



## Higher ground

Following the rebound of 2009 and consolidation of 2010, we are positive on the outlook for China's equity markets in 2011F. We have year-end targets for the MSCI China Index and HSCEI Index of 83 and 16,000, implying 24% and 25% upside potential, respectively. We see index performance being backed by: 1) 21%+ earnings growth, with large-cap sectors such as Financials and Energy on course to deliver strong earnings; 2) attractive valuations (on our forecasts, 13x FY11F earnings, in line with the past 10-year average, and 2.5x price/book with RoE of 20%); and 3) a positive liquidity outlook. We believe fundamentals will provide the surest footing for stock pickers in 2011. Sectors with improving earnings prospects and strong RoEs are best placed to scale the heights, in our view, particularly when there are uncertainties on the policy front and the cost of capital is on the rise. While concerns over high inflation could weigh on equity market performance in the short term, we recommend investors position themselves for resulting buying opportunities, since historically the market tends to rally once inflation has peaked out. Our 10 stocks for 2011: Agile Properties, ABC, China Everbright International, China Life Insurance, China Mengniu Dairy, CRCC, Gome, Perfect World, Sinopec and ZTE.

- ① 20%-plus upside potential for the markets in 2011
- ② Inflation to weigh on performance in short term
- ③ Sector scorecard – leveraging Nomura's bottom-up research
- ④ Our top 10 for 2011

Nomura Anchor Reports examine the key themes and value drivers that underpin our sector views and stock recommendations for the next 6 to 12 months.

Any authors named on this report are research analysts unless otherwise indicated.  
See the important disclosures and analyst certifications on pages 172 to 176.

## Stocks for action

Our top picks are front-line beneficiaries of investment opportunities in China in 2011, and feature strong earnings growth potential, healthy balance sheets, and attractive valuations.

Stock	Rating	Price	Price target
Agile Properties (3383 HK)	BUY	11.1	13.3
Agricultural Bank of China (1288 HK)	BUY	4.1	4.7
China Everbright (257 HK)	BUY	4.4	6.1
China Life Insurance (2628 HK)	BUY	33.7	40.0
China Mengniu (2319 HK)	BUY	22.7	32.0
China Railway Construction Corp (1186 HK)	BUY	9.4	11.8
Gome Electrical Appliances (493 HK)	BUY	3.2	4.3
Perfect World (PWRD US)*	BUY	23.7	37.0
Sinopec (386 HK)	BUY	7.3	9.6
ZTE Corp (763 HK)	BUY	29.4	36.0

Priced as at 1 December 2010 close; local currency

\* Priced as at 30 November 2010 close

## Analyst

Henry Wu, CFA  
+852 2252 2122  
[henry.wu@nomura.com](mailto:henry.wu@nomura.com)

And the China Equity Research Team

Don't miss our companion outlook reports on Asia, Singapore and Malaysia, published 6 December, 2010.

### ⊙ Action

We believe solid earnings growth (21%+ y-y), sufficient liquidity (+18% y-y M2 growth) and undemanding valuations (in line with historical average forward P/E of 12.6x) will support 20%-plus upside in China's equity market in 2011. Against a likely backdrop of surging inflation, interest hikes, RMB appreciation, the 12<sup>th</sup> FYP and rising global commodity prices, we spell out our sector winners/losers for 2011. We are Bullish on Financials, Property, Consumer, Oil & gas and Online gaming.

### Anchor themes

- ⚓ Near-term concern over inflation will weigh on equity market performance. But amid tightening monetary policy and price control efforts, any share price weakness should present buying opportunities for long-term gains.
- ⚓ Our sector scorecard — formulated by gauging a sector's fundamentals (EPS growth and ROE), valuations (forward P/E, P/BV) and momentum change (price performance during the previous year) — backs up our individual sector views.

### Stocks for action

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Priced as at 1 December 2010 close; local currency  
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## Higher ground

### ① 20%+ upside potential for the markets in 2011

We are positive on the prospects for China's equity market in 2011, after its rebound in 2009 and consolidation in 2010. We forecast the MSCI China Index and HSCEI Index will reach 83 and 16,000 by end-2011, for 24% and 25% upside potential, respectively. We see market performance being backed by: 1) 21%-plus earnings growth, with large-cap sectors such as Financials and Energy set for strong earnings; 2) attractive valuations (13x 2011F earnings, in line with the past 10-year average; 2.5x P/BV with RoE of 20%); and 3) a positive liquidity outlook.

### ② Inflation to weigh on performance in short term

Concern over high inflation will continue to weigh on market performance in the short term, we believe. Our examination of past performance shows the market tends to experience a short-term correction when inflation surprises on the upside and gains upward momentum before CPI has peaked (as in 2003-04). CPI in China has been above 3% for four consecutive months since July, compared with an 18-month run between May 2007 and October 2008 (including 10 months on the rise) and an 11-month run between December 2003 and October 2004 (9 months on the rise).

### ③ Sector scorecard – leveraging Nomura's bottom-up research

The goal of our new sector scorecard is to estimate potential performance by gauging Nomura's view of several factors: fundamentals (estimated EPS y-y growth % and forecast RoE), valuation (12-month forward P/E and P/BV) and momentum change (performance during the previous year). By giving different weight to each parameter, we then rank them from the highest score to the lowest representing our opinion from the most liked to the least. Our top-ranked sectors for 2011: online gaming, property, consumers and banking, as well as oil & gas.

### ④ Our top 10 for 2011

Our top 10 stocks: Agile Properties, ABC, China Everbright International, China Life Insurance, China Mengniu Dairy, CRCC, Gome, Perfect World, Sinopec and ZTE.

### Analysts

Henry Wu, CFA

+852 2252 2122

[henry.wu@nomura.com](mailto:henry.wu@nomura.com)

Yang Luo

+852 2252 2141

[yang.luo@nomura.com](mailto:yang.luo@nomura.com)

Michael Shen

+852 2252 2140

[michael.shen@nomura.com](mailto:michael.shen@nomura.com)

And the China Equity Research Team

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## Summary

## Executive summary

We are positive on China's equity market in 2011 after its rebound in 2009 and consolidation in 2010. We forecast the MSCI China Index and HSCEI Index will reach 83 and 16,000 by the end of 2011, implying 24% and 25% upside potential, respectively. We believe the strong performance will be backed by: 1) 21%+ earnings growth, with large-cap sectors such as financial and energy set to post strong earnings; 2) attractive valuation (13x 2011F earnings, in line with the 10-year average; 2.5x price/book with RoE of 20%). Note that 2011 will also be the first year of China's 12<sup>th</sup> Five Year Plan, and we think the sectors set to benefit, such as the seven emerging industries with strategic importance, will receive a boost in sentiment. We believe fundamental support will remain the most important factor to drive equity market performance in 2011. In our view, sectors with an improving earnings outlook and strong RoE tend to outperform. Earnings growth outlook and RoE will become increasingly important and be rewarded when there are still uncertainties on the policy side, and cost of capital is on the rise, in our view.

**We forecast MSCI China and HSCEI will offer >20% upside in 2011F**

### Exhibit 1. 2011 outlook for indices

	Target	Current index level	Upside potential (%)	Implied PE (x)		Historical average PE (x)		Historical range (past 5 yrs)		% diff. vs target	
				2011	2012	Trailing	Forward	High	Low	High	Low
MSCI China	83	67	24	14.4	12.1	14.6	12.6	104.18	27.23	(20)	205
HSCEI	16,000	12,818	25	13.6	11.4	13.5	11.7	20,400	4,990	(22)	221

Note: Pricing as of 1 December 2010 for HSCEI and 30 November 2010 for MSCI China. Historical average PE (x) is for the period from January 2002 to 2010 YTD

Source: Bloomberg, Nomura research

### Exhibit 2. Sector allocations

	Sector weighting	Nomura comment	Potential catalysts	Investment risks
Consumer	Bullish	Favour F&B and department stores	Upstream price weakness due to price controls	Inflation
Financial	Bullish	Favour banks and life insurance	Interest rate hike	Macro tightening
Media & internet	Bullish	Positive on on-line gaming	New game launches	Delay of new game launches
Oil & Gas/Chemicals	Bullish	Positive on oil and petrochemical	Rising oil prices, oil pricing mechanism changes, and natural gas price hikes	Government regulatory risks and resource tax
Property	Bullish	Positive on property developers with sound balance sheets and niche exposures	Transaction volume pickup	Unfavourable policies include a property gain tax, LAT, and price wars in the sector
Gaming, Hotels & Leisure	Neutral	Favourable supply demand dynamics, strong earning visibility and certainty. Supply capped at 13% for the next three years (7% for 2011); demand to be driven by high margin mass market business which was banking on structural change from infrastructure upgrades (18% for 2011)	More land approved on Cotai; foreign labour issue resolved; strong gaming numbers	Commission war in junket operation; policy risk: visa restriction
Healthcare	Neutral	Volume will drive sector earnings growth	Growing income to drive healthcare consumption	Product price cuts; regulatory risks
Industrial	Neutral	Favour railway equipment/infrastructure, cautious on auto	Growing investment in railway infrastructure and equipment	Railway infrastructure investment is sensitive to government policy changes, auto sales growth slowdown
Power & utilities	Neutral	Positive on water and gas, Neutral on power	12th FYP implementation; natural gas supply shortage	Interest rate hike
Telecom	Neutral	Positive on China Unicom, and telecom equipment	Mobile data usage, revenue and 3G take-up may surprise on upside, network convergence	Irrational tariff competition and change in regulatory environment.
Transportation	Neutral	Positive on Jiangsu Expressway and Cosco Pacific	Rmb appreciation, tariff hike	Railway competition
Basic materials	Bearish	Favour coal and cement; negative on steel	Fixed asset investment growth	Price controls, property sector slowdown
Solar	Bearish	Industry oversupply in 2011F will favour companies with better cost control. Pure-play makers unable to increase integration are likely to underperform. Prefer Trina, Yingli and Suntech	Continued policy support and faster-than-expected utility adoption of solar are potential key catalysts for demand, which could soak up the excess supply, although we caution competition could change with new stronger players	Weaker demand from new centres, further subsidy cuts, faster than expected ASP decline

Source: Nomura research

## Exhibit 3. 10 stocks to watch: valuation snapshot

Ticker	EPS - Nomura				EPS gth (%)			EPS - consensus		PE (x) - Nomura			RoE - Nomura (%)			Net debt/equity - Nomura (%)			
	2008	2009	2010F	2011F	2009	2010F	2011F	2010F	2011F	2009	2010F	2011F	2009	2010F	2011F	2009	2010F	2011F	
Agile Properties	3383 HK	1.46	0.48	1.01	1.27	(67.2)	110.4	25.7	0.79	0.97	20.0	9.5	7.6	13.8	36.0	20.9	42.3	53.0	56.1
Agricultural Bk of China	1288 HK	n.a.	0.25	0.32	0.38	n.a.	28.0	18.8	0.30	0.37	14.2	10.9	8.5	20.5	21.1	21.3	n.a.	n.a.	n.a.
China Everbright Intl	257 HK	0.11	0.11	0.16	0.21	1.9	45.5	31.3	0.15	0.20	40.7	26.8	20.8	10.1	12.3	14.2	23.6	41.0	60.8
China Life Insurance	2628 HK	0.75	1.16	1.23	1.38	54.7	6.0	12.2	1.21	1.45	25.2	23.3	20.0	17.1	16.3	17.0	n.a.	n.a.	n.a.
China Mengniu Dairy	2319 HK	(0.58)	0.68	0.70	1.03	(216.4)	2.9	47.1	0.76	0.97	28.5	27.2	17.7	17.1	13.5	17.5	net cash	net cash	net cash
China Railway Constr	1186 HK	0.32	0.53	0.37	0.82	68.1	(30.2)	121.6	0.51	0.78	14.4	20.9	9.4	13.1	8.3	16.8	net cash	net cash	net cash
Gome Electrical Appl	493 HK	0.07	0.09	0.13	0.16	23.5	44.4	23.1	0.12	0.14	29.4	19.5	15.8	13.8	16.2	16.3	net cash	net cash	net cash
Perfect World *	PWRD US	1.79	3.06	2.81	3.58	71.3	(8.2)	27.4	2.71	3.05	7.7	8.4	6.6	52.3	32.8	29.1	net cash	net cash	net cash
Sinopec	386 HK	0.33	0.71	0.87	1.00	115.5	22.5	14.9	0.80	0.86	9.0	7.3	6.4	17.6	18.6	18.6	55.8	49.0	42.5
ZTE Corp	763 HK	0.63	0.89	1.01	1.29	41.1	13.5	27.7	1.08	1.32	27.9	23.3	17.3	15.8	16.1	18.0	net cash	net cash	net cash

Note: Pricing as of 1 December 2010; \* pricing as of 30 November 2010

Source: Bloomberg, Nomura research

We think China's economic outlook will remain positive in 2011, supporting equity market performance. Our economic team forecasts GDP growth of 10.2% in 2010, 9.8% in 2011 and 9.5% in 2012. With strong economic development, we estimate that bottom-line growth for corporates will be 21.4% and 19.0% for 2011 and 2012, respectively. We think accelerating urbanisation, booming consumption, healthy export growth, robust investment and implementation of China's 12<sup>th</sup> Five Year Plan (FYP) will be the major drivers.

- Our 2011 EPS forecast for the market is slightly higher than consensus (currently 3.1% higher for 2011 and 5.4% for 2012).
- YTD, consensus 2011 EPS has been consistently revised up, driven by earnings upgrades for the industrial, healthcare, consumer discretionary, energy and IT sectors. In our view, further upward EPS revisions may come from the financial sector when 1Q11 earnings start to confirm margin expansion after interest hike benefits materialise.

Apart from the solid bottom-line growth, we believe liquidity is also sufficient in 2011 to support the current P/E level. We estimate new bank loans of about RMB8trn for 2011 (vs a government loan quota of around RMB6.5trn), which may translate into around 18% M2 y-y growth. Although this is off from the recent peak of 27.7% y-y growth in 2009, our forecast 2011 M2 growth is still slightly higher than the historical average growth of 17.6% for the past decade. In addition, we believe there is likely to be more liquidity flowing from developed markets to emerging markets in search of higher returns. Growth in 'unexplained' foreign capital inflow to China has been high in the past several quarters.

In 2010, more than 50% of Nomura-rated China stocks in terms of market cap have not performed well. Financials are among the weakest-performing sectors, in contrast to outperformers such as Industrials, Macau Gaming, Airlines, Internet and Healthcare. Banks in Western countries have continued to struggle with weak balance sheets and capital shortage. Meanwhile, the PBoC's two surprising required reserve ratio (RRR) hikes in early 2010 sent tightening signals to the market. A crackdown on the property market and slowdown in new loan additions further hurt investor confidence in banking stocks. As a result, YTD, the MSCI China index is still 21.7% below its 2007 closing level and 35.7% below its peak in October 2007; while on the fundamentals side, MSCI China index EPS in 2010 has already recovered to the 2007 level.

**21%+ y-y EPS growth in 2011F**

**Liquidity should be supportive in 2011**

**The market has not fully recovered from the 2008 crisis**

## Exhibit 4. 2010 YTD performance by sector

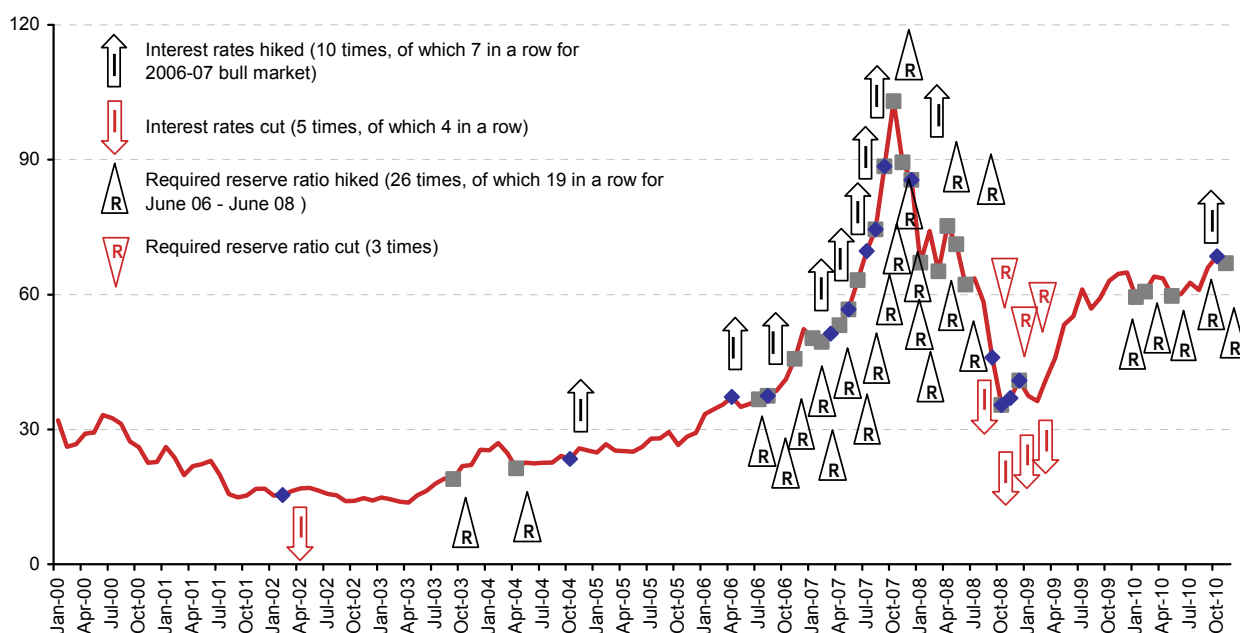
	Mkt cap (US\$bn)	Performance		
		1M	3M	YTD
Gaming, Hotels & Leisure	45.6	1%	43%	105%
Health Care & Pharmaceuticals	10.3	-4%	7%	90%
Media & Internet	111.9	-6%	22%	52%
Transport/Logistics	91.0	-1%	17%	34%
Industrials	154.2	-3%	25%	30%
Consumer Related	134.4	-2%	5%	20%
Oil & Gas/Chemicals	435.3	1%	19%	14%
<b>China - Total</b>	<b>2,832.2</b>	<b>-3%</b>	<b>13%</b>	<b>11%</b>
Power & Utilities	93.0	-5%	11%	10%
Telecoms	291.3	-2%	-1%	8%
Financials	1,225.0	-4%	12%	1%
Conglomerates	1.4	-6%	13%	-1%
Solar	12.8	-10%	17%	-6%
Basic Materials	141.7	-7%	13%	-10%
Property	61.0	-4%	0%	-10%
Technology	23.3	0%	8%	-21%

Note: Pricing as of 1 December 2010; sector performance figures based on a total of 180 Nomura-rated China stocks.

Source: Nomura Research

Continued 'unexplained' foreign capital inflows following US quantitative easing have expanded the PBoC's money base, leading to more liquidity. Renminbi appreciation expectations should further fuel such inflows, we believe. Our economics team forecasts four more interest rate increases and three RRR hikes during the course of 2011. We think there will also likely be more administrative measures, including loan quota controls. Whereas the RRR hikes earlier this year came as a surprise, we believe the market is now prepared for more RRR hikes in 2011. Any price weakness stemming from an initially negative reaction to these would likely present a buying opportunity, in our view.

## Exhibit 5. MSCI China Index performance vs Interest and RRR change



Note: Interest rate hike using one year lending rate and RRR changes represents large depository institution.

Source: WIND, CEIC, Bloomberg, Nomura research

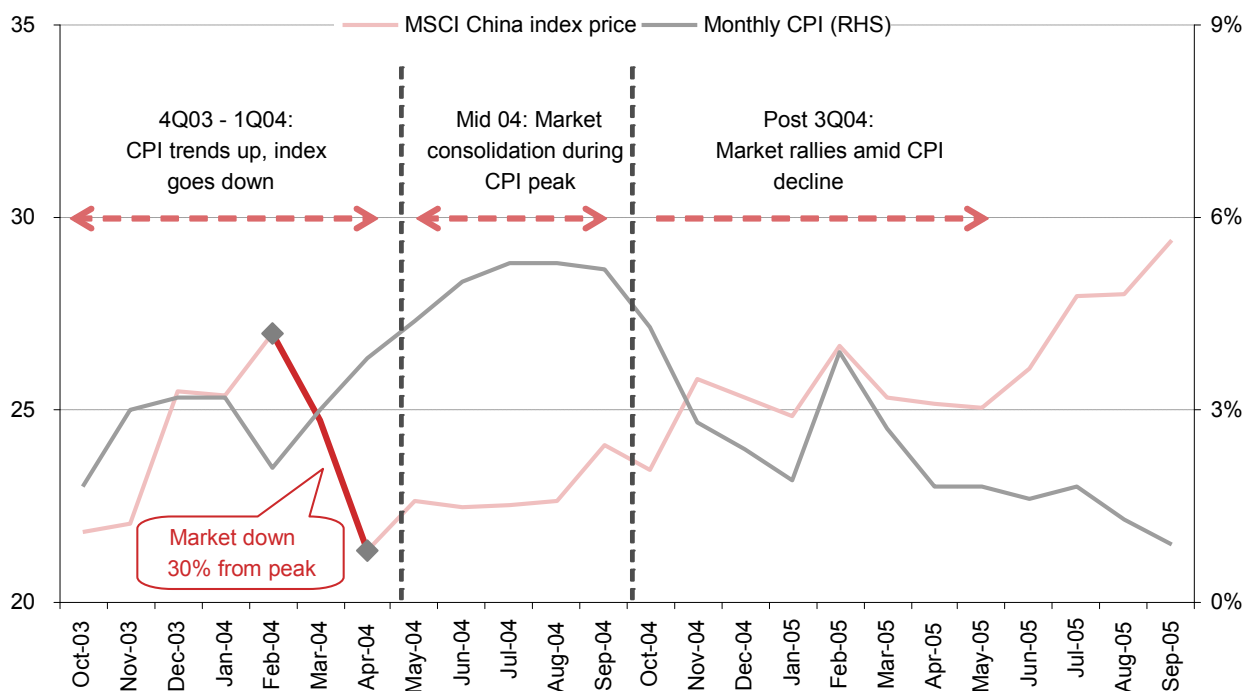
We think the equity market performance during the 2003-04 inflation cycle has important implications for the 2011 market outlook, given both factors are inversely correlated, especially during periods of high inflation.

- For the period of 4Q03 – 1Q04: when inflation (monthly CPI over 3%) surprised the market on the upside and was gaining momentum, the market tended to post negative returns due to concern over rising inflation. The MSCI China index was down by more than 30% from the peak during the period February 2004 – April 2004. Similarly, the MSCI China index has corrected by 9% during the current inflation cycle.
- For the period around mid-2004: the market was in consolidation as the CPI peaked.
- For the period post-3Q04: a market rally followed the decline in the CPI, ushering in a three-year bull market.

**Timing is everything and depends on where we are in the inflation cycle**

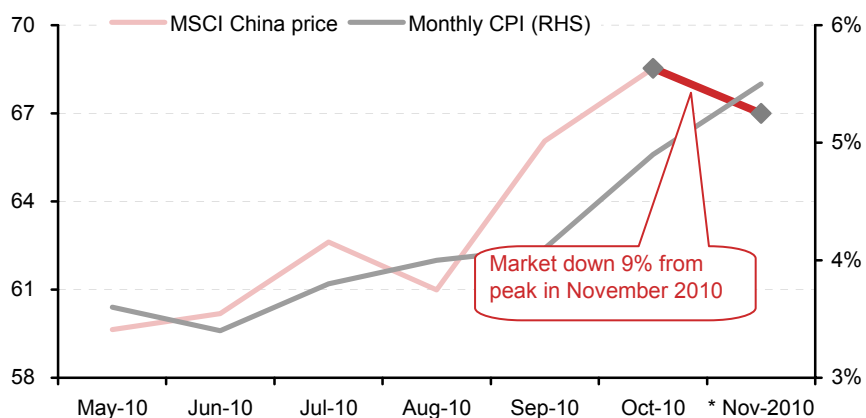
If the equity market in 2011 follows the pattern of the 2003-04 inflation cycle, market performance in the first quarter may not yield positive returns. Moreover, we highlight the following as factors that are potentially not supportive of market performance in 1Q11: 1) the CPI continues to surprise the market in the upside; 2) the MSCI China and HSCEI have posted negative returns in January in 12 of the past 17 years; 3) possible interest rate and RRR hikes; and 4) release of full-year loan quotas, reinforcing tightening measures.

**Exhibit 6. MSCI China index performance vs monthly CPI change during 2003-04 inflation cycle**



Source: WIND, CEIC, Bloomberg, Nomura research

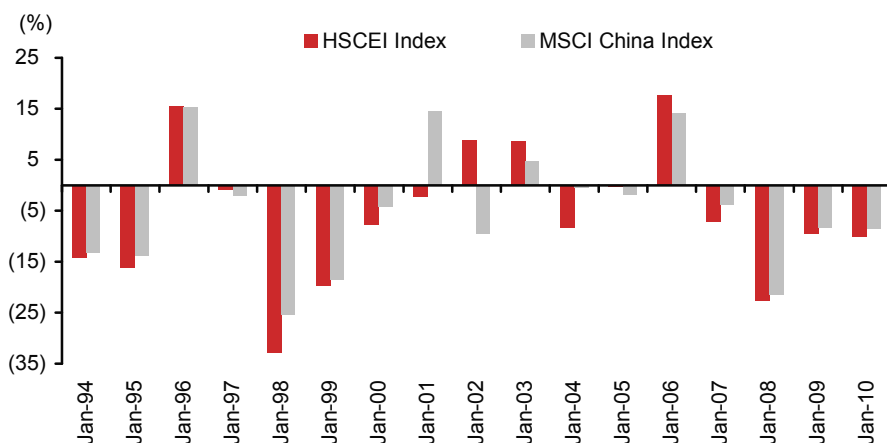
**Exhibit 7. MSCI China index performance vs monthly CPI change during current inflation cycle**



\* November 2010 CPI figure is our forecast of 5%

Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 8. January return of MSCI China and HSCEI index**



Source: Bloomberg, Nomura research

**Exhibit 9. Overview of MSCI China sector performance**

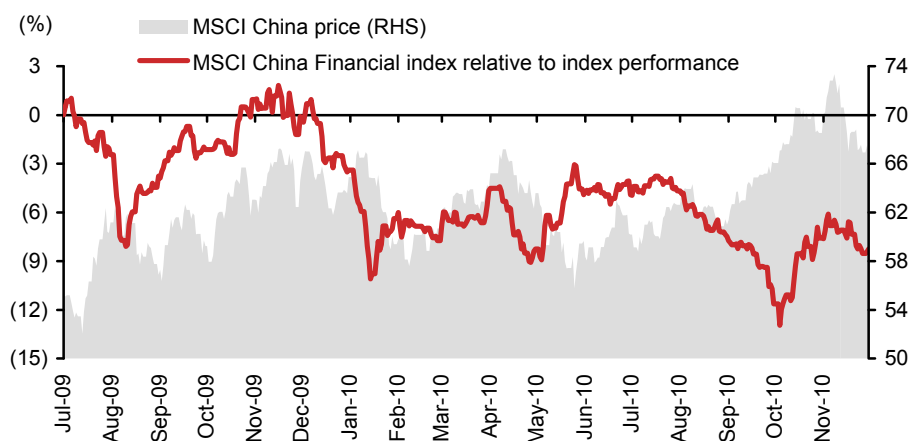
(%)	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD
<b>MSCI China Index</b>	<b>22.8</b>	<b>16.8</b>	<b>14.1</b>	<b>25.5</b>	<b>25.3</b>	<b>29.3</b>	<b>52.3</b>	<b>85.5</b>	<b>40.9</b>	<b>64.9</b>	<b>67.0</b>
MSCI China Return	(32)	(26)	(16)	80	(1)	16	79	64	(52)	59	3
-Consumer-Discretionary	(33)	28	2	104	(20)	(10)	37	73	(64)	146	3
-Energy	n.a.	4	19	137	2	32	67	61	(57)	74	13
-Consumer-Staple	(41)	10	(20)	224	(24)	0	89	48	(41)	113	5
-Healthcare	n.a.	(9)	100	77	(17)	(41)	(28)	n.a.	n.a.	39	20
-Material	(29)	(10)	28	225	(2)	13	89	99	(69)	82	(1)
-Industrial	(25)	(23)	(1)	70	14	(7)	48	104	(62)	46	6
-Telecom services	n.a.	(36)	(32)	40	7	30	77	96	(45)	(4)	0
-IT	(3)	(13)	(36)	25	(34)	5	(7)	20	(57)	231	7
-Utilities	79	34	4	96	(18)	(7)	49	59	(40)	(2)	(11)
-Financial	2	37	(44)	89	(5)	20	138	34	(46)	68	(1)
<b>Macro</b>											
Inflation (CPI) - Actual	0.4	0.7	(0.8)	1.2	3.9	1.8	1.5	4.8	5.9	(0.7)	3.3*
Inflation (CPI) - Target	n.a.	n.a.	n.a.	n.a.	n.a.	4.0	3.0	3.0	4.8	4.0	3.0
Lending Rate (1Y)	-	-	-54bp	-	+27bp	-	+54bp	+135bp	-216bp	-	+25bp
FX-RMB Change	0.0	0.0	0.0	0.0	0.0	2.6	3.3	6.9	6.9	0.1	3.5*
M2 growth, Y-y	14.0	14.4	16.8	19.6	14.6	17.6	16.9	16.7	17.8	27.7	19.3
<b>Company Fundamentals</b>											
EPS	0.66	1.11	1.34	1.68	2.16	2.41	2.57	3.81	3.16	3.83	4.8**
EPS Growth	(78)	68	21	25	29	12	7	48	(17)	21	26
ROE	10	20	16	16	19	21	20	23	18	19	20**
<b>Company Valuation</b>											
Forward PB (x)	2.4	1.4	1.1	1.9	1.7	1.8	2.4	3.7	1.6	2.2	2.0**
Forward PE (x)	20.5	12.6	8.4	11.8	10.5	11.4	13.7	27.1	10.7	13.4	12.1**

Note: Pricing date as of 30 November, 2010; \* Nomura estimate; \*\* consensus estimate

Source: WIND, CEIC, Bloomberg, Nomura research

With lower new loan quotas in 2011, the profitability outlook for banks in 2011 will be more dependent on the interest rate outlook, in our view. We forecast four quarterly symmetrical interest rate hikes in 2011, for a total increase of 100 bps. This should help banks to achieve better profits in 2011, driving sentiment on banking stocks. Despite share price underperformance due to fund raising and policy uncertainties, banking sector earnings have been on the rise since 2008. On the valuation side, we find that China banking stocks are trading at only 9.2x 2011F earnings and 7.3x 2012F earnings, and 1.7x and 1.5x price to book for 2011F and 2012F, respectively, with RoEs in both years forecast to exceed 20%. Also, we think insurance stocks will have greater scope to outperform when interest rates are on the rise.

**We are bullish on China financials**

**Exhibit 10. MSCI China financial index relative performance against index**

Source: Bloomberg, Nomura research

In our view, inflation will remain high in the near term. The question is: how long before it peaks? During the 2007-08 inflation cycle, monthly CPI was above 3% for a period of 18 months (May 2007 to October 2008). Inflation had been on the rise for 12 months until it started to slow from April 2008. Price controls were introduced in the ninth month (January 2008) after the CPI first broke 3% in May 2007, and one month after the price controls were rolled out, the CPI started to trend down (although it was above 3% for another eight months). This time, the CPI started to trend above 3% in July 2010.

**Consumption-related stocks also likely to outperform**

- The government will likely release a higher CPI target for 2011, just as it did in 2008 after the CPI started to surprise on the upside from the latter part of 2007. In 2003, 2007, and 2010 YTD, consumer stocks, including staples, tended to perform well before inflation gained momentum and outperformed again when the CPI was deemed to be under control in 2004 and 2008.
- In the 2003-4 inflation cycle, the equity market experienced a short-term correction in early 2004 when the CPI continued to rise, and gained momentum and started a three-year bull market when the CPI peaked in 3Q04.

### Exhibit 11. Historical monthly CPI

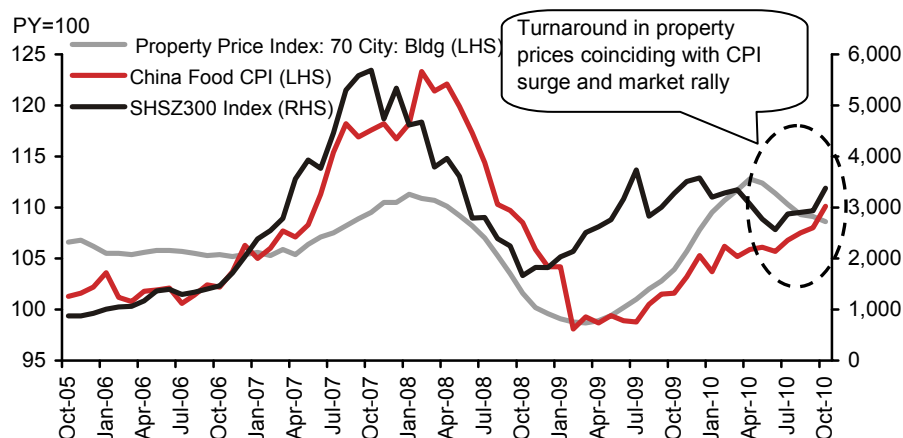
(%)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Jan	1.2	(1.0)	0.4	3.2	1.9	1.9	2.2	7.1	1.0	1.5
Feb	0.0	0.0	0.2	2.1	3.9	0.9	2.7	8.7	(1.6)	2.7
Mar	0.8	(0.8)	0.9	3.0	2.7	0.8	3.3	8.3	(1.2)	2.4
Apr	1.6	(1.3)	1.0	3.8	1.8	1.2	3.0	8.5	(1.5)	2.8
May	1.7	(1.1)	0.7	4.4	1.8	1.4	3.4	7.7	(1.4)	3.1
Jun	1.4	(0.8)	0.3	5.0	1.6	1.5	4.4	7.1	(1.7)	2.9
Jul	1.5	(0.9)	0.5	5.3	1.8	1.0	5.6	6.3	(1.8)	3.3
Aug	1.0	(0.7)	0.9	5.3	1.3	1.3	6.5	4.9	(1.2)	3.5
Sep	(0.1)	(0.7)	1.1	5.2	0.9	1.5	6.2	4.6	(0.8)	3.6
Oct	0.2	(0.8)	1.8	4.3	1.2	1.4	6.5	4.0	(0.5)	4.4
Nov	(0.3)	(0.7)	3.0	2.8	1.3	1.9	6.9	2.4	0.6	*5.0
Dec	(0.3)	(0.4)	3.2	2.4	1.6	2.8	6.5	1.2	1.9	*4.0
										<b>2010F / 2011F</b>
Annual	0.7	(0.8)	1.2	3.9	1.8	1.5	4.8	5.9	(0.7)	* 3.3 / * 4.5
Target	n.a.	n.a.	n.a.	n.a.	4.0	3.0	3.0	4.8	4.0	* 3.0 / * 4.0

\* Nomura forecasts

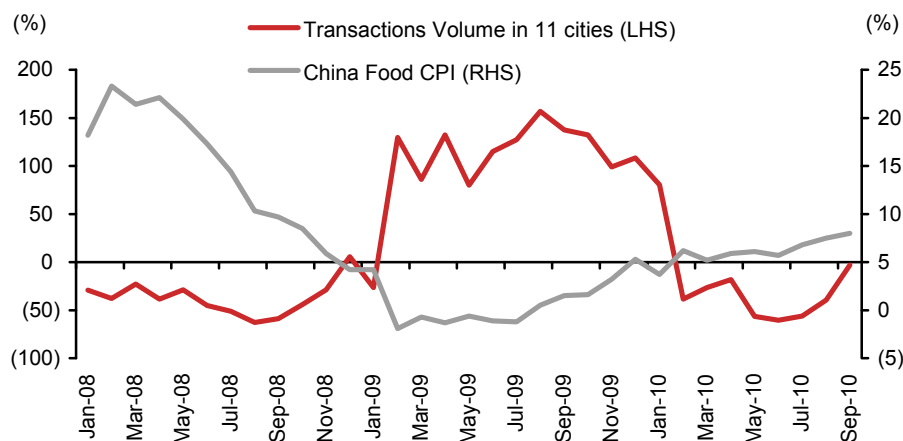
Source: WIND, CEIC, Nomura research

We are bullish on the China property sector in 2011. Trading at an NAV discount of 37%, vs an historical (2003 – 2010 YTD) average discount of 23%, with sector earnings growth of 32% and 22% in 2011F and 2012F, respectively, value looks to be emerging, in our view. Transaction volumes are lower compared with a year ago, partly due to softening demand after the government's attempt to crack down on property market speculation. There have also been product launch delays by developers in order to reduce supply and avoid property price cuts, contributing to lower transaction volumes. Balance sheets remain healthy for Chinese property developers, with 2011-12F net debt/equity ratios of 40-50%, in our view. Bringing inflation down will likely remain the top priority of the government in the next six months, we think, making more aggressive policies to discourage property market demand less likely. With fundamental demand for property in China remaining strong, an eventual recovery in transaction volume should be positive for Chinese property stocks in 2011, in our view.

**Bullish on property sector**

**Exhibit 12. Property price vs food CPI and SHSZ300 index performance**

Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 13. Property volume vs food CPI**

Source: WIND, CEIC, Bloomberg, Nomura research

In our opinion, renminbi beneficiaries such as airlines could overshoot in 2011. As a sector, airlines were up 136% in 2009 and are up 81% YTD 2010. As we see it, there is a likelihood of higher airline earnings in 2011 following record-high earnings in 2010F, though y-y earnings growth will likely slow sharply in 2011. Another sector that we think could overshoot in 2011 is Macau gaming, following 46% and 95% gains in 2009 and 2010 YTD, respectively. A strong renminbi will likely trigger more Chinese to travel overseas, including Macau. On the earnings growth side, after 346% and 153% y-y sector earnings growth in 2009 and 2010F, we believe upside in 2011 will come from a pickup in the mass market, though Macau gaming stocks will likely find it hard to repeat the earnings growth of 2009 and 2010.

We think a weak US\$ and QE will continue to boost commodity prices, including oil. We forecast oil prices will reach US\$110 per barrel by 2012F. Along with rising commodity prices, manufacturing and service costs will likely increase. Companies with solid RoEs should be able to pass on cost pressure, given their proven execution track records during economic upturn and downturn cycles.

Deep cyclical sectors such as metal and mining may face a more challenging operating environment as interest rates rise further and economic growth becomes more quality oriented, we believe. These sectors also have relatively highly geared balance sheets that may not bode well in times of money tightening.

**Renminbi appreciation beneficiaries**

We believe the government will continue to push for industry consolidation and upgrades to enhance investment returns. The seven industries deemed to be of strategic importance are: 1) energy efficiency and environmental protection; 2) next generation IT; 3) bio-technology; 4) high-end manufacturing; 5) new energy; 6) new materials; and 7) clean-energy vehicles. We expect these industries to grow in size in the next five to 10 years with the support of the Chinese government. Exposure to new energy and environmental protection will likely be rewarded, we believe.

We think the seven industries of strategic importance will enter a golden period of development commencing in 2011. The government expects the value-added production of these seven industries to reach to 8% of total GDP by 2015 and 15% by 2020. This implies significant upside potential for these seven industries. For example, the banking and insurance sector accounted for only 5% of total GDP in 2009, similar to the real estate sector's contribution, according to CEIC. The proposed tax preference measures for these seven industries will further boost their long-term development, in our view.

#### Exhibit 14. Outlook: sector by sector

SECTOR	Sub-sector	2011F earnings growth drivers		Upside risks	Downside risks
		Volume	Price		
Basic Materials	Cement	1,940mnt (+11% y-y)	Up 0-3% y-y	1. Rapid FAI growth; 2. Favourable government policies (such as building materials subsidies etc.); 3. Big drop in raw material costs	1. Rapid increase in local cement capacities leading to oversupply; 2. Slowing FAI growth; 3. Property development slowing down
Basic Materials	Steel	685mnt (+6% y-y)	RMB5306/t (up 3-5%)	1. Big drop in raw material costs; 2. Favourable government policies; 3. Stronger ASP	1. Deteriorating supply-demand balance; 2. Big hikes in raw material costs; 3 Property development slowing down
Basic Materials	Coal	We estimate volume will rise by 3%; around 40% of EPS growth driven by volume	We estimate coal ASP will increase by 6% in 2011	Higher-than-expected contract price and spot price for coal, driven by: 1) stronger-than-expected coal-fired power generation; 2) tightened transportation caused by bad weather; and 3) higher-than-expected global coal prices	1) Higher-than-expected cost hikes, mainly driven by policy-related cost increase; 2) Weaker than expected coal demand growth due to lower GDP growth or power / steel industry production growth; and 3) Higher coal imports boosted by a strengthening RMB
Consumer Related	Department store	16%, including new GFA growth and acquisition	Average SSS in mid-teens	Better-than-expected SSS on healthy underlying consumption, margin expansion, store acquisition	Higher-than-expected operating expense, more intensive competition
Consumer Related	F & B	Average volume growth of 22% y-y	ASP growth of 4% y-y	Product price hikes, EPS upgrades by the Street, M&A, positive updates on the macro side (ie, minimum wage increase and urbanisation)	Larger-than-expected cost hikes, fierce competition, food safety issues
Consumer Related	Foot & Sportswear	11%, including Lining: +760 stores pa; Belle: +1,200 stores pa; Ports: +30 stores pa	8%, including footwear SSS in high teens; sportswear SSS in mid-high single digits	Better-than-expected SSS, margin expansion	Greater-than-expected slowdown in order book (for sportswear), margin compression on extensive promotion activities and rising labour costs
Consumer Related	Supermarket	10%, including Wumart: +65 stores pa; Lianhua: +165 stores pa	Low-single digit SSS, in line with the CPI	Better-than-expected SSS on CPI inflation, margin expansion	Rising competition and margin compression
Consumer Related	Consumer services & distribution	Ctrip: volume +30% y-y; EDU: enrolment +20% y-y; Gome: weighted sales area +12.5% y-y	Ctrip ASP flat; EDU ASP +single digit % y-y	EDU: faster-than-expected enrollment growth; Ctrip: higher-than-expected volume growth in air tickets and hotel rooms; Gome: better-than-expected SSS and margin expansion	EDU: margin compression, rising competition; Ctrip: commission rate decline, slowdown in volume growth, rising competition; Gome: lower-than-expected SSS and margin compression
Financials	Banking	Forecast RMB8trn new loan	Four symmetric times interest rate hike with total 100bps	- Smaller-than-expected equity amount raised - Strong NIM rebound amid an interest rate hiking cycle - Synergies achieved after integration with Ping An Bank (SZDB) - Better expense control that lowers cost/income ratio (SZDB)	- A more severe-than-expected macro tightening could result in a sharp rise in bad debt - A slowing economy would have negative implications for loan growth

SECTOR	Sub-sector	2011F earnings growth drivers		Upside risks	Downside risks
		Volume	Price		
Financials	Insurance	We think volume should remain relatively strong in 2011 as China's insurance penetration remains low and demand for insurance should continue to increase: 1) as welfare of citizens continues to improve; and 2) on the back of the rising rate environment	Margins – should expand in 2011 as: 1) assets reprice faster than liabilities (eg, negotiated deposits can reprice immediately while crediting rate for participating policies announced annually); 2) new business margin should increase but the magnitude is impossible to quantify as it will depend on the type of products sold and the ultimate crediting rate used, which can be affected by the market environment	<p>Under a rising rate environment, we expect life insurers to have wider yield spread and thus, higher Value of New Business growth.</p> <p>Better-than-expected and sustained combined ratio for the P&amp;C sector would improve valuations for P&amp;C insurers</p> <p>Strong A-share market to spur better sentiment for insurance stocks</p>	<p>Poor returns from the A-share market would affect sentiment on insurers in general</p> <p>Intense competition leading to a continued squeeze in NB margins for life insurers</p> <p>Worse-than-expected combined ratio in 2H10 from intensifying competition</p>
Gaming, Hotels & Leisure	Gaming	Earnings to be driven more by volume		If infrastructure upgrades attract more people than expected; since liquidity remains abundant in the system, VIP revenue could continue to surprise on the upside	Project delays
Health Care & Pharmaceuticals	Healthcare	Volume growth will be the key driver, as a result of growing demand and new product launches	Sector ASP will remain under pressure		Policy risks such as drug price cuts and tightening regulations of production process
Industrials	Auto - CV	7%	2%	Stronger sales due to stronger FAI	Higher material costs will further weigh on margins
Industrials	Auto - PV	16%	-3%	<p>Stronger-than-expected sales growth</p> <p>Stronger high-end car sales that enhance the product mix</p>	<p>Higher material costs will weigh on margins</p> <p>Regulation changes may curb auto sales growth in large cities, which will hurt product mix</p>
Industrials	Capital goods - Construction machinery	NA	NA		
Industrials	Capital goods - Railway equipment	NA	40%	Revision up of railway plan in 12-5	Shift in government policy and price pressure from MoR
Industrials	Infrastructure - Ports	N/A	14%	Better-than-expected recovery of ports machinery	Shift in government policy and risks related to overseas projects
Industrials	Infrastructure - Railway & Highway	N/A	20%	Upward revision to railway plan in 12FYP	Shift in government policy and risks related to overseas projects
Media & Internet	E-Commerce	Membership growth will be minimal	Growth mainly from ARPU, driven by GMV (gross merchandise value)	Better-than-forecast growth trend in VAS contribution to revenue	Negative Net Adds of membership
Media & Internet	Internet	Growth of paying users or number of ads sold will contribute the other half of the overall growth	About half of the growth will come from growth of ARPU or ads pricing	Ramp-up in ad spending	Faster-than-expected slowdown in online advertising/marketing
Media & Internet	Online gaming	New game launches will increase the number of paying users	About 30% driven by ARPU growth	Faster-than-expected growth of existing games, especially ARPU	Further delay in new game launches
Media & Internet	Outdoor media	Most firms running near capacity — ARPU should be bigger driver	ARPU to drive growth over utilisations	Ramp-up in ad spending	Faster-than-expected slowdown in outdoor ads

SECTOR	Sub-sector	2011F earnings growth drivers		Upside risks	Downside risks
		Volume	Price		
Oil & Gas/Chemicals	Fertilizer	Expect sales volume growth in excess of 10%	Fertilizer retail price increases will be more significant than ex-factory price rises		Increase in fertilizer export tariff to curtail exports; higher-than-expected natural gas price hikes, natural disasters
Oil & Gas/Chemicals	Oil & Gas	Volume increase of 5-10%	Crude oil prices + 20%, natural gas price +10-15%		Government regulatory risks including resource tax, oil price volatilities, and chemical industry downturn
Power & Utilities	China equipment	Increase in EPS will be mainly attributable to potential increase in sales volumes, particularly relating to wind and nuclear equipment, the key growth drivers. For wind equipment, ASP/MW slightly increases as we expect CHST's product mix to gear towards higher-capacity models	For wind equipment, a 30% increase shipment to 12GW is expected over 2011F, in our view, largely driving CHST growth in 2011F	Orders from overseas should expand faster than forecast, given increased recognition of the competitive quality and relatively low price of Chinese-manufactured power equipment	Further decline in ASP or increase in raw materials prices, such as steel, could lead to margin contraction for power equipment manufacturers
Power & Utilities	China gas	We assume ~25% gas sales volume growth in 2011	Assume around 10% increase in the gas tariff, given the full-year effect from gas price hike in 2H10	1) Higher-than-expected gas demand growth, which is supported by sufficient gas supply; 2) value-accretive assets acquisition and margin enhancement through higher gas price hikes than wellhead cost hikes	1) Slower-than-expected gas demand growth; 2) margin squeeze due to no / partial pass thru of any wellhead cost hike; 3) gas supply which is not sufficient to meet strong gas demand growth
Power & Utilities	China power	We assume 9.8% power demand growth in 2011	No tariff hike assumed for 2011, but part of the EPS growth is driven by the full-year impact of our 5% tariff hike assumption in 3Q10, which is subject to change now as no tariff hike occurred in 3Q10	Higher-than-expected power demand growth and tariff hike, lower-than-expected interest rate hike and coal price increase	Higher-than-expected coal price increase and interest rate hike, resulting in margin squeeze; lower-than-expected power demand growth
Power & Utilities	China water	1-3% CAGR in water demand; 8% capacity growth in waste water treatment	5% water tariff hike expected	Stronger-than-expected water tariff hikes and policy support and investment in water sector; faster pace of acquisition of water plants	Slower growth in water demand, wastewater emission, and solid waste; smaller-than-expected growth in water tariffs; weak government policies on water and environmental sectors
Property	Property	We expect stable volume in 2011 vs 2010, given strong demand from upgraders and rapid urbanisation, offsetting decline in speculative activities. Developers have locked up at least 30-40% of earnings from 2010 pre-sale activity, supporting continuous EPS growth. Developers should replenish their land banks, but purchase activity may not be as active as in 2010. We do not expect significant M&A, given that most developers still have relatively strong balance sheets	We expect a price correction of 10% in overheated cities such as Beijing, Shanghai, Shenzhen and Hangzhou as they should face direct tightening. For non-overheated cities, we forecast a max price correction of only 0-5%, thanks for strong demand from upgrades and rapid urbanisation	Transaction volume keeps rising while property prices remain stable	More direct tightening of property market

SECTOR	Sub-sector	2011F earnings growth drivers		Upside risks	Downside risks
		Volume	Price		
Solar	Solar	Module shipments expected to rise 10% y-y	ASPs to see downward pressure. Module ASPs expected to fall 15~20% y-y	-Faster cost reductions -Better-than-expected ASPs -Stronger-than-expected demand from new markets	-Demand in new centres unable to offset lower demand from Germany -Further subsidy reductions in key markets -Acute oversupply leading to higher-than-expected fall in ASPs
Technology	Technology				
Telecoms	Telecoms equipment	1) Growth in optical network driven by network convergence in China and global network capacity shortage due to smartphone trend; 2) India 3G network rollout; 3) smartphones; 4) China TD-LTE (4G) network rollout	Handset ASP to grow moderately driven by growth in high ASP smartphone; optical network/component ASP declines moderately because of strong demand	1) faster-than-expected adoption of low-end smartphones; 2) faster-than-expected rollout of optical network in China	1) National security issues in foreign countries to the detriment of Chinese vendors; 2) delay in India 3G network rollout
Telecoms	Telecoms services	Steady subscriber addition due to rural market growth	ARPU growth due to 3G adoption	1) mobile data usage and revenue may surprise on upside; 2) 3G take-up may surprise on upside; and 3) street is too conservative on CM's earnings at the moment	Major risks to our price targets for the China telecom operators under our coverage include: 1) irrational tariff competition: if China Telecom or China Unicom lowers mobile tariffs in an attempt to gain market share, China Mobile may respond by launching similar tariff plans; 2) regulatory environment: any significant change in the regulatory environment could have important implications for mainland telecom operators; and 3) new technologies may disrupt the industry landscape: the introduction of new technologies may complement or cannibalise existing technologies (ie. GSM, GPRS, EDGE). Given that the telecom operators have invested heavily in existing networks, the potential obsolescence of networks could lead to asset write-offs, in our view
Transport/Logistics	Airlines	RPK growth by 11.3%	Gross passenger yields to increase 4% y-y	1) Higher-than-expected traffic volume and yields, 2) Higher-than-expected renminbi appreciation	1) Higher-than-expected oil prices; 2) higher-than-expected capacity growth which may result in lower-than-expected yields and load factors, 3) higher-than-expected competition from railways
Transport/Logistics	Airport	Passenger volume growth by 10.5%	No changes	1) Renewal of airport fee should remove earnings decline overhang; 2) higher-than-expected traffic volume; 3) possible A-share IPO	1) Possible cancellation of airport fee collection to the listed company, which may result in significant decrease in earnings; 2) Possible acquisition of under-productive assets
Transport/Logistics	Container box	We forecast 1.9mn TEUs global box production in 2010F and 3.2mn TEUs global box production in 2011F	We forecast US\$2,400 for a 20" dry container box in 2010F; price seen increasing to US\$2,550-2,600 in 2011F.	1) Stronger-than-expected box demand leading to severe box shortage problem, pushing up box prices and margins, 2) increase in containership supply	(1) Slow down in global trade leading to less demand for boxes, (2) lower-than-expected containership deliveries, (3) failure to pass on higher material costs to customers
Transport/Logistics	Ports	Container throughput to grow by 10%	Zero to 5%	1) Possible handling charge rate hike across the board; 2) Higher-than-expected container throughput volume	1) Lower-than-expected container throughput volume; 2) Possible acquisition of under-productive assets

SECTOR	Sub-sector	2011F earnings growth drivers		Upside risks	Downside risks
		Volume	Price		
Transport/ Logistics	Shipping services	On the dry bulk side, we expect demand in 2011F to remain strong (7.3% growth), but we are getting more concerned on supply as YTD slippages are below our forecast and greenfield shipyards are beginning to deliver (currently, we forecast supply growth of 8%). On the container side, while we forecast modest growth in demand (7.2% in 2011F), we expect 9% growth in containership supply in 2011F, resulting in pressure on freight rates	On the dry bulk side, our current BDI forecast is 3,436 for both 2010-11F, but this could be too optimistic given YTD BDI forecast of 2,866. On the container side, we forecast a 5% decline in average freight rates in 2011F	On the dry bulk side: 1) strong China fixed asset investment growth; 2) strong global steel demand; and 3) port congestion; On the container side: 1) higher-than-expected new containership slippages; 2) severe box shortage issue leading to implementation of "box repositioning surcharge"; 3) stronger-than-expected container demand	On the dry bulk side: 1) Potential slowdown in new buildings delays/cancellations; 2) lower old ships scrapping rate; 3) large bulk ship order book. On the container side: 1) higher-than-expected bunker price; 2) lower-than-expected new containership slippages
Transport/Logistics	Toll road	Traffic to see growth by 9.5%	Possible rate hike by 10%	1) Possible toll rate hike in other provinces; 2) Higher-than-expected traffic volume growth	1) Possible traffic diversion impact from new competition and /or maintenance work; 2) Possible acquisition of under-productive assets

Source: Nomura research

## Exhibit 15. Sector valuation comparable sheet

SECTOR	Sub-sector	Market cap (US\$bn)	EPS				EPS growth %				P/E (x)				PB (x)				ROE (%)			
			2009	2010F	2011F	2012F	2009	2010F	2011F	2012F	2009	2010F	2011F	2012F	2009	2010F	2011F	2012F	2009	2010F	2011F	2012F
Basic Materials	Cement	25.8	1.40	1.10	1.31	1.31	35	(22)	20	(0)	17.1	18.0	14.7	10.0	2.3	2.8	2.4	1.7	15.0	17.3	18.0	14.7
Basic Materials	Steel	30.6	0.22	0.59	0.70	0.75	(38)	167	18	7	49.1	12.1	10.2	9.5	1.2	1.1	1.0	1.0	4.0	9.8	10.7	10.9
Basic Materials	Others	85.3	1.59	1.89	2.12	2.28	19	18	12	8	18.3	15.0	12.5	11.6	3.4	2.8	2.3	2.0	19.9	20.5	20.1	19.0
Conglomerates	Conglomerates	1.4	0.48	0.15	0.26	0.59	385	(70)	78	126	8.6	28.4	15.9	7.1	0.7	0.7	0.7	0.6	22.2	4.2	6.2	11.6
Consumer Related	Department store	18.3	0.27	0.32	0.41	0.50	18	17	29	22	41.2	34.3	25.6	20.4	7.4	6.4	5.1	4.3	16.5	20.9	22.3	23.0
Consumer Related	F & B	72.3	0.52	0.59	0.75	0.95	58	15	27	26	32.7	30.5	23.4	18.1	6.7	5.7	4.8	4.1	23.9	24.2	24.3	26.5
Consumer Related	Foot & Sportswear	20.0	0.43	0.53	0.64	0.75	27	23	21	18	36.3	27.2	22.6	19.5	6.7	5.7	5.0	4.1	23.1	24.3	24.9	24.4
Consumer Related	Supermarket	6.3	0.57	0.65	0.75	0.85	27	14	16	13	44.0	36.9	30.4	25.4	8.6	6.3	5.2	4.9	19.5	19.7	18.8	19.8
Consumer Related	Others	17.5	4.29	5.86	7.75	10.10	33	37	32	30	51.0	36.2	27.7	21.6	9.3	7.5	5.7	4.5	19.9	22.2	23.3	23.6
Financials	Banking	960.4	0.49	0.58	0.68	0.84	4	19	18	23	13.3	10.8	8.7	6.9	2.5	2.0	1.6	1.4	19.9	20.7	20.5	21.9
Financials	Insurance	264.6	1.50	1.61	2.04	2.66	113	7	27	30	32.0	25.9	20.4	15.8	4.9	4.3	3.5	2.8	18.8	17.4	19.0	20.2
Gaming, Hotels & Leisure	Gaming	45.6	0.09	0.45	0.52	0.69	16	389	17	33	59.8	23.7	20.3	15.4	9.4	8.8	5.8	4.4	27.9	37.4	32.8	28.3
Health Care & Pharmaceuticals	Healthcare	10.3	0.44	0.58	0.72	0.90	62	30	26	24	41.3	30.5	23.6	18.7	6.0	4.8	4.3	3.8	19.8	19.5	20.5	22.5
Industrials	Auto - CV	14.9	3.36	3.21	3.22	3.76	74	(5)	1	17	12.8	12.0	11.7	10.2	2.9	3.6	2.7	2.1	29.0	36.6	26.5	23.7
Industrials	Auto - PV	59.9	0.61	1.17	1.37	1.51	127	91	17	11	18.9	12.8	10.5	9.3	3.8	3.0	2.5	2.0	16.0	27.7	26.7	24.5
Industrials	Capital goods - Construction machinery	9.1	1.18	1.68	1.84	2.19	43	43	10	19	15.4	10.7	9.8	8.3	3.9	4.0	2.9	2.2	28.4	44.7	34.2	30.2
Industrials	Capital goods - Railway equipment	26.8	0.20	0.33	0.49	0.65	(1)	65	47	33	48.4	29.0	19.1	14.3	4.6	4.1	3.5	3.0	10.7	14.7	19.3	21.8
Industrials	Infrastructure - Ports	13.0	0.49	0.50	0.60	0.71	19	4	19	19	11.4	11.0	9.3	7.8	1.5	1.4	1.2	1.1	15.0	13.0	14.0	14.9
Industrials	Infrastructure - Railway & Highway	26.4	0.42	0.37	0.63	0.74	125	(14)	73	18	14.4	16.8	9.8	8.4	1.7	1.6	1.4	1.3	12.4	10.3	15.3	15.9
Industrials	Others	4.0	0.19	0.38	0.50	0.60	(75)	101	30	20	34.6	17.2	13.3	11.0	1.8	1.7	1.5	1.3	5.4	10.2	11.8	12.5
Media & Internet	E-Commerce	8.4	0.24	0.35	0.43	0.56	(12)	44	24	30	47.0	32.1	25.3	19.4	11.4	8.3	6.1	4.7	20.7	24.6	23.7	23.9
Media & Internet	Internet	85.2	4.63	8.13	12.09	16.02	28	76	49	33	96.7	47.9	30.9	23.0	33.6	19.5	11.7	7.7	45.4	48.6	44.7	38.7
Media & Internet	Online gaming	14.4	14.67	13.86	17.19	19.89	28	(5)	24	16	12.6	12.9	10.5	9.1	3.6	2.7	2.1	1.7	39.3	25.2	22.5	20.1
Media & Internet	Outdoor media	3.9	3.69	7.06	8.66	9.79	(62)	91	23	13	30.1	24.9	16.2	14.3	2.5	2.4	2.0	1.8	(14.5)	6.9	10.8	11.2
Oil & Gas/Chemicals	Fertilizer	7.5	0.00	0.21	0.30	0.38	(101)	(10,229)	43	29	12.2	23.4	15.8	13.3	2.4	2.2	1.9	1.8	(4.2)	12.2	17.0	20.5
Oil & Gas/Chemicals	Oil & Gas	427.8	0.61	0.85	1.02	1.18	(7)	40	20	16	16.4	11.4	9.5	8.2	2.3	2.0	1.7	1.5	14.7	18.5	19.4	19.7
Power & Utilities	China Wind	7.0	0.15	0.25	0.35	0.39	119	71	38	12	42.8	24.8	17.4	15.2	1.7	2.0	1.7	1.5	6.9	8.2	10.4	10.4
Power & Utilities	China equipment	30.7	0.57	0.60	0.76	0.89	68	6	25	18	22.0	20.4	19.8	17.8	2.8	2.4	2.1	1.8	15.6	13.1	12.5	12.5
Power & Utilities	China gas	16.1	0.98	1.24	1.45	1.72	1	27	17	19	40.6	20.5	18.4	15.2	4.6	2.4	2.0	1.8	11.8	14.5	12.7	12.9
Power & Utilities	China power	31.0	0.53	0.53	0.59	0.62	258	0	11	6	13.2	13.9	12.0	11.7	1.3	1.2	1.2	1.1	11.9	9.8	10.4	10.5
Power & Utilities	China water	8.2	0.17	0.21	0.25	0.26	9	27	14	6	32.4	18.5	15.5	14.3	2.5	2.2	1.9	1.7	11.4	13.5	13.5	13.0
Property	Property	53.3	0.48	0.72	0.95	1.16	67	49	32	22	20.8	14.3	10.6	8.7	2.2	1.8	1.6	1.4	14.4	17.0	16.6	17.8
Solar	Solar	12.8	0.07	6.19	7.11	7.91	(98)	8,207	15	11	4.2	8.7	7.7	9.7	0.8	1.7	1.3	1.1	(0.7)	9.8	10.8	9.5
Technology	Technology	16.7	1.77	1.99	2.31	2.66	193	12	16	15	22.7	21.1	18.4	15.9	4.8	4.2	3.4	2.8	25.1	21.1	20.0	18.9
Telecoms	Telecoms equipment	16.4	0.69	0.80	1.07	1.25	40	15	34	17	25.5	20.7	15.0	13.0	3.2	3.2	2.7	2.3	17.3	17.2	19.0	19.0
Telecoms	Telecoms services	275.0	4.23	4.37	4.69	5.00	3	3	7	7	14.8	15.8	13.5	11.7	2.3	2.1	1.8	1.7	19.3	17.3	16.7	16.2
Transport/Logistics	Airline	28.8	0.25	0.81	0.76	0.78	(121)	225	(7)	3	64.7	8.4	8.6	7.9	10.5	2.6	1.9	1.5	12.8	45.3	26.6	21.2
Transport/Logistics	Airport	2.8	0.14	0.19	0.21	0.31	37	39	11	50	46.2	29.9	20.6	13.0	1.4	1.3	1.2	1.0	3.9	5.3	6.2	8.4
Transport/Logistics	Container box	8.2	-0.03	0.71	0.97	1.08	(104)	(2,628)	37	11	23.7	17.2	15.6	3.4	2.9	2.6	2.3	4.8	17.2	15.9	15.5	
Transport/Logistics	Ports	11.6	0.75	0.84	1.05		(25)	13	24	(100)	27.7	23.8	19.2		2.1	1.9	1.9		9.5	8.9	10.0	
Transport/Logistics	Shipping services	25.6	-0.30	0.57	0.62	0.68	(123)	(289)	8	10	11.0	12.4	13.5	11.7	1.5	1.3	1.2	1.1	(8.9)	12.7	11.1	11.2
Transport/Logistics	Toll road	14.1	0.36	0.44	0.51	0.57	6	23	16	11	17.6	14.1	11.7	10.0	2.0	1.9	1.6	1.4	12.6	13.9	15.2	15.8
<b>Total</b>		<b>2,817.9</b>	<b>1.24</b>	<b>1.53</b>	<b>1.86</b>	<b>2.21</b>	<b>16</b>	<b>24</b>	<b>21</b>	<b>19</b>	<b>22.6</b>	<b>16.4</b>	<b>13.0</b>	<b>10.6</b>	<b>4.1</b>	<b>3.2</b>	<b>2.5</b>	<b>2.0</b>	<b>18.6</b>	<b>20.5</b>	<b>20.3</b>	<b>20.5</b>

Note: Pricing as of 1 December 2010

Source: Nomura research

## Exhibit 16. Valuation comparables

COMPANY	Ticker	Price	Market cap US\$bn	Nomura rating	Consensus				TP	Nomura Upside to TP	Share performance (%)			
					Buy	Hold	Sell	Buy (%)			1M	3M	YTD	2-year beta
Agile Properties	3383 HK	11.1	5.0	BUY	21	5	1	77.8	13.3	19.7%	6.9	19.9	(4.4)	1.8
Agricultural Bank of China	1288 HK	4.1	132.4	BUY	13	18	-	41.9	4.7	13.8%	(1.0)	15.1	n.a.	n.a.
China Everbright International	257 HK	4.4	2.1	BUY	12	1	-	92.3	6.1	39.9%	5.6	24.0	8.5	0.8
China Life Insurance	2628 HK	33.7	101.5	BUY	15	20	2	40.5	40.0	18.7%	(1.8)	12.3	(13.0)	0.9
China Mengniu Dairy	2319 HK	22.7	5.1	BUY	23	5	2	76.7	32.0	41.0%	(0.2)	3.0	(20.2)	0.8
China Railway Construction Corp	1186 HK	9.4	12.9	BUY	12	8	3	52.2	11.8	25.3%	(4.9)	(7.1)	(7.3)	0.6
Gome Electrical Appliances	493 HK	3.2	6.8	BUY	13	3	1	76.5	4.3	36.5%	17.2	29.7	8.5	0.6
Perfect World *	PWRD US	23.7	1.2	BUY	13	6	3	59.1	37.0	56.1%	(24.1)	(5.2)	(39.9)	n.a.
Sinopec	386 HK	7.3	100.5	BUY	21	8	1	70.0	9.6	31.9%	(1.1)	17.4	4.6	0.9
ZTE Corp	763 HK	29.4	11.1	BUY	19	9	2	63.3	36.0	22.4%	(0.9)	(1.2)	(10.8)	0.8

Note: Pricing as of 1 December, 2010; \* pricing as of 30 November, 2010

Source: Bloomberg, Nomura research

Our top 10 China stocks for 2011: ABC, Gome, CRCC, ZTE, China Everbright International, China Life Insurance, Agile Properties, China Mengniu Dairy, Sinopec and Perfect World.

- These stocks provide exposure to our major sector overweight calls, including financials and property, consumer and on-line gaming;
- Three stocks (ABC, Gome and China Everbright) are also in our Top 10 12th Five Year Plan beneficiary list (see China Strategy: *Twelfth Five Year Plan – a healthy push*, 29 September 2010);
- Five stocks are either recently upgraded or among those we have initiated coverage on with BUY calls in 4Q: CRCC (November), China Life Insurance (November), China Mengniu Dairy (November), Perfect World (October), Agile Properties (October);
- We are not chasing momentum; stocks in this basket are mostly YTD share price underperformers. We believe sound fundamentals (average RoEs above 15%), forecast pick-ups in earnings growth in 2011F (average EPS growth of >20%) and conservative balance sheets (most with net cash) will support share price performance in 2011.

## Risks

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### Investment risks

- **Economic development uncertainty**

We believe all sectors' performances largely hinge on China's economic development. A weaker-than-expected economic recovery or a double-dip could significantly impact sectors' bottom-line growth, and hence the performance of the broader equity market.

- **Surging inflation**

If the CPI again surprises the market on the upside during 2011, equity market performance could be negatively impacted, as surging inflation would likely trigger the government to implement even more tightening measures on easing liquidity.

- **Change in government policies**

Equity market performance is susceptible to policies introduced by the government. Any change in policy or implementation could have a significant impact on market sentiment.

- **Assumption deviation**

We derive our MSCI China index price target based on certain forecasts for China's macro data during 2011, including four interest rate hikes, three RRR rises and about 5.8% RMB appreciation against the USD. If the actual largely deviates from our estimation, this could significantly affect our price target for the MSCI China index.

- **Liquidity fluctuation**

We believe liquidity will be sufficient in 2011 to support the market. Any major change in money supply or extreme tightening measures could substantially hit the market valuation level, causing market volatility.

## 2011 outlook

**Higher ground**

We are positive on China's equity market in 2011 after its rebound in 2009 and consolidation in 2010. We forecast the MSCI China Index and HSCEI Index will reach 83 and 16,000 by the end of 2011, offering 24% and 25% upside potential, respectively. We believe the strong performance will be backed by: 1) 21%+ earnings growth, with large-cap sectors such as financial and energy set to post strong earnings; 2) attractive valuations (13x 2011F earnings, in line with the 10-year average; 2.5x price/book with RoEs of 20%). Note that 2011 will also be the first year of China's 12<sup>th</sup> Five Year Plan, and we think the sectors set to benefit, such as the seven emerging industries with strategic importance, will receive a boost in sentiment. We believe fundamental support will remain the most important factor to drive equity market performance in 2011. In our view, sectors with an improving earnings outlook and strong RoE tend to outperform. Earnings growth outlook and RoE will become increasingly important and be rewarded when there are still uncertainties on the policy side, and cost of capital is on the rise, in our view.

We have developed a scorecard to quantify the impact of fundamentals (earnings growth, RoE), valuation (P/E, P/BV) and relative share price momentum on each sector. Our favoured sectors include Banking, Property, Online gaming, Consumption and Oil & Gas.

We believe that in 2011, a number of developments will impact company earnings and market sentiment, and thus present opportunities for equity market investment:

- 1) continuing from 2010, consumption will remain one of the major storylines in 2011;
- 2) inflation changes both company earnings expectations and market sentiment. We have found that in the past, the equity market has tended to experience a short-term correction when inflation continued to surprise on the upside, before picking up and gaining momentum after the CPI peaked. In addition, consumer-staple stocks tended not to perform well when inflation was out of control, but tended to perform very well during the early and latter stages of an inflation cycle;
- 3) implementation of China's 12<sup>th</sup> Five Year Plan (FYP) will likely trigger more investment opportunities for certain sectors, especially for emerging industries deemed to be of strategic importance;
- 4) the domestic interest rate hike cycle together with RMB appreciation will likely boost interest rate- and renminbi appreciation-sensitive sectors, including financials and transportation. However, concerns on valuations may offset some of the benefits to sectors such as airlines;
- 5) further global commodity price rises as a result of excess liquidity will likely eventually affect the China market and lead to divergent performance;
- 6) share price laggards with robust bottom-line growth and strong RoEs are included in our stock picks.

We think China will continue to deliver solid economic data in 2011, and this fundamentally makes us quite optimistic about China's equity market in 2011. Our economic team forecasts GDP growth of 10.2% in 2010, 9.8% in 2011 and 9.5% in 2012. With strong economic development, we forecast bottom-line growth for corporates of 21.4% and 19.0% for 2011 and 2012, respectively. We think accelerating urbanization, booming consumption, healthy export growth, robust investment and implementation of various measures as part of China's 12<sup>th</sup> Five Year Plan (FYP) will be the major drivers.

**We forecast MSCI China and HSCEI will offer >20% upside in 2011F**

**Key investment strategy for 2011**

**Solid bottom-line growth**

Apart from the solid bottom-line growth, we believe liquidity is also sufficient in 2011 to support the current P/E level. We estimate new bank loans of about RMB8trn for 2011 (vs a government loan quota of around RMB6.5trn), which may translate into around 18% M2 y-y growth. Although this is off from the recent peak of 27.7% y-y growth in 2009, our forecast 2011 M2 growth is still slightly higher than the historical average growth of 17.6% for the past decade. In addition, we believe there is likely to be more liquidity flowing from developed markets to emerging markets in search of higher returns. Growth in 'unexplained' foreign capital inflow to China has been high in the past several quarters.

During the 2008 bear market following the outbreak of the financial crisis, the index gave up more than it had put on during the 2007 bull run (the MSCI China index closed at 41 in 2008, after rallying from 52 in 2006 to 86 in 2007). With governments around the world launching more easing policies from 2Q09 onward, the market rebounded quickly from its 2008 low. Consumption stocks, both staple and discretionary, led the rally in 2009, joined by materials and financials – two important sectors that are contributing to the economic recovery. Meanwhile, booming liquidity as a result of quantitative easing around the globe has bid commodity prices higher, hence the outperformance of energy stocks.

### Macro-economic growth will remain healthy in 2011...

There is no little uncertainty over global economic prospects for 2011, associated with the probability of a double-dipping economy, excess liquidity from loosening monetary policy, relatively high unemployment, surging commodity prices and rising inflation. To tackle these problems, certain measures need to be implemented by policymakers which we believe will have a significant impact on China's overall economic development and hence its equity market.

Complicating the outlook for 2011, alongside these external uncertainties, China also faces its own challenges. The recent interest rate hike by the PBoC and three RRR rises signify the government's intention to tame excess liquidity and curb surging inflation. Plus, 2011 is the first year of China's Twelfth Five-Year Plan (FYP). We believe structural reform will be the major theme and, increasingly, the quality of economic growth is likely to hold more weight than the headline GDP growth number.

We estimate China's economic development will remain strong over 2011 and 2012, with growth of 9.8% y-y and 9.5% y-y, respectively, providing a solid basis for corporates' bottom-line growth. We think consumption will play an increasing role in terms of its contribution to GDP over the medium term, fuelled by the government's intention to shift the structure of economic development towards consumption and income distribution reform, including raising the minimum wage. Investment should also remain strong over the next two years, triggered by the rapid development of central and western China as the larger theme of industry transferring inland from eastern China, especially capital-intensive secondary industry, plays out.

**Liquidity should be supportive in 2011**

**Challenges for 2011: domestic and global**

**But still optimistic on China**

**Exhibit 17. China: major economic indicators**

% y-o-y unless otherwise stated	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	2010	2011	2012
Real GDP	<b>9.6</b>	9.2	9.4	9.7	9.9	10.0	9.0	9.4	10.2	9.8	9.5
Consumer prices	<b>3.5</b>	4.5	4.1	4.5	4.9	4.4	5.0	5.2	3.3	4.5	5.0
Core CPI	<b>1.1</b>	1.6	2.0	2.2	2.4	2.5	2.3	2.4	1.0	2.3	2.5
Retail sales (nominal)	<b>18.4</b>	18.6	20.1	19.7	19.9	20.1	20.3	20.6	18.4	20.0	21.0
Fixed-asset investment (nominal, ytd)	<b>24.0</b>	23.5	23.0	23.5	22.5	22.0	20.5	22.5	23.5	22.0	21.0
Industrial production (real)	<b>13.5</b>	13.7	12.8	14.2	15.1	16.0	15.1	14.1	15.8	14.5	14.2
Exports (value)	<b>32.3</b>	17.0	18.0	10.0	9.5	12.0	17.5	11.2	29.0	12.0	12.0
Imports (value)	<b>27.1</b>	18.5	12.0	14.0	13.0	16.0	14.0	17.0	35.6	13.8	16.0
Trade surplus (US\$bn)	<b>65.7</b>	35.4	35.3	31.4	59.1	61.9	53.2	12.1	189	188	147
Current account (% of GDP)									5.0	4.1	3.1
Fiscal balance (% of GDP)									-2.5	-1.3	-1.0
Net increase in RMB loans (RMB trn)									8.0	8.0	8.4
1-yr bank lending rate (%)	<b>5.31</b>	5.56	5.81	6.06	6.31	6.56	6.81	7.06	5.56	6.56	7.31
1-yr bank deposit rate (%)	<b>2.25</b>	2.50	2.75	3.00	3.25	3.50	3.75	4.25	2.50	3.50	4.75
Reserve requirement ratio (%)	<b>17.00</b>	18.50	19.00	19.50	20.00	20.50	20.50	20.50	18.00	20.50	20.50
Exchange rate (RMB/US\$)	<b>6.70</b>	6.60	6.50	6.40	6.30	6.22			6.60	6.22	6.00

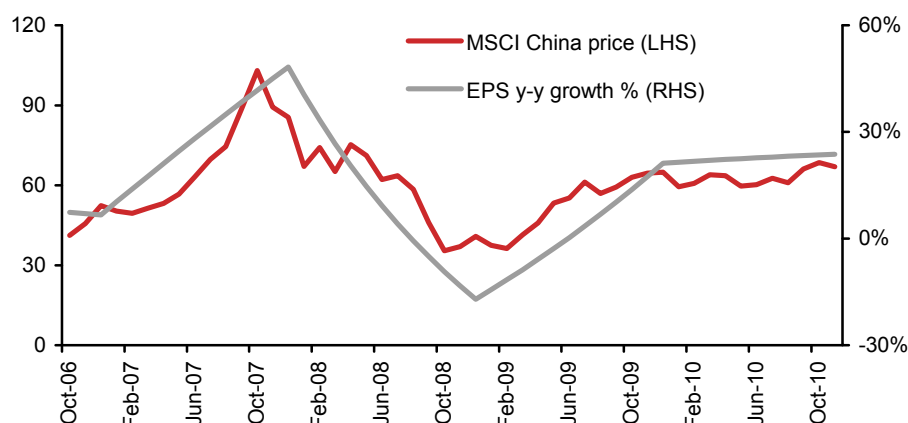
Note: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcomes).

Source: CEIC, Nomura economics team

**... and corporate earnings growth too**

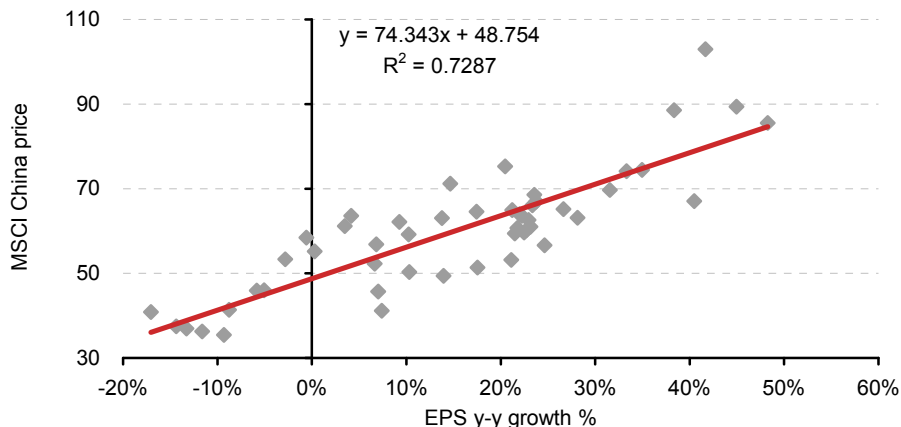
EPS growth is one of the fundamental drivers of equity market performance, as evidenced by the strong correlation historically between the MSCI China index price performance and bottom-line growth. We forecast Chinese corporate earnings growth for the MSCI China index of 21.4% in 2011 and 19.0% in 2012, following 23.9% EPS growth during 2010. This is also a clear manifestation of our positive view on China's overall business environment and robust demand, including rapid economic development, accelerating urbanisation and implementation of various measures as part of China's 12<sup>th</sup> FYP.

**Solid EPS growth amid strong economic development**

**Exhibit 18. MSCI China index price vs EPS y-y growth %**

Source: CEIC, Bloomberg, Nomura research

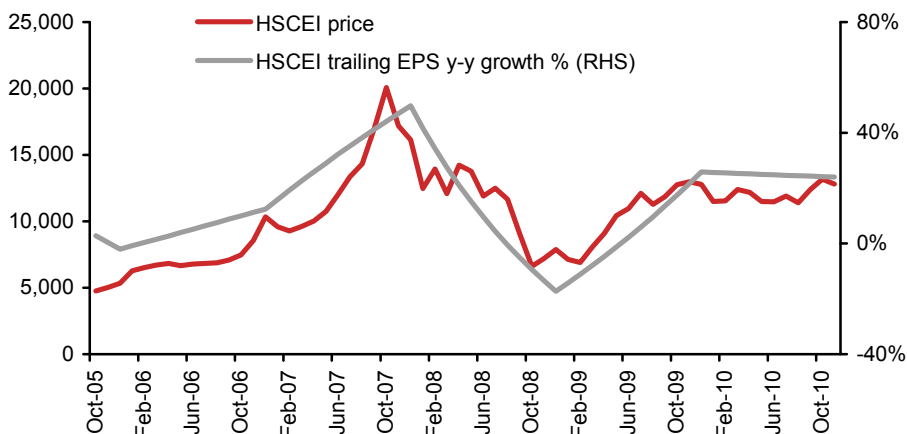
**Exhibit 19. Relationship between MSCI China index price and EPS growth**



Note: Using monthly data sets for the period from October 2006 – 2010 YTD

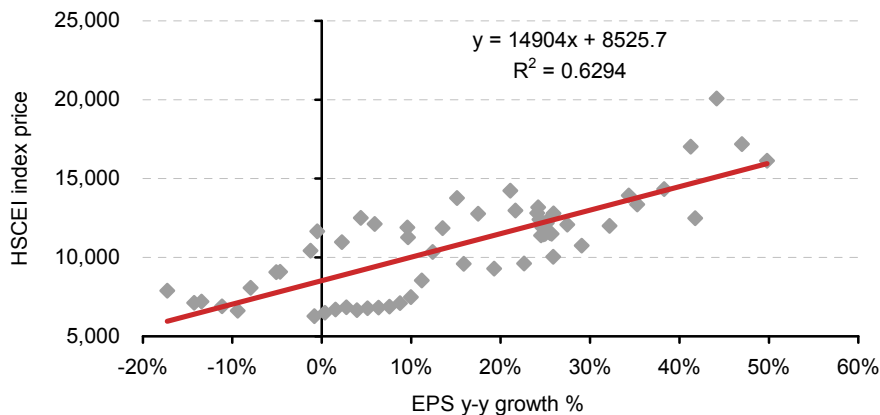
Source: CEIC, Bloomberg, Nomura research

**Exhibit 20. HSCEI price vs EPS y-y growth %**



Source: CEIC, Bloomberg, Nomura research

**Exhibit 21. Relationship between HSCEI price and EPS growth**



Note: Monthly data sets for the period from October 2005 – 2010 YTD

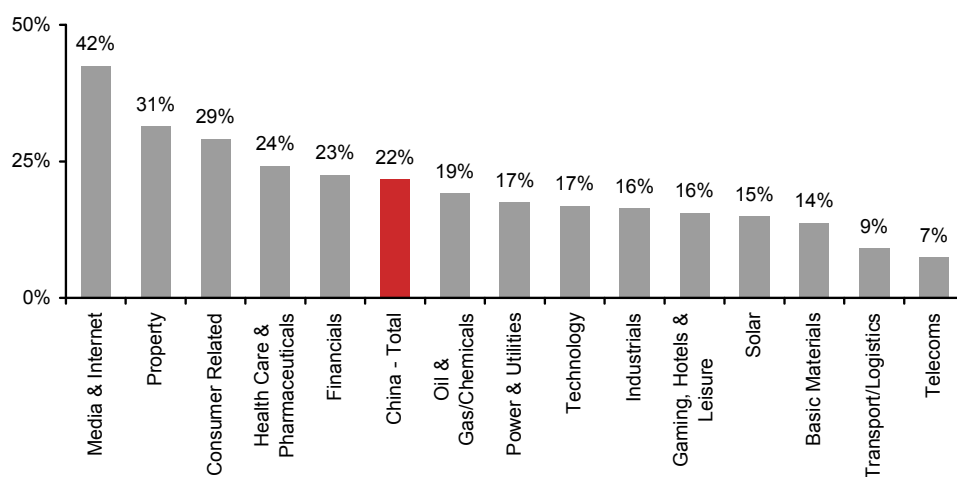
Source: CEIC, Bloomberg, Nomura research

Our EPS forecasts are slightly higher than market estimates (currently 3.1% higher for 2011F and 5.4% for 2012F). We forecast that the Media & Internet, Property, Consumer, Healthcare, and Financials sectors will outperform in 2011, whereas sectors including Industrials, Telecoms, Utilities, Transport and Macro gaming will likely underperform the index's bottom-line growth. This is one of our central considerations in assessing investment opportunities for 2011.

