# Time to be defensive

2018 has been a disappointing year for investors. Stock markets tumbled across the globe as investors worried about the arrival of next recession. Escalating trade conflicts made the situation even worse and worked as a trigger of China and HK market sell- off. Factors including trade war, China debt crisis, yuan weakness, policy uncertainties made the situation so unprecedented that both fundamental factors and investment sentiment becomes fragile.

Stepping into 2019, uncertainties continue to serve as an overhang on the global markets. We are especially concerned about the impact of transition from QE to QT brought to the market, the diminishing stimulus brought by the US tax reform, upcoming inverted yield curve, trade war impact and weak China economic outlook. **Considering all the factors, we predict HSI to trade at 21,900-27,700 points in 2019. Despite all these uncertainties, with China policy relaxation as countercyclical buffer, HSI valuation has already reached crisis level, any market pullback provides good opportunities for investors to pick value stocks and dividend yielders.**

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*Source: Cape Breton Post (Greg Perry's editorial cartoon)*

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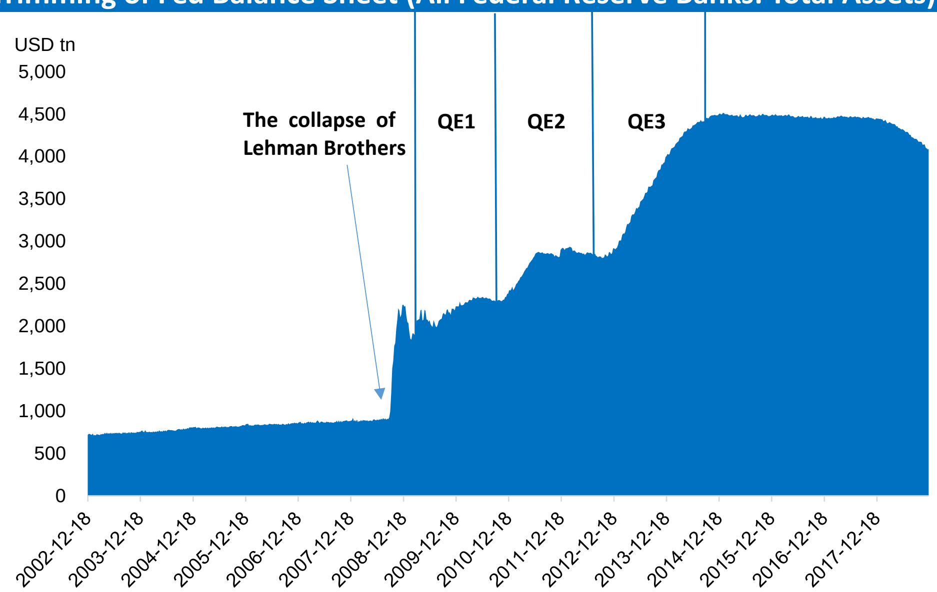
## 1. The transition from QE to QT causes evaporation of liquidity

**We see the skyrocketing debt level and asset bubble triggered by QE is worth to be paid attention.** FED initiated Quantitative Easing (QE) to save the world from recession in 2007, and the FED's balance sheet has expanded dramatically in the past decade and the low borrowing cost made the debt level rose to all-time high. It is undeniably true that the side effect of the QE is significant, as the global debt level is much higher than 10 years before, with the US government debt to be over USD20 trn. The ratio of non-financial corporate debt to GDP has reached an all-time high of more than 73%.

**A decade has passed, unwinding of QE is now on the way. We see the even faster trimming down of balance sheet according to FED normalization policy stepping in 2019 will negatively impact the stock market.** Since Oct 2017, the US central bank has begun to shrink its balance sheet by gradually reduce the size to a maximum of USD50bn per month. As a result, the total asset held by the FED has slowly dipped from about USD4.5tn to ~USD4.1tn recently. According to FED guidance, the scale of trimming (sum of agency debt and mortgage-backed securities plus treasury) should be around USD130bn in 2018, USD450bn in 2019 and USD600bn in 2020. So far, the trimming process is still a long way to go until the total assets level reduced to USD2.2tn. Meanwhile, ECB has also ended its EUR2.6 trn asset purchase scheme in the end of 2018, which will only further exacerbate the problem of liquidity shortage.

**Figure 1. Trimming of Fed Balance Sheet (All Federal Reserve Banks: Total Assets)**




*Source: Bloomberg, CASH*

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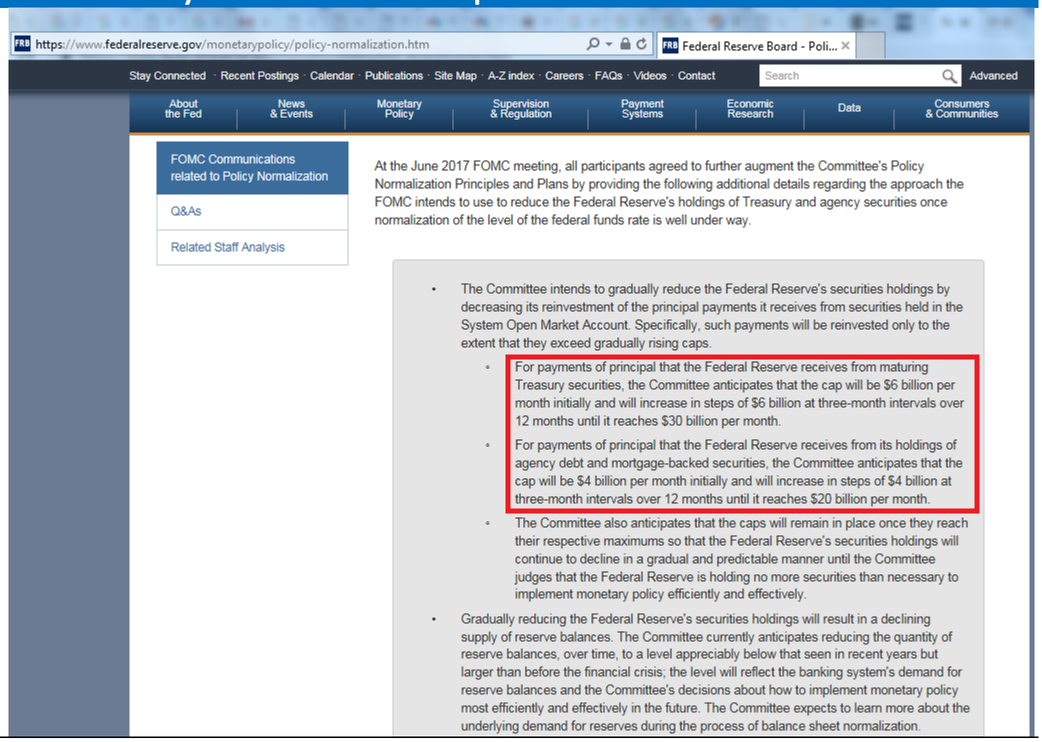
**Figure 2. FED Policy Normalization Principles and Plans**


https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm

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FOMC Communications related to Policy Normalization

Q&As

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At the June 2017 FOMC meeting, all participants agreed to further augment the Committee's Policy Normalization Principles and Plans by providing the following additional details regarding the approach the FOMC intends to use to reduce the Federal Reserve's holdings of Treasury and agency securities once normalization of the level of the federal funds rate is well under way.

- The Committee intends to gradually reduce the Federal Reserve's securities holdings by decreasing its reinvestment of the principal payments it receives from securities held in the System Open Market Account. Specifically, such payments will be reinvested only to the extent that they exceed gradually rising caps.
  - For payments of principal that the Federal Reserve receives from maturing Treasury securities, the Committee anticipates that the cap will be $6 billion per month initially and will increase in steps of $6 billion at three-month intervals over 12 months until it reaches $30 billion per month.
  - For payments of principal that the Federal Reserve receives from its holdings of agency debt and mortgage-backed securities, the Committee anticipates that the cap will be $4 billion per month initially and will increase in steps of $4 billion at three-month intervals over 12 months until it reaches $20 billion per month.
  - The Committee also anticipates that the caps will remain in place once they reach their respective maximums so that the Federal Reserve's securities holdings will continue to decline in a gradual and predictable manner until the Committee judges that the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively.
- Gradually reducing the Federal Reserve's securities holdings will result in a declining supply of reserve balances. The Committee currently anticipates reducing the quantity of reserve balances, over time, to a level appreciably below that seen in recent years but larger than before the financial crisis; the level will reflect the banking system's demand for reserve balances and the Committee's decisions about how to implement monetary policy most efficiently and effectively in the future. The Committee expects to learn more about the underlying demand for reserves during the process of balance sheet normalization.

*Source: Fed, CASH*

## 2. Slower than expected interest rate hike pace may imply economic slowdown

The Federal Reserve in Dec 2018 raised its target fed funds rate by 0.25%, as expected, to 2.25-2.5% but the Fed's latest dot plot shows the FOMC's median forecast calling for two rate hikes in 2019, down from three previously, and possibly another one in 2020. The FOMC lowered its outlook for the long-run funds rate, from 3% in the previous forecast to 2.8%. The 2019 estimate declined to 2.9% from 3.1% and both 2020 and 2021 dropped to 3.1% from 3.4%. We believe weaker global growth to be a valid concern. Meanwhile, Fed has changed the economic forecast and tuned down both real GDP and PCE inflation.

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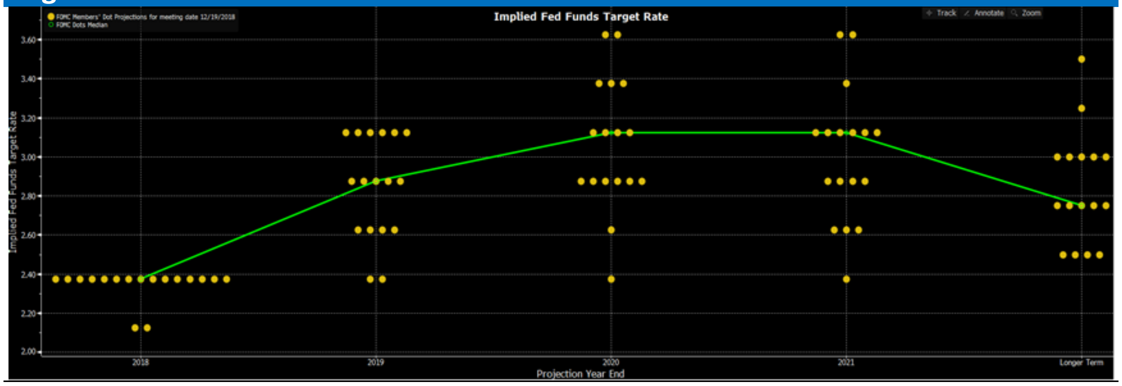
## Figure 3. The U.S. Federal Reserve Dot Plot




*Source: Bloomberg, CASH*

## Figure 4. Summary of Economic Projections

Percent

| Variable | Median[1] | | | | | Central tendency[2] | | | | | Range[3] | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2018 | 2019 | 2020 | 2021 | Longer run | 2018 | 2019 | 2020 | 2021 | Longer run | 2018 | 2019 | 2020 | 2021 | Longer run |
| Change in real GDP | 3.0 | 2.3 | 2.0 | 1.8 | 1.9 | 3.0–3.1 | 2.3–2.5 | 1.8–2.0 | 1.5–2.0 | 1.8–2.0 | 3.0–3.1 | 2.0–2.7 | 1.5–2.2 | 1.4–2.1 | 1.7–2.2 |
| September projection | 3.1 | 2.5 | 2.0 | 1.8 | 1.8 | 3.0–3.2 | 2.4–2.7 | 1.8–2.1 | 1.6–2.0 | 1.8–2.0 | 2.9–3.2 | 2.1–2.8 | 1.7–2.4 | 1.5–2.1 | 1.7–2.1 |
| Unemployment rate | 3.7 | 3.5 | 3.6 | 3.8 | 4.4 | 3.7 | 3.5–3.7 | 3.5–3.8 | 3.6–3.9 | 4.2–4.5 | 3.7 | 3.4–4.0 | 3.4–4.3 | 3.4–4.2 | 4.0–4.6 |
| September projection | 3.7 | 3.5 | 3.5 | 3.7 | 4.5 | 3.7 | 3.4–3.6 | 3.4–3.8 | 3.5–4.0 | 4.3–4.6 | 3.7–3.8 | 3.4–3.8 | 3.3–4.0 | 3.4–4.2 | 4.0–4.6 |
| PCE inflation | 1.9 | 1.9 | 2.1 | 2.1 | 2.0 | 1.8–1.9 | 1.8–2.1 | 2.0–2.1 | 2.0–2.1 | 2.0 | 1.8–1.9 | 1.8–2.2 | 2.0–2.2 | 2.0–2.3 | 2.0 |
| September projection | 2.1 | 2.0 | 2.1 | 2.1 | 2.0 | 2.0–2.1 | 2.0–2.1 | 2.1–2.2 | 2.0–2.2 | 2.0 | 1.9–2.2 | 2.0–2.3 | 2.0–2.2 | 2.0–2.3 | 2.0 |
| Core PCE inflation[4] | 1.9 | 2.0 | 2.0 | 2.0 | | 1.8–1.9 | 2.0–2.1 | 2.0–2.1 | 2.0–2.1 | | 1.8–1.9 | 1.9–2.2 | 2.0–2.2 | 2.0–2.3 | |
| September projection | 2.0 | 2.1 | 2.1 | 2.1 | | 1.9–2.0 | 2.0–2.1 | 2.1–2.2 | 2.0–2.2 | | 1.9–2.0 | 2.0–2.3 | 2.0–2.2 | 2.0–2.3 | |
| Memo: Projected appropriate policy path | | | | | | | | | | | | | | | |
| Federal funds rate | 2.4 | 2.9 | 3.1 | 3.1 | 2.8 | 2.4 | 2.6–3.1 | 2.9–3.4 | 2.6–3.1 | 2.5–3.0 | 2.1–2.4 | 2.4–3.1 | 2.4–3.6 | 2.4–3.6 | 2.5–3.5 |
| September projection | 2.4 | 3.1 | 3.4 | 3.4 | 3.0 | 2.1–2.4 | 2.9–3.4 | 3.1–3.6 | 2.9–3.6 | 2.8–3.0 | 2.1–2.4 | 2.1–3.6 | 2.1–3.9 | 2.1–4.1 | 2.5–3.5 |

*Source: Fed, CASH*

**Our view about slower macro growth in 2019 lies on high base effect brought by Trump stimulus policy.** The tax cut and USD1tn infrastructure spending plan in 2018 adopted by the Trump administration is one of the key drivers to boost GDP growth, jobs and employment in the US. But, we believe this one-off effect of fiscal stimulus may well start to fade out in 2019 due to high base. After the US mid-term elections, the House is now under the control of Democrats (fighting against the Republican-held Senate), this may reduce the possibilities of further policy stimulus in an intention to lower Trump's re-election chances in 2020. **We think given no strong macro fundamental to support, this round of US rate hike cycle enters into the last stage in 2019-20.**

We expect US Federal Reserve will continue to slower the pace of rate hikes amid slower macro, recent rising fears of stock market crash and trade conflict uncertainty. Taking a look at 2007, the global market reached the peak a month

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after Fed cut the target on a key short-term interest rate by 0.25% in Sep 2007 to 4.75%. **Therefore, investors should keep alert of the changing US monetary policy over time, end of rate hike or even start of rate cut will further confirm our bearish view on economic growth and stock market.**

**Figure 5. Market peak in 2007**


*Source: Bloomberg, CASH*

### 3. The upcoming inverted yield curve may imply recession? Yes, but probably not in 2019

**We think 2019 is not a recession year.** This round of US economic recovery from 2007-09 financial crisis has been unusually lengthy. As of Dec 2018, economic growth has already lasted 112 months, the second longest in US history and we think US economic growth will lose steam in 2019. And we use yield curve analysis to determine the timing of recession. 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 0.12% at present. We expect that the spread will become zero after one interest rate hikes, implying an inversion of yield curve. The timing between the emergence of the inverted yield curve and recession was different, with average of around 15.2 months. We estimate the possibility of a recession in 2019 is extremely low.

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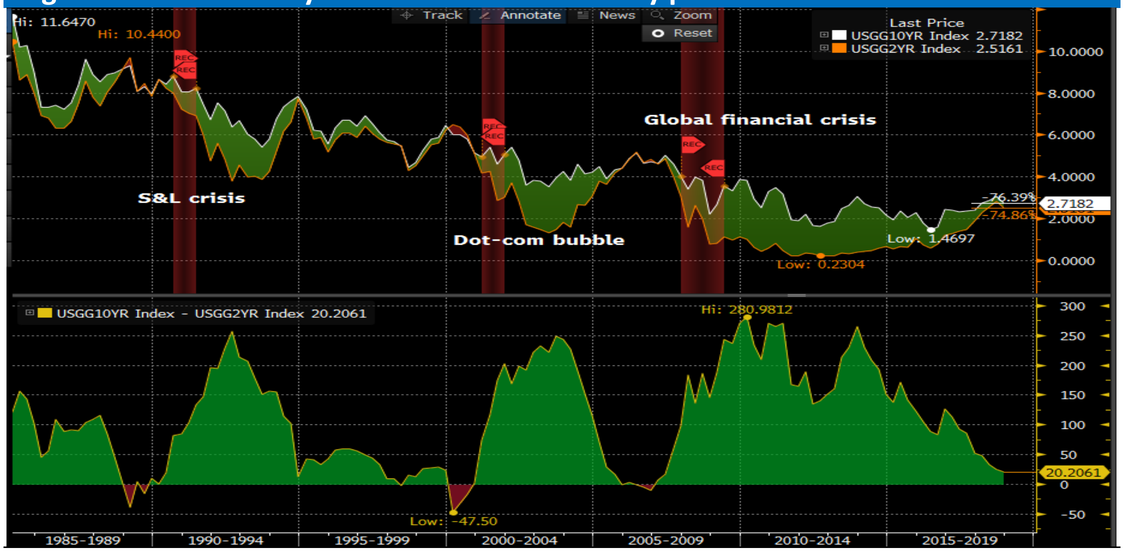
**Figure 6. An inverted yield curve has successfully predicted recessions**




*Source: Bloomberg, CASH*

**An inverted yield curve could be a reliable predictor of recession: Normally investors are looking for a higher yield to compensate the longer period that their money is being locked up. However, if the investors expect the future economy is going through downturn, so that the Fed fund rate has to be lowered to save the economy, they would like to invest their money in a longer maturity rather than reinvesting their money in a much lower rate in a sooner future. With a higher demand on the long-term bond, the long-term yield would be pushed down.*

## 4. Weak China economic outlook

**1H19 will remain weak.** With the backdrop of trade war and a tight credit environment, China's official manufacturing PMI edged closer to the 50% threshold that separates expansion from contraction in the manufacturing sector, where it has been for more than two years. The retail sales figures were also disappointing, with the growth to be only at 8.1% in Nov (down from the 9%-10% range in 2017). Meanwhile, the activity growth, as shown by IP data, became soft in 2H18. Amid the trade war, the seemingly healthy export data may reflect front-loading by exporters before more tranche of US tariffs to be imposed and RMB depreciation. Apart from (1) the negative impact of tariff war becoming more visible, we expect (2) broad-based slowdown in FAI activity (real estate investment has started to cool down, peaking manufacturing investment due to weak market sentiment, soft infrastructure investment due to weak credit growth) in 1H19. However, we believe the effect of policy relaxation will come in, which can help re-vitalize the economy.

