J.P.Morgan

Asia Pacific Equity Research
27 August 2010

Views from the Bund

China Equity Strategy and Economics

'Views from the Bund' is a monthly publication that gives clients a value-added view on China macro, strategy, and industry insights.

- **Key investment theme:** We expect China's equity market to experience more volatility in coming months due to downward earnings revision pressure as the economic slowdown ripples through the whole economy, but recommend buying on dips because: (1) China's real GDP growth, on a sequential basis, may have bottomed out at 7.2% Q/Q in 2Q10. Yet, we believe China's final demand growth will not bottom out until late FY10, because the modest sequential rebound in GDP in 3Q will be driven by a slowdown in de-stocking and the widening of the trade surplus on sharply falling imports, rather than by a decent recovery in final demand; (2) improving liquidity conditions—(a) China's M2 growth (which tends to lead H-share performance), on sequential terms, is expected to bottom out, with the trend growth reaching a trough of 11.8% 3m/3m, saar in September before rising to 16.8% in December; (b) we estimate new loans made by Chinese banks in 2H10 will reach around Rmb3 trillion, up 37% Y/Y; (3) we believe the worst of the policy tightening environment may be behind us. Key investment risks include: (1) the market may be concerned about a return of government tightening measures, if CPI continues to surprise on the upside; (2) asset-inflation risks, mainly on the property front; and (3) China's A-share market to face potential supply side pressure in 4Q10.
- ***What* is changing:** In light of our positive views on mid-cap sticky growth names in China's consumer staple and low-end consumer discretionary sectors, and factoring in the four key consumer stock picking criteria, we have chosen 20 names to form the J.P. Morgan China Mid-Cap Consumer (sticky growth) Basket. The Bloomberg ticker for this basket is JPHCHMCS Index <GO>.
- **China model portfolio adjustment:** In our model portfolio, we are overweight on: (1) mid-cap consumer names in staple, low-end discretionary, and service areas; (2) menswear; (3) beneficiaries of western China development strategy and China's visible railway capex; (4) insurance; and (5) mid-cap banks. We stay neutral on telcos, and underweight on commodities, energy, and property. We reduce our weighting in IPPs from overweight to underweight.

China

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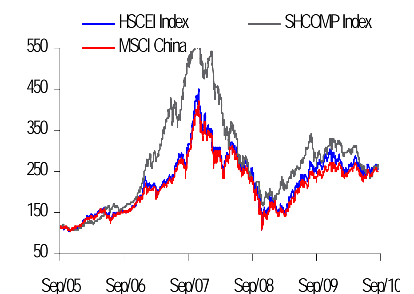
Relative index performance



Source: Bloomberg.

China top picks

	JPM	RIC	Mkt cap	EPS Y/Y growth (%)		P/E (x)		P/BV (x)	ROE (%)	Div. yld (%)
	Rec	ticker	(US$MM)	2010E	2011E	2010E	2011E	2010E	2010E	2010E
China Yurun Food Group	OW	1068.HK	5,954	8.6	21.6	23.2	19.1	3.9	19.6	1.3
DongFeng Motor Co., Ltd.	OW	0489.HK	12,542	47.8	6.3	9.2	8.7	2.7	29.3	1.4
Agile Property Holdings Ltd	OW	3383.HK	4,171	54.2	13.7	10.3	9.0	2.1	15.2	2.6
China Taiping Insurance Holdings	OW	0966.HK	5,222	20.0	44.5	37.6	26.0	3.6	10.0	0.2
China Merchants Bank - H	N	3968.HK	46,465	31.0	26.8	13.8	10.9	2.7	22.9	1.2

Source: Bloomberg, J. P. Morgan estimates. Share prices and valuations are as of 25 August 2010.

See page 100 for analyst certification and important disclosures, including non-US analyst disclosures.

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Investment summary

Reviewing our calls in July: (1) We predicted a near-term rebound of MSCI-China on the back of monetary loosening expectations. (2) We expected more volatility after the near-term rebound due to concerns about continued downward earnings revision risk. (3) Among others, we identified investment opportunities in: (a) China's mid-cap consumer space; (b) beneficiaries of western China development strategy; and (c) China's visible railway capex (such as China Railway Group). Looking back, the rebound did occur, with MSCI-China rising 4.1% in July FY10. Yet, the rally was much shorter than we expected, with MSCI beginning to correct on August 10 on renewed slowdown concerns.

Bottom building amid volatilities: We expect China's equity market to experience more volatility in coming months due to downward earnings revision pressure as the economic slowdown ripples through the whole economy, but recommend buying on dips because: (1) China's real GDP growth, on a sequential basis, may have bottomed out at 7.2% Q/Q in 2Q10. Yet, we believe China's final demand growth will not bottom out until late FY10, because the modest sequential rebound in GDP in 3Q should be driven by a slowdown in de-stocking and the widening of the trade surplus on sharply falling imports, rather than by a decent recovery in final demand; (2) improving liquidity conditions—(a) China's M2 growth (which tends to lead H-share performance), on sequential terms, is expected to bottom out, with trend growth reaching a trough of 11.8% 3m/3m, saar in September before rising to 16.8% in December; (b) we estimate new loans made by Chinese banks in 2H10 will reach around Rmb3 trillion, up 37% Y/Y; and (3) we believe the worst of the policy and tightening environment may be behind us.

Key investment risks: (1) The market may be concerned about a return of government tightening measures, if CPI continues to surprise on the upside. (2) Asset-inflation risks, mainly on the property front. (3) China's A-share market to face potential supply side pressure in 4Q10.

Sector views: In our model portfolio, we are overweight on: (1) mid-cap consumer names in the staple, low-end discretionary, and service areas; (2) menswear; (3) beneficiaries of western China development strategy and China's visible railway capex; (4) insurance; and (5) mid-cap banks. We stay neutral on telcos, and underweight on commodities, energy, and property. We reduce our weighting in IPPs from overweight to underweight.

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China model portfolio

(Extracted from the note, "China Strategy: A volatile bottoming process ahead", published on August 24, 2010; please see the original note for pricing dates)

Table 1: China model portfolio performance

		Weightings %		Performance YTD (%)		Performance from add in date		Add in	Add in
	Ticker	Benchmark	JPM	Ytd	vs. MSCI China %	Abs %	vs. MSCI China %	Date	Price LC
Consumer Discretionary	**MXCN0CD INDEX**	**4.6**	**5.5**	**-5.0**	**-1.2**	**79.7**	**-33.2**	**31/Dec/04**	**148.1**
Belle International Holdings Ltd.	1880 HK	1.0	2.5	45.3	49.0	19.6	33.2	4/May/10	11.0
Ports Design	589 HK	0	1.5	-9.5	-5.8	0.0	0.0	7/72010	0.0
Trinity Limited	891 HK	0	1.5	79.0	82.8	12.6	28.8	30/Mar/10	5.1
Consumer Staples	**MXCN0CS INDEX**	**5.5**	**16.0**	**2.2**	**6.0**	**262.3**	**149.3**	**31/Dec/04**	**367.1**
China Mid-cap consumer basket	**JPHCHMCS INDEX**	**0**	17.0	6.72*	4.33*	6.72	4.33	13/Jul/10	100.0
China Mengniu Dairy Co. Ltd.	2319 HK	0.6	3.5	-17.7	-13.9	3.4	16.7	30/Jun/08	22.1
China Yurun Food Group	1068 HK	0.6	1.5	14.3	18.1	163.0	145.8	30/Sep/08	10.0
Huabao International Holdings Limited	336 HK	0.3	2.0	35.0	38.8	23.2	36.8	4/May/10	9.2
Hengan International Group Ltd	1044 HK	0.9	1.0	17.4	21.2	52.9	62.0	4/Sep/09	44.3
Energy	**MXCN0EN INDEX**	**17.3**	**10.0**	**-4.4**	**-0.7**	**154.0**	**41.0**	**31/Dec/04**	**249.4**
CNOOC	883 HK	5.4	6.0	8.7	12.5	134.7	46.9	21/Sep/05	5.7
Sinopec Corp - H	386 HK	2.3	1.0	-8.0	-4.2	98.8	-14.2	31/Dec/04	3.2
China Shenhua Energy	1088 HK	2.4	0.5	-21.8	-18.1	221.1	137.9	10/Aug/05	9.3
Yanzhou Coal Mining - H	1171 HK	0.8	1.0	-2.3	1.4	39.9	55.3	15/Oct/09	12.0
PetroChina	857 HK	4.4	1.0	-7.0	-3.2	108.9	-4.0	31/Dec/04	4.2
China Coal Energy	1898 HK	0.9	0.5	-20.8	-17.0	-19.7	-3.5	16/Dec/09	14.0
Financials	**MXCN0FN INDEX**	**37.8**	**30.5**	**-7.2**	**-3.4**	**221.6**	**108.6**	**31/Dec/04**	**150.4**
China Life Insurance	2628 HK	6.1	4.0	-13.0	-9.3	541.3	428.4	31/Dec/04	5.2
Agile Property Holdings Ltd	3383 HK	0.3	1.0	-17.3	-13.5	8.3	21.9	4/May/10	8.7
Ping An Insurance 'H'	2318 HK	1.9	2.0	-5.4	-1.6	383.8	274.4	14/Feb/05	13.3
ICBC - H	1398 HK	6.4	3.0	-12.3	-8.5	31.7	30.3	30/Apr/07	4.3
China Merchants Bank - H	3968 HK	1.8	3.5	4.5	8.3	67.7	64.7	29/Dec/06	11.9
China Construction Bank	939 HK	6.8	2.5	-1.9	1.8	32.1	29.1	29/Dec/06	5.0
Bank of China -H	3988 HK	5.4	8.0	-4.0	-0.3	90.1	43.4	26/Feb/09	2.1
Bank of Communications - H	3328 HK	1.2	4.0	0.1	3.9	1.8	18.0	30/Mar/10	8.4
China Taiping Insurance	966 HK	0.5	1.5	-4.4	-0.6	0.0	0.0	16/Jul/10	0.0
China Overseas Land & Investment	688 HK	1.5	1.0	-2.3	1.5	9.3	22.9	4/May/10	14.7
Health care	**MXCN0HC INDEX**	**0.7**	**1.5**	**12.6**	**16.3**	**-34.2**	**-147.1**	**31/Dec/04**	**238.4**
Sinopharm	1099 HK	0.4	1.0	8.5	12.3	9.1	25.2	16/Dec/09	27.4
China Shineway Pharmaceutical Group Limited	2877 HK	0	0.5	41.3	45.1	55.4	72.4	13/Jan/10	13.2
Industrials	**MXCN0IN INDEX**	**7.8**	**7.0**	**-2.0**	**1.8**	**52.2**	**-60.8**	**31/Dec/04**	**110.9**
China High Speed Transmission	658 HK	0.4	2.0	-10.9	-7.1	-11.5	2.1	4/May/10	19.1
China Railway Group Limited	390 HK	0.5	1.5	-4.1	-0.4	0.0	0.0	7/Jul/10	0.0
China Railway Construction Corporation Limited	1186 HK	0.4	3.5	3.9	7.7	11.5	21.2	31/May/10	9.3
Information Technology	**MXCN0IT INDEX**	**6.1**	**11.0**	**-11.0**	**-7.2**	**48.5**	**-64.4**	**31/Dec/04**	**65.9**
ZTE Corp	763 HK	0.2	1.5	-16.3	-12.5	92.8	131.2	27/Sep/07	13.9
Alibaba.com Limited	1688 HK	0.5	1.5	-15.1	-11.3	-25.8	-16.7	4/Sep/09	20.6
Baidu.com	BIDU US	0	3.0	99.8	103.6	18.6	32.2	4/May/10	69.3
Shanda Games	GAME US	0	2.0	-31.1	-27.3	0.0	0.0	7/Jul/10	0.0
Netease	NTES US	0	3.0	11.3	15.1	27.8	41.4	4/May/10	32.8
Materials	**MXCN0MT INDEX**	**5.0**	**3.0**	**-12.2**	**-8.5**	**112.5**	**-0.4**	**31/Dec/04**	**454.8**
Zhaojin mining	1818 HK	0	3.0	22.3	26.1	17.8	27.4	31/May/10	16.1
Telecommunication Services	**MXCN0TC INDEX**	**13.3**	**14.0**	**12.5**	**16.2**	**172.1**	**59.2**	**31/Dec/04**	**47.5**
China Mobile (HK)	941 HK	10.8	5.0	13.7	17.4	234.5	126.4	2/Mar/05	24.8
China Telecom Corp	728 HK	1.2	1.5	17.9	21.7	-35.4	-8.3	25/Jan/08	5.9
China Unicom - H	762 HK	1.3	7.5	1.0	4.7	-8.9	-12.0	29/Dec/06	11.4
Utilities	**MXCN0UT INDEX**	**2.0**	**1.5**	**-3.4**	**0.4**	**25.7**	**-87.3**	**31/Dec/04**	**296.7**
China Resources Power Holdings	836 HK	0.6	0.5	10.9	14.7	-19.9	7.2	25/Jan/08	21.4
Beijing Enterprises Holdings Limited	392 HK	0.6	1.0	-4.2	-0.4	-3.1	13.8	13/Jan/10	55.7
MSCI Total	**MXCN INDEX**	**100**	**100**	**-3.8**	**0.0**	**146.8**	**33.8**	**31/Dec/04**	**25.3**

Source: Bloomberg and J.P. Morgan. Updated as of August 20, 2010. (Full details of our portfolio are available upon request; results cannot and should not be viewed as indicator of future performance). *Note: China Mid-cap consumer basket was launched on July 13, 2010, so its YTD performance and relative performance versus MSCI China only consider the share performance since July 13, 2010.

Market strategy

(Extracted from the note, "China Strategy: A volatile bottoming process ahead", published on August 24, 2010; please see the original note for pricing dates)

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Latest one-month rally snapped by renewed concerns on China's economic slowdown

Reviewing our calls in the previous issue of *China Strategy*

We made the following calls in our July issue of the *China Strategy* report:

(1) MSCI-China may see a near-term rebound, because: (a) MSCI-China's weak performance YTD may have already factored in the bad news about the economic slowdown; (b) China's liquidity situation has started to see some improvements, in light of our expectations of PBoC's net liquidity injection through open-market operations in July and a large amount of liquidity that was locked up in July's large IPO tide would be freed up and flowed back into China's secondary stock market.

(2) We expected China's equity market to be subject to additional volatility after the short-term rebound, because: (a) we would see continued downward earnings revision risk as China's economic slowdown ripples through from macro-sensitive sectors, such as steel, to more downstream sectors, such as property, industrials, capital goods, and airlines; (b) a number of sector-specific policy risks, which will hurt the earnings of and to de-rate multiples of related companies; (c) banks' fund-raising activities are only half-way through.

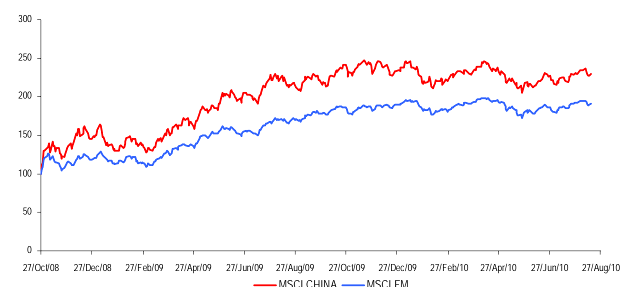
Looking back, we found that:

(1) The rebound did happen, with MSCI-China rising 4.1% in July FY10 with all sectors recording positive returns as liquidity conditions continued to improve and investors expected monetary loosening, on the back of lower-than-expected food prices in the June CPI releases, with the food component in CPI down 0.3% m/m, sa.

(2) However, the rebound proved to be shorter than expected, with MSCI-China beginning to correct as of August 10. The index fell 2.9% over the past two weeks, responding to July's macro economic data, which pointed decisively to an economic slowdown.

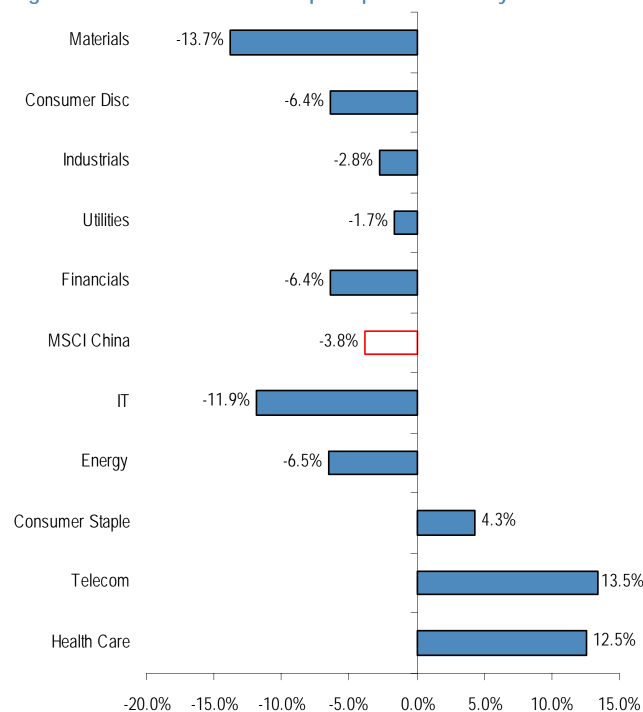
Valuation -wise, as of August 20, MSCI-China was trading at 14.0x trailing P/E, and 2.1x trailing P/BV, versus the average trailing P/E of 15.8x, and the average trailing P/B of 2.1x since 2000, based on consensus EPS growth forecast of 24.5% for FY10.

Figure 1: Price movements in basis points (as on August 20, 2010)



Source: Bloomberg.

Figure 2: 2010 YTD MSCI-China price performance by sector



Source: Bloomberg. Updated as of August 20, 2010.

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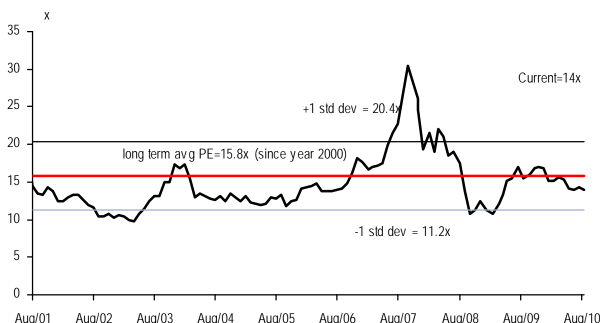
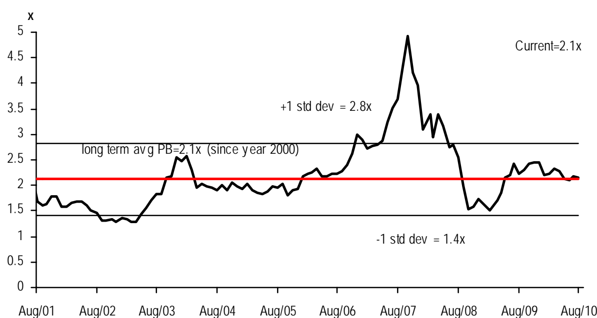
Figure 3: MSCI-China trailing P/E ratio



Source: Bloomberg, J. P. Morgan.

Figure 4: MSCI-China trailing P/B ratio



Source: Bloomberg, J. P. Morgan.

We expect MSCI-China to enter a volatile bottoming process over the next three months

(1) Expecting China's economy to engineer a soft landing, rather than a hard landing on the growth front

On one hand, we believe China equities may feel pressure arising from continued downward earnings revisions in the next three months as the economic slowdown continues to ripple through the economy, i.e. from the macro-sensitive sectors of steel and aluminum to more downstream sectors such as property and industrials.

Given that the macro tightening measures were adopted as of late FY09, and that it normally takes six to nine months for the tightening measures to have maximum impact on economic growth, China's economic growth is expected to bottom out in late 2Q or 3Q FY10 on a sequential basis.

On the other hand, our base-line forecast is that China will engineer a soft landing with China's GDP growth expected to bottom out in 1Q FY11 at 8.0% on a YoY basis. We do not expect China's economy to suffer from a hard landing by tanking below 7%, thanks to the government's initiatives of stimulating domestic consumption, launching the economic housing project across the country, and activating the western China development-related projects, which can help cushion the slowdown from the cracking down on the property market and from the moderation on infrastructure projects on the back of the banks' more stringent lending to the local governments' funding vehicles.

(a) Growing downward earnings revision risk, as China's economic slowdown ripples through macro-sensitive sectors

Six-to-nine-month time lag between tightening measures and their maximum impact on economic growth

The past tightening cycles suggest that it usually takes about six to nine months for the full-blown impact from monetary tightening to be transmitted to the real economy, leading to a moderation in the overall economic growth momentum.

For instance, in the 2003/2004 tightening episode, Chinese authorities kicked off the monetary tightening in late 2003 with a 100bp RRR hike; the quarter-on-quarter GDP growth rate started to fall entering 2004 (following the temporary post-SARS spike in 3Q03), and did not bottom out until late 2004. It was only in 3Q 2004 – six to nine months after the onset of macro tightening – that we saw the most negative impact on economic growth, in a belated response to the earlier tightening measures.

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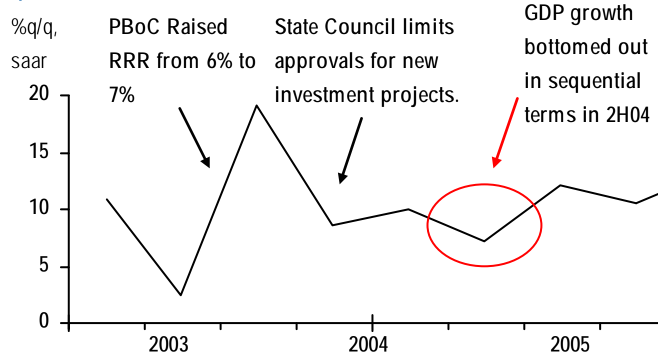
Figure 5: China's GDP growth trajectory in 2003/2004 tightening episode



Source: CEIC, J.P. Morgan.

As a result, given that the macro tightening measures were adopted as of late FY09, and that it normally takes six to nine months for the tightening measures to have the greatest impact on economic growth, we expect China's sequential GDP growth to bottom out in 2Q, or 3Q FY10.

China's final demand growth is not expected to bottom until late this year, even though the real GDP growth, on a sequential basis, may have already bottomed out in 2Q FY10.

Indeed, J.P. Morgan 's economics team believes that, on a sequential basis, China's real GDP growth pace, after downshifting notably to 7.2%q/q, saar in 2Q FY10, is expected to show a modest bounce in 2H10 to 7.5% in 3Q FY10, before stabilizing at 8.1% in 4Q.

That said, the modest sequential rebound in the GDP growth in 3Q FY10 is not driven by a decent recovery in final demand. In fact, we note that the latest data of fixed investment, retail sales and exports all suggested that final demand has continued to slow in 3Q FY10. Instead, it is the slow-down in de-stocking in the manufacturing sector and the widening of the trade surplus on sharply falling imports that explain the turn.

In other words, we expect inventory correction to be less of a drag and net trade to turn into a positive contributor to the headline growth: exports have slipped in recent months, but imports have been falling even faster. As such, trade surplus, having dipped to nearly zero early this year, has widened sharply recently and is likely to more than double the amount in 2Q.

Thus, in our view, China's final demand growth momentum may not bottom out until late this year, even though the real GDP growth, on a sequential basis, may have already bottomed in 2Q FY10.

In our baseline forecast, we expect China's sequential GDP growth to reach the trough in 2Q FY10, and China's final demand growth to bottom out in late FY10, which will likely mark the maximum stress point of economic growth on a sequential basis.

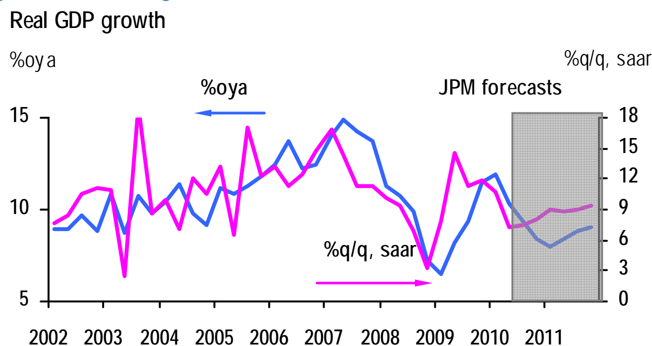
With regard to the YoY GDP growth trajectory, we believe it will not bottom out until 1QFY11.

Table 2: China's Real GDP growth (Y/Y%)

	2009	2010F	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10f	4Q10f	1Q11f	2Q11f	3Q11f	4Q11f
Headline GDP														
%oya	9.1	9.8	6.5	8.2	9.3	11.5	11.9	10.3	9.3	8.4	8.0	8.4	8.8	9.1

Source: CEIC, J. P. Morgan estimates.

Figure 6: Real GDP growth



Source: CEIC, J. P. Morgan estimates. Note: 2010E, 2011E are our forecasts.

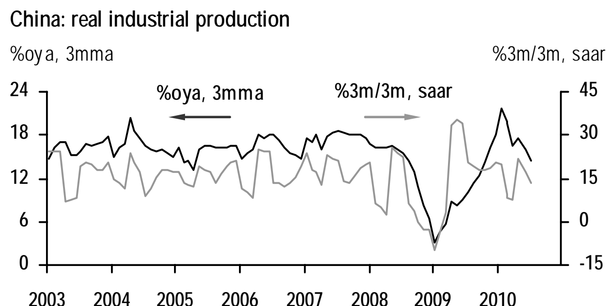
Macro leading indicators indicate economic deceleration may continue into 3QFY10

Latest macro leading indicators all point towards dwindling momentum of growth in China's industrial activities. These key macroeconomic indicators include: (a) July IP growth; and (b) manufacturing PMI.

(a) Focusing on China's industrial production, we note that China's IP rose below expectations, up 13.4%oya in July versus 13.7% in June. Seasonally adjusted, translating to a modest gain of 0.5% m/m, sa in July. Furthermore the pace of growth in fixed investment growth has decelerated further in recent months, with

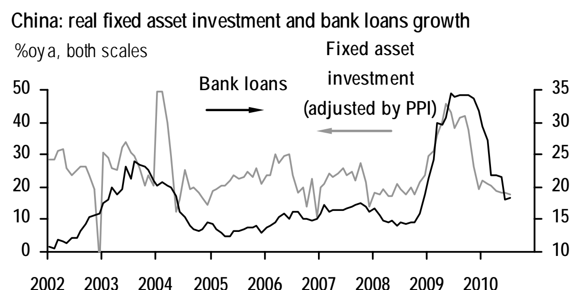
FAI raising 24.9% YoY YTD by July, compared with 25.5% YoY for 1HFY10 and 30.5% for FY09.

Figure 7: China: real industrial production



Source: CEIC, J. P. Morgan economics.

Figure 8: China: real fixed asset investment and bank loans growth



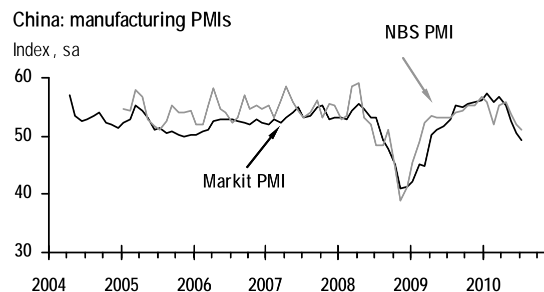
Source: CEIC, J. P. Morgan economics.

(b) China's manufacturing PMI has continued to fall for four consecutive months from April to July, declining from 55.7% in April to 51.2% in July with a fall of 4.5% over this period, the lowest point since China's manufacturing stopped contracting in February 2009.

Among others, the forward-looking new orders component of July's PMI fell 1.2 percentage points to 50.9%, indicating weak domestic demand in light of previous policy tightening measures. Additionally the export order component fell 0.5 percentage points to 51.2% in July showing the effects of the global slowing of the economic recovery. Last but not least, the inventory component eased somewhat to register at 49.9 in July, from 51.3 in June.

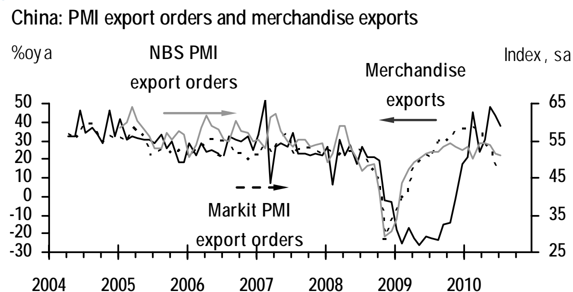
Together, with the fall in orders, the orders-to-inventory ratio stayed unchanged at 1.02 in July, the lowest level since January 2009. The easing in orders and rising inventory conditions in recent months, if continue, could translate into a loss for related sectors, such as steel and aluminum, in 2H10.

Figure 9: China: manufacturing PMIs



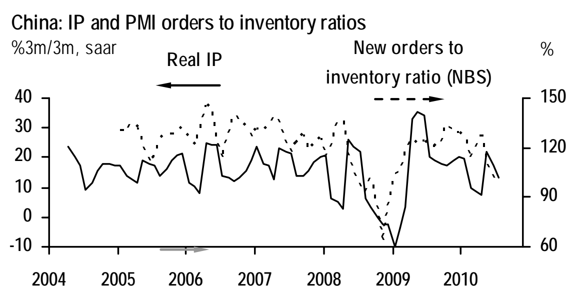
Source: CEIC, J. P. Morgan economics.

Figure 10: China: PMI export orders and merchandise exports



Source: CEIC, J. P. Morgan economics.

Figure 11: China: IP and PMI orders to inventory ratios



Source: CEIC, J. P. Morgan economics.

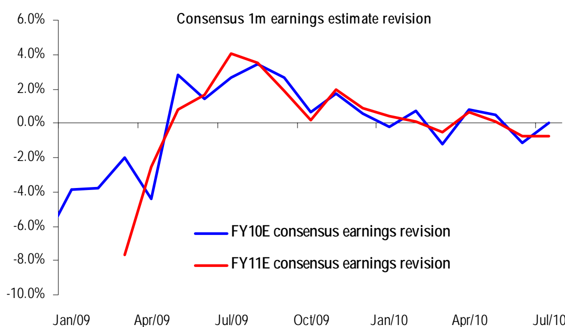
Continued downward consensus earnings estimate revisions may cause more market volatility

Despite the outlook for a soft landing in economic growth for the remainder of the year, we expect downward consensus earnings estimate revisions to continue in the coming months, with macro-sensitive sectors, such as materials, property and metal and mining, likely to see most downward revisions.

Notably, in respect of consensus earnings estimate revisions for MSCI-China, while the consensus FY10 earnings estimates remained unchanged in July, FY11 earnings estimates were revised down by -0.7% in July. Sector wise, consensus FY10 earnings forecasts were cut the most for materials (-3.4%), energy (-0.9%), and telecom (-0.7%), while upward earnings revisions were seen for sectors such as consumer discretionary (0.3%), insurance (0.2%), and health care (0.3%).

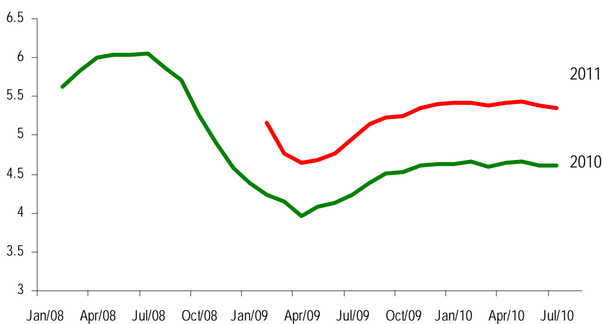
In our view, this trend of downward earnings revisions should persist for the coming months until we see China's final demand growth finally bottom out in late FY10, because: (1) the corporate earnings cycle in general follows the economic cycle; (2) the earnings revisions have tended to lag those of GDP growth by around one quarter in the past. Until then, the impact of the economic slowdowns will gradually spread from macro-sensitive sectors like steel and aluminum to more and more downstream sectors such as property, and industrials. This may cause volatility in the relevant China equities.

Figure 12: China—One-month consensus FY10 earnings estimate revisions for MSCI-China



Source: Bloomberg, J. P. Morgan.

Figure 13: China—Consensus earning estimate revisions for MSCI-China (EPS in Rmb)



Source: Bloomberg, J. P. Morgan.

Table 3: China—consensus FY10 earnings estimate revisions by sector over the past month

	1m earnings revision
CONSUMER DISCRETIONARY	0.3%
CONSUMER STAPLES	-0.5%
ENERGY	-0.9%
BANKS	-0.2%
INSURANCE	0.2%
REAL ESTATE	-0.4%
HEALTH CARE	0.3%
INDUSTRIALS	0.2%
INFORMATION TECHNOLOGY	-0.4%
MATERIALS	-3.4%
TELECOMMUNICATION SERVICES	-0.7%
UTILITIES	-0.7%

Source: IBES, Bloomberg.

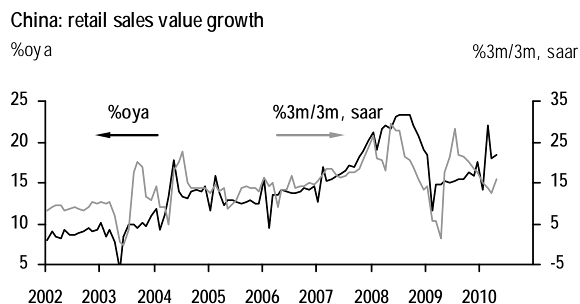
(b) China's economic growth may bottom out in 1Q 2011 on a Y/Y comparison basis

While China's economic growth, on a YoY basis, may continue to slowdown in the next few months, we do not foresee a hard-landing scenario for China's economy with the GDP growth tanking below 7%, thanks to the government's initiatives of stimulating domestic consumption, launching the economic housing project across the country and activating the western China development-related projects.

In our view, continued robust domestic consumption growth in the next few quarters and the bottoming out of investment growth in 1H FY11 will help cushion the slowdown in China's growth, which is expected to trough in 1Q FY11 on a YoY comparison basis.

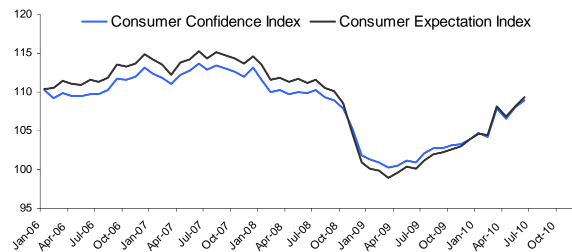
1) Robust domestic consumption: despite the general easing of growth momentum in industrial activity, China's domestic consumption remains on a solid upturn. The continued sequential improvement in headline retail sales, with its sequential trend growth rising to 22.5% 3m/3m, saar in July 2010, indicates that the consumer confidence in China is rather strong. Historically, the consumer confidence reading is generally taken as a gauge for the strength of domestic private consumption. Indeed, consumer confidence has continued to improve solidly over the past few months, suggesting further recovery in consumer spending in a 3-to-6-month period, given the lag between the time when consumers are willing to spend on discretionary goods and when they actually spend.

