農銀國際
ABC INTERNATIONAL
ABCI SECURITIES COMPANY LIMITED

Hong Kong/China Equity Research

2013 Market Outlook

December 20, 2012

New growth model, New Opportunities

2013 will be marked by China's new leadership with policy initiatives aiming at 'Four New Modernizations' of China's economy. Improving economic indicators has supported a turnaround in the oversold Hong Kong/China equity markets in 4Q12 and investors would likely increase their optimism on the pace of the China's economic recovery in 2013. We expect China's economic growth at 8.1% in 2013.

Attractive stock valuations, a market reconciled to a period of low interest rates, positive economic outlook and recovery of corporate earnings will drive the flow of liquidity which provides fundamental support for Hong Kong equity market. We forecast **the HSI and HSCEI to reach 25,000 and 12,800 by end-2013, equivalent to a 2013F PER of 12.1 and 9.7, respectively.**

Taking into account earnings cyclicality and structural reforms in 2013, we recommend **an Overweight position in insurance, property, construction machinery and consumer staples** and **a Neutral position in bank, thermal coal and wind power.**

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2013 Outlook and Strategy Overview

Entering a new era of investment cycle

2013 is the year of 'Water Snake'. Water means liquidity (money) in Hong Kong's culture. The continuous credit loosening through quantitative easing (QE) by developed economies has caused a flood of global liquidity and Hong Kong, as a 'Water Snake' in 2013, is highly likely to be the destination of liquidity. Surging market liquidity appears to be the major driver of short-term rebound of stock market but vulnerable global economic outlook amid the risks of fiscal cliff, EU sovereignty debt crisis, and the structural transition of China economy pose risks to sustain stock market momentum. In general, we still remain positive on China and Hong Kong's equity markets in 2013 with the following bullish themes in 2013:

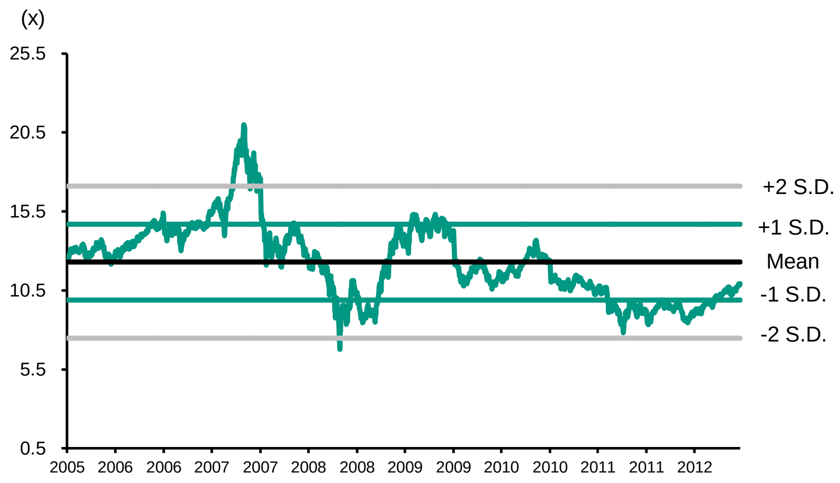
- The new Chinese leadership further strengthening structural economic reforms (i.e Four new modernizations).
- Cheap valuation and humble relative performance in 2012
- Equity valuation revised upward on improved earnings expectations and more optimistic market sentiment.
- Contained inflation risk with prudent monetary policies and proactive fiscal policies
- Stable renminbi appreciation surrounded by ample global liquidity

With economic cycle bottomed in 3Q12, investors would likely increase their optimism on the pace of China economic recovery in 2013. Together with the worry on US's fiscal cliff and the economic downturn in Europe, investors may shift their investment interest towards Asia to seek higher returns. The preferred stock ideas rest on the forward valuation and growth potentials driven by the firms' earning growth and economic environment of structural reforms.

