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## Direct financing: A major pillar of economic growth

- Direct financing is playing an increasingly important role in sustaining economic growth
- On a net basis, corporate bonds issued surged by 89.4% YoY in 1H16
- Equity financing jumped 52.8% YoY in 1H16
- Leading underwriters in direct financing market become the major beneficiaries

**Government is committed to deleveraging the economy.** Direct financing facilitates the process of deleveraging in the economy and stabilizes growth. For the public and private sectors alike, a company can either divest assets to repay liabilities, increase capital, or both to reduce financial leverage. To sustain economic growth, however, investments in new assets have to continue. The lack of medium-to-long-term funding sources to finance asset growth thus becomes one of the bottlenecks of economic growth. To provide more funding sources while deleveraging the economy, direct financing via issuances of corporate bonds and equity securities will need to expand.

**The economy is leveraging up - not down.** Deleveraging the economy proves to be a challenging task for China. According to the Ministry of Finance, liabilities/assets of the state-owned enterprises (SOEs) held by the central government increased to 68.08% at end-June 2016 from 67.97% at end-2015 and 65.66% at end-2014; liabilities/assets ratio of local government-owned SOEs reduced slightly to 64.36% at end-June 2016 from 64.41% at end-2015 and 64.64% at end-2014. According to NBS, liabilities/assets ratio of industrial enterprises above the designated size increased to 56.63% at end-June 2016 from 56.17% at end-2015. Except for the local government-owned SOEs, financial leverages of large SOE companies are in fact going up in 1H16.

**Diminishing importance of banks in the economy's aggregate financing.** Increase in bank loans (local currency and foreign currency loans) and undiscounted bank bills have played an important role in providing new finance to the economy. However, their joint proportion in the economy's aggregate financing reduced to 59.72% in 1H16 from 62.57% in 2015 and 60.98% in 2014. Undiscounted bank bills fell by RMB 1,276.9bn in 2H16 after declining by RMB 1,056.9bn in 2015 and RMB 128.6bn in 2014. We believe the undiscounted bank bill market has been partially eroded by the issuance of short-term corporate bonds (such as 90-day or 180-day corporate bills), with the latter becoming an increasingly important financing source for working capital. Moreover, companies with good credit ratings are able to issue corporate bonds with a lower interest cost or a longer maturity.

**Direct financing has become a major funding source.** Direct financing (including net corporate bond financing and domestic equity financing from non-financial institutions [non-FIs]) accounted for 23.95% of the total increase in aggregate financing in the economy in 1H16, up from 23.44% in 2015 and 17.16% in 2014. Direct financing



will continue to take away market share from the banks in the economy's aggregate financing unless the latter expand their capital bases aggressively to fuel loan growth.

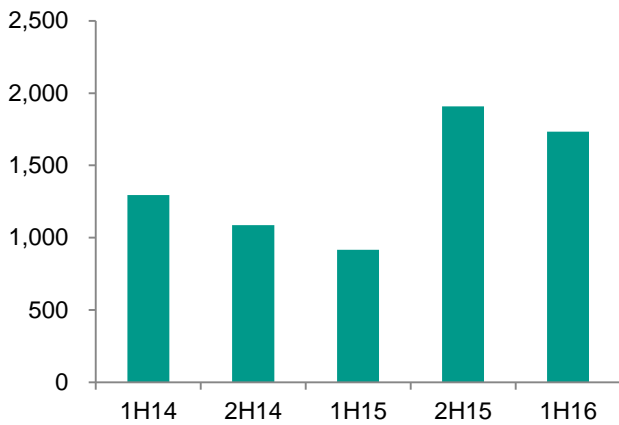
**Net corporate bond financing surged 89.4% YoY in 1H16, accounting for 17.8% of total increase in aggregate financing in the real economy.** Net corporate bond financing has become the 2<sup>nd</sup> largest financing source in the increase in aggregate financing. The proportion of net corporate bond financing in the increase in aggregate financing rose to 18.47% in 2015 from 14.51% in 2014. Net corporate bond financing increased by 89.4% YoY in 1H16 from 75.7% YoY in 2H15. The high growth in net corporate bond financing will benefit financial intermediaries with strong underwriting power in the corporate bond market. In 1H16, the leading corporate bond underwriters were China Securities, CITIC Securities (6030 HK), and Guotai Junan (601211 CH). By underwriting amount, their respective market shares were 10.1%, 8.0%, and 7.8%.

