SEPTEMBER 2022

Hong Kong/China Equity Perspectives

A Late Summer Night's Dream

Summary

It was a dramatic summer. Agitating, perplexing, thrilling and suspenseful scenes tangled together that drained the brainpower of sensible investors. The play opened with the eruption of stalled housing projects and mortgage boycotts in July 2022. Then, Nancy Pelosi's visit to Taiwan on 2 August brought tension to a climax. Soon afterwards, the market was surprised by the PBoC[1] which pushed on the interest rate string to stimulate credit. On the other hand, the China-US agreement on the audit of ADRs[2], the Chinese government's full guarantee on the bonds of private property developers and a forthcoming property bailout fund offered rays of hope. However, COVID lockdowns have come back to Shenzhen and Chengdu like a boomerang.

Now, attention will probably be drawn towards the 20th National Congress of the Chinese Communist Party, which has just been put on a definite date tag "16 October 2022" instead of "coming soon", with the market zeroing in on the key senior appointments. For the time being, we think China is not short of high-level stimulus plans, but their implementation at the local level has fallen behind. In our view, positive surprises may spring from actual policy implementation by local governments.

1. PBoC: *People's Bank of China*
2. ADRs: American depository receipts
3. PCAOB: Public Company Accounting Oversight Board
4. CSRC: China Securities Regulatory Commission
5. NEV: New energy vehicle

Notable developments in selected sectors

- China ADR Delisting: The US PCAOB[3] and CSRC[4] signed a Statement of Protocol to establish a framework for the inspection of audit records of China ADRs. This is the first time that US and China regulators have reached a common ground on the disputes that could lead to delisting of all China ADRs.
- China NEV[5]: There has been a notable reshuffling of the ranking of China NEV brands in the unit sales league table, suggesting a change in consumer preference.
- Chinese Consumers: While the overall picture may not be rosy, retail sales of certain consumer goods actually rose. Three categories – tobacco & alcoholic beverage, sports & recreation, household appliances & audio-visual equipment – are showing green shoots.
- China Oil & Gas: All of the China oil & gas majors have reported decent earnings growth in 1H 2022. We continue to like China oil & gas majors for their lucrative dividend yields.
- Hong Kong Property: Overall, we are cautious on Hong Kong property companies. In terms of sub-sector preference, we favour landlords over property developers.

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A Late Summer Night's Dream

It was a dramatic summer. Agitating, perplexing, thrilling and suspenseful scenes tangled together that drained the brainpower of sensible investors. The play opened with the eruption of stalled housing projects and mortgage boycotts in July 2022. Then, Nancy Pelosi's visit to Taiwan on 2 August brought tension to a climax. Soon afterwards, the market was surprised by the PBoC which pushed on the interest rate string to stimulate credit. On the other hand, the China-US agreement on the audit of ADRs, the Chinese government's full guarantee on the bonds of private property developers and a forthcoming property bailout fund offered rays of hope. However, COVID lockdowns have come back to Shenzhen and Chengdu like a boomerang. Now market attention will probably be drawn towards the 20th National Congress of the Chinese Communist Party, which has just been put on a definite date tag "16 October 2022" instead of "coming soon".

China-US rivalry has continued to evolve. We think the latest long-term game-changing events are the passage of the CHIPS Act and new export bans on some advanced chips and chip design software to China. The CHIPS Act (Creating Helpful Incentives to Produce Semiconductors Act of 2022) provides over USD50 billion for American semiconductor research, development, manufacturing, and workforce development. The White House said explicitly that the Act will "counter China". The Department of Commerce also banned exports of electronic computer-aided design (ECAD) software and high-end artificial intelligence chips to China. Despite China-US tensions, there is still a possibility of President Xi and President Biden meeting in person for the first time at the G20 Summit in Bali in November 2022.

On 14 August 2022, PBoC unexpectedly trimmed the 1-year medium-term lending facility (MLF) rate and 7-day reverse repo rate by 10 basis points (bps), in order to "keep the liquidity in the banking system adequate at a reasonable level". A week later, on 22 August, PBoC lowered the loan prime rates (LPR). Although the LPR cut was expected by the market following the MLF cut, the flattening of the LPR yield curve was not. The 1-year LPR fell 5bps to 3.65%, while 5-year LPR fell 15bps to 4.30%. This was also the first time for the 1-year LPR to fall less than the 1-year MLF rate. PBoC also said that major financial institutions, especially state-owned banks, should ensure reasonable financing needs of the property sector.

