February 22, 2012

China Strategy

China A-share strategy: What to do while awaiting a tailwind

Equity Research

Liquidity improvement supports A-share rebound

The A-share market has rebounded by 8.2% ytd, supported by easing global macro risks and improving domestic liquidity conditions. We revisit and fine-tune our sector preferences and recommend a list of small-mid cap growth stocks with appealing risk/reward profiles.

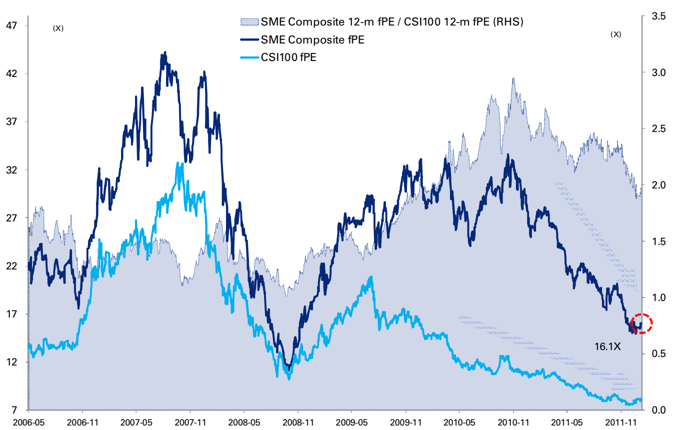
Upgrade IT & Electronic components/Shipping to neutral

The A-shares' ytd sector performance has seen a reversal in 2H2011, with the high-beta sectors leading this ytd move. Based on improving sector fundamentals and less demanding valuations, we upgrade the IT & Electronic components and Shipping sectors from underweight to neutral. Overall, we maintain our preference for a mixture of low valuation domestic cyclicals (**coal, securities**) and consumption stocks (**health care, auto, retailing, home appliances**). We **dislike telecom/utilities** (unfavorable valuation)**, steel/chemical** (weak sector fundamentals).

Recommend a list of small-mid cap growth stocks

Given market downside risk appears to have eased since 4Q2011, we look for growth opportunities within the small-mid caps segment, following their underperformance in the past several months. We screen for a list of small-mid cap growth stocks (Exhibit 13), mostly from consumer-related sectors. Their valuations have turned more supportive vs. several months ago, while fundamentals still appear reasonably stable.

We are less cautious towards small-mid caps



Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

Hanfeng Wang, Ph.D, CFA
+86(10)6627-3318 hanfeng.wang@ghsl.cn
Beijing Gao Hua Securities Company Limited

Helen Zhu
+852-2978-0048 helen.zhu@gs.com
Goldman Sachs (Asia) L.L.C.

Timothy Moe, CFA
+852-2978-1328 timothy.moe@gs.com
Goldman Sachs (Asia) L.L.C.

Ben Bei
+852-2978-1220 ben.bei@gs.com
Goldman Sachs (Asia) L.L.C.

Chenjie Liu
+86(10)6627-3324 chenjie.liu@ghsl.cn
Beijing Gao Hua Securities Company Limited

Fine-tuning sector views, recommending a list of small-mid cap growth stocks

The A-share market has rallied by 8.2% ytd supported by easing global macro risks and improving domestic liquidity conditions. While we largely maintain our market views (see *Liquidity should be improved further* (January 4), and *Fund flow should turn gradually more favorable* (February 3)), we adjust our sector preferences and recommend a list of growth stocks based on recent fundamental developments and stock valuation changes.

Key actions suggested are:

1) Upgrade the IT & Electronic components and Shipping sectors from underweight (UW) to neutral, based on improving sector fundamentals and undemanding valuation;

2) Looking for growth opportunities among select A-share small-mid cap growth stocks (mainly consumer-related names).

Our sector preferences: How have our views changed?

Our sector preferences ytd have been a mixture of low valuation domestic cyclicals (coal, securities) and consumption stocks (health care, auto, retailing, home appliances). This was to provide a balance between capturing potential market upside (on inexpensive valuations) and also protecting from any market downside (from continued macro uncertainties, especially pertaining to the property sector). We were underweight on telecom, utilities, shipping, and IT & electronic components in our October 25, 2011 report (*China: 2012 A-share Outlook: Growth slower, policy friendlier,* and *Liquidity should be loosened further, January 4, 2012*).

