19 October 2009

China Macro Strategy

From Cyclicality to Sustainability

As part of our 2010 strategy, we suggest that investors increase their exposure to companies that benefit from accelerating consumption growth. Our favorite subsectors include insurance, diaper, packaging, on-line travel, health care, PC distribution, juice and motorcycle.

Related recent research	Date
Inflation to surprise on upside by mid 2010	7 Sep 2009
Further upside to exports	20 Aug 2009
Exports to outperform FAI in next 12 months	29 Jun 2009

2009: A year to play cyclicals: the equity market has experienced the sequential recoveries of the most cyclical sectors – FAI and exports since late 2008:

- **FAI recovery (1H this year):** driven by extremely frontloaded policy stimulus, FAI growth accelerated to 39% y-o-y in May this year, up from 24% in January-February. From October 2008 to July 2009, the share prices of steel companies (the representative FAI play) rose 240%. Since then, these names have fallen 20% as FAI began to decelerate.
- **Export recovery (2H this year)**: Exports began to show a strong sequential recovery in June. As a result, the share price of export-related names significantly outperformed MSCI China. We would not be surprised to see another 20% share price upside to export-related names, but also think the export recovery will be largely priced in during the next 2-3 months as sequential export growth peaks.

2010: Switching to sustainable growth. Looking to 2010, we believe investors should gradually switch to sectors/companies that enjoy sustainable growth in domestic consumer demand. We have selected nine sub-sectors in the broadly defined consumer space, all of which should see accelerating growth in 2010. Positive catalysts include very low penetration rates, social security reform, policy stimulus, and inflation. The specific products/services they provide include **life insurance, diapers, packaging, PC distribution, drug distribution, medical equipment, online travel, juices, and motorcycles.** Based on Deutsche Bank and consensus forecasts, a basket of nine representative companies in these subsectors will likely deliver an EPS CAGR of 28% over the next two years, with a PEG at 0.77 (vs. the PEG of 1.15 for MSCI China consumer index).

Benefits from exposure to these sub-sectors include: 1) accelerating growth in 2010/11; 2) avoiding downside risk of "second dips" in FAI and export growth; 3) potential new policy catalysts that are not yet fully priced in; 4) liquidity support from sector rotations; and 5) lower-than-index volatility.

Two ways to play "sustainability": 1) Buy our "sustainability" basket or selected names within the basket; 2) Pair trade the "sustainability" basket against a "deceleration" basket. Our "deceleration" basket includes companies in telecom, beer, auto, and sportswear, which will likely see both the top-line and bottom-line slowing in coming years. The deceleration basket is trading at a PEG of 2.4x.

This report recommends one or more "pairs trades," involving the simultaneous purchase of one or more securities and sale of one or more other securities. As the name implies, this is a trade idea (not fundamental research) that is only recommended to be executed in its entirety. As such, the buy and sell components of the trade might not align with the analyst's current fundamental research rating on the stocks involved on a stand alone basis

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Table of Contents

From Cyclicality to Sustainability 3
Market rally driven by FAI recovery in 1H09 3
Export recovery dominates 2H09 4
2010: Switching from cyclical recovery to sustainable growth 5

Nine "sustainable growth" stories 8
Life insurance 8
Baby diapers – Hengan International 10
Packaging 13
Pharmaceutical distribution 14
Medical equipment 17
Juices 19
On-line travel 20
PC distribution 22
Motorcycles 24

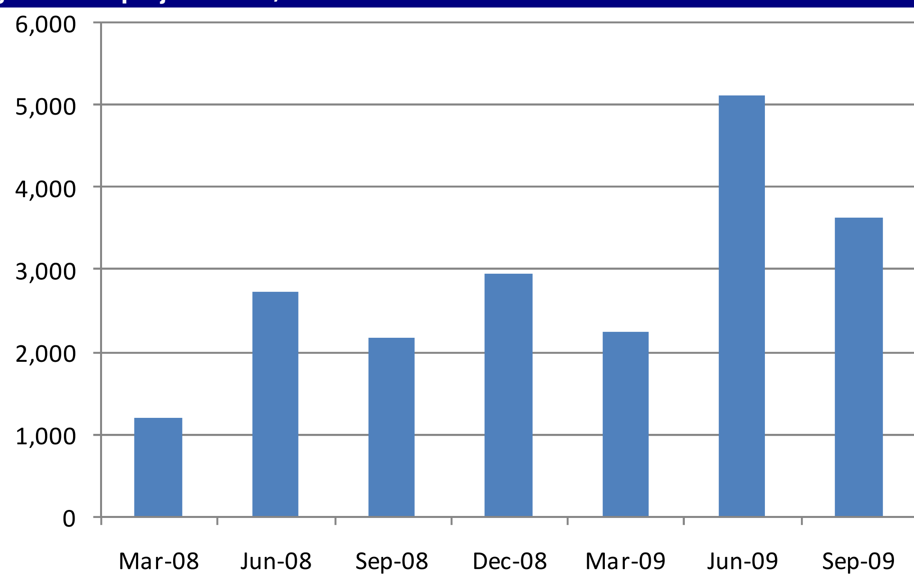
Investment implications 26
A "sustainable growth" basket 26
Why this basket? 27
Buy "sustainability", Sell "deceleration" 28
Update on overall market outlook and strategy 30