There were soothing news in August 2022 as well. China and US regulators finally reached an agreement on the ADR delisting issue. A Hong Kong-listed private Chinese property developer successfully issued RMB1.5 billion of bonds at 3.3% yield with full guarantee from a state-owned bond insurance company. China Central Television (CCTV) reported that the Ministry of Housing and Urban-Rural Development, the Ministry of Finance and PBoC will introduce joint policies to secure funding for stalled housing projects. And according to local news media Caixin, the policy banks of China will set up a property bailout fund with an initial size of RMB200 billion. Although the initial size of the fund may not be sufficient, we believe its establishment is a meaningful first step towards resolving home delivery uncertainty and mortgage boycott issues.

The Chinese Communist Party have finally fixed the date of its 20th National Congress, which will be held in Beijing on 16 October 2022, with the market zeroing in on the key senior appointments. For the time being, we think China is not short of high-level stimulus plans, but their implementation at the local level has fallen behind. In our view, positive surprises may spring from actual policy implementation by local governments. The man shall have his mare again, and all shall be well.

Notable developments in selected sectors

1) China ADR Delisting

On 26 August 2022, the US PCAOB and CSRC signed a Statement of Protocol to establish a framework for the inspection of audit records of China ADRs. This is the first time that US and China regulators have reached a common ground on the disputes that could lead to the delisting of all China ADRs within three years.

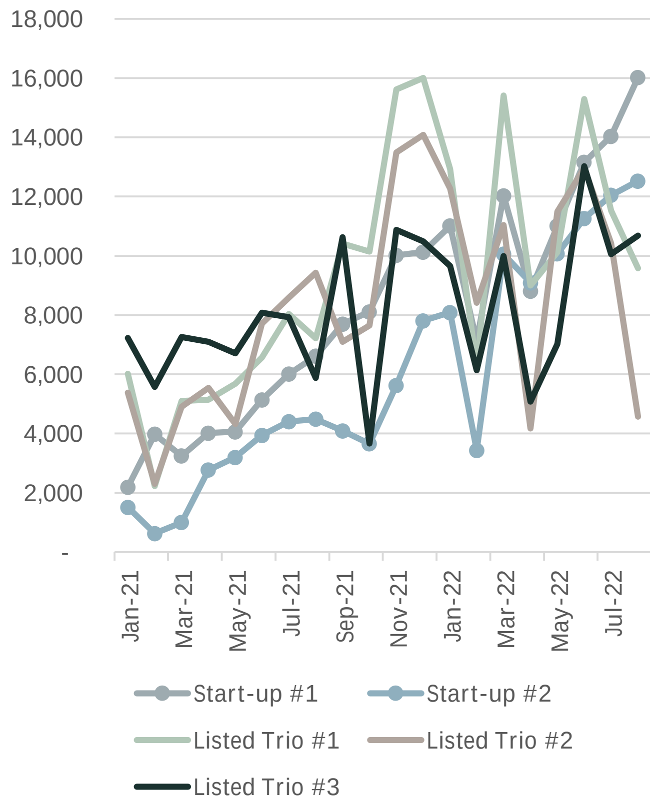
Notwithstanding the reconciliation, there are notable differences in the wording used by the two sides. For example, PCAOB said it has *full discretion* to select any ADR's audit for inspection, but CSRC stressed the inspections must be carried out with the *participation of and assistance from* China's regulators. Gary Gensler, chairman of the US Securities and Exchange Commission, described the agreement as "merely a step in the process". We believe the market is well aware of the differences, and perhaps still skeptical about the practicability of the framework. We also hold the view that more progress is needed to remove the delisting risk that has haunted China ADRs for over twenty months. Nonetheless, share prices of China ADRs reacted positively to the news on 26 August, and we expect more positivity when the US and China close their differences.

2) China NEV

There has been a notable reshuffling of the ranking of China NEV brands in the unit sales league table for the last two months, which we believe is suggesting a change in consumer preference for NEVs in China. The industry leader remains unchallenged by its colossal production volume of over 150,000 units, which is more than double of the next 5 China NEV pure-plays combined. In fact, the China NEV leader also topped the global NEV chart in terms of battery electric vehicle and plug-in hybrid electric vehicle unit sales in the first six months of 2022, seizing 15% of global market share with over 640,000 electric vehicles sold.