**Our 2011 EPS forecast is slightly higher than consensus**

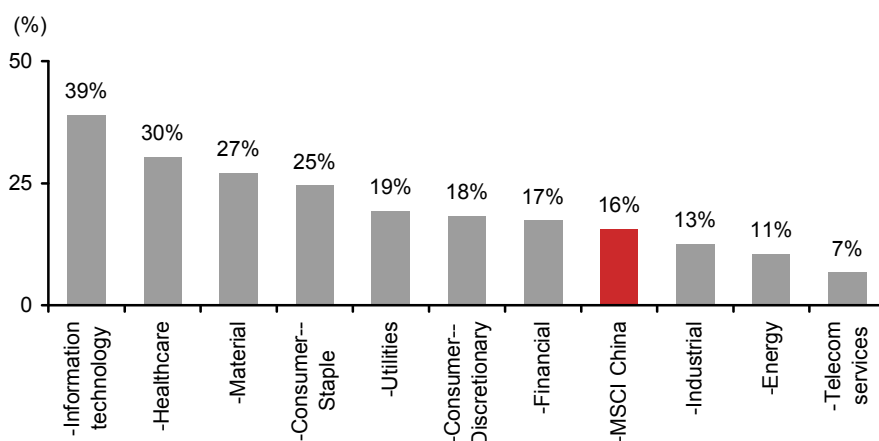
The market has been revising up its forecast of the index's bottom-line growth for 2011, narrowing the spread between our forecast and the consensus estimate. The market estimate for 2011 EPS for the MSCI China index has been revised up by 5% in 2010 YTD to 4.8%, from 4.6% at the beginning of this year. The Industrials and Healthcare sectors have seen the biggest upward revisions in estimated EPS. We attribute this to earnings upgrades for airline, commercial vehicle, construction machinery and healthcare companies after strong 1-3Q10 operating results. If the financial sector delivers better-than-expected 1Q11 operating results by confirming margin expansion, we believe further earnings upgrades and revisions will follow.

**Exhibit 22. Nomura China 2011 EPS growth by sector**

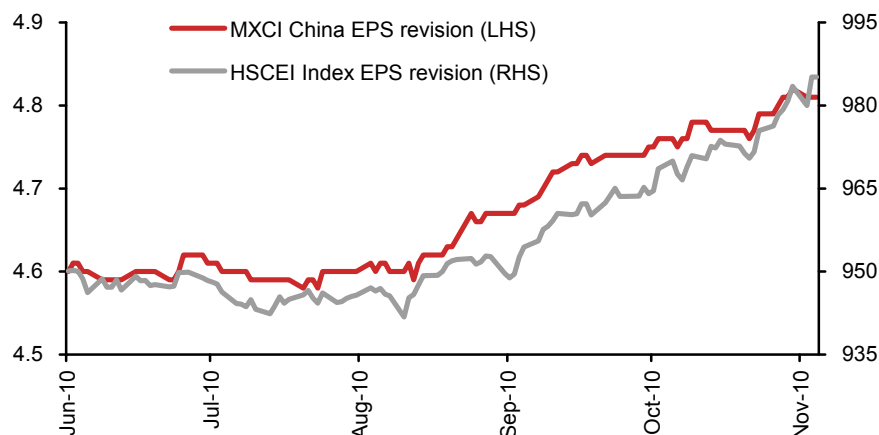


Source: Nomura research

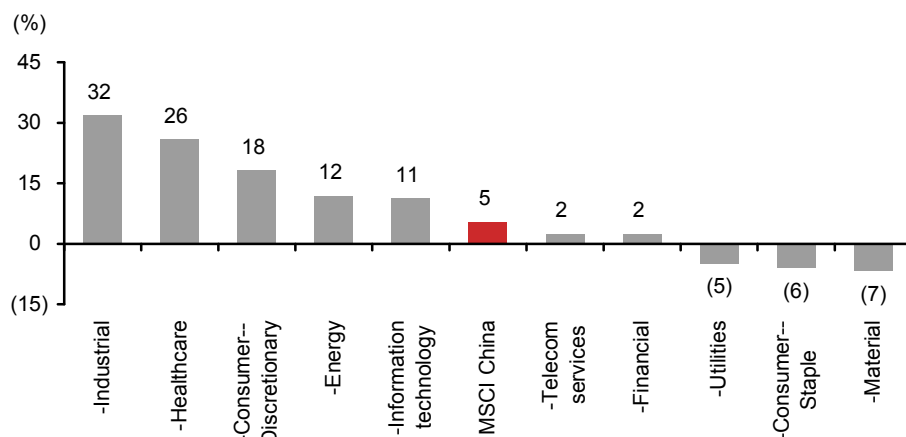
**Exhibit 23. MSCI China consensus 2011 EPS growth by sector**



Source: Bloomberg, Nomura research

**Exhibit 24. Consensus estimate 2011 EPS revisions**

Source: Bloomberg, Nomura research

**Exhibit 25. MSCI China consensus 2011 EPS % revisions by sector (TYD)**

Source: Bloomberg, Nomura research

## Sufficient liquidity will add fuel

We anticipate sufficient liquidity in 2011 to support current valuations. We estimate that the forward P/E for the MSCI China index changes slightly to 12.1x for 2011, from 11.8x at end November 2010, and the P/E for the HSCEI index to 11.4x by end-2011, from 11.1x at end November 2010. Our rationale:

- 1) a rising tide lifts all boats – keeping in mind a strong correlation between P/E valuation and M2 growth, we estimate M2 growth at 18.0% for China and 7.0-9% for Hong Kong in 2011. We estimate approximately RMB8.0trn in new loan growth for 2011, as the real economy is still facing considerable downside risk and needs to be further stimulated;
- 2) ‘unexplained’ foreign capital inflows – we witnessed ‘unexplained’ foreign capital inflows and FX reserve accumulation accelerating at their fastest pace in a decade, amid quantitative easing measures from developed markets, including the US and Japan, which will likely further increase liquidity;
- 3) wealth transfer – household savings are likely to an extent flow into the equity market and out of commercial banks, which will likely boost liquidity.

**Still ample liquidity in 2011F**

Sufficient money supply is partly the reason for China's hitherto booming economy. During the past decade, China has recorded much higher growth in money supply than GDP growth. When the real economy is in good shape, sufficient money supply will provide a solid base for economic development, such as financing the capital expenditure of enterprises. On the other hand, any slowdown in economic development could result in significant money oversupply relative to the needs of the real economy, causing excess liquidity for the overall economy. The likely outcome: asset bubbles, including rising commodity prices, increasing property prices and/or a surging equity market.

We think excess money supply is becoming more of a concern for the authorities, which will likely lead to tightening measures in 2011. Our economics team forecasts four interest rate hikes, for a total 100bps, and three RRR increases totalling 150bps over the course of 2011. We think these tightening open market measures could help mop up some liquidity, but history shows that excess liquidity may not be fully reined in. In the 2006-07 bull market, we note seven consecutive interest rate hikes and 11 successive RRR rises as the government relied solely on open market measures.

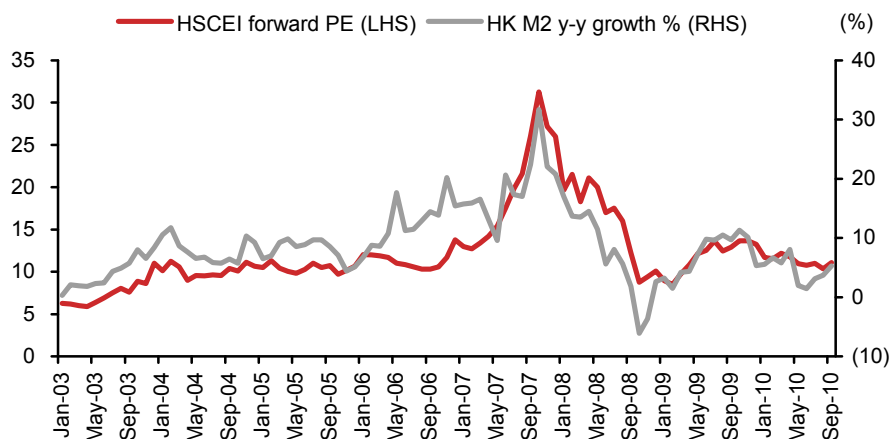
**Measures to be carried out to rein in liquidity, but these may not be effective**

**Exhibit 26. MSCI China index forward PE vs HK M2 growth**

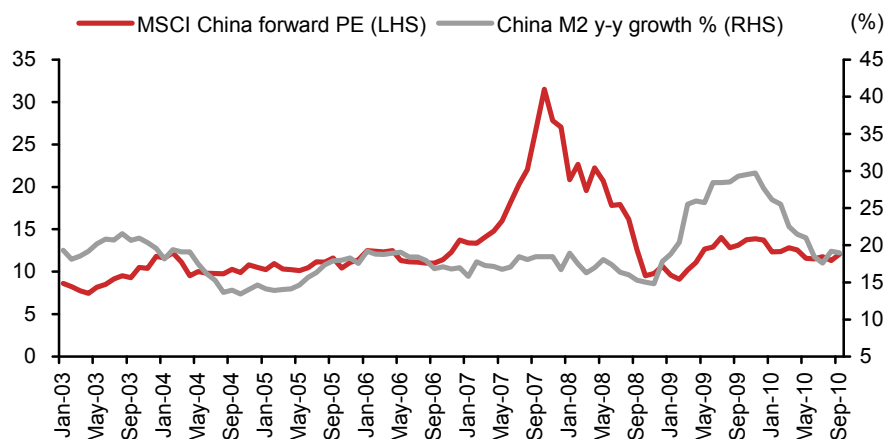


Source: CEIC, Bloomberg, Nomura research

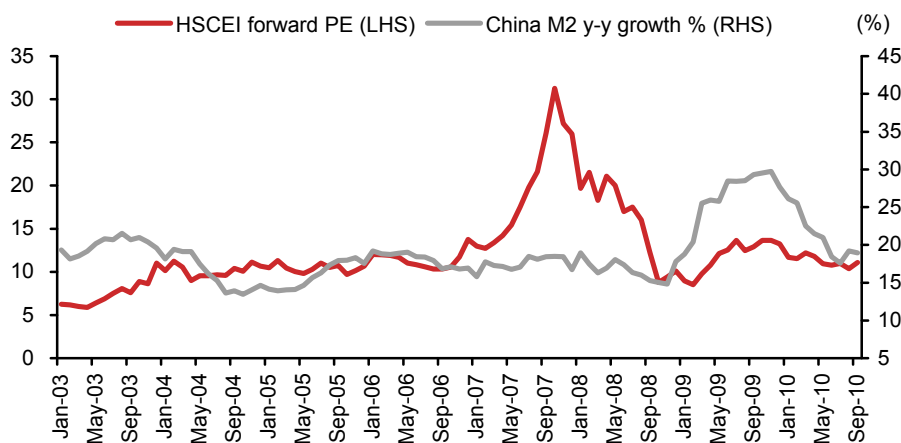
**Exhibit 27. HSCEI forward PE vs HK M2 growth**



Source: CEIC, Bloomberg, Nomura research

**Exhibit 28. MSCI China index forward PE vs China M2 growth**

Source: CEIC, Bloomberg, Nomura research

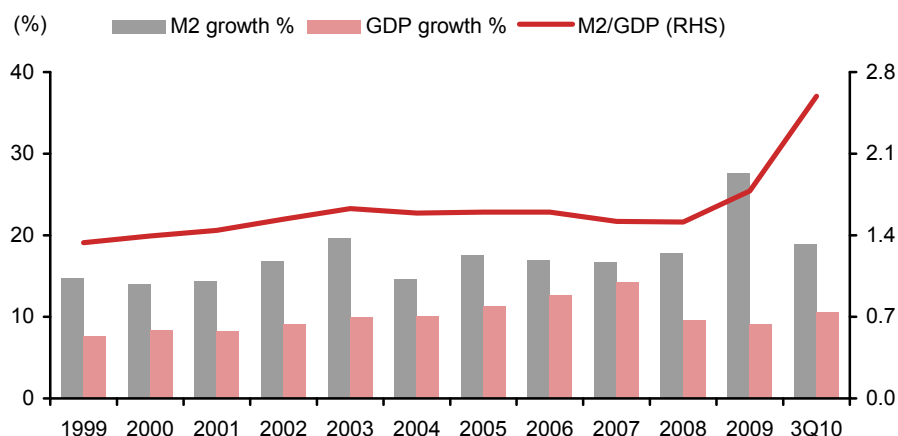
**Exhibit 29. HSCEI forward PE vs China M2 growth**

Source: CEIC, Bloomberg, Nomura research

M2 in circulation reached RMB69.6trn by end-3Q10, about RMB42.8trn higher than nominal GDP amounting to RMB26.9trn for 1-3Q10 — the largest such gap in the past decade. This underlines the current abundance of liquidity. Average growth in M2 over the past decade is 17.5%, far outpacing GDP growth of 10.1%. The ratio of M2 to nominal GDP reached 1.78 in 2009 and 2.59 for 1-3Q10, indicating that current money supply is far in excess of the needs of the real economy. We think this ratio will shrink in 2011 at a relatively slow pace and remain very high.

While the 2011 new loan quota will likely be lower — in the range of RMB6.0-7 trillion, on our estimates — we expect actual loan demand in China to reach RMB8.0 trillion in 2011, on 9.8% GDP growth and 22% FAI growth. Aggressive tightening of monetary policy is not likely, as we think the real economy still faces considerable downside risks and needs to be further stimulated. Capital expenditure, a major indicator of the real economy, is at its lowest in almost seven years, and there is no clear sign of a recovery for 2011, according to the consensus view. We estimate M2 growth will remain high, at 18.0% for China and 7-9% for Hong Kong in 2011.

**M2 growth remains high**

**Exhibit 30. M2 vs GDP**

Source: WIND, CEIC, Nomura research

**Exhibit 31. Actual loans vs loan quota**

	New loans (RMBbn)	Loan quota (RMBbn)	Difference (RMBbn)	Difference as % of loan quote	CPI (%)	MSCI China Financials sector relative return to MSCI China (%)
2002	1,898	1,300	598	46	(0.8)	(27)
2003	2,770	1,800	970	54	1.2	8
2004	1,920	2,600	(680)	(26)	3.9	(4)
2005	1,649	2,500	(851)	(34)	1.8	5
2006	3,066	2,500	566	23	1.5	59
2007	3,634	2,900	734	25	4.8	(30)
2008	4,170	3,630	540	15	5.9	6
2009	9,629	9,500	129	1	(0.7)	9
2010	6,900 for Jan.-Oct. 2010	7,500			3.0 (2010 YTD)	(4)
2011 *	8,000	6,000 – 7,000				

Notes: \* our forecast; pricing as of 1 December 2010

Source: WIND, CEIC, Nomura research

**Exhibit 32. Capex to sales by sector**

Capex to sales (%)	2004	2005	2006	2007	2008	2009	Oct 2010
-Utilities	48.1	44.1	44.5	42.5	58.3	45.7	35.0
-Telecom services	32.0	28.4	27.0	27.4	25.9	28.9	26.5
-Energy	16.9	13.2	11.6	15.2	15.8	19.5	14.2
-Material	10.6	10.3	10.5	12.5	11.0	11.4	10.3
-Consumer--Staple	3.1	14.8	15.5	10.0	11.2	8.9	8.4
-Industrial	20.1	14.8	14.4	10.4	10.7	9.0	7.5
-Financials	2.6	9.7	7.3	5.2	6.0	7.7	5.0
-Consumer--Discretionary	7.9	6.7	6.7	7.0	7.4	5.2	4.4
-Information technology	7.9	6.7	6.7	7.0	7.4	5.2	4.4
-Healthcare	44.1	44.1	15.0	15.0	15.0	21.7	2.0
<b>MSCI China</b>	<b>17.5</b>	<b>14.7</b>	<b>12.9</b>	<b>13.4</b>	<b>13.5</b>	<b>13.1</b>	<b>11.0</b>

Source: WIND, CEIC, Nomura research

We note a trend of wealth transfer, with household savings going from commercial banks to the equity market amid a large number of newly opened stock accounts, especially in periods featuring a stock-market rally and decreasing purchasing power (negative real interest rates). With a year of possibly continued negative real interest rates and our expected equity market rally, we expect the wealth transfer trend to play out once again, which in turn should boost liquidity in 2011.

**Wealth transfer further boosts liquidity**

We have examined 46 monthly data sets covering changes in household savings and the real interest rate, as well as index performance. The 11 instances of household savings outflow generally coincided with the stock market recording a better-than-average return and real interest rates being negative. At the same time, the number of newly opened stock accounts also reached a high level. The only exception was in April 2010, when there was a relatively small household savings outflow.

We also compared these data sets to changes in residential property prices, and found the relationship does not hold in this case. We think this phenomenon is understandable given: 1) people have an incentive to invest their money in the equity market when it is rising, as they go in search of more capital gains; 2) this situation is solidified when negative real interest rates start eating into household wealth; 3) the generally large downpayment required for property purchases is a concern for many interested parties; and 4) the stock market inevitably becomes the best pool for storing up liquidity, apart from property investment, due to the lack of other effective investment instruments in China.

### Exhibit 33. Change in household savings vs index performance and real interest rate

	One year deposit rate (%)	Monthly CPI (%)	Real interest rate (%)	MSCI China m-m % change	HSCEI m-m % change	Stock accounts newly opened (mn)	Change in household savings (RMBbn)	Residential property price m-m % change
Apr-07	2.8	3.0	(0.2)	3.6	4.4	4.8	(167.4)	(0.2)
May-07	3.1	3.4	(0.3)	6.6	7.0	6.0	(278.4)	1.0
Jul-07	3.3	5.6	(2.3)	10.4	11.4	2.0	(9.1)	1.5
Aug-07	3.6	6.5	(2.9)	6.9	7.3	3.8	(41.8)	1.6
Sep-07	3.9	6.2	(2.3)	18.9	18.7	4.0	(14.1)	1.3
Oct-07	3.9	6.5	(2.6)	16.3	18.0	3.6	(506.2)	1.0
Jul-09	2.3	(1.8)	4.1	10.8	10.6	2.4	(19.2)	1.2
Oct-09	2.3	(0.5)	2.8	6.4	7.7	0.9	(250.7)	0.6
Apr-10	2.3	2.8	(0.5)	(0.6)	(1.7)	1.3	(41.9)	2.6
Jul-10	2.3	3.3	(1.1)	4.1	3.8	1.1	(42.5)	(1.1)
Oct-10	2.5	4.4	(1.9)	3.8	6.1	1.2	(700.3)	1.2
<b>Average *</b>				<b>1.1</b>	<b>1.2</b>	<b>1.8</b>	<b>288.8</b>	<b>1.1</b>

\* Average represents the average monthly number for the period from January 2007 to October 2010.

Source: WIND, CEIC, Bloomberg, Nomura research

### Exhibit 34. Three-month rolling correlation between A and H shares



Source: Bloomberg, Nomura research

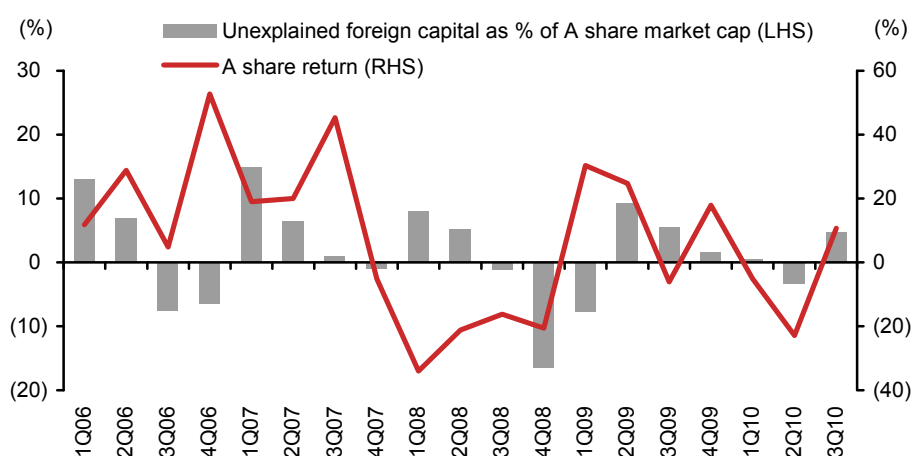
The 'unexplained' foreign capital inflows to China and Hong Kong are another support for liquidity in 2011, in our view. The recent QE2 plan implemented by the US government further pushes liquidity flows from developed markets into emerging markets like China.

**'Unexplained' foreign capital inflow is favourable for liquidity**

We have seen the 'unexplained' foreign capital inflows and FX reserve accumulation accelerating at the fastest pace in a decade in search of capital gains from renminbi appreciation, with the highest interest spread for the past decade between China and the US as well as the EU. During 2009, 'unexplained' foreign capital inflows reached a peak of US\$160.9bn, on our estimate, accounting for 7.3% of A-share market cap in circulation and hitting US\$88.1bn for 1-3Q10, accounting for 4.0% of A-share market cap in circulation. Moreover, 'unexplained' foreign capital inflows in Hong Kong reached some HK\$600bn in 2009, with HK\$400bn heading into the equity market, according to the HK government. We expect this trend to accelerate during the next two years.

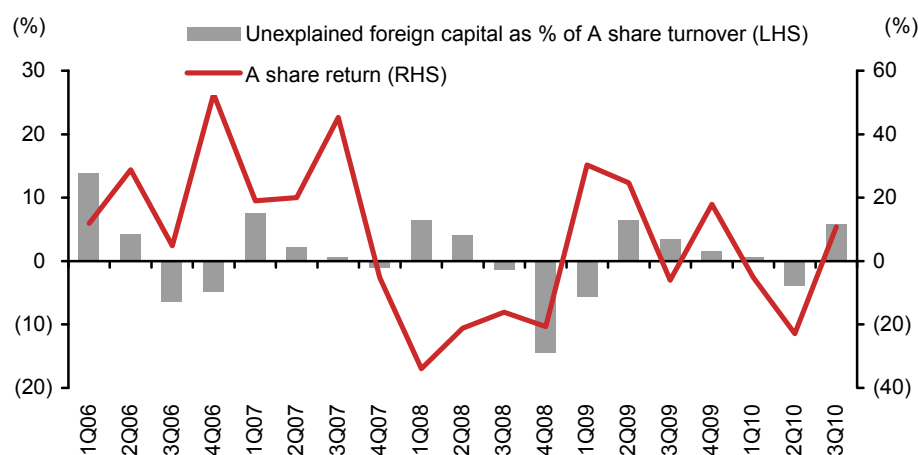
We do not think potential IPO fund raising will significantly impact market performance on the downside, since IPO fund raising tends to expand when the market is booming.

**Exhibit 35. 'Unexplained' foreign capital inflows as % of market cap vs A share return**



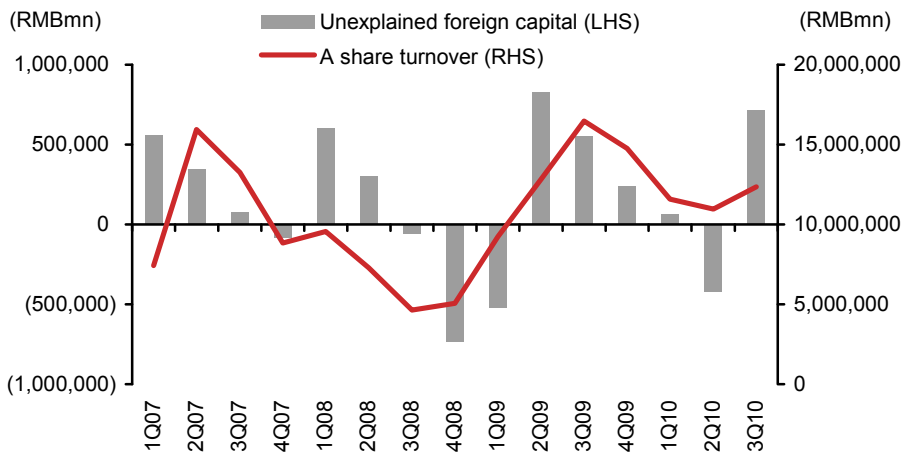
Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 36. 'Unexplained' foreign capital inflows as % of turnover vs A share return**



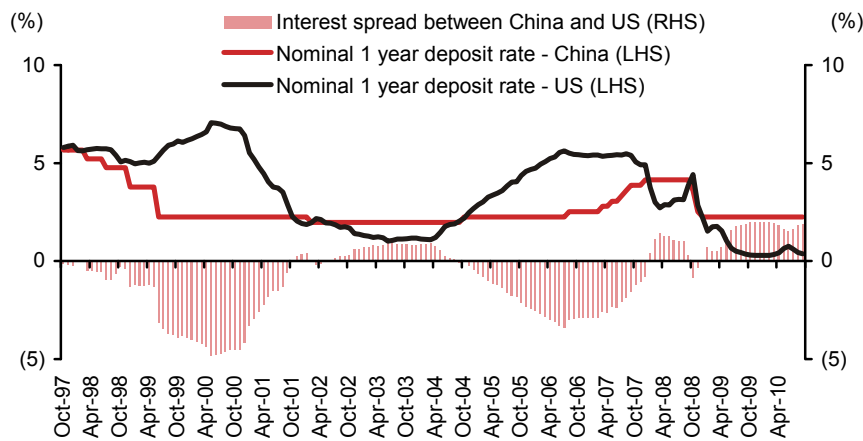
Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 37. 'Unexplained' foreign capital inflows vs A share turnover**



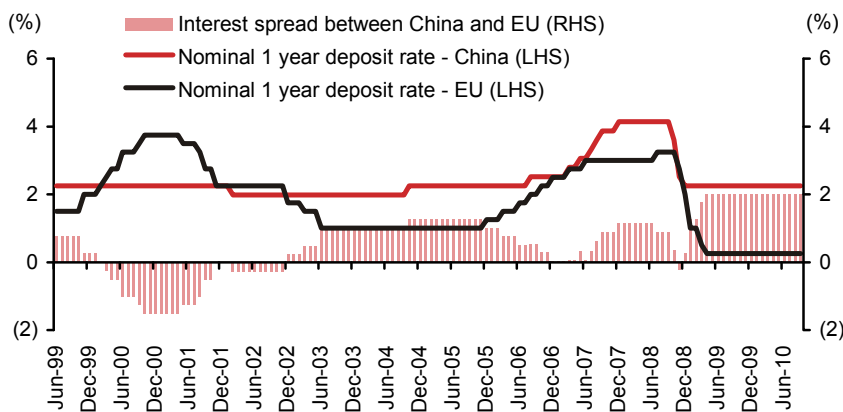
Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 38. Interest spread between China and US**

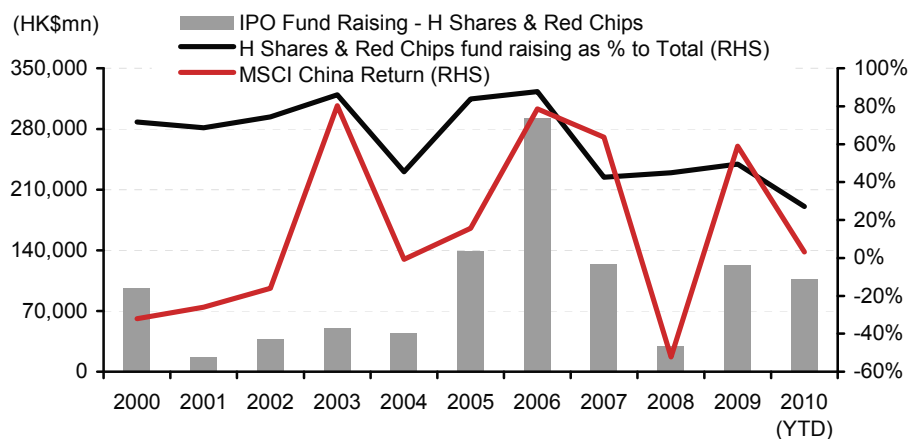


Source: CEIC, Nomura research

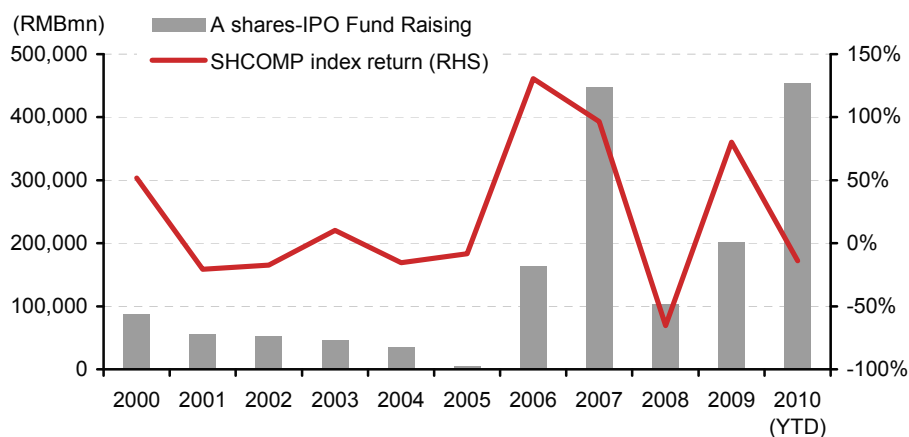
**Exhibit 39. Interest spread between China and EU**



Source: CEIC, Nomura research

**Exhibit 40. Index return vs IPO fund raising by China stocks (HK market)**

Source: CEIC, Nomura research

**Exhibit 41. Index return vs IPO fund raising by China stocks (China market)**

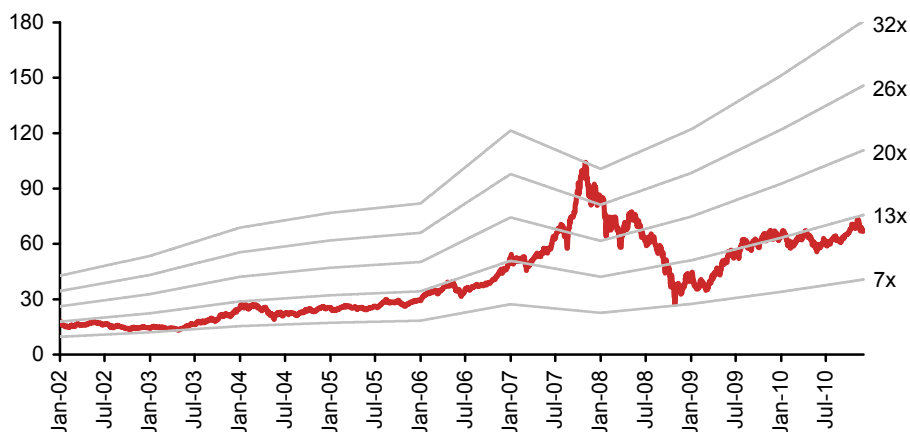
Source: CEIC, Nomura research

**Undemanding looking valuations**

We find the MSCI China and HSCEI are currently trading at 11.8x and 11.2x 12-month forward earnings, respectively, compared with average multiples of 12.6x and 11.7x for the past nine years.

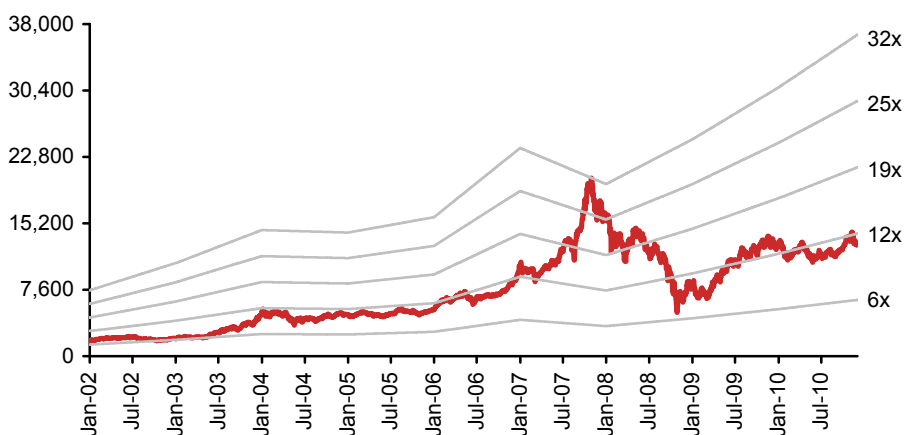
- We forecast MSCI China corporate earnings will grow by 21.4% and 19.0% in 2011F and 2012F, respectively. This compares with MSCI China average earnings growth of 18% since 1994;
- Most sectors are still trading in line with or below their respective historical averages. Sectors with valuations substantially above the historical average include Consumer staples, IT and Healthcare.
- When taking earnings growth and RoE into account, large-cap sectors including Financials, Properties and Oil & gas still look attractive, we find.

**Exhibit 42. MSCI China Index forward P/E band**



Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 43. HSCEI Index forward P/E band**



Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 44. MSCI China Index forward P/E**



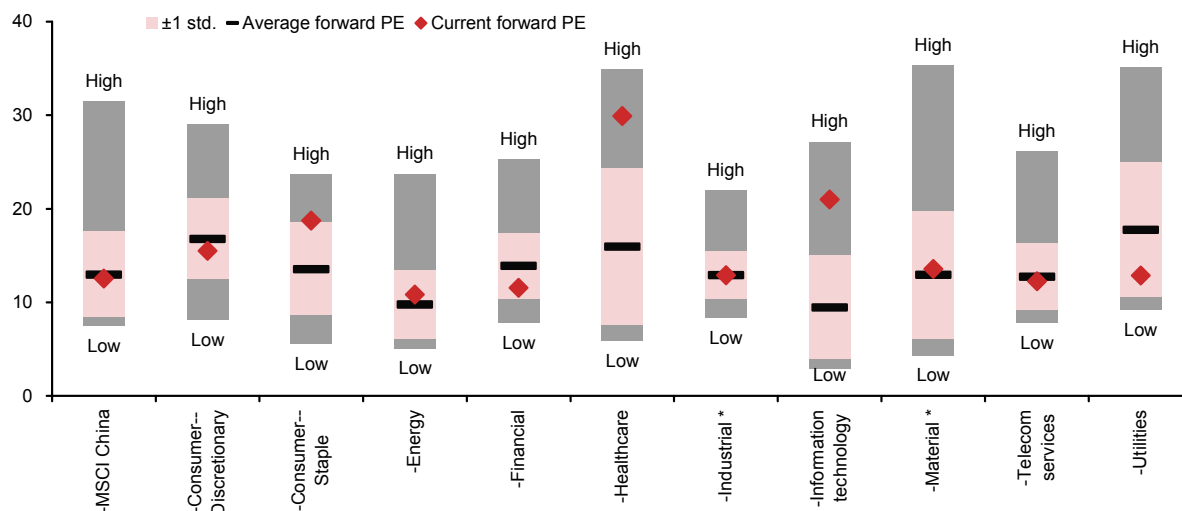
Source: CEIC, Nomura research

Exhibit 45. HSCEI Index forward P/E



Source: CEIC, Nomura research

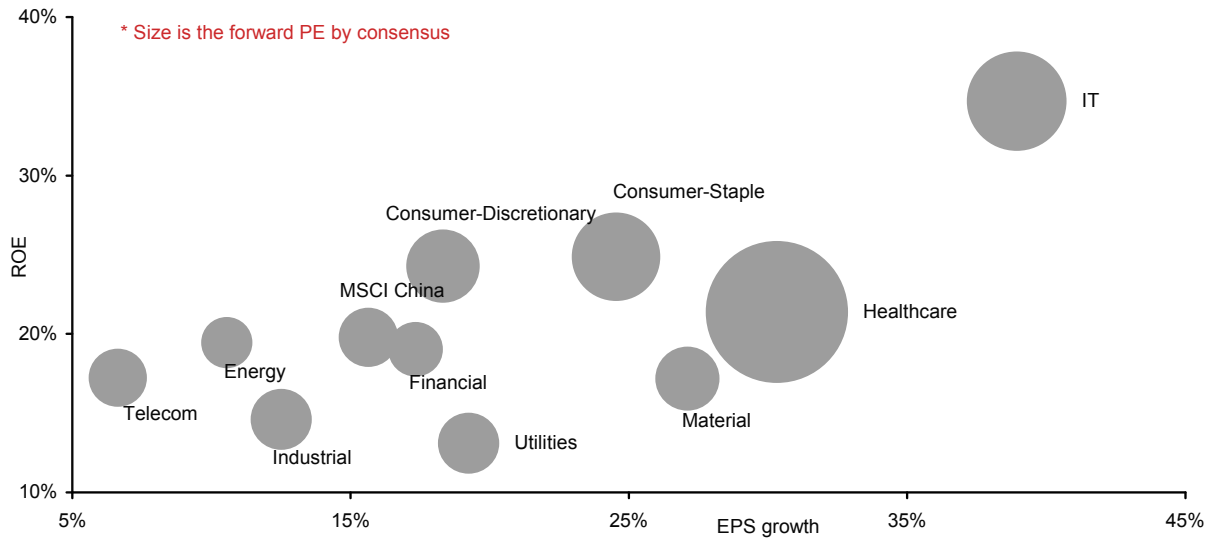
Exhibit 46. Forward P/E comparison by MSCI China index sector breakdown (January 2003 – 2010 YTD)



\* Adjusted, as there is a significant outlier number in 2009 which we believe does not objectively reflect market valuation

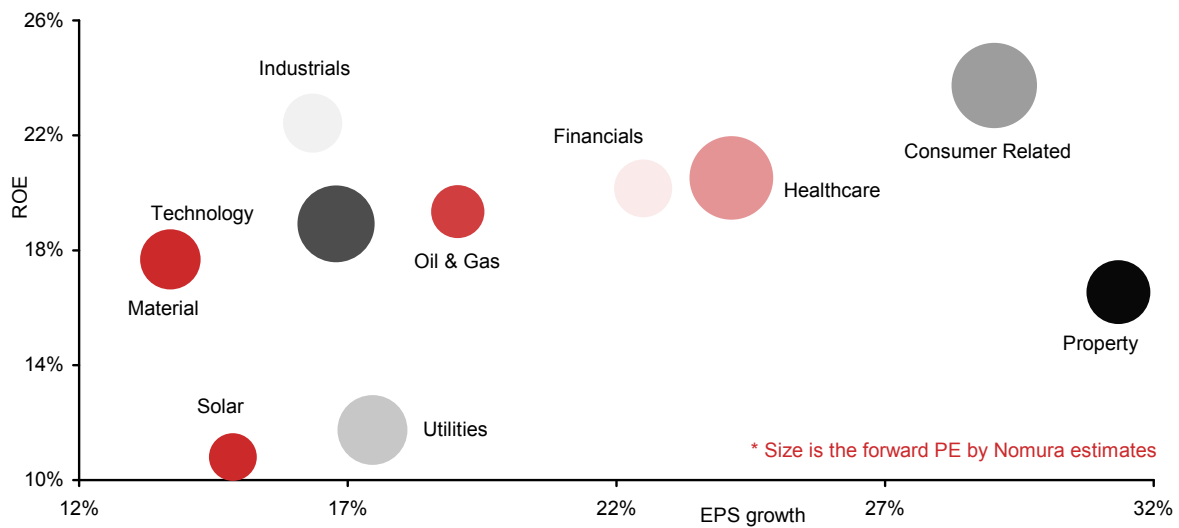
Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 47. Sector comparison of MSCI China (2011)**



Source: WIND, CEIC, Bloomberg, Nomura research

**Exhibit 48. Sector comparison of Nomura covered list (2011)**



Source: WIND, CEIC, Bloomberg, Nomura research

## Catalysts

## Investment opportunities in 2011

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We believe that in 2011, a number of developments will impact company earnings and market sentiment, and thus present opportunities for equity market investment:

- 1) continuing from 2010, consumption will remain one of the major storylines in 2011;
- 2) inflation changes both company earnings expectations and market sentiment. We have found that in the past, the equity market has tended to experience a short-term correction when inflation continued to surprise on the upside, before picking up and gaining momentum after the CPI peaked. In addition, consumer-staple stocks tended not to perform well when inflation was out of control, but tended to perform very well during the early and latter stages of an inflation cycle;
- 3) implementation of China's 12<sup>th</sup> Five Year Plan (FYP) will likely trigger more investment opportunities for certain sectors, especially for emerging industries deemed to be of strategic importance;
- 4) the domestic interest rate hike cycle together with RMB appreciation will likely boost interest rate- and renminbi appreciation-sensitive sectors, including financials and transportation. However, concerns on valuations may offset some of the benefits to sectors such as airlines;
- 5) further global commodity price rises as a result of excess liquidity will likely eventually affect the China market and lead to divergent performance;
- 6) share price laggards with robust bottom-line growth and strong RoEs are included in our stock picks.

### Consumption – long-term positive

We are bullish on consumption in the long run given: 1) consumption should benefit from transforming growth patterns; 2) income distribution reforms, especially the minimum wage adjustment, should boost consumption (See our Anchor report: *Twelfth Five Year Plan – a healthy push*, 29 September, 2010.) Our expectation that 2011 will be another year of inflation, with annual CPI reaching 4.5%, further supports our view, with consumption being a clear beneficiary in the near term. Given general price inelasticity in demand for consumption products, the implication is strong pricing power, especially for staples. We think price hikes are likely in a high inflation period, which is positive for sales. Possible price controls on certain upstream products will likely again enhance margins for the consumer sector. Both will likely prompt robust bottom-line growth and strong RoE, providing a platform for the consumer sector to outperform.

### Inflation makes the difference

The consumption sector is high susceptible to fluctuations in inflation, and we think investment strategy needs to be carefully considered, especially for 2011, with expected volatility in the monthly CPI figures. We forecast the annual CPI will reach 4.5% in 2011, for another year of high inflation, following on from 2004 and 2007-08.

After examining the consumer-staple index performance relative to the MSCI China index during the high inflation periods of 2004 and 2007-2008, we find that the consumer-staple sector underperformed the index during periods in which the monthly CPI exceeded 3%. The consumer-staple index, by contrast, outperformed the MSCI China index in both pre-inflation and post-inflation periods.

We think this is mainly attributable to the following: 1) pre-inflation period: booming demand likely drives sales in the consumer-staple sector ahead of inflation picking up, and the market then tends to reward the sector on improved operating results; 2) during inflationary periods: rising costs and possible government measures to tackle

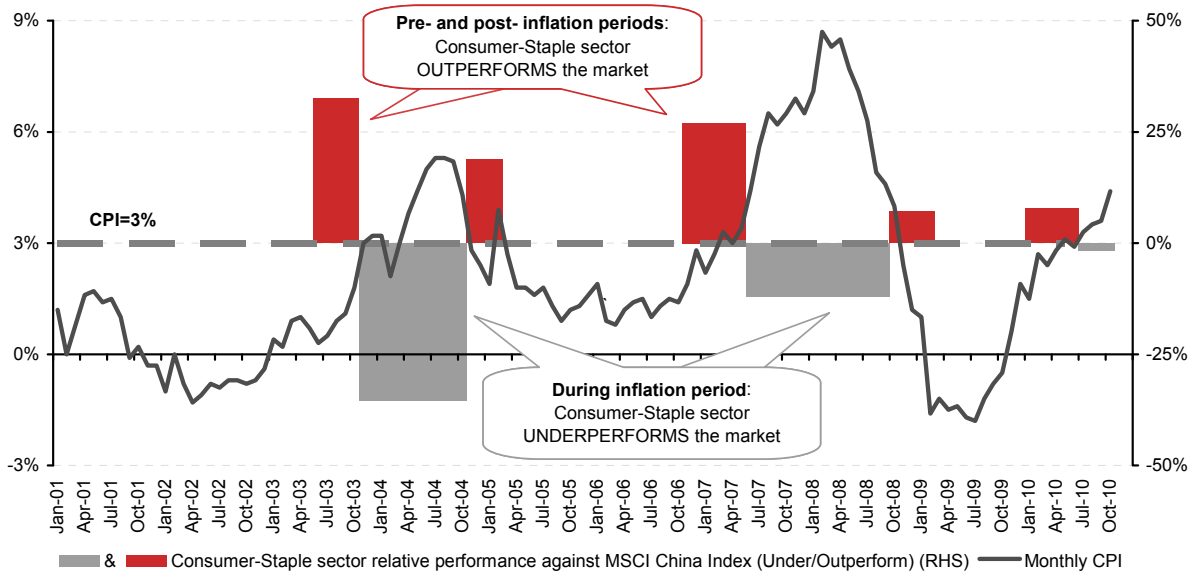
**Key investment strategy for 2011**

**Consumption remains the major storyline in 2011**

**Consumer sector investment to avoid high inflation period**

high inflation, including administrative and market measures such as price controls and interest rate hikes, likely drag down the already priced-in consumption sector; and 3) post-inflation period: easing concern on high inflation likely boosts the consumer-staple sector. Moreover, throughout the whole inflationary period, the consumer-staple sector benefits by recording higher top-line growth and improved margins, which by rights ought to be rewarded by the market.

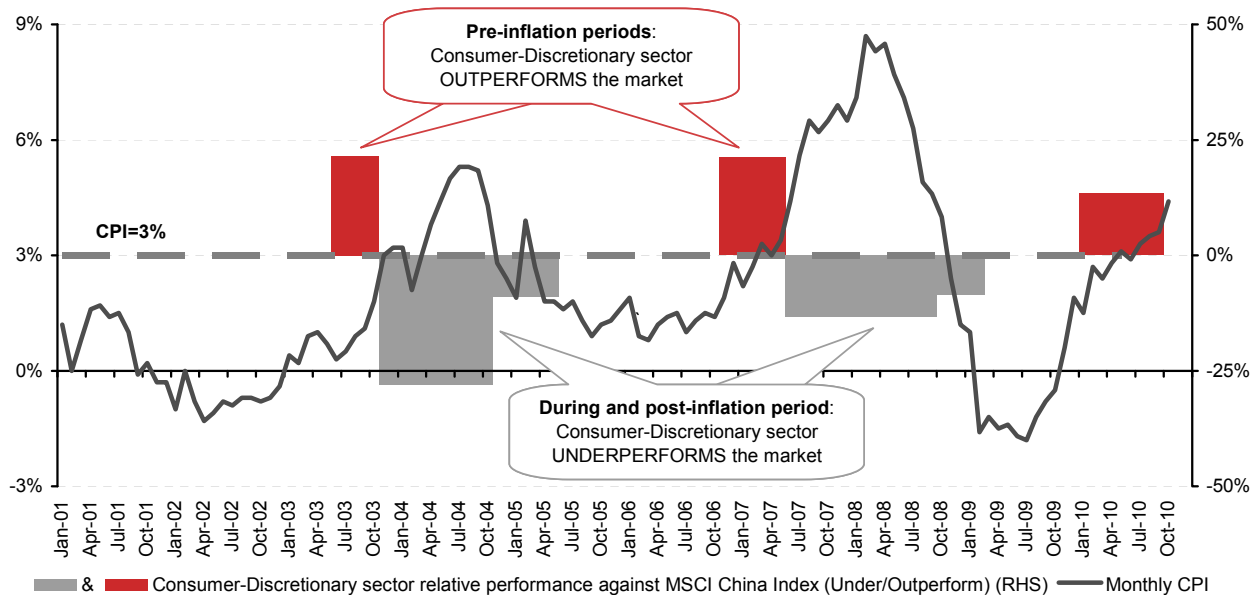
**Exhibit 49. Consumer-Staple sector relative performance vs inflation**



Source: WIND, CEIC, Bloomberg, Nomura research

We detect a similar trend in the performance of the consumer-discretionary sector relative to the market index in an environment of high inflation. The only exception is in the post-inflation period, when the consumer-staple sector outperformed the market index and the consumer-discretionary underperformed the index. We think this is mainly attributable to the aftermath of the government’s measures, including interest rate hikes and RRR rises aimed at taming liquidity, which will negatively impact demand in the discretionary sector relative to the consumer-staple sector, being less elastic to liquidity fluctuation.

**Exhibit 50. Consumer-Discretionary sector relative performance vs inflation**



Source: WIND, CEIC, Bloomberg, Nomura research

## Price controls – 2003, 2007, 2011?

The October major economic data released by the National Bureau of Statistics of China (Stats China) revealed that the monthly CPI surged to 4.4%, from 3.6% the previous month. This has heightened concern over inflation. YTD 2010 CPI stands at 3.0%, and we forecast the 2011 CPI will reach 4.5%. We think the recent aggressive tightening measures, including one interest hike and three RRR rises, suggest that inflation could further surprise the market on the upside in the coming months.

We think this would not bode well for the equity market in the short term, since historically the China H-share market has tended not to reward investors when inflation has exceeded 3%. Between October 2000 and October 2010, of the 33 months in which the CPI exceeded 3%, the H-share index posted negative returns in 18 months.

China has experienced two bouts of high inflation (CPI over 3%) in the past decade.

- December 2003 – October 2004, lasting 11 months, with the CPI taking around eight months to peak out
- May 2007 – October 2008, lasting 18 months, with the CPI taking about 10 months to peak out

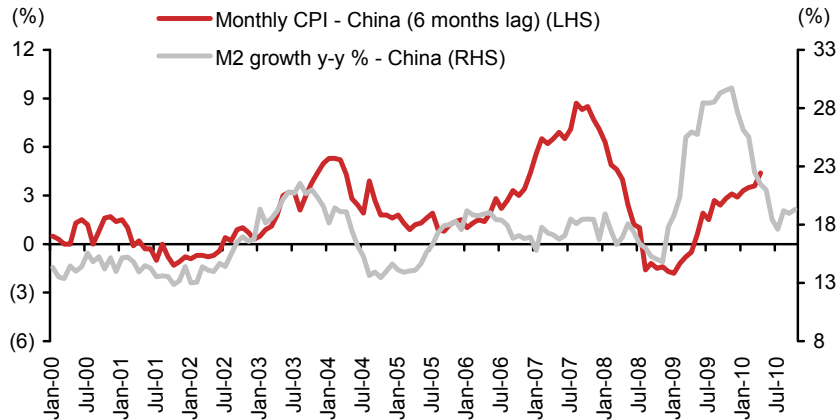
**Inflation: repeat of 2003-04 or 2007-08?**

The current run of inflation started in July 2010 (again, we take consecutive monthly CPI readings of over 3% as our definition of inflation) and has so far lasted four months. We think that a repeat of the historical CPI trajectory would be supportive of our positive view on the equity market for 2011.

The high inflation rate will in particular affect the downstream Food & Beverage sector due to raw material cost rises, in our view. We think highly concentrated sectors with relative strong bargaining power are likely to pass on rising costs to end-customers. According to Stats China, monthly PPI rose to 5.0% in October, from 4.3% in the prior month, for a 2010 YTD PPI reading of 5.5%. We think PPI will fall to 3.5% in 2011. Together with our forecast that the CPI will trend up to 4.5% in 2011, from the current YTD reading of 3.0%, we believe both factors are on course for a reversal in trend in the coming year. We think this is likely to benefit the material and industrial sectors — both tend to experience margin expansion due to material costs decreasing, stemming from a declining PPI growth rate, together with rising product selling prices resulting from rising inflation and relatively strong bargaining power. However, we view the auto sector as prone to facing margin pressure in the face of rising costs, since auto companies have very little bargaining power with end consumers.

We think it is possible that price controls are in place on certain daily necessities to curb inflation, mirroring the situation in 2004 and 2008, including meat and grains. The government imposed price controls on pork and wheat in mid-2007, when the monthly CPI reached 4.4%, and price controls were expanded to grain, edible oil, pork, beef, eggs, milks and LPG when the CPI surged to 7.1% in January 2008. In general, we think price controls will be effective for consolidated sectors or industries dominated by large SOE companies (autos, utilities, telecom, oil and chemical, agriculture), but not for segmented and privately owned industries such as F&B and retail. We think the price controls were mainly aimed at upstream products. As a result, downstream companies enjoyed the benefits from 2H07 onwards, and this was reflected in their share price outperformance in 2007 (during the market rally) and 2008 (during a market collapse). We think such short-term share price weakness could present buying opportunities, as the downstream would likely be among the first to feel the benefits of price controls when raw material costs fall while end-product prices remain firm or even go up.

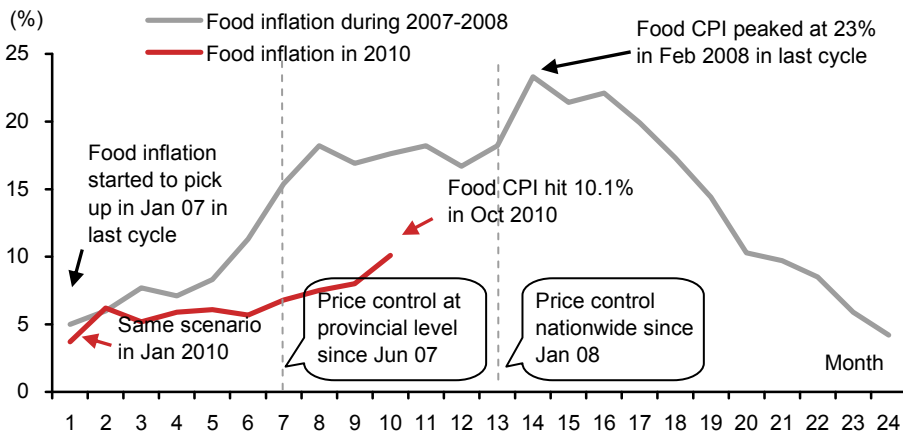
**Exhibit 51. Monthly CPI vs M2 y-y growth %**



**M2 growth has historically led inflation by about six months**

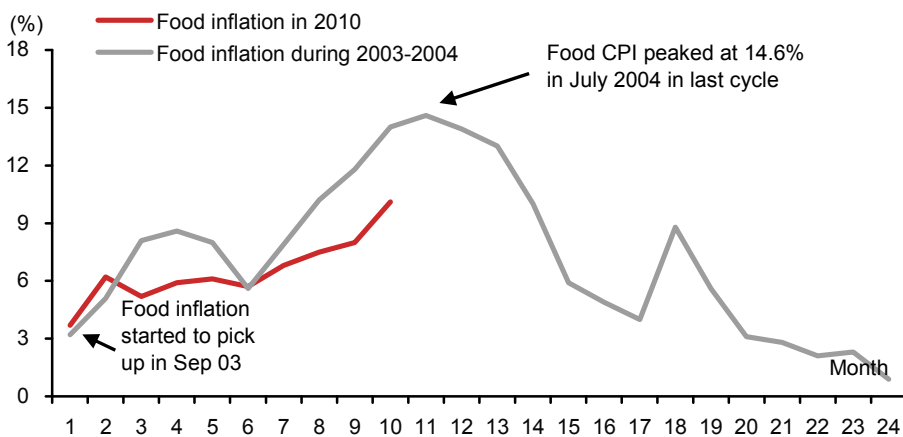
Source: CEIC, Nomura research

**Exhibit 52. Current inflation cycle vs 2007-08 cycle**



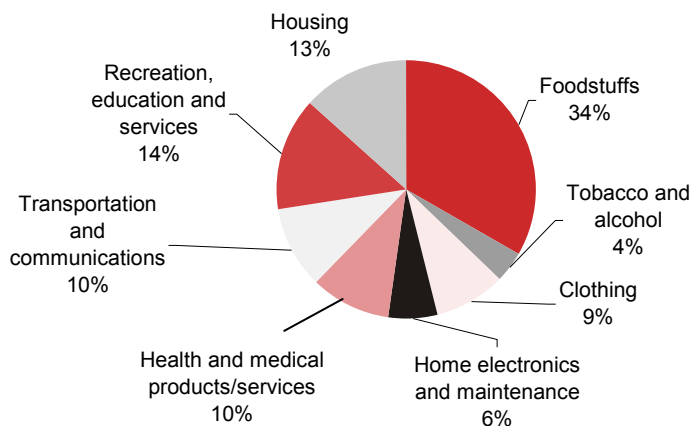
Source: CEIC, Nomura research

**Exhibit 53. Current inflation cycle vs 2003-04 cycle**



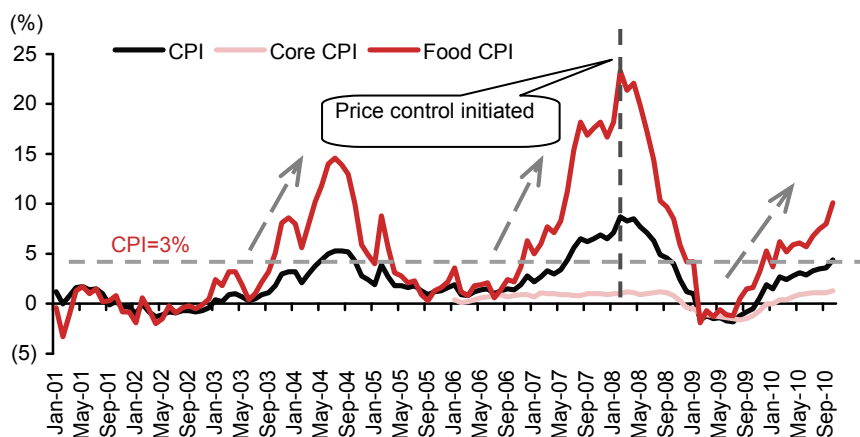
Source: CEIC, Nomura research

**Exhibit 54. CPI component**



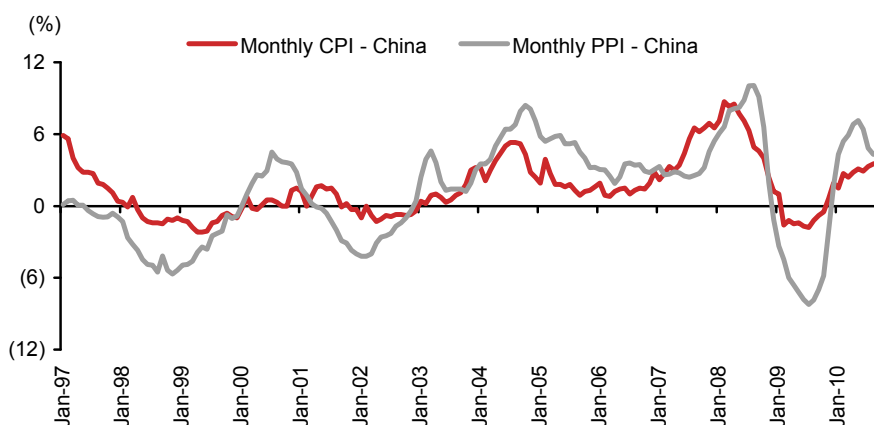
Source: Nomura research

**Exhibit 55. CPI breakdown**



Source: CEIC, Nomura research

**Exhibit 56. Monthly CPI vs monthly PPI**

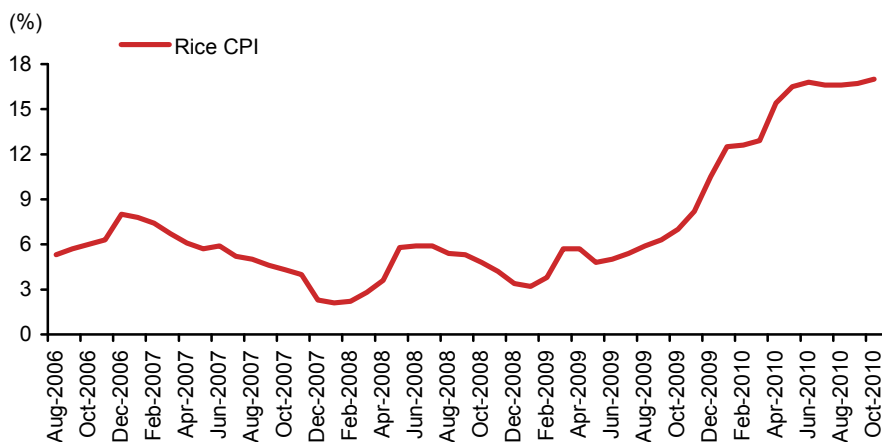


Source: CEIC, Nomura research

## 2007-08 inflation cycle vs current inflation cycle

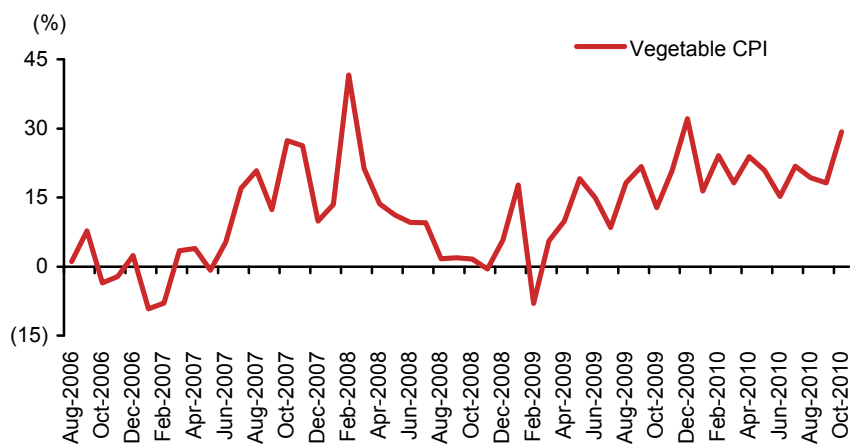
Items that contributed to CPI rise likely to be subject to price controls

Exhibit 57. Rice CPI



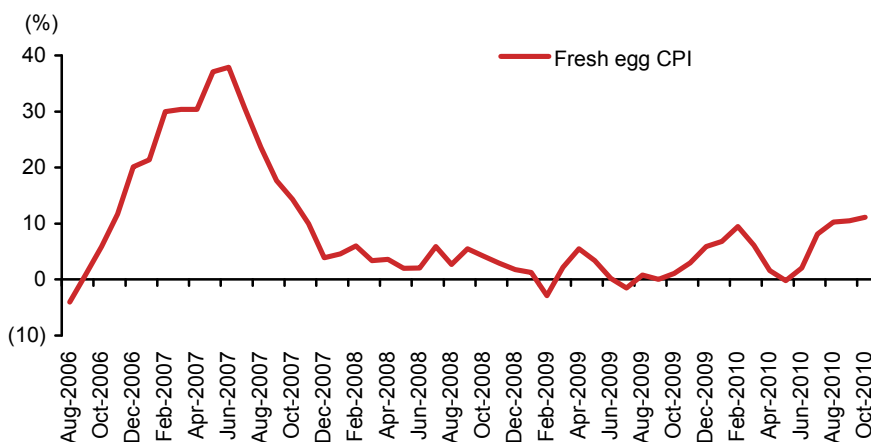
Source: CEIC, Nomura research

Exhibit 58. Vegetable CPI



Source: CEIC, Nomura research

Exhibit 59. Fresh egg CPI



Source: CEIC, Nomura research

## Items that rallied and were eventually subject to price controls in 2008

### Exhibit 60. Price control measures initiated by Chinese government (2008)

Date	Measures												
9-Jan-08	Premier Wen Jiabao said: "China will freeze price increases of oil products, natural gas and electricity in the near term".												
14-Jan-08	State Council announced prices of fuel, gas, electricity, tap water, heating, public transportation and entrance tickets to tourist destinations would not be allowed to rise in the near future. It also instructed local authorities not to raise school tuition and fees for accommodation, medical services and fertilizers. Mobile phone roaming fees were ordered to be cut.												
15-Jan-08	New law on the temporary price intervention of essential commodities and services implemented:												
	<table border="0"> <tr> <td><i>Intervened products</i></td> <td colspan="2">Grain, edible oil, pork, beef, mutton, milk, eggs and liquefied petroleum gas</td> </tr> <tr> <td><i>Measures</i></td> <td>Price raising report scheme</td> <td>Price adjustment report scheme</td> </tr> <tr> <td><i>Targets</i></td> <td>Production enterprises</td> <td>Wholesale and retail sale traders (with annual sales over RMB20mn for wholesale and RMB5mn for retail)</td> </tr> <tr> <td><i>Details</i></td> <td> <ol style="list-style-type: none"> <li>1) Major enterprises are required to submit price-raising application to the government for official approval 10 working days before they intend to raise prices</li> <li>2) The government should notify the enterprises within 7 working days after receiving application on whether it will approve or reject on the basis of whether the price rise is deemed to be reasonable</li> <li>3) When surging prices of commodities become stable, the government will lift interventions in a timely manner</li> </ol> </td> <td> <ol style="list-style-type: none"> <li>1) Big wholesale and retail sales traders are required to report to the government about sales conditions within 24 hours of raising prices: 1) by over 4% in one price rise; 2) in several increments totalling more than 6% within 10 days; 3) incrementally by more than 10% in 30 days.</li> <li>2) The price regulation agencies have the right to ask wholesale and retail sales traders to return prices to normal or reduce the price rise range if they regard the rise as unreasonable within 3 working days</li> <li>3) When surging prices of commodities become stable, the government will lift interventions in a timely manner</li> </ol> </td> </tr> </table>	<i>Intervened products</i>	Grain, edible oil, pork, beef, mutton, milk, eggs and liquefied petroleum gas		<i>Measures</i>	Price raising report scheme	Price adjustment report scheme	<i>Targets</i>	Production enterprises	Wholesale and retail sale traders (with annual sales over RMB20mn for wholesale and RMB5mn for retail)	<i>Details</i>	<ol style="list-style-type: none"> <li>1) Major enterprises are required to submit price-raising application to the government for official approval 10 working days before they intend to raise prices</li> <li>2) The government should notify the enterprises within 7 working days after receiving application on whether it will approve or reject on the basis of whether the price rise is deemed to be reasonable</li> <li>3) When surging prices of commodities become stable, the government will lift interventions in a timely manner</li> </ol>	<ol style="list-style-type: none"> <li>1) Big wholesale and retail sales traders are required to report to the government about sales conditions within 24 hours of raising prices: 1) by over 4% in one price rise; 2) in several increments totalling more than 6% within 10 days; 3) incrementally by more than 10% in 30 days.</li> <li>2) The price regulation agencies have the right to ask wholesale and retail sales traders to return prices to normal or reduce the price rise range if they regard the rise as unreasonable within 3 working days</li> <li>3) When surging prices of commodities become stable, the government will lift interventions in a timely manner</li> </ol>
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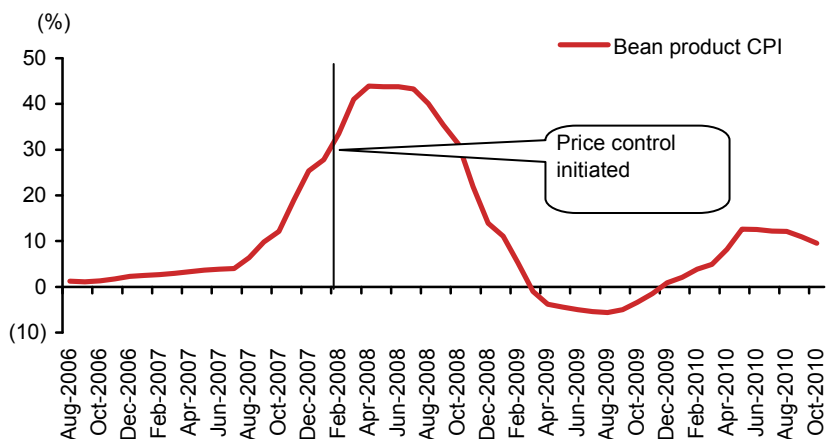
Source: Chinese government including NDRC, Nomura economics team

## Exhibit 61. Potential price control effects (2010)

	Key measures	Sector impact		Stock implications	
		Cost exposure	Revenue exposure	Biggest beneficiaries	Most impacted
Grain	Ensure supply of grain; set up "Green Channel" to lower transport costs for fresh and live agricultural products; abolish unreasonable charges; lower pitch fees/slotting fee; complete the grain reserves system; give price subsidy; adjust market balance through import/export			Tingyi and Uni-president China	China Agri
- instant noodle		17%	NA		
- beer		6%	NA		
- grain processing		NA	100%		
Edible oil	Ensure supply of edible oil; complete the grain reserves system; give price subsidy; lower slotting fee in supermarket; adjust market balance through import/export				
- instant noodle		16%	NA	Tingyi, Uni-president and Want Want	China Agri
- snack		9%	NA		
- edible oil processing		NA	100%		
Meat, poultry and egg	Ensure supply of meal, poultry and eggs; set up "Green Channel" to lower transport costs for fresh and live agricultural products; complete the food reserves system; give price subsidy; lower pitch fees/slotting fee; abolish unreasonable charges			Yurun's downstream	Yurun's upstream
- processed meat (ie, sausage)		70%	NA		
- hog slaughtering		NA	100%		
Vegetables	Set up "Green Channel" to lower transport costs; abolish unreasonable charges; lower pitch fees/slotting fee; ensure supply for vegetables				NA
Fertiliser	Ensure electricity and natural gas supply for fertilizer production; shorten the off peak season at lower export tariff by two months (8-month peak season at higher export tariff and 4-month off peak)	NA	67%		China BlueChem – impact is limited as the company can sell its fertilizer on the domestic market if the export window is narrowed
Coal	Due to surging coal price (RMB805/ton for 5,500Kcal/kg as at 22 November, 2010, 20% increase y-y), the NDRC has indicated twice recently the need for stable coal supply and coal prices. It ordered coal producers to boost self-discipline and local governments not to restrict sales of coal outside their provinces	For Shenhua, cost exposure (based on 3 <sup>rd</sup> party purchased coal cost) is around 20%	For Shenhua, as power segment accounted for 30% of total revenue; revenue exposure to coal price is 70%		Short term negative to Shenhua
Diesel	Limit sales price; punish companies that illegally raised prices; adjust demand/supply balance through import/export		Sinopec 29%, PetroChina 30%		Sinopec, PetroChina
Sugar	Complete sugarcane and sugar price linkage mechanism; lower slotting fee in supermarket; adjust market balance through import/export			Tingyi, Uni-president, Huiyuan and Want Want	
- Beverage		10%	NA		
- Snack		15%	NA		

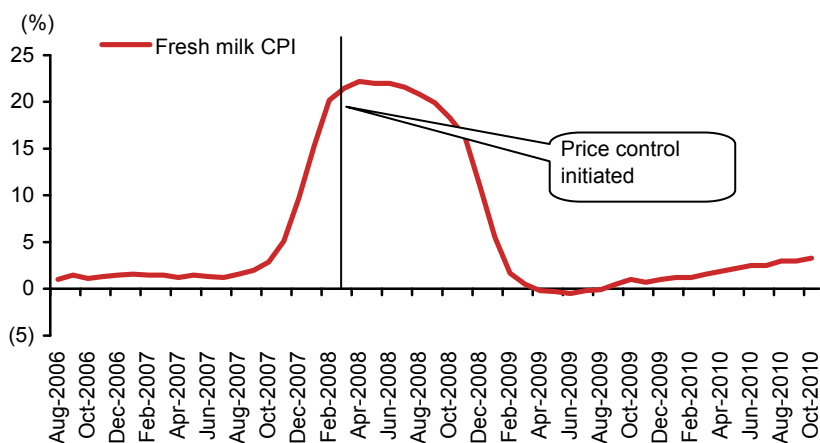
Source: Nomura research

**Exhibit 62. Bean product CPI**



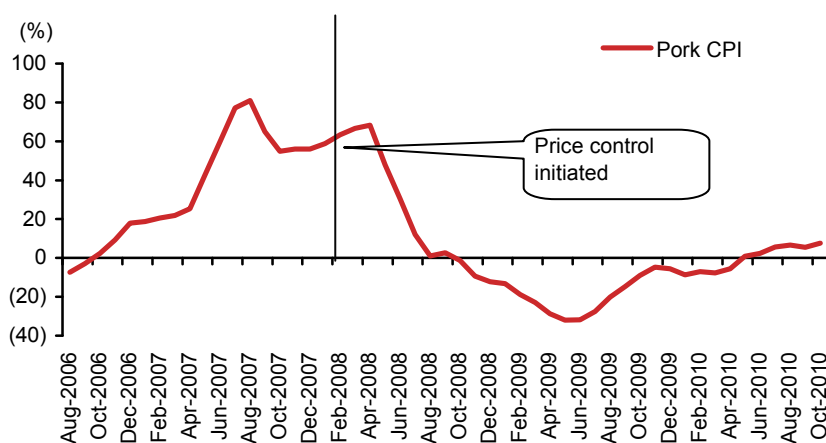
Source: CEIC, Nomura research

**Exhibit 63. Fresh milk CPI**

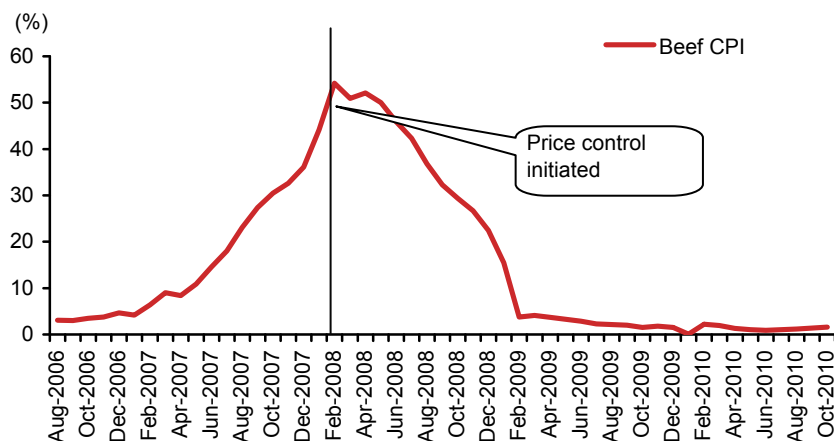


Source: CEIC, Nomura research

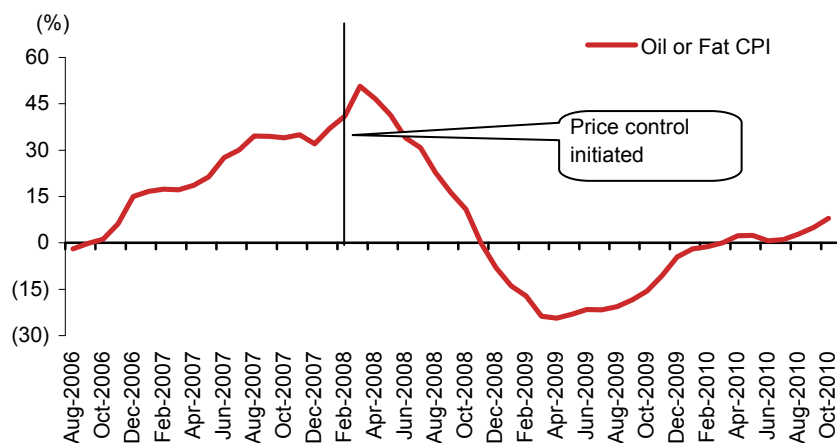
**Exhibit 64. Pork CPI**



Source: CEIC, Nomura research

**Exhibit 65. Beef CPI**

Source: CEIC, Nomura research

**Exhibit 66. Oil or Fat CPI**

Source: CEIC, Nomura research

**Interest rate hikes – can't be any more aggressive than in 2006-07**

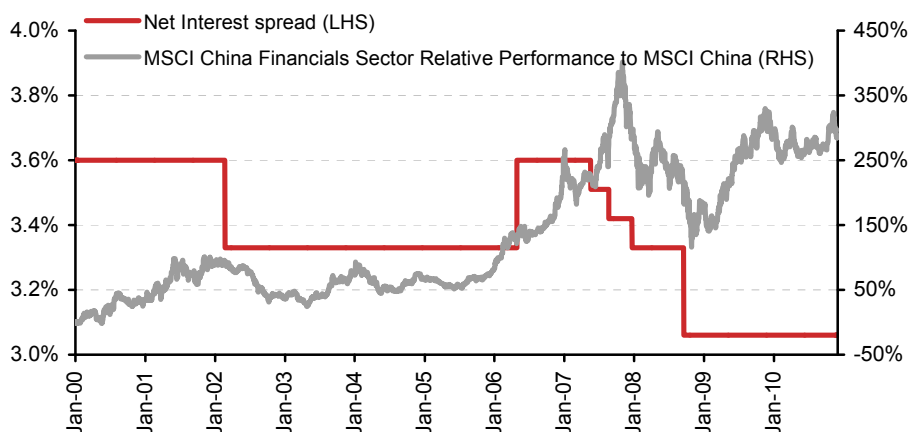
China's interest rate hike in October 2010, the first for almost three years (the last one was in December 2007), signalled the start of another rising rate cycle. The last interest rate hike cycle ran for 21 months, from April 2006 to December 2007. We think it could also be seen as an indication of a shift in gears in monetary policy — a shift into neutral, from previously the loose stance. Over the course of 2011, we expect four interest rate hikes totalling 100 bps, underlining the government's intention to tame excess liquidity, which is widely considered to be the major cause of the recent surge in inflation.

The upcoming rate hike cycle presents a dilemma, we believe. On one hand, given the CPI surpassed the one-year deposit rate in February 2010 and has been above it for nine straight months, rate hikes will help to address the currently negative real interest rate, which could become a serious problem in eroding wealth due to decreasing purchasing power — especially since China's savings rate is so high. On the other hand, expected rate hikes will expand the already historically high interest rate spread between China and the US, as well as the EU. This could potentially attract more fund inflows ("hot money") in pursuit of capital gains, together with possible renminbi appreciation. The likely result: even more money supply within the domestic market, which is contrary to the objective of rate hikes. Nevertheless, we believe more interest rate hikes will come through in step with the government's stricter scrutiny of its capital account.

We believe the four expected interest rate hikes in 2011 will have significant implications for China's equity market. Theoretically, rising interest rate will help tame liquidity, which tends to have a negative impact on equity market performance. Despite the policymakers' efforts, we think liquidity will remain sufficient. M2 growth reached an historical high of 27.7% y-y in 2009 amid the government's aggressive stimulus plan aimed at boosting the economy. For 1Q-3Q10, M2 growth stood at 19.0% y-y — the third highest level for the past one and a half decades. In absolute terms, the M2 to GDP ratio reached an historical high of 1.8x by end-2009, and expanded to 2.6x for the first three quarters in 2010. Both of these data points argue that liquidity should remain sufficient for the whole of 2011, in our view.

The expected interest rate hike cycle has varying implications across sectors. Given our forecast for four symmetric interest rate hikes, we highlight the banking sector as a clear beneficiary, since commercial banks ought to experience margin expansion during this period. We think the insurance sector should report higher interest income, since a large proportion of insurance premiums are term deposits, which tend to have a relatively high negotiable rate. But the property sector is likely to be negatively affected, since: 1) rising mortgage rates tends to curb demand from potential home buyers; 2) rising rates are likely to increase property developers' debt burden, which would eventually translate to lower bottom-line growth and RoEs; and 3) it will become harder for developers to finance new projects via bank loans or other financial instruments. Moreover, we think rising rates will have a negative impact on sectors with relatively high debt to asset ratios, such as utilities, materials and industrials.

**Exhibit 67. Interest spread vs MSCI China Financials index relative performance to MSCI China Index**



Source: CEIC, Nomura research

**Exhibit 68. Real 1-year deposit rate**



Source: CEIC, Nomura research

## Implementation of 12th FYP presents investment opportunities

In the first year of China's 12th FYP, we believe the government will push industry consolidation and upgrades with a view to enhancing investment returns and productivity. The key measures are likely to include strong support for M&A, relocation of plants from coastal areas to inland areas, and development of the seven industries of strategic importance.

We expect increased M&A activity and see outdated capacity being phased out during the 12<sup>th</sup> FYP period, resulting in greater efficiency and improved investment returns. The backdrop here is that the positive effects of the investment spree of the past two decades, especially in secondary industries, are diminishing. Moreover, recent measures by the government underscore our view that the government is encouraging industries such as textile and garments, toys, electrical appliances, agricultural product processing and equipment manufacturing to relocate their plants inland, from Guangdong, Zhejiang and other coastal provinces that are facing rising land and labour costs. We expect the government to reinforce this relocation trend to inland areas by circulating stimulus measures including financial support, tax treatment, industry allocation and government subsidiaries.

We think the seven industries deemed to be of strategic importance — 1) energy efficiency and environmental protection, 2) next generation IT, 3) bio-technology, 4) high-end manufacturing, 5) new energy, 6) new material, and 7) clean-energy vehicles — are set to enter a golden period of development commencing in 2011. The government expects the value-added production of these industries to account for 8% of GDP by 2015 and 15% by 2020. We see significant upside potential in these industries as a result. For example, the banking and insurance sector accounted for only 5% of total GDP in 2009, a contribution similar to the real estate sector, according to CEIC. Proposed tax preference measures for these industries should further boost their long-term development, in our view.

### Exhibit 69. GDP breakdown by industry

	2009	% of total	y-y growth %
GDP total (RMBbn)	34,050.69	100	9.1
Primary Industry	3,522.60	10	4.2
Secondary Industry: Industry	13,523.99	40	8.7
Secondary Industry: Construction	2,239.88	7	18.6
Tertiary: Transport, Storage & Post	1,705.77	5	3.7
Tertiary: Wholesale & Retail Trade	2,898.45	9	12.1
Tertiary: Accommodation and Catering Trade	711.82	2	5.5
Tertiary: Banking and Insurance	1,772.76	5	17.9
Tertiary: Real Estate	1,865.47	5	11.3
Tertiary: Others	5,809.95	17	7.4

Source: CEIC, Nomura research

## We know how to appreciate renminbi appreciation

At the end of October 2010, the spot rate stood at RMB6.69:US\$1, indicating the renminbi had appreciated by 2.0% against the greenback in the five months since it resumed its rally. Along with China's rapid economic development, the renminbi has appreciated by almost 20% since 2005, and we think it will continue to appreciate gradually in 2011. We forecast a spot rate of RMB6.60:US\$1 by end-2010 and RMB6.22:US\$1 by end-2011 — appreciation of 3.3% in 2010 and 5.8% in 2011.

The renminbi rally will likely push asset prices higher for those valued in renminbi, especially for foreign investors. Renminbi appreciation will likely lift made-in-China product prices, which could adversely affect exports. From a liquidity perspective, expected renminbi appreciation should be positive for the equity market, since it should bring in more capital inflows, ultimately resulting in higher valuations. Renminbi

appreciation should also devalue China's massive foreign exchange reserves, a large portion of which are denominated in US dollars. And the expected renminbi rally will, we think, help China to curb surging inflation as imported products will become 'cheaper', dragging down the CPI.

We highlight the property and airline sectors as two beneficiaries of this scenario. Ironically, the renminbi is appreciating in the international market but devaluing domestically, due to surging inflation and negative real deposit rates. We flag two possible outcomes: 1) foreign investors are drawn to renminbi assets in pursuit of capital gains through renminbi appreciation — property is one of the most effective and direct investment instruments for such investors, likely fuelling demand; and 2) domestic investors opt for property assets or head for the equity market in a bid to preserve wealth amid surging inflation and negative actual deposit rates, creating new demand. The expected renminbi appreciation should also benefit the airline sector, where approximately 30% of companies' costs are for fuel, which is typically priced in dollars.

