NOMURA

Global Markets Research

ANCHOR REPORT

China equity strategy 2016: A sober bull looks to regain credibility

A year of two halves

5 January 2016

In 2015, the young bull in Chinese equities rose to stardom and lost it all. In 2016, we see a sober bull regaining credibility: a range of 56-75 (+14.3% y-y return) for the MSCI-China vs. 55-85 in 2015. In our view, there are two key drivers for Chinese equities in 2016: 1) the US rate hike cycle, wherein Nomura estimates hikes in June and December; and 2) China's credit cycle, ie, supply-side reforms which are likely to result in closure of "zombie" businesses, rising NPLs and other defaults.

Nomura's China economics/FX forecasts do not see systemic risks despite continued moderating growth and slightly higher unemployment – they estimate total FX inflows of USD82bn in 2016 vs. outflows of USD141bn in 2015. Putting it all together, we may see an interim peak near the March NPC and the US Fed rate hike decision partly as concerns over currency and capital flight ease; and an interim low around mid-2016 partly as concerns over defaults rise, before resuming upward as China manages to stay systemically stable in 2016.

Key themes and analysis in this Anchor Report include:

- Long mass-end consumption, R&D leaders/enablers of manufacturing upgrades, survivors of consolidation; selective on financials.
- Peak, trough and range forecasts for the MSCI-China, the CSI-300 and the HSCEI; 1Q16 sector allocation and new picks for our equity model portfolio.

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China equity strategy 2016

EQUITY STRATEGY

A sober bull looks to regain credibility

A year of two halves

Two drivers for 2016: the Fed rate hike cycle, and China's credit cycle
Likely the mildest of all US Fed rate hike cycles commenced on 16 December 2015. Currently, Nomura is forecasting two rate hikes (in June and December) vs. consensus of four rate hikes. If the Nomura forecast materialises, the market could be heaving a sigh of relief around March. In China, its credit cycle will further unfold, as a key part of the supply-side reforms, which will likely lead to rising bank non-performing loans (NPLs), various credit defaults and closure of "zombie" companies, including some state-owned enterprises (SOEs). While this may raise risk aversion, it is the very reform that the market has been waiting for. We also anticipate anti-corruption measures in the financial space to continue.

A year of two halves: sell on rallies in 1H16, and buy on dips in 2H16
1Q16 may see a relief rally as concerns over China's capital outflow and currency weakness ease, and upon signs of more monetary and fiscal easing (Nomura forecasts four reserve requirement ratio (RRR) cuts and two interest cuts in 2016). But, subsequently, investors' concerns may mount again over rising NPLs, defaults and closure of "zombie" companies. By 2H16, the market will likely be reassured on China's sufficient liquidity buffers to avert systemic risks, and on early signs that listed companies are poised to benefit from the exit of weaker competitors that had been kept alive, partly for local government fiscal income and local employment reasons.

Positive returns on Chinese equities, thanks to valuation normalisation
We forecast 14.3%, 20.6% and 13.9% y-y total return on the MSCI-China, the CSI-300 and the HSCEI, respectively, in 2016 (detailed forecasts on trough, peak and year-end targets are inside). The CSI-300 may lead other indices as the new A-share IPO issuance system may direct liquidity from small caps to large caps.

We recommend three long themes: 1) mass market consumption proxies in goods and services; 2) leaders and enablers of China's manufacturing upgrade and innovation; and 3) beneficiaries of market share consolidation, be it via SOE reform, capacity exit or M&As. We are selective on financials, with preference given to leaders in property and non-bank financials.

In 1Q16, we will gradually add to internet, tech and telecom, gradually trim the underweight in energy, and gradually raise the underweight in financials.

Equity model portfolio return and picks: think mean reversion
Our model portfolio has posted a cumulative return of 85.7% since inception, vs. the benchmark's 20.9% return. In 2015, our return was 14.3% vs. -7.8% for the benchmark. These results benefited from practicing "mean reversion", which is akin to the "Middle Way" philosophy prevalent in China. As such, we believe that raising the portfolio turnover ratio and allowed minimum cash level may help long-onlys extract better returns in Chinese equities.

Removals from our model portfolio: China Construction Bank (939 HK, Buy), Greenland (337 HK, Buy) and SMIC (981 HK, Buy). New picks for our model portfolio: Cinda (1359 HK, Buy), Han's Laser (002008 CH, Buy), China Mobile (941 HK, Buy) and Tencent (700 HK, Buy).

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Anchor themes

In 2016, we forecast a range of 56-75 for the MSCI-China and a year-end value of 68 for 14.3% return y-y. We see two drivers for Chinese equities in 2016, the US rate hike cycle and China's own credit cycle. An interim peak may emerge around the March NPC and the US Fed rate hike decision; an interim low may emerge around mid-2016 on rising concerns over defaults.

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Nomura's view: global and China macro

We believe the US Fed rate hike cycle is one of the two most important drivers on Chinese equity returns in 2016. Nomura differs from consensus in estimating two rate hikes only, one in June and one in December. We also note that, during the last "taper tantrum", countries with larger current account deficits and higher domestic yields, that attracted more hot money inflows, saw the most aggressive investment fund outflow.

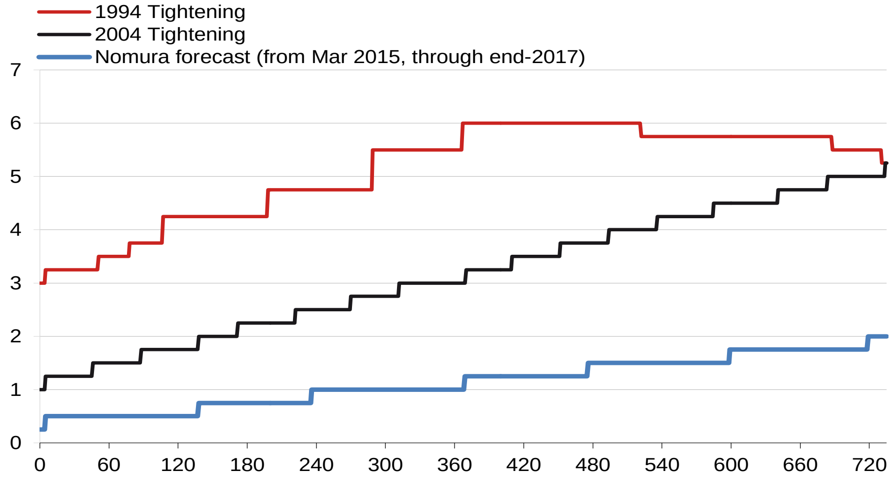
US Fed rate hike cycle has begun, albeit a mild one

The Fed may hike again in June and Dec 2016 (Lew Alexander)

Nomura expects the Fed's tightening cycle to be gradual and data dependent, with Fed fund rate forecasts at 88bp by end-2016 (after three 25bp hikes, including the December 2015 hike). This is close to the December 2016 Fed funds future market pricing of 89bp.

- We do not anticipate that the Fed will repeat the pace of interest rate hike in the 1994-1995 style (300bps in total over 12-months, peaking at 6%), or the 2004-2006 style (425bps in total, peaking at 5.25%).
- This milder Fed rate hike cycle will likely terminate at a Fed funds rate of 2.0%.

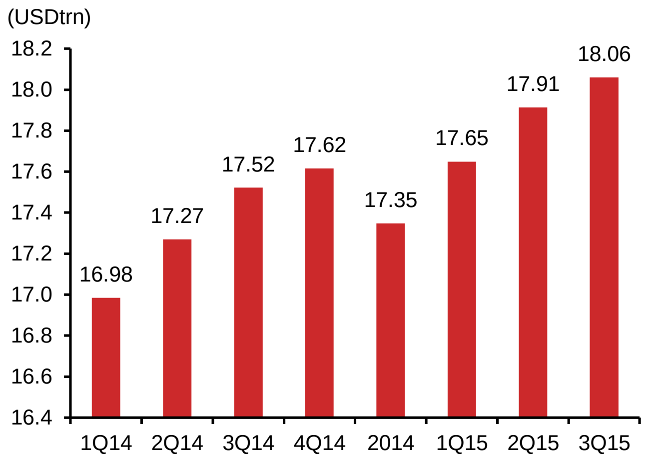
Fig. 1: Nomura 2015-17 Fed trajectory outlook vs. 1994 & 2004 cycles



Source: Bloomberg, Nomura Strategy Research

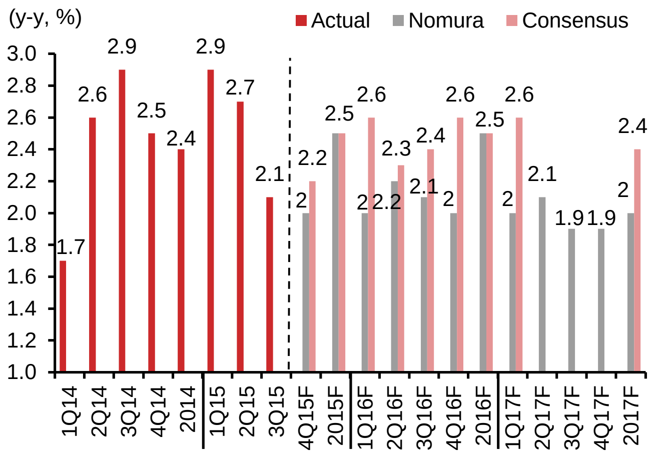
We believe that strength in the US high frequency data (non-farm payrolls, employment rate, housing starts, manufacturing ISM and nonmanufacturing ISM, consumer price and core CPI data) may influence market expectation on the timing and certainty of the next imminent US rate hike.

Fig. 2: US nominal GDP



Note: Quarterly nominal GDP is seasonally adjusted annual rate
Source: US Bureau of Economic Analysis, Nomura research

Fig. 3: US real GDP growth
Actual vs. forecast



Source: Nomura Global Economics, Bloomberg

The BOE is poised to hike rates also (Philip Rush)

- Philip expects the UK's GDP to grow from 2.4% y-y in 2015 to 2.5% y-y in 2016. In his view, the BoE should start hiking in May 2016 at 25bp/q, until it reaches 2% (August 2017F).
- Cyclical strength is being sustained in the UK economy against a structurally weak backdrop, with imbalances accumulating as a result. But for those risks to crystallise, a shock is needed. The main domestic risk event that may trigger this is the UK's referendum on EU membership and Philip sees a September 2016 vote as most likely.

BOJ and ECB poised to ease further

The BOJ is to ease further, likely in April 2016 (Tomo Kinoshita)

- GDP growth: Nomura forecasts real GDP growth to 1.2% in 2016 vs. 0.6% in 2015.
- Monetary policy: BOJ will likely conduct additional easing policy in April 2016.
- Inflation: Kinoshita-san expects core CPI inflation to rise from 0.6% in 1H FY16 to 1.1% in 2H FY16, and sees little prospects of it reaching 2% by "around 2H FY16," a new timeline by BOJ policy.
- Trade: Kinoshita-san expects that Japan's real exports may rise by 2.8% in 2016, vs. a 3.3% rise in 2015. A moderate global recovery can sustain gradual growth in Japan's real exports in 2016 and 2017.
- Private consumption: May rise moderately, in his view, on a steady rise in consumer income and improvement in consumer sentiment.
- Unemployment: Kinoshita-san expects the unemployment rate to reach 3.3% in 2016 vs. 3.4% in 2015. This means that the labour market is going from tight to tighter.

The ECB is to ease, likely in 2Q 2016, but March is not ruled out (Nick Matthews)

- Due to weak carry-over effect, Nick estimates that EU GDP growth will remain in a 0.3-0.4% q-q range in 2016. On the one hand, ECB policy accommodation has helped, but on the other hand, there are slow wage growth, debt overhang and external uncertainties. In all, stabilisation policies have calmed financial markets but have been deflationary, and the EU faces weak potential growth (around 1%).
- 2Q16 is likely the earliest the Governing Council could deliver further easing, alongside the "technical review" of the asset purchase programme (APP) that Mr Draghi indicated to take place in the spring. But an easing in March in the event of adverse financial conditions cannot be ruled out. Further easing may come in the form of additional APP extension to 2017, a small rise in the monthly pace of purchases (in the region of €10bn to €70bn), or another cut to deposit rate even though the ECB did not mention this last possibility explicitly in its December Introductory Statement.

- Political risks in the Eurozone in 2016 emanate either from elections or from unstable outcomes following elections in 2015.

The PBOC will ease more

The following are forecasts by Yang Zhao, Nomura's chief China economist.

- Monetary policy: Four bank reserves requirement ratio (RRR) cuts (by 50bp each) and interest rates twice (by 25bp each) in 2016. Fiscal policy: official fiscal budget deficit to rise to 3% of GDP in 2016, up from the budgeted level of 2.3% in 2015.
- GDP growth forecast: 5.8% in 2016 and 5.6% in 2017 vs. 6.8% in 2015. The primary drags are weak property investment growth and normalisation of financial services sector growth.
- Financial risks: may rise as more corporate defaults occur, and bank non-performing loan (NPL) ratio rises. Systemic financial risks are likely to be manageable as the government is a large shareholder in the financial sector and overall government debt is still manageable.
- Unemployment: Will likely rise over the next two years as GDP growth continues to slow and SOE reforms, but that labour demand and supply should remain largely balanced, may fall below 1x occasionally but still largely stay above 1x.
- Nomura's Chief AEJ FX Strategist Craig Chan forecasts USD/CNH at 6.65 (Consensus: 6.48; FX forward: 6.56) in 2Q16 and 6.80 (Consensus: 6.55; FX forwards: 6.64) in 4Q16. Craig estimates the net FX inflow in 2016 will be USD81.6bn vs. net FX outflow of USD140.5bn in 2015.

A tougher year for Asia in 2016

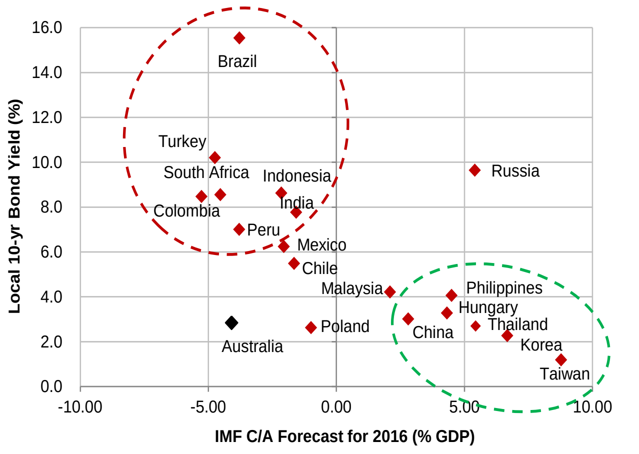
Rob Subbaraman, Nomura's Regional Head of Economics, views 2016 as a more challenging year for Asia than 2015 on a continued growth slowdown, the region's late-stage financial cycle, its high exposure to China and potential for external shocks – from the Fed to geopolitics and oil prices. Risk of financial crises is rising in Asia:

- Asian central banks cut policy rates to near record lows in 2009 and most remain around these levels today. QE has shifted Asia's entire yield curve lower and encouraged Asian companies to issue more FX debt, thus debt-servicing ratios may rise as Fed rate rises through 2016. Empirical studies show that the ratio of private credit to GDP is the single-best early warning indicator of financial crises. Nomura's Econ team sees that this ratio has risen to 100%+ in Thailand, Malaysia and Singapore, to 150%+ in Taiwan and Korea, and to around 200% or higher in China and Hong Kong. These ratios rose rapidly and fuelled overheated property markets.
- There has been a noticeable slowdown in total factor productivity (TFP) growth across Asia. In half of Asia's major economies, the growth rate of the working age (15-64) population has slowed markedly in recent years. China and Hong Kong turned negative in 2014 and 2015, respectively, and based on local official projections, it is set to do so in Taiwan in 2016 and Korea and Thailand in 2017. These two factors combined indicate that Asia's GDP growth may not recover anytime soon.
- China's investment-led slowdown is hurting the rest of Asia's economies more than other regions, due to stronger trade and financial linkages than elsewhere.

Where could the weakest link lie?

Nomura's global head of equity strategy, Michael Kurtz noted that during the summer of 2013, the "taper tantrum", during the September-October 2014 global equity correction, and again through Q2-Q3 2015, equity outflows were the worst in structurally weaker markets, ie larger current account deficits, and or higher domestic yields that attracted larger "hot money" inflows. As shown in the chart below, the strongest GEM quadrant is dominated by Asian markets, including Taiwan, Korea and China.

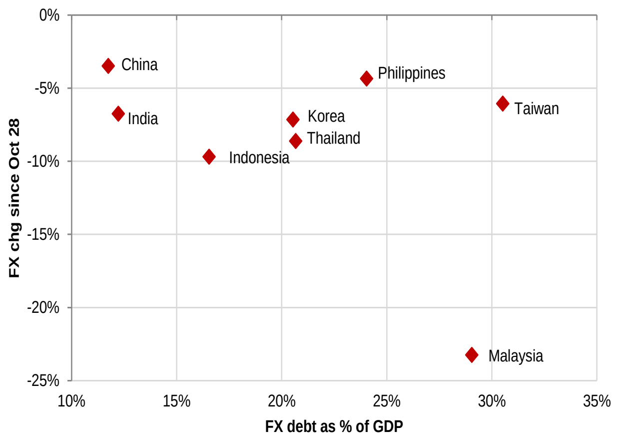
Fig. 4: GEMS: Current account balance & local sovereign yield



Source: Bloomberg, IMF, Nomura research

Fig. 5: Asian currency moves since Nov. 2014 vs. foreign currency debt*

(* Government, agency, and corporate FX bonds, plus cross-border bank loans)



Source: Bloomberg, IMF, Nomura research

Fig. 6: Summary of global economy outlook for 2016

GDP	Nomura believes only a modest recovery in potential growth to about 1.75% over the next couple of years on little meaningful acceleration in the trend of hours worked. GDP to grow 2.2% y-y in 2016.	A slightly slower pace in 2016 due to weaker carry-over effects and GDP growth remaining in a 0.3-0.4% q-q growth range.	Cyclical strength being sustained against a still structurally weak backdrop, with imbalances accumulating as a result. The team forecasts the UK's GDP to grow from 2.4% y-y in 2015 to 2.5% y-y in 2016.	Nomura forecasts real GDP growth to 1.2% in 2016 vs. 0.6% in 2015.	Nomura forecasts Asia-ex Japan GDP growth to slow further to 5.7% in 2016.	Nomura expects reported real GDP growth to slow to 5.8% in 2016 and to 5.6% in 2017 from his estimate of 6.8% in 2015. Nominal GDP growth may remain lower than real GDP growth, which makes deleveraging more challenging.
Fiscal policy	The congressional legislation that raised the limits on discretionary spending by USD80bn over the next two years, legislation should be marginally positive for growth in 2016. Ongoing economic expansion should continue to be positive for pro-cyclical state and local government spending.			A supplementary budget for FY15 to envisage this policy and currently anticipate this to be around JPY3.0-3.5trn, of which believing about JPY1.5trn is likely to be spent on public works projects.	Nomura believes the fiscal side to see the greatest scope for easing in 2016. The team expects fiscal policy to be noticeably more stimulatory in 2016 than in 2015 in HK, Indonesia, the Philippines and Taiwan; and mildly more stimulatory in China, India and Korea.	Nomura expects the China government to raise official budget deficit to 3% of GDP in 2016 from this year's budgeted 2.3%, but he believes the overall fiscal stimulus will only be moderate given diminished local government borrowing via financing vehicles and declining land sales revenue.
Monetary policy	Nomura expects the Fed's tightening cycle to be gradual and data dependent, with fed fund rate forecasts at 88bp by the end of December 2016 (after three 25bp hikes, starting December 2015).	The Governing Council could deliver further easing is probably the earliest in 2Q16. However, the team would not rule out the further easing may happen in March 2016. ECB may add further stimulus via the APP and potentially the deposit rate.	Nomura expects the BoE to start hiking in May 2016 at 25bp/q, until it reaches 2% (August 2017).	Nomura's Japan economics team maintains their view that BoJ will conduct additional easing policy in April 2016.	Nomura still expects more rate cuts and, unlike in past Fed hiking cycles, a decoupling.	Nomura believes PBoC has continued monetary easing, with cutting the bank reserves requirement ratio (RRR) four times (by 50bp each) and interest rates twice (by 25bp each) in 2016.
Inflation	Headline inflation measured on a 12-month change basis to rise steadily over 2016 as the effects of past declines in oil and other commodity prices annualises.	Nomura expects HICP inflation to remain below ECB expectations in the medium term.	Nomura thinks base effects are set to lift UK inflation sharply.	The team expects core CPI inflation to average 0.9% y-y in FY2016, still well below the 2% target.	Nomura expects Asia-ex Japan inflation rising to 2.9% from 2.4% in 2015.	Nomura expects China inflation rising to 1.9% from 1.4% in 2015.

Note: * Euro area excludes UK; Source: Nomura Global Economics

Fig. 7: Summary of global economy outlook for 2016 (cont'd)

	US	Euro area *	UK	Japan	Asia-ex Japan	China
Employment	The unemployment rate has fallen steadily since the fall of 2010, from 9.8% in November 2010 to 5% in October 2015. Nomura thinks the FOMC expects that with appropriate policy, the unemployment rate will stabilise close to current level.	Despite unemployment remains high (on both an absolute and relative basis, especially when compared with the US, UK and Japan), there has been some gradual labour market improvement. Nomura estimates the unemployment rate may decline from 10.9% in 2015 to 10.5% in 2016.	Nomura estimates the unemployment rate to reach 5.0% in 2016 vs. 5.4% in 2015.	Nomura estimates the unemployment rate to reach 3.3% in 2016 vs. 3.4% in 2015.	Nomura sees working-age populations are either shrinking, or on the cusp of shrinking, in China, HK, Korea, Taiwan and Thailand.	Nomura expects unemployment will likely rise over the next two years as GDP growth continues to slow and SOE reforms start to release hidden unemployment. However, the team believes labour demand and supply should remain largely balanced.
Currency	Nomura expects strong USD in 2016	Nomura expects USD/EUR at 1.00 in end 2016	Nomura expects USD/GBP at 1.54 in end 2016	Nomura expects USD/JPY at 130 in end 2016	Nomura expects Asian currencies depreciating against USD, thereby adding further easing dimension to Asia's monetary conditions.	- Nomura's FX team forecasts USD/CNH at 6.65 in 2Q16 and 6.8 in 4Q16 which is depreciation of 5% from current level 6.45 in end-15. The team believes a weaker RMB adds to depreciation risk in the region. - Nomura also expects FX intervention to moderate in 2016 as China moves towards a more market-driven exchange rate regime.
Risks	Nomura views the key risks are: 1) tighter financial conditions; 2) further appreciation of the dollar and; 3) slowdown in global growth.	Nomura sees political risks in the Eurozone next year emanate either from elections or from unstable outcomes following elections in 2015	Nomura views the main domestic risk event that could trigger a correction of these structural imbalances is the UK's referendum on EU membership and sees a September 2016 vote as most likely.	Nomura thinks the main risks are yen appreciation, a worsening European debt problem and the US and China slowing.	Asia is facing three main structural headwinds: 1) China's investment is slowing sharply. 2) Asia's aging-demographic challenges have crept up faster than most people realise. With productivity gains structurally challenged, hard to see a strong rebound in growth. 3) Asia's outsized financial cycle, in terms of excessive debt and elevated property prices, is at a late stage.	Nomura thinks financial risks are likely to increase as more corporate defaults occur, and as the bank non-performing loan (NPL) ratio continues to rise. But systemic risk is unlikely.

Note: * Euro area excludes UK; Source: Nomura Global Economics

China's credit cycle to unfold

We believe that the unfolding of China's credit cycle is likely a bigger risk than commonly feared ones including capital flight, currency weakness, local government debt swaps, and the physical property market. However, we anticipate this process to be paced and that no systemic risk is triggered on its account. Chinese bank stock valuations likely already capture banks' own NPL upcycle, but it may take some time to see the potential negative wealth effect due to various non-bank credit defaults.

#1: FX and capital outflows likely within tolerable range

A marginally more positive capital flow backdrop in 2016 than 2015
Nomura's Asia FX Strategist Craig Chan and team forecast USD81.6bn net inflow (including trade surplus) into China in 2016F vs. –USD140.5bn in 2015. The services account and errors & omissions are likely to see more outflows, whereas trade surplus and loans will improve for the better y-y.

Taking into account of Nomura Economics team's forecast of moderating growth in China, more monetary easing, questions over the handling of the multi-market intervention and continued anti-corruption push, Craig and team see risks of windows of net capital outflows and RMB depreciation. They forecast USD/CNY of 6.8 by end-2016.

Fig. 8: Capital flow simulation (select components)

all figures in USD bn	1Q15	2Q15	3Q15	4Q15	2014	2015	2016
Trade	123.7	139.5	163.6	159.7	380.1	586.6	787
Net FDI	50.5	41.5	2.4	67	208.7	161.4	104.2
Debt inflows	-1	-11.7	4.6	4.6	31.9	-3.5	58.3
Total inflow	**173.2**	**169.4**	**170.6**	**231.2**	**620.7**	**744.4**	**949.5**
Services	-45.1	-49.4	-66.4	-63.5	-151	-224.4	-366.5
Loans	-68.7	33.1	-210.1	-55.2	101.1	-300.8	31.7
Errors & omissions	-57.7	-32.5	-128.4	-141.2	-140.1	-359.7	-533.1
Total outflow	**-171.4**	**-48.8**	**-404.9**	**-259.9**	**-190.1**	**-884.9**	**-867.9**
Net inflow	**1.8**	**120.6**	**-234.3**	**-28.6**	**430.6**	**-140.5**	**81.6**

Notes: Trade (from Q4 2015), based on Nomura Economics' forecasts. Net FDI (from Q4 2015), on FDI liabilities, uses average year-on-year growth rate over past two years of 3%. On FDI assets, uses average year-on-year growth rate over past two years for 2015 (28%) and an acceleration of this growth rate by 2x in 2016. Debt inflows (from Q3 2015), based on average quarterly net inflow over the past two years of USD4.6bn. 2016 total includes assumed USD40bn of inflows as ~10% of the expected total allocation from reserve managers. Services (from Q4 15), on service credit, uses the average year-on-year growth rate from the past two years of 7.9%. Debit uses average year-on-year growth rate from past two years of 17.5%, an acceleration of this growth rate by 1.5x in Q4 15 and by 2x in 2016. Loans (from Q3 15) assume a 28% fall in Q3 15 and a 10% fall in Q4 15. Subsequently uses q-o-q growth rate of 1.6% in 2016, which is a quarter of the loan growth rate in the 10y to Q1 2015. Errors & omissions (from Q3 15) uses linear trend estimate of E&O outflows from past two years. Assumes acceleration in trend (by 2.0x) from Q4 15, a resumption of trend until Q2 16 and a further acceleration to 2.0x trend thereafter. Source: CEIC, Bloomberg, BIS, Nomura.

Source: CEIC, Bloomberg, Nomura Asia FX team estimate

Reality not as bad as perception, but the coast is not entirely clear
The capital market is concerned about adverse capital flight and further RMB weakening. Craig also sees certain medium term structural risks in the Chinese private sector wanting to offshore more assets given slowing growth and anti-corruption. While the potential for such risks exists medium term, the data right now suggest this risk is not yet imminent.

1. As of end November 2015, China's FX reserve stood at USD3.4trn, higher than the USD2trn comfortable FX reserve level for China (10.7 months of imports on 11M15 run-rate) as estimated by multiple third parties.
2. The current low foreign ownership of onshore assets (3.2% free-float market cap of A-shares and 2.4% value of onshore bonds) suggests low risk of plunge in price for RMB assets triggered by foreign investors leaving China. Some unverified estimates put hot money inflow through various gray channels at USD1trn; but even if this is

true, it may take time to offshore, given the Chinese government's tougher surveillance on underground banking.

3. Medium term, some modest level of inflow is to be considered: Nomura Asia Rates Strategist Albert Leung and team forecast an inflow of CNY50bn to the onshore bond market in 2016F and CNY100-200bn pa over 2017-19F, thanks to the SDR inclusion of the RMB.

Lessons from Japan: scrutinise the capital account, pace financial liberalisation, hold back irrational asset valuation, but allow appropriate offshore investments
We note four lessons from Japan's experience in walking the fine line between allowing the good capital outflow, and preventing excessive bad capital outflow. These four lessons are:

1. Good capital outflow is healthy as Japan did in the 1970s and through a good part of 1980s to allow onshore businesses to expand offshore, and domestic households to diversify assets overseas.

2. An open capital account requires careful scrutiny. The Chinese government has drastically stepped up in capital account surveillance to close various unofficial channels to offshore money, indicating that China has taken action in this regard. The historical experience of Japan's Heisei Bubble, Asian Financial Crisis and Latin America Financial Crisis suggests that cross-border capital flows without sufficient control will likely magnify the defects in China's financial system. As Yu Yongding, member of the Chinese Academy of Social Sciences and ex-consultant to the PBOC, noted, China hasn't built a sound financial system yet, and opening up the capital market now would result in bad capital flows adding to the inefficiency in financial resource allocation.

3. Phase in financial sector liberalisation steadily: Nomura's chief Japan economist, Kinoshita-san believes that financial sector liberalisation was likely just as responsible for the Heisei Boom in Japan as accommodating fiscal and monetary policies. We are seeing the Chinese government stepping up on financial regulation and enforcement, with paced financial liberalisation to keep easy credit and animal spirits in check. As history has shown, most corporate, financial entities and households are at a loss at figuring out how to harness the funds when they suddenly receive a ton of money!

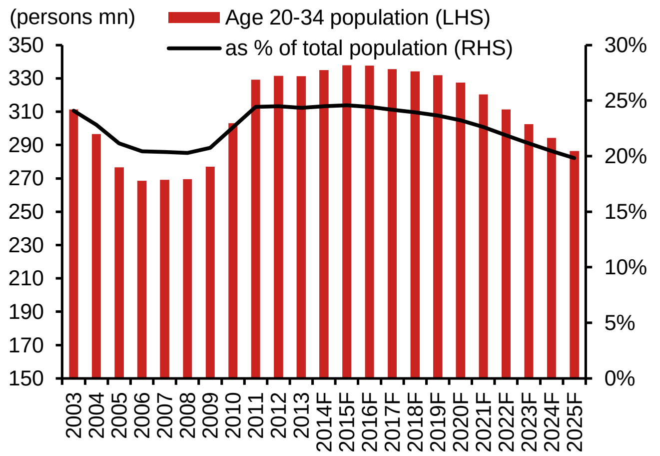
4. Bad capital flow prefers the company of unsustainable asset prices. China has been trying to hold back both property and equity prices to avoid bubbles and subsequent market crashes. As noted by senior fellow CH Kwan of Nomura Institute of Capital Markets Research, in contrast to Japan, Chinese housing and equity prices have been negatively correlated, thus offering some leeway for deflation and reflation between asset classes.

#2: Physical property continues to destock in Tier 3 & 4 cities

Nomura's forecast: flattish sales & FAI, rising market concentration to top players
For 2016, Nomura's China property analyst Jeffrey Gao and team forecasts flat property sales in 2016F vs. 2015F (2-3% ASP rise and 3% volume decline), -2-0% property FAI growth, and new starts to decline at a slower rate than 2015 on a recovery in land sales.

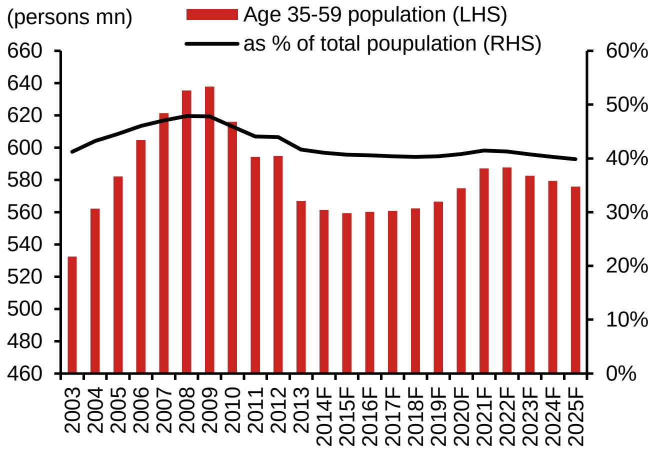
So far, the Chinese physical property market has held up better than the market's bearish perception. On the one hand, as we show in the figures below, marriage age population is likely to stay elevated through 2018-2019, thus underpinning resilient demand for self-use units. Meanwhile, from its trough in 2014-2015, demographics for upgrade buyers should continue to rise through 2021-2020. These data indicate a window of favourable demographics for the Chinese physical property market to continue to destock before challenges becoming greater over the medium term.

Fig. 9: China: first-time buyers of apartments



Source: CEIC, Wind data, Nomura estimates

Fig. 10: China: upgrade buyers of housing



Source: CEIC, Wind data, Nomura estimates

Tier 1 and Tier 2 cities housing inventory destocking on track

By late 2015, Tier 1 cities have gone through the destocking process, and with another year, Tier 2 cities should largely finish their destocking process also. The challenges lie with elevated inventory level in Tier 3 and 4 cities, together accounting for ~50% of Chinese property FAI. Our property team led by Jeffrey Gao, estimates inventory of 31 months in Tier 3 cities as of November 2015.

Property taxes, which may destabilise the physical property market, have been pushed out. Key hurdles for rolling these out at the national level include: 1) real-estate database establishment, which is expected to be completed by 2018; 2) inclusion of property tax into the formal law making process, hopefully by the National People's Congress meeting in 2017; and 3) agreement on the level of tax exemption.

Time for imaginative policies on unsold housing stock in 3rd and 4th tier cities

Based on our channel checks, there is evidence suggesting that policies as is are helpful to attract population into county towns or cities with 1mn+ population, but less effective for county towns with small sized population (say 200,000-300,000 people). There are several potential changes on the margin.

While China has massive housing inventory in the third and fourth tier cities, it also has a massive number of farmers and rural migrant workers that can use proper housing in the cities. This leaves plenty of room for imaginative policy making and strong execution powers. For example, in a work-out situation, if the banks that have housing projects in their NPL are willing to sell the projects at steep discounts to local governments, then the local governments with subsidies from the central government may attract rural migrants from nearby villages to take ownership at low and reasonable cost, while giving up their rural contractual land ownership rights.

In looking at how such an exchange may work, one interesting point was made by authors of "*Transformation and Treatments*" (page 123). It says that "for Chinese farmers, their interests tend to conflict with that of the local governments when big investments and infrastructure projects are launched, as these projects will take their land away from them. But if the developers provide sufficient compensation, such that farmers remain petite property owners, ie a swap from owning rural farm land and rural residential land contractual rights to urban housing ownership, then the farmers will take the exchange. But if the exchange is for the farmers to become tenants of urban subsidised rental units, then the farmers will fight against that."

#3: More LGFVs to swap into bonds at near sovereign rates

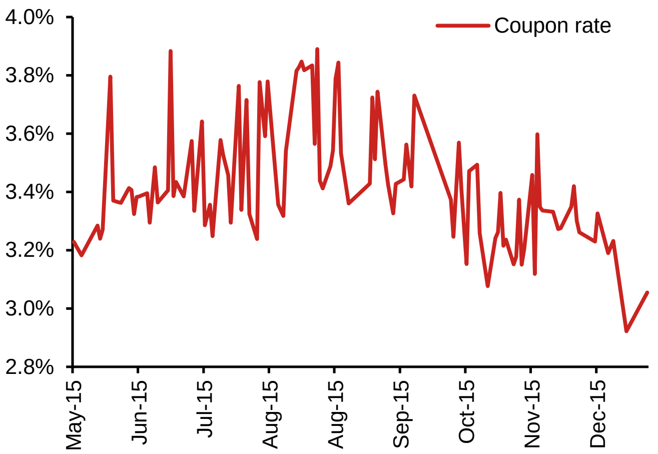
The swap: cut funding cost, improve maturity match and free up certain collaterals
According to the audited numbers released by the State Council on 29 August 2015, total local government debt amounted to RMB24trn (37.7% of GDP) as of end 2014, including RMB15.4trn direct debt and RMB8.6trn contingent debt. LOU Jiwei, Minister of Finance, noted on the same day that the debt-to-fiscal revenue ratio for local governments may reach 86% by end-2015F. In March 2015, Beijing launched a debt swap programme, approving a total quota of RMB3.2trn, thus fixing two issues with LGFVs.

- High financing cost – Historically, LGFVs had financing costs as high as 7.5-8% per annum, posing significant financial constraints on local government.
- Mismatch of duration – Most of the LGFV debts issued in the past have a maturity of 1 year, while the projects are mostly multi-year based.

By replacing the LGFV debt by local government bond, financing costs were reduced to ~3.5%, and the duration of the local government debt was extended to ~6 years on a weighted average basis. Certain collaterals pledged against the LGFV debt are freed up after debt swap and can be monetised again, providing more financial resources to the LGFVs. For commercial banks, their loss of interest yield for the debt swapped would be partially compensated by:

- Waiving of corporate income tax on interest income from local government bonds,
- Lower risk weight for local government bonds of 20% vs. 100% for LGFV debt, and
- Use the local government bonds as collaterals for low-cost borrowing from the PBOC.

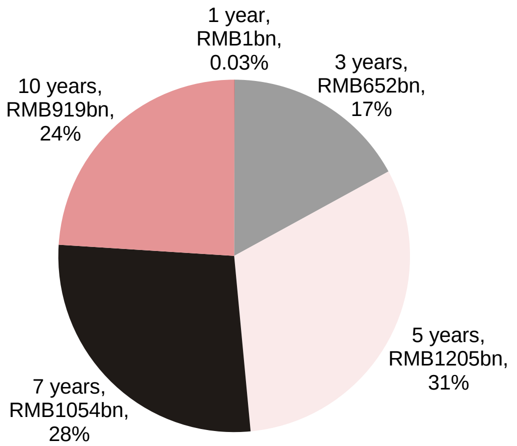
Fig. 11: Weighted average coupon rates of local government bonds issued in 2015



Note: The self-issuance and self-repayment scheme for local government bonds in China was trialled in 10 provinces in 2014 before fully implemented in 2015. On 18 May 2015, Jiangsu issued the first local government bond in 2015.

Source: iChoice data, Nomura research

Fig. 12: Maturity of local government bonds issued in 2015



Source: iChoice data, Nomura research

Establish China's market-driven municipal bond market by 2018
The current debt swap arrangement is a further step for China to build its formal "municipal bond" market. When the local governments publish their financials to the public by end-2017, they will get credit ratings based on their own financial strengths and as a result, pricing of local government bonds will be more market-driven vs. being priced near the sovereign yields right now.

#4: China's unfolding credit cycle could pose a new challenge

Currently, most clients are concerned about China exchange rate and capital account conditions, and what this may mean for other emerging market currencies in 2016. However, with the Central Economic Work Conference setting the tone for "supply side reforms" in 2016, we believe this refers to various forms of capacity exits, including business closures, defaults and rising NPLs, and they may become a source of challenges post the March NPC in 2016.

Manageable leverage by Chinese government and households

Many investors we speak to agree that combined central and local government leverage, as well as household leverage, appears manageable still. The main questions are focused on corporate leverage and banking sector NPL cycle.

Fig. 13: China: Debt-to-GDP ratio (breakdown by sectors)

(%)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Government	39	40	41	40	43	41	49	49	50	52	53	58
Household	18	18	17	16	19	18	24	28	28	30	34	36
Enterprises - non-financials	109	103	95	100	97	98	99	101	124	113	128	123
Financials	9	9	11	12	13	13	15	13	16	18	18	18
Total	**175**	**170**	**164**	**170**	**172**	**170**	**187**	**192**	**204**	**215**	**221**	**236**
Cumulative change from 2003-2014 (ppt)												
Government		1	2	1	4	2	10	10	11	13	14	19
Household		0	-1	-2	1	0	6	10	10	12	16	18
Enterprises - non-financials		-6	-14	-9	-12	-11	-10	-8	15	4	19	14
Financials		0	2	3	4	4	6	4	7	9	9	9
Total		**-5**	**-11**	**-5**	**-3**	**-5**	**12**	**17**	**29**	**40**	**46**	**61**

Source: Chinese Academy of Social Sciences (CASS), Wind data, Nomura research

Most leveraged sectors are property, capital goods, utilities and materials

Using A and H share listed universe as a proxy, and applying the GICS definition for sector classification, we show in the table below that, sectors shaded in grey are where debt to equity ratios were the highest at end-June 2016 were: property, capital goods, utilities, materials, and transportation.

Fig. 14: Leverage ratio (debt-to-equity) of Chinese A share companies* from 2000 to 1H15

(%)	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	1H15
Energy	91.0	80.7	73.3	69.5	77.2	73.9	72.4	66.4	65.9	80.0	81.5	90.8	98.1	106.7	108.8	102.1
Materials	70.7	88.7	92.8	96.9	106.8	121.5	133.2	126.9	135.6	147.5	147.4	148.3	159.7	167.0	173.1	173.1
Industrials	96.4	104.3	137.3	158.8	184.3	219.3	211.5	197.8	235.9	217.6	209.0	215.3	224.6	235.3	234.9	232.3
Capital goods	*99.6*	*112.3*	*141.0*	*177.4*	*249.4*	*312.2*	*309.2*	*267.7*	*301.3*	*258.0*	*247.2*	*249.2*	*260.5*	*270.5*	*270.3*	*267.4*
Transportation	*93.3*	*94.4*	*133.4*	*138.6*	*125.5*	*136.2*	*118.4*	*114.5*	*137.4*	*140.1*	*133.6*	*142.3*	*145.5*	*155.1*	*150.3*	*145.7*
Consumer Discretionary	97.9	98.4	118.3	121.8	140.4	146.7	153.6	146.8	152.5	157.1	153.3	145.9	133.2	136.5	130.2	134.3
Automobiles	*102.4*	*101.9*	*138.4*	*112.1*	*130.4*	*130.5*	*147.1*	*144.1*	*151.7*	*164.5*	*155.7*	*137.4*	*113.3*	*129.4*	*127.9*	*130.0*
Consumer Staples	88.8	87.6	94.8	100.8	108.2	109.5	106.8	110.4	108.3	102.6	96.9	96.4	91.8	84.5	77.1	73.0
Health Care	92.8	92.2	99.9	110.3	113.6	121.3	120.4	107.2	93.0	80.7	69.7	66.6	68.8	73.8	73.1	84.3
Technology	84.7	83.0	91.8	99.0	95.3	104.5	125.9	114.8	105.0	114.9	92.4	102.1	104.1	112.1	102.2	94.8
Telecom	106.3	93.2	95.3	113.1	104.8	88.4	78.8	65.3	80.0	81.9	77.3	73.0	85.8	83.4	84.1	81.8
Utilities	91.9	85.2	91.6	89.1	115.6	142.2	156.8	173.4	251.1	259.3	262.5	283.2	265.2	242.0	219.1	210.6
Financials	286.2	547.5	557.3	1096.7	750.4	95.6	34.6	42.9	34.3	42.9	49.5	57.0	59.9	65.8	63.8	67.6
Real Estate	102.2	104.6	119.7	138.2	165.8	185.5	196.8	170.2	176.8	194.7	237.8	267.7	283.4	303.2	297.2	317.5
Total	**116.1**	**149.1**	**173.7**	**214.1**	**187.9**	**124.9**	**107.9**	**110.9**	**113.5**	**119.7**	**121.1**	**128.0**	**131.2**	**137.5**	**134.1**	**134.9**
Excluding financials	*92.8*	*92.5*	*103.5*	*111.9*	*124.7*	*135.1*	*138.0*	*132.9*	*149.8*	*155.5*	*155.8*	*162.5*	*168.0*	*175.4*	*173.9*	*174.2*

Note: * our calculation is including all A-share listed companies and under our coverage that Chinese companies' market cap is over USD 3bn.

Source: Company data, Bloomberg, Wind data, Nomura research

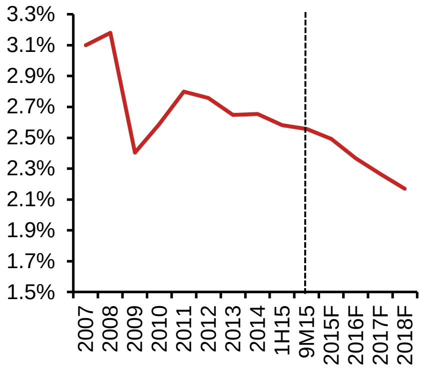
We note that property, capital goods, materials and transportation are also where significant overcapacity exits. These are the sectors where supply-side reforms, ie, business closures and combinations, are more likely to take place between 2016 and 2018.

Banks to have several tough years ahead

As shown in the following, Sophie Jiang & team identify the confluence of three negative cycles for the Chinese banks through 2018: lower NIM, rising NPL and capital-raising.

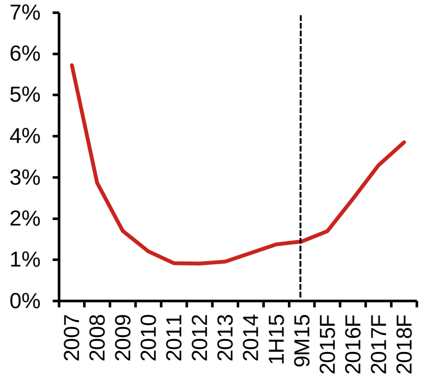
- NIM for China banks under Nomura coverage dropped 9bps from 2.65% by 2014 to 2.56% by 3Q15, and more margin pressure may come through after interest rates' full liberalisation in October 2015.
- NPL ratio for China banks under Nomura coverage to rise by 27 bps from 1.17% by FY14 to 1.44% by 9M15. It could touch 2.5% in FY16F, and peak at 3.9% in FY18F.
- China banks under Nomura coverage do not face immediate capital-raising pressure given their CET1 ratio of 10.9% as of 3Q15. However, the capital cycle is looming, as margin and credit cycles unfold. As such the covered banks' dividend payout ratio may be trimmed further in FY15/16F, and their dividend yield may decline from 4.9% in FY14 to 2.9% in FY16F, though still higher than peers in the US, JP and EU.

Fig. 15: Average NIM of China banks under Nomura coverage



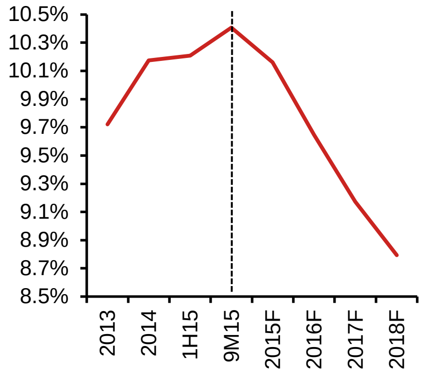
Source: Company data, Nomura estimates

Fig. 16: Average NPL of China banks under Nomura coverage



Source: Company data, Nomura estimates

Fig. 17: Average core tier-1 ratio of China banks under Nomura coverage



Source: Company data, Nomura estimates

RRR cuts may ease liquidity stress as credit cycle unfolds

Our China Banks team forecasts that the NPL ratio will rise. As of end 3Q15, the NPL coverage ratio in China was 167.7%.

