China H-Share Strategy

China Outlook 2016—Charting terra incognita

Equity Strategy

China

Wenjie Lu
Strategist
S1460513120001
wenjie.lu@ubssecurities.com
+86-213-866 8851

A year of divergence

Chinese equities experienced significant volatility this year, but ended up with largely flat performance—the MSCI China index has risen only 6% YTD. The market seems featureless—performance is broadly in line for the new versus old economy sectors, SOEs versus non-SOEs, and large cap versus small caps. In 2016, our year-end index target implies near zero upside—65 for MSCI China and 11,000 for HSCEI. However, we expect mid/small-cap non-SOE stocks in the new economy sectors to significantly outperform next year.

Terra incognita—go-global firms and consumer services as new growth poles

UBS China economists forecast only 6.2%/5.8% GDP growth for 2016/2017, with insufficient pro-growth stimulus compensating for the downward pressure. With persistent macro weakness, we expect investors to seek new growth poles in: 1) go-global companies; 2) domestic consumer service sectors; and 3) reformed SOEs. While all appear promising, none is mature enough to bear visible fruit—thus, we believe investors will have to chart the terra incognita via stock-picking rather than a trend-riding strategy.

Onshore bond market and Rmb volatility as the two major risks

We believe the market has not fully priced in the credit and FX risks. In the onshore bond market, the net issuance of bonds is now at a record high, but the credit spread has compressed to a five-year low. In the FX market, the China offshore (CNH) spot /forward rate only implies 2.5% Rmb depreciation in 2016. A bursting of the potential bond market bubble and a spurt in FX volatility could rekindle fears over the soundness of China's financial system.

Overweight ADRs, insurance, ports; Underweight banks, brokers, utilities

Most ADRs and insurance companies cater to the solid demand for consumer services. Ports and selective manufacturers appear well-positioned to expand assets and their businesses in the global market. We are Overweight on them. Meanwhile, banks and brokers are susceptible to credit risk. Utility companies may be vulnerable to the government forcing them to lower tariffs for the sake of cost savings in the broad economy. We are Underweight on them.

Figure 1: UBS H-share/ADR top picks in 2016

Name	Ticker	Sector	Mkt cap (US$ mn)	UBS Rating	Curr Px (local)	Upside to target	2016E PE	2015E EPS Gr	2016E EPS Gr	2016E PB	2015E ROE (%)	2015E Div Yield (%)
Consumer services												
Alibaba Group	BABA.N	Software & Services	201,941	Buy	78.76	21%	28.8	18%	15%	5.1	35.2	0.0
Ping An Insurance	2318.HK	Insurance	102,254	Buy	45.35	30%	11.1	19%	14%	1.8	19.2	1.6
58.com	WUBA.N	Software & Services	5,985	Buy	54.16	29%	n.a.	n.a.	n.a.	2.5	-14.4	0.0
Wisdom Sports Group	1661.HK	Media	951	Buy	4.74	20%	14.8	8%	40%	3.9	23.6	3.4
Patronomics + Rmb depreciation risk												
China Merchants Hldg	0144.HK	Transportation	10,118	Buy	25.75	59%	13.0	11%	10%	1.1	8.0	3.7
Fosun International	0656.HK	Capital Goods	12,808	Buy	14.88	31%	8.8	14%	19%	1.5	16.5	1.3
Weak economy + continous fiscal stimulus												
CRCC	1186.HK	Capital Goods	30,646	Buy	11.30	24%	8.9	-1%	3%	1.0	12.9	1.7
Beijing Urban	1599.HK	Capital Goods	854	Buy	5.19	58%	9.9	31%	19%	1.6	16.5	3.0

Note: Above data as of 13 November 2015. Source: Bloomberg, UBS estimates

UBS Research THESIS MAP | MOST FAVOURED | LEAST FAVOURED

ADRs, Insurance, Ports | **Banks, Brokers, Utilities**

PIVOTAL QUESTIONS

Read more

Q: Where can Chinese companies grow >15% per annum when GDP growth sinks below 7%?

This is terra incognita (i.e. unknown territory). We have three tentative answers: 1) overseas markets, 2) domestic consumer service sectors, and 3) reformed SOEs. They respectively tackle the sore points of the Chinese economy—overcapacity in the manufacturing industries, the inadequacy of public services, and low efficiency of state-run firms. All appear promising, but none are mature enough to bear visible fruit in the short term.

Read more

Q: What risks could trigger the next leg down?

A bursting of the potential onshore bond market bubble. Slumping yields and a dampened stock market have forced investors to plunge the depths of creditworthiness, while companies are in poor shape to repay debts. Rmb depreciation is another major risk. The central bank may have less incentive to intervene in the forex market after the IMF includes the Rmb in the special drawing rights (SDR).

Read more

Q: Can stimulus policies help?

Probably not. The current round of fiscal stimulus still focuses on infrastructure, which cannot last for long or scale up significantly. Monetary easing since late-2014 has resulted in an asset bubble rather than a pick-up in credit demand in the real economy. We welcome more stimuli to improve social welfare, which may have little impact on short-term growth, but help unleash the potential of household consumption in the long run.

WHAT'S PRICED IN?

Slower growth, but low FX and credit risks: We think bottom-up consensus forecasts for the MSCI China's earnings growth is realistic at 3.1% in 2016F. However, we believe credit and FX risks have not been fully priced in—the CNH forward rate only implies 2.5% depreciation in 2016 and the onshore AA-rated/treasury bond yield spread now stands at a five-year low.

UBS VIEW

Read more

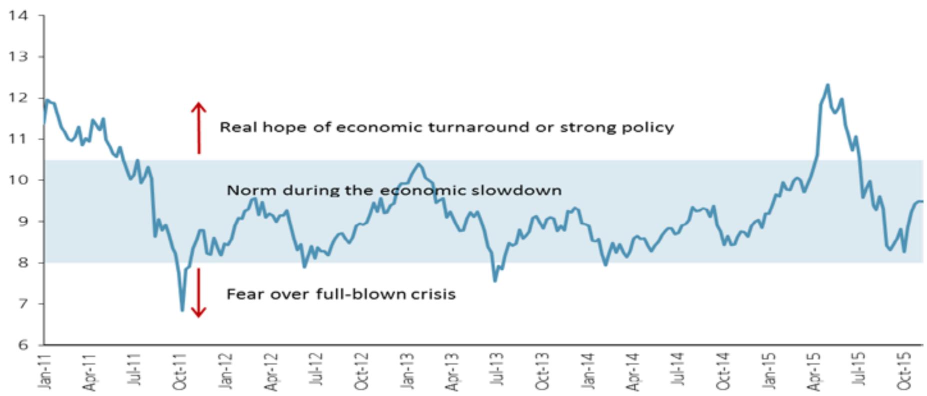
Downplay old economy, seek growth in consumer services and "go-global" sectors: The MSCI China index could reach 65 by end-2016E, implying flattish performance in the next 12 months. Two themes can outperform, in our view: consumer services (p.17) and Patronomics (p.19). We expect the market to favour mid/small-caps in the new economy sectors, as a result of the lack of interest in global allocation funds, but uprising trade flow from mainland China to Hong Kong.

VALUATION

Read more

Stock picks

MSCI China 12m forward PE and implied scenarios



Source: Datastream

Figure 2: Sector recommendations and valuations

Sector	% of index weight	Rating	2016F PE	2017F PE	2015F EPS Gr	2016F EPS Gr	2017F EPS Gr	2015F PB	2016F PB	2016F ROE
Energy	9.8%	Neutral	14.3	8.5	-55%	4%	68%	0.8	0.8	5%
Materials	2.6%	UW	9.5	8.2	-7%	27%	15%	0.8	0.8	8%
Industrials			9.3	8.1	24%	5%	14%	1.1	1.0	11%
- Capital Goods	5.3%	OW	8.7	7.6	22%	2%	15%	1.0	0.9	11%
- Commercial & Prof Services	0.5%	Neutral	18.4	14.9	33%	32%	24%	3.1	2.7	15%
- Transportation	2.0%	OW	11.3	10.4	41%	17%	9%	1.2	1.1	10%
Consumer Discretionary			11.1	9.7	4%	12%	14%	2.0	1.8	16%
- Automobiles & Components	3.1%	Neutral	9.3	7.9	2%	14%	18%	1.7	1.5	16%
- Consumer Durables & Apparel	1.4%	Neutral	13.5	12.3	7%	8%	10%	2.8	2.5	18%
- Retailing	0.2%	Neutral	13.2	11.8	15%	15%	11%	1.3	1.3	10%
Consumer Staples	4.0%	Neutral	22.6	21.1	5%	4%	7%	2.5	2.5	11%
Health Care	2.1%	OW	18.5	15.5	20%	20%	19%	3.4	3.0	16%
Financials			6.5	6.1	3%	0%	7%	0.9	0.8	13%
- Banks	22.4%	UW	5.2	5.0	-1%	-1%	4%	0.8	0.7	14%
- Diversified Financials	1.9%	UW	10.0	9.0	56%	-19%	11%	1.2	1.1	11%
- Insurance	10.4%	OW	12.3	10.8	31%	2%	14%	1.3	1.2	9%
- Real Estate	4.7%	Neutral	7.6	6.6	-3%	12%	15%	0.9	0.8	11%
Information Technology			25.1	20.1	15%	31%	25%	7.0	5.6	22%
- Software & Services	10.7%	OW	28.3	22.1	27%	32%	28%	10.2	7.7	27%
- Technology Hardware & Equipme	1.9%	Neutral	15.1	13.1	-20%	35%	15%	3.4	3.0	20%
Telecommunication Services	11.2%	Neutral	13.5	13.2	2%	2%	3%	1.5	1.4	10%
Utilities	3.8%	UW	11.3	10.5	11%	-3%	7%	1.6	1.5	13%
MSCI China	100%		**9.7**	**8.7**	**-0.2%**	**3.2%**	**11.3%**	**1.2**	**1.1**	**11.6%**
- ex Banks	78%		12.7	10.9	0.2%	6.1%	16.1%	1.4	1.3	10.5%
- ex Banks, Oils, and Telco	58%		12.2	10.7	13.2%	7.7%	14.7%	1.6	1.4	11.5%
ADRs (not yet included in MSCI China)	24%	OW	25.0	18.3	7.6%	37.2%	36.7%	6.0	4.8	19.1%

Source: Datastream, Bloomberg, UBS estimates

Top-down view: many band-aid solutions, few long-term answers

2016 index target: MSCI China—65, HSCEI—11,000

Over the past three years, the MSCI China index has been choppy, but it eventually generated nearly zero returns. The index concluded 2012 at 62.8 and lingered at around 63 in November 2015. These three years, in our view, reflect a tug-of-war between an inevitable slowdown of the investment-led old economy, and the relentless search for new growth poles.

In H115, a shed of light appeared temporarily. The MSCI China index rose about 30% within five months on the hope of reforms among state-owned enterprises (SOEs) as well as innovation in the private sector. Unfortunately, the healthy rally soon seemed to sink to a highly speculative market crowded with retail investors, with their pockets and confidence inflated by margin financing money. In the wake of the market crash in June, policy makers initially responded with direct interventions in stock trading. After spending around Rmb2trn on market stabilisation initiatives, the government finally decided not to maintain unsustainable valuations of small caps, and resorted to fiscal stimulus after mid-August.

In 2016 and onwards, the challenge remains unmet—where will long-term growth come from? In the third section of this report, we analyse three tentative answers —the consumer service sectors, overseas markets and reformed SOEs. Nevertheless, we believe none can bear visible fruit in the next 12 months. UBS China economists also advise against expecting significant stimulus in 2016.

Therefore, we set a conservative index target for 2016. By the end of next year, we expect the MSCI China index to reach 65, and the HSCEI to reach 11,000. These imply about 3% upside risk from the current levels. We base our MSCI China forecast on a target PE of 9.3x (on par with the five-year average) and EPS growth of 3.5%/5% in 2016/2017.

The two major downside risks are the bursting of the potential onshore bond market bubble (p11) and short-term volatility in the Rmb exchange rate (p12).

Figure 3: MSCI China index forecasts

MSCI China index	Spot	62.9		End-2016E target	65
EPS		YoY% growth		12m forward PE	
2014	6.17	2.5%		Spot	**9.5**
2015E	6.42	4.0%	(5.3% in H1)	End 2015E	9.5
2016E	6.64	3.5%		End 2016E	**9.3**
2017E	6.97	5.0%			
				Avg since 2011	9.3
				10Y average	11.6

Source: UBS-S estimates

Policy outlook—stimulus is merely a palliative move

UBS's China economist Tao Wang forecasts real GDP growth will slow in 2016 to 6.2%, down from 6.9-7% in 2015E. Her team believes that "another massive stimulus package is unlikely to be launched or be effective to fully offset the increased downward pressures in the economy".