### Exhibit 70. China stocks most sensitive to RMB appreciation

Company	Ticker	Impact to FY10 earnings from 1% rise in RMB	% of rev denominated in RMB	% of costs denominated in RMB
<b>Positive impact</b>				
<b>F&amp;B</b>				
Want Want	151 HK	1%	100	100
Yurun	1068 HK	1%	100	100
China Agri	606 HK	1%	100	100
<b>Steel</b>				
Maanshan	323 HK	2%	1%	27%
<b>Oil</b>				
Petrochina	857 HK	0.54%	78%	93%
Sinopec	386 HK	1.9%	100%	89%
<b>Utilities</b>				
Xiniao Gas	2688 HK	1.20%	100%	100%
China Resources Power	0836 HK	1.2	100	100
Huaneng Power International	0902 HK	1.5	95	95
<b>Properties</b>				
COLI	688 HK	1%	97%	97%
CRLand	1109 HK	1%	100%	100%
<b>Airlines</b>				
Air China	753 HK	2.8% on EPS, 0.6% on BVPS	80%	
China Eastern Airlines	670 HK	5.0% on EPS, 1.6% on BVPS	68%	
China Southern Airlines	1055 HK	5.7% on EPS, 1.1% on BVPS	90%	
*Post capital injection of RMB10.75bn				
<b>Banks</b>				
BOC	3988 HK	0.24%	79%	76%
<b>Negative impact</b>				
<b>F&amp;B</b>				
China Green	904 HK	-1%	53	100
<b>Utilities</b>				
Yingli Green Energy	YGE US	-1.85%	10%	70%
<b>Oil</b>				
CNOOC	883 HK	-0.2%	88%	94%

Consumer Retailers are not affected

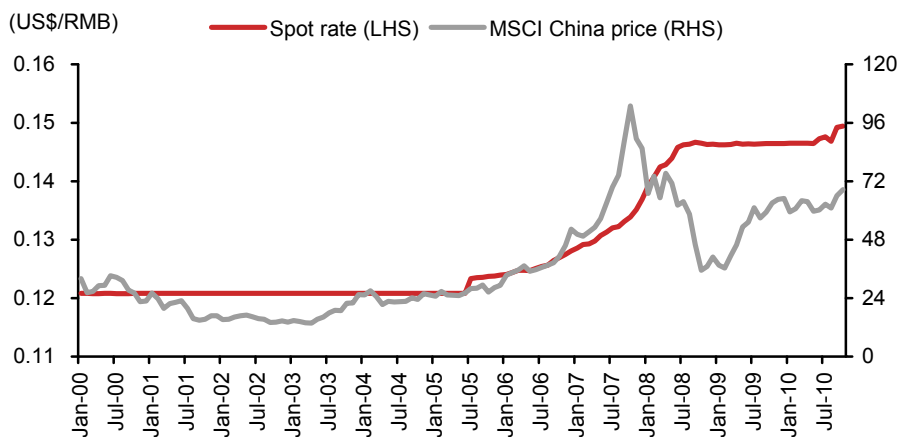
Shipping For the shipping companies, exposure to RMB is limited.

China Auto In the short term, the RMB appreciation should have a positive impact on the profitability of JVs in China, as they still need to import about 30% of their components from Overseas. Both European auto makers and Japanese automakers will benefit more than American automakers, due to low localization rates. We believe Dongfeng (DF PSA) could be a major beneficiary, followed by Brilliance (Brilliance BMW) and SAIC (SVW). However, further significant appreciation over the long term could distort the current pricing equilibrium in China's auto industry, exerting downward pressure on car prices.

China Industrial Limited impact

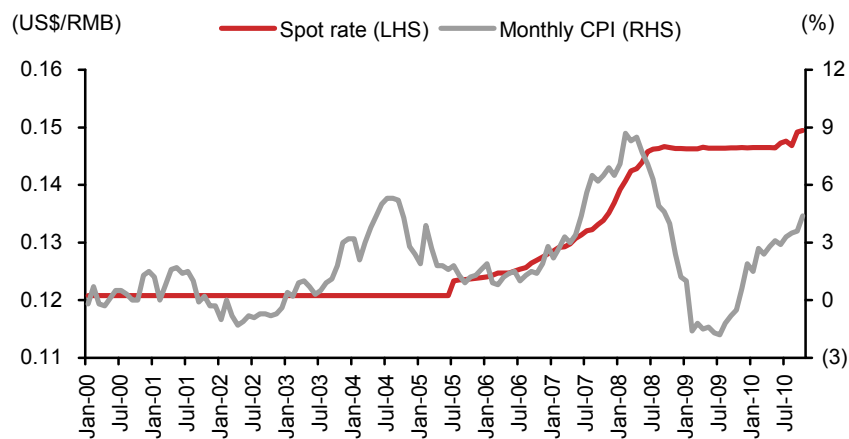
Source: Nomura

**Exhibit 71. MSCI China index price vs spot rate change**



Source: WIND, CEIC, Nomura research

**Exhibit 72. Spot rate vs monthly CPI**



Source: WIND, CEIC, Nomura research

## Effects of QE

**Commodity price hikes: thank you, QE!**

Domestic commodity prices are closely correlated to international prices, which continue to surge amid aggressive loosening of monetary policy by the majority of developed markets, including the US, Japan and the EU. Rising global commodity prices will likely expose China's economy to pressure from imported inflation, which would likely be negative for the overall equity market. On the other hand, we think it could benefit some corporates, such as oil and agri-products producers. Take the first round of US quantitative easing measures as an example. Crude oil and coal prices surged 69% and 51%, respectively, amid the first round of QE amounting to US\$1.7trn. The second round of QE, totalling US\$0.6trn, has already pushed most international commodities prices higher, and we believe prices will be further boosted as the effects of excess liquidity manifest themselves.

**Future global commodity price rises, heightening imported inflation risk for China**

**Exhibit 73. US QE effects**

FED Quantitative Easing Project	Prior period	1 <sup>st</sup> round	2 <sup>nd</sup> round *
Period	Jan-08~Mar-09	Mar-09~Mar-10	Aug-10~Jun 11
Fund Injection	n.a.	US\$1.7tn	US\$0.6tn
<b>International commodity (%)</b>			
Crude Oil (OPEC)	(49)	69	11
Coal (Aus BJ)	(30)	51	15
CBOT Wheat (Future Price)	(46)	(8)	(11)
CBOT Corn (Future Price)	(17)	(8)	29
<b>Domestic commodity (%)</b>			
Crude Oil and Products	(22)	39	5
Raw Coal	(1)	23	(1)
Corn (Dalian Future Market Price)	3	16	5
Wheat (Zhengzhou Future Market Price)	5	18	5
<b>Stock market index (%)</b>			
MSCI China Index	(38)	55	10
Dow Jones Index	(40)	43	10

\* Commodity price change under 2<sup>nd</sup> round QE as of 30 November, 2010.

Source: WIND, CEIC, Bloomberg, Nomura research

## Sector scorecard

## Scorecard — playing to win

Here we launch our sector scorecard. The goal is to estimate potential performance by gauging Nomura's view of several factors affecting each sector's fundamentals (estimated EPS y-y growth % and forecast RoE), valuation (12-month forward P/E and P/BV) and momentum change (historical performance during previous year). Giving different weights to each parameter, we rank the sectors from the highest score to the lowest, representing our favoured exposure from most liked to least liked. Our findings:

- 1) We are bullish on online gaming, property, consumers and banking, as well as oil & gas — these are among the highest scorers.
- 2) Airport, shipping services, utilities and ports have among the lowest scores, arguing for limited upside potential, on our reading.

The decisions suggested by our sector scorecard are almost identical to our sector screening and, we think, serve as a useful backstop to our recommendations.

Combination of fundamentals, valuations and price momentum

## Exhibit 74. Sector scorecard

Ranking	Sub-sector	EPS growth 2011	ROE 2011	PE 2011	PB 2011	Performance 2010YTD	EPS growth		ROE		PE		PB		Share price performance	
							Weight	35%	35%	20%	5%	5%	Score	Score	Score	Score
1	Online gaming	24%	22.5%	10.5	2.1	-16%	25	30	31	21	36					28.3
2	Internet	49%	44.7%	30.9	11.7	71%	39	40	1	1	5					28.2
3	Auto - PV	17%	26.7%	10.5	2.5	36%	16	37	32	17	13					26.5
4	Property	32%	16.6%	10.6	1.6	-12%	33	16	30	33	32					26.4
5	Telecoms equipment	34%	19.0%	15.0	2.7	1%	34	22	22	15	24					26.0
6	Banking	18%	20.5%	8.7	1.6	-1%	17	27	38	31	25					25.8
7	Fertilizer	43%	17.0%	15.8	1.9	13%	37	18	20	24	20					25.5
8	Capital goods - Railway equipment	47%	19.3%	19.1	3.5	46%	38	23	14	10	10					25.2
9	Oil & Gas	20%	19.4%	9.5	1.7	14%	20	24	36	29	19					25.0
10	F & B	27%	24.3%	23.4	4.8	8%	30	33	7	8	23					25.0
11	Consumer services & distribution	32%	23.3%	27.7	5.7	22%	32	31	3	4	16					23.7
12	E-Commerce	24%	23.7%	25.3	6.1	-28%	26	32	5	2	38					23.3
13	Capital goods - Construction machinery	10%	34.2%	9.8	2.9	82%	5	39	35	13	3					23.2
14	Department store	29%	22.3%	25.6	5.1	33%	31	29	4	6	14					22.8
15	Container box	37%	15.9%	17.2	2.6	48%	35	15	18	16	9					22.4
16	Airline	-7%	26.6%	8.6	1.9	82%	1	36	39	26	4					22.3
17	Foot & Sportswear	21%	24.9%	22.6	5.0	40%	22	34	8	7	12					22.2
18	Infrastructure - Ports	19%	14.0%	9.3	1.2	-8%	19	12	37	36	31					21.6
19	Healthcare	26%	20.5%	23.6	4.3	90%	28	28	6	9	2					21.4
20	Insurance	27%	19.0%	20.4	3.5	10%	29	21	10	11	21					21.1
21	Gaming	17%	32.8%	20.3	5.8	105%	14	38	11	3	1					20.6
22	China Wind	38%	10.4%	17.4	1.7	-27%	36	3	17	30	37					20.4
23	Cement	20%	18.0%	14.7	2.4	26%	21	19	23	18	15					20.3
24	Coal	12%	20.1%	12.5	2.3	-12%	8	26	26	19	34					19.8
25	Auto - CV	1%	26.5%	11.7	2.7	61%	2	35	28	14	7					19.6
26	Technology	16%	20.0%	18.4	3.4	-33%	12	25	16	12	39					18.7
27	Steel	18%	10.7%	10.2	1.0	-34%	18	5	33	40	40					18.7
28	Toll road	16%	15.2%	11.7	1.6	17%	13	13	29	32	18					17.4
29	Solar	15%	10.8%	7.7	1.3	-6%	10	7	40	35	29					17.2
30	China equipment	25%	12.5%	19.8	2.1	51%	27	9	12	20	8					16.4
31	Outdoor media	23%	10.8%	16.2	2.0	41%	23	6	19	23	11					15.7
32	Telecoms services	7%	16.7%	13.5	1.8	9%	3	17	25	28	22					14.5
33	China gas	17%	12.7%	18.4	2.0	-4%	15	10	15	22	28					14.3
34	Ports	24%	10.0%	19.2	1.9	18%	24	2	13	27	17					13.9
35	China water	14%	13.5%	15.5	1.9	-2%	9	11	21	25	27					13.8
36	China power	11%	10.4%	12.0	1.2	-12%	7	4	27	38	33					12.8
37	Shipping services	8%	11.1%	13.5	1.2	-2%	4	8	24	37	26					12.2
38	Supermarket	16%	18.8%	30.4	5.2	61%	11	20	2	5	6					11.8
39	Airport	11%	6.2%	20.6	1.2	-14%	6	1	9	39	35					8.0
	Total	21%	20.3%	13.0	2.5	11%	20.5	20.5	20.5	20.5	20.5					20.5

Source: Nomura research

- **EPS growth – fundamental parameter:** we are gauging expected EPS y-y growth for 2011F and hence our outlook on the sector's future profitability. Empirical research illustrates that rapid bottom-line growth tends to be rewarded with relatively high valuations. On our estimates, sectors such as consumer related and property are likely to deliver relatively high EPS growth in 2011.

- **RoE – fundamental parameter:** we are comparing forecast RoE for end-2011 across sectors, representing our sentiment on each sector's operating efficiency. Our findings show that the Internet sector is expected to have the highest RoE in 2011, followed by Capital goods. Even though the Airline sector is seen as likely to report a high sector RoE, we do not favour it given low estimated bottom-line growth of -7% for 2011.
- **Forward P/E and P/BV – valuation sentiment:** apart from fundamental parameters, we also assess valuation metrics for each sector in order to incorporate technical analysis into our scorecard. Together with the fundamental parameters, we are aiming to find sectors with high estimated EPS growth, strong forecast RoEs, and relatively low forward P/E and P/BV, since by rights we believe these sectors should outperform in 2011. For instance, we are bullish on the online gaming sector, where we see estimated EPS y-y growth of 24%, strong forecast RoE of 22.5%, and a low forward P/E. Although we see solid fundamental parameters for the healthcare sector, we are neutral due to stretched-looking valuations (relatively high forward P/E of 23.6x and P/BV of 4.3x).
- **Historical share price performance – momentum change:** empirical research has shown a basic inverse relationship between future price performance and historical share price performance for a specific sector or stock. We believe this is a reflection of momentum change.

We believe the fundamental parameters, including estimated EPS y-y growth and forecast RoE, are the most essential determinants of a sector or stock's future performance. Therefore, we give these two factors the highest weight of 35% each. We give a weight of 20% to forward P/E, as we think it is an important factor to consider, since technically it reflects valuation in comparison with historical performance. We then award a 5% weight each for forward P/BV and historical share price performance, as these two factors are least important to a sector or stock's future performance, in our view.

#### Exhibit 75. Weight by different factors

	EPS growth	RoE	P/E	P/BV	Hist. share price performance
Weight (%)	35	35	20	5	5

Note: EPS growth and RoE are estimates for 2011; P/E and P/B are forward.

Source: Nomura research

#### It has worked in the past

As a cross-check, we applied our sector scorecard methodology to historical sector price performance and conclude that our sector scorecard rationale is reasonable and feasible.

By examining the 2010 YTD data, our sector scorecard methodology suggests the top five-performing sectors are Airline, Autos – commercial vehicles, Capital goods – construction machinery, Gaming, and Autos – passenger vehicles. The average return from these sectors' share price performance YTD stands at 67% — more than 5.2x our covered sector index price return of 13% and more than 5.8x the average rate of return of the bottom five sectors on our scorecard.

Similarly, for 2009, the average actual return of the top five sectors indicated by our sector scorecard — including Autos – commercial vehicles, Technology, Capital goods – construction machinery, Online gaming and Gaming — was 186.0%, whereas the bottom five sectors reported a 102% return. The HSCEI index annual return was 62% for 2009.

## Exhibit 76. Top five vs bottom five sector performance by scorecard for 2010 YTD

Top five sectors' performance		Score										Actual	
		EPS					EPS					Total	* perf.
		growth	ROE	PE	PB	* perf.	growth	ROE	PE	PB	* perf.		
		2010	2010	2010	2010	2009	2010	2010	2010	2010	2009		2010YTD
1	Airline	225%	45%	4.7	1.5	136%	38	39	40	38	14	37.6	82%
2	Gaming	389%	37%	12.0	4.8	49%	39	37	32	7	32	35.0	105%
3	Capital goods - Construction machinery	43%	45%	5.9	2.2	164%	29	38	39	21	8	32.7	82%
4	Auto - PV	91%	28%	11.0	2.7	328%	36	35	34	17	2	32.6	36%
5	Oil & Gas	40%	19%	10.1	1.7	52%	28	23	37	29	31	28.3	14%
	Average												64%
<b>Bottom five sectors' performance</b>													
1	Shipping services	-289%	13%	12.7	1.4	78%	3	10	30	40	22	13.7	-2%
2	Airport	39%	5%	35.8	1.5	72%	27	1	2	36	24	13.2	-14%
3	Ports	13%	9%	20.3	1.6	66%	14	4	16	33	25	12.4	18%
4	Infrastructure - Railway & Highway	-14%	10%	18.0	1.7	0%	5	8	21	30	37	12.1	-7%
5	Fertilizer	-10229%	12%	21.6	1.9	32%	1	9	12	26	35	9.0	13%
	Average												1%
HSCEI performance													1.2%
Top five sectors performance / Bottom five sector performance													42.9
Top five sectors performance / HSCEI performance													52.4

\* Perf. represents historical share price performance during previous year.

Source: Nomura research

## Exhibit 77. Top five vs bottom five sector performance by scorecard for 2009

Top five sectors' performance		Score										Actual	
		EPS					EPS					Total	* perf.
		growth	ROE	PE	PB	* perf.	growth	ROE	PE	PB	* perf.		
		2009	2009	2009	2009	2008	2009	2009	2009	2009	2008		2009
1	Auto - CV	74%	29%	3.3	0.5	-58%	34	38	38	40	27	36.2	278%
2	Capital goods - Construction machinery	43%	28%	3.2	0.8	-64%	29	37	39	38	29	34.3	164%
3	Technology	193%	25%	7.4	1.4	-11%	39	35	34	25	5	34.2	396%
4	Auto - PV	127%	16%	6.0	1.0	-57%	38	22	36	34	25	31.2	328%
5	Online gaming	28%	39%	9.2	2.8	-4%	24	39	29	6	2	28.3	55%
	Average												244%
<b>Bottom five sectors' performance</b>													
1	Fertilizer	-101%	-4%	6.4	1.6	-43%	4	3	35	20	18	11.4	32%
2	Shipping services	-123%	-9%	7.5	0.9	-70%	1	2	33	36	34	11.2	78%
3	Outdoor media	-62%	-15%	11.7	1.0	-83%	6	1	24	35	40	11.0	72%
4	Capital goods - Railway equipment	-1%	11%	26.6	2.3	-7%	11	10	5	13	3	9.2	42%
5	Steel	-38%	4%	36.5	0.9	-65%	7	6	4	37	31	8.8	104%
	Average												66%
HSCEI performance													62.1%
Top five sectors performance / Bottom five sector performance													3.7
Top five sectors performance / HSCEI performance													3.9

\* Perf. represents historical share price performance during previous year.

Source: Nomura research

## Appendix

## Nomura insights

## Nomura's China coverage

## Exhibit 78. Nomura: China coverage

Sector	Sub-sector	Analyst	Company	Ticker	Curren- cy	Mkt cap (US\$m)	Rating	Price Perf.				EPS			ROE			P/E(x)			P/B(x)			Latest rawbeta
								1D	1M	3M	YTD	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011	
Basic Materials	Cement	Josephine Ho	Anhui Conch Cement	914 HK	RMB	15,009	Buy	4.76	1.54	19.35	32.26	1.98	1.33	1.6	13.3	15.6	16.3	13.8	20.5	17	1.7	2.99	2.6	0.97
Basic Materials	Cement	Josephine Ho	China National Bldg Material	3323 HK	RMB	5,089	Buy	3.11	-5.29	25.88	11.46	0.97	1.18	1.35	23.5	23.2	21.6	16.2	12.6	11	3.38	2.63	2.15	1.1
Basic Materials	Cement	Josephine Ho	China National Mat.	1893 HK	RMB	3,462	Buy	2.31	8.97	26.13	30.5	0.2	0.35	0.52	9.56	14.2	18.4	32.1	18.5	11.9	2.8	2.47	2.02	1.02
Basic Materials	Cement	Josephine Ho	China Shanshui Cement	691 HK	RMB	2,281	Buy	3.27	14.49	48.36	11.66	0.25	0.39	0.46	14.4	20.1	20.9	21.7	13.3	11.4	2.95	2.52	2.24	0.72
Basic Materials	Steel	Josephine Ho	Angang Steel	347 HK	RMB	10,432	Buy	0.18	-8.05	1.82	-34.58	0.1	0.65	0.88	1.43	8.72	11.1	89.1	14.3	10.6	1.28	1.22	1.14	1.62
Basic Materials	Steel	Josephine Ho	Baoshan Iron & Steel	600019 CH	RMB	16,486	Neutral	-1.41	-12.41	-2.94	-34.99	0.33	0.63	0.67	6.22	11.1	11.1	18.9	9.96	9.3	1.16	1.06	1	1.07
Basic Materials	Steel	Josephine Ho	Maanshan Iron & Steel	323 HK	RMB	3,399	Neutral	0.49	-7.88	3.02	-27.99	0.05	0.24	0.28	1.5	6.76	7.39	66.4	14.2	12.3	0.98	0.93	0.88	1.45
Basic Materials	Others	Ivan Lee	China Shenhua	1088 HK	RMB	83,604	Buy	-1.51	-5.36	15.17	-14.08	1.59	1.89	2.12	19.9	20.5	20.1	17.9	14.7	12.3	3.33	2.73	2.23	1.36
Conglomerates	Conglomerates	Charlene Liu	Shun Tak	242 HK	HK\$	1,334	Buy	-1.85	-6.65	6.71	-2.25	0.58	0.19	0.33	22.2	4.22	6.24	8.49	28	15.7	0.68	0.73	0.69	1.29
Consumer Related	Dept store	Candy Huang	Golden Eagle	3308 HK	RMB	5,395	Neutral	2.95	10.19	10.73	43.31	0.41	0.48	0.61	11	28.7	29.1	47.5	39.7	30.5	12.1	10.3	7.74	0.66
Consumer Related	Dept store	Candy Huang	Intime Department	1833 HK	RMB	2,744	Neutral	3.42	1.85	26.7	68.52	0.19	0.26	0.38	13.8	12	13.9	54.9	39.7	26.2	5.18	3.8	3.27	0.56
Consumer Related	Dept store	Candy Huang	Maoye Int'l	848 HK	RMB	2,660	Neutral	0.5	20.36	18.24	87.85	0.08	0.1	0.12	15	15.3	16.7	43	35.1	27.2	5.08	4.56	3.79	1.34
Consumer Related	Dept store	Candy Huang	PCD	331 HK	RMB	1,343	Buy	2.49	-1.2	13.3	-17.94	0.08	0.07	0.1	21.9	14.4	18.4	27	29.4	19.6	3.08	3.94	3.33	na
Consumer Related	Dept store	Candy Huang	Parkson Retail	3368 HK	RMB	4,672	Buy	-0.46	-7.85	0	-5.56	0.33	0.38	0.47	24.7	24.9	26.8	34	29	22.6	7.76	6.76	5.43	0.83
Consumer Related	Dept store	Candy Huang	New World Dept Store	825 HK	HK\$	1,561	Buy	2.13	-0.14	6.68	1.13	0.29	0.28	0.36	12.8	12.6	13.4	24.4	25.3	19.7	2.74	2.54	2.34	1.16
Consumer Related	Foot & Sportsware	Candy Huang	Belle International	1880 HK	RMB	15,332	Buy	-2.89	0.86	3.98	55.85	0.3	0.39	0.47	17.76	20.59	21.65	40.23	29.57	24.5	6.53	5.63	4.98	0.7
Consumer Related	Foot & Sportsware	Candy Huang	Li Ning	2331 HK	RMB	2,766	Buy	-1.68	-7.47	-18.36	-30.68	0.91	1.08	1.32	43.43	39.46	38.55	19.53	15.41	12.42	6.68	5.17	4.34	0.83
Consumer Related	Foot & Sportsware	Candy Huang	Ports Design	589 HK	RMB	1,736	Buy	4.12	27.93	26.45	-0.41	0.83	0.86	0.99	37.92	32.59	32	24.64	23.02	19.66	8.34	6.74	5.95	0.86
Consumer Related	Others	Candy Huang	Ctrip.Com Intl	CTRP US	RMB	6,655	Buy	-5.67	-13.7	8.12	21.84	4.67	7.04	10.09	26.7	30.18	32.64	62.53	40.87	27.81	13.82	10.83	7.69	na
Consumer Related	Others	Candy Huang	Gome Ele Appliances	493 HK	RMB	6,573	Buy	-0.33	17.24	29.66	8.51	0.09	0.12	0.14	13.84	15.78	16.17	29.35	21.08	17.86	3.28	2.82	2.37	0.57
Consumer Related	Others	Candy Huang	New Oriental Edu	EDU US	US\$	4,110	Neutral	-0.21	1.45	7.31	39.83	1.59	2.01	2.47	18.78	19.98	20.02	66.55	52.65	42.85	11.56	9.58	7.64	na
Consumer Related	Supermarket	Candy Huang	Wumart Stores	8277 HK	RMB	3,381	Neutral	4.49	12.64	26.23	66.94	0.36	0.44	0.54	18.61	18.63	17.7	49.26	39.78	31.23	9.35	6.09	5.04	0.65
Consumer Related	Supermarket	Candy Huang	Lianhua Supermarket	980 HK	RMB	2,915	Reduce	-0.14	10.3	20.53	55.56	0.81	0.89	0.99	20.46	20.99	20.16	38.23	33.93	29.7	7.72	6.6	5.45	0.56
Consumer Related	F&B	Emma Liu	Chaoda Modern Agri	682 HK	RMB	2,051	Reduce	0.32	-0.47	8.45	-24.22	1.09	1.18	1.37	28.61	20.63	21.94	5.47	4.5	4.22	0.81	0.84	0.75	0.96
Consumer Related	F&B	Emma Liu	China Agri-Industries	606 HK	HK\$	4,822	Buy	-0.43	-17.73	-1.9	-9.02	0.52	0.7	0.95	13.26	16.14	19.29	17.95	14.38	10.6	2.26	2.04	1.75	0.76
Consumer Related	F&B	Emma Liu	China Foods	506 HK	HK\$	1,998	Reduce	1.83	-13.66	-4.79	-20.11	0.21	0.17	0.24	11.14	8.38	11.31	26.34	32.89	22.93	2.83	2.69	2.5	0.7
Consumer Related	F&B	Emma Liu	China Green	904 HK	RMB	896	Buy	-1.25	-1.01	7.51	6.78	0.51	0.65	0.78	18.91	20.64	21.77	13.36	10.44	8.64	2.36	1.97	1.8	0.52
Consumer Related	F&B	Emma Liu	China Huiyuan	1886 HK	RMB	1,055	Neutral	0	7.31	-0.89	1.09	-0.11	0.11	0.18	4.97	3.03	4.61	na	45.56	25.34	1.49	1.28	1.07	0.5
Consumer Related	F&B	Emma Liu	China Mengniu Dairy	2319 HK	RMB	4,949	Buy	-3.28	-0.23	3.02	-20.18	0.68	0.7	1.03	17.11	13.45	17.45	28.46	27.19	17.71	3.93	3.41	2.81	0.75
Consumer Related	F&B	Emma Liu	China Resources Ent.	291 HK	HK\$	10,135	Neutral	-1.94	0.31	1.39	15.87	0.78	0.75	0.93	13.07	17.14	7.22	42.31	43.82	35.35	3.04	2.61	2.5	0.95
Consumer Related	F&B	Emma Liu	China Yurun Food	1068 HK	HK\$	6,467	Buy	-0.89	-7.96	-1.77	20.65	1.01	1.4	1.89	25.69	23.27	23.27	27.73	19.79	14.68	5.55	3.64	3.05	0.36
Consumer Related	F&B	Emma Liu	Huabao International	336 HK	HK\$	4,885	Buy	-3.91	5.31	8.27	46.95	0.36	0.43	0.52	50.19	42.99	39.06	34.53	28.89	23.91	13.38	10.01	7.71	0.12
Consumer Related	F&B	Emma Liu	Tingyi	322 HK	US\$	13,824	Buy	1.16	-8.91	-2.24	0.1	0.07	0.1	29.1	29.91	29.77	37.32	34.07	25.19	9.41	7.11	6.13	0.29	
Consumer Related	F&B	Emma Liu	Singtao Brewery- H	168 HK	RMB	7,322	Reduce	1.81	1.57	2.93	-2.09	0.95	1.13	1.23	17.53	17.42	16.84	38.68	32.11	28.13	5.9	5.18	4.34	0.71
Consumer Related	F&B	Emma Liu	Uni-President China	220 HK	RMB	2,257	Neutral	-1.62	-11.78	4.96	-14.71	0.19	0.13	0.17	11.56	7.48	9.06	22.15	31.87	23.38	2.38	2.21	1.99	0.41
Consumer Related	F&B	Emma Liu	Want Want	151 HK	US\$	11,366	Buy	-0.15	-6.43	6.36	22.98	0.02	0.03	0.04	32.52	37.12	44.78	36.31	30.69	23.24	11.46	11.25	9.61	0.37
Financials	Banking	Lucy Feng	Agricultural Bank	1288 HK	RMB	169,344	Buy	-0.98	-0.98	15.06	0	0.25	0.32	0.38	20.5	21.1	21.3	14.2	10.9	8.5	2.69	2.04	1.62	na
Financials	Banking	Lucy Feng	Bank of China - H	3988 HK	RMB	135,944	Buy	-0.48	-10.34	6.39	-0.95	0.32	0.34	0.4	16.6	17.1	17.3	11.4	10.3	8.34	1.81	1.55	1.33	0.91
Financials	Banking	Lucy Feng	Bank of Comm	3328 HK	RMB	51,153	Buy	-0.86	-4.25	-1.7	-9.99	0.61	0.75	0.86	19.2	20.6	20.9	11.6	9.89	7.57	2.12	1.73	1.45	1.33
Financials	Banking	Lucy Feng	Bank of Nanjing	601009 CH	RMB	2,742	Buy	-2.16	-17.14	-5.02	-28.97	0.94	1.39	2.1	14.2	17.9	22.2	10.6	7.18	4.74	1.41	1.18	0.95	0.99
Financials	Banking	Lucy Feng	Bank of Ningbo	002142 CH	RMB	4,580	Neutral	-1.61	-11.51	-2.47	-30.13	0.59	0.79	1.06	15.8	18.7	21.6	20.9	15.6	11.5	3.13	2.71	2.29	0.75
Financials	Banking	Lucy Feng	China CITIC Bank	998 HK	RMB	27,236	Buy	-0.18	-3.73	7.33	-18.25	0.43	0.48	0.54	16.9	17.1	17	11	9.54	8.92	1.78	1.5	1.28	0.98
Financials	Banking	Lucy Feng	China ConstrBank-H	939 HK	RMB	210,894	Buy	-0.99	-2.22	12.56	8.35	0.46	0.57	0.66	20.8	21.3	21.1	13.4	10.5	8.5	2.56	1.98	1.64	1.06
Financials	Banking	Lucy Feng	China Merchants Bk	3968 HK	RMB	49,473	Buy	-1.95	-8.64	0.25	5.01	0.95	1.27	1.68	21.2	24	24.1	18.5	13.4	9.6	3.62	2.63	2.05	1.23
Financials	Banking	Lucy Feng	Huaxia Bank	600015 CH	RMB	8,244	Reduce	-1.52	-14.9	-5.81	-11.27	0.75	0.86	0.91	13.6	16.9	11.6	14.6	12.7	12.1	1.81	1.4	1.27	1.04
Financials	Banking	Lucy Feng	Industrial Bank	601166 CH	RMB	18,011	Buy	-0.66	-11.52	-6.32	-36.6	2.66	3.14	3.52	24.5	22.3	20	9.05	7.65	6.83	2.02	1.5	1.25	1.22
Financials	Banking	Lucy Feng	Shanghai Pudong Bk	600000 CH	RMB	16,797	Neutral	-2.08	-12.36	-9.29	-23.94	1.5	1.31	1.61	24.1	18.7	16.4	8.48	9.68	7.88	1.65	1.4	1.2	1.09
Financials	Banking	Lucy Feng	Shenzhen Dev Bank	000001 CH	RMB																			

Sector	Sub-sector	Analyst	Company	Ticker	Curr-ency	Mkt cap (US\$m)	Rating	Price Perf.				EPS			ROE			P/E(x)			P/B(x)			Latest rawbeta
								1D	1M	3M	YTD	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011	
Gaming, Hotels & Leisure	Gaming	Charlene Liu	Galaxy Entertainment	27 HK	HK\$	4,016	Neutral	0.25	8.08	31.5	145.79	0.12	0.3	0.41	15.1	13.6	16.2	67.1	26.5	19.2	3.81	3.36	2.88	0.92
Gaming, Hotels & Leisure	Gaming	Charlene Liu	Melco Crown Ent	MPEL US	US\$	3,175	Reduce	-1	-0.5	53.08	77.68	-0.2	-0.03	-0.04	-12	-2.2	-2.6	na	na	na	3.8	3.88	3.98	na
Gaming, Hotels & Leisure	Gaming	Charlene Liu	Melco Int'l Dev.	200 HK	HK\$	718	Reduce	-1.95	2.95	46.6	26.54	-0.92	-0.16	-0.18	-20	-3	-3.5	na	na	na	0.83	0.86	0.89	1.48
Gaming, Hotels & Leisure	Gaming	Charlene Liu	SJM Holdings	880 HK	HK\$	8,924	Buy	10.52	11.28	71.39	199.53	0.22	0.61	0.77	11.5	29.8	29.4	57.9	21	16.7	7.58	5.4	4.51	0.93
Gaming, Hotels & Leisure	Gaming	Charlene Liu	Sands China	1928 HK	US\$	17,302	Buy	-3.24	-1.18	38.25	76.53	0.03	0.07	0.08	8.62	14.7	14.1	81.1	29.5	26.6	4.68	4.04	3.51	na
Gaming, Hotels & Leisure	Gaming	Charlene Liu	Wynn Macau	1128 HK	HK\$	10,512	Neutral	0.9	-8.17	17.29	64.82	0.4	0.74	0.86	91.8	103	85	38.9	21.1	18.3	21.7	22.2	12.01	na
Industrials	Auto - CV	Yankun Hou	Sinotruk	3808 HK	RMB	2,915	Buy	0	-8.17	11.56	-9.59	0.44	0.58	0.61	6.83	9.07	8.91	16.3	11.8	11	1.11	1.03	0.94	0.82
Industrials	Auto - CV	Yankun Hou	Weichai Power	2338 HK	RMB	11,561	Neutral	-0.46	5.89	66.62	71.93	4.1	3.86	3.87	34.6	43.5	30.9	11.4	11.6	11.4	3.28	4.13	3.08	1.41
Industrials	Auto - PV	Yankun Hou	Brilliance China Auto	1114 HK	RMB	4,587	Reduce	6.56	5.15	116.67	226.48	-0.37	0.22	0.3	-30	19.9	21.9	na	27	19.6	6.09	4.77	3.83	0.93
Industrials	Auto - PV	Yankun Hou	Dongfeng Motor	489 HK	RMB	16,394	Buy	0.54	-12.02	22.35	32.2	0.73	1.32	1.41	25.7	34.9	28.2	17.6	9.34	8.61	4.01	2.76	2.16	1.15
Industrials	Auto - PV	Yankun Hou	Geely Automobile	175 HK	RMB	3,881	Buy	0.71	-2.29	67.45	0	0.17	0.23	0.32	22.4	23.5	26.6	22.9	18	12.8	3.94	3.26	2.6	1.14
Industrials	Auto - PV	Yankun Hou	Great Wall Motor	2333 HK	RMB	3,983	Buy	5.81	16.02	69.36	191.84	0.93	1.8	2.17	14.3	23.5	23.5	25.2	13.1	10.7	3.4	2.81	2.29	0.85
Industrials	Auto - PV	Yankun Hou	Guangzhou Auto	2238 HK	RMB	8,326	Neutral	-2.41	-10.85	15.35	0	0.55	0.87	0.95	16.6	25.5	27.7	16.8	10.4	9.33	2.76	2.91	2.33	1.24
Industrials	Auto - PV	Yankun Hou	SAIC Motor	600104 CH	RMB	21,869	Buy	-0.93	-14.49	4.33	-14.83	0.77	1.43	1.77	17.1	26	26.8	22.1	12	9.65	3.44	2.86	2.37	na
Industrials	Capital goods - Construction machinery	Yankun Hou	Lonking Holdings	3339 HK	RMB	1,400	Neutral	4.96	22.12	52.78	88.5	0.37	0.56	0.6	23	30.4	26	11.6	7.58	7.1	2.44	2.06	1.67	1.24
Industrials	Capital goods - Construction machinery	Yankun Hou	Sany Heavy Ind	600031 CH	RMB	7,820	Buy	-3.52	2.22	65.43	85.18	1.32	1.88	2.06	29.4	47.2	35.7	16.4	11.5	10.5	4.28	4.47	3.22	1.13
Industrials	Capital goods - Construction machinery	Yankun Hou	Zoomlion Heavy	000157 CH	RMB	3,624	Neutral	-2.89	-4.11	32.33	38.89	1.35	1.66	2.05	37.3	36.8	34.8	10.7	8.72	7.06	3.55	2.83	2.17	1.08
Industrials	Capital goods - Railway equipment	Yankun Hou	CSR Corporation	1766 HK	RMB	14,191	Buy	-0.85	18	42.14	63.33	0.14	0.25	0.39	10.1	16.2	21.7	54.7	30.7	19.9	5.3	4.69	3.99	0.68
Industrials	Capital goods - Railway equipment	Yankun Hou	China CNR Corp	601299 CH	RMB	7,764	Buy	-4.15	10.25	22.83	1.79	0.16	0.23	0.38	9.43	8.75	13.2	39.4	27	16.4	2.46	2.28	2.04	na
Industrials	Capital goods - Railway equipment	Yankun Hou	Midas Holdings	1021 HK	SGD	818	Buy	-0.93	-4.29	0	0	0.04	0.05	0.07	14.2	12.4	14.8	22.2	17.4	12.6	2.59	1.69	1.76	na
Industrials	Capital goods - Railway equipment	Yankun Hou	Zhuzhou CSR Times Electric	3898 HK	RMB	4,138	Neutral	3.49	25.37	46.78	86.48	0.49	0.81	1.06	14.8	21.5	24	50.4	30.5	23.3	7.08	6.09	5.15	0.3
Industrials	Infrastructure - Ports	Yankun Hou	China Comm Construction	1800 HK	RMB	12,902	Neutral	-1.17	-8.77	-1.74	-9.02	0.49	0.5	0.6	15	13	14	11.3	10.9	9.16	1.49	1.35	1.22	1.22
Industrials	Infrastructure - Railway & Highway	Yankun Hou	China Railway Construction Corp	1186 HK	RMB	12,395	Buy	-2.43	-4.85	-7.06	-7.34	0.53	0.37	0.82	13.1	8.26	16.8	14.4	20.9	9.37	1.78	1.68	1.48	0.63
Industrials	Infrastructure - Railway & Highway	Yankun Hou	China Railway Group	390 HK	RMB	13,620	Neutral	0.18	-12.96	-3.89	-9.93	0.32	0.36	0.46	11.8	12.2	13.9	14	12.5	9.9	1.59	1.45	1.31	0.89
Industrials	Others	Yankun Hou	Shanghai Zhenhua	600320 CH	RMB	3,998	Reduce	-2.79	-11.62	-1.05	-35.98	0.19	0.38	0.5	5.43	10.2	11.8	34.6	17.2	13.3	1.84	1.66	1.48	1.26
Media & Internet	E-Commerce	Jin Yoon	Alibaba.Com	1688 HK	RMB	8,441	Reduce	-1.67	-14.66	-14.89	-28.22	0.24	0.35	0.43	20.7	24.6	23.7	47	32.1	25.3	11.4	8.31	6.14	1
Media & Internet	Internet	Jin Yoon	Baidu	BIDU US	RMB	36,676	Buy	-2.17	-6.35	33.94	155.47	4.54	10.19	16.51	37.9	53	50	159	69.8	42.1	52.2	29.6	17.08	na
Media & Internet	Internet	Jin Yoon	Sina	SINA US	US\$	4,197	Buy	-1.79	16.76	49.51	41.7	1.18	1.76	2.12	44.6	8.28	8.54	54.3	36.4	30.2	2.87	2.89	2.59	na
Media & Internet	Internet	Jin Yoon	Sohu	SOHU US	US\$	2,710	Reduce	-4.68	-4.85	43.24	21.21	3.98	4.11	4.98	29.7	20.9	20.5	17.4	16.9	13.9	4.36	3.36	2.66	na
Media & Internet	Internet	Jin Yoon	Tencent Holdings	700 HK	RMB	41,324	Buy	0.47	-2.7	21.36	2.49	2.97	4.73	6.65	53.1	50.7	45.3	50.9	31.7	22	22.1	13.3	8.37	0.85
Media & Internet	Online gaming	Jin Yoon	Changyou.Com	CYOU US	US\$	1,572	Buy	-1.74	-11.28	10.44	-11.44	3.07	3.39	3.97	88.9	55.4	40.1	9.59	8.67	7.42	6.71	3.8	2.49	na
Media & Internet	Online gaming	Jin Yoon	Giant Interactive	GA US	US\$	1,613	Neutral	-2.13	-1.15	12.21	-1.71	0.56	0.52	0.61	15.2	13	13.9	12.4	13.4	11.2	1.8	1.66	1.49	na
Media & Internet	Online gaming	Jin Yoon	Kingsoft Corp	3888 HK	RMB	638	Reduce	4.67	8.67	15.76	-33.64	0.37	0.34	0.36	26.5	20	18	10	10.9	10.1	2.5	2.17	1.83	1.16
Media & Internet	Online gaming	Jin Yoon	NetEase	NTES US	US\$	4,976	Neutral	-1.09	-6.67	-3.9	1.49	2.12	2.42	3.06	28.6	23.9	23.4	18	15.8	12.5	4.53	3.53	2.75	na
Media & Internet	Online gaming	Jin Yoon	Netdragon Websoft	777 HK	RMB	267	Neutral	20.12	10.99	12.57	-2.48	0.17	0.07	0.09	5.99	2.43	3.34	21	50.9	36.2	1.26	1.24	1.21	0.45
Media & Internet	Online gaming	Jin Yoon	Perfect World	PWRD US	US\$	1,255	Buy	-3.66	-24.11	-5.2	-39.91	3.06	2.81	3.58	52.3	32.8	29.1	7.73	8.42	6.61	3.56	2.45	1.78	na
Media & Internet	Online gaming	Jin Yoon	Shanda Games	GAME US	US\$	1,595	Buy	-1.58	-17.16	-1.06	-45.04	0.83	0.71	0.84	74.2	36.1	29.2	6.78	7.9	6.7	3.77	2.6	1.87	na
Media & Internet	Online gaming	Jin Yoon	Shanda Interactive	SNDA US	US\$	2,716	Neutral	-1.17	-1.22	-4.24	-24.86	3.72	2.56	3.21	21	8.59	9.87	10.6	15.4	12.3	1.57	1.41	1.26	na
Media & Internet	Outdoor media	Jin Yoon	AirMedia Group	AMCN US	US\$	453	Buy	-1.43	-1	89.32	-7.99	-0.44	0.11	0.57	-13	-2	9.43	na	64.3	12	1.72	1.7	1.51	na
Media & Internet	Outdoor media	Jin Yoon	Focus Media	FMCN US	US\$	3,441	Neutral	-2.91	-4.39	22.47	47.19	0.68	1.18	1.39	-15	8.08	11	34.1	19.7	16.8	2.56	2.47	2.08	na
Oil & Gas/Chemicals Fertilizer		Gordon Wai	China Blue Chemical	3983 HK	RMB	3,674	Buy	-0.64	0.98	22.33	30.32	0.21	0.29	0.39	9.86	13	15.8	25.5	19.1	14	2.6	2.35	2.09	0.6
Oil & Gas/Chemicals Fertilizer		Gordon Wai	Sinofert Holdings	297 HK	RMB	3,910	Neutral	-0.23	5.61	6.91	-0.23	-0.21	0.14	0.21	-18	11.5	18.1	na	28.2	18	2.2	2.04	1.85	0.89
Oil & Gas/Chemicals Oil & Gas		Cheng Khoo	CNOOC	883 HK	RMB	96,840	Buy	-1.86	4.86	25.3	38.03	0.66	1.17	1.34	17.7	27.3	26	22.5	12.7	11.1	3.81	3.16	2.64	1.29
Oil & Gas/Chemicals Oil & Gas		Cheng Khoo	China Oilfield Ser	2883 HK	RMB	8,218	Reduce	-0.28	12.88	42.71	52.69	0.7	0.87	0.96	15.4	16.8	16.3	17.9	14.5	13.1	2.59	2.28	2	1.61
Oil & Gas/Chemicals Oil & Gas		Cheng Khoo	PetroChina	857 HK	RMB	227,371	Buy	-0.31	2.01	14.34	3.54	0.56	0.73	0.91	12.6	15	17.1	15.3	11.7	9.33	1.87	1.68	1.52	1.3
Oil & Gas/Chemicals Oil & Gas		Cheng Khoo	Sinopec	386 HK	RMB	80,701	Buy	-1.9	-1.09	17.37	4.63	0.71	0.87	1	17.6	18.6	18.6	8.95	7.33	6.36	1.47	1.27	1.11	0.9
Oil & Gas/Chemicals Oil & Gas		Cheng Khoo	Sinopec Sha Petro	338 HK	RMB	3,532	Buy	-2.81	9.48	26.16	24.1	0.22	0.33	0.35	11.2	14.7	14	15.2	10.2	9.66	1.61	1.41	1.29	1.02
Oil & Gas/Chemicals Oil & Gas		Gordon Wai	Kunlun Energy	135 HK	HK\$	7,207	Buy	4.63	14.6	17.34	9.5	0.27	0.52	0.64	9.61	16.7	18	42.8	21.9	17.6	3.94	3.41	2.97	0.72

Sector	Sub-sector	Analyst	Company	Ticker	Currenc	Mkt cap (US\$m)	Rating	Price Perf.				EPS			ROE			P/E(x)			P/B(x)			Latest rawbeta
								1D	1M	3M	YTD	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011	
Power & Utilities	China gas	Ivan Lee	Beijing Enterprises	392 HK	HK\$	7,167	Buy	-2.97	-7.73	-10.84	-12.98	2.11	2.67	3.11	7.87	9.35	9.86	23.8	19.2	16.4	1.78	1.66	1.52	0.33
Power & Utilities	China gas	Ivan Lee	China Gas	384 HK	HK\$	2,228	Reduce	-10.59	-10.38	0.51	-6.37	0.03	0.26	0.19	3.26	23.8	12.4	135	19.5	27.6	4.11	3.24	2.17	0.81
Power & Utilities	China gas	Ivan Lee	China Resources Gas	1193 HK	HK\$	2,607	Buy	0.55	-3.83	-1.25	-2.98	0.31	0.46	0.6	27.2	20.9	16.9	35.3	24.2	18.4	15.2	3.32	2.9	0.41
Power & Utilities	China gas	Ivan Lee	ENN Energy Holdings	2688 HK	RMB	3,022	Neutral	-5.5	-4.08	7.19	11.75	0.78	0.97	1.14	17	18.3	18.8	26.6	20.6	16.8	4.01	3.37	2.76	0.48
Power & Utilities	China gas	Ivan Lee	Towngas China	1083 HK	HK\$	1,195	Neutral	-0.79	6.76	13.81	21.09	0.14	0.16	0.19	3.84	4.45	5.12	28	24.1	20	1.15	1.1	1.05	0.58
Power & Utilities	China power	Ivan Lee	China Power Intl	2380 HK	RMB	757	Neutral	-1.81	-7.39	-1.21	-16.41	0.14	0.09	0.13	5.06	3.7	4.95	14.2	15.9	11.5	0.59	0.58	0.56	0.67
Power & Utilities	China power	Ivan Lee	China Res Power	836 HK	HK\$	7,260	Buy	2.41	-8.71	-20.63	-11.79	1.2	0.98	1.17	16.4	11.7	12.6	12	13.9	11.7	1.7	1.55	1.41	0.33
Power & Utilities	China power	Ivan Lee	China Yangtze Power	600900 CH	RMB	10,680	Buy	-1.56	-6.89	-4.42	-15.01	0.58	0.72	0.73	11.7	12.9	12.3	14.6	10.5	10.4	1.39	1.31	1.25	na
Power & Utilities	China power	Ivan Lee	Datang Intl Power	991 HK	RMB	4,215	Neutral	-3.12	-10.58	-9.42	-16.72	0.14	0.13	0.16	6.18	5.78	7.2	18.2	19.9	15.2	1.12	1.12	1.07	1.02
Power & Utilities	China power	Ivan Lee	Huadian Power Intl	1071 HK	RMB	1,217	Neutral	-3.09	-11.8	-11.8	-23.79	0.19	0.11	0.1	8.41	4.18	4.22	7.29	13.9	13.4	0.52	0.57	0.56	0.76
Power & Utilities	China power	Ivan Lee	Huaneng Power Intl	902 HK	RMB	6,456	Buy	-1.89	-6.09	-10.92	-5.24	0.41	0.25	0.31	12.5	6.95	8.46	9.08	15	11.9	1.06	1.03	0.99	0.59
Power & Utilities	China water	Elaine Wu	China Water Affairs	855 HK	HK\$	511	Buy	-1.97	0.67	10.33	-3.24	0.02	0.11	0.15	6.33	13.6	7.63	144	28.2	21.4	1.92	1.56	1.5	0.87
Power & Utilities	China water	Ivan Lee	Beijing Ent Water	371 HK	HK\$	1,206	Buy	0	-0.74	6.75	3.86	0.07	0.1	0.13	8.8	13.4	14.3	38.2	25.9	21	3.57	3.39	2.81	0.64
Power & Utilities	China water	Ivan Lee	China Everbright Intl	257 HK	HK\$	2,033	Buy	2.6	5.6	24	8.5	0.11	0.16	0.21	10.1	12.3	14.2	40.7	26.8	20.8	3.45	3.12	2.79	0.82
Power & Utilities	China water	Ivan Lee	Guangdong Invest	270 HK	HK\$	3,112	Buy	-2.51	0	2.64	-14.13	0.32	0.38	0.4	12.6	13.1	12.8	12.2	10.5	9.83	1.42	1.3	1.19	0.29
Power & Utilities	China water	Ivan Lee	Sound Global	967 HK	RMB	792	Buy	-0.21	-8.27	0	0	0.22	0.28	0.4	19.6	21.1	22.1	19.3	14.9	10.6	3.5	2.83	2.01	na
Power & Utilities	China water	Ivan Lee	Tianjin Capital Environ	1065 HK	RMB	514	Reduce	0.36	4.87	19.15	1.08	0.17	0.2	0.16	7.59	8.59	6.35	14.8	12.4	16.2	1.09	1.04	1.01	1.02
Property	Property	Alvin Wong	China Overseas Land	688 HK	HK\$	15,698	Buy	-1.19	-8.47	-10.12	-9.02	0.79	1.11	1.5	19.8	23	22.6	18.8	13.4	9.95	2.9	2.45	2.08	0.86
Property	Property	Alvin Wong	China Res Land	1109 HK	HK\$	9,653	Reduce	-1.42	-8.9	-6.45	-21.09	0.64	0.74	0.95	13	8.8	10.2	21.7	18.9	14.6	1.85	1.55	1.44	0.85
Property	Property	Alvin Wong	Guangzhou R&F Prop	2777 HK	RMB	1,349	Reduce	-0.39	-6.69	-8.51	-24.67	0.59	1.19	1.39	18.2	21.1	21.4	15.3	7.63	6.56	1.73	1.52	1.3	1.62
Property	Property	Alvin Wong	KWG Properties	1813 HK	RMB	2,157	Buy	-0.86	-5.7	6.63	-3.34	0.25	0.45	0.61	7.63	11.8	14.5	20.7	11.3	8.3	1.42	1.28	1.14	1.55
Property	Property	Alvin Wong	Shimao Property	813 HK	RMB	5,351	Buy	-0.51	-8.58	-7.13	-20.38	0.59	1.03	1.3	16.7	14.7	16.3	17.6	9.93	7.95	1.57	1.37	1.22	1.46
Property	Property	Alvin Wong	Sino-Ocean Land	3377 HK	RMB	3,339	Neutral	-0.86	-13.86	-15.6	-35.93	0.23	0.31	0.5	7.91	7.14	8.83	18	13	8.11	0.98	0.74	0.69	1.16
Property	Property	Sunny Tam	Agile Properties	3383 HK	RMB	4,873	Buy	-3.02	6.86	19.91	-4.39	0.48	1.01	1.27	13.8	36	20.9	20	9.52	7.55	2.46	1.7	1.47	1.81
Property	Property	Sunny Tam	Country Garden	2007 HK	RMB	6,041	Neutral	-0.71	2.55	20.6	-2.77	0.11	0.17	0.23	10.4	12.8	15.7	23.3	14.8	10.6	1.93	1.77	1.57	1.27
Property	Property	Sunny Tam	Poly (HK) Invest	119 HK	HK\$	3,359	Buy	-2.43	-9.27	-12.77	-25.51	0.28	0.39	0.6	6.31	8.03	9.24	25.7	18.5	12.1	1.48	1.16	1.07	1.12
Property	Property	Tony Darwell	Global Logistic Prop	GLP SP	US\$	7,565	Buy	0	-4.31	0	0	0	0.05	0.06	0	0	16.4	0	45.3	35.6	0	5.08	1.57	na
Solar	Solar	Clarisse Pan	GCL Poly Energy	3800 HK	RMB	5,019	Neutral	5	2.44	40	8.62	0	0.08	0.08	0	0	0	na	10.5	9.57	0.02	2.49	1.89	1.56
Solar	Solar	Clarisse Pan	JA Solar	JASO US	US\$	1,124	Neutral	-4.93	-18.45	12.85	21.75	-0.11	1.31	1.38	-1.9	26.7	22.2	na	5.31	5.03	1.16	1.25	1	na
Solar	Solar	Clarisse Pan	LDK Solar	LDK US	US\$	1,298	Neutral	-8.59	-16.67	46.84	42.65	-1.71	1.46	1.71	-27	19.6	18.8	na	6.83	5.86	1.46	1.22	1.01	na
Solar	Solar	Clarisse Pan	Solariga Energy	757 HK	RMB	362	Reduce	-2.26	-2.81	13.82	-14.36	-0.06	0.16	0.19	-7.4	18.2	17.3	na	8.83	7.45	1.64	1.43	1.15	1.52
Solar	Solar	Clarisse Pan	Yingli Green Energy	YGE US	RMB	1,462	Buy	-4.65	-18.05	-11.5	-37.7	-3.31	7.85	9.82	-8	16.1	17.1	na	8.48	6.63	1.37	1.2	1.01	na
Solar	Solar	Nitin Kumar	Canadian Solar Inc	CSIQ US	US\$	556	Neutral	-5.72	-11.79	10.81	-54.82	0.51	1.59	1.67	5.87	8.41	12.7	26.1	8.4	8.01	1.16	1.06	0.93	na
Solar	Solar	Nitin Kumar	Suntech Power Hldg	STP US	US\$	1,286	Buy	-1.79	-18.86	-7.75	-57.07	0.49	0.86	1.02	6.06	-5.6	11.4	14.8	8.45	7.12	0.8	0.84	0.75	na
Solar	Solar	Nitin Kumar	Trina Solar	TSL US	US\$	1,762	Buy	-6.57	-19.57	-13.42	-17.29	2.28	3.01	3.46	17.6	24.2	20.4	11.3	8.33	7.25	1.8	1.46	1.19	na
Technology	Technology	Chitra Gopal	BYD	1211 HK	RMB	13,736	Buy	0.32	-0.74	4.69	-31.48	1.77	1.83	2.12	27.1	23.1	22.1	23.1	22.3	19.3	5.26	4.79	3.84	1.19
Technology	Technology	Chitra Gopal	BYD Electronic	285 HK	RMB	1,111	Neutral	0.52	-6.36	2.41	-39.69	0.34	0.34	0.37	12.3	11.2	10.7	9.92	9.82	9.14	1.14	1.04	0.93	1.19
Technology	Technology	Eve Jung	Ju Teng International	3336 HK	HK\$	448	Reduce	-1.27	-19.22	-23.96	-59.77	0.64	0.47	0.4	20.8	12.6	9.64	4.87	6.63	7.82	0.86	0.79	0.72	0.63
Technology	Technology	Eve Jung	Lenovo Group	992 HK	HK\$	6,526	Neutral	0.19	3.98	17.04	7.41	-0.02	0.01	0.03	-15	8.87	16.2	na	51	23.9	4.73	4.11	3.69	1.52
Telecoms	Telecoms Equip	Leping Huang	Asiainfo-Linkage Inc	ASIA US	US\$	1,231	Neutral	-2.4	-24.52	-6.77	-45.32	1.06	1.53	1.69	14.8	9.93	8.1	31.2	19.2	16	2.85	1.34	1.24	na
Telecoms	Telecoms Equip	Danny Chu	China CommServices	552 HK	RMB	3,507	Buy	-3.08	4.42	21.65	23.56	0.28	0.33	0.37	12.8	13.9	14.2	15	12.6	11.2	1.83	1.67	1.53	0.77
Telecoms	Telecoms Equip	Leping Huang	Comba Telecom	2342 HK	HK\$	1,295	Buy	0.35	-1.7	8.67	4.78	0.51	0.68	0.8	25.8	27.5	26	17.8	13.4	3.54	3.16	2.54	0.8	
Telecoms	Telecoms Equip	Leping Huang	O-Net CommGroup	877 HK	HK\$	579	Buy	8.38	3.01	22.53	0	0.14	0.26	0.35	53.7	34.5	26	42.6	22.6	16.9	17.9	5.03	3.88	na
Telecoms	Telecoms Equip	Leping Huang	ZTE Corp	763 HK	RMB	10,537	Buy	0.18	-0.87	-1.21	-10.78	0.89	1.01	1.4	15.8	16.1	19.4	27.9	23.3	16	2.72	3.54	2.88	0.76
Telecoms	Telecoms Ser	Danny Chu	China Mobile	941 HK	RMB	200,062	Buy	-1.02	-1.9	-2.15	6.31	5.74	5.88	6.29	24.3	21.8	20.6	12	11.6	10.8	2.7	2.38	2.1	0.83
Telecoms	Telecoms Ser	Danny Chu	China Telecom	728 HK	RMB	40,739	Neutral	-1.26	-2.49	3.99	20.68	0.16	0.19	0.22	6.1	6.72	7.35	21	18.3	16	1.26	1.2	1.15	0.75
Telecoms	Telecoms Ser	Danny Chu	China Unicom	762 HK	RMB	32,005	Buy	-2.06	-5.08	-2.23	1.75	0.4	0.24	0.35	4.63	27.1	3.93	23	38.6	26.2	1.05	1.04	1.02	0.74
Transport/Logistics	Airline	Shirley Lam	Air China	753 HK	RMB	15,961	Neutral	0	-2.88	21.93	66.72	0.41	1	0.86	22.1	37.7	23.6	21.7	8.7	9.69	4.54	2.58	2.03	1.22
Transport/Logistics	Airline	Shirley Lam	China Eastern Airlines	670 HK	RMB	6,649	Buy	0	-6.53	17.14	65.34	0.03	0.51	0.59	-2.9	75.9	39.1	138	7.79	6.34	31.1	3.17	2.01	0.

## Major calendar events in 2011

### Exhibit 79. What to watch for: Nomura view

Date/period	Events	Implication
1) 11 January	December 2010 trade, CPI, FAI, Loan, etc., data to be released	Counting the last month's economic data, the 2010 whole year's economic operation result is quite clear, which can give some idea of the 2011 target
2) 10-12 February	January loan growth data to be released	Strong loan growth should drive outperformance of bank stocks. But overly high loan growth could heighten the risk of early tightening (implicit loan quotas and RRR hike).
3) March	National People's Congress (NPC), Chinese People's Political Consultative Conference (CPPCC)	12th FYP to be discussed and approved; likely to focus on the themes of industry consolidation, energy saving, central/western China development, household living standard improving, etc; Whole year target for GDP, CPI, Trade, Unemployment rate, etc to be released
4) 1 April - 31 October	Xi'an Garden Expo	Positive for consumption and tourism in the Shaanxi area
5) April	1Q11 economic data to be released in late April	Continuing high CPI in 1Q11 (Nomura forecast: 3.4% for 1Q11) and loan growth rebound could lead to more tightening measures, which could trigger a market pull-back. Potential opportunity to accumulate
6) January - May	Around 60% A-share stock market restricted shares to be lifted from ban	Number of non-tradable shares to be released in 2011 is less than half of that for 2010. Positive for both A- and H-share market sentiment
7) June	"Quantitative Easing" (QE2) monetary policy to mature	QE2 is expected to prompt another period of big commodity price increases. The Fed is likely to continue the easing monetary policy in 2011, which should benefit the stock market.
8) July	2Q11 economic data to be released in late July	1H11 economic performance will be a frame of reference for decision makers in terms of 2H policy adjustment. Inflation is expected to remain high, but price control measures will start to work.
9) October	3Q11 economic data to be released in late October	The Chinese government is likely to take strict control in 4Q11 to achieve the whole year target after 3Q11 economic data is released.
10) November - 2012	Change in provincial and municipal government heads	Local government policy is expected to be more strict and frequent during this period, especially in price control, economic growth maintenance, unemployment reduction.

Source: Nomura research

## Stocks: historical performance recap

### Exhibit 80. Stocks historical performance recap (outperformers)

Nomura covered			Sector name		Return (%)						
(Y/N)	Tickers	Company name	ICB_SECTOR_NAME	2003	2004	2005	2006	2007	2008	2009	YTD
<b>Over 6 years in a row outperformed MSCI China</b>											
	1066 HK	Shandong Weigao Group Medical Polymer	Health Care Equipment & Servic	n.a.	n.a.	82	308	54	18	61	57
Y	700 HK	Tencent Holdings Ltd.	Software & Computer Services	n.a.	n.a.	63	155	50	37	178	0
	1044 HK	Hengan International Group	Personal Goods	16	23	57	40	18	23	72	20
<b>5 years in a row outperformed MSCI China</b>											
	1066 HK	Shandong Weigao Group Medical Polymer	Health Care Equipment & Service	n.a.	n.a.	82	308	54	18	61	57
	8058 HK	Shandong Luoxin Pharmacy Stock	Pharmaceuticals & Biotechnolog	n.a.	n.a.	n.a.	104	260	5	122	58
Y	700 HK	Tencent Holdings Ltd.	Software & Computer Services	n.a.	n.a.	63	155	50	37	178	0
	1044 HK	Hengan International Group	Personal Goods	16	23	57	40	18	23	72	20
<b>4 years in a row outperformed MSCI China</b>											
	8045 HK	Jiangsu Nandasoft	Software & Computer Services	(101)	(20)	(58)	(114)	66	7	94	10
	8049 HK	Jilin Province Huinan Changlong Bio-pharmacy	Pharmaceuticals & Biotechnolog	(69)	(44)	(29)	(82)	36	24	26	186
	8258 HK	Shaanxi Northwest New Technology Ind	Chemicals	n.a.	(39)	(21)	(79)	46	1	26	21
Y	883 HK	CNOOC Ltd.	Oil & Gas Producers	(31)	38	10	(38)	16	7	10	36
Y	1068 HK	China Yurun Food Group Limited	Food Producers	n.a.	n.a.	n.a.	(13)	17	22	94	14
Y	2688 HK	ENN Energy Holdings Limited	Gas, Water & Multiutilities	54	4	23	(36)	12	5	86	11
Y	371 HK	Beijing Enterprises Water	Gas, Water & Multiutilities	(51)	(76)	(24)	(51)	83	65	129	0
<b>3 years in a row outperformed MSCI China</b>											
	921 HK	Hisense Kelon Electrical Holdings	Household Goods & Home Constr	196	(51)	(61)	(79)	(64)	52	276	6
Y	980 HK	Lianhua Supermarket Holdings	Food & Drug Retailers	n.a.	17	(39)	(50)	(51)	44	84	51
	1000 HK	Beijing Media Corporation Limited	Media	n.a.	n.a.	(68)	(101)	(103)	3	36	19
	1122 HK	Qingling Motors	Industrial Engineering	(12)	(22)	(15)	(72)	(45)	3	88	37
Y	3898 HK	Zhuzhou Csr Times Electric Co.,Ltd	Industrial Engineering	n.a.	n.a.	n.a.	n.a.	(57)	7	96	81
	3928 HK	Zhengzhou Gas	Oil Equipment, Services & Dist	35	(8)	(24)	(56)	(3)	6	47	3
	8247 HK	Biosino Bio-technology And Science Inc	Pharmaceuticals & Biotechnolog	n.a.	n.a.	n.a.	n.a.	(11)	10	12	23
Y	8277 HK	Wumart Stores, Inc.	Food & Drug Retailers	n.a.	65	4	6	(67)	39	54	63
	8287 HK	Nanjing Sample Technology	Electronic & Electrical Equipm	n.a.	n.a.	(28)	160	(93)	34	2	57
	8331 HK	Zhejiang Shibao Company Limited	Automobiles & Parts	n.a.	n.a.	n.a.	n.a.	(17)	7	228	88
Y	135 HK	Kunlun Energy Company Limited	Oil & Gas Producers	71	(8)	25	73	(47)	1	269	9
	560 HK	Chu Kong Shipping Development	Industrial Transportation	(3)	7	(35)	(45)	(34)	1	4	28
	570 HK	Winteam Pharmaceutical Group Limited	Pharmaceuticals & Biotechnolog	(11)	(15)	(43)	(60)	(45)	45	39	46
	934 HK	Sinopec Kantons Holdings Ltd.	Oil Equipment, Services & Dist	(17)	(3)	(1)	(35)	(66)	5	70	88
	1203 HK	Guangnan (Holdings) Ltd.	General Industrials	(43)	(9)	(34)	(63)	(50)	4	41	4
	2302 HK	CNNC International Limited	Industrial Engineering	n.a.	19	(65)	(75)	(17)	347	110	1
	268 HK	Kingdee International Software Group	Software & Computer Services	25	(14)	(33)	44	(16)	5	59	157
	360 HK	New Focus Auto Holdings Limited	Automobiles & Parts	n.a.	n.a.	n.a.	16	(84)	8	38	39
	527 HK	China Ruifeng Galaxy Renewable Engrgy	Technology Hardware & Equipmen	n.a.	n.a.	n.a.	n.a.	(80)	2	103	126
	546 HK	Fufeng Group Limited	Chemicals	n.a.	n.a.	n.a.	n.a.	(77)	23	966	36
	769 HK	China Rare Earth Holdings Ltd.	Chemicals	(49)	(9)	(35)	(24)	(23)	0	25	113
	827 HK	Ko Yo Ecological Agrotech (Group) Ltd.	Chemicals	n.a.	(40)	(5)	(35)	(35)	14	64	44
	1169 HK	Haier Electronics Group	Household Goods & Home Constr	58	4	(43)	(62)	(100)	8	386	40
Y	2342 HK	Comba Telecom Systems Holdings Ltd.	Technology Hardware & Equipment	n.a.	(9)	(37)	(57)	(85)	10	569	14
Y	2877 HK	China Shineway Pharmaceutical Group	Pharmaceuticals & Biotechnolog	n.a.	n.a.	(25)	(63)	(38)	29	175	69
Y	3308 HK	Golden Eagle Retail Group Limited	General Retailers	n.a.	n.a.	n.a.	n.a.	(46)	19	132	38
Y	1111 HK	Chong Hing Bank	Banks	(9)	(2)	(11)	(38)	(56)	2	5	35
Y	SINA US	Sina	Software & Computer Services	339	(4)	(40)	(60)	(9)	4	36	38
Y	3 HK	Hong Kong & China Gas	Gas, Water & Multiutilities	(63)	36	(13)	(73)	(13)	6	8	5
Y	14 HK	Hysan Development	Real Estate Investment & Serv	27	37	2	(73)	(54)	8	17	51
Y	4 HK	Wharf Holdings	General Industrials	(32)	27	(15)	(74)	(16)	4	52	22
Y	HKL SP	Hongkong Land	Real Estate Investment & Serv	(57)	57	3	(52)	(39)	2	41	37
	970 HK	Sparkle Roll Group Limited	Media	(101)	24	(13)	(2)	(83)	20	20	106
Y	1177 HK	Sino Biopharmaceutical Limited	Pharmaceuticals & Biotechnolog	(10)	83	38	(121)	(3)	23	310	20

Note: Our stock pool includes all the Hong Kong listed China companies as well as Nomura covered offshore listed China companies. Pricing as 1 December 2010

Source: Bloomberg, Nomura research

**Exhibit 81. Stocks: historical performance recap (underperformers)**

Nomura Covered		Company Name	Sector Name ICB_SECTOR_NAME	Return (%)							
(Y/N)	Tickers			2003	2004	2005	2006	2007	2008	2009	YTD
<b>Over 6 years in a row underperformed MSCI China</b>											
Y	1071 HK	Huadian Power International Corporation	Electricity	7	(29)	(30)	(24)	(34)	(1)	(48)	(24)
Y	2380 HK	China Power International Development	Electricity	n.a.	n.a.	(27)	(11)	(78)	(4)	(37)	(19)
	362 HK	China Zenith Chemical Group	Chemicals	181	(14)	(47)	(82)	(39)	(1)	(5)	0
Y	659 HK	NWS Holdings	Construction & Materials	29	63	(17)	(21)	(24)	(1)	(35)	(16)
<b>5 years in a row underperformed MSCI China</b>											
Y	330 HK	Esprit Holdings	General Retailers	16	83	2	(21)	(30)	(10)	(38)	(29)
<b>4 years in a row underperformed MSCI China</b>											
	8251 HK	Shanghai Tonva Petrochemical	Construction & Materials	n.a.	n.a.	n.a.	275	(74)	(11)	(27)	(34)
	910 HK	China Grand Forestry Green Resources	Forestry & Paper	(69)	(29)	(54)	521	(9)	(28)	(70)	(10)
<b>3 years in a row underperformed MSCI China</b>											
Y	576 HK	Zhejiang Expressway Co., .	Industrial Transportation	1	(1)	(26)	(55)	46	(11)	(1)	(1)
Y	694 HK	Beijing Capital International Airport Company	Industrial Transportation	(29)	25	(8)	(7)	54	(18)	(27)	(22)
Y	1138 HK	China Shipping Development Company	Industrial Transportation	172	21	(33)	30	10	(10)	(7)	(9)
Y	1800 HK	China Communications Construction	Construction & Materials	n.a.	n.a.	n.a.	n.a.	102	(1)	(81)	(11)
	2899 HK	Zijin Mining Group Co.	Mining	n.a.	15	79	138	115	(9)	(1)	(5)
	8211 HK	Zhejiang Yonglong Enterprises Co.	Personal Goods	(10)	(31)	(77)	(53)	1177	(44)	(59)	(3)
	8253 HK	Sanmenxia Tianyuan Aluminum Co.	Industrial Metals & Mining	n.a.	n.a.	(80)	0	404	(12)	(57)	(24)
	217 HK	China ChengTong Development Group	Real Estate Investment & Servi	(3)	46	(48)	114	163	(15)	(5)	(42)
	218 HK	Shenyin Wanguo (H.K.) Ltd.	Financial Services	(42)	(9)	(49)	76	374	(12)	(18)	(8)
	308 HK	China Travel International Investment	Travel & Leisure	(61)	71	(41)	(42)	39	(18)	(5)	(26)
Y	3382 HK	Tianjin Port Development Holdings	Industrial Transportation	n.a.	n.a.	n.a.	n.a.	78	(17)	(5)	(36)
	8178 HK	China Information Technology Development	Software & Computer Services	(125)	(24)	(54)	(122)	1753	(30)	(75)	(3)
	1180 HK	Paradise Entertainment	Pharmaceuticals & Biotechnolog	(119)	48	(58)	(65)	25	(28)	(78)	(68)
	2700 HK	Smart Union Group (Holdings)	Leisure Goods	n.a.	n.a.	n.a.	n.a.	148	(42)	(59)	(3)
	8053 HK	China Electric Power Technology Holdings	General Retailers	n.a.	n.a.	27	(46)	66	(26)	(97)	(29)
	8270 HK	China Leason Investment Group	Software & Computer Services	n.a.	(18)	(75)	(48)	650	(13)	(87)	(24)
Y	3368 HK	Parkson Retail Group	General Retailers	n.a.	n.a.	n.a.	96	80	(1)	(3)	(7)
Y	STP US	Suntech Power Hldg	Alternative Energy	n.a.	n.a.	n.a.	(54)	79	(34)	(17)	(60)

Note: Our stock pool includes all the Hong Kong listed China companies as well as Nomura covered offshore listed China companies. Pricing as of 1 December 2010

Source: Bloomberg, Nomura research

## Nomura Survey – Ideas for 2011

Our survey of 50 investors was conducted on 17 and 18 October, 2010.

### Exhibit 82. Nomura survey – ideas for 2011

Macro	Result Summary
1. Do you think PBoC will hike interest rates this year?	41
Yes	8
No	33
2. If there is an interest rate hike this year, do you think it will be symmetric or asymmetric?	38
Symmetric	14
Asymmetric	24
3. Nomura is forecasting 4 interest rate hikes in 2011. Do you think this is	41
Aggressive	24
In line	16
Conservative	0
4. Do you think tightening policies for the property market will eventually bring down property prices?	41
Yes	4
No	12
Will have some effect	25
5. Do you think a property tax will be launched in	40
2010	5
2011	27
Not in both years	8
6. Nomura is forecasting a 6.22 RMB/US\$ exchange rate at the end of 2011. Do you think this is	41
Aggressive	15
In line	22
Conservative	4
7. What is your view on the GDP growth outlook for 2011?	41
<8%	5
8-9%	23
9-10%	12
>10%	1
8. What is your view on the CPI outlook for 2011?	41
<3%	3
3-5%	33
>5%	5
9. In 2011, you think China's bank loan quota will be	36
<RMB 7tril	1
RMB 7-8tril	19
RMB 8-9tril	16
>RMB 9tril	0
10. In 2011, what do you think are the biggest risks to China economic growth?	37
Global economic growth uncertainty	10
High inflation	25
Credit tightening	9
Hot money inflow	8
RMB appreciation	6
High crude oil price	4

Source: Nomura research

**Exhibit 82. Nomura survey – ideas for 2011 (Cont'd)**

Market/ Sectors	Result Summary
11. In 2011, you think the A-share market will post a year-end return of	35
>20%	9
10-20%	18
0-10%	6
-10%-20%	1
>-20%	1
12. In 2011, you think the H-share market will post a year-end return of	35
>20%	9
10-20%	17
0-10%	7
-10%-20%	2
>-20%	0
13. In 2011, you think the China property market will post a year-end return of	35
>20%	3
10-20%	5
0-10%	20
-10%-20%	7
>-20%	0
14. Which three sectors are you most positive on for 2011?	35
Airlines	2
Agriculture	10
Autos	6
Insurance	7
Banks	10
Cement	1
Steel	1
Technology	13
Utilities (water and electricity)	1
Chemicals	2
Consumer goods	21
Commodities	12
Engineering and machinery	7
Food	12
Property	2
Shipping	3
Telecoms	7
15. Which three sectors are you most negative on for 2011?	32
Airlines	8
Agriculture	2
Autos	4
Insurance	0
Banks	2
Cement	6
Steel	15
Technology	2
Utilities (water and electricity)	10
Chemicals	5
Consumer goods	1
Commodities	1
Engineering and machinery	4
Food	2
Property	9
Shipping	9
Telecoms	1

Source: Nomura research

**Exhibit 83. RoE**

(%)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Oct 2010
<b>MSCI China</b>	<b>n.a.</b>	<b>11</b>	<b>8</b>	<b>8</b>	<b>8</b>	<b>10</b>	<b>20</b>	<b>16</b>	<b>16</b>	<b>19</b>	<b>21</b>	<b>20</b>	<b>23</b>	<b>18</b>	<b>19</b>	<b>21</b>
Consumer--Discretionary	14	5	(5)	12	17	20	20	18	22	16	16	19	20	18	20	25
Energy	n.a.	n.a.	n.a.	n.a.	n.a.	19	19	17	20	26	28	28	23	20	17	20
Consumer--Staple	n.a.	8	2	2	2	1	(13)	0	9	7	17	19	22	16	25	26
Healthcare	n.a.	n.a.	n.a.	n.a.	n.a.	15	11	15	26	11	8	7	7	7	23	21
Material	18	7	6	3	7	(1)	5	8	14	23	21	26	26	14	12	15
Industrial	n.a.	14	8	6	5	8	7	9	8	14	18	13	24	10	10	16
Telecom services	n.a.	n.a.	n.a.	n.a.	n.a.	9	29	21	19	19	20	21	23	25	21	19
Information technology	14	5	-5	12	17	20	20	18	22	16	16	19	20	18	20	25
Utilities	n.a.	n.a.	13	12	12	12	14	13	14	14	13	15	14	2	13	14
Finance	20	17	9	5	1	9	8	(3)	7	11	17	16	21	16	18	20

Source: Bloomberg, Nomura research

**Exhibit 84. Profit margin**

(%)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Oct 2010
Finance	26	36	56	20	9	16	73	(402)	29	6	22	20	30	27	35	38
Healthcare	n.a.	n.a.	n.a.	n.a.	n.a.	15	12	14	20	10	7	5	5	5	34	22
Telecom services	n.a.	n.a.	n.a.	n.a.	n.a.	12	28	24	22	21	21	21	23	25	22	21
Industrial	23	26	20	42	28	25	29	30	29	40	39	32	23	19	15	21
Energy	n.a.	n.a.	n.a.	n.a.	n.a.	15	21	21	19	22	22	22	21	19	19	20
Consumer--Staple	10	4	2	2	2	4	(181)	1	3	3	19	14	16	13	16	15
Material	14	5	4	1	6	(14)	7	9	12	17	13	13	14	10	12	14
Utilities	n.a.	27	25	24	21	21	21	19	20	16	18	19	15	4	13	13
Consumer--Discretionary	8	5	(14)	3	22	8	28	24	47	50	53	62	48	54	41	13
Information technology	8	5	(14)	3	22	8	28	24	47	50	53	62	48	54	41	13
<b>MSCI China</b>	<b>17</b>	<b>19</b>	<b>18</b>	<b>23</b>	<b>17</b>	<b>14</b>	<b>25</b>	<b>15</b>	<b>23</b>	<b>23</b>	<b>24</b>	<b>23</b>	<b>24</b>	<b>23</b>	<b>26</b>	<b>26</b>

Source: Bloomberg, Nomura research

**Exhibit 85. Debt to asset ratio**

(%)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Oct2010
Utilities	n.a.	35	35	30	28	28	29	28	32	41	47	47	48	61	58	58
Material	23	31	34	30	31	31	25	27	24	21	25	28	29	35	35	39
Industrial	28	29	26	32	31	28	25	26	24	29	30	32	24	25	27	28
Consumer--Discretionary	30	27	28	27	27	16	22	18	22	25	22	21	18	16	15	23
Information technology	30	27	28	27	27	16	22	18	22	25	22	21	18	16	15	23
Energy	n.a.	n.a.	n.a.	n.a.	n.a.	35	24	25	23	24	23	17	14	21	21	21
Healthcare	n.a.	n.a.	n.a.	n.a.	n.a.	22	24	23	21	31	33	34	34	34	10	16
Consumer--Staple	23	31	36	28	34	18	16	12	31	30	23	26	17	20	18	15
Finance	26	31	28	13	15	32	24	23	25	5	4	6	12	10	12	12
Telecom services	n.a.	n.a.	n.a.	n.a.	n.a.	15	17	21	20	23	20	17	13	11	12	11
<b>MSCI China</b>	<b>26</b>	<b>30</b>	<b>30</b>	<b>30</b>	<b>29</b>	<b>26</b>	<b>23</b>	<b>24</b>	<b>23</b>	<b>20</b>	<b>15</b>	<b>11</b>	<b>15</b>	<b>14</b>	<b>15</b>	<b>15</b>

Source: Bloomberg, Nomura research

**Exhibit 86. Asset turnover ratio**

(%)	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Oct 2010
Healthcare	n.a.	46	53	60	74	52	47	59	59	59	48	141
Consumer--Discretionary	57	93	75	78	80	80	89	100	89	89	79	109
Information technology	57	93	75	78	80	80	89	100	89	89	79	109
Consumer--Staple	43	22	6	9	118	141	99	95	105	106	101	97
Energy	n.a.	45	61	66	78	91	106	109	97	97	74	97
Material	63	51	65	63	78	97	103	91	81	78	62	67
Industrial	31	32	28	33	39	42	47	54	65	64	55	63
Telecom services	n.a.	50	58	43	48	47	49	52	58	61	52	54
Utilities	29	29	35	38	40	38	32	32	31	28	28	34
Finance	13	25	31	24	28	24	8	6	7	6	4	6
<b>MSCI China</b>	<b>44</b>	<b>45</b>	<b>53</b>	<b>53</b>	<b>62</b>	<b>56</b>	<b>39</b>	<b>27</b>	<b>30</b>	<b>26</b>	<b>20</b>	<b>20</b>

Source: Bloomberg, Nomura research

## MSCI China Index components

### Exhibit 87. MSCI China Index components and performance

TICKER	SECURITY NAME	SUB-INDUSTRY NAME	WEIGHTING (%)	2009 Return (%)	2010 YTD Return (%)
<b>MSCI China Index</b>			100.0	59	3
<b>Energy Sector</b>			17.6	74	13
2883 HK	CHINA OILFIELD SVCS H	Oil & Gas Drilling	0.4	49	55
386 HK	CHINA PETRO & CHEM H	Integrated Oil & Gas	2.3	47	5
857 HK	PETROCHINA CO H	Integrated Oil & Gas	4.0	37	5
883 HK	CNOOC	Oil & Gas Exploration & Production	5.8	69	39
135 HK	KUNLUN ENERGY	Oil & Gas Exploration & Production	0.5	328	12
1898 HK	CHINA COAL ENERGY H	Coal & Consumable Fuels	0.9	131	-12
1088 HK	CHINA SHENHUA ENERGY H	Coal & Consumable Fuels	2.3	132	-12
900948 CG	INNER MONGOLIA YITAI B	Coal & Consumable Fuels	0.6	251	60
1171 HK	YANZHOU COAL MINING CO H	Coal & Consumable Fuels	0.9	202	29
<b>Materials Sector</b>			5.7	82	-1
338 HK	SINOPEC SHANGHAI PETRO H	Commodity Chemicals	0.2	54	27
3983 HK	CHINA BLUECHEMICAL H	Fertilizers & Agricultural Chemicals	0.2	49	29
297 HK	SINOFERT HOLDINGS	Fertilizers & Agricultural Chemicals	0.2	16	-2
336 HK	HUABAO INTL HLDG	Specialty Chemicals	0.4	65	47
914 HK	ANHUI CONCH CEMENT H	Construction Materials	0.5	40	33
2009 HK	BBMG CORP H	Construction Materials	0.2	n.a.	29
3323 HK	CHINA NAT BUILDING MAT H	Construction Materials	0.5	73	14
2600 HK	ALUMINUM CORP OF CHINA H	Aluminum	0.6	110	-18
1333 HK	CHINA ZHONGWANG HOLDINGS	Aluminum	0.1	n.a.	-32
639 HK	FUSHAN INT'L ENERGY(CN)	Diversified Metals & Mining	0.3	289	-29
1393 HK	HIDILI INDUSTRY INTL DEV	Diversified Metals & Mining	0.2	300	-28
358 HK	JIANGXI COPPER CO H	Diversified Metals & Mining	0.6	223	26
2899 HK	ZIJIN MINING GROUP H	Gold	0.6	58	-1
347 HK	ANGANG STEEL H	Steel	0.3	97	-34
656 HK	FOSUN INT'L(CN)	Steel	0.2	113	8
323 HK	MAANSHAN IRON&STEEL H	Steel	0.1	106	-26
2314 HK	LEE & MAN PAPER MFG(CN)	Paper Products	0.2	461	18
2689 HK	NINE DRAGONS PAPER	Paper Products	0.4	466	-5
<b>Industrials Sector</b>			7.8	46	6
1800 HK	CHINA COMMUNIC CONSTRU-H	Construction & Engineering	0.6	-22	-8
1186 HK	CHINA RAILWAY CONST H	Construction & Engineering	0.3	-14	-5
390 HK	CHINA RAILWAY GROUP H	Construction & Engineering	0.5	12	-9
1618 HK	METALLURGICAL CHINA H	Construction & Engineering	0.2	n.a.	-25
658 HK	CHINA HIGH SPEED TRANSMI	Heavy Electrical Equipment	0.3	102	-25
1072 HK	DONGFANG ELECTRIC CORP H	Heavy Electrical Equipment	0.3	114	86
2727 HK	SHANGHAI ELECTRIC GRP H	Heavy Electrical Equipment	0.3	14	48
392 HK	BEIJING ENTERPRISES HLDG	Industrial Conglomerates	0.5	78	-14
267 HK	CITIC PACIFIC	Industrial Conglomerates	0.5	149	-4
363 HK	SHANGHAI IND HLDGS	Industrial Conglomerates	0.4	124	-16
1766 HK	CHINA SOUTH LOCOMOTIVE H	Construct & Farm Machinery & Heavy Trucks	0.3	35	63
3808 HK	SINOTRUK (HONG KONG)	Construct & Farm Machinery & Heavy Trucks	0.1	74	-7
2338 HK	WEICHAI POWER CO H	Construct & Farm Machinery & Heavy Trucks	0.4	329	78
200039 CS	CHINA INTL MARINE B SZ	Industrial Machinery	0.2	132	67
753 HK	AIR CHINA H	Airlines	0.4	153	73
1919 HK	CHINA COSCO HOLDINGS H	Marine	0.5	77	-11
2866 HK	CHINA SHIPPING CONTAIN H	Marine	0.2	139	12
1138 HK	CHINA SHIPPING DEV H	Marine	0.3	51	-5
694 HK	BEIJING CAP INT'L AIRP H	Airport Services	0.2	32	-19
177 HK	JIANGSU EXPRESSWAY CO H	Highways & Railtracks	0.2	21	24
576 HK	ZHEJIANG EXPRESSWAY H	Highways & Railtracks	0.2	58	3
144 HK	CHINA MERCHANTS HLDGS	Marine Ports & Services	0.6	69	21
1199 HK	COSCO PACIFIC	Marine Ports & Services	0.4	26	24

TICKER	SECURITY NAME	SUB-INDUSTRY NAME	WEIGHTING (%)	2009 Return (%)	2010 YTD Return (%)
<b>MSCI China Index</b>			<b>100.0</b>	<b>59</b>	<b>3</b>
<b>Consumer Discretionary Sector</b>			<b>5.4</b>	<b>146%</b>	<b>3</b>
1211 HK	BYD CO H	Automobile Manufacturers	0.5	439	-30
489 HK	DONGFENG MOTOR GROUP H	Automobile Manufacturers	0.9	347	38
175 HK	GEELY AUTOMOBILE HLDGS	Automobile Manufacturers	0.3	578	0
2238 HK	GUANGZHOU AUTO GROUP H	Automobile Manufacturers	0.5	n.a.	n.a.
751 HK	SKYWORTH DIGITAL HLDGS	Consumer Electronics	0.1	1734	-49
2020 HK	ANTA SPORTS PRODUCTS	Apparel, Accessories & Luxury Goods	0.3	226	27
3818 HK	CHINA DONGXIANG	Apparel, Accessories & Luxury Goods	0.2	219	-42
2331 HK	LI NING CO	Apparel, Accessories & Luxury Goods	0.3	144	-29
308 HK	CHINA TRAVEL INT'L	Hotels, Resorts & Cruise Lines	0.1	54	-22
3308 HK	GOLDEN EAGLE RETAIL GRP	Department Stores	0.3	191	41
3368 HK	PARKSON RETAIL GROUP(CN)	Department Stores	0.3	55	-4
1880 HK	BELLE INT'L HLDGS(CN)	Apparel Retail	1.1	166	57
493 HK	GOME ELEC APPLIANCES	Computer & Electronics Retail	0.5	180	12
<b>Consumer Staples Sector</b>			<b>5.8</b>	<b>113%</b>	<b>5</b>
291 HK	CHINA RESOURCES ENT.	Food Retail	0.7	110	18
8277 HK	WUMART STORES INC H	Hypermarkets & Super Centers	0.2	113	67
168 HK	TSINGTAO BREWERY H	Brewers	0.2	166	-3
200869 CS	YANTAI CHANGYU PIONEER B	Distillers & Vintners	0.3	154	32
682 HK	CHAODA MODERN AGRI.	Agricultural Products	0.3	68	-24
606 HK	CHINA AGRI HOLDINGS	Agricultural Products	0.3	165	-9
2319 HK	CHINA MENGNIU DAIRY CO	Packaged Foods & Meats	0.5	175	-18
1068 HK	CHINA YURUN FOOD GROUP	Packaged Foods & Meats	0.8	152	17
322 HK	TINGYI HOLDING CORP(CN)	Packaged Foods & Meats	0.7	114	0
151 HK	WANT WANT CHINA HLDGS	Packaged Foods & Meats	0.8	69	25
1044 HK	HENGAN INT'L GROUP CO	Personal Products	1.0	131	23
<b>Health Care Sector</b>			<b>0.8</b>	<b>n.a.</b>	<b>20</b>
1066 HK	SHANDONG WEIGAO GP MED H	Health Care Supplies	0.3	120	61
1099 HK	SINOPHARM GROUP CO H	Health Care Distributors	0.3	n.a.	3
2877 HK	CHINA SHINEWAY PHARM GRP	Pharmaceuticals	0.2	233	72
<b>Financials Sector</b>			<b>38.6</b>	<b>68</b>	<b>-1</b>
1288 HK	AGRI BANK OF CHINA H	Diversified Banks	1.4	n.a.	n.a.
3988 HK	BANK OF CHINA H	Diversified Banks	5.1	98	5
3328 HK	BANK OF COMMUNICATIONS H	Diversified Banks	1.1	61	-4
998 HK	CHINA CITIC BANK H	Diversified Banks	0.7	150	-18
939 HK	CHINA CONSTRUCTION BK H	Diversified Banks	6.8	57	9
3968 HK	CHINA MERCHANTS BANK H	Diversified Banks	1.7	84	7
1988 HK	CHINA MINSHENG BANK H	Diversified Banks	0.5	n.a.	-5
1398 HK	ICBC H	Diversified Banks	6.7	58	-5
165 HK	CHINA EVERBRIGHT	Other Diversified Financial Services	0.3	102	-5
2628 HK	CHINA LIFE INSURANCE H	Life & Health Insurance	4.8	63	-12
2601 HK	CHINA PACIFIC INS GRP H	Life & Health Insurance	0.5	n.a.	-1
966 HK	CHINA TAIPING INSURANCE	Life & Health Insurance	0.4	111	4
2318 HK	PING AN INSURANCE H	Life & Health Insurance	2.8	81	34
2328 HK	PICC PPTY & CASUALTY H	Property & Casualty Insurance	0.5	67	66
817 HK	FRANSHION PROPERTIES	Diversified Real Estate Activities	0.2	30	-10
119 HK	POLY HNG KNG INVST(CN)	Diversified Real Estate Activities	0.3	431	-24
900932 CG	SHANGHAI LUJIA. B SS(USD)	Diversified Real Estate Activities	0.1	115	-16
1387 HK	RENHE COMMERCIAL HLDGS	Real Estate Operating Companies	0.2	49	-19
3383 HK	AGILE PROPERTY HLDGS	Real Estate Development	0.3	182	-3
688 HK	CHINA OVERSEAS LAND & INV	Real Estate Development	1.2	52	-6
1109 HK	CHINA RESOURCES LAND	Real Estate Development	0.6	86	-20
200002 CS	CHINA VANKE CO B	Real Estate Development	0.3	63	2
2007 HK	COUNTRY GARDEN HLDGS	Real Estate Development	0.2	52	1
3900 HK	GREENTOWN CHINA HLDGS	Real Estate Development	0.1	275	-29
2777 HK	GUANGZHOU R&F PROP H	Real Estate Development	0.2	60	-21
754 HK	HOPSON DEVELOPMENT HDGS	Real Estate Development	0.1	100	-26
1813 HK	KWG PPTY HLDG	Real Estate Development	0.2	160	2
960 HK	LONGFOR PROPERTIES CO	Real Estate Development	0.2	n.a.	16
813 HK	SHIMAO PROPERTY HLDGS	Real Estate Development	0.4	174	-18
272 HK	SHUI ON LAND(CN)	Real Estate Development	0.2	107	-13
3377 HK	SINO-OCEAN LAND HLDGS	Real Estate Development	0.3	105	-34
410 HK	SOHO CHINA	Real Estate Development	0.2	26	45

TICKER	SECURITY NAME	SUB-INDUSTRY NAME	WEIGHTING (%)	2009 Return (%)	2010 YTD Return (%)
<b>MSCI China Index</b>					
<b>Information Technology Sector</b>			5.1	231%	0
1688 HK	ALIBABA.COM	Internet Software & Services	0.4	223	-28
700 HK	TENCENT HOLDINGS LIM(CN)	Internet Software & Services	3.4	237	3
763 HK	ZTE CORP H	Communications Equipment	0.3	207	-8
992 HK	LENOVO GROUP	Computer Hardware	0.5	130	8
148 HK	KINGBOARD CHEM. HOLD(CN)	Electronic Components	0.4	122	32
981 HK	SMIC	Semiconductors	0.2	54	16
<b>Telecommunication Services Sector</b>			11.4	-4%	7
552 HK	CHINA COMM SERVI H	Integrated Telecommunication Services	0.2	-21	28
728 HK	CHINA TELECOM CORP H	Integrated Telecommunication Services	1.0	12	22
762 HK	CHINA UNICOM	Integrated Telecommunication Services	1.2	11	2
941 HK	CHINA MOBILE	Wireless Telecommunication Services	9.1	-6	7
<b>Utilities Sector</b>			1.7	-2	-11
2688 HK	ENN ENERGY HOLDINGS	Gas Utilities	0.3	145	14
270 HK	GUANGDONG INVESTMENT	Water Utilities	0.2	46	-14
916 HK	CHINA LONGYUAN POWER H	Independent Power Producers & Energy Traders	0.3	n.a.	-27
836 HK	CHINA RESOURCES POWER	Independent Power Producers & Energy Traders	0.5	6	-10
991 HK	DATANG INT'L POWER H	Independent Power Producers & Energy Traders	0.2	-18	-16
902 HK	HUANENG POWER INTL H	Independent Power Producers & Energy Traders	0.2	-22	-6

Note: Pricing as of 1 December 2010

Source: Bloomberg, Nomura research

## Autos and Auto Parts

# NEUTRAL

### ⊙ Action

We estimate China's total auto sales will increase 15% y-y to reach 20mn units in 2011, driven mainly by strong PV sales (16% y-y). We believe limited capacity growth, and thus limited pricing pressure, will help sustain PV makers' high operating margins in 1H 2011. We believe the small car will regain market share, but only slightly, as large sedan and SUV sales will be supported by replacement demand. Reiterate BUY on Dongfeng, Geely and Great Wall.

