ABCI China/Hong Kong Equity Research
2017 Economic Outlook & Investment Strategy

New Cycle, New Strategy

農銀國際
ABC INTERNATIONAL
ABCI SECURITIES COMPANY LIMITED

A Bird's Eye view

GLOBAL ECONOMY

- Expect escalating cost-push inflation pressure in major industrial nations
- Higher chances of monetary tapering by major central banks
- Loosening fiscal policies would play a more important role to stimulate global demand
- Strengthening USD and rising USD funding costs would direct liquidity away from developing markets

CHINA ECONOMY

- Deflationary pressure has been reducing; cost-push inflation is set to increase
- PBOC may tolerate a higher inflation in 1H17 to lower real interest rate, boosting investment and consumption
- Narrowing interest rate gap between China and the U.S. would drive up devaluation pressure
- Investment-led economic growth model has been resumed; more private-public partnerships can be expected
- Slow growth in household disposable income would constrain consumption growth

INVESTMENT STRATEGY

- Companies in businesses such as municipal facilities services, environmental protection, green energy production, insurance, healthcare, education, tourism, entertainment, Internet, and logistics would continue to flourish
- Investment banks would benefit from increasing demand for direct financing and financial advisory services in view of possible changes in monetary policy
- Uneven provincial economic growth would favor niche players in high-growth provinces
- New forms of investment-led growth in China would benefit large contractors
- Chinese capital would continue to flow into the HK capital market
- We expect HSI and HSCEI to reach 24,014 and 10,692 by end-2017F

Sector	Rating	Stock Picks
China Banks	Overweight	CCB (939 HK) ; ICBC (1398 HK)
China Insurance	Neutral	CPIC (2601 HK); Ping An (2318 HK)
China Securities & Brokerage	Overweight	China Merchants Sec. (6099 HK); Guangfa Sec. (1776 HK)
China Real Estate	Overweight	Logan (3380 HK); Times Property (1233 HK)
Food & Beverage	Neutral	WH Group (288 HK)
China E-commerce	Overweight	Tencent (700 HK)
China Alternative Energy	Overweight	CGN Power (1816 HK); Huaneng Renewables (958 HK)
China Environmental Protection	Overweight	Beijing Enterprises Water (371 HK) ; China Everbright Int'l (257 HK)
China Healthcare Services	Overweight	Phoenix Health (1515 HK)
China Pharma	Overweight	CSPC Pharma (1093 HK); Sinopharm-H (1099 HK)

Source(s):ABCI Securities

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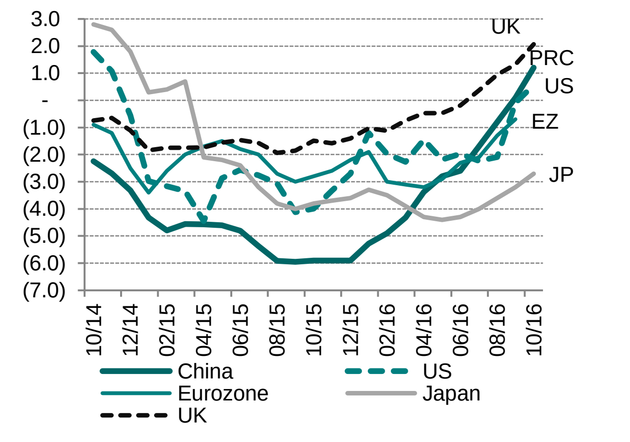
2017 Global Economic Outlook

Change of game plan under Trump's presidency in the U.S.: End of QE; beginning of an aggressive fiscal stimulus cycle

- *Expect escalating cost-push inflation pressure in major industrial nations*
- *Higher chances of monetary tapering by major central banks*
- *Loosening fiscal policies to play a more important role to stimulate global demand*
- *Strengthening USD and rising USD funding costs to direct liquidity away from developing markets*

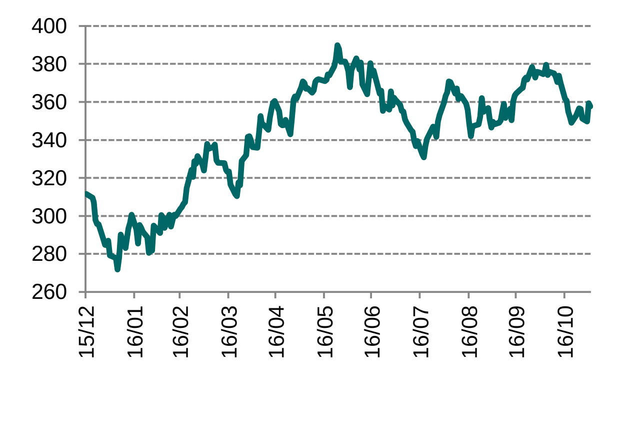
Inflation outlook. Cost-push inflation pressure will be escalating in 2017. PPI in major industrial nations (China, Eurozone, Japan, the U.S., and the U.K.) have been trending up in 2016 while global deflationary pressure has been easing significantly. YTD, S&P GSCI Index has surged ~15%.

Exhibit 1: PPI (%YoY) in major nations are trending up



Source(s): Bloomberg, ABCI Securities

Exhibit 2: S&P GSCI Index Spot CME

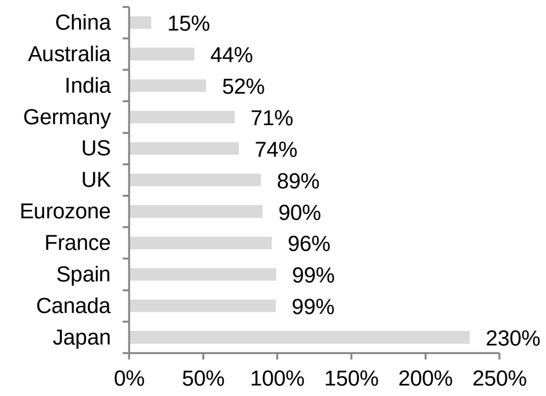


Source(s): Bloomberg, ABCI Securities

Monetary policy: Central banks in major industrial nations would adopt a less accommodative monetary policy as deflationary pressure eases and cost-push inflation risk escalates in 2017. We believe central banks in major advanced economies are likely to taper monetary policy gradually to contain the rising inflationary pressure.

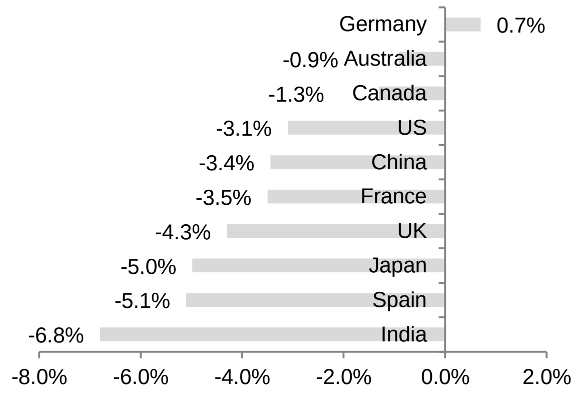
Fiscal policy: Governments in major advanced economies would rely more on fiscal stimulus to boost demand and stabilize global economic growth in 2017. However, the relatively high level of government debts in advanced economies means room for aggressive fiscal stimulus would be limited. Attracting FDI and investments from the private sector to finance economic stimulus plans would become crucial for the advanced economies. To encourage capital expenditures and entice FDI, measures to lower tax burden for foreign or domestic corporations are expected by the market as Trump's presidency in the U.S. that begins in 2017.

Exhibit 3: Government debt (% of GDP) in 2015



Source(s): Bloomberg, ABCI Securities

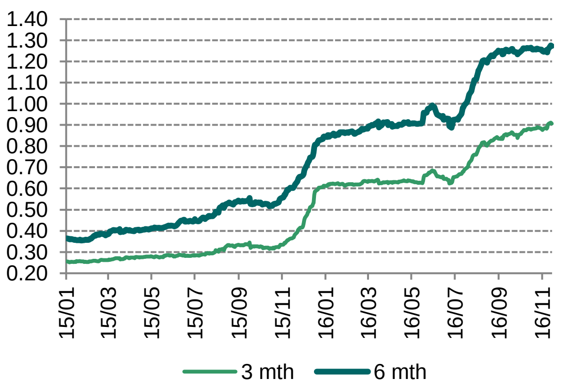
Exhibit 4: Fiscal surplus (deficit) (% of GDP) in 2015



Source(s): Bloomberg, ABCI Securities

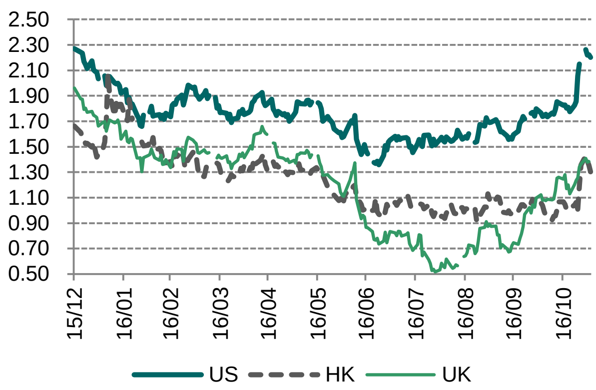
Interest rate cycle: Downtrend of the U.S. interest rate cycle ended in late 2015 and interest rate will be rising in 2017-18. Given the centrality of USD in the global economy, interest rate cycle in the advanced economies will follow that in the U.S. Increase in risk-free rates (measured by 10-year treasury yields) will raise the opportunity costs for USD-denominated investors holding foreign assets.

Exhibit 5: US$ LIBOR has been trending up since 2015



Source(s): Bloomberg, ABCI Securities

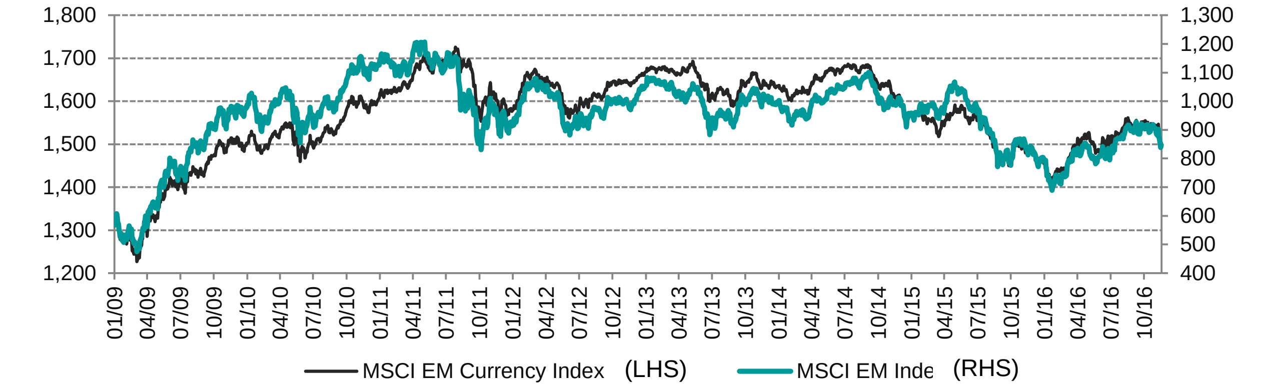
Exhibit 6: 10-yr treasury yields (risk-free rates) have been rising since mid-2016



Source(s): Bloomberg, ABCI Securities

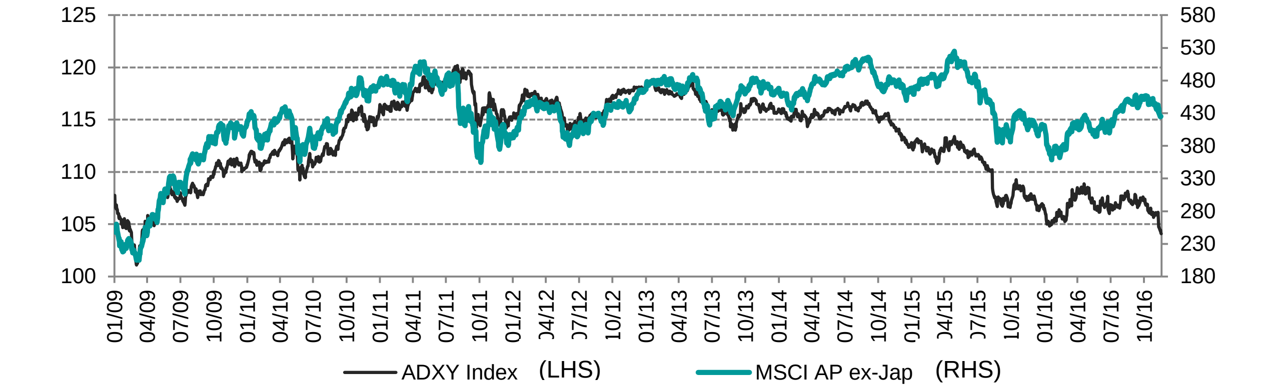
Liquidity flow: Strengthening of USD and increasing USD funding cost would direct liquidity away from the developing countries, driving up asset price risk in 2017. Competitive devaluation in the developing countries may neutralize the impacts of economic stimulus. Correlation statistics suggests devaluation of emerging markets currencies will depress stock market performance; hence, downside risk of stock markets in developing countries would increase in 2017.

Exhibit 7: MSCI EM Currency Index vs. MSCI EM Index (U.S. presidency of Barack Obama: 1/2009-1/2017)

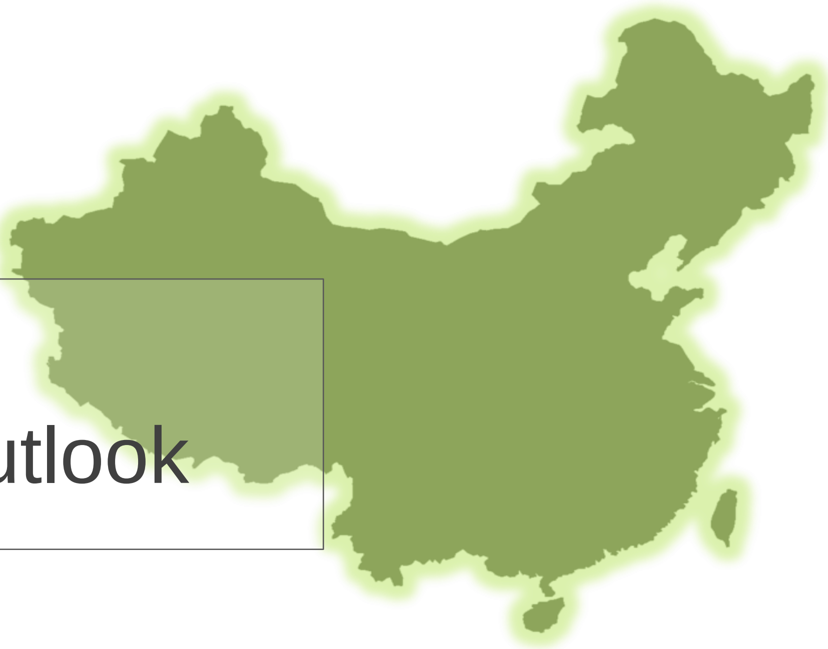


Source(s): Bloomberg, ABCI Securities

Exhibit 8: Asia Dollar Index (ADXY) vs. MSCI AP ex-Jap Index (U.S. presidency of Barack Obama: 1/2009-1/2017)



Source(s): Bloomberg, ABCI Securities

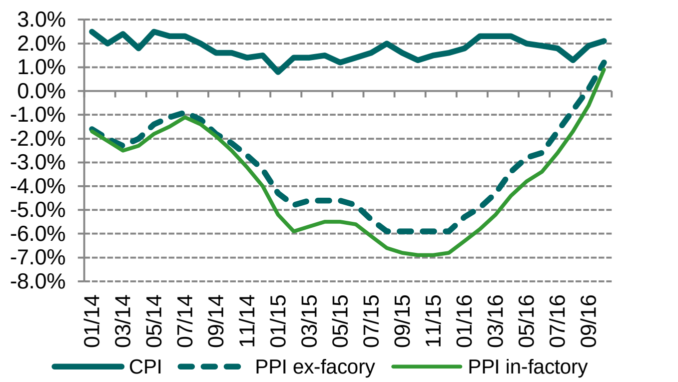


2017 China Economic Outlook

- *Deflationary pressure has been reducing; cost-push inflation is set to increase*
- *PBOC may tolerate a higher inflation in 1H17 to lower real interest rate, boosting investment and consumption*
- *Narrowing interest rate gap between China and the U.S. would increase devaluation pressure*
- *Investment-led economic growth model has been resumed; more private-public partnerships can be expected*
- *Slow growth in household disposable income would constrain consumption growth*

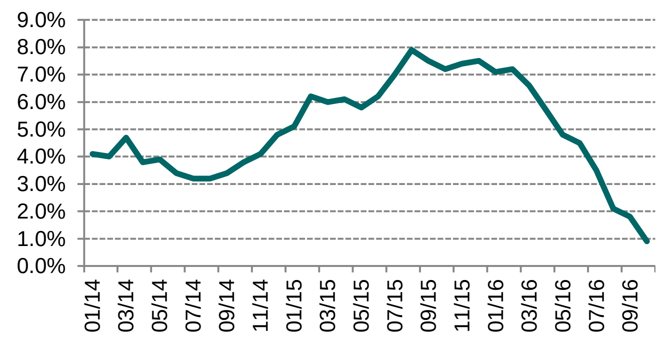
Inflation outlook. Cost-push inflation pressure would escalate in 2017. Gap between CPI and ex-factory PPI has been narrowing, suggesting lower profit margins for downstream wholesalers/retailers would compel them to raise prices in 2017. Supply-side reform in 2016 plays an important role in constraining excessive supply of base materials and energy resources, preventing China from spiraling down in deflation and contraction. With the continuation of the supply-side reform, inflation risk would be higher than deflation risk in 2017.

Exhibit 1: Cost-push inflation pressure is escalating



Source(s): NBS, ABCI Securities

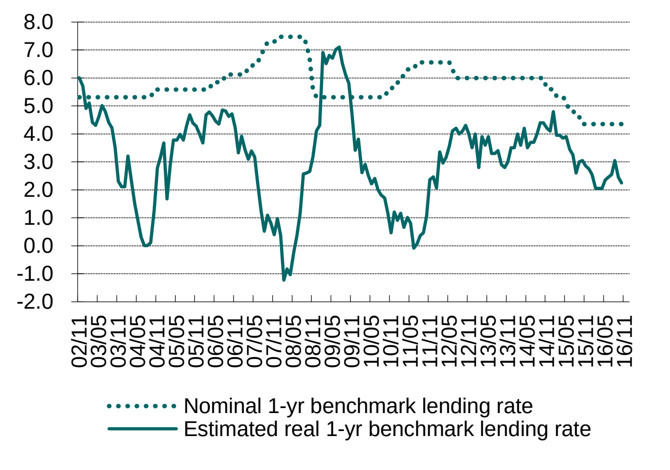
Exhibit 2: CPI minus ex-factory PPI gap is narrowing



Source(s): NBS, ABCI Securities

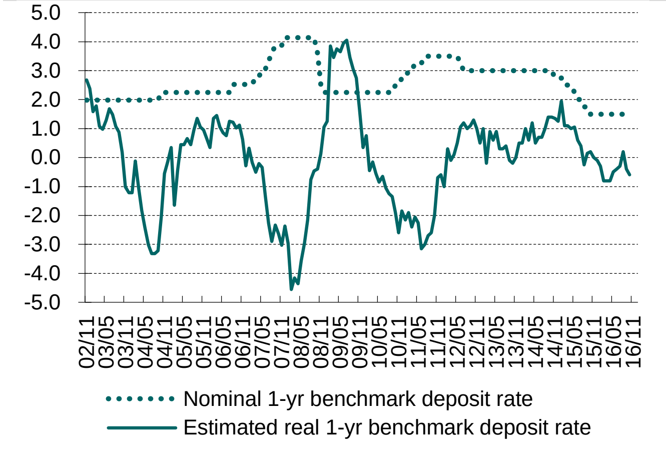
Monetary policy: With the rising inflation pressure, room for further monetary easing would be reduced. CPI has been above the 1-year deposit rate since Dec 2015. Higher inflation in 2017 would help lower real deposit rates and lending rates, which in turn would stimulate investments. Instead of slashing nominal interest rates, the PBOC may tolerate a slightly higher inflation (CPI at ~3%) in 1H17 to lower real interest rate, thus boosting investment and consumption. The PBOC would taper its monetary policy in the future if needed.

Exhibit 3: Real lending rates have room to fall further



Source(s): Bloomberg, ABCI Securities

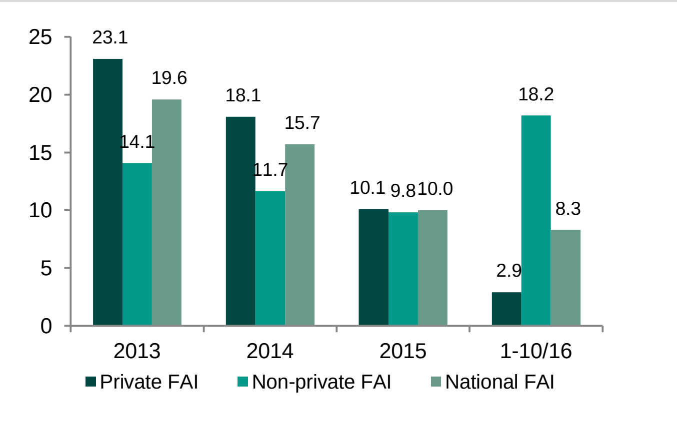
Exhibit 4: Depositors are suffering from negative real deposit rate



Source(s): Bloomberg, ABCI Securities

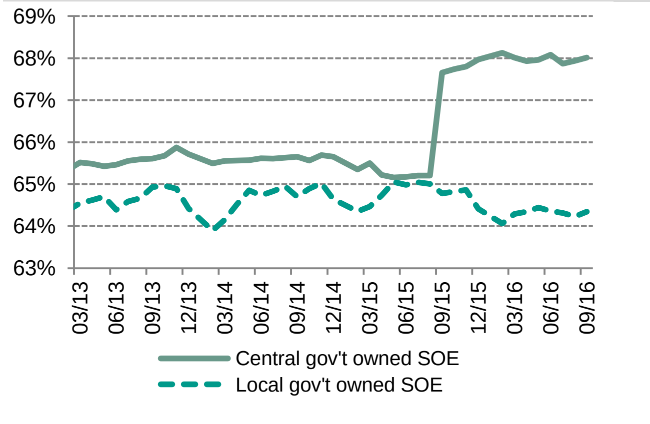
Fiscal policy: We expect the government to promote aggressively for the private-public partnership (PPP) business model in coming years to stimulate investments in the real economy. Due to the sharp decline in private FAI growth in 2016, the central government-owned SOEs have leveraged up to support overall FAI. The higher gearing, however, is inconsistent with the government's initial objective of deleveraging and reducing the systematic risk in the economy. As real interest rates stay low, profit-oriented private sector would actively seek for investment opportunities. We expect the government to release more PPP projects to increase involvement of the private sector.

Exhibit 5: FAI (%YoY): Private sector is actively seeking for investment opportunities in 2017



Source(s): NBS, ABCI Securities

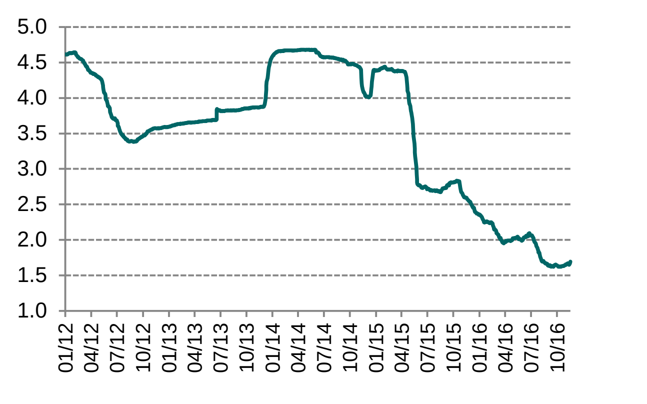
Exhibit 6: Liability-asset ratio of non-financial SOE (%)



Source(s): Ministry of Finance, ABCI Securities

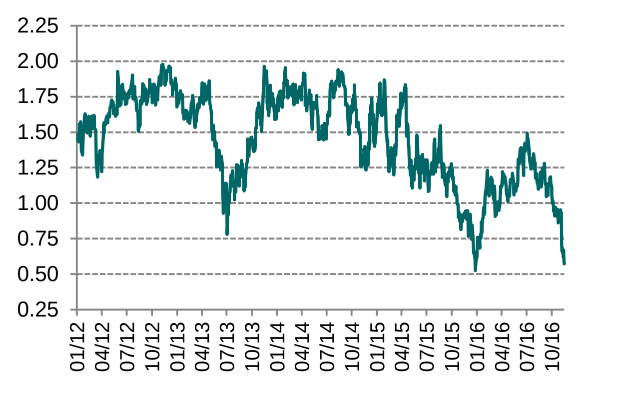
Interest rate cycle: The market has generally expected the PBOC to lower interest rates for growth if needed. For 2017, however, we think chances of a rate cut would reduce further because: 1) Cost-push inflation pressure would rise rather sharply; 2) The interest rate gap between China and the U.S. has narrowed substantially. When the Fed raises interest rates, the gap would be closed further. In 2016, narrowing interest rate or treasury yield gap has added to the devaluation pressure in RMB. As mentioned, the PBOC would tolerate a slightly higher inflation rate in 1H17 to lower real interest rate. The nominal interest rates would enter the upcycle in late 2017 if CPI stays above 3% for more than 6 months.

Exhibit 7: Narrowing rate gap (RMB 6-mth SHIBOR - USD 6-mth LIBOR)



Source(s): Bloomberg, ABCI Securities

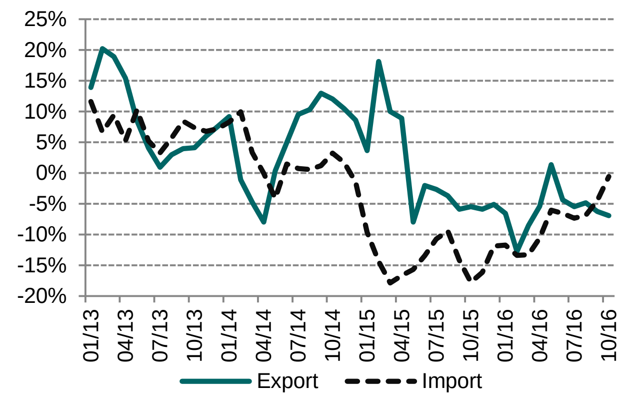
Exhibit 8: Narrowing 10-yr yield gap (China treasury yield – U.S. treasury yield)



Source(s): Bloomberg, ABCI Securities

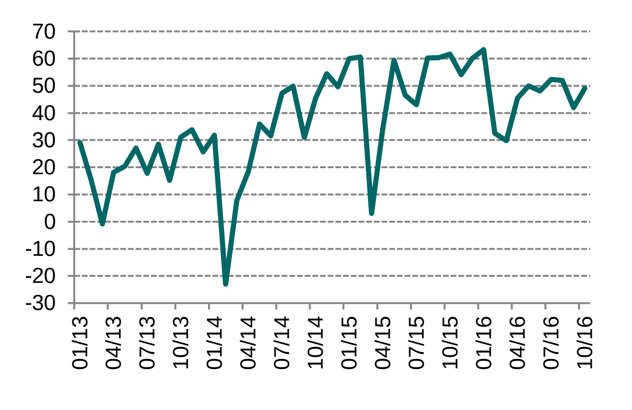
Export sector: Weakening exports have not reduced trade surplus in 2015-16. In contrast, China's trade surplus expanded during the period, thanks to lower import prices of materials and energy. As major commodity prices have been increasing, we believe trade surplus would narrow with the risen import value.

Exhibit 9: Three-mth moving average growth (%YoY)



Source(s): Bloomberg, ABCI Securities

Exhibit 10: Trade surplus (US$bn)



Source(s): Bloomberg, ABCI Securities

Private consumption is under pressure. Austerity measures on the real estate sector in 2H16 would result in a negative wealth effect in 2017. Retail sales growth was 10.3% YoY in 10M16; nonetheless, we believe a double-digit growth is hard to sustain given that national household disposable income only grew 8.4% YoY (or 6.3% YoY in real term) in 9M16. The real disposable income growth is lower than real GDP growth (6.7%YoY) over the same period.

E-commerce alone cannot reverse the slowdown in consumption growth. Online retail sales growth slowed to 24.9% YoY in 10M16 from 31.6% YoY in 2015. Growth in consumption demand is capped by household disposable income growth, which in turn is constrained by economic growth. While providing consumers with new shopping channels, e-commerce alone would not elevate aggregate purchasing power substantially. For large retailers, e-commerce poses threat as new small retailers are eroding their market shares. Market shares of large retailers by total retail sales declined to 45.4% in 10M16 from 47.4% in 2015; moreover, their retail sales rose only by 7.8% YoY in 10M16, 2.5ppt below the national retail sales growth.

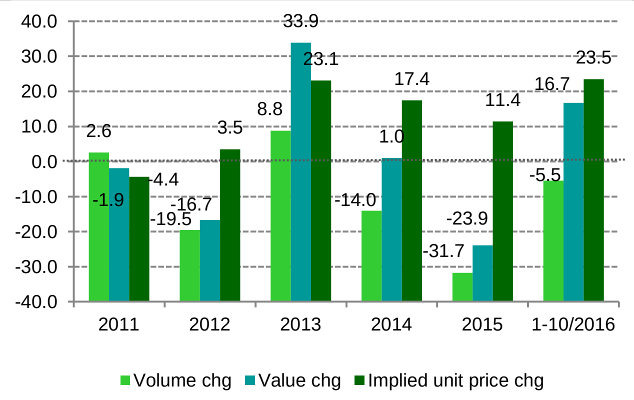
Exhibit 11: Consumer landscape in China is transforming quickly

Period	10M16 (RMB bn)	Chg(YoY)	Prop	2015 (RMB bn)	Chg(YoY)	Prop
Total retail sales	26,960	10.3%	100.0%	30,093	11.1%	100.0%
1.Offline retail sales	23,786	8.6%	88.2%	26,851	9.0%	89.2%
2.Online retail sales of physical consumer goods	3,174	24.9%	11.8%	3,242	31.6%	10.8%
Period	**10M16 (RMB bn)**	**Chg (YoY)**	**Prop**	**2015 (RMB bn)**	**Chg (YoY)**	**Prop**
Total retail sales	26,960	10.3%		30,093	11.1%	
1.Consumer goods	24,050	10.3%	100.0%	26,862	10.6%	100.0%
Large retailers	11,490	7.9%	47.8%	13,389	7.9%	49.8%
Small retailers	12,559	12.6%	52.2%	13,473	13.4%	50.2%
2.Restaurant receipts	2,911	10.9%	100.0%	3,231	11.7%	100.0%
Large retailers	741	6.0%	25.5%	867	7.0%	26.8%
Small retailers	2,170	12.7%	74.5%	2,364	13.5%	73.2%
Overall large retailers	12,231	7.8%	45.4%	14,256	7.8%	47.4%
Overall small retailers	14,729	12.6%	54.6%	15,837	13.4%	52.6%

Source(s): NBS, ABCI Securities

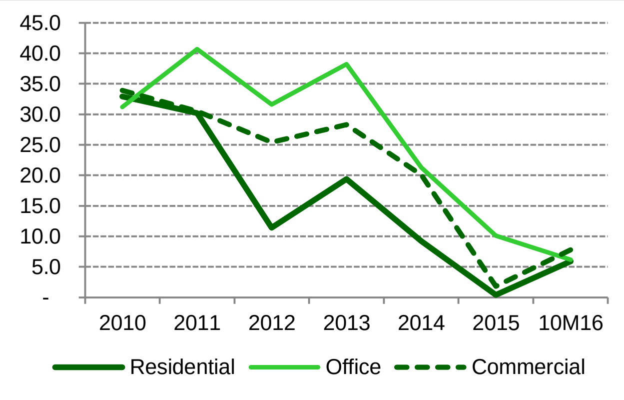
Housing market: Home purchase restriction reintroduced in 2H16 would not be lifted in 2017. We believe these measures would discourage property developers to increase investments in 2016-17 and subsequently reduce supply of new homes in 2018-19. Home prices would surge again in 2019 when new supply falls to low levels.

Exhibit 12: Declining land supply in 2014-10M16



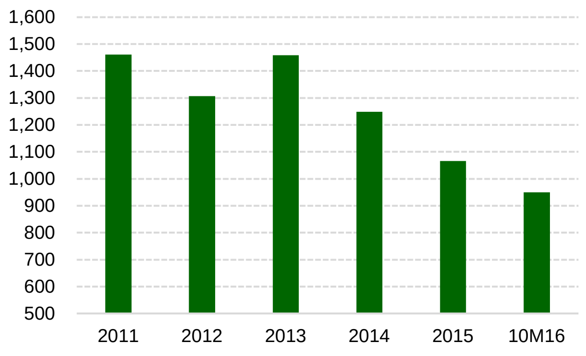
Source(s): NBS, ABCI Securities

Exhibit 13: Declining investment growth in property development (%YoY)



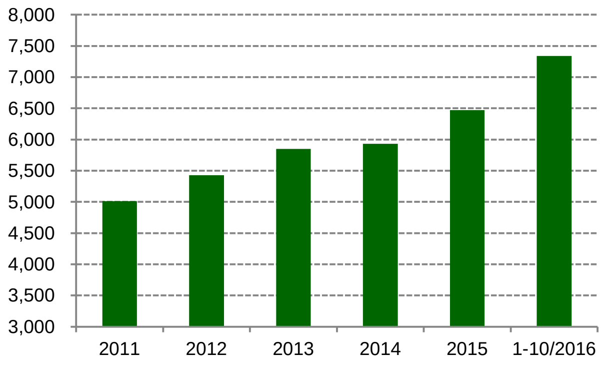
Source(s): NBS, ABCI Securities

Exhibit 14: Declining new home construction since 2014 (mn sqm)



Source(s): NBS, ABCI Securities

Exhibit 15: National average new home price (RMB/sqm.)



