



China: Portfolio Strategy

China Conference Key Takeaways:

Things could get worse before getting better

Things could get worse before they get better

We held our two-day China Investment Frontier Conference 2008 in Beijing on Nov. 3 and 4. In sum, conference participants are cautious on China's macro development in 2009, with the so-called "triple-headed chariot" — exports, investment and consumption — all being hampered by various external and internal factors. The most asked question by investors at the conference was: How long and how severe will the economic slowdown in China be? Our view is that China's growth momentum could further weaken in the coming quarters before it stabilizes towards the end of 2009.

Potential government policy responses to the slowdown were certainly under the spotlight, and discussions and forums held with a variety of government officials suggest that any potential stimulus package could encompass monetary and fiscal policies, as well as changes in regulation. The timing and details of any such policies should become clearer during the upcoming Central Economic Work Conference, scheduled for late November/early December.

The notably low macro visibility at present has led to divergent views among investors on corporate earnings growth and potential resulting effect on index price returns for 2009. We continue to estimate the HSCEI could reach 8,900 and the CSI300 1980 by the end of 2009E; and that price returns will primarily be driven by a normalization of multiples on the back of emerging signs of global/domestic economic growth stabilization towards the end of next year — which is the central case being made by our global economists.

Popular topics of discussion

Popular investment themes discussed in the conference include: (1) Rural reform; (2) Energy prices liberalization, (3) Infrastructure spending by the government; (4) How robust domestic consumption will be; and (5) The duration and the severity of the property down-cycle and its potential contagion to banks' NPL risks and commodity/shipping demand.

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Key takeaways from 2009 China Investment Frontier Conference

Macro: The duration and the severity of China's cyclical slowdown in focus

Generally speaking, investors concur with our macro assessment that China is likely to have entered a cyclical downturn and that its growth trajectory may track that of the US. Growth momentum could further weaken in the coming few quarters, before possibly stabilizing towards the end of next year, if not later.

While our economists are still expecting 8.7% real GDP growth for 2009E, many investors believe the risks could be on the downside given recent disappointing data points at both macro and sector levels, such as:

- Lackluster export goods orders from the biannual Canton Fair held in Guangzhou, which could suggest weak export-related activity in 2009.
- Eight consecutive months of negative growth in new investment projects started nationally between February and September 2008.
- Retail sales have held up well so far, but demand for discretionary goods seems to be contracting rapidly as shown by negative growth in airline passenger traffic and auto sales in recent months.
- Significant inventory build-up for coal, iron ore and automobiles, based on our channel checks and opinion of conference participants.

While emerging data-points seem to be skewed towards the negative side, our economists think the improvement in the terms of trade amid sharply decreasing commodity prices could nevertheless raise the national income and overall economic efficiency. In addition, abating inflationary pressure may allow the Chinese government greater policy flexibility engineer a soft landing, in our view.

Policy responses: Potential stimulus package under the spotlight

Our discussions with a wide range of government officials suggest that Chinese policymakers are on high alert about the deteriorating external environment and the resulting adverse impact on the domestic economy. For economic and social reasons, we believe the Chinese government is likely to adopt a combination of monetary and fiscal policies to mitigate downside economic risks. Specifically, we think potential policy tools might include:

Monetary: Our economists expect China's Central Bank to cut benchmark interest rates by a further 100-150 bp by the end of 2009 and that most of the cuts will likely take place in 4Q08 and 1H09. Also, they believe the PBOC will cut the Required Reserve Ratio (RRR) a few times during the same period.

Fiscal: It has been widely reported by domestic media (eg, Sina.com) that the government could raise the minimum threshold for personal income tax and change the current production-based VAT to a consumption-based model. Moreover, the general view among our panelists was that the government may increase spending focused on urban infrastructure (subways and railways) and health care and education systems, but less so on expressways, ports and power grid.

Having said that, we still believe **supply-side reforms** (beyond tax cuts) should include energy prices liberalization, rural reforms, and the introduction of greater competition and private capital into SOE-dominated monopolistic or oligopolistic sectors. We consider that any reform along these lines may be more effective tools to catalyze sustainable aggregate demand in the long run.