Targets of HSI and HSCEI

The Hong Kong market was downgraded partly due to much slower EPS growth (of 0.7% in 2012F versus 10.3% in 2011 for HSI Index) in 2012. The HSI and HSCEI are currently trading on an attractive forward PER of 10.8 and 8.4, respectively, for 2013, with which the consensus outlook has not reflected the recovery momentum of corporate earnings in 2013. Both indices are trading below the mean of PER over the past 15 years. This situation has been caused mainly by excessive market worries (e.g. economic risks and corporate earnings risks), which led to a high risk premium for stock investments. Should the market concerns abate and corporate earnings gaining momentum, we estimate **the HSI and HSCEI to reach 25,000 and 12,800 by end-2013, equivalent to a 2013F PER of 12.1 and 9.7, respectively.**

The leading PE of HSI is attractive (up to Dec. 19, 2012)



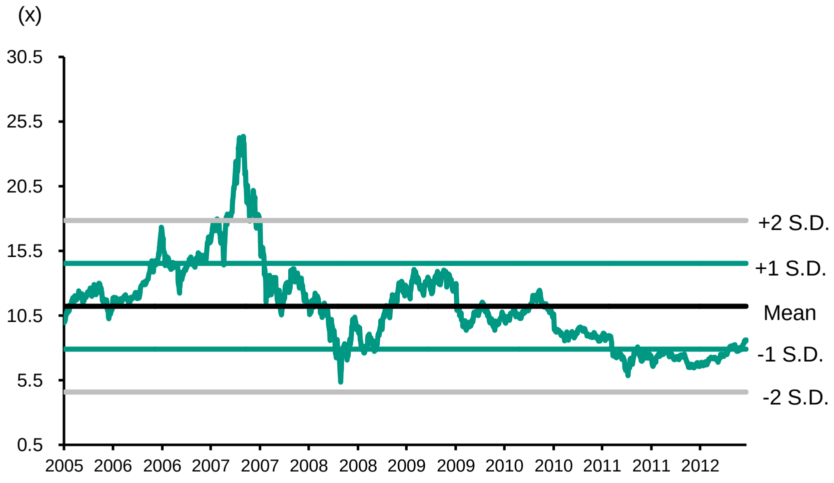
Source: Bloomberg, ABCI Securities estimates

Descriptive statistics of the leading PE movement of HSI

Statistics	Leading PE(x)
Mean	12.3
Mean +1 S.D.	14.7
Mean -1 S.D.	9.9
Mean +2 S.D.	17.1
Mean -2 S.D.	7.5

Source: Bloomberg, ABCI Securities estimates

The leading PE of HSCEI is attractive (up to Dec. 19, 2012)



Source: Bloomberg, ABCI Securities estimates

Descriptive statistics of the leading PE movement of HSCEI

Statistics	Leading PE(x)
Mean	11.2
Mean +1 S.D.	14.5
Mean -1 S.D.	7.9
Mean +2 S.D.	17.9
Mean -2 S.D.	4.6

Source: Bloomberg, ABCI Securities estimates

Investment themes for 2013 – Top picks

Investment Theme		ABCIS's Picks	Ticker
Four new modernizations (FNM) trigger real demand	Urbanization ~ the top focus	Zoomlion	1157 HK
		China railway construction	1186 HK
		CSR	1766 HK
		Kunlun Energy	135 HK
		Country Garden	2007 HK
		Sinopharm	1099 HK
	Informatization ~ benefits high-tech and internet sector	Tencent	700 HK
		Digital China	861 HK
		Lenovo	992 HK
	Industrial modernization~ profound impact on manufacturing sector in China	China Metal Recycling	773 HK
		China Everbright	257 HK
		Shanghai Electric	2727 HK
		China Longyuan	916 HK
	Agriculture modernization ~ enhances productivity	Tianye Water	840 HK
		Anhui Conch	914 HK
		Shanshui Cement	691 HK
		First Tractor	38 HK
		Sinofert	297 HK
		China Agrotech	1073 HK
Consumption-led recovery		Hengan	1044 HK
		Vinda	3331 HK
		Tingyi	322 HK
		Belle	1880 HK
		Springland	1700 HK
Financial deregulation ~ different impacts on financial sector		China life	2628 HK
		China Taiping	966 HK
		CITICS	6030 HK
		Haitong	6837 HK
		ICBC	1398 HK
		CCB	939 HK
		ABC	1288 HK
		BOCHK	2388 HK
		HangSeng Bank	11 HK
Property regains growth momentum in 2013		COLI	688 HK
		Country Garden	2007 HK
		Evergrande	3333 HK
		KWG	1813 HK

