Strategy

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Strategy | China

Sino-US trade conflict: where to look for resilience?

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Trade tensions – one of the key risks for market volatility

In our 2Q18 market outlook (published 19 March), we highlighted worries on trade protectionism as one of the four risk factors that may exacerbate market volatility. We think the probability of a full-blown trade war is low, but any escalation of or news on expansion of the scope of trade protection could lead to worries on systemic risks in the near term. On the other hand, select areas, which are less impacted due to resilient demand or which could benefit because of import substitution or industry consolidation, can provide some shelter, in our view. Market correction on news flows can provide opportunities for bargain hunting in those names. From this perspective, we like healthcare, air transport, apparel leaders, and software leaders.

A systemic concern to weigh on overall market valuation

As we analyzed in our previous note, fears on a full-blown trade war could weigh on overall market valuation, in our view. If retaliatory moves escalate and prevail, the course of global economic recovery might be disrupted. Specifically, consumers could be hurt due to higher prices after tariff increase, leading to weaker consumption power. Inflation rise might pick up pace, putting central banks in a more delicate position of weighing between faster moves on liquidity tightening and accommodating the economy. Lastly, if demand deteriorates, commodity prices, oil prices, as well as the shipping segment, could face the largest adverse impacts among the different sectors.

Overseas exposure – more to read behind the numbers

In 2016, 12.7% of the total revenue of HK- and US-listed Chinese companies was generated from overseas markets. Tech hardware, consumer durables and apparel, semiconductors, transport, energy, and consumer staples are the most export-oriented sectors, with over 20% of these sectors' revenue share coming from overseas (see Fig.3). We provide a list of companies with large revenue exposure to the US in Fig.1. However, we think there is more to consider in addition to these numbers, for reasons such as companies are in different positions along the global supply chain, and some companies could shift orders from US clients to those in other markets in the event of a Sino-US trade conflict.

Where to look for resilience?

While the overall market could see disruption from time to time, companies which — 1) enjoy resilient demand; 2) could benefit from import substitution; 3) have strong pricing power along the global supply chain or enjoy high barriers to entry; and 4) could benefit from industry consolidation — can provide some safe harbor, in our view. The full report provides detailed analysis from Huatai sector analysts on the oil equipment, materials, transportation, textiles, consumer staples, tech hardware, auto and healthcare sectors.

Oil equipment: limited positive impact on Hilong

In response to the US's decision to impose tariffs on Chinese steel and aluminum, China plans to impose tariffs on USD3bn worth of American products, including seamless steel pipes used as line pipes for oil and gas transmission, drill pipes and casing pipes. If the new tariff scheme is put in place, we think it would support the sales of Hilong (1623 HK), which is China's largest non-SOE drill pipe manufacturer, but the magnitude should be very limited given that most of China's drill pipes — mainly supplied to PetroChina, Sinopec and CNOOC — are sourced domestically, even for offshore drilling.

Steel and Aluminum: quantifying the potential impact on demand

Steel:

Three sources of impact on China steel demand include: 1) direct trade to the US, for which the impact is estimated at 0.44mt; 2) indirect trade involving steel processed elsewhere, then re-routed to the US from Turkey, Korea and Vietnam, for which the impact is estimated at 1.36mt; and 3) reduction in export volume from other countries which may be re-directed elsewhere, potentially squeezing China exports, for which the impact is estimated at 3.9mt. Adding up the above factors, the total potential impact on China steel demand is estimated at 5.7mt, accounting for 7.5% of total 2017 steel exports and 0.5% of total steel product output. However, given most key exporting countries are exempted from the tariff, the potential impact from the last point is more or less negligible. As a result, the effective impact on China steel could be less than 2mt, equal to only 2.6% of 2017 steel import. Moreover, above estimation is based on the assumption of flat global steel demand growth. The World Steel Association estimated 3% global demand growth (excl. China), compared to 4.9% in emerging and developing economies (excl. China). More detailed calculations can be provided upon request, and can be found in this report.

Aluminum:

The same three sources of impact on China steel demand also affect aluminum demand: 1) direct trade to the US, for which the impact is estimated at 84kt; 2) indirect trade involving steel processed elsewhere then re-routed to the US from Malaysia, Vietnam and Thailand, for which the impact is estimated at 2.6kt; and 3) reduction in export volume from other countries which may be re-directed elsewhere, potentially squeezing China exports, for which the impact is estimated at 777kt. Adding up the above factors, total potential impact on China steel demand is estimated at 862kt, accounting for 18% of total 2017 aluminum exports. However, given that most key exporting countries are exempted from the tariff, the potential impact from the last point is more or less negligible. As a result, the effective impact on China aluminum could be less than 90kt, only 1.9% of 2017 aluminum exports. More detailed calculations can be provided upon request.

