APRIL & MAY 2023

Hong Kong/China Equity Perspectives

Reopening, Reform and Recuperation

Summary

China's economic recovery since reopening has been unequivocally uneven. However, the big picture is no doubt favourable to China's equity market. The government has pledged to remain steadfast in deepening reform and opening-up. The country's economy and banking system have been largely insulated from the recent banking stress in the US and Europe, while its surprisingly low inflation should leave policymakers plenty of leeway to launch demand-side stimulus in the coming months.

In hindsight, the concerns that the rapid lift of COVID curbs would be inflationary is evidently overblown. Pent-up consumer demand seems to have been fully digested by increased supply via the normalisation of manufacturing capacity utilisation.

The 2023 Two Sessions, while light on short-term stimulus, centered around government reorganisation. The pragmatic GDP[1] growth target of 5% for 2023, which is PRC's[2] lowest target ever, has ignited worries that the government is reluctant to wire up the economy. However, we would argue that at a 5% growth rate, the incremental GDP in 2023 would amount to RMB6.1 trillion – the same size as 2022.

Chinese banks have limited exposure to regional banks in the US and Europe, thanks to its enclosed financial system. Moreover, Chinese policymakers' campaigns against financial risks have improved the health of the country's banking sector over the past few years. We believe China's banking system has a strong balance sheet to adsorb potential solvency shocks.

1. Gross domestic product; 2. *People's* Republic of China; 3. Initial public offering; 4. Loan prime rate; 5. Net interest margin; 6. New energy vehicle

Notable developments in selected sectors

- **China Internet:** The game-changing moment for the sector might have arrived, as e-commerce platforms unveiled potential spin-offs out of the blue.
- **China Financial Services:** Capital market reforms have shifted to a higher gear. The number of IPOs[3] in Shanghai and Shenzhen could increase by multiple folds with the introduction of registration-based IPO.
- **China Banking & Insurance:** We are seeing signs of life in the insurance industry. Meanwhile, large banks expect residual impact of LPR[4] cuts and early repayment of mortgages to weigh on NIM[5] in 2023.
- **China Telecommunication:** We believe telecom networks will play a key role in China's new digitalisation plan by providing all-in-one platforms for the digital economy.
- **China Automobile**: We reiterate our view that NEV[6] penetration rate will continue to increase but price competition is likely to drain profit margin in the near term.
- **Hong Kong Property**: Major property developers should be able to tap into their large contracted sales to deliver normalised earnings in 2023.

Chris ZEE

Head of Equity Advisory, Asia
BNP Paribas

Darren LEE

Investment Adviser
Equity Advisory Asia
BNP Paribas

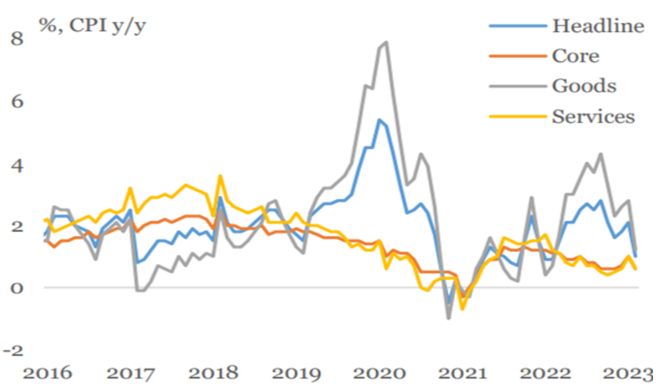
Reopening, Reform and Recuperation

China's economic recovery since reopening has been unequivocally uneven. We saw decent domestic spending especially during the Chinese New Year holidays, while the sales of durable goods remained weak. There were green shoots in property sales, but the rebound was off a very low base. The shrinkage in exports was severer than expected, but the total export value still sat on a very high base. However, the big picture is no doubt trending favourably for China's equity market. The government has pledged to remain steadfast in deepening reform and opening-up (source). The country's economy and banking system have been largely insulated from the recent banking stress in the US and Europe, while its surprisingly low inflation should leave policymakers plenty of leeway to launch demand-side stimulus in the coming months.