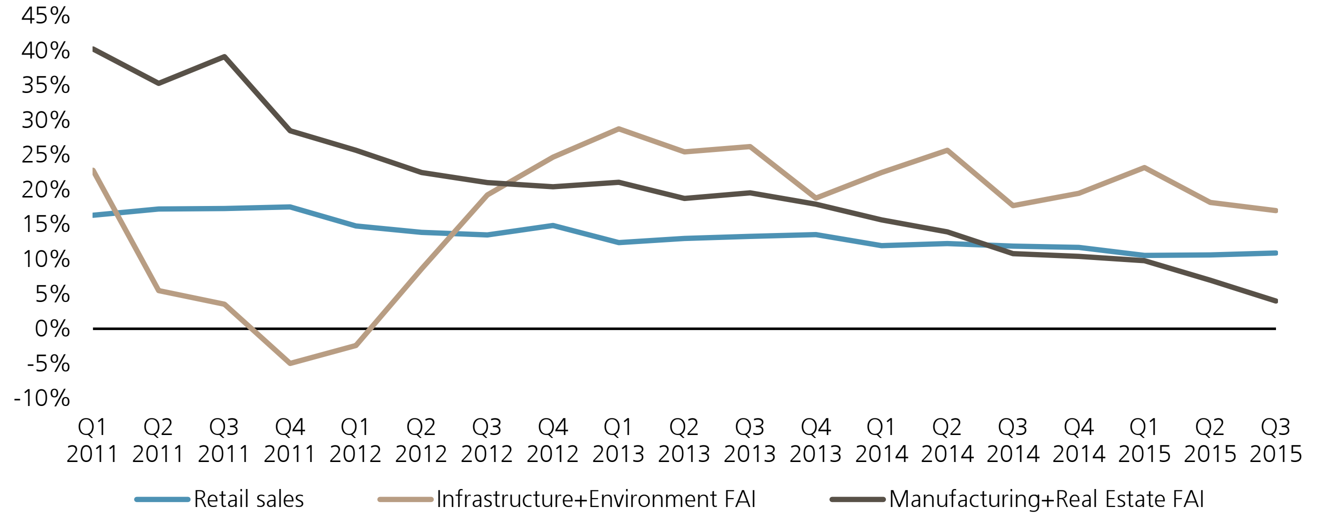
We concur with this view. Since mid-August 2015, a series of monetary and fiscal policies were launched to accelerate infrastructure investments, including the following.

- The People's Bank of China (PBoC) created a Rmb1.2trn "special construction fund" for the next three years. Around Rmb0.5trn has been disbursed as project capital, which allows leverage of up to 4-5 times.
- The State Council has lowered the capital requirement ratio from 25% to 20% for transport infrastructure projects.
- The Ministry of Finance released a set of 206 public-private partnership (PPP) projects worth Rmb659bn.
- The National Development and Reform Commission (NDRC) continued to expedite its project approvals, preparations and release process.

However, we believe these measures are merely palliative moves. Similar infrastructure-focused stimulus in 2009 left a poisonous legacy that includes heavy debts for local governments, bad loans for banks, and overcapacity for manufacturing companies.

Trends for the three lines in Figure 4 have stayed the same since 2013—retail sales as a proxy of consumption grew steadily, government-driven investments in infrastructure and environmental projects has fluctuated between 15% and 25% YoY growth, and private sector investments has continued to slow. In Q4 2015 and 2016, fiscal stimulus will probably lift the brown line slightly in the following chart, but may not affect the black and blue lines.

Figure 4: Fixed asset investment (FAI) retail sales YoY growth



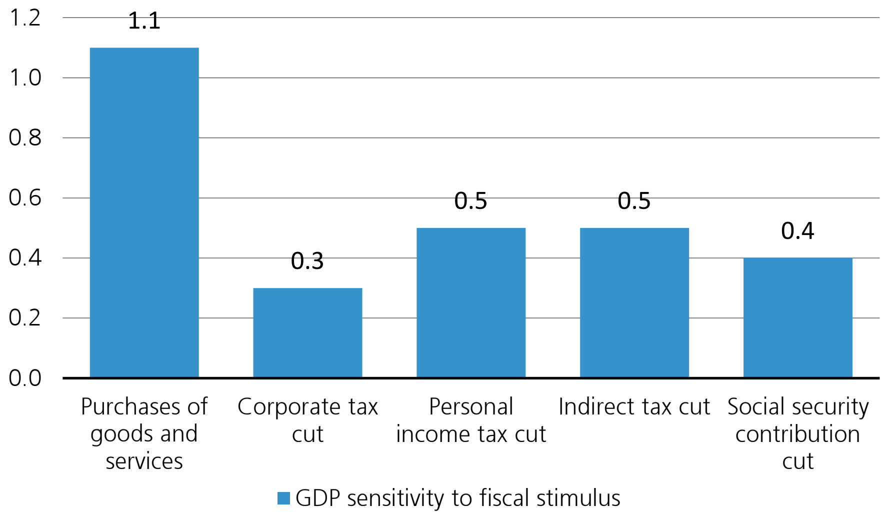
Source: CEIC, Wind

We believe the main bottlenecks for China to transit towards a consumption-driven, free market economy is the inadequacy of a social safety net for consumers, and the high friction costs involved with running private companies. In theory, stimulus policies should focus on cutting direct and indirect taxes for private firms, and adding social welfare.

However, international experience suggests such measures have a fiscal multiplier of less than 0.5 (see Figure 5). In brief, it means that US$1 in stimulus leads to less than a US$0.50 enhancement in the GDP as consumers and enterprises tend to deposit part of the benefits or use them to repay debts. Only the government's direct purchases of goods and services have a fiscal multiplier of more than 1x. For China, this means more direct government spending on infrastructure investments.

The bottleneck in household consumption is social welfare, but it has a much lower multiplier than direct government spending on infrastructure

Figure 5: Short-term fiscal multipliers (GDP sensitivity to fiscal stimulus) based on OECD cases



Note: The models surveyed are the National Bank of Belgium Model, Interlink, Deutche Bundesbank Model, Banca d'Italia model, Banco de Portugal model, Banco de Espana model, Area-Wide Model, ESRI Short-run Macroeconometric Model of the Japanese economy, Department of Finance's Canadian Economic and Fiscal Model, averages of US models as reported by Fromm and Klein 1976, averages of US models as reported by Bryant et al 1988, averages of US models as reported by Adams and Klein 1991 and averages of UK models as reported by Church et al 1993. These models cover the United States, Japan, the Euro area, Germany, France, Italy, the United Kingdom, Canada, Spain, Belgium and Portugal.
Source: Adams and Klein (1991), Bryant (1988), Church et al. (2000), Fromm and Klein (1976), Henry et al. (2004), Roeger and in't Veld (2009) and Perotti (2005).

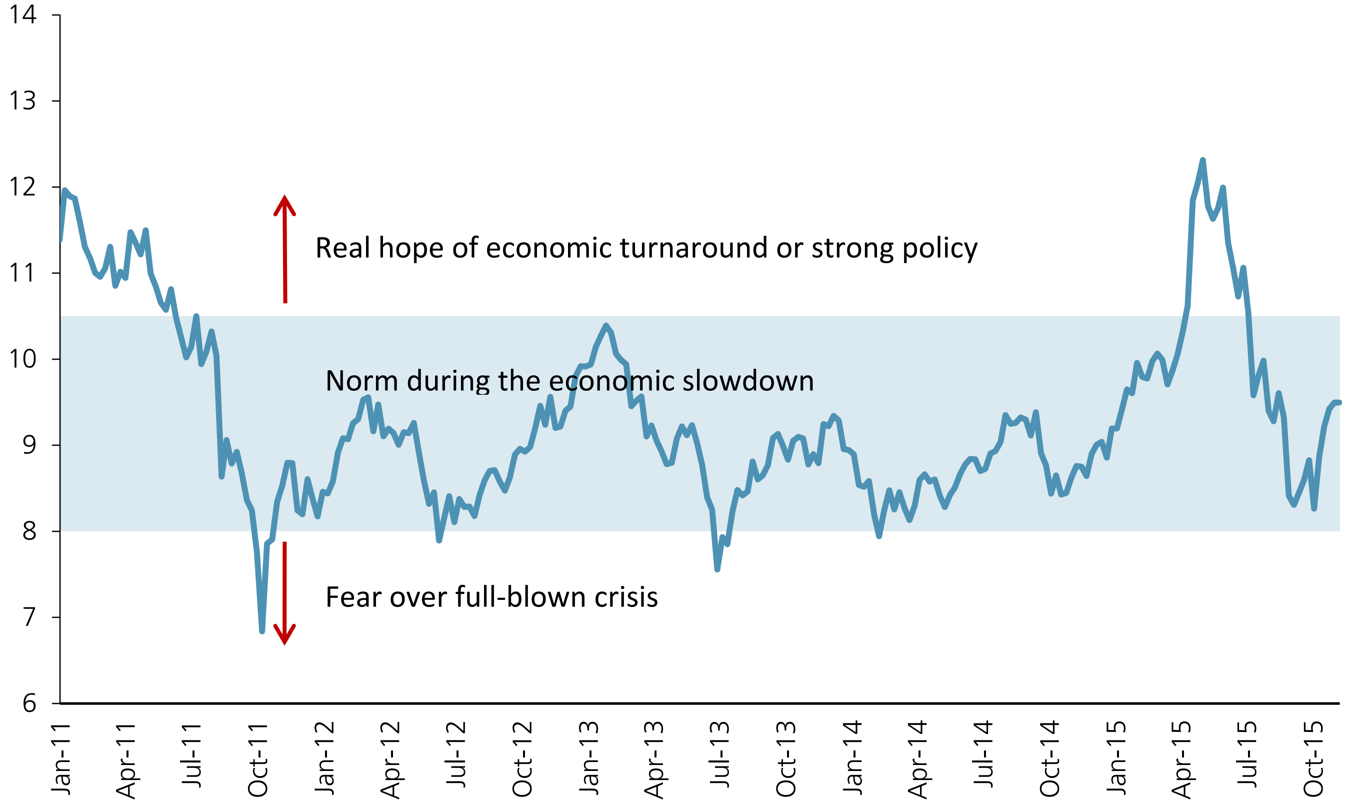
PE valuation—why a target PE of only 9.3x?

Signs of weakening economic growth as well as disappointment over the effectiveness of government stimulus are among the key factors supporting our cautious view for 2016. Our target forward PE for the MSCI China index is only 9.3x, on par with the 2011-14 average and 20% lower than the 10-year historical average of 11.6x.

Our target 2016 PE for the MSCI China is 9.3x; on par with the average over 2011-14

2015 has so far been a year with significant volatility and market turbulence. In the first half of 2015, the index forward PE reached a historical high at 12.3x in May. Affected by a dramatic A-share market correction, the index forward PE then took a sharp turn and dropped to 8.3x just before Q4 began (see Figure 6). In our view, the bullish performance in the first half was mainly the result of several interest rate cuts in H115 as China's policy stance turned more proactive to manage the macro risks. Favourable policies such as the introduction of the mutual recognition of funds and the Shanghai-Hong Kong Stock Connect programme, as well as SOE mega-merger stories also helped to boost Hong Kong's market performance.

Figure 6: MSCI China—12-month forward PE



Source: Datastream

Later on, a sharp correction and high volatility in the A-share market triggered a strong drop in the Hong Kong market. Along with some investors starting to fear potential systematic problems in China's financial market, the bubble started to burst and the index valuation recorded a downward trend (until recently). Despite a minor recovery over the past month, we remain cautious and sceptical about the index PE for 2016 and choose 9.3x as our target for the following two reasons.

- **When the market has lacked long-term growth perspective or strong policy stimulus, 82% of the index forward PE was 8.0-10.5x.** By looking at the historical index forward PEs since the beginning of 2011, we find that PEs experienced normal fluctuation between 8.0x and 10.5x at the most, where 82% of trading days were traded in that range. When there was real hope for an economic recovery or a large stimulus was introduced, the index forward PE would start to climb over 10.5x. Meanwhile, when valuations fell below 8.0x, there tended to be an overreaction to macro risks or a market liquidity crunch would occur. Both situations have only occurred at a 20% and 21% rate since 2011, respectively. Fortunately, PEs have not reached over 14x in the past five years as hyper-valuation usually indicates a bubble about to burst (as in 2007).

- **We believe the major overhangs capping MSCI China's valuations will most likely remain in 2016.** Domestic macro risks including Rmb depreciation, credit defaults and a continued downward trend in the property market (discussed in detail in a later section) should continue to concern investors with regard to where China's real economy growth will come from. We think it is also unlikely that these macro risks will be addressed by pragmatic solutions in a short period of time.

EPS growth—ADR inclusion will help, but modestly

Given a declining macroeconomic growth environment, we think the index's earnings growth could also be affected, and we expect only 3.5% YoY growth next year (see Figure 7). Moderate growth will be largely dragged by 0% growth in sectors such as energy, financial and telecom, which have almost an 80% index weighting. The inclusion of ADR could help lift growth slightly with 30% growth in earnings, but we expect its impact to be modest and limited.

Figure 7: MSCI China earnings growth at 3.5% in 2016E

Sector	% index weight	EPS growth
Energy, Financial, Telecom	65.0%	0%
Materials, Industrials, & Consumer etc.,	31.6%	8%
ADRs	3.4%	30%
Weighted average growth for MSCI China index		**3.5%**

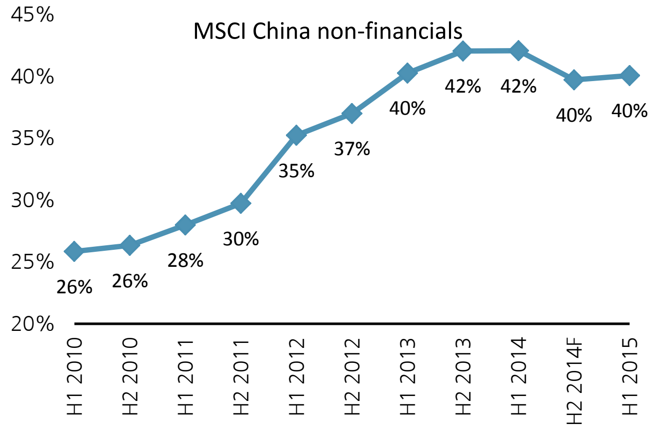
Source: UBS-S estimates

Balance sheet quality—stabilisation at first glance, but sensitive to earnings downgrades

Although the credit spread is now at a five-year low, the credit risk is definitely not.

