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Foreword

Since the beginning of this century, the pace of China’s economic growth and transformation has marvelled many, and catapulted the country to become the world’s second-largest economy by the end of 2010.

China is now, however, decidedly on a gentler growth trajectory. Not so much due to the persistent slump in its exports in the West, as the media would have it, but the result of conscious policy choice by the government.

Despite the ostensible material benefits, the formula for fast growth has not been without its problems. Over reliance on external markets rather than domestic consumption and excessive state directed investments have led to problems of overcapacity, asset bubbles and other economic and social imbalances.

The government in its current economic blueprint for the country, the 12th Five-Year Plan (2011-2015), attempts to steer the economy towards a more sustainable path; rebalancing the emphasis on the quality rather than the rate of growth.

Transition will not be easy, no doubt, especially at a time when the political leadership itself is going through major changes with Hu and his politburo cadres stepping down, after running the country for the last ten years.

Under these circumstances, the release of this report, DBS Asian Insights: China in Transition, cannot be more timely and opportune.

The report contains several policy recommendations by our senior economist, Chris Leung, on some of the key challenges confronting China as it makes this longer-term structural transition to a more domestically-driven economy.

In the “Business Briefings” section of the report, our China analysts share their assessments and insights on how slower growth and the 12th Five-Year Plan – the country’s current economic blueprint – would impact specifically the various sectors and industries of the Chinese economy such as banking, retail, energy and manufacturing.

We also took the opportunity to catch up with Neil Ge, Chief Executive Officer, DBS Bank (China) Limited, to get an insider’s view on how the political leadership is going to manage China’s economic transition. Last but not least, Tan Su Shan, Managing Director & Group Head Wealth Management, DBS Bank, caps off the report with some practical advice on how to be smart about investing in China.

We hope the report will make a contribution in our collective understanding of this complex process and help identify opportunities for those interested in the sustainable growth of China.

Yours sincerely,

Timothy Wong
Managing Director and Regional Head
DBS Group Research
Is the Chinese Miracle Over?
No need to panic over the slowdown in China’s economic growth

Chris Leung
Senior Economist
DBS Bank (Hong Kong) Limited

The market is often shortsighted and concerns that China is heading for a hard economic landing are, we believe, exaggerated. China’s slowdown is caused by sluggish external demand and the deceleration of fixed asset investment in the country. The former is involuntary, but the latter is an intended policy outcome. Headwinds on the external front are incessantly repeated in news reports and opinion columns. Yet the fact that China’s slowdown is primarily an intended policy outcome seldom gets a mention.

The Chinese government can easily spur growth by removing the numerous restrictions on the property market. Price controls on property have remained firmly in place and official rhetoric reinforces the expectation that this will continue, given the fact that property prices rebounded instantly when lending rates were cut recently. The fact that they have not chosen this easy route shows the increasing maturity of macroeconomic management that not only aims to propel short-term growth but prevent structural problems from deepening. Indeed, strategies have already been adopted by Chinese authorities to gradually steer the economy through a structural transition over the next few years. In line with this, a gradual investment slowdown is also considered healthy.

That is not to say China will do nothing to cushion the slowdown. Highly directive fiscal stimuli will be launched after the leadership transition is completed this year. The economy has bottomed out towards the close of this year and a mild growth rebound will follow in the first quarter of 2013. In this context, economic growth may not be as rapid as in the recent past, but that does not signal the end of the Chinese miracle.

China’s current economic slowdown is clearly not the end of the world.

The real hindrance to spurring consumption is the strong presence of “precautionary savings” among Chinese households...

Is the Chinese Miracle Over?
Chris Leung
Senior Economist
DBS Bank (Hong Kong) Limited

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Investment remains the primary driver

Let’s be realistic. Private consumption, which now represents only 35% of gross domestic product (GDP), will not become the key driver of growth overnight. The concern is that fixed asset investment as a share of GDP has already exceeded 50% after a decade of investment-led growth (see Chart 1).

Meanwhile, the export engine is sputtering and will likely remain so as long as major trading partners’ economic activities are in a lull. This looks like a dead end for China. But there is a solution: interest rate liberalisation alongside a targeted fiscal stimulus programme.

China reinitiated interest rate liberalisation this year, much to everyone’s surprise. The lending rate floor was lowered from 90% of the benchmark lending rate to 70%. Banks can also offer 10% higher than the benchmark deposit rate – an unprecedented move in the country’s banking history.

The immediate impact is a cut in the banks’ profits. But why would China want to damage bank earnings when the economy is slowing? The crux of the issue is that such moves will rationalise banks’ lending behaviour. Borrowers with good credit will be able to borrow at lower costs. To prevent margin compression, banks will have to charge higher rates for customers with riskier profiles. Ultimately, lending behaviour will be rationalised over time and the banks’ asset quality will improve. Assuming liberalisation continues at a gradual pace, future investment funded by bank credit should be more productive.

The rate liberalisation strategy, however, needs to be paired with directive fiscal stimulus to cushion growth in the short term. For example, the National Development and Reform Commission (NDRC), the country’s top economic planning body, approved development plans of subways in 18 Chinese cities including Suzhou, Hangzhou, Guangzhou, Tianjin and Shenzhen. It also approved three inter-city rail projects, linking Hohhot-Baotou-Ordos, Gantang-Wuwei and eight cities in the Jiangsu province. The execution of such fiscal strategy may be seen by the market as too cautious compared to the bold and indiscriminate fiscal stimulus launched in 2009. However, this is the right way to go in order to prevent the reacceleration of asset inflation and the worsening of local government debt problems.

Population policy matters for private consumption

The aforementioned strategies should buy some time to stimulate private consumption. The Chinese government has been reliant on raising wages and providing indirect subsidies on key household items to propel consumption. The former is offset by the rising consumer price index and asset price inflation, and the latter can lose steam quickly when subsidy programmes come to a halt. The real hindrance to spurring consumption is however the strong presence of...
“precautionary savings” among Chinese households (see Chart 2).

This is an unintended result of China’s one-child policy. Ageing parents have only one offspring to rely on, meaning each child, in adulthood, has to shoulder the rather large financial burden of supporting his or her parents. The absence of well-established socioeconomic infrastructure such as a pension system and a well organised and executed medical system encourages even more saving by consumers, thereby further suppressing consumption.

Against this background, it is likely that the Chinese government will gradually relax the one-child policy as soon as 2015, the date the United Nations has predicted by which ageing will become a problem. By relaxing this policy, the number of consumers will increase. Demand for space will also increase, and that will in turn create demand for a wide array of other goods and services. The eventual relaxation of this policy, however, must happen in tandem with reforms of the medical and pension systems. This will happen fairly soon, in our view, given the clock is already ticking.

Deepening trade ties with South America and Africa

On the trade front, now is the right time to forge closer trade ties with South America and Africa because growth in Western markets has stalled. Over the last decade, exports to Africa increased 29.3% and exports to South America grew 33.1% versus 25.7% and 20.5% for the EU and US markets respectively. In 2011, a combined 11% of China’s exports went to Africa and South America, more than double the 5% of a decade ago and exceeding the 9% bound for ASEAN countries (see Chart 3).

Assuming exports to the EU and US markets grow annually at their ten-year average rate minus 2%, and exports to Africa and South America grow at their ten-year average rate, the share of the EU and US markets combined in 2020 would fall to 32.8% from 35.9% in 2011 and the share of African and South American markets would rise to almost 20% from 10.3%. And this is about equal to the current share of exports going to the EU.

Clearly, the current importance and future potential of the South American and African markets are immense.

Cautious optimism granted

There is no reason to be pessimistic if China picks the right set of strategies to ensure a smooth transition. Western economies have relied on the printing presses to fix their problems, but China has not. Real structural reforms could be painful in the short term, but if China were to follow the Western approach, it would eventually follow them along the road to economic disaster.

Clearly, macroeconomic management in China has matured in 2012. The stage is set for further reform once the latest leadership transition is completed. Yes, real GDP growth will likely slow to the range of 7.5% to 8.5% in the next few years, but in exchange for more sustainable and better quality growth over the longer run. This is what really matters. China will likely still fare much better than the rest of the world.
Section 1

Rebalancing the Chinese Economy
Much to everyone’s surprise, China reinitiated interest rate liberalisation this year after an eight-year hiatus, raising the cap on deposit rates and reducing the floor on lending rates (see Table 1). The lending rate floor was lowered to 70% of the benchmark lending rate from 90%. For the first time in the country’s banking history, banks can also offer more than the official deposit rate, with the rate capped at 10% higher than the benchmark rate (see Chart 2).

We believe the time is now right to allow market forces to play an even greater role in determining the allocation of credit in China. The current macroeconomic environment appears conducive, with demand for loans easing from the height of China’s 2009 credit binge and inflation largely under control. The relatively benign inflationary environment will not exert much upward pressure on nominal deposit rates if controls around interest rates were further relaxed.

More importantly, Chinese banks are now stronger than ever. Indeed, since 2004, bank profits have exploded. The combined net profit for all Chinese banks reached a high of Rmb1.04 trillion in 2011, ten times higher than the combined pre-tax profit of Rmb100 billion in 2004, according to the China Banking Regulatory Commission (CBRC). (The CBRC has no data for net profit.)

The health of the banking sector has also improved significantly. The official non-performing loan ratio for commercial banks has fallen steadily to just 1% at the end of 2011 compared to 12.4% in 2005.

From a rebalancing perspective, resuming interest rate liberalisation will help rationalise China’s investment growth engine. But will that actually take place?
Without appropriate reforms, China’s medium term growth will be severely constrained because of the economy’s heavy reliance on state-directed investment. Such investments have resulted in hard-to-cure structural problems such as the accumulation of public debt through local government financial vehicles (LGFVs), deepening overcapacity problems in some industries and as we have seen in relation to asset inflation in China in 2009.

Although the liberalisation of interest rates should gradually help reduce the dominance of state-directed lending, as capital will be properly priced with respect to risks, this is not a foregone conclusion.

The shareholding structure of the Chinese banks has changed substantially as a result of the public listing of large state-owned banks over the past decade. Even so, the government still holds large stakes in many banks. Yet, despite the public listings, banks’ lending practices are still an Achilles’ heel. This is evidenced by the prevalence of loans to LGFVs, and the magnitude of policy-directed lending activities that resulted from the government’s 2009 Rmb4 trillion fiscal stimulus package.

The present lending practice has caused some serious resource misallocation.

Banks have granted about 65% of loans to state-owned enterprises (SOEs), rather than to the more efficient private sector, even though SOEs’ share of industrial output has declined over the years. In addition, it is well known that SOEs in China are reluctant to pay back their loans to state-owned banks, and forbearance on debt has been the rule rather than the exception, creating further risks to the banking sector.

Clearly, the state has to reduce its influence on banks’ lending decisions. This is not an easy feat given the inherent conflict of interest stemming from the state’s vested interests in both large commercial banks and SOEs. Also, the preference for SOEs when making lending decisions has existed for decades. If the government’s visible hand continues to orchestrate lending decisions, interest rate liberalisation per se will not improve capital allocation. However, so long as the government is willing to loosen its grip, interest rate liberalisation can force banks to improve their lending practices. This is the power of markets.

