July 27, 2012

SAMSUNG SECURITIES

Samsung Market Strategy

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■ SAMSUNG MARKET STRAEGY

China yesterday and today

The path to 2020

In this report, we provide investors in the Korean market with a round-up of current and upcoming changes in China.

- **Politics and policies:** Chinese leadership will change this fall. The Central Politburo Standing Committee of the Communist Party will be determined in August, and the National People's Congress will meet in October to determine who from a fifth generation of leaders will run the country. Strong government has always been the source of power behind the world's number-two economy, and the new leadership will have to deal with numerous issues, including the eurozone crisis, long-standing structural economic problems, and how to raise China's status in the world community. Provincial government debt, bad bank loans, private-lending reform, economic restructuring, agricultural issues, market liberalization, and welfare program improvements should headline its challenges.

- **Industry restructuring:** Industry restructuring is imperative for China, due to: 1) demographic changes; 2) intensifying global competition; 3) weakening competitiveness of its manufacturers; and 3) increasing social unrest.

  Presumed next-generation leaders Xi Jinping and Li Keqiang will likely be judged by their success in: 1) pushing industries up the value chain; 2) implementing M&A activities; 3) fostering tertiary industries; and 4) advancing privatization. China's industry restructuring over the next decade will present threats and opportunities to Korean industries that serve the nation as its biggest clients.

- **Women, children, and elderly to lead consumption:** In recent times**,** China has seen dramatic changes in major consumer groups and consumption patterns, and going forward, women, children born to the so-called "little emperor" generation, and a growing elderly population are likely to wield increasing influence on consumption. To gain dominance in the Chinese consumer market amid stiffening competition, we believe Korean companies need to establish strong brands and distribution channels, thereby preemptively targeting women, children, and the elderly in markets likely to grow and in which they can compete. Such markets include smart devices, small-to-medium cars, online shopping, cosmetics/fashion, travel (outbound demand to Korea), educational/game content, healthcare, and coffee/beverages.

- **Long-term outlook on China's stock market—opportunities to emerge:** Although China's stock market plays an important role in forming a model of social market economy, many are wondering whether it will rebound in the near term, and how it will evolve over the medium-to-long term. The incoming next generation of leaders appears more committed to opening up financial markets, but we expect the stock market to be mired in a cyclical trap for some time—a typical trend in rapidly-growing nations. That said, investors in the Chinese market would enjoy solid returns if a cyclical economic recovery materializes in 2H12, as share prices are now close to record lows. From a medium-term perspective, two opportunities should emerge: 1) top-tier players are facing a winners-take-all situation; and 2) the planned liberalization of capital markets should push the Shanghai Composite index into the 6,000-8,200 range by 2020. Korean stocks are particularly influenced by China's stock market, as the country is a major trading partner and export destination.

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1. Politics and policies

China is at a crossroads. Its leadership will change this fall. The ouster of political star Bo Xilai from his posts has created confusion as to how the transition will play out, though power struggles have always been a part of succession conducted behind closed doors.

Table 1. Chinese leadership power struggle cases

1966	1971	1976	1987
Branded a capitalist, Xiaoqi Liu loses power. Cultural Revolution begins.	Vice President Biao Lin leads failed coup, dies in plane crash. Gang of Four rises to power.	Gang of Four brought down. Xiaoping Deng declares reformation.	General Secretary Yaobang Hu loses power. Conservationist Peng Li puts brakes on political reformation.
1989	**1992**	**2006**	**2012**
Tiananmen massacre, General Secretary Ziyang Zhao loses power. Zemin Jiang elected.	Conservatives Shangkun Yang resigns presidency. Zemin Jiang takes charge of military.	Communist Party head and growth-first proponent Liangyu Chen resigns in scandal.	Chungqing branch Community Party head and income-distribution proponent Xilai Bo brought down.

Source: Media, Samsung Securities

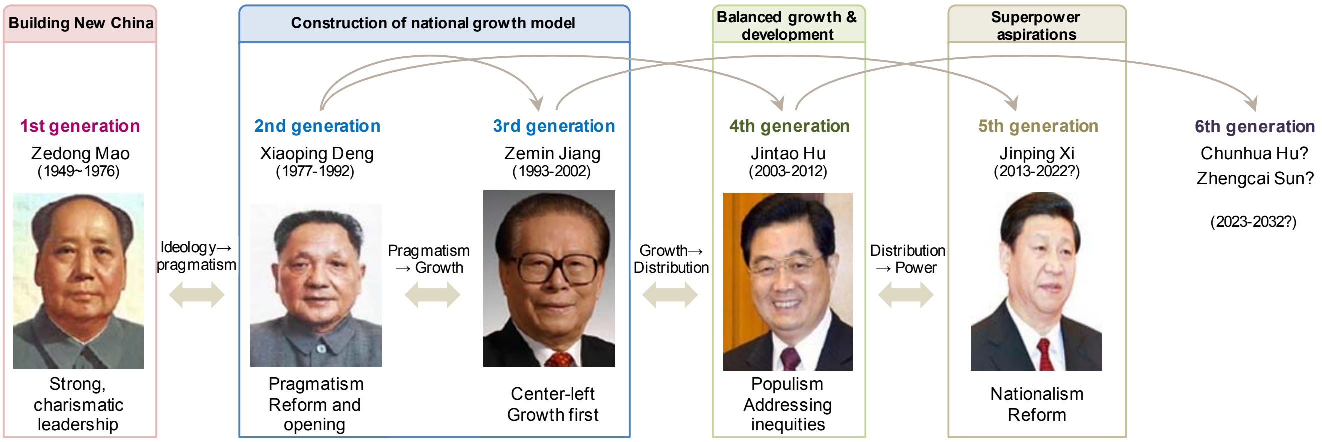
The country faces volatile external conditions linked to the eurozone crisis, and the risk of a middle income trap internally. The next 10 years are likely to bring substantial demographic changes, a weakening of the nation's industrial competitiveness, and tensions over the mismatch between the nation's quality-of-life and political development. New leadership will determine the country's fate, and this year and next are likely to prove crucial to China's long-term growth.

Regime succession

China considers democratic elections pretentious and indecisive; leaders are elected behind the scenes. Deng Xiaoping created a tradition of guaranteeing top leaders 10 years of rule, and designated Jiang Zemin as his successor and Hu Jintao as the fourth-generation leader. Hu is reportedly considering passing the torch to Xi Jinping, and blessing Hu Chunhua and blessing Sun Zhengcai as sixth-generation leaders.

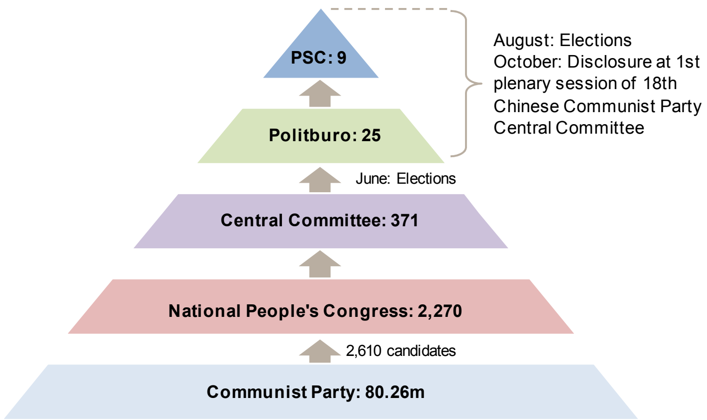
The new leaders will be elected through several sets of elections—2,270 National People's Congress delegates will elect 371 Central Committee members, who will elect 25 Politburo members, including 9 for the Central Politburo Standing Committee (PSC). Congress delegates and Central Committee members have already been elected; PSC members will be determined in August at a meeting at Beidaihe. Given the multi-layered candidate pool system in China's political system, the election of a dark horse is virtually unthinkable.

Chart 1. Generational leadership changes



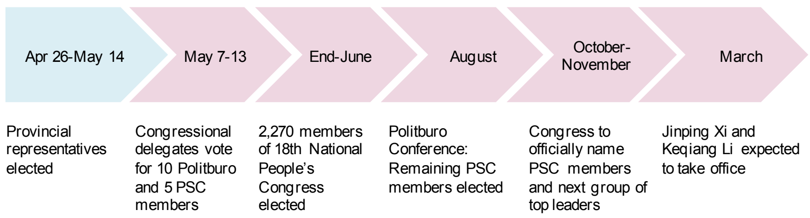
Source: Samsung Securities

Chart 2. Political power structure



Source: Samsung Securities

Diagram 3. Leadership transition schedule

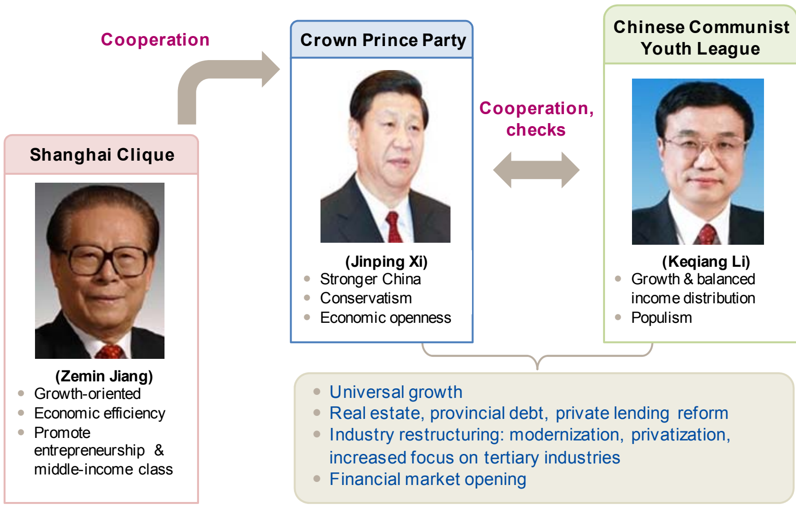


Source: Samsung Securities

Taking the reins

China's fifth-generation leaders are a mix of reformers and conservatives. Descendants of prominent senior Communist Party officials, the so-called princelings are likely to abide by Deng's policy of "taoguang yanghui"—"bide time, conceal capabilities, but do some things"—but focus more on the last clause, working to assert China's influence on the world diplomatically and militarily, while pushing for more reform and market liberalization at home. The nine PSC members will be elected in August—seven positions are already fixed; two are being closely contested. We expect Xi Jinping to assume the presidency, supported by Jiang Zemin and checked by Hu Jintao and Li Kequiang.

Chart 4. Fifth-generation leadership expectations



Source: Samsung Securities

Table 2. Political generations: Overview

Leaders	Period	Accomplishments	Characteristics
Zedong Mao/Enlai Zhou	1949-1976	Birth of socialist nation; land reform	Strong, charismatic leadership
Xiaoping Deng/Ziyang Zhao	1977-1992	Reform; opening up	Pragmatist
Zemin Jiang/Longqi Zhu	1993-2002	Growth; industrialization; opening of financial markets	"Three Represents Theory"; center-left
Jintao Hu/Jiabao Wen	2003-2012	Balanced growth; strengthened middle-income class	Populist; "iron fist in velvet glove" diplomacy
Jinping Xi/Keqiang Li?	2013-	Economic reorganization	Nationalist; conservative but open to reform

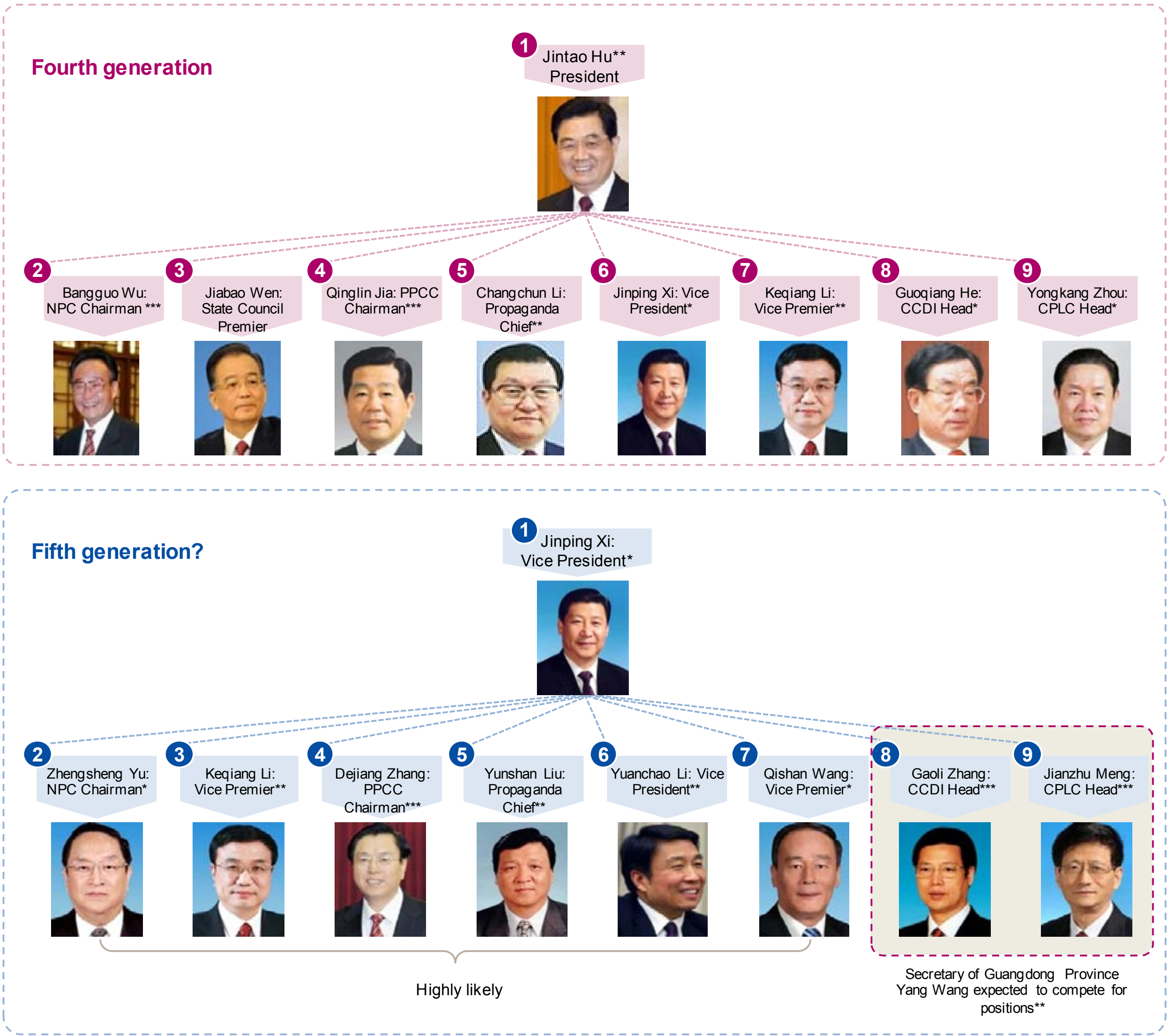
Source: Samsung Securities

Table 3. Major political associations

	Crown Prince Party	Communist Youth League	Shanghai Clique
Composition	High-ranking, first-generation officials	Founded as Socialist Youth League in 1920	Shanghai politicians (led by Zemin Jiang)
Core members	Jinping Xi, Qishan Wang, Xilai Bo	Jintao Hu, Keqiang Li, Yang Wang, Yuanchao Li	Zemin Jiang, Dejiang Zhang, Gaoli Zhang, Huning Wang
Political inclinations	Conservatism; nationalism	Populism; universalism	Elitism
Main policies	Government-driven growth; Chongqing model; job creation; Maoism	Balance between growth and society; social integration; agricultural and environmental issues	Growth first; efficient economic growth; support entrepreneurs and middle class

Source: Samsung Securities

Chart 5. Political factions: Fourth and fifth generations



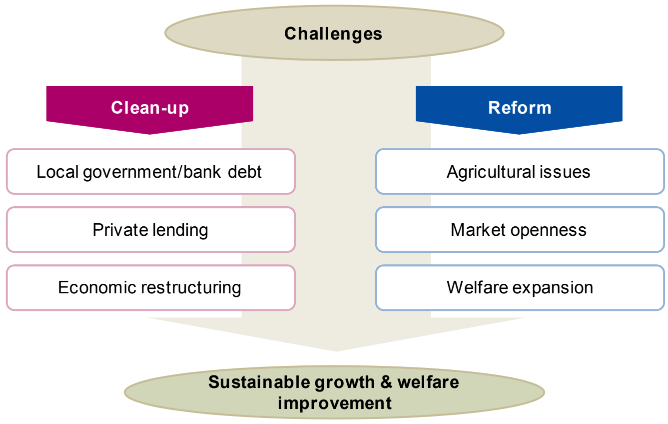
Note: * Crown Prince Party
** Chinese Communist Youth League
*** Shanghai Clique

Source: Media reports, Samsung Securities

Challenges ahead

We expect new leadership to make political stability its top priority, with the power transition taking place much as it did with Jiang Zemin in 1993 and Hu Jintao in 2003. Xi Jinping and Li Keqiang helped create the current five-year plan (to run through 2015), and will likely look to put their stamp on China's development over 2018-2023.

Chart 6. Challenges facing new leadership



Source: Samsung Securities

Table 4. Six tasks for new leadership

Tasks	Top priorities	Specific goals
Bad loans	• Improve bank soundness and open banking market • Consolidate local government debt-management supervision • Provide liquidity through local government bond issues	• Dispose of ailing banks after raising BIS CARs to 11.5% • Execute through long-term policy, not one-off bad loan disposal
Private lending reform	• Institutionalize private loan market • Improve financial environment • Regulate lending chain	• Regulate private lending market • Reduce inter-bank lending rates; boost bank lending capacity • Resolve issue of negative medium- and long-term interest rates
Economic Restructuring	• Revitalize domestic market and modernize industries • Increase private purchasing power: raise minimum wages • Industry reform; nurture service and cultural content industries • Energy/environment industry goals	• Raise minimum wages • Promote emerging industries: Invest CNY5t over five-year plan • Strengthen regulations on faltering and polluting industries
Agricultural Issues	• Stabilize agricultural product supply: raise minimum prices and grain subsidies • Modernize rural areas; improve productivity through mechanization, R&D, and affiliated industries • Improve infrastructure, housing, distribution networks, maintain low prices	• Reduce gap between urban and rural incomes: improve annual farm incomes by at least 13% • Extend farm machine financing and increase farm subsidies • Expand online distribution networks
Opening of financial markets	• Open financial markets: banking, insurance, equities • Internationalize currency: Reform system and maintain rate stability • Introduce foreign capital to mid-western region, widen service industry, attract foreign direct investment	• Marketize interest rates; open equity and financial markets to foreigners • Increase yuan-based trade; restructuring; expand economic bloc • Promote inbound and outbound M&A policy
Welfare system Reform	• Support for low-income class: Consumer subsidies, social security network • Tax reform: Value-added, property, consumption, resource, and other taxes • Expand social security to senior care; support workers from countryside • Regulate real estate market; build more affordable and small housing	• Build 3.6m affordable housing units during five-year plan • Restructure census system • Create jobs and help venture companies develop

Source: Media reports

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2. Provincial government/ bank debt and private lending

Among the first of the issues new leadership will face is how to deal with shaky provincial government and bank debts. In the wake of the global financial crisis, Beijing spent CNY4t (USD628b) on stimulus programs. Of this, CNY1.2t or 30% went toward building provincial infrastructure, which resulted in provincial government debt ballooning from CNY5.6t in 2008 to CNY10.7t (USD188.4b), or 27.3% of China's nominal GDP in 2010—putting the stability of the country's economic growth and financial system at risk. We believe a review of the past can provide insight into how China will deal with the situation.

Third- and fourth-generation leadership pushed through bank reform

China began to address bad debts at state-owned commercial banks in 1998, and prepared to liberalize its banking market—a precondition of its joining the World Trade Organization (WTO)—by transforming banks into (at least partially) publicly held firms.

Bank reform background

China maintained a mono-banking system until 1978, when financial market liberalization and growing financial demand gave birth to several new commercial banks. Over 1978-1995, the Agricultural Bank of China (ABC), China Construction Bank (CCB), the Bank of China (BOC), the Industrial & Commercial Bank of China (ICBC), and other banks appeared, giving companies an alternative to the government to turn to for loans.

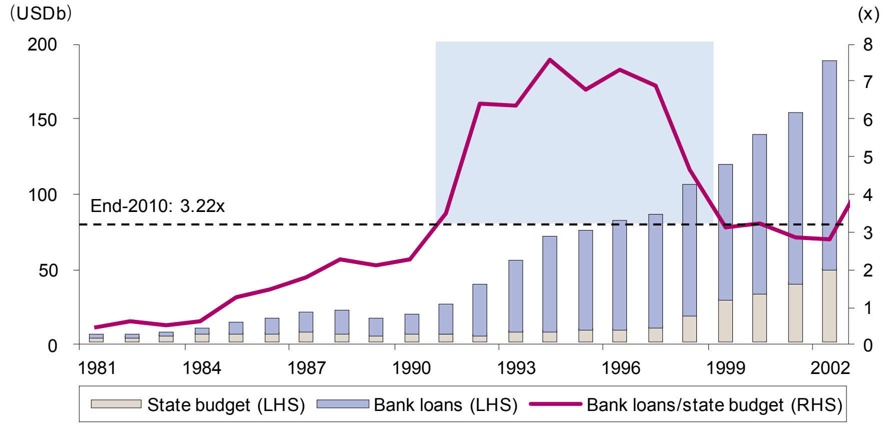
Table 5. Commercial bank reform

Year	
1978	• Deng Xiaoping leads reform movement and opening of markets
1979	• ABC and CCB created, split off from finance ministry
1983	• BOC created, split off from PBOC
1984	• ICBC created, split off from PBOC; two-tier banking system established
1985	• CCB expands role in housing finance
1986	• CITC established
1987	• Bank of Communications created as first of 12 limited commercial banks

Source: KDBRI, Samsung Securities

As they replaced government as a resource for investments in infrastructure and state-owned corporations, banks experienced explosive growth. In 1981, the bank-to-government ratio of financing for fixed asset investment (FAI) was 0.45x; by 1994, it had hit 7.3x. Over the following two decades, banks assumed more lending responsibilities, and by 2012 their loans were 3.2x as large as the government budget.

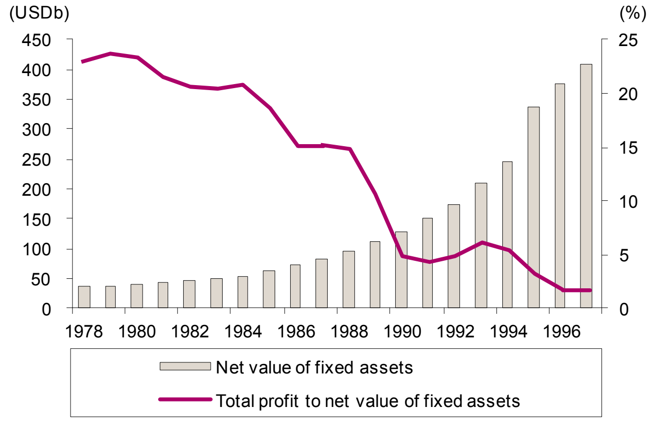
Chart 7. FAI sources: Government budget vs bank lending (1981-2002)



Note: Based on current forex rates
Source: China Statistical Yearbook (2010), Samsung Securities

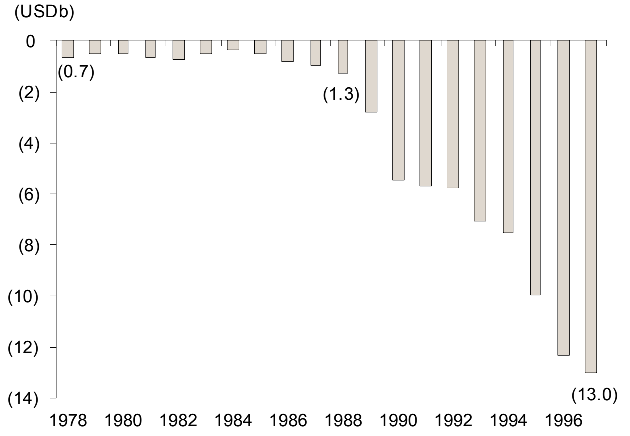
As investments in China have grown, a fragile banking system has remained a headache for the government. Corporate debt ratios have soared, and the opening of markets and more competition has weighed on corporate profitability, especially at state-owned firms. Bank loans sparked a surge in such firms' fixed asset investments, but as pre-tax returns on these investments have tumbled since the 1980s, banks' asset quality has deteriorated.

Chart 8. State-owned firms: FAI vs profit/FAI ratio (1978-1997)



Note: Based on current forex rates
Source: China Statistical Yearbook (1997), Samsung Securities

Chart 9. State-owned firms: Total losses



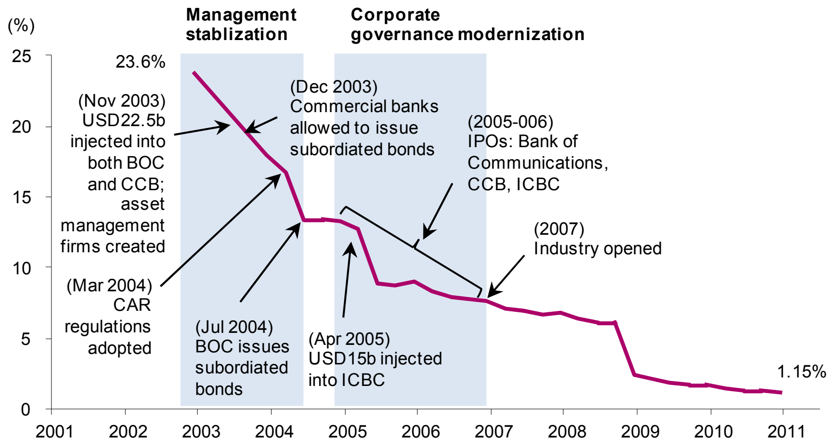
Note: Based on current forex rates
Source: China Statistical Yearbook (1997), Samsung Securities

In response, the government began moving to strengthen bank fundamentals in Nov 1993. It gave the central bank greater independence, transformed banks dedicated to special economic purposes into commercial enterprises, and set up a foundation for banks to manage profits and risk (later establishing special banks like the China Agricultural Development Bank to provide window guidance). Since 2000, it has striven to modernize the system, aiming to address bad assets and improve governance by making banks publicly held firms, and setting the stage for banks to become competitive global players.

Bank reform: Public fund injections

Beijing became more aggressive on banks' bad debts after the Asian financial crisis. The Ministry of Commerce in 1998 invested USD32b to set up four asset management firms that by 2000 had bought USD170b worth of NPLs from state-owned banks. Over 2003-2005, the government injected USD22.5b into BOC, USD22.5b into CCB, and USD15b into ICBC, helping them reduce their average NPL ratio from 23.6% at end-2002 to 13.3% at end-2004. It also introduced capital adequacy ratio regulations and allowed banks to issue subordinated bonds, setting up a risk-management framework that bolstered bank fundamentals ahead of the 2006 industry opening.