Although we believe China remains well-positioned to ease policy relative to its regional peers, given its strong fiscal and external positions, we believe the challenges are tougher now than they were during/after the Asian financial crisis in 1997/1998 because China is now more integrated into the global economy (with total imports and exports accounting for almost 60% of GDP) and the slowing domestic property sector is much larger than a decade ago.

We expect greater policy clarity in terms of timing and details of implementations in the forthcoming annual Central Economic Work Conference, which is likely to be held in late Nov/early Dec in 2008.

Market: Divided earnings growth expectations among investors

We fielded many questions on our earnings expectations for Chinese stocks in 2009 during the conference. In our latest 2009 outlook report, we highlighted that consensus forecasts (I/B/E/S) for both H- and A-share markets are too optimistic, in our view, (particularly the assumption that asset turnover can increase further in 2009) in light of the rapidly deteriorating business and operating environment. Specifically, consensus is currently calling for yoy EPS growth of 13.1% for the H-Share market and 15.0% for A-share market in 2009.

The combination of our top-down sales growth/margin sensitivity analysis and our analysis' bottom-up earnings stress-test lead us to consider that a 2009E EPS growth range of -10.2% to 21.2% for H shares and -6.2% to -27.8% for A shares is more realistic.

A handful of investors expect mid-teen levels of EPS growth for 2009 as they believe that high absolute EPS growth from the heavily-weighted sectors such as banks and telecoms could push up the average market EPS growth. However, at the other extreme, a small number of investors were expecting 2009 EPS growth to decline as much as 50%, which would more or less resemble the experience in 1998.

These variations in EPS growth expectations for 2009 naturally feed into meaningful divergence in expectations for index returns, although most participants agreed the market could trade considerably higher by end 2009 if price multiples normalize to their historical mean on the back of emerging signs of global/domestic economic stabilization in 2H2009.

Key investment themes from the conference

Investors appeared increasingly focused on thematic ideas to generate alpha in still-challenging market conditions. The most-discussed investment themes during the conference were:

- **Rural reforms and energy prices reforms:** Regulators from various government departments have repeatedly emphasized the importance of raising the living standards in rural households via direct subsidies and by lifting procurement prices for agricultural products. Rural reform has been frequently discussed by policymakers, but no detail on any farmland transfer rights has yet been released. Upstream agricultural producers are generally small in size and illiquid and investors seem to have turned to the fertilizer producers in order to monetize this theme.
- **Energy prices liberalizations:** Government officials and industry experts who presented at the conference believe now is an opportune time to liberalize downstream oil product prices and power tariffs given the substantial pullback in crude oil prices and more subdued inflationary pressure. Downstream oil refiners and financially sound IPPs would likely be the major beneficiaries of potential energy price liberalization, in our view.
- **Infrastructure spending by the government:** Many market participants have high hopes for potential government's spending increases on infrastructure projects designed to stimulate the domestic economy; and our panelists believe that Rmb700 bn could be invested in railway-related projects between now and the end of 2010, which would offer a certain degree of revenue visibility for infrastructure constructors. Margin pressure from unfavorable product mixes and cost control, however, makes the story less compelling, in our view.
- **Robustness of domestic consumption:** Although discretionary goods could face greater demand headwind as economic weakness feeds through, investors generally agreed with our view that consumer staples offer better earnings security relative to other sectors. Additionally, there was general consensus that internet/media remains a defensive, counter-cyclical sector given its low operating leverage, fast-growing customer bases, and still-low penetration rates.
- **The duration and the severity of the property down-cycle and its potential contagion** to banks' NPL risks and commodity/shipping demand: Further property price declines in the physical property market have more or less become a consensus view among investors and speakers at the conference. Investors generally believe property stocks are still exposed to further price falls in the physical market and many said they would consider selling on any meaningful rebounds. On the same note, investors believe the sluggish property market is likely to further weigh on Chinese banks' performance via NPL concerns and decreasing mortgage and property related loans. Investors also think it is still too early to bottom fish in deeply cyclical industries— which includes materials and shipping stocks — as it remains unclear when the likely trough in the economic cycle may be.