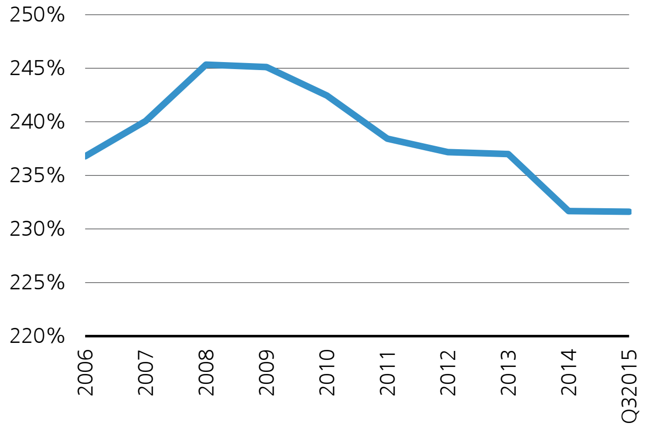
At first glance, companies' net gearing seems to have stabilised among both listed and non-listed companies since 2014 (see Figure 8 and Figure 9). We argued in our earlier reports that this was largely due to the capex reduction of SOEs under the pressure of reform and the anti-corruption campaign (MSCI China H114 interim results review—giving more credit to SOEs, published on 10 September 2014).

Figure 8: Net gearing of MSCI China constituent companies



Source: Bloomberg

Figure 9: Financial leverage of overall companies including non-listed companies since 2006 (total assets/shareholder equity)



Source: Wind

However, the decline in corporate profits could add pressure to the quality of balance sheets and stretch cash flows. A recent sensitivity study by UBS China bank sector analyst Lucy Feng suggests that a 3ppt erosion of the EBITDA margins of non-financial companies would increase the "hidden NPL ratio" from 11.7% to 22% (see A deeper dive into hidden NPLs published on 2 November 2015). This is because many companies are on the verge of 1x EBITDA/interest coverage. They are thus vulnerable to a further deterioration in the operating environment. Unfortunately, the Q315 results of A-share listed companies depict quite a dim outlook—net profits in the non-financial sectors dropped 10.2% YoY and gross margins have started to compress despite lower raw material costs.

More worrying, a few defaults in corporate bonds surfaced in September and October (see Figure 10). The involved size of the defaulted bonds sum up to Rmb5.3bn and we suspect these may not be standalone cases. We believe significant risk in corporate balance sheets looms during an economic downturn.

Figure 10: Defaults of corporate bonds since September 2015

Name	Sector	Size (Rmb bn)	Date of annoucement on possible default	Follow-up
Erzhong Heavy Machinery	Heavy machinery	4.0	9/15/2015	Last minute bail out by parentco
Yurun Food	Food & Beverage	1.3	10/12/2015	In the process of financing to pay off debts
Yingli Solar	Solar	1.0	10/13/2015	No solution yet
Sino Steel	Steel	2.0	10/19/2015	Payment delayed
Huayan Investment Group	Real estate	1.2	10/28/2015	No solution yet

Source: UBS-S, SSE, SZSE

Nevertheless, we believe the Chinese government still has the ability to prevent a full-blown credit crisis. Parent or sister SOEs, commercial banks, and policy banks can usually bail out companies on the brink of insolvency. However, it is common practice for financial institutions to borrow short-term cheap capital from the interbank market and invest in longer-duration corporate bonds. The shockwave associated with a few bond defaults could be potent enough to lead to a big spike in interbank short-term funding costs, which was what happened in mid-2013 and early 2014. The impact on the equity market is usually negative.

Key risks—Rmb, credit defaults and the property market

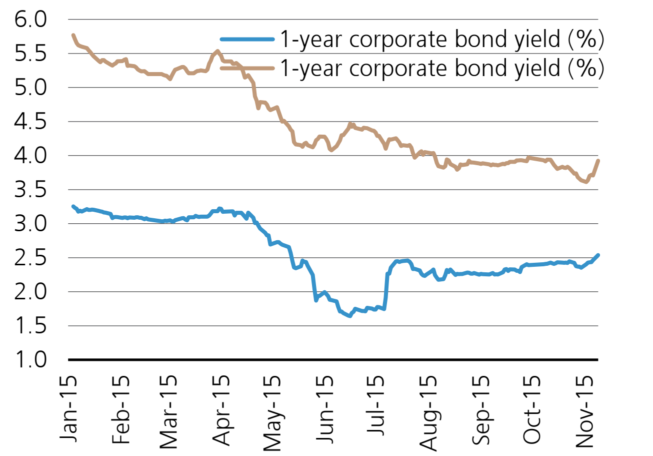
Onshore bonds: potential bubble could burst on credit defaults

We believe relaxed monetary policy and regulations have given rise to a bubble in the onshore bond market, possible akin to what happened in the stock market in H115. We are concerned that a shockwave of credit defaults will catch investors off-guard sometime next year.

After the stock market crash in June 2015, the excess liquidity flowed to the bond market given continued monetary easing. Along with the interest rate cuts (by 125bp in total over the last 12 months), the one-year treasury yield has dropped about 80bp since the start of 2015. More importantly, the credit spread of AA-rated corporate bonds has sharply narrowed by 150bp since mid-June (see Figure 11 and Figure 12).

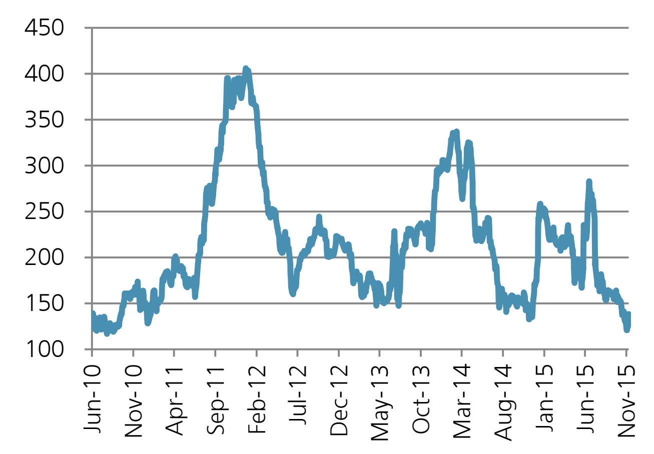
Excess liquidity swamped onshore bonds after the stock market crash in mid-June 2015, resulting in a potential bubble

Figure 11: 1Y treasury yield has dropped about 80bp since the start of 2015



Source: Wind

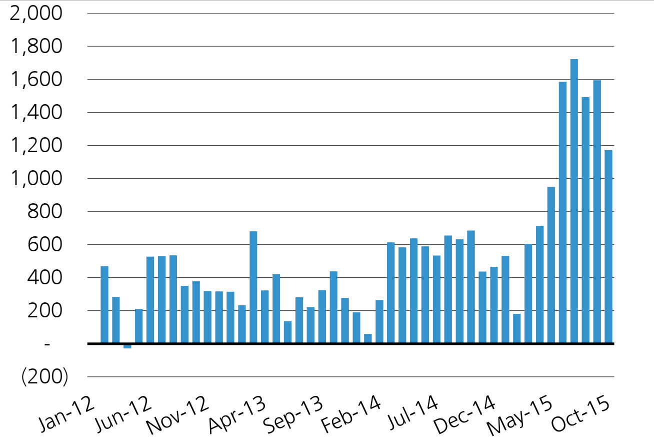
Figure 12: Credit spread for AA-rated corporate bonds has sharply narrowed (1Y AA-rated versus treasury)



Source: Wind

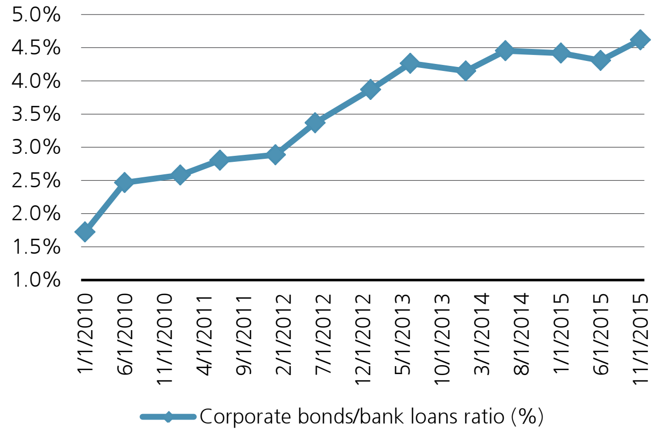
Following the current trend, the amount raised by bond issuances in 2015 could amount to nearly Rmb1.2trn in 2015E, double that in 2014 (see Figure 13). The outstanding amount of corporate bonds is now Rmb4.1trn. We believe corporate bonds have gained significant importance in corporate financing compared to bank loans (see Figure 14).

Figure 13: Net issuance of bonds (Rmb bn)



Source: Wind

Figure 14: Corporate bonds/bank loans ratio (%)



Source: Wind

Soaring bond prices are in contrast with rising credit risk. In September and October, at least four large companies (Sino Steel, Yingli Solar, Erzhong Heavy Machinery, and Yurun Food) defaulted or nearly defaulted (save for last-minute bailouts from their parent companies) on their debt payments. The involved bonds sum up to Rmb5.3bn.

The HSCEI lost 20% in January-February 2014 due to a credit default in the bond market

We think memories of a credit default at the beginning of 2014 have faded for many investors—the HSCEI fell from about 10,800 to 9,500 during the first months of 2014 due to the Rmb1bn credit default of Chaori, a solar company in Shanghai. This marked the first case to break the "implicit guarantee" of Chinese corporate bonds, striking fear in investors around the globe on cascading credit events in China during the economic downturn.

In 2014, the credit risk was finally well-contained, due largely to monetary easing in Q4. In 2016, could an even greater potential bubble in the bond market dodge the bullet again? With less room for monetary policy manoeuvres and weaker economic growth, we believe the bond market could pose risk.

Rmb depreciation—magnitude manageable, but volatility may surprise the market

In UBS economists' central scenario, the Rmb/USD will gradually depreciate from a spot rate of 6.36 (as of 10 November) to 6.5 by the end of this year and 6.8 by end-2016. From the perspective of equity investments, our concern is not the magnitude of depreciation, but the volatility.

If the pace of depreciation is well-managed, weakness in the Rmb can be conductive in helping Chinese households diversify into overseas assets. To some extent, it could even benefit H-share stocks, which are a natural destination for domestic investors looking for overseas exposure, and a liquid market for foreign investors to hold Chinese assets.

Nevertheless, we cannot rule out the possibility that in a couple of weeks, depreciation could exceed the annualised pace of 10% or more. This could then arouse concerns over a "panic FX conversion" by Chinese corporates and households, and create problems in the stock market. Historically, the H-share market's response to Rmb depreciation has tended to be negative, especially when the depreciation is sharp and deep (see Figure 15).

Figure 15: Stock market reaction to Rmb depreciation

From	To	Maximum pace of depreciation (annualised %)	Rmb/USD depreciation (%)	MSCI China performance	SHCOMP performance
5/1/2012	7/25/2012	-16%	-1.7%	-13.8%	-12.4%
1/14/2014	5/1/2014	-27%	-3.5%	-4.2%	0.0%
10/29/2014	3/3/2015	-18%	-2.6%	8.0%	37.5%
8/10/2015	8/25/2015	-32%	-3.2%	-14.6%	-24.5%

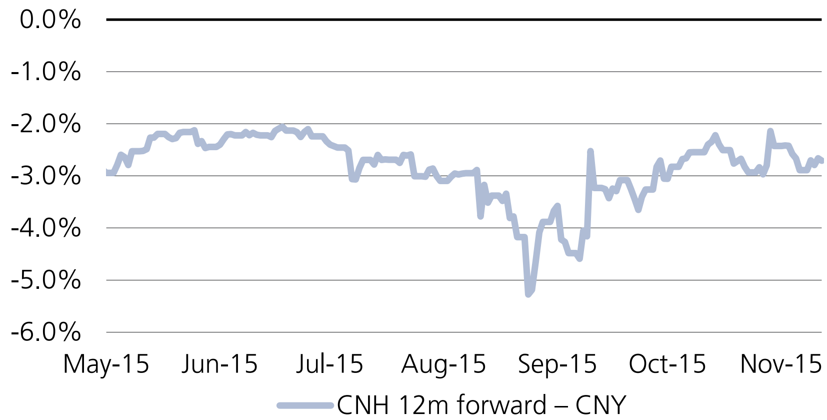
Source: Bloomberg

In the next 3-6 months, we believe the currency risk to H-shares is skewed to the downside.

In the next 3-6 months, we believe the currency risk to H-shares is skewed to the downside

Firstly, the forward rate of CNH implies only 2.7% depreciation in the next 12 months (see Figure 16). Given that the PBoC intervenes primarily in spot rates rather than forward rates, we think this suggests that the market has not priced in sufficient currency risk.