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**Figure 7. China official manufacturing PMI with sub-indicators**

| Indicators | 2018/12/31 | 2018/11/30 | 2018/10/31 | 2018/9/30 | 2018/8/31 | 2018/7/31 | 2018/6/30 |
|---|---|---|---|---|---|---|---|
| Manufacturing PMI | 49.4 | 50 | 50.2 | 50.8 | 51.3 | 51.2 | 51.5 |
| Output PMI | 50.8 | 51.9 | 52 | 53 | 53.3 | 53 | 53.6 |
| New order PMI | 49.7 | 50.4 | 50.8 | 52 | 52.2 | 52.3 | 53.2 |
| Backlogs of Orders PMI | 44.1 | 44.3 | 44.3 | 45.2 | 46.7 | 45.7 | 45.5 |
| New Export Orders PMI | 46.6 | 47 | 46.9 | 48 | 49.4 | 49.8 | 49.8 |
| Imports PMI | 45.9 | 47.1 | 47.6 | 48.5 | 49.1 | 49.6 | 50 |
| Stocks of Finished Goods PMI | 48.2 | 48.6 | 47.1 | 47.4 | 47.4 | 47.1 | 46.3 |
| Invetories of Raw Materials PMI | 47.1 | 47.4 | 47.2 | 47.8 | 48.7 | 48.9 | 48.8 |
| Input Prices PMI | 44.8 | 50.3 | 58 | 59.8 | 58.7 | 54.3 | 57.7 |
| Purchase of Inputs PMI | 49.8 | 50.8 | 51 | 51.5 | 51.8 | 51.5 | 52.8 |
| Suppliers' Delivery Time PMI | 50.4 | 50.3 | 49.5 | 49.7 | 49.6 | 50 | 50.2 |
| Production and Business Activities PMI | 52.7 | 54.2 | 56.4 | 56.4 | 57 | 56.6 | 57.9 |
| Employment PMI | 48 | 48.3 | 48.1 | 48.3 | 49.4 | 49.2 | 49 |

*Source: Bloomberg, CASH*

**Figure 8. China economy indicator**

| Indicators | 2018/11/30 | 2018/10/31 | 2018/9/30 | 2018/8/31 | 2018/7/31 | 2018/6/30 | 2018/5/31 | 2018/4/30 | 2018/3/31 |
|---|---|---|---|---|---|---|---|---|---|
| IP (yoy %) | 5.4 | 5.9 | 5.8 | 6.1 | 6 | 6 | 6.8 | 7 | 6 |
| FAI (yoy %) | 5.9 | 5.7 | 5.4 | 5.3 | 5.5 | 6 | 6.1 | 7 | 7.5 |
| Exports (yoy %) | 5.4 | 15.6 | 14.4 | 9.5 | 11.6 | 10.7 | 11.9 | 11.9 | -3 |
| Import (yoy %) | 3 | 20.8 | 14.5 | 20.7 | 26.9 | 13.8 | 26.1 | 22.2 | 14.8 |
| Trade Balance (RMB bn) | 306.04 | 238.76 | 209.02 | 168.52 | 172.8 | 256.67 | 147.26 | 166.94 | -35.06 |
| Retail Sales (yoy %) | 8.1 | 8.6 | 9.2 | 9 | 8.8 | 9 | 8.5 | 9.4 | 10.1 |
| CPI (yoy %) | 2.2 | 2.5 | 2.5 | 2.3 | 2.1 | 1.9 | 1.8 | 1.8 | 2.1 |
| PPI (yoy %) | 2.7 | 3.3 | 3.6 | 4.1 | 4.6 | 4.7 | 4.1 | 3.4 | 3.1 |
| M2 Growth (yoy %) | 8 | 8 | 8.3 | 8.2 | 8.5 | 8 | 8.3 | 8.3 | 8.2 |

*Source: Bloomberg, CASH*

## 5. Policy relaxation as countercyclical buffer

**We expect China will take combination of policy actions to control the pace of economic slowdown.** Overall, our forecast for full-year 2018 GDP growth to be at 6.6% yoy, and we expect 2019 GDP growth to moderate to 6.2% yoy. Amid macro headwinds, on fiscal policy, **fiscal deficit target will increase from 2.6% of GDP in 2018 to 3% of GDP in 2019** with the increase of official local government special bond issuance quota to no less than RMB1.35 trn in 2019. Tax cuts of at least RMB1.3trn (e.g. (1) in the form of individual income tax cuts for the household, (2) reduction in value-added tax, corporate income tax and social security contribution rate to support the corporate sectors), as well as (3) tariff cuts and higher tax rebate for exporters) would stimulate the economy; while on the monetary policy front, **we look for two more RRR cuts in 2019** to lower funding cost for real economy, with TSF growth turning up modestly. Economic activity may improve after the policy dividend of stepped-up easing finally comes in.

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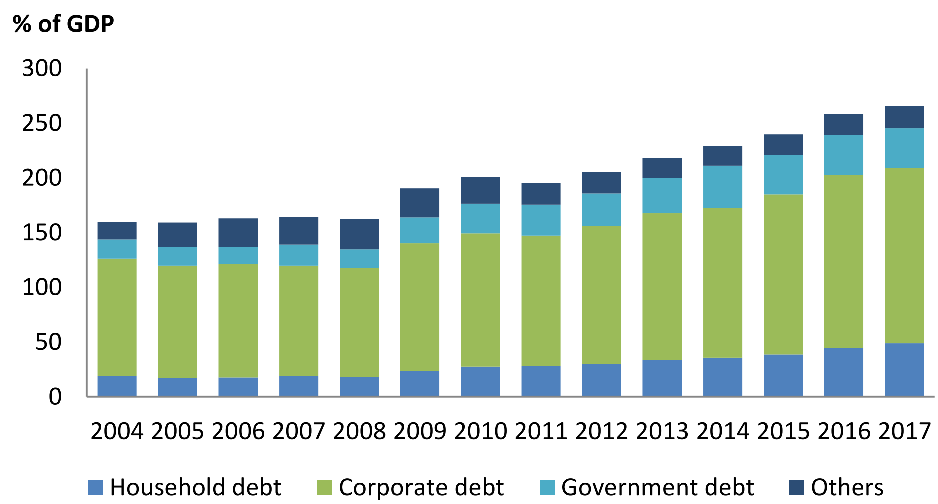
### 6. Favorable adjustment of China deleveraging Policy

**Our view is that the policymakers want China to stay growth-conducive(穩增長).** We think Policymakers may gradually adjust the deleveraging policy to a milder one by shifting the target from lowering the debt to GDP ratio to stabilizing debt growth in line with nominal GDP growth. On one hand, stabilize the economy. On the other hand, not to reflate any housing bubble, not to further boost the debt risk (Currently, China's total debt exceeded 250% of its GDP) and to avoid large scale default. In the perspective of policy tone, we see that the Politburo pointed out the deteriorating downside pressure for China in the Oct meeting and called for timely policies to support economic growth, strengthen private confidence and resist capital market stress. In view of monetary policy, the PBOC has already cut the RRR three times since Apr 2018 and has been guiding bank to expand their credit especially to private enterprises and SMEs. But, we do not expect aggressive credit loosening or stimulus in 2019 due to recent RMB weakness. (tightening policy for the housing sector and local government opaque debt likely to remain)

**Figure 9. China's total debt reaching over 250% of its GDP, 100pp higher than it was 10 years ago**




*Source: Bloomberg, CASH*

To increase liquidity in the private sectors, on Nov. 9, 2018, banking and monetary authorities announced guidelines, a.k.a the "one two five" goal, for banks. For large-scale banks, lending to private companies should not be less than 1/3 of their new corporate loans, while that of small and medium-size banks, the proportion should be no less than 2/3. The policy aims to establish that no less than 50% of banks' new corporate loans will be given to private enterprises over the following three years. Short term method, including the

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recent targeted medium-term lending facility (TMLF) may temporality improve the private sector's liquidity problem and lower the default risks.

### 7. Wrestling between the powers

**US- China Trade war concern remains an overhang.** After the G20 meeting, US and China agreed to a temporary truce on trade. Trump agreed to maintain the 10% tariffs on USD200 bn worth of Chinese goods, and not raise to 25% ahead of a January 1 deadline during the 90- day negotiation period. In exchange, China agreed to purchase a "very substantial" amount of agriculture, energy and other goods from the United States to help reduce the trade imbalance. Despite the temporary truce, we think US- China Trade war concern remains an overhang as the 90- days negotiation is only a temporary solution, the tension between a rising and status-quo power will remain in the long run, with the conflict going beyond trade and relating to export control/investment restriction in technology, market access, IP protection, competition of economic system and geopolitical issues. **Given large size of China's manufacturing capacity, we think relocation of global supply chain can be disruptive without sufficient adjustment period. We think escalation in US-China trade war will continue to hurt market sentiment and trigger RMB depreciation and valuation de-rating in the near term.**

### 8. Undemanding valuation and search for value stocks/high dividend yielders

(1) Escalation of US-China trade conflict; (2) rising concerns about growth outlook; (3) disappointment on the progress in market-oriented structural reform(for example the role of private-owned enterprises (POEs) in China); (4) negative industry policies (e.g. drug price control, internet gaming license suspension, new rules on asset management, stricter enforcement in environment protection) have sent China and HK stock market lower, these factors are mostly priced in, in our view. **We expect smart money prefers China/HK stock market to global stock market like US, Japan, EU, given Central Government's "policy put" to avoid systemic risk and unchanged market-oriented structural reform incentive.**

According to Bloomberg, the forward PE ratio of the HSI is now around 8.8X, which is largely lower than the 10-year average of 9.6X, reflecting the undemanding valuation. The SSE's forward PE ratio is now 8.1, significantly lower than the 10-year average of 9.9X

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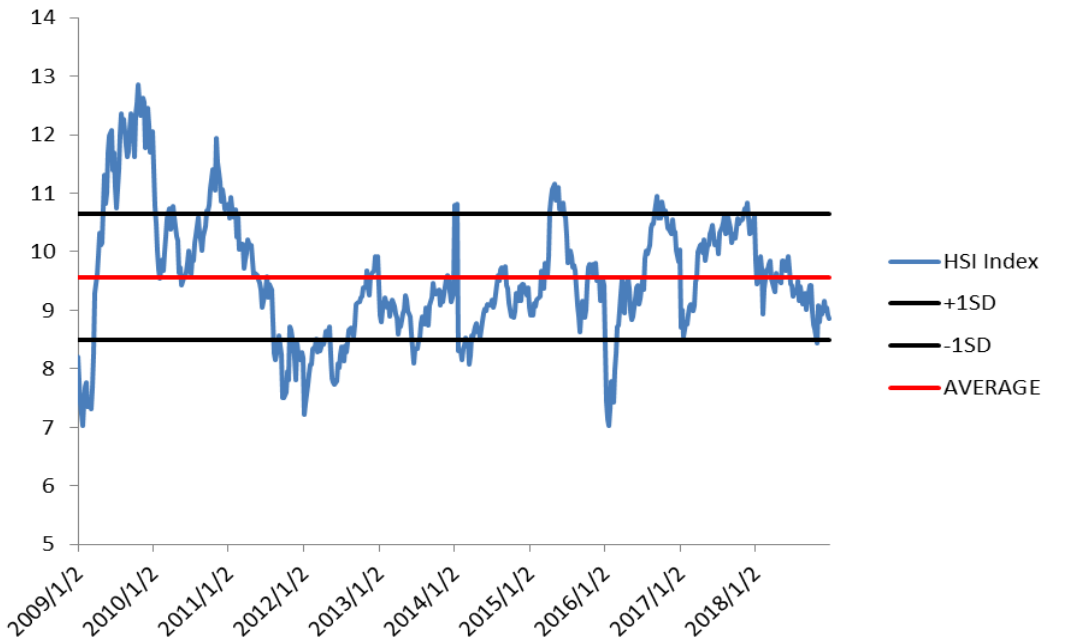
**Figure 10. HK Stock's PE is still lower than 10 year average**




*Source: Bloomberg, CASH*

**Our HSI target 27,700 in 2019: Currently, the HSI is trading at forward PE 8.8X and PB 1.01X.** Our base case target of HSI is 27,700 in 2019, reflecting a PE of 9.6X which is the 10-year average. If trade war worries resolve, coupled with stronger than expected corporate earnings growth (though we think the possibility is very low), **HSI's bull case target will be 30,600**, reflecting a PE of 10.5X PE; On the contrary, if economic slowdown comes more severe than expected with large-scale RMB devaluation and strong risk-off sentiment, **HSI may fall back to our bear case around 21,900**, reflecting a PB of 0.87X.

**In 2019, our stock picks are China Mobile (941.HK), CKI (1038.HK), Sands China (1928.HK), Link REIT (823.HK) and CSPC (1093.HK).**

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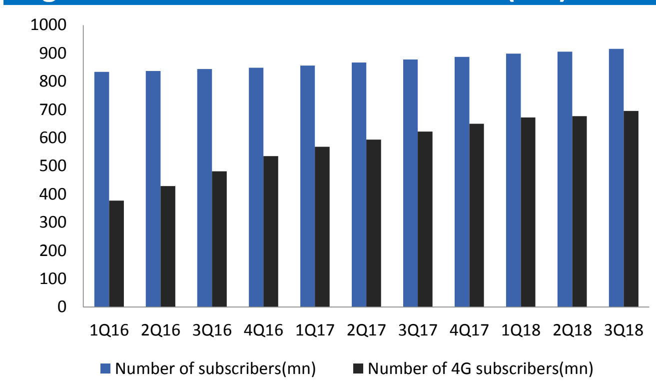
# China Mobile (941.HK)

**Scale advantage:** We believe China Mobile (00941) has scale advantage with its dominant mobile market share. China Mobile is the largest telecom operator in China. It has over 910mn mobile users (4G subscribers: 695mn), reaching almost 60% of China totaled 1,546mn mobile users (4G subscribers: 1,150mn). Its business segments include telecom service (data/voice service) and sales of products and others. We think the scale advantage will allow CM to have a higher margin (2018E EBITDA margin: ~37%, CU: ~29% and CT: ~28%)

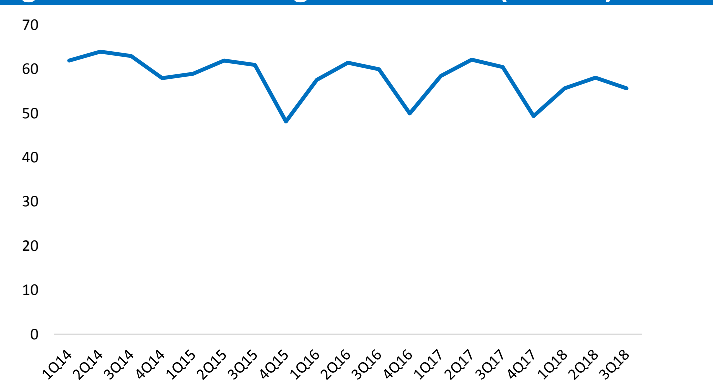
**Number of subscribers is still growing:** Due to the large presence in rural and regional areas, CM's mobile ARPU will continue to be negatively impacted by the cancellation of data roaming on a YoY basis until the end of 2Q19 (previously elimination of voice roaming tariffs played out by 3Q18). However, we think unlimited and high capacity data plans launched in 3Q18 will help with customer acquisition including 4G subscribers. We expect the above positive effect can more than offset the declining ARPU and CM revenue can achieve low-single-digit revenue growth.

**Figure 11. CM number of subscribers(mn)**




*Source: China Mobile, CASH*

**Figure 12. CM declining mobile ARPU (in RMB)**




*Source: China Mobile, CASH*

CM has lost its mobile subscriber market share since 2016, mainly due to uncompetitive pricing, but we see subscriber market reaching the inflection point. (probably an intention to alleviate the potential regulatory risk arising from being overly dominant). Our recent checks suggested that CM's pricing of mobile data plan has cut to almost aligned with its peers (CM's Beijing "Freely Use it Nationwide" package (任我用全國不限量套餐) RMB78 vs. RMB238 before). CM has the cost advantage/ stronger cash position/ strong customer experience (lowest rate of network complaints) compared with peers, market share loss will not be sustainable.

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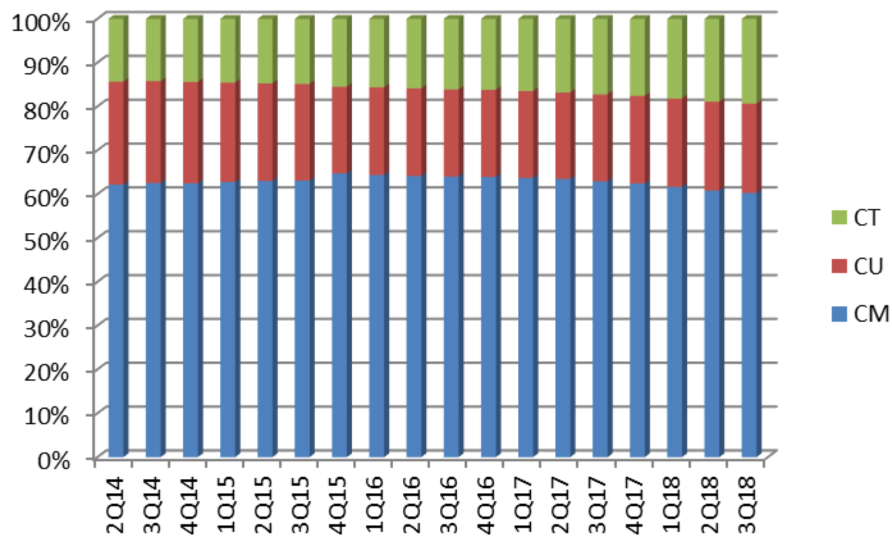
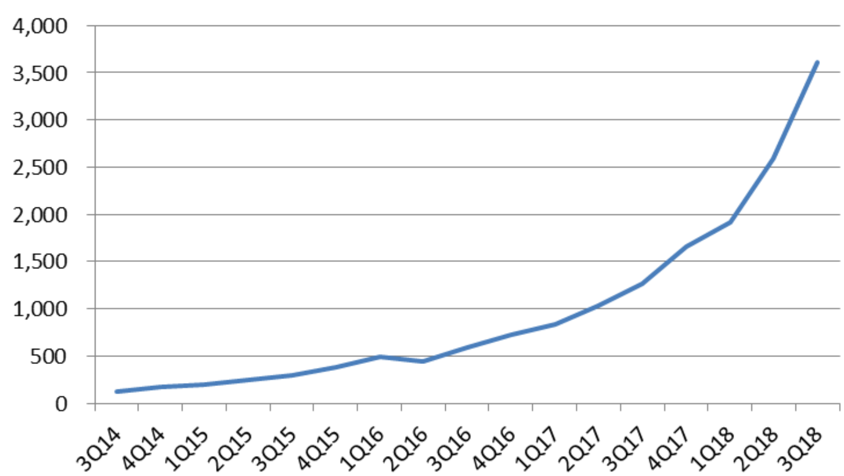
**Figure 13. Major 3 telecom operators' market share of mobile subscribers**




*Source: CM, CU, CT, CASH*

**Jump in mobile traffic also helps:** CM's mobile data traffic grew exponentially, driven by strong growth of data of usage (demand for sharing images, streaming music, high definition video or playing games, etc). Looking forward, considering that 5G will bring disruptive changes to the development of drones, connected cars, industrial Internet and robots, we can foresee even higher demand for mobile traffic in long run, alleviating the negative impact of 'speed upgrade and tariff reduction policy' addressed by Central government.