Key takeaways from panels and investment implications

Airlines - Hino Lam

Key takeaways:

- Traffic and yield deterioration are clearly the focal points for airlines. The recent decline in fuel price has also sparked concern on potential hedging losses for 2008E and 2009E.

Investment Implications:

- With an incremental recovery in the latest Chinese operating statistics, those Chinese airlines with high exposure to domestic traffic growth could sustain reasonable growth within a poor regional operating environment. We continue to favor airlines with a more conservative and transparent hedging policy. Within the airline sector, we prefer China Southern (1055.HK; Neutral) on a relative basis.

Alternative Energy - Cheryl Tang

Key takeaways:

- PV module ASPs: Suntech Power (STP; Buy) and Solarfun (SOLF; Neutral) both expect PV module ASPs to fall by over 10% in 2009, given the current tightening credit environment, less generous subsidies going forward, and unfavorable forex trend — which are all in-line with our view.
- Margin trend: expected soft polysilicon prices should help to ease margin pressure from ASP weakness in 2009. Spot market polysilicon prices have fallen by as much as 20% since September.
- Expansions: STP and SOLF are becoming more cautious in formulating future capacity expansion plans amid the deteriorating macro environment.
- Demand outlook: Participants remain positive on long term global solar demand and expect the US to be as major source of new growth in the near future.

Investment Implications:

- We believe our expectation of ASP drops of 14-15% yoy in 2009E are reasonable given the current global macro environment and reduced government subsidies in Spain and Germany. However, current soft spot market price for polysilicon and the potential for an easing of supply tightness in 2H09 should help alleviate margin pressure from ASP weakness, in our view.
- We maintain our view that strong volume growth will fuel the industry's top-line growth going forward, but we believe forex fluctuations will be a near term earnings swing factor.
- We maintain our Buy ratings on STP and Yingli Green Energy (YGE; Buy) given their sound financials and solid industry footprint.

Banks - Ning Ma

Key takeaways:

- In addition to asset quality pressure on property developer loans, panelists believe the following sectors with high financial leverage and/or high fixed costs may face more cash flow problems during the economy downturn — steel, textile, equipment manufacturing and airlines.
- Despite negative news flow on recent defaults by some privately-owned and export-oriented companies in the Yangtze and Pearl River deltas, panelists believe these two regions still offer more attractive operating environment and growth potential than in-land provinces; and that differences in sector loan exposure play a greater role in banks' asset quality pressure than geographic distribution of loans.

- Despite notable improvement in risk management at China banks in the past five years, their asset quality remains pro-cyclical and has not been tested during an economic downturn.

Investment Implications:

- We believe these takeaways are broadly in-line with our neutral sector stance on China banks. We prefer ICBC H-shares/A-shares (1398.HK; 601398.SS; both rated Buy) as our top pick and the most defensive stock — based on its relatively low sector loan exposure to high risky property and manufacturing company loans, conservative management, and potential NIM pick-up after Rmb900 billion in low-yielding government bonds matures in 1H2010 and is likely rolled over.

For special disclosures as to Goldman Sachs' investment in ICBC, see the statement preceding the Reg AC certification.

Branded consumer - Caroline Li, CFA

Key takeaways:

- New data points from company managements confirmed our expectations of a slowdown in comps. For the two weeks following Golden week, Belle observed comps down to 5% from 10% in the first 9 months of 2008. Other brands, including Kappa (at the retail level as tracked by Dongxiang), Ports, and Daphne, all saw slower or flattish growth during the same period.

Investment Implications:

- Despite comps slowing, we believe earnings visibility is still good for brands. Belle (1880.HK; Buy) and Dongxiang (3818.HK; Buy) remain our top picks in the sector.
- For Belle, even with flat to low single digit comps, we would still expect mid to high teen growth driven by store expansion, and as with first-time full period contribution from new stores in 2008.
- For sportswear brands that are wholesalers, 1H09 order books remain strong at 30-40% yoy growth.
- Our single-store economics analysis shows that if retail sales fall by more than 20% at the per store level the typical store operator would likely be pushed into the red. As current real wage growth is still around 10%, we believe the probability is low for comps to fall as far as this.

