

Huatai Research

5 July 2018

Strategy | China

Valuations closer to trough, but short-term uncertainties remain

Market concerns drive valuations closer to trough

The China/HK market declined further despite a halt in RMB depreciation. The 12-month forward PE of HSCEI is now 7.1x (6.7x excluding index enhancement effect). Compared to the market trough in 2013-2014, when valuation reached 6.2-6.5x, the downside is limited, in our view. However, we think liquidity tightening overhang will not disappear soon amid uncertainties and given that RMB depreciation could pose a negative impact on corporate earnings.

RMB depreciation pressure relieved?

RMB depreciation adds to valuation pressure on HK- and overseas-listed Chinese companies. However, so far, large-scale capital flight from the domestic market has not yet been observed. Stock Connect northbound net-sell remained moderate compared to the large inflow in the past few months, and foreign investors' holdings in onshore bonds picked up faster in June. This partially explained the quick recovery of both CNH and CNY after the PBOC governor assured the market about the stability of the RMB. For the HK stock market, however, this may not lead to an immediate reversal in fund flows, in our view, because the USD index remains high, and money effect is still not clear enough for domestic investors.

Quantifying impact on earnings

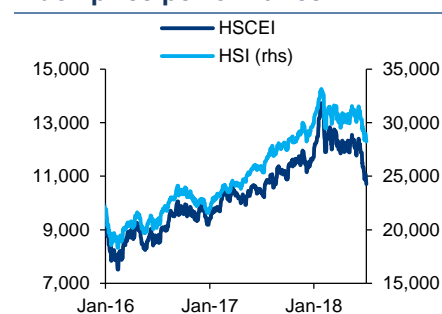
Corporate earnings can be influenced via three channels: 1) RMB depreciation leads to translation costs; consensus forecasts of HSI/HSCEI 2018E index EPS growth in HKD could be eroded to 3.1/13.3% if the RMB devalues to 6.8 against the USD, whereas without forex change influences, their growth rates are 5.2% and 17.4%, respectively; 2) although a weakening RMB boosts export, with trade war overhang persisting, it may be premature to make such a conclusion; and 3) companies with costs or debts in USD are victims, most notably airlines because of their large USD costs and debts, as well as Chinese property companies due to rising financing costs in USD. Companies with overseas orders and USD exposure could benefit from a weaker RMB; such companies include select oil service companies.

Remain cautious amid near-term uncertainties

In the short-term, we remain cautious on the overall market and favor broad consumption areas, for its resilient growth outlook. We are particularly cautious on China's property sector due to its high sensitivity to rising refinancing costs and policy uncertainties. Liquidity tightening could continue to bring pressure on liquid large-caps such as Internet leaders and banks, though in 2H, we still like those names. We are prudent on over-crowded new economy sectors, as upcoming new listings could divert liquidity from incumbents with stretched valuations.

