

China H-Share Strategy

China outlook 2015: growth sags but risks recede

Equity Strategy

China

A bull market – we forecast end-2015 MSCI China of 73 and HSCEI of 12,500

H-shares have significantly lagged behind A-shares this year; the MSCI China index has inched up only 3% during Jan-Nov versus the CSI300 index's 21%. We think overseas investors have dwelled too much on the growth slowdown. While we believe GDP will continue to sag in 2015, an active PBoC and reform-minded top leaders are providing pragmatic solutions to tackle structural issues including bad debts, vacant houses and idle factories. We forecast an end-2015 MSCI China level of 73; from a 7% valuation re-rating and 8% index earnings growth, implying c15% upside from current levels.

Multiple positive themes have not been priced in

We believe the market has not priced in the following positive themes: 1) a new cycle of interest rate cuts, which will likely reduce funding costs, allowing debt-laden local governments, property developers and manufacturers to refinance more easily. The consequential improvement of asset quality has not been fully priced in given the distressed valuation in financial sectors; 2) the commodity price crunch causes the margins of transporters and equipment makers to expand; 3) the reform bolsters asset restructuring among SOEs; 4) the 13th Five-Year-Plan kick starts infrastructure and alternative energy projects; and 5) IT and healthcare firms plan to launch innovative services to address under-penetrated consumer markets. As a result, investors' focus will likely shift towards new sources of growth when macro risks recede, in our view.

Risks: unknown policy reactions to known problems

Widely known risks facing China equities include: a hard landing in the property market, shadow banking defaults, currency depreciation against the US\$, and capital exodus. In our view, improper government policies to address these risks may shock the market. An overdose of liquidity, for example, may threaten to derail the transition from investment- to consumption-driven economy, and exacerbate credit default risk.

Overweight insurance, property, capital goods, healthcare, software and auto

We prefer insurance and real estate sectors for their leverage to declining interest rates and receding credit risk. Capital goods could benefit from deflation and infrastructure projects in the 13th Five-Year-Plan. Healthcare, software and auto companies could sustain healthy growth due to rapid production innovation and a resilient labour market. We Underweight the energy, telcos, consumer staples and retailing sectors.

China H-share most-preferred stocks and relevance to key investment themes

Name	Ticker	Mkt cap (US\$ bn)	UBS Rating	2015E PE (x)	2015E EPS Gr	2015E PB (x)	Declining funding cost & credit risk	Deflation	13th Five- Year-Plan	SOE reform	Under- penetrated consumption	MSCI inclusion
Baidu	BIDU.O	82.7	Buy	26.8	36%	7.1					x	x
Ping An Insurance	2318.HK	70.2	Buy	10.5	4%	1.7	x					
COLI	0688.HK	24.6	Neutral	8.0	9%	1.3	x					
Great Wall Motor	2333.HK	17.5	Buy	8.7	30%	2.2		x			x	
Fosun International	0656.HK	7.9	Buy	7.7	20%	0.8				x	x	
CSCI	3311.HK	5.7	Buy	10.1	25%	2.0			x			
China Southern Airlines	1055.HK	6.9	Buy	9.8	47%	0.8		x		x		
CSPC Pharma	1093.HK	4.9	Buy	22.6	30%	4.1					x	
Huaneng Renewable	0958.HK	3.1	Buy	12.5	87%	1.2	x		x			
Beijing Urban	1599.HK	0.7	Buy	8.4	39%	1.4			x			

Note: Priced as of 1 December 2014. Source: UBS estimates

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Summary: a bull market with receding tail risks

Chinese equities are currently rallying, following the interest rate cut announced on 22 November 2014. Although economic growth continues to sag, we believe the rate cut seemingly reflects policy makers' quick reaction to the tail risks in the making, such as a potential collapse of the property market and defaults on bad debts.

In our view, the receding macro risks and the concern over economic growth will co-exist in 2015. **Our end-2015 index targets (12,500 for HSCEI and 73 for MSCI China) suggest about 15% upside from the current level**, driven by around a 7% valuation re-rating due to receding risks and 8% EPS growth due to a lukewarm corporate profit recovery (page 5).

We believe the key investment themes next year include:

(1) Declining corporate funding costs and credit risk (page 14)

Monetary easing will allow local governments, property developers and highly leveraged manufacturers to refinance debts more easily and at a lower cost. The quality of financial institutions' balance sheets will likely be enhanced.

(2) Deflation (page 17)

Upstream energy and mining companies are negatively affected by the commodity price crunch. But transporters, auto/equipment/F&B manufacturers, and coal- and gas-based utilities will likely benefit from less expensive fuel and lower other input costs.

(3) SOE reformation (page 22)

Many investors are interested in participating in this theme and are wondering how to identify the next reform candidates. We take our cue from central government inspections on SOEs.

(4) Under-penetrated consumption sectors (page 27)

The ~10% wage growth and mere ~5% unemployment rate underpins solid growth in the under-penetrated consumption sectors. We compare the penetrate rate of 40 items between China and the world.

(5) 13th Five-Year-Plan (page 30)

The drafting of the 13th Five-Year-Plan (2016-2020) is underway and will set a growth strategy for the whole nation and in every major industry. Early evidence indicates high-growth targets in subway construction, nuclear/solar/wind power and automation.

(6) Chinese ADRs (page 33)

MSCI Inc. will potentially include ADRs in its indices, resulting in capital flow in excess of US\$25bn. ADRs also appeal to local investors due to their low correlation with A-shares and low PEG ratio (0.77x).

Overall, we think the market will continue to **favour mid/small-caps and new economy sectors in the long term**. It is hard for large-caps in the old economy to consistently outperform without a clear sign of GDP turnaround and/or success in structural transition (page 12).

We recommend investors to **Overweight capital goods, auto, healthcare, insurance, real estate and software**. We **Underweight energy, consumer staples, telecom, retailing and commercial services** (page 35).

The 10 stocks we most prefer in 2015 are **Baidu, Ping An, COLI, Great Wall Motor, Fosun International, CSCI, China Southern Airlines, CSPC Pharma, Huaneng Renewable and Beijing Urban** (page 43).

Figure 1: Sector recommendations and valuations

Sector	% of index weight	Rating	2015F PE	2015F EPS Gr	2015F PB	Rating rationale
Energy	8.9%	OW → UW	8.8	-1%	1.0	Downside risk of gas pricing and demand has not been fully priced in
Materials	2.1%	Neutral	9.5	18%	0.9	Deflation positive to input cost, but selling price also under pressure due to excessive capacity
Industrials			8.6	18%	0.9	
- Capital Goods	5.6%	UW → OW	7.6	17%	0.9	Subway mileage to quadruple by 2020; rail equipment exports; likely mega-projects in 13th FYP
- Commercial & Prof Services	0.4%	Neutral → UW	22.5	32%	3.1	Stretched valuation cannot be justified by ~10% ROE of waste and water treatment projects
- Transportation	1.5%	UW → Neutral	13.4	28%	1.0	Benefit from fuel cost deflation; but demand growth remains lukewarm
Consumer Discretionary			10.8	20%	1.8	
- Automobiles & Components	1.9%	OW	9.1	20%	1.6	Sustainable growth due to low penetration; beta play in consumer space if property sales recover
- Consumer Durables & Apparel	1.1%	Neutral	14.8	18%	3.0	Imported products and foreign brands now easily reach low-tier cities on arrival of e-commerce
- Retailing	0.9%	UW	11.4	18%	1.6	Online shopping accounts for one-tenth of retail sales; offline retail space in excessive supply
Consumer Staples	5.1%	Neutral → UW	20.2	24%	2.2	Quality issue of local F&B; e-commerce allows foreign brands to proliferate in low-tier cities
Health Care	1.9%	OW	20.8	21%	3.1	Product-driven high profit growth; immune from macro policies; mid/small-caps fit market style
Financials			5.5	8%	0.9	
- Banks	22.0%	Neutral	4.6	7%	0.8	Benefit from rate cut to enhance balance sheet; but NIM still under pressure
- Diversified Financials	1.3%	Neutral	10.2	20%	1.2	Benefit from rate cut but margin financing business is unsustainable due to capital constraint
- Insurance	5.6%	OW	12.2	13%	1.7	Benefit from rate cut and product mix is improving
- Real Estate	6.0%	Neutral → OW	6.0	9%	0.7	Lower credit risk of developers; property sales to recover on more and cheaper mortgage loans
Information Technology			24.5	23%	5.4	
- Software & Services	9.6%	OW	29.6	28%	8.4	Chinese ADRs to benefit from MSCI inclusion and outbound investment of mainland investors
- Technology Hardware & Equipment	1.6%	OW → Neutral	13.7	13%	2.1	Unfavourable product cycle; growth of major products to be in low-single-digit in domestic market
Telecommunication Services	18.9%	UW	14.0	3%	1.5	4G subscriber addition does not translate into APRU increase; heavy capex
Utilities	3.9%	Neutral	12.5	13%	1.9	IPPs still enjoy high yield; but home connection growth of gas utilities faces downside risk
MSCI China	100%		8.8	8.8%	1.2	
- ex Banks	78%		11.7	9.9%	1.4	
- ex Banks, Oils, and Telco	70%		11.7	15.6%	1.5	
ADRs (not included in MSCI China)	35%		33.1	39%	6.7	

Note: Above data as of 1 December 2014.

Source: Datastream, Bloomberg, UBS estimates

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Top-down view: growth to moderate but macro risks to recede

Directional view in 2015

We expect the H-share equities to rise about 15% in 2015E. We roll over our year-end index target for MSCI China from 65.5 in 2014E to 73 in 2015E (and for HSCEI from 11,200 in 2014E to 12,500 in 2015E).

Our target PER is 9.2x, in line with the average level during 2011-14 and 7% above the current level. And, we expect the index EPS to grow by 8% in 2015E; similar to this year's pace.

Index targets at end-2015:

MSCI China: 73

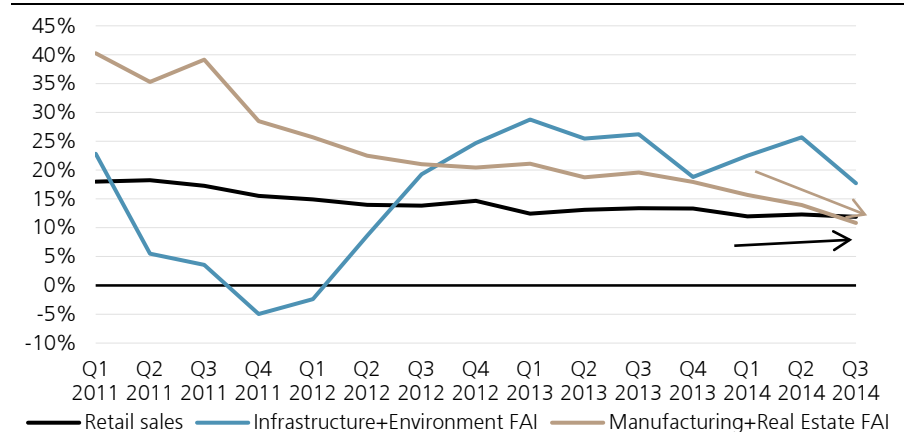
HSCEI: 12,500

Macroeconomic growth and index earnings

Tao Wang, our Chinese economist, forecasts real GDP growth in China to slow down to 6.8% and 6.5% in 2015E and 2016E, respectively, from 7.3% in 2014E.

We believe domestic demand will continue to be weakened by lacklustre investment in the property and manufacturing sectors. And, government-driven investment on transport infrastructure and environmental projects is insufficient to compensate for the slowdown in private sector investment. Meanwhile, we expect consumption growth will stay resilient due to the well-contained unemployment rate (about 5%) and decent household income growth (about 10% YoY).

Figure 2: YoY growth of fixed asset investment and retail sales



Source: CEIC, Wind

Despite the moderating GDP growth, we think the index earnings growth could stabilise at around 8% YoY next year; similar to the levels in 2013 and 2014E.

We expect index earnings to benefit from a number of structural changes: First, the new economy sectors, including IT, healthcare, alternative energy and selective consumer goods, have expanded their weights in the MSCI China index to 22%, from 15% previously. And, the inclusion of Chinese ADRs into MSCI China as proposed, would account for nearly one-third. According to IBES consensus forecasts, the earnings of new economy sectors, including ADRs, are expected to grow 25-30% in 2015.

Second, in the old economy sectors, the state-owned enterprises (SOEs) typically take reforms seriously. They endeavour to cut expenses and capex, improve operational efficiency, and tap into new businesses. Their earnings growth is only 0-5% YoY for now, but will potentially rebound after the reform.

We expect index earnings to grow 8% in 2015E; similar to 2014E

Third, the global commodity price crunch, coupled with the domestic monetary easing, has been positive for corporate profit margins. Given the resilience in mass market consumption, some midstream manufacturing sectors, such as automobile, apparels and F&B processing, tend to benefit from cost deflation.

Among the major sectors, we expect banks to maintain about 8% earnings growth in 2015, reflecting a slightly thinner net interest margin but benign outlook on credit costs. In the energy and telecom sectors, we expect the earnings growth to be nearly zero. The global crude oil and domestic coal prices will likely remain low; and the saturated telecom market allows little room for growth in either the number of subscribers or revenue per user. The sectors with high earnings growth (>15% YoY) are primarily the technology- or product-driven new economy industries such as healthcare, IT and automobile. (Our detailed discussions on sector earnings outlook and data can be found on page 35.)

Macro risks and index valuation

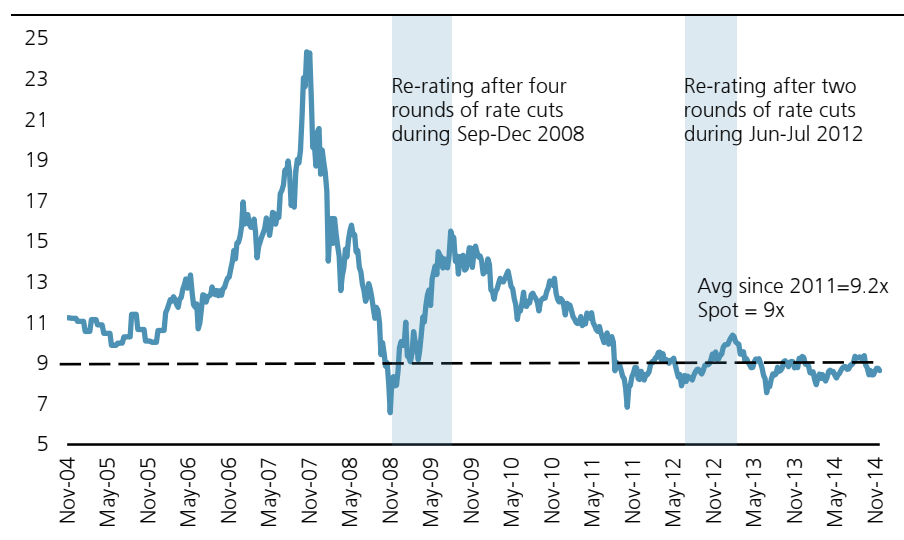
The signs of receding macro risks are the key reason to support our bullishness in 2015. Our target forward PER for MSCI China index is 9.2x; broadly in line with the 2011-14 average level and 20% lower than the 10-year historical average of 12x.

During Jan-Nov 2014, the index forward PER was virtually unchanged at 8.9x. The valuation multiples took two knocks this year: the first one in January when some shadow banking products threatened to default, and the second one in September when the many global funds turned cautious on the US dollar's sudden strength and oil price slump. Following the interest rate cut in November 2014, we believe a new re-rating cycle has started (see Figure 3).

Slower GDP growth could be offset by a larger share of new economy stocks in the index, cost reduction of SOEs, and input price deflation

Our target 2015E PER for MSCI China is 9.2x; in line with the average level during 2011-14

Figure 3: MSCI China – 12-month forward PER



Source: Datastream

The last two rounds of interest rate cuts triggered a substantial valuation re-rating

We believe the major overhangs to cap Chinese equities' valuations remain domestic macro factors including heavy local government debts, vacant properties, bad debts in shadow banking system, and excessive manufacturing capacity. These are the legacy of excessive fixed asset investment and money supply post the 2008 global financial crisis. Fortunately, the Xi-Li government is now tackling these issues via a series of reforms.

The #43 Notice of the State Council in October 2014 provides a solution to unwind local government debts. The document basically calls for swapping high-cost, short-duration bonds issued by local government financing vehicles (LGFVs) with low-yield, long-duration municipal bonds. Meanwhile, budgetary management is set to become stricter to ensure less borrowing at the local level. Our Chinese economist forecasts the issuance of municipal bonds to ramp up from Rmb110bn this year to more than Rmb1trn in 2015. This will reduce the burden on local governments, allowing them to repay the outstanding LGFV bonds of Rmb3.6trn.

In 2015, many macro risks will likely find pragmatic solutions

LGFV bonds can be swapped for lower-cost municipal bonds

We believe an active central bank could prevent a shadow banking meltdown. The PBoC proactively uses various monetary policy tools (PSL, SLF, MLF¹, on-lending, etc.) to keep ample liquidity in the financial system. UBS economists think the benchmark lending rate could be cut three times (by a sum of 75bp) by end-2015. The first rate cut of 40bp already took place in November 2014. Under a relaxed monetary environment, the shadow banking products will be refinanced more easily and at lower cost, lowering the odds of a full-blown default.

Shadow banking defaults can be managed by active liquidity provision

The property market downturn has been cushioned by a combination of mortgage rate cuts, tax breaks/subsidies, and shanty town reconstruction (to mobilize residents to buy new residences). Property developers have to endure a destocking process with profit margin erosion and cash flow drainage. But we believe the risk of a sudden collapse in the property market has receded, given the rebound in property sales in October and November 2014, and the property developers' cautious stance to start new construction and to acquire land.

Property market can be buoyed by mortgage rate cuts

No formula can eliminate all macro risks overnight. However, we believe the aforementioned measures point in the right direction: 1) to deleverage the financial system; and 2) to reduce government's intervention in the economy. This should then lower the market risk premium, the risk-free-rate should decline in the wake of benchmark rate cuts, and the index valuation multiple is thus set to rise.

Key risks

In UBS' *Global Economic Outlook 2015-2016*, 3 November 2014, our economists assign a 10% probability of property-led hard-landing risk in China and a 10% probability of heavy capital outflows from emerging markets. In these two scenarios, China's real GDP growth would decelerate sharply to 5.2% and 5.6%, respectively, in 2015E and Chinese equities could decline by more than 20%.

Another downside risk is that government fails to manage the aforementioned macro risks. For example, an overdose of liquidity injection could only delay, rather than reduce, the risk of full-blown credit defaults.

We think the upside risk to our 2015 index earnings growth forecast of 8% may come from either the stronger-than-expected demand from G3 countries, or the sharper-than-expected crude oil, iron ore and copper price deflation.

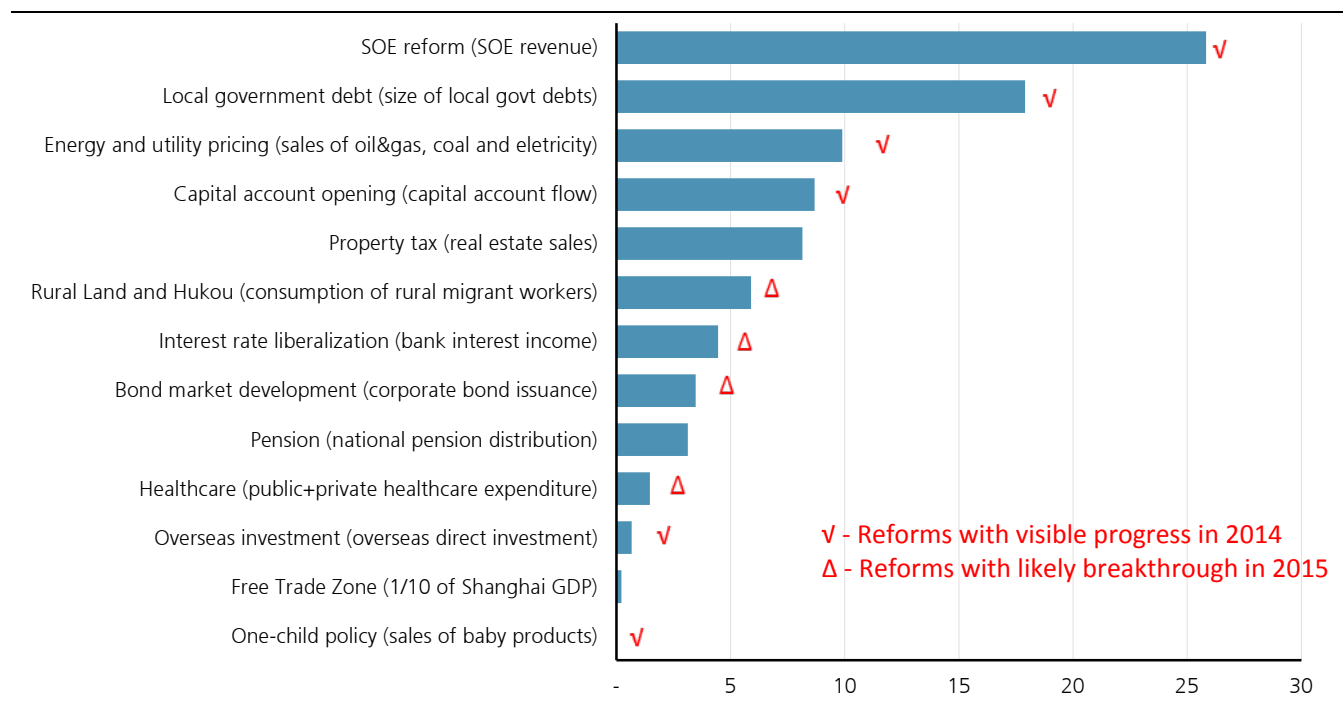
The upside risks to our valuation forecast include: 1) the rapid pace of structural reforms; 2) a pragmatic solution to banks' non-performing loans; 3) a rapid recovery in real estate sales; and 4) further capital account opening programmes to encourage overseas investment.

¹ Pledged Supplementary Lending; Standing Lending Facility; Medium-term Lending Facility

Reform progress summary

Reform is the single-best solution to rebalance the Chinese economy and to revitalize the equity market, in our view. Many of the reforms promised at the 3rd Plenum in November 2013 have been initiated and have made solid progress this year. Figure 4 summarises those with significant economic implications, ranked by the size of the involved segments.

Figure 4: Scale of major reforms, with size of affected interest groups as proxy (RMB trn)



Source: Wind, CEIC, World Bank, National Bureau of Statistics, Ministry of Finance, UBS estimates

Reforms with visible progress in 2014

State-owned enterprise (SOE) reform

In 2014, the announcement of reform paths and the first batch of six reforming national SOEs in July² heralded an SOE reform milestone. The reform programmes have been launched in many large national and provincial SOEs, including Sinopec, Datang Power, Shanghai Auto and Shanghai Port Group. We expect reform in 2015 to be bolder and more wide-ranging, including the adjustment of remuneration and incentives for SOE directors, employee shareholding as a path of partial privatisation, mixed ownership, and state asset-holding platforms to restructure non-performing SOEs (see detailed discussion on page 22).