Commodities - Song Shen

Key takeaways:

- We invited key commodity valuation participants to give us a gauge on the China commodity fundamentals. Our panelists include Minmetals (the largest metal trader in China), Shenhua Energy (the largest national coal producer), and China Coal Transportation and Marketing Associations (coordinator of annual coal control negotiations).
- Cyclical demand headwind from both domestic and external.
- Using copper as an example of demand, air conditioner producers (10% of copper demand in China) are struggling as exports slow down with deterioration in the US/Europe property cycle. Domestic inventory is also rising as domestic property developers are struggling to absorb the rising inventory, which is now as high as 22 months in our selected 16-city sample.
- Power generation, a good demand indicator and one that accounts for 50% of coal demand in China, has shown demand weakness since May. The domestic spot thermal coal price of US\$120/t is down 20% from 2Q peak with price falls accelerating now in even in what is traditionally a strong season.
- De-stocking across the board, exacerbating recent price weakness. Traders are still facing credit restraint from banks and are keeping inventory at minimum levels. The expectation of further price weakness also means

producers are not eager to build inventory as long as there is ample supply and as downstream demand indicators continue to show weakness.

- Some supply anchors started loosening up against the backdrop of weakening demand. For example, railway bottlenecks for coal have eased significantly after coke and iron ore rail throughput has fallen off due to steel mills cutting production by 15 to 20%.

Investment Implications:

- We remain bearish on the sector against the backdrop of weakness in two key demand drivers — the property domestic cycle and external consumers/housing. Our top Sell-rated stock is Yanzhou Coal (1171.HK, 600188.SS; both rated Sell as the coal price and sector profitability are still high, but downstream demand is slowing across the board. If coal prices fell to their middle cycle level of Rmb450/t level, we estimate YCM's valuation could be as high as 7X 2009E P/E vs its trough of 3X (in 1998).
- We retain our Sell on Jiangxi Copper (0358.HK; Sell, Conviction list; 600362.SS; Sell) as both its earnings drivers (Copper price and sulfuric acid price) are weakening.
- The cement sector, being directly affected by housing cycle, should also face more pressure. Our top Sell in cement is Anhui Conch (0914.HK, 600585.SS; both Sell) as valuation is close to replacement cost vs the 2005 trough of 77%.

Consumers - Joshua Lu

Key takeaways:

- Most companies have observed a more noticeable slowdown in growth in the past few weeks. They have also turned more cautious on the outlook for demand. Slowdown seems to be across the board: from big ticket item retailers like Gome (0493.HK; Buy) (comps turning negative again past few weeks vs mid single digit increase in 3Q) to restaurant chains like Ajisen (AJJCY, Not Covered) (comps slowing down to mid single digits from high single digits ytd).

Investment Implications:

- On November 3, we cut our growth assumptions across the board for 2009; and based on trading updates from the companies at the conference we remain confident in our current earnings estimates. We believe current valuations have already priced in a substantial slowdown in the growth rate in 2009. While the sector has few positive catalysts in the near-term, in our view, (besides potential government policy stimulus), we believe many stocks now offer attractive value for long-term investors.

Energy – Kelvin Koh, CFA

Key takeaways:

- Inventories are high and building, especially for the three regulated products (gasoline, diesel, jet fuel).
- Due to the regulated pricing on these three products, China's demand growth in 1H2008 was exaggerated to the upside because of the build-up in inventories (possibly in expectation of substantial price hikes on the back of rising international crude oil prices). Demand growth in 2H2008 would likely be exaggerated to the downside due to the destocking effect.

Investment Implications:

- The near-term oil demand outlook for China is negative as the inventory overhang is being corrected. We believe that due to the need to rationalize inventory levels, retailers are likely to discount prices at the pumps — which may lead to lower realized prices for them.