### ⚡ Catalysts

Better-than-expected sales could serve as a positive catalyst. Government policy could be negative if a high tax rate is levied on large displacement engines.

### ⚓ Anchor themes

We expect China PV sales to remain strong in the next few years due to improving affordability, while government policy remains a swing factor for product mix.

### Stocks for action

Dongfeng's rich product line-up and high operating leverage should help it record solid earnings growth. Geely should benefit from new product launches and enhanced brand equity, while Great Wall could maintain strong SUV and sedan sales momentum.

Stock	Rating	Price	Price target
Dongfeng (489 HK)	BUY	15.48	19.5*
Geely (175 HK)	BUY	4.29	5.5
Great Wall (2333 HK)	BUY	28.55	32.0

Priced as of 1 December 2010; \* Changed on 29 Nov

## Passengers in front

### ① We prefer passenger cars over commercial vehicles

We believe traditional passenger vehicle sales volume in China will increase 16% y-y in 2011F to 12.8mn vehicles. We expect prices to stay strong in 2010F due to limited capacity growth, although it could start weakening by year end. We expect the small car to regain market share due to rising inland demand and potential policy support, but only marginally as sales of large sedans and SUVs will be supported by replacement demand. Therefore, we believe operating margin will remain high as in 2010. However, we are cautious on heavy duty truck demand growth (+7% y-y) due to a decline in newly started projects and a high base effect.

### ② Supply in focus: limited capacity growth

Based on our extensive survey among almost all Chinese automakers, we expect PV capacity to rise by 16% y-y to 15.1mn units in 2011; thus, the industry-wide utilisation rate should stay above 80%, as in 2010. JVs are expected to operate at 104%, while we expect domestic brands to operate at 70%. Our survey also shows capacity will grow 23% to 18.6mn in 2012. Contrary to consensus, we rule out the possibility of overcapacity in the auto industry even in 2012. However, we believe some automakers' operating margin will decline sharply in 2012 due to a possible decline in operating leverage.

### ③ Investment conclusion: BUY Dongfeng, Geely and Great Wall

Our stock picks are based on a combination of product cycle, profitability cycle and company investment/cost cycle. We prefer Dongfeng, Geely and Great Wall for 1H 2011, in this order, and believe GAC could be interesting in 2H 2011 due to new product launches and an improving utilisation rate. We expect the Chinese government to enact some policies to curb large car sales growth and discourage private driving in metropolises (by encouraging the use of public transport) in 2011, which could exert downward pressure on share prices.

### Analysts

Yankun Hou

+852 2252 6234

[yankun.hou@nomura.com](mailto:yankun.hou@nomura.com)

Ming Xu

+852 2252 1569

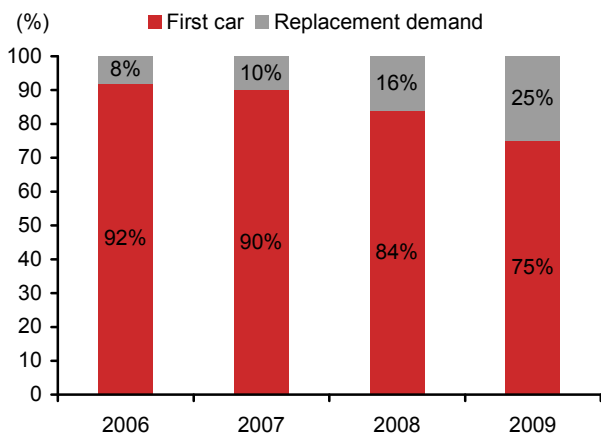
[ming.xu@nomura.com](mailto:ming.xu@nomura.com)

**Exhibit 88. PV industry sales and capacity overview**

	2008	2009	2010F	2011F	2012F
<b>Capacity</b>	<b>9,887,500</b>	<b>11,184,000</b>	<b>13,022,000</b>	<b>15,142,000</b>	<b>18,637,000</b>
<i>Growth (%)</i>		13.1	16.4	16.3	23.1
JV	6,000,500	6,457,000	7,045,000	7,850,000	9,875,000
<i>Growth (%)</i>		7.6	9.1	11.4	25.8
Domestic	3,887,000	4,727,000	5,977,000	7,292,000	8,762,000
<i>Growth (%)</i>		21.6	26.4	22.0	20.2
<b>Sales</b>	<b>5,660,000</b>	<b>8,390,000</b>	<b>11,026,540</b>	<b>12,834,106</b>	<b>14,502,540</b>
<i>Growth (%)</i>		48.2	31.4	16.4	13.0
<b>Utilization rate (%)</b>	<b>57.2</b>	<b>75.0</b>	<b>84.7</b>	<b>84.8</b>	<b>77.8</b>

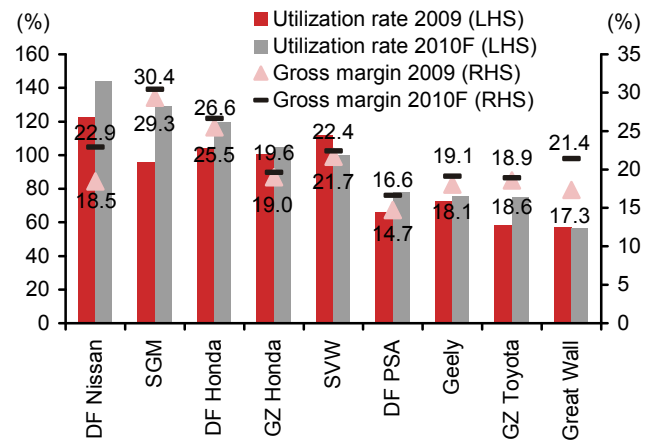
Source: Company data, Nomura estimates

**Exhibit 89. Auto demand breakdown in China**



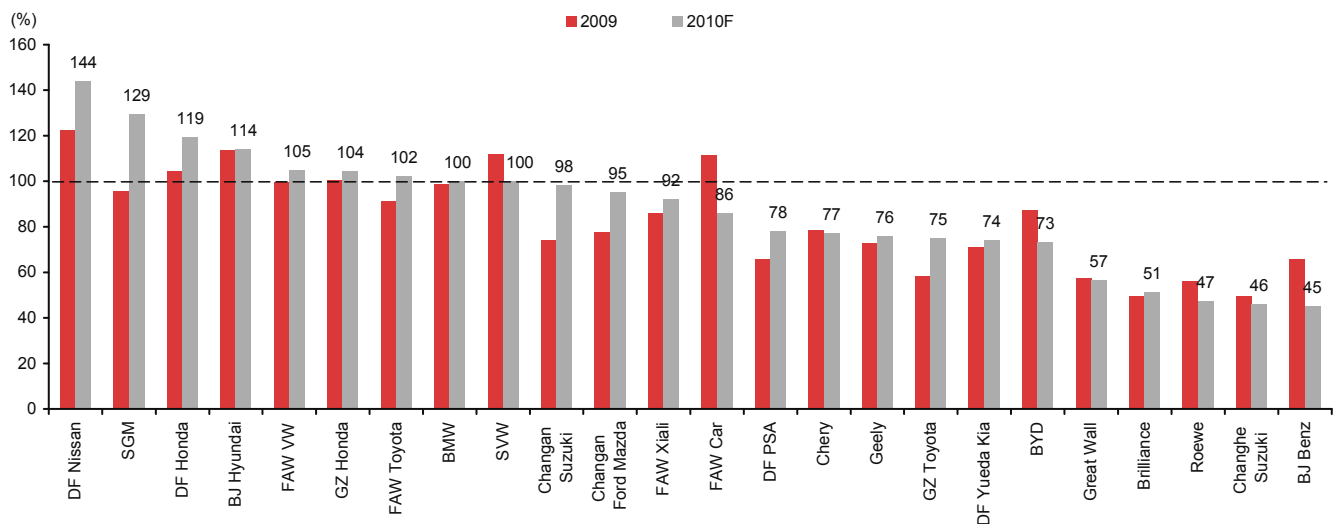
Source: JD Power, Nomura research

**Exhibit 90. Major OEM capacity utilisation and gross margin trend**



Source: Bloomberg, Nomura research

**Exhibit 91. OEM utilisation comparison**



Source: CEIC, Nomura research

## Banks

### 🕒 Action

We reiterate our Bullish stance on Chinese banks and expect 16-35% y-y net profit growth in 2011F, despite likely lower new loan growth as well as tighter liquidity. We think any substantial policy change will likely come with phase-in periods and, hence, should not have a significant earnings impact. With the overhang from capital-raising probably gone by early next year, we recommend a basket of Chinese banks with their own themes. Our top picks: BOC, CMB and ABC.

### 📈 Catalysts

Rate hikes could serve as a catalyst to expand the sector's NIM.

### ⚓ Anchor themes

The operating environment for Chinese banks remains favourable in 2011F, but the negative sentiment from uncertainties over policies and asset quality continues to weigh on valuation. Better visibility on regulatory policies (capital and provisioning) could trigger a re-rating in the near term.

## Maintaining growth amid tightening policy

### ① China banks set to maintain decent earnings growth in 2011F

We forecast 16-35% y-y earnings growth for Chinese banks in 2011F, due to expanding NIMs, moderate new loan growth and benign asset quality trends. Despite that liquidity tends to be becoming less abundant and, according to the government, new loan growth is likely to be lower in 2011F, we believe the likely introduced four rate hikes, as expected by our economics team, will boost banks' NIMs by 6-16bps, thus underpinning banks' earnings growth in FY11F.

### ② Asset quality should remain benign in the next year

We think the market has generally over-reacted to concerns about asset quality and policy risks. Based on our estimates as well as the managements of Chinese banks, asset quality should continue to be benign in 2011F. According to our sensitivity analysis, we believe NPL ratios would only increase by 0.4-0.5pct if property prices drop by 20% and 0.03-0.49pct if an additional 2% of LGFV loans become NPL. In addition, we understand that banks have already tightened lending standards, which should help reduce the risk of loan defaults in the future. As a result, even if PBOC hikes interest rate by 60bps, we do not think it would weigh much on Chinese banks' asset quality in the following year.

### ③ New policies soon to be introduced for capital and provisioning

We expect the CBRC to soon unveil a main framework for capital and provisioning regulation of commercial banks. We believe the minimal CAR ratio requirements of 11.5% for total CAR and 10% for T1 CAR would be maintained. Given China's banking capital adequacy ratio already stands at 11.1% and T1 CAR at 9% on average as of 1H10, and capital raising amounting to a total estimated amount of RMB312bn, we think most Chinese banks should be able to meet the new capital standard.

In our view, the continued benign asset quality environment would spur the CBRC to introduce a proposed 2.5% provision-to-total loan requirement in order to allow banks to better cover the risks from future loan defaults. We estimate the Chinese banks already maintain a provision/loan ratio of 2.5%, assuming a normalised annual credit cost of 50-60bps. That said, banks must also consider the added impact of provisioning on the bottom line as they expand their loan books.

## BULLISH

### Stocks for action

We remain positive on the sector, with BOC, ICBC, CMB and ABC our top H-share picks, and Industrial Bank our preferred A-share stock.

Stock	Rating	Price	Price target
ABC-H (1288 HK)	BUY	4.13	4.70
CCB-H (939 HK)	BUY	7.03	8.50
BOC-H (3988 HK)	BUY	4.22	5.30
BOCOM-H (3328 HK)	BUY	8.22	11.00
CMB-H (3968 HK)	BUY	20.50	26.36
CITIC Bank-H (998 HK)	BUY	5.46	6.60
Minsheng-H (1988 HK)	NEUTRAL	6.91	7.40

Note: All as of 1 December, 2010. All in local currency.  
Source: Bloomberg, Nomura research

### Analysts

Lucy Feng

+852 2252 2165

[lucy.feng@nomura.com](mailto:lucy.feng@nomura.com)

Donger Wang

+852 2252 1590

[donger.wang@nomura.com](mailto:donger.wang@nomura.com)

## Exhibit 92. CAR and T1 CAR

	CAR (%)		T1 CAR (%)	
	10F	11F	10F	11F
China (H-share)				
ABC - H	12.89	12.58	9.70	9.73
CCB-H	12.27	11.31	9.42	8.94
BOC-H	12.40	11.69	9.57	9.08
BOCOM-H	13.62	13.42	9.48	9.44
CMB-H	11.26	10.88	8.36	8.48
CITIC Bank-H	10.15	10.99	8.23	9.14
Minsheng-H	11.33	10.88	8.09	7.76

Source: Nomura estimates

## Exhibit 93. Provision to total loan ratios and NPL

(%)	Provision/ total loans (3Q10)	NPL		
		10F	11F	12F
ABC - H	3.32	2.05	1.77	1.80
CCB-H	2.43	1.30	1.39	1.51
BOC-H	2.19	1.43	1.44	1.47
BOCOM-H	2.05	1.26	1.20	1.16
CMB-H	1.94	0.67	0.72	0.75
CITIC Bank-H	1.43	0.85	0.80	0.77
Minsheng-H	1.93	0.96	1.10	1.21

Source: Company data, Nomura research estimates

## Exhibit 94. Forecast summary

China (H-share)	BVPS			EPS			DPS			ROE (%)			ROA (%)		
	09	10F	11F	09	10F	11F	09	10F	11F	09	10F	11F	09	10F	11F
ABC - H	1.32	1.64	1.96	0.25	0.28	0.38	0.08	0.06	0.17	20.5	21.1	21.3	0.82	0.96	1.11
CCB-H	2.39	2.93	3.35	0.46	0.55	0.66	0.20	0.25	0.30	20.8	21.3	21.1	1.24	1.31	1.36
BOC-H	2.01	2.22	2.44	0.32	0.34	0.40	0.14	0.15	0.18	16.6	17.1	17.2	1.09	1.06	1.05
BOCOM-H	3.36	3.89	4.38	0.62	0.75	0.87	0.25	0.30	0.35	19.2	20.6	20.9	1.01	1.08	1.13
CMB-H	4.85	6.32	7.66	0.95	1.27	1.68	0.21	0.38	0.51	21.1	24.0	24.1	1.00	1.20	1.30
CITIC Bank-H	2.77	3.10	3.41	0.37	0.48	0.49	0.09	0.17	0.17	14.3	16.5	16.4	0.98	0.94	0.94
Minsheng-H	3.99	3.99	3.99	0.54	0.56	0.70	0.05	0.11	0.14	17.0	16.0	18.8	0.98	0.93	0.95

Source: Company data, Nomura estimates

## Exhibit 95. Valuation comparison

China (H-share)	Rating	Price target	Potential			Mkt cap (US\$m)	P/BV (x)			P/E (x)			Div. yield (%)			Price performance (%)			
			Current price	up/down-side (%)			09	10F	11F	09	10F	11F	09	10F	11F	YTD	1M	3M	6M
ABC - H	BUY	4.70	4.13	13.80	132,407	2.74	2.08	1.65	14.47	12.01	8.43	2.13	1.87	5.34	na	(0)	17	na	na
CCB-H	BUY	8.50	7.03	20.91	224,380	2.57	1.98	1.64	13.47	10.57	8.29	3.28	4.26	5.43	9	(5)	13	17	3
BOC-H	BUY	5.30	4.22	25.59	141,681	1.83	1.57	1.35	11.57	10.13	8.22	3.79	4.44	5.47	5	(8)	13	15	(1)
BOCOM-H	BUY	11.00	8.22	33.82	53,018	2.14	1.75	1.47	11.66	9.07	7.43	3.43	4.41	5.38	(4)	(3)	(1)	6	(7)
CMB-H	BUY	26.36	20.50	28.61	45,132	3.70	2.68	2.09	18.82	13.31	9.52	1.17	2.25	3.15	7	(10)	2	14	4
CITIC Bank-H	BUY	6.60	5.46	20.88	30,460	1.72	1.46	1.25	12.82	9.34	8.74	1.84	3.75	4.01	(18)	(6)	7	19	(16)
Minsheng-H	NEUTRAL	7.40	6.91	7.09	21,123	1.52	1.43	1.35	11.13	10.25	7.69	0.83	1.95	2.60	(5)	(4)	(2)	9	na

Note: Closing prices as of 1 December 2010.

Source: Bloomberg, Nomura estimates

## Cement

**BULLISH**

### ⊙ Action

Cement prices across most parts of China were solid in Oct, thanks to strong demand and power rationing since end-August. We remain upbeat on Northwest China's cement market prospects and believe the strong profitability clocked this year should continue into 2011F. We remain Bullish on China's cement sector. Our top two picks in the China cement space: Sinoma and Anhui Conch.

### ⚡ Catalysts

Stronger-than-expected demand growth, faster-than-expected cement price hikes, industry consolidation and favourable government policies.

### ⚓ Anchor themes

We consider cement the best proxy for China's investment-driven economic growth, as it is used 100% in the construction sector. Nomura's China economics team calls for 30% y-y FAI growth in 2010F, providing solid support to the cement demand outlook.

### Stocks for action

Sinoma and Anhui Conch are our top picks in the China cement space. We like Sinoma for its significant exposure to the lucrative West China market, while Anhui Conch stands out for its leading market share.

Stock	Rating	Price	Price target
Anhui Conch (914 HK)	BUY	HK\$33.2	HK\$40.0
CNBM (3323 HK)	BUY	HK\$18.26	HK\$22.0
Asia Cement (1102 TT)	BUY	NT\$30.70	NT\$36.2
Taiwan Cement (1101 TT)	BUY	NT\$32.20	NT\$40.8
Sinoma (1893 HK)	BUY	HK\$7.19	HK\$8.70

Prices as of 1 Dec. market close.

## Bullish stance intact

### ① Regional market updates

Cement prices were largely stable across North and Northwest China markets in October, while prices in East, Central and South China saw both m-m and y-y increases. Prices in East China averaged RMB360/t in October, up 21% y-y and 7% m-m. Prices in Zhejiang province, where power rationing was applied earliest and most extensively, were up 37% y-y and 2% m-m to RMB389/t in October, while cement prices in neighbouring Jiangsu surged 10% m-m and 26% y-y. Cement prices in Central China are also benefiting from power rationing, albeit applied on a smaller scale, with rises of 15% m-m and 13% y-y to RMB345/t in October. Prices in South China went up 23% y-y and 2% m-m to RMB434/t in October. Northeast and South west markets were the laggards in October. Cement prices in Northeast China slid 1% m-m and 5% y-y to RMB366/t in October due to negative seasonality. Prices in Southwest China were flat m-m but down 9% y-y to RMB329/t in October. Encouragingly, prices in Sichuan inched up 1% m-m at RMB314/t in October, suggesting local prices might finally stabilise in 4Q10 with potential demand from post-flood reconstruction.

### ② Northwest China: the promised land during 12<sup>th</sup> FYP period

Backed by significant FAI and rich natural resources, Northwest China has long enjoyed higher-than-national average cement prices but relatively low coal prices. Thus, Northwest China has the highest gross margin, usually above 25% versus 10-18% for the rest of China and around 15% for the national average, according to data from China Cement Net. Our recent conversation with Xinjiang-based Tianshan Cement validates the data: Tianshan's cement gross margin in Xinjiang is generally >30% (gross profit/t of RMB70-80/t), while the gross margin in its eastern market usually hovers around 10%.

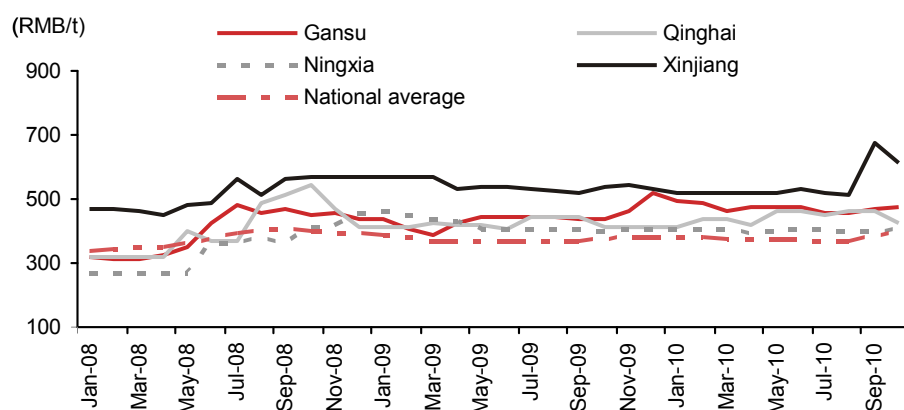
We believe Northwest China will remain the promised land for cement business over the next five years as the West China Development Plan will continue into 12<sup>th</sup> FYP period, meaning continued massive government investment.

### Analyst

Josephine Ho

+852 2252 2177

[josephine.ho@nomura.com](mailto:josephine.ho@nomura.com)

**Exhibit 96. Cement price movements in West China versus national average**

Source: China Cement Net, Nomura research

### ③ Potential push in demand from social welfare housing program

It is reported that China will build a total of 13mn social welfare apartments in 2011-12F (21 CBH, 18 November), of which 6.8mn and 6.2mn units will be completed in 2011 and 2012F, respectively. Assuming the average living space per household is 60 m<sup>2</sup> and the average cement consumption per m<sup>2</sup> of floor space is roughly 0.2 tonnes (industry average), we find the incremental cement demand from social welfare apartments could reach 82mt and 74mt in 2011-2012F, respectively, representing 5% and 4.5% of China's total 2009 cement production of 1,637mt. As such, we believe the social welfare housing programme, if implemented well, should provide a boost to cement volume and prices in 2011-12F. However, we are a bit sceptical that local governments and developers will develop so many affordable apartments as mandated by the central government. Nomura property analyst Alvin Wong reckons that local governments and developers lack the incentive to develop social welfare apartments, given the low margins. Alvin thinks it makes sense for local governments to gradually place less emphasis on the provision of subsidised housing over the years, as they have multiple projects that they want to do, and land sales revenue is a major source of their annual income for funding other projects. Thus, we retain our 2011F cement demand forecast of 1.95bn tonnes (up 10.9% y-y), to be conservative. We will keep monitoring the updates of China's social housing program and will likely revisit our forecast if any solid data points come in.

### ④ Bullish on China cement sector

China cement stocks under our coverage have outperformed the market by 1.2-20% in the past three months, with investors welcoming strong seasonality in 2H fuelled by power rationing across the country. With the Chinese government preparing to unveil its 12<sup>th</sup> FYP around March-April 2011F, we believe a lot more industry and policy positives have yet to be fully priced in. Thus, we stay Bullish on the China cement sector, with Sinoma and Anhui Conch being our two top picks.

## Container box manufacturing

**BULLISH**

### ⊙ Action

The global box shortage (highlighted by current slot ratio dropping below 2.0x norm and restart of old boxes disposal) and box manufacturers tightly controlling production capacity lead to our Bullish view on the sector. We forecast marginal improvement of 8% in the ASP of boxes and 66% growth in global box production.

### ✈ Catalysts

Catalysts include stronger container demand, lower-than-expected containership delays/cancellation driven by stronger container activity and rise in ASP of boxes.

### ⚓ Anchor themes

We remain Bullish on the box manufacturing sector due to strong box demand (from old box replacement, new box demand from new ships), coupled with tight control on capacity. We expect box shortage would remain a global issue for at least 18 months, leading to support to ASP of boxes and high margins.

### Stocks for action

While we have a BUY on both CIMC and Singamas, we prefer CIMC as it is trading below mid-cycle while Singamas is above mid-cycle.

Stock	Rating	Price	Price target
CIMC (000039 CH)	BUY	18.66	21.00
Singamas (716 HK)	BUY	2.41	2.22*

Local currency; prices as at 1 December market close

\* PT under review

## Another good year in 2011

In our view, the global box shortage issue will remain a problem in 2011F. We believe the key reasons for the shortage come from: 1) strong box demand (as supported by current slot ratio dropping to only 1.6-1.7x compared with an average of 2.0x and replacement demand for restart of old box disposals); and 2) tight production capacity controlled by box manufacturers. Based on our forecast, we estimate the ASP of a 20" dry container box will increase from US\$2,400 in 2010F to US\$2,550-2,600 in 2011F, and global box production will total 3.2mn TEUs in 2011F (1.9mn TEUs in 2010F).

We continue to foresee strong container box demand driven by:

- **Replacement demand** – We believe most box owners postponed their box disposal plans during 2010 due to the box shortage issue, leading to replacement demand from restart of disposal plans in 2011.
- **New box demand** – With new ship capacity continuing to be delivered in 2011F (we forecast 9% growth in 2011F containership supply), this is another driver for new boxes. Highlighted by an average slot ratio of 2.0x (for example, a 1,000 TEUs containership requires an average of 2,000 TEUs of container boxes), we estimate 2.7mn TEUs of boxes are required for new vessels in 2011F.

Another positive catalyst comes from the slow steaming strategy currently adopted by carriers, as the boxes would have longer at sea, leading to a longer repositioning time. According to Textainer (the largest container leasing company), the currently slow steaming strategy has absorbed some 5-7% of boxes.

While current global box production capacity is still lower (we estimate about 3.0 TEUs by end-2010F) than the 5.9mn TEUs peak capacity in 2007 (when all factories operated under double shifts), we foresee tight capacity control in 2011F, and hence, capacity is likely to increase only gradually. Eg, only some factories with stronger, more stable demand (such as in Shanghai) may operate under double shifts, while the remainder may be under one shift plus some overtime, in our view. We estimate production capacity will reach 3.6mn TEUs in 2011F, from 3.0mn TEUs at end-2010.

### Analysts

**Cecilia Chan**

+852 2252 6181

[cecilia.chan@nomura.com](mailto:cecilia.chan@nomura.com)

**Andrew Lee**

+852 2252 6197

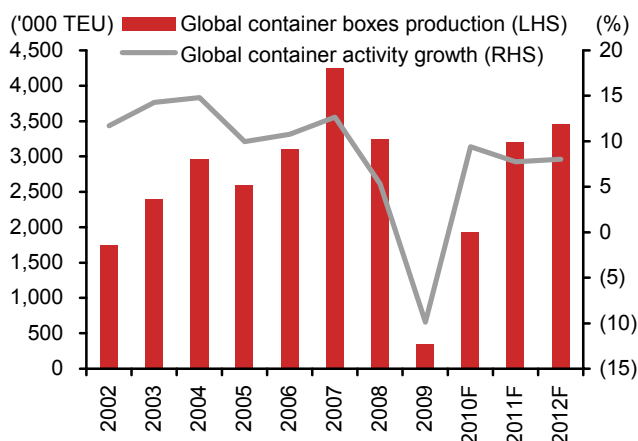
[andrew.lee@nomura.com](mailto:andrew.lee@nomura.com)

**Exhibit 97. Global container box supply**

('000 TEUs)	2002	2003	2004	2005	2006	2007	2008	2009	2010F	2011F	2012F
Global container boxes supply, 1 January	15,530	16,560	18,085	19,965	21,415	23,335	26,235	28,135	27,135	28,385	29,537
y-y % chng	4.4	6.6	9.2	10.4	7.3	9.0	12.4	7.2	(3.6)	4.6	4.1
Production	1,740	2,400	2,960	2,600	3,100	4,250	3,250	350	1,928	3,204	3,461
y-y % chng	35.9	37.9	23.3	(12.2)	19.2	37.1	(23.5)	(89.2)	450.8	66.2	8.0
Disposal	710	875	1,080	1,150	1,180	1,350	1,350	1,350	678	2,051	1,691
y-y % chng	13.6	23.2	23.4	6.5	2.6	14.4	0.0	0.0	(49.8)	202.3	(17.5)
<b>Global container boxes supply, 31 December</b>	<b>16,560</b>	<b>18,085</b>	<b>19,965</b>	<b>21,415</b>	<b>23,335</b>	<b>26,235</b>	<b>28,135</b>	<b>27,135</b>	<b>28,385</b>	<b>29,537</b>	<b>31,307</b>
y-y % chng	6.6	9.2	10.4	7.3	9.0	12.4	7.2	(3.6)	4.6	4.1	6.0

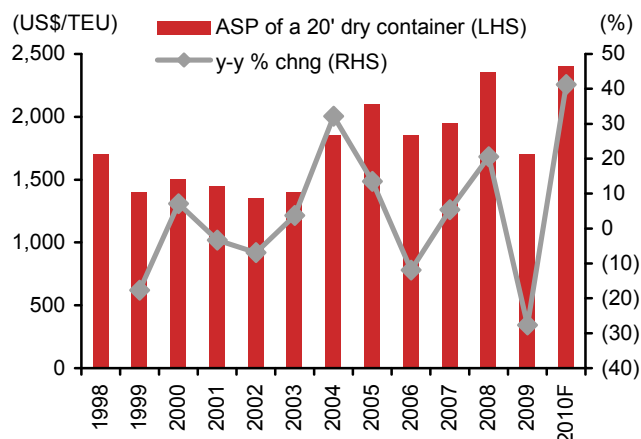
Source: Containerisation International, Nomura estimates

**Exhibit 98. Global box production vs container activity**



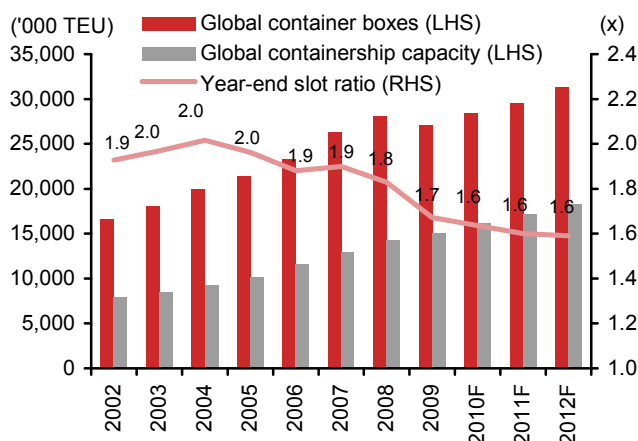
Source: Containerisation International, Nomura estimates

**Exhibit 99. ASP trend of a 20' dry container box**



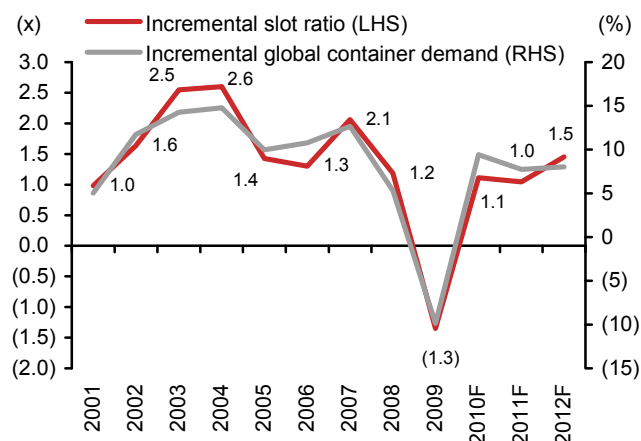
Source: Containerisation International, Nomura estimates

**Exhibit 100. Year-end slot ratio**



Source: Container International, Nomura estimates

**Exhibit 101. Incremental slot ratio**



Source: Containerisation International, Nomura estimates

## Food & Beverages

**BULLISH**

### ⊙ Action

We think it is coming to the stage for downstream F&B plays with pricing power to convert cost hikes into price hikes. Based on our higher ASP assumptions, we expect average EPS growth for China F&B to pick up in FY11F (31% y-y, vs 11% for FY10F). We are bullish on the sector outlook for FY11F. Mengniu and Yurun are our top picks.

### ✈ Catalysts

Product price hikes, EPS upgrades by the street, M&A activity and positive macro updates (ie, minimum wage increase and urbanisation) stand as catalysts.

### ⚓ Anchor themes

We are positive on China's long-term consumption outlook. China's GDP per capita (about US\$3,700 in 2009) is close to seeing consumption pick up, based on the experience of developed markets.

### Stocks for action

We favour Mengniu and Yurun most for FY11F, given strong earnings and undemanding-looking valuations.

Stock	Rating	Price (HK\$)	Price target (HK\$)
China Mengniu (2319 HK)	BUY	22.70	32.0
China Yurun (1068 HK)	BUY	26.85	39.0
Tingyi (322 HK)	BUY	19.22	23.2
Huabao (336 HK)	BUY	12.32	14.8
China Agri (606 HK)	BUY	9.27	13.5
Want Want (151 HK)	BUY	6.81	8.2
Tsingtao Brewery (168 HK)	REDUCE	41.65	37.0
China Foods (506 HK)	REDUCE	5.44	4.2

Pricing as of 1 Dec, 2010

## Second part of the cost story

### ① Time to pass it on

We think any cost pressure as a result of price rises in soft commodities poses just a short-term threat to market leaders in the downstream F&B industry, since they can pass on cost pressure through product price hikes. Given the time lag from cost hike to price hike, and persistent cost pressure, we think market leaders that are suffering from cost pressure will raise product prices. We expect more price hikes in the sector in the short term. We think Mengniu, Want Want and Tingyi are most likely to raise prices.

### ② Downside risk of price control should be low

The market has been concerned about the potential for price controls on food. In our view, price controls would have more of an impact on investment sentiment than on company fundamentals. Moreover, any price controls on food might not be universally applied across the sector. Most of the leaders, such as Tingyi, Mengniu and China Foods in the staples sector which are most exposed to the risk of price controls, have raised product prices already.

### ③ Low penetration suggests strong, sustainable growth

According to Euromonitor, Chinese consumer spending on processed packaged products accounts for about 10% of total expenditure on food, compared with 48% in Japan and 57% in the US. Assuming 20% y-y growth in consumer spending on processed packaged products (versus 10% y-y growth in total expenditure on food) in China, it would take 15-20 years for Chinese consumers' diet mix to shift to the current level of developed countries. Given low penetration, we expect a sales CAGR of 27% for the listed entities in FY11-12F, compared with 21% for FY08-09. Yurun places top at 45%, while Tsingtao and CRE have the lowest score of 14%.

### ④ Valuation – premium looks justified

On our estimates, China's F&B sector is at a 53% premium to global peers on P/E. Still, we think China F&B is more attractive in terms of PEG, at 0.8x, versus 1.6x for global peers. We believe the P/E premium is warranted in view of the China F&B sector's defensiveness and sustainable growth.

### Analysts

Emma Liu

+852 2252 6172

[emma.liu@nomura.com](mailto:emma.liu@nomura.com)

Anita Chu

+852 2252 1425

[anita.chu@nomura.com](mailto:anita.chu@nomura.com)

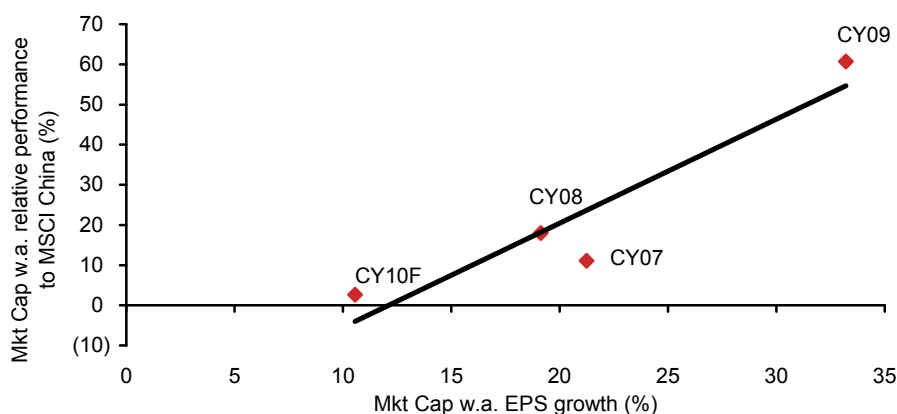
## Brighter outlook for FY11F

Due to input cost pressure, average EPS growth for the China F&B sector will likely slow to 11% y-y in FY10F, from 33% y-y in FY09, on our estimates. The share price performance of the stocks in the sector has been mixed, with the sector outperforming the MSCI China Index by 5% ytd.

We think now is the time for downstream F&B companies with pricing power to pass on cost pressure through product price hikes. Based on our higher ASP assumptions, we estimate average EPS growth for FY11F will pick up to 31% y-y and foresee better share performance for the overall sector in 2011F.

**We expect higher average earnings growth for the China F&B sector in 2011F**

### Exhibit 102. China F&B sector's EPS growth vs share relative performance



Source: Nomura research

We categorise companies in the food value chain into three groups, according to the impact from food inflation.

**Group 1: beneficiaries of food inflation.** These are either upstream or midstream F&B suppliers. Both their inputs and outputs are soft commodities. They can directly translate cost hikes into price hike and target a fixed margin. The companies are Yurun (slaughtering business) and China Agri.

**Group 2: defensive plays in food inflation.** These have a diversified manufacturing cost structure and some of their inputs may not be food-related, or they could see limited impact from inflation on account of their diversified businesses. They are Huabao and CRE.

**Group 3: deferred beneficiaries if they have strong pricing power.** These are downstream F&B companies. They use soft commodities as inputs and supply processed packaged and branded food and beverage products. Due to fierce competition, they could face a margin squeeze amid food inflation. Should they have strong pricing power in the segment, however, the companies could pass on cost pressure with product price hikes sooner or later and benefit from price rises. Downstream companies: Mengniu, Tingyi, UPC, Want Want, Huiyuan, China Foods and Tsingtao.

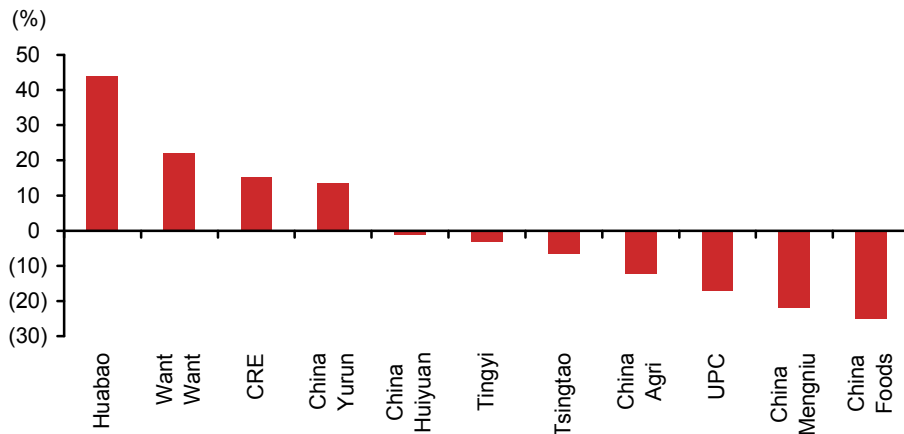
Most of the stocks in Groups 1 and 2 have outperformed the market y-t-d, ie, Huabao, Yurun and CRE. Want Want (Group 3) has also outperformed, likely mainly because of its turnaround at the top line from a low base. China Agri (Group 1) has slightly underperformed the market, with market expectations of the company's restructuring turning less positive and potential price control concern amid inflation.

**Food inflation has different impact on F&B companies along the food value chain**

We expect that cost inflation in FY10F will translate into price inflation in FY11F for downstream F&B plays. While they saw cost pressure and margin squeeze in FY10F, now is the time for them to pass on cost pressure by direct product price hikes and product mix upgrade, in our view. We expect steadier gross margins generally for this sector in FY11F.

In Group 1, we continue to like Yurun and China Agri; in Group 2, we favour Huabao given its solid growth and undemanding valuation; and in Group 3, we are positive on Mengniu, Tingyi and Want Want given their pricing power.

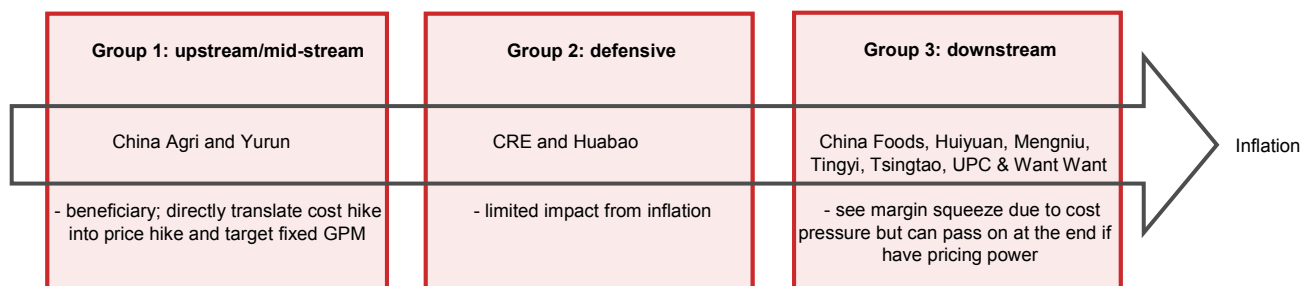
**Exhibit 103. Y-t-d relative share price performance**



Note: closing as of 1 Dec, 2010

Source: Thomson Reuters Datastream, Nomura research

**Exhibit 104. China F&B: impact from food inflation**



Source: Nomura research

## Downside risk of price controls: low

### Impact more on sentiment than fundamentals

China CPI headline hit 4.4%, with food CPI, the main driver, exceeding 10% in October 2010. As flagged by our strategist Sean Darby in “China: an inflationary surprise (IX) and the Engel coefficient” dated 17 November, 2010, the likelihood of a reintroduction of price controls on food is growing.

Imposition of price controls would pose a downside risk to our investment view, since much of our investment thesis rests on pricing power. However, we think the negative impact of price controls would be felt more in investment sentiment than in company fundamentals.

### Upstream/midstream – hard to control

The effectiveness of direct price caps in the upstream and midstream parts of the food sector is open to question, we believe, given a fragmented industry structure. In the slaughtering industry where Yurun is positioned, we believe there are more than 20,000 producers in China; in the oilseed crushing industry where China Agri is engaged, there are still more than 2,000 processors in the country. How could the authorities control the product prices of thousands of players in a single sector?

### Downstream – price controls may not be universal

Most downstream sectors in food are also fragmented, again calling into question the effectiveness of price caps. Moreover, we believe any price controls might not be universally applied to all segments downstream, since some segments — snack, alcohol, soft drinks — are discretionary and not related to basic necessities.

We would see sectors that feature food staples and have relatively consolidated market structures as most at risk of being included in any price controls. Among these sectors we include instant noodles, liquid pure milk and consumer-pack edible oil, all of which were included in the last price controls in 2008.

Still, we think potential price controls are most likely to take the form of an approval system (as they did in 2008) rather than direct price caps per se. Our expectation of leading food suppliers’ product price hikes is based on the pre-condition that they have already seen cost pressures and margin squeeze as a result.

Should we see the worst case, where the authorities put direct price caps on instant noodles, liquid pure milk and consumer-pack edible oil, our earnings estimates for related stocks, including Tingyi, Uni-president, Mengniu and China Foods, would not be at significant downside risk, in our opinion. These companies have already raised product prices, such that further hikes would likely not be significant, we believe.

Authorities could again implement price controls...

...but we see only limited downside risk

Effectiveness of price caps open to question, particularly upstream/midstream

Price controls, if any, may not be universally applied

Also see our Asia Pacific Strategy piece — China: an inflationary surprise (IX) and the Engel coefficient, 17 November, 2010

The thumbnail shows the top portion of a research report. It includes the Nomura logo, the title 'China: an inflationary surprise (IX) and the Engel coefficient', and a table of contents. The table lists sections such as 'Market calls', 'Analysts', 'Country allocation', and 'Appendix'. The report is dated 17 November 2010.

# China Healthcare & Pharmaceutical

## NEUTRAL

### Ⓞ Action

We recommend investors to rein in their urge to buy healthcare stocks until the policy overhang clears; a clearer picture should emerge in 2Q11F after the government announces new drug price regulations and other process reform policies. Our top BUY calls are Sino Biopharmaceutical and China Shineway.

### ⚡ Catalysts

Short-term consolidation catalysts could come from lower product prices but could also push up product costs.

### ⚓ Anchor themes

We see significant long-term re-rating potential for top flight firms, considering that they could benefit from the upcoming market consolidation and industry upgrade set in motion by government policies and an evolving market.

### Stocks for action

We like Sino Biopharmaceuticals (industry upgrade theme) and China Shineway (market consolidation theme) in view of the potential long-term re-rating of the fast-growing pharmaceuticals sector in China.

Stock	Rating	Price	Price target
Sino Biopharm (1177 HK)	BUY	3.02	3.75
China Shineway (2877 HK)	BUY	25.0	32.30

Prices in local currency as of 1 December, 2010

## A year of two halves

### ① Looming policy risks in 1H11F – short-term overhang

We view 2011F as a policy inflection year as it is a cross-over for the last year of the ongoing healthcare reform plans and the first year of the 12<sup>th</sup> Five-year Plan (FYP). This implies that the healthcare sector may face higher policy risks and uncertainties. On analysing the past reforms in 2004-06, we identify some controversial healthcare policies that could bring short-term pain before generating long-term gains.

The key near-term policy risks may come from: 1) new regulations to control drug and other medical product prices in the national drug reimbursement list; and 2) new measures to reform industry processes and product quality, such as the introduction of good manufacturing practices (GMP) and the streamlining of distribution systems. These will likely lead to profit margin pressure in the short term, despite prospects for long-term positive effects that will help accelerate market consolidation and industry upgrades.

In view of the short-term policy overhang, we believe the re-rating impetus via P/E value expansion should ease for most stocks in 2011F, which will likely continue the sector's on-going consolidation for a while. In the coming months, we believe, some stocks face a risk of correction due to: 1) stretched valuations, reflecting the high expectations; 2) unintended outcomes from some controversial reform policies, especially for some single-product companies; and 3) other risk factors, such as cost inflation, interest rate hikes and renminbi appreciation.

### ② Re-entry opportunities in mid-2011F on clear long-term growth visibility

Nevertheless, we are positive on the robust long-term growth prospects of China's healthcare and pharmaceuticals sector, underpinned by the country's favourable macroeconomic and demographic features and trends. Our positive stance is premised on: solid economic growth and development, sustainable urbanisation, a large ageing population, and the healthy policy push from healthcare reforms and the 12<sup>th</sup> FYP.

### Analyst

Gideon Lo, CFA

+852 2252 6190

[Gideon.lo@nomura.com](mailto:Gideon.lo@nomura.com)

In this regard, we note buying opportunities for long-term winners in the sector, as long-term growth prospects could heat up again against the backdrop of new growth opportunities from future market consolidation and industry upgrades. Market leaders post consolidation should enjoy a long-term re-rating, amid growth opportunities from demand upgrade and M&A in China. We see re-entry opportunities after the market clearly evaluates policy risks to the sector in mid-2011F.

### ③ Picking long-term winners from a paradigm shift

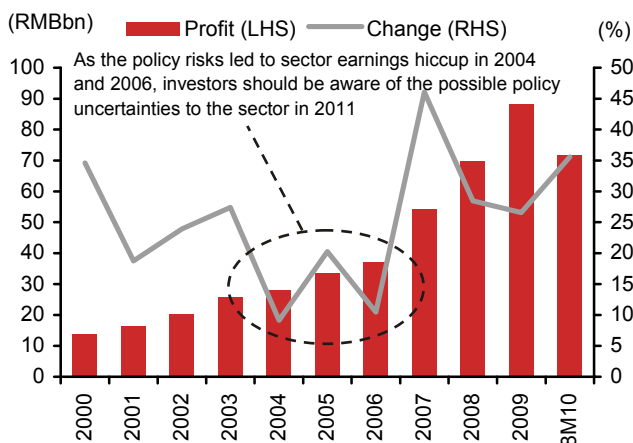
With positive policy support from the healthcare reforms and the 12<sup>th</sup> FYP measures, we expect the sector to achieve faster consolidation and industry upgrades in the next five years. This should provide new expansion and M&A opportunities for market leaders, as well as ongoing margin expansion through economies of scale, enhanced operating efficiency and product upgrades, supporting the re-rating opportunity ahead.

We believe domestic leaders in the medtech, biotech and first-to-market generic drugs segments will have better opportunities to achieve product and technology upgrades. Meanwhile, leaders with superior market share and cost advantages in traditional Chinese medicine (TCM) and generic drugs could benefit from market consolidation, but their long-term re-rating potential looks less attractive than companies with industry upgrade potential, in our view.

### ④ Stocks picks – winners in consolidation and industry upgrade

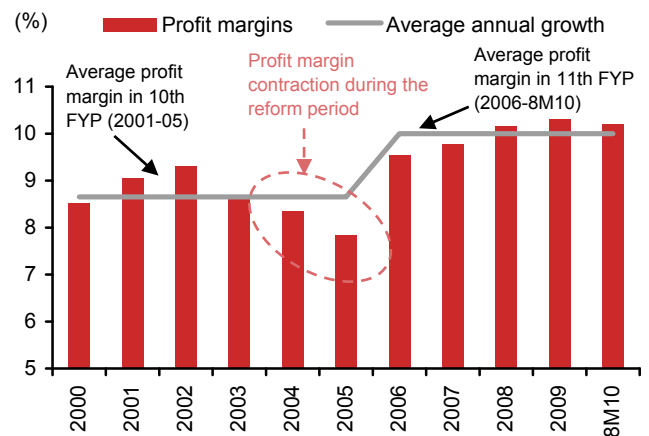
Among the five China pharmaceutical companies listed in Hong Kong under our coverage, our top pick is Sino Biopharmaceutical, which we believe has the potential and is best positioned to achieve product upgrades and M&A expansion in the sector, given its strong competence in R&D, marketing and M&A strategy. The anticipated consolidation in the TCM injection sector should present China Shineway with attractive growth opportunities. We expect Shineway to clock stronger growth in mid-2011F on capacity expansion.

Exhibit 105. Sector profit growth hiccup in 2004-06

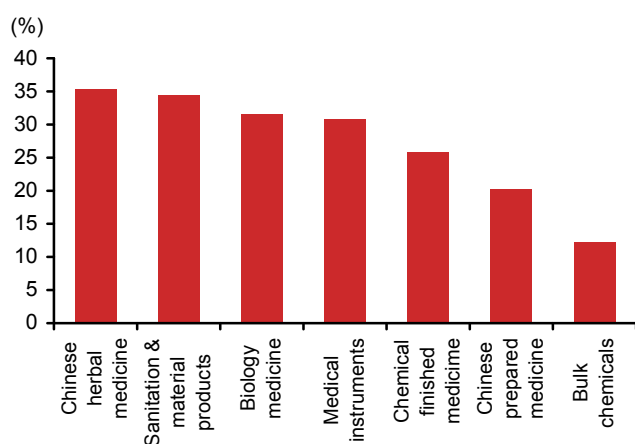


Source: Nomura Research, CEIC

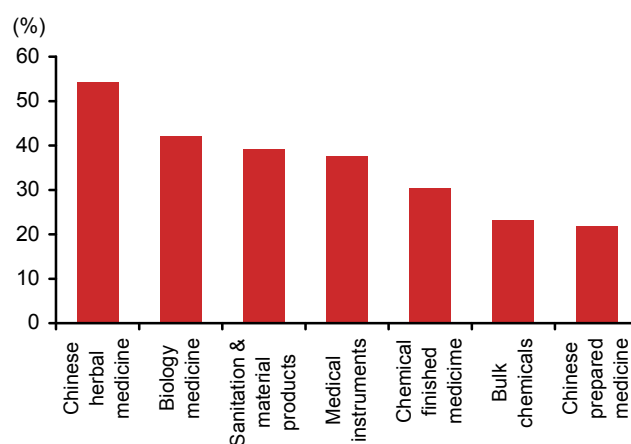
Exhibit 106. Sector profit margin contracted in 2004-05



Source: Nomura Research, CEIC

**Exhibit 107. Average segmental revenue growth per annum (2006-8M2010)**

Source: Nomura Research, CEIC

**Exhibit 108. Average segmental profit growth per annum (2006-8M2010)**

Source: Nomura Research, CEIC

**Exhibit 109. Stock picks: valuation comparison**

	China Shineway 2877HK	Lijun International 2005HK	Sino Biopharma 1177HK	Sinopharm 1099HK	United Laboratories 3933HK
<b>Bloomberg code</b>	2877HK	2005HK	1177HK	1099HK	3933HK
Price (HK\$)	25.00	2.51	3.02	28.35	14.44
Issued shares* (mn)	827	2,455	4,957	690	1,302
Market cap* (HK\$m)	20,675	6,162	14,969	19,570	18,794
<b>Rating</b>	Buy	Reduce	Buy	Neutral	Neutral
Target price (HK\$)	32.30	2.45	3.75	32.50	14.56
Upside / downside (%)	29	(2)	24	15	1
Valuation method	23x FY11PE; implied 1.03x PEG	18x FY11PE; implied 0.92x PEG	30x FY11PE; implied 1.08x PEG	36x FY11PE; implied 1x PEG	SOTP: 2x P/BV cyclical assets; 20x FY11PE for finished drugs
<b>Valuation</b>					
PE (x)					
2009	23.7	23.6	34.4	66.7	32.0
2010F	21.8	21.3	30.8	44.1	18.7
2011F	17.8	18.4	24.1	31.4	16.0
2012F	14.6	15.0	18.9	31.4	13.1
Yield (%)					
2009	1.7	1.6	1.6	1.1	1.0
2010F	2.1	1.6	1.6	0.6	2.6
2011F	2.7	2.0	2.1	0.8	3.1
2012F	3.3	2.5	2.6	1.0	3.8
Price to book (x)					
2009	6.7	3.3	5.5	5.2	5.4
2010F	5.7	2.7	3.9	4.8	3.9
2011F	4.9	2.5	3.6	4.3	3.4
2012F	4.2	2.2	3.3	3.8	3.0
Net profit (HK\$m)					
2009	873	216	397	962	541
2010F	949	274	476	1,457	959
2011F	1,164	341	621	2,045	1,177
2012F	1,418	412	795	2,674	1,436
2011-12 CAGR	22	23	29	35	22

Note: Prices as of 1 December, 2010

Source: Nomura research, Bloomberg

## Exhibit 110. Sector valuation summary

Company name	Code	Rating	Currency	Price local (\$)	Mkt cap (US\$m)	Fiscal Yr	Price performance			PE (x) 10F	PE (x) 11F	PEG (x) 10F	PEG (x) 11F	P/Bk (x) 10F	P/B (x) 11F	EV/EBITDA (x)		ROE (%) 10F	ROE (%) 11F
							1-wk (%)	1-mth (%)	1-yr (%)							10F	11F		
China Shineway	2877 HK	Buy	HK\$	25.00	2,662	Dec-09	(2.7)	(7.4)	96.6	21.7	17.7	1.2	1.0	5.7	4.9	15.5	12.3	28.3	29.8
Lijun Int'l Pharmaceutical	2005 HK	Reduce	HK\$	2.51	793	Dec-09	(6.3)	(6.3)	79.3	21.7	18.7	1.1	0.9	2.9	2.6	14.1	11.8	14.7	14.9
Sino Biopharmaceutical	1177 HK	Buy	HK\$	3.02	1,927	Dec-09	(1.9)	(1.6)	24.8	31.7	24.9	1.4	1.1	4.0	3.7	16.3	13.6	15.1	15.6
Sinopharm Group	1099 HK	Neutral	HK\$	28.35	2,520	Dec-09	(0.4)	(6.6)	5.2	47.6	33.9	1.2	0.8	5.1	4.6	24.7	17.7	11.2	14.3
United Laboratories	3933 HK	Neutral	HK\$	14.44	2,420	Dec-09	(9.1)	0.4	256.5	18.8	16.0	0.5	0.5	3.9	3.5	12.4	10.6	23.8	22.8
<b>Nomura coverage Average</b>							<b>(4.1)</b>	<b>(4.3)</b>	<b>92.5</b>	<b>28.3</b>	<b>22.2</b>	<b>1.1</b>	<b>0.9</b>	<b>4.3</b>	<b>3.9</b>	<b>16.6</b>	<b>13.2</b>	<b>18.6</b>	<b>19.5</b>
China Medical System	867 HK	Not-rated	HK\$	5.61	826	Dec-09	9.8	14.7	n.a.	26.8	21.2	1.1	0.9	n.a.	n.a.	23.0	17.2	n.a.	n.a.
China Pharmaceutical	1093 HK	Not-rated	HK\$	4.18	826	Dec-09	(2.6)	(3.9)	(7.5)	8.5	11.1	9.3	12.3	1.2	1.1	4.8	5.7	13.2	11.3
Dawnrays Pharmaceutical	2348 HK	Not-rated	HK\$	3.22	330	Dec-09	0.6	(4.7)	170.6	12.0	9.5	0.3	0.2	2.6	2.2	12.6	9.9	24.2	25.8
Golden Meditech	801 HK	Not-rated	HK\$	1.52	334	Mar-10	10.9	5.6	(16.9)	21.1	11.6	0.6	0.3	0.8	0.8	21.7	13.2	3.6	5.7
Guangzhou Pharmaceutical	874 HK	Not-rated	HK\$	11.02	312	Dec-09	3.2	31.5	108.7	26.0	20.7	1.1	0.8	2.2	2.0	41.6	34.2	8.0	9.3
Hua Han Bio-Pharmaceutical	587 HK	Not-rated	HK\$	3.22	664	Jun-10	15.4	23.8	91.7	16.6	12.5	0.5	0.3	1.9	n.a.	14.4	7.6	12.3	14.9
Lansen Pharmaceutical	503 HK	Not-rated	HK\$	3.90	208	Dec-09	(0.5)	6.3	n.a.	20.1	3.7	0.6	0.1	2.2	1.9	13.8	11.2	14.1	13.6
Lee's Pharmaceutical	950 HK	Not-rated	HK\$	3.72	216	Dec-09	12.7	0.3	118.8	23.3	16.9	n.a.	n.a.	8.5	6.1	n.a.	n.a.	36.0	36.0
Microport Scientific	853 HK	Not-rated	HK\$	7.51	1,394	Dec-09	0.7	(7.4)	n.a.	29.3	26.1	1.5	1.4	4.4	3.8	27.0	20.0	17.1	15.3
Mingyuan MedicareLtd	233 HK	Not-rated	HK\$	1.25	602	Dec-09	5.0	15.7	(10.7)	25.0	19.5	0.8	0.6	2.5	2.2	14.7	12.8	12.5	13.6
Shihuan Pharmaceutical	460 HK	Not-rated	HK\$	5.92	3,954	Dec-09	4.8	(0.7)	n.a.	39.1	31.7	1.9	1.5	4.6	4.1	n.a.	n.a.	9.5	11.0
Shandong Weigao	1066 HK	Not-rated	HK\$	20.80	2,293	Dec-09	11.3	1.7	46.0	43.8	35.1	1.7	1.4	10.4	8.3	n.a.	n.a.	24.7	26.7
Shandong Luoxin	8058 HK	Not-rated	HK\$	10.04	213	Dec-09	(1.6)	(3.1)	54.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Shandong Xinhua	719 HK	Not-rated	HK\$	3.48	67	Dec-09	0.6	(0.9)	20.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tong Ren Tang Tech	1666 HK	Not-rated	HK\$	22.75	256	Dec-09	(2.8)	0.7	48.7	18.9	16.6	1.3	1.1	2.4	2.1	11.8	10.1	n.a.	n.a.
Trauson Holdings	325 HK	Not-rated	HK\$	3.66	365	Dec-09	1.7	5.8	n.a.	19.6	17.2	1.0	0.9	2.2	2.0	14.4	11.2	16.5	12.3
United Gene High-Tech	399 HK	Not-rated	HK\$	0.16	247	Jun-10	(1.3)	(8.1)	(62.1)	143.6	n.a.	n.a.	n.a.	4.5	n.a.	114.8	n.a.	4.2	n.a.
Wuyi International	1889 HK	Not-rated	HK\$	0.70	154	Dec-09	(2.8)	(4.1)	(12.5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>HK listed stocks average</b>							<b>1.3</b>	<b>1.7</b>	<b>61.8</b>	<b>30.8</b>	<b>19.9</b>	<b>1.5</b>	<b>1.4</b>	<b>3.8</b>	<b>3.4</b>	<b>22.7</b>	<b>13.6</b>	<b>16.2</b>	<b>17.3</b>
3SBio Inc	SSRX US	Not-rated	US\$	15.35	330	Dec-09	(5.5)	1.7	9.3	25.2	18.9	0.9	0.7	2.0	1.8	11.5	8.9	9.2	10.2
China Biologic Products Inc	CBPO US	Not-rated	US\$	11.64	141	Dec-09	13.7	19.4	21.3	6.6	8.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
China Kanghui Holdings Inc	KH US	Not-rated	US\$	20.74	158	Dec-09	7.1	10.3	n.a.	41.7	37.2	2.8	2.5	2.4	2.1	n.a.	n.a.	12.1	7.6
China Medical Technologies Inc	CMED US	Not-rated	US\$	11.43	92	Mar-10	(16.4)	(4.6)	(13.8)	n.a.	7.3	n.a.	n.a.	13.3	1.1	12.3	11.1	(3.2)	14.9
Mindray Medical International Ltd	MR US	Not-rated	US\$	26.25	444	Dec-09	(6.3)	(9.3)	(15.6)	18.3	16.1	1.0	0.9	3.7	3.0	12.8	10.8	21.7	21.6
Simcere Pharmaceutical Group	SCR US	Not-rated	US\$	12.48	125	Dec-09	19.3	32.3	55.4	31.5	23.5	0.9	0.6	2.2	2.0	17.9	15.0	10.5	9.9
WuXi PharmaTech Cayman Inc	WX US	Not-rated	US\$	16.75	167	Dec-09	(5.0)	1.4	(3.6)	16.9	15.5	1.1	1.0	3.4	2.9	10.2	9.2	22.6	21.4
<b>US listed stocks average</b>							<b>1.0</b>	<b>7.3</b>	<b>8.8</b>	<b>23.4</b>	<b>18.2</b>	<b>1.3</b>	<b>1.1</b>	<b>4.5</b>	<b>2.2</b>	<b>12.9</b>	<b>11.0</b>	<b>12.2</b>	<b>14.3</b>

Note: pricing as of 1 December, 2010

Source: Nomura Research, Bloomberg

## Industrials

**BULLISH**

### ⊙ Action

With detailed railway construction plans to be released shortly as part of the 12<sup>th</sup> Five-year Plan, we believe likely upward revisions will boost the railway sector. We think CSR, CNR and Zhuzhou CSR stand to be major beneficiaries of the demand for trains and components, while CRCC and CRG benefit from enlarged railway construction plans. After studying past experience overseas, we believe China can continue its large-scale, high-speed railway construction for some years to come despite the MoR's weak balance sheet and cashflow.

### ✂ Catalysts

Upward revisions to railway construction plans in the 12<sup>th</sup> Five-year Plan.

### ⚓ Anchor themes

Despite the MoR's weak balance sheet, we believe railway investment will continue, particularly given that China's current railway network is far from excessive.

## Still plenty of railway to come...

### ① Railway network not excessive

On current plans, China will have a larger high-speed railway network than the rest of the world combined. While this sounds excessive, if we look at railway density and demand, we are inclined to believe that the "four-vertical, four-horizontal" plan is just the beginning. Given rigid demand for railway transportation, coupled with the radiation effect on regional economic growth, long-term cost efficiency and the green nature of high-speed rail, we expect continued large-scale railway investments during the 12th Five-year Plan period. New railways will likely be built inland as well as in coastal regions not yet penetrated.

### ② Overseas experience shows way to success

We have studied past experience overseas, including the 1987 railway reform in Japan and the 1980 Staggers Rail Act in the US, both of which improved railway operation efficiency, enhanced railway profitability, and led to more effective passenger and freight railway transportation, respectively. With reference to the railway system's organisational structure and mode of operation in China, we believe the government will have sufficient money for as long as it is willing to transform the network. We believe that price deregulation, commercialisation, revenue diversification, sharing of land appreciation value and employing capital markets should help the national railway to pare losses from the high-speed rollout and make building a large-scale, high-speed network more sustainable.

### ③ Like CSR and CNR, and see attraction in CRCC

While we still think the higher valuation of equipment makers relative to constructors is justified due to exposure to the longer, fatter-tail effect, we also see valuation appeal in CRCC. We believe train density will gradually ramp up with the completion of track construction, and service and replacement revenue will fatten up equipment makers' books. Meanwhile, we expect the railway built in west to have a more positive effect on constructors' books than the one in the east, due to the larger geographical area and more complex geology involved. We find the construction players and equipment makers are trading at only 10x and 20-21x FY11F P/E, respectively, despite robust FY09-12F EPS CAGRs of 20-50%.

### Stocks for action

We like CSR and CNR for the benefits they enjoy from the railway boom and margin expansion on better scale economies. We also highlight that CRCC looks attractive on valuations after being hit by previously negative sentiment.

Stock	Rating	Price	Price target
CSR Corp (1766 HK)	BUY	9.27	10.50
China CNR (601299 CH)	BUY	6.23	8.20
Zhuzhou CSR (3898 HK)	NEUTRAL	29.25	28.00
CRCC (1186 HK)	BUY	9.42	11.80
CRG (390 HK)	NEUTRAL	5.5	6.60

Pricing as of 1 December, 2010; local currency

### Analysts

**Yankun Hou**

+852 2252 6234

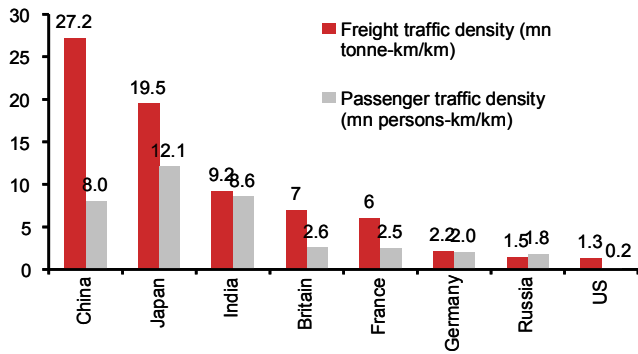
[yankun.hou@nomura.com](mailto:yankun.hou@nomura.com)

**Paul Gong**

+852 2252 6177

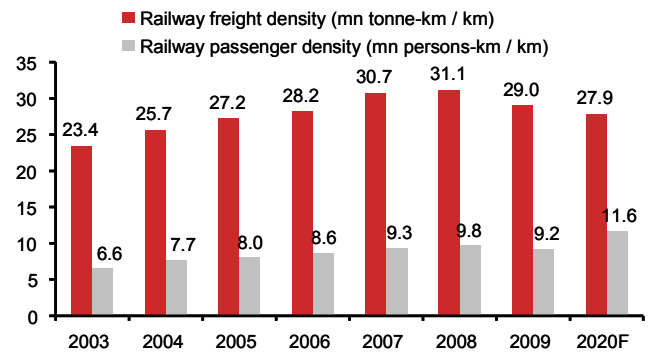
[paul.gong@nomura.com](mailto:paul.gong@nomura.com)

Exhibit 111. Railway freight & traffic density (2005)



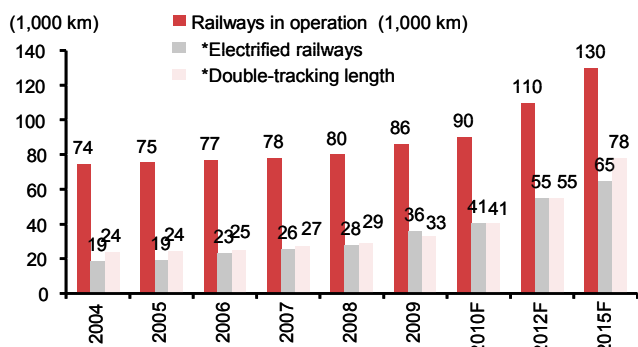
Source: MoR, Nomura research

Exhibit 112. China railway freight & traffic density



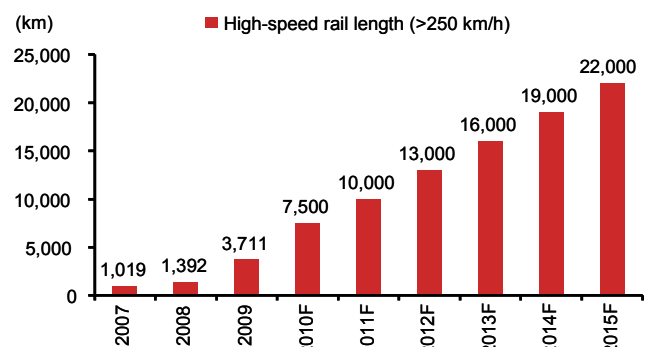
Source: MoR, Nomura research

Exhibit 113. Railway length



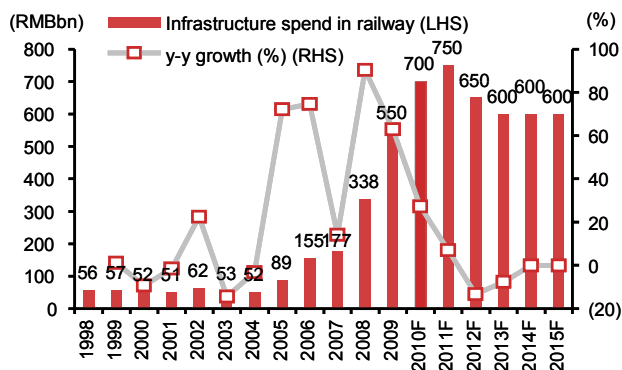
Source: MoR, Nomura estimates

Exhibit 114. High-speed railway length



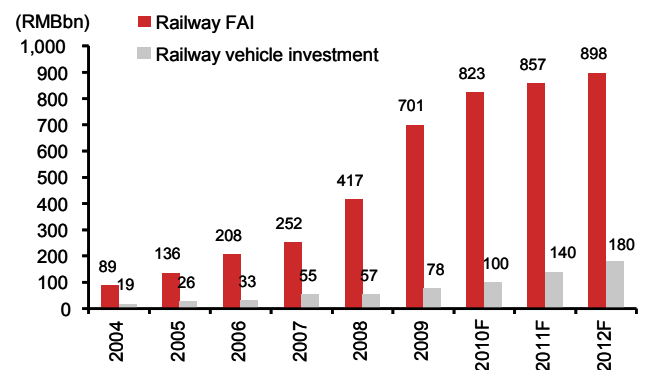
Source: MoR, Nomura estimates

Exhibit 115. Railway construction investment



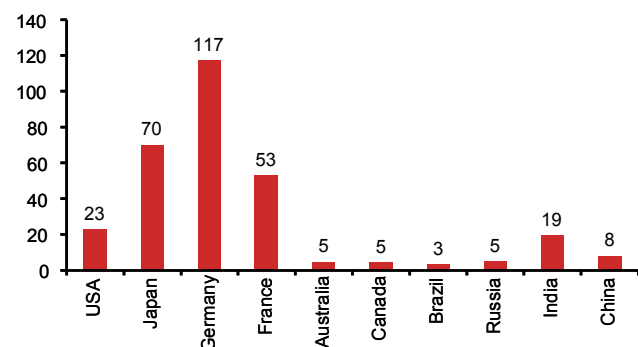
Source: MoR, Nomura estimates

Exhibit 116. Railway FAI



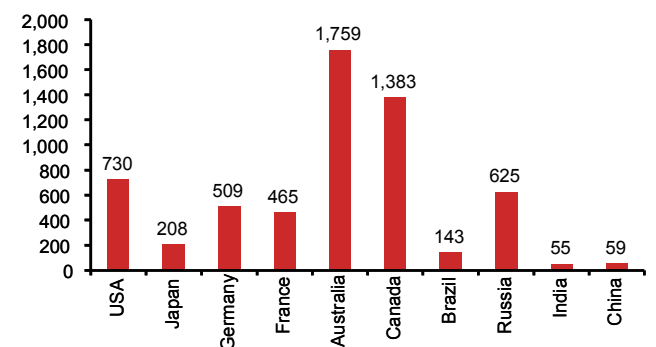
Source: MoR, Nomura estimates

Exhibit 117. Railway (km) per thousand sq km



Source: CIA, Nomura research

Exhibit 118. Railway (km) per million people



Source: CIA, Nomura research

## Insurance

### ⊙ Action

The consensus bullish view on rising rates has provided little more than downside valuation support to the sector. With a “golden 10 years for insurance” still ringing in our ears, the concern over tighter liquidity in 2011 is now driving sentiment. With the overhang on investment market sentiment, demand in insurance is returning to basic par products, supporting our positive view on China Life and Taiping (CTIH).

### ⚡ Catalysts

Further rounds of rate hikes in 2011 could boost insurers' earnings, together with any positive sentiment on the A-share market or expectations of more liquidity.

### ⚓ Anchor themes

Investor perception of Chinese insurers' ability to control investment risk is a highly valuable intangible asset and should not be taken for granted. Given the Chinese insurance industry remains a growth story and investors' focus on VoNB growth, we believe Chinese insurers should continue to trade at higher multiples.

## Rising rate, but lower liquidity and unclear distribution channels

### ① Going separate ways in life

We believe the market is increasingly distinguishing between the approaches and offerings of China Life and Ping An in financial services. For China Life, clearly the focus remains on growth in its agency channel and Value of New Business (VoNB). The rural debate aside, it appears the market needs convincing over a higher VoNB growth figure. We expect a rebound from 1H10 levels and believe the downside is limited for 2H10F and 2011F. For Ping An, an increasingly mature life insurance market in urban areas means it must increase the wallet share from existing customers. Ping An's 400,000-strong agency force remains key to it competing in retail financial services. While we appreciate the rationale, and management's strong record in integrating businesses, full-scale competition in retail banking represents an altogether different challenge. This, together with generally higher market expectations for Ping An, suggests there is more room for disappointment. Finally, we think a rerating of the stock continues to hinge on the ability of the market to properly value Ping An as a financial conglomerate.