Source: Bloomberg, ABCI Securities estimates

Investment themes for 2013

1. Four new modernizations (FNM) trigger real demand

Urbanization is the top focus. Accelerating the pace urbanization is of paramount importance in driving economic growth of China in coming decades. China's urbanization rate had reached 51.3% by end-2011. We expect the rate will accelerate to 55% in the next ten years. With over half of China's population now living in cities, China needs to improve conditions in its urban centers by paying more attention to people's quality of life, the balance of urban and rural development, benefits for migrant workers and protection of natural and cultural resources. In sum, urbanization triggers the construction of satellite cities and infrastructure in large and first-tier municipalities benefiting construction and infrastructure sector, real estate developers, medical care sector, logistic service providers and so on. We prefer stocks such as **Zoomlion (1157 HK), China railway construction (1186 HK), CSR (1766 HK), Kunlun Energy (135 HK), Country Garden (2007 HK) and Sinopharm (1099 HK).**

Informatization benefits high-tech and internet sector. Informatization development lays a good foundation for China which is striding toward the information society. As China is in the process of building a moderately prosperous society in all respects, vigorously pushing forward informatization development will be crucial in promoting social and economic development. Leading IT service providers and hardware manufacturers are the main beneficiaries. In light of recent financial deregulation and mobile internet development, we also encourage investors to focus on the e-commerce service providers. We prefer stocks such as **Tencent (700 HK), Digital China (861 HK) and Lenovo (992 HK).**

Industrial modernization has profound impacts on China manufacturing sector in China. Modernization of industries aims at enhancing productivity and competitiveness which involve investment in high value-added industries and energy efficiency. We anticipate more investment projects within the seven new strategic industries identified by the 12th five-year plan in 2013. These industries are expected to generate higher employment and productivity, and more value-added products. We prefer **China Metal Recycling (773 HK), China Everbright (257 HK), Shanghai Electric (2727 HK) and China Longyuan (916 HK)**

Agriculture modernization enhances productivity. One main goal of agriculture modernization is to foster large and modern agriculture groups. We believe an increase in water irrigation investment will strengthen the agriculture sector’s ability to cope with severe weather conditions and ensure stable production. The central government will continue to increase agricultural subsidies and raise minimum grain purchase prices to support the development of agricultural sector.

In our view, companies engaged in the water irrigation business and equipment providers, such as **Tianye Water (840 HK),** will benefit from expanding fiscal investment in these areas. Meanwhile, investment growth in water irrigation will also boost total demand for cement by around 3-4% over the next several years. Therefore, leading cement players in the northeastern provinces such as **Anhui Conch (914 HK) and Shanshui Cement (691 HK)** will benefit the most. **First Tractor (38 HK)** will benefit from improving automation in agricultural production while the increasing usage of fertilizer to enhance agricultural productivity will benefit **Sinofert (297 HK) and China Agrotech (1073 HK).**