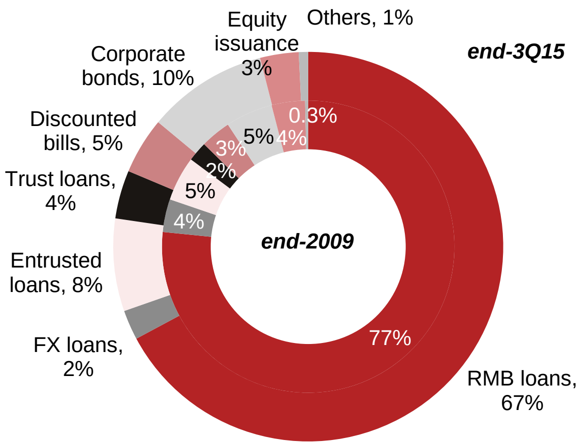
Although they assume regulators to lower the minimum 150% NPL coverage ratio as NPL rebounds, Chinese banks may still need to raise their NPL provisions from current levels. For shadow financing, risk normalisation may also lead to removal of rigid payment practice and defaults of vulnerable products.

#5: However, the bond market is to help generate new credit

As shown below, share of corporate bonds in total social financing doubled from 5% as of end 2009 to 10% as of end 3Q15. Loans, including bank loans, entrusted loans and trust loans, still dominate total funding in China (81% as of end 3Q15 vs. 87% as of end 2009). Nomura's China Bank team anticipates strong structural growth of the Chinese corporate bond market due to:

- Lower entry barriers as Chinese regulators loosened restrictions and simplified the review procedures on corporate bond issuance.
- Further opening of bond market domestically to attract more investors. The interbank market, the primary bond market in China (besides the smaller exchange traded bond market), is currently closed to households. As of 3Q15, commercial banks had 61% market share, followed by corporate investors (29%) and non-bank financial institutions (10%).
- Potential increase in international investors as RMB internationalises.

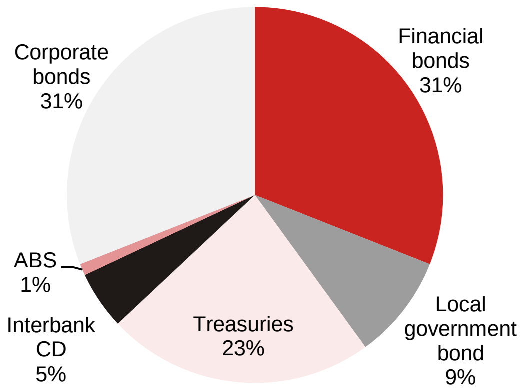
Fig. 18: Breakdown of China's total social financing



Note: Equity issuance is for non-financial enterprises only

Source: Wind data, iChoice data, Nomura research

Fig. 19: Breakdown of bond balance by issue type (3Q15)

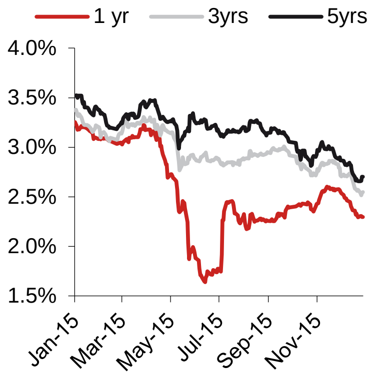


Source: PBOC, Nomura research

Bond yields have been heading lower

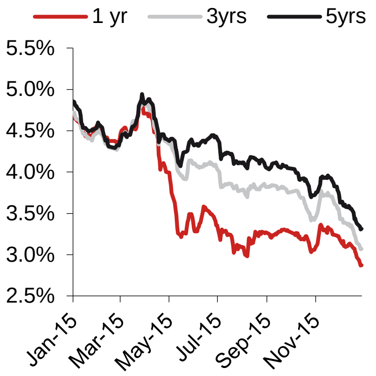
China's bond yields have dropped to a six-year low in 2H15 owing to monetary easing and an aversion to the A-shares market. Currently supply in the bond market still appears to lag demand with credit spread narrowing for enterprise bonds, mid-term notes and corporate bonds, as shown in the figures below.

Fig. 20: YTM for Chinese government bonds



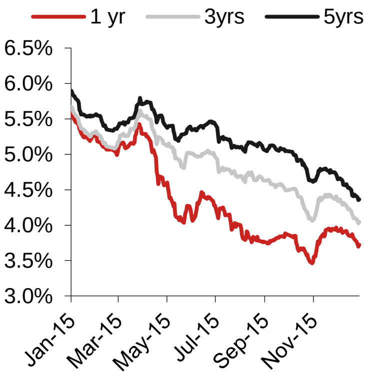
Source: iChoice data, Nomura research

Fig. 21: YTM for AAA-rated mid-term notes



Source: iChoice data, Nomura research

Fig. 22: YTM for AA-rated mid-term notes



Source: iChoice data, Nomura research

Our channels checks with onshore portfolio managers and risk managers suggest that on the positive side:

- Bonds are less volatile than stocks & risk control measures are in place
- Bond investments are dominated by institutional investors, who tend to be more rational and have more risk awareness than retail investors.

After the liquidity crisis in June 2013 and the A-share market crash in 2015, the Chinese authorities, including the PBOC, the CBRC and the CSRC, should be more ready to take immediate actions to prevent a bond market crisis from happening. (Changing the playbook in 2016, 2 November 2015)

Albert Leung, Nomura's Rate Strategist, sees a good sign for China's fixed income market in 2016, on further capital account liberalisation and opening of local bond markets. Specifically, Albert forecasts:

- Interbank rate to decline only moderately given FX outflow risks.

- China Government Bonds (CGBs) continue to outperform swaps in 2016, with 10yr CGB yields reaching 2.6% or even lower by end-2016.
- The 7-day repo could eventually fall to 2.0%, or even lower, in 2H16 based on the Econ team's assumption for two policy rate cuts starting in 2Q16.

The current spread of over 150bp (for 1-yr) is too high. It should gradually narrow in 2016 as China further liberalises its capital account and promotes closer integration between the onshore and offshore markets after IMF SDR basket inclusion.

What risks should we watch out for in the bond market?
The question we ask is if certain one-off events, e.g. cutting the discount ratio of pledged bonds in repo, or credit events e.g. break of implicit guarantee and large-scale defaults of bonds, may trigger a brief liquidity squeeze in the money market.

Various local press including 21st CBH and wallstreetcn.cm, reported that some bond investors are levered up to 10x.

- Structured fund product: 75% to 90% of the total AUM is funded by senior tranche investors who are guaranteed with a return of 5.5-6%, and the rest is funded by junior tranche investors. The junior tranche investors, i.e. the borrowers, in turn get 4x-10x leverage.
- Repurchase agreement (repo): investors use the bonds that they hold as collaterals to lever up. Mismatch of durations are prevalent in these cases, as investors often use 1-day and 7-day repo
- Combination of structured fund product and repo: total funds raised by issuing structured fund products get further leverage via repo. For example, if a junior tranche investor get 4x leverage via the structured fund products and 2x leverage via repo, his/her total leverage would be 8x.

#6: And, a new infrastructure investment model may help also

To address local governments' needs for funding, China started to promote public-private partnership (PPP) in infrastructure and public services investments in late-2014. However, complexity in deal structure, lack of confidence in partnership with local governments and the gap between the high return expected by private-sector investors and the return that can be realistically offered by the projects may have kept the contract rate at a low level (31.5% as of end November 2015 for the first batch of 1,043 projects promoted by the central government in May 2015)

While the PPP model has proven to be less effective than expected, this model is likely to be complemented by a new model in 2016. The regionally pooled infrastructural fund led by local governments, e.g. in Beijing-Tianjin-Hebei, will likely play a more active role in the future.

The Beijing-Tianjing-Hebei tri-province transit development may start a new investment model. At the funding level, the three local governments will each contribute some fiscal budget. At the planning level, all three local governments will collaborate and jointly agree to a final plan. This we believe is likely a model that can lead to more efficient use of capital and investment dollars than before.

Related to this, we understand that the central government has been seeking ways to correct the information loss when on-the-ground realities get reported to the top through different layers of bureaucracy. Due to self-preservation among the bureaucrats and selective retention of data, the folks at the top can be among the last ones to know what is taking place at the bottom. The prevalence of the internet in China is undoubtedly helpful for the Chinese government to govern. Another recent example is that, in economic data reporting, more toggles have been built into the spreadsheet so that there is little room for local level innovation.

2016: A year to regain credibility

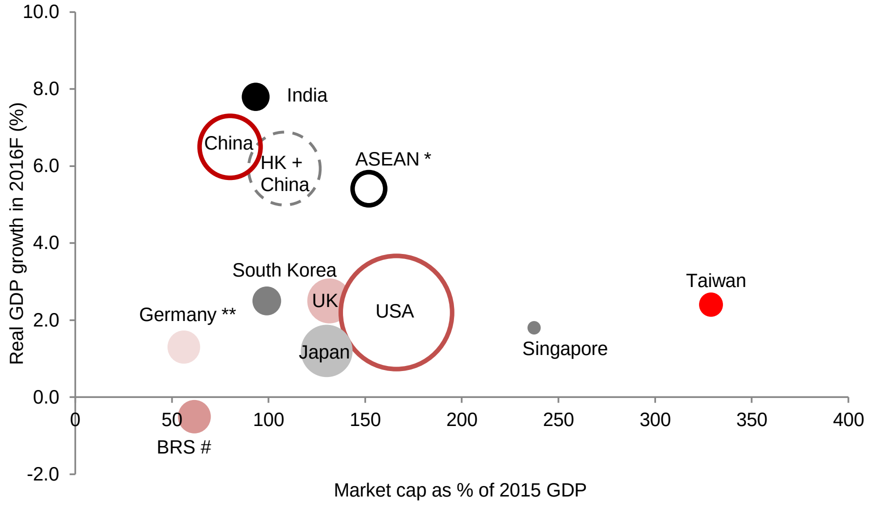
We anticipate 2016 to be less volatile than 2015 in terms of return on Chinese equities and still delivering positive returns, primarily on risk normalisation, plus prospects of listed names benefiting from the exit of excess capacity by 2H16. We advocate selling on rallies in 1H16 and buying on dips in 2H16. We see the potential of the new A-share IPO issuance mechanism raising the supply of small mid cap names and ultimately directing liquidity toward large caps instead of small mid-caps, with the help of anti-corruption measures in the financial sector.

The Middle Kingdom's "Middle Way" = Mean reversion

Large, cheap and growing fast…

Based on end-2015 data, Chinese equities (A and H combined), represent the second largest pool of publicly traded equities in the world. The combined market capitalisation is about 108% to the combined underlying GDP in mainland China and HK, against a faster-than-global-average GDP growth.

Fig. 23: Market cap as % of 2015 GDP vs. 2016F real GDP growth



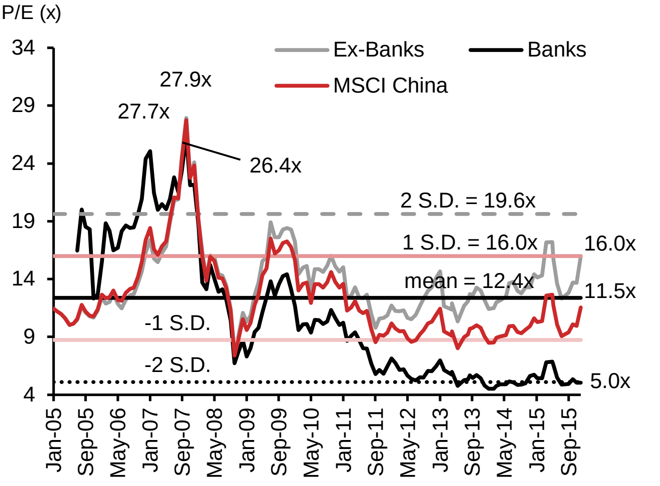
Note: Market cap is as of 30 November 2015. The size of bubble is based on market capitalisation of the market. * ASEAN includes Indonesia, Malaysia, The Philippines, Singapore, Thailand and Vietnam; ** Germany's market cap number is only calculate domestic stocks; # BRS includes Brazil, Russia and South Africa

Source: IMF data, JSE Ltd, Moscow Stock Exchange, Bloomberg estimates, Nomura research

…neither H- nor A-shares are demanding in terms of valuation at the index level

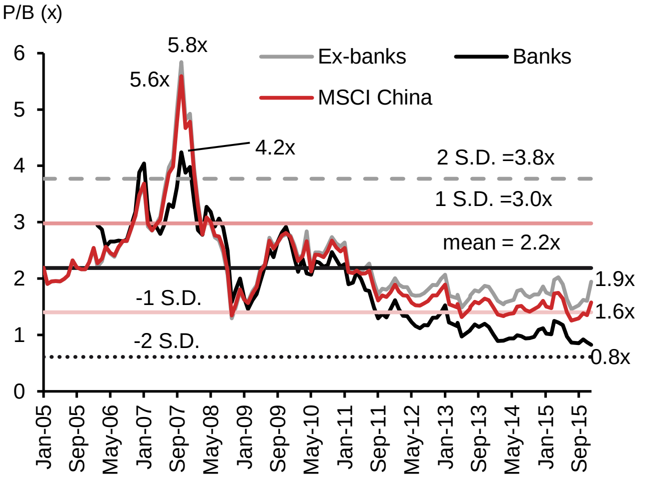
We note that while the average valuation for A-shares is higher than the index, this is partly skewed by A-shares' outlandishly low delisting ratios. It has been rather easy for companies that should delist to gain multiple lives via asset injections. As such, many small mid cap carry impressive valuation multiples for such embedded optionality, above and beyond the value of their ongoing business concern.

Fig. 24: MSCI China: 1Yr forward P/E (x)



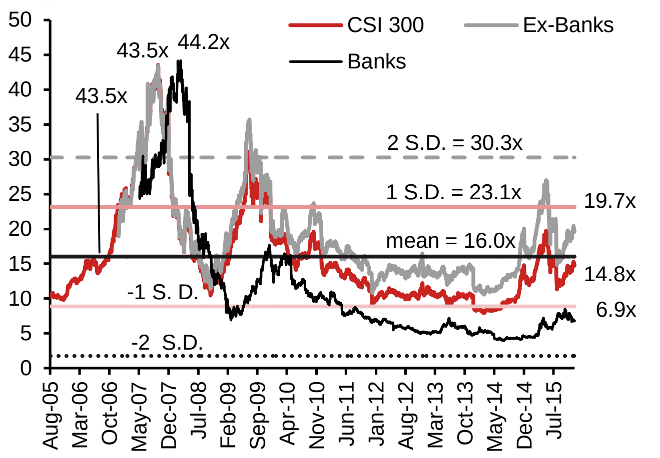
Source: IBES, Datastream, Nomura research

Fig. 25: MSCI China: current P/B



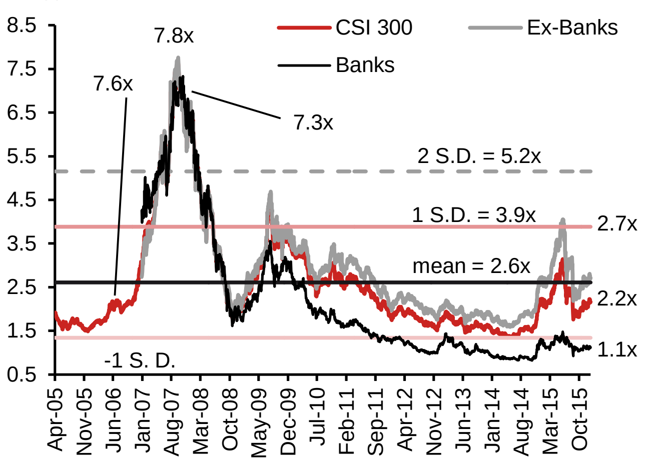
Source: IBES, Datastream, Nomura research

Fig. 26: CSI 300: 1Yr forward P/E (x)



Source: Bloomberg, Nomura research

Fig. 27: CSI 300: Current P/B (x)



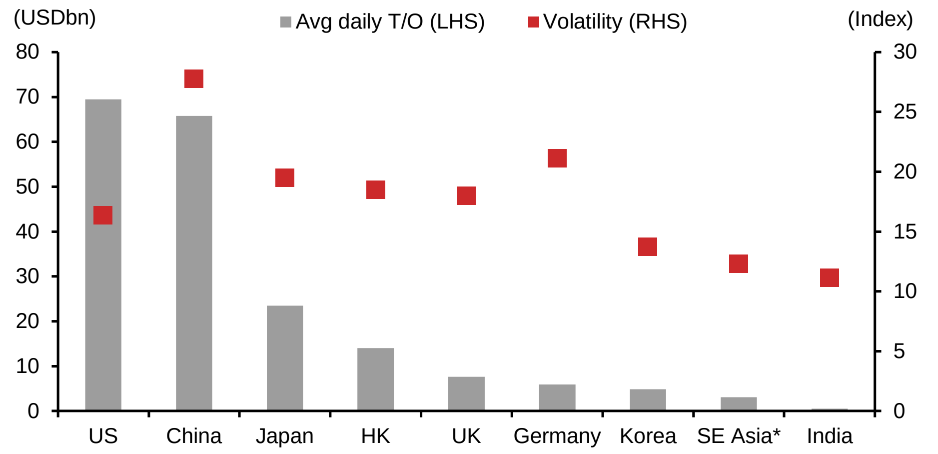
Source: Bloomberg, Nomura research

But rather volatile for the size of the market

In 2015, Chinese equities, particularly the A-shares quickly rose to stardom, and then lost it all even faster. For global investors, it is odd to see such a large and liquid equity market being so volatile.

At their respective peaks, Chinese equities delivered greater than expected return vs. our estimate. But both A- and H-shares' end year performance was weaker than we anticipated. This we believe partly reflects the loss of confidence in Chinese regulators' capability in deliver a properly regulated and supervised equity market, as well as ability to communicate to the financial market.

Fig. 28: Chinese equities: the second highest turnover, but the highest volatility



Note: * SE Asia includes Indonesia, Malaysia, Philippines, Singapore and Thailand. Avg daily T/O number = year to November. Turnover number: US is only calculated NYSE; China is only calculated CSI 300, Japan and Korea is calculated 1st section and KOSPI, respectively.

Source: CEIC, London Stock Exchange, Bloomberg, Nomura research

Think “mean reversion” to help extract better returns in Chinese equities

Despite the challenges, many offshore investors have also been learning and some of the most successful ones in Chinese equities we speak to are those with extensive GEM investment experience. Some investors have started to realise that when it comes to Chinese equities, the best approach is “mean reversion”.

When things are good, take some money off the table. When things are bad, buy more Chinese stocks. This is precisely the way the Chinese central government manages its affairs, along the lines of “Way of middle.”

In this regard, the single metric that would help Chinese equity portfolios to generate better returns is to raise the annual turnover ratio, from below 50% to 100%-150%; and to raise the allowed level of cash from below 5% to 10-20%.

Things that may improve on the margin in 2016

A rebalanced MSCI-China to reflect more organic growth and less cyclicality

Starting from 1 December 2015, MSCI has added 14 US-listed Chinese names in MSCI China that should offer a better picture of the Chinese economy in its mid-to large-stages of industrialisation, with the rising importance of IT and public and private service sectors.

IPO mechanism change may make small- and mid-caps less attractive

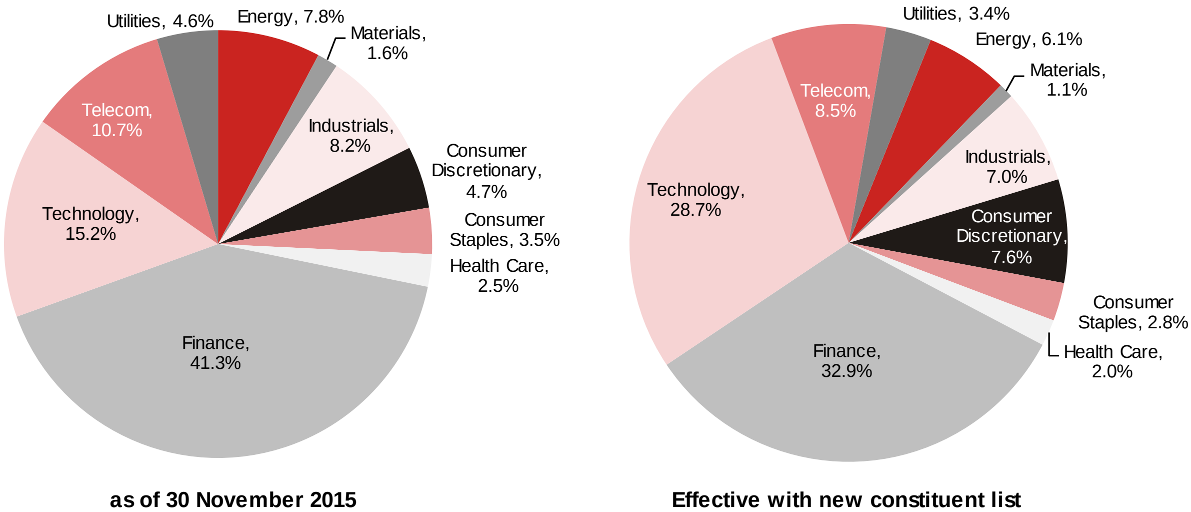
On 27 December, China’s top legislature approved the proposal to revamp the initial public offering (IPO) system, authorising the shift from approval-based to registration-based. As reported by South China Morning Post on the same day, the changes would likely be gradually carried out in the next two years starting from 1 March 2016.

In our view, this may over time make small- and mid-cap stocks less attractive and channel fund flow back to large-cap stocks.

Regulators may learn from their failures in A-shares in 2015

A key criticism of Chinese equities in 2015 among offshore investors was with regard to government intervention. On the way up, the proactive government talked up the A-share market; on the way down, the government stepped in too early to stabilise without allowing the market forces do the clearance. All these put most offshore investors, which are used to making investment decisions under regulated market mechanism, at a disadvantage.

Fig. 29: Technology sector has increased weighting in new MSCI China



Source: MSCI, Datastream, Bloomberg, Nomura research

As some have put it, "failure is the mother of success" – we see 2016 as a year where there is more thoughtful stewardship of A-shares, and regulators learn from their mistakes. This is also a process to be aided by relentless anti-corruption measures in the Chinese financial industry. Specifically, investors have pointed to three areas with room for improvement.

- Coordination among various regulators: While the Chinese Securities Regulatory Commission (CSRC) supervises the micro level issues for the A-share market, the bigger financial capital market (including FX, fixed income and credit) looks to the PBOC for macro level guidance on monetary stance and liquidity outlook, SAFE for the exchange rate outlook, and the MOF on local government debt and fiscal policies. The coordination between the PBOC and the CSRC is particularly important, as the financial market is much bigger than just the A-shares equities market.
- Communication from regulators to capital market could be more timely and consistent coming out of different ministries on essentially the same issue.
- Merging the China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC) and China Insurance Regulatory Commission (CIRC) into a single regulatory body may help coordinate policy responses, improve the risk management by filling the regulation gaps for cross-asset developments and enable Beijing to better supervise the Chinese financial market. It is not clear whether the PBOC will be part of the new super-regulatory body, but based on the PBOC's announcement on 29 December 2015 on upgrading the Macro Prudential Assessment (MPA) system, adding capital adequacy ratio, rate pricing and investments in bonds and equity into the assessment framework, the central bank will likely play a leading role in overseeing China's financial market in the future.

Index targets and sector allocation calls

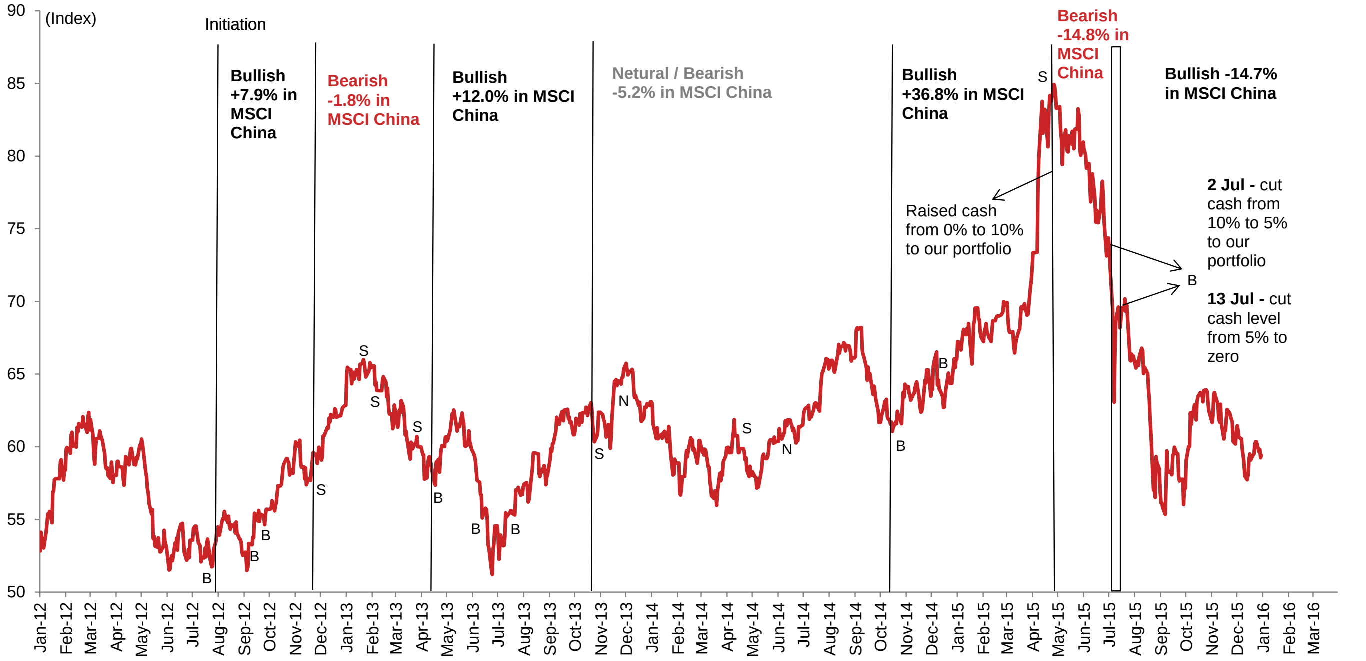
2015: Call to trim in mid-April and call to add during July

We started 2015 with a bullish view on Chinese equities on a 3-year bull market call that is to peak in 2017 ("The birth of a steady bull", 6 January 2015).

But on 17 April 2015, we turned cautious in our view and advocated that investors raise level of cash given the young bull has turned into a mad bull.

Post the June and early July correction, we advised clients to gradually put their cash to work, and add quality beta on dips. Since then, we have stayed positive on Chinese equities, but our year-end rally call did not pan out. While we pushed out the timing for the next rally peak to 1Q16 on 5 October 2015, the negative return from end-2014 to end-2015 on the MSCI-China and the mid-single digit return on A-shares are worse than we had expected.

Fig. 30: Our published calls on the MSCI China since initiation on 30 July 2012



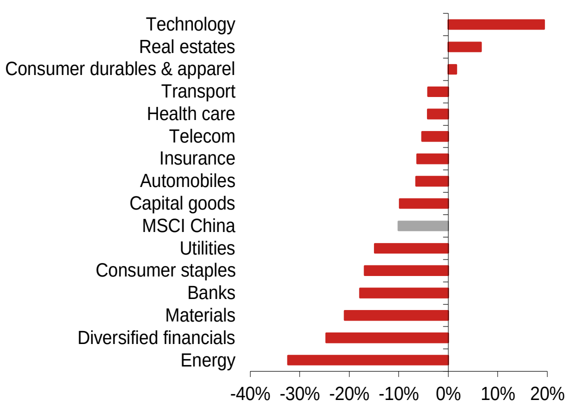
Source: Datastream, Nomura research

2015 sector allocation calls were directionally correct

Our sector rotation calls mostly worked out. We advised underweight in energy and materials vs overweight in technology throughout 2015; we advised underweight in non-property financials vs overweight in telecom through 3Q15. These sector switches, plus raising the cash level in the model portfolio on 20 April, were the main contributors to the outperformance of model portfolio to the benchmark.

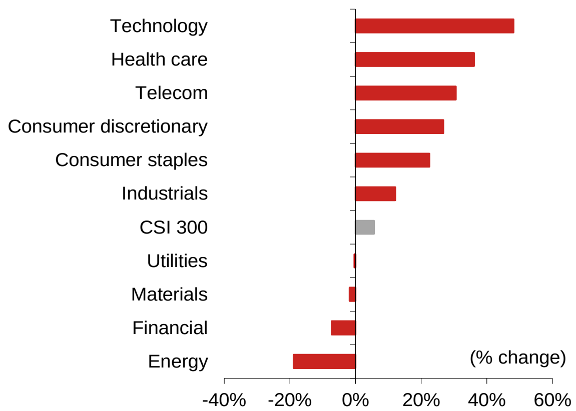
For all of 2015, the top three performing MSCI-China sub-sectors are: technology (+19.4%), real estate (+6.6%), and consumer durables & apparel (1.7%), and the bottom three performing MSCI-China sub-sectors are: energy (-32.4%), diversified financials (-24.6%), and materials (-20.9%).

Fig. 31: 2015: MSCI China and sub-sectors performance



Note: Price as of 31 December 2015; Source: Datastream, Nomura research

Fig. 32: 2015: CSI300 and sub-sectors performance



Note: Price as of 31 December 2015; Source: Bloomberg, Nomura research

Establishing index targets for 2016

In 2016, we believe Chinese equities will less volatile than 2015, they will deliver positive returns, but are unlikely to revisit their 2015 peaks until 2017. At the index level, the key driver for return in 2016 is going to the valuation normalisation, as macro concerns for

China normalise, particularly in comparison to other emerging market economies and stock markets.

As shown in the following table, we forecast index targets for 2016 for all three indices, including the MSCI-China, the CSI-300 and the HSCEI.

- We estimate CSI 300 to an end-2016 target of 4,500, or 20.6% above the end-2015 of 3,731, which is equivalent to 14.8x our FY16F EPS forecast of 305.
- We estimate MSCI China to an end-2016 target of 68, or 14.3% above the end-2015 of 59, which is equal to 10.4x our FY16F EPS forecast of 7.
- For HSCEI, we forecast an end-2016 target of 11,000, or 13.9% beyond the end-2015 of 9,661, which is equivalent to 7.9x our FY16F EPS forecast of 1,400.

Our basic logic in making our estimates is the following:

- Listed companies should be able to grow their EPS in line with or better than nominal GDP growth. For 2016, Nomura's China economist Yang Zhao estimates nominal GDP growth of 5.5% for China. The exceptions are banks, telecom, and utilities due to sector-specific reasons. On the other hand, listed internet, technology, education, travel, entertainment and non-bank financials are likely to grow their earnings faster than the nominal GDP growth due to rising demand and rising operating leverage.
- However, we have seen in the past several years, Chinese equities have not been driven by earnings growth, but rather by relatively cheap valuation, and top down directional calls with regard to macroeconomic and financial risks. We believe that had investors not lost confidence in Chinese regulators' ability to safeguard its A-share market, the respective Chinese equity indices should have closed the year at higher levels. Therefore, part of our 2016 index upside is to reflect the closing of this gap.
- Valuation multiples will favour stocks with strong organic growth, hence favouring the CSI-300 and the MSCI-China over the HSCEI. But should macro stabilise and improve by 2016, the improvement of valuation multiples could be more significant for banks than for technology and internet.

Fig. 33: Nomura: Forward index forecast

	2015F	2016F		2016F			
	Yr-end	Yr-end		Start	Trough	Peak	End
MSCI-China			**Estimated index value (MSCI-China)**	**59**	**56**	**75**	**68**
Nomura estimated EPS	6	7	PE	9.1	8.6	11.5	10.4
Nomura estimated BVPS	48	52	PB	1.14	1.08	1.44	1.31
Dividend per share	1.8	1.9	Dividend yield	3.2%	3.4%	2.6%	2.8%
EPS Y-Y growth (%)	1.56	8.8%					
BVPS Y-Y growth (%)	10.0%	7.4%	Index y-y return				14.3%
CSI 300			**Estimated index value (CSI-300)**	**3,731**	**3,550**	**4,800**	**4,500**
Nomura estimated EPS	278	305	PE	12.2	11.6	15.7	14.8
Nomura estimated BVPS	2,084	2,250	PB	1.66	1.58	2.13	2.00
Dividend per share	76	84	Dividend yield	2.2%	2.4%	1.7%	1.9%
EPS Y-Y growth (%)	4.66	9.7%					
BVPS Y-Y growth (%)	11.7%	7.9%	Index y-y return				20.6%
HSCEI			**Estimated index value (HSCEI)**	**9,661**	**8,900**	**11,900**	**11,000**
Nomura estimated EPS	1,348	1,400	PE	6.9	6.4	8.5	7.9
Nomura estimated BVPS	10,988	11,380	PB	0.85	0.78	1.05	0.97
Dividend per share	408	442	Dividend yield	4.6%	5.0%	3.7%	4.0%
EPS Y-Y growth (%)	-1.21	3.9%					
BVPS Y-Y growth (%)	10.0%	3.6%	Index y-y return				13.9%

Source: Bloomberg, Nomura estimates

1Q16 sector allocation recommendation

In 1Q16, we may gradually take down our exposure to the overall financial sector as easing concerns over FX and capital outflow give them a bit more upside, but new concerns over defaults and NPL cycles set in and make share prices in this sector more vulnerable to downside. In 1Q16, we will further add technology/telecom and selected internet names on pullbacks, as this group collectively will demonstrate strong and sustainable organic growth.

By the end of 1Q16F, our biggest overweight sectors are likely to be autos, capital goods as well as technology (including internet). Our biggest underweights are likely to be in energy, followed by banks.

Fig. 34: MSCI-China benchmarked portfolio sector allocation recommendation

	MSCI China Abs weight 25/12/2015 (%)	MSCI China Recommendation 4-Jan-16	Nomura recommendation Deviation (ppt) 4-Jan-16
Capital goods	5.2	8.2	3.0
Consumer			
- Automobiles	2.4	5.4	3.0
- Consumer discretionary	3.6	3.6	-
- Consumer staples	3.0	2.0	(1.0)
Energy	6.7	3.7	(3.0)
Financial			
- Banks	19.7	17.7	(2.0)
- Diversified financials	3.0	3.0	-
- Insurance	9.2	9.2	-
- Real Estate	5.9	5.9	-
Healthcare	2.2	2.2	-
Materials	1.3	0.3	(1.0)
Technology & Internet	22.5	25.5	3.0
Telecom	9.4	9.4	-
Transport	2.0	1.0	(1.0)
Utilities	4.0	3.0	(1.0)
Total	**100.0**	**100.0**	**-**

Source: IBES, Datastream, Nomura estimates

2016 sector investment themes

We anticipate three broad structural investment themes in China: the rise of mass market consumption of goods and services, manufacturing upgrades and innovation, and consolidation of market share in fragmented or over-capacity sectors. Both Chinese domestic names and multinational companies may benefit from these same trends, by being either a leader/winner or an enabler. In 2016, one marginal risk to watch out for is if negative wealth effect impacts a certain discretionary portion of the Chinese consumption, eg, outbound travel to more expensive developed markets.

#1: Mass market consumption of goods and services

The top down view

1. Tsinghua University's Center for China Study: China to be the largest consumer market in the world by 2020

Chinese household consumption has grown rapidly during the past three decades. From 1980 to 2013, consumption-related expenditure by urban/rural residents per capita per year rose from RMB412/RMB162 to RMB18,488/RMB6,626, with a CAGR of 12.2%/11.9% in nominal terms, or 6.9%/6.6% in real terms.

Since 2010, among the three pillars of China's GDP growth (gross capital formation, net export and consumption), consumption growth has held up the best. Tsinghua University's Center for China Study forecasts that China would replace the US as the largest consumer market by 2020 with total consumption reaching USD15.8trn based on calculation methodology adopted by the World Bank. They expect consumption to GDP ratio will rise from 47.4% in 2010 to mid- to high-60s over 2020-2030 on the back of:

- Growth in household income; Rising marginal propensity to consume with lower income residents see more rapid income growth than average; and
- Growing demand for various services, including education, healthcare, entertainment, culture, leisure, sports activities, etc;
- Rising public consumption as government steps up on the quality of social safety net and mutually reinforcing private and public consumption.

Fig. 35: GDP by expenditure method breakdown

As % of total GDP	1980	1985	1990	1995	2000	2005	2010	2014
Consumption	65.5%	65.0%	63.3%	59.1%	63.7%	54.1%	49.1%	51.4%
Household consumption	51.5%	50.7%	49.7%	45.8%	47.0%	40.1%	35.9%	37.9%
Government consumption	14.0%	14.3%	13.6%	13.3%	16.7%	14.0%	13.1%	13.5%
Gross capital formation	34.8%	39.0%	34.0%	39.3%	33.9%	40.5%	47.2%	45.9%
Net export	-0.3%	-4.0%	2.7%	1.6%	2.4%	5.4%	3.7%	2.7%

Source: iChoice data, Nomura research

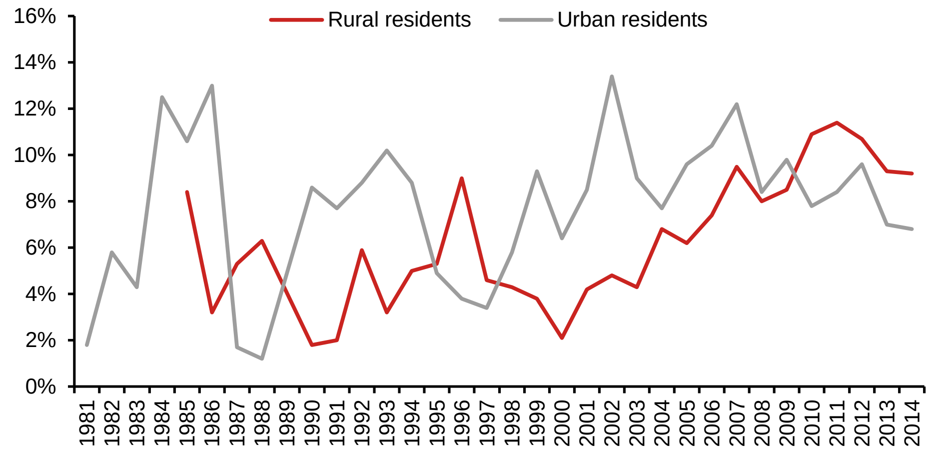
2. Expand the middle-income class

In recent years, the Chinese central government has increasingly become more pro-labour. This is evident from the steady creation of new jobs and measured pace of layoffs among SOEs. Among SOEs, the preference has been to keep working level wages growing, while trimming executive compensation and other cost items.

We show that despite moderating GDP growth in China, real income per capita for rural and urban residents has been growing at high single digit in real terms. Looking forward, channel checks suggest that China's consumption growth will remain at ~10% in 2016F, driven by growth in real income per capita, especially among low income residents.

According to Chinese Academy of Social Science, high-income and middle-income group account for 5% and 28% of the Chinese population respectively, leaving the lower-income group, who tend to have higher marginal propensity to consume, representing 2/3 of the Chinese population. During the 13th Five Year Plan, Beijing will spend more on public services, including healthcare services, elderly care, education (including vocational educating and retraining), and culture & heritage building activities.

Fig. 36: High single digit y-y growth of average distributable income in real term



Source: National Statistics Bureau, Nomura research

3. Housing or land right ownership is broad-based in China

We note one unique aspect of China's housing and land ownership situation that has tended to be overlooked by investor clients. Currently, close to 90% of Chinese households own their own residence. During the late 1990s, China conducted urban housing reform where housing units were given to qualified urban permanent residents at token prices. This constitutes one of the biggest wealth transfers from state to households in China's recent history, in our view. This sizeable transfer of wealth, we believe, underpins the health of the household balance sheet in China today.

Furthermore, 90%+ of Chinese farmers own contractual rights to farmland, forest, and rural residential land. While less than efficient as productive assets, this institutional arrangement has made Chinese rural migrant workers less vulnerable to the loss of cash income earned through jobs when they become unemployed.

4. Progressive taxes for the wealthy

Currently, China applies 11 different income tax rates over various types of personal income, including a progressive rate for payroll but a 20% fixed rate for most other categories. We believe that, going forward, China will have a comprehensive income tax scheme, where it aggregates different types of personal income and then applies a progressive tax rate on the total amount. This means that taxes will go up for those that are paying the flat rate for non-payroll types of income.

We noted on p.28 of our report "4Q14: the return of a sober bull" (5 October 2015) that China has minimum taxes imposed on wealth and assets; for example, the country does not have comprehensive income taxes, inheritance taxes, property taxes or capital gains taxes in the same sense as the average OECD country. While employees pay a payroll tax for their salaries earned, owners of income-producing assets only pay taxes related to their businesses, not their individual income. This situation will likely change in the coming years as China reforms it income tax scheme to promote common prosperity.

Fig. 37: Payroll tax: China has payroll taxes, but not comprehensive income taxes

Monthly salary from (RMB)	To (RMB)	Tax rate (%)	quick deduction (RMB)
0	1,500	3	0
1,500	4,500	10	105
4,500	9,000	20	555
9,000	35,000	25	1,005
35,000	55,000	30	2,755
55,000	80,000	35	5,505
80,000	-	45	13,505

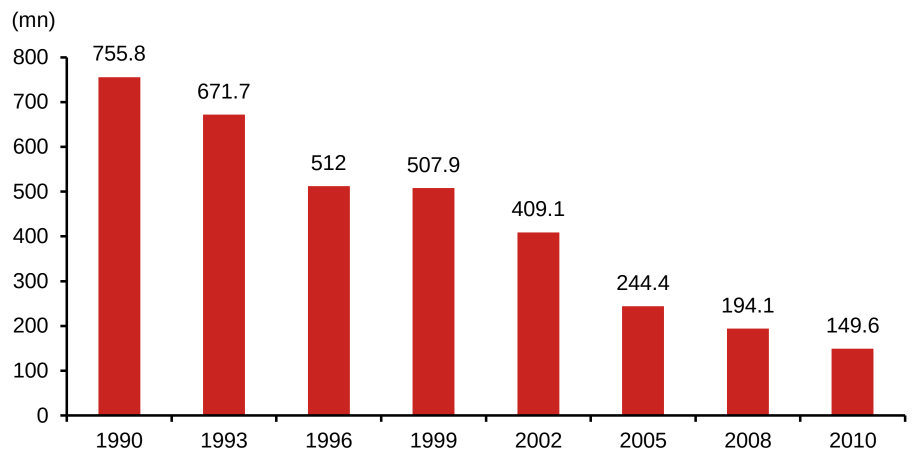
Note: tax exemption is RMB3,500 for regular employees and RMB4,800 for non-residents; monthly tax = (taxable income - tax exemption) * tax rate - quick deduction

Source: Nomura research

5. Fighting poverty – 70 million people out of poverty by 2020

One of the three binding mandates out of the 5th plenum was to lift China's 70mn population out of poverty by supporting local economic growth, relocation or transfer payments by 2020. Currently, China has 70.2mn people, 14 regions and 592 county towns below China's standard for poverty (living on less than RMB2,300/2,800 per person per annum in cash income by 2010/2014 price standards). We note that the World Bank's definition of poverty is living on less than USD1.9 per person per day, and on this basis, China has 149.6mn of people living below the poverty line in 2010.

Fig. 38: People living on less than USD1.9 a day in China has gradually decreased



Source: World Bank, Nomura research

China's consumption upgrade: sectoral trends

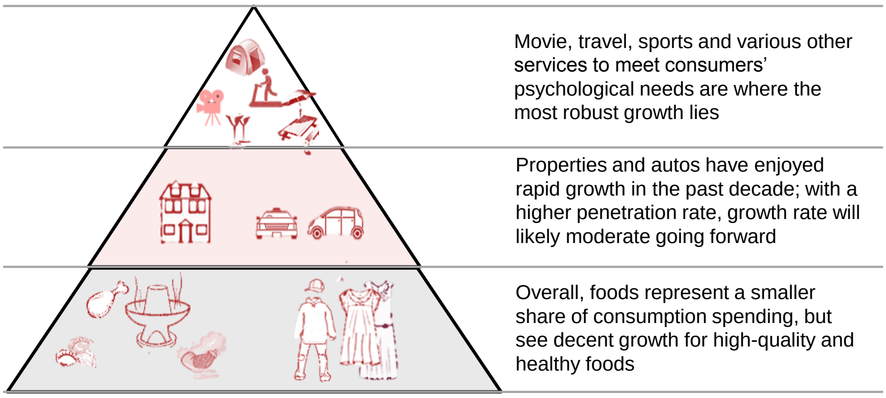
As shown in Fig. 39 & Fig. 40, the Chinese consumers have been moving up the Maslow pyramid. After their basic needs are satisfied, they have started to improve their quality of living, such as healthier foods, better housing conditions, more convenient ways of transportation and communication, and entertainment, travel and sports.

This trend is also reflected by the data on merchandise sales by enterprises above designated size as shown in Fig. 41.

- Food reported steady growth rate of low-teens in the past two years, in line with the growth in disposable income.
- While autos have represented the biggest consumption category in China in the past few years, we see moderating sales growth in 2015 given the higher penetration rate.
- The most robust growth reported by communication appliances in the past two years corresponds with Chinese consumers moving toward internet and mobile.
- There was a drastic increase (from low single-digit to mid-teens) in sales growth for sports and entertainment products.

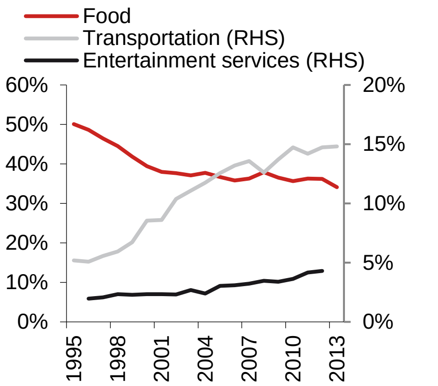
In the following, we identify 10 Chinese consumption trends by sub-sectors as well as Nomura's top picks in those categories where we have research coverage.