Chart 10. Banking industry: Reform and NPL ratios



Source: CEIC, BOK, KDBRI, Samsung Securities

Bank reform: Better governance

By 2004, Chinese banks were making substantial progress toward normalization. To make them more globally competitive through better governance, the government encouraged them to enter into strategic alliances with foreign banks and transform themselves into publicly held firms .Central Huijin Investment was set up to handle public fund injections and government stake sales. The establishment of shareholders meetings, boards of directors, and supervising committee further improved governance.

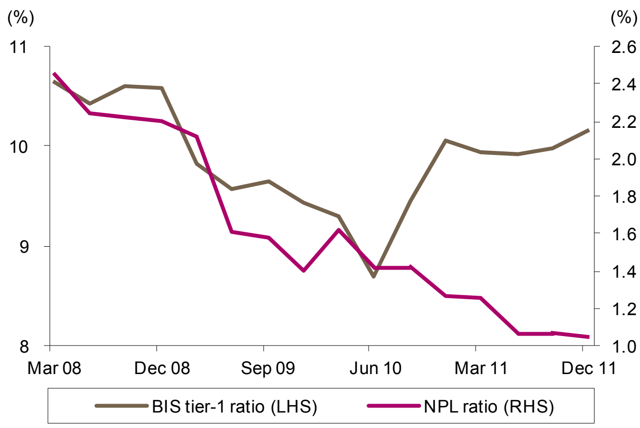
As China's economy has grown, key commercial banks—those that have gone public since 2005—have built themselves into players on the level of global players. ICBC is the world's largest bank in market cap; three other Chinese banks are in the top 10. Even amid eurozone risk, government control and supervision has helped the banks maintain solid asset quality—the average NPL ratio of China's top-four banks fell to 1% in 2011, while their BIS tier-1 ratio stood at 10.2% in 1Q12 and has remained above 10% since 2010.

Table 6. World's top-10 banks by market cap

(USDb)	Country	Market cap	Total assets	NPL ratio (%)	BIS tier-1 Ratio (%)
ICBC	China	208.9	2,456.8	0.8	10.1
Wells Fargo	US	175.6	1,313.9	2.6	11.3
China Construction Bank	China	164.7	1,949.6	1.0	11.0
HSBC Holdings	UK	159.9	2,555.6	3.7	11.5
JPMorgan Chase	US	130.1	1,853.7	1.5	9.5
Agricultural bank of China	China	129.0	2,265.8	1.0	12.3
Bank of China	China	117.4	1,877.9	0.8	10.1
Commonwealth Bank	Australia	87.2	715.3	1.0	10.0
Bank of America	US	82.5	2,129.0	2.2	12.4
Citigroup	US	77.3	1,873.9	n/a	13.6

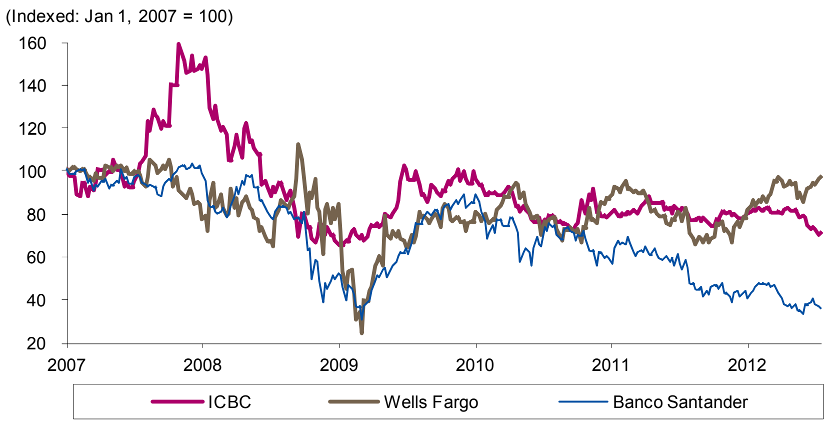
Note: As of Jul 20
Source: Bloomberg, Samsung Securities

Chart 11. China's top-four banks: BIS tier-1 and NPL ratios



Source: Bloomberg, Samsung Securities

Chart 12. Share performances: ICBC, Wells Fargo, and Banco Santander



Source: Bloomberg, Samsung Securities

Provincial government debt risks asset quality deterioration at banks

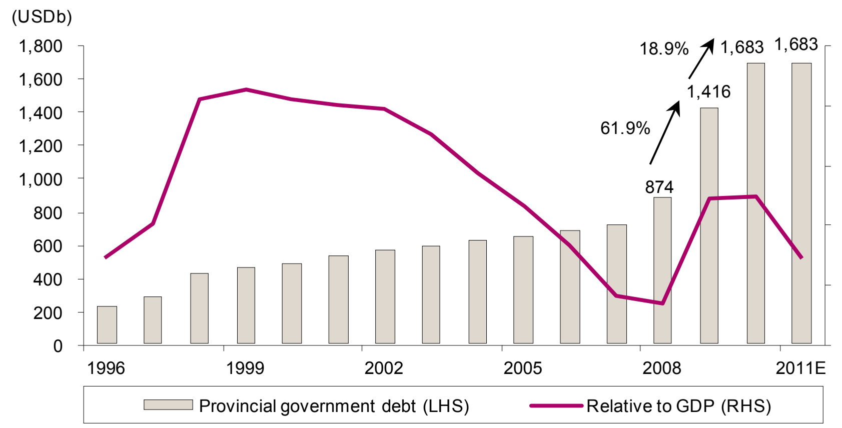
After years of reform, China's banking system was able to weather the 2008 financial crisis well, with a heavy focus on traditional deposit/lending businesses—rather than the complex derivatives businesses their global peers engaged in—holding them in good stead. Now, however, the sector is dealing with the fallout of the CNY4t (USD628b) in stimulus rolled out by the government, 30% (CNY1.2t or USD220b) of which went to provincial government infrastructure projects. While Chinese law does not allowing provincial governments to directly engage in credit activity, local government financing platforms were created to borrow money from banks on the governments' behalf, backed by collateral such as government income or assets. As these governments' debts have grown, concerns over banks' asset quality have risen. We believe the issue is manageable, however, and see little chance of it deteriorating into a debt crisis.

Total provincial debt estimated at USD1.7b or 22.3% of 2011 GDP

In a Nov 2011 report, the National Audit Office of China (CNAO) estimated provincial government debt in 2010 at USD1.7t, or 27.3% of the nation's nominal GDP. At the Mar 2012 meeting of the National People's Congress, Premier Wen Jiabao said governments had added CNY300m (USD47m) in debt in 2011, suggesting that at the end of last year provincial government debt remained around USD1.7t, or 22.3% of China's 2011 GDP.

China's Banking Regulatory Commission estimated provincial government debt in 2010 at USD1.4t or CNY9.1t, while in Jun 2011 the People's Bank of China (PBOC) estimated the figure at 30% of China's total yuan-denominated loans in 2010 of CNY47t. China's mass media tends to base debt estimates on CNAO data, but earlier this year started reporting a figure of around CNY14t extrapolated from the estimate put forth by the PBOC, which responded by saying it actually estimated the debt not at, but less than 30% of China's yuan-denominated loans. We base our estimates on CNAO data.

Chart 13. Provincial government debt trends

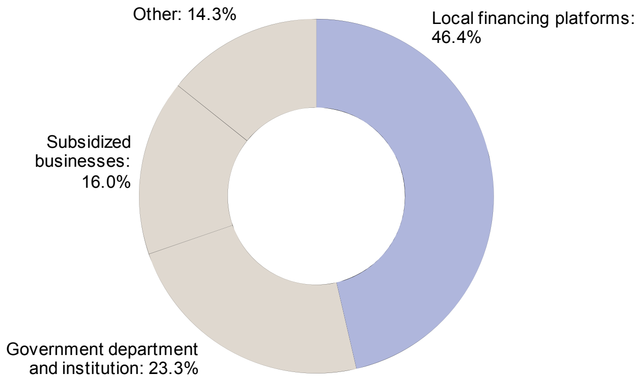


Note: Based on current forex rates; 1999-2001, 2003-2006, and 2011 figures our estimates
Source: CNAO, Samsung Securities

Most debt going to financing, municipalities, eastern China

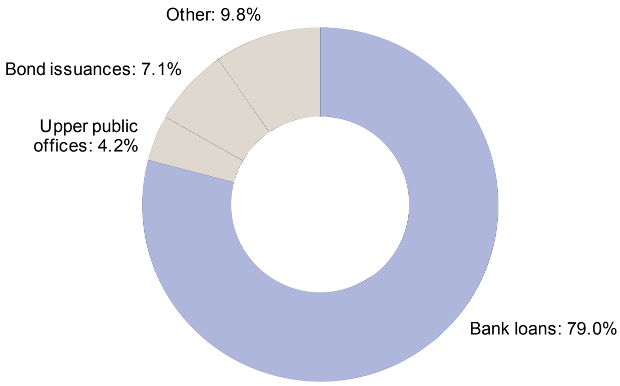
According to the CNAO, local financing platforms took on 46.4% (USD780b) of provincial government debt in 2012, government departments and institutions 23.2%, groups receiving subsidies 16%, and other operations 14.3%. Banks extended 79% (USD1.3t) of the debt, with the lending equivalent to 8.9% of their total assets in 2010. Meanwhile, the provinces themselves accounted for 29.9% of the debts, municipalities 43.5%, and counties 26.5%. China's administrative districts include 28 provinces, 392 municipalities, and 2,779 counties, and a higher percentage of debt at municipalities than provinces suggests risk. The more developed eastern region of China accounted for 49.65% of the debt, followed by western China with 27.29% and central China with 23.06%.

Chart 14. Provincial debt, by debtor (2010)



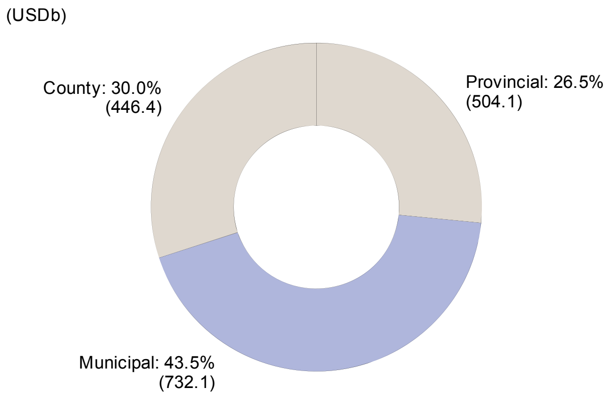
Source: CNAO

Chart 15. Provincial debt, by source of financing (2010)



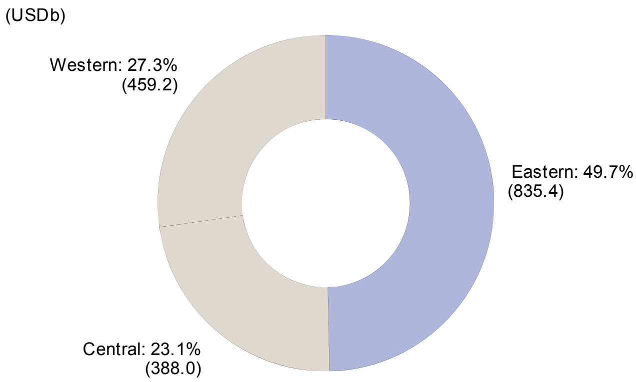
Source: CNAO

Chart 16. Provincial debt, by administrative district (2010)



Source: CNAO

Chart 17. Provincial debt, by region (2010)



Source: CNAO

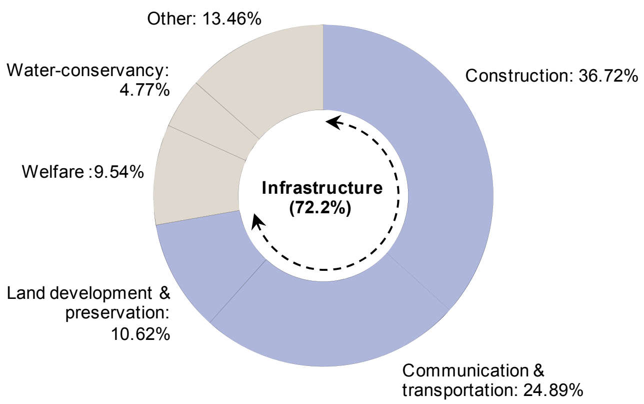
Bold stimulus packages made it easier to obtain funds

Provincial government debt surged 61.9% over 2008-2009, increasing almost as twice as fast as the 35.4% rate it increased over 1997-1998, when massive investments were made to stimulate the economy. With bold stimulus packages making it easier to obtain funds, provincial governments stacked up bank loans though their funding platform.

The CNAO has identified three areas of concern. First, no clear accountability has been assigned. At times, the central government has repaid debts when provincial governments could not. Fund-raising methods differ from province to province, are opaque, and tend not to be detailed in budget records. Second, governments' financials are weak in some cases—as many as 78 counties and 99 municipalities have debt ratios exceeding 100%. Some need to borrow to pay off old debt; others have fallen behind in repayments. (At end-2010, 3 municipalities and 23 counties were known to be delinquent on more than 10% of loans). Governments planning to sell land to pay off debts could be in trouble if real estate prices fall. Third, governments have spent 72.2% (USD1.1t) of their debt on infrastructure, but it generally takes a long time to recoup investments on such. Infrastructure investments are rarely recouped within two to three years, but 41.7% of China's provincial government debt was or is due over 2011-2012.

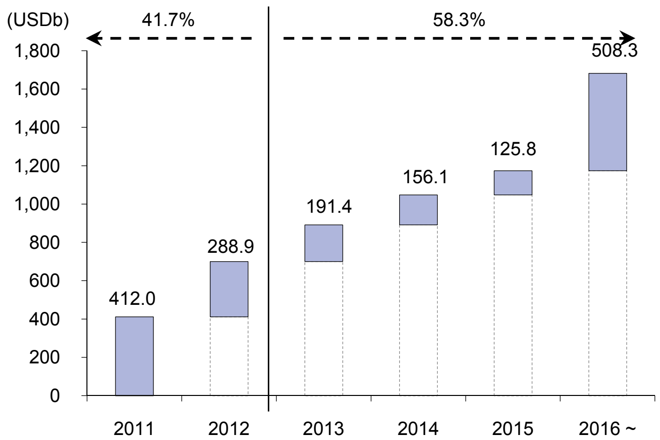
In addition, as of end-2010, 46.38% of debt had been borrowed through 6,576 provincial government funding platforms that are barely regulated. With no clear rules or standardized management practices, problems are rampant. Approximately 26.37% of the platforms are known to be making losses.

Chart 18. Provincial debt, by use (2010)



Source: CNAO

Chart 19. Provincial debt repayment schedule

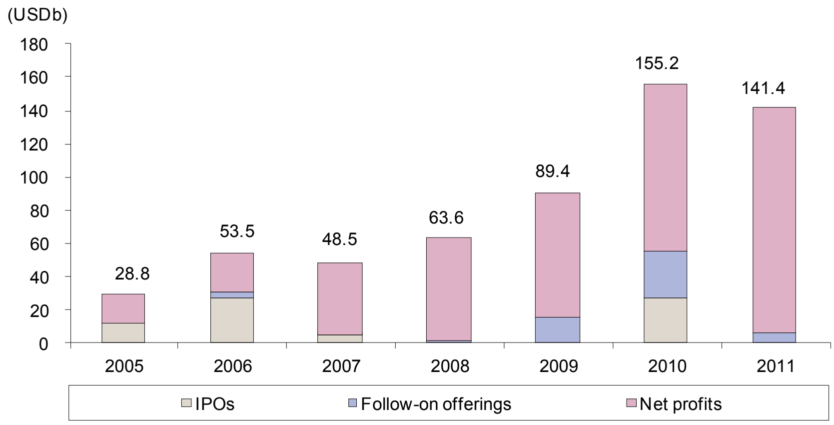


Source: CNAO

Crisis unlikely

We do not think provincial government debt will spiral into a crisis, however, believing the central government—with healthy financials—can manage the situation, and banks' asset quality has improved significantly since 2009. In the near term, debt can be rolled over or paid down by issuing bonds. Virtually all debt due in 2011 (24.5% of the 2010 total) appears to have been rolled over or repaid, given Wen Jiabao's statement that debt grew only CNY300m in 2011. Meanwhile, the government has encouraged banks to recapitalize while guaranteeing them net interest margins of 300bps, which should create a three- to four-year buffer during which the banks can establish adequate firewalls themselves.

Chart 20. Commercial bank IPOs, follow-on offerings, and net profits (2005-2011)

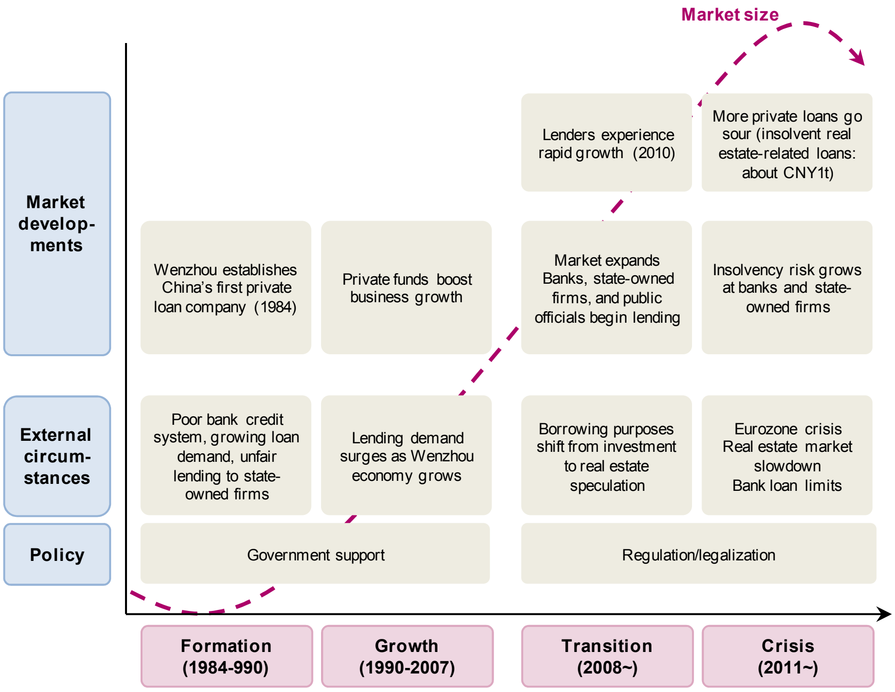


Source: Dealogic, Bloomberg, Samsung Securities

Private lending reform the first step toward financial-system reform

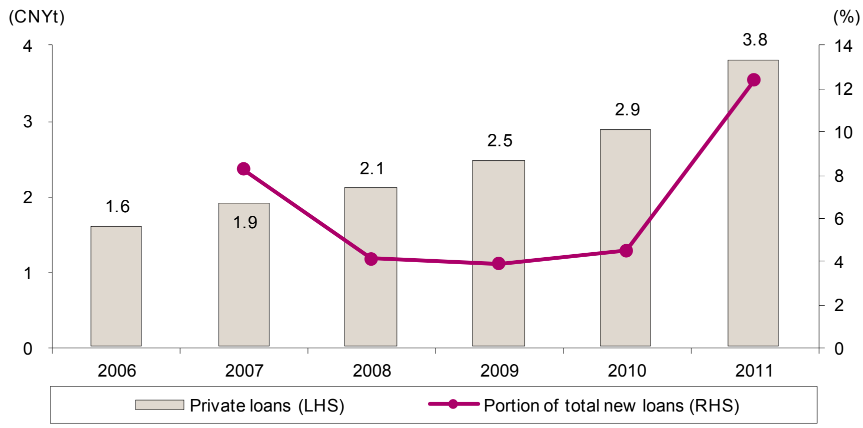
Private lending will likely prove a tougher challenge for the new leadership. As in Korea until the 1980s, a backward financial system has triggered rapid growth in private lending since a market formed in 1984 around Wenzhou and spread nationwide in the 2000s. It quickly became a pillar of the financial market, due to: 1) capital-allocation mechanisms favoring state-owned companies; 2) inadequate credit-rating systems that prompted banks to restrict lending to private firms; and 3) low funding costs combined with a real estate bubble. The China Banking Regulatory Commission estimated private lending in 2011 at CNY3.8t, equal to 7% of bank loans and 33% of total shadow banking loans.

Chart 21. China private lending market history



Source: KIEP, media, Samsung securities

Chart 22. Private lending trends



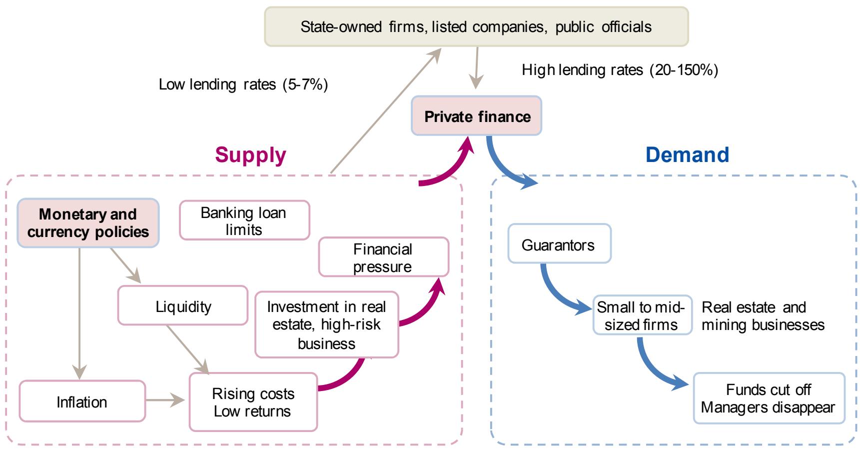
Source: 21 Century Expectations, Samsung Securities

Private lending the weakest link in China's financial system

We believe private lending is the weak link in China's financial system. Countermeasures can be devised to deal with troubles at provincial governments and banks, which are largely predictable. However, a real estate market slump and slowing exports could trigger a slew of bankruptcies that causes the private lending market to collapse, sending prices of assets plunging as debtors dump them, saddling large companies and banks with toxic assets, and sending shockwaves through the economy.

According to the PBOC, 89% of households and 59.7% of firms in and around Wenzhou have borrowed from private lenders, which charge interest rates averaging 24% and up to 60%. Loans are often taken out for real estate speculation—the PBOC estimates property purchases, short-term loans, and money market brokerage each account for 20% of the market, vs just 35% for corporate management and production. This suggests the system will be hit harder than banks by slowdowns in the real estate market and the economy.

Chart 23. Private lending market structure



Source: 21 Century Expectations; Samsung Securities

Countermeasures: Legalization and financial market improvement

China is taking a two-track approach to the issue, seeking to legalize private lending and improve the overall financial market environment. Through legalization, it would bring private lending under regulatory oversight, just like banks. By cutting interbank rates, expanding bank lending capacity, and reversing negative real interest rates, it hopes to draw demand away from loan sharks and into the regulated market. Aiming to prevent lending to speculators, keep interest rates for small companies low, and improve SME lending methodologies, the government on Oct 10, 2011 announced that it would ban private lenders from: 1) linking loans to deposits; 2) making unreasonable charges, such as fees for loan confirmation, management, and advisory; 3) bundling loans and financial products; 4) lending to private loan brokers; and 5) forcing corporate clients to help meet bank performance targets.

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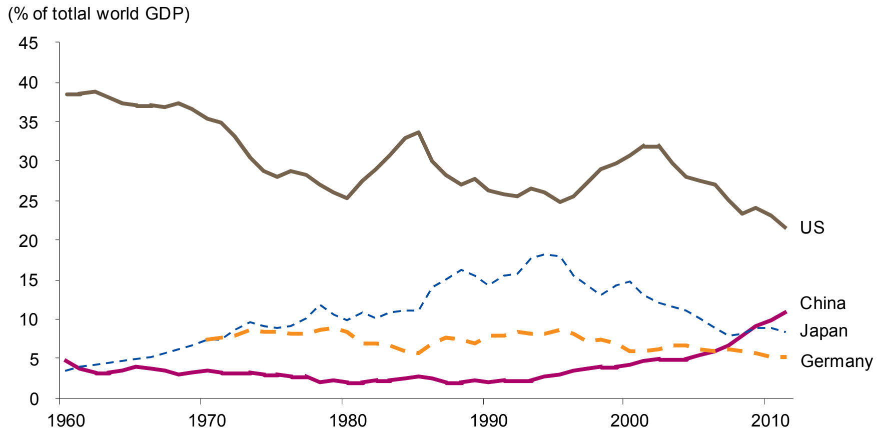
3. Industry restructuring

Successful thus far

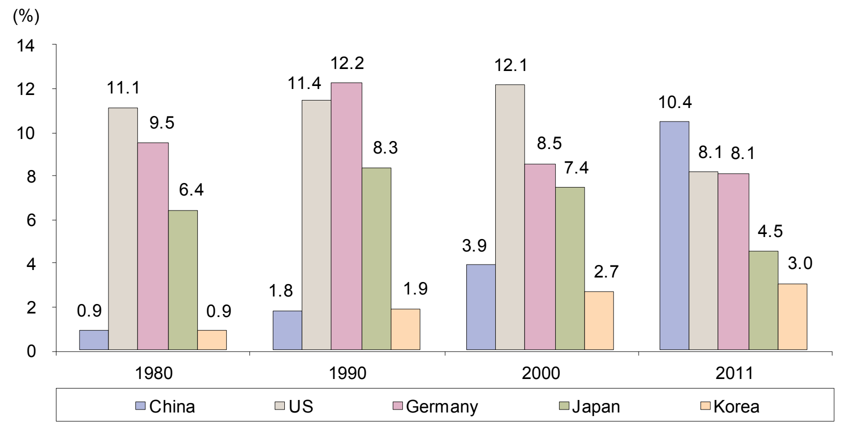
China is the world's second-largest economy, the next decade should answer the question of whether it can supplant the US as the largest, or gets stuck in a middle income trap that begets political and economic crises. Already the world's top exporter and manufacturer, China narrowed the gap between its economy and the US's from more than 5x to less than 2x over 1960-2010. The US overtook the UK economically in the late 1900s, and avoided German, Russian, and Japanese efforts to catch it, making this the first time in around 150 years it risks not being the world's top economy.