**Equity financing in the domestic stock market by non-financial enterprises surged 52.8% YoY in 1H16, accounting for 6.2% of total increase in aggregate financing in the economy.** One of the effective ways to deleverage the economy is to enlarge the capital base of the enterprises. The proportion of equity financing in the total increase in aggregate financing rose to 6.2% in 1H16 from 4.97% in 2015 and 2.65% in 2014. Equity financing in the domestic stock market by non-financial enterprises grew by 52.8% YoY in 1H16 and 47.9% YoY in 2H15. Collapse of the A-share market in mid-2015 allowed investors to inject capital into the listed companies at more attractive prices. In the A-share market, 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 might have underestimated the significance of share placement activities and its impact on the brokerage industry since most of the focus is on the IPO market. Active share placement should alleviate investors' concern on the brokerage industry amid tightening regulations in the IPO market. By industry, 18% of the fund raised via the equity market in 1H16 went to utilities, followed by TMT (17%), financials (14%), property (12%), retailing (10%), materials (8%), and capital goods (8%). In 1H16, the leading equity financing underwriters (including IPO and share placement in secondary market) were CITIC Sec (6030 HK) and Guotai Junan (601211 CH). By underwriting amount, their respective market shares were 11.5%, and 6.5%.

**Banks are capturing growth opportunities in the direct financing market.** Banks are increasing proportion of bond investments and reducing proportion of loans in their fund uses. Instead of providing loans to corporate borrowers, banks purchase corporate bonds issued by their existing or new corporate customers. According to PBOC, total domestic loans to non-households accounted for 49.5% of total fund uses at end-June 2016, down from 52.2% at end-Dec 2015. Meanwhile, total investments in bond portfolio and shares accounted for 28.33% of total fund uses at end-June 2016, up from 25.36% at end-Dec 2015. YTD, total investments in bond portfolio and shares were up by 25% in 1H16, whereas total domestic loans to households and non-households expanded by 10.9% and 6.1% in 1H16.

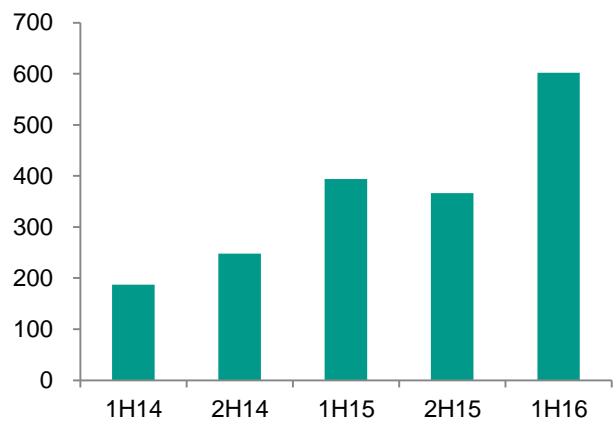


Exhibit 1 Increase in aggregate financing from net financing of corporate bonds (RMB bn)