Low Inflation Despite Reopening

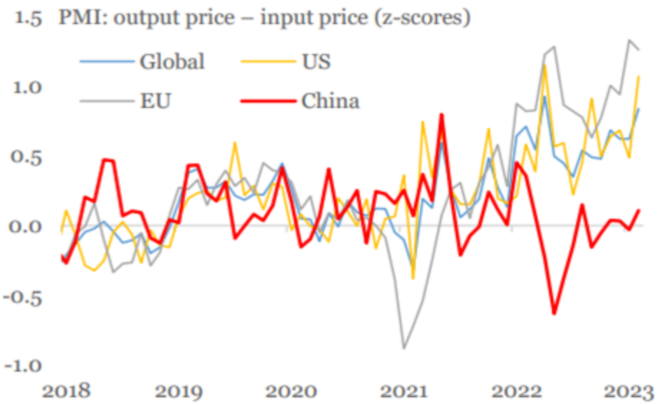
Despite reopening, consumer price inflation was relatively muted year to date (see Chart 1). In hindsight, the concerns that the rapid lift of COVID curbs would be inflationary is evidently overblown. Pent-up consumer demand seems to have been fully digested by increased supply via the normalisation of manufacturing capacity utilisation. As a result, the input-output price gap stayed near zero in China (see Chart 2). This indicates that manufacturers have limited power to raise prices, whilst the year-on-year (YoY) decrease in energy prices could be deflationary if lower input costs are passed on to consumers.

CHART 1. CHINA CONSUMER PRICE INDEX (CPI) GROWTH



Source: Haver, IIF, as of 3 April 2023

CHART 2. EXCESS PRODUCTION CAPACITY KEEPS EX-FACTORY PRICES IN CHECK



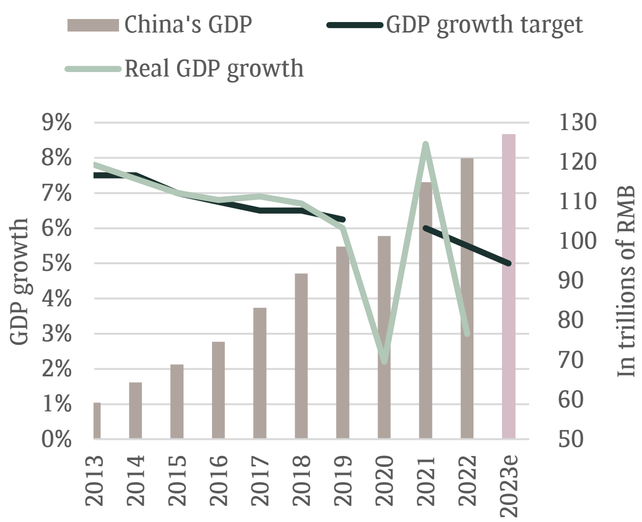
Source: Haver, IIF, as of 3 April 2023

Government and Capital Market Reforms

The 2023 Two Sessions, while light on short-term stimulus, centered around government reorganisation. One of the major changes was the reshuffling of responsibilities among financial regulators. We think the new regulatory framework will streamline accountabilities and allow more effective governance of financial institutions. This also goes hand in hand with the recent capital market liberalisation, such as the A-shares IPO reform, Stock Connect expansion and new overseas listing rules.

The pragmatic GDP growth target of 5% for 2023, which is PRC's lowest target ever (see Chart 3),

CHART 3. CHINA GDP GROWTH

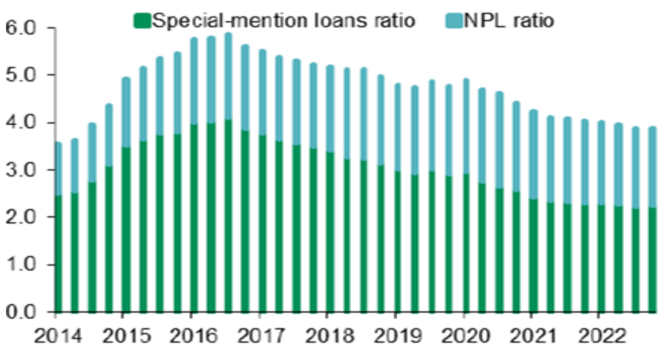


Source: Bloomberg, BNPP WM as of 6 April 2023 has ignited worries that the government is reluctant to wire up the economy. However, we would argue that at a 5% growth rate, the incremental GDP in 2023 would amount to RMB6.1 trillion (circa USD0.9 trillion) – the same size as 2022. As a reference, China's incremental GDP target is equal to 3.4% of US GDP in 2022.

