Morgan Stanley

MORGAN STANLEY ASIA INSIGHT

M O R G A N   S T A N L E Y   R E S E A R C H

A S I A / P A C I F I C

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Asia Insight

Asia/GEMs Strategy

Asia Insight: Hang Seng 50,000 by 2015?

We introduce a new long-term bull scenario in which the Hang Seng Index achieves the 50,000 level (+121% gain from current levels) before the end of calendar year 2015. There are four reasons we think this bull tail-risk scenario is worth exploring.

1) Easy money and accelerating global growth. The top-down macro environment is one of ultra-easy monetary policy in the developed world and reacceleration in global and Chinese GDP growth. These have been associated with strong bull runs in the Hang Seng since its inception.

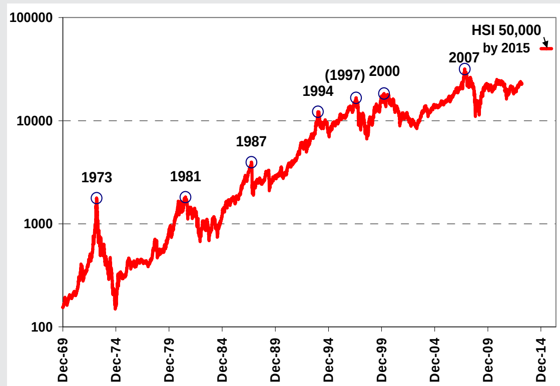
2) Historical precedent of 6- to 8-year peak-to-peak cycle. The Hang Seng rising by 121% in three years or less would seem like a tough task. It has, in fact, been achieved in 32.5% of the total months in the Hang Seng's existence. Peaks in the Hang Seng have occurred on average every 6-8 years since its inception (1973, 1981, 1987, 1994, 2000, and 2007), each after growth of at least 121% in a 3-year period. Based on this 6- to 8-year cycle, a new peak would seem likely to form some time between end-2013 and end-2015. The Hang Seng at 50,000 would be 58% above the prior peak of 31,638, consistent with the prior peak-to-peak moves.

3) Valuation backtests support our view. Trailing P/E (currently 11.0x, or 83rd percentile cheap to history) and trailing P/B (1.52x, or 75th percentile cheap) backtest for mean returns 36 mths fwd consistent with a 50,000 target. Div yld (3.24%) backtests for a level near 40,000.

4) QDII initiatives from China's government and the HK government's property market controls are also factors supportive of our call. It is noteworthy that Hong Kong property transaction volumes are moderating whilst stock market volumes are increasing currently.

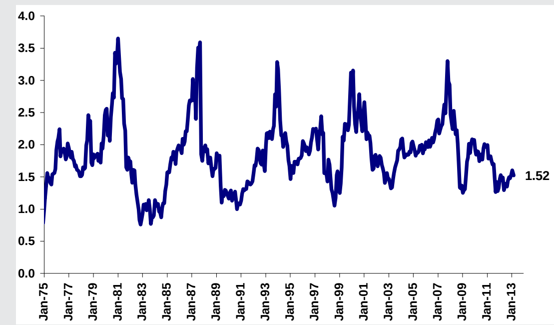
Lastly, with the help of MS's bottom-up analysts, we explore bull case scenarios for 2015E EPS & P/E for the Hang Seng on a stock-by-stock basis. Overall, this suggests 38,800 (72% upside) as a bottom-up Bull Case 2015 target. Our analysts see the greatest upside for Energy, Consumer Services (Gaming) and Retailing.

Hang Seng Index Peaks since 1970 – 6- to 8-year peak-to-peak cycle implies next peak in 2013-2015



Source: HSI Company, Datastream, Morgan Stanley Research, data as of March 14, 2013

HSI trailing price-to-book value – 0.6 SD below average



Source: HSI Company, CEIC, Morgan Stanley Research, data as of March 14, 2013

Introducing a bull scenario of the Hang Seng Index achieving 50,000 (+121% gain from current levels) before the end of calendar year 2015.

In our experience, some of the best insights often come from client meetings. In this case, we found ourselves debating in the year-end holiday season late last year with one of our most experienced clients the implications for the Hang Seng index of the twin forces of: a) a China economic recovery in 2013/14, and b) the Fed's QE3 announcement. There was agreement that the combination of a reacceleration in China growth and US easy money was likely to be positive for HK asset prices. Moreover, we pointed out that increased government stamp duty taxation on property transactions in Hong Kong cut two ways from a stock market perspective. However, in a bull case scenario, it had the potential to concentrate asset price inflation away from property and into the stock market. As the debate deepened, we proposed that the Hang Seng Index might reach 50,000 before the Fed raised the Fed Funds Rate at some point in 2015. For the client, this was pushing a good line of argument too far. We parted agreeing to meet in the year-end holiday season three years from now to review the market's performance.

The purpose of this note is to put detail on the bones of a bull case scenario that the Hang Seng index could reach 50,000 before the end of 2015. Our current near-term bull, base and bear case forecasts for the Hang Seng, derived from varying EPS and P/E assumptions for 2013, are given in Exhibit 1 below and remain unchanged. For 2013, the base case scenario suggests a target price of 25,600, with upside to 32,000 in the bull case scenario. We have not published detailed scenario analysis at this stage for 2014 and 2015.

Exhibit 1

Hang Seng Index 2013 scenario analysis

Scenarios 2013 Outlook	2013 Assigned Weight	HSI Dec 2013E EPS (HK$)	HSI 2013E EPS Growth Rate (%)	Global Growth Outlook 2013	Trailing PE Assumptions*	Scenarios Target Price (Dec 2013)	Implied Price HK$ Return Upside (Dec 2013)
Bull Scenario	20%	2,220	14%	Global growth of 3.9% with China growth of 8.7%	14.4	32,000	41%
Base Scenario	60%	2,060	6%	Global growth of 3.2% with China growth of 8.2%	12.5	25,600	13%
Bear Scenario	20%	1,650	-15%	Global growth of 2.4% with China growth of 7.6%	9.2	15,200	-33%
Scenario Weighted Average						24,800	10%

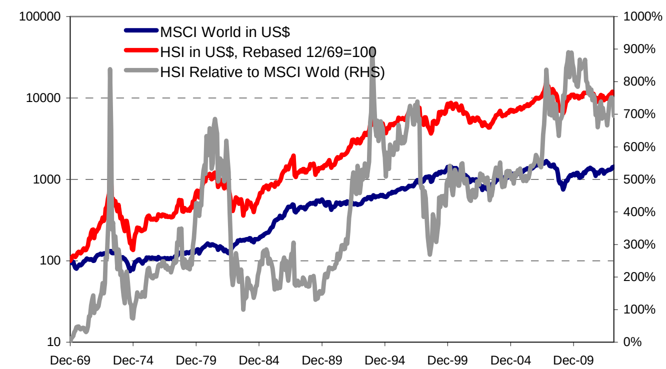
Source: CEIC, IBES, Morgan Stanley Research. Data as of March 14, 2013.