**Figure 14. Major Data of usage (DOU) (MB/user/month)**




*Source: China Mobile, CASH*

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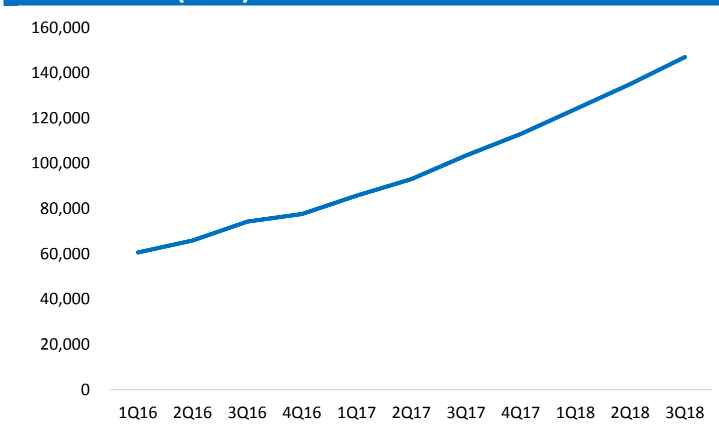
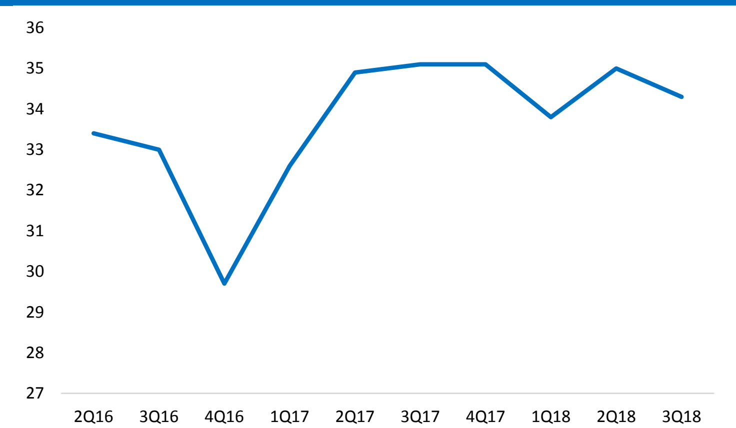
**CM Fixed Broadband is a future bright spot:** A few years ago, China Mobile acquired part of the asset business of China TieTong Group for more than RMB30 bn, and obtained a fixed broadband license and expanded this part of the business. After the integration with Tietong in recent years, China Mobile further enhanced its fixed network capacity, coverage and efficiency, its wireline broadband customers recorded a positive trend and exceeded 147 million in 3Q18, we expect the integration of mobile and fixed business can increase customer loyalty and reduce churn rate with the provision of bundled services, and the trend will go on in the near future with stable ARPU (RMB34-35, discount to its bigger peers), and finally overtaking China Telecom to become the market leader. We see internet of things (IoT), internet data center (IDC) and cloud segments are the emerging fixed-line areas.

**Figure 15. Wireline broadband - number of subscribers ('000)**




*Source: China Mobile, CASH*

**Figure 16. Wireline broadband – ARPU (in RMB)**




*Source: China Mobile, CASH*

**CM's 5G Capex lower than expected:** Previously, market expects CM will have much 5G burden by using the 4.8GHz spectrum band, while its two smaller peers will be allocated the 3.5GHz band, which is the global standard. But CM will be allocated 100MHz in the 2.6GHz band for 5G, resulting in lower capex (enabling it to re-use existing 3G and 4G locations for its 5G network rollout). We think that is positive to CM as (1) CM will have 3x more 5G spectrum than CT and CU; (2) the 2.6Ghz is adjacent to CM's 4G LTE spectrum, enabling it to leverage its current infrastructure to rollout 5G rapidly and inexpensively, which can ensure its 5G leadership.

Also, ramp up in 5G capex is likely to be slower than that of 4G which pick up fast at initial stage, since China Telecom operators initially focus on 5G outdoor

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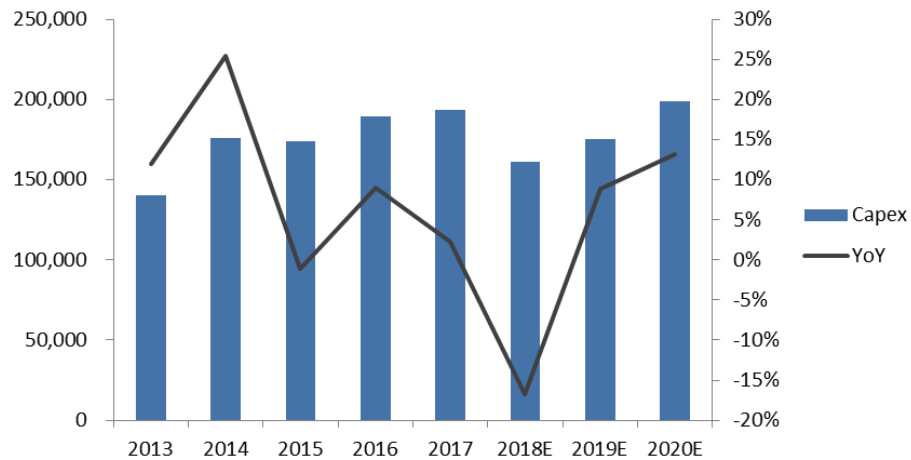
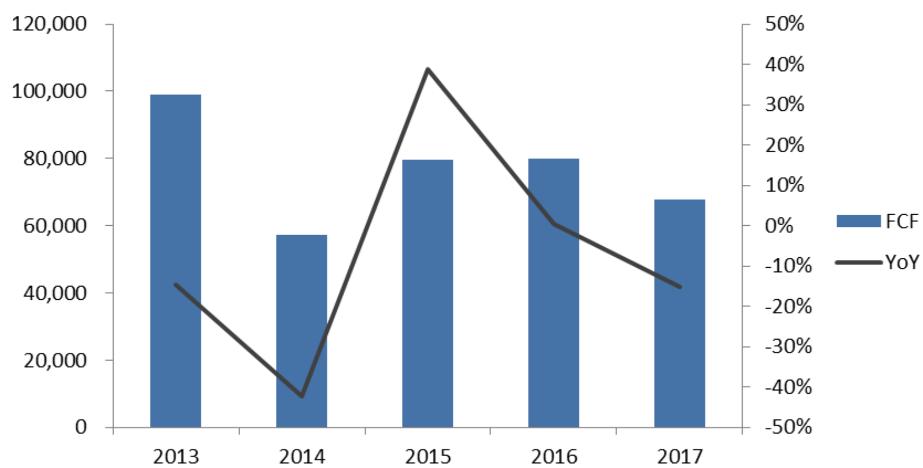
coverage, along roads or areas for IoT and edge computing activities, with indoor coverage rollouts coming after 2021. Also, the utilization rates of CM, CT and CU are 40%, 36% and 65% as of mid-2018, which means CM has a rate lower than the benchmark rate that require major network capacity upgrade. As CM is able to handle the sudden increase in data usage, we do not see a strong capex demand in the near term. We forecast 2018/19/20 capex of CM will grow by -16.7%/8.8%/22.6% YoY vs. 0.5%/12%/25% YoY in 2012/13/14, leading to a healthy near term outlook for free cash flow.

**Figure 17. CM's 5G capex (in mn RMB)**




*Source: China Mobile, CASH*

**Figure 18. CM's FCF (in mn RMB)**




*Source: China Mobile, CASH*

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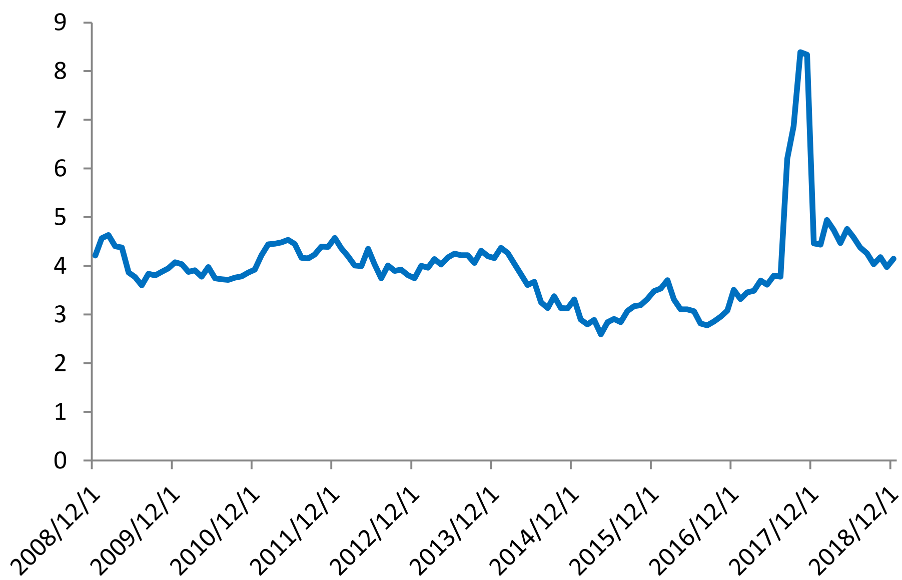
**CM will be the biggest beneficiary in 5G:** We do not believe many consumers are willing to pay a higher ARPU for 5G low latency and high speed as 4G is good enough for high-resolution video and gaming. Applications like surveillance, edge computing, AR/VR, autonomous driving, IoT are designed for corporate users who are less price sensitive but quality sensitive. In this sense, CM is likely to become the biggest beneficiary due to its quality service. Also, its widest coverage will continue to provide scale advantage and margin in 5G.

**Improvement in payout ratio:** China Mobile has the strongest financial position among the three major telecom operators in China. As of June 2018, China Mobile recorded net cash with RMB382bn cash & cash deposits with no debt, its cash ratio reached 88%, the highest among its global peers. Its cash reserves provide a good buffer for capex increase from 5G rollout. CM enhanced its payout ratio in the last 2 years after 9 years of flat payout given the gradual monetarization after 4G roll-out completion and higher demand from the government in improving SOE payout.

**Figure 19. CM's dividend yield for the past 10 years**




*Source: Bloomberg, CASH*

CM dividend yield with stable growth remain attractive. We forecast CM to deliver a dividend yield of ~4% in 2018, slightly higher than its long run average. We predict its EPS will record a low single digit growth with strong free cash flow for next 3 years, which can provide support to its DPS growth.

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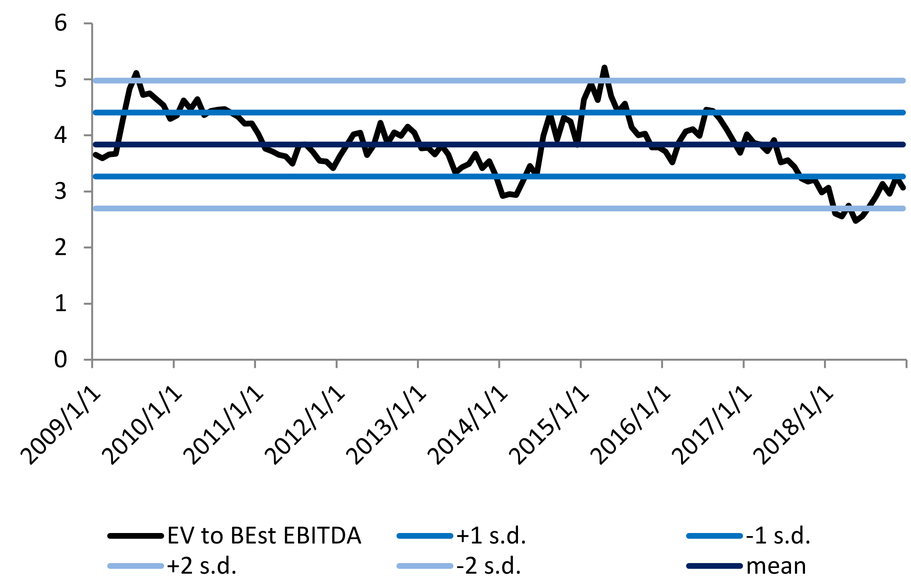
**Valuation:** CM's BEST EV/EBITDA is around 3.2X, lower than 10-year average of ~4X. Our target price of HKD86, implies 14% upside based on our FCF model (assume growth rate in perpetuity=2%, market risk premium=10%, beta=0.77). We initiate our Buy rating as we think 5G capex risk is overdone and current stock valuation and dividend yield is attractive. We also like CM's highly defensive telecom business especially when economy may slow down.

**Figure 20. CM's BEST EV/EBITDA**




*Source: Bloomberg, CASH*

**Key Risk:**

1. Reduction in CM's dividend value due to RMB depreciation;
2. More intense competition in the mobile market (drive down data revenue and put more pressure on China Mobile's pricing);
3. Faster-than-expected decline in voice revenues (CM is the market leader providing the widest voice call coverage in China, with voice contributing a larger part of total revenue compared with the other two operators);
4. CM acts as a tool of state policy and may be over-investing in 5G (but we think technology research in the early stage of network deployment gives them a competitive edge, coupled with free marketing in remote regions and better network coverage compared with peers, also overinvesting risk reduced after the establishment of China Tower);
5. Slowdown in 4G monetarization.

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# China Mobile

# 941.HK, Buy, TargetPrice: HK$86

**Income Statement (million RMB)**

| Year-end 31 Dec | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Revenue | 708,421 | 740,514 | 767,962 | 797,818 | 827,674 |
| SG&A | -590,333 | -620,388 | -636,663 | -661,415 | -686,166 |
| Other expense | -57,493 | -61,086 | -57,835 | -60,083 | -62,332 |
| Operating profit | 118,088 | 120,126 | 131,299 | 136,403 | 141,508 |
| EBITDA | 256,677 | 270,421 | 284,332 | 295,209 | 306,133 |
| Depreciation | -138,090 | -149,780 | -152,514 | -158,443 | -164,372 |
| Amortization | -499 | -515 | -519 | -362 | -253 |
| EBIT | 118,088 | 120,126 | 131,299 | 136,403 | 141,508 |
| Net interest expense | 16,005 | 15,883 | 15,466 | 16,477 | 17,525 |
| Associates & JCEs | 8,636 | 9,949 | 9,949 | 9,949 | 9,949 |
| Other income | 1,733 | 2,179 | 2,179 | 2,179 | 2,179 |
| Earnings before tax | 144,462 | 148,137 | 158,893 | 165,008 | 171,161 |
| Income tax | -35,623 | -33,723 | -37,676 | -39,126 | -40,585 |
| Net profit After tax | 108,839 | 114,414 | 121,216 | 125,881 | 130,575 |
| Minority interests | -98 | -135 | -135 | -135 | -135 |
| Other items | 0 | 0 | 0 | 0 | 0 |
| Preferred dividends | 0 | 0 | 0 | 0 | 0 |
| Normalised NPAT | 108,741 | 114,279 | 121,081 | 125,746 | 130,440 |
| Extraordinary items | 0 | 0 | 0 | 0 | 0 |
| Reported NPAT | 108,741 | 114,279 | 121,081 | 125,746 | 130,440 |
| Dividends | -48,993 | -110,909 | -54,553 | -56,655 | -58,770 |
| Transfer to reserves | 59,748 | 3,370 | 66,528 | 69,092 | 71,671 |
| EPS | 5.31 | 5.58 | 5.91 | 6.14 | 6.37 |
| DPS | 2.39 | 5.42 | 2.66 | 2.77 | 2.87 |

**Balance Sheet (million RMB)**

| Year-end 31 Dec | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Cash & equivalents | 90,413 | 120,636 | 188,235 | 258,094 | 296,700 |
| Marketable securities | 367,194 | 345,001 | 345,001 | 345,001 | 345,001 |
| Accounts receivable | 19,045 | 24,153 | 22,635 | 23,515 | 24,395 |
| Inventories | 8,832 | 10,222 | 10,061 | 10,453 | 10,844 |
| Other current assets | 101,161 | 58,184 | 85,002 | 88,307 | 91,611 |
| Total current assets | 586,645 | 558,196 | 650,934 | 725,369 | 768,550 |
| LT investments | 124,039 | 132,499 | 132,499 | 132,499 | 132,499 |
| Fixed assets | 712,209 | 726,141 | 734,899 | 751,976 | 802,799 |
| Goodwill | 35,343 | 35,343 | 35,343 | 35,343 | 35,343 |
| Other intangible assets | 1,708 | 1,721 | 1,202 | 840 | 586 |
| Other LT assets | 61,050 | 68,213 | 68,213 | 68,213 | 68,213 |
| Total assets | 1,520,994 | 1,522,113 | 1,623,090 | 1,714,239 | 1,807,990 |
| ST debt | 10,561 | 8,646 | 8,646 | 8,646 | 8,646 |
| Accounts payable | 250,838 | 233,169 | 256,864 | 266,850 | 276,836 |
| Other current liabilities | 274,990 | 288,167 | 298,475 | 310,079 | 321,683 |
| Total current liabilities | 536,389 | 529,982 | 563,985 | 585,575 | 607,165 |
| LT debt | 0 | 0 | 580 | 1,183 | 1,809 |
| Convertible debt | 0 | 0 | 0 | 0 | 0 |
| Other LT liabilities | 2,467 | 3,250 | 3,250 | 3,250 | 3,250 |
| Total liabilities | 538,856 | 533,232 | 567,816 | 590,009 | 612,224 |
| Minority interest | 3,117 | 3,245 | 3,110 | 2,975 | 2,840 |
| Preferred interest | 0 | 0 | 0 | 0 | 0 |
| Common stock | 402,130 | 402,130 | 402,130 | 402,130 | 402,130 |
| Retained earnings | 536,313 | 522,748 | 589,276 | 658,368 | 730,039 |
| Proposed dividend | -48,993 | -110,909 | -54,553 | -56,655 | -58,770 |
| Other equity and reserves | 40,578 | 60,758 | 60,758 | 60,758 | 60,758 |
| Total shareholders' equity | 982,138 | 988,881 | 1,055,274 | 1,124,231 | 1,195,767 |
| Total equity & liabilities | 1,520,994 | 1,522,113 | 1,623,090 | 1,714,239 | 1,807,990 |

**Cashflow statement (million RMB)**

| Year-end 31 Dec | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Net income | 108,741 | 114,279 | 121,081 | 125,746 | 130,440 |
| Depreciation | 138,090 | 149,780 | 152,514 | 158,443 | 164,372 |
| Amortization | 499 | 515 | 519 | 362 | 253 |
| Change in Net Working Capital | 55,311 | -54,180 | -8,864 | -17,014 | -17,014 |
| Cashflow from operations | 253,701 | 245,514 | 282,978 | 301,566 | 312,080 |
| Capital expenditures | -189,366 | -193,605 | -161,272 | -175,520 | -215,195 |
| Other non current assets | 43,415 | -15,636 | 0 | 0 | 0 |
| Other non current liabilities | 973 | 783 | 0 | 0 | 0 |
| CF from investing acts | -194,523 | -106,533 | -161,272 | -175,520 | -215,195 |
| CF after investing acts | 59,178 | 138,981 | 121,706 | 126,046 | 96,885 |
| Equity issue | 25,561 | 20,308 | -135 | -135 | -135 |
| Debt issue | -1,710 | -1,915 | 580 | 603 | 625 |
| Convertible debt issue | 0 | 0 | 0 | 0 | 0 |
| Dividends | -48,993 | -110,909 | -54,553 | -56,655 | -58,770 |
| CF from financial acts | -48,958 | -108,231 | -54,107 | -56,187 | -58,279 |
| Net cashflow | 10,220 | 30,750 | 67,599 | 69,859 | 38,606 |
| Beginning cash | 79,842 | 90,413 | 120,636 | 188,235 | 258,094 |
| Adjustments | 351 | -527 | 0 | 0 | 0 |
| Ending cash | 90,413 | 120,636 | 188,235 | 258,094 | 296,700 |
| Ending net debt | -79,852 | -111,990 | -179,008 | -248,265 | -286,245 |

*Source: Company data, CASH*

**Key Ratios**

| | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Growth (%)** | | | | | |
| EPS | 1.9% | 5.1% | 6.0% | 3.9% | 3.7% |
| Revenue | 6.0% | 4.5% | 3.7% | 3.9% | 3.7% |
| **Profitability (%)** | | | | | |
| EBITDA margin | 36.2% | 36.5% | 37.0% | 37.0% | 37.0% |
| EBIT margin | 16.7% | 16.2% | 17.1% | 17.1% | 17.1% |
| Net Margin | 15.4% | 15.5% | 15.8% | 15.8% | 15.8% |
| Effective tax rate | 24.7% | 22.8% | 23.7% | 23.7% | 23.7% |
| Dividend payout | 45.1% | 97.1% | 45.1% | 45.1% | 45.1% |
| ROE | 11.1% | 11.6% | 11.5% | 11.2% | 10.9% |
| ROA | 7.1% | 7.5% | 7.5% | 7.3% | 7.2% |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.09 | 1.05 | 1.15 | 1.24 | 1.27 |
| Interest coverage | N/A | N/A | N/A | N/A | N/A |
| **Leverage** | | | | | |
| Net Debt/EBITDA (x) | net cash | net cash | net cash | net cash | net cash |
| Net Debt/Equity (%) | net cash | net cash | net cash | net cash | net cash |
| **Activity (days)** | | | | | |
| Days receivable | N/A | N/A | N/A | N/A | N/A |
| Days inventory | N/A | N/A | N/A | N/A | N/A |
| Days payable | N/A | N/A | N/A | N/A | N/A |
| Cash cycle | N/A | N/A | N/A | N/A | N/A |

*Source: Company data, CASH*

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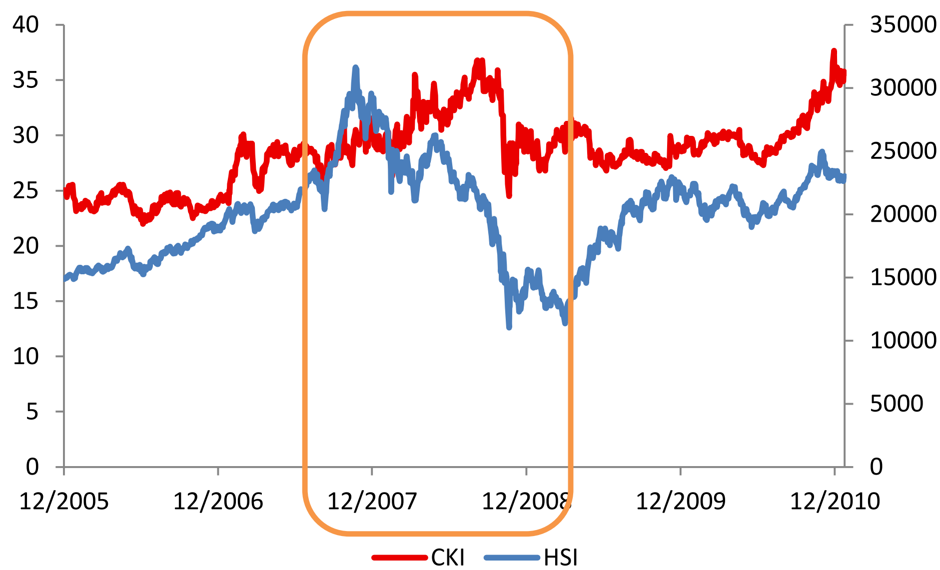
# CK Infrastructure Holdings (1038.HK)

**Comfortable valuation:** CKI's share price fell by 27% since its peak of ~HK$81 in Feb2016, dragged by the concern over Brexit. With the share weakness, we find CKI valuation to be a comfortable one. CKI is currently trading at 13.6x PE and offering 4.2% dividend yield. We are positive towards CKI as it has a defensive nature in long term. Historically speaking, the share usually outperformed the market during economic turmoil, especially evidenced by its performance during financial tsunami in 2008-09.

