Wrestling of the Power

In 1H2018, southbound inflow actively deployed HK stocks. However, amid the 10-year U.S. Treasury bond yield appreciation, strengthening USD, and Sino-US trade war and other factors, HK stocks hovered around 29,000-32,000 level most of the time. We believe (1) Sino-US trade war, (2) continued strength of USD under US interest rate hikes, (3) European Central Bank's downsizing of QE may drag down the market, but considering (4) US tax reform and (5) China's robust economic growth will benefiting corporate earnings, **we believe HK stocks will range-bound (around 27,000-31,000 points) for most of the time in 2H18.**

Source: Sina Tech

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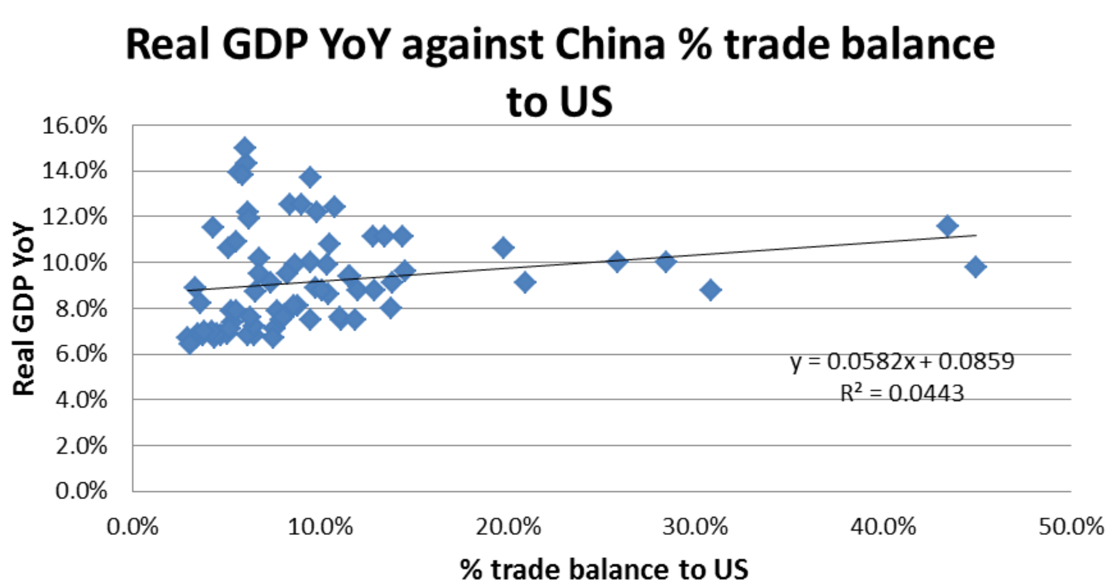
1. Sino-US trade war - negative

US officially announced the imposition of a punitive tariff list of USD50bn on Chinese imports. We believe that the trade war is not conducive to investment sentiment, but we expect the long-term impact on economy will be limited. It is expected that shipping, logistics, ports and aviation stocks will be mostly affected by Sino-US trade war, including OOIL (316.HK), Sinotrans (598.HK), Kerry Logistics (636.HK) and Cathay Pacific (293.HK). Some auto parts stocks such as Minth (425.HK) and Fuyao Glass (3606.HK) may also suffer, of which the former 16% of operating profit come from North American. The tariff list will help reinforce Trump's bargaining power at the time of negotiation.

However, it covers a large number of consumer goods and intermediate goods, including integrated circuit board processors, chips, and manufacturing equipment, since some of these products are produced by US companies in China, tariffs result in just little deterrent effect. Considering that US currently creates too many enemies and its tariff targets are spread throughout the European Union, Japan, Canada, Mexico and other countries, if multiple countries form an alliance to boycott the United States, it may cause a major blow to the United States. Trump should be able to stop the intended trade sanctions at the right time when attacking his 'trade opponents', we believe. Therefore, **trade war will not have a significant long-term impact on stock market**. A 25% tariff is levied on USD50 bn of Chinese products, which is equivalent to 0.4% of China's GDP (0.25% of the US), or 0.2% of China's total exports (3.2% of the US). For the time being, unless the trade war has seriously undermined business confidence, the direct macroeconomic impact of tariffs on China is limited.

In addition, we use regression analysis to find that the correlation coefficient between China's GDP growth and % trade balance to US is nearly zero, and there is no statistically significant positive relationship, confirming our view that the long-term impact of the Sino-US trade war on China's economic growth should be limited.

Figure 1. Relationship between China real GDP growth and % trade balance to US



Source: Bloomberg, CASH

2. US tax reform - positive

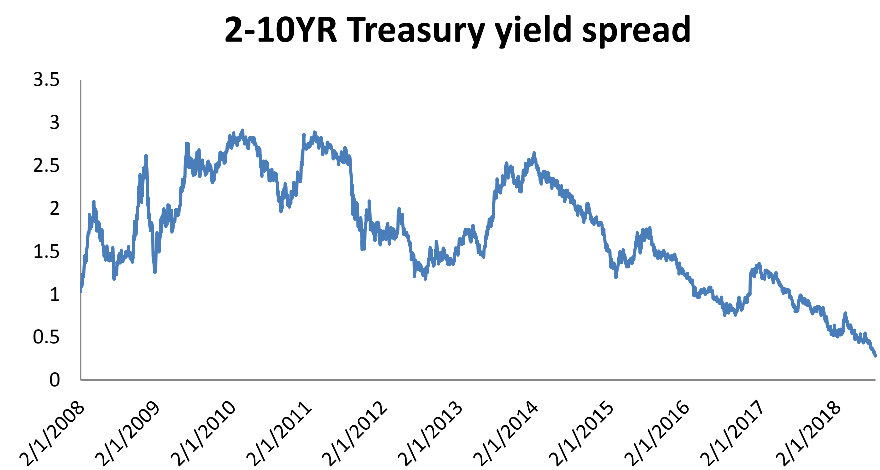
Tax reform stimulates earnings: We reiterate that the U.S. tax will be the main driving force for corporate earnings growth in 2018. Market focuses on that corporate tax will be substantially reduced from the current 35% to 21%, which greatly improves the post-tax profits of some traditional industries, including the financials, manufacturing, and retail consumer industries.

3. U.S. rate hike cycle - negative

Economic growth supports interest rate hikes: After the new Fed chairman Powell succeeded Yellen in February, we do not expect major changes in monetary policy next year. Even if the US economy is performing well and inflation has reached the target level, considering that the authority has described the inflation target "symmetrically" around 2% twice in the policy statement, it means that even if inflation rises slightly above the target level, it will not raise interest rate aggressively. We expect the Fed will continue to raise interest rates slowly (it is currently expected to raise interest rates four times this year), and we think the market should not be over-concerned about the fund outflow in emerging markets due to its gradual rate hike pace.

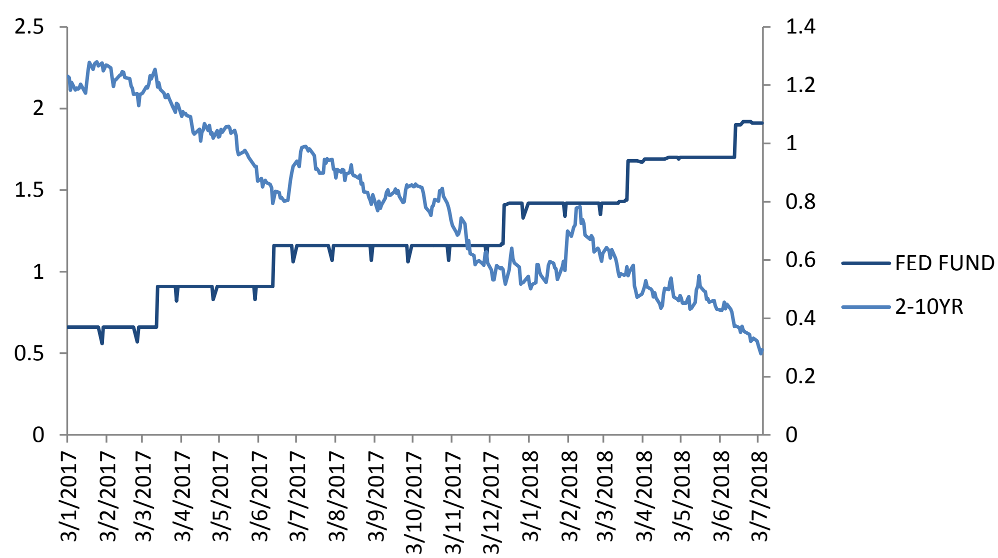
The economy has yet to turn around: One of the hidden risk of interest rate hike is inverted yield curve. In the past 10 years, the long-term and short term interest rate spread has narrowed and is trending to be flattened. The inverted yield curve has successfully predicted the economic recession several times. The spread between the 2-year and 10-year Treasury bond yields fell from 1.3% at the end of December 2016 to about 0.3% at present. Using sensitivity analysis, we expect that the spread will become zero after two interest rate hikes. The timing between the emergence of the inverted yield curve and the peak of the stock market was different, typically two years. We believe the possibility of a recession this year is extremely low.

Figure 2. Yield spread continues to be narrowed



Source: Bloomberg, CASH

Figure 3. Fed fund rate and yield rate spread



Source: Bloomberg, CASH

4. European Central Bank cuts its debt purchase – negative

The ECB's monetary policy is slowly tightening: The current EU inflation rate is close to ECB's target level, and ECB's debt purchase scale in the last three months of this year will be reduced from EUR30bn/month to EUR15bn/month. By the end of this year, ECB will end its debt purchase plan and it stated that the interest rate will remain unchanged at least until next summer. We think the overall tone will be dovish, and the trimming down of balance sheet will have little effect on the market.

5. Steadily growing China economy- positive

Strong PMI data supported with consumption upgrades: Despite reduced credit, shrinking fiscal expenditures, limited PPP projects, and tightening of local financing pipelines due to debt risk, manufacturing activity remained strong with robust domestic and export demand remained robust. China's official manufacturing PMI is still at an expansion level of around 51, which has been higher than 50 threshold level for 23 consecutive months. At the same time, consumer spending in 2017 has contributed nearly 60% to economic growth. With the rapid growth of residents' disposable income, health care, education, culture and entertainment, and high value-added products can benefit from consumption upgrades.

Loosening monetary policy to stabilize the economy: In May, the scale of total social financing has increased by RMB 760.8 billion, which was the lowest level in 22 months, reflecting the negative impact of deleveraging and stronger supervision that began to surface, the sharp fall in off-balance-sheet financing may weigh on the real economy. With the lingering concerns over Sino-US trade and the increase in external instability, we believe that the PBOC will continue to lower its RRR to stabilize the economy.

Figure 4. China official manufacturing PMI with sub-indicators

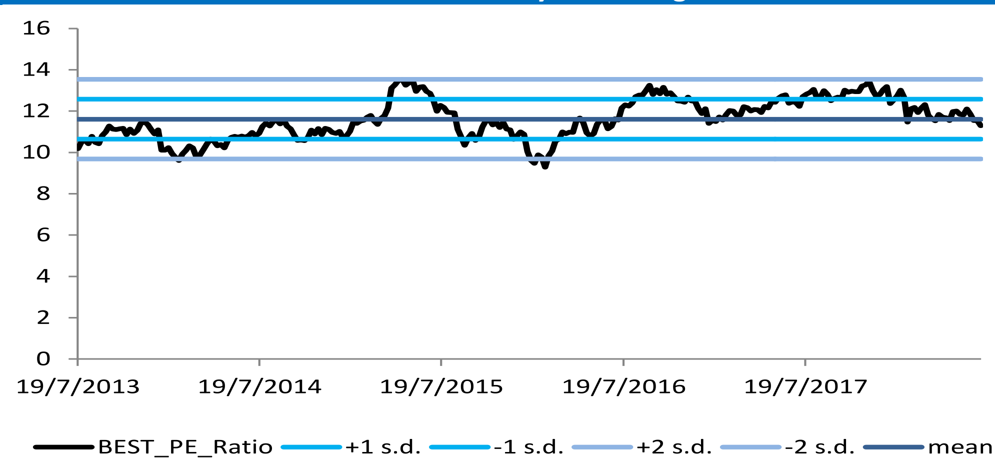
	6/30/18	5/31/18	4/30/18	3/31/18	2/28/18	1/31/18
China Manufacturing PMI	51.5	51.9	51.4	51.5	50.3	51.3
New Orders PMI	53.2	53.8	52.9	53.3	51	52.6
Employment PMI	49	49.1	49	49.1	48.1	48.3
New Export Orders PMI	49.8	51.2	50.7	51.3	49	49.5
Output PMI	53.6	54.1	53.1	53.1	50.7	53.5
Input Prices PMI	57.7	56.7	53	53.4	53.4	59.7
Imports PMI	50	50.9	50.2	51.3	49.8	50.4
Backlogs of Orders PMI	45.5	45.9	46.2	46	44.9	45.3
Production and Business Activities Expectati	57.9	58.7	58.4	58.7	58.2	56.8
Purchasing of Inputs PMI	52.8	53	52.6	53	50.8	52.9
Inventories of Raw Materials PMI	48.8	49.6	49.5	49.6	49.3	48.8
Stocks of Finished Goods PMI	46.3	46.1	47.2	47.3	46.7	47
Suppliers' Delivery Time PMI	50.2	50.1	50.2	50.1	48.4	49.2

Source: Bloomberg, CASH

6. Attractive valuation with southbound capital inflows reducing - neutral

According to Bloomberg, the PE ratio of the HSI is now around 11.6X, which is slightly lower than the 10-year average of 12.1X, reflecting the undemanding valuation. However, compared with the mainland A-share market (the SSE's PE ratio is now 10.9), HSI valuation is still high, reducing the desire of southbound inflow to Hong Kong stocks. In view of the attractiveness of A share valuations, we will recommend Shenzhen-listed Hikvision (002415.SZ) for long-term investment in 2H18.

Figure 5. HK Stock's PE is still lower than 10 year average



Source: Bloomberg, CASH

Our HSI target 31,000 in 2018: Our base case target of HSI is 31,000 in 2018, reflecting a PE of 12.1X which is the 10-year average. If corporate earnings growth is better than market expectations, HSI's bull case target will be 33,200, reflecting a PE of 13X PE; On the contrary, if the USD continues to be strong, causing huge amount of funds to flow out of emerging markets rapidly (which can be reflected in the large-scale devaluation of the Renminbi), coupled with the worsening of Sino-US trade tension, HSI may fall back to our bear case around 27,000, reflecting a PE of 10.6X.

Worst-case scenario: In the past decade, there had been great slumps in the market for 3 times, in 2008, 2011, 2016 respectively. Among those three slumps, the market reached the bottom when the PB ratio dropped until 1X-1.1X. Currently, the HSI's price-to-book ratio is 1.23X. In any case that the market counters another financial crisis, the stock market will plummet again. It is expected that the 1-1.1x PB ratio implies that the Hang Seng Index may also bottom out at 23,260-25,586. .

In 2018, investors can pay attention to artificial intelligence, gaming and healthcare sectors. Our recommended shares include Hikvision (002415.SZ), Sunny (2382.HK), CSPC Pharma (1093.HK), Galaxy (27.HK) and Sands (1928.HK).

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AI Sector – Machine vision

Machine vision is one of the key focus of AI: Machine vision is the technology and methods used to provide imaging-based automatic inspection and analysis for such applications as process control, and robot guidance, usually in industry.

Surveillance market growth: The IP-based video surveillance is expected to grow at a CAGR of around 13.5% during 2017-2020. We believe the strong growth in IP based cameras is due to (1) enhanced image quality, (2) high scalability with easy installation, (3) remote accessibility, (4) video analytics supported with cloud storage and other cloud-related service for centralized data to fit 'smart city' and 'smart home' development.