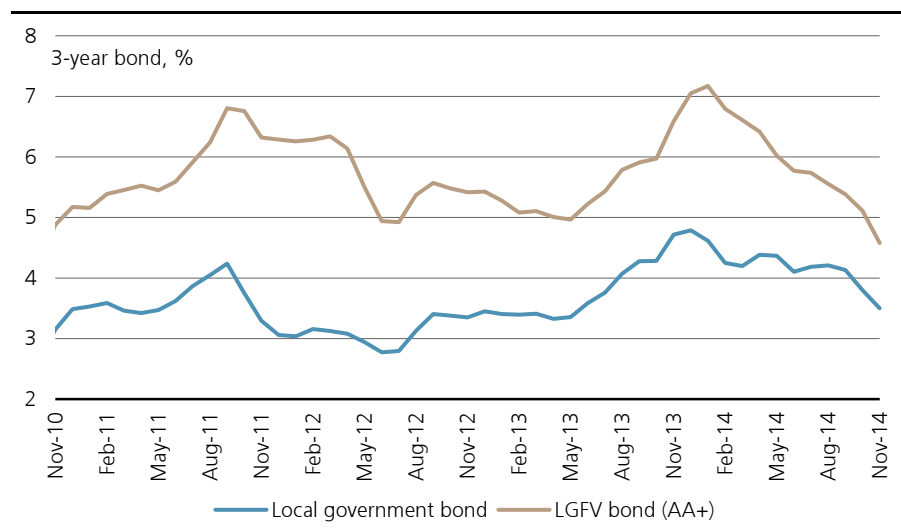
Local government debt

In October 2014 the State Council laid down a pragmatic framework for budgetary system reform and local debt resolution. The majority of the LGFV bonds, which are mainly used to finance public projects will be swapped for municipal bonds. The municipal bonds currently have a less than 4% yield (see Figure 5) and more than five-year duration, and will thus lessen the financial

² Reformation: National SOEs go on stage, 16 Jul 2014

burden on local governments. A part of the LGFV bonds, which finance commercial projects, such as office towers, industrial parks, and logistic facilities, will be converted to corporate bonds issued by private entities and/or simply retired. This reduces the government's intervention in the local economy and constrains expansion of public debts.

Figure 5: Yield-to-maturity of local government bonds and LGFV bonds (AA+)



Source: Wind

Energy and utility pricing

In November 2014, the National Development and Reform Commission (NDRC) announced a trial programme of power transmission and distribution price reform in Shenzhen, Guangdong. The power grid companies, whose cost structures are notoriously opaque, are no longer allowed to monopolise the profits of electricity transmission and distribution. Instead, they now need to follow an ROE-based pricing mechanism.

The trial programme in Shenzhen aims to establish a free market in power transmission and distribution, and to increase the transparency of the state-owned operators' power transmission and distribution. UBS analyst, Yinzheng Xu, regards this as a significant change in the regulatory framework and an important signal to accelerate power sector reform.

Capital account opening

In 2014, the existing Qualified Foreign Institution Investors' (QFII) and RMB Qualified Foreign Institution Investors' (RQFII) quotas expanded by 29% (US\$14.4bn) and 87% (RMB136.9bn), respectively. Besides, the Hong Kong-Shanghai Stock Connect programme began in November, opening Shanghai-listed A-share stocks to foreign investors and the Hong Kong equity market to mainland investors. As the next step of capital account opening, the central bank claimed to be engineering a QDRI (Qualified Domestic Retail Investors) programme³ to allow direct investment on overseas equities and real estate (see page 33).

³ <http://www.yicai.com/news/2014/10/4025872.html>

Overseas investment

China has been actively acquiring overseas assets for more than a decade. But instead of the conventional approach to simply bid for oilfields and mines, the Xi-Li government has adopted a new approach to promote overseas investment via the establishment of multi-national organizations. Three such organizations have been set up in 2014:

- **Silk Road Fund:** focusing on infrastructure investment along the silk road and marine silk road. The total committed capital is initially US\$40bn, fully funded by China but open to other countries.
- **BRICS Bank:** focusing on infrastructure investment in the five BRICS countries. The initial capital is US\$50bn with a quarter contribution from China.
- **Asian Infrastructure Investment Bank:** aiming to compete with Asian Development Bank, in which Japan is the lead investor, by investing in infrastructure projects in Asia. The initial capital is US\$100bn, half from China and the other half from other 20 member countries (including India and Singapore, but excluding Japan).

We think these platforms reflect Chinese leaders' intentions to strengthen international collaborations. The trade of Chinese high-end equipment and construction services for foreign resources has the potential to balance China's capital and current accounts in the long term.

Pending reforms with likely breakthrough in 2015

Rural land and Hukou reform

The reform on rural land and Hukou (ie, household registration) had a slow start due mainly to constraints on local governments' fiscal capacities. According to the National Academy of Social Sciences' calculation, the social welfare package costs local government Rmb100th per capita to urbanize each rural Hukou⁴. A small city (by Chinese standards) with a population of 1m, typically has about 1m rural residents in the surrounding regions. Even the initial stage of Hukou reform would cost billions of renminbi, which is supposed to come from the appreciation of rural lands when converted to urban ones. But the rural land reform is very complex due to unclear ownership and is unable to generate much cash flow amid the current property market downturn.

In selective regions where rural lands are highly valuable, the rural land and Hukou reform could make some progress next year. Such pilot programmes will help explore several reform paths and accumulate experience for national replication.

⁴ <http://politics.people.com.cn/n/2014/1104/c1001-25970907.html>

Interest rate liberalisation

The PBoC cut the benchmark lending rate by 40bp on 22 November 2014. It simultaneously raised the deposit rate ceiling to 1.2x benchmark rates, from 1.1x previously, and indicated the next step of liberalisation would be to allow corporates and individuals to trade certificates of deposit.

The deposit rate has virtually already been liberalised, given the easy access to wealth management products and money market funds. The yields of such products fluctuate freely according to the credit environment and interbank liquidity. The lending rate of bank loans, however, remains rigid and fails to reflect the credit profile of borrowers. The pricing of the shadow banking system is more flexible. But it remains distorted, given that implicit government guarantee stays in place behind both public and private projects.

In 2015, a possible and crucial step towards reform is the abolishment of the implicit guarantee for debt repayment, especially among large SOEs. We think the regulators will most likely allow this to happen when economic growth stabilises and monetary supply is relaxed. Such an environment is favourable to reform as the risk of debt default contagion could be well contained.

In 2015, a possible and crucial step towards reform is the breakup of ironclad guarantee for debt repayment

Corporate bond and SME financing

SME financing, by its high-credit-risk nature, cannot fully rely on formal bank loans. The corporate bond market is a viable alternative, as are other shadow banking channels, such as P2P lending, financial leasing, trust loans, directional investment plans of securities firms, and special subsidies of asset management companies.

The regulation on SME financing is murky. The government is aware of the credit risk involved but is also concerned about obstructing healthy development of non-bank financing. In our view, the most promising breakthrough in 2015 could be in internet financing. This is probably not the result of policy design (thus not necessary a top-down reform per se), but rather the innovation outlook of internet companies and financial institutions, such as asset securitisation, P2P loans and crowd-funding.

Medical reform

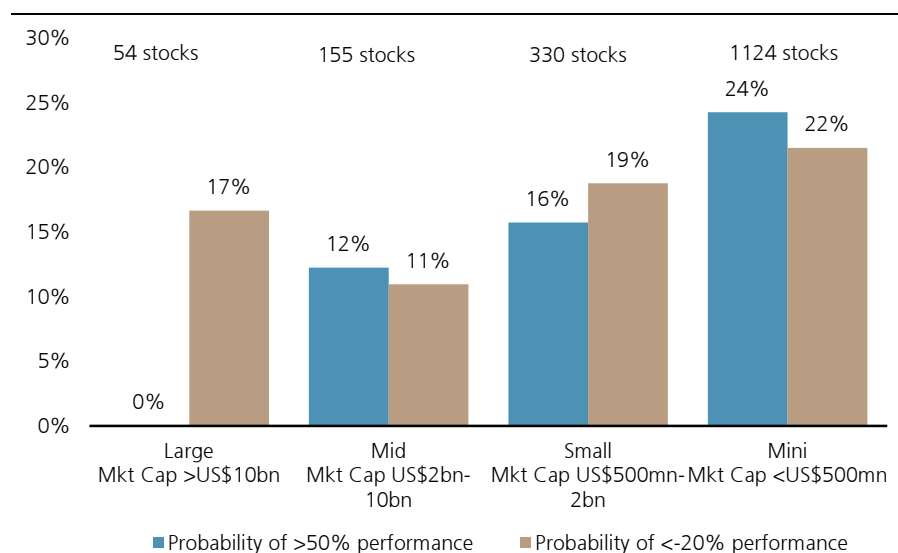
The reform in the healthcare sector has so far concentrated on the drug procurement mechanism. It has not fully addressed the key issues of uneven distribution of medical resources and unaffordability for urban low-incomers and rural residents. The breakthrough in 2015 is likely to be regulatory relaxation to encourage the entry of private operators to provide medical services. Possible policy supports include, but are not limited to, preferential tax treatment for private institutions, multi-sited licences for doctors, and partial privatisation of public hospitals.

The opening up of the healthcare service segment to private capital and the creation of multiple markets to target different patients and customer groups is an important part of the overall solution to rectify China's healthcare system.

Market style: mid/small caps and new economy are the sweet spots

In recent years, a phenomenal trend among investors is to favour mid/small-caps over large-caps. We find that the risk/reward profile is very unfavourable for large-caps. Among the companies with a market cap less than US\$10bn, the risk/reward is broadly symmetric (see Figure 6).

Figure 6: Probability of ">50% return" and "<20% return" during Jan-Nov 2014
(MSCI China index performance was 3.5% during the period)



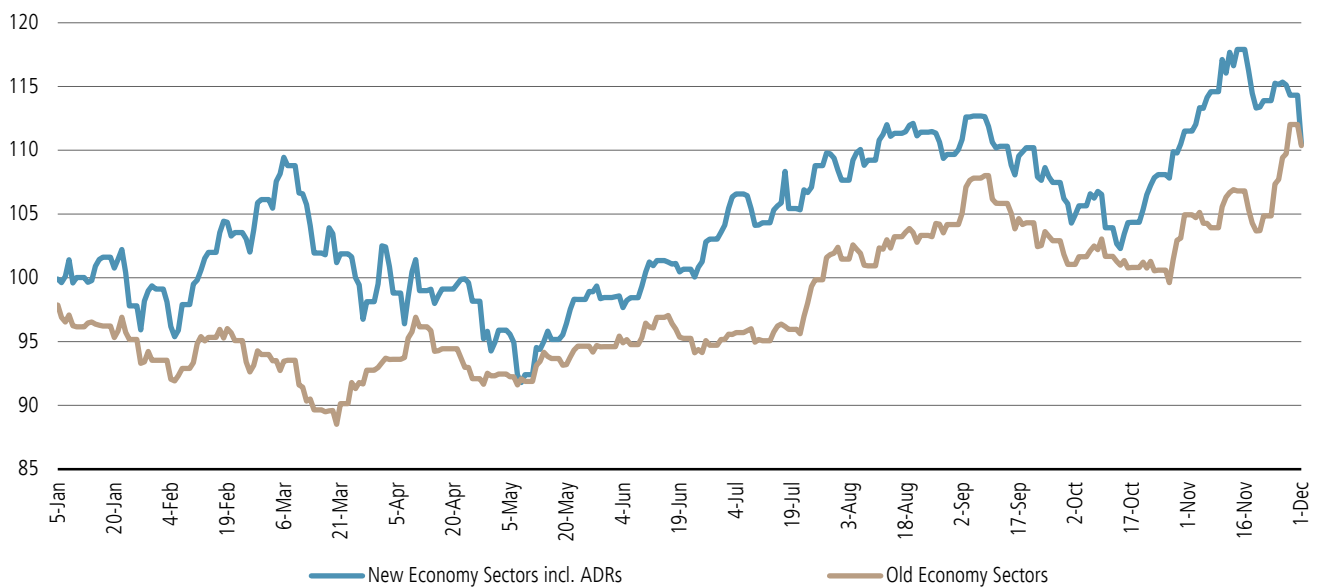
Mid/small-caps are the sweet spot of the market

Source: Bloomberg

Another phenomenal market style trend is that the new economy sectors sustainably outperform old economy sectors. In 2013, the new economy sectors outperformed the old economy by 69%⁵. During January-November 2014, the new economy again outperformed consistently (see Figure 7).

⁵ Note that we take a broad definition of the new economy as all the sectors and stocks with technology and talents as key growth drivers. The new economy thus includes automobile manufactures and F&B brands, which typically differentiate from competitors on new products and branding strategies. By contrast, sectors and companies with capital and low-end labour force as key inputs are categorized as the old economy. If we take a narrow definition of the new economy, which only includes IT, healthcare, alternative energy and environment equipment sectors, the outperformance of new economy stocks would become even larger.

Figure 7: Price performance of new economy sectors (including ADRs) and old economy sectors



Note: Above data as of 1 December 2014.
Source: Bloomberg

These two trends are underpinned by fundamental justifications. In a sluggish macroeconomic growth environment, mid/small-sized companies are more nimble than large companies, and more resourceful than mini-sized companies to capture growth opportunities. And the new economy, which relies less on policy support but more on entrepreneurship, tends to outgrow amid reforms when the government tries to reduce intervention in economic growth and encourages private investment.

In 2015, we believe the market style will continue to favour mid/small-caps and new economy sectors, as the above-mentioned macro context remains valid.

Risk/reward statistics by market cap size

Figure 6 shows the results of a statistical test of stock performance by market cap.

During January-November 2014, not a single large-cap company with market cap over US\$10bn achieved an absolute return of more than 50%. On the contrary, the stock prices of 17% of large-caps fell by more than 20%. The risk/reward profile is asymmetric with an unfavourable skew.

By comparison, among mid-caps with market cap between US\$2bn and US\$10bn, the odds of a ">50% YTD performance" and a "<20% YTD performance" are close (12% versus 11%, respectively).

Small-cap companies with a market cap of US\$0.5-2bn have around a 16% chance of ">50% YTD performance" and a 19% chance of "<20% YTD performance". Compared with mid-caps, they are higher return and higher risk investments.

Key investment themes

1. Declining corporate funding cost and credit risk

Tao Wang, our Chinese economist, forecasts three cuts in the benchmark lending rate (totalling 75bp) by end-2015. The first rate cut of 40bp was realised on 22 November 2014. In our note on 5 November, we stated the effective corporate funding cost will also likely decline in 2015⁶.

Historically, market has responded very positively to lower corporate funding cost

The market has tended to respond very positively after interest rate cuts (see Figure 8 and Figure 3). Materials, real estate, banks, and energy sectors outperformed every time during the market rebound after interest rate cuts. These sectors outperform for different reasons.

Figure 8: Historically, outright rate cuts have led to lower corporate funding cost, followed by market rebound

Benchmark rate cut			
Time	N.A.	Sep-Dec 2008 (4 times)	Jun & Jul 2012 (2 times)
Magnitude	N.A.	189bps	50bps
... followed by immediate decline of corporate funding cost			
Time	Jun 2005-Mar 2006	Aug 2008-Jun 2009	May 2012-Dec 2012
Decline in average lending rate	~50bps	~210bps	~80bps
... and MSCI China index responded very positively			
Time	Oct 2005 - May 2006	Oct 2008 - Jun 2009	Sep 2012 - Jan 2013
Length of market rally	~4 months	~8 months	~5 months
Magnitude of index rebound	51%	108%	27%
... with the following sectors outperforming every time			
Time	Oct 2005 - May 2006	Oct 2008 - Jun 2009	Sep 2012 - Jan 2013
Materials sector performance*	110%	284%	43%
Real estate	145%	235%	45%
Banks**	62%	172%	43%
Energy	57%	140%	26%
Insurance***	103%	131%	47%

Source: Datastream, PBoC

Notes: *The materials sector's rally started about 2 months earlier than the overall market in 2005 and ended 1 month later in 2013.

**The banks' rebound ended 2 months earlier than others in 2005 and 5 months later in 2009.

***The insurance sector's rally ended 1 month later than other sectors in 2009 started 3 months earlier than others in 2012.

Banks and insurance companies benefit due to asset quality improvement.

Lower interest rates mean lower refinancing costs for companies, thus receding credit default risks and better quality of existing lending. Banks and insurance companies could benefit, given their large holdings of fixed-term assets. Meanwhile, lowering funding costs helps banks and insurance companies expand their balance sheets more quickly, leading to larger provisions and lower bad debt ratios to strengthen their balance sheets.

Materials, energy, and real estate sectors benefit from lower interest rates due to asset price inflation. These sectors enjoy better margins brought about by increasing the prices of metals, building materials, petrochemicals, etc. Also, because these sectors are typically high-leverage sectors, they have less of an interest burden after an interest rate cut.

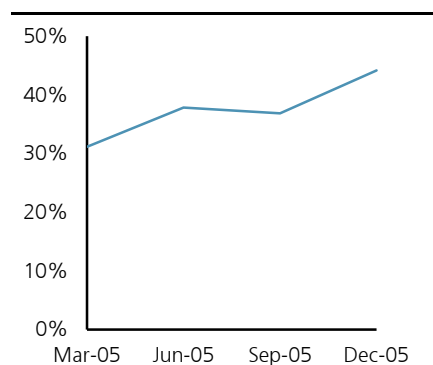
Consumer discretionary sectors also outperform because consumers anticipate CPI inflation and make purchases in advance, but the impact is more indirect.

⁶ A "new norm" to invest if Central Bank cuts interest rates in 2015, 5 Nov 2014

Would historical experience apply this time?

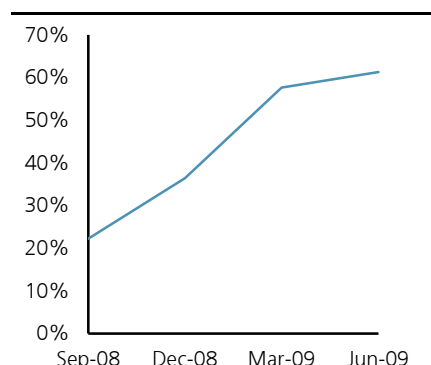
Energy and materials sectors' glorious history might not repeat due to smaller influence of fixed asset investment (FAI). During the previous three rounds of lowering corporate funding cost, FAI accelerated every time, driven by the manufacturing sector in 2005, infrastructure and environment sectors in 2008/09, and real estate and environment sectors in 2012/13 (see Figure 9, Figure 10, and Figure 11).

Figure 9: Manufacturing FAI in 2005 (YoY %)



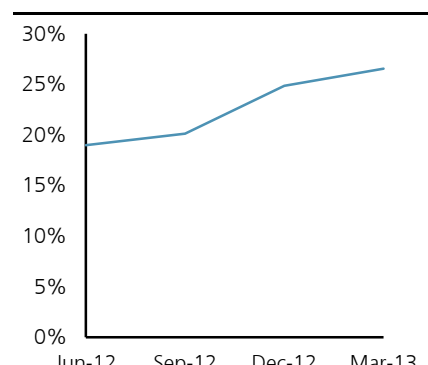
Source: CEIC

Figure 10: Infrastructure and environment FAI in 2008/09 (YoY %)



Source: CEIC

Figure 11: Real estate and environment FAI in 2012/13 (YoY %)



Source: CEIC

This time, however, manufacturing, infrastructure and real estate sectors already have excessive investment. Manufacturing SOEs, especially, are likely to deleverage, using new less-expensive borrowings to repay old expensive debts, and are less likely to invest massively. Thus, energy and materials might face sluggish demand and not outperform.

Financial sectors are beneficiaries, given their distressed valuations.

Financials sectors' valuations are at the low end of their historical levels. Nowadays, investors focus more on credit risks and thus on financials' balance sheets. With lower funding costs set to improve asset quality, we believe financial sectors are well positioned to reap the reward.

Consumer discretionary will deliver more visible results thanks to fast growing consumer credit.

We think lower interest rates will boost consumer credit to grow rapidly. The size of consumer loans, excluding home mortgages, has exceeded Rmb3trn and continues to expand by more than 25% per annum. And with internet financial services (eg, P2P lending, instalment auto loans and credit card overdraft) becoming more popular, household purchasing will be boosted in our view.

Bond market will likely accelerate the reduction of corporate funding cost this time

The past two rounds of interest rate cuts happened in October 2008 and June 2012. The outstanding size of the corporate bond market was only Rmb0.5trn and Rmb1.9trn, respectively. Now it has reached Rmb3.6trn. A larger and more active corporate bond market accelerates the transmission of the cut in bank lending rate to the reduction of actual corporate funding cost.

In 2014, the corporate bond market became a less expensive funding source than bank loans. Large companies, especially SOEs, can currently obtain an AA or higher credit rating and their bonds are issued at an average yield of 4.75%. It is more than 200bp lower than the average banking lending rate (see Figure 12). This is a new phenomenon due to the central bank's liquidity easing this year. One year ago, the yield of AA-rated bonds used to be similar to the bank lending rate. The issuance of AA-rated bonds surged by 193% YoY in Q214 and 343% in Q314.

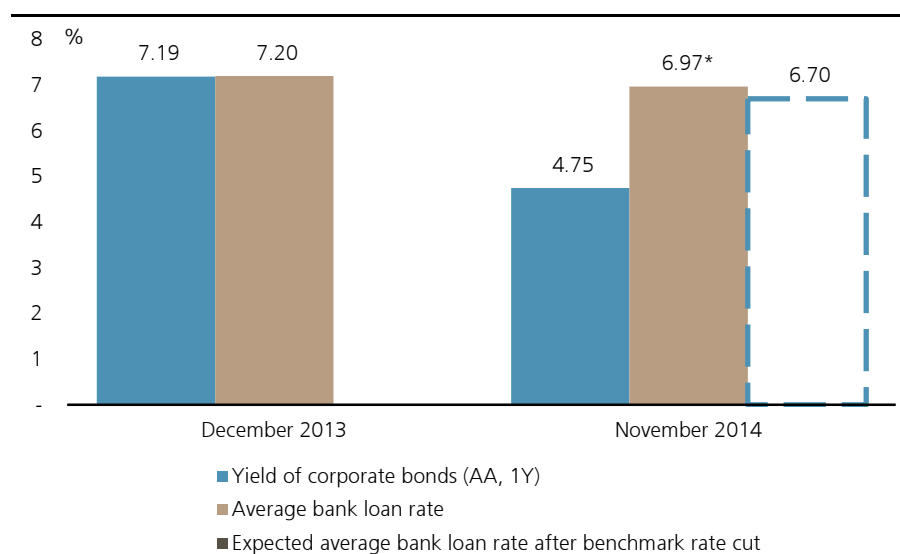
Average yield of an AA-rated corporate bond is 200bp lower than the banking lending rate, indicating the declining corporate funding cost

After the recent rate cut, the yield of AA-rated bonds is still much lower than the bank lending rate. The future lending rate will thus decline further, in our view. This means banks are likely to quickly implement the reduced lending rates at the beginning of 2015, when every bank has got the new loan quota. Otherwise, they will lag behind peers in terms of both the loan growth rate and average loan pricing for the rest of the year.

A ripple effect is that mortgage loans will likely accelerate in early-2015. Priced at around 7% in November 2014 (before the rate cut), mortgage loans are less profitable than average corporate loans to banks. But unlike corporates, home purchasers do not have a less expensive alternative funding source. Banks that expect a sharp decline in corporate loan rates (ie, from 7.5% currently, to 6% in 12 months) may frontload their mortgage loans (at a c6.5% rate) in the early part of the year.