Figure 16: Spread of forward rate of CHN stabilised at around 2.7%



Note: Data as of 13 November 2015.
Source: Bloomberg

Secondly, the inclusion of the Rmb into the SDR could reduce the PBoC's incentives to support the exchange rate. Moreover, there is no guarantee that foreign investors will add exposure to Chinese assets even with the IMF's endorsement for the Rmb as a reserve currency. In fact, the entry of the yen into the SDR in early 1973 marked a milestone for the Japanese stock market then. However, the Topix index lost 40% in the following 20 months and did not fully recover until 1978.

Thirdly, the diminishing impact on capital outflow after the depreciation in August 2015 could mislead the PBoC into relaxing some administrative control over the capital account. China's forex reserves dropped by US$94/US$43/US$11bn in August/September/October 2015. However, we believe this should not be a reason for the PBoC to become complacent as pent-up demand for FX conversions could have built up given a recent crackdown in underground money exchange shops and scrutiny over forex accounts by commercial banks.

In the long term, a weaker Rmb may have two conflicting effects on the stock market. On one hand, Chinese investors need to diversify their savings to foreign assets. On the other hand, Rmb-denominated assets are expected to become an indispensable part of all global funds' portfolios, along with the liberalisation of the capital account in China. MSCI Inc, the index provider, currently expects Chinese equities—including A-shares, H-shares, ADRs, Red-chips and P-chips—to account for 37.5% of the MSCI EM index and 4.8% of the MSCI All Country Word Index in its "end-game" scenario. This should bode well for Chinese equities.

In the long term, a group of Chinese companies (not necessarily exporters) may develop into true global firms, benefiting from a soft currency at home and a diversified market overseas

More importantly, persistent Rmb depreciation could alter the financial behaviour of Chinese corporates and households. We believe the ultimate beneficiaries will be the companies developing into true global firms.

We think a few Chinese companies, especially some entrepreneurial private firms, already have "go-global" potential. In the manufacturing sectors, we believe the "go-global" candidates include automobile makers such as Geely, tech hardware manufacturers like Lenovo, and consumer brands such as WH Group and Gree. In the service sectors, companies such as Alibaba, Fosun Int'l and Vipshop have built their successes by bridging demand between their Chinese and foreign customers. We think the go-global strategy is embedded in their DNA. Meanwhile, home market-oriented, but capital-rich giants such as Vanke, Wanda and Tencent are also likely candidates to execute a similar global strategy.

Nevertheless, sectors with a heavy reliance on foreign inputs may suffer when Rmb depreciation becomes a long-term trend. For example, steelmakers (which import iron ore), petrochemical processors (which import oil), paper manufacturers (which import pulp), airlines (which import aircraft and/or fuel), and shipbuilders (which import engines and other core components) are typical sectors with limited room to offset higher input costs by lifting their average selling prices. Deep Rmb depreciation would probably force many companies to exit these sectors and totally reshape the industry landscape.

Nevertheless, sectors with heavy reliance on foreign input may suffer when Rmb depreciation becomes a long-term trend

The real estate market could also face fundamental changes. Accounting for around 40% of household wealth, properties are the most important Rmb-denominated assets for Chinese households. Persistent Rmb depreciation would discourage home purchases and accelerate capital flight. The commercial property market is also very sensitive to FX movements. Having harboured most of its earnings in China over the last two decades, in the future, many multinational companies could select to rent instead of owning Rmb-based fixed assets such as offices, factories, warehouses, and even equipment. We estimate the cumulative profit of multinational companies amount to about US$3trn currently, equivalent to nearly one-third of China's annual GDP.

Market trend—another year in favour of mid/small-caps in new economy sectors

Mid/small-caps continue to be favoured by the market

In our outlook report last year, we noted an emerging trend of investors starting to favour mid/small-caps over large-caps. In 2015 YTD, the mid-cap stocks outperformed both large caps and small caps by 6.4% and 1.6% (see Figure 17). For 2016, we think this trend is likely to continue as the risk/reward profile is still unfavourable for large-caps.

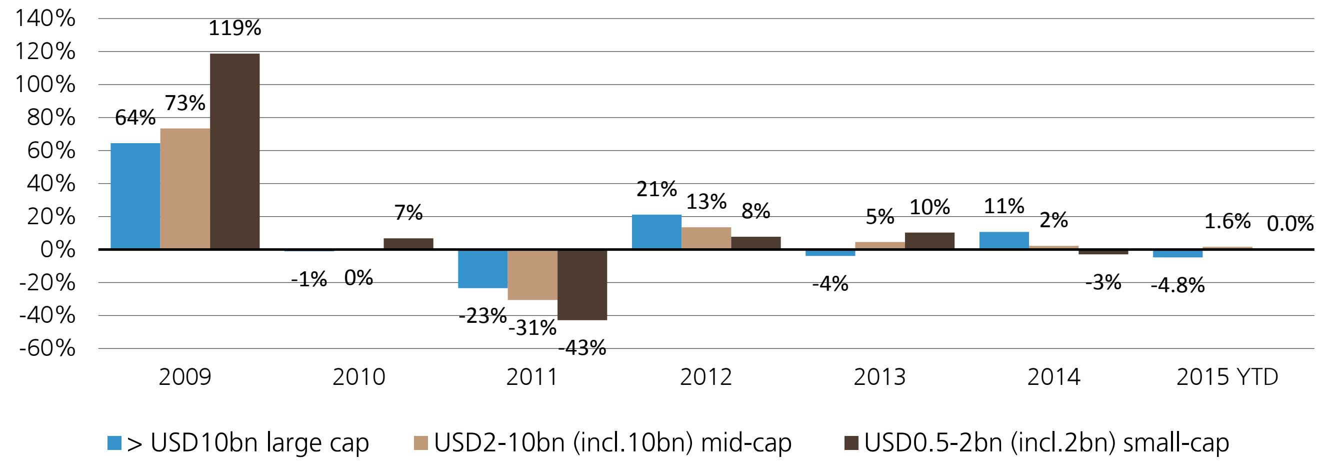
The main reasons for this are as follows.

(1) **Large-caps tend to perform well when liquidity in the market is good** as we saw in 2012 and 2014. We think overall liquidity in the H-share market will remain tight despite the Shanghai-Hong Kong Stock Connect programme, which may be launched next year. The lack of interest in global allocation funds on Chinese equities will probably persist due to fears about Rmb depreciation, Fed rate hikes, and low visibility on China's long-term economic growth.

(2) **SOEs' performance may lag behind non-SOEs' moderately.** Although SOE reform has been a popular topic for a long time, we worry about its sufficiency as well as its progress. Unlike profit-seeking companies like non-SOEs, SOEs also carry great social responsibility such as supporting employment and helping other industries in need. This burden will become especially visible if GDP deceleration becomes sharper.

(3) **New economy sectors will benefit from policy deregulation in the service sectors.** We believe the scope for the government to add stimulus in manufacturing sectors is fast narrowing. In consequence, policy makers have started to deregulate a few heavily-regulated sectors, including telecom, Internet finance, medical services, elderly care, culture, and media to encourage private sector investment. The policy catalysts in 2016 will likely further drive the outperformance of the new economy sectors.

Figure 17: Historical price performance comparison among small, mid and large caps



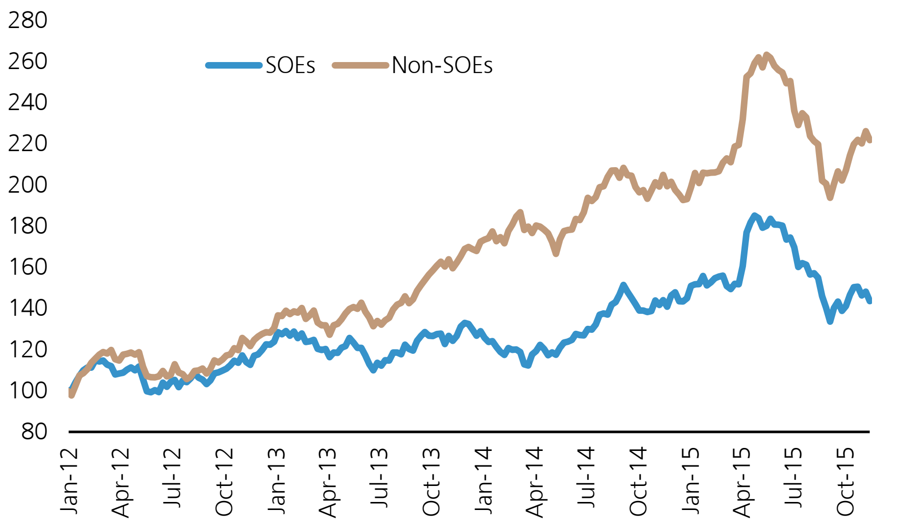
Note: Above data as of 13 November 2015.
Source: Bloomberg

Another market trend we have written on before is that the new economy sectors[1] will sustainably outperform the old economy sectors. The trend has become clear since 2013 and the gap has since been broadened (see Figure 19). According to our calculation, the new economy sectors outperformed the old economy by 55% between 2013-15 YTD. During January-October 2015, the new economy sectors again consistently outperformed the old.

As shown in our valuation comparison table (Figure 20), earnings growth of new economy sectors, especially after including ADRs, are almost three times higher than that for the old economy sectors. Even though their PE is higher, we think the outperformance is justified. In particular, when the macroeconomic growth environment is sluggish, new economy sectors, which rely less on policy support and more on entrepreneurship, tend to outperform.

Thus, we continue to believe the market in 2016 will favour mid/small-caps and the new economy sectors.

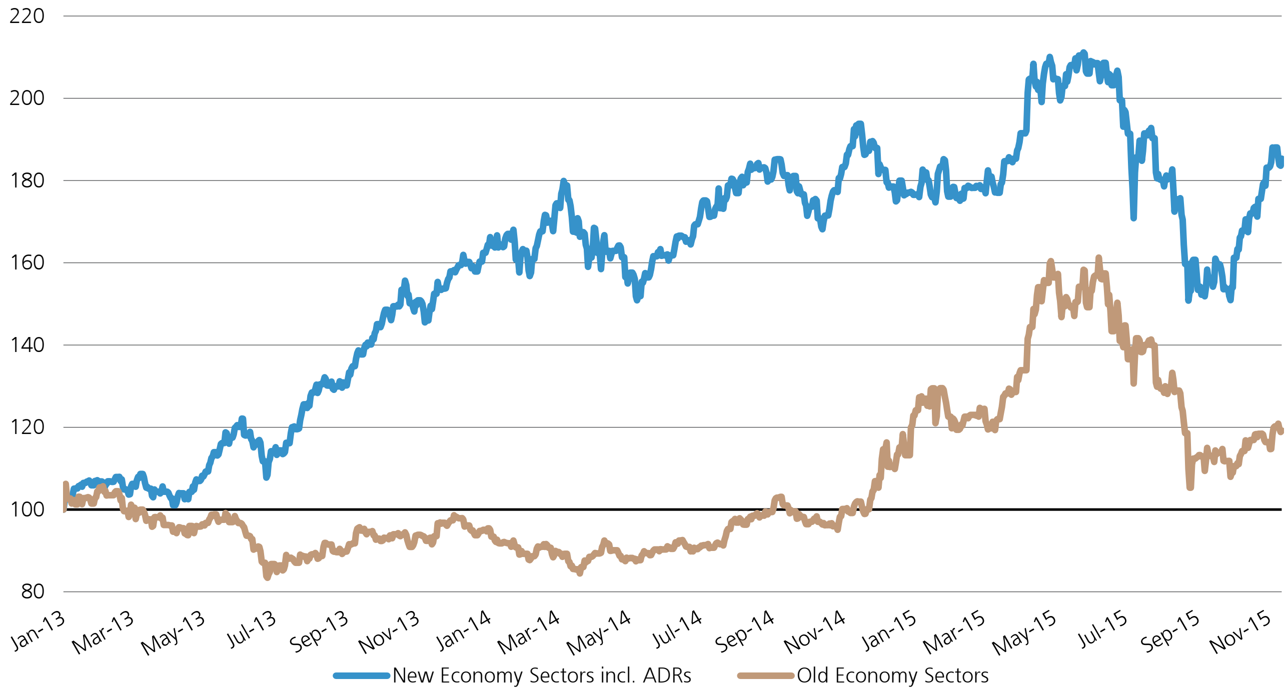
Figure 18: Share price performance of H-share SOEs and non-SOEs (rebased to 1 January 2012)



Note: Above data as of 13 November 2015.
Source: Bloomberg

[1] We have a broad definition of the new economy as all sectors and stocks with technology and talent as their key growth drivers. The new economy thus includes automobile manufacturers and F&B brands, which typically differentiate themselves from competitors on new products and branding strategies. In contrast, sectors and companies with capital and a low-skilled labour force as key inputs are categorised as old economy. If we take a narrow definition of the new economy, which only includes IT, healthcare, alternative energy, and environmental equipment sectors, the outperformance of new economy stocks would become even larger.