**Figure 21. CKI v.s HSI during financial tsunami in 2008**




*Source: Bloomberg, CASH*

**A pleasant choice during trade war:** As a global infrastructure company, CKI's investments span all continents, with only 3-4% NI contributed by China (including the PAH in the calculation). See figure 22 for details. Despite the 90-day ceasefire of trade war, the Huawei incident aroused global attention. With the US- China relation remain an unknown, it is better to search for companies that have global operation to diversify geographical risk.

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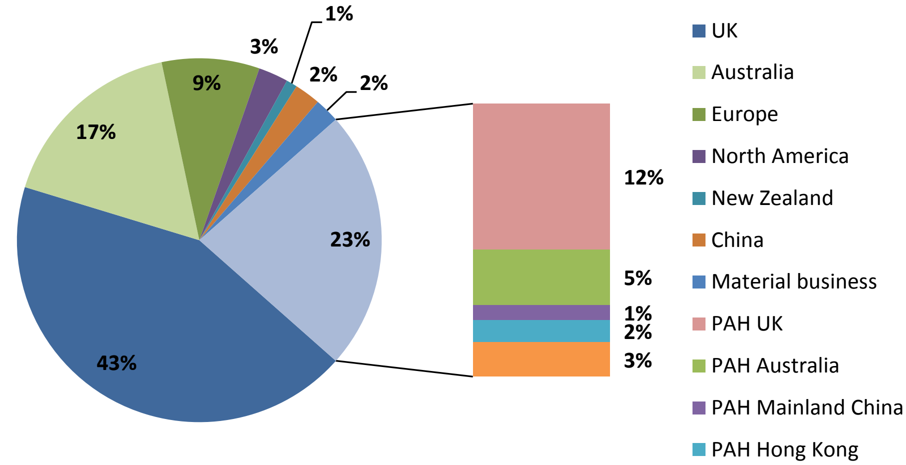
**Figure 22. Net Profit contribution by region**

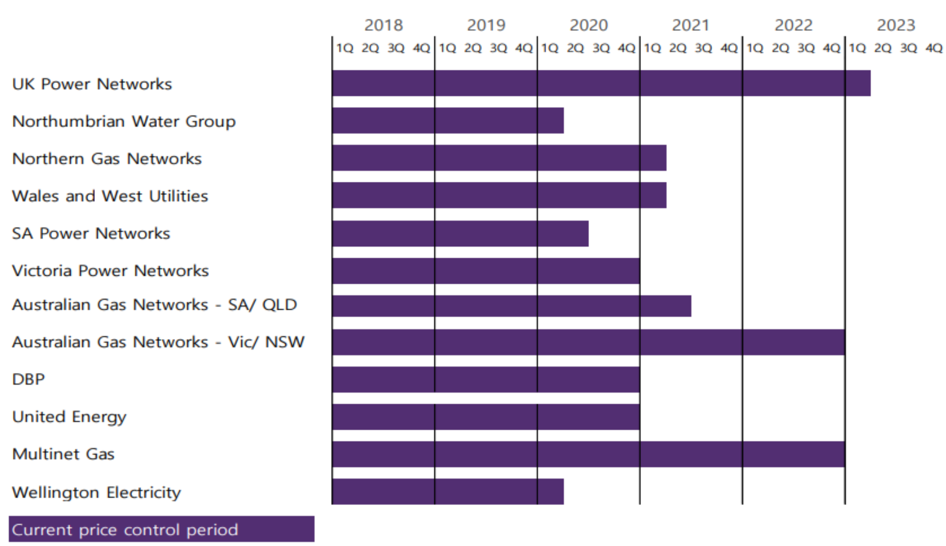



*Source: CKI, CASH*

**High visibility with stable recurring return:** Despite regulations limited utility companies' abilities to set the tariff unreasonably high, predictable revenues in accordance with the regulatory plan allows investors to have a clear picture of the future revenue.

The diagram below outlines the scheduled regulatory reset dates for CKI. As we can see, there would be no regulatory reset until 2020.

**Figure 23. CKI regulatory resets timetable**




*Source: CKI, CASH*

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The following examples explain the high predictability of returns for CKI.
**PAH of HK:** new Scheme of Control is scheduled to commence in January 2019, assuring secure returns for the business over the next 15 years.
**UK portfolios:** Current regulatory plan until March 2023 is expected for UKPN.
**Australia Portfolio:** As the regulatory price reset for Victoria and New South Wales commenced in January 2018, stable and predictable revenue streams have been secured for the next 5 years.

**Despite the following ST regulatory headwind, utility companies remain attractive:**
*AER's final decision on rate of return*
The Australian Energy Regulator (AER) initiated review of its 2013 Guidelines in mid-2017, setting a framework for determining regulated returns that gas and electricity networks are allowed to earn going forward. Its purpose is for the sake of long term interests of consumers with respect to the price, quality, safety, reliability and security of supply.
On 17 Dec 2018, the final Rate of Return Guidelines was released. According to the guideline, there would be a 45 basis point reduction in the overall rate of return compared to the approach applied in the 2013 Guidelines.

*UK's network price controls- to start from 2021*
The current network price controls for gas and electricity transmission (RIIO-T1) and gas distribution (RIIO-GD1) run from 2013-2021, and for electricity distribution (RIIO-ED1) from 2015-2023. Starting from 2021/2023, RIIO-2 will be the next price controls for the electricity system operator/ electricity distribution network operators (DNOs). The reduction in achieved returns of c2-2.8% is expected.
Meanwhile, for water regulation, Ofwat will make final decisions on the price controls that water companies must use for regulated activities from 2020 to 2025, and a 5% reduction in average bills is expected by 2020.

**Why we still think utility companies attractive in long term, with regards to the aforementioned increasing regulation?** The aim of regulator is not to simply lower prices, but also to ensure the lowest efficient costs required to build and maintain safe and reliable networks. If the rate of return is too low, insufficient investment may result, risking reliability. In case the increasing regulation affects the profit outlooks of the utility companies, it will eventually make their fundraising harder than before. Increased financing costs arising from unsustainable regulatory returns will affect network businesses' credit metrics which in return result in higher future costs to customers.

Thus, there is a need to achieve a balance between attracting lowest-cost

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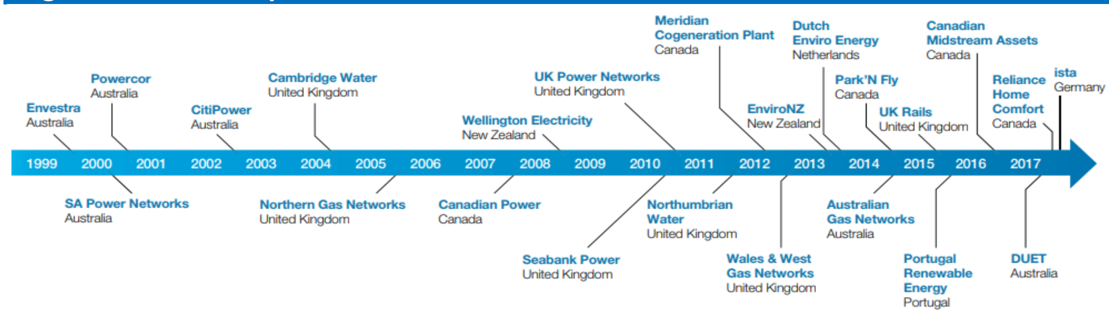
finance for essential power infrastructure investment and keeping prices down.

**M&A being the key to sustain recurring EPS rise:** In recent years, the Group has continued the expansion of its business portfolio through both organic growth and acquisitions. Since 2010, CKI has an average of two acquisitions per year. The Group has made three sizeable acquisitions, with a total investment of approximately HKD56 bn, in 2017, (i) a 40% interest in the DUET Group, an owner and operator of energy utility assets principally in Australia, (ii) a 25% interest in Reliance Home Comfort, a building equipment service provider operating primarily in Canada, and (iii) a 35% interest in ista, an energy management services provider with strong presence in Europe.

**Figure 24. CKI's Acquisition Trail**




*Source: CKI, CASH*

Through the acquisitions in 2017, CKI has increased earnings contribution from Australian, North American and European markets respectively. In 1H18, CKI recorded i) 37% YoY rise in Australia recurring profit, benefitted from DUET acquired in June '17; ii) 220% rise in European recurring profit, benefitted from Ista acquired in Oct '17; iii) 49% YoY rise in North America recurring profit, benefitted from RHC acquired in Sep '17.

**Figure 25. CKI's earning bolstered by overseas M&A**

| Profit contribution from: (HKD million) | 1H18 | 1H17 | % change |
|---|---|---|---|
| Investment in Power Assets | 1,566 | 1,564 | 0.1% |
| UK portfolio | 2,930 | 2,922 | 0.3% |
| Australia portfolio | 1,151 | 838 | 37.4% |
| Europe portfolio | 588 | 184 | 219.6% |
| North America portfolio | 179 | 120 | 49.2% |
| New Zealand portfolio | 66 | 87 | -24.1% |
| Mainland China portfolio | 156 | 154 | 1.3% |
| Material business | 150 | 149 | 0.7% |

*Source: CKI, CASH*

The acquisition allows CKI to pursue high-quality assets with regulated returns

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and stable income. Duet Group and ista achieved satisfactory results so far.

**Positive economic benefits from CKH transaction:** CKI announced on 3 Sep 2018 that the Company, together with CKA/PAH, entered into economic benefits agreement with CKH whereby CKI/CKA/PAH will pay HKD7.2/9.6/4.8bn for the profit stream generated from CKH's infrastructure related investments including:
1) 50% of Park'N Fly, the largest off-airport car park provider in Canada;
2) 40% of Northumbrian Water, one of the 10 regulated water and sewerage companies in England and Wales;
3) 27.51% of Australian Gas Networks, one of Australia's largest distributors of natural gas;
4) 30% of Wales & West Gas Networks, a gas distribution network that serves Wales and the South West of England;
5) 50% of UK Rails, one of the three major rolling stock operating companies in the United Kingdom and
6) 35% of Dutch Enviro Energy, the largest energy-from-waste company in the Netherlands.

**Figure 26. % of profit attributable to CKI/CKH/PAH/CKA**

| | Before CKH transaction | | | After CKH transaction | | | |
|---|---|---|---|---|---|---|---|
| | CKI | CKH | PAH | CKI | CKH | PAH | CKA |
| Australian Gas Networks | 45% | 28% | 28% | 53% | 3% | 33% | 11% |
| Park'N Fly | 50% | 50% | 0% | 65% | 5% | 10% | 20% |
| Dutch Enviro Energy | 35% | 35% | 20% | 46% | 4% | 27% | 14% |
| Northumbrian Water | 40% | 40% | 0% | 52% | 4% | 8% | 16% |
| Wales & West Gas Networks | 30% | 30% | 30% | 39% | 3% | 36% | 12% |
| UK Rails | 50% | 50% | 0% | 65% | 5% | 10% | 20% |

*Source: CKI, CASH*

The relevant assets recorded a net profit of HKD2bn in FY17, implying 12x historical PE and 0.99x PB based on transaction price. As shown in Figure 26, CKI already has experience in operating these assets through its direct stakes in all six (PAH has direct stakes in three). We estimate around 3% FY19E EPS enhancement from this deal for CKI and PAH. Given the cash generation ability of the transacted assets, the deal could further boost dividend growth of CKI and PAH.

**Sustainable Dividend Growth:** CKI's dividend for the financial year 2017 is HKD2.38, a 5.3% increase over that of the previous year. It signifies the 21st consecutive year of year-on-year dividend growth since listing in 1996.

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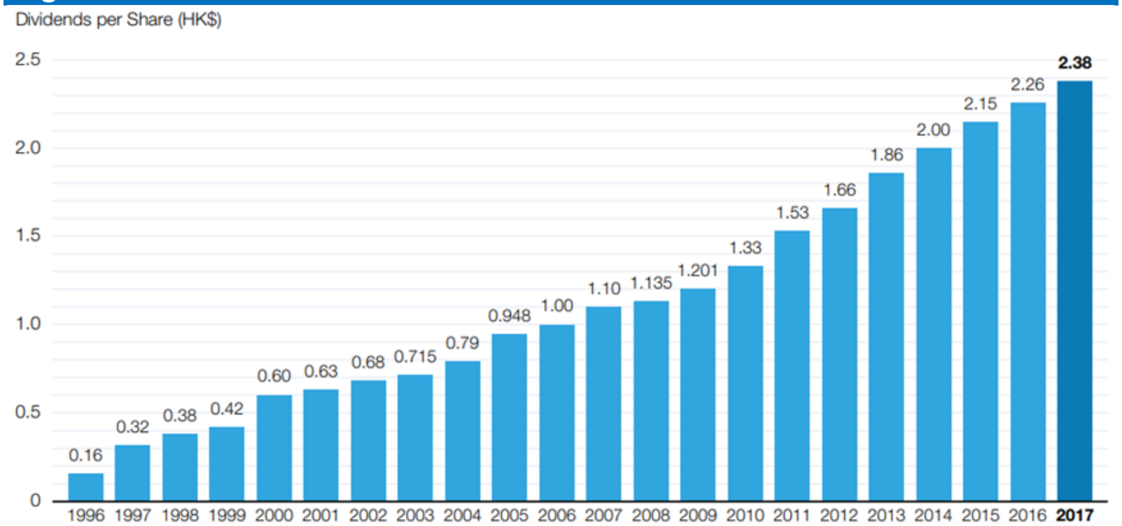
**Figure 27. Historical DPS of CKI**




*Source: CKI, CASH*

A strong balance sheet and cash flow statement provides a stable platform to support the Group's future expansion and dividend growth. As at 30th June, 2018, the Group had cash on hand of HKD9.6 bn and a net debt to net total capital ratio of 15.2%. This ratio was slightly improved when compared with the net debt to net total capital ratio of 17.6% at the year end of 2017.

**Potential spin- off of European infrastructure assets:** CKI informed the market in November 2018 that it is considering disposing off minority interests in some European infrastructure assets via an IPO in London. In fact, this type of corporate action is not new for the Group, as CKI has disposed of a minority stake in Spark in Australia in 2005. If it were to proceed, it would probably adapt the trust structure for its potential UK listing so that it could be a vehicle that focuses on dividend yield. A transaction would also help CKI to raise cash for further infrastructure deals elsewhere.

**PAH valuation looks undemanding:** CKI currently holds 38% stake in PAH. The market cap of PAH represents 28% of the valuation for CKI. At the current market price, we find the dividend yield of PAH to be attractive, as the recent share weakness makes its dividend yield v. 10- year US Treasury to be at an attractive spread of 235bps, above the historical spread of 102bps**.**

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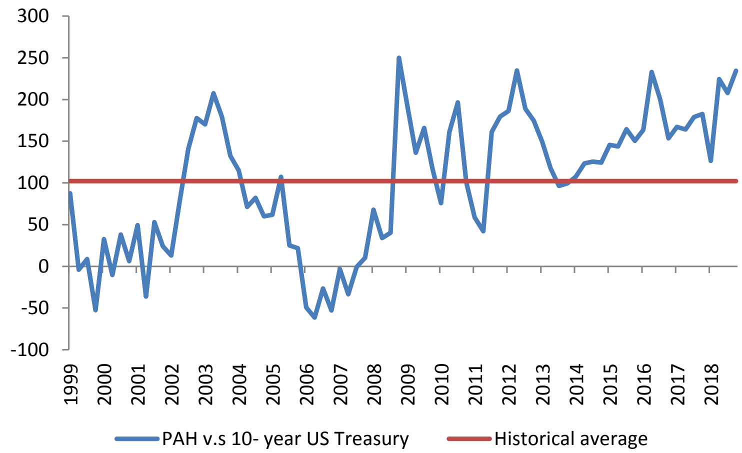
**Figure 28. PAH's dividend yield v. 10- year US Treasury**




*Source: Bloomberg, CASH*

**Valuation:** Our target price for CKI of HKD76 is derived by using DCF, assuming a WACC of 8% and a terminal growth rate of 2%. At our target price, CKI would trade at 17x 2019E P/E.

