China/Hong Kong SMID sector
Potential impact from TPP on OEM SMID

Equities

Asia Pacific Ex. Japan
Industrial

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Trans-Pacific Partnership—negotiations could close in 2014

Negotiations for the Trans-Pacific Partnership (TPP)—a free trade agreement between 12 countries including the US, Japan and Vietnam—could close within 2014. One of the TPP's goals is to eliminate the tariff and non-tariff barriers among its members. Apart from the 12 countries currently involved, some other Southeast Asian (SEA) countries have also expressed their interest in the TPP. China is currently not involved, but it has expressed an interest in joining eventually.

Potential impact on Chinese/Hong Kong OEM manufacturers

TPP aims to eliminate tariffs. Among the countries currently involved, the US and Japan are the major markets for Chinese original equipment manufacturers (OEM) and Vietnam is a competitor. OEMs based in Vietnam (and other SEA countries that may join the TPP later) could have significant tariff advantages over China-based manufacturers under the TPP by avoiding tariffs—this could help them gain market share. Currently, both the US and Japan charge import tariffs (typically 8-30%) on products made in China and Vietnam.

Relocating to SEA—advantages/disadvantages to being in China versus SEA

With the consideration of lower tariffs (not only under the TPP, but preferential/zero tariffs for countries such as Cambodia exporting into the EU and Japan), lower salaries, a large labour supply, an improving infrastructure/supply chain, and Rmb appreciation, some apparel and footwear OEMs are relocating from China to SEA. We expect this to continue over the next few years even though China should remain a major OEM base due to its complete supply chain, sufficient utilities/infrastructure, skilled workers, and a stable political environment. In addition, China itself is a major market.

Relevant small and mid-caps (SMID)—OEMs and affiliated companies

Certain apparel and footwear OEMs such as Win Hanverky (supplies Adidas and potentially Puma, Uniqlo and Zara), Kingmaker (supplies New Balance, Asics, Sketchers), Luen Thai (supplies Polo, Coach, Uniqlo, Gap) are expanding in Vietnam and Cambodia. Other relevant companies in the value chain include Texhong (yarns), Pacific Textile (fabric) and Nine Dragons (packaging paper) are also expanding in SEA.

Figure 1: Valuation matrix of selected OEM and relevant companies

			Mkt Cap	ADTV		PE (x)		P/BV (x)	ROE (%)		Div.Yield (%)		EPS growth	
Name	Ticker	Price	(US$ m)	(US$ m)	2012	2013E	2014E	2013E	2013E	2014E	2013E	2014E	2013E	2014E
Win Hanverky*	3322.HK	1.22	200	0.2	7.2	15.8	11.1	na	na	na	na	na	-34.7%	42.9%
Kingmaker*	1170.HK	1.69	151	0.1	10.6	na	na	na	na	na	na	na	na	na
Luen Thai*	0311.HK	2.46	328	0.2	3.9	6.2	5.8	0.9	14.1	14.6	5.7	6.0	30.9%	7.8%
Shenzhou*	2313.HK	26.15	4,717	5.1	11.4	15.2	13.0	2.8	20.4	20.0	3.0	3.6	13.2%	17.0%
Stella*	1836.HK	18.78	1,924	1.3	14.0	16.4	14.0	2.0	12.7	13.9	4.9	5.7	-23.6%	16.6%
Yue Yuan	0551.HK	23.20	4,933	6.7	10.2	10.2	9.2	1.2	11.8	11.0	3.9	3.9	-22.2%	-0.3%
Texhong*	2678.HK	8.55	975	1.9	7.1	6.3	5.2	1.8	31.5	32.9	5.8	7.1	102.2%	21.7%
Pacific Textiles*	1382.HK	11.04	2,059	1.3	14.3	13.4	11.9	3.9	29.6	32.2	7.2	8.6	28.8%	12.5%
Nine Dragons	2689.HK	6.28	3,779	8.3	10.7	8.1	6.9	0.9	9.0	11.1	3.3	4.8	36.1%	33.2%
Lee & Man	2314.HK	4.97	3,010	2.7	11.5	9.6	7.8	1.5	13.2	14.5	3.1	3.6	52.2%	20.2%
Average		10.43	2,207	2.8	10.1	11.2	9.4	1.9	17.8	18.8	4.6	5.4	20.3%	19.1%

* Bloomberg consensus.
Note: Above data as of 21 February 2014.
Source: Bloomberg, UBS estimates

What is the TPP?