Figure 19: New versus old economy sectors—share price performance since 2013



Note: Above data as of 13 November 2015.
Source: Bloomberg

Figure 20: New versus old economy sectors—valuation comparisons

	Mkt Cap (USD bn)	No. of companies	PE (x) 2016F	EPS growth 2015F	EPS growth 2016F	P/BV (x) 2015F	ROE 2015F	Div. Yield 2015F
New Economy Sectors	562	111	18.5	6.4%	25.8%	3.1	13.1%	1.1%
New Economy Sectors incl. ADRs	1,026	172	21.7	15.1%	31.0%	3.8	13.5%	0.7%
Old Economy Sectors	3,349	278	9.3	-2.9%	6.9%	1.2	11.9%	3.2%
Old Economy Sectors ex. Banks	2,268	265	12.9	-4.1%	11.1%	1.4	9.4%	2.2%

Note: Above data as of 13 November 2015.
Source: Bloomberg

Terra incognita—new growth poles

Theme#1 Consumer services: rapid growth despite demanding valuation

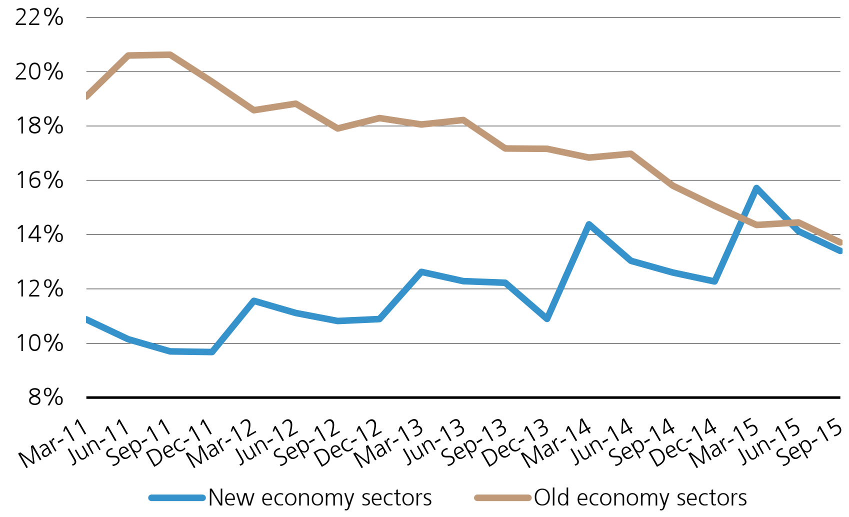
According to UBS economist Dr Wang's forecast, consumption growth could slow from slightly above 7% in 2015E to 6.7% in 2016 and 6.4% in 2017. Despite sluggish economic growth, mass market consumption seems to remain resilient. In fact, any slowdown in consumption should be limited due to the rise of China's service sector and expected government policy support.

Service industries now account for almost 50% of total GDP, while consumer-related services only contribute about 15%

In our view, China is a market of 1.4 billion people. With the rise of both the size and spending power of its middle class, we expect China will continue to hold substantial potential for consumer goods and services, especially in new economy sectors, where technology and talent are the key growth drivers. However, since their portion in overall GDP is still small, their impact on the real economy is also small at the moment.

As shown in Figure 21, the new economy sector's size as a percentage of GDP has been catching up recently, and even started to exceed the old economy sectors in early 2015. We think its advantages will continue to grow and it will make bigger contributions to China's GDP growth.

Figure 21: Representative new and old economy sectors' size as a percentage of GDP



Source: Wind, Bloomberg

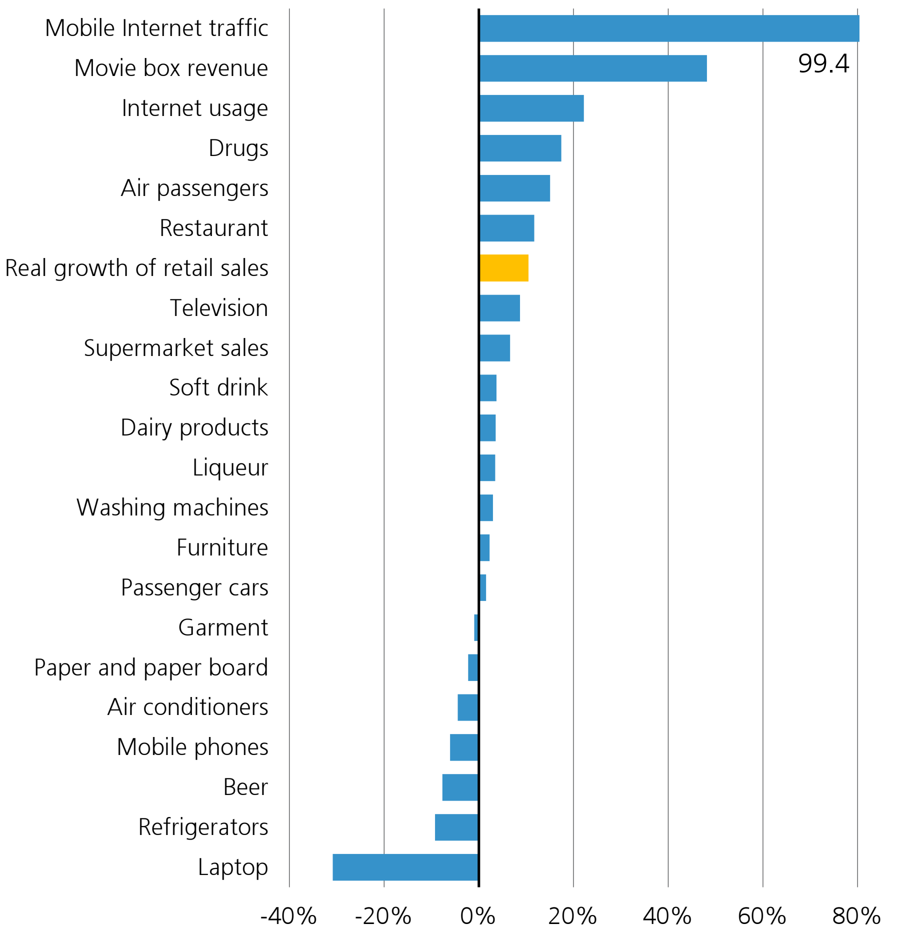
Moreover, among all the consumer sectors, entertainment-related consumer sectors such as mobile Internet, movies and air travel have shown the strongest growth in consumption volume since the beginning of 2015 (see Figure 22). In our view, these sectors will mostly likely experience more robust growth in 2016. For instance, with mobile plan prices expected to be cut by a third before the end of 2016, more people will be able to afford mobile Internet services, thus encouraging further volume growth in this segment.

As for movies, UBS media analyst Chen Xin predicts +30% growth pa in Chinese box office revenue in 2015-17. Given the popularity of Hollywood blockbusters, a rising middle class hungry for movies, and rapid growth of multiplex cinemas, we

think China could overtake the US as the world's largest film market soon. The same logic applies to air travel as well as demand for overseas travel has been on a constant rise.

In addition, after several government support policies such as the nationwide relaxation of the one-child policy, further Hukou reforms as well as the expansion of pension and serious illness healthcare insurance coverage were announced, we expect more demand growth for the education and healthcare sectors.

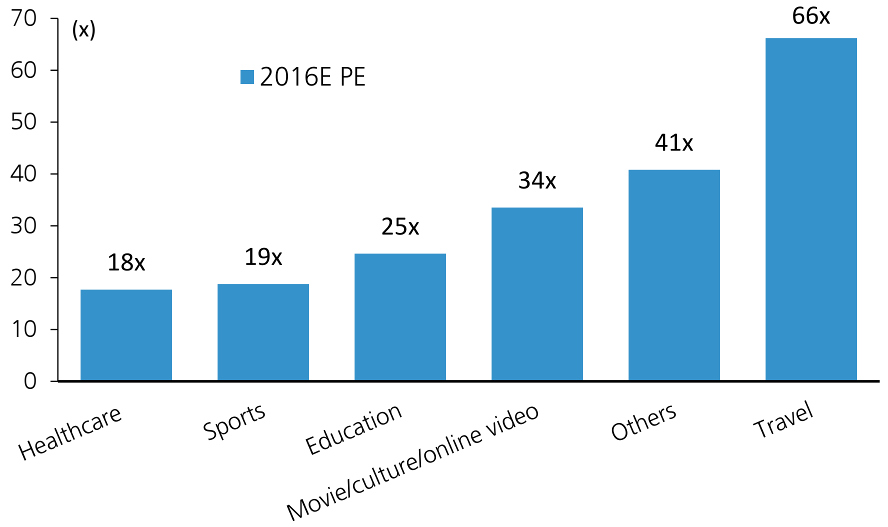
Figure 22: Volume growth for consumer sectors YTD



Source: Wind

Last but not least, with strong growth increasingly becoming a scarcity, investors may pay valuation premiums for the consumer service sectors as well. By selecting iconic companies in the H-share market for different service sectors, we calculate the PE for these sectors in Figure 23. From a valuation perspective, the PEs of these sectors already appear high. However, considering future potential high growth, we think there may still be investment opportunities.

Figure 23: Services sector—PE comparisons



Note: Above data as of 13 November 2015.
Source: Bloomberg, UBS-S estimates

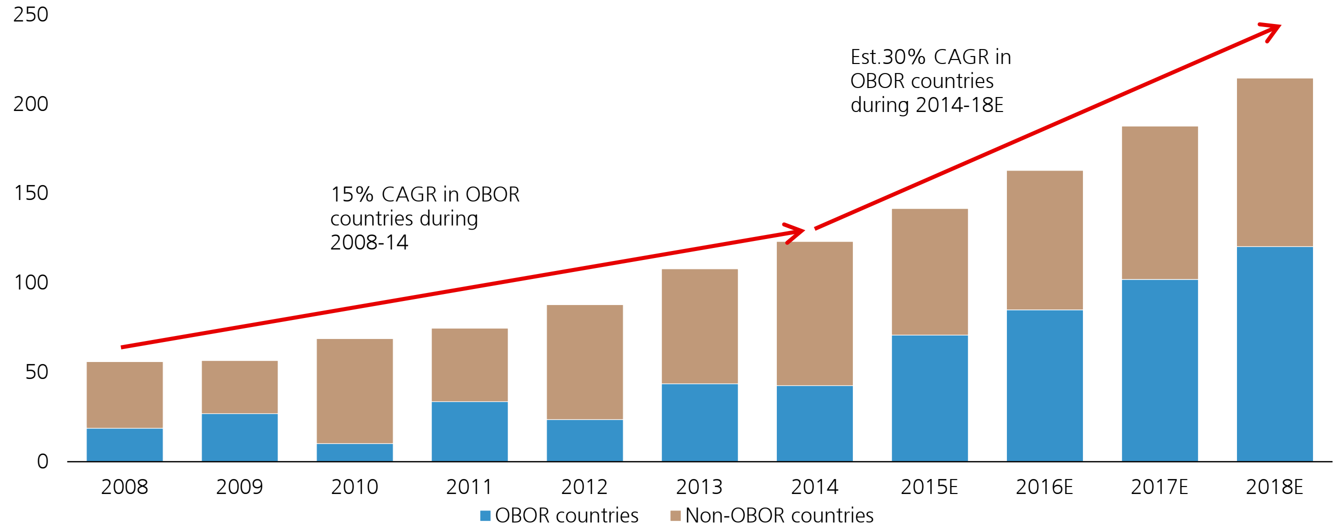
Theme#2 Patronomics: large, but remote potential

In our latest report Patronomics: more than Chinese railways, we stated that China is becoming increasingly important patrons of regional economic development. With the "One Belt, One Road" (OBOR) initiative becoming a pivotal national strategy for China since its inception in 2013, we have witnessed strong growth of Chinese outbound foreign direct investment (ODI) in the OBOR countries, especially this year. According to data from the Ministry of Commerce, during January to August 2015, China's investment in the OBOR regions have increased 48.2% YoY, accelerating from a 15% CAGR in 2008-14.

It is also noteworthy that the share of OBOR countries in overall ODI has climbed to over 50% in the first half of this year, exceeding the historical average of 37% since 2005. This clearly reflects the resolution of the Chinese government to expand in overseas markets, by leveraging China's large amounts of capital, established engineering experience and competitive equipment.