Source(s): NBS, ABCI Securities

2017 Investment Strategy

- *Companies in businesses such as municipal facilities services, environmental protection, green energy production, insurance, healthcare, education, tourism, entertainment, Internet, and logistics would continue to flourish*
- *Investment banks would benefit from increasing demand for direct financing and financial advisory services in view of possible changes in monetary policy*
- *Uneven provincial economic growth would favor niche players in high-growth provinces*
- *New forms of investment-led growth in China would benefit large contractors*
- *Chinese capital would continue to flow into the HK capital market*
- *We expect HSI and HSCEI to reach 24,014 and 10,692 by end-2017F*

1. China's major social, economic, and demographic trends in 2017-20

We believe the following trends would continue in 2017-20:
a) Rising urbanization would drive up housing and automobile ownership rates
b) Rising household incomes in urban and rural areas would support demand for physical goods and services
c) Improvement in living standard (better public utilities services, lower pollution, more leisure activities, convenient communications and transportation, and better quality of education, social hygiene and food)
d) Both aging and newborn populations would expand at a faster pace
e) China's political and economic influences would increase further in Asia
f) Increasing military power to protect national interests and overseas assets

Companies in businesses related to these development trends, such as municipal facilities services; environmental protection, green energy production; supply of products or services in insurance, healthcare, education, tourism, entertainment, Internet, logistics and national defense, would continue to flourish.

2. Escalating cost-push inflation risk in major industrial nations (including China) would reverse the monetary stance from accommodative to tight in 2017-18

Companies with a high gearing would rush to deleverage or restructure their balance sheets before liquidity supply tightens. Investment banks would flourish on increasing demand for direct financing and financial advisory services. Risk of net interest margin (NIM) contraction in commercial banks would reduce.

3. Uneven provincial economic growth in China would favor niche companies

Profits of regional companies (such as city commercial or rural commercial banks, mid-sized home builders, mid-sized municipal service providers) focusing on high-growth regions (such as the "Tianjin-Beijing-Hubei" belt, YRD economic belt, transportation hubs in "one-belt one-road initiative") would grow faster than their peers with nationwide exposure.

4. China's fiscal stimulus plan: new forms of investment-led growth

To avoid a significant increase in government deficit, public-private-partnership (PPP) business model would be widely promoted to increase FAI. Infrastructure construction companies with technological skills and capital would be the major partners in PPP; surplus capital owners in insurance firms and commercial banks would become the financial partners. Economic feasibility of PPP projects would be assessed by private partners before commencement; hence, capital can be allocated more efficiently.

5. Liquidity continues flowing into HK capital markets but with different purpose

Mainland investors would re-evaluate their goals of investing in the HK stock market. Previously, most were looking to accumulate China-related stocks listed in HK at bargain price instead of diversifying their exposure to international markets. In the future, we believe Mainland investors would favor HK-listed companies with international businesses or overseas market index ETF so as to diversify their investment portfolios. YTD (up to Nov 22), Hang Seng Foreign Companies Composite Index rallied 22%, whereas Hang Seng Index advanced 3% and H-share Index was almost flat.

Exhibit 1: Summary of ABCI's views on the global economic environment and HK stock market

Our view on the world in 2017	Implications on the HK stock market
• Rising populism, anti-globalization, and protectionism will heighten risks in world trade and intensify geopolitical and military tensions	• Increase in systematic risk due to adverse externalities • Rising risk premium in HK stock market will suppress stock valuation
• Escalating cost-push inflation pressure in major industrial nations reduces room for further accommodative or loosening monetary policy • Global competition for financial FDI will begin. This will benefit countries with capital surplus, as they can export surplus capital to enhance returns	• The U.S., to be followed by other industrial nations, will enter an interest rate upcycle • Interest rate cycle in HK will follow that of the U.S. • Financial sector will benefit from the early stage of an interest rate upcycle • Strong USD and weak RMB are favorable to China's export sector • Chinese capital continues to flow into the HK capital market
• More aggressive fiscal stimulus plans in the U.S. under Trump's presidency implies more business opportunities and better investment returns • Supply of treasury bonds will increase to finance fiscal stimulus plan • Risk of financial crisis and social unrest in developing markets will increase on the departure of USD-denominated capitals, reversal of interest rate trend and rising inflation	• Economic risk in the U.S. will lessen • Diversion of liquidity from developing markets into the U.S. FDI in the U.S. is expected to increase with the rollout of fiscal stimulus plans • Net inflow of liquidity from the U.S. to the HK capital market will reduce; risk of liquidity outflow will increase
• Aggressive fiscal stimulus in China • Lower real interest rates resulted from a higher inflation will stimulate investment and consumption • Investment-led growth model resumes with increased participation from private sector • The trends of increasing urbanization, growing household incomes, aging population and improving living standard (lower pollution, more leisure activities, convenient communications and transportation, better quality of education, social hygiene and food) remain intact • Uneven provincial economic growth continues • Departure of USD-denominated capitals from the Asian markets pave the way for higher market penetration of RMB-denominated capitals	• Public and private sectors will rely more on direct financing, which will benefit investment banks in China • "Supply-side reform" helps eliminate excessive competition and profitability of industrial enterprises will recover • Positive effects of SOE reforms will surface • Businesses supportive of China's long-term development trends, such as urban utilities; environmental protection, green energy production; healthcare, education, tourism and entertainment services; Internet and logistics services, will continue to flourish • Profits of some regional banks may grow faster than their larger, national peers • Increased geographical diversification of business and investment

Source(s): ABCI Securities estimates

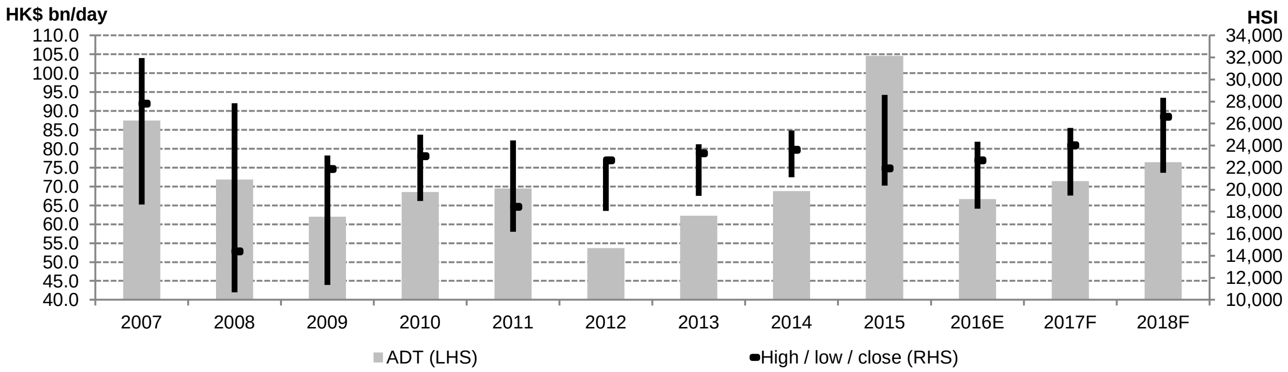
HK Stock Market

Hang Seng Index

EPS of Hang Seng Index has declined for two consecutive years. For 2016F, we estimate EPS to fall 11.8% YoY in 2016E on lower profits of developers, insurers, casino operators, oil producers, power producers, banks, and conglomerates. IT companies would post strong profit growth.

The trading range of Hang Seng Index in 11M16 was 18,278.80-24,364.00, representing 10.19x-13.58x of 2016F P/E, 0.94-1.25x of 2016F P/B, and a 2016F dividend yield of 4.33%-3.25%. We estimate the average daily turnover of Hang Seng Index to be HK$ 23.7bn/day for 2016F, down 23.8%YoY and representing 35% of daily stock market turnover in the Mainboard, which we estimate to be HK$66.7 bn/day for 2016F, down 36.2% YoY.

Exhibit 2: Hang Seng Index (high/low/close) and average daily stock market turnover



Source(s): HKEx, Bloomberg, ABCI Securities estimates

Looking forward, we expect the Hang Seng Index to post a 9% earnings growth in 2017F. Earnings growth in IT and telecom would exceed other constituent categories in the index; profit growth of the heavyweight China banks would remain flat. Earnings in insurers, property developers and energy producers in 2017 would recover due to the low bases in 2016. The adverse impacts of austerity measures in China's and HK's housing markets in 2016 would not be reflected in the income statements until 2018. Instead, developers' income statements in 2017 would be boosted by the positive effect of property price rally in 2H15-1H16.

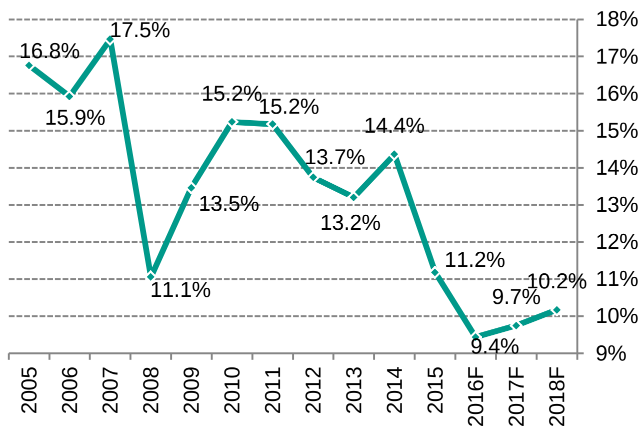
Combining the P/E, P/B, and dividend yield valuations, we expect the trading range of Hang Seng Index to be 19,456-25,594 for 2017F, which represents 9.89x-13.01x 2017F P/E, 0.94x-1.23x 2017F P/B, and a 2017F dividend yield of 4.24%-3.22%. We set our end-2017F target at 24,014, which represents 12.21x 2017F P/E, 1.16x 2017F P/B. and a 2017F dividend yield of 3.43%. Average daily stock market turnover in the Mainboard would improve by 7% YoY to HK$ 71.4 bn/day in 2017F.

Exhibit 3: Projected trading range of HSI in 2017

Method	Valuation band range in 2017E			Corresponding HSI trading range		
1	P/B high	P/B low	End-2017F	Index high	Index low	End-2017F
	1.25	0.95	1.20	25,985	19,748	**24,945**
2	P/E high	P/E low	End-2017F			
	13.00	10.00	12.00	25,576	19,673	**23,608**
3	Yield low	Yield high	End-2017F			
	3.27%	4.35%	3.51%	25,223	18,947	**23,490**
			Average	**25,594**	**19,456**	**24,014**
			Implied '17 P/E (x)	13.01	9.89	**12.21**
			Implied '17 P/B(x)	1.23	0.94	**1.16**
			Implied '17 yield	3.22%	4.24%	**3.43%**

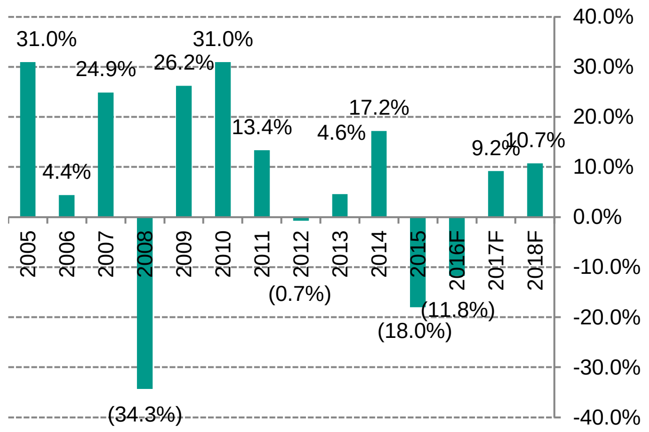
Source(s): ABCI Securities estimates

Exhibit 4 : HSI's ROAE



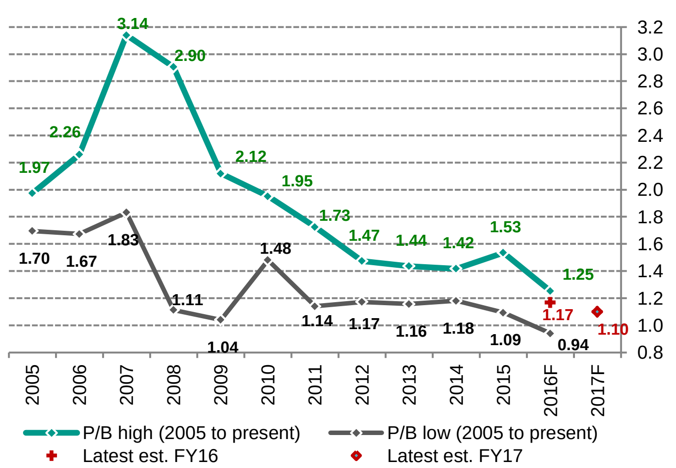
Source(s): Bloomberg, ABCI Securities

Exhibit 5 : HSI's EPS growth



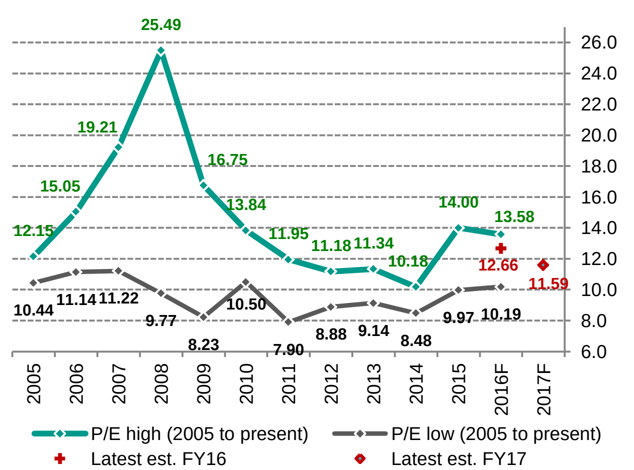
Source(s): Bloomberg, ABCI Securities

EBloomberghibit 6: HSI's P/B band (Index: 22,723)



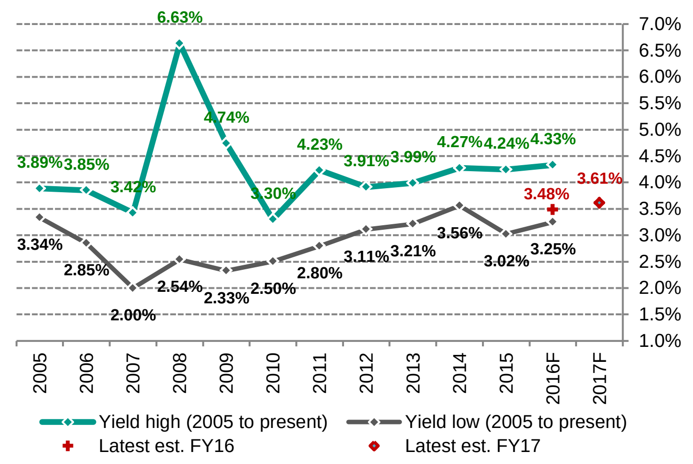
Source(s): Bloomberg,ABCI Securities

Exhibit 7:: HSI's P/E band (Index: 22,723)



Source(s): Bloomberg, ABCI Securities

Exhibit 8: HSI's dividend band (Index: 22,723)



Source(s): ABCI Securities estimates

HSCEI

We estimate the EPS of Hang Seng China Enterprises Index (or HSCEI) to decline by 15.7% in 2016F on lower EPS in financial, coal & oil and thermal power stocks. Clean energy, automobile, property and infrastructure construction counters would post a positive EPS growth for 2016.

The trading range of HSCEI in 11M16 was 7,498.81-10,341.65, representing 6.76-9.21x of 2016F P/E, 0.75-1.02x 2016F P/B, and a 2016F dividend yield of 4.39%-3.23%. The average daily turnover value of HSCEI member stocks is estimated to be HK$12.8 bn/day in 2016F, down 38%YoY.

Among the Chinese financial stocks, we expect the profits of insurance, securities and asset management stocks to recover in 2017; profit growth in banks would be flat. Owing to the lower comparison base in 2016 and the recovery in commodity prices, profits of coal and oil stocks would demonstrate a substantial rebound in 2017. Profit growth of clean energy, automobile, property and infrastructure construction stocks would continue in 2017.

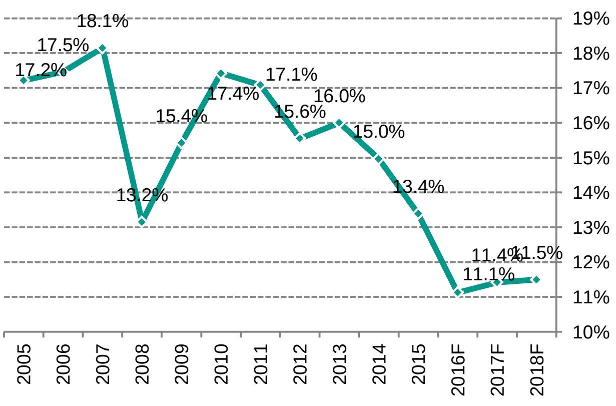
For 2017F, the trading range of the HSCEI Index would be 8,176-11,927, which represents 6.75-9.85x 2017F P/E, 0.74-1.08x 2017F P/B, and a 2017F dividend yield of 4.35-2.98%. We set our end-2017F target at 10,692, which represents 8.83x 2017F P/E, 0.97x 2017F P/B, and a 2017F dividend yield of 3.33%.

Exhibit 9: Projected trading range of HSCEI in 2017

Method	Valuation band range in 2017E			Corresponding HSCEI trading range		
1	**P/B high**	**P/B low**	**End-2017F**	**Index high**	**Index low**	**End-2017F**
	1.15	0.75	1.05	12,727	8,300	**11,620**
2	**P/E high**	**P/E low**	**End-2017F**			
	10.00	6.80	8.50	12,107	8,233	**10,291**
3	**Yield low**	**Yield high**	**End-2017F**			
	3.25%	4.45%	3.50%	10,948	7,996	**10,166**
			Average	**11,927**	**8,176**	**10,692**
			Implied '17 P/E (x)	9.85	6.75	**8.83**
			Implied '17 P/B(x)	1.08	0.74	**0.97**
			Implied '17 yield	2.98%	4.35%	**3.33%**

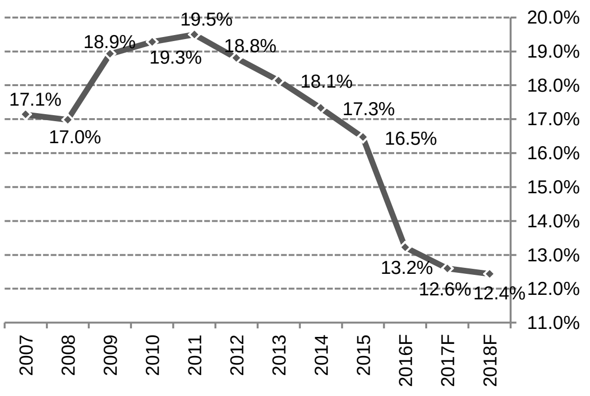
Source(s): ABCI Securities estimates

Exhibit 10: HSCEI's ROAE



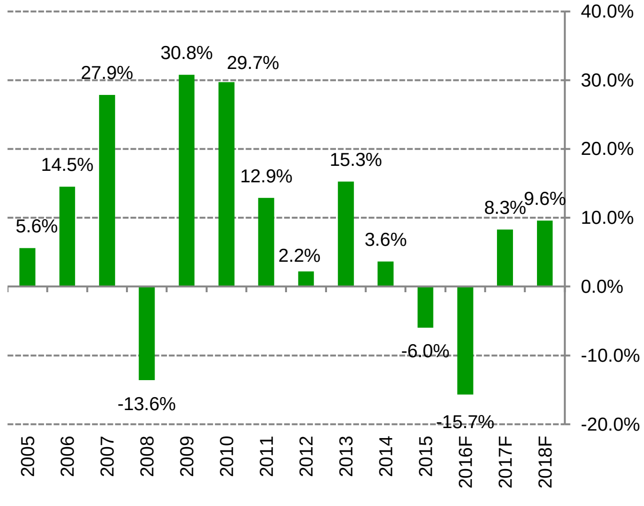
Source(s): Bloomberg,ABCI Securities estimates

Exhibit 11:H-Financial Index's ROAE



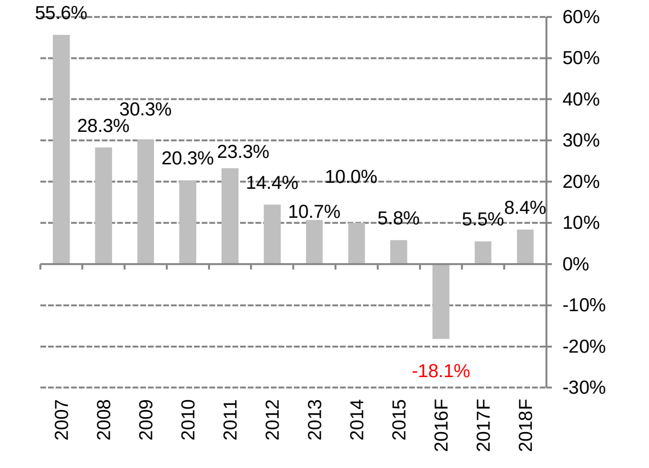
Source(s): Bloomberg, ABCI Securities estimates

Exhibit 12: HSCEI's EPS growth



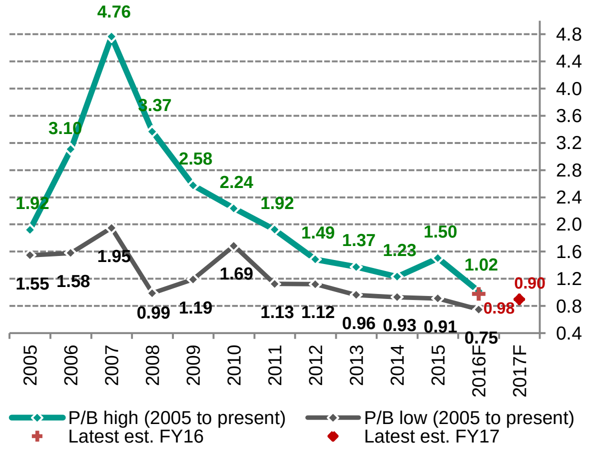
Source(s): Bloomberg,ABCI Securities estimates

Exhibit 13: H-Fin. Index's EPS growth



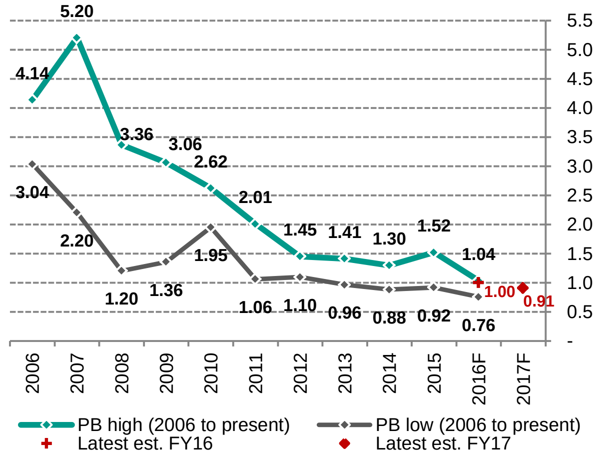
Source(s): Bloomberg,ABCI Securities estimates

Exhibit 14: HSCEI's P/B band (Index: 9,790)



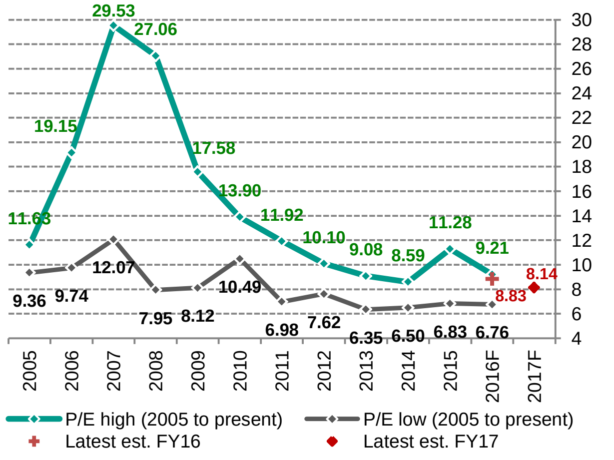
Source(s): Bloomberg,ABCI Securities estimates

Exhibit 15: H-Fin Index's P/B band (Index: 15,765)



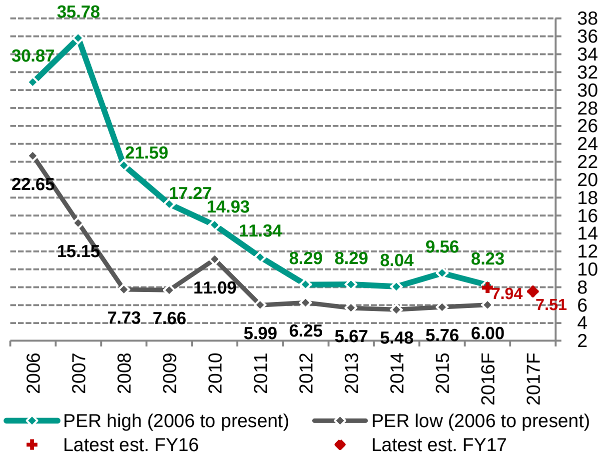
Source(s): Bloomberg,ABCI Securities estimates

Exhibit 16: HSCEI's P/E band (Index: 9,790)



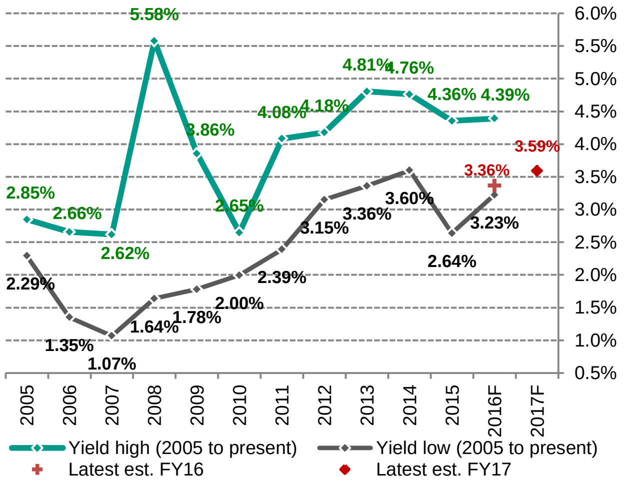
Source(s): Bloomberg,ABCI Securities estimates

Exhibit 17: H-Fin Index's P/E band (Index: 15,765)



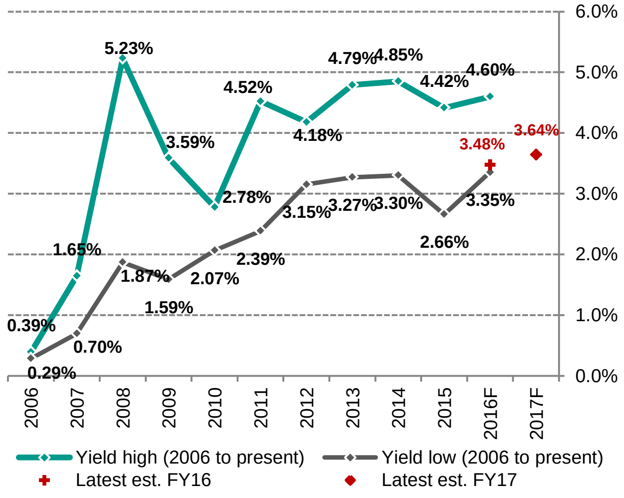
Source(s): Bloomberg,ABCI Securities estimates

Exhibit 18: HSCEI's dividend yield band (Index: 9,790)



Source(s): Bloomberg,ABCI Securities estimates

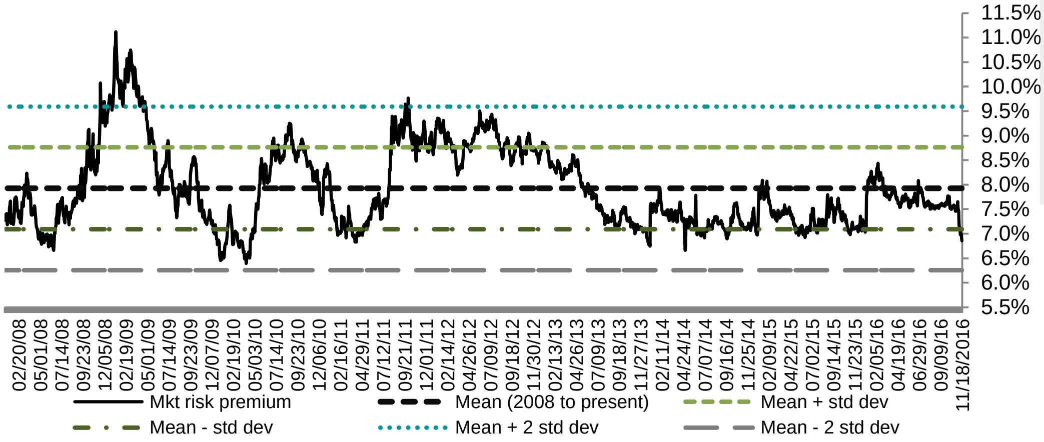
Exhibit 19: H-Fin Index's dividend yield band (Index: 15,765)



Source(s): Bloomberg,ABCI Securities estimates

Market Risk Trend

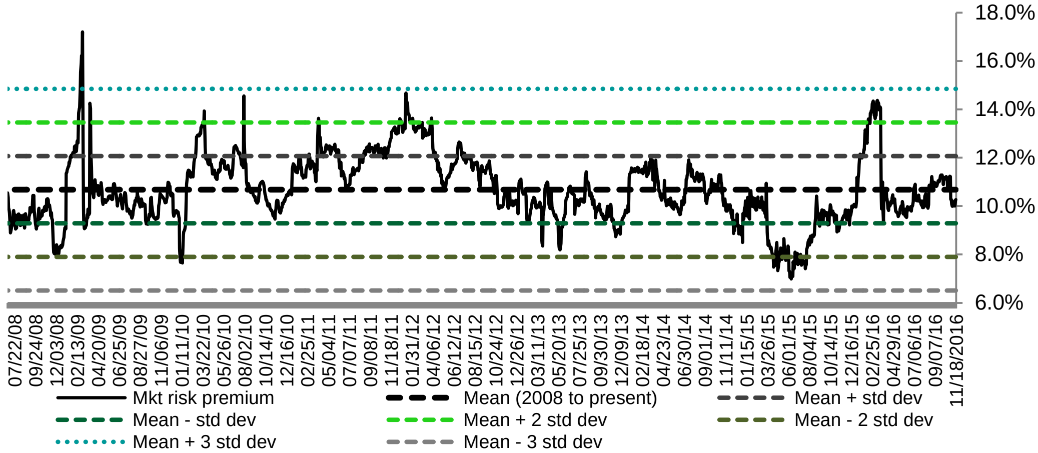
Exhibit 20: U.S. stock market risk premium (1/2008- 11/2016)



Downside risk in the U.S. stock market is high given the current market risk premium nears at 1 S.D. below average.

Remark: Average risk premium (2008-2016): 7.93%; standard deviation: 0.83%; Current risk premium (11/21/2016): 6.86%
Source(s): Bloomberg, ABCI Securities

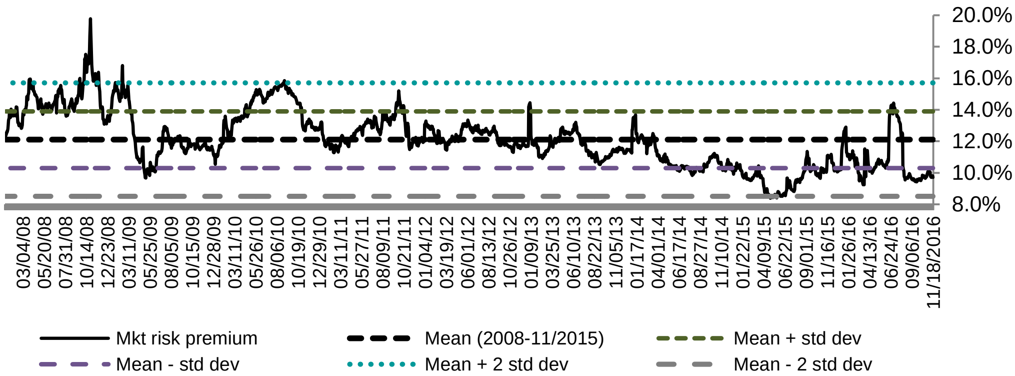
Exhibit 21: China stock market risk premium (1/2008- 11/2016)



Current market risk premium suggests the China stock market is fairly priced and nears the historical average level.

Remark: Average risk premium (2008-2016): 10.68%; standard deviation: 1.39%; Current risk premium (11/21/2016): 10.27%
Source(s): Bloomberg, ABCI Securities

Exhibit 22: Hong Kong stock market risk premium (1/2008- 11/2016)

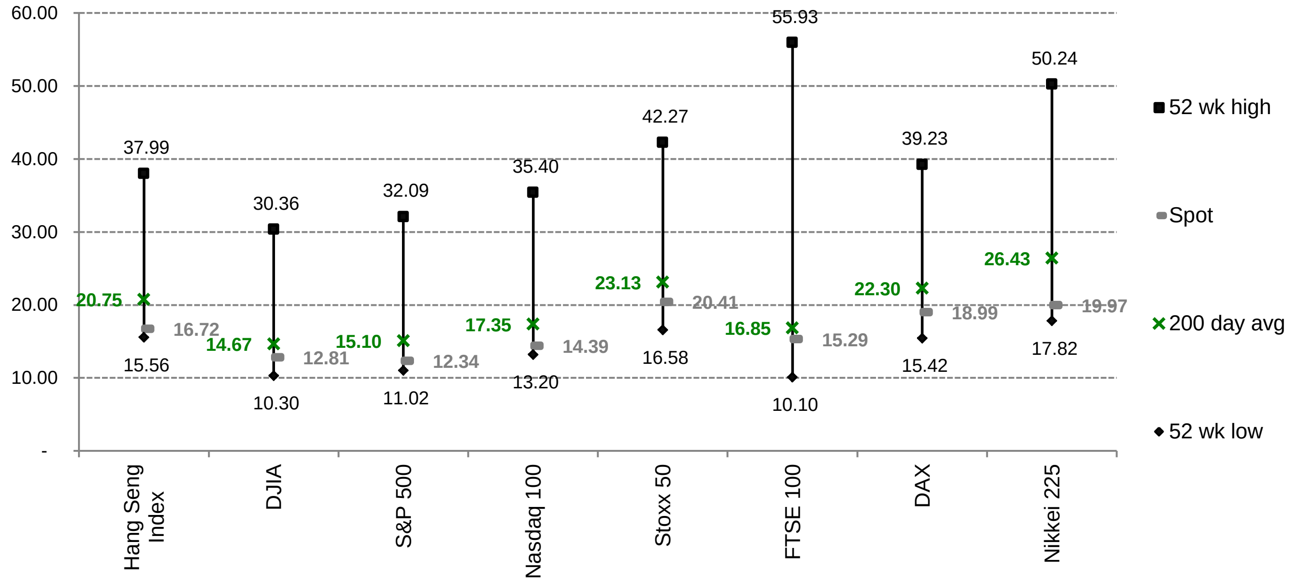


Current market risk premium in the HK stock market is below the historical average minus 1 S.D., suggesting inflated stock values.