Paper: impact from indirect export could be more noticeable

The volume of direct export of packaging paper is small, only about 3% of domestic production. However, the volume of indirect exports could be more noticeable as packaging paper is consumed as external packaging or transportation containers for some of the final products sold overseas, including electric and electronic appliances, apparel, decorative goods and furnishings, daily-use chemicals and all sorts of components and parts. Thus demand could be undermined if the export of these final products is affected. Given that there are so many final products involved, it is almost impossible to get an accurate statistic on how much packaging paper is indirectly exported. Some industry experts estimate the percentage should be somewhere around 10-15%.

Transportation: influence to be mixed

Airlines: limited impact from trade war

We think the impact on the airlines sector from a trade war is relatively small. For passenger service (Sino-US flights account for around 4.0% of total Chinese carriers' flights). Although a trade war might have a negative influence on business demand, we think the influence on yield and PLF is small, considering: 1) the yield is already low due to oversupply in the past few years; and 2) the supply already expanded fiercely in the last two years and will most likely remain stable this year. For the cargo business (of which international cargo revenue accounts for around 5%), although demand will decrease in the event of a trade war, we estimate the impact will be less than 1% thanks to it accounting for a small percentage of the total revenue; and 3) for the aircraft introduction, orders with Boeing might be affected in the following years; however, considering it usually takes 2-3 years between order and delivery and because Chinese companies can always purchase from Airbus instead of Boeing, we therefore think the depreciation and amortization caused by aircraft will remain stable.

Hurt China – US container shipping, ports and freight forwarding sectors

As sectors which have both contributed to and benefited from the global trade, container shipping, ports and freight forwarding will hurt by US-China trade wars. The majority of export products from China to the US are furniture, clothing, equipment and plastics (representing 40% of total shipped containers), which are not on the tariffs list this time. However, we estimate the affected products would account for around 4% of total shipped containers, and whether there would be further retaliatory tariffs on other products becomes the biggest risk. Moreover, international freight forwarders would also be hurt by reduced demand on related goods. We think that the tariff announcement would cause a disturbance on the market first, and the negative effects in terms of throughput and earnings would come in gradual waves.

Textile exporters: potentially benefiting industry consolidation

Assuming textile products are included on the list of items subject to higher tariffs, we would expect the associated incremental cost to be absorbed by players along the whole value chain, in particular, by raw material providers, fabric suppliers, garment makers, brands and US consumers. If OEMs absorb the incremental cost associated with the tax plan, their earnings will shrink. This would mean further consolidation in the global OEM industry, in our view, with industry leaders such as Shenzhou continuing to gain wallet share.

Within our coverage, Shenzhou is the least impacted by policy risk as it: 1) has limited sales exposure to the US (10% of sales); 2) has the ability to shift capacity elsewhere (eg, Europe), considering it has 100% utilization, and capacity remains its bottleneck; 3) has overseas capacity (c. 25% of total) that could help; and 4) is well positioned to take market share from peers with lower profitability (OPM of 25% vs industry average of 10%), as it has more room to absorb additional cost.

Pork importer: limited impact on WH Group

Pork is on the list of US goods on which China might raise tariffs amid a trade war with the US. We see limited impact on WH Group. When China hog price is 1.4-1.6x that of US price, it is justified to import US pork into China. The price difference had previously peaked at c. 3x in 2011 and 2016. It is 1.1x for now, and is likely to remain at a similar level in 2018, barring the opportunity of pork price arbitrage. WH Group imported 70,000 tonnes of pork (2014), 160,000 tonnes (2015) and 300,000 tonnes (2016) from US to China.

Tech hardware: bargaining power matters the most

Based on the latest annual results announcements, AAC/SMIC/Lenovo/Huahong/ASM Pacific/Sunny had 62/40/30/18/6/3% of their revenue come from the US. Yet we believe the impact of the US tariff strategy should not only be determined by revenue contribution from the US, but also bargaining power against upstream suppliers and downstream customers along the industry chain. Some technology companies are likely to be indirectly impacted when they provide electronic parts and components to mainland customers which export terminal products to the US.