2. Consumption-led recovery

With domestic demand being the major growth driver in coming decades, China has stepped up great efforts to achieve the goal of doubling 2010's individual income in 2020 in an attempt to boost the contribution of consumption to GDP. The move provides sustainable growth potential and structural opportunities in consumption sector in 2013. We believe that policymakers have realized that the key to improve consumption affordability and inclination is to optimize the country's income structure by raising average income for the middle- and low-income segments. We believe consumer staples will benefit the most and stocks such as **Hengan (1044 HK), Vinda (3331 HK), Tingyi (322 HK)** are our picks in this place. Despite some selling on consumer discretionary stocks in 2H12, sector fundamentals continue to improve and we like retailers and supermarket operators as they tend to benefit from rising inflation. We prefer **Belle (1880 HK) and Springland (1700 HK).**

3. Financial deregulation has different impacts on financial sector

Reforming China's financial sector looks to be a top priority for China's new leadership as financial reforms are high on the central government's agenda. These reforms are essential in facilitating China's rebalancing away from an export-driven to consumption-focused economy. In 2013, we expect China will speed up financial reforms, including interest rate liberalization, widening renminbi trading band, bond market reform, etc. We expect insurance companies will benefit from the reforms as more diversified business opportunities are available for them to explore. We like **China life (2628 HK) and China Taiping (966 HK).** Also, we maintain our positive stance on brokers including **CITICS (6030 HK) and Haitong (6837 HK)** as they will be the beneficiaries of ongoing capital market deregulation and a leverage play for a recovery in the A-share market.

China banks may face headwind under financial reforms as the acceleration of interest rate liberalization will hit hardest on banks' net interest margin (NIM). Bigger banks are at better position to withstand the headwinds as they have stronger growth in fee income to offset NIM contraction. We prefer **ICBC (1398 HK), CCB (939 HK) and ABC (1288 HK).**

Renminbi internationalization continues to be a major focus in 2013. There are more and more moves to full convertibility of the renminbi. The need for a fully convertible currency is building as the global use of the renminbi as a trade settlement currency is on the rise with which around 9% of global trade uses renminbi to settle. Our economics team predicts that China will further widen the trading band of renminbi to 2% and encourage the use of the renminbi as trade settlement currency in 2013. China has also stepped up efforts to widen the scope of QDII scheme for overseas investment and to allow more QFII capital to invest in China's capital markets. Given Hong Kong's well-equipped financial system and China's dedication to developing the region into an important offshore renminbi center, Hong Kong will take center stage on the renminbi internationalization platform. We see exciting growth opportunities for Hong Kong's financial intermediaries including **BOCHK(2388 HK) and HangSeng Bank (11 HK).**

4. Property regains growth momentum in 2013

China's property market has faced extreme surge in the residential housing prices, becoming a matter of concern for the central government. The government's tightening measures to control the rising prices in the domestic real-estate market are laying more emphasis on promoting affordable housing in the country for the poor people and raising percentage of down payments for the first home buyers and ban of home loans for the third home buyers. The object of the maintaining policy tightening is to engineer a soft landing for China's property market. We expect sentiment to improve and volume to further pick up in 2013 after housing prices corrected in 2012. In 2013, our China property team expects that tightening property policies will remain in place. It is highly possible that the property tax will be implemented in broader regions and will substitute the administrative intervention of home purchase restriction. These imply that the sector will be more competitive and large players will benefit. The team also believes the sector is reviving its growth momentum in 2013 in light of accelerating urbanization and economic recovery. Stocks such as **COLI (688 HK), Country Garden (2007 HK), Evergrande (3333 HK) and KWG (1813 HK)** are the main beneficiaries.