Fig. 39: Chinese consumers moving up the pyramid: the Maslow's hierarchy of needs



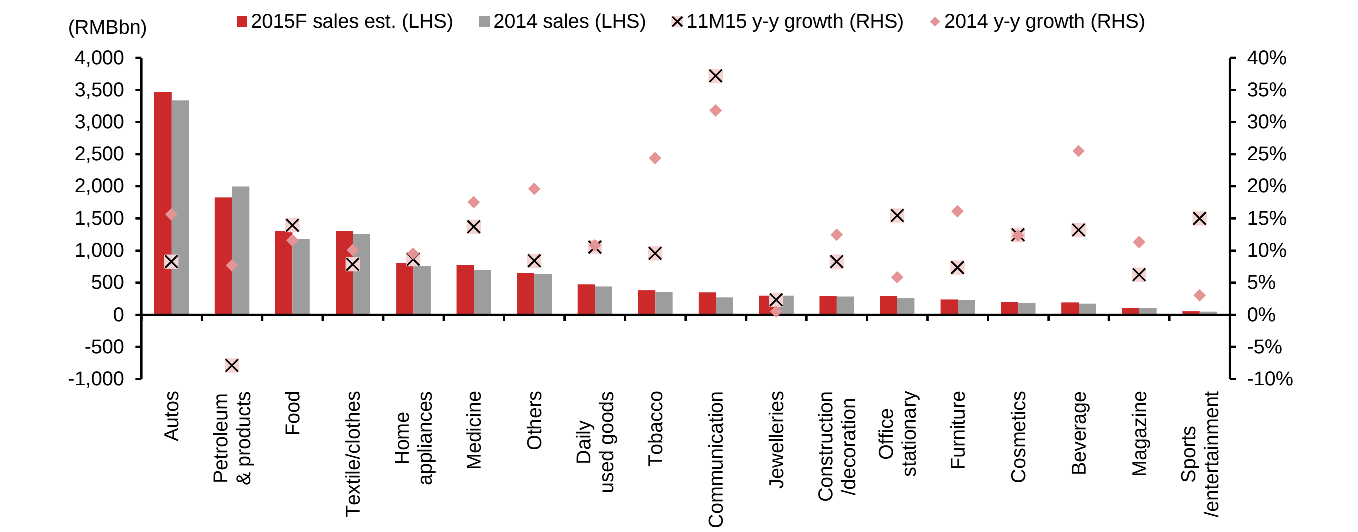
Source: Nomura research

Fig. 40: Percentage of urban household expenditure on food, transportation and entertainment services



Source: iChoice data, Nomura research

Fig. 41: Sales by enterprises above designated size



Note: 2015F sales estimate is based on the run rate of commodity sales in 11M15

Source: iChoice data, Nomura estimate

1. The Chinese are working out more than before

China's middle-class, who are more health-conscious, have been cutting back on not-so-healthy fast food in favour of a healthier lifestyle.

One very notable change is that more Chinese are working out. Indeed, sports are becoming the new "cool thing" for China's middle class. Instead of showing newly-purchased luxury goods, the middle-class Chinese are now posting their running routes, calories burned, muscles and vest lines in their WeChat Moments. According to China Household Finance Survey (CHFS) in 2015, 70% of the middle-class Chinese set "healthiness" as a top life priority – they are regular visitors to gyms and golf courses and often have a less pedestrian hobby, e.g. horse riding, diving, mountaineering or skiing, that distinguishes themselves from the commoners.

According to the Communique on 2014 Survey of National Fitness Activities (《2014年全民健身活动状况调查公报》) published by the General Administration of Sport of China on 16 November 2015, 33.9% of Chinese residents participated in sports or exercised regularly in 2014, 5.7% higher than in 2007, but still much lower than 49% in the US, 45% in Korea and 47.5% in Japan, suggesting significant room of potential growth.

Xinhua News reported on 12 October 2015 that the total size of the sports industry would likely reach RMB7trn in 2025, 40% higher than the RMB5trn target set by the State Council in Directive #46 on 9 October 2014, or 17.5x the size of ~RMB400bn in 2014 as reported by People's Daily on 19 November 2015.

Fig. 42: What's cool: Running a marathon in Shanghai

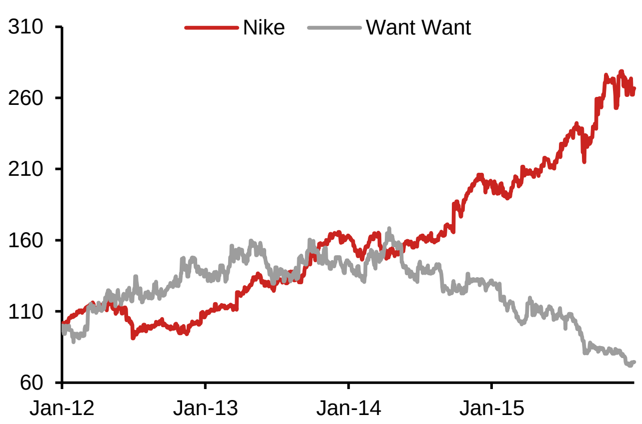
Source: Nomura research

Fig. 43: What's cool: practicing yoga in Beijing

Source: Nomura research

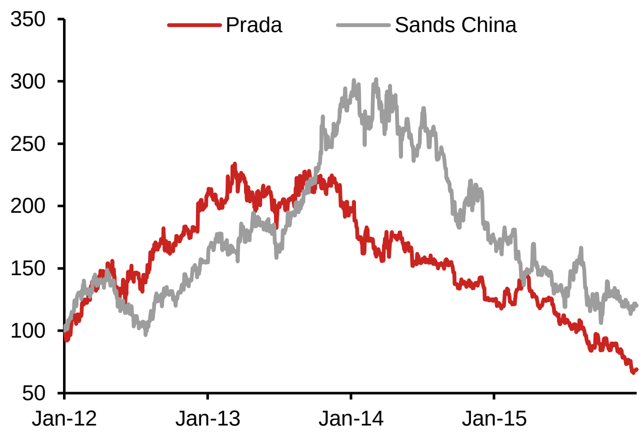
- Nike (NKE US, Buy; covered by Robert Drbul) benefited from the shift. Management of the company noted at its investors meeting on 14 October 2015 that it sees significant opportunity in Greater China for the "ever-growing middle-class" and "a consumer base that loves sports". Want Want (151 HK, NR), on the contrary, suffered from both top-line and bottom-line declines in 1H15 as Chinese consumers are turning away from unhealthy snacks.
- The anti-corruption measures in the past two years have had a significant negative impact on consumption of luxury goods and services by Chinese consumers. Share prices of Prada (1913 HK, Reduce) and Sands China (1928 HK, Buy) have suffered as a result.

Fig. 44: Working out more and snacking less



Source: Bloomberg data, Nomura research

Fig. 45: Rolling the dice in high fashion no longer so cool



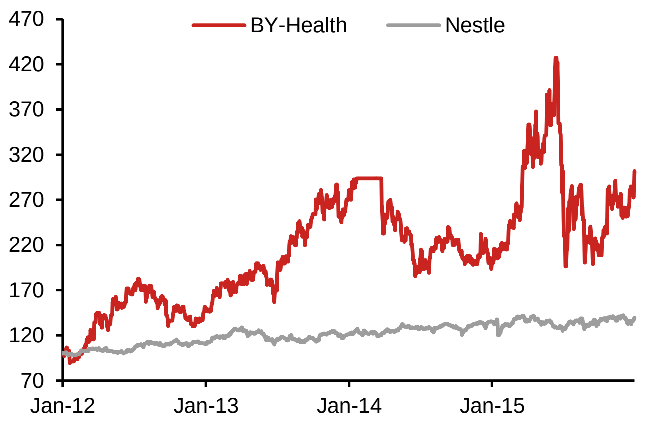
Source: Bloomberg data, Nomura research

2. The Chinese are eating less but better quality food

Not only are the Chinese working out more, they are taking care of themselves better in consuming better food, more dietary supplements and less fast foods. Interestingly, more are drinking coffee too, likely for the leisurely style as much as for coffee itself.

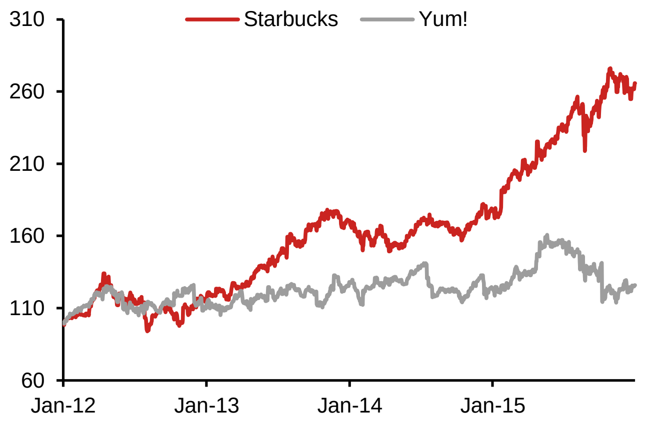
- With a focus on developing safe, high-quality products to meet the nutritional needs of infants and children, By-Health, an A-share listed Chinese company with total market cap of USD4.3bn focusing on dietary supplements, took advantage of the rising demand protein, vitamins, minerals and natural herbal extracts in China. Its share price outperformed that of Nestle (NESN VX, Buy; covered by David Hayes), which owns a more diversified portfolio of products with confectionery, canned food and beverages accounting for a big proportion of sales (beverages, prepared dishes, cooking aids and confectionery together accounted for 45% of Nestle's 9M15 sales).
- More Chinese drinking coffee. Shopping malls that used to have just one coffee shop have literally been tripling or quadrupling their coffee shop numbers in the past several years. Shoppers these days are seeking experience, rather than running straight to the shop, paying at the cash register and running back home as in the old days. Starbucks, with its chic interiors and comfortable setting, has a strong appeal to the rising middle-class. The company now has ~1,800 stores in 95 cities throughout China and management expects to have 3,500 stores by 2019. The western fast food vendors, e.g. McDonald's and KFC, are trying hard to retain customers by offering coffee and healthier diets.

Fig. 46: More nutrition, less sweet tooth



Source: Bloomberg data, Nomura research

Fig. 47: Sipping coffee vs. wolfing down chips, soda and pizza



Source: Bloomberg data, Nomura research

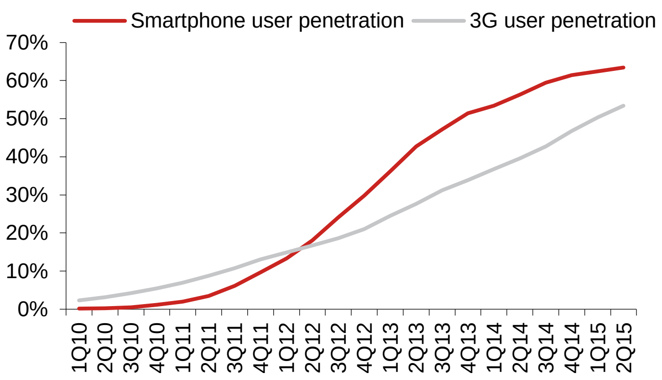
3. Going internet and mobile: fastest growing category in 2014 and 2015

As of end October 2015, China had 1,302mn mobile phone users and 951mn subscribers of mobile internet services. Mobile internet data use in 10M15 reached 3.2bn GB, up 100% from 1.6bn GB in 10M14.

Nomura's telecom and technology analyst Leping Huang and team expect data growth to be the key growth driver for the telecom industry in 2016, offsetting the negative impacts from over 30% decline in data tariff in response to Premier Li Keqiang's talk in May on lower the cost of communication and as a result of fiercer competition as China Unicom and China Telecom complete their 4G network.

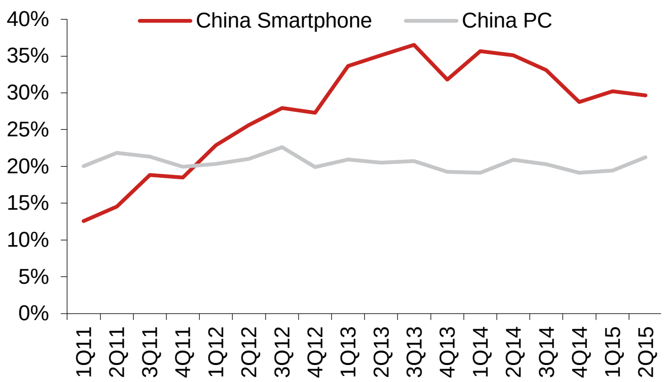
Given the already high penetration rate of mobile phones in China, unit volume of handset sales grows at a low- to mid-single digit level, mainly driven by replacement and upgrading demand. This has led to fierce competition among handset manufacturers, in which innovation leaders are more likely to survive. Leping and team believe that domestic players Huawei and Xiaomi, together with Apple, could build on their healthy 2015 results in 2016F.

Fig. 48: Smartphone and 3G user penetration in China



Source: MIIT, Nomura research

Fig. 49: Growth in consumer electronics sales volume in China



Source: Company data, Nomura research

Nomura's top picks: Leping and team rate **China Unicom (762 HK, Buy)** as their top buy for its likely momentum (ARPU, subscriber and etc) recovery starting in 2H16 after building up a competitive 4G network. We add **China Mobile (941 HK, Buy)** into our model portfolio for its structural growth opportunity in 4G and ability to provide full service including broadband.

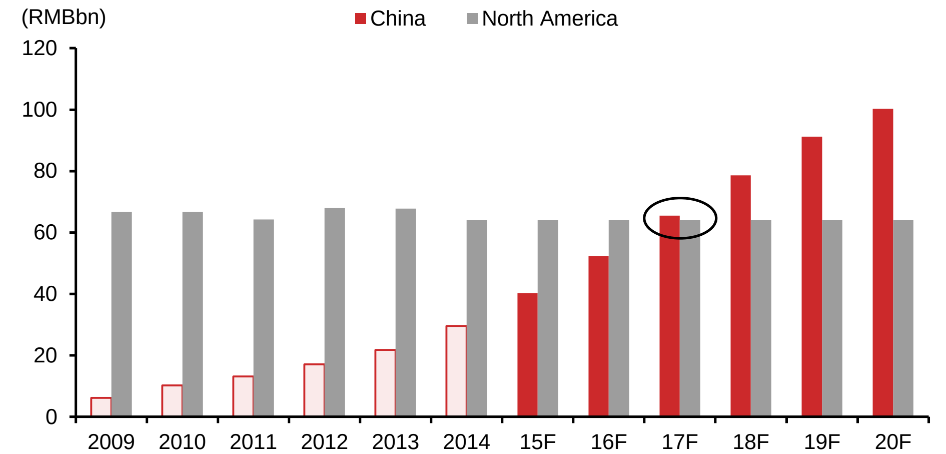
4. Entertainment & movies: most improved growth rate from 2014 to 2015

Market penetration for China's movie industry has been low. In 2014, annual per capita spending on movies was USD4 in China, vs. USD16 in Japan, USD29 in North America and USD32 in Korea. Annual movie admission per capita was 0.6x in China, vs. 3.6x in North America and 4.2x in Korea. Our China movie analyst Richard Huang and team believe that Chinese people's movie consumption will rapidly pick up, and estimate that China's movie box office income will grow from RMB30bn in 2014 to RMB100bn in 2020F, representing a 23% CAGR over the next five years. They expect China to overtake North America (US and Canada) to become the world's largest movie market in 2017F with RMB66bn box office income.

Nomura's top picks: Nomura's China movies and entertainment analyst Richard Huang and team like the sector's long-term growth but see limited near-term upside with stretched industry valuations. They believe **IMAX (1970 HK, Neutral)** is best-positioned in the industry as the cinema overbuild situation will translate into increased screen sales which is positive for the company in the near/medium term, and the company is also less affected by potential reduction in ticket subsidies which is more prevalent for domestic low-budget movies.

Fig. 50: China: Movie box office income

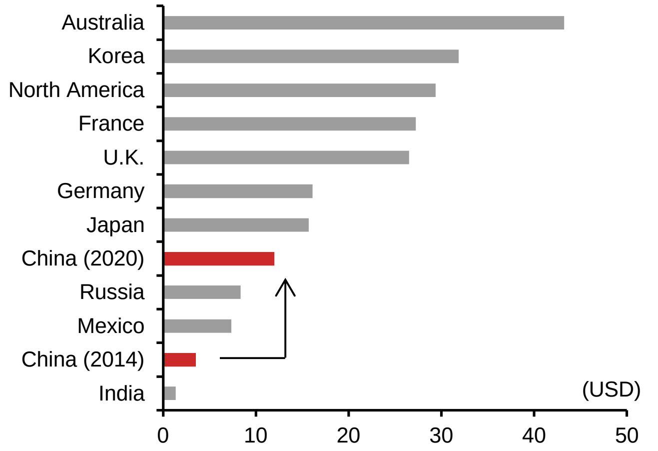
China looks set to overtake North America in 2017F and reach RMB100bn in 2020F



Source: Nomura research, Entgroup, Motion Pictures Association of America (MPAA)

Fig. 51: Annual spend on movies per capita (2014)

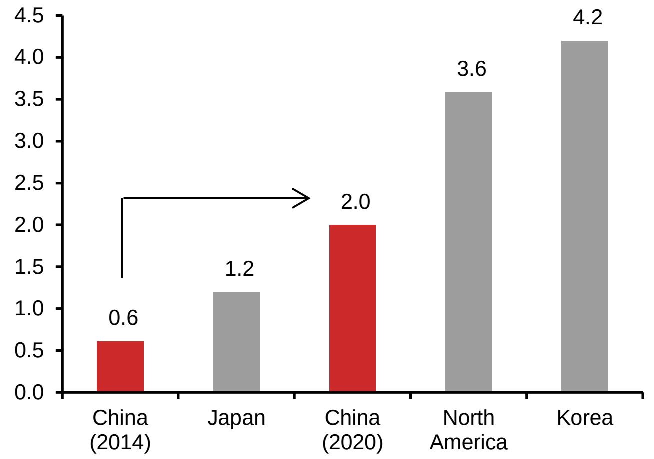
RMB100bn box office income implies annual per capita spend of USD12…



Source: MPAA

Fig. 52: Annual movie admission per capita (2014)

…and annual movie admission per capita of 2.0x



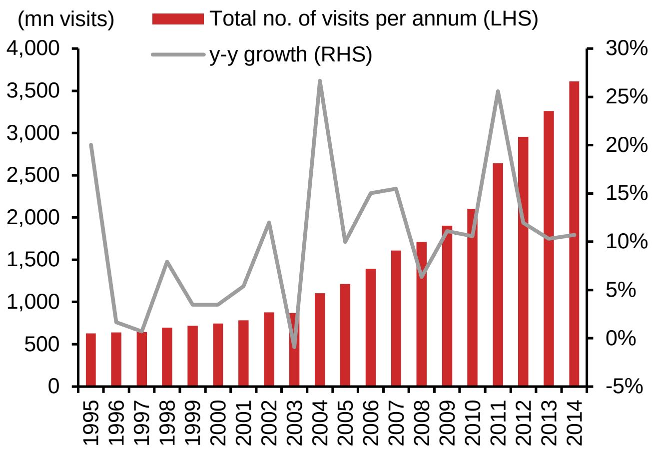
Source: MPAA

5. Travel: slightly less of 'shop till you drop' and more of exploration

China's domestic and outbound tourism markets have expanded persistently in the past decade. In 2014, total number of domestic and outbound trips reached 3,611mn and 117mn, representing 10.7% and 19.2% y-y growth, respectively. This means that, on average, Chinese people take ~2.6 domestic trips and ~0.1 overseas trips per person per year. In comparison, the US population takes ~6.6 domestic trips and ~0.2 overseas trips per person per year based on the US Travel Association's statistic and our estimates. As such, we think there is still plenty of room for China's tourism industry to grow.

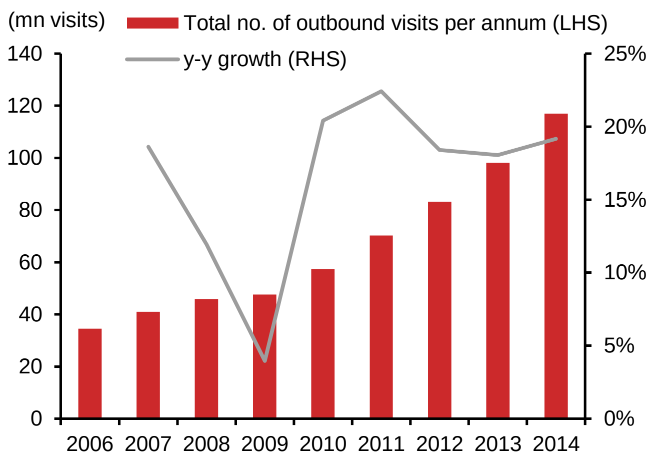
Shaun Rein, author of the best-seller "The End of Copycat China" and head of China Market Research Group, noted in his interview with Japan Times on 23 June 2015 that in addition to buying things, having experiences has become a new status symbol in China, and Chinese people have shifted their interests from simply owning a Louis Vuitton bag to "doing something cool". Indeed, we note that the Chinese tourists are seeking more diversified tourism experiences, ranging from leisure, medical services, education and adventure, and destinations expanding to the Amazon forests, the Himalayas and the Polar. We think this shift could benefit the online travel agencies that are capable of providing tailor-made solutions to Chinese consumers.

Fig. 53: Growing domestic tourism market



Source: National Statistics Bureau, Nomura research

Fig. 54: Growing outbound tourism market



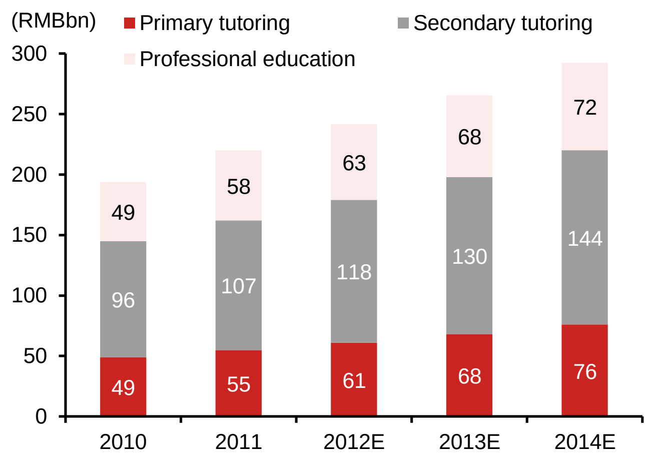
Source: China National Tourism Administration, Nomura research

6. Education services: vocational education on the rise

Our China Internet and New Media analyst, Andrew Orchard, and team note that due to the rise in the overall number of people in the demographic range and rising opportunities for higher education study, the number of university of college students has surged over the past three decades. They think that given the limited number of attractive employment opportunities for new graduates, new graduates will likely take professional training courses to gain more competitive advantage in the job market, and this will benefit the adult education segment.

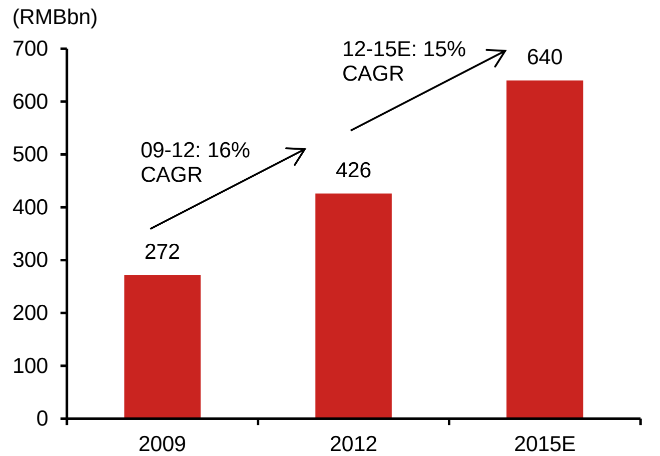
Nomura's top picks: Andrew and team also believe that the rising household affordability allows for increased demand for higher quality and more personalised services, and this should benefit the premium branded listed education companies. They have **TAL Education (XRS US, Buy)** as their top buy.

Fig. 55: China's estimated tutoring and adult education market revenue



Source: IDC, Xueda

Fig. 56: Private sector education revenue is forecast to grow at a 15% CAGR between 2012-15E

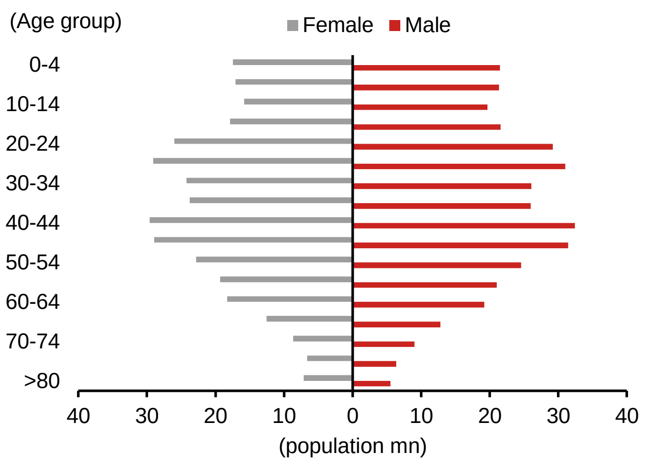


Source: Deloitte, Nomura research

7. Elderly care: large unmet demand, figuring out business model is key

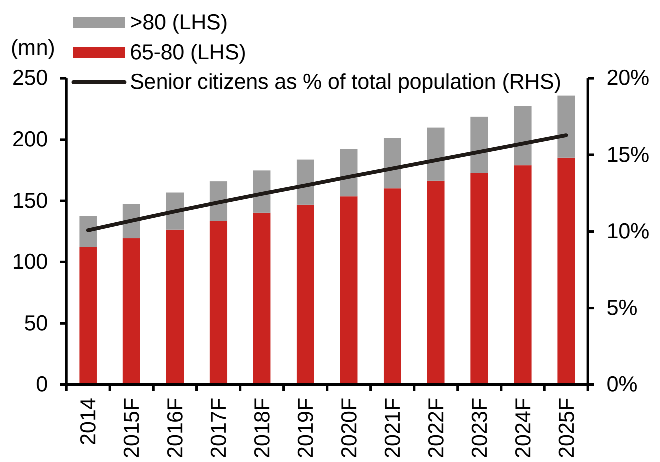
The proportion of Chinese population over the age of 65 reached 10% in 2014, up from 8.5% in 2004. We expect the percentage to rise further in the coming decade, reaching 16% in 2025F, with the senior population amounting to ~230mn.

Fig. 57: Chinese population by age group in 2014



Source: iChoice data, Nomura research

Fig. 58: Fast growth of senior citizens in the next 10 years



Source: iChoice data, Nomura estimate

The rapidly aging population in China brings with it various business opportunities, e.g. in healthcare, home services, residential property and financial services.

- PricewaterhouseCoopers (PwC) noted in its research on elderly care published in November 2015 that while most elderly citizens prefer to stay at home, the percentage selecting nursing homes will likely rise in coming years, driven by higher payment capacity given higher disposable income, inability of the younger generation to perform elderly care due to smaller family size, and the shift of social perception from lacking family care to a preferred form of retirement. They forecasted the demand for elderly care beds may rise from 6,590 in 2015F to 12,852 in 2025F, with a CAGR of 6.9% over the period. Nomura's property analyst Jeffrey Gao and team note that while some Chinese property developers such as Vanke and SinoOcean have expressed their interest in this field, things are still at a very early stage. Companies with access to healthcare resources and capability of hospital management may have a lead, in their view.
- Internet and technology companies have also actively participated in this theme. The development of O2O platforms have provided Chinese consumers easier access to elderly care services. Also, companies such as Fukangtong in Nanjing and Qianhai Guardian Cloud Health Management have developed elderly care systems that include internet-linked sensors to collect health data from senior citizens and can promptly alert their nurses on emergencies.

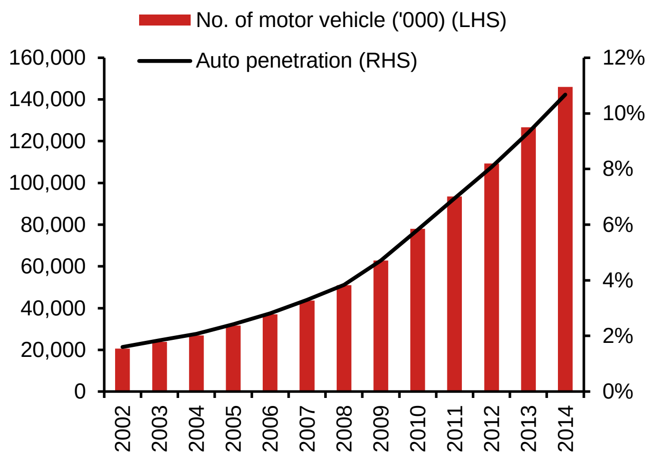
8. Autos: the biggest consumption category in China

China's auto sector experienced a challenging 1H15 with sales slowdown and pricing pressure. The new passenger vehicle sales volume started to recovered in September 2015 (3.3% y-y), and speeded up to 13% in October on release of pent-up demand accumulated since April and encouraged by the 5% purchase tax cut for new vehicles with engine sizes of 1.6L or less.

Nomura's auto analyst Benjamin Lo and team believe that the tax cut may lead to a small uplift in 2016F new PV sales volumes, though the impact is likely smaller than in 2009 due to the moderating GDP growth and higher auto penetration in China (10.7% in 2014 vs. 4.7% in 2009).

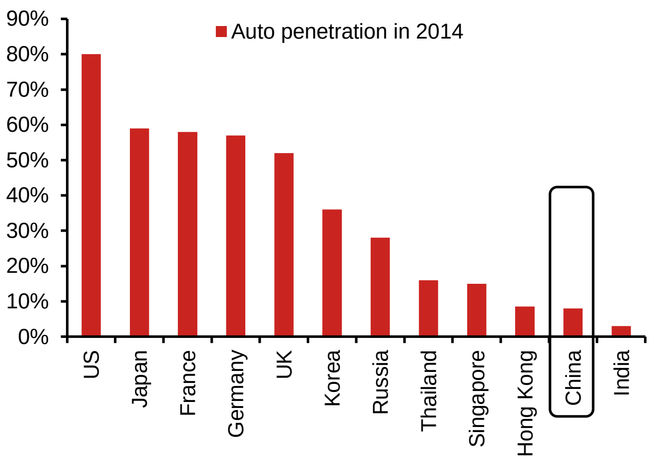
Nomura's top picks: We have **Brilliance China (1114 HK, Buy)** which is poised to benefit from entry-level luxury segment's sustained double-digit growth in the next three years, **Great Wall Motor (2333 HK, Neutral)**, the leading domestic SUV maker in China, and **Fuyao Glass (3606 HK, Buy)**, which is the No.1 auto glass maker in China and No.2 globally with a strong focus on product innovation, in our model portfolio. A full list of auto and auto parts stocks is available in the sector note.

Fig. 59: Auto penetration has rapidly ramped up in China in the past decade…



Source: CEIC, Nomura research

Fig. 60: … Though still remains at a low level relative to its peers

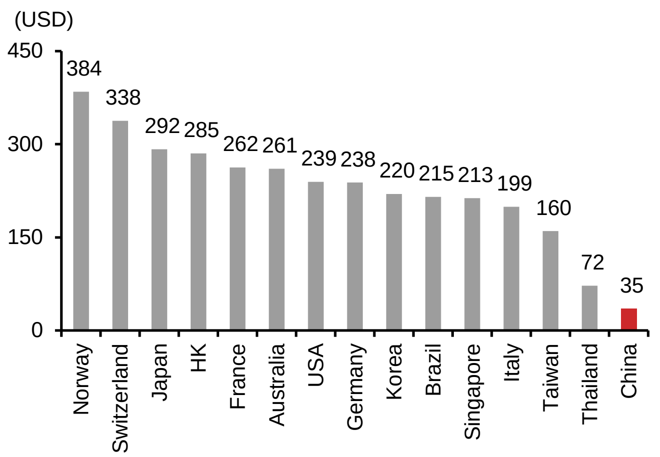


Source: World Bank, CEIC, Nomura research

9. Cosmetics: a consistent grower in 2014 and 2015

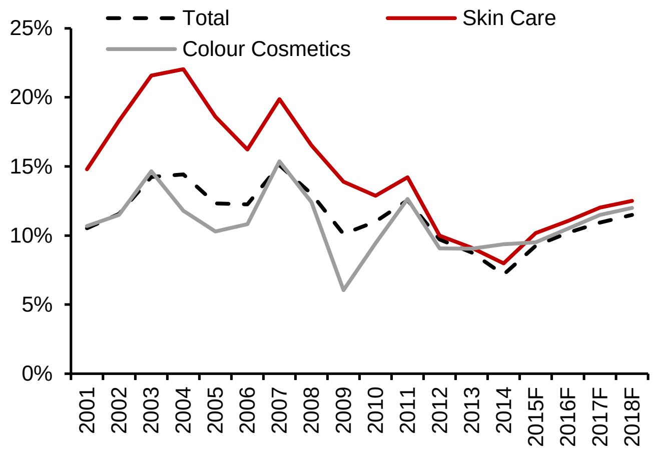
Cosmetic sales by enterprises above designated size in China have maintained a steady growth of 12% per annum in 11M15, unchanged from 2014. Nomura's consumer analyst Katherine Chan and team see stable earnings growth for China's cosmetics sector in the long term, driven by stable demand for cosmetic and skincare products with higher usage frequency and aging demographics. Katherine and team note that per capita spending on cosmetic and personal care products in China (excluding the effectively inaccessible rural market) is much lower than in its Asian peers such as Hong Kong, Taiwan, South Korea, Singapore and Thailand. They also note that cosmetics and skincare are less vulnerable to the Chinese government's crackdown on extravagant spending vs. other sub-sectors e.g. luxury products.

Fig. 61: Per capita spending on beauty & personal care products in 2014



Source: Euromonitor, Nomura research

Fig. 62: China beauty & personal care market growth



Source: Euromonitor, Nomura research

Nomura's top picks: Katherine and team believe that the mid-mass market, currently representing ~73% of local skincare market in China, will likely maintain its lead, growing at a faster rate than the overall market. Their channel checks suggest that Chinese skincare brands are catching up rapidly in the mid-mass and herbal skincare categories. **Jahwa (600315 CH, Buy)** is a pick in our equity model portfolio. Its business stands to benefit from the rising preference for domestic brands that offer value for money among Chinese consumers. Our full cosmetics coverage is included in the sector note.

10. Rapid growth of online retail sales of services

No discussion is complete about Chinese consumption without a reference to e-commerce. China's e-commerce has grown drastically in the past seven years, with total annual turnover rising from RMB56.1bn in 2007 to RMB2,814.5bn in 2014, representing ~10% of total retail sales of consumer goods in 2014.

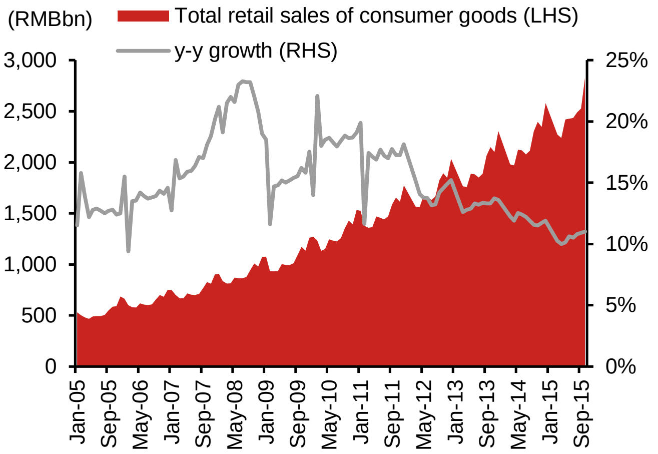
While the growth in online retail sales of goods has been moderating due to the high-base effect, the growth in online retail sales of services has remained at a high level in 10M15. Financial services, such as insurance and fund products, and tourism products have been the two hotspots of online sales.

One notable point raised by consumer experts we spoke to is that e-commerce-based retailing is not as low cost as commonly perceived due to their high fixed cost platforms. The advantage that e-commerce has over physical retailers is that whereas investors for the former demand top line growth to provide funding, investors for the latter require net profit to provide funding.

Due to their high fixed costs, e-commerce platforms have a bias toward a volume-driven top line model, which means that quality control invariably becomes an issue. This quality concern is now perceived by some physical retailers as an opportunity. Experts noted that the quality problems for online sales can be reduced by setting proper standards. Xinhua News reported on 7 January 2015 that the law-makers were drafting the E-commerce Law, which they hoped to finalise by end-2015.

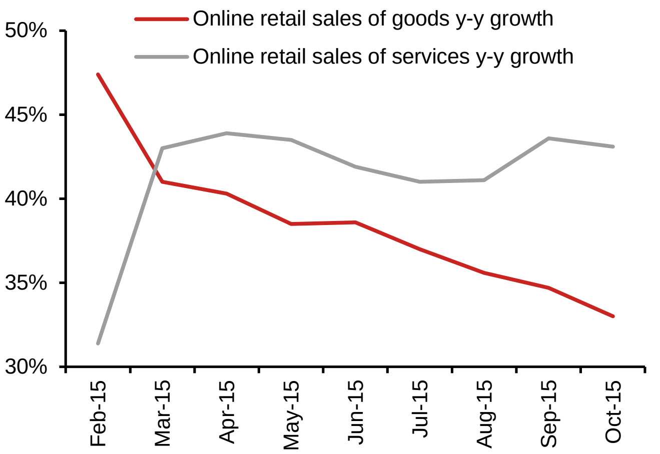
Nomura's top pick: We have included **VIPShop (VIPS US, Buy)** in our model portfolio, for its competitive advantage gained on reduced supplier payment period and supplier finance and for likely improvement in brand reputation.

Fig. 63: Total retail sales of consumer goods



Source: National Statistics Bureau, Nomura research

Fig. 64: Online retail sales y-y growth



Source: iChoice data, Nomura research

China consumption sector's supply side reforms

Improving quality standard and enforcement at home will lift consumption

Experts we spoke with noted lower quality of products sold in China vs. in overseas developed markets can be partially attributed to the lower quality and safety standards set by the Chinese regulators, as well as lax enforcement, evidenced by the high failure rate of 9.7% in the most recent national quality spot inspection in 3Q15, 2pp higher than in 2014. As a result, Chinese consumers have been lining up at shops abroad for toilet seats, rice cookers, formula milk powder, diapers, iPhones and luxury products during the past year, and cross-border e-commerce on these items has also flourished.

- The annual run-rate of Chinese tourists traveling overseas is 120mn. While Hong Kong and Macau remain the most favoured destinations, the mix of tourists to these two cities has been declining for three years. Meanwhile, South Korea and Japan have gained since 2014. Data from different sources, e.g. China National Tourism Administration and Chinese-Luxury.com, suggest Chinese outbound tourists spent ~USD600-1,330 per person on average in 2014. Assuming Chinese tourists' overseas purchase reaches USD1,500 per person on average, this would total USD180bn on a run rate basis, for approximately 1.7% of China's GDP in 2015 on our estimate.

Fig. 65: Chinese outbound tourism by destination

Unit: mn visitors	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Hong Kong (shopping)	43.6%	41.5%	39.4%	38.3%	39.2%	40.3%	40.3%	42.0%	41.0%	40.5%
Macau (shopping, gambling)	27.3%	28.7%	31.2%	33.9%	31.7%	28.1%	28.1%	25.9%	25.7%	24.7%
South Korea (mainly shopping)	2.7%	3.2%	3.2%	3.0%	3.1%	3.4%	3.4%	3.6%	4.3%	5.3%
Thailand (sightseeing + shopping, lifestyle experiences)	1.9%	2.2%	1.8%	1.4%	1.3%	1.8%	2.2%	2.7%	4.1%	3.4%
Taiwan (sightseeing + shopping)	0.0%	0.0%	0.0%	0.0%	2.1%	2.9%	2.6%	3.2%	3.0%	3.4%
USA (sightseeing + shopping)	0.0%	0.0%	0.0%	0.0%	1.7%	1.9%	1.9%	2.1%	2.0%	1.9%
Japan (mainly shopping)	3.6%	3.7%	3.6%	3.4%	3.3%	3.4%	2.3%	2.4%	1.9%	2.1%
Malaysia (sightseeing)	1.1%	1.3%	1.4%	1.4%	1.3%	1.8%	2.5%	1.6%	1.4%	1.0%

Source: China National Tourism Administration

Fig. 66: Sensitivity analysis of Chinese tourists' overseas spending

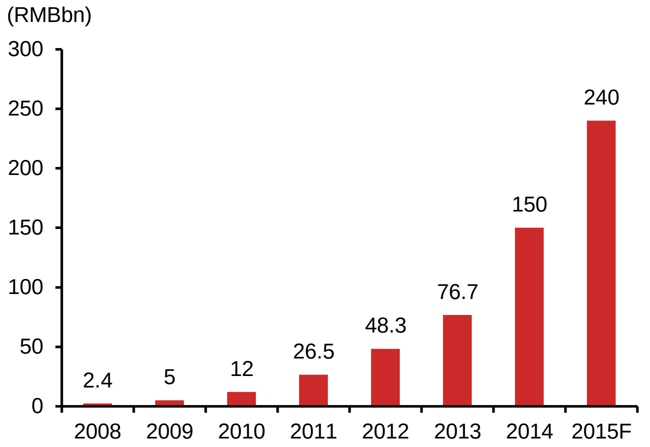
Average overseas purchase per tourist (USD)	Total overseas spending by 120mn Chinese tourists (USD bn)	As % of est. China's GDP in 2015 (~RMB68trn, or ~USD10.6trn)
500	60	0.6%
1000	120	1.1%
1500	180	1.7%
2000	240	2.3%
2500	300	2.8%

Note: Estimated China's GDP in 2015 is based on Nomura China Economics team's forecast

Source: Nomura research

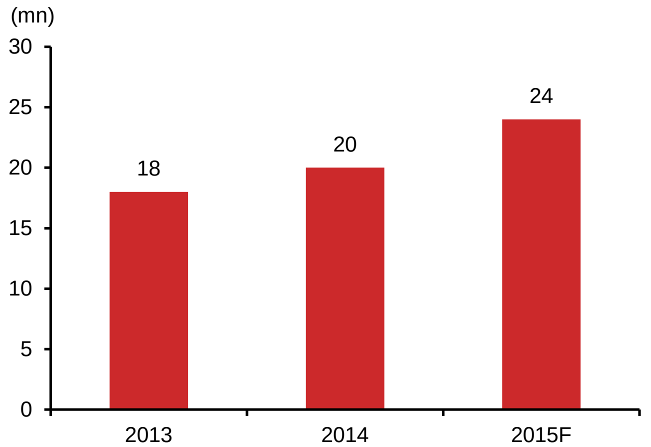
- Cross-border ecommerce has also taken off for the same quality concerns. According to BigData-Research's estimate, cross-border E-commerce may reach RMB240bn in 2015F, for ~0.36% of China's 2015F GDP.

Fig. 67: Market size of cross-border e-commerce in China



Source: BigData-Research, Nomura research

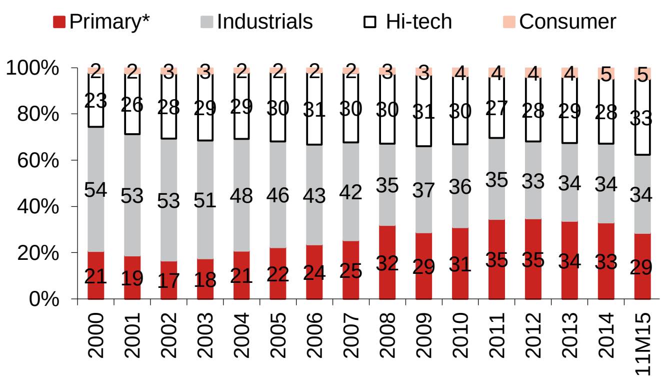
Fig. 68: No. of buyers in cross-border E-commerce in China



Source: BigData-Research, Nomura research

Separately, as shown in the figures below, the value of consumer-related imports has been growing rapidly and consistently over 2000-14 (CAGR of 23%) and accounting for a rising share of China's total imports. This has occurred despite the fact that China has relatively high import duties on consumer product imports (mostly low teens) vs. commodities, industrials, and technology products (9.8% on average as reported by Xinhua News on 2 March 2015). Should the import duties, the value-added tax and the consumption tax get lowered, growth of consumer product imports can be even higher, as many Chinese consumers are currently purchasing overseas products via cross-border e-commerce channels or during their trips abroad, which are not captured in the official import figures.

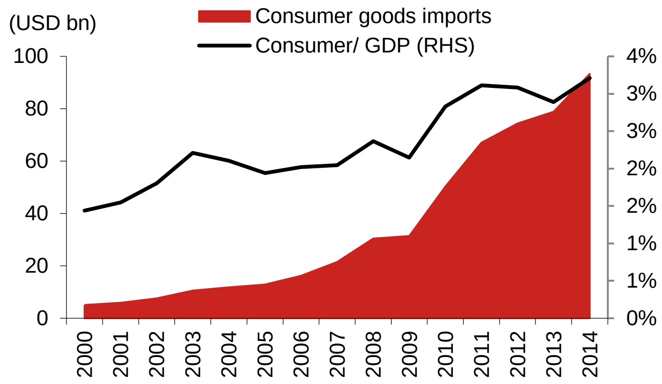
Fig. 69: China's imports by category



Note: * Primary imports include crude oil, foods, raw materials and fuel

Source: National Statistics Bureau, CEIC, Nomura research

Fig. 70: 23% CAGR for consumer goods imports in 2000-14



Source: National Statistics Bureau, CEIC, Nomura research

Changing local governments tax revenue away from manufacturing & land sales

The Chinese local governments have three major sources of fiscal income – taxation primarily imposed on manufacturing sectors (although starting to change with the VAT reform), transfer payment and tax refund from higher level governments, and land sales proceeds. They hardly impose any taxes on non-payroll income, wealth (eg property or inheritance taxes), or local consumption (eg sales taxes). Therefore, there have been a lot of incentives for local governments: 1) to court outside business investments, because they can collect taxes from it; 2) to court upper level governments, because they can collect transfer payment from it; and, 3) to support local property and land prices because they can collect money from it.

None of these three sources are stable and recurring fiscal income sources. Essentially, local governments have spent way too much of bandwidth figuring out where the money is going to come, and have little luxury to make medium to long term planning. There are early signs that recurring local tax revenues (property taxes and consumption taxes) could be coming, and primarily to the benefit of local governments.

After the fiscal reform in 1994, China charged a value-added tax (VAT), which is shared between central and local governments on merchandises, a business tax, which is a local government tax, on services, and a consumption tax, which is a central government tax on a selected few categories of luxury goods, such as tobacco, alcohol, jewelleries, cosmetics, autos and etc. All three taxes are included in the price.

As China carries out its recent round of fiscal reform replacing the business tax with the VAT, the local Chinese governments lose an important source of fiscal income. Many policy researchers recommend changing the consumption tax to a local government tax or a tax shared by central and local governments as a potential remedy. This should help motivate local governments to improve physical environment and quality standards, so as to promote local-based consumption in our view.

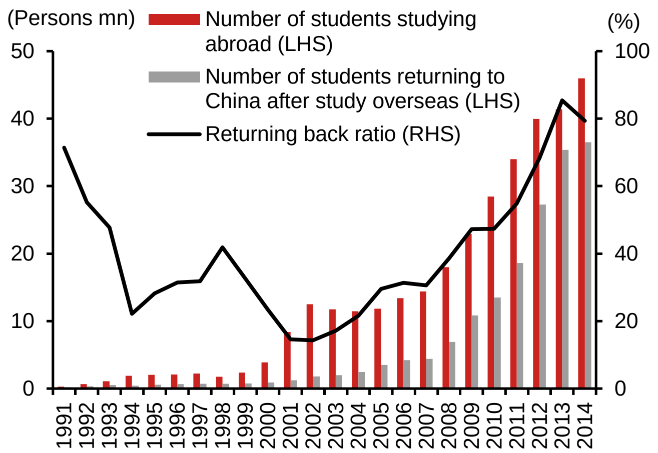
#2: Manufacturing upgrade & innovation

China has a sprawling industrial sector…

In "Transformation and Treatment", authors at China's Strategic Think-tank noted the following:

1. China's manufacturing industry grew 18-fold in the past three decades, and it is the most complete in terms of sectors, sector clustering, supply-chain and basic infrastructure among developing and developed countries. China has commanded the top spot for manufacturing related GDP in the world since 2009. While Chinese manufacturers used to compete with peers in other EM countries, in recent years, they increasingly compete with DM countries' manufacturers.
2. While there is concern over China losing its population dividend, automation level in Chinese manufacturing is still low, machination in agriculture is still low, and education level for the average Chinese has continued to grow at a faster rate than global average. For population above the age of 25, the average Chinese received 9.28 years of education (data as of 2014), vs. the global average of 7.9, and OECD average of 11.3 (data as of 2013). While China continues to see more talent leaving the country than returning, the rate of overseas returnees vs. departures has risen significantly since 2004 (Fig. 71).
3. As an aside, there are signs of rising wage pressures as well as shortage of skilled labour among the ASEAN countries that China has been directing labour intensive export businesses to. The key issue is skill level of the underlying labour pool. If the average years of education are significantly below that of global average, that means the effective labour pool could be smaller than the actual working age population.

