JUNE & JULY 2023

Hong Kong/China Equity Perspectives

Walking Alone

Summary

Market enthusiasm about China's reopening seems to have vanished obscurely. As at 5 June 2023, both the CSI 300 index and Hang Seng China Enterprise Index entirely returned to where they started 6 months ago. Although geopolitical tension and fierce market competition in China may have led to waning confidence in Hong Kong and China stock markets, there is also concrete evidence that China's economy has rehabilitated. There are also market rumors that the PBoC[1] has leeway to lower interest rates soon, when other major central banks are close to wrapping up their rate hikes. Empirically, interest rate cuts tend to be a positive catalyst to the stock market.

China AI[2] is a promising yet isolated market

Generative AI is undeniably one of the hottest topics thus far in 2023. Global investors are pouring money into shares of semiconductor and AI technology leaders to ride on the theme's enormous yet unmapped business potential. Dozens of Chinese companies had discussed their vision of generative AI. Shares of some popped up briefly, but most have given back their gains since April 2023. We think the market is underestimating the AI opportunities in China, though we also think that only a handful of large technology firms are capable of surfing this revolutionary tech wave.

China's AI market is forecasted to grow from USD10.4 billion in 2021 to USD26.4 billion by 2026, translating to a CAGR[3] of 21%. We think accelerated investments in AI could spawn numerous use cases in other fields, which could bring even larger opportunities in our view.

1. People's Bank of China;
2. Artificial intelligence;
3. Compound annual growth rate;
4. New energy vehicle;
5. State-owned Enterprise

Notable developments in selected sectors

- **China Internet:** Market reactions were mixed after the sector's better-than-expected financial results for the first quarter of (Q1) 2023. Looking ahead, we expect strong online advertising demand, the 6.18 Shopping Festival and new game launches to underpin decent earnings growth in 2023's second quarter (Q2).
- **China NEV[4]:** The sector experienced healthy unit sales growth and an easing price war, but swinging lithium prices pose risks.
- **China Banks:** Shares rallied in April and May 2023, driven by supportive monetary policy and a re-rating of SOEs[5]. Despite all that, shares of the big banks still traded at deep discounts to their book values and with decent dividend yields.
- **China Tourism**: Despite growing signs of continuing recovery in the months after, share prices of tourism-related companies underperformed the broader stock market in May 2023. Nonetheless, we believe the sector should benefit from a recovery of China-international air passenger capacity to 80% of pre-COVID levels by the end of 2023.

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Market enthusiasm about China's reopening seems to have vanished obscurely. As at 5 June 2023, both the CSI 300 index and Hang Seng China Enterprise Index entirely returned to where they started 6 months ago. In comparison, developed stocks markets such as U.S. (S&P 500 +6.9%), Japan (TOPIX +14.0%) and Europe (STOXX Europe 600 +4.2%) recorded much better performance over the same period. Although geopolitical tension and fierce market competition in China, especially among e-commerce platforms and new energy vehicle makers, may have led to waning confidence in Hong Kong and China stock markets, there is also concrete evidence that China's economy has rehabilitated.

There are also market rumors that the PBoC has leeway to lower interest rates soon, when other major central banks are close to wrapping up their rate hikes. The key interest rates in China (i.e. 1-year medium-term lending facilities (MLF) and 1-year loan prime rate (LPR)) have been held unchanged since August 2022. In March 2023, the PBoC pledged to support loan growth and reduce total financing costs[6]. Furthermore, on 6 June 2023, the state-owned China Securities Journal quoted experts saying the PBoC is likely to lower interest rates in the second half of 2023[7]. Empirically, interest rate cuts tend to be a positive catalyst to the stock market.

Generative AI is not just a buzz word

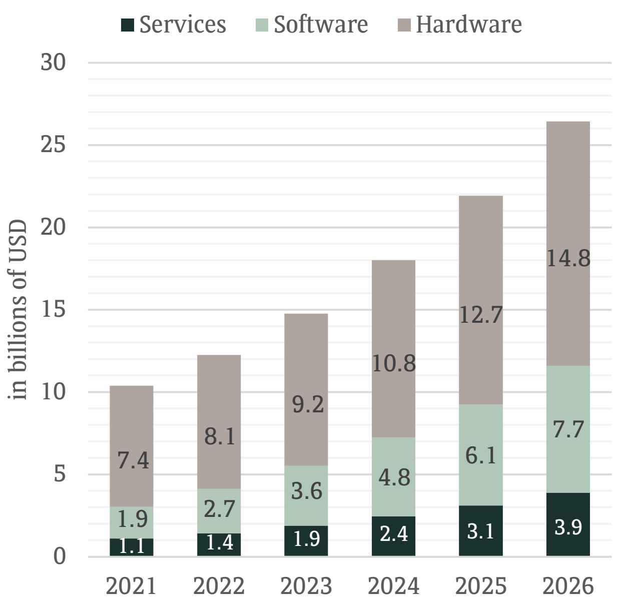
Generative AI is undeniably one of the hottest topics thus far in 2023. Global investors are pouring money into shares of semiconductor and AI technology leaders to ride on the theme's enormous yet unmapped business potential. Given the massive investment inflow, a famous chief investment strategist at one of the leading U.S. investment banks called AI "a baby bubble" that could echo the excessive valuations of dot-com companies in the early 2000s[8].