Auto: a likely lever to ease trade tensions with the US

The auto sector has not been directly impacted by the rhetoric on tariffs so far, but we believe auto could be used as a lever to ease trade tensions between the two major economies. We continue to believe that China will cut import tariff on autos from today's 25% to a lower level of 10-15% in order to comply with WTO requirements and to increase imports from the US (full report here).

Healthcare: no need to worry

We believe a trade war would have a limited influence on the domestic healthcare industry, given: 1) chemical drugs, as the sector's main components, are characterized as 'modern technology on manufacturing' and 'products under rigid demand'; 2) traditional Chinese medicines (TCM) are mostly exported to Southeast Asia, and would be barely affected by a potential Sino-US trade war; and 3) bulk medicines have a chance to suffer somehow since a large proportion is delivered to the EU and US markets; however, considering the prohibitive replacement cost for the *cut* local medicine manufacturers in the EU/US (due to protocol changes, safety problems, and redo of FDA review) plus the relatively cheap prices of bulk medicines, we don't expect to see a strong effect on China's healthcare industry.

There might be even benefits for local drug suppliers in the event of a trade war, because of: 1) acceleration of local substitution (prices should increase for imported drugs, thus local drugs become more advantageous in pricing under National Reimbursement Drug List); and 2) high-quality local drugs will stand out during the healthcare reform process (eg, priority review and consistency evaluation), and we expect market leaders to continue to benefit from industry consolidation.

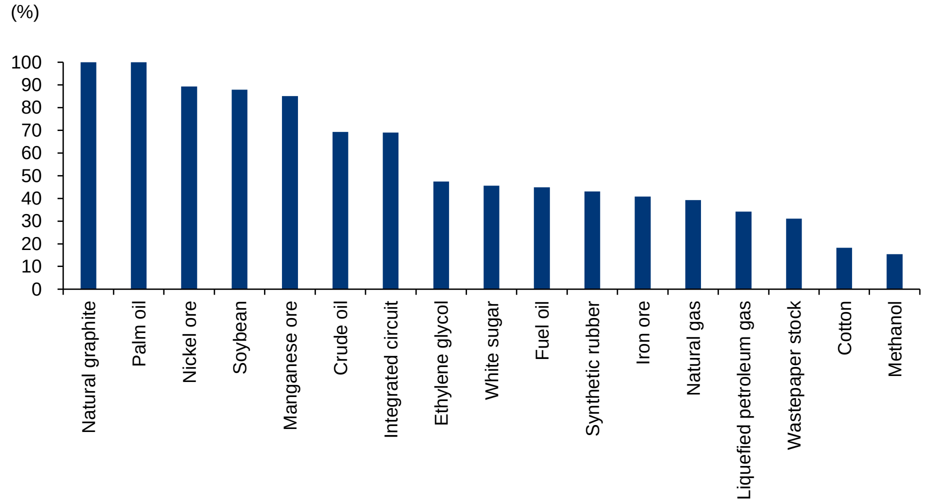
We anticipate strong growth momentum for the following healthcare sub-sector leaders: 1) innovative leader CSPC (1093 HK) and Livzon (1513 HK), given fueling up of current portfolios and strong R&D pipelines; and 2) subsector leaders SSY Group (2005 HK) and CMS (0867 HK), driven by the trend of market consolidation in which small businesses are being gradually squeezed out.