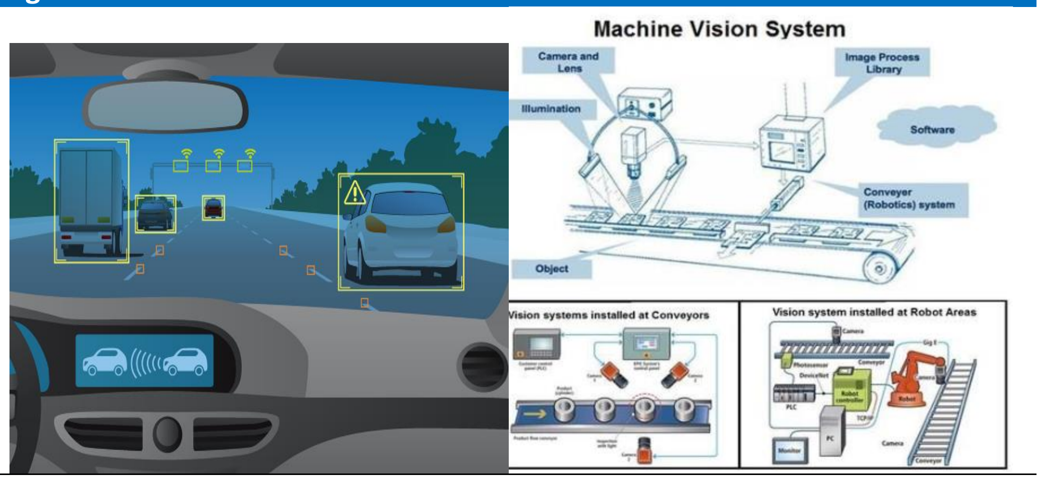
Expanding video analytics market: Tractica forecasts that the overall video analytics market will increase from USD858mn in 2015 to nearly USD3.0bn in 2022, at a compound annual growth rate (CAGR) of 19.6%. These systems may use smart cameras with onboard vision processing or specialized server-based software platforms, which are increasingly being aided by deep learning algorithms to help interpret and analyze meaning within a multitude of video content.

Supportive China policy: We think that China wishes to capture a leading manufacturing positon of Industry 4.0 with the use of industrial internet, artificial Intelligence, machine learning, robotics, sensing, and data collection. We expect that will create demand for industrial camera supported with video analytics (machine vision) which helps to monitor production process or robots (machine arms) which facilitate automation, save labor costs and boost efficiency (accuracy + processing speed). Other applications, including self-driving cars embrace bright future too.

Eye on Hikvision and Sunny: We believe tremendous amount of big data can be captured in surveillance camera market for deep learning and create the machine vision. Inside HK and China stock coverage, we have high conviction that the global No.1 surveillance product provider, **Hikvision (002415.SZ)** will benefit with its AI cameras and machine vision products (robots, industrial cameras and drones). We also believe top lens supplier **Sunny Optical (2382.HK)** will continue to have upside earning revisions and re-rate from the current PE given its long-term growth on dual-cams/triple cams, 3D sensing ability, strengthened capabilities in vehicles lens, and penetration into vehicles modules market.

Machine vision (MV) is the technology and methods used to provide imaging-based automatic inspection and analysis for such applications as process control, and robot guidance, usually in industry. A large number of technologies, software and hardware products, integrated systems, actions, methods and expertise work together. A machine vision camera captures image data and sends it uncompressed to the PC. And network cameras or IP (Internet Protocol) camera can record video and compress it and they are widely used in surveillance. AI's applicability in machine vision relies on machine learning, in particular deep learning and we expect machine vision application will become more popular. According to IHS, in five years, for instance, it is possible that an end user could simply ask Siri to check their home surveillance system's facial recognition log and report back with information on whether or not the user's children have arrived home from school.

Figure 6. Machine Vision



Source: AIA | Vision, IndiaMART

We believe tremendous amount of big data can be captured in surveillance camera market for deep learning and create the machine vision. Inside HK and China stock coverage, we have high conviction that the global No.1 surveillance product provider, Hikvision (002415.SZ) will benefit with its AI cameras and machine vision products (robots, industrial cameras and drones).

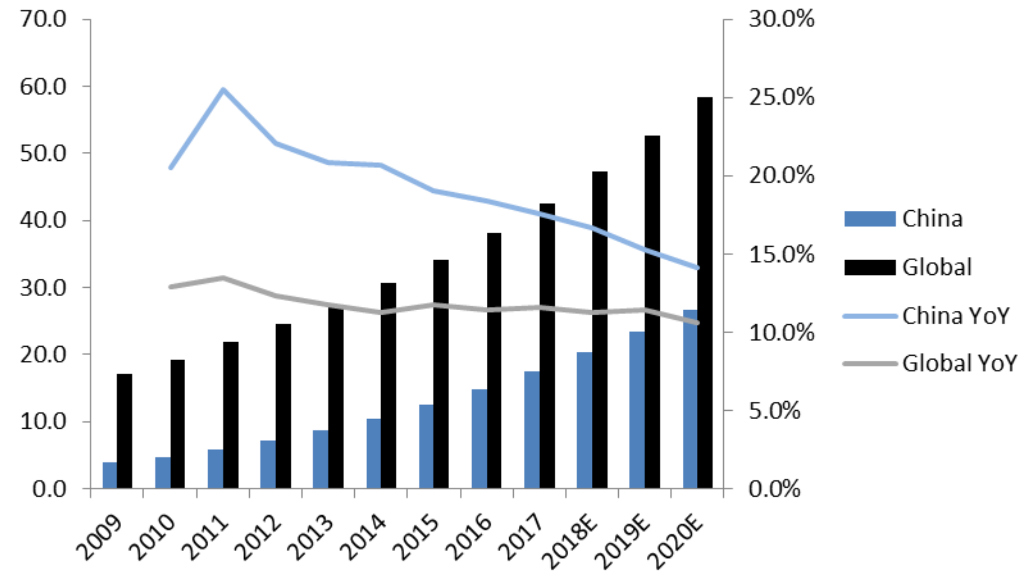
For instance, its AI system can compare facial photos to 1) people with criminal records in public security systems plus 2) other facial photos captured in other locations. These help police identify who the suspect is and where the suspect went after committing a crime within a short period of time. Per our understanding, it usually takes about 30 days and 1,500 police to search around 10 days of video from >10,000 cameras, but AI systems need just several minutes to complete. **We also believe top lens supplier Sunny Optical (2382.HK) will continue to have upside earning revisions and re-rate from the current PE given its long-term growth on dual-cams/triple cams, 3D sensing ability, strengthened capabilities in vehicles lens, and penetration into vehicles modules market.**

The surveillance market

The global video surveillance market was valued at USD42.5bn in 2017 according to statista and our estimation and is expected to reach USD58.3bn by 2020, at a CAGR of 11.1%. Asia Pacific especially India and China will be the fastest-growing region in the video surveillance market because of heavy capex in building new and improving the existing infrastructure, and also rising security concerns. China video surveillance market will grow at a CAGR of 15.4% during 2017-2020 according to statista and our estimation.

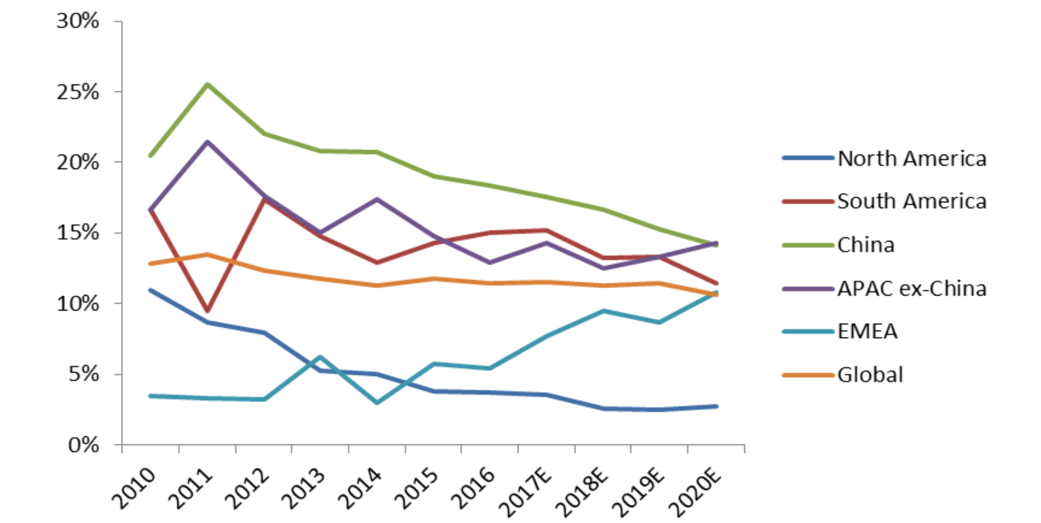
On the other hand, **we see the shifting preference from analog to IP systems.** The IP-based video surveillance is expected to grow at a CAGR of around 13.5% during 2017-2020. We believe the strong growth in IP based cameras is due to (1) enhanced image quality, (2) high scalability with easy installation, (3) remote accessibility, (4) video analytics supported with cloud storage and other cloud-related service for centralized data to fit 'smart city' and 'smart home' development.

Figure 7. Global/China video surveillance market from 2009 to 2019 (in bn USD)



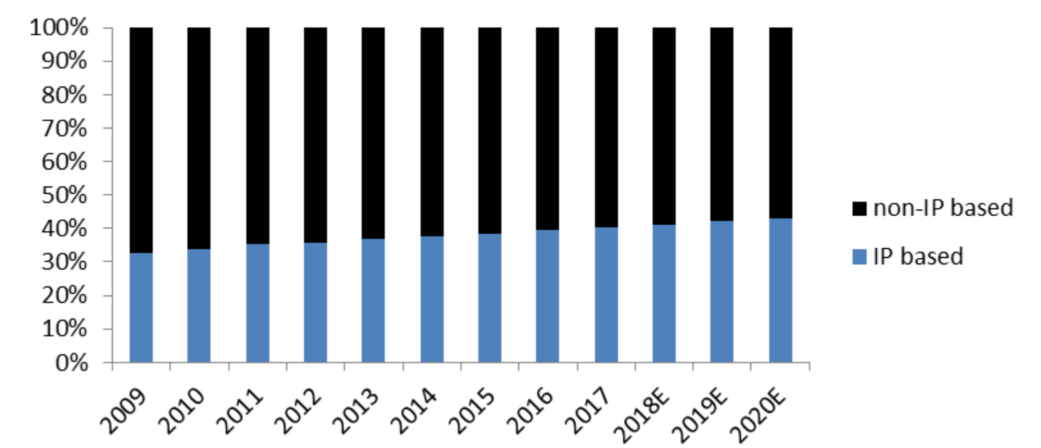
Source: Statista, CASH

Figure 8. APAC is leading the growth….



Source: Statista, CASH

Figure 9. Global shifting preference from analog to IP systems



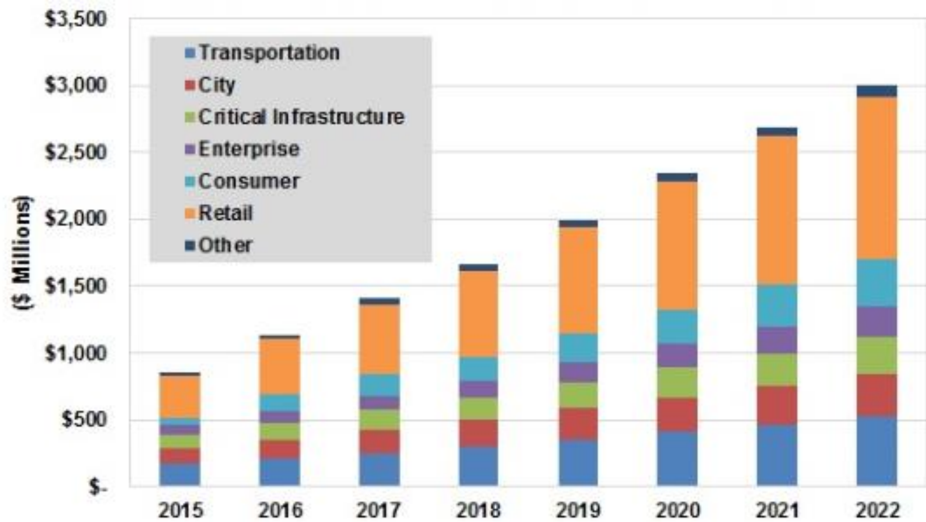
Source: Statista, CASH

Expanding video analytics market

Video analytics systems, which extract useful information from video content, are gaining more attention in wide range of application including retail, transportation, consumer, cities, critical infrastructure, and enterprise, according to Tractica. These systems may use smart cameras with onboard vision processing or specialized server-based software platforms, which are increasingly being aided by deep learning algorithms to help interpret and analyze meaning within a multitude of video content.

Tractica forecasts that the overall video analytics market will increase from USD858mn in 2015 to nearly USD3.0bn in 2022, at a compound annual growth rate (CAGR) of 19.6%. The top two application markets, retail and transportation are expected to continue to be the largest markets over the next several years

Figure 10. Video analytics systems

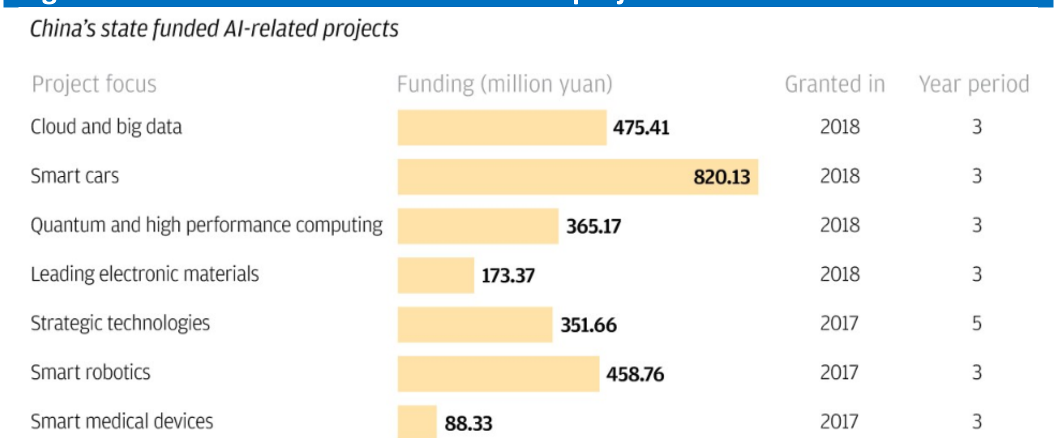


Source: Tractica, CASH

Supportive China policy

The Chinese government's “Made in China 2025” plan forms part of a three-stage blueprint to boost the country's manufacturing competitiveness. The plan states 10 strategic industries within the manufacturing sector: aerospace equipment, robotics, maritime engineering, new energy vehicles, electrical power equipment, new materials, rail transportation, agricultural equipment, medical devices and information technology. We think that China wishes to capture a leading manufacturing positon of Industry 4.0 with the use of industrial internet, artificial Intelligence, machine learning, robotics, sensing, and data collection. We expect that will create demand for industrial camera supported with video analytics (machine vision) which helps to monitor production process or robots (machine arms) which facilitate automation, save labor costs and boost efficiency (accuracy + processing speed). Other applications, including self-driving cars embrace bright future too.