Moreover, we expect the initiative to boost Chinese ODI in the OBOR countries in the coming years. Given China's spending power, investment demand from OBOR countries and the execution risks, we estimate the size of "patro-dollars", namely China's ODI in the OBOR regions, to exceed US$200bn in 2016-18. We estimate "patro-dollar" growth will likely accelerate to 30% per annum from 15% in the past (see Figure 24)

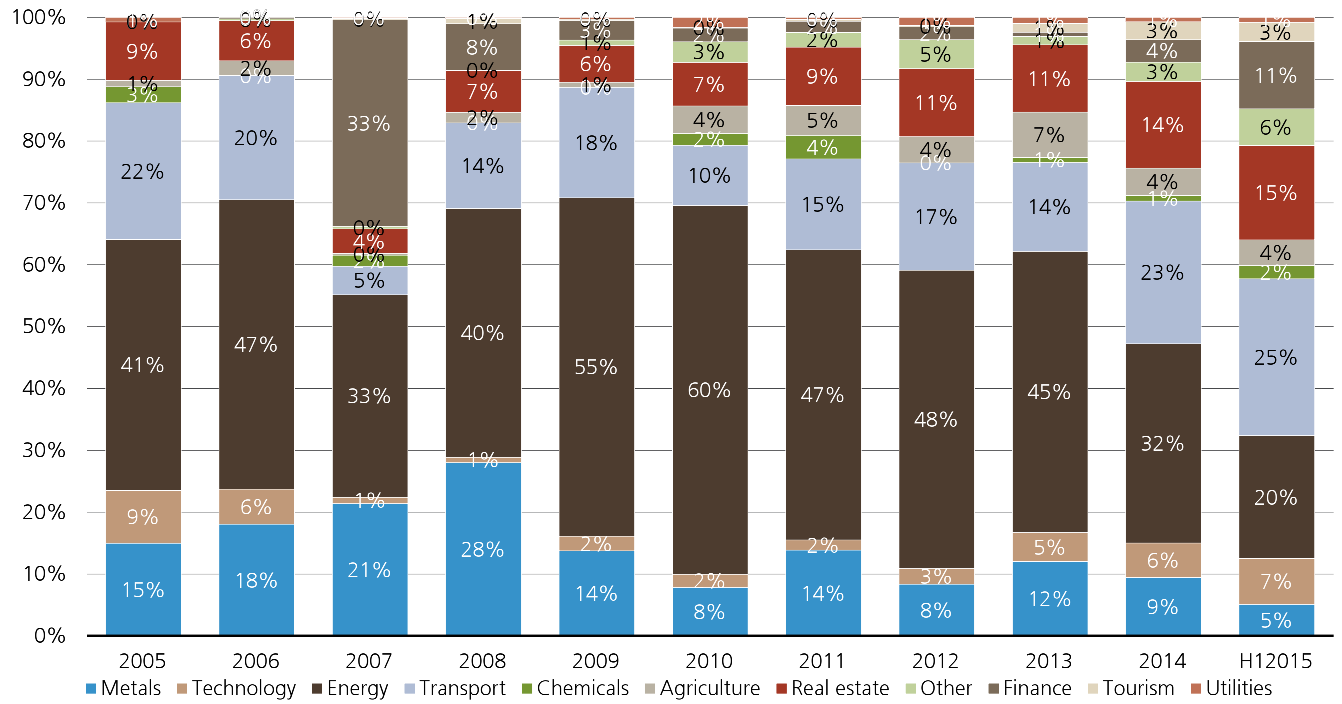
Figure 24: China annual outward investment—inside and outside the OBOR regions (US$ bn)



Source: Ministry of Commerce, China Global Investment Tracker compiled by the American Enterprise Institute and The Heritage Foundation, UBS estimates

More importantly, a new trend is also noteworthy. Two years ago, 72% of China's overseas projects were concentrated on three traditional sectors—energy, transport infrastructure and metal mining. In the first half of this year, the share of these sectors dropped to 50%. In contrast, there has been increasing patro-dollars spent by Chinese private companies on the real estate, IT and financial sectors (see Figure 25). For instance, Chinese e-commerce giant Alibaba acquired a 40% stake of India's leading mobile payment company just a few months ago. We expect overseas expansion in these untraditional sectors to continue to grow.

Figure 25: Destination of Chinese outward investment, based on 1,500+ projects from 2005 to H115



Source: China Global Investment Tracker compiled by the American Enterprise Institute and The Heritage Foundation

In the future, we believe "patronomics" will build a new regional order. Poor infrastructure is a key bottleneck for the development of many less advanced areas in the OBOR regions. The Asian Development Bank (ADB) estimated that the need for infrastructure investments in Asian countries will amount to US$8trn during 2010-20. Meanwhile, many Asian countries possess abundant resources ready to be utilised. We think patronomics will benefit both local economies and the exports of "patrons" (especially Japan and China to the ASEAN region). For instance, countries like Thailand, Sri Lanka, Malaysia, and Indonesia all have rich tourism resources.

The "patro-dollars" could facilitate a win-win strategy by upgrading transport infrastructure, hotels and resorts, in our view. We think the overseas expansion of Chinese private companies will give rise to many investment opportunities in non-infrastructure sectors, which could become a major investment theme in 2016.

However, one concern for its implication for Chinese equities is that for many companies, patronomics do not represent a big share of their assets today. Despite their potential for significant contributions, it may take a long time for these investments to truly generate solid profit growth. In addition, the US$200bn worth patrodollars are still relatively small compared to China's GDP. Thus, we believe its contribution to real economic growth is limited. Overall, we think market expectations for patronomics may remain modest.

Theme#3 SOEs—more fat to cut

As we highlighted in our 2015 outlook, SOE reformation is a multi-year theme that continues to evolve.

In H115, there was much speculative news on mega-mergers among national SOEs in the market, which stirred up expectations and resulted in hyper-market performance for the related stocks. In our report SOE "mega-mergers": don't overreact to the hype published on 5 May 2015, we think it is too simplistic to assume merging weak SOEs will create good synergy, and the pace of SOE consolidation will need to comply with the national strategy. Thus, we advised investors not to overreact to the hype and stick with mega-merger theme stocks that have more pros than cons in the context of national strategies and the overall reform agenda.

When the long-waited "Guidelines to deepen the reform of State-Owned Enterprises" (or the Guidelines) was announced in early September, market response was mixed as many investors found the policy stance on SOE ownership less progressive and guidelines on SOE management more encouraging.

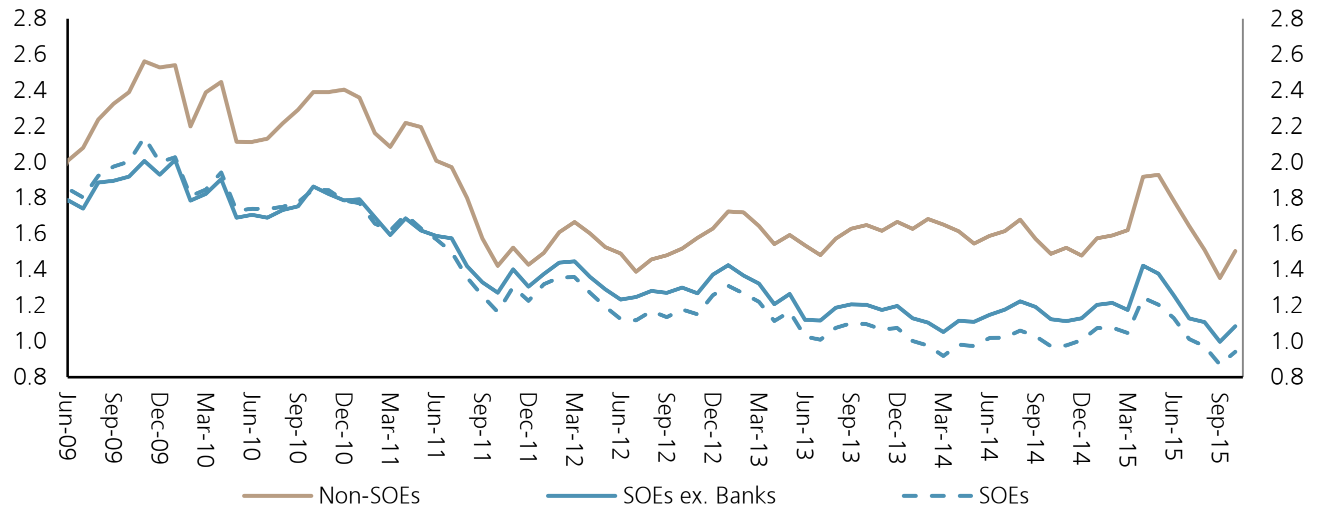
The guidelines listed the aims and measures for completing modern systems and structures, achieving mixed ownership of SOEs, and supervising the potential losses of state assets. For instance, the Guidelines categorised SOEs as commercial entities or public service providers. The key performance indicators (KPI) will be operational efficiency and asset returns for the former, and cost control and service quality for the latter. Meanwhile, the State-owned Assets Supervision and Administration Commission of the State Council's (SASAC) role is streamlined to managing only state capital, rather than SOE operations and personnel. We think this could lead to faster execution among SOEs.

Moreover, from Figure 26, we see that the gap between share price performance of H-share SOEs and non-SOEs have slightly narrowed since mid-2015. We believe

the closing gap may be the result of positive market expectations on SOE reforms. In fact, there are at least three implications from the Guidelines: 1) the theme of "SOE reformation" could help re-rate SOEs (trading at 1.1x 12-month forward P/BV in the H-share market) in 2016 due to potentially faster reform execution; 2) poorly-run SOEs could have little chance of turning profitable quickly given conservatism in SOE privatisation; and 3) M&As among SOEs should be selective given that the SASAC may not engineer rapid consolidation among unwilling SOEs.

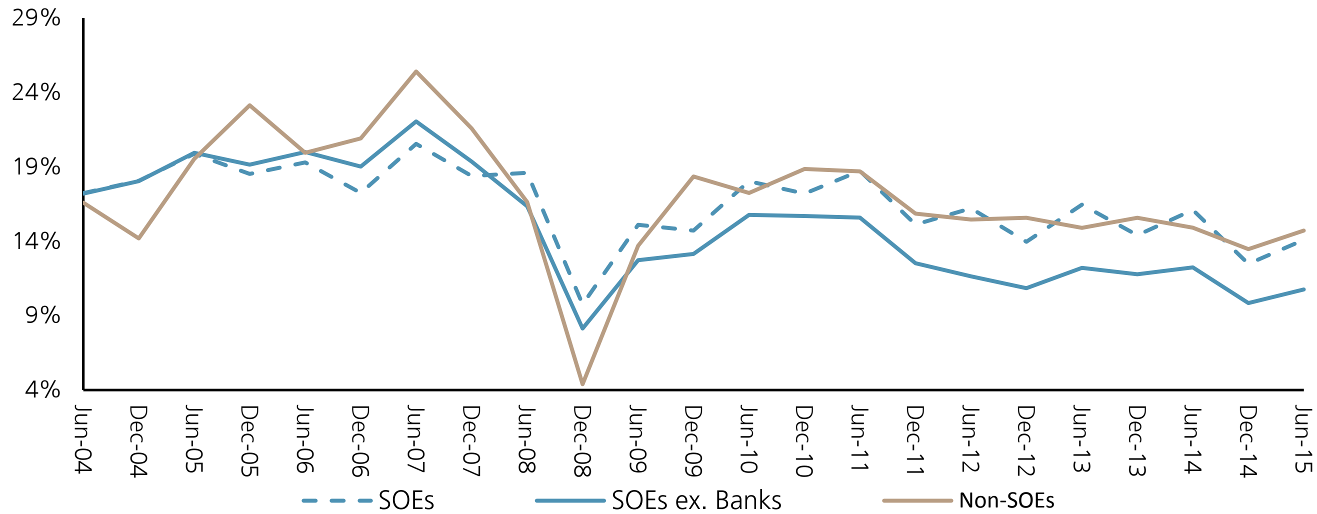
In addition, when we wrote about mega-mergers in our report 'SOE mega-mergers: don't overreact to the hype', the P/BV multiple of SOEs was 1.2x compared to 1.9x for non-SOEs. The gap has narrowed slightly since then (0.9x versus 1.5x as of end-October 2015) and the P/BV multiple for SOEs has declined from 1.2x to 0.9x (see Figure 26). In Figure 27, the annualised ROE for SOEs has also been improving, in line with growth for non-SOEs.

Figure 26: 12-month forward P/BV of H-share SOEs and non-SOEs



Source: Datastream

Figure 27: Annualised ROE of H-share SOEs and non-SOEs



Source: Bloomberg

Over the past 12 months we recommended SOEs with both solid fundamentals and reform potential. For 2016, we maintain our view that quality SOEs will stand out, while mega-mergers will be highly selective. From an ROE perspective, we believe the Guidelines are in favour of high-ROE SOEs, where star employees could monetise R&D and management expertise via shareholding schemes. In contrast, capital-intensive and loss-making SOEs may find it challenging to unload low-return assets.

However, the downside risks for SOE performance still remain solid. There was no timetable set for the mixed ownership of SOEs, which disappointed many investors who had expected complete privatisation. Even though we think the SOE reform theme will continue to play out in 2016, the sufficiency and progress of SOE reform may remain questionable.

When macroeconomic growth is sluggish, SOEs are asked to take on even more social responsibility

Unlike profit-seeking companies like non-SOEs, SOEs also carry great social responsibility such as supporting employment and helping other industries in need. When macroeconomic growth is sluggish, SOEs are asked to take on more. For instance, mobile plan prices are expected to be cut by a third before the end of 2016 as the government wants to push for more affordable mobile Internet services. Also, according to the guidelines released by the State Council in October, China will lift price controls over basically all goods and services in the competitive sectors (the six major sectors are energy, environmental, farm produce, healthcare, public services and transportation) by 2017.

We think such pricing mechanisms will continue to impose pressure on SOEs that are already suffering from weak demand and low profitability. Thus, many difficulties will likely remain in the reform of state-owned asset management, and more work is needed in 2016. Since the government regards SOE reform as an essential step for the economy's transition, we expect a more aggressive policy stance from the government in the future.

Sector ratings

We use the aforementioned key investment themes and risk factors to decide on our sector allocation recommendations.