Mortgage loans will likely accelerate in early-2015

Figure 12: Average bank loan rate and corporate bond yield (AA-rated bonds account for 52% of corporate bond issuance during Jan-Nov 2014)

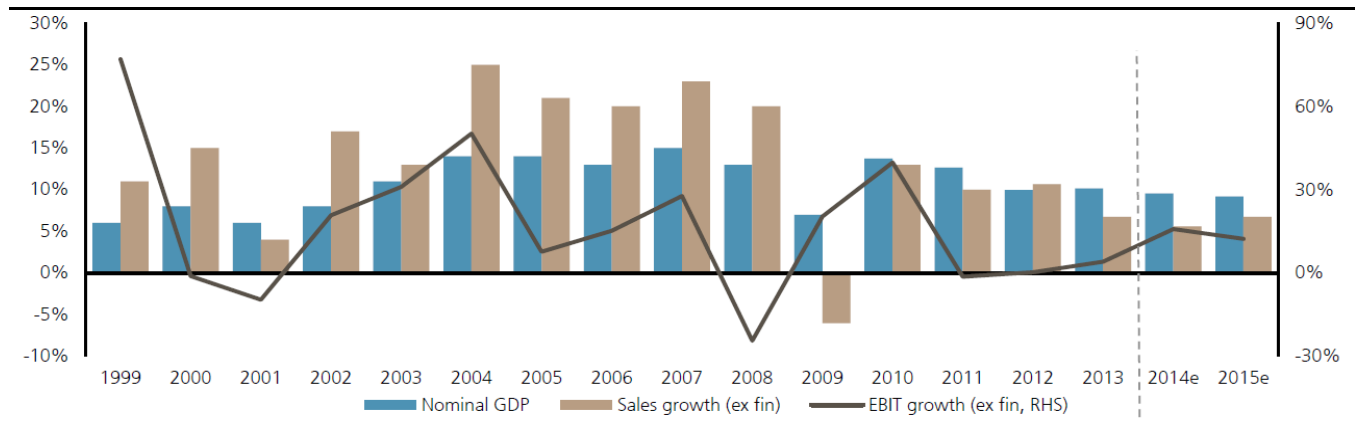


Note: *Average bank loan rate as of Q3 2014.
Source: Wind

2. Deflation

The deflation-driven profit margin improvement is a key theme highlighted by UBS' Asian strategist, Niall Macleod. He believes the current commodity price crunch is a supply-driven decline rather than a broad-based demand decline. If commodity prices remain low for a long time (eg, oil US\$100/bbl, iron ore US\$75/t), the lower commodity prices could support earnings growth significantly (see Figure 13).

Figure 13: Asia ex Japan GDP, sales and EBIT growth



Source: Worldscope, IBES, Thomson Datastream, UBS estimates

In the case of China, we estimate every US\$1 decline in the oil price shaves about US\$2.2bn off the import bill, based on latest import data. Similarly, a US\$1 decline in iron prices saves US\$1bn annually. The recent fall in oil and iron ore prices, if sustained, lowers total imports by US\$120bn, or 6% next year. Meanwhile, most of China's exports are manufactured goods whose prices have not fallen much.

The sector implications are clear. Lower commodity prices will of course be a drag on the oil and gas and mining stocks, and their equipment and service suppliers. But many more sectors and stocks will benefit. We classify the beneficiaries into three categories:

- Air and marine transport operators to benefit from less expensive fuel
- Mid-stream manufacturers in auto, machinery and F&B sectors to benefit from less expensive steel and aluminium prices
- Coal- and gas-based utilities to benefit from lower input costs or smoother fuel-cost pass-through to end-users

Three types of beneficiaries from lower commodity prices

In a recent report⁷, Niall Macleod's team has compiled a detailed guide for more than 60 Chinese stocks, with key commodities each stock is exposed to and the positive/negative implications (see Figure 14). Adding in other elements such as valuation, earnings momentum and fundamental views, we think the most interesting proxies of the deflation theme include China Southern Airlines, Datang Power, and Great Wall Motor.

China Southern Airlines, Datang Power, and Great Wall Motor are beneficiaries of the deflation theme, in our view

⁷ APAC Equity Strategy - Commodity crunch: Asia's earnings beneficiaries, 20 Oct 2014

Figure 14: Stock implication of deflation

Name	Sub-Industry	Mkt Cap (USD bn)	Price	Upside to PT	UBS rating	positive (✓) or negative (✗) impact of falling commodity prices												Commodity Exposure	Analyst Comment
						Crude Oil	Nat Gas	Copper	Iron Ore	Steel	Coal	Aluminium	Rubber	Wheat	Corn	Cotton			
Air and marine transport operators affected by deflation																			
Air China	Airlines	9	4.84	7%	Neutral	✓											Fuel accounts for 35% of opex	Air China does not hedge fuel cost and we estimate every \$1/bbl decline in oil price will lift FY14E EPS by 11%.	
China Eastern Airlines	Airlines	6	2.74	-5%	Neutral	✓											Fuel accounts for 34% of opex	China Eastern Air does not hedge fuel cost and we estimate every \$1/bbl decline in oil price will lift FY14E EPS by 26%.	
China Southern Airlines	Airlines	4.5	2.64	33%	Buy	✓											Fuel accounts for 38% of opex	China Eastern Air does not hedge fuel cost and we estimate every \$1/bbl decline in oil price will lift FY14E EPS by 40%.	
China COSCO Holdings	Marine	6	3.18	15%	Neutral	✓				✓							Dry Bulk (Iron Ore) represents 22% of revenue; fuel 23% of opex	~20% of China COSCO's revenue is generated from dry bulk shipping. Recent decline in iron ore price would have likely delayed shipment and reduced near term volume, however in the longer run, if high-cost Chinese iron ore producers are eliminated to benefit low-cost offshore producers, shipment volume could increase and support freight rates. On the cost front, we estimate every 1% decline in bunker price will lift FY14E EPS by 10%.	
China Shipping Container Lines	Marine	5.1	2.05	10%	Neutral	✓											Fuel cost accounts for ~30% of opex	Given CSCL's thin operating margin (UBSe -0.7% for FY14,) a small movement in bunker price could cause big earnings swings, and we estimate every 1% decline in bunker price will lift FY14E EPS by 39%.	
China Shipping Development	Marine	2.7	4.58	42%	Buy	✓				✓							Crude oil shipping (43%) / Coal shipping (21%) / Iron Ore & other dry bulk (36%); fuel ~44% of opex	Revenue from dry bulk shipping could be negatively impacted in the short term due to weak iron ore price, however long term impact should be on the upside if high-cost Chinese iron ore producers are eliminated to benefit low-cost offshore producers and increase shipment volume. On cost, we estimate every 1% move in bunker price could lift FY14E EPS by 21%, however this is expected to be partly offset by lower tanker revenue.	
Mid-stream manufacturers affected by deflation																			
Giordano	Apparel Retail	0.8	3.94	2%	Sell											✓	Cotton cost could be 50% of Giordano's OEM suppliers' COGS	10% fall in cotton costs could raise Giordano's operating profit by around 8%	
BYD Company Limited	Automobile Manufacturers	17.3	49.25	-54%	Sell	✓			✓	✓		✓					Steel (33%), Iron (6%), Plastics (5%), Aluminium (6%) of COGS.	Steel is the biggest component for a motor vehicle which typically account for c46% of the total material cost. We believe a 1% change in commodity price (in the Auto segment only) will lead to a 6% change in net profit	
Great Wall Motor	Automobile Manufacturers	14.2	30.85	10%	Neutral	✓			✓	✓		✓					Steel (36%), Iron (6%), Plastics (6%), Aluminium (6%) of COGS.	We believe a 1% change in commodity price will lead to a 3% change in net profit	
Dongfeng Motor	Automobile Manufacturers	13.2	11.9	47%	Buy	✓			✓	✓		✓					Steel (43%), Iron (7%), Plastics (7%), Aluminium (8%) of COGS.	We believe a 1% change in commodity price will lead to a 5% change in net profit	
Brilliance China Automotive	Automobile Manufacturers	8.1	12.66	21%	Neutral	✓			✓	✓		✓					Steel (42%), Iron (7%), Plastics (7%), Aluminium (7%) of COGS.	We believe a 1% change in commodity price will lead to a 5% change in net profit	
Guangzhou Automobile	Automobile Manufacturers	7.7	7.26	54%	Buy	✓			✓	✓		✓					Steel (39%), Iron (7%), Plastics (6%), Aluminium (7%) of COGS.	We believe a 1% change in commodity price will lead to a 6% change in net profit	
Geely Automobile	Automobile Manufacturers	3.6	3.37	7%	Buy	✓			✓	✓		✓					Steel (40%), Iron (7%), Plastics (7%), Aluminium (7%) of COGS.	We believe a 1% change in commodity price will lead to a 6% change in net profit	
Tsingtao Brewery	Brewers	9.2	53.1	9%	Sell							✓					packaging (50%), malting barley (15%), rice (6%)	Aluminium is used as packaging material for its canned beverages. A 10% fall in all major raw material mentioned would likely see operating profits rise 67%.	

Source: UBS. This table has been extracted from APAC Equity Strategy note "Commodity crunch: Asia's earnings beneficiaries" dated 20 October 2014

Figure 15: Stock implication of deflation – continued

Name	Sub-Industry	Mkt Cap (USD bn)	Price	Upside to PT	UBS rating	positive (✓) or negative (✗) impact of falling commodity prices											Commodity Exposure	Analyst Comment
						Crude Oil	Nat Gas	Copper	Iron Ore	Steel	Coal	Aluminium	Rubber	Wheat	Corn	Cotton		
Mid-stream manufacturers affected by deflation																		
Weichai Power	Construction & Farm Machinery & Heavy Trucks	6.7	27.6	18%	Neutral			✓	✓	✓	✓					Material procurement cost accounted 80% of COGS, while steel account for 10% alone	We believe a 1% change in commodity price will lead to a 7% change in net profit	
Sinotruk (Hong Kong)	Construction & Farm Machinery & Heavy Trucks	1.4	4.04	11%	Neutral			✓	✓	✓	✓					Material procurement cost accounted 71.5% of COGS, while steel account for 7.5% alone	We believe a 1% change in commodity price will lead to a 34% change in net profit. The reason for a higher sensitivity is attributable to the high operating cost compared to its peers.	
Want Want China Holdings	Packaged Foods & Meats	16.2	9.5	-7%	Sell					✓						Packaging material (31%), milk powder & condensed milk (20%), sugar (7%), rice (4%), palm oil (2%)	Steel is used as packaging material for Want Want's hot kid milk. A 10% fall in all major raw materials mentioned would likely see operating profits rise 18%.	
Tingyi Cayman Islands	Packaged Foods & Meats	13.5	18.78	39%	Buy									✓		PET resin (30%), Palm oil (7%), Flour (5%), Sugar (5%)	PET resin is used for packaging material while palm, flour and sugar are used for production. A 10% fall in all major raw material mentioned would likely see operating profits rise 40%.	
China Mengniu Dairy	Packaged Foods & Meats	8.2	32.65	24%	Neutral											packaging (21%), sugar and other raw material (18%)	A 10% fall in major raw materials mentioned would likely see operating profits rise 80%.	
Uni-President China Holdings	Packaged Foods & Meats	4	7.1	-23%	Sell									✓		PET resin (22%), sugar (11%), palm oil (3%), Flour (4%)	PET resin is used for packaging material while palm, flour and sugar are used for production. A 10% fall in major raw material mentioned would likely see operating profits rise 149% due to low EBIT margin in 2013/14.	
Yashili International	Packaged Foods & Meats	1.2	2.72	-1%	Sell					✓						Milk powder (47%), packaging (10%)	Steel is used as packaging material. A 10% fall in all major raw material mentioned would likely see operating profits rise 23%.	
China Huiyuan Juice Group	Packaged Foods & Meats	1.1	3.17	-18%	Sell											packaging (29%), sugar (12%)	n/a as Huiyuan records operating loss	
Coal and gas based utilities affected by deflation																		
China Gas Holdings	Gas Utilities	8.7	13.54	-26%	Sell		✓									84% Gas	Gas utilities needs to purchase gas from upstream suppliers at the city-gate price. Gas utilities' profitability depends on the ability of the companies to achieve fuel cost pass-through. In a falling gas price environment, fuel cost pass through should be more easily achieved compared to a rising gas price environment	
ENN Energy Holdings	Gas Utilities	7.3	52.1	15%	Neutral		✓									84% Gas	Gas utilities needs to purchase gas from upstream suppliers at the city-gate price. Gas utilities' profitability depends on the ability of the companies to achieve fuel cost pass-through. In a falling gas price environment, fuel cost pass through should be more easily achieved compared to a rising gas price environment	
China Resources Gas Group	Gas Utilities	6.5	22.5	11%	Neutral		✓									80% Gas	Gas utilities needs to purchase gas from upstream suppliers at the city-gate price. Gas utilities' profitability depends on the ability of the companies to achieve fuel cost pass-through. In a falling gas price environment, fuel cost pass through should be more easily achieved compared to a rising gas price environment	
Towngas China	Gas Utilities	2.7	8.09	26%	Neutral		✓									85% Gas	Gas utilities needs to purchase gas from upstream suppliers at the city-gate price. Gas utilities' profitability depends on the ability of the companies to achieve fuel cost pass-through. In a falling gas price environment, fuel cost pass through should be more easily achieved compared to a rising gas price environment	
Huaneng Power International	Independent Power Producers & Energy Traders	14.4	8.53	32%	Buy		✓				✓					65% Coal, 4% Gas	Coal is required to boil water, which drive steam turbines, which in turn generates power. Hence higher coal prices mean lower margins for power producers given the on-grid tariff is not a flexible mechanism. Gas works in a similar fashion	

Source: UBS. This table has been extracted from APAC Equity Strategy note "Commodity crunch: Asia's earnings beneficiaries" dated 20 October 2014

Figure 16: Stock implication of deflation – continued

Name	Sub-Industry	Mkt Cap (USD bn)	Price	Upside to PT	UBS rating	positive (✓) or negative (✗) impact of falling commodity prices											Commodity Exposure	Analyst Comment
						Crude Oil	Nat Gas	Copper	Iron Ore	Steel	Coal	Aluminium	Rubber	Wheat	Corn	Cotton		
Coal and gas based utilities affected by deflation																		
China Resources Power	Independent Power Producers & Energy Traders	12.7	20.55	41%	Buy		✓				✓						67% Coal, 2% Gas	Coal is required to boil water, which drive steam turbines, which in turn generates power. Hence higher coal prices mean lower margins for power producers given the on-grid tariff is not a flexible mechanism. Gas works in a similar fashion
Datang International Power	Independent Power Producers & Energy Traders	8.3	3.91	51%	Buy						✓						70% Coal	Coal is required to boil water, which drive steam turbines, which in turn generates power. Hence higher coal prices mean lower margins for power producers given the on-grid tariff is not a flexible mechanism. Gas works in a similar fashion
Huadian Power International	Independent Power Producers & Energy Traders	5.7	5.36	31%	Buy		✓				✓						71% Coal 5% Gas	Coal is required to boil water, which drive steam turbines, which in turn generates power. Hence higher coal prices mean lower margins for power producers given the on-grid tariff is not a flexible mechanism. Gas works in a similar fashion
Huadian Fuxin Energy Corporation	Independent Power Producers & Energy Traders	4.6	4.45	30%	Buy						✓						75% coal	75% coal costs is distorting reality given very low fuel costs for renewables
China Power International Development	Independent Power Producers & Energy Traders	2.5	3.39	50%	Buy						✓						70% coal	Coal is required to boil water, which drive steam turbines, which in turn generates power. Hence higher coal prices mean lower margins for power producers given the on-grid tariff is not a flexible mechanism. Gas works in a similar fashion
Other companies																		
China Shenhua Energy	Coal & Consumable Fuels	49.7	20.85	31%	Buy	✗	✗				✗						Coal (68%) of revenue; coal price is a key driver of its revenue.	Coal is the biggest segment of its revenue. A 10% fall in coal price will cause its operating profit decrease about 16-18%.
China Coal Energy	Coal & Consumable Fuels	9.4	4.62	0%	Neutral	✗	✗				✗						Coal (83%) of revenue; coal price is a key driver of its revenue.	Coal accounts for 83% of its total revenue. A 10% fall in coal price will lead to its operating profit to decline about 27%-30%.
Yanzhou Coal Mining	Coal & Consumable Fuels	5.9	6.21	-24%	Sell	✗	✗				✗						Coal (97%) of revenue; coal price is a key driver of its revenue.	Coal accounts for 97% of its total revenue. A 10% fall in coal price will lead to its operating profit to decline about 45%-50%.
Sinopec Shanghai Petrochemical	Commodity Chemicals	5.6	2.61	11%	Buy	✗	✗										n/a	n/a
China Sanjiang Fine Chemicals	Commodity Chemicals	0.5	3.98	51%	Buy	✗											n/a	Crude oil is the ultimate feedstock for Sanjiang's product, ethylene oxide. Thus decreasing oil price could translate to a mild decrease in product selling price.
Sinopec Engineering Group	Construction & Engineering	4.7	8.24	46%	Buy	✗	✗										n/a	n/a
Yangzijiang Shipbuilding (Holdings) Ltd.	Construction & Farm Machinery & Heavy Trucks	3.3	1.1	10%	Neutral				✗	✓	✗						50% of revenue is driven by demand for bulk ships - vessels used to ship commodities. Steel is around 20% of its costs.	YZJ builds containerships and bulk vessels. Steel prices form around 20% of its costs. However, underlying demand for commodities is a more important driver of earnings as this influences demand for the vessels itself, and order books.
Yingde Gases	Industrial Gases	1.5	6.56	48%	Buy					✗							n/a	60% of Yingde's customers are steel mills, so if steel prices weaken, sentiment could be negative to Yingde's demand, even though it has offtake contract protection
CIMC Enric Holdings	Industrial Machinery	1.8	7.42	75%	Buy	✗		✓		✓	✓						n/a	A fall in oil price would narrow LNG's discount vs diesel price thus discourage the equipment demand for LNG segment.
PetroChina	Integrated Oil & Gas	229.7	9.29	17%	Neutral	✗	✓										n/a	A fall in oil price would lower E&P earnings and lead to inventory loss risks for refining, marketing and chemical segments. However, lower global gas price would mitigate some of the import losses.
China Oilfield Services	Oil & Gas Drilling	11.1	17.98	20%	Neutral	✗	✗										n/a	n/a
Anton Oilfield Services	Oil & Gas Equipment & Services	0.6	2.06	-8%	Sell	✗	✗										n/a	n/a

Source: UBS. This table has been extracted from APAC Equity Strategy note "Commodity crunch: Asia's earnings beneficiaries" dated 20 October 2014

Figure 17: Stock implication of deflation – continued

Name	Sub-Industry	Mkt Cap (USD bn)	Price	Upside to PT	UBS rating	positive (✓) or negative (✗) impact of falling commodity prices											Commodity Exposure	Analyst Comment
						Crude Oil	Nat Gas	Copper	Iron Ore	Steel	Coal	Aluminium	Rubber	Wheat	Com	Cotton		
Honghua Group	Oil & Gas Equipment & Services	0.6	1.56	47%	Buy	✗	✗			✓							n/a	n/a
SPT Energy Group	Oil & Gas Equipment & Services	0.5	2.54	128%	Buy	✗	✗										n/a	n/a
China National Offshore Oil Corporation	Oil & Gas Exploration & Production	69.3	12	21%	Neutral	✗											n/a	CNOOC is a pure upstream company, thus earnings would deteriorate under falling crude environment.
Kunlun Energy	Oil & Gas Exploration & Production	10.6	10.2	-12%	Sell	✗	✓										n/a	n/a
Dongyue Group	Specialty Chemicals	0.8	2.81	69%	Buy	✗												Dongyue is in fluorochemical - a fine chemical so less relevant to these commodities; but some of its products can be substituted by petrochemical products, thus has a positive correlation
China Modern Dairy	Agricultural Products	1.9	3.13	33%	Buy										✓		Corn; alfalfa	Corn and alfalfa used as feed for dairy cows
Belle International Holdings	Apparel Retail	9.4	8.62	-25%	Sell	✓							✓			✓	Cotton (5%), rubber (5%), crude oil (10%) and leather (35%) of costs	Cotton, rubber (5%), crude oil (10%) and leather are the key cost items. A 10% drop in commodity prices will drive operating profit up c8%. Raw materials mostly hedged.
China Communications Construction	Construction & Engineering	11.8	5.64	51%	Buy	✓											Well below 5% for crude oil or steel, others are even smaller	Although raw materials (e.g. steel) is a major cost item, but construction companies tend to renegotiate contracts should there be any unexpected change of raw materials prices.
China Railway Construction	Construction & Engineering	11.8	7.39	47%	Buy	✓											Well below 5% for crude oil or steel, others are even smaller	Although raw materials (e.g. steel) is a major cost item, but construction companies tend to renegotiate contracts should there be any unexpected change of raw materials prices.
China Railway Group	Construction & Engineering	11.8	4.29	17%	Buy	✓											Well below 5% for crude oil or steel, others are even smaller	Although raw materials (e.g. steel) is a major cost item, but construction companies tend to renegotiate contracts should there be any unexpected change of raw materials prices.
China State Construction International	Construction & Engineering	5.3	10.62	41%	Buy	✓											Well below 5% for crude oil or steel, others are even smaller	Although raw materials (e.g. steel) is a major cost item, but construction companies tend to renegotiate contracts should there be any unexpected change of raw materials prices.
China Machinery Engineering Corporation	Construction & Engineering	2.1	3.89	98%	Buy	✓											Well below 5% for crude oil or steel, others are even smaller	Although raw materials (e.g. steel) is a major cost item, but construction companies tend to renegotiate contracts should there be any unexpected change of raw materials prices.
China BlueChemical	Fertilizers & Agricultural	2	3.34	8%	Sell	✗	✓										n/a	n/a
Anta Sports Products	Footwear	5.1	15.84	20%	Buy	✓							✓			✓	Cotton (10%), rubber (20%) and crude oil (5%) of costs	Cotton, rubber, crude oil/petrochems are the key CoGS items. A 10% drop in all commodity prices would drive operating profit up c15%. Costs are partially hedged.
Daphne International	Footwear	0.8	3.76	33%	Buy (CBE)	✓							✓			✓	Cotton (5%), rubber (5%), crude oil (10%) and leather (35%) of costs	Cotton, rubber (5%), crude oil (10%) and leather are the key cost items. A 10% drop in commodity prices will drive operating profit up c8%. Raw materials mostly hedged.
Sinopec	Integrated Oil & Gas	98.6	6.51	37%	Buy	✗	✓										n/a	A fall in oil price would lower E&P earnings and lead to inventory loss risks for refining, marketing and chemical segments. However, lower global gas price would mitigate some of the import losses.
Sinopec Kantons	Oil & Gas Refining & Marketing	1.8	5.75	60%	Buy	✓											n/a	A lower oil price would stimulate oil demand thus increase Kantons' jetty throughput.
China Huishan Dairy	Packaged Foods & Meats	3.3	1.75	17%	Neutral										✓		Corn; alfalfa	Corn and alfalfa used as feed raw material for dairy cows. Huishan suggests that its own planted corn and alfalfa could meet internal demand for feed raw material soon. Thus we expect limited impact from corn and alfalfa price changes.

Source: UBS. This table has been extracted from APAC Equity Strategy note "Commodity crunch: Asia's earnings beneficiaries" dated 20 October 2014

3. SOE reformation

SOE reformation is a multi-year theme which keeps evolving.

In H1 2014, we emphasised that the reform took place first among provincial SOEs where partial privatisations and management incentives could be quickly deployed⁸ (eg, Shanghai Auto, Shanghai Int'l Port). In H2 2014, national SOEs stepped on the stage⁹ with active asset restructurings, such as the asset disposal of Datang Power, pending integration between CSR and CNR, and numerous military asset injection deals.

In 2015, we think the reform will be wide-ranging across SOEs; and the anti-corruption inspections provide a good guide on the next reform candidates.

