3 January 2011

China: Themes and Strategy for 2011

From Inflation to Disinflation

Strategy

Inflation will likely be the most important macro driver for market performance in 2011. High inflation in 1H tends to depress the market as it generates fear and uncertainty over policy tightening. An easing of inflation near the middle of the year should justify a market rerating. The key risk to this outlook is government failure to implement aggressive anti-inflation measures at the beginning of the year.

We are overweight in sectors that benefit from major structural changes. These beneficiaries include 2nd- and 3rd-tier city developers, tourism, IT services, property agencies, equipment, new energy and cement, as well as local retailers and banks with major exposure to inland growth.

Jun Ma, Ph.D
Chief Economist
(+852) 2203 8308
jun.ma@db.com

Wenjie Lu
Research Analyst
(+852) 2203 6187
wenjie.lu@db.com

Hui Miao, Ph.D
Strategist
(+852) 2203 5934
hui.miao@db.com

Deutsche Bank AG/Hong Kong

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Deutsche Bank

3 January 2011

China Macro Strategy

2011 Themes and Strategy

From Inflation to Disinflation

15% upside to MSCI China in 2011
Our end-2011 MSCI China index target implies a 15% upside in the coming 12 months. This based on our expectation of 15% EPS growth in 2011 and unchanged market valuation at the year-end.

1H inflation and 2H disinflation should drive market dynamics
The inflation trajectory in 2011 will likely be the most important macro driver for market performance. We raise our annual CPI inflation forecast to 4.4% from 4.1%, and our policy rate expectation to another three hikes totaling 75bps. We expect inflation to stay uncomfortably high during most of 1H (to peak at 5.5%yoy in 2Q), but it will likely decline towards 3-4% in 2H. High inflation in 1H tends to depress the market as it generates fear and uncertainty over policy tightening. An easing of inflation near the middle of the year should justify a market rerating as policy uncertainties are removed. Key risks to this outlook include government failure to tighten policy aggressively at the beginning of the year, worsening weather conditions, a surge in global commodity prices, and an increase in money velocity.

Sector rotation on change in inflation profile
Our sector preference for the year should change according to the inflation profile. During periods in 1H when inflation remains high and even rises, we will prefer sectors that are less vulnerable to credit tightening, rate hikes and price intervention. In particular, we prefer large banks, insurance, commercial properties, retailing, equipment, IT services and tourism. We will be cautious on IPPs, coal, smaller banks, oil and gas, and highly leveraged developers. When inflation begins to abate, which we expect to start in the middle of 2011, the victims of inflation should begin to outperform the market.

Sector strategy for the year as a whole
For the year as a whole, we are overweight in sectors that should benefit from major structural changes. These beneficiaries include 2nd- and 3rd-tier city developers, tourism, IT services, property agencies, equipment, new energy and cement, as well as local retailers and banks with major exposure to inland growth.

Six structural themes
We highlight six major structural themes: 1) financial reforms will likely depress the EPS growth of mid-sized banks; 2) the public housing program, which will likely grow more than 100% in 2011, should support cement, but challenge developers in the mid-end market; 3) the equipment sector will likely outperform the rest of manufacturing; 4) services will likely outperform manufacturing; 5) smart grid equipment, wastewater treatment and waste recycling will likely present growth opportunities arising from the government's effort to promote energy saving and environmental protection; and 6)

Top Ten Buys

Company	Ticker	Rating	PE 2011	EPS CAGR 10-12
ABC	1288.HK	Buy	9.2	25%
Evergrande	3333.HK	Buy	6.5	25%
CRE	0291.HK	Buy	28.7	32%
CSR	1766.HK	Buy	25.1	37%
China Ship Dev	1138.HK	Buy	9.8	48%
Shangri-La Asia	0069.HK	Buy	26.0	40%
Soufun	SFUN.N	Buy	17.1	40%
Geely Auto	0175.HK	Buy	13.1	23%
ZTE	0763.HK	Buy	20.2	19%
Longyuan Power	0916.HK	Buy	16.7	48%
Average			17.2	34%
MSCI China			11.8	15%

Jun Ma, Ph.D
Chief Economist
(+852) 2203 8308
jun.ma@db.com

Wenjie Lu
Research Analyst
(+852) 2203 6187
wenjie.lu@db.com

Hui Miao, Ph.D
Strategist
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2011 economic outlook

Modest deceleration of GDP growth in 2011

We expect GDP growth to slow from 10% in 2010 to 8.7% in 2011. Figure 1 shows our forecasts of annual average growth rates for GDP, its components (in real terms) and various other economic indicators.

The major contributor to the deceleration of GDP growth is export slowdown. Measured in US dollar terms, we expect nominal export growth to slow to 15% in 2011 from around 31% in 2010. In constant local currency terms, China's total export growth will likely decelerate to 12% in 2011 from 22% in 2010.

Figure 1: China macroeconomic forecasts

yoy %	2009	2010F	2011F	2012F
Real GDP (yoy%)	9.1	10.0	8.7	8.4
o/w: Private consumption (real)	10.8	9.0	9.0	8.8
Govt consumption (real)	7.1	8.0	9.0	8.5
Gross capital formation (real)	20.2	11.2	9.5	8.5
Exports (real)	-10.8	20.0	12.0	12.0
Imports (real)	-0.9	23.0	14.0	13.0
Fixed asset investment (nominal)	30.1	23.0	20.0	17.0
Retail sales (nominal)	15.5	18.0	17.5	16.5
Industrial production (real)	11.0	13.7	12.0	11.0
Exports (nominal)	-16.0	31.0	15.0	14.0
Imports (nominal)	-11.2	37.4	16.5	15.0
Loan growth (nominal, eop)	31.7	20.0	16.0	14.5
CPI	-0.7	3.3	4.4	3.5
1-Yr lending rate (%, eop)	5.31	5.81	6.56	6.56
1-Yr deposite rate (%, eop)	2.25	2.75	3.50	3.50
RMB/USD (eop)	6.83	6.63	6.30	6.08

Source: Deutsche Bank, CEIC

The main reasons (which are not necessarily mutually exclusive) for export deceleration are as follows:

1) A less favorable base effect: In 2009, China's exports were down 16%, which created favorable support for yoy growth in 2010. In 2011, this benefit will no longer exist;

2) Decelerating global growth, especially in Europe and Japan: Our top-down global view is that growth peaked in the first half of 2010 and will lose some momentum in the course of the second half and into 2011 on the back of fading credit and fiscal impulses, along with rising stress in the financial market. Our global forecast for GDP growth is that it could slow to 3.9% in 2011 from 4.7% in 2010. Among the G3, the relatively more significant deceleration will come from Europe (from 1.7% in 2010 to 1.2% in 2011) and Japan (from 3.4% in 2010 to 0.1% in 2011); and

3) A rapid increase in wage rates in China: From the middle of 2010, China witnessed a wave of rapid minimum-wage increases (by about 24% yoy in 2H), which will likely impact 2011 export competitiveness in the labor-intensive manufacturing sector more visibly than in 2010.

We expect fixed-asset investment to decelerate modestly to 20% in 2011 from 23% in 2011: The following factors should explain this modest slowdown in FAI growth.

First, the second-round property-cooling measures introduced since October will likely lead to a further decline in property transactions, and the surge in property supply in the coming

quarters (reflecting the 100% yoy rise in real estate completions in recent months) should reinforce this trend (as potential buyers tend to hold off their purchases on the expectation of oversupply). This will eventually lead to a slowdown in real estate FAI by developers.

Second, new FAI project starts have decelerated steadily to around 20% yoy in recent months, down from 50% yoy at the beginning of 2010. In particular, banks are instructed to strictly control their lending to projects sponsored by local financial vehicles. This will likely result in a major deceleration in infrastructure FAI growth.

Third, although public housing investment will likely rise 100% in 2011, due to its limited size as a percentage of total FAI, it would not be able to offset the likely slowdown in overall FAI.

Figure 2: Fixed-asset investment growth forecasts

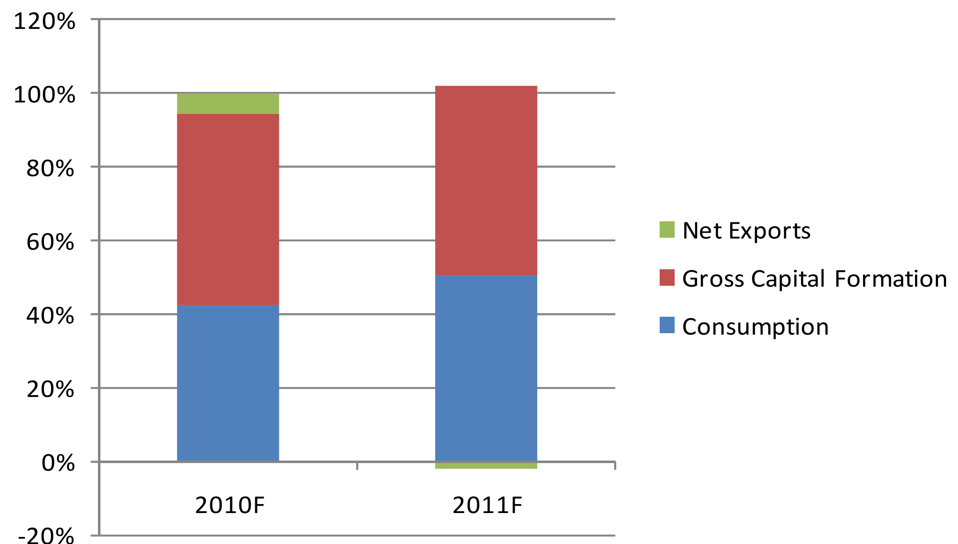
	2011 Weight (%)	2008	2009	2010F	2011F
			yoy% growth		
Total FAI		26%	30%	23%	20%
Real estate	*24.2%*	25%	22%	31%	25%
By developers	*15.2%*	20%	18%	35%	20%
Govt investment in policy housing	*2.0%*	56%	45%	79%	120%
Rural and other housing	*7.0%*	33%	23%	30%	20%
Agriculture	*2.9%*	49%	36%	18%	18%
Mining	*4.1%*	31%	20%	20%	22%
Manufacturing	*34.1%*	27%	25%	25%	25%
Infrastructure	*10.4%*	20%	47%	24%	12%
Railways	*3.2%*	90%	68%	27%	17%
Roads	*4.6%*	2%	40%	22%	8%
Waterways	*0.7%*	6%	38%	20%	15%
Subway	*0.7%*	21%	60%	5%	10%
Air transport	*0.4%*	-2%	3%	50%	30%
Others	*0.9%*	37%	48%	23%	12%
Utilities	*5.4%*	16%	31%	10%	12%
Power grids	*1.0%*	18%	21%	-21%	5%
Others	*4.4%*	16%	36%	22%	14%
Pulblic services	*11.0%*	29%	47%	13%	12%
Others	*7.9%*	26%	33%	25%	15%

*Source: Deutsche Bank, CEIC. *public service includes environment, science, healthcare, education and culture*

Consumption growth should remain steady: We expect retail sales growth to continue at around 17.5% in 2011, in line with 2010. This is partly supported by rising CPI inflation, which we expect to accelerate by 1.1ppt to reach 4.4% in 2011. In terms of real retail sales growth, it implies a modest deceleration by about 1.5ppt. Within the major categories, we believe food consumption (in nominal terms) will accelerate as average yoy food inflation will be most significant, while auto sales growth will likely slow the most. We expect auto sales growth to slow to 15% in 2011 from more than 30% in 2010 as the tax incentive (purchase tax reduction) and the government subsidies for rural sales and trade-in policies are phased out from the beginning of 2011. The likely fall in property purchases may also negatively affect demand for automobiles (as fewer new parking lots would be purchased).

Consumption should play a bigger role in GDP growth. For 2011, consumption will likely increase its contribution to GDP growth to slightly more than 50% (up from 43% in 2010). This increase in significance in consumption should largely offset the decline in contribution of net exports to GDP growth. This trend is consistent with the desired structural change that is promoted by various government policies (see the last section of this chapter).

Figure 3: Contribution to GDP growth, 2010-11 (%)



Source: Deutsche Bank estimates.

Sequential deceleration in GDP growth from 2Q 2011

As for the quarterly profile of GDP growth, the trajectory of yoy GDP growth and qoq (saar) GDP growth rates will likely look very different in the coming quarters. On a qoq basis, we expect growth to remain robust in 4Q 2010 and 1Q 2011 before decelerating in 2Q 2011. For 4Q 2010 and 1Q 2011, we expect sequential growth to remain in the neighborhood of 9.5%, driven by the following factors.

First, a rapid increase in prices and the expectation of further price inflation tend to generate excessive demand for goods. This has been evident in the recent PMI reports, which showed that the sectors that experienced the biggest increases in prices are seeing the strongest increases in new orders.

Second, after the Party Congress, the pressure on local governments to implement mandatory power cuts to enforce energy-intensity targets has diminished. In fact, the government announced on 1 December that its energy-intensity target for 2010 had already been achieved, hinting that there would no longer be a need for power cuts.

However, we do not think the relatively fast pace of qoq growth will be sustained beyond 2Q 2011. The December PMI report, which was published on 1 January 2011, showed that the growth of new orders for raw materials has begun to decelerate. From 2Q, we expect sequential GDP growth to slow towards 8.5%. This trend should reflect the following forthcoming changes:

1) The acceleration in inflation is forcing the government to tighten monetary conditions via raising interest rates (the PBOC has raised rates by 50bps in the past two months, and we expect 75bps in 2011) and credit control (a deceleration of loan growth by about 4ppts in 2011). The contractionary impact of these policies on the real economy will likely become visible from the middle of next year. Based on last 30 years' data, we estimate that a 4ppt decline in loan growth tends to slow real GDP growth by 0.8ppt.

2) The rise in global commodities prices and its initial positive impact on demand (as reflected in new orders on the expectation of further inflation) will likely diminish by the middle of 2011, as QE2 ends.

3) The property-tightening measures already implemented will likely begin to slow property FAI a few months later.

4) As mentioned earlier, auto demand growth will likely decelerate by as much as 15-20ppts next year. Given that the auto sector output accounts for about 3.8% of GDP, the auto demand deceleration alone will likely translate into a 0.6ppt fall in GDP growth.

On a yoy basis, the GDP growth trajectory will likely show steady deceleration throughout the next five quarters. The deceleration in 4Q 2010 and 1Q 2011 mainly reflects the base effect, while the deceleration afterwards reflects the slowdown in sequential growth, as discussed above. As a result, we expect yoy growth to trend towards 8.5% in 4Q 2011, down from 9.6% in 3Q 2010.

Figure 4: Yoy and qoq annualized GDP growth forecasts

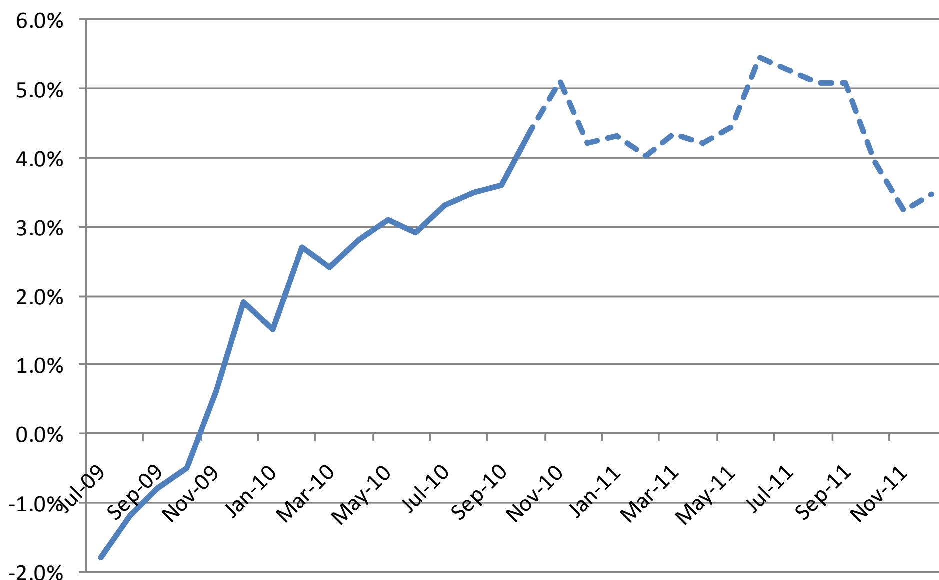
GDP	yoy%	qoq%, saar
2010Q1	11.9%	9.6%
2010Q2	10.3%	8.2%
2010Q3	9.6%	9.4%
2010Q4F	9.1%	9.4%
2011Q1F	9.0%	9.1%
2011Q2F	9.1%	8.4%
2011Q3F	8.8%	8.3%
2011Q4F	8.5%	8.2%

Source: Deutsche Bank, CEIC.

CPI inflation will likely reach 5.5% yoy in 2Q 2011

We further raise our 2011 CPI inflation forecast to 4.4% next year (from the previous 4.1%), mainly because the 2011 loan growth target (RMB7.5tn) exceeded our expectation of RMB6.5-7.0tn. As for monthly trajectory, CPI inflation rose to 5.1% in November; after a brief deceleration due to the base effect in December and January, it will likely trend towards 5-5.5% in 2Q.

Figure 5: Monthly CPI inflation forecast, yoy%



Source: Deutsche Bank, CEIC

The following factors should contribute to strong CPI inflation in the coming two quarters.

Food inflation

Daily agriculture prices have risen by nearly 15% in the past six months. Speculative demand is rampant, causing a 48% rise in cotton prices, an 18% rise in vegetable prices and a 13% rise in egg prices during these months. In response, the government has taken a series of measures against speculation on agricultural products, reducing government fees and charges, and selling reserves to stabilize market prices. Agricultural price inflation is now passing through the food-processing industry and will likely show up in increases in processed-food prices in coming months.

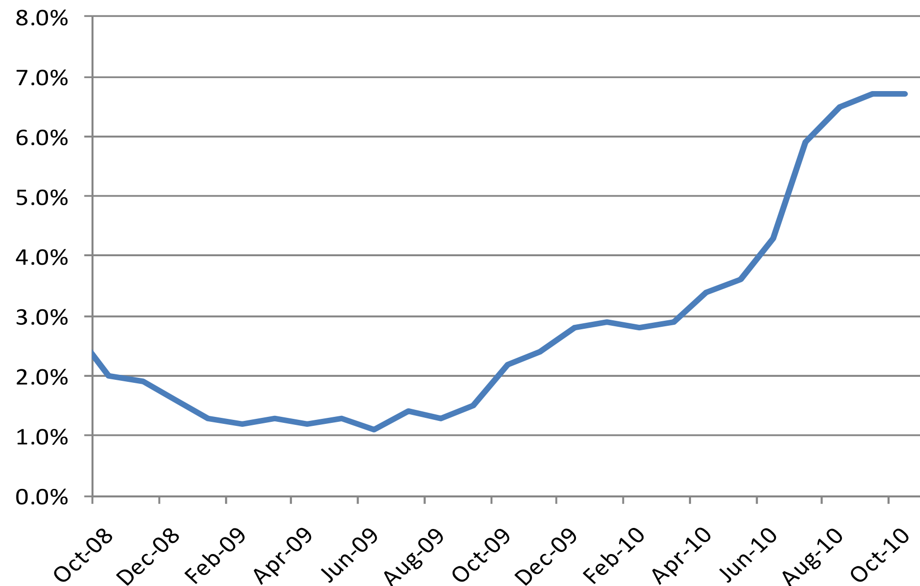
Figure 6: Daily agriculture wholesale price index

Source: Ministry of Agriculture

Rental inflation

Demand for rental properties increased rapidly as a result of the recent property tightening measures, which restricted and/or discouraged the purchase of properties. Figure 7 shows that yoy rental inflation, including actual rents and imputed rentals, rose to 6% yoy in recent months, up from 1.5% in the middle of last year. We think this trend is poised to continue as many large cities have been reporting 10-20% yoy rental inflation in recent months.

Figure 7: Rental inflation, yoy%

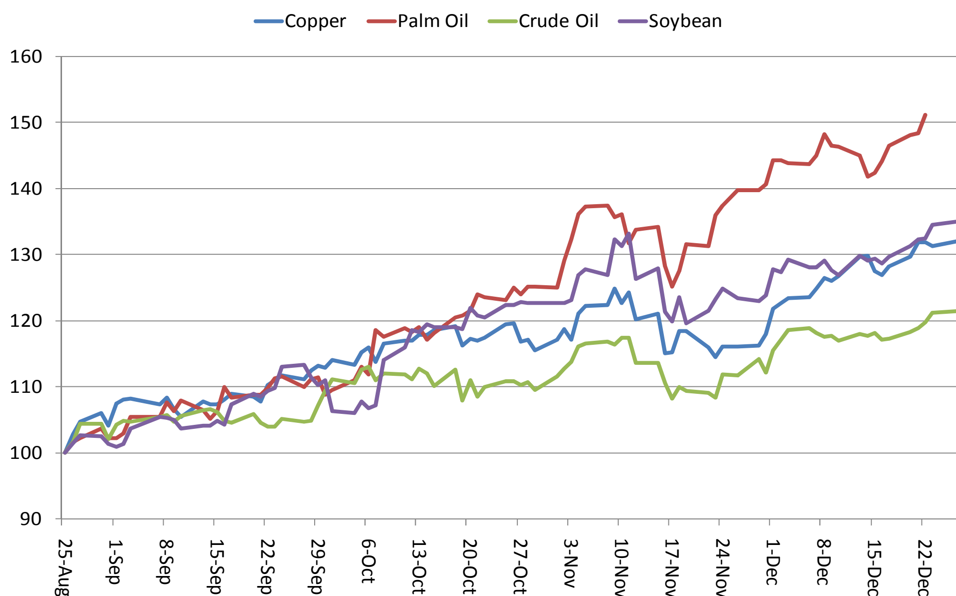


Source: CEIC.

Rising global commodity prices

The rise in global commodity prices has largely been driven by the market reaction to the anticipated QE2 program in recent months. The CRB commodity price index was up 20% since May last year. The impact on manufacturing costs is evident from the recent input price sub-index of the manufacturing PMI. Input price inflation tends to translate into upward pressure on the CPI, with a lag of about two quarters.

Figure 8: Imported commodity prices in USD terms (25 August 2010 = 100)

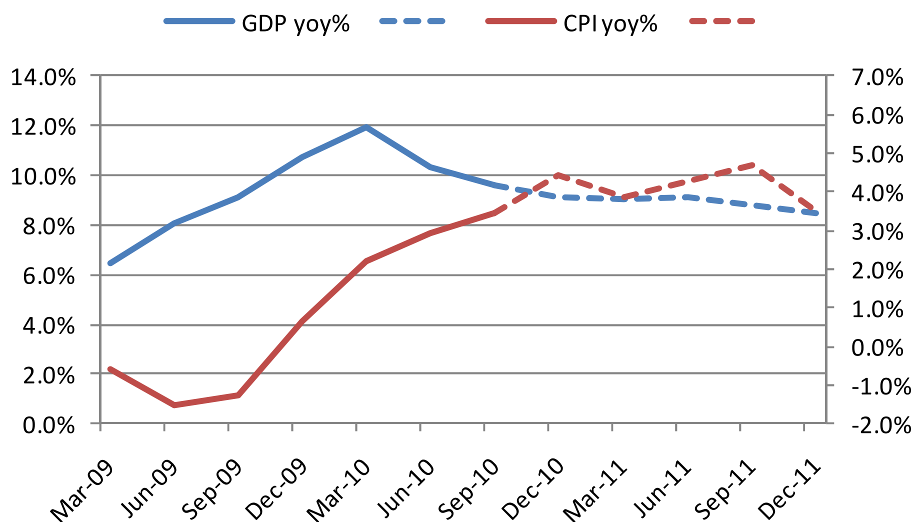


Source: Bloomberg Finance LP

1H 2011: Policy tightening on rising inflation

Figure 9 depicts the yoy CPI and GDP growth trajectories. This is the most straightforward way to understand the policy environment for decision makers as public sentiment tends to react strongly to yoy growth rates (although qoq growth rates are more relevant in gauging the latest changes in the growth trend) and yoy CPI inflation (although mom inflation is leads yoy inflation).

Figure 9: GDP vs. CPI, yoy %



Source: Deutsche Bank

For 1H 2011, the most salient feature of Figure 9 is that yoy CPI should rise towards 5-5.5% – a politically dangerous level that is often associated with rapidly growing public discontent and a further rise in expectations of inflation. During the same period, we expect yoy GDP growth will likely remain in the comfort zone of around 9%. This combination of the rising CPI and acceptable GDP is politically convenient (i.e. easier to reach a policy consensus) on

further policy tightening. As we forecast in our China strategy report published on 10 November 2010, we expect the government to respond to the worsening inflation with the following actions.

1) Increased subsidies for low-income households and farmers. This has been implemented fairly aggressively over the past few weeks.

2) Price intervention: As we had expected, the State Council officially stated in late November that price intervention measures should be adopted whenever necessary on important consumer necessities and production inputs. Water, gas, power, oil, public transportation prices are now frozen for the foreseeable future. The government has also instructed coal companies to "refrain from raising contract prices."

3) Further rate hikes: Following the PBOC rate hike on December 26, we further raised our policy rate expectation to three more hikes totaling 75bps in 2011(vs. our previous forecast of 50bps hikes). We expect most (at least 50bps) of those hikes to occur in 1H 2011.

4) Faster RMB appreciation. We expect the RMB to appreciate 3% against the USD in the coming six months vs. NDF-implied 6m appreciation of only 0.85%.

5) Loan growth deceleration by 4ppts: It was reported that the government has set a target for new lending of RMB7.5tr in 2011, down from an estimated RMB7.8tr in 2010. On a comparable basis, which includes the off-balance sheet lending, total lending should decline from an estimated RMB8.6tn (including RMB7.8tn lending and about RMB0.8tn increase in outstanding off-balance sheet trust loans) in 2010 to RMB7.5tn in 2011. According to these targets, on a yoy basis, total outstanding loans will therefore slow to around 16% in 2011, down from 20% in 2011. This pace of deceleration is less aggressive than we had expected a few weeks ago, and was the main reason for us to revise up our CPI forecast for 2011.

2H 2011: Policy relaxation on disinflation and weaker growth

Figure 5 shows that our forecast CPI inflation will likely decelerate towards 3-4% at the end of 2011. This disinflation trend in 2H 2011 should reflect the following factors:

1) The monetary (including credit deceleration and rate hikes) and property tightening measures should begin to restrain inflation and inflation expectations by mid-2011. This is because there is statistically a lag of about 9-12 months in China between monetary tightening and its impact on the CPI.

2) The real economy should begin to decelerate on a sequential basis from 2Q 2011. As discussed earlier, this will likely be driven by the fading of inflation-led demand growth, deceleration in developers' FAI, and a slowdown in export growth. A deceleration of the real economy should also help cool down demand and thus prices.

We believe that monetary tightening will likely end in the middle of next year. Policy debate will probably start to turn its focus onto whether policies need to be relaxed and/or new stimulus would be warranted in 3Q.

Less expansionary fiscal policy in 2011

We expect fiscal policy to become less expansionary in 2011, though it will still likely be labeled "proactive." Specifically, we expect the deficit/GDP ratio to fall to around 2.2% in 2011 (down from 2.7% in the 2010 budget). The RMB amount of the fiscal deficit will likely decline to RMB900bn in 2011 from RMB1.05tr in 2010. At the sector level, we expect fiscal spending to give priority to public housing, agriculture, energy saving and environmental protection, as well as to supporting tax cuts for individuals and the service sectors.

75bp rate hikes would reduce corporate profits by 1.5%

Many investors have asked how sensitive corporate profits are to rate hikes in China. Our simple calculation shows that 75bp rate hikes would reduce corporate profits by about 1.5%. The following are our assumptions and calculations.

For 2010, we estimate that total corporate profits will reach RMB11tr, or around 30% of GDP. This is based on estimates from provincial statistical bureaus' income approach to GDP figures in past years and the likely GDP growth rate in 2010. We also know that at the end of 2010, the net debt (outstanding corporate loans minus corporate deposits) of the corporate sector will likely amount to about RMB20tr. Therefore, an average lending rate hike (across maturities) of 75bps would reduce annual profits by about RMB150bn. This is equivalent to about 1.4% of total corporate profits in 2010.

Key risk is government failure to tighten policy in 1H

The above discussed outlook is our baseline forecast. Under this scenario, inflation will be contained in the second half of 2011, while GDP growth will moderate to a more sustainable, but still respectable rate of 8.5% yoy.

However, there are two major risks to this scenario. First, if the government fails to implement aggressive tightening policies in the earlier part of 2011, especially on interest rates and credit tightening, inflation -- especially core inflation -- can exceed our expectation, which already higher than the government annual average target of 4%. There is a strong incentive for local governments to initiate a large number of new projects in the first half of 2011, in order to justify the fiscal and monetary resource allocation for them in the five year plan. Politically, it is risky for central government leaders to be too harsh on local officials, who will have a significant influence in the election of the new leadership in the run up to the Party Congress in late 2012.

In particular, we are concerned about the possibility that credit growth can again exceed expectations in the beginning of 2011, which may then force the PBOC and CBRC to adopt more draconian measures later.

Second, a number of uncontrollable factors may affect the inflation outlook. For example, whether conditions in the next few months may again be worse than expected and lead to a surge in agriculture prices. Global oil prices can surprise to the upside. Inflation expectations may also boost the velocity of money, which will in turn increase inflationary pressure even if the money supply is controlled precisely at the target level.

If inflation surprises to the upside, it is almost certain that the policy and economic outlooks will worsen. Under this "bad" scenario, the government will have no choice but to tighten policy more aggressively, which may eventually lead to a harder landing of the economy.

Structural reforms

We expect the government to delay the planned resource pricing reform due to inflation concerns, but it will likely continue to implement income distribution reform, fiscal support for priority sectors and RMB internationalization.

Resource pricing reform to be delayed

Due to rising inflationary pressure, the resource pricing reform will likely be delayed. On 21 November, the State Council published its 16 measures to curb inflation. It stated that "ministries and local governments should carefully manage the timing of price adjustments" and be "prudent" in implementing price adjustments that have already been planned. In plain language, this means that the planned increases in government-controlled prices (e.g., gas, water, power, oil, and public transportation) will be postponed. It also said that the government needs to ensure the stability of natural gas. On contract coal prices, the State Council requested that coal companies exercise "self-discipline" and "ensure price stability." This confirms our expectation (see our China strategy note published on 17 November) of diminishing probability for a significant contract price increase in the coming months.