Going back to the topic of Chinese companies, dozens of Chinese companies had discussed their vision of generative AI. Shares of some popped up briefly, but most have given back their gains since April 2023. We think the market is underestimating the AI opportunities in China, though we also think that only a handful of large technology firms are capable of surfing this revolutionary tech wave.

China AI is a promising yet isolated market

According to market research firm IDC, the China AI market is forecasted to grow from USD10.4 billion in 2021 to USD26.4 billion by 2026, translating to a CAGR of 21%. AI hardware is (and is still expected to be by 2026) the largest component that accounts for over half of the AI market, but software and services are expected to grow at faster pace (Chart 1). China is also expected to chip-in above the world's average incremental spending in digital transformation through 2024 (Chart 2). We think the accelerated investments in AI could spawn numerous use cases in other fields, which could bring even larger opportunities in our view. We wish to highlight that these opportunities may not fall in the hands of non-Chinese companies. On one hand, it could be a big challenge to satisfy strict content censorship requirements without jeopardizing the algorithm of a comprehensive AI system. On the other hand, the government may simply prefer local companies due to personal data sensitivity (i.e. internet search engines and social media in China).

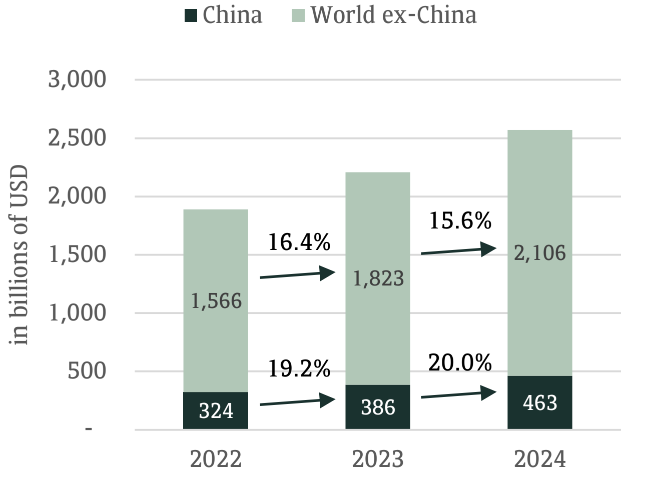
CHART 1. CHINA AI MARKET SIZE FORECAST, 2021-2026



Source: IDC, BNP Paribas as of 18 May 2023

6. *Source: People's Bank of China, as of 15 May 2023*
7. *Source: China Securities Journal, as of 6 June 2023*
8. *Source: Bank of America, as of 19 May 2023*

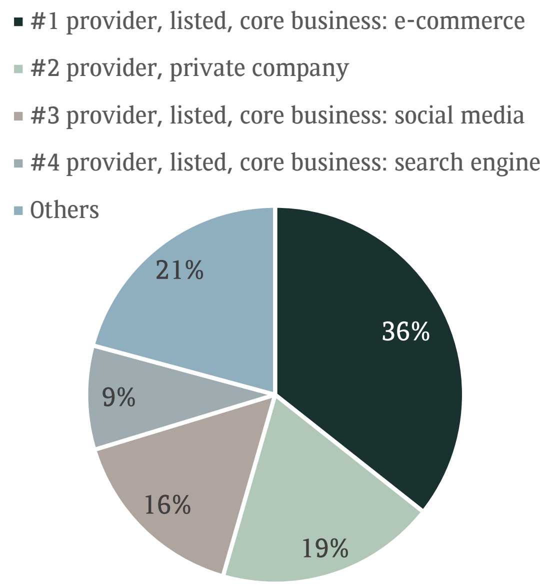
CHART 2. GLOBAL SPENDING ON DIGITAL TRANSFORMATION, 2022 - 2024



Source: IDC, BNP Paribas as of 18 May 2023

It is advisable to gain exposure to generative AI in China, but we also suggest to narrow the list of candidates down to a few cloud infrastructure service providers at the current stage. The four largest cloud infrastructure service providers collectively own 79% of the market share in China (Chart 3). All of them also have a strong portfolio of complementary businesses, such as internet search engine, social media and office productivity tools, which provide both essential data and immediate use cases for empowering AI systems.