Figure 11. China’s state funded AI-related projects



Source: National Science and Technology Information System, SCMP, CASH

Figure 12. Valuation and financial ratios of AI and big data related stocks

	Stock Code	Price ($LC)	TP	%upside	18EPS YoY	19EPS YoY	18PE	19PE	18ROE	19ROE	18PB	19PB
Google	GOOGL US Equity	1141.29	NA	NA	19.35	11.03	22.24	20.03	17.72	16.66	4.36	3.62
Facebook	FB US Equity	198.45	NA	NA	22.67	21.17	23.20	19.15	25.01	24.51	6.26	4.82
Amazon	AMZN US Equity	1699.73	NA	NA	106.84	37.10	81.29	59.29	16.26	19.42	21.21	15.18
Microsoft	MSFT US Equity	99.76	NA	NA	24.74	5.65	25.97	24.58	34.93	35.37	9.31	7.94
IBM	IBM US Equity	141.43	NA	NA	0.20	2.05	10.23	10.02	62.41	55.56	6.17	5.20
Twitter	TWTR US Equity	45.06	NA	NA	59.32	21.97	64.28	52.70	9.70	13.10	5.96	5.13
Baidu	BIDU US Equity	244.07	NA	NA	-0.62	18.68	25.61	21.58	15.98	16.24	3.89	3.30
Alibaba	BABA US Equity	186.88	NA	NA	25.87	28.83	30.02	23.31	19.19	21.11	6.74	5.40
Tencent	700 HK Equity	386.60	NA	NA	29.47	32.65	36.54	27.55	28.28	28.24	9.18	7.13
Hikvision	**002415 CH Equity**	**32.50**	**45.85**	**41.1%**	**28.93**	**30.50**	**24.47**	**18.75**	**35.06**	**35.54**	**7.82**	**6.12**
Average					31.68	20.96	34.38	27.70	26.45	26.58	8.09	6.38
Median					25.31	21.57	25.79	22.44	22.10	22.81	6.50	5.30

Source: Bloomberg , CASH

Figure 13. Valuation and financial ratios of handsets related stocks

	Stock Code	Price ($LC)	TP	%upside	18 EPS YoY	19 EPS YoY	18PE	19PE	18ROE	19ROE	18PB	19PB
SUNNY OPTICAL	**2382 HK Equity**	**142.00**	**200.00**	**41.0%**	**39.08**	**38.09**	**32.41**	**23.47**	**43.85**	**42.77**	**12.17**	**8.67**
COWELL	1415 HK Equity	1.58	NA	NA	3.03	8.82	5.92	5.44	7.71	7.49	0.47	0.44
TRULY INTL HLDGS	732 HK Equity	1.39	NA	NA	792.02	55.79	7.32	4.70	8.43	13.60	0.55	0.52
Q TECHNOLOGY G	1478 HK Equity	4.90	NA	NA	-23.37	37.05	13.60	9.93	15.00	17.47	1.88	1.60
O-FILM TECH CO-A	002456 CH Equity	15.73	NA	NA	102.63	40.78	20.43	14.51	19.47	22.00	3.86	3.14
ZHEJIANG CRYST-A	002273 CH Equity	11.74	NA	NA	51.19	23.73	18.69	15.11	14.00	14.90	2.58	2.23
LITE-ON TECH	2301 TT Equity	35.80	NA	NA	212.04	9.05	10.15	9.31	11.51	11.05	1.06	1.08
LG INNOTEK CO LT	011070 KS Equity	156000.00	NA	NA	-7.74	86.59	22.90	12.27	7.95	13.30	1.74	1.52
SAMSUNG ELECTR	009150 KS Equity	148500.00	NA	NA	231.33	34.46	20.70	15.39	12.18	14.28	2.40	2.11
LARGAN PRECISIO	3008 TT Equity	4605.00	NA	NA	-0.66	26.64	23.94	18.90	26.18	27.65	5.62	4.77
GENIUS ELEC	3406 TT Equity	460.00	NA	NA	29.62	NA	33.80	NA	NA	NA	NA	NA
AAC TECHNOLOGI	2018 HK Equity	105.90	NA	NA	19.06	24.35	17.31	13.92	31.58	31.39	4.98	4.00
Median					51.19	37.05	18.69	12.27	12.18	14.28	1.88	1.60
Average					155.58	37.15	16.90	12.24	15.57	17.43	2.97	2.37

Source: Bloomberg , CASH

Hikvision (002415.SZ, Buy, RMB45.85)

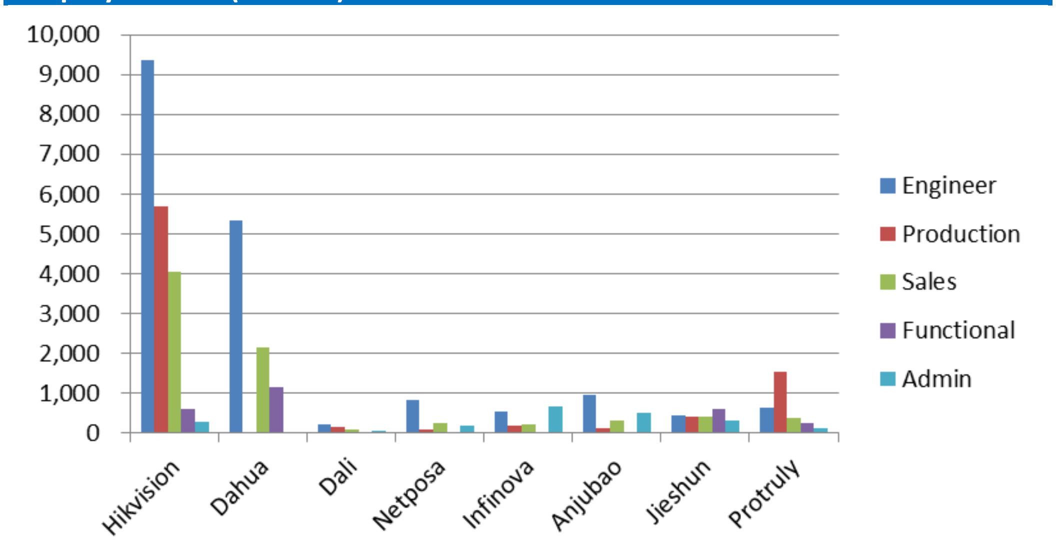
AI and surveillance

Investment thesis

1. Sales force and distribution network

Strong sales force which helps understand customers'need: As of end 2017, Hikvision had 26,330 employees in total, and 4,999 (19%) of these were from sales. Over the past ten years, Hikvision grew its sales force from 707 in 2009 to 4,999 in 2017 (28% CAGR). We think the trend will go on with Hikvison's global expansion. As of May 2018, there are 665 cities in China, Hikvision has over 7 sales people for every city. Hikvision's in-house sales force is significantly larger than that of Dahua, which ranked 2nd in China surveillance market (3rd in global according to A&S, 2nd position belongs to German company called Bosch Security Systems). This can help to **increase users' stickiness given its better understanding to customers' demand**.

Figure 14. Hikvision significantly higher vs domestic competitors in terms of employee scale (in 2016)

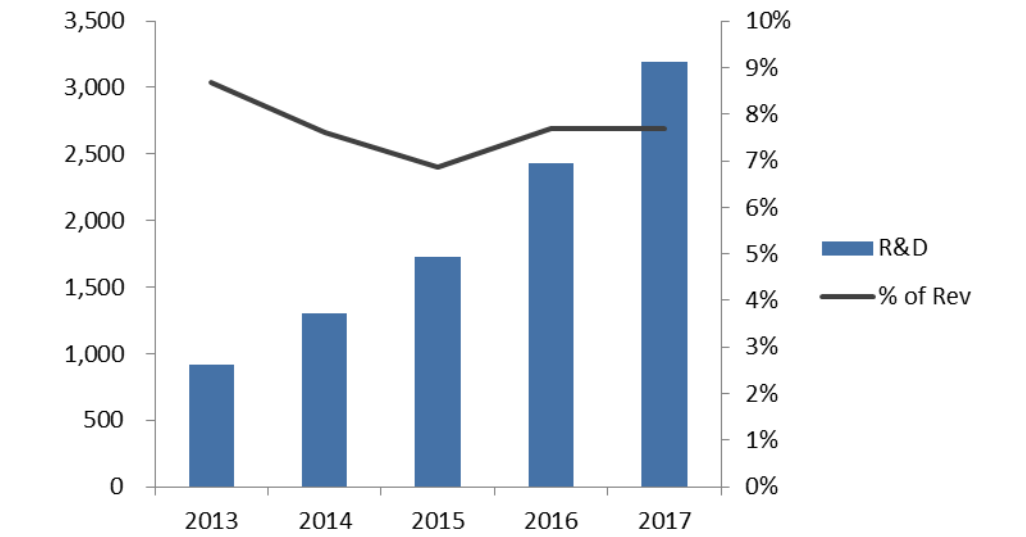


Source: Jetro Data, CASH

2. Large R&D scale

High R&D spending to support innovation: Hikvision consistently allocates 7%-8% of its revenue to technology upgrade for the over the past 4 years. Hikvision's dedication and investment in technology has created a high entry barrier for any new entrants and small players, helping the Company capture the first- mover advantage for its products. With its comprehensive product portfolio (front-end + back-end to control center equipment and software), Hikvision has achieved R&D synergy across different business segments, and also across industries.

Figure 15. R&D expenses (in RMB mn) and the percentage of revenue



Source: Company data, CASH

3. Low SG&A demonstrates economies of scale and automation

Hikvision has a below industry average SG&A to revenue ratio due to economies of scale and automation (Hikvision: 12.8%, Dahua: 15.3%). Hikvision currently has 3 manufacturing bases in Hangzhou, Tonglu and Chongqing, and has a large-scale production expansion plan in Wuhan, Tonglu and Chongqing. The Company has gradually launched more than 800 intelligent warehouse robots at the Tonglu Production Base which has an output value of more than RMB100mn, and comprehensively implemented the warehousing and internal logistics automation, reducing the labor cost by approximately 58% and improving efficiency by nearly 84%.

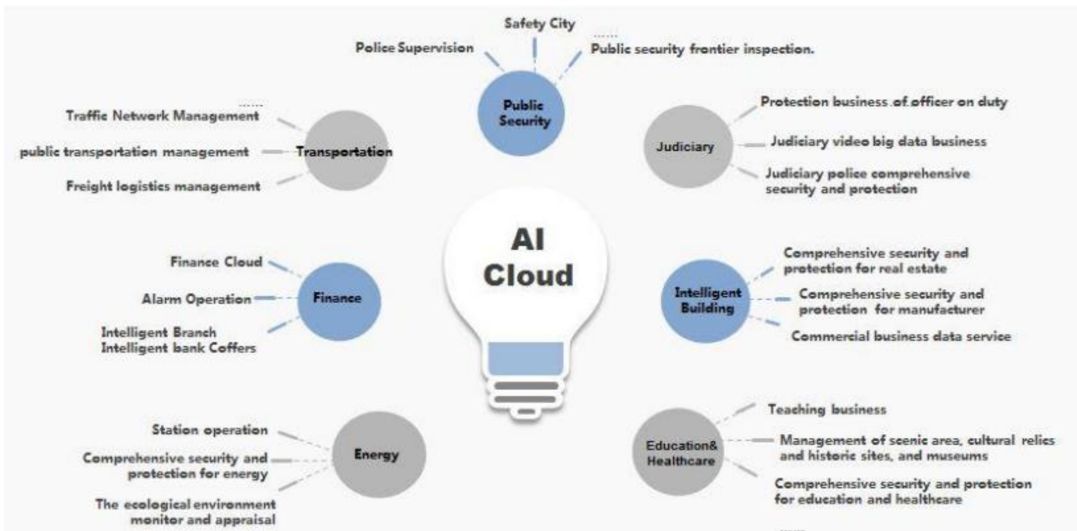
4. High pricing power with suppliers and customers

Hikvision was the largest global surveillance provider in 2017, and paid its top five suppliers a total of RMB7.16bn (~30% of total purchases) and its top one supplier RMB3.8bn last year (around 16% of total purchases). On the other hand, the top five customers accounted for a total of RMB2.2bn (~5.3% of total sales) and its top one supplier RMB0.8bn last year (~2% of total sales). We think this helps strengthen Hikvision's bargaining power on negotiation a favorable pricing with its suppliers and customers. Per our understanding, Hikvision sometimes books the entire capacity of certain supplier for the next six to twelve months, and that Hikvision can continue to lead the other peers.

5. Strong database

Hikvision has started to introduce AI surveillance products into the market since 2015. With access to numerous data sets from its huge and wide customer base (covering public security, transportation, civil, judicial, financial, energy, and building) needed to train the machine, the Company has a strong competitive edge compared with peers. For example, we see potential demand in brick-and-mortar retail stores, who may need data on customer age profile and peak visiting hours to enhance sales efficiency.

Figure 16. Hikvision's AI Cloud industry coverage



Source: Company data, CASH

6. Supported by SOE to further enhances its pricing power

Hikvision was established in 2001 by the No.52 Research Institute of China Electronics Technology Group Corporation (CETC) (中國電子科技集團公司第五十二研究所), which is under the State-owned Assets Supervision and Administration Commission (SASAC). CETC is mainly involved in the research, development, and production of large-scale electronic information systems, communication and electronic equipment, software and key components for major national military and civilian applications. Hikvision is partially-owned by 2 SOEs (CETC and the 52nd Research Institute at China Electronics Technology Group Corporation).

Figure 17. Hikvision's shareholdings in 2017

Shareholders	% of shares
The 52nd Research Institute	1.96%
CETC	39.59%
Gong Hongjia	15.01%
Xinjiang Weixun Investment	5.74%
Xinjiang Pukang Investment	2.08%
Public investors	35.62%
Total	100%

Source: Company data, CASH

Hikvision's second customer is the No.52 Research Institute under CETC. Leveraging its SOE background and relationship with the public sector (i.e. public security, transportation, judicial, etc.), we expect Hikvision is positioned well to provide surveillance solutions in a large lot, including catching alleged suspects more efficiently, monitoring drivers using phones or pedestrians running a red light). Its products have been adopted by Nanchang City's SkyNet project, effectively improving the accuracy and speed of identifying potential suspects. We think Hikvision has a strong pricing power given its expertise in solution business as these government-related projects focus more on technology and delivery rather than pricing.

Figure 18. AI Cloud pilot project for Skynet public security project

Source: Hikvision, CASH

7. Hardware-software integrated solution

Most mobile robots (AGV, drone, industrial cameras, autonomous vehicle, etc) (which are classified as hardware) use the same key machine vision algorithm (software), which enables the extraction of depth information, navigation and obstacle avoidance. Sensors are the foundation from which information is collected and then fed into the algorithm. For instance, programming makes up at least 40% of the total integration cost inside industrial robots. We believe this is similar to Hikvision's existing business model in surveillance - customized solution and integration of the platform is the key for customer acquisition, rather than product based (separate hardware or software) which has a lower GPM.

Valuation

Retain Buy with target price up to HKD45.85: Given Hikvision's leading edge in big data, we compare it to Global AI big data plays and find that it is inexpensive. ***We reiterate 'Buy' with TP RMB45.85 based on 2019 P/E target of 27x and 2018-2020E EPS CAGR growth of 26%, implying a 41% upside.*** We like Hikvision due to (1) robust growth of smart surveillance industry, (2) bright future of machine vision during AI/IoT/Industry 4.0 era, (3) riding along the growth of edge computing (4) strong scale advantage and (5) attractive valuation.