Figure 14: China: retail sales value growth



Source: CEIC and J. P. Morgan.

Figure 15: China—Consumer confidence and expectations index



Source: CEIC and J. P. Morgan.

Table 4: China—Pro-consumption policies announced since early 2009

- Ministry of Commerce announced to extend the period of passenger vehicles' "Old for New" policy from the original last day of May 31, 2010 to Dec 31, 2010
- Ministry of Commerce, Ministry of Finance and Ministry of Environment Protection jointly issued the Proposal to Promote the "Old for New" Plan for Home Appliances, which extended the plan's coverage area from 9 provinces and municipalities to 19. The plan is tentatively set to expire on Dec 31, 2011
- More than 10 provinces and municipals have raised minimum wage requirements by an average of 20% this year, aiming to boost the disposable income of and consumption by low-income residents (2010)
- NDRC raised minimum purchase price of grains by 3% to 10% this year (2010)
- At the NPC meeting 2010, Premier Wen noted that the central government will spend Rmb318.5B to help build the social safety network and to increase the basic pension of retirees by 10% in 2010 (2010)
- At the NPC meeting 2010, Premier Wen noted that central government will spend Rmb198.1B on education in 2010, up 23.6% y/y (2010)
- CBRC approved the launch of four consumer financial companies in China in 2010. The first group of banks establishing consumer financial companies includes Bank of Beijing, Bank of China, and Bank of Chengdu, etc. The fourth consumer financial company was approved by CBRC this February and will be launched in Tianjin (2010)
- The State Council meeting in 2010 re-emphasized to promote the " Promoting the sale of home appliances to rural households" program by easing price caps, increasing product offerings and extending target consumer universe (2010)
- State Council in 2009 released the "Healthcare Reform Implementation Plan", and stipulated that basic medical care will be extended to all urban and rural residents by 2011 (2009)
- Premier Wen noted at the 2009 NPC meeting that China would increase the basic per capita financial subsidy for urban and rural residents participating in the medical insurance program by 50% in 2010 (2009)
- Premier Wen noted at the 2009 NPC meeting that the government will provide Rmb133.5B financial subsidy in 2010 to farmers (2009)

Source: Ministry of Finance, State council, J. P. Morgan.

Moreover, Chinese authorities have realized the importance of boosting domestic demand to sustain China's long-term economic prosperity and therefore would likely introduce more pro-consumption policies in the coming months. Among others, four policy directives: (a) raising Chinese residents' disposable income; (b) improving national income distribution by narrowing the income gap among different income level groups; (c) speeding up the urbanization process, especially in western and central China; and (d) promoting consumer finance – will likely be included in the draft Twelfth Five Year Plan to be examined during the Chinese Communist Party Central Committee of the Seventeenth session of the fifth plenary meeting in October this year.

2) **Investment growth to bottom out in 1H FY11**: From a top-down perspective, we expect China's FAI growth to slow down from 20.5% YoY in 2H FY10 to around 18% YoY in 1H FY11, which may mark the trough point of China's FAI growth in FY11, given the assumptions of stable FAI growth of the infrastructure and the manufacturing sectors, and the bottoming-out of property FAI growth in 1H11.

On a full year basis, we believe China's headline nominal fixed investment growth will moderate to 20% in FY11, from 22.5% in FY10 and 30.5% in FY09.

Should we strip out the pricing effect (using PPI as a proxy), the real FAI growth in 2011 would slow to only 17%oya in FY11, from 35.9% in FY09 and 19.1% in FY10, given that the negative PPI of -5.4%oya in 2009 and the expected positive PPI of 3.4%oya in 2010 and 3%oya in 2011.

Table 5: J.P. Morgan FAI and PPI forecasts

	2009	2010E	2011E
Nominal FAI growth	30.5%	22.5%	20%
PPI	-5.4%	3.40%	3%
Real FAI growth	35.9%	19.1%	17%

Source: J.P. Morgan estimates.

(i) Infrastructure FAI, which accounts for 13% of total FAI in FY09, is expected to continue easing in 2HFY10, given the earlier restriction on the approval of new investment projects as of late FY09.

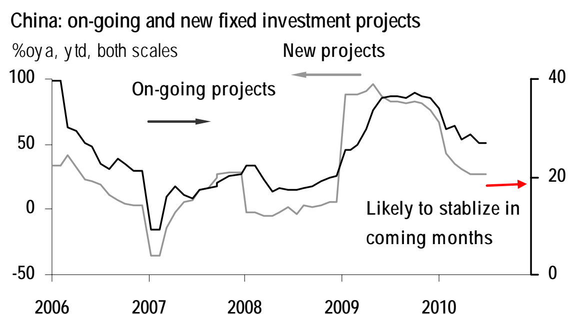
However, we expect the central government to gradually loosen the tight grip on certain infrastructure projects in 2H FY10 to help cushion the ongoing economic slowdown as well as further stimulate the western China development.

Indeed, the authorities have already moved on this front over the past month, by:

(1) Announcing 23 major new infrastructure projects for western China this year totaling Rmb682.2 billion (US$100 billion);

(2) Raising insurance companies' permitted maximum investment into infrastructure projects to 10% of their total assets, from the previous regulatory limit of 6% for life insurers and 4% for property insurance companies.

Figure 16: China: on-going and new fixed investment projects

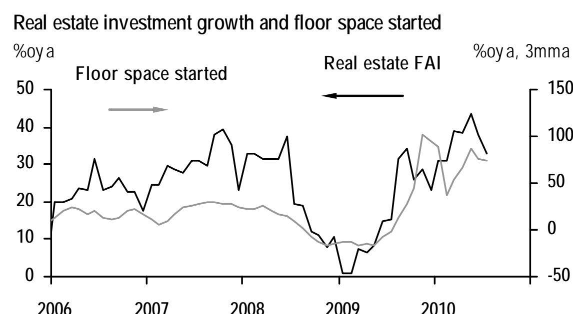


Source: CEIC and J. P. Morgan.

Given that investment projects normally proceed in full swing six months after approval, the government's more relaxed stance towards infrastructure projects in 2H FY10 could well lead to stable infrastructure FAI growth in 1H FY11, considering the high base of 1H FY10. We expect China's infrastructure FAI to rise around 20% YoY in 1H FY11, compared with an estimated 16.8% YoY in 2H FY10.

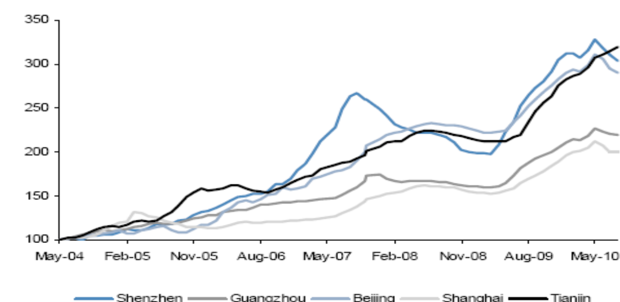
(ii) The earlier crackdown on China's red-hot property sector has finally started to bite into housing-related investments. With the pace of growth on new floor space starting to fall and housing prices moderating in recent months (housing prices in Shanghai, Beijing and Shenzhen have lost 6-7.3% cumulatively since Apr-10), real-estate FAI growth has decelerated from 43.5% YoY in May FY10 to 32% in July FY10.

Figure 17: Real estate investment growth and floor space started



Source: CEIC and J. P. Morgan.

Figure 18: Centaline secondary price index by city



Source: Centaline and Bloomberg, JPM property research team.

In light of a roughly six-month time lag between the slowdown in property sales in the secondary market and the start of new construction, we may see new construction starts falling in the next two to three quarters to reflect the ongoing slowdown in property transaction volume (current property sales are 24% below their 2008-09 average), which may lead to property FAI growth to ease to 17% YoY in 2H10E and to around 10% YoY in 1H11E.

Given that the Chinese property developers competed with each other to build properties as of 4Q FY09 on the back of the government's crackdown on the property sector, we might see an increase in China property supply in 4Q FY10 (it usually takes about a year for a new property project to be completed), which could help

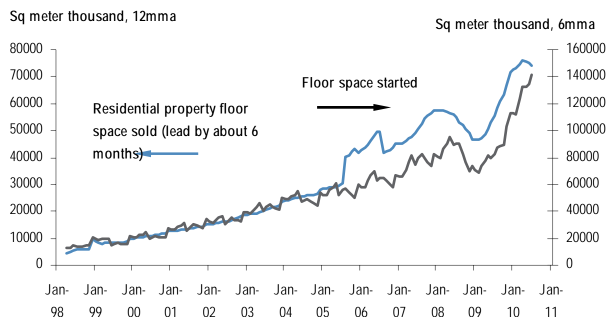
bring down the property prices by 5-10%. This, in turn, can hopefully attract genuine demand and drive up transaction volumes of the property again.

Given the above-mentioned time lag between the growth of property sales and the new construction starts, we may see China's new property construction starts, and consequently property-related FAI growth to gradually pick up momentum in 2H11.

Meanwhile, around half of the planned 3 million units of affordable housing as well as the rehabilitation of 2.8 million units of run-down housing are expected to be completed in 2011.

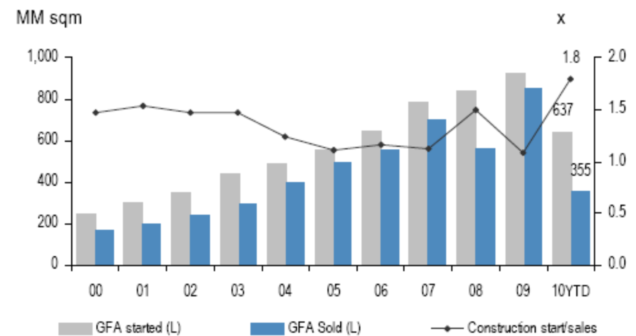
This, combined with the expected pick-up of new construction starts in 2H FY11, may help to contribute to a mid-teen growth in China's property FAI in FY11.

Figure 19: Residential property sales vs. new construction starts



Source: CEIC.

Figure 20: Residential construction start vs. GFA sold



Source: CEIC.

(iii) Given the anticipated loosening in infrastructure project approval in the next few months combined with the rebound in new construction starts toward the middle of FY11, and the expected modest export growth on still solid EM demand next year, the FAI growth in manufacturing sectors (such as supplying products to infrastructure and real estate-related areas) and the FAI growth in manufacturing sectors focusing on the export market may also stabilize in 1HFY11, in our view.

In fact, we expect China's FAI growth in the manufacturing segment to rise moderately to 15% in 1H FY11, from 12.9% in 2H FY10.

Table 6: China's FAI growth by sector

		Overall	Primary Industry	Mining	Manufacturing	Infrastructure	Property	Service	Others
2009	% share	100%	1.7%	4.2%	30.3%	13.0%	22.2%	21.7%	6.9%
2009A	Y/Y growth	31.0%	49.5%	17.1%	26.9%	49.4%	22.3%	40.0%	28.6%
1H10A	Y/Y growth	25.5%	17.8%	19.0%	24.9%	25.7%	37.0%	21.4%	10.2%
2H10F	Y/Y growth	20.5%	39.0%	12.6%	12.9%	16.8%	16.9%	32.6%	26.2%
1H11F	Y/Y growth	18.0%	28.0%	12.0%	15.0%	20.0%	10.0%	30.0%	20.7%

Source: CEIC, J. P. Morgan.

(2) Improving liquidity conditions cushioning further market downside

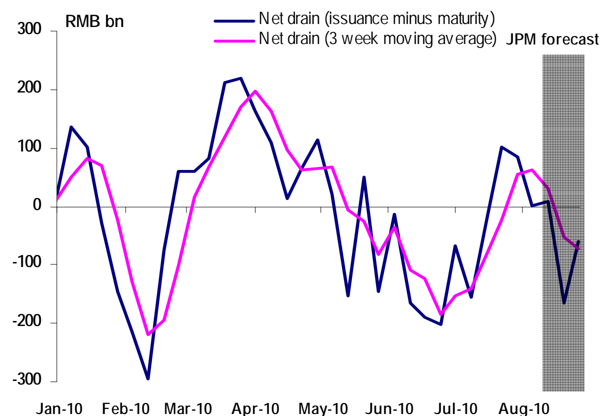
a) The money markets' liquidity situation is improving, as around Rmb1 trillion cash that was locked up in the big IPOs in July has returned to the system, while on the outflow side the central bank's mop-up operations have been less aggressive since late May.

Indeed, over the past 12 weeks, we saw notable liquidity injections totaling Rmb957 billion through open-market operations (OMOs) for the first 8 weeks, and then slight net withdrawals totaling Rmb254 billion over the last 4 weeks.

This is in sharp contrast to PBoC's earlier practice of draining liquidity through OMOs for 11 consecutive weeks starting from mid-February FY10.

Looking ahead, we expect continued liquidity injections of around Rmb200 billion in August, following Rmb110 billion net liquidity injection in July and a Rmb517 billion net injection in June.

Figure 21: PBoC's liquidity withdrawal/injection through open market operations



Source: PBoC, CEIC, J.P. Morgan estimates.

Table 7: PBoC's weekly open market operations summary

Rmb in billions

Week ending	Repo Issuance	Repo Maturity	PBoC bill Issuance	PBoC bill Maturity	Total Issuance	Total Maturity	Net Drain (+)	Net Drain (3mma+)
02/27/10	30	30	107	46	137	-76	61	-102.7
03/06/10	49	30	150	110	199	-140	59	15.0
03/13/10	133	30	220	241	353	-271	82	67.3
03/20/10	163	20	240	170	403	-190	213	118.0
03/27/10	95	0	238	115	333	-115	218	171.0
04/03/10	98	10	125	50	223	-60	163	198.0
04/10/10	140	80	150	100	290	-180	110	163.7
04/17/10	129	123	113	105	242	-228	14	95.7
04/24/10	110	93	153	105	263	-198	65	63.0
05/01/10	105	30	95	55	200	-85	115	64.7
05/08/10	0	80	144	42	144	-122	22	67.3
05/15/10	30	60	34	156	64	-216	-152	-5.0
05/22/10	0	75	146	20	146	-95	51	-26.3
05/29/10	0	85	35	95	35	-180	-145	-82.0
06/05/10	0	49	130	95	130	-144	-14	-36.0
06/12/10	10	83	35	128	45	-211	-166	-108.3
06/19/10	0	80	23	133	23	-213	-190	-123.3
06/26/10	0	50	10	161	10	-211	-201	-185.7
07/03/10	0	68	77	76	77	-144	-67	-152.7
07/10/10	15	60	16	126	31	-186	-155	-141.0
07/17/10	0	69	240	190	240	-259	-19	-80.3
07/24/10	50	35	125	39	175	-74	101	-24.3
07/31/10	40	50	130	36	170	-86	84	55.3
08/07/10	30	0	30	58	60	-58	2	62.3
08/14/10	40	30	119	62	159	-92	67	51.0

Source: PBoC, CEIC.

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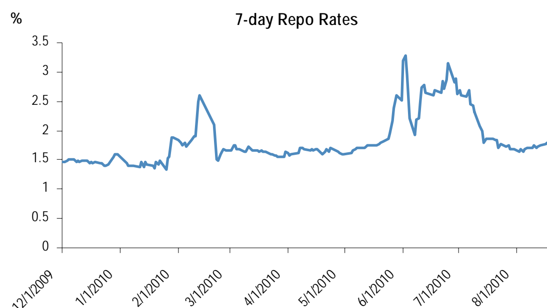
Notably, short-term market interest rates have been staying at a relatively low level since mid-June, reflecting still ample domestic liquidity in the system.

As shown in the (charts below), the seven-day repo rate stood at 1.80% on August 17, largely unchanged from 1.87% a month earlier, versus this year's peak of 3.28% on June 2, while the Shanghai inter-bank rate stayed at 1.77% on August 17 versus 3.28% on June 2.

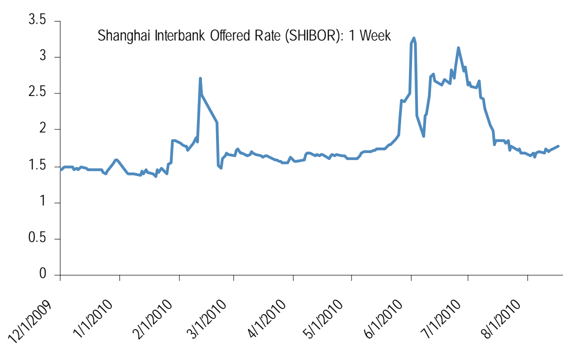
In our view, short-term market interest rates may remain at the current level, suggesting relatively benign liquidity situations in China, which should help cushion further downside in the domestic equity market.

Figure 22: China—Seven-day repo rates



Source: Bloomberg.

Figure 23: China—Shanghai inter-bank offered rate (SHIBOR)—One week



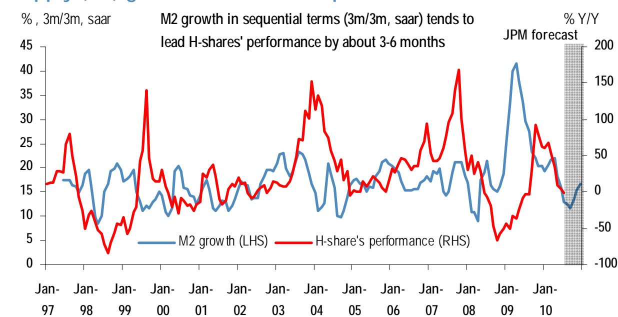
Source: CEIC.

b) If we look more broadly at the monetary supply growth in China, our analysis also points to gradually improving liquidity conditions

In our forecasts, while M2 growth in the YoY comparison may continue to ease towards the year end (from 17.6% YoY in July to 16.4% in December), M2 growth in sequential terms, however, will start to bottom out, with the trend growth reaching a trough of 11.8%3m/3m, saar in September, before rising to 16.8% in December, in our view.

Given that the money supply (M2) sequential trend growth tends to lead H-shares' performance (chart below), the bottoming-out in M2 sequential growth is expected to provide support for China's equity market at a time when China equities are facing downward pressure from continued downward revisions in the consensus earnings forecast. That said, the slowly improving liquidity situation itself may not be enough to fuel a major turnaround in China equities.

Figure 24: China—The correlation between the sequential money supply (M2) growth and H-shares' performance



Source: CEIC, J.P. Morgan estimates.

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c) Commercial banks' new loan creation could see a notable YoY increase in 2H FY10, adding conviction to our calls that despite no massive monetary loosening for the rest of the year, we may have already passed the maximum monetary tightening stress point.

To avert a seasonal fluctuation in banks' new lending due to the poor implementation of the quarterly loan quota last year, CBRC has asked Chinese banks to strictly comply with a more balanced lending plan this year to smooth out potential volatilities that bank lending could bring to China's economic growth, i.e. banks are being asked to lend 30%, 30%, 20%, and 20% of their Rmb7.5 trillion new loan creation quota for FY10 in 1Q, 2Q, 3Q, and 4QFY10, respectively.

Indeed, CBRC has firmly controlled banks' new loan creation in 1H FY10, with banks lending out a total of Rmb4.62 trillion in the first six months of this year, largely in line with the budgeted Rmb4.5 trillion (60% of Rmb7.5 trillion new loan quota). As a result, around Rmb3 trillion loan quota remains for banks in 2H FY10, which suggests a notable 37% YoY jump from the Rmb2.19 trillion new loans lent over the same period last year.

The room for YoY increases in new lending in 2H FY10 actually confirms our view that China may have passed the maximum monetary tightening point.

This view will be strengthened by potential further slowdown of economic growth momentum toward the year end. In fact, we now only call for one 27bp interest rate hike from the PBoC in 4Q and no RRR hike for the rest of the year.

Table 8: Banks' new loans and CBRC's loan quota in 1H/2H FY09 and FY10

	2009A			2010F			
	Quarterly loan quota	Actual amount % of full year new loans	Actual amount in RMB billion	Quarterly loan quota	Actual amount % of full year new loans	Actual amount in RMB bn	Growth rate %Y/Y
1H	60%	77%	7366.7	60%	61%	4617.6	-37%
2H	40%	23%	2190.6	40%	39%	3000*	37%

Source: CEIC, J.P. Morgan estimates. Note (*): numbers are our estimates.

(3) Policies to become tailwinds from headwinds

First of all, we believe the worst policy environment should be behind us, as the major concerns hurting the market will be addressed in the next three to six months.

(1) More clarity on the size and quality of the debt held by local government funding vehicles (LGFV).

A government notice released on August 16 indicated that local finance departments, local development and reform commissions and local branches of the PBOC and CBRC will work together to investigate the level of debt owed by local financing vehicles.

As such, the findings of this investigation, which will be reported to Ministry of Finance by the end of October, will help the market gain a clear understanding of the actual scale of the bad debts, and commercial banks' exposure as well as NPL risks associated to these debts.

Our banking analyst, Sam Chen, believes that the market has been overly concerned about LGFVs and he does not expect any inflection point in China's credit cycle in the foreseeable future yet.

(2) The market has been concerned about Chinese banks' massive fundraising activities which might increase supply-side pressure in the secondary market. The last week's announced bond issue by China Central Huijin, i.e. the major shareholder of large Chinese banks, to raise money for it to participate in major Chinese banks' fund raising activities should be able to alleviate the market's concern over the banks' fund raising activities.

Central Huijin Investment noted that the debt issue will be the first batch of Central Huijin's planned bond issue, which could total up to Rmb187.5 billion by 2011, to maintain Central Huijin's controlling shareholder status in major domestic banks, including ICBC, BOC, CCB, which have been lining up for share offerings and convertible bond sales in recent months to boost their capital.

Second, we hold our view that we will see more supportive policies from the government to support the economic re-balancing in the next few months. Notably, a number of these policies will very likely be highlighted in the draft Twelfth Five-Year Plan to be examined during the Chinese Communist Party Central Committee of the Seventeenth session of the fifth plenary meeting in October this year. Among others, we expect areas such as consumption, healthcare, culture, education, entertainment, and hi-tech industries to receive the most policy support in the next Five-Year Plan.

These policy tailwinds, in our view, should help enhance the earnings visibility and re-rate multiples for related stocks in the China universe.

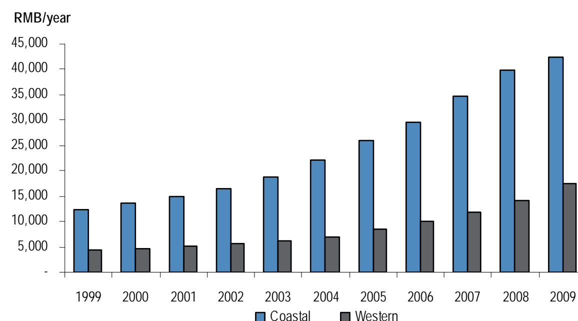
1) Pro-consumption policies:

In our view, in order to further boost domestic consumption to fast-track the economic rebalancing, we believe China may well focus on the below four policy directives: (a) raising Chinese residents' disposable income; (b) improving national income distribution by narrowing the income gap among different income level groups; (c) speeding up the urbanization process, especially in western and central China; and (d) promoting consumer finance.

2) Measures targeting Western China development

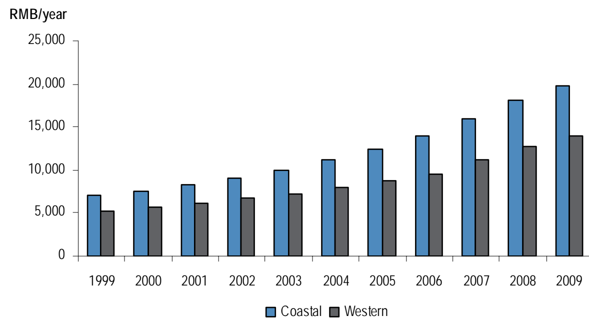
Clearly western China still boasts of significant room for economic growth compared to the more developed coastal region. In 2009, the average per capita GDP in the 12 western provinces (Rmb17,595) was less than half of that in coastal provinces (Rmb42,469); the average per capita urban income for the 12 western provinces (Rmb13,896) was only 70% of that in coastal provinces (Rmb19,766).

Figure 25: China—GDP per capita—Western vs. coastal provinces



Source: CEIC, J. P. Morgan economics.

Figure 26: Urban disposable income—Western vs. coastal provinces



Source: CEIC, J. P. Morgan economics.

We believe the importance of developing the western region in sustaining China's overall economic growth cannot be underestimated against the backdrop of the latest global economic recession, given the huge growth potential embedded in western China.

Against this backdrop, the Chinese government has announced a series of supportive measures targeting western China over the past few months, which include:

- NDRC announced the new construction projects starting in 2010 focused on western development. The total government investment in these projects amounted to Rmb682 billion.

- President Hu announced in NPC working meeting that the implementation of the western development strategy would be placed amongst the top priorities in the Twelfth Five-Year Plan. The Central government will continue both the capital and policy support for projects in western China development. The Central government's investment in western area infrastructure projects will grow at 20% per year during the period of the Twelfth Five-Year Plan (2011-2015).

- Premier Wen announced in the western development's working meeting that the State Council would continue to support the key sectors and enterprises in western China by, among others, keeping a low corporate income tax rate at 15% (vs. the national 25% level).

3) Policies focusing on the energy saving and emission reduction

As noted before, the current administration has been committed to cutting China's energy consumption per unit of GDP by 20% in the 11th Five Year plan period (2006 to 2010).

Looking ahead, we expect the Chinese government to stick with the policy of energy conservation and emission reduction. Hence, we believe the reduction in energy and emissions may remain a key priority in the Twelfth Five Year Plan, to be released in October.

Table 9: A summary of various policies released YTD

Pro-consumption policies

- Ministry of Commerce announced to extend the period of passenger vehicles' "Old for New" policy from the original last day of May 31, 2010 to Dec 31, 2010
- Ministry of Commerce, Ministry of Finance and Ministry of Environment Protection jointly issued the Proposal to Promote the "Old for New" Plan for Home Appliances, which extended the plan's coverage area from 9 provinces and municipalities to 19. The plan is tentatively set to expire on Dec 31, 2011
- In mid July. Ministry of Labor introduced a draft plan targeting a doubling of wage income in Five Years

Western China development

- NDRC announced the new construction projects starting in 2010 for western development. The total government investment in these projects amounted to Rmb682 billion.
- President Hu announced in NPC working meeting that the implementation of western development strategy would be placed amongst the top priorities in the Twelfth Five-Year Plan. Central government will continue both the capital and policy support for projects in western development. Central government investment in western area's infrastructure will grow at 20% per year during the period of Twelfth Five-Year Plan (2011-2015)
- Premier Wen announced in western development's working meeting that the State Council would continue to support the key sectors and enterprises in western China by, among others, keeping a low corporate income tax rate at 15% (vs. the national 25% level).

Economy re-balancing

- NDRC revoked preferential power price policy for energy-intensive enterprises in all the 22 provinces. The power cost difference may add up to approximately Rmb15 billion.
- MIIT announced on Aug 8, 2010 that a total of 2,087 companies from 18 industries shall be shut down by the end of Sep 2010 as part of the overall national move to eliminate backward and obsolete industrial capacity. Of the total, there are 762 cement plants, 279 paper mills, 201 dying plants, 192 coke producers, 175 iron mills, 143 iron alloy producers and 84 synthetic leather producers.
- The range of controlled pollutants will likely extend to include ammonia nitrogen, nitrogen oxides, and heavy metal in the Twelfth Five-Year Plan.
- Twelfth Five-Year Plan will continue to restrain development of energy-intensive and high-pollution industries, and targets at 40%-50% reduction of carbon emission per GDP by the end of 2020
- MIIT is contemplating establishing funds to invest in emission-reduction and energy-saving technology and products; the GEM board and small-and-mid cap board could be an effective exit method for those investment
- The Twelfth Five-Year Plan will strictly control the capacity of non-ferrous metal. By the end of 2015, the capacity of copper smelting will be less than 5 million tons, copper cathodes will be less than 7 million tons, and electrolytic aluminum will be less than 20 million tons. The capacity expansion of non-ferrous metals will be very limited.
- The Twelfth Five-Year Plan will accelerate the consolidation in copper, aluminum, lead, and zinc smelting, and guide that the top 10 producers in these sectors should account for 90%, 90%, 70%, and 70% respectively of the entire industry.

Government investment

- Central government investments will focus on technology innovation and promotion projects.
- NDRC proposes to invest up to Rmb5 trillion from 2011 to 2020 together with market funding in new energy industries. The benefited new energy industries contain not only the wind, hydro and nuclear energy, but also include upgrading of traditional coal, oil and gas power. Approximately 60% of the Rmb5 trillion fund will be deployed in new energy development, while the remaining 40% will be allocated to upgrading of traditional energy.
- Ministry of Housing and Urban-Rural Development expects that investment in city rail transit will amount to over Rmb700 billion, only second to highway and railway construction

Economic housing development

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- The State Council announced the acceleration of the construction of economic housing projects, and targets to provide housing for the nationwide 15 million low-income families by the end of 2012.
- The housing for the nationwide 15 million low-income families will be offered through a combination of affordable housing, low-rent housing, and renovated housing in shanty areas. By the end of 2010, roughly 3 million units of affordable housing and 2.8 million units of renovated housing will be completed.

Source: Ministry of Finance, NDRC, State council, J. P. Morgan

The risks to our base-case scenario of a volatile bottoming process

1) CPI Inflation risks

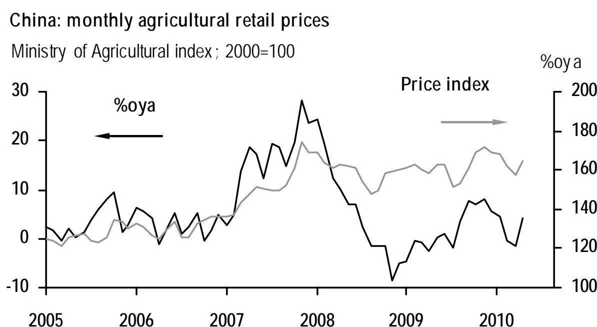
Currently, the prevailing market perception is that China has passed the maximum policy tightening stress point given the ongoing economic slowdown. However, depending on the magnitude of any upside inflation surprises, the market may be concerned about additional tightening measures from the Chinese government to tame the inflationary pressure.

Should China's CPI in August rise above 4%, we could see the tightening concern re-emerge to weigh on China's equity market.

It is indeed worth noting that food prices – especially grain, vegetable and pork prices, which are key items driving the food inflation – have been on the rise since early July due to domestic and external supply shocks.

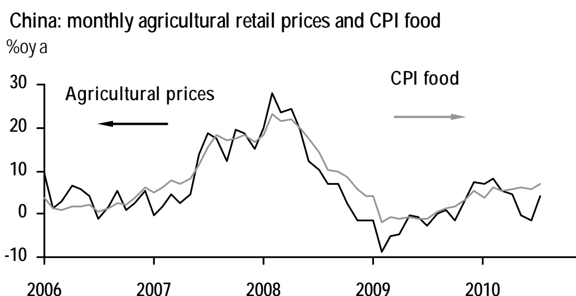
As shown in the chart below, the Ministry of Agricultural Index – a proxy to China's food prices – surged 4.6% MoM in July FY10, and 5.4% again month-to-date in August FY10.

Figure 27: China—Monthly agricultural retail prices



Source: CEIC, J. P. Morgan.

Figure 28: China: monthly agricultural retail prices and CPI food



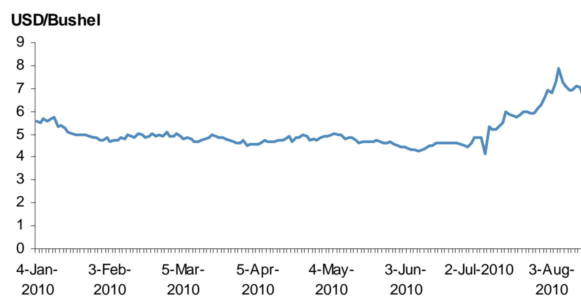
Source: CEIC, J. P. Morgan.

On the domestic front, the worst floods seen in a decade have pushed up agricultural prices across the nation. According to the Ministry of Agriculture, as of August 17,2010, agricultural products' wholesale price index stood at 173.9 (with the year 2000 as 100), rising a notable 5.4% MoM.

It is also worth noting that China has had very good harvests over the past few years which helped the country largely achieve a supply-demand balance in major agricultural produce. Should China's wheat and rice suffer a very poor harvest as a result of the frequently destructive weather this year, grain and vegetable prices may be lifted due to supply-side shortages.

On the external front, Russian export ban on food grains have distorted the international grain market, resulting in a sharp run-up of the international grain prices in early August. While the impact of this single event seems to have faded somewhat over the past two weeks, we cannot underestimate the negative impacts other unexpected shocks may have on global agricultural prices.

Figure 29: CBOT wheat futures 1st month settlement price



Source: CEIC, J. P. Morgan

Meanwhile, we have seen pork prices stage a rebound due to the increasing feeding costs and the supply shortage arising from the earlier decline in the total number of hogs raised. Notably, hog-corn ratio has bottomed since mid-June, a prelude to continued pork price increases down the road. Meanwhile, China's total number of hogs is already down from 480mn at beginning of the year to 430mn now, and the reduction in the number of hogs is expected to provide strong support to hog prices.

Figure 30: Hog-corn price ratio in China

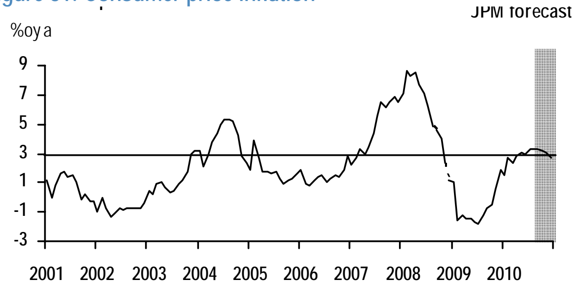
Source: NDRC

Given that food items account for 33.2% of China's CPI basket, should the spikes in food prices stay longer than anticipated due to any supply side shortage or unexpected distortions, we could see higher CPI readings than we have now priced in.

That said, our base-case economic forecast still suggests that China's headline CPI should peak this summer, when the unfavorable base effect gradually fades away and the earlier monetary tightening as of late 2009 takes effect on the real economy.

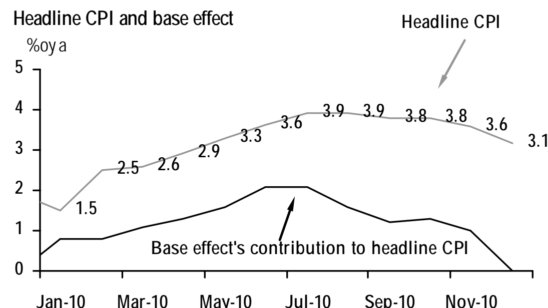
Notably, the non-food inflation in China is still benign given the overcapacity problems in a few industrial sectors and the ongoing economic rebalancing to reduce energy consumption in China, will help check excessive increases in global commodity prices.

