ABCI
Policy
Snapshot

Macroeconomic and Industry Perspectives on PBOC's fourth RRR cut in 2018

Oct 9, 2018

農銀國際
ABC INTERNATIONAL
ABCI SECURITIES COMPANY LIMITED

Macroeconomic and Industry Perspectives on PBOC's fourth RRR cut in 2018

Macroeconomic view of PBOC's RRR cut

PBOC announced last Sunday (Oct 7) to lower the RRR for most commercial banks by 1 percentage point, effective from Oct 15. The cut will release a total of RMB 1.2tr, of which RMB 450bn will be used to repay existing MLF and RMB 750bn will be injected into the banking system.

After this reduction, RRR for large financial institutions will be 14.5%; RRR for medium and small financial institutions will be 12.5%, the lowest levels since 4Q07. We believe such moves are targeting to (1) support economic growth amid escalating Sino-US trade conflict and weakening domestic demand; (2) lower financing costs, especially for small, private and startup enterprises; (3) boost domestic stock and bond markets due to surging US treasury yields during Golden Week holiday (Oct 1-7) .

PBOC's RRR cut is a form of monetary easing, which is likely to increase depreciation pressure on RMB. PBOC has more than US$ 3tr in foreign exchange reserves and a number of policy instruments, such as countercyclical factor mechanism on the CNY fixing rate, as well as the ability to intervene the offshore market. Therefore, we expect only a modest depreciation for the currency. We expect the onshore USD/CNY rate to fluctuate at ~6.90 in the near future.

According to PBOC's announcement, the main purpose of the RRR cut is to optimize the liquidity structure and enhance the capacity of financial services to serve the real economy. The property market is unlikely to directly benefit from the RRR cut as regulatory measures for real estate will remain in place, and the government's grip on mortgage quotas and interest rates will remain tight. However, given that interest rates in financial markets may fall due to this RRR cut, debt financing for property developers may improve to some extent.

Policy Snapshot

Looking ahead, we forecast RRR would be slashed one more time in the remainder of 2018 and thrice in 2019, given the mild inflationary pressure, accelerating economic slowdown, as well as the high RRR level around the world. Regarding the exchange rate, we expect spot USD/CNY rate to approach 6.90 at end-2018E and 7.00 at end-2019E with the rising US interest rates.

Impact on industry:

China Banks Sector

Industry impact:

- PBOC announced to cut RRR of large commercial banks, joint-stock commercial banks, city commercial banks, non-county rural commercial banks, and foreign banks by 1ppt, effective from Oct 15. RRR of large financial institutions and medium-to-small sized financial institutions will be 14.5% and 12.5% after the reduction. This RRR cut is expected to release RMB 1.2tr of liquidity to the market, of which RMB 450bn will be used to repay the medium-term loan facility (MLF) due on Oct 15, while the remaining RMB 750bn will be directed to the banking system.

- PBOC is reducing the size of its balance sheet, aligning with the country's key policy of de-leveraging and gradually shifting the responsibility of regulating market liquidity to the banks. The government is encouraging market-driven liquidity as well as providing conditions for banks to support the real economy. Recent data shows sufficient banking system liquidity, as evidenced by the decline in SHIBOR of various duration since July while excess deposit reserve ratio rebounded from 1.51% by end-Mar to 2.19% by end-June. The data also points to the fact that banks remain cautious and only lend selectively. Nonetheless, if banks refuse to increase support to the policy-targeted areas over the next few months, policy risk in the sector will increase. .

- This RRR cut aims to optimize the liquidity structure and enhance the capacities of financial services to serve the real economy. With the increase in credit supply in recent months, data shows increasing demand for medium- and long-term liquidity in financial institutions. PBOC indicated that guidance will continue be given to financial institutions to support funding of small and micro enterprises, private enterprises, and innovative enterprises by reducing corporate financing costs. Although loan pricing reflected strong demand (75.24% of loans were priced at above the benchmark interest rate by end-June), financing cost of these policy-supported industries will gradually reduce.

- PBOC has repeatedly emphasized on maintaining a prudent and neutral monetary policy. It focuses on targeted adjustment to maintain liquidity at a reasonable and sufficient level, and guides towards a rational expansion in credit and social financing supportive to high-quality development and supply-side reforms in China. Since the Sino-US conflict shows no sign of abating, and President Trump is likely to maintain an unyielding attitude before the US mid-term election in Nov, we believe the latest RRR cut reflects that PBOC is preparing for a prolonged trade war.