In Exhibit 1, we show the ytd A-share performance by sector and note that sector performances have generally reversed from that in 2H2011. Low valuation cyclical sectors with higher betas, which had underperformed significantly in 2H2011, have outperformed ytd whereas relatively higher valuation and defensive sectors lagged, reflecting rising risk appetite amid a global equity market rally and improving domestic liquidity conditions.

Consequently, the coal and securities sectors (overweight) have been among the top performing sectors as market interest in these high-beta sectors rose vs. in 4Q2011, while the performance of the auto sector (overweight) was in-line with that of the market. The health care and retail sectors (overweight) underperformed with a positive sector return of around 5%. The telecom and utilities sectors (underweight) were among those that saw the most downside, while some other sectors, such as shipping and IT & Electronics (underweight) and banks, insurance, property (neutral), also underperformed ytd but by a lesser magnitude.

We fine-tune our sector preference in this note based on recent developments in sector fundamentals and valuations, but we largely maintain our preference for a combination of low valuation domestic cyclicals (coal, securities) and consumption stocks (such as health care, auto, retailing, home appliances) – all rated overweight. We still dislike the telecom/utilities because of unfavorable valuations (22.6X 2012E P/E for the telecom sector, and 21X 2012E P/E for the utilities sector), and the steel/chemical sectors because of weak fundamentals (please see the note by GS sector analyst, *Sentiment very weak; 2Q demand rebound likely smaller magnitude,* February 14, 2012*)*—all rated underweight.

Upgrade IT & Electronic components/Shipping to neutral

We make some sector preference adjustments based on recent market developments and changes in sector fundamentals. Specifically, we move the IT & Electronic components and Shipping sectors from underweight to neutral, while keeping our other sector weightings unchanged.

Upgrade IT & Electronic components from underweight to neutral

We had downgraded this sector to underweight (UW) in our 2012 annual outlook (*Growth slower, policy friendlier*, October 25, 2011), as our sector analysts had believed fundamentals (i.e., downcycle, earnings growth) had not reached a bottom yet, with valuations still high compared with the market amid an overall unfavorable tight liquidity environment. Recent developments that led to our change in view on the sector include:

1) **Bottoming out of sector fundamentals appears to be in sight.** Our GS tech team's inventory analysis suggests the sector fundamentals are approaching a trough, with inventory dollars at their lowest since 2010. And they expect wafer shipments to rebound in March (Exhibit 2). (please see *TSMC (2330.TW): First take: end of correction confirmed; higher structural profitability*, January18, *Taking profits after recovery underway; TSMC off CL but still Buy*, February 10, *Inventory database update; ADI and Marvell earnings previews*, February 21, 2012).

2) **Sector valuation has come down to a more sustainable level** vs. several months ago. The sector is currently trading at 15.7X 12m forward P/E, close to the historical trough level we saw in late 2008 (Exhibit 3, Exhibit 6).

3) **Liquidity has been improving gradually**, as suggested by the declining market rates (yield on the commercial discount bills has declined to 5.8% from around 10% in 4Q2011), which we think should help to alleviate the tight liquidity situation faced by many small-mid cap tech companies.

Despite these positive developments, we are not turning bullish towards the sector at the moment as our GS tech team thinks the slope of potential recovery is uncertain, although they believe sector fundamentals are approaching a trough.

Upgrade Shipping from underweight to neutral

We downgraded the sector in April 2011, but we now believe there are signs of a turn-around in the sector:

1) **Global macro risks appear to have eased** during recent months, especially after the introduction of the ECB's liquidity provision to the EU banks, and better than expected macro momentum globally since late last year as suggested by our GLI index (Exhibit 4) as well as the BDI index bouncing back from recent lows (Exhibit 5). In our view, these signs suggest macro risks from the EU's debt woes and weak DM growth are easing, at least temporarily, which should be supportive to the Shipping sector—one of the global cyclical sectors sensitive to changes in global macro momentum.