Remark: Average risk premium (2008-2016): 12.10%; standard deviation: 1.80%; Current risk premium (11/21/2016): 9.71%
Source(s): Bloomberg, ABCI Securities

Stock Market Risk

Exhibit 23: Volatility index of major stock market index (11/25/2016)



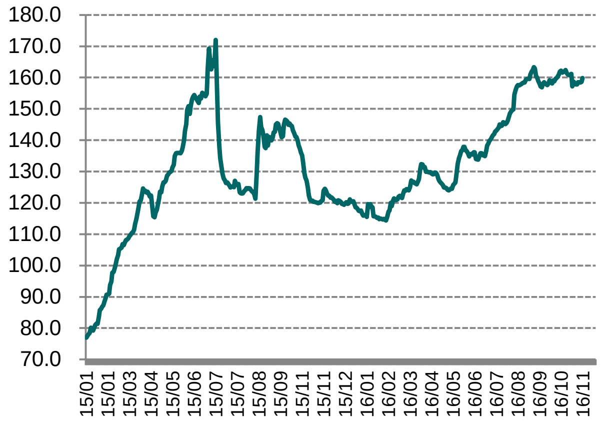
Remarks: Volatility index approaching the year-low (or year-high) suggests a short-term peak (or bottom) may occur for the underlying index
Source(s): Bloomberg, ABCI Securities

China – HK Stock Connect

Shanghai – HK Stock Connect

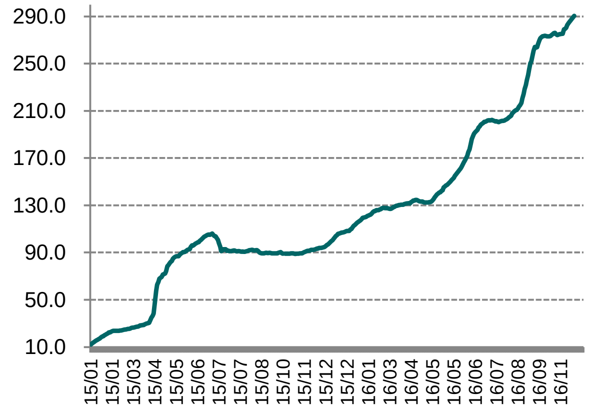
Since the launch of Shanghai-HK Stock Connect, mainland investors have been aggressively accumulating HK stocks; foreign investors, however, have remained cautious on A-shares. YTD (until Nov 22), foreign investors, on a net buy basis, purchased RMB 46.75 bn of A-shares (vs. RMB 24.41 bn in 2015); meanwhile, mainland investors bought HK$ 219.74bn of HK stocks (vs. HK$ 127.49bn in 2015). Based on our estimates, mainland investors have bought RMB 290.4 bn of HK stocks while foreign investors have purchased RMB159.9 bn of A-shares since the launch of the program.

Exhibit 24: SH-HK Connect (Northbound) aggregate net flow (RMB bn)



Source(s): Bloomberg, ABCI Securities

Exhibit 25: SH-HK Connect (Southbound) aggregate net flow (RMB bn)



Source(s): Bloomberg, ABCI Securities

Shenzhen – HK Stock Connect

Impending launch of the Shenzhen-HK Stock Connect would allow foreign investors to invest in eligible A-shares listed in the Shenzhen Stock Exchange and mainland investors to invest in eligible HK stocks. As the investment pool expands, the total amount of bilateral investments (SH-HK Stock Connect and SZ-HK Stock Connect) is expected to increase further.

What's next?

We expect the variety of investments in the Connect schemes to expand in 2017-18. The investment pool of HK stocks may include structured securities such as ETF, REIT, and trusts. Some HK-listed ETFs are tracking overseas stock market indices. The inclusion of ETF into the investment pool would widen the choices for mainland investors, accelerating the development of ETF market in HK.

What're the challenges?

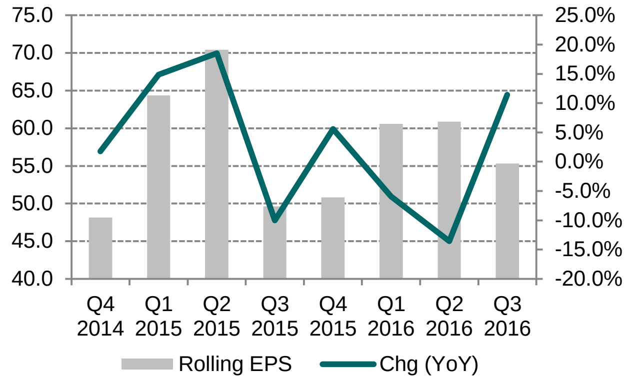
We believe foreign investors would be able to access to the A-share IPO market through the Connect schemes in 2018 the earliest, which could potentially reduce the significance of HK stock market as a major fundraising ground for mainland companies, posing threat to the HK-based investment banks. Moreover, opening up the A-share IPO markets to foreign investors would help attract financial FDI. With these additional channels to acquire capitals from foreign investors, mainland companies would have less incentive to seek listing in HK. Finally, competition for funds may increase with the expanded choices in China and HK IPO markets.

2017 China A-share Stock Markets

Earnings growth is gathering momentum

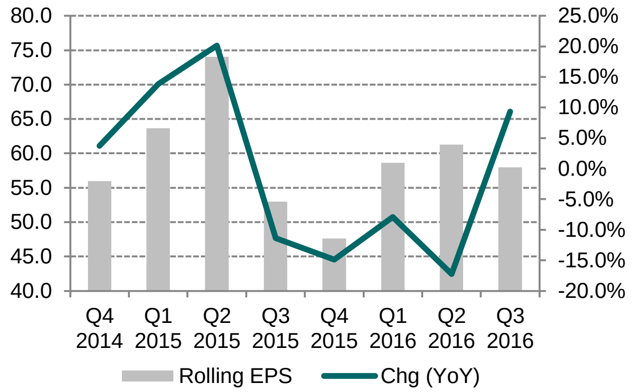
EPS growth of most of A-share companies has bottomed out since 1Q16. The rebound in EPS growth among small-/mid- caps is stronger than that of the large-caps. Rolling EPS of the large-cap stock indices, the SSE 50 Index and CSI 300 Index, advanced 11.4% YoY and 9.3% YoY in 3Q16. Rolling EPS of the Shanghai Composite Index and Shenzhen Component Index soared 10.2% YoY and 28.0% YoY in 3Q16. As the earnings growth has only recovered since 3Q16, we believe most investors would be cautious on accumulating A-shares. Hence, the A-share market is not overpriced at this stage.

Exhibit 26: SSE50 Index rolling EPS (RMB) vs. Change (YoY)



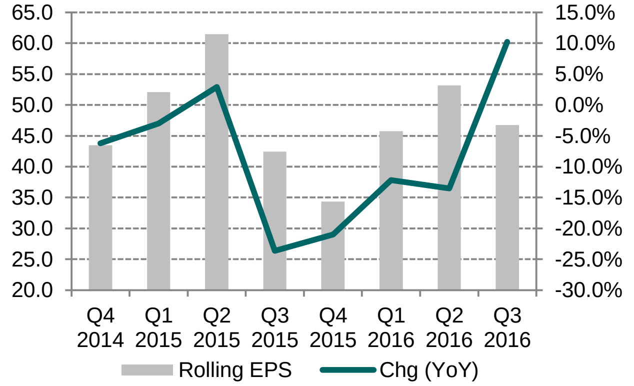
Source(s): Bloomberg, ABCI Securities

Exhibit 27: CSI300 Index rolling EPS (RMB) vs. Change (YoY)



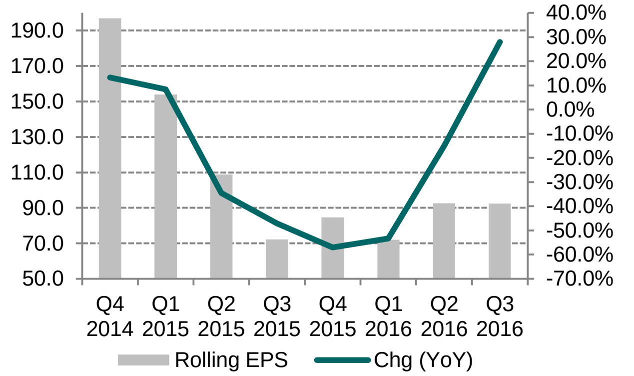
Source(s): Bloomberg, ABCI Securities

Exhibit 28: Shanghai Composite Index rolling EPS (RMB) vs. Change (YoY)



Source(s): Bloomberg, ABCI Securities

Exhibit 29: Shenzhen Component Index rolling EPS (RMB) vs. Change (YoY)

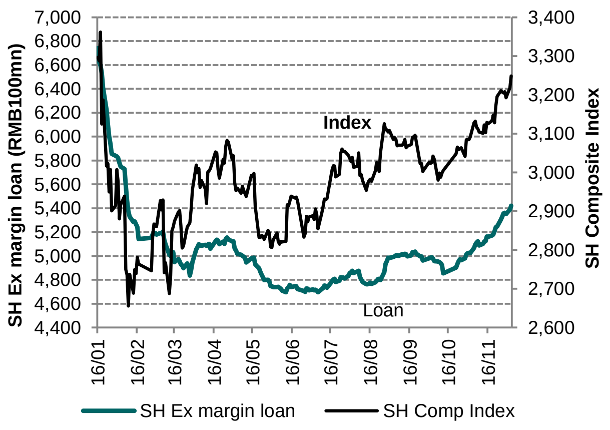


Source(s): Bloomberg, ABCI Securities

Some investors may have leveraged up to buy stocks

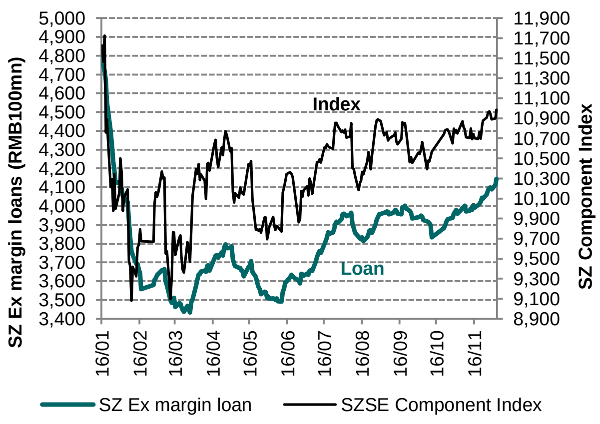
Some aggressive investors have started to leverage up for stock investment since 3Q16. Total outstanding margin loans of the A-share markets increased to over RMB 950.0bn in Nov 2016, compared to RMB 850.9 bn at-end June 2016. Nonetheless, the current outstanding loans are far below RMB 1,171.3 bn at end-2015 or the peak at RMB 2,266.6bn in 2015.

Exhibit 30: SSE margin loans



Source(s): Bloomberg, SHEx, ABCI Securities

Exhibit 31: SZE margin loans

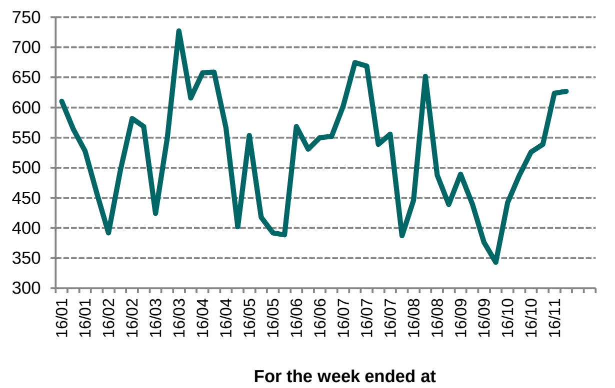


Source(s): Bloomberg, SZEx, ABCI Securities

A-share stock market investors are turning more active, providing support to the market turnover

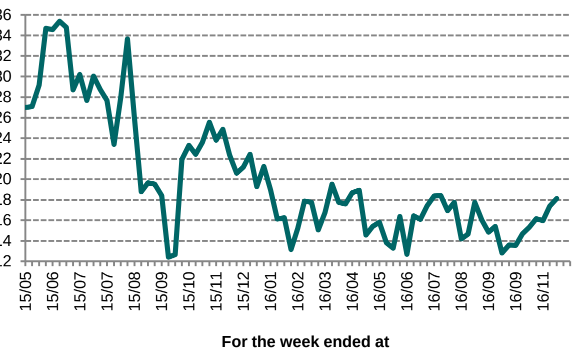
Although the A-share market has over 115.34mn investors, only 18mn are currently active, representing a participation rate of less than 16%. Most A-share investors are latent or only active when a bull trend emerges. We expect continuous recovery in corporate earnings would attract more investors to participate in 2017, driving up the average daily turnover of the A-share market.

Exhibit 32: Average daily turnover during the week (RMB bn /day)



Source(s): Bloomberg, ABCI Securities

Exhibit 33: Number of active A-share investors during the week (mn)



Source(s): CSDC, ABCI Securities

Government to promote direct financing

Bank loan has been the major source of total social financing. With the rising NPL and declining NPL coverage ratio in 2015-16, banks would not be able to expand their loan assets substantially in 2017. To fulfill funding needs essential for economic growth, direct financing (equity or bond financing) provides an alternative funding source. As the cost of equity is usually more expensive than the cost of debt, the growth in direct financing would be partially dependent on a bullish equity or bond market in 2017. In another words, a bearish market would be highly unfavorable to the development of direct financing. We believe investment banks would be the immediate beneficiaries of increased direct financing and a bullish capital market.

A-share markets valuation

Indices tracking the mid-/large-caps are trading at 9-12x 2017F P/E or 1.2-1.4x 2017F P/B, indicating an attractive valuation of the large-caps. Meanwhile, small-caps are trading at over 20x 2017F P/E and 2.4x 2017F P/B.

Although certain small-cap companies are able to demonstrate a strong profit growth, the average profitability of small-caps (as measured by ROE) is lower than the mid-/large-cap ones. Therefore, we expect mid-/large-caps to outperform the smaller peers in 2017.

Exhibit 34: Benchmark Index Valuation

Index	Price	2016F P/E	2017F P/E	2016F P/B	2017F P/B	2016F Yield	2017F Yield	2016F ROE	2017F ROE
Tracking large-cap:									
SSE 50	2,360.34	10.85	10.00	1.35	1.22	2.54%	2.73%	12.4%	12.2%
FTSE CHINA A50	10,310.30	9.95	9.25	1.30	1.17	2.67%	2.85%	13.0%	12.7%
Tracking mid-cap:									
SSE 180	7,494.99	12.84	11.70	1.52	1.38	2.13%	2.30%	11.9%	11.8%
Tracking small-cap:									
SSE 380	5,820.47	29.89	23.43	2.61	2.41	-	-	8.7%	10.3%
Tracking broad market:									
CSI 300	3,474.73	14.65	13.00	1.74	1.58	1.98%	2.17%	11.9%	12.2%
SH Composite	3,241.14	15.32	13.51	1.57	1.45	1.84%	2.00%	10.2%	10.7%

Source(s): Bloomberg, ABCI Securities

2017 Hong Kong IPO Market

Financials dominates the scene

- ***In 11M16, Hong Kong IPO market has raised US$ 22.9bn with an average deal size of US$ 234mn. The Chinese investment banks continued to gain market share, accounting for 7 of the top 10 underwriters by volume***

- ***Financial stocks continued to be the main driver contributing to 75% of IPO volume in 11M16 (2014: 28%) due to its capital intensive nature and larger deal size. We expect the trend to continue over the next 1-2 years***

In 11M16, total volume of Hong Kong equity IPO amounted to US$ 22.9bn. Ninety-eight IPOs were issued, with an average issue size of US$ 234mn each. Seven out of the top 10 underwriters with the highest underwriting volume were the Chinese investment banks in 11M16 (2015: 6), indicating an ongoing share gain by the Chinese investment banks against the foreign investment banks in the IPO market.

Financial stocks such as Postal Savings Bank of China (1658 HK), CMS (6099 HK), Everbright Sec (6178 HK), etc. were the main drivers of the HK IPO market, contributing to 75% of the total amount raised in 11M16. Overall, the share of financial industries in HK's IPO market increased from 28% in 2014 to 75% in 11M16. In our view, this structural uptrend can be attributed to:

1) Financials is a capital- intensive industry with ongoing funding needs;

2) Financial IPO generally has a larger deal size than other industries, rendering it more appealing to investors' current preference for larger-cap stocks. In 11M16, average deal size of financial IPO was US$ 748mn, compared to only US$ 77mn for non-financial IPO.

Looking ahead, we expect financials to be the major contributors of HK's IPO market in the next 1-2 years. In particular, we believe upcoming financial IPOs would be driven by mid-sized banks, insurers, and brokers.

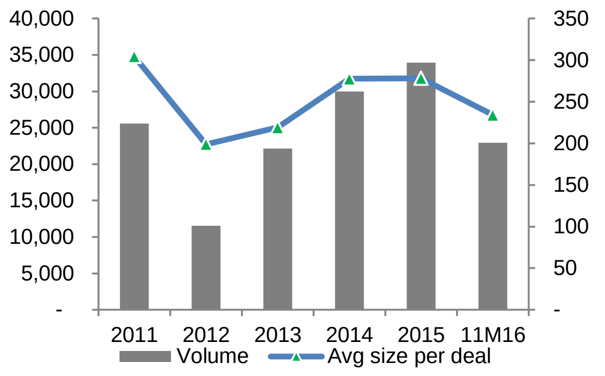
Market share of non-financial industries in HK's IPO market dropped from 72% in 2014 to 25% in 11M16. In 2014, industrials amounted to 18% of HK's IPO but its share has since dropped to 5% in 11M16. Similarly, market share of consumer discretionary dropped from 18% to 4% over the same period. In our view, the declines could be due to: 1) Non-financial industries are generally less capital-intensive than financials; 2) Average IPO size of non-financial IPO is significantly lower than that of financial IPO, hence investor interest is low especially given the current market condition tinted by uncertainty.

Exhibit 35: 11M16 HK IPO Overview

Industry	Volume (US$ mn)	Avg deal size (US$ mn)
Financials	17,213	748
Healthcare	2,433	304
Industrials	1,070	41
Consumer Discretionary	1,005	46
Consumer Staples	758	152
Others	477	208

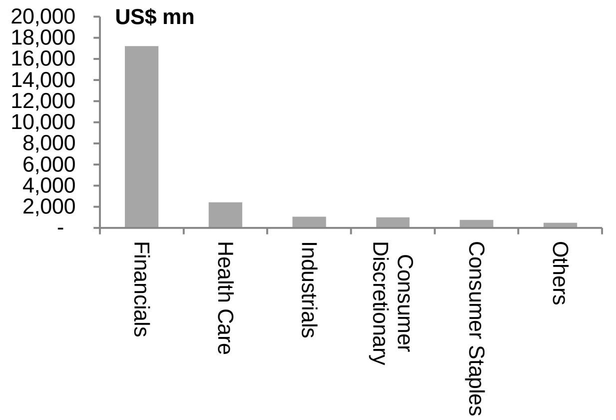
Source(s): Bloomberg, ABCI Securities

Exhibit 36: HK IPO volume (LHS) and average deal size (RHS) (US$ mn)



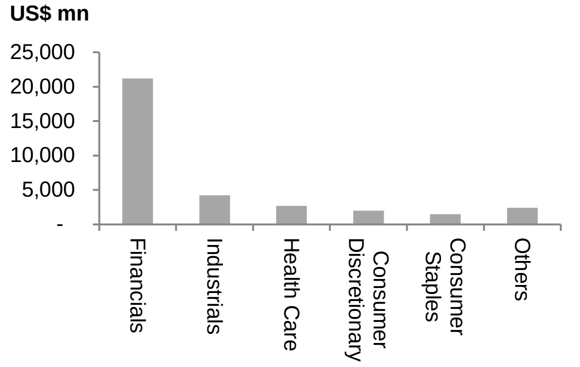
Source(s): Bloomberg, ABCI Securities

Exhibit 37: HK IPO volume by industry (11M16)



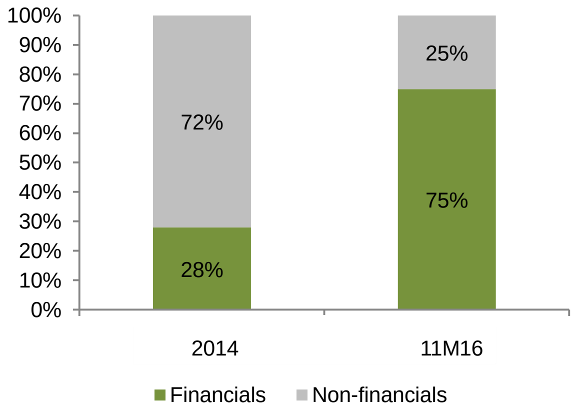
Source(s): Bloomberg, ABCI Securities

Exhibit 38: HK IPO volume by industry (2015)



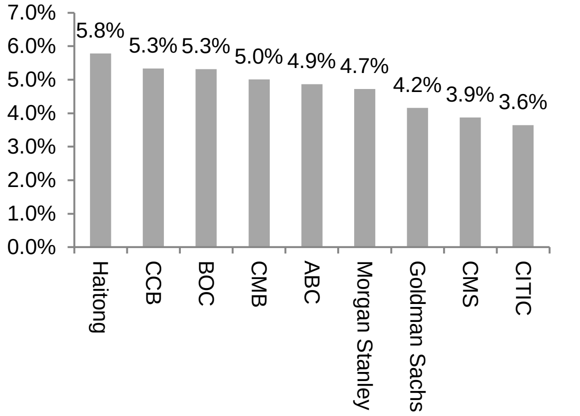
Source(s): Bloomberg, ABCI Securities

Exhibit 39: HK IPO volume – financial vs. non-financial



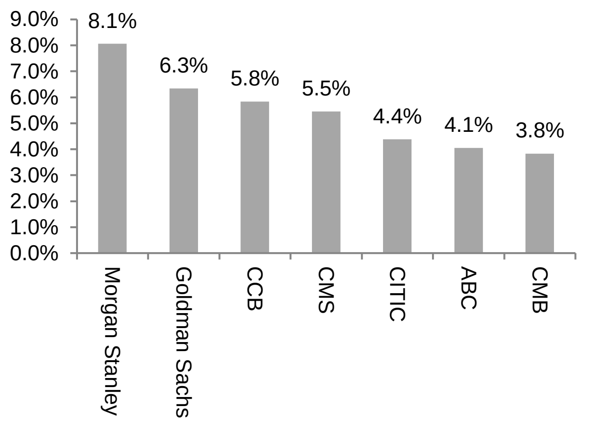
Source(s): Bloomberg, ABCI Securities

Exhibit 40: HK IPO underwriter volume market share (11M16)



Source(s): Bloomberg, ABCI Securities

Exhibit 41: HK IPO underwriter volume market share (2015)



Source(s): Bloomberg, ABCI Securities

Sector fundamentals to stabilize in 2017

- System NIM and asset quality would stabilize in 2017
- We expect a stable interest rate environment in 2017F-19F
- Loan growth to stay robust at 12%-14% over 2017F-19F
- NPL ratio would rise mildly but increased handling channels should help support asset quality
- The 13th FYP would result in structural changes in revenue and facilitate offshore expansion
- Maintain **OVERWEIGHT** on low valuation and sustainable yield

China Banks

OVERWEIGHT

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Sector re-rating has begun. Share price performance in the sector indicates re-rating has begun since mid-May. Investor concerns on NIM and asset quality are easing. We expect sector fundamentals to stabilize in 2017 with 1) A stable interest rate environment; 2) NIM to bottom in 2017 on loan re-pricing and VAT reform; 3) Solid loan growth driven by concrete demand; 4) Stable asset quality on increased NPL handling capacity; 5) Possible changes in revenue structure under the 13th FYP.

Interest rate environment remains stable. With increasing expectation of a global interest rate upcycle to be led by the U.S, China will face more pressure to raise rates. Nonetheless, with the government's priority to reduce social financing cost, we believe the PBOC would maintain a stable interest rate environment over 2017F-19F and tolerate a higher inflation rate. A lower social financing cost would be achieved through continuous development in indirect funding channels and industry deleveraging. Meanwhile, market liquidity would be adjusted through increased deployment of short-term monetary tools.

NIM to bottom in 2017. Under China's "new normal" economic growth, loan demand would remain solid and serve as a buffer against the minor adjustments expected for the benchmark interest rates. We assume the sector NIM to bottom in 4Q16-1Q17 due to the impacts of loan re-pricing and VAT reform. On an annual basis, sector NIM should bottom in 2017 and gradually stabilize after that. For individual banks, balance sheet growth and flexibility in asset allocation would become the key differentiating factors in performance. Compared to big banks and JSBs, district banks in the growth phase could potentially attain higher NIM and earnings growth in our view.

Solid loan growth outlook. Based on the loan data in 9M16, the 2016F full-year loan target of RMB 12.3tr will likely be achieved. Meanwhile, stabilized loan yield since 1Q16 and the high proportion of loans priced at above-benchmark rates indicate a robust loan demand. Loan duration improved with increased new loan allocation shifting from short term to medium-to-long term in 2016. In 9M16, the proportion of medium-to-long-term loans to total new loans was 72.9%, much higher than the 56.2% reported in 2015. We expect MSEs and Sannong-related sectors to be the core loan growth drivers in the next 3 years. China's loan growth would be 12%-14% p.a. over 2017F-19F.

Key Data

Avg.17F P/E (x)	5.28
Avg.17F P/B (x)	0.65
Avg.17F Dividend Yield (%)	5.31

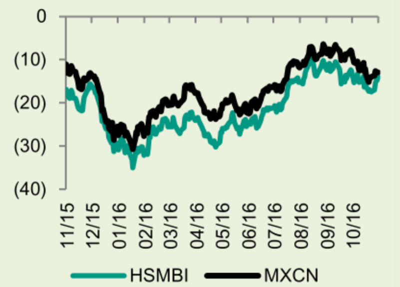
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	(0.46)	3.82
3-mth	1.29	3.30
6-mth	17.64	6.21

* HSMBI relative to HSI
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Increased NPL handling enhances asset quality. NPL level in 9M16 was well-contained, thanks to increased NPL handling through write-offs and disposals. We expect a mid-to-high level of NPL pressure to persist over the next few years. With increased handling channels, overall system NPL ratio would be under control. Taking a conservative stance, we assume NPL ratio to rise 6bps QoQ going forward.

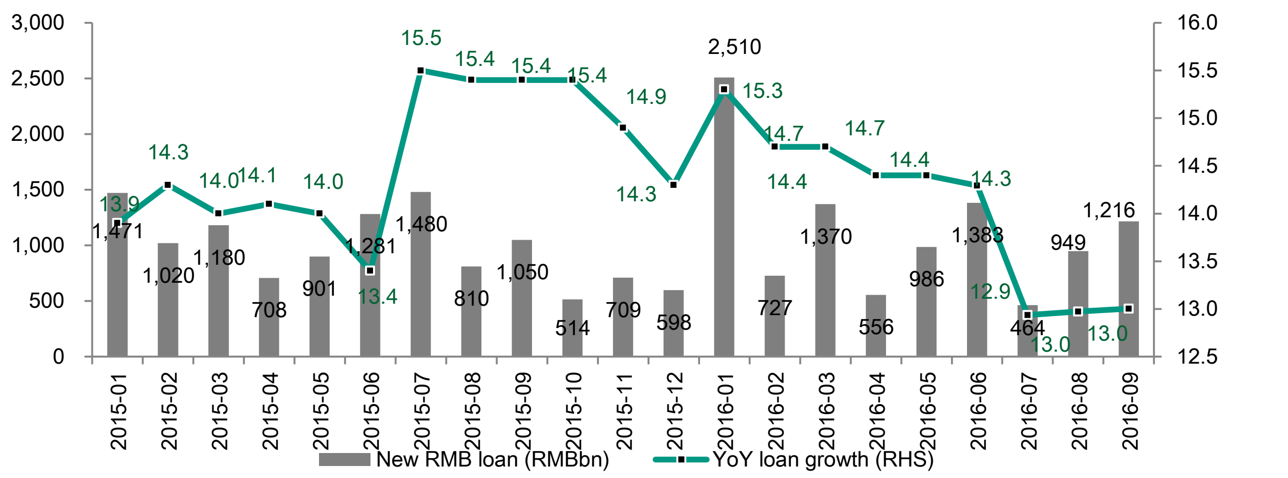
District banks to achieve faster growth. Large provisions would persist and suppress the sector's earnings growth in 2017F-19F. We forecast earnings in big banks would remain flat while that of the JSBs would achieve a low single-digit growth in the next 3 years. District banks, with a relatively small operation size, would demonstrate faster earnings growth.

Possible changes in revenue structure under the 13th FYP. Innovations and reforms accelerating fee income growth in the bank sector are encouraged in the 13th FYP. We expect the proportion of non-interest income to exceed 30% of total in the next 3 years. Policy risk, however, will rise on demand from regulators to manage risk. Development of mixed operation and internationalization in the financial sectors would expand income sources, increase operational synergy, and M&A activities. Nevertheless, with continuous balance sheet growth and emerging overseas expansion opportunities, banks may need to strengthen capital position through equity and debt issuances.

To reiterate, we prefer big banks. Big banks such as CCB (939 HK, BUY, TP: HK$ 8.02) and ICBC (1398 HK, BUY, TP: HK$ 6.84), with a decent dividend yield as well as a high degree of business diversification and defensiveness against policy risk, continue to be our sector top picks. ABC (1288 HK), with its robust risk buffer and high dividend yield, also presents a sensible investment option. Higher operational flexibility would be seen in district banks since their balance sheets are relatively smaller. Nonetheless, we remain cautious on their low average daily trading volume. New capital rule requirements and higher capital needs arising from the development of mixed operation will motivate more Chinese banks to seek listing on HKEx. The increasing choices of H-share banks in the stock market, however, may potentially dilute investment.

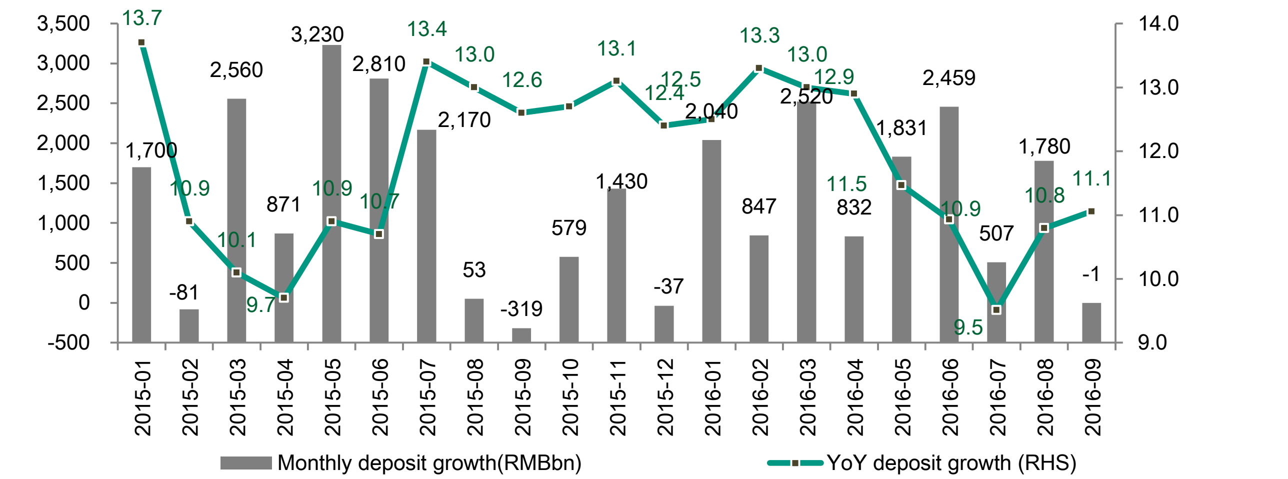
Risk factors: 1) Financial reforms in faster pace than expected; 2) Increasing competition from non-bank financial institutions; 3) Sharp asset quality deterioration in specific regions; 4) Weak loan demand.