Hikvision

002415.SZ, Buy, TargetPrice: 45.85

Income Statement (million RMB$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Revenue	31,935	41,905	54,962	70,511	88,250
Cost of goods sold	-18,908	-23,838	-31,150	-38,891	-47,893
Gross profit	13,027	18,067	23,812	31,619	40,357
SG&A	-6,101	-8,636	-11,491	-15,452	-20,237
R&D	-2,433	-3,194	-3,978	-5,038	-6,232
Operating profit	6,926	9,432	12,321	16,167	20,119
EBITDA	7,167	9,773	12,752	16,720	20,811
Depreciation	-212	-302	-380	-488	-611
Amortization	-29	-39	-51	-65	-81
EBIT	6,926	9,432	12,321	16,167	20,119
Net interest expense	41	126	86	151	161
Associates & JCEs	0	-3	-3	-3	-3
Other income/other adj	1,347	932	932	932	932
Earnings before tax	8,314	10,487	13,337	17,248	21,210
Income tax	-890	-1,109	-1,419	-1,835	-2,257
Net profit After tax	7,424	9,378	11,918	15,413	18,953
Minority interests	-1	33	33	33	33
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	7,423	9,411	11,951	15,446	18,986
Extraordinary items	0	0	0	0	0
Reported NPAT	7,423	9,411	11,951	15,446	18,986
Dividends	-2,931	-3,800	-4,772	-6,202	-7,603
Transfer to reserves	4,492	5,611	7,179	9,244	11,384
EPS	0.94	1.02	1.30	1.68	2.07
DPS	0.37	0.41	0.52	0.67	0.83

Balance Sheet (million RMB$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Cash & equivalents	13,638	16,468	16,561	18,859	22,203
Marketable securities	16	4	4	4	4
Accounts receivable	11,243	14,705	19,319	24,784	31,019
Inventories	3,830	4,940	6,382	7,968	9,812
Other current assets	7,805	8,535	12,314	15,797	19,772
Total current assets	36,532	44,653	54,580	67,413	82,810
LT investments	35	130	130	130	130
Fixed assets	2,854	3,024	4,537	6,478	8,908
Goodwill	249	249	249	249	249
Other intangible assets	410	429	379	314	233
Other LT assets	1,268	3,085	3,085	3,085	3,085
Total assets	41,349	51,571	62,960	77,669	95,415
ST debt	32	97	100	97	97
Accounts payable	7,009	10,040	12,333	15,399	18,963
Other current liabilities	5,092	7,064	8,810	10,999	13,545
Total current liabilities	12,133	17,201	21,243	26,495	32,605
LT debt	1,722	490	625	807	1,026
Convertible debt	0	0	0	0	0
Other LT liabilities	3,014	3,275	3,275	3,275	3,275
Total liabilities	16,870	20,967	25,144	30,577	36,906
Minority interest	193	246	279	312	345
Preferred interest	0	0	0	0	0
Common stock	6,103	9,229	9,229	9,229	9,229
Retained earnings	14,861	16,598	23,777	33,021	44,404
Proposed dividend	-2,931	-3,800	-4,772	-6,202	-7,603
Other equity and reserves	3,322	4,531	4,531	4,531	4,531
Total shareholders' equity	24,479	30,604	37,816	47,092	58,509
Total equity & liabilities	41,348	51,571	62,960	77,669	95,415

Cashflow statement (million RMB$)

Year-end 31 Dec	FY17	FY18E	FY19E	FY20E
Net income	9,411	11,951	15,446	18,986
Depreciation	302	380	488	611
Amortization	39	51	65	81
Change in Net Working Capital	-288	-5,795	-5,280	-5,944
Cashflow from operations	7,373	6,587	10,718	13,734
Capital expenditures	-1,692	-1,894	-2,429	-3,040
Other non current assets	-1,912	0	0	0
Other non current liabilities	261	0	0	0
CF from investing acts	-1,209	-1,894	-2,429	-3,040
CF after investing acts	6,164	4,693	8,289	10,694
Equity issue	4,388	33	33	33
Debt issue	-1,167	138	178	219
Convertible debt issue	0	0	0	0
Dividends	-3,800	-4,772	-6,202	-7,603
CF from financial acts	-3,402	-4,601	-5,991	-7,350
Net cashflow	2,763	93	2,298	3,344
Beginning cash	13,638	16,468	16,561	18,859
Adjustments	68	0	0	0
Ending cash	16,469	16,561	18,859	22,203
Ending net debt	-15,881	-15,836	-17,956	-21,080

Source: Company data, CASH

Key Ratios

	FY17	FY18E	FY19E	FY20E
Profitability (%)				
Gross margin	43.1%	43.3%	44.8%	45.7%
EBITDA margin	23.3%	23.2%	23.7%	23.6%
EBIT margin	22.5%	22.4%	22.9%	22.8%
Net Margin	22.4%	21.7%	21.9%	21.5%
Effective tax rate	10.6%	10.6%	10.6%	10.6%
Dividend payout	40.4%	39.9%	40.2%	40.0%
ROE	30.9%	31.7%	32.9%	32.6%
ROA	18.2%	19.0%	19.9%	19.9%
Liquidity (x)				
Current ratio	2.60	2.57	2.54	2.54
Interest coverage	N/A	N/A	N/A	N/A
Leverage				
Net Debt/EBITDA (x)	net cash	net cash	net cash	net cash
Net Debt/Equity (%)	net cash	net cash	net cash	net cash
Activity (days)				
Days receivable	128.1	128.3	128.3	128.3
Days inventory	43.0	42.4	41.2	40.6
Days payable	87.4	81.9	79.7	78.4
Cash cycle	83.7	88.8	89.8	90.4

Source: Company data, CASH

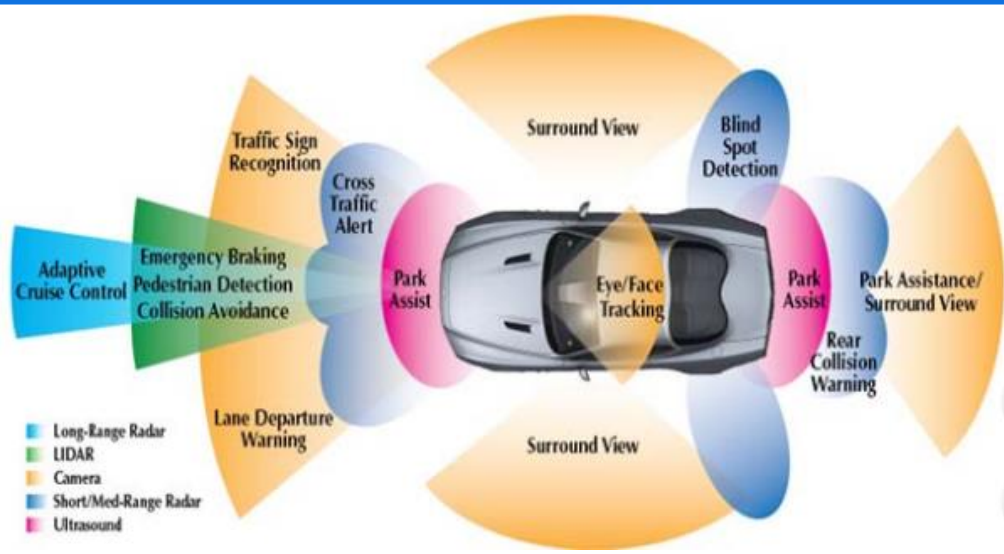
Sunny Optical (2382.HK, Buy, HKD200)

AI and surveillance

Investment thesis

Penetrating into auto camera module market: Management surprised the market by announcing that it would enter the auto camera module market. Rising number of road accidents has resulted in increased regulations by government regarding the safety of both passengers and pedestrians, triggering the CCM demand for lane departure warning, traffic sign recognition, adaptive cruise control, parking assistance, etc. Sunny stated its auto camera module has qualified with a global tier-1 client, setting a milestone for its product development and also strengthening its goodwill among the auto industry. Sunny will penetrate into tier 2 clients and will not compete directly with existing customers, according to management.

Figure 19. A single car may be equipped with 6 cameras (current average: <1)



Source: CASH, WCP

Riding on the trend of smartphone spec upgrade: Management said that Sunny has made solid progress in high-end projects. R&D on handsets lens with 7P has been completed and also ready for a high-end flagship smartphone model. Other customized design **(high-end large aperture**, **ultra-thin**, **20MP**, **VR fresnel)** also commenced mass production. We also think its **Periscope-design** and **triple camera** modules are also ready for clients' high-end models. Trio-cam CCM projects may kick off in 2H (such as Huawei P20 Pro), we believe.

Stronger than expected CCM guidance: Management expects the product mix will continue to improve in 2018. Sunny has guided for its **handset CCM shipment to grow by 15-20% yoy (2017:20-25%)**, despite the high base in 2017. This shipment data would be driven by Huawei's Honor and Xiaomi, MOB/MOC manufacturing process and yield improvement this year, we think. The product mix 10MP+ weight in module from 64.5% in 2017 to >70% in 2018E while the dual cam module weight will be >25% in 2018 (which we think is conservative VS industry average: 30% in 2018E VS 2017:20%). We think this strong guidance can alleviate concerns on recent smartphone shipment weakness. Management expects camera module ASP and gross margin to further improve in 2018.

Robust guidance on Handsets lens/Vehicles lens: For handset lens, **Sunny guided its handset lens shipment to grow 30~35% yoy (2017:45%-50%)**. Percentage of 10MP+ handsets lens will increase from 47.6% in 2017 to >60 in 2018E. However, we think there is uncertainty on its competitor Largan's return after resolving its capacity issues in and also break into Samsung's share for the first time around 2H18E. On the other hand, Sunny's **vehicle lens volumes** continue to outperform the market (up 41% YoY in 2017) and management **expects to increase by 30-35% in 2018 (2017:35%-40%).**

3D sensing progress on track: Sunny is working on its in-house algorithm, VCSEL and collimator lens too (we think it seeks to be a total-solutions provider. Hybrid lens (which is more heat-resistant and better suits 3D sensing) has commenced mass production. Sunny has both "structure light" and "ToF" solutions (but demand could stay low in 2018). Its structure light 3D sensing module has commenced batch production, based on own and third-party algorithm. In the long run, its cooperation with AMS, a leading worldwide supplier of high-performance sensor solutions will further help Sunny's market share expansion in 3D sensing in the future.

R&D progress: Sunny Optical obtained 634 patents. During 2017 alone, 223 patents were added. The upward pace will be faster in 2018, according to management. 7P lens and Hybrid lens are also in mass production (Sunny Optical was the first supplier to provide hybrid lens globally in 2017). VR Fresnel lenses have started mass production.

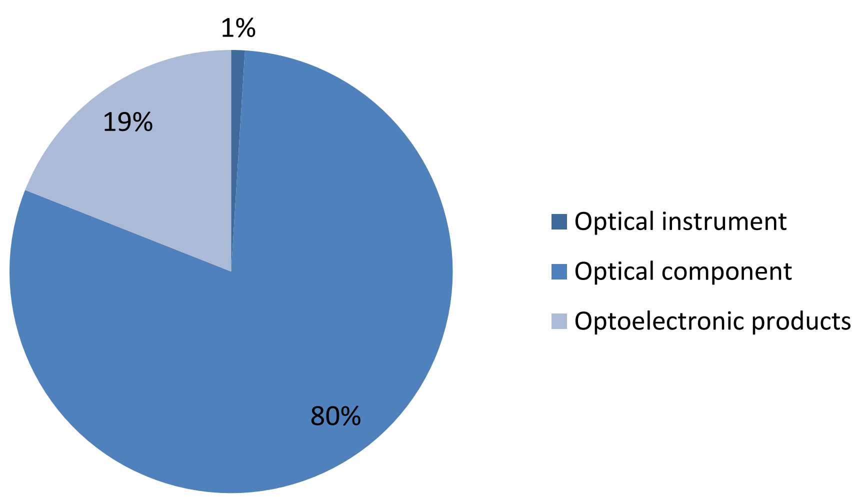
Focus and R&D as long-term core competency: According to management, Sunny has consistently invested in optical area for 30 years and never diverged its expertise. We think R&D will lead to a snowball effect, building a stronger moat with its leading technology difficulties.

Retain Buy with target price up to HKD200: ***<u>We forecast Sunny's 2018 earnings growth will be around 56% based on strong guidance, better than expected results and penetration into new market. We reiterate buy with TP raised to HKD200 from HKD178.7 based on target 2019 PE of 26x, implying a 41% upside.</u>*** We believe Sunny will continue to have upside earning revisions and re-rate from the current PE given its long-term growth on dual-cams/triple-cams, 3D sensing ability, strengthened capabilities in vehicles lens, and penetration into vehicles modules market.

Background

Sunny Optical, which was established in 1984, is a leading supplier of optical-related products in China with strong design and production capabilities (manufacture both lenses (5MP/8MP/13MP/16MP/20MP) and modules (5MP/8MP/13MP/16MP/OIS and 3D). The group is mainly engaged in three business segments: 1) Optical components (Defocus Control lens, handset lens and vehicle lens); 2) Optoelectronic products (handset camera modules); 3) Optical instruments (microscopic instruments and analytical instruments). It has a diversified customer mix, including Huawei, Samsung, Xiaomi, OPPO, Lenovo with 5 production bases in China, as well as R&D centers in China, Singapore, South Korea and the US.

Figure 20. Sunny Optical's revenue exposure in 2017



Source: CASH, Company data

Sunny Optical

2382.HK, Buy, TargetPrice: 200

Income Statement (thousands RMB$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Revenue	14,612	22,366	31,972	43,543	57,484
Cost of goods sold	-11,932	-17,563	-24,622	-32,646	-41,927
Gross profit	2,680	4,803	7,350	10,897	15,556
SG&A	-1,205	-1,420	-2,116	-2,969	-4,000
R&D	-694	-1,168	-1,704	-2,408	-3,294
Other expense	-26	343	343	343	343
Employee share expense	0	0	0	0	0
Operating profit	1,475	3,383	5,235	7,928	11,556
EBITDA	1,792	3,874	5,944	8,895	12,832
Depreciation	-317	-491	-710	-967	-1,276
Amortization	-0	-44	-0	-0	-0
EBIT	1,475	3,383	5,235	7,928	11,556
Net interest expense	-16	-49	-54	-82	-124
Associates & JCEs	-12	-16	-16	-16	-16
Other income	0	0	0	0	0
Earnings before tax	1,447	3,318	5,165	7,830	11,416
Income tax	-175	-404	-615	-932	-1,359
Net profit After tax	1,272	2,914	4,550	6,898	10,057
Minority interests	-3	-13	-13	-13	-13
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	1,269	2,902	4,537	6,885	10,045
Extraordinary items	0	0	0	0	0
Reported NPAT	1,269	2,902	4,537	6,885	10,045
Dividends	-228	-318	-497	-755	-1,101
Transfer to reserves	1,041	2,583	4,040	6,130	8,943
EPS	1.16	2.64	4.14	6.28	9.16
DPS	0.21	0.29	0.45	0.69	1.00

Balance Sheet (thousands RMB$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Cash & equivalents	467	1,227	4,435	9,603	18,154
Marketable securities	2,302	2,114	2,114	2,114	2,114
Accounts receivable	3,716	5,666	8,383	11,417	14,747
Inventories	2,828	2,622	3,538	4,691	7,036
Other current assets	5	7	12	16	20
Total current assets	9,318	11,635	18,482	27,841	42,071
LT investments	177	308	308	308	308
Fixed assets	1,794	2,586	3,876	4,909	5,633
Goodwill	0	0	0	0	0
Other intangible assets	0	392	392	392	392
Other LT assets	348	804	804	804	804
Total assets	11,637	15,726	23,863	34,255	49,209
ST debt	904	1,348	1,667	1,667	1,667
Accounts payable	5,573	6,183	9,400	12,463	16,783
Other current liabilities	181	175	337	446	543
Total current liabilities	6,658	7,705	11,403	14,576	18,992
LT debt	0	0	412	1,513	3,120
Convertible debt	0	0	0	0	0
Other LT liabilities	65	502	502	502	502
Total liabilities	6,723	8,207	12,317	16,591	22,614
Minority interest	18	31	18	6	-7
Preferred interest	0	0	0	0	0
Common stock	105	105	105	105	105
Retained earnings	3,949	6,532	10,572	16,702	25,645
Proposed dividend	-228	-318	-497	-755	-1,101
Other equity and reserves	841	851	851	851	851
Total shareholders' equity	4,913	7,519	11,546	17,664	26,595
Total equity & liabilities	11,637	15,726	23,863	34,255	49,209

Cashflow statement (thousands RMB$)

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Net income	1,269	2,902	4,537	6,885	10,045
Depreciation	317	491	710	967	1,276
Amortization	0	44	0	0	0
Change in Net Working Capital	-323	-954	-259	-1,018	-1,264
Cashflow from operations	1,616	2,436	4,988	6,834	10,057
Capital expenditures	-400	-1,766	-2,000	-2,000	-2,000
Other non current assets	-47	-587	0	0	0
Other non current liabilities	13	437	0	0	0
CF from investing acts	-1,260	-1,686	-2,000	-2,000	-2,000
CF after investing acts	356	750	2,988	4,834	8,057
Equity issue	-167	22	-13	-13	-13
Debt issue	221	444	730	1,101	1,608
Convertible debt issue	0	0	0	0	0
Dividends	-228	-318	-497	-755	-1,101
CF from financial acts	-81	12	220	334	494
Net cashflow	274	762	3,209	5,168	8,551
Beginning cash	187	467	1,227	4,435	9,603
Adjustments	6	-2	0	0	0
Ending cash	467	1,227	4,435	9,603	18,154
Ending net debt	437	121	-2,357	-6,424	-13,367

Source: Company data, CASH

Key Ratios

Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Growth (%)					
EPS	66.7%	128.6%	56.4%	51.7%	45.9%
Revenue	36.6%	53.1%	42.9%	36.2%	32.0%
Profitability (%)					
Gross margin	18.3%	21.5%	23.0%	25.0%	27.1%
EBITDA margin	12.3%	17.3%	18.6%	20.4%	22.3%
EBIT margin	10.1%	15.1%	16.4%	18.2%	20.1%
Net Margin	8.7%	13.0%	14.2%	15.8%	17.5%
Effective tax rate	12.1%	12.2%	11.9%	11.9%	11.9%
Dividend payout	18.0%	11.0%	11.0%	11.0%	11.0%
ROE	26.0%	38.9%	39.5%	39.1%	37.8%
ROA	10.9%	18.5%	19.0%	20.1%	20.4%
Liquidity (x)					
Current ratio	1.40	1.51	1.62	1.91	2.22
Interest coverage	91.17	69.33	97.48	96.51	93.43
Leverage					
Net Debt/EBITDA (x)	0.24	0.03	net cash	net cash	net cash
Net Debt/Equity (%)	0.09	0.02	net cash	net cash	net cash
Activity (days)					
Days receivable	92.8	92.5	95.7	95.7	93.6
Days inventory	70.7	42.8	40.4	39.3	44.7
Days payable	139.2	100.9	107.3	104.5	106.6
Cash cycle	24.3	34.3	28.8	30.6	31.8

Source: Company data, CASH

China Healthcare Sector

The pharmaceutical industry is regaining momentum again: As the policies and insurance system in China have become matured and the silver hair market is growing at a fast pace, we believe that the industry growth has bottomed and will stay at 15-25% in the coming 3 years.