2) **Seemingly less risk of a hard landing scenario in China.** This has been one of the major risks that have weighed on the shipping sector in 2H2011, but recent data (such as the January PMI data) suggest market concerns over China's hard landing may have been overdone.

3) **Sector valuation is not demanding,** in terms of P/B. Currently, the sector is trading at 1.4X 2012E P/B, the lowest level since late 2008 (Exhibit 8).

That said, we are not turning bullish on the sector either, as the shipping sector's excess supply remains an overhang, and our sector analysts continue to see increase in idling and delays in newbuild deliveries (see *Containership: Valuations reflect normalized returns,* February 13).

Screening for a list of small-mid cap growth stocks

Small-mid caps have underperformed large caps (SME composite index vs. CSI300) by around 10% since 4Q2011. We had been cautious towards small-mid caps in the A-share market due to their relatively high valuation and consensus earnings downgrade risks, especially given the tight liquidity conditions then (see *China: 2012 A-share Outlook: Growth slower, policy friendlier*, October 25, 2011). However, given the easing in macro risks (e.g., ECB's liquidity provisions), less demanding valuations, and less tradable-share-reduction pressure in the coming several months (Exhibit 9), we think investors' interests in those small-mid caps with good fundamentals and undemanding valuations should rise.

We turned less cautious towards the small-mid caps in our note on February 2 (see *Fund flow should gradually turn more favorable*) as we see less downside risk after its significant underperformance since 4Q2011. We suggested bottom-up stock selection within the small-mid caps segment.

1) **Valuations for small-mid caps have come down to a more sustainable level vs. several months ago**. The SME composite index is trading at 16.1X 12m forward P/E (based on WIND consensus earnings), which is the lowest level since late 2008. The valuation premium over large caps (CSI100 index) has also shrank substantially since 4Q2010 as the SME composite index (small caps) significantly underperformed the CSI100 index (large caps) (see cover exhibit).

2) **Earnings downgrade risks remain, but likely already largely priced in**. WIND consensus still expects 20%/37% earnings growth for the SME composite index in 2011E/2012E, but we don't think the market has factored in such a high growth expectation given that the SME valuation is only slightly above the historical trough level in late 2008.

That said, we are not turning bullish on the entire small-mid cap segment, as we think uncertainties (such as how the demand will evolve going forward) for the property and FAI-related small-mid caps sectors still remain. Given the non-consumer related sectors' relatively high weighting in the SME composite index (around 47%, Exhibit 11), we believe their performance may continue to weigh on the overall performance of the SME index.

We suggest focusing on those stocks/sectors with **relatively stable growth and undemanding valuations**, most of which are from the consumer-related sectors (health care, consumer discretionary, IT & electronic components, etc). Historically, consumer-related sectors have generally delivered higher and less volatile average earnings growth of 30.4% vs. 19.4% for non-consumer related ones (during year 2005-2010, see Exhibit 10). The valuation of consumer-related sectors has come down to around 18X 12-m forward P/E (Exhibit 12) vs. historical average of 24X, due to the sell-off in small-mid caps in 4Q2011, which we think is not demanding against the backdrop of historical average earnings growth of around 30% (implying PEG of only 0.6).

Note that our preference for consumer-related growth stocks is consistent with our overall sector preference for a mixture of consumption and low valuation domestic cylicals (coal and securities), even though our favored consumption sectors generally have a relatively higher weighting in small-mid caps and our preferred cyclical sectors tend to have a low representation in small-mid caps (Exhibit 11).

Screening for medium-long term outperformance candidates. Given that small-mid cap stocks differ significantly in terms of corporate governance, industry position, growth potential and valuation, we suggest using bottom-up stock selection to identify potential medium-long term outperformance candidates.

We re-run our small-mid cap screen for a list of our preferred A-share small-mid caps using the following criteria (Exhibit 13):

1) Covered by our GS/Gao Hua A-share sector analysts;

2) A leader within its own sub-sector and a market cap of between Rmb5 bn-Rmb35 bn.