Ideally, the government should at the same time cultivate private sector investment by improving their credit accessibility in accordance to their risk profiles. From the banks’ perspective, the quest for profit in a competitive banking environment means they would need to improve their risk assessment capabilities and credit information systems. That would mean loans would only be offered to the most productive opportunities and credit risks would be minimised.

Out of all the structural changes in the rebalancing process, interest rate liberalisation may be the hardest to implement effectively. The government must have tenacity while banks must be willing and able to change the way they assess credit risks and grant loans. Weakness in any link could cause banking sector instability or a return to the bad old days. South Korea reinstated interest rate controls after a failed attempt in the early 1990s to liberalise rates, a precedent China should mindfully shy away from.
Demographic Deficit
China’s one-child policy a drag on growth

China’s one-child policy, in place since 1979, looks set to be eased as the world’s most populous nation considers the longer-term economic consequences of its radical population control.

The one-child policy was, ironically, introduced for economic reasons – to ensure China’s limited resources were not overburdened by the demands of the nation’s ballooning population.

Although enforcement of the one-child policy is generally strict in urban areas, rural families are allowed to have a second child if the first is a girl and some ethnic minorities are also exempt from the policy. More recently, areas such as Beijing and Henan have relaxed the restrictions by allowing two parents who are only children themselves to have a second child.

The concept of adopting a nationwide two-child policy was raised during the 2011 National People’s Congress but the government said the current one-child policy will remain in place until at least 2015.

The changing economic landscape in China, however, shows an imminent need to review the one-child policy – the sooner the better.

China’s working population will peak in just three years time. According to the United Nations, the one-child policy will reduce the number of 15 to 24-year-olds, the lynchpin of factories, by 27% to 164 million by 2025. It takes at least 16 years for babies born today to enter the workforce. Even if authorities relax the policy now, it will not make a positive impact on the Chinese labour pool until at least 2028.

If authorities do not act soon, China’s overall productivity will eventually decline with fewer young workers. Already, labour costs have on average increased faster than labour productivity since 2005.

China’s old-age dependency ratio has also been rising since 2010, and will continue to do so. Between 2000 and 2010, the dependency ratio, which measures the number of elderly people as a share of those of working age, was largely constant (see Chart 1).

It is the steep climb of the black line that highlights the nub of the problem – there will be more and more retirees that need to be supported by a smaller workforce.

To better see the extent of the problem, take a look at Japan. Its productivity has slowed due to ageing, partially...
explaining the lower economic growth rates over the recent decade. If China’s one-child policy is not relaxed soon, the Middle Kingdom’s population structure in 2050 may resemble that of Japan’s today, which has grave implications for future economic growth (see Charts 2 and 3).

An ageing population also puts pressure on the health care and pension systems. According to the United Nations, pension and health care costs will soar as the number of people aged over 65 surges by 78% to 196 million by 2025. The young and able will opt to increase precautionary savings to provide for themselves directly as they anticipate increasing pressures on public services. A more savings-oriented mindset will work against the government’s objective of domestic consumption supporting economic growth.

A more direct way to increase aggregate consumption is to increase the number of consumers. Removing the one-child policy is a sure-fire way to achieve this. Without preemptive reforms in the population policy, China’s rebalancing path will become even more difficult when ageing eventually kicks in.

The success of China’s rebalancing is thus not only a result of conventional growth factors, but also a function of how authorities relax the one-child policy while simultaneously introducing reforms in other social domains.

Given China has already decided to opt for a growth model that relies on domestic demand, relaxing the one-child policy is a must and in all likelihood will take place before the scheduled review in 2015.
The Wealth of Nations
How human capital can rebalance Chinese growth

A nation's wealth should be measured by not just its physical and natural capital, but by its human capital as well. A United Nations report on long-term sustainability and human wellbeing released earlier this year says it is time to do away with the conventional economic measure of a country, its gross domestic product.

The *Inclusive Wealth Report 2012*, overseen by renowned economist Sir Partha Dasgupta of the University of Cambridge, recalculates the worth of 20 countries using three measures instead of just GDP.

Using this method, it quickly becomes obvious that China's wealth is not as great as typically believed. The report shows China's wealth represented a mere 17% of the wealth of the US and 36% of Japan's in 2008. This is in stark contrast to how standard economic measures portray China's economic growth, which was the world's fastest between 1990 and 2008.

For developed countries, human capital makes up a huge share of their wealth (see Chart 1). By this measure, human capital represents 75% of the total wealth of the US and 88% of the total wealth of the UK.

It's possible even for developed countries to substantially increase their human capital. Germany, which increased its human capital by 50% over the past two decades has been able to sustain its lead in high-end capital exports.

The economic growth of China has been heavily reliant on the rapid expansion of its manufactured or physical capital (see Chart 2). Dasgupta's study found China increased its stock of manufactured capital by an astounding five-fold between 1990 and 2008.

But merely pumping up investment in fixed assets, as China has done, is not sustainable in the long run. China increased its manufacturing capital stock by an average of 10% a year between 2000 and 2006 (the most current data available), compared to an average of 0% in the same period for Japan.

Insights from the *Inclusive Wealth Report 2012* need to be considered alongside China's rebalancing policy. One of the aims of the policy is to lower China's investment to GDP ratio and correspondingly raise the private consumption to GDP ratio. In short, reprioritising the engines of growth. But the rebalancing policy is silent on the composition of a country's wealth which relates directly to the sustainability of its growth.

For China, an extraordinary buildup of physical capital gave it more than a decade of fast growth, as gauged by traditional economic measures. However, the marginal productivity of physical capital would have diminished by now.

Human capital creation is necessary if China is serious about fulfilling its ambition to climb the value-added chain. Human capital is also important for the branding and strategic market positioning of all “made-in-China” products both for domestic sales and exports. These are areas widely

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**1. Inclusive wealth per person (2008, US$ 000)**

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<th>Country</th>
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Source: United Nations
That would imply some 40% growth in education spending this year recognized to be China’s main weaknesses.

Human capital formation is also necessary to arrest the recent rise in unit labour costs in China. The pickup in unit labour costs was primarily caused by double-digit wage growth against only single-digit labour productivity growth. Rapid wage growth is unlikely to reverse course anytime soon since it is part of the strategy to rebalance the economy. To maintain competitiveness, reforms should concentrate on boosting labour productivity.

China now has a choice. We believe the People’s Republic should start moving away from building up its physical capital buildup and conscientiously focus on its largest asset, human capital.

Currently China lags behind other countries in education spending (see Chart 3). Under the United Nation’s definition, a country’s human capital is calculated by measuring the average years of schooling, the level of workers’ wages and the number of years each worker can expect to remain in the labour force.

To be fair, China has raised its education spending from 2.7% of GDP in 2007 to 3.2% in 2011. And the level of spending is expected to rise to 4% in 2012, according to statements made by Premier Wen Jiabao at the annual session of the National People’s Congress. That would imply some 40% growth in education spending this year, compared to an average of 20% in the past four years. This surge in spending could be considered better late than never - the 4% of GDP figure has been suggested since the late 1980s.

In China’s case, the human capital problem cannot be wholly accounted for by the quantitative measures of years of schooling and education spending. Human capital investment needs to be well paced. While expanding human capital stock is vital, it is equally important to ensure efficient use of existing human capital. The spike in university graduates, which saw a six-fold increase between 2000 and 2011, merely led to an excess supply of graduates in Chinese cities. The rapid surge in the number of university graduates in China in the fields of engineering and science is no guarantee of future success.

True wealth building requires growth in hard-to-measure factors such as innovation, quality of education and even cultural factors. Nevertheless, China’s aim to shift to a new growth model will not be successful without a corresponding boost in investment in the country’s human capital.
At this rate, by 2020 the value of China’s exports to Africa and South America combined will have ballooned to match current share of exports going to the EU...
Growing South-South Trade

China looks to Africa and South America to take up slack left by traditional trade partners

It is difficult to project a rosy medium term outlook for Chinese exports. The trade surplus has been falling since it peaked at 7.6% of gross domestic product in 2007, reflecting the persistent economic weakness of China's major trading partners. Even while China tries to rebalance its economy towards domestic consumption, its export engine cannot be entirely placed on the back burner.

To reduce reliance on Western markets, where growth has been anaemic at best, China has strengthened its trade ties with Africa and South America. In 2011, 11% of China's exports went to Africa and South America combined, more than double the 5% of a decade ago and exceeding the 9% share sent to China's ASEAN neighbours (see Chart 1).

At this rate, by 2020 the value of China's exports to Africa and South America combined will have ballooned to match current share of exports going to the EU.

Perhaps more importantly, Chinese exports to these developing country markets are also growing in sophistication. By skill level, over the last decade, Chinese exports of high- and medium-skilled technology manufactured goods as a share of total exports to Mexico, South Africa and Nigeria has been on an uptrend, while the share of labour intensive and low-skilled technology manufactured goods has shrunk (see Charts 2 to 4). More than 70% of China's exports to Brazil and Mexico have involved high- and medium-skilled technology in recent years.

In 2010, exports of machinery and equipment accounted for more than 30% of manufactured goods exports to the three developing markets. In Mexico, as much as 54% of manufactured goods exports were machinery and equipment.

That said, it is worth exploring exactly what sort of machinery and equipment China has been exporting to these markets. Charts 5 and 6 show the key machinery and equipment items exported to South America and Africa.
From a trend perspective, the export share of general electrical machinery has fallen the most in both markets, while the export share of other transport equipment (excluding road vehicles) has climbed quickly in recent years to Africa. In both markets, telecommunication and sound recording apparatus make up the largest share of machinery and equipment exports. For example, listed company ZTE Corporation, a developer of videoconferencing and mobile communication systems and data communication devices, derived one-third of its revenues from Africa over the full years from 2007 to 2011.

However, China has quite a sizeable trade deficit with her southern trading partners (see Chart 7). In fact, the deficit with Brazil has deepened every year over the last decade, while the deficit with South Africa has increased threefold since 2008.

Exports to and imports from Brazil grew at just about the same rate on average over 2001 to 2011, with the growth of imports from Brazil mainly driven by primary commodities and precious stones. More than 93% of imports from Brazil and 65% of imports from South Africa were primary commodities and precious stones in 2010. The deficit with South Africa deepened quickly over 2008 to 2011, driven by much quicker average import growth (55%) over export growth (18%). Unlike the Brazilian case, the growth of imports from South Africa was driven by a mix of manufactured goods and primary commodities, differing from year to year.

China must quickly formulate a strategy to boost net exports to complement its rebalancing plan. Given China’s reliance on Western markets, now is the right time to forge closer trade ties with South America and Africa, even though these markets may look inconsequential now. We have shown that enormous potential lies ahead in these markets.

