobile dominates telecom market in China with the highest market share by the no. of mobile users (59.2% as of Apr 2019). We expect the Group to benefit from increased mobile data consumption amid tariff cut in data service. Our TP is set at HK\$ 90.0, which implies 12.3x/13.3x FY19E/20E P/E.

### Risk Factors

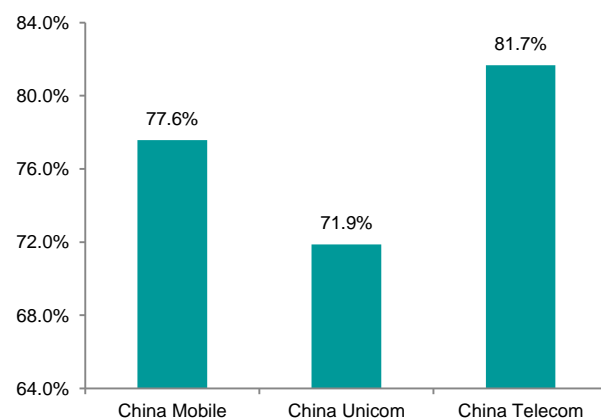
1) Further reduction in service tariff as requested by authorities; 2) User saturation; 3) Intensifying market competition; 4) Slower growth in smartphone shipments.

**Exhibit 1: China's average monthly data usage**



Source(s): MIIT, ABCI Securities

**Exhibit 2: China's 4G users penetration in Apr 2019**



Source(s): MIIT, ABCI Securities

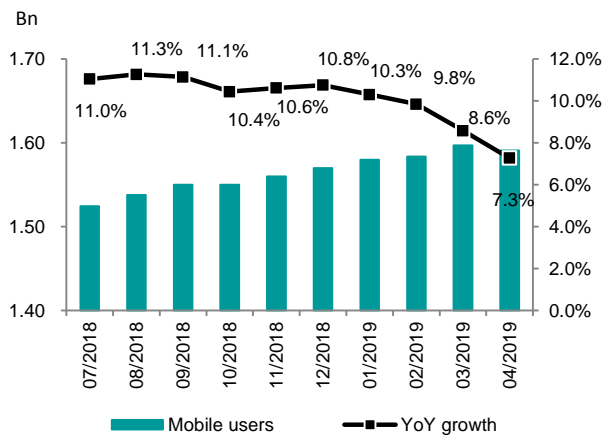


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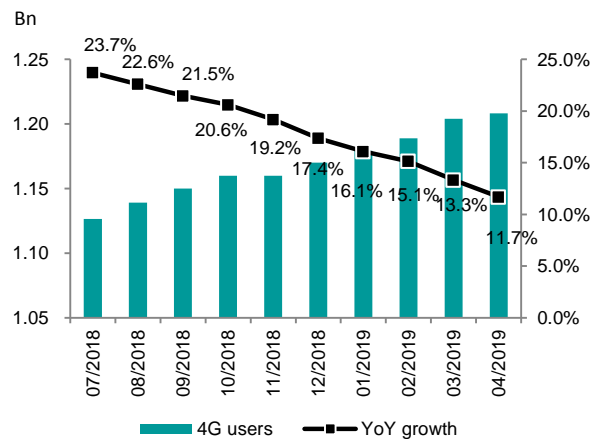
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Exhibit 3: China's overall mobile users and YoY growth



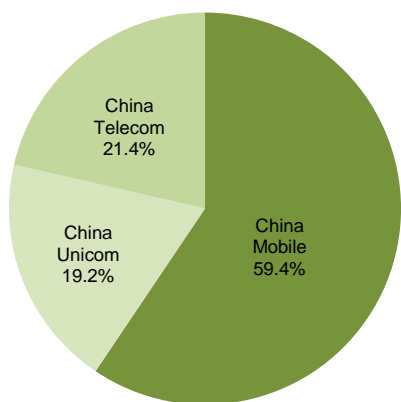
Source(s): MIIT, ABCI Securities.