Chart 24. GDPs of major economies



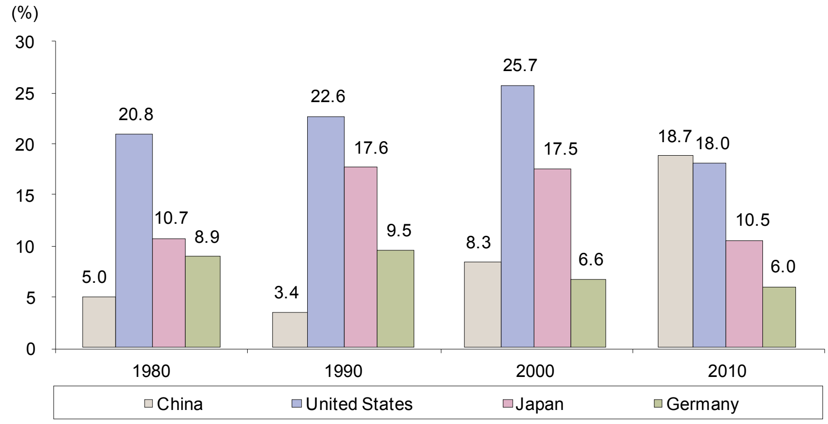
Note: In current US dollars; Germany since 1970
Source: World Bank, Samsung Securities

Chart 25. Export portions of major economies



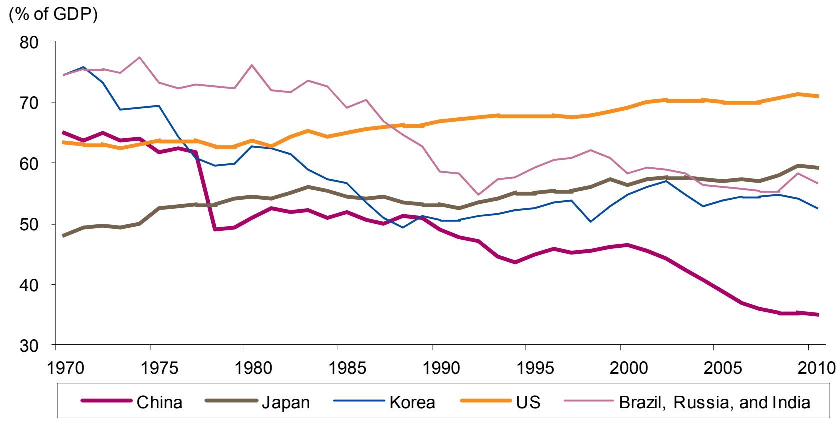
Source: World Bank, Samsung Securities

Chart 26. Manufacturing of major economies



Source: UN (2011), Samsung Securities estimates

Chart 27. Household-expenditure-to-GDP ratios of major economies



Source: UN (2011), Samsung Securities estimates

Remade in the USA

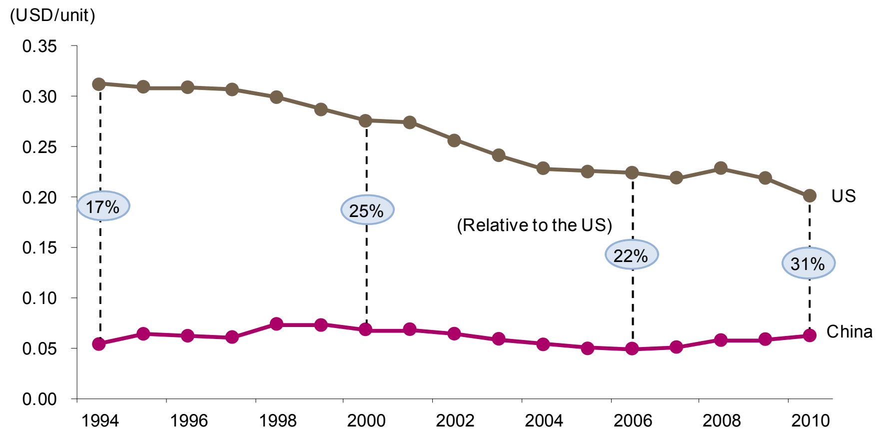
What matters now for China is how it progresses amid weakening of its manufacturing competitiveness as the world's production base, due to: 1) rising labor, transportation, and land costs; and 2) yuan strengthening. Also important is a recent reshoring trend among US manufacturers, including Whirlpool, General Electric (GE), Otis Elevator, and Caterpillar all moving production facilities out of emerging markets like China back to the US or making new investments therein. Such repatriations of manufacturing facilities from overseas indicate that the US economy may regain competitiveness as China loses its. China faces the challenge of moving its industries higher up the value chain, which should prove vital if its economy is to scale new heights.

Table 7. Multinationals downsizing and departing China

Date	Company	HQ	Industry	Details
2011	Nestle	Switzerland	Food	Stopped producing and selling ice cream in the Huadong region
	Mattel	US	Toy	Withdrew its Barbie flagship store
	Danone	France	Food	Ceased operations at its Shanghai yogurt factory
	NCR	US	IT	Move parts of ATM production chain to US state of Georgia
2012	Saint-Gobain	France	Construction	Shuttered seven Maison subsidiaries in Shanghai
	Ford	US	Automobile	Moved some component production from China to the US
	Whirlpool	US	IT	Moved Kitchen Aid hand mixer production line from China to the US state of Ohio
	GE	US	IT	Moved water heater production facility from China to the US, plans to move its washer and dryer production facilities (allocated USD600m for this through 2014)

Source: Kotra, various local media

Chart 28. Per-unit production cost: US vs China



Source: CEIC, Samsung Securities estimates

Chart 29. China's productivity and wage growth

Source: CEIC, Samsung Securities estimates

Four paths to industry restructuring

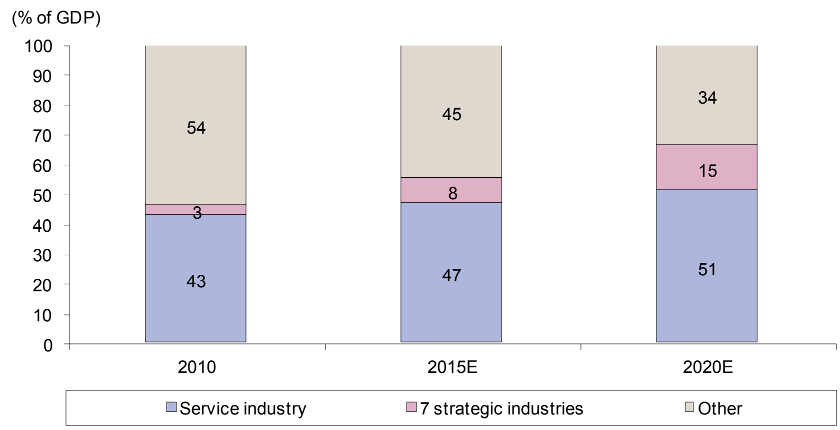
China has a four-point blueprint to transform into an economic powerhouse, that: 1) pushes industries up the value chain; 2) increases the size of corporations via M&A activities; 3) fosters tertiary industries; and 4) encourages the private sector to increase investment.

1) Pushing industries up the value chain

Pushing industries up the value chain is inevitable for China as its approaches a "Lewis turning point," which began by targeting seven industries to strategically foster: renewable energy, electric vehicles, new materials, next-generation IT, green energy/sustainable industries, bio, and high-tech equipment.

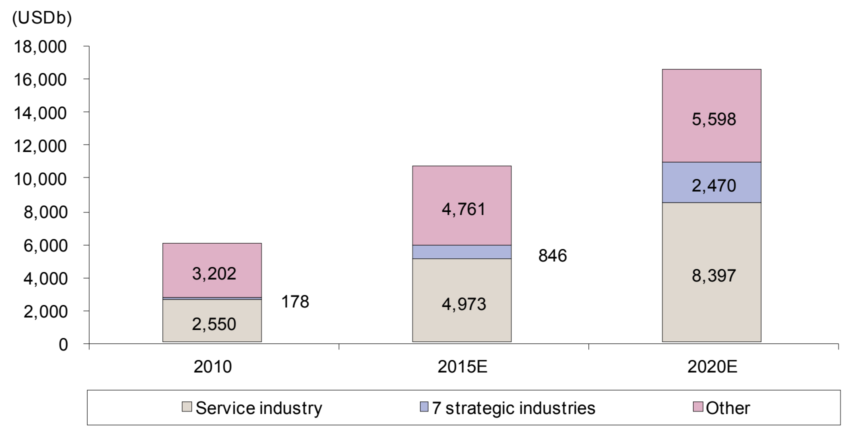
China challenges developed nations that foster high-value-added industries, and targets growth of 15x for the seven aforementioned industries from USD170b in 2010 to USD2.5t in 2020 by investing CHY5t through 2015. Such developments are likely to bring more challenges to Korean players than opportunities.

Chart 30. China's medium-to-long term industry restructuring plan



Source: PRC, Samsung Securities estimates

Chart 31. Growth forecasts for seven strategic industries and service industry (China)



Note: Assumes 9% nominal GDP growth after 2017
Source: IMF, PRC, Samsung Securities

Table 8. Prospects for China's traditional leading industries

Industry	Status in 2010	Strategies of major domestic players	Potential threats to Korean firms through 2020
Petrochemicals	World's largest upstream market	Sinopec, PetroChina,	• Local firms nearly self sufficient
	Weak downstream/technology	SinoChem, ChemChina	• Intense price/quality competition domestically
	40-70% self sufficient in primary areas	• Vertical systemization • Enlarge economies of scale • Form global partnerships, pursue M&A activities	
Shipbuilding/Marine	Quantity exceeds Korea's,	Shanghai Waigaoqiao Shipbuilder, Dalian Heavy Industry, Jiangsulongsheng Heavy Industry	• Become major manufacturers with domestic demand
	but technology lacks	• Improve basic designs, R&D capabilities • Move into marine industries	
Autos	Low quality and economies of scales	SAIC	• Improve processes and product technology
	High dependency on core technology for parts	• Expand R&D activities and facility investments • Develop proprietary technology	• Dominate domestically

Source: SERI, Samsung Securities

Table 9. Prospects for development of China's IT industry

Industry	Status in 2010	Strategies of major domestic players	Potential threats to Korean firms through 2015
TV	Domestic domination via pricing power	Hisense, Skyworks • Develop next-generation products/core technology • Expand overseas	• Reduce technological gaps • Expand overseas, including into EMs
Cellular phones	Focus on inexpensive handsets, EMs	ZTE, Lenovo • Improve software/content competency	• Leap to become global brands • Focus on premium domestic market and DMs
	Poor brand image	• Provide equipment and handsets • Possibly provide financing	
LED lighting	Comprises numerous small, specialized firms	Sanan Optoelectronics, NVC Lighting Technology	• Improve technologic competency
	Low level of technology	• Secure overseas technology • Establish in-house distribution networks	• Government-led growth
System semiconductors	Low design/manufacture levels	Hisilicon	• Improve design competency
	Low demand from local set makers	• Develop telecommunications semiconductors for parent company	• Increase demand from local set makers

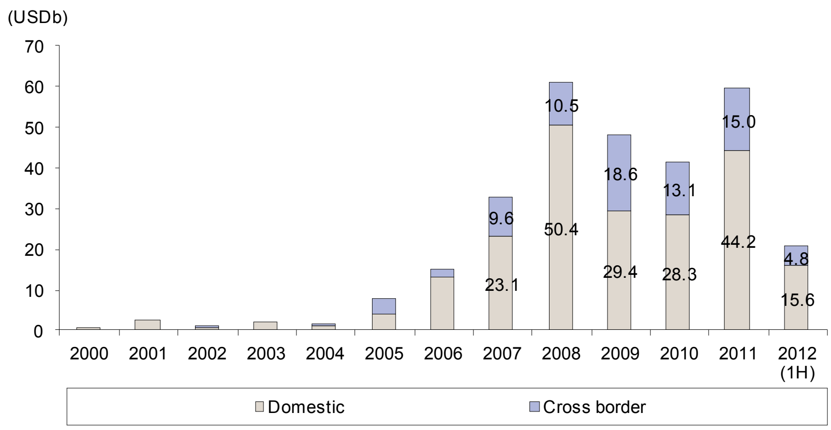
Source: SERI, Samsung Securities

2) M&A activities

China's M&A market has seen marked growth since 2005, and exceeded USD60b in 2011, while the industry's mainland consolidation is being driven by two main factors.

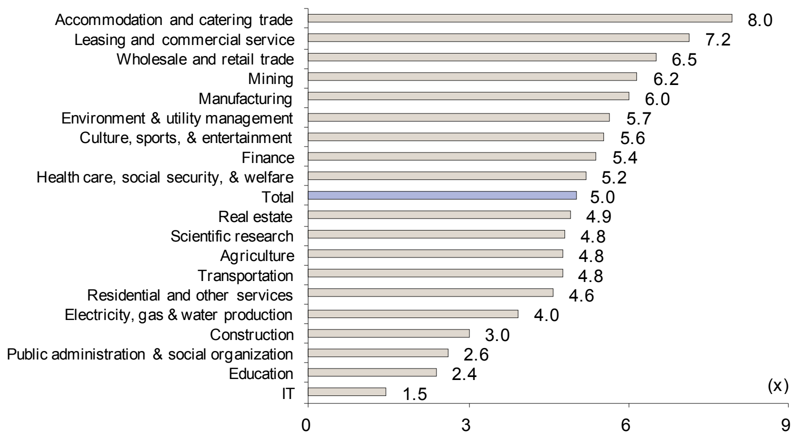
First, M&A activities are strategic choices to survive oversupply. Since 2000, aggressive investments have been fueled by the greed of provincial governments, which caused widespread, cross-sector oversupply, ranging from low-value-added businesses—*eg*, textiles, plastics, PC assembly—to process industries such as steel, cement, coal, shipbuilding, autos, LCD, and solar power, with retailers and financial firms also being affected. These activities appear unavoidable for firms at the crossroad between market exit and consolidation.

Chart 32. Domestic and overseas M&A activities (China)



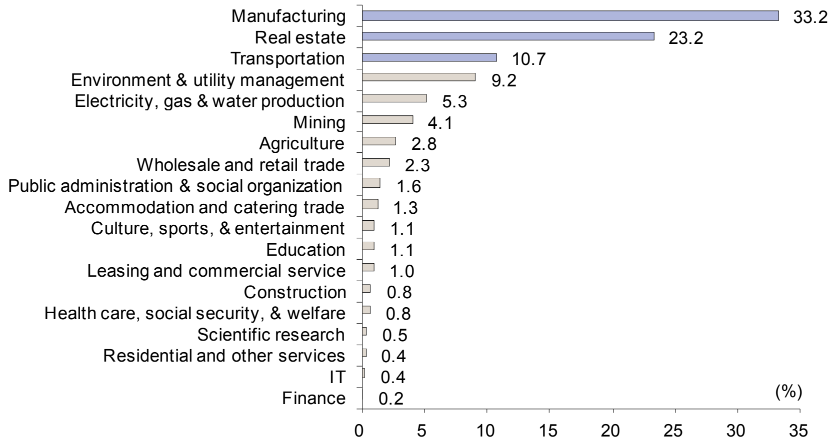
Note: Takeover deals only, excludes those lacking reported values
Source: Bloomberg, Samsung Securities estimates

Chart 33. China fixed-investment growth over 2003-2010, by industry



Source: CEIC

Chart 34. China fixed-investment growth contribution over 2003-2010



Source: CEIC

Second, M&A is aimed at a quantum leap in brand and technology. Having pursued rapid volume growth, China lags in brands and technology. Global brands it has are only cost advantage.

China should eventually play catch-up, given its high education fervor and untapped growth potential. But there is a shortcut for a country with huge domestic market and capital: buy or partner with global players. Takeover of Volvo in 2010(USD1.8b) and AMC in 2012(USD2.6b) are such examples. Eurozone and US financial crises are offering good M&A opportunities for China. The mainland will likely keep hunting for cross-border M&A targets.

Table 10. Top-ten domestic acquisitions over the past decade (China)

No.	Date	USDb	Acquirer	Targeted firm	Industry
1	Jun 2008	29.3	China Unicom Hong Kong	China Netcom Group Corp Hong Kong	Telecommunications
2	Dec 2008	2.4	Hebei Iron & Steel	Handan Iron & Steel	Steel
3	May 2010	2.4	Guangzhou Automobile Group	Denway Motors	Automobile
4	Feb 2010	2.4	Shandong Iron and Steel	Laiwu Steel	Steel
5	Jun 2008	2.2	China Merchants Bank	Wing Lung Bank	Finance
6	Nov 2004	2.0	China Southern Airlines	Xinjiang Airlines & China Northern Airlines	Transportation
7	Nov 2010	1.9	Shanghai Friendship Group	Shanghai Bailian Group	Distribution
8	Dec 2008	1.9	Hebei Iron & Steel	Chengde Xinxin Vanadium & Titanium	Steel
9	Jul 2007	1.4	Aluminum Corp of China	Baotou Aluminium	Material
10	Jul 2011	1.4	Shanghai Electric Power	Shanghai Hexi Energy Investment	Utility

Note: Branch company and treasury stock related deals excluded; unregistered deal cost deals excluded
Source: Bloomberg league table, organized by Samsung Securities

Table 11. Top-ten overseas acquisitions over the past decade (China)

No.	Date	USDb	Acquirer	Targeted firm	Industry
1	Jun 2009	8.8	China Petrochemical	Addax Petroleum (Switzerland)	Energy
2	Aug 2005	3.9	China National Petroleum	Petro Kazakhstan (Kazakhstan)	Energy
3	Mar 2010	3.3	PetroChina, Royal Dutch Shell	Arrow Energy Holdings (Australia)	Energy
4	Apr 2009	3.3	PetroChina, KazMunai Gas Exploration	MangistauMunai Gas (Kazakhstan)	Energy
5	Mar 2008	3.1	China Huaneng Group	Tuas Power (Singapore)	Utility
6	Jul 2008	2.8	China Oilfield Services	COSL Drilling Europe (Finland)	Energy
7	Oct 2011	2.8	China Petrochemical	Sinopec Daylight Energy (Canada)	Energy
8	Aug 2009	2.6	Yanzhou Coal Mining	Yancoal Resources (Australia)	Energy
9	May 2012	2.6	Dalian Wanda Group	AMC Entertainment (US)	Media
10	Dec 2010	2.5	China Petroleum & Chemical	Occidental Argentina Exploration & Production (US)	Energy

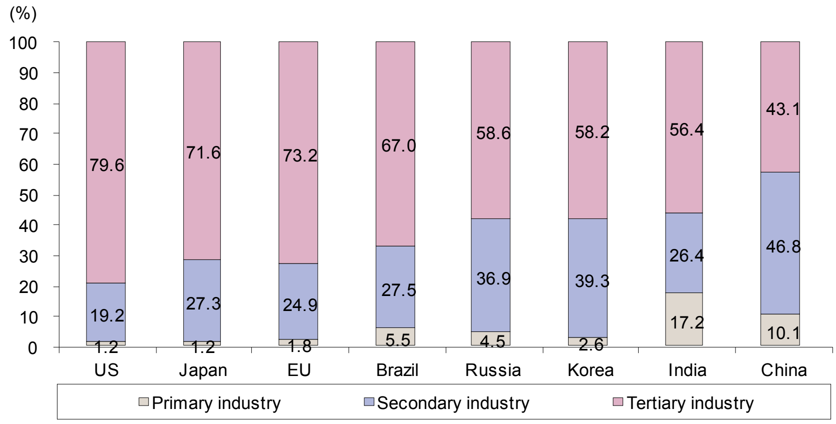
Note: Excludes deals related to branch firms and treasury stocks and those with undisclosed values
Source: Bloomberg

3) Tertiary industries

China became the world's second-largest economy thanks to its vibrant tertiary (or secondary) industries, with the government shifting manufacturing focus from light industries over 1978-1990 to heavy ones over 1990-2007, with the focus now on high value-added industries like IT, autos, and renewable energy. There is a problem, however, in the immaturity of the nation's domestic consumption-related service industries, with the 46.8% portion (of total economy) of its secondary industry exceeding the 43% of its tertiary industry as of 2011—*cf*, which was also below the secondary portions seen in the US (77.4%), Japan (67.6%), Taiwan (69.7%), Korea (60.7%), and India (53.7%).

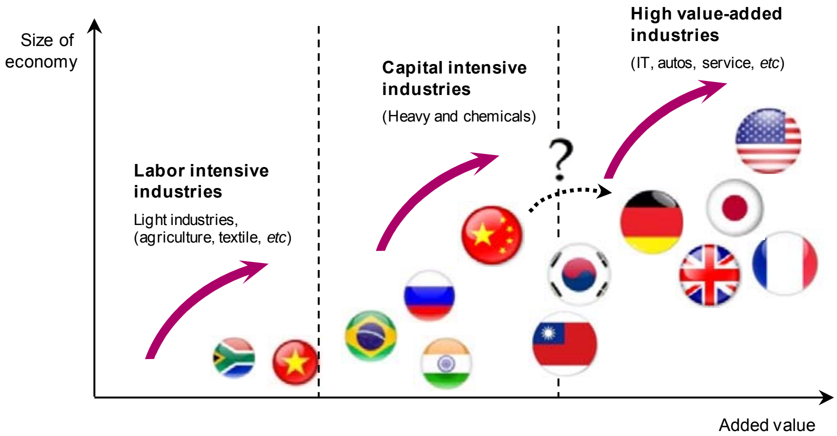
Like a Penny-farthing bicycle[1], China initially required an oversized front wheel, a role filled by the government, exports, and manufacturing industries. Excessive capital investments in infrastructure deterred growth of domestic consumption and the services industry, however, so the nation now needs a stronger rear wheel (*ie*, domestic consumption and service industries) to move ahead and correct the imbalance.

Chart 35. Structural comparisons of major world economies



Note: As of 2011
Source: World Bank

Chart 36. Industrial development stages

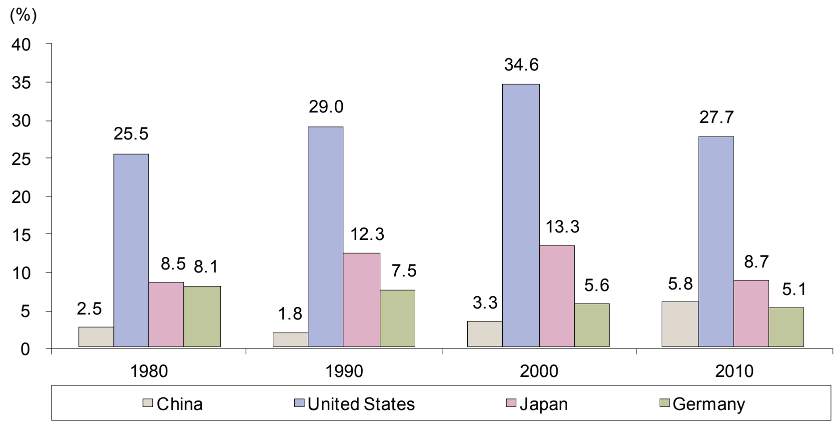


Source: Samsung Securities

1 The bicycle's large front wheel enables higher speeds and reduced weight, analogous to initial economic development phases that require strong government pushes and vibrant secondary industries

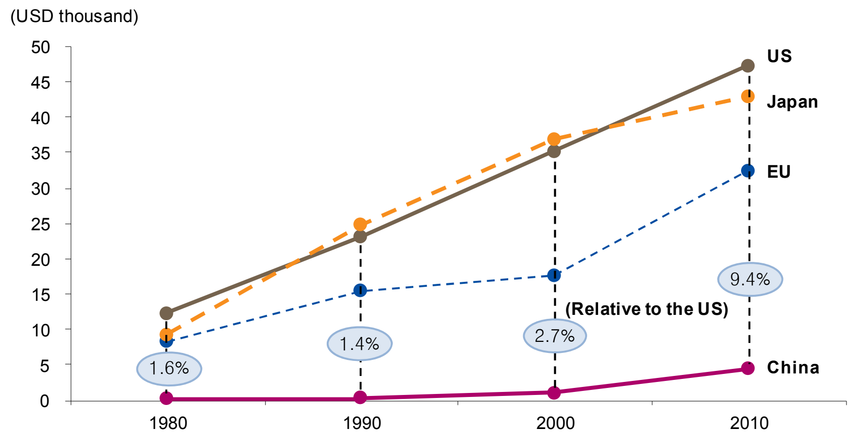
Consumerism in China retains ample room for growth, as its respective consumer market and *per capita* income are just 6% and 9.4% of those in the US—despite it accounting for only 10.8% of global GDP—which the government plans to grow by a respective CHY30t and USD900b by 2015, making this is a good time for Korean firms to take note of potential opportunities in that nation's consumer market and soft industries (as discussed below in topic 3).

Chart 37. Household-expenditure-to-GDB ratios in major economies



Source: UN (2011), Samsung Securities

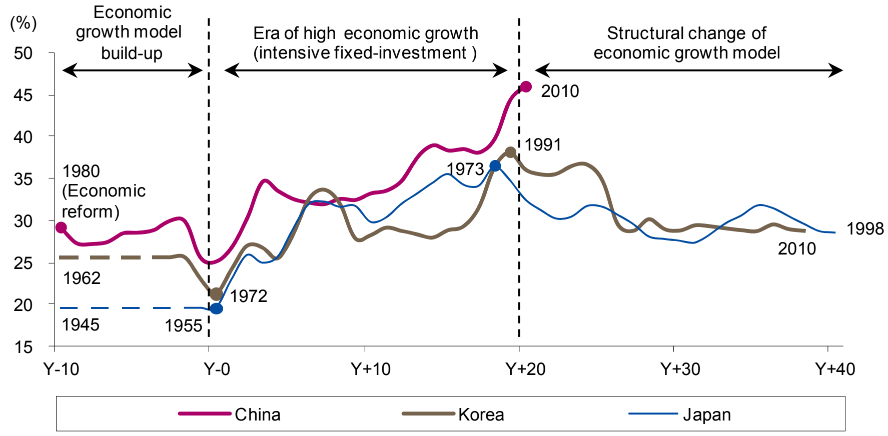
Chart 38. Per-capita GDPs of major economies



Source: World Bank, Samsung Securities

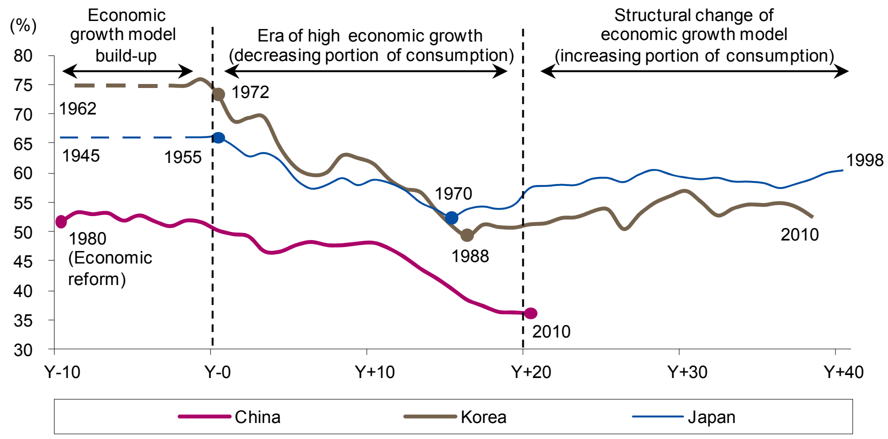
From the perspective of a nation's industrial development cycle, China is set to enter the soft industry growth phase. Japan and Korea both had 20 years of overwhelming secondary industry growth (exports, manufacturing) before their main growth driver was replaced by domestic consumption and service related industries (and subsequent high employment effect).