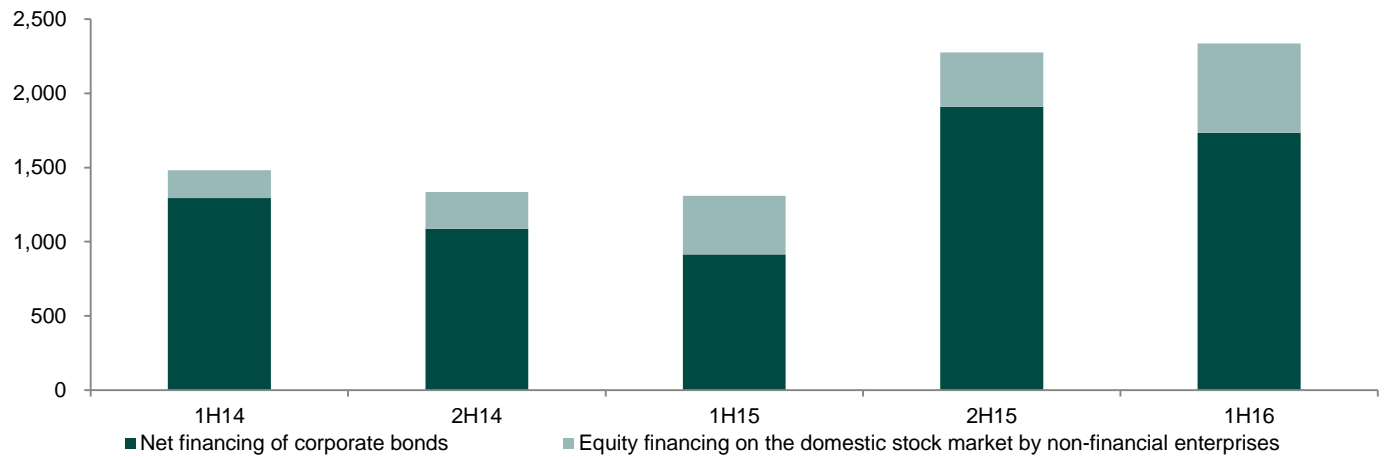
Source(s): PBOC, ABCI Securities

Exhibit 2: Increase in aggregate financing from equity financing in the domestic stock market by non-financial enterprises (RMB bn)



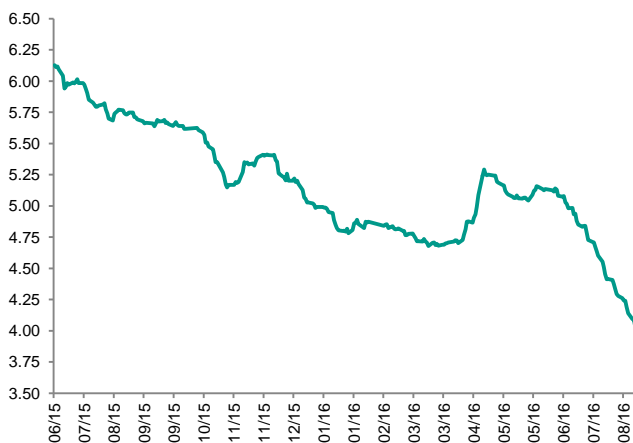
Source(s): PBOC, ABCI Securities

Exhibit 3: Direct Financing (RMB bn)



Source(s): PBOC, ABCI Securities

Exhibit 4: 5-yr corporate bond yield (AA-) shows liquidity entering the corporate bond market, lowering bond yields (%)



Source(s): Chinabond, Bloomberg, ABCI Securities

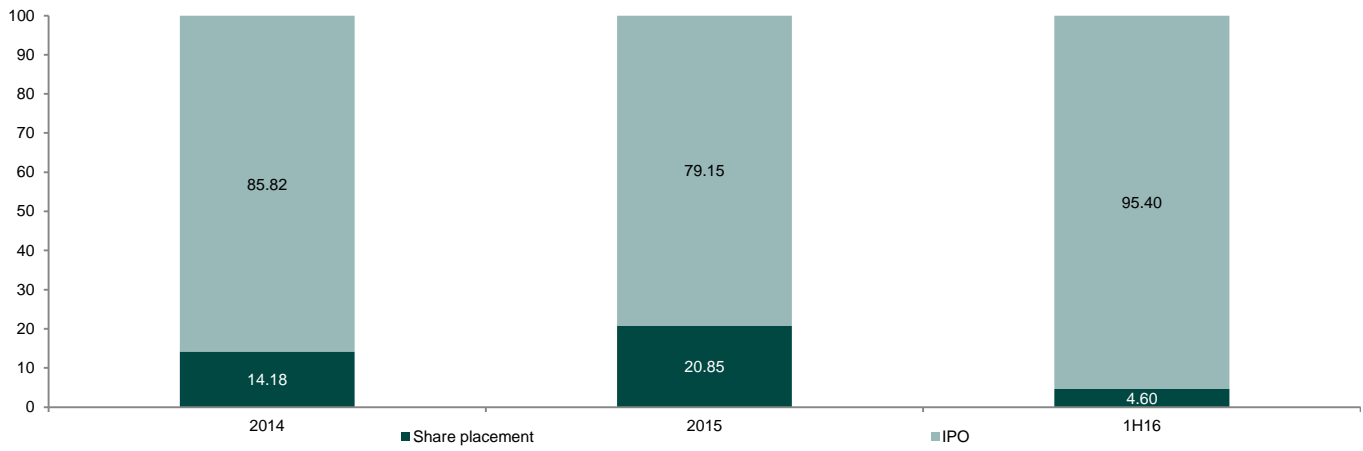
Exhibit 5: Yield gap between 5-yr corporate bond (AA-) yield and 5-yr treasury yield shows declining attractiveness of corporate bonds with good credits (%)