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Index price performance

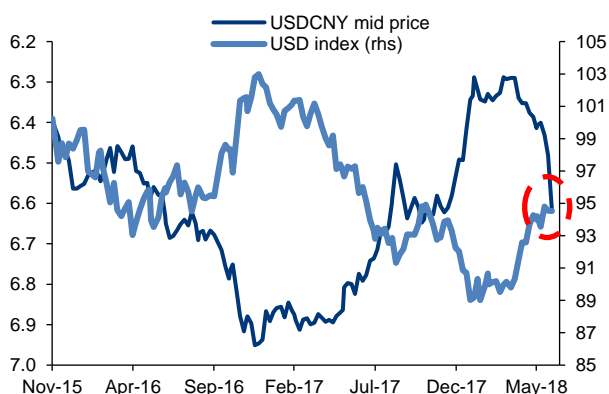


Source: Huatai HK Research estimates

A second look at RMB depreciation and HK market

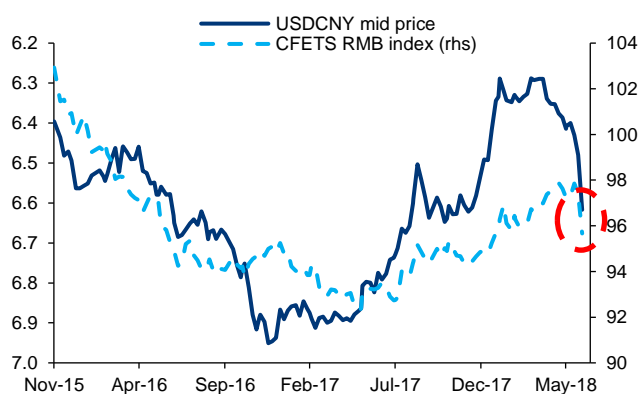
This round of RMB depreciation can be divided into two phases – the first phase was mainly caused by USD index strengthening, and the second phase featuring RMB devaluation was led by market concerns on trade war and economic resilience, whilst the USD index stayed relatively steady. We analyzed the impact of strong RMB and weak USD to the Hong Kong stock market in our previous [in-depth report published on 2 Feb.](#) Since 17 April, USDCNY mid-rate has weakened by 5.6%, bringing RMB declining against the USD by 1.7% in 2018 year to date. Now with RMB weakening and USD strengthening, the impact has reversed.

Fig.1. USDCNY mid-price and USD index



Source: Wind, Huatai HK Research

Fig.2. USDCNY mid-price and RMB index



Source: Wind, CFETS, Huatai HK Research

Detrimental to valuation

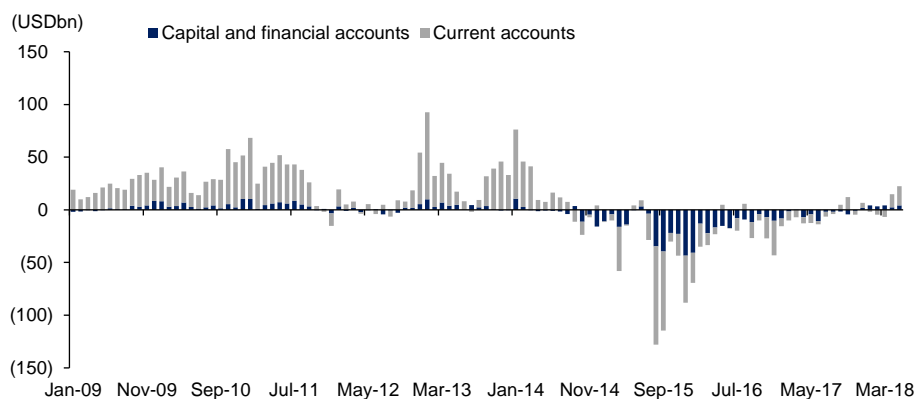
The impact on the overall China/HK market is that all RMB-denominated assets will be less attractive to overseas funds in terms of valuation, which may lead to fund outflows.

For the HK stock market, the strong USD has been a more important driver of fund flight from emerging markets, and recent RMB weakening could add more pressure on Chinese companies listed in overseas markets.

For the domestic market, banks’ net settlements of forex on behalf of clients still indicate moderate inflows in both current accounts and capital and financial accounts in May. Nonetheless, we believe sluggish performance in the domestic financial market and worries on economic resilience, instead of the RMB exchange rate changes, is the root cause of overseas fund outflows so far. Stock Connect northbound investors only sold RMB5.1bn worth of A shares from mid-June to 4 July compared to RMB28.5bn net buy in June. In the meantime, foreign investors’ holdings in the domestic interbank bond market increased by RMB87.1bn in June, vs an average monthly increase of RMB46.9bn from January to May this year.

To sum up, we think at the current stage, RMB depreciation is detrimental to valuations and fund flows to Chinese companies that are listed in the HK and overseas markets, but so far, large-scale capital flight from the domestic market has not yet been observed.