Hang Seng – one of the great long-term equity index investments

The Hang Seng index has been a potent force for wealth creation from the moment of its inception in 1969. Since then, it has delivered a CAGR in US$ terms of 11.6% per annum, versus 6.3% for the MSCI DM World (price return in US$; see Exhibit 2). This makes it one of the best long-term equity index investments of all time.

Exhibit 2

HSI has outperformed MSCI World over the cycle with an excess return of 5.3% per annum: price performance since index inception (in US$)

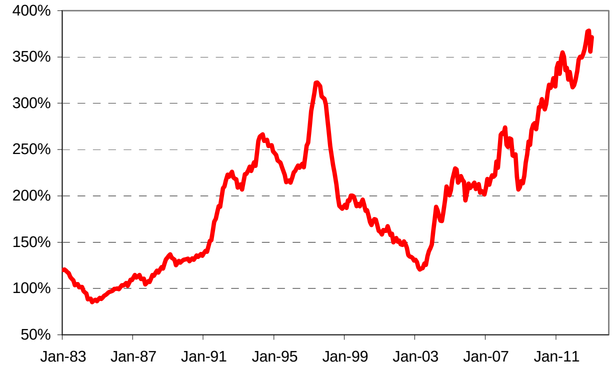


Source: HSI Company, MSCI, Datastream, Morgan Stanley Research, data as of March 14, 2013

The sources of this sustained outperformance are many. Hong Kong has been a key beneficiary of China's economic growth story, with the Hong Kong economy morphing from a high labour force growth manufacturing centre to a more mature provider of financial, shipping, tourism and consumer/retail services. Leading Hong Kong corporates have successfully used the cash flow from local oligopoly positions in key economic segments to create diversified conglomerates with a particular focus on Asia. A low personal and corporate tax environment, open capital account and reasonably high standards of market regulation and supervision, and corporate governance (notwithstanding some major scandals in the 1970s and 1980s) have helped to develop a shareholder/share ownership culture that is one of the most stable outside of the US.

Hong Kong's asset markets are amongst the largest in the world relative to the size of the economy. Household net worth per capita is also probably amongst the highest globally. Hong Kong residential property value is estimated at 372% of GDP (see Exhibit 3).

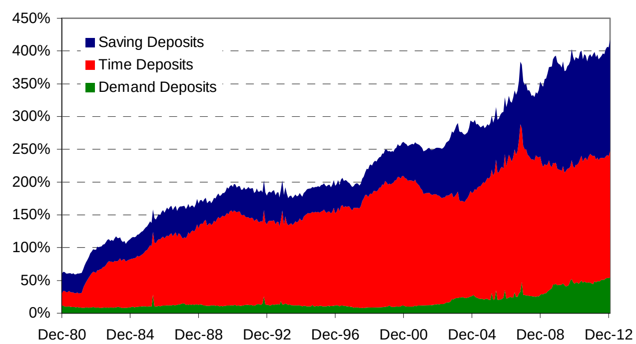
Exhibit 3
Hong Kong – Estimated residential property value to GDP



Source: CEIC, Morgan Stanley Research. Data as of January 2013.

Total Hong Kong bank deposits are 417% of GDP (see Exhibit 4).

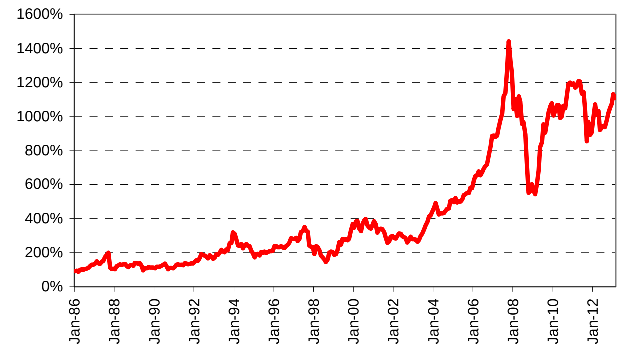
Exhibit 4
Hong Kong – Total deposits to GDP



Source: CEIC, Morgan Stanley Research. Data as of January 2013.

Stock market capitalization is about 1,110% of GDP. This, of course, has been impacted positively by the listing of H shares in recent years.

Exhibit 5
Hong Kong – Stock market capitalization to GDP



Source: CEIC, Morgan Stanley Research. Data as of February 2013.

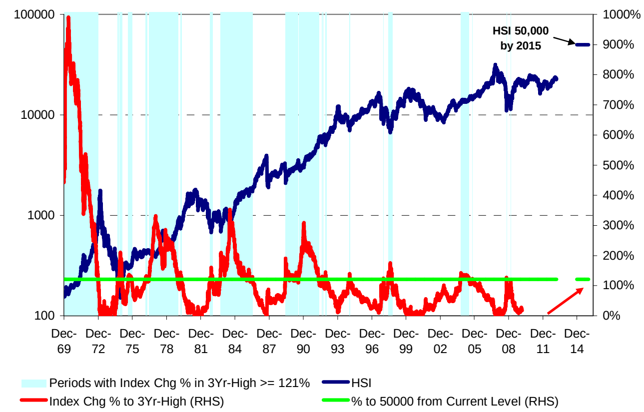
In summary, the total value of financial assets and residential real estate alone subject to jurisdiction in Hong Kong is probably around US$5trn.

Hang Seng 50,000 in 2015 – Historical precedent suggests more likely than might seem at first sight

Hang Seng 50,000 in 2015 would require the index to rise by 121% in a little less than three years from the current level. Although this may seem like a tough task, it has, in fact, been achieved in 32.5% of the total months in the Hang Seng's existence since 1969. Admittedly, as shown in Exhibit 6, this phenomenon was more frequent in the 1970s and 1980s (when global nominal GDP growth rates were higher than today). However, since 1990, cumulative gains of 121% in three years or less have occurred in 16.7% of total months. The most recent occasion when this occurred was March 2009.

Exhibit 6

Historical Precedent (1): Prior occasions when the Hang Seng Index has risen more than 121% within three years

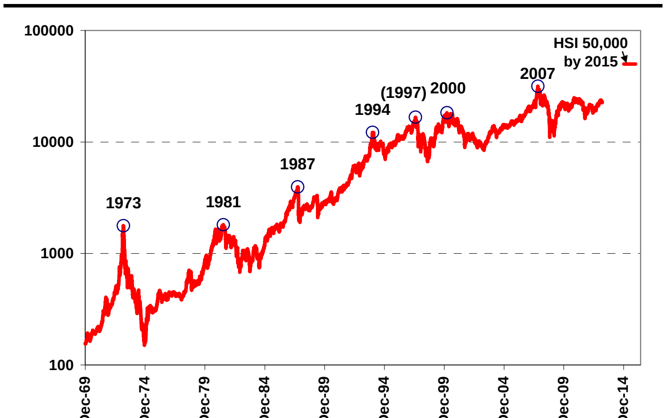


Source: HSI Company, Datastream, Morgan Stanley Research. Data as of March 14, 2013.