Central inspections – guide on next reform candidates

Every year the Central Commission for Discipline Inspection and the National Audit Office send teams to inspect 15-20 SOEs. Figure 18 summarises the published inspection results in 2013-14; we believe it provides a meaningful guide to following reforms.

If corruption is discovered or big loopholes are found in the corporate management mechanism (marked in red in Figure 18), the chance of reform is close to nil and top directors are often discharged. If the inspection result focuses on business losses (marked in yellow), neither reform nor management reshuffling could take place in the following months. If the inspection does not find any issues with the SOE management or only find minor issues, such as improper employee remuneration, the reform could be initiated in the following one to two quarters.

Figure 18: Result of central inspections on large SOEs during 2013-14

SOE Group	2013/2014 audit results	Following reform / management reshuffling
Datang Group	Unapproved investment on coal chemical	Announced to spin off coal chemical business in Jul 2014
China Tobacco	No major problems	
China Nuclear Engineering Group	Grey remuneration to employees	Public listing plan announced in May 2014
China Aerospace Science and Technology Corp.	Heavy losses of overseas investment	
China Aerospace Science & Industry Corp.	No major problems	
China State Shipbuilding Corp.	Understating profits	Asset injection plan (to GZ Shipyard) announced in Apr 2014
China South Industries Group	Heavy losses of solar and overseas business	
China National Petroleum Corp.	Improper project procurement	Officials involved arrested; pipeline and other assets to divest
China Shipping Group	Improper fuel and vessel procurement	Officials involved arrested
China Resources Group	Improper project procurement	Officials involved arrested
China Metallurgical Group Corp.	Heavy losses	
China Three Gorges Corp.	Improper project procurement	Chairman and CEO removed
COFCO	No major problems	Designated to launch state asset holding reform
FAW Group	Sell government positions	Officials involved arrested

Source: Central Commission for Discipline Inspection and the National Audit Office, people.cn, the following reform measures are compiled by UBS Securities

⁸ SOE reform breakthroughs and implications, 30 Oct 2013; Reformation, SOE bad it is good, 30 Apr 2014

⁹ Reformation: National SOEs go on stage, 16 Jul 2014

If history serves as a useful guide, the next SOE reform candidates will likely appear on the list of the latest round of inspection, which started in November 2014 (see Figure 19). Among them, we like China Southern Airlines, Huadian Power and Dongfeng Motor also due to their solid fundamentals. We believe the reform potential could be an added reason to invest in these companies.

Figure 19: SOEs undergoing the latest round of central government inspection (starting in November 2014)

Group	Largest H-share subsidiary	Ticker	UBS Rating
China Southern Air Holding Company	China Southern	1055.HK	Buy
China State Shipbuilding Corporation	Guangzhou Shipyard	0317.HK	NR
China Unicom	China Unicom	0762.HK	Buy
China Shipping Group	China Shipping Container	2866.HK	Neutral
China Huadian Corporation	Huadian Power	1071.HK	Buy
Dongfeng Motor	Dongfeng Motor	0489.HK	Buy
Shenhua Group	China Shenhua	1088.HK	Buy
Sinopec Group	Sinopec	0386.HK	Buy

Source: <http://www.ccdi.gov.cn/>; UBS

Future reform candidates will likely appear among those passing the central government inspection

What reforms to expect in the future?

Adjusting SOE directors' salaries

Chinese official media reported a new remuneration framework for SOEs to start in 2015¹⁰. The total salary of government-appointed directors is to be capped at under six times that of average employees, plus incentive bonus of up to 30% of salary. This could be substantially lower than many directors' current total package, which is often about 12 times the remuneration of average employees. However, the professional managers hired from the market are not subject to these rules.

Encouraging employee shareholding as a path of partial privatisation

The China Securities Regulatory Commission (CSRC) issued guidance on employee share incentives in June 2014. Since then, four SOEs have launched such programmes. For instance, Shanghai Int'l Port (600018.SS) announced its intention to issue Rmb1.82bn worth of shares to around 72% of its employees. The raised capital will be used to repay bank loans, which would shave about Rmb90m off interest expenses per annum. Similar plans have been proposed by Minsheng Bank and are being considered by state-owned banks.

Central government promoting mixed ownership

A senior official of the State-owned Assets Supervision and Administration Commission (SASAC) revealed in November 2014¹¹ that the central government would announce steps to promote mixed ownership. Many SOEs are currently hesitant to sell stakes to private enterprises in the fear of being accused of eroding state assets. Clear-cut guidance on what they can sell and at what valuation would be very helpful to speed up public-private collaborations.

¹⁰ <http://ccnews.people.com.cn/n/2014/0902/c141677-25590032.html>

¹¹ <http://www.nbd.com.cn/articles/2014-11-21/877534.html>

Establishing more state asset-holding platforms to restructure non-performing SOEs

In July 2014, the SASAC announced the first batch of state asset-holding platforms – SDIC (parent company of SDIC Huajing Power, 600886.SS) and COFCO Group (parent company of and China Foods 0506.HK and China Agriculture 0606.HK). These platforms are proactively consolidating some non-performing state-owned assets, such as a loss-making fruit juice producer SDIC Zhonglu (600962.SS) and a white liquor brand Jiugui (000799.SZ).

These platforms have their unique advantages. Unlike private companies, they could acquire SOEs below book value. And they enjoy the full support of policy banks to finance M&A deals. Our previous research¹² indicated that other SOEs are likely to be selected as future state asset-holding platforms, such as China Merchants Group (parent company of China Merchants, 0144.HK), China Reform Holdings, and China Chengtong.

Reform impact to manifest in capex and expense reduction

The SOE reformation can take many forms, including privatisation by employees or private companies, management incentive programmes, asset restructuring and M&As, breaking-up monopolies, etc. The market response to one-off reform news about asset restructuring is usually positive but short-lived. A sustainable re-rating of SOE stocks usually requires visible improvement in corporate financial indicators. In 2015, we think a visible impact of the reform is the capex reduction and the consequent improvement in cash flow and financial gearing.

We highlighted in our review of 2014 interim results¹³ that SOEs' net gearing declined for the first time since 2010, especially in the coal, utilities and transport sectors. Moreover, the revenue of SOEs declined 6.1% HoH in H114 but EBIT improved 9.1%. We attributed this to the anti-corruption campaign, which discourages unnecessary expenditure and capex. Such a trend will probably continue in 2015, with the anti-corruption becoming more systematic and putting more SOEs under scrutiny¹⁴.

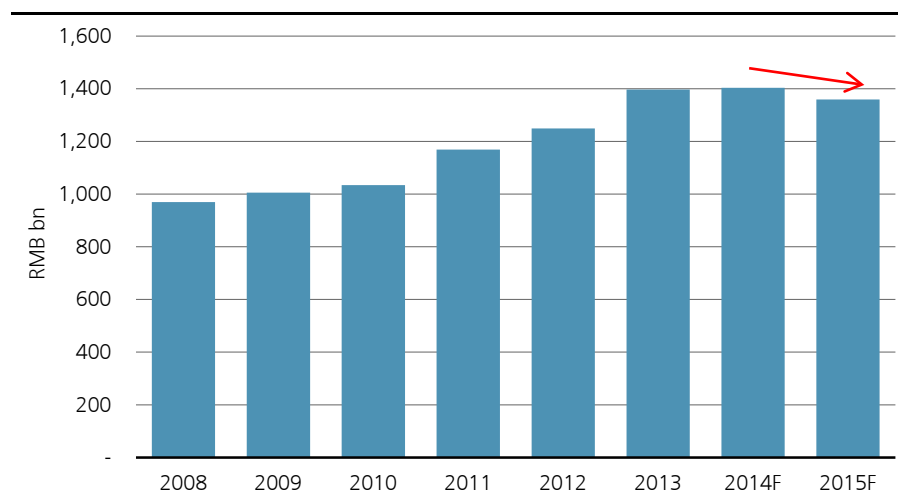
The total capex of members of the MSCI China index turns flattish in 2014F and the consensus expectation is for a 3% decline next year (see Figure 20). The capex reduction is no longer selective, but across the board (see Figure 21). Especially in transport, utilities, and coal sectors, company managements have guided for prudent capex in 2015 and consensus forecasts suggest a more than 2.5% decline in capex/revenue ratio.

¹² Reformation: National SOEs go on stage, 16 Jul 2014

¹³ MSCI China H114 interim results review - giving more credit to SOEs, 10 Sep 2014

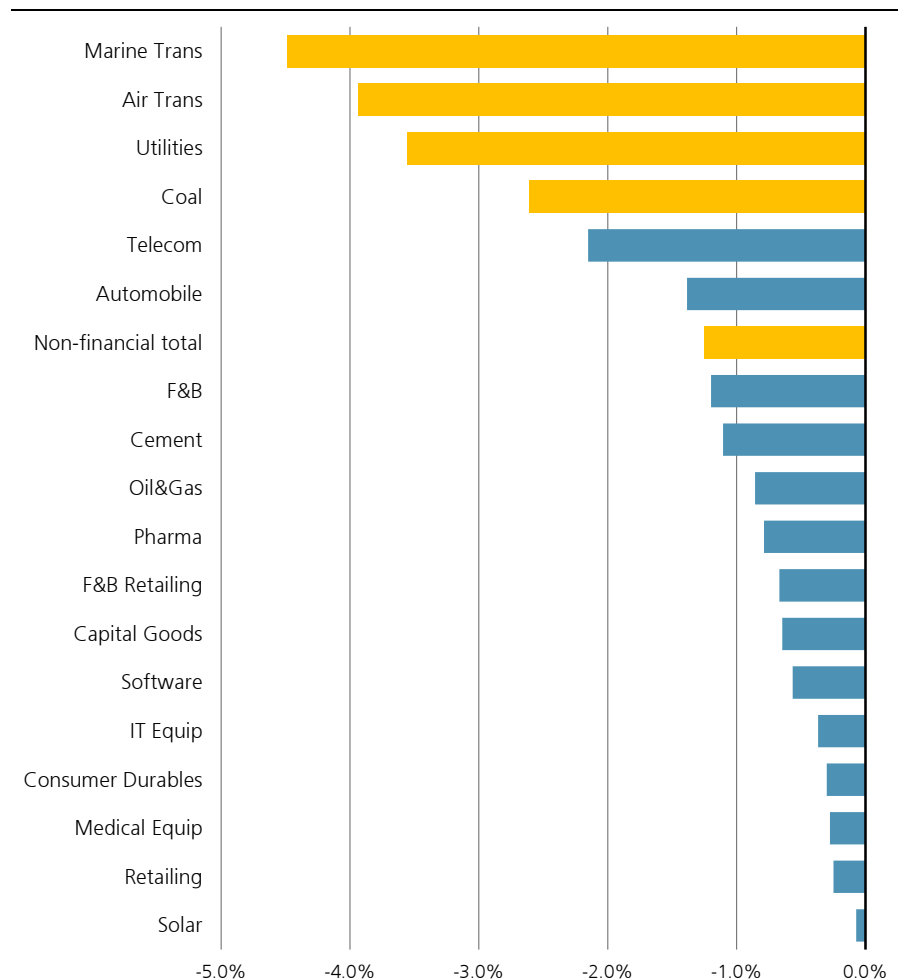
¹⁴ Is anti-corruption less of a drag on consumption stocks after the 4th Plenum?, 27 Oct 2014

Figure 20: Total capital expenditure of MSCI China excl financials (Rmb bn)



Source: Datastream

Figure 21: MSCI China sector capex as % of revenue (2015F versus 2014F)



Source: Datastream

The capex reduction could be universal next year, for the first time in over a decade

An updated list of reform beneficiaries

We published lists of SOE reform beneficiaries in our SOE reformation theme initiation report on 30 April 2014, including Sinopec, Guangzhou Automobile, Shanghai Pharmaceuticals, China Agri Industries, and SAIC Motor.

We update the list of SOE reformation beneficiaries below, based on the following criteria: 1) relatively visible reform potential; 2) UBS rating as Buy or Neutral; and 3) inspected or being inspected by central government for potential corruption (see Figure 22).

Figure 22: Potential reform beneficiaries under UBS research coverage

Name	Ticker	Remark on reform potential	UBS Rating	Sector	Mkt cap (US\$ mn)	2015E PE	2015E EPS Gr	2015E PB	2015E ROE (%)	2015E Div Yield (%)
China Agri-Indus	0606.HK	Potential asset injection from parent company	Neutral	F&B	1,970	11.2	n.a.	0.5	4.6	2.2
China Merchant	0144.HK	Potential candidate for a state asset holding platform	Buy	Transportation	8,507	13.9	8%	1.1	8.2	3.3
Zhuzhou Csr-H	3898.HK	Potential consolidation of CNR and CSR	Buy	Capital Goods	5,055	13.7	1%	2.5	19.8	2.3
Sinopharm-H	1099.HK	Pioneer of mixed ownership reform and a consolidator in pharmaceutical industry	Buy	Medical Equip	10,027	16.5	21%	2.2	13.8	1.8
Huadian Power-H	1071.HK	Breaking-up monopoly in power transmission and distribution	Buy	Utilities	6,848	8.2	-18%	1.3	16.0	4.9

Note: Above data as of 1 December 2014

Source: UBS estimates

4. Under-penetrated consumption sectors

Against the backdrop of a slowing economy, we believe growth lies in sectors exposed to Chinese consumption. We compare 40 items' penetration rates in China and the world (see Figure 23) and identify at least 10 under-penetrated sectors which we think could deliver double-digit growth in the next three to five years¹⁵.

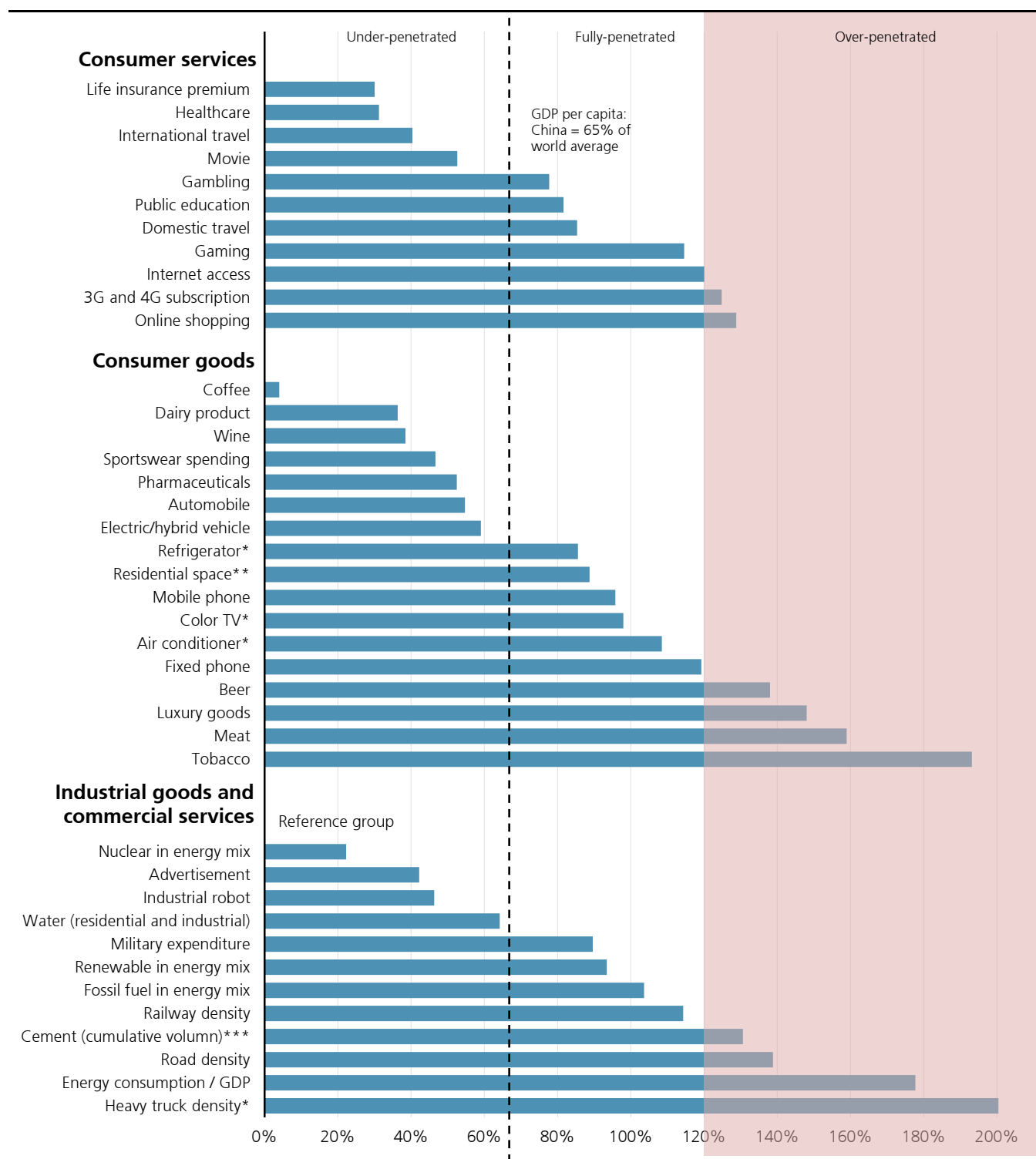
These under-penetrated sectors' growth will be driven primarily by: 1) Chinese consumers' rapid income growth (10.5% in Q1-Q3 2014); 2) under-utilised credit in Chinese households (China is half of the OECD average in terms of household debt as percentage of GDP); and 3) the narrowing gap between domestic and imported goods.

Additionally, China's specific circumstances, such as a large and aging population (more "silver-hair" consumption), strong work ethic and long working hours (more online shopping, mobile game, etc), severe pollution (increasingly use clean energy and demand for environment protection), and cultural influence (emphasis on education) will also shape and boost the development of consumer sectors.

- (1) Consumer services are mostly under-penetrated.** We think this is mainly due to the lack of human resources to provide premium services. As more and more highly-educated graduates enter the labour market, these under-penetrated consumer service sectors will likely have the adequate support for rapid growth. Life insurance, healthcare, outbound travel and movie services are typical under-penetrated service sectors.
- (2) Many consumer goods are fully-penetrated.** China, as the "world factory", enjoys an ample supply of consumer goods. With the rapid economic growth during the past 10 years, urbanization, and policy support or government subsidies, many consumer goods, eg, home appliances, have entered most households and reached higher-than-world-average penetration. We expect players in the fully-penetrated sectors, such as property development, beverage manufacturing, and gaming will face increasing competition and industry reshuffling.
- (3) Industrial goods are over-penetrated.** China's previously high growth rate, which has leaned heavily on investment, has led to a better transport infrastructure, heavier usage of building materials, and a larger fleet of wheel-loaders and construction machines. However, we believe the penetration rate of these over-penetrated industrial goods sectors will gradually converge to the global average, as China transfers to a more consumption-driven economy.

¹⁵ China H-share Strategy - Seeking growth in under-penetrated consumption sectors, 29 Oct 2014

Figure 23: Penetration rate comparison between China and the world (unless otherwise defined, penetration rate is defined as per capita ownership of durable goods, and per capita consumption of non-durable goods and services)



Source: World Bank, OICA, CEIC, CIA World Factbook, Euromonitor, China Daily, OECD, Wind, Scientific American, Qianzhan.com, BP, China Energy News, China Development Strategy Institute for Building Materials Industry, Zenithoptimedia, WHO, University of Washington, China Livelihood development report, , Department of Commerce, IMS Health, USDA, Fondazione Altagamma and Bain & Company, iResearch, eMarketer, Newzoo, MPAA, World Travel & Tourism Council, Swiss Re, GBGC Global Gambling Report, MobiThinking, Centre for Solar Energy and Hydrogen Research Baden-Württemberg, Macau DICJ, National Bureau of Statistics of China, Company data, UBS estimates

Notes: *China versus US. **China versus the average of US, UK, Spain, South Korea, Japan, and France. ***China versus the average of UK, Japan, West Germany, France, South Korea, and Taiwan in their peak years of construction. Detailed definition, source and raw data are available upon request.

(1) Typical under-penetrated sectors with high growth potential: drugs, life insurance, autos, outbound travel, advertising, movies, robot, and nuclear power

We believe there are three types of sectors, based on their penetration and growth potential

We think these sectors could deliver double-digit top-line growth as long as the current leaders maintain their position. Their growth should be supported by increasing demand, innovation, and improvement of productivity. Our most-preferred companies under this category include Baidu, Great Wall Motor, iKang Healthcare, CSPC Pharma, Ping An Insurance, Huadian Fuxin, and Huaneng Renewable.

(2) Typical fully-penetrated sectors looking for differentiation: F&B and home appliances

These sectors' penetration rates are at similar level to the world average. The underlying companies may no longer achieve high growth. Their growth will likely hinge on their ability to differentiate themselves from competitors, via new product development and innovative business strategies, etc.

Among these sectors, TingYi (Key Call Buy) is our F&B analyst's top pick, Want Want and Tsingtao Brewery are her least-preferred names. Haier Electronics and Gome have Buy ratings.

(3) Fully-penetrated sectors with sustained growth: education, gaming, gambling, and renewable energy

Although these sectors have already reached full-penetration in China, we think their growth will be sustainable and supported by aforementioned China-specific circumstances.

UBS analysts think Sands, Huadian Fuxin, Datang International, and Huaneng Renewable will remain on a decent growth trajectory, but they dislike Tian Ge Interactive.

Combining UBS ratings and previous analysis, we select a list of Buy-rated stocks in under-penetrated sectors and Neutral-rated stocks in over/fully-penetrated sectors that could see sluggish growth for years to come (see Figure 23).

Figure 24: Companies we like in under-penetrated sectors, dislike in over/fully-penetrated sectors, given China-specific factors

Sector	Name	Ticker	Mkt cap (US\$ mn)	UBS Rating	Upside to Target Px	2015E PE	2014E EPS Gr (%)	2015E EPS Gr (%)	2015E PB	2015E ROE (%)	2015E Div Yield (%)
Companies we like in the under-penetrated sectors:											
Advertisement	Baidu	BIDU.O	82,672	Buy	13%	26.8	27%	36%	7.1	30.8	-
Automobile	Great Wall Motor	2333.HK	17,509	Buy	5%	8.7	-1%	30%	2.2	28.3	3.5
Gambling	Sands China	1928.HK	46,014	Buy	21%	14.7	23%	16%	6.7	47.0	6.7
Healthcare services	iKang Healthcare	KANG.O	1,217	Buy	26%	33.7	57%	58%	3.6	14.8	-
Pharmaceuticals	CSPC Pharma	1093.HK	4,891	Buy	27%	22.6	33%	30%	4.1	19.5	-
Home appliance	Gome	0493.HK	2,524	Buy	82%	9.8	47%	25%	1.0	10.3	4.1
Life insurance	Ping An Insurance	2318.HK	70,229	Buy	34%	10.5	31%	4%	1.7	19.1	1.7
Renewable energy	Huaneng Renewable	0958.HK	3,051	Buy	37%	12.5	-22%	87%	1.2	10.0	1.6
Renewable/Nuclear	Huadian Fuxin Energy	0816.HK	4,106	Buy	47%	10.0	34%	21%	1.4	16.2	2.0
Companies we dislike in the over/fully-penetrated sectors:											
Telecom	China Mobile	0941.HK	241,409	Sell	-19%	15.9	-11%	-14%	1.7	10.7	2.7
Beer	Tsingtao Brewery	0168.HK	9,582	Sell	7%	25.1	12%	8%	2.8	11.9	1.3
Online entertainment	Tian Ge Interactive	1980.HK	664	Neutral	28%	13.0	-93%	18%	1.7	14.1	-

Note: Above priced as of 1 December 2014.