Policymakers have already caught on. On the last stop of his South America tour in late June this year, Premier Wen Jiabao said China and South America should combat protectionism and develop closer economic ties. His comments show that China is being proactive when it comes to reviving export growth.
5. Composition of machinery and transport equipment (MTE) exports to South America: major items

6. Composition of machinery and transport equipment (MTE) exports to Africa: major items

7. Deepening trade deficits with Brazil and South Africa
Surplus To Stay
China is expected to report narrower current account surpluses in coming years

Chris Leung
Senior Economist
DBS Bank (Hong Kong) Limited

China’s trade surplus has been dwindling for three straight years since 2008 from the peak of almost US$300 billion to US$155 billion in 2011. Consequently, China’s current account surplus is expected to be 2% to 3% of gross domestic product this year compared to 2.8% in 2011, significantly down from the peak of 10.1% in 2007.

It would be naïve, however, to conclude from this declining trend that the country will face persistent current account deficits in the next few years.

Broadly speaking, a country’s current account balance reflects the difference between its income and its expenditures. A deficit country spends more than it is producing whereas the reverse is true for a surplus country. Since saving is the difference between income and consumption, and expenditure consists of consumption and investment, it is also possible to view the current account balance as the difference between saving and investment. A surplus country saves more than it invests whereas the reverse is true for a deficit country.

Looking ahead, China is unlikely to address the sluggish global economy with another behemoth fiscal stimulus as it did in 2009. While this development will not drag China into a hard landing because of support from other strategic industries spelled out in the 12th Five-Year Plan, the pace of investment growth will likely decline slowly over the medium term. And chances are savings rates will descend at an even slower pace.

The government’s pivotal strategy of upping wages in the hope of boosting private consumption and discouraging savings is not going to deliver results overnight. There is no guarantee that wage increments will be completely translated into consumption unless the government finds a way to discourage the Chinese people’s tendency to save rather than spend in difficult times.

Chinese households tend to exhibit strong precautionary savings bias as evidenced by the rise of the national savings rate to above 50% of GDP since 2007 (see Chart 1) despite rapid wage growth during that period. (Household saving accounts for approximately 50% of China’s national savings.) Savings cannot be reduced without corresponding reforms in medical services, education and China’s pension system. And such reforms must be implemented as soon as possible before demographic dividends wear off. Once population ageing kicks, the Chinese population’s precautionary savings bias will only strengthen.

Gross National Savings/GDP have increased consistently

Source: CEIC Data Company
Chinese exporters’ market share continued to rise despite Rmb appreciation

Given that the crawling pace at which savings rate will fall coupled with policy-induced restraints on investment, the current account balance has room to rebound and is unlikely to fall into a deficit.

What about China’s shrinking trade revenues as a result of eroding export competitiveness due to rising labour costs? Since 2005, the wages per worker measure has increased at double-digit rates every year.

In theory, decreasing export competitiveness due to rising unit labour costs could hammer the current account balance. When labour costs increase faster than labour productivity, unit labour costs go up. Unit labour cost growth averaged 2.0% from 2008 to 2010, versus 0.2% over 2005 to 2007 and -0.3% from 2002 to 2004.

Thankfully, competitiveness is relative. Empirical data suggests no serious threat to China’s trade stemming from the loss in its cost competitiveness. Unlike Japan, which quickly lost market share in export markets due to slower labour productivity growth and a strong yen, China has maintained its share in key EU and US markets despite losing cost competitiveness in recent years and a stronger yuan (see Chart 2). This implies China still holds a comparative edge in other areas such as economies of scale, supply chain efficiencies and improving product quality, many of which are unquantifiable.

The upshot is that China’s current account will likely remain in surplus over the medium-term (2013-2016), but it will not be as sizeable as 7% to 10% of GDP. It will more likely fall to 3% to 5% of GDP. And if the yuan appreciation continues to track well with current account surpluses following the expectations set out in chart 3, the recent retreat in yuan appreciation expectations should be regarded merely as a short-term phenomenon.

Source: CEIC Data Company

After years of galloping at an exceptional pace, the Chinese economy appears to be finally slowing down.

China’s gross domestic product grew at “only” 7.6% in the second quarter, lower than the average annual rate of about 10% it has posted for the last 30 years. Even more alarming was the export data, which showed exports rose 1% year-on-year in July compared to an 11.3% year-on-year increase in June.

The reasons for this dip in growth are twofold. China’s key export markets, including the US and the EU are struggling, and the Chinese government has been curbing lending stimulus to rein in investment.

The ripples from the subdued demand for Chinese goods have already reached China’s trading partners. The countries most affected are those that are most strongly integrated into the Chinese supply-chain: Taiwan, Korea, Thailand, Malaysia and the Philippines. According to the International Monetary Fund, a 1% fall in exports by China will slow other Asian economies by 2% to 3%.

In Taiwan, for example, exports in July fell 12% from a year earlier, as demand for computers and mobile phones collapsed. The same month, South Korea reported an 8.8% fall in exports to US$44.6 billion, the largest drop in nearly three years. And this may have serious consequences on the economy of South Korea, which relies on exports for half of its GDP. Meanwhile in the Philippines, exports in June rose only 4.2% – dramatically less than the 19.7% year-on-year rise posted in May – as demand for electronic components fizzled out.

The Chinese slowdown has also affected commodities exporters including Indonesia and Australia, which had enjoyed economic growth driven by Chinese demand for raw materials. A slowing demand from China coupled with plummeting commodity prices hurt corporate profits and investment as Australian and Indonesian coal miners cut production. Indonesia’s coal exports to China dropped by 16% in July 2012 from a year ago.

Countries which export high quality products to China, such as Japan, are also feeling the pinch. One example of the impact: Japanese mining and construction equipment manufacturer Komatsu Ltd, which has prospered on China’s rise in recent years, said construction equipment sales were down by about half in the June quarter.

China’s central bank has already cut rates twice this year in an effort to boost the economy. The actions – in June and July – were the first rate cuts since 2008. At the APEC summit in September, President Hu Jintao acknowledged that the Chinese economy was experiencing “a lack of balance, coordination and sustainability”, and that the government would promote “inclusive growth” to improve people’s lives. That means that the economic crisis could push China to accelerate the rebalancing of its economy from export-driven growth to a consumption-driven economy. On September 5, China announced the approval of infrastructure spending to support growth. The National Development and Reform Commission, the nation's top planning agency, gave the go ahead to construct 2,018 kilometres of roads as well as subway projects in 18 cities. This package is likely to be worth more...
than US$158 billion. The government is also introducing a raft of measures in line with its 12th Five-Year Plan to boost private consumption.

But is propelling investment and domestic consumption good news for China’s trading partners?

When it comes to China’s new stimulus, the answer is yes. Building roads, subways and waterways requires imports of raw materials such as coal, steel, iron ore and nickel. Since the stimulus package was announced, global iron ore prices have topped US$100/ton, up from a near-three year low of US$86.70/ton the day the Chinese infrastructure package was announced. This has also helped shares of Australian miners Rio Tinto and BHP Billiton recover some of the ground lost when the iron ore price was languishing below US$100/ton. However, some analysts are skeptical that China’s infrastructure projects will have any significant economic effect, arguing that the impact of the new package will be small compared to the massive stimulus injected into the Chinese economy in 2009 in response to the global financial crisis.

Would China’s trading partners benefit from the rebalancing towards more domestically-driven growth?

At first glance, ASEAN economies appear to be well-positioned, given their relative strength in consumer goods exports. The problem, however, is Chinese demand for imported consumer goods is still weak, accounting for 2% of global consumer goods imports. Moreover, Chinese consumers have increasingly turned to domestically-produced goods. This is the result of several factors, including the difficulty foreign companies encounter when trying to create efficient distribution networks in China and the fact that manufacturers tend to produce in China to be closer to consumers and more in touch with their tastes and preferences. But that does not mean foreign suppliers will completely miss out on the Chinese consumer market. There are opportunities for foreign companies to become integrated into the supply chains of Chinese firms that sell their products in the domestic market.

One of the key imbalances in the region is also that China’s trading partners are too export-dependent and under invested in their own economics. “In several economies including Malaysia, Singapore, the Philippines, Taiwan and Indonesia, investment rates have been hovering around 20% of GDP in recent years, less than half the rate in China,” said Yılmaz Akyüz, special economic advisor to the independent intergovernmental think tank of developing nations, the South Centre. This is in part due to the majority of the world’s foreign direct investment to emerging markets flowing into China. One of the solutions could be, as Akyüz puts it, for China to use its reserves to invest in Southeast Asia. Currently, while the bulk of Chinese outbound direct investment, some 65%, is in Asia, they are primarily concentrated in Hong Kong, which takes up to three quarters of it. There is enormous scope for China to expand into other Asian markets to deepen economic linkages and increase South-South trade.
Changing of the Guard

Every ten years sees a ritualistic changing of the guard at China’s elite inner circle. Seven Communist Party luminaries have formed the all-powerful 18th Politburo Standing Committee, downsized from a previous nine members. Among the choices made by the party’s leading lights are so-called “red royalty” related to first-generation leaders, and a sprinkling of western-educated technocrats. The new crop of leaders will decide China’s political and economic course for the next decade. Here are the men who will shape the future of China.

Xi Jinping  59

Position: General-secretary of the Chinese Communist Party; Chairman of the Central Military Commission
Factional ties: Princeling; considered a protégé of former president Jiang Zemin

Vice-president Xi, who succeeds Hu jintao as head of the party and military, has red royal blood courtesy of his father Xi Zhongxun, a veteran revolutionary from Chairman Mao’s era. His expected ascendency to the post of president next year has been smooth, given his popularity with party elders and key factions including Hu and his premier, Wen Jiabao. He is believed to have good relations with the People’s Liberation Army, and espouses orthodox views on Communist ideology and – more importantly for the party brokers - the party’s uncontested place at the helm of governance in China. Also known for his tough stance on corruption and knack for defusing sticky situations, Xi has been drafted in to oversee damage control and manage the spill-over from high profile corruption scandals. He is charismatic as well, charming foreign dignitaries with an affability most unlike the more formal Hu. He is also a strong supporter of close relations with the US, which was on display during his well-publicised visit of the country earlier this year. He has economic expertise, too. As party secretary at booming Zhejiang province, Xi helped in attracting foreign investment, cultivating its entrepreneurs and transforming the eastern province into a successful economic model for China’s development. Xi’s ability to manoeuvre through the political quagmire that rocked China in 2012 after the arrest of former Chongqing chief Bo Xilai, secured his position for the country’s top job. However, his mysterious two-week disappearance from the public scene in September this year spurred speculation of ill health or a political misstep. Still, judging by the fairly positive international response to his first public speech as the CCP general-secretary, Xi is China’s best hope to deliver the political stability needed to cope with changing fortunes as the economy slows.
Li Keqiang  57

Position: Presumptive Premier and Secretary of the State Council
Factional ties: Tuanpai; considered a protégé of President Hu Jintao

A consummate political survivor, Executive Vice-premier Li Keqiang will take over from Wen Jiabao the position of premier of the world’s second largest economy. Li is a long-time confidant of President Hu Jintao, and was tipped for the top job before losing credibility after a string of political setbacks while being the governor of Henan and Liaoning provinces. Another factor in his fall from grace may have been his reputation as an economic reformer. Nonetheless, his doctorate in economics and master’s and bachelor’s degrees in law leave him well qualified for his portfolios spanning finance, economic development, price controls, climate change and health care reform. His pronouncements on economic management reflect an open-mindedness often uncommon among China’s cautious bureaucracy. Li has argued for less export-driven growth and investment pump priming, to more sustainable growth based on domestic consumption. These views may jar with traditionalists, but nevertheless Li will likely steer China’s next round of economic reform plans. The hope seems to be that Li’s blueprint will help to deliver political stability as well as sustainable economic growth. He sees wealth distribution as key, to spread the benefits of economic growth across more members of the middle class. With his eye on the long game, Li has championed innovation, a greener economy and the gradual internationalisation of the yuan. Li is one of the few top leaders who is fluent in English.