Exhibit 4: China's 4G users and YoY growth



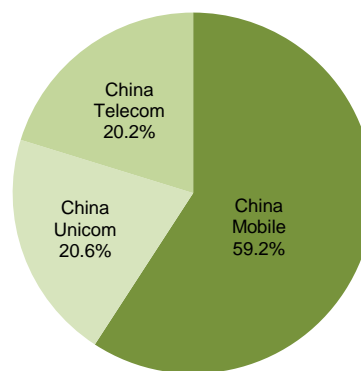
Source(s): MIIT, ABCI Securities

Exhibit 5: China's 4G user market share in Apr 2019



Source(s): MIIT, ABCI Securities

Exhibit 6: China's mobile user market share in Apr 2019



Source(s): MIIT, ABCI Securities

Exhibit 7: Valuation of sector top picks (Data as of June 21, 2019)

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
China Mobile	941	BUY	90.00	26.8	10.7	10.3	1.1	1.1	4.8	4.8

Source(s): Bloomberg, ABCI Securities estimates



## NEUTRAL

### China Education Sector – Pick the industry leaders

Paul Pan

Key Data		Sector Performance (relative to HSI)	Absolute (%)	Relative (%)	
Avg. 19E P/E (x)	15.12	1-mth	(0.91)	(3.86)	<p>1-year sector performance (%)</p>
Avg. 19E P/B(x)	2.09	3-mth	0.20	2.26	
Avg. 19E div yield (%)	2.39	6-mth	16.63	6.07	
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities			
<p>➢ Policies regarding vocational education sector have been launched; uncertainties remain as the “MOJ Draft for Comments” has not been finalized</p> <p>➢ Fundamentals of the listed education companies vary</p> <p>➢ Education industry remains attractive for its consistent growth; higher education sub-segment faces less policy risks and is the direct beneficiary of pro-vocational education policies</p> <p>➢ Recommend <b>BUY</b> on <b>CEG (839 HK)</b> and <b>Wisdom Education (6068 HK)</b></p>					

**Education sector continues to be in the policy spotlight.** After releasing the Vocational Education Reform Measures in Jan 2019, the government reiterated the emphasis on the development of the vocational education industry by targeting to increase student enrollment by 1mn in the Government Work Report on Mar 3, 2019. Such measures would bring more opportunities to the private education industry. However, the education industry still faces uncertainty in the potential regulatory changes, which mainly concerns the “MOJ Draft for Comments”.

**Diverging fundamentals.** Fundamentals of the listed education players in Hong Kong continue to diverge. Those active in M&A are able to expand in a quicker pace. Dispersion of return ratios also increases, suggesting enlarging variations in earnings quality among companies.

**Industry leaders remain attractive.** Since the education industry is relatively shielded from direct impacts of the Sino-US trade war, the sector’s investment appeal increases as the event escalates. Industry leaders continue to find support in valuation level. Among the listed companies, CEG (839 HK) and Wisdom Education (6068 HK) have the largest 2018/19 school year student enrollment in higher education and fundamental education sub-segments.

#### Long-term Outlook

We believe growth prospects remain attractive in the long term, supported by the demand for quality education and the large population base. More industry leaders will emerge.

#### Short-term Outlook

The education sector still faces uncertainties brought by the “MOJ Draft for Comments”. The policies aiming to boost the development of vocational education segment would bring more opportunities for the private education industry. We believe the higher education sub-segment has a lower level of policy risk compared to other sub-segments and is the direct beneficiary of the pro-vocational education policies.



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### Stock Recommendations

Our top picks are **CEG (839 HK)** and **Wisdom Education (6068 HK)** based on the (1) lower policy risk faced by the companies, their larger scale, and solid track record.

### Risk Factors

1) Demographic changes; 2) Policy risk; 3) Education quality and dropout risk; 4) Operation and reputation risks; 5) Expansion bottleneck; 6) Low share turnover implies stock liquidity risk