The Trans-Pacific Partnership (TPP) is a free trade agreement currently being negotiated by 12 countries. It is a vehicle for Asia Pacific-wide economic integration, which will strengthen ties between the region's economies. The initiative started with an economically significant group of countries that share a vision of negotiating a high-standard, 21st-century regional agreement. The goal is to include additional Asia Pacific countries in successive clusters to eventually cover a region that represents more than half of global output and over 40 percent of world trade.

Key features

The TPP's key features are as follows (according to the Office of the United States Trade Representative). We believe one of the most important measures of the TPP is the elimination of tariffs.

- **Comprehensive market access:** To eliminate tariffs and other barriers to goods and services' trade and investment.
- **Fully regional agreement:** To facilitate the development of production and supply chains among TPP members.
- **Cross-cutting trade issues:** To build on work being done in APEC and other fora by incorporating four new, cross-cutting issues in the TPP. These are:
  - Regulatory coherence—commitments will promote trade between the countries by making it more seamless and efficient.
  - Competitiveness and business facilitation—commitments will enhance the domestic and regional competitiveness of each TPP country's economy, and promote economic integration and job creation within the region.
  - Small- and medium-sized enterprises (SME)—commitments will address concerns SMEs have raised about the difficulty in understanding and using trade agreements, which would encourage them to trade internationally.
  - Development—comprehensive and robust market liberalisation, improvements in trade and investment-enhancing disciplines, and other commitments.
- **New trade challenges:** To promote trade and investments in innovative products and services, including those related to the digital economy and green technologies, and to ensure a competitive business environment across the TPP region.
- **Living agreement:** To enable the updating of the agreement as appropriate to address trade issues that emerge in the future as well as new issues that arise with the expansion of the agreement to include new countries.

The involved countries—without China for now

As of end-2013, 12 countries have joined the TPP negotiations. These are Australia, Brunei, Chile, Canada, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the US, and Vietnam.

Apart from these 12 countries officially attending the negotiations, Bangladesh, Cambodia, Colombia, India, Indonesia, Laos, Philippines, South Korea, Taiwan and Thailand have also expressed their interest in TPP membership.

China also has some interest in eventually joining the TPP, but has yet to decide whether or not to do so or when to join the negotiations. According to the deputy head of the Ministry of Finance of China, Mr Zhu Guangyao, China will not be among the first batch of countries signing the TPP agreement.

The agreements could be signed in 2014

There had been 20 rounds of negotiations since March 2010. A new round of negotiations began on 17 February 2014 in Singapore. According to the Prime Minister of Singapore, Mr Lee Hsien Loong, the 12 countries could conclude their negotiations within 2014 and sign the agreements.

The potential impact on China

Elimination of import tariffs for involved countries

Among the 12 countries involved in the TPP negotiations, the US and Japan are two of China's major export markets. Vietnam is China's competitor for exports of some products such as apparel and shoes.

Currently, products made in China and Vietnam are subject to similar tariffs when exported into the US and Japan. However, under the TPP, products made in Vietnam for export into the US and Japan could have their tariffs waived. This indicates that it will be more attractive for customers to have their OEM products (for export into the US and Japan) made in Vietnam under the TPP.

The following figures show the latest import tariffs for selected products (apparel and shoes) in the US and Japan.