Chat 39. Fixed-income investment to GDP: China, Korea, and Japan



Source: CEIC, UN (2011), Samsung Securities

Chart 40. Retail sales to GDP: China, Korea, Japan



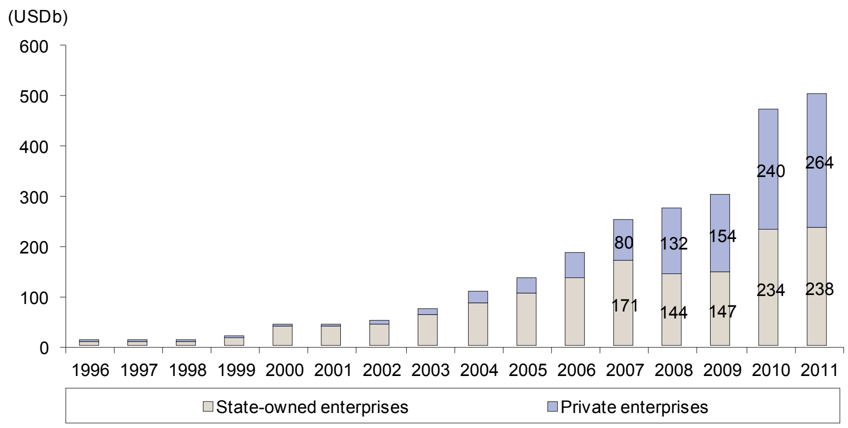
Source: CEIC, UN (2011), Samsung Securities

4) Privatization

Strong state-run firms alongside weak private ones are a side effect of industrialization in China, with the government pressing ahead with reforms and opening up markets to reduce the role of the former while increasing the latter's numbers and strengthen their competitiveness. State-run enterprises gained ground under fourth-generation leaders Hu Jintao and Wen Jiabao, however, due to: 1) a credit system that favored large firms; 2) them losing infrastructure investment during economic corrections; and 3) private firms losing competitiveness amid oversupplies. Xi Jinpin and Li Keqiang are poised to take China's helm in 2013, and both have said the state will pursue privatization, so we might witness sea change over the next decade that ushers in an era of private enterprise.

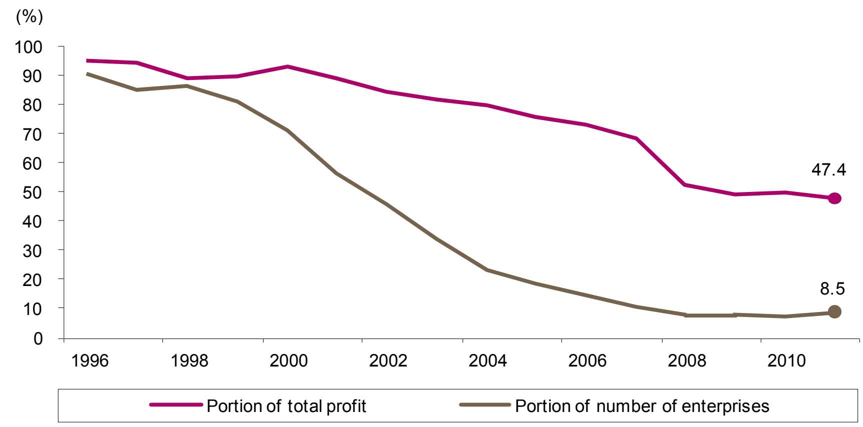
China will likely take a two-pronged approach to encourage investment at private firms, and intends to support that related to low-margin public businesses (heretofore monopolized by state-run firms) and those investing in high-margin, free market entities to enhance efficiency.

Chart 41-1. Total profit: State-owned vs private enterprises



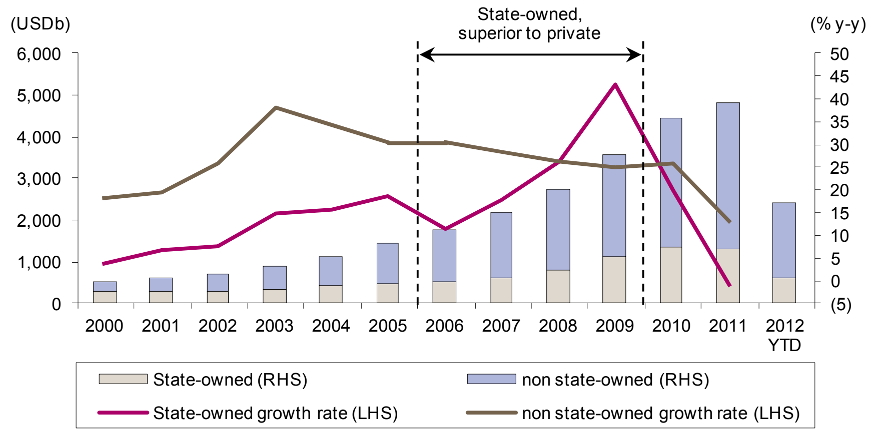
Source: CEIC, Samsung Securities

Chart 41-2. Portion of China's state-owned enterprises and profit to total



Source: CEIC, Samsung Securities

Chart 42. Fixed investments: State-owned vs non state-owned enterprises (China)



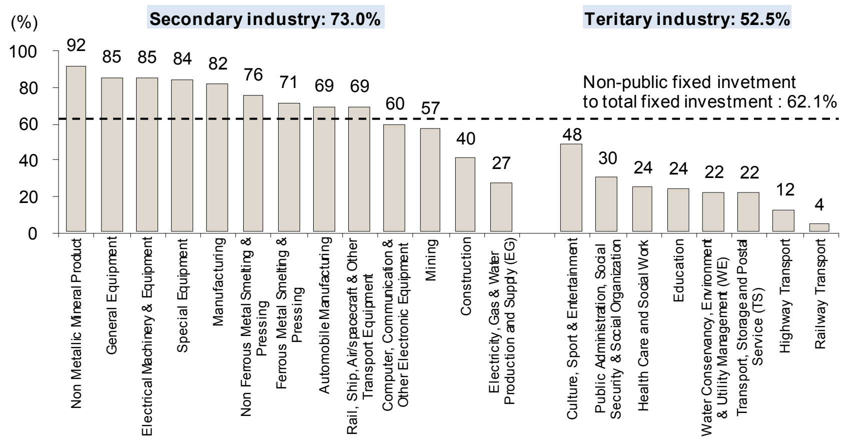
Source: CEIC, Samsung Securities

Table 12. Article 36: Revision/tax benefits to promote/develop private investment (China)

Classification	Details	Availability of tax benefits
Basic industry	Construct roads, waterways, docks, private airports, and airline facilities and create a railroad industry investment fund	Yes (public infrastructure)
	Secure water resources	Yes
	Construct electric generators	Yes (cogeneration, wind power, waterpower)
Social security	Construct public housing	Yes
	Expand medical facilities	Yes
	Build educational and social care institutions	Yes
	Expand social care services	Yes
Other	Culture, tourism, sports	Yes
	Wholesale and retail, distribution	Yes
	National defense	No
	Allow private funds to join state-owned enterprise reform	No
	Establish private financing corporation	No

Source: China State Council, CNAO

Chart 43. Portion of private investment to total fixed investment (1H12)



Source: CEIC

Implications

China's industry restructuring has just begun, with next-generation leaders Xi Jinping and Li Keqiang will likely be evaluated by their success in: 1) pushing industries up the value chain; 2) encouraging M&A activities, 3) foster tertiary industries; and 4) privatize state-owned enterprises. The nation's industry restructuring over the next decade will present threats and opportunities to its biggest clients: Korean players.

Regarding threats, Korean firms could: 1) lose competitiveness in high-value-added businesses as China pushes industries up the value chain; 2) see oversupply in businesses strategically fostered by Beijing; or 3) face volume competition from Sino firms that expand via M&A activities. The overall competitiveness of Chinese players may well soar on that government's tertiary industries and the form the focus of privatization.

As for opportunities, China's removal of oversupply might help Korea's shipbuilders and steelmakers with top-tier global positions reinforce dominance. In addition, Beijing's fostering of its domestic consumer market may ensure quantitative growth of Korean firms that have established a presence in China. Finally, firms that supply global stalwarts Samsung Electronics (SEC) and Hyundai Motor Group (HMG) could win orders from local Chinese firms seeking to raise their brand values.

Chat 44. Opportunities and risks for Korean firms from China's industry restructuring

Industry change	Industry sophistication	M&A / restructuring	Tertiary industries	Privatization
Threats	• Intense competition with Korea's core fields (medium-to-long term) • Oversupply in new growth industry	• Strengthen of Chinese firms competitiveness (technology, brand power, economies of scale, *etc.*)	• Strengthen competitiveness of Chinese tertiary industries (culture, content industry)	• Rapidly grow competitiveness of private companies
Opportuni -ties	• Core value-chain growth • New growth industry to make inroads in China	• Resolve global oversupply in industrial sectors (steel, shipbuilding, chemistry) • Strengthen top-tier competitiveness via consolidation	• Benefit from domestic market growth	• Increased chance of penetration for value-chain and software companies
Related industry	New growth industries, IT, autos	Steel, chemistry, shipbuilding, solar power	Consumer goods (cosmetics, distribution, food)	IT & auto components, software

Source: Samsung Securities

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4. Consumption trends

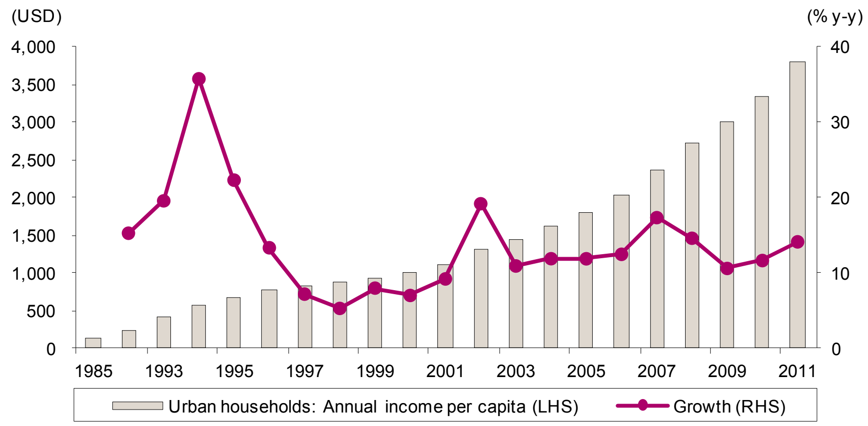
With rising urbanization and an increasingly older population is effecting consumer trends over the medium-to-long term, the Chinese consumer market has been growing more quickly than the economy, which we believe will lead to: 1) stronger fundamentals that may offer local industries some protection from the external environment; and 2) improved quality of life for the general populace. As the Chinese consumer market is improving and diversifying, consumption trends are changing dramatically. To assess the implications of such changes, we must take a close look at powerful, emerging consumer groups.

Wealth expansion

Consumption generally rises hand in hand with income. In China, steep economic growth following economic reforms in the 1980s gave rise to explosive growth in disposable income. The annual disposable income *per capita* for urban households in China rocketed from USD118 in 1985 to USD3,806 in 2011—signifying a doubling of wages every four to five years. In its twelfth five-year plan, the Chinese government also stated its ambition to double wages over 2010-2015.

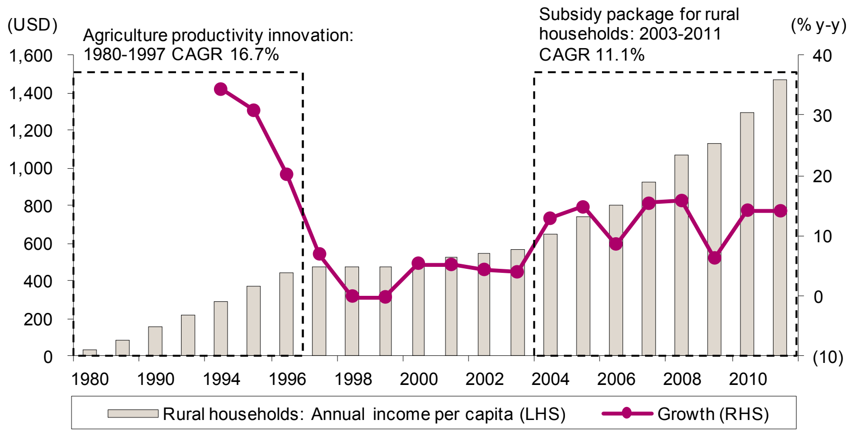
While the eurozone crisis has caused growth in Chinese wages to slow recently, we expect China to continue to enjoy the world's fastest income and consumption growth for the time being. As China is transforming from a global manufacturing base to a consumption base, we attribute the country's consumption boom to a wealth expansion.

Chat 45. China: Disposable income of urban households



Source: Wind

Chat 46. China: Disposable income of rural households



Source: Wind

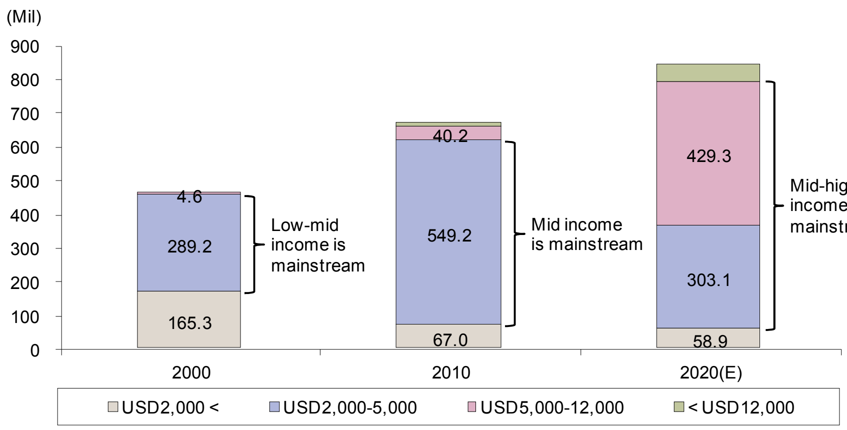
Double-peak structure in consumption to remain

We define double-peak consumption as consumption-volume growth in second-, third-, and fourth-tier cities, and consumption-quality growth in first-tier cities. As of 2012, China's mainstream urban consumer population in the USD2,000-5,000 *pa* income range numbers 550m people. We believe this group will grow and be divided into 300m in the USD2,000-5,000 range and 430m in the USD5,000-12,000 range by 2020.

China's double-peak consumption structure will likely be further consolidated over the next ten years, as inequalities between urban and rural areas, and between rich and poor have deepened.

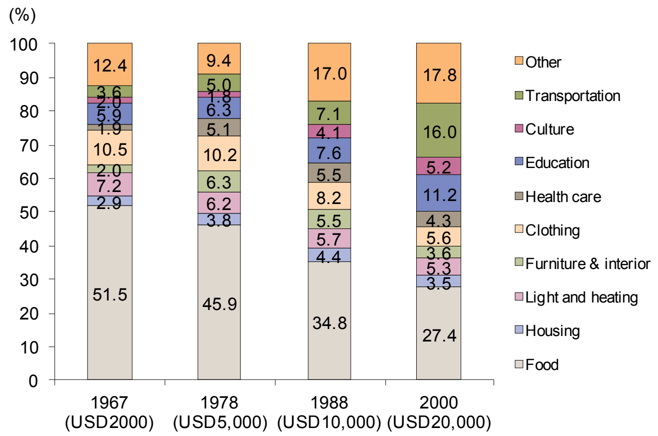
In Korea and Japan, when annual *per capita* GDP was in the USD2,000-5,000 range, consumption focused on living essentials—such as food, clothing, and housing—and also included low-end to medium-range consumer electronics and cars. When *per capita* GDP was in the USD5,000-10,000 range, consumption expanded to include culture and leisure, and motor vehicles featured much more strongly. Demand for leisure and health care surged once *per capita* GDP rose above USD10,000.

Chart 47. China: Distribution of urban-household income levels, trends and forecast



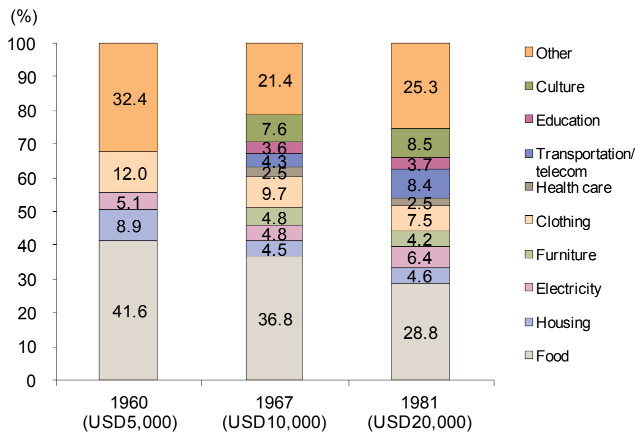
Source: McKinsey Insights China (Mar 2011), Samsung Securities

Chart 48. Korea: Consumption trends (1967-2000)



Source: Statics Korea, Samsung Securities

Chart 49. Japan: Consumption trends (1960-1981)



Source: Statics Japan, Samsung Securities

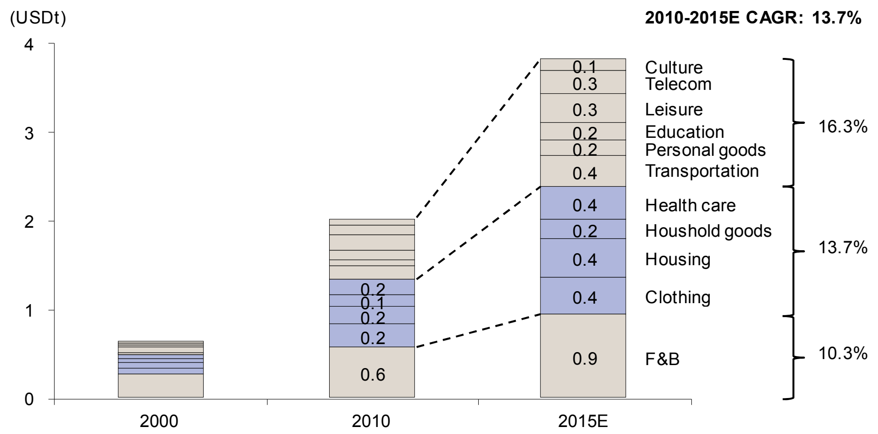
Table 13. Korea: Change in consumption breakdown as *per-capita* income level rises

(%)	1967	1978	1988	2000	Change from USD5,000 to USD20,000 (%pts)
Income (USD)	2000	5000	10,000	20,000	
Food	51.5	45.9	34.8	27.4	(18.5)
Clothing	10.5	10.2	8.2	5.6	(4.6)
Heating	7.2	6.2	5.7	5.3	(0.9)
Housing	2.9	3.8	4.4	3.5	(0.3)
Furniture	2.0	6.3	5.5	3.6	(2.6)
Portion spent on living essentials	74.2	72.4	58.6	45.5	(26.9)
Education	5.9	6.3	7.6	11.2	4.9
Transportation and Telecom	3.6	5.0	7.1	16.0	11.0
Culture	2.0	1.8	4.1	5.2	3.4
Health care	1.9	5.1	5.5	4.3	(0.8)
Other	12.4	9.4	17.0	17.8	8.5

Source: Statistics Korea, Samsung Securities

As income levels in China rise, consumption patterns should go through similar changes to those seen in Japan and Korea. We expect the Chinese consumer market to grow 13.7% *pa* to USD3.8t through 2015. By segment, consumer staples should grow 10.2% *pa* (USD0.9t for food), semi-staples 13.7% *pa* (USD0.4t for clothing, USD0.4t for housing, and USD0.2t for household goods), and discretionary goods at 16.3% *pa*.

Chart 50. China: Consumption growth forecasts, by product and service



Source: Statistics China, Samsung Securities estimates

Table 14. China: Consumption growth forecasts, by product and service

(USDb)	2000	2010	2015E	2010-2015 CAGR (%)
Food	270.9	574.6	936.0	10.3
Clothing	50.4	246.2	429.0	11.7
Housing	75.6	205.2	429.0	15.9
Household goods and services	37.8	123.1	214.5	11.7
Health care	37.8	184.7	370.5	14.9
Other living essentials	201.6	759.2	1443.0	13.7
Transportation	18.9	143.6	351.0	19.6
Personal goods	18.9	82.1	175.5	16.4
Education	63.0	102.6	195.0	13.7
Telecom	25.2	184.7	331.5	12.4
Leisure goods	12.6	102.6	253.5	19.8
Leisure and culture	12.6	61.6	136.5	17.3
Non-essentials	151.2	677.2	1443.0	16.3
Total	**623.7**	**2.010.9**	**3.822.0**	**13.7**

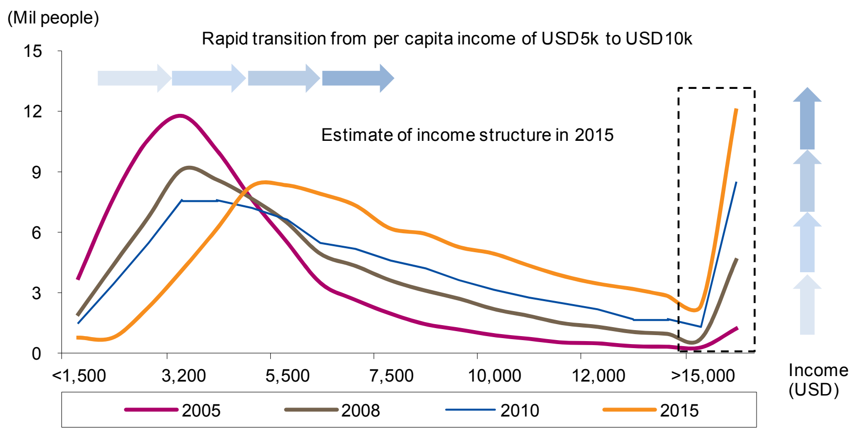
Source: Statistics China, Samsung Securities estimates

Population change by income and consumption models

Chinese consumption can be said to have a double-peak structure—*ie*, there are high income inequalities between urban and rural areas and between the rich and the poor. The urban and rural populations are nearly balanced, accounting for 51.3% and 48.7% of the total population, respectively—in 2011, the urban population outnumbered the rural population for the first time. Government urbanization policies should raise the country's urban population to 60% of the total by 2020, thus the double-peak structure in income and consumption should continue for the time being.

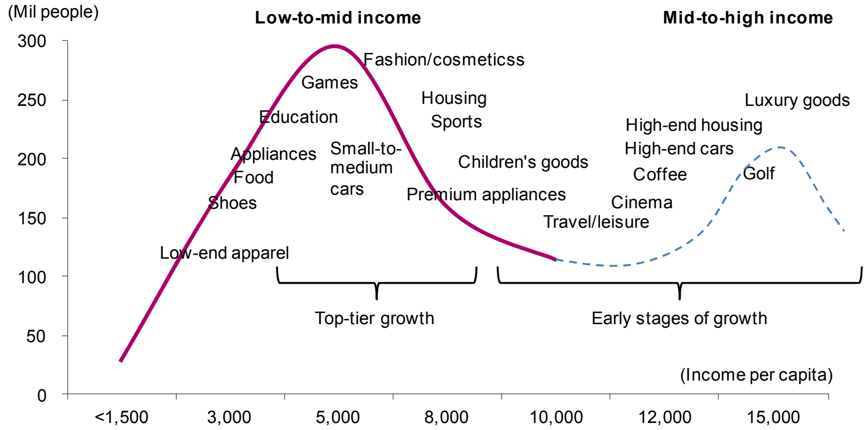
Our simulation suggests Chinese population growth will be concentrated in the USD3,000-5,000 *pa* and USD10,000-15,000 *pa* income ranges. Since 2008, the 590m people in the USD1,500-5,500 *pa* income range led consumption growth for food & beverages, apparel, consumer electronics, and small-to-medium cars, while the 390m people in the USD5,500-10,000 *pa* income range led growth in the real-estate, premium consumer-electronics, travel, and leisure markets.

Chart 51-1. China: Income structure trends



Source: Statistics China, Samsung Securities estimates

Chart 51-2. China: Consumption growth forecasts



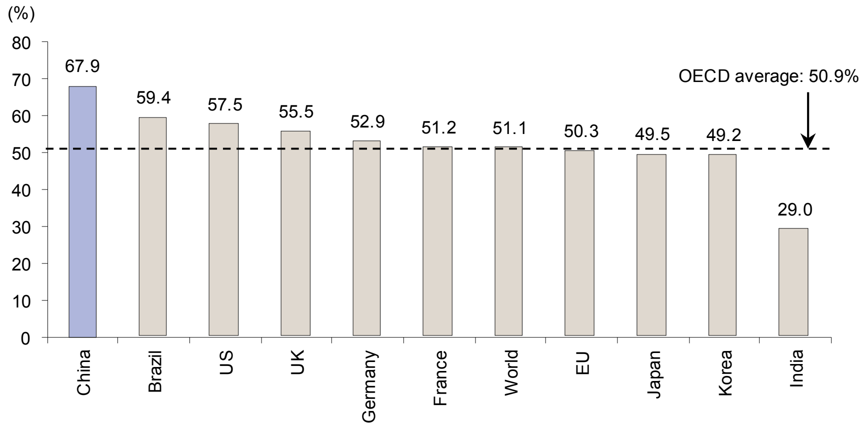
Source: Statistics China, Samsung Securities estimates

Women, children, the elderly to wield greater influence on consumption

As Chinese demographics have changed, consumption patterns have also altered. We believe changes in consumption patterns have been led by women, children, and the elderly and that these groups wield the greatest influence on Chinese consumer market growth over the next ten years.

We expect women's influence on the Chinese consumer market to grow, noting that: 1) China has a very high female labor force participation rate; and 2) women in the so-called little-emperor generation have emerged as a mainstream consumer group.

Chart 52. Female labor force participation rate

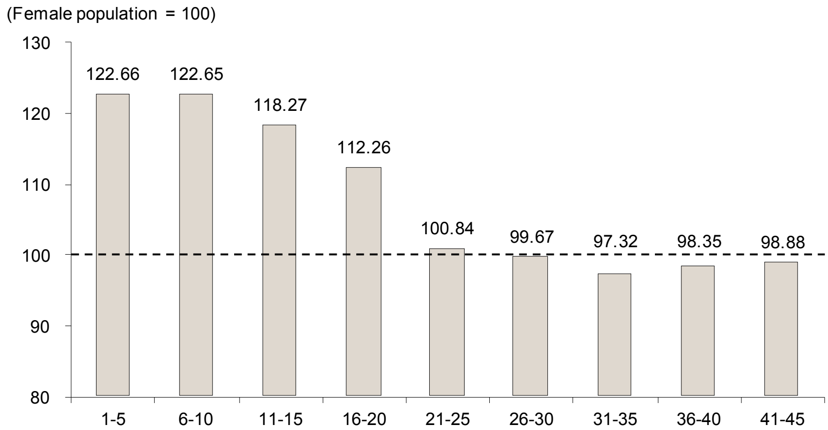


Note: As of 2011
Source: Statistics China, OECD

Another influence on female consumer power is the issue of population gender imbalance brought on by China's one-child policy. Since the implementation of the policy in 1979, China's male-to-female ratio has been distorted. It is estimated that there will be 112.3 men for every 100 women in the 20-30 year-old cohort in ten years' time and 122.7 men in twenty years' time. This imbalance will remain an issue for at least the next 20 years.

Despite the population gender imbalance, the female consumer market has grown steeply thanks to: 1) an increasing portion of high-income women (mainly high-ranking government officials and corporate executives); and 2) women gaining increased economic power.

