

China / Hong Kong Market Focus Strategist's Blog

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DBS Group Research . Equity

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Takeaways from my LEGO hobby, part two

- Hong Kong youths face structural difficulties and this increases political risk in Hong Kong
- We favor laggards or China plays with structural growth outlooks for 2Q
- Adding Sinopharm into top ten; taking out China Hongqiao

I can no longer afford my LEGO hobby. I have run out of display space after adding several Star Wars sets following the Millennium Falcon. Buying additional square footage in Hong Kong is prohibitively expensive. For instance, the Star Destroyer set 10030 measures 23inches x 20inches, and it costs HK\$55,000 to add 3.2sq ft of living space in where I live.

Hong Kong's youths have it much worse. But my problem, if you can call it that, pales in comparison with the plight of Hong Kong's youth. We estimate the average household needs to save 50% of their income for 18 years just for the down payment of a 600sq ft home (pg 2). The unemployment rate of Hong Kong's youth in their 20's has also widened against the overall rate in recent years. Public rental housing is also not an attractive solution since the queue has climbed to over 250k individuals from just over 100k in 2007 (pg 3). The abundance of love hotels in the city are evidence of large demand for private quarters.

Catch-22 situation for Hong Kong policy. If property prices and income inequality are not dealt with, we see risk of a repeat of Occupy protests. But in tackling the above issues, Hong Kong companies' profitability will likely take a hit from property and wage policies. Both scenarios are not favourable for Hong Kong plays. We remain underweight on Hong Kong retailers, and prefer consumption plays with earnings from outside of Hong Kong such as Belle (1880.HK) and Samsonite (1910.HK). Similarly, we are cautious on Hong Kong's retail property landlords. We also see limited upside for Hong Kong property developers given policy headwinds and risk of mortgage rate increases.

Adding Sinopharm to replace China Hongqiao in our top ten.

What should investors hold if not Hong Kong plays? We favor laggards or China plays with structural growth or reform prospects for 2Q. Our last strategist blog highlighted companies and sectors that fit China's reform roadmap. One such sector is healthcare, and we are adding Sinopharm (1099.HK), our preferred play in the sector to our top ten list. The drug distributor delivered 28% earnings growth in 2014 and showed it can capture market share using its size and balance sheet as a competitive advantage. We expect earnings CAGR of 21% during 2014-2017. On the other hand, we cut our losses on China Hongqiao (1378.HK) due to uncertainties from Deloitte's delay in signing off on Hongqiao's 2014 figures.

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Latest LEGO collection (from left to right, 10175, 10221, 10030, 7181)



Source: DBS Vickers

DBSV top ten BUY list

Ticker	Closing price (HK\$)	PBV (X)	FY 16F			Tgt Price (HK\$)	
			PER (X)	yield (%)	ROE (%)		
Anhui Conch	914.HK	27.75	1.3	8.4	3.7	16.5	32.20
CCB	939.HK	6.37	0.8	4.8	7.2	16.5	7.72
CMB	3968.HK	18.30	0.9	5.5	5.5	16.6	22.39
CR Land	1109.HK	21.00	1.1	10.0	2.7	11.1	24.43
Haier Electronics	1169.HK	20.45	2.5	11.5	0.9	24.2	27.35
Kingdee	268.HK	3.15	2.6	19.3	0.8	14.4	3.20
Nexteer Auto	1316.HK	7.99	2.4	10.6	1.9	25.0	9.30
Sino-Ocean Land	3377.HK	4.76	0.6	6.4	5.1	9.9	5.40
Sinopharm Group	1099.HK	30.00	2.0	15.9	1.7	13.2	34.50
Tencent	700.HK	142.70	7.7	24.9	0.5	31.5	163.00

Source: DBS Vickers

Based on 25 March 2015 closing prices

The plight of Hong Kong youths

During my recent marketing trips, many overseas investors questioned why some of Hong Kong's youth are against Chinese rule. From their point of view, Hong Kong's economy has benefitted from China since SARS outbreak in 2003. There is ample evidence of prosperity from reading HK-listed companies' financial statements. So why bite the hand that feeds? We believe out of reach property prices and income inequality underpin some of their frustration.

Out of reach property prices. The mortgage affordability ratio is misleading due to low mortgage rates. The mortgage affordability ratio also does not factor in stringent loan to value or debt servicing ratio requirements enacted in recent

years. These measures effectively increase the amount of downpayment home buyers need to make. And Hong Kong youths, unless they have well off parents, often find the downpayment to be a huge hurdle.