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



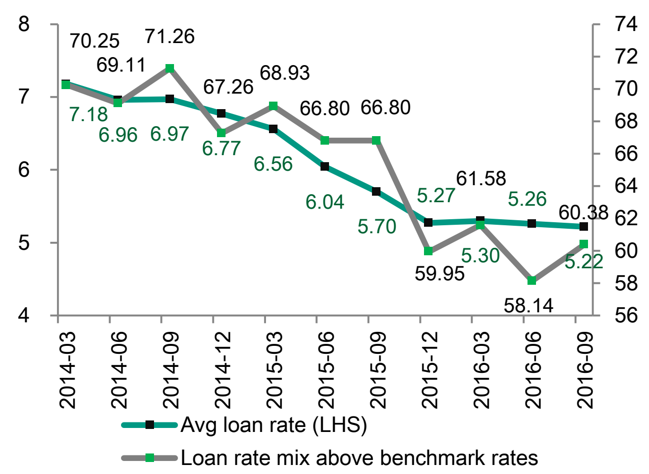
Source(s): PBOC, ABCI Securities

Exhibit 2: Monthly deposit growth (RMB bn) and YoY growth (%)



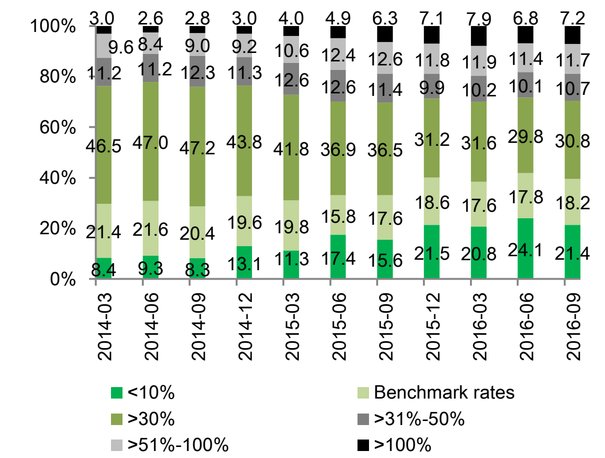
Source(s): PBOC, ABCI Securities

Exhibit 3: Average loan yield vs. proportion of loans priced at above-benchmark rates (%)



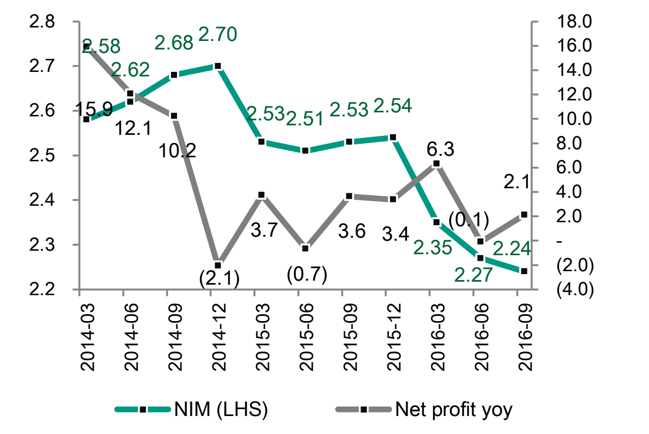
Source(s): PBOC, ABCI Securities

Exhibit 4: Breakdown of loan pricing (%)



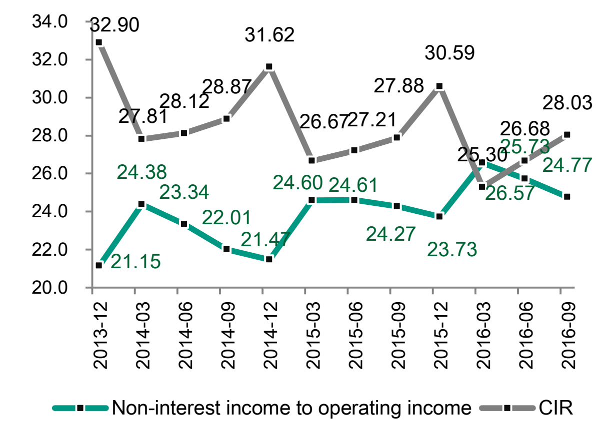
Source(s): PBOC, ABCI Securities

Exhibit 5: System NIM and system net profit YoY (%)



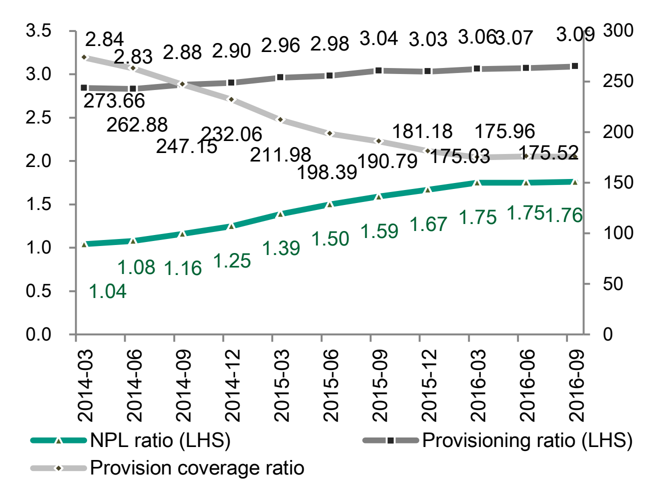
Source(s): CBRC, ABCI Securities

Exhibit 6: System non-interest income to operating income and system CIR (%)



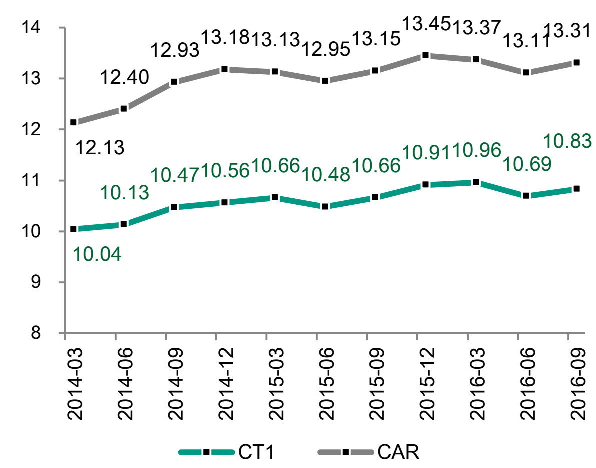
Source(s): CBRC, ABCI Securities

Exhibit 7: Key asset quality indicators (%)



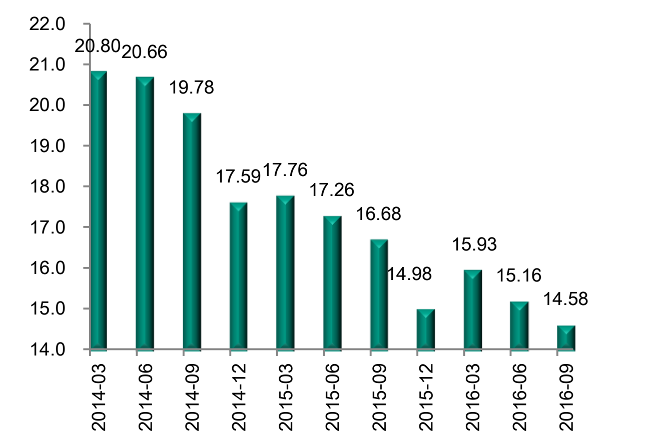
Source(s): CBRC, ABCI Securities

Exhibit 8: System CT1 and CAR (%)



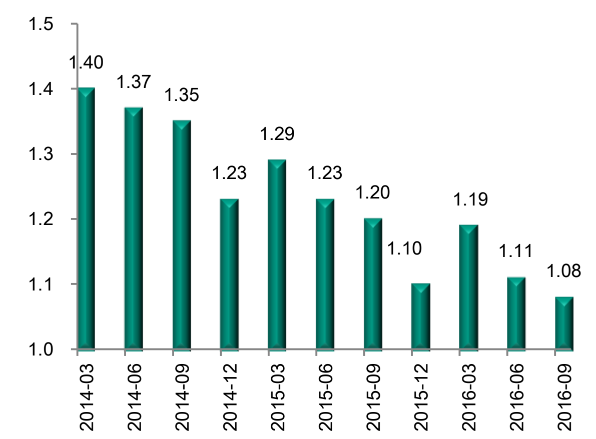
Source(s): CBRC, ABCI Securities

Exhibit 9: System ROAE (%)



Source(s): CBRC, ABCI Securities

Exhibit 10: System ROAA (%)



Source(s): CBRC, ABCI Securities

Exhibit 11: Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield(%)	FY17F Yield(%)
ICBC	1398 HK	BUY	6.84	46.47	5.28	5.21	0.74	0.67	6.00	6.00
CCB	939 HK	BUY	8.02	39.48	5.64	5.52	0.80	0.73	5.26	5.45
ABC	1288 HK	BUY	4.56	42.06	5.12	4.94	0.70	0.63	5.93	6.28
BOC	3988 HK	BUY	5.01	43.14	5.39	5.21	0.64	0.59	6.08	6.08
BoCom	3328 HK	BUY	7.71	27.65	5.99	5.93	0.69	0.63	5.01	5.01
CMB	3968 HK	BUY	25.40	32.43	7.35	6.99	1.07	0.96	4.03	4.15
MSB	1988 HK	BUY	11.73	34.83	6.07	5.88	0.83	0.74	2.83	2.83
CITICB	998 HK	BUY	6.13	20.20	5.23	5.06	0.62	0.55	4.83	4.83
CEB	6818 HK	BUY	5.26	42.93	4.83	4.63	0.61	0.55	6.09	6.39
HB	3698 HK	BUY	4.59	18.60	5.76	5.32	0.76	0.65	4.92	5.21
HRB	6138 HK	BUY	2.84	22.94	4.69	4.21	0.60	0.53	5.33	5.82
BoCQ	1963 HK	BUY	8.20	30.16	4.93	4.43	0.68	0.57	5.33	5.69

Source(s): Bloomberg, ABCI Securities estimates

2017: A year of challenges

- Oligopolistic situation remains intact
- Healthy premium growth in 2016-20
- Price liberalization, changes in actuarial estimates, and implementation of IFRS 9 will cause temporary setbacks on insurers' profit and embedded value in 2017-18
- CPIC (2601 HK) and Ping An (2318 HK) are in better positions to tackle changes in our view

China Insurance

NEUTRAL

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Rising insurance demand. Based on our estimates, 9M16 insurance penetration and density increased to 4.75% (2015: 3.54%) and RMB 1,824 per capita (2015: RMB 1,766). The 13th FYP targets for insurance penetration and density are 5% and RMB 3,500 per capita by 2020, assuming a nominal GDP per capita of RMB 70,000 per capita by 2020 (2015-20 CAGR of 7%). Such targets imply that total insurance premium and insurance premium per capita would grow at 13.1% CAGR and 14.6% CAGR in 2015-20; total assets of the insurance industry would expand by a 5-year CAGR of 15.1%.

Challenges ahead in 2017. The government reduces regulatory price control on major insurance products to boost demand. Life insurance premium jumped 43% YoY in 9M16. Price liberalization in insurance has driven up the liability cost of insurance contracts. Meanwhile, the low interest rate environment limits investment return despite the growing asset size. Underwriting profit of life insurers in 2016-17 will be dragged by the significant increase in insurance liability cost.

Risk management is crucial to insurance industry. Proportion of bank deposits and bond investments in total assets reduced to 45.38% at end-Sep 2016 from 50.81% in 2015 and 59.96% in 2014. Meanwhile, the proportions of equities and alternative investments in total assets increased to 42.30% from 39.64%in 2015 and 31.90% in 2014. To enhance investment returns, insurers would need to reduce the proportions of bank deposits and high-grade bonds in their asset portfolio while increasing the holding of riskier assets (low-grade bonds, equities, or alternative investments) and assets with a longer repayment period. As a result, liquidity risk, credit risk, and asset price risk of insurers will continue to increase.

Change of accounting standard in 2018. Reported net profit based on the current accounting standard is unable to give a full picture of financial performance of insurers. In 9M16, China Life (2628 HK) reported a net profit and a comprehensive net loss with a reduction in shareholders' value. The new accounting standard IFRS 9, which will be introduced in 2018, would provide a more comprehensive view of the insurers' financial performance. Under the new accounting standard, negative impacts of the increased amount of risky assets on balance sheets will be more fully reflected.

Key Data

Avg.17F P/E (x)	12.7
Avg.17F P/B (x)	1.3
Avg.17F Dividend Yield (%)	1.6

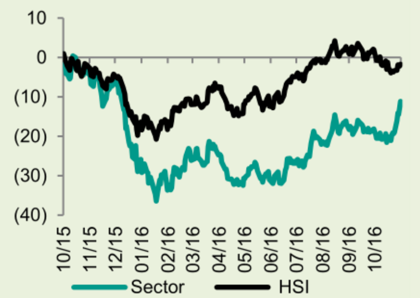
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	8.56	12.13
3-mth	4.59	1.30
6-mth	12.87	0.85

* Sector relative to HSI
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Outlook in 2017

Surge in liabilities of life and health insurance contracts would erode underwriting profit. Changes in business and investment environments would lead to changes in actuarial estimates of liabilities for life and health insurance contracts. We expect the liabilities of long-term life or health insurance contracts to surge, with the negative impacts to be fully reflected in the income statements for2017. China Life and Ping An warned that their pre-tax profits would be reduced by RMB 18.5bn and RMB 17.2bn for 9M16 based on the new actuarial liability estimates.

Embedded value would be suppressed. We expect insurers to revise down actuarial estimates of investment returns, which in turn would drag down underwriting profits and embedded values. However, insurers may lower their risk discount rates to support embedded values. Based on our estimates, CPIC, with the most conservative return assumptions among peers, would be less affected by the lower return estimates. Embedded value of NCI (1336 HK), which adopts the highest discount rate among peers, would also be supported despite the lower return estimates. Meanwhile, PICC Group (1339 HK) would suffer the most due to its already-low discount rate and the aggressive assumptions on investment returns. CPIC is our preferred pick among the insurers. .

Oligopolistic situation remains intact. The top 10 domestic life insurers captured 76%/73% of total life premium income for 2015/9M16; the top 10 domestic P&C insurers captured 86%/85% of total P&C premium income for 2015 /9M16; 7 HK-listed China insurers captured 53%/75% of total life/P&C premium income for 9M16. Anbang Life is an unlisted insurer competing neck and neck with the listed counterparts. Anbang Group, the third largest life insurance group in China, has a total life and health insurance premium higher than CPIC’s and below Ping An’s .

Insurers are transforming into financial conglomerates. Over the years, we have seen alliances formed between banks and insurers: (1) China Life raised its stakes in Guangdong Development Bank to 43.686% in Aug 2016; (2) PICC P&C (2328 HK) agreed to acquire a 19.99% stake in Huaxia Bank (600015 SH); (3) China Re (1508 HK) has a 4.94% stake in its associate Everbright Bank (6818 HK); Ping An Bank (000001 CH) contributed to ~20% of Ping An (2318 HK)’s net profit.

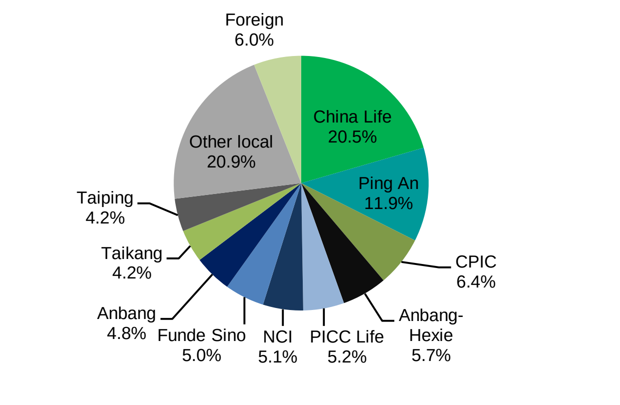
Customers are the most valuable intangible assets. Ultimately, the intrinsic value of an insurer depends on how it can optimize the value of its customers. Insurers are building up e-commerce platforms to cross-sell financial products to customers. Ping An, in our view, has been the most successful in this regard.

Exhibit 1: Current assumptions on valuation of embedded value of insurers

	China Life	NCI	Ping An	CPIC	PICC Gp	Taiping	China Re
Discount rate (%)	11.0%	11.5%	11.0%	11.0%	10.0%	11.0%	11.0%
Investment returns (%)	5.1-5.5%	5.0-5.5%	4.75-5.5%	5.2%	5.5%	5.5%	5.5%

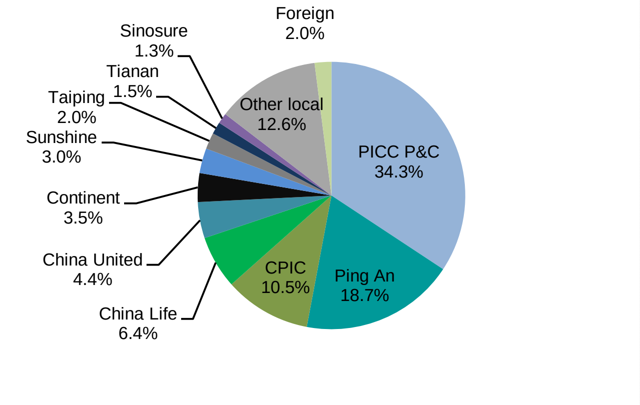
Source(s): Companies’ financial reports

Exhibit 2: Top 10 life insurers in 9M16



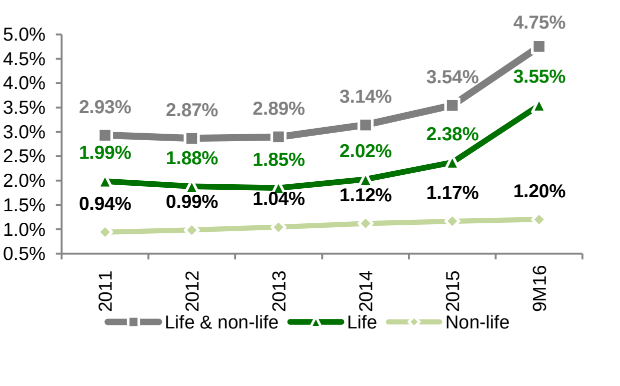
Source(s): CIRC, ABCI Securities

Exhibit 3: Top 10 P&C insurers in 9M16



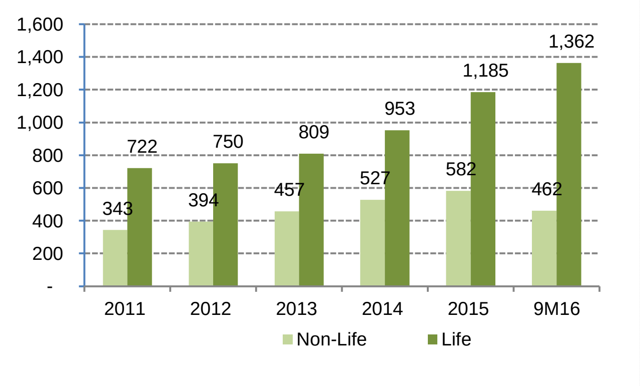
Source(s): CIRC, ABCI Securities

Exhibit 4: Insurance penetration (% of GDP)



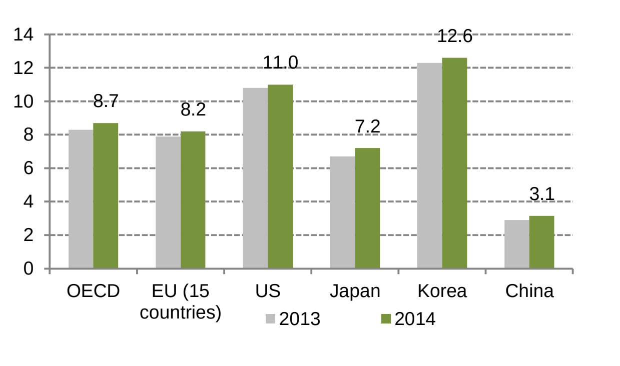
Source(s): CIRC, NBS, ABCI Securities

Exhibit 5: Insurance density (RMB per capita)



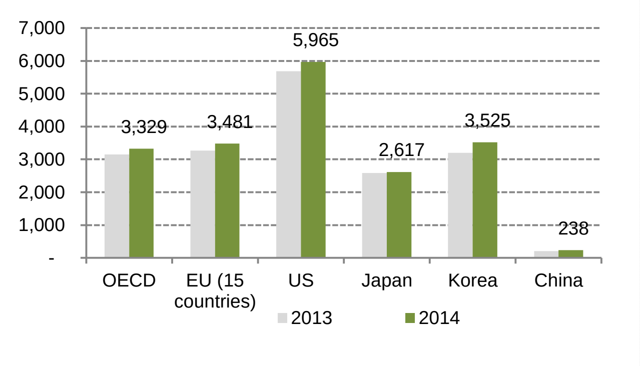
Source(s): CIRC, NBS, ABCI Securities

Exhibit 6: Insurance penetration (% of GDP)



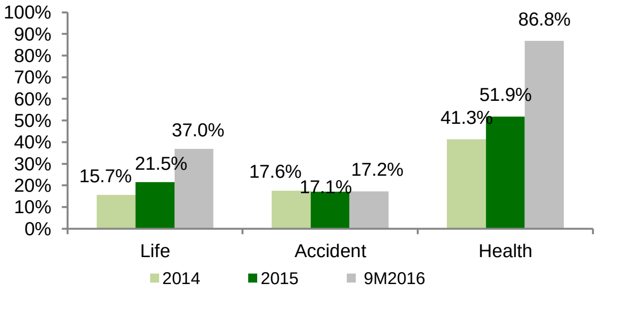
Source(s): OECD, CIRC, NBS, ABCI Securities

Exhibit 7: Insurance density (US$ per capita)



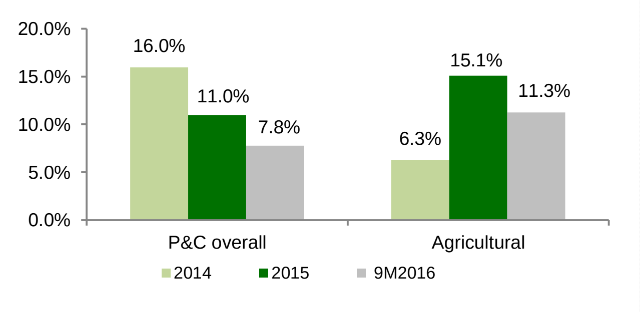
Source(s): OECD, CIRC, NBS, ABCI Securities

Exhibit 8: China Insurance premium (%YoY)



Source(s): CIRC, ABCI Securities

Exhibit 9: China Insurance premium (%YoY)



Source(s): CIRC, ABCI Securities

Exhibit 10: Original insurance premium income

Life insurance premium income	10M 16 (RMB bn)	Chg (YoY)	2015 (RMB bn)	Chg (YoY)	2014 (RMB bn)	Chg (YoY)
China Life (2628 HK)	394.7	19.9%	364.1	9.9%	331.2	1.4%
Ping An Life[1]	236.4	32.6%	208.4	19.8%	174.0	19.1%
CPIC Life[2]	126.2	29.3%	108.6	10.0%	98.7	3.8%
PICC Life[3]	98.7	18.1%	89.4	13.6%	78.7	4.6%
NCI (1336 HK)	102.2	-0.3%	111.9	1.8%	109.9	6.0%
Anbang-Hexie Health[4]	105.7	374.3%	30.8	19,156.3%	0.16	-
Anbang Life [4]	100.0	113.2%	54.5	3.1%	52.9	3,760.6%
Taiping Life[5]	82.4	19.8%	79.9	22.7%	65.1	25.6%
Taikang Life	82.4	24.9%	76.0	12.0%	67.9	11.1%
PICC Health[3]	22.9	52.0%	16.1	1.9%	15.8	106.8%
Ping An Health[1]	0.7	43.8%	0.5	24.6%	0.4	36.2%
P&C insurance premium income	**10M 2016 (RMB bn)**	**Chg (YoY)**	**2015 (RMB bn)**	**Chg (YoY)**	**2014 (RMB bn)**	**Chg (YoY)**
PICC P&C (2328 HK)[3]	256.3	10.5%	281.0	11.3%	252.4	13.2%
Ping An P&C[1]	141.8	5.6%	163.6	14.5%	142.9	23.8%
CPIC Property[2]	78.5	1.0%	94.4	1.7%	92.8	13.8%
China Life P&C[6]	48.2	19.2%	50.4	24.7%	40.4	26.8%
China United P&C[7]	29.8	-1.7%	39.4	12.9%	34.9	17.4%
Continent P&C[8]	26.3	20.5%	26.6	18.9%	22.4	12.6%
Taiping General[5]	14.9	15.4%	15.6	17.7%	13.3	22.9%
Anbang P&C[4]	4.0	-6.81%	5.3	2.1%	5.1	-20.9%

[1] Ping An Life, Ping An Health and Ping An P&C are 99.51%, 75.01% and 99.51% owned by Ping An Insurance (Group) (2318 HK)
[2] China Pacific Life (CPIC Life) and China Pacific Property (CPIC Property) are 98.29% and 98.5% owned by China Pacific Insurance (Group) (2601 HK)
[3] PICC Life and PICC P&C and PICC Health are 80%, 68.98% and 93.95% owned by The People's Insurance Co (Group) (1339 HK)
[4] Anbang Life holds 48.65% of Anbang P&C which holds 65.17% of Hexie Health
[5] Taiping Life and Taiping General are 75.1% and 100% owned by China Taiping Insurance (966 HK)
[6] China Life P&C is 40%-owned by China Life Insurance (2628 HK)
[7] CRCC (1766) acquired a 13.06% stake of China United P&C for RMB4455mn in Jan 2016
[8] China Continent P&C is 93.18% owned by China Re (1508 HK)
Source(s): Bloomberg, ABCI Securities

Exhibit 11: Sector Financial Performance Summary (Data as of Nov 25, 2016)

Company	Ticker	EBV (RMB)	Life new contracts chg (YoY)	1H16 ROAA (p.a.)	1H16 ROAE (p.a.)	Assets / Equity (x)	1H16 Invest yield	P&C combined ratio	Life core solvency	P&C core solvency
China Life	2628 HK	20.65	50.4%	0.85%	6.65%	8.44	4.4%	-	298%	-
NCI	1336 HK	35.16	18.1%	0.99%	11.54%	11.89	5.3%	-	252%	-
Ping An	2318 HK	33.62	40.9%	1.86%	23.36%	11.28	4.4%	95.3%	207%	257%
CPIC	2601 HK	23.76	55.9%	1.31%	9.44%	7.61	4.7%	99.4%	249%	250%
PICC Gp	1339 HK	3.26	56.6%	2.59%	13.04%	5.52	5.0%	95.0%	147%	251%
Taiping	966 HK	26.72	61.3%	1.63%	11.47%	7.40	4.7%	99.6%	240%	-
PICC P&C	2328 HK	-	-	4.88%	19.26%	4.03	-	95.0%	-	251%
China Re	1508 HK	1.73	24.3%	2.03%	7.74%	3.05	2.4%	97.2%	289%	215%

Source(s): Companies, ABCI Securities

Exhibit 12: Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	Price (HK$)	Price / EBV (x)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)
China Life	2628 HK	HOLD	22.70	0.98	28.07	20.76	1.77	1.66	1.33	1.64
NCI	1336 HK	SELL	39.95	1.01	17.90	14.57	1.77	1.59	0.60	0.76
Ping An	2318 HK	BUY	43.25	1.15	11.59	11.17	1.82	1.58	1.44	1.58
CPIC	2601 HK	BUY	30.25	1.13	18.98	17.05	1.79	1.66	2.44	2.46
PICC Gp	1339 HK	HOLD	3.25	0.89	9.17	8.25	0.98	0.87	0.52	0.55
Taiping	966 HK	HOLD	18.06	0.68	13.44	11.23	1.07	0.97	0.34	0.68
PICC PC	2328 HK	BUY	13.16	-	9.50	8.43	1.43	1.26	2.68	2.86
China Re	1508 HK	HOLD	1.88	0.97	12.15	10.22	0.96	0.89	1.91	2.27

Source(s): Bloomberg, companies, ABCI Securities estimates

Investment banking is the bright spot

- Investment banking business will be the industry's bright spot in the next 2-3 years; under the 13th FYP, the government is committed to boosting direct financing in capital markets.
- The market size of debt financing is 3-4 times larger than that of equity financing. Hence, brokers with a strong market position in bond underwriting should benefit the most
- **BUY** GF (1776 HK) and CMS (6099 HK) for their consistent performance despite market volatility

China Securities & Brokerage

OVERWEIGHT

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Key Data

Avg.17F P/E (x)	11.3
Avg.17F P/B (x)	1.2
Avg.17F Dividend Yield (%)	2.6

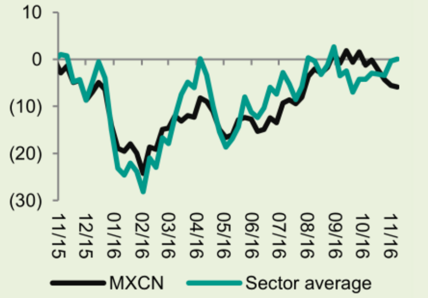
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	3.6	9.0
3-mth	5.1	6.5
6-mth	15.6	2.4

* Relative to MXCN
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Investment banking – the industry's bright spot. Investment banking business will be the industry's bright spot in the next 2-3 years. Revenue from investment banking among major brokers achieved a 50% growth in 1H16, as compared to the 61%, 50%, and 43% declines in brokerage, trading, and total revenue. We expect investment banking to outperform other business segments in the short to medium term.

The rise of direct financing. We believe investment banking business would benefit from a long-term structural uptrend, given the government's commitment to deleverage the economy through boosting direct financing in the capital markets via issuance of corporate bonds and equity securities. Direct financing accounted for 24% of the aggregate financing in the economy in 1H16, up from 17% in 2014. We expect the trend to continue in the near term.

Direct financing to help deleverage the economy. Financial leverages of large SOEs and industrial enterprises have been increasing in recent years. Liability-asset ratio of SOEs increased to 68% at end-June 2016 from 66% at end-2014 while that of the industrial enterprises above the designated size rose to 57% from 56%. In addition, the lack of medium-to-long-term funding sources to finance asset growth has become one of the bottlenecks of economic growth.

Bonds matter more than equity in direct financing. In direct financing, debt financing historically accounted for 70-80% of the total amount while equity financing only took up a minor proportion. As a result, brokers with a strong market position in bond underwriting should benefit the most from the increase in direct financing. Net financing of corporate bonds increased from RMB 1.3tn in 1H14 to RMB 1.7tr in 1H16, indicating a healthy market in general. Debt financing accounted for 18% of total aggregate financing in 1H16, up from 12% in 1H14. The easing of regulations on corporate bond issuance by CSRC in 2015 (e.g. companies are required to register instead of obtaining approval and authorization from CSRC to issue bonds; unlisted companies are eligible for corporate bond issuance) have quicken the pace of bond market development in recent quarters.

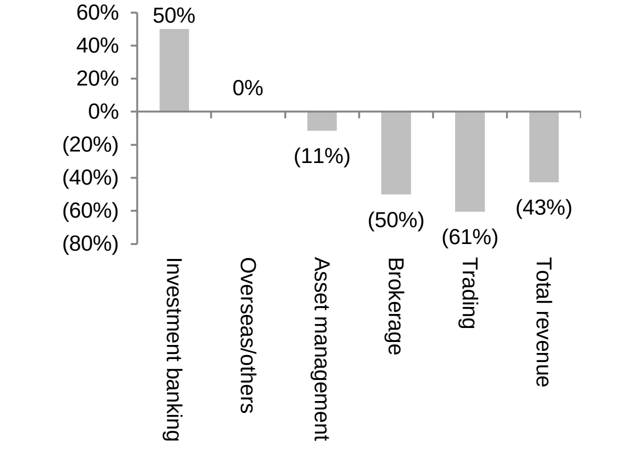
Share placement matters more than IPO. Overall, fundraising activities in the A-share market have been rising in recent years. According to PBOC, equity financing by non-financial enterprises in the stock market rose 53% YoY to RMB 0.6tn in 1H16. Equity financing accounted for 6.1% of total aggregate financing in 1H16, up from 1.8% in 1H14. In equity financing, IPO's contribution to total equity financing has been much lower than that of share placement in the secondary market. In 1H16, about 95% of equity financing was conducted via share placement in the secondary market while IPO only accounted for 5%. In our view, investors have underestimated the weight of share placement in the market and its impact on the brokerage industry since IPO market usually draws the most spotlight.

Developing a more sophisticated capital market. Under the current 13th FYP (2016-20), the government will increase the contribution of direct financing in the economy and deleverage through the development of a diverse, multi-layered capital market with GEM, NEEQ, regional stock market, etc. It also aims to promote product innovations such as high-yield bonds, hybrid financing and more. In our view, such developments will be supportive to the investment banking business.

Favor GF (1776 HK) and CMS (6099 HK) for consistent performance. To assess the performance of brokers throughout a market cycle, we compare the ROEs of major brokers in 2015 and1H16 and conclude that : 1) GF(1776 HK) and CMS (6099 HK) have demonstrated solid execution capability by consistently achieving above-peer ROEs in 2015 and 1H16; 2) Everbright (6178 HK), Galaxy (6881 HK), and DFZQ (3958 HK) had high ROEs in 2015 but performance failed to sustain during the market correction in 1H16; 3) Huatai (6886 HK), Haitong (6837 HK, CITIC (6030 HK) are underperformers with below-peer ROEs in 2015 and 1H16. In particular, CICC had the lowest ROEs among peers in 2015 and 1H16, indicating erosion of competitive edge.

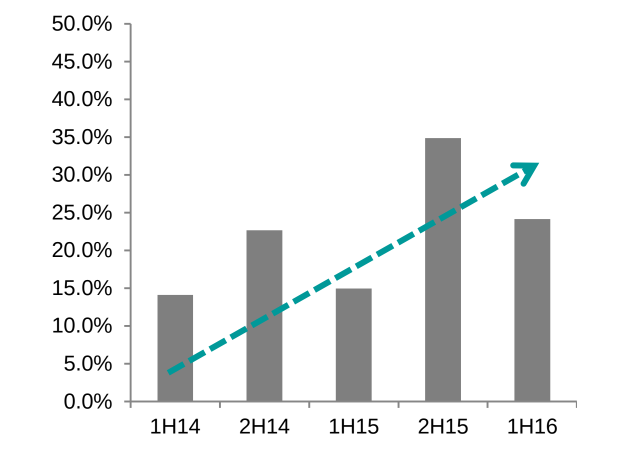
Risk factors: (1) Market risk of financial assets; (2) Credit risk associated with bond investments and lending business; (3) Volatility in market turnover; (4) Penalties on misconduct or staff malpractice in securities firms; (5) Regulatory changes in direct financing.

Exhibit 1: Segmental revenue growth of major brokers* in 1H16 (YoY %.)