Source: UBS estimates

5. 13th Five-Year-Plan

The drafting of the 13th Five-Year-Plan (2016-2020) started in April 2014 and will be finalised in 2015. The aim is to set a growth strategy for the whole nation and every major industry. By convention, the final document will be announced and reviewed at the People's Congress in March 2016. Throughout 2015, there will be plenty of policy discussions around the five-year-plan, sending mainly positive signals to the stock market, in our view.

Within the reform context, we think overall the government will likely reduce its intervention in economic development. But in the sectors relying heavily on government spending, such as infrastructure, energy and environment protection, the Five-Year-Plan will remain a useful reference of sector CAGR till 2020.

The early-stage plans are already available in some sectors. Based on the available information, we find the 13th Five-Year-Plan indicates high growth (>15% CAGR) in subway, nuclear, wind and solar power, and industrial robots. Some mega-projects in selective regions are looming.

Mega-projects in selective regions

In September 2014, Premier Li Keqiang convened with the drafters of the national 13th Five-Year-Plan and requested a batch of mega-projects of national significance and in favour of economic transition be planned. The NDRC later proposed the development of three regions as the "national strategy" – Silk Road, Yangtze-River Belt, and Greater Beijing¹⁶. We sense that in the future years, only selective regions will receive strong support from the central government to build mega-projects. The infrastructure is already quite good in many coastal regions and heavy investment may no longer be in dire need.

The development in the regions along the Silk Road, Yangtze-River Belt, and in Greater Beijing matches the objective of economic transition to upgrade exports and absorb excessive manufacturing capacity. We think the mega-projects in the 13th Five-Year-Plan may focus on the roads and railways in west China (eg, Xinjiang as a section of the Silk Road), ports in North China (eg, Dalian in the Greater Beijing region), and heavy industry upstream of the Yangtze River (eg, Chongqing and Sichuan).

Subway – mileage under operation to quadruple by 2020E

By the end of 2013, 19 cities had 2,073km of subway under operation. According to the 13th Five-Year-Plan, the Ministry of Transport and various cities, the mileage under operation will reach 8,000km in 2020. Big cities like Beijing and Nanjing plan to extend their subway length by two to three times. Around 40 mid-sized cities with more than 1m residents could all commercially justify subway construction. On a recent field trip, UBS analyst Edwin Chan found that major subway constructors BRC, BRCC and CSCE were all very optimistic on the subway market's outlook. Their new orders from subways grew 33%, 91%, and 60% YoY in Q1, Q2, and Q314, respectively¹⁷.

We expect the 13th Five Year Plans to guide for high growth (>15% CAGR) for subway, nuclear, solar and wind power, and industrial robots

Mega-projects in the 13th Five-Year-Plan may focus on roads and rails in West China, ports in North China and heavy manufacturing upstream of the Yangtze River

¹⁶ http://finance.ifeng.com/a/20141113/13273113_0.shtml

¹⁷ Beijing Urban (1599.HK, Buy) - Higher convictions post mgmt. meetings with Beijing Urban, CRG, CRCC and CSCE, 16 Nov 2014

Wind and solar power: 15%-plus CAGR during 2014-20E

An energy industry planning document was released by the State Council in November 2014¹⁸. The document requires the coal consumption in the energy mix to reduce to less than 62% in 2020, from 65.7% in 2013. Wind and solar power will both grow fast. The 2020 targets of 200GW for wind power and 100GW for solar power represent 15% and 31% CAGR, respectively, of installed capacity. We note the wind power tariff is already close to the coal-fired electricity tariff. Without a heavy reliance on government subsidies, wind power should generate steady growth in the next few years.

Nuclear power: 20% CAGR till 2020E

The preliminary plan sets the 2020 nuclear power capacity target at 58GW¹⁹. It represents installed capacity CAGR of 21% during 2013-20. To some extent, market concern was alleviated by the suspension of new nuclear power project approval after the Fukushima Nuclear Accident in 2011. UBSS analyst Benson Li estimates nuclear equipment demand to reach Rmb320bn in the next five years.

Industrial robots: penetration rate to triple by 2020F

A senior official of the Ministry of Industry highlighted in a conference in July 2014²⁰ that China's penetration rate of industrial robots significantly lagged behind the global average (see Figure 23). He revealed that in the 13th Five-Year-Plan, the government targeted to build three to five world-leading industrial robot manufacturers and to triple the penetration rate by 2020.

Water facilities – incremental capacity to double

In May 2014, the State Council decided to start 172 major projects on water facilities during 2014-20. As of September 2014, 40 of these projects are under construction; 44 are planned to start by the end of 2015; and the remaining 88 will commence during 2016-20²¹. Currently the water facilities around the country have a total water supply capacity of 700bn cubic metres. These projects will add new capacity of 80bn cubic metres in the 13th Five-Year-Plan, versus the incremental capacity of about 40bn cubic metres in the 12th Five-Year-Plan.

Petrochemical – current plan seeming too optimistic

The early draft in September 2014 suggests that the capacity of coal chemical products will surge from 9.15m tonnes in 2013 to 89.29m tonnes in 2020²². This compares with the view of UBS analyst Peter Gastreich²³ that the coal-to-gas capex will peak out after 2017. Peter's caution seems well warranted following the recent slump in crude oil prices. If the government reduces its 2020 target next year, the negative newsflow will remain an overhang to the sector.

¹⁸ <http://politics.people.com.cn/n/2014/1119/c1001-26053481.html>

¹⁹ http://news.xinhuanet.com/energy/2014-11/20/c_1113328638.htm

²⁰ <http://www.robot-china.com/news/201407/10/12014.html>

²¹ http://www.chinadaily.com.cn/hqsj/hqlw/2014-05-23/content_11733043.html

http://news.gmw.cn/2014-09/11/content_13158775.htm

²² http://news.cnstock.com/news/sns_bwxx/201409/3175596.htm

²³ Q-Series®: Will a coal-to-gas boom eventually go bust? 23 Aug 2013

Electric vehicles – ambitious but uncertain growth target

The Minister of Science and Technology claimed in September 2014 that a five-year-plan had already been drafted for the development of electric vehicles²⁴. The government will subsidise R&D and incentivise parking lots to install charging posts. The latest official target is to sell 1m new energy vehicles by 2020 versus the sales of around 50,000 units this year. In our view, the industry is still in its infancy. The growth in future years could easily exceed 100% per annum but the uncertainty is also very high.

²⁴ http://www.cnautonews.com/pl/zl/201409/t20140918_326051.htm

6. Chinese ADRs

The US-listed Chinese companies, most of which are in the form of ADRs (American Depositary Receipts), are actively traded but under-owned. Many investors do not realise the ADRs aggregate market cap represents more than 28% of the Hong Kong-listed Chinese companies. Given the accelerating pace of China's capital account opening, the ADRs have received increasing interest from mainland Chinese investors. In 2013 and Jan-Nov 2014, the MSCI Overseas China index (of which most constituents are ADRs) surged 75% and 21%, respectively. We expect the ADRs to sustain this outstanding performance in 2015.

We like ADRs for three reasons. First, the potential MSCI inclusion will result in large capital influx into this space. Second, the ADRs as a whole have a low correlation to the A-share index and they are thus a good destination for Chinese investors to diversify assets. Third, the ADRs are concentrated in new economy sectors and trade at an attractive PEG ratio.

Regulators open up overseas assets to Chinese investors

The conventional vehicles for mainland Chinese to invest overseas are limited. Each citizen has an annual quota of US\$50,000 to exchange into foreign currencies. They can then wire the money to any overseas accounts, which are not easy to open for non-professionals. Alternatively, they can subscribe to QDII funds, which domestic institutions distribute and manage. However, most QDII funds do not perform well due to a lack of understanding of global markets and some simply allocate capital on exchange-traded funds (ETFs).

In 2014, the regulators liberalised a few new outbound investment vehicles. First, the Hong Kong authority scrapped the daily renminbi conversion limit of Rmb20,000 for local residents in November 2014. The unlimited conversion could increase the size and liquidity of the offshore renminbi market. Second, the Shanghai-Hong Kong Stock Connect also commenced in November to allow mainland investors to trade HK-listed companies. Third, in October the central bank claimed to be engineering a QDRI (Qualified Domestic Retail Investors) programme to allow direct investment in overseas equities and real estate²⁵.

Apart from these official programmes, Chinese high-net-worth-individuals and hedge funds have already found their own ways to transfer assets overseas. A large proportion of such official and unofficial overseas investment goes to US equities.

Potential MSCI inclusion

In October 2014, MSCI announced two proposals to include Chinese ADRs in MSCI Global indexes²⁶. In the first proposal, Chinese ADRs will be included in only MSCI Global indexes, including MSCI ACWI and MSCI EM. In the second proposal, Chinese ADRs will be included in both the MSCI Global and MSCI China index. The consultation ended on 28 November 2014 and the MSCI Inc. may disclose the result in late-December 2014 or early-January 2015. The actual implementation will likely take place in June 2015 after the annual review of MSCI indices.

Market cap of ADRs already amounts to US\$540bn, equivalent to 28% of HK-listed Chinese companies

We like ADRs for three reasons:

- 1) Potential MSCI inclusion**
- 2) Low correlation to A-shares**
- 3) PEG of only 0.77x**

QDRP is likely the next big programme to allow Chinese to invest overseas

²⁵ <http://finance.sina.com.cn/china/20141009/182920494932.shtml>

²⁶ China H-share Strategy - Potential MSCI inclusion of Chinese ADRs, dated 27 Oct 2014

ADRs would account for 16% of MSCI China index weight in the second proposal. And, the IT sector's weighting would rise from 13% to 23%, even higher than that of banks (see Figure 25). We think few Chinese fund managers currently have so much exposure to this space. In other words, ADRs are underweighted.

ADRs are now underweighted, as they would account for 16% of MSCI China index weight after inclusion

Figure 25: Potential impact of Chinese ADR inclusion into MSCI China index

Eligible companies		MSCI China sector weight				MSCI China valuation	
			#Const.	Weight	#Const.	Weight	Bloomberg consensus
Baidu	Leju	Energy	9	11.3%	9	9.5%	Now
Alibaba	Sohu.Com	Materials	11	2.5%	11	2.1%	
Jd.Com	Bitauto	Industrials	25	6.7%	27	5.7%	
Ctrip.Com	21Vianet	Consumer Disc	14	5.0%	21	8.3%	2015E PE
NetEase	Home Inns	Consumer Staples	10	4.6%	10	3.9%	2014E EPS gr
Qihoo 360	Tal Education	Health Care	8	2.4%	8	2.0%	2015E EPS gr
Vipshop	58.Com	Financials	38	38.2%	38	32.0%	After inclusion
Sina Corp	Seaspan	IT	9	13.5%	22	23.3%	
New Oriental	Autohome	Telecom	5	11.8%	5	9.9%	
Jumei Intl	51Job	Utilities	10	4.1%	10	3.4%	2015E EPS gr
Youku Tudou	Soufun	Total	139		161		

Note: Above data as of 1 December 2014.

Source: potentially eligible stock lists from MSCI Inc.; index weight and valuation changes estimated by UBS Securities; Bloomberg

If the MSCI inclusion of ADRs is accepted by the investment community, it may cause a large fund influx into Chinese ADRs. As disclosed by MSCI, the size of funds benchmarked to the MSCI EM index is around US\$1.3trn and those benchmarked to MSCI Asia index amount to around US\$360bn. We estimate the inclusion of ADRs may lead to at least US\$25bn funds being allocated to Chinese stocks.

It is noteworthy that the inclusion of ADRs in the MSCI carries a heavier weight than the inclusion of Chinese A-shares. The former raises the country weight of China in the MSCI EM index by about 2.2%; the later by 0.6%.

Low correlation with A-share market

We have pointed out in previous research²⁷ that asset diversification is a major objective for Chinese to invest overseas. US equities, Australian real estate, Hong Kong high yield bonds have been popular destinations for such investment in the past one to two years. A common feature of these assets is the low correlation to the local A-share stock market.

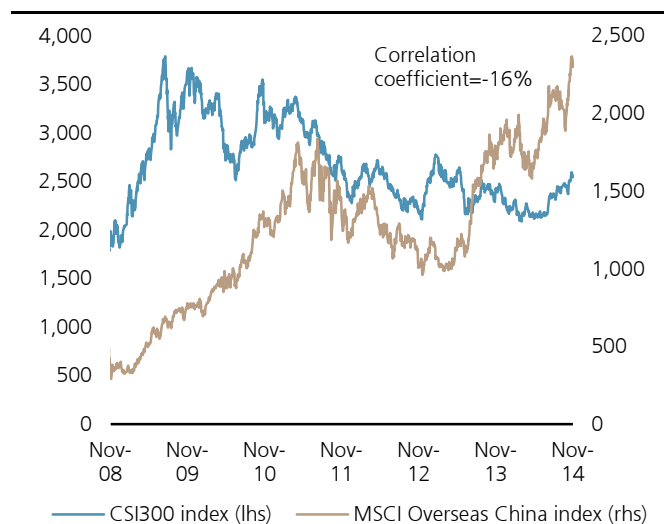
ADRs are attractive to mainland investors for a similar reason. A big part of Chinese investors' existing portfolios include A-share stocks. They thus have a low appetite for assets such as Hong Kong equities, which are highly correlated to the A-share market. Indeed, the Shanghai-Hong Kong Stock Connect fails to attract much southbound interest in trading Hong Kong equities (only 6.1% quota utilised in the first week after launch).

ADRs are negatively correlated to A-shares; therefore, they effectively diversify Chinese investors' portfolios

²⁷ Unconventional thinking about MMA, dated 26 2014

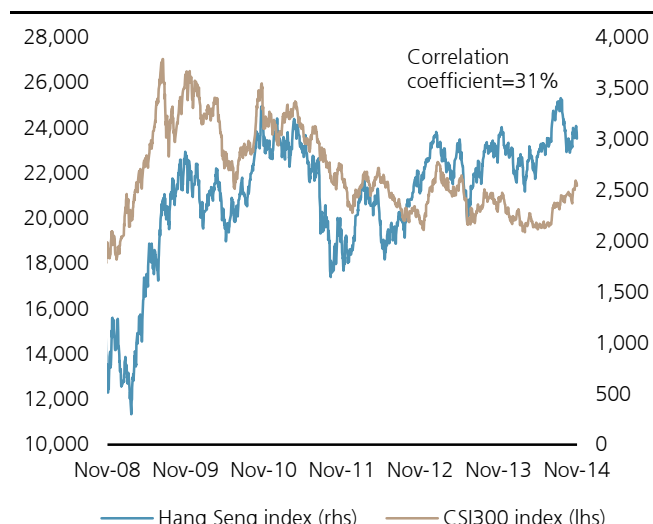
Compared with Hong Kong equities, the correlation of ADRs to A-shares is much lower (see Figure 26). Besides, ADRs are more actively traded than Hong Kong equities. Their annual turnover/market cap is 3.2 times, close to 2.8 times for A-share mid/small-caps and much higher than 0.5 times for HK equities. It thus well fits the investment habits of both Chinese institutional and retail investors, who typically have a short holding period and pursue new themes every few weeks.

Figure 26: China ADRs have much lower correlation with A-share market...



Source: Bloomberg

Figure 27: ...than Hong Kong equities

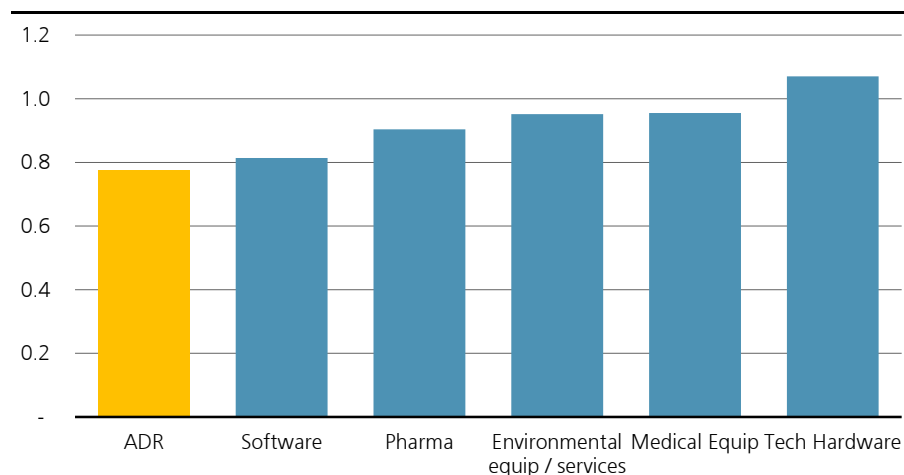


Source: Bloomberg

Reasonable valuation

Chinese ADRs as a whole are trading at a reasonable valuation. The 61 Chinese ADRs with market cap greater than US\$500m have an aggregate 2015 consensus PER of 32x. The high PER is primarily due to the sector bias of ADRs. Most of them are engaged in high-growth businesses such as internet, media and healthcare. The Bloomberg consensus EPS growth of ADRs is 48%, 39% and 41% in 2014-16F. On a PEG basis, the ADRs' valuation is below other HK-listed growth sectors (see Figure 28).

Figure 28: Growth sectors PEG ratio (2015F P/E divided by 2014-16F EPS CAGR)



Source: Bloomberg, Datastream

Sector outlook and weighting

We recommend the following sector weighting changes, based largely on valuations and two macro themes discussed in the previous session: 1) declining corporate funding cost, and 2) deflation.

- Upgrade real estate and capital goods to Overweight,
- Upgrade transport to Neutral
- Downgrade consumer staples and commercial services to Underweight
- Downgrade energy and tech hardware to Neutral

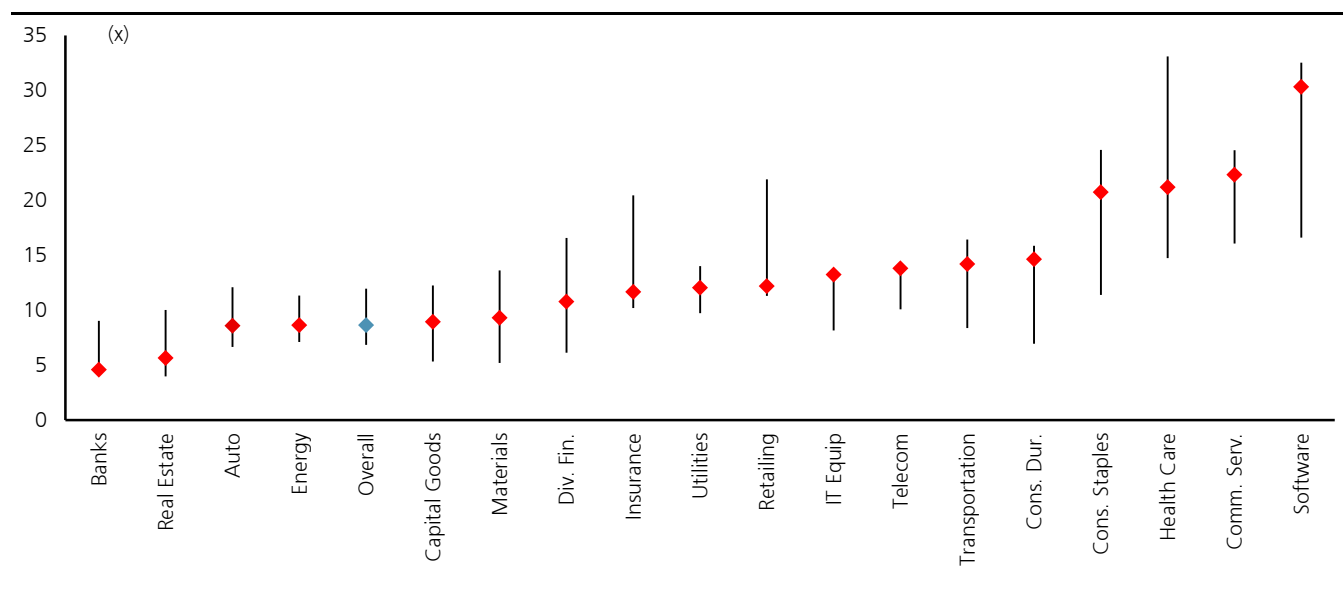
Figure 29: UBS sector recommendations and valuations

Sector	Rating	2015F PE	2015F EPS Gr	2015F PB	Rating rationale
Energy	OW → UW	8.8	-1%	1.0	Downside risk of gas pricing and demand has not been fully priced in
Materials	Neutral	9.5	18%	0.9	Deflation positive to input cost, but selling price also under pressure due to excessive capacity
Industrials		8.6	18%	0.9	
- Capital Goods	UW → OW	7.6	17%	0.9	Subway mileage to quadruple by 2020; rail equipment exports; likely mega-projects in 13th FYP
- Commercial & Prof Services	Neutral → UW	22.5	32%	3.1	Stretched valuation cannot be justified by ~10% ROE of waste and water treatment projects
- Transportation	UW → Neutral	13.4	28%	1.0	Benefit from fuel cost deflation; but demand growth remains lukewarm
Consumer Discretionary		10.8	20%	1.8	
- Automobiles & Components	OW	9.1	20%	1.6	Sustainable growth due to low penetration; beta play in consumer space if property sales recover
- Consumer Durables & Apparel	Neutral	14.8	18%	3.0	Imported products and foreign brands now easily reach low-tier cities on arrival of e-commerce
- Retailing	UW	11.4	18%	1.6	Online shopping accounts for one-tenth of retail sales; offline retail space in excessive supply
Consumer Staples	Neutral → UW	20.2	24%	2.2	Quality issue of local F&B; e-commerce allows foreign brands to proliferate in low-tier cities
Health Care	OW	20.8	21%	3.1	Product-driven high profit growth; immune from macro policies; mid/small-caps fit market style
Financials		5.5	8%	0.9	
- Banks	Neutral	4.6	7%	0.8	Benefit from rate cut to enhance balance sheet; but NIM still under pressure
- Diversified Financials	Neutral	10.2	20%	1.2	Benefit from rate cut but margin financing business is unsustainable due to capital constraint
- Insurance	OW	12.2	13%	1.7	Benefit from rate cut and product mix is improving
- Real Estate	Neutral → OW	6.0	9%	0.7	Lower credit risk of developers; property sales to recover on more and cheaper mortgage loans
Information Technology		24.5	23%	5.4	
- Software & Services	OW	29.6	28%	8.4	Chinese ADRs to benefit from MSCI inclusion and outbound investment of mainland investors
- Technology Hardware & Equipment	OW → Neutral	13.7	13%	2.1	Unfavourable product cycle; growth of major products to be in low-single-digit in domestic market
Telecommunication Services	UW	14.0	3%	1.5	4G subscriber addition does not translate into APRU increase; heavy capex
Utilities	Neutral	12.5	13%	1.9	IPPs still enjoy high yield; but home connection growth of gas utilities faces downside risk
MSCI China		8.8	8.8%	1.2	
- ex Banks		11.7	9.9%	1.4	
ADRs (not included in MSCI China)		33.1	39%	6.7	

Note: Above data as of 1 December 2014.

Source: Datastream, Bloomberg, UBS estimates

Figure 30: MSCI China 12-month forward PE ratio versus historical high and low (2011-13)



Note: Above data as of 24 November 2014.
Source: Datastream

Top-down view of Overweight sectors

Insurance

We are a bit surprised at the insurance sector's underperformance during most of this year, until the interest rate cut on 22 November 2014. The sector fundamentals are actually very strong. The insurance premium growth accelerated from 11.2% YoY in 2013 to 18.3% during January-October 2014. The annualised investment yield of above 5% reached a new high since 2009, thanks to the widened investment scope and the bull market in local bonds and A-share equities.