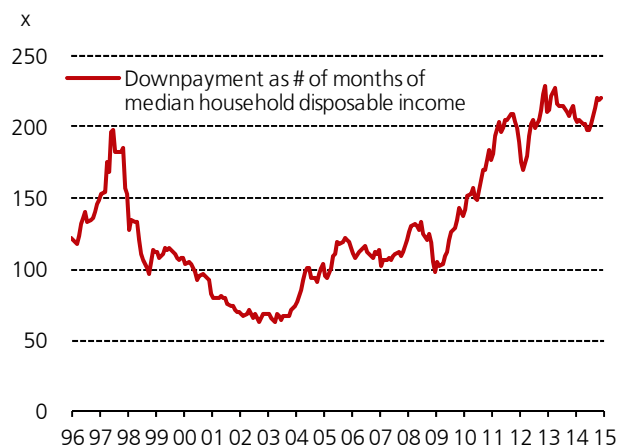
We estimate a young family earning the median household income of HK\$24,000 per month would need to save 220 months for the downpayment of an average 600 sq.ft. flat. What is worse, Hong Kong's youths have not benefitted from Hong Kong's prosperity as much. Their unemployment rate is higher than the overall rate. They are also not as competitive as mainland counterparts when competing for the city's best jobs. There are many reasons for this, but numbers is a key factor. The brightest 1% in China's population already outnumber the city's total population.

Mortgage affordability ratio

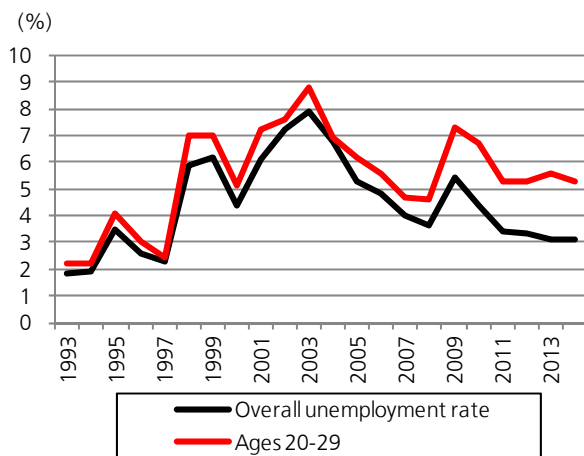


Sources: CEIC., DBS Vickers

of months a household needs to save for down payment

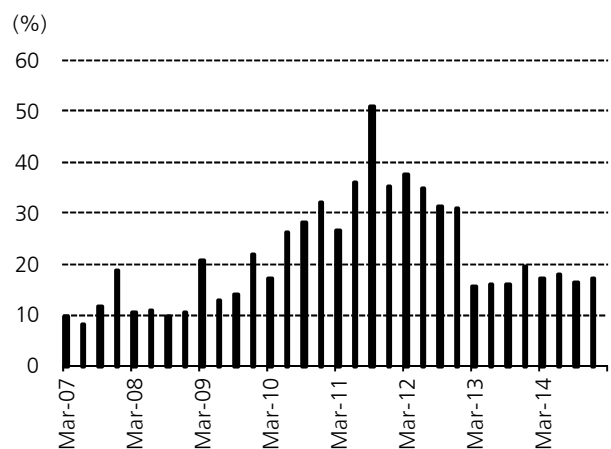


Unemployment rate

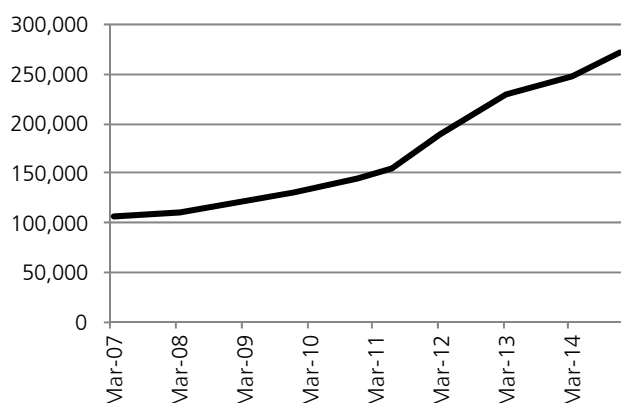


Sources: HK Census and Statistics Bureau, DBS Vickers

% of primary property purchases by mainland buyers



Public rental housing application queue



Sources: HK Housing Authority, CEIC., DBS Vickers

Love hotels are evidence of demand for privacy. Many young couples in Hong Kong struggle to find a private place to be intimate. The costs of moving out are high. The abundance of love hotels in Hong Kong is evidence for large demand for private quarters. There are even websites and mobile apps dedicated to love hotels in Hong Kong. One example is www.goopenroom.com. Love hotels are not only abundant,

but also come in many varieties. There are the upscale ones around Lan Kwai Fong, like the Mingle Place at the Eden. There are ones with thematic rooms like the boutiquehotel group in Kowloon Tong. Or there are the chain love hotels like Hotel Victoria, which has locations all over Hong Kong. I pass by two of them in my drive back home from work.

Super VIP room in Mingle Place at the Eden



Sources: www.hong-kong-hotels.ws, www.boutiquehotel.com.hk

Room of a Boutique Hotel Group's property



Changes to our top ten

Adding healthcare pick Sinopharm. As highlighted in our last strategist blog, we favor laggards or China plays with structural growth outlooks in 2Q. We believe the market and monetary policies will be muted in 2Q, and these groups of stocks should outperform the market. We are adding Sinopharm into our top ten as our healthcare pick. We are confident on healthcare spending growth given China's rising wealth and aging population. Large players like Sinopharm has also been capturing market share. There is also excitement from Sinopharm's parent being a pilot for SOE reform.