### ② Tighter liquidity could affect the usually strong 1Q

Chinese insurers will report FY10 results by end-March next year. Between now and then, we think monthly premium data, especially for the first couple of months of next year, will serve as potential catalysts for share price performance. Our view is that volume growth is quite likely going to slow down, given that the liquidity environment seemed to be much stronger in 1H10 relative to the environment we envisage for early next year. Thus, margins could be the key to any upside, and we would pay close attention to the type of products that insurers are selling as well as their agency force productivity. Additionally, industry consolidation could happen as early as next year as capital becomes increasingly scarce. Finally, we note that the rising rate environment is no longer significantly meaningful to negative spread books. We estimate only a 6% impact on EV for Ping An and 3% for China Pacific (CPIC), even if we remove their entire negative spread book.

## BULLISH

### Stocks for action

We would recommend to BUY China Life for relatively less uncertain exposure to China's life insurance industry, while CTIH remains a high-margin and multiple growth story.

Stock	Rating	Price (HK\$)	Price target (HK\$)
China Life (2628 HK)	BUY	33.70	40.00
CTIH (966 HK)	BUY	26.00	35.00
CPIC (2601 HK)	REDUCE	30.70	28.00
Ping An (2318 HK)	NEUTRAL	91.00	90.00
PICC (2328 HK)	NEUTRAL	11.64	12.00

Note: Pricing as of 1 Dec 2010

### Analysts

David Chung

+852 2252 6210

[david.m.chung@nomura.com](mailto:david.m.chung@nomura.com)

Lucy Feng

+852 2252 2165

[lucy.feng@nomura.com](mailto:lucy.feng@nomura.com)

## New Bancassurance rule – no impact on volume, but margins will be affected

Most insurers appear to be monitoring the situation and, according to our channel checks, there has not been a significant impact on premium from the bancassurance channel so far.

Nonetheless, we think that bargaining power for this channel has shifted to banks during this transitional period.

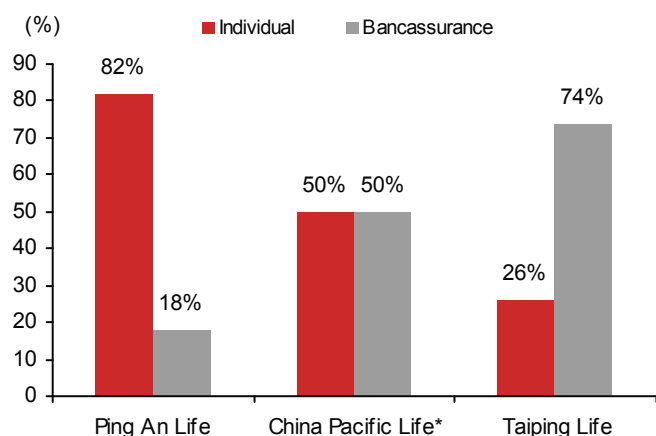
We note there are several forces that should drive future trends here:

- The premium from this source is unlikely to slow significantly because banks would still like commissions, but growth of Value of New Business could slow as it becomes harder to sell regular premium products through this channel. Most insurers we met acknowledged this, but some also said that insurers could continue to have staff in bank branches to train them for insurance product sales.
- Smaller sized insurers that are willing to pay higher commissions could benefit. Although commission rates are generally capped, benefits could still be passed on through other means. In the end, most insurers are likely to gain and lose access to some branches, so the actual net impact remains uncertain.
- More positively, though, insurance products from this channel could focus more on risk protection-based products rather than investment.
- In any case, the tighter liquidity environment next year will likely affect bancassurance growth; hence, premium growth could be slower in 1H11F relative to 1H10.

At this stage, we believe the most affected insurers are CPIC and Taiping, given their reliance on bancassurance to sell regular premium products. China Life should not be as affected, given its relatively higher bargaining power, especially in rural areas, and its relatively lower reliance on the bancassurance channel for regular premium sales.

Additionally, most insurers do not see banks entering the insurers' turf as a threat at this stage. They point out that insurers need to have sub-branches in the provinces before banks are allowed to sell insurance products there, and most of the smaller insurers have only sub-branches in certain provinces. Having said that, when we visited a joint-stock bank branch in Shanghai, we noticed it was already selling products from its own insurance company although sales staff told us they used to sell products from another insurer.

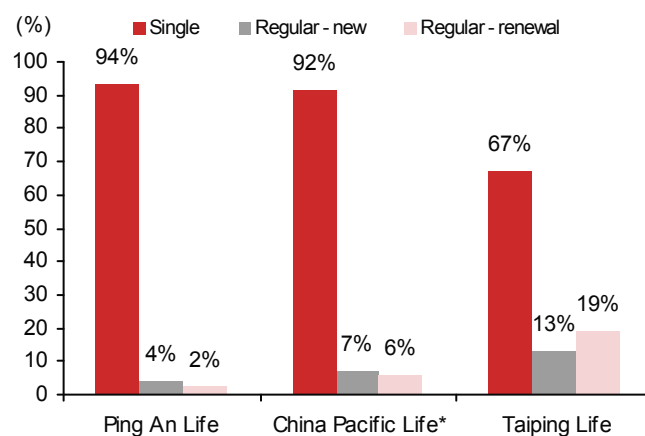
**Exhibit 119. Total premium mix by distribution – 1H10**



\* As at FY09

Source: Company data, Nomura research

**Exhibit 120. Bancassurance premium mix – 1H10**



\* As at FY09

Source: Company data, Nomura research

## **Agency reform – chicken and egg, but the impact could be less than expected**

While the China Insurance Regulatory Commission (CIRC) is clearly interested in improving the social status and financial wellbeing of the agency force, which in turn is likely to drive agency force productivity, there is a lot of push back from insurers.

In any case, if applied, we expect a more gradual change, with higher-productivity agents moving from a contract basis to employees after demonstrating good performance or, for example, switching from an agent to becoming a trainer in bank branches and getting a base pay and welfare benefits (which we see as natural to maintain higher-productivity agents).

As a result, we expect likely higher fixed costs (wage and welfare) but possibly lower variable (commission) costs, which might actually be good for insurers on a net basis.

In addition, in our opinion, changing to an employee basis may not have a significant impact or dramatically change the dynamics of the industry after all.

This is because it is already difficult for insurers to poach high-productivity agents from competitors. By definition, these agents would already be receiving kick-back commissions from the continued stream of regular premiums and therefore would be very costly to poach.

Agents most susceptible to poaching are rising stars who have the potential to grow and are not so expensive to poach. By joining a smaller insurer, these agents are likely to get a better title, income and profit sharing going, and their opportunity costs are also lower.

If a larger insurer can offer better welfare benefits to its employees, it would perhaps make poaching of agents more difficult as, in the end, the commission level is regulated and set by the actuary.

## Intermediary channel gaining momentum – commission rate balancing act begins

Clearly, other distribution channels such as direct/phone/internet marketing and intermediaries will continue to be more important, in our opinion. Looking at trends in other developed markets, China is likely to move to a 40:40:20 mix for agents:bancassurance:direct marketing & intermediaries in the medium term.

Generally, direct marketing usually has cheaper acquisition costs but higher claims and losses, and generally applies more to P&C than life insurance. In fact, we understand that in China, the penetration level for phone marketing is already very high. For example, Ping An has already derived over a quarter of its motor business from phone marketing. From overseas experiences, direct marketing usually becomes saturated at certain levels and we believe in China, it could already be quite close to this level given recent aggressive marketing by larger insurers, such as PICC and Ping An.

For intermediaries, we see them becoming more active and in fact, an intermediary guided that intermediaries have been allocated 2011 premium targets that are 2-3x that of 2010 and in addition, they are guiding for higher commission rates. Having said that, we note that commissions for life products are regulated and therefore, we believe there could be some sort of a cap as to how far this rate could go. Additionally, given life insurers focus on quality and premium margin rather than on pure volume, we believe intermediaries will also need to have the same focus and therefore, costs to train high productivity employees.

## Online Gaming & Media

**BULLISH**

### Ⓞ Action

We are Bullish on China online gaming. Driven by new game launches (delayed from 2010), the sector should see a rebound in top-line growth and margin expansion. We expect Perfect World, Changyou and Shanda Games to outperform heading into 2011, with new games driving incremental growth. We recommend a switch from media to gaming.

### ⚡ Catalysts

The launch of new games delayed from 2010 should drive incremental growth across the board in 2011.

### ⚓ Anchor themes

The Internet run in China still has room to advance, in our view, with growth momentum likely to accelerate on strong user-base expansion and increased utilisation. Among the sub-sectors and at this stage of the industry lifecycle, we see online gaming as the major potential beneficiary.

### Stocks for action

We think media stocks have had a strong run and are vulnerable to macro pressures. Our recommendation is to switch into gaming, where we expect a rebound led by new titles.

Stock	Rating	Local price	Price target
Focus Media (FMCN US)	NEUTRAL	23.33	24.00
Sohu (SOHU US)	REDUCE	69.43	64.00
Changyou (CYOU US)	BUY	29.41	39.00
Netease (NTES US)	NEUTRAL	38.18	43.00
Perfect World (PWRD US)	BUY	23.70	37.00
Shanda Games (GAME US)	BUY	5.60	8.00
Tencent (700 HK)	BUY	174.00	200.00

Pricing as of 30 November, 2010; US-listed stock prices in US dollars; others local currency

## Back in the game

### ① Making the switch

After a decent rally in the share prices of advertising names this year, we are advising investors to start taking profits on media-related names and switching to online gaming names. This year has been a rather grim one for the online gaming companies in China, mainly due to a perfect storm of heightened competition, fickle users, delayed new products, climbing cost structures and regulatory overhang. While this is likely to become the “new norm”, we take a more positive stance on the sector, since new games delayed in 2010 will likely be ready to launch in 2011, which should help to drive growth.

### ② Likely outperformers

Heading into 2011, we like the sector underdogs or those that have significantly underperformed in 2010, including Perfect World, Changyou and Shanda Games. Ironically, we like these players for the same reason they vastly underperformed in 2010 — we see launches of new games that were pushed back from this year to 2011 as potential catalysts for next year, given that many of these companies depend on their next game to drive incremental revenue growth.

### ③ Buying a basket

Given sector competition and the abundance of potential “hit” games slated for launch in 2011, we recommend a basket of gaming names, including Netease, Tencent, Perfect World, Shanda Games and Changyou. Year to date, this basket has returned -14.3%, versus +107.6%, -10.9% and +74.8% in the three years prior. We believe that this basket will outperform on new game launches in the coming year.

### ④ Valuation

We believe that it is time to revisit this sector, considering our projections for free cashflow yields of 10-22% and forward P/E trading discounts of 20-30% to historical averages, coupled with catalysts on the horizon. Our sector top BUY is Perfect World, given its pipeline of four new games over the next five quarters.

### Analyst

Jin Yoon

+852 2252 6204

[jinkyu.yoon@nomura.com](mailto:jinkyu.yoon@nomura.com)

## Turning positive on online gaming

- **Making the switch.** After a decent rally in the share prices of advertising names this year, we are advising investors to start to take profits on media-related names and switching to online gaming names. The advertising industry in China performed poorly in 2009, but so far in 2010, it has recovered on an improved economy, rising consumption growth and special one-off events, including the World Cup and the World Expo. Coming off a low base in 2009, Internet advertising companies in China have outperformed in 2010 as the secular growth story remains intact. We believe that the Internet advertising outlook in China remains positive in the longer term, and we remain positive on the Chinese consumption story and the switch from traditional to digital media. However, we believe the share prices of Internet advertising companies in China would not continue to see strong increases in 2011F, due to higher comparables and lack of one-off special events. We would be taking profits on Media-related names and switching to online gaming.
- **Business environment to improve.** This has been a rather grim year for online gaming companies, mainly owing to a perfect storm of heightened competition, fickle users, delayed new products, climbing cost structures and regulatory overhang. While this is likely to become the “new norm”, we take a more positive stance on the sector, since new games delayed in 2010 will be ready to launch in 2011, which should help to stir interest from gamers and investors alike.
- **Margin relief ahead.** We continue to believe that non-GAAP operating margins will never again reach prior years’ historical highs (55%-plus). A lack of top-line leverage for many of the game companies plus rising costs and licensing fees has resulted in a dramatic drop in operating margins in 2010 of as much as 10%-plus from last year’s levels. In 2011, we see margin run rates improving for gaming companies, due largely to better top-line leverage as delayed new games will soon hit the marketplace, providing incremental revenues.
- **The unlikely overachievers.** Internet businesses are highly monopolistic, largely due to strong networking impact. Hence, we see companies such as Tencent, Baidu and Alibaba.com trading at a significant premium to peers. However, heading into 2011, we like sector underdogs or companies that have significantly underperformed in 2010, including Perfect World, Changyou and Shanda Games. These companies do not possess the “edge” in maintaining sticky traffic, thus we believe they will not be as structurally sound as Tencent or Baidu. However, we believe these three companies will outperform peers in 2011, mainly on new game catalysts. Ironically, we like these companies in 2011 for the same reason that they significantly underperformed in 2010 — we see new game launches that were pushed back from this year to 2011 as catalysts for next year, given that many of these companies depend on their next game to drive incremental revenue growth.
- **Buying a basket.** Given sector competition and the significant number of potential “hit” games to be launched in 2011, we believe that buying a basket of gaming names may prove to be prudent. On examining a basket of gaming names including Netease, Shanda Games, Perfect World, Tencent and Sohu/Changyou, we see a wave-like pattern where the basket of companies outperforms/underperforms the NASDAQ every other year. Year to date, the basket has returned -14.3%, versus +107.6%, -10.9% and +74.8% in the three years prior. We believe the group can outperform given that various companies will be launching new games in the coming year.

## Making the switch

### A basket approach

We recommend buying a basket of gaming names heading into 2011 rather than taking a stock-picking approach, given the growing difficulty in pin-pointing winning games and the relative underperformance of the online gaming sector in China. Competition is stiff in the sector and there are a significant number of potential "hit" games to be launched in 2011. While the top-three players are likely to continue to see market-share gains, we also see growth opportunities for the smaller operators. In our view, companies such as Perfect World, Changyou and Shanda Games, which have clearly underperformed in 2010, will generate higher returns in 2011F on new game launches and product upgrades.

We believe the sector deserves another look heading into the new year, as valuations and cashflow yields look undemanding compared with recent history. Free cashflow yields appear to be rising across the board, with our basket of companies offering yields of 8-19% in 2010F, on our estimates. Further, our current forecasts show yields climbing even higher to 10-22% in 2011F.

On a historical forward basis, many of the companies in our basket are trading near historical lows, excluding periods of financial crisis. Save for Tencent, our basket of proposed companies is trading at around 6-10x forward P/E, compared to the historical average of 10-12x P/E.

### Exhibit 121. Performance of the gaming basket

Price at end of year	NTES	SNDA	PWRD	SOHU/ CYOU	Tencent	Total	Change (%)	Nasdaq % change for the same period
Price at 31 Dec 06	18.69	21.67	N/A	S:24.00	27.70			
Price at 31 Dec 07	18.96	33.34	27.88	S:54.52	60.00			
Price at 31 Dec 08	22.10	32.36	17.25	S:47.34	50.00			
Price at 31 Dec 09	37.62	52.61	39.44	C:33.21	168.70			
Current price	38.18	39.53	23.70	C:29.41	174.00			
Yearly return 2007 (%)	1.4	53.9	N/A	127.2	116.6			
Yearly return 2008 (%)	16.6	(2.9)	(38.1)	(13.2)	(16.7)			
Yearly return 2009 (%)	70.2	62.6	128.6	39.0*	237.4			
Yearly return 2010 (%)	1.5	(24.9)	(39.9)	(11.4)	3.1			
Investing amount Jan 1, 2007	25,000	25,000		25,000	25,000	<b>100,000</b>		
Value at Dec 31, 2007	25,361	38,463		56,792	54,152	<b>174,768</b>	74.8	9.8
Investing amount Jan 1, 2008	20,000	20,000	20,000	20,000	20,000	<b>100,000</b>		
Value at Dec 31, 2008	23,312	19,412	12,374	17,366	16,667	<b>89,132</b>	(10.9)	(40.5)
Investing amount Jan 1, 2009	20,000	20,000	20,000	20,000	20,000	<b>100,000</b>		
Value at Dec 31, 2009	34,045	32,515	45,728	27,800	67,480	<b>207,568</b>	107.6	43.9
Investing amount Jan 1, 2010	20,000	20,000	20,000	20,000	20,000	<b>100,000</b>		
Value at current price	20,298	15,028	12,018	17,712	20,628	<b>85,683</b>	(14.3)	10.1

\* 39% is the return on SOHU from Jan 2009 to Mar 2009, compounded with the return on CYOU from Apr 2009 to Dec 2009, as we switched from SOHU to CYOU upon the latter's IPO.

Pricing as of 30 Nov 2010 for US listed companies and 1 Dec for HK listed companies.

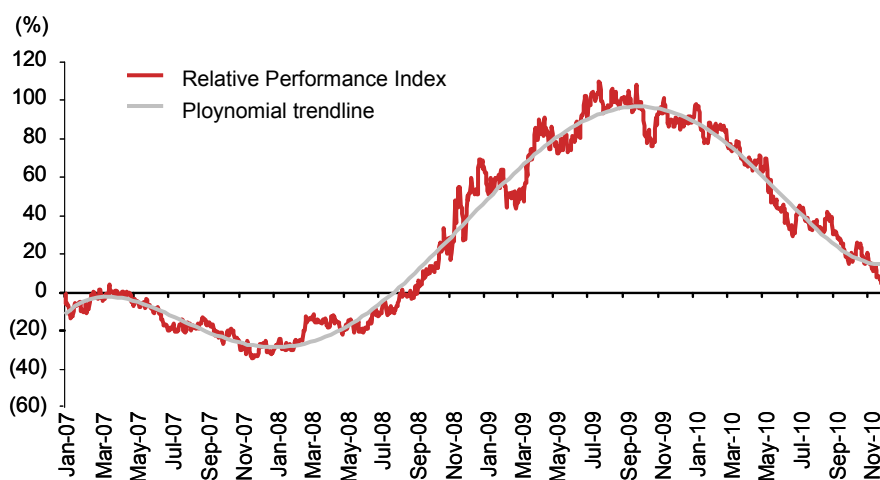
Source: Nomura research

## When is a good time to make the switch?

We look at gaming and media returns over the past several years and use historical data to forecast the future. In order to compare the gaming sector's performance with that of the media sector, we created a "Relative Performance Index" (RPI), defined as the percentage difference between a "Gaming Index" and a "Media Index", ( $RPI = [G/M - 1] \times 100\%$ , where G is the Gaming Index and M is the Media Index). To avoid any particular large-cap stocks such as Tencent and Baidu dominating, both the "Gaming Index" and "Non-gaming Index" are designed as unweighted indices. In other words, on the base day, we establish two investment portfolios with the same initial value — one consisting of gaming stocks, the other consisting of media stocks. Within each portfolio, the same dollar amounts of cash are allocated evenly to each stock in the category, regardless of their prices and market caps. After that, we keep holding the two portfolios without doing any rebalancing and monitor their values over time to find their performances.

We include Tencent, Netease, Shanda Interactive, Perfect World and Changyou in the gaming basket, while putting Baidu, Sina, Sohu, Focus Media, AirMedia and Alibaba in the media basket. We set the base days at 1 January 2007, 2008, 2009 and 2010, respectively, and plot the gaming sector's relative performance over the media sector in the year that follows. Since not all the stocks were listed as at 1 January, 2007, we only include companies that were listed as at each base day. For example, for the gaming portfolio in 2007, we only have Tencent, Netease and Shanda Interactive in it. For 2008, we add Perfect World to the slate, as this name was listed in mid-2007.

### Exhibit 122. Gaming over media (2007 onwards)



Note: The gaming basket initially included Tencent, Netease and Shanda Interactive. We added Perfect World on 1 Aug 2007 and Changyou on 8 Apr 2009. The media basket started with Baidu, Sina, Sohu and Focus Media, Alibaba and AirMedia were added to the basket on 12 and 13 Nov 2007, respectively.

Source: Nomura research

In the above exhibit, using 1 January, 2007 as the base day, we can see that a positive RPI indicates a better performance of the gaming sector compared with the media sector, and vice-versa. The trough and peak on the curve show the possibility that investors switched between the two sectors, instead of sticking to one of them. The RPI reached its peak in 3Q09 and started to trend down in 4Q09, largely in line with the time that gaming companies delayed their games. For instance, as early as in July 2009, Changyou's management was already talking about delaying Duke of Mount Deer (DMD) in the 2Q09 financial results conference call. This chart indicates that we may be nearing the trough of the gaming downturn (or the upcycle in media) and hence, we would advise investors to pay closer attention to gaming names in the near future.

## Macau gaming

# NEUTRAL

### 🕒 Action

Off a VIP-driven high base in 2010F, we think mass market will take over as the main growth driver in 2011F. Aside from bringing faster growth, we think that what mass market business lacks in glamour, it makes up for with margin and cashflow sustainability. We forecast 2011F GGR growth of 18% for Macau, and see the table cap improving clarity on supply and earnings. Our top picks are the dominant mass market players offering attractive valuations, namely SJM and Sands China.

### 🚀 Catalysts

Macau stands to benefit from continued infrastructure enhancement, a potential increase in foreign labour approvals and China consumption growth.

### ⚓ Anchor themes

Cashflow sustainability is what we are looking for in 2011F. We favour stocks with an enduring competitive advantage, resilient qualities that can help to counter a downturn and relatively inexpensive valuations.

### Stocks for action

Our top BUYs in the Macau gaming space are SJM and Sands China, both dominant mass market players with attractive-looking valuations.

Stock	Rating	Local price (1 Dec)	Price target
SJM (880 HK)	BUY	12.18	15
Sands China (1928 HK)	BUY	17.40	20

Pricing as of 1 December, 2010; local currency

## Mass market wins hands down

### ① Macau gaming revenue growth of 18% y-y in 2011F

Macau's underlying story continues to be China, with growth this year of more than 50% y-y amid a surge in Chinese consumption and diversion of liquidity from China. Specifically, strong VIP revenue growth has been driven by a mix of: 1) the opening of new VIP facilities; 2) property tightening measures encouraging liquidity to exit China; 3) the robust economy helping to speed up the repayment cycle for gamblers; and 4) new sources of funding. For next year, we think the base effect will make it tough for the VIP segment to register much growth. The mass market segment, however, will likely continue to see growth on increased connectivity to China. We see potential upside to our 18% pa gross gaming revenue (GGR) growth forecast from the opening of Galaxy Macau and infrastructure enhancements.

### ② Long-lasting structural change favours high-margin mass market

The sort of VIP revenue growth seen last year is contingent on the sustainability of junket liquidity, which investors have no systematic way of gauging. For 2011F, we expect stronger growth from mass market business on structural changes from infrastructure enhancements, which should have a more lasting impact and thus improve earnings visibility. Moreover, while mass market business, which we see as the growth driver for 2011F, may look modest at the top line, it generates margins that are 3-4x those of VIP business, on our estimates.

### ③ Favourable supply-demand dynamics enhance earnings visibility

With table numbers capped by the Macau government at 5,500 through 2013F (extended from 2012F), we estimate supply growth will be kept in check at a healthy 13% spread over the next three years. Therefore, provided demand growth exceeds that range, the operational environment will likely remain favourable for gaming operators. Future supply-demand dynamics should help investors to gain a better sense of earnings expectations for the industry.

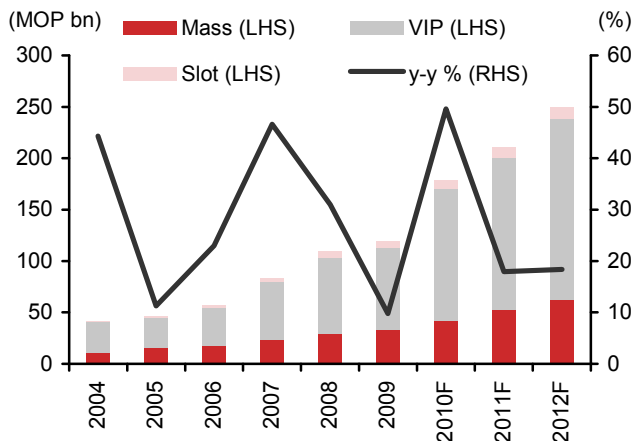
### ④ BUY mass market dominant players

SJM and Sands China offer investors access to the faster-growing mass market GGR in 2011F at attractive valuations. Approval of Cotai land (likely by year-end) for SJM and further foreign labour approvals for Sands China are upcoming potential catalysts for the stocks. We recommend accumulating on any pullbacks.

### Analyst

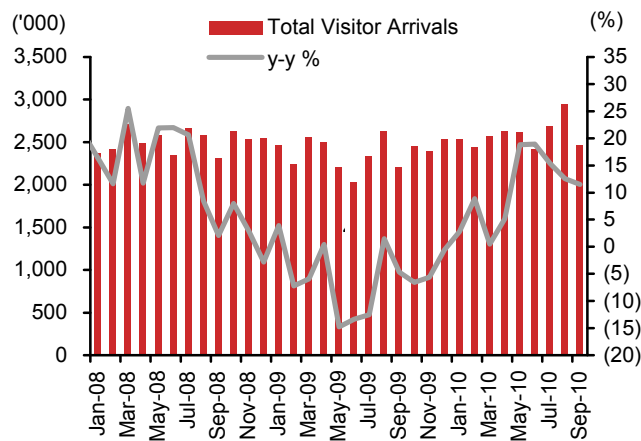
**Charlene Liu**  
+852 2252 6134  
[charlene.liu@nomura.com](mailto:charlene.liu@nomura.com)

Exhibit 123. Macau: gaming revenue



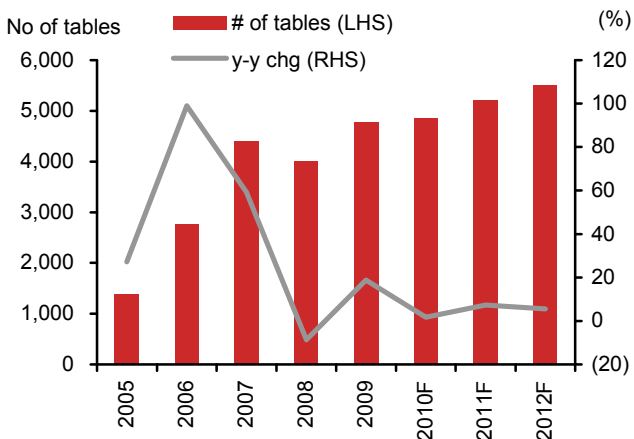
Source: DSEC, Nomura estimates

Exhibit 124. Macau: total visitor arrivals



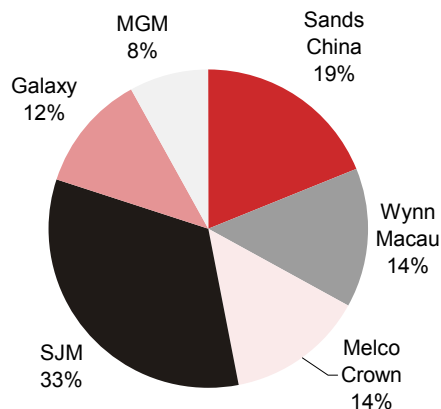
Source: DSEC, Nomura research

Exhibit 125. Macau: gaming table supply



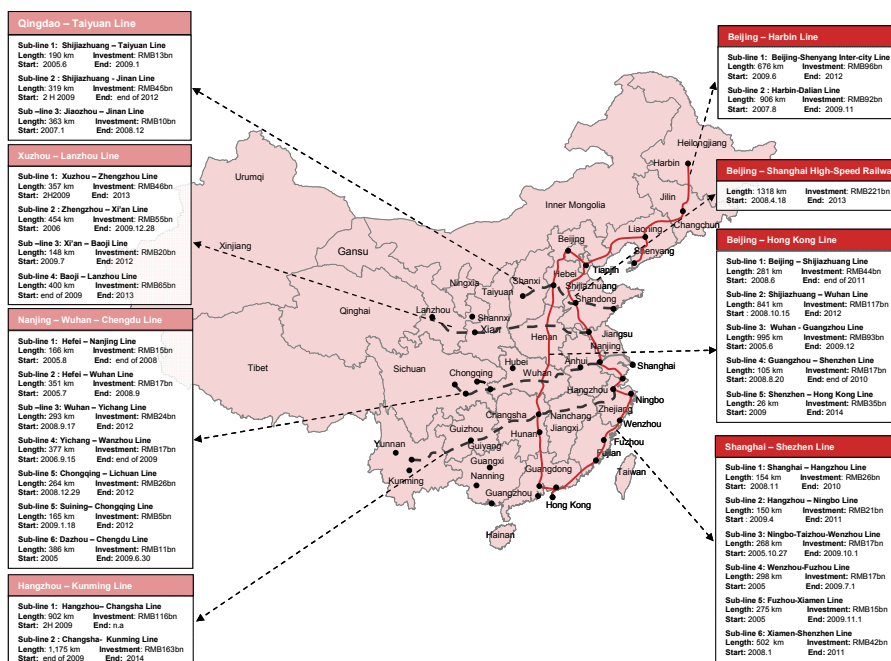
Source: DSEC, Nomura estimates

Exhibit 126. Macau: overall gaming revenue market share (Oct 2010)



Source: Company data, Nomura research

Exhibit 127. Map of high-speed railways with opening dates



Source: Nomura research

## Oil and Gas

### ⊙ Action

Sinopec is our near-term top pick in the China oil and gas sector, due to appealing valuations, upside in petrochem earnings, and a likely rerating of the stock in line with its improving returns, despite our assumption of low refining margins. Reaffirm BUY rating and price target of HK\$9.60, based on ROACE/WACC (14.3%/10.3%).

### ✈ Catalysts

The next catalyst could be when the government improves the oil product pricing mechanism or VAT on oil products, which we believe could be towards end-2010F or early 2011F.

### ⚓ Anchor themes

We believe the chemical sector is poised to enter a Golden Age, benefiting from rising demand and restrained capacity additions over the next two years. This should result in improved margins and petrochem sector earnings.

## BULLISH

### Stocks for action

Sinopec is our near-term top pick in the China oil and gas sector.

Stock	Rating	Local price	Price target
Petrochina (857 HK)	BUY	9.74	13.0
Sinopec (386 HK)	BUY	7.28	9.60
CNOOC (883 HK)	BUY	16.98	19.50
Shanghai Petrochem (338 HK)	BUY	3.90	4.20
Kunlun Energy (135 HK)	BUY	11.54	13.50

Priced as 1 December, 2010

## Policies and regulatory changes

### ① Regulations and taxes

We believe there are several outstanding regulatory changes which could impact the sector in 2011. These include changes in the pricing mechanism for refined oil products and natural gas which, if implemented, should result in a favourable outcome for oil companies. In terms of taxes, there are outstanding changes in: 1) implementing nationwide resource tax; 2) raising the hurdle rate of the windfall tax (currently at US\$40/bbl); and 3) VAT on refined oil products and consumption tax. We believe that if the government were to implement a resource tax on oil crude oil and natural gas production, it would most likely raise the hurdle rate of the windfall tax. We think this would likely be relatively neutral for Petrochina and Sinopec, though much depends on the hurdle rate of the windfall tax. This does, however, present an uncertainty for CNOOC, since we cannot verify if it will be required to pay the resource tax. As for the revamp on the VAT on oil products + consumption tax, the likely outcome should be favourable to Sinopec and Petrochina, we believe.

### ② Gas pricing mechanism

The government increased domestic wellhead gas prices by RMB230 per '000 cm, or around 25% on average, effective June 2010. This was a positive step for domestic gas producers such as Petrochina and Sinopec. However, the domestic price, which averages US\$4.6/mcf, is still below the imported price. In particular, the price of gas imported from Turkmenistan was contracted at around RMB3/m<sup>3</sup> but the selling price was set at only RMB1.8/m<sup>3</sup>. Since the volume imported from Central Asia was a modest 5-6bcm, the overall price increase should, we think, offset the price difference for gas from Central Asia. We think the government will further increase the selling price of gas from Turkmenistan as import volumes increase, though there is a risk that the timing of the increase may not be later rather than sooner, considering inflation and the lag in the downstream price increases. Eventually, we expect the government to introduce a pricing mechanism that tracks alternative fuel prices. We believe this could be the next catalyst for Petrochina's share price, without which the stock may not perform.

### Analysts

**Cheng Khoo**

+852 2252 6180

[cheng.khoo@nomura.com](mailto:cheng.khoo@nomura.com)

**Gordon Wai**

+852 2252 6176

[gordon.wai@nomura.com](mailto:gordon.wai@nomura.com)

### ③ Expecting an improved oil product pricing mechanism

We believe the government is likely to modify the mechanism by shortening the number of days (currently 22 working days) and narrowing the trigger (currently 4% of oil price fluctuation), which we think should be positive for their refining sector. While the government has not given specific timing for the change, we believe it is possible that the new measures will be announced at the end of 2010F or early 2011F.

Since the introduction of the pricing mechanism at end-2008, the NDRC followed the mechanism strictly in 1H09 but then found that margins were extremely high. Since 1H09, margins have fallen and prices are now in line with regional levels, indicating the government has already reset prices from the initially high levels. Going forward, we believe margins are likely to be in line with regional levels and price changes will take into consideration regional product prices rather than just crude oil prices.

Our view is that the government is unlikely to let the refiners incur losses, since losses would deter future investment in the sector, which would ultimately lead to a shortage in the system. However, we think it is unlikely that the government will allow windfall profits, such as those in 1H09, especially in light of the inflationary environment. We think the government will probably lower the VAT burden on the refiners and allow a narrow margin that moves more in line with international prices.

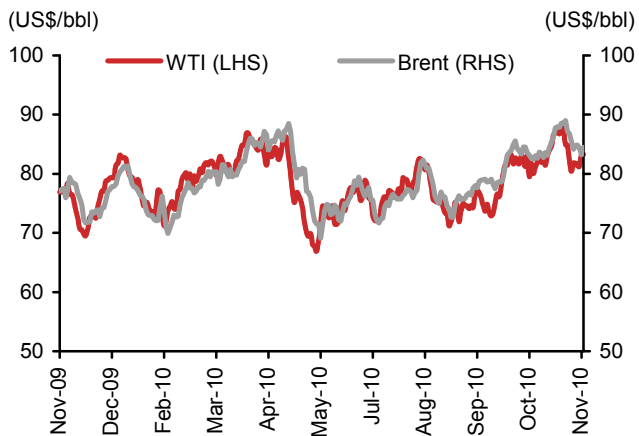
On our reading, future product price hikes will be beneficial to Sinopec, Shanghai Pet, Petrochina and Kunlun Energy. Even though Kunlun Energy is not a refiner, CNG prices are linked to gasoline prices at a ratio of 1:0.75.

### ④ Oil price to edge up

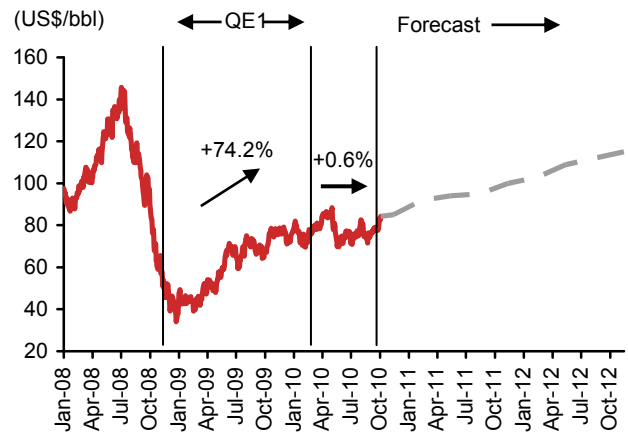
Weakness in the US dollar, abundant money supply and, potentially, higher inflation expectations that could come with QE-2, plus strengthening in oil fundamentals via higher demand in 2011F, could fuel higher oil prices. We believe oil prices could reach US\$100/bbl in the coming year. We forecast oil prices will average US\$95/bbl in 2011F, up around 20% y-y. CNOOC, being the only pure E&P company in China, will likely see its share price trade higher with oil prices, in our view.

### ⑤ Petrochemicals – transition year before entering a Golden Age

We believe the chemical sector is poised to enter a Golden Age, benefiting from rising demand and restrained capacity additions over the next two years. We believe that rising consumption growth in China brought about by favourable government policies, structural factors and the 12th Five-year Plan are likely to result in stronger chemical demand growth. In terms of supply, we think we are close to passing the peak of new cracker start-ups. The last phase of ethylene expansion will likely be over by early 2011F, we believe, after which we expect the sector to transition into a Golden Age for petrochemicals. We project margins across a range of key products will be strong in 2011F. For gearing to petrochemicals, we are most positive on Shanghai Pet (BUY) followed by Sinopec (BUY) and Petrochina (BUY).

**Exhibit 128. Oil price charts**

Source: Datastream

**Exhibit 129. Nomura price forecasts**

Source: Nomura estimates

**Exhibit 130. Natural gas price hike**

(RMB/'000 cubic meter)	Before	After	Change (%)
Fertiliser	661	868	31.3
Direct industrial use	1,067	1,274	19.4
City Gas (industrial use)	1,073	1,280	19.3
City Gas (non-industrial use)	713	920	29.0

Source: NDRC, Nomura Research

**Exhibit 131. Sinopec refining margins**

(US\$/bbl)	Refining margins	Quarterly avg.
Jan-09	2.7	
Feb-09	8.6	
Mar-09	7.3	<b>1Q09</b> 6.2
Apr-09	9.6	
May-09	7.6	
Jun-09	10.4	<b>2Q09</b> 9.2
Jul-09	6.1	
Aug-09	0.1	
Sep-09	2.6	<b>3Q09</b> 2.9
Oct-09	(1.0)	
Nov-09	2.5	
Dec-09	(1.3)	<b>4Q09</b> 0.1
Jan-10	0.4	
Feb-10	(0.7)	
Mar-10	3.3	<b>1Q10</b> 1.0
Apr-10	4.1	
May-10	(0.7)	
Jun-10	(5.9)	<b>2Q10</b> (0.9)
Jul-10	2.8	
Aug-10	3.9	
Sep-10	2.4	<b>3Q10</b> 3.1
Oct-10	5.8	
Nov-10	3.7	

Source: Bloomberg, Nomura estimates

**Exhibit 132. Asia Pacific petrochemical product margin trends & forecast**

(US\$/tonne)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010F	2011F	2012F
Ethylene-Naphtha	242	177	186	512	419	554	452	346	287	380	360	420
LDPE-Naphtha	412	351	393	718	631	645	733	740	584	600	540	660
HDPE-Naphtha	368	285	325	555	535	629	603	582	521	440	410	540
Propylene-Naphtha	201	219	279	434	456	518	392	371	343	460	400	460
PP-Naphtha	319	331	414	570	568	641	616	593	481	520	480	580
AN-Propylene	259	179	294	301	401	405	670	633	336	880	840	900
Butadiene-Naphtha	164	324	423	566	733	770	367	1,274	445	1,100	1,200	1,250
Benzene-Naphtha	93	114	171	445	338	303	337	167	136	200	220	240
SM-Naphtha	291	377	415	660	646	610	578	469	396	460	520	600
PS-SM	111	63	94	138	39	56	156	94	97	110	100	110
ABS-Naphtha	645	563	644	903	922	946	1,002	1,014	796	1,100	1,150	1,080
Phenol-Naphtha	310	332	409	752	559	597	869	558	300	800	750	780
BPA-Phenol	515	227	270	225	525	235	178	282	418	350	400	375
PVC-Ethylene	274	338	382	432	362	246	360	428	355	400	440	430
MEG-Ethylene	174	176	374	380	318	169	421	252	125	160	260	300
PX-Naphtha	228	186	336	431	419	577	440	340	432	300	350	400
PTA - Naphtha	247	252	293	388	325	317	182	55	275	230	270	250

Source: Thomson Reuters Datastream, Nomura estimates

**Exhibit 133. Valuations**

	Bloomberg ticker	Curr	Price 1-Dec	Target price	Potential upside (%)	Rating	P/E		EV/EBITDA		P/BV		Net debt/equity (%)		ROE (%)	
							2010F	2011F	2010F	2011F	2010F	2011F	2010F	2011F	2010F	2011F
Petrochina	0857 HK	HK\$	9.74	13.00	33	BUY	11.4	9.1	5.4	4.8	1.6	1.5	22.5	29.3	15	18
Sinopec	0386 HK	HK\$	7.28	9.60	32	BUY	7.4	6.4	4.4	3.9	1.3	1.1	49.0	42.5	19	19
CNOOC	0883 HK	HK\$	16.98	19.50	15	BUY	12.7	11.1	6.8	5.8	3.2	2.6	Net cash	Net cash	27	26
Shanghai Petrochem	0338 HK	HK\$	3.90	4.2	8	BUY	10.0	9.4	7.3	6.6	1.4	1.3	44	41	14	13
Kunlun Energy	135 HK	HK\$	11.54	13.50	17	BUY	22.3	18	17.2	15.9	3.5	3.0	Net cash	Net cash	17	15

Source: Company data, Nomura estimates

## Retail

**BULLISH**

### ⊙ Action

We remain positive on China's retail growth outlook in 2011F on rapid urbanisation, a young population and rising income. Mild inflation should be positive for retailers' ASP increases. Among all retail formats, we believe electronic retailers are most geared to increasing demand from low-income groups and department stores are well positioned to capitalise on the consumption upgrade trend. Valuations appear fair and earnings upside revisions are key catalysts. Gome remains our top BUY.

### ⚡ Catalysts

Improved margins, better-than-expected SSS and potential acquisitions.

### ⚓ Anchor themes

With China's GDP likely to remain strong at 9.8% in 2011F, we are positive on the growth outlook for retail stocks. The transformation of China's economic growth appears to be underway, with consumption becoming increasingly important.

### Stocks for action

Gome is our top pick for the next 12 months. We expect margins to continue to improve in FY11F, which will be the key for earnings upside revisions, in our view.

Stock	Rating	Local price	Price target
Gome (493 HK)	BUY	3.15	4.3
PCD (331 HK)	BUY	2.43	3.1
Parkson (3368 HK)	BUY	13.1	17.5
NWDS (825 HK)	BUY	7.09	9.2
Ctrip (CTRP US)	BUY	43.78	60.0
Belle (1880 HK)	BUY	14.26	16.0

Pricing as of 1 Dec 2010

## Strong pulse of consumption

### ① A favourable macro backdrop

We remain positive on China's retail growth outlook in 2011. The recently announced 12-5 plan provides a favourable macro backdrop as economic growth is transitioning to a consumption-driven model from an investment-driven one. Rapid urbanisation, a young population and rising income (especially in rural and inland areas) favour accelerating consumption growth.

### ② Growth drivers: penetration and upgrade of consumer goods

We believe growth will continue to be driven by 1) increasing penetration of consumer goods in rural areas and low income groups in urban areas and 2) consumption upgrades among higher-income urban households. Among retail formats, we believe electronic retailers are most geared to increasing demand from low-income groups. Product mix upgrades and operating efficiency improvement are key for electronic retailers to sustain long-term growth. In our view, department stores are well positioned to capitalise on consumption upgrades and are now entering a rapid store expansion phase. As the economy grows, more people will fall into the middle class, their key customers.

### ③ Consumption still healthy in inflationary world

Concern over China's inflation escalated as October CPI hit a new high with a 4.4% increase. Unlike early 2008, when high inflation and decelerating income growth caused a sharp consumption slowdown, the current situation is less challenging, because Nomura expects GDP will grow at 9.8% in 2011F. In our view, mild inflation will be positive as retailers can raise ASPs and sustain margins. With increasing disposable household income, we believe consumption growth will remain solid.

### ④ Valuations look fair. Top pick: Gome

Retail stocks are trading at 21x FY11F P/E or 1x PEG. The valuation multiple appears fair. However, after major outperformance in FY10 (outperforming HSI by 32% YTD), we are now more selective in stock picks. We believe earnings upside revisions will be key share price catalysts and look for companies with turnaround potential. As such, Gome remains our top pick in 2011F. Besides favourable policies to stimulate consumption, we believe a rising minimum wage will drive up demand for home appliances in a sustainable manner, which would benefit Gome.

### Analyst

Candy Huang

+852 2252 1407

[candy.huang@nomura.com](mailto:candy.huang@nomura.com)

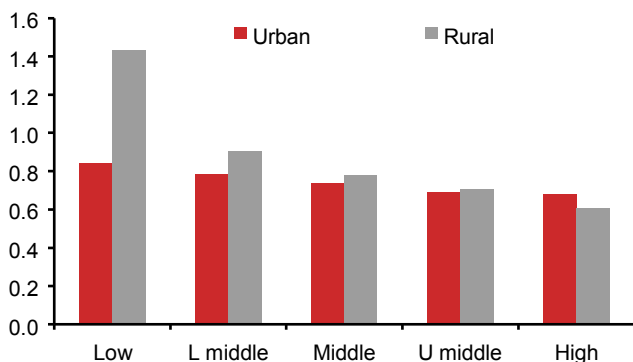
## 2011 outlook remains positive

We remain positive on China's retail growth outlook in 2011F. The recently announced 12-5 plan provides a favourable macro backdrop as economic growth is transitioning to a consumption-driven model from an investment-driven one. Rapid urbanisation, a young population and rising income (especially in rural and inland areas) favour accelerating consumption growth.

We believe growth will continue to be driven by 1) increasing penetration of consumer goods in rural areas and low income groups in urban areas, as the government tries to adjust the income distribution system, narrowing the wealth gap. With additional disposable income, we think low-end workers are more likely to spend on items like apparel, shoes, snacks and home appliances; and 2) consumption upgrades among higher-income urban households. We expect to see more demand for cars, branded products, travel and entertainment along with lifestyle changes.

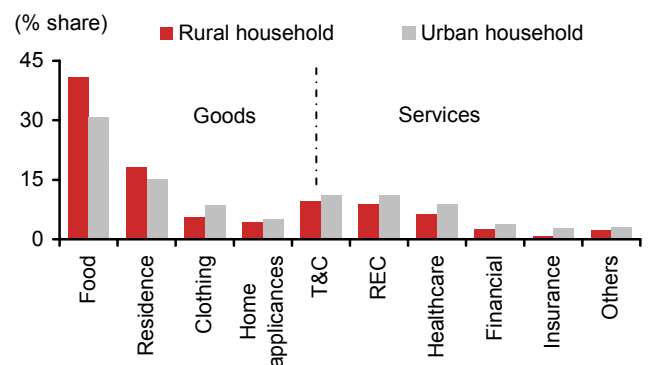
We expect China's retail market to see multi-retail formats in the next 5-10 years, such as the development of shopping malls/outlet malls/speciality stores, etc. We also expect online shopping to gain ground in China's home appliance market in 2011F. In 2009, the online home appliances market generated sales of RMB3.55bn, up 111.31% y-y (source: 21cbh, 28 June). Suning, Haier and TCL have already built online platforms; on 22 Nov, Gome acquired an 80% stake in B2C consumer electronic website Coo8.com for RMB48mn, with the aim of gaining a 15% share of China's B2C market or annual sales of RMB25-30bn by 2014F (source: 21cbh, 23 Nov).

**Exhibit 134. Propensity to consume by income level (2008)**



Source: CEIC, World Bank, Nomura research

**Exhibit 135. Household consumption basket**



Source: CEIC, World Bank, Nomura research

### ● Electronic retailers, most geared to minimum salary increase

We believe electronic retailers like Gome will continue to benefit the most from the government policy to adjust the income distribution system. 2010 has been a fruitful year, as the direct stimulus policy (rural subsidy/old for new programme) greatly promoted the sales growth of electronic retailers. We expect rising minimum wages to further drive up demand in a more sustainable manner. With additional disposable income, rural households have a higher propensity to consume than their urban counterparts, particularly in the case of low-income households.

To tap into the increasing demand from low-income groups, we believe electronic retailers will further expand to third and fourth tier cities. As at end-3Q10, Suning owned 95 county/town level stores out of 1,206 stores; Gome has announced plans to focus more on lower-tier cities, where 3Q saw better SSS than first-tier cities. Nevertheless, operating expense remains key as building logistics and winning customer loyalty in a new market normally necessitate high initial costs.

For electronic retailers, product mix upgrades and operating efficiency improvement will be key factors to sustain long-term growth, in our view. With its store-closure

programme largely done, Gome launched 185 projects during 3Q10 to optimise the operation of its 185 stores in tier-2 markets. Margin upside could come from good execution of such projects.

#### Exhibit 136. Same store sales

(%)	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10
Gome	3.2	(2.2)	9.0	(36.0)	(20.8)	(8.3)	2.1	25.7	23.9	25.7	14.1
Suning	12.0	(12.0)	9.7	(32.6)	(12.0)	3.7	4.8	31.3	27.0	19.1	18.0

Source: Company data

#### Exhibit 137. Operating margin

(%)	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10
Gome	4.4	5.8	5.2	0.8	3.3	3.3	4.4	4.1	4.5	5.5	5.0
Suning	4.7	6.2	6.2	4.6	4.7	6.9	6.5	7.3	6.7	6.8	6.0

Source: Company data

#### ● Department stores well positioned to capitalise on consumption upgrade

We believe department stores are well positioned to benefit from the consumption upgrade trend. They are good proxies for the fashion/luxury segments in China, as cosmetics, apparel, footwear and jewellery account for more than 70% of their total sales, on our estimates. All department stores under our coverage target mid-high end markets. As the economy grows, more people will fall into the middle class, their key customers.

Benefiting from rising income and city expansion, department stores are now entering a rapid expansion phase. Regional department stores are embarking on cross-regional expansion, while national department stores are deepening their market penetration to improve economies of scale. For example, PCD is expanding store GFA at a 37.7% CAGR over FY10-12F, with self-operated stores targeted to double to 18 by end-FY12F from 9 at end-FY09.

We think acquisitions could be key for earnings upside in 2011F. PCD and NWDS have relatively good visibility on their pipeline of store acquisitions from their parent companies and/(or) third parties. The possibility of Maoye and Intime making acquisitions also appears higher than peers, given balance sheet improvements after recent fund raisings and continued efforts to dispose non-core assets.

In addition to traditional department stores, we expect the emergence of shopping malls, outlet malls, etc. For select first-tier cities like Beijing/Shanghai, shopping mall is as an attractive retail format, as it provides an upscale one-stop shopping experience. Outlets mall are likely to grow fast on rising demand from Chinese looking for branded products at good value.

#### Exhibit 138. Department store: recurring net profit growth

Company	Ticker	% y-y growth			
		FY09	1H10	FY10F	FY11F
Parkson	3368 HK	8.3	9.3	15.7	25.2
Golden Eagle	3308 HK	32.0	21.1	25.0	26.8
Intime	1833 HK	25.8	78.1	47.7	47.6
Maoye	848 HK	(7.1)	28.7	20.6	26.1
NWDS	825 HK	6.7	5.4	(3.5)	28.3
PCD	331 HK	45.6	30.7	25.3	46.2
<b>Average</b>		<b>18.6</b>	<b>28.9</b>	<b>21.8</b>	<b>33.4</b>

Note: Golden Eagle's FY09F EPS includes CB conversion; NWDS is fiscal year ended June  
Source: Company data, Nomura estimates

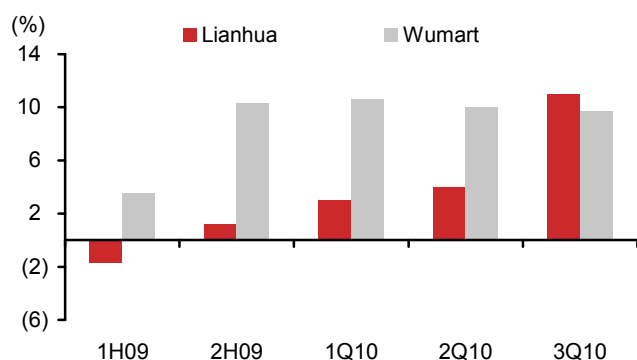
### ● Who is the winner in an inflationary world?

While concern over China's inflation has escalated, we believe the retail sector outlook remains positive. Unlike early 2008, when high inflation and decelerating income growth resulted in a sharp consumption slowdown, the current situation seems less challenging. In our view, with increasing disposable household income, consumption growth can still be healthy.

Nomura economists expect CPI of 3.6% in 2011, which is benign for consumption growth. China's State Council has pledged to make more efforts to stabilise commodity prices ('price control'). While this may cloud investor sentiment, we believe retailers are less affected than staple companies, as prices of apparel, appliances, etc are less likely to be controlled.

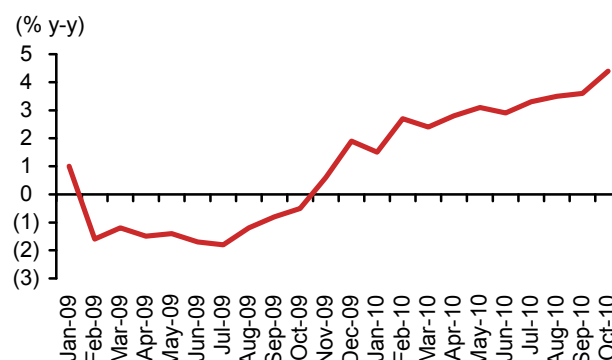
We believe supermarkets will be key beneficiaries of inflation, as food (including fresh food) accounts for 70-80% of sales for most Chinese grocery chain stores. With CPI at 3.6% in September, Wumart and Lianhua 3Q SSS accelerated to 9.7% and c.11%, respectively. For branded retailers and department stores, mild inflation could mean an ASP increase. Names like Belle, Lining and Ports enjoy the greatest pricing flexibility in an inflationary world. However, rising operating expenses remains a key challenge for retailers, primarily due to increased rents and wage inflation.

Exhibit 139. Supermarket SSS



Source: Company data

Exhibit 140. CPI



Source: CEIC

### ● Valuation appears fair, Gome top pick

On average, retailers outperformed the Hang Seng Index by 10.0% and 43.3% in the past 6 and 12 months, respectively. We believe the outperformance of the department store sector is largely due to valuations in tandem with the market rally and solid fundamentals, which have held up better than the market had expected.

The sector is trading at 21x FY11 P/E, or 1x PEG. Valuation multiples seem fair for the next 12-months. We believe earnings upside revisions will be key share price catalysts. We favour companies with turnaround potential and accelerating earnings growth and have BUYS on Gome, PCD, Parkson, NWDS, Belle, Ports, Li Ning and Ctrip.

While supermarket companies are perceived as inflationary players, we think share prices in this sector do not have a high correlation with CPI level. For example, during 2H FY07, supermarket companies underperformed the Hang Seng Index by 31.6% while on average, retailers outperformed the index by 11.1%.

Gome is our top pick for the next 12 months. We think the worst is over for the company with regard to conflicts between the ex-Chairman and existing Chairman. We expect margins will continue to improve in the next 12 months given the product mix upgrade and sales efficiency improvement. This will be the key for earnings upside revisions in our view. We expect store expansion and SSS to be earnings drivers beyond FY12, in line with the company's 5-year plan.

# Shipping

**Bulk shipping –  
BULLISH**

**Container shipping –  
BEARISH**

## ⊙ Action

Amongst our shipping coverage, Pacific Basin and CSD are our top BUYs as we are more Bullish on drybulk than containers. We are positive on drybulk given strong demand, despite growing concern over supply. We are Bearish on container shipping due to pressured margins, declining rates and higher oil prices.

## ⚡ Catalysts

Potential upcoming catalysts include a higher and stronger rebound in dry bulk freight rates and a continued decline in container freight rates.

## ⚓ Anchor themes

Bearish on container shipping as we believe container freight rates have peaked and will decline into 2011F, leading to weaker earnings. We are Bullish on drybulk shipping (for now) as we see seasonally stronger 4Q and earnings improvement in 2011F. However, we note that drybulk supply is an increasing concern.

## Stocks for action

Amongst HK/China shipping coverage, we prefer Pacific Basin and CSD. Pacific Basin operates smaller-sized vessels (with more attractive fundamentals) while CSD benefits from secured contracts in the domestic coastal trade.

Stock	Rating	Local price	Price target
China Cosco (1919 HK)	BUY	8.46	12.10
CSD (1138 HK)	BUY	11.02	15.60
Pacific Basin (2343 HK)	BUY	5.30	8.50
Sinotrans (368 HK)	BUY	2.98	4.60
CSCL (2866 HK)	REDUCE	3.13	2.05
OOIL (316 HK)	NEUTRAL	76.90	61.80

Pricing as of 1 Dec. 2010

## Mixed view on shipping

### ① Drybulk shipping – Bullish for now; yet concern on supply

We remain Bullish on the drybulk shipping sector (for now) as we expect strong bulk demand in 2011F, especially from China (accounts for 45% of global steel production in 9M10). Despite concerns over slowing demand from construction activities (due to a tightening property market and slowing infrastructure investment), Nomura's China steel team remains Bullish on China's steel sector and estimates 6.0% production growth in 2011F, after 13.7% production growth in 2010F. However, bulkship supply is becoming a concern, with YTD newbuilding slippages (43% from January to October) tracking below our expectation. Greenfield shipyards are beginning to deliver despite our previous view of possible execution problems with new shipyards. This could lead to oversupply, in our view. One potential positive catalyst is port congestion during peak periods, which could help to ease the oversupply problem. While port congestion could help to cap effective capacity, we believe drybulk freight rates will likely remain volatile in 2011F.

### ② Container shipping – Bearish view from oversupply concern

With quarterly container earnings peaking in 3Q10, we have a Bearish view on the Asian container shipping sector as we see supply growth outpacing demand growth. We expect weaker demand as highlighted by global economic indicators (such as US ISM and EU PMI). Further, we believe inventory restocking is over and demand in 2011F is likely to depend on end-user retail sales. Hence, we expect global economic growth in 2011F to be a key demand driver. On the supply side, we are concerned about the orderbook, which is skewed toward larger sized vessels (about 62% of orderbook are +8,000 TEUs ships) that can only operate on long haul routes. This, in our view, is likely to lead to cascading effect into other routes, resulting in supply problems.

While container freight rates have already begun to decline 10% from the peak in end-August (according to data from the Shanghai Shipping Exchange), we expect this trend to continue into 1H11F. Further, margins are set to be further eroded from high oil prices, as we expect the average Brent oil price to increase 14% to US\$95/bbl in 2011F. While idled capacity could help ease the oversupply, we believe idled capacity is unlikely to reach the last peak (12% in December 2009),

## Analysts

**Andrew Lee**

+852 2252 6197

[andrew.lee@nomura.com](mailto:andrew.lee@nomura.com)

**Cecilia Chan**

+852 2252 6181

[cecilia.chan@nomura.com](mailto:cecilia.chan@nomura.com)

give the overall sector is profitable this year while newbuilding delivery slippages is likely to slow. We maintain a Bearish view on the sector and estimate freight rates to decline 5% in 2011F.

**Exhibit 141. Global bulk shipping demand, supply and freight rates**

	2002	2003	2004	2005	2006	2007	2008	2009	2010F	2011F	2012F
Nominal supply growth (%)	2.7	2.5	6.8	7.0	6.8	6.5	6.6	9.8	8.7	8.0	6.9
Global demand growth (%)	1.6	6.8	8.4	8.8	7.7	7.0	2.3	(4.0)	8.2	7.3	7.1
+/- balance (%)	(1.1)	4.4	1.6	1.8	1.0	0.5	(4.3)	(13.8)	(0.5)	(0.7)	0.2
<b>Baltic Drybulk Index</b>	<b>1,145</b>	<b>2,626</b>	<b>4,515</b>	<b>3,353</b>	<b>3,197</b>	<b>7,088</b>	<b>6,355</b>	<b>2,623</b>	<b>3,436</b>	<b>3,436</b>	<b>3,891</b>
Change (% y-y)	(6)	129	72	(26)	(5)	122	(10)	(59)	31	0	13

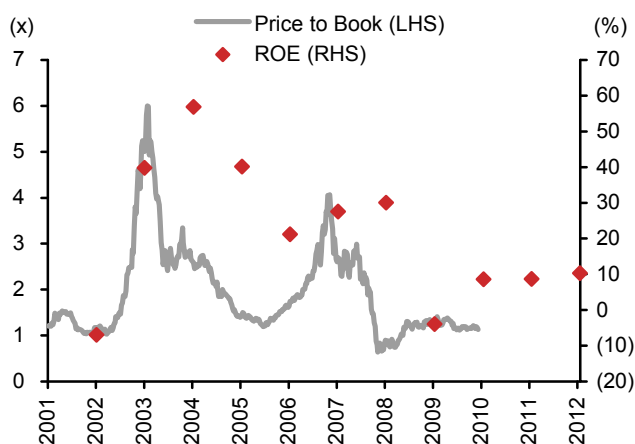
Source: Containerisation International, Nomura estimates

**Exhibit 142. Global container shipping demand, supply and freight rates**

	2002	2003	2004	2005	2006	2007	2008	2009	2010F	2011F	2012F
Global demand growth (%)	11.7	14.3	14.8	10.0	10.8	12.7	5.3	(9.9)	11.5	7.2	8.3
Nominal supply growth (%)	10.5	8.9	9.7	13.1	16.6	13.7	12.9	6.3	8.6	9.0	6.1
+/- balance (%)	1.2	5.4	5.0	(3.1)	(5.8)	(1.1)	(7.6)	(16.2)	2.9	(1.8)	2.1
<b>Head-haul rates (avg. annual)</b>	<b>1,340</b>	<b>1,663</b>	<b>1,821</b>	<b>1,822</b>	<b>1,610</b>	<b>1,755</b>	<b>1,856</b>	<b>1,251</b>	<b>1,693</b>	<b>1,605</b>	<b>1,667</b>
Change (% y-y)	(13.2)	24.2	9.5	0.0	(11.6)	9.0	5.8	(32.6)	35.3	(5.2)	3.9

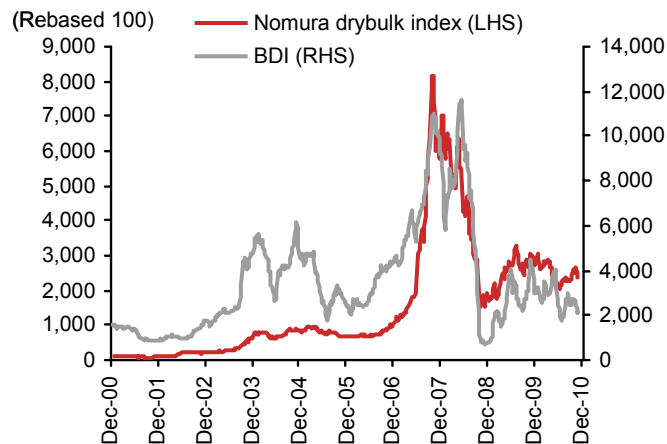
Source: Containerisation International, Nomura estimates

**Exhibit 143. Drybulk shipping P/BV and ROE**



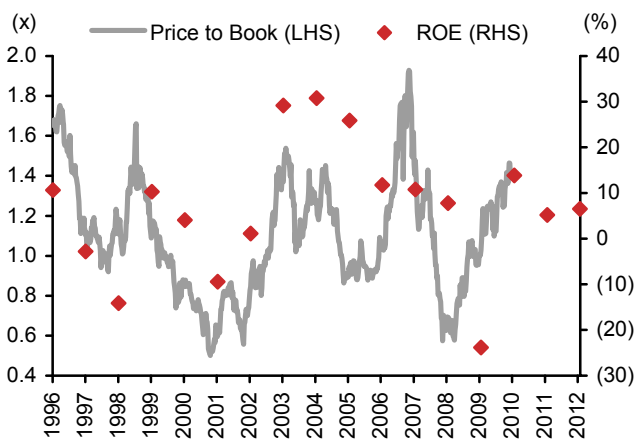
Source: Thomson Reuters Datastream, Nomura estimates

**Exhibit 144. Drybulk shipping index and BDI**



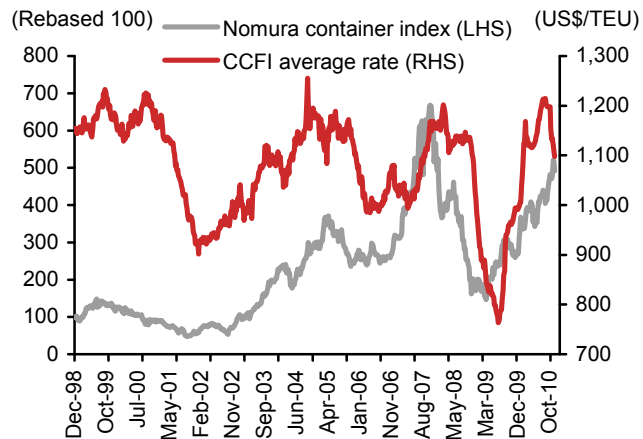
Source: Thomson Reuters Datastream, Nomura estimates

**Exhibit 145. Container shipping P/BV and ROE – bearish sector view as ROE declining in 2011**



Source: Thomson Reuters Datastream, Nomura estimates

**Exhibit 146. Container shipping index and overall container freight rates**



Source: Thomson Reuters Datastream, Nomura estimates

## Steel

**BULLISH**

### ⊙ Action

We believe steel prices will be range-bound through 4Q10F, with short supply from power rationing and slowing demand towards year-end. We expect China steel production to slow in 2011F, given the increasing focus on environmental protection. We remain selectively positive on the China/Taiwan steel sector, with BUYs on Angang and China Steel, and NEUTRALs on Baosteel and Maanshan.

### ⚡ Catalysts

Steel demand growth, steel price movements, government policy changes, interest rate changes and changes in raw material prices.

### ⚓ Anchor themes

Steel equities in China/Taiwan will likely see range-trading, as iron ore spot prices tend to move in tandem with steel prices. A major boost to steel makers' margins is unlikely if iron ore contract prices are reviewed on a monthly basis, as is being proposed by iron ore miners.

### Stocks for action

Angang looks best positioned in our China/Taiwan steel space, given its semi-integration to iron ore. China Steel, a low-beta steel stock, tends to outperform peers when the steel cycle turns.

Stock	Rating	Price	Price target
Angang (347 HK)	BUY	HK\$11.34	HK\$16.00
China Steel (2002 TT)	BUY	NT\$31.35	NT\$37.0
Baosteel (600019 CH)	NEUTRAL	RMB6.29	RMB7.00

Pricing as of 1 December, 2010; local currency

## Favour integrated players

### ① Steel prices likely to be range-bound through 4Q10F

We are confident that steel mills under our coverage will register better earnings in 4Q10F than in 3Q10, given a recovery in China's average steel prices of 2.2-6.3% q-q in 4Q10F. However, we expect steel prices to be range-bound for the rest of the year, owing to a mix of inventory de-stocking, short supply from power rationing, slowing demand towards year-end, and China's tight monetary policies. The downside risks to steel prices should be limited at current levels, in our view, given: 1) continuing inventory de-stocking; 2) decreased crude output; and 3) high raw material costs.

### ② Moderate production growth expected into 2011F

China is raising the bar in terms of environmental protection. We believe that tightening environmental standards and government controls are likely to slow steel capacity and production growth during the 12th Five-year Plan (FYP). One recent example is the power rationing in the steel sector and some other energy-intensive industries since August. As a result, China's daily crude output has dropped since August to 1.6mt in October, down 2.8% y-y. While China is likely to end power rationing at the end of this year or early next year, we believe the authorities will keep a close eye on steel capacity and production growth to ensure that China reaches its energy-saving targets under the 12th FYP. As such, we expect moderate production growth over 2011-12F of 6.0% pa and 8.0% pa to 685mt and 739mt, respectively. Backed by more disciplined supply and China's push for industry consolidation, we expect the average steel industry utilisation rate to improve from 85% in 2010F to 89.1% in 2012F.

### ③ Industry consolidation is no solution for margin contraction

We believe consolidation would only marginally benefit the Chinese steel industry. Rather, the key issue, in our view, is China's dependence on iron ore imports. With our global mining team recently extending the peak of the iron ore cycle to 2012F (from 2011F), we expect Chinese steel mill margins to move sideways. Thus, we look for steel equities as a whole to be range-bound over the next two years.

### Analyst

Josephine Ho

+852 2252 2177

[josephine.ho@nomura.com](mailto:josephine.ho@nomura.com)

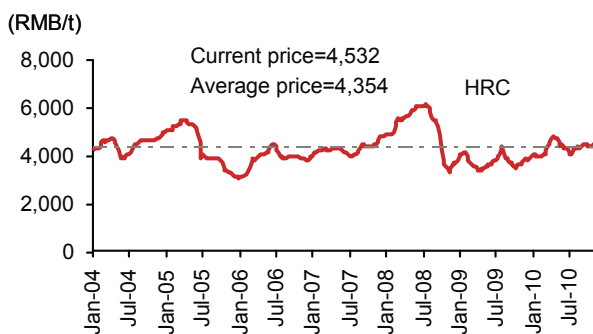
#### ④ Still selectively positive on China steel sector

China steel equities have underperformed the market by 12-13% in the past month, mainly on disappointing 3Q10 results (we believe now fully priced in) and low earnings visibility for 2011F from uncertainties in the property sector (17% of steel demand) and iron ore price moves. Based on our recent rentals and mining field trip, we believe the property market could be a swing factor for steel demand going into 2011F. However, according to *21 CBH* (18 November), China plans to build 13mn social welfare apartments in 2011-12F, completing 6.8mn units in 2011F and 6.2mn units in 2012F. If this target is achieved, it should help to partially offset a potential decline in demand from the commercial property sector.

On the cost front, the floating pricing system has taken away the inventory gains that the steel industry used to enjoy. As it is likely to continue to be a seller's market for iron ore in 2011F, we believe steel mills with mining assets will gain a cost advantage amidst spiralling iron ore prices.

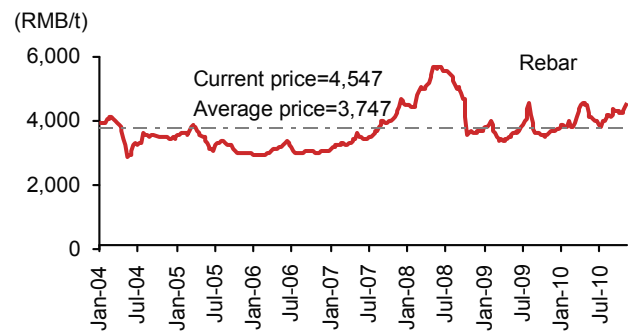
That said, our top pick in our China steel universe remains Angang, for its semi-integration to iron ore and strength in flat steel making. We also like China Steel, for its low share-price volatility and stable dividend payout ratio. On the other hand, we remain NEUTRAL on Baosteel and Maanshan, given: 1) Maanshan's weak execution and 2) Baosteel's mixed product outlook.

**Exhibit 147. Hot-rolled coil (HRC) prices, since 2004**



Source: Mysteel, Nomura research

**Exhibit 148. Rebar prices, since 2004**



Source: Mysteel, Nomura research

## Telecom services

# NEUTRAL

### Ⓞ Action

On our channel checks, we remain positive that China Unicom's 3G business is moving in the right direction: 1) launching affordable smartphones for mass market; and 2) capturing high-ARPU corporate customers. Our near-term pecking order remains China Unicom (BUY) > China Mobile (BUY) > China Telecom (NEUTRAL), given strong momentum in 3G net adds at Unicom.

### ✂ Catalysts

Better-than-expected financial results, growth of DPS in absolute terms, increase in market share and higher-than-expected subscriber growth are potential catalysts.

### ⚓ Anchor themes

Gradual blossoming of smartphone usage, rising mobile data usage and maturing 3G network coverage will put telecom operators back on the growth track.

### Stocks for action

BUY China Unicom, where we expect 3G monthly net adds to jump on iPhone 4 'mania' in China. BUY China Mobile, where we expect a re-rating. We are NEUTRAL on China Telecom, on a lack of positive catalysts.

Stock	Rating	Price	Price target
China Mobile (941 HK)	BUY	78.10	95.00
China Telecom (728 HK)	NEUTRAL	3.95	4.80
China Unicom (762 HK)	BUY	10.48	13.50

Pricing as of 1 December, 2010; local currency

## Smartphones to drive 3G penetration

### ① Variety and affordability of smartphones to continue to improve

When compared to 2010, we expect the variety of smartphones to increase in 2011. At the same time, due to improved economies of scale, we expect ASP of smartphones to decline further in China. This should lower switching costs for the mass market segment of 2G subscribers and drive up volume of 2G mobile subscribers migrating to the 3G mobile platform.

### ② The thunder of MNP, but little rain on the horizon

We believe the government's key priority still lies with achieving technological superiority (eg, TD-SCDMA, TD-LTE), despite the beginning of the commercial phase of mobile number portability (MNP) in Hainan province and Tianjin effective 22 November. With China Mobile spearheading the effort in promoting both proprietary technologies, we expect the government to provide a benign operating environment for China Mobile in return.

### ③ China Mobile could be the first to launch 4G service

Having gained sound knowledge of 4G technology through the rollout of TD-LTE at the Shanghai World Expo, China Mobile appears to have the deepest knowledge base in next-generation technology compared to the other two operators. We would not be surprised to see China Mobile be the first to launch 4G service in China.

### ④ Top pick in the China telecom universe

China Unicom is our top pick in the Chinese telecom universe. Our relative order of preference is China Unicom > China Mobile > China Telecom.

### Analysts

Danny Chu, CFA

+852 2252 6209

[danny.chu@nomura.com](mailto:danny.chu@nomura.com)

Leping Huang, PhD

+852 2252 1598

[leping.huang@nomura.com](mailto:leping.huang@nomura.com)

## Investment summary

For China Unicom, we expect the company to continue benefitting from 3G net adds (at relatively higher ARPU), outnumbering its 2G net adds. For China Mobile, we expect the company to benefit from: 1) inclusion of SPDB's earnings; and 2) a passionate and energetic CEO taking the driver's seat. We expect consensus estimates to rise to reflect the improving fundamentals.

- **At China Unicom, more visible 3G enhancing effect on blended ARPU.** For FY09, China Unicom's 3G and 2G subscriber ARPU figures were RMB142 and RMB41, respectively. We see two key drivers for Unicom's blended ARPU: 1) 3G ARPU; and 2) 3G subscriber additions. In our sensitivity exercise (shown below), we assume 2G ARPU will stay at RMB40 and 2G monthly net adds will remain flat at 0.7mn. Our sensitivity analysis suggests that a 3G ARPU of RMB120 and 3G net adds of 10mn imply a blended ARPU of RMB48.1 for FY11F (FY08: RMB41.6) for Unicom. Even if 3G ARPU is at RMB60 and 3G net adds for FY11F is 8mn, then the blended ARPU of China Unicom could still be about RMB41.90.

**Our order of preference is China Unicom > China Mobile > China Telecom**

**With 3G monthly net adds outnumbering its 2G monthly net adds, we expect Unicom's blended ARPU to keep rising**

### Exhibit 149. Sensitivity analysis of blended ARPU to 3G ARPU and 3G subscriber base

3G net adds (mn)	ARPU of 3G service (RMB)										
	60	70	80	90	100	110	120	130	140	150	160
8	41.9	42.9	43.8	44.8	45.8	46.7	47.7	48.6	49.6	50.6	51.5
9	42.0	43.0	43.9	44.9	45.9	46.9	47.9	48.9	49.9	50.8	51.8
10	42.0	43.0	44.0	45.1	46.1	47.1	48.1	49.1	50.1	51.1	52.1
11	42.1	43.1	44.1	45.2	46.2	47.3	48.3	49.3	50.4	51.4	52.4
12	42.1	43.2	44.2	45.3	46.4	47.4	48.5	49.6	50.6	51.7	52.7
13	42.2	43.3	44.3	45.4	46.5	47.6	48.7	49.8	50.9	52.0	53.0
14	42.2	43.3	44.5	45.6	46.7	47.8	48.9	50.0	51.1	52.2	53.4
15	42.3	43.4	44.5	45.7	46.8	48.0	49.1	50.2	51.4	52.5	53.6

Source: Nomura estimates

- **Revenue and earnings growth rates for Chinese telecom operators have tended to rise significantly in the year when a new CEO assumes his position. If history repeats itself, we may see higher earnings growth at China Mobile in FY11F.** In the following exhibit, we look at: 1) revenue y-y growth in the year before and the year after a new CEO's appointment and 2) net profit y-y growth for the corresponding years. Our study suggests that in 40% of these cases, revenue growth accelerated. **Even more importantly, in every case, earnings growth accelerated.** If history repeats itself, we believe China Mobile's FY11F earnings growth will be higher than in FY10F.

**Earnings growth tends to accelerate with the appointment of a new CEO (this has been the case in the past 13 years for Chinese telecom operators)**

### Exhibit 150. Business growth before/after change of senior management (CEO)

y-y growth (%)	Revenue growth		NP growth	
	Yr before chg	Yr after chg	Yr before chg	Yr after chg
<b>CHINA MOBILE</b>				
Mar-99	70.1	46.6	43.0	45.6
Nov-04	21.3	26.3	17.4	28.3
<b>CHINA TELECOM</b>				
Nov-04	7.7	6.4	3.3	8.0
<b>CHINA UNICOM</b>				
Aug-03	38.0	66.7	(0.1)	6.1
Dec-04	17.8	10.1	(8.9)	9.7

Source: Company data

## Telecom equipment

### 🕒 Action

We are Bullish on the telecom equipment sector in 2011F, since we expect network convergence in China, India's 3G network rollout and the budget smartphone trend to drive market growth. Chinese vendors are likely to leverage their cost leadership to grow faster than the industry average and deliver c25% EPS growth in 2011F.

### 🚀 Catalysts

Positive catalysts include increasing spending by telecom operators and the government, plus favourable industry policies such as VAT refunds. Negative catalysts include a ban on China projects by foreign countries for security reasons.

### 📍 Anchor themes

We see network convergence in China, India's 3G network rollout and the entry-level smartphone trend as key themes that will drive growth in the telecom equipment sector in 2011F.

## Rising with convergence

### ① Wireline: network convergence to benefit optical supplier chain

Convergence of telecom, Internet and television networks will be an important industry policy for the telecom service and equipment industry in the next 5 years. We believe it will stimulate telecom and cable-TV operators to accelerate their network upgrades to fibre based, in preparation for impending competition with each other, and this should benefit the whole optical network supplier chain, including network equipment vendors such as ZTE Corp, and optical component vendors such as O-Net Communications. We expect major capex from cable-TV operators will start from 2H11F after they streamline their internal organisation.

### ② Mobile: India's 3G rollout likely to offset weak China demand

We forecast mobile capex in China will continue to decline at a 15% CAGR from 2010F to 2012F on completion of the 3G rollout. Although China Mobile's TD-LTE network rollout has strategic importance for Chinese equipment vendors' long-term growth, the revenue contribution in 2011F will be still small, in our view. On the other hand, we believe India's 3G rollout and the recovery of telecom capex in developed markets present equipment vendors with business opportunities to offset weak domestic demand in China. We prefer ZTE Corp, since we think it can leverage its cost and technology leadership in base station products to capitalise on the overseas business opportunities.

### ③ Handset: entry-level smartphones to flood China and globally

Total shipment volume from Chinese brand handset vendors (Huawei, ZTE, TCL, Lenovo and China Wireless) already accounts for more than 10% of global handset shipment volume in 2010F, but most of their products are in the low-end segment (ASP <US\$60). We believe the advent of Android-based entry-level smartphones will be an important industry trend in China and globally in 2011F. Operators prefer entry-level smartphones since they attract subscribers to migrate to 3G service and generate more data revenue without causing a significant increase in handset subsidies. The Chinese vendors mentioned above are the major players in this emerging market segment. We believe that success in this market will help some of them to expand their addressable business segment within the global handset market, which will be important for their long-term growth.

## BULLISH

### Stocks for action

Our top sector BUY is ZTE, since it appears to be positioned to enjoy growth opportunities from network convergence in China, India's 3G network rollout and the entry-level smartphone trend.

Stock	Rating	Price	Price target
ZTE Corp (763 HK)	BUY	HK\$29.3	HK\$36.0
O-Net (877 HK)	BUY	HK\$5.83	HK\$7.0

Note: O-Net price target adjusted to reflect 7.8% new share issuance undertaken on 4 November

Pricing as of 1 December 2010

### Analysts

Leping Huang, PhD

+852 2252 1598

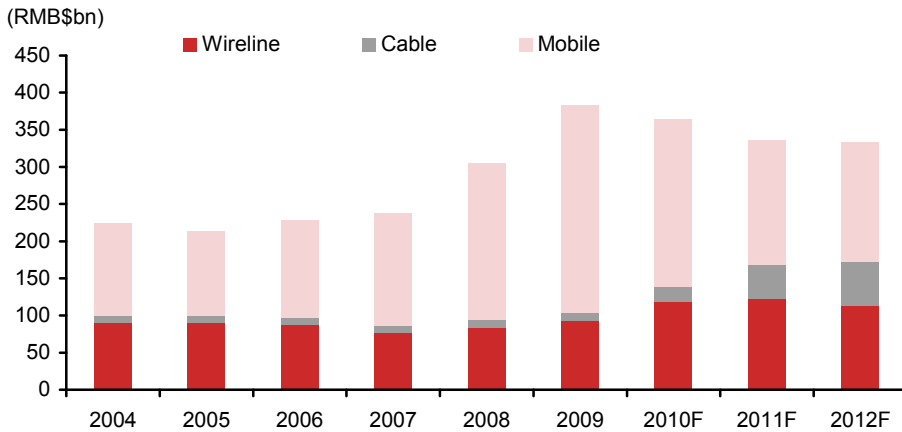
[leping.huang@nomura.com](mailto:leping.huang@nomura.com)

Danny Chu, CFA

+852 2252 6209

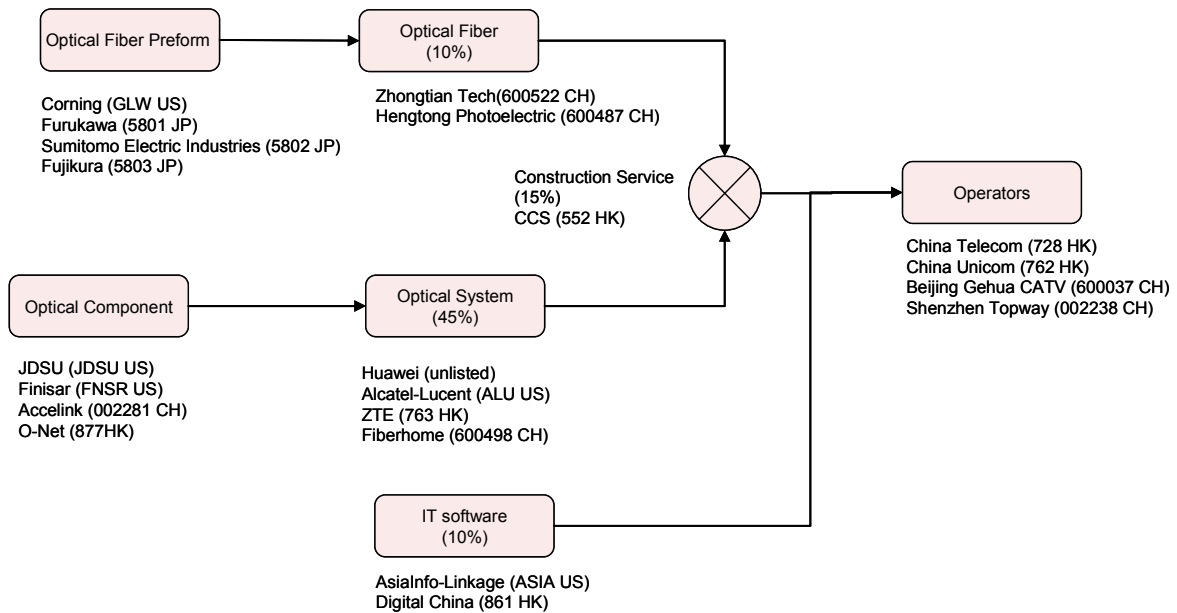
[danny.chu@nomura.com](mailto:danny.chu@nomura.com)

**Exhibit 151. China: telecom and cable-TV capex trends**



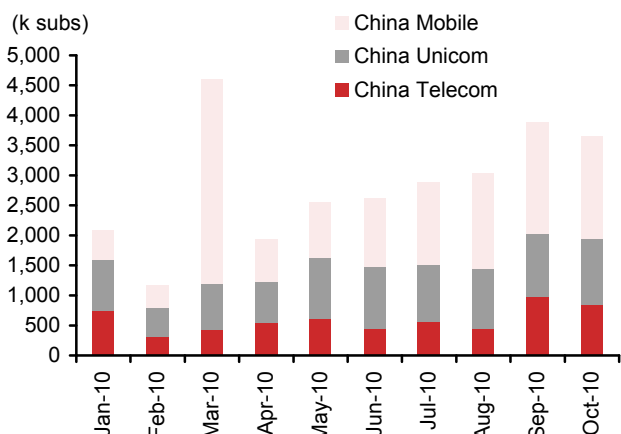
Source: Company data, MIIT, Nomura estimates

**Exhibit 152. China: optical-network supply chain**



Note: Percentage indicates vendors' share of addressable market within operators' capex. Rest of spending includes IT hardware (5%) and other (15%)  
Source: Nomura research

**Exhibit 153. Monthly net-add of 3G subscribers in China**



Source: Company data, MIIT

**Exhibit 154. Major entry-level smartphones**

Model	U8150 Ideos	ZTE X850
Photo		
Vendor	Huawei	ZTE
Screen	2.8 inch QVGA capacitive touch	2.8inch QVGA Resistive touch
Communication standard	GSM/HSPA	GSM/HSPA
OS	Android 2.1	Android 2.1
CPU	n.a.	Qualcomm MSM 7227
Market	UK, HK, Taiwan, China	UK, France, China
Retail price	Below US\$200	~US\$150

Source: Company data, Nomura research

## Transport

### ⊙ Action

We remain bullish on various Chinese transport segments. We see continued strong China domestic demand incrementally driving growth for Chinese transport players versus regional peers. Our top picks are Jiangsu Exp for expressways, Cosco Pacific for ports, China Eastern Airlines for airlines and Beijing Capital International Airport for airports.