**Figure 29. CKI's Forward P/E**

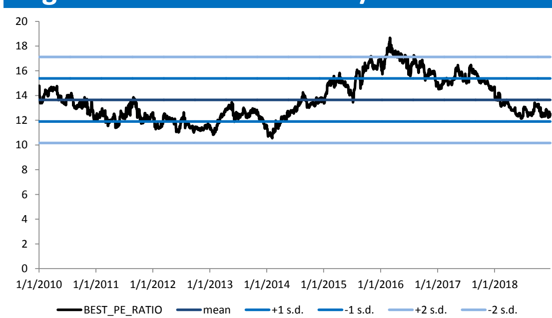
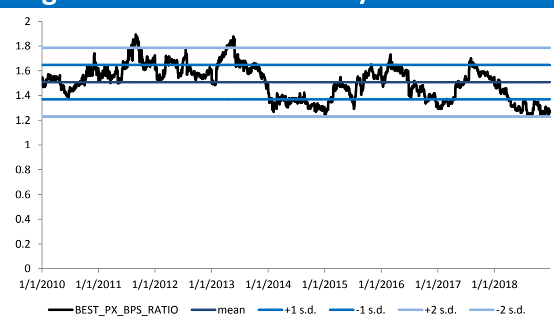



**Figure 30. CKI's Forward P/B**




*Source: Bloomberg, CASH*

**Key Risk:**

1. Adverse changes in regulations;
2. FX loss (depreciation of the sterling), in case of hard brexit;
3. Unsuccessful/ over- priced M&A transaction;
4. Sharp increase in US treasury yield

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# CKI

## 1038.HK, BUY, TargetPrice: HK$76

| Year-end Dec 31 | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| Revenue | 5,321 | 6,016 | 6,088 | 6,453 | 6,657 | 6,585 |
| Cost of goods sold | -2,427 | -2,614 | -2,615 | -2,740 | -2,793 | -2,729 |
| Gross profit | 2,904 | 3,418 | 3,497 | 3,737 | 3,885 | 3,874 |
| SG&A | -817 | -877 | -863 | -889 | -891 | -855 |
| Operating profit | 1,861 | 2,310 | 2,391 | 2,589 | 2,719 | 2,728 |
| EBITDA | 2,087 | 2,541 | 2,634 | 2,848 | 2,994 | 3,020 |
| Depreciation | -193 | -202 | -214 | -229 | -244 | -260 |
| Amortisation | -33 | -29 | -29 | -30 | -31 | -32 |
| Net interest expense | -446 | -551 | -837 | -946 | -1,024 | -1,073 |
| Net income from associates | 2,861 | 3,693 | 3,276 | 3,277 | 3,415 | 3,323 |
| Share of results in JV | 5,887 | 5,038 | 6,505 | 7,149 | 6,841 | 7,284 |
| Earnings before tax | 10,200 | 10,928 | 11,543 | 11,675 | 12,098 | 12,437 |
| Income tax | 8 | -72 | -20 | -21 | -40 | -49 |
| Minority interests | 12 | 26 | 28 | 27 | 29 | 30 |
| Preferred dividends | -584 | -626 | -600 | -600 | -600 | -600 |
| Extraordinary items | 0 | 0 | 0 | 0 | 0 | 0 |
| Income attr. to shareholders | 9,636 | 10,256 | 10,951 | 11,082 | 11,487 | 11,818 |
| | | | | | | |
| EPS | 3.82 | 4.07 | 4.35 | 4.40 | 4.56 | 4.69 |
| DPS | 2.26 | 2.38 | 2.50 | 2.53 | 2.62 | 2.70 |

**Cashflow statement (In million HK$)**

| Year-end Dec 31 | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| Income pre-preferred share dividends | 10,220 | 10,882 | 11,551 | 11,682 | 12,087 | 12,418 |
| Non-cash item | -8,534 | -8,946 | -9,674 | -10,301 | -10,136 | -10,491 |
| Change in working capital | 574 | 217 | -44 | 150 | 17 | -79 |
| Cashflow from operations | 4,231 | 2,969 | 1,818 | 1,457 | 1,927 | 1,863 |
| Capital expenditure | -322 | -260 | -304 | -323 | -333 | -329 |
| Investments | -1,741 | -36,014 | -8,000 | -6,400 | -5,120 | -4,096 |
| Other investment cash flow items | 6,773 | 16,485 | 7,238 | 8,366 | 9,137 | 9,600 |
| CF from investing acts | 4,713 | -19,760 | -1,066 | 1,643 | 3,684 | 5,175 |
| Cash dividend | -6,076 | -6,421 | -6,897 | -6,973 | -7,205 | -7,396 |
| Equity issue | 1,560 | 5,081 | 0 | 0 | 0 | 0 |
| Debt issue | 135 | 16,758 | 4,000 | 3,200 | 2,560 | 2,048 |
| Others | -670 | -636 | 0 | 0 | 0 | 0 |
| CF from financial acts | -5,051 | 14,782 | -2,897 | -3,773 | -4,645 | -5,348 |
| Net cashflow | 3,893 | -2,009 | -2,146 | -672 | 966 | 1,689 |
| Beginning cash | 7,897 | 11,790 | 9,781 | 7,635 | 6,963 | 7,929 |
| Ending cash | 11,790 | 9,781 | 7,635 | 6,963 | 7,929 | 9,618 |
| Ending net debt | 5,055 | 25,255 | 31,401 | 35,273 | 36,867 | 37,226 |

*Source: Company data, CASH*

**Balance Sheet (In million HK$)**

| Year-end Dec 31 | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| Cash & equivalents | 11,790 | 9,781 | 7,635 | 6,963 | 7,929 | 9,618 |
| Accounts receivable | 628 | 804 | 814 | 818 | 844 | 790 |
| Inventories | 139 | 170 | 170 | 178 | 182 | 178 |
| Other current assets | 982 | 0 | 0 | 0 | 0 | 0 |
| Total current assets | 13,539 | 10,755 | 8,619 | 7,959 | 8,955 | 10,586 |
| Fixed assets | 2,404 | 2,462 | 2,584 | 2,705 | 2,837 | 2,969 |
| Net intangibles | 2,554 | 2,569 | 2,616 | 2,666 | 2,718 | 2,768 |
| Total investments | 106,150 | 141,570 | 152,615 | 161,151 | 167,623 | 172,917 |
| Other LT assets | 3,263 | 2,458 | 2,473 | 2,547 | 2,587 | 2,573 |
| Total assets | 127,910 | 159,814 | 168,907 | 177,028 | 184,719 | 191,813 |
| ST debt | 9,901 | 10,896 | 10,896 | 10,896 | 10,896 | 10,896 |
| Accounts payable | 3,837 | 4,242 | 4,207 | 4,371 | 4,417 | 4,280 |
| Other current liabilities | 99 | 531 | 1,033 | 1,109 | 1,341 | 1,532 |
| Total current liabilities | 13,837 | 15,669 | 16,137 | 16,375 | 16,654 | 16,708 |
| LT debt | 6,944 | 24,140 | 28,140 | 31,340 | 33,900 | 35,948 |
| Other LT liabilities | 942 | 1,813 | 1,813 | 1,813 | 1,813 | 1,813 |
| Total liabilities | 21,723 | 41,622 | 46,090 | 49,528 | 52,367 | 54,469 |
| Minority interest | 38 | 18 | -10 | -38 | -66 | -97 |
| Preferred interest | 0 | 0 | 0 | 0 | 0 | 0 |
| Common stock | 2,651 | 2,651 | 2,651 | 2,651 | 2,651 | 2,651 |
| Retained earnings | 93,954 | 100,822 | 105,476 | 110,185 | 115,067 | 120,089 |
| Perpetual capital securities | 9,544 | 14,701 | 14,701 | 14,701 | 14,701 | 14,701 |
| Total shareholders' equity | 106,187 | 118,192 | 122,817 | 127,499 | 132,352 | 137,344 |
| Total equity & liabilities | 127,910 | 159,814 | 168,907 | 177,028 | 184,719 | 191,813 |

**Key Ratios**

| | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| **Growth (%)** | | | | | | |
| Revenue | | 13.1% | 1.2% | 6.0% | 3.2% | -1.1% |
| Gross profit | | 17.7% | 2.3% | 6.9% | 4.0% | -0.3% |
| Operating profit | | 24.1% | 3.5% | 8.3% | 5.0% | 0.3% |
| Income attr. to shareholders | | 6.4% | 6.8% | 1.2% | 3.7% | 2.9% |
| | | | | | | |
| **Profitability (%)** | | | | | | |
| Gross margin | 54.6% | 56.8% | 57.5% | 57.9% | 58.4% | 58.8% |
| Operating margin | 35.0% | 38.4% | 39.3% | 40.1% | 40.8% | 41.4% |
| Net Margin | 181.1% | 170.5% | 179.9% | 171.7% | 172.5% | 179.5% |
| Dividend payout | 59.1% | 58.5% | 57.5% | 57.5% | 57.5% | 57.5% |
| ROE | 9.1% | 8.7% | 8.9% | 8.7% | 8.7% | 8.6% |
| ROA | 7.5% | 6.4% | 6.5% | 6.3% | 6.2% | 6.2% |
| | | | | | | |
| **Liquidity (x)** | | | | | | |
| Current ratio | 1.0 | 0.7 | 0.5 | 0.5 | 0.5 | 0.6 |
| Interest coverage | 4.2 | 4.2 | 2.9 | 2.7 | 2.7 | 2.5 |
| | | | | | | |
| **Leverage** | | | | | | |
| Net Debt/EBITDA (x) | 2.4 | 9.9 | 11.9 | 12.4 | 12.3 | 12.3 |
| Net Debt/Equity (%) | 4.8% | 21.4% | 25.6% | 27.7% | 27.9% | 27.1% |

*Source: Company data, CASH*

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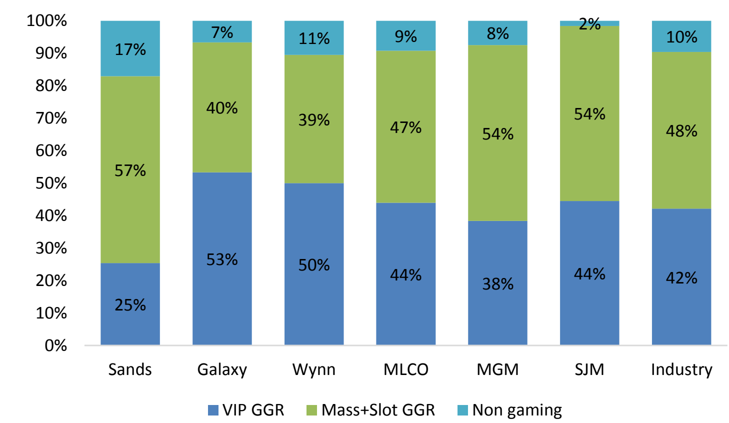
# Sands China (1928.HK)

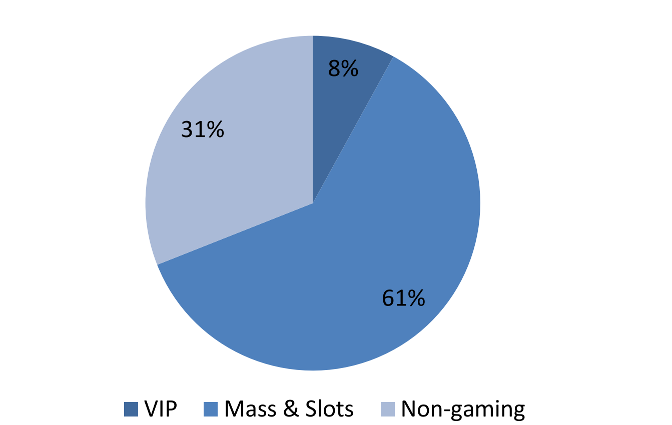
**We like the defensive nature of Sands China:** We understand that investors are cautious about the market outlook for next year, given the macro uncertainties (e.g. US/China Trade War, yuan depreciation), especially for the VIP and premium mass segments. However, Sands China's business focus mainly on mass segment, which is defensive in nature when compared to VIP gaming as it has less exposure to liquidity risk and policy changes.

**Figure 31. Revenue split of Macau concessionaries**




*Source: Company data, CASH*

**Figure 32. Profit contribution of Sands China**

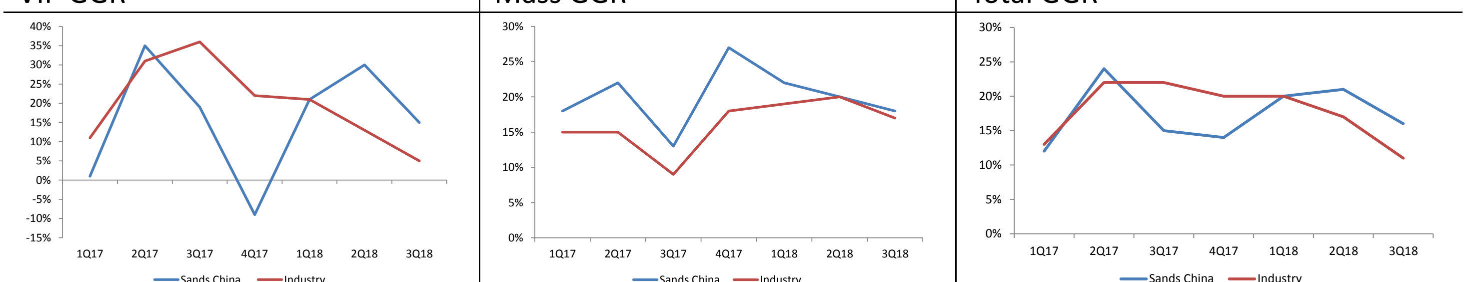



*Source: Sands China, CASH*

**The result of Sands China is nice so far:** In the prior quarters, Sands China's performance kept beating the street consensus. It was driven by the flagship Venetian Macao (EBITDA +20%/+29%/+30% yoy in 1Q/2Q/3Q respectively), helped by the recent upgrade of VIP rooms. Sands Cotai Central has also delivered solid results (EBITDA +41%/+31%/+21% yoy in 1Q/2Q/3Q respectively). Venetian Macao and Sands Cotai Central all together account for > 70% of the Group EBITDA.

**Figure 33. The YoY growth of Sands GGR vs Industry GGR**

VIP GGR | Mass GGR | Total GGR




*Source: Sands China, CASH*

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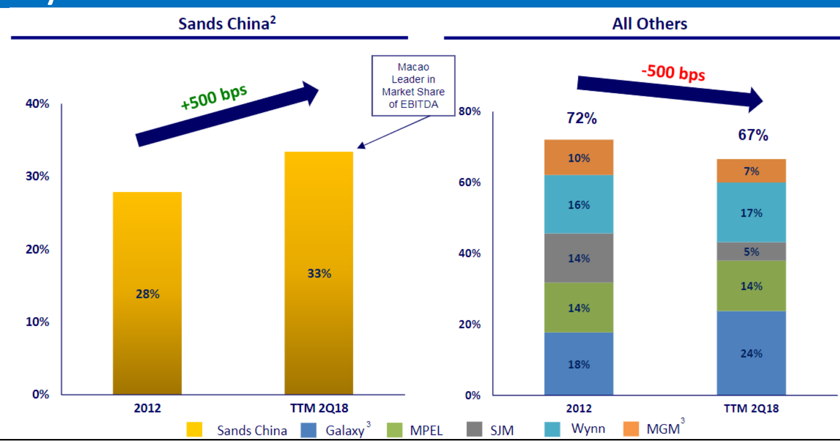
In fact, Sands China has always been able to deliver satisfactory result. Its adjusted EBITDA market share increased from 28% in 2012 to 33% in 2018. We see upside for further EBITDA share gain helped by various property revamp initiatives in progress, e.g. upgrading hotel rooms in Parisian, building new luxurious suites at St. Regis/Four Seasons, refurbishing VIP gaming areas in Venetian/Plaza, and rebranding SCC into Londoner.

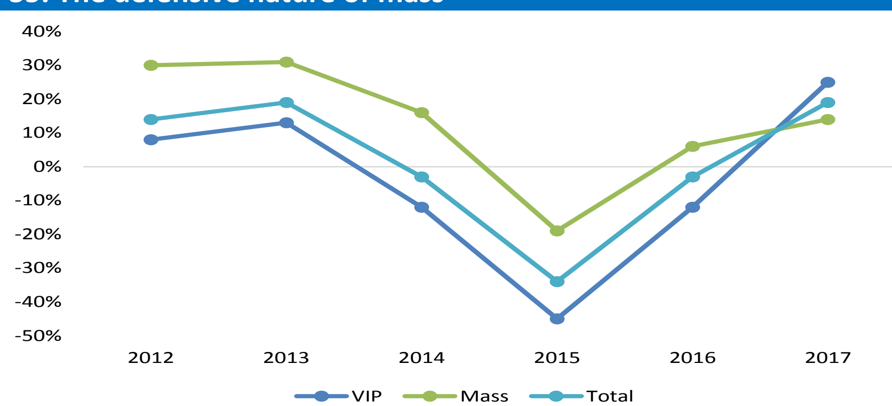
**Figure 34. Adjusted property EBITDA market share of Sands China increased by 500bps in 5 years time**




*Source: Sands, CASH*

**Mass story still intact:** We see grind market to remain as a resilient growth engine for casino operators despite VIP/premium mass momentum slowing down. Mass market GGR growth has always been more sustainable than VIP GGR growth, as it is less influenced by i) junket liquidity; ii) negative regulatory changes, e.g. capital controls, anti- corruption campaigns; iii) VIP smoke ban that comes into force on 1 Jan 2019.

**Figure 35. The defensive nature of mass**




*Source: DICJ , CASH*

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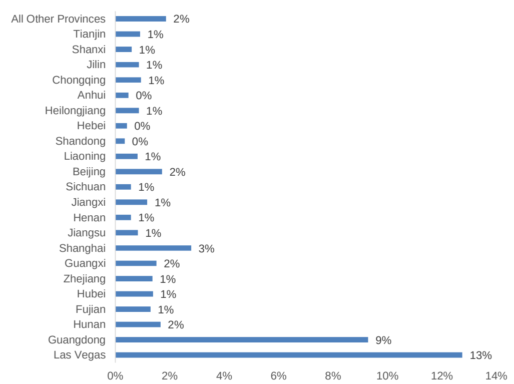
According to Frost & Sullivan, the per capita tourism expenditure in China increased from RMB2,363.2 in 2013 to RMB3,887.6 in 2017, representing a CAGR of 13.3%. This figure is expected to further increase to RMB6,486.3 in 2022, growing at a CAGR of 10.8% from 2017. Meanwhile, the Mainland Chinese visitation to Macau penetration remains low. With the increasing tourism expenditure and penetration rate, together with the improved transportation infrastructure and connectivity throughout China, together with the HZM Bridge opened on 23 Oct, Macau secular growth trajectory remains intact. Sands China is the name that can definitely benefit from intact mass, as it is the market leader in the mass segment (~30% market share) and is expected to have 35% of the room inventory in Macau by the end of 2020, taking all new room additions into consideration.

**Figure 36. Low Macau penetration**




*Source: Sands China, DSEC, CASH*

**Figure 37. Increase connectivity throughout China**


*Source: Sands China, CASH*

With Wuhan – Guangzhou High-Speed Rail, Guangzhou – Shenzhen – Hong Kong Rail, Guangzhou – Zhuhai Intercity Rail, Gongbei – Hengqin Railway (expected completion in 2019), Hong Kong-Macao-Zhuhai Bridge (opened in Oct 2018), the travel time is significantly shortened. The low Macau penetration rate (Guangdong's 9% v.s Las Vegas's 13%) provides rooms for visitation growth which can support Mass segment in long term.

**Be patient to reap a harvest:** We do agree that big rally is unlikely in the near term given the uncertain macro and market backdrop. However, the potential (or perceived) downturn that the industry faces today is a cyclical one. After all, the attractiveness of Macau gaming industry remains. This is driven by Macau's monopoly status as the only legalized gambling jurisdiction in China, underpinned by the surprisingly low penetration, rising disposable income, improving infrastructure within mainland China, and ongoing supply of quality properties (which in itself can attract gamblers). In particular, the Greater Bay

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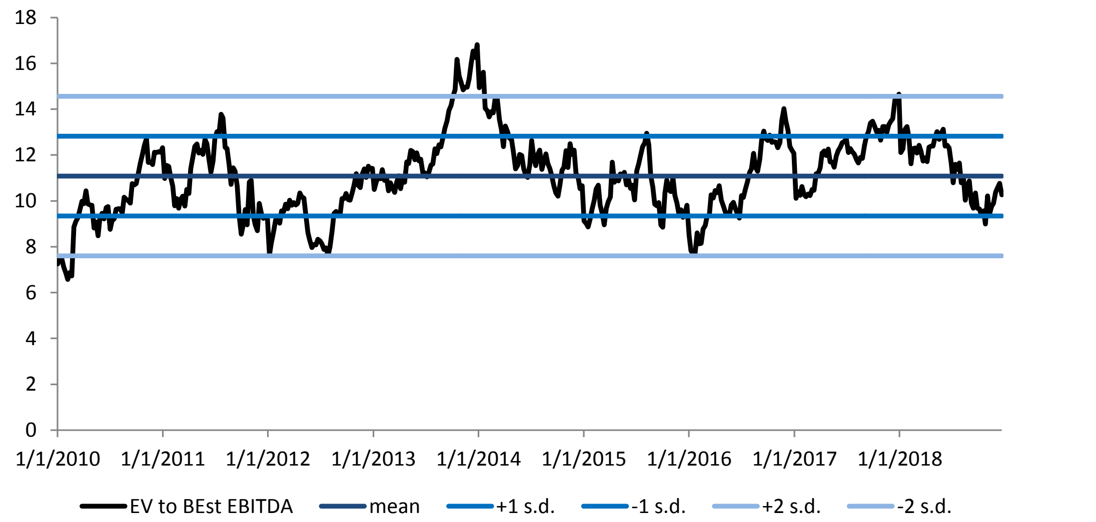
Area Initiative and the development of Hengqin Island will contribute to Macao's diversification and to its further development as a leisure and business tourism destination. With the current industry ~11X EV/EBITDA, we think the risk-reward is very compelling, even if we consider the negative factors.