**Exhibit 1: Recent regulations/policies on education industry**

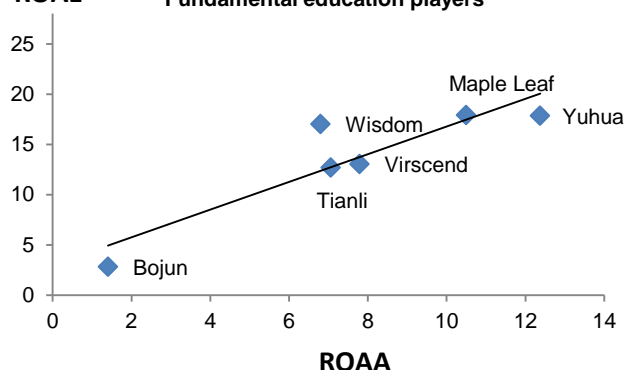
Regulation/Policy	Target	Objective
<p>Notice on Measures and Mechanism on Promoting Consumption in 2018-2020</p> <p>(国务院办公厅关于印发完善促进消费体制机制实施方案(2018—2020年)的通知)</p>	Entire education sector	<ol style="list-style-type: none"> <li>1) Accelerate the amendment process of the law for promoting private education</li> <li>2) Experiment on the cooperation between corporations and education institutions, and encourage shareholding structure reform of vocational schools</li> <li>3) Develop preschool/kindergarten education that benefits the mass - encourage local government to guide and support private preschool/kindergarten to provide education services at more favorable rates by purchasing services, reducing rent, and offering teaching staff support</li> <li>4) Launch policies and measures to support the development of care service for children under the age of 3</li> <li>5) Implement the opinion for regulating the after-school tutoring service providers</li> <li>6) Encourage the introduction of high-quality higher education/vocational education resources; start high-level Sino-Foreign cooperation at program and school level; establish the mechanism in which education bureau and the local government jointly participate in the approval of Sino-Foreign education programs at above the bachelor level</li> </ol>
<p>Guangdong – Hong Kong- Macau Greater Bay Area Development Guidelines</p> <p>(粤港澳大湾区发展规划纲要)</p>	Formal Education	<ol style="list-style-type: none"> <li>1) Encourage higher education institutions in the Area to recognize credits of designated courses, launch flexible exchange programs, and apply science for commercial use</li> <li>2) Introduce world-class higher education institutions into the region to promote development of regional higher education industry</li> <li>3) Encourage cooperation in employment, training, teacher-student communication, and professional skill competition for vocational education</li> <li>4) Encourage cooperation among primary/middle/high schools in the area; set up classes and provide boarding services for the children of the residents from Hong Kong and Macau</li> <li>5) Explore ways to open up the education industry for teachers in Grade 1-9 from Hong Kong &amp; Macau by allowing them to acquire teacher qualification in Guangdong and apply for teaching positions in schools in Guangdong</li> <li>6) Expand school capacity in the area to meet the needs resulted from increasing mobility within the area</li> </ol>
<p>Committee Draft of the regulations on the Implementation of the Law on Promoting Private Education in PRC (Revised Draft)</p> <p>(MOJ Draft for Comments)</p> <p>(中华人民共和国民办教育促进法实施条例(修订草案)(送审稿))</p>	Entire education sector	<ol style="list-style-type: none"> <li>1) To provide national guidelines for provincial governmental authorities to issue their own implementation opinions and licensing measures in relation to the specific implementation methods and operative approaches of the amended law based on the local conditions</li> <li>2) One of the newly-added policy is: Private education groups cannot take control of not-for-profit private schools via M&amp;A, franchising, or agreements</li> </ol>
<p>State Council's Opinion on Regulating the Tutoring Industry "State Council Opinions 80"</p> <p>(国务院办公厅关于规范校外培训机构发展的意见)</p>	K-12 after-school tutoring industry	<ol style="list-style-type: none"> <li>1) To provide guidance on regulating after-school training market for primary and secondary school students, including, among others, the operation standards that after-school training institutions should follow, the requirements and approvals necessary for opening new after-school training institutions, the guidance for daily operation of after-school training institutions, and the regulatory supervision scheme for after-school training institutions.</li> <li>2) Avg. floor space per student during one tutorial session should be no less than 3sqm</li> <li>3) Instructors in Chinese, Math, English, Physics, Chemistry, and Biology should obtain teacher qualifications</li> <li>4) Tutorial centers cannot receive students' tuition payments for more than 3 months in advance</li> <li>5) Contents of tutorial courses should not exceed the national guideline; students should be placed in courses that match their grade levels</li> </ol>
<p>Circular on Special Enforcement Campaign concerning After-school Training Institutions to Alleviate Extracurricular Burden on Students of Primary Schools and Middle Schools</p> <p>(关于切实减轻中小学生学习负担开展校外培训机构专项治理行动的通知)</p>	K-12 after-school tutoring industry	<ol style="list-style-type: none"> <li>1) Aims to alleviate after-school burden on primary and middle school students through inspection and rectification on after-school tutoring institutions</li> <li>2) By end-June 2018, the process of surveying the industry condition should be completed</li> <li>3) By end-2018, rectification process of non-compliance should be completed</li> <li>4) By end-June 2019, the inspection and review processes should be completed</li> </ol>