Insulated from Western Banking System Risks

Chinese banks have limited exposure to regional banks in the US and Europe, thanks to its enclosed financial system. Moreover, Chinese policymakers' campaigns against financial risks and the People's Bank of China (PBoC)'s cautious monetary policy have improved the health of the country's banking sector over the past few years. The capital adequacy ratio of commercial banks improved from 13.7% in 2017 to 15.2% in 2022, which was far above the Basel III requirement of 8% and higher than that of many US and European banks. Meanwhile, the sum of the special-mention loans ratio and non-performing loan (NPL) ratio declined to 3.9% at the end of 2022 from close to 6% in 2016 (see Chart 4). We believe China's banking system has a strong balance sheet to absorb potential solvency shocks.

CHART 4. CHINESE BANKS' BAD-LOAN RATIO (%)



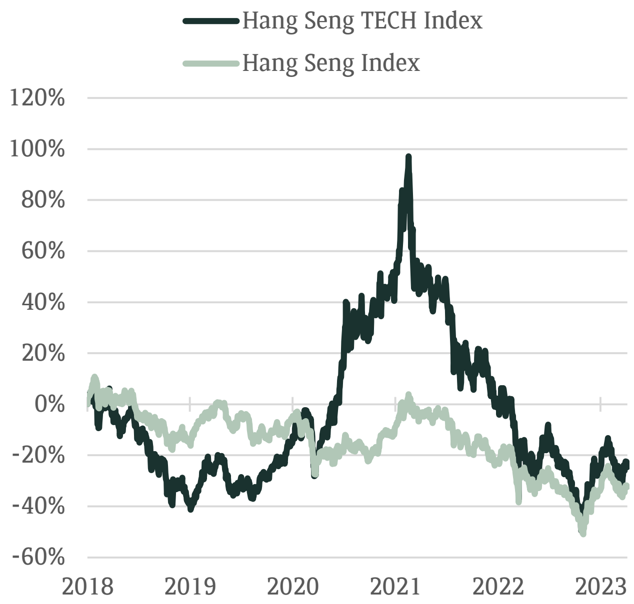
Source: CBIRC, WIND, BNP Paribas as of 3 April 2023

Notable developments in selected sectors and industries

1) China Internet

The game-changing moment for China's internet sector might have arrived in our view. A leading domestic e-commerce platform unveiled a major corporate reorganisation and potential spin-off plan out of the blue in late March 2023. Another domestic e-commerce platform filed separate IPO applications for two of its subsidiaries on the very next day. The proposed spin-offs are expected to unlock value for shareholders, which we agree and feel a sense of déjà vu. From 2018 to 2021, there were over a dozen IPOs by subsidiaries and associates of leading China tech giants. Coincidentally, Hang Seng TECH Index outperformed Hang Sang Index by as much as 100% between mid-2020 and early 2021 (see Chart 5).

CHART 5. CUMULATIVE PERFORMANCE OF HANG SENG TECH INDEX AND HANG SENG INDEX, 2018-PRESENT



Source: Bloomberg, BNPP WM, as of 6 April 2023
Past performance is not indicative of current or future performance.

In our opinion, the restructuring and spin-off plans are major positive share price catalysts. Shares of leading China internet companies are considerably undervalued when measured by their sum of the parts. In addition to improving operational flexibility, we believe corporate breakups will help the internet giants to become nimbler and thus less subjected to regulatory scrutiny in the future. We also think the positive market reactions to the spin-off plans of the e-commerce leaders could prompt the other internet giants to review their non-core business portfolios, which may turn into waves of spin-offs and re-ratings.

As we have suggested in our previous issue, the pendulum of China's internet sector regulations has swung from stringent controls to potential loosening. Recalling the episodes of the short-lived listing of a leading car hailing company in 2021 and 2022, it could be inauspicious to go public without the blessing from regulators. The high-profile corporate actions by the two e-commerce giants clearly signal a welcome change in the government's attitude.

2) China Financial Services

China's capital market reform has shifted to a higher gear. In Q1 2023, the China Securities Regulatory Commission (CSRC) launched the main board IPO reform, which had been brewing since 2019. The most important change was the simplification of the IPO system on stock exchanges' main boards from "approval based" to "registration based". The first batch of companies that had gone through the registration-based process were listed on 10 April 2023. The key amendments to the IPO system include:

- Regulators now focus on the inspection of listing documents and due diligence, and no longer judge the valuations of listing companies.
- The lead time of the IPO process is shortened significantly.
- Removal of the daily share price change cap in the first five trading days.
- IPO shares will be eligible for margin financing and short selling since day one.

