ABCI Policy Snapshot

Macroeconomic and Industry Impacts of Latest Polices in China

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Policy Snapshot

The Chinese government has rolled out a slew of policies to stabilize economic growth this year. The Ministry of Finance (MOF), together with the State Administration of Taxation, has proposed the personal income tax reduction plan; PBOC, in a bid to facilitate financing for micro and small enterprises and private firms, has increased relending and rediscounting quota by RMB 150bn; the Securities Association of China also announced securities firms will form an asset management scheme specifically to inject funds into private companies in need. In this report, we will analyze the impacts of these policies on the macro and industry levels.

Macroeconomic impacts of China's Personal Income Tax Deduction Plan

China released a detailed draft plan for personal income tax cuts on Saturday (Oct 20). Briefly stated, eligible taxpayers can claim deductions for expenses on children and adult education, treatments for serious medical diseases, housing loan interest, housing rent, and elderly support. Tax deduction for mortgage interest will only apply to first-home purchase by taxpayers or their spouses. Eligible taxpayers can claim RMB 12,000 per year in tax deduction for children education, and RMB 3,600 to RMB 4,800 for adult education. Deduction amount for supporting parents aged 60 or above will be RMB 24,000 per year, to be equally split among siblings. Rent deduction ranges from RMB 800 per month in small cities, RMB 1,000 in mid-sized ones, and RMB 1,200 in big cities. For medical expenses, taxpayers can claim up to RMB 60,000 per year if their expenses exceed RMB 15,000 after public health insurance coverage. The set amount is RMB 12,000 per year. According to Ministry of Finance (MOF), the policy will take effect from Jan 1, 2019 and will be adjusted according to changes in education, housing, medical, and other livelihood expenses.

China's slowed GDP growth at 6.5% in 3Q18 and the rise in Sino-US trade friction are indicative of growing downward pressure in the economy. The MOF issued the draft with the intention to provide buffers against the impacts of an economic slowdown. Data from MOF show that there were about 64mn of Chinese taxpayers earning more than RMB 5,000 per month in 2017 and the population will benefit from the latest tax deduction plan. According to the government's estimates, residents of Beijing with a monthly income of RMB 20,000 will have their personal income tax reduced by 70% after the six additional tax deductions mentioned above; residents with a monthly income of RMB 10,000 per month will incur no personal income tax. We believe the tax deduction is rather significant and steeper than the market would have expected.

Policy Snapshot

We estimate the proposed personal income tax deductions will represent an actual tax cut of RMB 100bn; together with the RMB 320bn in annual tax cut estimated by MOF from the change in personal tax threshold, we estimate the total annual tax cut resulted from the personal tax reform would be ~RMB 420bn, representing ~0.5% of China's total GDP in 2017.

Such personal income tax break will undoubtedly increase disposable income growth and boost consumption. If half of the RMB 420bn freed up is channeled to consumption, GDP would be boosted by ~0.25%. We believe value-added tax and corporate income tax are likely to be lowered in the future. With the slowdown in real economy, tax cut will become an important tool to boost domestic demand and economic growth. Finally, we expect the government's fiscal deficit to rise to 3.5% of GDP in 2019E, up from an estimated 3.0% in 2018E, since the tax cut will inevitably slow fiscal revenue growth.

Impact on industry:

China Banks Sector

Industry impact:

- The latest draft plan for personal income tax cuts aims to reduce personal tax burden. This policy covers tax deduction items for education, major medical care, housing loan interest, housing rent, and elderly expenditure. Asset quality risk, especially in the retail banking segment with residential mortgage and personal consumption loans, can be alleviated by easing personal tax burden. Still, we expect banks to continue NPL handling effort to manage the overall NPL ratio while keeping the provisioning ratio and provision coverage ratios at sufficient levels.

- PBOC has increased the amount of refinancing and rediscounting by RMB 150bn in June this year, with the primary purpose of improving the financing environment for small and micro enterprises and private companies. Together with the additional RMB 150bn proposed in the tax cut plan, these actions added up to a total of RMB 300bn in quota to support the market. Combined with the multiple RRR cuts earlier this year, it is clear that the government is committed to maintaining a stable financial system and support the real economy. In our view, policy risk remains the largest concern for the China banks sector. With the ongoing Sino-US trade war, we expect more policies will be devised in the future.

Policy
Snapshot

China Securities Sector

Industry impact:

- The Securities Association of China announced plan to form an asset management scheme to alleviate pressure from "share pledges" for companies.

- Under the proposal, 11 securities firms involved will initially invest RMB 21bn to set up various asset management funds, bringing on board banks, insurers, state-owned enterprises and government agencies as investors. Size of the asset management fund is expected to reach RMB 100bn, with the intention of bailing out listed companies with good prospects but is at risk of forced sale of shares.

- Compared to the intervention in July 2015, measures taken this time are more targeted in the sense that it will help reduce share pledge risk in the A-share market instead of simply supporting share price levels. Measures such as temporary suspension of IPO and brokers refrained from selling holdings under a set index level are not proposed this time. Back in 2015, 21 securities firms injected RMB 120bn to support the market; the RMB100bn fund to be raised this time will be contributed by multiple parties including securities firm, insurers, SOEs and government institutions.