Income distribution reform to proceed

We see two aspects of income distribution reform as significant. First, the government has already announced that it would raise the dividend payout ratios for centrally owned SOEs. Although details have not yet been released, we expect the ratios (currently at 5-10%) to be doubled in 2011. They will likely be raised further in the coming years. Second, a reduction in effective personal income tax again becomes a possibility for 2011, as income distribution reform requires some concrete fiscal policy action.

Policy housing

The government has set the 2011 target of public housing starts at 10m units, vs. 5.8m in 2010. We estimate the policy housing investment (both government investment and total investment)to increase 100% in 2011, as those started in 2010 and newly started in 2011 should all require investments. Government-sponsored public housing investments will likely represent around 8% of real estate investment, adding 1.3ppt to FAI growth and 0.6ppt to GDP growth in 2011. oops

Tax cut on service sectors

The government is considering reducing the tax burden on the service sectors by converting the business tax to a VAT. Currently, the business tax (typically at 5%) is levied on revenue, and creates the problem of double taxation at different stages of the service provision. If the business tax is converted to a value-added tax with a reasonable rate, it could reduce the effective tax rate and avoid double taxation. We expect this reform to be implemented in sectors such as banking, insurance, telecom, transportation, construction, culture and entertainment, real estate agencies, and other services, though the exact timing remains hard to predict. The implementation of a pilot program in Shanghai is likely.

Promotion of new strategic sectors

The government has named seven sectors as the new strategic industries: environment/energy saving technology, alternative energy, biology technology, new IT, high-end equipment, new materials and new energy cars. Local press reported that in December 2010 an official proposal had been submitted to the State Council to invest up to RMB2tr p.a. in these industries over the next five years. If true, this would represent 15% of the manufacturing FAI. We believe the primary policy incentives will include subsidies on technology acquisitions and R&D, tax incentives, lower land costs, and localization policies.

RMB internationalization

RMB internationalization will likely be the most profound change of financial sector reform in the coming five years. In the near term, we expect the government to release two regulations permitting RMB-denominated FDI and ODI. The RMB FDI rule would allow companies to raise RMB (e.g., via borrowing, bond issuance, and IPOs) from the offshore RMB market (mainly Hong Kong) and legally remit the RMB proceeds to the mainland for direct investment in projects. The RMB ODI rule would promote the use of RMB for outward investments in other regions such as Africa and Latin America. We expect these policies to significantly boost RMB lending and bond issuance in Hong Kong, and support exponential growth in Hong Kong's RMB offshore market in the coming years.

Equity-market strategy

We believe that the inflation trajectory in 2011 will likely be the single most important macro driver for market performance. We expect inflation to stay uncomfortably high in most of 1H 2011 (in the range of 4-5% yoy), but it will likely decline towards 3-4% in 2H due to the impact of monetary tightening and a more favorable base effect. High inflation in 1H tends to depress the market as it generates fear of policy tightening. An easing of inflation in 2H should justify a market rerating as policy uncertainties are removed. For the year as a whole, we expect the MSCI China to rise 15% from its current level.

Our sector strategy for the year will likely change according to the inflation profile. During periods in 1H when inflation remains elevated even rises, we would prefer sectors that are less vulnerable to credit tightening, rate hikes, and price intervention. In particular, we prefer large banks, insurance, commercial properties, retailing, equipment, IT services, and tourism. We would be cautious on IPPs, coal, smaller banks, oil and gas, and highly leveraged developers.

When inflation begins to abate, which we expect to start in the middle of 2011, the victims of inflation should begin to outperform the market.

For the year as a whole, we are overweighting sectors that should benefit from major structural changes in the 12th Five-year Plan. These include second- and third-tier city developers, tourism, IT services, property agencies, equipment, new energy, cement, as well as beneficiaries of western development such as local retailers and banks.

We expect 15% upside to the MSCI China Index in 2011

We have several reasons to believe that macro fundamentals will justify the use of an unchanged forward P/E multiple, which is now broadly in line with the historical average, for end-2011. Given our bottom-up EPS growth forecast of about 15% -- which is consistent with our top-down estimate – we expect 15% upside to the MSCI China for 2011. Our MSCI China Index target for the end of 2011 is 75.7 vs. the current level of 65.8.

Figure 10: Valuation and EPS growth estimates for MSCI China and HSCEI

MSCI China Index	CY2009	CY2010	CY2011	CY2012
EPSg	17.1%	22.5%	15.1%	15.6%
PER	16.4	13.6	11.8	10.2
PBR	2.4	2.1	1.9	1.7

HSCEI Index	CY2009	CY2010	CY2011	CY2012
EPSg	18.9%	25.3%	14.7%	16.8%
PER	16.0	12.2	10.7	9.1
PBR	2.3	2.0	1.7	1.6

Source: Deutsche Bank estimates.

The most important assumption for determining the 12-month index target is the valuation. We need to consider several conflicting factors that would affect the valuations. On the negative side, these are as follows:

a) Deceleration of EPS growth implies a potential de-rating of the Chinese market

We expect GDP growth to slow to 8.7% in 2011 from 10% in 2010, and EPS growth for the MSCI China to decelerate to 15% in 2011 from about 23% in 2010. This deceleration trend is likely to continue over the medium term (see our report, *Lower Growth, Better Structure,* published on 16 September 2010), given the decline in long-term growth potential as well as the negative impact of income distribution reform on earnings growth. Note that the government stated in its 12th Five-Year Plan that household income growth should exceed that of national income. This means that over the medium term, corporate earnings growth should not exceed nominal GDP growth, which we expect to be 11% in 2015. Deceleration in EPS growth justifies a de-rating of the market.

b) Policy uncertainty due to strong inflation pressure also tends to depress the market valuation

This is a headwind facing the market in the coming few months as inflation remains high. However, its impact will likely diminish in 2H 2011, when CPI inflation is likely to fall towards a much more comfortable 3% at the end of the year.

On the positive side, we also see two factors as supportive of the China market's P/E multiple:

c) A decline in economic and market volatility over the medium term tends to boost the market valuation

As GDP growth decelerates to a more sustainable level, tighter monetary conditions reduce the probability of inflation and asset bubbles, and structural reforms in the economy improve the economic balance and reduce structural bottlenecks, the market valuation should be boosted. We believe the market will therefore expect China to gradually reduce its earnings volatility in the coming years. A reduction in earnings volatility tends to boost market valuations.

d) Over the longer term, changes in the composition (constituents) of market indices may offset part of the EPS deceleration

As more listcos in the "right" sectors, such as services, equipment, new energies and companies with large exposure to inland regions, grow larger and begin to replace some of the names in the traditional sectors, such as oil, telco, coal, IPP, and steel, the composition change in market indices will likely mitigate part of the index EPS deceleration. However, this change will likely take five years or longer and may not have a meaningful impact on the MSCI China within the next 12 months.

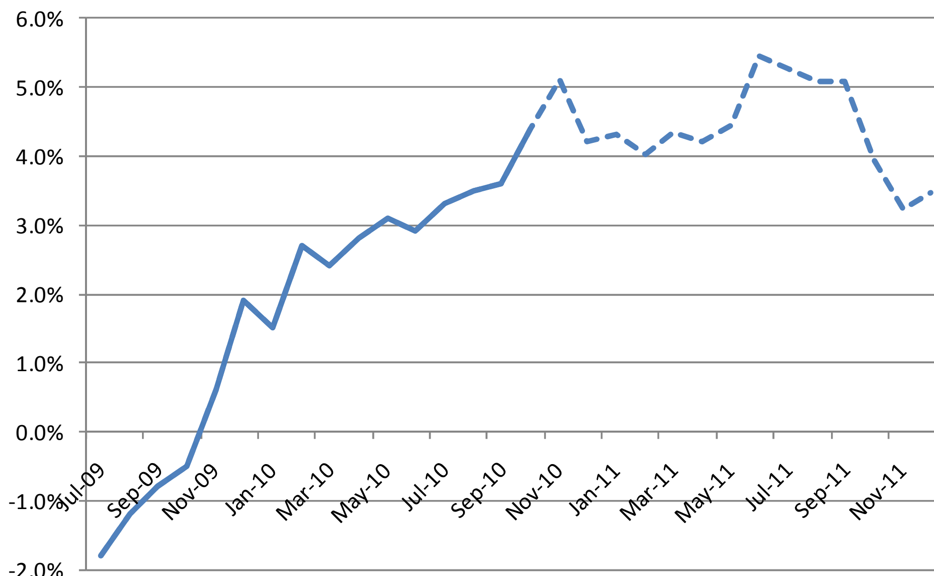
On balance, we think the most important factors to consider are points (a) and (c). We have run a number of regressions on the relationship between EPS growth and earnings volatility on the one hand, and P/E on the other. Although the results are sensitive to the selection of samples, time periods, and growth and volatility measures, they generally point to the conclusion that the positive impact of volatility reduction on P/E and the negative impact of EPS deceleration on P/E tend to offset each other. This supports the use of an unchanged forward P/E for the market valuation for the end of 2011.

Other valuation measures, such as the P/B ratio, also suggest that the pricing of the MSCI China is in line with the historical average. In comparison with the EM average, the MSCI China's forward P/E is only slightly above (by a few percent) and is therefore not a major concern.

Inflation in 1H and disinflation in 2H: the biggest market driver

We believe the single most important macro driver for the MSCI China's performance next year is likely to be the changing inflation trajectory. As we discussed above, CPI inflation will likely remain in the uncomfortable range of 4-5.5% in 1H 2011, given the unfavorable base effect, high agriculture prices and the pass-through of global commodity prices to the CPI. During this period, policy responses will likely include price intervention, rate hikes, RRR hikes, slowdown in credit growth, and faster RMB appreciation. These policies should in general be depressive for EPS growth and negative for sentiment. A removal of the inflation risk in 2H due to the eventual working of monetary tightening and a favorable base effect tends to lift market sentiment and performance.

Figure 11: CPI inflation forecast, yoy%



Source: Deutsche Bank, CEIC

1H: inflation likely to be the biggest challenge to the market

Rising inflation implies a higher probability of rate hikes, liquidity and credit tightening, and price control. As we discussed in the economic section, a 75bp rate hike tends to reduce corporate earnings growth by 1.5%; a 4ppt deceleration in loan growth tends to slow GDP growth by 0.8ppt; and price intervention tends to depress the earnings of IPPs, coal, natural gas and other utility companies, and may increase the perceived earnings risks to milk, edible oil and noodle makers.

Historically, the market tends to move in the opposite direction of CPI inflation when it exceeds the threshold of 4% yoy. Higher CPI inflation tends to generate more intense policy responses that are negative to earnings or earnings visibility, and would thus tend to be negative to the market. During 1H 2011, market sentiment may swing along with the monthly performance of CPI inflation: a tentative decline in inflation due, e.g., to better weather conditions or a drop in global commodity prices or even base effects could boost market confidence, but a reacceleration of inflation would do the opposite.

Inflation essentially consists of a process of redistribution of benefits (profits, for example) across sectors, and should also force policy tightening that depresses the overall profits of the corporate sector. In the following section, we discuss a few winners and losers in an inflationary environment in 1H.

Beneficiaries of inflation – apparel, supermarkets, investment properties and airlines
We see three types of beneficiaries in this inflationary environment.

1) Sectors that enjoy rising pricing power, but are unlikely to be subject to price intervention. In the short term, sectors that meet these criteria include restaurants, supermarkets, agriculture, apparel and cement. In these sectors, we believe the following names are good examples: Anta, Hengan, Wumart and Little Sheep. Their products will likely face little risk of price control, while their gross margins are on the rise as they tend to raise ASPs faster than their cost increases. According to our consumer analyst Rebecca Jiang, Little Sheep could expand net profits by around 8% with a 1% ASP increase due to its high operating leverage.

2) Investment properties that benefit from rental inflation. The beneficiaries include mainly commercial property names such as Hang Lung, Soho, Franshion and Yuexiu Properties. The office rentals in Shanghai, Beijing and Guangzhou have increased 12%, 16% and 8% ytd, respectively, and the companies are largely immune to policy tightening in the residential market.

3) Airlines that benefit from faster RMB appreciation. The RMB will likely appreciate 5% in the coming 12 months vs. market consensus of 2.7%. According to our airline analyst Vincent Ha, a 2ppt additional appreciation of the RMB would translate into an increase in 2011 EPS for China Eastern of about 15%. It would translate into additional EPS growth of 14% for China Southern and 9% for Air China. China Eastern is Vincent's top pick, even without additional RMB appreciation.

Victims of inflation – IPPs, gas, oil and leveraged property developers
We have identified three potentially disadvantaged sectors.

1) Highly leveraged sectors
These include IPPs and some real estate and manufacturing names that would suffer from stronger-than-expected rate hikes due to the rise in funding costs. For example, for the largest Chinese power companies, a 50bp rise in lending rates would reduce their 2011 EPS by more than 10%. Our power analyst, Michael Tong, believes Huadian and Huaneng are most vulnerable to rate hikes and sensitive to coal price inflation.

2) Residential property developers
Developers are the obvious casualty of rate hikes. Rate hikes hit property developers in three ways. First, demand for mortgage loans is more sensitive to interest rates than loan demand in all other sectors, and thus a series of rate hikes will likely significantly slow property demand. Second, a rate hike would send a signal of monetary tightening, which will likely weaken the sentiment or pricing outlook of property investors. Sentiment is important in sustaining demand and prices in major cities such as Shanghai, where speculative demand is more than 40%. Third, some developers are highly geared and will likely suffer from higher funding costs. Our property analysts believe Greentown, Guangzhou R&F, Agile and Shimao are most vulnerable to rate hikes.

3) Sectors that suffer from price intervention
Based on our discussion in the previous sections, we believe gas, oil, power, water and public transport are the most likely victims. At the company level, power companies will likely suffer the double whammy of a rate hike and price control. Specifically, they have experienced a sharp rise in coal prices, but could see declining probability in power tariff hikes. On oil and gas, our analyst David Hurd believes the biggest potential loser is PetroChina, whose gas business is expected to contribute most of its EPS growth next year. If gas prices are not raised (our current assumption is a 20% rise in June next year), PetroChina's 2011 EPS growth could fall from 11% to 4%. Sentiment-wise, a slower pace of retail oil price increases after the crude price exceeds USD80/bbl, which implies a reduction

in refining margin, may also be negative for Sinopec, though the magnitude of the negative impact is likely to be smaller than that on PetroChina. Finally, it is now clear that contract coal prices are unlikely to be raised in the foreseeable future.

2H: disinflation should support market

As discussed in the economic section, we expect CPI inflation to fall from the peak of 5.5% in 2Q towards 3-4% at the end of 2011. This reflects the lagged impact of monetary tightening, RMB appreciation and deceleration in infrastructure spending. The slowdown in aggressive demand growth due to these policy changes and the favorable base effect should help reduce yoy CPI inflation in 2H 2011.

The decline in CPI inflation will likely end the monetary tightening. That is, when yoy CPI inflation begins to fall on a more sustainable basis from mid- or late 2Q, the market will likely expect rate hikes to end and credit tightening to ease.

In general, this environment should boost sentiment for two types of sectors: 1) those sensitive to interest rates and monetary conditions, including banks, properties, and commodities; and 2) those suffering from fear of price intervention, such as coal, IPPs, and oil and gas. In other words, these sectors should outperform when inflation begins to fall.

Six structural themes

The themes discussed below offer a number of fundamental reasons for investors to overweight a number of sectors, namely IT services, second-tier city developers, equipment, new energy, tourism, as well as raw materials and retailers in the western provinces.

Theme #1: Financial sector reform
We expect several major changes in the financial sector to reduce loan growth and NIMs over the medium term. These include credit tightening, disintermediation (due to faster bond market growth), tougher regulations, interest-rate liberalization and RMB internationalization. In this environment, we favor big banks whose NIMs are more resilient due to relatively lower funding costs and less dependency on loan growth.

During 2011, we believe that banks' share price performance will be closely linked to the inflation cycle. We believe banks are unlikely to perform well during aggressive policy tightening when inflation risk is high in the early part of the year. However, outperformance from 2Q 2011 is likely as the market begins to expect an end to aggressive policy tightening due to disinflation in 2H. The possibility of the bank sector outperforming the market for the full year is limited, however, given the structural headwinds in the years to come.

Theme #2: Public housing program
The government has set a target of building 10m public housing units in 2011. After taking a closer look at the public housing plans, we conclude that 1) public housing investment growth will likely reach or exceed 100% in 2011 and 2) the public housing investment growth rate will likely fall sharply to zero in 2012.

The investment implications are: 1) public housing investment could provide strong support for cement demand and prices (but less for steel); and 2) the surge in the supply of public housing could cap the demand and pricing for developers in the mid-end market in 2011.

Theme #3: An updated "equipment basket"
In our report *China's Manufacturing Upgrade*, published on 31 August 2010, we argued that the equipment sector would grow during the next five years at 17-20% p.a. vs. 10-12% for overall IP growth, 7-10% for raw materials and 5-7% for labor-intensive manufacturing. We

believe the best-performing sub-sector in the equipment space will include coal-mining machinery, construction machinery, medical equipment, rail equipment, new energy equipment, shipbuilding, telco equipment and industrial automation. We provide an updated basket of companies that should outperform the broader manufacturing sector and the overall market in 2011.

Theme #4: Acceleration of service-sector growth

One of the most important structural changes in the Chinese economy over the coming five years is likely to be the shift from the consumption of goods to the consumption of services. In terms of nominal output, we expect China's service sector growth to outperform the manufacturing sector by 4-5ppts per year in the coming five years. This trend reflects very low penetration, growing pricing power, and stronger government policy support for services. We expect the following service sub-sectors to experience an average of more than 20% annual growth in the coming five years: branded real estate agencies, tourism, IT services and enterprise software, as well as culture and entertainment.

We have selected a basket of nine listed companies in these service sectors. These companies are likely to witness EPS growth of a 32% CAGR in the coming two years, and are trading at an attractive average PEG of 0.67x on 2011 earnings.

Theme #5: New energy and environmental protection

The government announced in October a plan to accelerate the development of seven strategic emerging industries, with the energy-saving and environmental protection industry flagged as the first priority. The increasing clarity on policy leads us to believe that the energy-saving and environmental protection industry will likely grow at a CAGR of 25% over the next ten years. We see attractive investment opportunities in sectors such as smart grid equipment, wastewater treatment and waste recycling.

Theme #6: Western development

We expect inland provinces to grow their GDP, investment and property sectors at a much faster pace than the coastal provinces over the coming five years. This reflects the trends of a migration of manufacturing, faster urbanization and lower penetration of many consumption items in the inland provinces. The investment implication is that real estate developers, banks, cement, and retail businesses in inland provinces will likely outperform those in the coastal areas.

Our top Buys

`We list below our ten top Buys, which reflect the views detailed in our macroeconomic outlook and our key investment themes, as well as the bottom-up analyses conducted by our sector analysts.

Within the list, Agricultural Bank of China is our top pick in the financial sector, primarily due to its low loan-to-deposit ratio (57% vs. 70-80% for smaller banks), higher NPL coverage (160% vs. 90-120% for smaller banks), higher exposure to inland development, and limited credit tightening in rural areas. We view Evergrande as a shelter from tightening measures in the property sector, given its focus on Tier-2 and -3 cities, and its fast asset turnover. CRE is a beneficiary of higher inflation, as the operating costs of its retail business are largely stable. CSR and ZTE are major equipment plays with a significant competitive edge against their western peers in the global market. Shangri-la and Soufun reflect our bullish view on China's consumer service sector growth.

On China Shipping Development, despite some downside risk to our freight rate assumption, we think its recent share price correction has already priced in that risk. We remain constructive on its underlying growth outlook and believe the company is priced attractively.

In the new energy space, Longyuan has a capacity expansion pipeline that is ten times its existing installation and enjoys attractive valuations. Finally, we view Geely offers unusually attractive growth vs. its P/E multiple in the automobile sector, thanks to the launch of more automatic transmission models and government support for local brands.

Figure 12: Our top Buys

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	PE 2010	PE 2011	PB 2011	EPS CAGR 10-12	PEG (10-12EPS /2011PE)
ABC	1288.HK	Banks	Buy	3.9	162,791	11.0	9.2	1.6	25%	0.36
Evergrande	3333.HK	Real Estate	Buy	3.8	7,287	8.3	6.5	1.9	25%	0.26
CRE	0291.HK	Food & Staples Retailing	Buy	31.9	9,812	39.2	28.7	2.3	32%	0.89
CSR	1766.HK	Capital Goods	Buy	10.2	15,551	39.4	25.1	4.5	37%	0.68
China Ship Dev	1138.HK	Transportation	Buy	10.4	4,533	15.7	9.8	1.2	48%	0.20
Shangri-La Asia	0069.HK	Consumer Services	Buy	21.1	7,824	40.6	26.0	1.7	40%	0.65
Soufun	SFUN.N	Software & Services	Buy	71.5	1,443	27.5	17.1	7.5	40%	0.43
Geely Auto	0175.HK	Automobiles & Components	Buy	3.4	3,195	16.5	13.1	2.3	23%	0.58
ZTE	0763.HK	Technology Hardware & Equipment	Buy	30.9	11,384	25.0	20.2	3.1	19%	1.05
Longyuan Power	0916.HK	Utilities	Buy	7.1	6,820	26.3	16.7	1.7	48%	0.35
Average						24.9	17.2	2.8	34%	0.51
MSCI China						13.4	11.8	1.9	15%	0.80

Source: Deutsche Bank

Theme #1: Financial reform

We expect several major changes in the financial sector to reduce loan growth and NIMs over the medium term. These include growth deceleration, disintermediation, tougher regulations, interest-rate liberalization and RMB internationalization. In this chapter, we discuss the different implications of these structural changes for large and smaller banks.

We also look at the impact of inflation on banks' share price performance. We believe that banks are unlikely to perform well during aggressive policy tightening when inflation risk is high in the early part of the year. However, we believe outperformance is possible beginning in 2Q 2011 as the aggressive policy tightening comes to an end on expectations of disinflation for 2H.

We conclude that large banks will likely outperform mid-sized banks, and that the entire banking sector will likely see improved stock performance when the inflation risk recedes.

Five major changes in the financial system

We see five major challenges to the banking industry in the coming few years.

First, we believe loan volume growth will likely slow down as the nominal GDP and demand for money both decelerate on structural economic factors. The non-inflationary M2 growth rate should slow from the current 20% to around 13% within the next five years.

Second, direct finance is likely to be promoted via the faster development of the bond market. In other words, banks will likely suffer from "disintermediation" as demand for bank lending from the best companies weakens and banks' pricing power and NIM are compromised.

Third, interest rate liberalization will likely occur. The prevailing negative real interest rates should not be sustainable as they create social discontent and exacerbate inflation and asset bubbles. We believe interest-rate liberalization to be one of the few ways to address the negative rate issue. More importantly, the need to establish an effective monetary policy transmission mechanism also requires interest-rate liberalization. In a liberalized rate environment, competition for deposits should intensify and NIMs should be under pressure.

Fourth, significant progress is likely to be made on RMB internationalization. This implies the gradual opening of the capital account, which would expose the domestic banking system to new competition from overseas lenders and force the regulators to speed up the interest-rate liberalization process.

Fifth, tougher bank regulations should be phased in from 2011. Systematically important banks should be required to furnish 1% extra capital requirement. Loan-loss provisions are likely to be increased to 2.5% of total outstanding loans, or 150% coverage of NPLs, whichever is bigger. These new regulations should increase the banks' operational costs.

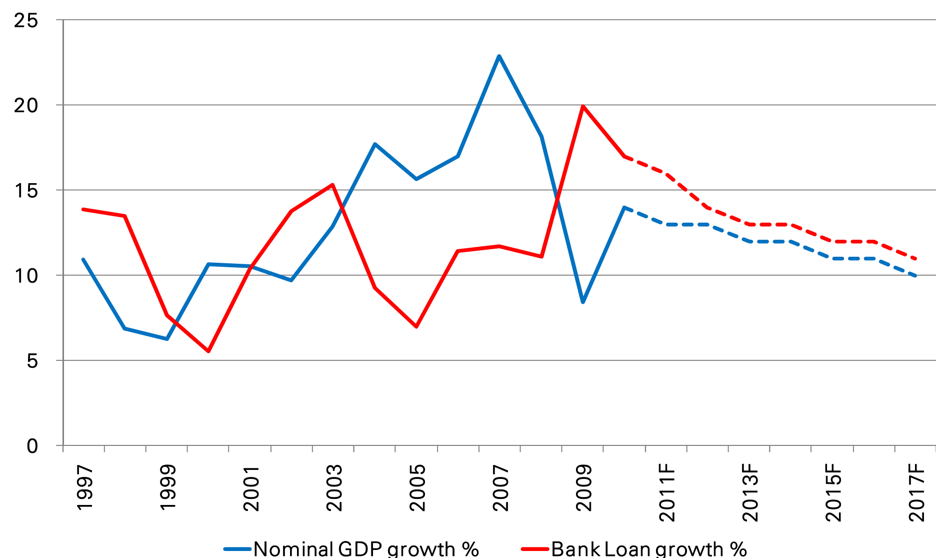
Below, we elaborate on the details of these mega-trends and their implications for banks.

Loan growth deceleration will likely challenge banks' top lines

Chinese banks depend heavily on the loan business for growth and profit. Net interest income accounts for 80% of the operational income, while fee income businesses, such as consumer credit card and wealth management, still account for a very small share. A slowdown in loan volume growth is inevitable, in our view, and should pose a major challenge to earnings growth if banks do not change their business models quickly.

First, M2 growth should slow as a result of GDP growth deceleration. We expect China's potential real GDP growth rate to drop to 7% in the next decade from 10% in the last decade. The GDP growth deceleration should be driven by structural factors such as an aging population, weakening export growth, declining productivity growth, and deceleration in urbanization. Historically, as a rule of thumb, the M2 growth rate has been close to the nominal GDP growth rate plus 3% (which reflected the monetization process due to financial deepening). For example, when GDP growth is 9% and inflation is 4%, the implied nominal GDP growth would be 13% and M2 growth would be 16%. If GDP growth slows to 7% and average inflation is at 3%, then M2 growth should moderate to 13%, according to the old rule of thumb. Considering the fact that M2 growth was near 30% in 2009, its decline to 13% over the coming five years would be substantial (Figure 13).

Figure 13: Nominal GDP growth and bank loan growth



Source: Deutsche Bank

Second, the additional 3% demand for M2 due to financial deepening may no longer be needed. Historically, several key structural changes led to financial deepening by converting barter transactions (or government allocation of resources) to monetized transactions and by developing investment products. These few changes are: 1) the development of the agriculture market at the beginning of rural reform; 2) the monetization of the housing market in 1998; 3) the monetization of the land market since the mid-1990s; and 4) the development of the securities markets since the early 1990s. We can hardly foresee any further reforms that would have such a fundamental impact on financial deepening as most transactions in the economy are already monetized. Therefore, M2 growth is unlikely to need to be 3ppt higher than nominal GDP growth in order to maintain a non-inflationary macro environment. In other words, the deceleration in M2 or loan growth may be even faster than nominal GDP growth in the coming five years, given the slowdown in financial deepening.

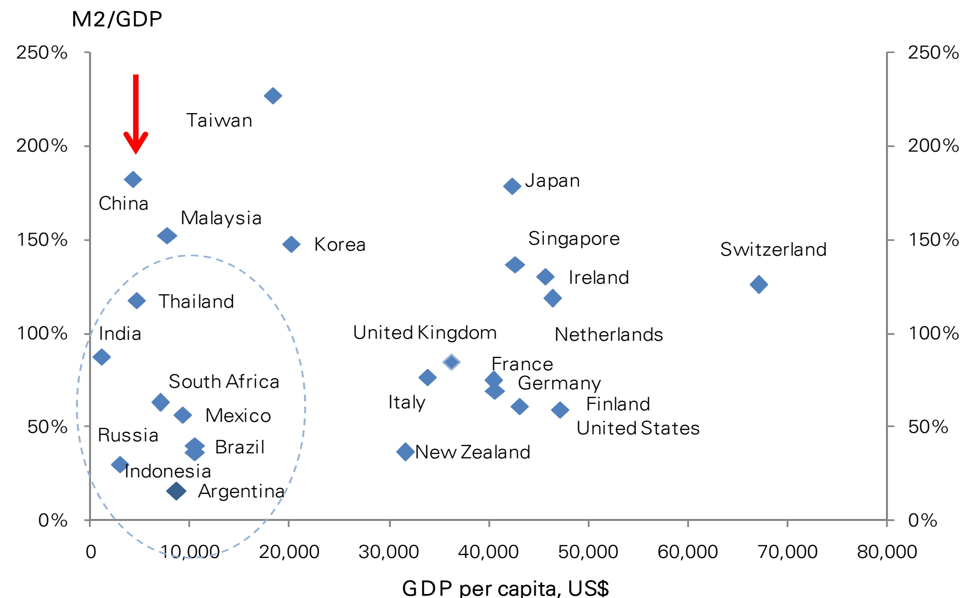
Finally, loan growth should be slower than M2 growth due to the growing significance of bond financing. The fact that banks provide most of the corporate financing (e.g., 90% of non-equity financing of infrastructure projects comes from bank lending) implies an excessive concentration of risks in the banking system. Policy makers are fully aware of this risk, and consensus has been reached on accelerating the development of the corporate bond market. We expect corporate bond issuance to grow 30-40% per year in the coming few years vs. 12-15% annual loan growth. As banks will also hold bonds on their balance sheet, this development typically means that loan growth will be lower than M2 growth.

International experience also suggests that the development of the capital markets tends to reduce the M2/GDP ratio. This occurred in a number of OCED countries (such as the US and France) in the early 1980s.

Financial disintermediation may depress bank margins

As a legacy of central planning, big state banks have dominated financial intermediation in China. By the end of 2009, China's M2/GDP ratio reached 180%, among the highest in the world, while its corporate bond market remained very underdeveloped. The MOF, central bank and policy banks are the major issuers, accounting for 78% of the total bonds outstanding. The outstanding corporate bonds account for less than 10% of GDP, while in the US, corporate bonds account for more than 170% of GDP.