The market's concern on the insurance sector probably relates to balance sheet quality. Indeed insurance companies do have heavy exposure to corporate bonds and commercial property project financing. In particular, Ping An Group owns the largest trust company in China and an SME-oriented commercial bank.

The interest rate cut in November 2014 partially relieved concerns about insurance companies' asset quality. A relaxed monetary environment will allow corporates to refinance more easily and at a lower cost. The rate cuts also reduce the pressure on bancassurance, which has limited product differentiation with bank deposits.

We rate the insurance sector as Overweight on the expectation of continuous monetary easing, as well as the improvement in portfolio mix and NBV growth into 2015 for leading insurers.

Real estate

We hold a more bullish view than UBS sector analyst Eva Lee. Eva believes the oversupply issue will persist in 2015, albeit a slight improvement from 32% to 24% in the excessive supply ratio²⁸. She is concerned about the inevitable gross margin compression and operational challenges for developers to manage funding cost, inventory and asset turnover.

We very much agree with Eva's earnings forecast. Our top-down perspective focuses more on the valuation re-rating potential due to the rising risk appetite of the overall market. In our view, the property sector is one of the best places to add beta in the short term.

The property sector has the second-lowest PE ratio among all MSCI sectors (see Figure 30). We believe the market has priced in the substantial probability of a full-blown sector crisis. But, as we highlighted in the theme section "Declining corporate funding cost", the market's concerns about refinancing difficulties in domestic capital markets tend to ease after interest rate cuts. UBS credit analyst, Glenn Ko, holds a sanguine view on developers' offshore refinancing, as he expects only cUS\$5.1bn offshore bond refinancing demand from property developers in 2015, versus more than US\$20bn in 2014.

We admit the uncertainty of mortgage loans in early 2015 remains high. The effective mortgage rate for home buyers has already declined by more than 70bp to c6% after the recent benchmark lending rate cut and relaxed classification of first homes. Commercial banks' willingness to supply a large amount of mortgage loans in early-2015 is crucial to the property sales recovery. Banks usually regard mortgage loans as unprofitable but they may not have too many choices as corporates can issue bonds with an average yield as low as 4.7% currently (versus 7.2% one year ago, see Figure 12).

Capital goods

We were previously Underweight this sector due primarily to the weakening construction activities. Indeed, the FAI growth of transport infrastructure slowed from 26% YoY in Q3 2013 to 15% in Q3 2014. The construction equipment and service companies suffered from weak top-line growth and their stock prices underperformed.

However, the 13th Five-Year-Plan and strong government support for high-end equipment exports will likely reshape the growth outlook in this sector. As discussed in the theme section, the 13th Five-Year-Plan could shed some light on mega-projects such as roads and rails in West China, ports in North China and heavy manufacturing upstream of the Yangtze River. And, subway plans will quadruple the operational mileage by 2020.

We believe the sector earnings will likely rebound (see Figure 29) due partially to the deflation-driven margin expansion of equipment manufacturers. The sector's valuation of 7.6x PER and 0.9x P/B in 2015E looks very attractive, in our view.

²⁸ China Property - No more super magic, 18 November 2014

Healthcare

We think the healthcare sector's PER can hover around a high level of 25x. The Overweight rating is justified, in our view, by the sector's strong earnings growth of 20%-plus per annum in the next couple of years. We think this sector rewards investors who carefully research the product portfolio and management quality. Fundamental-oriented investors could identify long-term compounders in the healthcare space regardless of macro conditions, as the companies with strong R&D capacity and distribution power are largely immune to policy uncertainties.

Many healthcare stocks fit our favoured market style – where risk/reward is positively skewed to mid/small-caps in new economy sectors (see page 12 for detailed discussion). The healthcare sector is currently trading on 20.8x 2015E PERs and the EPS CAGR is 23% for 2014-16E. The PEG ratio is thus only 0.93x.

Software

We Overweight the software sector, mainly because of our positive outlook on ADRs. As discussed in the theme section (see page 33), the Chinese ADRs can benefit from: 1) potential MSCI inclusion in 2015; 2) low correlation to A-shares to attract mainland Chinese investors; and 3) a reasonable valuation of 0.8x PEG. However, we are cautious on the "cannibalisation effect" of Hong Kong-listed software names.

Automobile

UBS sector analyst Yankun Hou is cautious on the industry due to the increasing headwinds facing domestic passenger vehicle manufacturers. With bottlenecks in cost, product and R&D, domestic brands could further lose market share, and consolidate. However, he expects outperformance in the small car (inland demand), SUV (replacement demand) and luxury segments (replacement demand).

We are a bit more optimistic on the auto sector for its relative attractiveness in the consumer space. As discussed earlier in the section "Top-down view", household consumption is the most resilient part of economic growth. But stock picking is difficult as the F&B sector's valuation is demanding and e-commerce competition dents the growth of all retailers and apparel/footwear brand owners. The auto sector, however, does not face an industry-wide overhang. The household penetration is still low and demand is particularly strong in inland provinces. In addition, it provides reasonable beta if the current monetary easing lifts the market risk appetite.

In 2015, the IBES consensus forecast suggests c20% EPS growth and 18% ROE for the auto sector. The forward PER of 9.1x and PB of 1.6x could be fully justified and stand out among all sectors (see Figure 30).

Top-down view of Underweight sectors

Energy

We downgrade Energy sector to Underweight as we believe the market has not fully priced in the bleak outlook of gas demand and pricing. UBS sector analyst Peter Gastreich cut the long-term (2020) gas demand forecasts from 429bcm to 370bcm on 26 November 2014. None of the big three oil companies will be immune to the risk of weaker-than-expected crude oil and natural gas prices.

The SOE reformation remains a relevant theme to this sector. The reduction of capex and SG&A expenses is helpful. But the energy pricing is a more potent contributor to corporate profits. The seemingly inexpensive sector valuation of 8x 2015E PER could be misleading, given the downside risk of earnings forecasts.

Telecom

We are bearish on the telecom sector because we do not believe 4G will reverse the sector downtrend. China Mobile's 4G subscribers increase by around 15m per month but the ARPU stays low. The rise in data ARPU and the decline in voice and SMS ARPU cancel each other out. And, we expect the competition will intensify in 2015 when China Unicom and China Telecom also tap into the 4G market.

In Q314, the telecom industry revenue declined for the first time in history. The subsidy reduction, mandated by the SASAC in July 2014, has translated into weaker consumption. Indeed, mobile penetration is high in China and infrastructure is sufficiently good to allow for a high return of new investment (see Figure 23).

The telecom sector trades near the top of its historical PER range (see Figure 30). With near-zero profit growth and below 3% dividend yield, the sector does not warrant its 12% weight in MSCI China index, in our view.

Consumer staples

The consumer staples (mainly F&B companies) face the structural issue of product quality and brand image. We think consumers have great demand for the healthy, nutritious F&B products. But domestic manufacturers have failed too many times on food safety and quality control. Consumers increasingly turn to foreign brands, including imported products. The weakness in the distribution network of foreign brands is offset by the arrival of e-commerce in low-tier cities.

We Underweight the consumer staples sector. It trades at around 2.2x 2015E P/B; much higher than most other sectors. The usual justification of the steady cash flow in this sector is questionable, given the frequent food safety scandals. The material price deflation is favourable to the sector margins due to less packaging cost. But the relaxed monetary environment is usually not in favour of low-beta non-cyclical stocks.

Retailing

We Underweight retailing due to the oversupply of retail space and the competition of e-commerce. Online shopping now accounts for nearly 10% of total retail sales and continues to grow at an annual rate of around 45%. The offline department store and supermarket sales are in low single digits.

The sector 2015E PER (11.4x) is on a par with the MSCI China index excluding banks (11.7x). We do not think the de-rating process has ended.

Commercial services

The commercial services sector (mostly environment service providers) has the second-highest PER among all MSCI China sectors (second to software). Although we like the growth potential of the environment equipment and services market, the ROE of waste and water treatment projects is usually only around 10%. The rapid expansion puts pressure on company equities. Therefore, we downgrade the sector to Underweight on concerns about its profit growth sustainability and demanding valuation.

Top-down view of Neutral sectors

Banks

We argued in the theme "Declining corporate funding cost" that banks are set to benefit from asset quality improvement. Although the asymmetric rate cut in November 2014 is negative for banks' NIM, we believe the market focus is currently on the receding balance sheet risks.

However, we do not Overweight the banks from a relative perspective. In the financial space, we believe investors looking for beta should prefer insurance and real estate sectors on the expectation of further rate cuts and ample liquidity. Investors cautious on economic growth should prefer asset management companies, like Cinda, due to the counter-cyclical nature of their businesses.

Diversified financials

Our key concern in this sector is the excessive speculation in A-share market and the unsustainable surge in margin financing. The size of margin financing has risen significantly to over Rmb820bn currently, from Rmb400bn in July 2014. Retail investors borrow at an 8% annualised rate to speculate on the large absolute gain of small-cap A-share stocks. This is the most lucrative business for local brokers. However, UBS A-share strategist Li Chen holds a bearish view on small-caps in 2015 for the lack of fundamental support. Even if the momentum of speculative trading remains, brokers need to raise capital sometime next year to fulfil the regulatory requirement of margin financing business.

After its 17% rally in November, the diversified financial sector is now trading around an 11.5x 12-month forward PER. This is above the midpoint of the 2011-14 PER range of 6-16.5x.

Materials

Deflation has a mixed impact on this sector. On one hand, metal smelters, cement plants and chemical producers benefit from a lower fuel cost. On the other hand, their selling price outlook is also bleak, given the weak demand and over-supply. Given the sector's distressed valuation, we do not rule out opportunities next year. But a full recovery awaits aggressive capacity reduction and financial deleveraging, which probably takes multiple years.

Transport

We upgrade the transport sector from Underweight to Neutral because we believe it is set to benefit from fuel cost deflation. UBS sector analyst Eric Lin remains cautious on the outlook for domestic air passenger traffic. He forecasts a 9.0% demand growth in 2015E (versus 9.5% in 2014E). The marine transport sector's growth may pick up moderately in view of UBS' economic forecast of 5.6% YoY real-term growth in exports in 2015E (versus 4.5% in 2014E).

Utilities

We like the high dividend yields of the independent power producers (IPPs) but are concerned about the market's elevated expectation on the gas utilities' profit growth. UBS energy sector analyst Peter Gastreich estimates that at US\$80/bbl Brent oil prices, the city gate prices could be cut by 11-24%. This probably has not been factored in by many investors.

The sector ROE is currently near an historical peak level of 15%. It could justify the P/B ratio of 1.8x but is vulnerable to surprises such as a coal price rebound, electricity/gas tariff cuts, lack of high-quality water projects, etc. We thus rate the sector as Neutral.

Tech hardware

We downgrade this sector to Neutral as we believe the key product refresh cycle is factored in. UBS tech sector analysts forecast PC unit growth of 1.1% YoY, mobile phone revenue of 4.5%, and LCD TV shipment growth of 3.1% in 2015E. Given the high penetration of consumer electronics in China (see Figure 23), it is difficult for major tech hardware players to sustain high growth in the domestic market. The sector's forward PER of 13x is now near the top of its three-year range.

High-conviction stock ideas

Our most-preferred stocks among Chinese overseas listed stocks are summarised in Figure 31. A few highlights are:

- 6 out of 10 stocks we picked up are mid-caps. This reflects our preference for the favourable risk/reward profile of this space (see Figure 6).
- 6 out of 10 stocks are in the new economy sector. Although we think it is time to add beta in short term, we continue to expect new economy sectors to deliver much higher earnings growth than the old economy.
- In general, we prefer growth stocks. The simply average 2015E PER of the 10 stocks is 12.9x, and the EPS growth is 34%; both are much higher than the index average.

Figure 31: China H-shares most-preferred stocks

Name	Ticker	Sector	Mkt cap (US\$ bn)	UBS Rating	Curr Px (local)	Target Px (local)	Upside to Target	2015E PE	2015E EPS Gr	2015E PB	2015E ROE (%)	2015E Div Yield (%)
Baidu	BIDU.O	Software	82.7	Buy	236.61	268.00	13%	26.8	36%	7.1	30.8	-
Ping An Insurance	2318.HK	Insurance	70.2	Buy	64.85	86.80	34%	10.5	4%	1.7	19.1	1.7
COLI	0688.HK	Real Estate	24.6	Neutral	22.80	23.81	4%	8.0	9%	1.3	17.2	2.5
Great Wall Motor	2333.HK	Automobiles	17.5	Buy	38.10	40.00	5%	8.7	30%	2.2	28.3	3.5
Fosun International	0656.HK	Conglomerate	7.9	Buy	9.22	13.10	42%	7.7	20%	0.8	11.5	1.9
CSCI	3311.HK	Capital Goods	5.7	Buy	11.36	15.00	32%	10.1	25%	2.0	21.6	3.1
China Southern Airlines	1055.HK	Transportation	6.9	Buy	3.60	4.00	11%	9.8	47%	0.8	8.0	2.4
CSPC Pharma	1093.HK	Pharmaceuticals	4.8	Buy	6.69	8.49	27%	22.6	30%	4.1	19.5	-
Huaneng Renewable	0958.HK	Renewable energy	3.1	Buy	2.71	3.70	37%	12.5	87%	1.2	10.0	1.6
Beijing Urban	1599.HK	Capital Goods	0.7	Buy	4.06	6.10	50%	8.4	39%	1.4	17.9	3.6
Average			22				26%	12.5	33%	2.3	18.4	2.0
MSCI China								8.8	8.8%	1.2	13.8	3.7

Note: Above data as of 1 December 2014.

Source: UBS estimates

Baidu (Buy; price target US\$268.00)

We have expressed our positive views on ADRs in the theme section "Chinese ADRs". If the ADRs are included into MSCI China index, the weight change of "BAT" (Baidu, Alibaba and Tencent) would respectively be 0->6.1%, 0->2.9% and 10.3%->8.6%. Baidu would be largest winner. Among "BAT", Baidu also has the lowest 2015F consensus PER – 27x for Baidu versus 29x for Tencent and 40x for Alibaba.

UBS' internet sector analyst, Erica Poon Werkun, is optimistic on Baidu's mobile monetisation as well as top-line growth in 2015. She expects its intensive investment in technology to boost efficiency and raise market entry-barriers in the long term, despite short-term margin pressure.

COLI (Neutral; price target HK\$23.81)

We select COLI from a top-down perspective. A declining corporate funding cost (as discussed in the theme section) is very positive for property developers but property prices in low-tier cities and inventory pressure cannot improve in the short term.

COLI has the highest sell-through rate in 2014E among all UBS-covered Chinese property names. Its NAV exposure to tier-1/2 cities is 73%; higher than most other national developers. Moreover, in the middle of a mortgage-driven property market, it is easier for large developers to win support from banks to provide favourable mortgage rates to home buyers.

Great Wall Motor (Buy; price target HK\$40.00)

We include an auto name on the list because of our belief in the sustainable growth of the under-penetrated automobile market (see Figure 23). Great Wall is one of the top picks of UBS sector analyst, Yankun Hou. In 2015, he expects the passenger car sales growth to slow down to 6% but the SUV segment to maintain strong growth of 16%.

After a year in the doldrums in 2014, Great Wall is entering a major product cycle in 2015/16. Yankun expects it to launch five new SUVs during Q4 2014 to H2 2015, which could give a strong boost to its 2015/16 sales. He forecasts Great Wall's sales to rise 17%/14% YoY in 2015/16, respectively, after a 9% decline in 2014. Yankun's price target implies 9x 2015E PER; broadly in line with the sector average.

Ping An Insurance (Buy; price target HK\$86.80)

In our view, the insurance sector is best positioned in the financial space when monetary easing reduces the tail risk of credit defaults. Investors are currently concerned about Ping An Bank's exposure to wealth management products and SME lending, and Ping An Trust's exposure to trust products. Such concerns could be relieved to some extent in 2015 and could even become an advantage, demonstrating the cross-sales capability among different platforms of Ping An Group.

UBS sector analyst Bob Leung expects the NBV of Ping An Insurance to grow 12% in 2015. The private placement announced in November 2014 will also help Ping An Insurance's valuation recovery due to less concern on capital needs.

Fosun International (Buy; price target HK\$13.10)

We regard Fosun International as a proxy for SOE reform and dynamic new economy sectors. As a leading privately-held investment group with a 20-year investment track record, Fosun is welcomed by SOEs to collaborate on new businesses and to improve corporate governance. In 2014, it negotiated to acquire stakes in at least four SOEs, all at favourable valuations. In addition, in 2014 Fosun has partnered with Alibaba to found the first internet bank in China, acquired stakes in multiple hospitals, and launched retirement home projects.

Following the acquisition of the Portuguese insurance company Caixa Seguras de Saude and a pending acquisition of a 20% stake in American insurance firm Ironshore, the insurance business now accounts for c37% of Fosun's total assets, versus 3% in 2013. The low-cost funding from insurance companies allows Fosun to capture opportunities to buy valuable state-owned assets, and to build new businesses in the internet, healthcare and environmental sectors.

CSCI (Buy; price target HK\$15.00)

We think CSCI is set to benefit from government's plan to export China's infrastructure construction capacity to overseas markets (see discussions on Silk Road Fund, BRIC Bank and Asian Infrastructure Bank on page 10). Most Chinese construction companies currently have small overseas exposure (eg, CRCC/CRG ~4% and CCCC 17%). But CSCI has nearly half of its projects outside mainland China and has built a strong brand image overseas.

UBS sector analyst Robin Xu likes CSCI for its market share gain in the booming affordable housing market. He expects CSCI's new contracts to grow 34% and 15% in 2014E and 2015E, respectively. The overseas projects, if they materialise, could lift the company profit margins and cash flows (as payments are funded by policy banks).

CSPC Pharma (Buy; price target HK\$8.49)

We like the healthcare sector due to the visibility and sustainability of high earnings growth. Stock-picking is highly important in this space and CSPC Pharma is one of the top picks of UBS analyst Shaojing Tong. Shaojing believes CSPC is one of the best-positioned Chinese pharma companies, and is poised to deliver around 30% growth during 2014-16E as: 1) its top selling drugs are likely to deliver over 30% sales growth; and 2) newly launched oncology drugs and pipeline drugs should sustain its high growth in 2015 and beyond. A major overhang was largely removed in October 2014 when Chairman Cai bought a 10.19% stake from the largest shareholder, Hony Capital. Management confirmed it does not intend to sell any part of its existing stake, whereas it is interested in increasing its shareholding if regulations permit.

Trading at 0.75x PEG, we believe CSPC Pharma presents an attractive buying opportunity.

China Southern Airlines (CSA) (Buy; price target HK\$4.00)

We include CSA as a core beneficiary of fuel price deflation. Fuel accounts for 38% of CSA's opex. UBS sector analyst Eric Lin estimates every US\$1/bbl decline in the oil price would lift CSA's 2015E net profit by 5%. In addition, CSA is now undergoing a central government inspection. If it passes without any corruption or governance issues, SOE reform could follow, in the form of an employee shareholding programme or mixed ownership.

CSA's near-term earnings momentum has turned incrementally more positive after it delivered better-than-peer results in Q314, where strong passenger capacity growth (up 11% YoY) was supported by cost controls that drove a 0.7ppt margin expansion. The 2015E P/B of only 0.7x, is near the bottom of the historical range of 0.6-1.5x since 2011, providing enough of a safe cushion, in our view.

Huaneng Renewable (Buy; price target HK\$3.70)

We expect the 13th Five-Year-Plan in the energy sector to indicate high growth (see page 31) in the wind power sector. UBS sector analysts Stephen Oilfield and Ken Liu forecast a 14% capacity CAGR between 2013 and 2020. The growth could be particularly strong in 2014/15 as companies front-load installation ahead of a possible tariff cut in 2015. This could result in a backlog of capacity waiting for connection, but Stephen and Ken expect the impact on operating cash flow is moderate.

As a leading wind farm with about 8GW installed wind capacity (c8.5% of the country's total), we believe Huaneng Renewable is well positioned to capture the secular growth. It also benefits from the declining corporate funding cost due to a hefty net debt-to-equity ratio of nearly 200%. The stock's 13x 2015E PER valuation looks very attractive versus 87%/35% EPS growth in 2015/16E, respectively. UBS analysts have already assumed a 10% tariff cut for the new wind farms effective 1 January 2015.

Beijing Urban (Buy; price target HK\$6.10)

Subway construction is a highly visible part of the 13th Five-Year-Plan. The mileage under operation will probably quadruple from 2,073km at end-2013 to around 8,000km by end-2020. With its number one market share in design services for China's subway development, Beijing Urban is poised to enjoy rapid growth. According to the recent channel check of UBS analyst Edwin Chen, Beijing Urban expects its order backlog to exceed Rmb10bn by end-2014, and its order/revenue coverage to be over 3x.

With recent share price weakness (concerns about new order growth and upcoming expiry of cornerstone investors' lock-up in January 2015), Eric believes Beijing Urban presents a good buying opportunity at around 9.3x 2015E P/E and 6.5x EV/EBITDA.