Zhang Dejiang  66

Position: Expected to be Secretary of the National People’s Congress (NPC)
Factional ties: Princeling; considered a protégé of former president Jiang Zemin

Vice-premier Zhang Dejiang stands out as the former top official at Zhejiang and Guangdong provinces, both of which have helped to drive China’s economic growth. Having graduated from Pyongyang’s Kim Il Sung University with a degree in economics, he is also fluent in Korean. He provides a valuable link to the troublesome regime on China’s northeastern border, whose collapse would usher in all manner of economic problems. Most recently, Zhang replaced the disgraced Bo Xilai as party chief at Chongqing, and performed creditably in reassuring foreign investors while righting a local political culture skewed by Bo’s personal ambitions. Chongqing’s economy has also rebounded, enhancing Zhang’s credentials as a sound economic manager. The hardliner is, however, tainted by criticism of his seeming indifference for human rights issues, and support for harsh controls on media freedoms. Known for his commitment to conservative CCP principles, Zhang’s leadership is characterised by his iron-fisted style and focus on rapid economic development. He is a keen supporter of state-owned enterprises, indigenous innovation and the global expansion of Chinese businesses.
Yu Zhengsheng 67

Position: Expected to be Chairman of the Chinese People's Political Consultative Conference (CPPCC)
Factional ties: Princeling; considered a protégé of former president Jiang Zemin

As Shanghai party secretary, Yu Zhengsheng is the power behind China's largest and most financially dynamic city. The oldest member in the elite club of seven also has experience and seniority on his side. A princeling, Yu has had a storied life, as his father was a senior party activist who was once married to Jiang Qing – later the fourth and final wife of Mao Zedong. Yu's close ties with Deng Xiaoping's family has been key to his emerging unscathed from corruption allegations and from portfolios that would have condemned a lesser name to anonymity. These ties have also bolstered his standing among cadres who consider themselves disciples of the great reformer. Although fairly conservative, Yu has been known to support private sector liberalisation, social reform and the rule of law. He is noted for combining a low profile with political savvy, which has enabled him to maintain good relations with the rival factions loyal to former general-secretary Jiang Zemin and outgoing leader Hu Jintao respectively.

Liu Yunshan 65

Position: Expected to be Executive Secretary of the Central Secretariat
Factional ties: Tuanpai; linked to President Hu Jintao

China's propaganda chief began his career in Inner Mongolia, where he worked for nearly 30 years, first as a teacher and later as a state news reporter and propaganda official. He became director of the publicity, or propaganda, department in 2002, which maintains tight control over the media and the internet. In the past decade, he has been known to manipulate and control the Chinese media to protect and ensure the CPP's continued rule. Undoubtedly, he has had his fair share of controversy. Last July, he ordered tighter control of the media following public anger that intensified over the internet regarding the government's handling of the high-speed train crash in Wenzhou, Zhejiang province, which left 40 people dead and more than 200 injured. Liu trumpets party orthodoxy and is often involved in drafting official statements. He is also credited for helping to create China's infamous Great Firewall that monitors the internet traffic of some 500 million users. While critics say he may be out of step with new media and its challenges, he is recognised for boosting the international presence of state-owned media in recent years. Tipped to lead the Secretariat, he will most likely oversee many aspects of the 82 million-member party, as well as the running of the state's main departments.
Zhang Gaoli 66

Position: Expected to be Executive Vice-premier
Factional ties: Considered a protégé of former president Jiang Zemin

An economist, Zhang Gaoli started his career in the oil industry, rising to party officer and manager at one of China’s biggest refineries. A protégé of Jiang Zemin, he was later elevated to top positions in Shenzhen, a financial centre and capitalist test-bed, and at the similarly freewheeling Guangdong province. He repaid Jiang’s faith with solid performances, and was rewarded with the job of party secretary at Shandong. Currently the party secretary in Tianjin, Zhang maintained his impressive track record by guiding the port city to China’s fastest GDP growth level last year, further burnishing his bona fides for promotion. Zhang’s policy initiatives are guided by Jiang Zemin’s signature ideology, the “Three Represents”, in which the primacy of the Communist Party is promoted in affairs relating to economic production, culture, and citizen welfare. Zhang is known to pride himself on a low-key approach and shuns public speeches, although he has, in recent months, been more forthcoming with the public and media. Nevertheless he is known to be pro-market and a supporter of foreign investment to spur economic growth.

Wang Qishan 64

Position: Expected to be the Secretary of the Central Commission for Discipline Inspection
Factional ties: Princeling; considered a protégé of former president Jiang Zemin

The former Beijing mayor and vice-premier in charge of economy, energy and finance is nicknamed “chief of the fire brigade” for his ability to solve some of China’s toughest problems, having helped to establish China’s first foreign-invested investment bank despite parlous economic conditions in the late 1990s. He was swiftly appointed as Beijing’s acting mayor after the incumbent botched the handling of the 2003 SARS outbreak, was tapped to steer the 2008 Beijing Olympics through to its successful conclusion, and was involved in the party’s response to the global financial crisis. Liked by foreign counterparts for his confidence and intelligence, Wang has performed with distinction in economic talks with the US, perhaps unsurprising given his past experience as vice-governor of China’s central bank, head of China Construction Bank and director of the Office for Economic Restructuring. As a progressive voice, many had expected Wang to take a leading role in setting China’s future macroeconomic policies, and pursue monetary policy liberalisation and openness for foreign investment. Instead, Wang’s stellar track record has landed him the role of China’s new anti-corruption chief as its leaders resolve to combat endemic graft.

Princeling versus Tuanpai

The Communist Party of China can be divided into two distinct factions that jockey for political leverage: 

- **Princelings** with blood ties to first generation leaders and top officials, often have strong family connections and support that help them rise through the ranks. Their party pedigree makes them a safe choice as well, given they are likely to support the party’s strong hand in state affairs.
- **Tuanpai** is a term used to identify a populist group of officials with relatively humble beginnings who trained under the Communist Youth League and ascended to national prominence. These officials often have succeeded by dint of educational achievement, often through post-graduate study sometimes undertaken overseas.
Section 2

Business Briefings
Industrial overcapacity has long been a critical issue in China's economic development. The situation is not just a problem for specific industries; it has become a broader issue for the whole economy. It is not limited to raw materials such as cement, steel and chemicals. Even manufacturers in emerging industries, including solar equipment and wind power, are not managing to sell as much as they produce.

The sluggish macro environment remains a challenge for export-oriented industrial manufacturers in China. Domestically-oriented manufacturers are expected to enjoy relatively higher sales growth on rising domestic consumption as the Chinese economy rebalances. But all manufacturers are struggling to cope with a chronic overcapacity problem. And to sustain profitability, they will have to adopt greater technological innovation in production and product development and offer more value-added services.

The overcapacity problem began to emerge in China in the early 2000s and became even more serious after the government's Rmb4 trillion stimulus package was launched in 2009 to combat the global financial crisis. Government investment was blindly made with the sole purpose of boosting overall gross domestic product and employment even though there was insufficient demand. Capacity utilisation is estimated to have fallen from just under 80% pre-crisis to 60% in 2011, compared to about 63% for the US in June 2009 (see Chart 1).

Since the 2009 stimulus package, the government has been introducing various measures to alleviate the overcapacity problem. It has tightened environmental requirements to eliminate inefficient and out-dated capacity and restricted bank lending and the number of new projects. In some industries, particularly those dominated by private enterprises, market forces have resulted in gradual market consolidation. However, ineffective
execution of the above measures, especially in industries where state-owned enterprises (SOEs) still have substantial influence, has not totally resolved the overcapacity issue. In fact, with slower growth, production utilisation will be even more difficult, resulting in even lower selling prices and thinner profit margins.

Another major issue for China’s industrial sector, particularly for labour-intensive industries, is climbing labour costs. This is a result of the government’s aim to boost the disposable incomes of workers to spur domestic consumption as a driver of economic growth. The proportion of direct labour costs in China’s cost of goods sold (COGS) has increased at least 3 percentage points over the past few years and under the government’s 12th Five-Year Plan, workers’ salaries are set to double.

There is no easy way to resolve the issue of overcapacity, short of capacity elimination through massive structural reform. More emphasis has to be put on higher product quality with more value-added services.

The overcapacity problem is also more severe in low-end sectors. Thus, increasing research and development, more product development and greater emphasis on technological innovation to produce higher quality products, should help improve profitability. This will be a particularly helpful strategy for domestic manufacturers as living standards in China rise and consumers become more discerning.

Chinese manufacturers should also intensify their efforts to diversify their export markets to other developing countries, such as South America, Africa and the Middle East, as market demand in the traditional markets of the US and the EU remain weak.

Chinese manufacturers should start looking into cost-cutting strategies such as automation. Not every industry would be able to adopt this easily such as the sewing of garments or production of shoes. However, it is interesting to note that for many factories, automation need not be complicated. For example, in simple material loading tasks, a basic conveyer belt or similar systems eliminate the need for machines to be fed manually.

Relocating production facilities to areas were labour costs are lower is another option. Enterprises could move factories inland or to Southeast Asian countries such as Indonesia, Thailand or Vietnam where labour costs are lower. The change of geographical location should also take into consideration the impact this may have on infrastructure and logistics arrangements. In our view, Guangdong has the best arrangement in terms of supply chain and component supply.

We believe it will be particularly tough for exporters in the medium term due to the gloomy economic outlook of the US and the EU. For domestic producers, despite the moderated GDP growth target in the 12th Five-Year Plan, their sales growth rate could still be respectable given the official emphasis on stimulating domestic consumption. Thus, we expect a compound annual growth rate of low- to mid-teens for the overall industrial sales in China over the coming five years.
China’s new emphasis on technology will push the country up the value chain

China, often dubbed the factory of the world, has been synonymous with low cost and low-tech manufacturing rather than technological sophistication and innovation, but we believe this is set to change.

As the country’s manufacturing and design capacities mature, China is ready to move to the next rung on the development ladder where its competitive edge will be based on human capital, technology and know-how.

In China’s current economic blueprint – the 12th Five-Year Plan – seven strategic industries have been identified to spearhead its technological upgrade. They are: information technology, biotechnology, energy savings/environmental protection, advanced equipment manufacturing, new energy, new materials, and new energy vehicles.