Figure 2: US latest import tariffs for selected products

	US import tariffs
Articles of apparel and clothing accessories, knitted or crocheted	
Cotton: coats	15.9%, except certain free trade countries
Cotton: suits	9.4%, except certain free trade countries
Cotton: shirts	19.7%, except certain free trade countries
Cotton: T-shirts	16.5%, except certain free trade countries
Cotton: sweaters	16.5%, except certain free trade countries
Footwear	
Sports footwear, tennis shoes, basketball shoes, gym shoes, training shoes and the like	
Over 50% of the external surface area is leather	10.5%, except certain free trade countries
Others, valued below US$12/pair	7.5%, except certain free trade countries

Source: US International Trade Commission

Figure 3: Japan latest import tariffs for selected products

	Japan import tariffs
Articles of apparel and clothing accessories, knitted or crocheted	
Cotton: coats	16.8%, or 10.9% for WTO, or free for LDC
Cotton: suits	16.8%, or 10.9% for WTO, or free for LDC
Cotton: shirts	16.8%, or 10.9% for WTO, or free for LDC
Cotton: T-shirts	16.8%, or 10.9% for WTO, or free for LDC
Cotton: sweaters	16.8%, or 10.9% for WTO, or free for LDC
Footwear	
Sports footwear, tennis shoes, basketball shoes, gym shoes, training shoes and the like	10%, 8% for WTO or free for LDC

Note: WTO = World Trade Organization members, LDC = Least Developed Countries, including Cambodia etc.
Source: Japan Customs

Non-tariff benefits for TPP members

Apart from the apparent tariff benefits for TPP members, there could also be non-tariff benefits with regard to access to the US and Japan markets, such as avoiding quota and licensing constraints. The TPP also aims to eliminate non-tariff measures that can serve as trade barriers.

Advantages and disadvantages of OEMs in China

Advantages

Based on our discussions with some Chinese OEMs, by being in China, they still benefit from its complete supply chain, readily-sufficient utilities and infrastructure, skilled and easily-managed workers with high productivity, a stable political environment, and government support (such as tax rebates). In addition, China itself is also a large and growing market for some consumer products.

Disadvantages

However, for some OEMs, being based in China has also been less attractive than being based in Southeast Asia (e.g. Vietnam and Cambodia) given tariff disparities, China's rising labour costs and labour shortages as well as Rmb appreciation.

With regard to the tariff disparities, some SEA countries are already paying preferential tariffs to export into the European Union and Japan.

- Most SEA countries including Cambodia, Indonesia, Laos, Malaysia, the Philippines, Thailand, and Vietnam could benefit from the EU's Generalised System of Preferences, which gives preferential import tariffs to these countries. In particular, as a Least Developed Country (LDC), Cambodia benefits from the most favourable regime available under the EU's Everything But Arms (EBA) scheme, which gives Cambodia duty-free access to the EU for exports of all products (except arms and ammunition).

- The EU is negotiating free trade agreements with countries such as Malaysia, Vietnam and Thailand.

- Japan also gives preferential tariffs to most of the developing countries under its Generalised System of Preferences. Cambodia (as a LDC) has duty-free access to the Japan market.

Future trends and their impact on companies

OEM manufacturers are relocating to SEA

Given existing tariff benefits as well as potentially duty-free access to the US and Japan markets under the TPP, rising labour costs in China and Rmb appreciation, and improving infrastructure in SEA, more OEMs (particularly those for lower-end products) are relocating from China to SEA (especially to Vietnam and Cambodia).

However, China remains attractive to some manufacturers and customers for its complete supply chain, utilities/infrastructure and skilled workers—particularly for some high-end and more complex manufacturing.

OEM companies with SEA exposure—now and in the future

Certain apparel and footwear OEMs have been expanding in SEA, or have plans to do so in the next couple of years. Accordingly, some relevant companies in the supply chain (e.g. yarn/fabric and packaging material makers) are also expanding in SEA. The following figure shows the SEA exposure of selected OEMs and relevant companies.