1. We are Overweight on ADRs, and the healthcare and insurance sectors as beneficiaries from the consumer service theme.

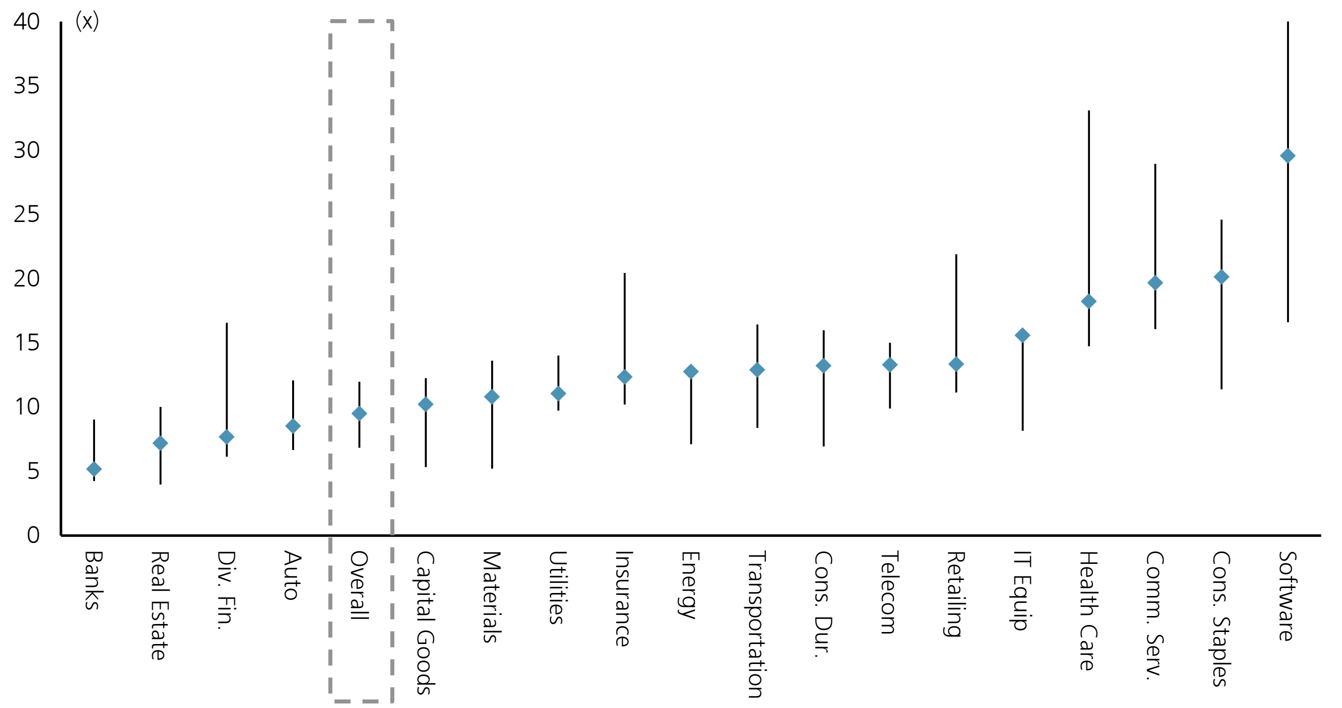
2. Due to FX risk and the patronomics theme, we are Overweight on ports, airlines and capital goods on their increasing exposure to international markets.

3. Due to credit risk in the bond market, we are Underweight on materials and utilities as these are the two sectors with the highest net gearing, and we are Underweight on banks and brokers given their vulnerability to financial market turmoil.

4. We have a Neutral stance on most other sectors, including energy, telecom, real estate, IT hardware, consumer discretionary, and consumer staples. These sectors either have weak fundamentals or inexpensive valuations (energy, IT hardware, retail).

From a valuation perspective, the PE valuations for most sectors is now near the midpoint of the five-year range (see Figure 28).

Figure 28: 12-month forward PE of MSCI China sectors versus historical high and low (2011-14)



Note: Above data as of 13 November 2015.
Source: Datastream

A few sectors—banks, diversified financials, utilities—look inexpensive, but face structural tailwinds such as rising non-performing loan (NPL) pressure for banks, a fluid regulatory environment for brokers, and tariff cuts for IPPs and gas utilities.

We rate the remaining inexpensive sectors as Overweight—insurance, healthcare and commercial services (mostly environmental services). Although they are not entirely trouble-free, sector demand is at least solid and their inexpensive valuations seems have captured most of the risks.

From a valuation perspective, insurance, healthcare, and commercial (environmental) services are the only inexpensive sectors without structural headwinds

No sectors are particularly expensive on a PE basis except energy. This is due to the high earnings sensitivity to oil and coal prices. On a P/BV basis, the 0.8x 2016E P/BV of energy companies looks largely consistent with a sector ROE of 6%.

No sectors look particularly expensive

High-conviction stock ideas

From a top-down perspective, we have a flattish outlook for MSCI China. We are concerned over a potential onshore bond market bubble and FX risks, and we prefer mid/small-caps in new economy sectors. We also favour the consumer services and patronomics themes. Our top picks are listed in Figure 29 below.

Figure 29: Our top picks for 2016

Name	Ticker	Sector	Mkt cap (US$ mn)	UBS Rating	Curr Px (local)	Upside to target	2016E PE	2015E EPS Gr	2016E EPS Gr	2016E PB	2015E ROE (%)	2015E Div Yield (%)
Consumer services												
Alibaba Group	BABA.N	Software & Services	201,941	Buy	78.76	21%	28.8	18%	15%	5.1	35.2	0.0
Ping An Insurance	2318.HK	Insurance	102,254	Buy	45.35	30%	11.1	19%	14%	1.8	19.2	1.6
58.com	WUBA.N	Software & Services	5,985	Buy	54.16	29%	n.a.	n.a.	n.a.	2.5	-14.4	0.0
Wisdom Sports Group	1661.HK	Media	951	Buy	4.74	20%	14.8	8%	40%	3.9	23.6	3.4
Patronomics + Rmb depreciation risk												
China Merchants Hldg	0144.HK	Transportation	10,118	Buy	25.75	59%	13.0	11%	10%	1.1	8.0	3.7
Fosun International	0656.HK	Capital Goods	12,808	Buy	14.88	31%	8.8	14%	19%	1.5	16.5	1.3
Weak economy + continous fiscal stimulus												
CRCC	1186.HK	Capital Goods	30,646	Buy	11.30	24%	8.9	-1%	3%	1.0	12.9	1.7
Beijing Urban	1599.HK	Capital Goods	854	Buy	5.19	58%	9.9	31%	19%	1.6	16.5	3.0

Source: Above data as of 13 November 2015.
Source: Bloomberg, UBS estimates

Our rationale in picking the following stocks are as follows.

1. **Buy-rated stocks in consumer services: Alibaba, Ping An, 58.com, Wisdom Sports.** In our view, ADRs are particularly favoured as they will collectively account for 16% of MSCI China, but are insufficient owned by many investors.

   - **Alibaba Group –** We have a positive outlook for it given strong revenue growth (via eCommerce and online advertising TAM expansion in local & international markets, the Suning partnership, cloud business, etc.), the sustainability of its core margins, and strong strategic positioning.

   - **Ping An Insurance –** It has benefitted from a growing insurance business as well as Internet financing. We continue to see strong investment results despite a difficult market.

   - **58.com –** As the leading online marketplace in China serving both SMEs and consumers, we believe it will continue to expand its online-to-offline (O2O) business, which will be a strong catalyst for revenue growth.

   - **Wisdom Sports Group –** We believe sports services, especially event organising, will be the next big thing in China. As the market leader, the company is well-positioned to benefit from this industry trend.

(4) Patronomics + Rmb depreciation risk: CMHI, Fosun International

- **China Merchants (CMHI) –** The company recently announced a joint investment with China Investment Corporation in a Turkish container terminal, and it is participating in the bidding process for the new Tanjun Priok port in Indonesia. Overseas acquisitions will continue to be positive catalysts for the share price, in our view.

- **Fosun International -** Fosun has been active in overseas investments since its first investment (an effective 7.1% stake) in Club Med in 2010. The company has since invested in a number of overseas assets in the consumer and health services sectors that could benefit from China's growing middle class.

(5) Weak economy + continued fiscal stimulus: CRCC, Beijing Urban

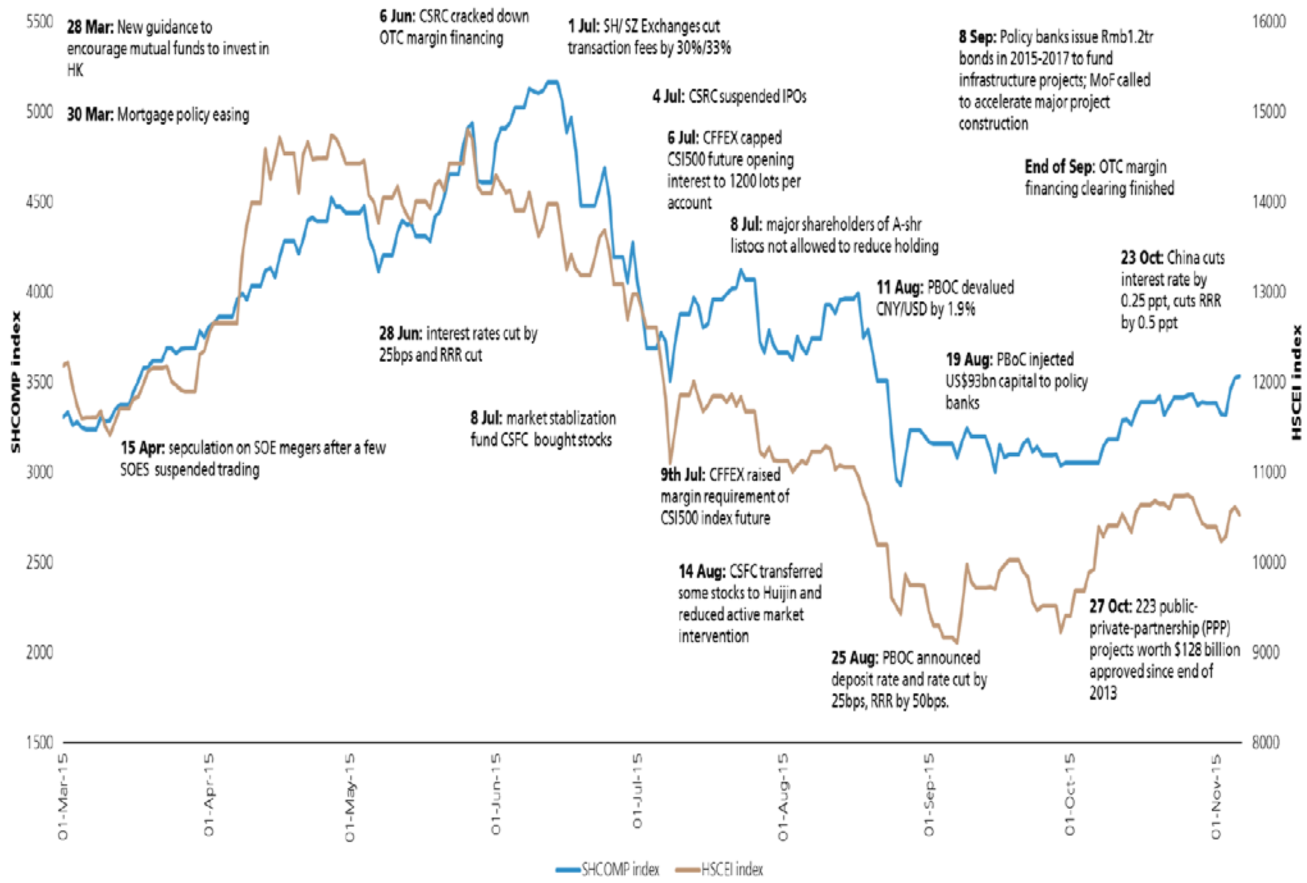
- **China Railway Construction (CRCC) -** The company appears set to outperform other E&C companies (in and outside China) due to significant infrastructure demand (e.g. railways and subways) both in and outside China.

- **Beijing Urban Construction Design & Development –** UBS analyst Edwin Chen estimates the total operating length of urban rail transit will reach more than 9,400km (mostly subways) by 2020. As the No. 1 design/survey/consultancy service provider in China, the company is well-positioned to benefit from the rapid development of urban rail transit in the next five years.

Appendix

Key policy events and market turning points in 2015

Figure 30: Summary of recent capital market policy changes



Source: Wind, UBS-S

Statement of Risk

We think the widely-known risks facing China's equities include a hard landing for the property market, corporate bond defaults, currency depreciation against the US dollar, and a capital exodus. In our view, improper government policies to address these risks could shock the market. An overdose of liquidity, for example, could threaten to derail the transition from an investment- to a consumption-driven economy and exacerbate the credit default risk.

Required Disclosures

This report has been prepared by UBS Securities Co. Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request. UBS Securities Co. Limited is licensed to conduct securities investment consultancy businesses by the China Securities Regulatory Commission.

Analyst Certification: Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2015.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS: Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

EXCEPTIONS AND SPECIAL CASES: UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; **Neutral:** Neutral on factors such as structure, management, performance record, discount; **Sell:** Negative on factors such as structure, management, performance record, discount. **Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

Research analysts contributing to this report who are employed by any non-US affiliate of UBS Securities LLC are not registered/qualified as research analysts with the NASD and NYSE and therefore are not subject to the restrictions contained in the NASD and NYSE rules on communications with a subject company, public appearances, and trading securities held by a research analyst account. The name of each affiliate and analyst employed by that affiliate contributing to this report, if any, follows.

UBS Securities Co. Limited: Wenjie Lu.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
58.com[16b]	WUBA.N	Buy	N/A	US$54.16	12 Nov 2015
Alibaba Group Holding Limited[10, 16b, 18]	BABA.N	Buy	N/A	US$78.76	12 Nov 2015
Bank of China[2, 4, 5, 16a]	3988.HK	Buy	N/A	HK$3.53	12 Nov 2015
Beijing Urban Construction Design & Dev[4]	1599.HK	Buy	N/A	HK$5.19	12 Nov 2015
China Merchants Holdings[4]	0144.HK	Buy	N/A	HK$25.75	12 Nov 2015
China Railway Construction[5, 16a]	1186.HK	Buy	N/A	HK$11.30	12 Nov 2015
Fosun International[2, 4, 5, 16a]	0656.HK	Buy	N/A	HK$14.88	12 Nov 2015
Ping An Insurance (Group)[16a, 22]	2318.HK	Buy	N/A	HK$45.35	12 Nov 2015
Wisdom Sports Group	1661.HK	Buy	N/A	HK$4.74	12 Nov 2015

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity or one of its affiliates.
5. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.
10. The equity analyst covering this company, a member of his or her team, or one of their household members is an officer, director, or advisory board member of this company.