Fertilizers - Chris Shiu, CFA

Key takeaways:

The outlook for China's fertilizer demand is still positive for the following reasons:

- The demand elasticity of fertilizers tends to be lower than other commodities because fertilizers are used in food production.
- Over the past three decades, China's historical annual fertilizer demand has been consistently growing - even in the low years, it was still about 2%.
- The price of fertilizers relative to agricultural outputs will likely be more favorable to Chinese farmers in 2009E, because the minimum acquisition prices of grains from farmers have been revised upward, while the pressure of costs of raw materials (e.g. coal) is likely to fall.

Investment Implications:

- We believe the takeaways are generally positive for the Chinese fertilizer stocks, including Sinofert (0297.HK, Buy) and China BlueChemical (3983.HK, Buy).

Media / Internet - Leah Hao

Key takeaways:

- Overall outlook toward 2009 ad spending trend is "cautiously optimistic"; visibility remains high as commitments are normally quite firm. Initial indications for 2009 orders remain on track, even though the final contract signing might happen slightly later than usual (normally the contract negotiation starts around late November, and contract signing tend to end around Chinese new year).
- Among the different media, online should generate the most growth, while TV spending might be tracking flat. Media with short-term driven campaigns offer more flexibility and could be least impacted.
- Overall focus on China market remains the same. Some MNCs have cut ad budget elsewhere but have increased allocation/moved their budget to China to invest in brand building. Local companies, especially consumer driven companies, continue to increase ad spending.
- Industries that are maturing tends to ramp up ad budget more aggressively to build brands and push sales; instead of just using advertising as a distribution channel. Part of the reason that ad spending accounted for <1% of China GDP in the past decade (vs. 2-3% in the US) is that it has been relatively easy to sell products and services in China given how large the market is, but that might change slowly as industries become more mature/competitive/sophisticated.
- Participants expect good growth in 2009 from financial services, auto, telcos, FMCG, consumer staples, and food and beverage, etc
- Advertisers increasingly look for integrated services/campaigns. Digital media definitely seems to be taking a greater share overall, although allocation varies depending on different campaigns.
- There has been increasing advertiser demand for effectiveness/ROI analysis. CPM/CPC or other effectiveness-driven pricing models will come through gradually.
- Large ad clients are not changing their 3-5 year brand building strategies for China just because of slower macro conditions. Believe ad industry will continue to generate robust growth for years to come.

Investment Implications:

- We believe the industry will continue to generate robust growth over the coming years. Although we expect macro drivers such as GDP growth and consumer purchasing power to slow down modestly, we believe industry-specific factors such as rising adoption of Internet, broadband, and wireless products, and growing demand for information and entertainment should accelerate.

- We favor companies with appreciating franchise values, solid execution track record, expanding industry outlooks, and clear industry leadership positions.

Infrastructure Construction - Michael Feng

Key takeaways:

- Panelists and listed companies are relatively positive on the outlook for the infrastructure construction sector in 2009E, especially the railway sub-sector — underpinned by widespread expectation of the government embarking on policy designed to stimulate economic activity.
- Key investors concerns were: 1) the impact of increasing government investment on revenue growth of construction companies, 2) whether the falling raw material price will benefit construction companies, and 3) the potential to improve profit for construction companies.

Investment Implications:

- We retain our neutral stance on the sector and our top pick remains CRCC (1186.HK, 601186.SS; Buy).

Healthcare – Wei Du, PhD

Key takeaways:

- Positive sentiment: Many investors indicated that they are overweight in China's healthcare sector, given strong growth prospects supported by rising domestic market demand, and that some stocks are trading close to net cash. Some long funds see the recent share pullback as an entry opportunity, while insufficient liquidity remains a major concern.
- The medical device sector will likely continue to attract capital over the next three years.
- The healthcare services sector is likely to follow, if policies are favorable.
- The process of separating hospital services from medicine sales could be slow, unless the government is willing to provide additional funding to public hospitals.
- Traditional Chinese medicine (TCM) will likely continue to be perceived as a health supplement. Challenges remain in globalizing traditional medicine, given the complexity of the TCM structure, unclear mechanisms and lack of proper control over clinical trials.