Appendix I: China Inc

Figure 32: China Inc. (bottom-up financial indicators of non-financial China H-share stocks)

Profit & Loss (US\$,m)	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E	Profitability	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
Sales	706,902	703,074	985,662	1,256,685	1,357,475	1,422,574	1,515,359	1,651,249	1,797,608	EBITDA Margin	15.1%	16.8%	15.7%	13.1%	12.1%	12.3%	12.7%	12.8%	12.9%
Depreciation and Amortization	48,117	46,462	55,275	61,419	66,348	74,514	81,966	88,799	95,607	EBIT Margin	8.3%	10.2%	10.0%	8.2%	7.2%	7.1%	7.3%	7.5%	7.6%
EBIT	58,941	71,410	98,992	103,463	98,307	100,726	111,117	123,060	136,238	Valuation	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
EBITDA	107,058	117,872	154,267	164,882	164,655	175,239	193,084	211,859	231,845	P / BV	3.1	2.4	2.2	2.0	1.7	1.5	1.5	1.4	1.3
Other Income/(Expense)	5,759	4,783	7,445	9,967	11,330	14,462	12,363	15,203	15,974	PE Adjusted	26.2	18.7	14.3	14.3	13.8	12.6	13.0	11.8	10.6
Net Interest Income/(Expense)	(6,052)	(5,454)	(5,981)	(7,343)	(10,224)	(10,648)	(11,086)	(12,138)	(11,946)	EV / Sales	1.8	1.6	1.2	1.0	0.9	0.9	0.9	0.8	0.8
Profit Before Tax	58,648	70,739	100,455	106,088	99,412	104,540	112,394	126,125	140,266	EV / EBIT	21.9	15.9	12.3	12.3	12.4	12.4	12.4	11.1	9.9
Tax	(10,943)	(15,576)	(20,982)	(22,919)	(22,204)	(22,181)	(25,033)	(27,946)	(31,579)	EV / EBITDA	12.1	9.6	7.9	7.7	7.4	7.1	7.1	6.5	5.8
Extra	(278)	(257)	152	86	202	78	76	0	0	EV / IC	2.7	2.2	2.1	1.9	1.6	1.5	1.6	1.5	1.4
Minorities	(771)	(1,541)	(3,219)	(4,226)	(3,957)	(3,904)	(3,888)	(4,608)	(5,041)	Price / Sales	1.6	1.4	1.1	0.8	0.7	0.7	0.7	0.6	0.6
Other	(776)	35	11	(176)	(78)	(44)	(25)	(25)	(57)	Yield	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
Net Income Reported	45,879	53,400	76,418	78,852	73,375	78,489	83,525	93,546	103,589	Earnings Yield	3.8%	5.3%	7.0%	7.0%	7.3%	7.9%	7.7%	8.5%	9.4%
Net Adjusted Income	44,083	52,502	73,019	74,406	70,006	75,588	81,384	89,973	99,719	FCFE Yield	-2.9%	0.4%	1.1%	-0.9%	-2.6%	-1.8%	1.0%	4.4%	4.5%
Cash Flow (US\$,m)	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E	Div + Buy Back Yield	1.2%	1.7%	1.2%	2.4%	2.7%	2.9%	2.6%	3.0%	3.3%
EBIT	58,941	71,410	98,992	103,463	98,307	100,726	111,117	123,060	136,238	Dividend Yield	1.9%	2.0%	2.1%	2.6%	2.9%	3.1%	2.8%	3.0%	3.3%
Depreciation	48,117	46,462	55,275	61,419	66,348	74,514	81,966	88,799	95,607	Buy Back Yield	-0.7%	-0.3%	-0.9%	-0.2%	-0.2%	-0.2%	-0.2%	0.0%	0.0%
Working Capital (Increase) / Decrease	(10,686)	13,139	(1,038)	(16,228)	(14,485)	(7,666)	(385)	(2,429)	(3,564)	DuPont	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
Other Operating	3,153	3,365	(1,818)	(1,788)	2,943	(5,551)	(3,780)	(5,519)	(6,672)	Net Income Margin	6.2%	7.5%	7.4%	5.9%	5.2%	5.3%	5.4%	5.4%	5.5%
OperationalCashFlow	99,524	134,376	151,411	146,866	153,113	162,022	188,918	203,912	221,610	Asset Turn	149.8%	135.0%	169.5%	188.6%	182.0%	174.8%	173.6%	179.8%	187.5%
Capital Expenditure	(103,875)	(110,145)	(112,034)	(127,185)	(137,049)	(147,265)	(147,555)	(141,122)	(138,381)	Leverage	126.9%	126.3%	121.2%	124.4%	128.2%	128.1%	126.6%	121.7%	117.0%
Taxation	(13,363)	(15,463)	(19,715)	(22,585)	(22,701)	(22,570)	(23,532)	(27,707)	(31,151)	Return on Equity	11.9%	12.7%	15.2%	13.9%	12.0%	11.9%	11.8%	11.9%	12.2%
Interest	(6,833)	(5,414)	(6,486)	(7,891)	(10,917)	(12,089)	(12,844)	(13,061)	(12,956)	Ebit Margin	8.3%	10.2%	10.0%	8.2%	7.2%	7.1%	7.3%	7.5%	7.6%
Other	(8,392)	948	(1,404)	1,242	(7,074)	3,115	5,317	24,976	9,038	Return on Invested Capital	12.5%	13.7%	17.0%	15.5%	13.2%	12.4%	12.7%	13.4%	14.2%
Free Cash Flow to Equity	(32,938)	4,302	11,771	(9,553)	(24,628)	(16,787)	10,304	46,998	48,160	Momentum	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
Net (Acquisitions) / Disposals	(2,581)	(5,099)	(8,828)	(3,511)	(3,349)	2,187	(1,235)	(789)	(875)	Sales Growth	20.5%	-0.5%	40.2%	27.5%	8.0%	4.8%	6.5%	9.0%	8.9%
Dividends	(21,772)	(19,313)	(21,693)	(27,165)	(28,116)	(29,484)	(29,917)	(32,175)	(35,272)	EBIT Growth	-28.7%	21.2%	38.6%	4.5%	-5.0%	2.5%	10.3%	10.7%	10.7%
Share (Buybacks) / Issuance	8,053	3,102	8,957	1,986	2,246	1,505	2,015	(2)	18	Net income Growth (UBS adjusted)	-26.0%	19.1%	39.1%	1.9%	-5.9%	8.0%	7.7%	10.6%	10.8%
Net Cash Flow	(49,238)	(17,008)	(9,793)	(38,243)	(53,847)	(42,579)	(18,834)	14,032	12,030	Dividend growth	-0.9%	-11.3%	12.3%	25.2%	3.5%	4.9%	1.5%	7.5%	9.6%
Balance Sheet (US\$,m)	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E	Capital Expenditure growth	16.4%	6.0%	1.7%	13.5%	7.8%	7.5%	0.2%	-4.4%	-1.9%
Net Tangible Fixed Assets	455,157	525,496	585,145	646,895	725,343	781,274	839,828	882,373	919,031	Dividend + Buyback growth	587.2%	18.2%	-21.4%	97.7%	2.7%	8.2%	-0.3%	15.3%	9.6%
Net Intangible Fixed Assets	32,961	41,385	48,757	63,881	72,597	87,413	88,469	90,996	93,194	Productivity	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
Net Working Capital	(16,065)	(45,903)	(52,473)	(44,584)	(51,949)	(54,980)	(55,299)	(54,768)	(53,612)	Capex / Sales	14.7%	15.7%	11.4%	10.1%	10.1%	10.4%	9.7%	8.5%	7.7%
Total Invested Capital	472,053	520,977	581,429	666,192	745,991	813,707	872,998	918,601	958,613	Capex / Depreciation	215.9%	237.1%	202.7%	207.1%	206.6%	197.6%	180.0%	158.9%	144.7%
Investments	58,216	70,191	96,700	113,061	137,181	167,907	180,486	193,411	206,052	Capex / Ebit	176.2%	154.2%	113.2%	122.9%	139.4%	146.2%	132.8%	114.7%	101.6%
Total Capital Employed	530,269	591,168	678,129	779,254	883,172	981,614	1,053,484	1,112,012	1,164,665	Gearing	2008	2009	2010	2011	2012	2013	2014E	2015E	2016E
Net (Cash) / Debt	113,282	124,154	129,732	161,371	204,361	236,604	249,125	228,972	211,156	Dividend Payout	49.4%	36.8%	29.7%	36.5%	40.2%	39.0%	36.8%	35.8%	35.4%
Provisions	774	644	807	822	1,110	1,042	995	957	925	Interest Cover (EBIT)	8.6	13.2	15.3	13.1	9.0	8.3	8.7	9.4	10.5
Minority Interests	24,588	28,902	36,009	43,730	51,203	59,225	63,089	76,154	81,902	Net Debt / Equity	30.5%	30.1%	27.0%	30.1%	35.1%	37.3%	36.1%	30.3%	25.8%
Other Liabilities	19,711	24,943	31,810	37,631	44,426	49,722	50,873	51,065	51,372	Net Debt / EBIT	1.92	1.74	1.31	1.56	2.08	2.35	2.24	1.86	1.55
Shareholders Funds	371,914	412,526	479,771	535,700	582,073	635,021	689,402	754,864	819,310	Net Debt / EBITDA	1.06	1.05	0.84	0.98	1.24	1.35	1.29	1.08	0.91
Total Liabilities	530,269	591,168	678,129	779,254	883,172	981,614	1,053,484	1,112,012	1,164,665										

Source: Company data, UBS estimates

Appendix II: MSCI China sector valuation

Figure 33: MSCI China sector valuation

China	PE			EPS Growth(%)			PBOOK			ROE(%)			Net Div Yield(%)			Net Margin(%)		
	2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E
Energy	8.7	8.8	8.2	-2.6	-1.4	7.1	1.1	1.0	0.9	12.3	11.2	11.2	4.1	4.1	4.3	5.1	5.2	5.3
Materials	11.2	9.5	7.8	4.6	18.2	21.2	1.0	0.9	0.8	9.1	9.9	10.7	2.4	2.5	2.9	3.8	4.5	5.2
Industrials	10.2	8.6	7.6	-2.2	18.2	13.1	1.0	0.9	0.9	9.9	10.7	11.2	2.7	3.0	3.3	4.4	4.7	5.0
- Capital Goods	8.9	7.6	6.8	-1.2	16.6	12.3	0.9	0.9	0.8	10.6	11.3	11.6	2.7	3.0	3.3	4.3	4.4	4.6
- Commercial & Professional Services	29.6	22.5	18.7	21.5	31.8	20.1	3.5	3.1	2.7	11.7	13.7	14.5	0.8	1.0	1.3	24.4	24.3	26.7
- Transportation	17.1	13.4	11.4	-12.0	27.6	17.5	1.1	1.0	1.0	6.3	7.7	8.7	3.0	3.2	3.5	5.4	7.3	8.4
Consumer Discretionary	12.6	10.8	9.4	17.1	19.6	15.2	2.1	1.8	1.6	16.5	17.2	17.3	1.9	2.5	2.9	10.2	10.8	11.2
- Automobiles & Components	11.0	9.1	7.8	22.5	20.4	17.3	1.9	1.6	1.4	17.5	17.8	17.8	1.5	1.9	2.3	14.5	15.0	15.9
- Consumer Durables & Apparel	17.6	14.8	12.7	12.6	18.4	16.5	3.5	3.0	2.6	19.8	20.1	20.1	2.2	2.5	2.9	6.6	6.9	7.1
- Retailing	12.0	11.4	10.4	4.9	18.1	10.0	1.3	1.6	1.5	10.5	14.4	14.6	2.7	3.6	4.0	3.6	5.5	5.1
Consumer Staples	25.2	20.2	17.4	-7.2	24.4	16.0	2.5	2.2	2.0	9.3	10.9	11.7	1.7	2.0	2.5	3.2	3.7	3.9
Health Care	25.2	20.8	17.2	26.1	21.2	21.1	3.5	3.1	2.7	13.9	14.8	15.8	1.1	1.4	1.6	3.8	3.8	3.9
Financials	5.9	5.5	5.0	8.1	8.2	9.2	1.0	0.9	0.8	16.2	15.6	15.2	5.3	5.7	6.3	25.3	24.7	24.3
- Banks	5.0	4.6	4.3	7.1	7.2	7.4	0.9	0.8	0.7	17.9	17.0	16.2	6.7	7.1	7.8	38.9	38.2	37.8
- Diversified Financials	12.3	10.2	8.4	24.7	20.2	21.4	1.3	1.2	1.1	10.9	11.9	12.9	2.2	2.7	3.2	32.2	32.5	34.2
- Insurance	13.8	12.2	10.4	30.1	13.4	17.7	1.9	1.7	1.5	13.7	13.8	14.2	1.5	1.7	2.0	7.0	7.2	7.4
- Real Estate	6.6	6.0	5.4	3.7	9.3	12.1	0.8	0.7	0.7	12.3	12.2	12.4	4.2	4.6	5.2	13.1	12.7	12.6
Information Technology	30.0	24.5	19.7	45.8	22.5	24.8	6.6	5.4	4.3	22.1	21.9	21.9	0.6	0.7	0.9	7.9	8.4	9.4
- Software & Services	38.0	29.6	23.2	53.2	28.5	27.8	11.2	8.4	6.2	29.4	28.2	26.6	0.3	0.4	0.5	30.2	31.1	32.3
- Technology Hardware & Equipment	15.5	13.7	10.9	0.3	13.4	26.4	2.4	2.1	1.8	15.5	15.3	16.9	2.2	2.7	3.0	3.1	3.1	3.5
Telecommunication Services	14.4	14.0	12.9	-6.6	2.8	9.0	1.6	1.5	1.4	10.9	10.5	10.7	3.0	3.0	3.3	10.7	10.4	10.8
Utilities	14.1	12.5	11.2	17.1	13.3	11.7	2.1	1.9	1.7	14.8	15.0	15.0	2.3	2.6	2.9	10.7	10.7	10.9
Overall	9.5	8.8	7.9	5.3	8.8	10.7	1.3	1.2	1.1	14.0	13.8	13.8	3.4	3.7	4.0	11.4	11.6	11.8
ex Banks	12.9	11.7	10.4	4.0	9.9	13.0	1.6	1.4	1.3	12.0	12.1	12.4	2.5	2.7	3.0	6.5	6.7	7.0
ex Banks ex Oils ex Telecom	13.5	11.7	10.1	10.1	15.6	15.7	1.7	1.5	1.3	12.3	12.9	13.3	2.0	2.3	2.6	7.0	7.3	7.6

Note: Above data as of 26 November 2014.

Source: Datastream, UBS estimates

Appendix III: UBS China H-share universe

Figure 34: UBS China H-share universe

Ticker	Name	Rating	Sector	Mkt cap (USD bn)	ADT (USD mn)	Last price	Price Target	Upside to PT	EPS Gr 2014E	EPS Gr 2015E	EPS Gr 2016E	PE 2015E	PB 2015E	ROE 2015E	Div Yield 2015E	Net Gearing 2014E
1114.HK	Brilliance China	Neutral	Automobiles & Components	8.3	20.5	12.84	15.30	19.2%	36%	11%	13%	10.0	2.4	26.9	2.5	-6%
1211.HK	BYD	Sell	Automobiles & Components	15.6	25.8	44.85	22.80	-49.2%	293%	16%	17%	33.4	3.0	9.5	-	45%
0489.HK	Dongfeng Motor	Buy	Automobiles & Components	12.8	27.2	11.54	16.00	38.6%	25%	10%	12%	5.5	1.0	19.7	2.3	-33%
0175.HK	Geely Auto	Neutral	Automobiles & Components	3.5	15.5	3.23	3.50	8.4%	-20%	15%	22%	8.8	1.1	12.7	1.5	-34%
2333.HK	Great Wall Motor	Buy	Automobiles & Components	17.0	37.5	38.10	40.00	5.0%	-1%	30%	16%	8.7	2.2	28.3	2.7	-29%
2238.HK	GZ Automobile	Neutral	Automobiles & Components	7.7	9.1	7.15	7.30	2.1%	38%	20%	15%	8.3	1.0	12.1	4.7	10%
1288.HK	ABC	Neutral	Banks	148.0	51.6	3.60	3.60	0.0%	10%	-4%	-4%	5.3	0.9	17.4	5.9	n.a.
3988.HK	Bank of China	Neutral	Banks	146.9	166.9	3.91	3.70	-5.4%	11%	-7%	10%	5.6	0.7	14.7	5.0	n.a.
3328.HK	BCOM	Neutral	Banks	60.5	27.0	6.29	5.40	-14.1%	6%	-5%	11%	5.9	0.7	12.9	4.3	n.a.
1963.HK	BoCQ	Sell	Banks	1.9	0.8	5.50	4.40	-20.0%	-12%	2%	6%	4.5	0.7	16.0	4.3	n.a.
0939.HK	CCB	Buy	Banks	185.7	160.8	5.73	6.40	11.7%	7%	0%	8%	4.9	0.8	17.6	5.0	n.a.
0998.HK	CITIC Bank	Sell	Banks	42.7	29.8	5.56	4.50	-19.1%	3%	-1%	-2%	5.2	0.7	14.5	3.9	n.a.
3968.HK	CMB	Neutral	Banks	49.3	45.9	15.62	15.50	-0.8%	4%	-2%	8%	5.3	0.9	17.4	4.8	n.a.
3618.HK	CQRCB	Sell	Banks	5.1	5.3	4.18	3.20	-23.4%	11%	-6%	-3%	4.9	0.7	14.3	4.3	n.a.
3698.HK	Huishang Bank	Sell	Banks	4.7	3.0	3.33	3.20	-3.9%	11%	-2%	4%	5.5	0.7	14.1	5.6	n.a.
0392.HK	Beijing Enterprises	Sell	Capital Goods	10.1	13.1	62.15	63.00	1.4%	25%	21%	14%	13.5	1.3	9.7	2.1	38%
1599.HK	Beijing Urban	Buy	Capital Goods	0.7	1.4	4.06	6.10	50.2%	-8%	39%	13%	8.4	1.4	17.9	3.6	-89%
1800.HK	CCCC	Buy	Capital Goods	15.6	25.6	7.42	9.00	21.3%	6%	13%	10%	6.6	0.8	13.0	3.6	136%
3899.HK	CIMC Enric	Buy	Capital Goods	1.8	3.9	7.54	13.00	72.4%	5%	12%	11%	9.9	1.6	17.6	2.0	-34%
1829.HK	CMEC	Buy	Capital Goods	2.9	4.9	5.46	7.70	41.0%	29%	6%	6%	6.6	1.2	18.9	6.1	-102%
6199.HK	CNR Corp	Buy	Capital Goods	12.7	15.8	7.66	8.52	11.2%	21%	12%	10%	11.2	1.4	12.7	1.3	20%
1186.HK	CRCC	Buy	Capital Goods	13.8	17.8	8.57	10.50	22.5%	10%	5%	5%	6.5	0.8	13.4	2.4	79%
0390.HK	CRG	Buy	Capital Goods	15.0	16.7	5.42	6.45	19.0%	24%	14%	14%	7.8	0.9	11.6	2.0	126%
3311.HK	CSCI	Buy	Capital Goods	5.6	9.3	11.36	15.00	32.0%	33%	25%	19%	10.1	2.0	21.6	3.1	43%
1766.HK	CSR Corp	Buy	Capital Goods	13.2	15.3	7.89	8.10	2.7%	32%	14%	12%	13.9	1.9	14.6	2.2	-16%
3898.HK	CSR Times Electric	Buy	Capital Goods	5.1	13.5	33.35	39.60	18.7%	42%	1%	18%	13.7	2.5	19.8	2.3	-42%
2208.HK	Goldwind	Buy	Capital Goods	5.0	8.9	11.38	15.20	33.6%	257%	10%	3%	14.6	1.5	10.8	2.1	29%
0363.HK	Shanghai Industrial	Neutral	Capital Goods	3.3	3.3	23.40	26.70	14.1%	17%	21%	10%	8.2	0.6	7.9	4.2	19%
2386.HK	Sinopec Engineering	Buy	Capital Goods	3.7	4.4	6.42	12.00	86.9%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-47%
3808.HK	Sinotruk	Neutral	Capital Goods	1.5	0.7	4.25	4.50	5.9%	49%	28%	24%	11.2	0.5	4.2	1.9	9%
2338.HK	Weichai Power	Neutral	Capital Goods	7.4	10.4	29.50	32.50	10.2%	29%	9%	10%	9.4	1.3	14.6	0.8	-32%
0257.HK	Everbright Int'l	Sell	Commercial Services & Supplies	6.7	11.4	11.50	10.30	-10.4%	32%	20%	17%	22.3	3.0	13.9	1.1	34%
2020.HK	Anta	Buy	Consumer Durables & Apparel	5.3	12.8	16.24	19.00	17.0%	22%	15%	7%	17.5	3.9	23.3	4.1	-56%
0210.HK	Daphne International	Buy	Consumer Durables & Apparel	0.7	2.0	3.40	5.00	47.1%	30%	37%	21%	9.5	1.0	10.7	3.7	-25%
1169.HK	Haier Electronics	Buy	Consumer Durables & Apparel	6.9	7.8	21.35	25.00	17.1%	19%	18%	17%	15.0	3.4	25.1	0.6	-60%
2331.HK	Li Ning	Buy	Consumer Durables & Apparel	0.7	2.0	3.92	7.70	96.4%	n.a.	n.a.	46%	10.9	1.3	13.1	0.1	-20%
2382.HK	Sunny Optical	Buy	Consumer Durables & Apparel	1.9	9.5	13.90	15.00	7.9%	31%	37%	17%	14.1	3.0	22.9	1.1	-8%

Source: UBS estimates

Figure 34: UBS China H-share universe – continued

Ticker	Name	Rating	Sector	Mkt cap (USD bn)	ADT (USD mn)	Last price	Price Target	Upside to PT	EPS Gr 2014E	EPS Gr 2015E	EPS Gr 2016E	PE 2015E	PB 2015E	ROE 2015E	Div Yield 2015E	Net Gearing 2014E
1448.HK	Fu Shou Yuan	Buy	Consumer Services	1.0	0.8	3.87	6.22	60.7%	3%	27%	21%	21.3	2.1	10.5	0.5	-59%
0165.HK	China Everbright	Buy	Diversified Financials	3.9	11.0	17.50	23.00	31.4%	20%	16%	8%	16.1	1.0	6.0	2.0	n.a.
1359.HK	Cinda	Buy	Diversified Financials	18.3	30.5	3.95	6.18	56.5%	52%	27%	30%	6.4	1.1	18.0	3.0	n.a.
6030.HK	CITIC Securities - H	Neutral	Diversified Financials	31.2	26.1	22.10	21.50	-2.7%	46%	11%	17%	22.7	1.9	8.7	1.4	n.a.
6881.HK	Galaxy Securities	Buy	Diversified Financials	7.9	24.6	7.98	7.80	-2.3%	32%	20%	14%	14.1	1.6	11.9	1.4	n.a.
6837.HK	Haitong Securities-H	Buy	Diversified Financials	22.5	31.0	16.18	18.00	11.2%	47%	34%	20%	15.5	1.7	11.3	1.9	n.a.
3337.HK	Anton Oilfield	Neutral	Energy	0.5	7.5	1.82	1.88	3.3%	-44%	8%	8%	13.5	1.3	9.7	2.1	44%
1898.HK	China Coal Energy	Neutral	Energy	10.8	12.3	4.81	4.62	-4.0%	38%	12%	2%	8.6	0.5	5.9	3.0	74%
1088.HK	CN Shenhua Energy	Buy	Energy	53.4	46.7	21.30	27.40	28.6%	-11%	9%	7%	7.7	1.0	13.5	4.2	18%
0883.HK	CNOOC Ltd	Neutral	Energy	62.9	121.8	10.72	14.50	35.3%	4%	0%	1%	6.5	0.9	15.0	5.4	28%
2883.HK	COSL	Neutral	Energy	8.2	38.4	12.94	21.50	66.2%	4%	11%	7%	6.0	1.0	17.7	3.8	42%
0196.HK	Honghua Group	Buy	Energy	0.5	2.3	1.14	2.30	101.8%	22%	20%	22%	3.7	0.5	14.3	6.4	75%
0135.HK	Kunlun Energy	Sell	Energy	8.4	28.4	7.93	8.15	2.8%	-10%	3%	-2%	10.1	1.1	11.1	2.7	28%
0857.HK	PetroChina	Neutral	Energy	237.0	120.1	8.04	10.90	35.6%	-2%	7%	12%	8.6	0.9	10.9	5.2	41%
0386.HK	Sinopec	Buy	Energy	100.1	105.6	6.09	8.90	46.1%	-11%	14%	13%	7.8	0.9	11.2	4.9	53%
0934.HK	Sinopec Kantons	Buy	Energy	2.0	4.4	6.20	9.20	48.4%	43%	60%	23%	12.9	1.2	9.6	0.9	18%
1251.HK	SPT Energy	Buy	Energy	0.4	2.2	1.74	5.80	233.3%	4%	48%	40%	4.5	0.9	21.8	3.8	-14%
1171.HK	Yanzhou Coal	Sell	Energy	7.1	14.9	6.60	4.73	-28.3%	188%	14%	18%	10.1	0.5	5.6	2.5	83%
6808.HK	Sun Art	Sell	Food & Staples Retailing	10.8	6.0	8.51	7.50	-11.9%	6%	9%	7%	20.3	3.2	16.0	3.4	-34%
0606.HK	China Agri	Neutral	Food, Beverage & Tobacco	2.0	2.5	2.90	3.31	14.1%	-93%	1096%	4%	11.2	0.5	4.6	1.2	69%
0506.HK	China Foods	Buy	Food, Beverage & Tobacco	1.0	1.5	2.77	3.40	22.7%	n.a.	n.a.	26%	20.3	1.2	6.1	0.7	30%
6863.HK	China Huishan Dairy	Neutral	Food, Beverage & Tobacco	2.8	5.4	1.53	2.04	33.3%	23%	26%	16%	11.1	1.3	12.0	1.8	18%
1886.HK	China Huiyuan Juice	Sell	Food, Beverage & Tobacco	1.1	0.9	3.11	2.60	-16.4%	n.a.	n.a.	n.a.	-220.0	0.6	-0.3	-	28%
2319.HK	China Mengniu	Neutral	Food, Beverage & Tobacco	7.7	23.2	30.50	40.45	32.6%	19%	21%	25%	18.8	2.0	11.4	1.1	0%
1117.HK	China Modern Dairy	Buy	Food, Beverage & Tobacco	1.4	10.2	2.36	4.17	76.7%	70%	24%	8%	7.1	1.2	17.9	-	67%
0322.HK	Tingyi	Buy	Food, Beverage & Tobacco	13.2	18.4	18.40	25.10	36.4%	16%	30%	15%	21.4	3.9	18.9	2.3	21%
0168.HK	Tsingtao Brewery	Sell	Food, Beverage & Tobacco	9.5	8.9	54.10	57.70	6.7%	12%	8%	9%	25.1	2.8	11.9	1.2	-33%
0220.HK	Uni-President China	Sell	Food, Beverage & Tobacco	3.9	3.0	7.00	5.49	-21.6%	24%	5%	12%	33.8	2.6	7.8	0.9	77%
0151.HK	Want Want	Sell	Food, Beverage & Tobacco	16.8	20.6	9.96	8.82	-11.4%	0%	10%	-2%	22.5	6.9	32.5	1.8	-32%
1230.HK	Yashili	Sell	Food, Beverage & Tobacco	1.0	2.3	2.30	2.70	17.4%	-36%	12%	46%	20.4	1.8	9.3	1.3	-6%
1345.HK	Pioneer Pharma	Buy	Health Care Equipment & Services	1.2	2.2	6.80	9.04	32.9%	2%	35%	29%	17.3	4.9	29.9	2.6	-23%
8199.HK	Shandong Weigao	Neutral	Health Care Equipment & Services	3.7	7.7	6.49	7.98	23.0%	2%	18%	20%	20.4	2.2	11.1	-	-28%
2607.HK	Shanghai Pharma	Neutral	Health Care Equipment & Services	6.6	5.9	18.24	20.76	13.8%	13%	14%	15%	13.5	1.3	10.0	1.5	-20%
1099.HK	Sinopharm	Buy	Health Care Equipment & Services	9.4	19.5	27.95	35.28	26.2%	24%	21%	21%	16.5	2.2	13.8	1.8	56%
1044.HK	Hengan	Buy	Household & Personal Products	12.9	19.7	82.50	93.60	13.5%	13%	16%	13%	20.9	5.0	25.3	2.9	-2%
2628.HK	China Life	Buy	Insurance	95.1	101.9	25.65	27.06	5.5%	38%	10%	6%	15.4	2.1	14.4	2.0	n.a.
2601.HK	CPIC - H	Buy	Insurance	36.8	43.2	31.50	32.21	2.3%	6%	12%	12%	20.5	2.0	9.9	1.5	3%
1339.HK	PICC Group	Buy	Insurance	19.7	13.3	3.55	4.35	22.5%	27%	1%	0%	11.5	1.4	12.7	-	8%
2328.HK	PICC P&C	Neutral	Insurance	26.8	32.7	15.34	14.00	-8.7%	10%	-7%	1%	14.5	2.2	16.1	1.8	108%
2318.HK	Ping An Insurance	Buy	Insurance	67.4	137.3	64.85	91.22	40.7%	15%	12%	15%	11.2	1.8	19.5	1.6	153%