ABCIS's Sector Recommendations

Exhibit: ABCIS's Sector Rating

Sector	ABCI Rating	Analyst
China Insurance	Overweight	Francis Chan
China Property	Overweight	Vivian Li
Consumer	Overweight	Judy Hu
Construction Machinery	Overweight	Steve Wong
China Banks	Neutral	Johannes Au
Thermal Coal	Neutral	Mark Chen
Wind Power	Neutral	Lisa Lee

Source: ABCI Securities estimates

Sectors with 'Overweight' rating

Insurance

We hold a positive stance towards the sector of China Insurance in 2013E. In 1H12, Life industry reached an inflection point in operations. P&C industry remained solid in underwriting performance. Also the sector is blessed with multiple national policies and is situated at a cyclical sweet spot of investments. **Our top picks are China Life (2628 HK) and China Pacific (2601 HK).**

Property

With decline in supply and stronger release for suppressed demand, we forecast the S/D ratio to drop to 1.13 in 2013, approaching to mid-cycle level. We are expecting a reviving S&D dynamic for the sector in 2013. Specifically, we expect the long-awaited property tax might be extended to more cities in 2H13 and will finally replace the home purchase restriction (HPR). We prefer tax tools to administrative restrictions and expect more intensified competition within this sector. In our view, high-beta property developers deserve more attention which will benefit from better sales activities to increase asset turnover and ROE. Thus, we expect property developers to be re-rated in early 2013 due to a reduction of risk premium, and this will be more noticeable for developers like **Evergrande (3333 HK) and KWG (1813 HK).**

Consumer

As China's macro environment continues to exhibit healthy growth, we expect consumer sector starts to enter the recovery phase. The continued urbanization and surging disposable income will be the key drivers of retail sales growth. Consumer staples are well-positioned to maintain growth momentum and we prefer leading names such as **Hengan (1044 HK) and Vinda (3331 HK).** Discretionary names will enjoy gradual rebound with stronger recovery of SSSG next year. We like **Belle (1880 HK) and Intime (1833 HK).**

Construction Machinery

Construction activities surge in an increasingly rapid process of industrialization and urbanization. We expect the construction machinery sector will regain its growth momentum in 2013. We like the leading construction machinery makers with diversified product-portfolio and abundant cash on hand, such that they are able to efficiently capture the recovery of the sector. Our top pick is **Zoomlion (1157 HK).**

Sectors with 'Neutral' rating

China banks

Going into 2013, with the change of Chinese government leadership, we believe policy development will continue to play a critical role to the banking sector. As the CBRC has announced a looser-than- market expected new capital requirements, we do not expect massive fund raising activities of China banks in 2013. Given that financial reforms are high on the government's agenda, we expect China will speed up interest rate liberalization in 2013, which continues to cast shadow on banks' NIM outlook and we do expect continued NIM pressure will be hard for banks to outperform the market. We are of the view that improved economic outlook will stabilize asset quality of China banks and big banks are more defensive amid their developed brand names and diversified business mix. **Our top picks include ICBC (1398 HK), ABC (1288 HK) and CCB (939 HK).**

Thermal Coal

Thermal coal prices suffered from weak economic growth in 2012. For 2013, we expect that: 1) coal prices will remain stable due to mild economic recovery; 2) sector liberalization provides more upside catalysts to large coal producers. However, the sector still faces oversupply problem and it takes time for the government to fully consolidate the outdated and those unqualified small and medium-sized coal miners. We favor the large players which have broad clients base and strong logistic capacities, and our top pick is **China Shenhua (1088 HK).**

Wind power

Stable cost and lower financial expense will provide better return outlook to the wind power operators but upside will be limited by slower-than-expected recovery in utilization hours. Wind curtailment problem remains as the major concern within the industry which may not be solved until 2014. We therefore favor diversified players who are less affected by natural resources risks. **Our top picks are Huaneng Re (958 HK) and Hudian Fu (816 HK).**

Disclosures

Analyst Certification

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Definition of equity rating

Rating	Definition
Buy	Stock return ≥ Market return rate
Hold	Market return – 6% ≤ Stock return < Market return rate
Sell	Stock return < Market return – 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate from 2007-2011

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	2.6 ≤180 day volatility/180 day benchmark index volatility
High	1.5 ≤ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	1.0 ≤180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index.
Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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