Stock impact:

- Given the sufficient liquidity at present, we believe the RRR cut would have limited impact on the bank sector. Big banks would be less affected, thanks to their high degree of business diversification. **ABC (1288 HK)**, whose business is supported by national policy and **CCB (939 HK)**, who is prudent in practices, are our sector top picks.

- Conversely, reduction in social financing costs will mildly affect joint-stock banks and district banks since they are more heavily dependent on businesses from small- and medium-sized enterprises and private enterprises. In particular, district banks do not possess the same bargaining power as their sizeable counterparts.

China Securities Sector

Industry impact:

- Overall, the short-term impact of the RRR cut on the sector will be determined by reactions in the domestic capital market, which in turn will affect related businesses in the securities industry.

- According to the Securities Association of China, revenue contributions of different segments in the securities industry in 1H18 were as follows: securities brokerage (29%), securities trading (23%), investment banks (14%), asset management (11%), and Others (23%). As securities trading and brokerage revenue accounted for more than half of the industry's revenue, changes in trading volume as well as major benchmark indices in the stock market has affected performance of the securities industry.

- In general, the trading volume of A-shares has been declining since the beginning of this year. Average turnover has fallen from the peak in Jan at RMB 521bn to RMB 261.6bn in Sep. Within the period, four RRR cuts have been effected in China. The impact on trading turnover, however, was muted and the declining trend continued. In addition, the Shanghai Composite Index fell from above 3,500 in Jan this year to below 2,800 at present, implying negligible impact of the RRR cut on supporting major indices.

- Although the RRR cut is conducive to optimizing the liquidity structure of the financial market and creating a suitable monetary and financial environment for high-quality development and supply-side structural reforms, its impact on the securities industry are limited in the short term.

Stock impact:

- We maintain a Neutral rating for the China Securities sector. Valuation is reasonable, but there is a lack of positive catalysts amid the deteriorating operational environment

- We suggest investors to reduce exposure to securities companies such as **DFZQ (3958 HK)** whose revenue is dependent on propriety trading.

China Property Sector

Industry impact:

- The Chinese real estate market has been tightly regulated by tightening measures over the past few years. The purpose of the latest RRR reduction is to support the real economy − and funds released by the RRR may not be able to flow into the real estate sector. With home purchase restrictions (HPRs) and borrowing restrictions in place, banks have been conservative in loaning to real estate companies and personal mortgages. We believe RRR cut would not be able to reduce the hefty financing cost in the property sector. According to the latest data from Rong 360, the average interest rate of the first-home loan in Aug 2018 was 5.69%, equivalent to 1.161x benchmark interest rate, up 5bps MoM or 57bps YoY. Based on our statistics on 20 major developers listed in HK, average borrowing costs increased from 6.1% for FY17 to 6.5% for 1H18. RRR cuts in 2018 have limited impacts on reversing the rising interest rate in the sector.

- The RRR cut will add to the deleveraging effort in China. PBOC's Pledged Supplemental lending (PSL) is the main source of monetary compensation for China's shanty-town redevelopment projects. As deleveraging continues, money released from PSL to these projects may slow, affecting the home-purchasing demand of residents finding a replacement home. In fact, impetus in shanty-town projects has begun to slow a few months ago. In July, the Ministry of Housing and Urban-Rural Development (MOHURD) said policy on shanty-town redevelopment has to be adjusted accordingly for cities with rising property price and insufficient inventories. The slowdown in shanty town redevelopment may adversely affect the real estate market in third- and fourth-tier cities.

- The RRR cut may also aggravate depreciation pressure of RMB. If the RMB depreciates against the USD, foreign exchange losses in the income statement will increase for developers when they revalue their USD debts at year-end and lower profitability as a result.

Stock impact:

- As the rising trend of real estate interest rates is unlikely to reverse, we believe developers with fast sales growth and ability to generate strong cash inflow from their own businesses will have less refinancing pressure. Contracted sales of **Times China (1233 HK)** and **China Aoyuan (3883 HK)** in 9M18 rose 55%YoY and 137%YoY. The two developers, which are our sector top pick, have high exposure in the Greater Bay Area (GBA), with the region accounting for 87% and 53% of their 2017 contracted sales. Also, these developers have a substantial number of redevelopment projects lined up in the GBA, which is promising for future presales and earnings growth.

- For investors seeking to gain exposure in the China property market, the property management sector is an alternative. **A-living (3319 HK)** is our top pick among the HK-listed property management companies (PMCs). Agile (3383 HK) and Greenland (600606 CH), A-living's two major shareholders, provide a steady pipeline of new projects for the company to manage. Driven by fast-growing GFA under management, A-living's 1H18 net profit rose 196% YoY to RMB 332mn; injection of property agency business from parent group also drove VAS revenue up by 352% YoY to RMB 655mn in 1H18.