From Cyclicality to Sustainability

Market rally driven by FAI recovery in 1H09

The few sectors that enjoyed the best share price performance in between late last year and the middle of this year were mainly driven by the massive sequential growth in fixed asset investment as part of the extremely front-loaded policy stimulus. For example, the share prices of major steel companies[1] rose 240% from October last year to July this year, outperforming MSCI China by a substantial 160% during this period. The macro backdrop is that new FAI project starts surged nearly 100% y-o-y in the first half of this year, and y-o-y FAI growth accelerated from 24% y-o-y in Nov-Dec of 2008 to 39% y-o-y in May this year.

Figure 1: FAI project starts, RMB bn

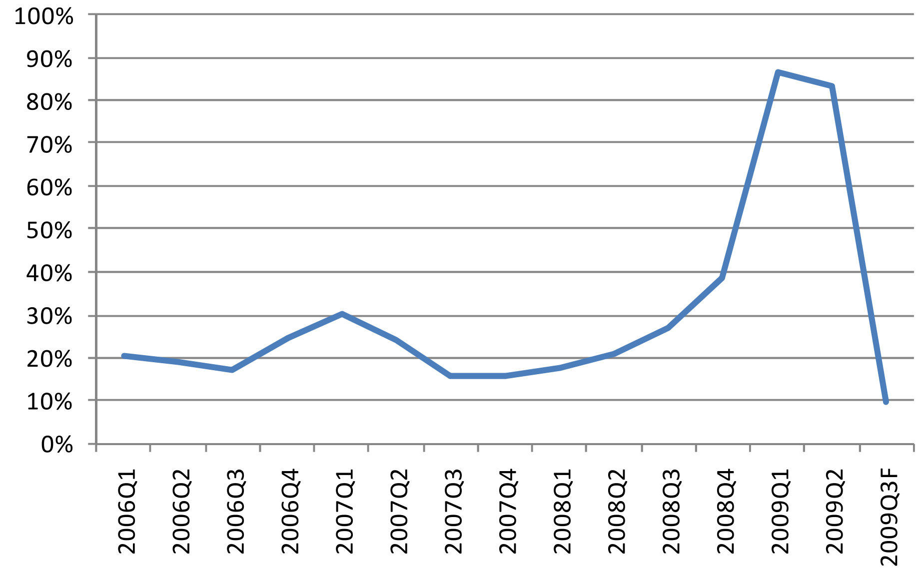


Source: Deutsche Bank, CEIC

However, since 3Q this year, the sequential momentum of real FAI growth has begun to fade. The annualized q-o-q (seasonally adjusted) FAI growth, which is more relevant to equity market performance than y-o-y growth, has decelerated sharply from 87% and 83% in 1Q and 2Q (the historical peak) respectively to only 10% in 3Q. The direct cause of this weakening momentum is that the RMB amount of FAI project starts began to decline both in y-o-y growth and absolute terms from June this year. The policy reason is that most central government sponsored stimulus projects have started by the end of September, in order to complete the spending of the RMB4tn stimulus package by the end of next year. In other words, the design of the stimulus package meant that most of the acceleration in FAI growth would have to be completed in the first half of this year. Recently, the State Council and NDRC have issued a series of notices to stop approving new projects in eight overcapacity sectors, which should also contribute to the deceleration of manufacturing FAI growth in the coming year or so.