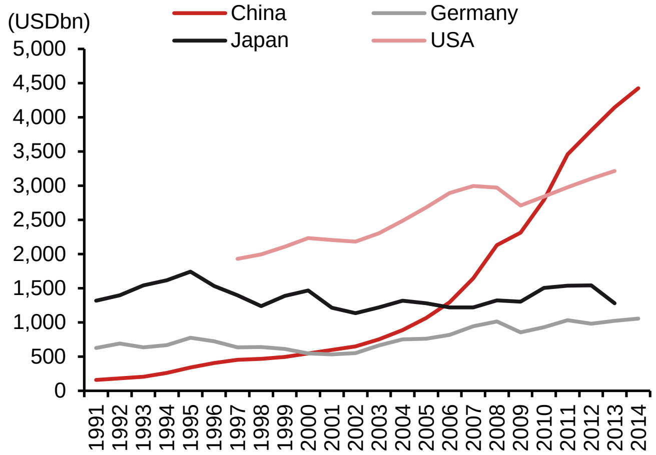
Fig. 71: Number of students studying abroad and returning



Source: National Bureau of Statistics, Nomura research

Fig. 72: Industry valued added comparison

China vs. Germany, Japan and USA



Source: World Bank, Nomura research

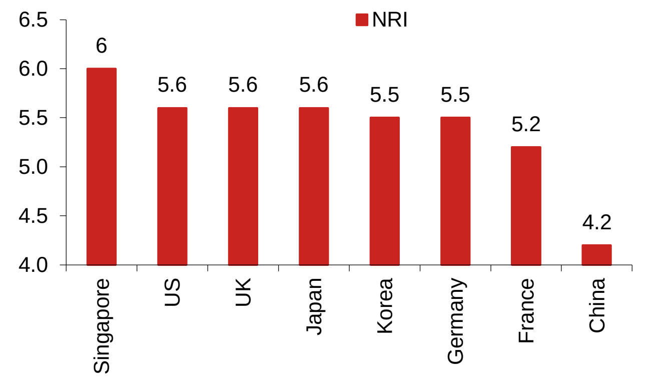
…but while big, it is not yet strong in terms of core competency

In particular, the Ministry of Industry and Information Technology (MIIT) has identified a range of challenges for the Chinese manufacturing industry.

- Limited self-developed innovation capability, as well as heavy reliance on imports of high-end equipment, core parts and core materials, has left many Chinese manufacturers at the low end of the value chain.
- China lags behind in informatisation and still relies on imports of core software used in manufacturing. China scored 4.2 in the Network Readiness Index (NRI) compiled by the World Economic Forum to measure the propensity for countries to exploit the opportunities offered by information and communications technology, and ranked No. 62 among the 143 countries under review. Detailed examination of the subcategories suggests that China lags behind in business usage and economics impacts, and falls

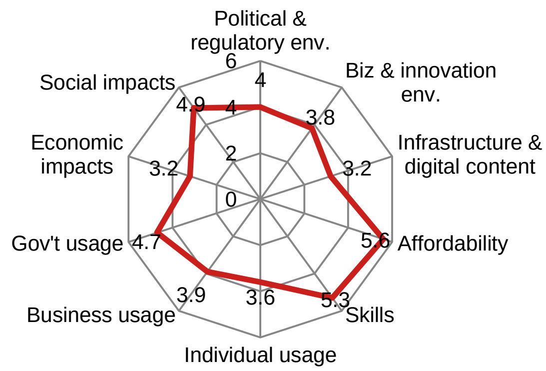
into the bottom one-third (No. 107 out of the 143 in total) as measured by employment in knowledge-intensive activities as % of workforce.

Fig. 73: China lags behind in NRI



Source: World Economic Forum, Nomura research

Fig. 74: China's NRI performance overview



Source: World Economic Forum, Nomura research

- R&D to sales ratio for China's large- and mid-sized industrial companies has increased over the past decade, but remained at a low level of 1.1% in 2014.
- The problem of low product quality remains to be resolved. China remained the No.1 country of origin in the EU's alert system for dangerous non-food products, accounting for 64% of the total number of notification in 2014, unchanged from 2013 and ~6pp higher than in 2012.
- Chinese manufacturers overall has low energy efficiency. Latest available data from the World Bank show that in 2012 China's energy use per unit of GDP (in constant 2011 PPP $) is 1.4 x the level in the US, 1.9x the level in Japan, and 1.7x the OECD average.

Post GFC, various developed countries are pursuing Industry 4.0

Hit by the Global Financial Crisis, the leading developed countries, including the US, Japan, Germany, the UK and France, turned to manufacturing upgrade to boost their economies. These developed countries have gone through the era of Industry 2.0 (when manufacturers rely on mass production to achieve economies of scale) and 3.0 (when manufacturers adopt new paradigm of planning, development and production to produce customised products to meet customers' demand), and are moving toward Industry 4.0, which is underlined by more flexible organisation of production resources and facilities with the Internet of Things and Internet of Services.

This new round of industrial revolution may create various new job opportunities with high added value, e.g. system developers, transport network engineers, healthcare equipment consultants, data analysts and smart grid engineers. It is estimated that cloud computing and big data will bring the EU millions of new jobs in the next decade.

Fig. 75: The most frequently cited definitions of Industry 1.0-4.0

	Industry 1.0	Industry 2.0	Industry 3.0	Industry 4.0
Duration	(1784-1870)	(1870-1969)	(1969-now)	(now-future)
Milestone	First mechanical loom, 1784	First production line, 1870	First programmable logic controller, 1969	Internet of things
Key feature	Introduction of mechanical production facilities with the help of water and steam power	Division of labour and mass production to achieve economies of scale	Gain competitiveness through new paradigm of planning, development and production to produce customised products to meet customers' needs	More flexible organisation of production resources and facilities

Note: the duration refers to the time period when a majority of manufacturers in developed economies, e.g. Germany and the US went through the stage

Source: MIIT, Nomura research

Fig. 76: Developed countries have started on Industry 4.0 since the end of the Global Financial Crisis

	Milestones
US	
2009	American Recovery and Reinvestment Act
2010	Manufacturing Enhancement Act
2011	Advanced Manufacturing Partnership
2012	US Manufacturing Renaissance Plan
2012	National Network for Manufacturing Innovation
Japan	
2009	Manufacturing Competitiveness Strategy
2010	Japan's Manufacturing Industry
2012	Initiatives toward the Creation of New Industries and New Markets
Germany	
2013	Recommendations for implementing the strategic initiative Industry 4.0
UK	
2013	Future of manufacturing: a new era of opportunity and challenge for the UK
2015	Strengthening UK manufacturing supply chains: an action plan for government and industry
France	
2013	The New Industrial France

Source: MIIT, Nomura research

And, Chinese manufacturers also need to catch up

According to industry experts we speak to, most Chinese manufacturers are still at the Industry 2.0 stage or on their way to Industry 3.0 driven by oversupply, weak demand and rising input costs have been forced down their margins. This transition calls for improved ability to organise production and service activities more efficiently. Improved supply-chain management would help most company through this transition. Some industries in China, such as auto, has encountered the issue and upgraded their ways of manufacturing in response. A selected few companies in Shenzhen, e.g. Huawei and Eternal Asia have also been pioneers in this regard.

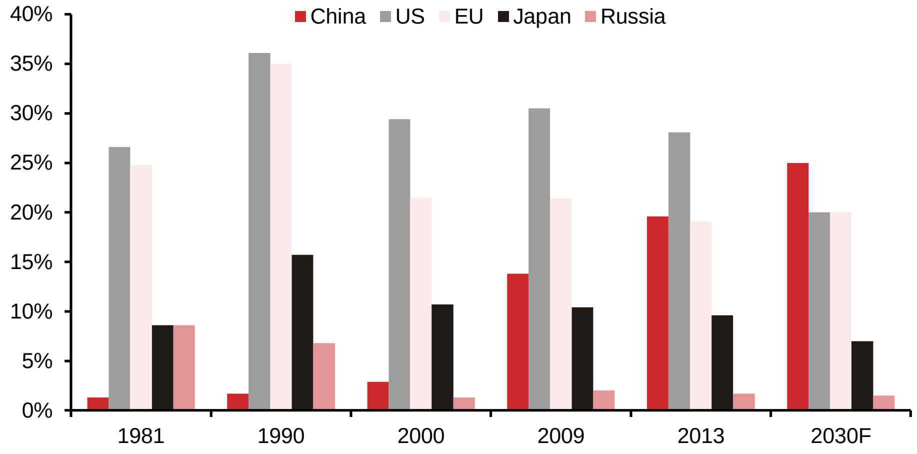
As a live example, there is much inefficiency still in the Chinese logistics services. In 10M15, the total cost of logistics reached RMB8.3trn, up 4% y-y. National Business Daily reported on 24 Nov 2015 that the total cost of logistics to GDP ratio in China is ~15.2%, down 40bps y-y, but still much higher than 8-10% in the US, Japan and Germany.

- There are 20,000 different types of truck in China, vs. about a dozen types in the US. While the vast majority of trucks in the US are capable of drop and pull, 95%+ of trucks in China cannot do this.
- According to industry experts, a typical truck driver only drives 10-15 days per month, while spending the rest of his time waiting for assignment or goods to be loaded or unloaded. China can improve efficiency of logistics services by adopting better IT system working on standardisation and refining the operating system.

China has ramped up on R&D spending since GFC

China played catch-up for several decades post its opening-up in the 1970s. But things have changed in recent years. In 2014, R&D spending in China totaled RMB1.3trn, for 9.9% y-y growth and 2.05% of GDP, 2bps and 141 bps higher than in 2013 and 1994. China's R&D spending accounted for the second largest share (20%) of the world's total R&D spending in 2013, surpassing the EU (19%) while still lower than the US. The Tsinghua University China Research Institute forecasted that China will take the biggest share (25%) of global R&D spending in 2030.

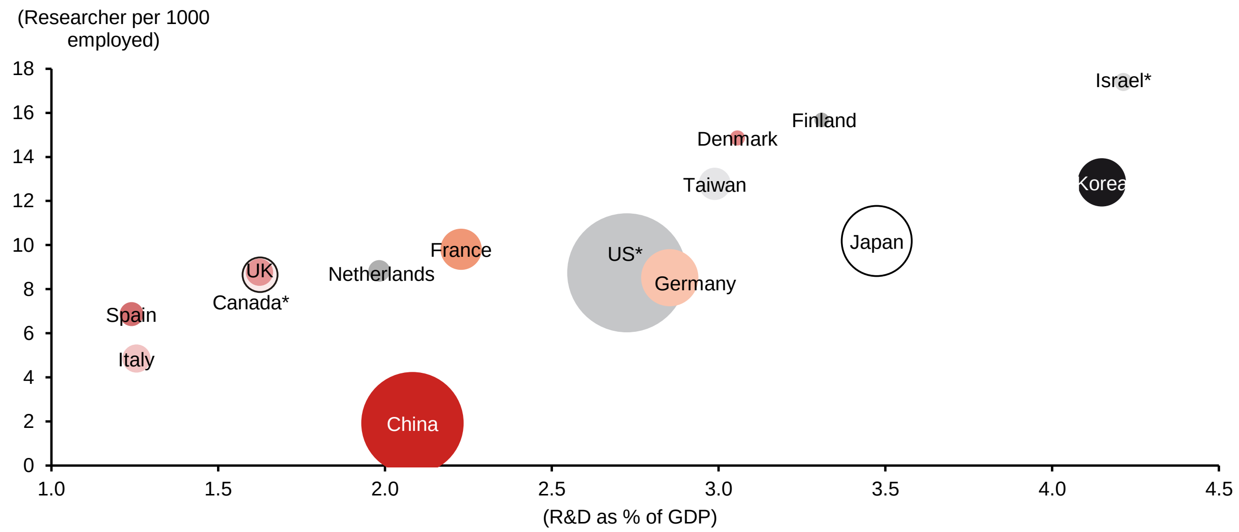
Fig. 77: Changes in the share of global R&D spending over time



Source: Tsinghua University China Research Institute, UNESCO, Nomura research

China's more advanced half is approaching US and German level of R&D to GDP
In 2014, for the four most advanced coastal provinces (Zheijiang, Guangdong, Jiangsu, and Shandong) in China plus three coastal autonomous cities (Beijing, Shanghai, and Tianjing), that together accounted for 46% of China's GDP, R&D to GDP ratio was 2.75%, on par with the ratios in the US and Germany.

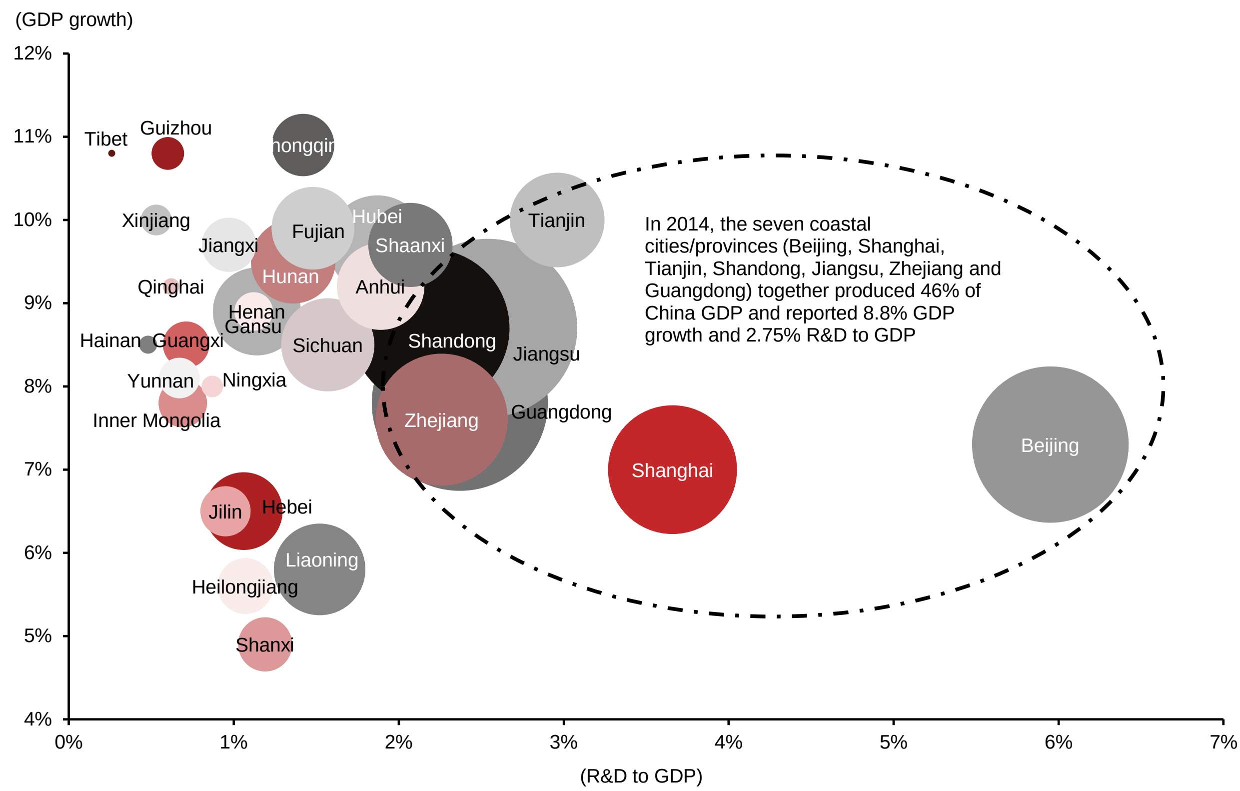
Fig. 78: China's spending on R&D vs. some major developed countries



* Researcher per 1000 employed as of 2012; ** Researcher per 1000 employed as of 2011

Source: OECD data, Nomura research

Fig. 79: R&D spending by province in 2014

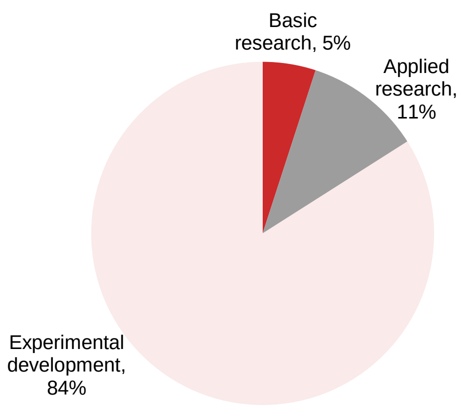


Source: National Statistics Bureau, Nomura research

The Chinese private sector is a key party to drive upgrade and innovation
Similar to most developed economies, China's spending on R&D has been concentrated on experimental developments. Over three quarters of China's R&D spending has been by corporates, and the corporates are focused on generating solutions to practical problems over funding long-dated basic and applied research, pursued by the higher education institutions and R&D institutions.

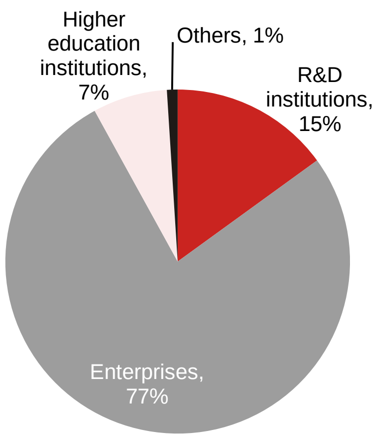
It appears to us that, in the 1980s, the making of a successful entrepreneur required, first and foremost, guts! In the 1990s, the first requisite was relationships! Since the new millennium, both skills and relationships are required, but increasingly brain power rises to the fore. The recent promotion of mass entrepreneurship and innovation by the Chinese government is precisely a reflection of this shifting underlying dynamic.

Fig. 80: China's spending on R&D in different fields



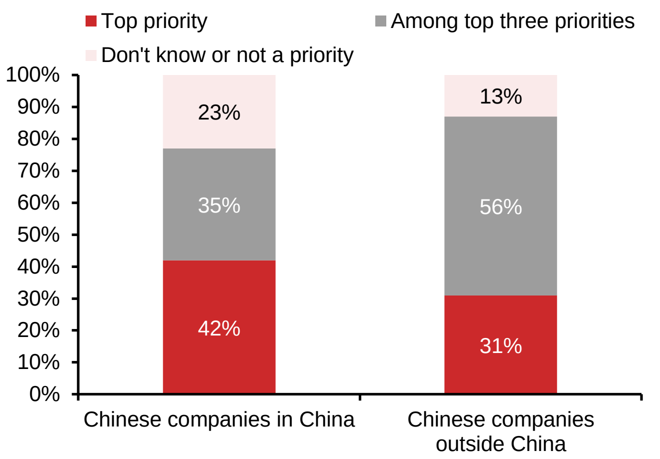
Source: CEIC data, Nomura research

Fig. 81: China's spending on R&D by institutions



Source: CEIC data, Nomura research

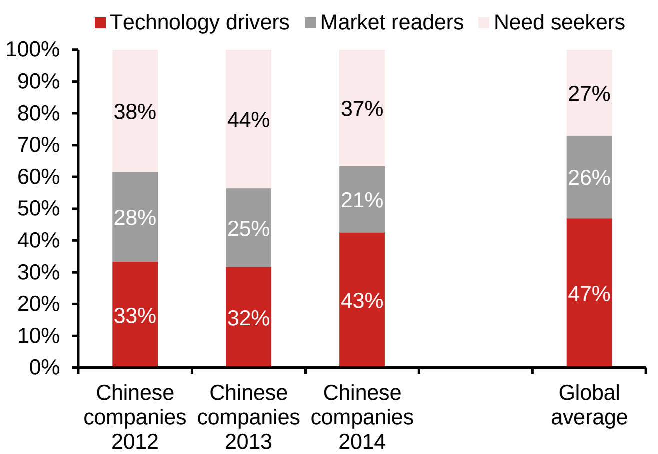
Fig. 82: Chinese companies set a high priority on innovation



Note: the survey is based on a sample of a limited size, which may subject to certain bias

Source: Strategy&, CEIBS

Fig. 83: Chinese companies are embracing technology



Note: the survey is based on a sample of a limited size, which may subject to certain bias

Source: Strategy&, CEIBS

ESOP to incentivise innovation and employees at SOEs

While SOEs have not been driving innovation, and are not expected to lead in this area, Beijing is also trying to lift the level of innovation among SOEs.

The Directives on SOEs Developing Mixed Ownership Economy, published on 24 September 2015, noted that employee stock ownership plans (ESOP) will be trialled at R&D institutes converted into enterprises as well as high-tech and technological services enterprises. Eligible participants of ESOP include R&D personnel, management and core staff that are crucial for the SOE's sustainable development. It can be in the form of equity issuance via private placement for an existing SOE subsidiary or as part of capital raised for a new subsidiary.

We note that offering equity options to SOE employees, particularly senior management, has been a challenge. Because SOEs in China technically belong to all Chinese, giving a piece of the public asset away for free can be difficult to justify. Instead, ESOPs for a relatively wide range of employees and for R&D staff are allowed.

Beijing is focused on creating a supportive ecosystem…

We think that Beijing understands that the private sector, not the SOEs, will drive innovation in China. As such, the best that a government can deliver is a supportive ecosystem.

- Anti-corruption helps to level the playing field for legitimate businesses: Business people are smart. If they can parlay government connections to their advantage, they would not need to spend that much on R&D. But when this does not work anymore, they would adapt. Reducing administrative approvals and optimising ministerial functions to trim costs for corporates.
- Basic scientific research effort helps to lift the self-dependency of China's technological development: Wan Gang, China's Minister of Science and Technology (MOST), noted at a meeting on 26 March 2015 that China will continue to increase the investment in basic scientific research in the coming years, focusing on building China's competitiveness in the future. These research projects will be financed by special fiscal funds from central and local governments. The State Council issued the "Plan for Deepening the Reform on Management of Central Fiscal Funding for Technological Projects" on 7 January 2015 to detail the management measures.
- Protection of intellectual property: If one has no technology to speak of, it certainly makes sense to copy. But as China develops more and more of its own technology and innovation, raising the level of protection makes sense. One important directive, eg, "Decision on Major Issues Concerning Comprehensively Deepening Reforms", adopted at the 3rd plenum on 12 November 2013, promised to "build a system that encourages innovation and strengthens intellectual property application and

protection." Since then, specialised intellectual property courts have been set up, e.g. in Beijing, Shanghai Chongqing, Guangdong and Shandong.

- Preferential fiscal arrangements, eg, governmental funds supporting the development of SMEs and promoting entrepreneurship and innovation; preferential tax arrangements for high-tech enterprises, entrepreneurs and investors; and government procurement of innovative products.

…and outlining a road map toward upgrading manufacturing capabilities

To address these issues, on 19 May 2015, China's State Council released the "Made in China 2025" guidelines. The goal is to propel China into the ranks of world's leading countries by 2049 with itemised deliverables by 2020 and 2025. There are five key aspects in delivering this blueprint as specified below.

Fig. 84: Five key projects in "Made in China 2025" and their objectives

Manufacturing innovation center

- 2020: Build ~15 manufacturing innovation centers
- 2025: Build ~40 innovation centers

Intelligent manufacturing

- 2020: Significant rise in the level of intelligent manufacturing in key areas; for model projects in trial, cut operating costs by 30%, cut production cycle by 30%, and cut defect rate by 30%
- 2025: Full implementation of intelligent manufacturing in key areas; for model projects in trail, cut operating costs by 50%, cut production cycle by 50%, and cut defect rate by 50%

Industrial foundation strengthening

- 2020: Achieve self-dependence in 40% of the core basic products and materials
- 2025: Achieve self-dependence in 70% of the core basic products and materials

Green manufacturing

- 2020: Build 1,000 model green manufacturing plants and 100 model green industrial zones; cut the intensity of emission in key industries by 20%
- 2025: Reach advanced levels of green manufacturing and energy efficiency for key products; build a green manufacturing system

High-end equipment innovation

- 2020: Achieve self-dependence in research, manufacturing and application in selected fields, e.g. aircrafts, rolling stocks, new energy vehicles, marine engineering, smart grid, nuclear power, high-end medical equipment and etc.
- 2025: Become world leaders in manufacturing of equipment with intellectual property rights

Source: MIIT, Nomura research

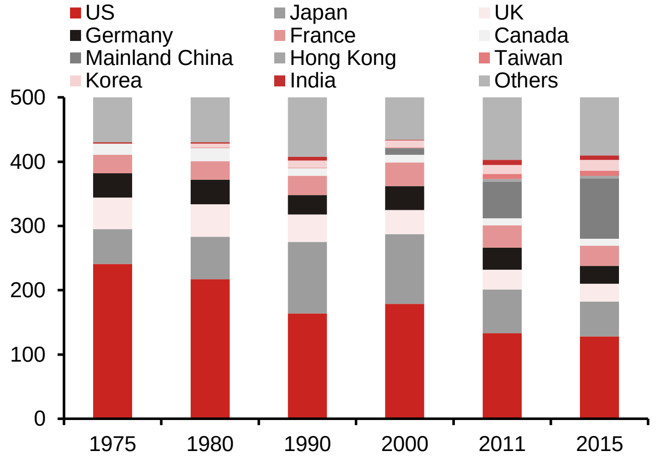
What are the investment implications?

The investment implications are either to invest in winners or leaders of this wave of manufacturing upgrade or innovation, or to invest in the enablers of this trend.

More private sector companies are starting to stand out globally

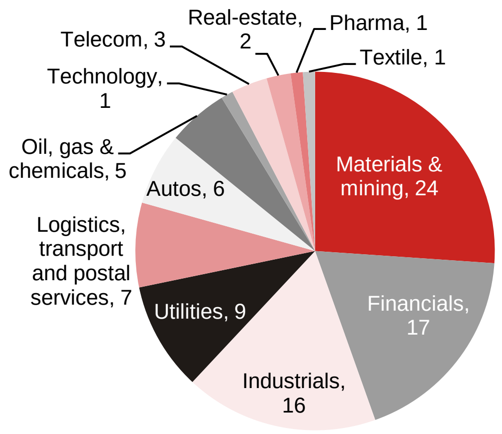
In 2015, 94 Chinese companies were ranked as Fortune Global 500 on revenue, up from 57 in 2011 and 10 in 2000. While materials & mining and financials companies account for the biggest shares, aerospace & defence names including China North Industries, Aviation Industry Corp. of China (AVIC) and China Aerospace Science & Technology (CASC), telecom companies including China Mobile, China Telecom and China Unicom, and technology companies such as Lenovo and Huawei, also made it to the list.

Fig. 85: No. of Fortune Global 500 companies in each country



Source: Fortune, Tsinghua University China Research Institute, Nomura research

Fig. 86: No. of Chinese Fortune Global 500 companies in each sector



Source: Fortune, Nomura research

Chinese internet companies are also world leaders in the industry. In the listed universe, out of the Top 20 internet companies in terms of market cap (as of 31 Dec 2015), 8 were domiciled in China.

Fig. 87: Top 20 internet companies in terms of market cap (as of 31 Dec 2015)

Ticker	Company	Country	Market Cap (USD bn)	Revenue (USD bn)	R&D/Net Sales (%)
GOOGL US	ALPHABET INC-A	US	528.0	66.0	14.9
FB US	FACEBOOK INC-A	US	296.0	12.5	21.4
BABA US	ALIBABA GRP-ADR	CN	201.2	12.3	14.0
700 HK	TENCENT	CN	185.0	12.8	9.6
BIDU US	BAIDU INC-SP ADR	CN	65.3	8.0	14.2
EBAY US	EBAY INC	US	33.0	17.9	11.2
YHOO US	YAHOO! INC	US	31.4	4.6	26.1
LNKD US	LINKEDIN CORP-A	US	29.5	2.2	24.2
NTES US	NETEASE INC-ADR	CN	23.7	1.9	11.3
4689 JP	YAHOO JAPAN CORP	JP	23.4	3.9	0.0
035420 KS	NAVER CORP	KR	18.4	2.6	41.7
300104 CH	LESHI INTERNET-A	CN	16.8	1.1	11.9
TWTR US	TWITTER INC	US	15.8	1.4	49.3
300059 CH	EAST MONEY INF-A	CN	14.9	0.1	0.0
UTDI GR	UNITED INTERN-RE	DE	11.3	4.1	0.0
VRSN US	VERISIGN INC	US	9.7	1.0	6.7
QIHU US	QIHOO 360 TE-ADR	CN	9.4	1.4	29.2
AKAM US	AKAMAI TECHNOLOG	US	9.4	2.0	6.4
WUBA US	58.COM-ADR	CN	9.2	0.3	16.5
CSGP US	COSTAR GROUP INC	US	6.7	0.6	9.6

Source: Bloomberg data, Nomura research

37 Chinese listcos spent 5% of sales on R&D on average in the past 3 years

We screen for Chinese R&D leaders listed on the domestic exchanges and abroad and find 37 stocks with the following requirements: Free-float market cap above USD1bn;Positive revenue growth in the past three fiscal years; Positive eps growth in the past three fiscal years and positive eps growth forecast for FY15F, and the average R&D-to-sales ratio higher than 5% in the past three years.

Fig. 88: Chinese leaders focusing on R&D

Ticker	Company	Name	R&D to sales based on 3-year average (%)	Free-float mkt cap (USD bn)	EPS growth in FY15F (%)	Revenue growth in FY14 (%)
Commercial & professional services						
002117 CH	TUNGKONG INC -A	东港股份	5.5	1.3	29.3	20.0
Consumer						
002292 CH	GUANGDONG ALPH-A	奥飞动漫	5.3	2.9	41.2	56.4
Healthcare, pharma & biotech						
300171 CH	SHANGHAI TOFFL-A	东富龙	6.6	1.1	49.1	23.8
002223 CH	JIANGSU YUYUE-A	鱼跃医疗	6.5	1.4	37.5	18.0
300199 CH	HYBIO PHARMACE-A	翰宇药业	11.1	1.5	68.8	38.0
600557 CH	JIANGSU KANION-A	康缘药业	10.3	1.3	26.7	14.9
300009 CH	ANHUI ANKE BIO-A	安科生物	9.7	1.4	36.2	26.7
600276 CH	JIANGSU HENGRU-A	恒瑞医药	9.5	8.3	42.7	20.1
002294 CH	SHENZHEN SALUB-A	信立泰	5.4	1.3	25.3	23.9
Software & services						
QIHU US	QIHOO 360 TE-ADR	奇虎 360	38.2	7.1	38.0	107.2
300379 CH	BEIJING TONGTE-A	东方通	28.8	1.1	76.5	7.6
600571 CH	HANGZHOU SUNYA-A	信雅达	28.3	1.2	31.5	18.9
002230 CH	IFLYTEK CO LTD-A	科大讯飞	24.2	4.8	35.3	41.7
300113 CH	HANGZHOU SHUNF-A	顺网科技	18.8	2.1	52.8	88.3
002439 CH	VENUSTECH GROU-A	启明星辰	13.0	2.3	51.2	25.9
300315 CH	OURPALM CO LT-A	掌趣科技	11.6	3.4	86.5	107.7
300182 CH	BEIJING JETSEN-A	捷成股份	11.6	1.7	74.1	32.3
300166 CH	BEIJING ORIENT-A	东方国信	10.3	1.8	59.4	31.0
NTES US	NETEASE INC-ADR	网易公司	10.0	23.6	44.9	24.3
700 HK	TENCENT	腾讯控股	9.2	104.3	27.5	30.6
300170 CH	HAND ENTERPRIS-A	汉得信息	8.2	1.9	26.4	19.1
300339 CH	JIANGSU HOPERU-A	润和软件	8.1	1.6	57.1	53.9
002153 CH	BEIJING SHIJI-A	石基信息	6.9	1.9	11.1	101.3
ATHM US	AUTOHOME INC-ADR	汽车之家	6.7	1.7	25.3	75.3
600446 CH	SHENZHEN KINGD-A	金证股份	5.3	3.4	267.2	16.1
300168 CH	WONDERS INFORM-A	万达信息	5.2	4.1	60.0	27.1
Technology						
002465 CH	GUANGZHOU HAIG-A	海格通信	15.6	3.6	31.8	75.0
300367 CH	NETPOSA TECHNO-A	东方网力	11.4	1.9	65.5	46.9
600498 CH	FIBERHOME TELE-A	烽火通信	10.6	2.1	28.8	17.8
002236 CH	ZHEJIANG DAHUA-A	大华股份	9.0	2.8	23.2	35.8
002415 CH	HANGZHOU HIKVI-A	海康威视	8.3	5.7	33.2	60.7
300115 CH	SHENZHEN EVERW-A	长盈精密	7.5	2.6	63.9	34.8
300202 CH	JULONG CO LTD -A	聚龙股份	7.4	1.7	23.4	31.3
002104 CH	HENGBAO CO LTD-A	恒宝股份	7.0	2.0	37.8	22.7
002185 CH	TIANSHUI HUATI-A	华天科技	6.4	1.6	28.1	34.8
002152 CH	GRG BANKING -A	广电运通	5.9	1.7	22.6	25.1
002179 CH	CHINA AVIATION-A	中航光电	5.2	1.4	72.6	34.2

Note: Free-float market cap is as of 31 December 2015.

Source: Bloomberg data, Nomura research

Out of the 37 stocks, 33 are A-shares, 1 is listed in Hong Kong (Tencent, 700 HK, Buy) and 3 are listed in the US; 17 are from the internet industry, 11 are from the technology industry, 7 are from the healthcare and pharmaceutical industry and the rest two are from consumer and commercial & professional services industries respectively.

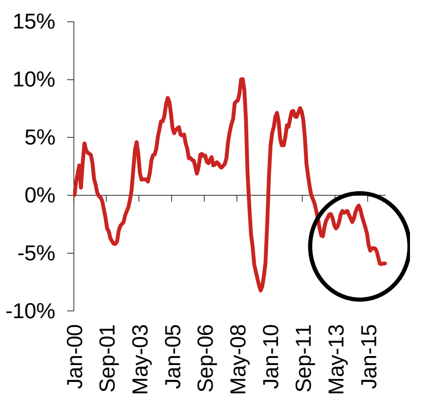
#3: Rising market share concentration – Supply side reforms

Weak industrial profits exacerbated due to lack of capacity exits

The Production Price Index (PPI) for all industrial products has been in the negative territory for 45 consecutive months and this has put considerable pressure on the profitability of industrial companies in the past few years. 3Q15 earnings for the 2,778 names listed on A-shares indicate that decline in profits y-y accelerated for many overcapacity industries, eg steel, mining, construction materials, non-ferrous metals, industrials and petrochemicals from 1H15 to 3Q15.

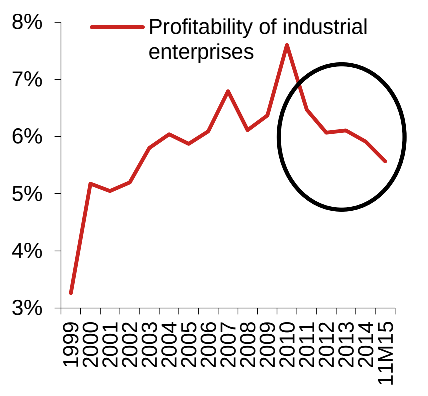
- For example, Bloomberg reported on 21 October 2015 that Mr. Xu Lejiang, chairman of China's second largest producer Shanghai Baosteel, noted that the Chinese steel sector lost RMB18bn in 8M15 vs. RMB14bn profit in 8M14. Essentially every steel producer in China is "feeling the pain" and he foresees that China's steel production may drop by 20% due to chronic oversupply.

Fig. 89: China's PPI has been in the negative territory for 45 consecutive months



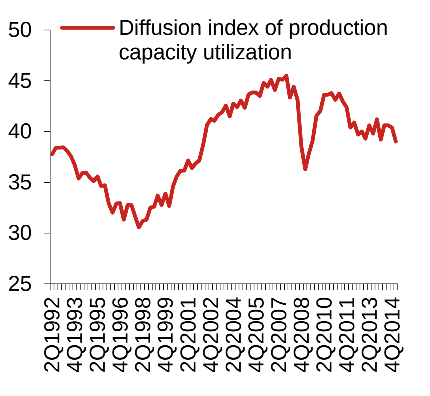
Source: iChoice data, Nomura research

Fig. 90: Profit margins of Chinese industrial enterprises have declined since 2011



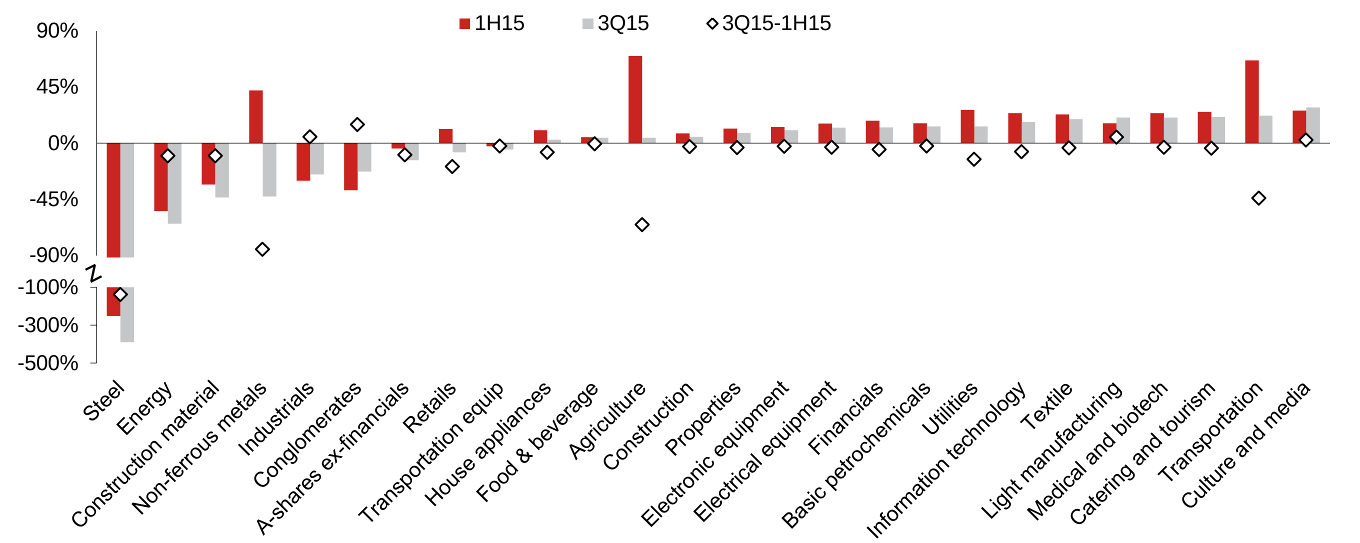
Source: iChoice data, Nomura research

Fig. 91: The diffusion index of production capacity utilisation has fluctuated around 40 in 2014



Source: CEIC data, Nomura research

Fig. 92: y-y net profit growth slowing down further for A-shares, especially for those sectors facing overcapacity



Source: iChoice data, Nomura research

We note that, so far, Beijing has let the private sector SMEs in the industrial and export sectors fold on their own, while the central and local SOEs have largely been left untouched to try to avoid negative spillovers to the broader economy.

Anecdotally, there has been a rising number of "zombie" enterprises that have been operating at losses for some time. These are concentrated in low-tech, energy-intensive industries, e.g. materials and mining, construction and general machinery. They comprise a large part of the uncompetitive industrial capacity which is fuelling the misappropriation of financial resources.

Capacity exits among SOEs to rise between 2016-2018

For local-government owned SOEs, local governments do prefer to see them staying in business to save local fiscal income, local jobs and local social stability. As long as the production lines are still running, banks are unlikely to foreclose on the loans. But there is a limit as to the local governments' own fiscal budgets.

Heading into 2016, we anticipate supply-side reforms to tackle this persistent over-capacity issue. The Central Economic Work Conference (CEWC) for 2016, which concluded on 21 December 2015, also set capacity exit as the top priority in 2016. In 2016, we may see cases of local government bankruptcies going through the courts, which will help establish useful precedents for subsequent bankruptcy cases.

- At the Executive Meeting on 9 December, the State Council decided to tackle enterprises that have been incurring losses for more than three years and those failing to meet the national standards of energy use, environmental protection, quality and safety.
- Mr. Zheng Gongcheng, a member of the National People's Congress Standing Committee, noted in an interview with China Daily on 28 December 2015 that a considerable number of these "zombie" enterprises are SOEs.
- Mr. Zhang Xiwu, deputy head of the SASAC, noted at a news briefing on 11 December 2015 that China would work to reorganise and merge central-government owned SOEs in key industries in the next two years to cut repetitive investments, exit from low-efficiency industries and improve resource allocation.

Pragmatic reforms for SOEs: no need for the 1990s privatisation spree

To envision what this round of exits may mean, it helps to examine China's last round of SOE reforms in the late 1990s and how it compares its SOE reforms to similar efforts overseas.

Recall that the last round of reforms was driven by China moving from a command economy to a market-driven economy. In the 1990s, many SOEs lost competitiveness to their peers in the private sector. Thousands of state-owned SMEs in China and ~5,010 big/medium-size SOEs were closed down, and ~10mn SOE staff lost their jobs.

- After closing down the big- and medium-sized SOEs running losses and hundreds of uncompetitive state-owned SMEs scattered around China, the aggregate profitability of industrial SOEs improved significantly in the first half of 2000s. The percentage of industrial SOEs in loss also gradually declined.

Historically, various countries have carried out SOE reforms, but they are not a ready example for China to follow, according to Shao Ning, Former Deputy Director of the State-owned Assets Supervision and Administration Commission (SASAC).

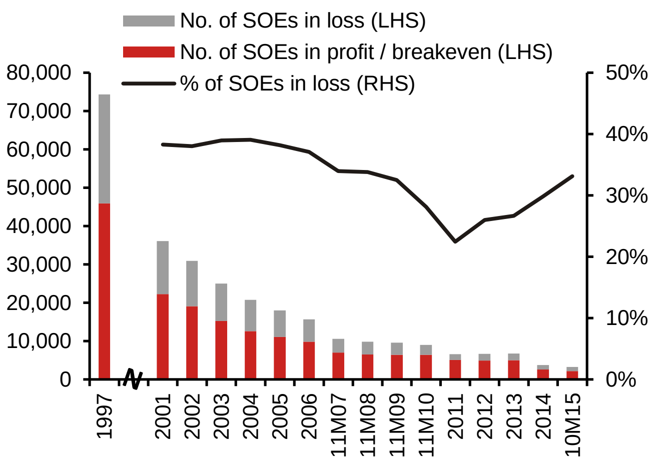
- The SOE reforms in ex-Soviet Union countries were essentially full privatisation on regime changes and failed to generate positive economic outcomes.
- The SOE reforms in western European countries, such as the one carried out by Margaret Thatcher in the UK, were economically successful, but on a drastically different setting of an already well-developed market economy and a small number of SOEs. The reformed SOEs could easily blend into the existing market system.

This time, the SOE reforms are driven by China having to cope with higher costs for its manufacturing sector as enterprises relying on low cost inputs can no longer survive. The aggregate profitability for industrial SOEs, many of which engage in traditional manufacturing industries, dropped from high-single digit in 2005-07 to mid-single digit after 2008, as shown in figures 93-94. In fact, more private sector enterprises than SOEs are affected. We note several specific aspects to the current round of reforms based on our channel checks.

- Selling state assets too cheaply and massive lay-offs of SOE workers back in the last round of "privatisation" in China had undesirable side-effects, and the central government is keen to avoid a repeat of that this time around.

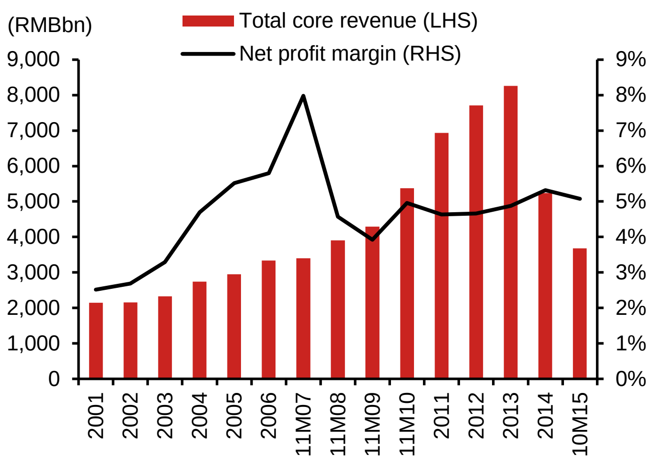
- It appears to us that Beijing is looking for a pragmatic and executable recipe that combines market and non-market measures to lift returns of the SOE assets.
- It appears to us that jobs for the average workers will be protected while senior executive compensation levels are cut, and that various forms of hidden payroll expenses (be it in SG&A or capex) will be further trimmed.

Fig. 93: Percentage of industrial SOEs in loss has picked up since 2012



Source: National Statistics Bureau, Nomura research

Fig. 94: Profitability of industrial SOEs has deteriorated since 2008

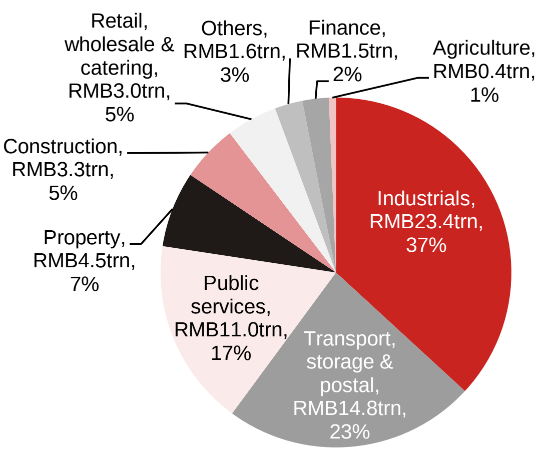


Source: National Statistics Bureau, Nomura research

While SOEs are still big in China…

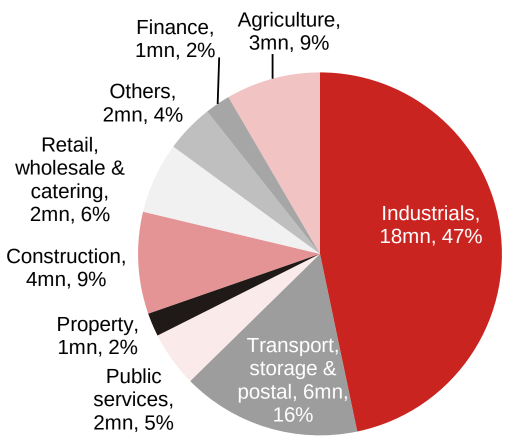
China, with a big share of its economy being state-owned (in total, China's SOEs employed 39.2mn staff and held RMB63.5trn assets as of end 2013), has been trying to boost the vitality of its economy via SOE reform while maintaining social stability.