Source(s): Chinabond, Bloomberg, ABCI Securities



Exhibit 6: Composition of equity financing in the A-share market (%)



Source(s): Wind, ABCI Securities



China Economic Indicators																
	2015											2016				
	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Real GDP (YoY %)	7.0	---	---	7.0	---	---	6.9	---	---	6.8	---	---	6.7	---	---	6.7
Export Growth (YoY %)	(15.0)	(6.4)	(2.5)	2.8	(8.3)	(5.5)	(3.7)	(6.9)	(6.8)	(1.4)	(11.2)	(25.4)	11.5	(1.8)	(4.1)	(4.8)
Import Growth (YoY %)	(12.7)	(16.2)	(17.6)	(6.1)	(8.1)	(13.8)	(20.4)	(18.8)	(8.7)	(7.6)	(18.8)	(13.8)	(7.6)	(10.9)	(0.4)	(8.4)
Trade Balance (USD/bn)	3.1	34.1	59.49	46.6	43.0	60.2	60.3	61.6	54.1	60.9	63.3	32.6	29.9	45.56	49.98	48.11
Retail Sales Growth (YoY %)	10.2	10.0	10.1	10.6	10.5	10.8	10.9	11.0	11.2	11.1	10.2		10.5	10.1	10.0	10.6
Industrial Production (YoY %)	5.6	5.9	6.1	6.8	6.0	6.1	5.7	5.6	6.2	5.9	5.4		6.8	6.0	6.0	6.2
PMI - Manufacturing (%)	50.1	50.1	50.2	50.2	50.0	49.7	49.8	49.8	49.6	49.7	49.4	49.0	50.2	50.1	50.1	50.0
PMI - Non-manufacturing (%)	53.7	53.4	53.2	53.8	53.9	53.4	53.4	53.1	53.6	54.4	53.5	52.7	53.8	53.5	53.1	53.7
FAI (YTD) (YoY %)	13.5	12.0	11.4	11.4	11.2	10.9	10.3	10.2	10.2	10.0	10.2		10.7	10.5	9.6	9.0
CPI (YoY %)	1.4	1.5	1.2	1.4	1.6	2.0	1.6	1.3	1.5	1.6	1.8	2.3	2.3	2.3	2.0	1.9
PPI (YoY %)	(4.6)	(4.6)	(4.6)	(4.8)	(5.4)	(5.9)	(5.9)	(5.9)	(5.9)	(5.9)	(5.3)	(4.9)	(4.3)	(3.4)	(2.8)	(2.6)
M2 (YoY %)	11.6	10.1	10.8	11.8	13.3	13.3	13.1	13.5	13.7	13.3	14.0	13.3	13.4	12.8	11.8	11.8
New Lending (RMB/bn)	1,180	707.9	900.8	1,280.6	1,480	809.6	1,050	513.6	708.9	597.8	2,510	726.6	1,370	555.6	985.5	1380
Aggregate Financing (RMB bn)	1,241	1,056	1,236	1,833	742	1,082	1,300	476.7	1,020	1,815.1	3,425.3	824.5	2404.0	751.0	659.9	1630