3) Has a positive rating from our sector analyst ;

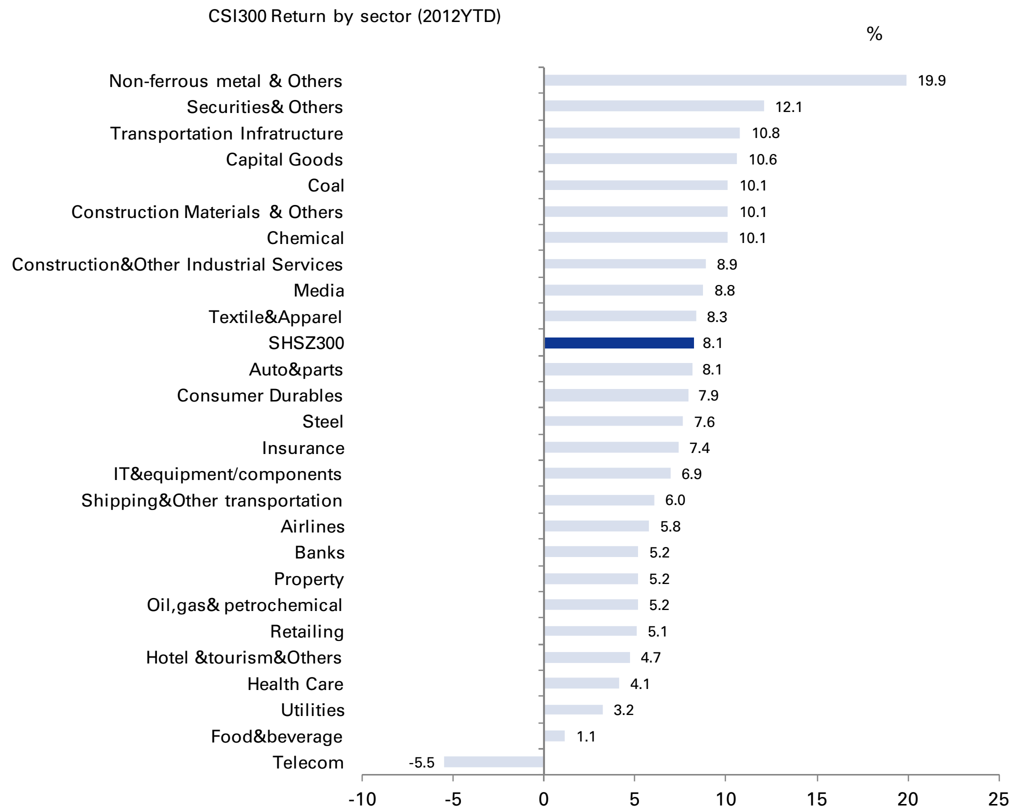
4) Earnings CAGR for the next two years expected to be higher than the earnings growth we expect for large cap CSI300 index (above 20%, based on GS/GH estimates);

5) Valuation less than 30X 2012E P/E (based on GS/GH estimates), which we think is generally the high-end of the acceptable valuation range for growth stocks for local A-share investors.

Results of our screen include a number of stocks from consumer discretionary (Huayu Auto, CITS, BesTV New Media, Jinjiang Hotel, Huangshan Tourism), healthcare (WH Humanwell, Yuyue) and IT-related sectors (Fiberhome, BJ Ultrapower), which are mostly of the consumer related theme.

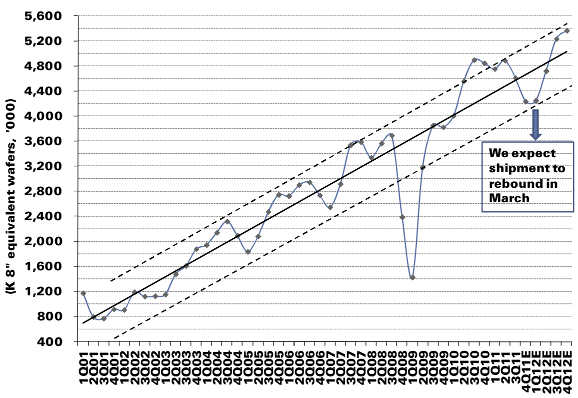
The above list of stocks has underperformed the CSI300 by 8.4 ppt since 4Q2011 (Exhibit 14). According to our sector analysts' estimates, these stocks could see average earnings growth of 35% in 2012E, while currently trading at 21X 2012E P/E (Exhibit 13).