It is also noteworthy that peaks in the Hang Seng Index have occurred on average every 6-8 years since its inception – there were peaks in 1973, 1981, 1987, 1994, (1997), 2000 and 2007. We have placed 1997 in brackets in the above list as, with the benefit of hindsight, the 1998 market crash was a temporary interruption in the peak-to-peak move from the 1993/4 euphoria on urban price liberalization in China to the 2000 dotcom peak. Based on this 6-8 year cycle, a new peak would seem likely to form some time between the end of 2013 and the end of 2015.

Exhibit 7

Historical precedent (2): Hang Seng Index peaks since 1970 – 6-8 year peak-to-peak cycle implies next peak in 2013-2015



Source: HSI Company, Datastream, Morgan Stanley Research. Data as of March 14, 2013.

Hang Seng peaks have invariably formed as exponential price moves. The peak-to-peak moves in price in % terms are given in Exhibit 8. The average gain was 90% (median gain was 73%) versus our suggested peak-to-peak gain from the late 2007 peak to Hang Seng 50,000 of 58%. Hence, a Hang Seng 50,000 peak would be well within the range of peak-to-peak returns seen historically.

Exhibit 8

Historical Precedent (3): Hang Seng Index peak-to-peak gain and duration – Hang Seng 50,000 implies a peak-to-peak gain of 58%, well within historical range

Peak Date	Peak Level	Peak to Peak (%)	Peak to Peak (Yrs)
9-Mar-73	1,775	NA	NA
17-Jul-81	1,810	2%	8.4
1-Oct-87	3,950	118%	6.2
4-Jan-94	12,201	209%	6.3
7-Aug-97	*16,673*		
28-Mar-00	18,302	50%	6.2
30-Oct-07	31,638	73%	7.6
Before End 2015	**50,000**	**58%**	**=< 8.2**

Source: HSI Company, Datastream, Morgan Stanley Research. Data as of March 14, 2013.

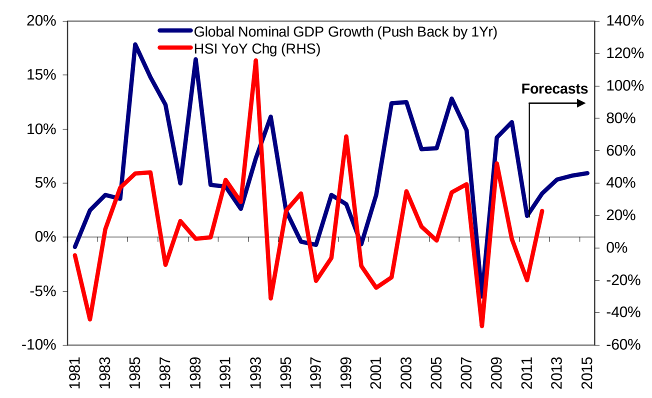
Easy money and china growth drive Hang Seng bull runs

Hang Seng bull runs have generally been triggered by the combination of an easy monetary policy in the developed world and accelerating economic growth globally and in China.

The Morgan Stanley global macro team, led by Joachim Fels, is currently forecasting just such an environment. Exhibit 9 shows the relationship between global growth and Hang Seng Index performance. Morgan Stanley's global economics team is currently forecasting an acceleration in GDP growth from the "twilight zone" rate of 3.2% in 2013 to 3.9% in 2014.

Exhibit 9

Hang Seng index vs economic global growth – positive relationship

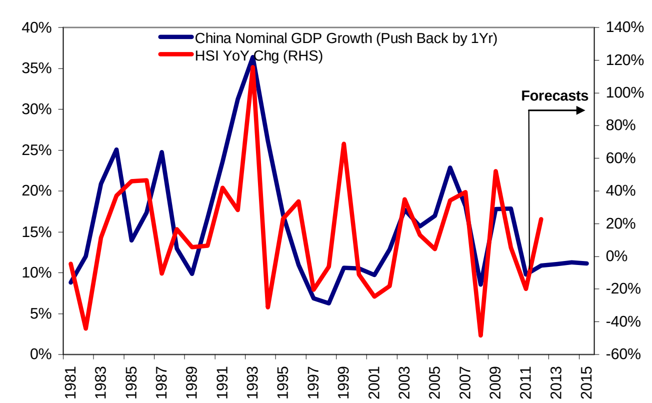


Source: HSI Company, CEIC, IMF, Morgan Stanley Research.

The Hang Seng Index in recent years has also become highly correlated with cycles in China's economy, not least as stocks with direct China sales and earnings drivers have become heavily represented in the market. Overall, we estimate that approximately 62% of Hang Seng Index earnings currently are derived from China. Exhibit 10 shows this positive correlation between the Hang Seng Index and China GDP growth.

Exhibit 10

Hang Seng Index vs China GDP Growth – positive relationship



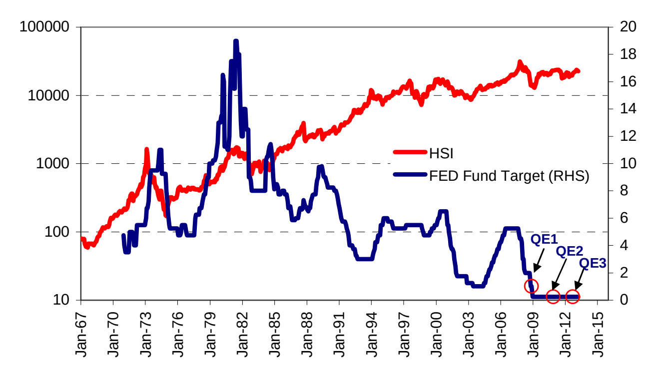
Source: HSI Company, CEIC, IMF, Morgan Stanley Research.

On the monetary policy side, Morgan Stanley's global economics team argues that we are in the third phase of global monetary easing since the 2008/09 crisis. The central players this time are the Federal Reserve in the form of QE3 and the Bank of Japan with its upcoming reflation initiatives under incoming governor, Haruhiko Kuroda.

Easy monetary policy in the US has historically been used to stimulate growth. Its reflationary impact has been amplified in Hong Kong's asset markets by the US dollar peg, which, *inter alia*, has resulted in Hong Kong money market rates closely tracking those in the US, even when domestic economic conditions in Hong Kong can be divergent. Looking at the history of the Hang Seng Index and the Fed Funds Rate (Exhibit 11), there are two interesting findings: firstly, as Exhibit 12 shows, the inverse relationship between the Hang Seng Index 3-year forward % change and the Fed Funds Rate (the correlation since 2000 is -0.63).

Exhibit 11

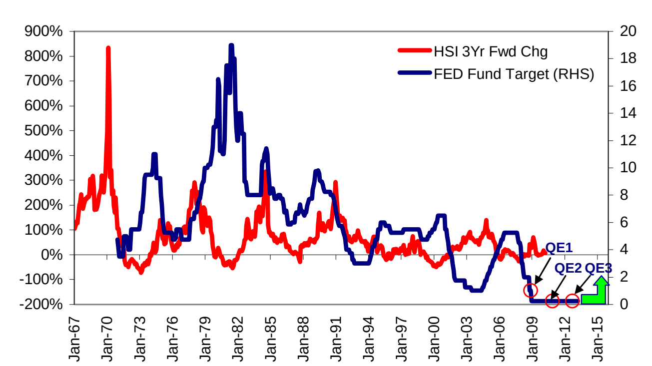
Hang Seng Index vs. Fed Fund Target



Source: HSI Company, Datastream, Morgan Stanley Research. Data as of March 14, 2013.