China Environmental Protection Sector / Alternative Energy Sector

Industry impact:

- **Waste incineration:** As a capital- and technology- intensive industry demanding a large start-up capital, China's waste incineration industry is mostly operated by state-owned enterprises (SOEs) or those with an SOE background. Since there are only a few private enterprises, the direct benefits to industry players are limited. Nonetheless, lowering the RRR will help reduce the cost of borrowing, easing some of the financial pressure faced by highly leveraged companies.

- **Sewage treatment:** Similar to the waste incineration industry, sewage treatment industry is a capital- and technology-intensive industry. While SOEs are the main players, the proportion of private participants is slightly higher compared to that in waste incineration industry. The latest RRR cut will provide support to these private sewage companies. Since sewage treatment is not an innovative industry, assistance to the private players would mainly be in the form of lowering the interest rate for loans.

- **Nuclear power:** Nuclear power generation is an industry with high entry barriers, demanding high technology, massive capital investment, and government approval. Therefore, all participants in this industry are SOEs. The interest rate of SOEs is generally at an acceptable between 4% and 5%. The aim of the latest RRR cut is to help financing for small and micro enterprises, we believe the nuclear power companies will not be benefiting much.

- **Wind power:** State-owned power generation groups are early entrants in the wind power industry, occupying quality regions where wind resource is abundant. Private companies tend to find it hard to enter the industry and control only a minor market share. Borrowing rates of wind power operators are similar to that of the nuclear operators at ~4%-5% due to stable cash flow and SOE background. Latest RRR cut would not offer much support to the sector.

Stock impact:

- **Beijing Enterprises Water（371 HK）.** Net gearing of the company was 84% in 1H18, and the RMB lending rate was at ~4%. The RRR cut would improve the mobility of social capital, helping the company to replace its high-cost RMB borrowing with cheaper alternatives.

- **CGN Power（1816 HK）** and **Datang Renewable（1798 HK）** should benefit the most from the latest RRR cut. Net gearings of CGN and Datang were 177% and 318% in 1H18, which were high, and RMB borrowing cost was at ~5%. This RRR cut offers a good opportunity for these companies to replace its high-cost debts with cheaper ones to lower financial burden.

- We believe waste incineration, sewage treatment, nuclear power generation and wind power generation industries are capital- and technology-intensive; private and smaller-sized enterprises have always been the minority. Also, these industries are not regarded as innovative industries, hence direct benefits from the latest RRR cut would be limited. Indirect benefits of the slashed RRR include improvement in social capital mobility, which may help reduce borrowing cost.

China Internet Media and Consumer Commerce

Industry impact:

- China's Internet / e-commerce companies mainly rely on capital markets, such as stock markets and venture capital markets, for funding. Except for mammoth Internet / e-commerce platforms such as Tencent (700 HK) and Alibaba (BABA US), other small- and medium-sized Internet / e-commerce platforms or new-economy startups often find it difficult to obtain bank loans due to their business model and financial status. As a result, we believe the direct benefit of RRR cut to these companies is limited.

- For large Internet/ e-commerce platforms such as Tencent and Alibaba, there is no negative impact on their existing market leadership due to limited direct benefit from the RRR cut on small and medium-sized Internet / e-commerce platforms.

- **Stock impact:**

- Overall, the online gaming industry is facing various headwinds. First, the rising popularity of short video platforms may reduce the time users spend on online games. In addition, regulatory control over the online games industry has been tightening, as marked by .a more stringent online gaming approval process that would inevitably disrupt the pace of game launching and eventually, revenue.

- Online retail sales growth remains sound. According to the National Bureau of Statistics, online retail sales in 8M18 increased by 28.2% YoY to RMB 5,520bn. In addition, online sales of physical goods increased by 28.6% YoY to RMB 4,199bn, which was 19.6 percentage points higher than the total retail sales growth for the same period. Overall, online sales of physical goods accounted for 17.3% of the total retail sales in 8M18, an increase of 3.5 percentage points over the same period last year.

- Headwinds in the internet gaming segment will continue, while online sales growth should remain largely resilient in the near term. Alibaba (BABA US) remains our sector top pick.