Fig. 95: Assets owned by China's SOEs by sector



Source: Wind data, Nomura research

Fig. 96: Sector distribution of employees of China's SOEs

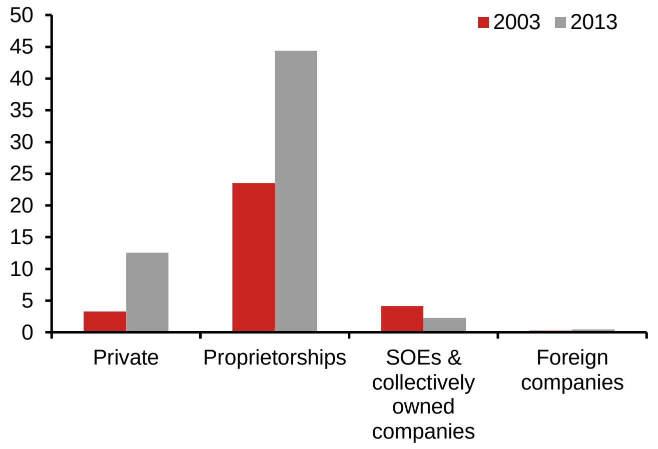


Source: Wind data, Nomura research

…the private enterprises are bigger at 75%+ of China's economic output…

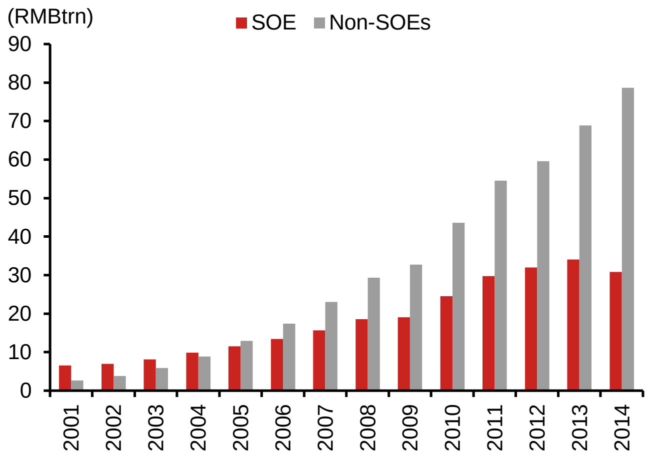
According to Edward Tse, author of China Disruptors, at the time of Mao Zedong's death in 1976, China had no private businesses. But thanks to economic reforms of the last 35 years, the private sector now accounts for at least three-quarters of China's economic output. Edward noted that such a transformation has been led by a sizeable crop of private sector entrepreneurs and business leaders: "These are business leaders that survived the Asian financial crisis, compete head-on against MNCs post China's WTO entry in 2001, the global financial crisis and the post RMB4trn stimulus economic slow-down." They are the reason that (as of August 2014) China hosts the world's second-largest concentration of billionaires after the United States – 152 out of the total 1,645, according to Forbes magazine. Today, China remains home to approximately 2.3 million state-owned companies, but this number has fallen by almost half since 2004.

Fig. 97: Number of Chinese companies by ownership



Source: State Administration of Industry and Commerce

Fig. 98: Revenues by company type



Source: iChoice data, Nomura research

…and some MNCs are not doing as well as they used to in China

At this juncture, we also like to share that a common investor feedback is that many MNCs in China are not doing so well, and as such the underlying Chinese economy is likely weaker than officially reported numbers are indicating. From research conducted by Edward Tse, a veteran management consultant for MNCs, founder of Gao Feng Institute and author of China's Disruptors, there could be another angle to this phenomenon.

According to Edward, MNCs are no longer attracting the best and brightest young talent in China today, a stark contrast to their immense popularity about two decades ago. He observes that most MNCs have tended to underestimate the complexity and idiosyncrasies in China, and are yet to tweak their global practices to suit China's local conditions, be it product, service delivery, or business model. Over the past decade, home grown private sector enterprises in China have become strong rivals to MNCs, as they tend to be more agile, responsive, adaptive and eager to learn.

The MNCs, particularly the big ones with strong heritage, have found it difficult to delegate to local management in China. Instead key business and resource allocation decisions continue to be made at the global level, with less than optimal understanding of China's local realities.

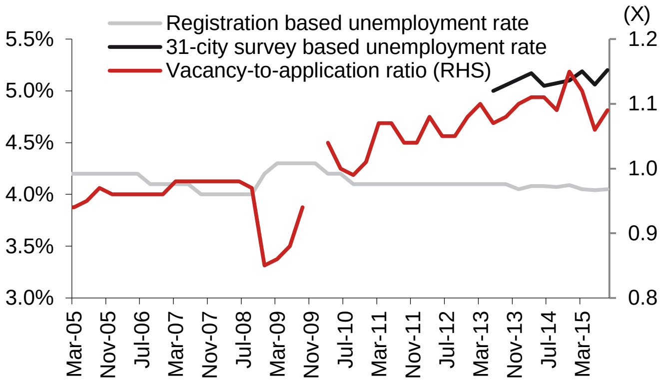
Unemployment may rise, but some will join the services sector

The SOE bankruptcies, layoffs and closures in the 1990s led to serious social instability, without a pre-existing social safety net. As an alternative, re-employment centres were established, providing unemployment subsidies, training and job placement services.

This time, given the consistent rise in the Chinese services industry, while unemployment may rise, according to our Chief China economist, overall social risks are unlikely to surface in 2016. So far, many foreign-owned enterprises, JVs and domestic private-sector businesses have closed in the Yangtze River Delta and the Pearl River Delta. Thanks to robust job creation in the services sector, unemployment in China has been kept at a low rate and we haven't seen much social unrest.

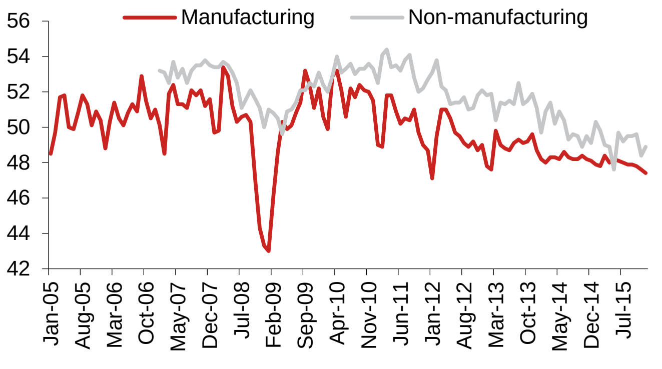
There are several metrics that track China's employment data. One measure, registered urban & township unemployment rate, has been stable at 4.2%. Another measure, the survey-based unemployment rate, has been fluctuating around 5.2%. A third, and much followed, measure of urban vacancy-to-application ratio has been holding above 1x.

Fig. 99: Unemployment rate in China has been kept at a low level



Source: iChoice data, CEIC data, Nomura research

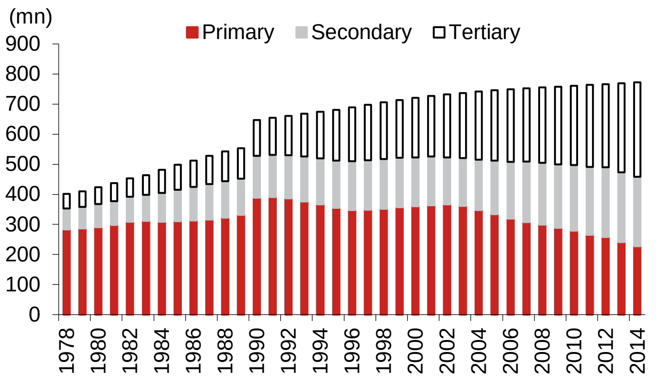
Fig. 100: Employment reading under the monthly non-manufacturing PMI and manufacturing PMI



Source: CEIC data, Nomura research

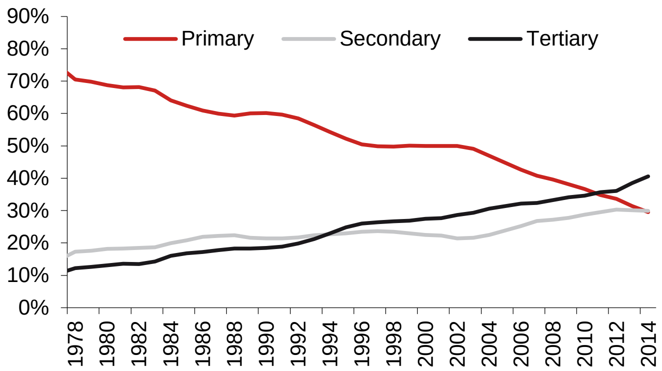
Anecdotally, many of the younger generation are choosing to join start-ups. A typical internet start-up combination in Beijing now consists of three types of founders: someone with government/SOE background, an ex-BAT employee, and someone from the post-1990 born generation. Among workers leaving the manufacturing sectors, many are entering labor-intensive service sectors with lower entry barriers, such as logistics services and elderly care. The number of workers hired by the Chinese logistics industry has been growing at a CAGR of ~8.5% since 2005.

Fig. 101: Number of employees in different industries in China



Source: CEIC data, Nomura research

Fig. 102: Mix of employees in different industries in China



Source: CEIC data, Nomura research

Investment implications: stick with leaders/winners and survivors

At the headline level, the capacity exit process will be accompanied by business closures, bankruptcies, and M&As, this means that certain family wealth being wiped out in 2016 and that such headline pressure may persist into 2018. But coming out of this process, public market investors will likely see a pool of listed names with larger market share and potentially better pricing powers.

We believe that there is some credibility to the local news report by Economic Information Daily that ultimately the number of central government owned SOEs will decline from 100+ now to 40-50. Reviewing the six M&A cases for central government owned SOEs after the 18th CCP Congress, we note that they share some common features as follows.

- These SOEs were industry leaders that were competent globally
- The merged SOEs had overlaps in their business scope
- The monopoly created after the mergers would not negatively affect the livelihood of Chinese households as their key customers are governments or corporates.

Fig. 103: M&As among central government-owned SOEs after the 18th CCP Congress

Industry	M&As
Machinery	China National Machinery Industry Corporation (Sinomach) and China Erzhong
Rolling stock	CSR and CNR
Power generation	China Power Investment Corporation and State Nuclear Power Technology Corporation (SNPTC)
Metallurgy	Minmetals and China Metallurgical Group
Shipping	COSCO and China Shipping
Shipping	China Merchants Group and Sinotrans & CSC Group

Source: Xinhua News, Nomura research

Chinese property developers – another space with rising concentration

Jeffrey Gao and team expect major developers to cut average borrowing cost from 7.2% in FY14 and 6.7% in 1H15 to 6% in FY16F as offshore USD borrowings are replaced with onshore RMB corporate bond issuance at lower interest cost. But small developers are unlikely to be able to do this, and rising operating challenges may ultimately persuade them to exit the business by selling off their land banks. The team expects combined market share of the top-20 developers in China to exceed the 23.2% in value and 15.2% in volume in 3Q15.

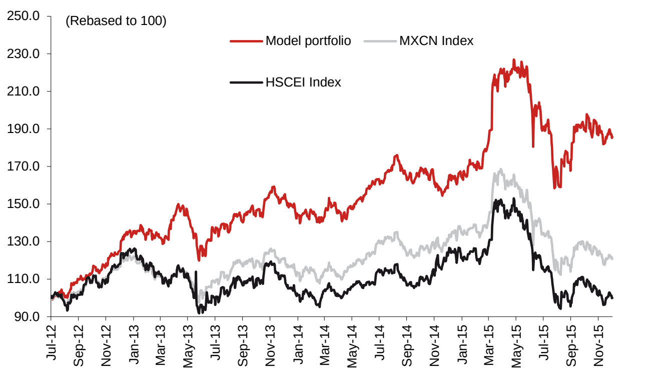
Model portfolio and rationale for picks

The cumulative results of our 20-stock average return portfolio since end-July 2012 lead us to recommend "mean reversion" strategy to investing in Chinese equities. Our model portfolio tends to outperform in bear markets and under-perform in rallies, due in part to our quality and large cap bias in stock selection. We believe that offshore long-only portfolios could extract more returns from Chinese equities by raising portfolio turnover ratio as well as minimum cash level.

Model portfolio performance metric in summary

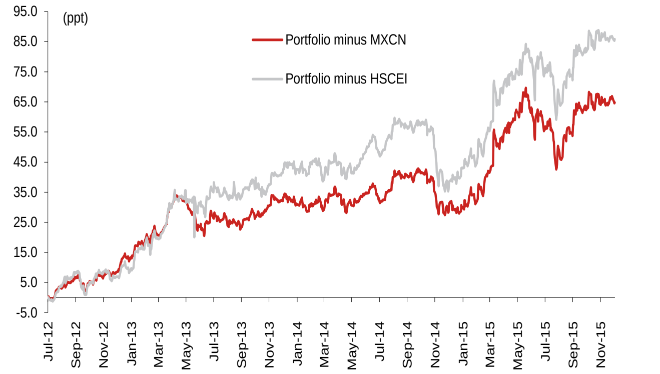
Our model portfolio has posted cumulative return of 85.7% since inception, vs. the benchmark's 20.9% return; in 2015, the average performance was 14.3% vs. the benchmark's -7.8%.

Fig. 104: Total returns since inception



Source: Bloomberg, Nomura research

Fig. 105: Cumulative performance Portfolio minus MXCN and HSCEI



Source: Bloomberg, Nomura research

Fig. 106: Tracking indicators
(1 August 2012 - 31 December 2015)

	Total	Bull	Bear
Alpha	0.05	-0.08	0.13
Beta	0.94	1.03	0.98
Mean Excess Return	19.70	-18.36	68.73
Information ratio	1.33	-1.16	5.21
Tracking Error	10.30	11.60	8.70

Source: Bloomberg, Nomura research

Fig. 107: Returns summary
(%)

Performance: Daily	Portfolio	Benchmark
Total return in 2012	25.1	16.5
Total return in 2013	23.5	4.0
Total return in 2014	5.1	8.3
Total return in 1Q15	13.1	8.1
Total return in 2Q15	16.3	6.2
Total return in 3Q15	-18.8	-22.8
Total return in 4Q15	7.0	4.0
Total return in YTD 2015	14.3	-7.8
Total return since initiation	85.7	20.9

Source: Bloomberg, Nomura research

Fig. 108: Model portfolio on 5 January 2016

Name	Ticker	Rating	Share price (31-Dec-15)	Market cap (US$m)	3mth avg daily T/O (US$m)	2016F PE (x)	2017F PE (x)	2016F PB (x)	2016F Dvd yield (%)
Consumption									
Brilliance China	1114 HK	Buy	9.75	6,322	17.8	7.4	6.4	1.6	1.1
Fuyao Glass	3606 HK	Buy	18.68	5,904	4.5	13.4	11.8	2.3	5.0
Great Wall Motor *	2333 HK	Neutral	9.03	14,787	47.9	6.5	6.3	1.2	4.6
Shanghai Jahwa (CNY)	600315 CH	Buy	39.49	4,099	59.2	22.4	19.3	4.7	2.2
Financials - Banks									
Bank of China HK	2388 HK	Buy	23.70	32,329	32.5	8.7	8.0	1.2	5.1
ICBC	1398 HK	Buy	4.68	242,565	143.3	5.5	5.1	0.7	4.7
Financials - Diversified financials									
China Cinda	1359 HK	Buy	2.87	13,425	18.8	5.0	4.3	0.8	5.0
Huatai Securities	6886 HK	Buy	18.08	20,541	13.5	11.6	9.5	1.5	1.0
Financials - Insurance									
China Life	2628 HK	Buy	25.05	114,832	119.8	12.6	11.3	1.7	1.7
China Pacific Insurance	2601 HK	Buy	31.90	39,362	40.9	12.4	10.9	1.7	2.5
Financials - Property									
China Resources Land	1109 HK	Buy	22.60	20,210	32.1	9.4	7.7	1.0	3.4
Industrials									
CRRC	1766 HK	Buy	9.58	50,753	36.0	14.4	12.1	2.2	2.1
Han's Laser	002008 CH	Buy	25.89	4,210	120.1	26.6	21.0	5.2	0.6
Weichai Power	2338 HK	Buy	8.58	5,579	3.9	13.6	10.8	0.8	1.5
Technology & Telecom									
China Mobile	941 HK	Buy	87.50	231,154	178.0	12.4	11.4	1.5	3.5
BYD Company	1211 HK	Buy	42.65	20,516	41.4	36.1	26.1	2.1	n/a
Hikvision (CNY)	002415 CH	Buy	34.39	21,548	124.5	15.0	10.4	5.2	2.2
ZTE Corp	763 HK	Buy	17.68	11,390	9.8	13.9	12.4	2.0	1.9
Internet									
Tencent	700 HK	Buy	152.50	185,011	306.1	27.9	22.0	7.8	n/a
VIPShop (USD)	VIPS US	Buy	15.27	8,882	203.0	21.5	16.7	7.7	n/a

Note: Share price as of 31 December 2015; we are reviewing our target price for Great Wall Motor.
Transaction costs not included in returns. Past performance should not and cannot be viewed as an indicator of future performance.
Complete record upon request. For changes in the portfolio over time and calculation of returns, see http://www.nomura.com/research/GetPub.aspx?pid=335789. For the most recent changes in the portfolio, see our 13 November 2015 report, Feedback from Europe marketing.
Source: Bloomberg, Nomura estimates

Model portfolio picks and rational in a summary table

Fig. 109: Model portfolio picks and rational

			Mktcap	EPS growth (%)		P/E (x)		P/B (x)	Dvd yield (%)	
Name	**Ticker**	**Rating**	**(USDmn)**	**FY16F**	**FY17F**	**FY16F**	**FY17F**	**FY16F**	**FY16F**	**Investment rationale**
Consumption										
Brilliance China	1114 HK	Buy	6,322	29.4%	16.6%	7.4	6.4	1.6	1.1	Our China auto analyst, Benjamin Lo, maintains Buy mainly on a recovery scenario from September and new model launches in 1H16F.
Fuyao Glass	3606 HK	Buy	5,904	15.4%	14.1%	13.4	11.8	2.3	5.0	Our auto analyst Joseph Wong and team believe that rising glass content per vehicle and rising after-sales repair glass (ARG) market penetration will be key drivers of a 15% net earnings CAGR over FY14-17F. Additionally, Joseph expects that new capacities could help generate an ~15% additional sales for Fuyao over the next three years as it's actively expanding overseas, building new capacity in the US and Russia to shorten lead time. He also believes Fuyao to improve its gross margin and maintains its net margin due to cost saving on lower energy costs in the US, though partially offset by higher labour costs.
Great Wall Motor	2333 HK	Neutral	14,787	23.8%	3.8%	6.5	6.3	1.2	4.6	While Ben Lo & team expect sales volumes to improve sequentially since September thanks to the purchase tax cut, they think GWM will face a tough base effect owing to robust sales volumes in 4Q14/1Q15 as well as price cuts in mid-2015 which has led to lower margins since 3Q15. Hence, they are wary that the underlying earnings improvements might not live up to investors' expectations.
Shanghai Jahwa (CNY)	600315 CH	Buy	4,099	18.1%	15.6%	22.4	19.3	4.7	2.2	Katherine Chan, our consumer discretionary analyst, believes Jahwa can achieve its Rmb12bn sales target by 2018F with new brand and product launches as it now covers a wide clientele (age group: 20-45+).
Financials - Banks										
Bank of China	2388 HK	Buy	32,329	7.6%	9.2%	8.7	8.0	1.2	5.2	Our China banking analysts, Sophie Jiang, favours BOC (HK) as its top seed for RMB internationalisation, with a stable ROE of c.14% in 2009-1H15 on prudent management - which may help it to expand into the tricky ASEAN market.
ICBC	1398 HK	Buy	242,565	-5.3%	7.2%	5.5	5.1	0.7	4.7	ICBC is Sophie Jiang's top pick among China banks due to the most defensive among its peers, with a decent capital base, low asset risk, stable funding franchise and strong credit risk controls.
Financials - Diversified financials										
China Cinda	1359 HK	Buy	13,425	14.7%	17.6%	5.0	4.3	0.8	5.0	Sophie favours China Cinda as she believes that it is positioned to benefit from the unfolding credit cycle and the bond cycle in China.
Huatai Securities	6886 HK	Buy	20,541	19.5%	22.4%	11.6	9.5	1.5	1.0	Huatai Securities (HTSC) has grown rapidly in the past decade, combining its resourcefulness and vision as an SOE and a private firm's energy and intensity. The company was the earliest adopter of IT and mobile internet tools among Chinese brokers. Building on its unified client database and CRM system cross units, HTSC is leveraging its strengths in brokerage and wealth management market to higher-margin asset management and investment banking business.

Note: Market cap as of 31 December 2015; * we are reviewing our target price for Great Wall Motor; Source: Bloomberg, Nomura estimates

Fig. 110: Model portfolio picks and rational (cont'd)

			Mktcap	EPS growth (%)		P/E (x)		P/B (x)	Dvd yield (%)	
Name	**Ticker**	**Rating**	**(USDmn)**	**FY16F**	**FY17F**	**FY16F**	**FY17F**	**FY16F**	**FY16F**	**Investment rationale**
Financials - Insurance										
China Life	2628 HK	Buy	114,832	11.6%	12.2%	12.6	11.3	1.7	1.7	Our China insurance analyst, Shengbo Tang, favours China Life as he believes it is well positioned to take advantage of the boom. He expects NBV to grow by 25% for FY15F with the double-digit growth momentum continuing into 2016F vs. 2-9% in FY11-14. In the medium term, our analysts believe health and pension insurance will grow at CAGR of 26% and 31%, respectively, before 2020 on the back of tax benefits.
China Pacific Insurance	2601 HK	Buy	39,362	10.7%	13.9%	12.4	10.9	1.7	2.5	Shengbo Tang has favours CPIC due to: 1) overhang on its underperform may be removed due to P&C stabilisation with combined ration around 100% in 2015F-2016F vs. 103.8% in 2014; 2) life growth momentum is still strong with business mix improved as cutting in bancassurance; and 3) sound capital position, solid asset quality and steady operation with focus on insurance should be preferred amid slowdown.
Financials - Property										
China Resources Land	1109 HK	Buy	20,210	15.7%	21.3%	9.4	7.7	1.0	3.4	Jeffrey Gao has favours CR Land for its solid sales and rental growth, with >20% FY15F earnings growth, and potential asset injection in Shenzhen.
Industrials										
CRRC	1766 HK	Buy	50,753	25.8%	19.2%	14.4	12.1	2.2	2.1	CRRC is our industrials analyst Patrick Xu's top pick among China industrials as he believes it will benefit from the strong growth in passenger volume in the major high-speed railway trunk lines and rapidly expanding metro network in both tier-1 and tier-2 cities. He also expects its operating margins to expand following the recent merger of CSR and CNR, driven by cost-saving synergies and stronger pricing power in the domestic market. CRRC looks attractive at a low-teens FY16F P/E (EPS: Rmb0.56), vs. our EPS growth estimate of 20% for FY17F.
Han's Laser (CNY)	002008 CH	Buy	4,210	39.1%	26.6%	26.6	21.0	5.2	0.6	Our industrial analyst, Zhuoran Wang, favours Han's as he believes that, led by Apple's biannual iPhone capex, it will once again become the main driver for automation and laser (including marking and cutting/welding) equipment.
Weichai Power	2338 HK	Buy	5,579	38.2%	26.0%	13.6	10.8	0.8	1.5	Patrick Xu and team like Weichai as they expect its earnings to rebound sharply in FY16F/17F driven by recovery in diesel engine sales and operating margin. The company's Linde Hydraulics plant in Weifang commenced operations in June 2015. The team expects Weichai to leverage on its capability of hydraulic parts in winning more diesel engine orders from engineering machinery manufacturers in FY16-17F.

Note: Market cap as of 31 December 2015; Source: Bloomberg, Nomura estimates

Fig. 111: Model portfolio picks and rational (cont'd)

			Mktcap	EPS growth (%)		P/E (x)		P/B (x)	Dvd yield (%)	
Name	Ticker	Rating	(USDmn)	FY16F	FY17F	FY16F	FY17F	FY16F	FY16F	Investment rationale
Technology & Telecom										
China Mobile	941 HK	Buy	231,154	4.6%	8.3%	12.4	11.4	1.5	3.5	Our China telecoms analyst, Leping Huang, recommends China Mobile for its structural growth opportunity in 4G and ability to provide full service including broadband.
BYD Company	1211 HK	Buy	20,516	86.0%	38.3%	36.1	26.1	2.1	n/a	Leping Huang, our China technology analyst, likes BYD in the EV and battery space, given its: 1) complete EV product portfolio in the growing China market, 2) migration in battery technology from lithium iron phosphate (LFP) to nickel manganese cobalt (NMC) to improve energy density, and 3) battery capacity expansion to resolve bottlenecks in EV ramp-up as well as consolidation in battery components to control costs.
Hikvision (CNY)	002415 CH	Buy	21,548	41.8%	44.5%	15.0	10.4	5.2	2.2	Leping Huang expects Hikvision's overseas business to maintain higher than 50% y-y growth in 2016F on rising capex in security systems globally. He also likes its initiatives in new frontiers such as door opening technology, industrial drones and machine vision.
Internet										
Tencent	700 HK	Buy	185,011	33.3%	26.8%	27.9	22.0	7.8	n/a	Our China internet & new media analyst, Andrew Orchard, and team favour Tencent as they expect online ad growth to accelerate as Official Accounts and Moments ads revenue grow. The team also sees renewed mobile game growth, off a low base, in 1H15.
VIPShop (USD)	VIPS US	Buy	8,882	26.7%	29.1%	21.5	16.7	7.7	n/a	Given VIPS has reduced its supplier in payment period and provided supplier finance, our analyst, Andrew Orchard, and team believe these favourable terms should enable VIPS to more effectively compete with bigger e-commerce portals like JD. We also see more marketing expenditure as the company tries to improve brand reputation. Andrew expects that VIPS's current valuation of 23x FY16F P/E (EPS: Rmb4.61) provides a sufficient margin of safety on an estimated 27% 3-year EPS CAGR.

Note: Market cap as of 31 December 2015; Source: Bloomberg, Nomura estimates

Consumer goods & services

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NOMURA

Autos

EQUITY STRATEGY

Outlook 2016: U-shaped policy impact likely

Strong on both ends, soft volume likely in the middle

Global Markets Research

5 January 2016

Anchor themes

Despite near-term volume growth recovery, China's auto demand is likely to be uneven during 2016-17F owing to distortions caused by policy support measures.

Three important trends to watch out for in 2016

- **Policy boost pulls sales into 2016F, but not as impactful as 2009-10**. We believe the 5% purchase tax cut for new vehicles with engine sizes of 1.6L or less (and any further potential policy support measures) will likely result in a smaller uplift in 2016F new PV sales volumes than in 2009 because of slower potential GDP growth in 2015-16F, and already higher auto penetration. For now, we estimate the tax cut alone will result in a rise in our 2016F PV sales volume growth estimate to 7.9% (from 4.8% previously). Improved demand in 2016F will also likely come at the expense of 2017F, which we estimate will slow to just 1.8% owing to the "brought-forward" impact of the tax cut.
- **"U-shaped" impact on volume sales likely due to policy**. While we are encouraged by the strong double-digit y-y recovery since October, we caution that out of the 15-month period when the purchase tax cut is effective (from 1 Oct 2015 till 31 December 2016), the positive impact is likely to be more evident at the beginning (initial excitement) and towards the end (rushed buying). As such, we believe volume growth may start to ease back to single digit levels after 1Q16F. Sales volume in absolute terms will likely be lacklustre before picking up in 4Q16F before the tax cut ends.
- **We expect pricing pressure in 2Q-3Q16F before recovering in 4Q16F**. Going into 2016F, we are more concerned about pricing/margin pressure (than volume growth) that may resume in 2Q-3Q16F when demand is likely to be softer. Our estimated industry capacity growth of 10% y-y in 2016F is also not helping the pricing picture. Hence, we recommend investors to exercise caution towards the sector after 1Q16F, and prefer names with strong new model cycles to help defy weaker volume trends in the sector.

Stock recommendations – Dongfeng, Geely, Minth

- **OEMs – Dongfeng (489 HK, Buy)** remains our top pick amongst the OEMs as we believe its recovery story is gaining further momentum thanks to its robust new model cycle, and is not fully appreciated by investors yet (trading below 1SD below mean).
- Amongst the domestic OEMs, we prefer **Geely (175 HK, Buy)**, owing to its improving product mix (key new SUV launches in the next 12 months) and continued progress on its co-operation with Volvo in jointly developing the shared CMA platform.
- **Parts suppliers – Minth (425 HK, Buy)** should enjoy a similar recovery cycle above as a result of its exposure to domestic Japanese brands, in addition to its strong overseas sales growth trajectory.

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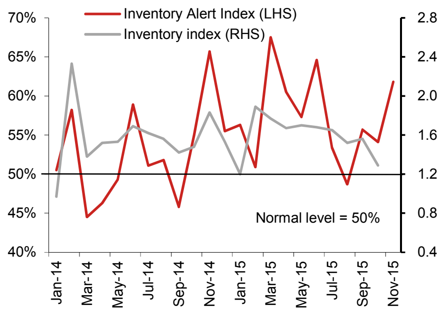
Fig. 112: China PV sales volume growth, 2009-2017F

Demand being pulled forward to 2016F

	2009	2010	2011	2012	2013	2014	2015F	2016F	2017F
Sedan	**7,460,638**	**9,494,194**	**10,124,599**	**10,745,776**	**12,009,704**	**12,376,702**	**11,448,449**	**11,276,723**	**10,938,421**
YoY	*48.0%*	*27.3%*	*6.6%*	*6.1%*	*11.7%*	*3.1%*	*-7.5%*	*-1.5%*	*-3.0%*
% of total	*72.3%*	*69.1%*	*69.8%*	*69.4%*	*67.0%*	*62.8%*	*55.5%*	*50.7%*	*48.3%*
SUV	**657,494**	**1,317,585**	**1,617,502**	**1,998,192**	**2,988,758**	**4,077,897**	**6,014,898**	**7,759,219**	**8,535,140**
YoY	*47.4%*	*100.4%*	*22.8%*	*23.5%*	*49.6%*	*36.4%*	*47.5%*	*29.0%*	*10.0%*
% of total	*6.4%*	*9.6%*	*11.2%*	*12.9%*	*16.7%*	*20.7%*	*29.1%*	*34.9%*	*37.7%*
MPV	**248,954**	**445,401**	**497,483**	**493,341**	**1,305,181**	**1,914,255**	**2,105,681**	**2,368,891**	**2,511,024**
YoY	*26.1%*	*78.9%*	*11.7%*	*-0.8%*	*161.5%*	*46.7%*	*10.0%*	*12.5%*	*6.0%*
% of total	*2.4%*	*3.2%*	*3.4%*	*3.2%*	*7.3%*	*9.7%*	*10.2%*	*10.6%*	*11.1%*
Others	**1,948,277**	**2,491,704**	**2,258,436**	**2,256,260**	**1,625,215**	**1,331,715**	**1,065,372**	**852,298**	**681,838**
YoY	*83.2%*	*27.9%*	*-9.4%*	*-0.1%*	*-27.3%*	*-18.1%*	*-20.0%*	*-20.0%*	*-20.0%*
% of total	*18.9%*	*18.1%*	*15.6%*	*14.6%*	*9.1%*	*6.8%*	*5.2%*	*3.8%*	*3.0%*
PV sales	**10,315,363**	**13,748,884**	**14,498,020**	**15,493,569**	**17,928,858**	**19,700,569**	**20,634,400**	**22,257,129**	**22,666,423**
YoY	*52.9%*	*33.3%*	*5.4%*	*6.9%*	*15.7%*	*9.9%*	*4.7%*	*7.9%*	*1.8%*

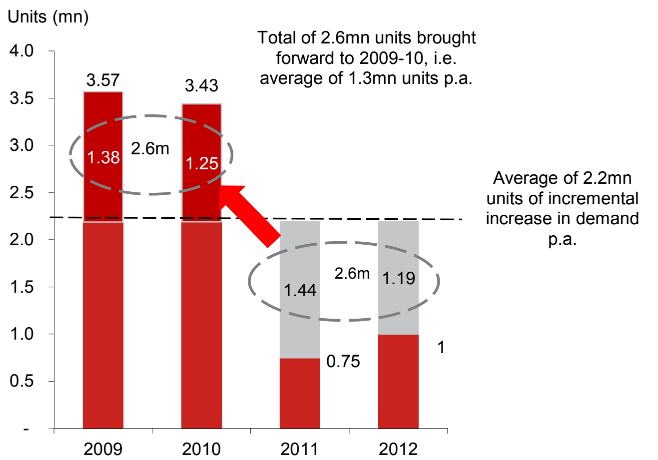
Source: China Auto Market, Nomura estimates

Fig. 113: China vehicle inventory indices



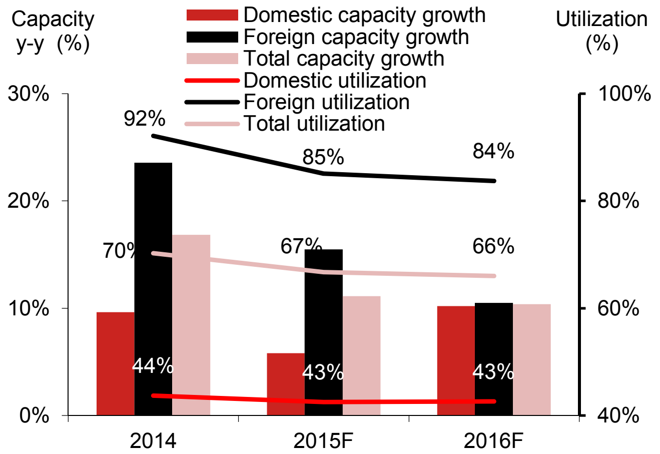
Source: CADA, Nomura research

Fig. 114: Government supportive policies in 2009/10 led to demand being brought forward from 2011/12 to 2009/10



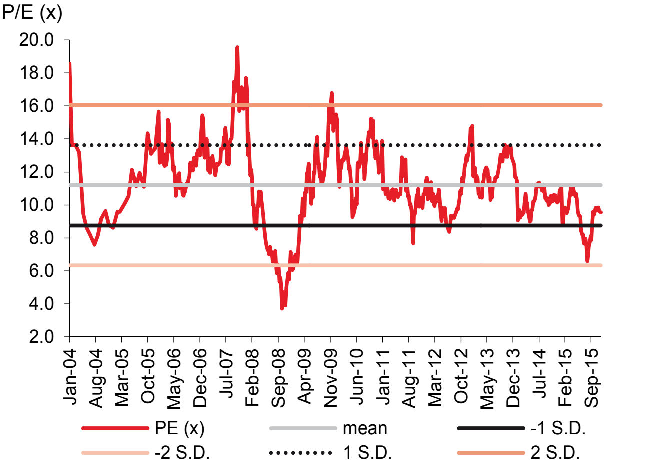
Source: China Auto Market, Nomura estimates

Fig. 115: Industry capacity growth and utilisation



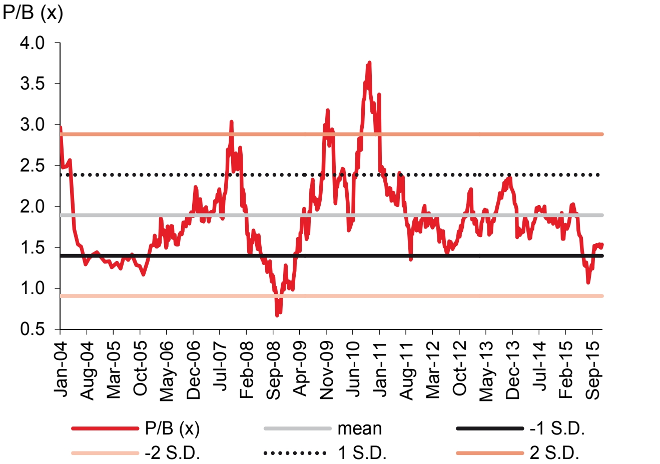
Source: China Auto Market, LMC Automotive, Nomura estimates

Fig. 116: MSCI China Auto: 1Yr forward P/E



Source: IBES, Datastream, Nomura research

Fig. 117: MSCI China Auto: 1Yr forward P/B



Source: IBES, Datastream, Nomura research

Fig. 118: China auto and auto parts valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth FY14	FY15	FY16	Normalised P/E (x) FY14	FY15	FY16	P/B (x) FY14	FY15	FY16	Dividend yield (%) FY14	FY15	FY16
	Autos & Auto Parts																				
1958 HK	BAIC Motor	Benjamin Lo	Buy	HKD	7.76	8.90	14.7	7,605	2.3	45%	-15%	39%	9.2	10.8	7.8	1.3	1.2	1.0	4.7%	2.3%	3.2%
1114 HK	Brilliance China	Benjamin Lo	Buy	HKD	9.77	15.00	53.5	6,335	18.3	60%	-21%	29%	7.6	9.6	7.4	2.4	2.0	1.6	1.1%	1.1%	1.1%
200625 CH	Changqn Auto - B	Benjamin Lo	Buy	HKD	17.10	19.30	12.9	11,807	6.8	124%	23%	12%	8.8	7.2	6.4	2.6	2.2	2.2	1.7%	2.1%	2.4%
000625 CH	Changqn Auto - A	Benjamin Lo	Neutral	CNY	16.94	15.70	-7.3	11,807	133.8	124%	23%	12%	10.4	8.5	7.6	3.1	2.6	2.6	1.5%	1.8%	2.0%
489 HK	Dongfeng Motor	Benjamin Lo	Buy	HKD	10.36	12.40	19.7	11,517	24.8	22%	2%	15%	5.8	5.7	5.0	1.0	0.8	0.7	2.3%	2.4%	2.7%
175 HK	Geely Automobile	Benjamin Lo	Buy	HKD	4.20	4.60	9.5	4,770	32.3	-49%	75%	34%	21.6	12.3	9.2	1.8	1.6	1.4	0.6%	1.0%	1.3%
2333 HK	Great Wall Motor	Benjamin Lo	Neutral	HKD	9.05	11.00	21.5	14,857	48.9	-2%	6%	24%	8.6	8.1	6.6	2.1	1.4	1.2	3.5%	3.7%	4.6%
2238 HK	Guangzhou Auto	Benjamin Lo	Neutral	HKD	6.92	7.04	1.7	16,814	12.1	20%	8%	20%	11.7	10.8	9.0	1.1	1.0	0.9	2.8%	3.0%	3.6%
	OEM average									**43%**	**13%**	**23%**	**10.5**	**9.1**	**7.4**	**1.9**	**1.6**	**1.4**	**2.3%**	**2.2%**	**2.6%**
	OEM - median									**34%**	**7%**	**22%**	**9.0**	**9.1**	**7.5**	**1.9**	**1.5**	**1.3**	**2.0%**	**2.2%**	**2.6%**
3606 HK	Fuyao Glass - H	Joseph Wong	Buy	HKD	18.58	23.50	26.5	5,928	4.5	16%	-9%	15%	14.0	15.4	13.3	3.5	2.4	2.3	4.8%	4.4%	5.1%
600660 CH	Fuyao Glass - A	Joseph Wong	Buy	CNY	15.28	18.70	22.4	5,928	29.9	16%	-9%	15%	13.8	15.1	13.1	3.5	2.4	2.2	4.9%	4.5%	5.2%
179 HK	Johnson Electric	Joseph Wong	Buy	HKD	25.85	29.50	14.1	2,936	1.1	9%	314%	10%	14.3	13.8	12.6	1.7	1.6	1.4	1.8%	1.8%	2.0%
425 HK	Minth Group	Joseph Wong	Buy	HKD	15.46	19.60	26.8	2,208	2.2	15%	12%	15%	12.6	11.2	9.7	1.7	1.6	1.4	3.2%	3.6%	4.1%
1316 HK	Nexteer Automotive	Joseph Wong	Buy	HKD	8.45	9.30	10.1	2,724	2.6	11%	24%	28%	16.8	13.6	10.6	4.0	3.2	2.6	1.2%	1.5%	1.9%
	Auto parts average									**13%**	**67%**	**17%**	**14.3**	**13.8**	**11.9**	**2.9**	**2.2**	**2.0**	**3.2%**	**3.2%**	**3.7%**
1728 HK	China ZhengTong Auto	Joseph Wong	Buy	HKD	3.55	4.60	29.6	1,012	2.4	-4%	-16%	24%	8.2	9.8	7.9	0.8	0.8	0.7	2.6%	2.2%	2.7%
	Auto dealers average									**-4%**	**-16%**	**24%**	**8.2**	**9.8**	**7.9**	**0.8**	**0.8**	**0.7**	**2.6%**	**2.2%**	**2.7%**

Note: Share price as of 30 December 2015; we are reviewing our target price for Great Wall Motor.

Source: Bloomberg, Nomura estimates

NOMURA

Consumer: Brands & retailing

EQUITY STRATEGY

Outlook 2016: Lifestyle continues to shine

Buy Intime and Jahwa

Global Markets Research

5 January 2016

2016F is likely to be a year of stabilisation for Chinese department stores on easier comps y-y. Cosmetics should see more stable growth in the long term, due to aging demographics, still low per capita spending on cosmetics in China, etc. For Hong Kong retailers, long term challenge of tourist diversion to other countries will continue to weigh on earnings, in our view.

Three important trends to watch out for in 2016

- **Chinese department stores may show y-y growth in 2H16.** In the past several years, lifestyle services that offer value for money has certainly outpaced consumer merchandise in terms of growth. The only major stand-out among merchandise is sportswear. Sportswear names have been providing an upbeat outlook in general for FY16F. For Chinese department stores, we think 2016 could be a year of stabilisation after three years of contraction, particularly in 2H16 on easy comparison y-y.
- **Local cosmetic brands advancing into high-end markets.** We view entering overseas markets and then re-entering the domestic market as an efficient way for local Chinese brands to build a high-end brand image. Jahwa (600315 CH, Buy, TP: CNY46.0) and L'Occitane (973 HK, Neutral, TP: HKD16.0) are good examples. M&As can also help upgrade local brands to higher-end ones.
- **Brand rejuvenation, innovation and differentiation rank over price cuts.** Brand rejuvenation seems common among both global and local brands these days, aimed at tapping the high consumption growth among younger consumers (born after 1985). Jahwa and Adidas (ADS GY, Neutral, TP: EUR89), for example, have adopted this strategy. Creating star products has become the focus area for many local brands. Based on our channel checks, we don't believe global brands' cosmetics sales in China will improve after global pricing harmonisation.

Stock recommendations – Intime and Jahwa

- **Intime (1833 HK, Buy, TP: HKD14.0): early signs of O2O success.** The O2O business vindicated its presence by posting strong sales on Single's Day (11 November; offline SSSG of 42% y-y and online sales growth of 75% y-y). We believe that the combined 'browse, feel and touch' connection points from online (Yintai.com, Choice and Tmall) to offline (Intime City/Intime Store) should raise sales conversion rate. This is an edge which a pure e-tailer does not possess vs. a complete O2O player like Intime.
- **Jahwa (600315 CH, Buy, TP: CNY46.0): reviving an old Chinese household favourite.** Jahwa has introduced colour cosmetics under the more profitable brand, Herborist. In an effort to revitalise the brand, it is hiring younger brand ambassadors and repackaging key products to extend its reach to a younger clientele (enlarged clientele covering the 20-45+ age group). On 6 Dec, Ping An (2318 HK, Buy) succeeded in purchasing 1.5% of Jahwa through tender offer, raising its stake in Jahwa from 27.9% to 29.4%. Ping An offered to pay CNY40.0 apiece for up to 31% of Jahwa on 30 Oct. We believe this is a positive share price catalyst for Jahwa (see report).

Anchor themes

We see 2016F as a year of stabilisation for consumer discretionary companies, after contracting for three years in sales growth terms. Three key trends to watch for: 1) consumer services and sportswear sectors continue to shine; 2) local brands advancing into high-end markets; and 3) brand rejuvenation, innovation and differentiation rank over price cuts.