Exhibit 12

Hang Seng Index 3-yr Forward Return vs. Fed Fund Target – inverse relationship



Source: HSI Company, Datastream, Morgan Stanley Research. Data as of Mar 14, 2013.

Secondly, as Exhibit 13 shows, the time lag between the Fed Funds Rate hitting a floor for the cycle and subsequent peaks in the Hang Seng Index. The average/(median) time lag of its previous cycles is 2.6 (1.7) years. If we assume that the September 2012 announcement of QE3 was the final act in the monetary easing cycle this time (Fed Funds having hit zero in December 2008), then 2.6 years from September 2012 would take us to early 2015 as a target time period for the Hang Seng to peak in this cycle (with the Fed starting to exit its easing later in that year).

Exhibit 13

The time lag between the Fed Funds Rate hitting its floor and Hang Seng Index reaching its peak

Fed Funds Target Trough Date	HSI Peak Date	Duration (Yrs)
Feb-71	Mar-73	2.0
Jan-76	Jul-81	5.5
Aug-86	Oct-87	1.1
Sep-92	Jan-94	1.3
Nov-98	Mar-00	1.3
Jun-03	Oct-07	4.3
Dec-08	???	???

Source: HSI Company, Datastream, Morgan Stanley Research

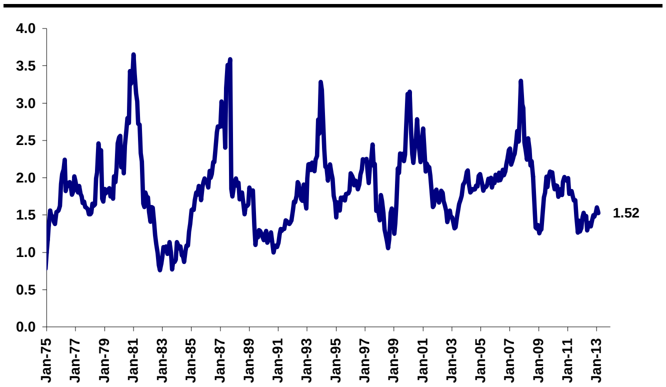
Two out of three valuation backtests support Hang Seng 50,000 bull case Target

We have also undertaken backtests on standard valuation metrics to explore likely returns going forward. The metrics we used are:

1) Trailing price-to-book value ratio

Exhibit 14

Hang Seng Index trailing price-to-book value – 0.6 SD below average



Source: HSI Company, CEIC, MSCI, Morgan Stanley Research, data as of Mar 14, 2013

Exhibit 15

Hang Seng Index historical backtest based on trailing P/B ratio

HKD Price Return Performance if trailing PB <= 1.52x

	12m Fwd Ret	24m Fwd Ret	36m Fwd Ret
count (month)	105	100	100
median	34.0%	68.6%	101.4%
mean	34.5%	71.2%	114.5%

12/24/36M target price based on Mar 14's closing price 22,619

	12m Fwd Ret	24m Fwd Ret	36m Fwd Ret
median	30,306	38,133	45,561
mean	30,424	38,735	48,511

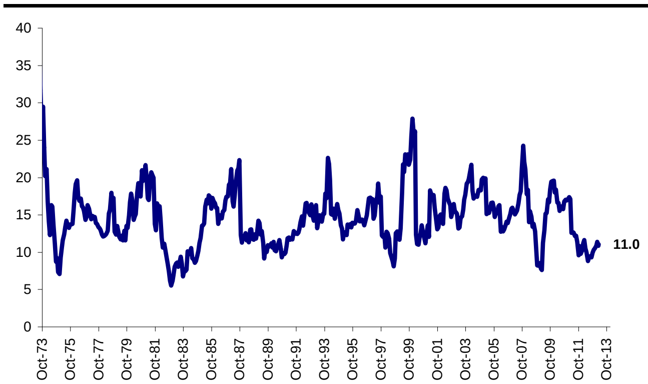
Source: HSI Company, CEIC, Morgan Stanley Research, data as of March 14, 2013

Currently, the Hang Seng Index is trading at 1.52x trailing price-to-book value, which is 0.6 SD below its long-term average level since 1975, or 75th percentile cheapness to its history. Our backtest on this metric suggests around 101% (median) and 115% (mean) upside next 36 months forward price return from the current price-to-book ratio. This is consistent with the required gain of 121% to our suggested level of 50,000.

2) Trailing price-to-earnings ratio

Exhibit 16

Hang Seng Index trailing price-to-earnings – 0.9 SD below average



Source: HSI Company, CEIC, MSCI, Morgan Stanley Research, data as of Mar 14, 2013

Exhibit 17

Hang Seng Index historical backtest based on trailing P/E ratio

HKD Price Return Performance if trailing PE <= 11.0x

	12m Fwd Ret	24m Fwd Ret	36m Fwd Ret
count (month)	69	65	65
median	29.8%	69.3%	111.4%
mean	31.9%	69.6%	118.8%

12/24/36M target price based on Mar 14's closing price 22,619

	12m Fwd Ret	24m Fwd Ret	36m Fwd Ret
median	29,366	38,293	47,822
mean	29,844	38,352	49,500

Source: HSI Company, CEIC, Morgan Stanley Research, data as of March 14, 2013

We also ran a backtest based on Hang Seng's current trailing price-to-earnings of 11.0x (0.9 SD below its long-term average level since 1975, or 83rd percentile cheapness to its history). The backtest result is qualitatively similar to the result on P/B. We see a median return of 111% and mean return of 119% looking 36 months forward, again supporting our suggested level of 50,000.

3) Trailing dividend yield

Exhibit 18

Hang Seng Index trailing dividend yield – around the average level

Source: HSI Company, CEIC, MSCI, Morgan Stanley Research, data as of Mar 14, 2013

Exhibit 19

Hang Seng Index historical backtest based on trailing dividend yield

HKD Price Return Performance if trailing DY >= 3.24%

	12m Fwd Ret	24m Fwd Ret	36m Fwd Ret
count (month)	269	265	265
median	24.9%	54.6%	68.9%
mean	28.9%	60.6%	82.0%

12/24/36M target price based on Mar 14's closing price 22,619

	12m Fwd Ret	24m Fwd Ret	36m Fwd Ret
median	28,263	34,965	38,215
mean	29,163	36,324	41,161

Source: HSI Company, CEIC, Morgan Stanley Research, data as of March 14, 2013

Backtest results on the trailing dividend yield of the Hang Seng are supportive as well, although not as strong as the results from P/B and P/E. Using the current trailing dividend yield of 3.24% (which is around its long-term average level), the backtest suggests a 69% (median) to 82% (mean) price return in next 36 months.