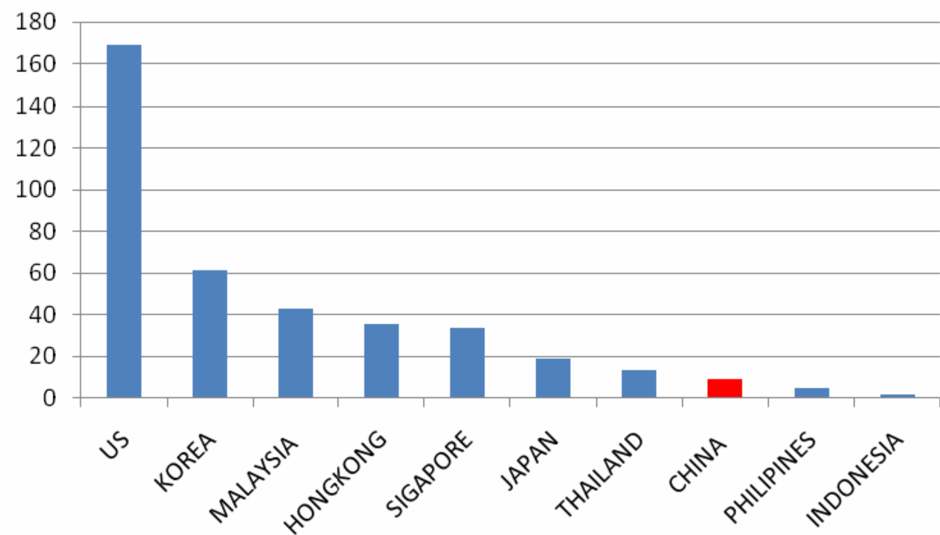
Figure 14: China's M2/GDP ratio is among the highest in the world



Source: Deutsche Bank, IMF and Bloomberg Finance LP

Policy makers have been pushing for the development of the bond market as an alternative to bank lending. At present, most credit risks are concentrated in the banking system. The large banking system poses an implicit fiscal risk to the government, as many banks are too big to fail. By promoting direct finance, the credit risks can be better assigned to those who are willing and capable to take them. For example, most insurance companies and pension funds need long-dated fixed-income securities, but due to the lack of bond supply, a large part of insurance and pension assets is invested in low-yielding bank deposits. Therefore, there are both supply- and demand-related reasons to promote the growth of the corporate bond market. The room for corporate bond market development is quite large, as shown in Figure 15.

Figure 15: Underdevelopment of Chinese corporate bond market (ratio of corporate bonds outstanding to GDP)



Source: Deutsche Bank

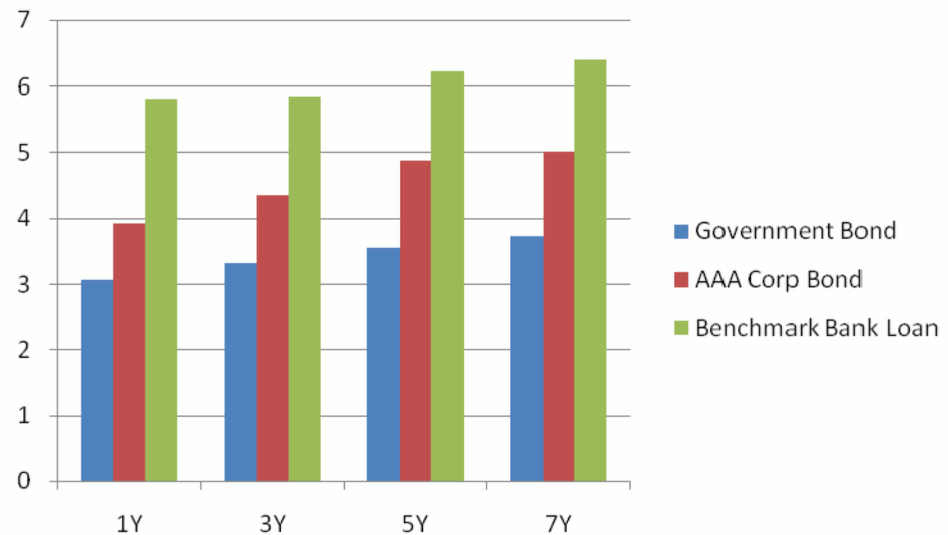
On the asset side of the banks' balance sheets, bond financing will compete against bank lending. Bond issuances will likely substitute for bank loans, as bond finance is typically cheaper than bank loans for large SOEs. Currently AAA corporate bonds' five-year yield is about 4.87% vs. the 5Y benchmark bank lending rate of 6.22% (Figure 16). Big SOEs have been the best bank clients and contributed to a large part of banking profits, as the risk-adjusted NIM is very attractive. When a major SOE receives the NDRC approval to issue bonds, the company usually repays its bank loan and the bank loses its lending business. To avoid serious disintermediation in this environment, banks could be forced to reduce lending rates.

On the liability side, household deposits are lured away by insurance products, equity mutual funds, stock trading accounts and property investments. The competition for household savings has intensified as the negative real deposit rate has prompted investors to search for higher yields elsewhere. Insurance companies and pension funds maintain large deposits in the banking system, but as investment opportunities offered by the bond market become more attractive, some of the deposits in the banking system will likely decline. To retain the deposits, banks would have to raise deposit rates and their margins could be squeezed.

Currently, corporate bond issuance requires government approval, and the annual quota for bond issuance is administered by the NDRC (for enterprise bonds), CSRC (for corporate bonds) and PBoC (for medium-term notes).

Outstanding bank loans currently amount to RMB47tr, while outstanding corporate and enterprise bonds are only RMB1.3tr. If the Chinese corporate bond market grows 30% annually to 20% of GDP within 10 years (which is comparable to Thailand's level today), then total outstanding corporate bonds would reach RMB20tr. That is, more than 15% of total bank loans would be replaced by corporate bonds in 10 years. Since the yield gap between bank loans and AAA-rated corporate bonds is currently about 1.5%, banks' net interest margin would shrink by 23bps if the banks decide to hold corporate bonds issued by their former borrowers. The NIM impact could be bigger if the competition from the capital market eventually leads to a broad-based reduction in lending rates.

Figure 16: Relative spread between bank loan and bond financing costs (24 December 2010)



Source: Deutsche Bank, www.chinabond.com

If depositors move their funds to invest in corporate debt directly, the banking system would be bypassed by the direct interface between depositors and corporate borrowers. As a result, the volume of bank loans would shrink. Therefore, financial disintermediation would impact the volume and margins of the banking sector.

Interest rate liberalization and RMB internationalization may also reduce NIMs

At present, the central bank regulates deposit and lending rates by setting the caps on deposit rates and floors on lending rates, thereby protecting the banks' net interest margins. As a result, the Chinese banks' net interest margin is around 2.5%, which is substantially higher than that of OECD banks after adjusting for credit costs.

In contrast to developed markets, China's credit allocation across banks is based on predetermined quotas. Interest rates do not play a major role as they are heavily regulated. This system is not sustainable due to the following reasons.

First, a quota-based credit-allocation system does not ensure that funds go where they are needed most (or where they produce the most risk-adjusted return). It also favors less-efficient banks as their margins are overly protected.

Second, the operating target of monetary policy would need to be switched from monetary aggregates to interest rates as it will be increasingly difficult to estimate money demand when financial innovations blur the gap between various financial assets (e.g., checking accounts vs. money market funds vs. consumer credit lines). In other words, targeting aggregate M2 growth will not be effective in controlling inflation, as demand for money is unstable and difficulty to measure. When a policy rate (e.g., the seven-day repo) becomes the operating target for monetary policy, all interest rates have to be free of control in order to achieve effective monetary policy transmission from the policy rate to the real economy.

Third, the internationalization of the RMB will likely speed up the interest-rate liberalization process and expose domestic banks to more foreign competition. PBoC governor Zhou Xiaochun stated recently that China will open its capital account in the next few years. When a country's capital account is opened, it should be even more difficult to estimate the

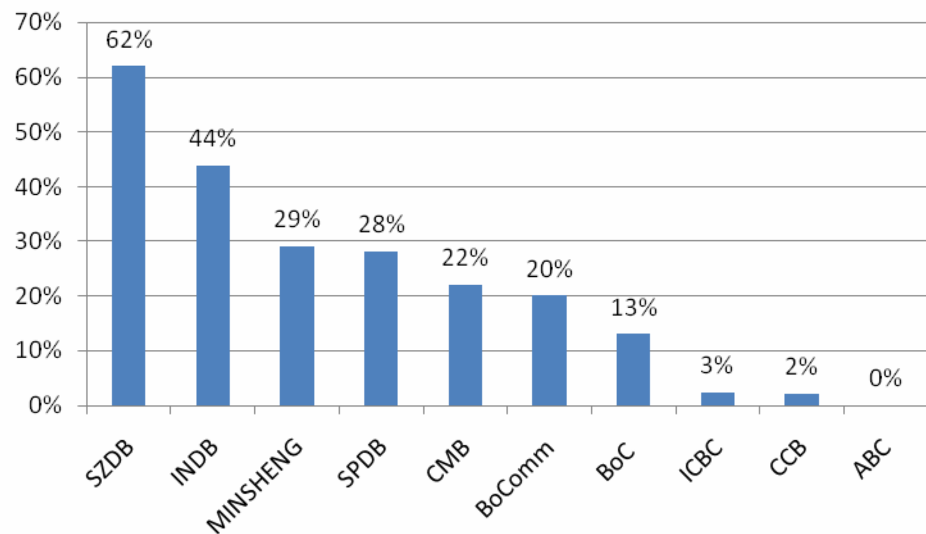
demand for money, as some of this demand will be from overseas investors and for international trade. Thus, the internationalization of the RMB would require an interest rate-based monetary policy-targeting mechanism as a precondition. The liberalization of interest rates would thus need to take place before the full opening of the capital account.

In addition, RMB internationalization means that the domestic banking sector will be exposed to competition from the offshore market. When RMB funds become more mobile internationally, international banks that are satisfied with a much narrower NIM will begin to force a reduction in lending rates and/or an increase in deposit rates in the onshore market.

Tougher bank regulations pose additional risks

As part of the global trend toward safer and more liquid banks, banks are required to hold more capital and more liquid assets. As a result, the cost of capital for banks will likely rise and the return on equity would fall on reduced leverage. In the case of China, systematically important banks will be required to hold an additional 1% capital. More importantly, the provisioning requirements will be raised to meet the following two criteria, whichever is more stringent: 1) 150% coverage of NPLs and 2) loan loss reserves at 2.5% of total outstanding loans. These new measures are due to be phased in beginning in 2011. For mid-sized banks that used to enjoy low NPLs, the 2.5% loan-loss reserves on total outstanding loans will likely pose a major challenge for them in 2011. Systematically important banks will have from 2011 to 2012 to complete the provisioning requirements, while other banks (mainly small ones) will have to fully meet the requirements by 2016. Our bank analyst Tracy Yu estimates that the total provisions of listed banks will likely increase by RMB86bn, equivalent to 8.5% of 2011 estimated earnings. Figure 17 shows that the mid-sized banks should see substantial increases in provisions in 2011, while the big four should be largely unscathed.

Figure 17: Estimated provision shortfall (as % of 2010 PBT) on 2.5% of total loans



Source: Deutsche Bank estimates.

The other two major balance sheet items that will likely pose new capital charges are bank trust products sold in 2010 and loans to LGFV. In August, the CBRC instructed the banks to bring the off-balance sheet bank trust products back to the balance sheet by 2012. Assuming that the listed banks are prepared to roll over all of the remaining trust loans (around RMB1tr) onto their balance sheets upon maturity, Tracy estimates that the earnings impact should be around RMB10bn, or 1% of 2011 profits. On 23 December, the CBRC required banks to raise the risk-weighting for LGFV loans on the basis of cash flows. Tracy estimates that the new risk weighting will likely lower the banks' pre-tax profits by 13%, given that the total size of

LGFV is near RMB3tr. In particular, the regulatory treatment of bank trust products and LGFV loans will likely pose particular challenges to the mid-sized banks as their existing loan-loss provisions are significantly lower relative to outstanding loans compared with the big banks.

In summary, the new provisioning and capital requirements could negatively impact the banking sector earnings by up to 22% of expected PBT in 2011, according to Tracy. The mid-sized banks are even more vulnerable compared with the sector average (Figure 17).

Inflation and banks' share performance

The above-mentioned structural and regulatory risks will likely pose challenges to the banking sector over the medium term. In the coming months, however, we believe the main policy overhang over bank stocks is inflation-led policy tightening, as inflation will likely remain elevated for at least a few more months.

Banks tend to underperform the market in a macro environment where CPI inflation is more than 4% yoy and policy tightening is aggressive and uncertain. The typical responses of the PBoC to high inflation include credit tightening, rate hikes, and increases in the reserve requirement ratio. Credit tightening is obviously negative for the banks' top-line growth and could lead to economic deceleration and less liquidity support for asset prices. Although asymmetric interest rate hikes typically expand banks' NIMs, rate hikes also raise concerns about an economic slowdown, corporate earnings deceleration, a potential bursting of property bubbles and worsening loan quality. RRR hikes tend to marginally depress NIMs.

In addition to the negative impact of these policy actions on market sentiment, we believe a more important headwind comes from the uncertainty of inflation. When inflation exceeds 4%, it is almost always less stable than the scenario of 2% inflation. Thus, policy uncertainty – e.g., the timing and magnitude of policy actions – will likely dominate the market even though the consensus forecast points towards a benign outlook over the medium term. In other words, even if every economist predicts that inflation will come off after six months, the market could remain nervous about the near-term market reaction to higher inflation.

We forecast CPI inflation to be near the peak around mid-2011 (see the previous sections of this report). It is therefore likely that the banks' share performance will remain depressed for a few months from now before a rebound in 2Q 2011. This rebound should drive a rerating of the banking sector in anticipation of the end of policy tightening.

One caveat is that banks' performance in 2H 2011 will also depend on the GDP growth outlook. Only reasonable growth accompanied by declining inflation would lead to a consistently good performance from the banks. Our central scenario is that GDP growth will likely decelerate modestly to around 8.5% yoy in 2H11. This implies that banks should deliver an acceptable, but not outstanding, performance. In the case that GDP growth falls to below 8% in 2H next year, we believe banks could be underperformers for most of next year.

Big banks to outperform mid-sized banks

We believe big banks are better prepared for the changing macro/regulatory environment and their franchise networks will likely become more valuable.

First, mid-sized banks are more sensitive to the inflation cycle, given their heavy dependence on volume growth and reliance on interbank funding. That is, mid-sized banks will likely underperform large banks in a macro tightening environment. Part of the valuation discount for mid-sized banks vs. the big banks could also be attributable to NIM risks arising from financial reforms, and thus may persist for a long time.

Second, big banks have already built up enough loan-loss provisions to meet the new provisioning requirement of 2.5% of total outstanding loans, or 150 coverage of NPL, whichever is bigger, while most mid-sized banks are facing provisioning shortfalls of up to 86%.

Third, big banks are funded mostly by cheap short-term retail deposits and their loan-to-deposit ratios are not stretched. As the net lenders in the interbank market, big banks also could benefit from rising interbank rates.

In contrast, mid-sized banks rely heavily on corporate deposits or short-term interbank borrowing, so their funding costs will most likely increase as the interbank bank liquidity becomes tighter following the upcoming RRR hikes and deposit rate hikes. Their business models are geared toward volume growth, while their loan-to-deposit ratio is already around the 75% limit.

Fourth, big banks have more retail branches and diversified loan books, whereas some mid-sized banks are concentrated in the coastal areas, where competion is intensifying. The development of the inland provinces and rural areas will likely benefit those big banks.

Fifth, big banks are viewed as implicitly guaranteed by the governement. When deposit rates are liberalized, they tend to enjoy lower funding costs than smaller banks, which could need to pay a premium to attract deposits.

Conclusion: we favor big banks over mid-sized banks while focusing on inflation-driven price dynamics

We believe that NIM compression risk arising from regulatory reforms and financial liberalization is substantial. As a result, the ongoing de-rating of the banking sector is unlikely to be reversed any time soon, in our opinion.

In this environment, we favor big banks over mid-sized banks as their NIMs are more resilient and their business model is more sustainable. In particular, we believe big banks will likely benefit from their franchise value and lower retail funding costs, less dependence on volume growth, and fewer NPL risks and conservative provision policies.

The banks' share price dynamics in 2011 are likely to be closely linked to the inflation cycle. We think a recovery sometime in 2Q 2011 is possible as the market will likely begin to expect disinflation and an end to aggressive policy tightening in 2H. The possibility of the banking sector significantly outperforming the overall market for the year as a whole is limited, however, given the strong structural headwinds over the medium term.

Theme #2: Public housing

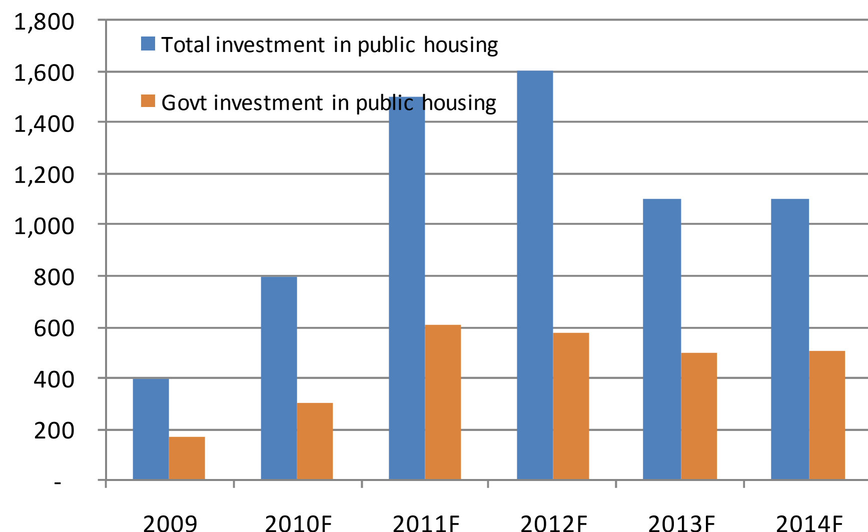
After starting the construction of 5.8m public housing units in 2010, the Chinese government's target for 2011 is 10m units. In this section, we will look at a range of implications of this apparently massive number on FAI, commodities, and the real estate market.

After examining the public housing plans of the country and those of 15 cities, as well as many technical details in definitions, funding, and the construction cycle, we conclude the following:

1) **The boost to investment and raw material demands is likely to be most visible in 2011** (see Figure 18), **as total public housing investment will likely double in 2001.** It will also likely account for 20% of real estate investment and 40% of real estate investment growth in 2011, providing strong support for cement demand and prices (but less for steel). **However, public housing investment growth will likely decelerate sharply to zero beginning in mid-2012.**

2) **The surge in the supply of public housing will likely cap the demand and pricing for developers in the mid-end market in 2011.**

Figure 18: Surge in public housing investment in 2011



Source: Deutsche Bank estimates

The myth of the 5.8m units in 2010

Many investors have been confused by the government's claim that 5.8m public housing units were constructed in 2010. Some 5.8m units would be equivalent to nearly 60% of total commodity housing sales (around 10m units per year), but very few low-income earners have been offered the chance to buy or rent these public housing units. What's wrong here?

Public housing is vaguely defined and subject to interpretation by local governments. Based on our discussions with government agencies, including the NDRC, Ministry of Construction, and local governments, as well as property developers and industrial experts, we have come up with the following breakdown of the 5.8m units:

- **The figure of 5.8m is a new-start target, and only around half were completed in 2010.** The Ministry of Construction originally aimed for a 60% completion rate, but by the end of August, less than 30% had been completed and another 30% had not even been started (and thus are unlikely to be completed by the year-end).

At least 30% of the official public housing units have received little government funding

- We estimate that around 2m of the 5.8m units have received little government funding. The reasons are as follows:
  - Approximately 10%[1] of these public-housing units are Liang Xian Fang (两限房), i.e., apartments with government-imposed caps on sizes and selling prices. These apartments are constructed by developers (rather than government-owned projects or construction companies), but local governments provide a small discount on land prices in exchange for the developers' acceptance of the size and price caps;
  - Approximately 20%[2] of these public-housing units are built for relocation-area residents (动迁房) or for shanty-area redevelopment (棚户区改造). While developers buy a plot of land in an old residential area, they are responsible for moving the original residents to a newly built residential property. The replacement residence is typically constructed by the developer without government funding;
  - Occasionally, small (<90 sqm) commodity housing units are also labeled public housing; and
  - In some localities, workers' dormitories built by companies (without government funding support) are classified as public housing.
  - The construction cost for public housing is much lower than commodity housing (properties constructed by developers with no price caps set by the government). We estimate that the cost per square meter of public housing is at least 50% lower than that of commodity housing. The Ministry of Construction estimates that the 5.8m units of public housing would require an investment of RMB800bn, or around RMB2,100 per sqm. However, the cost per square meter of commodity housing is RMB7,800, according to the January-November data reported by the Statistics Bureau. The media have also reported some cases of serious quality issues with public housing, partly due to cost savings[3].

A typical public-housing project takes 12-18 months to complete. Considering the above-mentioned issues surrounding the definition of public housing, we estimate that the total government investment into public housing has been about RMB300bn in 2010[4] vs. a total investment of about RMB800bn. We define government investment here as including budgetary funding, as well as the borrowing and bond issuance of government-sponsored public-housing project companies. This does not include the investments made by developers on Liang Xian Fang, relocation replacement residencies and small commodity housing units, and does not include investments made by companies in workers' dormitories. Using this narrower definition, government investment in public housing accounted for only 5% of the total real estate investment and 1.3% of the total urban FAI in 2010. The broadly defined public housing investment – which includes government-funded low-income housing and public rental housing units, as well as those supplied by developers

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[1] Our estimate of 10% is based on the 2010-12 public housing plans of Beijing (22%), Guangzhou (22%), Chengdu (25%), Hainan (16%) and Tianjin (23%), Wuhan (30%), Zhuhai (0%), Huizhou (0%), Shenzhen (0%) and Shijiazhuang (0%).

[2] 20% is estimated based on 2010-12 public housing plans of Taiyuan (61%), Shanghai (43%), Beijing (45%), Tianjin (42%), Nanning (27%), Hainan (10%), and Guangzhou (0%), Chengdu (0%), Shenzhen (0%) and Zhuhai (0%).

[3] See reports on http://www.financialnews.com.cn/fdc/txt/2010-08/10/content_304105.htm, http://www.focus.cn/news/2010-10-15/1071971_2.html and http://www.news365.com.cn/xwzx/gn/201010/t20101009_2846098.htm

[4] We start with the RMB800bn investment needed for 5.8m units (as estimated by the Ministry of Construction), then apply the completion rate of 50% and the 30% public funding ratio (RMB800bn * 50% * (1-30%) = RMB280bn). Then we round this number to RMB300bn.

and companies at below-market prices -- accounted for about 14% of total real estate FAI and about 3.5% of total urban FAI in 2010.

According to the Ministry of Land and Resources, land supply for broadly defined public-housing projects increased 43% yoy in the first 11 months of 2010, and accounted for 14% of total residential land supply during that period.

Public housing investment will likely double in 2011

The public-housing target has been set at 10m units for 2011. This target is likely to be achieved, in our view, given the strong political pressure on the government to supply affordable housing to mid- and low-income households. The aggressive 2011 target, coupled with the continuation of many public-housing projects started in 2010 (around half of the 5.8m units), suggests that the investment (broadly or narrowly defined) in public housing will likely double in 2011.

However, public housing investment growth will likely fall to around 10% in 2012 and become negative around mid-2012. The long-term growth of public housing investment is likely to be capped due to several factors: 1) the annual supply of public housing from 2012 (largely reflecting investments in the previous 12-18 months) would be sufficient to meet the government targets on coverage (see discussion below); 2) an increasing proportion of lower-income households' housing demand will likely have been met beginning in 2012; and 3) land revenue growth will likely slow due to the diminishing proportion of land sales at market prices, thus capping the fiscal capacity of local governments.

The public-housing targets of local governments suggest a jump in investment in 2011, but low growth thereafter

The plans for public housing made by most local governments suggest a jump start in 2010 and follow-through in 2011, but much lower growth afterwards. Translating into investments, this confirms that the peak of investment growth will likely be in 2011. For example, Chongqing targets to start the construction of around 9m sqm of public-housing units each year during 2010-12, representing around 40% yoy growth in 2010, but less than 15% in 2011-12 (note that investment growth peaks typically one year after the project starts to peak). Similarly, the targets of Shanghai, Guangzhou and Shenzhen imply around 100%, 60% and 100% yoy growth, respectively, in public-housing project starts in 2010, but a sharp deceleration afterward. The projects of local governments in lower-tier cities show a similar trend.

What proportion of households will and should be covered by public housing? The answer for Chongqing will likely be 20% by 2015 and 30% by 2020. However, Chongqing has the most ambitious provincial government in the country and enjoys a huge land bank due to a special central government policy as an experiment in urbanization. Most other large cities only aim to cover 10-15% of urban households as their long-term goals (2020 targets). Smaller cities usually avoid taking on a concrete target of public-housing coverage due to lack of incentives and/or fiscal capacity.

With this targeted coverage ratio, we can then calculate the implied investment growth. Assuming public housing will cover 10% of the total number of urban residents by 2015, this implies that 25m units would need to be built during these five years, or 5m units per year. Given the project starts of 5.8m units in 2010 and 10m units in 2011, new starts would only need to be 5-6m units per year after 2012. This confirms that investment growth will likely peak in 2011 and trend down thereafter (see Figure 18). Over the medium term (2012-15), we believe government investment in public housing will likely account for about 10% of real estate investment, but the broadly defined public-housing investment will likely account for about 20% of total real estate FAI.

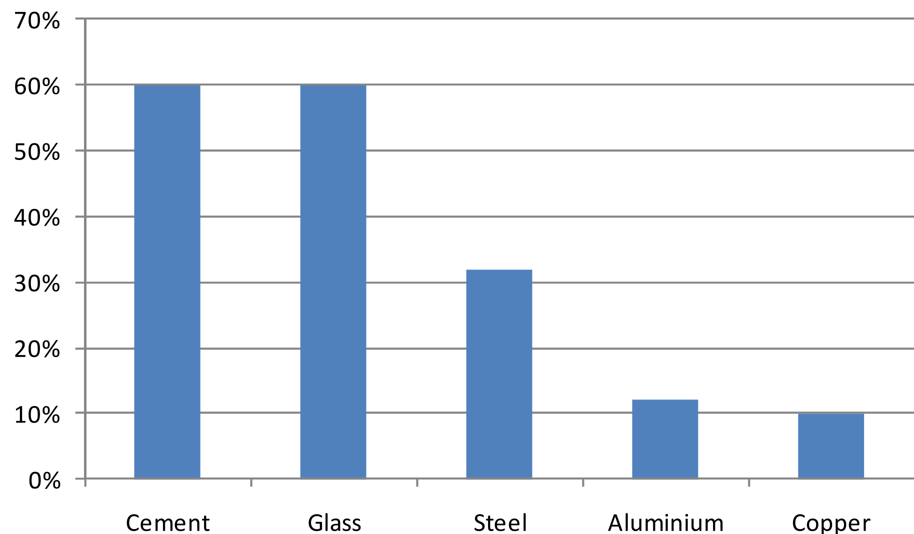
Investment implications

Public housing to support cement price

Despite the government's tightening measures, property investment growth remained strong in 2H 2010, increasing 37% yoy during January-November. However, a deceleration in investment in commodity housing seems inevitable in 2011, given 1) the likely sharp increase housing supply in 1H 2011 following the record-high growth in project starts (measured in floor space) at 63% yoy during 1Q-3Q 2010; and 2) the fact that government policies will likely continue to become tougher on speculative demand and price increases. In particular, we expect the property tax to be introduced in a few major cities, such as Shanghai and Chongqing, in 2011.

We expect FAI growth in the commodity housing segment to slow to 20% in 2011 from 35% in 2010. Meanwhile, government investment in public housing could double in 2011. Given that government investment accounted for 5% of total real estate FAI in 2010, this means that government investment can boost overall real estate FAI growth by 5ppt in 2011. In other words, public housing could be an important cushion to mitigate demand deceleration for building materials. The positive impact of the public-housing program is likely to be most obvious in cement, which derives around 60% of demand from the real estate sector and rural housing construction. In contrast, only about 30% of steel demand comes from real estate construction (see Figure 19).

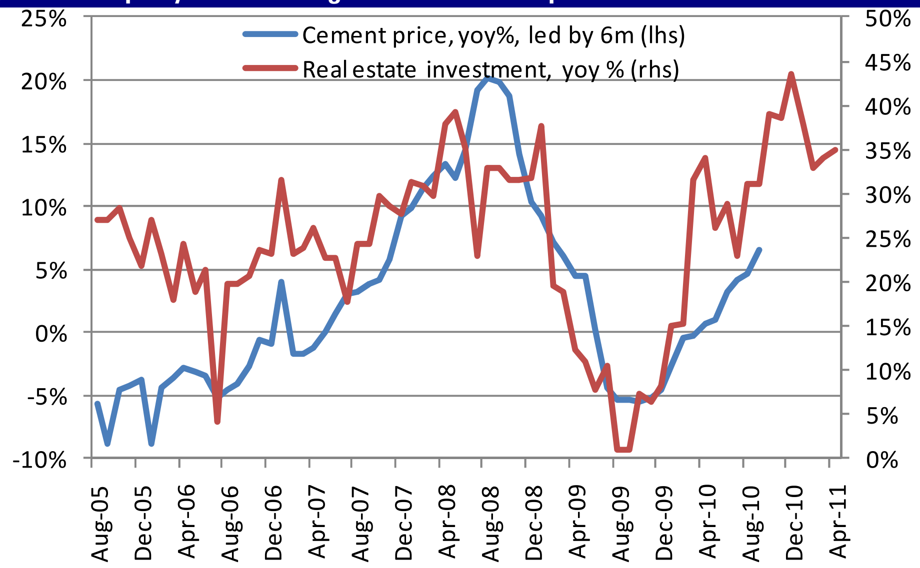
Figure 19: Demand dependence on real estate (including rural housing)



Source: China Iron & Steel Association, China Nonferrous Industry Association, China Cement Association, Deutsche Bank

Historically, the spot price of cement has remained closely correlation to real estate investment, with a lag of a few months (see Figure 20). Figure 20 shows that a 25% increase in real estate investment, which is our projection for next year, should imply a 5-10% rise in cement prices.