Investment Implications: Emerging opportunities

- The conference panelists expect the medical devices sector to continue to attract capital, driven by market demand in the short term, and technology over the long term.
- We expect many healthcare companies to move to high-end active pharmaceutical ingredients to enhance profitability. Vaccines were a focus item at the conference, with many panelists describing still unmet demands in the domestic market.

Insurance - Darwin Lam, CFA

Key takeaways:

- Likely further rate cuts will suppress investment spreads given China insurers' concentration of fixed-income investments (typically more than 80% of total investment assets) and duration mismatch between assets and liabilities.
- Some investors who expect substantial rate cuts (e.g. more than 200bp) are concerned that negative spreads may recur since the guaranteed rates of return offered by insurers are close to 2.5%

- Investors generally are still concerned about further MTM losses on equity investments, although insurers' equity exposure has already fallen by more than half from peak levels
- Bancassurance growth will likely decelerate in 2009 off a high base this year, and as crediting rates fall amid the weaker investment environment
- The partial offset is that low interest rates and weak equity market may make insurance products seem relatively attractive/safe compared with deposits or stocks
- Some investors believe the earnings visibility for insurers is improving marginally, given the general view that we are close to half way through the rate cut cycle, and insurers' equity exposure has fallen sharply.

Investment Implications:

- These takeaways are broadly in line with our Neutral stance on the China insurance sector, and our preference for China Life (2628.HK, 601628.SS; both Neutral) for its greater defensiveness (less trading assets, no negative spread policies, no banking NIM/asset quality issues).

Property - Yi Wang, CFA

Key takeaways:

- Property prices will continue to fall in 2009E was the consensus view. Those who were more bearish believe property price will fall more than 30% in tier-1 and major tier-2 cities as affordability is generally more stretched in these cities.
- There was no consensus view on when the physical market will recover. Estimate fell between 2H09 and 2010. Macro and policy outlook are the key variables.
- Investment cycle for the sector is unlikely to resume before the physical market sees sign of stabilization. Developers generally stated that they will scale back investment more significantly next year.
- Recent easing on second-home mortgage policy might not necessarily stimulate demand substantially.

Investment Implications:

- We retain our cautious view on the sector and estimate the physical market will not be stabilize until 2H09.
- Most stocks are trading at significant discount to our adjusted book value, which leads us to think some share prices may rebound if we see more policy stimulus coming through.
- However, a sustainable recovery of the sector still hinges on improvement on macro and industry outlook.

Port - Edward Chan, CFA

Key takeaways:

- Throughput (volume) growth: there is no doubt that there will be a slowdown in China's container throughput growth in 2009. However, at the moment, it is not possible to assess how slowly throughput will grow or even stagnate or decline. Nonetheless, port operators believe that if their port assets are a hub port that ships have to call at, then their throughput should be more resilient to the slowdown.
- Tariff: port operators said they have no intention to cut tariffs. However, average revenue per TEU may fall as there could be more discounts for those shipping lines that can bring in more incremental businesses. Port operators believe that there are unlikely to be price wars among different operators, as this is unhealthy for the entire industry, and this is not the way the port industry has functioned in the past, nor is it likely to be in future. However, port operators have no room to raise tariffs in the near term
- In general, port operator sees no over supply for these ports — Dalian, Tianjin, Shanghai — as one operator can control all the new supply in these ports. In the Pearl River Delta, although there are several operators, port operator believes supply and demand balance is manageable.

Investment Implications:

- No change to our investment theme that there could be more earnings downside risk to port operators in 2009 than upside risks. We retain our neutral sector view mainly because of the sector's valuation in general looks undemanding at current price level.