Other factors – mainland QDII policy and Hong Kong property controls

There are two other factors that could also support a Hang Seng 50,000 view.

Firstly, the chairman of the CSRC, Guo Shuqing, recently proposed further expansion of outbound QDII flows from the mainland to Hong Kong. Whilst this is not yet the "through train" proposal of 2007, it represents a step towards further liberalization of China's capital account. We believe that, as this process continues to unfold over the next three years, the Hong Kong equity market will benefit from it.

Exhibit 20
Further liberalization of China's capital account

Date	Events
14-Dec-12	The State Administration of Foreign Exchange (SAFE) would allow foreign sovereign wealth funds, central banks and monetary authorities to have QFII investment quota exceeding U$1bn.
11-Jan-13	The People's Bank of China listed the trail of QDII2 (Qualified Domestic Individual Investor) as one of its major tasks for 2013.
14-Jan-13	CSRC Chairman Guo Shuqing said QFII and RQFII investment asset was about 1.5% to 1.6% of China equity market capitalization and their quotas could be increased by 10 times.
14-Jan-13	CSRC Chairman Guo Shuqing said the regulator would improve the QDII scheme, launch pilot program on QDII2 scheme.
24-Jan-13	The Shanghai Securities News quoted sources as saying that the details for QDII2 might be available in May this year. The new quota might be given to overseas subsidiary of mainland brokers.
30-Jan-13	CSRC Chairman Guo Shuqing announced the initial RQFII quotas to Taiwan would be Rmb100bn, allowing Taiwan investors to participate in the A-share market.
6-Mar-13	CSRC expanded RQFII program to include financial institutions registered in Hong Kong and the Hong Kong units of Chinese banks and insurers. The regular also relax investment restriction of RQFII funds.

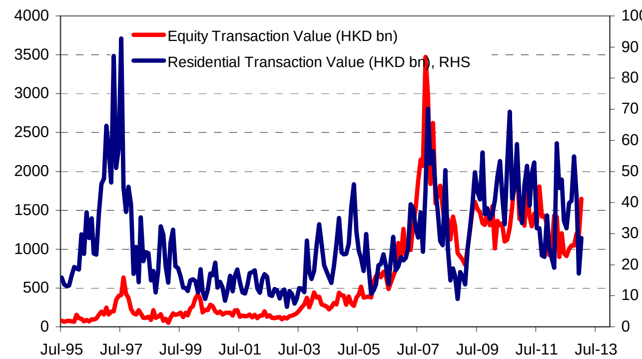
Source: Factiva, Bloomberg, CSRC, SAFE, Morgan Stanley Research

Secondly, government measures to reduce the attractiveness of investment in Hong Kong property have intensified (including rezoning and increased land supply release). In the last few weeks, there have been further increases in stamp duty, as shown in Exhibit 22.

These property controls potentially impact the stock market in two directions. On the negative side, they are likely to slow earnings growth for the listed developers, although Morgan Stanley analyst Praveen Choudhary argues that this effect will be relatively limited (see his report *These Policies Will Help Keep Speculators at Bay*, dated Feb 25, 2013). However, they also have the potential to drive the top-down-driven liquidity inflow process at the margin more towards the stock market – an asset market that the Hong Kong government has rarely, if ever, tried to control during bull phases. (Famously, it did intervene once to support the stock market during a bear phase, in 1997/98, arguing that the HK dollar peg was being threatened by speculative shorting activity).

Indeed, a decline in housing transaction volumes and pick-up in stock market volumes is already becoming visible (see Exhibit 21).

Exhibit 21
Stock market transactions up, property market transactions down



Source: CEIC, HKex, Morgan Stanley Research. Data as of January 2013.

Exhibit 22
Property policy comparison: HK vs SG – most recent property control measures

	Hong Kong	Singapore
Stamp duty - Residential		
Regular	First time local buyers: =<4.25% Others: =<8.5%	Buyers: 3%
Special/Sellers	Special: 20%/15%/10% for property held <6mths/<6-12mths/<1-3yrs	Seller: 16%/12%/8%/4% for property held <1yr/<1-2yr/<2-3yr/<3-4yr
Buyers - Foreigners/Corporates	+15%	+15%
Mortgage		
1st mortgage	LTV: 70%/60%/50% for homes valued <HK$7mn/HK$7-10mn/>HK$10mn	LTV: 80%/ 60% for loans </>30yrs; 20% for institutions
2nd mortgage	LTV: 50%	LTV: 50%/ 30% for loans </>30yrs; 20% for institutions
3rd mortgage	LTV: 50%	LTV: 40%/ 20% for loans </>30yrs; 20% for institutions
Foreigner	20% lower LTV for foreigner	
Max tenor	30 years	35 years
Others	30% max LTV or mortgages based on net worth Max 40% DSR	No comparable measure
Supply		
	Targeting 20,000 unit land sales per annum	Targeting 14,000-16,000 unit land sales per annum

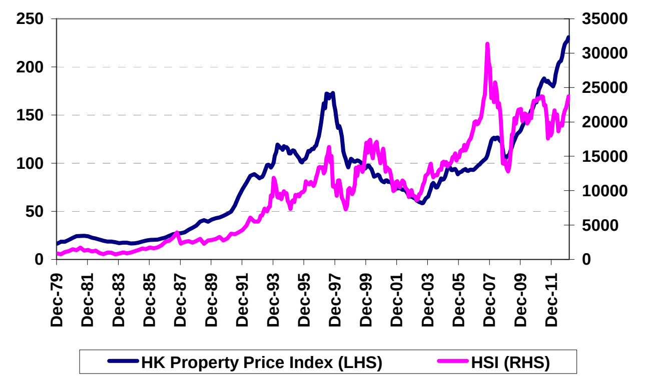
Source: HK/SG gov't sources, Morgan Stanley Research

Exhibit 23 shows the historical time series of the Hong Kong Residential Property Price Index and the Hang Seng Index. Not surprisingly, both the levels and changes in these two series are positively correlated with each other, which is consistent with a feature of Hong Kong – the property market plays an important role in both the real economy and the stock market.

However, Exhibit 24 shows a big divergence between the performance of the Hong Kong property market and the Hang

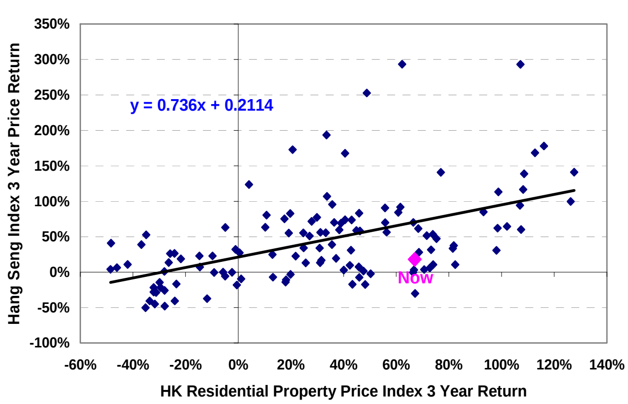
Seng Index recently. The Hong Kong Residential Property Price Index has risen 67% over the past three years, whereas the Hang Seng has recorded a 3-year rolling price return of only 7% (as of March 14, 2013). This divergence is sharply different from their historical relationship. Our Hang Seng 50,000 bull scenario envisages the Hang Seng Index “catching up” with the gains the property market has already made. A bear case scenario would have the property market peaking and then declining, putting downward pressure on the Hang Seng.