Exhibit 1: A-share sector performance ytd: A reversal of the sector performance in 2H2011



Source: Wind, Gao Hua Securities Research

Exhibit 2: Our GS tech team believes the fundamentals for IT hardware could be reaching a bottom

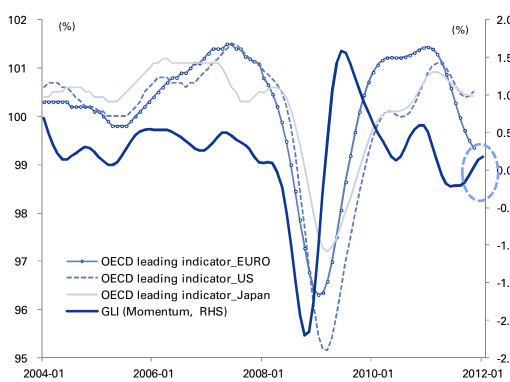


Source: Gao Hua Securities Research, Goldman Sachs Global ECS Research

Exhibit 3: The IT & equip/components sector's valuation has come down to a more sustainable level, in our view

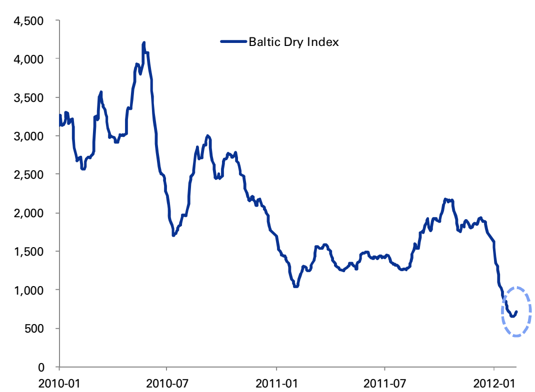
Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

Exhibit 4: GS GLI (momentum) index suggests the global macro momentum continues to improve



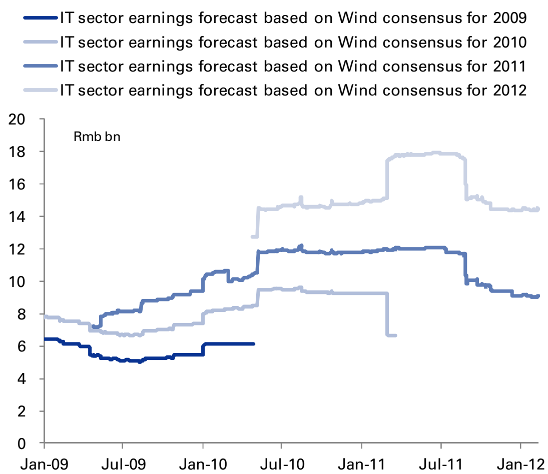
Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

Exhibit 5: BDI index is bouncing back from the recent historical low



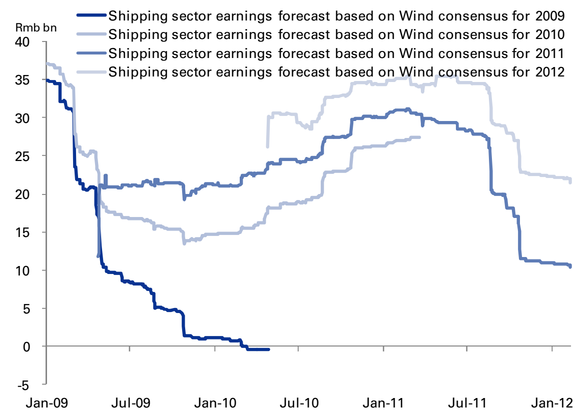
Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

Exhibit 6: WIND consensus earnings for IT & electronic components seems to have stabilized



Source: Wind, Gao Hua Securities Research

Exhibit 7: WIND consensus earnings for shipping sector have been cut substantially since mid-2011