A game of giants: It is found that the industry is getting more concentrated. The industry top 100 concentration was up from 38.9% in 2005 to 47.8% in 2016. Nevertheless, the figure was still far below the target of 50% set in the 12th Five-Year Plan. We believe that the industry concentration will continue to rise, given the implementation of various policies.

China social medical insurance scheme is improving: China government is now managing to combine URBMIS and NRCMS into a new Urban-Rural Basic Medical Insurance Scheme so that patients in the rural area could enjoy healthcare services with a higher standard and quality. It is believed that the move could improve rural patients' affordability and thus stimulate drug consumption and benefit the pharma industry.

Policy reform: In our opinion, the impact from policies such as 1) accelerating new drugs approval, 2) bioequivalence test (BE Test), 3) update of NRDL in 2017, and 4) two invoice system will persist in the coming 2 years.

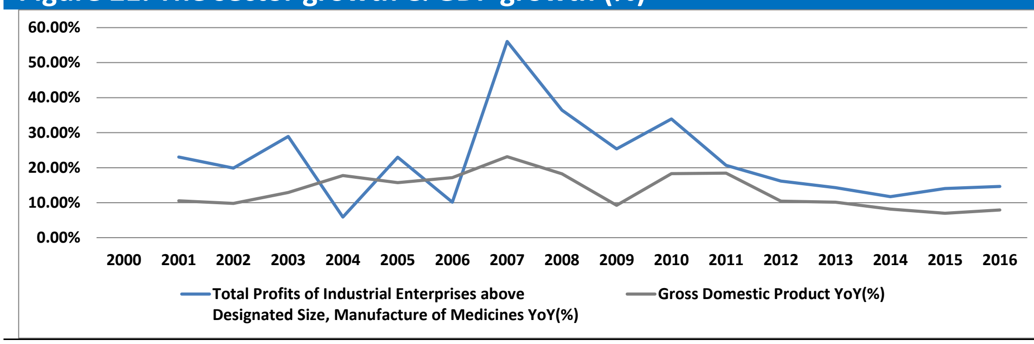
CSPC is our top pick in healthcare sector with TP of HKD32: CSPC's EPS is expected to climb to HKD0.61/0.83 in FY18E/FY19E. We reiterate "BUY" rating for CSPC and raise our Dec-18 TP to HKD32 (Previous: HKD22), based on 1.2X PEG with FY18E-20E CAGR of 32%. Key downside risks include 1) an unexpected sales growth slowdown for CSPC's key products such as NBP, 2) delay or failure of R&D pipeline drugs, 3) unexpected restriction posted by the China government towards the use of drugs, and 4) increasing competition from domestic and international players.

The industry is regaining momentum

Since 2000, the medicine manufacturing industry in China has outpaced the GDP growth of China in most of the years. According to IMS Top 10 Pharmaceutical Markets Worldwide, China was the second largest pharmaceutical market, with sales of USD80.3 billion in 2016.

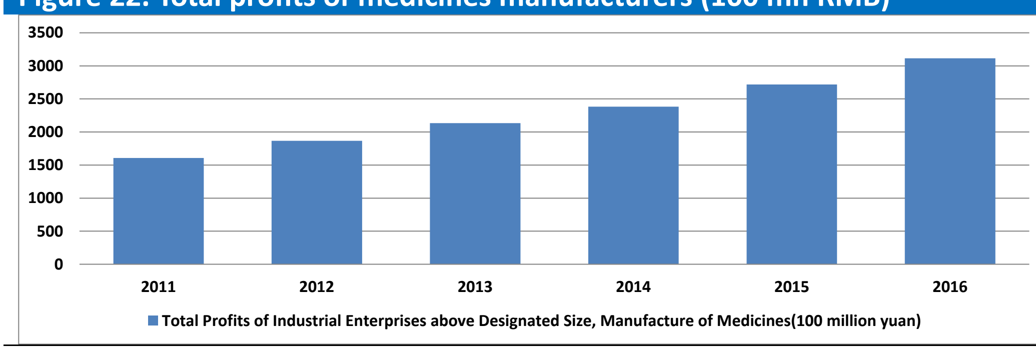
Figure 1 compares the growth rate of profits of medicine manufacturers and China's GDP growth. As we can see, the profit growth of medicine manufacturer was quite fluctuated, began from 5% to 30% in 2001-2006, peaked in 2007 at 56% and gradually slowed down to 10-15% in recent years. The fluctuation was mainly due to the progress of policy reform and industry competitive landscape in different periods. As the policies and insurance system in China have become matured and the silver hair market is growing at a fast pace, we believe that the industry growth has bottomed and will stay at 15-25% in the coming 3 years.

Figure 21. The sector growth & GDP growth (%)



Source: National Bureau of Statistics of PRC, CASH

Figure 22. Total profits of medicines manufacturers (100 mn RMB)



Source: National Bureau of Statistics of PRC, CASH

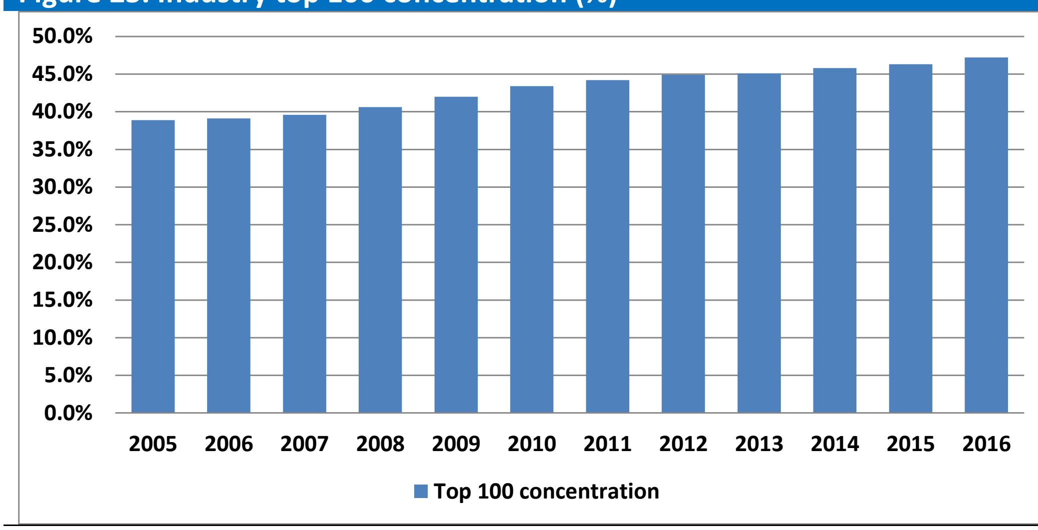
A game of giants

It is found that the industry is getting more concentrated. The industry top 100 concentration was up from 38.9% in 2005 to 47.8% in 2016. Nevertheless, the figure was still far below the target of 50% set in the 12th Five-Year Plan.

We believe that the industry concentration will continue to rise, given that the implementation of policies such as "Two Invoice System", "Bioequivalence Test (BE Test)", the review of New National Reimbursement Drug List (NRDL) in 2017, and the acceleration of new drugs approval. **1) Small new drugs developers with a low reputation and relatively bad distribution networking**, **2) small generic producers who are not able to afford the necessary cost to pass the BE Test**, and **3) the whole secondary distributors market** will be eliminated very soon.

Therefore, we prefer **drugs developers** with *1) great drug pipeline and portfolio*, *2) great R&D capability covering important therapeutic areas*, and *3) strong financial to fund its R&D activities*, and **large generic drugs manufacturers** with a *strong financial position to support the great cost of passing BE Test*. Our top pick in healthcare sector is CSPC (1093.HK, TP: HKD32, Buy).

Figure 23. Industry top 100 concentration (%)



Source: Medical Economic Journal, CASH

Improving medical insurance scheme

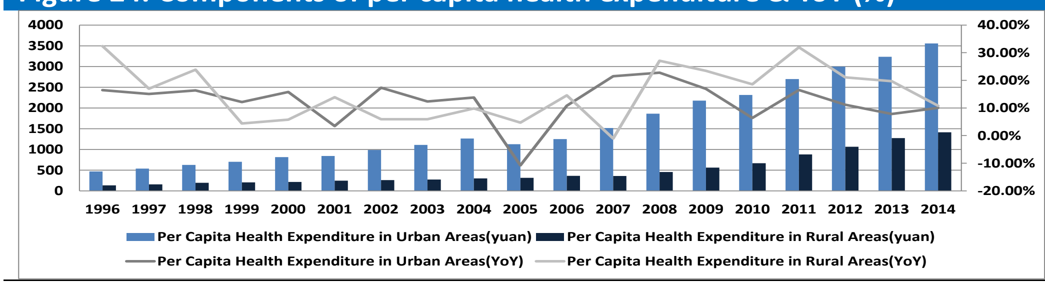
There are 3 basic social medical insurance schemes in China, including:

1. Urban Employees Basic Medical Insurance Scheme (UEBMIS, since 1998)
2. Urban Resident Basic Medical Insurance Scheme (URBMIS, since 2007)
3. New Rural Cooperative Medical Scheme (NRCMS, since 2003)

The whole medical insurance system covers over 95% of Chinese residents in 2015. Because of the implementation of these schemes, China health expenditure in both rural and urban area recorded a fast growth in the past 20 years. As we can see from figure 24, both the growth rates stayed at above 5% for most of the years.

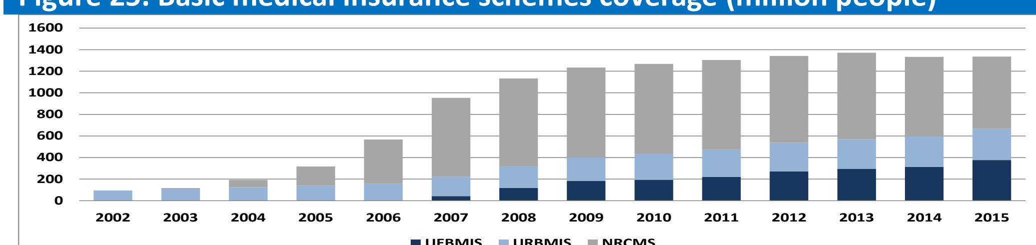
Although the system coverage ratio is high, there is a significant difference between the schemes for urban patients and for rural patients. In general, the reimbursement ratio of NRCMS is relatively lower and drug reimbursement list under the scheme is also not as comprehensive as that under UEBMIS and URBMIS. This made some of the rural patients cannot afford the healthcare services. China government is now managing to combine URBMIS and NRCMS into a new Urban-Rural Basic Medical Insurance Scheme so that patients in the rural area could enjoy healthcare services with a higher standard and quality. It is believed that the move could improve rural patients' affordability and thus stimulate drug consumption and benefit the pharma industry.

Figure 24. Components of per capita health expenditure & YoY (%)



Source: National Bureau of Statistics of PRC, NHFPC, CASH

Figure 25. Basic medical insurance schemes coverage (million people)



Source: National Bureau of Statistics of PRC, CASH

Policy reform

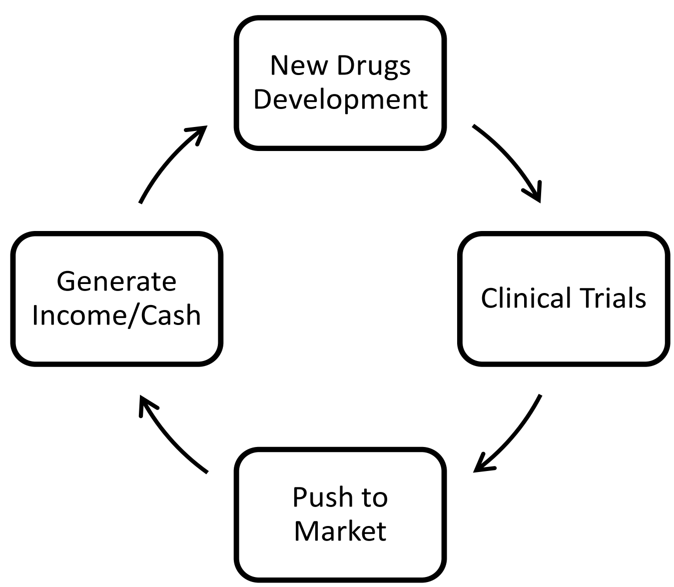
Accelerating CFDA new drugs approval

2015 was a tough year for the pharma sector. After the launch of stricter clinical trial inspection, there came to more than 1,000 production application withdrawal, hindering the development of innovative drugs.

China Food and Drug Administration (CFDA) and State Council are now striving to shorten the time for the review of new drugs and meanwhile enhance the quality standard of drugs manufacturing. They initiated fast-track approval for drugs addressing significant unmet medical needs.

Normally, after CFDA reviewed and approved new drugs, a pharma firm will market the drugs to hospitals. The marketed drugs will then generate income and cash for the next round R&D of new drugs. Therefore, the fastened review process will speed up the whole cycle of new drugs development and benefits the large pharma firms. We believe that the stronger the drug pipeline and R&D capability a pharma company has, the greater the benefit the company will gain from this policy.

Figure 26. Pharma Sector Business Cycle



Source: CASH

Bioequivalence Test (BE Test)

The problem of inconsistent quality of generic drugs has existed for a very long time in China and has caused lots of medical incidents. Besides, because of the poor quality, doctors in China prefer expensive original drugs over cheap generic drugs, making patients hard to afford the heavy medical fees.

Realizing the problem, in 2013, CFDA issued guidance for consistency evaluation of generic drugs. The generic drugs are required to achieve bioequivalence to brand-name drugs, based on in vivo BE tests or in vitro dissolution studies. The goal is to drive generic drugs with inconsistent quality and efficacy out of the market.

289 generic drugs in oral solid dosage form on 2012 Essential Drug List approved before October 2007 are required to finish the BE Test. Deadline for these drugs to pass the test is set at the end of 2018.

In our opinion, the BE Test will eliminate small generics manufacturers, who are unable to afford the necessary cost to upgrade the quality of the drug and unable to meet the deadline of BE test. Besides, it is believed that the stricter requirements of consistency evaluation will set a great entry barrier for the industry. Large generic drugs companies with a strong financial base to support their BE trial could then capture the market share lost by small generic manufacturers.

Two Invoice System

The two-invoice system was introduced by State Council in the 13th Five-Year Plan. It allows only two invoices in the transaction process, one from manufacturers to distributors and another one from distributors to hospitals (i.e. only one layer of distributors between manufacturers and hospitals). The aim of the policy is to lower the medical fee charged by secondary distributors and therefore lower the financial burden of patients.

It is believed that the policy will eliminate the entire secondary distributors market and pharmaceutical companies that have a weak sales network. We believe that there will be an earthquake in the distributors market in short term. In long run, survived distributors and also pharma companies with strong distribution channel will be benefited by gaining market shares of eliminated firms.

National Reimbursement Drug List Review

National Reimbursement Drug List (NRDL) was first published in 2009 on the basis of National Essential Drug List (NEDL). NRDL contains drugs that can be 100% or partially reimbursed and is managed by government agencies such as Ministry of Human Resources and Social Security (MOHRSS), National Health and Family Planning Commission (NHFPC) and China Food and Drug Administration (CFDA), etc. Drugs in NRDL are divided into 2 types: Type A and Type B.

Type A drugs refer to those that are designated by the central government as necessary for treatment, widely used, effective and at a relatively low price. It includes all the drugs under NEDL. 100% cost of Type A drugs could be reimbursed under patient's medical insurance scheme.

Type B drugs refer to those that are more expansive than Type A drugs. Generally, only about 70-80% cost of Type B drugs could be reimbursed under patient's medical insurance scheme.