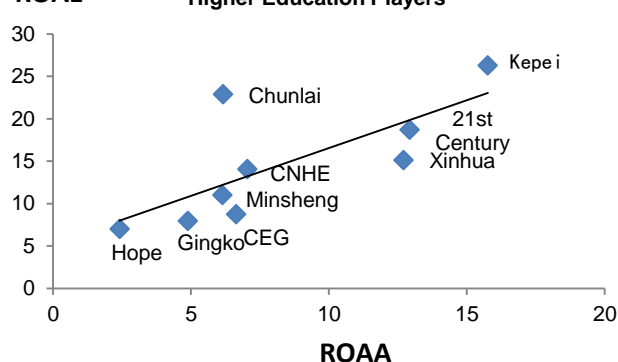
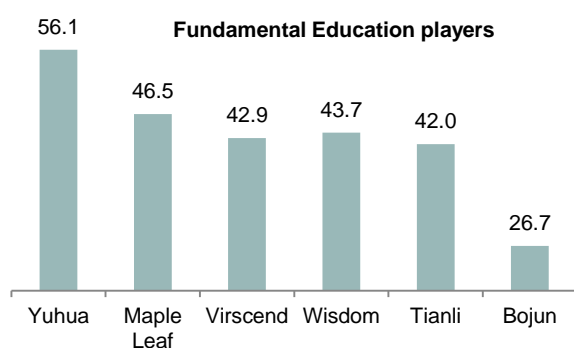
Regulation/Policy	Target	Objective
Mandatory salary increase for teachers in Grade1-9  (全力保障义务教育教师工资待遇 不断提高教师职业吸引力)	Compul- sory education (Grade 1-9)	1) Emphasize the current regulations' guidance on salary level of teachers in compulsory education (Grade 1-9) 2) Increase the salary levels of teachers in compulsory education to match those of the civil servants in the same region 3) Resolve the low salary issue of compulsory education teachers in three years
Opinion on Deepening Reform for Preschool Education  (中共中央国务院关于学前教育深化改革规范发展的若干意见)	Preschool education	1) Increase coverage of kindergartens that benefits the mass (普惠性幼儿园) to 80% by 2020; Increase the gross admission rate (毛入园率) for kindergarten to 85% by 2020 2) Complete the systematic establishment of preschool education related majors in bachelor/junior college and increase the number of bachelor/junior college graduates majoring in preschool education to 200k+ by 2020; increase the number of teachers/principals to 1.5mn 3) By 2035, coverage of preschool education for both urban and rural areas should be completed 4) Private kindergartens are prohibited to sell shares to the public either by themselves or as part of asset packages 5) Listed companies are not allowed to invest in private kindergartens through share sales or cash injections under the new policy 6) Private investors will be barred from backing public kindergartens
Notice on Reform Measures for Vocational Education  (国家职业教育改革实施方案)	Vocation- al education	1) By 2022, a large number of higher education institutions offering bachelor degree education would be transformed into institutions focusing on vocational education; 50 high-level vocational education schools should be established 2) By 2020, the number of outstanding vocational education groups should reach 300 3) Encourage different ownership structure in the development of vocational education industry 4) Establish a transparent mechanism that lays out threshold for entry and enables efficient approval for industry participants 5) Explore the negative list mechanism for private vocational education 6) Establish an exit mechanism for industry participants
Notice on Managing Kindergarten in Urban Residential Community  (国务院办公厅关于开展城镇小区配套幼儿园治理工作的通知)	Preschool education	1) The notice lays out the following tasks: * increase supply of kindergartens for urban residential community and ensure the construction of current and future kindergartens to be up to code; * ensure the timely transfer of kindergartens to local education authority; * after transfer, kindergartens should become public schools or schools that benefits the masses 2) By end-Apr 2019, the surveying of the condition for kindergartens for urban residential community should be completed 3) By end-Jun 2019, the transfer of existing kindergartens that have been waiting to be transferred should be completed 4) By end-Sep 2019, the transfer of existing kindergartens that have to be repurchased, reclaimed, or replaced should be completed 5) By end-Dec 2019, the required further construction of kindergartens should be completed; by end-Dec 2020, the inspection of these constructions should be completed
Notice on promoting modern apprenticeship system  (教育部办公厅关于全面推进现代学徒制工作的通知)	Vocation- al education	1) Promote cooperation between school & corporation in student recruitment 2) Build up standardized course system and dual-teacher system 3) Develop teaching materials that combine the resources of school and corporation 4) Develop flexible teaching methods to increase students' exposures to practical training
Notice on student recruitment in all types of schools  (教育部办公厅关于严格规范大中小学招生秩序的紧急通知)	Entire education sector	1) Provide guidelines on how to conduct student recruitment in the formal education sector 2) Emphasize student recruitment in compulsory education (Grade 1-9) should be conducted in a fair and unbiased manner; public and private schools should conduct student recruitment at the same time and private schools should not conduct student recruitment in ways that would disrupt the local recruitment order 3) Prohibit high school education institutions to conduct student recruitment that favors students with high grades or those would receive favorable treatment in the college entrance exams 4) Measures to manage student recruitment in higher education institutions