Fortuitously, state and financial support for these industries come at a time when investment and export-driven growth is slowing down. And with it, these selected industries will grow at a pace faster than China’s overall GDP growth.

As of 2010, these emerging industries collectively only accounted for 3% of GDP. The government aims to raise this to 8% of GDP by 2015 and subsequently to 20% by 2020. The government plans to see a compound annual growth rate (CAGR) of 20% from these sectors between 2011-2015, the duration of the 12th Five-Year Plan.

Putting money where its mouth is, the government of China pledged a total of Rmb10 trillion of investment into these strategic industries from 2011-2015.

Selected government support on the strategic industries

<table>
<thead>
<tr>
<th>Industry</th>
<th>Sub-sector</th>
<th>Type</th>
<th>Programme</th>
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<tbody>
<tr>
<td>New energy</td>
<td>Solar</td>
<td>Subsidy</td>
<td>Golden Sun &amp; Roof programme takes up half of the construction costs</td>
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<tr>
<td></td>
<td>Wind</td>
<td>Tariff</td>
<td>Premium over fossil based power</td>
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<tr>
<td></td>
<td>Solar</td>
<td>Tariff</td>
<td>Solar national tariff at Rmb1/kwh</td>
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<td>Auto</td>
<td>Subsidy</td>
<td>Rmb60,000 for Battery EV and Rmb50,000 for Hybrid</td>
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<td></td>
<td>Auto</td>
<td>Tax</td>
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<tr>
<td>Environmental protection</td>
<td>All</td>
<td>Investments</td>
<td>Rmb3.2 trillion in investments</td>
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<tr>
<td>Waste to energy</td>
<td>Tariff</td>
<td></td>
<td>Rmb0.25/kwh on top of fossil based power</td>
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<tr>
<td>Advanced information technology</td>
<td>PC</td>
<td>Subsidy</td>
<td>Rmb260 subsidy on energy saving desktops</td>
</tr>
<tr>
<td>Advanced equipment manufacturing</td>
<td>Satellite</td>
<td>Subsidy</td>
<td>40% R&amp;D entity, 60% Application</td>
</tr>
</tbody>
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Source: NDRC
Table 1 illustrates selected government policies in support for these technology-driven sectors.

One of the driving forces behind the official emphasis on the technology sector is the clear focus on energy efficiency and environmental protection. This is evidenced by the government's push on new energy, energy savings, environmental protection and more energy efficient vehicles.

Another apparent motivation is the desire to wean Chinese industries from their reliance on foreign high-tech manufacturing equipment and materials. Even listed Chinese companies in the advanced manufacturing equipment sector still rely on German, Swiss or Japanese imports for their operational needs.

Most factory managers deem Chinese-made machinery vastly inferior for critical tasks. Although China's major players such as Haitian strive to compete globally with their plastic injection moulding machines, the majority of quality-conscious factories still prefer foreign products from Germany, Switzerland and Japan.

Developing these industries require more than mere material and financial resources; it will entail the support of human capital and intellectual know-how. This represents a fundamental shift from the labour intensive driven economy of previous decades.

To be sure, China is not starting from square one. Although China still lacks key technological and human capital, it has become familiar with many of the technology-driven sectors due to its manufacturing prowess. It has developed its own capacity in the manufacture and assembly of high-end technology products such as smartphones and tablets. Another example would be China's massive capacity in the solar panel and wind turbine industry.

There is a real risk, however, of overinvestment in these sectors given the strong state push. A case in point would be the new energy segment, where strong government support has created a massive overcapacity in both the wind turbine equipment and solar panel equipment. The big players in the solar industry such as Sinovel, GCL, Trina and Yingli are likely to survive, although the current consolidation will continue to be painful. We see a similar situation in the new materials segment, where producers of PTFE (Polytetrafluoroethylene), such as Dongyue, are facing lower selling prices as the economy slows and the industry deals with overcapacity.

China's economy and manufacturing prowess is maturing and the world's most populous economy is no longer just a factory to the world. China is moving up the value chain and we believe the government's new focus on technology will drive the next phase of growth in China. We believe the selected sectors will see the most investment and growth, pushing them to outperform other segments that are more reliant on labour and capital.
A strong overseas presence is increasingly important for Chinese banks...
Banking

End of an Era

China’s banks will see declining profitability amid reforms

As China’s rapid GDP growth trajectory comes to an end, so will its banks’ golden era of high growth and profitability. Naturally, Chinese banks’ balance sheet growth will decelerate along with China’s GDP. But the larger impact will come from new banking reforms that are being rolled out to facilitate China’s economic transformation. Some of these new measures will structurally lower the industry’s profitability, but would be good for the economy as a whole.

The plight of Chinese SMEs in obtaining financing provides a good example. The banking sector is China’s dominant financing channel, but SMEs are often crowded out of bank lending by the state-owned enterprises. In 2010, SMEs accounted for 60% of GDP but only 37% of bank loans (see Chart 1).

Policymakers are trying to fix this discrepancy by requiring banks to grow their SME loan book quicker than their overall portfolio. Also, new SME loan amounts must be higher than the previous year. Moreover, regulators have adopted favourable risk weightings for SME loans and also for consumer loans. Interest rate liberalisation will also spur lending to SMEs, as banks have more incentive to seek higher yielding assets to offset rising funding costs.

Amongst these changes, interest rate liberalisation is shaping as a key drag on Chinese banks’ profitability in the coming years. Lowering the floor for lending rates is expected to have only minimal impact on profitability as very few loans are made below benchmark rates. Rather, the drag on net interest margins (NIM) will come from funding costs. For every 10% increase in the deposit rate ceiling, the sector’s NIM should decline by between 8 and 14 basis points. Banks with more liquid deposits, either through a strong retail banking network or settlement accounts, will see lower funding cost pressure.

Chinese banks currently have very similar balance sheets and loan mixes. However, we expect interest rate liberalisation will polarise the sector’s asset mix. Banks with funding cost advantages will likely have a higher proportion of lower yielding assets, as these banks can afford to avoid aggressive risk. Conversely, smaller banks that rely on more expensive funding sources will be forced to seek higher yields to compensate for higher funding costs. The expected growth in SME loans and consumer loans will be balanced by expected declines in infrastructure loans and loans to large corporations.

Direct financing channels are also being developed to

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Source: National Bureaus of Statistics, SAIC, CBRC, DBS Vickers
Accelerate disintermediation and as a result negatively affect loan demand from large borrowers. Large enterprises are increasingly tapping the bond market for financing needs instead of using pricier bank loans. As of August 2012, newly issued corporate bonds rose 69% year-on-year, compared to 17% growth in bank loans (see Chart 2). Disintermediation of large corporations is expected to continue in the coming years. Consequently, banks will target large customers more for fee opportunities and deposits, while shifting more on-balance sheet lending to smaller customers.

Fee income at Chinese banks did not grow as expected in the first half of 2012 due to tight controls on charges. However, we expect momentum to pick up as reforms start to deliver results. Disintermediation offers investment banking fee opportunities. A growing pool of bond instruments will also enhance wealth management opportunities for retail clients. Further relaxation of fees could also occur, as Chinese banks are still barred from much of the businesses common at international banks, including insurance and securities.

As the economy slows, the People’s Bank of China has lowered bank cash reserve levels three times since 5 December 2011 last year and is expected to loosen ratios further. However, Chinese regulators are still expected to roll out new capital rules based on Basel III over the next few years starting from 2013. The new capital rules will raise the bar for capital adequacy ratios, which will in turn put pressure on return on equity (ROE). In light of the new capital rules, banks will be adjusting their business structure to optimise capital allocation. We expect banks will favour incomes that are less capital intensive such as fees or loan segments that carry lower risk weightings such as small and micro enterprise loans and retail consumption loans.

The listed H-share bank average ROE during 2010-2011 exceeded 20%. We expect the sector’s average ROE to dip to a range of between 12% and 16% by 2018, due to negative impacts from interest rate liberalisation and tougher capital requirements. Large banks will likely have higher ROE levels of around 14% to 16%, due to their funding cost advantage and economies of scale. Smaller national banks will see their ROE levels dip into the low teens.

Banks will have to adjust their business structures to optimise capital allocation. And while reforms will compress the sector’s profitability, banks will still have growth opportunities. Loan and deposit growth is well placed to expand at an average annual growth rate of 12% from 2012 through 2018. Loan growth has historically tracked the GDP growth rate plus inflation plus 1 to 2 extra points. By 2018, deposit and loan balances are
estimated to double from current levels to Rmb183 trillion and Rmb129 trillion respectively, while total bank assets should total Rmb250 trillion.

We also foresee higher growth potential for banking in rural China, which is currently underserved by financial institutions. Loan to deposit ratios as well as fee income is lower in rural areas. We expect this to change as living standards rise in line with a push to boost rural wealth and narrow income disparities.

Another expected development is overseas expansion by Chinese banks. A strong overseas presence is increasingly important for Chinese banks, as corporations and individuals increasingly invest abroad. A global platform also helps secure trade settlement accounts, which provide cheap liquid demand deposits. We expect overseas expansion by Chinese banks to accelerate; especially large banks that have demonstrated the ability to correctly price risk in free market environments.

In sum, China’s banks can expect lower net interest margins from interest rate liberalisation, greater differentiation in balance sheets, disintermediation, and a loan mix shift towards SMEs.

A looming banking crisis?

Overdue loans are fuelling fears of a debt crisis as exports contract and property sector losses take their toll. Loans less than 90 days overdue increased by 49% in the first half of 2012, while the average overdue loan ratio jumped from 1.17% to 1.33%. The rise in overdue loans is alarming as they may be downgraded to non-performing if not repaid. Concerns are compounded by heightened systemic risk due to chain loan guarantees between companies. As worrying as this sounds, however, the good news is that most of the problems are isolated to Eastern China, particularly Zhejiang province. Based on trends in July and August, banks believe the non-performing loan (NPL) situation is contained to this region and do not expect the problem to spread to other areas. We agree, and do not foresee a systemic NPL issue for banks in the coming years.
China will lead the world in middle class consumption by 2020...

1 PRC retail sales CAGR by segment (2011-2016F)

Source: Euromonitor
Efforts to rebalance China’s top-heavy economy towards domestic consumption is good news for the consumer sector. Under the current official blueprint for the Chinese economy – the 12th Five-Year Plan – the government aims to boost disposable household income and achieve a fairer distribution of income. This should help to enhance overall spending power and retail sales growth (see Chart 1).

Specifically, the Plan calls for a 13% annual growth of minimum wages, further increases in income tax thresholds, improved health care benefits, increased social housing and greater job creation. All these initiatives are geared to bolster the growth of China’s middle class.

The bet is that rapid middle class expansion will drive the domestic consumption that China needs in order to deliver sustainable economic growth. Its middle class is forecasted to gobble up 13% of global middle class consumption by 2020, from its current single-digit levels (see Table 2).