Fig.1. Chinese companies with revenue exposure to the US of greater than 10%

Ticker	Name	Market cap (USDmn)	Rating	Sector	Industry Group	2016 total revenue (RMBmn)	Revenue from US (RMBmn)	% of revenue exposure to US in 2016
8265 HK	China Trustful Group Ltd	822	-	Consumer Discretionary	Retailing	260	28	10.7
547 HK	Digital Domain Holdings Ltd	580	-	Consumer Discretionary	Media	653	206	31.5
2199 HK	REGINA MIRACLE	1,029	-	Consumer Discretionary	Consumer Durables & Apparel	4,166	2,566	61.6
1836 HK	STELLA HOLDINGS	1,095	-	Consumer Discretionary	Consumer Durables & Apparel	10,303	5,056	49.1
2232 HK	Crystal International Group Lt	2,762	-	Consumer Discretionary	Consumer Durables & Apparel	11,715	4,079	34.8
321 HK	Texwinca Holdings Ltd	724	-	Consumer Discretionary	Consumer Durables & Apparel	7,659	2,217	28.9
526 HK	Lisi Group Holdings Ltd	854	-	Consumer Discretionary	Consumer Durables & Apparel	1,086	309	28.5
551 HK	YUE YUEN IND	7,078	-	Consumer Discretionary	Consumer Durables & Apparel	56,339	13,890	24.7
1382 HK	Pacific Textiles Holdings Ltd	1,425	BUY	Consumer Discretionary	Consumer Durables & Apparel	5,679	586	10.3
2313 HK	SHENZHOU INTL	14,767	BUY	Consumer Discretionary	Consumer Durables & Apparel	15,099	1,548	10.3
1316 HK	Nexteer Automotive Group Ltd	3,856	-	Consumer Discretionary	Automobiles & Components	25,525	11,605	45.5
288 HK	WH Group Ltd	16,323	BUY	Consumer Staples	Food, Beverage & Tobacco	143,057	76,823	53.7
ATNX US	Athenex Inc	1,024	-	Health Care	Pharmaceuticals, Biotechnology	137	24	17.4
2866 HK	COSCO SHIP DEV	703	-	Industrials	Transportation	15,528	1,909	12.3
658 HK	C TRANSMISSION	2,421	BUY	Industrials	Capital Goods	8,966	2,211	24.7
2018 HK	AAC Technologies Holdings Inc	22,420	BUY	Information Technology	Technology Hardware & Equipment	15,507	9,669	62.4
777 HK	NetDragon Websoft Holdings Ltd	1,325	-	Information Technology	Software & Services	2,793	842	30.1
CSIQ US	Canadian Solar Inc	983	-	Information Technology	Semiconductors & Semiconductor	18,954	5,737	30.3
981 HK	SMIC	6,321	HOLD	Information Technology	Semiconductors & Semiconductor	19,360	5,706	29.5
1347 HK	Hua Hong Semiconductor Ltd	2,061	BUY	Information Technology	Semiconductors & Semiconductor	4,793	938	19.6
1333 HK	China Zhongwang Holdings Ltd	2,861	-	Materials	Materials	16,696	1,904	11.4

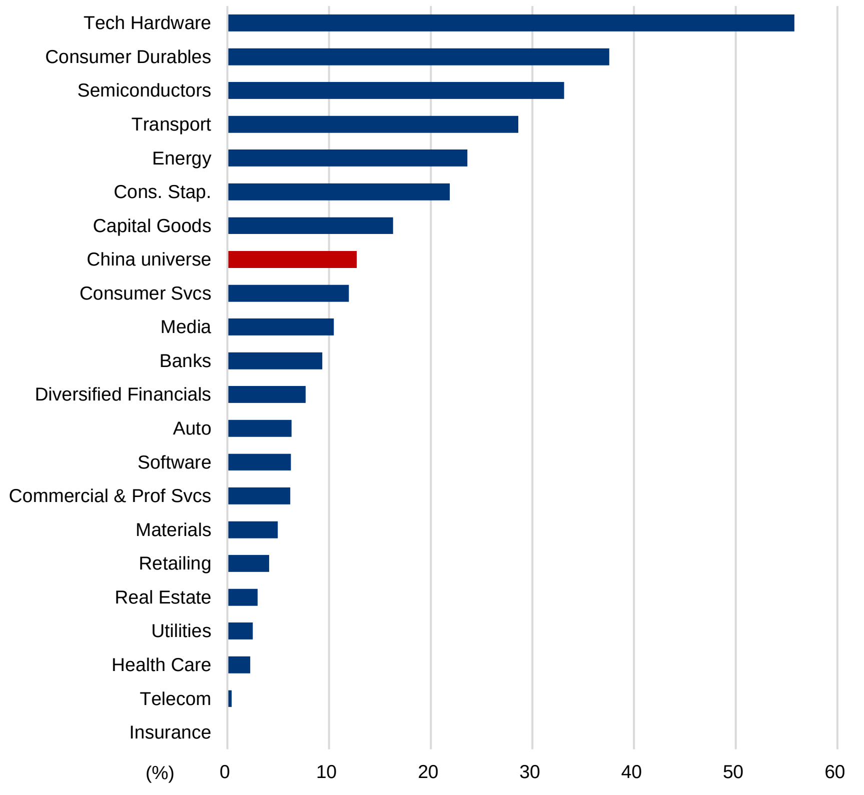
Source: Bloomberg, Huatai HK Research

Fig.2. Products with highest degree of import dependence



Source: Wind, Huatai HK Research estimates

Fig.3. Overseas revenue exposure of Chinese companies in 2016 by sector



Note: includes HK- and US-listed Chinese companies with a total market cap larger than USD500mn
Source: Bloomberg, Huatai HK Research

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