Regulation/Policy	Target	Objective
Notice on increasing vocational education student recruitment (高职扩招专项工作实施方案)	Vocational education	1) Target to increase vocational education student enrollment by 1mn in 2019 - a target mentioned in the Government Work Report released in Mar 2019 2) Major tasks include: increasing the student enrollment quota across the nation; conducting an additional application process before the college entrance exam in 2019;
Notice on increasing the skill level of the technician talent pool (国务院办公厅关于印发职业技能提升行动方案(2019—2021年)的通知)	Vocational education	1) Lay out the target to increase the overall skill level of the technician talent pool from 2019 to 2021, during which the subsidized vocational training would reach more than 50mn students; in 2019 such training should reach more than 15mn students; the proportion of technicians in the total employable population should reach more than 25% and the proportion of high-skill level technicians should reach more than 30% by end-2021 2) Provide subsidies for corporations that provide vocational training 3) Mandate local government should pool together RMB 100bn to be used in vocational training related development 4) Provide incentives for corporations: the maximum % of education expenses deduction for pretax profit increases to 8%

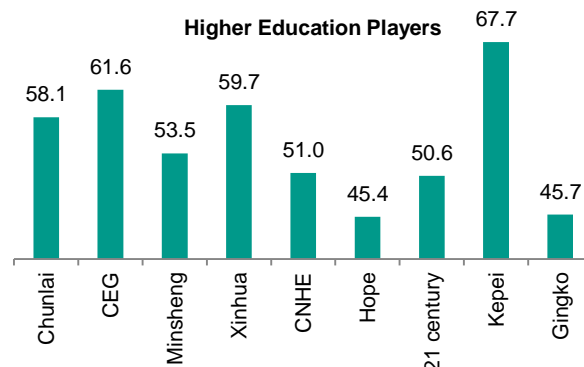
Source(s): gov.cn, MOE

**Exhibit 2: FY18 Return ratios of listed education companies (%)**
**ROAE Fundamental education players**


Source(s): Companies, ABCI Securities

**ROAE Higher Education Players**

**Exhibit 3: FY18 Gross profit margin of listed education companies (%)**


Source(s): Companies, ABCI Securities



Remarks: 21st Century (1598 HK); Bojun (1758 HK); CEG (839 HK); Chunlai (1969 HK); CNHE (2001 HK); Gingko (1851 HK); Hope (1765 HK); Kepei (1890 HK); Maple Leaf (1317 HK); Minsheng (1569 HK); Tianli (1773 HK); Virscend (1565 HK); Wisdom (6068 HK); Yuhua (6169 HK)