The first and second runner-up positions were taken by two privately-owned start-ups (see Chart 1), both of which have been regarded as second-tier NEV brands that target the entry-level price segment (<RMB150,000). On the other hand, the US- and Hong Kong-listed China NEV trio had bumpy rides and struggled to grow sales so far in 2022. All of them scaled back production in April and May 2022 due to an industry-wide shortage of auto chips, worsened by the Shanghai lockdowns. In addition, each of the NEV trio has encountered operational issues: retooling assembly lines for several new models and model upgrades; overcapacity after a very aggressive ramp-up of production capacity; new car model catching media attention after accidents during test drives. Monthly unit sales of the trio managed to increase on a year-on-year (YoY) basis in July 2022, but were down sequentially, on a month-on-month (MoM) basis.

CHART 1. MONTHLY UNIT SALES OF CHINA NEV PURE-PLAY BRANDS



Source: Companies, as of 2 September 2022

Two of the NEV trio had stepped up their promotional discounts in late-July/early-August 2022, but seemingly failed to turbocharge sales growth. These two companies released lower-than-expected delivery guidance for Q3 2022 that hinted further decreases in monthly deliveries in August and, likely, in September.

Meanwhile, investors were spooked by a preeminent US investment holding company's decision to take profit on its investment in the China NEV leader. Although fundamentally we remain constructive on the China NEV sector in view of strong structural demand and concrete policy support from the Chinese government, we believe the market needs some time to digest the divestments. Hence, it is NOT yet the ideal time to go bottom-fishing.

3) Chinese Consumers

The number of new COVID cases in China has been kept under control. That said, different cities are still combating new COVID variants, while consumer sentiment has been dampened by a slowing economy. According to the National Bureau of Statistics, retail sales growth rate moderated from 3.1% YoY in June 2022 to 2.7% YoY in July. While the overall picture may not be rosy, retail sales of certain consumer goods actually rose. Three categories – tobacco & alcoholic beverage, sports & recreation, household appliances & audio-visual equipment – were showing green shoots (see Chart 2). We see investment opportunities in these segments in 2H 2022.

Chinese liquor and beer

Retail sales growth rate of tobacco & alcoholic beverage accelerated from 3.8% YoY in May 2022 to 5.1% YoY in June, and further to 7.7% YoY in July. The sales decline in the catering industry also narrowed from a doomy -21.1% YoY in May to -4% YoY in June and -1.5% in July, mainly driven by relaxed social distancing in major cities. Although potential resurgence of the pandemic remains a near-term threat, we believe new vaccines and a higher inoculation rate will help China mitigate COVID transmission.

The Chinese liquor sector has been one of our favourites because of distillers' excellent track record of passing soaring costs to consumers through price hikes. We believe the ultra-premium Chinese liquor brands have deep economic moat and highly visible growth potential beyond COVID recovery. It is a consumer staple segment that can leverage long-term wealth growth.

Meanwhile, Chinese beer makers reported better-than-expected 1H 2022 results with consumption recovery getting back on track in Asia. Even though rising raw material and packaging costs remained near-term challenges to the companies, we believe the premiumisation trend (i.e. sales mix shifting from budget brands to premium brands) could bolster share prices in 2H 2022.

Looking forward, key near-term share price catalysts for the brewery sector include: 1) recovery of on-premise consumption amid easing COVID restrictions, 2) potential sales tailwinds due to the most severe heatwave on record in China, and 3) quadrennial demand related to the 2022 FIFA World Cup, which is scheduled to kick-off in November.

CHART 2. CHINA RETAIL SALES GROWTH OF SELECTED CATEGORIES

Source: National Bureau of Statistics, as of 15 August 2022

Chinese sportswear

Sales of sportswear has recovered quickly since June 2022 as logistic challenges have faded. Retail sales growth of sports & recreation goods rebounded from -12.7% YoY in April to -0.9% YoY in May, 9.7% YoY in June and 10.1% YoY in July.

The leading domestic sportswear brands have released encouraging 1H 2022 results and 2H 2022 guidance. We are allured by their success in winning market share from foreign brands and maintaining sales growth momentum in July and August. Furthermore, the recent pullback of cotton prices should ease the gross margin pressure on the sportswear makers.

Household appliances

In fact, we were surprised by the strong sales in household appliances & audio-visual equipment that climbed 3.2% YoY in June 2022 and 7.1% YoY in July. The property sector debacle starting in late 2020 resulted in declining housing constructions since 2021, which in turn had knocked sales of household appliances to depressed levels. We expect the long-waited launch of a nationwide household appliance subsidy program, which has been discussed by several government departments for a few months, could provoke notable sales growth for household appliances manufacturers.