If history is any indication, the number of IPOs on Shanghai and Shenzhen could increase by multiple folds with the introduction of registration-based IPO. The total IPO proceeds on ChiNext surged notably from 2020 to 2022, after the Chinese stock exchange for start-ups adopted the registration-based system in August 2020.

Apart from the IPO system reform, CSRC and the stock exchanges have also implemented other structural enhancements:

- Clarification of the positioning of various stock exchanges: Shanghai and Shenzhen main boards will focus on mature, blue-chip companies, STAR Market on tech companies, ChiNext on fast-growing start-ups, and the Beijing Stock Exchange on innovative small- and medium-sized enterprises.
- Other reforms on private placements, mergers and acquisitions, convertible bonds, preferred shares, depositary receipts, as well as trading halts and delisting.

We believe a higher IPO volume will inevitably lead to higher IPO-related revenues and subsequent trading/brokerage income. The leading domestic investment banks are likely to grab the lion's share and benefit from the reform disproportionately.

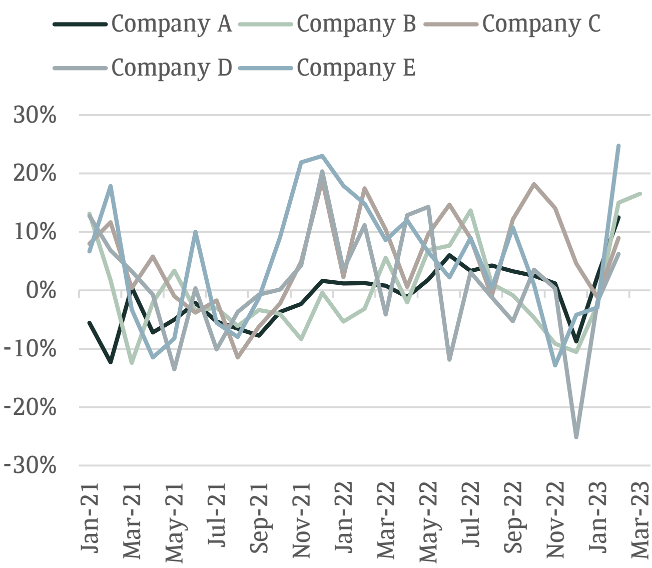
3) China Banking and Insurance

Zooming out from the capital market reform, we believe the upcoming overhaul of the financial regulatory framework could have a material impact on China's financial sector in the longer term. Supervisory power over banks, insurance companies and certain parts of the securities market will be consolidated under a newly established super regulator, the National Financial Regulatory Administration (NFRA), which reports directly to the State Council. NFRA will replace the China Banking and Insurance Regulatory Commission (CBIRC) and will take away regulatory responsibilities from PBoC. Some capital market regulatory functions will also be transferred to NFRA from CSRC, which will in turn take over the authority of approving certain types of bond issuance from the National Development and Reform Commission (NDRC). Also, CSRC's ranking will be upgraded from a "public institution" to a "government agency", which should empower CSRC with more resources. We believe a streamlined financial regulatory structure can enhance oversight of financial institutions, eliminate regulatory arbitrage and rein in cross-industry activities such as wealth management products at banks.

We think the valuations of China's insurance sector remain undemanding with their H-shares trading at an estimated price-to-book multiple of 0.7 times on average. Despite continued weakness in new business value in Q4 2022, the monthly premium income growth of leading insurers gained upward momentum year to date (see Chart 6).

Given that premium income in the first quarter tends to be seasonally higher than the remaining quarters of the year, the strong growth across domestic insurers so far bodes well for earnings and dividend growth for fiscal year 2023. After two years of industry-wide consolidations and re-ratings of shares, we are seeing signs of life in the insurance sector.