Exhibit 23
Hang Seng Index vs. HK Residential Property Price Index



Source: HSI Company, CEIC, Morgan Stanley Research, monthly data as of January 2013.

Exhibit 24
Hang Seng Index vs. HK Residential Property Price Index 3-year rolling return – the Hang Seng has lagged the HK property market thus far

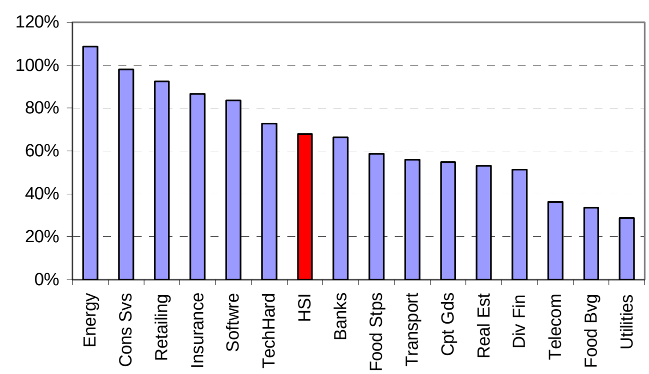


Source: HSI Company, CEIC, Morgan Stanley Research, monthly data as of January 2013.

Morgan Stanley analysts comments on 3-year forward bull case target price suggest Hang Seng reaching 38,794
In order to explore the likelihood of Hang Seng 50,000 by 2015, we asked Morgan Stanley bottom-up coverage analysts to outline bull case valuation assumptions for their stocks over this time frame. The results are given in Exhibits 26-27. In aggregate, the Target Prices given would suggest a bottom-up bull case for the Hang Seng of 38,794. Although this is some 72% above current levels, it is 22% below the 50,000 level.

By sector our analysts see the most upside for Energy, Consumer Services (Gaming) and Retailing. They see the least upside for Utilities, Food Beverage and Telecom.

Exhibit 25
% Upside to MS Bottom-up 2015E Bull Target by Sectors



Source: HSI Company, Morgan Stanley Research

Exhibit 26

Hang Seng Index Components with MS 2015E Bull Case Valuations

Name	Ticker	Index Weight %	MS EPS Currency	MS Bull EPS 2015E	MS Bull PE 2015E	MS Bull Value 2015E	Brief Discussion of Potential Bull Scenario Drivers for 2015E EPS and P/E Assumptions
AIA Group Ltd.	1299-HK	5.7	USD	0.3	25.9	60.0	Assuming a significant market share increase through organic growth and more acquisitions: AIA's key markets grow between 15% and 20% and it raises its market share significantly particularly in Malaysia due to M&A and further expand into other EM countries such as Indonesia, China etc.
Bank of China Ltd.	3988-HK	4.0	CNY	0.6	7.1	5.3	ROE: 2nd stage (2016-2027) - 13.1%, final stage - 11%; no book value impairment.
Bank of Communications Co. Ltd.	3328-HK	0.7	CNY	1.0	6.4	8.1	ROE: 2nd stage (2016-2027) - 12.7%, final stage - 10.7%; no book value impairment.
Bank of East Asia Ltd.	23-HK	0.6	HKD	3.8	14.0	52.5	Assuming ROA moves to around 1% - low probability.
Belle International Holdings Ltd.	1880-HK	1.0	CNY	1.0	21.0	25.3	Our bull case scenario reflects better-than-expected SSSG recovery plus acquisition synergies: 1) We assume top-line growth of CAGR 19%, coming from footwear SSSG of 7-10%, strong than our base case scenario. 2) Favorable product mix: Higher proportion of higher-end products and improvements in new brands GPM as they mature. 3) Net Profit growth of low-twenties between 2012-15, and low-teens between 2016-2020. Our bull value is based on the average HK$22.5 at 23x P/E (at the historical P/E average range of 23x) and HK$ 28 from DCF (5% terminal growth and low-teen EBIT growth in 2016-2020E).
BOC Hong Kong (Holdings) Ltd.	2388-HK	1.4	HKD	3.0	14.0	42.0	Assuming ROA moves to around 1.25% - low probability.
Cathay Pacific Airways Ltd.	293-HK	0.2	HKD	1.5	18.0	27.0	Globalwise macro recovery would bring more premium traveling from corporate accounts and cargo shipping would be also rebounding from current historical low level. The oil price uncertainty and low cost carriers' competition in HK market would give Cathay more pressure on earning back to 2010 high level, we estimates the P/E valuation would hike to 18.0x in 2015.
Cheung Kong (Holdings) Ltd.	1-HK	2.3	HKD	11.2	15.0	168.6	Market share gain and growing recurring income for higher P/E multiples.
China Coal Energy Co. Ltd.	1898-HK	0.4	CNY	0.9	13.1	14.0	Reach 200mt production target in 2015. Coal price back to previous peak.
China Construction Bank Corp.	939-HK	7.4	CNY	1.0	9.0	11.5	ROE: 2nd stage (2016-2027) - 16.9%, final stage - 14.6%; no book value impairment.
China Life Insurance Co. Ltd. (China)	2628-HK	2.4	CNY	1.6	21.6	44.0	Assuming a strong new business growth of 15%-20% in the next three years and ROEV returns 18% level. This should allow the company to re-rate to its historical valuation level of 1.8x EV.
China Merchants Holdings (International)	144-HK	0.5	HKD	2.4	18.0	43.2	Global expansion stratey with several equity acquistions deals since 2010-2013 would bring more growth opportunities in financial and operational perspectively, amid the global macro recovery and international trading activities rebounding. The valuation would definately hike above historical mean at 15.7x to 18.0x 2015E.
China Mobile Ltd.	941-HK	7.0	CNY	6.0	15.0	110.0	We use bull case 2015 EPS and the 15x PE. EBITDA margin declines gradually, from 47.5% in 2011 to 40% at terminal year, 500bp above base case due to stable competition; Capex/sales declines gradually, from 24.3% in 2011 to 12% at terminal year.
China Overseas Land & Investment Ltd.	688-HK	1.3	HKD	3.0	13.5	40.6	Assuming 8% ASP growth per annual from 2013E-2015E & Taget Prem. using +1SD above LT average disc to NAV.
China Petroleum & Chemical Corp.	386-HK	2.4	CNY	1.1	13.9	18.0	Refining maintained at 5% margin, bull cycle chemicals margins, LT oil price US$110/bbl.
China Resources Enterprise Ltd.	291-HK	0.4	HKD	1.7	23.3	40.6	Bull value could be achieved as long as the sales growth momentum continued with some margin expansion from retail business.
China Resources Land Ltd.	1109-HK	0.6	HKD	2.1	22.0	46.2	Assuming 8% ASP growth per annual from 2013E-2015E & Target Prem. using +1SD above LT average disc to NAV.
China Resources Power Holdings Co. Ltd	836-HK	0.6	CNY	1.9	11.5	28.0	Assuming unit fuel cost to decline by 4% in 2013.
China Shenhua Energy Co. Ltd.	1088-HK	1.4	CNY	3.1	14.2	54.3	Asset injection from parentco, coal price back to previous peak.
China Unicom (Hong Kong) Ltd.	762-HK	0.7	CNY	0.9	20.0	22.0	We use bull case 2015 EPS and the 22x PE. Mobile EBITDA margins (on service revenue) to improve gradually, from 31.3% in 2012E to 41% at terminal levels, ~300bp above base case due to increasing scale and stable competition; Mobile capex/sales to decline from 43% in 2012E to 15% at terminal levels; Fixed-line EBITDA margins to decline gradually, from 40% in 2012E to 38% at terminal years, 300bp above base case due to cost control; Fixed-line capex/sales to decline from 54% in 2012E to 18% at terminal years.
CITIC Pacific Ltd.	267-HK	0.2	HKD	2.4	7.2	17.0	Iron Ore price 10% above base case assumptions, steel price 5% above base case assumptions.
CLP Holdings Ltd.	2-HK	1.7	HKD	5.6	13.0	73.0	Assuming a 5-10% dividend growth and dividend yield remains low.
CNOOC Ltd.	883-HK	3.6	CNY	2.3	12.6	35.0	Assuming company hit high end of 6-10% CAGR by 2015. full contribution from Nexen, LT oil price US$110/bbl.
Cosco Pacific Ltd.	1199-HK	0.3	USD	0.2	16.5	23.3	As global macro recovery with active trading growth, Cosco Pacific's terminals in Europe and China would bring more profits/growth in 2015, and P/E valuation would rebound above historical mean at 15.0x to 16.5x in 2015E.
Esprit Holdings Ltd.	330-HK	0.3	HKD	1.2	25.1	31.2	Succesful re-branding measures results in faster sales recovery and margin improvement.