China Consumer Sector / Education Sector

Industry impact:

Consumer goods

- China retail sales growth declined from 10.1% YoY in Mar to 9.0% in Aug. Meanwhile, the interim results of consumer goods companies' showed increase in S&D expenses, indicating intensifying market competition and softening sentiment in the consumer market.
- We do not believe RRR cut would have a significant impact on consumption growth in the short term, as liquidity created by the RRR cut would take time to affect the real economy. We expect retail sales growth would continue to decline in the next few months, and consumer good players will encounter intensifying competition.

Education

- The education sector would not be heavily impacted by the RRR cut, due to its much longer industry cycle and strong demand in China. Although China's economic growth has slowed, business performance of the listed education companies remain resilient.

Stock Impact:

- **Consumer goods:** As retail sales growth declines and market competition intensifies, we believe the large consumer goods companies would be preferable based on defensiveness. Our top-picks are **Yili (600887 CH), Mengniu (2319 HK), WH Group (288 HK), and Anta (2020 HK)**, which unanimously recorded a decent revenue growth in 1H18.
- **Education:** For the education sector, school size, geographical distribution, and operational track record are important criteria to consider for investment. Our top picks are: **CEG (839 HK)** and **Wisdom Education (6068 HK)**. CEG (839 HK) currently has the largest student enrollment among the HK-listed education companies and has successfully conducted several acquisitions. In addition, both companies are operating schools in prosperous regions such as Guangdong and cities in eastern coastal area.

China Telecom Sector

Industry impact:

- The RRR cut will boost information consumption. On Sep 20, the State Council of China proposes to increase the role of consumption in promoting economic growth, to develop more mature consumption market segments and to improve systems and mechanisms for stimulating consumer spending.

- PBOC decided to lower the deposit reserve ratio of some financial institutions to lessen financing cost and reducing the interest cost for SMEs. This will help enterprises to expand businesses. Demand for internet services from SMEs will increase, and operators can accelerate the development of 5G telecom network, facilitating the development of Internet of Things and industrial internet in the future.

Stock impact:

- RRR cut has entered the normalization cycle. We believe the latest cut aims at providing targeted support to SMEs and allocating resources to support the real economy amid the downturn triggered by the trade war. RRR cuts will help improve market risk appetite, reduce credit spreads, and improve private sector financing to boost information consumption.

- Information consumption, as an important emerging consumer sector, is at a critical stage of rapid development. According to estimates by the Ministry of Industry and Information Technology, the amount of information consumption in China in 1H18 reached RMB 2.3tr, up 15% YoY, which is 2.2 times the GDP growth rate for the same period. It plays an important role in stimulating domestic demand, promoting employment, and fostering industrial upgrade. Information consumption is expected to reach RMB 5tr in 2018, up 11% YoY compared to 2017. The telecom industry will contribute to information consumption, and the rapid development of communication networks will deepen the integration of information and consumption both online and offline.

Policy Snapshot

- **China Mobile (00941 HK)** is developing its fixed-line business. From Jan-Aug 2018, user addition in its fixed-line business is much higher than other operators. In the future, the company will further improve its share in enterprise fixed-line segment and profitability.

Policy Snapshot

Contributors

Investment Strategy - Philip Chan,
Head of Research
philipchan@abci.com.hk

Macroeconomics - Andy Yao
yaoshaohua@abci.com.hk

China Banks Sector - Johannes Au
johannesau@abci.com.hk

China Brokerage Sector / Internet Media & Consumer Commerce - Steve Chow
stevechow@abci.com.hk

China Property Sector - Kenneth Tung
kennethtung@abci.com.hk

China Environmental Protection / Alternative Energy Sectors - Kelvin Ng
kelvinng@abci.com.hk

China Consumer / Education Sectors - Paul Pan
paulpan@abci.com.hk

China Telecom Sector - Ricky Lai
rickylai@abci.com.hk

More Research Reports

Disclosures

Analyst Certification

The analysts 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 my 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 have no financial interests in relation to the listed company (ies) covered in this report, and we and/or my associates do not serve as officer(s) of the listed company (ies) covered in this report.

Disclosures of Interests

ABCI Securities Company Limited and/or its affiliates, within the past 12 months, have investment banking relationship with one or more of the companies mentioned in the report.

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

Definition of equity rating

Rating	Definition
Buy	Stock return rate≥ Market return rate (10%)
Hold	- Market return rate (-10%) ≤ 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 2005-17 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.

Disclaimer

report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither ABCI Securities Company Limited nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. Additional information will be made available upon request.

Office address: ABCI Securities Company Limited, 13/F Fairmont House, 8 Cotton Tree Drive, Central, Hong Kong.

Tel: (852) 2868 2183