Figure 20: Property investment growth vs. cement price increase



Source: Deutsche Bank

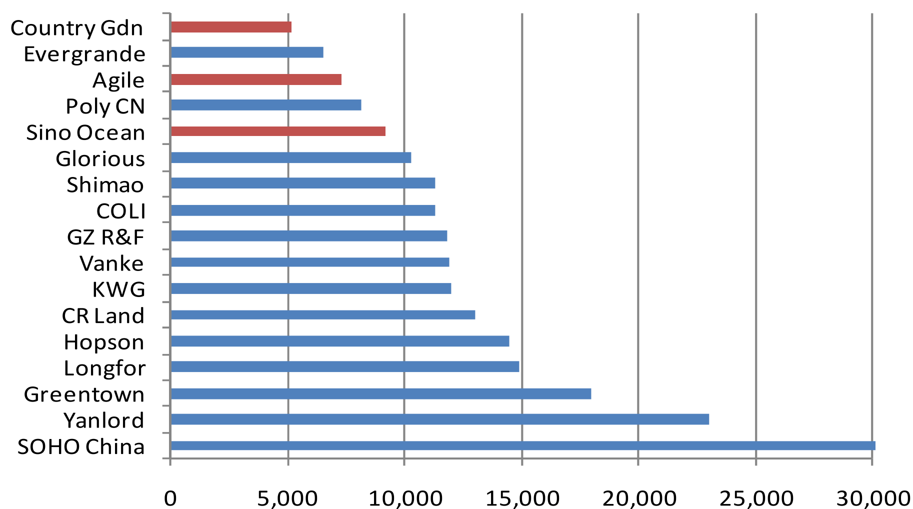
Public housing to challenge the demand for and pricing of developers in the mid-end market

The public-housing program will likely become a serious challenge for low- to mid-end property prices in 2011. In cities with aggressive public-housing plans, public housing could account for one-third of the total supply in the mid- and low-end segments of the market. At least part of the demand for commodity housing would be substituted by the public-housing program and therefore would generate downward pressure on prices.

Our property sector analyst Venant Chiang views Country Garden, Agile and Sino Ocean as the most likely victims among the overseas listed property names. Evergrande, though widely perceived as a mass-market developer, focuses on tier-2 and -3 cities where the public-housing program is likely to be less aggressive. Therefore, public housing does not pose a serious threat to Evergrande in most of its target cities.

The high-end property market is likely to be largely immune from the public-housing program, even in Tier-1 cities, as no direct substitution should take place. Companies such as Shui On, Yanlord, Longfor and Greentown are thus unlikely to be affected.

Figure 21: Property developers' estimated average selling price



Source: CRIC, company reports, Deutsche Bank

Theme #3: An updated "equipment" basket

In our report titled *China's Manufacturing Upgrade* on 31 August 2010, we argued that the growth of the equipment and machinery sectors should significantly outpace that of the labor-intensive and material-intensive manufacturing sectors over the next five years. We continue to view this argument as one of the most important long-term themes for the equity market in the coming years. This section recaps some of the arguments for the theme, and provides an updated basket of companies that should benefit from this structural trend in 2011.

The best performing sub-sectors in the equipment space, in our view, will include coal-mining machinery, construction machinery, medical equipment, rail equipment, power equipment, shipbuilding, telco equipment and industrial automation.

Reasons for equipment sector to outperform material- and labor-intensive sectors

For the next five years, we believe the single most important investment theme for China's manufacturing sector will be its upgrading. Our analysis suggests that China's industrial structure will likely shift rapidly towards equipment manufacturing, and away from the material- and labor-intensive sectors. [5]

Specifically, we expect the equipment sector to grow (in real terms) over the next five years at 17-20% p.a. vs. 10-12% for overall IP growth, 7-10% for raw materials, and 5-7% for labor-intensive manufacturing. As for exports, we expect equipment export volume growth to exceed 20% p.a. vs. low single-digit growth in the labor-intensive export sectors. Figure 1 summarizes our forecasts of IP growth by sector in the next five years. One can see that most of the outperformers in the next few years will likely be in the equipment/machinery sectors.

We see at least five drivers for this structural upgrading:

1) Domestically, the acceleration of wage growth will likely lead to higher demand for equipment;

2) China's technical competency in the equipment sector is now in its "golden age" to gain export market share from Japan, South Korea and Germany, where production costs are much higher;

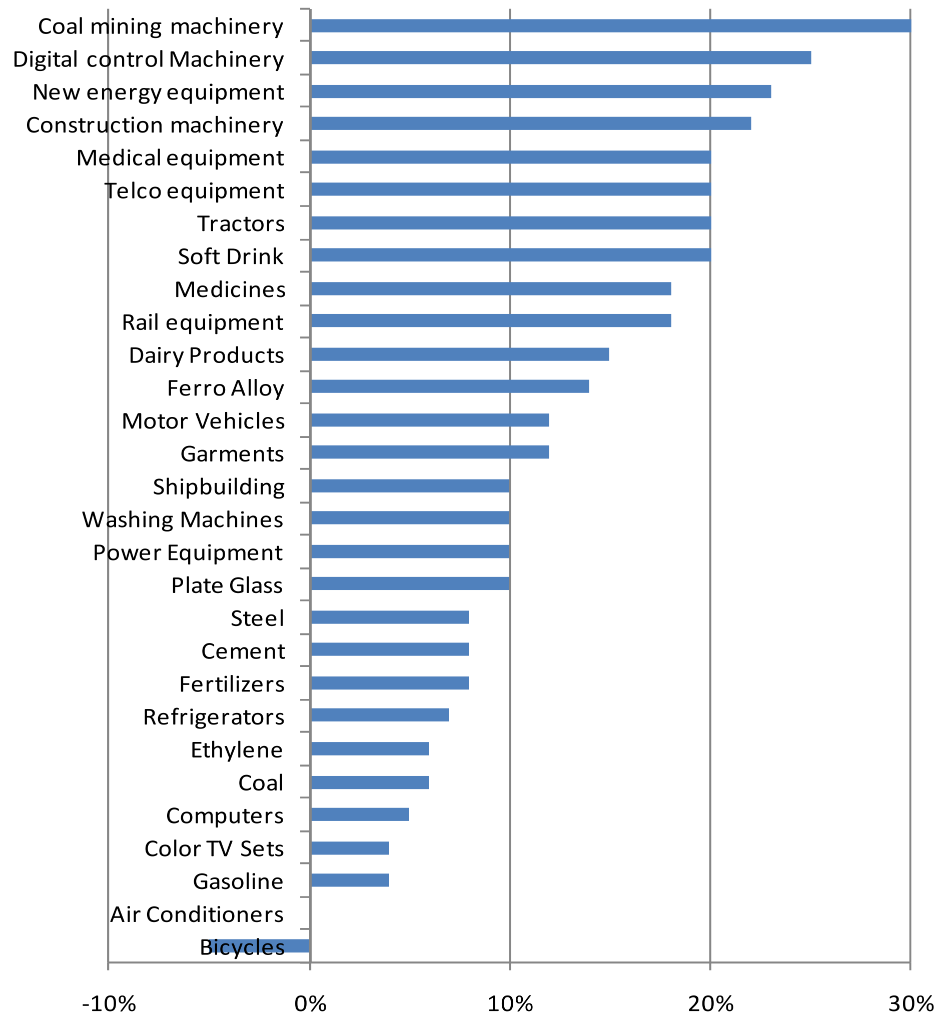
3) China's costs are falling faster than its competitors due to productivity growth;

4) The large domestic market and localization policy mean that China is best placed to enjoy economies of scale, which will likely offer growing cost advantages to domestic producers against global competitors; and

5) The Chinese "Marshall Plan" should speed up equipment exports.

[5] Despite the slight difference between "equipment" and "machinery", we use these terms almost interchangeably in the report to refer to sectors such as mining machinery, construction machinery, railway equipment, medical equipment, power equipment, and shipbuilding.

Figure 22: Our forecasts for industrial production (volume) growth, annual average, in %



Source: Deutsche Bank

Higher wage inflation should boost demand for machinery

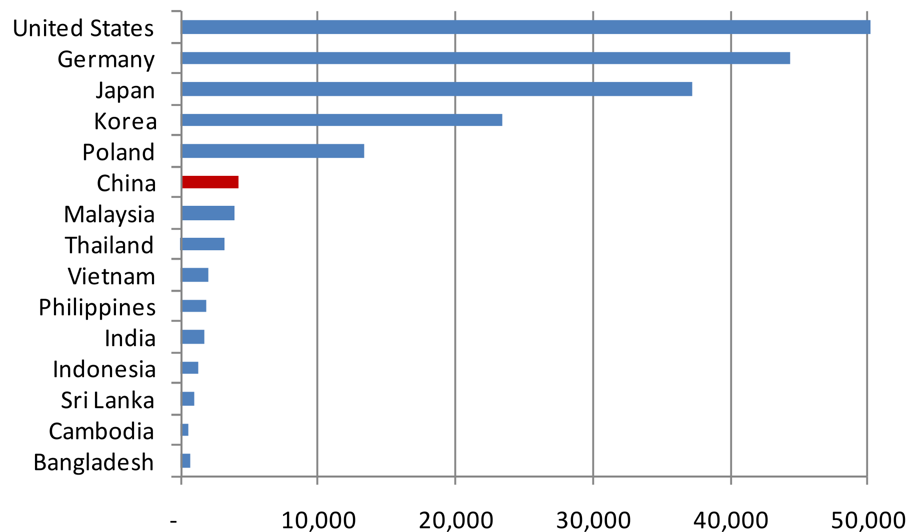
Here we discuss the five points in greater detail.

In the next few years, we expect wage inflation to accelerate to 14% p.a. from 10% p.a. in the past decade. This reflects the growing social and political pressure due to the significant deterioration in income distribution in the last ten years. The structural implication of higher wage inflation on the manufacturing sector will likely be a rise in machinery intensity. When average labor cost rose 12% p.a. (vs. 6% in the prior ten years) between 1960 and 1973, the capital intensity (measured by the capital-to-labor ratio, a proxy of usage of machinery to replace labor) rose by an average of about 17% per year, significantly higher than in previous periods (7-10% in the 1950s) and after (5-7% in the 1980s).

In equipment sector, China's wage rate is still 1/10th that of its competitors

In the equipment sector, China is now competing with countries where wage levels are 10 times higher than the Chinese wage rate. China's main competitors are from OECD countries, such as Japan, Germany, South Korea, and the US. Even five years later, China's wage rate will likely still be about one-sixth of that in competing countries, in our view.

Figure 23: Annual wage comparison (US$/person), 2009 or latest available



Source: Deutsche Bank, CEIC, OECD

China's rapid productivity growth should allow further reduction in costs

Productivity growth should dynamically reveal China's competitive edge stemming from its low labor costs. While labor productivity growth is slowing in many other manufacturing sectors, China's equipment sectors continue to enjoy the strongest productivity growth rate as the country's productivity level remains so much lower than those of global peers. For most equipment sectors, China's labor productivity remains only one-fifth to one-tenth of that in Japan, South Korea and Germany. This suggests considerable room for growth and thus significant potential for further unit cost reduction in China.

China's huge market size should allow domestic firms to enjoy economies of scale

Another key advantage that differentiates China from other competitors in the equipment market is that the country has or will likely have the biggest domestic market, which allows it to enjoy most economies of scale, i.e., unit cost reduction, and thus to gain global market share. By 2015, China's new energy equipment will be nearly 10 times that of Japan, nine times for rail equipment and five times for power equipment and shipbuilding.

China's "Marshal Plan" expected to facilitate exports to developing countries

Another interesting development that may help facilitate the export of equipment made in China is the Chinese version of the "Marshall Plan," proposed by some policy advisors in addition to direct fiscal and financial support from the government for high-end manufacturing. The term "Marshall Plan" refers to the strategy for China to invest in or lend to emerging economies such as Africa, Central Asia and Latin America for their infrastructure and resource projects, including railways, roads, bridges, mining projects, power stations and telecommunications networks, and simultaneously sell equipment, such as construction machinery, railway equipment, power equipment and telco equipment, to these countries. As these projects are financed by China, and are typically implemented by Chinese construction companies, it is natural for them to use equipment and components produced in China.

A typical example is the trade agreement of railway vehicles between China and Pakistan in December 2009. According to the agreement, the Export-Import Bank of China provided the Ministry of Railway of Pakistan a loan of US$203m, which was earmarked to cover 85% of the payment for importing 277 locomotives made in China. Compared with aid or bilateral loans provided by the World Bank or western countries, China applies fewer political prerequisites on developing countries.

China is replicating Japan's upgrading experience in the 1960s-70s, but on a much larger scale

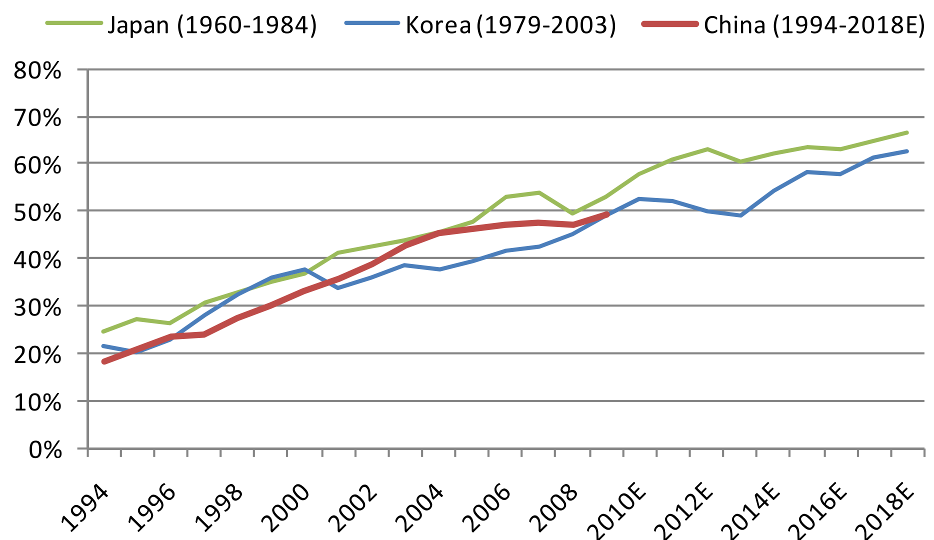
Japan experienced an export upgrade in the 1960s-1970s by replacing textiles and food products with machinery and equipment such as automobile, ships, and industrial automation equipment. We think the transition in China for the next 5-10 years will be very similar, but it is likely to be on a scale three times that seen in Japan 30-40 years ago and should thus have a much greater global impact.

Japan and South Korea increased their share of machinery exports by 1.5-2ppt per year during their upgrading periods

Japan and South Korea increased their share of machinery exports by 1.5-2ppt per year during their upgrading period (see Figure 24). Between 1960 and 1974, the proportion of machinery exports to total Japanese exports rose from 40% to 65%, i.e., by roughly 1.8ppt per year. During this period, Japan's machinery IP growth reached 11% per year, and the growth rate of its machinery exports was maintained at 25% per year. The increase in machinery exports as a percentage of total exports was about 1.5ppt p.a. during its upgrading period between the late 1970s and early 2000s.

It is easy to draw parallels between China today and Japan in the 1960s: for both, we can see energy and raw material constraints, currency appreciation, wage inflation, industrial consolidation and acceleration of international technology transfers. The fact that China's current position in machinery and equipment exports is similar to that of Japan in the mid-1960s, and that of South Korea and Taiwan in the mid-1980s, suggests to us that China should enjoy another 10 years of high growth in its equipment sector.

Figure 24: Machinery and equipment as a percentage of total exports



Source: CEIC, Japan Customs, Deutsche Bank

The difference, however, is that China's upgrading today is taking place on a much larger scale than that of Japan in the 1960s

The difference, however, is that China's upgrading today is taking place on a much larger scale than that of Japan in the 1960s, and could pose a bigger threat to its competitors in the OECD. In the 1960s, a 10ppt rise in the ratio of Japan's machinery and equipment export in total exports implied an increase in exports of US$5bn (in 2009 constant dollars). Today, a 10ppt rise in the ratio of China's equipment exports as a percentage of exports implies an increase in exports of US$160bn (also in 2009 constant dollar terms). In dollar terms, this suggests that the global impact of Chinese manufacturing upgrading (expressed here in the form of export upgrading) is about 30 times larger than that of Japan. Even if one takes into account the fact that the global size of the equipment market is now about 10 times that seen 40 years ago (6% growth p.a.), it still implies that the global impact of China's industrial

upgrading is three times that seen in Japan in the 1960s. In particular, it means that China's rise in the global equipment market will likely be a more serious threat to its OECD competitors than Japan was to the US and Europe in the 1960s.

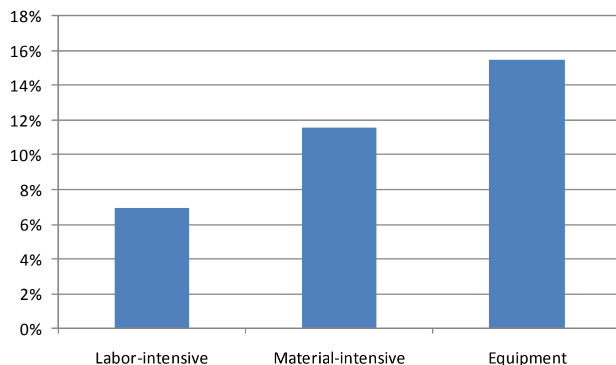
Market underestimates the potential structural upgrade

By studying 150 Chinese manufacturing listcos (with a market cap greater than US$1bn for A-share companies and larger than US$500m for overseas listed companies), we found that the market has seemingly not distinguished the difference in growth potential between the equipment, material-intensive, and labor-intensive sectors. The market consensus forecasts for 2010-12 EPS growth for the three groups of companies are almost identical.

However, as we have pointed out throughout this report, structural upgrading is most likely inevitable and should be significant. Our forecast is that the IP (in real terms) growth of the equipment sector will reach 17-20% p.a. over the next five years, significantly outperforming the 7-10% for material-intensive sectors and 5-7% for labor-intensive sectors.

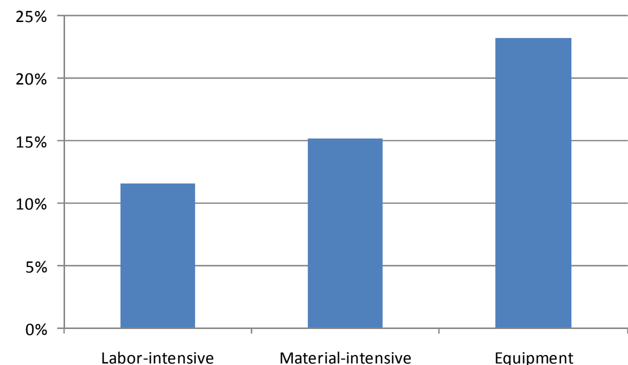
Historical experience from Japan and Korea also supports our projection (see Figure 25 and Figure 26)[6]. If the history of manufacturing upgrading in Japan and Korea provides any guide, the equipment sector should show obvious growth outperformance over the other two categories. Figure 25 shows that during Japan's manufacturing upgrading period (in 1962-1972), the IP growth of the equipment sector reached 15% p.a. vs. 11% for the material-intensive sector and only 7% for the labor-intensive sector. For Korea, Figure 26 shows that the country's upgrading era (1972-1982) saw its equipment sector growing at 23% p.a. vs. 15% for the material-intensive sector and 12% for the labor-intensive sectors. These patterns are consistent with what we forecast for China over the next five years.

Figure 25: Japan IP growth differential of equipment, material- and labor-intensive sectors (1962-1972)



Source: Deutsche Bank, Statistics Bureau of Japan

Figure 26: Korea IP growth differential of equipment, material- and labor-intensive sectors (1972-1982)



Source: Deutsche Bank

Eight equipment sectors and a "China equipment basket"

For the following equipment sectors, we identified the major Chinese listcos with strong competitiveness in both the domestic and overseas markets. These include telco equipment, ship building, rail vehicle/equipment, new energy equipment, coal-mining machinery and

[6] A potential challenge to our comparison above is that the IP growth trend does not necessarily indicate a similar trend for earnings growth. Indeed, if the pricing power in a particular sector rises more quickly than for others and its profit margin is expanding, then its earnings growth can significantly outperform its IP growth. However, it is difficult to argue that the change in pricing power will move in the opposite direction when demand (measured by volume) growth is stronger (or weaker). Given the uncertainty on margin trends, we choose to focus on the IP growth projection as a guide to structural changes.

construction machinery. In the medical and industrial automation equipment space, the Chinese market is still dominated by foreign vendors, but many Chinese companies are quickly catching up.

We compiled in Figure 27a list of the 10 leading companies from the eight equipment sectors that reflect China's "manufacturing upgrade" trend. The table shows Deutsche Bank or consensus forecasts of EPS growth rates and market valuations. We would like to highlight that the market has, in general, not fully priced in the potential for a major structural upgrade, as many analysts tend to merely extrapolate past growth in making their forecasts.

Figure 27: Leading companies in eight equipment sectors

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	PE 2011	EPS 2010-12	PEG (2010-12EPS /2011PE)
ZTE CORP-H	0763.HK	Telco equipment	Buy	30.9	11,384	20.2	19%	1.05
YANGZIJIANG SHIP	YAZG.SI	Ship building	Buy	1.9	4,569	12.2	7%	1.81
CSR CORP LTD-H	1766.HK	Rail vehicle and equip	Buy	10.2	15,551	25.1	37%	0.68
CHINA HIGH-SPEED	0658.HK	New energy equip	Buy	12.0	1,926	8.5	12%	0.69
INTERNATIONAL MI	1683.HK	Coal mining mach	NR	7.0	1,153	14.1	41%	0.34
SANY HEAVY EQUIP	0631.HK	Coal mining mach	NR	12.1	3,082	20.2	42%	0.49
SANY HEAVY INDUS	600031.CH	Construction machine	NR	21.5	16,485	17.9	24%	0.73
CHANGSHA ZOOML-A	000157.CH	Construction machine	NR	14.8	10,961	15.7	23%	0.67
MINDRAY MEDI-ADR	MR.N	Medical eqiupment	Buy	26.4	2,842	16.0	16%	1.02
HOLLYSYS AUTOMAT	HOLI.N	Industrial automation	NR	15.1	778	17.8	24%	0.74
Average					6,873	17	25%	0.82
MSCI China						11.8	15%	0.80

Source: Deutsche Bank, DataStream, Bloomberg Finance LP;
Note1: For Non-Rated stocks (NR), we use Bloomberg consensus estimates for EPS, P/E, P/B and revenue calculation. The NR stocks are not covered by Deutsche Bank's fundamental research and consequently we make no representation to the quality of the business, assets or management. Note2: the PEG of Yangzijiang Shipbuilding is high, but the earnings period typically lags the order period by two years

Telco equipment – ZTE (763.HK, HK$30.35, Buy)

The global telco equipment market totaled US$154bn in 2009, down 5.2% from 2008 due to the global recession, but will reach US$208bn in 2014, according to Infonetics Research, a US-based market research firm. In our view, Chinese manufacturers, mainly Huawei (a private company) and ZTE, will likely enjoy 15-20% growth p.a. by further expanding their overseas markets.

Since their first overseas orders in 1996-97, cross-town rivals Huawei and ZTE have transformed from local vendors into multinational telco equipment makers. They already dominate the domestic market (ZTE and Huawei respectively have 35% and 33% market shares in the 3G equipment market). In the global market, the combined market share of Huawei and ZTE currently stands around 30%, according to Dell'Ore Group. Compared with western peers, Huawei and ZTE offer not only lower prices than most competitors but also excellent quality of products. In November 2009, Norway's largest telco operator, Telenor ASA signed a six-year contract with Huawei to supply its new Norwegian wireless network, which will replace the old gear supplied by Ericsson and NSN. In December 2009, Spain's Telefónica, Europe's second-largest telco carrier, selected ZTE for WiMax (4G) deployment. The votes of confidence made by these large clients in developed markets demonstrate the technological maturity of "made-in-China" telco equipment. Huawei and ZTE have also secured a good position in the next-generation product market with 28% and 11% shares, respectively, of the de facto global 4G standard LTE trial programs.

Our tech analyst Alan Hellawell expects ZTE to enter a stronger year in 2011 driven by the optical and handset segment. His discussions with ZTE's operator customers suggest a spending recovery, complemented by strong handset ASPs and improving margin trends for the company. ZTE resumed wireless shipments to India in October 2010, and Alan expects market share expansion in other markets such as Hungary, Taiwan and Indonesia. The Deutsche Bank forecast suggests that ZTE is trading around 20x 2011 P/E with a 19% 2010-12 EPS CAGR.

Shipbuilding – Yangzijiang Shipbuilding ("YZJ", YZJ.SP, SG$1.94, Buy)
Among all the equipment and machinery sectors, China's shipbuilding industry is probably the most ready to take a leading global position. According to the London-based ship broker Clarkson, China overtook South Korea in 1H10 and became No. 1 by all key measures, including new orders, order backlogs and delivery. It put China around five years ahead of the government's stated ambition to become the world's largest shipbuilder by 2015.

It remains unclear whether Chinese shipyards can maintain high growth due to rising labor costs and currency appreciation. We are optimistic, however, on the outlook for the Chinese shipbuilding industry and expect 40-50% new order growth p.a. for the leading players over the next three years. This forecast is made on the basis of a further increase in China's market share and the rapidly improving global industry outlook. According to Deutsche Bank shipbuilding analyst Sanjeev Rana, global shipbuilding order growth will likely be in the range of 30-40% p.a. in the coming years. For China, we expect to see a further strengthening of its competitiveness due to its huge potential to improve productivity and technologies.

YZJ, a private shipbuilder, is among the top-five shipyards in China. Its products include large- and medium-sized containerships, large bulk carriers and medium-sized multi-purpose ships. Our analyst Kevin Chong has observed increasingly positive support from vessel financing by Chinese banks (China ExIm Bank alone has financed more than 3,700 vessels). Besides, the industry is being consolidated by the large shipyards: small players are continuing to struggle with order cancellations and most of the new orders are going to the large ones. YZJ management expects to grow shipbuilding capacity by 40% by 2012, and Kevin believes such an expansion and solid execution track record justify YZJ's current valuation of 4.0x 2011 P/B and 12.3x 2011 P/E.

Rail vehicle and equipment – China South Rolling Stock ("CSR", 1766.HK, HK$10.0, Buy)
China's rail vehicle market is dominated by the twin state-owned companies CSR and CNR, with nearly equal market shares, similar product lines and technology levels. There are a few smaller overseas listed rail equipment makers including Zhuzhou CSR (3898.HK, NR) and Sun King (580.HK, NR).

China's technology transfer and localization strategy for high-speed rail has made significant breakthroughs since 2003. With large orders on hand, the Ministry of Railways has successfully negotiated with all four major global players – Alstom, Siemens, Bombardier and Kawasaki/Hitachi – for the most favorable conditions for technology transfers. As part of the train-procurement agreements, joint ventures were established between these foreign manufacturers with either CSR or CNR. In other words, the design of China Railway High-Speed (CRH) models has been mixed with the advanced technologies from these foreign partners via technology-licensing agreements. More importantly, the Chinese technicians quickly grasped the key know-how. As supporting evidence, we point to China's CRH3 model, one of the world's fastest trains, which has been in successful operation, running at speeds of 330-350km/h, for more than two years. In a test conducted in December 2010, a CSR-made CRH380A train broke the global speed record and reached 486.1km/h.

Such a strong track record bodes well for CSR and CNR to explore overseas markets, though it is still very hard to penetrate into the western European and Japanese markets given the dominance of existing players for several decades. In other regions, CSR and CNR could prove to be formidable competitors for the likes of Alstom and Siemens. China has already sold high-speed trains to the Philippines, Tunisia, Ghana, Turkey and Venezuela, among others. Its prices are at least 20% lower than those quoted by its western peers.

Our rail sector analyst Phyllis Wang believes China's railway infrastructure spending in the next five years may be below the already-very-high expectations. She likes equipment names over constructors as the former should embrace strong domestic orders (which lag behind railway construction), rising overseas orders (including M&A potential) and proprietary core technologies to develop derivative products such as wind-power generators and electric autos. Her top pick in the sector is CSR, with 26x 2011 P/E and an estimated 37% 2010-12 EPS CAGR.

New energy equipment – China High Speed Transmission ("CHSTE", 658.HK, HK$11.4, Buy)

Apart from thermal power equipment, China is already the world's largest production base for solar PV modules and is quickly closing the technology gap with European and American wind power manufacturers. Over the last five years, Chinese wind equipment makers have defeated the imported systems in the domestic market by expanding their share from 25% in 2004 to currently over 90%. Nuclear power technology is controlled by the American and European players, however, and China is still lagging behind by at least five years in core design and manufacturing know-how.

In the power equipment space, our sector analyst Michael Tong prefers wind equipment given that the regulations are stable and favorable, the grid connection bottleneck should be resolved in the mid-term and the 2020 installation target of 150GW has upside potential.

CHSTE is the largest wind gearbox maker in China and among the top three in the world. The wind gearbox is a crucial component of the wind turbine, typically accounting for one-eighth of the total costs and involving high repair costs. Michael believes that the direct-drive turbine will pose no major threat to the gearbox-type turbine and thus the order flow of CHSTE will remain solid. The company is trading at around 8.2x 2011 P/E with a 12% EPS CAGR.

Coal mining machinery – Sany Heavy Equipment (631.HK, HK$11.66, NR) and International Mining Machinery ("IMM", 1683.HK, HK$6.18, NR)

Coal mining in China is vastly under-mechanized by international standards. Responsible for 40% of world coal production, China has more than 4m coal miners, which is 60 times more than that in the US. However, China's total coal production is only three times that of the US due to the much lower mechanization rates. Apart from low productivity, the heavy dependence on manual operations results in wasted resources – China's coal recycling rate is only 35% vs. 65% in other major coal-producing countries, and there are a considerable number of accidents. For each ton of coal production, the death toll of Chinese coal miners is 100 times that in the US and Australia, 32 times that in South Africa, 12 times that in Russia and 10 times that in India.