Figure 4: Selected OEM and related companies' Southeast Asia exposure

	China	SEA
Win Hanverky	70%	20% of capacity in Vietnam and 10% in Cambodia in 2013; plans to have 37.5% in Vietnam and 12.5% in Cambodia by 2014
Kingmaker	63%	29% of capacity in Vietnam and 8% in Cambodia in 2013; targets to have 33% in Vietnam and 15% in Cambodia by early 2015
Luen Thai	50%	50% of capacity in the Philippines, Indonesia, Vietnam and Cambodia
Shenzhou	87%	13% of garment capacity in Cambodia by 2013; plans to have 20% of fabric capacity in Vietnam by 2015
Stella	80%	16% of capacity in Vietnam and 4% of capacity in Indonesia
Yue Yuan	34%	34% of capacity in Vietnam, 31% in Indonesia and 1% in other SEA countries in 2013; expects SEA capacity exposure to increase to 75-80% in next couple of years
Texhong	60%	40% of total capacity in Vietnam in 2013, or 60% of total cotton production in Vietnam in 2013
Pacific Textiles	95%	Only a small capacity in Sri Lanka in 2013; targets to have 34% of capacity in Vietnam by 2015
Nine Dragons	97%	3% of capacity in Vietnam by end-2015
Lee & Man	94%	6% of capacity in Vietnam by end-2014

Source: Company data, UBS estimates

Company background

Textile and footwear OEM manufacturers

Win Hanverky (3322.HK, not rated)

- An integrated sportswear manufacturer, distributor and retailer of various top-tier sportswear brands. Adidas is its largest customer (with a focus on football apparel).
- A 25% capacity expansion in Vietnam and Cambodia in 2014 according to the company.
- Has an expanding customer base with potential new customers such as Puma, Uniqlo and Zara.

Kingmaker (1170.HK, not rated)

- A leading footwear manufacturer of 'rugged casual', 'dress casual', work, and sports footwear.
- A 20% capacity expansion in Vietnam and Cambodia in 2014, according to the company.
- It is shifting from manufacturing casual and children's shoes (Sketchers, Clarks, Stride Rite) to athletic shoes (New Balance, Asics).

Luen Thai (311.HK, not rated)

- A leading apparel (casual, fashion, sweaters, and lifestyle apparel) and accessories (laptop, fashion and camera bags as well as fabric 'fashion' shoes) OEM supplier.
- 50% of its production capacity was in SEA at end-2013.
- It has quality customers such as Polo, Coach, Uniqlo, Adidas, and Gap.

Shenzhou International (2313.HK, not rated)

- The largest knitwear OEM manufacturer and exporter in China, with a vertically-integrated business model.
- According to the company, it is gaining market share among its top customers (Uniqlo, Adidas, Nike and Puma) as customers consolidate their suppliers.
- Has an integrated business model and the largest scale among its peers in China. Its customers participate in the product development, R&D and engineering process.

Stella International (1836.HK, not rated)

- A leading developer and manufacturer of quality casual and fashion footwear products.
- According to the company, it has a strong customer base including top casual footwear brands (Clarks, Deckers, ECCO, Rockport, Timberland and Wolverine) and fashion footwear brands (Brian Atwood, Cole Haan, Guess, Jones Grup and Michael Kores).

- Started a retail business in 2006 in China through its own brands such as Stella Luna and What For.

Yue Yuen Industrial (551.HK, Sell)

- The world's largest branded footwear manufacturer, an OEM/original design manufacturer (ODM) for major international brands such as Nike, Adidas, Reebok, New Balance, Timberland and Rockport.
- Its 2013 earnings could drop due to lower profitability given wage increases in China and SEA as well as sluggish OEM volume growth.
- Aims to reduce its production volume in China from 35% currently to 20-25% in two years.