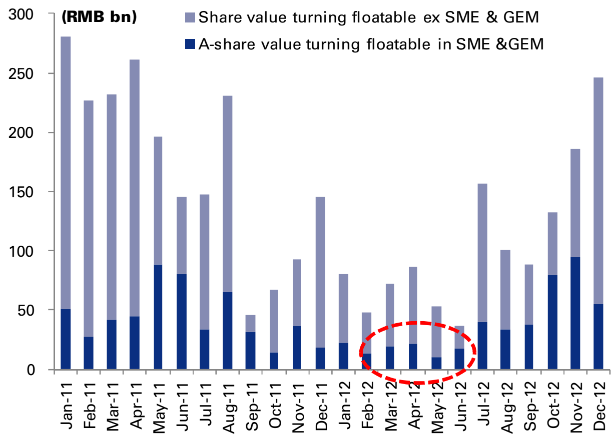


Source: Wind, Gao Hua Securities Research

Exhibit 8: Shipping sector is trading at 1.4X 2012E P/B, the lowest level since late 2008

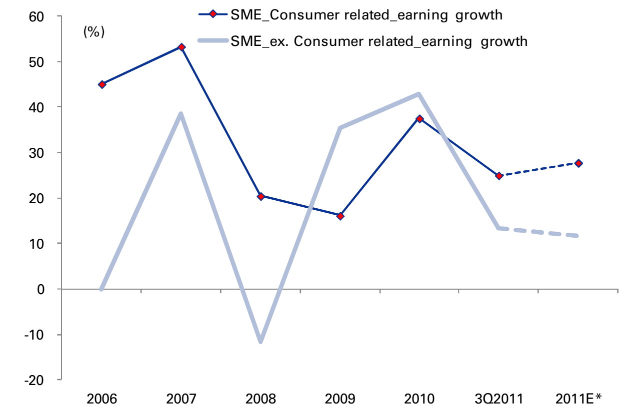
Source: Wind, Gao Hua Securities Research

Exhibit 9: Value of shares becoming tradable should be less in SME and GEM than in the past several months



Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

Exhibit 10: Small-mid caps: Consumer-related sectors delivered higher and less volatile earnings growth



*Based on WIND consensus

Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

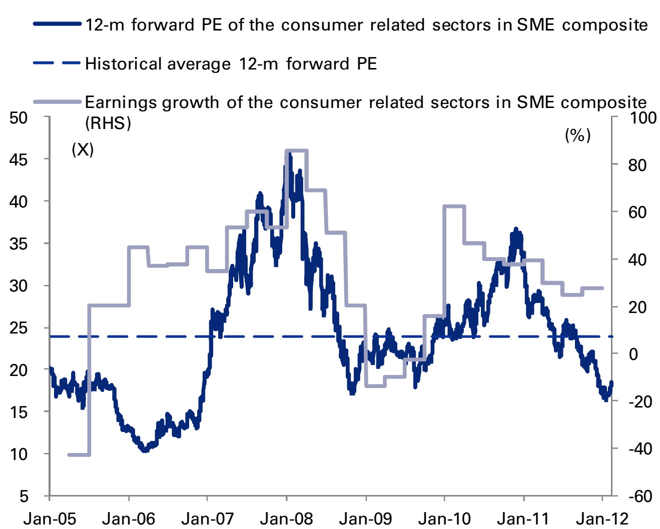
Exhibit 11: Non-consumer related sectors as shown by the unhighlighted sectors account for around 47% of the SME index's weighting

Sector	Sector weighting	
	CSI300 Index	SME Comp Index
IT&equipment/components	2.3	16.0
Capital Goods	10.3	15.6
Food&beverage	7.1	9.2
Chemical	2.4	8.9
Health Care	4.3	8.2
Textile&Apparel	0.3	6.4
Construction&Other Industrial Services	3.0	5.3
Consumer Durables	2.2	4.7
Retailing	2.1	4.2
Non-ferrous metal & Others	7.0	4.1
Construction Materials & Others	1.5	3.1
Property	4.4	2.2
Auto&parts	2.4	2.0
Oil,gas& petrochemical	2.4	1.7
Banks	21.4	1.6
Coal	6.3	1.3
Steel	2.5	1.3
Hotel &tourism&Others	0.8	1.1
Securities& Others	5.8	0.6
Household & Personal Products	0.0	0.5
Utilities	2.5	0.4
Media	0.4	0.4
Telecom	1.0	0.4
Transportation Infratructure	0.4	0.3
Airlines	0.8	0.3
Shipping&Other transportation	1.9	0.2
Insurance	4.7	0.0
Weightings of consumer related sectors		52.7