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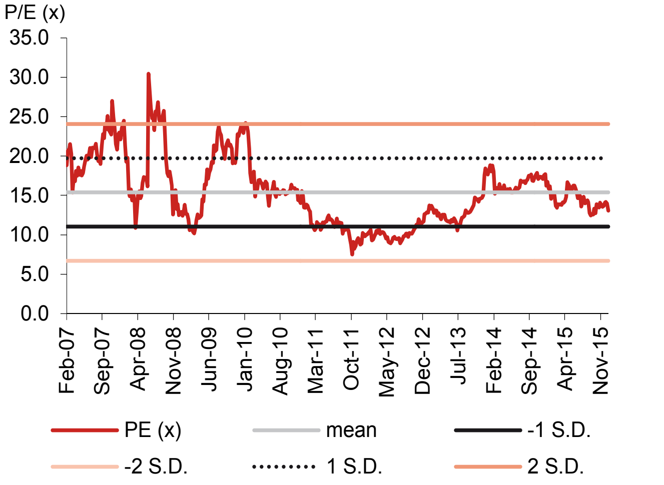
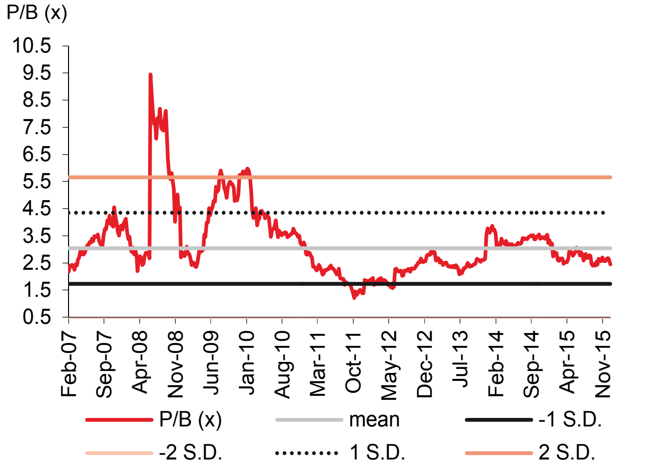
Fig. 119: MSCI China Consumer durables & apparel: 1Yr forward P/E



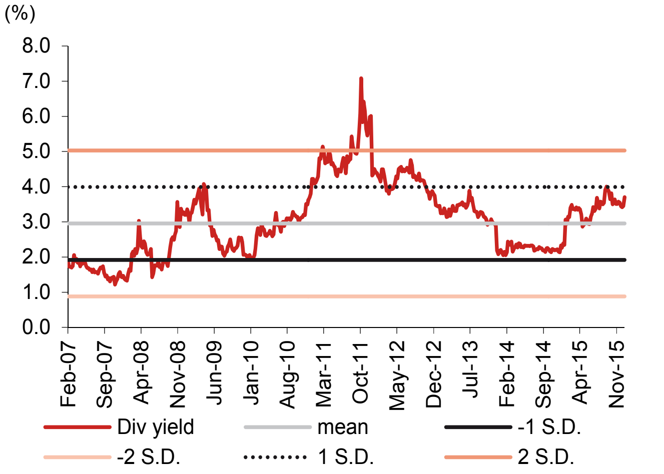
Source: IBES, Datastream, Nomura research

Fig. 120: MSCI China Consumer durables & apparel: 1Yr forward P/B



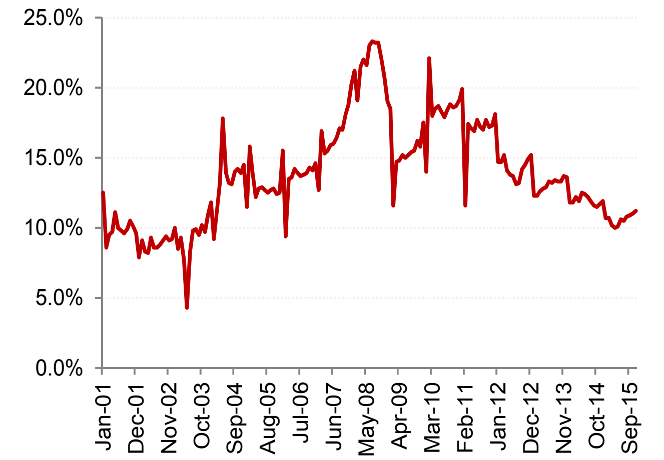
Source: IBES, Datastream, Nomura research

Fig. 121: MSCI China Consumer durables & apparel: 1Yr forward dividend yield



Source: IBES, Datastream, Nomura research

Fig. 122: China retail sales of consumer goods y-y % growth



Source: NBS, Nomura research

Fig. 123: China consumer-related stocks valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
										FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Consumer Discretionary																				
1880 HK	Belle International	Katherine Chan	Neutral	HKD	5.84	7.50	28.4	6,355	17.7	n/a	8%	-8%	9.4	8.7	9.5	1.6	1.6	1.5	4.1%	12.3%	6.5%
3308 HK	Golden Eagle Retail Group	Katherine Chan	Buy	HKD	9.36	13.50	44.2	2,040	0.9	-12%	5%	7%	13.0	12.4	11.6	2.6	2.3	2.0	3.7%	3.2%	3.4%
1833 HK	Intime Department Store	Katherine Chan	Buy	HKD	7.65	14.00	83.0	2,152	8.6	-23%	-4%	9%	17.8	18.6	17.0	1.3	1.3	1.3	3.6%	3.2%	3.5%
178 HK	Sa Sa International	Katherine Chan	Reduce	HKD	2.58	1.70	-34.1	947	1.7	13%	-11%	-47%	7.8	8.7	16.4	3.1	3.0	3.3	9.2%	9.1%	4.6%
	Retailing - Department stores, etc									**-7%**	**0%**	**-10%**	**12.0**	**12.1**	**13.6**	**2.1**	**2.0**	**2.0**	**5.1%**	**7.0%**	**4.5%**
973 HK	L'Occitane	Katherine Chan	Neutral	HKD	15.00	16.00	6.7	2,858	3.2	-27%	37%	-6%	34.8	25.4	27.1	4.1	3.6	3.3	1.0%	1.4%	1.3%
1910 HK	Samsonite	Katherine Chan	Buy	HKD	23.45	28.50	21.5	4,266	11.9	9%	-6%	20%	20.6	21.9	18.3	3.4	3.1	2.9	2.1%	2.0%	2.5%
	Interntaional brands									**-9%**	**16%**	**7%**	**27.7**	**23.7**	**22.7**	**3.7**	**3.4**	**3.1**	**1.5%**	**1.7%**	**1.9%**
116 HK	Chow Sang Sang Holdings	Katherine Chan	Neutral	HKD	12.78	15.00	17.4	1,116	0.5	-11%	4%	9%	8.0	7.7	7.0	1.0	0.9	0.9	4.8%	5.0%	5.4%
1929 HK	Chow Tai Fook Jewellery	Katherine Chan	Reduce	HKD	4.99	4.40	-11.8	6,438	3.5	32%	-25%	-39%	6.9	9.1	15.0	1.3	1.3	1.2	7.2%	5.6%	3.5%
590 HK	Luk Fook Holdings	Katherine Chan	Reduce	HKD	16.34	17.00	4.0	1,242	2.8	50%	-13%	-34%	5.2	6.0	9.1	1.3	1.1	1.0	7.8%	6.7%	4.4%
	Retailing - Jewellery									**24%**	**-11%**	**-21%**	**6.7**	**7.6**	**10.4**	**1.2**	**1.1**	**1.0**	**6.6%**	**5.8%**	**4.4%**
	Retailing - A																				
600315 CH	Shanghai Jahwa - A	Katherine Chan	Buy	CNY	39.99	46.00	15.0	4,153	58.9	12%	12%	18%	29.9	26.8	22.7	7.1	5.3	4.7	1.5%	4.8%	2.2%
	Cosmetics - A									**12%**	**12%**	**18%**	**29.9**	**26.8**	**22.7**	**7.1**	**5.3**	**4.7**	**1.5%**	**4.8%**	**2.2%**

Note: Share price as of 30 December 2015; we are reviewing our target prices for Belle International, Chow Sang Sang Holdings and Luk Fook Holdings

Source: Bloomberg, Nomura estimates

NOMURA

Education

EQUITY MEDIA & INTERNET

Outlook 2016: Stability combined with growth

TAL Education remains our top sector pick

Global Markets Research

5 January 2016

Anchor themes

Although we think aging demographics will slow addressable K-12 market growth, we think that premium branded education companies are nevertheless well-positioned as they benefit from rising incomes and affordability. We think that the adult education segment will also prosper as university graduates swell and competition for jobs intensifies.

Three important trends to watch out for in 2016

Although the addressable K-12 market is not likely to grow rapidly due to the aging Chinese demographic, we believe that the premium-branded education companies are well positioned due to their strong brand reputation and their ability to act as demand aggregators. We see the following earnings catalysts:

- **Further focus on utilisation improvements:** After a phase of rapid expansion, we think that the education companies will be more conservative in growing their learning centre network. We expect that both TAL and New Oriental will observe net learning centre growth of below 10% in CY16. Rather, we think that there is going to be a greater priority placed on improving utilisation in existing learning centres to boost profitability.
- **Stable pricing, even in larger markets:** One of the upshots of slower expansion is the ability of education companies to have a better control over pricing. We believe that, even in large markets such as Beijing, pricing pressure for the listed companies will be subdued. Overall, we think that hourly ASPs in individual markets should rise between 0-5%, although blended ASPs may decline due to city and product mix shift.
- **We expect O2O and online investment to continue:** We believe that most of the large education companies will continue to complement their existing offline products by expanding their online and O2O platforms. We believe that investment in these areas as a proportion of revenue is likely to be relatively unchanged in FY16 (3-5% of revenue), although we expect that it will moderate in FY17 due to a larger top-line base.

Ranking of stocks under our coverage

As affordability rises, we think that there will be increased demand for higher quality and more personalised services. This should benefit the premium-branded listed education companies.

- **TAL Education (XRS US, Buy, TP: USD55).** We think TAL's strong brand profile should allow it to expand profitably outside Tier-1 and Tier-2 markets. It has also traditionally been able to report better margins outside of Beijing and Shanghai, and as revenue contribution shifts further away from these markets, both top and bottom-lines should rise.
- **Tarena (TEDU US, Buy, TP: USD12.50**). In the professional training sector, we like Tarena for its market leading position in IT training. We think the company's high job placement rates should keep enrolments high, while increased reliance on retail channels should also help ASP.
- **New Oriental (EDU US, Neutral, TP: USD24.50).** Despite increased reliance on the faster growing K-12 segment, we think that margins are unlikely to improve markedly in the near term as the company shifts away from higher profit segments.

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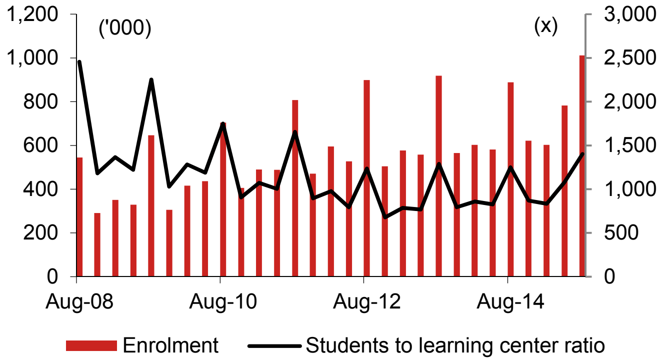
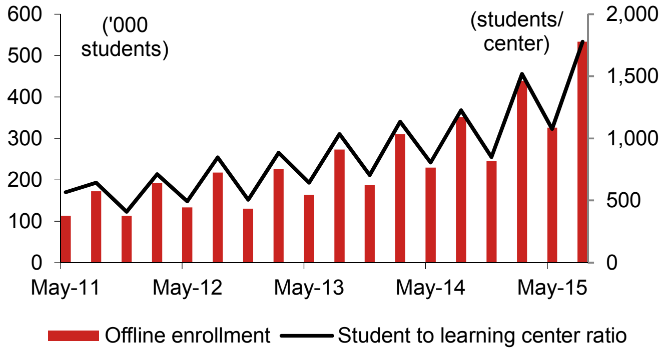
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Fig. 124: EDU – enrolment growth and student to learning centre ratio



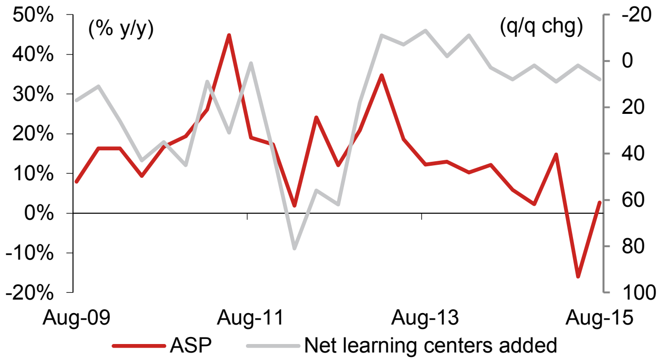
Source: Company data, Nomura research

Fig. 125: TAL – offline enrolment growth and student to learning centre ratio



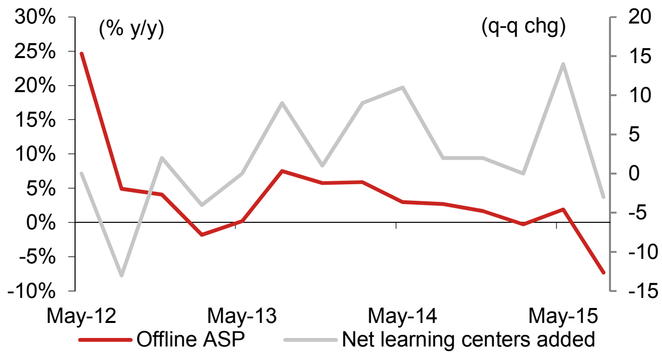
Source: Company data, Nomura research

Fig. 126: EDU – ASP chg. vs. net learning centres added



Source: Company data, Nomura research

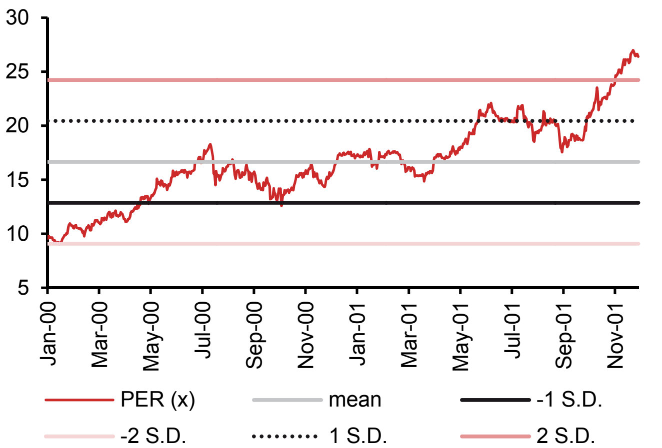
Fig. 127: TAL – ASP chg. vs. net learning centres added



Source: Company data, Nomura research

Fig. 128: China education: Blended current P/E

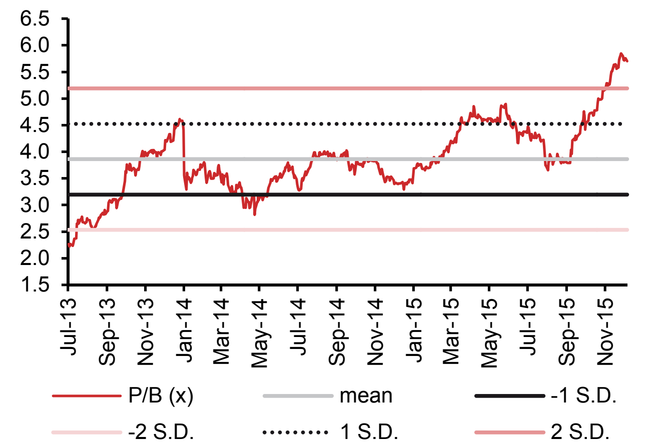
P/E (x)



Source: Bloomberg, Nomura research

Fig. 129: China education: Blended current P/B

P/B (x)



Source: Bloomberg, Nomura research

Fig. 130: China education valuation comparison table

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
										FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Education																				
EDU US	New Oriental	Andrew Orchard	Neutral	USD	31.60	24.50	-22.5	4,945	40.2	45%	-12%	13%	20.9	23.7	21.0	4.8	4.1	3.5	n/a	n/a	n/a
XRS US	TAL Education	Andrew Orchard	Buy	USD	46.47	55.00	18.4	3,714	30.4	125%	22%	13%	53.1	43.4	38.4	14.0	11.7	8.5	n/a	n/a	n/a
TEDU US	Tarena International	Andrew Orchard	Buy	USD	10.43	12.50	19.8	547	2.4	-125%	17%	22%	15.2	18.3	15.0	2.3	2.7	2.3	n/a	0.5%	0.6%
	Average									**15%**	**9%**	**16%**	**29.7**	**28.5**	**24.8**	**7.1**	**6.1**	**4.8**	**n/a**	**0.5%**	**0.6%**
	Median									**45%**	**17%**	**13%**	**20.9**	**23.7**	**21.0**	**4.8**	**4.1**	**3.5**	**n/a**	**0.5%**	**0.6%**

Note: Share price as of 30 December 2015; we are reviewing our target price for New Oriental.

Source: Bloomberg, Nomura estimates

NOMURA

Gaming & leisure

EQUITY STRATEGY

Outlook 2016: About affordable consumption

Top picks: Sands China and IMAX China

Global Markets Research

5 January 2016

Anchor themes

We are Bullish on future box office income growth; IMAX China is our preferred sector pick. Industry demand remains challenging in Macau gaming. We recommend investors to stay defensive and own Sands China for its attractive dividend yield.

Three most important trends to watch out for in 2016

- **We forecast continuing consumption upgrades in China in 2016:** 1) strong demand for experience-oriented entertainment, such as watching movies, 2) continuously robust investment in the entertainment sector from corporates, and 3) sluggish high-end consumption and declining interest in "pure shopping-oriented" tourism cities.
- **China movies: Rapid growth to continue; still prefer IMAX China:** The movie industry is one of the rare sectors in China where growth is still clocking 50% in YTD Oct-15. We expect the strong growth to continue and forecast box office income to more than triple in 2015-20F (Fig.131), helped by: 1) low market penetration (annual movie admission per capita of 0.6x in 2014, Fig. 132), 2) growing demand for entertainment, and 3) cheap movie ticket prices at RMB36 (one of the cheapest forms of entertainment in China). Within the China movie industry, we prefer downstream cinema operators over the upstream movie studios, given downstream cinema operators have: 1) higher earnings visibility, 2) a stronger economic moat, 3) lower execution risk, 4) stronger cashflow generation, and 5) healthier returns. Our preferred sector pick is IMAX China (1970 HK, Neutral), followed by Wanda Cinema (002739 CH, Reduce) and Beijing Enlight (300251 CH, Reduce).
- **Macau gaming: Challenged industry demand; stay defensive:** Gaming industry demand in Macau remains challenging, with the opening of Galaxy Phase 2 in May-15 and Studio City in Oct-15 failing to significantly boost citywide gaming revenues (Fig. 133). However, the worst appears to be over for Macau, with the impact from continued VIP weakness offset by 1) cost-cutting efforts, and 2) a mild uptick in mass gaming revenues. That said, we see no reason to get too excited about Macau as we are not expecting any substantial pick-up in industry profitability in the near/medium future given a likely slow ramp up at the new Cotai properties. With flattish industry profitability, we expect only: 1) range trading, and 2) dividends opportunities in Macau. Hence, Sands China (1928 HK, Buy) is our top pick for its attractive 8% dividend yield.

Stock recommendations – Sands China and IMAX China

- **IMAX China (1970 HK, Neutral, HKD55.80 TP):** IMAX China is still our preferred sector pick but we downgraded it to Neutral after the sharp post-IPO rally of more than 75%. We still see robust company fundamentals in 2016F backed by its: 1) strong IMAX movie pipeline in 2016, 2) strong order momentum in 2H15F, and 3) favourable positioning that makes it resilient to potential cinema overcapacity.
- **Sands China (1928 HK, Buy, HKD34.20 TP):** Our top gaming sector pick is Sands China, where we like its: 1) low VIP exposure, 2) lowest breakeven point among all new Cotai projects, and 3) highest dividend yield of ~7.6%.

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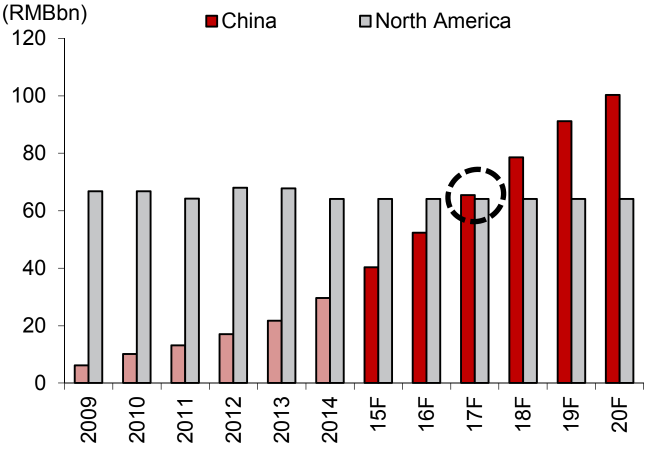
Fig. 131: Movie box office income: China vs North America

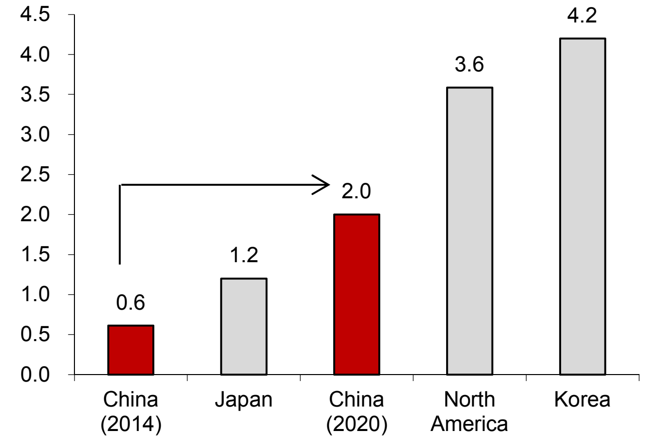
Forecast 23% box office income CAGR in 2015-20F



Source: MPAA, SARFT, Nomura research

Fig. 132: Annual movie admission per capita (2014)

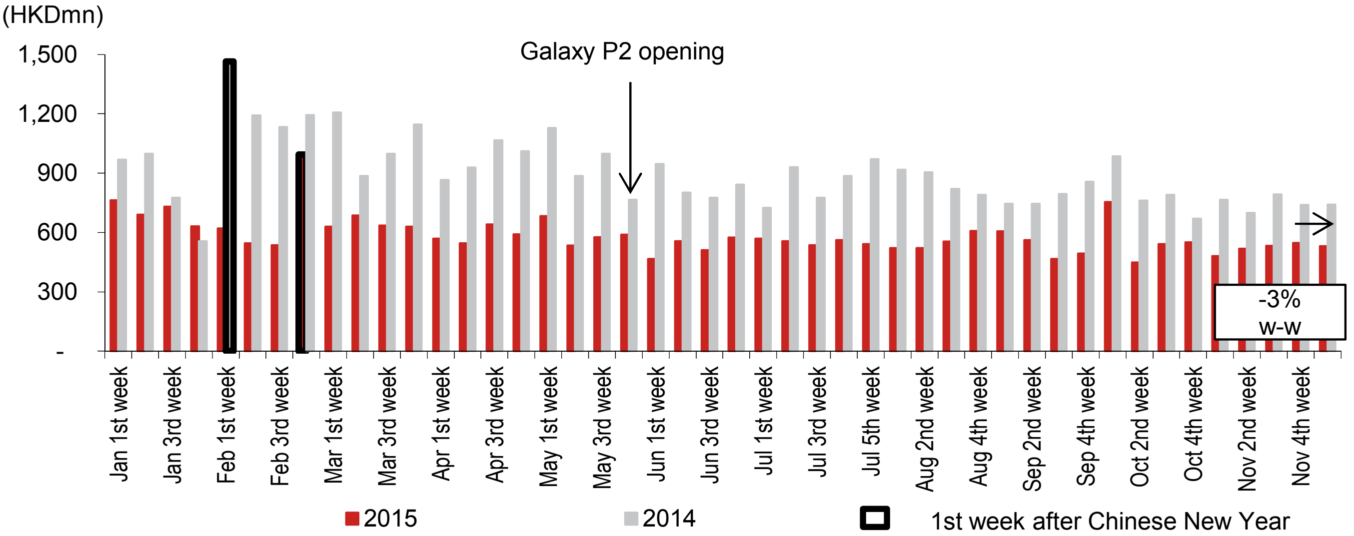
Average cinema visit at only 0.6x per year



Source: MPAA, SARFT, Nomura research

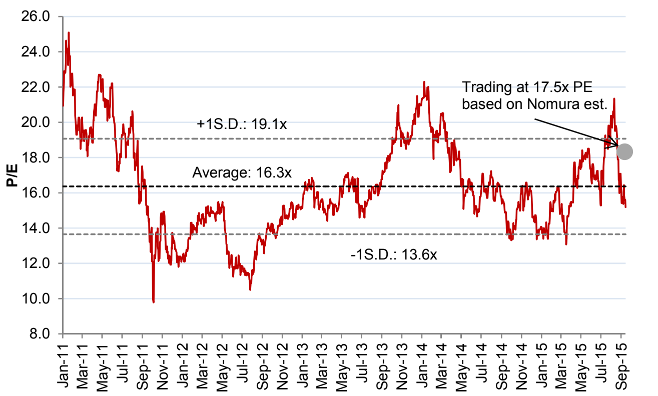
Fig. 133: Average daily table gaming revenue

New openings fail to boost citywide gaming revenues



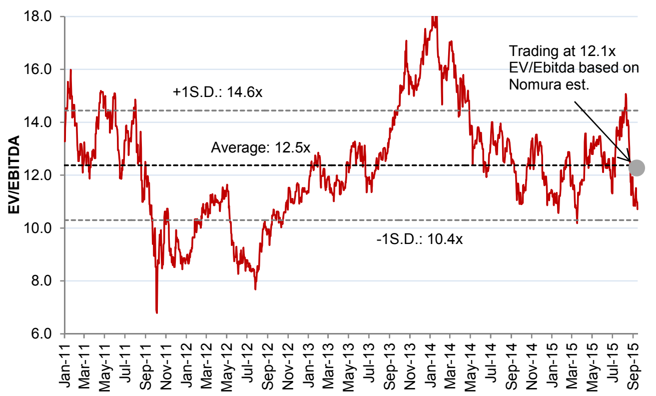
Source: Asia Pacific Gamin, Nomura research

Fig. 134: Macau Gaming: Industry P/E



Source: Bloomberg, Nomura estimates

Fig. 135: Macau Gaming: Industry EV/Ebitda



Source: Bloomberg, Nomura estimates

Fig. 136: China – Gaming & Leisure valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth FY14	FY15	FY16	Normalised P/E (x) FY14	FY15	FY16	P/B (x) FY14	FY15	FY16	Dividend yield (%) FY14	FY15	FY16
	Gaming, Hotels & Leisure																				
	Gaming																				
27 HK	Galaxy Entertainment Group	Richard Huang	Neutral	HKD	24.50	28.60	16.7	13,464	64.2	8%	-47%	-1%	9.2	17.4	17.6	2.7	2.6	2.3	3.0%	1.4%	1.6%
2282 HK	MGM China	Richard Huang	Neutral	HKD	9.75	12.70	30.3	4,780	7.7	7%	-44%	-22%	6.5	11.7	14.9	5.9	4.7	4.2	13.8%	4.3%	2.4%
1928 HK	Sands China	Richard Huang	Buy	HKD	26.40	34.20	29.5	27,486	63.5	15%	-40%	-8%	10.8	18.1	19.5	4.3	4.7	5.3	7.5%	7.5%	7.5%
880 HK	SJM Holdings	Richard Huang	Neutral	HKD	5.40	7.60	40.7	3,941	11.0	-13%	-51%	-27%	4.5	9.2	12.6	1.2	1.2	1.1	15.5%	7.6%	5.6%
1128 HK	Wynn Macau	Richard Huang	Neutral	HKD	9.01	11.10	23.2	6,040	15.4	-15%	-60%	-88%	7.1	17.9	145.1	6.6	4.8	4.7	19.4%	n/a	n/a
	Average									**0%**	**-49%**	**-29%**	**7.6**	**14.8**	**41.9**	**4.1**	**3.6**	**3.5**	**11.8%**	**5.2%**	**4.3%**
	China movie																				
300251 CH	Beijing Enlight Media	Stella Xing	Reduce	CNY	30.52	12.90	-57.7	6,898	198.7	0%	4%	26%	135.9	131.2	104.0	14.2	7.2	6.9	0.3%	0.3%	0.3%
1970 HK	IMAX China	Richard Huang	Neutral	HKD	53.30	55.80	4.7	2,444	n/a	44%	44%	67%	97.4	67.5	40.3	92.9	59.7	24.1	n/a	n/a	n/a
002739 CH	Wanda Cinema	Richard Huang	Reduce	CNY	121.51	80.00	-34.2	20,969	144.0	-34%	39%	54%	151.7	108.8	70.8	45.4	15.6	12.8	0.3%	0.4%	0.6%
	Average									**4%**	**29%**	**49%**	**128.3**	**102.5**	**71.7**	**50.8**	**27.5**	**14.6**	**0.3%**	**0.4%**	**0.4%**

Note: Share price as of 30 December 2015; we are reviewing our target prices for Galaxy Entertainment, MGM China, SJM Holdings and Wynn Macau

Source: Bloomberg, Nomura estimates

Cyclicals

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NOMURA

Capital goods

EQUITY STRATEGY

Outlook 2016: Railway & Automation in demand

Top pick CRRC (1766 HK)

Global Markets Research

5 January 2016

Anchor themes

We are bullish on China's railway sector, with a preference for rolling stock firms over construction ones as we believe rolling stock names stand to benefit from railway network expansion, rising service density and industry consolidation.

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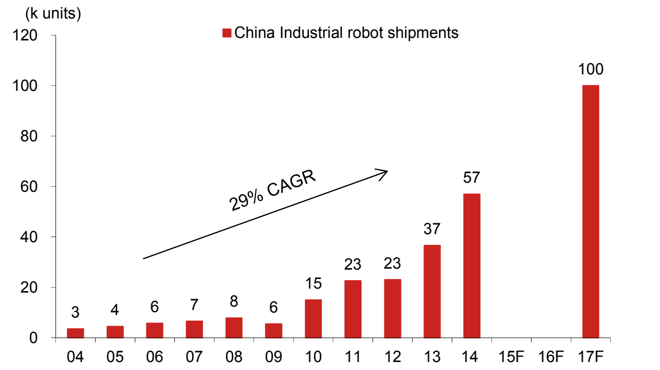
Three important trends to watch out for in 2016

- **Rolling stock to be the bright spot in 2016F as demand continues to rise in China** - We prefer rolling stock names to E&C companies, and expect passenger volumes for railways to grow more than 10% per annum, which is a major demand driver for rolling stock firms.
- **Sales of construction machinery to rebound, driven by replacement** - Utilisation hours of construction machinery are expected to recover in 2016F as various delayed infrastructure projects in 2015 will gradually kick in during 2016F. We also expect the year-on-year sales of construction machinery including both earth-moving and concrete machinery will end the three-year down-period and record positive year-on-year growth in 2016F, driven by replacement demand and improving utilisation hours.
- **Industrial automation to structurally influence manufacturing growth in 2016F** – We expect China's manufacturing sector to cope with multiple challenges in 2016F, on rising domestic costs, including labour cost, and as competition in other emerging countries gradually catch up. We see structural growth in automation and high precision equipment as Chinese manufacturers deploy intelligent manufacturing to lift productivity and efficiency, and as more traditional manufacturing sectors come up on the learning curve regarding the deployment of factory automation equipment.

Stock recommendations: CRRC, Han's Laser

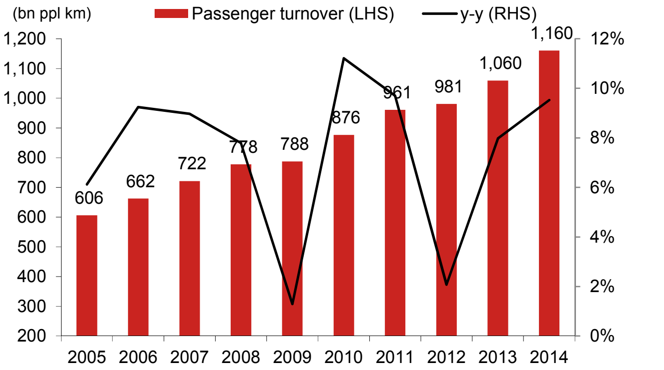
- **CRRC (1766 HK, Buy, TP: HKD11.49):** We expect the company, the monopolistic train maker in China, to benefit from the strong growth in passenger volumes in the major high-speed railway trunk lines and rapidly expanding metro network in both tier-1 and tier-2 cities. It is competing aggressively overseas and should gain market share from its western peers. We expect its operating margins to expand following the recent merger of CSR and CNR, driven by cost-saving synergies and stronger pricing power in the domestic market. CRRC looks attractive at a low-teens FY16F P/E (EPS: CNY0.56), versus our EPS growth estimate of 20% for FY17F.
- **Zoomlion (1157 HK, Buy, TP: HKD3.56):** We expect the company's earnings to improve closer to breakeven in FY16F driven by replacement demand. We find the stock attractive at 0.5x FY16F P/B.
- **Han's Laser (002008 CH, Buy, TP: CNY34.86):** Our Buy stock in the China automation space is Han's Laser. The electronics sector, led by Apple's biannual iPhone capex, will once again become the main driver for industrial robots and laser (including marking and cutting/welding) equipment, in our view.

Fig. 137: China Industrial robot shipments



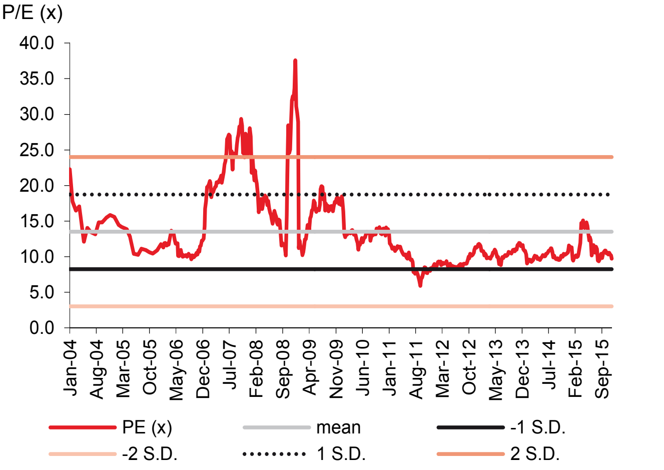
Source: IFR, Nomura research

Fig. 138: China railway passenger turnover



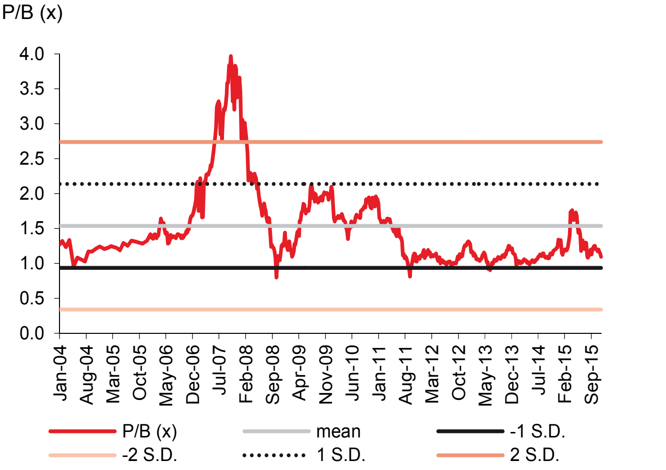
Source: CRC, Nomura research

Fig. 139: MSCI China Capital Goods: 1Yr forward P/E



Source: IBES, Datastream, Nomura research

Fig. 140: MSCI China Capital Goods: 1Yr forward P/B



Source: IBES, Datastream, Nomura research

Fig. 141: China capital goods valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
										FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Industrials																				
	Capital goods																				
1766 HK	CRRC	Patrick Xu	Buy	HKD	9.65	11.49	19.1	51,207	36.4	31%	12%	26%	20.4	18.2	14.5	2.7	2.4	2.2	1.5%	1.7%	2.1%
3969 HK	China Railway Signal & Comm.	Patrick Xu	Neutral	HKD	5.21	4.95	-5.0	5,911	2.6	49%	-5%	-7%	15.0	15.8	16.9	2.6	2.2	2.2	0.5%	n/a	1.3%
HOLI US	Hollysys Automation	Patrick Xu	Reduce	USD	22.21	16.81	-24.3	1,296	5.8	29%	35%	10%	18.6	13.8	12.6	2.6	2.2	2.0	1.8%	n/a	n/a
3898 HK	Zhuzhou CSR Times	Patrick Xu	Buy	HKD	45.35	55.97	23.4	6,878	19.1	53%	10%	17%	18.6	17.0	14.5	4.1	3.4	2.9	1.1%	1.2%	1.4%
	Rolling stocks									**41%**	**13%**	**12%**	**18.2**	**16.2**	**14.6**	**3.0**	**2.6**	**2.3**	**1.2%**	**1.4%**	**1.6%**
1800 HK	China Comm Construction	Patrick Xu	Neutral	HKD	7.97	7.92	-0.6	28,952	29.4	10%	4%	2%	7.7	7.4	7.3	0.9	0.8	0.8	2.6%	2.8%	2.9%
1186 HK	China Railway Construction	Patrick Xu	Buy	HKD	9.62	12.73	32.3	26,612	14.8	10%	5%	3%	8.8	8.3	8.1	1.1	0.9	0.9	1.9%	2.0%	2.0%
390 HK	China Railway Group	Patrick Xu	Buy	HKD	5.90	7.22	22.4	34,446	18.6	9%	10%	4%	10.3	9.3	8.9	1.1	0.9	0.9	1.6%	1.8%	1.8%
3311 HK	China State Construction	Patrick Xu	Neutral	HKD	13.26	12.18	-8.1	6,940	8.1	25%	18%	18%	15.2	12.8	10.9	2.6	2.3	2.0	1.2%	1.2%	1.4%
	Constructors									**13%**	**9%**	**7%**	**10.5**	**9.5**	**8.8**	**1.4**	**1.3**	**1.1**	**1.8%**	**1.9%**	**2.0%**
1882 HK	Haitian International	Zhuoran Wang	Buy	HKD	11.28	17.75	57.4	2,323	2.5	5%	6%	13%	12.0	11.3	9.9	2.1	2.4	2.3	2.9%	3.2%	3.6%
	Industrial equipment									**5%**	**6%**	**13%**	**12.0**	**11.3**	**9.9**	**2.1**	**2.4**	**2.3**	**2.9%**	**3.2%**	**3.6%**
38 HK	First Tractor	Patrick Xu	Buy	HKD	5.00	7.07	41.4	1,552	1.5	-24%	50%	25%	24.9	16.6	13.3	0.9	0.9	0.8	1.2%	1.8%	2.3%
2338 HK	Weichai Power	Patrick Xu	Buy	HKD	8.35	11.11	33.1	5,608	4.0	41%	-85%	38%	2.8	18.2	13.2	0.4	0.8	0.8	3.6%	1.1%	1.5%
1157 HK	Zoomlion Heavy Industry	Patrick Xu	Buy	HKD	2.87	3.56	24.0	5,746	2.3	-85%	-282%	86%	31.2	n/a	n/a	0.5	0.5	0.5	2.1%	n/a	n/a
	Construction machinery									**-23%**	**-105%**	**50%**	**19.6**	**17.4**	**13.2**	**0.6**	**0.7**	**0.7**	**2.3%**	**1.5%**	**1.9%**
601800 CH	China Comm Construction - A	Patrick Xu	Reduce	CNY	13.48	7.43	-44.9	28,952	107.2	10%	4%	5%	15.6	15.0	14.3	1.9	1.7	1.6	1.3%	1.4%	1.5%
601186 CH	China Railway Construction - A	Patrick Xu	Reduce	CNY	13.56	11.14	-17.8	26,612	121.6	10%	5%	3%	14.7	14.0	13.7	1.8	1.6	1.5	1.1%	1.2%	1.2%
601390 CH	China Railway Group - A	Patrick Xu	Reduce	CNY	10.88	6.98	-35.8	34,446	212.7	9%	10%	4%	22.6	20.5	19.7	2.4	2.1	1.9	0.7%	0.8%	0.8%
601766 CH	CRRC - A	Patrick Xu	Neutral	CNY	12.96	12.71	-1.9	51,207	425.4	31%	12%	26%	32.7	29.2	23.2	4.3	3.9	3.5	0.9%	1.0%	1.3%
	Constructors - A									**15%**	**8%**	**9%**	**21.4**	**19.7**	**17.7**	**2.6**	**2.3**	**2.1**	**1.0%**	**1.1%**	**1.2%**
601038 CH	First Tractor - A	Patrick Xu	Reduce	CNY	14.13	8.41	-40.5	1,552	43.5	-24%	50%	25%	83.9	56.0	44.9	3.1	2.9	2.8	0.4%	0.5%	0.7%
600031 CH	Sany Heavy	Patrick Xu	Neutral	CNY	6.67	6.99	4.8	7,828	87.4	-76%	-222%	83%	71.6	n/a	n/a	2.1	2.3	2.3	0.7%	n/a	n/a
000338 CH	Weichai Power - A	Patrick Xu	Neutral	CNY	9.78	9.56	-2.2	5,608	51.5	41%	-85%	38%	3.9	25.5	18.4	0.6	1.2	1.1	2.6%	0.8%	1.1%
000157 CH	Zoomlion Heavy Industry - A	Patrick Xu	Reduce	CNY	5.41	3.65	-32.5	5,746	81.1	-85%	-282%	86%	70.2	n/a	n/a	1.0	1.1	1.1	0.9%	n/a	n/a
	Construction machinery - A									**-36%**	**-135%**	**58%**	**57.4**	**40.7**	**31.7**	**1.7**	**1.9**	**1.8**	**1.1%**	**0.7%**	**0.9%**
002008 CH	Han's Laser Technology - A	Zhuoran Wang	Buy	CNY	26.50	34.86	31.5	4,312	120.6	28%	5%	39%	39.6	37.8	27.2	6.8	6.3	5.3	0.8%	0.4%	0.6%
300024 CH	Siasun Robot & Automation - A	Zhuoran Wang	Reduce	CNY	70.18	48.39	-31.0	7,669	256.7	30%	28%	31%	141.1	110.4	84.4	23.8	20.2	17.5	0.1%	0.1%	0.2%
	Factory automation - A									**29%**	**16%**	**35%**	**90.3**	**74.1**	**55.8**	**15.3**	**13.2**	**11.4**	**0.4%**	**0.3%**	**0.4%**
000410 CH	Shenyang Machine Tool - A	Patrick Xu	Reduce	CNY	25.18	2.64	-89.5	2,970	292.5	18%	-507%	32%	753.5	n/a	n/a	7.1	7.4	7.6	0.1%	n/a	n/a
	Machine tools - A									**18%**	**-507%**	**32%**	**753.5**	**n/a**	**n/a**	**7.1**	**7.4**	**7.6**	**0.1%**	**n/a**	**n/a**

Note: Share price as of 30 December 2015

Source: Bloomberg, Nomura estimates

NOMURA

Oil & gas

EQUITY STRATEGY

Outlook 2016: Prefer downstream to upstream

Top pick is Sinopec

Global Markets Research

5 January 2016

Anchor themes

We believe costs cuts and market liberalisation reforms will position China's majors for a gradual oil price rebound. We prefer firms with downstream exposure like Sinopec and SPC over more upstream-focused companies like CNOOC and COSL.

Three important trends to watch out for in 2016

- **Majors' cost efficiency gains on track**. We believe the three oil majors will continue to lower their cost structure by shutting down marginal wells and adopting more fit-for-purpose, standardised solutions rather than fancy, custom-made works. This could involve tighter collaborative multi-disciplinary efforts across the value chain, with oil companies bringing in their services contractors and equipment vendors to the early project design stage to ensure smoother implementation, mitigating costly execution mistakes. Long term, this should help further deflate project cost structures while diversifying operating risks. We expect the 2016 outlook will remain challenging for the global oil industry as continuing to oversupply. Still, potentially higher-than-expected *Chinese crude oil imports* could partly offset the impact of additional Iranian crude exports, supporting our forecast of Brent crude price will rebound to average USD55/bbl in 2016F and USD60/bbl in 2017F.
- **Sharper capital allocation discipline to enhance ROE and ROC**. We expect the three oil majors to further reduce their capex by 15% in 2016 amidst depressed oil/gas prices. All projects must compete for a smaller pool of capital and this could mean force-ranking based on returns and long term strategic value. Enhanced capital allocation following the corruption probes could structurally lift ROE over the long term, potentially triggering a re-rating of the prevailing distressed below-book valuation.
- **Asset restructuring may trigger large exceptional gains for 2016**. The government wants to see increased private participation in the energy industry. This could be a win-win as the SOE oil majors could have less of a capex burden. Moreover, the private sector could introduce more creative, entrepreneurial ideas to make the SOE operations more profitable without compromising safety and environment. Nothing has been cast in concrete yet. But the most likely scenario could involve the IPOs of PetroChina's gas pipeline network and Sinopec's retail fuel marketing business. The IPO proceeds could be deployed to deleverage their balance sheet, to increase dividend payout and to reinvest in higher return projects.

Stock recommendations: Sinopec, PetroChina and SPC

- **Sinopec (386 HK, Buy, TP: HKD7.30)** remains our top pick because of the firm's defensive exposure to downstream.
- **PetroChina (857 HK, Buy, TP: HKD8.80)** is also attractive as a laggard play as gas demand improves following the recent price cut.
- **Sinopec Shanghai Petrochemical (SPC, 338 HK, Buy, TP: HKD4.0)** is a leveraged downstream play on refining and chemicals. China's diesel fuel upgrades and the firm's enhanced synthetic fibre business could trigger positive earnings surprises.