Assisting this transition is China’s rapid urbanisation that has created new markets in lower-tier cities, which has in turn prompted leading corporations to expand into these territories. As first-movers, these firms can augment their customer base and establish greater economies of scale. For some companies, this comes as a welcome development, as profit margins at larger cities are shrinking amid intensifying competition and rising rents.

Brand equity will become increasingly important as consumers become more sophisticated and demanding. Global brands and successful domestic labels are poised to benefit most from this trend, given their relatively low market base and the increasing affluence of Chinese consumers.

The cosmetics segment could see solid growth, as it has proven in the past to be a resilient performer even in bad economic times. Home appliances are shaping as less attractive given that most products are relatively commoditised and retailers face intensifying competition from online rivals.

Admittedly, retail sales performance has slowed in recent months due to fading consumer sentiment influenced by uncertain global economic conditions. However, this could also be explained by a higher base effect overhanging from last year, suppressing near-term sales growth momentum.

Looking ahead, rising disposable income, a strong yuan and widening availability of credit should encourage Chinese consumers to spend. And low inflation could provide some scope for prices to be lifted without hurting effective demand and therefore provide a boost to retail sales performance.

Overall, we expect retail sales in China to sustain between 8% and 10% annual growth rates over the medium-term, totalling at least Rmb30 trillion by 2018, after taking into account the strong spending by China mainland consumers in Hong Kong and Macau for tax-free product offerings, and potentially a weaker HKD following the recent announcement of the third round of quantitative easing.
...there will be around 240 million vehicles on China’s roads.
The Chinese auto market, driven by rising incomes, rapid urbanisation and government incentives, has grown exponentially over the last few years to become the world’s largest in terms of sales. Domestically, auto sales account for the largest chunk of total retail sales (27% in 2011), and will remain so for the foreseeable future. By 2018, annual auto sales are expected to reach 26 million units, by which time there will be around 240 million vehicles on China’s roads – more than double the current number (see Table 1). By that time, however, vehicle penetration will have reached only 17 units per 100 people, far behind the 50-80 vehicles per 100 people common in Europe and North America, still leaving plenty of room for growth (see Chart 2).

The sheer size and potential of China’s market has attracted some of the world’s famous auto brands. American, European and Japanese auto groups have been selling vehicles in China for years, and other brands are knocking at the door for market access. And the Chinese consumers are welcoming them with open arms. With rising incomes, they now favour bigger and more expensive cars. As a result, the booming auto market is increasingly dominated by foreign brands, leaving China’s fledgling automakers struggling to compete. Cornering half the market several years ago, local automakers now take up only 40% of it.

Foreign auto brands are also moving down the value chain, in direct competition with local manufacturers; rolling out entry-level models geared towards new car buyers and to tap the potential of China’s smaller cities in the interior. At less than ten vehicles per 100 people in these cities, the potential is huge for future volume growth. With foreign

### Market size

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<th>2018F</th>
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<td>Urbanisation rate (%)</td>
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Source: CEIC Data Company, China State Council, DBS Vickers and news reports
cars an increasingly common sight in China’s cities, growth margins of foreign and domestic brands will continue to diverge.

In response, Chinese auto brands have been forced to produce bigger and pricier vehicles to appeal to consumers wanting to trade up. However, they are still hampered by the common perception that foreign brands simply offer better quality.

Even as Japanese cars are shunned, the main beneficiaries would be other foreign brands rather than the local makes. Japanese carmakers find themselves caught up in the heated territorial dispute between China and Japan. Strong public sentiment against Japan could weigh in on the performance of Japanese cars in the China market. Japanese auto brands account for about 20% of total passenger vehicle sales in China. Already, Nissan, Honda and Toyota have decided to halve their China output according to news reports in early October this year.

Local automakers are faced with other issues. Despite the robust demand for cars, zealous expansion in capacity has led to concerns of oversupply in the sector. Industry sales peaked at 4% less than total production in July 2012. Auto original equipment manufacturers (OEMs) are cutting back production and may now be operating at 70% or less utilisation rate. The utilisation rate is expected to improve in 2013 after the market has digested the current capacity overruns.

Also, with worsening traffic congestion in major cities, local governments are looking at ways to reduce harmful carbon emissions. Curbs on car pollution in Beijing and Guangzhou have halved annual auto sales in these two cities and more cities might follow. This could dent sales in the low-end market.

Given the limited licences available for new car sales

Source: Auto News, ACEA, CAAM, ID Powers, HIS Automotive
to curb pollution, consumers may ironically end up with bigger vehicles, further hurting local automakers.

The economic slowdown will only compound these problems, and domestic automakers are adjusting their product pipelines, marketing strategies and finances to ride out the doldrums. Some are better placed than others to prosper, given their branding advantages and consistent effort to renew product lines.

Consolidation of the local auto sector will be unavoidable over the next few years. Within the industry, this will take place more quickly with the dealers than the assemblers. This is mainly because auto dealers are privately owned, while the auto OEMs are typically controlled by state-owned enterprises. The overcrowded sector is in dire need of a shakeout; of the 100 automakers in China, the top ten account for over 80% of total sales.

China's auto market is huge and will remain a core sector of the economy. The mass market will remain the volume driver over the long term, and will be dominated by SOE-foreign auto groups such as Shanghai Motor Corp. (SAIC), First Auto Works (FAW), and Dongfeng. Among the Chinese companies, Great Wall Motor has established a strong presence in the SUV segment, ahead of other foreign branded vehicles.

The government wants to encourage more Chinese car companies to sell their products abroad. And local automakers including Chery, Geely and Great Wall Motor are eager to do so. But in order to gain popularity in foreign markets, product quality must improve. Consequently, Chinese auto companies are buying foreign ones to obtain access to better technology and know-how, as seen in the case of Geely Holding Group acquiring part of Volvo. Only time will tell whether this strategy will pay dividends.

Hybrid over electric vehicle?

The Chinese government supports clean energy car development, allocating an impressive Rmb100 billion of incentives and subsidies for automakers and consumers to boost electric car sales. The government has already set an aggressive sales target of 500,000 alternative energy vehicles by 2015, and 5 million by 2020. These targets look challenging given the current low adoption rate. The government is also focusing on the public transport sector by providing subsidies of between Rmb200,000 and Rmb400,000 for each hybrid bus sold across the nation.
Next Generation
A shift to 3G data services

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The global environment has a limited direct impact on the country's telecoms sector, which depends more on domestic demand factors and the dictates of government policies to secure its fortunes.

Besides, investing in the telecoms infrastructure during an economic downturn has always been part of the government's policy strategy. According to industry sources, the sector is expected to receive some Rmb1 trillion of public spending on 3G/4G network development over the next five years.

This will help boost network quality that is crucial to the user experience of data services. Additionally, if China can sustain a moderate GDP growth through domestic consumption by increasing incomes and lifting living standards, we could see a quickened transition in consumption behaviour from voice to mobile data usage – the so-called 2G/3G migration.

Data usage is viewed as a consumer good that goes beyond mere necessity and therefore affordability apart from user experience will drive the 3G pick up rate. In this regard, the availability of cheaper, entry-level smart phones and affordable data plans will further facilitate 3G penetration.

Currently, China's 3G-subscriber base accounts for only 18% of a mobile population of one billion subscribers. While revenues from voice services are slowing down, the growth of data will represent a new revenue stream for the industry.

China Unicom, one of the country's leading telecoms companies, already posted 2.6 times higher average revenue per user (ARPU) for its 3G service in the first half of 2012, over its 2G services.

Interestingly, the growing 3G-subscriber base is also helped by the convoluted market which prevents subscribers from easily porting their mobile numbers between providers, leaving users with multiple numbers. China Mobile is the preferred 2G-service provider, while China Telecom and China Unicom are the preferred 3G operators. China Unicom and China Telecom are growing their 3G-customer base from China Mobile's high-end 2G users. Migration from 2G to 3G has resulted in subscribers holding China Mobile's 2G numbers as well as China Telecom/China Unicom's 3G numbers.

While mobile penetration in the country stands at about 80%, this is unevenly spread across the country with less developed provinces such as Jianxi and Hunan with at as low as 60%. Thus, mobile subscriber numbers will continue to grow steadily in the coming years, as network coverage expands into the rural areas.

Stable growth is expected overall in the fixed-line segment, including broadband. The traditional wire-line voice service is regarded as a utility, and to a certain extent it is a commoditised service. Subscriber numbers are stable, but pricing pressure is squeezing margins. A decline in fixed-line usage is largely offset by growth in broadband under government initiatives like “Broadband China”, and a focus on “fibre-in, copper out”. Fixed-line development should be largely immune to problems resulting from the economic uncertainties.

Overall, we expect the telecoms market to hit Rmb1.5 trillion in annual revenue by financial year 2018 from the current Rmb1.1 trillion, driven largely by mobile usage.
China’s property sector is expected to keep growing albeit at a slower pace, driven by growing real demand from unrelenting urbanisation, low levels of home ownership and growing affluence.

Half of the country’s 1.3 billion population now live in urban centres, and this is expected to reach 60% over the next several years as migration from rural areas brings an estimated 10 million new residents into cities each year. This flood of new arrivals will constitute a stubborn demand for new housing. The ratio of units per household is around 0.92, according to the Development Research Centre of the State Council. International experience suggests markets stabilise at a ratio of 1.10. In addition, China has more than 50% of its urban population living in the government-subsidised housing built before the 1990s, which are often in shabby conditions. This group of people will continue to upgrade to commodity housing built by developers, which serve as another strong demand driver.

Improvement in affordability will also help foment housing demand. Rising incomes coupled with government controls on property prices to curb speculation are likely to make housing increasingly affordable.

As such, we expect continued growth in property sales although at a more modest single digit rate compared to a CAGR of 17% in the past decade. We forecast that property transaction volume will grow to 1,100 million square metres in 2014 from 970 million square metres in 2011, and stabilise at this level from 2015 through 2018 (see Chart 1).

Property prices will remain stable due to continued concerted efforts by the government to curb rising prices. Since January 2011, Beijing has announced a series of measures to rein in housing prices and directed local governments to implement price controls. Over the next five years, the government plans to build 36 million units of social housing for low- and middle-income earners. Against this backdrop, we estimate modest price
hikes of between 3% and 5% annually until 2018, compared to 10% annually over the past ten years.

These developments combined with rising labour and construction costs will invariably narrow the profit margins of developers. With growth contracting, developers are expected to cut back their expansion plans and smaller players will be forced out of the market.

The 18 developers we track have a cumulative market share of 13% and this is expected to reach 23% by 2018, as a result (see Chart 2).

Developers will continue to diversify their revenue sources in order to manage their risks, mainly policy risk, in the residential segment. They will have to work harder to build recurring income by holding more investment properties. This will require intensive capital investment and cheap funding costs, as the payback period for holding investment properties is relatively long. Presently, recurring income accounts for less than 10% of developers' top line. We expect this to rise to 20% by 2018.

The build-up of investment property portfolio requires significant capital investment, and developers will start to de-leverage through slowdown in land acquisitions. Land acquisition as percentage of contracted sales has fallen from 98% in 2009 to 36% in 2011 and will hover at low levels going forward. The average net debt ratio for the sector was 64% in the first half of 2012. With developers slowing their expansion plans but growing their recurrent income base, we expect average net debt ratios to drop to below 50% by 2018.