Chart 53. China: Female to male ratio



Note: As of 2010
Source: Statistics China, CEIC

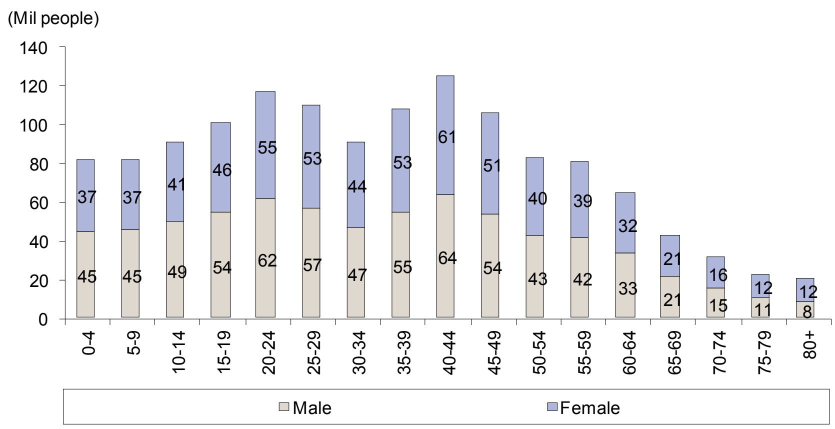
1) Female consumers

Since China implemented its one-child policy in 1979, Chinese women have wielded increasingly stronger purchasing power thanks to: 1) a surge in the number of nuclear families; 2) the improved social status and better education for women; and 3) the rising penetration of smart devices. Women are now more conscious of paying for quality, less price-sensitive, and more enthusiastic about specialty retailers of private label apparel. We take particular note of two population groups—the 206m women born since 1980 and the 170m women aged 35-49—which together account for 57.3% of the female population and are mainstream consumers.

The 206m female consumers born since 1980 are relatively insensitive to price and are more focused on brand and product quality. Price is becoming a stronger factor, however, as they can use smart devices to access product information. When this group becomes a mainstream consumer group, markets that will likely grow include small-to-medium cars, smart devices, fashion, cosmetics, children's products, new retail channels, educational/game content, and coffee/beverages.

Chinese people born between 1960-1978 witnessed explosive economic growth and rising income levels stemming from Deng Xiaoping's economic reform. Such people are generally conservative and have a high savings rate, but they have greater purchasing power than the little-emperor generation does, and are the main consumers of expensive housing and cars, travel and leisure, healthcare, premium fashion, and cosmetics.

Chart 54. China's demographics



Source: UN

We draw three conclusions about these Chinese female consumers. First, the little-emperor generation comprises open and aggressive consumers with weak brand loyalty, which offers opportunities to Korean industries in markets such as small-to-medium cars, smart devices, fashion, cosmetics, children's products, new retail channels, educational/game content, and coffee/beverages.

Table 15. Chinese women consumption patterns

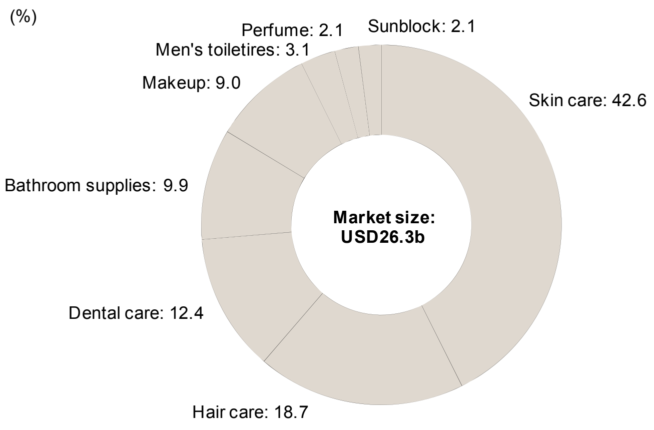
	Younger generation	Older generation
Age	• 15- 35 (born after 1979)	• 36-49 (born 1960-1978)
Population	• 206m	• 170m
Focus	• Brand, quality, price	• Brand, price, quality, after-service
Retail channels	• Ads, online, smart devices	• Recommendations, store recommendations
Behavior	• Seek new products	• Seek upgraded goods
Brand preferences	• Imported goods	• High-end imported goods
Main consumption items	• Small-to-medium cars, smart devices, fashion/cosmetics, children's products, education, games	• Autos, housing, high-end appliances, travel/leisure, high fashion, cosmetics

Source: China Consumption Market (2007), Samsung Securities

Second, female consumers born between 1960-1978 have the most means and the strongest propensity to consume. They show strong brand loyalty based on rising income levels, which in turn is benefiting markets such as travel (*eg*, outbound demand to Korea), healthcare, leisure, expensive housing/home appliances, fashion, cosmetics, jewelry, and furniture. In terms of brand and price, we see the outbound-travel, premium home-appliance, fashion/cosmetics, and auto sectors as most promising.

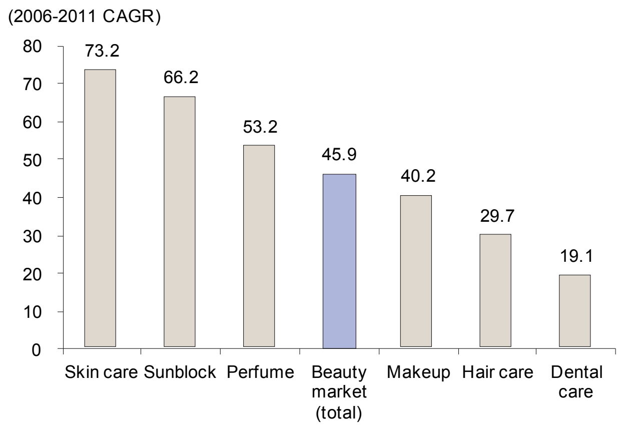
Third, among these females, wealthy shoppers are raising consumer spending while the less affluent are reducing their household expenditure. Global players will engage in fierce brand competition, while local players will compete on price. Any product that does not meet the 15% rule[2] may be forced out of the market.

Chart 55. Breakdown of Chinese beauty market



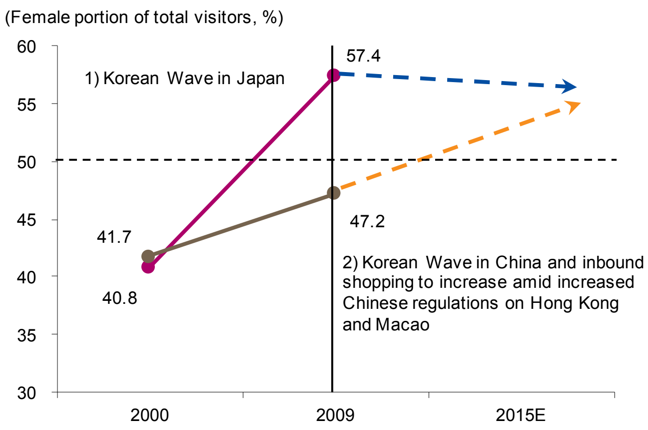
Note: As of 2011
Source: Euromonitor

Chart 56. Chinese beauty market growth, by product



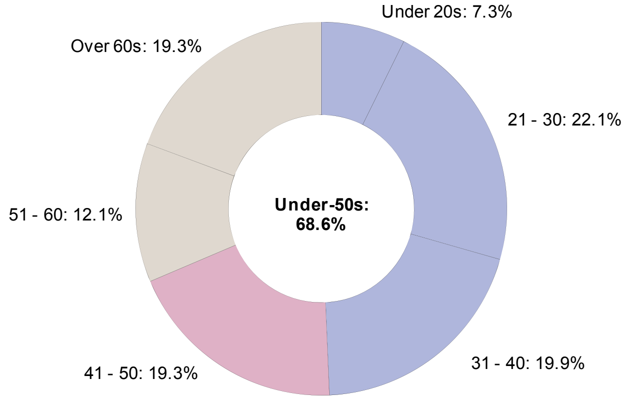
Source: Euromonitor

Chart 57. Female portion of Japanese and Chinese visitors to Korea



Source: KTO, Samsung Securities estimates

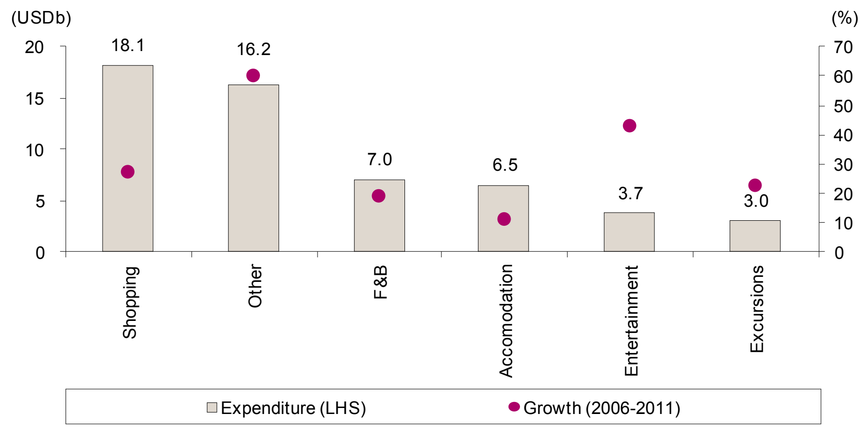
Chart 58. Chinese visitors to Korea, by age group



Source: KCCI

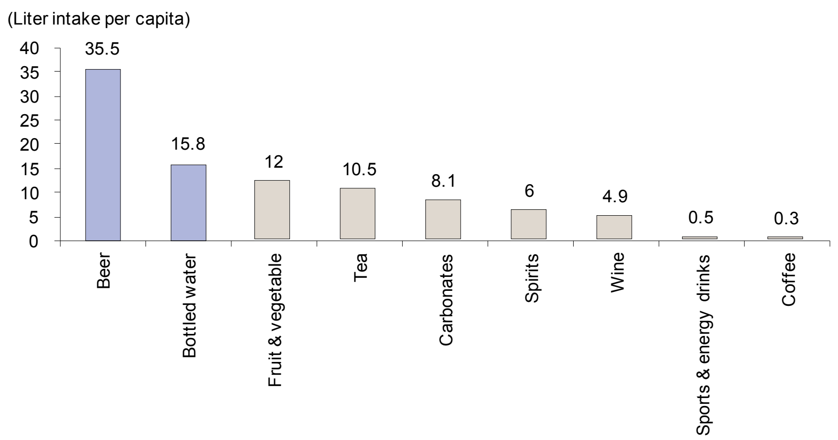
2 15% rule: Any product that does not record 15% y-y growth in sales and operating profit—China's retail sales growth average—will likely lose competitiveness or suffer slowing growth

Chart 59. China: Household overseas expenditure



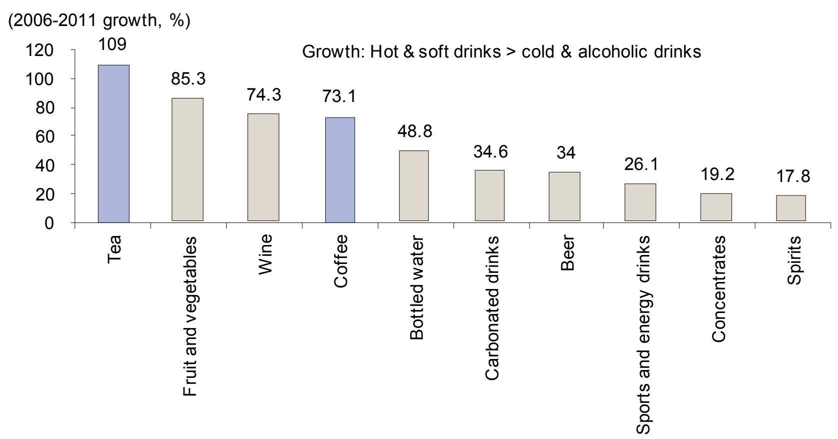
Note: As of 2011
Source: Euromonitor

Chart 60. China: Beverage consumption



Note: As of 2011
Source: Euromonitor

Chart 61. China: Beverage market growth, by drink



Note: As of 2011; Based on liter-intake *per capita*
Source: Euromonitor

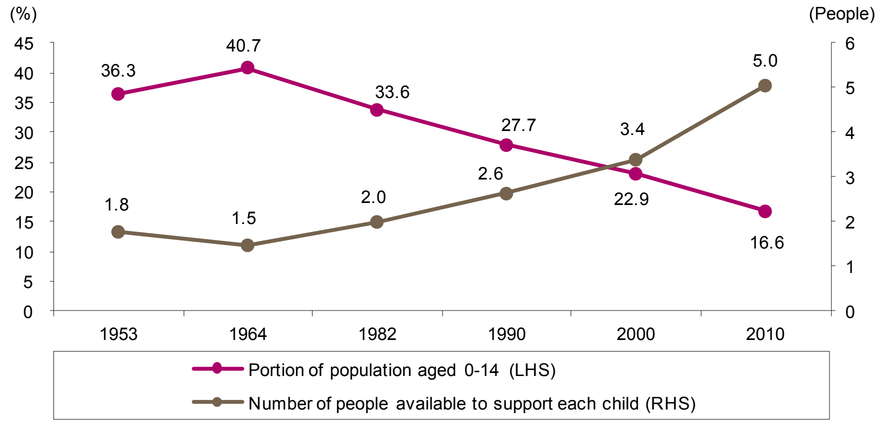
2) Children's products

China's market for children's products should deliver stable growth, relatively unaffected by the global economic cycle, as many Chinese families are of the 4-2-1 structure.

The population of 0-14 year-olds accounted for a massive 40.7% in the 1960s, but now stood at a mere 16.6% in 2010. Meanwhile, the economically-active population has ballooned, and the average child was supported by 5 people in 2010, up from 1.5 in 1964.

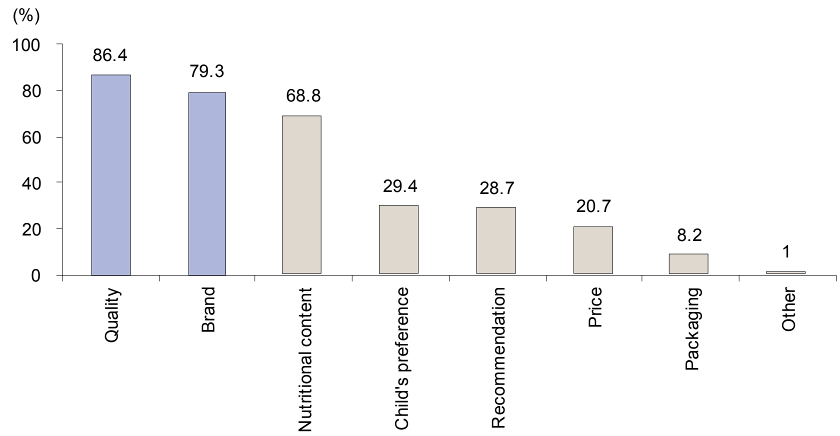
Alongside little-emperor couples having more wealth and a greater propensity to spend than others, China's market for children's products has shifted towards premium items. Consumers, startled by scandals over tainted milk powder in China and radioactive food from Japan, are increasingly safety conscious. Placing brands and quality at the top of their priorities, consumers in large cities favor imported brands that their parents were unable to afford. All in all, Chinese consumers tend to shy away from lower-quality items when choosing children's products.

Chart 62. Chinese: Child population



Source: Statistics China

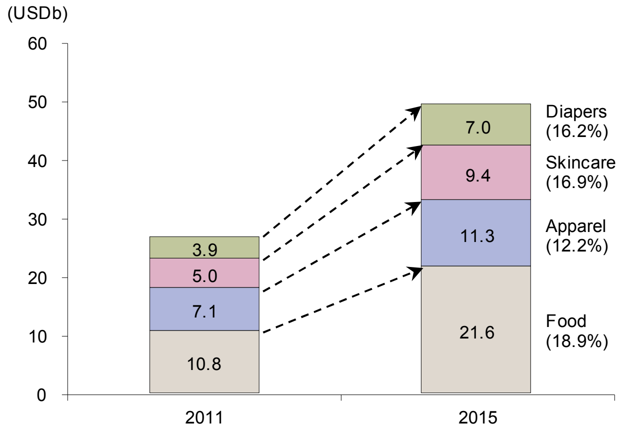
Chart 63. Survey: Importance of factors in choosing children's products



Source: SINA, Beijing Infant Consumption Report (2009)

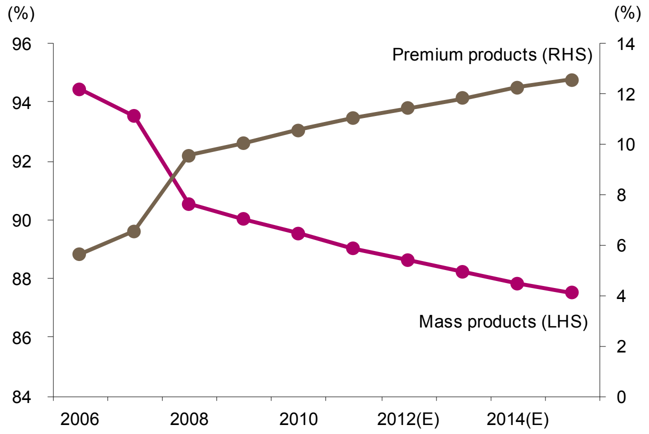
This market (comprised of clothing, food, skincare, and diapers) was sized at USD27b last year (or 1.2% of the entire retail market). What really catches our attention, however, is the speed of growth. We expect this market to expand at a 16.5% CAGR over 2010-2015, to be sized at USD49b—outpacing China's retail sales growth for the next ten years—given: 1) the rising portion of families raising children; 2) strong consumption by people born in the 1980s; and 3) the growing popularity of premium products amid safety concerns.

Chart 64. China: Children's market growth forecast



Note: CAGR
Source: Euromonitor

Chart 65. China: Premium vs mass children's products

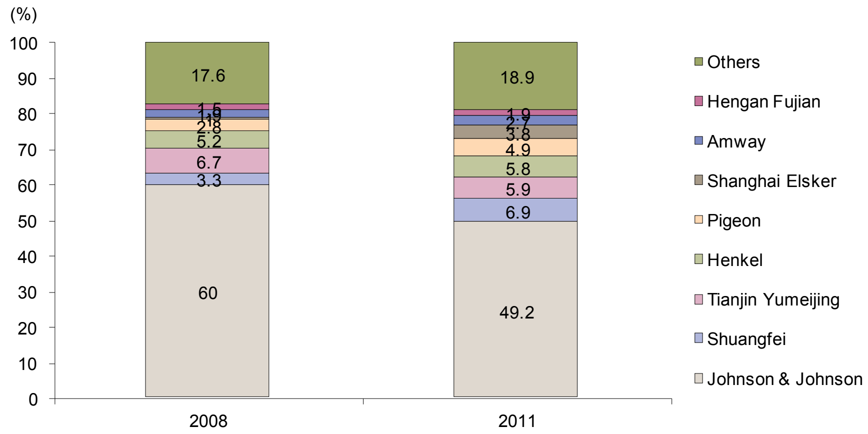


Source: Euromonitor, Samsung Securities

We have identified a number of characteristics that mark out the Chinese children's product market. First, premium-product growth has far outstripped mass-product growth due to food-safety scandals and new consumer patterns (with quality becoming more important than price). Chinese companies have performed well in second-and third-tier cities where low- and medium-income households reside, but we believe Korean companies have opportunities in food, skin care, and diapers—items for which quality is at the top of parents' concerns.

Second, global brands have lost some of their dominance, as consumer loyalty toward them has waned. As consumers move towards premium products, they are increasingly accepting new brands offering quality at reasonable prices. Thus, firms with brands focused more on decent quality than prices should find growth opportunities, as a majority of low- to middle-income consumers have been moving towards semi-premium markets.

Chart 66. China: Children's product market share trends

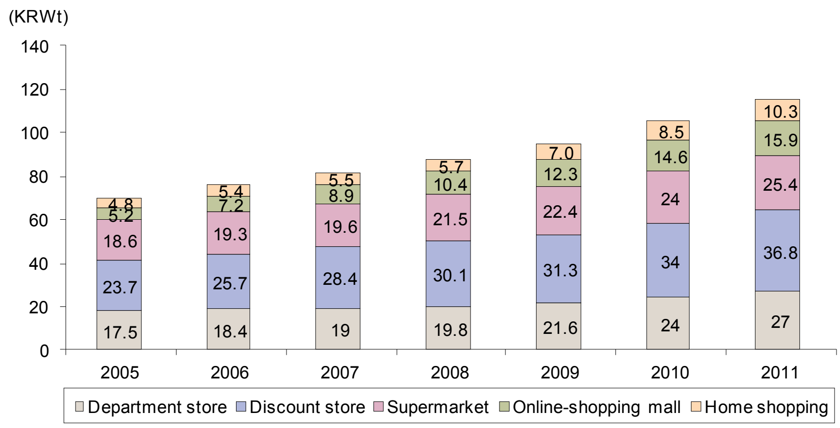


Source: Euromonitor

Third, distribution channels in the Chinese children's product market are two-pronged. Offline channels need to secure their competitiveness. The Chinese children's product market has high entry barriers and Korean brands have largely failed to secure a meaningful market presence due to difficulties in establishing distribution channels. In China, children's products mainly sell in department stores, large discount stores, and specialty stores, with the first two accounting for 70% of the total. Yuhan Kimberly, Maeil Dairy, and Namyang Dairy have aggressively sought to tap such channels.

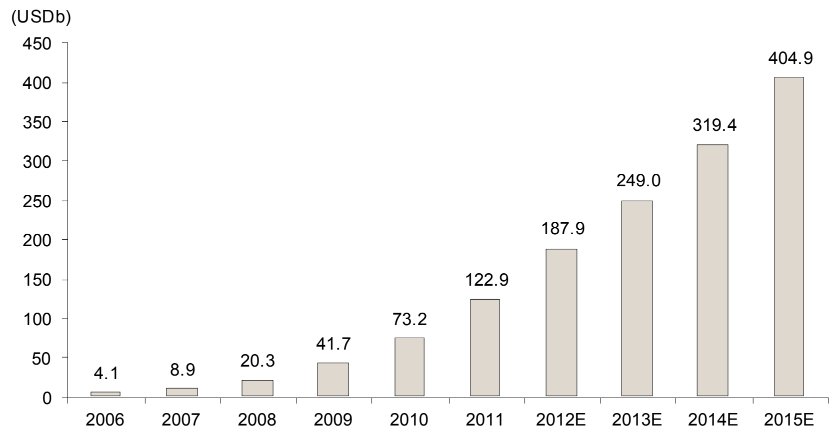
Meanwhile, home shopping and online shopping have rapidly expanded. The little-emperor generation (now becoming parents themselves) is increasingly purchasing children's products online and through mobile devices. These new channels are the most effective for brand marketing by latecomers. Thus, firms that position themselves for consumers using online services stand to benefit.

Chart 67. China: Retail market



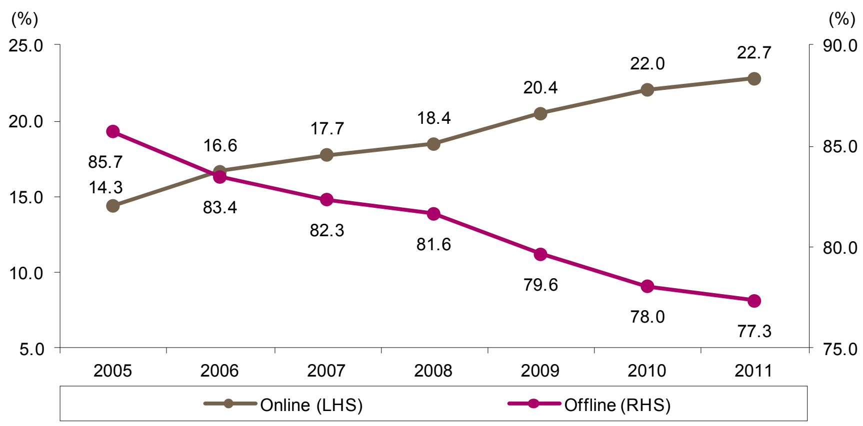
Source: Korea Statistical Office

Chart 68. China: Online retail market trends and forecasts



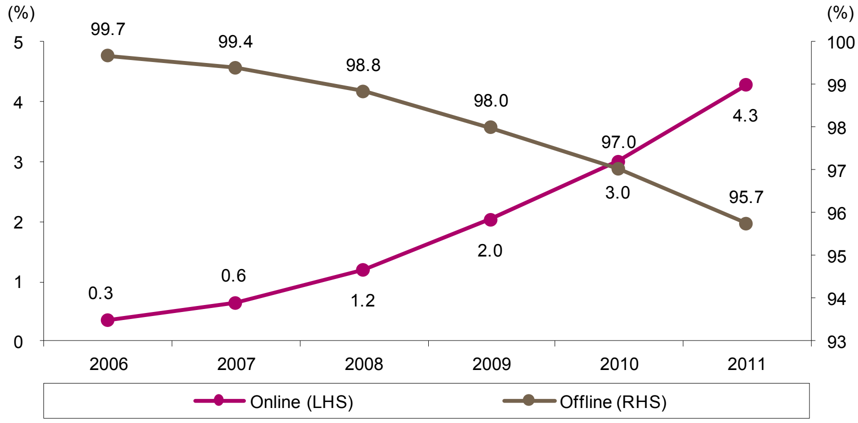
Source: Euromonitor

Chart 69. Korea: Online and offline retail market trends



Source: Euromonitor

Chart 70. China: Online and offline retail market trends



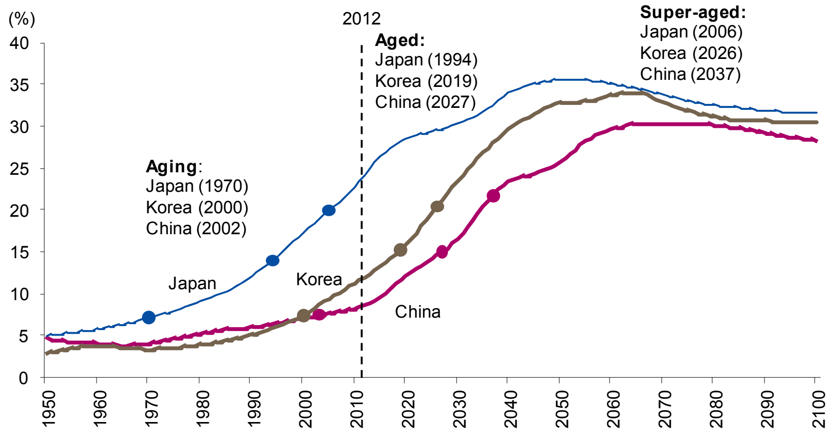
Source: Euromonitor

3) The elderly

Consumption among the elderly in China is rising. Along with changes in global demographics, populations in advanced countries are aging. China is also on track to an aged society due to its one-child policy and increasing life expectancy. China's population aged over 60 years now numbers 177m.

The problem is that the country's income growth has failed to keep pace with its population aging. More specifically, when China's population began aging in 2002, its *per capita* GDP (based on purchasing power) was just USD2,881, whereas Korea and Japan's *per capita* GDPs were USD14,097 and USD16,502, respectively, when their populations began aging. In other words, China is not yet ready for an aging society.