CHART 3. CHINA CLOUD INFRASTRUCTURE SERVICE MARKET SHARE, 2022



Source: Canalys, as of 20 March 2023

Notable developments in selected sectors and industries

1) China Internet

Q1 2023 overview

Most of the leading China internet companies were able to report better-than-expected results for Q1 2023. The online advertisers saw recovery across the board, and further expect travel-related advertising to boost revenue growth for Q2 2023; the e-commerce platforms cleared fears of intensifying price competition with resilient gross margins and efficiency gains; online game publishers managed to beat both consensus revenue and earnings as existing game titles held up well in the quarter where a couple of popular mobile games achieved record-high revenue from the app stores; and last but not least, regulatory environment normalization also helped the sector.

Beyond fundamentals

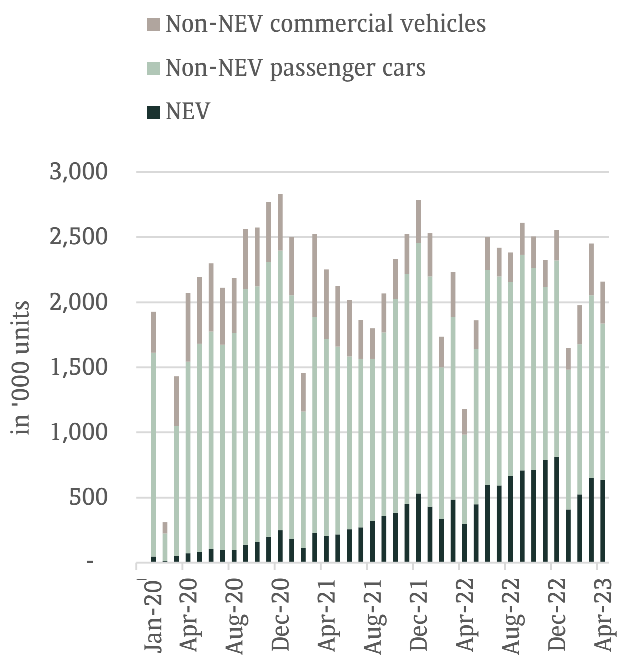
Despite the good news, we notice mixed market reactions after the result announcements. It seems geo-political tensions as well as faltering confidence in the economy steered the sector's share price trajectory in mid-to-late May 2023. Looking ahead, we expect strong online advertising demand, the 6.18 Shopping Festival and new game launches to underpin decent earnings growth in Q2 2023. The proposed spin-offs at two of the leading Chinese e-commerce platforms in the second half of 2023 may also re-capture investors' attention in our view.

2) China New Energy Vehicle (NEV)

Healthy unit sales growth in April

April 2023 retail sales of automobiles in China jumped 38% Year-on-Year (YoY) to RMB362 billion. Q1 2023 sales also grew 5.4% to a total of RMB1,411 billion compared to the same period in 2022, according to the China Association of Automobile Manufacturers (CAAM). Aggregate unit sales of passenger cars in the first four months of 2023 also increased by 6.9% compared to the same period in 2022 (+2.5% versus same period in 2020) to 6.95 million units, with passenger NEV up 43% to 2.1 million units and internal combustion engine passenger cars (ICE) down 3.8% to 4.8 million units. While the China automobile market may have reached its saturation point, the substitution of ICE with NEV will continue to propel high growth at leading NEV makers in our view. The penetration rate of NEV rose 4.6 percentage points YoY and 3 percentage points MoM to 33.6% of total monthly car sales in April 2023 (Chart 4).