World Economic/Financial Indicators

Equity Indices				Global Commodities				Bond Yields & Key Rates						
	Closing price	Chg. WTD (%)	P/E	Unit	Price	Chg. WTD (%)	Volume (5-Day avg.)		Yield (%)	Chg. WTD (Bps)				
<b>U.S.</b>				<b>Energy</b>				US Fed Fund Rate						
DJIA	18,613.52	0.38	17.96	NYMEX WTI	USD/bbl.	43.52	4.11	619,161	US Prime Rate	3.50	0.00			
S&P 500	2,185.79	0.13	20.52	ICE Brent Oil	USD/bbl	45.90	3.68	258,998	US Discount Window	1.00	0.00			
NASDAQ	5,228.40	0.14	32.87	NYMEX Natural Gas	USD/MMBtu	2.53	(8.66)	182,367	US Treasury (1 Yr)	0.2687	5.07			
MSCI US	2,082.33	0.15	21.17	Australia Newcastle Steam Coal Spot fob <sup>2</sup>	USD/Metric Tonne	61.80	N/A	N/A	US Treasury (5Yr)	1.1266	(0.97)			
<b>Europe</b>				<b>Basic Metals</b>				US Treasury (10 Yr)						
FTSE 100	6,926.63	1.96	57.54	LME Aluminum Cash	USD/MT	1,642.50	0.55	11,653	Japan 10-Yr Gov. Bond	(0.102)	(0.90)			
DAX	10,709.56	3.30	24.34	LME Aluminum 3 -mth. Rolling Fwd.	USD/MT	1,653.00	0.49	24,431	China 10-Yr Gov. Bond	2.7040	(6.20)			
CAC40	4,504.19	2.12	23.21	CMX Copper Active	USD/lb.	4,839.50	1.26	11,589	ECB Rate (Refinancing)	0.00	0.00			
IBEX 35	8,732.90	2.27	21.69	LME Copper 3- mth Rolling Fwd.	USD/MT	4,848.00	1.23	35,041	1-Month LIBOR	0.5177	1.38			
FTSE MIB	16,995.02	2.22	38.53	<b>Precious Metals</b>				3 Month LIBOR	0.8176	2.53				
Stoxx 600	346.90	1.62	29.63	CMX Gold	USD/T. oz	1,343.90	(0.04)	166,414	O/N SHIBOR	2.0210	1.90			
MSCI UK	2,016.19	1.81	61.11	CMX Silver	USD/T. oz	19.92	0.49	64,364	1-mth SHIBOR	2.7050	(2.40)			
MSCI France	127.62	1.92	21.11	NYMEX Platinum	USD/T. oz	1,146.80	(0.41)	10,995	3-mth HIBOR	0.5638	0.41			
MSCI Germany	137.25	3.62	24.49	<b>Agricultural Products</b>				Corporate Bonds (Moody's)						
MSCI Italy	48.23	2.25	38.64	CBOT Corn	USD/bu	331.50	(0.82)	177,251	Aaa	3.30	(12.0)			
<b>Asia</b>				CBOT Wheat	USD/bu	435.75	(0.51)	82,144	Baa	4.21	(11.0)			
NIKKEI 225	16,919.92	4.09	20.98	NYB-ICE Sugar	USD/lb.	19.66	(3.39)	57,530	Note:					
S&P/ASX 200	5,530.91	0.61	24.19	CBOT Soybeans	USD/bu.	987.00	1.28	83,836	1. Data sources: Bloomberg, National Bureau of Statistics of China, ABCIS (updated on date of report)					
HSI	22,766.91	2.80	11.62	2. Australia Newcastle Steam Coal Spot fob is the Australia Newcastle 6700 kc GAD fob Steam Coal Spot price published by McCloskey										
HSCEI	9,554.85	4.64	7.52											
CSI300	3,294.23	2.78	14.37											
SSE Composite	3,050.67	2.48	16.87											
SZSE Composite	1,973.67	1.65	45.25											
MSCI China	60.31	3.24	12.05											
MSCI Hong Kong	12,865.95	1.13	14.18											
MSCI Japan	794.42	2.75	16.61											

Currency								
	Euro/USD	GBP/USD	AUD/USD	USD/JPY	USD/CHF	USD/CNY	USD/HKD	USD/CNY NDF 12-mth Spot pr.
Spot Rate	1.1156	1.2954	0.7688	102.04	0.9747	6.6452	7.7563	6.7858
Chg. WTD (%)	0.63	(0.91)	0.91	(0.22)	0.62	0.23	(0.02)	0.17



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Rating	Definition
Buy	Stock return $\geq$ Market return rate
Hold	Market return - 6% $\leq$ Stock return < Market return rate
Sell	Stock return < Market return - 6%

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

Market return: 5-year average market return rate from 2009-2013

Time horizon of share price target: 12-month

### Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq$ 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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