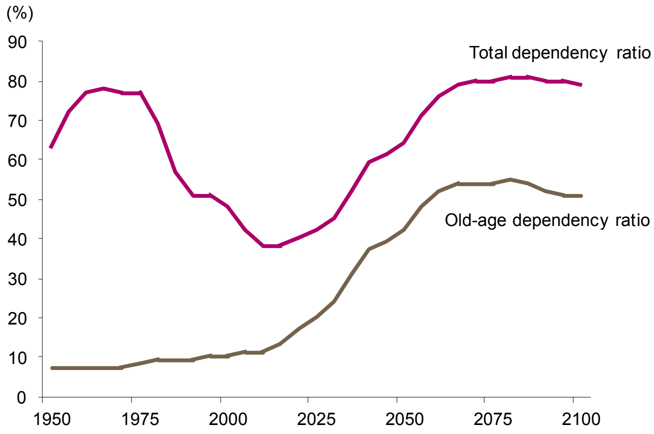
Chart 71. Aging trends in Japan, Korea, and China



Source: UN

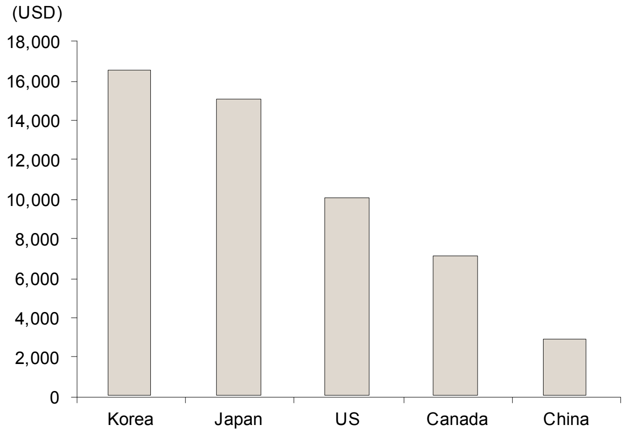
In the long term, China's GDP growth should decline due to a rising dependency ratio and falling population, which in turn should weigh on productivity growth. The country's savings rate could also decline as the older members of the population begin to rely upon their savings to finance the rest of their lives—a likely scenario given China's immature social security system.

Chart 72. China: Dependency ratios rising



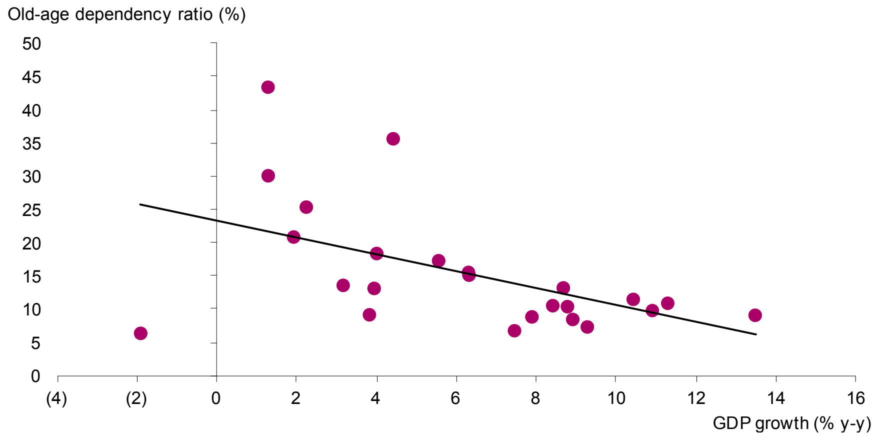
Note: The total dependency ratio is the ratio of the sum of the population aged 0-14 and that aged 65+ to the population aged 15-64. The old-age dependency ratio is the ratio of the population aged 65 years or over to the population aged 15-64
Source: UN

Chart 73. GDP *per capita* when population began aging



Source: UN, IMF, US Department of Commerce, BEA, Samsung Securities

Chart 74. Old-age dependency ratio and GDP growth



Note: Compares old-age dependency ratio to GDP growth for Korea, China, Japan from 1980-2015E
Source: IMF, UN, Samsung Securities

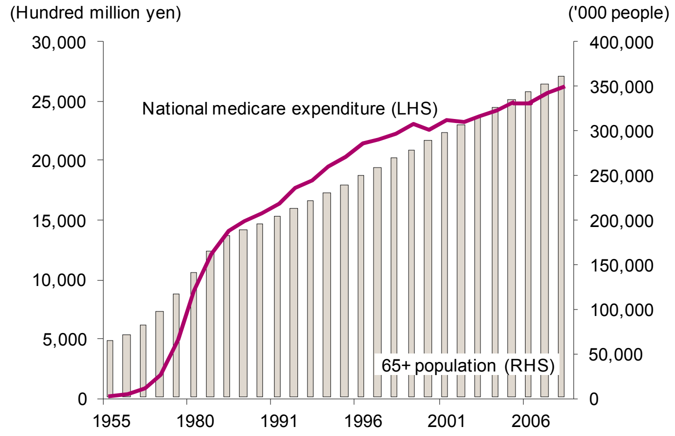
Table 16. Global aging trends

	Portion of population aged over 65			Years to transit categories	
	7% (aging)	14% (aged)	20% (super-aged)	7%→14%	14%→20%
France	1864	1979	2018	115	39
UK	1929	1975	2028	46	53
US	1942	2014	2032	72	18
Japan	1970	1994	2005	24	11
Korea	2000	2017	2026	17	9
China	2002	2027	2037	25	10

Source: UN

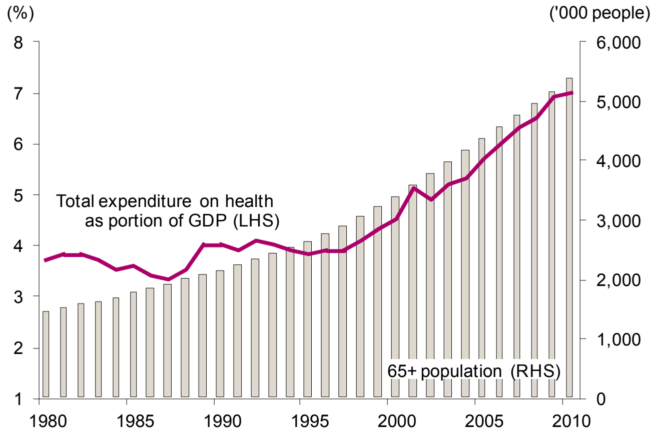
We expect aging society-related changes in consumption patterns to lead to changes in the industrial structure, with the health-care industry being a major beneficiary. The life-science and medical-equipment sectors should also enjoy increased demand, as was seen in the US, Japan, and Korea, which already have aging populations.

Chart 75. Japan: National medical expenditure



Source: MHLW, UN

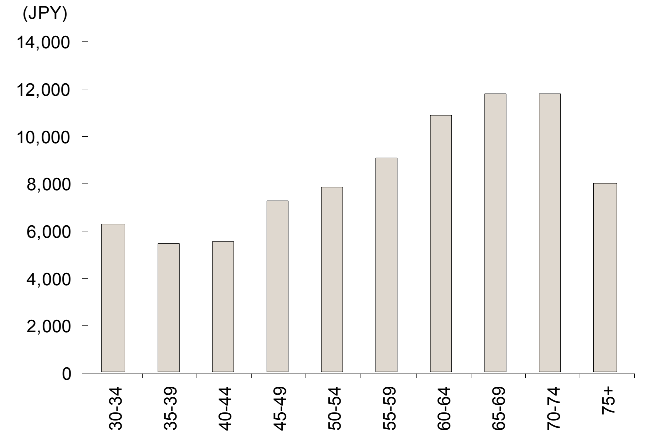
Chart 76. Korea: National expenditure on health as portion of GDP



Source: OECD, UN

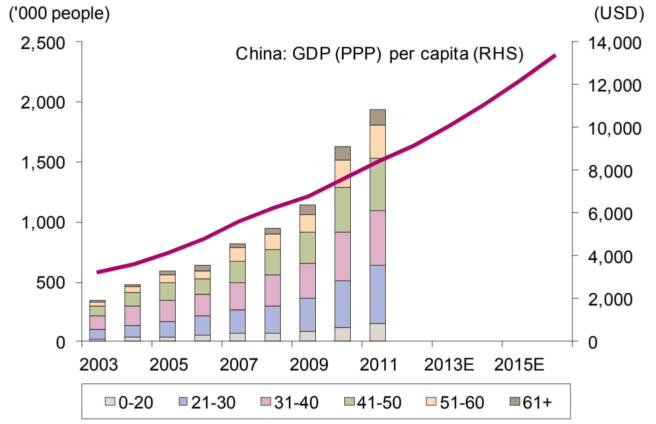
The leisure industry targeting older consumers could benefit from an aging population, as the elderly have built up savings and have enough free time to engage in leisure activities. In Japan, the elderly spend more per month on travel than any other age group. Thus, as the number of Chinese visiting Korea rises on the back of *per capita* GDP growth and an aging population, Korean airlines and hotels should benefit.

Chart 77. Japan: Monthly travel expenditure, by age group



Source: Japan Statistics Bureau

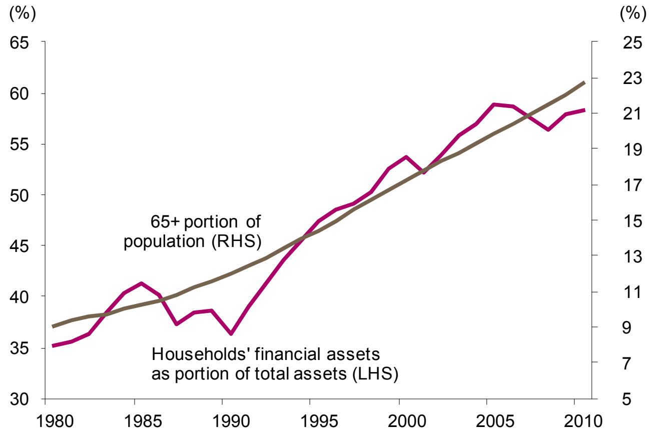
Chart 78. Chinese visitors to Korea, by age group



Source: KNTO, IMF

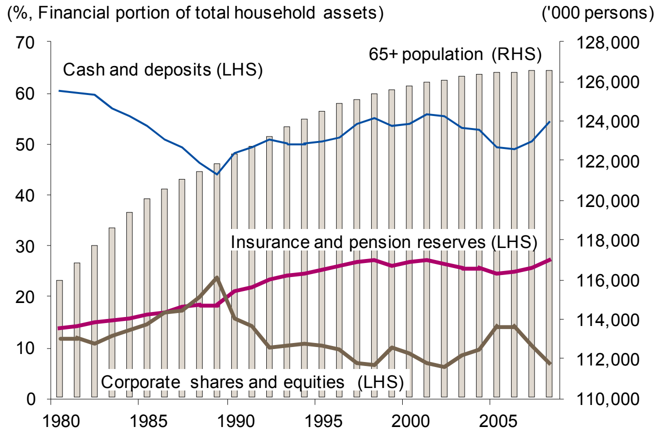
An aging population should also have a significant impact on the asset market—particularly in the financial services sector. Demand for pension products will likely increase rapidly. Household assets in China mainly consist of cash and cash deposits, implying the country's financial markets are still in a fledgling stage. As happened in Japan and Korea, we believe Chinese individuals will put a greater portion of their assets into financial markets as the population ages, income levels improve, more people migrate to cities, and education expands.

Chart 79. Japan: Financial portion of total household assets rises



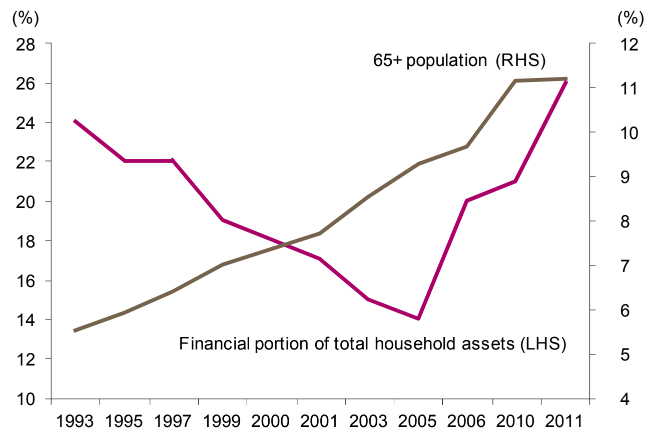
Source: Thomson Reuters, UN

Chart 80. Japan: Breakdown of household assets



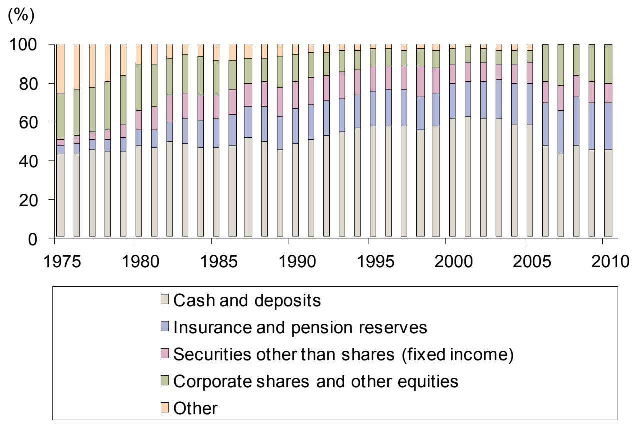
Source: Thomson Reuters, UN

Chart 81. Korea: Financial portion of total household assets rises



Source: KIRI, Daewoo Panel (1993-97), KLI (99-05),
KOSTAT (2006), KSO (10-11), UN, Samsung Securities estimates

Chart 82. Korea: Breakdown of household assets

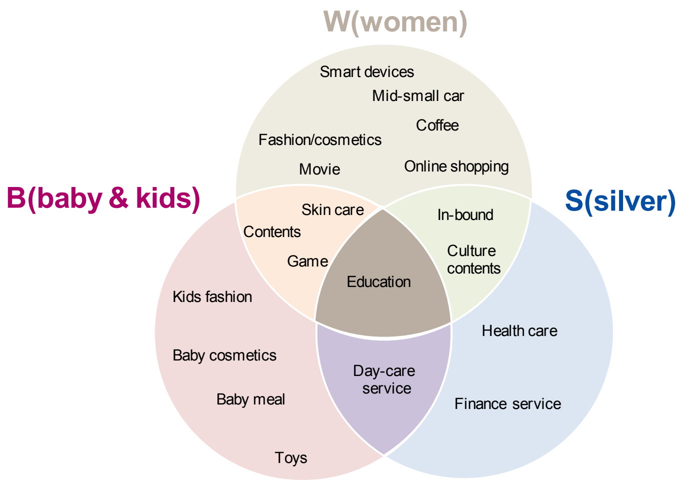


Source: BOK

Women, children, and elderly key to Chinese consumer market

Going forward, women, children born to the so-called "little emperor" generation, and a growing elderly population are likely to wield increasing influence on consumption. To gain dominance in the Chinese consumer market amid stiffening competition, we believe Korean companies need to establish strong brands and distribution channels, thereby preemptively targeting women, children, and the elderly in markets likely to grow and in which they can compete.

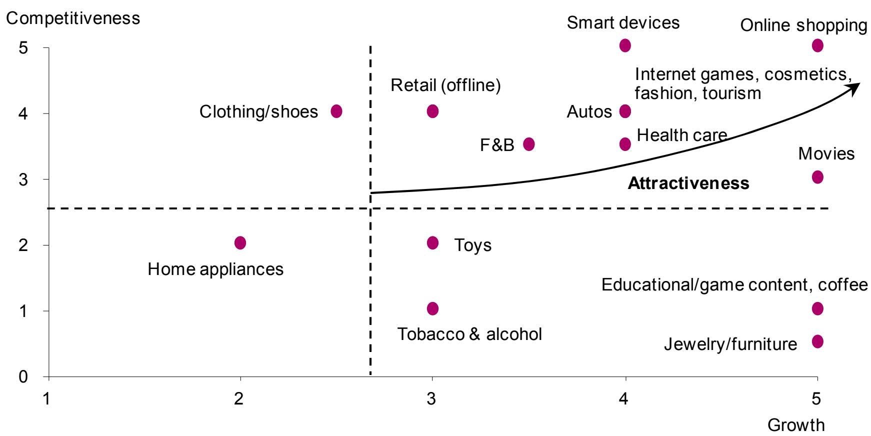
Chart 83. Investments in Chinese women, children, and the elderly



Source: Samsung Securities

Based on these criteria, we believe such markets include smart devices, small-to-medium cars, online shopping, cosmetics/fashion, travel (outbound demand to Korea), educational/game content, healthcare, and coffee/beverages.

Chart 84. Chinese consumer market vs Korean industry competitiveness



Source: Samsung Securities

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5. Long-term outlook on China's stock market

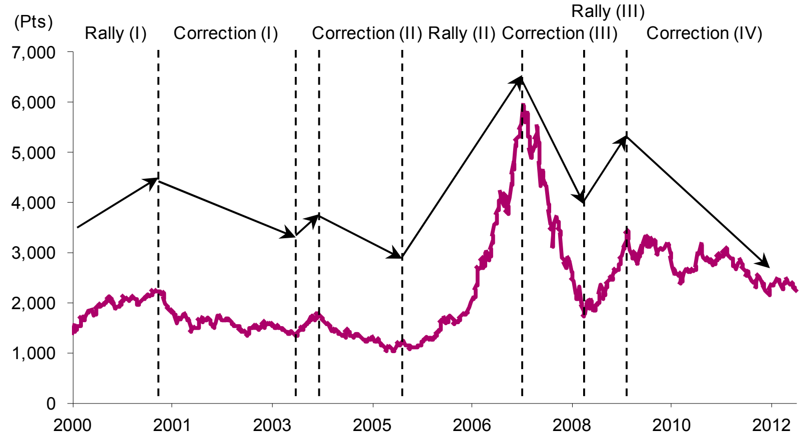
Although China's stock market plays an important role in forming the country's model of social market economy, many are wondering whether it will rebound in the near term, and how it will evolve over the medium-to-long term. As the incoming next generation of leaders appears more committed to opening up financial markets, we believe now is the time to examine the stock market's current status and long-term outlook.

Now in fourth correction phase since 2000

The Chinese stock market is now in its fourth correction phase since 2000, the result of three factors: 1) systemic risk stemming from the eurozone debt crisis; 2) uncertainty over economic bottoming amid faltering demand in advanced nations and a domestic recession in the real-estate market; and 3) overhang concerns following a steady stream of IPOs and rights offerings. Indeed, the market has now been trending downward for six straight months, as economic concerns continue to outweigh expectations of government stimuli.

If the Shanghai Composite Index were to fall below its January low, the correction would likely last for more than 31 months, the longest since the market opened. However, looking at economic and share-price cycles since 2000, we consider the current correction sufficient. Past correction phases have averaged 21.6 months, 4 months longer than the average uptrend period of 17.8 months, and the market now seems ready to confirm a support line, being close to past post-correction levels.

Chart 85. Shanghai Composite Index (cyclical phases since 2000)



Source: Wind

Table 17. Shanghai Composite Index trends since 2000

		Period (months)	Peak	Trough	Chg (%)	Conditions
	Correction period					
1	2001.06.13 - 2003.11.18	29.2	2,242	1,316	(41.3)	Bank insolvencies, stock market introduction (Dec 2002)
2	2004.04.02 - 2005.07.11	19.3	1,768	1,011	(42.8)	China's tightening, introduction of non-circulating shares (May 2005)
3	2007.10.16 - 2008.11.04	12.6	6,092	1,706	(72.0)	Stock market bubble in China, Lehman-related crisis
4	2009.11.23 - 2012.01.05	25.3	3,338	2,148	(35.7)	Tightening measures, eurozone risks, tepid real-estate market
Average		21.6			(47.9)	
	Growth period					
1	1999.12.23 - 2001.06.13	17.3	2,242	1,369	63.8	Expectations of demand recovery
2	2005.07.11 - 2007.10.16	27.2	6,092	1,011	502.6	Growth in China's infrastructure, investment boom
3	2008.11.04 - 2009.08.04	9.0	3,471	1,706	103.5	CNY4t expansionary package
Average		17.8			223.3	

Source: Wind, Samsung Securities

Market issue 1: Correlation with politics—Need for economic recovery

As mentioned earlier, 2012 is a year when new leadership will take office in China. Given the country's economic system and the impact government policies have on financial markets, political events correlate more with stock market performances than they do in other countries. Such performances this year should also hinge on the eurozone fiscal crisis and domestic real-estate market conditions. From a political perspective, finalization of China's new leadership team at next month's meeting in Beidaihe should prove a near-term positive for the market, as related uncertainty should dissipate.

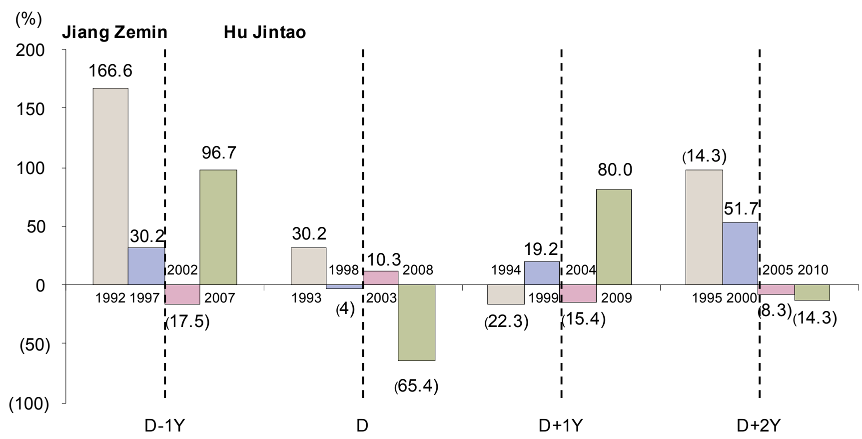
During periods of leadership change, the central government's desire to secure stability increases, while pressure builds on provincial governments prior to performance evaluations. The incoming central government should continue implementing economy-boosting measures, while provincial governments are likely to stick with growth-oriented policies. During past leadership changes, the Shanghai Composite Index moved largely on cyclical economic factors, but downside was limited. If eurozone tail risk dissipates and China's real-estate market recovers in 2013, the stock market would then be influenced by two remaining issues—provincial government debt and financial reform.

Table 18. Past governments and stock market performances

Generation	Leadership	Period	Economic model	Stock market performance (%)
2nd	Deng Xiaoping & Zhao Ziyang	1977-1992	Promotion of reforms, launching of stock market	192.7
3rd	Jiang Zemin & Zhu Rongji	1993-2002	Economic growth, expansion of capital goods and financial markets	462.2
4th	Hu Jintao & Wen Jiabao	2003-2012	Balanced growth, commodity super cycle	35.2
5th	Xi Jinping (projected)	From 2013	Industry, financial, regional, and bank insolvency reforms	?

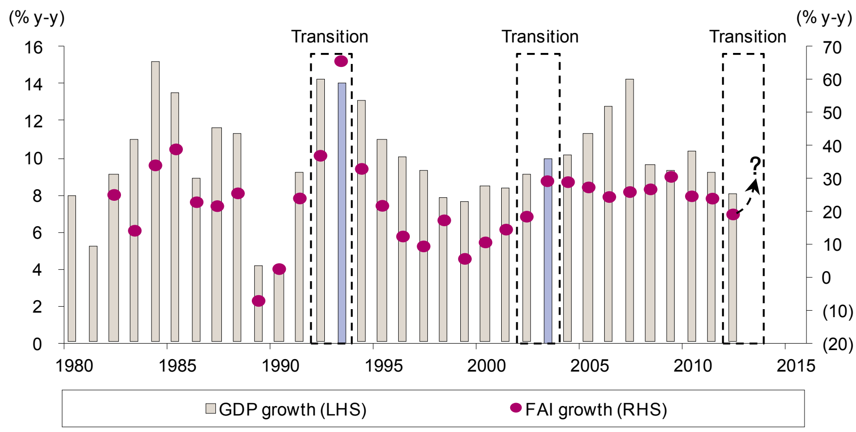
Source: Media reports, Samsung Securities

Chart 86. Government transitions and stock market performances



Source: Wind

Chart 87. Government transitions vs FAI/GDP growth



Source: Wind

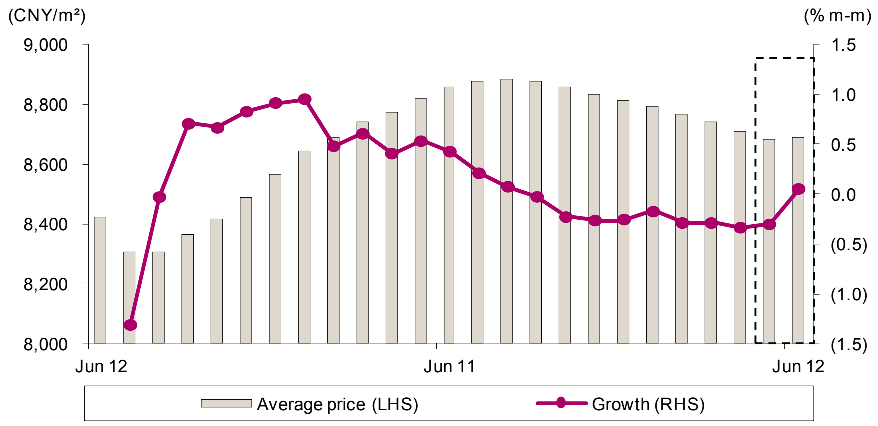
Market issue 2: Real-estate market passing through trough

The real-estate market is a double-edged sword for China's government. Although it has been intentionally slowed to bring stability, a severe recession in the market would deal a blow to both provincial government investment and private consumption.

Expectations of real-estate deregulation are mounting as 2Q economic data fell short of targets—in May, the government returned to an over-8% GDP growth policy, and lifted all regulations except lending-limit and real-estate rules.

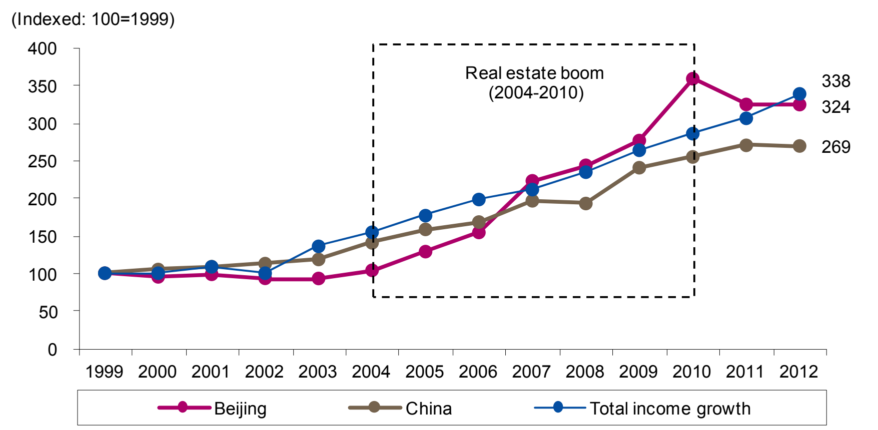
In sum, although full-on real-estate deregulation is unlikely, we see two reasons why provincial governments will take significant steps to free real buyers from regulations. First, as Premier Wen Jiabao said in July, price stabilization is politically vital to the next generation of leadership. Second, the government's three main priorities when it comes to easing social instability are tackling inflation, unemployment, and property issues.