CHART 4. CHINA MONTHLY CAR SALES



Source: CAAM, as of 16 May 2023

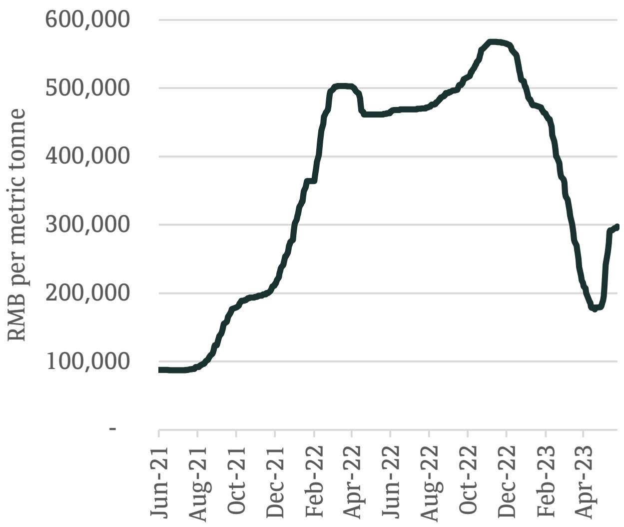
Easing price war

Overall market sentiment was hammered by an ongoing intense price war initiated by the leading US-based electric car (EV) maker in January 2023, on top of the impact of rushed sales in December 2022 due to the expiry of NEV subsidies and an uneven economic recovery. We had extensive discussions with several China NEV makers and upstream suppliers in mid-April 2023, and all of the management we met were expecting that US EV maker to cut its prices again in or before the third quarter of (Q3) 2023. However, the same US EV maker unexpectedly reversed a portion of its price cuts in its key markets on 2 May 2023, though the prices are still much lower than the levels at the start of 2023. Generally, shares of China NEV makers reacted positively to the price hike, probably due to growing expectation for an end to the price war. The pricing strategy of the US EV maker stirred up confusion among car makers and consumers in our view, and we believe most of the China NEV sector would prefer to hold on to their current product prices until visibility into consumer demand improves.

Swinging lithium prices pose risks

Lithium carbonate accounts for roughly 50% of battery material costs, while batteries typically account for around 30-50% of an EV's cost. In the first quarter of 2023, most of China's NEV makers said the dramatic decline in battery cost since the end of 2022 relieved gross margin pressure from the price war. Although the price of lithium carbonate rebounded over 60% in mid-May 2023, we still expect NEV makers to report a quarter-on-quarter (QoQ) increase in gross margin in the second quarter of 2023 as it generally takes up to one month to pass through the change in lithium carbonate prices to NEV makers. In our view, this lithium carbonate price trend reversal poses downside risk to gross margin in the third quarter of 2023 instead (Chart 5).

CHART 5. CHINA LITHIUM CARBONATE 99.5% PRICE CHART



Source: Bloomberg, as of 30 May 2023

3) China Banks

Valuation system with Chinese characteristics (VSC)

The China Securities Regulatory Commission (CSRC) proposed the idea of VSC on 21 November 2022[9]. Although the regulatory body has not elaborated the idea clearly, we believe the private placement of A-shares of a state-owned bank for one of the large telecom network operators at 43% premium (valued under the VSC scheme) to the closing price of the bank's A-shares on 29 March 2023 (57% premium to its H-shares) had put the VSC under the spotlight for investors.

9. *Source: The People's Republic of China State Council, as of 21 November 2022*

The issuance price was priced at 1x the price-to-book multiple (P/B), which became a potential anchor for the VSC. Currently, roughly 30% of all listed SOEs are trading below 1x P/B. Even among the SOEs, the banks typically stand out in the VSC because of their low P/B and large market cap.

Shares of state-owned Chinese banks and other China financials rallied in April and May 2023 to the point that the Hang Seng China H-Financials Index outperformed the Hang Seng and Hang Seng China Enterprise Indices by 10% and 11.3% respectively over the period. In our view, the outperformance was driven by supportive monetary policy and, to a large extent, the re-rating of SOEs in the hope of government actions to promote VSC. Despite all that, shares of the big 4 state-owned Chinese banks still traded at deep discounts to their book values (around 0.4x P/B) and with decent dividend yields of over 8%. We suggest long-term investors to consider having a chunk of their stock portfolio in this sector if they have not done so already.

4) China Tourism

Bound by outbound capacity

Domestic transportation and accommodation booking during the "Golden Week" holiday between 29 April and 3 May 2023 surpassed the level in 2019. Despite growing signs of continuing recovery in the months after, share prices of tourism-related companies underperformed the broader stock market in May 2023. The cool-down in market sentiment is likely attributable to the moderating recovery of revenue generated per available hotel room (RevPar) and domestic air revenue passenger kilometers (RPK). Nonetheless, we believe the sector should benefit from a recovery of China-international air passenger capacity from 50% currently to 80% of pre-COVID levels by the end of 2023. There are trading opportunities in online travel agencies and airlines in our view.

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