[1] Including the five listed Chinese companies with largest market caps: Maanshan Iron(323.HK), Angang Steel(347.HK), Fosun Int'l(656.HK), Baoshan Iron(600019.CH) and Wuhan Iron(600005.cCH)

Figure 2: Annualised q-o-q (seasonally adjusted) real FAI growth peaked in 1H09



Source: Deutsche Bank, CEIC

After reaching its recent peak in July, steel prices begin to decline substantially in August; share prices of the major steel companies have dropped 20% since end-July while the MSCI China index inched up by 4%. Many market participants have noticed that the era of FAI outperforming the broader economy (in terms of sequential growth) has ended.

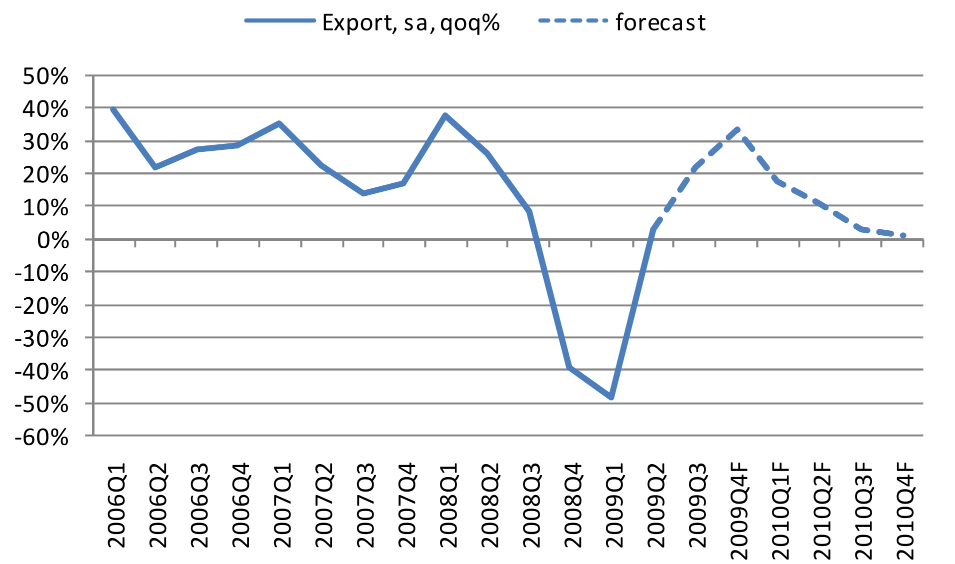
Looking into 2010, we expect nominal FAI growth to continue its deceleration to around 17% y-o-y from this year's estimated 32%. This reflects the "design" (or "nature") of the stimulus program (which involved an 80% rise in government capex in 2009 and less than 20% increase in 2010), as well as the need for further FAI slowdown in the manufacturing and mining sector in light of significant overcapacity. Real estate FAI recovery should offset part of the government and manufacturing FAI deceleration, but it is far from sufficient to sustain the overall FAI growth at the current level. Given this trend, we believe it will be difficult for FAI-related companies (such as steel makers, construction and construction machinery companies) to resume their outperformance next year.

Export recovery dominates 2H09

Our China Strategy published on 29 June – "Exports to outperform FAI in next twelve months" -- highlighted the outlook for export recovery, and forecast its outperformance in 2H this year. Our pair trade involving 'Long export-related sectors/Short investment goods' has delivered an absolute return of 25% since then. The most leveraged export name, China Shipping Container, has risen sharply by 50% since then, and has outperformed MSCI China by about the same magnitude.

Indeed, the most significant macro development over the past four months has been a sequential recovery in the export sector. Although y-o-y growth of exports improved only modestly (from -26% y-o-y in May to -15% in September), the more relevant (to the market) and less distorted measure of annualized q-o-q (seasonally adjusted) export growth has surged to 22% in 3Q, up from -49% in 1Q and 4% in 2Q (see Figure 3).

Figure 3: Annualised q-o-q (seasonally adjusted) export growth will peak in 4Q



Source: Deutsche Bank, CEIC

Our outlook is that China's sequential export growth will peak at about 34% in 4Q this year, which should then be followed by some modest deceleration. This forecast is based on our global economists' view that G3 (and especially the US) will deliver a sharper and earlier-than-expected recovery in the coming quarters. For example, we expect q-o-q US GDP growth to average 4% or above in 3Q and 4Q this year, followed a slowdown to around 3% in 1H next year, and a likely drop in 2H next year. This is because the current three growth drivers (inventory restocking, fiscal stimulus, and consumer) will likely be left with only one pillar (consumer) from 2H next year as inventory levels normalize and fiscal stimulus is withdrawn.