Figure 31: Consumer price inflation



Source: CEIC, J.P. Morgan estimates.

Figure 32: Headline CPI forecast and base effect in 2010

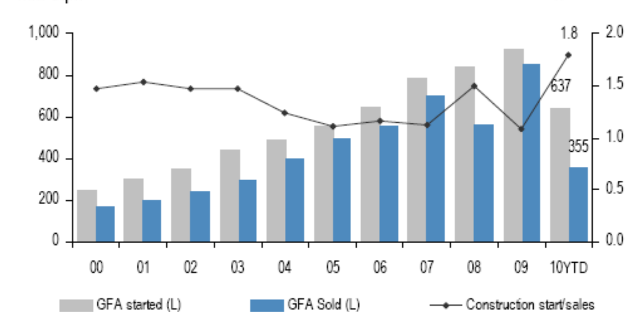


Source: CEIC, J.P. Morgan estimates.

2) Asset Inflation risks

Most investors hold the view that the property market is expected to achieve a soft-landing scenario in 4Q FY10, with property prices expected to experience a decline in 4Q FY10 on a surge in property supply – we expect potential upcoming housing supply of 980 million sqm in the next nine months, given that Chinese property developers started to compete with each other in building properties as of 4Q FY09, and that it normally takes one year to build properties.

Figure 33: China: Residential construction start vs. GFA sold



Source: CEIC.

However, property prices are yet to see a 10-15% correction from peak. Should the property prices fail to see a meaningful correction or even start to rise in coming months, as fueled by improving liquidity leaking into the asset markets, the government may well take additional and harsher policies to crack down the property market in China, including the long speculated property tax.

Notably, the recently reported news that Chongqing municipal government has obtained the central government's approval to launch the property tax, even though the time table for the official implementation of this tax is still not decided *(source: China Times)*, has

indicated that top authorities are ready to crack down on the property sector if the property prices kick off another round of rally.

3) A-shares facing supply-side pressure in Oct/Nov FY10

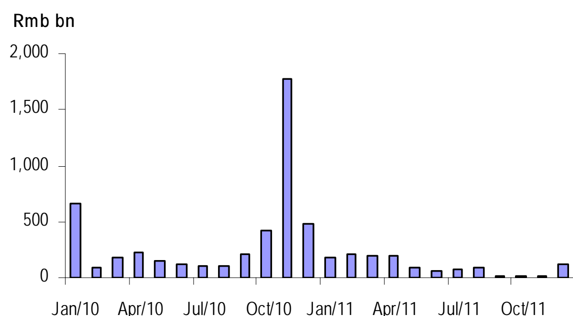
We believe China's A-share market may see substantial supply-side pressure arising from:

1) Locked-up legal person shares gaining floatable status in the main boards in 2H FY10, with an estimated value of Rmb3.090 trillion, compared to Rmb1.423 trillion in 1H10, with the maximum stress points lying in October (Rmb415 billion) and November (Rmb1773 billion);

Average monthly legal person shares gaining floatable status for the period of September to December 2010 stands at Rmb800 billion, versus Rmb204 billion for the period from January to August this year.

That said, we should take note that the majority (around two-thirds) of these legal person shares are state-owned shares, which may not be sold down in the secondary market as state-owned entities normally want to maintain controlling stakes in these listed companies. As a result, the amount of the unlocked legal person shares to be sold onto the secondary market in 2H10 is estimated at around Rmb 1 trillion, which is lower than the above Rmb3.09 trillion, but could still represent big selling pressure for the secondary market. This compares with around Rmb400 billion of unlocked legal person shares which have been sold onto the secondary market in 1H10.

Figure 34: The market value of legal person shares gaining floatable status in the main boards for FY10E and FY11E



Source: Wind. Note: the market value of these shares is based on their close price of Aug 18, 2010.

Table 10: The number of shares and the market value of legal person shares gaining floatable status in the main boards for FY10E and FY11E

	The market value of legal shares gaining floatable status (Rmb B)	The number of legal shares gaining floatable status (billion shares)
Jan/10	654	27.0
Feb/10	90	6.1
Mar/10	186	14.6
Apr/10	227	30.1
May/10	143	16.9
Jun/10	122	14.0
Jul/10	107	16.5
Aug/10	104	11.8
Sep/10	204	15.2
Oct/10	415	23.6
Nov/10	1,773	170.3
Dec/10	488	51.6
Jan/11	187	18.7
Feb/11	214	15.8
Mar/11	194	16.4
Apr/11	189	21.3
May/11	94	8.8
Jun/11	59	7.2
Jul/11	69	8.4
Aug/11	88	13.1
Sep/11	19	1.4
Oct/11	20	1.9
Nov/11	15	1.2
Dec/11	115	11.5

Source: Wind. Note: the market value of these shares is based on their close price of Aug 18, 2010.

2) IPO locked-up shares gaining floatable status in the small-and-mid cap (SMC) board and Growth Enterprise Market ("GEM") board in 2H FY10, which is estimated at Rmb400 billion (Rmb341 billion on SMC board and Rmb59 billion on GEM board), compared to Rmb271 billion in 1H10, with the maximum amount to be freed up for sale in November (Rmb119 billion) and December (Rmb86 billion). The average monthly amount of such shares gaining floatable status for the period from September to December FY10 stands at Rmb66 billion, versus Rmb45 billion for the period from January to August this year.

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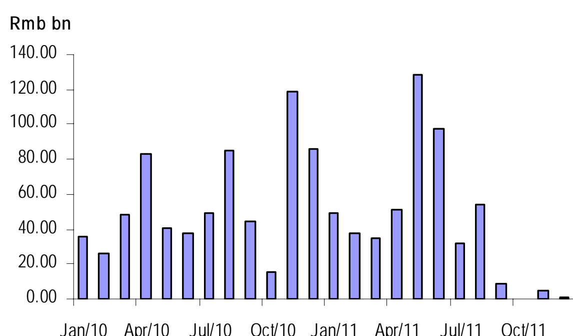
Unlike the companies listed on the main board, the companies listed in SMC and GEM are mostly privately owned companies. This, together with their high valuations, and low investment cost, means that a large part of these locked-up shares are expected to be sold onto the secondary market. In fact, our channel check indicates that some of the legal person shares of SMC and GEM, to gain floatable share status, are already trading at a 30% discount in the grey market to their secondary market prices.

Figure 35: The market value of unlocked tradable shares in SMC and GEM boards for FY10E and FY11E



Source: Wind. Note: the market value of these shares is based on their close price of Aug 18, 2010.

Table 11: The number of shares and the market value of IPO shares to be free for sales in SMC and GEM boards for FY10E and FY11E

	The expiration of locked-up shares (Rmb B)	The expiration of locked-up shares (billion shares)
Jan/10	36	1.2
Feb/10	26	0.9
Mar/10	49	1.6
Apr/10	83	2.2
May/10	41	1.5
Jun/10	38	1.3
Jul/10	50	2.7
Aug/10	85	4.4
Sep/10	44	2.5
Oct/10	15	0.7
Nov/10	119	3.6
Dec/10	86	4.4
Jan/11	49	2.4
Feb/11	37	1.7
Mar/11	35	1.2
Apr/11	52	2.1
May/11	128	5.0
Jun/11	97	3.4
Jul/11	32	1.7
Aug/11	54	2.7
Sep/11	9	0.4
Oct/11	0	0.0
Nov/11	4	0.3
Dec/11	1	0.0

Source: Wind. Note: the market value of these shares is based on their close price of Aug 18, 2010.

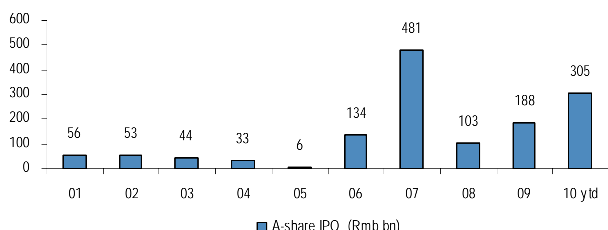
Table 12: Valuations for A-shares' GEM, small and mid caps and the large caps

	P/E	
	2010E	2011E
GEMs	51.7x	37.1x
Small and Mid cap	34.8x	26.5x
CSI 300	13.9x	11.6x

Source: Wind..

3) IPOs that have obtained the China CSRC's approval to be listed in the domestic stock markets in the remainder of this year are estimated at Rmb34.4 billion.

Figure 36: The amount of A-shares' IPOs (Rmb B)



Source: CEIC.

Adding them together, the total amount of floatable new share supply that could come to the market (excluding the state-owned legal person shares) for the rest of the year may well exceed Rmb1.4 trillion, which is a significant amount compared to the average daily trading turnover of Rmb184.4 billion YTD in the A-shares. Notably, the majority of this new share supply (around Rmb 860 billion) is expected to be dumped onto the secondary market at around October/November FY10.

(4) A number of sector-specific policy risks could hurt corporate earnings

As we highlighted in our July issue of VFB, we believe there could be more sector-specific policy directives, such as rolling out the resources tax reform to more provinces across the country, and launching the long-awaited reforms on the healthcare sector.

(1) Resources tax
We believe the establishment of the resources tax in Xinjiang is only a prelude to its popularization across the whole country.

Assuming that a 5% resource tax will be levied on the sales revenue of onshore oil and gas products across the country starting 3Q FY10, we expect the EPS impact on PetroChina and Sinopec will be -6% and -4%, respectively. That said, investors should not write off the full-year impact. Our oil and gas analyst, Brynjar Bustnes, estimates that FY11 impact on a nationwide change would be more meaningful to EPS for PetroChina (-12%) and Sinopec (-7%).

In our view, Heilongjiang Province, where PetroChina's major Daqing oilfield is located may well become the next province to adopt the resource tax. Should this happen, PetroChina could feel the most negative impact from the resource tax.

(2) Regulation on drug price and margins

Over the past two months, the National Reform and Development commission (NDRC) issued plans to scrutinize distribution margins that hospitals and wholesale distributors earn on selling pharmaceutical products, and to investigate the pricing of 900 drugs (including the newly added essential drug list and drugs with capped prices). The purpose is to lower drug-related cost for patients as well as to reduce the incentives for the over-prescription of drugs.

In our view, the government is very serious about limiting the sales prices and margins for both the drug producers and for the distributors, in light of the public anger over the high drug prices.

We reiterate our view that the government is expected to release effective regulations sooner than market expectations, i.e. in a month or two. The government's above efforts are believed to set the stage for stipulating and launching the formal regulations, whose negative impact on the medial distribution companies and drug producers should not be underestimated, in our view.

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Table 13: China — YTD major policy tightening initiatives targeting different sectors

Commodities

- China's NDRC put price caps on coal prices in an apparent effort to help curb potential inflation and to prevent possible power shortages caused by higher coal costs.
- The new resource tax, which has been levied in Xinjiang as of June 1 FY10, and is charged at 5% of the revenue of coal, oil and gas companies, should be extended to all 12 provinces in western China. Du Ying, vice chairman of the National Development and Reform Commission, noted that the resource tax would be extended to the whole country.
- The State Council approved the scrapping of export tax rebates on 406 products, effective July 15, seeking to discourage exports of energy-intensive products. The affected products included some steel and non-ferrous metals products, fertilizers, as well as some plastic, rubber and glass products

Internet

- Detailed requirements (such as registered capitals, etc) for online game companies to obtain "Online Culture Operating Permit".
- Required real name registration system for internet users.
- Required online game companies to implement "anti-addiction system" (such as time limits) for minors.

Healthcare

- NDRC noted that China would set some upper limits on price and margins on: A) pharmaceutical product margins; B) distributors' wholesale margins; and C) hospital level retail margin.

Real estate

- Ministry of Housing and Urban-Rural Development strictly bans loans to households purchasing the third property in tier-one cities, including Beijing, Shanghai, Guangzhou, Shenzhen, and Hangzhou (Aug 2010)
- Shenzhen Local Taxation raised land value-added tax rate from 1% to 2% for residential apartments, from 3% to 4% for villas, and from 2% to 3% for other types of properties, effective from Aug 1, 2010 (Aug 2010)
- Strictly controls land sales to ensure 70% of land supply developed for affordable housing and small-to-mid-size housing (July 2010)
- Raise land premium deposit for residential projects from 20% to 30% (July 2010)
- Raise down payment requirement for buyers of above-90m2 flats from 20% to 30%
- Banks to stop lending to buyers purchasing 3rd home, as well as to restrict non-resident home purchases
- Beijing banned all families from buying more than one property
- PBoC increased RRR three times YTD, from 15.5% to 17%
- Raise down payment requirement for 2nd home buyers from 40% to 50% and strictly implements 1.1x PBoC rate for such buyers

Banking and finance

- CBRC requested banks to conduct a new round of stress tests to gauge the impact of residential property prices falling as much as 60 percent in the hardest-hit markets (Aug 2010)
- CBRC orders banks to take existing trust credit assets onto balance sheets by the end of 2011 and set aside loan loss reserve to be included in capital ratio calculations. Besides, the balance of financing trust credit products must be capped at 30% of the total trust credit balance (Aug 2010)
- CBRC bans cooperation between banks and trust companies to constrain bank lending through wealth management products, in order to mitigate off-balance sheet risks (July 2010)

Source: Ministry of Finance, State council, J. P. Morgan.

Sector Views

With regard to our asset allocations, **we are positive on the following sectors and thematic ideas**:

(1) Mid-cap consumer (sticky growth) names

As noted in our strategy note, dated July 12, entitled *Rebalancing economy, re-weighting portfolios*, some of the most successful investment stories come from mid-cap consumer (sticky-growth) areas. The combined effects of the continuous re-rating and consistent earnings growth amid the economic upturns and downturns have brought about 50 times share price appreciation for Hengan Intl and Changyu Winery as of 2001.

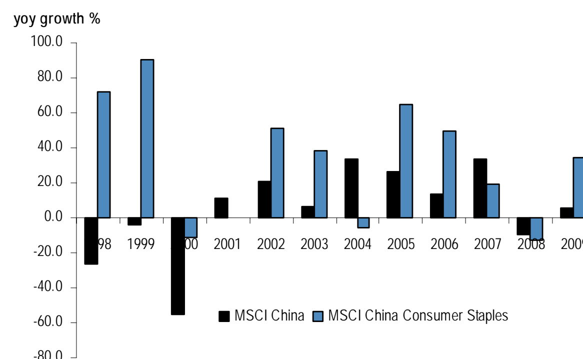
Against the backdrop of Chinese equities entering a volatile bottom-forming process, and of China's transition from an investment-driven economy to a consumption-driven economy, we reiterate our view that China's mid-cap consumer staple and low-end consumer discretionary sectors may offer the best risk-reward profile. This is because:

(1) These sectors have a sticky growth track record, both in upturns and downturns of the economic cycle;

Staple and low- and middle-end consumer discretionary segments have shown good resilience in terms of their solid earnings growth during past economic downturns, as these names are relatively immune to the impact of an economic slowdown in China.

As shown in Figure 37, consumer staple companies in these segments have been able to post strong earnings growth during the past three economic downturns, namely: (a) Asian financial crisis (1998-2000), during which period, China's consumer staple sector's EPS grew at a CAGR of 30%; (b) China monetary tightening triggered a correction (2004-2005), when China's consumer staple sector's EPS grew at a CAGR of 25%; and (c) the global economic recession (2008-early 2009), when China's consumer staple sector's EPS grew at a CAGR of 8.4% versus -2.1% for MSCI-China. Hence, the staples shares significantly outperformed the overall market during these market downturns.

Figure 37: Earnings growth—MSCI-China consumer staples vs. MSCI-China



Source: Bloomberg.

Figure 38: Index performance—MSCI-China versus consumer staple and consumer discretionary (Jan 3, 2000=100)

Source: Bloomberg.

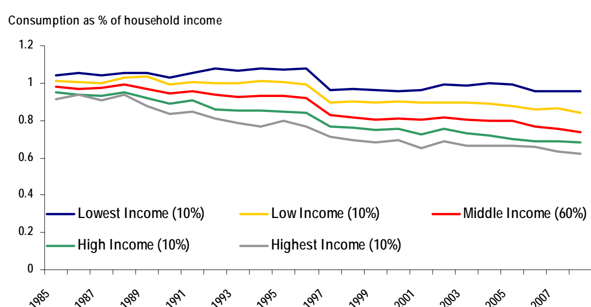
(2) The wage hike for the mass working class people in China as of FY10

We see rising labor wages for the mass working class as a major positive for China's consumer staple and low-end consumer discretionary sectors, as the rising disposable income of China's massive labor force in manufacturing industries should translate to rising demand for quality consumer staples and low- and mid-end consumer discretionary products.

This is particularly true if we take into consideration two underlying factors: (a) low income groups in general boast of a higher propensity to consume than their high-income peers. Hence, they are more likely to spend more money due to the wage hike; and (b) most big-ticket consumer items such as cars or high-end consumer discretionary products like luxury watches or yachts, exceed low income groups' affordability. With limited purchasing power, they are most likely to spend their

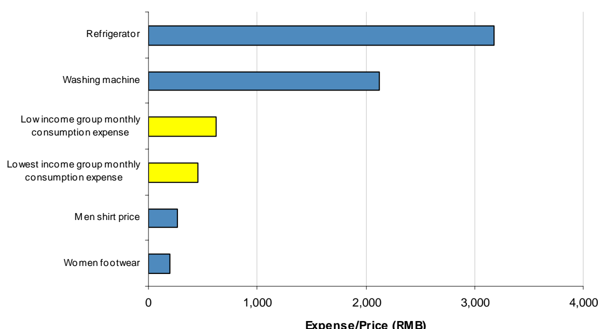
money to buy low- and medium end consumer discretionary items, such as garments, footwear, accessories and cosmetics.

Figure 39: Propensity to consume by different income groups in China



Source: CEIC, J.P. Morgan. Note: All households are grouped, by per capita disposable income of the household, into groups of lowest income, low income, middle income, high income and highest income, each group consisting of 10%, 10%, 60%, 10% and 10% of all households, respectively.

Figure 40: China—Monthly consumption expenditure by lowest income group and low income group versus major discretionary products' retail prices



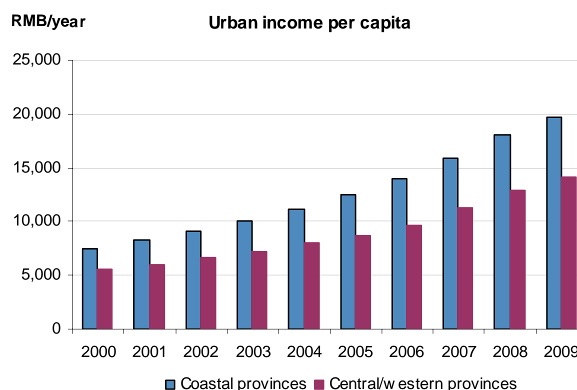
Source: CEIC, J.P. Morgan. Note: All households are grouped by per capita disposable income of the household, into groups of lowest income, low income, middle income, high income and
highest income, each group consisting of 10%, 10%, 60%, 10% and 10% of all households, respectively.

(3) China's strategy of developing the undeveloped western and central China should translate into faster disposable income growth for people in these regions;

With the urbanization rate at below 50% level, China has significant growth potential to be derived from this urbanization trend, which can help unleash many rural households' pent-up demand for quality consumer staples, and low-and mid-end consumer discretionary products.

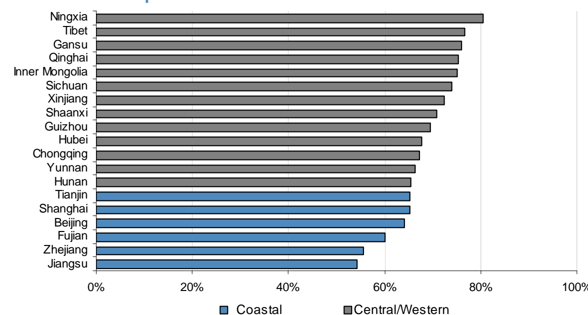
The economic development and the rapid urbanization in central/western China will enable the 800 million people in these regions to gradually catch up with their rich peers in eastern China, in terms of consumption of quality consumer staple products and low- and-medium end consumer discretionary products.

Figure 41: China—Per-capita urban residents' disposable income in coastal regions vs. central/western regions



Source: CEI, J.P. Morgan. Note: Coastal provinces include Beijing, Tianjin, Liaoning, Jilin, Heilongjiang, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, and Hainan. All other provinces are classified as central/western provinces.

Figure 42: China—Propensity to consume (%)—Coastal vs. central/western provinces



Source: CEIC, J. P. Morgan.

(4) These sectors have long been subject to complete market competition. Their failure to enjoy the preferential policy treatment in the past is now turning out to be a blessing, as they are now subject to the least policy risk, such as resource tax which will hurt China's oil and coal companies.

We believe China's mid-cap sticky growth consumer names possess the best chance to repeat Hengan International's success

We reiterate our view that China's mid-cap sticky growth consumer names in the consumer staple or low-end consumer discretionary sectors may stand the best chance to repeat Hengan International's success in the past decade.

Being a dominant player in the fast-growing tissue and diaper segment, Hengan has seen its share price surge by around 50x over the past 10 years, driven by the combined effects of:

(a) Consistent re-rating of its multiple from single-digit P/E (an average of 8.2x for FY00) to over 30x P/E currently on its expanding market cap; and

(b) Its sticky double-digit earnings growth track record (CAGR at 28%) over the past 10 years, immune to the upturns or downturns of the economic cycle and boosting its EPS by about 10x during the period.

In our view, the 50-bagger candidates in China's consumer space to repeat Hengan's performance (rising around 50 times over the past 10 years) should meet the following criteria:

(1) Operating in consumer staples, or/and low- and middle-end consumer discretionary segments;

(2) Trading at undemanding valuations, which leave room for further re-rating;

(3) Market cap between US$1 billion and US$3 billion;

(4) Audited by world's top five auditors.

J.P. Morgan China mid-Cap Consumer (Sticky Growth) Basket

In light of our positive views on mid-cap sticky growth names in China's consumer staple and low-end consumer discretionary sectors, and factoring in the above four key stock picking criteria, we have chosen 20 names to form J.P. Morgan China Mid-Cap Consumer (sticky growth) Basket.

Unlike the tier-one large cap China consumer names, which are mostly trading at 35-40x FY10E P/E, the basket constituent names are basically trading at teens' valuations, and offer over 20% EPS growth p.a.

Meanwhile, the combined daily trading volume of the 20 constituents of the basket records over US$100 million, which solves the liquidity issue for investors.

The Bloomberg ticker for this basket is **JPHCHMCS Index <GO>,** and the constituents of the basket are listed in the table below. Since we established the basket on July 13, it has gone up by 6.72% as of August 20, outperforming MSCI-China by 4.33%.

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Table 14: J.P. Morgan China Mid-Cap Consumer (Sticky Growth) basket {Ticker: JPHCHMCS Index <GO>}

Ticker	Name	Last Price (USD)	Shares in the Basket	Weighting in the Basket (%)	MSCI-China Weighting (%)	P/E (x) FY10E	P/E (x) FY11E
HMIN UW Equity	Home Inns & Hotels Management Inc	43.47	700	7.20	n/a	31.5	27.2
SNDA UW Equity	Shanda Interactive Entertainment Ltd	42.88	700	7.10	n/a	17.6	14.0
1068 HK Equity	China Yurun Food Group Ltd	3.41055	9000	7.26	0.75	22.1	18.2
336 HK Equity	Huabao International Holdings Ltd	1.45431	19000	6.54	0.38	21.7	18.0
2010 HK Equity	Ruinian International Ltd	0.84556	34000	6.80	n/a	18.3	14.0
1234 HK Equity	China Lilang Ltd	1.23681	21000	6.14	n/a	25.5	19.4
3331 HK Equity	Vinda International Holdings Ltd	1.07722	24000	6.12	n/a	20.6	16.4
1169 HK Equity	Haier Electronics Group Co Ltd	0.72201	36000	6.15	n/a	15.9	11.2
589 HK Equity	Ports Design Ltd	2.76705	9000	5.89	n/a	19.8	16.6
2319 HK Equity	China Mengniu Dairy Co Ltd	2.99228	8000	5.66	0.56	24.6	19.7
2331 HK Equity	Li Ning Co Ltd	3.46203	7000	5.73	0.39	21.1	17.4
210 HK Equity	Daphne International Holdings Ltd	0.97812	24000	5.55	n/a	18.0	14.2
1361 HK Equity	361 Degrees International Ltd	0.8121	27000	5.19	n/a	13.3	11.4
175 HK Equity	Geely Automobile Holdings Ltd	0.35779	60000	5.08	0.22	11.6	9.6
1368 HK Equity	XTEP International Holdings	0.78378	17000	3.15	n/a	14.4	12.0
SVN UN Equity	7 Days Group Holdings Ltd	14.34	700	2.37	n/a	39.8	27.4
538 HK Equity	Ajisen China Holdings Ltd	1.27284	7000	2.11	n/a	28.7	22.4
8277 HK Equity	Wumart Stores Inc	2.16216	4000	2.05	0.18	33.6	26.7
848 HK Equity	Maoye International Holdings Ltd	0.41956	20000	1.99	n/a	26.3	22.2
829 HK Equity	Shenguan Holdings Group Ltd	1.01673	8000	1.92	n/a	23.5	18.4

Source: Bloomberg and J. P. Morgan. Note: Bloomberg subscribers can use the ticker **JPHCHMCS Index** to access tracking information on JPM China Mid Cap Consumer (Sticky Growth) basket created by the J.P. Morgan Delta One desk to leverage the theme discussed in this report. For information on JPM China Mid Cap Consumer (Sticky Growth) basket, please contact your J.P. Morgan salesperson or the Delta One Desk.

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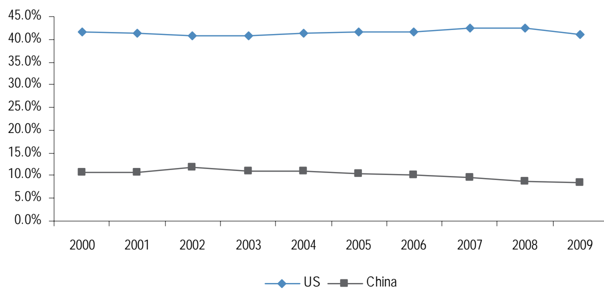
2) Consumer service providers

We believe leading consumer service providers in China could also benefit from the rising disposable incomes and the improving living standard of Chinese people.

It's worth noting that urban residents in China in the past decade spent less than 10% of their disposable income on recreational service – including travel, cultural, and entertainment service, and this percentage even slightly declined from 10% to 8.6% in 2008 and 2009 amid the concerns of the global financial crisis.

In contrast, the recreational service expenditure consistently took up as high as 40% of the disposable income per capita in the US in the past decade. The gap in recreational service consumption between the two countries shows that service industry has a low penetration rate and thus remarkable growth potential in China. The catch-up in China's penetration rate to that of more developed countries will unleash solid secular growth potentials for the recreational service industry in China, even without factoring in the population growth and demographic change in China.

Figure 43: Recreational service expenditure per capita as % of disposable income – China vs. US



Source: CEIC

a) Tourism sub-sector

We believe the tourism sector in China is still in a very early development stage, compared to developed countries, which should enable leading tourism service providers, such as Ctrip.com, a consolidator of hotel accommodations and airline tickets in China, and Home Inns, a chain of budget hotels in China, to enjoy solid secular growth.

Notably, tourism-related retail sales in China have seen a robust rising trend over the past 15 years. The domestic tourism revenue grew by 10x from 1994 to 2009, implying a CAGR of 17% and cumulatively outperformed retail sales by 40%.

Figure 44: Domestic tourism revenue growth vs. retail sales growth (rebased to 1994)

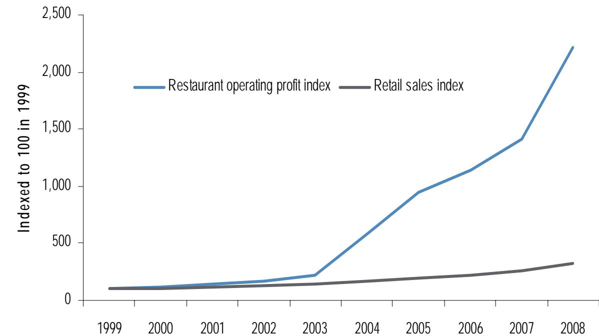
Source: CEIC

b) catering/restaurant sub-sector

Catering/restaurant sector in China is also much less developed compared to developed countries, implying big secular growth opportunities in China.

Restaurant revenue in China saw strong growth from 1999 to 2008 at a CAGR of 40%. The restaurant market is more than 22 times the size it was in 1999 in terms of revenue, outperforming the retail sales by 590% accumulatively.

Figure 45: Restaurant profit growth vs. retail sales growth (rebased to 1999)



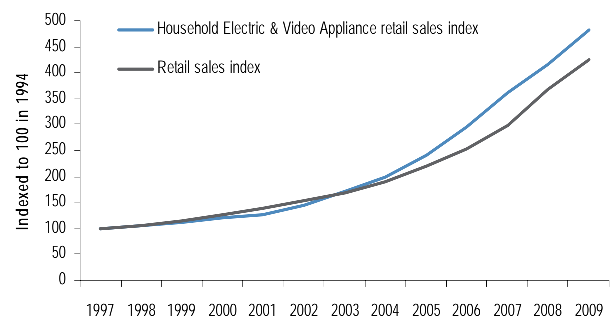
Source: CEIC.

c) home appliances in tier-three, tier-four cities and rural areas

Meanwhile, home appliances sector in China also registered solid growth, consistently outpacing the headline retail sales growth, over the past decade on increasing demand from tier-one and tier-two cities.

Looking ahead, we believe the rapid growth in this sub-segment will continue or even accelerate given the incremental demand from tier-three, tier-four cities as well as from the rural areas thanks to: a) rising urban and rural households' disposable income in these areas catching up those in the tier-one or two cities; and b) the government's preferential policy stimulating rural area demand for home appliances, such as the "Home appliance subsidy program in rural areas" introduced in early 2009.

Figure 46: Home appliance v.s headline retail sales growth (rebased to 1997)



Source: CEIC.

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(3) China's visible rail capex beneficiaries

China's railway sector, which plays an important role in upgrading the country's infrastructure and logistics system to enhance the overall productivity but is still in the early development stage, is expected to receive strong policy support from the central government, which should bring about good investment opportunities.

To put this into perspective, the new railway-related orders rose above 40% YoY YTD, beating market expectations. We believe the railway FAI should stay robust for the next three to five years as railway investment remains a top priority while most other projects are now half-way completed.

Our top picks within this sector include China Railway Group (390 HK) and China Railway Construction-H (1186 HK).

(4) Western China development beneficiaries

In our view, western China still boasts of significant room for economic growth compared to the more developed coastal region. In 2009, the average per capita GDP in the 12 western provinces (Rmb17,595) was less than half of that in coastal provinces (Rmb42,469); the average per capita urban income for the 12 western provinces (Rmb13,896) was only 70% of that in coastal provinces (Rmb19,766).

Moreover, the urgency to re-balance the economic growth over different regions with a bias in favor of the less-developed western China is rising at a time when: the external demand recovery proves to be lukewarm at best; the trade friction is intensifying between China and the US/Europe; and the export-oriented manufacturing sector is suffering from rising labor costs.

Against the backdrop of the implementation of China's Western China Development strategy, as stressed by the top policymakers in China, we believe the likely beneficiaries of this regional rebalance include local cement companies, such as Xinjiang Tianshan Cement Co. Ltd. (000877 CH), benefiting from the infrastructure spending in the western China, and local retailers such as Xinjiang Youhao Group Co. Ltd. (600778 CH), benefiting from robust households' disposable income growth in the western part of China.

(5) Menswear

We also like the menswear segment, which boasts of strong growth potential in the coming three to five years.

We believe the menswear segment, which is still not well developed in China in terms of menswear consumption per capita (US$291 p.a. in China, compared with US$1,175 p.a. in the US and US$1,489 p.a. in Europe), has significant room for growth, as Chinese men become more brand and fashion conscious, and start to spend more on purchasing branded menswear.

As noted before, according to *Euromonitor*, menswear could record a 17.7% CAGR in its retail sales in China from 2006 to 2011, notably higher than women's wear CAGR of 11.7%, children wear CAGR of 9.2%, and the overall apparel market's CAGR of 14.2%.

Table 15: Different apparel segments' CAGR of retail sales in China

CAGR (2006-2011)	
Total apparel market	14.2%
Menswear	17.7%
Womenswear	11.7%
Children wear	9.2%

Source: Euromonitor.

In light of the strong secular growth potential, we believe the menswear segment could represent a good investment opportunity in China. Among others, leading companies in China's menswear sector, such as China Lilang and Trinity may all benefit from such a secular growth trend, in our view.

(6) Insurance

From the macro strategy perspective, we choose to be overweight on the China's insurance sector. Our arguments are summarized as follows:

(1) Long-term positive on sector secular growth
China is currently the third-largest insurance market in Asia by premium size behind only Japan and South Korea but its growth potential is significant. With its insurance penetration rate of 3% (defined as premiums/GDP), implying a barely penetrated market by Asian standards, Swiss Re has forecast an average annual premium growth of 14% per annum for the life sector and 12% per annum for the non-life insurance sector for the next decade. The tremendous growth potential is underpinned by an aging population, a rising income level and, more importantly, a strong desire by the

government to develop the sector to ensure social stability.

(2) More investment opportunities for the sector from the liberalization of investment channels: CIRC has finally allowed insurers to invest in real estate (up to 10% of total assets) and unlisted companies (5%). At the same time, it has further increased the investment limit in equities (from 20% of total assets to 25%), unsecured bonds (from 15% to 20%) and infrastructure projects (from 4% for non-life insurers/6% for life insurers to 10%). The breakthrough in real-estate investment finally put the Chinese insurers on a par with their regional peers in terms of the type of assets they are allowed to invest in. The announced liberalizations should help insurers to achieve better asset-liability matching and higher investment return.

The 25% investment limit in equities for China's insurance sector is much higher than the insurers in Asia, e.g. South Korea and Taiwan, which only have 10% of their investments in equities.

At the same time, the change may also increase the insurers' investment risks.

(3) Proposed pricing liberalization on traditional products to have mixed impact on China's insurance sector: CIRC is studying the possibility of removing the 2.5% cap on guaranteed rate on traditional life insurance policies. Should this proposal take effect, we expect very limited near-term impact given that traditional life insurance accounts for less than 10% of first-year premiums and CIRC has been guiding guaranteed rates no higher than 3.5%.

From a longer-term perspective, we see mixed impact from the pricing liberalization initiative. On the negative side, we may see the proposed pricing liberalization translating into greater competition for the sector. On the positive side, the move may help China's insurers to attract more premium growth as it enhances the insurance products' attractiveness against bank deposits.

Among China's insurance sector, we like Ping An and China Taiping Insurance Holdings.

Ping An (Overweight): It is the cheapest life insurer in our universe with no value attached to other business as implied by the current share price. It has the most profitable life franchise due to its strong focus on agency-driven business, and we see other operations staging strong growth. We see risks of capital raising and new acquisitions.