4) China Oil & Gas

All of the China oil & gas majors have reported decent earnings growth in 1H 2022, mainly driven by higher exploration and production profits and inventory gains. In 2H 2022, we believe widening refinery margin and sales volume recovery in the midstream and downstream businesses will pick up the baton to drive earnings growth.

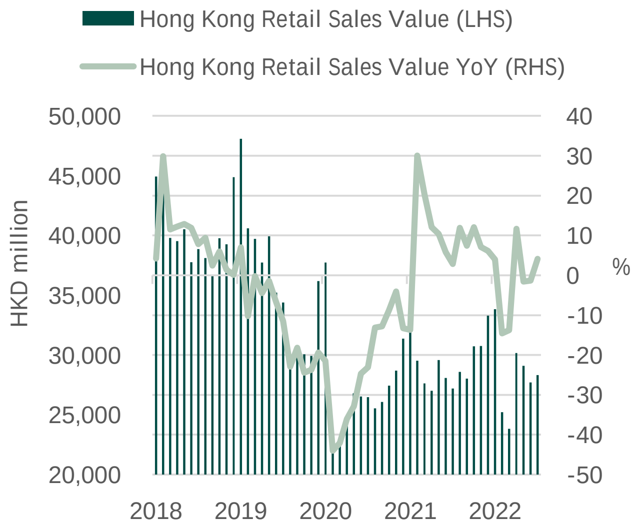
In our August 2022 issue, we mentioned above-the-norm gross profit and double-digit yields of China oil & gas stocks. We continue to like China oil & gas majors for their lucrative dividend yields, which may provide downside protection for investors in a whipsaw market.

5) Hong Kong Property

Overall, we are cautious on Hong Kong property companies. Despite their strong financial discipline and solid balance sheets, the accelerated interest rate hikes in Hong Kong may dent their share prices.

In terms of sub-sector preference, we favour landlords over property developers. The relaxation of social distancing measures and rollout of the second batch of consumption vouchers are spurring a retail sales recovery in 2H 2022, which would in turn underpin a recovery in turnover rent. According to the Hong Kong Census and Statistics Department, total retail sales jumped from -4.1% YoY in June 2022 to 4.1% YoY in July. However, we do not expect the fixed portion of retail and office rent to rebound meaningfully in 2H 2022, given the low visibility on the timing of Hong Kong-China border reopening, and that total retail sales is still roughly 30% below 2018 levels (see Chart 3). Nonetheless, the growing chance of eventual reopening to international visitors, which we believe could happen in 2023, is a tailwind to the valuations of landlords.

CHART 3. HONG KONG RETAIL SALES

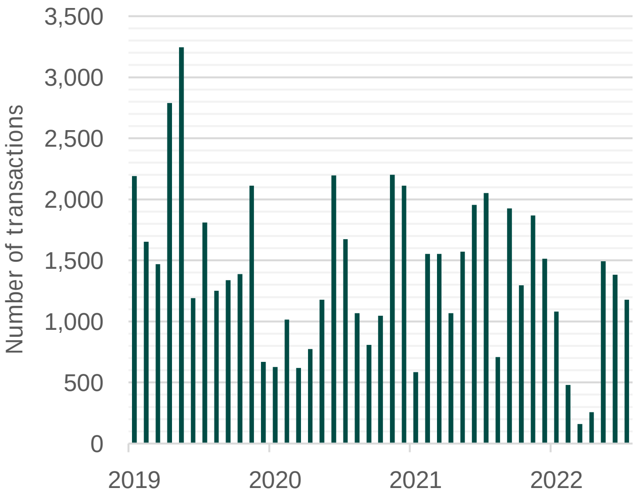


Source: Hong Kong Consensus and Statistics Department, Bloomberg, as of 31 August 2022

Meanwhile, we are cautious on the share price developments of Hong Kong property developers. Primary market residential property sales is clearly in a downward trend (see Chart 4). Pent-up demand related to strict COVID measures in March-April 2022 have been digested quickly, and the number of units sold fell sequentially from 1,492 in

May to 1,382 in June and then 1,177 in July. The slowed property sales is putting pressure on the gearing of some property developers, which in turn increases the chance of a downward revaluation of development properties. As interest rates have started to rise in Hong Kong (two leading banks have already raised their mortgage rate caps in August), we believe the macro headwinds are intensifying.

CHART 4. HONG KONG PRIMARY MARKET RESIDENTIAL PROPERTY SALES



Source: The Land Registry of Hong Kong, as of 31 August 2022

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