Shipping & Railroads – Tom Kim**Key takeaways:**

- China container trade is clearly slowing, and certain regions like southern China have been hit harder but this may not show in company-specific data due to capacity growth; eg, Guangzhou port throughput was actually down recently.
- Direct links may offer some new opportunities, but the supply side of the equation tends to be overlooked; eg Cosco's (1919.HK, Neutral; 601919.SS, Sell) domestic container shipping volumes were up, but rates were down, reflecting increased competition. That is probably a good barometer of what we could see for cross-straits container shipping trade.
- Inflation expectations drove up shipping demand earlier in the year, but now that commodity prices are declining there is less seaborne trade hurting freight rates.
- Asset deflation is now impacting the sales and purchase market. Bulkers are seeing the greatest decline in prices, while containership vessels are holding up relatively better because they have not appreciated as much.
- Coal producers and power companies expect relatively stable railway freight rates, but they expect seaborne freight rates will face market forces, and it is now a buyer's market.

Investment Implications:

- Asset impairment is a growing concern for the industry, particularly dry bulk. We maintain our cautious view, as vessel prices are plunging, down 50% from the peak in 1H2008.
- Remain cautious on shipping, including domestic freight transportation; eg, China Shipping Dev (1138.HK; Neutral).
- While demand is expected to be stable, power suppliers are facing slower growth, which may impact Daqin's Railway's (601006.SS, Neutral) traffic data.

Small and medium enterprises - Richard Xu, CFA**Key takeaways: loosening monetary policies not a quick fix to SME challenges**

- While the liquidity tightening measures exacerbated funding issues at China SMEs, the panelists believe it was also the result of a number of key factors including: 1) low profitability and limited growth potential at many SMEs and high concentration of SMEs in export-related sectors given the monopoly or oligopoly by SOEs in many industries; 2) lack of understanding of true credit risks and opportunities associated with SME lending at many banks, particularly at large banks; and 3) rapid expansion of SMEs in Yangtze River Delta (despite historical good credit culture) founded in the economic booming cycle with under-developed operating and risk management skills.
- When discussing potential solutions to the SME funding challenges, the panelists believe that in addition to encouraging banks to increase lending to SMEs and expanding funding channels, it is also important to broaden growth opportunities for SMEs by creating a fair competitive environment in more industries and to develop financial institutions that are specialized in SME lending and are willing to help SMEs to enhance operating and financial risk controls. Separately, from a regional perspective, non-coastal areas, such as Beijing, appear to be relative better off than coastal areas, where SMEs highly are more reliant on export business. However, signs of asset quality deterioration have started to show up in Beijing as well, albeit more modestly. Mr. Zhang Lisheng,

Chairman of Zhongguancun Sci-tech Guarantee, indicated that of the 3700+ SMEs guaranteed by his firm, about 110 SMEs are facing some weaknesses, which is above historical averages.

Investment Implications:

- Given the aforementioned root drivers of SME issues in China and the challenging macro backdrop, we believe looser monetary policy may not be a quick fix for struggling SMEs. Since SMEs have been meaningful contributors to GDP growth in the past couple years, their challenges will likely be a drag on GDP growth and pose NPL risks to China banks in the near term. Positively, despite the large scale of reported SME failures, local entrepreneurs continue to search for new opportunities to deploy capital. For example, Mr. Zhang indicated that while there were around 1500 SME failures in the first 9 months of 2008 in Wenshou, Zhejiang province, there were also more than 4000 of new business registrations during the same period. This will likely partly offset the negative GDP impact from SMEs failures, in our view. Among the banks that we cover, we believe small banks, especially city commercial banks located in the Yangtze River and Pearl River deltas, will be subject to higher credit risks, and big banks, which have smaller SME exposure and Bank of Beijing (601169.SS, Neutral) with SME exposure concentration in Beijing, will be relative better off.