CTIH (Overweight): Value is slowly emerging after the recent sell-off and we believe the market expectation on NBV growth has been recalibrated to a lower level. Resumption of branch opening and agent recruitment would underpin steady 30%+ NBV growth which is the strongest in our universe. Ming An (China) disposal gain could surprise on the upside. We see risk of expense overrun worsening as branch opening resumes and bancassurance partner ICBC teaming up with others.

(7) Mid-cap banks

We believe the market is mainly concerned about asset-quality issues relating to LGFVs, and the banks' capital raising overhang. In our view, uncertainty relating to capital raising which the market feared, has been dismissed with announcement of rights issue by each of the big banks and the announcement of Central Huijin, i.e. the controlling shareholder in big Chinese banks, to issue bonds to raise money to participate in these Chinese banks' equity raising activities.

Meanwhile, CBRC's recent initiatives to ask Chinese banks to work with local governments to ask the latter to provide adequate mortgage protection for those exposed to LGFV debt may help alleviate the market concern over LGFV debt.

In short, Chinese banks' low valuation of less than 10x FY10E PE, and 20% plus earnings growth in 2011/2012 may have discounted the above two concerns.

On the other hand, the market's fear for economic slowdown and asset quality may limit the room for multiple expansion or re-rating for Chinese banks.

Within Chinese banks, we are positive on mid-cap banks with a relatively small exposure to local government's funding vehicle debt, and with a focus on China's consumer financing business.

China Merchant Bank:

- **Management call boosted our confidence in earnings outlook:** During its briefing, management hinted higher internal capital generation in 2H10. For the next three years, management plans a "second transformation" to achieve improved revenue mix and risk pricing ability. In particular, the bank targets to maintain superior profitability by focusing more on

higher-yield SME lending, retail and non-interest income business. We maintain our 2010-12E earning estimates unchanged.

- **NIM outlook remains positive**: NIM in July was stable compared with June level. Management expects modest room for NIM expansion in 2H10 so that FY10 NIM may be modestly higher than 1H10's level, consistent with our expectation. Meanwhile, on back of strong NIM recovery, management also expects cost-income ratio to be much better than 2009.

- **Trust loans of value less than Rmb10bn to be included on balance sheet.** Management said that Rmb10 billion of trust loans potentially to be included on balance sheets by end of 2011 as a result of the new directives on loan-related trust products, less than 0.7% of FY10 loans, or 0.7% of FY10E RWA. Thus there is negligible impact from such directives.

- **Expect no material provisioning impact from LGFV loans.** Total LGFV loans were 10.77% of total loans, down 0.15% vs. end of 2009. NPL ratio on such loans was 0.09% and LLR were over 2% of total such loans. Its LGFVs are largely top-tier city construction and transportation projects with good cash flows. CMB expects even if CBRC issues any new guideline on LGFV provisioning, the amount will be negligible in its case.

Meanwhile, we are negative on some low-beta super-large-cap banks with a relatively large exposure to the LGFV debt.

Meanwhile, we maintain our UW stance on the following sectors from an equity strategy perspective

(1) Commodities

Our UW position in commodities has hurt us over the past month. Despite possible short-term trading opportunities, we maintain our UW position in China's commodities space.

Our arguments are as follows:

(1) China is increasingly shifting from a commodity-heavy investment-driven economy to a consumption- and service-driven economy. Among others, Chinese government has adopted the following policies, which are expected to hurt China's commodity sector:

a) Chinese government's policy to close down backward industrial capacities.

China's Ministry of Industry and Information Technology announced on August 8, 2010, that a total of 2,087 companies from 18 industries shall be shut down by the end of September 2010 as part of the overall national move to eliminate backward and obsolete industrial capacity. Of the total, there are 762 cement plants, 279 paper mills, 201 dying plants, 192 coke producers, 175 iron mills, 143 iron alloy producers and 84 synthetic leather producers.

We believe the current administration is committed to cutting China's energy consumption per unit of GDP by 20% in the Eleventh five-year plan period (2006 to 21010). Yet the cumulative reduction of energy consumption per unit of GDP achieved in the first four years of the Eleventh Five Year plan recorded only 15.61%, which means the government has a challenging job over the next four months to shut down energy-intensive industries to meet the above energy reduction target.

We believe the crackdown on energy-intensive industries will, at best, be a medium-term positive as it is meant to alleviate the overcapacity issue in these oversupplied industries, such as glass, steel, aluminum.

In reality, the past efforts by the government in weeding out overcapacities in energy-intensive industries proved not effective in addressing the overcapacity issue. In fact, the removal of the small inefficient industrial capacities in the past has been accompanied with the addition of large capacities, with the industries involved ending up with higher capacities.

b) China has announced the removal of export rebate for 406 energy-intensive industrial products;

c) China has removed preferential power tariffs for energy intensive industries;

d) China has restricted the land supply and credit lending to the energy intensive material industries.

As a result of the above policies, many of the above energy-intensive materials industries may face short-term negative impact as a result of the energy reduction initiative, which may come from higher power tariffs, and the restriction of land supply, and credit lending for these industries.

Meanwhile, the existing material companies, such as steel and aluminum companies, may also find it difficult to receive approval for capacity expansion plans unless they agree to take over weaker and smaller peers;

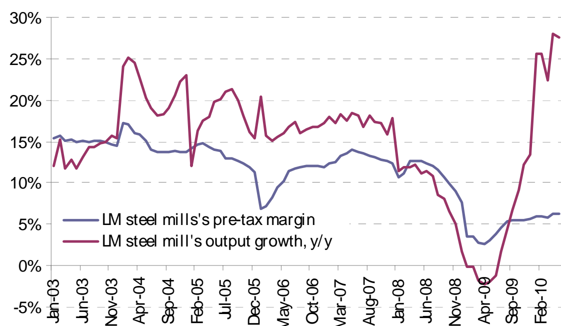
Looking ahead, we expect China to stick with the policy of shifting from an investment driven economy to a consumption driven economy. In October, we expect China to release its Twelfth Five Year Plan, whereby the reduction in energy and emissions may remain a key priority.

(2) Historically, **China's steel sector has found it difficult to make a decent margin unless the industry demand growth can exceed 20%.** Against the backdrop of China's shift from an investment driven economy to a consumption driven economy, China may find it difficult to post 20-30% demand growth as it did in the past, which may translate into a structural de-rating for the sector.

We believe the structural low profitability of China's steel sector is due to: (a) the structural overcapacity issue. China has found it difficult to weed out inefficient capacities due to taxation and employment considerations for the local government; (b) China's lack of iron ore resources has positioned China's steel mills at disadvantageous positions versus the overseas iron ore suppliers.

As shown in the figure below, there is a close correlation between steel output growth (which is used as a proxy for industry demand growth) and the steel sector's gross margin, except for FY10 because of the high demand growth rate this year is really to a very low comparison base from last year. In other words, the steel sector continues to suffer from low profitability despite the seemingly high output growth rate achieved on the back of the low comparison effect.

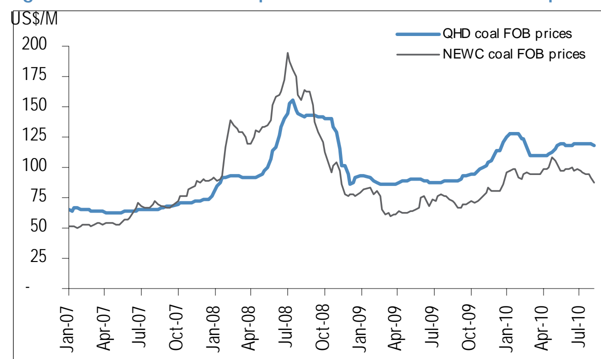
Figure 47: China – steel industry output growth vs. steel industry's gross margin (3mma, %)



Source: mysteel.com, J.P. Morgan.

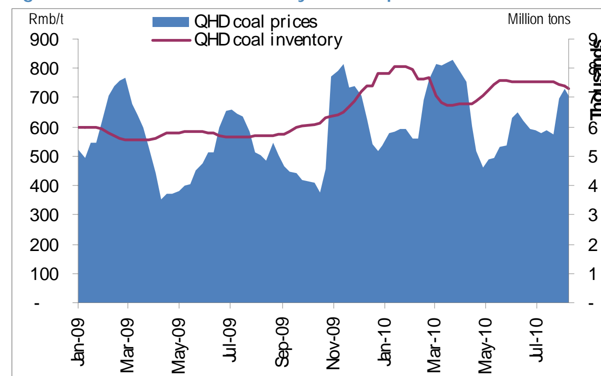
(3) The crackdown in energy intensive industries has started to hurt China's coal demand, with both regional and China's thermal coal prices falling for the past three consecutive weeks.

Figure 48: China QHD coal prices versus NEWC coal FOB prices



Source: mysteel.com, globalcoal.com.

Figure 49: China--Coal inventory at QHD port



Source: mysteel.com, globalcoal.com.

4) In China's Twelfth Five-Year Plan, to be released in October this year, there is a risk that China might adjust down its medium-term GDP growth target from above 8% to around 7%, which may have negative implications on China's demand for commodities and , hence , for domestic and global commodity prices.

(2) Energy

First, we take a cautious view on crude price given the near-term downbeat global economic growth outlook. Indeed, our US economists have revised down US real GDP growth forecast to 1.5% for 3Q10 (from 2.5%) and 2.0% for 4Q10 (from 3.0%). In light of this US growth rate downward revision, our China economists also lowered the forecast for China's real GDP growth to

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9.8% YoY in 2010 (previous forecast: 10.0%) and 8.6% YoY in 2011 (previous forecast: 8.8%).

Second, we believe the potential establishment of the resources tax to be popularized across the whole country will meaningfully weigh on earnings for Energy companies.

Assuming a 5% resource tax will be levied on the sales revenue of onshore oil and gas products across the country starting 3Q FY10, we expect the EPS impact on PetroChina and Sinopec will be -6% and -4%, respectively. That said, investors should not write off the full-year impact. Our oil and gas analyst, Brynjar Bustnes, estimates that FY11 impact on a nationwide change would be more meaningful to EPS for PetroChina (-12%) and Sinopec (-7%).

In our view, Heilongjiang Province, where PetroChina's major Daqing oilfield is located may well become the next province to adopt the resource tax. Should this happen, PetroChina could feel the most negative impact of the resource tax

(3) Property

After decreasing our weighting from OW to UW in August 2009 in our model portfolio, we have kept an UW stance on China's property sector.

Going forward, we will keep a close watch over whether the so called "soft-landing scenario" (For details, please see the analysis below) of the property sector can materialize in 4Q FY10. Should the soft-landing scenario materialize in 4Q FY10, we would consider turning more positive on the sector.

Soft-landing scenario in 4Q FY10 for China's property sector?

China's housing market may see the bottom in 6-9 months when new construction starts are channeled into supply. The expected mild 5-10% fall in the property's selling prices on the back of the expected increase in property supply in 4Q FY10 may attract real demand from end-users, thus bringing about a strong recovery in the property transaction volume. This, in turn, may address the authorities' concern about the frothy property market, and engineer a so called "soft-landing scenario" for China's property sector.

Should the above soft-landing scenario prevail in 4Q FY10, the ramp-up of property supply and property inventory may provide room for the Chinese government to potentially loosen the tightening measures targeting this sector. As a result, we could see China's property sector being re-rated on the back of the reduced crack-down risks.

In fact, our China property analyst, Lucia Kwong, estimates a potential property supply of 982 million sqm in the next nine months based on the cumulative housing starts levels since 4Q09. She believes that the rising supply should lead to price consolidation, but a market-collapse scenario is unlikely this time given the current more positive economic outlook than that was as of late 2008. She holds the view that the contract sales should have bottomed in May/June and are poised for a rebound when more developers put up more launches in the next few months. Most developers have not scaled back their production plans and hence would price their new launches at lower prices than existing projects. Notably, 4Q may also be the watershed for developers with good execution ability and branding to start to fetch stronger sales, as opposed to those who lack pricing power but choose to hold back launches until market recovers.

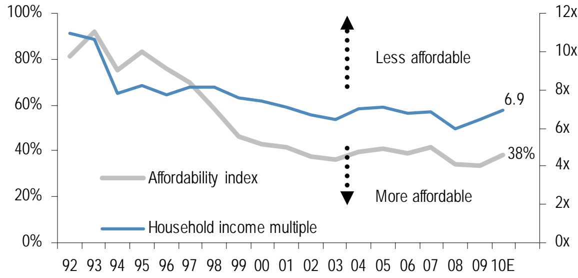
Figure 50: China property supply projects

	2004	2005	2006	2007	2008	2009	2010E	2005-09 avg
New commodity residential construction area (Sqm in MM)								
(A)	490	552	644	788	836	925	1,091	749
Commodity residential sales volume (Sqm in MM)(B)								
(B)	338	498	544	691	559	862	700	631
Estimated "available for sale" floor area (inventory)= Leftovers from previous year + previous year's construction starts								
(C) t = (C) t-1 - (B) t-1 + (A) t-1	501	652	706	807	903	1,131	1,244	850
Est. Sales rate (B/C)	68%	76%	77%	86%	62%	73%	56%	75%
Difference (D) = (C)- (B)	163	155	162	115	345	319	544	
Months' of inventory = (D) / (B / 12)	5.8	3.7	3.6	2.0	7.4	4.4	9.3	4.2
Commodity residential sales value (Rmb Billion)								
National	862	1,499	1,704	2,532	2,042	3,216	3,226	
Average sales price (Rmb/sqm)								
National	2,549	3,010	3,132	3,665	3,655	4,474	4,608	
Commodity residential completion (Sqm in MM)								
National	347	400	432	473	477	596	-	477

Source: J.P. Morgan Property Team.

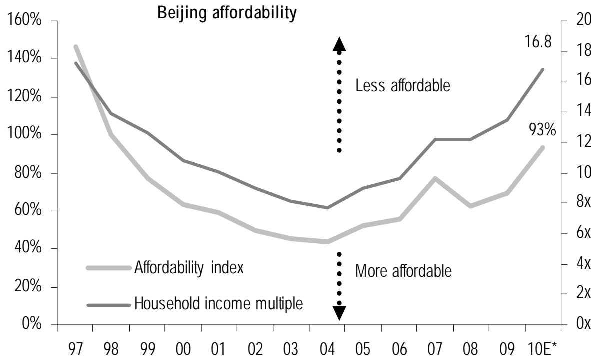
Among China's property developers, we like the property developers whose business models are focusing on the volume rather than on the margins, such as Vanke. Also, we prefer the property developers with the most exposure to tier-two and tier-three cities over those focusing on tier-one cities with the frothiest prices.

Figure 51: China: Housing affordability on a national level

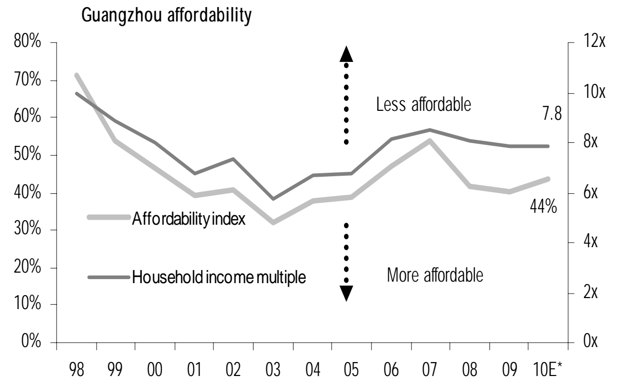


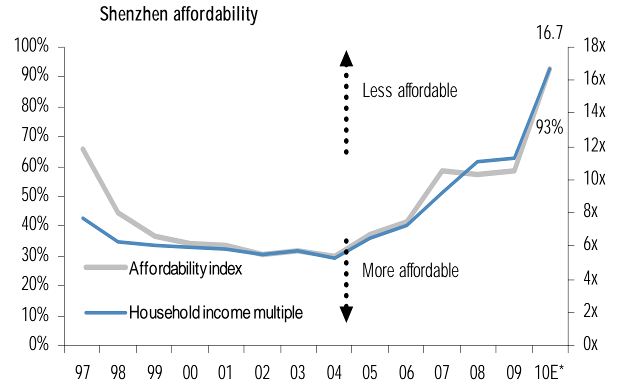
Source: CEIC and J. P. Morgan property team. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio * FY10E property price assumption is based on the price at the end 1Q, FY10.

Figure 52: China: Housing affordability ratio in Beijing



Shanghai affordability
Less affordable
More affordable
Affordability index
Household income multiple
10.8
60%





Source: CEIC and J. P. Morgan property team. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio. * FY10E property price assumption is based on the price at the end 1Q, FY10.

Our property analyst, Raymond Ngai, notes below the key arguments why he prefers Vanke within the China property universe:

(1) Strong profit growth: Having seen flat core net profit in FY09, Vanke should be back on profit growth from this year onward underpinned by improved profit margins in FY10 and volume growth in FY11. We expect Vanke's market share to rise to 2.5% from 1.7% with estimated contracted sales of Rmb80 billion this year (2009: Rmb63 billion) for Vanke. Being the largest developer in the nation, Vanke is a good proxy to play the China's housing market. Vanke has penetrated more than 40 cities with 200 projects under developments totaling 8.0 million sqm.

(2) High earnings lock-in: As of end-June 2010, Vanke still had Rmb57.3 billion of presales not yet recognized, representing a floor area of 5.3 million sqm. Most of this would be recognized in 2H10 and 2011. The ASP of the un-recognized sales is high at around Rmb10,811/sqm,

about the same as the recognized ASP of Rmb10,931/sqm in 1H10. We expect margins to maintain stable at around 29% in 2H10 but may fall slightly next year in anticipation of lower overall ASP as more supply will hit the market in 2H10. By our forecast, almost all of FY10 property sales have been locked-in and around 40% in FY11.

(3) Expansion into affordable housing: Vanke will participate in affordable housing because this is a big market capturing 30% of total supply in future and Vanke's focus on industrialization and pre-fabrication which needs large-scale production to succeed. Vanke has investments in affordable housing projects in Beijing, Nanjing and Guangzhou. The one in Nanjing will provide 2.0 million sqm with a tight completion schedule by 2012. Management said margin is around 6-10% for affordable housing and ROI is 14%.

We take a neutral stance on China telcos in China strategy context

Our China telco analyst, Lucy Liu, recently launched coverage on China's telco sector. Among China telcos, she prefers China Unicom (CU) over China Telecom (CT) and China Mobile (CM) because she believes that China Unicom's mobile businesses are currently undervalued by the market. Unicom will largely stick to its handset subsidy guidance in 2010/2011E, which will set an EBITDA breakeven path in due course. We believe the market would reassess the quite low expectation on China Unicom's execution capability in light of the recent developments, which would thus result in a multiple rerating and better monetization of the mobile operations.

With regard to China Mobile, Lucy holds that China Mobile's long-term outlook remains upbeat, but it is too early to buy China Mobile for the moment: CM's early foray into TDD-LTE and new value-added service present an optimistic long-term outlook, but we believe any excessive excitement at the moment might be premature as we foresee the meaningful impact of TDD-LTE will only emerge in 2013-2014E.

With regard to China telco's industry dynamics, we hold that:

(1) 3G just took off in China one and half years ago and it's still at the early stage of the development. However, mobile data usage is going to post explosive growth over time in China, just as the trend as seen in developed countries years ago. The growth of mobile internet is likely to be underpinned by the affordability rise as well as the increasing popularity of smart-phones in China. China Unicom, with the premier WCDMA network and best 3G handset support, should be the largest beneficiary of such trend in our view.

(2) Chinese telcos' growth profile this year is still subdued due to the upfront opex/capex of 3G launch. However, when the market is looking forward to next year, China Unicom and China Telecom should post strong earnings recovery (up 27% and 50% YoY) thanks to the breakeven of their 3G and mobile operations. Lucy holds that China telcos' earnings visibility will be largely improved as of next year.

(3) Valuation wise, CM trades at the lowest on P/E (12x 2011E), CU and CT trade at 4x 2011E EV/EBITDA, and 1x 2011E P/B, all at fairly reasonable levels. CU and CT look a bit high on P/E side, partly due to the network depreciation difference (they have both 3G and 2G networks depreciated by listed company vs the other two guys who have part of the networks on parent company), and however, CU and CT look attractive on P/E to growth basis.

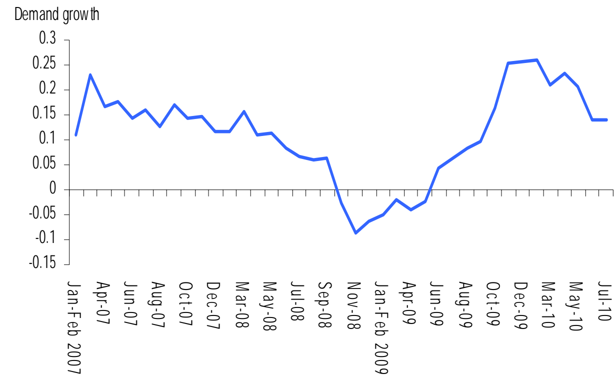
Last but not least, we decide to decrease our weighting in IPPs from OW to UW in the China equity strategy context

Given our view that the China market is entering a volatile bottom-forming process, we would like to take a more pro-growth stance in our model portfolio, and decide to take profit on China IPPs.

While China's IPPs are expected to benefit from the decline in coal prices in the spot market in 2H10, we believe the rising food prices reduces the chance of power tariff increases in 2H10, which is likely to hinder a further re-rating of this sector.

Moreover, we expect China's power demand growth to see a sharp slowdown from 18% in 1H10 to 2-5% in 2H10 on economic slowdown concerns, which could be negative for IPPs' performance.

Figure 53: China power demand--Decelerating growth in 2H10



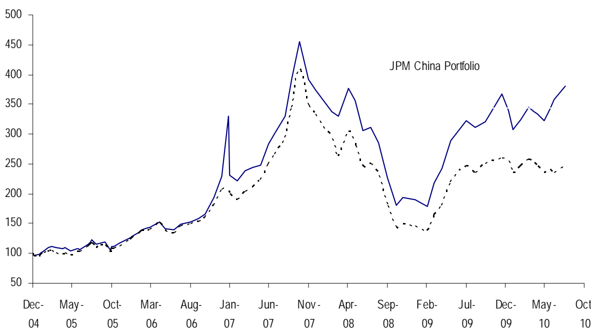
Source: CEIC and J. P. Morgan.

China Model Portfolio (CMP) adjustments

As of August 19, 2010, our model portfolio rose 5.92% since January 1, 2010, versus a 3.54% decline in MSCI-China during the same period. Since December 31, 2004, our model portfolio has outperformed MSCI-China by 91%.

Over the past month, among others, our model portfolio has been helped by Netease, Belle International Holdings, China Merchants Bank – H, and Shanda Games, which rose 21%, 21.1%, 10.6%, and 18.1%, respectively. On the other hand, detractors from performance included China Taiping Insurance, China Gas Holdings Limited, China Life Insurance, and China Mengniu Dairy Co. Ltd., which dropped 10.4%, 7.9%, 2.5%, and 6.8%, respectively.

Figure 54: Since 31 December 2004, our CMP has outperformed MSCI-China by 91%



Source: Bloomberg and J. P. Morgan.

Over the past month, we have made the following adjustments to our China model portfolio.

(1) We cut exposure to utilities, gas and expressways

In light of our view that the China market is entering a volatile bottoming forming process over the next three months, we decide to take a more pro-growth stance in our China model portfolio.
First, we took profit on Huaneng Power (-1.5%), and cut our weight in China Resources Power by 2.5% to 0.5% (-2.5%). China's IPPs, such as Huaneng Power, has outperformed China equities YTD, thanks to its defensive nature against the backdrop of economic slowdown.

Second, we trimmed some positions in the gas sector, which has had a great run as of 2009. We took out China Gas (-1.5%), and cut our weight in Beijing Enterprise from 2% to 1% (-1%).

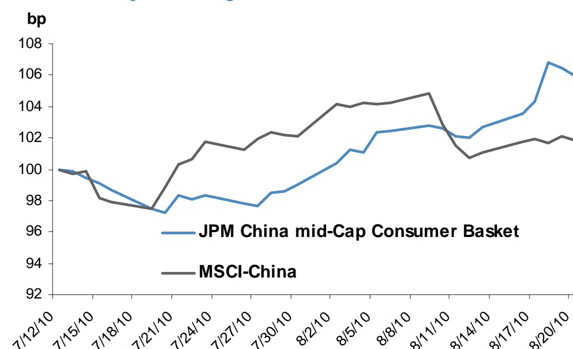
Third, we also took profit on Jiangsu Expressway (-1.5%), despite the upside from its possible toll tariff adjustments next year.

(2) With the proceeds, we added weight in China's mid-cap consumer sector

As noted before, we believe China's mid-cap consumer staple and low-end and mid-range consumer discretionary sectors offer the best risk-reward ratio *(*for more details, please refer to the earlier section "Mid-cap consumer (sticky growth) names" on pages 21-24*).*

To leverage our China mid-cap consumer-sticky growth theme, we added the China mid-cap consumer sticky growth basket to our model portfolio with a weight of 8% on July 13, the day when it was officially launched.

Figure 55: Price performance in basis points for J.P. Morgan's China mid-cap consumer basket versus MSCI China over the period from July 13 to August 20



Source: Bloomberg.

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Table 16: J.P. Morgan Model Portfolio for China

	Ticker	Price	Rating	Change (%) 1m	Change (%) 12m	MSCI Weight	JPM Weight	Dev. (%)	P/E 2010	P/E 2011	DY 2010	ROE 2010
Consumer Discretionary	**MXCN0CD INDEX**	**266.2**		**4.6**	**31.1**	**4.6**	**5.5**	**0.9**	**15.8**	**13.4**	**1.8**	**18.0**
Belle International Holdings Ltd.	1880 HK	13.2	OW	11.1	91.0	1.0	2.5	1.5	30.8	29.3	1.1	19.4
Ports Design	589 HK	21.8	OW	4.3	16.3	0	1.5	1.5	20.3	16.6	3.0	36.5
Trinity Limited	891 HK	5.7	N	15.4	na	0	1.5	1.5	33.4	26.8	1.8	13.0
Consumer Staples	**MXCN0CS INDEX**	**1329.7**		**2.2**	**56.3**	**5.5**	**16.0**	**10.5**	**18.4**	**15.5**	**1.8**	**17.0**
China Mid-cap consumer basket	JPHCHMCS INDEX	105.5	N/A	7.4	na	0	8.0	8.0	NM	NM	NM	NM
China Mengniu Dairy Co. Ltd.	2319 HK	22.9	OW	-7.3	19.6	0.6	3.5	2.9	25.8	19.2	0.9	14.9
China Yurun Food Group	1068 HK	26.3	OW	2.9	105.5	0.6	1.5	0.9	23.2	19.1	1.2	19.6
Huabao International Holdings Limited	336 HK	11.3	N	8.7	32.9	0.3	2.0	1.7	26.4	21.9	0.0	40.7
Hengan International Group Ltd	1044 HK	67.7	N	5.5	64.6	0.9	1.0	0.1	32.4	27.7	2.0	27.3
Energy	**MXCN0EN INDEX**	**633.3**		**5.7**	**18.0**	**17.3**	**10.0**	**-7.3**	**10.5**	**9.2**	**3.4**	**17.0**
CNOOC	883 HK	13.3	N	8.2	35.6	5.4	6.0	0.6	11.6	11.3	4.7	24.9
Sinopec Corp - H	386 HK	6.4	OW	5.1	0.3	2.3	1.0	-1.3	7.1	6.2	3.5	17.1
China Shenhua Energy	1088 HK	29.7	N	4.9	4.8	2.4	0.5	-1.9	14.9	NM	2.4	18.9
Yanzhou Coal Mining - H	1171 HK	16.8	N	9.4	61.5	0.8	1.0	0.2	13.8	NM	1.9	15.9
PetroChina	857 HK	8.7	UW	1.0	2.6	4.4	1.0	-3.4	10.5	10.1	4.3	15.0
China Coal Energy	1898 HK	11.3	OW	11.2	21.2	0.9	0.5	-0.4	12.1	NM	2.5	15.2
Financials	**MXCN0FN INDEX**	**483.7**		**1.0**	**5.7**	**37.8**	**30.5**	**-7.3**	**11.9**	**10.0**	**3.2**	**16.8**
China Life Insurance	2628 HK	33.4	UW	-0.1	8.3	6.1	4.0	-2.1	23.3	19.4	1.6	15.2
Agile Property Holdings Ltd	3383 HK	9.4	OW	7.4	-6.8	0.3	1.0	0.7	13.1	10.9	2.3	15.2
Ping An Insurance 'H'	2318 HK	64.4	OW	0.0	8.3	1.9	2.0	0.1	26.8	20.8	0.9	14.6
ICBC - H	1398 HK	5.7	OW	-0.7	7.0	6.4	3.0	-3.4	10.1	8.3	4.4	22.1
China Merchants Bank - H	3968 HK	20.0	N	4.6	25.8	1.8	3.5	1.7	15.2	12.0	1.3	21.4
China Construction Bank	939 HK	6.5	OW	3.5	11.6	6.8	2.5	-4.3	10.0	8.5	4.3	21.6
Bank of China -H	3988 HK	4.0	OW	-1.9	9.8	5.4	8.0	2.6	8.5	6.5	5.0	18.9
Bank of Communications - H	3328 HK	8.6	OW	3.0	2.2	1.2	4.0	2.8	9.6	8.0	3.4	21.1
China Taiping Insurance	966 HK	24.0	N	-6.1	27.1	0.5	1.5	1.0	38.7	26.4	0.0	6.6
China Overseas Land & Investment	688 HK	16.0	OW	0.5	-7.2	1.5	1.0	-0.5	14.2	13.7	1.6	20.2
Health care	**MXCN0HC INDEX**	**156.9**		**11.6**	**na**	**0.7**	**1.5**	**0.8**	**39.8**	**30.0**	**0.6**	**14.5**
Sinopharm	1099 HK	29.9	UW	8.3	na	0.4	1.0	0.6	45.8	38.6	0.5	11.4
China Shineway Pharmaceutical Group Limited	2877 HK	20.6	OW	6.9	165.2	0	0.5	0.5	18.4	14.8	1.6	27.0
Industrials	**MXCN0IN INDEX**	**168.8**		**5.6**	**3.8**	**7.8**	**7.0**	**-0.8**	**14.0**	**11.7**	**2.2**	**10.6**
China High Speed Transmission	658 HK	16.9	OW	8.8	-5.7	0.4	2.0	1.6	13.8	11.0	2.4	27.6
China Railway Group Limited	390 HK	5.8	OW	3.4	-10.1	0.5	1.5	1.0	12.9	10.9	1.5	13.1
China Railway Construction Corporation Limited	1186 HK	10.3	OW	-0.4	-11.0	0.4	3.5	3.1	14.0	12.1	2.1	14.2
Information Technology	**MXCN0IT INDEX**	**97.8**		**5.3**	**45.1**	**6.1**	**11.0**	**4.9**	**27.9**	**19.6**	**0.7**	**15.8**
ZTE Corp	763 HK	26.8	N	18.3	38.6	0.2	1.5	1.3	13.2	10.5	1.7	17.5
Alibaba.com Limited	1688 HK	15.3	N	-7.7	8.2	0.5	1.5	1.0	51.7	35.3	0.0	21.9
Baidu.com	BIDU US	73.2	OW	-0.4	127.6	0	3.0	3.0	6.0	3.8	0.0	46.1
Shanda Games	GAME US	74.2	OW	1100.8	na	0	2.0	2.0	13.8	11.0	0.0	38.3
Netease	NTES US	30.4	OW	-8.0	-22.5	0	3.0	3.0	13.2	11.2	0.0	23.9
Materials	**MXCN0MT INDEX**	**966.6**		**12.9**	**-4.8**	**5.0**	**3.0**	**-2.0**	**12.2**	**9.8**	**2.3**	**13.4**
Zhaojin Mining	1818 HK	19.0	NR	5.8	51.7	0	3.0	3.0	21.5	18.9	2.1	20.9
Telecommunication Services	**MXCN0TC INDEX**	**129.3**		**6.7**	**5.1**	**13.3**	**14.0**	**0.7**	**12.1**	**11.5**	**3.6**	**15.2**
China Mobile (HK)	941 HK	82.8	N	7.5	8.1	10.8	5.0	-5.8	12.3	12.0	3.5	20.7
China Telecom Corp	728 HK	3.8	OW	3.5	-0.5	1.2	1.5	0.3	17.0	13.9	2.3	7.0
China Unicom - H	762 HK	10.4	OW	3.6	-7.8	1.3	7.5	6.2	35.7	25.3	1.3	2.8
Utilities	**MXCN0UT INDEX**	**372.9**		**3.3**	**-16.6**	**2.0**	**1.5**	**-0.5**	**13.7**	**11.5**	**2.6**	**10.8**
China Resources Power Holdings	836 HK	17.1	N	3.8	-3.7	0.6	0.5	-0.1	13.4	10.6	2.3	15.1
Beijing Enterprises Holdings Limited	392 HK	53.9	OW	5.8	39.3	0.6	1.0	0.4	19.7	17.3	1.6	7.7
MSCI Total	**MXCN INDEX**	**62**		**4**	**11**	**100**	**100**	**0**	**13**	**11**	**3**	**16**

Source: Bloomberg and J.P. Morgan. Note: Updated as of August 20, 2010. *Bloomberg estimates for NR companies.

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Macroeconomic views

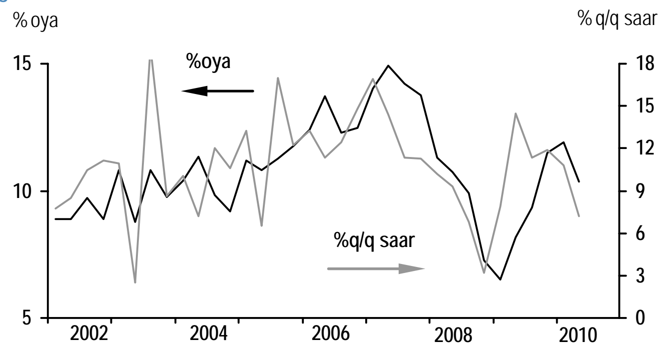
2Q GDP growth moderated to 10.3%oya, government sticks with "flexible" and "targeted" macro policy

The Chinese economy's pace of growth moderated in 2Q10, as we expected, with real GDP rising 7.2%q/q saar following an increase of 10.8%q/q saar in 1Q. In over-year-ago terms, 2Q GDP rose by 10.3%oya (J.P. Morgan: 10.9%; consensus: 10.5%), following an 11.9%oya growth in 1Q. The moderation in the economy's overall pace of growth in 2Q was accompanied by slower fixed investment growth on the back of tightening measures aimed at the housing sector and a restraint on local governments' investment projects. There was some inventory adjustments, too, while on the other hand, retail sales and exports continued to expand solidly. Looking ahead, possible risks to China's growth picture for 2H10 include the possibility of weaker external demand (as highlighted by our US team's recent downward revision to the US growth outlook) and a severe inventory correction in China's industrial sector (the June PMI inventory component rose to its highest level since October 2008, with a marked fall in the orders-to-inventory ratio). Meanwhile, the impact of various measures to restrain the pace of credit expansion as well as tightening measures directed at the housing sector since mid-April suggest further moderation in FAI growth. By contrast, improving labor markets and hence household income should support the solid expansion in private consumption demand.