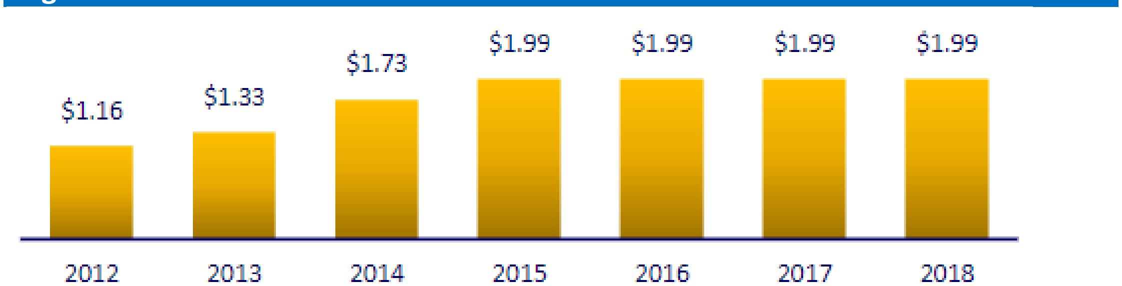
**Figure 38. Industry EV/EBITDA**




*Source: Bloomberg, CASH*

**Solid 6% dividend yield work as a downside protection for the stock:** On 3Q result, LVS Board of Director announced the increase of the LVS recurring annual DPS for the 2019 calendar year by USD0.08 to USD3.08 per share. With the need to fund the parent co, we believe Sands China will at least maintain its DPS. Its current 6% dividend yield is attractive enough to work as a downside protection for the stock in the near term.

**Figure 39. DPS of Sands China in 2012-2018**




*Source: Sands, CASH*

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**Possessing long term investment value:** We see Sands as a good choice for long term investment as it remains committed to returning capital to shareholders while maintain a strong balance sheet and have the financial flexibility to pursue development opportunities. We believe its rebranding of SCC to The Londoner Macao and also the two luxury suites towers, which will start operation in 2020 could allow Sands to capture market share and generate growth in every segment of the Macau market, including retail, entertainment, hotel and gaming.

**Figure 40. Ongoing strategic reinvestment of Sands China**

| Reinvestment | Estimated Timeframe |
|---|---|
| **The Londoner Rebranding:** | |
| Renovation, expansion and rebranding to The Londoner Macao | Commencement in late 2018 – completion of all components in 2020 |
| **Hotel Suite Additions and Renovations:** | |
| **New Luxury Suites in St. Regis Macao Tower:** Approximately 370 new luxury suites ranging in size from 1,400 to 3,100 SF | Work is progressing – completion in late 2019 |
| **New Luxury Suites in Tower Adjacent to The Four Seasons Macao:** Expand suite inventory with approximately 280 new luxury suites, ranging in size from 2,000 to 4,700 SF | Work is progressing – completion in late 2019 |
| **The Parisian Macao:** Create additional suites | Phase I is completed – Phases II and III progressing – all Phases completed by end of 2018 |
| **The Venetian Macao and Four Seasons Hotel Macao:** Total property hotel room renovations | Completed |

*Source: Sands, CASH*

**Reiterate "Buy" with Dec-19 TP of HKD38:** ***<u>We reiterate "BUY" rating for Sands China and adjust our Dec-19 TP to HKD38 (Previous: HKD50), taking into account the uncertain macro backdrop and potential China economy slowdown.</u>*** We forecast the company's EBITDA to grow by 2%/11%/10% in 2019E/20E/21E. The target price HKD38 implies 13.5x 2019 EV/EBITDA and 5.3% dividend yield. We continue to like Sands China due to its defensive nature (mass game market leader) and attractive dividend yield.

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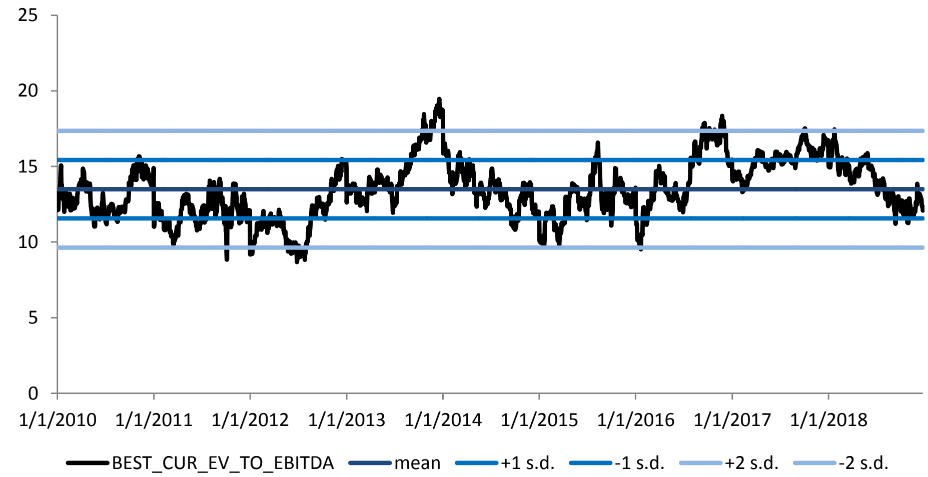
**Figure 41. Sands China's Forward EV/EBITDA**




*Source: Bloomberg, CASH*

**Key Risk:**

1) China economy slowdown;
2) Unfavorable changes associated with concession renewal;
3) Bigger- than- expected disruption at properties during renovation

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## Sands China

## 1928.HK, Buy, Target Price: HK$38

**Income Statement (USD mn)**

| Year-end 31 Dec | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| Revenue | 7,715 | 8,655 | 8,770 | 9,411 | 10,213 |
| EBITDA | 2,449 | 2,809 | 2,868 | 3,177 | 3,497 |
| Depreciation & Amortisation | -676 | -613 | -658 | -672 | -681 |
| EBIT | 1,773 | 2,196 | 2,210 | 2,506 | 2,816 |
| Net interest income | -148 | -157 | -174 | -185 | -186 |
| Earnings before tax | 1,625 | 2,039 | 2,036 | 2,321 | 2,630 |
| Income tax | -22 | -38 | -28 | -43 | -62 |
| Income attr. to shareholders | 1,603 | 2,001 | 2,008 | 2,278 | 2,568 |
| | | | | | |
| EPS (USD) | 0.20 | 0.25 | 0.25 | 0.28 | 0.32 |
| DPS (USD) | 0.26 | 0.26 | 0.26 | 0.29 | 0.33 |

**Balance Sheet (USD mn)**

| Year-end 31 Dec | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| Cash & equivalents | 1,239 | 1,541 | 1,415 | 1,623 | 1,907 |
| Accounts receivable | 293 | 329 | 273 | 228 | 178 |
| Inventories | 15 | 16 | 16 | 17 | 18 |
| Other current assets | 11 | 12 | 12 | 13 | 13 |
| Total current assets | 1,558 | 1,897 | 1,716 | 1,881 | 2,117 |
| Fixed assets | 7,687 | 7,875 | 8,466 | 8,645 | 8,764 |
| Intangible assets | 34 | 34 | 34 | 34 | 34 |
| Investment | 1,311 | 1,311 | 1,311 | 1,311 | 1,311 |
| Other LT assets | 57 | 60 | 61 | 63 | 66 |
| Total assets | 10,647 | 11,177 | 11,588 | 11,934 | 12,291 |
| ST debt | 54 | 54 | 54 | 54 | 54 |
| Accounts payable | 1,537 | 1,633 | 1,597 | 1,633 | 1,748 |
| Other current liabilities | 6 | 0 | 8 | 285 | 585 |
| Total current liabilities | 1,597 | 1,687 | 1,659 | 1,972 | 2,387 |
| LT debt | 4,358 | 4,858 | 5,358 | 5,458 | 5,478 |
| Other LT liabilities | 154 | 154 | 154 | 154 | 154 |
| Total liabilities | 6,109 | 6,699 | 7,171 | 7,584 | 8,019 |
| Common stock | 81 | 81 | 81 | 81 | 81 |
| Retained earnings | 4,457 | 4,397 | 4,337 | 4,268 | 4,191 |
| Total shareholders' equity | 4,538 | 4,478 | 4,418 | 4,349 | 4,272 |
| Total equity & liabilities | 10,647 | 11,177 | 11,588 | 11,934 | 12,291 |

**Cashflow statement (USD mn)**

| Year-end 31 Dec | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| Net profit After tax | 1,603 | 2,001 | 2,008 | 2,278 | 2,568 |
| Non-cash item | 688 | 613 | 658 | 672 | 681 |
| Change in working capital | 127 | 60 | 19 | 80 | 165 |
| Cashflow from operations | 2,626 | 2,669 | 2,685 | 3,027 | 3,411 |
| Capital expenditure | -432 | -800 | -1,250 | -850 | -800 |
| Free cashflow | 2,194 | 1,869 | 1,435 | 2,177 | 2,611 |
| CF from investing acts | -461 | -800 | -1,250 | -850 | -800 |
| Cash dividend | -2,067 | -2,067 | -2,061 | -2,069 | -2,346 |
| Equity issue | 0 | 0 | 0 | 0 | 0 |
| Debt issue | -19 | 500 | 500 | 100 | 20 |
| Others | -121 | 0 | 0 | 0 | 0 |
| CF from financial acts | -2,207 | -1,567 | -1,561 | -1,969 | -2,326 |
| Net cashflow | -45 | 302 | -126 | 208 | 284 |
| Beginning cash | 1,284 | 1,239 | 1,541 | 1,415 | 1,623 |
| Ending cash | 1,239 | 1,541 | 1,415 | 1,623 | 1,907 |
| Ending net debt | 3,173 | 3,371 | 3,997 | 3,889 | 3,625 |

*Source: Company data, CASH*

**Key Ratios**

| | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| **Growth (%)** | | | | | |
| Revenue | | 12.2% | 1.3% | 7.3% | 8.5% |
| EBITDA | | 14.7% | 2.1% | 10.8% | 10.1% |
| Income attr. to shareholders | | 24.8% | 0.4% | 13.4% | 12.7% |
| | | | | | |
| **Profitability (%)** | | | | | |
| EBITDA margin | 31.7% | 32.5% | 32.7% | 33.8% | 34.2% |
| EBIT margin | 23.0% | 25.4% | 25.2% | 26.6% | 27.6% |
| Net Margin | 20.8% | 23.1% | 22.9% | 24.2% | 25.1% |
| Dividend payout | 128.9% | 103.0% | 103.0% | 103.0% | 103.0% |
| ROE | 35.3% | 44.7% | 45.5% | 52.4% | 60.1% |
| ROA | 15.1% | 17.9% | 17.3% | 19.1% | 20.9% |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.0 | 1.1 | 1.0 | 1.0 | 0.9 |
| Interest coverage | 12.0 | 13.9 | 12.7 | 13.6 | 15.2 |
| | | | | | |
| **Leverage** | | | | | |
| Net Debt/EBITDA (x) | 1.30 | 1.20 | 1.39 | 1.22 | 1.04 |
| Net Debt/Equity (%) | 70% | 75% | 90% | 89% | 85% |

*Source: Company data, CASH*

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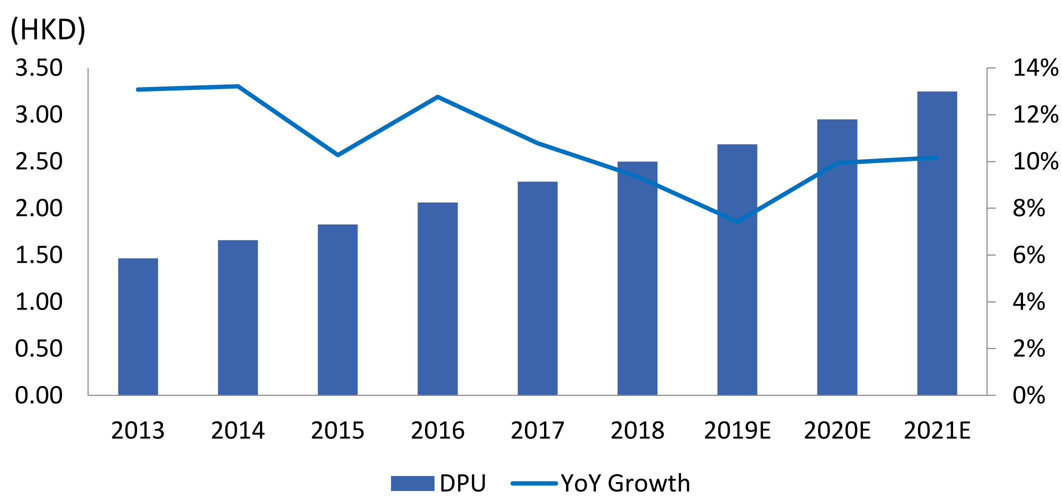
# Link REIT (823.HK)

**Snapshot:** Link REIT (823.HK) is the first real estate investment trust (REIT) listed in HKEx, also one of the world's largest retail-focused REITs in terms of market capitalization. The distribution per unit (DPU) of the fund increased from HKD1.46 in 2013 to HKD2.5 in 2018, representing a compound annual growth rate (CAGR) of 11.3%. Amid the uncertainties of global economic environment, we are still optimistic about the prospects of the Link REIT, based on **(1) superior management track record (through renovation of malls, disposal of malls and acquisition of high-quality projects), (2) strong defensive nature with non-discretionary retail portfolio and lower FX risk, (3) HK retail rents supported by opening of High Speed Rail and Hong Kong-Zhuhai-Macao Bridge in the longer term, and 4) potential stock repurchase.**

Since 2013, Link recorded stable DPU growth of around 10% (2018: 9.4% YoY, 2017:10.8% YoY). **We expect the DPU growth during FY2019-2021 will rebound to more than 10%** due to (1) the completion of more than 10 new projects with its superior management track record, resulting in additional rental income; (2) increase in cash balance through disposal of the malls.

**Figure 42. DPU and Growth Forecast**




*Source: Bloomberg, CASH*

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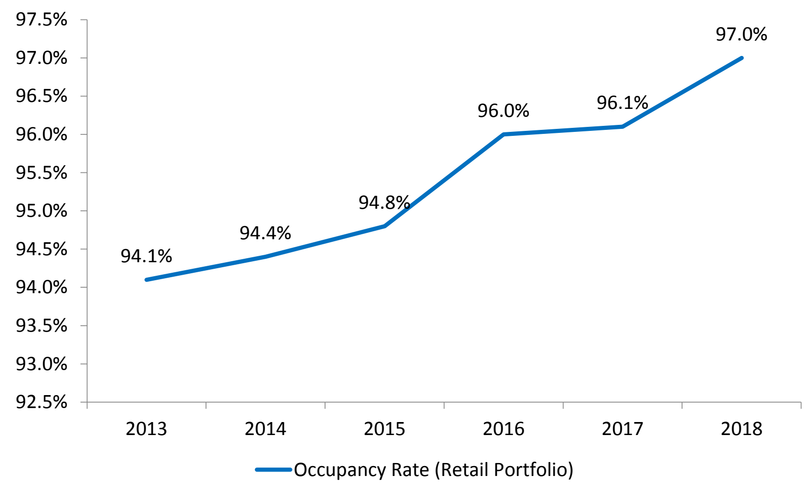
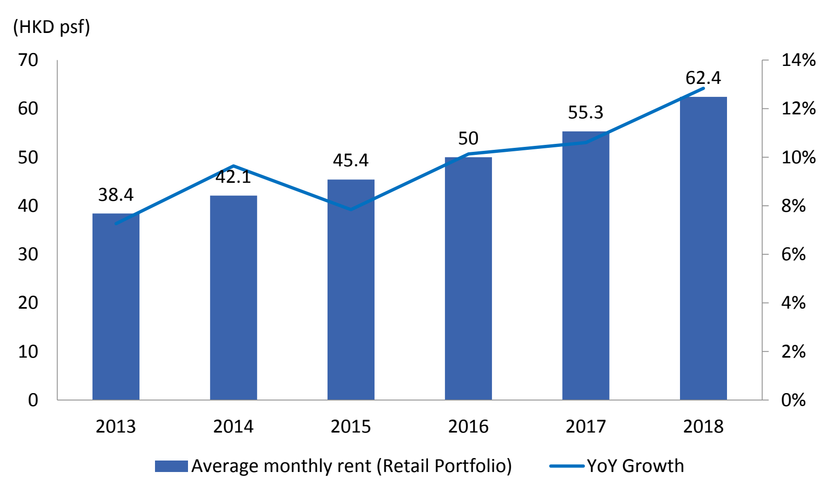
**Superior management track record:** During the past five years, the occupancy rate of the Hong Kong retail portfolio under Link has been rising, favored by its superior management, asset enhancement, acquisition and disposal strategy. As of the end of March 2018, the occupancy rate reached 97.0%. If we exclude all property disposals and acquisitions in FY18, the retail rental income in FY18 increased by 9.5% YoY to HKD62.4/sq ft (vs 2017: HKD55.3/sq ft), and the CAGR of rental income in past 5 years was 10.2% with rental reversion rate more than 20%, reflecting the strong rental revenue growth of the current property portfolio.

**Figure 43. Occupancy Rate (Retail Portfolio)**




*Source: Link, CASH*

**Figure 44. Monthly Rent (Retail Portfolio)**




*Source: Link, CASH*

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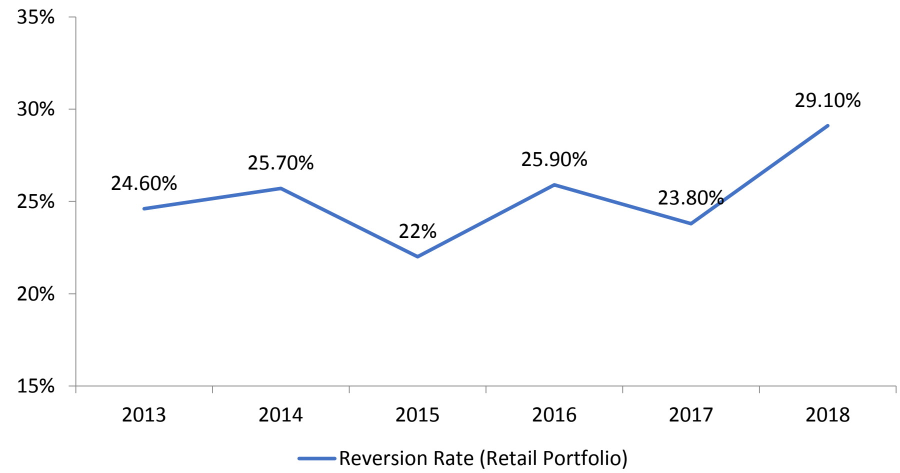
**Figure 45. Reversion Rate (Retail Portfolio)**




*Source: Link, CASH*

Looking forward, Link REIT is expected to renovate malls, disposal of malls and acquisition of high-quality projects, which will benefit the occupancy rate and monthly rental in the long run, and achieve NAV enhancement.

**(1) Renovation of shopping malls:** On Jun 1, 2018, the new shopping mall "T.O.P " at 700 Nathan Road opened after more than two years of renovation. "700 Nathan Road" is a 23-storey building, including 18 floors for offices (over 70% occupancy rate) and 5 floors for shopping malls (up to 80% occupancy rate). The project will provide new rental revenue contribution during 2019 financial year. In addition, at the beginning of June, Link said that 10 projects are being upgraded, 4 projects are about to start, and the asset enhancement plan will be extended to 2023 to support its continued rental income growth.

**(2) Disposal of the properties (selling price > book value of the property):** Link REIT recently announced that it has entered into 12 property disposal agreements with a consortium led by Gaw Capital Partners for a total consideration of HKD12.01 bn. The net gain from the disposals will be approximately HKD2.788 bn. The Properties Consideration represents a premium of approximately 32.1% over the aggregate Appraised Value of the Properties as at the Valuation Date (i.e. 30 September 2018) and a premium of approximately 36.8% over the aggregate appraised value of the Properties as at 31 March 2018.