- From a valuation perspective, the current valuation of the CSI 300 Index is 11.0x P/E and 1.6x P/B, which is different from July 2015 when the CSI 300 Index was valued at 15.4x P/E and 2.4 x P/B. Hence, the risk and return prospects will be different.

Policy
Snapshot

China Property Sector

Industry impact:

- The government has proposed tax deductions for housing costs: **1) interest deduction on first-home loan.** Taxpayers or their spouses are granted RMB 12,000 in tax deduction per annum on interest payments for first-home loans; **2) rental expenses deduction.** Taxpayers who do not own any residential property in the city they reside are granted RMB 9,600-14,400 in tax deduction on rental payments incurred.

- We believe the tax deduction on interest payment and rental expenses should not be interpreted as a sign of policy relaxation in the property sector. According to data from NBS, 64 out of 70 cities registered MoM increase in housing prices for Sep. As property price is still rising, we believe tightening measures such as home purchase restriction and presales price control will remain in place. We believe the primary goal of the tax cut is to boost consumption. According to Rong360, average mortgage rate in Sep 2018 was 5.69%, up 0.57ppt YoY. Coupled with rising property prices, the augmenting burden of housing cost is reducing consumers' spending power in China. Besides, the higher amount of maximum tax deduction on rental expenses (RMB 14,400k/annum) may encourage more people to rent instead of purchasing. In particular, given the relatively low rental yield in China, the cost of renting a home is much lower than buying.

- We believe that this is in line with the government's goal to actively develop the housing rental market and promote the rental consumer market, as stated in the State Council (2018) No. 93 Document.

China Internet Media and Consumer Commerce

Industry impact:

- In our view, the tax cut could potentially be supportive for online sales, which bodes well for major online e-commerce platforms.

- Online retail sales growth remains sound. According to the NBS, online retail sales in 9M18 increased by 27.0% YoY to RMB 6,279bn. In addition, online sales of physical goods increased by 27.7% YoY to RMB 4,794bn. Overall, online sales of physical goods accounted for 17.5% of the total retail sales in 9M18. Among online retail sales of physical goods, food, clothing and other commodities grew by 43.8%, 23.3% and 27.7% in 9M18.

- Online gaming segment is facing headwinds unlikely to be offset by the latest tax cut, in our view. Rising popularity of short video platforms may reduce the time users spend on online games. In addition, regulatory control over the online games industry has been tightening, as marked by .a more stringent online game approval process that would inevitably disrupt the pace of game launch and eventually, revenue.

China Consumer Sector / Education Sector

Industry Impact:

Consumption

- Six categories of household spending are eligible for tax deductions. The proposed deduction would free up RMB 420bn annually in taxes, equivalent to 1.15% of total retail sales in 2017, hence increasing consumers' spending power and consumption. By estimates, if half of the RMB 420bn is channeled to consumption, the annual GDP growth would increase by 0.25 ppt. We believe that the spending would be first allocated to daily consumer goods, education services, and housing-related expenses.

Education services

- Among the six categories of household spending eligible for tax deduction, two belong to education expenses, which include formal education for children (from preschool to higher education) and adult education. The maximum deduction for formal education for children is RMB 12,000 per year (RMB 1k per month).

- We believe that the tax deduction on education spending would benefit the K12 education service providers, especially those with middle and primary schools (the 9-year compulsory education). Currently, the number of middle and primary school students attending the public schools is much higher than those in the private schools. The zero tuition policy for Grade 1-9 in the public school system means most students will not be benefiting from the tax deduction. Therefore, we believe the new tax cut will provide additional incentives for families with sufficient financial resources to switch to private schools especially if their children are in Grade 1-9.

Policy
Snapshot

China Telecom Sector

Industry impact:

- The Implementation Plan on Promoting the Consumption System and Mechanism (State Council [2018] No.93 Document) released by the State Council on Oct 11 states that information consumption will be expanded and upgraded. Information consumption will be one of the focuses in promoting consumption in China. Tax cuts are beneficial to the development of telecom operators by encouraging electronic consumption, which will boost user data usage and consequently, revenue of telecom operators. Tax cuts also help increase information consumption. The Ministry of Industry and Information Technology (MIIT) encourages enterprises to utilize cloud computing to accelerate digital, network, and intelligent transformations, hence promoting integration of the Internet, big data, and artificial intelligence with the real economy. MIIT, together with the National Development and Reform Commission, jointly released a three-year action plan for expanding and upgrading information consumption (2018-20); by 2020, the scale of information consumption is targeted to reach RMB 6tr, with an average annual growth of 11%. In our view, the telecom industry will facilitate information consumption, while rapid development of communication networks will deepen integration of information and consumption online and offline.

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Definition of equity rating

Rating	Definition
Buy	Stock return rate≥ Market return rate (10%)
Hold	- Market return rate (-10%) ≤ Stock return rate < Market return rate (+10%)
Sell	Stock return < - Market return (-10%)

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

Market return rate: average market return rate since 2005 (HSI total return index 2005-17 CAGR at 10%)

Time horizon of share price target: 12-month

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

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