We believe the government remains vigilant in setting macro policies intended to deliver solid growth. In particular, Chinese policymakers have become increasingly concerned about the sustainability of the global recovery and the prospects for China's export sector. This was likely an important factor behind Premier Wen's recent reiteration of the importance of maintaining a "flexible" and "targeted" policy approach in order to confront China's prevailing macro challenges, and the central bank's latest reiteration of its "appropriately accommodative" monetary policy stance during the rest of the year. In an effort to boost growth, the NDRC last week announced an Rmb682 billion investment plan for 23 major infrastructure projects. Initial indications are that majority of these will be new projects, not simply the "fast-tracking" of existing ones. The announcement was somewhat of a surprise to the market given that the government has been reluctant to approve new infrastructure projects since late last year due to concerns about overinvestment and the quality of bank assets associated with local government borrowing. Although we believe the direct impact on the economy from the investment program is likely to be very limited in 2010, the initiative is an important signal that the government is keen to set policies that promote growth. On the monetary policy, interbank liquidity has tightened and the interbank interest rate has increased notably due to the central bank's intensified sterilization of excess liquidity resulting from the balance of payment surplus and three increases in the required reserve ratio (RRR) early this year. However, the central bank has started to inject considerable liquidity since mid-May. The People's Bank of China (PBoC) injected Rmb224 billion in May, Rmb517 billion in June, and Rmb155 billion in the first week of July. As a result, liquidity has eased recently and the seven-day repo rate declined further to around 2.0%. Looking ahead, we expect the PBoC to continue focusing on open market operations to manage liquidity conditions. We believe the chance for further RRR hikes during 2H10 is now low.

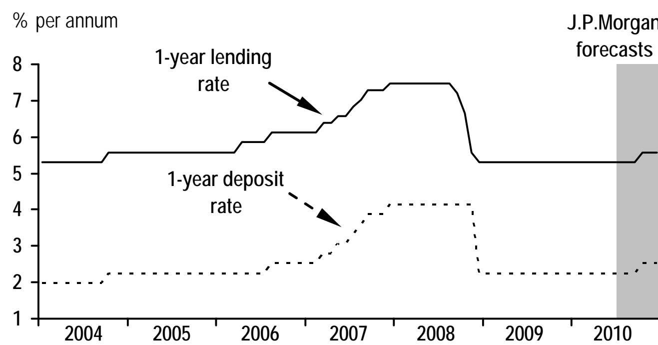
CPI inflation in June remained around the 3%oya hurdle, which is seen as a necessary level for authorities to trigger a rate hike cycle. However, Chinese policymakers currently seem content that as growth momentum in the overall economy has moderated, the near-term gentle upward trend in headline CPI inflation can be tolerated. Furthermore, the latest softening in global commodity prices should help to ease underlying inflation pressure. In the meantime, Chinese policymakers are closely observing the global economic recovery, as well as the impact of their own tightening measures implemented so far on the Chinese economy. We now expect the PBoC to raise the benchmark policy rate once this year, by 27bp in 4Q (our previous forecast called for a total of two hikes in 2H10), when it becomes more confident about the global recovery and in order to calm inflation expectations. On the currency, our year-end Rmb/US$ target now stands at 6.6. China is set to increase the flexibility of the currency regime, and Rmb appreciation could well be front-loaded in time for the US midterm elections to heighten the political significance, in our view.

Figure 56: China—Real GDP



Source: CEIC, J.P. Morgan Economics.

Figure 57: China—Benchmark lending and deposit rates



Source: CEIC, J.P. Morgan Economics.

More details about June macro indicators suggest external demand still holding up

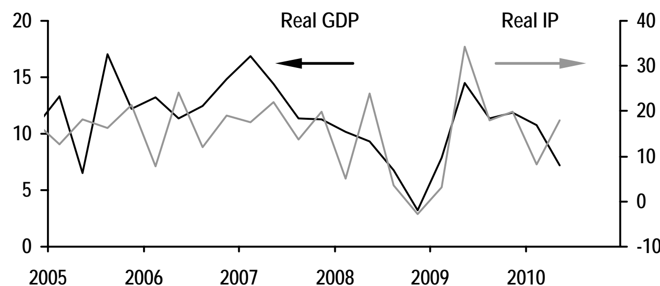
IP rose by 13.7%oya in June, compared with 16.5%oya the month before. Seasonally adjusted, IP fell by 0.2%m/m in June, following a modest 0.4%m/m gain in May,

with the sequential trend rising 17.8% 3m/3m saar. Domestic demand remained healthy with retail sales climbing 18.3% oya in June, translating to a 1.5% m/m sa gain. Fixed investment growth eased slightly, increasing 25.5% oya in January-June after advancing 25.9% oya in the first five months of the year—our calculation suggests fixed investment rose by 24.8% oya in June. Real estate investments rose by 38.1% oya in January-June, compared with 38.2% oya in the first five months of 2010. Meanwhile, the pace of growth in infrastructure investment, which picked up sharply last year on the back of the government's aggressive fiscal stimulus, appears to have peaked in recent months. The pace of railway investment growth, for example, rose at a moderate 22.5% oya in January-June compared with 67.5% oya in 2009.

China's June exports exceeded expectation, rising 43.9% oya (J.P. Morgan and consensus: 38.0%), which translates to a modest decline of 0.9% m/m sa. However, this was on the back of the sharp 13.0% m/m rise in May. The underlying sequential trend rate of growth for exports thus turned up notably, to 35.7% 3m/3m saar in June from 7.1% 3m/3m saar in May. The picture was different for imports, which was little below expectation, rising 34.1% oya in June—this translates to a 3.3% m/m sa decline following a 2.5% m/m gain in May, with the sequential trend growing at a modest 4.4% 3m/3m saar. The trade surplus rose modestly in June to US$20.02 billion, compared with US$19.53 billion in May. For the first six months of this year, the trade surplus was US$55.3 billion, compared with $96.2 billion during the same period last year.

The June trade report shows broad-based sequential gains in major export product categories, including higher-end tech products and lower-end consumer goods. Exports from the country show that shipments to the US and to Europe continued to lead the solid upturn in sequential trend growth in June. This is consistent with our view that developed economies' growth may have peaked in 2Q10 (see "China trade flows tracking global growth contours," *GDW*, July 2). In our view, the stronger-than-expected export figures in the past two months (May and June) were likely magnified by exporters' frontloading activity ahead of the government's reduction in export VAT rebates, effective July 15. Looking ahead, developed markets' (DM) growth is expected to slow steadily in coming quarters, as the boost from the inventory cycle fades and the fiscal policy moves from net stimulus to a drag. The developed markets' private sector final sales, which are more important for China's export sector, are expected to still rise fairly steadily in coming quarters, suggesting that the net impact of a DM slowdown on China's exports and overall growth would likely be moderate.

Figure 58: China—Real GDP and industrial production
% q/q, saar, both scales



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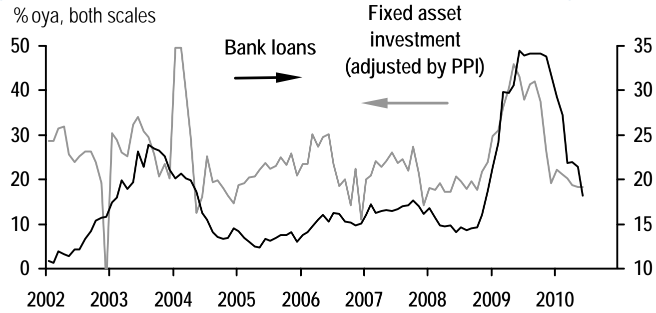
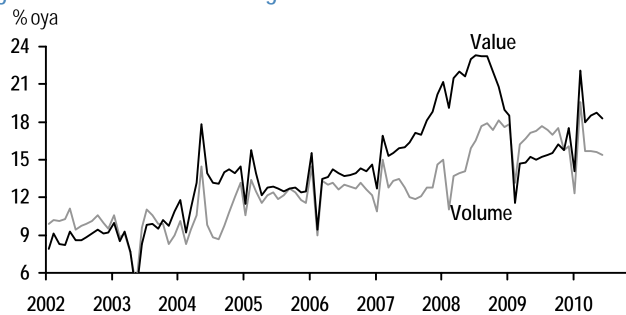
Source: CEIC, J.P. Morgan Economics.

Figure 59: China—Real fixed asset investment and bank loans growth



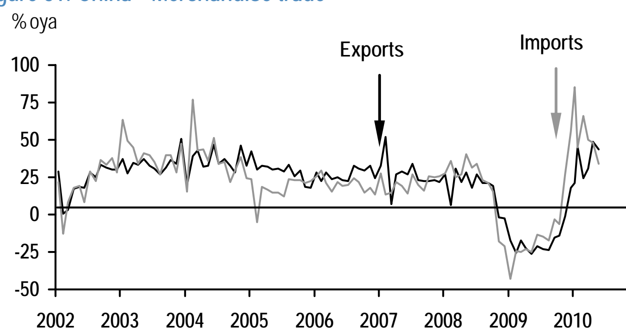
Source: CEIC, J.P. Morgan Economics.

Figure 60: China—Retail sales growth



Source: CEIC, J.P. Morgan Economics.

Figure 61: China—Merchandise trade



Source: CEIC, J.P. Morgan Economics.

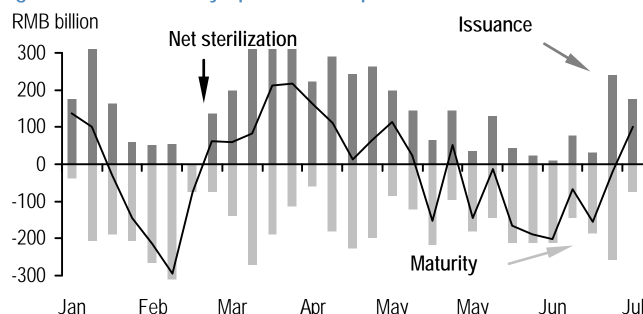
Central bank to keep the liquidity situation accommodative

Following heavy sterilization through open market operations and three RRR hikes since January this year, interbank liquidity has tightened notably since mid-May and the interbank interest rate surged sharply. This situation has been exacerbated by some temporary factors, such as the IPO of a major bank. Hence, the central bank has

increased its net liquidity injections since mid-May. The PBoC injected Rmb224 billion in May, Rmb517 billion in June, and Rmb174 billion during the first two weeks of July. As a result, liquidity started easing recently and the seven-day repo rate fell. However, in the past two weeks the central bank has started to withdraw some of the liquidity injected previously as some temporary factors begin to fade. During the weeks between July 19 and July 26, the central bank sterilized Rmb185 billion on net. Nonetheless, this is a rather modest amount, and the overall monetary environment remains accommodative. Despite the recent withdrawal of liquidity, the interbank rate has remained steady, with the seven-day repo rate stabilizing near 1.7%.

Our rates team estimates that excess reserves are about Rmb700 billion at end-July, about 1.2% of total deposits, and we expect this to remain stable going forward. We believe policymakers have to stay vigilant in setting policies to deliver solid growth. Consequently, the central bank recently reiterated its "appropriately accommodative" monetary policy stance for the rest of the year, and we expect that the central bank will rely on open market operations in coming months to manage the overall liquidity situation.

Figure 62: PBoC weekly open market operation



Source: CEIC, J.P. Morgan Economics.

Information

July manufacturing PMI points to a gradual moderation in industrial activity

China's NBS manufacturing PMI eased again in July, to register the lowest level in 17 months, but still staying above the expansionary threshold of 50. This suggests that industrial activity growth has continued to ease steadily, along with the monetary normalization and policy curbs targeting at the property market and local government investment activities. The official NBS manufacturing PMI fell from 52.1 in June to 51.2 in July (J.P. Morgan: 51.6; consensus: 51.4). The NBS commented that most of the PMI components eased further in July, but the pace of decline had moderated. Of the 11 manufacturing PMI components, only the employment index rose in July. A breakdown by product groups suggests that PMIs for raw materials and energy industries fell below the threshold of 50, while PMIs for intermediate goods, consumer goods and producer goods continued to stay above 50. Meanwhile, Markit released its July manufacturing PMI for China at 49.4 (J.P. Morgan: 50.2), compared with 50.4 in June. This is the first time that Markit PMI came in below the expansionary threshold of 50 since April 2009.

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Going forward, we expect industrial activities to grow at a moderate pace in coming months, in line with our outlook for China's real GDP growth to slow to around 8.2%-8.6%q/q saar pace during 2H10, compared with the strong double-digit pace of increase seen in previous quarters. In our view, risks to the growth outlook for 2H10 could come from a weaker-than-expected external demand environment, and further inventory correction in China's industry sector. On the policy front, we believe the government remains vigilant in setting macro policies intended to deliver solid growth. In particular, Chinese policymakers have become increasingly concerned about the sustainability of the global recovery and the prospects for China's export sector. We expect the PBoC to raise the benchmark policy rate once this year, by 27bp in 4Q, when it becomes more confident about the global recovery and in order to calm inflation expectations. With regard to the currency, our year-end Rmb/US$ target stands at 6.6. Details are below:

- The NBS PMI output component slipped to 52.7 in July from 55.8 in June. Among forward-looking components, new orders fell to 50.9 in July from 52.1 in June. On the external side, the export orders component in the NBS series fell to 51.2 in July from 51.7 in June. The recent decline in new orders reflects the moderation on the domestic front under policy tightening measures. Indeed, while consumer spending has continued to show a solid expansion, latest macro figures have confirmed a steady moderation in FAI growth, especially in price-adjusted terms. Besides, on the external front, we continue to highlight that one of the risks to China's 2H10 growth picture is the possibility of weaker-than-expected external demand.

- The inventory component eased somewhat to register 49.9 in July compared with 51.3 in June. Together with the fall in orders, the orders-to-inventory ratio stayed unchanged at 1.02 in July, the lowest level since January 2009. The easing in orders and rising inventory conditions in recent months, if continue, could raise concerns about a significant inventory correction going forward, especially if end-demand slows meaningfully.

- With regard to labor market conditions, the employment component of the NBS series rose to 52.2 in July, compared with 50.6 in June, pointing to a sustained, upward trend in private consumption spending.

- On the pricing front, the NBS PMI input price components fell further in July to 50.4, compared with 51.3 in June and the recent peak of 72.6 in April, reflecting the latest trend in global commodity prices and easing pressure on import price inflation. Overall, the recent easing in the PMI input price components, and the easing in the sequential trend in PPI, should help to ease China's underlying inflationary pressure going ahead.

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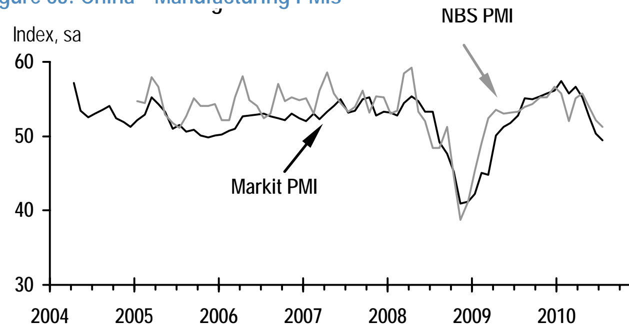
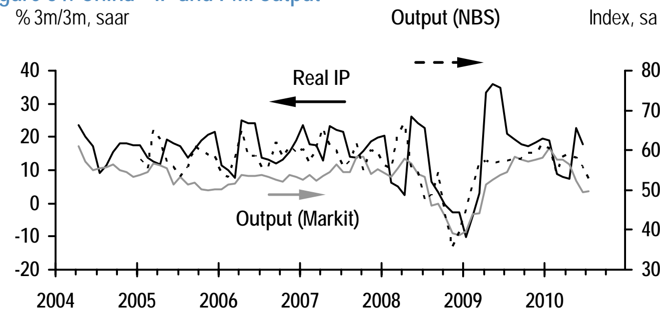
Figure 63: China—Manufacturing PMIs



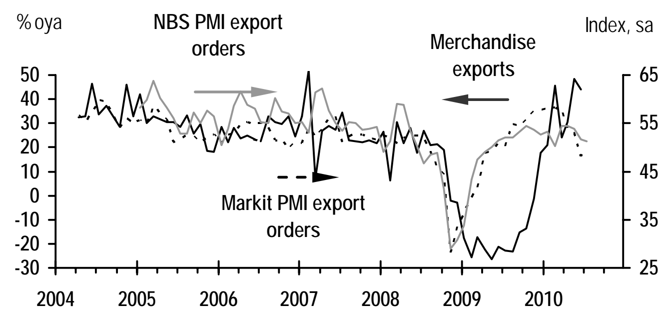
Source: CEIC, J.P. Morgan Economics.

Figure 64: China—IP and PMI output



Source: CEIC, J.P. Morgan Economics.

Figure 65: China—PMI export orders and merchandise exports



Source: CEIC, J.P. Morgan Economics.

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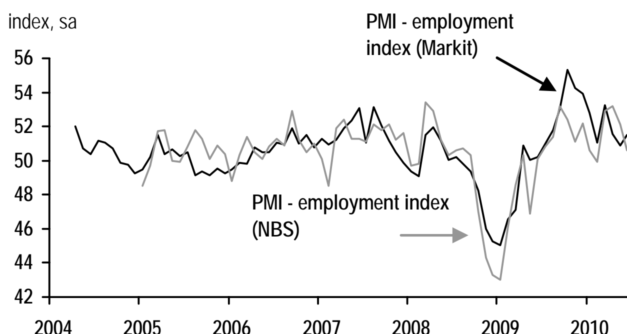
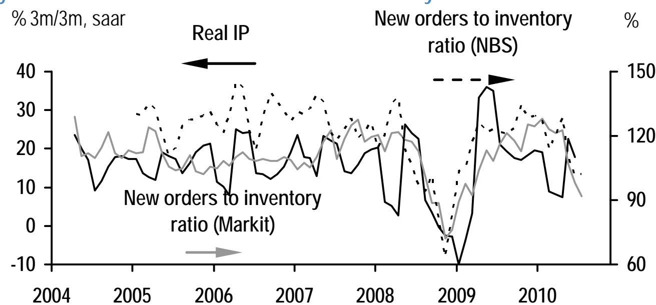
Figure 66: China—PMI employment indices



Source: CEIC, J.P. Morgan Economics.

Figure 67: China—IP and PMI orders to inventory ratios



Source: CEIC, J.P. Morgan Economics.

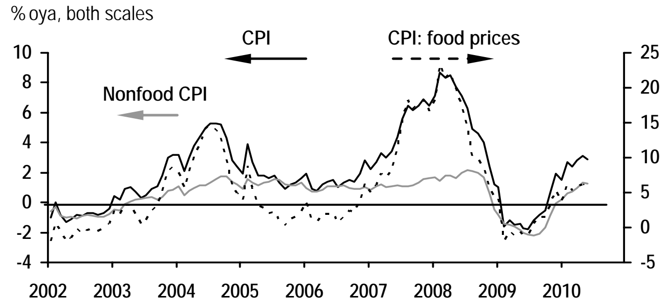
Food and residence prices prompt a fall in June CPI

Among major June China economic indicators released last week, CPI inflation surprised on the downside, falling 0.1%m/m sa, with the over-year-ago rate easing to 2.9% from 3.1% in May, marginally below the 3% hurdle seen as a necessary level to trigger the beginning of a rate hike cycle. Looking at the CPI inflation picture since late last year, two major forces behind the rise in headline CPI have been food prices and the cost of residence (which together accounted for 88.6% of the headline CPI inflation rate during 1H10). In this regard, the easing in food prices was the key driver of the decline in June headline CPI. This in turn reflects some payback from the weather-related surge in vegetable prices in previous months (over-year-ago rise in vegetable prices eased to 15.2% in June, compared with 23.9% in April and 20.9% in May). Vegetable prices have been generally volatile and sensitive to weather conditions, and would likely have rebounded in July. Meanwhile, prices for other major food items, including grain and pork, continued to trend up in June. Moreover, having picked up notably since late last year, the rise in the residence component of the CPI remained unchanged at 5.0%oya in June. This was due to a slower pace of %oya rise in the price of water, electricity, and fuel, while the rent component continued to increase, rising 4.3%oya in June.

Meanwhile, China's PPI has been easing over the past two months, falling 0.6%m/m sa in June after staying flat in May, with the sequential trend easing to 2.1%3m/3m saar by June after peaking at 16.0%3m/3m saar in February. This is consistent with the latest signals from the NBS manufacturing PMI input component, which fell

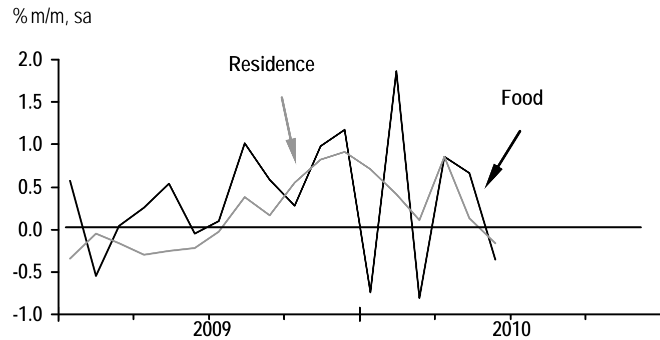
sharply to 51.3 in June, having reached a two-year high of 72.6 in April. The recent easing in China's PPI is parallel to the stabilizing trend in global commodity prices, and likely reflects the impact of the latest inventory correction in China's industrial sector as we have highlighted recently. Overall, the notable moderation in China's PPI suggests some easing in pipeline inflation pressure in China. Our forecast for 2010 average CPI inflation stands at a moderate 2.8%oya, and we expect the PBoC to raise the benchmark policy rate once this year, by 27bp in 4Q, when it becomes more confident about the global recovery and in order to calm inflation expectations.

Figure 68: China—Headline CPI, food prices, and nonfood CPI inflation



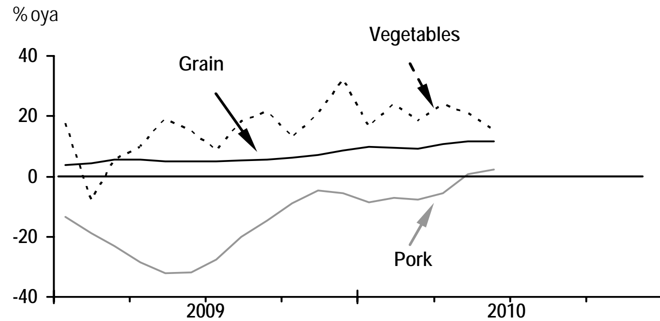
Source: CEIC, J.P. Morgan Economics.

Figure 69: China—CPI for food and residence



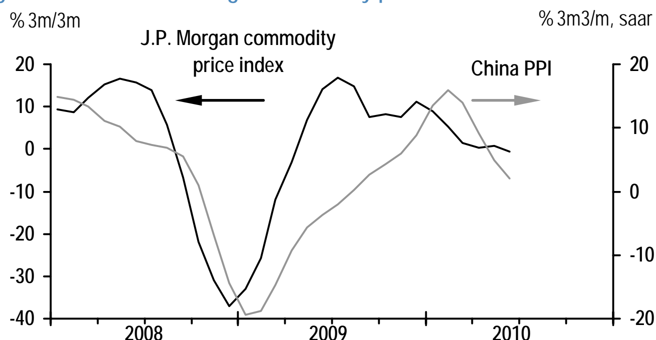
Source: CEIC, J.P. Morgan Economics.

Figure 70: China—Major CPI food items



Source: CEIC, J.P. Morgan Economics.

Figure 71: China—J.P. Morgan commodity price index and China PPI



Source: CEIC, J.P. Morgan Economics.

Non-consensus calls

China trade flows tracking global growth contours

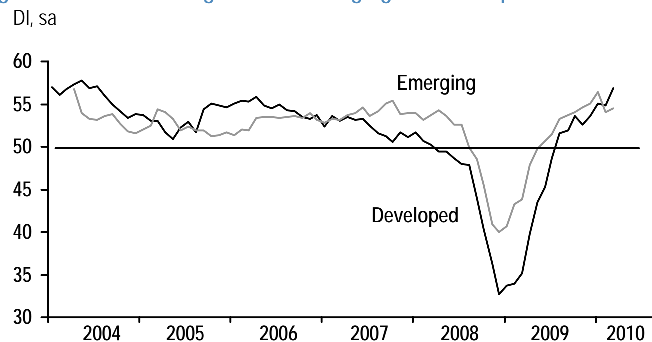
Amid ongoing financial market volatility, uncertainty about a "soft landing" for the Chinese economy has been a key focus for international investors. On the broad macro front, we have been expecting a moderation in real GDP growth (to around 9.0%-9.5%q/q saar) through the rest of this year from the double-digit pace seen in recent quarters. Beyond headline growth figures, significant undercurrents regarding changes in the sources of growth are worth noting. China's latest data flow confirmed solid gains in consumer spending and exports, which are cushioning the impact of the moderation in fixed asset investment growth. We expect these trends in the sources of China's economic growth to continue through rest of the year. On the external front, our global team expects DM growth to peak at 3.3% during 2Q10 and to slow to 2% during 1H11, as the boost from the inventory cycle fades and fiscal policy moves from net stimulus to drag. The developed markets private sector final sales, which are more important for China's export sector, are expected to continue with the steady rise in coming quarters. On the domestic front, China's fixed investment growth is likely to continue to moderate, which in turn would indicate a further near-term slowing in commodity imports. A close look at China's latest trade data provides timely information on these developments.

Recent data flow has suggested a geographical rebalancing with the source of global growth rotating from EM Asia toward the US and Europe, as highlighted by the recent outperformance of DM over EM PMI for the first time in four years. China's latest merchandise trade report is consistent with this global trend, with the surge in May exports (13.0%m/m sa)—led by shipments to the US (up 23.5%m/m sa) and Europe (up 18.9%m/m sa)—highlighting the strong near-term momentum in aggregate demand in these developed markets (though the magnitude of the surge in May exports may have been magnified by exporters' front-loading activity ahead of the Chinese government's reduction in export VAT rebates). Hence, if the DM growth picture tracks our forecasts, with solid DM private sector final sales despite less assistance from the inventory cycle and fiscal policy (see "DM policy stances move to extremes," *GDW*, June 25), the net impact on China's export sector from the upcoming easing in DM growth could be less severe than the financial markets fear, in our view.

On the domestic front, the latest slowdown in IP (with a sub par 0.5% m/m gain in May) likely reflects the beginning of an inventory correction in the industrial sector, reversing the trend of inventory accumulation seen earlier in the year. The recent spike in the inventory component of the manufacturing PMI and the decline in the orders-to-inventory ratio are early indicators. Similar messages are conveyed by the latest data on merchandise imports. China's imports trend (apart from processing-related imports) is closely related to the fixed investment cycle, especially for imports of commodities and machinery. The latest figures suggest that fixed investment growth, particularly in real terms, has eased notably along with commodity import volumes. In particular, by our calculation, total raw metal imports, in volume terms, fell 8.1% 3m/3m saar in May, while total oil imports slumped 20.7% 3m/3m saar. Looking ahead, a more serious inventory correction in the industrial sector could be another threat to China's manufacturing sector and should be monitored closely.

In terms of regional trade flows, in recent years China's imports from Emerging Asia have closely tracked its exports of mechanical and electronic products, reflecting the close integration of the regional supply chain with the tech industry. This relationship broke down temporarily last year, as China's fiscal stimulus—including fiscal subsidies on household purchases of electronic appliances, etc—led to a spike in Chinese imports from EM Asia. Since early this year, the usual relationship between the two series has returned, suggesting that global demand has once again become a dominant factor for regional trade in Asia. Taking into account the latest developments on the domestic front and global outlook, as well as our expectation that China's fixed investment growth is set to moderate steadily in coming months, we expect China's merchandise trade balance to register solid surplus during 2H10. This should in turn provide fundamental support for a gradual appreciation in the Rmb/US$ exchange rate.

Figure 72: Manufacturing PMIs for emerging and developed markets



Source: CEIC, J.P. Morgan Economics.

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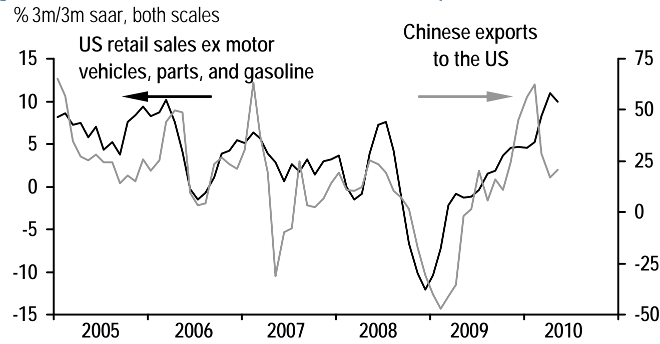
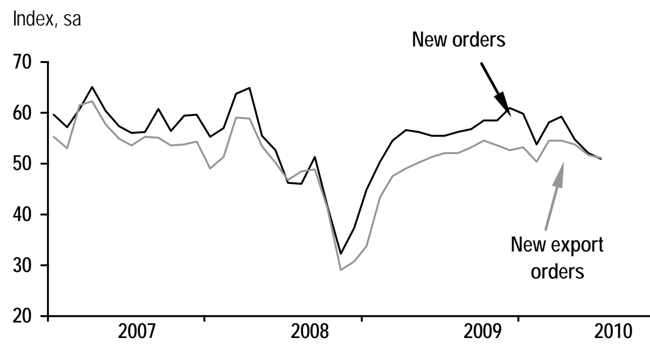
Figure 73: China—US retail sales and Chinese exports to the US



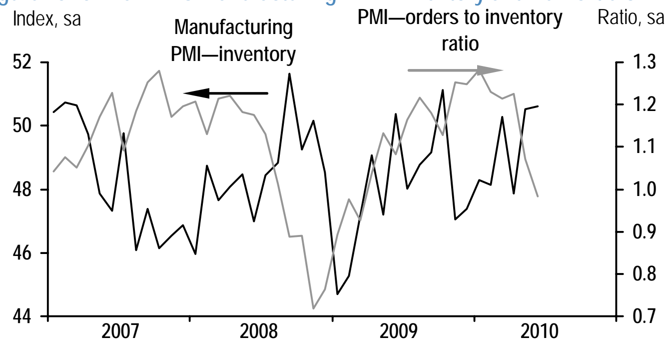
Source: CEIC, J.P. Morgan Economics.

Figure 74: China—NBS manufacturing PMI—New orders and new export orders



Source: CEIC, J.P. Morgan Economics.

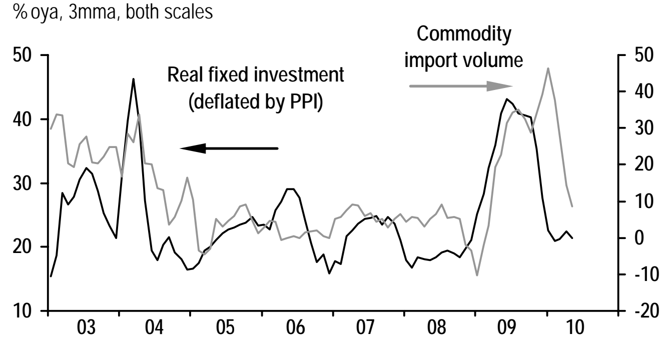
Figure 75: China—NBS manufacturing PMI—Inventory and new orders



Source: CEIC, J.P. Morgan Economics.

Figure 76: China—Fixed investment and commodity imports

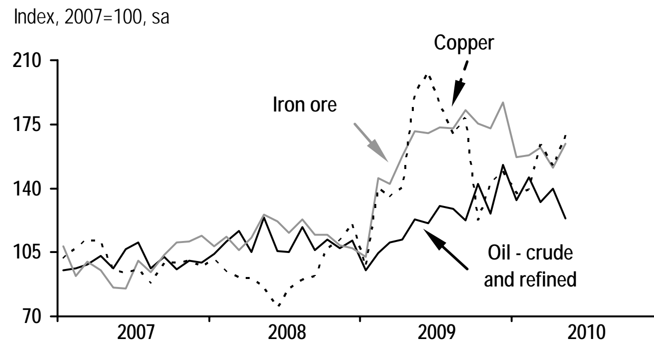
% oya, 3mma, both scales



Source: CEIC, J.P. Morgan Economics.

Figure 77: China—Commodity import volume

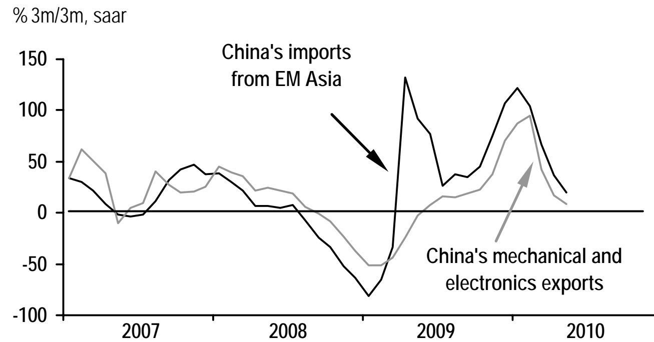
Index, 2007=100, sa



Source: CEIC, J.P. Morgan Economics.

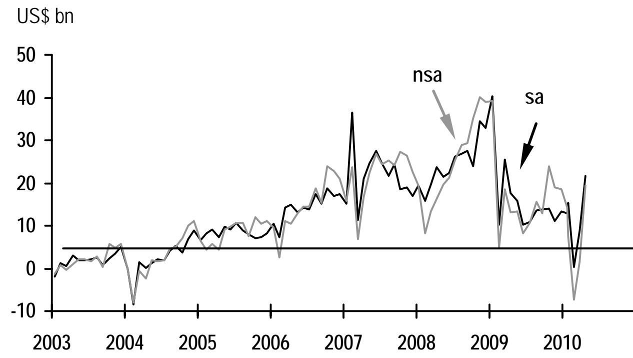
Figure 78: China—Mechanical and electronics exports vs. imports from EM Asia

% 3m/3m, saar



Source: CEIC, J.P. Morgan Economics.

Figure 79: China—Merchandise trade balance



Source: CEIC, J.P. Morgan Economics.

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Consumer

Discretionary

Results season kicks off

(Extracted from the note, "Talking Retail: 1H10 Earnings Preview for HK/China Retailers", published on July 16, 2010; please see the original note for pricing dates)

1H10 results season for retailers will kick off with Dairy Farm results at the end of July. We expect most HK/China retailers to announce in August.

In this issue of *Talking Retail,* we provide 1H10 results previews for all Greater China retailers under our coverage, along with where we are notably different from consensus in terms of earnings expectations.