**(3) Acquisition of high-quality projects:** In Nov 2018, Link announced the purchase of Beijing Plaza at nearly RMB2.6bn. It is the second acquisition of the Group in Beijing and the fourth acquisition project in the first-tier cities in

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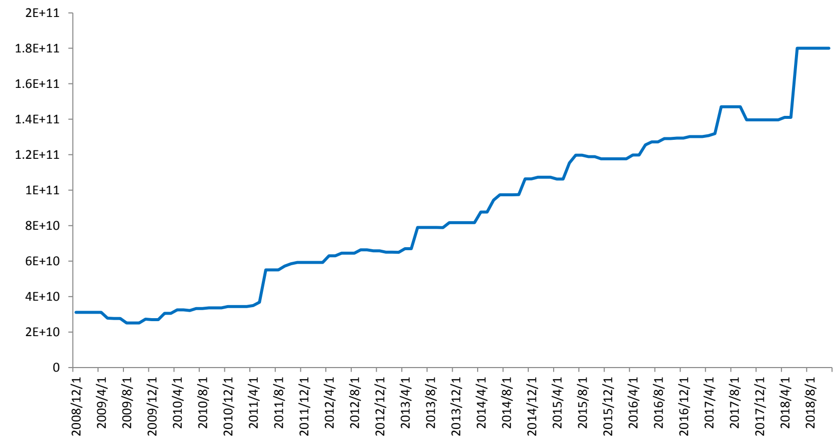
Mainland. The property comprises retail GFA of approximately 67,545.7 sqm, with the occupancy rate at 96.2% by the end of October 2018.

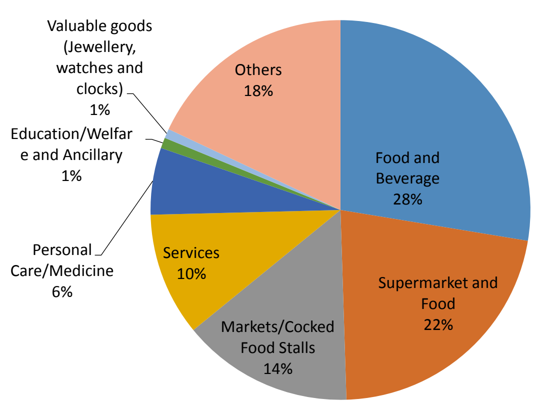
**Figure 46. Net Asset Value**




*Source: Bloomberg, CASH*

**Strong defensive nature with non-discretionary retail portfolio and lower FX risk:** Retail properties under the Link REIT have strong defensive nature, which are mainly shopping malls (69.7%) which are mostly located in public housing estates. The businesses operated by the tenants of the malls are generally related to the necessities and are relatively immune to macro weakness. In addition, Hong Kong business is the largest part in its property portfolio (Hong Kong: 91% vs China: 9%). With the ceiling of mainland investment over total investment (20%) set at the earlier time, we expect the exchange loss brought by recent RMB depreciation to be relatively low.

**Figure 47. Hong Kong Portfolio Retail Trade Mix (By monthly rent in FY2018)**




*Source: Link, CASH*

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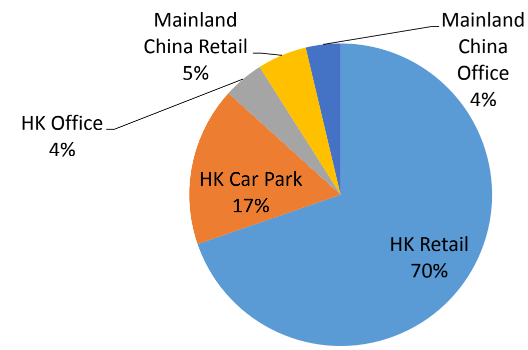
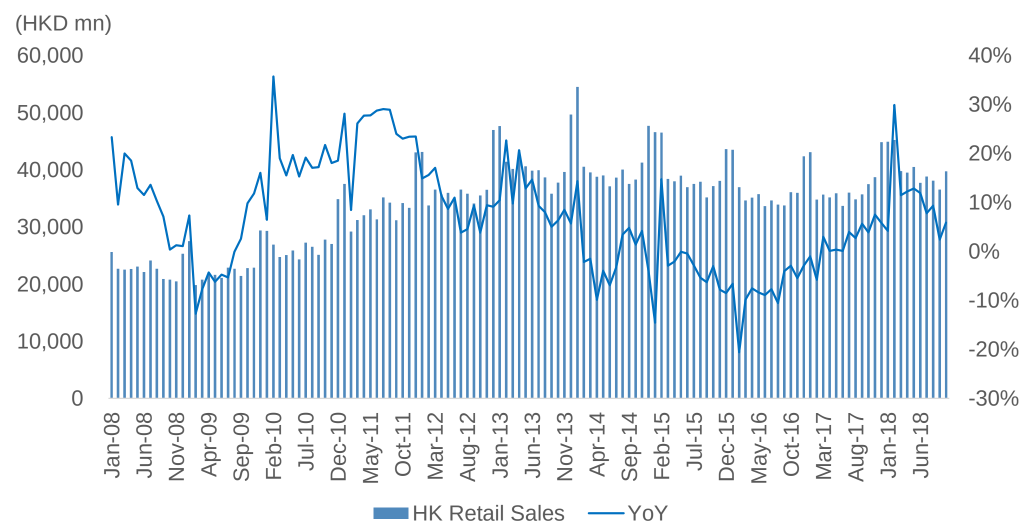
**Figure 48. Link REIT's property portfolio**




*Source: Link, CASH*

**HK retail rents supported by opening of High Speed Rail and HZMB:** The decision on rent adjustment for Link REIT is mainly determined by the performance of its tenants' sales. In the long run, Hong Kong retails will be benefitted by the High Speed Rail Hong Kong Section (opened on 23 Sep 2018) and the Hong Kong-Zhuhai-Macao Bridge (opened on 24 Oct 2018).

**Figure 49. Value of HK Retail Sales (in mn HKD)**




*Source: Census and Statistics Department, CASH*

**Potential stock repurchase:** The stock repurchase in 2018 was active. The company had repurchased a total of 79.02 million shares (repurchase price: HKD64.67-78.9) in 2018, which is 1.7 times more than the 2017 annual repurchase volume. After the 12 property disposal transaction with Gaw Capital Partners, Link can increase the cash balance by HKD2.78 bn, which can

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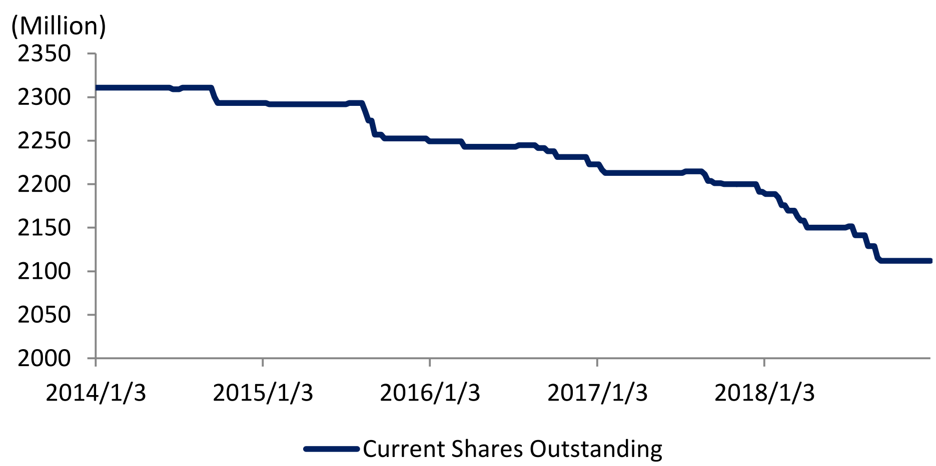
support the stock repurchase.

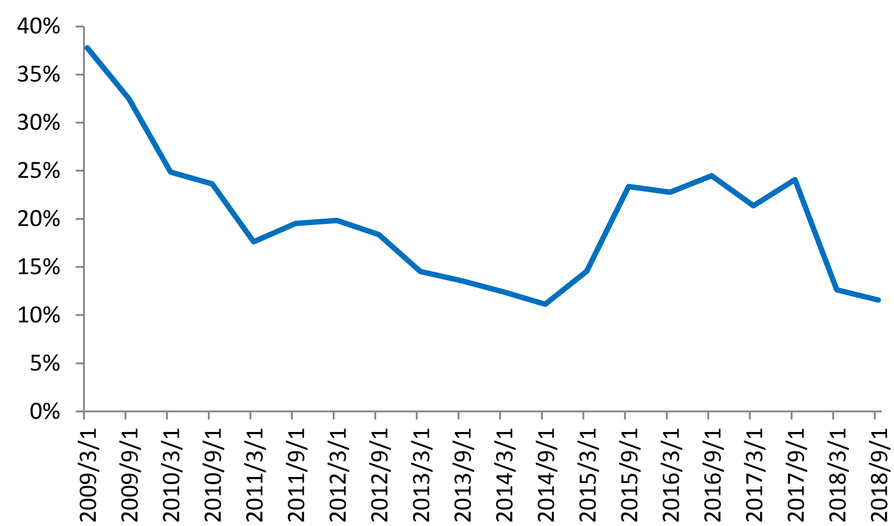
**Figure 50. Current Share Outstanding**




*Source: Bloomberg, CASH*

**Strong financial stability:** Link REITs possess a strong balance sheet. Its net gearing ratio in 3Q2018 has dropped to a 10-year low, about 11.6%, far below the industry average of about 38%, which is conducive to its sustainable refurbishment, sale and asset acquisition strategies.

**Figure 51. Net debt ratio**




*Source: Bloomberg, CASH*

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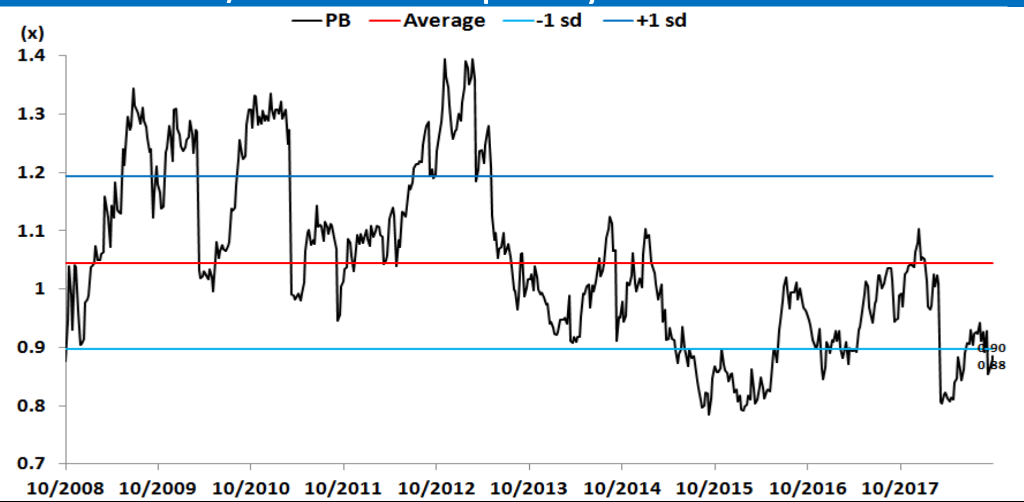
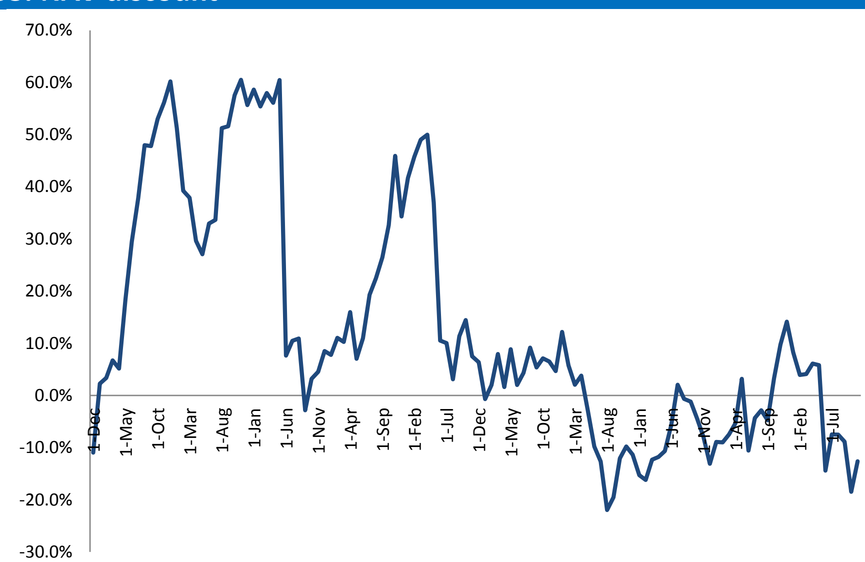
**Initiate "Buy" with the target price of HKD88: The current P/B value of Link is 0.9X, which is lower than -1SD of the average, with NAV discount ~7%, near the 10-year low, so the valuation is not expensive. Our target price is HKD88, indicating an upside of around 11%.** The valuation method is the DDM model, based on 1% permanent growth rate and 5.5% cost of capital.

**Figure 52. Forward P/B of Link REITs for past 10 years**




*Source: Bloomberg, CASH*

**Figure 53. NAV discount**




*Source: Bloomberg, CASH*

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**Key risks:** (1) Faster than expected rate hike raises US bond yields, reducing the attractiveness of REITs; (2) Property disposal prices miss market expectation; (3) Slower Hong Kong economic growth with lower inflation and (4) the Company becomes overly aggressive in asset acquisitions.

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## Link REIT

## 823.HK, Buy, Target Price: HK$88

**Income Statement (million HKD)**

| Year-end 31 Mar | FY17 | FY18 | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| Rental income | 8,854 | 9,600 | 9,773 | 10,696 | 11,766 |
| Other revenue | 401 | 423 | 431 | 471 | 518 |
| Total revenue | 9,255 | 10,023 | 10,203 | 11,168 | 12,284 |
| Operating expenses | -2,261 | -2,360 | -2,402 | -2,630 | -2,892 |
| Net Property income | 6,994 | 7,663 | 7,801 | 8,538 | 9,392 |
| General and admin. expenses | -342 | -417 | -437 | -546 | -690 |
| EBITDA | 6,652 | 7,246 | 7,364 | 7,992 | 8,702 |
| Depreciation and Amortization | 27 | 20 | 20 | 21 | 21 |
| EBIT | 6,625 | 7,226 | 7,344 | 7,971 | 8,681 |
| Earning before tax | 7,476 | 13,906 | 14,133 | 15,340 | 16,705 |
| Income tax | -1,057 | -1,420 | -2,261 | -2,454 | -2,673 |
| Net profit after tax | 6,419 | 12,486 | 11,872 | 12,886 | 14,033 |
| Minority interst | -202 | -218 | -218 | -218 | -218 |
| Other & non-tax deductible | -1,346 | -7,060 | -6,107 | -6,647 | -7,259 |
| Net profit for distribution | 4,871 | 5,208 | 5,547 | 6,020 | 6,556 |
| | | | | | |
| EPS | 2.3 | 2.5 | 2.6 | 2.9 | 3.1 |
| DPU | 2.3 | 2.5 | 2.7 | 3.0 | 3.3 |

**Cashflow statement (million HKD)**

| Year-end 31 Mar | FY17 | FY18 | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| EBITDA | 6,652 | 7,246 | 7,364 | 7,992 | 8,702 |
| Change in working capital | 3,276 | -7,718 | 0 | 0 | 0 |
| Other operating cash flow | -3,851 | 6,957 | 100 | -289 | -375 |
| Cash flow from operations | 6,077 | 6,485 | 7,464 | 7,703 | 8,327 |
| | | | | | |
| Free cash flow | 6,077 | 6,485 | 7,464 | 7,703 | 8,327 |
| Acquisition of investment | 489 | 16,494 | 0 | 0 | 0 |
| Adjustments | -67 | -8,407 | 70 | 75 | 81 |
| CF after investing acts | 6,499 | 14,572 | 7,534 | 7,778 | 8,408 |
| Cash dividends | -4,898 | -5,254 | -5,806 | -6,444 | -7,218 |
| Equity issue | -1,697 | -4,349 | 0 | 0 | 0 |
| Debt issue | 304 | -2,359 | -625 | -681 | -722 |
| Others | -9 | 19 | 0 | 0 | 0 |
| CF from financial acts | -6,300 | -11,943 | -6,431 | -7,125 | -7,940 |
| Net cash flow | 199 | 2,629 | 1,103 | 653 | 468 |
| Beginning cash | 336 | 535 | 3,164 | 4,267 | 4,920 |
| Ending cash | 535 | 3,164 | 4,267 | 4,920 | 5,388 |

*Source: Company, CASH*

**Balance Sheet (million HKD)**

| Year-end 31 Mar | FY17 | FY18 | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| Cash & equivalents | 535 | 3,164 | 3,870 | 4,734 | 5,790 |
| Accounts receivable | 503 | 715 | 715 | 715 | 715 |
| Other current assets | 227 | 8,623 | 8,623 | 8,623 | 8,623 |
| Total current assets | 1,265 | 12,502 | 13,208 | 14,072 | 15,128 |
| Investment properties | 174,006 | 203,091 | 233,089 | 267,517 | 307,031 |
| Other LT assets | 669 | 811 | 2,071 | 3,464 | 4,998 |
| Total assets | 175,940 | 216,404 | 248,368 | 285,054 | 327,158 |
| | | | | | |
| Short-term debt | 300 | 2,589 | 2,850 | 3,138 | 3,455 |
| Accounts payable | 1,870 | 2,462 | 2,949 | 3,532 | 4,230 |
| Other current liabilities | 1,876 | 2,174 | 2,456 | 2,776 | 3,136 |
| Total current liabilities | 4,046 | 7,225 | 8,256 | 9,446 | 10,821 |
| Long-term debt | 29,815 | 23,196 | 25,489 | 28,009 | 30,778 |
| Other LT liabilities | 3,582 | 6,915 | 9,489 | 13,022 | 17,869 |
| Total liabilities | 37,443 | 37,336 | 43,234 | 50,476 | 59,468 |
| Total unitholders' funds | 138,497 | 179,068 | 205,134 | 234,578 | 267,690 |
| Units' funds & liabilities | 175,940 | 216,404 | 248,368 | 285,054 | 327,158 |

**Key Ratios**

| Year-end 31 Mar | FY17 | FY18 | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|
| **Valuation** | | | | | |
| Reported P/E (x) | 6.9 | 3.1 | 3.4 | 15.2 | 27.4 |
| Dividend yield | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| P/B (x) | 1.1 | 0.9 | 0.9 | 0.7 | 0.7 |
| EV/EBITDA (x) | 8.3 | 3.9 | 4.1 | 17.5 | 30.3 |
| EV/EBIT (x) | 8.3 | 3.9 | 4.1 | 17.5 | 30.3 |
| EBITDA margin | 72% | 72% | 72% | 71% | 71% |
| Effective tax rate | 14% | 10% | 16% | 16% | 16% |
| ROA (pre tax) | 4% | 6% | 6% | 5% | 5% |
| **Growth (%)** | | | | | |
| Revenue | 5.9% | 8.3% | 1.8% | 9.5% | 10.0% |
| EBITDA | 8.3% | 8.9% | 1.6% | 8.5% | 8.9% |
| EBIT | 8.3% | 9.1% | 1.6% | 8.5% | 8.9% |
| DPU | 10.8% | 7.3% | 10.5% | 11.0% | 12.0% |

*Source: Company, CASH*

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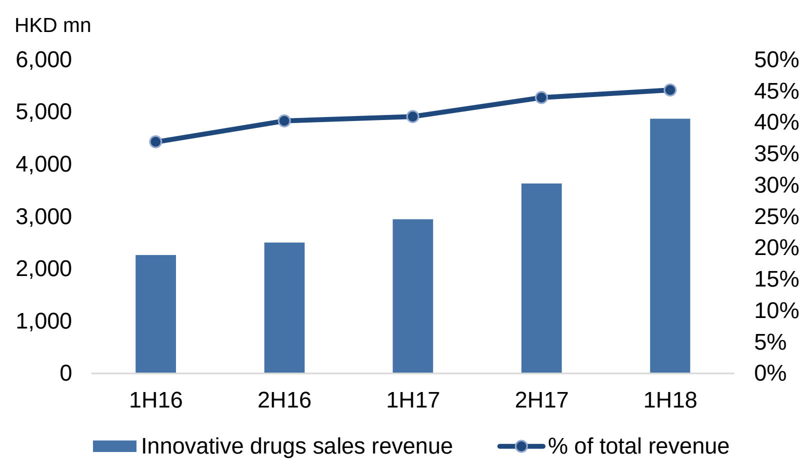
# CSPC (1093.HK)

**Impact from GPO on CSPC is being exaggerated:** Market sell- off occurred after the procurement tender result revealed the price cut of listed drugs to be higher than expected.