Fig.3. Net settlements of forex of banks on behalf of clients indicate mild inflows until May



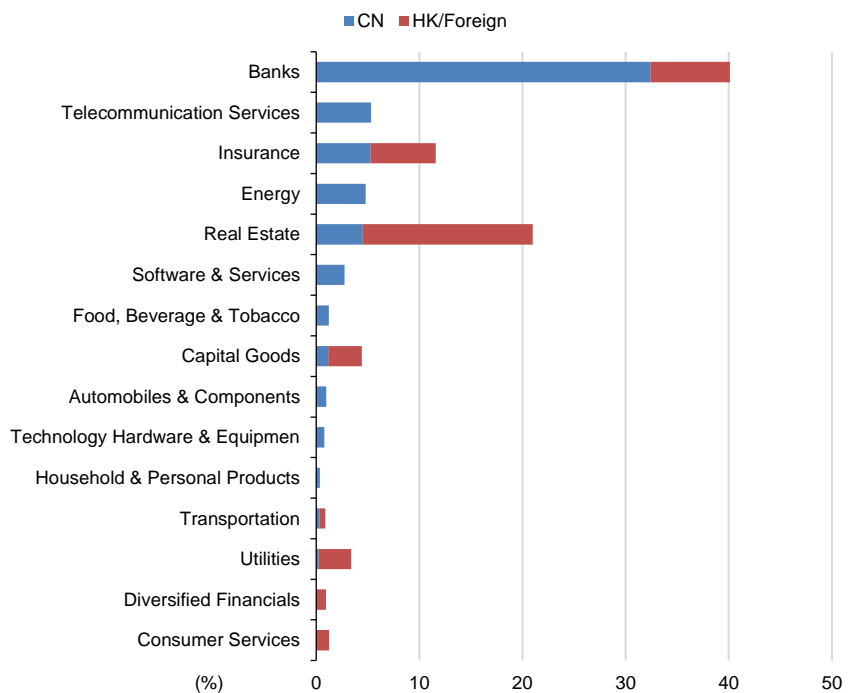
Note: data as at May 2018

Source: State Administration of Foreign Exchange, Huatai HK Research

Quantifying the impact on corporate earnings

In addition to fund flows and valuations, RMB depreciation can also influence corporate earnings primarily via three channels: 1) currency translation costs; 2) potentially higher export volumes; and 3) higher import costs and higher debt costs for companies that have large USD denominated debts or costs but mostly RMB cash inflows.

First, translation costs have a direct impact on index EPS quoted in HKD. Chinese companies contributed 60.4% of the 2017 index EPS of the Hang Seng Index. Among the banking, telecom, insurance, energy, and real estate sectors, Chinese companies account for the largest shares in index EPS. Therefore, these sectors within HSI will probably see more valuation pressure than others. In 2018 year to date, RMB depreciation against the USD and HKD has brought consensus forecast of 2018E HSI index EPS growth rate down to 4.5% from 5.2% and 2018E HSCEI index EPS growth rate down to 15.8% from 17.4%. Please see sensitivity analysis on 2018E index EPS growth against different exchange rate assumptions in Fig.5.

Fig.4. Index EPS contribution from different types of companies (on 2017 EPS)

Source: Bloomberg, Huatai HK Research estimates

Fig.5. Scenario analysis of translation costs on 2018E index EPS growth

As of 3 July	2017 year-end = 6.5342					
2018E Consensus EPS growth (in HKD)	No forex change	USDCNY: 6.4	6.6	Current: 6.6497	6.8	7.0
HSI	5.2%	6.9%	4.9%	4.5%	3.1%	1.3%
HSCEI	17.4%	20.3%	16.7%	15.8%	13.3%	10.1%

Note: data as at 3 July

Source: Bloomberg, Huatai HK Research estimates

Second, a weaker RMB could potentially boost exports, which could particularly benefit some lower-end manufacturers. However, at the verge of a trade war, it is premature to draw conclusions.

Third, companies that are highly dependent on imports in USD or with large amounts of USD-denominated obligations may also face rising costs. Huatai sector analysts believe the impact of RMB depreciation on select sectors'/companies' earnings are as follows:

Auto: Imported parts from Europe account for 40% of the COGS of BAIC, which means potentially higher costs amid RMB depreciation.