Table 17: Expected 1HFY10 results announcement dates

	Results announcement date last year	Results announcement date this year (if announced)
Hong Kong retailers		
Lifestyle	10-Aug-09	
Dairy Farm	6-Aug-09	29-Jul-10
China retailers		
Department Stores		
Golden Eagle	19-Aug-09	
Parkson	23-Aug-09	
Sportswear Brands		
Anta	17-Aug-09	
China Dongxiang	9-Sep-09	
Li Ning	26-Aug-09	
Xtep	7-Sep-09	
Shoes and Clothing		
Belle	26-Aug-09	
Ports	27-Aug-09	
Trinity	NA	
Restaurants and Supermarkets		
Ajisen	14-Sep-09	

Source: Company data, Bloomberg.

Where we are different from consensus

There are few 1H10 estimates available on Bloomberg. Therefore, in the table below we have provided J.P. Morgan and Bloomberg consensus FY10 earnings and sales estimates for the stocks under our coverage to show where we are different from consensus on FY basis.

Our estimates for most retailers under our coverage are generally in line with consensus, except for sportswear companies (Anta, Li Ning, Xtep), Trinity in the menswear space, and Golden Eagle in the department stores.

If we look at sportswear first, we are comfortable with our estimates for both Li Ning and Xtep. In the case of Xtep, while top line could surprise on the upside, given replenishment orders, higher A&P spending and higher tax rate is putting some pressure on margins especially for 2010, therefore we do not foresee upside risk to

earnings estimates for 2010. In the case of Li Ning, earnings will be mostly a function of trade fair order growth with little surprises from replenishment orders and margins. However, we believe our estimates could have upside risk for Anta. Currently, we are looking for contracting net margins on the back of higher A&P spending and tax rate. Management is comfortable that they can pass through most of this pressure, given that other cost items are under strict control.

For both Trinity and Ajisen, our recurring earnings growth estimates are higher than the headline net profit growth. For Trinity, we are looking for 46% recurring earnings growth in FY10, which is 9% below consensus. Given strong performance in 1H10 we believe Trinity could surprise on the upside. For Ajisen, we are looking for 21% recurring earnings growth, which is in line with consensus.

Table 18: FY10 J.P. Morgan and consensus net income estimates

	FY09	FY10E	% chg y/y	Bloomberg Consensus FY10E Growth
Hong Kong retailers				
Lifestyle (HK$m)	959	1,172	22%	22%
Dairy Farm (US$m)	364	423	16%	16%
China retailers				
Department Stores				
Golden Eagle (RMBm)	713	902	27%	32%
Parkson (RMBm)	911	1,125	24%	22%
Sportswear Brands				
Anta (RMBm)	1,251	1,380	10%	15%
China Dongxiang (RMBm)	1,460	1,670	14%	15%
Li Ning (RMBm)	945	1,107	17%	21%
Xtep (RMBm)	648	770	19%	23%
Shoes and Clothing				
Belle (HK$m)	2,533	3,179	25%	23%
Ports (RMBm)	443	535	21%	22%
Trinity (HK$m)	188	269	43%	55%
Restaurants and Supermarkets				
Ajisen (HK$m)	314	360	15%	21%

Source: Company data, Bloomberg, J.P. Morgan estimates.

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Table 19: FY10 J.P. Morgan and consensus sales estimates

	FY09	FY10E	% chg y/y	Bloomberg Consensus FY10E Growth
Hong Kong retailers				
Lifestyle (HK$m)	3,756	4,191	12%	14%
Dairy Farm (US$m)	7,029	8,109	15%	15%
China retailers				
Department Stores				
Golden Eagle (RMBm)	1,850	2,387	29%	30%
Parkson (RMBm)	3,908	4,530	16%	14%
Sportswear Brands				
Anta (RMBm)	5,875	7,128	21%	22%
China Dongxiang (RMBm)	3,970	4,726	19%	21%
Li Ning (RMBm)	8,387	10,008	19%	21%
Xtep (RMBm)	3,545	4,357	23%	25%
Shoes and Clothing				
Belle (HK$m)	19,762	22,382	13%	16%
Ports (RMBm)	1,538	1,748	14%	16%
Trinity (HK$m)	1,645	1,900	16%	19%
Restaurants and Supermarkets				
Ajisen (HK$m)	1,986	2,443	23%	28%

Source: Company data, Bloomberg, J.P. Morgan estimates.

1HFY10 previews

Retailers maintain 2H09 momentum in 1H10 as well

Excluding the two Hong Kong-driven companies, we are looking for on average 26% earnings growth for Chinese retailers in 1H10 compared to 30% growth of 2H09. Earnings growth seems to decelerate in 1H10 but it is worth highlighting that this is mostly due to sportswear companies which posted strong 2H09 earnings growth on the back of lower A&P spending. If we exclude the sportswear brands from the average and look at the retailers only, we expect c33% earnings growth in 1H10, which is almost in line with the 34% earnings growth of 2H09.

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Table 20: Chinese retailers' core earnings growth

	1H09 (% chg y/y/)	2H09 (% chg y/y/)	FY09 (%chg y/y)	1H10E (%chg y/y)
Hong Kong retailers				
Lifestyle (HK$m)	-7.3%	6.4%	0.1%	32.5%
Dairy Farm (US$m)	10.3%	16.5%	13.8%	17.1%
China retailers				
Department Stores				
Golden Eagle	18.2%	48.0%	32.1%	25.9%
Parkson	12.2%	4.5%	8.3%	24.1%
Sportswear Brands				
Anta	40.1%	39.5%	39.8%	14.5%
China Dongxiang	41.3%	3.8%	19.5%	15.4%
Li Ning	41.6%	21.8%	31.0%	16.6%
Xtep	20.4%	34.5%	27.4%	18.0%
Shoes and Clothing				
Belle	14.9%	36.9%	26.0%	27.9%
Ports	12.6%	4.3%	8.0%	14.9%
Trinity	-44.8%	NA	62.3%	84.3%
Restaurants and Supermarkets				
Ajisen	12.1%	77.5%	42.4%	18.4%
Average	16.9%	30.1%	29.7%	26.0%
Average excluding sportswear	14.0%	34.2%	29.8%	32.6%

Source: Company data, J.P. Morgan estimates.

China retailers – 1H10 previews

Excluding the two Hong Kong-driven companies, we are looking for on average 19% sales growth for Chinese retailers in 1H10 compared to 16% growth of 2H09.

Table 21: Chinese retailers' sales growth

	1H09 (% chg y/y/)	2H09 (% chg y/y/)	FY09 (%chg y/y)	1H10E (%chg y/y)
Hong Kong retailers				
Lifestyle (HK$m)	2.5%	10.5%	6.6%	9.8%
Dairy Farm (US$m)	1.2%	7.5%	4.4%	15.0%
China retailers				
Department Stores				
Golden Eagle	27.7%	31.5%	29.7%	30.0%
Parkson	11.2%	9.8%	10.5%	15.9%
Sportswear Brands				
Anta	27.7%	26.3%	27.0%	21.6%
China Dongxiang	33.5%	9.3%	19.5%	18.7%
Li Ning	32.4%	19.3%	25.4%	18.6%
Xtep	19.1%	28.0%	23.7%	22.0%
Shoes and Clothing				
Belle	13.1%	8.6%	10.7%	15.0%
Ports	5.5%	1.4%	3.3%	12.2%
Trinity	1.2%	14.0%	7.6%	16.7%
Restaurants and Supermarkets				
Ajisen	24.3%	14.1%	18.7%	23.0%
Average	19.6%	16.2%	17.6%	19.4%
Average excluding sportswear	16.4%	13.1%	13.4%	18.8%

Source: Company data, J.P. Morgan estimates.

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Anta (2020.HK, N)

For Anta, we expect 22% sales and 14% earnings growth in 1H10. We do not expect too much upside risk to sales estimates, however, we believe there could be upside risk to margin estimates. Currently, we are looking for contracting net margins on the back of higher A&P spending and tax rate. Management is comfortable that they can pass through most of this pressure, given that other cost items are under strict control.

Table 22: Anta 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	2,817	3,425	22%	22%
Gross profit	1,169	1,440	23%	
Operating profit	683	804	18%	
Net interest income	26	30	13%	
Share of associates and JVs	0	0	NA	
Other income (expense)	0	0	NA	
PBT	709	834	18%	
Tax	-101	-138	36%	
PAT	608	696	14%	
Minority stake	0	0	NA	
Net Income to Equity Holders	608	696	14%	15%
Gross margin	41.5%	42.0%		
Operating margin	24.2%	23.5%		
Net margin	21.6%	20.3%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Ajisen (0538.HK, N)

We expect Ajisen to post 23% revenue growth in 1H10, mostly driven by store additions on China. We are looking for flat gross and operating margins and this should lead to 22% operating profit growth for1H10 and 18% earnings growth with a slightly higher tax rate.

Table 23: Ajisen 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

HK$ in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	937	1,152	23%	28%
Gross profit	645	794	23%	
Operating profit	170	208	22%	
Net interest income	10	10	-2%	
Share of associates and JVs	0	0	NA	
Other income (expense)	0	0	NA	
PBT	181	218	21%	
Tax	-42	-53	28%	
PAT	139	165	19%	
Minority stake	-6	-7	24%	
Net Income to Equity Holders	133	158	18%	21%
Gross margin	68.9%	68.9%		
Operating margin	18.2%	18.1%		
Net margin	14.2%	13.7%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Belle (1880.HK, OW)

We expect overall revenue growth of 15% for 1H10, driven mostly by footwear division (20% sales growth at footwear and 8% sales growth at sportswear). We expect operating margin to improve to 14.7% from 13.5% in 1H09 on the back of

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lower discounting and also sportswear business store rationalization, leading to c25% operating profit and 28% earnings growth.

Given YTD strong performance at the footwear division, we believe there could be upside risk to our sales estimates.

Table 24: Belle 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	9,310	10,706	15%	16%
Gross profit	4,878	5,707	17%	
Operating profit	1,253	1,570	25%	
Net interest income	17	57	233%	
Share of associates and JVs	0	0	NA	
Other income (expense)	12	3	-76%	
PBT	1,282	1,630	27%	
Tax	-149	-179	20%	
PAT	1,133	1,451	28%	
Minority stake	3	3	-4%	
Net Income to Equity Holders	1,136	1,453	28%	23%
Gross margin	52.4%	53.3%		
Operating margin	13.5%	14.7%		
Net margin	12.2%	13.6%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

China Dongxiang (3818.HK, OW)

For China Dongxiang, we expect 19% y/y sales and 15% y/y earnings growth in 1H10. Similar to other sportswear companies, we do not expect too much upside risk to sales estimates as the company has already announced order growth during trade fairs covering all of 2010.

We are looking for slight erosion in margins mainly due to A&P spending and higher tax rate.

Table 25: China Dongxiang 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	1,868	2,218	19%	21%
Gross profit	1,163	1,385	19%	
Operating profit	850	990	17%	
Net interest income	57	68	18%	
Share of associates and JVs	-5	-3	-33%	
Other income (expense)	2	0	-100%	
PBT	904	1,054	17%	
Tax	-182	-221	22%	
PAT	722	833	15%	
Minority stake	0	0	NA	
Net Income to Equity Holders	722	833	15%	
Recurring earnings	722	833	15%	15%
Gross margin	62.2%	62.5%		
Operating margin	45.5%	44.6%		
Net margin	38.6%	37.6%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

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Golden Eagle (3308.HK, N)

For Golden Eagle, we are looking for a 30% revenue growth and 26% recurring earnings growth in 1H10 (excluding the derivatives component). While we expect other income to come lower in 1H10, this should be compensated for by lower interest expense on the P&L.

Table 26: Golden 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Gross Sales Proceeds	3,752	4,690	25%	
Revenue	871	1,132	30%	30%
Gross profit	679	868	28%	
Operating profit	498	572	15%	
Net interest income	-23	13	NA	
Share of associates and JVs	0	0	NA	
Other income (expense)	-264	0	NA	
PBT	211	585	177%	
Tax	-136	-158	16%	
PAT	75	427	467%	
Minority stake	0	0	NA	
Net Income to Equity Holders	75	427	467%	
Recurring net profit	339	427	26%	32%
Based on Gross Sales				
Gross margin	18.1%	18.5%		
Operating margin	13.3%	12.2%		
Net margin	2.0%	9.1%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Li Ning (2331.HK, N)

For Li Ning, we are looking for 19% y/y sales growth and 17% y/y earnings growth in 1H10. While we expect some pressure on operating margin due to gross margin decline and slightly higher A&P spending, thanks to lower interest expense and stable tax rate, we expect only slight erosion at the net margin level.

Table 27: Li Ning 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	4,052	4,804	19%	21%
Gross profit	1,937	2,279	18%	
Operating profit	686	776	13%	
Net interest income	-36	-28	-22%	
Share of associates and JVs	0	0	NA	
Other income (expense)	0	0	NA	
PBT	650	749	15%	
Tax	-165	-183	11%	
PAT	485	565	17%	
Minority stake	-12	-14	13%	
Net Income to Equity Holders	473	551	17%	21%
Gross margin	47.8%	47.4%		
Operating margin	16.9%	16.2%		
Net margin	11.7%	11.5%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Parkson (3368.HK, N)

For Parkson, we are looking for 14% y/y sales growth and 22% y/y earnings growth in 1H10. It is worth highlighting that our estimates do not include stock option expenses yet. Incorporating RMB40m employee share option expense, our 1H10 estimates would be at around RMB523mn, c13% earnings growth y/y.

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Table 28: Parkson 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Gross Sales Proceeds	6,104	7,050	16%	
Sales	1,953	2,226	14%	14%
Operating profit	678	804	19%	
Net interest income	-52	-40	-23%	
Share of associates and JVs	0	0	-100%	
Other income (expense)	0	0	NA	
PBT	626	764	22%	
Tax	-150	-183	22%	
PAT	476	581	22%	
Minority stake	-14	-17	25%	
Net Income to Equity Holders	462	563	22%	22%
Based on Gross Sales				
Operating margin	11.1%	11.4%		
Net margin	7.6%	25.3%		

Source: Company data, J. P. Morgan Estimates.

Ports Design (0589.HK, OW)

We expect 12% revenue growth, driven by c.15% SSS growth and slight store closures. As we expect margin expansion to continue at the retail level (thanks to APS increase), we are looking for c15% earnings growth. We expect Ports Design's earnings growth to be back loaded in 2010, as margins will be over a weak base in 2H10.

Table 29: Ports Design 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

PORTS (Rmb mn)	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	731	820	12%	16%
Gross profit	596	680	14%	
Operating profit	236	269	14%	
Net interest income	-3	0	NA	
Share of associates and JVs	0	0	NA	
Other income (expense)			NA	
PBT	232	270	16%	
Tax	-26	-32	26%	
PAT	206	237	15%	
Minority stake	0	0	NA	
Net Income to Equity Holders	206	237	15%	
Recurring earnings	206	237	15%	22%
Gross margin	81.5%	82.9%		
Operating margin	32.3%	32.8%		
Net margin	28.2%	28.9%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Trinity (891.HK, N)

We expect Trinity to post very strong earnings growth of around 84% in 1H10, given that 1H09 was a very weak base for the company during which earnings were one half of 2H09 levels. The recovery will mainly come from margin improvement both at the gross margin front (lower discounting and less inventory provisions) and also on the operating expenses front (given high fixed costs at Trinity).

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Table 30: Trinity 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	768	897	17%	19%
Gross profit	558	668	20%	
Operating profit	100	156	56%	
Net interest income	-20	-6	-72%	
Share of associates and JVs	13	16	24%	
Other income (expense)			NA	
PBT	93	167	79%	
Tax	-26	-42	63%	
PAT	68	125	84%	
Minority stake	0	0	NA	
Net Income to Equity Holders	68	125	84%	55%
Gross margin	72.6%	74.5%		
Operating margin	13.0%	17.4%		
Net margin	8.8%	13.9%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Xtep (1368.HK, OW)

We expect Xtep brand to report 22% revenue growth and 18% earnings growth for 1H10. In the case of Xtep, while top line could surprise on the upside, given replenishment orders, higher A&P spending and higher tax rate is putting some pressure on margins especially for 2010; therefore, we do not foresee upside risk to earnings estimates for 2010.

Table 31: Xtep 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	1,677	2,046	22%	25%
Gross profit	648	807	25%	
Operating profit	331	398	20%	
Net interest income	3	8	139%	
Share of associates and JVs	0	0	NA	
Other income (expense)			NA	
PBT	331	407	23%	
Tax	-25	-45	82%	
PAT	307	362	18%	
Minority stake	0	0	NA	
Net Income to Equity Holders	307	362	18%	23%
Gross margin	38.6%	39.4%		
Operating margin	19.8%	19.5%		
Net margin	18.3%	17.7%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

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Hong Kong retailers – 1H10 previews

Lifestyle (1212.HK, OW)

While we expect c.10% revenue growth at Lifestyle (9% from HK operations and c20% from China operations, thanks to new stores sales ramping up), we are looking for much stronger recurring earnings growth of 33%, given lower losses at new China stores (Suzhou and Dalian) and higher interest income.

Table 32: Lifestyle 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

HK$ in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	1,740	1,910	10%	14%
Gross profit	983	1,097	12%	
Operating profit	555	686	23%	
Net interest income	-7	10	NA	
Share of associates and JVs	25	13	-47%	
Other income (expense)	10	0	-100%	
PBT	583	709	21%	
Tax	-114	-136	19%	
PAT	469	573	22%	
Minority stake	-25	-33	30%	
Net Income to Equity Holders	444	540	22%	
Recurring earnings	407	540	33%	22%
Gross margin	56.5%	57.4%		
Operating margin	31.9%	35.9%		
Net margin	25.5%	28.2%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Dairy Farm (DAIR.SI, N)

For 1H10, we are looking for c9% sales growth in LC terms and with the help of currency moves, we expect USD revenue growth to be at 15% y/y. We expect Dairy Farm to report a small improvement in margins and we are looking for 17% earnings growth in 1H10.

Table 33: Dairy Farm 1H10 J.P. Morgan and FY10 Bloomberg consensus estimates

US$ in millions

	1H09	1H10E - JPM	% chg y/y	Bloomberg Consensus FY10E Growth
Sales	3,353	3,856	15%	15%
Gross profit	1,034	1,162	12%	
Operating profit	187	222	19%	
Net interest income	-10	-10	2%	
Share of associates and JVs	30	10	-67%	
Other income (expense)			NA	
PBT	188	222	18%	
Tax	-32	-39	20%	
PAT	155	183	18%	
Minority stake	1	-1	-216%	
Net Income to Equity Holders	156	183	17%	
Recurring earnings	156	183	17%	16%
Gross margin	30.8%	30.1%		
Operating margin	5.6%	5.8%		
Net margin	4.7%	4.7%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Staples

(Extracted from the note, "Food For Thought: 1HFY10 Results Preview for China Staples", published on July 24, 2010; please see the original note for pricing dates)

Results season kicks off

In this section, we provide 1HFY10 results previews for all China staples companies under our coverage, along with where we are notably different from consensus in terms of earnings expectations.

The below table lists estimated results dates based on last year's announcement dates.

Table 34: 1HFY09 results announcement dates

	Results announcement date last year
Breweries	
China Resources Enterprise	9-Sep-09
Tsingtao Brewery	5-Aug-09
Dairies	
China Mengniu Dairy	8-Sep-09
Instant noodles & juices	
China Huiyuan Juice	15-Sep-09
Tingyi	17-Aug-09
Uni-president China	26-Aug-09
Meat Processors	
China Yurun	9-Sep-09
Snack manufacturers	
Want Want	24-Aug-09
Personal Care	
Hengan	2-Sep-09

Source: Company data, Bloomberg. *Year ends in March.

Where are we different from consensus

As there are few 1H estimates available on Bloomberg, we have compared J.P. Morgan and Bloomberg consensus estimates for FY10 earnings and sales for the stocks under our coverage to show where we are different from consensus on a full year basis.

Our earnings estimates for Tsingtao, Tingyi and Hengan are almost in line with the consensus. We are 4-8% below consensus on Want Want, UPC and Mengniu. We differ notably from the consensus on the names of Yurun and Huiyuan. For CRE given that there are one-off gains related to property division we do not find comparison with Bloomberg consensus estimates useful as we are not sure whether Bloomberg estimates are based on headline results or recurring earnings.

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Table 35: FY10 J.P. Morgan and consensus net income estimates

	FY09	FY10E JPM	% chg y/y	Bloomberg Consensus vs JPM estimates
Breweries				
CRE (HK$ mn) (Reported profit)	2,785	2,635	-5.4%	28.2%
Tsingtao Brewery (Rmb mn)	1,281	1,529	19.3%	-1.9%
Dairies				
China Mengniu Dairy (Rmb mn)	1,116	1,354	21.3%	-7.6%
Instant noodles & juices				
China Huiyuan Juice (Rmb mn)	-167	224	NA	-11.9%
Tingyi (US$ mn)	383	443	15.6%	-0.3%
Uni-president China (Rmb mn)	705	684	-2.9%	-5.6%
Meat Processors				
China Yurun (HK$ mn)	1,196	1,548	29.3%	-22.5%
Snack manufacturers				
Want Want (US$ mn)	313	372	18.9%	-3.7%
Personal Care				
Hengan (HK$ mn)	2,118	2,551	20.5%	0.6%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Table 36: FY10 J.P. Morgan and consensus sales estimates

	FY09	FY10E JPM	% chg y/y	Bloomberg Consensus vs JPM estimates
Breweries				
CRE (HK$ mn)	64,131	83,228	29.8%	-1.2%
Tsingtao Brewery (Rmb mn)	17,761	19,899	12.0%	-0.2%
Dairies				
China Mengniu Dairy (Rmb mn)	25,710	30,513	18.7%	1.2%
Instant noodles & juices				
China Huiyuan Juice (Rmb mn)	2,833	3,661	29.3%	0.3%
Tingyi (US$ mn)	5,081	6,234	22.7%	-1.4%
Uni-president China (Rmb mn)	9,109	11,393	25.1%	1.3%
Meat Processors				
China Yurun (HK$ mn)	13,870	19,691	42.0%	-0.1%
Snack manufacturers				
Want Want (US$ mn)	1,711	2,215	29.5%	-1.1%
Personal Care				
Hengan (HK$ mn)	10,834	13,401	23.7%	-2.6%

Source: Company data, Bloomberg, J.P. Morgan estimates.

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1HFY10 previews

The following tables summarize our 1HFY10 earnings and sales growth estimates for the stocks under our coverage. On average, we are looking for 27% sales growth and 19% earnings growth in 1H10. While the sales growth expectation is stronger than 1H09 and 2H09 growth rates, our earnings estimates show a slowdown against 47% and 72% growth shown in 1H09 and 2H09, respectively. Pressure on margins due to raw material prices and higher promotions are the major reasons. But the figures are also distorted due to Uni-President which had the highest growth rate in 2009 and we expect 23% earnings decline in 1H10 because of its aggressive promotion campaign. Excluding Uni-President, the earnings growth will be 27% in 1H10 as compared to 36% and 65% in 1H09 and 2H09, respectively.

We have excluded CRE from average growth rate calculations as they disposed of the textile business and Esprit JV in 2009 and hence the growth rates are not on a like-for-like basis. Similarly, Mengniu booked losses and Huiyuan Juice is an outlier and hence stands out from our average estimates calculation.

Table 37: Staples' core earnings growth

	1H09 (%chg y/y)	2H09 (%chg y/y)	FY09 (%chg y/y)	1H10E (%chg y/y)
Breweries				
CRE (Reported profit)	-22.2%	110.4%	25.5%	3.7%
Tsingtao Brewery	68.2%	61.7%	64.8%	27.6%
Dairies				
China Mengniu Dairy	13.6%	NA	NA	-9.3%
Instant noodles & juices				
China Huiyuan Juice	-590.3%	117.7%	-240.1%	NA
Tingyi	40.6%	53.5%	47.2%	14.1%
Uni-president China	101.2%	111.2%	105.0%	-23.4%
Meat Processors				
China Yurun	25.1%	97.0%	59.5%	30.3%
Snack manufacturers				
Want Want	-6.5%	43.3%	18.8%	43.0%
Personal Care				
Hengan	54.0%	69.6%	62.1%	20.3%
Average (ex Huiyuan, Mengniu and CRE)	47.1%	72.7%	59.6%	18.6%
Average (ex Huiyuan, Mengniu, CRE, Uni-President)	36.3%	65.0%	50.5%	27.1%

Source: Company data, J.P. Morgan estimates.

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Table 38: Staples' sales growth

	1H09 (%chg y/y)	2H09 (%chg y/y)	FY09 (%chg y/y)	1H10E (%chg y/y)
Breweries				
China Resources Enterprise	10.2%	-11.4%	-0.8%	16.4%
Tsingtao Brewery	15.1%	10.0%	12.5%	10.0%
Dairies				
China Mengniu Dairy	-11.7%	34.0%	7.7%	21.7%
Instant noodles & juices				
China Huiyuan Juice	-32.0%	28.0%	0.5%	81.0%
Tingyi	22.1%	16.0%	18.9%	24.0%
Uni-president China	-10.4%	9.3%	-1.4%	32.7%
Meat Processors				
China Yurun	-3.5%	15.2%	6.5%	39.5%
Snack manufacturers				
Want Want	12.5%	8.1%	10.1%	31.4%
Personal Care				
Hengan	36.1%	34.8%	35.4%	25.3%
Average (ex Huiyuan, Mengniu and CRE)	12.0%	15.6%	13.7%	27.2%
Average (ex Huiyuan, Mengniu, CRE, Uni-President)	16.5%	16.8%	16.7%	26.1%

Source: Company data, J.P. Morgan estimates.

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Company Details

China Huiyuan Juice

We are looking for 81% sales growth from 1H09 and 20% growth from 1H08, 89mn net profit in 1H10 vs. 295mn loss in 1H09 and 60mn net profit in 1H08. We expect 1H sales growth will be lower than full year as sales were affected by unfavorable weather in 2Q. Gross margin and operating margin will also be lower than full year because of product mix seasonality and high A&P for new products.

Table 39: Huiyuan 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	879	1,592	81%	0%
Gross profit	221	613	177%	
Operating profit	-250	121	NA	
Net interest income	-30	-17	NA	
Share of associates and JVs	0	0	NA	
Other income (expense)	0	0	NA	
PBT	-280	105	NA	
Tax	-16	-16	1%	
PAT	-296	89	NA	
Minority stake	0	0	NA	
Net Income to Equity Holders	-296	89	NA	-12%
Gross margin	25.1%	38.5%		
Operating margin	-28.4%	7.6%		
Net margin	-33.6%	5.6%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

China Mengniu Dairy

In 1H10, we are looking for 22% sales growth and 2% recurring net profit growth (excluding option expense). In our recent trip to Inner Mongolia, management indicated sales growth (high teen to twenty), gross margin (flattish or slight decline) and A&P expense (as % of sales not higher than last year) have met expectations despite raw milk cost pressure. As A&P was low in 1H09 and high in 2H09, we expect 1H10 results to show 2%YoY growth and 35% HoH growth.

Table 40: Mengniu 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	12,098	14,720	22%	1%
Gross profit	3,233	3,842	19%	
Operating profit	844	729	-14%	
Net interest income	(32)	26	NA	
Share of associates and JVs	8	10	36%	
Other income (expense)	-	-	NA	
PBT	820	764	-7%	
Tax	(98)	(99)	2%	
PAT	722	665	-8%	
Minority stake	(60)	(65)	8%	
Net Income to Equity Holders	662	600	-9%	-8%
Net Income excluding option expense	785	800	2%	
Gross margin	26.7%	26.1%		
Operating margin	7.0%	5.0%		
Net margin	5.5%	4.1%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

China Resources Enterprise

For CRE, we are looking for 16% y/y revenue growth and 4% y/y headline profit growth in 1H10. 1H10 estimates for CRE are not comparable on a like for like basis because of the discontinuation of the textile and Esprit JV in 2009. Slowdown in earnings growth is due to lower income from associates, slight deterioration in operating margin, and a higher tax rate.

It is worth highlighting that retail earnings from China operations were up 51% y/y in 1Q10 and we estimate 35% of this coming from Home World. Home World's margins in 1Q10 were similar to CRE's existing margins, which points to a notable turnaround from almost break-even levels. We expect China and HK supermarket business to post 18% and 15% growth in 1H10, respectively.

Table 41: CRE 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

HK$ in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	35,047	40,812	16%	-1%
Operating profit	2,035	2,204	8%	
Net interest income	-120	-47	-60%	
Share of associates and JVs	144	18	-88%	
Other income (expense)	0	0	NA	
PBT	2,059	2,174	6%	
Tax	-471	-544	15%	
PAT	1,588	1,631	3%	
Minority stake	-430	-429	0%	
Net Income to Equity Holders	1,158	1,201	4%	28%
Operating margin	5.8%	5.4%		
Net margin	3.3%	2.9%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

China Yurun

For 1H10, we are looking for 40% sales growth and 30% recurring net profit growth (excluding government subsidy and foreign exchange). We expect upstream volume

growth 55% but ASP decline 3% due to weak hog price; downstream volume growth 10%, and ASP increases 2%. The volume upside have offset negative impact from lower-than-expected hog price.

Table 42: Yurun 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

HK$ in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	5,831	8,136	40%	0%
Gross profit	976	1,232	26%	
Core Operating profit	601	774	29%	
Net interest income	-25	-28	12%	
Share of associates and JVs	0	0	NA	
Other income (expense)	0	0	NA	
PBT	573	746	30%	
Tax	-82	-107	30%	
PAT	491	639	30%	
Minority stake	-1	-1	0%	
Net Income to Equity Holders	490	638	30%	-23%
Gross margin	16.7%	15.1%		
Operating margin	10.3%	9.5%		
Net margin	8.4%	7.8%		

Source: Company data, Bloomberg, J.P. Morgan estimates. Core operating profit excludes government subsidy and negative goodwill.

Hengan International

We are looking for 25% sales growth and 20% net profit growth in 1H10. We expect gross margin to slightly decline due to 1) raw material price, especially wood pulp price increase, 2) product mix improving and less promotion. In products breakdown, we expect tissue gross margin decline, sanitary napkin margin flat and diaper margin increase yoy.

Table 43: Hengan 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

HK$ in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	5,113	6,405	25%	-3%
Gross profit	2,302	2,858	24%	
Operating profit	1,212	1,467	21%	
Net interest income	-28	0	NA	
Share of associates and JVs	0	0	NA	
Other income (expense)	0	0	NA	
PBT	1,184	1,467	24%	
Tax	-190	-264	39%	
PAT	994	1,203	21%	
Minority stake	-27	-40	48%	
Net Income to Equity Holders	967	1,163	20%	1%
Gross margin	45.0%	44.6%		
Operating margin	23.7%	22.9%		
Net margin	18.9%	18.2%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Tingyi

The margins came in worse than our expectations in 1Q10 though earnings were saved by a sharp cut in A&P expenses. We believe gross margin will erode further in

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2Q on the back of raw material price increase (mainly for the beverage division) but the sharp cut in A&P expenses in not sustainable. Management indicates that they will try to mitigate the impact via various measures which might include price increase for noodles division in our view but due to pressure on margins we expect only 14% growth in 1H10 earnings on the back of strong 24% sales growth.

Table 44: Tingyi 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

US$ in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	2,502	3,103	24%	-1%
Gross profit	906	1,016	12%	
Operating profit	314	348	11%	
Net interest income	-5	8	NA	
Share of associates and JVs	7	7	6%	
Other income (expense)	-2	0	NA	
PBT	314	363	16%	
Tax	-65	-76	18%	
PAT	249	287	15%	
Minority stake	-70	-82	18%	
Net Income to Equity Holders	179	205	14%	0%
Gross margin	36.2%	32.8%		
Operating margin	12.6%	11.2%		
Net margin	7.2%	6.6%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Tsingtao Brewery

For Tsingtao, we are looking for 10% revenue growth and 28% recurring profit growth in 1H10. The y/y margin recovery that started in 2Q09 continued well into 1Q10 as 1Q09 margins were still weak. However, we expect the y/y increase in gross margin to be limited in 2Q10 as raw material prices will not be a driver anymore, the only positive impact on margins in 2Q10 will be favorable product mix shift.

Table 45: Tsingtao Brewery 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

RMB in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	8,969	9,866	10%	0%
Gross profit	3,036	3,503	15%	
Operating profit	873	1,124	29%	
Net interest income	-37	-16	-56%	
Share of associates and JVs	-1	0	NA	
Other income (expense)	0	0	NA	
PBT	836	1,108	33%	
Tax	-169	-266	57%	
PAT	666	842	26%	
Minority stake	-27	-32	19%	
Net Income to Equity Holders	640	811	27%	-2%
Recurring net profit	624	796	28%	
Gross margin	33.9%	35.5%		
Operating margin	9.7%	11.4%		
Net margin	7.1%	8.2%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

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Uni President China

We are looking for 33% sales growth but 23% net profit decline in 1H10. Uni President China is aggressive for market share this year. Therefore, sales growth will be higher than competitors but margin will get double hit from raw material inflation and price competition. We expect gross profit and operating margin to decline from 41.9%/10.1% in 1H09 to 35%/5.8% in 1H10.

Table 46: Uni-President 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

Rmb in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	4,512	5,989	33%	1%
Gross profit	1,890	2,096	11%	
Operating profit	454	349	-23%	
Net interest income	20	29	45%	
Share of associates and JVs	58	48	-17%	
Other income (expense)	0	0	NA	
PBT	531	425	-20%	
Tax	-104	-98	-6%	
PAT	427	327	-23%	
Minority stake	0	0	NA	
Net Income to Equity Holders	427	327	-23%	-6%
Recurring net profit			NA	
Gross margin	41.9%	35.0%		
Operating margin	10.1%	5.8%		
Net margin	9.5%	5.5%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

Want Want

We are looking for 31% sales growth and 43% net profit growth in 1H10. As 1H09 was a low base due to unfavorable Chinese New Year timing and channel inventory problem, the sales growth in 1H will be higher than the full year. We expect gross margin to be flat driven by two factors: 1) rice cracker has higher growth due to low base last year; 2) raw material price increase. We expect operating margin to improve on yoy base as there is no big inventory write-off this year.

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Table 47: Want Want 1HFY10 J.P. Morgan and FY10 Bloomberg consensus estimates

US$ in millions

	1H09	1H10E JPM	% chg y/y	Bloomberg Consensus FY10 vs JPM
Sales	798	1,049	31%	-1%
Gross profit	308	406	32%	
Operating profit	138	202	47%	
Net interest income	1	4	200%	
Share of associates and JVs	0	0	-33%	
Other income (expense)	0	0	NA	
PBT	139	206	48%	
Tax	-18	-33	79%	
PAT	121	173	43%	
Minority stake	0	0	161%	
Net Income to Equity Holders	121	173	43%	-4%
Gross margin	38.6%	38.7%		
Operating margin	17.3%	19.3%		
Net margin	15.2%	16.5%		

Source: Company data, Bloomberg, J.P. Morgan estimates.