The y-o-y growth rate of Chinese exports, which is a lagging indicator, will likely peak in 2Q next year at 15-20%y-o-y, up massively from 3Q's -20%. In 2H next year, y-o-y growth will likely level off as q-o-q growth falls further. Again, y-o-y growth rates are less relevant to the market, as equity investors tend to react to changes in sequential growth.

The aforementioned export growth profile suggests that the market will likely have discounted the export recovery story towards the end of this year, when sequential growth peaks. Downside risks to the market may appear in 2Q next year, when investors begin to worry about a US-led second dip, which would hurt export sector performance in Asia.

We therefore believe that although the export recovery story is not yet fully priced in – and we would not be surprised to see another 20% upside to share prices of export-related names -- it will lose steam in 2-3 months time. The question for us now – given that FAI-driven companies lost momentum a few months ago, and export-led market recovery will largely run its course within few months – is what will be the theme to play in 2010?

2010: Switching from cyclical recovery to sustainable growth

Both FAI and exports are highly cyclical segments of the Chinese economy, with growth rates easily changing 20-30ppts within a year. Therefore we believe they are great sectors to play in the market when their respective sequential growth accelerates sharply. Looking forward, given that FAI has begun its deceleration, and that export growth will peak soon (sequentially in 4Q this year, y-o-y in 2Q next year), there is limited upside to play these sectors in 2010 and holding exposure to these sectors for too long may become increasingly risky.

Nine "sustainable growth" stories

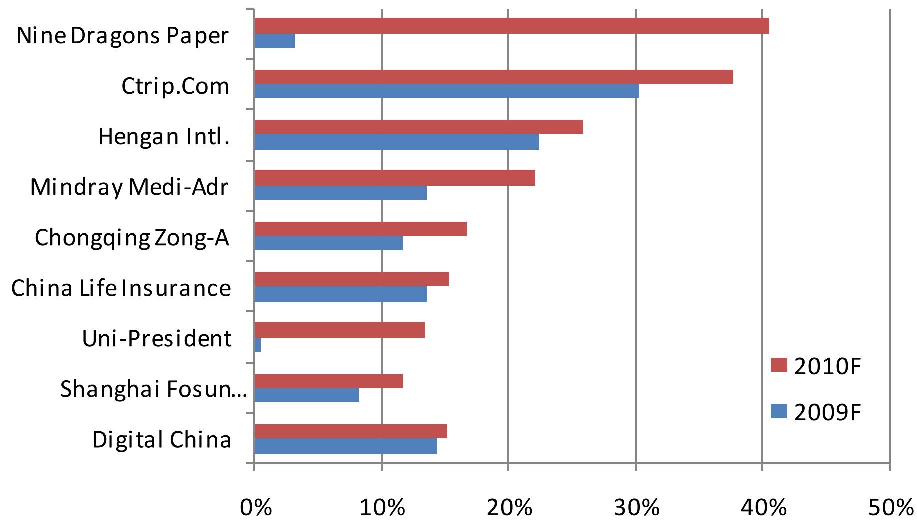
Relative to the very cyclical FAI and export-related sectors, consumption should demonstrate much more resilience in the current business cycle. We expect overall retail sales growth to sustain at 15% next year (same as this year), supported by improved wage growth and rising inflation. And it is possible to identify a number of subsectors within the consumer space that can significantly outperform overall retail sales growth in 2010.

In the rest of this report, we highlight nine sub-sectors in the consumer, insurance, and technology space that should provide the opportunity for investors to enjoy sustainable and accelerating growth in 2010. The driving forces behind their more impressive and sustained performance (than FAI and exports, as well as overall retail sales) include structural reasons such as shifts in consumption patterns, very low penetration rates, social security reform, policy stimulus, and inflation (we will elaborate on each of these reasons below). The nine specific subsectors/products/services we refer to include:

1. **Life insurance**: catalysts include accelerating premium growth, higher bond yields and negotiated deposit rates (due to rising inflation and benchmark interest rates), as well as pension and health care reforms.
2. **Diapers**: the very low penetration ratio (only 5% in small cities and rural areas) for disposal diapers implies easily 40% sales growth in China's rural market with a population of 700m.
3. **Packaging**: China's per capita packaging paper consumption remains one-third of that in Japan and Taiwan, indicating strong growth momentum of 20%+ per year. Margin expansion will also support acceleration in EPS growth for packaging papers next year.
4. **Drug distribution**: with underlying health care spending growth at nearly 20% per annum and rising market shares, top distributors will likely sustain 25% growth for many years to come.
5. **Medical equipment:** the delay in domestic health care reform implies stronger domestic demand growth next year, while exports should recover simultaneously when US health care reform kicks off.
6. **Juices:** Per capita consumption of juice in China is only one-tenth that of the global average, supporting an annual average demand growth of over 30%.
7. **Online travel**: with only a 2% market share of China's travel industry, on-line travel is poised to continue 25% annual growth in coming years.
8. **PC distribution:** growth to accelerate in 2010, due to strong recovery of demand for PCs and IT services from consumers and enterprises which have cut their discretionary spending in the past 12 months, as well as 3G-related telco capex growth.
9. **Motorcycles**: this sector should benefit from accelerating demand for 3-wheeled motorcycles, a potential change in policy (tax cuts) that should boost rural sales, and better export performance on rising EM currencies and demand recovery. We expect sales growth to recover to 15% next year from -10% this year.

Figure 4 shows our or consensus estimates of top line (revenue) growth for representative companies in the above nine product/service categories in 2009 and 2010. All these companies are showing acceleration of growth. On average, we believe this basket of companies will see their sales growth rising to 22% in 2010E, up from 13% in 2009. The next section will look into the specific reasons for this growth outlook.

Figure 4: Estimated Revenue growth of representative companies in the abovementioned nine industries



Source: Deutsche Bank, Bloomberg, Wind
Note: 1. Hengan acquired Qinqin Food in 2008. For comparable purpose, its 2009 revenue growth is calculated excluding Qinqin's sales in both 2008 and 2009. 2. Deutsche Bank analysts cover Nine Dragons, Hengan, Ctrip, and China Life. For non-rated stocks, we use market consensus estimates for revenue growth calculation. 3. For stocks that are not covered by Deutsche Bank's fundamental research and consequently we make no representation to the quality of the business, assets or management.

Catalysts for sustainable growth

The above mentioned nine subsectors broadly fall into three sectors: insurance, consumer, and technology. The driving forces of their sustainable and accelerating growth can be briefly summarized as follows (for details, see discussions in the second chapter of this report).

1. **Very low penetration rates**: diapers, life insurance, juices, on-line travel.
2. **Potential new policy incentives**: motorcycles.
3. **Pension and health care reforms**: life insurance, medical equipment, and drug distribution.
4. **Matthew effect**: Drug distribution, PC distribution.
5. **Recovery/normalization of consumer confidence**: PC distribution, packaging, motorcycles.
6. **Inflation and rate hikes**: insurance, juices.

More attractive risk/reward than FAI or exports

In terms of the risk-reward profiles, we believe this basket of "sustainable growth" should enjoy several advantages over FAI and/or exports in 2010:

- The basket's growth rate should accelerate in 2010, while FAI has already started its deceleration, and exports' sequential growth is likely to peak in the current quarter. Given that the equity market tends to track sequential economic growth, the growth sustainability of the basket suggests its potential upside is more significant, and its downside is more limited than sectors that are driven mainly by FAI or exports.
- Historically, the share price volatility of representative companies in the above mentioned sub-sectors is much lower than those of exporters or investment goods. With more upside on growth and lower volatility, the basket should offer a more attractive risk/reward profile (see last section for some quantitative measures).

Nine "sustainable growth" stories

In the following subsections, we present the "stories" of sustainable growth in the aforementioned nine product/service categories. For each category, we discuss the key driving forces of its growth outlook, describe a few representative companies, and provide company earnings estimates and valuations to the extent possible.