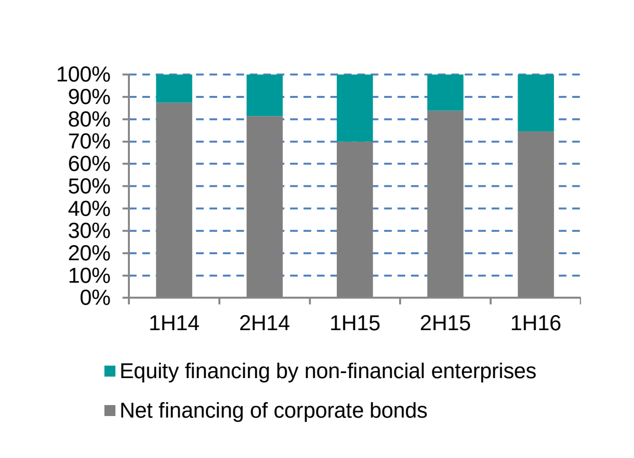
* Aggregate of CMS, DFZQ, CITIC, Galaxy, GF, Haitong, Huatai, and China Securities
Source(s): Companies, ABCI Securities

Exhibit 2 Direct financing as a percentage of aggregate financing



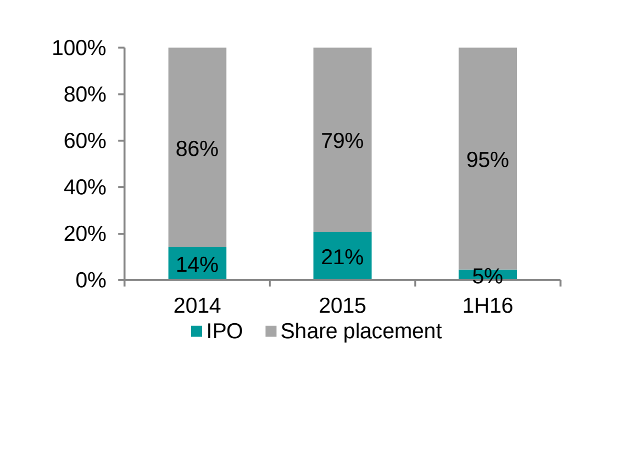
Source(s): PBOC

Exhibit 3: Direct finance – equity vs. bonds



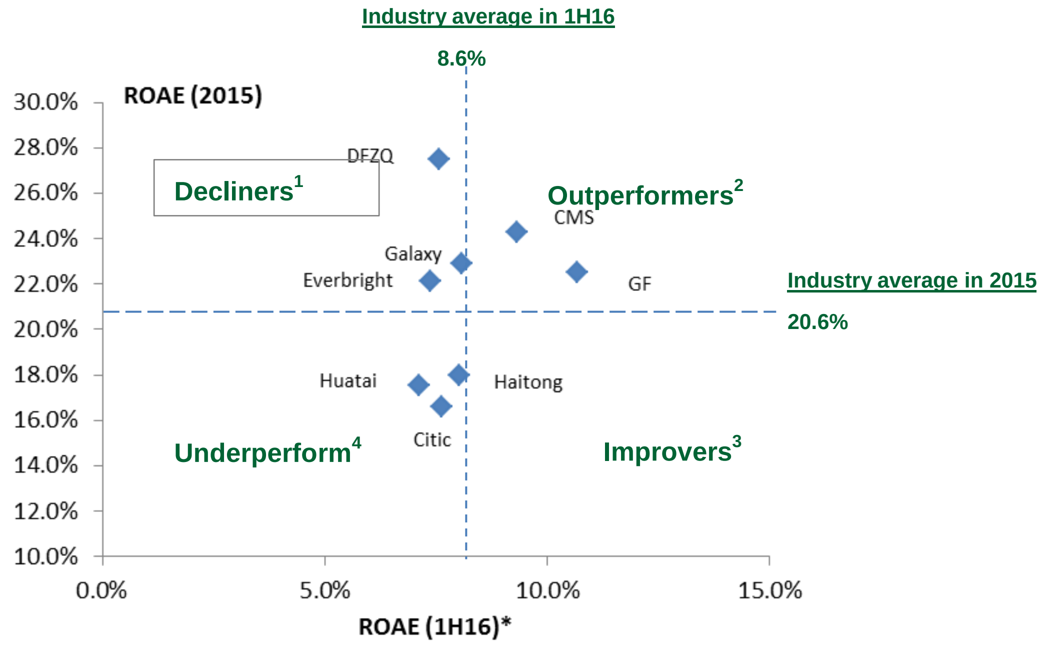
Source(s): PBOC

Exhibit 4: Equity finance – IPO vs. share placement



Source(s): WIND

Exhibit 5: ROAE comparison



*Annualized
[1]Decliners: those with above-average ROE in 2015 and below-average ROE in 1H16
[2]Outperformers: those with above-average ROE in both 2015 and 1H16
[3]Improver: those with below-average ROE in 2015 and above-average ROE in 1H16
[4]Underperformers: those with below-average ROE in both 2015 and 1H16
Source(s): Companies, SAC, ABCI Securities

Exhibit 6: Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield(%)	FY17F Yield(%)
GF	1776 HK	BUY	19.6	10%	14.6	12.2	1.5	1.4	2.2	2.6
CMS	6099 HK	BUY	14.0	12%	13.8	11.4	1.2	1.1	2.5	3.2
Everbright	6178 HK	HOLD	12.7	4%	13.2	11.2	1.0	1.0	2.1	2.1
DFZQ	3958 HK	HOLD	8.3	1%	11.5	9.0	1.1	1.0	2.5	3.3
Guolian	1456 HK	HOLD	4.4	3%	10.9	9.1	0.9	0.8	3.2	3.8

Source(s): Bloomberg, ABCI Securities estimates

Major downturn unlikely

- Presales targets among developers have been largely fulfilled for 2016. With the slowdown of project launch in 4Q, impact of the Oct tightening would only be seen in 2017
- Increasing corporate bond issuance onshore and offshore ease pressure to cut price
- We expect presales growth to slow to 10% YoY for 2017E
- Times Property (1233 HK) is our top small-/mid-cap pick for the sector. We also favor Logan (3380 HK)

China Real Estate

OVERWEIGHT

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Effect of increased policy tightening to be seen in early 2017. In Oct, over 15 cities announced the first or second round of property tightening measures that involve raising the mortgage down payments and various forms of home purchases restriction (HPR). As of Oct 2016, HPR was implemented in about 20 cities. We believe the full impact of these tightening policies will only be seen in early 2017 as developers may slow down project launch in 4Q. For most, presale targets for 2016 have been largely completed.

Onshore corporate bond unlikely to be halted. In Oct, the Shanghai Stock Exchange announced restrictions will be imposed on bond issuance by developers, which include: 1) Proceeds raised cannot be used for land acquisition; 2) Developers involved in overpriced sites would not be allowed to issue corporate bonds. There are speculations that onshore bond issuance for all developers will be halted in the near term as the government seeks to rein in the property market. However, such restriction is unlikely to be enforced because the government is aiming for a steady cooling of the property market instead of a hard landing. Constricting the funding channels may slow down construction, reducing future housing supply in the long term. Moreover, developers may instead issue trust loans with complex structures at higher costs. Such funding restriction, if applied, is most likely to be confined to smaller, unlisted players.

Offshore bond issuance to rise next year. In 9M16, the Chinese developers issued RMB 504bn of onshore corporate bonds, up 83% YoY. Bond yield in 3Q16 was just 4.4%, down 0.7ppt YoY or 0.3% QoQ. In 3Q16, however, onshore corporate bond issuance declined substantially by 33%YoY, possibly because of the tightened approval process. As a result, offshore bond issuance rebounded 700% QoQ to US$ 7.2bn. Driven by low onshore financing cost, offshore USD bond yield also trended lower to 5.8% in 3Q16, down 2.7ppt YoY. We believe ample liquidity onshore and offshore would allow developers to refinance or gear up even if cash flow is impaired by the recent tightening measures. Hence, pressure to cut price would be mild in the near term.

Supply side looks healthy. In 9M16, residential completion and new construction starts jumped 11% YoY and 7% YoY, reversing the downtrend in 2014-15. We think the supply growth is still reasonable

Key Data

Avg.17F P/E (x)	5.3
Avg.17F P/B (x)	0.7
Avg.17F Dividend Yield (%)	6.1

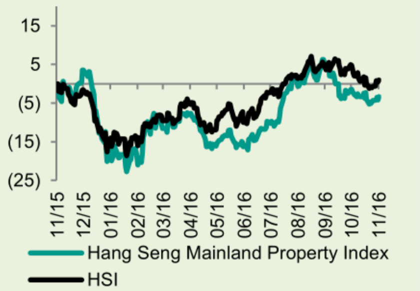
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	(1.89)	1.68
3-mth	(5.00)	(3.81)
6-mth	13.28	2.85

* HSMPI relative to HSI
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

given the significant rise in property demand (9M16 new home sales: +43% YoY). Although HPR was implemented in 2011, new home sales recorded a double-digit growth during 2011-13 on robust first-home buyer demand. It took almost 3 years for such demand to subside before oversupply became apparent in 2014 when new home sales dropped 8% YoY.

Next downturn may not occur until interest rate rises by 150bps. After multiple rate cuts since 2014, the 5-year lending rate has dropped to the 10-year low at 4.9%. Homebuyers enjoy lower monthly mortgage installments on reduced borrowing cost and purchasing power improves considerably. More importantly, with deposit rate fallen to as low as 1.1%, investors are driven to invest in property for better returns. Compared to the A-share market, property is a safer investment given its appreciation record in the past decade. We believe a meaningful correction in the property market would not occur until interest rate rises by 150bps and returns to the historical average.

Expect presales to grow 10% YoY in 2017E and 5% YoY in 2018E-19E. 10M16 presales of 22 major developers jumped 68% YoY to RMB 2,060bn; on average, 103% of 2016 presales targets have been reached. Developers would defer project launch to avoid setting a high base for 2017. By deferring some of the presales, we think developers would achieve a 10% YoY growth in 2017E. The impact on HPR will be more prominent in 2018-19 as demand from first-home buyers depletes and investment demand shrinks.

Favor PRD cities; Times Property (1233 HK, BUY, TP: HK$5.70) as top small-mid cap pick. Based on our recent visits to Nanjing, Hangzhou, Ningbo, and Qingyuan, we notice the extent of tightening varies significantly across cities. In our view, the PRD cities (except Shenzhen) are less proactive in enforcing relevant policies, and austerity moves have only started to take place in Dongguan and Foshan in early Oct 2016. In contrast, a second round of property tightening has been enforced in YRD cities such as Nanjing and Suzhou after the initial round in Aug. Times Property is our top small-/mid-cap pick because of its: (1) High exposure to property markets in Guangzhou/Foshan; (2) Redevelopment pipeline with superb margins; (3) Attractive valuation. We also like Logan (3380 HK, BUY, TP: HK$4.30); its Logan City project in Huizhou would capture huge investment demand from Shenzhen as a result of the HPR.

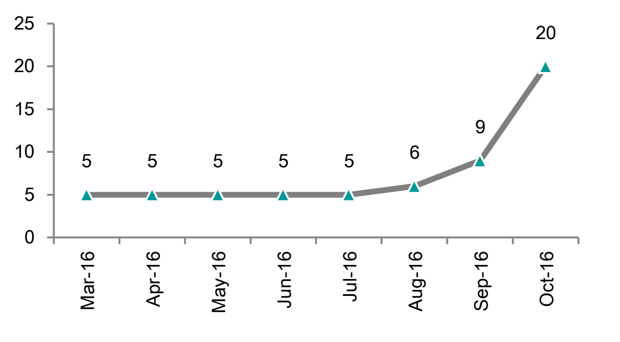
Risk factor: 1) Increased policy tightening; 2) Restrictions on bond issuance.

Exhibit 1: Numerous cities have announced new property tightening measures in 2016 (i.e. increased mortgage down payment requirements and HPR)

Month	Cities announced new tightening measures	No. of cities
Mar	Shenzhen, Shanghai	2
June	Hefei	1
Aug	Nanjing, Suzhou, Wuhan	3
Sep	Xiamen, Hangzhou, Beijing, Tianjin	4
Oct	**Initial tightening:** Guangzhou, Chengdu, Wuxi, Jinan, Zhengzhou, Zhuhai, Foshan, Dongguan, Fuzhou 2[nd] **round of tightening:** Shenzhen, Hefei, Nanjing, Suzhou, Wuhan, Xiamen	15

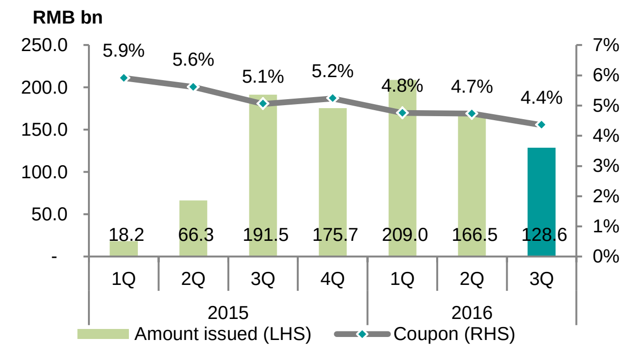
Source(s): Local governments, ABCI Securities

Exhibit 2: No. of cities with HPR in place



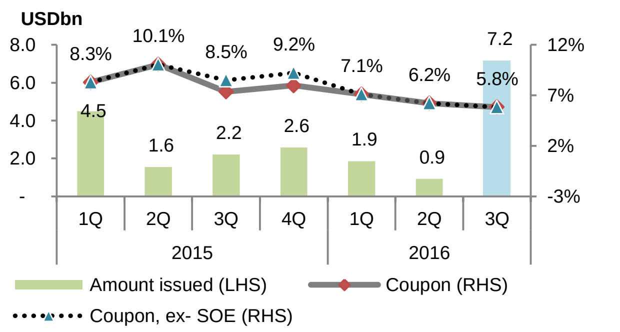
Source(s): Local governments, ABCI Securities

Exhibit 3: Onshore corporate bond issuance (1Q15-3Q16)



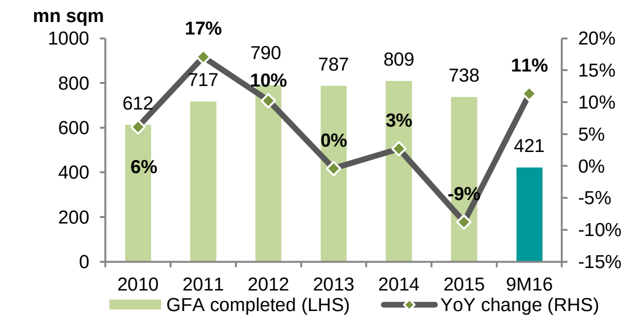
Source(s): Bloomberg, ABCI Securities

Exhibit 4: Offshore USD bond issuance (1Q15 -3Q16)



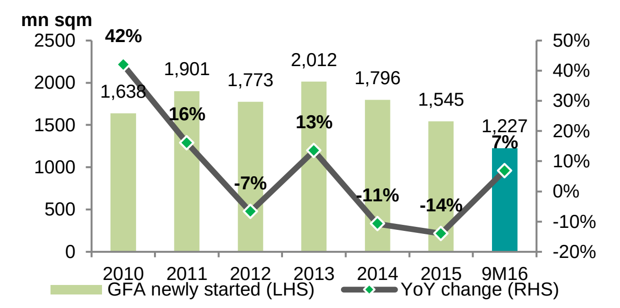
Source(s): Bloomberg, ABCI Securities

Exhibit 5: Completion of residential properties



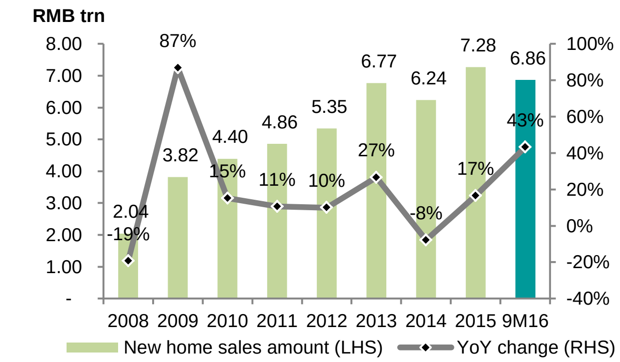
Source(s): NBS, ABCI Securities

Exhibit 6: New construction starts for residential properties



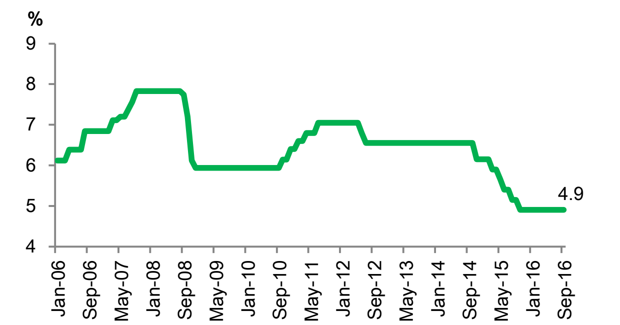
Source(s): NBS, ABCI Securities

Exhibit 7: New home sales



Source(s): NBS, ABCI Securities

Exhibit 8: 5-year lending rate in China



Source(s): Bloomberg, ABCI Securities

Exhibit 9: 10M16 presales of HK-listed mainland developers

	Developer	Amount RMB bn	*YoY*	GFA 000 sqm	*YoY %*	ASP RMB/sqm	10M16 *YoY*	2016 Target RMB bn	Achieved ratio
1	Country Garden	271.5	170%	33,170	113%	8,186	27%	220.0	123.4%
2	CIFI	46.5	118%	2,579	61%	18,043	36%	43.8	106.2%
3	Evergrande	316.7	105%	38,639	93%	8,196	6%	300.0	105.6%
4	Yuzhou	20.4	102%	1,617	50%	12,601	34%	22.0	92.6%
5	Sunac	102.7	97%	4,821	84%	21,301	7%	110.0	93.4%
6	Longfor	78.4	88%	5,272	56%	14,867	20%	62.0	126.4%
7	Times	24.0	73%	2,125	30%	11,278	33%	21.5	111.5%
8	Beijing Capital	33.7	60%	1,719	-11%	19,581	79%	38.0	88.6%
9	Jinmao	29.3	57%	1,269	46%	23,092	7%	29.5	99.3%
10	Logan	24.7	54%	1,968	-6%	12,530	63%	28.0	88.1%
11	Greentown	78.4	54%	3,990	43%	19,649	7%	65.0	120.6%
12	Vanke	311.5	53%	23,349	43%	13,340	6%	300.0	103.8%
13	COLI*	195.9	50%	11,888	24%	16,482	21%	210.0	93.3%
14	Poly-A	173.6	43%	13,095	36%	13,258	5%	NA	NA
15	Sino-Ocean	38.3	39%	2,317	8%	16,526	29%	48.0	79.8%
16	Agile	46.5	38%	4,730	23%	9,822	12%	46.0	101.0%
17	R&F	52.8	34%	4,016	27%	13,144	6%	60.0	88.0%
18	CR Land	90.9	26%	6,554	11%	13,868	13%	96.0	94.7%
19	SZI	18.7	26%	858	-3%	21,769	29%	18.5	101.0%
20	Yuexiu	24.9	24%	2,041	13%	12,182	10%	25.8	96.4%
21	KWG	19.3	22%	1,478	24%	13,039	-2%	22.0	87.6%
22	Shimao	61.9	15%	4,515	1%	13,710	14%	67.0	92.4%
	Total	**2,060.4**	**68%**	**172,010**	**53%**	**11,978**	**10%**	**1,833**	**102.9%**

Source(s): Companies, ABCI Securities

Exhibit 10: Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)
Times	1233	BUY	5.70	54.9%	3.1	2.4	0.7	0.5	6.4	8.4
SZI	604	BUY	4.10	21.7%	8.5	6.8	0.7	0.7	5.9	7.3
Logan	3380	BUY	4.30	41.9%	5.8	4.9	1.0	0.9	5.0	6.6
Yuzhou	1628	BUY	3.30	13.8%	5.1	3.8	1.0	0.9	7.2	9.6
CIFI	884	BUY	2.90	30.6%	4.4	3.7	0.9	0.8	6.8	7.2
Jinmao	817	BUY	3.40	62.7%	6.4	5.0	0.6	0.5	5.0	6.5
LVGEM	95	BUY	2.70	12.5%	15.4	6.8	2.0	1.7	2.4	5.3
COLI	688	BUY	27.40	23.4%	6.4	4.8	1.0	1.0	4.7	6.3
Fantasia	1777	BUY	1.40	40.0%	7.6	5.3	0.5	0.4	4.1	5.8
Evergrande	3333	BUY	6.60	23.4%	11.2	4.8	0.6	0.6	4.5	10.4
CSC	1668	HOLD	1.60	-4.8%	12.9	8.7	0.5	0.5	2.6	3.8
Sunac	1918	HOLD	5.10	-13.6%	6.1	6.2	0.8	0.7	3.0	2.9
Greentown	3900	HOLD	5.40	-17.2%	9.8	6.6	0.5	0.5	2.0	3.0

Source(s): Bloomberg, ABCI Securities estimates

Moderate and uneven growth in 2017

- Growth in national retail sales fluctuates in 2016; recent CPI indicates a lower transaction volume growth
- Growth momentum of online retail sales is reducing
- The Chinese consumers are exercising more moderation in spending. More emphasis is placed on higher product/service quality and lifestyle upgrade
- The sector would continue to experience constant disruptions
- Maintain **NEUTRAL** on moderate growth prospect of the sector and the uneven performances of companies in the sector

China Consumer

NEUTRAL

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Retail sales growth will fluctuate in 2017. Retail sales growth declined from 10.7% YoY in Sep to 10.0% YoY in Oct, touching 10% for the second time in 2016. Many consumer products showed waning growth, except for "Furniture", "Cultural & office appliances", "Petroleum & related products", "Apparel", and "Sports & entertainment consumables", whose growth accelerated. Online retail sales growth in Oct also dropped. We believe national retail sales would continue to grow unevenly in 2017. Fluctuating growth would be the new norm over the next few years as GDP maintains a mid single-digit growth.

Consumer market to expand on higher inflationary pressure. Despite continuous growth in national retail sales, divergence between national retail sales growth and CPI since Feb 2015 indicates the former has been receiving less support from transaction volume, meaning that consumers in China are buying less than they used to. The divergence turned more obvious in Aug-Oct as national retail sales growth decreased from 10.6% YoY to 10.0% YoY and CPI increased from 1.3% YoY to 2.1% YoY. With cost-push inflationary pressure escalating in 2017, consumer market could be elevated by the upward price pressure. E.g., sales growth of "Tobacco & Liquor" and "Traditional Chinese & Western Medicines" is mostly driven up by the upward price pressure. Industries whose sales expand without the support of the inflated price are the ones with a solid growth basis– the "Apparel" and "Automobile" industries recorded high retail sales growth despite the declining inflationary pressure.

Online retail is expanding with less steam. In 2016, online retail market accounts for a larger share in the national retail market. In 10M16, total online retail sales reached RMB 3,928.8bn, equivalent to 14.57% of the national retail sales of RMB 26,960.1bn. Growth momentum of online retail sales seems to have calmed recently. For 3Q16 and Oct, the growth was only 28.13% YoY and 21.54% YoY, the lowest rates ever recorded. Contribution of online retail sales to national retail sales have only improved marginally since June 2016 when the figure reached 14%. As the online retail market matures and competition intensifies, the slowdown in growth would continue in the future.

Key Data

Avg.17F P/E (x)	16.55
Avg.17F P/B (x)	2.13
Avg.17F Dividend Yield (%)	2.36

Source(s): Bloomberg, ABCI Securities estimates

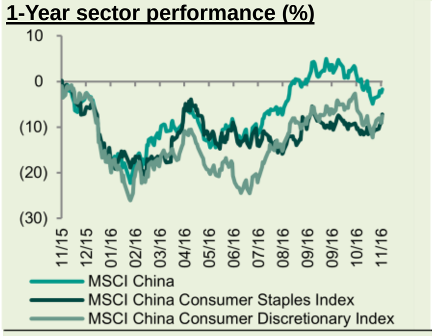
Sector performance (%)

	Absolute	Relative*
1-mth	(2.94)	1.73
3-mth	6.54	7.15
6-mth	20.59	8.87

* Average performance of MSCI China Consumer Staples & Discretionary Index relative to MSCI China Index

Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



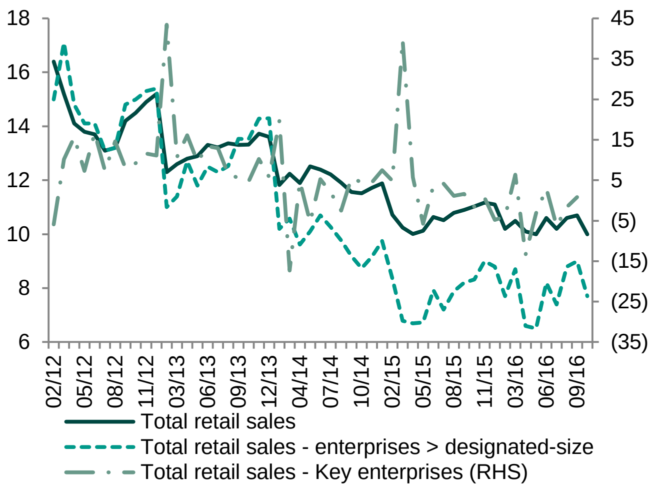
Source(s): Bloomberg, ABCI Securities

Three developments transforming China's consumer market. We think China's consumer market is undergoing three major changes. (1) As economic and personal income growth remains tepid, **consumers would exercise more moderation**, tightening their purse strings and reducing discretionary purchases; (2) **The pursuit for quality** is slowly replacing the ubiquitous focus on low prices among the consumers. Bargain hunting means striking the delicate balance between price and function; (3) Moreover, urbanization and rise of the neo-consumer class means people will be aspired to a **lifestyle upgrade** that goes beyond material possession.

Constant disruptions in 2017. To capture the changing consumer taste, we believe the Chinese consumer market will undergo more disruptions, which include innovations aiming to create a sense of community or combining products and services. More new technologies, such as VR or live broadcasting employed in the 2016 "Double-11" events across multiple e-commerce platforms, will be introduced.

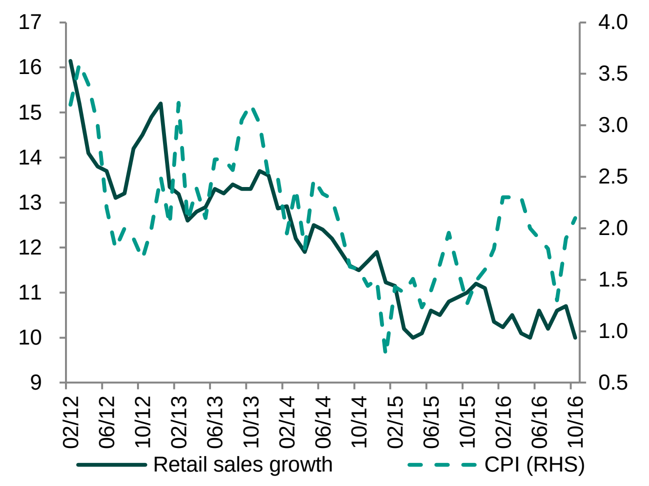
Risk factors: 1) Drastic fall in GDP; 2) Personal disposal income growth continues to lag behind GDP growth; 3) Online retail sales growth declines faster than expected; 4) Safety incidents that raise concerns on quality of China-made products; 5) Consumer taste changes more rapidly than expected.

Exhibit 1: Retail sales growth in China (YoY %)



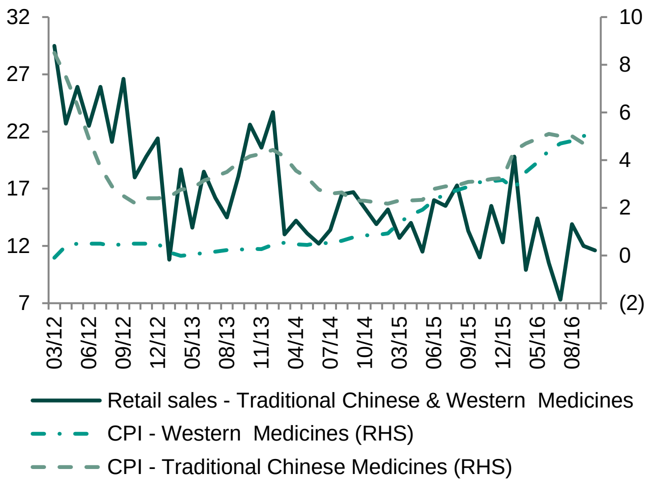
Source(s): NBS, Wind, ABCI Securities

Exhibit 2: Retail sales growth and CPI (YoY %)



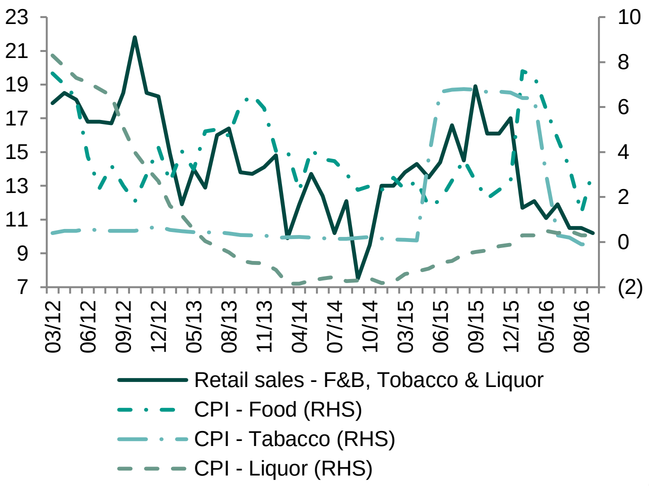
Source(s): NBS, Wind, ABCI Securities

Exhibit 3: Retail sales growth and CPI of "Traditional Chinese & Western Medicines" (YoY %)



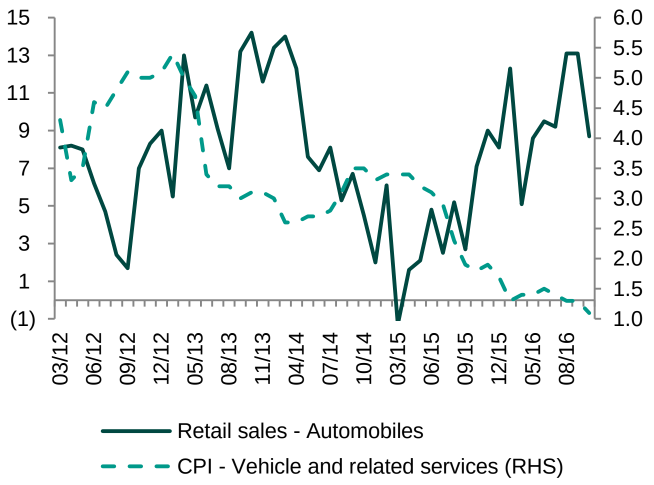
Source(s): NBS, Wind, ABCI Securities

Exhibit 4: Retail sales growth and CPI of "F&B, Tobacco & Liquor" (YoY %)



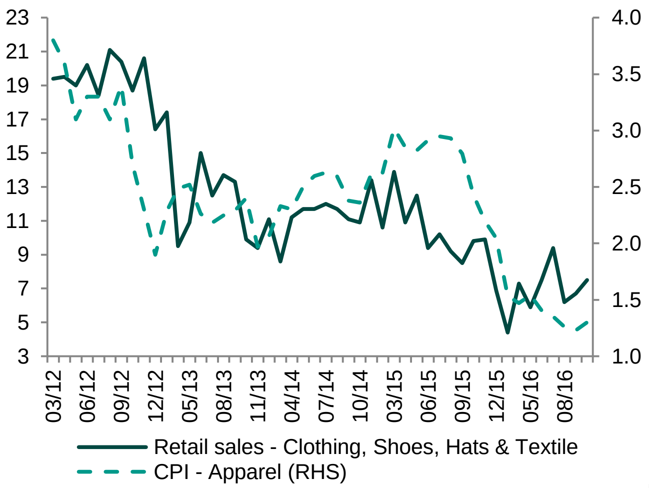
Source(s): NBS, Wind, ABCI Securities

Exhibit 5: Retail sales growth and CPI of "Automobile" (YoY %)



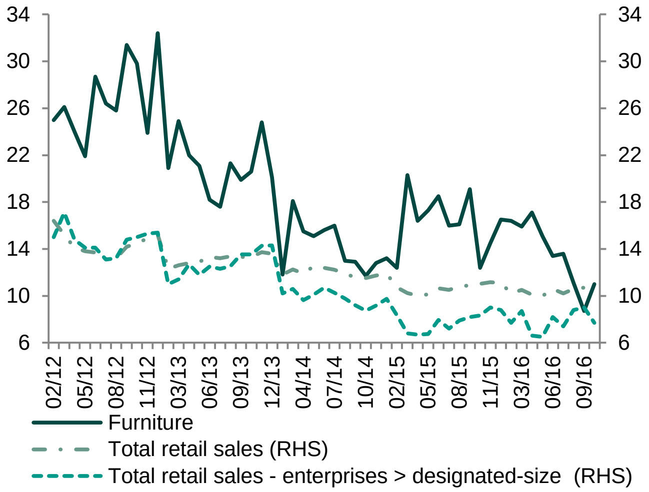
Source(s): NBS, Wind, ABCI Securities

Exhibit 6: Retail sales growth and CPI of "Apparel & Textile" (YoY %)



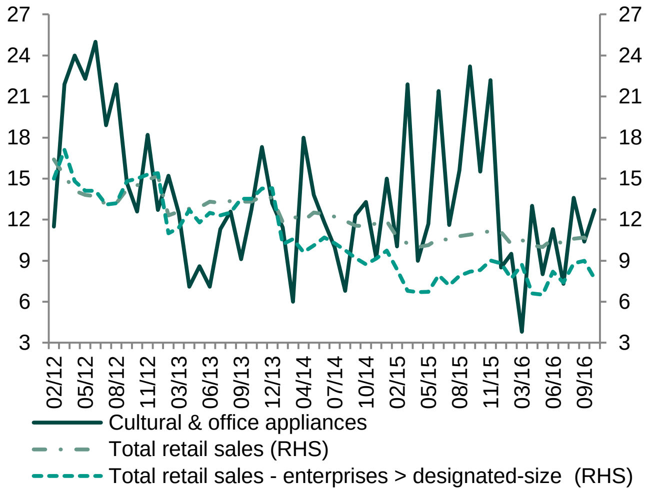
Source(s): NBS, Wind, ABCI Securities

Exhibit 7: Retail sales growth of "Furniture" (YoY %)



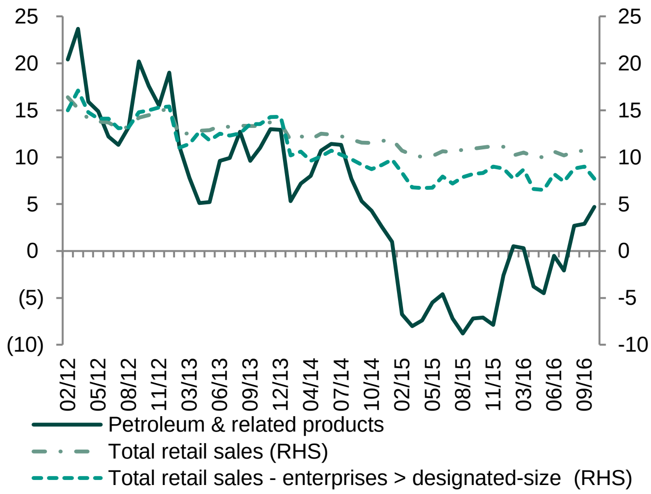
Source(s): NBS, Wind, ABCI Securities

Exhibit 8: Retail sales growth of "Cultural and Office appliances" (YoY %)



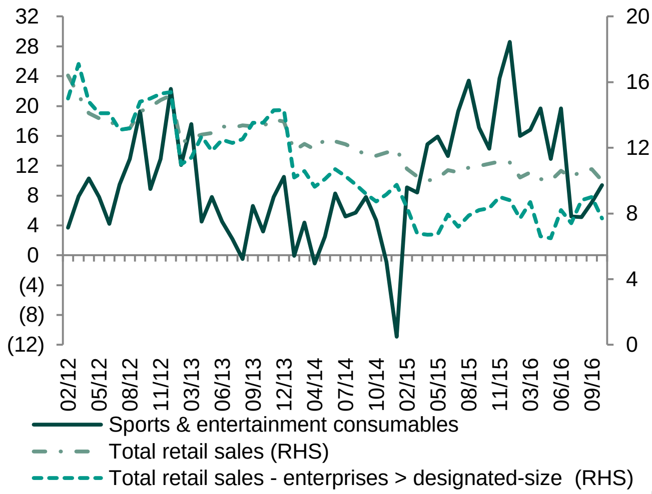
Source(s): NBS, Wind, ABCI Securities

Exhibit 9: Retail sales growth of "Petroleum & related products" (YoY %)