The domestic coal machinery market has been expanding by more than 40% p.a. since 2003. Given the low coal-mining mechanization rate (around 44% vs. 100% in developed economies), stricter safety standards and enormous export potential, we believe that 40% top-line growth is sustainable for the leading Chinese coal-mining machinery manufacturers in the next two to three years.

Sany Heavy Equipment and IMM are the two largest manufactures of road headers in China. According to the China National Coal Mining Machinery Industry Association, they each

accounted for about 27% of the domestic market share in 2008. Both companies are going global by attacking western peers such as Joy Global (JOYG.US, NR) and Bucyrus International (BUCY.US, NR) in developing economies such as Russia and South Africa. Sany Heavy Equipment, for example, has the aggressive plan to expand its overseas sales to 20% of total revenue (up from the current 2%). The Bloomberg consensus forecast suggests 41-42% EPS CAGR for both companies during 2010-12. IMM is trading at around 14x 2011 P/E vs. 20x for Sany.

Construction machinery – Changsha Zoomlion (000157.CH, CNY13.62, NR) and Sany Heavy Industrial (600031.CH, CNY20.59, NR)

Although the peak of China's infrastructure and real estate investment growth is now behind us, this does not necessarily mean a downtrend for the construction-machinery industry. Chinese manufacturers in this sector took the opportunity of the financial crisis to double their global market share and will likely generate more growth from overseas markets in the coming two to three years.

The upgrading of the construction-machinery industry in China today is very much like that in Japan during early 1970s. In both cases, the boom of fixed-asset investment incubated a group of powerful machinery makers. In the 1970s, Japan increased its construction machinery exports from 10% of the total output to over 30%. China currently stands at around a 17% export share. If Japan's history provides a guide, this would imply that Chinese construction machinery export growth could be 30% p.a. over the next three to five years and overall industry growth should exceed 20% p.a.

Zoomlian and Sany are the second- and third-largest manufacturers in the industry, respectively, with each around 10% market share. But their product lines are relatively more diversified and high-end than the largest player XCMG (000425.CH, NR), which focuses on truck cranes and crawler cranes. With less than 10% overseas sales exposure for both companies, Zoomlian targets to sell 60% products overseas by 2015 and Sany aims at 40% by 2012. If their global sales targets are achieved, their exports could contribute more than 70% to their growth in the next three to five years.

According to Bloomberg consensus, Zoomlian and Sany are trading at around 16x and 18x 2011 P/E, both with a 23-24% 2010-12 EPS CAGR. Zoomlian was listed in Hong Kong on 17 December 2010 (1157.HK) and has a market cap of about US$2.1bn.

Medical equipment – Mindray (MR.US, US$25.75, Buy)

China's medical equipment market has been about US$26bn in 2010 and our healthcare sector analyst Jack Hu projects that it should grow at a 20% CAGR over 2010-15. Compared with pharmaceuticals, medical equipment is massively under-consumed by the average Chinese patient. For instance, the five-year survival rate of cancer patients is 81% in the US but less than 25% in China. The primary reason for this huge difference is that many cancer patients are not diagnosed and treated at the early stages due to the inadequate use of diagnostic equipment.

The high-end medical equipment market is dominated by global players such as GE, Siemens and Phillips given their huge technical advantage over domestic manufacturers. But in the mid- and low-end markets, the market environment favors local players which have lower costs, extensive ties with hospitals, and multi-layered distribution networks. Besides, the government encourages the use of local brands by providing equal reimbursement rates for diagnostic fees – accordingly, even if it uses much more expensive imported equipment, a hospital cannot charge a patient more money.

Mindray is a leading domestic manufacturer in patient monitoring devices, diagnostic laboratory instruments and ultrasound imaging systems. The company generated 59% of

revenue from the overseas market in 1H 2010, mainly North America and Latin America. As the world's third-largest player in the c.US$4bn global patient monitoring device segment, Mindray is one of the few Chinese medical equipment makers which are technically mature enough to compete in the global market.

Jack expects Mindray to achieve faster growth after its sales force restructuring in 2Q11. He also expects the company's EPS to grow 16% p.a. in the coming two years and the stock to trade at around 16 times of 2011 earnings.

Industrial automation – Hollysys (HOLI.US, NR)

Industrial automation is an inevitable trend resulting from rising wage rates. At the same time, many high-end manufacturing sectors require automation equipment such as digital control, real-time monitoring, and high-precision processing systems to enhance the quality and accuracy of the products.

The size of China's automation equipment industry quadrupled over the last five years, but it still represents only 0.8% of total industrial production, vs. around 4% in the United States. The most automated industries are usually those dominated by large SOEs – power, petrochemical, metal refining and automobile. Foreign players such as Schneider, ABB, Honeywell, Emerson and Siemens command around 70% of China's market share, and 90% of the high-end segment.

Hollysys is one of the few domestic automation and control equipment makers which are capable of substituting foreign products. It has over 1,700 customers in the energy, power, petrochemical, railway and nuclear industries. It also commands 11% of China's industrial automation market and is among the only two qualified providers of high-speed rail automation equipment in the country. It is also the only domestic company to supply automated control systems to nuclear power plants in China.

According to Bloomberg consensus, the company is trading at around 18x 2011 P/E and its EPS will likely grow 24% p.a. during 2010-12.

Theme #4: Consumption shift towards services

One of the most important structural changes in the Chinese economy over the coming five years will be the shift from the consumption of goods to the consumption of services. In terms of nominal output, we expect China's service sector to grow 14-15% p.a. in the next five years, vs. 10-11% for the manufacturing sector and 7% for the agricultural sector. This broad trend of services outperforming manufacturing is supported by 1) high penetration of most goods but low penetration of services, 2) GDP per capita of US$4000-5000 as the empirical inflection point for service demand growth to accelerate, 3) stronger pricing power of service sectors than manufacturing sectors, and 4) no environment and resource constraints to develop the service sector.

The government will likely provide stronger policy support for the service sector in the 12th Five-Year Plan. Recently, the Chinese politburo stated that the government would "aggressively promote service consumption". The policy measures will likely include a reduction in taxes (by converting the business tax to a VAT) on services, permission for private and foreign investments in many service sectors, government investments in service sector infrastructure, favorable financing policies, lower rents, and subsidies for R&D.

We expect the following service sub-sectors to experience an average of over 20% annual growth in the coming five years: branded real estate agencies, tourism, IT services, enterprise software, as well as culture and entertainment.

Drivers for outperformance of service sector growth

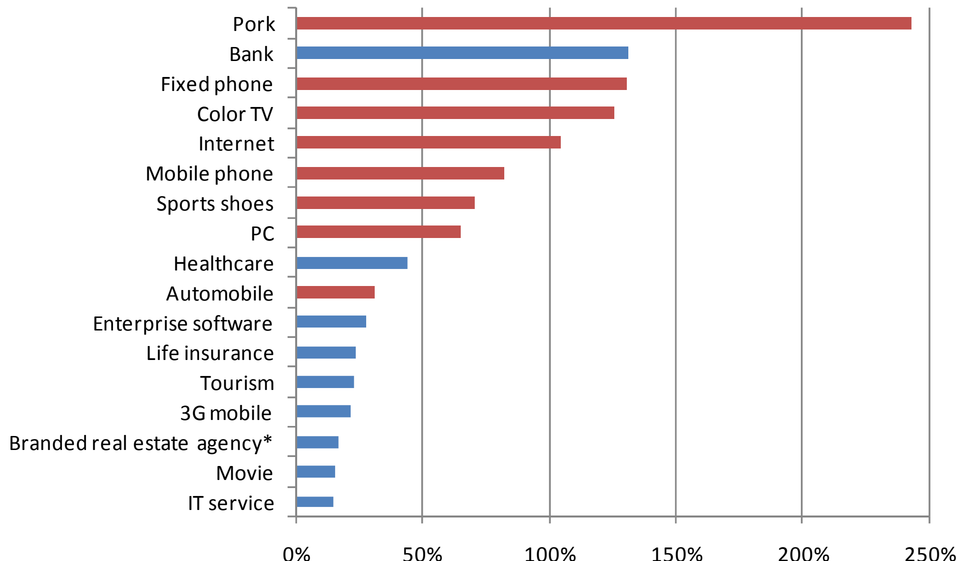
Reason # 1: Low penetration of services implies faster growth

In the past few decades, consumption growth in China has been led largely by the purchases of goods – homes, household appliances, automobiles, and PCs, to name a few examples. In particular, home purchases in the urban area have risen by 35% p.a. in the last ten years, nearly 20ppts higher than nominal GDP growth.

As a result, the penetration ratios of items in most goods sectors have exceeded 60% of the global average – note that China's per capita income is about 60% of the global average (see Figure 28). The penetration of many goods sectors, such as fixed-line phones, homes, color TVs and Internet connections, has exceeded 100% of the global average. In contrast, the penetration rates of many services including health care, software, insurance, tourism, IT services, and branded property agencies are significantly below the global average (averaging just 20% of the global penetration).

The S curve theory of consumption tells us that products or services that are of very low penetration are poised to grow at a significantly faster pace than those of higher penetration. In other words, the consumption of services in China will generally outpace the consumption of goods in the coming decade.

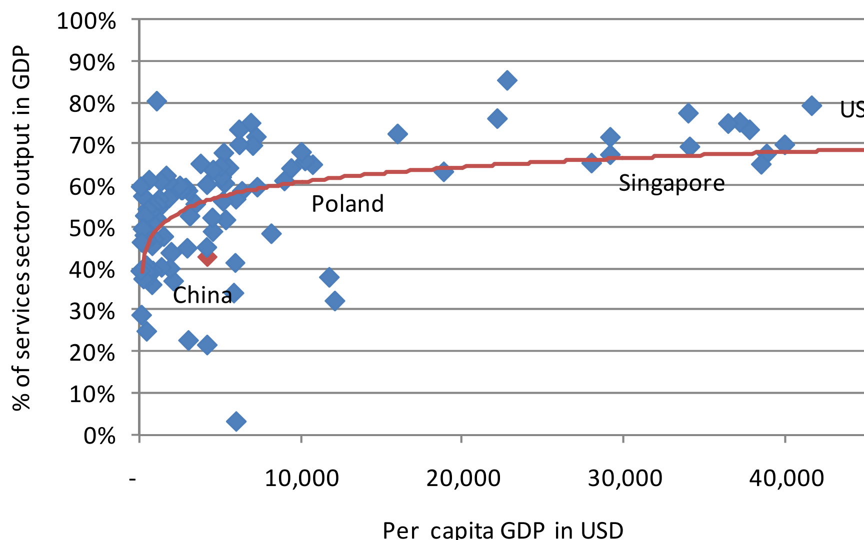
Figure 28: China's penetration as percent of global average – Penetration of services is much lower than that of goods (red)



*Source: 2009 data (or 2010 data if available) complied by Deutsche Bank; Note: * for property agency, the number refers to China penetration as % of US average*
Definitions and sources of penetration rate:
IT service: market size as % of GDP; Gartner
Movie: box revenue per capita p.a.; the Motion Picture Association of America; the State Administration of Radio Film and Television of China
Branded real estate agency: as % of total real estate agency fee; IBISWorld, Frost & Sullivan
3G mobile: subscribers per 100 inhabitants; MIIT of China, International Telecom Union
Tourism: international tourism receipt in USD per capita; the World Tourism Organization
Life insurance: insurance density (USD premium per capita); Swiss Re
Enterprise software: market size as % of GDP; Gartner
Automobile: Vehicle per 1000 people; World Bank
Healthcare: total public and private healthcare expenditure as % of GDP; WHO
PC: ownership per 1000 people; Gartner, China Statistic Yearbook
Sports shoes: sales per capita; Euromonitor
Mobile phone: ownership per 1000 people; MIIT of China, International Telecom Union
Color TV: ownership per 100 people; Dataxis Intelligence
Fixed phone: ownership per 1000 people; MIIT of China, International Telecom Union
Bank: revenue as % of GDP; IFSL
Pork: carcass weight kg per capita; USDA

In addition, China's service sector is underdeveloped (or underpenetrated) compared with countries with a similar per capita GDP level, and thus it will need to "catch up". We estimate that China's per capita GDP reached US$4,300 in 2010 and will rise to US$5,000 by 2012. Figure 29 shows a non-linear positive relationship between per capita GDP and the ratio of service sector output in GDP, based on data of about 100 countries. This cross-country analysis shows that when per capita GDP reaches US$4,300 (China's level this year), the service sector as a percentage of GDP should be around 55%, vs. China' actual of 44%.

Figure 29: Global comparison: Service as % of GDP vs. per capita GDP (in US$)



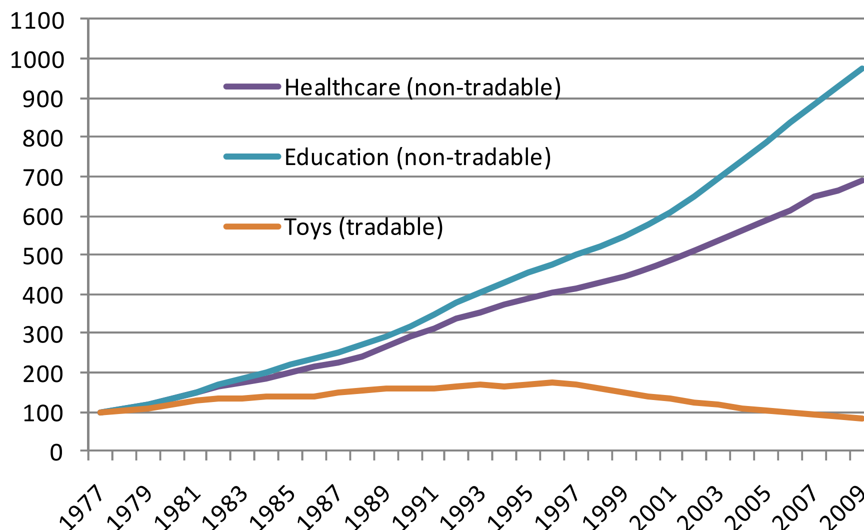
Source: World Bank

Reason # 2: Services enjoy higher pricing power

In addition to stronger volume growth, which is justified by its low penetration, the services sector also enjoys, and should continue to enjoy, stronger pricing power, in our view.

Figure 30 shows the American experience of a diverging pricing trend between a few typical non-tradable services and tradable goods. For example, the price of toys declined by a cumulative 18% between 1977 and 2009, largely due to the import of Chinese products into the US. However, education (mainly tuition) and health care services – the two most important non-tradable services – saw their prices rising by 870% and 590% respectively during this period, when overall CPI inflation was about 250%.

Figure 30: US: prices of tradable vs. non-tradable goods/services (1977 price =100)



Source: CEIC.

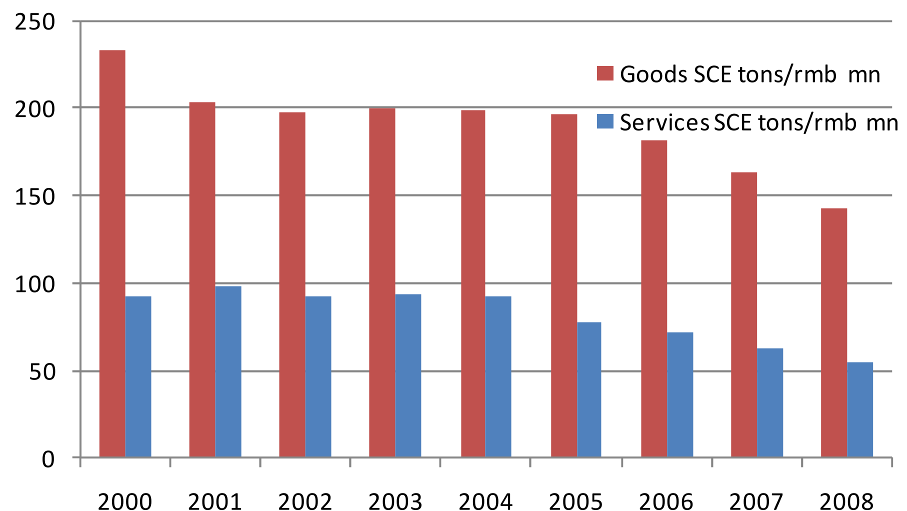
This difference between the pricing power of goods and services reflects several interesting factors. First, due to limited entry barriers, the manufacturing sector tends to suffer from oversupply. Second, the manufacturing of goods enjoyed a rapid increase in productivity

growth in the past due to innovation in technologies and product mixes, and improvement in management efficiency. Meanwhile, productivity growth in most services looks harder to achieve due to the sector's labor-intensive nature. In the future, the acceleration in labor cost increase will likely imply faster growth in service sector prices. Third, goods are generally tradable in nature and their prices tend to converge with those in low-income exporting countries. However, most services are non-tradable in nature and thus would see their prices rising along with local income growth. In the future, when China's low-end manufacturing will likely shift to neighboring countries such as Vietnam and India, their pricing power will continue to be capped, while the prices of services should enjoy faster growth in line with China's income growth.

Reason # 3: Service sector growth is less subject to resource and environmental constraints

The rapid growth of manufacturing activities in China in past decades has led to significant deterioration in the environment, and China is now facing serious constraints due to the growing shortage and/or import dependency on energy and raw materials. It is clear from Figure 31 that the energy intensity of the service sector is only a third that of the manufacturing industry. By raising the percentage of the service sector in GDP by 1ppt per year, China can reduce the energy intensity of its entire economy by 0.6ppt per year.

Figure 31: Energy consumption per unit of GDP (SCE tons/RMB m)



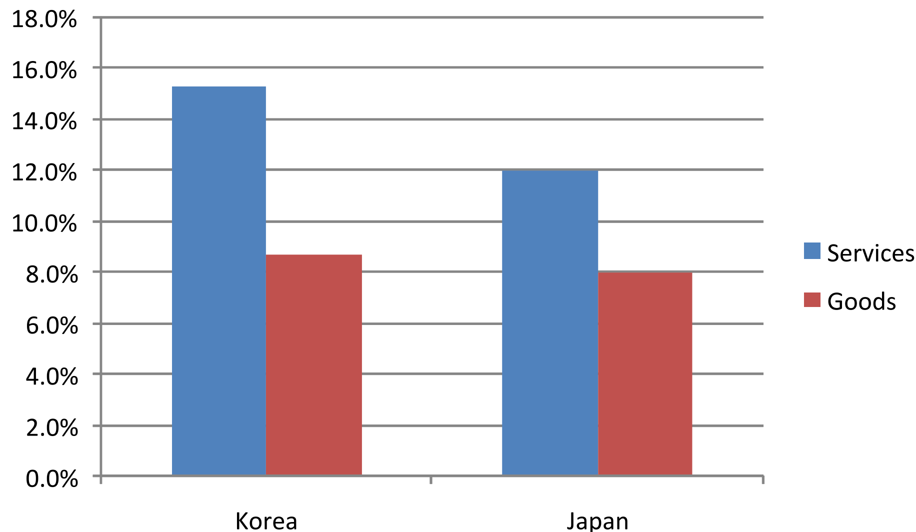
Source: WIND

Reason # 4: International experience suggests stronger service sector growth after per capita GDP reaches US$4000-5000

Figure 29 has shown that countries with per capita GDP at US$4000-5000 tend to see a sharp rise in their service-to-GDP ratio, i.e., the service sector tends to significantly outperform GDP growth from that inflection point. Asia's experience gives more specific examples. Figure 32 depicts the nominal consumption growth of services and manufacturing in Korea and Japan during the ten-year periods after their per capita GDP touched US$5,000 (measured by 2005 constant USD). It shows that Japan's service consumption rose by 14% p.a. vs. 10% for goods, while Korea's consumption of services expanded by 15.3% p.a. vs. 8.7% for goods. On average, Korea and Japan's service sectors outperformed their manufacturing sectors by over 5ppts during the respective ten-year periods.

In light of the Japanese and Korean experiences, our expectation of Chinese service sector growth at 14-15% p.a. in the coming five years vs. 10-11% for manufacturing sector growth does not appear to be aggressive, in our view.

Figure 32: Annual average growth in Japan and Korea during ten years after per capita GDP reaches US$5,000

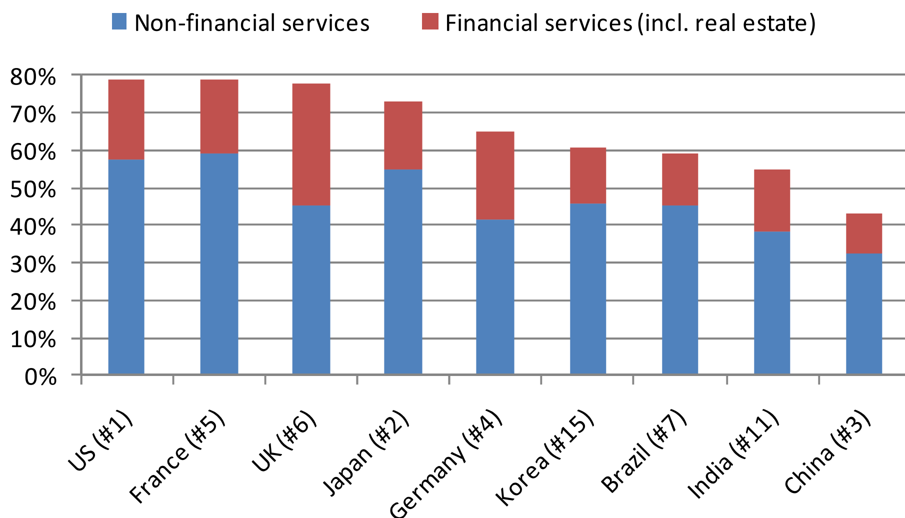


Source: Deutsche Bank calculation based on CEIC data. The ten-year period for Japan was 1976-1985. The ten-year period for Korea was 1989-1998.

Forecasting service sector growth in China

Among the world's largest developed and developing economies, China's service sector as a percentage of GDP is the lowest (see Figure 33). This ratio is even lower than that of India, although China's per capita GDP is twice that of India.

Figure 33: Service sector as percentage of GDP, 2009



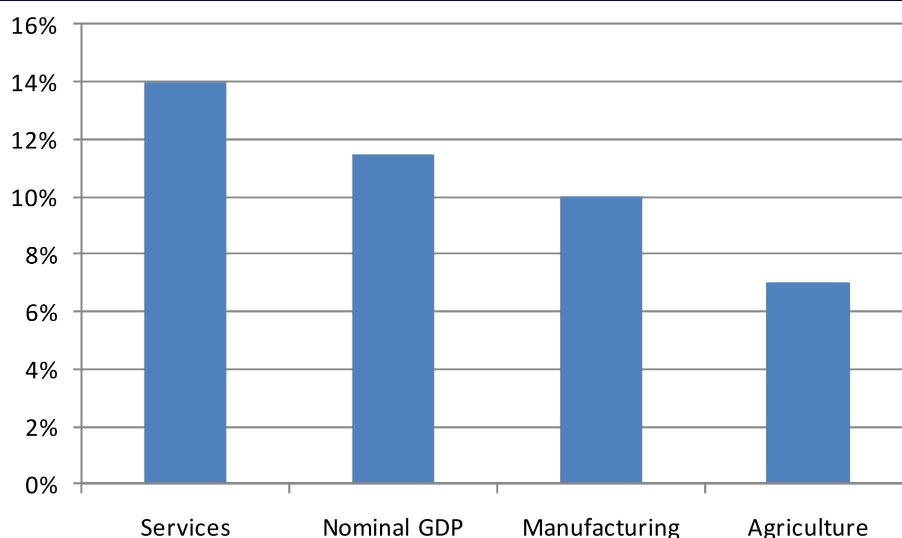
Source: Deutsche Bank, CEIC; Note: numbers in the brackets refer to the rank of economy size

The output of the service sector currently accounts for 44% of China's nominal GDP (2010 estimate). Although the 12th Five-Year Plan has not yet unveiled the 2015 target, policy advisors have proposed that China should aim at achieving a 50% ratio for the service sector by 2015[7]. Assuming a more realistic target of 48% for 2015, this implies that the nominal

[7] finance.jrj.com

value added of the service sector will grow at a 14% 2011-15 CAGR, vs. 10% for the manufacturing sector and 7% for the primary (mainly agriculture) sector. That is, the nominal growth of the service sector will outpace the manufacturing sector by 4ppts per year. This projection is consistent with the experiences of Japan and Korea (see the previous section) during their ten-year periods after per capita GDP reached US$5,000. Note that our benchmark is that China's nominal GAP growth will be around 11.5% p.a., assuming 8% real GDP growth and 3.5% annual inflation.

Figure 34: Deutsche Bank's annual average nominal growth forecasts, 2011-15



Source: Deutsche Bank forecasts.

Some local governments have announced even more ambitious targets. Shandong province, for example, expects the weight of the service sector to reach 45% by 2015, up from 35% in 2009. Jiangsu expects its service sector to account for 48% of GDP by 2015, up from the current 40%. These targets imply that the growth of their services sector would outpace manufacturing by 6-8ppts per year in the coming five years.

Five interesting service sectors

In this section, we discuss five sub-sectors in the services industry that we believe are most promising in terms of their growth outlook in the next five years, and where liquid listed companies are available and the valuations have not yet fully reflected their growth upside. These five sectors are:

- Branded property agencies;
- Branded hotel chains;
- IT services;
- Enterprise software; and
- Culture and entertainment.

Our conclusion is that these sub-sectors will easily grow at 20% p.a. in the coming five years – significantly faster than nominal GDP growth of about 11% p.a. -- on very low penetration rates, strong government support, and growing consumer preference for branded services. We believe several specific companies in these sectors will, as market leaders, likely grow at an even faster pace than the sectors they are in.

We believe that many other service sub-sectors, such as health care, education, sports, retail and restaurants, will also likely enjoy substantial growth in the next few years. However, we will not focus on these sectors in this report due either to the limited availability of investable companies or because market valuations have more or less fully reflected their growth outlook.

Branded property agencies – E-House (EJ.US, Buy, US$14.45) and SouFun (SFUN.US, Buy, US$69.25)

We believe that branded real estate agencies and consultancy businesses can maintain strong growth even if the construction and sales of new homes decelerate sharply in the coming few years.

China is unlikely to sustain its real estate investment growth of 25% and residential property sales growth of 34% p.a. during 2002-09, with the urban household ownership ratio above 80% and per capita living space already above the average of mid-income countries. But the decade-long high growth has left a huge stock of existing homes worth RMB100tr, and an enormous group of market participants including 200m urban households.

Branded property agencies account for only 10% of the market in China vs. 70-80% in the US and Hong Kong

The deceleration of the primary property market does not mean secondary market transactions will slow. In developed economies such as the US, secondary property transactions account for 75-80% of total property sales. In China, they account for only 20% in hundreds of second- and third-tier cities and 50% in a few first-tier cities like Shanghai and Guangzhou. For the country as a whole, no official statistics have been given, but we estimate that the average proportion of secondary market transactions is only about 20-25% of total property sales. Given that the proportion of secondary transactions will likely rise quickly, this implies that total property transactions could grow at a much faster pace than property investment (and new home sales) growth in the future.

Other than property brokerage, services such as real estate asset management, consultancy, escrow and fiduciary barely exist, and thus will likely grow at a very high rate due to the base effect. For instance, the real estate consultancy market in China is around US$12bn in the US – 40 times the size of the US$300m Chinese market – whilst China's residential property sales are already 75% the size of those in the US.

E-House is a leading real estate service provider acting as a primary and secondary agency and is involved in consulting and IT. Its core business, primary agency, contributes 44% of its FY10E revenue and its real estate consulting/IT service accounts for 52%.

Branded real estate agencies like E-House have great scope to consolidate the market. Around 90% of Chinese real estate brokerage fees are currently taken by local/independent agencies, but in the US, the market share of branded agencies is as high as 60%. E-House has formed solid partnerships as a primary agency with leading developers, which our property analyst Jason Ching believes is an advantage given that the company has no close competitors. Besides, with over US$460m cash handy, E-House could avail of the plentiful growth opportunities in the secondary agency market via acquisitions.

CRIC (CRIC.US, NR), the 52%-owned spin-off subsidiary of E-House, manages one of the most comprehensive real estate databases in China with over 46,000 real estate projects and 50,000 land plots in more than 80 cities. It typically provides land acquisition and project development consulting services to developers.

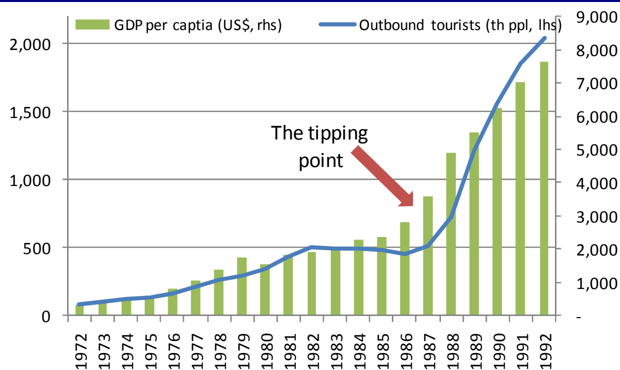
Jason expects E-House's top line to expand 32% p.a. during 2010-12 in its primary agency business and a 28% 2010-12 CAGR in consulting/IT services.

SouFun is a leading real estate vertical providing real estate advertising and consultancy services. It runs one of the largest real estate portals in China and commands about 48% of China's online real estate advertising market. Our company analyst Alan Hellawell expects China's online real estate advertising market to grow at a 30-35% CAGR from 2009-12 given that online ads as a percentage of total ad spend is only 5.8% in China vs. 17.4% in the US. Alan identifies the major growth drivers as: 1) existing advertisers continuing to shift the ad budget online, 2) players that target niche markets (i.e. warehouse rentals) driving up the overall market size, and 3) real estate companies in lower-tier cities gradually adopting online advertising as a supplementary marketing channel. Alan's channel checks suggest the 4Q10 ad momentum remains strong despite recent property tightening. With the property supply increasing in 2011, developers will likely be more eager to increase online ad budgets and to stick to the market leaders in uncertain times. The longer-term growth will likely come from ongoing geographic expansion. SouFun currently covers 106 cities across China, but 84% of its revenue is from 11 cities. In the coming years, the faster and more sustainable property sales growth in low-tier cities will allow SouFun to monetize its nation-wide coverage.