We are taking out China Hongqiao from our top ten. The company has delayed its board meeting, as Deloitte has not signed off on the company's 2014 report. The company explained the delay is due to Deloitte's change in partner and project managers to China Hongqiao during Chinese New Year, as the previous team was appointed for the merger of CSR and CNR. Our analyst tried to channel check the validity of this claim, but her findings were mixed. To avoid further negative surprises, we are cutting losses on China Hongqiao.

DBSV top ten BUYs

Top picks	Ticker	Closing price (HK\$)	DBSV rating	Tgt Price (HK\$)	EPS			ROE			PBV		Div yield	
					PER FY15F (X)	PER FY16F (X)	CAGR 14-16 (%)	ROE FY15F (%)	ROE FY16F (%)	PBV FY15F (X)	PBV FY16F (X)	Div yield FY15F (%)	Div yield FY16F (%)	
Anhui Conch	914.HK	27.75	BUY	32.20	9.4	8.4	12.9	17.4	16.5	1.5	1.3	3.3	3.7	
CCB	939.HK	6.37	BUY	7.72	5.3	4.8	6.0	17.6	16.5	0.9	0.8	6.7	7.2	
CMB	3968.HK	18.30	BUY	22.39	6.2	5.5	8.0	17.1	16.6	1.0	0.9	4.9	5.5	
CR Land	1109.HK	21.00	BUY	24.43	11.4	10.0	-9.0	11.2	11.1	1.2	1.1	2.4	2.7	
Haier Electronics	1169.HK	20.45	BUY	27.35	13.6	11.5	18.7	25.7	24.2	3.1	2.5	0.7	0.9	
Kingdee	268.HK	3.15	BUY	3.20	24.5	19.3	30.6	12.7	14.4	3.0	2.6	0.6	0.8	
Nexteer Auto	1316.HK	7.99	BUY	9.30	13.0	10.6	25.9	25.3	25.0	3.0	2.4	1.5	1.9	
Sino-Ocean Land	3377.HK	4.76	BUY	5.40	8.2	6.4	0.7	8.4	9.9	0.6	0.6	4.1	5.1	
Sinopharm Group	1099.HK	30.00	BUY	34.50	19.2	15.9	15.3	12.1	13.2	2.2	2.0	1.4	1.7	
Tencent	700.HK	142.70	BUY	163.00	32.0	24.9	32.1	31.8	31.5	10.1	7.7	0.4	0.5	
Simple average					14.3	11.7	14.1	17.9	17.9	2.7	2.2	2.6	3.0	

Sources: DBS Vickers

DBSV top ten BUYs

Anhui Conch (914.HK)	Shareholding structure change paves way for further reform; Anhui Conch may become privately owned Benefits to include flexibility on dividend payout ratio and refinancing, better aligned incentives H-share premium overhang is less concerning, as premium is down to close to zero
CCB (939.HK)	CCB is our preferred large cap Chinese bank and offers one of the best dividend yields in the sector Bank is well capitalized and has small dilution risk H-share is at discount to A-shares
CMB (3968.HK)	Best deposit franchise among joint stock banks More nimble to compete effectively after China's financial reforms and deregulations Valuation premium over sector has narrowed
CR Land (1109.HK)	Contracted sales likely to pick up strongly One of the few developers who have potential to succeed in China's retail market place Asset injection is potential catalyst if price is attractive
Haier Electronics (1169.HK)	Recovering property sales to aid future demand for Haier products Rising logistics revenue thanks to cooperation with Alibaba on logistics for Alibaba's large product orders Valuation gap against A-share parent has narrowed
Kingdee (268.HK)	Software and information technology solutions should be in demand as China pushes for technology upgrades Core product Enterprise Resource Planning (ERP) solutions should see increasing penetration and adoption Cloud business is a key driver, with expected medium term growth of 50%+ p.a.
Nexteer Automotive (1316.HK)	Nexteer is the world's leading electronic power steering producer Push for fuel-efficiency is triggering shift from hydraulic power steering to electronic systems Traditionally strong in the US, Nexteer is expanding to China to augment growth
Sino-Ocean Land (3377.HK)	We foresee a turnaround for Sino-Ocean due to improvements in landbank structure Latest land acquisitions are NAV-accretive and likely to lift gross margins Beneficiary of interest rate cuts
Sinopharm (1099.HK)	Healthcare is highlighted as a focus area in China's government work report; parent company is also pilot for SOE reform Aging population and rising wealth underpin the industry's demand growth Large drug distributors like Sinopharm has been gaining market share with its reliability in supply and ability to extend credit
Tencent (700.HK)	New advertising offerings help drive revenue growth; Tencent only has 5% market share in online ads We foresee Tencent can better monetize its >800m users through new ad offerings and other new products We project Tencent can grow its revenues by 50% CAGR during FY14-16

Sources: DBS Vickers

DBSV recommendations are based on an Absolute Total Return* Rating system, defined as follows:

STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return i.e. > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame)

Share price appreciation + dividends

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