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Infrastructure

What's new?

(Extracted from the alert, "Dalian Port: 1HFY10 results inline: net profit +20% Y/Y resulting from strong gains by the oil segment –ALERT", published on 9 August 2010; please see the original note for pricing dates)

Interim results met expectations: DP's earnings result was Rmb326MM for 1HFY10, +20% Y/Y and achieving 48% of our full year estimate (FY10E: JPM estimate of Rmb681MM versus Bloomberg consensus of Rmb667MM). The result was in line with consensus. DP has not declared any interim DPS, inline with prior practice.

Recent oil pipeline explosion. The accident occurred on July 16, 2010, at two crude oil pipelines owned by a 20%-held associate. The group's damage has been limited to certain ancillary facilities only

- **Core oil segment** recorded a 59% rise in profit during 1HFY10 on a 30% increase in throughput volume primarily benefiting from recent additions of crude oil storage tanks in Dalian.
- **Container terminal segment** dragged by increased depreciation charges from first operations of Phase 3 (Dayao Bay III Berth #17~18).
- **Auto terminal segment** turned profitable for first time after 3 loss-making years since the injection in 2007.

(Extracted from the note, "Dalian Port: Key takeaways from the briefing in-line; maintain Neutral ahead of the A-share listing", published on 10 August 2010; please see the original note for pricing dates)

No major surprises from the analyst briefing:

- **A-share listing should take place within the next two months**: DP is in the final stage of preparation for its A-share listing, expected to be completed by end-3Q10.
- **Further update on the recent oil pipeline explosion:** Management expects any loss to be covered by insurance and other means; furthermore, operations related to loading & offloading have all normalized from Jul 29. That said, management notes that due to damage on its auxiliary facilities and control systems, about one-third of the storage tanks are currently out of order, with full restoration expected to take 3-6 months.
- **Oil throughput growth is guided at 10~15% Y/Y for FY10E:** Management guides for softer volume growth in 2HFY10 for the oil segment, down from a stellar 35% growth in 1H, in light of higher base effects as well as recent damages on some of its faculties.
- **Sluggish performance by container terminal segment in 1HFY10** driven by: a) losses from Phase 3 due to higher depreciation from two newly launched terminals (Berth #17~18); b) delay in booking disposal gains from logistics assets sold in 1H (to be booked by end FY10).

Maintain Neutral ahead of the A-share listing. Our SOTP-based Dec-10 PT is HK$3.4. Key risks to our PT/thesis include major unexpected fluctuations in crude oil prices affecting end-demand, execution risk with the acquisition of all port operations currently owned by the parent PDA, or unexpected changes in global container trade

Post interim results, we revise our EPS by +2%/+4% for FY10/11E. In the near term the stock may continue moving sideways as both A-share listing price and the return profile of the injected assets remain two variables—hence an overhang, in our view. We would be buyers at levels below HK$2.8. Key risks are a major unexpected fluctuation in crude oil prices or the global container trade, and on the positive side, a successful A-share listing at levels favoring earnings accretion.

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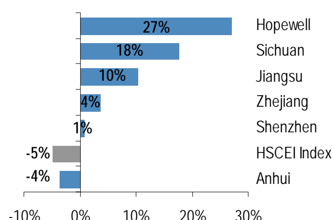
China tollroad sector: 6MFY10 traffic tracker and operational review. Top picks: ZJE and SHE

(Extracted from the note, "China tollroad sector: 6MFY10 traffic tracker and operational review. Top picks: ZJE and SHE", published on 6 August 2010; please see the original note for pricing dates)

Figure 80: China tollroad sector-YTD price performance



Source: Bloomberg. Pricing is as of Aug. 6, 2010.

The sector's toll income growth accelerated to 18% Y/Y in 1H10 (v/s an average 2% decline in 1H09 and a 7% rise in 2H09): Based on an average earnings multiplier of 1.8x~2x (due to operational leverage), we estimate a net profit growth of c30% Y/Y in 6M2010 other things being equal. That said we do expect the profit growth by Anhui Exy to come in softer than the sector average (as depreciation charges and interest costs related to the reconstruction programs for Hening Exy and Gaojie Exy were capitalized during 1H09).

Positive earnings surprises likely for Zhejiang Exy and Shenzhen Exy in the upcoming interim results: In 1QFY10, the sector's earnings beat our expectations by 3~5% across all tollroad operators during 2QFY10. On a sequential basis Zhejiang Exy and Shenzhen Exy recorded most impressive growth in toll income, +13%/+7% respectively Q/Q. It is worth highlighting that Zhejiang Exy's 13% rise in average toll during 2Q, driven by the new weightbased tolls effective from mid-April, came in above mgmt guidance (+3~5% in average toll for the full year) and our underlying assumption (+8% by JPM estimate), hence offering positive earnings surprise in our view.

Capex on tollroad construction rose by 25% Y/Y to Rmb452 billion in 1H10: Most of the sector's capex is concentrated in central and western part of China (altogether forming 68% of total, up 38% Y/Y), given the highway network is more or less complete in Easter China.

We retain our positive fundamental view on the sector. Top picks: Zhejiang Expressway (576 HK, OW) and Shenzhen Expressway (548 HK, OW)

The sector remains an excellent bear market play in light of rising market volatility given solid cash flow generation, balance sheet strength and steady high payout. The sector trades an average 9x EV/EBITDA, offering 13% ROE and 5% dividend yield on FY10E. With undemanding average EPS growth of 8% in FY10E based on JPM estimates and on the 1HFY10 operational results, scope of positive earnings surprises exists, in our view.

Table 48: China tollroad sector—Y/Y changes of Quarterly Average Daily Traffic

Avg Daily Traffic's Y/Y changes (Y/Y Cngs %)	2008 Avg	2009 Avg	1Q 09	2Q 09	3Q 09	4Q 09	1Q 10	2Q 10	1H 09	1H 10
Jiangsu Exy	-4%	10%	11%	3%	10%	17%	14%	12%	6%	13%
Zhejiang Exy	-13%	-9%	-21%	-13%	-6%	6%	14%	11%	-17%	13%
Hopewell Hwy	-6%	5%	-1%	4%	4%	11%	17%	18%	2%	17%
Shenzhen Exy	-6%	5%	-1%	1%	7%	14%	20%	23%	0%	22%
Anhui Exy	-3%	6%	11%	-7%	6%	15%	23%	36%	2%	29%
Suchuan Exy	-1%	17%	16%	16%	18%	20%	11%	11%	16%	11%
Sector Average	-6%	6%	2%	1%	7%	14%	17%	18%	1%	17%

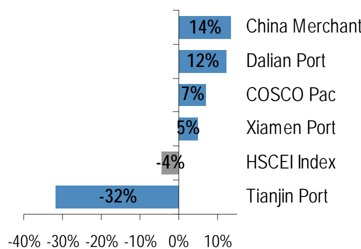
Source: Companies, J.P. Morgan.

Table 49: China tollroad sector—Valuation summary

	Stock Code	JPM Rating	Price	JPM PT	Mkt Cap	P/E (x)		Ex-cash P/E (x)		EV/EBITDA (x)		Div Yld (%)		ROE (%)	P/B (x)
			(HK$)	(HK$	(US$B)	10E	11E	10E	11E	10E	11E	10E	11E	10E	10E
ANE	995 HK	OW	4.88	6.00	1.3	10.4	9.2	10.2	9.1	7.2	6.8	5.3	6.0	13.1	1.2
ZJE	576 HK	OW	7.55	8.10	4.2	13.7	12.1	10.9	9.0	6.7	6.1	4.7	5.4	17.2	1.9
JSE	177 HK	OW	7.50	8.80	4.9	13.7	12.2	13.5	12.0	9.4	8.8	5.8	6.6	15.4	2.1
SHE	548 HK	OW	3.71	6.30	1.4	12.5	10.7	10.8	9.3	11.8	10.8	4.0	4.7	6.6	0.8
HWY	737 HK	OW	5.87	6.20	2.2	17.7	15.9	16.9	14.4	10.2	9.0	5.9	6.7	12.6	2.1

Source: Bloomberg, J.P. Morgan estimates. Note: For Hopewell Hwy, next FY figures taken because FY ends in June. All share prices are as of 8/6/2010.

Figure 81: China port sector—2010 YTD Price performance



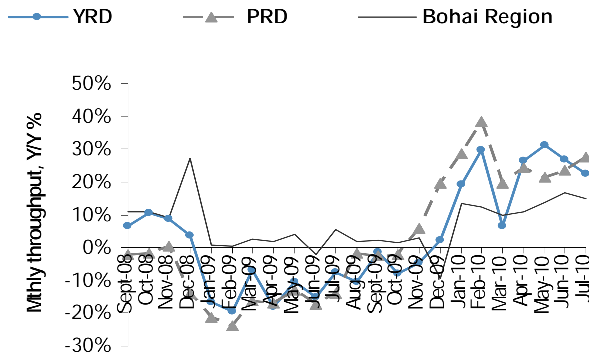
Source: Bloomberg. Based on the last prices are as of Aug. 9, 2010.

China port sector: July throughput beat expectations; we raise estimates for CMHI and DP

(Extracted from the note, "China port sector: July throughput beat expectation, we raise estimates for CMHI and DP", published on 10 August 2010; please see the original note for pricing dates)

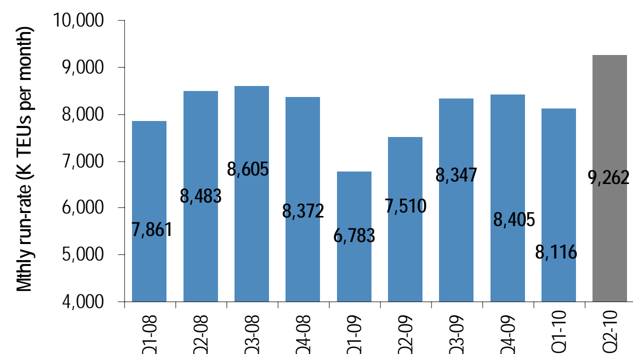
China's container throughput gained further ground in July, 6% ahead of our expectations, though leading indicators are pointing to softer growth ahead: July's throughput growth further advanced to 23% Y/Y, possibly driven by inventory re-stocking. With an average run rate of 371K TEUs per day, the month's volume was 8% above the run rate in 1H10 and 15% above 2H09. Key highlights: 1) By region, PRD recorded the strongest gains, +28% Y/Y. 2) Among the top 8 ports, Shenzhen surged the most on a sequential basis, +9% M/M. On the other hand, new order growth momentum under China PMI continued softening, possibly pointing to softer growth ahead.

Figure 82: China port sector—Container throughput trend by region



Source: MOC of PRC. Note: Excluding throughput handled by inland river ports.

Figure 83: China port sector—Container throughput trend by region



Source: MOC of PRC. Note: Excluding throughput handled by inland river ports.

CMHI - Maintain Neutral. Our Dec-10, SOTP PT is now at HK$29.0. Key risks to our PT are tariff cuts or weaker-than-expected volume growth

CP - Maintain OW, Dec-10 SOTP-based PT of HK$15.3. Key risks to our PT are tariff cuts, weaker-than-expected volume growth, and execution risk with new port investments

- **CMHI—Ongoing major shifts in strategic directions:** Though winding down capex on domestic port projects, CMHI intends to use future surplus cash on two fronts—overseas port projects in Vietnam as well as the roll-out of a cold-chain logistics network in China. We now work with a 16.5% throughput growth for FY10E in light of the YTD run rate at 23% Y/Y.
- **CP—At the inflection point:** Positive drivers include: 1) CP's recent investments reaching the inflection point from 2H FY10; 2) a key beneficiary from the ongoing container shortage; 3) recent changes of business profile, with the port segment now forming c70% of the total NAV.

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DP - Maintain Neutral and Dec-10, SOTP-based PT of HK$3.4. Key risks: an unexpected fluctuation in crude oil prices or the global container trade; on the positive side, a successful A-share listing at levels favoring earnings accretion

- **DP—Interim results in line; maintain Neutral ahead of the A-share listing:** DP reported a 20% profit growth for 1H FY10, driven by the oil segment. We stay Neutral as the A-share listing price and the return profile of the injected assets remain uncertain.

Table 50: China port sector: Valuation summary

Name	Ticker	JPM rating	Last price HK$	Mkt cap US$MM	P/E FY10E	P/E FY11E	Core P/E FY10E	Core P/E FY11E	P/B FY10E	P/B FY11E	EV/EBITDA FY10E	EV/EBITDA FY11E	Core EPS CAGR 2-yr fwd
DP	2880 HK	N	3.37	1,264	12.3x	12.0x	13.9x	13.4x	1.3x	1.1x	9.6x	8.8x	9%
CMHI	144 HK	N	28.70	8,977	21.3x	19.1x	22.7x	19.1x	2.0x	1.9x	16.7x	15.0x	38%
CP	1199 HK	OW	10.62	3,692	10.2x	11.1x	13.7x	11.3x	1.0x	1.0x	10.4x	8.9x	35%

Source: Bloomberg, J.P. Morgan estimates. Valuations are as of 9 August 2010.

What's changing?

We upgrade CIMC-A to Neutral (versus the prior UW), while retaining CIMC-B at Neutral

China International Marine Containers

(Extracted from the note, "China International Marine Containers – A and B: Acute container shortage to support demand well into 2011/2012, upgrading CIMC-A to Neutral", published on 7 July 2010; please see the original note for pricing dates)

Recent conference calls with CIMC and Singamas (716 HK, NR) reaffirmed the demand outlook for container production, driven by a combination of unmet replacement needs as well as new demand from the slow steaming by carriers: The world's total dry freight containers produced amounted only to 205K TEUs in 2009, far below the output in 2007 and 2008 (3~4 MM TEUs p.a.), as shippers/leasing companies shelved replacement orders, normally about 5% to 7% p.a. of the total container fleet. Though a majority of the plants were restarted beginning in 4Q09, production remained low in 1H10, while the bottlenecks are now gradually being resolved as producers are adding a second shift in certain locations. Nevertheless, part of the replacement needs will be unmet this year, being pushed back into 2011/2012. Both CIMC and Singamas are receiving orders for delivery in Sept/Oct (versus the usual one- to two-month production cycle), while ASP for containers rose by low teens Q/Q in 2Q10. On strong volume recovery, we note margins on per-box basis for CIMC are returning back to pre-crisis levels.

Our earnings estimates for CIMC are raised by 127%/160% for FY10/11, largely in line with current consensus forecasts. On our estimates, both CIMC-A and CIMC-B are trading at +1x standard deviation against the historical mean estimate on a P/E basis, at mid-cycle multiples on a P/B basis, which appears fairly valued, in our view; hence, upgrading to Neutral but not OW. Key risks to our PT are unexpected changes in global container trade or fluctuations in raw material costs.

COSCO Pacific: The point of inflection

(Extracted from the note, "COSCO Pacific: The point of inflection", published on 8 July 2010; please see the original note for pricing dates)

Maintain OW and keep the stock on our Asia Analysts' Focus List. Revise our SOTP-based PT to HK$15.3 by Dec-10 (vs. prior HK$15.6)

Positive driver #1: CP's investments with younger maturity are at the inflection point: The losses on these newer investments have been narrowing notably, driven by improving utilization rates beginning in 2H09. During 1Q10, we believe two port assets in Dalian have turned profitable, while for those that are still under water (e.g., Nansha, COSCO-PSA), losses have also reduced notably. Furthermore, for CP's Piraeus project in Greece, we note that the transition period—during which CP was required to retain all personnel previously employed by PPA—ended smoothly in May 2010. Now with the reduction in headcount, the Piraeus project may be able to achieve a breakeven on a full-year basis for FY10E (against our current estimated loss of US$7 MM for FY10.

Positive driver #2: CP's container leasing and manufacturing arms are a key beneficiary of the ongoing global container shortage: On strong volume recovery, we note margins on a per-box basis for CIMC are returning to pre-crisis levels. Furthermore, CP's container leasing business also improved its utilization rate markedly to 97% in 2Q10, while average leasing rates should rise by c10% in FY10 based on our estimates.

Our Dec-10 PT at HK$15.3 translates to a target core P/E multiple of 16x, a target EV/EBITDA of 11x and a target P/B of 1.4x for FY10E (still vs. CP's 10-year mid-cycle P/B multiple of 1.7x)

Positive driver #3: With the completion of the Yantian acquisition, the container port segment contributes to 70% of the group's NAV based on our estimate, up from the prior 55%. The valuation gap versus other port operators of similar scale may narrow, with CP's improving financial returns as well as turnaround of under-performing port assets, in our view.

Key risks to our PT are: tariff cuts, weaker-than-expected volume growth and execution risk with new port investments.

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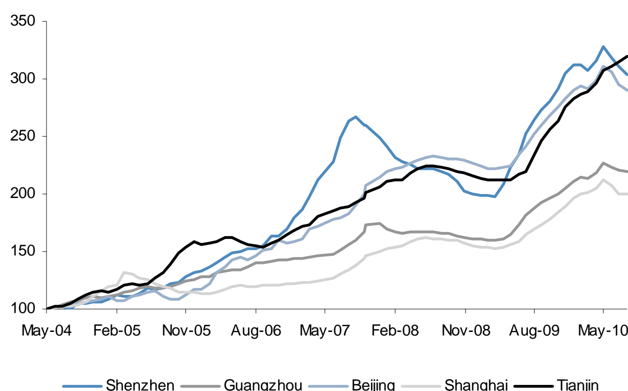
Real estate

(Extracted from the note, Jul-10 update: Potential supply glut would hinder stock performance, published on Aug 11, 2010; please see the original note for pricing dates)

Jul-10 primary sales volume recovered from year-lows
Primary sales volume in the eight major cities we track increased 14% Y/Y to 5.1 million sqm after staying flat M/M in May. Sales volume increased in all cities by 9-25% except Shenzhen. However, as the CBRC re-iterated stringent down-payment requirements on third-home mortgages in Beijing, Shanghai, Shenzhen and Hangzhou, which dampens buying sentiment again, we expect sales volume may increase only moderately in August. Sales in 7M10 amounted to 39.3 million sqm, down 40% Y/Y. Volume in 1H10 nationwide totaled 355 million, up 12.7% Y/Y.

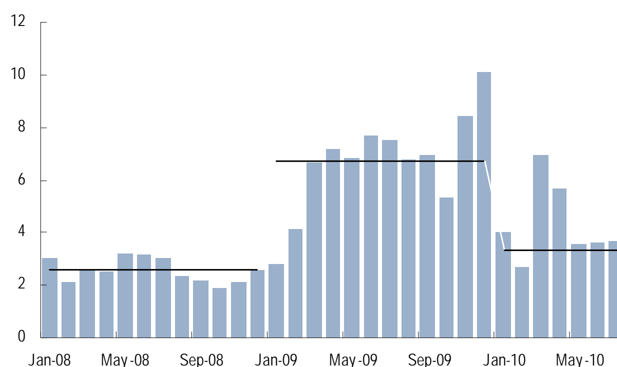
Secondary market: Property prices eased further with thin volume
The Centaline secondary-price indices on five cities edged down 0.58% M/M in Jul-10 on the back of 1.79% decline in Jun-10. Since the peaks in Apr-10, secondary transaction prices have come off 3.7%, with those in Shanghai, Beijing and Shenzhen losing 6%, 6.5% and 7.3%. Volume remained at 2008 levels or 46% below the year-highs in Mar-10 which showed that sentiment in the major cities have not yet improved.

Figure 84: Centaline secondary price index by city
Index (May-04=100)



Source: Centaline and Bloomberg.

Figure 85: Residential secondary transaction volume in 6 major cities
Sqm in millions



Source: Soufun, Centaline, J.P. Morgan estimates. Note: Combined monthly secondary transaction volume from Shanghai, Beijing, Guangzhou, Shenzhen, Tianjin and Hangzhou.

Supply/demand dynamics

In 1H10, residential new construction starts amounted to 637 million sqm. This adds to the 338 million sqm of residential area which started construction in 4Q09, and we estimate that 80% of such spaces (i.e. 877 million sqm) have not been pre-sold. The National Statistics Bureau unveiled that 106 million sqm of residential spaces are currently available for sale. Hence there could be a potential supply of 982 million sqm in the next 9 months. In fact, pre-sale permit approvals and launches have already been ramped up in some second-tier cities (e.g. Changsha, Wuhan, Shenyang) as well as Beijing and Guangzhou.

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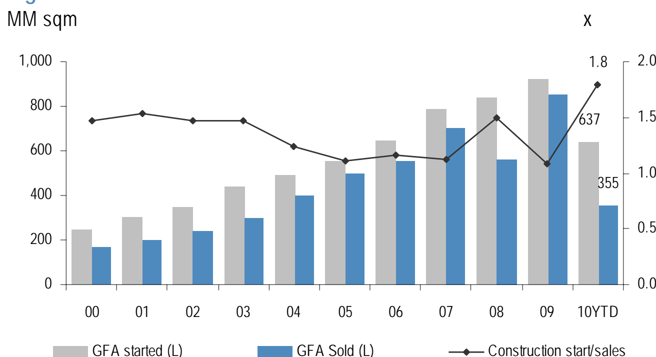
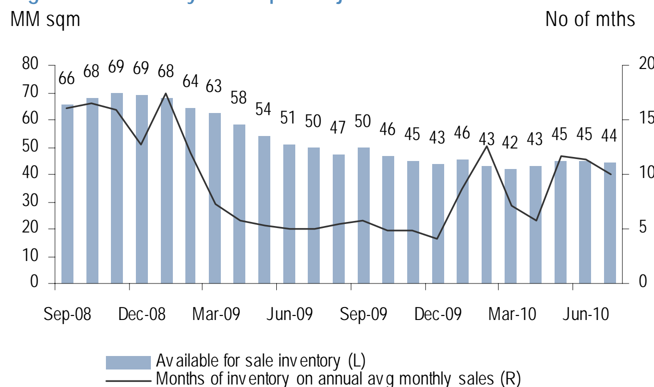
On the demand side, we estimate residential sales in 2010 to drop 19% to 700 million sqm, and hence 345 million sqm to be sold in 2H10. In the near term, the units available for sale has been stable as developers are holding back launches (those without per-sale permits are not included). However, the inventory could revert to the peak again by 1Q11 even if construction starts would slow down in 2H10.

Figure 86: Residential construction start vs. GFA sold



Source: CEIC.

Figure 87: Inventory build-up in major cities



Source: CEIC. Note: Combined figures of Shanghai, Beijing, Guangzhou, Shenzhen, Hangzhou, Chongqing and Chengdu.

Increasing dependence on second-tier cities for sales performance

Diverse contract sales performance of listed developers

Developers' contract sales performance has been diverse since tightening, with city developers (those concentrated in first-tier cities) lagging behind the national or regional developers. As of end Jun/Jul-10, developers have achieved 40-70% of their respective contract sales targets. While more launches have been scheduled, those in Beijing, Shanghai, Hangzhou and Shenzhen could be more impacted by the unavailability of mortgage lending.

Table 51: Contracted sales YTD by developers

	2010 YTD sales Rmb bn	May 10 contract sales Rmb mn	Jun 10 contract sales Rmb mn	Jul 10 contract sales Rmb mn	M/M chg %	YTD Y/Y chg %	ASP Rmb/sqm	Company 10 sales target Rmb bn	% achieved
Agile	10.5	1,000	2,000	NA	NA	36%	10,194	25.0	42%
Beijing Capital Land	4.9	370	380	480	26%	-26%	10,795	10.0	49%
C C Land	2.7	263	385	488	27%	248%	6,906	3.5	76%
China Vanke	36.8	5,110	8,770	8,240	-6%	20%	14,058	80.0	56%
China Overseas Land	24.7	3,024	5,289	4,331	-18%	10%	10,951	50.0	49%
Country Garden	13.2	2,200	1,500	NA	NA	50%	5,455	30.0	44%
Evergrande	26.2	4,048	4,796	5,081	6%	115%	6,267	40.0	65%
Glorious	2.8	236	892	677	-24%	27%	9,629	13.0	22%
Greentown	24.4	2,000	3,100	2,600	-16%	4%	18,289	67.0	36%
Guangzhou R&F	15.4	1,182	1,412	3,092	119%	6%	12,538	30.0	51%
KWG	6.5	800	600	NA	NA	117%	NA	10.0	65%
Longfor	10.5	1,550	1,880	1,940	3%	23%	NA	24.8	50%
Poly (HK)	5.2	500	500	500	0%	24%	7,123	10.0	52%
Shanghai Forte	8.6	650	3,579	988	-72%	82%	14,334	13.0	66%
Shimao	13.3	1,544	1,776	2,002	13%	-12%	11,630	30.0	44%

Source: Company reports and J.P. Morgan estimates.

Policy update

- **CBRC required banks to run more stringent stress tests on housing price declines**: In late July, the CBRC requested commercial banks to run stress tests based on a scenario of 60% housing price decline.

- **Third-home mortgage suspended in major citie**s: On August 5, the CBRC responded to the recent speculation that third-home mortgage is suspended in Beijing, Shanghai, Shenzhen and Hangzhou. The CBRC did not call for a one-off suspension but re-iterated the more stringent requirements on third-home mortgages than first-home mortgages, and that the government will not loosen the policy measures in the near term. Some banks have thus suspended third-home mortgage approvals in these cities, while banks in other cities (e.g. Chengdu and Chongqing) have very stringent requirements of 55-60% downpayment and 1.15-1.2x PBoC benchmark rate for customers with good credit records.

- **CIRC released new investment guidelines on real estate**: On August 5, the CIRC announced the new investment guidelines on Aug 5, allowing insurance companies to invest up to 10% of assets to real estate effective Aug 31. However, they are refrained from property development. We believe the commercial property segment can benefit from the new rule and would encourage development of high-quality rental properties, as developers could sell the properties to insurance firms upon completion.

Trading ideas

Investigation on idle land may put pressure on developers' cashflow
According to *China Securities News*, the Lands Bureau has identified 1,457 idle land cases nationwide, 25% of which is located in Beijing, Guangzhou, Hainan and Jiangsu. Most of these sites are planned for residential usage. The Lands Bureau may take back the sites if developers deliberate set them idle. This is the government's latest move to discourage land hoarding and to ensure adequate future housing supply. We believe developers would be under pressure to start construction on these sites which would cast pressure on cashflow, but we do not rule out developers could hold on to the development until completion if they view that property prices in those locations would stay on the long-term uptrend.

More potential capital raising activities to prepare for landbanking opportunities
Vanke just announced 1H10 financials and reported a net gearing of 50% as of end Jun-10. Management views that this is the maximum gearing they would endure and hence has raised the contract sales target to Rmb80 billion from Rmb65 billion for 2010. Vanke will target sales rate of 60% within one month of launch to generate contract sales. The target Rmb35 billion to be achieved in the next few months will be used to finance the land premium (Rmb20 bn acquired in 1H10) and upcoming purchase, when land prices come down further. To Vanke, raising capital from either the A-share market or domestic bond market is not readily available.

In contrast, the Hong Kong-listed property developers face more alternative fund raising channels. YTD, they have raised US$6.7 billion from bond issue (US$4.3 bn) and syndicated loans, mainly to refinance the existing debts. The only share issuance was Poly (HK) which has raised HK$3 billion from issue of 400 million shares. We

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believe more fund raising activities may be underway given the upcoming land acquisitions opportunities.

Valuation not attractive, in our view

The China property sector lost 7.3% since the re-iteration of mortgage tightening, but was still 17% above the year-low on May 20. The sector trades at an average 14.8/12.3 FY10/11 P/E and is not particularly attractive, in our view, considering the potential housing price correction that could be triggered by increasing housing and land supply. While we have incorporated conservative assumptions in our earnings forecasts and believe most of the housing price downside is factored in, chances for imminent re-rating are low until housing prices bottom out. We would suggest re-entry when share prices are 10% lower. We prefer companies that deliver more stable sales performance through flexible sales strategy and diversified launch pipeline (especially those with inland cities exposure), as well as companies showing improvements in financials. Our preferred picks include Vanke and R&F, and Shimao (at HK$13 or below).

Table 52: China property developers' valuation summary

	Rtg	Stock Code	Price 6-Jul-10 LC$	Market cap US$MM	NAV Current HK$	Discounts to NAV (%)	Core PER FY10E (X)	Core PER FY11E (X)	Div Yield FY10E (%)	P/B FY10E (X)	End FY10E Gearing (%)
China Vanke - B shares	OW	200002.SZ	9.40	13,049	10.00	-6%	15.0	11.7	1.0%	2.1	47%
China Overseas Land Investment	OW	0688.HK	16.52	17,420	16.04	3%	13.0	13.6	1.8%	2.7	37%
New World China Land	N	0917.HK	2.70	2,006	6.72	-60%	28.7	27.5	2.2%	0.3	27%
Poly (HK)	N	0119.HK	9.10	3,761	11.84	-23%	29.9	17.5	0.5%	1.4	73%
China Resources Land	OW	1109.HK	15.78	10,257	18.97	-17%	18.8	13.5	1.6%	2.0	41%
Sino-Ocean Land	N	3377.HK	5.68	4,132	11.51	-62%	14.1	10.9	2.8%	1.2	36%
Beijing Capital Land	N	2868.HK	2.48	659	6.51	-62%	9.7	12.9	5.5%	1.0	70%
Franshion Properties	OW	0817.HK	2.22	2,624	4.32	-49%	22.1	5.9	1.3%	1.1	59%
Greentown	N	3900.HK	9.31	1,965	20.14	-54%	8.9	5.1	6.1%	1.2	169%
Shanghai Forte	N	2337.HK	2.24	731	7.63	-71%	6.8	5.3	3.7%	0.6	102%
Shimao	OW	0813.HK	13.88	6,350	18.86	-51%	12.8	12.1	2.9%	1.6	74%
Shui On Land	N	0272.HK	3.47	2,308	7.03	-51%	15.9	16.8	3.3%	0.7	79%
Yanlord*	OW	YNLG.SI	1.83	2,563	3.00	-39%	12.3	10.7	0.8%	1.3	35%
Guangzhou R&F	OW	2777.HK	12.08	5,023	16.91	-29%	9.7	8.0	4.2%	1.8	91%
Hopson	OW	0754.HK	10.64	2,406	29.60	-64%	6.3	8.4	2.2%	0.6	33%
KWG Property	OW	1813.HK	5.29	1,975	8.76	-40%	11.3	8.3	2.2%	1.2	74%
Agile Property	OW	3383.HK	9.72	4,355	15.07	-36%	13.5	11.2	2.2%	1.9	81%
C C Land	N	1224.HK	3.30	1,090	6.44	-49%	NA	NA	0.9%	0.7	-11%
Sector average (ex Vanke)						**-37%**	**14.7**	**12.1**	**2.3%**	**1.7x**	**54%**

* in Singapore Dollars
Source: Company reports, Bloomberg, J.P. Morgan estimates.

Technology Hardware

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(This Alert was originally published on 23 July 2010; please see the original note for pricing dates)

TV – high inventory persists: According to AVC, inventory in TV panels and full sets has been a very high 7-8MM units since May, with major local brands carrying close to 1MM units each. With no obvious slowdown in TV sell-out, according to GOME, we believe local brands have been overly optimistic while hurt by unfavorable product mix (little exposure in LED TV). Low-tier cities and rural regions could carry big inventory, in our view, as local brands invest heavily in the expansion of the rural stimulus program (which raises TV price ceiling from Rmb3500 to Rmb7000) while actual demand has not yet materialized due to seasonality. As panel prices will start to fall in August, locals are cutting prices aggressively to clear inventory, yet will still face uphill battles against global brands in 2H.

PC – summer promotion started off mediocre; likely backend-loaded in 3Q: 2Q vendor sell-in had been erratic – strong in April, weak in May, and in June recovering somewhat. However end-demand did not improve in June with flat m/m with May, according to our checks. Summer promotion started late this year (July 10 vs. late June in the past two years) and promotions are warming up slowly, possibly due to already thin vendor margin amid high component prices. However Lenovo has started cutting prices recently amid the high channel inventory on hand, and we expect price competition to intensify in late 3Q amid the falling prices in key components (DRAM, panel).

Handsets – white-box recovering and MediaTek cutting prices: After the severe slowdown in 2Q after the government crackdown, white-box handset activity is recovering in July in anticipation of the traditional high season for both China and overseas markets. Channel inventory has been largely digested, according to our checks (although baseband IC inventory is likely to remain high at MediaTek). MediaTek is turning aggressive in pricing with the new 6253D chip which is pin-to-pin computable with 6253, yet achieves a much lower PCB BOM cost of $11, down from $14 before, and flat with Spreadtrum solution.

Seasonality and stimulus programs could indeed help clear inventory …: September/October is the high season for TVs, PCs, and handsets, especially in rural regions. Moreover, the expansion of the rural stimulus program and urban "Old for New" program (likely to be rolled out in August) should further help.

… yet ASP/margin could become key risks in 2H: We believe a key reason for inventory build-up is the overly optimistic expectation that strong YoY growth in 4Q09 and 1Q10 would continue. Now that vendors are turning aggressive in pricing in order to clear inventory, ASP and margin could become key downside risks in 2H. We remain cautious on MediaTek and Lenovo.

Telecoms

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Initiations on the Chinese telecom sector

(Extracted from the note, "Chinese Telcos: Looking for profitability revival – Spotlight the undervalued opportunities; prefer CU and CT over CM", published on August 2, 2010; please see the original note for pricing dates)

We turn more constructive on the China telecom sector: We initiate coverage of China Telecom sector with an Overweight rating on China Unicom and China Telecom, Neutral on China Mobile. We also initiate on China Unicom A-share with a Neutral rating. We see a clear pick up in the growth profile of the Chinese telecom sector in the coming years fostered by both macro and micro factors. While market will remain focused on top-line growth, which is hinged on the industry competition landscape and 3G subscriber take-up, we expect the attention on EBITDA and profitability to revive rapidly. We expect China Unicom's and China Telecom's EBITDA and earnings to largely turn around in 2011E when their 3G/mobile operations reach the EBITDA breakeven in the next 12 months.

We prefer China Unicom and China Telecom as we believe their mobile businesses are currently undervalued by the market. We believe both the companies will largely stick to their handset subsidy guidance in 2010/2011E, which will set an EBITDA breakeven path in due course. We believe market would reassess the quite low expectation on China Unicom's execution capability and CDMA value chain evolvement in light of the recent developments, which would thus result in a multiple rerating and better monetization of the mobile operations.

China Mobile long-term outlook upbeat, but too early to buy now: CM's early foray into TDD-LTE and new value-added service present an optimistic long-term outlook, but we believe any excessive excitement at the moment might be premature as we foresee the meaningful impact of TDD-LTE will only emerge in 2013-2014E.

Ecosystem competition to heat up: We believe 3G competition has increasingly evolved into a competition of ecosystem as the network differentiation has largely converged. Recent developments suggest that WCDMA value-chain advantage prevails, while CDMA has shown some early sign of catching up. We expect a much improved handset selection on public market and the handset price to evolve rapidly in the coming quarters. This, if realized, would impact operators' subsidy profile positively.