To get access to cheaper credit outside China, developers will also work on diversifying funding sources to support their business transition. This trend could manifest in more A-listed developers seeking financing through the Hong Kong share market, such as Vanke’s acquisition of Winsor Properties and Gemdale’s acquisition of Frasers Property.

In terms of risks, the sector is highly regulated and thus vulnerable to policy changes which could include the implementation and/or extension of property tax, an increase in social housing, and other tightening measures.

Oversupply in tier III/IV cities is another concern in the long run. Over the next five years, oversupply risk in smaller cities is likely to be more severe than in larger cities where limited land supply places a natural constraint on development.

Despite various risks facing the sector, we expect some developers to outperform others. Over the past five years, we have seen some developers perform well in both up and down cycles. To prosper in the new economic climate, developers with strong execution and risk management capabilities, a strong brand name, quality products, easy access to cheap funding and well organised tax plans will outperform others.
Power Trouble?

Government directives to cap energy demand will challenge power providers

As China rebalances to a slower but more sustainable rate of economic growth, incremental demand for power is expected to scale back correspondingly to between 5% to 7% per annum from the 11% average over the last five years.

Still, China will remain a major player in the energy sector. Over the last ten years, China's energy demand has more than doubled to 3.5 billion tons of standard coal equivalent (SCE) in 2011, surpassing the US as the world's largest energy consumer.

Slower GDP growth will not impact negatively nor derail energy demand in China. If anything, slower economic growth could help China become a more efficient user, lowering energy consumption and carbon emissions levels to meet targets set out in the country's official economic blueprint, the 12th Five-Year Plan. The energy targets are premised on an average GDP growth of 7% and the anticipated slowdown will help China cut its energy consumption intensity (energy consumption per unit of economic output) by the mandated 16% at the end of 2015.

The People's Republic may introduce an energy consumption cap on top of existing energy saving and emissions reduction targets. A proposal to cap demand at 4.2 billion tons of SCE by 2015 is presently awaiting State Council approval. In the longer run, China aims to keep its total energy consumption under 5 billion tons of SCE by 2020 (see Chart 1).

The slower demand growth, however, will be a major challenge to many independent power providers (IPPs) such as Huaneng and Datang which have previously relied heavily on capacity expansion for growth. These companies will now have to focus on cost control, efficiency gains and other strategies to drive earnings growth.

The margins of IPPs have been squeezed over the last couple of years by high fuel costs, an unreliable supply of coal and their inability to pass on higher power generation costs to end users.

China's National Development and Reform Commission (NDRC), the country's top economic planning agency, has initiated reforms in the power sector to address some of the structural issues, including the absence of a cost pass-through mechanism. The NDRC is taking gradual steps to ease cost pressure on the IPPs with periodic tariff adjustments and caps on contract and spot coal prices. The China Electricity Council has recently proposed a coal power price linked mechanism to regulate contract coal prices and widen the scope for the direct supply of electricity to major users. However, the details of the proposed scheme have not been finalised.

Given the complications involved in regulatory change, we anticipate more regular tariff reviews as the immediate solution for IPPs. At the moment,
the timing of the next tariff adjustment remains uncertain given the 20% decline in global and China coal prices this year and the slower pace of power demand growth, which was only 5% in September 2012. However, we expect to see opportunities for tariff hikes next year as power demand picks up in tandem with the economy.

The lack of clarity on the cost pass-through mechanism is the key risk for the power sector. While IPPs are trying hard to defend the cost pass-through of up to 70% of fuel costs, adjustments to tariffs are ultimately decided by the government. This uncertainty over the timing of tariff hikes will continue to hurt the profitability of IPPs. They face other risks such as lower-than-expected power demand, higher-than-expected inflationary pressure and unexpected events such as coal supply disruption and transportation bottlenecks that could lead to higher-than-expected coal prices.

These risks have prompted some IPPs to seek overseas ventures to diversify their earnings base, such as Huaneng’s Tuas Power investment in Singapore and Huadian’s recent coal power plant investment in Indonesia. IPPs may also look to grow through less capital-intensive acquisitions, such as existing power assets and coal-related investments. IPPs with low gearing, such as China Resources Power (CRP), are in a more favourable position in this regard to participate in mergers and acquisitions.

We expect China’s power landscape to experience stronger competition going forward as demand growth moderates. The ongoing reforms could lead to power pooling for grid companies so they can take supply from the lowest cost producers and sell power directly to larger industry users. This could further erode the margins of less efficient IPPs. Going forward, earnings growth will be driven mainly by efficiency gains through diligent cost controls and deeper vertical integration by IPPs investing in coal mines and related businesses. Both CRP and Datang have been investing in coal-related projects over the past three years.

Of China’s power stocks, CRP is the best proxy to the sector given its efficient cost controls and relatively low gearing, coupled with sustainable long-term growth because it is self-sufficient in coal and has a diversified fuel strategy.

The combined market capitalisation of the top five power stocks listed in Hong Kong is currently about US$36 billion. Assuming 5% average annual revenue growth to reflect power demand growth and stable margins resulting from ongoing efforts to encourage IPPs to make new capex investments, we expect China power stocks market capitalisation to reach US$48.3 billion in 2018.
Coal output growth is due to be reined in to about 3%-4% per annum...

Coal
**Coal to Cool**

Policies to rationalise the sector will challenge miners’ bottom-line

The rate of growth for coal production and consumption in China is expected to cool partly because of the general economic slowdown, but more so due to official plans to consolidate the sector as spelt out in the country’s economic blueprint – the 12th Five-Year Plan.

For starters, coal output growth is due to be reined in to about 3%-4% per annum from the 10% growth rate over the last decade (see Chart 1). Official production targets of 4.1 billion tons of capacity and 3.9 billion tons of output by 2015 have been set, in line with the government’s overall objective of reducing China’s energy consumption by about 16% by the end of 2015.

Some 2,900 small mines are also scheduled to be closed. However, they make up only 2.4% of the total capacity. This will invariably create merger and acquisition opportunities within China’s coal sector, with smaller miners becoming potential takeover targets. Any consolidation will benefit the large state-owned enterprises, especially the nation’s two largest coal producers, Shenhua and China Coal.

As a result of the government’s efforts to cap coal capacity and production, we expect the cash-rich coal miners to actively seek acquisition opportunities elsewhere such as Australia, Indonesia and Canada. And while South Africa and Mongolia are emerging coal-mining areas with abundant coal reserves, they are less favourable targets. South Africa’s geographical location is a major disadvantage, while any operation in Mongolia would face political obstacles.

Policy interventions such as a resource tax and a price mechanism for independent power providers’

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1. China’s coal output growth

Source: SX Coal, DBS Vickers
coal contracts as well as spot transactions could further affect the miners’ profitability.

The proposal to switch from volume-based to price-based coal resource tax has been bandied around, but the magnitude of the tax and its timing remain uncertain. Some recent progress, however, appears to have been made with the government indicating that the new resource tax may be trialled in Shanxi. We estimate for every 1% increase in the resource tax, coal miners’ earnings would be reduced by 2%-6%.

Government plans to expand China’s coal rail line capacity to meet the expected demand of 2.8 - 3 billion tons/per annum by the end of 2015, would also put downward pressure on domestic coal prices. Existing issues with restricted supply leading to costlier coal due to current transportation bottleneck would be resolved.

Coal demand could also be hurt by China’s plans to increase natural gas

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Trend of energy mix

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<td>5.3%</td>
<td>5.5%</td>
<td>6.4%</td>
<td>6.3%</td>
<td>6.8%</td>
<td>6.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Renewable</td>
<td>0.1%</td>
<td>0.1%</td>
<td>0.1%</td>
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<td>0.2%</td>
<td>0.3%</td>
<td>0.5%</td>
<td>0.7%</td>
<td>-</td>
</tr>
</tbody>
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Source: BP, DBS Vickers
Ultimately, subdued coal prices... mean that miners’ gross margins are to normalise to 20%-30%

consumption to 8% of its energy consumption by 2015, from 4% now (see Table 2). The Chinese government is studying policy incentives to spur development of its vast shale gas reserves, which it estimates at 25.08 trillion cubic metres. China is currently producing insignificant volumes of shale gas, but the government has set ambitious targets of 6.5 billion cubic metres per year (bcm/y) by 2015 and 60-100 bcm/y by 2020.

Although we expect to see a significant jump in natural gas consumption, it is unlikely that this will challenge coal’s dominant position as the country's chief source for power generation. Natural gas consumption faces the hurdle of inadequate infrastructure for its transportation and power plants are also unlikely to switch to the more expensive gas until a mechanism to pass on the higher costs is established.

All things considered, China’s reliance on coal is unlikely to change in the foreseeable future, given its rich reserves and relatively low cost of production. The urbanisation and industrialisation trends that have transformed and driven the Chinese economy may have moderated, but they will not come to an end anytime soon. These trends will continue to drive coal demand.

Ultimately, subdued coal prices due to slower demand growth and ample supply mean that coal miners’ gross margins are set to normalise to 20%-30% from the current peaks of more than 40%.

The current combined market capitalisation for China's top five coal mining stocks listed in Hong Kong is about US$92 billion. Assuming average organic net profit growth of 3.5% per annum (to reflect 6%-7% demand growth, partly offset by weaker margins on the back of assumed long-term average selling price of US$85/ton and cost increases), we expect their combined market capitalisation to reach US$117 billion in 2018.

Companies such as Shenhua, China’s largest coal mining company, would perform well for its integrated business model, proven track record of delivering steady earnings, good cost management, strong balance sheet for mergers and acquisitions and parental injections.
Gas

Gas to Rise
Concerns over carbon emissions will boost demand for gas

Coal and oil are currently responsible for more than 85% of China's energy needs, but its future lies in cleaner fossil fuels such as natural gas, and renewables such as hydroelectricity and solar power.

Heeding the example set by the US, China is looking to diversify its energy mix by replacing coal and oil with natural gas to cut its carbon dioxide emissions. The country has set an ambitious goal to increase the share of natural gas to 8% and 10% of its energy mix by 2015 and 2020 respectively, from 4.5% just a year ago (see Table 1).

China consumed 129 billion cubic metres (bcm) of natural gas in 2011, a robust five-year compound annual growth rate of 18%. About 40% of that demand came from China's top three economic zones – the Yangtze River Delta Economic Rim, the Pearl River Delta Economic Rim and the Bohai Economic Rim – which collectively account for more than half of the country's GDP. Manufacturing and electricity generation industries are among the heaviest users of natural gas, consuming half of the resources, followed by residential users.

Based on its target of increasing natural gas consumption to 8% of total energy mix, this would mean 260bcm of gas demand by 2015, which translates to an annual growth rate of 19% over four years.