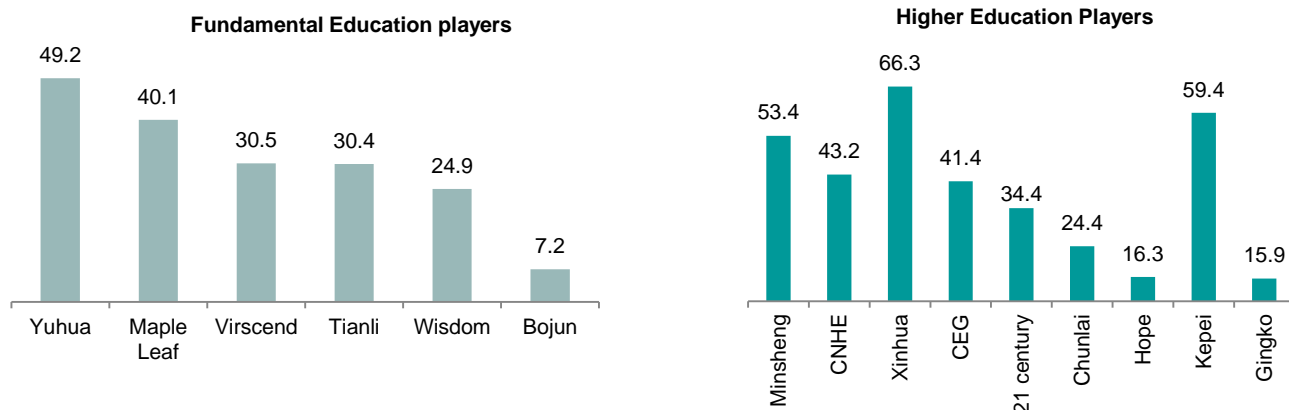


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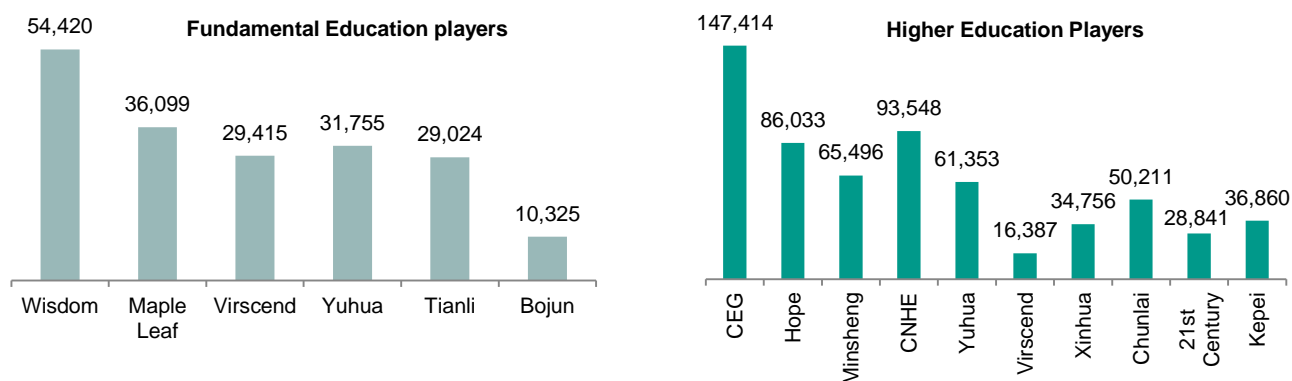
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**Exhibit 4: FY18 Net profit margin of listed education companies (%)**



Source(s): Companies, ABCI Securities

**Exhibit 5: 2018/19 school year student enrollment of listed education companies (ppl)**



Source(s): Companies, ABCI Securities

Remarks: 21st Century (1598 HK); Bojun (1758 HK); CEG (839 HK); Chunlai (1969 HK); CNHE (2001 HK); Gingko (1851 HK); Hope (1765 HK); Kepei (1890 HK); Maple Leaf (1317 HK); Minsheng (1569 HK); Tianli (1773 HK); Virscend (1565 HK); Wisdom (6068 HK); Yuhua (6169 HK)

**Exhibit 6: Valuation of sector top picks (Data as of June 21, 2019)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
CEG	839	BUY	14.0	15.89	26.80	21.81	3.57	3.21	1.20	1.55
Wisdom Education	6068	BUY	4.7	12.44	21.38	15.80	3.57	2.91	1.78	2.41

Source(s): Bloomberg, ABCI Securities estimates



## NEUTRAL

### China Consumer Goods Sector – Near-term challenges inevitable Paul Pan

Key Data		Sector Performance (relative to HSI)		
			Absolute (%)	Relative (%)
Avg. 19E P/E (x)	17.29	1-mth	4.20	1.24
Avg. 19E P/B(x)	2.35	3-mth	(2.30)	(0.25)
Avg. 19E div yield (%)	2.35	6-mth	16.65	6.08
Source(s):Bloomberg, ABCI Securities estimates		Source(s):Bloomberg, ABCI Securities		
<div>➤ Volatile retail sales growth reflects a new economic reality of moderating growth</div> <div>➤ Inflationary pressure is ticking up again</div> <div>➤ The government has dispatched policies to support domestic consumption; we expect more pro-consumption measures to be rolled out soon</div> <div>➤ We favor leaders in the consumer goods sector with a strong domestic presence. Maintain <b>BUY</b> on <b>WH Group (288 HK)</b></div>				

**1-year sector performance (%)**

Legend: — Sector avg. — HSI

Source(s):Bloomberg, ABCI Securities

**Volatile retail sales growth reflects a new economic reality.** Retail sales growth in China declined to 7.2% YoY in Apr 2019 from 8.7% YoY in Mar. 5M19 online retail sales growth was 17.8% YoY, compared to the 30.7% YoY for 5M18. The volatile growth suggests the downward pressure on retail sales growth increases.

**Inflation may weaken consumption.** Substantial price increase of basic consumer goods was seen in 2019. According to MOA, the wholesale pork price has increased by 27.1% YoY or 6.4% YTD as of the second week of June; the wholesale price of broilers has soared by 46.5% YoY and 16.6% YTD, showing the substitution for pork with chicken is like to push up chicken price as the African Swine Fever continues to spread. In addition, the average wholesale price of five fruits monitored by MOA increased by 41.1% YoY and 37.3% YTD as of the 3rd week of June. We believe that the disruption in the supply chain, Sino-US trade dispute and unfavorable weather are contributing to the rising inflation. We project domestic consumption growth would lessen given the rising inflationary pressure amid a stable disposable income growth.

**More supportive policies to boost consumption.** The government has dispatched policies to support domestic consumption. In 2018, the government released the Notice on Measures and Mechanism on Promoting Consumption in 2018-20; the State Council launched the “Notice on Personal Tax Deductibles” to reduce the tax burden for consumers; the State Council, NDRC, and 8 other authorities released the “Measures to Promote Domestic Consumption and Strengthen the Consumer Market in 2019”. We expect more policies concerning the consumer market would be launched later in 2019.