Tourism service – Shangri-La (69.HK, HK$21.10, Buy), SJM (880.HK, HK$11.90, Buy), Home Inns (HMIN.OQ, US$41.7, Buy), Shenzhen Overseas (000069.CH, CNY12.25, NR)

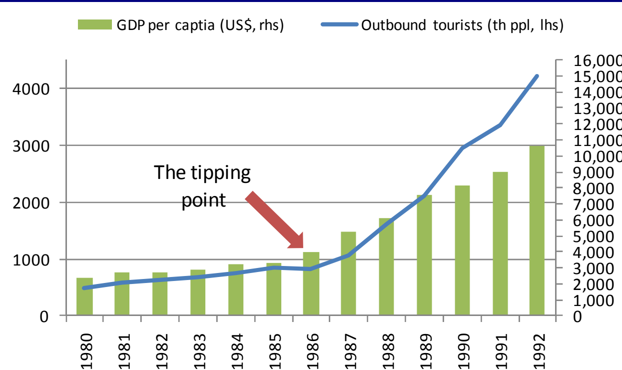
Global empirical evidence suggests the inflection point for tourism will accelerate when per capita GDP approaches US$4000. Such a tipping point occurred in Taiwan and Korea in the mid-1980s, and should occur in China over the coming years (see Figure 35 and Figure 36).

Figure 35: Tipping point of tourism growth when GDP reached around US$4,000 per capita in Korea



Source: Deutsche Bank, CEIC

Figure 36: Tipping point of tourism growth when GDP reached around US$4,000 per capita in Taiwan



Source: Deutsche Bank, CEIC

Another important driver of tourism growth will be the maturity of transport infrastructure. With the massive investments in railways in the past few years, the total length of railways in China will exceed that in the US and Europe in 2015. For example, it now only takes three hours for high-speed trains to go from Wuhan to Guangzhou, a distance which used to take 12 hours on older trains. Similar high-speed railways will cover other cities, including Changsha, Fuzhou, Xiamen, Nanning and Guiyang, in the next few years. The significant investment in transport infrastructure and the rapid increase in car ownership will improve the convenience and affordability of travel. Several cities with major tourism attractions, such as Qingdao, Xiamen and Guilin, have already reported 50-100% growth in the number of self-driving tourists in 2010.

Investors may gain exposure to the impending acceleration in travel sector growth via hotels, travel agencies and airlines. Based on our analyses of the valuation, growth potential, and market liquidity of companies listed in overseas markets, our conclusion is that the most attractive and investable names are branded hotel chains in China and gaming operators in Macau.

Our analyst Karen Tang views Shangri-La as the best Chinese luxury travel brand. Shangri-La pursues a strategy to go where the wealthy Chinese go, expanding hotel rooms in outbound destinations to 50% of its portfolio by 2013-14. As we argued above, China's outbound travel will likely see exponential growth as its per capita GDP already reached US$4,300 in 2010.

Karen expects very strong RevPAR growth in 2011 as the market fully recovers from the financial crisis. She projects 19% RevPAR growth for Shangri-La's China operation and 15% on average for all of the 70 hotels. This projection finds solid support from the expected 17% Chinese corporate travel budget increase next year, according to a study by American Express Business Travel.

Macau's gaming business provides another interesting avenue for investors to benefit from China's booming tourism market. Mainland tourists contribute around 60-65% of Macau's gaming revenue but 50% of these gamblers are from only one province – Guangdong. By end-2015, Guangdong will be the hub of five high-speed rails and will thus significantly extend Macau's catchment area. The fact that casinos should remain illegal in the Mainland will be the biggest support for Macau's position as the preferred destination of Chinese gamblers in the foreseeable future. We believe Macau's gaming business can easily enjoy 20-30% annual average growth in the next few years.

SJM is Karen's top pick given the widest brand recognition of its flagship casino Grand Lisboa. Karen estimates that Chinese gamblers account for c.70% of its earnings. 43% of SJM's 2010E EBITDA comes from the mass market, which is close to the numbers for Galaxy but much higher than for other gaming operators.

Branded hotel chains are a natural product of tourism market development. Internationally branded hotels are perceived to be better managed with high standards of quality control, and lower risks (e.g., fire and food safety). From a business standpoint, branded hotel chains enjoy a significant advantage in marketing, as clients tend to have "stickiness" in using their services repeatedly and globally. In the US market, branded hotels represent approximately 70% of the total hotel supply. In China, branded economy hotels have boosted room numbers more than 40 times since 2003. By the end of 2009 there were 3,757 branded economy hotels, representing 25% of the total room supply. Given the current high occupancy rate of leading economy hotel brands (over 85%), we believe the market is still three to five years away from maturity. In the high-end hotel segment, first-tier cities are already crowded but branded luxury hotels usually enjoy solid RevPAR growth.

Home Inns is the largest economy hotel brand in China with around 16% market share in 2009, followed by Jingjiang, 7 Day, Hanting and Motel 168 (with market share ranging from 6% to 9%). The total room supply of economy hotels has increased 40x from around 10,000 in 2003 to 412,000 in 2009. But the market will likely enjoy high growth for another three to five years given that about 60% of economy hotels are in first/second-tier cities; meanwhile, lower-tier cities are still underpenetrated.

Our company analyst Chris Woronka views Home Inns as one of the best risk-adjusted Chinese tourism growth plays given its consistent product, strong management team, and early mover advantage. He has confidence in the company achieving 25% revenue growth in 2011 in light of its plan to open 250+ hotels.

Shenzhen Overseas Holding is a unique mid-cap name listed on the A-share market (market cap equivalent to US$5.5bn). The parentco is a central SOE and holds 56% stake of the listco. The company current operates 12 theme parks in six cities and has another three projects under construction. Management guides to increase its visitor numbers from around 20m in 2010 to 30m by 2018-20. Theme park ticket prices tend to increase by 20-30% every three to five years, based on the experience of Chinese and regional peers. Shenzhen Overseas is

also involved in real estate, which contributed 35% of total revenue as of 1H2010. The company develops high-end residential and commercial properties around its theme parks with usually very low initial land costs. Given its SOE background, Shenzhen Overseas is often involved in the local governments' planning sessions for the tourism sector. This provides the company an advantage in planning its real estate development in the surrounding areas.

IT services – VanceInfo (VIT.US, US$34.43, Buy)
According to IT consulting firm Gartner, China and India will lead global IT service market growth in 2009-13. The most important reason behind the strong growth in IT services in China is its very low penetration rate, as China's IT capex has so far been heavily hardware-centric.

In the early 2000s software and services typically accounted for 5% of Chinese corporate IT expenditure. The weighting has increased to 30-40%, but is still much lower than the 70-80% in developed markets. Overall, IT services only represent 0.2% of Chinese GDP, vs. 0.5% in India, 1.1% in Korea and over 2% in the US and Japan.

Apart from the low penetration, we see the following dynamics as being especially beneficial to the local leading IT service providers:

1) The government and local clients will likely favor domestic service providers due to information security concerns and language considerations;

2) Chinese IT outsourcing companies have a significant language advantage over Indian competitors in winning businesses from overseas Chinese companies (which are currently using foreign vendors) as well as Japanese and Korean clients;

3) Under the current tax regime, IT outsourcing is not granted as a business tax credit. The likely conversion of the business tax on IT services to a VAT should reduce the effective tax burden on IT outsourcing businesses; and

4) The IT service market is very fragmented with thousands of small suppliers. Less than ten service providers have an annual turnover of over US$100m (the IBM global service division recorded US$58bn revenue in 2009 and Accenture reported annual revenue of US$23bn). Leading local players have huge potential for consolidation over the next few years.

Our sector analyst Tim Fox has a strong Buy rating on VanceInfo, which he forecasts will post a 28% EPS CAGR over 2010-12. VanceInfo provides software R&D outsourcing services (58% of January-September 2010 revenue) and other IT services including customized implementation of IT platforms, application maintenance and development, quality assurance, etc. Its customers in the Greater China region account for 44% of its net revenue, followed by those from the US (33%), Europe (15%) and Japan (5%).

Tim believes that the solid execution track record of VanceInfo demonstrates the capability of the management team to lead the company through a volatile, early-stage growth period. The company guides for 28% EPS growth in 2011 and stable margins over the next several years by reinvesting any incremental margin gains back into the business to drive revenue growth. Management's commitment to investing in growth initiatives helps justify its FY11E PE of 36x.

Enterprise software – Kingdee (268.HK, Not Rated), Longtop (LFT.US, US$36.8, Buy)
IT consulting firm Gartner expects China's enterprise spending on software to grow 15% p.a. through 2013, vs. the 6.4% CAGR for the worldwide market. We believe the 15% CAGR still

understates the growth potential of the domestic leading software vendors, which are gaining market share from international players such as SAP, Oracle and IBM.

Chinese enterprises are still lagging far behind foreign firms in software adoption. The size of the Chinese enterprise software market is currently only 0.1% of GDP, which is just a quarter of the world's average penetration rate, and one-eighth of North America's.

For domestic software developers, it is widely believed that government support is a major competition edge. Admittedly, tax rebates, government subsidies and preferential government/SOE procurement policies are all very helpful, but this is not the whole story. Governments purchase around 60% of office applications from local providers, but, when combining public and private users, the Microsoft Office series still commands over 85% market share. Despite limited government support, domestic ERP software is gaining popularity among SMEs and now accounts for 78% of the market.

In our view, vendors that are capable of tailor-making products based on the local language, corporate culture and user habits deserve some pricing premiums in the equity market. Other factors being equal, we also prefer companies with a strong presence among private companies to those that rely heavily on government and/or SOE spending.

Among overseas listed enterprise software companies, the representative names include Travelsky (696.HK), Longtop (LFT.US), Kingdee Int'l (268.HK), China ITS (1900.HK) and Kingsoft (3888.HK). Travelsky, Longtop, China ITS and Kingsoft respectively focus on civil aviation software, banking software, expressway/railway management system, and office applications. Their revenues and profits are heavily driven by government and SOE capex. Kingdee Int'l, with its expertise in ERP and middleware products, is more extensively rooted in the private sector.

Kingdee has traditionally focused on ERP (Enterprise Resources Planning) products for SMEs. As of June 2010, it had more than 800,000 enterprise customers, 1,700 channel partners and 2,800 salespersons. Despite its smaller market share in the entire ERP market than the main competitor UFIDA (15% for Kingdee vs. 31% for UFIDA), Kingdee is indisputably No. 1 in the SME market. Its top five customers account for only 4% of its 2009 revenue and government/SOE customers represent roughly 20% of its revenue, vs. around 50% for UFIDA. According to CCW Research, 58% of large enterprises had implemented ERP systems by 2005, and this penetration rate recently rose to above 80%. But the ERP penetration rate among SMEs is only about 20%. To better compete in the large enterprise ERP market, Kingdee signed a five-year agreement with IBM in June 2010, making it the exclusive ERP service partner of IBM in China and accordingly creating cross-selling synergies for both parties.

Longtop is a leading software developer in the financial industry. The Big Four banks account for 44% of its FY10 revenue and other banks represent another 37%. The customer concentration may pose a long-term risk, but our analyst Tim Fox believes the company has built strong relationships with key customers that should help ward off threats from both domestic and international rivals. More importantly, the company is actively consolidating the market with around ten acquisitions since 2006. This will likely prove an effective growth strategy because Longtop commands only 8.3% market share (even as the largest financial IT software provider in China) and the company has a strong war chest of around US$410m net cash, over 55% of its total assets.

Culture and entertainment

After the bust of the Heisei bubble, Japan's merchandize export growth quickly ran out of steam. For instance, automobile exports decelerated from a 23% CAGR during 1986-95 to -3% during 1996-2005. But Japan achieved great success in transforming itself into a pop-

culture export powerhouse. Japan's cultural exports to the United States, including anime, manga, video games, etc., are estimated to be four times greater than its steel exports. The Marubeni Research Institute found that between 1992 and 2002 royalties from Japan's cultural exports tripled, while manufacturing exports grew only 20%. South Korea followed suit with 30-40% p.a. growth in movies and TV series exports since 2003.

We think it is time for China to catch up. In the 12th Five-Year Plan, the central government for the first time labeled culture a "pillar industry", reflecting its ambition to reprise the nation's past glory as a cultural superpower. A pillar industry, in our view, should at least account for 5% of GDP, and the share of the culture industry was only 2.5% in 2009. Policy support in the coming five years will play a crucial role in the culture and entertainment industry. For instance, domestic animation production achieved a 45% CAGR during 2004-09, largely thanks to a new regulation in 2005 which required all children's TV channels to broadcast at least 70% domestic content (rather than imported titles) during 5-7pm.

The low penetration rate and improving affordability of culture and entertainment services also set the stage for acceleration in growth. For the relatively nascent items such as digital publishing, Internet video and mobile phone games, the annual growth of the global market is already over 30%. With the increasing popularity in China, this sector could easily grow by over 50% p.a. in the coming years. A good example of such an industry is e-books. US-based research firm Forrester Research estimates that global e-book sales will grow by 470% in 2010 from a low base and slow down to a 25% p.a. clip during 2011-15. The current penetration in China, however, is only 1/30th that of the US and 1/135th that of Japan. Usually priced at a discount to paper books, e-books are obviously more affordable to most Chinese readers. Besides, this is a relatively closed market due to language and cultural barriers.

Even some conventional culture and entertainment items could sustain 20-30% growth in China as a result of the consumption upgrading. Box office revenues, for example, have been increasing at around 30% p.a. since 2003, and the Association of Film Makers of China is confident of the industry maintaining this pace over 2011-15. Their optimism has a strong basis as film ticket sales are currently only at RMB5 per capita in China, i.e. each person watches only 0.1 movies a year, on average. This implies a penetration rate in China of only one-sixth the global average and about 1/50th the US.

Shanda (SNDA.US) and Huayi Brothers (300027.CH) are among the few listed companies in the cultural industry. Shanda is in a transition period from an online gaming company to an integrated cultural/entertainment platform. With a series of recent acquisitions, the company has accumulated a large user base on separate platforms, including online literature, Internet video, wireless value-added service, chess and board games platform and e-sport platform. These non-gaming businesses generated 21% of total revenue in 3Q09, up from 9% in 2Q09 and 15% in 1Q10. That said, it is still too early to tell whether and when such a transition will be successful. Huayi Brothers is China's largest movie producer with around six movie titles and 200-300 drama series every year. Its revenue increased by a 69% CAGR during 2006-09. Year-to-date, its revenue and profits increased 62% and 136% yoy respectively.

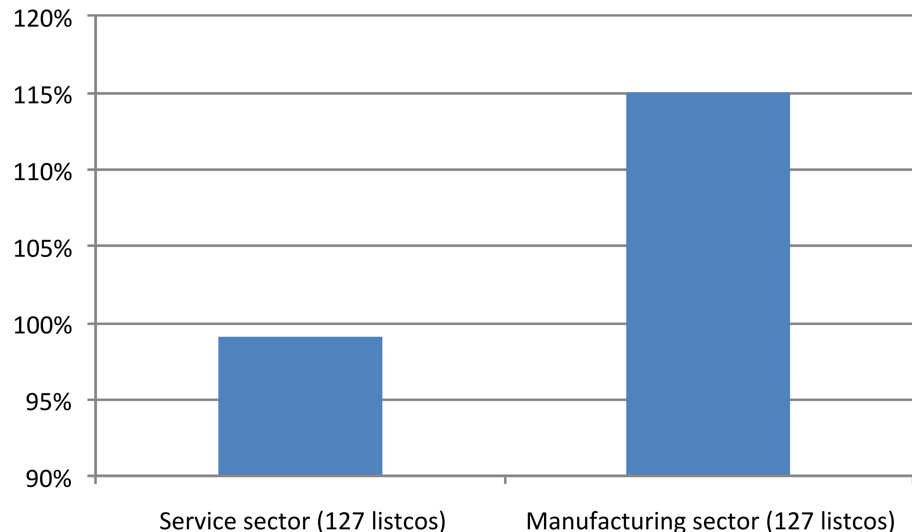
Market has not fully priced in the growth potential of services

As discussed in the first section of this chapter, we have strong reasons to believe that the service sector will outperform the manufacturing and agriculture sectors in terms of annual average growth in the coming five years.

Among the overseas listed companies (H shares, red-chips, and those listed in the US and Singapore) with a market cap of over RMB500bn, 127 can be classified as belonging to the service sector, accounting for 50% of the total. On average (using an arithmetic average to

avoid the distortion of large-cap names), service sector companies are currently trading on a par with their historical average P/E ratio, while manufacturing companies are trading at a 15% premium (see Figure 37). In our view, this suggests that the market has not fully appreciated the strong potential of service sector outperformance over manufacturing in the coming years.

Figure 37: Current trailing P/E over historical average: services vs. manufacturing



Source: Deutsche Bank, Bloomberg Finance LP

Overall, we believe that the market consensus EPS growth for the next few years will be upgraded by 5ppts per year from the current levels. If these companies also enjoy another 10% rise in valuation premium (as discussed earlier), a 15% annual average outperformance of these companies' share price performance over the index will be justified, in our view.

A basket of beneficiaries in the service sector

Based on our previous discussions, we selected ten listed companies that we believe are good representatives of the accelerating growth in the service sector.

This basket of companies is trading at 24x of 2011 P/E based on analysts' earnings forecasts (when they are not covered by Deutsche Bank analysts, consensus estimates are used). Their EPS growth is expected to reach 32% CAGR in the next two years, yielding a PEG of 0.68. This PEG compares favorably with the MSCI China average of 0.84. As we highlighted earlier, a number of factors could generate further upside to EPS growth for these service companies, including potential tax cuts and a rise in pricing power (and thus an expanding profit margin).

Figure 38: Representative beneficiaries in the service sector

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	PE 2010	PE 2011	EPS CAGR 10-12	PEG (10-12EPS /2011PE)
E-House	EJ.N	Real estate service	Buy	15.0	1,199	21.2	12.8	52%	0.24
Soufun	SFUN.N	Real estate service	Buy	71.5	1,443	27.5	17.1	40%	0.43
Shangri-La Asia	0069.HK	Travel - Hotel	Buy	21.1	7,824	40.6	26.0	40%	0.65
Home Inns	HMIN.OQ	Travel - Budget hotel	Buy	41.0	1,658	25.8	21.4	23%	0.95
SJM	0880.HK	Travel - Macau gaming	Buy	12.3	8,692	19.4	15.7	19%	0.82
Shenzen Overse-A	000069.CH	Travel - Theme park	NR	11.8	5,489	15.7	12.3	29%	0.42
Longtop Financial Technologies	LFT.N	IT services	Buy	36.2	1,572	21.0	20.5	20%	1.02
Vanceinfo	VIT.N	IT services	Buy	34.5	1,381	43.3	33.9	28%	1.19
Kingdee International	0268.HK	Corporate software	NR	4.6	1,226	36.1	27.5	33%	0.83
Average					3,387	27.8	20.8	32%	0.66
MSCI China						14.0	11.8	15%	0.80

Source: Deutsche Bank;
Note: For Non-rated stocks (NR), we use Bloomberg consensus estimates for EPS, P/E and PEG calculation. The NR stocks are not covered by Deutsche Bank's fundamental research and consequently we make no representation to the quality of the business, asses or management.

Theme #5: Energy saving and environmental protection

This section was contributed by our power and equipment sector analyst Michael Tong and his team.

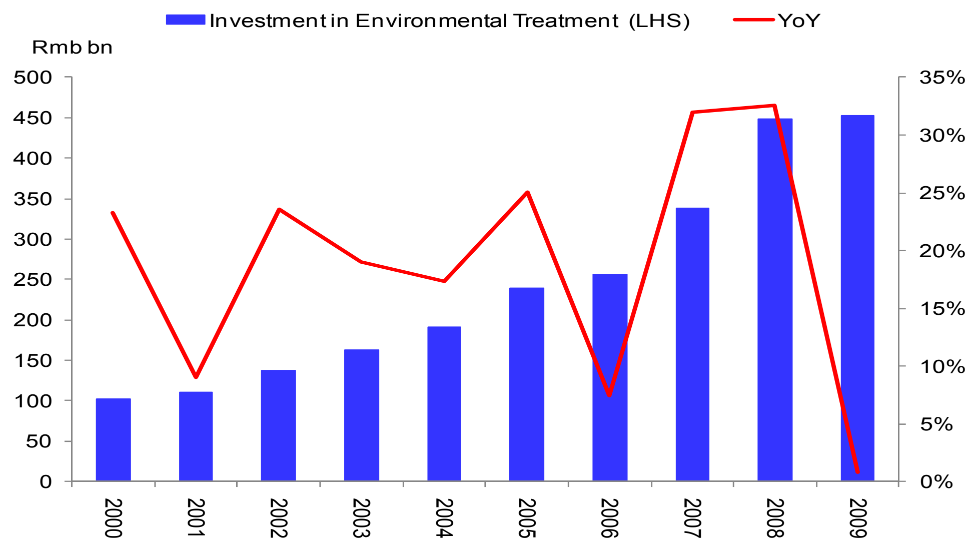
The government announced in October 2010 a plan to accelerate the development of seven strategic emerging industries, with the energy saving and environmental protection industry flagged as the first priority. The increasing clarity on policy leads us to believe that the energy saving and environmental protection industry will account for 8% of China's total GDP by 2015 and 15% by 2020 versus the current level of 3%, which implies a CAGR of 25% in 2010-20.

We think the new government efforts in the above-mentioned areas will create interesting investment opportunities in sectors such as smart grid equipment, wastewater treatment and waste recycling sectors.

Investments in energy saving and environmental protection

Given the concerns on pollution cost and energy security, China's investments in environmental treatment have increased steadily over the past years. In the last decade, China's investment in environmental treatment has increased by a CAGR (2000-09) of 18% to RMB452.5bn in 2009, which was higher than the country's nominal GDP growth. The strong growth in environmental investment in the past decade partly reflects China's determination to achieve its energy efficiency and environmental targets that were set in 2005.

Figure 39: Investment in environmental treatment



Source: Deutsche Bank, CEIC

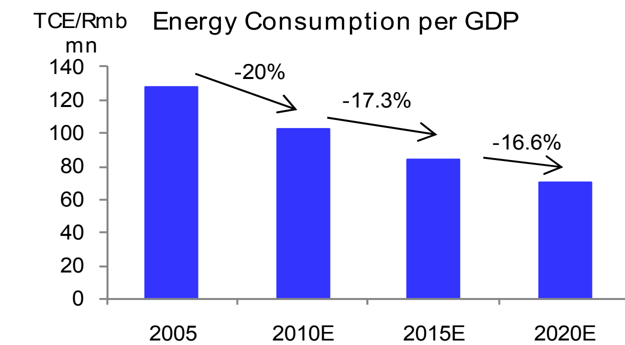
Energy savings and environmental targets and investment plans

Aggressive energy intensity target by 2015 and 2020

Although China has not finalized its new energy intensity targets, government officials such as Huang Li, deputy director of the National Energy Bureau's Department of Energy

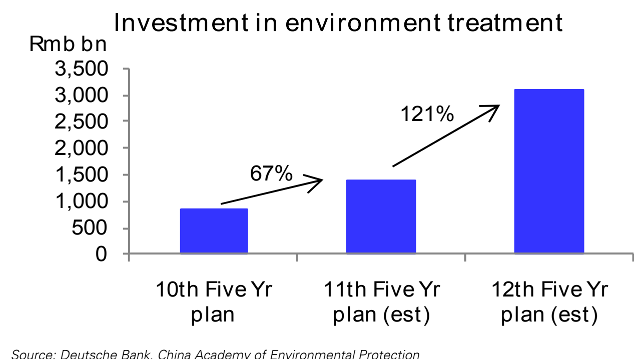
Conservation and Technology Equipment, said that China plans to reduce its energy intensity in the 12th and 13th Five-Year periods by 17.3% and 16.6%, respectively (Figure 40).

Figure 40: China's energy intensity target



Source: Deutsche Bank, CEIC, National Energy Bureau

Figure 41: Planned investment in environmental treatment



Source: Deutsche Bank, China Academy of Environmental Protection

Two more pollutants to be included into the 12th Five-Year pollution control program
According to Zhou Shengxian, Minister for Environment Protection, the government will include another two pollutants, namely nitrogen oxide, which causes acid rain and haze, and ammonia nitrogen, which leads to excessive food sources for bacteria in water bodies, in the pollution control program in the 12th five-year period. Hence, key targets will be set for sulphur dioxide (SO_2), chemical oxygen demand (COD), nitrogen oxide, and ammonia nitrogen for the 2011-15 periods. In the previous 11th Five-Year Plan, the government had set a 10% reduction target for SO_2 and COD. SO_2 is a major contributor to air pollution and COD contributes to water pollution.

Investment in environmental treatment to double in 12th Five-Year Plan

Investment in environmental treatment to double in 12th Five-Year Plan
To achieve the planned target for energy intensity and pollution control set in the 12th Five-Year Plan, Wang Jinnan, Research Fellow of Chinese Academy for Environmental Protection, said that China may more than double its investment in the pollution treatment industry to RMB3,100bn. We believe environmental investments will likely be targeted towards industries that are highly energy-intensive and cause the most pollution, including power supply, metal smelting and chemical materials.

Supporting policies

Policies for energy savings and environmental protection have become more specific and favorable
In the past decade, China has designed and implemented several policies to encourage and promote the development of energy efficiency. Although China's current energy intensity is still very high, we believe it is clear that these policies will help pave the way for greater energy efficiency in the future. Our belief stems from the fact that the institutional and structural requirements, such as clearer legal and regulatory frameworks, are now in place to promote energy savings. In addition, the government's favorable tax incentives and funding should further aid the growth of this industry. Figure 42 summarizes the specific policy actions initiated in the past ten years.

Figure 42: Key government policies on energy efficiency in the last 10 years

Policy Type	Agency	Policy and directives	Date	Significance
Nationwide energy saving and environmental protection policies	State Council	Energy conservation law	1998 (revised 2007)	1) Identifies the government bodies in charge of the 11th Five Year Energy Conservation plan, prohibits many high energy intensive products, and authorizes provinces to charge companies that are wasting energy 2) Provides a legal basis for enterprises to be held liable for selling/producing products that does not meet energy efficiency standard
	State Council	State Council's decision on strengthening energy conservation	2006	1) Restricts new high energy consumption projects 2) Prioritize clean energy in the power generation sector 3) Promotes tax and fiscal policies to support energy conservation
	NDRC	11th Five Year Energy Conservation Plan	2007	1) Specify the efficiency targets for electricity generation, selected industrial process, appliances and transport 2) Targets to reduce energy intensity by 20% by 2010 3) Targets to reduce COD and SO2 by 10% by 2010
	State Council	Plan Environmental Impact Assessment Regulation	2009	1) The objective of the regulations is to strengthen the Plan Environmental Impact assesment and to improve the scientic rationality of planning
	State Council	National Energy Saving and Environment Protection (ESEP) conference	May-10	1) The province's ESEP industry will be part of the local government performance matrix 2) As such, local governments that do not meet the ESEP targets will be punished severely
	State Council	State Council's decision to accelerate the development of strategic emerging industries	Sep-10	1) Identified 7 key emerging industries to be established by 2020, including energy efficiency and environmental protection industries 2) Establish a fund to support R&D, major innovation projects, major demonstration projects, etc
Tax Policies	NDRC & MOF	Reduced Export Tax Rebates for several low value added but high energy intensity products	2006-2007	1) Export tax rebate was reduced from 11% to 8% for steel, 13% to 11% for glass, 13% to 8% for cement, & 13% to 5%, 8% to 11% for some non-ferrous metal products 2) Cancelled or cut 5% of export rebates on most steel products
	MOF	Interim measures for incentives to environmental conservation technology reforms and phase out program	2007	1) Government set aside Rmb23.5bn to improve energy efficiency & abate pollution in 2007 2) In 2008, allocated another Rmb27bn for energy conservation and carbon reduction
	SAT	Regulations on implementation of corporate income tax for energy conservation enterprises	2008	1) Grants preferential tax treatment for energy saving investment, technology and equipments 2) Qualified investments receive a tax exemption for 3 yrs followed by a 60% reduction in corporate tax

Source: Deutsche Bank, various government websites

Latest policy: emerging industries to account for 15% of GDP by 2020

On 18 October, the State Council published its plan to accelerate the development of seven strategic emerging industries. According to the development plan, these industries will account for 8% and 15% of China's total GDP by 2015 and 2020, respectively, versus the current level of 3%. Seven strategic industries are listed under the plan, including energy efficiency and environmental protection, alternative energy, next-generation information technology, bio-engineering, high-end equipment manufacturing, alternative material, and alternative-energy vehicle industries. The plan has also set specific guidelines for the energy efficiency industry. These guidelines include measures to promote the development of energy saving technologies and equipment so that China will be able to manufacture high-quality energy saving products and export them overseas.

Key sub-sectors providing investment opportunities

We identify 11 sub-sectors that will benefit from the boom of the energy saving and environment protection industry. These include:

- Energy management contract
- Frequency converter
- Waste heat recovery
- Group source heat pump
- Light-emitting diode (LED)
- Energy efficient building materials
- Smart grid
- Waste recycling

- Wastewater treatment
- Solid waste treatment
- Exhaust gas control

For foreign investors, investment opportunities are primarily in the smart grid equipment, wastewater treatment and waste recycling sectors

A summary and comparison of the major energy efficiency and environment protection sub-sectors can be found on the next page (see Figure 43). For foreign investors, we believe that investment opportunities are primarily in smart grid equipment, wastewater treatment and waste recycling. We will discuss these three sub-sectors in the next section.

Smart grid

The smart grid takes the existing electricity delivery system and makes it "smart" by linking and applying communications systems to the grid so that it can communicate information about the grid condition to system users, operators, and automated devices, making it possible to dynamically respond to changes in the grid condition. Such processes would help improve the performance of electric devices, thus reducing overall energy consumption. China has strong incentive to develop the smart grid for two reasons, namely 1) to optimize inter-regional power transmission and 2) to effectively integrate renewable energy into the grid system.