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Exhibit 27

Hang Seng Index Components with MS 2015E Bull Target Case Valuations (cont'd)

Name	Ticker	Index Weight %	MS EPS Currency	MS Bull EPS 2015E	MS Bull PE 2015E	MS Bull Value 2015E	Brief Discussion of Potential Bull Scenario Drivers for 2015E EPS and P/E Assumptions
Hang Lung Properties Ltd.	101-HK	0.9	HKD	1.5	25.0	38.2	Increase in ROI of new China investment properties, strong China retail sales growth.
Hang Seng Bank Ltd.	11-HK	1.4	HKD	11.0	15.0	165.0	Assuming ROA moves to around 1.5%, low probability.
Henderson Land Development Co. Ltd.	12-HK	0.7	HKD	3.7	20.0	74.3	Continuous low cost land banking strategy and more farmland conversion in HK.
Hong Kong & China Gas Co. Ltd.	3-HK	1.6	HKD	1.2	31.0	35.7	31x PE is the historical average PE + 1 standard deviation. Estimate HKCG can maintain organic growth of 20% YoY until 2015 with successful deployment of its new energy business.
Hong Kong Exchanges & Clearing Ltd.	388-HK	2.1	HKD	6.0	35.0	210.0	Assuming ADV at ~ 100 bn.
HSBC Holdings PLC	5-HK	14.8	HKD	13.0	11.0	142.0	All round improvement in loan growth, NIM's and credit costs.
Hutchison Whampoa Ltd.	13-HK	2.5	HKD	7.1	18.5	131.5	Global GDP growth of 3-4% p.a.
Industrial & Commercial Bank of China Lt	1398-HK	5.6	CNY	0.9	9.0	10.2	ROE: 2nd stage (2016-2027) - 17.3%, final stage - 14.7%; no book value impairment.
Kunlun Energy Co. Ltd.	135-HK	0.7	HKD	1.2	20.0	24.0	Assuming high end of historical PE of 20x and ~20% EPS growth in 2013-15.
Lenovo Group	992-HK	0.7	USD	0.1	16.0	14.5	Assuming Lenovo's net profit to grow at a CAGR of 25% from F2013-2016e on the back of 1) intact market share gains in overall PC market along with stronger PC end demand; and 2) Better-than-expected sales growth and margin expansion in smartphone business.
Li & Fung Ltd.	494-HK	0.9	USD	0.1	18.0	20.6	Strong cross-selling between business platforms results in strong organic growth. Margin recovery in the LF USA distribution business after the restructuring efforts. More earning-accretive acquisitions.
MTR Corp. Ltd.	66-HK	0.7	HKD	2.0	20.6	42.1	EPS growth of 5-6% p.a.
PetroChina Co. Ltd.	857-HK	3.2	CNY	1.5	12.1	23.0	New gas price formula fully implemented, LT oil price US$110/bbl.
Ping An Insurance (Group) Co. of China	2318-HK	1.8	CNY	6.2	18.8	143.0	In our bull case, we assume a rapid new business recovery in the next three years of 25% and 23% ROEV of the life business. This should allow the company to re-rate to its historical valuation level of 2.0x Group EV.
Power Assets Holdings Ltd.	6-HK	1.4	HKD	5.9	15.0	86.0	Organic growth of 10-15% per annum plus dividend yield remains low.
Sands China Ltd.	1928-HK	1.2	USD	0.4	22.0	71.3	15% p.a. growth in Macau gaming revenue.
Sun Hung Kai Properties Ltd.	16-HK	2.3	HKD	9.2	20.0	184.3	Overhang of the litigation removed with growing contribution from property sales/leasing.
Swire Pacific Ltd.	19-HK	0.9	HKD	8.4	14.5	122.5	Cathay share price up 20% and property rental income up 20% over 2013-15.
Tencent Holdings Ltd.	700-HK	4.3	CNY	13.3	31.0	517.0	Better-than-expected sales growth: We assume Tencent's IVAS sales 10-year CAGR to be mid-20%, MVAS sales 10-year CAGR to be mid-10%, and online advertising sales 10-year CAGR to be high-20%.
Tingyi (Cayman Islands) Holding Corp.	322-HK	0.6	USD	0.2	26.6	34.7	Probability is not high given the business adjustment may take time in so 2015 may be just a start for new growth phase.
Want Want China Holdings Ltd.	151-HK	1.2	USD	0.1	23.4	13.6	Our bull value could be reached as long as new products can ride on the momentum and distribution channel can be better managed.
Wharf (Holdings) Ltd.	4-HK	1.4	HKD	5.1	20.0	102.7	Continuous expansion in China and strong HK retail sales growth.
Hang Seng Index				**2,798**	**13.9**	**38,794**	