Materials: Earnings impact from forex for the coal/steel/metals sectors mainly depends on debt and asset exposure to foreign currency. Among the companies under Huatai coverage, Jiangxi Copper has the highest sensitivity to forex change, with 5% change in forex resulting in 3.25% change in earnings. While Yancoal has the highest USD exposure in terms of percentage contribution in debt, a 5% change in forex would result in 1% of earnings change as its overseas operation uses USD as its coal sales transaction settlement currency, offsetting increases in interest expense from a stronger USD.

Among the cement, paper and environment sectors, Nine Dragons Paper (2689 HK) and CR Cement (1313 HK) are two companies that have higher sensitivity due to their relatively higher exposure to forex-denominated debt (USD and EUR debts for Nine

Dragons Paper and HKD debt for CR Cement). Every 5% change in forex would cause a 6.8% change in 2018E earning for Nine Dragons Paper and a 3% change in 2018E earning for CR Cement.

Banks: after the rapid rise in RMB at the beginning of this year, Chinese banks adjusted their forex exposure. A 10% depreciation in RMB could result in a 10% impact on pre-tax income.

Oil and gas: RMB depreciation has a mixed impact on China's oil and gas companies. Though the majority of oil and gas companies operate in the PRC, with most transactions denominated and settled in RMB, companies that have large exposure to USD-denominated purchases, borrowings and long-term bonds could be negatively impacted by RMB depreciation. However, companies that have proportional amounts of USD-denominated sales and bank-savings are likely to hedge against the negative impact of RMB devaluation.

Transportation: airlines are the biggest victim; shipping, logistics and express delivery are relatively safe. Airlines: 1) forex loss resulting from a large amount of USD-denominated debt, mainly from aircraft introduction (ie, c. RMB40bn of dollar debts for both Air China and CSA as of 2017); we calculated that the 2018E net profit for both Air China and CSA would be 3.4% less resulting from forex loss as of a 1% RMB depreciation against the USD; 2) rising operating cost exposure to US dollars resulting from period-average RMB depreciation against the USD, ie, increasing ex-factory jet fuel price as it is calculated based on the dollar-denominated Singapore Jet Kerosene Spot Price, as well as rising operating lease rental, depreciation & amortization fee, aircraft maintenance fee and take-off and landing charges, as 100% or a portion of which are settled by US dollars due to the business nature. Shipping: minor impacts from RMB depreciation. Shipping companies operate internationally, with the majority of both revenue and cost being exposed to foreign currency, and we see limited impact from the weakening RMB. Logistics and express delivery: companies are mainly focused on the domestic market, and the risk exposure to RMB depreciation are very limited, in our view.

Semiconductor: In terms of semiconductor companies under our coverage, both SMIC and Hua Hong are reported in US dollars and are mainly exposed to RMB as they had 47% and 55% of their revenues generated in China in 2017. According to companies' estimates, a 5% decrease in RMB against the USD would cause 26% and 7% profit loss for SMIC and Hua Hong in 2017, respectively. By this token, SMIC is more sensitive to exchange fluctuation due to weak profitability against large revenue scale. Following such conclusions, assuming 6.5 USDCNY exchange rate in our base case, we believe SMIC and Hua Hong should suffer 38% and 9% profit loss if USDCNY reaches 7 by end-2018.

Utilities: the influence of RMB depreciation mainly lies on foreign debt and translation difference.

Healthcare: In the short run, we are neutral on the impact of RMB depreciation on the healthcare sector, given: 1) most import/export business applies to bulk medicines (API), accounting for a minor proportion in both revenue and net profit; 2) most related companies have hedged on foreign exchange as the RMB stayed at a high-level from 4Q17 to 1Q18, thus we see minimal effect on profit in the short term; and 3) if RMB depreciation continues, we are positive on firms with sustained export business (eg, Huahai and China Meheco) or CROs (eg, WuXi AppTec, Wuxi Biologics and Asymchem) to enjoy incremental profits in 2H18 and 2019E.