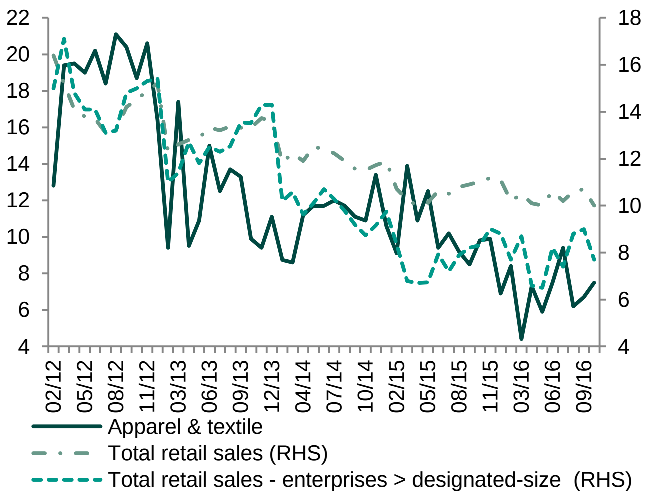
Source(s): NBS, Wind, ABCI Securities

Exhibit 10: Retail sales growth of "Sports & Entertainment consumables" (YoY %)



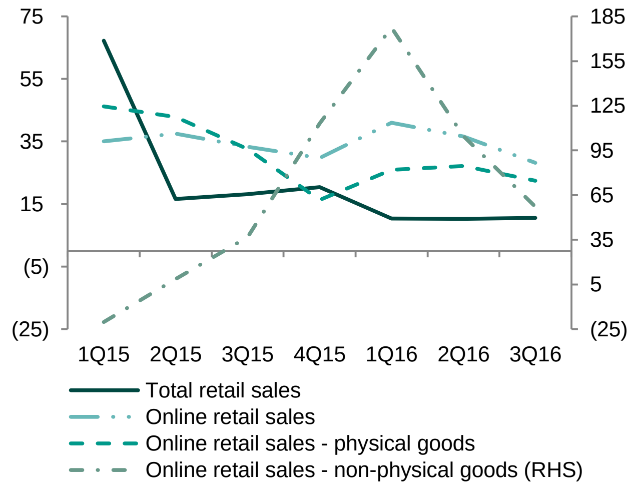
Source(s): NBS, Wind, ABCI Securities

Exhibit 11: Retail sales growth of "Apparel & Textile" (YoY %)



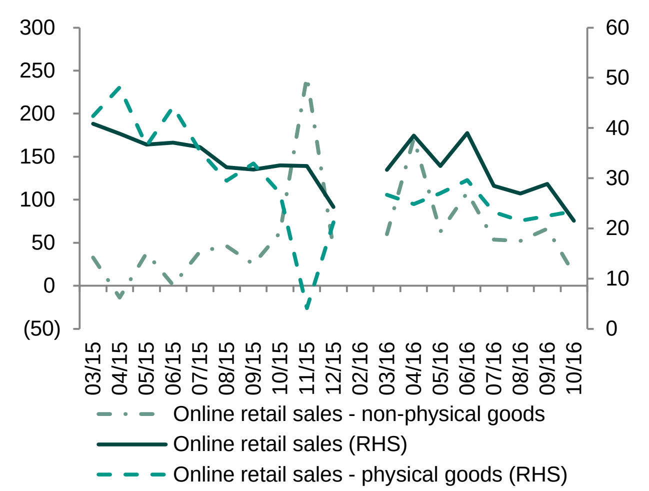
Source(s): NBS, Wind, ABCI Securities

Exhibit 12: Quarterly online retail sales (YoY %)



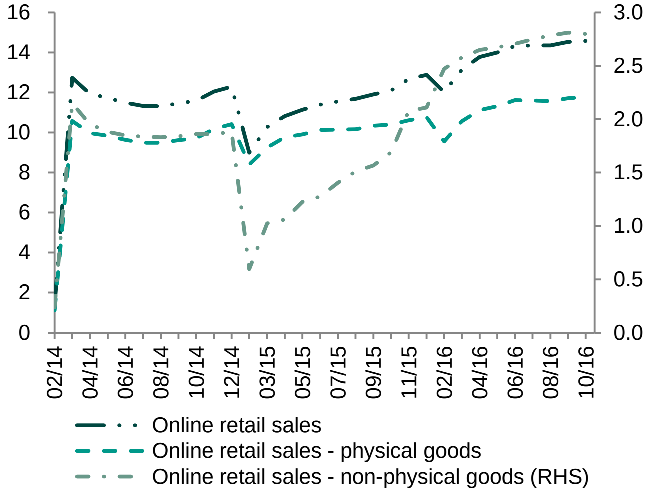
Source(s): NBS, Wind, ABCI Securities

Exhibit 13: Monthly online retail sales growth (YoY %)



Source(s): NBS, Wind, ABCI Securities

Exhibit 14: YTD contribution of online retail sales contribution to total retail sales (%)



Source(s): NBS, Wind, ABCI Securities

Optimistic on pork industry

- Food retail sales grew more slowly in 2016; rising food CPI indicates lower retail transaction volume growth in the segment
- Dairy and pork industries are under mild inflationary pressure; stable demand and changes in consumer lifestyle would benefit both
- The dairy industry would consolidate; two downstream leaders would dominate and compete more fiercely with each other
- Optimistic on the pork and related industry as demand for pork is relatively countercyclical
- Maintain **NEUTRAL** on lower and uneven growth expectations

China Food & Beverage

NEUTRAL

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Key Data

Avg.17F P/E (x)	23.83
Avg.17F P/B (x)	2.12
Avg.17F Dividend Yield (%)	1.53

Source(s): Bloomberg, ABCI Securities estimates

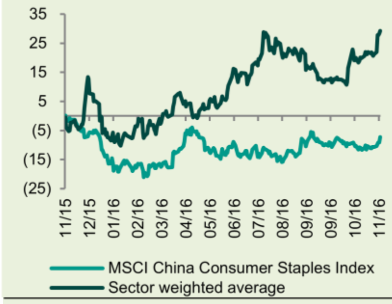
Sector performance (%)

	Absolute	Relative*
1-mth	9.37	7.21
3-mth	6.80	3.23
6-mth	23.42	17.13

* Sector weighted average relative to MSCI China Consumer Staples Index

Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Overall food sector has been weakening. Retail sales of food products have been growing at slower rates. Sales growth of "Grain, Oil & Food" declined from 12.6% YoY in Feb to 9.1% YoY in Oct, lower than the headline retail sales growth at 10.0% YoY. In 9M16, food retail sales has been growing at an average rate of 11.4% YoY, compared to 10.3% YoY for the national retail sales or 7.8% YoY for retail sales for enterprises above designated size. We believe the economic slowdown has affected consumption in China and the impact is starting to show in the food sector.

Inflationary pressure and retail sales growth for food are moving in opposite directions Inflationary pressure has been increasing since Aug. From Aug to Oct, Food CPI increased from 1.3% YoY to 3.7% YoY while retail sales growth of "Grain, oil & food" decreased from 10.2% YoY to 9.1% YoY. Rising price level across the food sector failed to boost food retail sales. We believe the retail sales growth and CPI data suggest overall transaction volume of food products may have experienced slower growth or decline in recent months amid higher competition.

Not much pricing pressure in pork and dairy industries. Upward price pressure has lessened for the pork and dairy products. From Jan to Oct, pork CPI declined from 18.8% YoY to 4.8% YoY; CPI of milk and dairy products have recorded negative growth since July. For the pork segment, decline in CPI has been caused by the increased supply and lower price of hogs; for the dairy segment, the negative CPI has been driven by the low international IMF price and raw milk price in China. As the two segments are relatively less sensitive to the economic cycle, we expect demand would be rather stable. Also, cost advantage enabled by the low raw material prices also allow for higher pricing flexibility. We believe competition in the pork and dairy industries would increase in the next few years.

Industry leaders would benefit as consumers turn more quality conscious. Driven by changing needs, the consumer market has been evolving quickly in China. In addition to quality, convenience is valued as a fast-paced lifestyle becomes more common. Dairy and processed meat products, with their high nutritional value and ease of consumption, would satisfy the arising need for efficiency. Being quality conscious, Chinese consumers would prefer companies with established brands, benefiting the industry leaders.

Upstream dairy companies: a new wave of industry consolidation. With the international milk powder price and domestic raw milk price declining to low levels, many upstream players are facing challenges in 2016. While the international milk powder price has been climbing in recent weeks, raw milk price may only improve gradually with the large inventory of milk powder in China purchased at lower prices. Recent acquisition of Shengmu (1432 HK)'s stakes by Yili (600887 CH) indicates industry consolidation would occur among players across the industry value chain and not just among the upstream players.

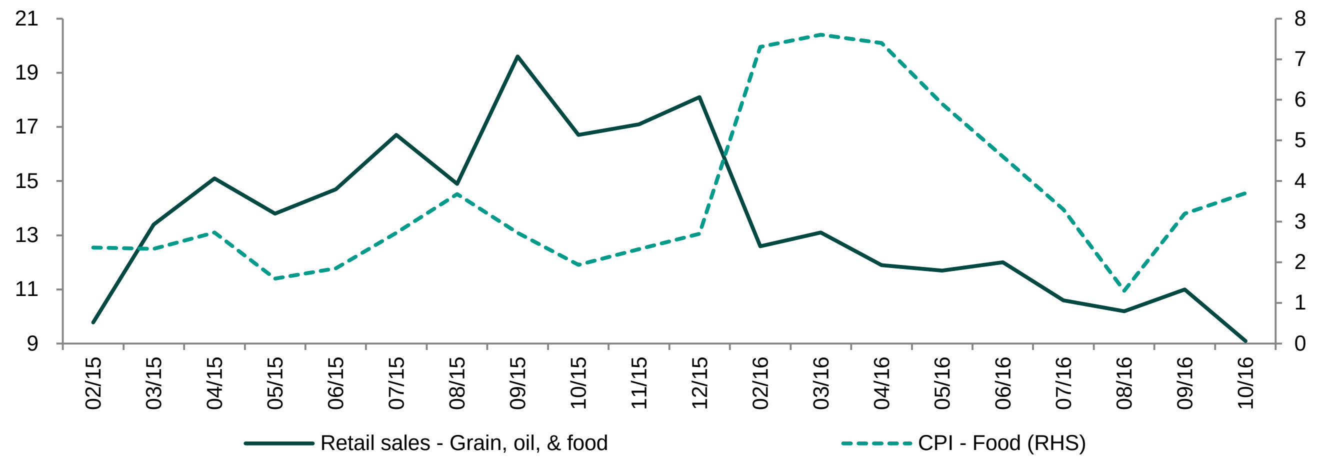
Downstream dairy industry: a changing battlefield. Liquid milk market shares of Mengniu (2319 HK) and Yili (600887 CH) further increased to 27.4% and 26.7% in 1H16 from 27.3% and 25.7% in FY15. Medium players are feeling the squeeze, as collective market share of the third and fourth largest players declined from 18.3% in 2014 and 16.1% in 2015 to 14.1% in 1H16. We believe the competition landscape in the downstream has changed – the two national leaders are winning with their economies of scale. While the small players are able to stay put in the niche markets, the medium players, with their smaller size and shorter operating history than the large national players, are more vulnerable because much resources would need to be invested before they can successfully build a national brand from the ground up. Given the current economic situation, the two national dairy giants (Mengniu and Yili) will dominate the market in the foreseeable future.

Meat product segment: brand building becomes a priority. Lifestyle change, higher disposable income, and a wider variety of meat products drive consumers to purchase more processed meat products. We believe the competition would intensify among several industry leaders in the processed meat segment which entails a higher margin. Brand-building would become essential, meaning that industry players with a leading market position or a strong brand portfolio would be the winners.

Conservative on dairy players; optimistic on WH Group.. We are cautious on the dairy players. Mengniu (2319 HK, HOLD; TP: HK$ 14.53) 's revenue growth in 1H16 may not be sustainable considering the declining margins, and the recent alliance between Yili and Shengmu may reduce Mengniu's upstream raw milk sales. Yili (600887 HK, HOLD, TP: RMB 19.82) maintained its margins in 1H16 and showed stronger momentum in 3Q16, but considerable uncertainties still exist regarding its recent plans of share placement, production capacity expansion and acquisition of stakes in Shengmu. We are more optimistic on WH Group (288 HK, BUY; TP: HK$ 7.68) as pork is still a major source of meat consumption in China. The Group has been successful in building and transforming the brands of its processed meat product segment as well as realizing post-acquisition synergies.

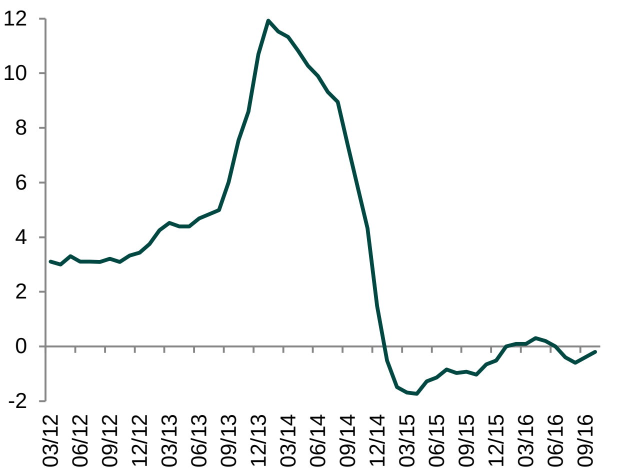
Risk factors: 1) Commodity price risk; 2) Biological asset risk; 3) regulatory risk; 4) Food safety risk; 5) Foreign exchange rate risk; 6) Interest rate risk.

Exhibit 1: Retail sales of food slowed amid rising food inflation since Aug (YoY %)



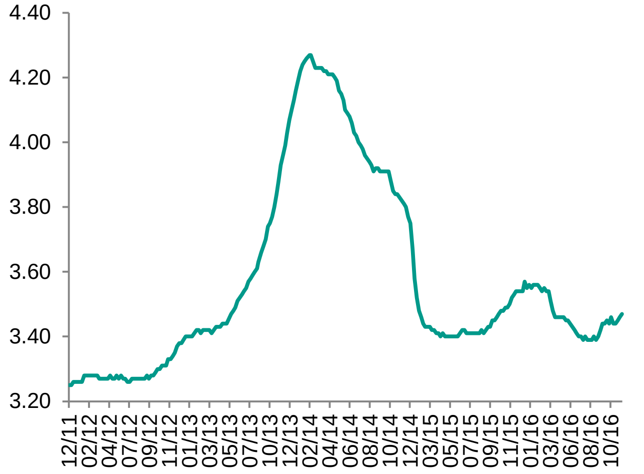
Source(s): NBS, Wind, ABCI Securities

Exhibit 2: CPI of milk and dairy products (YoY %)



Source(s): NBS, Wind, ABCI Securities

Exhibit 3: National average raw milk price (RMB/kg)

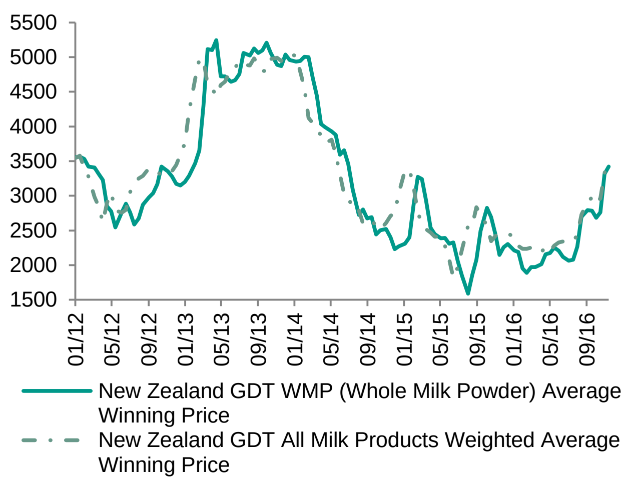


Source(s): NBS, Wind, ABCI Securities

Exhibit 4: GDT price index

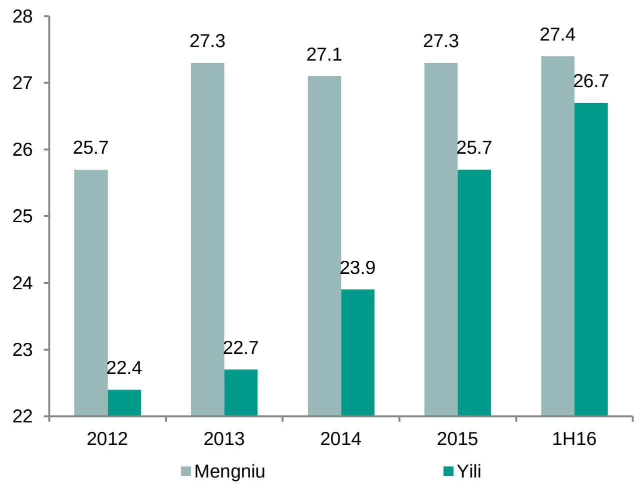
Source(s): Bloomberg, ABCI Securities

Exhibit 5: Weighted avg. winning price of GDT WMP (USD/tonne)



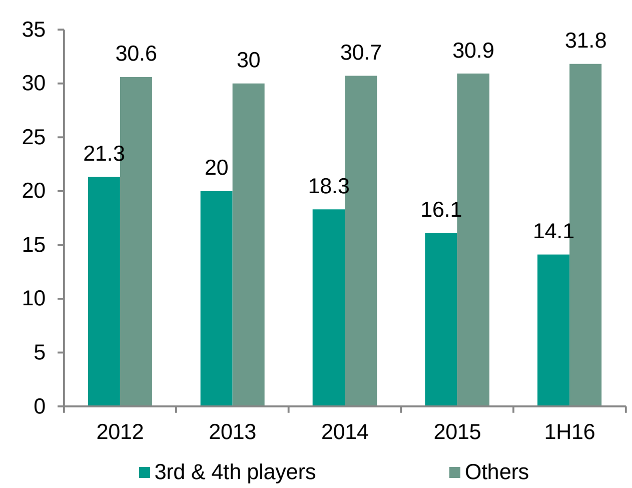
Source(s): Bloomberg, ABCI Securities

Exhibit 6: Liquid milk market share of Mengniu and Yili (%)



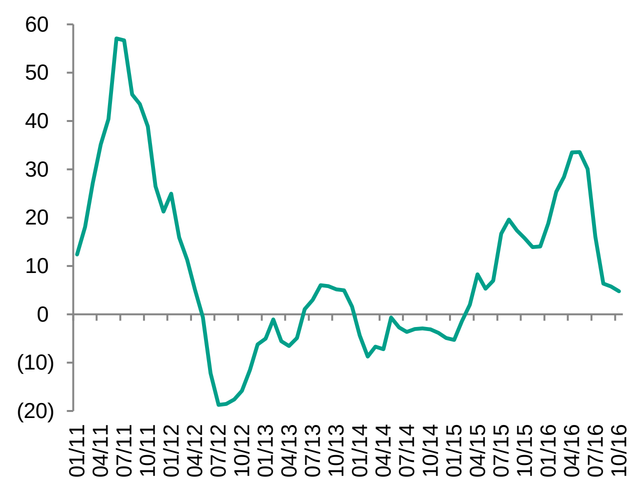
Source(s): Mengniu presentation material, ABCI Securities

Exhibit 7: Liquid milk market share of other industry players (%)



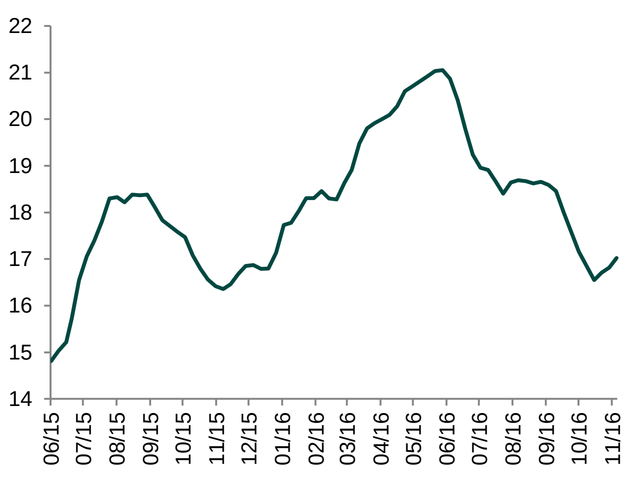
Source(s): Mengniu presentation material, ABCI Securities

Exhibit 8: CPI of pork (YoY %)



Source(s): NBS, Wind, ABCI Securities

Exhibit 9: Ex-farm gate hog price (RMB/ kg)



Source(s): NBS, Wind, ABCI Securities

Exhibit 10: Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)
WH Group	288 HK	BUY	7.68	21.71	13.97	12.92	2.37	2.23	2.71	3.03
Yili	600887 CH	HOLD	19.82	5.88	22.76	19.36	5.27	4.26	3.06	1.73
Mengniu	2319 HK	HOLD	14.53	(10.97)	24.13	25.57	2.09	1.98	0.80	0.96
Biostime	1112 HK	HOLD	22.83	(8.86)	23.97	23.69	2.88	2.43	0.00	0.00

Source(s): Bloomberg, ABCI Securities estimates

Chasing the alpha

- Subdued inflation in China's apparel market and growth pick-up signal healthy increase in retail transaction volume
- Competition is keen in the apparel market. China's slower economic growth may intensify competition and eliminate smaller players
- Performance of listed sports apparel companies are under pressure in 2016
- Maintain **NEUTRAL** on unexciting growth prospect

China Sports Apparel

NEUTRAL

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Inflationary pressure is mild in the apparel segment, signaling healthy retail transaction volume growth. In Jan-Oct 2016, inflationary pressure in the apparel Industry has been low. Clothing CPI was 1.9% YoY in Jan and declined to 1.3% YoY in Oct. Shoes CPI fell from 2% YoY in Jan to 1.2% YoY in Oct. Retail sales of apparel (clothing, shoes & hats) and textile reached 9.4% YoY in July and 7.5% YoY in Oct, suggesting demand for apparel is increasing.

Keen competition in China's apparel market. Apparel sales of enterprises above designated size has shown been accelerating, but the same cannot be said of key enterprises. From Feb to May 2016, clothing sales of key enterprises declined on a YoY basis; shoes retail sales of key enterprises declined in Feb-July 2016. The apparel market in China is still fragmented, resulting in fierce competition and diverging performance between enterprises above designated size and key enterprises. As China's economic growth moderates to mid-single-digit levels, competition in the apparel market would intensify.

Sports apparel Industry is also under pressure. Revenues of industry players reveal current conditions of the sports apparel market. Monthly revenues of Pou Sheng (3813 HK) and Yue Yuan (551 HK) in 2016 were lower on a YoY basis. Performance of domestic sports apparel players also deteriorated. 1H16 revenue growth of Anta (2020 HK) and Xtep (1368 HK) dropped to 20.21% YoY and 6.02% YoY, while Peak (1968 HK)'s revenue declined by 5.96% YoY. 1H16 net profit of Anta, 361 Degree (1361 HK), and Xtep grew 16.98% YoY, 1.3% YoY, and 10.64% YoY while that of Peak declined 3.73% YoY.

Challenging environment to pressure growth of smaller sports apparel players. We believe lower growth momentum and challenging environment in the consumer market would pressure growth in sports apparel companies. According to Euromonitor International, sales of sports apparel and footwear would expand at a slower pace in 2016-20. Smaller players would suffer more with possibility of industry consolidation. We believe Anta (2020 HK), an industry leader in terms of size and market penetration, would weather the storm better than its peers. Our rating and TP for Anta is **HOLD** and HK$ 23.43, which represents 26.53x/23.98x FY16F/FY17F P/E, and 6.34x/5.85x FY16F/FY17F P/B.

Key Data

Avg.17F P/E (x)	15.68
Avg.17F P/B (x)	1.73
Avg.17F Dividend Yield (%)	3.96

Source(s): Bloomberg, ABCI Securities estimates

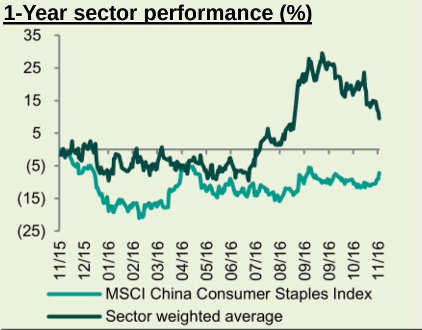
Sector performance (%)

	Absolute	Relative*
1-mth	(7.10)	(9.26)
3-mth	(9.48)	(13.06)
6-mth	17.05	10.76

* Sector weighted average relative to MSCI China Consumer Staples Index

Source(s): Bloomberg, ABCI Securities

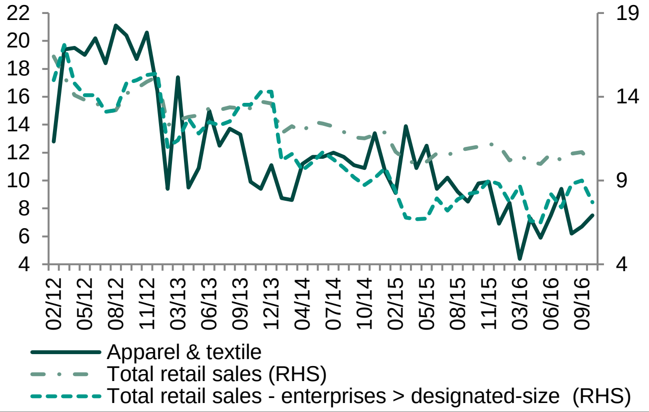
1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

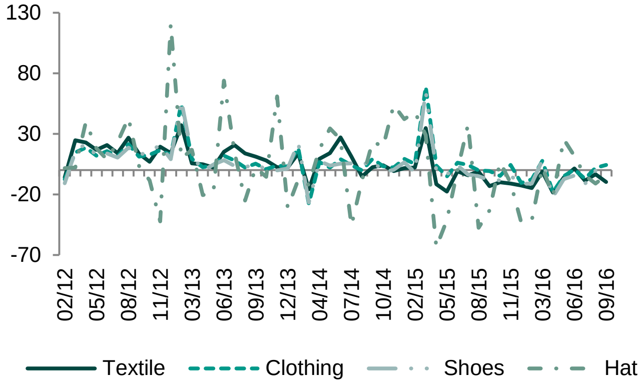
Risk factors: 1) Regulatory risk; 2) Rapidly changing consumer tastes in China; 3) Commodity price risk; 4) Business acquisition risk; 5) Product safety risk; 6) Production risk; 7) Forex risk; 8) Interest rate risk.

Exhibit 1: Retail sales growth of apparel and textile (YoY %)



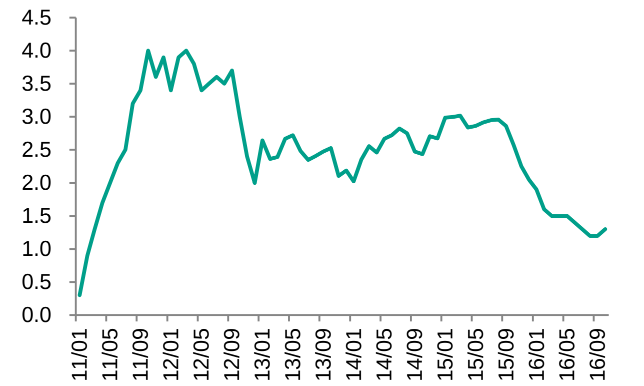
Source(s): NBS, Wind, ABCI Securities

Exhibit 2: Retail sales growth of key enterprises in apparel and textile products (YoY %)



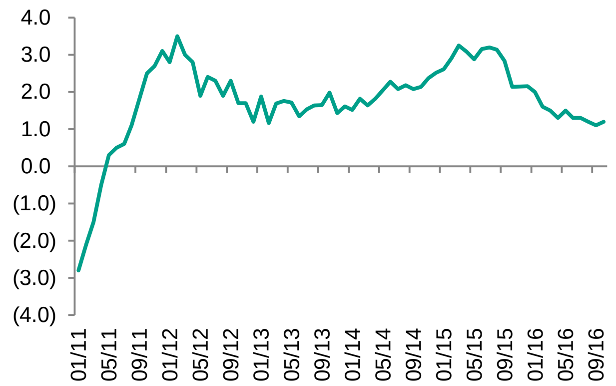
Source(s): NBS, Wind, ABCI Securities

Exhibit 3: CPI of clothing (YoY %)



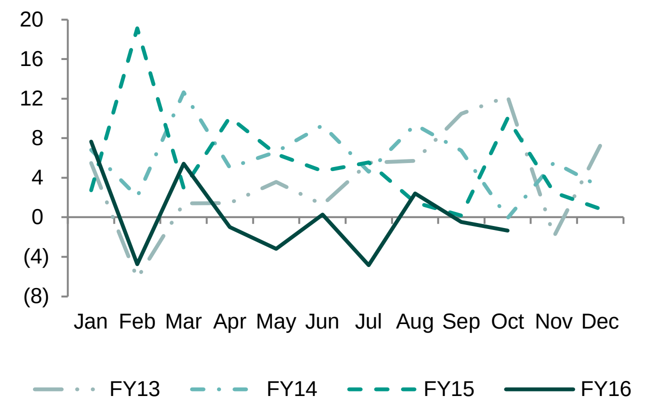
Source(s): NBS, Wind, ABCI Securities

Exhibit 4: CPI of shoes (YoY %)



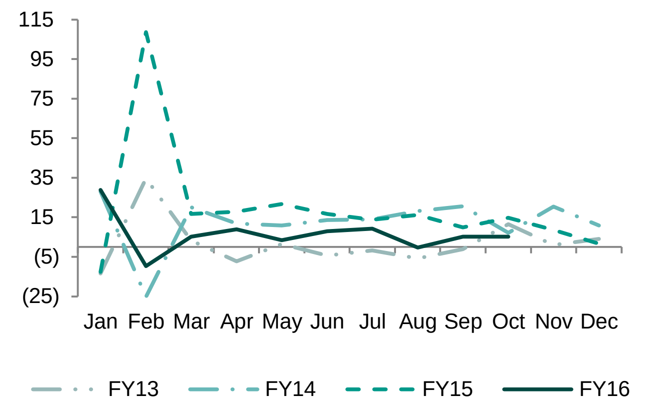
Source(s): NBS, Wind, ABCI Securities

Exhibit 5: Revenue growth of Yue Yuen (YoY %)



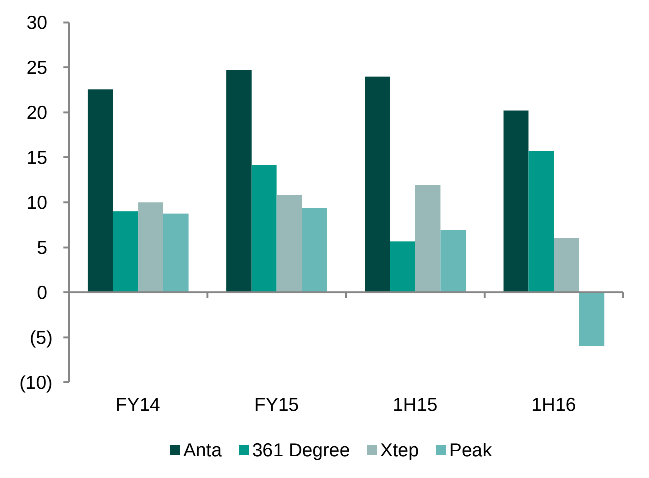
Source(s): Companies, ABCI Securities

Exhibit 6: Revenue growth of Pou Sheng (YoY %)



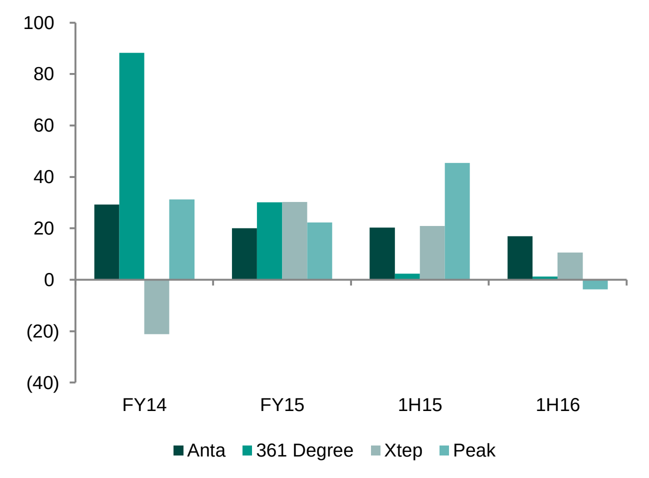
Source(s): Companies, ABCI Securities

Exhibit 7: Revenue growth of sports apparel companies in China (YoY %)



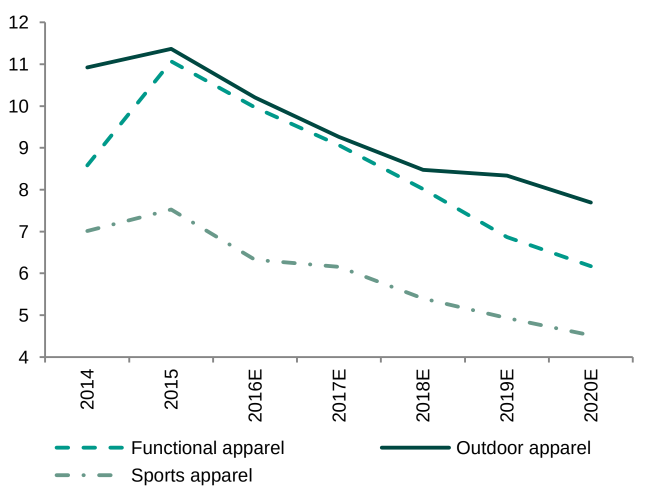
Source(s): Companies, ABCI Securities

Exhibit 8: Net profit growth of sports apparel companies in China (YoY%)



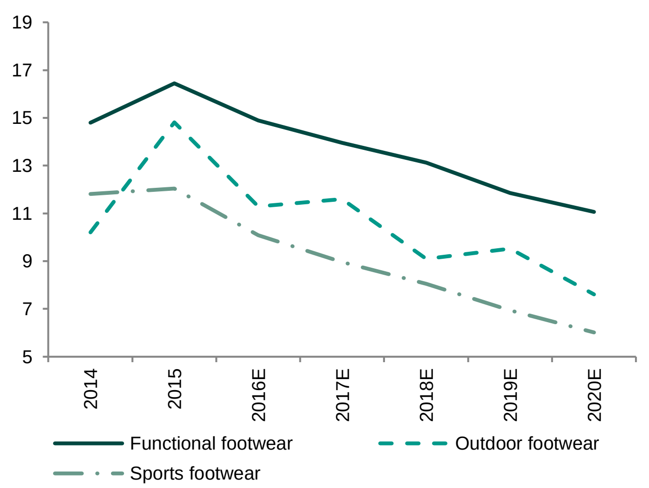
Source(s): Companies, ABCI Securities

Exhibit 9: Revenue growth projection of China's function/outdoor/sports apparel market (YoY %)



Source(s): Euromonitor International, ABCI Securities

Exhibit 10: Revenue growth projection of China's function/outdoor/sports footwear market (YoY %)



Source(s): Euromonitor International, ABCI Securities

Exhibit 11: Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY1F P/B (x)	FY16F P/B (x)	FY15F Yield (%)	FY16F Yield (%)
Anta	2020 HK	HOLD	23.43	11.57	26.53	23.98	6.43	5.85	4.09	3.89
361 Degree	1361 HK	N/A	N/A	N/A	9.85	8.39	0.94	0.88	5.35	5.00
Xtep	1368 HK	N/A	N/A	N/A	9.51	8.53	1.31	1.22	6.15	6.90

* 361 Degree & Xtep forward estimates are Bloomberg consensus

Source(s): Bloomberg, ABCI Securities estimates

From strength to strength

- Tencent (700 HK) is our top pick for the sector. We believe the Group would dominate the mobile gaming space in 2017-18
- Tencent would benefit immensely from the swift development of online advertising , which we believe contains huge earnings potential
- Online shopping would continue to experience high growth in 2017-18, boosted by rural e-commerce, online supermarket, and improving delivery services

China E-commerce

OVERWEIGHT

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Key Data

Avg.17F P/E (x)	21.9
Avg.17F P/B (x)	5.7
Avg.17F Dividend Yield (%)	0.3

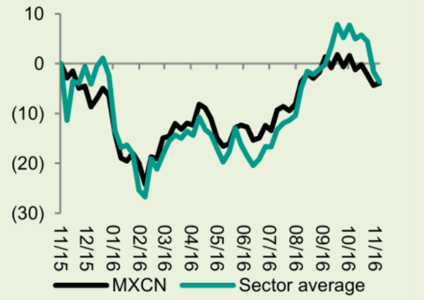
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	(8.7)	(3.3)
3-mth	(1.3)	0.1
6-mth	11.0	(2.2)

* Relative to MXCN
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Tencent dominated the online games realm. Tencent has been a leader in the mobile gaming industry. Of the 10 highest-grossing games in China over the past 2 years, generally 6-7 were published by the Group. In addition, we believe its recent acquisition of Supercell, a leading mobile game developer, would enhance Tencent's gaming portfolio, strengthen its market position locally, and establish a good foundation for its overseas business.