16a. UBS Securities (Hong Kong) Limited is a market maker in the HK-listed securities of this company.
16b. UBS Securities LLC makes a market in the securities and/or ADRs of this company.
18. The equity analyst covering this company, a member of his or her team, or one of their household members has a long common stock position in Alibaba Group Holding Ltd.
22. UBS AG, its affiliates or subsidiaries held other significant financial interests in this company/entity as of last month`s end (or the prior month`s end if this report is dated less than 10 working days after the most recent month`s end).

For a complete set of disclosure statements associated with the companies discussed in this report, including information on valuation and risk, please contact UBS Securities LLC, 1285 Avenue of Americas, New York, NY 10019, USA, Attention: Publishing Administration.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Global Disclaimer

This document has been prepared by UBS Securities Co. Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

Global Research is provided to our clients through UBS Neo, the UBS Client Portal and UBS.com (each a "System"). It may also be made available through third party vendors and distributed by UBS and/or third parties via e-mail or alternative electronic means. The level and types of services provided by Global Research to a client may vary depending upon various factors such as a client's individual preferences as to the frequency and manner of receiving communications, a client's risk profile and investment focus and perspective (e.g. market wide, sector specific, long-term, short-term, etc.), the size and scope of the overall client relationship with UBS and legal and regulatory constraints.

When you receive Global Research through a System, your access and/or use of such Global Research is subject to this Global Research Disclaimer and to the terms of use governing the applicable System.

When you receive Global Research via a third party vendor, e-mail or other electronic means, your use shall be subject to this Global Research Disclaimer and to UBS's Terms of Use/Disclaimer (http://www.ubs.com/global/en/legalinfo2/disclaimer.html). By accessing and/or using Global Research in this manner, you are indicating that you have read and agree to be bound by our Terms of Use/Disclaimer. In addition, you consent to UBS processing your personal data and using cookies in accordance with our Privacy Statement (http://www.ubs.com/global/en/legalinfo2/privacy.html) and cookie notice (http://www.ubs.com/global/en/homepage/cookies/cookie-management.html).

If you receive Global Research, whether through a System or by any other means, you agree that you shall not copy, revise, amend, create a derivative work, transfer to any third party, or in any way commercially exploit any UBS research provided via Global Research or otherwise, and that you shall not extract data from any research or estimates provided to you via Global Research or otherwise, without the prior written consent of UBS.

For access to all available Global Research on UBS Neo and the Client Portal, please contact your UBS sales representative.

This document is for distribution only as may be permitted by law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject UBS to any registration or licensing requirement within such jurisdiction. It is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document ('the Information'), except with respect to Information concerning UBS. The Information is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. UBS does not undertake to update or keep current the Information. Any opinions expressed in this document may change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS. Any statements contained in this report attributed to a third party represent UBS's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party.

Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor's individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgement in making their investment decisions. The financial instruments described in the document may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates or other market conditions. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument referred to in the document. For investment advice, trade execution or other enquiries, clients should contact their local sales representative.

The value of any investment or income may go down as well as up, and investors may not get back the full (or any) amount invested. Past performance is not necessarily a guide to future performance. Neither UBS nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information.

Any prices stated in this document are for information purposes only and do not represent valuations for individual securities or other financial instruments. There is no representation that any transaction can or could have been effected at those prices, and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions by UBS or any other source may yield substantially different results.

This document and the Information are produced by UBS as part of its research function and are provided to you solely for general background information. UBS has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. In no circumstances may this document or any of the Information be used for any of the following purposes:

(i) valuation or accounting purposes;

(ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or

(iii) to measure the performance of any financial instrument.

By receiving this document and the Information you will be deemed to represent and warrant to UBS that you will not use this document or any of the Information for any of the above purposes or otherwise rely upon this document or any of the Information.

Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained in this document is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting market information. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this document is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues; however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this document. For financial instruments admitted to trading on a non-EU regulated market: UBS may act as a market maker save that where this activity is carried out in the US in accordance with the definition given to it by the relevant laws and regulations, such activity will be specifically disclosed in this document. UBS may have issued a warrant the value of which is based on one or more of the financial instruments referred to in the document. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein; such transactions or positions may be inconsistent with the opinions expressed in this document.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is distributed by UBS Limited to persons who are eligible counterparties or professional clients. UBS Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France S.A. UBS Securities France S.A. is regulated by the ACPR (Autorité de Contrôle Prudentiel et de Résolution) and the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this document, the document is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Turkey:** Distributed by UBS Limited. No information in this document is provided for the purpose of offering, marketing and sale by any means of any capital market instruments and services in the Republic of Turkey. Therefore, this document may not be considered as an offer made or to be made to residents of the Republic of Turkey. UBS AG is not licensed by the Turkish Capital Market Board under the provisions of the Capital Market Law (Law No. 6362). Accordingly, neither this document nor any other offering material related to the instruments/services may be utilized in connection with providing any capital market services to persons within the Republic of Turkey without the prior approval of the Capital Market Board. However, according to article 15 (d) (ii) of the Decree No. 32, there is no restriction on the purchase or sale of the securities abroad by residents of the Republic of Turkey. **Poland:** Distributed by UBS Limited (spolka z ograniczona odpowiedzialnoscia) Oddzial w Polsce regulated by the Polish Financial Supervision Authority. Where an analyst of UBS Limited (spolka z ograniczona odpowiedzialnoscia) Oddzial w Polsce has contributed to this

document, the document is also deemed to have been prepared by UBS Limited (spolka z ograniczona odpowiedzialnoscia) Oddzial w Polsce. **Russia:** Prepared and distributed by UBS Bank (OOO). **Switzerland:** Distributed by UBS AG to persons who are institutional investors only. UBS AG is regulated by the Swiss Financial Market Supervisory Authority (FINMA). **Italy:** Prepared by UBS Limited and distributed by UBS Limited and UBS Italia Sim S.p.A. UBS Italia Sim S.p.A. is regulated by the Bank of Italy and by the Commissione Nazionale per le Società e la Borsa (CONSOB). Where an analyst of UBS Italia Sim S.p.A. has contributed to this document, the document is also deemed to have been prepared by UBS Italia Sim S.p.A. **South Africa:** Distributed by UBS South Africa (Pty) Limited (Registration No. 1995/011140/07), an authorised user of the JSE and an authorised Financial Services Provider (FSP 7328). **Israel:** This material is distributed by UBS Limited. UBS Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. UBS Securities Israel Ltd is a licensed Investment Marketer that is supervised by the Israel Securities Authority (ISA). UBS Limited and its affiliates incorporated outside Israel are not licensed under the Israeli Advisory Law. UBS Limited is not covered by insurance as required from a licensee under the Israeli Advisory Law. UBS may engage among others in issuance of Financial Assets or in distribution of Financial Assets of other issuers for fees or other benefits. UBS Limited and its affiliates may prefer various Financial Assets to which they have or may have Affiliation (as such term is defined under the Israeli Advisory Law). Nothing in this Material should be considered as investment advice under the Israeli Advisory Law. This Material is being issued only to and/or is directed only at persons who are Eligible Clients within the meaning of the Israeli Advisory Law, and this material must not be relied on or acted upon by any other persons. **Saudi Arabia:** This document has been issued by UBS AG (and/or any of its subsidiaries, branches or affiliates), a public company limited by shares, incorporated in Switzerland with its registered offices at Aeschenvorstadt 1, CH-4051 Basel and Bahnhofstrasse 45, CH-8001 Zurich. This publication has been approved by UBS Saudi Arabia (a subsidiary of UBS AG), a Saudi closed joint stock company incorporated in the Kingdom of Saudi Arabia under commercial register number 1010257812 having its registered office at Tatweer Towers, P.O. Box 75724, Riyadh 11588, Kingdom of Saudi Arabia. UBS Saudi Arabia is authorized and regulated by the Capital Market Authority to conduct securities business under license number 08113-37. **Dubai:** The information distributed by UBS AG Dubai Branch is intended for Professional Clients only and is not for further distribution within the United Arab Emirates. **United States:** Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a **'non-US affiliate'**) to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a document prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this document must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. UBS Securities LLC is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule"), and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule. **Canada:** Distributed by UBS Securities Canada Inc., a registered investment dealer in Canada and a Member-Canadian Investor Protection Fund, or by another affiliate of UBS AG that is registered to conduct business in Canada or is otherwise exempt from registration. **Brazil:** Except as otherwise specified herein, this material is prepared by UBS Brasil CCTVM S.A. to persons who are eligible investors residing in Brazil, which are considered to be: (i) financial institutions, (ii) insurance firms and investment capital companies, (iii) supplementary pension entities, (iv) entities that hold financial investments higher than R$300,000.00 and that confirm the status of qualified investors in written, (v) investment funds, (vi) securities portfolio managers and securities consultants duly authorized by Comissão de Valores Mobiliários (CVM), regarding their own investments, and (vii) social security systems created by the Federal Government, States, and Municipalities. **Hong Kong:** Distributed by UBS Securities Asia Limited and/or UBS AG, Hong Kong Branch. **Singapore:** Distributed by UBS Securities Pte. Ltd. [MCI (P) 018/09/2015 and Co. Reg. No.: 198500648C] or UBS AG, Singapore Branch. Please contact UBS Securities Pte. Ltd., an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110); or UBS AG, Singapore Branch, an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110) and a wholesale bank licensed under the Singapore Banking Act (Cap. 19) regulated by the Monetary Authority of Singapore, in respect of any matters arising from, or in connection with, the analysis or document. The recipients of this document represent and warrant that they are accredited and institutional investors as defined in the Securities and Futures Act (Cap. 289). **Japan:** Distributed by UBS Securities Japan Co., Ltd. to professional investors (except as otherwise permitted). Where this document has been prepared by UBS Securities Japan Co., Ltd., UBS Securities Japan Co., Ltd. is the author, publisher and distributor of the document. Distributed by UBS AG, Tokyo Branch to Professional Investors (except as otherwise permitted) in relation to foreign exchange and other banking businesses when relevant. **Australia:** Clients of UBS AG: Distributed by UBS AG (Holder of Australian Financial Services License No. 231087). Clients of UBS Securities Australia Ltd: Distributed by UBS Securities Australia Ltd (Holder of Australian Financial Services License No. 231098). Clients of UBS Wealth Management Australia Ltd: Distributed by UBS Wealth Management Australia Ltd (Holder of Australian Financial Services Licence No. 231127). This Document contains general information and/or general advice only and does not constitute personal financial product advice. As such, the Information in this document has been prepared without taking into account any investor's objectives, financial situation or needs, and investors should, before acting on the Information, consider the appropriateness of the Information, having regard to their objectives, financial situation and needs. If the Information contained in this document relates to the acquisition, or potential acquisition of a particular financial product by a 'Retail' client as defined by section 761G of the Corporations Act 2001 where a Product Disclosure Statement would be required, the retail client should obtain and consider the Product Disclosure Statement relating to the product before making any decision about whether to acquire the product. The UBS Securities Australia Limited Financial Services Guide is available at: www.ubs.com/ecs-research-fsg. **New Zealand:** Distributed by UBS New Zealand Ltd. The information and recommendations in this publication are provided for general information purposes only. To the extent that any such information or recommendations constitute financial advice, they do not take into account any person's particular financial situation or goals. We recommend that recipients seek advice specific to their circumstances from their financial advisor. **Korea:** Distributed in Korea by UBS Securities Pte. Ltd., Seoul Branch. This document may have been edited or contributed to from time to time by affiliates of UBS Securities Pte. Ltd., Seoul Branch. **Malaysia:** This material is authorized to be distributed in Malaysia by UBS Securities Malaysia Sdn. Bhd (Capital Markets Services License No.: CMSL/A0063/2007). This material is intended for professional/institutional clients only and not for distribution to any retail clients. **India:** Prepared by UBS Securities India Private Ltd. (Corporate Identity Number U67120MH1996PTC097299) 2/F, 2 North Avenue, Maker Maxity, Bandra Kurla Complex, Bandra (East), Mumbai (India) 400051. Phone: +912261556000. It provides brokerage services bearing SEBI Registration Numbers: NSE (Capital Market Segment): INB230951431, NSE (F&O Segment) INF230951431, NSE (Currency Derivatives Segment) INE230951431, BSE (Capital Market Segment) INB010951437; merchant banking services bearing SEBI Registration Number: INM000010809 and Research Analyst services bearing SEBI Registration Number: INH000001204. UBS AG, its affiliates or subsidiaries may have debt holdings or positions in the subject Indian company/companies. Within the past 12 months, UBS AG, its affiliates or subsidiaries may have received compensation for non-investment banking securities-related services and/or non-securities services from the subject Indian company/companies. The subject company/companies may have been a client/clients of UBS AG, its affiliates or subsidiaries during the 12 months preceding the date of distribution of the research report with respect to investment banking and/or non-investment banking securities-related services and/or non-securities services. With regard to information on associates, please refer to the Annual Report at: http://www.ubs.com/global/en/about_ubs/investor_relations/annualreporting.html

The disclosures contained in research documents produced by UBS Limited shall be governed by and construed in accordance with English law.

UBS 瑞银