Regulatory environment relatively benign in the next 6-12 months: Mobile-number portability (MNP) is likely to be commercialized in small scale in 4Q10/1Q11, but a dramatically unfavorable term against China Mobile is unlikely, in our view. 'Three network convergence' policy remains on the big-picture level up to date, and we believe it could take time to show meaningful impact on both telecom and cable TV companies.

Initiation on China Mobile

(Extracted from the note, "China Mobile Limited: No harm to own but too early to buy", published on August 1, 2010; please see the original note for pricing dates)

- **We initiate coverage on China Mobile (CM) with a Neutral rating and Dec-11 PT of HK$83:** We are comfortable with CM's solid and stable fundamentals, but the constraint of TD-SCDMA ecosystem still puts the company at a disadvantage amid accelerating 3G competition. CM's TD strategy turned out to be more muted than we expected in 1H2010. Meanwhile, we are concerned about the lack of near-term catalysts for the stock, which has outperformed MSCI China by 11.2% YTD. We view CM as a macro play over the next six months.
- **'Ex-growth' profile well-perceived by the market:** We believe that the market has understood CM's 'ex-growth' profile well, and that is already reflected in its low-teen multiple. CM tends to focus more on revenue market share, which it maintains relatively stable compared to a rapidly reduced subs market share. We expect CM to maintain top-line growth at high single digits and net profit growth at mid-to-low single digits over the next few years, which is broadly in line with the market's expectations. We do not expect major surprise from its 2Q10E results.
- **Early TDD-LTE excitement unwarranted, in our view:** We agree that CM's early foray into TDD-LTE technology and the new value-added services (VAS) development should provide a very positive long-term outlook, but is unlikely to be a near-term price driver. Though TDD-LTE is progressing better than expected, we do not foresee a meaningful commercialization before 2013-2014. We expect 2Q10E results to be largely in line with market expectations, and believe a better entry point would emerge towards 4Q10E, should there be any meaningful TD value chain improvement from the launch of more HTC/Ophone models and better visibility on the timing of A-share listing.

Our Dec-11 price target is based upon a 10-year DCF model. We assume a WACC of 10.8% derived from a cost of equity of 11.0%, cost of debt of 5.0%, beta of 1.0, and terminal growth rate of 1.0%. Upside risks to our PT are: better TD-SCDMA take-up in 2H10 due to the handset breakthrough, or an earlier-than-expected domestic listing. Downside risks could be ARPU weakness due to softer elasticity, or a strong recovery of the stock market in which CM, as the lowest beta name among the Chinese telcos, would tend to underperform.

Initiation on China Telecom

(Extracted from the note, "China Telecom Corporation Limited – Buy China Telecom, get CDMA for free", published on August 1, 2010; please see the original note for pricing dates)

- **We initiate coverage of China Telecom with an Overweight rating and Dec-11 PT of HK$4.60.** We think this might be the case in the past year and half when CDMA EBITDA was still on the falling slop of the 'V' shape, while the visibility to call the inflection point remained low. However, we expect a better monetization of the network value in the coming quarters mainly driven by:
- **1) EBITDA inflection point is approaching near, and we forecast the breakeven to take place in 2011.** We believe this is helped by a more positive

stance on company's scrutiny to control the handset subsidy within the budget, which is achievable in our view in light of the firm control in execution as well as the a better than expected value chain improvements.

- **2) Recent ecosystem developments highlight the overlooked long term value of CDMA.** We think recent developments of CDMA value chain in China suggest a likely revival of CDMA long term value. For instance, EVDO handset selection has largely improved underpinned by good traction obtained by Android-based smartphones and an improved scale effect.
- **Although it might not present an upside, we see limited downside to fixed-line operation.** We expect a contained fixed line revenue drop in 2H2010 from -5% yoy in 1Q10, driven by a moderation of the PHS migration as suggested by the company. We believe CT can still achieve the ~3% yoy fixed line revenue decline for the full year 2010E.

Our PT of HK$4.60 is based on the SOTP methodology. We use a DCF approach for both mobile and fixed-line businesses and then combine the two to arrive at our price target. The DCF based fair value for fixed line and mobile business implies a 2011E fixed and mobile EV/EBITDA based on our forecasts, separately. Downside risks to our PT could be macro weakness and intensified mobile competition.

SOTP assumptions

China Telecom	HK$	Implied 2011E EV/EBITDA	Methodology
Mobile operation	0.7	30.1	DCF
Fixed-line operation	4.0	3.6	DCF
Share price equivalent	**4.6**	**4.6**	**Sum-of-the-parts**

Source: J.P. Morgan estimates.

Initiation on China Unicom

(Extracted from the report, "China Unicom – Something must be undervalued; our top pick in China telecom sector", published on August 2, 2010)

- **We initiate coverage of China Unicom red chip, with an Overweight rating and a Dec-11 PT of HK$13.20, and of CU A–share, with a Neutral rating and a Dec-11 PT of Rmb5.50.**
- **1) 3G profitability to turn around rapidly.** Unicom's top-line advantage is well recognized by the market, but worries are surging lately on the possible profitability deterioration caused by the handset subsidies acceleration, exemplified by the almost doubled iPhone payback period.

  - We believe company will stick to its 3G handset subsidy guidance of Rmb3-5bn for 2010, just that it will be heavily skewed to Unicom's 'strategic terminals', such as iPhone and LePhone, etc.

  - The perceived lengthy payback time of iPhone, etc., is calculated upon the committed ARPU, but arguably the payback based on actual ARPU might not be as bad as it appears. We forecast 3G EBITDA to rapidly turn around in 2011. This, if realized, should provide an uplift to 2011E consensus EBITDA.

- **2) Doubts on execution capability are soothed, but might take time to be relieved.** Recent acceleration in brand construction and value chain enhancement should help Unicom to better utilize its WCDMA advantage. It might take time to

fully play out, but any positive outcome could be a boost to the already very low market expectation on company's execution capability.

Our PTs are SOTP-based. We use the DCF approach for both mobile and fixed-line businesses and combine the two to arrive at our price targets. The DCF-based fair value of fixed-line and mobile operation implies 4x and 5x 2011E EBITDA, respectively based on our forecast of fixed line and mobile EBITDA. Key downside risks to our PTs include a slowdown in subs adds and weaker-than-expected fixed-line business.

SOTP assumptions

CU-H	HK$	Implied 2011E EV/EBITDA	Methodology
Mobile operation	9.7	5.4	DCF
Fixed-line operation	3.5	4.3	DCF
Share price equivalent	**13.2**	**5.0**	**Sum-of-the-parts**
CU-A	**Rmb**		**Methodology**
Mobile operation	3.7		DCF
Fixed-line operation	1.8		DCF
Share price equivalent	**5.5**		**Sum-of-the-parts**

Source: J.P. Morgan estimates.

China Mobile TDD-LTE investor tour key takeaways

(Extracted from the note, "Company Visit Note: China Mobile Limited: TDD-LTE progresses upbeat than expected; commercialization likely in 3-4 years", published on July 14, 2010; please see the original note for pricing dates)

China Mobile (CM) hosted an investor tour in Shanghai on July 12 to share the latest TDD-LTE developments and demonstrate the feasible applications in a small lab-based environment. **Management believes that the market's concerns about CM's long-term competitiveness in the technology due to the TDSCDMA handicap are unwarranted and therefore the question on how much TDD-LTE (the long-term evolution path beyond TD-SCDMA) could change the game. Takeaways from the trip make us believe that TDD-LTE could be much more effective than the market expects because:**

- **TDD LTE will largely converge with the main stream technology of FDD LTE** (the evolution path of WCDMA and CDMA EVDO) in that the two standards can largely share the network platform with an insignificant cost differential. We believe it will incentivize the product development of dualmode equipment and terminals, and thereby solve the value chain shortage as seen in TD-SCDMA. Moreover, TDD LTE can provide comparable performance to FDD LTE in throughput, spectrum efficiency, etc.
- **TDD LTE should enjoy a much better global scale with larger involvement from global vendors:** Global vendors such as Ericsson and Motorola have shown strong commitment to TDD LTE, exemplified by their close cooperation with CM in developing the TDD LTE solutions from an early stage. The strong incentive of global vendors is driven by a likely global scale adoption of TDD LTE in the US, India, and China. We believe the scale effect and the involvement of major vendors will result in better value chain maturity and cheap equipment price that TD-SCDMA lacks as a primarily China game.

- **Timing of commercialization is a big question mark, likely still 3-4 years away:** We think commercialization will largely depend on the development of the value chain, particularly the terminals and handsets. The roadmap laid out by CM and vendors indicate that meaningful commercialization of handsets and smartphones will be likely in 2013-14 at the earliest and industrialization will follow thereafter.

Chinese operators' June subs statistics

- **China Unicom 3G subs momentum maintained.** CU continued to report an over 1 million 3G subs adds in June, a second consecutive month to add over 1 million 3G subs due to the accelerated 3G marketing campaign which started in May. We expect to see the 3G subs addition to gradually increase in the next two quarters, helped by the 'thousand Rmb' smartphones launched in July, improvement in the handset supply issue of iPhone as well as a potential iPhone 4/iPad launch in 2H10.

- **China Mobile regained lost ground in June.** CM added 5.1 million 2G+3G subscribers in June, recovering from 4.8 million in May. CM added 1.1 million TD-SCDMA 3G subscribers in the month, the first time to exceed 1 million since the inception of 3G services. However, we view the 2G/3G breakdown of CM subscribers less meaningful as the company changed the 3G subscriber definition in March 2010 to 'customers who own 3G terminals', and therefore the number of customers who have 3G handsets (most of the handsets in the market are now 3G-enabled) but for 2G services only (voice/SMS) inflated the 3G subs headline figure.

- **China Telecom subs adds flattish in the past two months.** China Telecom reported a flattish subs addition of 3.02 million in June, exactly the same as in the past two months.

Table 53: YTD subs statistics

('000)	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10
China Mobile	5,115	5,518	5,974	5,323	4,769	5,060
2G	4,625	5,136	2,564	4,610	3,852	3,919
3G	490	382	3,410	713	917	1,141
China Unicom	1,662	1,206	1,632	1,414	1,786	1,675
2G	809	736	873	733	763	643
3G	853	470	759	681	1,023	1,032
China Telecom	3,050	3,010	3,300	3,030	3,020	3,020
Total wireless net adds	**9,827**	**9,734**	**10,906**	**9,767**	**9,575**	**9,755**
China Telecom fixed	(1,900)	(1,030)	(1,400)	(1,200)	(1,070)	(890)
China Unicom fixed	(300)	(410)	(274)	(201)	(510)	(275)
Total fixed subs	**(2,200)**	**(1,440)**	**(1,674)**	**(1,401)**	**(1,580)**	**(1,165)**
China Telecom broadband	790	780	810	810	800	880
China Unicom broadband	965	791	1,198	596	828	831
Total broadband subs	**1,755**	**1,571**	**2,008**	**1,406**	**1,628**	**1,711**

Source: Company data.

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Transportation

Key investment theme

- **Airlines:** Passenger traffic growth continued to accelerate, pushing up load factors, even as airlines reinstated capacity. Cargo traffic continued to show strong growth momentum, particularly on international routes. Plans to increase the number of cross-strait (China-Taiwan) flights failed to materialize owing to certain differences and talks are expected to resume in October.
- **Bulk shipping**: The expected fall in iron ore benchmark prices could spur resumed buying and restocking in China in 4Q. 3Q's soft demand will likely contribute to a weaker 2H10 vs. 1H10. The RoRo market continues to remain weak.
- **Container shipping:** Slow steaming practices have allayed some of the overcapacity concerns as freight rates continued to remain strong. Shippers are optimistic and expect rates, particularly on trans-pacific trades, to inch higher in 3Q. Freight rates to Europe have been fairly strong.

What is changing?

Airlines

Passenger traffic growth accelerated in June, growing 29% Y/Y vs. the YTD growth rate of 22% Y/Y for China Southern, while Air China reported a 27% Y/Y increase. Notably, traffic across Hong Kong/Macau/Taiwan route jumped more than 70% Y/Y. Domestic traffic on China Southern was up 23% Y/Y, while international traffic improved 70% Y/Y. Air China's domestic and international traffic was up 22% and 32% Y/Y, respectively. Load factors surged, rising 7ppt to 79% on CSA's flights, and Air China's load factors improved 7ppts to 80%. CSA's cargo traffic increased 80% Y/Y, beating Air China's 31% Y/Y increase. Both the airliners were aggressive in boosting capacity, with Air China and CSA increasing passenger capacity by 18% and 16% Y/Y, respectively. On the cargo front, China Southern increased capacity by 54% Y/Y in comparison to Air China's 19% increase.

Bulk shipping

The BDI increased slightly (+3% W/W—week-ended August 6) as rising capesize freight rates helped offset softer rates in other vessel segments: Average daily earnings for Capesize vessels rose 10% W/W. Notwithstanding the low freight rates in recent months, the number of newbuild bulk carrier orders continued to grow. The total number of newbuild bulk vessel orders totaled 540 year-to-date, +205% Y/Y, amounting to c.6% of the global dry bulk fleet. Newbuilding prices have risen by 6% on an average YTD. In the second-hand market, 298 bulk vessels changed hands and prices for five-year old bulk carriers rose 14% YTD on an average.

Container shipping

Freight rates have softened slightly in the Asia-Europe (AE) trade given the industry's rapid reintroduction of a sizeable amount of capacity (idle fleet amounts to only c.1.9% of global capacity) and managements are concerned about the upcoming industry delivery of 40+ >10,000 TEU vessels in 2H, which can only operate in AE. Transpacific rates could come under pressure in 4Q. Intra-Asia trade route will likely experience a cascading of smaller vessels from AE plus cost pressure from higher vessel charter rates, new container and leasing costs. Compared to the pre-downturn levels in 2Q08, the average freight rate was only 2% lower, but note that average bunker fuel prices were also 20% lower.

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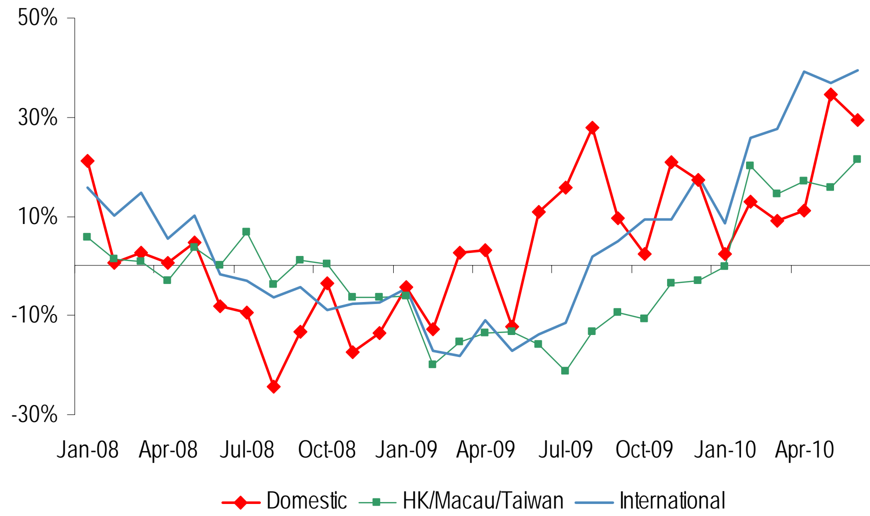
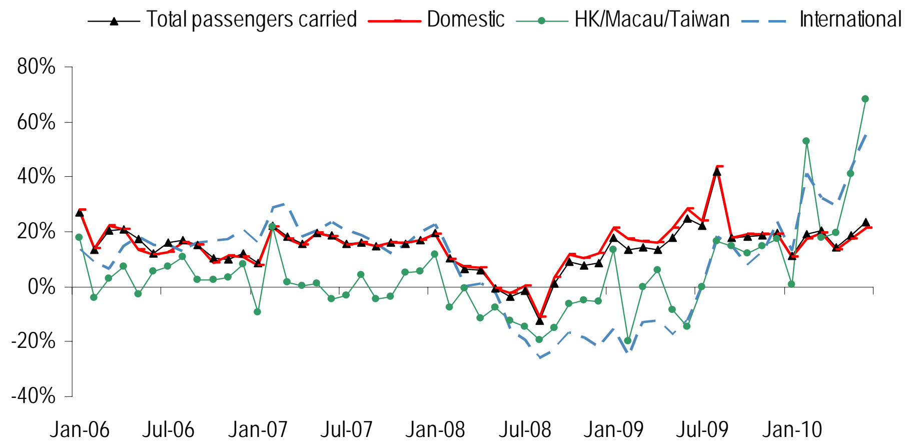
Figure 88: China airline ticket prices



Source: CEIC database.

Figure 89: China passenger traffic—Y/Y Growth (%)



Source: CEIC database.

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Appendix I:

Following text used by permission from Professor Robert D. Fiala of Concordia University, Nebraska, USA—as excerpted from www.orientalarchitecture.com

The Bund (Waitan) is one of the most recognizable architectural symbols of Shanghai. "Bund" derives from an Anglo-Indian word for an embankment along a muddy waterfront and that is what it was in the beginning when the first British company opened an office there in 1846. Located on the west bank of a bend (running north and south at this point) in the Huangpu River and just south of Suzhou Creek, the Bund became the site of some of the earliest foreign settlements after Shanghai was opened as one of five "Treaty Ports" in the Treaty of Nanjing that ended the Opium War in 1842. Because of its proximity to the Yangtze (Changjiang) River--the path into central China, Shanghai grew rapidly as the economic center of foreign interests.

Jardine Matheson & Company bought its first land here in 1848 and the river front soon became vital to the interests of the entire foreign settlement. In the latter 19th early 20th century the Bund became the financial and political center of the international community and (indeed of much of China). It was China's Wall Street, as Shanghai's financial market became the third largest in the world (behind London and New York). Nearby were located a number of important consulates, including the British, American, Russian and Japanese.

The twenty-four major structures, of uneven height along approximately 1.5 kilometers of Zhongshan Lu and the Huangpu River, have changed little externally since the 1930s. All were constructed in western-inspired styles—classical, Gothic, renaissance, eclectic and modern—a reported seventeen styles of architecture. The Bund has been called a 'museum of international architecture', and indeed it was and still is. But it was also much more. Here were located the banks, hotels, exclusive clubs, press organizations and headquarters of international concerns.

After the establishment of the People's Republic of China in 1949 the old tenants were gone. They had already been impacted by the wartime crises. Many of the structures were subdivided into government offices, department stores or storage areas, furnishings were sold off or destroyed, and architectural features covered. The Bund, one might say, was moribund.

Much of this now is changing with the revitalization of Shanghai, strongly encouraged by a visit of Deng Xiaoping in 1992. The next year the plans for the Bund were finalized and the renewal of Shanghai began in earnest. Although many of the state-protected historic buildings of the Bund remain vacant, or perhaps underutilized as government offices as of this writing (April 2002), there are strong indications that this might change—even though the old tenants have outgrown their old quarters and will not return since many are now in more spacious and comfortable quarters on the east side of the river in Pudong. But their old buildings are newly appreciated, with even brass plates outlining their previous use, and efforts are being made to bring elements of the international community back to where it started in the Bund, as well as on the Pudong side.

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The area does have a new vitality. Zhongshan Dong Lu has been widened to ten lanes to accommodate the increased Shanghai motor traffic, and the promenade along the banks of the Huangpu has also been elevated and enhanced as a place to view the ever-changing skyline of Pudong across the water. It actually is part of a new dike to protect the city. One only need look at a few images of this area taken in 1980 that are on this site to gain an appreciation of this new vitality. A decade ago there was little in Pudong besides warehouses, shipping facilities and small shops. Now it is the most extensive construction site in the world. Both sides of the Huangpu River reflect important aspects of Shanghai's heritage—its past, present and future.

Text by Professor Robert D. Fiala of Concordia University, Nebraska USA.

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Table 54: China coverage universe

Name	Ticker	Rating	Price (LC)
Shenzhen Development Bank	000001.SZ	Overweight	17.51
China International Marine Containers A	000039.SZ	Neutral	14.39
Cheung Kong Holdings	0001.HK	Overweight	97
CLP Holdings	0002.HK	Neutral	57.45
Hong Kong & China Gas	0003.HK	Neutral	18.68
HSBC Holdings plc	0005.HK	Overweight	75.9
Hong Kong Electric Holdings	0006.HK	Neutral	47.4
Angang Steel Company Limited - A	000898.SZ	Neutral	8.44
Hang Lung Group	0010.HK	Neutral	45.95
Hang Seng Bank	0011.HK	Neutral	107.2
Henderson Land Development	0012.HK	Overweight	47.45
Hysan Development Co	0014.HK	Neutral	24.15
Sun Hung Kai Properties	0016.HK	Overweight	110.2
New World Development	0017.HK	Overweight	12.84
Swire Pacific	0019.HK	Overweight	93.1
Bank of East Asia	0023.HK	Overweight	30.05
Great Eagle	0041.HK	Overweight	20.9
MTRCL	0066.HK	Neutral	27.95
Sino Land	0083.HK	Overweight	13.52
Hang Lung Properties	0101.HK	Neutral	34.45
Poly (HK) Investments Limited	0119.HK	Neutral	8.77
China Merchants Holdings Int'l	0144.HK	Neutral	25.9
Kingboard Chemical	0148.HK	Overweight	37.5
Want Want China Holdings Ltd	0151.HK	Neutral	6.06
Tsingtao Brewery	0168.HK	Underweight	39.55
K Wah International Holdings	0173.HK	Overweight	2.66
Jiangsu Expressway - H	0177.HK	Overweight	7.8
Sa Sa International Holdings Limited	0178.HK	Underweight	5.64
Uni-President China Holdings Ltd	0220.HK	Underweight	4.49
Guangdong Investment Limited	0270.HK	Overweight	3.7
Shui On Land Ltd	0272.HK	Neutral	3.45
BYD Electronic	0285.HK	Neutral	4.1
China Resources Enterprise	0291.HK	Neutral	31.55
Cathay Pacific	0293.HK	Overweight	19.46
Wing Hang Bank	0302.HK	Overweight	80.6
Orient Overseas Int'l Ltd	0316.HK	Overweight	63.25
Texwinca	0321.HK	Neutral	7.68
Tingyi (Cayman Islands) Holding Corp	0322.HK	Underweight	19
Maanshan Iron and Steel - H	0323.HK	Overweight	4.13
Esprit Holdings	0330.HK	Overweight	45
Huabao International Holdings Limited	0336.HK	Neutral	11.26
Cafe de Coral Holdings Ltd	0341.HK	Underweight	20.05
Angang Steel Company Limited - H	0347.HK	Neutral	11.38
ICBC (Asia)	0349.HK	Overweight	28.65
China Gas Holdings Limited	0384.HK	Neutral	3.93
Sinopec Corp - H	0386.HK	Overweight	6.16
Hong Kong Exchanges & Clearing	0388.HK	Overweight	124.9
China Railway Group Limited	0390.HK	Overweight	5.63
Beijing Enterprises Holdings Limited	0392.HK	Overweight	54.35
Minth Group	0425.HK	Overweight	11.42
Dah Sing Financial	0440.HK	Neutral	47.1
DongFeng Motor Co., Ltd.	0489.HK	Overweight	11.32
ASM Pacific	0522.HK	Neutral	64
Ajisen China Holdings Ltd	0538.HK	Neutral	11.1
Shenzhen Expressway - H	0548.HK	Overweight	3.68
Yue Yuen Industrial	0551.HK	Neutral	25.7
Zhejiang Expressway	0576.HK	Overweight	7.24
Ports Design	0589.HK	Overweight	22.1
Public Financial Holdings Limited	0626.HK	Overweight	4.27
China High Speed Transmission	0658.HK	Overweight	16.92
Techtronic Industries	0669.HK	Overweight	6.68
China Eastern Airlines	0670.HK	Neutral	4.1
Zhong An Real Estate	0672.HK	Neutral	1.92
Kerry Properties	0683.HK	Overweight	38.55
China Overseas Land & Investment	0688.HK	Overweight	15.9

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Beijing Capital International Airport	0694.HK	Overweight	3.9
Shougang Concord International	0697.HK	Overweight	1.26
Tencent	0700.HK	Overweight	141.5
Giordano	0709.HK	Overweight	4.14
Hopewell Highway Infrastructure Ltd.	0737.HK	Overweight	6.14
Skyworth Digital Holdings	0751.HK	Overweight	4.79
Air China	0753.HK	Overweight	8.68
Hopson Development Holdings	0754.HK	Overweight	9.44
ZTE Corp	0763.HK	Overweight	26.55
Value Partners Group Limited	0806.HK	Overweight	4.42
Shimao Property Holdings	0813.HK	Overweight	13.44
Franshion Properties (China) Ltd.	0817.HK	Overweight	2.26
Link REIT	0823.HK	Overweight	21.8
New World Department Stores Ltd	0825.HK	Overweight	6.79
China Resources Power Holdings	0836.HK	Overweight	17.06
Glorious Property	0845.HK	Overweight	2.24
PetroChina	0857.HK	Underweight	8.52
Digital China	0861.HK	Overweight	12.18
Xinyi Glass	0868.HK	Overweight	3.88
CNOOC	0883.HK	Neutral	13.08
Trinity Limited	0891.HK	Neutral	5.54
Huaneng Power Int'l - H	0902.HK	Overweight	4.62
TPV Technology	0903.HK	Overweight	4.76
Anhui Conch Cement Company Limited - H	0914.HK	Neutral	27.3
New World China Land	0917.HK	Neutral	2.55
China Construction Bank	0939.HK	Overweight	6.43
China Taiping Insurance Holdings	0966.HK	Overweight	23.85
Datang International	0991.HK	Neutral	3.24
Lenovo Group Limited	0992.HK	Neutral	4.56
Anhui Expressway	0995.HK	Overweight	5.03
China Citic Bank - H Share	0998.HK	Overweight	5.2
Cheung Kong Infrastructure	1038.HK	Overweight	30.05
Hengan International Group Ltd	1044.HK	Neutral	67.1
China Southern Airlines	1055.HK	Neutral	3.69
China Yurun Food Group	1068.HK	Overweight	26.25
TCL Multimedia	1070.HK	Overweight	3.16
Huadian Power International - H	1071.HK	Neutral	1.87
Dongfang Electric Corporation Limited - H	1072.HK	Overweight	27.1
Towngas China Company Limited	1083.HK	Neutral	3.16
China Shenhua Energy	1088.HK	Neutral	29.1
Sinopharm	1099.HK	Underweight	29.3
China Resources Land	1109.HK	Overweight	14.96
Chong Hing Bank	1111.HK	Neutral	16.84
Brilliance China Automotive	1114.HK	Neutral	3.15
Qingling Motors Co	1122.HK	Neutral	2.12
Harbin Power Equipment Company Limited	1133.HK	Neutral	7.38
Centron Telecom	1155.HK	Overweight	2.14
Yanzhou Coal Mining - H	1171.HK	Neutral	16.42
China Railway Construction Corporation Limited	1186.HK	Overweight	10.1
COSCO Pacific	1199.HK	Overweight	10.32
BYD	1211.HK	Neutral	44.65
Lifestyle International Holdings	1212.HK	Overweight	16.94
C C Land	1224.HK	Neutral	3.25
China Zhongwang Holdings	1333.HK	Neutral	4.73
Xtep International Holdings Limited	1368.HK	Overweight	5.99
Industrial and Commercial Bank of China - H	1398.HK	Overweight	5.59
Alibaba.com Limited	1688.HK	Neutral	14.92
China Communications Construction Co. Ltd.	1800.HK	Neutral	6.92
Shandong Chenming Paper	1812.HK	Overweight	6.27
KWG Property Holding Ltd.	1813.HK	Overweight	5.51
Belle International Holdings Ltd.	1880.HK	Overweight	12.78
China Huiyuan Juice Group Ltd	1886.HK	Neutral	5.7
Kingboard Laminates	1888.HK	Overweight	7.78
China Coal Energy	1898.HK	Overweight	11.08
China Cosco Holdings, Ltd.	1919.HK	Neutral	8.66
Chu Kong Petroleum and Natural Gas Steel Pipe Holdings	1938.HK	Neutral	2.84
China Minsheng Banking - H	1988.HK	Neutral	7.16
China Vanke Company	200002.SZ	Overweight	9.6

China International Marine Containers B	200039.SZ	Neutral	11.47
BBMG Corp	2009.HK	Overweight	9.96
AAC Acoustic	2018.HK	Overweight	12.94
Anta Sports Products Ltd.	2020.HK	Overweight	15.86
Foxconn Int'l Holdings	2038.HK	Underweight	5.72
Lee & Man Paper Manufacturing	2314.HK	Overweight	5.49
Ping An Insurance Group - H	2318.HK	Overweight	64.35
China Mengniu Dairy Co. Ltd.	2319.HK	Overweight	22.05
PICC Property and Casualty	2328.HK	Underweight	8.79
Li Ning Co Ltd	2331.HK	Neutral	26.25
Great Wall Motor Company Limited	2333.HK	Neutral	15.34
Shanghai Forte Land	2337.HK	Neutral	2.34
Weichai Power	2338.HK	Overweight	66.1
Pacific Basin Shipping	2343.HK	Overweight	5.4
Dah Sing Banking Group	2356.HK	Neutral	11.62
Bank of China (BOCHK)	2388.HK	Overweight	20.15
Aluminum Corporation of China Limited	2600.HK	Neutral	6.26
China Pacific Insurance Group - H	2601.HK	Neutral	30.75
China Life Insurance - H	2628.HK	Underweight	32.8
Xinao Gas	2688.HK	Neutral	18.64
Nine Dragons Paper Holdings Ltd	2689.HK	Overweight	11.48
Shanghai Electric Group Company Limited	2727.HK	Neutral	3.57
Guangzhou R&F Properties	2777.HK	Overweight	11.76
Champion REIT	2778.HK	Neutral	3.78
China Shipping Container Lines	2866.HK	Overweight	2.9
Beijing Capital Land	2868.HK	Neutral	2.47
China Shineway Pharmaceutical Group Limited	2877.HK	Neutral	20.85
Dalian Port	2880.HK	Neutral	3.1
China Oilfield Services Limited	2883.HK	Underweight	9.93
Standard Chartered Plc (HK)	2888.HK	Overweight	203
Zijin Mining Group Co Ltd	2899.HK	Neutral	5.54
Golden Eagle Retail Group Ltd	3308.HK	Neutral	18.7
China National Building Material	3323.HK	Neutral	14.62
Bank of Communications Co	3328.HK	Overweight	8.39
Ju Teng International Holdings Limited	3336.HK	Neutral	4.79
Parkson Retail Group Ltd	3368.HK	Neutral	12.92
Sino-Ocean Land	3377.HK	Neutral	5.44
Agile Property Holdings Ltd	3383.HK	Overweight	9.34
Sinotruk	3808.HK	Overweight	7.58
China Dongxiang Group Co Ltd.	3818.HK	Overweight	4.33
Greentown China Holdings	3900.HK	Neutral	8.88
The United Laboratories	3933.HK	Overweight	13.76
China Merchants Bank - H	3968.HK	Neutral	19.68
China BlueChemical Ltd	3983.HK	Overweight	5.08
Bank of China - H	3988.HK	Overweight	3.98
Shanghai Pudong Development Bank	600000.SS	Overweight	14.38
Huaneng Power Int'l - A	600011.SS	Neutral	6.23
Huaxia Bank	600015.SS	Underweight	11.89
China Minsheng Banking - A	600016.SS	Overweight	5.53
Baoshan Iron & Steel - A	600019.SS	Overweight	6.48
China Merchants Bank Co., Ltd - A	600036.SS	Overweight	14.07
Yanzhou Coal Mining - A	600188.SS	Neutral	18.21
Shenzhen Expressway - A	600548.SS	Overweight	5.14
Anhui Conch Cement Company Limited - A	600585.SS	Overweight	20.97
Tsingtao Brewery - A	600600.SS	Underweight	35.02
Maanshan Iron and Steel - A	600808.SS	Overweight	3.6
Dongfang Electric Corporation Limited - A	600875.SS	Neutral	25.88
China Yangtze Power Co Ltd - A	600900.SS	Overweight	8.1
Ping An Insurance Group - A	601318.SS	Overweight	46.81
Industrial and Commercial Bank of China - A	601398.SS	Overweight	4.14
China Pacific Insurance Group - A	601601.SS	Neutral	24.62
China Life Insurance - A	601628.SS	Neutral	23.81
Bank of China - A	601988.SS	Overweight	3.43
Shandong Weigao Group Medical Polymer Co. Ltd.	1066.HK	Overweight	37.8
Asian Citrus Holdings Ltd	ACHLA.L	Neutral	6.71
AirMedia	AMCN	Neutral	3.63
Baidu.com	BIDU	Overweight	77.34
Concord Medical Services Holdings Limited	CCM	Overweight	6.25

CNinsure, Inc	CISG	Overweight	24.74
Focus Media	FMCN	Overweight	18.94
Shanda Games	GAME	Overweight	6.28
China Finance Online	JRJC	Neutral	7.35
Mindray Medical	MR	Overweight	26.4
The9 Limited	NCTY	Neutral	5.05
Ninetowns Internet Technology Group Co. Ltd.	NINE	Neutral	1.44
Netease	NTES	Overweight	41.02
Sina Corp	SINA	Neutral	41.36
Shanda Interactive Entertainment Ltd	SNDA	Overweight	41.65
Sohu.Com	SOHU	Overweight	47.06
Suntech Power Holdings Co., Ltd.	STP	Overweight	7.82
VisionChina	VISN	Neutral	3.52
VanceInfo Technologies Inc.	VIT	Overweight	26.79
WSP Holdings	WH	Neutral	1.17
Xinhua Sports & Entertainment	XSEL	Neutral	0.22

Source: Bloomberg, J.P. Morgan. *Price currency=HK$ and reporting currency=US$; **Price currency=HK$ and reporting currency=Rmb. Prices are updated as of August 24, 2010.

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(Jin Luo's and Lan Deng's roles have been limited to assisting in gathering information for this report)

Companies Recommended in This Report (all prices in this report as of market close on 26 August 2010, unless otherwise indicated)

361 Degrees International Ltd. (1361.HK/HK$6.72/Not Covered), 7 Days Group Holdings Ltd. (SVN/$14.39 [25-August-2010]/Not Covered), China Lilang Ltd. (1234.HK/HK$9.84/Not Covered), Daphne International Holdings Ltd. (0210.HK/HK$7.51/Not Covered), Geely Automobile Holdings Ltd (0175.HK/HK$2.60/Not Covered), Haier Electronics Group Co Ltd (1169.HK/HK$5.40/Not Covered), Home Inns & Hotels Management Inc. (HMIN/$41.94 [25-August-2010]/Not Covered), Maoye International Holdings Ltd. (0848.HK/HK$3.29/Not Covered), Shenguan Holdings Group Ltd. (0829.HK/HK$8.09/Not Covered), Vinda International Holdings Ltd. (3331.HK/HK$8.39/Not Covered), Wumart Stores Inc. (8277.HK/HK$16.12/Not Covered)

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