Other related companies in the supply chain

Texhong Textile (2678.HK, not rated)

- A leading cotton textile manufacturer that is principally engaged in the manufacture and distribution of yarn, grey fabrics and garment fabrics.
- It had 40% of its total capacity (cotton and polyester) and 60% of its total cotton production in Vietnam in 2013.
- International cotton prices remained lower than China's domestic cotton prices in 2013.

Pacific Textiles (1382.HK, not rated)

- A leading manufacturer of customised knitted fabric, with integrated services for knitting, dyeing, printing and finishing.
- It is the No. 1 fabric supplier to Uniqlo. Its other major customers are Sears, Walmart, Target and Kohl's.
- Currently, most of its production capacity is in China, but the company expects 34% to be in Vietnam by 2015.

Nine Dragons Paper (2689.HK, Buy)

- The largest containerboard paper manufacturer in China with an around 20% market share.
- It is a key beneficiary of a reversal in industry trends, with disciplined capacity expansion and steady demand growth.
- It is committed to lowering its gearing and financing costs through disciplined capacity additions and debt restructuring.

Lee & Man Paper Manufacturing (2314.HK, Buy)

- The second-largest containerboard paper manufacturer in China with an around 10% market share.
- A key beneficiary of a reversal in industry trends, with disciplined capacity expansion and steady demand growth.
- Its margin and return premium over peers is likely to be sustained, in our view.

Statement of Risk

We believe there are many uncertainties with equity investing, including but not limited to: 1) the macroeconomic environment; 2) policy changes; and 3) financial market volatility. The risks for Chinese equities include a prolonged slowdown in global and domestic economic growth, regulatory and policy mistakes, and an increase in investor risk aversion. The financial crisis could be more severe than we expect given: 1) US consumption may continue to shrink; 2) credit tightening could occur in China over non-performing loan (NPL) and inflation concerns; and 3) risks from an asset bubble bursting.

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Neutral	FSR is between -6% and 6% of the MRA.	45%	35%
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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 31 December 2013.
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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Lee & Man Paper Manufacturing	2314.HK	Buy	N/A	HK$4.97	21 Feb 2014
Nine Dragons Paper[2, 4]	2689.HK	Buy	N/A	HK$6.28	21 Feb 2014
Yue Yuen Industrial[16]	0551.HK	Sell	N/A	HK$23.20	21 Feb 2014