Online advertising has huge potential. Online advertising, driven by advancement in location-based targeting technology and mobile advertising, especially those in the video format, presents huge potential. We believe Tencent will be a major beneficiary thanks to its highly successful Weixin platform. The Group has been ramping up its online advertising initiatives, including the Weixin Moment and Public Accounts, in recent quarters. Revenue during the period jumped ~60%-120% YoY, and we expect such growth momentum to persist in the near term.

Online shopping: going from strength to strength. Online sales of goods rose 25.7% in 10M16, significantly higher than the 10.3% overall retail sales growth, indicating an ongoing shift in consumption pattern from offline to online. In addition, major online shopping platforms, such as Tmall and JD.com, achieved strong revenue growth ranging from 50-70% in recent quarters. We expect this structural change to continue over the next few years.

Sales growth of non-physical goods is higher than that of physical ones. In 10M16, online sales of non-physical goods, including games and media contents, increased 29.2% YoY, higher than the 24.9% online sales growth for physical goods such as apparel and electronics. Hence, Tencent, with a significant proportion of income from sales of virtual goods, would outperform Alibaba (BABA US) and JD.com (JD US) that focus mainly on sales of physical goods.

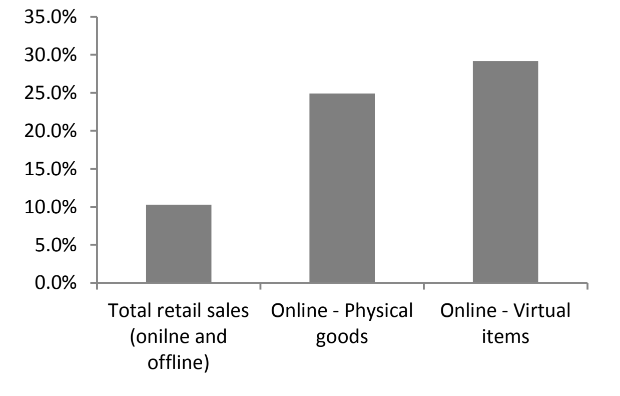
Tencent (700 HK, BUY, TP: HK$230) is our top pick. We remain positive on the China e-commerce sector. With a leading position in China's mobile gaming market and strong potential in online advertising business, Tencent is our top pick for the e-commerce sector.

Online shipping boosted by rural e-commerce, online supermarket, and improving delivery services. Rural e-commerce has become an emerging driver for overall e-commerce growth. Major players, including JD.com and Alibaba, have been setting up numerous service centers in the rural regions. Online supermarket is another bright spot given aggressive promotions by major players such as JD.com and Tmall. JD.com acquired YHD, a major online supermarket in China, from Walmart (WMT US) in June 2016 and spent RMB 1bn on promotion in subsequent months. In Oct 2016, Walmart has become the third largest shareholders of JD.com with a 9% stake, indicating a strengthened co-operation between the two giants. In addition, the recent/upcoming listings of major delivery companies, including ZTO Express, SF Express, YTO Express, ShenTong Express and Yunda Express, would imply expansion and investments in logistic services crucial for the further development of China's e-commerce.

M&A opportunities for leading players. Leading players, such as Tencent, JD.com and Alibaba are strengthening their market positions through M&A. Tencent has recently merged its online music platform, QQ Music, with another music streaming platform, KuGou/Kuwo, to increase its market share in the online music Industry from 15% to 56%. In addition, JD.com has recently acquired YHD.com, the largest standalone online supermarket and the 6th largest B2C platform in China, to expand into the fresh food and groceries segment. In the O2O space, Didi has acquired Uber China operation in Aug 2016, increasing its market share to ~90%.

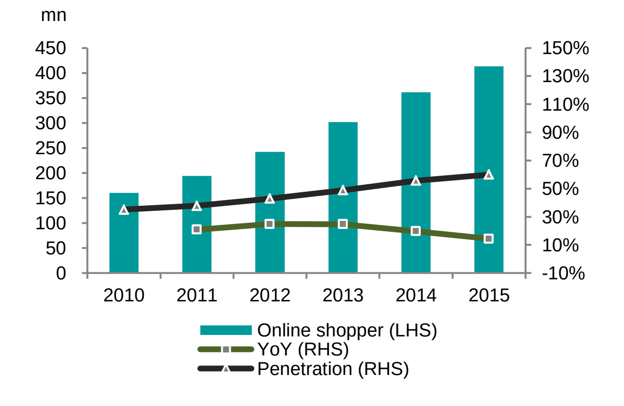
Watch out for listing of internet finance companies. According to press reports, Alibaba plans to list its internet finance business, Ant Financials, in 2017. In our view, other major payment platforms (e.g. JD Finance) would follow suit if Ant Financials is successfully listed.

Exhibit 1: 10M16 sales growth – online vs. offline



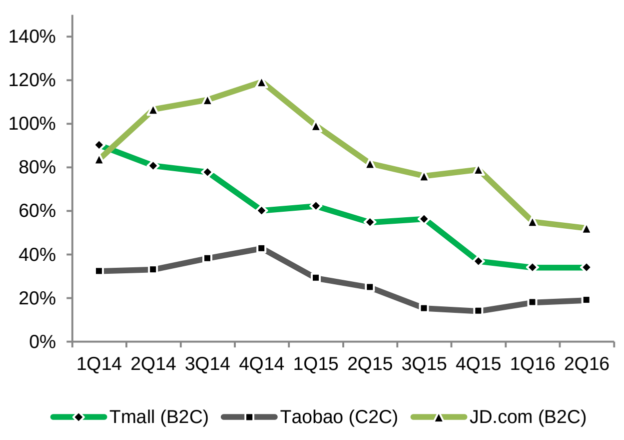
Source(s): National Bureau of Statistics, ABCI Securities

Exhibit 2 Online shoppers continued to expand



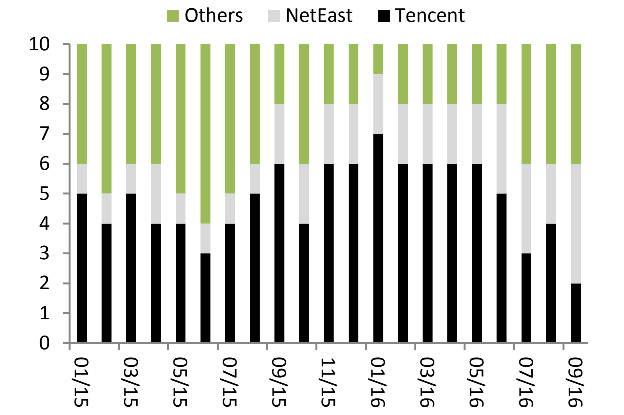
Source(s): CNNIC, ABCI Securities

Exhibit 3: Gross Merchandize Value (MV) growth of major online platforms



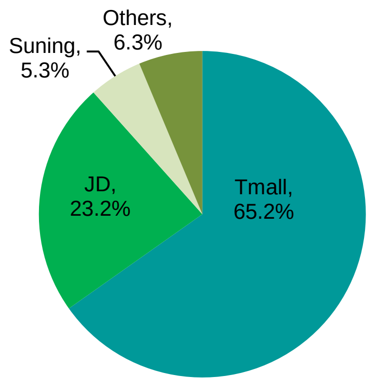
Source(s): Companies, ABCI Securities

Exhibit 4: Market share - Top 10 grossing games in China (iOS platform)



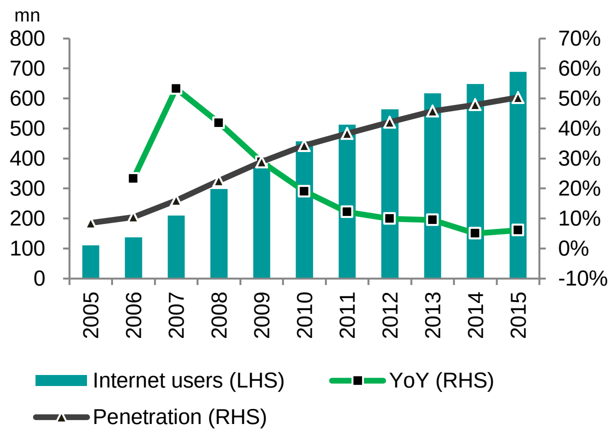
Source(s):): App Annie, ABCI Securities

Exhibit 5: B2C e-commerce market share (2015)



Source(s): CNNIC, ABCI Securities

Exhibit 6: Internet users growth



Source(s): CNNIC, ABCI Securities

Exhibit 7: Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)
Tencent	700 HK	BUY	230	19	37.0	28.4	10.4	8.0	0.3	0.3
Alibaba	BABA US	NR	NA	NA	29.2	23.4	5.9	4.8	-	-
JD.com	JD US	NR	NA	NA	NA	157.0	8.2	8.0	-	-
Baidu	BIDU US	NR	NA	NA	18.6	14.9	8.3	5.5	-	-
VIP Shop	VIPS US	NR	NA	NA	17.8	15.1	5.6	4.3	1.3	1.5
NetEase	NTES US	NR	NA	NA	36.1	27.7	4.3	3.7	-	-

Source(s): Bloomberg, ABCI Securities estimates

農銀國際
ABC INTERNATIONAL
ABCI SECURITIES COMPANY LIMITED

Strong fundamental with supportive policy

- China's new policy would support expansion in non-hydro renewable power output
- For 2015-20, China targets to expand wind power output by 14% CAGR and nuclear power output by 16% CAGR
- Lower production cost would help nuclear power to attain a higher mix in China's overall energy structure.
- Maintain **OVERWEIGHT** on China Alternative Energy sector

China Alternative Energy

OVERWEIGHT

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China's new policy to support non-hydro renewable power output in 2015-20. Under the government's new policy approved in Mar 2016, the proportion of non-hydro renewable energy (e.g. wind and solar) generated in each Independent Power Producers (IPP) will account for no less than 9% of their total power generation by end-2020. New policy would prompt IPPs to expand wind power generation. Assuming the 9% standard mandated by the policy and coal-fire power output to remain unchanged, renewable output (wind and solar) by end-2020 would increase by 15% CAGR in 2015-20F nationwide.

China targets to expand wind power output by 14% CAGR during 2015-20F. According to "the Draft of 13th FYP for Renewable Energy" issued by National Energy Administration (NEA) in 2016, China government targets to attain 250GW of installed wind power capacity by end-2020. This implied a 95% increase from the 128GW at end-2015 or a 14% CAGR in 2015-20. In addition, the "13th FYP for Power" issued by NEA on Nov 7, 2016 establishes a wind power capacity target of no less than 210GW by end-2020. If utilization hour remains similar to the 2015 level, wind power output would expand by a CAGR of 14% in 2015-20F. We believe the sharp increase in output would accelerate earnings for the wind power operators.

Wind power tariff cut will be a long-term trend. Wind power tariff in China would maintain a downtrend going forward due to 1) A lower wind power tariff would encourage more users to switch from traditional coal-fire energy to wind energy; 2) China will alleviate the financial burden of industrial companies to boost growth in industrial production. To evaluate the earnings strength of any wind power operator, investors should focus on capacity growth, all-in unit capacity cost and net gearing ratio.

China's nuclear power output would expand by 16% CAGR in 2015-20F. The average proportion of nuclear power to overall power output in developed countries is ~30% while the global average is 14%. China's figure, however, was low at 3% in 2015. According to the "Strategic Action Plan of Energy Development (2014-2020)" issued by the State Council in June 2014 and the "13th FYP for Power" issued by NEA on Nov 7, 2016, the Chinese government targets to boost nuclear power capacity to 58GW by end-2020, representing a 114% jump from 27GW in 2015. If we assume utilization hour to remain unchanged, nuclear power output would expand by 16% CAGR in 2015-20F.

Key Data

Avg.17F P/E (x)	9.00
Avg.17F P/B (x)	0.90
Avg.17F Dividend Yield (%)	2.15

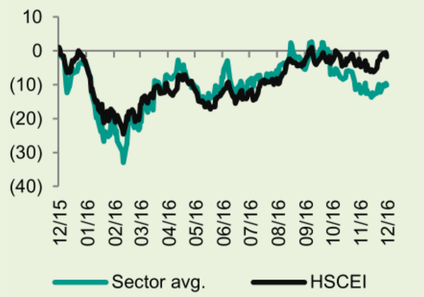
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	2.10	(0.96)
3-mth	(9.64)	(8.06)
6-mth	(6.65)	(16.98)

* Relative to HSCEI
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)

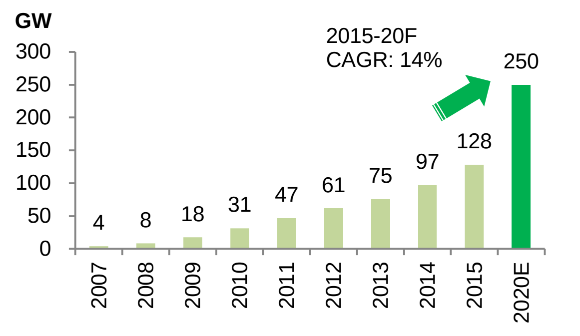


Source(s): Bloomberg, ABCI Securities

Lower production cost would increase the mix of nuclear power in China's overall energy structure. We believe a low production cost would facilitate adoption. According to the industry data, unit production cost for nuclear power is ~RMB 0.28/kWh, similar to RMB 0.3/kWh for hydro but much lower than RMB0.4/kWh for coal-fire, RMB0.5/kWh for wind, and RMB0.9/kWh for solar.

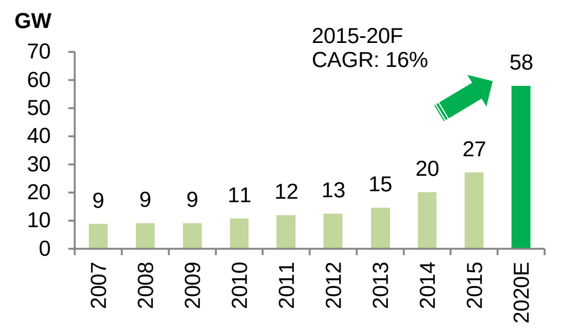
Our top picks are CGN and HNR. We like Huaneng Renewables (HNR, 958 HK, BUY, TP: HK$3.40) for its solid capacity growth under the new policy. We also prefer CGN Power (CGN, 1816 HK, BUY, TP: HK$2.90) for its leading status in the nuclear industry as well as its facilities in prime locations.

Exhibit 1: China's wind power capacity would expand substantially in 2015-20



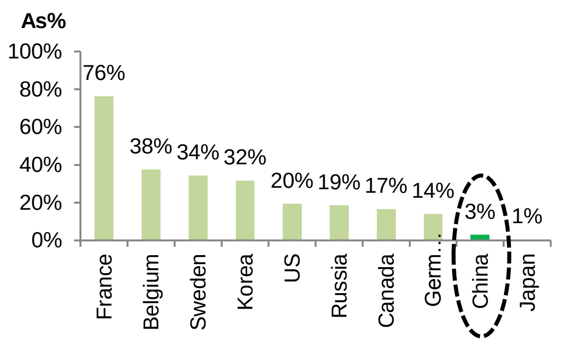
Source(s): NEA, ABCI Securities

Exhibit 2: China's nuclear power capacity would grow rapidly in 2015-20



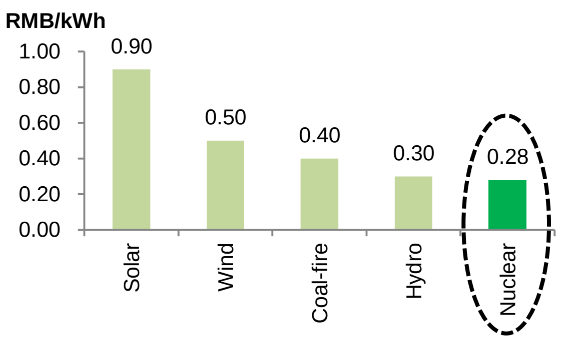
Source(s): State Council, ABCI Securities

Exhibit 3: Nuclear power has ample room to grow in China, as illustrated by its low contribution to overall power generation as of 2015



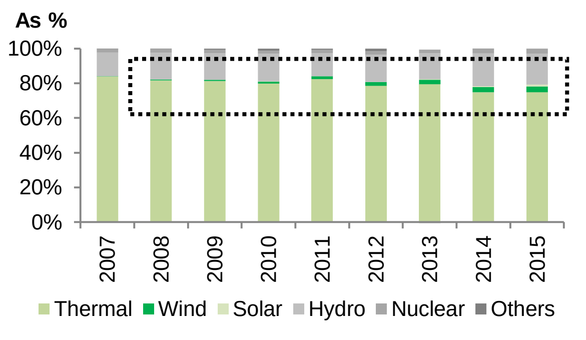
Source(s): IAEA, ABCI Securities

Exhibit 4: Low production cost should facilitate adoption of nuclear power in China



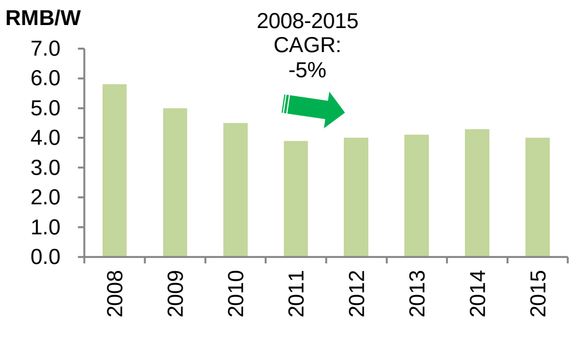
Source(s): Huadian Fuxin, ABCI Securities

Exhibit 5: China's power output structure



Source(s): NEA, ABCI Securities

Exhibit 6: China's wind power equipment unit cost has been trending down



Source(s): bjx.com, NEA

Exhibit 7: Nuclear Power Operators Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)
CGN Power	1816 HK	BUY	2.90	30.04%	12.1	11.2	1.4	1.3	2%	3%
CNNP	601985 CH	-	-	-	27.9	24.1	2.7	2.6	1%	1%
Tokyo Electric Power	9501 JP	-	-	-	5.1	7.8	0.5	0.4	0%	0%
Kansai Electric Power	9503 JP	-	-	-	9.9	10.1	0.8	0.7	1%	2%
Kyushu Electric Power	9508 JP	-	-	-	11.5	9.2	1.3	1.1	1%	1%
Korea Electric Power	015760 KS	-	-	-	3.7	4.2	0.4	0.4	5%	4%
E.On Se	EOAN GR	-	-	-	14.4	12.0	2.6	2.6	3%	4%
Edf	EDF FP	-	-	-	6.9	9.2	0.6	0.6	9%	8%
Duke Energy Corp	DUK US	-	-	-	15.9	16.0	1.3	1.2	5%	5%
Nextera Energy	NEE US	-	-	-	18.4	17.4	2.2	2.1	3%	3%
Exelon Corp	EXC US	-	-	-	12.2	12.6	1.1	1.0	4%	4%
Firstenergy Corp	FE US	-	-	-	12.2	12.2	1.1	1.1	4%	4%
Entergy Corp	ETR US	-	-	-	10.2	15.1	1.2	1.2	5%	5%

Source(s): Bloomberg, ABCI Securities

Exhibit 8: Wind Power Operators Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)
China Longyuan	916 HK	BUY	8.00	35.82%	11.8	9.7	1.0	1.0	2%	2%
Huaneng Renew.	958 HK	BUY	3.50	38.34%	8.4	7.2	1.1	1.0	2%	2%
Datang Renew.	1798 HK	HOLD	0.80	12.68%	15.0	7.9	0.4	0.4	1%	1%
Huadian Fuxin	816 HK	-	-	-	5.5	5.0	0.6	0.6	3%	4%
Beijing Jingneng	579 HK	-	-	-	7.0	6.0	0.9	0.8	3%	4%
China Suntien Green Energy	956 HK	-	-	-	9.4	7.6	0.5	0.4	3%	4%
Acciona Sa	ANA SM	-	-	-	17.6	16.1	1.0	1.0	4%	4%
Futuren Sa	FTRN FP	-	-	-	22.3	78.0	1.0	0.9	-	-
Edp Renovaveis	EDPR PL	-	-	-	37.4	29.7	0.8	0.8	1%	1%
Greentech Energy Systems	GES DC	-	-	-	15.2	10.0	0.5	0.5	0%	-

Source(s): Bloomberg, ABCI Securities

Huge demand for China's waste treatment industry

- Net profit growth among incineration and wastewater treatment operators in 2017 would remain robust
- Increasing urbanization and the government's new policy would increase waste incinerated by 12% CAGR and wastewater treatment volume by 9% CAGR in 2015-20F
- Maintain **OVERWEIGHT** on China Environmental Protection sector.

China Environmental Protection

OVERWEIGHT

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Key Data

Avg.17F P/E (x)	12.90
Avg.17F P/B (x)	2.20
Avg.17F Dividend Yield (%)	2.72

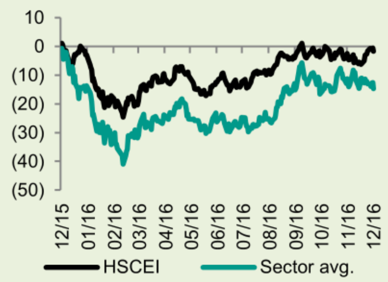
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	(1.51)	(4.56)
3-mth	(8.30)	(6.72)
6-mth	13.68	3.34

*Relative to HSCEI
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Increasing urbanization will pressure the existing urban wastewater and solid waste treatment systems. According to the estimates by NDRC, urbanization rate in China would reach 60% by end-2020, up from the 56% at end-2015, suggesting an additional 99mn people would move to the urban areas. Increasing population and rising hygienic standard would spur demand for wastewater and solid waste treatment services in major cities. We believe increasing population and tightening treatment standard would continue to fuel the earnings growth for incineration and wastewater treatment operators.

China targets to expand urban incineration capacity by 19% CAGR in 2015-20F. Historically, around 70% of residential waste has been disposed of via landfill in China. Due to the limited land resources and the resultant underground water pollution, China is reducing its use of landfill. According to "The Draft of 13th FYP on Urban Residential Waste Treatment" issued by the NDRC on Sep 22, 2016, China targets to raise the proportion of waste incinerated in urban areas from 34% at end-2015 to 50% by end-2020F, making incineration the key solid waste treatment in urban areas. Incineration capacity in urban areas is set to reach 520kt/day by end-2020 from 216kt/day at end-2015, indicating a 141% increase or 5-year CAGR of 19% for the period. Incineration will be a major waste treatment method, presenting enormous opportunities to operators in urban areas.

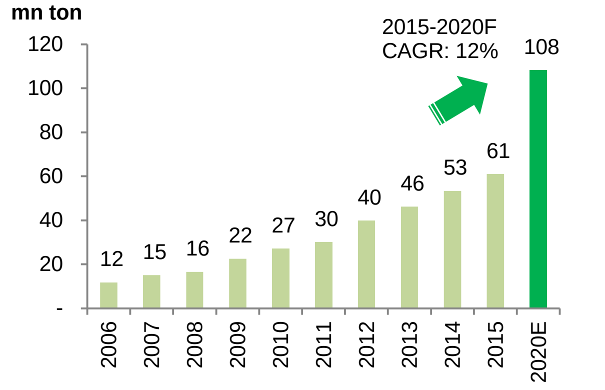
Waste incinerated to increase by 12% CAGR during 2015-20F. Based on the 50% standard set forth by the NDRC in Sep 2016 and assuming residential waste per capita to stay unchanged in 2015-20, residential waste produced would reach 217mt by end-2020F (2015: 180mt), of which 108mt (2015: 61mt) of solid waste would be treated via incineration, representing a 78% increase or 12% CAGR in 2015-20F. Waste treatment operators would benefit from the rising demand.

China's rising urban wastewater treatment rate indicates more services are required. The Chinese government will continue to raise wastewater treatment rate in urban areas to improve hygienic standard. Urban wastewater treatment rose from 61% in 2008 to 84% by end-2014. In the announcement of "Action Plan for Water Pollution" issued by the State Council on Apr 2, 2015, the end-2020F target of urban wastewater is 95%. With the rising treatment volume, the current wastewater treatment system would be overstressed, hence driving the need for new capacity. The rising demand for wastewater treatment would provide great opportunities for operators.

Urban wastewater treatment volume to rise by 9% CAGR in 2014-20F. Total volume of urban wastewater to be treated would grow strongly in years to come. Assuming an urbanization rate of 60% and a wastewater treatment rate of 95% by end-2020F, total wastewater treatment volume would be 71bn tons, representing a 65% increase from end-2014 (~43bn tons), or a 9% CAGR during 2014-20F. We believe urban wastewater treatment operators should benefit from the strong demand.

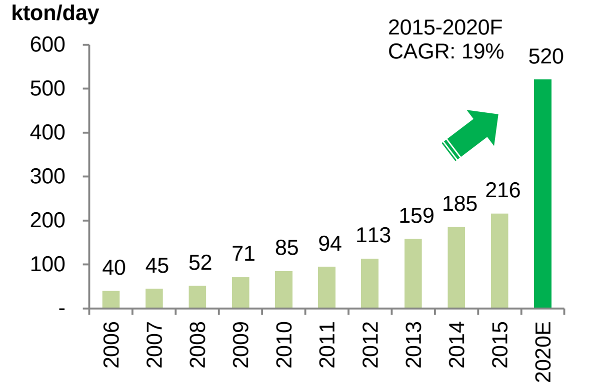
Recommend BUY for China Everbright Int'l (257 HK, BUY, TP: HK$13.00) and Beijing Enterprises Water (371 HK, BUY, TP: HK$7.00). We are positive on the outlook for environmental protection sector. Our top pick is China Everbright Int'l based on its solid growth in incineration capacity and facilities in prime regions; we also like Beijing Enterprises Water for its leading position in the wastewater treatment industry and strong growth in water distribution capacity.

Exhibit 1: China's urban solid waste to be treated via incineration would rise



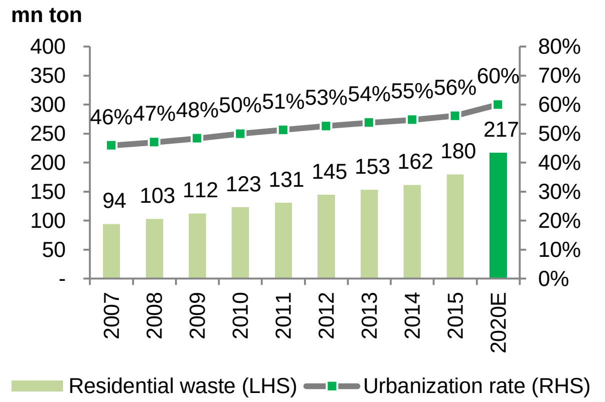
Source(s): NDRC, MEP, ABCI Securities

Exhibit 2: China's incineration capacity would record robust growth in the next few years



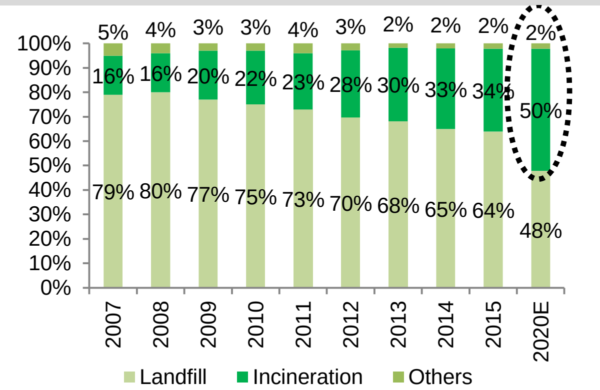
Source(s): NDRC, MEP, ABCI Securities

Exhibit 3: China's urbanization rate is likely to reach 60% by end-2020F



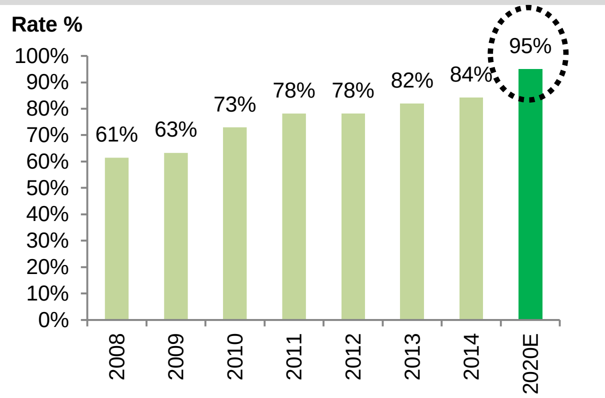
Source(s): NDRC, ABCI Securities

Exhibit 4: China targets to increase proportion of solid waste treated via incineration in urban areas



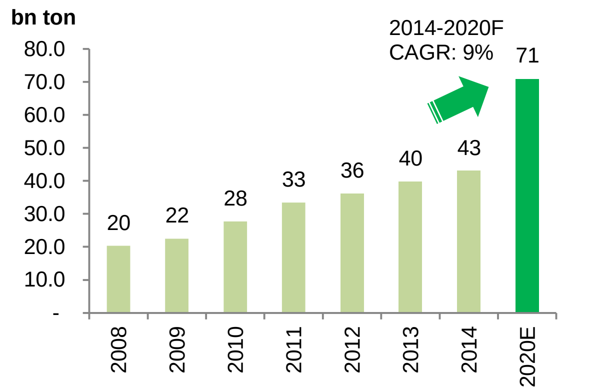
Source(s): NDRC, MEP, ABCI Securities

Exhibit 5: China's urban wastewater treatment rate would rise



Source(s): State Council, ABCI Securities

Exhibit 6: China's urban wastewater treatment volume would expand by 9% CAGR in 2014-2020F



Source(s): NDRC, MEP, ABCI Securities

Exhibit 7: Incineration Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)
China Everbright Intl	257 HK	BUY	13.00	40.85%	15.9	12.8	2.2	2.0	2%	3%
Capital Environment	3989 HK	-	-	-	13.0	8.3	0.9	0.8	-	-
Beijing Enterprises Enviro.	154 HK	-	-	-	-	-	-	-	-	-
Dynagreen Enviro.	1330 HK	-	-	-	10.0	7.4	1.2	1.0	1%	2%
Kaidi Ecological	000939 CH	-	-	-	28.0	21.7	2.1	1.9	-	-
Asahi Holdings Inc	5857 JP	-	-	-	8.1	8.1	-	-	3%	3%
Daiseki Co	9793 JP	-	-	-	21.5	19.4	1.6	1.5	1%	1%
Republic Services	RSG US	-	-	-	25.4	23.6	1.7	1.7	2%	2%
Waste Connections	WCN US	-	-	-	31.1	26.1	1.8	1.8	1%	1%
Clean Harbors	CLH US	-	-	-	-	57.3	3.5	3.3	-	-
Waste Management	WM US	-	-	-	23.9	22.1	5.7	5.4	2%	2%
Waste Connections	WCN CN	-	-	-	31.5	26.4	1.8	1.8	1%	1%

Source(s): Bloomberg, ABCI Securities estimates

Exhibit 8: Wastewater treatment Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	TP (HK$)	Upside (%)	FY16F P/E(x)	FY17F P/E(x)	FY16F P/B(x)	FY17F P/B(x)	FY16F Yield (%)	FY17F Yield (%)
Beijing Enterprises Water	371 HK	BUY	7.00	23.67%	16.1	13.0	2.7	2.4	2%	3%
China Everbright Intl	257 HK	BUY	13.00	40.85%	15.9	12.8	2.2	2.0	2%	3%
Ct Environment	1363 HK	-	-	-	14.8	12.2	2.9	2.4	1%	2%
Tianjin Capital Environ	1065 HK	-	-	-	15.2	14.5	1.2	1.1	2%	2%
China Water Affairs	855 HK	-	-	-	12.1	10.4	1.5	1.3	2%	2%
Chongqing Water	601158 CH	-	-	-	25.4	25.8	2.7	2.7	3%	3%
Tianjin Capital	600874 CH	-	-	-	35.2	31.9	2.8	2.6	1%	1%
Beijing Originwater	300070 CH	-	-	-	26.5	19.3	3.4	2.9	0%	1%
Beijing Water Business	300055 CH	-	-	-	55.5	42.2	2.8	2.7	0%	0%
Heilongjiang Interchina	600187 CH	-	-	-	-	-	-	-	-	-
Beijing Capital	600008 CH	-	-	-	31.3	26.4	2.4	2.3	2%	2%
Manila Water	MWC PM	-	-	-	12.2	11.9	1.5	1.4	3%	3%
Ttw Pcl	TTW TB	-	-	-	16.0	15.5	3.7	3.6	6%	6%
Eastern Water Resources	EASTW TB	-	-	-	12.5	11.6	1.9	1.7	4%	5%
Aqua America	WTR US	-	-	-	23.1	22.0	3.2	3.0	2%	3%
American States Water	AWR US	-	-	-	27.0	25.5	-	-	-	-
California Water Service	CWT US	-	-	-	37.3	26.8	2.5	2.3	2%	2%

Source(s): Bloomberg, ABCI Securities estimates

Growing healthcare expenditure as the new normal

- Expenditure on health accounted for 6.0% of GDP in China, significantly below that in most OECD countries
- Private and public capitals are flowing to the healthcare industry
- Consumers are willing to pay a huge premium on quality healthcare services
- Idle capacity in lower-tier private hospitals depresses investment returns
- Investors should focus on the high-tier hospital assets

China Healthcare Services

OVERWEIGHT

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Key Data

Avg.17F P/E (x)	15.4
Avg.17F P/B (x)	2.3
Avg.17F Dividend Yield (%)	1.6

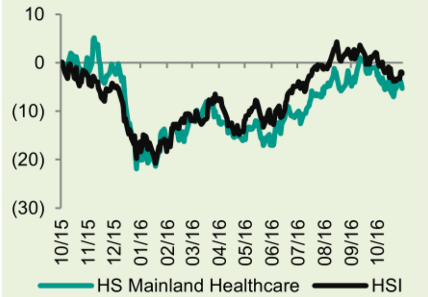
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	(3.93)	0.13
3-mth	1.22	2.12
6-mth	12.34	1.34

* HS Mainland Healthcare relative to HSI
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Expenditures on health accounted for 6.0% of China's GDP in 2015, significantly lower than that in most OECD countries. The top 5 OECD countries with the highest health expenditure-to-GDP ratio in 2015 were the U.S., Switzerland, Japan, Germany, and Sweden, with the respective ratios of 16.9%, 11.5%, 11.2%, 11.1% and 11.1%. In China, health expenditure-to-GDP ratio increased from 5.15% in 2012 to 5.56% in 2014 and 6.0% in 2015. China's 2015 figure was slightly higher than that of Mexico and similar to the U.K.'s in 2000.