While **all the type A drugs** are designated by national authorities to be reimbursed drugs, a **maximum of 15% Type B drugs** can be adjusted by the provincial government based on the local demand condition.

NRDL will be updated every 4-5 years. The latest version was published in Feb 2017. It includes a total of 2,535 western and Chinese medicines. Evidence shows that even though the drug price will be lowered once a drug is added to the list as a result of negotiation between the government and the drug manufacturers, sales volume of the drugs being added will rise significantly and offset the negative impact brought by the lower price, resulting in a sharp increase in revenue. Again, it is believed that companies with strong drug pipeline/portfolio and R&D capability will be the main beneficiaries of this policy as more new drugs are expected to be added to the list in the future.

Figure 27. Valuation and financial ratios of China Healthcare Sector related stocks

	Stock Code	Price ($LC)	TP	%upside	18 EPS YoY	19 EPS YoY	18PE	19PE	18ROE	19ROE	18PB	19PB
SINO BIOPHARM	1177 HK Equity	11.24	NA	NA	26.49	23.89	38.53	31.10	25.34	23.95	7.43	6.00
SINOPHARM-H	1099 HK Equity	30.25	NA	NA	2.83	14.05	13.04	11.43	14.48	14.80	1.74	1.56
CHINA RESOURCES	3320 HK Equity	10.08	NA	NA	16.36	15.63	15.75	13.62	8.18	8.46	1.17	1.05
CSPC PHARMACEUTI	**1093 HK Equity**	**21.90**	**32.00**	**46.1%**	**30.83**	**27.06**	**36.81**	**28.97**	**22.11**	**24.17**	**7.75**	**6.78**
TRAD CHI MED	570 HK Equity	6.50	NA	NA	14.35	20.20	18.22	15.16	10.27	11.14	1.69	1.60
LUYE PHARMA GROU	2186 HK Equity	8.07	NA	NA	18.15	18.26	19.19	16.23	15.74	15.95	2.72	2.40
SSY GROUP LTD	2005 HK Equity	8.12	NA	NA	33.08	22.19	26.11	21.37	23.28	24.13	5.79	4.83
FOSUN PHARMA-H	2196 HK Equity	39.75	NA	NA	18.58	19.52	22.35	18.70	13.89	15.09	2.99	2.69
SHANGHAI PHARM-H	2607 HK Equity	20.30	NA	NA	9.47	15.70	11.99	10.37	10.93	11.24	1.26	1.17
SIHUAN PHARM	460 HK Equity	1.62	NA	NA	-1.96	6.67	9.14	8.57	12.93	12.68	1.07	0.97
Median					17.26	18.89	18.71	15.70	14.18	14.94	2.23	2.00
Average					16.82	18.32	21.11	17.55	15.71	16.16	3.36	2.91

Source: Bloomberg , CASH

CSPC (1093.HK, Buy, HKD32)

China Pharmaceutical Sector

Investment thesis

NBP revenue growth momentum remains strong: According to company statistics, NBP sales recorded a high yearly growth of 45%YoY in 1Q18. This is a surprise to the market. Besides, in March 2018, NBP capsule form was granted orphan drug designation for the treatment of amyotrophic lateral sclerosis (ALS) by the U.S. FDA. The indication has also been undergoing a clinical study in China since July 2015. We believe that new indication may help extend NBP patent period in China and bring new market potentials and opportunities. Going forward, we believe that the growth will persist given that the NBP penetration in county-level hospitals is still low.

Oncology drugs another growth engine: We see a very fast revenue growth in CSPC's oncology portfolio. In 1Q18, CSPC's revenue from Duomeisu sales soared 78%YoY to HKD196 mn, revenue from Jinyouli increased 119%YoY to HKD151 mn and revenue from other oncology drugs increased 110%YoY to HKD56 mn. Besides, in February, CSPC announced that the "Albumin-bound PTX" developed by the group has been granted drug registration approval by the CFDA. The drug generated HKD15 mn revenue in March 2018 and HKD55 mn revenue by 23th May 2018. Management guided that Albumin-bound PTX sales in FY18 will reach HKD200-300 mn. It is expected that the revenue growth in CSPC's existing oncology portfolio will persist given the robust demand in China.

Supported by a solid new drugs pipeline: 2 blockbuster class 1 new drugs, recombinant GLP-1 receptor agonist injection (rE4 注射用重組胰高血糖素樣肽-1 受體激動劑) and Compound levamlodipine and atorvastatin calcium tablet (複方左旋氨氯地平阿托伐他汀鈣片) are now in phase III clinical trial, with a high certainty in successfully being commercialized. We believe that the pipeline provides a solid support to CSPC's top line growth in the coming future.

Reiterate "Buy" with Dec-18 TP of HKD32: CSPC's EPS is expected to climb to HKD0.61/0.83 in FY18E/FY19E. ***We reiterate "BUY" rating for CSPC and raise our Dec-18 TP to HKD32 (Previous: HKD22), based on 1.2X PEG with FY18E-20E CAGR of 32%.*** Key downside risks include 1) an unexpected sales growth slowdown for CSPC's key products such as NBP, 2) delay or failure of R&D pipeline drugs, 3) unexpected restriction posted by the China government towards the use of drugs, and 4) increasing competition from domestic and international players.

CSPC Pharmaceutical Group

1093.HK, BUY, TargetPrice: HK$32

Income Statement (In million HK$)

Year-end Dec 31	FY17	FY18E	FY19E	FY20E
Revenue	15,463	21,380	27,060	33,585
Cost of goods sold	(6,117)	(7,523)	(8,667)	(9,709)
Gross profit	9,346	13,857	18,393	23,876
SG&A	(5,057)	(8,179)	(10,722)	(14,158)
R&D	(815)	(912)	(1,154)	(1,433)
Other expense	8	8	8	8
Employee share expense	0	0	0	0
Operating profit	3,482	4,774	6,525	8,293
EBITDA	4,198	5,542	7,411	9,334
Depreciation	(613)	(718)	(832)	(979)
Amortisation	(104)	(51)	(54)	(62)
EBIT	3,482	4,774	6,525	8,293
Net interest expense	(27)	(60)	(64)	(75)
Associates & JCEs	10	32	44	55
Other income	0	0	0	0
Earnings before tax	3,465	4,746	6,504	8,274
Income tax	(685)	(939)	(1,287)	(1,638)
Net profit After tax	2,780	3,807	5,217	6,636
Minority interests	(10)	(10)	(10)	(10)
Other items	0	0	0	0
Preferred dividends	0	0	0	0
Normalised NPAT	2,780	3,807	5,217	6,636
Extraordinary items	0	0	0	0
Income attr. to shareholders	2,771	3,797	5,207	6,626
Dividends	(726)	(1,139)	(1,562)	(1,988)
Transfer to reserves	2,044	2,658	3,645	4,638
EPS	0.45	0.61	0.83	1.06
DPS	0.15	0.18	0.25	0.32

Balance Sheet (In million HK$)

Year-end Dec 31	FY17	FY18E	FY19E	FY20E
Cash & equivalents	5,163	6,119	7,679	9,911
Marketable securities	1,395	1,423	1,451	1,480
Accounts receivable	2,334	3,222	4,078	5,061
Inventories	2,901	3,092	3,562	3,990
Other current assets	1,842	1,878	1,916	1,954
Total current assets	13,635	15,734	18,686	22,397
LT investments	427	435	444	453
Fixed assets	6,663	7,554	8,758	10,307
Goodwill	122	122	122	122
Other intangible assets	103	101	109	124
Other LT assets	594	606	618	630
Total assets	21,543	24,552	28,736	34,032
ST debt	927	1,647	1,537	1,600
Accounts payable	4,513	4,122	4,749	5,320
Other current liabilities	319	326	332	339
Total current liabilities	5,760	6,095	6,618	7,259
LT debt	60	60	60	60
Convertible debt	0	0	0	0
Other LT liabilities	316	322	328	335
Total liabilities	6,135	6,477	7,006	7,654
Minority interest	85	95	105	115
Preferred interest	0	0	0	0
Common stock	12,922	12,922	12,922	12,922
Retained earnings	7,042	9,700	13,344	17,983
Proposed dividend	726	1,139	1,562	1,988
Other equity and reserves	(4,642)	(4,642)	(4,642)	(4,642)
Total shareholders' equity	15,407	18,075	21,730	26,378
Total equity & liabilities	21,543	24,552	28,736	34,032

Cashflow statement (In million HK$)

Year-end Dec 31	FY17	FY18E	FY19E	FY20E
Income attr. to shareholders	2,780	3,807	5,217	6,636
Non-cash item	717	768	886	1,041
Change in working capital	(1,633)	(1,528)	(759)	(901)
Cashflow from operationgs	3,288	3,047	5,345	6,776
Capital expenditure	(1,164)	(1,609)	(2,036)	(2,527)
Free cashflow	2,124	1,438	3,308	4,248
Dec in other LT assets	(39)	(12)	(12)	(12)
Inc in other LT liabilities	72	6	6	7
Adjustment	(300)	(57)	(70)	(86)
CF from investing acts	(3,287)	(1,672)	(2,113)	(2,619)
Cash dividend	(726)	(1,139)	(1,562)	(1,988)
Equity issue	2,353	0	0	0
Debt issue	(151)	720	(110)	63
Convertible debt issue	0	0	0	0
Others	1,094	0	0	0
CF from financial acts	1,631	(419)	(1,672)	(1,925)
Net cashflow	1,632	956	1,560	2,232
Beginning cash	3,235	5,163	6,119	7,679
Adjustments	296	0	0	0
Ending cash	5,163	6,119	7,679	9,911
Ending net debt	(4,176)	(4,413)	(6,082)	(8,252)

Source: Company data, CASH

Key Ratios

	FY17	FY18E	FY19E	FY20E
Growth (%)				
Revenue	25.0%	38.3%	26.6%	24.1%
Gross profit	48.1%	48.3%	32.7%	29.8%
Operating profit	31.4%	37.1%	36.7%	27.1%
Income attr. to shareholders	31.9%	37.0%	37.1%	27.3%
Profitability (%)				
Gross margin	60.4%	64.8%	68.0%	71.1%
Operating margin	22.5%	22.3%	24.1%	24.7%
Net Margin	18.0%	17.8%	19.3%	19.8%
Dividend payout	26.2%	30.0%	30.0%	30.0%
ROAE	23.7%	29.5%	40.4%	51.4%
ROAA	15.3%	16.5%	19.6%	21.1%
Liquidity (x)				
Current ratio	2.4	2.6	2.8	3.1
Interest coverage	130.7	79.9	102.0	110.8
Leverage				
Net Debt/EBITDA (x)	0.9	0.7	0.8	0.8
Net Debt/Equity (%)	24.7%	22.3%	26.2%	29.8%

Source: Company data, CASH

Macau Gaming Sector

Too early to call an end to the upcycle: 6M18 GGR amounted to MOP150.2bn, rose 18.9% YoY. We believe the industry rally is not yet over, it is too early to interpret the recent UnionPay ban issue as a signal of change in policy direction. Meanwhile, the benefit brought by the HZM Bridge, which will start operation in 2H18, is a more- certain catalyst that can support the mid-to- long term growth of the industry.

Reasons behind the recent softness: The Macau gaming sector underperformed the HSI by 9pts in June (-14% sector correction vs -5% in HSI). It is mainly due to 3 reasons, i) news of UnionPay POS terminal removal; ii) World cup impact; iii) high base effect. We believe this could provide an opportunity for 2H outperformance.

What to expect in 2H18? Thanks to the opening of Hong-Kong Zhuhai Macau bridge (HKZB) and the extension of the Guangzhou-Zhuhai Intercity Rail to Hengqin over the coming few months, we expect visitations growth to remain strong and thereafter driving the mass market in 2H18.It is believed that the HZM Bridge will favour long-term visitation growth. We forecast Macau's visitation growth to increase from 3% CAGR in 2012-17 to 5% CAGR in 2018E -20E.

Comfortable valuation: The sector is now trading at the average level of the forward EV/EBITDA. Our view is that, the recent share softness make the valuation attractive. We are cautiously optimistic towards the industry sector in the coming half year, given that 1) junket liquidity remains abundant, 2) visitation growth supported by infrastructure improvement, 3) the Unionpay issue seems to be an isolated event. Investors should consider the long- term prospect of the companies before making investment decisions. Looking forward, we expect VIP/ Mass GGR growth to be at 17%/ 19% in 2018, leading to a 18% growth in total GGR.

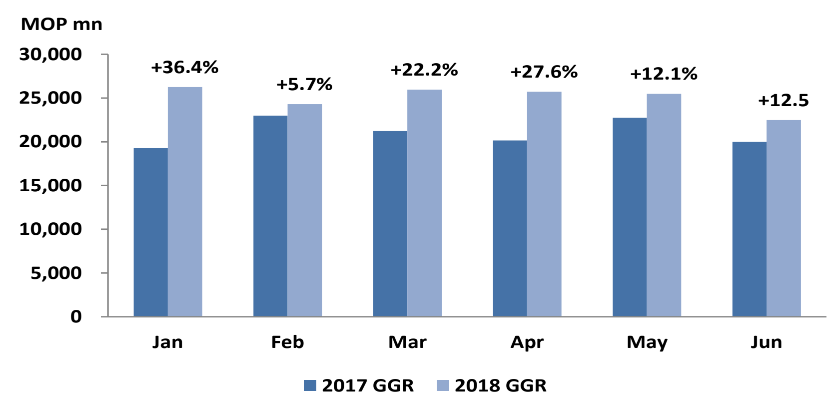
We performed analysis on Galaxy (27.HK, TP: HK$76), Sands China (1928.HK, TP: HK$50): We appreciate Galaxy's future potential as the Group has numbers of project launch, including Phase 3,4, Hengqin resort, coupled with the potential cooperation with Wynn and its international opportunities, all the above can support its long- term growth. Sands, as a mass game leader, is expected to be the largest beneficiary of the 2H opening of HZM Bridge.

Too early to call an end to the upcycle

6M18 GGR amounted to MOP150.2bn, rose 18.9% YoY. The average daily run rate was above MOP800mn, for the prior six months. The result is satisfactory compared to the average MOP729 mn in FY17. We believe the industry rally is not yet over, it is too early to interpret the recent UnionPay ban issue as a signal of change in policy direction. Meanwhile, the benefit brought by the HZM Bridge, which will start operation in 2H18, is a more- certain catalyst that can support the mid-to- long term growth of the industry.

We believe the industry is still in the midst of upcycle, favoured by the increasing visitation, benign credit environment offered by junkets, improving infrastructure from 2H18 onwards. Figure 29 shows the historical run rate in 2009-2018. Upside potential remains when comparing the current daily rate with the peak of MOP1,357mn in Feb 2014. Meanwhile, the 1Q industry EBITDA is growing at 27% YoY, greater than the high teen revenue growth. We see the uptrend to continue as the high- margin mass is growing at a healthy rate, and therefore improving the GGR mix. As a review of 1Q data, the VIP/Mass GGR grew by 23% and 19% YoY.

Figure 28. 6M18 GGR



Source: DICJ, CASH

Figure 29. Daily run rate (2009-2018)

MOP mn	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Jan	277	450	599	808	867	927	766	602	621	847
Feb	283	480	709	837	967	1357	698	673	821	868
Mar	307	438	648	806	1011	1144	693	580	685	837
Apr	278	473	684	833	944	1044	639	578	672	858
May	284	551	784	841	954	1044	656	593	734	822
Jun	276	455	693	778	942	907	579	529	666	750
Jul	309	526	781	793	951	917	600	573	741	
Aug	363	509	799	843	992	931	601	608	731	
Sep	365	510	708	796	965	852	571	613	712	
Oct	406	609	866	894	1177	904	647	704	859	
Nov	407	578	769	829	1006	809	548	626	768	
Dec	366	609	762	911	1079	751	592	639	732	
Average	*327*	*516*	*733*	*831*	*988*	*966*	*632*	*610*	*729*	*830*

Source: DICJ, CASH

Reasons behind the recent softness

The Macau gaming sector underperformed the HSI by 9pts in June (-14% sector correction vs -5% in HSI). It is mainly due to 3 reasons, 1) news of UnionPay POS terminal removal; 2) World cup impact; 3) high base effect. We believe this could provide an opportunity for 2H outperformance.

UnionPay Situation

What happened?