### ⚡ Catalysts

With recent confirmation on sustained strong volumes and/or yield numbers in October 2010, full-year 2010F results may surprise on the upside.

### ⚓ Anchor themes

Strong domestic demand has helped Chinese transport stocks weather the global economic downturn better than most regional peers. We see this trend continuing for the foreseeable future.

## Domestic demand drives added growth

### ① Airlines – continued growth into 2011F

We remain bullish on airlines' growth prospects for 2011F, on tight supply and strong demand amidst the bottleneck in airspace, limited time slots at airports, and the continued aircraft delivery delays (ie, B787 aircraft, A380 engine problem). Traffic will likely be driven by China departures to overseas destinations. We expect net profit of Chinese airlines to continue to clock growth in 2011F, before coming down in 2012F. Given the strong competition posed by railways (set to intensify from 2012F onwards) and likely higher oil price (coupled with reduced oil hedging exposure), net profit for Chinese airlines is likely to edge lower in 2012F. We call BUY on CEA (M&A play) and CSA (1055 HK, domestic growth and renminbi appreciation), and NETURAL on Air China (753 HK, stable growth).

### ② Airports – safer exposure to fast-growing aviation market

Concerns over whether the airport fee will be renewed and by how much in 2011 and beyond have weighed on the share price performance of the two Chinese airport operators listed in Hong Kong: Beijing Capital International Airport (BCIA) and Hainan Meilan International Airport (HMIA, 357 HK). Should this overhang be lifted by 2010 (with the airport fee being renewed without change) — as we believe it will be — we think the stocks could be significantly re-rated as investors would have a much higher degree of confidence in these airports' forward earnings and dividends. Given their higher margins, lower cyclicality, and no exposure to possibly volatile oil prices, the Chinese airports arguably offer safer exposure to the fast-growing China aviation market. With Chinese airport shares down by an average of 8% YTD, vs an 88% YTD gain for Chinese airlines, we believe that BCIA and HMIA will be laggard plays.

### ③ Expressways – steady growth on domestic demand

While the China expressway sector had previously been largely ignored by the market in favour of "more exciting" sectors, sector revenues and projected profits have been quietly but steadily recovering to above pre-crisis levels. Increased uncertainties in the market may renew investor interest in this more defensive sector. Further, with the recent toll rate hike by Anhui Expressways (995 HK), investors may no longer see the sector as just a pure volume growth story.

## BULLISH

### Stocks for action

Our top picks are CEA for airlines, Jiangsu Exp for expressways, Cosco Pacific for ports, and BCIA for airports.

Stock	Rating	Price	Price target
Jiangsu Expressway (177 HK)	BUY	8.57	11.95
Cosco Pacific (1199 HK)	BUY	12.34	15.50
China Eastern Airlines (670 HK)	BUY	4.54	5.90
BCIA (694 HK)	BUY	4.18	5.85

Note: local currency, pricing as of 1 Dec, 2010

### Analysts

**Jim Wong**  
(Regional Transport & Infrastructure)  
+852 2252 2195  
[jim.wong@nomura.com](mailto:jim.wong@nomura.com)

**Shirley Lam (Airlines)**  
+852 2252 2196  
[shirley.lam@nomura.com](mailto:shirley.lam@nomura.com)

Expressways remain high-quality investments, in our view, providing sustainable earnings and dividend growth. Historical and updated company data confirm that growth in expressway traffic volumes is largely independent of growth in other modes of transport. Jiangsu Expressway is our top BUY for its larger market capitalisation, sustainability of forward EPS and DPS growth, and likely approval of a toll rate hike. We see Shenzhen Expressway (548 HK, BUY) as a recovery play.

#### ④ Ports – domestic volumes add to incremental recovery

While the China port sector saw container throughput volumes decline in 2009 as a result of the global economic downturn, continued growth in domestic volumes has ensured that the volume deterioration has been less severe compared with that seen at most other ports around the Asia Pacific region. With China container port volume growth having averaged 20% for the first ten months of 2010, it is likely that the initial target of 10-15% volume growth for the full year of 2010F set at the beginning of the year will be exceeded. As for container box manufacturing and box leasing, side businesses for the larger China port operators, the continued shortage in box supply is expected to help sustain box leasing rates and sale prices at the current high levels for at least another year, which should further boost earnings for the China port operators in 2010. We rate COSCO Pacific and China Merchants Holdings International (144 HK) as BUYs, given that they have the most exposure to China's container port and related segment.

# Power, Utilities, Coal and Renewable

**BULLISH**

## ⊙ Action

Rising interest rate, soaring commodity prices, increasing inflation and the strengthening of Asia currencies (against US\$) are headwinds for Asian Utilities. We recommend staying defensive in 2011F. We expect positive news for gas, water and renewables in the 12<sup>th</sup> five-year plan. Thus we like China gas, coal and water companies. Negative on IPP, and Neutral on HK utilities, wind and solar.

## ✂ Catalysts

Defensive and M&A (HK utilities), a stronger coal price (China Coal), rising costs of coal and interest (China IPPs), privatisation and tariff reform (Asia gas and water utilities) and climate change (Asia renewable energy).

## ⚓ Anchor themes

Climate change, water shortages, rising commodity prices, relief of gas supply shortages. Risks: rising interest rates and fuel costs, and tariff cap

## ① Hong Kong Utilities (Neutral): attractive defensive plays

Hong Kong utilities benefit under a low interest rate environment because their regulated returns are calculated based on a fixed 9.99% return on the net fixed asset values after interest on borrowed capital. In addition, lower discount rates boost DCF-based values. Hence, the forecast rise in interest rates will be negative for Hong Kong utilities as the opposite would happen under a high interest rate environments.

HK utilities outperformed the Hang Seng Index during the low interest rate environment during 2001-05. However, when the interest rates started rising again post-2005, they started to underperform the market index. This could be the case again if governments begin to increase rates (as forecast by Nomura economists) in 2011F.

A strong RMB will likely benefit HKCG the most, which has ~50% of FY11F net profit coming from its China businesses. The impact on CLP, HKE and CKI is likely to be smaller, with 20%, 13% and 1% of profit coming from China.

Hong Kong utilities enjoy 100% fuel cost pass-through mechanism in their tariffs and are, therefore, protected from the rising fuel costs. We believe that the rising inflation should also have a neutral-to-positive impact on the HK utilities, as CLP and HKE submit plans to the government each year for any need for tariff adjustment based on their capital expenditure and projected electricity demand, among other factors. If capital expenditure rises due to rising inflation, the two companies could request higher basic tariffs to help cover these costs; this would enhance earnings to shareholders.

Overall, we see a limited impact on HK utilities on the back of these four macro factors, and we highlight CKI (1038 HK, BUY) and HK Electric (6 HK, BUY) as the top picks due to their defensive profiles and because we believe positives from their acquisition of the UK power grid assets have not been fully priced in.

## ② China IPP (Bearish): victim of the prevailing macro environment

We remain fundamentally neutral on China IPPs due to the lack of effective fuel cost pass through mechanism, whereas the current "coal-electricity price linkage policy" is unfavourable to IPPs due to the 10-12 month time delay, the maximum 70% pass through formula and government's strong influence on the execution. We maintain our preference for coal over IPPs into 2011. This is due to the negative impacts arising from economic factors like high inflation and rising interest rate. Also, the persistent strong coal price does not provide a positive backdrop. In particular, out of the four key earnings drivers for IPPs, namely tariff, coal price, interest rate and utilization rate, in the sequence of their impact to earnings, the final three are unfavourable to the IPPs in 2011, except for the strong power demand growth (or utilization).

## Stocks for action

Stock	Rating	Local price	Price target
CKI (1038 HK)	BUY	34.75	36.60*
China Everbright (257 HK)	BUY	4.36	6.10
Beijing Ent. Water (371 HK)	BUY	2.68	4.20
China Res. Gas (1193 HK)	BUY	11.04	14.80
Beijing Enterprise (392 HK)	BUY	48.25	70.50
Shenhua (1088 HK)	BUY	33.30	44.60
Longyuan (916 HK)	REDUCE	7.28	7.60#
China High Speed Transmission (658 HK)	BUY	14.24	22.00
Trina Solar (TSL US)	BUY	22.32	36.00

\* PT under review with upward bias. # PT under review with downward bias  
Pricing as of 1 Dec 2010

## Analysts

**Ivan Lee, CFA**  
Head of Asia Power, Utilities & Renewable Energy  
+852 2252 6213  
[ivan.lee@nomura.com](mailto:ivan.lee@nomura.com)

**Joseph Lam, CFA**  
+852 2252 2106  
[joseph.lam@nomura.com](mailto:joseph.lam@nomura.com)

**Elaine Wu**  
+852 2252 2194  
[elaine.wu@nomura.com](mailto:elaine.wu@nomura.com)

**Nitin Kumar**  
+852 2252 2194  
[elaine.wu@nomura.com](mailto:elaine.wu@nomura.com)

Due to the prevailing high inflation, while many IPPs have been loss making since 3Q10, the pressing tariff hike is likely to be delayed to early next year when CPI inflation falls below 3% and when the 2011 contract coal price negotiation finishes.

Also, we hold the view that even though there is a tariff hike, coal is the ultimate winner. This is because a higher contract coal price increase will likely be proposed in the next round of price negotiation given the prevailing 30% plus discount on the contract coal price to the spot price. In 2011, we expect the contract coal price to rise by 8% y-y. In addition, with the high gearing of the China IPPs, ranging from 114% to 607%, the expected 1% rise in interest rate in 2011 will negatively impact the IPPs' bottom line. Therefore, though IPPs can benefit from strong power demand growth (9.8% in 2011, we estimate), there margins will be reduced dramatically in 2011 given that utilization is the least earnings sensitive factor.

Also, due to the lack of a proper fuel cost pass through policy, any tariff hike can be viewed as a short term positive and an opportunity to take profit. And last but not least, in the 12<sup>th</sup> five year plan, Beijing's determination to reduce energy intensity and to create a low carbon economy do not bode well for IPPs.

Having said that, we believe a sector rerating is possible and is contingent on the implementation of a "power pooling" system. However, this is likely to happen in 3-4 years' time, ie 2013-14, given the current government would not carry out a big reform close to the end of their term and the three preconditions of power pooling (sufficient power capacity, 5 well-connected regional power grids, and an energy bureau) are expected to be ready by that time, in our view. Therefore, without power pooling in place, we maintain our neutral view on the China IPPs. We dislike the sector; China Resources Power (836 HK, Buy) is our only BUY. We believe China Resources Power's ROE spread over peers will expand amid market turbulence, given its superior cost control and lucrative coal portfolio.

### ③ **China Water (Bullish): benefit from strong government supports**

Rising interest rates look negative for the highly geared China water sector, but the strengthening of the RMB would benefit companies that report their earnings in HKD. Rising commodity prices are neutral to water plays as raw water charges are passed onto customers. Rising inflation could slow the pace of water tariff hikes and hence be negative for water companies, but we believe the impact is limited given that water tariffs are the lowest among all utilities (1% of average household disposal income, compared with 2-8% for electricity bills and the 3% recommended by the Ministry of Housing as an effective benchmark to reflect water conservation). In addition, water tariffs are determined by the local government, unlike the power tariff, which the central government sets. In conclusion, we see water, as a basic necessity at a low price, as immune to these macro factors.

Going into 2011F, we remain bullish on the China water sector as we think increased earnings visibility and still inexpensive valuations will drive a continued re-rating of China water and environmental stocks. We expect the sector to get a big new push from three "doubling" policies under the 12th Five-Year Plan (2011-15): doubling investment in waste-water treatment to RMB700bn, doubling the number of waste-to-energy (WTE) plants to 300, and doubling the water recycling rate to 10% of wastewater emissions. Although we think tap water suppliers have the best business model, we look towards 2011 with a preference for companies in wastewater/ WTE/ recycling, which we believe will experience higher growth rates of annual capacity growth rates of 10-20%. China Everbright International (257 HK, BUY) is our top pick for its strong track record and low gearing. We believe Sound Global (967 HK, BUY) deserves a re-rating for its transformation into an integrated wastewater play and its dual listing in Hong Kong. Guangdong Investment (270 HK, BUY) remains a defensive play, in our view. Beijing Enterprises Water (371 HK, BUY) and China Water Affairs (855 HK, BUY) provide more opportunities in asset acquisition and land disposal, we believe, though with somewhat more risk than CEI.

### ④ **China gas distribution (Bullish): mid-to-large sized project M&A leads the way**

We are bullish on the gas distribution sector, given: 1) strong 20%-plus pa gas demand growth under the government's support on gas usage; 2) with the commencement of new gas pipelines, such as Sichuan-to-East, West-to-East II, etc., more gas supply will

be flowing to China to fulfil the strong gas demand; 3) neutral impact from any potential gas pricing adjustments; and 4) more mid-to-large sized project M&A in the next few years.

Besides the favourable gas demand/supply matrix, we also see limited macro headwinds to the gas distribution sector. Based on the gas pricing history, any wellhead price hike would be followed by an end user price hike. As such, despite the concern on high CPI in the coming year, we believe the gas companies should be at least be able to maintain their absolute dollar margin. For interest rate hike risk, we estimate the impact to the gas distributors (except for China Gas Holdings) is limited, given their low gearing ratios.

In our coverage universe, China Resources Gas (1193 HK, Buy) and Beijing Enterprises (392 HK, Buy) are our top picks, given their potential to secure new projects in the coming years and be the market consolidators in the long term. We do not like China Gas Holdings (384 HK, Reduce), due to its exposure to the volatile LPG business, option dilution risks and the high gearing.

### ⑤ **China coal (Bullish): strong coal demand vs. short-term tight supply**

We are long term fundamentally positive on the China coal sector given the strong pricing power and sustainable demand growth. We see the balanced-to-tight supply/demand outlook leading to a higher coal price over the next two years. The strong GDP growth, rising power, steel and cement consumptions drive up coal demand; while industry consolidation and transportation bottlenecks (to be eased in 2014F) will cause short-term supply tightness. Given the large spot-to-contract price gap and demand/supply outlook, we expect the contract price to rise by 8% y-y, and the spot price to rise by 3% y-y in 2011F, with a stronger spot price in 4Q10-1Q11 due to winter (cold) restocking.

Although the near-term outlook is clouded by NDRC's policy intervention, we expect strong spot coal prices going into year-end and 1Q11, due to winter (cold) restocking, lapse of power rationing to high energy-insensitive industries (steel and cement) and potential positive news on volume and pricing during Jan contract coal price negotiations.

We like China Shenhua (1088 HK, Buy), given: 1) its vertically integrated business model which allows it to enhance third-party coal purchases and sales volumes, 2) it is a major beneficiary of the contract coal price increase in 2011F, 3) its improving sales-mix (to more spot) will drive up ASP and margin, and 4) its high production growth, driven by existing mines upgrades, greenfield projects and potential parent injection. Risks are a high CPI leading to government pressures on the 2011 contract price and a potential 5% resources tax; extreme weather causing seasonal tightness. We hold the view that any potential resource tax or electricity tariff hike will be imposed post the determination of the 2011 contract coal price, likely in January, given the CPI inflation pressure. Also, the net impact from a centralized resources tax should be minimal given a number of other local levies and taxes will be eliminated.

### ⑥ **China wind (Neutral): prefer the component plays**

While we believe that policy support and growth here will remain strong, we see 2011F as a transitional one for players along the China wind value chain. We estimate that growth of annual wind capacity installation will start to slow from 100% y-y each year between 2007 and 2009 to around 15% y-y in 2010F and 2011F. As a majority of Chinese wind companies have been generating 70-90% of their wind revenues within China, those unable to start to bring in meaningful overseas revenue will, we believe, begin to see earnings growth slow significantly.

Besides slowing the growth rate of capacity installation (end demand) within China, we identify several other challenges: 1) grid connection bottlenecks; 2) overcapacity within certain segments such as blades and wind turbine generators (WTG); 3) the outlook for Clean Development Mechanism (CDM); and 4) quality concerns at Chinese equipment/component manufacturers, which generally have a short track record.

According to several National Development and Reform Commission (NDRC) officials and industry players, the Chinese government is likely to announce in 1Q11F a cumulative wind power capacity target of 150GW by 2020F, implying an 18% 11-year

CAGR. We believe that the Chinese wind industry could surpass this target and we remain confident about the clear visibility into wind demand growth in China.

Nonetheless, we adopt a more selective approach on stock picks and prefer equipment/component manufacturers that can start meaningful overseas sales and sustain a high earnings growth profile. We retain our conservative stance on wind turbine manufacturers and wind farm operators (Longyuan [916 HK, Reduce]) due to downward tariff pressure, falling turbine prices, uncertainty on CDM, grid connection bottleneck and increasing competition. Our top pick is China High Speed Transmission (CHST, 658 HK, Buy).

## ⑦ China solar (Neutral): too much of a good thing

Over FY10, pure-play cell makers and wafer makers have benefitted from a surge in demand and thus ASP improvements, which are reflected in their relative outperformance within the solar sector. We believe pure-play cell and wafer makers are likely to see their earnings margins peak in 3Q10F, with continued bullish comments, as impacts from the changed industry dynamics are only starting to manifest, in our opinion. We expect 2011F to see three changes:

- **Undersupply to oversupply.** Looking at the expansion plans of companies in the different segments of the value chain, we see mean available capacity across the chain at 23-24GW (+50% y-y) by end-2011F.
- **ASPs to see pressure across supply chain.** With Germany likely to see an additional 12-14% cut in feed-in-tariffs from January, we believe ASP pressure will increase. We estimate a 12-18% y-y decline in module ASPs in 2011F.
- **Polysilicon industry enters oligopoly.** With the exit of GCL Polysilicon from the pure polysilicon market, only three key suppliers remain – Hemlock, Wacker and OCI – in the market. As such, we expect pricing wars to be minimal and spot prices to revert to long-term pricing contracts.

Deteriorating demand-supply dynamics are likely to raise ASP pressure and we see module ASPs falling 12-18% y-y to US\$1.4-1.5/W in 2011F from US\$1.7-1.8/W currently. This will have a ripple effect across the solar value chain and we expect companies with better cost management to drive market-share gains, resulting in consolidation. We believe companies best positioned to ride the market dynamics in 2011F require key characteristics of: 1) better cost management, which favours companies with vertical integration; 2) R&D in cell-efficiency improvements – key to continued cost reductions in the segment, in our view; and 3) geographical sales diversification to capture demand from new growth markets as demand growth from Europe comes to a halt.

Within the solar industry, we believe vertically integrated players are best placed to stabilise margins, given: 1) streamlined cost structure; 2) better access to diversified end-markets; and 3) strong supplier relations.

We see companies with a pure-play business model as most vulnerable to ASP pressure, given they have reduced avenues for cost reductions and are exposed to market share shifts at their customers. Here, among the pure-play makers, we see a business model shifting towards increased vertical integration, which we believe is the right step forward.

We reaffirm our BUY ratings on Trina (Price target: US\$36.0) and Yingli (Price target: US\$ 15.0), as we see their margins as defensive due to the following: 1) they are leaders in vertical integration; 2) 2011F will see R&D efforts bearing fruit; and 3) their investments into improving their brand names. In our view, Suntech has the best brand name among China-based peers and a well-documented R&D programme, although its progress in 2010 has been disappointing due to balance sheet restructuring and execution delays in the launch of its high-efficiency Pluto cells. We see potential positive catalysts in 2011F from: 1) expected upstream integration into wafers; and 2) a wider Pluto cell launch looks to be on track in 2011F. We reaffirm our BUY on Suntech (Price target: US\$11.0).

## Property

**BULLISH**

### ⊙ Action

We believe the best time to enter China's property sector will be in late-December 2010, as we expect transaction volume, as a share price indicator, to stabilise 2-3 months after the new round of tightening in late-September 2010. Trading at an average discount of 35% to our 12M forward NAV estimates, the sector looks attractively valued. We turn Bullish on the China property sector for 2011F.

### ⚡ Catalysts

Developers (under Nomura's coverage) are likely to hit sales targets for 2010F and this should help to pare gearing.

### ⚓ Anchor themes

We expect less aggressive policy measures in 2011F, with most of the impact from more frequently discussed measures, such as property tax and enforcement of LAT largely priced in. Fundamental demand should continue to drive transaction volumes and annualised ASP is likely to continue to climb.

### Stocks for action

We continue to like stocks with: 1) less exposure to overheated cities; 2) strong balance sheets; and 3) high earning visibility. Our top BUYs are COLI, Agile and KWG.

Stock	Rating	Local price	Price target
Agile (3383 HK)	BUY	11.10	13.29
COLI (688 HK)	BUY	15.36	21.00
CRL (1109 HK)	REDUCE	14.18	14.87
Country Gdn (2007 HK)	NEUTRAL	2.91	2.78
GZ R&F (2777 HK)	REDUCE	10.88	9.98
KWG (1813 HK)	BUY	6.10	7.52
Poly (HK) (119 HK)	BUY	7.36	9.98
Shimao (813 HK)	BUY	12.06	15.39
Sino-Ocean (3377 HK)	NEUTRAL	4.75	5.30

Pricing as of 1 December, 2010; local currency

## 2011F: from cautious to positive

### ① Turning positive on China property sector

The intentions of 2010's property policies were very clear – ie, to increase supply of affordable housing and curb surging home prices. With two major rounds of property tightening in 2010, China's property sector has underperformed the Hang Seng Index by 18%. Looking into 2011F, we do not underestimate the policy impact. However, we expect less aggressive measures in the property market given that inflation control is likely to be of top priority on the agenda for the government, in our view. Raising interest rates and RRR should be one of the concerns but the impact is likely to be minimal on share performance. Trading at an average discount of 35% to our 12-month forward NAV estimates, the China property sector looks attractive, in our view.

### ② Fundamental demand should continue to drive volume

Including inventory of 576mn sqm GFA, we expect a total GFA of 1.85bn sqm to be available for sale in 2011F, representing an increase of 30% y-y, partly driven by a huge supply of economical housing. Despite some decline in speculative activities, we expect fundamental demand from end-users to remain intact. We forecast 2011F transaction volume to grow by 11% y-y to 939mn sqm, which includes a 4% y-y increase in the private housing sector and a 145% y-y increase in economical housing.

### ③ More importantly, annualised ASP should continue to trend up

To recap, we expect average residential property prices to drop 5-10% from now to end-2011F (0-5% for non-overheated cities; 5-10% for overheated cities). However, assuming an average price correction of 5% across all cities (from an ASP of RMB5,196psm in October 2010), we estimate an overall annualised ASP in 2011F of RMB4,936psm, 2% higher than our 2010F ASP forecast of RMB4,840psm. With both transaction volumes and ASP likely to continue to trend up, we believe this explains why developers have raised their 2011F sales targets by 15-30%.

### Analysts

**Alvin Wong**

+852 2252 1563

[alvin.wong@nomura.com](mailto:alvin.wong@nomura.com)

**Sunny Tam, CFA**

+852 2252 6226

[sunny.tam@nomura.com](mailto:sunny.tam@nomura.com)

**Jianping Chen (Researcher)**

## On average, developers unlikely to cut prices

We estimate the developers under our coverage will have average net gearing of 60% by end-2010F, which we think is quite stretched. With more restrictions on proceeds from pre-sales, bank borrowing and trust financing, some in the market are concerned about possible price cuts in 2011F. We believe this is unlikely. In general, developers can reduce capex by slowing construction or speeding up property pre-sales. On the bright side, most of the developers have already lengthened their debt maturity profile by issuing 5-7-year senior notes or granting syndicated loans. We see no bankruptcy risk for the developers and we do not expect them to sell assets at distressed values.

## Strong earnings growth and lock-in in 2011F

As of October 2010, developers under our coverage had already achieved an average 89% of their 2010 sales targets, which should further strengthen 2011F revenue. We now forecast sector EPS growth of 36% y-y for 2011F, with 58% of the earnings already secured. Such high earnings visibility, as one of our criteria for stock picking, should provide strong support for share price performance.

## Fundamentals should offset any further policy risks

Policy tightening, especially in overheated cities such as Beijing, Shanghai, Shenzhen and Hangzhou, is likely to continue in 2011F, while we believe the more frequently discussed measures, such as tax implementation and full LAT collection, are the major themes in the current round of tightening. With the China property sector trading at an average discount of 35% to our end-2011F NAV estimates, we believe the policy headwinds are largely priced in. With fundamental demand likely to support both transaction volume and ASP in 2011F, we believe this will offset further policy risks.

Transaction volume is likely to remain the major driver of share performance in 2011F and we expect a 4% increase in the private residential market due to fundamental demand. History tells us the sales volume will stabilise two to three months after the new round of tightening, and we therefore stick with our view that the best time to enter the China property sector will be late-December 2010 (the previous round of tightening started at the end of September 2010). Most of the aggressive measures have already been announced and factored into the share price, we believe. With expectations of less aggressive measures in 2011F and continuously rising transaction volumes and annualised ASP, we turn Bullish on China's property sector in 2011F.

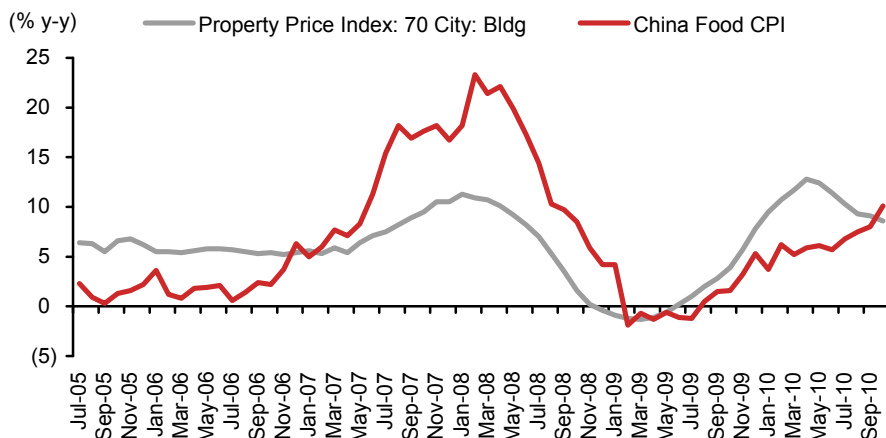
We still stick with our criteria on stock picking, preferring developers with less exposure to overheated cities, strong balance sheets and high earning visibility. We continue to prefer big-cap stocks such as COLI, mid-cap stocks such as Agile, and small-cap stocks such as KWG.

Risks to our investment include tighter-than-expected policy measures and an unexpected economic slowdown in China.

### Exhibit 155. China property: valuation summary

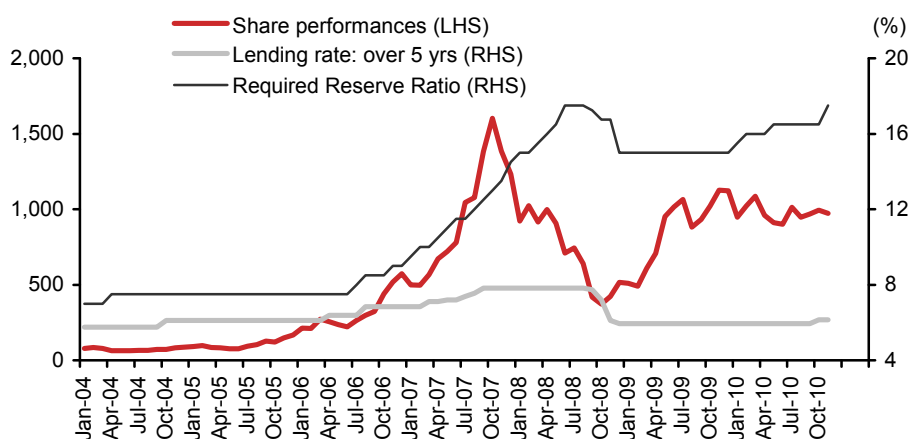
Company	Ticker	Rating	Last Price (HK\$)	Mkt cap (HK\$ mn)	Forward NAV		P/E (x)		Yield (%)	P/B (x)		Net debt / equity (%)	
					(HK\$/sh)	Prem/ (Disc)(%)	FY10E	FY11E		FY10E	FY10E	FY11E	FY09
China Overseas Land Investment	0688 HK	BUY	15.36	125,530	17.64	-12.9	13.8	10.2	2.1	2.5	2.1	net cash	46.6
China Resources Land	1109 HK	Reduce	14.18	76,384	18.59	-23.7	19.2	14.9	1.5	1.6	1.5	21.0	59.6
Country Garden	2007 HK	Neutral	2.91	48,594	3.97	-26.7	15.2	11.0	2.3	1.8	1.6	44.7	47.2
Shimao Properties	0813 HK	BUY	12.06	42,774	21.98	-45.1	10.2	8.2	2.9	1.4	1.3	55.9	74.4
Agile Property	3383 HK	BUY	11.10	38,547	18.99	-41.5	9.7	7.7	3.7	1.7	1.5	42.3	53.0
Guangzhou R&F	2777 HK	Reduce	10.88	35,059	16.64	-34.6	8.0	6.9	3.7	1.6	1.4	97.6	92.6
Poly (HK)	0119 HK	BUY	7.36	26,558	12.47	-41.0	18.8	12.3	0.8	1.2	1.1	2.5	68.7
Sino-Ocean Land	3377 HK	Neutral	4.75	26,782	8.83	-46.2	13.4	8.3	2.5	0.8	0.7	14.2	45.8
KWG Property	1813 HK	BUY	6.10	17,648	10.75	-43.2	11.9	8.7	2.5	1.3	1.2	48.4	55.1

Source: Bloomberg, Company data, Nomura estimates; Note: Ratings and Price Targets are as of the date of the most recently published report(<http://www.Nomura.com>) rather than the date of this document

**Exhibit 156. China property price index vs food CPI**

Source: CEIC, Nomura research

Cooling real estate sector can hardly be blamed for rising food prices, in our view

**Exhibit 157. China property share performance vs interest rate and RRR hike**

Source: CEIC, Bloomberg, Nomura research

Raising interest rate and RRR does not have a significant impact on share performance

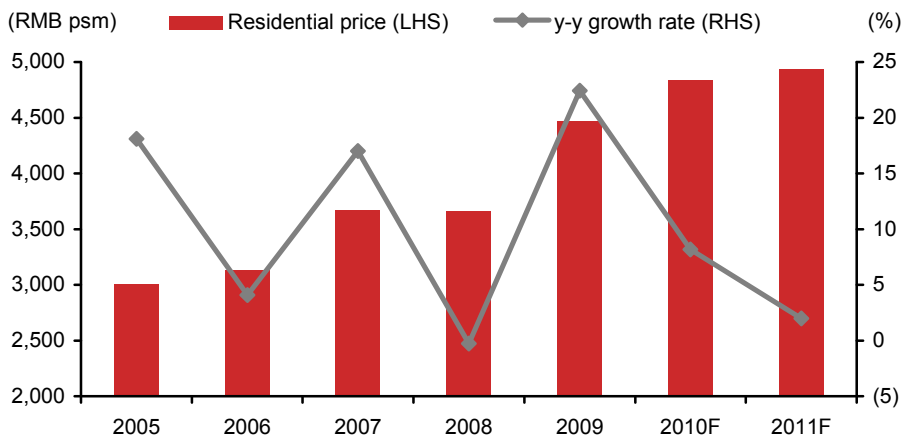
**Exhibit 158. China property: supply and demand forecast**

	2007	2008	2009	2010F	2011F
<b>Starts in '000 sqm</b>					
<b>Total residential starts</b>	<b>787,955</b>	<b>836,421</b>	<b>932,984</b>	<b>1,288,777</b>	<b>1,546,532</b>
Growth rate (% y-y)	22	6	12	38	20
Private housing	739,852	780,203	879,438	1,216,777	1,354,532
Growth rate (% y-y)	23	5	13	38	11
Economic housing	48,103	56,219	53,547	72,000	192,000
Growth rate (% y-y)	10	17	(5)	34	167
<b>Available for sale in 000 sqm</b>					
<b>Total residential available for sales</b>	<b>971,052</b>	<b>1,090,581</b>	<b>1,257,503</b>	<b>1,420,292</b>	<b>1,850,305</b>
Growth rate (% y-y)	11	12	15	13	30
Private housing	930,807	1,052,766	1,222,310	1,367,324	1,734,214
Growth rate (% y-y)	12	13	16	12	27
Economic housing	40,245	37,815	35,192	52,968	116,092
Growth rate (% y-y)	2	(6)	(7)	51	119
<b>Sales in 000 sqm</b>					
<b>Total residential sales</b>	<b>701,359</b>	<b>592,804</b>	<b>861,849</b>	<b>844,107</b>	<b>939,215</b>
Growth rate (% y-y)	27	(15)	45	(2)	11
Private housing	666,284	556,531	831,260	799,084	828,928
Growth rate (% y-y)	28	(16)	49	(4)	4
Economic housing	35,075	36,273	30,589	45,023	110,287
Growth rate (% y-y)	5	3	(16)	47	145

Source: CEIC, Nomura research

We expect 2011F transaction volume to increase by 4% y-y in the private housing market

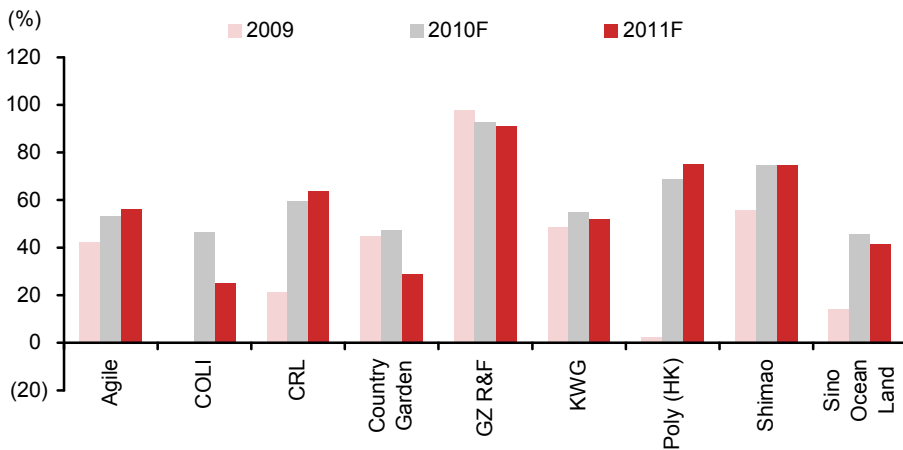
**Exhibit 159. China property: annualised residential selling price**



Despite a 5-10% decline in ASP from now to end-2011F, we estimate annualised ASP will still be up 2% y-y to RMB4,936 psm

Source: CEIC, Nomura research

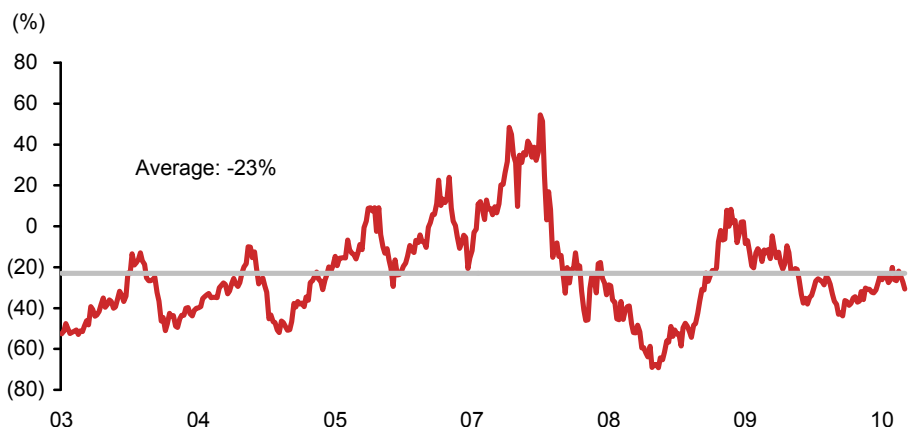
**Exhibit 160. Developers' gearing ratio comparison**



Gearing is still high but manageable

Source: Company data, Nomura research

**Exhibit 161. China property: sector NAV discount**



Trading at an average discount of 36% to our 12M-forward sector NAV estimate, the policy headwinds look largely priced in

Source: Bloomberg, Nomura research

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# Stock picks

### ⊙ Action

With relatively low gearing (we forecast 53% at year end), high FY11F earnings visibility (43% already secured) and attractive valuation (42% discount to NAV), we see strong upside potential for Agile. We expect Hainan sales to continue to surprise the market. We reiterate BUY and retain Agile as a top sector pick.

### ⚡ Catalysts

We believe the stock will gradually be rewarded for its steady operations in traditional markets. Street estimates will likely be revised up in the next six months.

### ⚓ Anchor themes

We expect less aggressive policy measures in 2011F, with most of the impact from more frequently discussed measures such as property tax and enforcement of LAT largely priced in. Fundamental demand should continue to drive transaction volumes and annualised ASP is likely to continue to climb.

## Well positioned

### ① Ample capacity for more land acquisitions

Agile looks set to exceed its own contract sales target of RMB24.7bn for FY10F, with RMB22.6bn already achieved in the first 10 months of the year. We estimate net gearing will revert to around 53% levels by year end if the company can achieve RMB26.9bn in sales this year. The company should have ample capacity for further land acquisitions should the opportunity arise.

### ② Earnings surprise a key catalyst

We believe the street has underestimated Agile's FY10-11F earnings. Looking at the strong contract sales achieved so far, Agile has secured 100% and 43% of our above-consensus FY10-11F sales forecasts, respectively. We also expect upside to consensus profit margin estimates. We believe the street will upgrade forecasts for Agile in the next few months, closer to the final results announcement.

### ③ Hainan sales still steady under policy tightening

On our recent visit to Hainan, we found the Hainan project is still seeing quite steady sales after the announcement of new policies; upcoming launches of new phases are likely to boost sales even further. Buyers are largely wealthy individuals living in Northern/Eastern China who prefer to have holiday homes away from the cold winter. Some 70-80% of buyers have purchased flats without mortgages, making sales less vulnerable to the current policies.

### ④ 42% discount to NAV – attractive valuation

Agile shares are trading at a 42% discount to our end-FY11F NAV estimate and 7.7x FY11F P/E. We see room for NAV upgrades later stemming from new acquisitions and our valuation of the Hainan project is very conservative. Our end-FY11F PT is based on a 30% discount to our end-FY11F NAV estimates of HK\$18.99. Risks to our PT include weaker-than-expected property sales and further tightening measures applied to the property sector.

Closing price on 1 Dec	HK\$ 11.10
Price target	<b>HK\$13.29</b> (set on 5 Nov 10)
Upside/downside	19.7%
Difference from consensus	<b>15.1%</b>
FY11F net profit (RMBmn)	4,409
Difference from consensus	<b>31.4%</b>
Source: Nomura	

### Nomura vs consensus

We are optimistic that the company can beat its own sales target for FY10F and comfortably achieve our higher-than-consensus revenue estimate.

### Key financials & valuations

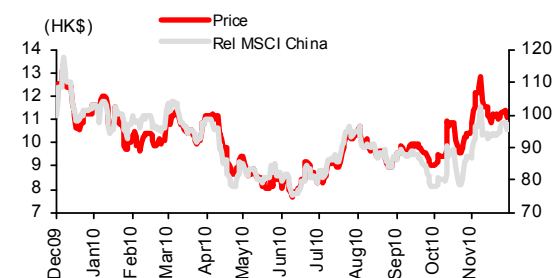
31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Revenue	13,331	20,857	27,579	36,448
Reported net profit	1,865	6,052	4,409	5,147
Normalised net profit	1,728	3,562	4,409	5,147
Normalised EPS (RMB)	0.48	1.01	1.27	1.48
Norm. EPS growth (%)	51.1	109.8	26.1	16.7
Norm. P/E (x)	20.4	9.7	7.7	6.6
EV/EBITDA (x)	11.2	5.5	4.9	4.2
Price/book (x)	2.5	1.7	1.5	1.3
Dividend yield (%)	1.6	3.7	4.6	5.3
ROE (%)	13.8	36.0	20.9	21.0
Gearing (%)	27.3	24.9	21.8	20.9

#### Earnings revisions

Previous norm. net profit	3,562	4,409	5,147
Change from previous (%)	-	-	-
Previous norm. EPS (RMB)	1.01	1.27	1.48

Source: Company, Nomura estimates

### Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	6.9	21.4	39.4
Absolute (US\$)	6.7	21.6	39.9
Relative to Index	11.3	12.3	24.7
Market cap (US\$m)			4,963
Estimated free float (%)			36.1
52-week range (HK\$)			13.22/7.47
3-mth avg daily turnover (US\$m)			21.77
Stock borrowability			Easy
Major shareholders (%)			
Chan Cheuk Yin			61.7

Source: Company, Nomura estimates

## Drilling down

### Street earnings estimates too conservative?

Consensus revenue forecasts for FY10-11F look conservative at RMB18.3bn and RMB22.5bn, respectively. With the company carrying forward RMB9.5bn from FY09 and achieving RMB22.6bn of its sales target in the first 10 months of 2010, it has already locked in 100% and 61% of consensus FY10-11F revenue forecasts (100% and 43% on our estimates). By the end of FY10F, the lock-in rate for FY11F revenue could be as high as 70-80%, which makes consensus earnings look far too conservative, in our view.

We also expect decent net margin improvement in 2010 -11. Revenue booked in 1H10 was mainly from sales in rather tough markets in FY09, with the ASP for booked revenue only at RMB8,122psm. Unrecognised revenue as of end-FY09 amounted to RMB9.5bn, with an ASP of RMB11,585psm, so the margin on those sales not yet booked should be considerably higher than in 1H10. Also, we expect the next batch of Hainan sales to be booked in 2H10F (with an estimated ASP of more than RMB20,000psm) to fetch net margins of ~26%, giving a boost to overall margins. We estimate around 25% of revenue booked in FY10F will come from Hainan.

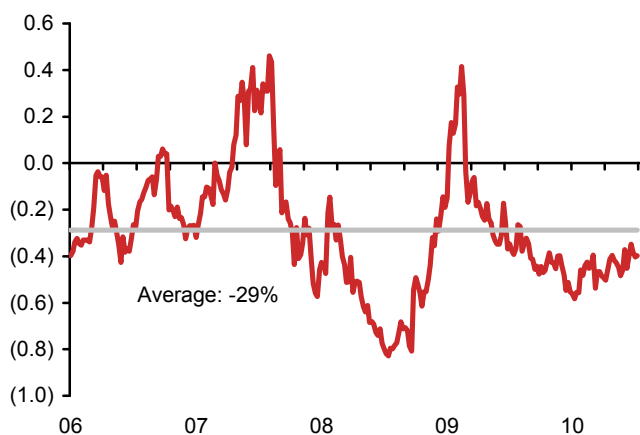
### Scale expansion taking shape

Agile's expansion in the past few years is gradually taking shape, with impressive success demonstrated in new markets (eg, Nanjing). It has also strengthened its brand recognition. New projects acquired in the past 1-2 years will gradually be ready for sales in the next few years, giving the company a strong base for growth, we believe. The company has maintained a relatively healthy balance sheet as compared with its peers, and should have ample capacity for further land acquisitions, in our view. The company is looking to further strengthen its position in Shanghai and Hainan, apart from recent acquisitions in Nanjing and Foshan.

**Agile just needs to sell another RMB8.7bn to achieve street revenue estimates for FY11F, which we think can easily be achieved in a few months' time**

**We expect decent sales growth in FY11F, even under tougher market conditions. Agile will have more new projects for launch next year (2011), which should help to gain market share**

Exhibit 162. Agile: NAV discount



Source: Bloomberg, Nomura research

Exhibit 163. Agile: FY11F NAV forecast

	(RMBmn)	HK\$/share	% of total assets
<b>Dev. prop/under dev't</b>			
Residential	60,711	19.93	86.0
Commercial	331	0.11	0.5
<b>Inv. prop/under dev't</b>			
Office	1,345	0.44	1.9
Retail	1,509	0.50	2.1
<b>Hotel prop under dev't</b>	6,659	2.19	9.4
Net debt (incl. land premium)	(12,714)	(4.17)	
Total net asset	57,840		
<b>NAV/share</b>		<b>18.99</b>	

Source: Nomura research

## Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Investment properties	-	-	-	153	245
Property development	9,094	13,058	20,490	26,743	35,223
Hotels/serviced apartments	29	40	88	348	578
Other Revenue	203	233	279	335	402
<b>Revenue</b>	<b>9,326</b>	<b>13,331</b>	<b>20,857</b>	<b>27,579</b>	<b>36,448</b>
<b>EBIT contributions</b>					
Investment properties	-	-	-	99	159
Property development	2,405	3,582	8,421	9,582	10,734
Hotels/serviced apartments	(7)	(15)	1	2	2
Other income	-	-	-	-	-
Management expenses	(126)	(36)	(378)	(375)	(371)
<b>EBITDA</b>	<b>2,302</b>	<b>3,579</b>	<b>8,092</b>	<b>9,356</b>	<b>10,572</b>
Depreciation and amortisation	(31)	(48)	(48)	(48)	(48)
<b>EBIT</b>	<b>2,272</b>	<b>3,531</b>	<b>8,044</b>	<b>9,309</b>	<b>10,525</b>
Net interest expense	(103)	(9)	(259)	(210)	(147)
Associates & JCEs	-	-	-	151	249
Other income	180	4	45	-	(0)
<b>Earnings before tax</b>	<b>2,348</b>	<b>3,526</b>	<b>7,830</b>	<b>9,250</b>	<b>10,626</b>
Income tax	(1,172)	(1,661)	(3,759)	(4,151)	(4,611)
<b>Net profit after tax</b>	<b>1,176</b>	<b>1,865</b>	<b>4,070</b>	<b>5,099</b>	<b>6,016</b>
Minority interests	9	(137)	(508)	(690)	(869)
Other items					
Preferred dividends					
<b>Normalised NPAT</b>	<b>1,186</b>	<b>1,728</b>	<b>3,562</b>	<b>4,409</b>	<b>5,147</b>
Extraordinary items	4,281	137	2,490	-	-
<b>Reported NPAT</b>	<b>5,467</b>	<b>1,865</b>	<b>6,052</b>	<b>4,409</b>	<b>5,147</b>
Dividends	(1,089)	(560)	(1,247)	(1,543)	(1,801)
<b>Transfer to reserves</b>	<b>4,377</b>	<b>1,306</b>	<b>4,805</b>	<b>2,866</b>	<b>3,345</b>
<b>Valuation and ratio analysis</b>					
FD normalised P/E (x)	31.2	20.4	9.7	7.7	6.6
FD normalised P/E at price target (x)	37.3	24.4	11.6	9.2	7.9
Reported P/E (x)	6.8	18.9	5.7	7.7	6.6
Dividend yield (%)	3.0	1.6	3.7	4.6	5.3
Price/cashflow (x)	na	12.0	17.6	5.9	8.9
Price/book (x)	2.8	2.5	1.7	1.5	1.3
EV/EBITDA (x)	17.1	11.2	5.5	4.9	4.2
EV/EBIT (x)	17.3	11.3	5.5	4.9	4.2
EBIT margin (%)	24.4	26.5	38.6	33.8	28.9
Effective tax rate (%)	49.9	47.1	48.0	44.9	43.4
Dividend payout (%)	19.9	30.0	20.6	35.0	35.0
ROA (pretax %)	8.3	10.4	16.6	14.4	14.1
<b>Growth (%)</b>					
Revenue	(9.6)	42.9	56.5	32.2	32.2
EBITDA	(48.9)	55.4	126.1	15.6	13.0
EBIT	(49.4)	55.4	127.8	15.7	13.1
Normalised EPS	(43.5)	51.1	109.8	26.1	16.7
Normalised FDEPS	(43.5)	51.1	109.8	26.1	16.7
<b>Per share</b>					
Reported EPS (RMB)	1.46	0.52	1.71	1.27	1.48
Norm EPS (RMB)	0.32	0.48	1.01	1.27	1.48
Fully diluted norm EPS (RMB)	0.32	0.48	1.01	1.27	1.48
Book value per share (RMB)	3.50	3.90	5.63	6.53	7.57
DPS (RMB)	0.30	0.16	0.36	0.44	0.52

Source: Nomura estimates

**Cashflow (RMBmn)**

<b>Year-end 31 Dec</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10F</b>	<b>FY11F</b>	<b>FY12F</b>
EBITDA	2,302	3,579	8,092	9,356	10,572
Change in working capital	(3,852)	3,171	774	819	(1,933)
Other operating cashflow	(1,072)	(3,822)	(6,902)	(4,439)	(4,851)
<b>Cashflow from operations</b>	<b>(2,622)</b>	<b>2,928</b>	<b>1,964</b>	<b>5,737</b>	<b>3,788</b>
Capital expenditure	(157)	(354)	(5,145)	(4,710)	(1,000)
<b>Free cashflow</b>	<b>(2,779)</b>	<b>2,575</b>	<b>(3,181)</b>	<b>1,027</b>	<b>2,788</b>
Reduction in investments					
Net acquisitions	2,771	-	-	-	-
Reduction in other LT assets	(1,705)	(1,924)	(6,168)	(5,901)	(249)
Addition in other LT liabilities	190	(15)	772	-	-
Adjustments	1,851	(1,443)	3,437	3,788	93
<b>Cashflow after investing acts</b>	<b>328</b>	<b>(807)</b>	<b>(5,139)</b>	<b>(1,086)</b>	<b>2,632</b>
Cash dividends	(1,401)	(379)	(569)	(1,272)	(1,543)
Equity issue	(165)	(340)	-	-	-
Debt issue	1,777	1,996	4,091	500	1,500
Convertible debt issue					
Others	768	406	1,244	-	-
<b>Cashflow from financial acts</b>	<b>979</b>	<b>1,682</b>	<b>4,766</b>	<b>(772)</b>	<b>(43)</b>
<b>Net cashflow</b>	<b>1,307</b>	<b>875</b>	<b>(373)</b>	<b>(1,858)</b>	<b>2,589</b>
Beginning cash	3,945	5,252	6,128	5,755	3,897
Ending cash	5,252	6,128	5,755	3,897	6,486
Ending net debt	4,816	5,953	10,356	12,714	11,625

Source: Nomura estimates

**Balance sheet (RMBmn)**

<b>As at 31 Dec</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10F</b>	<b>FY11F</b>	<b>FY12F</b>
Cash & equivalents	5,252	6,128	5,755	3,897	6,486
Properties held for sale	16,254	15,096	26,337	32,610	39,013
Accounts receivable	1,479	1,291	1,420	1,562	1,718
Other current assets	4,607	8,705	6,276	6,276	6,276
<b>Total current assets</b>	<b>27,591</b>	<b>31,220</b>	<b>39,788</b>	<b>44,345</b>	<b>53,493</b>
Investment properties	-	-	4,822	4,822	4,822
Other fixed assets (net)	261	1,869	2,821	3,774	4,726
Associates		2,040	2,040	2,191	2,440
Other LT assets	7,126	9,050	15,217	21,118	21,367
<b>Total assets</b>	<b>34,978</b>	<b>44,178</b>	<b>64,688</b>	<b>76,249</b>	<b>86,848</b>
Short-term debt	3,510	2,229	2,229	2,229	2,229
Accounts payable	7,318	12,536	20,117	25,121	27,376
Other current liabilities	2,773	3,480	5,614	7,844	10,215
<b>Total current liabilities</b>	<b>13,601</b>	<b>18,245</b>	<b>27,960</b>	<b>35,195</b>	<b>39,820</b>
Long-term debt	6,559	9,851	13,883	14,383	15,883
Convertible debt					
Other LT liabilities	1,023	1,009	1,781	1,781	1,781
<b>Total liabilities</b>	<b>21,183</b>	<b>29,105</b>	<b>43,624</b>	<b>51,359</b>	<b>57,484</b>
Minority interest	879	1,011	1,520	2,210	3,079
Preferred stock					
Shareholders' Equity	4,937	4,597	4,597	4,597	4,597
Other equity and reserves	7,979	9,465	14,947	18,084	21,688
<b>Total shareholders' equity</b>	<b>12,916</b>	<b>14,062</b>	<b>19,544</b>	<b>22,681</b>	<b>26,285</b>
<b>Total equity &amp; liabilities</b>	<b>34,978</b>	<b>44,178</b>	<b>64,688</b>	<b>76,249</b>	<b>86,848</b>

**Leverage**

Interest cover	22.0	377.0	31.0	44.3	71.4
Gross debt/property assets (%)	28.8	27.3	24.9	21.8	20.9
Net debt/EBITDA (x)	2.09	1.66	1.28	1.36	1.10
Net debt/equity (%)	37.3	42.3	53.0	56.1	44.2

**Dupont decomposition**

Net margin (%)	58.6	14.0	29.0	16.0	14.1
Asset utilisation (x)	0.3	0.3	0.4	0.4	0.4
ROA (%)	17.2	4.7	11.1	6.3	6.3
Leverage (Assets/Equity x)	2.9	2.9	3.2	3.3	3.3
ROE (%)	49.9	13.8	36.0	20.9	21.0

Source: Nomura estimates

Lucy Feng +852 2252 2165 [lucy.feng@nomura.com](mailto:lucy.feng@nomura.com)  
 Donger Wang +852 2252 1590 [donger.wang@nomura.com](mailto:donger.wang@nomura.com)

Maintained

BUY

### ⊙ Action

We reaffirm BUY on ABC, with a price target of HK\$4.70. Amid tightening monetary policy and likely lower loan growth next year, we believe ABC, with its focus on rural business and relatively low LDR ratio, will outperform its peers. Since ABC is at the forefront of county banking in China, we believe it stands to benefit most from China's urbanisation.

### ✂ Catalysts

Rate hikes could serve as a catalyst to expand its NIM.

### ⚓ Anchor themes

The operating environment for Chinese banks should remain favourable in 2011F, but negative sentiment from uncertainties over policies and asset quality continues to weigh on valuations. Better visibility on regulatory policies (capital and provisioning) could trigger a re-rating in the near term.

## County business offers immunity from policy risks

### ① ABC is more than just a county area bank

County area banking business accounted for 30.4% and 40.2% of ABC's loans and deposits, respectively, as of 1H10. We highlight that county area banking is not just about providing micro loans to farmers ("Sannong"), but rather supporting China's fast-growing agriculture business development, SMEs and tertiary industries. These businesses are benefiting from China's rapid urbanisation, with villages being transformed into towns and cities with their own shops, banks and bases of economic activity.

### ② Policy support for county banking

Positioned as the leading financial services provider for China's county development, ABC receives preferential treatment for providing banking services in rural areas. Its county area banking business is subject to a Required Reserve Ratio (RRR) of 13.5% currently, versus 17.0% for peers. We estimate this frees up RMB106bn for loans at an additional yield of 4.14%, boosting FY10F NPAT by 5%. Moreover, its county area banking is subject to a business tax rate of 3%, against an industry standard of 5%. With China's 12th Five-Year Plan focusing on urbanisation, we believe ABC will be one of the biggest beneficiaries.

### ③ ABC can manage asset quality to boost profitability

We believe ABC has strong risk management and selective pricing to ensure high ROAs from county business are not offset by higher credit costs. For loans made since 2004 (92.8% of its total loans as at end-FY09), the NPL ratio stood at 2.33% at end-FY09 (versus an ABC group NPL ratio of 2.91% and NPL ratio for loans made before 2004 of 10.49%). We take this as an indication that legacy asset quality issues at ABC have largely been addressed, with asset quality seen improving in step with China's strong economic development.

Closing price on 1 Dec	HK\$4.13
Price target	<b>HK\$4.70</b> (set on 22 Oct 10)
Upside/downside	13.8%
Difference from consensus	<b>20.9%</b>
FY11F net profit (RMBmn)	124,459
Difference from consensus	<b>13.0%</b>
Source: Nomura	

### Nomura vs consensus

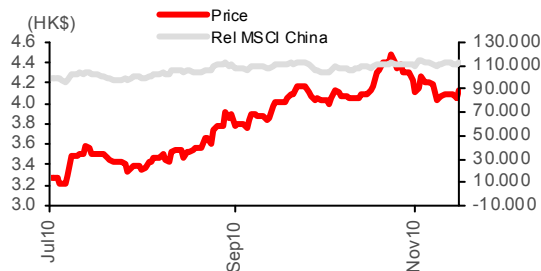
Our net profit forecast is above consensus estimates, likely owing to our higher NIM and lower credit cost assumptions.

### Key financials & valuations

31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
PPOP	114,070	152,413	197,710	244,866
Reported net profit	64,992	92,382	124,459	159,699
Normalised net profit	64,992	92,382	124,459	159,699
Normalised EPS (RMB)	0.25	0.32	0.38	0.49
Norm. EPS growth (%)	(7.3)	26.4	21.3	28.3
Norm. P/E (x)	14.5	11.1	8.7	6.6
Price/adj. book (x)	2.74	2.08	1.65	1.42
Price/book (x)	2.74	2.08	1.65	1.42
Dividend yield (%)	2.1	1.8	5.2	6.9
ROE (%)	20.5	21.1	21.3	23.2
ROA (%)	0.82	0.96	1.11	1.23
<b>Earnings revisions</b>				
Previous norm. net profit		92,382	124,459	159,699
Change from previous (%)		-	-	-
Previous norm. EPS (RMB)		0.32	0.38	0.49

Source: Company, Nomura estimates

### Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	(0.2)	17.0	na
Absolute (US\$)	(0.4)	17.1	na
Relative to Index	4.1	7.8	na
Market cap (US\$m)			172,712
Estimated free float (%)			62.0
52-week range (HK\$)			4.49/3.21
3-mth avg daily turnover (US\$m)			131.4
Stock borrowability			Easy
Major shareholders (%)			
MOF			39.2
Huijin			40.0

Source: Company, Nomura estimates

## Valuation

Our price target of HK\$4.70 is based on 2.2x P/BV applied to the average FY10F and FY11F BVPS. Our sustainable ROE is 16.6%. We use a Gordon Growth model (target P/BV= (sustainable ROE – long-term growth) / (cost of equity – long-term growth)) to derive our fair P/BV range, assuming a cost of equity of 12% and terminal growth rate of 8.3%. We derive our terminal growth rate by applying a 50% payout ratio to our long-term sustainable ROE assumption.

## Investment risks

Being one of the largest banks in China, ABC remains closely tied to the Chinese economy. We believe that a more severe-than-expected macro tightening could result in a sharp rise in bad debt costs. The government may implement certain policies specifically for ABC in county areas which might or might not be of benefit to ABC. A slowing economy would likely have negative implications for loan growth and asset quality. The concept of market and operations-related risks has only been introduced into China's banking system in recent years, and the system itself is yet to go through a full credit cycle. Therefore, there is no historical data showing how Chinese banks may perform under a more testing credit environment.

## Financial statements

Profit and Loss (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Interest income	321,855	296,147	382,331	465,804	570,719
Interest expense	(121,852)	(114,508)	(150,188)	(180,405)	(232,099)
<b>Net interest income</b>	<b>200,003</b>	<b>181,639</b>	<b>232,143</b>	<b>285,398</b>	<b>338,620</b>
Net fees and commissions	23,798	35,640	43,505	53,467	65,975
Trading related profits	(571)	271	48	421	611
Other operating revenue	(9,214)	6,087	3,001	3,168	4,690
<b>Non-interest income</b>	<b>14,013</b>	<b>41,998</b>	<b>46,553</b>	<b>57,056</b>	<b>71,276</b>
<b>Operating income</b>	<b>214,016</b>	<b>223,637</b>	<b>278,696</b>	<b>342,454</b>	<b>409,897</b>
Depreciation	(11,423)	(10,775)	(11,314)	(11,879)	(12,473)
Amortisation	-	-	-	-	-
Operating expenses	(98,752)	(98,792)	(114,970)	(132,865)	(152,557)
Employee share expense	-	-	-	-	-
<b>Op. profit before provisions</b>	<b>103,841</b>	<b>114,070</b>	<b>152,413</b>	<b>197,710</b>	<b>244,866</b>
Provisions for bad debt	(39,858)	(44,289)	(30,843)	(35,003)	(36,092)
Other provision charges	(11,620)	4,147	-	-	-
<b>Operating profit</b>	<b>52,363</b>	<b>73,928</b>	<b>121,570</b>	<b>162,707</b>	<b>208,774</b>
Other non-operating income	(14)	-	-	-	-
Associates & JCEs	-	-	-	-	-
<b>Pre-tax profit</b>	<b>52,349</b>	<b>73,928</b>	<b>121,570</b>	<b>162,707</b>	<b>208,774</b>
Income tax	(896)	(8,926)	(29,177)	(38,236)	(49,062)
<b>Net profit after tax</b>	<b>51,453</b>	<b>65,002</b>	<b>92,393</b>	<b>124,471</b>	<b>159,712</b>
Minority interests	21	(10)	(11)	(12)	(13)
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
<b>Normalised NPAT</b>	<b>51,474</b>	<b>64,992</b>	<b>92,382</b>	<b>124,459</b>	<b>159,699</b>
Extraordinary items	-	-	-	-	-
<b>Reported NPAT</b>	<b>51,474</b>	<b>64,992</b>	<b>92,382</b>	<b>124,459</b>	<b>159,699</b>
Dividends	-	(20,000)	(20,786)	(56,012)	(71,871)
<b>Transfer to reserves</b>	<b>51,474</b>	<b>44,992</b>	<b>71,596</b>	<b>68,447</b>	<b>87,829</b>

### Valuation and ratio analysis

FD normalised P/E (x)	13.9	14.5	11.1	8.7	6.6
FD normalised P/E at price target (x)	15.8	16.5	12.7	9.9	7.5
Reported P/E (x)	13.9	14.5	11.1	8.7	6.6
Dividend yield (%)	-	2.1	1.8	5.2	6.9
Price/book (x)	3.2	2.7	2.1	1.6	1.4
Price/adjusted book (x)	3.2	2.7	2.1	1.6	1.4
Net interest margin (%)	3.13	2.28	2.53	2.73	2.84
Yield on interest earning assets (%)	5.03	3.71	4.16	4.45	4.78
Cost of interest bearing liabilities (%)	2.01	1.51	1.70	1.78	1.99
Net interest spread (%)	3.02	2.20	2.46	2.67	2.79
Non-interest/operating income (%)	6.5	18.8	16.7	16.7	17.4
Cost to income (%)	51.5	49.0	45.3	42.3	40.3
Effective tax rate (%)	1.7	12.1	24.0	23.5	23.5
Dividend payout (%)	-	30.8	22.5	45.0	45.0
ROE (%)	(23.5)	20.5	21.1	21.3	23.2
ROA (%)	0.84	0.82	0.96	1.11	1.23
Operating ROE (%)	(24.0)	23.3	27.8	27.8	30.3
Operating ROA (%)	0.85	0.93	1.26	1.45	1.61

NIM rebound

### Growth (%)

Net interest income	21.8	(9.2)	27.8	22.9	18.6
Non-interest income	(27.3)	199.7	10.8	22.6	24.9
Non-interest expenses	47.8	0.0	16.4	15.6	14.8
Pre-provision earnings	(4.6)	9.9	33.6	29.7	23.9
Net profit	17.6	26.3	42.1	34.7	28.3
Normalised EPS	(25.1)	(7.3)	26.4	21.3	28.3
Normalised FDEPS	(25.1)	(7.3)	26.4	21.3	28.3

Source: Nomura estimates

<b>Balance Sheet (RMBmn)</b>					
<b>As at 31 Dec</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10F</b>	<b>FY11F</b>	<b>FY12F</b>
Cash and equivalents	1,145,884	1,517,806	2,040,042	2,229,280	2,345,929
Inter-bank lending	107,147	111,128	124,463	139,399	156,127
Deposits with central bank	-	-	-	-	-
Total securities	2,269,060	2,504,496	2,787,232	3,102,115	3,452,826
Other interest earning assets	246,370	421,093	463,202	509,523	560,475
Gross loans	3,100,159	4,138,187	4,933,182	6,005,136	7,362,171
Less provisions	(85,175)	(126,692)	(152,862)	(182,811)	(214,804)
<b>Net loans</b>	<b>3,014,984</b>	<b>4,011,495</b>	<b>4,780,319</b>	<b>5,822,325</b>	<b>7,147,367</b>
Long-term investments	155	141	141	141	141
Fixed assets	103,883	111,973	114,212	116,497	118,827
Goodwill	-	-	-	-	-
Other intangible assets	17,107	19,659	17,693	15,924	14,331
Other non IEAs	109,761	184,797	68,622	69,309	70,002
<b>Total assets</b>	<b>7,014,351</b>	<b>8,882,588</b>	<b>10,395,927</b>	<b>12,004,512</b>	<b>13,866,024</b>
Customer deposits	6,097,428	7,497,618	8,708,128	10,135,681	11,801,584
Bank deposits, CDs, debentures	346,894	714,218	763,475	825,933	901,717
Other interest bearing liabilities	51,774	163,681	223,762	234,852	247,050
<b>Total interest bearing liabilities</b>	<b>6,496,096</b>	<b>8,375,517</b>	<b>9,695,366</b>	<b>11,196,465</b>	<b>12,950,351</b>
Non interest bearing liabilities	227,714	164,146	167,842	171,653	175,586
<b>Total liabilities</b>	<b>6,723,810</b>	<b>8,539,663</b>	<b>9,863,208</b>	<b>11,368,119</b>	<b>13,125,937</b>
Minority interest	96	106	107	108	109
Common stock	260,000	260,000	324,794	324,794	324,794
Preferred stock	-	-	-	-	-
Retained earnings	12,022	39,817	(8,660)	36,862	96,152
Proposed dividends	-	20,000	20,786	56,012	71,871
Other equity	18,423	23,002	195,692	218,617	247,161
<b>Shareholders' equity</b>	<b>290,445</b>	<b>342,819</b>	<b>532,613</b>	<b>636,285</b>	<b>739,978</b>
<b>Total liabilities and equity</b>	<b>7,014,351</b>	<b>8,882,588</b>	<b>10,395,927</b>	<b>12,004,512</b>	<b>13,866,024</b>
<i>Non-performing assets (RMB)</i>	<i>134,067</i>	<i>120,241</i>	<i>101,260</i>	<i>106,159</i>	<i>132,218</i>

**Balance sheet ratios (%)**

Loans to deposits	50.8	55.2	56.7	59.2	62.4
Equity to assets	4.1	3.9	5.1	5.3	5.3

**Asset quality & capital**

NPAs/gross loans (%)	4.3	2.9	2.1	1.8	1.8
Bad debt charge/gross loans (%)	1.29	1.07	0.63	0.58	0.49
Loss reserves/assets (%)	1.21	1.43	1.47	1.52	1.55
Loss reserves/NPAs (%)	63.5	105.4	151.0	172.2	162.5
Tier 1 capital ratio (%)	8.0	7.7	9.7	9.7	9.5
Total capital ratio (%)	9.4	10.1	12.9	12.6	12.0

**Growth (%)**

Loan growth	11.3	33.1	19.2	21.8	22.8
Interest earning assets	33.8	25.0	15.7	17.4	18.2
Interest bearing liabilities	10.8	28.9	15.8	15.5	15.7
Asset growth	32.2	26.6	17.0	15.5	15.5
Deposit growth	15.3	23.0	16.1	16.4	16.4

**Per share**

Reported EPS (RMB)	0.27	0.25	0.32	0.38	0.49
Norm EPS (RMB)	0.27	0.25	0.32	0.38	0.49
Fully diluted norm EPS (RMB)	0.27	0.25	0.32	0.38	0.49
DPS (RMB)	-	0.08	0.06	0.17	0.22
PPOP PS (RMB)	0.54	0.44	0.52	0.61	0.75
BVPS (RMB)	1.12	1.32	1.64	1.96	2.28
ABVPS (RMB)	1.12	1.32	1.64	1.96	2.28
NTAPS (RMB)	1.05	1.24	1.59	1.91	2.23

Source: Nomura estimates

Asset quality maintained

## ⊙ Action

As leader in WTE, CEI will benefit from incineration as the preferred solid waste treatment method in urban China. Together with its strong portfolio in wastewater treatment, we believe CEI will continue to add new projects in these two high growth areas. Trading at 21x FY11F EPS, valuation is in line with peers' 16-21x. We believe this is undemanding, as we think CEI deserves to trade at a premium given its WTE expansion is likely to provide higher returns (10-15%). BUY.

## ✂ Catalysts

Comfortable gearing will allow the company to look for additional WTE, water and environmental projects. Potential new projects would be share price catalysts.

## ⚓ Anchor themes

Water shortages, exacerbated by growing demand and pollution, underscore the need for conservation. Privatisation, tariff hikes are the solution. We like the tap water model but prefer wastewater treatment, WTE, recycled water near term on policy support.

## Quality name in WTE

### ① Strong policy support expected from Twelfth FYP

We expect continued support from China's central government policies for wastewater treatment (potential investment of RMB700bn during 2011-15F) and expansion of waste-to-energy (WTE) plants (300 WTE plants by end-FY15F, from ~100 in FY08). As a leader in WTE with high emissions standards, CEI should benefit from growth in the WTE sector, we believe.

### ② Recent new projects underpin continued growth

CEI has traditionally been strong in Jiangsu and Shandong, but was recently awarded a WTE project in Huidong county, Guangdong, and a straw-fired project in Suzhou city, Anhui. We believe CEI should be able to obtain more projects from these locations as management further strengthens ties with local government officials following the completion of projects in hand.

### ③ Beneficiary of stricter emission standards

The Chinese government will require dioxin emission to be reduced by 10% in five years, according to the Ministry of Industry and Information Technology (source: Hexun, 6 November). The government plans to expedite the closure of highly polluting incinerators and promote the use of centralised waste incinerators to lower emissions. We see this as a positive development for CEI, whose WTE plants already operate at international standards and above PRC regulatory requirements, according to management.

### ④ Reiterate BUY; WTE expansion widens premium

CEI is trading at 21x FY11F EPS, in line with peers' 16-21x. We believe this is undemanding given WTE expansion will provide higher returns (10-15%) and warrants a premium. We believe CEI's quality output in wastewater treatment and WTE should be reflected in higher ROE spread against peers. New projects would be catalysts, in our view.

Closing price on 1 Dec	HK\$4.36
Price target	<b>HK\$6.10</b>
	(set on 15 Oct 10)
Upside/downside	39.9%
Difference from consensus	<b>41.9%</b>
FY11F net profit (HK\$m)	760
Difference from consensus	<b>-0.1%</b>
Source: Nomura	

## Nomura vs consensus

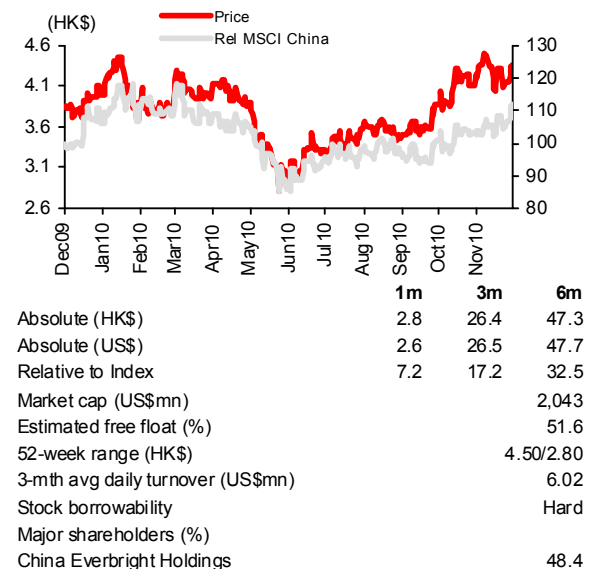
We believe CEI will continue project execution in FY11F-12F and have reflected such in our projections for capacity build-out.

## Key financials & valuations

31 Dec (HK\$m)	FY09	FY10F	FY11F	FY12F
Revenue	1,766	3,090	4,044	4,310
Reported net profit	372	593	760	892
Normalised net profit	367	593	760	892
Normalised EPS (HK\$)	0.11	0.16	0.21	0.25
Norm. EPS growth (%)	18.5	50.6	28.1	17.4
Norm. P/E (x)	40.9	26.9	20.9	17.8
EV/EBITDA (x)	24.4	18.4	15.0	12.7
Price/book (x)	3.5	3.1	2.8	2.5
Dividend yield (%)	0.5	0.8	1.0	1.1
ROE (%)	10.1	12.3	14.2	14.8
Net debt/equity (%)	23.6	41.0	60.8	68.6
<b>Earnings revisions</b>				
Previous norm. net profit		593	760	892
Change from previous (%)		-	-	-
Previous norm. EPS (HK\$)		0.16	0.21	0.25

Source: Company, Nomura estimates

## Share price relative to MSCI China



Source: Company, Nomura estimates

## Drilling down

# Well positioned to benefit from environmental protection policies

## Large exposure to WTE and WWT, with development in alternative energy

We expect continued support from China's central government policies for wastewater treatment (potential investment of RMB700bn during 2011-15F) and expansion of waste-to-energy (WTE) plants (300 WTE plants by end-FY15F, from ~100 in FY08). As a leader in WTE with high emissions standards, CEI should benefit from growth in the WTE sector.

China Everbright International (CEI) is a recognised leader in China's WTE space, with a focus on developing environmental protection industrial parks, which often comprise various projects including methane-to-energy, wastewater treatment (WWT) and WTE. We expect WTE to remain the main revenue driver, contributing 65% of total FY10F revenue, followed by WWT at 26% of total.

## Strong balance sheet; credit facility with ADB

Net debt to equity as of June 2010 was 39%, which would give CEI room to further gear up to fund new projects. The company has credit facilities of US\$200mn with Asia Development Bank, which we expect it to draw down in 2H10. We estimate this would increase gearing to 70%, within management's guided gearing range of 60-70%. This loan will allow the company to fund HK\$4.7bn of investments, on our estimate, assuming project level gearing of 67%. Therefore, we believe CEI's RMB1bn-2bn capex pa is not under pressure.

## CEI stands to benefit from stricter government requirements on WTE emission standards

The Chinese government has drafted a document to require dioxin emission to be reduced by 10% in five years, according to Ministry of Industry and Information Technology (source: Hexun, 6 November 2010). The government plans to expedite the closure of highly polluting incinerators and promote the use of centralised waste incinerators to lower emissions. We see this as a positive development for CEI, whose WTE plants already operate at international standards and above the PRC regulatory requirements as per management.

## Reiterate BUY

CEI is trading at 21x FY11F EPS vs peers' 16-21x. We think the valuation is undemanding as we believe WTE expansion should provide higher returns. Its quality output in both WWT and WTE should reflect higher ROE-spread against peers as the government raises the bar for environmental protection, in our view. Also, the company's growth momentum remains strong. We believe potential new projects would be share price catalysts. Hence, we maintain our BUY rating.

**Valuation methodology and investment risks:** Our price target is derived using DCF, with a WACC of 10.0% and a 2% terminal growth rate. Our target price is subject to growth assumptions in treatment volumes (including tap water supply, wastewater treatment and waste-to-energy), tariffs, capacity and capex. Changes in the macro landscape and government regulations over the water industry may result in key changes in our forecasts, and hence our target price.

Potential investment of RMB700bn in China during 2011-15F

Net debt to equity as of June 2010 was 39%

Valuation is undemanding in our view

## Financial statements

Income statement (HK\$mn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
<b>Revenue</b>	1,863	1,766	3,090	4,044	4,310
Cost of goods sold	(1,198)	(947)	(1,981)	(2,571)	(2,534)
<b>Gross profit</b>	<b>665</b>	<b>819</b>	<b>1,109</b>	<b>1,473</b>	<b>1,776</b>
SG&A	(127)	(165)	(189)	(242)	(235)
Employee share expense	-	-	-	-	-
<b>Operating profit</b>	<b>538</b>	<b>654</b>	<b>921</b>	<b>1,231</b>	<b>1,541</b>
<b>EBITDA</b>	<b>574</b>	<b>693</b>	<b>975</b>	<b>1,288</b>	<b>1,600</b>
Depreciation	(13)	(15)	(18)	(21)	(24)
Amortisation	(24)	(24)	(36)	(36)	(36)
<b>EBIT</b>	<b>538</b>	<b>654</b>	<b>921</b>	<b>1,231</b>	<b>1,541</b>
Net interest expense	(147)	(170)	(198)	(236)	(291)
Associates & JCEs	-	1	-	-	-
Other income	18	18	62	38	25
<b>Earnings before tax</b>	<b>408</b>	<b>503</b>	<b>785</b>	<b>1,033</b>	<b>1,274</b>
Income tax	(95)	(99)	(157)	(227)	(319)
<b>Net profit after tax</b>	<b>313</b>	<b>404</b>	<b>628</b>	<b>806</b>	<b>956</b>
Minority interests	(26)	(37)	(35)	(46)	(64)
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
<b>Normalised NPAT</b>	<b>287</b>	<b>367</b>	<b>593</b>	<b>760</b>	<b>892</b>
Extraordinary items	52	5	-	-	-
<b>Reported NPAT</b>	<b>339</b>	<b>372</b>	<b>593</b>	<b>760</b>	<b>892</b>
Dividends	(50)	(75)	(120)	(154)	(180)
<b>Transfer to reserves</b>	<b>289</b>	<b>297</b>	<b>473</b>	<b>606</b>	<b>712</b>
<b>Valuation and ratio analysis</b>					
FD normalised P/E (x)	49.0	40.9	26.9	20.9	17.8
FD normalised P/E at price target (x)	68.5	57.3	37.7	29.2	24.9
Reported P/E (x)	40.4	39.8	26.8	20.9	17.8
Dividend yield (%)	0.4	0.5	0.8	1.0	1.1
Price/cashflow (x)	na	94.1	17.5	14.6	12.3
Price/book (x)	4.9	3.5	3.1	2.8	2.5
EV/EBITDA (x)	31.0	24.4	18.4	15.0	12.7
EV/EBIT (x)	33.1	25.9	19.5	15.7	13.1
Gross margin (%)	35.7	46.4	35.9	36.4	41.2
EBITDA margin (%)	30.8	39.2	31.6	31.8	37.1
EBIT margin (%)	28.9	37.1	29.8	30.4	35.7
Net margin (%)	18.2	21.1	19.2	18.8	20.7
Effective tax rate (%)	23.3	19.7	20.0	22.0	25.0
Dividend payout (%)	14.8	20.2	20.2	20.2	20.2
Capex to sales (%)	54.5	30.8	51.9	51.1	40.7
Capex to depreciation (x)	78.6	37.3	87.5	100.4	74.4
ROE (%)	12.9	10.1	12.3	14.2	14.8
ROA (pretax %)	11.3	10.7	12.4	13.1	13.4
<b>Growth (%)</b>					
Revenue	38.2	(5.2)	75.0	30.9	6.6
EBITDA	41.0	20.7	40.7	32.0	24.3
EBIT	42.1	21.7	40.7	33.7	25.2
Normalised EPS	(3.7)	18.5	50.6	28.1	17.4
Normalised FDEPS	(4.2)	19.7	51.9	29.0	17.4
<b>Per share</b>					
Reported EPS (HK\$)	0.11	0.11	0.16	0.21	0.25
Norm EPS (HK\$)	0.09	0.11	0.16	0.21	0.25
Fully diluted norm EPS (HK\$)	0.09	0.11	0.16	0.21	0.25
Book value per share (HK\$)	0.90	1.26	1.39	1.56	1.75
DPS (HK\$)	0.02	0.02	0.03	0.04	0.05

Earnings continue to be boosted by further expansion in WTE

Cashflow (HK\$mn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
EBITDA	574	693	975	1,288	1,600
Change in working capital	(116)	(216)	(214)	(174)	(155)
Other operating cashflow	(584)	(320)	146	(26)	(156)
<b>Cashflow from operations</b>	<b>(126)</b>	<b>157</b>	<b>907</b>	<b>1,087</b>	<b>1,289</b>
Capital expenditure	(1,015)	(545)	(1,604)	(2,067)	(1,753)
<b>Free cashflow</b>	<b>(1,141)</b>	<b>(388)</b>	<b>(697)</b>	<b>(980)</b>	<b>(464)</b>
Reduction in investments	37	1	-	-	-
Net acquisitions	-	-	-	-	-
Reduction in other LT assets	9	4	-	-	-
Addition in other LT liabilities	39	66	0	(0)	0
Adjustments	128	(12)	10	(1)	(13)
<b>Cashflow after investing acts</b>	<b>(927)</b>	<b>(329)</b>	<b>(687)</b>	<b>(981)</b>	<b>(477)</b>
Cash dividends	(50)	(63)	(120)	(154)	(180)
Equity issue	8	1,445	16	-	-
Debt issue	986	518	228	962	744
Convertible debt issue	-	-	-	-	-
Others	52	(246)	(207)	(235)	(278)
<b>Cashflow from financial acts</b>	<b>995</b>	<b>1,654</b>	<b>(83)</b>	<b>573</b>	<b>286</b>
<b>Net cashflow</b>	<b>68</b>	<b>1,325</b>	<b>(771)</b>	<b>(408)</b>	<b>(191)</b>
Beginning cash	631	699	2,024	1,253	846
Ending cash	699	2,024	1,253	846	655
Ending net debt	1,912	1,077	2,075	3,445	4,380

Source: Nomura estimates

Balance sheet (HK\$mn)					
As at 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Cash & equivalents	699	2,024	1,253	846	655
Marketable securities	-	-	-	-	-
Accounts receivable	98	198	186	225	287
Inventories	12	13	15	19	27
Other current assets	582	708	1,032	1,346	1,733
<b>Total current assets</b>	<b>1,391</b>	<b>2,944</b>	<b>2,488</b>	<b>2,436</b>	<b>2,702</b>
LT investments	22	21	21	21	21
Fixed assets	145	144	145	151	161
Goodwill	46	46	46	46	46
Other intangible assets	578	554	518	482	445
Other LT assets	4,118	4,959	6,301	8,179	9,761
<b>Total assets</b>	<b>6,301</b>	<b>8,667</b>	<b>9,519</b>	<b>11,315</b>	<b>13,137</b>
Short-term debt	546	696	451	545	719
Accounts payable	471	481	580	758	1,054
Other current liabilities	9	10	12	16	22
<b>Total current liabilities</b>	<b>1,026</b>	<b>1,188</b>	<b>1,042</b>	<b>1,319</b>	<b>1,795</b>
Long-term debt	2,065	2,405	2,878	3,745	4,316
Convertible debt	-	-	-	-	-
Other LT liabilities	79	145	145	145	145
<b>Total liabilities</b>	<b>3,170</b>	<b>3,738</b>	<b>4,065</b>	<b>5,209</b>	<b>6,255</b>
Minority interest	311	357	392	438	502
Preferred stock	-	-	-	-	-
Common stock	314	364	364	364	364
Retained earnings	2,505	4,209	4,698	5,304	6,016
Proposed dividends	-	-	-	-	-
Other equity and reserves	-	-	-	-	-
<b>Total shareholders' equity</b>	<b>2,820</b>	<b>4,573</b>	<b>5,062</b>	<b>5,668</b>	<b>6,380</b>
<b>Total equity &amp; liabilities</b>	<b>6,301</b>	<b>8,667</b>	<b>9,519</b>	<b>11,315</b>	<b>13,137</b>

**Liquidity (x)**

Current ratio	1.36	2.48	2.39	1.85	1.51
Interest cover	3.7	3.8	4.7	5.2	5.3

**Leverage**

Net debt/EBITDA (x)	3.33	1.55	2.13	2.68	2.74
Net debt/equity (%)	67.8	23.6	41.0	60.8	68.6

**Activity (days)**

Days receivable	14.9	30.6	22.7	18.6	21.7
Days inventory	2.7	4.8	2.6	2.4	3.4
Days payable	123.1	183.6	97.8	94.9	130.9
Cash cycle	(105.5)	(148.2)	(72.5)	(73.9)	(105.8)

Source: Nomura estimates

Gearing remains healthy,  
positive for expansion

### ⊙ Action

We think China Life is likely to be an outperformer in FY11F on a rising interest rate and still relatively high liquidity. Its share price performance has lagged in FY10, but we expect a rebound in FY11F VoNB growth to support performance. Valuation looks undemanding at FY11F PEV of 2.1x and NBM of 21x for a stock offering around 15% VoNB growth, 2.5% ROA and 2-3% dividend yield.