CHART 6. MONTHLY PREMIUM INCOME YOY GROWTH OF LEADING INSURANCE GROUPS



Source: the Companies, BNPP WM, as of 11 April 2023

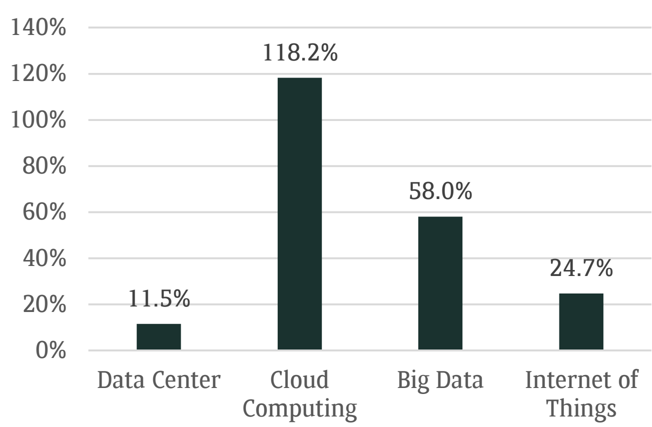
Meanwhile, all major national banks reported resilient net profits and raised dividend per share for fiscal year 2022. However, growth weakened sequentially in Q4 2022 due to NIM pressure, net fee income contraction and investment losses. Management of large banks expect the residual impact of LPR cuts in 2022 and early repayment of mortgages to continue to weigh on NIM in 2023. Nonetheless, we expect NIM pressure to ease gradually in the second half of 2023 on the back of abundant market liquidity. On 17 March 2023, PBoC cut the reserve requirement ratio (RRR) by 25 basis points (bps) in a surprise move. The RRR cut was asymmetrically favourable to large- and medium-sized banks, as the RRR of some smaller rural banks were already at the statutory minimum level of 5%, which was left unchanged. PBoC Governor Yi Gang said that real interest rate was at an appropriate level, and he saw RRR cuts as a more effective tool to support the economy. We believe the combination of RRR cuts and steady LPRs will bolster net interest income growth.

4) China Telecommunication

On 27 February 2023, the State Council unveiled a development plan for China's digitalisation, which lay down medium-term goals including (i) infrastructure upgrades and integrations by 2025, and (ii) becoming one of the global leaders in digitalisation by 2035. We believe the government is formulating detailed plans and will release favourable policies when ready.

At the moment, we think this is advantageous to the Chinese telecommunication sector. Regarding infrastructure development, the State Council has explicitly set the following targets: (i) accelerating the collaborative constructions of 5G network and gigabit optical network, (ii) deepening the development of IPv6 (Internet Protocol version 6), (iii) facilitating comprehensive development of IoT (internet of things), and (iv) promoting the BeiDou Navigation Satellite System. The government will also put up a national data management system to improve the collection, commercialisation and distribution of data. We believe telecom networks will play a key role in providing all-in-one platforms (infrastructure + cloud servers + software) for the digital economy. Indeed, cloud computing and big data were two of the major revenue growth drivers for telecom networks in 2022 (see Chart 7).

CHART 7. TELECOM VALUE-ADDED SERVICE REVENUE YOY GROWTH



Source: Ministry of Industry and Information Technology, BNPP WM, as of 19 January 2023

5) China Automobile

On 9 April 2023, the world's largest battery electric vehicle (EV) maker announced to build a new battery factory in Shanghai, which should further cement China's overwhelming share in the global EV supply chain. The EV maker said construction is scheduled to begin in Q3 2023, and production is expected to commence in Q2 2024. Meanwhile, a Spanish newspaper reported that the world's largest NEV (including battery EV and hybrid EV) maker from China had started preliminary talks to build a battery factory in Spain, and had been studying plans to build facilities in Germany and Hungary.

We reiterate our view that NEV penetration rate will continue to increase at the expense of internal combustion engine vehicle sales, but, at the same time, price competition is likely to drain profit margin in the near term. The recent dramatic decline in lithium prices should relieve raw material cost pressure, but NEV makers were passing the benefits to consumers. In Q1 2023, around 20% of passenger car models in China's market saw transaction price drops of more than RMB10,000, according to data complied by China Auto Market and Bloomberg. Industry consolidation seems inevitable and that could happen any time soon in our view. We suggest investors to stay with leading NEV makers in terms of shipment volume, and avoid those with single-digit or lower gross margin.

6) Hong Kong Property

Many Hong Kong property developers saw sharp declines in revenue and earnings in the second half of 2022, as the total number of real estate project completion was lower than usual in the period, partly due to COVID disruptions. However, as the number of project completion is set to rebound in 2023, major property developers should be able to tap into their relatively large contracted sales to deliver normalised earnings.

Investors have become more concerned about the potential deleveraging of property developers after an unexpected rights issue by one of the largest listed real estate investment trusts (REITs) in Hong Kong. Indeed, there is a moderate correlation between the gearing ratio and expected dividend yield of Hong Kong property stocks. We believe the dividend guidance and gearing targets of individual companies are perhaps more important than their near-term financial results. In terms of subsector, our preference is Retail > Residential > Office.

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