Grey indicates consumer-related sectors

Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

Exhibit 12: Valuation of consumer-related sectors within the SME composite index has declined substantially



Source: Wind, Gao Hua Securities Research estimates

Exhibit 13: A list of our preferred small-mid cap growth stocks within the GS/GH A-share coverage universe

Ticker	Name	Sector	Rating	Price (Rmb, 2012-2-20)	Market cap (US$mn)	2012E EPS growth (%)	P/E CY 2012 (X)	P/E CY 2013 (X)
600741 CH	Huayu Automotive Systems	Industrials	Buy	10.24	4,259	21.2	8.5	8.0
601888 CH	China International Travel Service	Consumer Discretionary	Buy*	26.57	3,602	46.8	20.6	15.7
600498 CH	Fiberhome Telecom Tech	Information Technology	Buy	28.68	1,929	32.4	20.9	16.5
600754 CH	Shanghai Jinjiang International	Consumer Discretionary	Buy	17.33	1,662	25.0	23.9	19.9
600637 CH	BesTV New Media	Consumer Discretionary	Buy	15.04	1,584	48.6	27.7	19.9
600079 CH	Wuhan Humanwell	Health Care	Buy	18.10	1,430	37.4	23.2	18.2
002223 CH	Jiangsu Yuyue	Health Care	Buy*	19.60	1,260	44.9	25.2	18.9
300002 CH	Beijing Ultrapower	Information Technology	Buy	20.62	1,187	34.5	17.3	13.8
600054 CH	Huangshan Tourism	Consumer Discretionary	Buy	15.67	1,150	24.1	17.1	13.5
Average						35.0	20.5	16.0

Note: * Conviction Buy,stock price as of Feb 20, 2012

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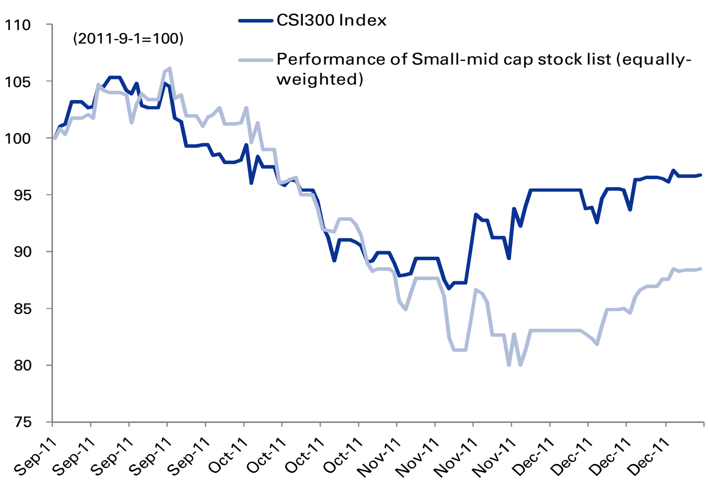
Note: The ability to trade this basket will depend upon market conditions, including liquidity and borrow constraints at the time of trade.

Source: Gao Hua Securities Research estimates, Goldman Sachs Global ECS Research

Exhibit 14: Our list of small-mid cap stocks has underperformed the CSI300 by 8.4 pp since 4Q2011



Note: Results presented should not and cannot be viewed as an indicator of future performance.

Source: Wind, Gao Hua Securities Research, Goldman Sachs Global ECS Research

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Reg AC

We, Hanfeng Wang, Ph.D, CFA, Helen Zhu, Timothy Moe, CFA, Ben Bei and Chenjie Liu, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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