### ⚡ Catalysts

Further rounds of rate hikes in 2011 could boost insurers' earnings together with any positive sentiment on the A-share market or expectations of more liquidity.

### ⚓ Anchor themes

Investor perception of Chinese insurers' ability to control investment risk is a highly valuable intangible asset and should not be taken for granted. Given the Chinese insurance industry remains a growth story and investor focus on VoNB growth, we believe Chinese insurers should continue to trade at higher multiples.

## A brighter 2011 led by VoNB rebound

### ① Are you a believer in wealth dispersion or concentration?

Fundamentally, our positive stance on China Life is still premised on its pure life insurance penetration story. Without getting in too deep on the rural debate, our view is that its rural business would continue to be the engine of its Value of New Business (VoNB) growth as life insurance penetration continues to increase in the rural areas and will likely be supported by government policies. China Life's rural reach seems incomparable to peers. This is in sharp contrast to Ping An, which must continue to strive and compete intensely with banks, securities and wealth management houses in urban areas for a slice of the non-insurance business. Investors believing in the rural growth catchup story should prefer the simpler China Life theme.

### ② More potential for upside surprise in VoNB growth

With the overhang on investment market sentiment, demand in insurance is going back to the basic par products, supporting our positive view on China Life. The market still needs convincing over a higher VoNB growth figure. We expect a rebound from 1H10 levels and believe downside is limited for 2H10F and FY11F.

### ③ Factors that could drive VoNB in 2011

Under a rising rate environment, margins between single and regular premium could narrow because single premium can be invested at a higher yield, whereas the regular premium will still be assumed at the longer-term yield. Additionally, China Life's continued shift of bancassurance to individual agent products should help expand margins. Finally, we expect China Life to sell more long-term regular premium products in 2H10/FY11F under the rising rate environment, in contrast to 1H10.

Closing price on 1 Dec	HK\$33.70
Price target	<b>HK\$40.00</b>
	(set on 8 Oct 10)
Upside/downside	18.7%
Difference from consensus	<b>7.4%</b>
FY11F net profit (RMBmn)	38,896
Difference from consensus	<b>-5.4%</b>
Source: Nomura	

### Nomura vs consensus

Our lower FY11F earnings forecast is due to consensus factoring in higher investment earnings for FY11F.

### Key financials & valuations

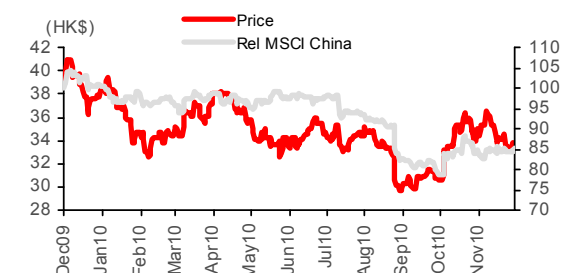
31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Net premium	275,812	311,881	364,945	431,828
Reported net profit	32,881	34,847	38,896	44,907
Normalised net profit	32,881	34,847	38,896	44,907
Normalised EPS (RMB)	1.16	1.23	1.38	1.59
Norm. EPS growth (%)	71.8	6.0	11.6	15.5
Norm. P/E (x)	25.4	23.6	20.2	16.5
Price/EV (x)	2.9	2.6	2.1	1.7
Price/implied VNB (x)	31.1	24.5	16.2	10.1
Dividend yield (%)	2.4	2.6	3.0	3.6
ROE (%)	17.1	16.3	17.0	17.5
ROA (%)	2.97	2.65	2.53	2.48

### Earnings revisions

Previous norm. net profit	34,847	37,689	42,082
Change from previous (%)	-	3.2	6.7
Previous norm. EPS (RMB)	1.23	1.33	1.49

Source: Company, Nomura estimates

### Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	(3.7)	12.7	0.4
Absolute (US\$)	(3.9)	12.8	0.8
Relative to Index	0.6	3.5	(14.5)
Market cap (US\$mn)			122,642
Estimated free float (%)			95.3
52-week range (HK\$)			41.00/29.70
3-mth avg daily turnover (US\$mn)			265.4
Stock borrowability			Easy
Major shareholders (%)			
CLIC			68.4
HKSCC			25.7

Source: Company, Nomura estimates

## Rural accounts for half of China Life's business

### China Life

In our view, investors interested in China's urbanisation theme should also consider China Life. According to China Life management, rural business accounts for around half of its total (in terms of premium and agency force). The profitability for the rural business is around the same as urban, but subject to more seasonality.

The key difference between the rural and urban business is that the rural branch and staff cost could be lower, while health for the rural areas is poorer, leading to higher mortality generally. These two factors tend to even out each other. Premium growth rates have also been roughly equal for its urban and rural business during 2010, according to management.

From a life insurance perspective, China Life is probably the only real rural urbanisation play as other life insurers focus more on the cities while high initial investments also mean they are unlikely to invest significantly in their rural business.

**In our view, investors interested in China's urbanisation theme should also consider China Life**

Exhibit 164. Rolling forward PEV



Source: Bloomberg, Nomura

Exhibit 165. Rolling forward NB Multiple



Source : Bloomberg, Nomura

### Valuation

Our PT of HK\$40.00 is premised on an NB multiple of 25.0x, derived by a risk discount rate (RDR) of 11%, according to China Life's EV assumptions. We use our explicit VoNB growth forecasts for FY10-13F, an assumed 15% VoNB growth over the next seven years (FY14-20F), levelling off to 10% in FY21-25F. The valuation is based on a 15-year basis and assumes no perpetuity growth, an approach similar to standard actuarial practice, as long-term growth is deemed too uncertain and therefore has close to zero value.

We apply the target NB multiple to China Life's FY12F new business value and add FY11F embedded value.

### Risks to our view

The key downside risks include poor returns from the A-share market, which would affect sentiment towards insurers in general. Plus: intensified competition leading to a continued squeeze in NB margins for life insurers, especially China Life, which hopes to recapture market share.

## Financial statements

Profit and Loss (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Gross premiums	265,656	275,970	312,059	365,154	432,076
Government charges	-	-	-	-	-
Reinsurance ceded	(156)	(158)	(179)	(209)	(247)
<b>Net written premium</b>	<b>265,500</b>	<b>275,812</b>	<b>311,881</b>	<b>364,945</b>	<b>431,828</b>
Change in unearned premium reserves	(323)	(735)	(831)	(973)	(1,151)
<b>Net earned premium</b>	<b>265,177</b>	<b>275,077</b>	<b>311,049</b>	<b>363,972</b>	<b>430,677</b>
Claims and benefit payments	(134,649)	(154,372)	(178,983)	(201,901)	(237,944)
Change in reserves	-	-	-	-	-
Commission and DAC expenses	-	-	-	-	-
Other expenses	(145,721)	(143,877)	(145,902)	(185,798)	(221,322)
<b>Underwriting surplus</b>	<b>(15,193)</b>	<b>(23,172)</b>	<b>(13,835)</b>	<b>(23,728)</b>	<b>(28,589)</b>
Recurrent investment income	44,946	38,890	48,476	68,996	81,031
Realised and unrealised gains	(13,158)	22,693	5,897	-	-
<b>Investment income</b>	<b>31,788</b>	<b>61,583</b>	<b>54,373</b>	<b>68,996</b>	<b>81,031</b>
Other income	-	-	-	-	-
Employee share expense	-	-	-	-	-
<b>Operating profit</b>	<b>16,595</b>	<b>38,411</b>	<b>40,538</b>	<b>45,268</b>	<b>52,442</b>
Amortisation	-	-	-	-	-
Other non-operating income	3,420	2,630	2,893	3,182	3,501
Associates and JCEs	(56)	704	810	931	1,071
<b>Pre-tax profit</b>	<b>19,959</b>	<b>41,745</b>	<b>44,240</b>	<b>49,381</b>	<b>57,013</b>
Income tax	(685)	(8,709)	(9,230)	(10,302)	(11,894)
<b>Net profit after tax</b>	<b>19,274</b>	<b>33,036</b>	<b>35,011</b>	<b>39,079</b>	<b>45,119</b>
Minority interests	(137)	(155)	(164)	(183)	(212)
<b>Other items</b>					
Preferred dividends					
<b>Normalised NPAT</b>	<b>19,137</b>	<b>32,881</b>	<b>34,847</b>	<b>38,896</b>	<b>44,907</b>
Extraordinary items					
<b>Reported NPAT</b>	<b>19,137</b>	<b>32,881</b>	<b>34,847</b>	<b>38,896</b>	<b>44,907</b>
Dividends					
Transfer to retained earnings	19,137	32,881	34,847	38,896	44,907
<b>Valuation and ratio analysis</b>					
FD normalised P/E (x)	45.3	25.4	23.6	20.2	16.5
FD normalised P/E at price target (x)	53.7	30.2	28.0	23.9	19.6
Reported P/E (x)	45.3	25.4	23.6	20.2	16.5
Dividend yield (%)	0.8	2.4	2.6	3.0	3.6
Price/book (x)	4.8	4.0	3.7	3.2	2.7
Investment return (%)	3.56	5.84	4.25	4.58	4.59
Recurrent investment return (%)	5.03	3.69	3.79	4.58	4.59
Non-recurrent return/inv. return (%)	(41.4)	36.8	10.8	-	-
Price/EV (x)	3.5	2.9	2.6	2.1	1.7
Price/implied VNB (x)	42.9	31.1	24.5	16.2	10.1
Loss ratio (%)					
Combined ratio (%)					
Effective tax rate (%)	3.4	20.9	20.9	20.9	20.9
Dividend payout (%)	-	-	-	-	-
ROE (%)	11.5	17.1	16.3	17.0	17.5
ROA (%)	2.04	2.97	2.65	2.53	2.48
ROR (%)	7.9	10.4	9.9	9.7	9.5
<b>Growth (%)</b>					
Life premiums	173.5	3.7	13.2	17.3	18.7
Non life premiums	(32.7)	6.7	10.4	10.7	10.9
Net profit	(50.8)	71.8	6.0	11.6	15.5
Normalised EPS	(50.8)	71.8	6.0	11.6	15.5
Normalised FDEPS	(50.8)	71.8	6.0	11.6	15.5

Source: Nomura estimates

Potential earnings upside from investment gains

<b>Balance Sheet (RMBmn)</b>					
<b>As at 31 Dec</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10F</b>	<b>FY11F</b>	<b>FY12F</b>
<b>Cash and deposits</b>	<b>262,357</b>	<b>381,180</b>	<b>519,284</b>	<b>609,266</b>	<b>714,969</b>
Bonds	575,885	582,315	671,316	787,642	924,293
Equities	75,077	179,405	154,469	181,236	212,679
Unit trusts					
Loans and mortgages					
Foreign investments					
Real estate					
Other investments	24,084	29,245	40,259	47,235	55,430
<b>Total investments</b>	<b>937,403</b>	<b>1,172,145</b>	<b>1,385,329</b>	<b>1,625,378</b>	<b>1,907,371</b>
Deferred acquisition costs					
Prepaid and unearned prem. reserves					
Debtors and prepayments					
Fixed assets					
Goodwill					
Separate account assets					
Other assets	50,090	54,112	21,492	40,467	53,718
<b>Total assets</b>	<b>987,493</b>	<b>1,226,257</b>	<b>1,406,821</b>	<b>1,665,845</b>	<b>1,961,089</b>
Insurance reserves	2,780	5,997	6,619	7,324	8,125
Catastrophe reserves	654,848	809,223	988,206	1,190,107	1,428,051
Insurance protection fund					
Deposit and investment contracts					
Separate account liabilities					
Provision for Unearned Premiums					
Provision for Outstanding Claims					
Interest bearing liabilities					
Other liabilities	154,994	198,261	194,786	225,496	251,511
<b>Total liabilities</b>	<b>812,622</b>	<b>1,013,481</b>	<b>1,189,610</b>	<b>1,422,927</b>	<b>1,687,687</b>
Minority interest	924	1,704	1,704	1,704	1,704
Common stock	28,265	28,265	28,265	28,265	28,265
Preferred stock	-	-	-	-	-
Retained earnings	145,682	182,807	187,242	212,949	243,433
Proposed dividends					
Other equity					
<b>Shareholders' equity</b>	<b>173,947</b>	<b>211,072</b>	<b>215,507</b>	<b>241,214</b>	<b>271,698</b>
<b>Total liabilities and equity</b>	<b>987,493</b>	<b>1,226,257</b>	<b>1,406,821</b>	<b>1,665,845</b>	<b>1,961,089</b>
<b>Balance sheet ratios (%)</b>					
Life solvency margin	na	na	na	na	na
Non-life solvency margin					
Net premiums/equity	152	130	144	151	159
Tech. reserves/total premiums	1	2	2	2	2
<b>Investment portfolio mix (%)</b>					
Cash and deposits	28.0	32.5	37.5	37.5	37.5
Bonds	61.4	49.7	48.5	48.5	48.5
Equities	8.0	15.3	11.2	11.2	11.2
Unit trusts	-	-	-	-	-
Loans and mortgages	-	-	-	-	-
Foreign investments	-	-	-	-	-
Real estate	-	-	-	-	-
Other investments	2.6	2.5	2.9	2.9	2.9
<b>Per share</b>					
Reported EPS (RMB)	0.68	1.16	1.23	1.38	1.59
Norm EPS (RMB)	0.68	1.16	1.23	1.38	1.59
Fully diluted norm EPS (RMB)	0.68	1.16	1.23	1.38	1.59
DPS (RMB)	0.23	0.70	0.74	0.83	0.96
BVPS (RMB)	6.15	7.47	7.62	8.53	9.61
Life/LT EVPS (RMB)	8.49	10.09	11.13	12.89	15.01
Life/LT VNBPS (RMB)	0.49	0.63	0.71	0.87	1.04
Value of non-life bus. PS (RMB)	-	-	-	-	-

Growing equity to boost ANW in EV

Source: Nomura estimates

## ⊙ Action

Mengniu shares have underperformed the MSCI China by 16% in the past six months, mainly due to cost pressure concerns, we think. We see a potential earnings turnaround for 2H FY10F and FY11F given product upgrades, pricing power and positive operating leverage. Management indicates that it will focus more on profitability rather than market share gain, given its leading position (already 40% share in the liquid milk segment).

## ✂ Catalysts

EPS upgrades by the street, product price hikes and M&A.

## ⚓ Anchor themes

We are positive on China's long-term consumption outlook. China's GDP per capita (about US\$3,700 in 2009) is close to seeing consumption pick up, based on the experience of developed markets.

## Earnings turnaround

### ① Time to pass on cost pressure

In our view, Mengniu could pass on its raw milk cost pressures through product upgrades and ASP hikes in FY11F. We forecast a 7% y-y increase in raw milk cost for FY11F following an estimated 13% y-y increase in FY10F. Management indicates that its high-end products (with GPM of 28% to 40%) will increase by 2-3pp pa as a percentage of total sales from 18% currently. Moreover, according to management, the company has raised selling prices by 4% on average recently. On our estimate, its 5% ASP increase (1pp from product upgrade and 4pp from direct price hike) could help it to fully pass on cost pressure for FY11F. Compared with an estimated 26.1% GPM for FY10F, we expect a GPM of 26.6% for FY11F on a 5% y-y ASP increase.

### ② Focus on the bottom line

Based on our recent conversation with management, we believe Mengniu will focus more on profitability than gaining market share given its no.1 market share and thin net margin (4.3% in 1H FY10). While its selling expense will likely continue to increase in absolute value, management sees scope for selling expenses, as a percentage of turnover, to decline gradually in the long term with increasing economies of scale. Management targets this ratio to be within 18% for 2H FY10F and FY11F. We expect a 0.2pp decrease y-y in each of FY11-12F, from an estimated 18% in FY10F.

### ③ Reaffirming BUY with price target of HK\$32

Mengniu's bottom line is highly sensitive to changes in margins. Our earnings estimates reflect its recent ASP hike and slightly positive operating leverage. We stick to our valuation method, 23x 12-month forward EPS (excluding stock option expense), at par with the China F&B sector, with a price target of HK\$32.00, which implies 41% potential upside. Maintain BUY.

Closing price on 1 Dec	HK\$22.70
Price target	<b>HK\$32.00</b>
	(set on 19 Nov 10)
Upside/downside	41.0%
Difference from consensus	<b>23.1%</b>
FY11F net profit (RMBmn)	1,784
Difference from consensus	<b>7.1%</b>
Source: Nomura	

## Nomura vs consensus

Our numbers are higher than the Street mainly because we expect Mengniu to pass on cost pressure.

## Key financials & valuations

31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Revenue	25,710	30,536	36,231	43,289
Reported net profit	1,116	1,217	1,784	2,347
Normalised net profit	1,116	1,217	1,784	2,347
Normalised EPS (RMB)	0.68	0.70	1.03	1.35
Norm. EPS growth (%)	na	2.9	46.6	31.6
Norm. P/E (x)	29.2	27.9	18.1	13.0
EV/EBITDA (x)	14.4	13.8	8.1	5.1
Price/book (x)	4.0	3.5	2.9	2.3
Dividend yield (%)	0.7	0.8	1.2	1.7
ROE (%)	17.1	13.4	17.5	19.8
Net debt/equity (%)		net cash	net cash	net cash

## Earnings revisions

Previous norm. net profit		1,217	1,784	2,347
Change from previous (%)		-	-	-
Previous norm. EPS (RMB)		0.70	1.03	1.35

Source: Company, Nomura estimates

## Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	0.9	(1.9)	(0.9)
Absolute (US\$)	0.7	(1.8)	(0.6)
Relative to Index	5.2	(11.1)	(15.8)
Market cap (US\$m)			5,072
Estimated free float (%)			65.0
52-week range (HK\$)			28.80/20.55
3-mth avg daily turnover (US\$m)			20.86
Stock borrowability			Easy
Major shareholders (%)			
COFCO			14.0
HOPU			6.0

Source: Company, Nomura estimates

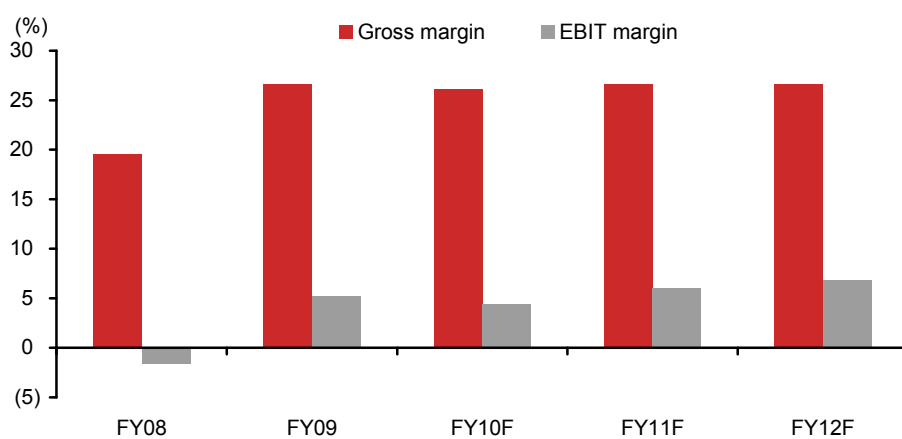
**Downside investment risks:** higher-than-expected raw milk prices, higher-than-expected A&P expenses and food safety concerns.

### Exhibit 166. Our assumptions

	FY09	FY10F	FY11F	FY12F
Raw milk cost y-y change (%)	0.0	13.0	7.0	0.0
ASP y-y change (%)	2.0	7.0	5.0	3.0
Gross profit margin (%)	26.7	26.1	26.6	26.7
SG&A as % to turnover (%)	21.5	21.7	20.6	19.9

Source: Nomura estimates

### Exhibit 167. GPM and EBIT margin



Source: Company data, Nomura estimates

## Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
<b>Revenue</b>	23,865	25,710	30,536	36,231	43,289
Cost of goods sold	(19,196)	(18,858)	(22,574)	(26,578)	(31,751)
<b>Gross profit</b>	<b>4,669</b>	<b>6,852</b>	<b>7,962</b>	<b>9,653</b>	<b>11,539</b>
SG&A	(5,050)	(5,517)	(6,620)	(7,473)	(8,601)
Employee share expense					
<b>Operating profit</b>	<b>(381)</b>	<b>1,335</b>	<b>1,342</b>	<b>2,180</b>	<b>2,938</b>
<b>EBITDA</b>	<b>249</b>	<b>1,999</b>	<b>1,942</b>	<b>2,770</b>	<b>3,522</b>
Depreciation	(630)	(664)	(600)	(590)	(584)
Amortisation	-	-	-	-	-
<b>EBIT</b>	<b>(381)</b>	<b>1,335</b>	<b>1,342</b>	<b>2,180</b>	<b>2,938</b>
Net interest expense	15	24	91	125	174
Associates & JCEs	29	20	20	20	20
Other income	(753)	(32)	61	61	61
<b>Earnings before tax</b>	<b>(1,089)</b>	<b>1,346</b>	<b>1,514</b>	<b>2,385</b>	<b>3,192</b>
Income tax	161	(126)	(159)	(286)	(431)
<b>Net profit after tax</b>	<b>(928)</b>	<b>1,220</b>	<b>1,355</b>	<b>2,099</b>	<b>2,761</b>
Minority interests	(24)	(104)	(138)	(315)	(414)
Other items	3				
Preferred dividends					
<b>Normalised NPAT</b>	<b>(949)</b>	<b>1,116</b>	<b>1,217</b>	<b>1,784</b>	<b>2,347</b>
Extraordinary items	-	-	-	-	-
<b>Reported NPAT</b>	<b>(949)</b>	<b>1,116</b>	<b>1,217</b>	<b>1,784</b>	<b>2,347</b>
Dividends	-	(245)	(268)	(392)	(516)
<b>Transfer to reserves</b>	<b>(949)</b>	<b>870</b>	<b>949</b>	<b>1,391</b>	<b>1,831</b>
<b>Valuation and ratio analysis</b>					
FD normalised P/E (x)	na	29.2	27.9	18.1	13.0
FD normalised P/E at price target (x)	na	41.1	39.3	25.6	18.4
Reported P/E (x)	na	29.2	27.9	18.1	13.0
Dividend yield (%)	-	0.7	0.8	1.2	1.7
Price/cashflow (x)	24.0	18.5	15.9	8.4	7.7
Price/book (x)	7.0	4.0	3.5	2.9	2.3
EV/EBITDA (x)	123.4	14.4	13.8	8.1	5.1
EV/EBIT (x)	na	21.5	19.9	10.3	6.2
Gross margin (%)	19.6	26.7	26.1	26.6	26.7
EBITDA margin (%)	1.0	7.8	6.4	7.6	8.1
EBIT margin (%)	(1.6)	5.2	4.4	6.0	6.8
Net margin (%)	(4.0)	4.3	4.0	4.9	5.4
Effective tax rate (%)	na	9.4	10.5	12.0	13.5
Dividend payout (%)	na	22.0	22.0	22.0	22.0
Capex to sales (%)	3.3	2.4	2.1	1.9	1.6
Capex to depreciation (x)	1.3	0.9	1.1	1.2	1.2
ROE (%)	(19.8)	17.1	13.4	17.5	19.8
ROA (pretax %)	(4.5)	16.7	16.0	24.9	31.9
<b>Growth (%)</b>					
Revenue	11.9	7.7	18.8	18.7	19.5
EBITDA	(84.0)	701.9	(2.9)	42.6	27.2
EBIT	(136.6)	na	0.5	62.4	34.8
Normalised EPS	(196.1)	na	2.9	46.6	31.6
Normalised FDEPS	(196.2)	na	2.9	46.6	31.6
<b>Per share</b>					
Reported EPS (RMB)	(0.64)	0.68	0.70	1.03	1.35
Norm EPS (RMB)	(0.64)	0.68	0.70	1.03	1.35
Fully diluted norm EPS (RMB)	(0.64)	0.68	0.70	1.03	1.35
Book value per share (RMB)	2.86	4.94	5.49	6.29	7.35
DPS (RMB)	-	0.14	0.15	0.23	0.30

Thin net margin makes Mengniu's bottom line highly sensitive to changes in costs

Cashflow (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
EBITDA	249	1,999	1,942	2,770	3,522
Change in working capital	833	(166)	231	1,197	691
Other operating cashflow	189	(77)	(41)	(133)	(228)
<b>Cashflow from operations</b>	<b>1,272</b>	<b>1,756</b>	<b>2,132</b>	<b>3,833</b>	<b>3,986</b>
Capital expenditure	(788)	(613)	(650)	(700)	(700)
<b>Free cashflow</b>	<b>483</b>	<b>1,143</b>	<b>1,482</b>	<b>3,133</b>	<b>3,286</b>
Reduction in investments	17	(27)	-	-	-
Net acquisitions	-	-	-	-	-
Reduction in other LT assets	(206)	(58)	-	-	-
Addition in other LT liabilities	(112)	(11)	-	-	-
Adjustments	-	-	-	-	-
<b>Cashflow after investing acts</b>	<b>183</b>	<b>1,048</b>	<b>1,482</b>	<b>3,133</b>	<b>3,286</b>
Cash dividends	(188)	-	(245)	(268)	(392)
Equity issue	(2)	2,694	-	-	-
Debt issue	1,502	(1,021)	-	-	-
Convertible debt issue	-	-	-	-	-
Others	(664)	387	124	(185)	(282)
<b>Cashflow from financial acts</b>	<b>648</b>	<b>2,060</b>	<b>(122)</b>	<b>(453)</b>	<b>(674)</b>
<b>Net cashflow</b>	<b>831</b>	<b>3,108</b>	<b>1,360</b>	<b>2,680</b>	<b>2,612</b>
Beginning cash	2,211	3,042	6,150	7,510	10,190
Ending cash	3,042	6,150	7,510	10,190	12,801
Ending net debt	(1,240)	(5,369)	(6,729)	(9,409)	(12,021)

Source: Nomura estimates

Balance sheet (RMBmn)					
As at 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Cash & equivalents	3,042	6,150	7,510	10,190	12,801
Marketable securities	-	-	-	-	-
Accounts receivable	349	580	523	785	778
Inventories	824	715	2,006	1,198	2,630
Other current assets	886	570	627	689	758
<b>Total current assets</b>	<b>5,102</b>	<b>8,014</b>	<b>10,666</b>	<b>12,862</b>	<b>16,968</b>
LT investments	58	85	85	85	85
Fixed assets	5,462	5,246	5,132	5,077	5,029
Goodwill	199	199	199	199	199
Other intangible assets	33	32	-	-	-
Other LT assets	462	520	520	520	520
<b>Total assets</b>	<b>11,315</b>	<b>14,096</b>	<b>16,602</b>	<b>18,743</b>	<b>22,800</b>
Short-term debt	1,282	431	431	431	431
Accounts payable	2,395	2,340	3,327	3,345	4,626
Other current liabilities	2,090	1,784	2,319	3,014	3,919
<b>Total current liabilities</b>	<b>5,766</b>	<b>4,554</b>	<b>6,077</b>	<b>6,790</b>	<b>8,975</b>
Long-term debt	520	350	350	350	350
Convertible debt	-	-	-	-	-
Other LT liabilities	291	280	280	280	280
<b>Total liabilities</b>	<b>6,577</b>	<b>5,184</b>	<b>6,707</b>	<b>7,420</b>	<b>9,606</b>
Minority interest	273	336	370	407	447
Preferred stock	-	-	-	-	-
Common stock	163	179	179	179	179
Retained earnings	4,301	8,397	9,346	10,738	12,569
Proposed dividends	-	-	-	-	-
Other equity and reserves	-	-	-	-	-
<b>Total shareholders' equity</b>	<b>4,465</b>	<b>8,576</b>	<b>9,525</b>	<b>10,916</b>	<b>12,747</b>
<b>Total equity &amp; liabilities</b>	<b>11,315</b>	<b>14,096</b>	<b>16,602</b>	<b>18,743</b>	<b>22,800</b>

**Liquidity (x)**

Current ratio	0.88	1.76	1.76	1.89	1.89
Interest cover	na	na	na	na	na

**Leverage**

Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

**Activity (days)**

Days receivable	5.6	6.6	6.6	6.6	6.6
Days inventory	16.2	14.9	22.0	22.0	22.1
Days payable	37.8	45.8	45.8	45.8	45.9
Cash cycle	(16.1)	(24.3)	(17.2)	(17.2)	(17.3)

Source: Nomura estimates

Net cash position in the long term



### ⊙ Action

We maintain BUY on CRCC after the market reacted strongly towards the negative news from Saudi Arabia, as, in our view: 1) its losses are one-off and should not affect FY11F EPS; 2) compensation from Saudi Arabia is possible; 3) its domestic business remains solid and is likely to surprise on the upside in 4Q and 4) its valuation looks attractive, especially considering its net cash position. Our PT is unchanged at HK\$11.8, which is based on 12x FY11F EPS of RMB0.82.

### ✂ Catalysts

Upward revisions to railway plans in China's 12th Five-Year Plan and compensation received for the Saudi metro project may serve as positive catalysts.

### ⚓ Anchor themes

While China's railway construction is still the most significant revenue contributor to Chinese E&C companies, the risks on their overseas projects may be an overhang for their stock performance.

## An undervalued railway player

### ① Stock undervalued due to Saudi loss

CRCC has obviously underperformed the Hang Seng index, railway equipment makers and even its peer CRG since July, partly due to losses from the Saudi metro project. Now trading at 9.6x FY11F P/E and 1.8x FY11F EV/EBITDA, we believe it is undervalued, especially considering its net cash position of over RMB30bn, taking about 35% of its market capitalisation, and this provides support on its downside.

We believe CRCC will eventually move out of the shadows, as: 1) the Saudi loss is more one-off in nature and the loss is fully booked in FY10F; 2) any compensation from the owner will be profit in FY11F; 3) this loss does not have a contagion effect on other projects and 4) CRCC will also learn lessons in terms of future overseas contracts.

### ② Domestic business remains solid

On the other hand, CRCC's domestic business remains solid. Excluding the Saudi loss, its 3Q10 revenue accounted for 51% of our 2H10 estimates, which is above our expectation, considering that 3Q:4Q revenue is typically about 40:60. Therefore, we believe the 4Q result will likely surprise the market on the upside, and revenue is likely to grow 20% in FY11F, due to the continuous investment by the Ministry of Railways (MoR).

### ③ Reiterate BUY and PT of HK\$11.80

We reaffirm BUY and our 12-month price target of HK\$11.8, which we derive by applying 12x target multiple to its FY11F EPS of RMB0.82 (forex assumption RMB1:HKD1.2). We believe the significant net cash position will provide protection on the downside. Risks to our view include any changes in government policy on railway development as well as country risks from its overseas projects.

Closing price on 1 Dec	HK\$9.42
Price target	<b>HK\$11.80</b> (set on 18 Nov 10)
Upside/downside	25.3%
Difference from consensus	<b>3.3%</b>
FY11F net profit (RMBmn)	10,113
Difference from consensus	<b>6.3%</b>
Source: Nomura	

### Nomura vs consensus

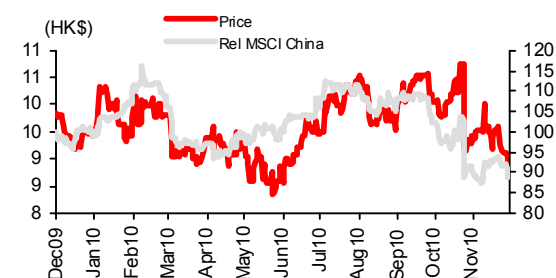
We believe its domestic business remains solid and CRCC will continue to benefit from China's railway boom.

### Key financials & valuations

31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Revenue	344,976	414,653	497,641	595,206
Reported net profit	6,599	4,535	10,113	12,021
Normalised net profit	6,599	4,535	10,113	12,021
Normalised EPS (RMB)	0.53	0.37	0.82	0.97
Norm. EPS growth (%)	65.0	(31.3)	123.0	18.9
Norm. P/E (x)	14.7	21.4	9.6	8.1
EV/EBITDA (x)	3.3	3.5	1.8	1.1
Price/book (x)	1.8	1.7	1.5	1.3
Dividend yield (%)	2.0	1.2	2.6	3.1
ROE (%)	13.1	8.3	16.8	17.5
Net debt/equity (%)		net cash	net cash	net cash
<b>Earnings revisions</b>				
Previous norm. net profit		4,535	10,113	12,021
Change from previous (%)		-	-	-
Previous norm. EPS (RMB)		0.37	0.82	0.97

Source: Company, Nomura estimates

### Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	(4.0)	(6.5)	3.6
Absolute (US\$)	(4.2)	(6.4)	4.0
Relative to Index	0.4	(15.7)	(11.3)
Market cap (US\$m)			12,666
Estimated free float (%)			71.5
52-week range (HK\$)			11.16/8.73
3-mth avg daily turnover (US\$m)			20.73
Stock borrowability			Easy
Major shareholders (%)			
Social Security Fund			8.2
JP Morgan Chase			7.2

Source: Company, Nomura estimates

## Drilling down

### Sunshine to come after heavy rain

The significant monetary loss incurred in the Saudi Mecca metro project announced on 25 October added to market concerns on overseas projects. However, we believe the effect has been fully or even overly factored in, as we believe CRCC will eventually step out of the shadow of this loss and remember this expensive lesson. The reasons for our positive view include: 1) the Saudi loss is more one-off in nature and the loss is fully booked in FY10F; 2) any compensation from the owner will be profit in FY11F; 3) this loss does not have any contagion effect on other projects and 4) we believe CRCC will learn lessons for future overseas contracts and seek to protect itself. Moving to FY11F, we estimate its revenue will grow 20% y-y, benefiting from the continuous investments by the Ministry of Railways (MoR).

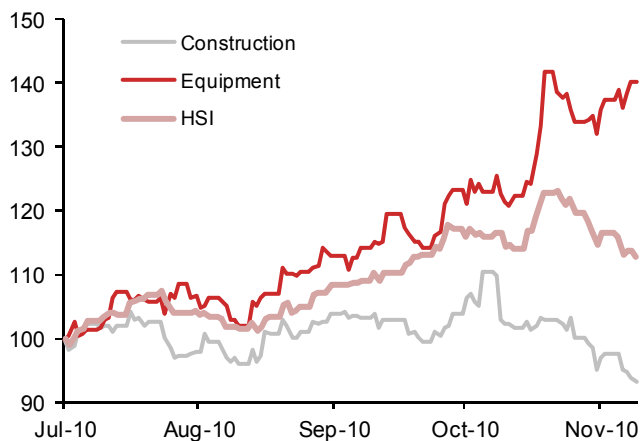
### Valuation methodology

Our 12-month price target of HK\$11.8 is derived by applying a 12x target multiple to its FY11F EPS of RMB0.82 (forex assumption RMB1:HKD1.2). We believe the target multiple of 12x is justified as global engineering and construction companies, on average, are trading at similar levels, based on Bloomberg consensus. With continuous investment in China's railway networks, we believe this target multiple is not aggressive.

### Risks to our investment view

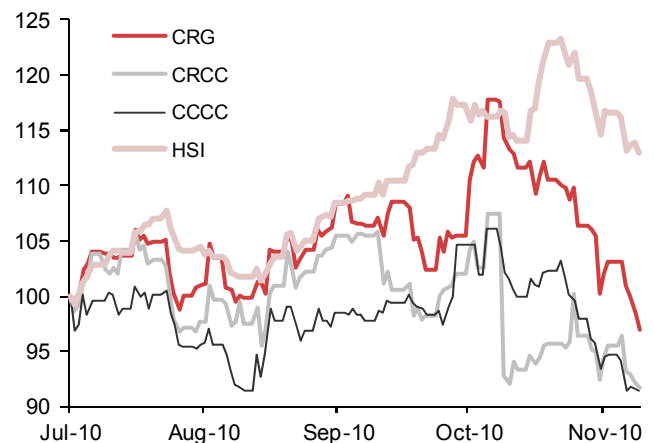
Any major shift in government policy in terms of infrastructure investments in China may impact the outlook for leading Chinese construction companies. Potential shortage of funding in emerging economies outside of China may result in lower sales and higher receivable write-offs for Chinese construction companies that have meaningful exposure to projects outside China. Any country risk incurred by its overseas project may significantly impact its earnings.

Exhibit 168. Historical price (18 Jul 10: 100)



Source: Bloomberg, Nomura research

Exhibit 169. Historical prices (18 Jul 10: 100)



Source: Bloomberg, Nomura research

## Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
<b>Revenue</b>	219,410	344,976	414,653	497,641	595,206
Cost of goods sold	(203,607)	(322,428)	(389,651)	(462,938)	(554,022)
<b>Gross profit</b>	<b>15,803</b>	<b>22,548</b>	<b>25,002</b>	<b>34,702</b>	<b>41,184</b>
SG&A	(10,233)	(14,913)	(16,918)	(19,756)	(23,630)
Employee share expense	(1,460)	(118)	(1,567)	(1,000)	(1,000)
<b>Operating profit</b>	<b>4,110</b>	<b>7,517</b>	<b>6,517</b>	<b>13,946</b>	<b>16,555</b>
<b>EBITDA</b>	<b>8,302</b>	<b>13,893</b>	<b>13,815</b>	<b>23,084</b>	<b>27,549</b>
Depreciation	(4,068)	(6,209)	(7,140)	(8,980)	(10,837)
Amortisation	(124)	(168)	(158)	(158)	(158)
<b>EBIT</b>	<b>4,110</b>	<b>7,517</b>	<b>6,517</b>	<b>13,946</b>	<b>16,555</b>
Net interest expense	55	(324)	(1,084)	(1,216)	(1,329)
Associates & JCEs	(9)	1	-	-	-
Other income	413	1,114	500	500	500
<b>Earnings before tax</b>	<b>4,569</b>	<b>8,307</b>	<b>5,933</b>	<b>13,230</b>	<b>15,726</b>
Income tax	(863)	(1,576)	(1,305)	(2,911)	(3,460)
<b>Net profit after tax</b>	<b>3,706</b>	<b>6,732</b>	<b>4,628</b>	<b>10,319</b>	<b>12,266</b>
Minority interests	(62)	(133)	(93)	(206)	(245)
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
<b>Normalised NPAT</b>	<b>3,644</b>	<b>6,599</b>	<b>4,535</b>	<b>10,113</b>	<b>12,021</b>
Extraordinary items	-	-	-	-	-
<b>Reported NPAT</b>	<b>3,644</b>	<b>6,599</b>	<b>4,535</b>	<b>10,113</b>	<b>12,021</b>
Dividends	(1,234)	(1,974)	(1,134)	(2,528)	(3,005)
<b>Transfer to reserves</b>	<b>2,410</b>	<b>4,625</b>	<b>3,401</b>	<b>7,585</b>	<b>9,016</b>

Domestic revenue remains solid

### Valuation and ratio analysis

FD normalised P/E (x)	24.2	14.7	21.4	9.6	8.1
FD normalised P/E at price target (x)	30.3	18.4	26.8	12.0	10.1
Reported P/E (x)	24.2	14.7	21.4	9.6	8.1
Dividend yield (%)	1.4	2.0	1.2	2.6	3.1
Price/cashflow (x)	12.1	5.5	7.7	4.2	3.2
Price/book (x)	1.8	1.8	1.7	1.5	1.3
EV/EBITDA (x)	5.9	3.3	3.5	1.8	1.1
EV/EBIT (x)	12.0	6.2	7.5	3.0	1.8
Gross margin (%)	7.2	6.5	6.0	7.0	6.9
EBITDA margin (%)	3.8	4.0	3.3	4.6	4.6
EBIT margin (%)	1.9	2.2	1.6	2.8	2.8
Net margin (%)	1.7	1.9	1.1	2.0	2.0
Effective tax rate (%)	18.9	19.0	22.0	22.0	22.0
Dividend payout (%)	33.9	29.9	25.0	25.0	25.0
Capex to sales (%)	5.5	4.5	3.6	3.0	2.5
Capex to depreciation (x)	3.0	2.5	2.1	1.7	1.4
ROE (%)	13.8	13.1	8.3	16.8	17.5
ROA (pretax %)	2.8	3.9	2.9	5.5	5.6

### Growth (%)

Revenue	27.6	57.2	20.2	20.0	19.6
EBITDA	22.9	67.4	(0.6)	67.1	19.3
EBIT	9.4	82.9	(13.3)	114.0	18.7
Normalised EPS	12.7	65.0	(31.3)	123.0	18.9
Normalised FDEPS	12.7	65.0	(31.3)	123.0	18.9

### Per share

Reported EPS (RMB)	0.32	0.53	0.37	0.82	0.97
Norm EPS (RMB)	0.32	0.53	0.37	0.82	0.97
Fully diluted norm EPS (RMB)	0.32	0.53	0.37	0.82	0.97
Book value per share (RMB)	4.25	4.32	4.59	5.19	5.92
DPS (RMB)	0.11	0.16	0.09	0.20	0.24

Source: Nomura estimates

Cashflow (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
EBITDA	8,302	13,893	13,815	23,084	27,549
Change in working capital	(2,851)	7,461	395	2,991	5,795
Other operating cashflow	1,849	(3,879)	(1,699)	(2,970)	(3,446)
<b>Cashflow from operations</b>	<b>7,300</b>	<b>17,475</b>	<b>12,511</b>	<b>23,104</b>	<b>29,898</b>
Capital expenditure	(12,103)	(15,571)	(15,000)	(15,000)	(15,000)
<b>Free cashflow</b>	<b>(4,803)</b>	<b>1,904</b>	<b>(2,489)</b>	<b>8,104</b>	<b>14,898</b>
Reduction in investments	(632)	(980)	(54)	(121)	(144)
Net acquisitions	-	-	-	-	-
Reduction in other LT assets	(1,200)	(38)	(130)	(130)	(130)
Addition in other LT liabilities	(255)	(830)	336	758	903
Adjustments	1,121	3,789	2,968	2,587	2,561
<b>Cashflow after investing acts</b>	<b>(5,768)</b>	<b>3,845</b>	<b>631</b>	<b>11,198</b>	<b>18,088</b>
Cash dividends	(1,234)	(1,974)	(1,134)	(2,528)	(3,005)
Equity issue					
Debt issue					
Convertible debt issue					
Others	35,818	5,492	(414)	1,591	2,050
<b>Cashflow from financial acts</b>	<b>34,584</b>	<b>3,518</b>	<b>(1,547)</b>	<b>(937)</b>	<b>(955)</b>
<b>Net cashflow</b>	<b>28,816</b>	<b>7,364</b>	<b>(916)</b>	<b>10,261</b>	<b>17,133</b>
Beginning cash	26,190	55,006	62,370	61,454	71,715
Ending cash	55,006	62,370	61,454	71,715	88,848
Ending net debt	(32,874)	(35,656)	(33,054)	(39,506)	(52,104)

Source: Nomura estimates

FCF expected to come

Balance sheet (RMBmn)					
As at 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Cash & equivalents	55,006	62,370	61,454	71,715	88,848
Marketable securities	364	945	998	1,119	1,263
Accounts receivable	32,774	44,896	46,577	55,899	66,859
Inventories	13,050	19,138	19,216	22,830	27,322
Other current assets	83,982	111,670	118,141	140,300	166,380
<b>Total current assets</b>	<b>185,176</b>	<b>239,019</b>	<b>246,387</b>	<b>291,864</b>	<b>350,672</b>
LT investments	1,661	2,060	2,060	2,060	2,060
Fixed assets	21,887	30,441	37,042	41,836	44,881
Goodwill	-	-	-	-	-
Other intangible assets	687	743	706	668	630
Other LT assets	10,690	10,728	10,858	10,988	11,118
<b>Total assets</b>	<b>220,101</b>	<b>282,990</b>	<b>297,051</b>	<b>347,415</b>	<b>409,360</b>
Short-term debt	16,412	12,579	13,374	15,167	17,303
Accounts payable	63,397	102,838	100,139	118,812	142,020
Other current liabilities	78,260	92,178	103,502	122,915	147,033
<b>Total current liabilities</b>	<b>158,069</b>	<b>207,595</b>	<b>217,014</b>	<b>256,894</b>	<b>306,356</b>
Long-term debt	5,720	14,134	15,027	17,042	19,441
Convertible debt	-	-	-	-	-
Other LT liabilities	8,011	7,181	7,517	8,276	9,179
<b>Total liabilities</b>	<b>171,800</b>	<b>228,911</b>	<b>239,558</b>	<b>282,211</b>	<b>334,976</b>
Minority interest	528	814	906	1,113	1,358
Preferred stock	-	-	-	-	-
Common stock	-	-	-	-	-
Retained earnings	47,773	53,265	56,587	64,091	73,027
Proposed dividends	-	-	-	-	-
Other equity and reserves	-	-	-	-	-
<b>Total shareholders' equity</b>	<b>47,773</b>	<b>53,265</b>	<b>56,587</b>	<b>64,091</b>	<b>73,027</b>
<b>Total equity &amp; liabilities</b>	<b>220,101</b>	<b>282,990</b>	<b>297,051</b>	<b>347,415</b>	<b>409,360</b>

**Liquidity (x)**

Current ratio	1.17	1.15	1.14	1.14	1.14
Interest cover	na	23.2	6.0	11.5	12.5

**Leverage**

Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

**Activity (days)**

Days receivable	52.6	41.1	40.3	37.6	37.7
Days inventory	18.9	18.2	18.0	16.6	16.6
Days payable	98.1	94.1	95.1	86.3	86.2
Cash cycle	(26.5)	(34.8)	(36.8)	(32.2)	(31.8)

Source: Nomura estimates

## Action

We lift our price target from HK\$4.1 to HK\$4.3 as we roll our valuations to FY11 and upgrade our earnings estimates due to better-than-expected sales and margin. We expect margins to continue to improve in the next 12 months, given Gome's product mix upgrade and sales efficiency improvement. We expect store expansion and SSS to drive earning growth beyond FY12F, as part of the company's five-year plan. Maintain BUY.

## Catalysts

Better-than-expected results, accelerating SSS and more favourable macro policies stand as positive catalysts.

## Anchor themes

With China's GDP likely to remain strong at 9.8% in 2011F, we are positive on the growth outlook for retail stocks. The transformation of China's economic growth appears to be under way, with consumption becoming increasingly important.

## Set to perform

### 1 Maintain BUY with a new PT of HK\$4.3

We maintain BUY on Gome and lift our price target to HK\$4.3, from HK\$4.1. We increase our recurring earnings forecasts by 7.0%, 12.6% and 14.1% for FY10F, FY11F and FY12F, respectively, factoring in accelerating store expansion and better margins. We believe the ongoing "old-for-new" programme and minimal wage increase will continue to benefit Gome, given its extensive network.

### 2 Store expansion pickup

As stated in the company's five-year plan, Gome will bring its total store number to 1,400 by 2014, from 787 stores by end-3Q10. We forecast 150 new store openings each year over FY11F-12F, from our previous forecast of 110 stores each year, with risks on the upside given the growth potential in lower-tier cities. In 3Q, the company already saw better SSS in lower-tier cities compared with those of first-tier cities. Gome may raise its store number in tier-2 markets as a percentage of the total to 55% in 2014 from 36% in end-3Q10. Store expansion and SSS will be key potential earnings drivers from FY12F.

Margin wise, we expect margins to continue to improve in the next 12 months, given its product mix upgrade and sales efficiency improvement. We expect its consolidated gross margin to improve from 17.1% in FY09 to 17.9% in FY10F, 18.1% in FY11F and 18.2% in FY12F, and operating margin to increase from 4.0% in FY09 to 5.1% in FY10F and 5.2% in each of FY11 and FY12F.

### 3 Aim to capture online shopping boom

E-commerce is one of the new initiatives in Gome's five-year plan. To capture the online shopping boom, Gome on Nov 22 acquired an 80% stake in B2C consumer electronic website Coo8.com for RMB48mn, aiming to command a 15% share in China's B2C market, or annual sales of RMB25-30bn by 2014. We expect Gome to gain more ground in the home appliance market with the help of the online shop.

Closing price on 1 Dec	HK\$3.15
Price target	<b>HK\$4.30</b> (from HK\$4.10)
Upside/downside	36.5%
Difference from consensus	<b>33.5%</b>
FY11 net profit (RMBmn)	2,320
Difference from consensus	<b>8.8%</b>
Source: Nomura	

## Nomura vs consensus

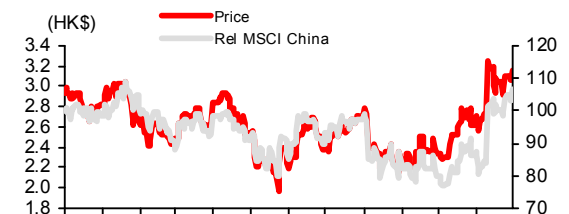
We are above the market, as we are more upbeat on Gome's growth outlook.

## Key financials & valuations

31 Dec (RMBmn)	FY09	FY10	FY11	FY12
Revenue	42,668	50,243	59,317	70,749
Reported net profit	1,409	2,042	2,320	2,788
Normalised net profit	1,598	2,319	2,780	3,228
Normalised EPS (RMB)	0.089	0.129	0.155	0.180
Norm. EPS growth (%)	(35.2)	45.1	19.9	16.1
Norm. P/E (x)	30.2	20.1	16.3	13.9
EV/EBITDA (x)	19.6	12.3	9.6	7.8
Price/book (x)	3.4	2.9	2.5	2.2
Dividend yield (%)	0.0	1.4	1.8	2.2
ROE (%)	13.8	16.2	16.3	17.3
Net debt/equity (%)		net cash	net cash	net cash
<b>Earnings revisions</b>				
Previous nom. net profit		2,168	2,469	2,829
Change from previous (%)		7.0	12.6	14.1
Previous nom. EPS (RMB)		0.121	0.138	0.158

Source: Company, Nomura estimates

## Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	16.2	37.0	40.6
Absolute (US\$)	16.0	37.1	41.1
Relative to Index	20.5	27.8	25.8
Market cap (US\$m)			6,106
Estimated free float (%)			59.0
52-week range (HK\$)			3.24/1.97
3-mth avg daily turnover (US\$m)			63.8
Stock borrowability			Easy
Major shareholders (%)			
Huang Guangyu			31.0
Bain capital			10.0

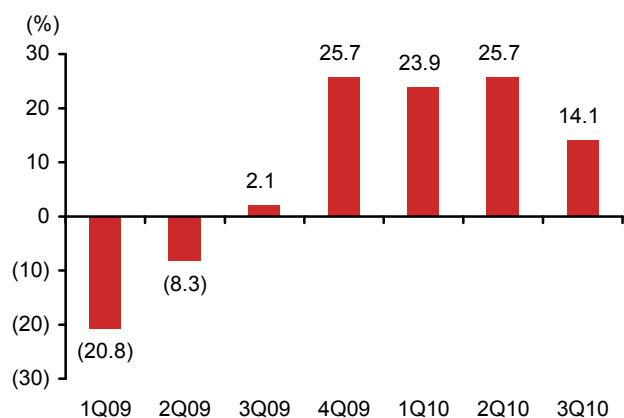
Source: Company, Nomura estimates

## Valuation methodology and risks

We lift our FY10-12F recurring earnings estimates by 7.0%, 12.6% and 14.1%, respectively, to reflect accelerating store expansion and margin expansions due to improved product mix. With our earning forecast 9% higher than consensus in FY11F, we expect upside revision in consensus earnings forecasts.

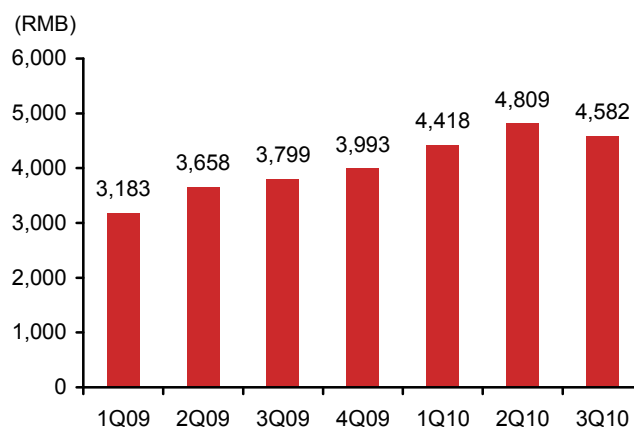
Our price target of HK\$4.3 is based on 22x FY11F P/E (EPS: RMB0.155), in line with its historical 12-month forward P/E. Our previous price target of HK\$4.1 was based on 28x FY10F P/E (EPS: RMB0.121), at a 25% premium over its historical 12-month forward P/E. The removal of the 25% premium is because: 1) we believe earnings will become more normalised from FY11F onwards after its store restructuring in FY07-09; 2) we expect the “old-for-new” and rural subsidy policy launched in 2009 nationwide to continue in 2011 and beyond. We estimate Gome will witness strong earnings growth of 45.1% in FY10F. While we think this remarkable growth is unlikely to be sustainable, we expect it to post strong growth of 19.9% in FY11F and 16.1% in FY12F. We foresee upside revision due to better-than-expected store efficiency and store number. Downside risks: lower-than-expected SSS and margins.

**Exhibit 170. Same store sales**



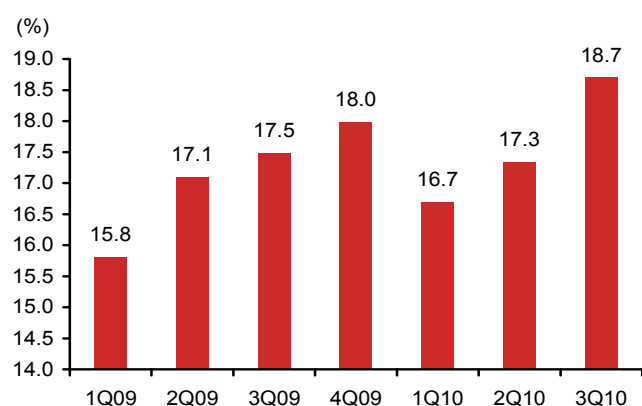
Source: Company data, Nomura research

**Exhibit 171. Sales per sqm**



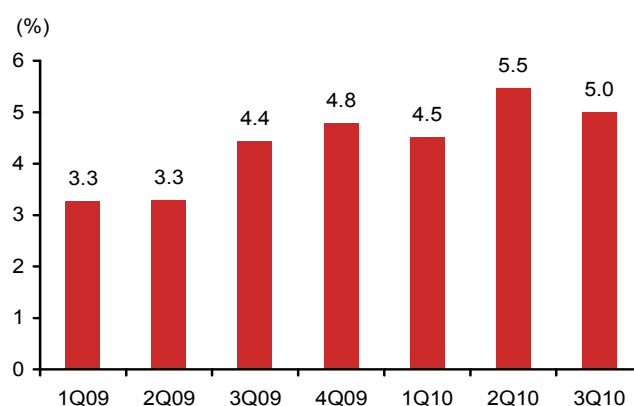
Source: Company data, Nomura research

**Exhibit 172. Consolidated gross margin**



Source: Company data, Nomura research

**Exhibit 173. EBIT margin**



Source: Company data, Nomura research

**Exhibit 174. Key assumptions**

Year-end Dec	2009	2010F	2011F	2012F
Number of stores	726	826	976	1,126
Total retail space (sqm)	2,675,000	3,104,686	3,705,176	4,317,365
Avg sales/sqm (RMB)	15,184	17,386	17,734	17,911
Consolidated gross margin (%)	17.1	17.9	18.1	18.2
EBIT margin (%)	4.0	5.1	5.2	5.2

Source: Company data, Nomura estimates

## Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10	FY11	FY12
<b>Revenue</b>	45,889	42,668	50,243	59,317	70,749
Cost of goods sold	(41,381)	(38,408)	(44,724)	(52,624)	(62,625)
<b>Gross profit</b>	<b>4,508</b>	<b>4,260</b>	<b>5,518</b>	<b>6,693</b>	<b>8,124</b>
SG&A	(2,564)	(2,563)	(2,981)	(3,601)	(4,473)
Employee share expense					
<b>Operating profit</b>	<b>1,944</b>	<b>1,696</b>	<b>2,538</b>	<b>3,091</b>	<b>3,651</b>
<b>EBITDA</b>	<b>2,250</b>	<b>2,051</b>	<b>2,920</b>	<b>3,536</b>	<b>4,159</b>
Depreciation	(306)	(355)	(382)	(445)	(508)
Amortisation					
<b>EBIT</b>	<b>1,944</b>	<b>1,696</b>	<b>2,538</b>	<b>3,091</b>	<b>3,651</b>
Net interest expense	441	325	361	384	384
Associates & JCEs					
Other income				-	-
<b>Earnings before tax</b>	<b>2,385</b>	<b>2,021</b>	<b>2,898</b>	<b>3,475</b>	<b>4,035</b>
Income tax	(435)	(406)	(580)	(695)	(807)
<b>Net profit after tax</b>	<b>1,950</b>	<b>1,615</b>	<b>2,319</b>	<b>2,780</b>	<b>3,228</b>
Minority interests	(51)	(17)	-	-	-
Other items					
Preferred dividends					
<b>Normalised NPAT</b>	<b>1,899</b>	<b>1,598</b>	<b>2,319</b>	<b>2,780</b>	<b>3,228</b>
Extraordinary items	(851)	(189)	(277)	(460)	(440)
<b>Reported NPAT</b>	<b>1,048</b>	<b>1,409</b>	<b>2,042</b>	<b>2,320</b>	<b>2,788</b>
Dividends	(344)	-	(552)	(696)	(836)
<b>Transfer to reserves</b>	<b>704</b>	<b>1,409</b>	<b>1,490</b>	<b>1,624</b>	<b>1,952</b>
<b>Valuation and ratio analysis</b>					
FD normalised P/E (x)	20.7	30.2	20.1	16.3	13.9
FD normalised P/E at price target (x)	28.2	41.3	27.4	22.2	19.0
Reported P/E (x)	37.5	34.3	22.8	19.5	16.1
Dividend yield (%)	0.9	-	1.4	1.8	2.2
Price/cashflow (x)	17.7	na	21.9	18.6	16.2
Price/book (x)	4.1	3.4	2.9	2.5	2.2
EV/EBITDA (x)	19.4	19.6	12.3	9.6	7.8
EV/EBIT (x)	22.4	23.7	14.1	10.9	8.9
Gross margin (%)	9.8	10.0	11.0	11.3	11.5
EBITDA margin (%)	4.9	4.8	5.8	6.0	5.9
EBIT margin (%)	4.2	4.0	5.1	5.2	5.2
Net margin (%)	2.3	3.3	4.1	3.9	3.9
Effective tax rate (%)	18.2	20.1	20.0	20.0	20.0
Dividend payout (%)	32.9	-	27.0	30.0	30.0
Capex to sales (%)	2.6	0.8	1.6	1.3	1.1
Capex to depreciation (x)	3.9	0.9	2.1	1.8	1.6
ROE (%)	11.1	13.8	16.2	16.3	17.3
ROA (pretax %)	8.1	6.3	8.5	9.8	10.6
<b>Growth (%)</b>					
Revenue	8.0	(7.0)	17.8	18.1	19.3
EBITDA	8.8	(8.8)	42.4	21.1	17.6
EBIT	7.8	(12.7)	49.6	21.8	18.1
Normalised EPS	7.9	(35.2)	45.1	19.9	16.1
Normalised FDEPS	7.9	(35.2)	45.1	19.9	16.1
<b>Per share</b>					
Reported EPS (RMB)	0.08	0.08	0.11	0.13	0.16
Norm EPS (RMB)	0.14	0.09	0.13	0.16	0.18
Fully diluted norm EPS (RMB)	0.14	0.09	0.13	0.16	0.18
Book value per share (RMB)	0.67	0.78	0.89	1.00	1.13
DPS (RMB)	0.03	-	0.04	0.05	0.06

Revenue driven by store openings

Cashflow (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10	FY11	FY12
EBITDA	2,250	2,051	2,920	3,536	4,159
Change in working capital	(267)	1,363	1,711	(327)	(534)
Other operating cashflow	238	(3,588)	(2,504)	(779)	(852)
<b>Cashflow from operations</b>	<b>2,220</b>	<b>(175)</b>	<b>2,126</b>	<b>2,430</b>	<b>2,772</b>
Capital expenditure	(1,180)	(330)	(800)	(800)	(800)
<b>Free cashflow</b>	<b>1,041</b>	<b>(504)</b>	<b>1,326</b>	<b>1,630</b>	<b>1,972</b>
Reduction in investments	-	-	-	-	-
Net acquisitions	(3,350)	(3)	-	-	-
Reduction in other LT assets	(927)	(3,163)	-	(0)	(0)
Addition in other LT liabilities	(2)	25	-	-	-
Adjustments	2,979	3,176	1,814	17	(2)
<b>Cashflow after investing acts</b>	<b>(259)</b>	<b>(469)</b>	<b>3,140</b>	<b>1,647</b>	<b>1,970</b>
Cash dividends	(661)	-	(276)	(624)	(766)
Equity issue	(2,068)	1,266	-	-	-
Debt issue	(130)	180	-	-	-
Convertible debt issue	-	2,037	-	-	-
Others	(101)	(37)	-	-	-
<b>Cashflow from financial acts</b>	<b>(2,960)</b>	<b>3,447</b>	<b>(276)</b>	<b>(624)</b>	<b>(766)</b>
<b>Net cashflow</b>	<b>(3,219)</b>	<b>2,978</b>	<b>2,865</b>	<b>1,023</b>	<b>1,204</b>
Beginning cash	6,270	3,051	6,029	8,894	9,917
Ending cash	3,051	6,029	8,894	9,917	11,121
Ending net debt	688	(324)	(3,188)	(4,211)	(5,415)

Source: Nomura estimates

Balance sheet (RMBmn)					
As at 31 Dec	FY08	FY09	FY10	FY11	FY12
Cash & equivalents	3,051	6,029	8,894	9,917	11,121
Marketable securities					
Accounts receivable	45	54	62	72	82
Inventories	5,473	6,532	7,759	9,312	11,303
Other current assets	9,913	10,657	9,484	10,201	11,029
<b>Total current assets</b>	<b>18,483</b>	<b>23,273</b>	<b>26,198</b>	<b>29,501</b>	<b>33,536</b>
LT investments					
Fixed assets	3,720	3,392	3,810	4,165	4,457
Goodwill	3,363	4,015	4,015	4,015	4,015
Other intangible assets	134	125	116	107	98
Other LT assets	1,795	4,958	4,958	4,958	4,958
<b>Total assets</b>	<b>27,495</b>	<b>35,763</b>	<b>39,098</b>	<b>42,746</b>	<b>47,065</b>
Short-term debt	170	2,530	2,530	2,530	2,530
Accounts payable	12,918	15,815	17,082	18,550	20,275
Other current liabilities	2,059	2,337	2,842	3,327	3,897
<b>Total current liabilities</b>	<b>15,147</b>	<b>20,682</b>	<b>22,454</b>	<b>24,406</b>	<b>26,703</b>
Long-term debt					
Convertible debt	3,570	3,175	3,175	3,175	3,175
Other LT liabilities	78	103	103	103	103
<b>Total liabilities</b>	<b>18,795</b>	<b>23,961</b>	<b>25,733</b>	<b>27,685</b>	<b>29,981</b>
Minority interest	140	-	-	-	-
Preferred stock					
Common stock	332	382	382	382	382
Retained earnings	8,228	11,420	12,983	14,679	16,701
Proposed dividends					
Other equity and reserves					
<b>Total shareholders' equity</b>	<b>8,560</b>	<b>11,802</b>	<b>13,365</b>	<b>15,062</b>	<b>17,083</b>
<b>Total equity &amp; liabilities</b>	<b>27,495</b>	<b>35,763</b>	<b>39,098</b>	<b>42,746</b>	<b>47,065</b>

Net cash position

<b>Liquidity (x)</b>					
Current ratio	1.22	1.13	1.17	1.21	1.26
Interest cover	na	na	na	na	na
<b>Leverage</b>					
Net debt/EBITDA (x)	0.31	net cash	net cash	net cash	net cash
Net debt/equity (%)	8.0	net cash	net cash	net cash	net cash
<b>Activity (days)</b>					
Days receivable	0.6	0.4	0.4	0.4	0.4
Days inventory	48.0	57.0	58.3	59.2	60.2
Days payable	117.1	136.5	134.2	123.6	113.5
Cash cycle	(68.5)	(79.1)	(75.5)	(64.0)	(52.8)

Source: Nomura estimates

### ⊙ Action

Perfect World's stock has pulled back significantly after failing to beat estimates in the core business in 3Q10. We estimate that 3Q will mark the bottom for non-GAAP operating margin and we believe that investors should look beyond current results and look to the new game launches and strong pipeline. We reaffirm our BUY rating and our 12-month PT of US\$37, equivalent to 10.3x FY11F P/E.

### ⚡ Catalysts

New games in the pipeline and increasing traction in current games should continue to drive growth in FY11F and serve as potential catalysts.

### ⚓ Anchor themes

Shielded from the slowing world economy (minimal revenue outside China) and with a low Internet penetration rate, Chinese online-gaming stocks offer good defensive and growth components for a China portfolio, in our view, given their counter-cyclical business model and high cashflow generation.

## Pipeline to drive incremental growth

### ① New games kicking in

Perfect World launched two new games, Forsaken World and Dragon Excalibur, in October. In addition, the company plans to launch two major expansion packs for Perfect World II and Zhu Xian in 4Q10F. Another expansion pack for BOI is also slated for the coming months. As a result, we believe that aggregate APUs and ACUs will improve going forward. We believe that investors should look beyond current results and look to the pipeline. There are another four games in the pipeline that the company plans to launch in 2011, starting with Empire of Immortals (EOI) in 1Q11. Xiao Ao Jiang Hu (XAJH) is tentatively scheduled for launch in 2H11, according to management.

### ② Operating margins hitting the bottom

We estimate that 3Q will mark the bottom for non-GAAP operating margin at Perfect World. Although the margins for the online gaming industry in China will likely remain under pressure as R&D and S&M expenses are not likely to decrease in the near future due to intensified competition, we expect gradual improvement on Perfect World's margins going forward, largely owing to top-line leverage, when new games and expansion packs contribute to the incremental growth.

### ③ Reaffirming BUY and PT of US\$37

We reaffirm our BUY rating and our 12-month PT of US\$37, equivalent to 10.3x FY11F P/E – in line with our adjusted peer group average – applied to our fully diluted FY11F EPS estimate (excluding sbc) of US\$3.58.

Closing price on 30 Nov	US\$23.70
Price target	<b>US\$37.00</b>
	(set on 16 Nov 10)
Upside/downside	56.1%
Difference from consensus	<b>9.7%</b>
FY11F net profit (US\$m)	167.3
Difference from consensus	na
Source: Nomura	

### Nomura vs consensus

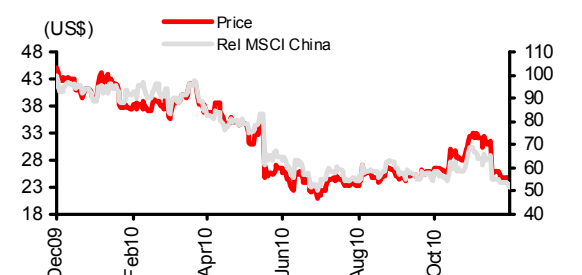
We believe consensus is in the process of adjustment for the latest announced results.

### Key financials & valuations

31 Dec (US\$m)	FY09	FY10F	FY11F	FY12F
Revenue	314.0	367.8	442.4	499.2
Reported net profit	151.9	134.5	167.3	193.2
Normalised net profit	163.3	148.5	182.8	210.7
Normalised EPS (US\$)	3.06	2.81	3.58	4.13
Norm. EPS growth (%)	59.3	(8.2)	27.4	15.3
Norm. P/E (x)	7.7	8.4	6.6	5.7
EV/EBITDA (x)	5.7	5.4	3.4	2.1
Price/book (x)	3.6	2.4	1.8	1.4
Dividend yield (%)	0.0	0.0	0.0	0.0
ROE (%)	52.3	32.8	29.1	25.0
Net debt/equity (%)		net cash	net cash	net cash
<b>Earnings revisions</b>				
Previous norm. net profit		148.5	182.8	210.7
Change from previous (%)		-	-	-
Previous norm. EPS (US\$)		2.81	3.58	4.13

Source: Company, Nomura estimates

### Share price relative to MSCI China



	1m	3m	6m
Absolute (US\$)	(26.9)	(8.7)	(10.5)
Relative to Index	(24.6)	(17.8)	(23.2)
Market cap (US\$m)			1,255
Estimated free float (%)			100.0
52-week range (US\$)			45.11/20.79
3-mth avg daily turnover (US\$m)			19.84
Stock borrowability			Easy
Major shareholders (%)			
Fidelity			11.9
Maverick			7.9

Source: Company, Nomura estimates

## Investment summary and valuation

## Key investment positives

- New games kicking in.** The company launched two new games, Forsaken World and Dragon Excalibur, in October. According to management, Forsaken World did better than expected (we believe ACUs continue to top 160K since release), while Dragon Excalibur is off to a slow start, with ACUs for that game topping 60K. Although we do not believe the two games will become hit games in China, we think they will provide much-needed incremental contributions to the top line, as the current games in the portfolio are stagnant, mainly driven by ARPU strength. We believe that the entire 1-5% q-q growth in guidance comes from the two new games, as we expect existing games to remain flat. In addition to the two new games, the company plans to launch two major expansion packs for Perfect World II and Zhu Xian in 4Q10F. Another expansion pack for BOI is also slated for the coming months. As a result, we believe that aggregate APUs and ACUs will improve going forward. We expect ARPU to decrease in 4Q10F due to the dilution effect of new games. The newly launched titles and upcoming expansion packs should be particularly impactful in 1Q11F and 2Q11F, in our view, and we believe that investors should look beyond current results and look to the pipeline. There are another four games in the pipeline that the company plans to launch in 2011, starting with Empire of Immortals (EOI) in 1Q11. Xiao Ao Jiang Hu (XAJH) is tentatively scheduled for launch in 2H11, according to management.
- Hitting the bottom.** We estimate that 3Q will mark the bottom for non-GAAP operating margin at Perfect World. While operating margins at 36.1% came in above our expectations, we expect gradual improvement going forward, hitting 42.3% in 3Q11F, largely owing to top-line leverage. We also believe that 3Q will be the trough for several key performing metrics such as APCs and APUs, as we expect contributions from the new games to drive traffic and momentum back to the company. We expect APCs and APUs to improve 5% and 7%, respectively, on a q-q basis, driven by new games such as Dragon Excalibur and Forsaken World. We do not expect significant contributions from declining legacy games; much of the incremental growth should come from the new games and expansion packs. However we believe that margins will likely remain under pressure, as R&D and S&M expenses are not likely to decrease in the near future.

Despite headwind in the industry, new games are kicking in

## Reaffirming BUY and PT of US\$37

We believe that with the launch of new games, Perfect World should experience a gradual expansion in valuations as investors feel more comfortable with the prospect of a timely game launch. Furthermore, we note that gaming companies typically trade well ahead of actual game commercialisation, as evidenced below by Netease and Shanda Interactive. Netease shares were up 37% after Wrath of Lich King was approved but prior to commercialisation, and Shanda was up 157% in the run-up to commercialisation of AION.

We use P/E valuation to determine our price target rather than using a discounted cashflow (DCF) basis, because we believe this is the most suitable metric to determine the value of Chinese Internet companies given the business cyclicality, the lack of earnings visibility and the short history of China's internet industry. We reaffirm our BUY rating and our 12-month price target of US\$37, equivalent to 10.3x FY11F P/E, largely in line with our adjusted peer group average of 9.7x FY11F P/E applied to our fully diluted FY11 EPS estimate (excluding share-based compensation) of US\$3.58. This implies potential upside of 56.1%. The valuation methodology is unchanged.

PT now implies 10.3x FY11F P/E, largely in line with our adjusted peer group average

**Investment risks.** Company-specific risks to our price target and estimates include: 1) any delays in future gaming releases; 2) new games failing to generate material revenue; 3) declining performance of existing games, including the newly launched *Fantasy Zhu Xian*; and 4) minimal penetration in tier-3 and tier-4 cities in China.

## Financial statements

Income statement (US\$mn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
<b>Revenue</b>	211	314	368	442	499
Cost of goods sold	(25)	(43)	(64)	(69)	(77)
<b>Gross profit</b>	<b>185</b>	<b>271</b>	<b>304</b>	<b>374</b>	<b>422</b>
SG&A	(67)	(101)	(148)	(179)	(194)
Employee share expense					
<b>Operating profit</b>	<b>118</b>	<b>170</b>	<b>156</b>	<b>195</b>	<b>228</b>
<b>EBITDA</b>	<b>133</b>	<b>180</b>	<b>166</b>	<b>207</b>	<b>241</b>
Depreciation	(15)	(10)	(10)	(11)	(13)
Amortisation	-	-	-	-	-
<b>EBIT</b>	<b>118</b>	<b>170</b>	<b>156</b>	<b>195</b>	<b>228</b>
Net interest expense	5	2	4	2	2
Associates & JCEs	(0)	(1)	(1)	-	-
Other income	(2)	2	1	2	2
<b>Earnings before tax</b>	<b>122</b>	<b>173</b>	<b>161</b>	<b>199</b>	<b>232</b>
Income tax	(8)	(10)	(14)	(17)	(21)
<b>Net profit after tax</b>	<b>114</b>	<b>163</b>	<b>147</b>	<b>183</b>	<b>211</b>
Minority interests	-	(0)	2	-	-
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
<b>Normalised NPAT</b>	<b>114</b>	<b>163</b>	<b>149</b>	<b>183</b>	<b>211</b>
Extraordinary items	(19)	(11)	(14)	(15)	(17)
<b>Reported NPAT</b>	<b>95</b>	<b>152</b>	<b>134</b>	<b>167</b>	<b>193</b>
Dividends	-	-	-	-	-
<b>Transfer to reserves</b>	<b>95</b>	<b>152</b>	<b>134</b>	<b>167</b>	<b>193</b>
<b>Valuation and ratio analysis</b>					
FD normalised P/E (x)	12.3	7.7	8.4	6.6	5.7
FD normalised P/E at price target (x)	19.2	12.1	13.1	10.3	9.0
Reported P/E (x)	14.8	8.3	9.3	7.2	6.3
Dividend yield (%)	-	-	-	-	-
Price/cashflow (x)	9.9	6.7	7.3	7.1	7.1
Price/book (x)	5.5	3.6	2.4	1.8	1.4
EV/EBITDA (x)	8.0	5.7	5.4	3.4	2.1
EV/EBIT (x)	9.0	6.0	5.7	3.6	2.2
Gross margin (%)	88.0	86.3	82.7	84.5	84.5
EBITDA margin (%)	63.2	57.2	45.2	46.7	48.3
EBIT margin (%)	56.2	54.2	42.4	44.1	45.7
Net margin (%)	45.0	48.4	36.6	37.8	38.7
Effective tax rate (%)	6.4	5.8	8.7	8.3	9.2
Dividend payout (%)	-	-	-	-	-
Capex to sales (%)	52.9	7.9	7.7	6.4	5.6
Capex to depreciation (x)	7.6	2.6	2.8	2.5	2.2
ROE (%)	43.6	52.3	32.8	29.1	25.0
ROA (pretax %)	116.3	86.7	69.5	78.1	81.2
<b>Growth (%)</b>					
Revenue	123.0	49.1	17.1	20.3	12.8
EBITDA	165.7	34.9	(7.5)	24.4	16.6
EBIT	141.0	43.6	(8.3)	25.2	16.8
Normalised EPS	102.1	59.3	(8.2)	27.4	15.3
Normalised FDEPS	102.1	59.3	(8.2)	27.4	15.3
<b>Per share</b>					
Reported EPS (US\$)	1.60	2.85	2.55	3.28	3.79
Norm EPS (US\$)	1.92	3.06	2.81	3.58	4.13
Fully diluted norm EPS (US\$)	1.92	3.06	2.81	3.58	4.13
Book value per share (US\$)	4.34	6.67	9.68	13.32	17.52
DPS (US\$)	-	-	-	-	-

Source: Nomura estimates

New games and expansion packs drive revenue growth

Margins remain under pressure due to increasing R&D and S&M expenses

Cashflow (US\$mn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
EBITDA	133	180	166	207	241
Change in working capital	61	(14)	13	18	14
Other operating cashflow	(51)	22	(8)	(53)	(83)
<b>Cashflow from operations</b>	<b>142</b>	<b>187</b>	<b>171</b>	<b>171</b>	<b>171</b>
Capital expenditure	(112)	(25)	(28)	(28)	(28)
<b>Free cashflow</b>	<b>31</b>	<b>163</b>	<b>143</b>	<b>143</b>	<b>143</b>
Reduction in investments	(11)	2	(1)	(1)	(1)
Net acquisitions	(22)				
Reduction in other LT assets	(3)	(4)	(1)	(2)	(1)
Addition in other LT liabilities	8	(5)	1	1	1
Adjustments	(20)	5	(2)	(2)	(2)
<b>Cashflow after investing acts</b>	<b>(17)</b>	<b>161</b>	<b>140</b>	<b>140</b>	<b>140</b>
Cash dividends					
Equity issue	1	2	-	-	-
Debt issue	-	-	-	-	-
Convertible debt issue					
Others	7	(129)	-	37	58
<b>Cashflow from financial acts</b>	<b>7</b>	<b>(127)</b>	<b>-</b>	<b>37</b>	<b>58</b>
<b>Net cashflow</b>	<b>(10)</b>	<b>34</b>	<b>140</b>	<b>177</b>	<b>198</b>
Beginning cash	205	195	230	369	546
Ending cash	195	230	369	546	743
Ending net debt	(195)	(230)	(369)	(546)	(743)

Source: Nomura estimates

Balance sheet (US\$mn)					
As at 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Cash & equivalents	195	230	369	546	743
Marketable securities	7	4	5	6	7
Accounts receivable	6	13	16	19	21
Inventories	-	-	-	-	-
Other current assets	28	9	11	13	15
<b>Total current assets</b>	<b>236</b>	<b>256</b>	<b>401</b>	<b>583</b>	<b>786</b>
LT investments	3	4	4	4	4
Fixed assets	129	149	167	189	214
Goodwill	-	17	17	17	17
Other intangible assets	4	8	8	8	8
Other LT assets	3	7	8	9	11
<b>Total assets</b>	<b>376</b>	<b>441</b>	<b>604</b>	<b>811</b>	<b>1,040</b>
Short-term debt	-	-	-	-	-
Accounts payable	2	13	16	19	21
Other current liabilities	121	84	98	118	133
<b>Total current liabilities</b>	<b>123</b>	<b>97</b>	<b>114</b>	<b>137</b>	<b>155</b>
Long-term debt	-	-	-	-	-
Convertible debt	-	-	-	-	-
Other LT liabilities	9	4	5	6	7
<b>Total liabilities</b>	<b>131</b>	<b>102</b>	<b>119</b>	<b>143</b>	<b>161</b>
Minority interest	-	3	1	1	1
Preferred stock	-	-	-	-	-
Common stock	-	-	-	-	-
Retained earnings	-	-	-	-	-
Proposed dividends	-	-	-	-	-
Other equity and reserves	244	337	484	667	878
<b>Total shareholders' equity</b>	<b>244</b>	<b>337</b>	<b>484</b>	<b>667</b>	<b>878</b>
<b>Total equity &amp; liabilities</b>	<b>376</b>	<b>441</b>	<b>604</b>	<b>811</b>	<b>1,040</b>

**Liquidity (x)**

Current ratio	1.93	2.63	3.51	4.25	5.08
Interest cover	na	na	na	na	na

**Leverage**

Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

**Activity (days)**

Days receivable	6.9	11.0	14.3	14.1	14.6
Days inventory	-	-	-	-	-
Days payable	37.8	65.5	84.1	92.7	95.7
Cash cycle	(30.8)	(54.5)	(69.8)	(78.6)	(81.2)

Source: Nomura estimates

### ⊙ Action

Sinopec is our near-term top pick in the China oil and gas sector due to its attractive valuations, potential upside in petrochem earnings and a likely rerating of the stock in line with its improving returns despite assuming low refining margins. We maintain our BUY rating and target price of HK\$9.60, based on ROACE/WACC (14.3%/10.3%).

### ⚡ Catalysts

The next catalyst could be when the government improves the oil product pricing mechanism or VAT on oil products, which we believe could be towards end-2010 or early 2011.

### ⚓ Anchor themes

We believe the chemical sector is poised to enter a golden age, benefiting from rising demand and restrained capacity additions over the next two years. This should result in improved margins and petrochem sector earnings.

Closing price on 1 Dec	HK\$7.28
Price target	<b>HK\$9.60</b>
	(set on 25 Nov 10)
Upside/downside	31.9%
Difference from consensus	<b>11.0%</b>
FY11F net profit (RMBmn)	86,837
Difference from consensus	<b>17.8%</b>
Source: Nomura	

### Nomura vs consensus

Our FY11F earnings estimates are above consensus due to factoring in the Angola oilfield.