The State Grid plan envisions a complete and advanced smart grid by 2020 after undergoing three fundamental development phases between 2009 and 2020:

2009-10 kick-off

- Strategic planning and key technology R&D
- Standards framework and critical technology standards
- Nine pilot projects across six cycles in power systems

2011-15 roll-out

- Construction of UHV power grids to speed up
- Major technical breakthroughs and extensive application of smart grid
- Preliminary smart grid operation, control, and interactive service systems

2016-20 scale-up

- A complete strong and smart grid with world-class technology and equipment
- Clean energy installed capacity will increase to 35% of the total

The government announced a total of RMB3.7tr investment for the smart grid industry in 2011-20. Equipment accounts for 60%

The government announced a total RMB3.7tr investment for the smart grid industry in 2011-20. As equipment accounts for 60% of the total power investment, about RMB2.2tr is likely to be allocated to equipment.

Wasion Group (3393.HK, NR)

Wasion Group, located in Hunan province, is a leading supplier of advanced energy metering products and solutions. Wasion distributes its products to China and overseas markets, including Southeast Asia and the Americas. Wasion Group was listed in Hong Kong in 2005 and is controlled by Mr. Ji Wei, president of the company, with a 50.5% stake.

Wasion Group is principally engaged in the development and manufacturing of electronic energy meters, water meters, gas meters，data collection terminals and metering systems. At the end of 2009, the company had annual production capacity of 3m units of three-phase electricity meters, 10m units of single-phase meters and 1m units of data collection terminals.

Figure 43: Summary of various energy-efficient and environmental protection technologies

	Energy efficiency							Environmental protection		
	Waste Heat Recovery	LED	Group Source Heat Pumps	Frequency Inverter	Energy Efficient Building Materials	Smart Grid	Waste Recycling	Wastewater Treatment	Solid Waste Treatment	Exhaust Gas Treatment
Sector fundamentals										
Addressable market size	++	++++	+	++	+++	++++	+++	++++	+++	++
Growth outlook	ΔΔΔ	ΔΔΔΔ	ΔΔΔΔ	ΔΔΔΔ	ΔΔΔΔ	ΔΔΔΔ	ΔΔ	ΔΔΔ	ΔΔΔ	ΔΔ
Entry barrier	OO	OOO	OO	OOOO	OOO	OOOO	OO	OO	OOO	OO
Market concentration	√√√	√√	√√	√√√	√√√	√√√	√√	√√√	√√√	√√
Technology	xxxx	xx	xxx	xxx	xx	xx	xxxx	xxxx	xxx	xxxx
Competiton	ϕϕϕ	ϕϕϕ	ϕϕϕ	ϕϕ	ϕϕϕ	ϕϕ	ϕϕϕ	ϕϕϕ	ϕϕ	ϕϕϕ
Listed players financials										
ROE (FY09)	16.0%	13.4%	N.A	24.1%	7.2%	17.8%	22.5%	15.1%	13.8%	11.7%
Revenue growth (2007-09)	58.8%	21.0%	N.A	36.9%	12.9%	27.2%	46.1%	25.9%	22.2%	16.7%
EPS growth (2007-09)	22.8%	16.0%	N.A	71.8%	41.3%	32.6%	46.8%	13.3%	7.4%	18.5%
EBITDA margin (2009)	15.5%	19.3%	N.A	16.7%	14.6%	16.8%	20.4%	35.6%	26.1%	14.5%
Net margin (2009)	9.9%	14.6%	N.A	15.1%	5.0%	15.2%	12.8%	21.3%	1.3%	8.4%
Consensus valuation										
PE (FY10E)	38.9	40.4	N.A	49.9	61.4	44.5	29.1	36.1	37.0	48.6
PE (FY11E)	28.9	26.5	N.A	34.3	28.8	30.8	20.8	28.1	29.1	30.2
PE (FY12E)	22.8	18.9	N.A	25.3	20.6	24.5	20.7	23.2	22.8	29.4
PB (FY10E)	4.3	4.4	N.A	6.0	5.3	7.1	4.2	3.6	4.1	4.6
Absolute Share price performance										
3 months	18%	20%	N.A	18%	23%	21%	31%	18%	21%	31%
6 months	-2%	22%	N.A	15%	25%	9%	17%	4%	6%	11%
1 year	23%	85%	N.A	56%	61%	41%	54%	33%	56%	54%
3 years	85%	322%	N.A	95%	76%	90%	16%	4%	39%	73%

Source: Deutsche Bank; Note: ++++ Very Large, +++ Large, ++ Medium and + Small; ΔΔΔΔ Very Strong, ΔΔΔ Strong, ΔΔ Neutral and Δ Weak ; OOOO Very High, OOO High, OO Neutral and O Low; √√√√ Very High, √√√ High, √√ Neutral and √ Low; xxxx Very mature, xxx mature, xx Neutral and x new; φφφφ Very High, φφφ High, φφ Neutral and φ Low

Note: Sector listed financials, consensus valuation and absolute share price comps are based on the comps table provided in the book. To make the comparison more meaningful, we remove some outliers in the calculation (For RoE, Revenue Growth and EPS Growth, we remove Sanan Optometrics for LED, Beijing Water Doctor for Wastewater treatment and Hembly for Solid Waste Treatment)

Source: Deutsche Bank, Bloomberg Finance LP

Deutsche Bank

Recently, Wasion signed a strategic cooperation framework agreement with Siemens to jointly conduct feasibility research on smart grid pilot projects in China.

Boer Power Holdings (1685.HK, NR)

Boer Power is primarily engaged in producing high-low-voltage electrical switchgear systems, switch components and electrical network management system. Its products are widely applied in residential, building, industry, energy and infrastructure. The company was developed from its predecessor, Wuxi City Power Instrumentation System Works, which was founded in 1985. Boer is one of the largest licensed partners of Schneider Electric in China. Boer Power has also partnered with ABB. Boer Power was recently listed in HK, and is controlled by King Able Limited (66.5%), which is owned by Mr. Qian Yixiang, chairman of the board and CEO. and Ms. Jia Lingxia, executive director and COO, and the wife of Mr. Qian Yixiang.

Boer Power's products are classified into four categories: electrical distribution systems (EDS), intelligent electrical distribution systems (iEDS), energy efficiency services (EE) and a components and spare parts business. The company was ranked the sixth-largest high-end MV and LV switchgear assembly producer in 2008 in the world in terms of revenue. For electrical distribution systems, its major products are MV and LV switchgear. For intelligent electrical distribution systems, its main products include intelligent power distribution switchgear and power monitoring systems applied in substation automation. For the spare parts business, the company provides mini-circuit breakers, multi-circuit monitoring units and power monitoring meters, and protection relay.

Waste recycling

Waste recycling will help China to ease its energy and resource constraints. According to China Association of Metal Scrap Utilization (CAMU), a large steel complex conserves energy consumption by up to 60% by using recycled-steel scrap instead of iron ore as a raw material. In addition, the association said it would save 95% of energy if aluminum producers were to use recycled scrap rather than electrolyze natural ore.

The largest metal-waste recycling market consists of steel, aluminum and copper. The metal recycling industry is highly competitive and decentralized, with a large number of market participants in the form of small workshops. Low entry barriers with regard to technology and regulatory requirements have created a competitive market. The location is critical to business operation for waste recycling. Key players are usually located in China's developed regions, such as the Pearl River Delta, the Yangtze River Delta and the Bohai Rim. Several factors need to be considered when choosing a location: 1) local government support; 2) proximity to port facilities, rail and highway networks; and 3) proximity to clients.

The price of these scrap metals is largely determined by the downstream metal price. According to CRU Strategies, a positive correlation ranging between 87.1% and 99.5% is established for the benchmark prices of scrap metal. Other price-determining factors include the sector demand for scrap metal, extent of difficulty in processing technology and purity of scrap metal.

China Metal Recycling (0773.HK, non-rated)

China Metal Recycling is a leading scrap-metal recycling company in China. The company produces recycled scrap ferrous and non-ferrous products from scrap steel, scrap copper and other scrap metal. China Metal Recycling also resells unprocessed metal scrap. The company was listed in Hong Kong in 2009, and Chun Chi Wai, president of China Metal Recycling, holds a 61.6% stake.

China Metal Recycling is primarily engaged in scrap-metal recycling. The company's annual capacity has reached approximately 4.1m tons for metal-scrap recycling. The company is establishing a wide network of business operations to allocate resources and capitalize on metal price differences across the country. China Metal Recycling is planning a new recycling facility in Hubei province. It plans to invest US$100m during 2010-13 in a new sales platform as well as distribution and logistics.

Dongjiang Environment (0895 HK, non-rated)

Dongjiang Environment (DJE), established in 1999 in Shenzhen, is primarily engaged in waste management and environmental services. DJE is also engaged in a landfill gas energy program in Shenzhen with a designed maximum annual power generation of up to 60m kWh. It was listed on Hong Kong's Growth Enterprise Market (GEM) in 2003 with a stock code of 8230.HK, and transferred to the main board in September 2010 with a new code of 0895.HK

In recent years, DJE has developed its recycling business from pure waste treatment to providing comprehensive environment services with the integration of waste collection, treatment and disposal, environmental engineering design, construction, operation and consultation. In terms of waste type, DJE recycles waste copper liquid, waste nickel liquid/sludge, waste ferrous liquid, waste animal oil and vegetable oil, waste organic solvent and waste oil, restaurant waste as well as construction and demolition waste. In 2009, DJE signed a cooperative contract with AES Corporation to jointly develop a ventilation air methane (VAM) utilization project.

Wastewater treatment

Over the last decade, the amount of sewage discharge has increased significantly at a 14.5% CAGR (1998-08) due to rapid urbanization and industrialization. At the same time, the number of wastewater treatment facilities also increased at a 14% CAGR due to the significant investments poured into the sector over the last few years of the period. Thus, there has been remarkable improvement in China's urban sewage treatment rate (to 65.3% in 2008 from 42.1% in 2003), and it is likely to reach the 70% target treatment ratio as set by the government for 2010. Nonetheless, China's urban sewage treatment rate is still below the levels for developed countries, which are usually above 80%.

China may double or even triple its investments in wastewater treatment

Given the increasing discharge volume in the next few years, and a low and stagnant percentage of discharge that meets the industry standard, the Chinese government is outlining aggressive investment plans for the sector in the next 12th Five-Year Plan. Although the official plan is still being finalized, several industry experts, such as Mr. Hao Chun, Deputy Secretary General of China Association of Environmental Protection Industry, said on 8 August 2010 that China will invest more than RMB1,000bn in industrial and urban wastewater treatment. In addition, in a separate China water industry report, China Water Network forecasted that between 2010 and 2015, China will require an RMB700bn investment in wastewater treatment (RMB550bn) and recycling (RMB110bn). These estimates imply that China may double or even triple its investments in wastewater treatment in the next few years.

China's wastewater treatment tariff still among the lowest in the world

In the last few years, China's residential wastewater treatment tariff increased steadily at a 9.4% CAGR (2003-08). Such a tariff increase reflects the increasing need to treat wastewater and compensate for the higher treatment cost to meet higher discharge standards. Nonetheless, China's wastewater tariff in 2009 was still significantly lower than that of most other countries.

China Everbright International (0257.HK, HK$4.03, Buy)

China Everbright International is primarily engaged in environmental protection project investments, such as sewage water treatment, waste-to-energy and solid waste disposal.

The company also operates a toll bridge in Fuzhou, Fujian province. China Everbright International is controlled by China Everbright Group and has positioned itself as the environmental investment arm of its parent.

In the last few years, the company has successfully expanded its exposure to the waste-water treatment business. As at end-2009, the company had secured a total of 17 waste water treatment projects with a total designed annual waste water treatment capacity of 550m cubic metres. It also processed 388m tons of waste water in the year, which represents an increase of 7% yoy. The company's wastewater treatment business is currently located mainly in Shandong and Jiangsu provinces.

As of FY09, the company recorded operating revenue of HK$1,766m, mainly from sewage treatment construction and operation services, which represent 52% of its total revenue. Its operating profit margin for its sewage business has remained relatively stable in the last few years at 28-32%. In 1H10, the company's net profit increased 24% yoy to HK$245m despite a 15% decline in revenue due to the lower contribution from lower-margin construction service revenue.

Figure 44: Potential beneficiaries from the growth of China's energy saving and environmental protection industry

Company	Ticker	Sector	Rating	31-Dec Price local	M. cap (US$m)	2011	EPS CAGR 10-12	PEG (10-12EPS /2011PE)
Wasion Group Hol	3393.HK	Smart grid	NR	5.2	633	11.1	25%	0.44
Boer Power Holdi	1685.HK	Smart grid	NR	6.5	659	NA	NA	NA
China Metal Recycling	0773.HK	Waste recycling	NR	8.2	1,128	6.5	35%	0.18
Shenzhen Dongj-H	0895.HK	Waste recycling	NR	2.9	304	15.2	21%	NA
China Everbright Int'L	0257.HK	Waste water treatment	Hold	4.2	1,910	24.6	35%	0.70
Average					927	14.4	29%	44%
MSCI China						11.8	15%	80%

Source: Deutsche Bank, Bloomberg Finance LP
Note: For Non-rated stocks (NR), we use Bloomberg consensus estimates for EPS, P/E and PEG calculation. The NR stocks are not covered by Deutsche Bank's fundamental research and consequently we make no representation to the quality of the business, asses or management.

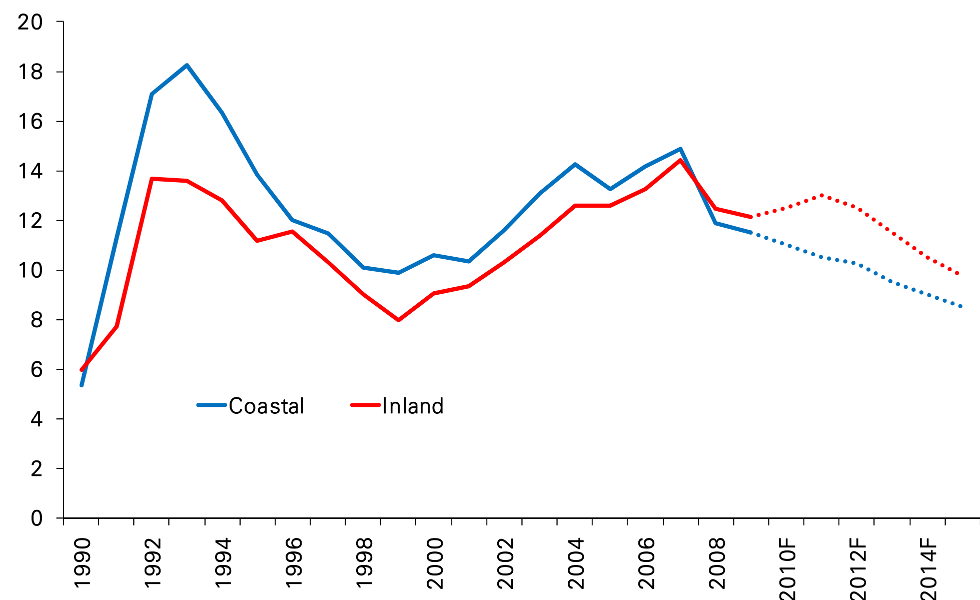
Theme # 6: Acceleration of inland development

We believe the inland provinces in China (including the middle and western provinces, as opposed to the coastal provinces) will experience faster economic growth in the coming five years. This outperformance of inland growth over that of the coastal areas will be driven by the relocation of manufacturing from the coastal regions, faster urbanization, and strong policy support. The market implications should be positive for real estate developers (both residential and commercial), cement producers, local commercial banks, and investment properties in the inland provinces.

Inland growth should significantly outperform coastal area

Over the past few years, industrial production growth in the inland provinces was already outperforming that in the coastal provinces. This outperformance has become more obvious since 2008, when manufacturing wage growth began to accelerate and infrastructure investments in the inland provinces accelerated as part of the RMB4tr stimulus program.

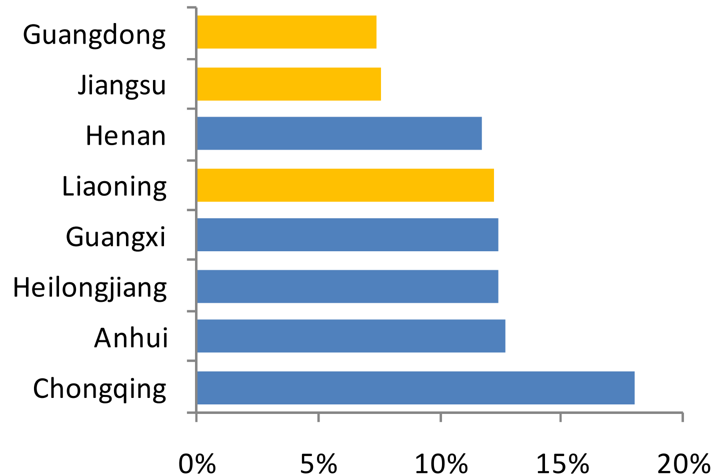
Figure 45: Inland provinces will more significantly outperform coastal provinces: real GDP growth forecasts



Source: Deutsche Bank

For the next five years, according to local government plans and projections, the inland provinces will likely continue their outperformance over the coastal provinces by a more significant margin. For example, the inland provinces of Chongqing, Anhui, Heilongjiang, Guangxi and Henan all expect per capita nominal GDP (or income) growth of 13-18% per year in the next five years. This is in sharp contrast with the only 7% per capita nominal growth target for coastal provinces such as Guangdong and Jiangsu. If these projections offer any guide, the real GDP growth differential between the inland and coastal provinces will expand to as much as 3ppts per year in the coming five years, from only 0.5% in the past five years. Our forecast of GDP growth in inland vs coastal provinces is shown in Figure 45.

Figure 46: Per capita nominal GDP growth targets for next five years, CAGR



Source: People's Daily, Xinhua News Agency.

Relocation of manufacturing activities to inland region

A key reason for the faster inland growth is the relocation of manufacturing activities. Rising production costs (e.g., wage rates and land prices) are forcing many low-end manufacturing activities in the coastal regions to relocate to the inland provinces. On average, wage rates in the inland provinces are about 30-40% lower than those in the coastal regions, and the average land prices in inland provinces are about 60% lower. Largely due to the surge in labor costs in coastal provinces (e.g., manufacturing wages were up by 20-25% in Guangdong and many other coastal provinces) in 2010, labor-intensive manufacturing has begun its massive relocation to the inland provinces.

Hon Hai is a typical example of manufacturers moving inland. As the top OEM electronics manufacturer in China, Hon Hai currently employs 900,000 workers, 80% of which are in coastal factories. But the company plans to reduce this ratio to 33% within five years – while at the same time expanding total employment to 1.3m in 2011. According to a recent survey by the Federation of Hong Kong Industries, within the 80,000 HK companies in the Pearl River Delta area, 37.3% are planning to relocate part or all production capacities out of the region, and 63% are preparing to move to another province in China.

The relocation of manufacturers should boost IP and GDP growth, which in turn should support income growth and retail sales, and demand higher investment. So it is not surprising that local governments in the inland provinces are introducing a wide range of preferential policies to encourage the relocation process. Specific policy measures include, among others, reductions and/or exemptions from local taxes and charges; subsidies for loan interest and R&D activities; construction of industrial parks; and simplification of project application and approval processes.

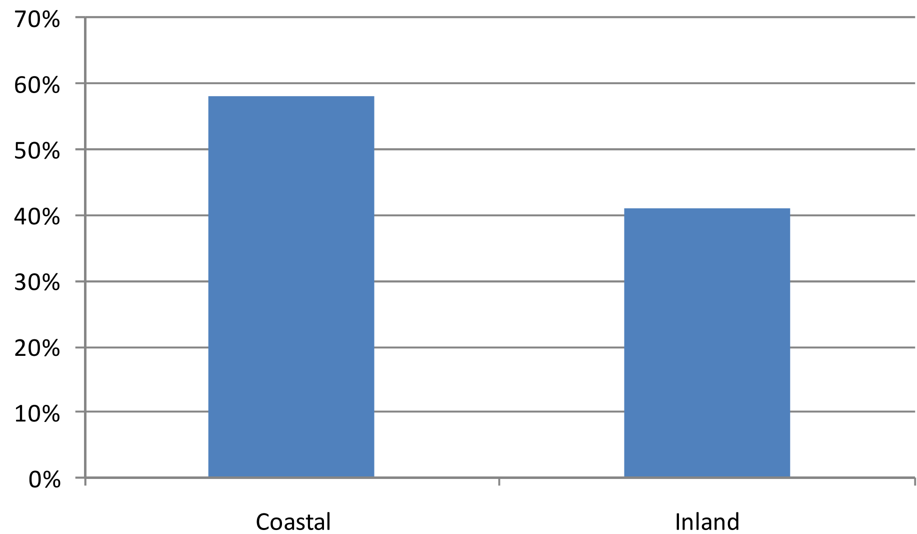
Urbanization to accelerate in inland region

Another key reason for the outperformance of the inland provinces over coastal provinces is that urbanization is accelerating in the former, while decelerating in the latter.

In 2009, the urbanization ratio (percentage of residents who are registered urban citizens of the total population) in the coastal region was 58%, compared to 43% in the middle region and 37% in the western region. Based on our study of international experience (using panel data from 24 countries), which examined the correlation between the urbanization ratio and

the growth of the urbanization rate (or pace of urbanization), we found that an urbanization ratio of 50% tends to be the tipping point for the pace of urbanization. That is, when a country/region's urbanization ratio is below 45%, it tends to witness strong growth in the urbanization ratio; when this ratio is above 45%, the pace of urbanization tends to decelerate.

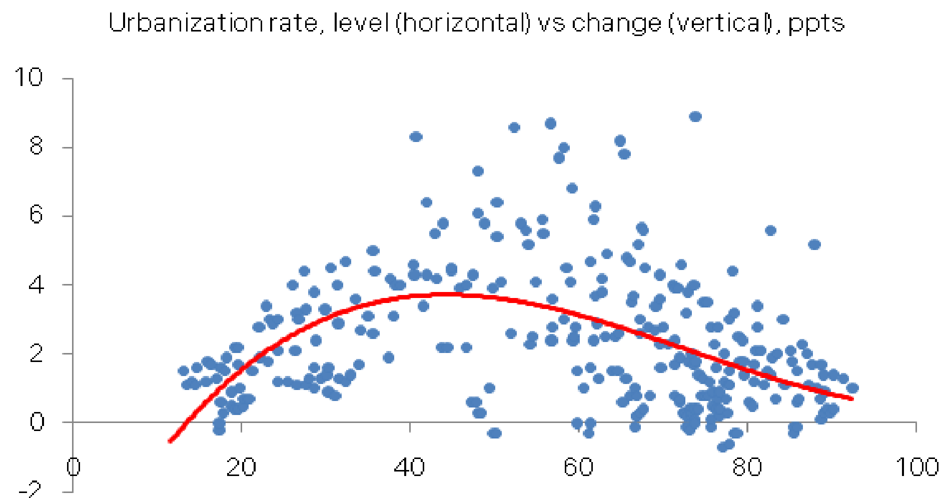
Figure 47: Urbanization ratios in inland vs coastal regions, 2009



Source: CEIC.

This empirical result suggests that China's coastal provinces – with an urbanization ratio of about 60% in 2011 – are already past their peak of urbanization. Slower urbanization immediately implies lower growth of demand for infrastructure and properties, and therefore lower investment-driven GDP growth. In contrast, inland provinces – with an average urbanization ratio at only slightly above 40% – will continue to enjoy faster urbanization and thus stronger investment-led growth in the coming few years.

Figure 48: International experience: urbanization decelerates when ratio hits 45%



Source: Deutsche Bank. Note: the horizontal axis refers to the urbanization ratio (%), while the vertical axis refers to the cumulative 5-year ppt change in the urbanization ratio.

This difference is not pure theory: the deceleration of urbanization is already taking place. For example, according to the household registry in Zhejiang province, the annual number of persons converted from "rural citizens" to "urban citizens" in the province fell to 198,000 in 2009 from 577,000 in 2004. This represented a decline of 67% in five years. To the contrary, in the western city of Chongqing, the government is expecting the annual "conversion" to urban citizens to reach 1.5m in 2010, significantly higher than the 0.5m figure seen in 2005.

Rapid infrastructure improvement in the west

Infrastructure in inland China has undergone a substantial improvement in the past decade and has become a major factor that attracts industries to relocate to the west. During the past ten years, the total length of highways grew at a 13.6% CAGR in inland China, compared to 11.8% in the coastal region; and freight transportation by air grew at a 16.5% CAGR in the inland region, vs. an 8.9% CAGR in the coastal region.

The fast growth in infrastructure will continue in the next five years, especially after the nation-wide high-speed rail network is built. Take Chongqing as an example: its municipal government has set the target of investing RMB150bn to construct 980 km of railway (a 76% increase from the current total of 1290 km) in the next five years. When these high-speed railway projects are completed, it will take just eight hours to travel from Chongqing to Shanghai, compared with the current 36 hours by regular train. The high-speed railway between Guangzhou and Wuhan, which was completed in December 2009, has already shortened the travel time by nine hours to only three hours.

Investment implications of inland development

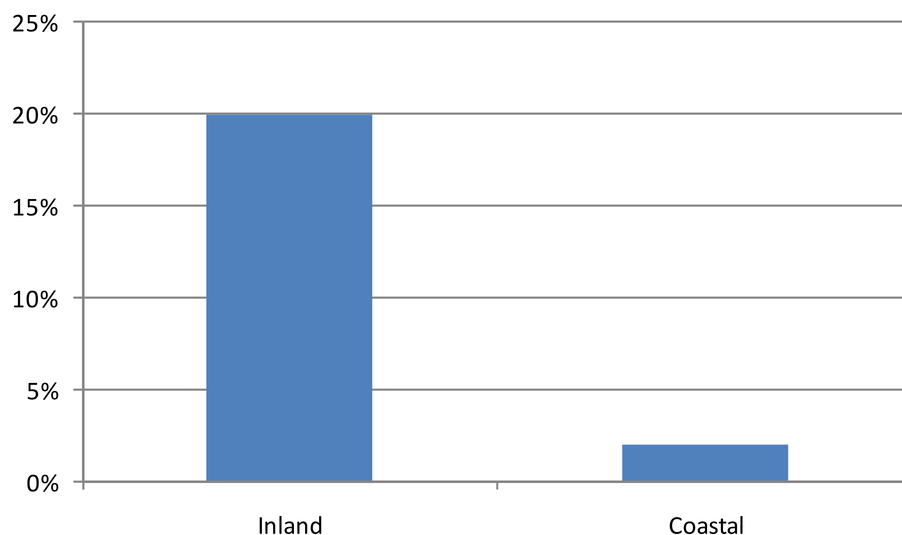
From the investors' perspective, we believe the most interesting beneficiaries of faster inland development should include real estate developers, cement producers, banks, and retailers with significant exposure to the inland provinces. Developers should benefit from the faster pace of urbanization. Cement producers will be the best material play from inland investments in real estate and infrastructure. Banks in inland provinces will be the financiers of investment growth. And income growth, which will come in tandem with faster GDP growth, will benefit retail businesses in the inland provinces.

Real estate developers

The urbanization process and increase in household income should boost demand for residential real estate. Between 1995 and 2009, the annual average construction of new residential area (on a per capita basis) in inland cities was only 57% of that in coastal regions. This suggests an under-provision of residential properties in the inland area relative to that in coastal regions.

On the demand side, we believe the potential genuine demand (from first-time buyers and upgrading demand) in inland provinces will grow much faster on faster urbanization and income growth compared with the coastal provinces. We ran a regression of residential property demand (in floor space terms) growth on real GDP growth and pace or urbanization (e.g., annual average in the urbanization ratio), and found strong statistical significance in these explanatory variables. By assuming that the inland region will grow its GDP by 3ppts faster than the coastal region, and the urbanization ratio of the inland region will rise by 1ppt (at 1.5ppt per year) faster than coastal (at 0.5ppt per year), our model shows that the annual floor space demand for residential properties will likely grow 20% in the inland provinces vs only 2% in the coastal region over the next five years.

Figure 49: Our forecast: property demand (floor space) growth in inland and coastal, annual average % for 2011-15



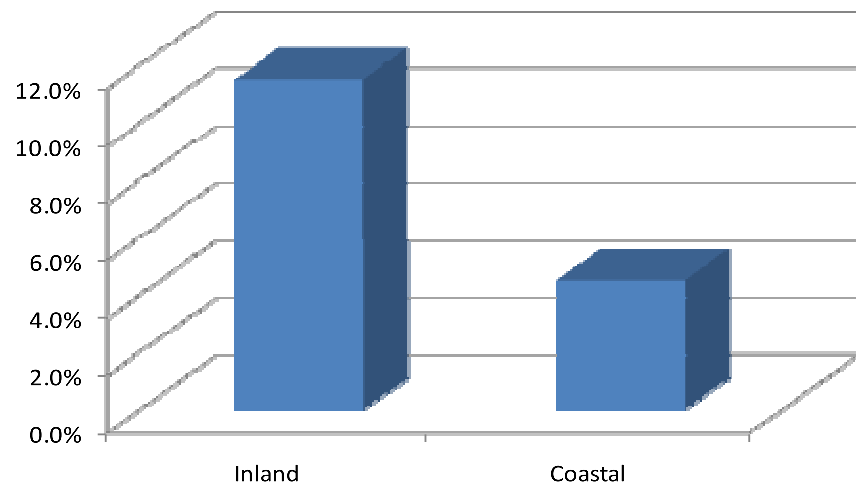
Source: Deutsche Bank estimates

Cement producers

The cement market is very localized because of the high transportation costs. Typical cement producers find their demand radius to be within 300km. As a rule of thumb, real estate accounts for about 40% of the demand for cement, and the rest consists of infrastructure and rural construction.

We believe that due to faster real estate and infrastructure investment growth cement demand growth in inland provinces will significantly outpace that in the coastal provinces in the coming few years. Given our forecast in the previous section that annual real estate demand growth in the inland region will exceed that in the coastal area by about 18ppts, and assuming conservatively that infrastructure investment (in real terms) in the inland provinces was in line with that in coastal provinces, cement's demand growth in the inland provinces should exceed that in the coastal provinces by 7-8ppts per year.

Figure 50: Cement demand growth in inland vs coastal provinces, annual average 2011-15



Source: Deutsche Bank estimates.

Retailers and shopping malls

Manufacturing relocation and urbanization bode well for economic growth and thus household income and expenditure growth. Based on the per capita GDP or income growth targets, consumption growth in the inland provinces will likely also outperform that of the coastal provinces by 3-4ppts p.a. in the coming years.