Telecoms – Helen Zhu

Key takeaways:

- Our Telecom panel this year titled "Restructuring/3G impacts on telecom value chain companies" was joined by panelists from four telecom value-chain companies - Citic 1616 (international roaming hubbing provider); ZTE (equipment provider), AsialInfo (BOSS system provider) and Simtech (handset design house). All panelists, from their different perspectives, acknowledged the opportunities/positive impacts led by the telecom restructuring, operators' capex rollout and likely imminent 3G licensing mainly in two aspects - a) operators' capex up-cycle in the coming 1 to 2 years will be positive to equipment providers such as ZTE and others sharing the capex pie (AsialInfo etc). b) increased traffic/usage is likely to be stimulated by greater competition and more demand from China Telecom's CDMA operations, resulting in a bigger market for the likes of Citic1616 (dependent on international voice/data traffic) and Simtech (increased handset demand).
- Specifically, panelists mentioned that a) they see more likelihood for telcos' capex budgets to be revised up rather than down in the upcoming 12-18 months, which would be largely driven by likely surge in usage. b) price competition is not as bad as the media has portrayed, as industry players are all aware that destroying returns for the overall sector benefits no one in the long term, and procurement for TD-SCDMA in particular has not seen much pricing pressure; c) generally limited macro impact has been witnessed thus far on the telcos' domestic value chain, and d) the Beijing Olympics seem to have temporarily paused/delayed procurement and disrupted usage slightly, but things should be back on track by 4Q08. Overall, panelists are all holding an optimistic view towards the opportunities/challenges from the restructuring/3G, and believe the general outlook for the value chain in 2009 still looks upbeat.

Investment Implications:

- We see less earning downside risks for value chain companies in 2009 vs telecom operators, as they should be the main beneficiaries of the capex up-cycle and incremental usage demands as discussed above. Valuations are more reasonable now for CCS (0552.HK, Buy, Conviction List) and Citic 1616 (1883.HK, Buy) (10X and 3X 2009E P/E, respectively, with 6% and 8% dividend yield support). We retain a Neutral stance on ZTE (0763.HK, 000063.SZ; both rated Buy) as its domestic benefits could be partly offset by the oversea exposures in our view, but the recent share price weakness could create some long-term entry points.

Toll Roads – Reggie Fang

Key takeaways:

- Investors continue to worry about next year's traffic growth across the board. Discussion with our panel indicates increasing level of interest in the companies with higher earnings visibility, lower leverage ratio and attractive dividend yield, supported by inexpensive valuation and strong cash flow.

Investment Implications:

Our top picks among H-share toll roads are:

- Zhejiang Expressway (0576.HK, Buy), for its inexpensive valuation, attractive dividend yield and positive catalysts including potential implementation of weight-based tolling system in Zhejiang province and possible extension of Huhangyong expressway's concession right;
- Sichuan Expressway (0107.HK, Buy), for its current inexpensive valuation (6.5X 2009E P/E), high dividend yield supported by low leverage level and stable toll revenue, and potential future asset injection opportunities.
- Among A share toll road companies, we prefer Jiangxi Ganyue Expressway (600296.SS; Buy) for its relatively low valuation and higher earnings visibility in 2009.
- Key risks to the sector remain to be: 1) larger than expected traffic slowdown and 2) policy risks related to toll rate and concession right transfer.

Utilities - Franklin Chow, CFA

Key takeaways:

- We see possible sharp slowdown in power consumption into 2009. We estimate power generation to grow at 3% in 2009E and utilization to fall by 5%. As a result of financing constraints and low profitability, many IPPs are likely further cut capex, in our view. We think this could somewhat mitigate falling power demand. Power equipment makers, on the other hand, may suffer from falling order books and delivery.
- Some IPPs think contract prices on average may see resistance to increases especially in areas where contract prices are already close to spot prices. Both IPPs and coal suppliers see further declines in coal prices due in part to faltering demand. We think the coal suppliers and IPPs recognize that the record-high inventory levels at Qinhuangdao are unsustainable and so the spot prices are subject to further correction.

Investment Implications:

- We estimate unit coal costs to fall by 2% in 2009E for companies under coverage but see significant favorable risks.
- We do worry about falling utilization. However, we continue to think falling coal prices and possibly higher tariffs could more than offset the utilization setback.
- Our top picks remain CRP (0836.HK, Buy) and Datang (0991.HK, Buy).

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