## Rerate on improving returns

### ① Upstream asset injection boosts earnings

Sinopec announced the purchase of an upstream asset, Block-18 Angola, from its parent on 26 March 2010 for US\$2.457bn. The incorporation of Angola Block-18 will add 102.49 mmbbl of 1P proven reserves (an increase of 3.63%) and 72.52 mmbbl/d of production (an increase of 9%) to Sinopec, in our view.

### ② Chemical upcycle spurs earnings momentum

Over the past 15 months, Sinopec has added around 50% or 2.8mn tonnes of ethylene capacity which has proven to be an opportune time as we think that the petrochemical cycle is entering an upward trend over the next few years which should boost overall margins and earnings.

### ③ Waiting for an improved pricing mechanism

Sinopec thinks that the market is overly concerned about its refining business due to losses during 2005-08. The company believes that the current pricing mechanism should ensure profits while an upcoming improved version should further benefit margins.

### ④ Valuation

We think Sinopec is trading at a compelling valuation at 6.4x FY11F PE, 3.9x EV/EBITDA and 1.1x P/B while ROACE is 14.3%.

### ⑤ Regulatory risks – remain cautious on refining

Even though we think that it is unlikely that the government will allow losses, we think that a high inflationary environment could put pressure on the NDRC to limit product price increases.

### Key financials & valuations

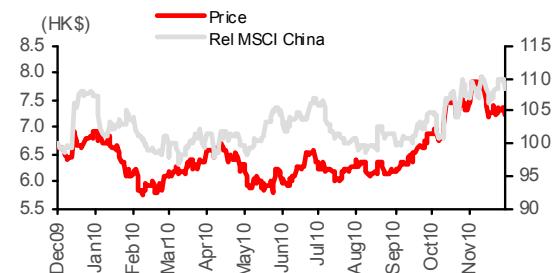
31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Revenue	1,345.05	1,851.79	2,212.35	2,531.56
Reported net profit	61,760	75,341	86,837	97,851
Normalised net profit	61,760	75,341	86,837	97,851
Normalised EPS (RMB)	0.71	0.87	1.00	1.13
Norm. EPS growth (%)	72.4	22.0	15.3	12.7
Norm. P/E (x)	9.0	7.4	6.4	5.7
EV/EBITDA (x)	5.6	4.6	4.1	3.6
Price/book (x)	1.5	1.3	1.1	1.0
Dividend yield (%)	2.8	3.7	4.2	4.7
ROE (%)	17.6	18.6	18.6	18.3
Net debt/equity (%)	55.8	49.0	42.5	36.3

### Earnings revisions

Previous norm. net profit	75,341	86,837	97,851
Change from previous (%)	-	-	-
Previous norm. EPS (RMB)	0.87	1.00	1.13

Source: Company, Nomura estimates

### Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	(2.8)	17.6	19.7
Absolute (US\$)	(3.0)	17.7	20.1
Relative to Index	0.7	7.5	3.9
Market cap (US\$mn)			81,259
Estimated free float (%)			22.6
52-week range (HK\$)			7.94/5.75
3-mth avg daily turnover (US\$mn)			90.2
Stock borrowability			Easy
Major shareholders (%)			
Sinopec Group			71.2

Source: Company, Nomura estimates

## Drilling down

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### Refining

Sinopec believes that the NDRC will likely continue to follow the mechanism until oil prices exceed US\$130/bbl since the government said that oil prices have little indirect impact on CPI. The government is likely to modify the mechanism by shortening the number of days (currently 22 working days) and by narrowing the trigger (currently 4% of oil price fluctuation) which should be positive for the refining sector. While the government has not given a specific timing for the change, it is possible that the new measures will be announced at the end of 2010, we believe.

We think the government is unlikely to let the refiners suffer losses since losses will deter future investments in the sector which will cause shortages in the system. However, it is also unlikely that the government will allow windfall profits like in 1H09 especially in light of the inflationary environment. We think that the government will probably lower the VAT burden on the refiners and allow a narrow margin that moves more in line with international prices. Over the next two years, we are forecasting refining EBIT of around RMB4bn per quarter or RMB16bn per year indicating a marginal operating margin of 1.1%-1.3%.

### Marketing

We continue to think that the marketing sector will remain stable, growing in line with volume growth. If the government improves the pricing mechanism to discourage hoarding and demand swings, margins will likely remain stable.

### Petrochem

Sinopec has added 2.8 mn tonnes of ethylene capacity or around +50% over the past two years to around 9mn tonnes. However, there will be no more additions until 2013 when its 800kMt plant in Wuhan comes onstream. Since bottoming out in 2Q and 3Q10, product prices and margins have picked up strongly and the outlook for 4Q and 2011 is looking good. We believe there is significant upside to its chemical earnings over the next few years.

### E+P

Sinopec has injected its parent's Block 18 Angola asset to enhance its upstream business. The asset produces around 4mntonnes of crude oil per year or around 9% of its domestic production. Further injections are likely even though there is no time line. For future injections, Sinopec will select currently producing assets from "friendly" countries in our view. For domestic assets, oil production growth target is around 1-2% per year while targeting RRR of 1x. For natural gas, 2010 volume will likely jump 40% due to the new Puguang field. It will further contribute another 20% production growth in 2011F. The wellhead price in Puguang is RMB1.51/m<sup>3</sup> while the transportation tariff was set at RMB0.86/m<sup>3</sup>, indicating a city gate price of RMB2.37/m<sup>3</sup>.

### Earnings

We are forecasting a 22% earnings increase in 2010F, 15% in 2011F and 13% in 2012F and believe that there could be potential upside to our forecast mainly on the back of a petrochemical upturn. Our 12-M target price of HK\$9.60 is based on 2011F ROACE/WACC (14.3%/10.3%). In our view, Sinopec is trading at a compelling valuation of 6.4x FY11F PE, 3.9x EV/EBITDA and 1.1x P/B while ROACE is 14.3%.

Downside risks to our view include: 1) rising inflation; 2) chemical downcycle and 3) resources tax. Upside risks: 1) potential change in oil product pricing mechanism and 2) lifting of the windfall tax hurdle rate.

# Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
<b>Revenue</b>	1,452,101	1,345,052	1,851,797	2,212,356	2,531,569
Cost of goods sold	(1,379,078)	(1,220,121)	(1,696,535)	(2,032,256)	(2,328,497)
<b>Gross profit</b>	<b>73,023</b>	<b>124,931</b>	<b>155,262</b>	<b>180,100</b>	<b>203,072</b>
SG&A	(39,392)	(40,500)	(49,999)	(59,734)	(68,352)
Employee share expense					
<b>Operating profit</b>	<b>33,631</b>	<b>84,431</b>	<b>105,264</b>	<b>120,367</b>	<b>134,719</b>
<b>EBITDA</b>	<b>79,952</b>	<b>134,918</b>	<b>162,871</b>	<b>184,313</b>	<b>205,165</b>
Depreciation	(46,321)	(50,487)	(57,607)	(63,946)	(70,446)
Amortisation					
<b>EBIT</b>	<b>33,631</b>	<b>84,431</b>	<b>105,264</b>	<b>120,367</b>	<b>134,719</b>
Net interest expense	(7,514)	(7,323)	(6,826)	(6,860)	(6,778)
Associates & JCEs	580	2,997	3,736	4,273	4,782
Other income	2,714	463	524	556	591
<b>Earnings before tax</b>	<b>29,411</b>	<b>80,568</b>	<b>102,698</b>	<b>118,335</b>	<b>133,314</b>
Income tax	2,840	(16,084)	(24,647)	(28,400)	(31,995)
<b>Net profit after tax</b>	<b>32,251</b>	<b>64,484</b>	<b>78,050</b>	<b>89,935</b>	<b>101,319</b>
Minority interests	3,569	(2,724)	(2,709)	(3,098)	(3,467)
Other items					
Preferred dividends					
<b>Normalised NPAT</b>	<b>35,820</b>	<b>61,760</b>	<b>75,341</b>	<b>86,837</b>	<b>97,851</b>
Extraordinary items					
<b>Reported NPAT</b>	<b>35,820</b>	<b>61,760</b>	<b>75,341</b>	<b>86,837</b>	<b>97,851</b>
Dividends	(10,404)	(15,606)	(20,342)	(23,446)	(26,420)
<b>Transfer to reserves</b>	<b>25,416</b>	<b>46,154</b>	<b>54,999</b>	<b>63,391</b>	<b>71,432</b>

## Valuation and ratio analysis

FD normalised P/E (x)	15.8	9.0	7.4	6.4	5.7
FD normalised P/E at price target (x)	20.8	11.9	9.7	8.4	7.5
Reported P/E (x)	15.8	9.0	7.4	6.4	5.7
Dividend yield (%)	1.8	2.8	3.7	4.2	4.7
Price/cashflow (x)	8.5	3.7	4.4	4.1	3.9
Price/book (x)	1.7	1.5	1.3	1.1	1.0
EVEBITDA (x)	9.9	5.6	4.6	4.1	3.6
EVEBIT (x)	23.2	8.8	7.1	6.2	5.5
Gross margin (%)	5.0	9.3	8.4	8.1	8.0
EBITDA margin (%)	5.5	10.0	8.8	8.3	8.1
EBIT margin (%)	2.3	6.3	5.7	5.4	5.3
Net margin (%)	2.5	4.6	4.1	3.9	3.9
Effective tax rate (%)	(9.7)	20.0	24.0	24.0	24.0
Dividend payout (%)	29.0	25.3	27.0	27.0	27.0
Capex to sales (%)	6.9	7.8	6.0	5.1	4.5
Capex to depreciation (x)	2.2	2.1	1.9	1.8	1.6
ROE (%)	11.3	17.6	18.6	18.6	18.3
ROA (pretax %)	4.6	10.7	12.0	12.5	12.8

Compelling valuations

## Growth (%)

Revenue	20.5	(7.4)	37.7	19.5	14.4
EBITDA	(38.1)	68.7	20.7	13.2	11.3
EBIT	(60.8)	151.1	24.7	14.3	11.9
Normalised EPS	(36.6)	72.4	22.0	15.3	12.7
Normalised FDEPS	(36.6)	72.4	22.0	15.3	12.7

## Per share

Reported EPS (RMB)	0.41	0.71	0.87	1.00	1.13
Norm EPS (RMB)	0.41	0.71	0.87	1.00	1.13
Fully diluted norm EPS (RMB)	0.41	0.71	0.87	1.00	1.13
Book value per share (RMB)	3.78	4.33	5.00	5.75	6.60
DPS (RMB)	0.12	0.18	0.23	0.27	0.30

Source: Nomura estimates

<b>Cashflow (RMBmn)</b>					
<b>Year-end 31 Dec</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10F</b>	<b>FY11F</b>	<b>FY12F</b>
EBITDA	79,952	134,918	162,871	184,313	205,165
Change in working capital	(8,101)	29,008	(7,252)	(14,997)	(24,150)
Other operating cashflow	(5,334)	(11,851)	(28,822)	(34,369)	(37,921)
<b>Cashflow from operations</b>	<b>66,517</b>	<b>152,075</b>	<b>126,797</b>	<b>134,947</b>	<b>143,094</b>
Capital expenditure	(100,544)	(104,761)	(112,000)	(113,066)	(114,153)
<b>Free cashflow</b>	<b>(34,027)</b>	<b>47,314</b>	<b>14,797</b>	<b>21,881</b>	<b>28,941</b>
Reduction in investments	3,923	(5,405)	-	-	-
Net acquisitions	(1,292)	(2,680)	-	-	-
Reduction in other LT assets	(7,831)	(6,640)	-	-	-
Addition in other LT liabilities	2,532	2,912	-	-	-
Adjustments	(6,813)	535	-	-	-
<b>Cashflow after investing acts</b>	<b>(43,508)</b>	<b>36,036</b>	<b>14,797</b>	<b>21,881</b>	<b>28,941</b>
Cash dividends	(12,572)	(13,559)	(17,448)	(21,549)	(24,602)
Equity issue	-	-	-	-	-
Debt issue	28,587	(19,116)	5,221	-	-
Convertible debt issue	29,850	-	-	-	-
Others	(3,045)	(1,619)	-	-	-
<b>Cashflow from financial acts</b>	<b>42,820</b>	<b>(34,294)</b>	<b>(12,227)</b>	<b>(21,549)</b>	<b>(24,602)</b>
<b>Net cashflow</b>	<b>(688)</b>	<b>1,742</b>	<b>2,570</b>	<b>332</b>	<b>4,338</b>
Beginning cash	7,696	7,008	8,750	11,320	11,652
Ending cash	7,008	8,750	11,320	11,652	15,990
Ending net debt	229,062	209,619	212,270	211,938	207,600

Source: Nomura estimates

Positive free cashflow

<b>Balance sheet (RMBmn)</b>					
<b>As at 31 Dec</b>	<b>FY08</b>	<b>FY09</b>	<b>FY10F</b>	<b>FY11F</b>	<b>FY12F</b>
Cash & equivalents	7,008	8,750	11,320	11,652	15,990
Marketable securities	-	-	-	-	-
Accounts receivable	16,650	28,702	29,850	31,044	32,596
Inventories	95,979	141,611	169,013	206,126	254,160
Other current assets	45,761	22,217	22,217	22,217	22,217
<b>Total current assets</b>	<b>165,398</b>	<b>201,280</b>	<b>232,400</b>	<b>271,039</b>	<b>324,963</b>
LT investments	28,859	34,264	38,404	43,113	48,366
Fixed assets	534,060	584,968	637,641	686,761	730,468
Goodwill	14,237	14,072	14,072	14,072	14,072
Other intangible assets	-	-	-	-	-
Other LT assets	36,618	43,258	42,446	41,675	40,942
<b>Total assets</b>	<b>779,172</b>	<b>877,842</b>	<b>964,964</b>	<b>1,056,660</b>	<b>1,158,812</b>
Short-term debt	108,926	72,541	74,982	74,982	74,982
Accounts payable	75,217	120,860	132,946	146,241	160,865
Other current liabilities	102,513	120,018	129,230	139,246	150,058
<b>Total current liabilities</b>	<b>286,656</b>	<b>313,419</b>	<b>337,158</b>	<b>360,469</b>	<b>385,905</b>
Long-term debt	93,437	110,565	113,345	113,345	113,345
Convertible debt	33,707	35,263	35,263	35,263	35,263
Other LT liabilities	16,830	19,742	19,742	19,742	19,742
<b>Total liabilities</b>	<b>430,630</b>	<b>478,989</b>	<b>505,508</b>	<b>528,819</b>	<b>554,255</b>
Minority interest	20,653	23,192	25,901	28,999	32,467
Preferred stock	-	-	-	-	-
Common stock	86,702	86,702	86,702	86,702	86,702
Retained earnings	149,253	197,141	255,034	320,322	393,571
Proposed dividends	12,572	13,872	17,448	21,549	24,602
Other equity and reserves	79,362	77,946	74,370	70,269	67,216
<b>Total shareholders' equity</b>	<b>327,889</b>	<b>375,661</b>	<b>433,554</b>	<b>498,842</b>	<b>572,091</b>
<b>Total equity &amp; liabilities</b>	<b>779,172</b>	<b>877,842</b>	<b>964,964</b>	<b>1,056,660</b>	<b>1,158,812</b>

**Liquidity (x)**

Current ratio	0.58	0.64	0.69	0.75	0.84
Interest cover	4.5	11.5	15.4	17.5	19.9

**Leverage**

Net debt/EBITDA (x)	2.86	1.55	1.30	1.15	1.01
Net debt/equity (%)	69.9	55.8	49.0	42.5	36.3

**Activity (days)**

Days receivable	6.6	6.2	5.8	5.0	4.6
Days inventory	28.1	35.5	33.4	33.7	36.2
Days payable	23.9	29.3	27.3	25.1	24.1
Cash cycle	10.8	12.4	11.9	13.6	16.6

Source: Nomura estimates

### ⊙ Action

Looking to 2011F, we believe the network convergence policy in China, 3G network rollout in India and emergence of entry-level smartphones will drive ZTE's revenue and earnings growth to offset weakening 3G equipment demand in China. Revenue from TD-LTE remains small in FY11F, but is important to its long-term growth. Reaffirming BUY and price target of HK\$36.

### ✈ Catalysts

Positive catalyst: further consolidation in the telecom equipment industry. Negative: any regulatory policy change that is unfavourable to Chinese vendors.

### ⚓ Anchor themes

The convergence of the telecom, Internet and television networks is an element of China's 12<sup>th</sup> Five-Year Plan. We believe this will spur both telecom and cable TV operators to accelerate optical-fibre network development, and benefit the whole optical network supplier chain in China.

## Three drivers in 2011F

### ① Network convergence: sustainable revenue driver

ZTE is the second largest optical vendor in China, with a 22% market share in 1Q10. We expect the network convergence policy to generate sustainable demand for optical network equipment in the coming years, and believe ZTE can use its strong product portfolio and customer relations to capitalize on the business opportunities. We forecast ~35% y-y growth in ZTE's optical and data communication revenue in FY11F.

### ② Entry-level smartphone: chance to step up

ZTE is the fourth largest handset vendor by shipments in 2Q10, per iSuppli, but it is mainly a low-end vendor, with an ASP less than 1/4 the global average. We believe the emergence of entry-level smartphones in China and globally gives ZTE an opportunity to raise its ASP and penetrate the mid-range handset market. By leveraging its strong ties with operators, we expect smartphones sales to contribute 15% of total handset and data card sales in FY11F, from less than 5% in FY10F.

### ③ Mobile: India 3G rollout and TD-LTE

Our initial analysis shows the TD-LTE capex will be around RMB42bn over next few years assuming similar coverage as TD-SCDMA today, but its contribution to ZTE's FY11 revenue is still too small to compensate for the decline in 3G, we believe. On the other hand, we note ZTE has secured several important contacts in the Indian 3G market, including Reliance Communications and BSNL. We expect these overseas revenue contributions to offset the decline in China, and forecast 7% y-y growth in its wireless business in 2011.

### ④ Reiterate BUY and PT of HK\$36

We have a BUY on ZTE with a PT of HK\$36, at 24x FY11F EPS of RMB1.29 (HK\$1.50). Downside risks: 1) regulatory policy change that is unfavourable to Chinese vendors; 2) larger-than-expected capex reduction plans by Chinese/overseas operators; 3) mounting price competition in 2G/3G market and 4) significant increase in bad debt/failure to control operating costs. Upside risks: 1) larger-than-expected volume of 3G handsets owing to operators' active subsidy strategy; 2) further consolidation in telecom equipment industry; 3) stronger-than-expected recovery in overseas infrastructure market; and 4) margin strength and better cost control.

Closing price on 1 Dec	HK\$29.40
Price target	<b>HK\$36.00</b>
	(set on 1 Dec 10)
Upside/downside	22.4%
Difference from consensus	<b>16.8%</b>
<hr/>	
FY11F net profit (RMBmn)	3,700
Difference from consensus	<b>-2.2%</b>
Source: Nomura	

### Nomura vs consensus

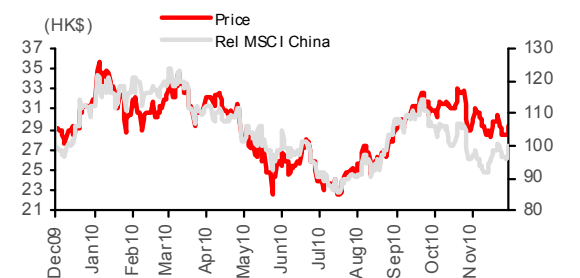
FY11F earnings are -2% but rev. is +3% vs consensus. This reflects our view that low-margin smartphone business will grow faster than the market expects.

### Key financials & valuations

31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Revenue	60,273	70,500	86,500	107,300
Reported net profit	2,458	2,900	3,700	4,600
Normalised net profit	2,458	2,900	3,700	4,600
Normalised EPS (RMB)	0.89	1.01	1.29	1.60
Norm. EPS growth (%)	41.2	13.0	27.6	24.3
Norm. P/E (x)	28.8	24.0	17.8	14.3
EV/EBITDA (x)	22.7	18.4	14.7	12.3
Price/book (x)	2.8	3.6	3.0	2.6
Dividend yield (%)	1.2	0.9	1.3	1.6
ROE (%)	15.8	16.1	18.0	19.3
Net debt/equity (%)		net cash	net cash	net cash
<hr/>				
<b>Earnings revisions</b>				
Previous norm. net profit		2,900	4,000	4,700
Change from previous (%)		-	-	-
Previous norm. EPS (RMB)		1.01	1.40	1.64

Source: Company, Nomura estimates

### Share price relative to MSCI China



	1m	3m	6m
Absolute (HK\$)	(0.8)	1.9	15.7
Absolute (US\$)	(1.0)	2.0	16.1
Relative to Index	3.5	(7.3)	0.9
Market cap (US\$m)			10,852
Estimated free float (%)			18.3
52-week range (HK\$)			35.60/22.65
3-mth avg daily turnover (US\$m)			22.22
Stock borrowability			Hard
Major shareholders (%)			
Shenzhen Zhongxingxin			32.5
HKSCC Nominees Limited			18.3

Source: Company, Nomura estimates

## Drilling down

## Heading into 2011F

ZTE's revenue growth slowed from 36% in FY09 to FY10 on weak demand in China and APAC (mainly India) geographically and weak demand for wireless communication equipment. We expect FY11 revenue to grow 23% y-y driven by the recovery in APAC (India) geographically because of 3G rollout and optical network equipment related segments (wireline switch + optical and data). We expect sales in China to grow moderately since weak demand for wireless equipment offsets the strong sales in optical network equipment.

ZTE has a strong product portfolio in access network-related products such in EPON (Ethernet-based Passive Optical network)/GPON (Gigabit PON). Since network convergence capex is mainly spent on access network to deploy the last mile between operator and subscribers' homes, we believe ZTE's strong product portfolio in EPON/GPON is a key strength to drive revenue growth in 2011F.

In the emerging entry-level smartphone (US\$150) space, ZTE has launched more than 10 Android based smartphones since early 2010 for three Chinese operators and several European operators including Vodafone and Orange. The company expects 1.5mn smartphone shipments in 2010. We expect ZTE will ship 4-5mn smartphones in 2011F, with the revenue contribution from smartphones within handset and data card (terminal) segment rising to 15% in FY11F, from less than 5% in 2010.

**Revenue growth to recover in 2011 driven by (1) network convergence, (2) entry-level smartphone, (3) India 3G**

**Leading supplier of EPON/GPON**

**Entry-level smartphone: ZTE to ship 4-5mn smartphones in 2011F from 1.5mn in 2010F**

### Exhibit 175. ZTE's entry-level smartphone

Model	ZTE Blade /Orange San Francisco	ZTE X850
Photo		
Screen	3.5inch QVGA Capacitive touch	2.8inch QVGA Resistive touch
Communication standard	GSM/HSPA	GSM/HSPA
OS	Android 2.2	Android 2.1
CPU	Qualcomm MSM 7227	Qualcomm MSM 7227
Market	France, China	UK, France, China
Retail price	~US\$150	~US\$150
Launch date	Q3 2010	Q1 2010

Source: Company Data, Nomura research

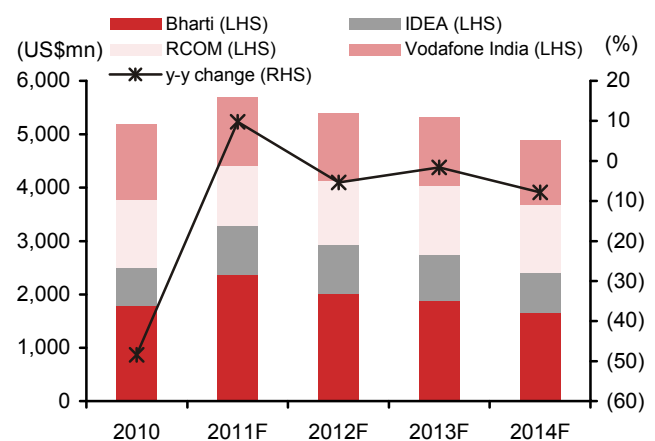
The India 3G network rollout will be the next big capex for global telecom equipment vendors. Our global telecom team forecasts total telecom capex from major four India telecom operators will grow 10% y-y in FY11 (ending March 2011). ZTE is already the key equipment supplier for RCOM and Bharti and is actively participating with other operators. We expect ZTE's sales in India will grow more than 50% y-y, and the sales contribution from India will account for ~8% in FY11 from ~6% in FY10 driven by the 3G rollout in FY11 and weak sales in FY10 due to the India government's ban on Chinese equipment from April until Autumn.

ZTE is the front runner in TD-LTE technology development and major LTE network equipment vendor globally. In addition to China Mobile's TD-LTE projects, ZTE has already signed several commercial LTE contracts globally, and will help CSL to launch the first commercial LTE service in Asia-ex-Japan. Although the revenue contribution from LTE is still small in FY11, we expect ZTE to leverage its technology leadership in LTE to gain market share in the global telecom equipment market.

**India 3G: key supplier already and gaining market share**

**LTE: front-runner**

### Exhibit 176. India capex trend



Source: Company data, Nomura estimates

## Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
<b>Revenue</b>	44,293	60,273	70,500	86,500	107,300
Cost of goods sold	(29,493)	(40,623)	(47,300)	(58,500)	(73,000)
<b>Gross profit</b>	<b>14,801</b>	<b>19,649</b>	<b>23,200</b>	<b>28,000</b>	<b>34,300</b>
SG&A	(13,114)	(17,179)	(20,300)	(24,500)	(30,000)
Employee share expense					
<b>Operating profit</b>	<b>1,687</b>	<b>2,470</b>	<b>2,900</b>	<b>3,500</b>	<b>4,300</b>
<b>EBITDA</b>	<b>2,387</b>	<b>3,233</b>	<b>3,800</b>	<b>4,500</b>	<b>5,400</b>
Depreciation	(700)	(763)	(900)	(1,000)	(1,100)
Amortisation	-	-	-	-	-
<b>EBIT</b>	<b>1,687</b>	<b>2,470</b>	<b>2,900</b>	<b>3,500</b>	<b>4,300</b>
Net interest expense	(442)	(406)	(500)	(500)	(600)
Associates & JCEs	-	-	-	-	-
Other income	1,017	1,261	1,600	2,000	2,500
<b>Earnings before tax</b>	<b>2,263</b>	<b>3,325</b>	<b>4,000</b>	<b>5,000</b>	<b>6,200</b>
Income tax	(351)	(629)	(800)	(900)	(1,200)
<b>Net profit after tax</b>	<b>1,912</b>	<b>2,696</b>	<b>3,200</b>	<b>4,100</b>	<b>5,000</b>
Minority interests	(252)	(238)	(300)	(400)	(400)
Other items					
Preferred dividends					
<b>Normalised NPAT</b>	<b>1,660</b>	<b>2,458</b>	<b>2,900</b>	<b>3,700</b>	<b>4,600</b>
Extraordinary items					
<b>Reported NPAT</b>	<b>1,660</b>	<b>2,458</b>	<b>2,900</b>	<b>3,700</b>	<b>4,600</b>
Dividends	(403)	(552)	(652)	(832)	(1,034)
<b>Transfer to reserves</b>	<b>1,257</b>	<b>1,906</b>	<b>2,248</b>	<b>2,868</b>	<b>3,566</b>
<b>Valuation and ratio analysis</b>					
FD normalised P/E (x)	41.5	28.8	24.0	17.8	14.3
FD normalised P/E at price target (x)	50.9	35.2	29.4	21.8	17.5
Reported P/E (x)	41.5	28.8	24.0	17.8	14.3
Dividend yield (%)	1.1	1.2	0.9	1.3	1.6
Price/cashflow (x)	18.9	19.0	18.8	19.4	19.4
Price/book (x)	2.5	2.8	3.6	3.0	2.6
EV/EBITDA (x)	31.7	22.7	18.4	14.7	12.3
EV/EBIT (x)	44.9	29.7	24.1	18.9	15.5
Gross margin (%)	33.4	32.6	32.9	32.4	32.0
EBITDA margin (%)	5.4	5.4	5.4	5.2	5.0
EBIT margin (%)	3.8	4.1	4.1	4.0	4.0
Net margin (%)	3.7	4.1	4.1	4.3	4.3
Effective tax rate (%)	15.5	18.9	20.0	18.0	19.4
Dividend payout (%)	24.3	22.5	22.5	22.5	22.5
Capex to sales (%)	4.3	3.4	3.1	2.7	2.2
Capex to depreciation (x)	2.7	2.7	2.4	2.3	2.2
ROE (%)	12.6	15.8	16.1	18.0	19.3
ROA (pretax %)	4.7	5.3	5.2	5.7	6.1
<b>Growth (%)</b>					
Revenue	27.4	36.1	17.0	22.7	24.0
EBITDA	30.8	35.4	17.5	18.4	20.0
EBIT	38.9	46.4	17.4	20.7	22.9
Normalised EPS	32.6	41.2	13.0	27.6	24.3
Normalised FDEPS	32.6	41.2	13.0	27.6	24.3
<b>Per share</b>					
Reported EPS (RMB)	0.63	0.89	1.01	1.29	1.60
Norm EPS (RMB)	0.63	0.89	1.01	1.29	1.60
Fully diluted norm EPS (RMB)	0.63	0.89	1.01	1.29	1.60
Book value per share (RMB)	10.61	9.19	6.66	7.67	8.93
DPS (RMB)	0.30	0.30	0.23	0.29	0.36

Margin declines due to growth in low-margin smartphone sales

Cashflow (RMBmn)					
Year-end 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
EBITDA	2,387	3,233	3,800	4,500	5,400
Change in working capital	1,365	(629)	(1,491)	(2,200)	(2,800)
Other operating cashflow	(104)	1,126	1,391	1,100	800
<b>Cashflow from operations</b>	<b>3,648</b>	<b>3,729</b>	<b>3,700</b>	<b>3,400</b>	<b>3,400</b>
Capital expenditure	(1,912)	(2,054)	(2,200)	(2,300)	(2,400)
<b>Free cashflow</b>	<b>1,736</b>	<b>1,675</b>	<b>1,500</b>	<b>1,100</b>	<b>1,000</b>
Reduction in investments	(115)	(274)	(6)	-	-
Net acquisitions					
Reduction in other LT assets					
Addition in other LT liabilities					
Adjustments	40	27	6	(1,000)	(600)
<b>Cashflow after investing acts</b>	<b>1,660</b>	<b>1,428</b>	<b>1,500</b>	<b>100</b>	<b>400</b>
Cash dividends	(830)	(1,045)	(552)	(652)	(832)
Equity issue	43	46	-	-	-
Debt issue	468	2,286	1,260	250	285
Convertible debt issue	3,961	-	-	-	-
Others	(306)	301	(4)	2	46
<b>Cashflow from financial acts</b>	<b>3,337</b>	<b>1,588</b>	<b>704</b>	<b>(400)</b>	<b>(500)</b>
<b>Net cashflow</b>	<b>4,997</b>	<b>3,017</b>	<b>2,204</b>	<b>(300)</b>	<b>(100)</b>
Beginning cash	6,483	11,480	14,497	16,700	16,400
Ending cash	11,481	14,497	16,700	16,400	16,300
Ending net debt	(1,009)	(1,621)	(1,300)	(800)	(400)

Source: Nomura estimates

Trend of positive operating cash will continue, in our view

Balance sheet (RMBmn)					
As at 31 Dec	FY08	FY09	FY10F	FY11F	FY12F
Cash & equivalents	11,480	14,497	16,700	16,400	16,300
Marketable securities	-	-	-	-	-
Accounts receivable	21,171	29,286	29,500	33,800	38,900
Inventories	8,978	9,325	11,300	14,000	17,400
Other current assets	1,659	2,870	2,900	2,900	2,900
<b>Total current assets</b>	<b>43,288</b>	<b>55,978</b>	<b>60,400</b>	<b>67,100</b>	<b>75,500</b>
LT investments	420	694	700	700	700
Fixed assets	4,103	4,715	5,886	7,086	8,286
Goodwill					
Other intangible assets	589	614	614	614	614
Other LT assets	2,466	6,342	6,300	6,300	6,300
<b>Total assets</b>	<b>50,866</b>	<b>68,342</b>	<b>73,900</b>	<b>81,800</b>	<b>91,400</b>
Short-term debt	5,664	6,846	6,100	6,500	6,500
Accounts payable	23,169	31,001	31,700	36,500	42,200
Other current liabilities	1,164	3,247	3,300	3,300	3,300
<b>Total current liabilities</b>	<b>29,997</b>	<b>41,095</b>	<b>41,100</b>	<b>46,300</b>	<b>52,000</b>
Long-term debt	1,293	2,396	5,700	5,500	5,800
Convertible debt	3,515	3,633	3,600	3,600	3,600
Other LT liabilities	878	3,269	3,300	3,300	3,300
<b>Total liabilities</b>	<b>35,682</b>	<b>50,393</b>	<b>53,700</b>	<b>58,700</b>	<b>64,700</b>
Minority interest	934	1,124	1,100	1,100	1,100
Preferred stock	-	-	-	-	-
Common stock	1,343	1,831	1,831	1,831	1,831
Retained earnings	12,906	14,994	17,269	20,169	23,769
Proposed dividends					
Other equity and reserves					
<b>Total shareholders' equity</b>	<b>14,250</b>	<b>16,825</b>	<b>19,100</b>	<b>22,000</b>	<b>25,600</b>
<b>Total equity &amp; liabilities</b>	<b>50,866</b>	<b>68,342</b>	<b>73,900</b>	<b>81,800</b>	<b>91,400</b>

**Liquidity (x)**

Current ratio	1.44	1.36	1.47	1.45	1.45
Interest cover	3.8	6.1	5.8	7.0	7.2

**Leverage**

Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

**Activity (days)**

Days receivable	163.3	152.8	152.2	133.6	124.0
Days inventory	101.8	82.2	79.6	78.9	78.7
Days payable	252.0	243.4	241.9	212.8	197.3
Cash cycle	13.1	(8.4)	(10.2)	(0.3)	5.4

Source: Nomura estimates

## Appendix

## Valuation methodology and risks

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
Agile Properties	3383 HK	11.1	BUY	13.29	Our PT of HK\$13.29 is based on a 30% discount (unchanged) to our end-11F NAV.	Investment risks include: 1) weaker-than-expected property sales; 2) further tightening measures applied to the property sector.
Agricultural Bank of China	1288 HK	4.13	BUY	4.7	Our TP of HK\$4.70 is based on 2.2x P/BV applied to the average FY10F and FY11F BVPS. Our sustainable ROE is 16.6%. We use a Gordon Growth model (target P/BV = (sustainable ROE – long-term growth)/(cost of equity – long-term growth)) to derive our fair P/BV range, assuming a cost of equity of 12% and a terminal growth rate of 8.3%. We derive our terminal growth rate by applying a 50% payout ratio to our long-term sustainable ROE assumption.	Being one of the largest banks in China, ABC remains closely tied to the Chinese economy. We believe that more severe-than-expected macro tightening could result in a sharp rise in bad debt costs. Specifically for ABC, the government may implement certain policies in county areas which might or might not be of benefit to ABC. A slowing economy would likely have negative implications for loan growth and asset quality. The concepts of market and operations-related risks have only been introduced into China's banking system in recent years, and the system itself has yet to go through a full credit cycle. Therefore, there is no historical data showing how Chinese banks may perform under a more testing credit environment.
Angang	347 HK	11.34	BUY	16	Our price target is based on 1.7x FY11F P/BV (one standard deviation from the stock's average P/BV since 2000).	Investment risks include a delay in price recovery, disappointing supply-demand balance and poor execution of stimulus programme elements.
Anhui Conch	914 HK	33.2	BUY	40	Our price target of HK\$40 is based on 12.2x 2011F EV/EBITDA.	Investment risks: potentially slower-than-expected execution of government spending; lower-than-expected demand and slower-than-expected supply increases.
Asia Cement	1102 TT	30.70	BUY	36.2	Our price target of NT\$36.2 is derived by applying 7.7x FY11F EV/EBITDA to the cement business and a 15% conglomerate discount to its long-term investment portfolio.	Risks to our rating and price target include: 1) complicated cross-holding structure; 2) delay in government spending kick-offs; 3) exposure to bulk shipping cyclicality, and; 4) changes in coal price assumptions.
Bank of Communications	3328 HK	8.22	BUY	11.0	Our PT of HK\$11.00 is based on a P/BV of 2.4x, which we apply to our FY10F BVPS forecast. In deriving our target multiple, we assume a sustainable ROE of 17.6%. We use the Gordon Growth Model [target P/BV = (sustainable ROE – long-term growth)/(cost of equity – long-term growth)] to derive our fair P/BV range, assuming a cost of equity of 12.5% and a terminal growth rate of 8.8%. We derive our terminal growth by applying a 50% payout ratio to our long-term sustainable ROE.	We believe that more-severe-than-expected macro tightening could result in a sharp rise in bad debt costs. A sharper-than-expected fall in exports could hurt BCOM more than peers, given its exposure to China's coastal regions. Finally, a slowing economy would have negative implications for loan growth.
Baosteel	600019 CH	6.29	NEUTRAL	7	Our price target is based on the regional peer average FY11F P/BV of 1.2x.	Downside risks include a delay in price recovery, disappointing supply-demand balance, deviations in nickel and stainless steel price from our assumptions, and asset injection. Upside risks include faster steel price increases and a bigger drop in iron ore prices than expected.
Beijing Capital International Airport	694 HK	4.18	BUY	5.85	Our price target for BCIA of HK\$5.85/shr is benchmarked to the group's historical mid-cycle P/BV of 1.6x.	The main risk to our price target is that the Airport Fee is not renewed as we have projected. Other risks include the eventual pricing of the proposed A-share IPO and forward passenger throughput growth differing substantially from our estimates. The pricing of other potential asset acquisitions may also represent swing factors to our price target for BCIA.
Beijing Ent. Water	371 HK	2.79	BUY	4.2	Our valuation methodology is based on DCF, assuming a WACC of 10.5% and a terminal growth rate of 2%.	Our price target is subject to growth assumptions in treatment volumes (including tap water supply, wastewater treatment, and waste-to-energy), tariffs, capacity and capex. Changes in the macro landscape and government regulations over the water industry may result in key changes in our forecasts, and hence our price target.
Beijing Enterprise	392 HK	49.9	BUY	70.5	Our PT of HK\$70.5 is based on a sum-of-the-parts (SOTP) valuation, which takes into account the different business nature and risk profile of BJE's investments.	Risks to our positive view include: 1) slower-than-expected sales growth for the gas, water and brewery businesses; 2) unfavourable regulatory changes to the above three segments; and 3) value-destructive asset acquisitions.
Belle	1880 HK	14.26	BUY	16	Our price target of HK\$16.00 is based on 28x FY11F P/E (EPS of RMB0.47), an unchanged 15% premium to its historical 12-month forward P/E.	Downside risks: rising competition; slower-than-expected SSS; larger-than-expected promotion activities; failure to achieve synergies with acquired brands.
Bank of China (H-share)	3988 HK	4.22	BUY	5.3	We derive our price target of HK\$5.30 by applying a P/BV multiple of 2x to our FY10F BVPS forecast. Our sustainable ROE assumption is 16.0%. We use the Gordon Growth Model [target P/BV = (sustainable ROE – long-term growth)/(cost of equity – long-term growth)] to derive our fair P/BV range, assuming a cost of equity of 12.0% and a terminal growth rate of 8.0%. We derive our terminal growth rate by applying a 50% payout ratio to our long-term sustainable ROE.	Downside risks: We believe that any more-severe-than-expected macro tightening could result in a sharp rise in bad debt costs, particularly after the massive loan growth recorded in 2009. Any downturn in the global economy, and especially Hong Kong's economy, could also weigh on the bank's earnings performance given its bigger foreign exposure relative to that of peers.

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
CCCC	1800 HK	6.83	NEUTRAL	7.5	Our price target of HK\$7.50 is based on 11x FY10-11F average EPS of RMB0.55, with the target multiple at a discount to the 13x target multiple we have applied to its railway peers.	Any major shift in government policies in terms of infrastructure investments in China may affect the outlook of leading Chinese construction companies. Rapid increases in critical raw material costs, such as steel and cement, may affect Chinese construction companies' gross margins and earnings. Any potential shortage in funding in other emerging economies outside China may result in lower sales and higher receivable write-offs for Chinese construction companies with meaningful exposure to projects outside China. On the other hand, any better-than expected recovery in the port machinery segment may mean our estimates prove to be too conservative.
Changyou	CYOU US	29.41	BUY	39	Our price target of US\$39.00 implies 9.8x FY11F P/E, largely in line with the adjusted peer group average of 10.0x FY11F P/E, applied to our fully diluted EPS estimate (excluding share-based compensation) of US\$3.97.	Downside risks to our price target include: 1) a faster-than-expected slowdown in TLBB; 2) further delays in new game launches; and 3) costs increasing faster than sales.
China Agri	606 HK	9.27	BUY	13.5	14x 12-month forward EPS.	Investment risks: a significant loss in its hedging and a significant drop in soybean prices.
China Merchants Bank	3968 HK	20.5	BUY	26.36	Our price target of HK\$26.36 is based on 3.5x P/BV applied to our FY10F BVPS forecast. Our sustainable ROE is 17.8%. We use the Gordon Growth Model [target P/BV = (sustainable ROE – long-term growth) / (cost of equity – long-term growth)] to derive our fair P/BV range, assuming a cost of equity of 11.5% and a terminal growth rate of 8.9%. We derive our terminal growth rate by applying a 50% payout ratio to our long-term sustainable ROE.	We believe that any more-severe-than-expected macro tightening could result in a sharp rise in bad debt costs. In addition, a slowing economy would have negative implications for loan growth.
China Construction Bank (H-share)	939 HK	7.03	BUY	8.5	Our price target of HK\$8.50 is based on 2.4x P/BV applied to FY10F BVPS. Our sustainable ROE assumption is 16.94%. We use the Gordon Growth Model [target P/BV = (sustainable ROE – long-term growth)/(cost of equity – long-term growth)] to derive our fair P/BV range, assuming a cost of equity of 12% and a terminal growth rate of 8.5%. We derive our terminal growth figure by applying a 50% payout ratio to our long-term sustainable ROE.	Downside risks to our price target: we believe that a more severe-than-expected macro tightening could result in a sharp rise in bad debt costs. In addition, a slowing economy would have negative implications for loan growth and could lead to a significant rise in NPLs, in our view.
China CNR	601299 CH	6.23	BUY	8.2	Our 12-month PT of RMB8.2 is based on a 22x target multiple applied to our FY11F EPS estimate of RMB0.38.	Risks to our call include any shift in government policy on railway development.
China Cosco	1919 HK	8.46	BUY	12.1	Our PT of HK\$12.10 is based on the mid-cycle P/BV of 2.0x.	Key risks include declining freight rates (both container and drybulk) and weaker global economic growth.
China Eastern Airlines	670 HK	4.54	BUY	5.9	Our price target of HK\$5.90 is based on 2.1x 2011F P/BV after assuming strategic investors take a 25% stake in CEA at HK\$3.80/shr.	The main risks to our price targets for Chinese airlines: passenger throughput growth may not meet our assumptions, passenger yield growth may be lower than we expect, currency movements and oil prices. Particularly for CEA, the main risk may come from the introduction of a strategic partner.
China Everbright International	257 HK	4.36	BUY	6.1	Our price target is derived using DCF, with a WACC of 10.0% and a 2% terminal growth rate.	Our price target is subject to growth assumptions in treatment volumes (including tap water supply, wastewater treatment and waste-to-energy), tariffs, capacity and capex. Changes in the macro landscape and government regulations over the water industry may result in key changes in our forecasts, and hence our price target.
China Foods	506 HK	5.44	REDUCE	4.2	We value China Foods at 18x 12-month forward EPS for our PT of HK\$4.20.	Upside investment risks include faster-than-expected progress of the distribution channel reform in wine and any product price hikes in beverages.
China High Speed	658 HK	14.24	BUY	22	Our DCF-based price target of HK\$22.0 assumes a WACC of 9.5% and terminal growth of 1% after FY20F.	Company-specific risks: uncertainty of government policies for wind power; tightening global credit market; development of direct-drive wind turbine technology; the company's failure to improve technology to compete with foreign competitors; severe shortage of raw materials; and delays in capacity expansions.
China Life Insurance	2628 HK	33.7	BUY	40	Our price target of HK\$40 is premised on an NB multiple of 25.0x derived by a risk discount rate (RDR) of 11% according to China Life's EV assumptions. We use our explicit VoNB growth forecasts for FY10-12F, assuming 17% VoNB growth over the next thirteen years (FY13-25F). The valuation is based on a 15-year basis and assumes no perpetuity growth, an approach similar to standard actuarial practice, as long-term growth is deemed too uncertain and therefore has close to zero value.	The key downside risks include poor returns from the A-share market, which would affect sentiment to insurers in general. Intense competition leading to a continued squeeze in NB margins for life insurers, especially China Life, which hopes to recapture market share.
China Mengniu Dairy	2319 HK	22.7	BUY	32	Based on 23x 12-month forward EPS (excluding stock option expense), we have a price target of HK\$32.00, which implies 50% potential upside.	Downside investment risks: higher-than-expected raw milk prices, higher-than-expected A&P expenses and food safety concerns.

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
China Mobile	941 HK	78.20	BUY	95	Our price target of HK\$95 is based on DCF. We assume a WACC of 11.7% and a long-term growth-to-perpetuity rate of 1.5%.	Risks to our investment view include: 1) irrational tariff competition; 2) the regulatory environment; and 3) new technologies may disrupt the industry landscape.
China Railway Construction Corp	1186 HK	9.42	BUY	11.8	Our price target of HK\$11.8 is based on FY11F EPS of RMB0.82 (forex assumption RMB1:HK\$1.2) and a multiple of 12x.	Risks to our view include any changes in government policy on railway development as well as country risk from its overseas projects.
China Res. Gas	1193 HK	10.72	BUY	14.8	Our price target of HK\$14.8 is based on a sum-of-the-parts (SOTP) valuation, of which HK\$12.29 comes from the existing 41 projects and HK\$2.50 from to-be-injected projects.	Upside investment risks include faster-than-expected progress of the distribution channel reform in wine and any product price hikes in beverages.
China Shineway	2877 HK	26.5	BUY	32.3	We value Shineway at HK\$32.3, based on 23x FY11F P/E, or 1x PEG, which we believe is conservative for a firm that operates on a superior scale and is the cost leader with net cash of HK\$2.5bn. Stripping out its net cash position, the ex-cash P/E target is c. 21x.	Despite the long-term effects from the expansion of EDL drugs sales amid support from new healthcare reforms, its product price and profit margin could expose the firm to downside risk if the Chinese government decides to impose deeper-than-expected price cuts for drugs listed in the EDL.
China Steel	2002 TT	31.35	BUY	37	Our price target is based on 1.8x FY11F P/BV, the mid-cycle multiple.	Risks include a delay in price recovery, disappointing supply-demand balance, disposal gains and the impact from Dragon Steel.
China Telecom	728 HK	3.98	NEUTRAL	4.8	Our DCF-based price target of HK\$4.80 assumes a WACC of 10.3% and a long-term growth-to-perpetuity rate of 0.5%.	Risks to our investment view include: 1) irrational tariff competition; 2) the regulatory environment; and 3) new technologies may disrupt the industry landscape.
China Unicom	762 HK	10.68	BUY	13.5	Our DCF-based price target of HK\$13.50 assumes a WACC of 11.2% and a long-term growth-to-perpetuity rate of 1.0%.	Risks to our investment view include: 1) irrational tariff competition; 2) the regulatory environment; and 3) new technologies may disrupt the industry landscape.
China Yurun	1068 HK	26.85	BUY	39	Our PT of HK\$39 is SOTP based.	Downside investment risks: an unexpected outbreak of pig disease across the country and potential food safety scandals within the food processing sector or at Yurun could have a negative impact on our earnings estimates.
CIMC	000039 CH	18.66	BUY	21	Based on discounted cashflow (DCF) valuation, our price target for CIMC of RMB21.00 is based on a WACC of 6.8% and 2% terminal growth.	Investment risks: global economic slowdown, failure to pass higher costs to customers, and operational risks from offshore business.
CITIC Bank	998 HK	5.46	BUY	6.6	Our price target of HK\$6.60 is based on 1.8x P/BV applied to our FY10F BVPS forecast and is on the back of a sustainable ROE of 15.3%. We use the Gordon Growth Model [target P/BV = (sustainable ROE – long-term growth)/(cost of equity – long-term growth)] to derive our fair P/BV, assuming a cost of equity of 12% and a terminal growth rate of 7.6%. We derive our terminal growth rate by applying a 50% payout ratio to our long-term sustainable ROE.	We believe that any more-severe-than-expected macro tightening could result in a sharp rise in bad debt costs. In addition, a slowing economy would have negative implications for loan growth.
CKI	1038 HK	34.75	BUY	36.6 <sup>^</sup>	SOTP valuation based on 8.5% cost of equity for assets in Australia, Canada, New Zealand and the UK, and a 10% cost of equity for its China and HK materials businesses.	Risks include strengthening of US dollar and the Japanese yen, lower-than-expected SOC capex spent during FY08-13F, poor operating performance at overseas projects.
CNBM	3323 HK	18.26	BUY	22	Our price target of HK\$22.00 is based on SOTP valuation. We use the same target multiples for its cement (11x EV/EBITDA) and non-cement business (14.8x of FY10F P/E).	Investment risks include 1) exposure to risk of slowing economic growth; 2) high financial leverage; 3) seasonality impact.
CNOOC	883 HK	17	BUY	19.5	Our price target of HK\$19.50 is based on our FY11F ROACE and WACC of 29% and 10%, respectively.	Downside risks include: 1) rising operating costs; 2) lower-than-budgeted production; 3) acquisition risks; and 4) weather-related risks — offshore China often experiences a large number of typhoons, which can affect the development and production of natural gas.
COLI	688 HK	15.36	BUY	21	Our price target of HK\$21.0 is based on a historical average of 14x 2011F P/E and implies a 19% premium to our end-11 NAV of HK\$17.64. We adopt a target P/E to derive our PT as we believe our NAV estimate does not capture any growth potential through land acquisitions. COLI's current landbank is only sufficient for 4-5 years development and it will likely buy more land to sustain future growth.	Investment risks include: 1) lower-than-expected sales; 2) tighter-than-expected property measures.
Cosco Pacific	1199 HK	12.34	BUY	15.5	Our price target for COSCO Pac of HK\$15.50 is benchmarked off a half standard deviation above the group's historical mid-cycle P/E of 12.6x.	We see risk to our price target for COSCO Pac if container throughput growth and/or cargo mix differ substantially from our estimates, given an uncertain macroeconomic picture. Further, changing market perceptions of the speed of a global trade recovery would affect the valuation multiples that the market is willing to assign the port stocks even if earnings estimates are unchanged.
Country Gdn	2007 HK	2.91	NEUTRAL	2.78	Our price target of HK\$2.78 is based on 30% discount to our end-11F NAV of HK\$3.97. Our NAV is based on sum-of-the-parts, where development properties are valued based on DCF and hotels are valued using the income-capitalization method. Our PT implies 15x/10x FY10F/FY11F P/E.	Upside risks to our view include faster than expected ramp up in production volume and higher than expected margins. Downside risks include stringent tightening policies that hit end-user demand, and the inability to acquire large enough sites to sustain their large community development business model.

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
CPIC	2601 HK	30.7	REDUCE	28	Our TP of HKD28 is premised on a sum of the parts (SOTP) valuation. For the life business, our target NB Multiple of 9.5x is derived by a risk discount rate (RDR) of 11.5%, according to CPIC's EV assumptions. We use our explicit VoNB growth forecasts for FY10-12F, and assumed 8.0% VoNB growth over the next 8 years (FY13-20F). The valuation is based on a 10-year basis and assumes no perpetuity growth, an approach similar to standard actuarial practice, as long-term growth is deemed too uncertain and therefore has close to zero value. We apply the target New Business (NB) multiple to the FY11F New Business Value and then add the FY10F Embedded Value. We value CPIC's P&C business using a present value of the net profit after tax and cost of capital approach. We assumed a sustainable combined ratio of 95%, a required cost of capital of 17.8%, which is derived from CPIC P&C's minimum capital requirement to net earned premium; a sustainable investment yield of 4.6%, a terminal growth rate of 2.5% and a RDR of 11.5%. For the other business, we use a present value of NPAT approach assuming 2% and 14% in terminal growth rates and RDR respectively.	The key upside risks: sales of bancassurance products supporting higher VoNB growth, stronger-than-expected returns from the A-share market which would affect sentiment toward insurers in general and Carlyle doing a share placement at a low discount to the market price.
CRCC	1186 HK	9.42	BUY	11.8	Our price target of HK\$11.8 is based on FY11F EPS of RMB0.82 (forex assumption RMB1:HK\$1.2) and a multiple of 12x.	Risks to our view include any changes in government policy on railway development as well as country risk from its overseas projects.
CRG	390 HK	5.5	NEUTRAL	6.6	Our TP of HK\$ 6.6 is derived by applying a 12x multiple to its FY11F EPS of RMB46 cents (FX assumption RMB1=HK\$1.2).	Any major shift in government policies in terms of infrastructure investments in China may impact the outlook for leading Chinese construction companies. Potential shortage in funding in emerging economies outside China may result in lower sales and higher receivable write-offs for Chinese construction companies that have meaningful exposure to projects outside China. However, if the government announces a larger package of infrastructure investments in the 12th five-year plan, our estimates may be proven too conservative. Any country risk incurred by its overseas projects may significantly impact its earnings.
CRL	1109 HK	14.18	REDUCE	14.87	Our price target of HK\$14.87 is based on a 20% discount to our end-11 NAV estimate of HK\$18.59.	Investment risks include 1) better-than-expected sales in BJ & SH and 2) no further tightening measures in the China property market.
CSCL (2866 HK)	2866 HK	3.13	REDUCE	2.05	For China Shipping Container Lines, we value the stock using the sum-of-the parts valuation, which is based on 0.6x 2010 P/B (which is the mid-point of trough and mid-cycle valuation) and 1.5x multiple to port business.	Risks include further asset injections and domestic China route returning to profitability.
CSD (1138 HK)	1138 HK	11.02	BUY	15.6	For China Shipping Development, our price target of HK\$15.60 is based on mid-cycle P/B of 2.0x in 2010, which is equivalent to a target EV/fleet of 1.9x, as we maintain our positive view on the bulk shipping industry.	Key risks for the bulk sector include decline in freight rates due to less-than-expected newbuilding cancellations/delays, and slower demand growth. Company-specific risks include a slowdown in oil and domestic coal demand.
CSR Corp	1766 HK	9.27	BUY	10.5	Our 12-month PT of HK\$10.50 is derived by applying a target P/E of 22x to FY11F EPS of RMB0.39 (assuming RMB1:HK\$1.2).	Risks to our call include any shift in government policy on the railway development plan, as well as future orders on low margin products by The Ministry of Railways.

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
CTIH	966 HK	26	BUY	35	Our PT of HK\$35 is premised on a sum of the parts (SOTP) valuation. For the life business, our target NB Multiple of 28.1x is derived by a risk discount rate (RDR) of 11.5% according to Taiping Life's EV assumptions. We use our explicit VoNB growth forecasts for FY10-12F and assume 30% VoNB growth over the next 7 years (FY14-20F). The valuation is based on a 10-year basis and assumes no perpetuity growth, an approach similar to standard actuarial practice, as long-term growth is deemed too uncertain and therefore has close to zero value. We apply the target New Business (NB) multiple to the FY11F New Business Value and then add the FY10F Embedded Value. We value TPRe using a present value of the net profit after tax and cost of capital approach. We assumed a sustainable combined ratio of 95.5%, a required cost of capital of 25%, which is derived from TPRe's minimum capital requirement to net earned premium; a sustainable investment yield of 5.3%, a terminal growth rate of 2.5% and a RDR of 11%. We value Taiping Insurance and CTPI (HK) using a present value of the net profit after tax and cost of capital approach. We assumed sustainable combined ratios of 100.0% and 99.6%, respectively, required cost of capital of 13.7% and 24.4%, respectively, which is derived from their minimum capital requirement to net earned premium; sustainable investment yields of 4.1% and 5.0%, respectively, and terminal growth rates of 2.5% and a RDR of 11% for both.	The key downside risks include poor returns from the A-share market, which would affect sentiment toward insurers in general, and Taiping Life's inability to deliver the expected high VoNB growth under market pressure.
Ctrip	CTRP US	43.78	BUY	60.0	Our price target of US\$60 is based on 37x FY11 P/E (EPS: RMB10.09), in line with its historical 12-month forward P/E.	Downside risks include lower-than-expected volume sales in the air ticket segment and hotel rooms, further price corrections, a commission decline and rising competition.
Dongfeng Motor	489 HK	15.48	BUY	19.5	Our PT for Dongfeng, of HK\$19.5, is based on 12x FY11F EPS of RMB1.41 (FX assumption: 1RMB=1.15HK\$).	Downside risks to our price target include widening losses in the company's independent brand operations.
Focus Media	FMCN US	23.33	NEUTRAL	24	Our DCF valuation assumes a WACC of 11.3% and terminal growth of 2%. Our price target implies 17.2x FY11F P/E.	Downside risks: 1) Recovery may be slower than expected, and; 2) new entrants, if any, could constitute competition. Upside risks: faster-than-expected penetration in tier 2 and tier 3 cities that may drive revenue even higher.
Geely Automobile	175 HK	4.29	BUY	5.5	Our price target is based on 16x FY11F fully-diluted EPS of RMB0.282 (FX assumption: RMB1 = HK\$1.15).	Downside risks to our call include disappointing new model sales and accelerating competition among domestic brands, which could hurt pricing and margin.
Gome Electrical Appliances	493 HK	3.15	BUY	4.3	Our price target of HK\$4.3 is based on 22x FY11F P/E (EPS: RMB0.155), in line with its historical 12-month forward P/E. We estimate Gome will witness strong earnings growth of 45.1% in FY10F. While we think this remarkable growth is unlikely to be sustainable, we expect it to post strong growth of 19.9% in FY11F and 16.1% in FY12F. We foresee upside revisions due to better-than-expected store efficiency and store number.	Downside risks: lower-than-expected SSS and margins.
Great Wall Motor	2333 HK	28.55	BUY	32	Our TP of HK\$32 is based on 13x our FY11F EPS of RMB2.17 (FX assumption: RMB1= HK\$1.15).	Investment risks include diesel shortage, which could bring downside risks to the company's diesel SUV sales.
GZ R&F	2777 HK	10.88	REDUCE	9.98	Our price target of HK\$9.98 is based on a 40% discount on our end-11 NAV estimate of HK\$16.64.	Investment risks include better-than-expected sales in 2H10-11 and significant improvement in financial position.
Huabao	336 HK	12.32	BUY	14.8	We value Huabao at 23x 12-month forward EPS, at par to the F&B sector average.	Downside risk: government policy changes for the tobacco industry and any share placement of old share by the chairwoman.
Jiangsu Expressway	177 HK	8.57	BUY	11.95	Our price target for Jiangsu Exp is HK\$11.95/shr, based on one standard deviation above the stock's historical mid-cycle PE of 15.7x. This is equivalent to an estimated 2011 PE of 17.5x and 2012 PE of 14.6x.	The main risk to our price target is if the diversion impact (from new competition and/or maintenance works) varies substantially from our estimates.
Kunlun Energy	135 HK	11.54	BUY	13.5	Our price target of HK\$13.50/share is based on FY11F ROACE of 17.7% and WACC of 7.1% with a LT growth rate of 3%.	Risks: (i) government regulatory risks; (ii) uncertain of Kunlun Gas and Kunlun Natural Gas, Petrochina's subsidiary, injection; (iii) LNG earnings contributions uncertainty in FY12F; (iv) crude oil price and production risks; and (v) share issuance leading to earnings dilution.
KWG	1813 HK	6.1	BUY	7.52	Our price target of HK\$7.52 is based on 30% discount to our end-11F NAV of HK\$10.75.	Investment risks include: 1) over-aggressive landbank replenishment; and 2) tighter-than-expected property measures.

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
Lijun Int'l Pharmaceutical	2005 HK	2.51	REDUCE	2.45	Our price target of HK\$2.45 is based on 18x FY11F P/E, equivalent to 0.92x PEG. Our target FY11 P/E is slightly lower than the sector average of c.19x for the HK-listed healthcare stocks.	Lijun has signed an agreement to set up an IV infusion joint venture (JV) in Jilin. In our view, the stock should react positively to this JV, which could also encourage Lijun to seek other external growth opportunities in the future. News of winning bids in more new provinces could be positive in terms of further consolidating its market share. Expansion in soft-packaged IV infusion capacity and its long-term development strategy for new finished drugs could drive solid revenue growth and improve profit margins. Increased local procurement could be an upside risk.
Longyuan	916 HK	7.28	REDUCE	7.6**	Our price target of HK\$7.60 (under review) is based on DCF, with a WACC of 11.8% and terminal growth after FY20F of 1%.	CER VER registration risks; resolution of grid connection bottlenecks in China; uncertainty regarding wind subsidies and policies.
Minsheng	1988 HK	6.91	NEUTRAL	7.4	Our price target of HK\$7.4 is based on 1.70x P/BV applied to our FY10F BVPS forecast as well as a sustainable ROE of 15.74%. We use the Gordon Growth Model [target P/BV = (sustainable ROE – long-term growth)/(cost of equity – long-term growth)] to derive our fair P/BV, assuming a cost of equity of 12.5% and a terminal growth rate of 7.9%. We derive our terminal growth rate by applying a 50% payout ratio to our long-term sustainable ROE.	We believe that any more-severe-than-expected macro tightening could result in a sharp rise in bad debt costs. In addition, a slowing economy would have negative implications for loan growth. If these risks were to exceed our expectations, it could affect our estimates and the achievement of our price target.
NetEase	NTES US	38.18	NEUTRAL	43	Our 12-month price target of US\$43.00 is based on the adjusted peer average of 14.1x FY11F P/E, applied to our fully diluted EPS estimate (excluding share-based compensation) of US\$3.06.	Company-specific downside risks to our price target and our estimates include: 1) disappointing performance of WoW and WLK; 2) a slide in FWJ performance from current levels; and 3) the advertising business losing upside momentum and market share. Upside risks include: Earlier-than-expected introduction of Cataclysm and Starcraft II in China.
NWDS	825 HK	7.09	BUY	9.2	Our PT of HK\$9.20 is pegged to 22x calendarised FY11F P/E (EPS: HK\$0.417), in line with the stock's historical 12-month forward P/E.	Downside risks could come from weaker-than-expected margins and SSS growth, and failure to proceed with acquisitions from the parent.
O-Net	877 HK	5.85	BUY	7.0	To reflect robust earnings growth underpinned by the network convergence story, we apply a target multiple of 22x to 2011F EPS, slightly lower than the 24x we apply to peer ZTE. We believe the relatively higher P/E multiples for O-Net reflect market expectations of higher-than-industry-average EPS growth for these vendors given considerable exposure to the fast-growing Chinese market and network convergence story.	Margins may be negatively affected if any major technological breakthroughs are achieved by its competitors. However, we do not see this having an effect on the company's short term earnings, as system vendors tend to have long certification processes. A sudden slowdown in optical network demand due to a change in the macro environment in, say, North America may also have a negative impact on company earnings.
OOIL	316 HK	76.9	NEUTRAL	61.8	Our price target of HK\$61.80 is based on sum-of-the-parts valuation. We value the shipping business using a FY11F midpoint between trough and mid-cycle P/BV of 0.8x and value its investment property at fair value.	Upside risk includes continuing to control capacity through reducing chartered fleet. Downside risk includes aggressive fleet expansion.
Pacific Basin	2343 HK	5.3	BUY	8.5	Our price target of HK\$8.50 is based on mid-cycle P/B of 1.4x in 2010, which is equivalent to a target EV/fleet of 1.5x, as we maintain our positive view on the bulk shipping industry.	Upside risk includes continuing to control capacity through reducing chartered fleet. Downside risk includes aggressive fleet expansion.
Parkson	3368 HK	13.1	BUY	17.5	Our PT of HK\$17.5 is based on 30x FY11F P/E (EPS: RMB0.47), unchanged, and in line with its historical trading average.	Downside risks: lower than expected SSS and margin compression.
PCD	331 HK	2.43	BUY	3.1	Our PT of HK\$3.1 is based on 24x FY11 P/E (EPS: RMB0.103), in line with the China department store average.	Downside risk: delay of Beijing store injection, competition of outlets business to intensify.
Perfect World	PWRD US	23.7	BUY	37	Our 12-month PT of US\$37 is equivalent to 10.3x FY11F P/E – in line with our adjusted peer group average – applied to our fully diluted FY11F EPS estimate (excluding sbc) of US\$3.58.	Company-specific risks to our price target and estimates include: 1) any delays in future gaming releases; 2) new games failing to generate material revenue; 3) declining performance of existing games, including the newly launched Fantasy Zhu Xian; and 4) minimal penetration in tier-3 and tier-4 cities in China.
Petrochina	857 HK	9.74	BUY	13	Our 12-month price target of HK\$13.00 is based on FY11F ROACE/WACC (13.2%/7.9%).	Risks to our view include: 1) lower-than-expected oil product prices; 2) international crude oil price volatility; and 3) government regulatory risks.
PICC	2328 HK	11.64	NEUTRAL	12	We value PICC using a present value of the net profit after tax and cost of capital approach. We assume a sustainable combined ratio of 98.6%, a required cost of capital of 16.0%, which is derived from PICC's minimum capital requirement to net earned premium, a sustainable investment yield of 3.8%, a terminal growth rate of 2.5% and a RDR of 11.5%.	Key downside risks include a worse-than-expected combined ratio in 2H10 from intensifying competition and poor returns from the A-share market, which would affect sentiment toward insurers in general. Key upside risks include a better-than-expected and sustained combined ratio from 2011 through a lower loss ratio and better-than-expected returns from the A-share market, which would affect sentiment of insurers in general.

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
Ping An	2318 HK	91	NEUTRAL	90	Our price target is based on a sum-of-the-parts (SOTP) valuation. For the life business, our target New Business (NB) multiple of 13.9x is derived by a risk discount rate (RDR) of 11%, based on Ping An's EV assumptions. We use our explicit VoNB growth forecasts for FY10-12F, assuming 15.5% VoNB growth over the next eight years (FY13-20F). Our valuation is on a 10-year basis and assumes no perpetuity growth, an approach similar to standard actuarial practice; long-term growth is deemed too uncertain and is thus assumed to have close to zero value. We apply the target new business (NB) multiple to the FY11F new business value and then add FY10F embedded value. We value Ping An's P&C business using a present value of net profit after tax and cost of capital approach. We assume a sustainable combined ratio of 99.3%, a required cost of capital of 17.8% (derived from Ping An P&C's minimum capital requirement to net earned premium), a sustainable investment yield of 3.6%, a terminal growth rate of 2.5% and a RDR of 11%. We have incorporated SZDB into our valuation of Ping An by applying our banking team's target P/BV multiple of 1.86x to our FY11F BV forecast. For the securities and other businesses, we use present value base on the NPAT approach, assuming terminal growth rates of 2.5% and 2.0% and RDR of 13% and 14%, respectively.	The key downside risks include poorer-than-expected: execution of the financial conglomerate model, integration with SZDB and returns from the A-share market. These would affect sentiment toward insurers in general, in our view. The key upside risks include better-and earlier-than-expected synergies from the integration of SZDB and continued strong growth in VoNB in 2H10.
Poly (HK)	119 HK	7.36	BUY	9.98	Our price target of HK\$9.98 is based on a 20% discount to our end-11 NAV estimate of HK\$12.5.	Investment risks include 1) Poly (HK)'s lack of a track record; and 2) tighter-than-expected policy measures in China.
Sands China	1928 HK	17.40	BUY	20	SOTP methodology.	Regulatory risks, especially regarding China; substantial delays from its Cotai project; and more market share losses from competition.
Shanda Game	GAME US	5.6	BUY	8	Our 12-month price target of US\$8.00 represents 9.6x FY11F P/E, largely in line with the adjusted peer average.	Company-specific downside risks to our PT and estimates are: 1) a continued steep drop in revenue from cash cows including Mir II and WoolL; and 2) delay in new game launches.
Shanghai Petrochem	338 HK	3.91	BUY	4.2	Our price target of HK\$4.20 is based on FY11F ROACE/WACC of 11%/8.6% (was 10.9%/8.7%).	Downside risks to our price target: 1) lower-than-expected oil product price hikes; 2) government regulatory risks; and 3) petrochemicals downcycle.
Shenhua	1088 HK	33.3	BUY	44.6	Our sum-of-the-parts-based price target of HK\$44.6 is equal to 13.5x FY10F P/E, in line with its peers and looks undemanding against a higher ROE.	1) higher-than-expected coal prices; 2) weaker-than-expected recovery in China's economy; 3) higher-than-expected cost hikes; 4) higher coal imports boosted by a strengthening RMB; and 5) overall market weakness given the stock's high correlation to the market index (Hang Seng Index).
Shimao	813 HK	12.06	BUY	15.39	13.5x FY10F P/E, in line with its peers' and looks undemanding.	Investment risks include lower-than-expected sales in 2H10-2011 and tighter-than-expected property policy in China.
Singamas	716 HK	2.41	BUY	2.22	Based on discounted cashflow (DCF) valuation, our price target for Singamas of HK\$2.22 is based on a WACC of 8.6% and 2% terminal growth.	Key risks for the container manufacturing sector include a global economic slowdown and failure to pass higher material costs on to customers. Company-specific risks diversifying product mix to non-dry container products.
Sino Biopharmaceutical	1177 HK	3.02	BUY	3.75	We value SBP at HK\$3.75, based on 30x FY11F P/E, or 25x ex-cash, which is a premium to the sector's average 19x P/E.	Risk factors will come from drug pricing pressure and slowdown in some mature products.
Sinoma	1893 HK	7.19	BUY	8.7	Our SOTP-derived PT of HK\$8.70, based on a 10% discount to fair value of RMB8.72 per share (HK\$9.70), implies an FY10F P/E of 21x and a P/BV of 3.0x, the mid-cycle valuation.	Investment risks include: 1) foreign exchange risk; 2) political risk; 3) raw material cost increase.
Sino-Ocean	3377 HK	4.75	NEUTRAL	5.3	Our price target of HK\$5.3 is based on a 40% discount to our end-11 NAV estimate of HK\$8.83, reflecting concerns on share disposal.	Upside risks: 1) faster-than-expected progress on share disposal; and 2) better-than-expected contracted sales in Beijing. Downside risks: 1) slower-than-expected sales; 2) over-aggressive in land banking; 3) a new round of tightening measures
Sinopec	386 HK	7.28	BUY	9.6	Our price target of HK\$9.60 is based on 2011F ROACE/WACC (14.3%/10.3%). Sinopec is trading at a compelling valuation of 6.4x 11F P/E, 4.1x EV/EBITDA and 1.1x P/BV, while ROACE is 14.3%.	Downside risks to our view include: 1) rising inflation; 2) chemical downcycle, and; 3) resources tax. Upside risks: 1) potential change in oil product pricing mechanism and 2) lifting of the windfall tax hurdle rate.

Company	Ticker	1 Dec closing price	Nomura rating	Price target	Valuation basis	Investment risks
Sinopharm Group	1099 HK	28.35	NEUTRAL	32.5	We set our 12-month valuation target at HK\$32.5, based on 36x FY11F P/E, or equivalent to 1x PEG to our earnings growth projection from 2011-12.	1) The Chinese government aims to cut drug prices in the EDL and national drug reimbursement list (NDRL) in 2011, which may have short-term negative effects on the profit margin of drug makers and distributors; 2) synergy effects from new asset integration are hard to gauge and predict until they are reflected in the interim or annual results; 3) major competitors are expected to list on the Hong Kong Stock Exchange; 4) upside earnings surprise could come from faster-than-expected M&A progress and better-than-expected benefits from the integration with its new M&A assets.
Sinotrans Shipping	368 HK	2.98	BUY	4.6	Our price target of HK\$4.60 is based on mid-cycle P/B of 1.1x in 2010, which is equivalent to a target EV/fleet of 1.2x, as we maintain our positive view on the bulk shipping industry.	Key risks for the bulk sector include decline in freight rates due to less-than-expected newbuilding cancellations/delays, and slower demand growth. Company-specific risks include lower contract rates if spot rates decline, counter-party risks with its customers and operational risks resulting from fleet expansion.
SJM	880 HK	12.18	BUY	15	SOTP-based valuation methodology.	Risks include: 1) regulatory changes in China, 2) Oceanus' / legacy casinos' underperformance, 3) uncertainty over the health of Dr Ho.
Sohu	SOHU US	69.43	REDUCE	64	SOTP peer group P/E multiple for FY11F serves as the basis for our PT.	Risks to our PT and earnings forecasts include: a significant ramp in new games; rebound in advertising spend; and a lower cost structure on video.
Taiwan Cement	1101 TT	32.2	BUY	40.8	Our price target at NT\$40.80 is based on a sum-of-the-parts net asset value (NAV) and the same multiple of 7.7x EV/EBITDA for FY11F.	Risks to our rating and price target include: 1) deviation in China's GDP and FAI growth assumptions; 2) any change in raw material prices, and; 3) execution risks.
Tencent	700 HK	174	BUY	210	Our price target of HK\$210 is equivalent to an FY11F PEG of 0.81, largely in line with the peer group average.	Downside risks: faster-than-expected slowdown in online advertising; rapid migration of SNS/gaming users to competing sites; and renegotiations with mobile operators.
Tingyi	322 HK	19.22	BUY	23.2	Valuation of 30x 12m forward EPS, a 30% premium to the F&B sector average.	Downside risks: weaker-than-expected sales growth and larger-than-expected cost pressure.
Trina Solar	TSL US	22.39	BUY	36	We use the average forward P/E of vertically integrated peers in YTD-FY10 to value the company, and give Trina a 10% discount to the average multiples for a target P/E of 10.4x.	Downside risks to our price target: 1) slower market share gains in new regions; and 2) demand at new growth centres being unable to offset lower demand from Germany.
Tsingtao Brewery	168 HK	41.65	REDUCE	37	PT set at 25x 12-month forward EPS.	Upside risks: stronger-than-expected volume growth and significant M&A.
United Laboratories	3933 HK	14.44	NEUTRAL	14.56	We set our 12-month price target at HK\$14.56, representing 16x FY11F P/E, which is below the sector average of 19x P/E.	Negative risks: 1) any delay in GMP approval for the company's new semi-synthetic penicillin workshop; and 2) worse-than-expected product price cuts by the government. Positive risks: 1) recovery in 6-APA and 7-ACA prices; and 2) approval of the company's other three new insulin products before the year-end.
Want Want	151 HK	6.81	BUY	8.2	Our PT of HK\$8.20 is set at 28x 12-m forward EPS.	Downside risks include slower-than-expected sales growth and a sharper-than-expected hike in input costs.
Zhuzhou CSR	3898 HK	29.25	NEUTRAL	28	Our price target is based on P/E of 22x and our FY11F EPS forecast of RMB1.06 (assuming RMB1:HK\$1.2).	Downside risks include negative market sentiment from possible low margins. Upside risks include higher-than-expected 4Q10F earnings and significant breakout in the localisation of key components.
ZTE	763 HK	29.30	BUY	36	The stock has traded at 2.5x 12-month forward P/BV and 23x 12-month forward P/E on average since 2005. Since on our forecasts its net profit CAGR from FY10 to FY12F is higher (24%) than that from FY05 to FY09 (around 19%), we believe it is reasonable to apply a 24x P/E multiple to FY11F EPS of RMB1.29 (HK\$1.50) to derive our revised price target of HK\$36 per share.	Downside risks include: 1) any regulatory policy change that is unfavourable to Chinese vendors; 2) larger-than-expected capex reduction plans by Chinese and overseas operators; 3) mounting price competition in the 2G/3G market; and 4) a significant increase in bad debt and failure to control operating costs.

\* Priced as at 1 December, 2010 close; local currency.

\*\* Price target under review with downward bias

^ Price target under review with upward bias

Note: Ratings and price targets are as of the date of the most recently published report (<http://www.Nomura.com>) rather than the date of this document.

Source: Nomura research

## CONTACTS

STRATEGY		
Sean Darby	852 2252 2182	sean.darby@nomura.com
Amy Lee	852 2252 2181	amy.lee@nomura.com
Mixio Das	852 2252 1424	mixio.das@nomura.com
CHINA		
Henry Wu	852 2252 2122	henry.wu@nomura.com
Yang Luo	852 2252 2141	yang.luo@nomura.com
Michael Shen	852 2252 2140	michael.shen@nomura.com
QUANTITATIVE STRATEGY		
Sandy Lee	852 2252 2101	sandy.lee@nomura.com
Yasuhiro Shimizu	852 2252 2107	yasuhiro.shimizu@nomura.com
Kenneth Chan	852 2252 2104	kenneth.chan@nomura.com
Rico Kwan	852 2252 2102	rico.kwan@nomura.com
Tacky Cheng	852 2252 2105	tacky.cheng@nomura.com
Desmond Chan	852 2252 2110	desmond.chan@nomura.com

SECTOR		
BANKS & OTHER FINANCIALS		
Lucy Feng	852 2252 2165	lucy.feng@nomura.com
David Chung	852 2252 6210	david.m.chung@nomura.com
Ben Huang	852 2252 6242	ben.huang@nomura.com
Donger Wang	852 2252 1590	donger.wang@nomura.com
Sunny Ding	852 2252 1559	sunny.ding@nomura.com
CONSUMER		
Candy Huang	852 2252 1407	candy.huang@nomura.com
Cherry Liu	852 2252 2183	qian.liu@nomura.com
Emma Liu	852 2252 6172	emma.liu@nomura.com
Anita Chu	852 2252 1425	anita.chu@nomura.com
GAMING		
Charlene Liu	852 2252 6134	charlene.liu@nomura.com
HEALTHCARE / PHARMACEUTICAL		
Gideon Lo	852 2252 6190	gideon.lo@nomura.com
AUTOS & AUTO PARTS		
Yankun Hou	852 2252 6234	yankun.hou@nomura.com
Ming Xu	852 2252 1569	ming.xu@nomura.com
INDUSTRIALS		
Yankun Hou	852 2252 6234	yankun.hou@nomura.com
Paul Gong	852 2252 6177	paul.gong@nomura.com
INFRASTRUCTURE		
Jim Wong	852 2252 2195	jim.wong@nomura.com
Yankun Hou	852 2252 6234	yankun.hou@nomura.com
Paul Gong	852 2252 6177	paul.gong@nomura.com
INSURANCE		
David Chung	852 2252 6210	david.m.chung@nomura.com
INTERNET/MEDIA		
Jin Yoon	852 2252 6204	jinkyu.yoon@nomura.com
George Meng	852 2252 1409	george.meng.1@nomura.com
METALS & MINING / BASIC MATERIALS		
Josephine Ho	852 2252 2177	josephine.ho@nomura.com
Jialong Shi	852 2252 1594	jialong.shi@nomura.com
OIL & GAS AND CHEMICAL		
Cheng Khoo	852 2252 6180	cheng.khoo@nomura.com
Gordon Wai	852 2252 6176	gordon.wai@nomura.com
Yong Liang Por	852 2252 6220	yongliang.por@nomura.com
Michael Lo	852 2252 6225	michael.lo@nomura.com
POWER, UTILITIES & RENEWABLE ENERGY		
Ivan Lee	852 2252 6213	ivan.lee@nomura.com
Joseph Lam	852 2252 2106	joseph.lam@nomura.com
Daniel Raats	852 2252 2197	daniel.raats@nomura.com
Nitin Kumar	65 6433 6967	nitin.kumar@nomura.com
Matty Zhao	852 2252 1397	matty.zhao@nomura.com
Alan Hon	852 2252 2193	alan.hon@nomura.com
Elaine Wu	852 2252 2194	elaine.wu@nomura.com
Zi Ying Xia	852 2252 1552	ziying.xia@nomura.com
TRANSPORTATION		
Jim Wong	852 2252 2195	jim.wong@nomura.com
Shirley Lam	852 2252 2196	shirley.lam@nomura.com
Andrew Lee	852 2252 6197	andrew.lee@nomura.com
Cecilia Chan	852 2252 6181	cecilia.chan@nomura.com
PROPERTY / REITS		
Paul Louie	852 2252 6189	paul.louie@nomura.com
Perveen Wong	852 2252 6254	perveen.wong@nomura.com
Alvin Wong	852 2252 1563	alvin.wong@nomura.com
Sunny Tam	852 2252 6226	sunny.tam@nomura.com
Jianping Chen	852 2252 2139	jianping.chen@nomura.com
TELECOMMUNICATIONS		
Danny Chu	852 2252 6209	danny.chu@nomura.com
Leping Huang	852 2252 1598	leping.huang@nomura.com

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**Any Authors named on this report are Research Analysts unless otherwise indicated**

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A **"Reduce"** recommendation indicates that potential downside is 5% or more.

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A "**Strong buy**" recommendation indicates that upside is more than 20%.

A "**Buy**" recommendation indicates that upside is between 10% and 20%.

A "**Neutral**" recommendation indicates that upside or downside is less than 10%.

A "**Reduce**" recommendation indicates that downside is between 10% and 20%.

A "**Sell**" recommendation indicates that downside is more than 20%.

### Sectors:

A "**Bullish**" rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.

A "**Neutral**" rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.

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## Nomura Asian Equity Research Group

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<b>Hong Kong</b>	Nomura International (Hong Kong) Limited 30/F Two International Finance Centre, 8 Finance Street, Central, Hong Kong Tel: +852 2536 1111 Fax: +852 2536 1820
<b>Singapore</b>	Nomura Singapore Limited 5 Temasek Boulevard #11-01, Suntec Tower Five, Singapore 038985, Singapore Tel: +65 6433 6288 Fax: +65 6433 6169
<b>Taipei</b>	Nomura International (Hong Kong) Limited, Taipei Branch 17th Floor, Walsin Lihwa Xinyi Building, No.1, Songzhi Road, Taipei 11047, Taiwan, R.O.C. Tel: +886 2 2176 9999 Fax: +886 2 2176 9900
<b>Seoul</b>	Nomura Financial Investment (Korea) Co., Ltd. 17th floor, Seoul Finance Center, 84 Taepyeongno 1-ga, Jung-gu, Seoul 100-768, Korea Tel: +82 2 3783 2000 Fax: +82 2 3783 2500
<b>Kuala Lumpur</b>	Nomura Securities Malaysia Sdn. Bhd. Suite No 16.5, Level 16, Menara IMC, 8 Jalan Sultan Ismail, 50250 Kuala Lumpur, Malaysia Tel: +60 3 2027 6811 Fax: +60 3 2027 6888
<b>India</b>	Nomura Financial Advisory and Securities (India) Private Limited Ceejay House, Level 11, Plot F, Shivsagar Estate, Dr. Annie Besant Road, Worli, Mumbai- 400 018, India Tel: +91 22 4037 4037 Fax: +91 22 4037 4111
<b>Indonesia</b>	PT. Nomura Indonesia Suite 209A, 9th Floor, Sentral Senayan II Building Jl. Asia Afrika No. 8, Gelora Bung Karno, Jakarta 10270, Indonesia Tel: +62 21 2991 3300 Fax: +62 21 2991 3333
<b>Sydney</b>	Nomura Australia Ltd. Level 25, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000 Tel: +61 2 8062 8000 Fax: +61 2 8062 8362
<b>Tokyo</b>	Equity Research Department Financial & Economic Research Center Nomura Securities Co., Ltd. 17/F Urbannet Building, 2-2, Otemachi 2-chome Chiyoda-ku, Tokyo 100-8130, Japan Tel: +81 3 5255 1658 Fax: +81 3 5255 1747, 3272 0869