Banks

The banking services in the inland region are under-developed as the majority of bank assets are located in the coastal areas. With the speedup in the urbanization and infrastructure investment in the inland provinces, financial wealth will increase faster on higher nominal income growth and more investment. In particular, the growth rate of bank lending should be 2-5% higher in the inland area than that in the coastal areas on regional growth divergence.

Beneficiaries at the company level

Below we list a few companies that we expect to be beneficiaries of faster inland development.

Evergrande (3333.HK, HK$3.85, Buy)

Evergrande is a volume player focusing on residential real estates in Tier-2/3 cities, mostly in the inland provinces. Among its October sales, 70% were in inland regions (e.g., Wuhan 11.3%, Changchun 8.5%, Changsha 8.0%, and Chengdu 7.5%). We believe the company is better positioned than its peers in the current policy-tightening environment, and likely to benefit from the faster growth of the real estate market in the inland provinces. It is currently trading at a large 35% discount to estimated NAV vs. the 20-30% discount for most of its peers. Our property analysts expect its net profit will grow at a 25% CAGR in 2010-12, driven by a surge in GFA delivery.

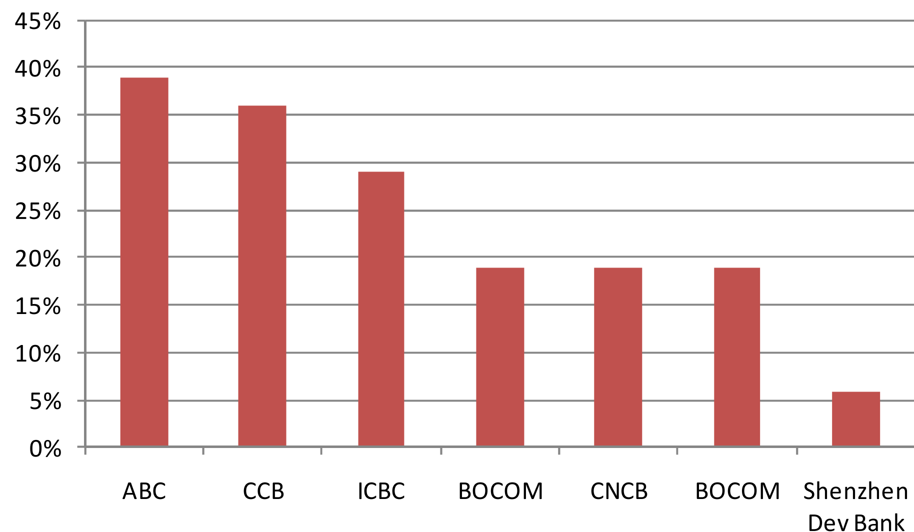
West China Cement (2233.HK, HK$2.88, NR)

West China Cement focuses on the Shaanxi market, with annual production of 11.4 million tons and a market cap around USD1.6bn. It is the second-largest cement producer in Shaanxi and has more than 50% market share in the southern part of the province. Overall cement demand in Shaanxi has been growing at a 23% CAGR since 2006, compared to a national average of 12%. West China Cement will continue to benefit from strong demand on the backdrop of inland urbanization. It has announced plans to expand production capacity to

12.5 million tons by 2011. Market consensus is that its EPS should grow at 36% and 26% in 2011 and 2012, respectively, and production capacity should grow 19% CAGR in the next three years. The company is trading at 9.5x P/E 2011E, compared to the industry average of 10.5x.

Agriculture Bank of China (1288.HK, HK$3.85, Buy)
ABC is uniquely positioned to capitalize on the next wave of China's growth, driven by urbanization and industrialization in the inland area, as the bank has larger exposure to the inland provinces than most other banks. ABC has nearly 40% of its deposits from the central and western part of China, compared with the average of 25% for the other big five banks, and single digit exposure for most mid-sized banks (Figure 51).

Figure 51: % of deposits from central and western China, end-2008



Source: Deutsche Bank

We noted earlier than urbanization will be faster in inland provinces, and developing small cities (such as county-level cities) will be the primary form of urbanization in inland provinces. ABC is the primary financial services provider in the county areas in terms of deposits (market share: 21.6% in 2008), loans (13.6% in 2008), and domestic branch outlets of 10,887, and ABC's country area banking accounted for 35% of total banking assets and 37% of total revenue the end of 1H10. We expect ABC's pre-tax profit in county areas to grow at a CAGR of 45.2% (urban area banking: 27.0%), and the stronger profit growth from the county areas should raise ABC's overall pre-tax profit CAGR by 6.0% to 33% (versus urban area: 27%) over 2009 to 2012E. This compares favorably with the other major Chinese banks' average of an estimated 21%. In 2012E we expect ABC's pre-tax profit contribution from the county areas to rise to 37.2% from 28.3% in 2009.

Appendix A: Deutsche Bank China universe

Figure 52: Deutsche Bank China universe (Buy recommendations)

Company	Ticker	Country	Sector	Rating	31-Dec Price local	M. cap (US$m)	Beta	Ratios 2010F			Ratios 2011F		
								PE (x) (DB EPS)	PB (x)	EPS gth % (DB EPS)	PE (x) (DB EPS)	PB (x)	EPS gth % (DB EPS)
Agri. Bank of China	1288.HK	CN	Banks	Buy	3.90	146,694	0.33	10.9	1.9	20.8	9.2	1.6	19.1
Alibaba.com Limited	1688.HK	CN	Softw are & Services	Buy	13.94	9,066	0.98	41.9	9.7	36.3	30.6	7.0	37.0
Anta	2020.HK	CN	Consumer Durables & Apparel	Buy	12.34	3,956	0.84	16.7	4.6	24.8	13.9	4.0	20.0
AsiaInfo-Linkage	ASIA.OQ	CN	Softw are & Services	Buy	16.57	1,228	1.03	14.6	1.3	5.9	11.2	1.2	30.5
Bank of Beijing	601169.SS	CN	Banks	Buy	11.44	10,811	0.45	9.7	1.6	30.4	8.0	1.4	22.1
Bank of China	3988.HK	CN	Banks	Buy	4.10	141,244	0.92	9.0	1.6	15.7	7.9	1.4	14.1
Bank of Nanjing	601009.SS	CN	Banks	Buy	9.94	3,636	0.51	10.2	1.5	15.6	9.5	1.3	7.6
Beijing Cap Int'l Airport	0694.HK	CN	Transportation	Buy	4.15	2,312	1.30	32.6	1.2	55.5	17.6	1.1	84.6
Beijing Enterprises	0392.HK	CN	Capital Goods	Buy	48.20	7,050	0.34	20.3	1.6	11.9	16.9	1.5	20.0
Belle Int'l Holding	1880.HK	CN	Retailing	Buy	13.14	14,257	0.73	26.7	5.6	37.6	21.8	4.7	22.9
China Construction Bank	0939.HK	CN	Banks	Buy	6.97	216,864	1.05	10.7	2.1	20.3	9.6	1.9	11.2
CHINA EASTERN AIRLINES	0670.HK	CN	Transportation	Buy	3.94	5,715	0.85	8.6	4.3	NM	7.4	2.4	17.1
China Everbright	0165.HK	CN	Diversified Financials	Buy	17.56	3,596	1.20	14.3	1.2	-56.1	13.3	1.0	7.5
China High Speed Trans	0658.HK	CN	Capital Goods	Buy	12.04	2,092	0.83	9.8	2.4	26.8	8.5	1.7	16.2
China Life Insurance	2628.HK	CN	Insurance	Buy	31.75	115,442	0.93	23.3	2.8	-0.5	19.2	2.4	21.1
China Medical Tech	CMED.OQ	CN	Health Care Equipment & Servic	Buy	11.24	294	0.92	15.8	1.4	-55.4	7.4	0.9	40.9
China Mengniu Dairy	2319.HK	CN	Food, Beverage & Tobacco	Buy	20.60	4,604	0.75	23.5	3.2	8.1	18.4	2.8	28.1
China Merchants	0144.HK	CN	Transportation	Buy	30.70	9,608	1.41	20.4	2.1	43.2	16.9	2.0	20.8
China Resources Land	1109.HK	CN	Real Estate	Buy	14.20	9,347	0.88	17.5	1.6	-2.8	19.4	1.5	-10.1
China Resources Pow er	0836.HK	CN	Utilities	Buy	14.08	8,455	0.36	13.2	1.6	-8.6	12.0	1.5	10.2
China Shipping Developmer	1138.HK	CN	Transportation	Buy	10.36	4,537	1.71	15.7	1.3	79.4	9.8	1.2	60.5
China Taiping Insurance	0966.HK	CN	Insurance	Buy	23.90	5,233	0.76	46.2	2.5	-1.8	40.9	2.3	12.8
China Telecom	0728.HK	CN	Telecommunication Services	Buy	4.07	42,373	0.78	18.5	1.2	13.8	16.3	1.2	13.1
China Vanke - A shares	000002.SZ	CN	Real Estate	Buy	8.22	13,715	0.42	12.9	2.1	43.9	9.8	1.8	31.1
China Vanke - B shares	200002.SZ	CN	Real Estate	Buy	9.60	13,578	0.67	12.8	2.1	43.9	9.7	1.8	31.1
China Yangtze Pow er	600900.SS	CN	Utilities	Buy	7.57	18,955	0.21	15.7	1.9	78.2	15.3	1.8	2.1
CNOOC Ltd	0883.HK	CN	Energy	Buy	18.44	105,853	1.23	14.6	3.4	62.3	12.8	2.9	13.5
COLI	0688.HK	CN	Real Estate	Buy	14.38	15,111	0.88	13.5	2.3	16.2	11.0	2.0	23.5
Cosco Pacific	1199.HK	CN	Transportation	Buy	13.54	4,706	1.53	18.4	1.3	50.7	14.1	1.2	30.6
CRE	0291.HK	CN	Food & Staples Retailing	Buy	31.85	9,790	0.90	39.2	2.5	41.3	28.7	2.3	36.4
CSR Corp Ltd	1766.HK	CN	Capital Goods	Buy	10.22	15,566	0.64	39.4	5.3	55.1	25.1	4.5	56.9
Dongfeng Motor	0489.HK	CN	Automobiles & Components	Buy	13.40	14,852	1.11	8.6	2.6	82.0	8.1	2.1	5.9
E-House	EJ.N	CN	Real Estate	Buy	14.96	1,199	1.28	21.2	1.3	-43.6	12.8	1.2	65.6
ENN Energy	2688.HK	CN	Utilities	Buy	23.30	3,148	0.54	19.3	3.5	19.0	16.6	3.0	16.4
Fantasia Holdings Group	1777.HK	CN	Real Estate	Buy	1.33	834	0.80	4.0	1.1	315.5	3.6	0.8	11.8
Franshion	0817.HK	CN	Real Estate	Buy	2.34	2,758	0.89	18.4	1.0	-21.3	15.0	0.9	22.8
Geely Auto	0175.HK	CN	Automobiles & Components	Buy	3.40	3,208	1.16	16.4	2.8	5.3	13.1	2.3	25.7
Global Bio-Chem	0809.HK	CN	Food, Beverage & Tobacco	Buy	1.18	412	1.27	10.5	0.5	NM	7.6	0.4	38.8
Glorious Property	0845.HK	CN	Real Estate	Buy	2.67	2,676	0.93	6.1	1.2	59.6	4.3	1.0	40.1
Golden Eagle Retail	3308.HK	CN	Retailing	Buy	19.16	4,785	0.67	33.0	8.8	25.2	25.4	7.1	29.8
Goldw ind Sci & Tech	2208.HK	CN	Capital Goods	Buy	16.10	5,580	0.02	14.9	2.6	17.9	12.8	2.2	15.7
Gome	0493.HK	CN	Retailing	Buy	2.80	5,423	0.63	22.6	2.6	19.5	16.4	2.3	37.7
Guangdong Investment	0270.HK	CN	Utilities	Buy	4.00	3,211	0.32	11.2	1.4	7.3	10.6	1.3	5.7
Guangzhou Auto	2238.HK	CN	Automobiles & Components	Buy	10.72	6,044	0.34	12.4	2.3	25.7	9.7	1.9	28.4
Hengan Intl.	1044.HK	CN	Household & Personal Products	Buy	67.05	10,517	0.40	31.4	8.8	21.1	25.4	7.7	23.5
Hengdeli	3389.HK	CN	Retailing	Buy	4.63	2,486	0.63	30.4	3.9	24.6	22.5	3.5	35.4
Huabao Int'l	0336.HK	CN	Materials	Buy	12.58	5,024	0.15	18.6	8.6	20.3	24.9	8.7	20.5
ICBC	1398.HK	CN	Banks	Buy	5.79	256,249	1.11	10.7	2.1	19.8	9.1	1.9	17.5
Industrial Bank	601166.SS	CN	Banks	Buy	24.05	20,059	0.55	7.9	1.6	14.8	7.1	1.3	11.1
KWG Property	1813.HK	CN	Real Estate	Buy	5.92	2,204	1.53	12.0	1.3	18.9	7.2	1.1	65.7
Little Sheep Group Limited	0968.HK	CN	Consumer Services	Buy	4.91	645	0.48	23.0	4.0	18.9	18.6	3.5	23.5
Longyuan Pow er	0916.HK	CN	Utilities	Buy	7.11	6,827	0.53	26.3	1.9	31.6	16.7	1.7	57.3
Mindray Medical	MR.N	CN	Health Care Equipment & Servic	Buy	26.40	2,937	0.51	18.0	3.8	12.5	16.0	3.2	12.6
Mingfa Group	0846.HK	CN	Real Estate	Buy	2.49	1,670	0.22	8.5	2.2	147.3	7.0	1.7	22.2
New Oriental	EDU.N	CN	Consumer Services	Buy	105.23	3,971	0.44	37.9	8.0	26.5	47.1	7.7	11.2
New World Dept Store Chin	0825.HK	CN	Retailing	Buy	6.40	1,388	1.22	19.7	2.6	5.5	15.4	2.1	21.2
Nine Dragons Paper	2689.HK	CN	Capital Goods	Buy	10.98	6,387	1.71	17.9	2.2	138.8	13.2	1.9	35.8
Renesola	SOL.N	CN	Semiconductors & Semiconduc	Buy	8.74	755	2.07	4.9	1.4	NM	3.5	1.0	39.2
Renhe	1387.HK	CN	Real Estate	Buy	1.36	3,849	0.29	5.0	1.7	-18.0	4.0	1.4	23.5
Shandong Weigao	1066.HK	CN	Health Care Equipment & Servic	Buy	22.05	6,106	0.40	52.4	11.3	21.1	37.7	9.1	38.9
Shanghai Forte Land	2337.HK	CN	Real Estate	Buy	2.50	813	1.07	8.7	0.8	45.2	7.1	0.8	21.8
Shanghai Industrial	0363.HK	CN	Capital Goods	Buy	33.60	4,666	0.81	15.7	1.3	166.5	10.0	1.2	57.7
Shenzhen Dev Bank	000001.SZ	CN	Banks	Buy	15.79	7,896	0.37	9.1	1.6	7.8	7.5	1.3	20.5
Shui On Land Ltd	0272.HK	CN	Real Estate	Buy	3.74	2,416	1.41	14.0	0.7	-65.9	18.8	0.6	-25.8
Sinopec-H	0386.HK	CN	Energy	Buy	7.44	82,981	0.85	7.4	1.3	18.9	7.0	1.1	6.3
Sinopharm Group	1099.HK	CN	Health Care Equipment & Servic	Buy	27.10	7,895	0.44	39.1	4.4	25.5	28.5	4.0	37.2
SOHO China	0410.HK	CN	Real Estate	Buy	5.78	3,857	0.93	9.1	1.3	80.6	23.9	1.3	-62.0
SouFun	SFUN.N	CN	Softw are & Services	Buy	71.52	1,360	0.48	27.5	14.1	-4.6	17.1	7.5	60.5
Sunac	1918.HK	CN	Real Estate	Buy	2.78	1,073	-0.07	4.7	1.3	-98.8	2.9	0.9	64.8
Suntech Pow er Holdings	STP.N	CN	Capital Goods	Buy	8.01	1,438	2.34	7.3	0.9	168.9	5.8	0.8	25.8
Trina Solar	TSL.N	CN	Capital Goods	Buy	23.42	1,592	1.58	6.2	1.5	113.7	6.1	1.2	2.4
Tsingtao Brew ery Co Ltd-H	0168.HK	CN	Food, Beverage & Tobacco	Buy	40.70	7,073	0.72	30.4	4.9	18.9	24.6	4.2	23.8
Wumart Stores	8277.HK	CN	Food & Staples Retailing	Buy	19.16	3,127	0.72	38.6	8.2	19.5	29.4	7.2	31.6
WuXi PharmaTech	WX.N	CN	Pharmaceutical & Biotechnology	Buy	16.14	1,122	0.81	17.7	3.0	2.6	14.2	2.4	24.2
Yingli Green Energy	YGE.N	CN	Capital Goods	Buy	9.88	1,475	2.23	6.9	1.3	271.1	5.6	1.0	23.1
Yuexiu Property	0123.HK	CN	Real Estate	Buy	2.08	1,997	1.25	13.1	0.9	NM	10.2	0.9	28.5
Zhejiang Expressw ay Ltd	0576.HK	CN	Transportation	Buy	7.66	4,280	0.52	15.2	1.9	4.3	13.6	1.8	11.3
ZTE Corp-H	0763.HK	CN	Technology Hardw are & Equipm	Buy	30.90	11,395	0.75	24.9	3.6	-22.2	20.2	3.1	23.4

Source: Deutsche Bank Note: details of coverage, ratings and target prices may be found on http://gm.db.com

Figure 53: Deutsche Bank China universe (Hold and Sell recommendations)

Company	Ticker	Country	Sector	Rating	31-Dec Price local	M. cap (US$m)	Beta	Ratios 2010F			Ratios 2011F		
								PE (x) (DB EPS)	PB (x)	EPS gth % (DB EPS)	PE (x) (DB EPS)	PB (x)	EPS gth % (DB EPS)
Brilliance China	1114.HK	CN	Automobiles & Components	Hold	5.93	3,806	0.95	25.0	4.2	NM	18.3	3.4	37.0
Air China	0753.HK	CN	Transportation	Hold	8.73	13,897	1.17	9.0	2.2	623.1	8.6	1.8	5.1
Baidu	BIDU.OQ	CN	Softw are & Services	Hold	96.53	33,588	0.72	65.2	27.1	128.8	42.8	16.6	52.3
Bank of Communications	3328.HK	CN	Banks	Hold	7.83	53,008	1.32	9.2	1.7	16.3	8.2	1.5	12.5
China CITIC Bank	0998.HK	CN	Banks	Hold	5.04	28,091	0.99	9.5	1.4	21.0	8.7	1.2	9.1
China Comm Services	0552.HK	CN	Telecommunication Services	Hold	4.63	3,438	0.77	12.2	1.6	16.5	11.1	1.5	10.0
China Cosco Hldgs	1919.HK	CN	Transportation	Hold	8.24	10,829	1.73	10.8	1.5	NM	13.3	1.4	-18.6
China Dongxiang	3818.HK	CN	Consumer Durables & Apparel	Hold	3.36	2,449	0.74	10.0	2.1	10.8	10.3	2.0	-3.4
China Everbright Int'l	0257.HK	CN	Commercial Services & Supplie	Hold	4.08	1,941	0.79	29.1	3.0	25.4	24.1	2.7	20.8
China Gas Holdings	0384.HK	CN	Utilities	Hold	3.39	1,662	0.68	24.9	3.6	41.0	21.3	1.8	37.9
China Merchants Bank-H	3968.HK	CN	Banks	Hold	19.62	51,392	1.16	12.6	2.6	22.4	10.9	2.1	15.7
China Minsheng	1988.HK	CN	Banks	Hold	6.65	20,949	0.44	8.8	1.5	8.3	8.4	1.3	4.8
China Minsheng Bank	600016.SS	CN	Banks	Hold	5.02	16,959	0.56	7.4	1.1	15.5	6.4	1.0	15.7
China Mobile	0941.HK	CN	Telecommunication Services	Hold	77.20	199,193	0.82	11.7	2.3	-1.7	11.7	2.1	0.2
China Oil & Gas Group	0603.HK	CN	Utilities	Hold	0.89	562	1.03	31.5	1.9	17.3	23.0	1.7	36.7
China Oilfield Services	2883.HK	CN	Energy	Hold	16.84	9,740	1.45	17.4	1.8	19.0	17.5	1.8	-0.4
China Pow er Int'l	2380.HK	CN	Utilities	Hold	1.59	1,037	0.71	11.1	0.5	-14.4	12.3	0.5	-9.2
China Rail Construction	1186.HK	CN	Capital Goods	Hold	9.36	14,855	0.62	23.0	1.7	-35.6	10.0	1.6	129.9
China Railw ay Group	0390.HK	CN	Capital Goods	Hold	5.61	15,371	0.85	12.8	1.5	14.5	9.9	1.4	29.3
China Shipping Container	2866.HK	CN	Transportation	Hold	3.44	5,170	1.63	9.4	1.2	NM	15.1	1.1	-38.1
China Southern Airlines	1055.HK	CN	Transportation	Hold	4.76	5,113	1.10	8.5	1.5	NM	8.8	1.2	-3.2
China Unicom	0762.HK	CN	Telecommunication Services	Hold	11.12	33,705	0.72	89.4	1.1	-73.6	45.7	1.1	95.8
ChinaCache	CCIH.OQ	CN	Softw are & Services	Hold	20.80	8,683	0.34	972.2	96.4	NM	639.1	88.4	52.1
Ctrip	CTRP.OQ	CN	Consumer Services	Hold	40.45	5,762	0.93	40.6	10.5	40.0	32.3	8.2	25.7
Datang Int'l Pow er	0991.HK	CN	Utilities	Hold	2.73	4,277	1.04	13.2	0.9	34.6	12.0	0.9	9.9
Focus Media	FMCN.OQ	CN	Media	Hold	21.93	3,064	1.17	35.4	2.5	19.7	18.6	2.2	90.6
Guangzhou R&F Prop	2777.HK	CN	Real Estate	Hold	11.12	4,610	1.61	9.7	1.6	40.2	7.6	1.4	27.7
Harbin Pow er Equipment	1133.HK	CN	Capital Goods	Hold	12.26	2,171	1.48	16.0	1.5	47.5	15.0	1.4	6.8
Huadian Pow er	1071.HK	CN	Utilities	Hold	1.52	1,324	0.76	-12.0	0.6	NM	30.4	0.6	NM
Huaneng Pow er Intl	0902.HK	CN	Utilities	Hold	4.11	6,374	0.59	10.1	1.0	-15.8	18.8	0.9	-46.1
Jiangsu Expressw ay-H	0177.HK	CN	Transportation	Hold	8.90	5,768	0.44	17.2	2.5	10.0	12.5	2.4	37.4
Lee & Man Paper	2314.HK	CN	Materials	Hold	5.89	3,520	1.39	9.2	2.8	459.7	14.9	2.4	-1.3
Lenovo Group Ltd	0992.HK	CN	Technology Hardw are & Equipr	Hold	4.98	6,089	1.49	38.5	4.0	NM	23.7	3.3	103.7
Lianhua Supermarket	0980.HK	CN	Food & Staples Retailing	Hold	37.15	2,973	0.58	30.7	7.2	25.9	24.8	6.1	23.8
Netease.com	NTES.OQ	CN	Softw are & Services	Hold	36.15	4,690	0.69	14.7	3.2	14.0	12.3	2.5	19.4
Parkson Retail Group	3368.HK	CN	Retailing	Hold	11.98	4,312	0.84	27.8	6.8	12.8	22.6	5.8	22.9
PetroChina	0857.HK	CN	Energy	Hold	10.16	239,205	1.30	11.4	1.7	31.4	10.5	1.6	8.0
Ping An Insurance Grp	2318.HK	CN	Insurance	Hold	86.90	83,780	1.09	36.6	5.3	6.4	33.0	4.8	11.1
Ports Design Limited	0589.HK	CN	Consumer Durables & Apparel	Hold	21.45	1,550	0.86	20.4	7.1	9.3	16.2	6.2	25.8
Shanda Games Limited	GAME.OQ	CN	Softw are & Services	Hold	6.44	1,840	0.14	9.7	2.9	-14.9	9.3	2.2	3.9
Shanghai Electric	2727.HK	CN	Capital Goods	Hold	5.13	8,358	1.19	18.1	2.1	22.3	15.1	1.9	20.3
Shanghai Pudong Bank	600000.SS	CN	Banks	Hold	12.39	21,791	0.48	7.1	1.4	-3.6	8.8	1.2	-19.3
Shenzhen Expressw ay-H	0548.HK	CN	Transportation	Hold	4.61	1,293	0.84	14.6	1.1	13.4	12.9	1.1	13.2
Sina Corp	SINA.OQ	CN	Softw are & Services	Hold	68.82	4,208	0.67	41.7	3.2	165.3	34.6	2.9	20.5
Sinotruk (Hong Kong)	3808.HK	CN	Capital Goods	Hold	8.01	2,845	0.88	13.6	1.0	19.3	12.0	1.0	12.9
Sohu.com Inc	SOHU.OQ	CN	Softw are & Services	Hold	63.49	2,405	0.73	16.9	3.2	-1.0	13.6	2.5	24.0
Tencent	0700.HK	CN	Softw are & Services	Hold	168.90	39,478	0.85	33.4	13.8	53.4	26.1	9.2	27.9
Tingyi	0322.HK	CN	Food, Beverage & Tobacco	Hold	19.90	14,302	0.28	30.7	8.4	21.9	27.5	7.3	11.3
Tow ngas China	1083.HK	CN	Utilities	Hold	3.73	1,056	0.59	22.4	1.1	26.5	19.4	1.0	15.0
Weichai Pow er	2338.HK	CN	Capital Goods	Hold	47.85	10,255	1.54	10.7	3.8	86.1	10.1	2.9	5.2
Zhong An Real Estate Ltd	0672.HK	CN	Real Estate	Hold	1.89	486	0.89	7.1	0.7	26.0	5.9	0.6	20.2
Agile Property	3383.HK	CN	Real Estate	Sell	11.44	5,262	1.78	14.8	1.9	15.9	11.9	1.7	24.4
Bank of Ningbo	002142.SZ	CN	Banks	Sell	12.40	5,065	0.52	15.0	2.3	41.7	12.6	2.0	18.5
BYD	1211.HK	CN	Capital Goods	Sell	40.85	11,956	1.25	22.5	4.1	-13.0	18.1	3.4	24.5
China Comms Construct	1800.HK	CN	Capital Goods	Sell	6.80	12,968	1.21	10.8	1.4	10.2	9.6	1.3	12.8
China Foods	0506.HK	CN	Food, Beverage & Tobacco	Sell	4.96	1,782	0.67	30.6	2.4	-20.3	24.1	2.3	27.0
Country Garden Holdings	2007.HK	CN	Real Estate	Sell	2.98	6,253	1.33	16.1	1.8	39.8	13.8	1.6	16.7
Dongfang Electric	1072.HK	CN	Capital Goods	Sell	38.50	9,924	1.43	26.4	5.9	44.8	20.6	4.7	28.3
Li Ning Co Ltd	2331.HK	CN	Consumer Durables & Apparel	Sell	16.48	2,198	0.73	12.8	4.5	22.3	14.3	4.0	-10.3
PICC	2328.HK	CN	Insurance	Sell	11.26	16,139	1.18	25.9	4.1	130.6	24.1	3.5	7.4
Shanda	SNDA.OQ	CN	Softw are & Services	Sell	39.64	2,392	0.52	20.1	1.7	-46.5	18.0	1.5	12.0

Source: Deutsche Bank Note: details of coverage, ratings and target prices may be found on http://gm.db.com

Appendix 1

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr.

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Jun Ma

Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.

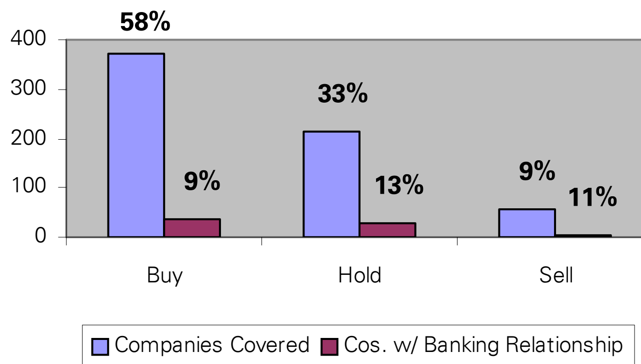
2. Ratings definitions prior to 27 January, 2007 were:

Buy: Expected total return (including dividends) of 10% or more over a 12-month period

Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period

Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



Asia-Pacific Universe

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Asia-Pacific locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
tel: (852) 2203 8888

Deutsche Equities India Pte Ltd
3rd Floor, Kodak House
222, Dr D.N. Road
Fort, Mumbai 400 001
India
Tel: (91) 22 6658 4600

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank (Malaysia) Berhad
Level 18-20
Menara IMC
8 Jalan Sultan Ismail
Kuala Lumpur 50250
Malaysia
Tel: (60) 3 2053 6760

In association with
Deutsche Regis Partners, Inc.
Level 23, Tower One
Ayala Triangle, Ayala Avenue
Makati City, Philippines
Tel: (63) 2 894 6600

Deutsche Securities Korea Co.
17th Floor, YoungPoong Bldg.,
33 SeoRin-Dong,
Chongro-Ku, Seoul (110-752)
Republic of Korea
Tel: (82) 2 316 8888

Deutsche Bank AG Singapore
One Raffles Quay
South Tower
Singapore 048583
Tel: (65) 6423 8001

Deutsche Securities Asia Ltd
Taiwan Branch
Level 6
296 Jen-Ai Road, Sec 4
Taipei 106
Taiwan
Tel: (886) 2 2192 2888

In association with
TISCO Securities Co., Ltd
TISCO Tower
48/8 North Sathorn Road
Bangkok 10500
Thailand
Tel: (66) 2 633 6470

In association with
PT Deutsche Verdhana Indonesia
Deutsche Bank Building,
6th Floor, Jl. Imam Bonjol No.80,
Central Jakarta,
Indonesia
Tel: (62 21) 318 9541

International locations

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

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