Banks in Macau have taken back some Unionpay card POS terminals from selective jewelry shops and pawnshops in early June.

What's the impact?

Players usually have several access to liquidity: 1) RMB20k cash per day brought physically across the border; 2) via ATM; 3) cash refund from pawnshops, watch & jeweley stores; 4) credits provided by junket agents. The Unionpay terminal removal mainly affect the premium mass business. (it is also one of the reason why MGM fell more among all the concessionaries in 2Q as it has greater portion of business from this segment.)

Yet, we believe the impact and the implication of the Unionpay issue is being overestimated. First of all, the Monetary Authority of Macao (AMCM) has recently issued a press release on the UnionPay situation, asking local banks to review and collect Unionpay card machines from shops which they consider "high-risk". At this stage, the intention maybe simply to urge banks to better manage their business risks, instead of being a prelude of controlling capital outflow.

Secondly, it is worth noting that banks had been instructed to take back Unionpay card machines in the past. The number being affected this time only represents a small proportion of the machines in operation, together with the fact that there is no follow-up clampdown so far, the recent ban may perhaps be an isolated incident.

Thirdly, VIP, grind mass and non- gaming segment is unlikely to be affected by the issue. VIP liquidity is provided by the junket agents, while grind mass player usually source the fund via ATM or physically bring cash across the border.

Only premium mass is affected, however, as mentioned before, the number of machines taken back only represents a small proportion, the impact of the issue seems to be overestimated.

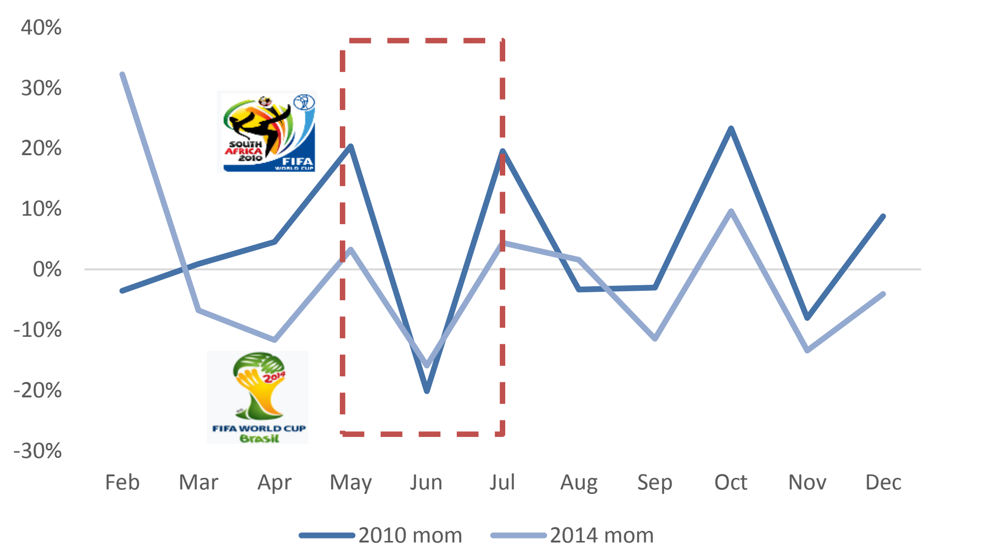
Anything to pay attention of?

Investors should pay attention to the policy updates for the coming few months. Though we believe the recent Unionpay issue simply has an intention for banks to better manage their business risks, instead of controlling capital outflow, the policy direction can be influenced by the future macro condition and RMB movement.

World cup impact

With the 2018 FIFA World Cup football tournament being held in Russia on 14 June- 15 July, the casino betting volume was affected in a certain extent. Using the last two Wold cup as a reference, we can see the GGR recorded a mom decline in June, as World Cup diverts attention from table gaming, either because some players place their bet on sports betting channel inside of casino, or some VIP players are taken to the tournaments by junket agents as a customer perk. During 2010 FIFA World Cup, June GGR fell by 20pts on a mom basis. During 2014 FIFA World Cup, June GGR fell by 16pts mom. (see the dotted area in the following figure)

Figure 30. Historical World Cup impact on GGR



Source: DICJ, CASH

High base effect

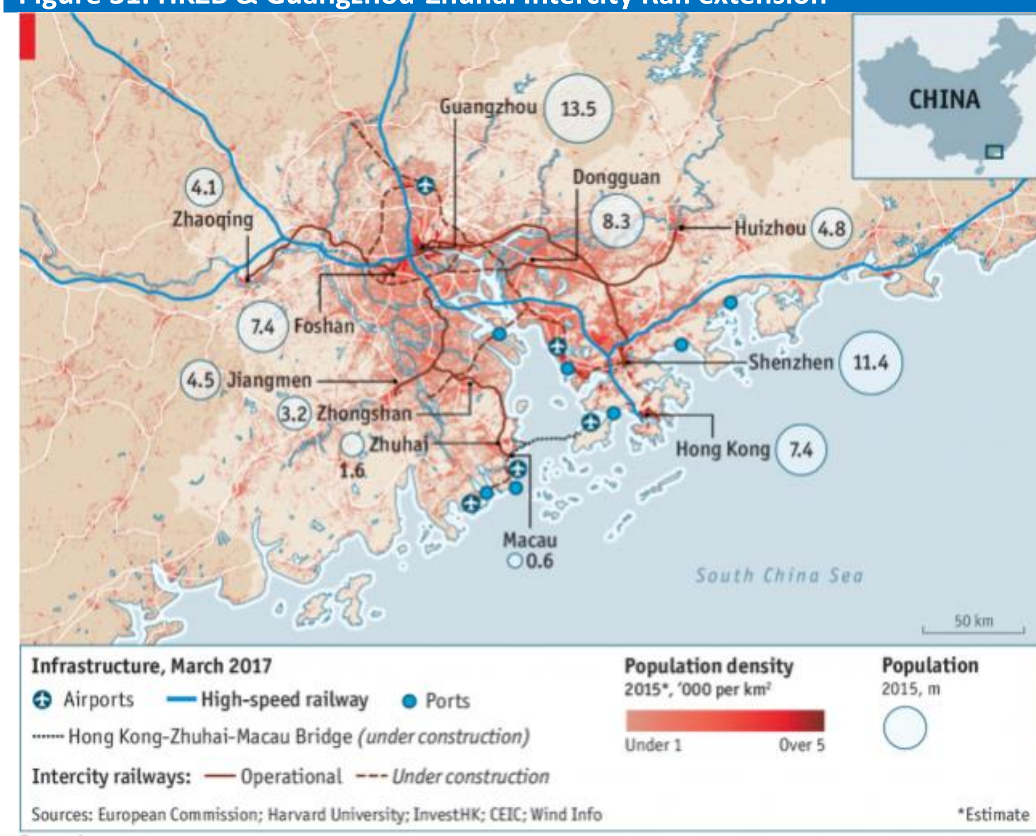
The gaming industry performed exceptionally well in 2Q17, with the VIP GGR rose by 30% YoY driven by the higher liquidity provided by junket operators. By that time, mid-sized junkets, such as David Group and Megstar, opened more VIP rooms in Macau and pushing the rolling chip volumes to a higher level. Having a high base, the June 2018 market performance was actually decent, especially considering World Cup impact.

To conclude, the market is currently unduly worried on the implication of the Unionpay issue and the soft GGR data. Given the fact that there is no sign signalling a change in policy direction towards more tightening, the recent share weakness provides an opportunity for investors to consider buying on dip and preparing for summer rally. The 2H catalyst (the opening of HKZB and comfortable sector valuation) can support higher growth of the Macau properties and trigger the stocks to rebound.

What to expect in 2H18?

Visitation growth driven by the opening of HKZB: Thanks to the opening of Hong-Kong Zhuhai Macau bridge (HKZB) and the extension of the Guangzhou-Zhuhai Intercity Rail to Hengqin over the coming few months, we expect visitation growth to remain strong and thereafter driving the mass market in 2H18. On top of that, the potential policy support with regard to the Greater Bay Area (GBA) should also be a positive catalyst for the sector, in the context that more wealth is likely to be created and movement of people in the GBA should become easier (with regard to visa and infrastructure). The Bay Area development will promote integration of the key cities in the region with greater economic cooperation and infrastructure development. Among the cities, Macau's role as a tourism & MICE centre would be highlighted.

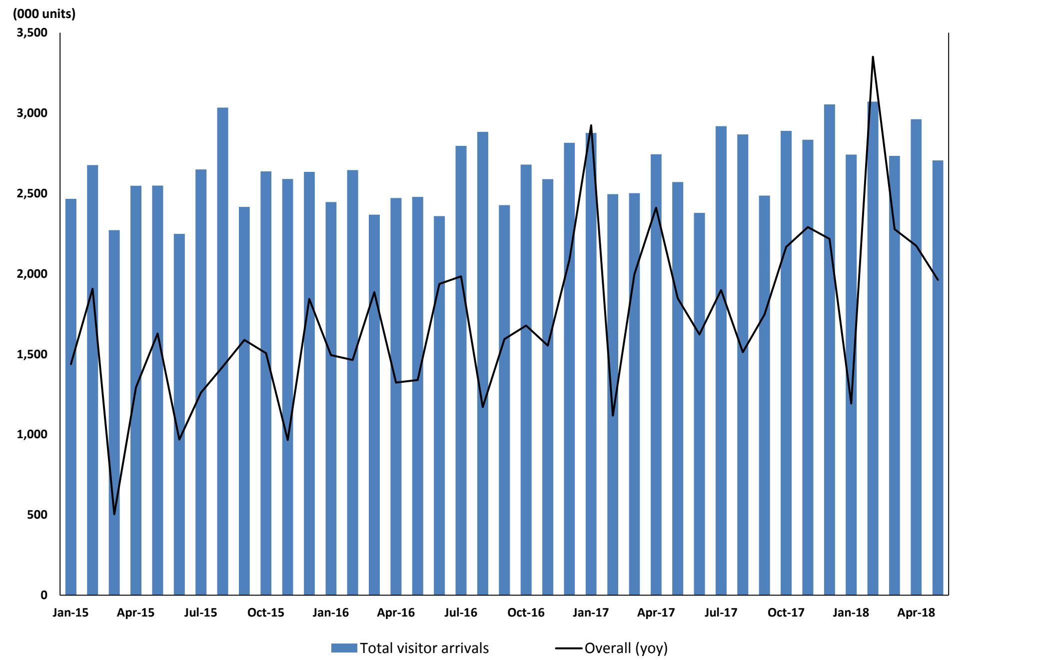
Figure 31. HKZB & Guangzhou-Zhuhai Intercity Rail extension



Source: Economist, CASH

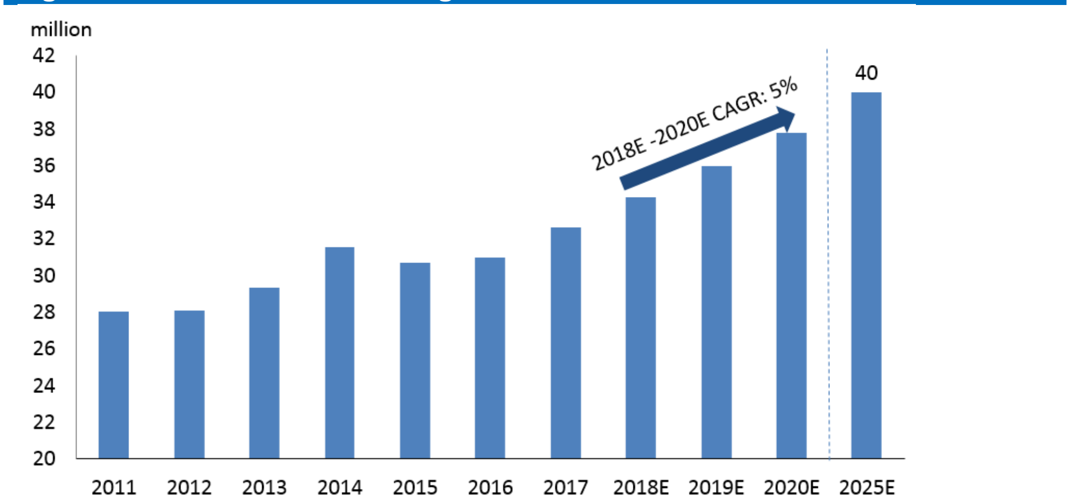
The 55-km HK-Zhuhai-Macau Bridge can shorten travel time between HK and Macau from 1 hour by ferry to 40 mins by road. It is believed that the HZM Bridge will favour long-term visitation growth. We forecast Macau's visitor growth to increase from 3% CAGR in 2012-17 to 5% CAGR in 2018E -20E. Overall, the Macau government aims to welcome 40m visitors annually by 2025, which is believed to be an easy target according to industry consensus.

Figure 32. Total visitor arrivals & YoY(%)



Source: DSEC, CASH

Figure 33. Forecasted visitation growth

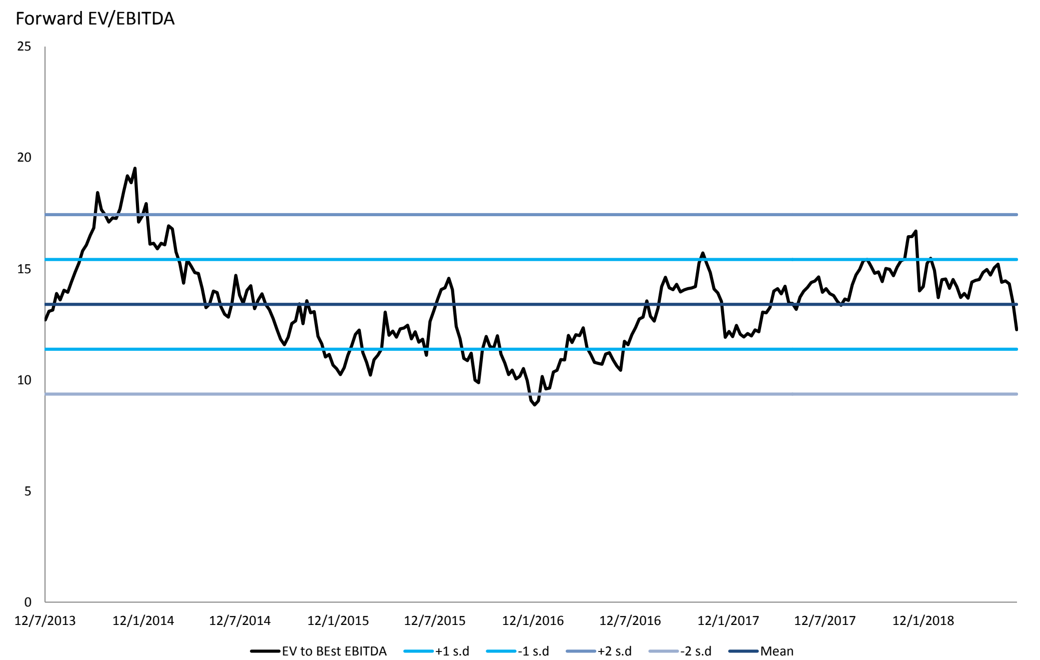


Source: DSEC, CASH

Comfortable valuation: The sector is now trading at the average level of the forward EV/EBITDA. Our view is that, the recent share softness make the valuation attractive. We are cautiously optimistic towards the industry sector in the coming half year, given that 1) junket liquidity remains abundant, 2) visitation growth supported by infrastructure improvement, 3) the Unionpay issue seems to be an isolated event. Investors should consider the long- term prospect of the companies before making investment decisions.

Looking forward, we expect VIP/ Mass GGR growth to be at 17%/ 19% in 2018, leading to a 18% growth in total GGR.

Figure 34. Industry 12M forward EV/EBITDA



Source: Bloomberg, CASH

We performed analysis on Galaxy (27.HK), Sands China (1928.HK): We appreciate Galaxy's future potential as the Group has numbers of project launch, including Phase 3,4, Hengqin resort, coupled with the potential cooperation with Wynn and its international opportunities, all the above can support its long- term growth. Sands, as a mass game leader, is expected to be the largest beneficiary of the 2H opening of HZM Bridge.