Chart 88. Real-estate price trends



Note: Averages of prices in 100 cities
Source: Wind

Chart 89. Real-estate market growth vs income growth

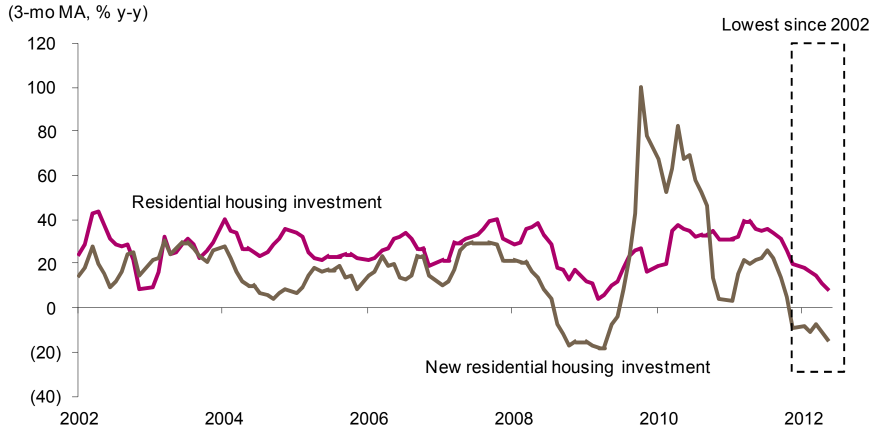


Source: Wind

We believe the Chinese real-estate market hit bottom in June, when housing transactions in Shanghai and Beijing jumped 30-50% from 4Q11 levels. Given that it should take three quarters for current inventories to be depleted, a real-estate market recovery would be the first indication that real buying has bottomed among real buyers—a full-fledged price recovery would come later.

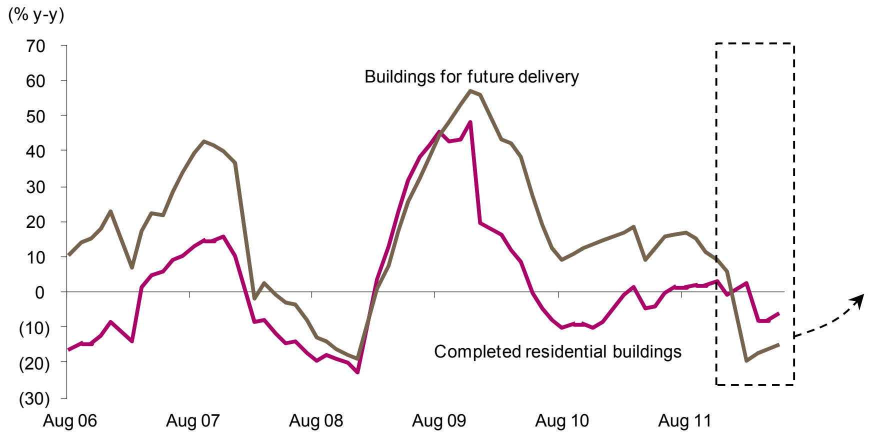
We expect a recovery in 3Q, driven by: 1) monetary easing and economic stimuli; 2) seasonal demand from September; and 3) solid pent-up demand amid growth in incomes.

Chart 90. Residential housing investment trends



Source: Wind

Chart 91. Real-estate inventory trends



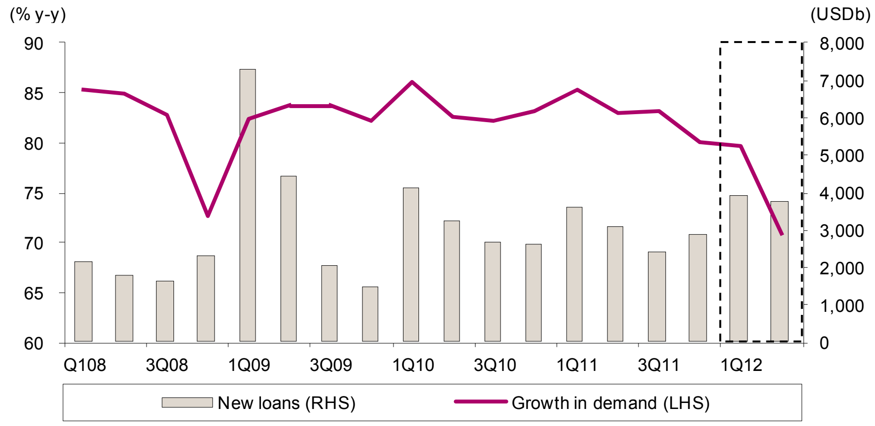
Source: Wind

Market issue 3: Additional stimuli to give impetus to economic rebound

The major point of contention involving government economic policy shifted from size and pace of stimuli (1H) to the effect of such stimuli and timing of an economic rebound (2H). Given that policies that do little for demand are understated, we expect a 2H stimulus package comprising further monetary easing, fiscal spending increases, and consumption-boosting measures (rather than eased lending-limit and real-estate regulations), and foresee impact from 3Q.

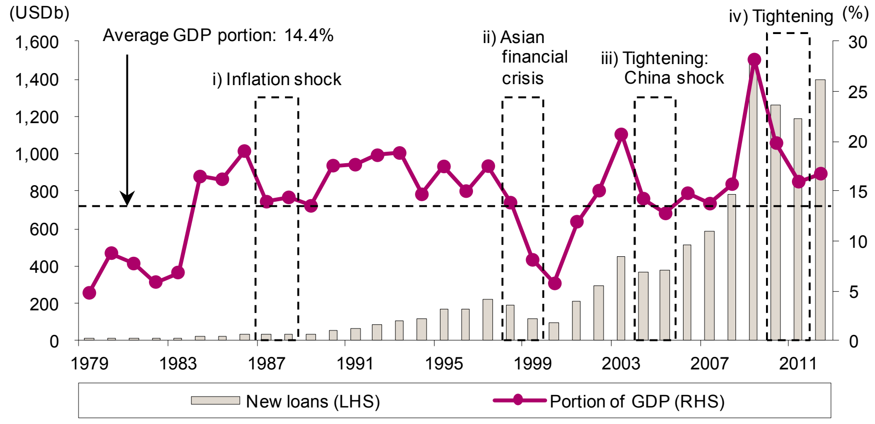
- **Further monetary easing:** China has expanded liquidity supply, starting with a reserve ratio cut in Nov 2011. This and two key rate cuts in June and July this year have begun to form a firewall against economic slowdown. Unless eurozone-related risk ebbs significantly, the country will likely cut its reserve ratio three or four more times and make further key rate cuts. Also noteworthy are new lending and loan-demand trends. In 1H, new lending hit USD760b (10.2% of GDP last year, and the highest figure since 1H09), but loan demand fell below its 2008 level. Looking ahead, we foresee measures to boost loan demand—*eg*, sharper lending-rate cuts and bigger discounts to such rates.

Chart 92. Quarterly new loan trends



Source: Wind

Chart 93. Annual new loans vs portion of GDP



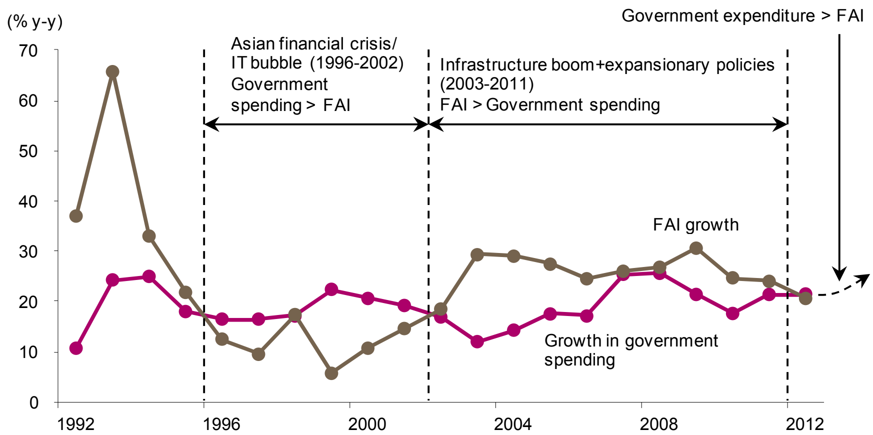
Source: Wind

- **Increases in fiscal spending:** The government is expanding fiscal spending, as it did in 2008. In 1H, it spent more than planned—*ie*, more than the fiscal spending growth target of 11%, decided at a National People's Congress in March.

  To prevent declines in GDP growth, the government remains focused on boosting fixed-asset investment. Fiscal spending should grow in every area, ranging from existing public housing and healthcare projects to new railway, expressway, and alternative-energy projects.

- **Consumption-boosting measures:** The government's fiscal policy will likely be two-pronged, comprising short- and long-term measures. In the near term, these should promote demand and aggressively prevent an economic slowdown by frontloading budgets in infrastructure investment and providing consumption-boosting subsidies—the impact should be felt in 3Q. (Notably, such a policy has not been the preferred choice in the past.) In the long term, the government should bring about structural improvements by shifting the targeted areas of investment from social infrastructure (*eg*, railways, expressways, airports) to soft-consumption sectors such as education, retail, public housing, and healthcare.

Chart 94. Growth in government spending vs FAI investment growth



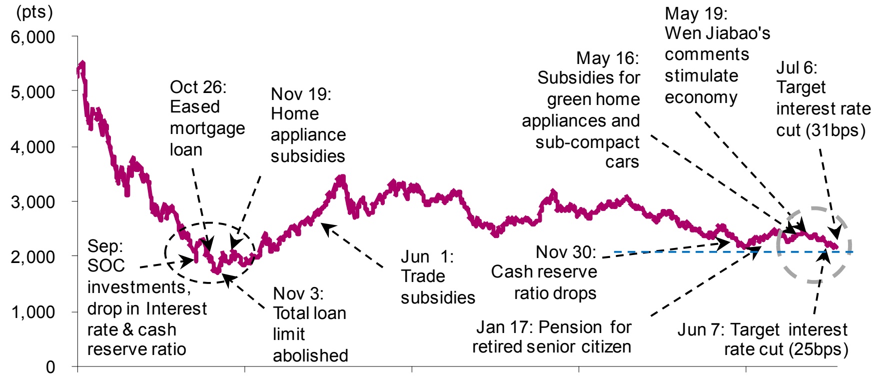
Source: Wind

Three catalysts for China's stock market

Although China's stock market rebound has been derailed since May by the resumption of eurozone tail risk, we expect an inflection point in 3Q, given: 1) the likelihood of economic bottoming in 3Q; 2) expected dissipation of political uncertainty after next month's meeting in Beidaihe; and 3) historically low valuation multiples.

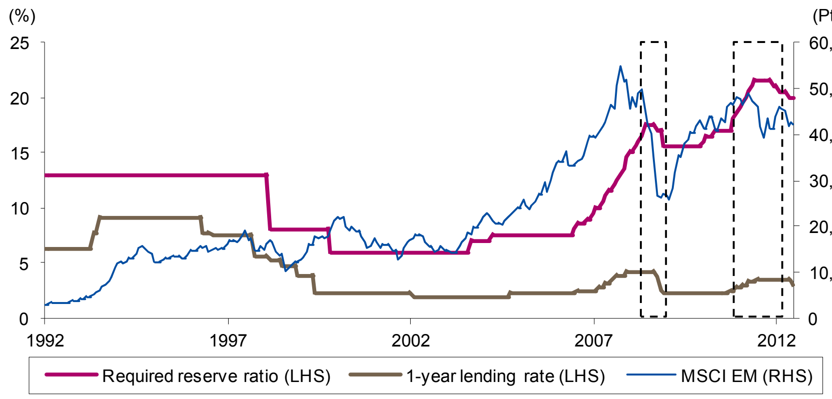
During an economic downturn, it is generally two or three quarters before monetary easing (*eg*, expansion in new lending) has a positive effect. China began expanding supply in 4Q11, so signals of economic recovery should soon emerge. At issue will be the magnitude of such a recovery.

Chart 95. Effect of expansionary policies on Shanghai Composite Index



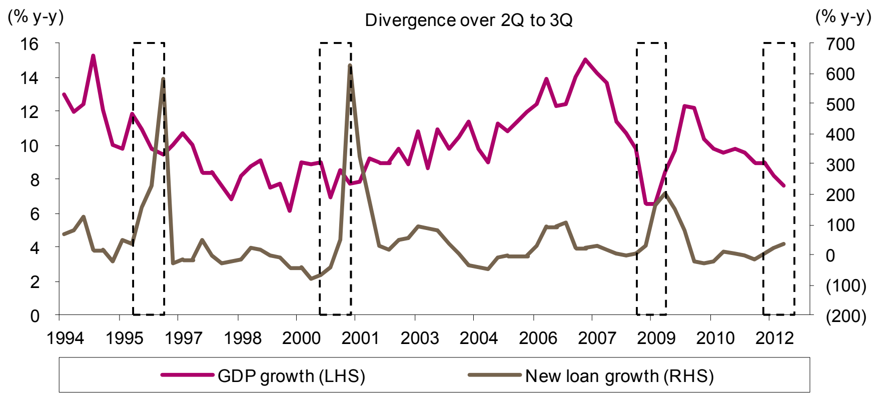
Source: WiseFn, media reports, Samsung Securities

Chart 96. Policy-rate trends vs MSCI EM Index



Source: Bloomberg

Chart 97. China: new loan growth vs GDP growth



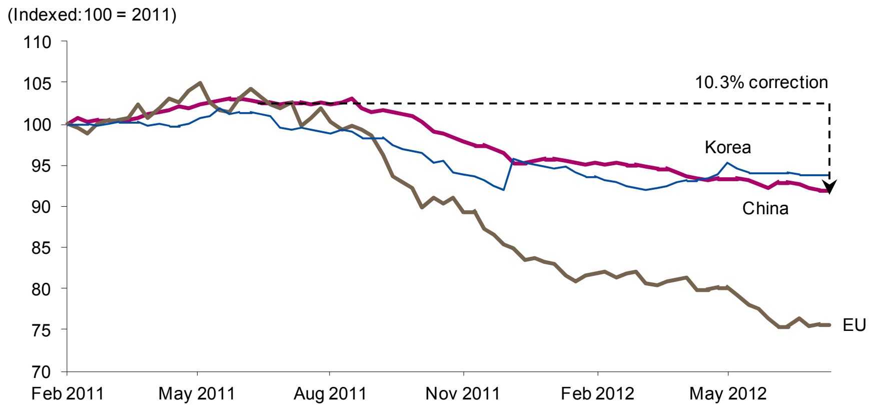
Source: Wind, Samsung Securities

Earnings vs valuation

Of the two major factors affecting share-price movement—namely, earnings and valuations—the former are now putting downward pressure on Chinese shares, while the latter are providing support. A share-price rebound therefore requires an end to cuts in earnings forecasts. This quarter, we expect market attention to shift to valuation attractiveness, given: 1) the prospect of positive macroeconomic improvements; and 2) the fact that downward forecast revisions are approaching completion.

Earnings forecasts for Chinese firms are now 10.3% lower than they were 12 months ago. From a short-term perspective, the revisions can be attributed to: 1) slowing demand following the re-emergence of eurozone tail risk; and 2) declines in fixed-asset investment and consumer sentiment amid a receding real-estate market. However, from a long term perspective, the forecast cuts also stem from a structural problem—supply gluts in multiple industries, caused by aggressive investment since 2000. Earnings forecasts for China's industrial goods and materials (cyclical) sectors have been lowered a respective 19.3% and 15.6%, driving the overall decline in EPS forecasts. That said, the risk of further downside is limited, depending mainly on the degree of economic recovery in 3Q.

Chart 98. EPS trends (MSCI Korea vs MSCI China vs MSCI EU)

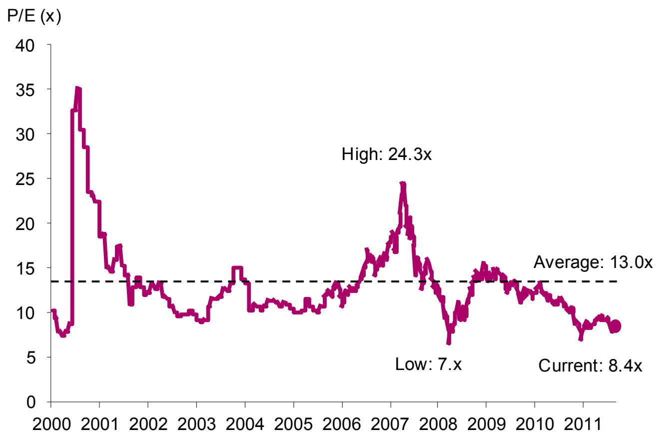


Source: Thomson Reuters

Currently trading at 8.4x P/E and 1.3x P/B, China's stock market is now approaching an all-time low, close to its level during the 2008 financial crisis. From a share-price mean reversion perspective, the most likely outcome will be a 20% rebound from its current level.

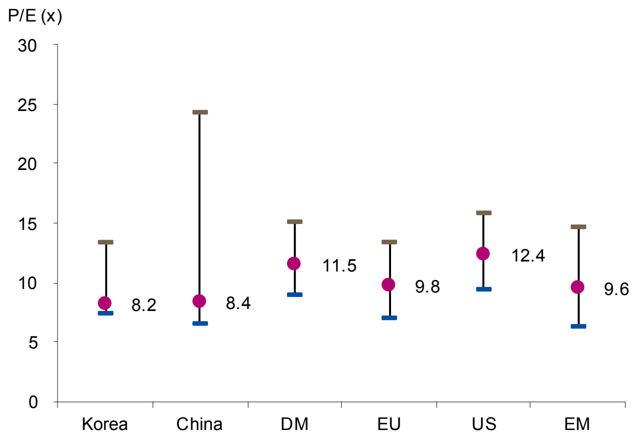
That said, issues remain—such as share overhang (caused by steady supply via rights offerings and IPOs) and earnings volatility—suggesting that valuation reratings are unlikely until the medium-to-long term. For reference, if China's stock market encounters another external shock as severe as the 2008 financial crisis, support would likely come at a level 5-15% lower than the current level.

Chart 99. MSCI China P/E trend



Source: Thomson Reuters

Chart 100. P/E comparison between countries/regions

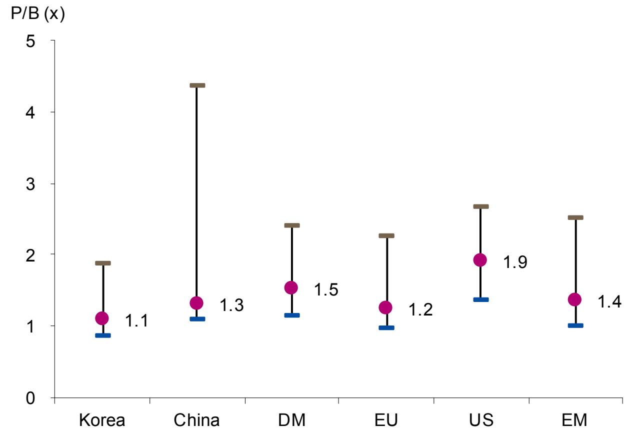


Source: Thomson Reuters

Chart 101. MSCI China: P/B trend

Source: Thomson Reuters

Chart 102. P/B comparison between countries/regions



Source: Thomson Reuters

China-related strategies for investors in Korean firms

Cyclical stocks good for short-term investments: When it comes to investing in Korean stocks, we recommend a bottom fishing strategy in 3Q with focus on oversold cyclicals. Reasons include: 1) the likelihood that such stocks will rebound first when a Kospi bottom is confirmed over July-August; 2) the fact that further economic stimuli in China bode well for Korean stocks sensitive to such policies; and 3) expectations that supply-demand dynamics will soon favor institutional and foreign investors. That said, we have only trading-buy recommendations on Korea's steel, shipbuilding, and chemical sectors, given the prospect of limited ASP hikes in China due to oversupply.

Top-tier domestic-oriented consumption plays better for medium term: Having enjoyed a valuation re-rating since 2008, China's consumption sector should continue to attract investors, given the new leadership's intention to nurture domestic consumption. Looking at Korean firms with solid growth potential—*ie*, where sales should expand faster than the retail sector average of 15%—we like top-tier growth plays and China consumption plays with first-mover advantages. Buy-and-hold strategies on such firms should generate high returns in the medium-to-long term.

Table 19. China's expansionary policies and stock market performances (2008 vs 2012)

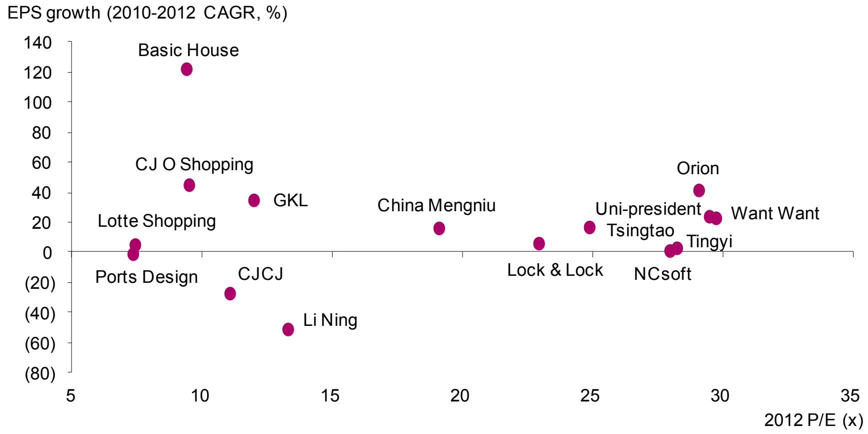
2008	D+5 days	D+20 days	D+3 months	Peak	2012	D+5 days	D+20 days	Current (D+2 months)
MSCI Korea	(11.9)	(2.5)	2.4	32.5	MSCI China	(1.2)	(0.1)	(2.6)
Energy	(17.1)	(10.0)	0.3	29.9	Energy	(1.1)	0.0	(2.6)
Materials	(16.6)	15.4	46.2	62.4	Materials	0.5	3.9	(4.4)
Industry	(17.8)	(0.9)	4.3	32.5	Industry	2.2	2.4	0.8
Consumer discretionary	(14.5)	(15.0)	(8.2)	46.2	Consumer discretionary	(2.0)	(2.0)	(8.5)
Consumer staples	(7.8)	11.6	17.9	3.9	Consumer staples	2.0	(1.2)	(3.2)
Financials	(4.8)	(12.1)	(8.5)	33.9	Financials	(5.6)	(1.9)	7.3
IT	(4.8)	2.7	2.0	39.7	IT	(3.2)	3.2	(2.5)
Telecom	(11.6)	2.7	9.4	0.2	Telecom	(2.9)	(5.6)	(1.5)
Utilities	(11.9)	(2.5)	2.4	20.6	Utilities	(1.2)	(0.1)	(2.6)

Note: 2008 package from Oct 22, 2008 to Aug 3, 2009; 2012 package from May 16, 2012
Source: Bloomberg, Samsung Securities

Chart 103. Performance of related Korean stocks (China consumption plays & cyclicals)

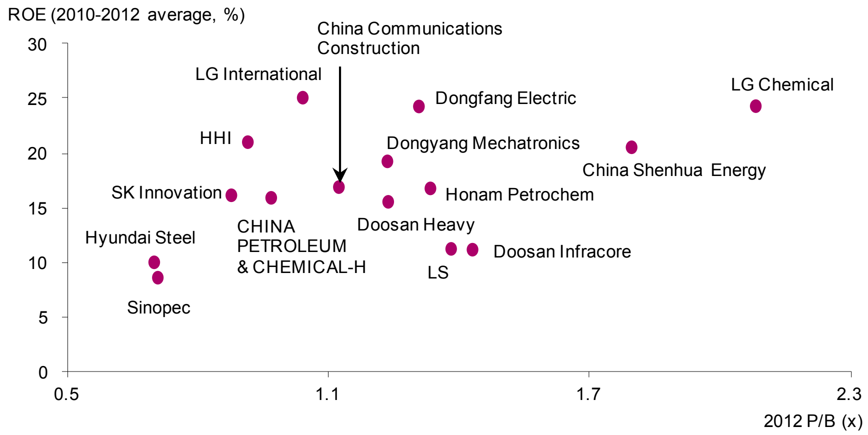
Note: China consumption plays: Hyundai Motor, Orion, Lock & Lock, CJ O Shopping, Amorepacific
Cyclicals: LG Chem, Honam Petrochem, SK Innovation, Doosan Infracore, Posco
Source: KRX, Samsung Securities

Chart 104. Valuations: Korean china-related plays vs Chinese retail firms



Note: As of Jul 20
Source: Bloomberg Consensus, WiseFn

Chart 105. Valuation comparison: Korean industrials/materials firms vs Chinese peers



Note: As of Jul 20
Source: Bloomberg Consensus, WiseFn

Table 20. Preferred China-related Korean stocks

Code	Stocks	Rating	Market cap	Close (KRW)		Upside	2012E P/E	2012E P/B	2012E ROE	2012E D/Y	Performance (%)*		
			(KRWt)	Current	Target price	(%)	(x)	(x)	(%)	(%)	1mo	3mo	12mo
Consumption related: Top-tier growth plays													
A005380	Hyundai Motor	BUY	49.1	223,000	298,000	33.6	7.2	1.4	21.1	0.8	(9.9)	(3.4)	10.0
A081660	Fila Korea	BUY	0.7	69,800	106,000	51.9	6.1	1.6	30.3	0.4	(8.3)	(8.1)	(10.5)
A035760	CJ O Shopping	BUY	1.2	188,300	267,000	41.8	12.5	2.7	24.1	0.7	11.4	7.8	(19.2)
A001800	Orion	BUY	5.3	885,000	1,080,000	22.0	17.7	4.8	18.2	0.3	(8.1)	11.7	78.8
A115390	Lock & Lock	Not rated	1.9	34,550	n/a	n/a	23.0	3.0	13.8	0.5	5.0	26.9	(10.6)
Industrials/materials firms: Bottom-fishing strategy													
A051910	LG Chem	BUY	20.9	315,000	355,000	12.7	12.9	2.2	16.1	1.3	9.3	8.6	(20.9)
A042670	Doosan Infracore	Not rated	3.0	17,550	n/a	n/a	11.5	1.4	12.9	0.0	(7.1)	(1.7)	(16.2)
A013570	Dongyang Mechatronics	Not rated	0.4	12,800	n/a	n/a	11.5	1.5	14.2	1.6	(4.1)	3.2	(20.7)

Note: As of Jul 20; valuations for Lock & Lock, Doosan Infracore, Dongyang Mechatronics are consensus estimates
* Relative to Kospi
Source: KRX, WiseFN, Samsung Securities

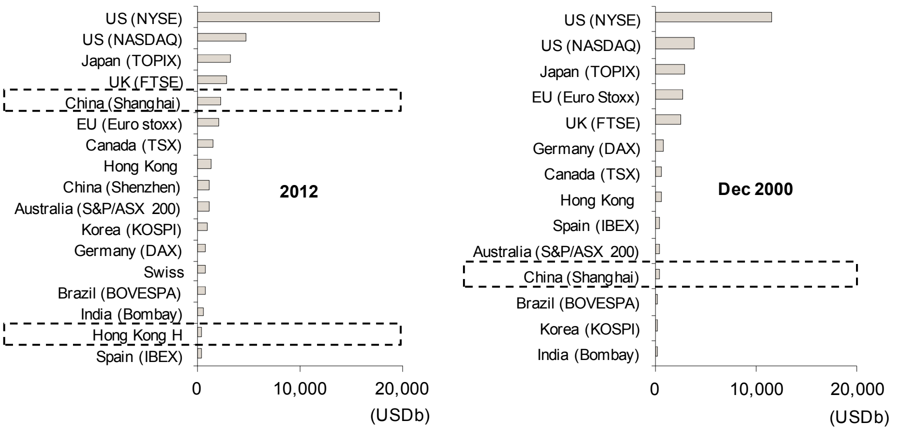
Long-term prospects for China's stock market

From a long-term perspective, the Chinese stock market is unlikely to see structural improvement for some time. In the meantime, we foresee repeated boom-bust cycles—a typical pattern seen in developed countries and Korea during phases of industry expansion. In our view, the Shanghai Composite Index will move between 2,000 and 6,000 over the next five-to-ten years.