#### Long-term Outlook

In the long-term, we are confident that China's consumer market will remain resilient, supported by the large population base and the continuous consumption upgrade.

#### Short-term Outlook

Near-term risks include the slowdown of the national economic growth, the increasing inflationary pressure, and a more challenging external environment involving increasing tension in trade relations.



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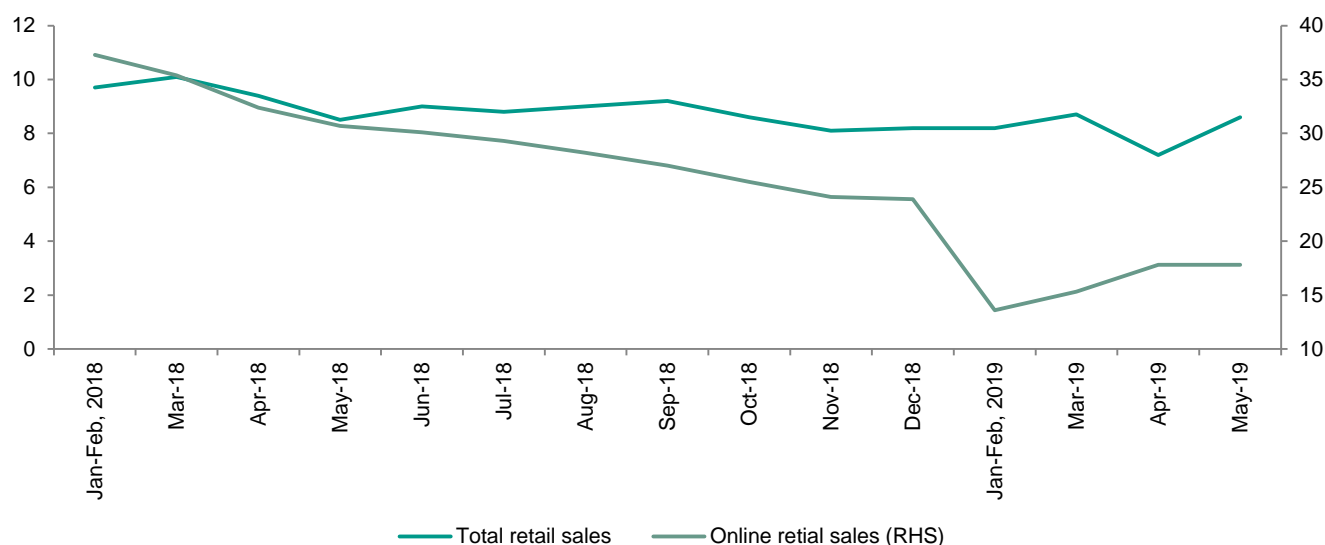
### Stock Recommendations

We favor companies with strong domestic presence, namely the industry leaders in the consumer goods industry. We maintain **BUY** on **WH Group (288 HK)** since the Group has more power in product pricing given the pork price inflation.

### Risk Factors

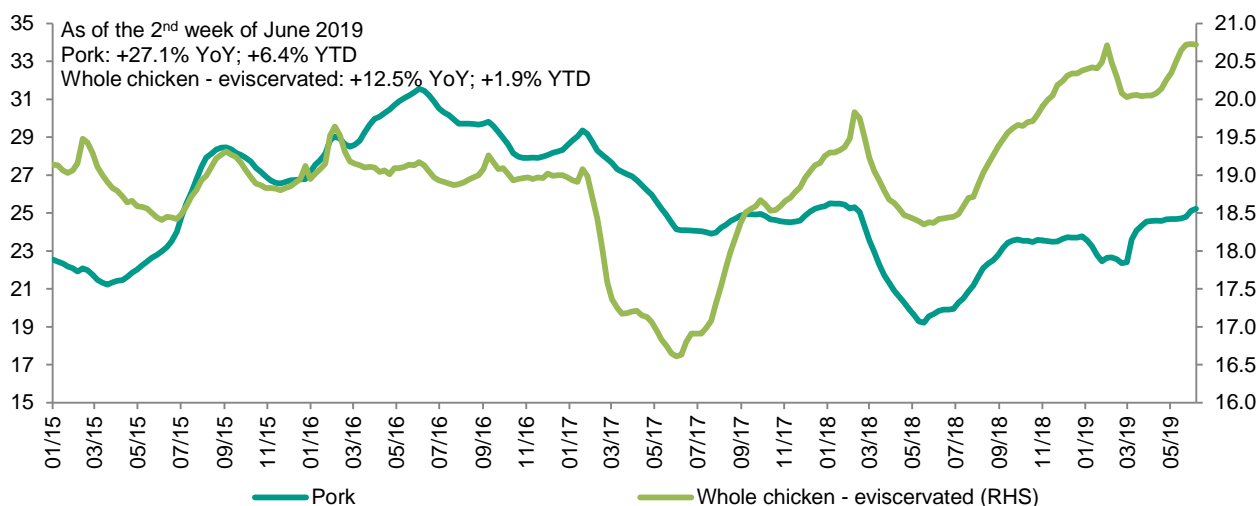
1) Macroeconomic risk; 2) Policy risk; 3) Product quality risk; 4) Commodity price risk