Huge liquidity generated from insurance and government expenditures is funneling into the value chains of pharma & healthcare industries. We believe the downstream healthcare services providers would be the one of the first beneficiaries in the value chain. Personal health and accident insurance premium jumped 72% YoY to RMB 401.4 bn in 9M16, whereas total claims of health and accident insurance increased by 31%YoY to RMB 81.9 bn in 9M16. Fiscal expenditures on medical & healthcare and family planning surged to RMB 1,079.2 bn, up 18.4%YoY in 10M16. In view of the 13th five-year target of the China insurance industry, we expect the penetration rate and density of the health & accident insurance to maintain its vigorous momentum in 2017-18. To improve living standard and social security coverage, the government would maintain a relatively loose fiscal policy in the areas of medical & healthcare and family planning in 2017-18.

Per capita expenditure on health grew at 14.65% CAGR in 2011 -15, 7.68ppt higher than the nominal GDP growth for the same period. Private and public sectors are willing to allocate more financial resources to upgrade living standard. According to National Health and Family Planning Commission (NHFPC), national health expenditure expanded at a CAGR of 15.23% from 2011-15. Increase in government and social expenditures on health was the major driver of total health expenditure growth.

Healthcare market is dominated by lower-tier hospitals. Class 3 hospitals (the highest hospital caliber)accounted for 7.6% of the total number of hospitals in China as of end-June 2016. Lower-tier hospitals (Class 1& 2; 1 as lowest) and unrated hospitals accounted for 59% and 33.4% of the total number of hospitals as of end-June. Between 2011 and June 2016, the number of Class 3 hospitals increased by 756, accounting for 12.0% of the total net increase in hospitals. The low proportion of Class 3 hospitals in the market suggests most of the new private hospitals are of the lower-tier or unrated.

Outlook in 2017

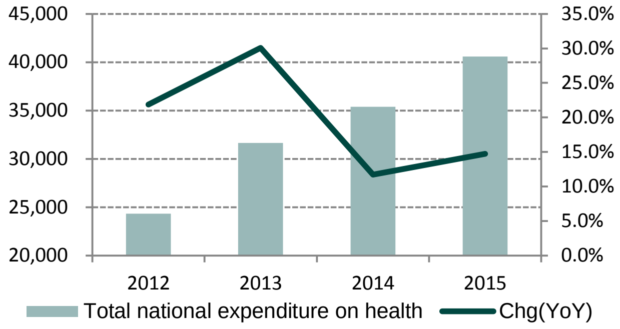
Potential market size of the health sector will reach RMB 6,850-7,829bn in 2020. The government aims to double the size of China's economy by 2020 from the 2010 levels. Assuming the target is achieved and the proportion of national health expenditure-to-GDP ratio increases to 7-8% by 2020F (from 6% in 2015), we project the total national health expenditure to be RMB 6,850.2-7,828.8bn. Such mammoth market size should attract private enterprises or investors to the healthcare sector.

The government is exiting the hospital market to provide room for private hospitals. Private capital, whose investments in the healthcare market have been increasing for the past few years, would be in high demand as a long-term funding source. In China, the total number of hospitals increased by 6,282 from 21,979 in 2011 to 28,261 in June 2016. During the period, the number of public hospitals reduced by 584 from 13,542 in 2011 to 12,958 in June 2016; the number of private hospitals increased by 6,866 from 8,437 in 2011 to 15,303 in June 2016.

High premium for better healthcare services. Market demand for quality healthcare services is strong despite the high premium commanded by the private service providers. The average outpatient fee for Class 3 hospital was RMB 289.6/patient for 1H16, 54% higher than the average outpatient fee for Class 2 hospital; the average inpatient fee for Class 3 hospital was RMB 12,901.2/patient for 1H16, 133% higher than average in-patient fee for Class 2 hospital.

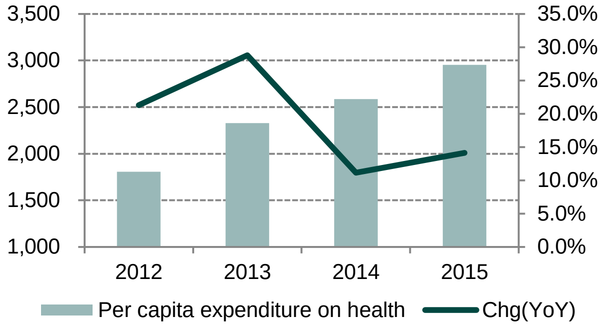
Higher ASP, patient flow, and bed occupancy in Class 3 hospitals suggest strong cash inflow and asset utilization. Equity or debt market investors in the healthcare sector should select companies with a high proportion of assets in the Class 3 hospitals. For 1H16, the average number of outpatients per public hospital was 106.0K; whereas the average number of outpatients per private hospital was 12.7K. Private hospitals are struggling to expand their customer base. For 1H16, the average number of outpatients per Class 3, 2, and 1 and unrated hospitals were 357K, 79K, 11K, and 11K, respectively. Average bed occupancy rates in Class 3, 2 and 1 hospitals were 99.3%, 87.1%, and 62.3%. Investment returns for lower-tier or unrated private hospitals are not ideal – the market players are engaging in fierce market competition with lower ASP, customer flow, and bed occupancy rate. In contrast, capacities in the Class 3 hospitals are overstretched by rising demand marked by high occupancy and frequent patient visits.

Exhibit 1: National health expenditure (RMB100 mn)



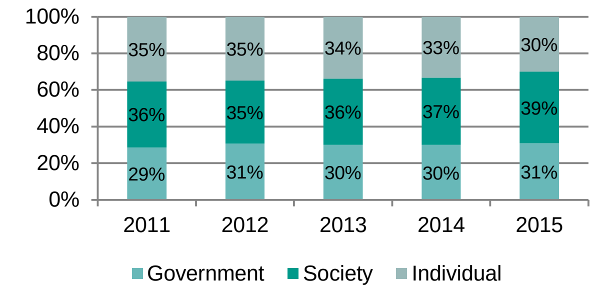
Source(s): NHFPC, ABCI Securities

Exhibit 2: : Per capita expenditure on health (RMB)



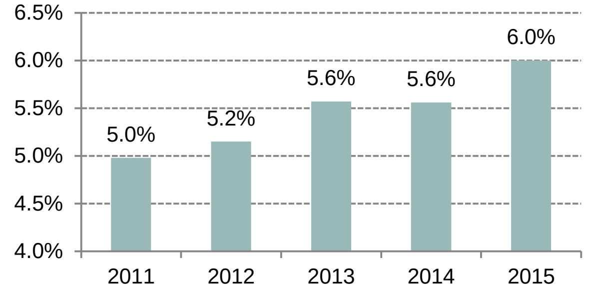
Source(s): NHFPC, ABCI Securities

Exhibit 3: Composition of national expenditure on health



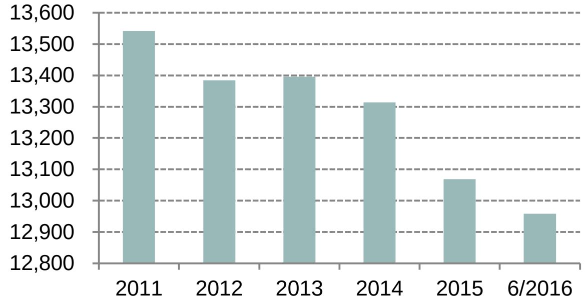
Source(s): NHFPC, ABCI Securities

Exhibit 4: National health expenditure (% GDP)



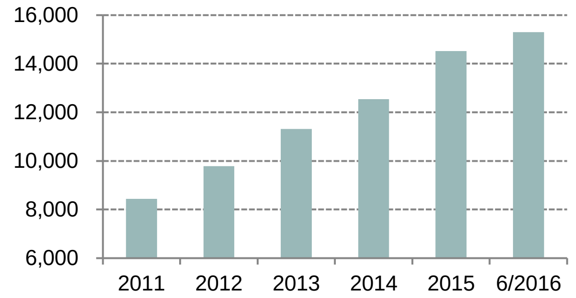
Source(s): NHFPC, ABCI Securities

Exhibit 5: Number of public hospitals in China



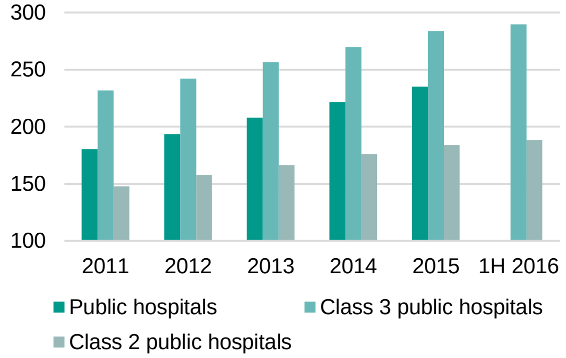
Source(s): NHFPC, ABCI Securities

Exhibit 6: Number of private hospitals in China



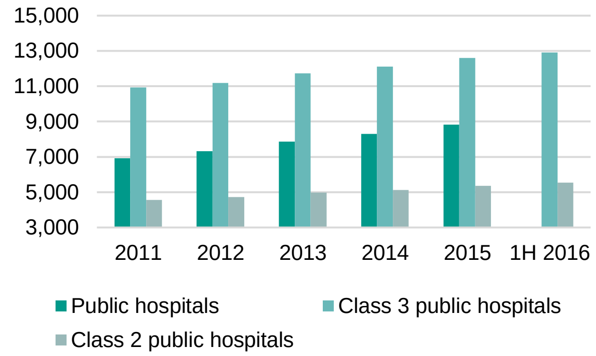
Source(s): NHFPC, ABCI Securities

Exhibit 7: Average outpatient fee (RMB/patient)



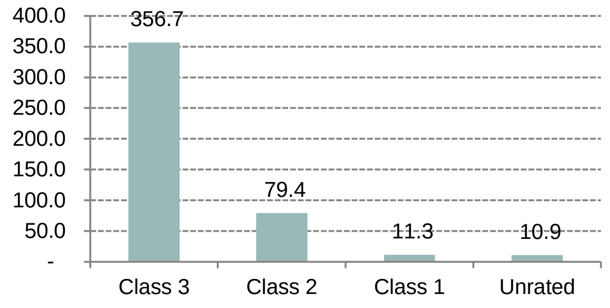
Source(s): NHFPC, ABCI Securities

Exhibit 8: Average inpatient fee (RMB/patient)



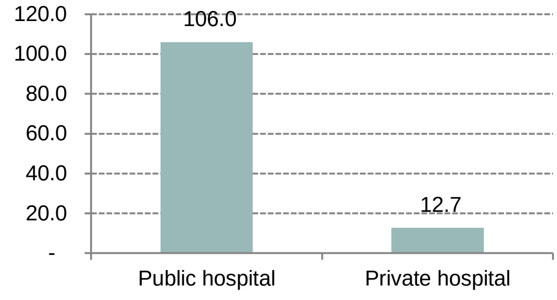
Source(s): NHFPC, ABCI Securities

Exhibit 9: Number of outpatients per hospital in 1H16 (1,000 patients)



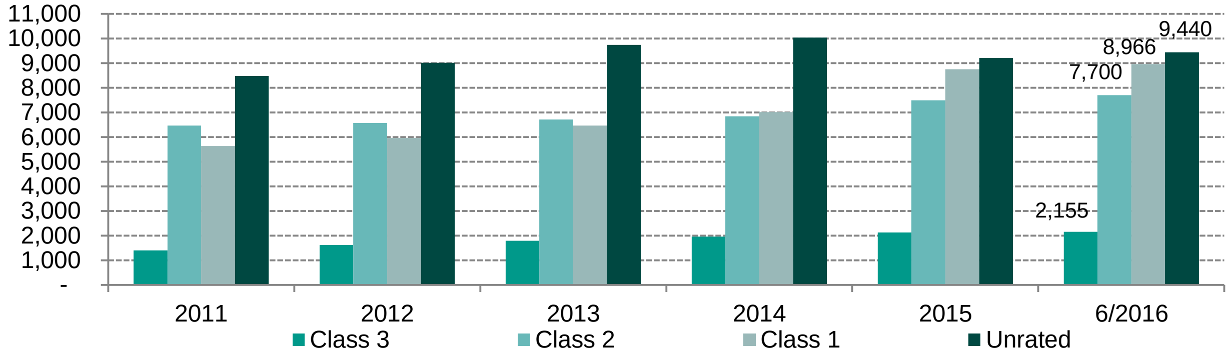
Source(s): NHFPC, ABCI Securities

Exhibit 10: Number of outpatients per hospital in 1H16 (per 1,000 patients)



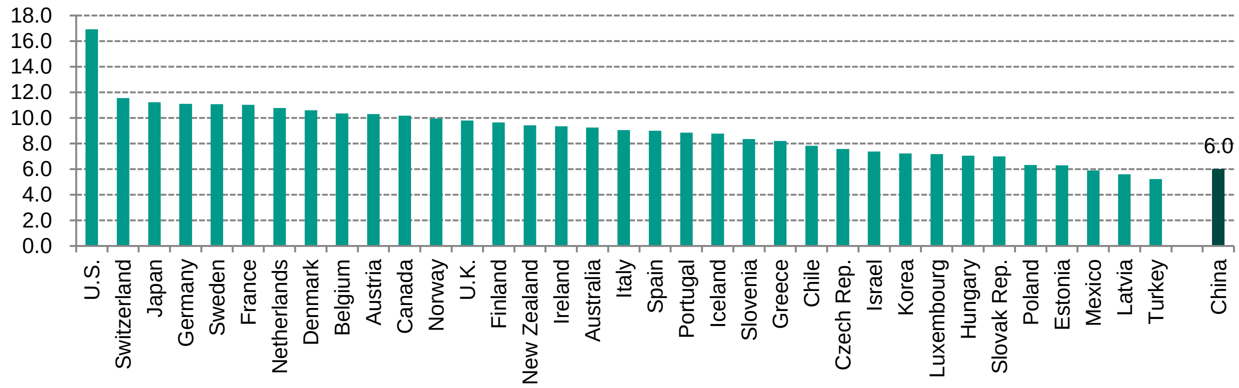
Source(s): NHFPC, ABCI Securities

Exhibit 11: Number of hospitals by quality tier (Class 3 as highest; 1 as lowest)



Source(s): NHFPC, ABCI Securities

Exhibit 12: Estimated expenditure on health/nominal GDP (%) in 2015



Source(s): OECD, NHFPC, ABCI Securities

Sector Valuation Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	Price (HK$)	FY16F P/E (x)	FY17F P/E (x)	FY16F P/B (x)	FY17F P/B (x)	FY16F Yield (%)	FY17F Yield (%)	FY16F ROAE (%)	FY17F ROAE (%)
Phoenix Health	1515 HK	BUY	11.78	32.94	27.73	4.76	4.34	0.64	0.78	14.25	16.37
Harmonicare Medi	1509 HK	HOLD	5.21	31.40	26.41	2.31	2.17	0.93	1.18	7.71	8.48
Wenzhou Kangni-H	2120 HK	HOLD	36.60	34.01	25.45	2.36	2.22	0.97	1.26	7.12	9.00
Beijing Chunli-H	1858 HK	BUY	13.60	13.94	11.23	1.63	1.43	1.24	1.57	12.82	13.57

Source(s): Bloomberg, companies, ABCI Securities estimates

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The heat is on

- Favorable fiscal policy and expanded health insurance coverage would boost demand in the pharma industry
- Wide CPI-PPI gap and adoption of two-invoice system are favorable to downstream pharma players, including those in the distribution and retailing of pharma products and services
- Pharma manufacturers are cautious on increasing FAI. Price war among upstream suppliers are unlikely
- Valuation of large-cap pharma stocks are at 11-15% discount to the small-caps

China Pharma

OVERWEIGHT

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Fiscal policy favors the pharma industry. According to the MOF, fiscal expenditure on medical and healthcare grew 18.4%YoY to RMB 1,079.2 bn in 10M16, accounting for 7.3% of total fiscal expenditure and was 8.4 ppt higher than growth in total fiscal public expenditure over the same period. China's determination to raise society's living standard and strengthen social security protection network is palpable. We believe the relatively high growth in fiscal expenditures on medical and healthcare will benefit the value chain in the pharmaceutical industry.

Health insurance — a flourishing sector bringing long-term business opportunities. In 9M16, total health and accident insurance premium income surged 72% YoY to RMB 401.4bn, exceeding the total premium income in 2015. Substantial rise in cash flow generated from the health and accident insurance premium income will eventually cascade through the supply chains in the pharmaceutical industry as insurance claims increase.

Inflation data (CPI) shows strong demand in the downstream pharmaceutical industry. CPI of medicines and medical services were higher than that of the national one, meaning that distributors/retailers have been raising the prices of pharma products or medical services. CPIs of consumer goods and services were up 1.9% YoY and 2.1% YoY for 10M16; CPIs of Chinese medicines, Western medicines, and medical and healthcare services were up 4.7% YoY, 3.9% YoY, and 3.5% YoY for 10M16, respectively.

Retail sales of medicines grew faster than that of consumer goods. Retail sales of Western & Chinese medicines grew by 12.4% YoY in 10M16, 2.1 ppt higher than the national retail sales of consumer goods. Continuous income growth, increase in government support, and the expansion of health and accident insurance coverage will enhance the purchasing power of end-users of medicines.

Demand for imported pharmaceutical products remains strong. Import of pharma products went up by 15.7% YoY in volume and 15.5% YoY in value for 10M16. Solid domestic demand for imported pharma products reflects the rising purchasing power of domestic end-users and the fact that domestic demand cannot be fulfilled by supply from the local pharma product producers alone.

Key Data

Avg.17F P/E (x)	17.9
Avg.17F P/B (x)	2.9
Avg.17F Dividend Yield (%)	1.8

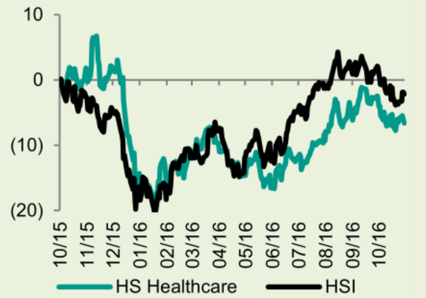
Source(s): Bloomberg, ABCI Securities estimates

Sector performance (%)

	Absolute	Relative*
1-mth	(3.80)	0.26
3-mth	2.99	3.89
6-mth	9.24	(1.76)

* HS Healthcare relative to Hang Seng Index
Source(s): Bloomberg, ABCI Securities

1-Year sector performance (%)



Source(s): Bloomberg, ABCI Securities

Outlook in 2017

Centralized procurement policy weakens bargaining power of pharma manufacturers but favors midstream distributors. Unlike the downstream distributors/retailers capable of increasing selling prices with relative ease, the upstream pharma manufacturers are not as able to conduct similar price adjustments. We believe centralized drug procurement in medical institutions and pharmacy chains has weakened the bargaining power of pharma manufacturers. Ex-factory PPI of pharma manufacturers was up 0.3% YoY for 10M16, while the CPI-PPI gap of pharma products was 3.4%, suggesting attractive gross margins for downstream drug distributors and pharmacy operators. The proposed two-invoice system in the supply chain of pharma products to medical institutions implies consolidation of the pharma distribution sector would accelerate in coming years. Profit margins of pharma distributors are likely to widen in 2017-18.

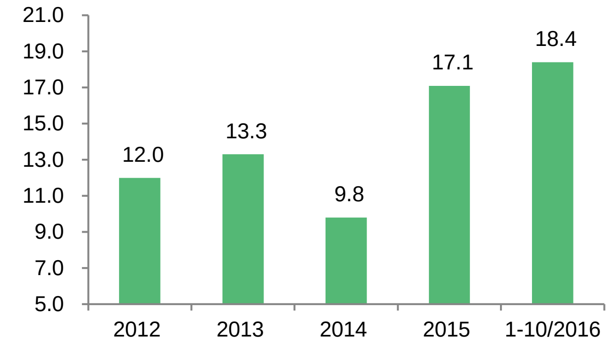
Value-added growth exceeding the national average implies decent profit growth in the pharma manufacturing industry. Value-added growth of pharma manufacturing industry was 10.6% YoY in 10M16, or 4.6ppt higher than the national average industrial value-added growth. The higher growth in the pharma manufacturing industry implies manufacturers have achieved higher revenue and profit over the same period. We expect the pharma manufacturing industry to maintain a low double-digit growth in 2017.

Pharmaceutical manufacturers are cautious on asset expansion despite optimistic industry outlook. The fixed assets investment (FAI) growth of the pharma manufacturing industry slowed to 8.9% YoY in 10M16 from 11.9% YoY in 2015. Local pharma manufacturers restrain capex growth to avoid from over-capacity risk. Severe price competition in the upstream drug production is unlikely in 2017.

Double-digit growth in revenue and profit for the pharma manufacturing industry. According to NBS, 10M16 revenue and profit of pharma manufacturers grew 9.6% YoY and 15.5% YoY to RMB 2,234.9bn and RMB 235.6bn. The higher growth in profit than revenue suggests profit margin has been rising in the pharma manufacturing industry amid the slowdown in economic growth. In view of an almost flat PPI in pharma manufacturing industry, the increased profit margin suggests the industry is shifting to produce more high-end products with more lucrative margins. We believe drug producers are optimizing their returns by adjusting their product portfolios- a change that will continue in years to come.

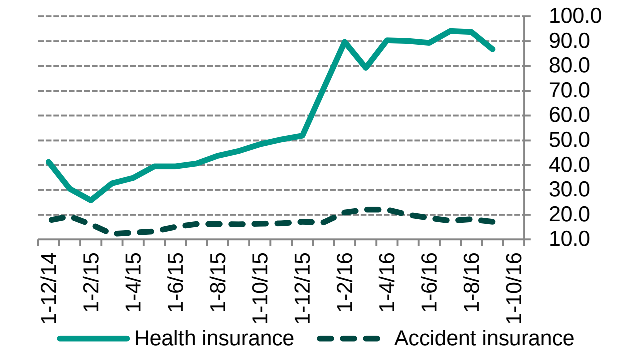
Large-cap pharma stocks are cheaper. Hang Seng Healthcare Index underperformed in 2016. The industry is recording a low double -digit profit growth but is valued at ~18x 2017 P/E and ~2.9x 2017 P/B, which we believe to be slightly overpriced even with the positive industry outlook. Average P/E and P/B of pharma stocks with a market cap over HK$ 10bn are at ~11-15% discount to the average P/E and P/B of the smaller peers. Since the average GP margins of the pharma stocks of different sizes are similar, pricing of the large-caps are relatively more reasonable in our view.

Exhibit 1: China's fiscal expenditures on medical treatment and healthcare (YoY %)



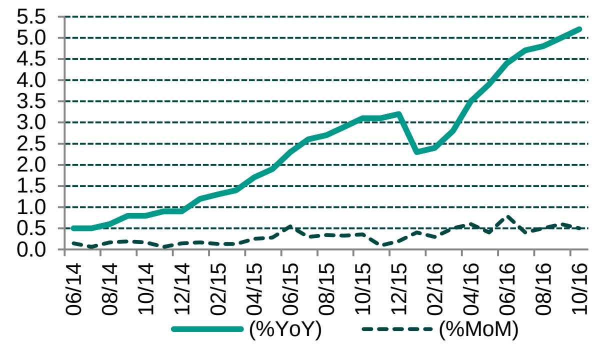
Source(s): Ministry of Finance, ABCI Securities

Exhibit 2: : Insurance premium growth in China (YTD YoY %)



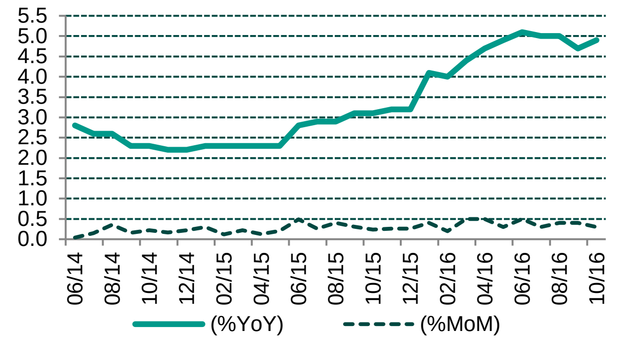
Source(s): CIRC, ABCI Securities

Exhibit 3: CPI of Western medicines



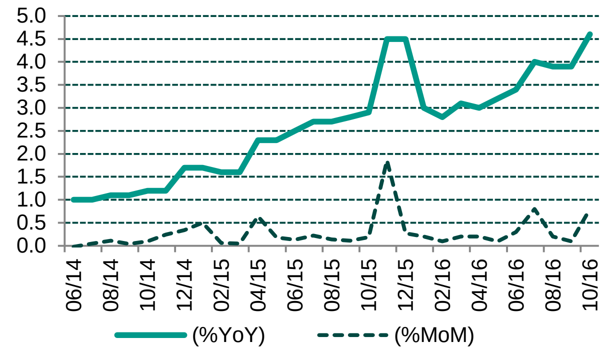
Source(s): NBS, ABCI Securities

Exhibit 4: CPI of Chinese medicines CPI



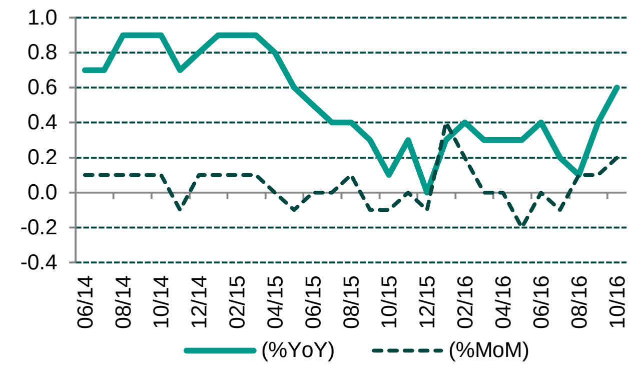
Source(s): NBS, ABCI Securities

Exhibit 5: CPI of medical healthcare services



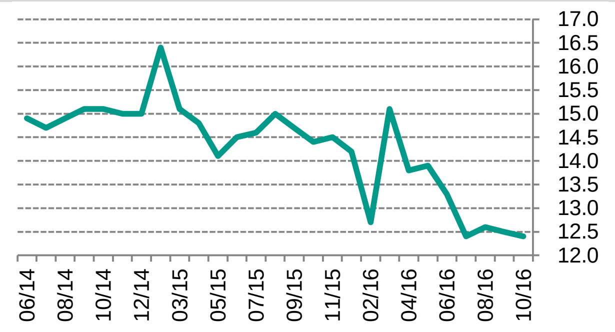
Source(s): NBS, ABCI Securities

Exhibit 6: PPI of pharma manufacturing - ex-factory



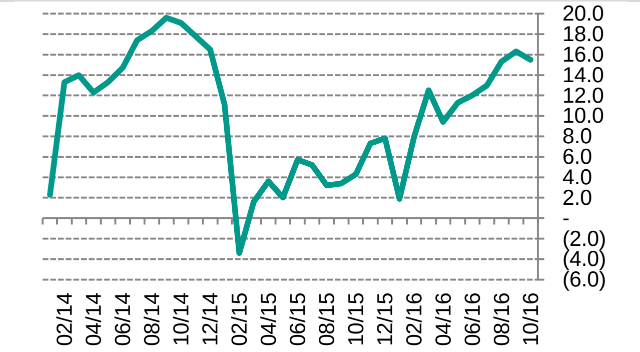
Source(s): NBS, ABCI Securities

Exhibit 7: Retail sales of medicines (YTD YoY %)



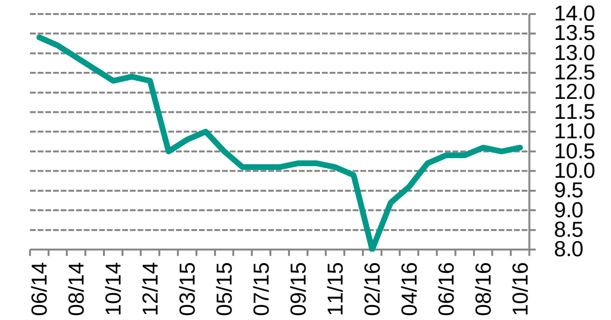
Source(s): NBS, ABCI Securities

Exhibit 8: Import of pharma products (YTD YoY %)



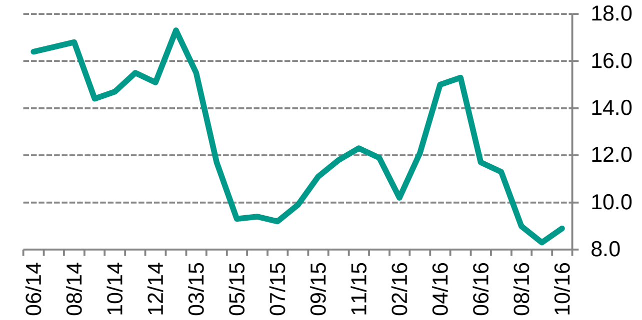
Source(s): China's Customs, ABCI Securities

Exhibit 9: Value-added growth of the pharma manufacturing industry (YTD YoY %)



Source(s): NBS, ABCI Securities

Exhibit 10: FAI in pharma manufacturing industry (YTD YoY %)



Source(s): NBS, ABCI Securities

Exhibit 11: Large-cap (>HK$10 bn) Pharma Stocks Summary

Company	Ticker	HK-listed Mkt cap (HK$mn)	ROAA (%)	ROAE (%)	5-yr avg ROAE (%)	GP margin (%)	3-yr avg GPM (%)	Asset/ Equity (x)
CSPC Pharma	1093 HK	47,936	13.48	21.74	16.99	45.82	38.51	1.54
Sinopharm-H	1099 HK	42,226	3.03	14.70	11.57	8.20	8.13	3.40
Sino Biopharm	1177 HK	40,248	10.23	23.80	21.55	77.67	77.19	1.58
China Medical	867 HK	32,284	14.88	21.50	21.44	57.58	56.10	1.20
3SBio INC	1530 HK	20,790	11.78	16.05	-	85.54	89.43	1.18
Sihuan Pharm	460 HK	19,031	10.61	12.21	15.50	70.35	65.03	1.10
Trad Chi Med	570 HK	17,372	5.57	8.21	12.56	59.15	60.12	1.54
Luye Pharma	2186 HK	16,738	11.45	14.27	-	81.44	82.01	1.22
Shanghai Pharm-H	2607 HK	14,720	4.11	10.40	9.41	11.88	12.28	2.20

Source(s): Bloomberg, companies, ABCI Securities estimates

Exhibit 12: Large-cap Pharma Stocks Summary (Data as of Nov 25, 2016)

Company	Ticker	Rating	Price (HK$)	FY16F P/E(x)	FY17F P/E (x)	FY16F P/B(x)	FY17F P/B (x)	FY16F Yield(%)	FY17F Yield(%)
CSPC Pharma	1093 HK	BUY	8.15	23.29	18.95	4.81	4.13	1.58	1.91
Sinopharm-H	1099 HK	BUY	35.25	18.89	16.73	2.49	2.19	1.63	1.83
Sino Biopharm	1177 HK	BUY	5.38	19.64	17.70	4.11	3.41	0.93	1.06
China Medical	867 HK	-	12.56	20.67	17.03	4.41	3.63	1.65	1.99
3SBio INC	1530 HK	-	8.49	26.48	19.47	3.05	2.65	-	0.09
Sihuan Pharm	460 HK	-	1.94	9.11	9.11	1.47	1.34	2.14	2.31
Trad Chi Med	570 HK	BUY	3.91	14.97	12.46	1.25	1.15	1.95	2.29
Luye Pharma	2186 HK	-	4.97	16.54	14.26	2.21	1.94	-	0.70
Shanghai Pharm-H	2607 HK	-	19.58	14.65	13.21	1.45	1.34	1.90	2.13

Source(s): Bloomberg, companies, ABCI Securities estimates

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. I 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. I and/or my associates have no financial interests in relation to the listed company (ies) covered in this report, and I 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).

Steve Chow holds H-shares of Tencent (700 HK).

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

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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