World's fifth-largest market

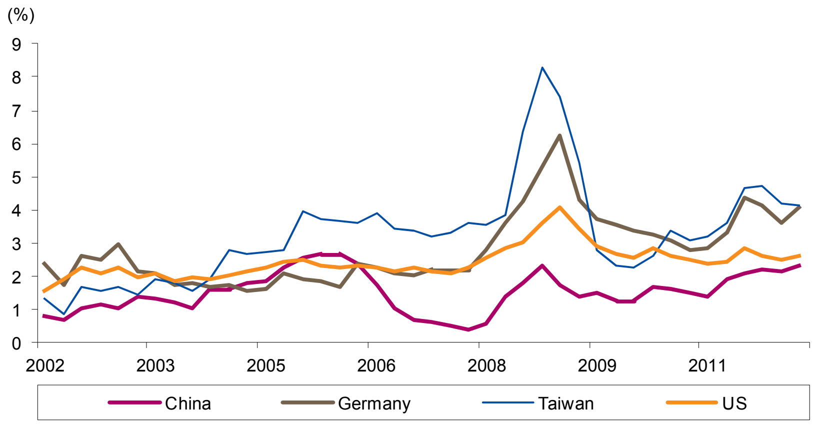
Although it has suffered its largest correction since 2008, China's stock market is showing quantitative growth. As an example, the Shanghai Composite Index has plunged to a third of its 2007 peak, yet with a market cap of USD230b now ranks fifth in the world—albeit partly due to poor performances of developed stock markets. Despite brisk economic and quantitative expansion, the Chinese market is not providing investors with solid returns, for three reasons: 1) IPOs and rights offerings have eroded shareholder value; 2) intense competition has driven down ROE; and 3) the market has become more sensitive to economic cycles in other countries.

Chart 106. Chinese stock market moves up to world's fifth largest (by market cap)



Source: Bloomberg

Chart 107. Dividend yield comparison



Source: Bloomberg

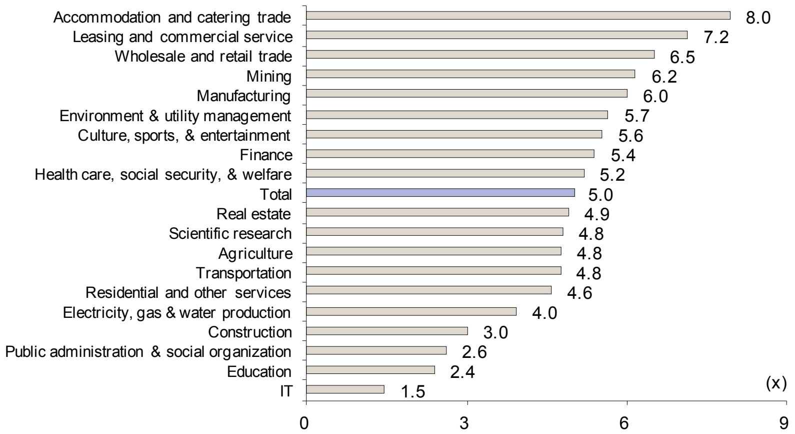
Three challenges ahead

China faces three major challenges in coming years.

- First, the country needs to address overcapacity issues across multiple industries. Its liberalization of state-owned and public firms since 1990 enhanced industrial competitiveness and efficiency, but at the same time set the scene for oversupply problems. To make matters worse, aggressive investments by provincial governments resulted in overcapacity, not only in labor-intensive sectors but also in the capital goods and retail industries. Such a trend is common before top-tier firms start dominating sectors amid rapid economic expansion. During the interim period of heavy investment, companies cannot return portions of their earnings to shareholders (*ie*, high-risk, low-return).

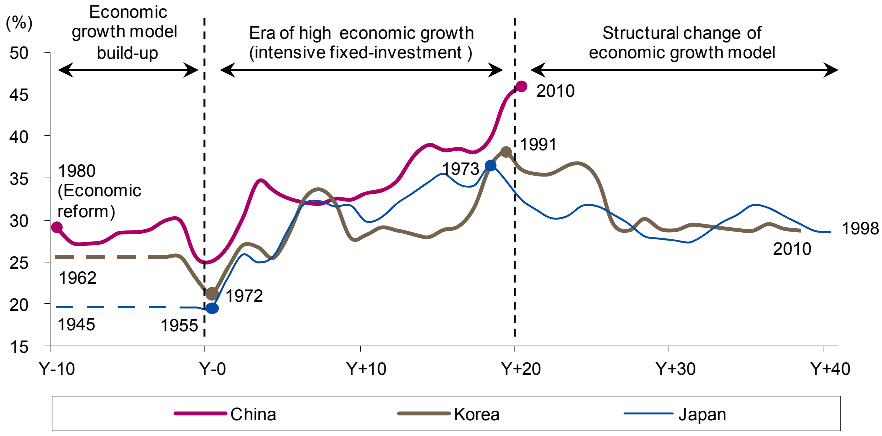
  That said, China is fortunate in that its fixed-asset-to-GDP ratio is about to peak out, suggesting that growth momentum will soon be driven by consumption and capital market investment. Stock markets in Korea and Japan notably generated very attractive investment returns when consumption expanded at the expense of fixed-asset-to-GDP ratios.

Chart 108. China's growth in fixed-asset investment, by sector (between 2003 and 2010)



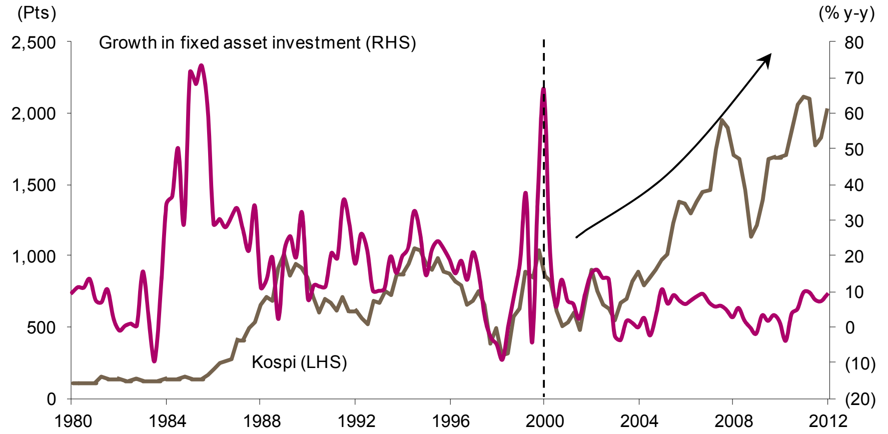
Source: CEIC, Samsung Securities

Chart 109. Fixed-asset-to-GDP ratio trends: China vs Korea vs Japan



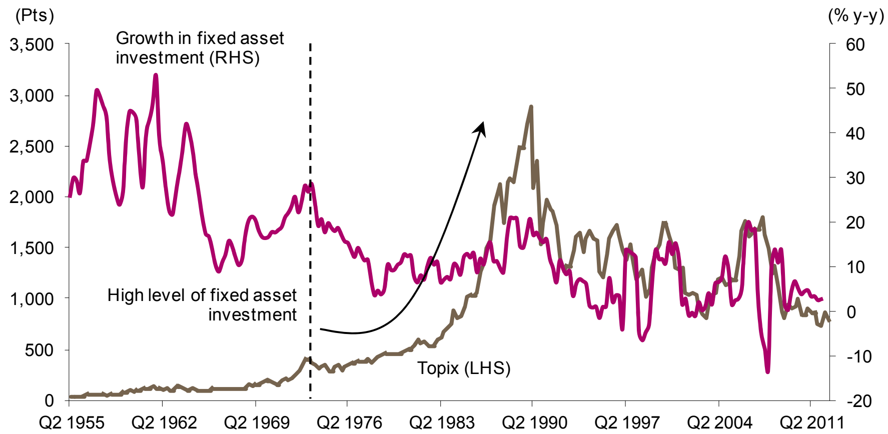
Source: CEIC, UN (2011), Samsung Securities

Chart 110. Korea: Growth in fixed-asset investment vs stock market performance



Source: Bloomberg

Chart 111. Japan: Growth in fixed-asset investment vs stock market performance



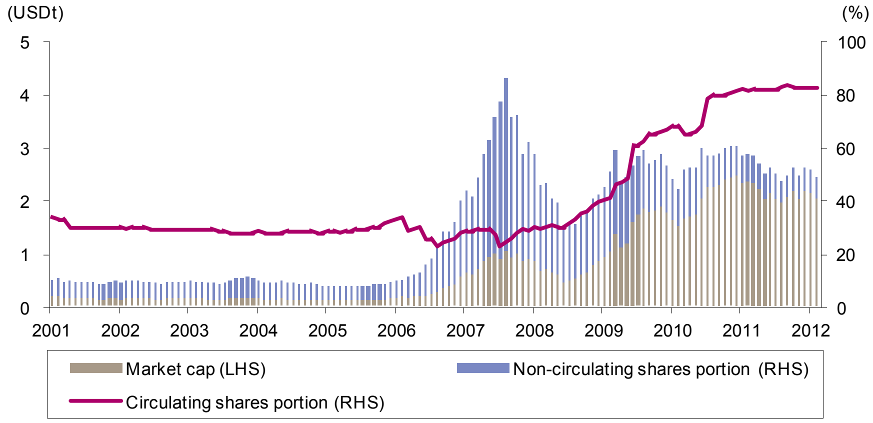
Source: Bloomberg

- Second, China needs to ease supply-demand imbalances in equities. Such demand fluctuates considerably, being dependent on the economic cycle, whereas supply has increased steadily—another trend common in developing countries when the major source of corporate funding shifts toward the secondary market.

  China's ongoing reforms to convert non-floating shares to floating ones have also been burdensome, weighing on the stock market since 2005. The Shanghai Composite Index, for example, has slid to only a third of its 2007 peak, yet the market cap of floating stocks is now 97% higher. On the flipside, the proportion of floating stocks has climbed to 82%.

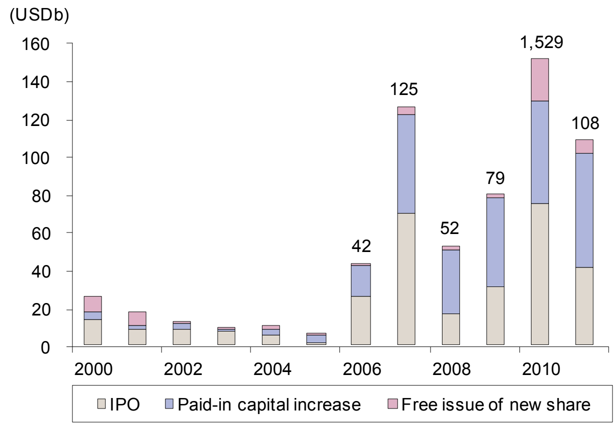
  When a country has a mature capital market, its market cap ultimately converges with GDP when most major firms are listed—their net profits represent most of a nation's economy. Since China's market cap is only 46.4% of GDP, IPOs and rights offering are likely to keep weighing on its stock market for the next ten years.

Chart 112. Shanghai Composite Index: Proportions of floating and non-floating shares



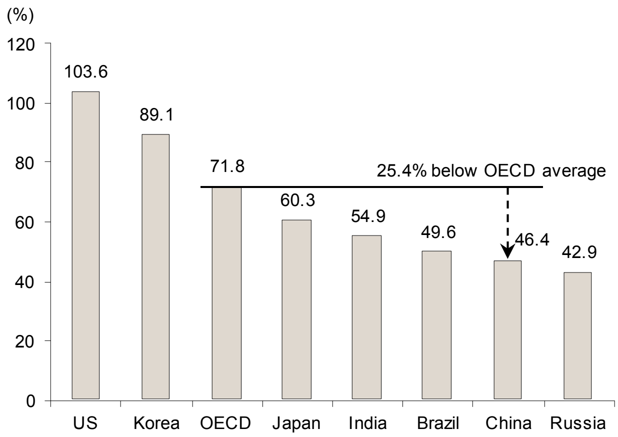
Source: Bloomberg

Chart 113. China's growth in paid-in capital vs IPO market



Source: Wind

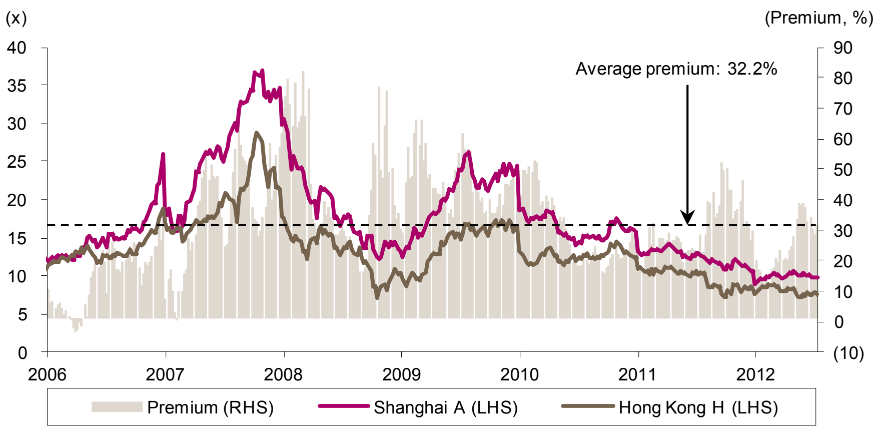
Chart 114. Market caps as % of GDP, by country/index



Source: World Bank

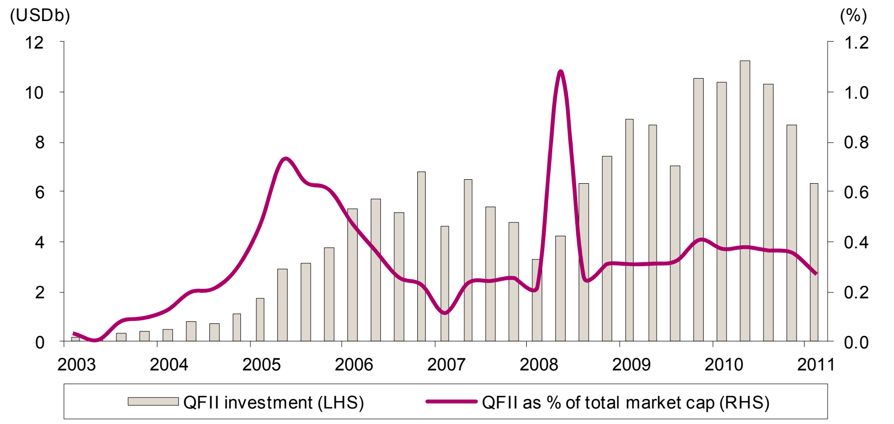
- Third, China needs to make its stock market more open. It is therefore positive that the country's new leadership seems focused on financial market liberalization. Until now, overseas investors have been allowed only limited access, so the market has received excessive premiums despite a lack of transparency and lax accounting standards. The Shanghai Composite Index this month has had an average premium of 32.2% to H-shares, with stocks trading at 17.8% premiums to identical ones in the latter index. Such premiums, however, should disappear as the market opens more to foreign investment.

Chart 115. Valuation comparison: Shanghai A shares vs Hong Kong H shares



Source: Bloomberg

Chart 116. QFII investment trends



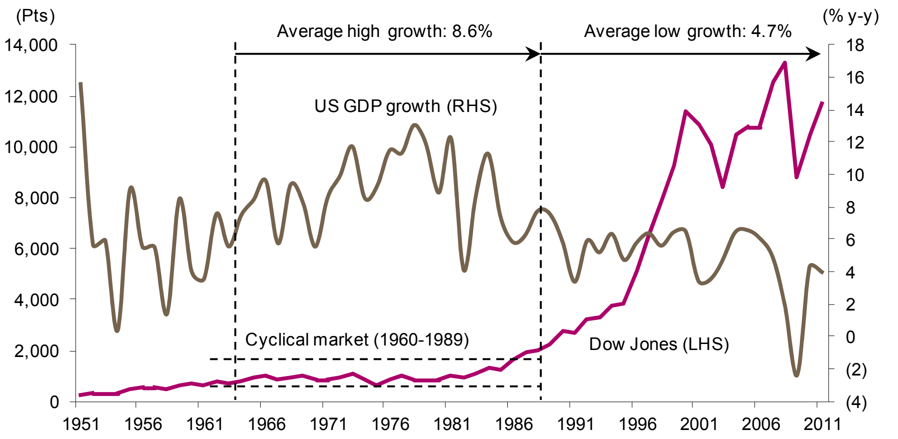
Source: Bloomberg

Stock market prospects and opportunities

China's stock market is set to experience repeated boom-bust cycles over the next few years, but investors should be able to profit (depending on the economic cycle) as share prices are now close to historical lows. Also positive, the country's capital market should gain in maturity as economic growth loses steam. We foresee many opportunities during future stock market fluctuations, and expect two investment strategies to be effective: 1) a short-term trading-buy approach based on economic and earnings cycles; and 2) attention to longer-term investment themes, such as top-tier consolidation amid industry restructuring—large dominant firms should come to the fore when over-investment eases.

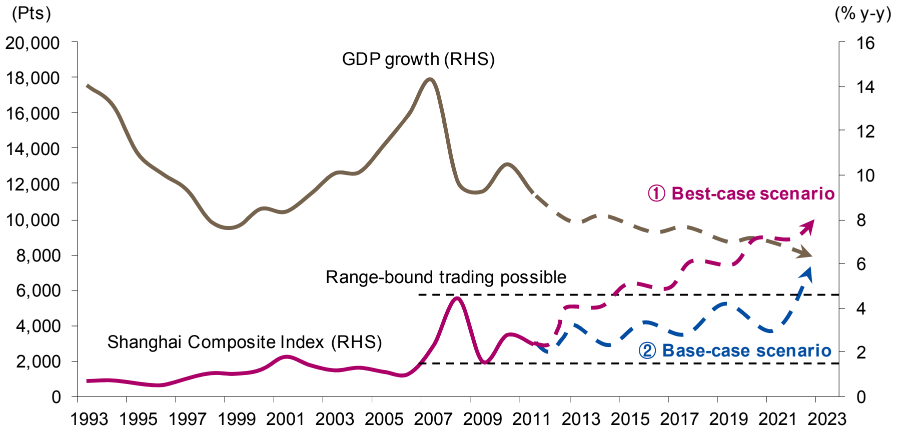
In sum, the long-term prospects for China's stock market boil down to quantitative expansion and improvement in fundamentals. The best-case scenario, one involving rapid liberalization of China's capital market, would lay the foundation for a re-rating of the country's stock market over the next ten years. As mentioned earlier, a country's market cap and GDP usually move in tandem. If China can overcome its middle-income trap issue and succeed in liberalizing its capital market, it may be able to move from its world-number-two position in GDP terms to the number-one slot.

Chart 117. US stock market vs GDP growth



Source: Bloomberg

Chart 118. Chinese stock market vs GDP growth



Source: Bloomberg

In the best-case scenario for China, its market cap would reach USD16t by 2020 (6.8 times what it is now) and the Shanghai Composite Index would reach 8,200—growth in the latter would be slower as it reflects certain dilution factors (*eg*, IPOs) and the Shenzhen Composite Index.

Chart 119. China's GDP vs market cap

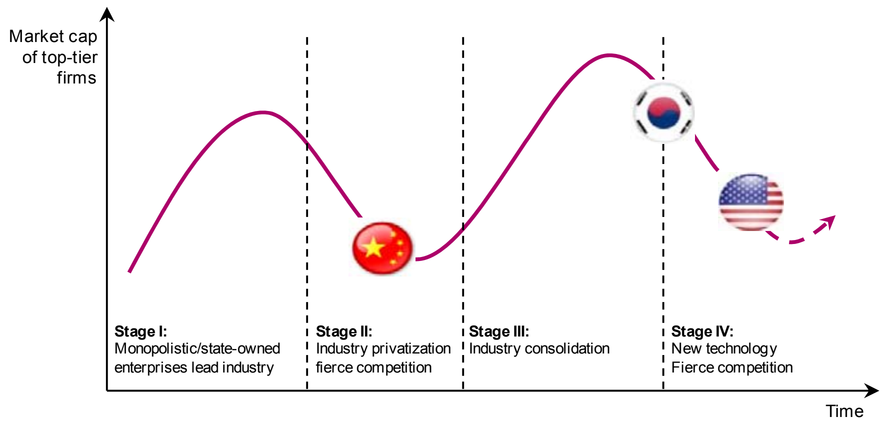
Source: IMF, Samsung Securities

Top-tier groups poised to start trending upward

Although monopolistic or state-owned companies tend to dominate their markets during the first stage of industrialization, liberalization and free competition emerges in the second stage, resulting in cutthroat competition and industry consolidation. As a result, dominant players are challenged by the advent of new technologies and the entrance of late-starters.

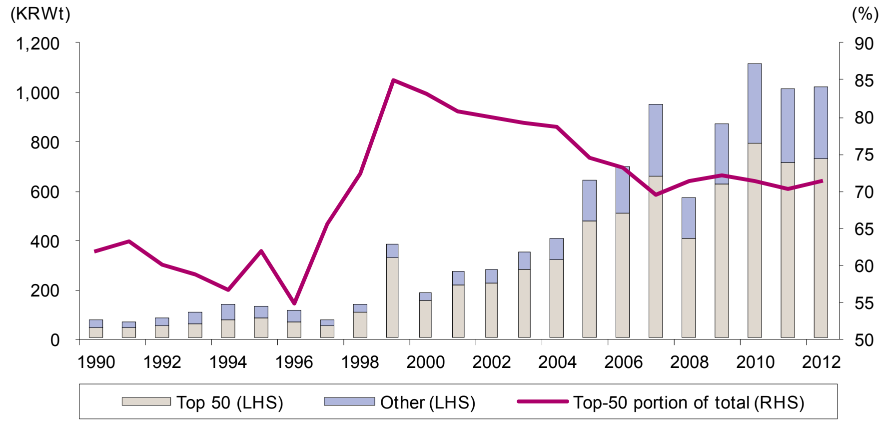
China is now entering the second stage, in which top-tier players enjoy a winners-take-all situation—Korea was at a similar stage in the 1990s. With the exception of some sectors, China's industries show high levels of competition, a good example being its beer market, in which four major players have more than doubled their combined share over the past ten years.

Chart 120. Top tier firms' market cap cycles: China vs Korea vs USA



Source: Samsung Securities

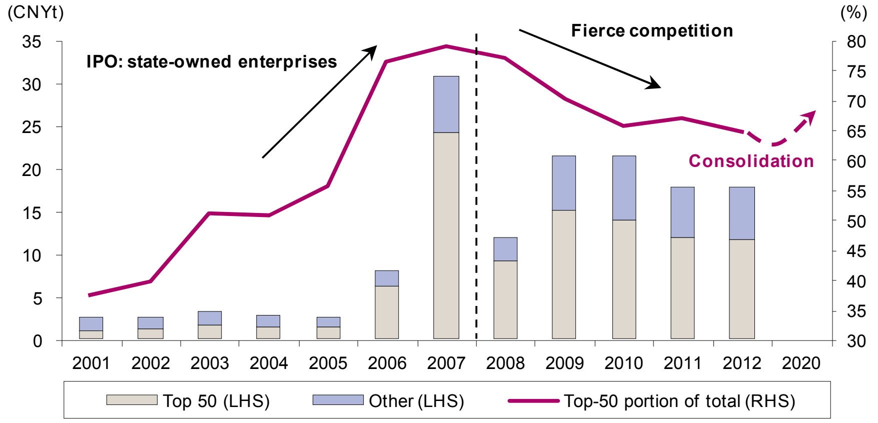
Chart 121. Korean top-tier firms' market cap trends



Source: Bloomberg, Samsung Securities estimates

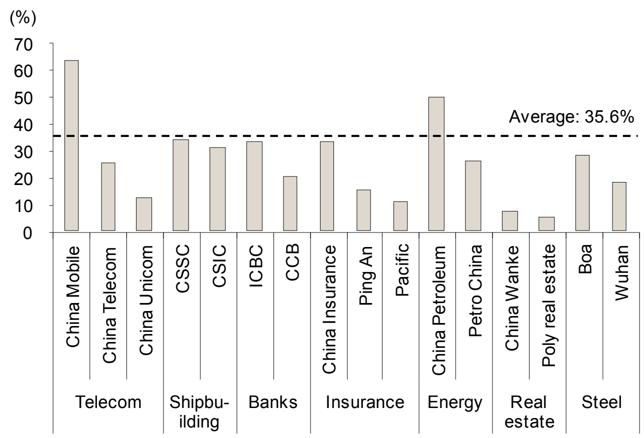
Industry restructuring and consolidation are key words in China's stock market—competition is stabilizing, distribution networks are being established nationwide, and Chinese consumers are becoming increasingly discerning with easier access to information on trends. Share-price re-rating opportunities should emerge not only for investors in Chinese firms but also for those eyeing Korean players that are set to become top-tier players in China. Good examples of such firms are Samsung Electronics, Hyundai Motor, Hankook Tire, Orion, Lock & Lock, CJ O Shopping, and Fila Korea.

Chart 122. Chinese top tier firms' market cap trends



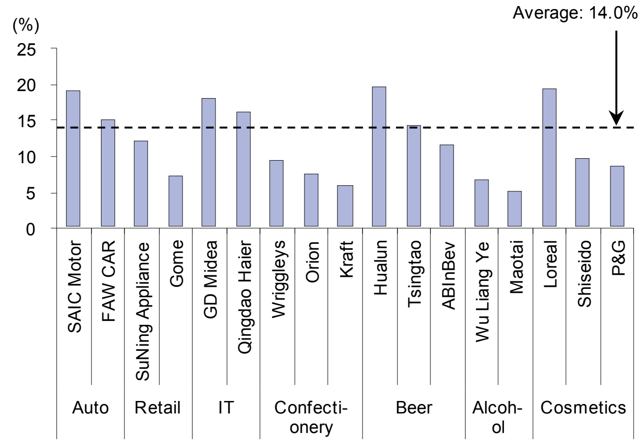
Source: Bloomberg, Samsung Securities estimates

Chart 123. Market caps of Chinese top tier firms, by sector



Source: Wind

Chart 124. Market caps of Chinese top-tier firms, by sector



Source: DCC

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