**Exhibit 1: National retail sales (YoY%) and online retail sales growth (YTD YoY %)**



Source(s): NBS, ABCI Securities

**Exhibit 2: Wholesale price of pork (RMB/kg) and chickens (RMB/head) in China (RMB)**



Source(s): MOA, ABCI Securities





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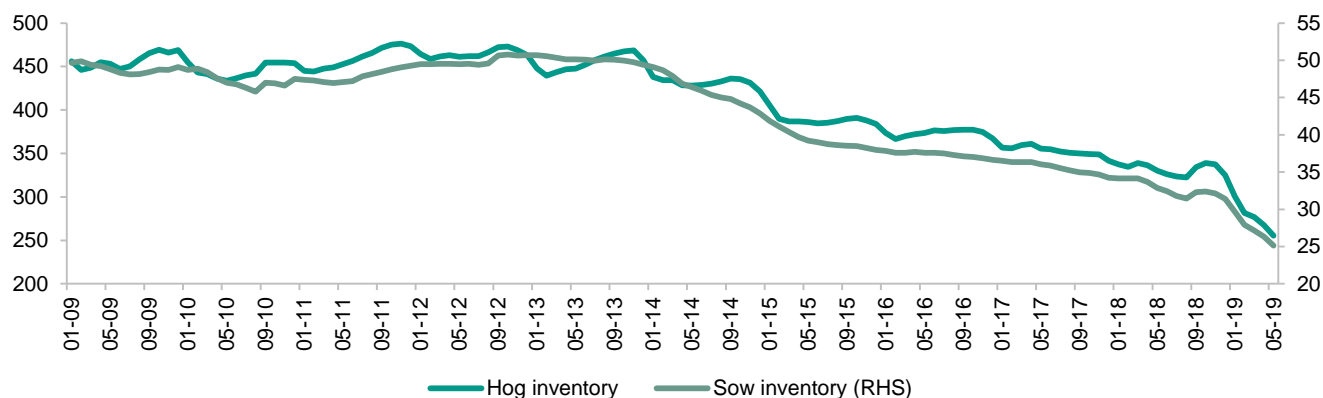
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**Exhibit 3: Wholesale price of broilers (RMB/head) and chickens (RMB/head) in China (RMB)**



Source(s): MOA, ABCI Securities

**Exhibit 4: Hog and sow inventory in China (mn heads)**



Source(s): MOA, ABCI Securities

**Exhibit 5: Fruit price\* (RMB/kg)**



\*Average price of the five fruits monitored by the MOA, including apple, grape, banana, pineapple, and watermelon

Source(s): MOA, ABCI Securities



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**Exhibit 6: Valuation of sector top picks (Data as of June 21, 2019)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY19E P/E(x)	FY20E P/E (x)	FY19E P/B (x)	FY20E P/B (x)	FY19E Yield (%)	FY20E Yield (%)
WH Group	288 HK	BUY	9.14	13.54	11.91	10.10	2.08	1.96	3.39	3.94

Source(s): Bloomberg, ABCI Securities estimates

## Disclosures

### Analyst Certification

The analysts, CHAN Sung Yan, AU Yu Hang, Johannes, CHOW Sau Shing, LAI Pak Kin, NG King Chuen, PAN Hongxing, TUNG Yiu Kei, Kenneth, YAO Shaohua, being the persons primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. We and/or our associates do not serve as officer(s) of the listed company (ies) covered in this report.

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Philip Chan holds H-shares of Agricultural Bank of China Ltd (1288 HK).

### Definition of equity rating

Rating	Definition
Buy	Stock return rate $\geq$ Market return rate (10%)
Hold	- Market return rate (-10%) $\leq$ Stock return rate < Market return rate (+10%)
Sell	Stock return < - Market return (-10%)

Notes: Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months

Market return rate: average market return rate since 2005 (HSI total return index CAGR at 10%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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