Source: UBS estimates

Figure 34: UBS China H-share universe – continued

Ticker	Name	Rating	Sector	Mkt cap (USD bn)	ADT (USD mn)	Last price	Price Target	Upside to PT	EPS Gr 2014E	EPS Gr 2015E	EPS Gr 2016E	PE 2015E	PB 2015E	ROE 2015E	Div Yield 2015E	Net Gearing 2014E
0347.HK	Angang Steel	Sell	Materials	5.4	7.0	5.45	4.20	-22.9%	39%	52%	45%	19.3	0.6	3.3	1.0	45%
2009.HK	BBMG	Buy	Materials	5.7	9.2	6.45	7.77	20.5%	0%	11%	11%	6.1	0.7	12.8	1.9	67%
3983.HK	China BlueChemical	Sell	Materials	1.6	5.3	2.69	2.50	-7.1%	-37%	-3%	-2%	9.8	0.6	6.2	3.8	-27%
0914.HK	Conch	Buy	Materials	16.0	41.2	25.80	32.00	24.0%	23%	7%	7%	8.8	1.4	17.6	2.3	28%
0189.HK	Dongyue	Buy	Materials	0.8	1.6	2.88	4.75	64.9%	15%	28%	20%	7.1	0.7	10.9	3.5	22%
0656.HK	Fosun International	Buy	Materials	7.8	7.3	9.22	13.10	42.1%	-7%	20%	18%	7.7	0.8	11.5	1.6	101%
2314.HK	Lee & Man Paper	Buy	Materials	2.6	3.1	4.29	5.92	38.0%	#N/A	#N/A	#N/A	n.a.	n.a.	n.a.	n.a.	63%
0323.HK	Maanshan Steel	Neutral	Materials	3.3	7.3	1.94	1.95	0.5%	-175%	n.a.	35%	18.0	0.5	2.8	0.8	100%
2689.HK	Nine Dragons Paper	Buy	Materials	3.9	4.6	6.43	7.50	16.6%	12%	28%	16%	10.6	0.9	9.0	2.6	109%
2198.HK	Sanjiang Chemical	Buy	Materials	0.4	2.2	3.21	5.60	74.5%	-60%	274%	12%	2.8	0.8	31.3	2.6	235%
0691.HK	Shanshui Cement	Buy	Materials	1.0	2.6	2.84	3.50	23.2%	-13%	25%	22%	5.8	0.6	10.6	3.5	136%
0338.HK	SPC	Buy	Materials	5.7	9.2	2.35	2.90	23.4%	-17%	9%	4%	10.9	1.0	9.5	2.2	30%
2168.HK	Yingde Gases	Buy	Materials	1.3	5.7	5.43	9.70	78.6%	15%	21%	11%	6.2	1.0	17.4	4.7	129%
2233.HK	WCC	Buy	Materials	0.4	1.5	0.76	1.00	31.6%	-8%	51%	22%	5.2	0.5	9.5	4.6	61%
0867.HK	China Medical System	Neutral	Pharmaceuticals, Biotechnology & Life Sciences	4.0	12.8	12.88	15.46	20.0%	30%	29%	27%	23.0	5.2	24.8	0.8	-19%
1093.HK	CSPC Pharma	Buy	Pharmaceuticals, Biotechnology & Life Sciences	4.8	16.2	6.69	8.49	26.9%	33%	30%	30%	22.6	4.1	19.5	-	-5%
2196.HK	Fosun Pharma	Buy	Pharmaceuticals, Biotechnology & Life Sciences	7.6	6.1	27.60	30.51	10.5%	11%	20%	25%	18.0	2.6	14.9	1.7	11%
2186.HK	Luye Pharma	Buy	Pharmaceuticals, Biotechnology & Life Sciences	4.4	10.2	10.00	12.70	27.0%	94%	85%	37%	23.6	4.0	18.6	-	-61%
0460.HK	Sihuan Pharma	Buy	Pharmaceuticals, Biotechnology & Life Sciences	7.6	19.9	5.72	7.20	25.9%	33%	28%	27%	21.3	4.4	22.1	1.6	-40%
1177.HK	Sino Biopharm	Neutral	Pharmaceuticals, Biotechnology & Life Sciences	4.8	12.2	7.50	8.06	7.5%	23%	22%	21%	23.3	4.8	22.5	1.2	-59%
3383.HK	Agile Property	Sell	Real Estate	2.2	13.0	4.45	3.74	-16.0%	-31%	-11%	-1%	4.3	0.3	8.4	5.0	80%
2202.HK	China Vanke - H	Buy	Real Estate	19.3	20.8	15.46	17.17	11.1%	7%	13%	14%	7.4	1.3	19.3	3.7	28%
0688.HK	COLI	Neutral	Real Estate	24.3	62.1	22.80	23.81	4.4%	13%	9%	18%	8.0	1.3	17.2	2.4	39%
2007.HK	Country Garden	Neutral	Real Estate	7.7	16.0	3.14	3.12	-0.6%	8%	-7%	-1%	5.4	0.8	16.0	7.1	60%
1109.HK	CR Land	Buy	Real Estate	14.1	28.4	18.66	20.74	11.1%	11%	10%	5%	9.5	1.1	12.0	2.5	49%
3333.HK	Evergrande	Sell	Real Estate	5.7	10.5	3.03	2.37	-21.8%	-36%	4%	15%	6.3	0.4	6.3	7.8	69%
3900.HK	Greentown China	Neutral	Real Estate	2.2	6.4	7.52	7.70	2.4%	-38%	23%	16%	4.0	0.4	11.0	4.1	80%
2777.HK	Guangzhou R&F	Neutral	Real Estate	4.0	13.7	9.46	9.00	-4.9%	-20%	3%	28%	5.0	0.5	9.2	6.7	62%
1813.HK	KWG Property	Buy	Real Estate	2.2	6.4	5.72	6.29	10.0%	17%	8%	13%	4.4	0.6	14.3	6.4	59%
0960.HK	Longfor	Buy	Real Estate	7.0	3.1	10.12	10.81	6.8%	5%	13%	15%	5.9	0.9	15.8	2.5	58%
0119.HK	Poly Property Group	Sell	Real Estate	1.5	7.1	3.09	2.61	-15.5%	5%	39%	26%	5.2	0.3	6.9	6.5	124%
0813.HK	Shimao	Buy	Real Estate	8.0	19.5	17.76	19.67	10.8%	20%	6%	12%	5.2	0.9	18.8	5.2	82%
0272.HK	Shui On	Neutral	Real Estate	1.9	1.6	1.91	1.93	1.0%	-59%	52%	252%	20.3	0.3	1.4	2.0	73%
3377.HK	Sino-Ocean	Buy	Real Estate	3.5	2.2	4.55	5.25	15.4%	20%	0%	1%	6.6	0.6	9.2	6.4	39%
0410.HK	SOHO China	Neutral	Real Estate	3.6	2.3	5.67	5.86	3.4%	-50%	-38%	-30%	16.2	0.6	3.7	5.6	15%
1233.HK	Times Property	Buy	Real Estate	0.7	0.5	3.21	3.97	23.7%	16%	25%	26%	2.5	0.6	28.8	8.1	90%

Source: UBS estimates

Figure 34: UBS China H-share universe – continued

Ticker	Name	Rating	Sector	Mkt cap (USD bn)	ADT (USD mn)	Last price	Price Target	Upside to PT	EPS Gr 2014E	EPS Gr 2015E	EPS Gr 2016E	PE 2015E	PB 2015E	ROE 2015E	Div Yield 2015E	Net Gearing 2014E
1293.HK	Baoxin Auto	Buy	Retailing	1.7	1.3	5.09	7.50	47.3%	14%	20%	25%	7.5	1.4	21.2	-	72%
1880.HK	Belle International	Sell	Retailing	9.1	22.6	8.60	6.50	-24.4%	#N/A	-19%	0%	13.8	2.1	15.4	4.4	-10%
1929.HK	Chow Tai Fook	Neutral	Retailing	14.0	6.8	10.90	11.80	8.3%	32%	-6%	13%	16.0	2.4	16.6	1.8	-11%
0709.HK	Giordano	Sell	Retailing	0.7	0.7	3.70	4.03	8.9%	-38%	16%	5%	12.2	2.0	16.1	8.2	-42%
3308.HK	Golden Eagle	Sell	Retailing	2.3	3.9	9.31	8.00	-14.1%	8%	14%	9%	9.2	1.9	22.0	2.9	37%
0493.HK	Gome	Buy	Retailing	2.5	13.5	1.16	2.11	81.9%	47%	25%	21%	9.8	1.0	10.3	3.8	-50%
3368.HK	Parkson Retail	Buy	Retailing	0.8	1.5	2.10	3.90	85.7%	8%	8%	-2%	11.4	0.8	6.9	2.1	40%
3669.HK	Yongda Automobiles	Neutral	Retailing	1.0	0.5	4.94	7.30	47.8%	22%	21%	27%	6.7	1.2	18.9	-	80%
1728.HK	Zhengtong Auto	Buy	Retailing	1.1	2.3	3.76	6.00	59.6%	15%	23%	17%	5.6	0.7	13.0	-	32%
0881.HK	Zhongsheng	Buy	Retailing	1.9	4.1	7.62	8.70	14.2%	15%	8%	18%	9.2	0.9	9.7	2.2	46%
0981.HK	SMIC	Sell	Semiconductors & Semiconductor Equipment	3.5	27.4	0.78	0.72	-7.7%	-24%	-5%	20%	25.8	1.2	4.7	-	20%
0700.HK	Tencent	Buy	Software & Services	143.3	306.9	120.30	155.00	28.8%	38%	32%	27%	28.0	8.0	32.7	0.5	-30%
1980.HK	Tian Ge Interactive	Neutral	Software & Services	0.7	1.0	4.11	5.27	28.2%	-93%	18%	29%	13.0	1.7	14.1	-	-77%
2018.HK	AAC Technologies	Buy	Technology Hardware & Equipment	7.0	11.9	44.30	60.00	35.4%	14%	31%	14%	13.1	3.7	31.2	2.4	-13%
0861.HK	Digital China	Neutral	Technology Hardware & Equipment	1.0	2.0	6.89	8.00	16.1%	-36%	5%	7%	8.5	0.8	9.9	3.5	-28%
3336.HK	Ju Teng	Neutral	Technology Hardware & Equipment	0.6	2.3	3.92	5.30	35.2%	4%	28%	13%	4.4	0.6	14.1	5.3	40%
0992.HK	Lenovo Group	Buy	Technology Hardware & Equipment	14.2	59.4	10.58	13.00	22.9%	28%	7%	32%	16.2	4.0	26.9	1.5	-20%
0763.HK	ZTE	Neutral	Technology Hardware & Equipment	8.5	8.8	18.38	20.00	8.8%	111%	30%	6%	13.5	1.8	13.8	2.1	1%
0552.HK	CCS	Neutral	Telecommunication Services	3.3	3.5	3.69	3.90	5.7%	5%	6%	7%	8.1	0.8	10.5	3.5	-36%
0941.HK	China Mobile	Sell	Telecommunication Services	238.4	228.5	92.80	75.00	-19.2%	-11%	-14%	-10%	15.9	1.7	10.7	2.9	-47%
0762.HK	China Unicom	Buy	Telecommunication Services	35.0	65.1	11.32	14.80	30.7%	22%	20%	14%	14.0	0.9	6.6	2.1	55%
0753.HK	Air China	Neutral	Transportation	11.6	7.4	5.98	5.90	-1.3%	51%	58%	9%	11.2	1.0	9.7	2.3	185%
1919.HK	China COSCO	Neutral	Transportation	7.8	7.0	3.72	3.65	-1.9%	n.a.	n.a.	182%	30.5	1.4	4.6	-	228%
0670.HK	China Eastern Air	Neutral	Transportation	9.7	7.0	3.89	3.70	-4.9%	194%	56%	29%	12.5	1.2	10.0	-	238%
0144.HK	China Merchants Hldg	Buy	Transportation	8.4	11.4	25.50	31.40	23.1%	7%	8%	7%	13.9	1.1	8.2	3.3	13%
1138.HK	China Shipping Dev	Buy	Transportation	3.2	8.6	4.97	6.50	30.8%	n.a.	192%	48%	10.9	0.6	5.6	3.5	163%
1055.HK	China Southern	Buy	Transportation	6.3	9.5	3.60	4.00	11.1%	1555%	47%	6%	9.8	0.8	8.0	2.4	224%
1199.HK	COSCO Pacific	Buy	Transportation	3.7	6.8	10.32	12.00	16.3%	-1%	21%	6%	10.1	0.8	8.2	4.0	34%
2866.HK	CSCL	Neutral	Transportation	5.7	11.4	2.26	2.25	-0.4%	n.a.	n.a.	119%	19.1	0.9	4.6	1.3	55%
0177.HK	Jiangsu Expressway	Buy	Transportation	5.4	3.8	8.95	9.60	7.3%	1%	5%	11%	12.8	1.8	14.0	5.5	15%
2880.HK	PDA	Neutral	Transportation	2.8	6.2	2.68	2.80	4.5%	-2%	12%	29%	12.5	0.6	5.3	1.6	54%
3369.HK	QPC	Buy	Transportation	2.4	0.1	3.72	5.13	37.9%	-8%	10%	17%	7.7	1.2	15.6	5.9	64%
6198.HK	QPIC	Buy	Transportation	2.2	0.2	3.53	4.60	30.3%	2%	0%	4%	7.7	1.1	14.6	5.2	-10%
0576.HK	Zhejiang Expressway	Neutral	Transportation	4.9	4.6	8.68	8.90	2.5%	15%	6%	9%	12.7	1.7	13.7	5.1	-9%

Source: UBS estimates

Figure 34: UBS China H-share universe – continued

Ticker	Name	Rating	Sector	Mkt cap (USD bn)	ADT (USD mn)	Last price	Price Target	Upside to PT	EPS Gr 2014E	EPS Gr 2015E	EPS Gr 2016E	PE 2015E	PB 2015E	ROE 2015E	Div Yield 2015E	Net Gearing 2014E
0371.HK	BE Water	Buy	Utilities	5.9	8.9	5.18	6.60	27.4%	15%	29%	21%	21.8	2.7	13.0	1.5	125%
0384.HK	China Gas	Sell	Utilities	9.2	14.2	14.18	9.20	-35.1%	43%	18%	3%	23.1	3.9	18.0	0.9	69%
2380.HK	China Power Intl	Buy	Utilities	2.8	6.3	3.82	5.10	33.5%	13%	-7%	6%	7.6	0.9	12.3	5.3	241%
1193.HK	China Resources Gas	Sell	Utilities	6.1	6.7	21.05	19.50	-7.4%	12%	3%	12%	18.2	2.6	14.9	1.2	30%
0836.HK	China Resources Pwr	Buy	Utilities	13.8	19.8	22.25	29.00	30.3%	-3%	-6%	3%	9.5	1.3	14.7	3.4	131%
0991.HK	Datang Int'l Power	Buy	Utilities	9.3	8.1	4.25	5.90	38.8%	4%	31%	9%	7.1	1.1	16.9	4.5	415%
2688.HK	ENN Energy	Buy	Utilities	6.8	22.9	48.90	55.50	13.5%	14%	7%	11%	17.8	3.2	19.3	1.4	46%
0270.HK	GDI	Neutral	Utilities	8.5	9.7	10.54	9.70	-8.0%	6%	2%	7%	18.9	2.1	11.4	2.4	-19%
0816.HK	Huadian Fuxin Energy	Buy	Utilities	4.1	6.7	3.94	5.80	47.2%	34%	21%	13%	10.0	1.4	16.2	2.0	334%
1071.HK	Huadian Power	Buy	Utilities	6.8	13.0	6.37	7.00	9.9%	16%	-18%	2%	8.2	1.3	16.0	4.9	352%
0902.HK	Huaneng Power	Buy	Utilities	15.5	33.7	8.98	11.30	25.8%	9%	-12%	9%	8.6	1.3	15.8	5.2	218%
0958.HK	Huaneng Renewable	Buy	Utilities	3.2	6.8	2.71	3.70	36.5%	-22%	87%	34%	12.5	1.2	10.0	0.8	206%
1083.HK	Towngas China	Sell	Utilities	2.7	3.3	7.93	8.00	0.9%	11%	5%	12%	17.7	1.4	8.4	1.2	42%

Note: Above data as of 1 December 2014.

Source: UBS estimates

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Although there are many uncertainties with equity investing, in general, economic and policy surprises pose the most consistent and continued risks. Economic growth can be volatile, leading to earnings uncertainty. Inflation volatility can likewise lead to interest rate uncertainty. The direction and level of policy rates also substantially affect equity valuations.

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Neutral	FSR is between -6% and 6% of the MRA.	42%	28%
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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 30 September 2014.

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.

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Company Disclosures

Company Name	Reuters 12-month rating	Short-term rating	Price	Price date
Baidu, Inc. ^{16b}	BIDU.O	Buy	N/A US\$236.61	01 Dec 2014
Beijing Urban Construction Design & Dev ^{2, 4, 5}	1599.HK	Buy	N/A HK\$4.06	01 Dec 2014
China Agri Industries Holdings	0606.HK	Neutral	N/A HK\$2.90	01 Dec 2014
China Cinda Asset Management ^{2, 4, 5, 6b, 7, 13, 16a}	1359.HK	Buy	N/A HK\$3.95	01 Dec 2014
China Merchants Holdings ⁴	0144.HK	Buy	N/A HK\$25.50	01 Dec 2014
China Mobile (HK) Ltd ^{16a, 16b, 22}	0941.HK	Sell	N/A HK\$92.80	01 Dec 2014
China Overseas Land & Investment ^{4, 16a, 18}	0688.HK	Neutral	N/A HK\$22.80	01 Dec 2014
China Southern Airlines ^{16b}	1055.HK	Buy	N/A HK\$3.60	01 Dec 2014
China State Construction International	3311.HK	Buy	N/A HK\$11.36	01 Dec 2014
CSPC Pharmaceutical Group ²	1093.HK	Buy	N/A HK\$6.69	01 Dec 2014
Datang International Power	0991.HK	Buy	N/A HK\$4.25	01 Dec 2014
Dongfeng Motor	0489.HK	Buy	N/A HK\$11.54	01 Dec 2014
Fosun International ^{4, 5, 16a}	0656.HK	Buy	N/A HK\$9.22	01 Dec 2014
Gome Electrical Appliances ^{2, 16a}	0493.HK	Buy	N/A HK\$1.16	01 Dec 2014
Great Wall Motor ^{16a}	2333.HK	Buy	N/A HK\$38.10	01 Dec 2014
Guangzhou Automobile	2238.HK	Neutral	N/A HK\$7.15	01 Dec 2014
Haier Electronics Group	1169.HK	Buy	N/A HK\$21.35	01 Dec 2014
Huadian Fuxin Energy Corporation ^{2, 4, 5}	0816.HK	Buy	N/A HK\$3.94	01 Dec 2014
Huadian Power International ^{2, 4, 5}	1071.HK	Buy	N/A HK\$6.37	01 Dec 2014
Huaneng Renewable Corporation	0958.HK	Buy	N/A HK\$2.71	01 Dec 2014
iKang Healthcare Group ^{2, 4, 5, 6a, 16b}	KANG.O	Buy	N/A US\$18.39	01 Dec 2014
Ping An Insurance (Group) ^{13, 16a, 22}	2318.HK	Buy	N/A HK\$64.85	01 Dec 2014
SAIC Motor	600104.SS	Buy	N/A Rmb19.41	01 Dec 2014
Sands China ^{16a}	1928.HK	Buy	N/A HK\$45.50	01 Dec 2014
Shanghai Pharmaceuticals ⁵	2607.HK	Neutral	N/A HK\$18.24	01 Dec 2014
Sinopharm Group ^{2, 4, 5}	1099.HK	Buy	N/A HK\$27.95	01 Dec 2014
Tian Ge Interactive Holdings ^{2, 4}	1980.HK	Neutral	N/A HK\$4.11	01 Dec 2014
Tingyi Cayman Islands	0322.HK	Buy	N/A HK\$18.40	01 Dec 2014
Tsingtao Brewery	0168.HK	Sell	N/A HK\$54.10	01 Dec 2014
Want Want China Holdings ^{16a}	0151.HK	Sell	N/A HK\$9.96	01 Dec 2014
Zhuzhou CSR Times Electric	3898.HK	Buy	N/A HK\$33.35	01 Dec 2014

Source: UBS. All prices as of local market close.

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