Source: UBS. All prices as of local market close.
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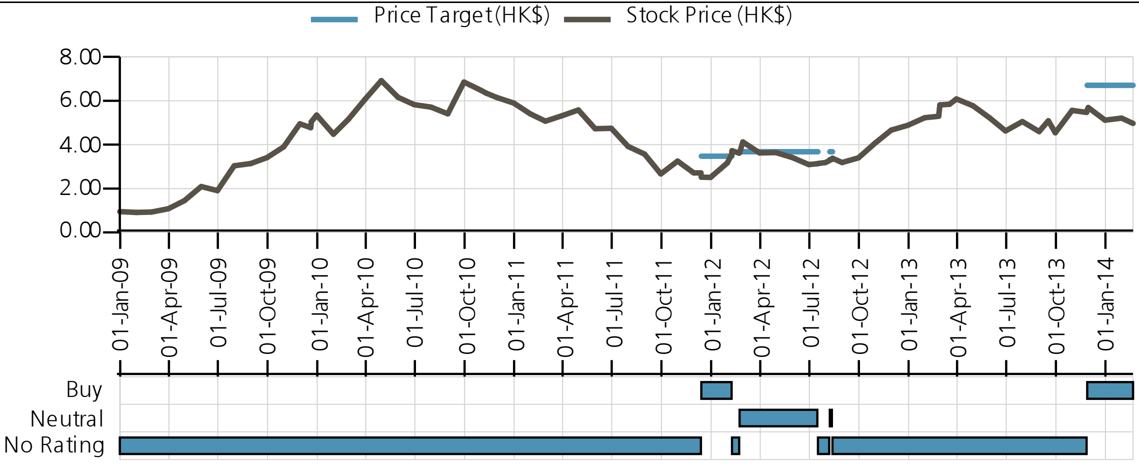
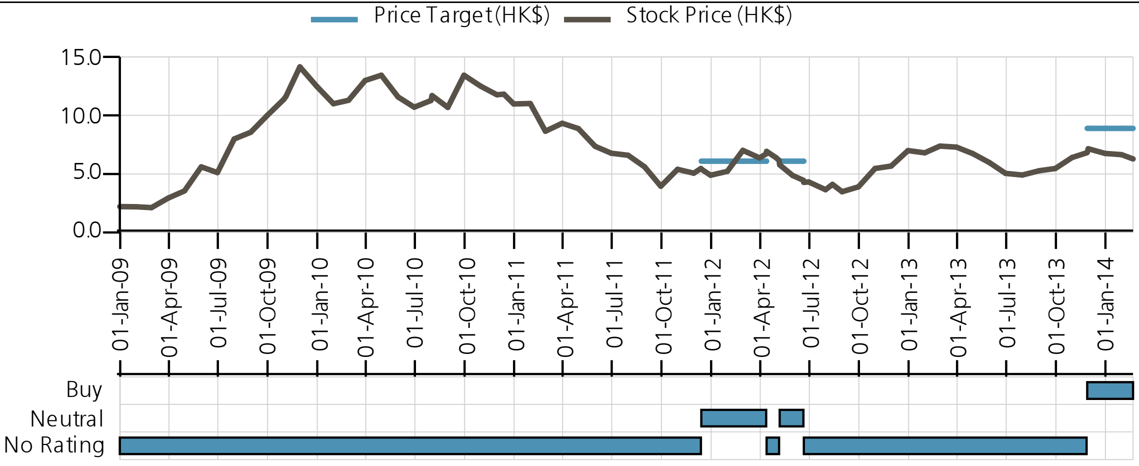
Lee & Man Paper Manufacturing (HK$)



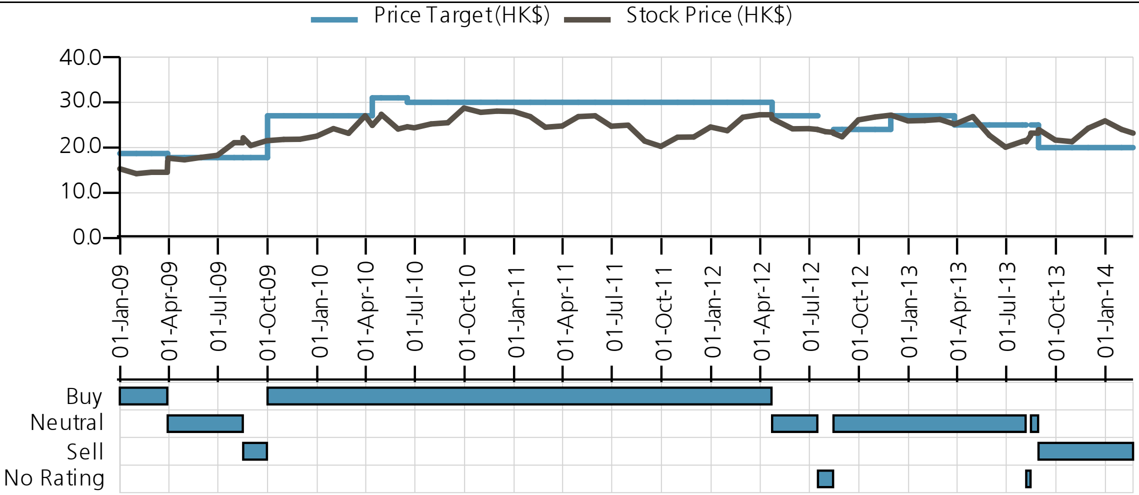
Source: UBS; as of 21 Feb 2014

Nine Dragons Paper (HK$)



Source: UBS; as of 21 Feb 2014

Yue Yuen Industrial (HK$)



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