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Source: HSI Company, Morgan Stanley Research

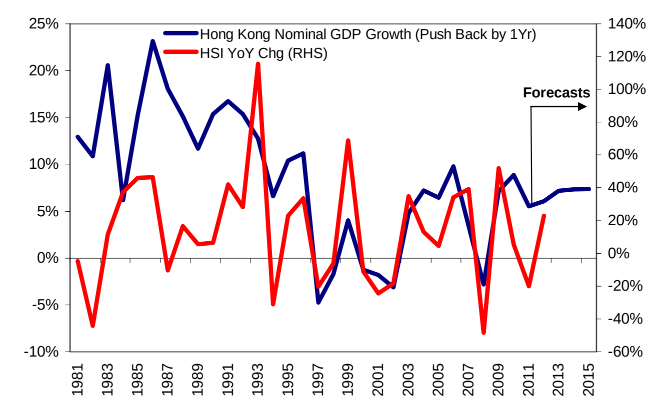
Counter-arguments to Our Bull Scenario

Clearly, our view is a bull tail risk. There are a number of challenges to the Hang Seng's achieving 50,000 in three years' time. We have already discussed Hong Kong's property market controls. An early exit from monetary accommodation in the US would also challenge further Hang Seng gains (as it did, for example, in 1994).

The most obvious other counter-argument to our bull scenario is that both Hong Kong and China's growth rates are slower than in the past. Exhibit 28 shows that Hong Kong's nominal GDP growth rate now typically runs at mid- to high single digits, rather than mid- to high teens as it did in the 1980s or earlier. This has clear implications for slower earnings growth of the Hang Seng Index constituents and, hence, the market's performance.

Exhibit 28

Hang Seng Index vs Hong Kong GDP growth – positive relationship



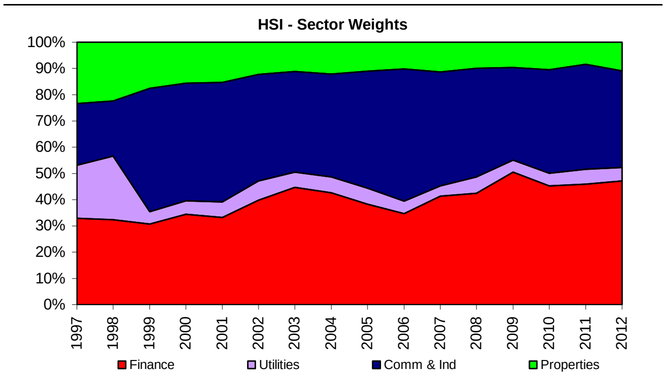
Source: HSI Company, CEIC, IMF, Morgan Stanley Research

Moreover, by the law of large numbers, it becomes harder for Hang Seng Index constituents with large market capitalization, such as HSBC and Cheung Kong, to continue delivering the compound returns that they achieved in the past when they were smaller relative to the opportunity sets in the industries in which they operate. Another key feature of Hong Kong is the relatively low level of M&A / private equity transactions compared with those in other mature markets, such as the US. Also, the level of M&A activity in Hong Kong has been relatively low in the past 10 years, with the total deal size at an average of 2% of total market capitalization per annum during the period.

Another key risk to our view would be if the sector composition of the Hang Seng index changed over time to become more defensive in nature. In fact, since 1997, the sector skew of the Hang Seng Index has remained reasonably stable. If anything, the defensive weighting has fallen over time with the declining weighting of Utilities. Since 1997, there have been two major bull market peaks, in 2000 and 2007.

Exhibit 29

Hang Seng sector composition has remained stable since 1999

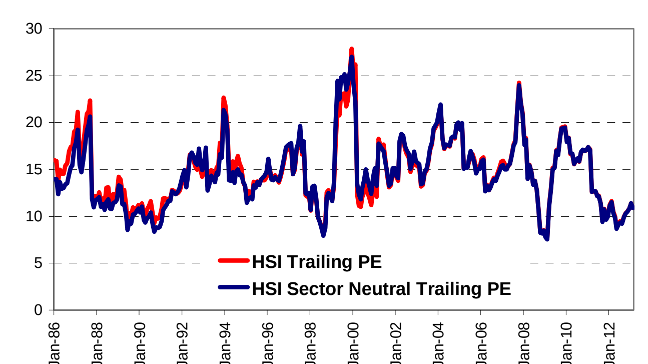


Source: HSI Company, Bloomberg, Morgan Stanley Research

To explore this, we generated the time-series of aggregated sector-neutral P/E of the Hang Seng Index by applying the latest sector weight of the index to the historical P/E of each Hang Seng Index sector. Exhibits 30 and 31 demonstrate that there is not a great difference between the current Hang Seng Index trailing P/E and our calculation of a sector neutral P/E through time.

Exhibit 30

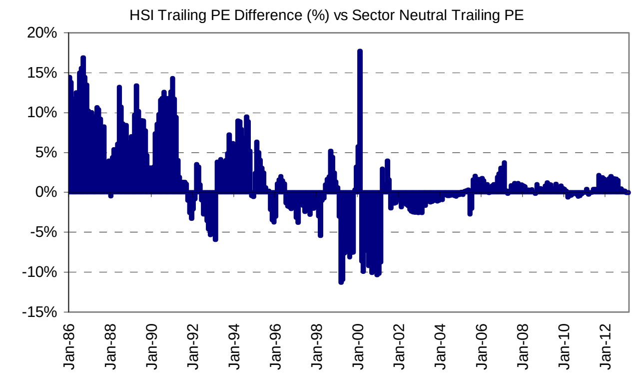
HSI Trailing P/E is close to HSI Sector Neutral Trailing P/E



Source: HSI Company, CEIC, Morgan Stanley Research. Data as of February 2013.

Exhibit 31

Difference between Hang Seng trailing P/E and sector-neutral trailing P/E was not significant in the past ten years



Source: HSI Company, CEIC, Morgan Stanley Research. Data as of February 2013.

Conclusion – Hang Seng 50,000 is a credible bull scenario over three years

In conclusion, from a top-down perspective, we think there is a credible bull scenario that has the Hang Seng Index achieving the 50,000 level (121% gain from current levels) before the end of calendar year 2015. The four reasons we think this is a scenario worth exploring are: a) a top-down environment of ultra-easy monetary policy in the developed world and reacceleration of Chinese growth; b) the historical precedent for a bull run in excess of 100% in three years; c) our valuation backtests; and d) recent initiatives from China's government in relation to QDII and the Hong Kong government in relation to property price controls. Morgan Stanley's bottom-up analysts' bull case scenarios for 2015E EPS and P/E for the Hang Seng on a stock-by-stock basis suggests a Hang Seng level of around 38,800 as a bottom-up bull case 2015 target.

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Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Equal-weight/Hold	**1242**	**44%**	**477**	**47%**	**38%**
Not-Rated/Hold	**104**	**4%**	**26**	**3%**	**25%**
Underweight/Sell	**474**	**17%**	**114**	**11%**	**24%**
Total	**2,845**		**1011**		

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