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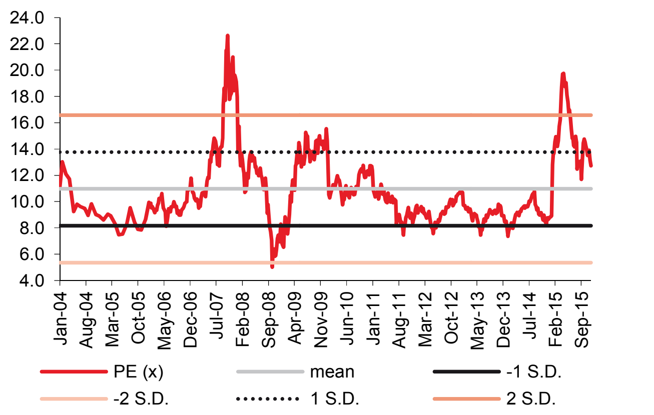
Fig. 142: MSCI China Energy: 1Yr forward P/E

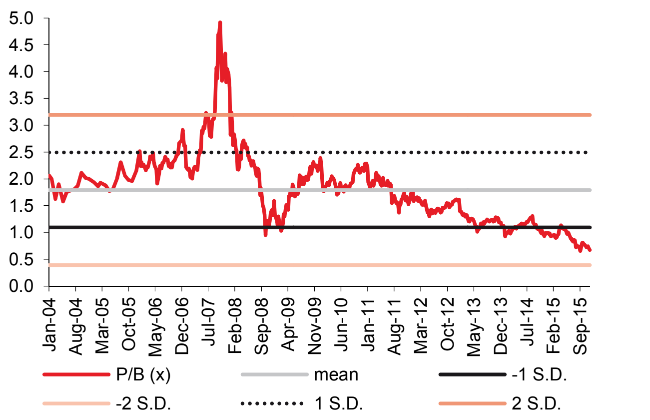
P/E (x)



Source: IBES, Datastream, Nomura research

Fig. 143: MSCI China Energy: 1Yr forward P/B

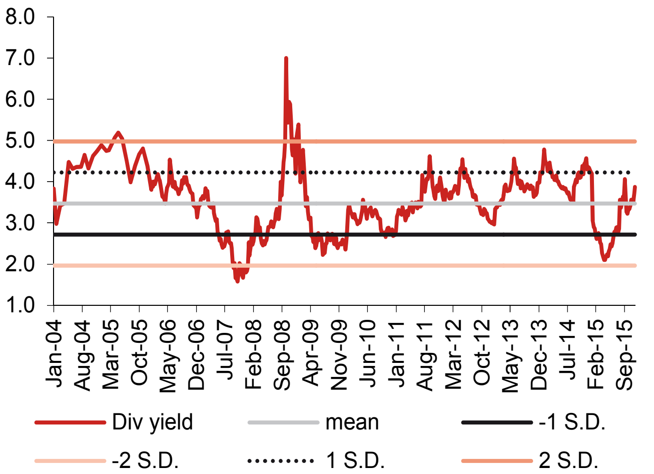
P/B (x)



Source: IBES, Datastream, Nomura research

Fig. 144: MSCI China Energy: 1Yr forward dividend yield

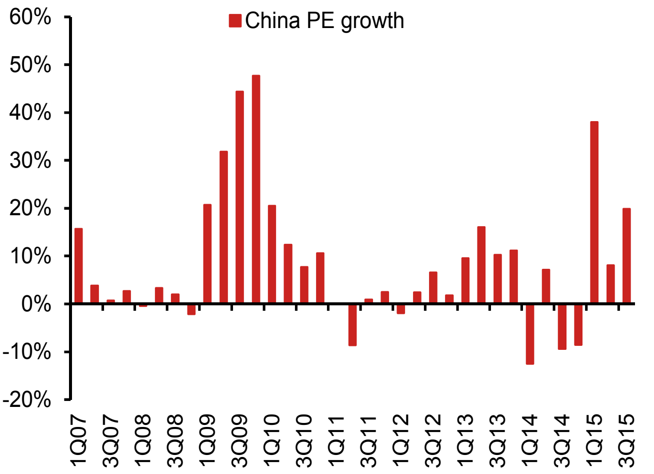
(%)



Source: IBES, Datastream, Nomura research

Fig. 145: China PE demand growth

(y-y, %)



Source: CEIC, CMAI, Nomura research

Fig. 146: China oil & gas valuation table

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth FY14	FY15	FY16	Normalised P/E (x) FY14	FY15	FY16	P/B (x) FY14	FY15	FY16	Dividend yield (%) FY14	FY15	FY16
	Energy																				
	Oil & Gas																				
3337 HK	Anton Oilfield Services	Gordon Kwan	Buy	HKD	0.75	1.50	100.0	215	0.6	-151%	82%	408%	n/a	n/a	12.4	0.7	0.7	0.6	n/a	n/a	n/a
2883 HK	China Oilfield Services	Gordon Kwan	Reduce	HKD	6.76	6.00	-11.2	8,719	11.7	5%	-76%	-11%	3.6	15.0	16.8	0.6	0.6	0.6	8.5%	n/a	n/a
1623 HK	Hilong Holding	Bob Chen	Buy	HKD	1.35	2.00	48.1	295	0.4	13%	-38%	4%	4.8	7.8	7.5	0.7	0.6	0.6	3.5%	2.6%	2.7%
342 HK	Newocean Energy Holdings	Bob Chen	Buy	HKD	3.06	4.60	50.3	584	0.6	11%	10%	22%	5.0	4.6	3.8	0.9	0.8	0.7	2.2%	2.6%	3.1%
2386 HK	Sinopec Engineering Group	Bob Chen	Buy	HKD	6.55	8.00	22.1	3,742	2.5	-16%	-10%	-6%	7.0	7.8	8.3	1.1	1.0	0.9	5.7%	5.2%	4.8%
934 HK	Sinopec Kantons	Bob Chen	Buy	HKD	4.60	8.00	73.9	1,476	1.1	51%	61%	21%	14.5	9.0	7.4	0.8	0.7	0.6	1.5%	1.7%	5.4%
1033 HK	Sinopec Oilfield Service	Bob Chen	Reduce	HKD	2.04	1.70	-16.7	16,121	2.4	62%	-209%	23%	10.8	n/a	n/a	1.4	1.1	1.2	n/a	n/a	n/a
	Oilfield svs & equip. - average									**-3%**	**-26%**	**66%**	**7.6**	**8.8**	**9.4**	**0.9**	**0.8**	**0.7**	**4.3%**	**3.0%**	**4.0%**
	Oilfield svs & equip. - median									**11%**	**-10%**	**21%**	**6.0**	**7.8**	**7.9**	**0.8**	**0.7**	**0.6**	**3.5%**	**2.6%**	**4.0%**
933 HK	Brightoil Petroleum	Bob Chen	Buy	HKD	2.69	3.30	22.7	3,525	1.8	176%	58%	79%	42.9	27.1	15.1	3.1	2.8	2.3	n/a	n/a	n/a
883 HK	CNOOC	Gordon Kwan	Neutral	HKD	8.20	10.00	22.0	47,237	88.5	7%	-61%	3%	5.1	12.9	12.5	0.8	0.8	0.8	7.0%	7.0%	7.0%
857 HK	PetroChina	Gordon Kwan	Buy	HKD	5.14	8.80	71.2	223,818	71.4	-17%	-51%	17%	7.4	15.0	12.9	0.7	0.7	0.6	6.1%	3.0%	3.5%
386 HK	Sinopec	Gordon Kwan	Buy	HKD	4.71	7.30	55.0	88,682	63.9	-30%	-1%	30%	9.9	10.0	7.7	0.8	0.7	0.7	5.1%	5.0%	5.6%
338 HK	Shanghai Petrochemical	Jamie Wang	Buy	HKD	3.02	4.00	32.5	8,836	6.9	-140%	518%	30%	n/a	9.9	7.6	1.7	1.4	1.3	n/a	4.0%	5.3%
	Oil majors & E&P									**-1%**	**93%**	**32%**	**16.3**	**15.0**	**11.2**	**1.4**	**1.3**	**1.1**	**6.1%**	**4.7%**	**5.3%**
601808 CH	China Oilfield Services - A	Gordon Kwan	Reduce	CNY	15.65	12.00	-23.3	8,719	32.8	5%	-76%	-11%	9.9	41.5	46.5	1.6	1.6	1.6	3.1%	0.7%	0.6%
600583 CH	Offshore Oil Engineering	Gordon Kwan	Reduce	CNY	9.09	7.90	-13.1	6,193	63.9	40%	-28%	27%	9.4	13.0	17.9	2.0	1.7	1.6	2.5%	0.8%	0.8%
601857 CH	PetroChina - A	Gordon Kwan	Buy	CNY	8.41	11.50	36.7	223,818	101.6	-17%	-51%	17%	14.4	29.4	25.1	1.3	1.3	1.2	3.1%	1.5%	1.8%
600028 CH	Sinopec - A	Gordon Kwan	Buy	CNY	4.97	7.30	46.9	88,682	146.4	-30%	-1%	30%	12.5	12.6	9.7	1.0	0.9	0.9	4.0%	4.0%	4.4%
600871 CH	Sinopec Oilfield Service - A	Bob Chen	Reduce	CNY	8.39	6.80	-19.0	16,121	87.4	62%	-196%	50%	52.8	n/a	n/a	6.8	5.3	5.5	n/a	n/a	n/a
600688 CH	Shanghai Petrochemical - A	Jamie Wang	Neutral	CNY	6.64	7.00	5.4	8,836	70.6	-140%	518%	30%	n/a	26.0	20.0	4.3	3.7	3.3	n/a	1.5%	2.0%
	Oil majors and oilfield svs & equip. - A									**-13%**	**28%**	**24%**	**19.8**	**24.5**	**23.8**	**2.8**	**2.4**	**2.4**	**3.2%**	**1.7%**	**1.9%**

Note: Price as of 30 December 2015

Source: Bloomberg, Nomura estimates

NOMURA

Transport & logistics

EQUITY STRATEGY

Outlook 2016: Quality to outlast

Freight forwarding growth may resume in 2016F

Global Markets Research

5 January 2016

Three most important trends to watch out for in 2016

- **Freight forwarding growth may resume in 2016F on better export**. Driven by CNY depreciation (our house view is looking for CNY to depreciate by 4.7% in 2015F and by another 3.8% in 2016F) and the resultant export recovery (our house view is looking for 6.2% growth on China export in 2016F compared to a decline of 2.7% in 2015F), we expect international freight forwarding to resume growth momentum in 2016F.
- **Margin pressure in contract logistics may benefit strong 3PLs**. We expect contracted logistics to experience more margin pressure given the tougher operating environment owing to more requirements from customers. But this may results in a tougher operating environment may lead more enterprises to outsource their non-core logistics business to third-party logistics companies (3PLs). We expect 3PLs with proven track record of quality management, extensive network and service coverage scale will likely benefit the most.
- **Logistics warehouses in tier-1 cities to maintain solid performance**. Given lack of warehouses supply in tier-1 cities and our expectation of continual strong demand in tier-1 cities, we expect rental rates in tier-1 cities to remain on a rising trend.

Stock recommendation – Top pick Shenzhen International

- **Shenzhen International (152 HK, Buy, TP: HKD17.0):** We maintain our Buy on Shenzhen International for potential value accretion and special dividends upon potential land disposal in Shenzhen (including Meilin Checkpoint and Qianhai). Upon the potential disposal of its 51% stake in Meilin Checkpoint and Qianhai Phase I to a property developer by 1H16, we estimate the company will record an aggregate net profit of up to HKD4.2bn, assuming no LAT (land appreciation tax). The sales should result in potential special dividends of up to HKD1.125/share (or a dividend yield of 10% at the stock's closing price), assuming 50% of disposal gains are paid as special dividends. Further, there is a possibility that Shenzhen's government may consider buying back some expressways in Shenzhen in FY19F which may lead to another special dividend in FY19F.
- **Sinotrans (598 HK, Buy, TP: HKD5.8):** We like Sinotrans due to its low valuation and possible earnings recovery of its freight forwarding in 2016F driven by recovery of the export business and bottoming out of the container shipping industry. A possible merger with China Merchants Group and assets injections from its parent company would be a bonus.
- **Kerry Logistics (636 HK, Buy, TP: HKD14.7):** We like Kerry Logistics due to its strong management quality and steady earnings growth profile which should help the company to gain market share under the tougher operating environment. Its well-established logistics network in ASEAN countries should provide promising growth potential in the long term.

Anchor themes

We are positive on growth for China's 3PL sector given the low penetration and high logistics costs as a % of GDP. We see growth drivers in urbanisation, industry migration inland and the e-commerce boom.

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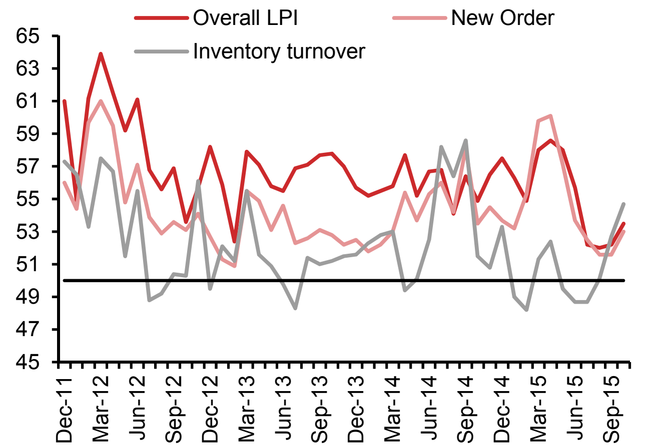
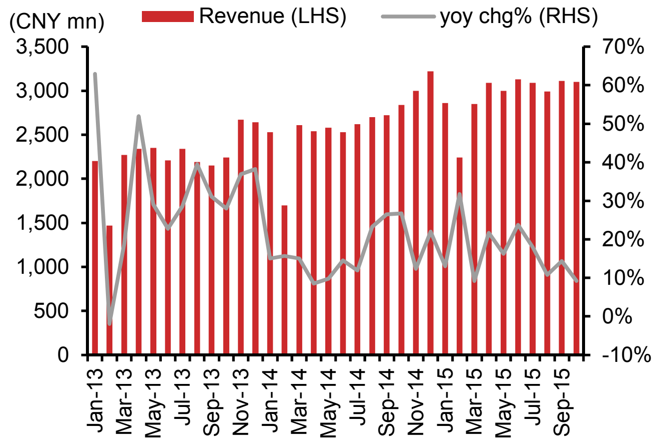
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Fig. 147: China logistics prosperity index (LPI)



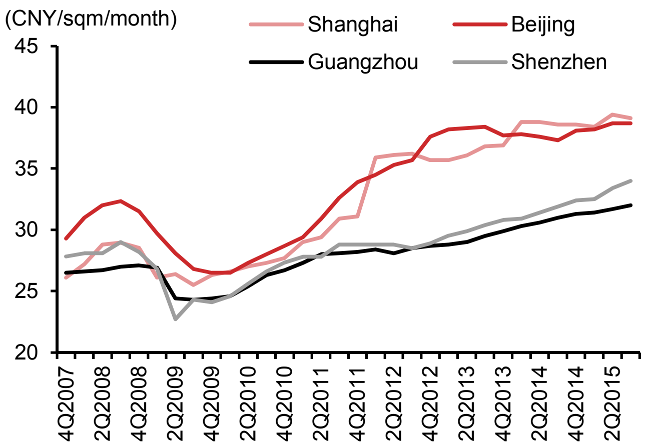
Source: WIND, Nomura research

Fig. 148: International air express revenue trend – monthly



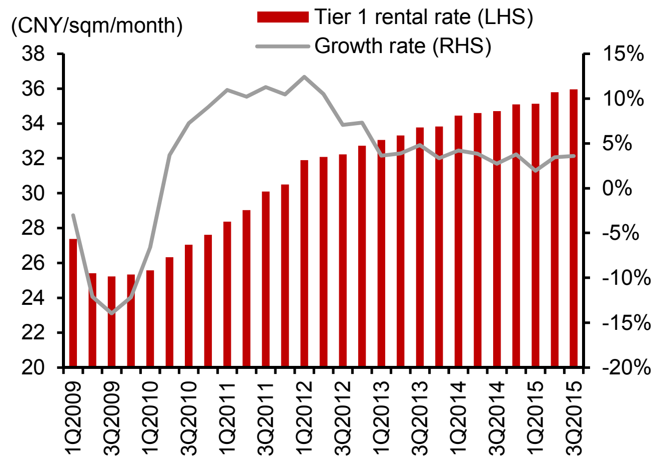
Source: WIND, Nomura research

Fig. 149: Average monthly rental rate in tier-1 cities



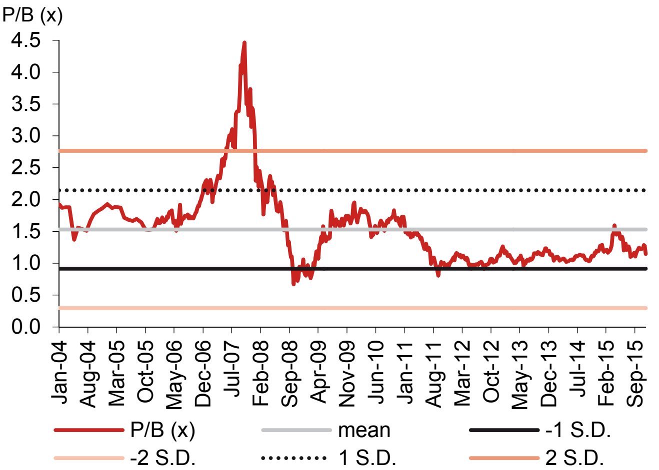
Source: WIND, Nomura research

Fig. 150: Average monthly rental rate in tier-1 cities



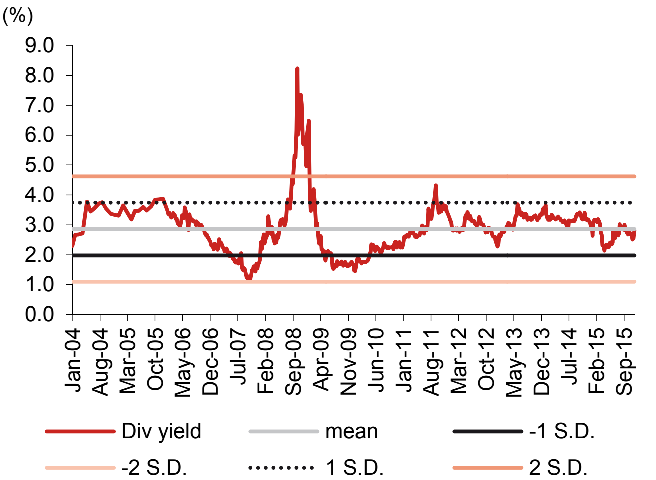
Source: WIND, Nomura research

Fig. 151: MSCI China Transport: 1Yr forward P/B



Source: IBES, Datastream, Nomura research

Fig. 152: MSCI China Transport: 1Yr forward dividend yield



Source: IBES, Datastream, Nomura research

Fig. 153: China logistics stock valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
										FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Logistics																				
636 HK	Kerry Logistics	Shirley Lam	Buy	HKD	11.18	14.70	31.5	2,444	1.0	20%	12%	10%	20.6	18.4	16.7	1.3	1.2	1.1	1.2%	1.4%	1.5%
152 HK	Shenzhen International	Shirley Lam	Buy	HKD	14.44	17.00	17.7	3,538	4.9	-1%	15%	-1%	15.4	13.4	13.6	1.5	1.4	1.4	3.2%	2.6%	2.6%
598 HK	Sinotrans	Shirley Lam	Buy	HKD	4.19	5.80	38.4	2,490	6.3	-10%	8%	14%	12.6	11.6	10.1	1.2	1.1	1.0	2.4%	3.0%	3.0%
	Average									**3%**	**12%**	**8%**	**16.2**	**14.5**	**13.5**	**1.3**	**1.2**	**1.2**	**2.3%**	**2.3%**	**2.3%**

Note: Share price as of 30 December 2015

Source: Bloomberg, Nomura estimates

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Financials

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Banks

EQUITY STRATEGY

Outlook 2016: Changing the playbook

From easing to efficiency during a tri-cycle

Global Markets Research

5 January 2016

Anchor themes

We stick to our tri-cycle call on margins, NPLs and capital after 3Q15 results and see strong earnings headwinds over FY15/16/17F. However, valuations may not move concurrently due to the likely change in the playbook in 2016F.

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Three important trends to watch out for in 2016F

We re-iterate our tri-cycle forecasts through 2018F on margin/NPL/capital for banks under our coverage universe: NPL ratio rises to 2.5% for 2016F and peaks at 5.3% in 2018F; NIM to soften gradually from 2.56% in 9M15 to 2.17% by 2018F; and lastly, a dividend cut sometime in 2015/16F, with dividend yield likely falling from 5.7% in FY14 to 4.5% by FY15F, and 3.1% by FY16F.

- **Changing the playbook from easing to efficiency:** With the total social financing balance at an all-time high of RMB135tn and money velocity down to 0.48x (as of 3Q15), we see a potential shift in the focus from M2 growth in 2015 to lifting efficiency of liquidity (M2 velocity) in 2016F. We foresee likely multiple expansion on high-quality banks if velocity starts to stabilise.
- **Risk normalisation may lead to a correction in the bond market, but won't stop its structural boom:** The size of China's bond market has increased significantly after equity financing hit a speed bump in 3Q15, with credit spreads down to five-year lows. Risk normalisation may lead to a bond market correction, though it is unlikely to stop the structural shift from bank loans to bonds in the coming years, in our view.
- **RMB internationalisation continues:** RMB was approved to be included in the IMF's Special Drawing Rights (SDR) basket on 30 November 2015, and we reiterate conclusions in our "What if" analysis in our 2016 outlook report on SDR inclusion — we expect the RMB's share in global central banks' reserves to grow to 4% (USD450bn), and that in international bank debt books to rise to 3-5% (USD1.0-1.7tn) by 2017F. China's large banks could record faster expansion overseas as well.

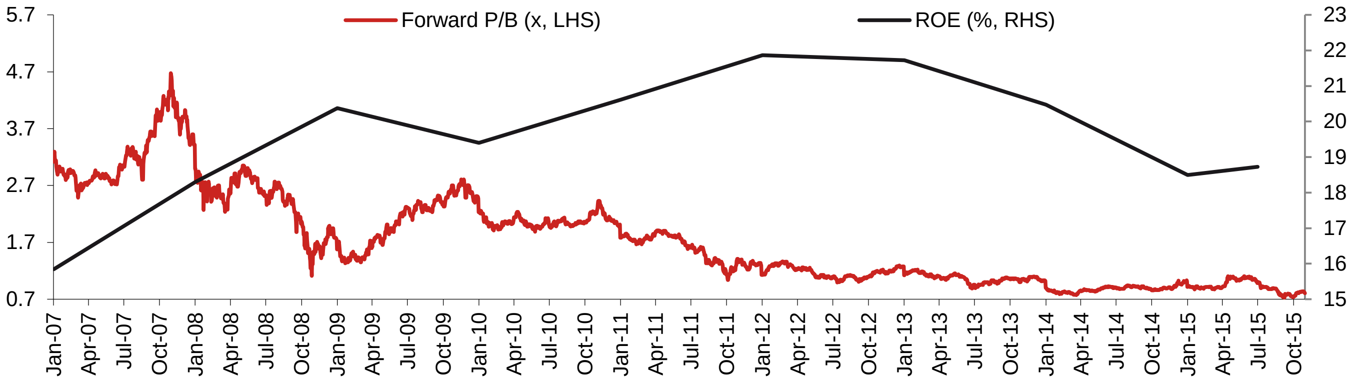
Stock recommendations – ICBC, BOCHK, CCB, Cinda and CRCB

We offer a detailed analysis on China banks in our 2016 outlook report and noted that mid-cap banks are most vulnerable as the tri-cycle unfolds.

- **ICBC (1398 HK – TP: HKD6.92; 601398 CH – TP: CNY5.32, both Buy):** Most defensive among China banks, with a decent capital base, low asset risk, stable funding franchise and strong credit risk controls.
- **BOCHK (2388 HK, TP: HKD32.77, Buy):** Top seed for RMB internationalisation, with a stable ROE of c.14% in 2009-1H15 on prudent management – which may help it to expand into the tricky ASEAN market.
- **CCB (939 HK, TP: HKD7.07, Buy):** The strongest capital base among peers, with decent risk control and prudent management.
- **Cinda (1359 HK, TP: HKD3.97, Buy):** Positioned to benefit from the unfolding credit cycle and the bond cycle in China.
- **CRCB (3618 HK, TP: HKD6.44, Buy):** Our pick in China's rural banking space, given it has the strongest margin/provision buffers in our universe.

Fig. 154: China banks' multiple movement does not reflect the ROE improvement since 2008

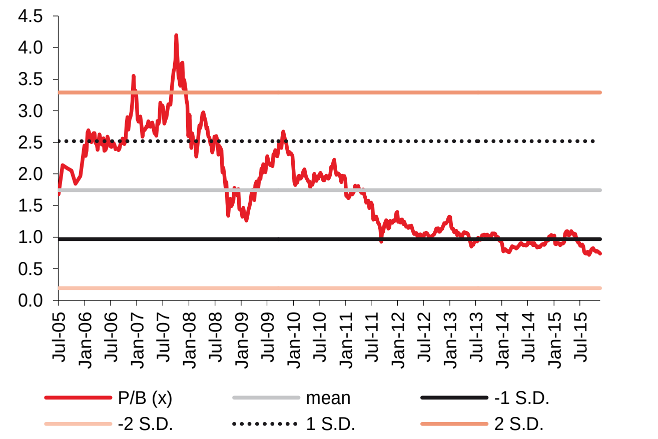
P/B vs. ROE of China banks



Source: Company data, Bloomberg, Nomura research. Data as of 30 October 2015

Fig. 155: MSCI China banks: 1Yr forward P/B

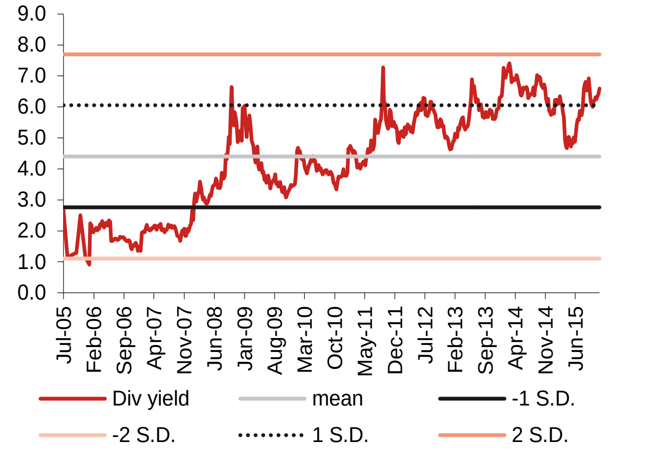
P/B (x)



Source: IBES, Datastream, Nomura research

Fig. 156: MSCI China banks: 1Yr forward dividend yield

(%)



Source: IBES, Datastream, Nomura research

Fig. 157: China banks valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
										FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Financials																				
	Banks																				
2388 HK	BOC Hong Kong	Sophie Jiang	Buy	HKD	23.65	32.77	38.6	32,262	33.2	10%	8%	8%	10.2	9.4	8.7	1.4	1.3	1.2	4.7%	5.1%	5.2%
11 HK	Hang Seng Bank	Sophie Jiang	Neutral	HKD	148.10	153.00	3.3	36,533	25.0	-5%	-11%	19%	16.4	18.3	15.4	2.0	1.9	1.8	3.8%	6.4%	4.2%
	Hong Kong banks - average									**3%**	**-1%**	**13%**	**13.3**	**13.9**	**12.1**	**1.7**	**1.6**	**1.5**	**4.3%**	**5.8%**	**4.7%**
1288 HK	Agricultural Bank of China	Sophie Jiang	Neutral	HKD	3.19	3.18	-0.3	159,000	54.1	8%	-13%	-9%	4.8	5.6	6.1	0.8	0.7	0.7	6.8%	3.7%	2.5%
3988 HK	Bank of China	Sophie Jiang	Reduce	HKD	3.46	3.38	-2.3	168,207	138.1	6%	-11%	-15%	4.9	5.5	6.4	0.7	0.6	0.6	6.6%	4.7%	3.2%
3328 HK	Bank of Communications	Sophie Jiang	Neutral	HKD	5.43	5.94	9.4	63,599	24.5	6%	-9%	-12%	5.1	5.6	6.4	0.7	0.6	0.6	5.3%	3.5%	2.3%
998 HK	China CITIC Bank	Sophie Jiang	Neutral	HKD	4.99	4.95	-0.8	45,567	26.5	4%	-6%	-13%	4.8	5.1	5.9	0.8	0.7	0.6	n/a	5.9%	3.4%
939 HK	China Construction Bank	Sophie Jiang	Buy	HKD	5.30	7.07	33.4	172,965	177.2	6%	-4%	-10%	4.9	5.1	5.7	0.9	0.9	0.9	6.8%	5.9%	4.4%
3968 HK	China Merchants Bank	Sophie Jiang	Reduce	HKD	18.24	16.70	-8.4	68,845	63.2	0%	-10%	-13%	6.9	7.6	8.8	1.2	1.1	1.0	4.4%	2.0%	1.7%
1988 HK	China Minsheng Bank	Sophie Jiang	Neutral	HKD	7.64	8.91	16.6	49,774	20.4	-4%	-12%	-12%	4.5	5.1	5.8	0.9	0.8	0.7	2.9%	2.9%	1.7%
3618 HK	CHQ Rural Commercial Bank	Sophie Jiang	Buy	HKD	4.67	6.44	37.9	5,604	5.8	14%	2%	-8%	5.3	5.2	5.7	0.9	0.7	0.6	5.1%	4.8%	3.5%
1398 HK	ICBC	Sophie Jiang	Buy	HKD	4.68	6.92	47.9	243,922	147.1	4%	-4%	-5%	5.0	5.2	5.5	0.9	0.8	0.7	6.5%	6.0%	4.8%
	Chinese banks: H share - average									**5%**	**-7%**	**-11%**	**5.1**	**5.6**	**6.3**	**0.9**	**0.8**	**0.7**	**5.5%**	**4.4%**	**3.1%**
601288 CH	Agricultural Bank of China	Sophie Jiang	Reduce	CNY	3.23	2.93	-9.3	159,000	149.6	8%	-13%	-9%	5.8	6.7	7.4	1.0	0.9	0.8	5.6%	3.1%	2.1%
601988 CH	Bank of China	Sophie Jiang	Reduce	CNY	4.03	2.95	-26.8	168,207	190.7	6%	-11%	-15%	6.7	7.6	8.9	1.0	0.9	0.8	4.7%	3.4%	2.3%
601328 CH	Bank of Communications	Sophie Jiang	Reduce	CNY	6.46	5.49	-15.0	63,599	139.4	6%	-9%	-12%	7.3	8.0	9.1	1.0	0.9	0.9	3.7%	2.5%	1.6%
601998 CH	China CITIC Bank	Sophie Jiang	Reduce	CNY	7.32	4.09	-44.1	45,567	122.5	4%	-6%	-13%	8.4	9.0	10.4	1.3	1.2	1.1	n/a	3.3%	1.9%
601939 CH	China Construction Bank	Sophie Jiang	Neutral	CNY	5.79	5.69	-1.7	172,965	72.7	6%	-4%	-10%	6.4	6.6	7.4	1.2	1.1	1.1	5.2%	4.5%	3.4%
600036 CH	China Merchants Bank	Sophie Jiang	Reduce	CNY	18.26	14.51	-20.5	68,845	174.6	0%	-10%	-13%	8.2	9.1	10.5	1.5	1.3	1.1	3.7%	1.6%	1.4%
600016 CH	China Minsheng Bank	Sophie Jiang	Reduce	CNY	9.43	7.37	-21.8	49,774	198.9	-4%	-12%	-12%	6.6	7.5	8.5	1.3	1.1	1.0	2.0%	2.0%	1.2%
601398 CH	ICBC	Sophie Jiang	Buy	CNY	4.61	5.32	15.4	243,922	131.5	4%	-4%	-5%	5.9	6.1	6.4	1.1	0.9	0.8	5.5%	5.1%	4.0%
000001 CH	Ping An Bank	Sophie Jiang	Reduce	CNY	12.10	10.07	-16.8	26,677	141.9	-9%	-25%	-16%	6.4	8.6	10.2	1.1	1.1	0.9	1.4%	1.1%	0.8%
	Chinese banks: A share - average									**2%**	**-10%**	**-12%**	**6.9**	**7.7**	**8.8**	**1.2**	**1.0**	**1.0**	**4.0%**	**3.0%**	**2.1%**
	Diversified financials																				
1359 HK	China Cinda Asset	Sophie Jiang	Buy	HKD	2.91	3.97	36.4	13,613	19.0	11%	27%	15%	7.4	5.8	5.1	0.9	0.9	0.8	4.0%	5.1%	4.9%
	Average									**11%**	**27%**	**15%**	**7.4**	**5.8**	**5.1**	**0.9**	**0.9**	**0.8**	**4.0%**	**5.1%**	**4.9%**

Note: Share prices as on 30 December 2015

Source: Bloomberg, Nomura estimates

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Insurance

EQUITY STRATEGY

Outlook 2016: Prefer life over P&C

Dynamics improving for life, weakening for P&C

Global Markets Research

5 January 2016

Anchor themes

China's life industry is growing out of its transition period on the back of improving investment and supportive policies, while China's P&C sector is struggling through a weak market.

Four important trends to watch out for in 2016

- **China life insurers: growing again after its transition period.** China's life sector appears to have outgrown the transition period with premium momentum very strong in 2014 (+18%) and 9M 2015 (+24%). The business mix is also improving, with a greater focus on protection-type traditional insurance products and high-margin agency business, which we believe is laying a solid foundation for double-digit NBV growth from 2016F onwards.
- **Improving business mix.** The business mix has also improved with the sale of more protection-type traditional insurance products. Since the deregulation of traditional life insurance product pricing in 2013, more protection-type insurance products (traditional + health & accident) are being sold, jumping to 49% in 2014, from just 17% in 2010.
- **Favourable regulatory environment.** Meanwhile, supportive government policies are likely to lead to new business opportunities and drive industry growth beyond the transition period. The new tax benefit health insurance policy should be a catalyst for commercial health insurance to grow by more than 26% between 2014 and 2020, on our estimates. We believe that the much-anticipated tax-deferred pension, which is critical to China's pension system, will encourage people to purchase commercial pension plans.
- **China P&C sector: struggling in the down-cycle on over-competition.** We see a disconnect between supply and demand. On the one hand, P&C insurers are still flush with capital. On the other hand, P&C premium growth has moderated. For example, total motor vehicle insurance premium growth has been challenging with slowing car parc (vehicles/capita) growth. We expect the sector-wide combined ratio to remain at a high level for the next few years. In addition, motor insurance deregulation may be the key concern in the near term given the motor insurance deregulation will be rolled out to 12 more provinces in 2016.

Stock recommendations – CPIC-A+H, NCI-H and China Life –A+H

China Pacific Insurance A & H (601601 CH, Buy / 2601 HK, Buy): Life growth momentum remains strong and P&C business will likely continue to stabilise in 2016F for CPIC. The company boasts a sound capital position, solid asset quality and steady operations with a clear focus on insurance.

New China Life (1336 HK, Buy): NCI-H offers an attractive investment opportunity as it is trading at a large discount to its peers, while riding on the improving life insurance market.

China Life A & H (601628 CH, Buy / 2628 HK, Buy): China Life is the largest, most liquid, pure play on the health and pension reform theme, as well as on the SOE reform theme.

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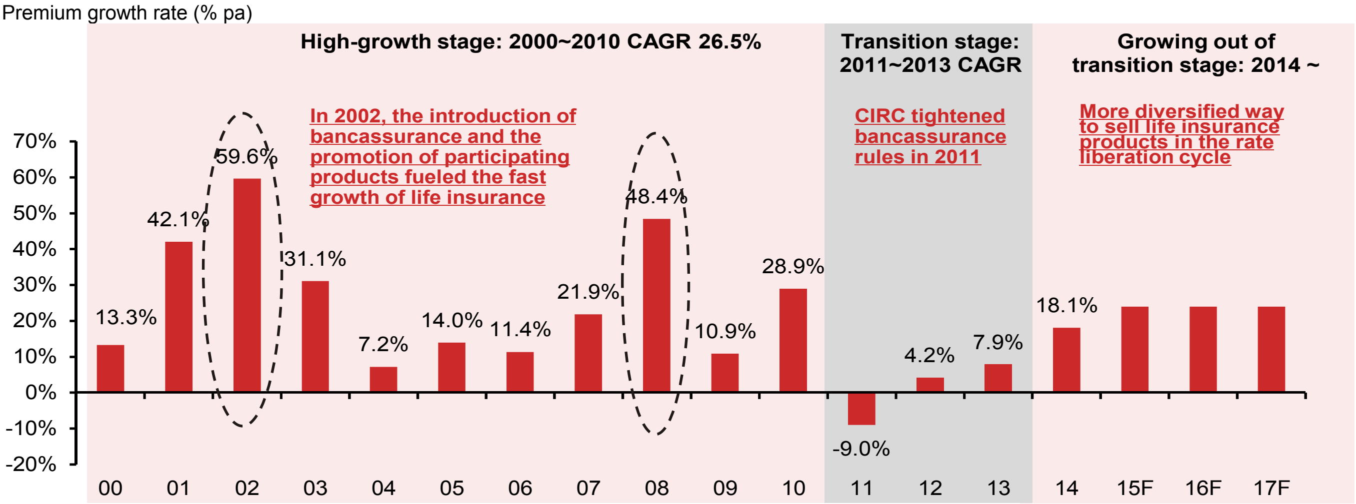
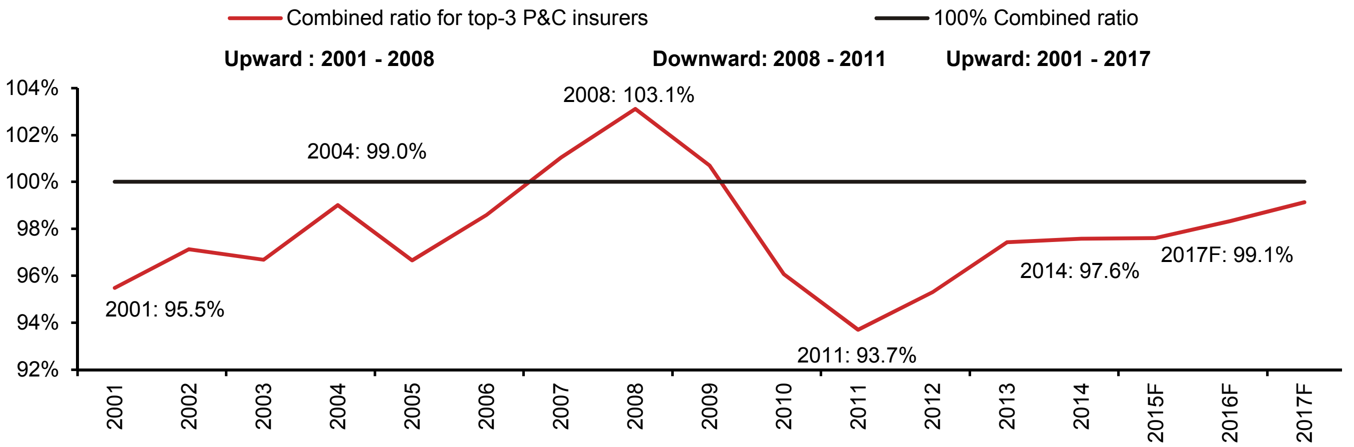
Fig. 158: Life is moving beyond the transition period

Premium growth rate (% pa)



Source: China Insurance Yearbook, Annual Report of Chinese Insurance Market, CIRC, Nomura estimates

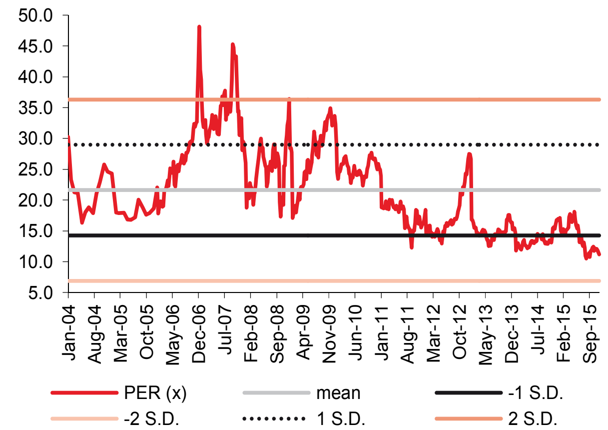
Fig. 159: China P&C combined ratio is expected to stay at a high level for the next few years



Source: Company data, Nomura estimates

Fig. 160: MSCI China Insurance: 1Yr forward P/E

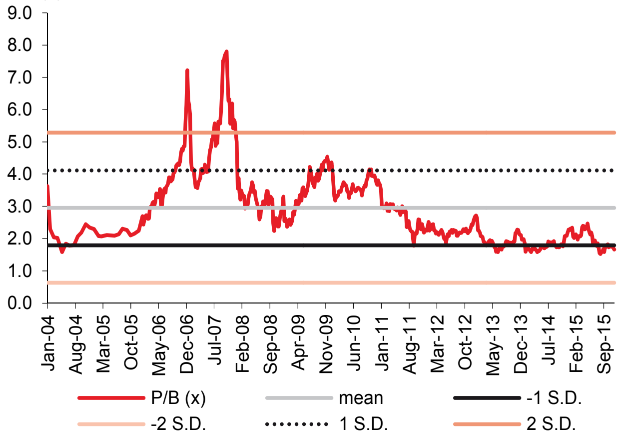
P/E (x)



Source: IBES, Datastream, Nomura research

Fig. 161: MSCI China Insurance: 1Yr forward P/B

P/B (x)



Source: IBES, Datastream, Nomura research

Fig. 162: China insurance valuation comparison

					30-Dec-15	Target	Upside/	Mktcap	3mth avg	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
Ticker	Company name	Analyst name	Rating	Currency	Share price	price	(downside) (%)	(US$m)	daily T/O (US$m)	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Financials																				
	Insurance																				
1299 HK	AIA	Shengbo Tang	Buy	HKD	46.35	60.00	29.4	72,053	141.3	22%	6%	12%	20.7	19.6	17.5	2.3	2.0	1.8	1.1%	1.3%	1.4%
2628 HK	China Life Insurance	Shengbo Tang	Buy	HKD	24.90	41.37	66.1	115,479	121.6	30%	30%	12%	18.3	14.0	12.6	2.1	1.9	1.7	2.2%	1.7%	1.7%
2601 HK	China Pacific Insurance	Shengbo Tang	Buy	HKD	31.30	47.15	50.6	39,125	41.2	19%	59%	11%	21.5	13.5	12.2	2.0	1.8	1.7	1.5%	1.5%	2.6%
1508 HK	China Re	Shengbo Tang	Neutral	HKD	2.40	2.75	14.6	13,051	n/a	60%	-1%	24%	13.5	13.7	11.0	1.4	1.2	1.1	0.6%	0.9%	1.1%
966 HK	China Taiping	Shengbo Tang	Buy	HKD	23.60	32.29	36.8	10,944	14.9	97%	59%	22%	16.1	10.1	8.3	2.0	1.2	1.1	n/a	n/a	n/a
1336 HK	New China Life	Shengbo Tang	Buy	HKD	31.95	57.51	80.0	21,043	19.6	45%	43%	17%	13.0	9.1	7.8	1.7	1.5	1.2	0.6%	0.7%	0.7%
1339 HK	PICC Group	Shengbo Tang	Buy	HKD	3.82	4.81	25.9	20,910	12.7	155%	57%	-17%	10.4	6.6	7.9	1.5	1.2	1.0	1.0%	4.1%	6.5%
2328 HK	PICC Property & Casualty	Shengbo Tang	Neutral	HKD	15.60	15.80	1.3	29,847	48.1	43%	39%	-11%	12.8	9.2	10.4	2.3	1.9	1.7	1.6%	2.1%	2.9%
2318 HK	Ping An Insurance	Shengbo Tang	Buy	HKD	42.95	56.87	32.4	100,960	177.9	24%	-31%	10%	8.1	11.9	10.8	1.1	1.9	1.6	1.7%	1.1%	1.1%
	HK-listed - average									**55%**	**29%**	**9%**	**14.9**	**12.0**	**10.9**	**1.8**	**1.6**	**1.4**	**1.3%**	**1.7%**	**2.3%**
601628 CH	China Life Insurance - A	Shengbo Tang	Buy	CNY	28.54	34.15	19.7	115,479	108.6	30%	30%	12%	25.0	19.2	17.2	2.8	2.5	2.3	1.6%	1.2%	1.2%
601601 CH	China Pacific Insurance - A	Shengbo Tang	Buy	CNY	28.82	38.91	35.0	39,125	121.4	19%	59%	11%	23.6	14.8	13.4	2.2	2.0	1.8	1.4%	1.4%	2.4%
601336 CH	New China Life - A	Shengbo Tang	Neutral	CNY	52.22	47.46	-9.1	21,043	205.2	45%	43%	17%	25.4	17.8	15.2	3.4	2.9	2.4	0.3%	0.4%	0.4%
601318 CH	Ping An Insurance - A	Shengbo Tang	Buy	CNY	35.76	46.94	31.3	100,960	503.6	24%	-31%	10%	8.1	11.8	10.7	1.1	1.9	1.6	1.7%	1.1%	1.1%
	Chinese insurers: A share - average									**30%**	**25%**	**12%**	**20.6**	**15.9**	**14.1**	**2.4**	**2.3**	**2.0**	**1.3%**	**1.0%**	**1.3%**

Note: Price as of 30 December 2015

Source: Bloomberg, Nomura estimates

NOMURA

Property

EQUITY STRATEGY

Outlook 2016: Big developers to gain share

Flattish sales, flattish REI, supportive policies

Global Markets Research

5 January 2016

Anchor themes

Amid consolidation, we expect big developers to maintain double digit y-y property sales growth in 2016F vs. flat growth for the broader sector. We expect valuation expansion due to supportive policy/credit relaxation and improving balance sheets.

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Three important trends to watch out for in 2016

- **Flattish sales and investments on softening volume but resident ASP:** YTD through November, total commodity property sales rose 15.6% y-y in terms of value (6.5% above 2013's all-time peak) and 7.4% y-y in GFA (1.4% lower than 2013's all-time peak). We believe sales volumes may have peaked in 2013 or 2015, and forecast a 3% decline in sales volume in 2016F due to high base. Together with our forecast for ASP appreciation of 2-3%, we arrive at flattish 2016F sales vs 2015. We forecast 2016 real estate investment (REI) growth of -2%-0%, vs 1.3% for 11M15 and 10.5% in 2014. We expect y-y growth in REI to stabilise in 1Q16 with land sales recovering gradually, in part due to likely policy stimulus.
- **Policy continues to support destocking**: By November, total housing inventory in the T3 cities remained high at 31 months, versus T1 cities at 9 months and T2 cities at 11 months. We believe policy may stay supportive particularly to facilitate further destocking in T3 markets. Potential policy relaxations may include payroll tax deduction for mortgage interest payments, local government subsidies for rural buyers, more flexible use of the Housing Provident Fund, and further cut in the down-payment ratio, etc.
- **Major developers to further gain market share:** Amidst the above industry backdrop, we forecast that combined market share for the top-20 developers' (23.2% in value and 15.2% in volume in 3Q15) to continue to rise. In fact, we forecast that major developers may record double-digit sales growth, versus flattish for the overall market. We also expect major developers to benefit from the relaxed credit policy, and deleverage further with smaller land purchases. Specifically, we forecast their average borrowing costs may decrease to around 6% in FY16F, from 6.7% in 1H15 and 7.2% in FY14.

Stock recommendations: CR Land, Wanda, COLI and KWG

We reiterate our view that large-caps and quality names will likely continue to outperform the sector over the next 12 months. Among the blue-chips, we like:

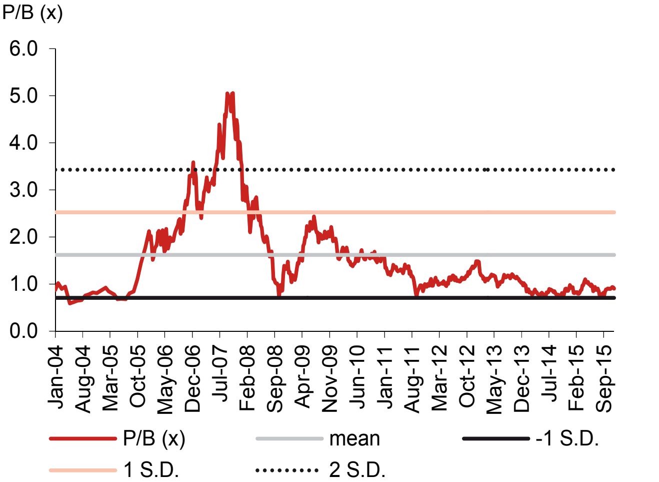
CR Land (1109 HK, Buy, TP: HKD28.58) for its solid sales and rental growth, with >20% FY15F earnings growth, and potential asset injection in Shenzhen.

Wanda (3699 HK, Buy, TP: HKD75.90) for its strong rental growth, expansion of asset-light business model, and potential A-share dual-listing.

COLI (688 HK, Buy, TP: HKD30.52) for its strong earnings growth of 20% in FY15F, high gross margins of >30%, management's five-year plan to grow volume market share from the current 1% to 2-3% (~20% sales growth p.a.), and a higher dividend payout ratio of 30%, from the current 20%.

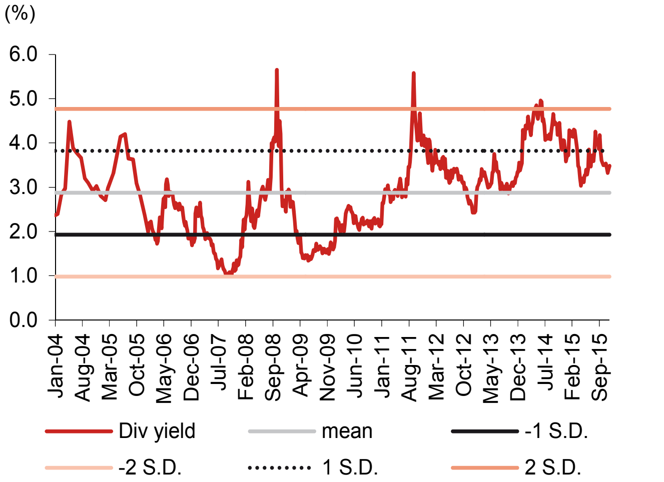
Among the small- and mid-caps, we like **KWG (1813 HK, Buy, TP: HKD8.80)** for its high exposure to T1/T2 cities, decent earnings growth (~15% in FY15F), attractive valuations (4.9x FY15F P/E), and high dividend yield of around 7%.