Fig.6. Scenario analysis of RMB exchange rate on corporate earnings

Ticker	Name	Industry group	2017		2018E		2018E net income (mn)				2019E net income (mn)				2018E net income growth (%)			
			Net Profit	Net Profit	Currency	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:	USDCNY:
			(mn)	(mn)		6.4	6.6	6.8	7	6.4	6.6	6.8	7 forecasts	6.4	6.6	6.8	7	
1055 HK	CSA	Transportation	5,961	8,226	CNY	8,226	6,744	5,261	3,779	15,238	13,864	12,490	11,116	38	38	13	(12)	(37)
981 HK	SMIC	Semiconductors	180	53	USD	58	50	41	33	91	78	65	51	(71)	(67)	(72)	(77)	(82)
3337 HK	Anton	Energy	60	173	CNY	154	133	112	91	327	307	286	266	187	156	121	86	51
753 HK	Air China	Transportation	7,244	9,011	CNY	9,011	7,784	6,557	5,331	13,828	12,557	11,286	10,015	24	24	7	(9)	(26)
1600 HK	Tianlun Gas	Utilities	404	441	CNY	441	400	360	319	507	460	413	367	9	9	(1)	(11)	(21)
1958 HK	BAIC Motor	Auto	2,253	8,845	CNY	8,657	8,092	7,526	6,961	10,072	9,391	8,709	8,028	293	284	259	234	209
1251 HK	SPT	Energy	6	78	CNY	168	158	149	140	213	204	195	187	1,305	2,924	2,760	2,595	2,431
1083 HK	Towngas	Utilities	1,365	1,388	HKD	1,388	1,316	1,244	1,172	1,574	1,492	1,411	1,329	2	2	(4)	(9)	(14)
2688 HK	ENN Energy	Utilities	2,802	3,956	CNY	3,956	3,758	3,560	3,363	4,657	4,309	3,961	3,613	41	41	34	27	20
358 HK	Jiangx	Materials	1,650	2,982	CNY	3,407	3,246	3,085	2,924	3,105	2,944	2,783	2,622	81	107	97	87	77
		Copper																
2689 HK	Nine Dragon	Materials	6,555	7,828	CNY	8,055	7,730	7,406	7,081	5,531	5,206	4,882	4,557	19	23	18	13	8
		Paper																
1347 HK	Hua Hong	Semiconductors	145	160	USD	164	157	151	144	183	175	168	161	10	13	8	4	(1)
836 HK	CR Power	Utilities	4,623	8,153	HKD	8,153	7,880	7,606	7,333	9,463	9,146	8,828	8,511	76	76	70	65	59
934 HK	Kantons	Energy	1,208	1,341	CNY	1,303	1,260	1,219	1,180	1,536	1,487	1,441	1,397	11	8	4	1	(2)
135 HK	Kunlun	Energy	4,760	3,383	CNY	3,383	3,279	3,174	3,070	4,017	3,893	3,769	3,646	(29)	(29)	(31)	(33)	(36)
		Energy																
857 HK	PetroChina	Energy	22,798	63,647	CNY	62,705	60,822	58,939	57,055	68,728	66,886	65,043	63,201	179	175	167	159	150
392 HK	Beijing	Utilities	6,880	7,508	HKD	7,508	7,304	7,100	6,896	8,333	8,107	7,880	7,654	9	9	6	3	0
		Enterprises																
386 HK	Sinopec	Energy	51,244	71,525	CNY	70,718	69,105	67,491	65,878	79,004	77,160	75,315	73,471	40	38	35	32	29
1313 HK	CR Cement	Materials	3,617	8,085	HKD	8,190	8,040	7,889	7,738	8,302	8,152	8,001	7,850	124	126	122	118	114
3800 HK	GCL-Poly	Semiconductors	1,974	2,195	CNY	2,195	2,162	2,129	2,095	2,387	2,351	2,315	2,279	11	11	9	8	6
1071 HK	Huadian	Utilities	436	3,570	CNY	3,570	3,520	3,471	3,421	3,307	3,261	3,215	3,169	719	719	708	696	685
		Power																
3 HK	HKCG	Utilities	8,225	8,396	HKD	8,396	8,285	8,174	8,063	8,678	8,563	8,449	8,334	2	2	1	(1)	(2)
902 HK	Huaneng	Utilities	1,580	5,435	CNY	5,435	5,365	5,295	5,225	6,868	6,780	6,691	6,603	244	244	240	235	231
		Power																
579 HK	Jingneng	Utilities	1,774	1,826	CNY	1,826	1,810	1,793	1,777	1,848	1,831	1,815	1,798	3	3	2	1	0
883 HK	CNOOC	Energy	24,677	57,407	CNY	57,120	56,833	56,546	56,259	57,016	56,730	56,443	56,157	133	131	130	129	128
384 HK	China Gas	Utilities	7,968	9,753	HKD	8,581	8,549	8,518	8,486	10,164	10,127	10,089	10,052	22	8	7	7	7
916 HK	China	Utilities	3,688	4,712	CNY	4,712	4,704	4,696	4,687	5,162	5,153	5,144	5,135	28	28	28	27	27
		Longyuan																
1193 HK	CR Gas	Utilities	3,654	3,986	HKD	3,986	3,980	3,973	3,967	4,408	4,401	4,394	4,387	9	9	9	9	9
1033 HK	SSC	Energy	(10,684)	119	CNY	120	120	120	120	369	369	369	369	101	101	101	101	101
958 HK	HN	Utilities	3,011	3,623	CNY	3,623	3,623	3,623	3,623	4,050	4,050	4,050	4,050	20	20	20	20	20
		Renewables																
2386 HK	SEG	Capital Goods	1,130	2,348	CNY	2,472	2,720	2,968	3,216	3,245	3,485	3,726	3,966	108	119	141	163	185
196 HK	Honghua	Energy	(1,239)	53	CNY	56	62	67	73	249	271	293	315	104	105	105	105	106
1623 HK	Hilong	Energy	119	129	CNY	136	152	168	184	154	170	185	200	8	15	28	41	55
2883 HK	COSL	Energy	33	512	CNY	559	653	747	841	849	1,032	1,214	1,396	1,447	1,590	1,874	2,159	2,443