China produced an estimated 103bcm of natural gas in 2011 (see Chart 2). Domestic production from conventional gas fields is limited, thrusting unconventional gas resources, such as coal bed methane (CBM) and shale gas, into the limelight. China sits on the world’s largest shale gas reserves – 134 trillion cubic metres (tcm) of shale gas resources and 25tcm (excluding Qingzang Plateau area) of exploitable shale gas reserves – compared to 4.6tcm of proven conventional natural gas reserves.

Despite the efforts made to unlock the potential of shale gas, China still has a long way to go before shale gas can be produced commercially given the country’s limited infrastructure, technological know-how and restrictive gas pricing policies.

In the meantime, gas imports will help to meet the surging demand for natural gas. China has secured close to 100bcm per annum from Central Asia and Myanmar, as well as 46 million tons per annum of LNG from countries such as Qatar and Australia.

Natural gas, we believe, will play a greater role because of its cleaner profile. More importantly, China’s abundance of shale gas reserves will underpin the long-term growth potential of the gas industry.

China’s national oil companies are betting on this too, allocating more resources to natural gas exploration than ever before, particularly in the sector of unconventional gas resources. Granted that natural gas is still only a small component of the companies’ overall portfolios, we expect an exponential growth once the shale gas story takes off after 2015. In the meantime, oil demand will remain the major earnings component of the national oil companies.

However, the longer term outlook for oil remains unexciting, as demand will likely taper off once gas supplies flood the market. We expect oil

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Energy targets under 12th Five-Year Plan

- Non-fossil fuel to account for 11.4% of primary energy consumption
- Energy consumption per unit of GDP to be cut by 16%
- Carbon dioxide emission per unit of GDP to be cut by 16%
- Natural gas demand to hit 260 bcm or 8% of energy mix
- Renewable energy to reach 478m SCE or 9.5% of energy mix

Source: Multiple including NDRC and BP Energy Outlook 2030, compiled by author
demand growth to normalise back to a five-year compound annual growth rate of 4%. Total oil consumption stood at 440 million tons in 2011 or close to 18% of China’s total energy mix. This figure is expected to hold in 2012 and grow moderately into 2015. The slower demand is not surprising considering the government’s preference for natural gas and the incentives offered, such as making it cheaper to switch to the relatively cleaner fuel.

As mentioned previously, energy prices in China are regulated by the government for public interest or policy objectives. Nonetheless, it is China’s ultimate intention to liberalise its energy sector. Market-based pricing is a double-edged sword. However, while it encourages efficient energy consumption, it also leaves inflation unchecked. A surge in international oil prices would raise domestic fuel oil prices, which would in turn accelerate inflation. Inflation has always been the Chinese government’s primary concern and the main stumbling block to any pricing reform over the last few years.

In the current economic climate, higher energy prices will put downward pressure on domestic consumption, which goes against the government’s economic objective of stimulating domestic demand. Still, we believe the reform agenda remains high on the Chinese policymakers’ list of priorities as evidenced by the new gas pricing mechanisms being tested in southern Guangdong province and Guangxi Zhuang autonomous region. This could set a precedent for more price increases in the future.

**Natural gas pricing reform**

Under the new system, gas distributors (city gas operators) can negotiate the city-gate price (the price the pipeline companies charge their customers) directly with suppliers (the oil majors). The government will use the price of imported fuel oil and liquefied petroleum gas as initial benchmarks to set a ceiling price, which will be adjusted periodically. The maximum city-gate prices will be Rmb2.74/cubic metre in Guangdong and Rmb2.57/cubic metre in Guangxi. These are higher than the cost of piped gas imports, which is approximately Rmb2.10/cubic metre. Although the near-term impact is minimal, this will incentivise oil and gas producers to increase domestic gas production (conventional and unconventional), which will encourage more investment in the longer run.
Economic Rebalancing Act

Neil Ge, CEO of DBS Bank (China) Limited, discusses the possible rebound of China’s sluggish economy and the need for a consumer-led growth to rebalance it.

Q: Public sentiments about China’s future seem less certain than before according to recent local Chinese media surveys and reports. Do you share this assessment?

Neil Ge (NG): I think this is probably due to the situation of where the Chinese economy is at right now. The economy is at a stage where it is creating a lot of uncertainty in terms of the direction which it is headed, whether the political system will continue to support the economic changes and developments that have been taking place. On top of that, China is also facing a once in a decade political leadership transition this year. So, in this context where there are a lot of things in a state of flux, people will naturally feel uncertain.

That said, in order for the people to feel confident about China, they need to see political stability; and a lot depends on the new leadership. Secondly, there should be a continuation of political and economic reforms that will benefit the vast majority of the people. And finally, a better distribution of wealth generated from economic growth.

Hopefully, with the new leadership in place, the policies on how to transform and mature the Chinese economy will be more visible and explicit. Everyone will then see the bigger picture and direction with greater clarity and calm.

Q: How will the new leadership steer the Chinese economy?

NG: The challenges and bottleneck issues of the Chinese economy are quite well understood.

I think the challenge is to successfully transform the economy from export-investment driven to more consumption, high-value chain driven kind of economy. However, issues of policy formulation and details of their implementation are hard to speculate. But I think the new leadership will learn from the past and continue with the path laid down by the current administration and leverage on past experience. The most important thing though, is to continue to create political and social stability, and then address the economic problems accordingly.

Q: Speaking of government measures, do you think they are pursuing the right course of action in dealing with the economic slowdown?

NG: I think the Chinese government has learnt lessons from the previous stimulus programme. We have noticed that this time around, the government has reacted differently than before. The government has demonstrated better discipline in its monetary and fiscal policies. And we think that these disciplines will help us
see more measured policy reactions.
For example, the government did not lower interest rates a lot to inject liquidity into the banking sector. In the past during the last slowdown, the government lowered interest rates quickly and dramatically, like what we saw in 2009. The impact of that had been high inflation, but this time, the government lowered interest rates a few times, gradually.

The government is also investing in infrastructure that will benefit the mass population, the public health care system, and the metro and railway networks. And that’s a smart thing to do.

Q: But there are concerns that the interest rate liberalisation would adversely impact the Chinese banks.

NG: Chinese banks need to make plans to generate non-interest incomes, to make up for the margin compression. Generally speaking, larger Chinese banks can deal with the changing environment better than the smaller ones, due to their vast customer and capital base, and other resources. So it is a challenge for some of the smaller banks. It would be harder for them to deal with the situation, if the liberalisation continues. I will not be surprised to see some small banks in trouble if the interest rate liberalisation continues.

Q: You have mentioned the need to promote domestic consumption as part of this transformation of the Chinese economy. Do you see that happening?

NG: We haven’t seen too much in terms of spending. That’s definitely the way to go, but it is challenging for China to transform its economy from being export and investment-driven, to one driven by domestic consumption. There are a couple of things the government needs to do to stimulate domestic consumption. For instance, we need better wealth distribution, better health care, better education and better pension systems. We also need a steady property market. And political stability counts, too. All these factors are important in establishing a consumption economy.

Q: In the effort to balance wealth, to encourage consumption, there will be necessary increase in wages. With the costs of doing business going up, will China remain competitive and continue to be the factory of the world churning out cheap products?

NG: Admittedly, China is facing increasing competition from other countries, especially in industries where labour cost is the main factor accounting for their business margins.
But labour cost is just one thing. If you look at China more closely, it has the world’s largest educated workforce, and over time, China has established a strong supply chain network. If you were to combine just these two advantages, which are not so easy for other countries to replicate, China will in that sense remain as the factory of the world. I hope to see China developing into an upgraded factory of the world.

Q: How do you see Chinese industries and businesses move up the value chain and become this upgraded factory?

NG: The government needs to promote innovation, support R&D, cultivate a long-term thinking culture and revamp the education system. And it has to do all these to transform the Chinese economy in order to move up the value chain. If you were to compare the Chinese economy with the Korean and Japanese economies, China still has less worldwide brands compared to the two. That’s a value chain issue, which in turn is a function of technological innovation and corporate sophistication. That’s where China should be headed in the long run.
Q: Is the economic slowdown something to worry about?

Tan Su Shan (TSS): China’s economy has continued to slow down in the past months. However, recent trade and financing data both suggest a bottoming out may be in sight. Robust financing flows in September are the clearest indication that the economy could be taking a turn for the better. Domestic demand, especially in the smaller second and third tier cities remains robust. Property prices and the volume of sales have already rebounded in the last few months. Retail sales in real terms have also improved. Most importantly, fixed asset investment growth is holding up and will likely get better. In terms of the mid- and long-term investment, China is still a good place to go; but we need to be cautious for the short-term investment in the volatile macro environment.

Q: What are some of these macro risks and vulnerabilities we should pay attention to?

TSS: The risks are whether the US can avoid a fiscal cliff, and whether the European crisis, with the focus now on Spain, will subside in the coming
Although China is now experiencing slowdown, nevertheless it still presents viable opportunities...

months. China is also undergoing a delicate period of leadership transition, and it remains to be seen whether Xi Jinping can help to maintain the stability of a country that is seeing a wider gap between the rich and poor. These risks need to be carefully monitored as China’s economy still relies on the demand factor in other countries and the internal stability factor that people have taken for granted with China’s leadership.

Q: What opportunities can investors consider in this climate of uncertainty and slower economic growth?

TSS: Although China is now experiencing slowdown, nevertheless it still presents viable opportunities. The A-share stock market offers value when compared to other emerging markets. There are also some interesting PE opportunities.

Q: And this is because valuation of Chinese equities is at an all time low. Is it therefore a good time for investors to go in?

TSS: Though we don’t have a crystal ball for the exact turnaround time, statistical data on the Shanghai Composite (SHCOMP) forward PE does reflect that the valuation is very attractive when the SHCOMP is trading around the perceived low levels of 2000. It dipped below the 2000 threshold in late September this year and the last time the index traded firmly below this psychological level was in early 2009 at the height of the global financial crisis. Historically, this indicates a high chance of rebound over the next 6-12 months time.

Q: But some listed companies in the US with majority of revenue derived from China perform way better than those listed directly in HK and China. Is it better to take advantage of China’s success story indirectly?

TSS: Undoubtedly, the US equity market has its advantage given its long history and popularity towards investors all over the world. However, the situation is changing gradually. With the continued development of local equity markets, many China companies selected to raise money locally or in HK. The high maintenance cost and the tightening of regulatory requirement in US, after the Lehman saga, slowed down the interest of China companies to be listed in the US market. The variety of choices for investors to invest in China corporations is much more in China and HK markets now. With the continued improvement of liquidity and listing rules, the China and HK markets are catching up. Investors who are looking for specific sectors or undervalued stocks should keep an eye on the local and HK markets.

Q: With the slowdown in exports and growth, the renminbi (Rmb) is no longer a steadily appreciating one-way bet, will there be more hedging opportunities for the Chinese currency?

TSS: Yes. The two-way movement implies an increase in Rmb volatility. This will bring more hedging and trading opportunities. Though the long-standing NDF (non-deliverable forward) market remains popular for Rmb hedging, the rapid grow of DF (deliverable forward) market amid the policy to liberalise offshore Rmb has fuelled the development of offshore Rmb-denominated financial products.
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