*Recall: On September 11, 2018, the State Medical Insurance Administration announced that 31 drugs will be included under the centralized procurement pilot project, and the program is going to be implemented in 11 cities in China including Beijing, Shanghai, Tianjin, Chongqing, Guangzhou, Shenzhen, Shenyang, Dalian, Xian, Chengdu, and Xiamen. Based on the draft guideline, only drugs that pass the consistency evaluation test will be considered during procurement. According to the program, about 60-70% of the total volume will be given to companies that win the bid, but the prerequisite is that the drug manufacturers need to cut price in order to win the bid.*

We understand that investors are concern about the price cuts of generic drugs. However, **we believe that CSPC is relatively defensive due to the fact that 1) the Company has rich innovative drug portfolio which will be unaffected by the central procurement. 2) CSPC actually does not have any major products that are under this round of trial. The drugs affected, i.e. Azithromycin, Tramadol, Amoxicillin have limited contribution to the profit, only 1-2%.** (versus SBP, which has major products that are on the list including Entecavir). **The near term impact of central procurement policy on CSPC is limited.**

**Figure 54. Increasing contribution from Innovative drugs**




*Source: CSPC, CASH*

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**Attractive valuation after the market sell- off, esp. given its higher-than-peer- visibility:** China healthcare names overreacted to the so-called negative factors in 2018. Incidents including CS Vaccine scandal, central procurement policy and adjuvant list contributed to the downturn. Yet, we find the share pullback provides better entry point for investors. In long term, China needs its own drugs to meet the ever-growing demand caused by the aging population and the growing health problem. Big names such as CSPC are the missing puzzle piece that the country needs to work with in order to solve the problem.

We like CSPC because of 1) its ability to develop innovative drugs; 2) stable earnings growth supported by NBP and oncology portfolios; 3) insignificant impact from central procurement policy in near term. Also, the current PE of ~20x is a comfortable valuation given the fact that the EPS of CPSC is expected to grow by CAGR >25% in 2018-2020.

**National adjuvant drug list unlikely to affect drugs with clear therapeutic benefits:** The rollout of adjuvant drug list is to reduce the excessive use of adjuvant drugs that have low clinical value. For the time being, it is unlikely for Oulaining and NBP to be included in the list. NBP will not be on the list because it has a patent in China and it is in many clinical guidelines and protocols. Also, the chemical component, safety, and efficacy of Oulaining is clear.

**Strong sales momentum of existing products:** NBP, Oulaining, and Xuanning sales grew 38%, 74% and 90% in 1-3Q18. For NBP, management expects the sales growth in 2019 and 2020 to be as strong as that in 2018, as the penetration in many market/low tier cities remains low, on top of that, they are going to carry out more academic promotions. Also, management is optimistic about the growth momentum of Oulaining and Xuanning as they are in the transition to direct sales. Apart from innovative drugs, CSPC recorded satisfactory growth in generic drugs, which grew 37% in 1-3Q18 due to: 1) better brand recognition; 2) rising market penetration in lower tiered cities and hospitals via direct sales force. Meanwhile, the management sees the central procurement list expansion to be unlikely in near future, given that the current round of trial is not yet implemented in a national wide basis.

**Detailed analysis of NBP:** The market potential for NBP is huge given China's increasing stroke market. The satisfactory result of NBP sales (>30% yoy in 2018) was explained by the inclusion of NBP injection in the 2017 NDRL. Currently NBP's penetration in lower-tier cities and towns remain low, its market share of ~14% shows unlimited potential in China. Its sales in 2018 are expected to reach HKD5bn, in line with the previous management guidance.

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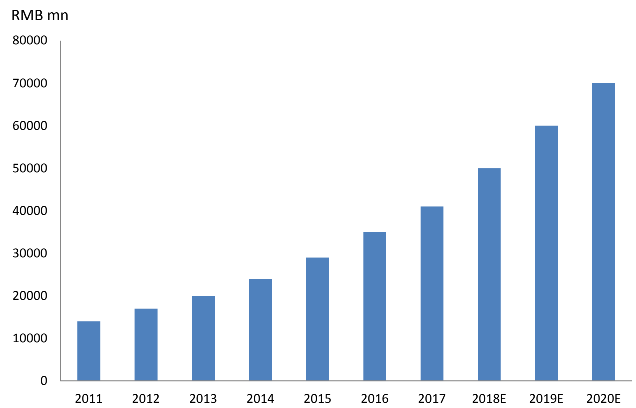
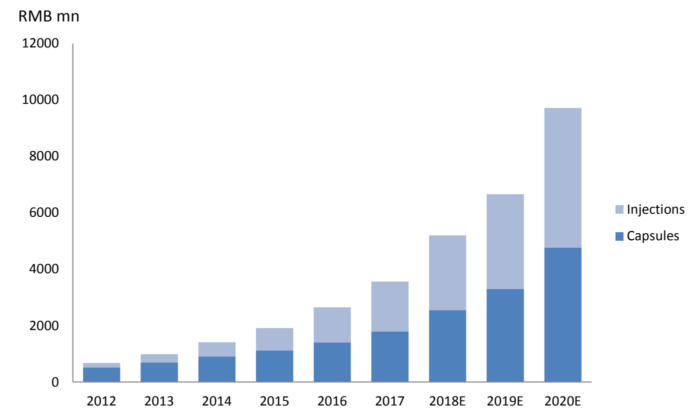
**Figure 55. China Stroke Market Size**




*Source: CSPC, CASH*

**Figure 56. NBP sales**




*Source: CSPC, CASH*

**Oncology drugs to be another growth engine:** Despite the fact that price- cut is a definite trend in China, domestic manufacturers with strong R&D capabilities can capture more market share and stand out from the crowd eventually. On 10 October, State Medical Insurance Administration has included new oncology drugs into the National Reimbursement Drug List B (NRDL B).

All the recent policies represents ongoing effort of the central government to improve accessibility of efficacious therapeutics in China. There would be increasing numbers of oncology drugs added to the list. We believe CSPC is the perfect player that can ride the trend. In fact, oncology portfolio has become a new area of growth for CSPC in recent years. Sales growth of Duomeisu and Jinyouli accelerated to 82%/117% YoY in 1-3Q18 respectively.

**Detailed analysis of Duomeisu:** Doxorubicin liposome (Duomeisu) is a 1st line drug used in various cancers' chemotherapy, including lymphoma, multiple myeloma, ovarian cancer, breast cancer and etc. The outstanding sales growth of Duomeisu is explained by China's increasing cancer drug market size.

**Detailed analysis of Jinyouli:** PEG-rhGCSF/PEG-GCSF is the 1st line drug for the prevention of leucopenia and infection induced by chemotherapy. The market potential of Jinyouli is huge, given i) its inclusion in NRDL list in 2017; ii) PEG-rhGCSF being a better choice over traditional rhGCSF, with longer half- life with more stable density in plasma, and has lower tendency to trigger antibodies.

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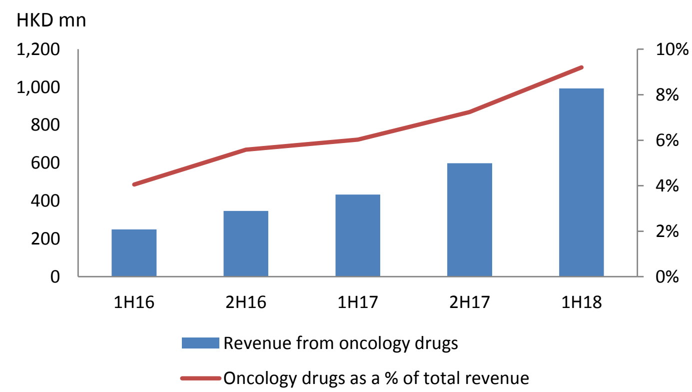
**Figure 57. Increasing revenue from oncology drugs**




*Source: CSPC, CASH*

**Figure 58. CSPC oncology drugs portfolio**


*Source: CSPC, CASH*

**Ramp of Albumin-bound paclitaxel demonstrates CSPC's great potential:** Keaili, use for the treatment of breast cancer, is the first-to-market in China. Paclitaxel (Albumin Bound) achieved 1-3Q18 sales of HKD191mn, since launch in March 2018. Because of its improved safety and efficacy profiles, the drug has already been included onto the reimbursement list of 5 provinces (Jiangsu, Hunan, Hubei, and Ningxia, Shandong). While it is not yet included in NRDL, management mentioned they are working on that, and they will try to increase the number of reimbursed provinces. Looking forward, the penetration rate of Keaili will increase in different provinces and its sales team will also enlarge in scale. Despite the fact that there is a new competing drug from Hengrui, the management is extremely confident towards the sales prospect of Albumin-bound PTX given the strong replacement demand in the mainland market (the drug will take up significant market share from older formulations of paclitaxel such as TAXOL) and therefore a huge potential for the entire industry. Management guided that Albumin-bound PTX sales in FY18/19 will exceed HKD0.3bn/1bn.

**Increasing R&D to enhance future growth:** R&D costs of CSPC increased by 112% yoy in 1H2018. Going forward, CSPC is going to spend about 60% of the R&D on innovative drugs including early stage biologics discovery and development and about 40% on bioequivalence studies as well as R&D of generic drugs.

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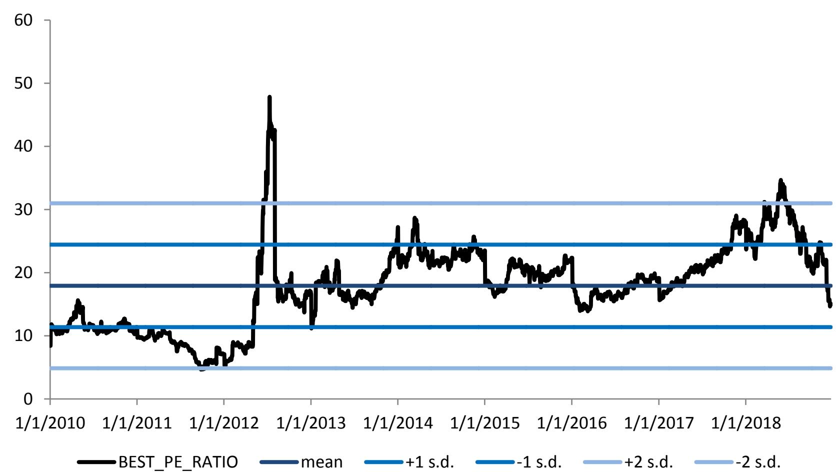
With respect to the generic drug development, its BE study plan for core generics remain unchanged. It is going to target on drugs that have higher technical entry barriers, or first-to-market generics.

With respect to the innovative drug development, according to management, M&A will be one of its strategy to expand the late-stage novel drug pipeline (10 biologics and 15 small molecule candidates licensed for the time being).

Management believes that the future trend will be the application of macromolecule biologics, combined usage of macromolecule biologics and small molecule drugs, and immunotherapy. In our view, the strategic collaboration between CSPC and Junshi shows the company's determination to expand its oncology business. The launch of PD1 after year 2020 will help CSPC to secure a better position in the oncology area. The building up of its in-house discovery capability in both the US and China (Shanghai), will strengthen the competitiveness of the Company.

**Valuation:** We believe the share of CSPC is currently oversold (19E at ~16x P/E). We maintain "buy" rating, with TP at $13 (previous TP at $22). The TP cut already reflect a slower growth of generic drugs sales and the weaker sentiment.

**Figure 59. CSPC's Forward PE**




*Source: Bloomberg, CASH*

**Key Risk:** 1) Policy headwind, e.g. list expansion of GPO and adjuvant drug list. 2) Unsatisfactory drugs sales, e.g. NBP, Keaili. 3) Competition eroding profit margin.

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## CSPC Pharmaceutical Group

## 1093.HK, BUY, TargetPrice: HK$13

**Income Statement (In million HK$)**

| Year-end Dec 31 | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| Revenue | 12,369 | 15,463 | 22,180 | 26,650 | 31,273 | 34,610 |
| Cost of goods sold | -6,060 | -6,117 | -8,552 | -10,009 | -11,432 | -12,479 |
| Gross profit | 6,309 | 9,346 | 13,628 | 16,641 | 19,840 | 22,131 |
| SG&A | -3,342 | -5,057 | -7,985 | -9,661 | -11,414 | -12,806 |
| Other expense | -317 | -808 | -1,600 | -1,620 | -1,630 | -1,629 |
| Operating profit | 2,649 | 3,482 | 4,043 | 5,360 | 6,796 | 7,696 |
| EBITDA | 3,237 | 4,198 | 4,923 | 6,442 | 8,120 | 9,292 |
| Depreciation | -551 | -613 | -804 | -906 | -1,028 | -1,159 |
| Amortisation | -37 | -104 | -77 | -176 | -295 | -437 |
| Net interest expense | -42 | -27 | -28 | -24 | -31 | -31 |
| Associates & JCEs | 28 | 10 | 20 | 20 | 20 | 20 |
| Earnings before tax | 2,635 | 3,465 | 4,035 | 5,357 | 6,784 | 7,685 |
| Income tax | -522 | -685 | -774 | -1,002 | -1,236 | -1,362 |
| Minority interests | -12 | -10 | -14 | -16 | -19 | -42 |
| Extraordinary items | 0 | 0 | 0 | 0 | 0 | 0 |
| Income attr. to shareholders | 2,101 | 2,771 | 3,248 | 4,338 | 5,529 | 6,280 |
| | | | | | | |
| EPS | 0.35 | 0.45 | 0.52 | 0.69 | 0.89 | 1.01 |
| DPS | 0.12 | 0.15 | 0.16 | 0.20 | 0.26 | 0.31 |

**Balance Sheet (In million HK$)**

| Year-end Dec 31 | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| Cash & equivalents | 3,235 | 5,238 | 6,599 | 8,569 | 11,326 | 14,639 |
| Accounts receivable | 1,835 | 2,334 | 3,348 | 3,841 | 4,293 | 4,514 |
| Inventories | 1,933 | 2,901 | 4,056 | 4,747 | 5,422 | 5,918 |
| Other current assets | 1,425 | 3,162 | 3,320 | 3,486 | 3,660 | 3,843 |
| Total current assets | 8,428 | 13,635 | 17,322 | 20,642 | 24,700 | 28,914 |
| Fixed assets | 5,415 | 6,663 | 7,345 | 8,236 | 9,327 | 10,526 |
| Net intangibles | 191 | 225 | 644 | 1,067 | 1,478 | 1,827 |
| Total investments | 80 | 110 | 230 | 350 | 470 | 590 |
| Other LT assets | 646 | 911 | 800 | 800 | 800 | 800 |
| Total assets | 14,760 | 21,543 | 26,342 | 31,095 | 36,775 | 42,658 |
| Accounts payable | 2,938 | 4,513 | 6,193 | 7,111 | 7,966 | 8,525 |
| ST debt | 898 | 927 | 827 | 627 | 477 | 427 |
| Other current liabilities | 249 | 319 | 613 | 865 | 1,242 | 1,497 |
| Total current liabilities | 4,085 | 5,760 | 7,633 | 8,604 | 9,685 | 10,449 |
| LT debt | 240 | 60 | 60 | 60 | 60 | 60 |
| Other LT liabilities | 244 | 316 | 300 | 300 | 300 | 300 |
| Total liabilities | 4,569 | 6,135 | 7,993 | 8,964 | 10,045 | 10,809 |
| Common stock | 10,108 | 15,322 | 18,250 | 22,016 | 26,596 | 31,672 |
| Retained earnings | -462 | 2,400 | 4,628 | 7,694 | 11,574 | 15,950 |
| Minority interest | 84 | 85 | 99 | 115 | 134 | 177 |
| Total shareholders' equity | 10,191 | 15,407 | 18,349 | 22,131 | 26,730 | 31,848 |
| Total equity & liabilities | 14,760 | 21,543 | 26,342 | 31,095 | 36,775 | 42,658 |

**Cashflow statement (In million HK$)**

| Year-end Dec 31 | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| Income pre-preferred share dividends | 2,101 | 2,771 | 3,248 | 4,338 | 5,529 | 6,280 |
| Non-cash item | 573 | 736 | 874 | 1,078 | 1,323 | 1,619 |
| Change in working capital | 168 | -304 | -489 | -265 | -272 | -159 |
| Cashflow from operations | 2,916 | 3,288 | 3,569 | 4,985 | 6,405 | 7,557 |
| Capital expenditure | -1,099 | -1,177 | -1,982 | -2,395 | -2,826 | -3,145 |
| Investments | -43 | -556 | -100 | -100 | -100 | -100 |
| CF from investing acts | -1,332 | -3,287 | -2,082 | -2,495 | -2,926 | -3,245 |
| Cash dividend | -650 | -730 | -726 | -1,020 | -1,272 | -1,649 |
| Equity issue | 563 | 2,351 | 500 | 500 | 500 | 500 |
| Debt issue | -283 | -193 | -100 | -200 | -150 | -50 |
| CF from financial acts | -452 | 1,631 | -326 | -720 | -922 | -1,199 |
| Net cashflow | 935 | 1,929 | 1,361 | 1,970 | 2,757 | 3,313 |
| Beginning cash | 2,299 | 3,235 | 5,238 | 6,599 | 8,569 | 11,326 |
| Ending cash | 3,235 | 5,238 | 6,599 | 8,569 | 11,326 | 14,639 |
| Ending net debt | -2,097 | -4,251 | -5,712 | -7,882 | -10,789 | -14,152 |

*Source: Company data, CASH*

**Key Ratios**

| | FY16 | FY17 | FY18E | FY19E | FY20E | FY21E |
|---|---|---|---|---|---|---|
| **Growth (%)** | | | | | | |
| Revenue | | 25.0% | 43.4% | 20.2% | 17.3% | 10.7% |
| Gross profit | | 48.1% | 45.8% | 22.1% | 19.2% | 11.5% |
| Operating profit | | 31.4% | 16.1% | 32.6% | 26.8% | 13.2% |
| Income attr. to shareholders | | 31.9% | 17.2% | 33.6% | 27.4% | 13.6% |
| | | | | | | |
| **Profitability (%)** | | | | | | |
| Gross margin | 51.0% | 60.4% | 61.4% | 62.4% | 63.4% | 63.9% |
| Operating margin | 21.4% | 22.5% | 18.2% | 20.1% | 21.7% | 22.2% |
| Net Margin | 17.0% | 17.9% | 14.6% | 16.3% | 17.7% | 18.1% |
| Dividend payout | 34.0% | 33.0% | 31.4% | 29.3% | 29.8% | 30.3% |
| ROE | 20.6% | 18.0% | 17.7% | 19.6% | 20.7% | 19.7% |
| ROA | 14.2% | 12.9% | 12.3% | 14.0% | 15.0% | 14.7% |
| | | | | | | |
| **Liquidity (x)** | | | | | | |
| Current ratio | 2.1 | 2.4 | 2.3 | 2.4 | 2.6 | 2.8 |
| Interest coverage | 63.5 | 130.7 | 143.8 | 227.0 | 215.8 | 251.5 |
| | | | | | | |
| **Leverage** | | | | | | |
| Net Debt/EBITDA (x) | (0.6) | (1.0) | (1.2) | (1.2) | (1.3) | (1.5) |
| Net Debt/Equity (%) | -20.6% | -27.6% | -31.1% | -35.6% | -40.4% | -44.4% |

*Source: Company data, CASH*

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