Figure 35. Valuation and financial ratios of Macau Gaming related stocks

	Stock Code	Price ($LC)	TP	%upside	18 EPS YoY	19 EPS YoY	18PE	19PE	18EBITDA%	19EBITDA%	18EV/EBITDA	19EV/EBITDA	18Div yield	19Div yield
SANDS CHINA LTD	**1928 HK Equity**	**39.35**	**50.00**	**27.1%**	**35.45**	**14.13**	**18.64**	**16.33**	**20.23**	**10.93**	**14.59**	**13.15**	**5.27**	**5.54**
GALAXY ENTERTAIN	**27 HK Equity**	**57.50**	**76.00**	**32.2%**	**25.62**	**11.20**	**18.67**	**16.79**	**20.11**	**9.48**	**14.23**	**13.00**	**1.51**	**1.75**
WYNN MACAU LTD	1128 HK Equity	22.90	NA	NA	97.89	16.80	16.30	13.95	31.64	8.79	12.85	11.81	5.35	6.30
SJM HOLDINGS LTD	880 HK Equity	8.60	NA	NA	20.17	-10.31	20.62	22.99	22.13	18.62	10.89	9.18	2.76	2.42
MELCO INTL DEV	200 HK Equity	20.85	NA	NA	343.23	28.60	15.17	11.80	30.54	11.08	7.36	6.63	0.33	0.37
MGM CHINA	2282 HK Equity	16.12	NA	NA	12.93	62.61	23.36	14.37	61.94	32.16	13.31	10.07	2.15	4.11
Median					30.54	15.46	18.66	15.35	26.34	11.00	13.08	10.94	2.45	3.27
Average					89.21	20.50	18.80	16.04	31.10	15.18	12.21	10.64	2.89	3.42

Source: Bloomberg , CASH

Galaxy Ent(27.HK, Buy, HKD76)

Gaming Sector

Investment thesis

EBITDA reaching historical high: GEG's 1Q adjusted EBITDA amounted to HKD4.3bn, up 36% YoY, explained by the topline growth and margin expansion. Revenue grew 32% YoY to HKD18.5bn. The EBITDA margin was at 23.3% in 1Q18. VIP/ Mass/ Total GGR rose 44%/18%/32% YoY in 1Q18, with VIP business gaining market share. The strong VIP revenues were driven by robust growth in Galaxy Macau and Starworld, partly offset by weaker win rates at Galaxy Macau. The mass market share loss is due to the temporary impact from gaming floor renovation. Yet, we believe the renovation will bring better efficiency beyond 2Q18.

Phase 3, 4 and Hengqin development will support the next phase of growth, a factor that has not been priced- in: The total capex for Phase 3, 4 will be approx. HKD45- 50bn. Phase 3 and 4 will be launched by the end of 2019 and 2020 respectively, together offering more than 4500 hotel rooms, doubling the current capacity. Apart from the gaming amenities, the new property will be family oriented, tech based, e.g. applying VR, and with a premium positioning. For the Hengqin development, the resort area will be 6 times larger than that of Phase 1-4. We like Galaxy as we see the company's ability to achieve sustainable growth in the next decades.

A win- win situation if cooperate with Wynn Resort: Galaxy Entertainment bought 4.9pc stake in Wynn Resorts for USD927.5 million in March. As we all know, Galaxy has a plan to expand its business globally. Its potential strategic cooperation with Wynn is possible as the latter's strong global brand image can help Galaxy build its brand recognition in the global market.

Overseas expansion on track: For the Japan IR project, Galaxy continues to expand its team in Japan and has recently appointed Mr. Ted Chan as COO of the Japan Development. For the Philippines project, despite the fact that Philippine Government temporarily closed Boracay for restoration, the Group remains optimistic to go ahead with its USD300-500mn project, with the help of its local partner, Leisure & Resorts World Corp.

Reiterate "Buy" with Dec-18 TP of HKD76: We continue to like Galaxy for its robust earnings growth momentum, solid net cash balance sheet (HKD34.5 bn by 1Q18), excellent execution capability and strong relationship with junkets. Its pipeline for Galaxy Macau phases three and four, Hengqin development, potential cooperation with Wynn and its future international opportunities will also support its long- term growth. ***We forecast the company's EBITDA to grow by 26% in 2018E. The target price HKD76 implies 16x 2019 EV/EBITDA.***

Galaxy Entertainment

27.HK, Buy, Target Price: HKD76

Income Statement (HKD mn)

Year-end 31 Dec	FY17	FY18E	FY19E	FY20E
Revenue	62,450	75,903	83,236	100,950
EBITDA	13,415	16,912	19,481	24,417
Depreciation	(3,029)	(3,015)	(2,862)	(3,182)
Amortisation	(320)	(220)	(258)	(276)
EBIT	10,067	13,676	16,361	20,959
Net interest income	562	230	416	657
Associates & JCEs	244	250	256	261
Other income	(244)	(126)	(147)	(172)
Earnings before tax	10,628	14,030	16,885	21,705
Income tax	(113)	(168)	(203)	(260)
Net profit After tax	10,516	13,862	16,682	21,444
Minority interests	(11)	43	52	66
Other items	0	0	0	0
Preferred dividends	0	0	0	0
Normalised NPAT	10,516	13,862	16,682	21,444
Extraordinary items	0	0	0	0
Income attr. to shareholders	10,504	13,905	16,734	21,511
Dividends	(2,526)	(4,449)	(5,355)	(6,883)
Transfer to reserves	7,979	9,455	11,379	14,627
EPS (HKD)	2.44	3.22	3.88	4.98
DPS (HKD)	0.74	1.03	1.24	1.59

Balance Sheet (HKD mn)

Year-end 31 Dec	FY17	FY18E	FY19E	FY20E
Cash & equivalents	15,702	25,346	33,331	29,931
Bank Deposits	1,898	1,942	1,986	2,032
Accounts receivable	1,962	2,763	3,030	3,674
Inventories	171	160	160	160
Other current assets	368	377	385	394
Total current assets	20,101	30,587	38,892	36,191
LT investments	0	0	0	0
Fixed assets	31,802	31,823	34,460	56,278
Intangible assets	921	1,081	1,156	1,284
Other LT assets	30,991	31,703	32,433	33,178
Total assets	83,815	95,193	106,941	126,932
ST debt	9,685	6,500	6,500	6,500
Accounts payable	17,237	17,634	18,039	18,454
Other current liabilities	113	116	119	121
Total current liabilities	27,035	24,250	24,658	25,076
LT debt	259	5,000	5,000	5,000
Other LT liabilities	504	516	528	540
Total liabilities	27,799	29,765	30,186	30,615
Minority interest	534	491	440	373
Common stock	21,469	21,469	21,469	21,469
Retained earnings	34,013	43,468	54,847	69,474
Proposed dividend	2,526	4,449	5,355	6,883
Total shareholders' equity	56,016	65,428	76,755	91,316
Total equity & liabilities	83,815	95,193	106,941	121,932

Cashflow statement (HKD mn)

Year-end 31 Dec	FY17	FY18E	FY19E	FY20E
Net profit After tax	10,516	13,862	16,682	21,444
Non-cash item	3,349	3,235	3,120	3,458
Change in working capital	5,066	(443)	88	(282)
Cashflow from operations	18,520	16,654	19,890	24,621
Capital expenditure	(1,999)	(3,036)	(5,500)	(20,000)
Free cashflow	16,521	13,618	14,390	4,621
Add: Dec in other LT assets	(21,402)	(713)	(729)	(746)
Add: Inc in other LT liabilities	(313)	12	12	12
Adjustment	0	(380)	(333)	(404)
CF from investing acts	(11,117)	(4,117)	(6,550)	(21,138)
Cash dividend	(2,526)	(4,449)	(5,355)	(6,883)
Equity issue	348	0	0	0
Debt issue	3,715	1,556	0	0
Convertible debt issue	0	0	0	0
Others	0	0	0	0
CF from financial acts	1,480	(2,894)	(5,355)	(6,883)
Net cashflow	8,884	9,643	7,985	(3,400)
Beginning cash	6,803	15,702	25,346	33,331
Adjustments	15	0	0	0
Ending cash	15,702	25,346	33,331	29,931
Ending net debt	(5,758)	(13,846)	(21,831)	(18,431)

Source: Company data, CASH

Key Ratios

	FY17	FY18E	FY19E	FY20E
Profitability (%)				
EBITDA margin	21.5%	22.3%	23.4%	24.2%
EBIT margin	16.1%	18.0%	19.7%	20.8%
Net Margin	16.8%	18.3%	20.1%	21.3%
Dividend payout	30.3%	32.0%	32.0%	32.0%
ROE	20.6%	23.1%	23.7%	25.7%
ROA	14.0%	15.5%	16.5%	18.7%
Liquidity (x)				
Current ratio	0.7	1.3	1.6	1.4
Interest coverage	157.5	45.8	40.6	52.1
Leverage				
Net Debt/EBITDA (x)	Net Cash	Net Cash	Net Cash	Net Cash
Net Debt/Equity (%)	Net Cash	Net Cash	Net Cash	Net Cash
Activity (days)				
Days receivable	10.4	11.4	12.7	12.1
Days inventory	NM	NM	NM	NM
Days payable	NM	NM	NM	NM
Cash cycle	NM	NM	NM	NM

Source: Company data, CASH

Sands China (1928.HK, Buy, HKD50)

Gaming Sector

Investment thesis

Strong 1Q with robust EBITDA growth: Sands generated adjusted EBITDA of USD789mn (+26% YoY) in 1Q18, the quarter result is well received by the market. We are especially pleasant with the EBITDA growth of its individual properties, with only Sands Macro as the exception. The Venetian/ Sands Cotai/ Parisian Macao/ Plaza/ Sands Macro recorded 20%/42%/41%/43%/-13% YoY EBITDA growth in 1Q. The Group's EBITDA margin jumped to 36.5% in 1Q18, being the highest EBITDA margin since 3Q2006, to be explained by its operating leverage and its effective cost control.

VIP gaining market share: We like Sands because we notice a strong rebound of its VIP segment. Its VIP/ Mass/ Total GGR rose 21%/22%/20% YoY in 1Q18. The VIP GGR of Venetian Macao, which accounted for half of the Group VIP business, rose 35% YoY. Meanwhile, Parisian and Plaza recorded a VIP GGR rebound, with their VIP GGR to grow at 21% and 52% YoY respectively. The improved performance of Parisian was explained by the release of first batch of additional high- end hotel suites in 1Q. (Note: Phase 1 has already completed, meanwhile Phase 2 and 3 is progressing. All phases are expected to be completed by the end of 2018.) Overall, the Group gained 2.9pp qoq VIP market share in 1Q.

Further growth to be driven by Sands' focus on reinvestment: In Feb18, Macau's second largest junket, Tak Chun, has opened VIP gaming club in Plaza. The management said they will continue to put more effort on the VIP segment, by doubling the junket rooms to 21 and refurbishing VIP amenities. Further efforts on VIP will be made, such as 370/280 new suite rooms at St Regis/Four Seasons towers to be completed by 2019 and expanded/refurbished VIP gaming areas at the Venetian and Plaza (to be gradually rolled out during 2018-19). With the continuous effort, the Group is likely to fulfill its long-term objective to grow its VIP segment faster than the market.

Being the largest beneficiary of the HZMB opening in 2H18: The HZMB is expected to commence operation in 2H18. We believe that Macau's mid- term visitation growth will grow from 3% CAGR in 2012-17 to 5% CAGR in 2018-20E. The visitation growth will favor the mass gaming business of the industry. Sands, as a mass game leader, will certainly enjoy the ride. In 1Q18, Sands recorded USD1.3bn Mass GGR, rose 22% YoY, outpacing the industry growth and maintaining its market leader position, with an almost 30% market share.

Reiterate "Buy" with Dec-18 TP of HKD50: We remain bullish on Sands China, and we'd view any meaningful pull back as an opportunity to add this operator at a good valuation. ***We forecast the company's EBITDA to grow by 28% in 2018E. The target price HKD50 implies 15x 2019 EV/EBITDA and 7% FCF yield.***

Sands China

1928.HK, Buy, Target Price: HKD50

Income Statement (USD mn)

Year-end 31 Dec	FY17	FY18E	FY19E	FY20E
Revenue	7,715	9,057	9,981	10,964
EBITDA	2,449	3,140	3,504	3,857
Depreciation & Amortisation	(676)	(615)	(624)	(638)
EBIT	1,773	2,525	2,880	3,219
Net interest income	(148)	(126)	(122)	(119)
Associates & JCEs	0	0	0	0
Other income	0	0	0	0
Earnings before tax	1,625	2,399	2,758	3,100
Income tax	(22)	(24)	(28)	(31)
Net profit After tax	1,603	2,375	2,730	3,069
Minority interests	0	0	0	0
Other items	0	0	0	0
Preferred dividends	0	0	0	0
Normalised NPAT	1,603	2,375	2,730	3,069
Extraordinary items	0	0	0	0
Income attr. to shareholders	1,603	2,375	2,730	3,069
Dividends	(2,067)	(2,069)	(2,064)	(2,066)
Transfer to reserves	(464)	306	666	1,004
EPS (USD)	0.20	0.29	0.34	0.38
DPS (USD)	0.26	0.26	0.26	0.26

Balance Sheet (USD mn)

Year-end 31 Dec	FY17	FY18E	FY19E	FY20E
Cash & equivalents	1,239	1,817	2,450	3,344
Accounts receivable	293	362	399	439
Inventories	15	15	15	15
Other current assets	11	10	10	10
Total current assets	1,558	2,203	2,874	3,808
LT investments	1,311	1,341	1,372	1,404
Fixed assets	7,687	7,797	7,971	8,211
Intangible assets	34	61	81	103
Other LT assets	57	56	56	56
Total assets	10,647	11,458	12,355	13,581
ST debt	54	60	64	65
Accounts payable	1,537	2,101	2,316	2,544
Other current liabilities	6	6	6	6
Total current liabilities	1,597	2,167	2,386	2,614
LT debt	4,358	4,300	4,300	4,300
Other LT liabilities	154	147	158	153
Total liabilities	6,109	6,614	6,844	7,067
Minority interest	0	0	0	0
Common stock	81	81	81	81
Retained earnings	4,457	4,763	5,430	6,433
Proposed dividend	2,067	2,069	2,064	2,066
Total shareholders' equity	4,538	4,844	5,511	6,514
Total equity & liabilities	10,647	11,458	12,355	13,581

Cashflow statement (USD mn)

Year-end 31 Dec	FY17	FY18E	FY19E	FY20E
Net profit After tax	1,603	2,375	2,730	3,069
Non-cash item	676	615	624	638
Change in working capital	(28)	496	177	189
Cashflow from operations	2,626	3,486	3,531	3,895
Capital expenditure	(410)	(725)	(799)	(877)
Free cashflow	2,216	2,761	2,733	3,018
Add: Dec in other LT assets	(2)	1	0	0
Add: Inc in other LT liabilities	(20)	(7)	11	(5)
Adjustment	(29)	(57)	(51)	(53)
CF from investing acts	(461)	(788)	(838)	(936)
Cash dividend	(2,067)	(2,069)	(2,064)	(2,066)
Equity issue	0	0	0	0
Debt issue	(19)	(52)	4	0
Convertible debt issue	0	0	0	0
Others	(121)	0	0	0
CF from financial acts	(2,207)	(2,121)	(2,060)	(2,065)
Net cashflow	(42)	578	633	894
Beginning cash	1,284	1,239	1,817	2,450
Adjustments	(3)	0	0	0
Ending cash	1,239	1,817	2,450	3,344
Ending net debt	3,173	2,543	1,914	1,020

Source: Company data, CASH

Key Ratios

	FY17	FY18E	FY19E	FY20E
Profitability (%)				
EBITDA margin	31.7%	34.7%	35.1%	35.2%
EBIT margin	23.0%	27.9%	28.9%	29.4%
Net Margin	20.8%	26.2%	27.4%	28.0%
Dividend payout	128.9%	87.1%	75.6%	67.3%
ROE	33.6%	50.6%	52.7%	51.0%
ROA	14.7%	21.5%	22.9%	23.7%
Liquidity (x)				
Current ratio	1.0	1.0	1.2	1.5
Interest coverage	11.6	19.1	22.0	24.6
Leverage				
Net Debt/EBITDA (x)	1.30	0.81	0.55	0.26
Net Debt/Equity (%)	70%	53%	35%	16%
Activity (days)				
Days receivable	15.3	13.2	13.9	13.9
Days inventory	NM	NM	NM	NM
Days payable	NM	NM	NM	NM
Cash cycle	NM	NM	NM	NM

Source: Company data, CASH