Fig. 163: MSCI China Property: 1Yr forward P/B



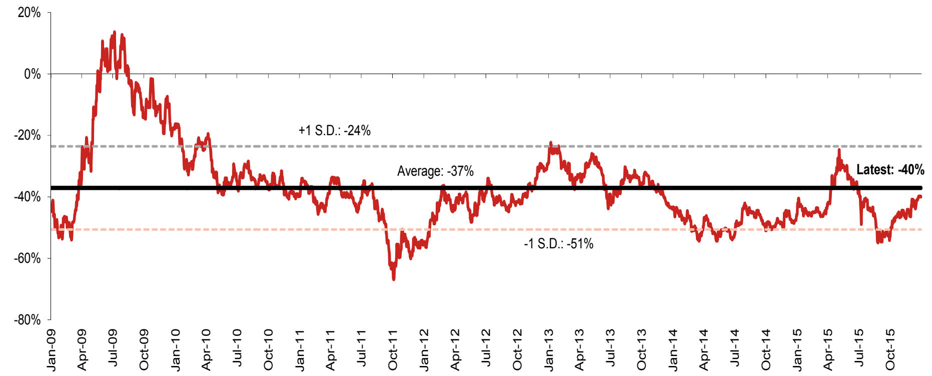
Source: IBES, Datastream, Nomura research

Fig. 164: MSCI China Property: 1Yr forward dividend yield



Source: IBES, Datastream, Nomura research

Fig. 165: Discount to NAV (%)



Source: Company data, Bloomberg, Nomura estimates

Fig. 166: China property valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
										FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Property																				
3383 HK	Agile Property	Elly Chen	Reduce	HKD	4.35	3.85	-11.5	2,198	2.8	-12%	-18%	0%	3.3	4.0	4.0	0.4	0.3	0.3	9.1%	5.0%	6.3%
2868 HK	Beijing Capital Land	Elly Chen	Buy	HKD	3.50	5.11	46.0	1,367	1.6	28%	-16%	7%	4.0	4.8	4.5	0.7	0.7	0.6	7.5%	6.2%	6.6%
884 HK	CIFI	Jeffrey Gao	Buy	HKD	1.72	2.44	41.9	1,482	1.4	23%	12%	10%	4.5	4.0	3.6	0.8	0.7	0.6	6.0%	6.3%	7.2%
81 HK	COGO	Jeffrey Gao	Reduce	HKD	3.13	2.83	-9.6	922	0.9	-55%	14%	-4%	5.7	5.0	5.2	0.6	0.5	0.5	1.6%	2.0%	1.9%
688 HK	China Overseas Land	Jeffrey Gao	Buy	HKD	26.70	30.52	14.3	33,970	72.4	26%	8%	12%	9.2	8.5	7.6	1.6	1.3	1.1	2.1%	2.4%	2.6%
1109 HK	China Resources Land	Jeffrey Gao	Buy	HKD	22.00	28.58	29.9	19,674	32.6	25%	3%	16%	10.9	10.6	9.1	1.2	1.1	1.0	2.9%	3.0%	3.4%
1966 HK	China SCE Property	Stephen Cheung	Buy	HKD	1.67	2.15	28.7	738	0.5	-28%	139%	24%	11.5	4.8	3.9	0.6	0.5	0.4	n/a	5.2%	6.5%
2202 HK	China Vanke #	Jeffrey Gao	Buy	HKD	22.90	22.30	-2.6	40,482	27.8	3%	14%	15%	13.6	11.9	10.3	2.4	2.1	1.9	2.6%	3.0%	3.4%
2007 HK	Country Garden	Elly Chen	Buy	HKD	3.12	4.18	34.0	9,093	6.6	12%	-4%	15%	5.4	5.7	4.9	0.9	0.9	0.8	6.0%	5.6%	6.5%
3333 HK	Evergrande Real Estate *	Jeffrey Gao	Neutral	HKD	6.72	5.61	-16.5	12,114	38.3	-27%	49%	12%	14.9	10.1	9.0	1.6	1.4	1.3	7.6%	3.5%	3.9%
817 HK	Franshion Properties	Jeffrey Gao	Buy	HKD	2.66	3.02	13.5	3,662	3.8	24%	-4%	10%	6.7	7.0	6.4	0.6	0.5	0.5	4.3%	4.3%	4.7%
337 HK	Greenland HK	Jeffrey Gao	Buy	HKD	3.02	6.09	101.7	1,089	2.1	-281%	307%	75%	n/a	11.2	6.4	1.2	0.9	0.8	n/a	0.4%	0.9%
3900 HK	Greentown *	Elly Chen	Neutral	HKD	7.71	6.45	-16.3	2,151	4.3	-50%	23%	7%	6.2	5.1	4.7	0.6	0.5	0.5	n/a	4.0%	4.2%
2777 HK	Guangzhou R&F	Elly Chen	Buy	HKD	9.54	10.90	14.3	3,966	7.4	-31%	31%	15%	6.4	4.9	4.2	0.7	0.6	0.6	n/a	7.4%	8.3%
1813 HK	KWG Properties	Jeffrey Gao	Buy	HKD	5.77	8.80	52.5	2,231	4.6	9%	9%	14%	5.5	5.0	4.4	0.7	0.6	0.6	6.9%	7.3%	8.7%
960 HK	Longfor Properties	Jeffrey Gao	Neutral	HKD	11.70	12.14	3.8	8,798	4.7	6%	-1%	6%	8.1	8.2	7.8	1.2	1.0	0.9	2.3%	2.5%	2.7%
119 HK	Poly Property Group	Elly Chen	Neutral	HKD	2.53	2.44	-3.6	1,195	4.8	-89%	294%	24%	45.4	11.5	9.3	0.3	0.3	0.3	3.0%	2.6%	3.2%
813 HK	Shimao Property	Elly Chen	Buy	HKD	13.80	15.77	14.3	6,183	11.6	8%	3%	8%	5.1	4.9	4.5	0.9	0.7	0.7	6.1%	6.4%	7.2%
272 HK	Shui On Land	Jeffrey Gao	Buy	HKD	2.15	2.10	-2.3	2,227	3.5	-64%	808%	-61%	32.0	3.5	9.0	0.3	0.3	0.3	2.7%	2.8%	2.8%
3377 HK	Sino-Ocean	Jeffrey Gao	Buy	HKD	4.93	5.58	13.2	4,778	29.1	-4%	-2%	14%	9.2	9.3	8.1	0.8	0.7	0.7	4.7%	4.6%	5.2%
410 HK	SOHO China	Stephen Cheung	Neutral	HKD	3.71	4.04	8.9	2,489	5.8	-62%	-49%	7%	9.1	17.7	16.6	0.4	0.4	0.3	8.0%	3.1%	3.3%
1918 HK	Sunac China	Jeffrey Gao	Buy	HKD	5.90	10.52	78.3	2,588	8.7	4%	3%	12%	4.4	4.3	3.9	1.0	0.9	0.7	3.9%	4.8%	6.1%
3699 HK	Wanda Commercial	Jeffrey Gao	Buy	HKD	45.10	75.90	68.3	26,345	14.2	12%	9%	24%	9.7	8.9	7.2	1.1	1.0	0.9	3.0%	3.4%	4.2%
YLLG SP	Yanlord Land	Stephen Cheung	Reduce	SGD	1.01	0.91	-9.9	1,393	0.8	-43%	74%	36%	13.7	7.9	5.8	0.5	0.4	0.4	1.4%	1.9%	2.6%
	Property developer - average									**-24%**	**71%**	**12%**	**10.6**	**7.4**	**6.7**	**0.9**	**0.8**	**0.7**	**4.6%**	**4.1%**	**4.7%**
	Property developer - median									**-1%**	**9%**	**12%**	**8.1**	**6.3**	**6.1**	**0.8**	**0.7**	**0.6**	**4.1%**	**3.7%**	**4.2%**
000002 CH	China Vanke #	Jeffrey Gao	Buy	CNY	24.43	18.43	-24.6	40,482	288.5	3%	14%	15%	17.3	15.1	13.2	3.1	2.7	2.4	2.1%	2.3%	2.7%
600383 CH	Gemdale Corp *	Elly Chen	Neutral	CNY	14.50	12.09	-16.6	10,053	70.0	60%	11%	13%	18.7	16.9	14.9	2.1	1.9	1.7	0.9%	0.9%	1.0%
600048 CH	Poly Real Estate Group	Jeffrey Gao	Buy	CNY	10.85	11.53	6.3	17,981	250.0	-25%	15%	14%	9.7	8.4	7.3	1.9	1.6	1.4	2.0%	2.4%	2.7%
600823 CH	Shanghai Shimao	Elly Chen	Neutral	CNY	12.42	11.00	-11.4	3,663	24.3	4%	10%	-3%	10.3	9.3	9.6	0.9	1.2	1.1	1.4%	1.6%	1.6%
	Property developer A - average									**10%**	**13%**	**10%**	**14.0**	**12.4**	**11.3**	**2.0**	**1.9**	**1.6**	**1.6%**	**1.8%**	**2.0%**
	Property developer A - median									**3%**	**13%**	**14%**	**13.8**	**12.2**	**11.4**	**2.0**	**1.7**	**1.5**	**1.7%**	**2.0%**	**2.1%**

Note: Share prices as of 30 December 2016; * TP is under review; # the stock is under suspension.

Source: Bloomberg, Nomura estimates

Internet, technology & telecom services

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NOMURA

Internet & new media

EQUITY STRATEGY

Outlook 2016: With easy funding gone…

…back to driving profitable growth

Global Markets Research

5 January 2016

Anchor themes

We believe 2016 will see continued migration to mobile. In addition, the reduced availability of private capital has sparked consolidation and reduced promotional activities in the sector, which should usher in a period of more profitable growth.

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Three important trends to watch out for in 2016

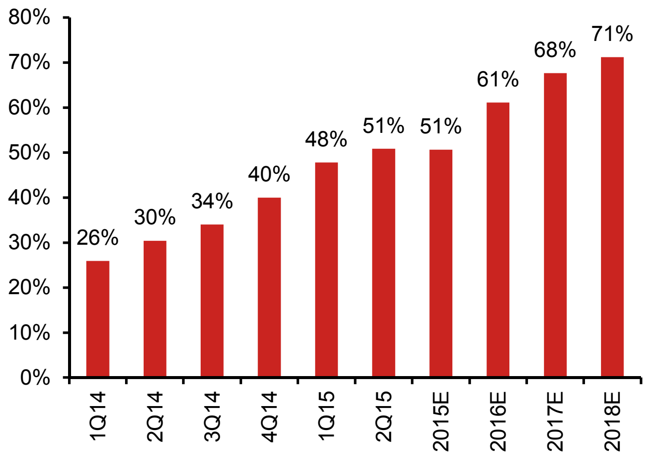
- **Accelerating mobile migration in 2016.** Across the sub-sectors we cover, we expect an increase in the proportion of revenue or traffic derived from mobile. We forecast that, within e-commerce, online shopping on mobile will comprise 61%+ of total shopping GMV in 2016F (see figure on next page). Similarly, we project that more than half of the industry revenues in search (57%) and video (59%) will come from mobile channels in FY16F. Going forward, we see more differentiated mobile offerings, such as through WeChat shops built into a micro-App or through enhanced Location Based Services.
- **Less easy funding: more rational competition.** In our view, less easy capital means enterprises will need to refocus on profitability vs. just user growth or activity. This means reduced competition and less aggressive pricing. Spending on advertising, subsidies and promotions may decline, especially in verticals such as O2O. This means the ad environment will become increasingly difficult. For search, declining ROIs caused by a rising cost-per-click (CPC) on mobile may hurt advertising budgets allocated to search engines.
- **Less easy funding: more M&As and market share consolidation.** In 2015, some verticals saw M&A deals within them: transportation (Didi-Kuadi), OTA (Ctrip-Qunar), classifieds (Wuba-Ganji) and O2O (Meituan-Dianping). In 2016, we anticipate large platforms seeking to round-out their ecosystems may pursue acquisitions across verticals. We believe that listed K-12 companies in the education sector will benefit from consolidation and high brand recognition as they expand into lower-tier cities.

Stock recommendations – Tencent and Alibaba

Our 2016 assessments above bode well for on e-commerce, but not so well for advertising or search. Online video will remain competitive, although usage of subscription-based models may provide added revenue.

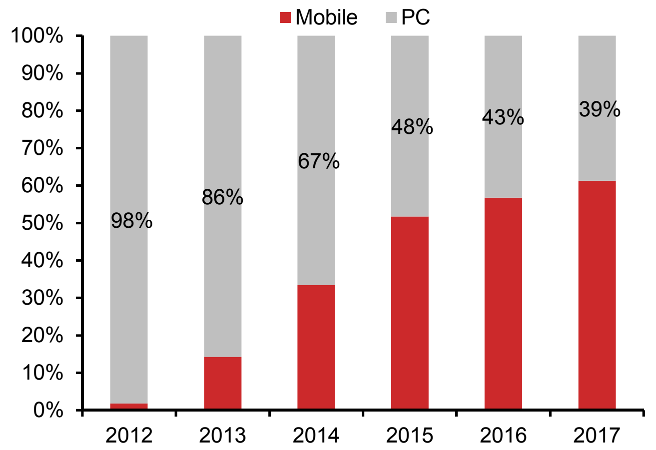
- **Tencent (700 HK, Buy, TP: HKD170.0):** Online ad growth should accelerate as Official Accounts and Moments ads revenue grow. We also see renewed mobile game growth, off a low base, in 1H15.
- **Alibaba (BABA US, Buy, TP: USD95.0):** We think PC monetisation appears to be bottoming out, while mobile monetisation remains on an uptrend.

Fig. 167: Mobile shopping as % of GMV



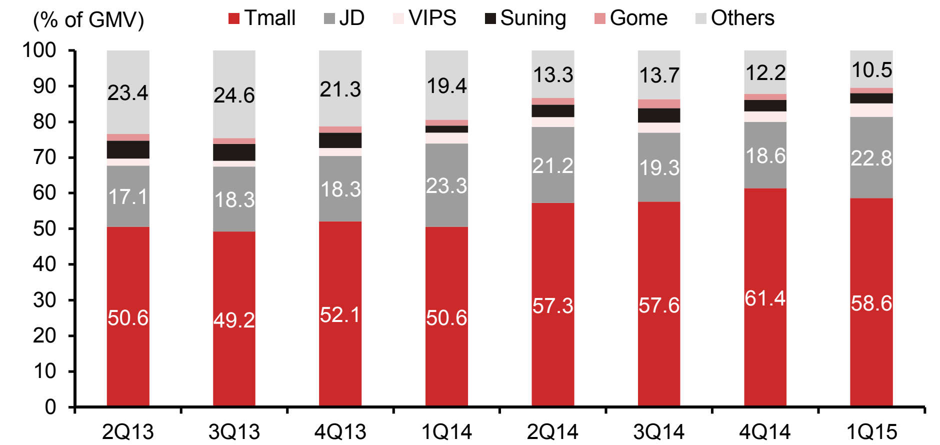
Source: iResearch

Fig. 168: Search revenue split between mobile and PC



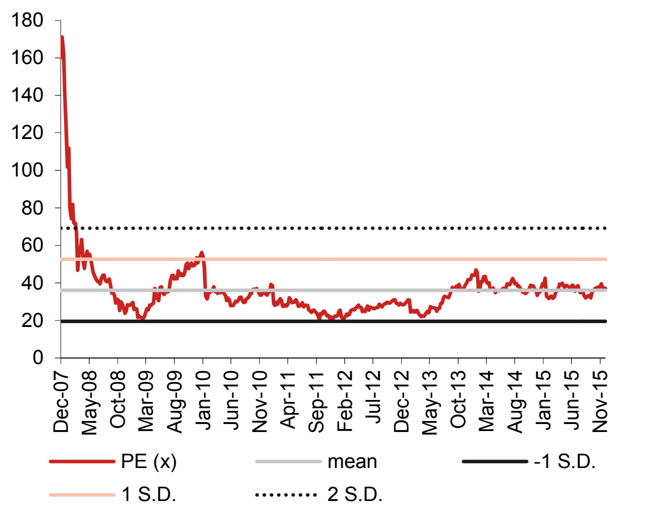
Source: Nomura estimates

Fig. 169: In the B2C market, both Tmall and JD have been gaining market share at the expense of smaller companies



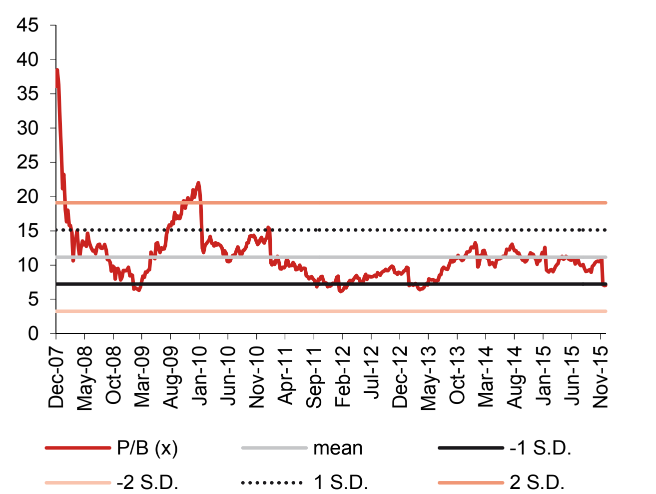
Source: iResearch

Fig. 170: MSCI China internet software & services: 1Yr forward P/E



Source: IBES, Datastream, Nomura research

Fig. 171: MSCI China internet software & services: 1Yr forward P/B



Source: IBES, Datastream, Nomura research

Fig. 172: China internet valuation table

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth			Normalised P/E (x)			P/B (x)			Dividend yield (%)		
										FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
	Internet																				
BABA US	Alibaba Group	Andrew Orchard	Buy	USD	81.68	95.00	16.3	202,232	1457.6	173%	33%	20%	47.1	35.4	29.4	31.2	8.5	5.4	n/a	n/a	n/a
BIDU US	Baidu	Andrew Orchard	Buy	USD	192.13	200.00	4.1	66,405	798.6	28%	-9%	32%	31.0	34.2	25.9	8.5	6.8	5.3	n/a	n/a	n/a
JD US	JD.com	Andrew Orchard	Neutral	USD	32.08	27.00	-15.8	44,381	324.0	-677%	-91%	1020%	n/a	n/a	166.0	7.6	7.5	7.1	n/a	n/a	n/a
QIHU US	Qihoo	Andrew Orchard	Buy	USD	72.66	65.00	-10.5	9,369	124.0	40%	27%	35%	28.2	22.2	16.5	8.8	6.2	4.5	n/a	n/a	n/a
700 HK	Tencent	Andrew Orchard	Buy	HKD	150.70	170.00	12.8	182,825	308.8	52%	24%	33%	45.5	36.8	27.6	14.6	10.5	7.7	0.2%	n/a	n/a
VIPS US	VIPSHOP	Andrew Orchard	Buy	USD	15.19	18.00	18.5	8,835	205.1	197%	68%	27%	45.5	27.1	21.4	21.5	11.8	7.6	n/a	n/a	n/a
	Average									**-31%**	**9%**	**194%**	**39.5**	**31.1**	**47.8**	**15.3**	**8.5**	**6.3**	**0.2%**	**n/a**	**n/a**
	Median									**46%**	**25%**	**33%**	**45.5**	**34.2**	**26.7**	**11.7**	**8.0**	**6.3**	**0.2%**	**n/a**	**n/a**

Note: Price as of 30 December 2015; we are reviewing our target prices for JD.com and Qihoo.

Source: Bloomberg, Nomura estimates

NOMURA

Technology

EQUITY STRATEGY

Outlook 2016: EV, semi, security systems

China's high-tech ambitions

Global Markets Research

5 January 2016

Anchor themes

Investing in the China technology sector is a key focus of the China government, to promote: 1) innovation and 2) domestic substitution of imported products. We believe this theme is positive for strategic sectors inclding electric vehicles and semiconductors.

Three important trends to watch out for in 2016

- **Smart and electric vehicles: EV market finally taking off; risk of battery oversupply.** We expect China's electric vehicle (EV) and battery market to maintain solid growth in 2016F, driven by the government's strong support to reduce air pollution and lower dependence on oil imports. Our research shows that China has become the largest EV market globally in 2015 (68% of global consumption), with 82% of EV batteries used in buses. We expect the China EV market to continue to grow at 82% y-y in volume terms or 50% y-y in revenue terms in 2016F, and maintain a 48% volume CAGR through 2020F. On the supply side, we note that global and local lithium battery suppliers are aggressively expanding production capacity in China; hence we see risks of EV battery oversupply in 2H16F. We prefer EV OEMs, EV motors, ADAS component suppliers and battery raw materials in the EV value chain, and we believe that battery suppliers, with better technology (eg, BYD) and a strong customer base should stand out.
- **China semiconductor: Improving eco-system on market, capital and talent pool.** We expect China's semiconductor industry growth to accelerate in 2016F on: 1) rising demand (domestic IC design players Hisilicon and SPRD have risen to No. 6 and 10 in terms of global revenue), 2) strong capital support (the government and private sector have already pooled a USD35bn IC industrial fund), and 3) a large talent pool in the greater China area. We prefer SMIC as the best proxy to this theme, given its leading position as the 'national champion' in foundries.
- **Security systems: Rising government spend against terrorism.** In the electronics space, we expect strong growth in security systems in line with rising government spending against terrorism. With continued R&D investment, we think Hikvision has become a global leader in this space, and we expect it to benefit from surging global demand.

Stock recommendations: BYD, SMIC and Hikvision

- **BYD (1211 HK, Buy, HKD64.0 TP):** We like BYD in the EV and battery space, given its: 1) complete EV product portfolio in the growing China market, 2) migration in battery technology from lithium iron phosphate (LFP) to nickel manganese cobalt (NMC) to improve energy density, and 3) battery capacity expansion to resolve bottlenecks in EV ramp-up as well as consolidation in battery components to control costs.
- **SMIC (981 HK, Buy, HKD1.1 TP):** We prefer SMIC in the semiconductor space for its prudent corporate strategy to focus on internationalisation and independence during expansion.
- **Hikvision (002415 CH, Buy, HKD58.0 TP):** We expect Hikvision's overseas business to maintain higher than 50% y-y growth in 2016F on rising capex in security systems globally. We also like its initiatives in new frontiers such as door opening technology, industrial drones and machine vision.

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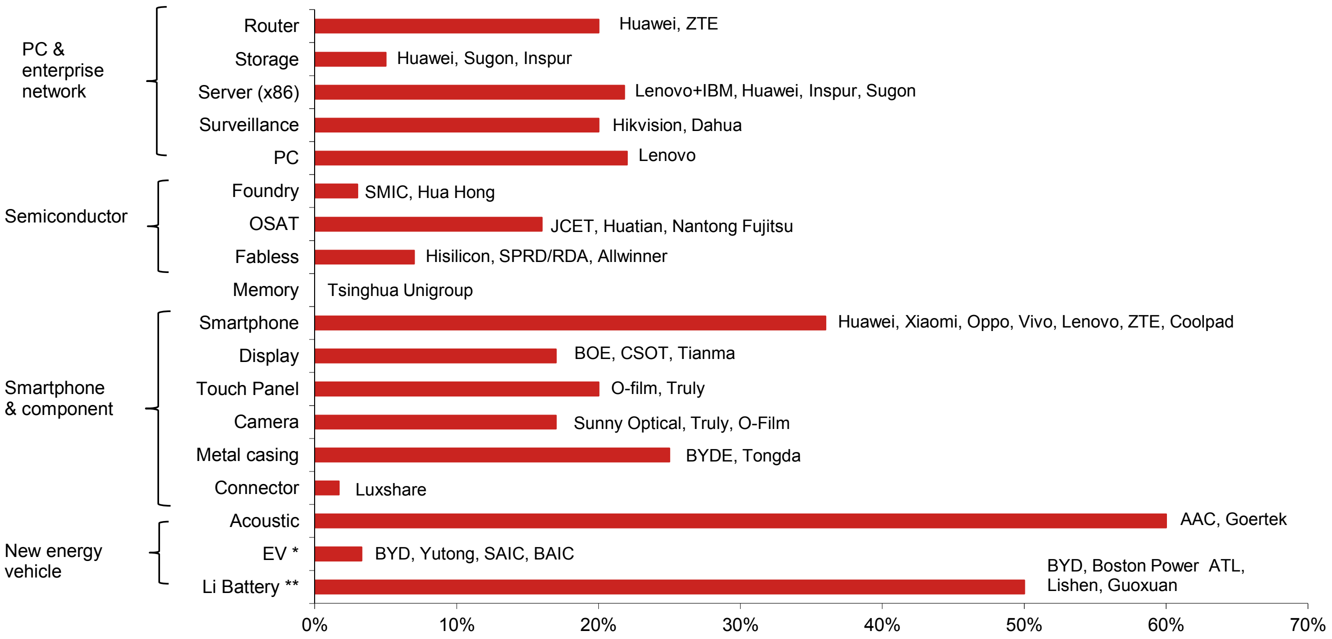
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Fig. 173: China vendor market share in global technology sub-sectors

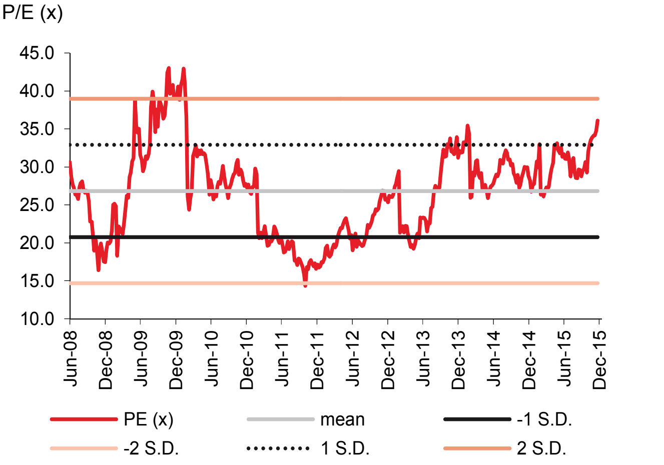


Note: * EV includes hybrid EV, pure EV, PH EV;

** Li Battery is shipment market share = (China pure + PH EV shipment)/Global pure + PH EV shipment

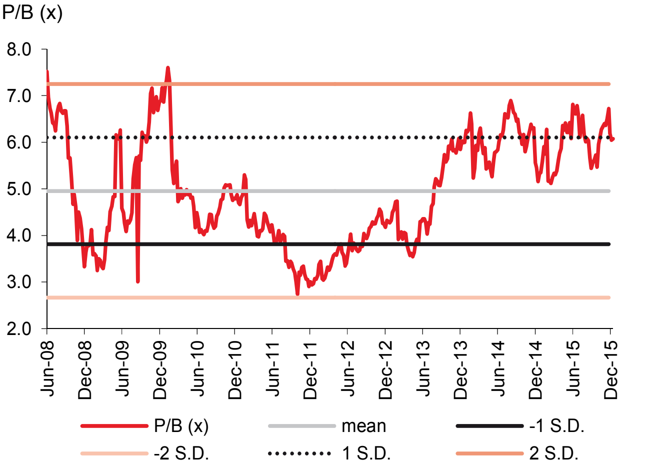
Source: Gartner, Nomura estimates

Fig. 174: MSCI China Technology: 1Yr forward P/E



Source: IBES, Datastream, Nomura research

Fig. 175: MSCI China Technology: 1Yr forward P/B



Source: IBES, Datastream, Nomura research

Fig. 176: China Technology valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth FY14	FY15	FY16	Normalised P/E (x) FY14	FY15	FY16	P/B (x) FY14	FY15	FY16	Dividend yield (%) FY14	FY15	FY16
	Technology																				
1211 HK	BYD	Leping Huang	Buy	HKD	43.65	64.00	46.6	21,028	41.9	-24%	197%	86%	204.5	68.8	37.0	3.6	2.3	2.2	n/a	n/a	n/a
285 HK	BYD Electronic	Leping Huang	Buy	HKD	4.15	5.80	39.8	1,206	3.7	39%	5%	17%	8.7	8.3	7.1	0.8	0.7	0.7	n/a	1.2%	1.4%
861 HK	Digital China	Leping Huang	Buy	HKD	8.85	13.50	52.5	1,252	6.8	734%	-56%	23%	13.8	31.1	25.2	1.1	1.8	1.7	2.2%	36.2%	1.2%
1347 HK	Hua Hong Semiconductor	Leping Huang	Buy	HKD	7.59	13.60	79.2	1,012	1.1	45%	-26%	-19%	8.8	11.9	14.6	0.7	0.6	0.6	n/a	1.5%	2.9%
992 HK	Lenovo Group	Leping Huang	Buy	HKD	7.89	11.50	45.8	11,309	45.0	29%	20%	9%	13.0	10.9	10.0	3.4	2.8	2.9	3.0%	3.4%	n/a
751 HK	Skyworth	Leping Huang	Buy	HKD	5.07	8.00	57.8	1,908	11.0	-18%	37%	4%	11.2	8.1	7.8	1.3	1.0	1.0	3.4%	3.9%	2.3%
981 HK	SMIC	Leping Huang	Buy	HKD	0.79	1.10	39.2	4,289	17.9	-11%	65%	6%	23.1	14.0	13.3	1.2	1.0	0.8	n/a	n/a	n/a
2382 HK	Sunny Optical *	Leping Huang	Buy	HKD	18.02	17.60	-2.3	2,551	8.5	29%	27%	31%	29.2	22.9	17.6	5.0	4.3	3.6	1.0%	1.3%	1.7%
	Technology - average									**103%**	**34%**	**20%**	**39.0**	**22.0**	**16.6**	**2.1**	**1.8**	**1.7**	**2.4%**	**7.9%**	**1.9%**
	Technology - median									**29%**	**24%**	**13%**	**13.4**	**12.9**	**13.9**	**1.3**	**1.4**	**1.3**	**2.6%**	**2.4%**	**1.7%**
002594 CH	BYD - A	Leping Huang	Neutral	CNY	66.00	69.00	4.5	21,028	211.7	-24%	220%	73%	369.2	115.3	66.7	6.4	4.2	4.0	n/a	n/a	n/a
002236 CH	Dahua Technology	Leping Huang	Buy	CNY	37.89	39.00	2.9	6,772	78.9	1%	-17%	59%	37.6	45.1	28.3	8.2	7.1	5.8	n/a	0.2%	0.4%
002415 CH	Hikvision	Leping Huang	Buy	CNY	34.95	58.00	66.0	21,911	125.1	52%	39%	42%	30.1	21.6	15.2	9.4	7.1	5.2	1.2%	1.5%	2.2%
002475 CH	Luxshare Precision	Leping Huang	Buy	CNY	31.55	36.00	14.1	6,113	33.1	22%	48%	49%	62.5	42.2	28.3	7.9	7.3	5.9	0.2%	0.3%	0.4%
002456 CH	O-film	Leping Huang	Buy	CNY	33.30	35.00	5.1	5,288	153.5	14%	64%	38%	46.8	28.6	20.7	8.9	7.1	5.5	0.3%	0.5%	0.8%
	Technology - A - average									**13%**	**71%**	**52%**	**109.2**	**50.5**	**31.8**	**8.2**	**6.6**	**5.3**	**0.5%**	**0.6%**	**0.9%**
	Technology - A - median									**14%**	**48%**	**49%**	**46.8**	**42.2**	**28.3**	**8.2**	**7.1**	**5.5**	**0.3%**	**0.4%**	**0.6%**

Note: Share price as of 30 December 2015; * Target price is under review.

Source: Bloomberg, Nomura estimates

NOMURA

Telecoms

EQUITY STRATEGY

2016 Outlook: Will China Uni-Tel catch up?

Merger pressure to intensify competition

Global Markets Research

5 January 2016

Anchor themes

As TowerCo will help CU and CT in resolving the bottlenecks in 4G, we expect an aggressive 4G network roll-out plan for CU and CT in 2016 while we expect CM to roll out its fixed line broadband infrastructure. Hence, we believe CM will enhance its market position as an intergrated operator while CU should regain momentum in/beyond 2H16 when it builds up a competitive 4G network.

Three important trends to watch out for in 2016

- **Merger pressure to push cooperation between CU/CT in 4G:** We see a clear acceleration of cooperation between China Unicom (CU) and China Telecom (CT) in recent weeks including unifying smartphone sourcing requirements, sharing 4G base station, data center and transmission resources. Although CT+CU is still smaller than China Mobile (CM) in mobile revenue (43%) and subscriber (59%), we believe the collaboration provides an opportunity for them to catch up with CM in terms of 4G network operation in 2016.
- **CM to accelerate fixed line capex.** After acquiring 100% assets of China Railcom in November 2015, we expect CM to accelerate fixed line broadband spending in 2016, especially for enterprise customers, and we think this will intensify the competition.
- **Data growth to offset tariff reduction 2016**. During 2015, we estimate that all of the three telco players have reduced their data tariff by more than 30% in response to Premier Li Keqiang's talk in May. Going forward, we expect that data tariff will continue to be under pressure not only because of regulatory requirements but also because competition may intensify as CU/CT complete their 4G network. However, we expect this may be partially offset by the strong growth in data usage per subscriber (DOU). As of 3Q15, industry DOU has reached 286MB per sub in contrast to only 140MB per sub one year ago, up 104% y-y.

Stock Recommendations – preference is CU, CM followed by CT

- **China Unicom (762 HK, Buy, TP: HKD12):** We recommend CU for its momentum (eg, ARPU, subscribers, etc.) recovery in/beyond 2H16 after it builds up a competitive 4G network and launches its "Wo 4G+" Brand. We expect CU to be the major beneficiary from the resource co-sharing scheme with CT. CU has underperformed CM and CT both financially and operationally in 2015. We think the TowerCo has come to CU's rescue to resolve its bottlenecks in deploying the 4G network.
- **China Mobile (941 HK, Buy, TP: HKD130):** We recommend CM for its structural growth opportunity in 4G and ability to provide full service including broadband. CM has seen increases in monthly data usage per subscriber (DOU), and we expect CM to retain its leadership in 4Q, despite recent negatives in terms of data carry-over plan (ie declining data tariff) and tower asset transfer (ie rising tower-leasing expenses).
- **China Telecom (728 HK, Neutral, TP: HKD4.2):** While China Telecom (CT) faces a similar situation as CU and the TowerCo should resolve the bottlenecks it faced in deploying 4G networks, and it is also likely to benefit from the co-sharing scheme with CU, we expect CT to face earnings pressure in 2016 on to rising opex and depreciation should it raise capex to fund aggressive 4G network roll-out. We believe that cooperation with CU may not significantly impact its market share until 2H16.

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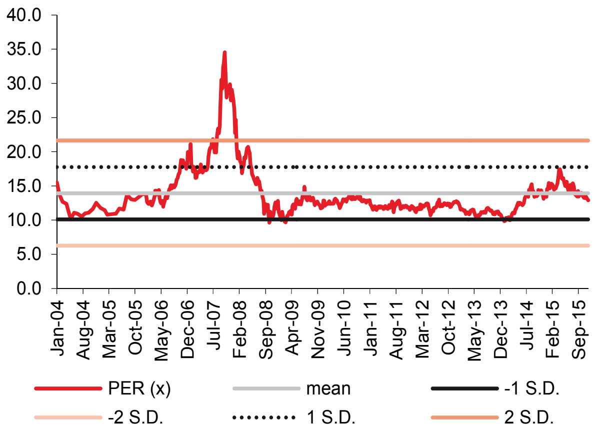
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Fig. 177: MSCI China Telecom: 1Yr forward P/E

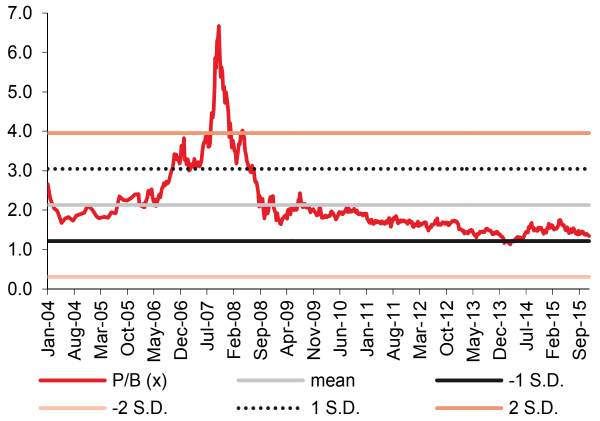
P/E (x)



Source: IBES, Datastream, Nomura research

Fig. 178: MSCI China Telecom: 1Yr forward P/B

P/B (x)



Source: IBES, Datastream, Nomura research

Fig. 179: China telecom valuation

Ticker	Company name	Analyst name	Rating	Currency	30-Dec-15 Share price	Target price	Upside/ (downside) (%)	Mktcap (US$m)	3mth avg daily T/O (US$m)	Normalised EPS growth FY14	FY15	FY16	Normalised P/E (x) FY14	FY15	FY16	P/B (x) FY14	FY15	FY16	Dividend yield (%) FY14	FY15	FY16
	Telecoms & Telecom equipment																				
552 HK	China Communications Services	Leping Huang	Buy	HKD	2.92	4.35	49.0	2,609	2.9	-4%	4%	7%	7.9	7.6	7.1	0.7	0.7	0.6	3.8%	4.0%	4.2%
941 HK	China Mobile	Leping Huang	Buy	HKD	87.35	130.00	48.8	230,767	183.8	-26%	5%	5%	13.6	12.9	12.4	1.7	1.6	1.5	3.2%	3.3%	3.5%
728 HK	China Telecom	Leping Huang	Neutral	HKD	3.65	4.20	15.1	38,115	34.4	1%	1%	12%	14.0	13.8	12.3	0.9	0.8	0.8	2.5%	2.5%	2.8%
762 HK	China Unicom	Leping Huang	Buy	HKD	9.44	12.00	27.1	29,168	64.4	15%	-4%	-5%	15.6	16.2	17.1	0.8	0.8	0.8	2.5%	2.6%	2.1%
2618 HK	TCL Communication Tech	Leping Huang	Buy	HKD	5.74	8.00	39.4	936	0.9	233%	4%	3%	6.3	6.0	5.9	1.7	1.5	1.3	6.7%	5.7%	5.9%
763 HK	ZTE Corp	Leping Huang	Buy	HKD	17.26	25.00	44.8	11,625	9.9	94%	34%	25%	22.6	16.9	13.5	2.4	2.2	1.9	1.2%	1.5%	1.9%
	Telecoms & Telecom equipment - average									**52%**	**7%**	**8%**	**13.3**	**12.2**	**11.4**	**1.4**	**1.3**	**1.2**	**3.3%**	**3.3%**	**3.4%**
600050 CH	China Unicom - A	Leping Huang	Reduce	CNY	6.32	6.20	-1.9	20,641	161.5	16%	16%	19%	33.6	29.0	24.4	1.7	1.7	1.6	3.2%	1.1%	1.4%
000063 CH	ZTE Corp - A	Leping Huang	Buy	CNY	19.15	22.50	17.5	11,625	183.6	94%	34%	25%	30.0	22.4	17.9	3.2	2.9	2.6	0.9%	1.2%	1.5%
	Telecoms & Telecom equipment: A - average									**55%**	**25%**	**22%**	**31.8**	**25.7**	**21.1**	**2.5**	**2.3**	**2.1**	**2.0%**	**1.2%**	**1.4%**

Note: Share price as of 30 December 2015

Source: Bloomberg, Nomura estimates

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Appendix A-1

Analyst Certification

I, Wendy Liu, hereby certify (1) that the views expressed in this Research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of my compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Issuer Specific Regulatory Disclosures

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Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Previous rating	Date of change	Sector rating
Han's Laser Technology Industry	002008 CH	CNY 23.33	04-Jan-2016	Buy	Not Rated	20-Aug-2015	N/A
Hikvision	002415 CH	CNY 31.24	04-Jan-2016	Buy	Not Rated	01-Jun-2015	N/A
Wanda Cinema	002739 CH	CNY 108.00	04-Jan-2016	Reduce	Buy	28-Oct-2015	N/A
China Resources Land	1109 HK	HKD 21.55	04-Jan-2016	Buy	Not Rated	07-Jan-2014	N/A
Brilliance China	1114 HK	HKD 9.09	04-Jan-2016	Buy	Neutral	16-Jan-2015	N/A
Zoomlion Heavy Industry	1157 HK	HKD 2.78	04-Jan-2016	Buy	Neutral	17-Jun-2015	N/A
BYD	1211 HK	HKD 41.25	04-Jan-2016	Buy	Neutral	19-Apr-2013	N/A
New China Life	1336 HK	HKD 31.30	04-Jan-2016	Buy	Not Rated	01-Sep-2015	N/A
China Cinda Asset Management	1359 HK	HKD 2.75	04-Jan-2016	Buy	Not Rated	21-Sep-2015	N/A
ICBC	1398 HK	HKD 4.52	04-Jan-2016	Buy	Not Rated	15-Apr-2015	N/A
Shenzhen Int'l	152 HK	HKD 14.04	04-Jan-2016	Buy	Not Rated	22-Apr-2015	N/A
Geely Automobile	175 HK	HKD 3.99	04-Jan-2016	Buy	Neutral	09-Jul-2014	N/A
CRRC	1766 HK	HKD 9.08	04-Jan-2016	Buy	Reduce	08-Jul-2015	N/A
KWG Properties	1813 HK	HKD 5.55	04-Jan-2016	Buy	Not Rated	18-Feb-2014	N/A
Intime Retail (Group)	1833 HK	HKD 7.34	04-Jan-2016	Buy	Reduce	07-Jul-2015	N/A
Prada SpA	1913 HK	HKD 23.95	04-Jan-2016	Reduce	Neutral	03-Apr-2014	Neutral
Sands China	1928 HK	HKD 25.75	04-Jan-2016	Buy	Neutral	24-Aug-2015	N/A
IMAX China	1970 HK	HKD 53.50	04-Jan-2016	Neutral	Buy	14-Dec-2015	N/A
Ping An	2318 HK	HKD 40.85	04-Jan-2016	Buy	Not Rated	01-Sep-2015	N/A
Great Wall Motor	2333 HK	HKD 8.57	04-Jan-2016	Neutral	Buy	13-Oct-2015	N/A
Weichai Power	2338 HK	HKD 8.08	04-Jan-2016	Buy	Not Rated	17-Jun-2015	N/A
BOC Hong Kong	2388 HK	HKD 23.15	04-Jan-2016	Buy	Not Rated	06-Oct-2015	N/A
China Pacific	2601 HK	HKD 30.05	04-Jan-2016	Buy	Not Rated	01-Sep-2015	N/A
China Life Insurance	2628 HK	HKD 23.80	04-Jan-2016	Buy	Not Rated	01-Sep-2015	N/A
Siasun Robot & Automation	300024 CH	CNY 61.77	04-Jan-2016	Reduce	Not Rated	20-Aug-2015	N/A
Beijing Enlight Media	300251 CH	CNY 27.31	04-Jan-2016	Reduce	Not Rated	07-Sep-2015	N/A
Greenland Hong Kong Holdings	337 HK	HKD 2.82	04-Jan-2016	Buy	Not Rated	13-May-2015	N/A
Sinopec Shanghai Petrochemical	338 HK	HKD 2.89	04-Jan-2016	Buy	Not Rated	24-Sep-2015	N/A
Fuyao Glass	3606 HK	HKD 17.96	04-Jan-2016	Buy	Not Rated	06-Jul-2015	N/A
Chongqing Rural Comm. Bank	3618 HK	HKD 4.58	04-Jan-2016	Buy	Not Rated	03-Nov-2015	N/A
Dalian Wanda Comm. Properties	3699 HK	HKD 43.25	04-Jan-2016	Buy	Not Rated	26-Jan-2015	N/A
Sinopec	386 HK	HKD 4.53	04-Jan-2016	Buy	Rating Suspended	25-Sep-2013	N/A
Minth Group	425 HK	HKD 14.94	04-Jan-2016	Buy	Not Rated	13-Jan-2014	N/A
Dongfeng Motor	489 HK	HKD 10.08	04-Jan-2016	Buy	Neutral	28-Aug-2015	N/A
Sinotrans	598 HK	HKD 4.08	04-Jan-2016	Buy	Neutral	19-Aug-2015	N/A
Shanghai Jahwa	600315 CH	CNY 36.66	04-Jan-2016	Buy	Not Rated	12-May-2015	N/A
China Pacific	601601 CH	CNY 27.20	04-Jan-2016	Buy	Not Rated	01-Sep-2015	N/A
China Life Insurance	601628 CH	CNY 26.27	04-Jan-2016	Buy	Not Rated	01-Sep-2015	N/A
Kerry Logistics	636 HK	HKD 11.34	04-Jan-2016	Buy	Not Rated	22-Apr-2015	N/A
China Overseas Land & Inv	688 HK	HKD 25.80	04-Jan-2016	Buy	Not Rated	07-Jan-2014	N/A
Huatai Securities	6886 HK	HKD 17.38	04-Jan-2016	Buy	Not Rated	02-Jul-2015	N/A
Tencent Holdings	700 HK	HKD 149.10	04-Jan-2016	Buy	Not Rated	05-Mar-2014	N/A
China Telecom	728 HK	HKD 3.51	04-Jan-2016	Neutral	Buy	08-Jan-2014	N/A
China Unicom	762 HK	HKD 9.23	04-Jan-2016	Buy	Neutral	11-Feb-2010	N/A
ZTE Corp	763 HK	HKD 16.94	04-Jan-2016	Buy	Neutral	26-Oct-2012	N/A
PetroChina	857 HK	HKD 5.02	04-Jan-2016	Buy	Rating Suspended	25-Sep-2013	N/A
China Construction Bank	939 HK	HKD 5.15	04-Jan-2016	Buy	Not Rated	15-Apr-2015	N/A
China Mobile	941 HK	HKD 85.10	04-Jan-2016	Buy	Neutral	03-Jun-2014	N/A
L'Occitane	973 HK	HKD 14.90	04-Jan-2016	Neutral	Buy	28-Oct-2015	N/A
SMIC	981 HK	HKD 0.77	04-Jan-2016	Buy	Neutral	16-Sep-2014	N/A
Alibaba Group Holding	BABA US	USD 81.27	31-Dec-2015	Buy	Not Rated	29-Oct-2014	N/A
Nestlé R	NESN VX	CHF 74.55	30-Dec-2015	Buy	Reduce	14-Sep-2015	Bearish
NIKE, Inc.	NKE US	USD 62.50	31-Dec-2015	Buy	Not Rated	12-Feb-2014	Neutral
VIPSHOP	VIPS US	USD 15.27	31-Dec-2015	Buy	Not Rated	05-Mar-2014	N/A
TAL Education	XRS US	USD 46.47	31-Dec-2015	Buy	Not Rated	04-Sep-2015	N/A

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