Note: BAIC-Benz, a joint venture of Beijing Automotive, has a total COGS of 40% for imported parts settled in euros. For BAIC, the scenario assumes that the exchange rate of the US dollar against the euro remains unchanged; for semiconductors companies, both SMIC and Hua Hong are reported in USD.

Source: Huatai HK Research estimates

Fig.7. Sensitivity analysis of 10% depreciation of RMB on 2017 earnings

	Pre-tax income chg (RMBmn)	Pre-tax income (RMBmn)	Impact on pre-tax income in RMB (%)	Impact on pre-tax income in HKD (%)
Insurance				
NCL	305	7,330	4.2	(5.8)
PICC Group	856	30,831	2.8	(7.2)
PICC P&C	400	27,161	1.5	(8.5)
CPIC	366	21,102	1.7	(8.3)
China Life	308	41,671	0.7	(9.3)
Ping An	(2,564)	134,740	(1.9)	(11.9)
Bank				
BoCom	9,864	83,265	11.8	1.8
PSBC	2,327	51,111	4.6	(5.4)
BOC	5,360	222,903	2.4	(7.6)
CITIC	1,164	52,276	2.2	(7.8)
Minsheng	951	60,562	1.6	(8.4)
ABC	2,188	239,478	0.9	(9.1)
BoCQ	30	4,895	0.6	(9.4)
CEB	141	40,646	0.3	(9.7)
CQRCB	(48)	11,960	(0.4)	(10.4)
ICBC	(230)	364,641	(0.1)	(10.1)
CMB	(193)	90,680	(0.2)	(10.2)
Huishang	(902)	9,613	(9.4)	(19.4)

Note: As of 2017; assuming HKD/USD remains stable

Source: FactSet, Huatai HK Research estimates

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