Life insurance

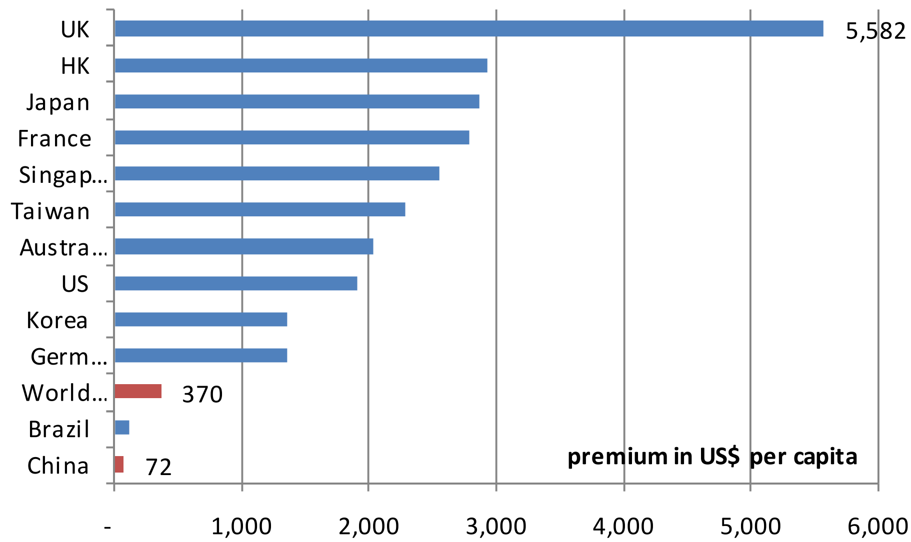
Life insurance companies are likely to see acceleration of earnings growth in 2010 due to stronger premium growth, escalating inflation pressure, and pension and health care reforms.

In our recent report "Inflation to surprise on upside by mid 2010" (7 September), we forecast that China's CPI inflation would rise from -1.8% y-o-y in July 2009 to around 4% by mid next year, and as a result interest rates and bond yields would rise in 2010. In the China Insurance sector report "Higher inflation/bond yields: China Life and CTI best placed" dated 25 September, our insurance analyst Michael Chang echoed that higher inflation and interest rates would benefit insurers via higher bond yields and actuarial investment return assumptions. He estimated that 55-80% of insurers' investment portfolios comprise fixed income investment. We believe it is extremely likely that insurers will revise up both near-term and long-term investment return assumptions when they report their FY09 results.

As to the life insurance premium outlook, Michael expects y-o-y growth to accelerate from the low-teens this year to 17-18% in 2010, as household income growth recovers from the trough in 2009. We also see further upside potential to this estimate from continuing penetration/density improvement and China's health care and pension reforms (please also see our insurance sector report "Benefiting from the next stage of stimulus programs" dated 31 July).

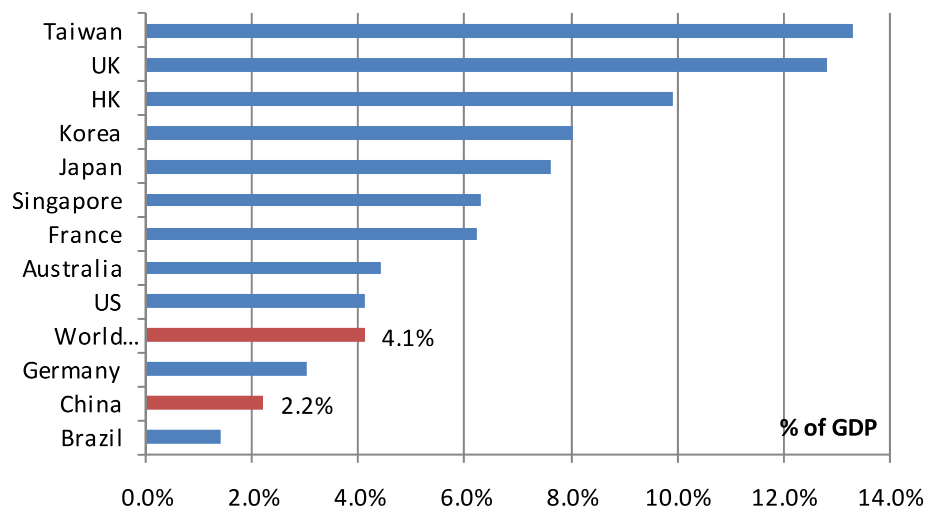
Data from Swiss Re indicates that China's life insurance penetration (premium as a percentage of GDP) and density (premium in US$ per capita) is respectively one-half and one-sixth of the world average. Indeed, the life insurance premium CAGR reached 29% in 2000-08, and Figure 5 and Figure 6 show plenty of upside potential ahead. Moreover, Chinese insurance companies will unify Chinese (CAS) and Hong Kong (HKFRS) accounting standards from the start of next year. In his report "New accounting changes – China Life best placed" dated 22 June, Michael estimates that about half of insurance premiums under CAS will vanish under the stricter HKFRS. So China's "true" penetration rate was only 1.2% instead of 2.2% in 2008. On a comparable basis, we believe an average top-line growth of 20% per annum is easily conceivable for China life insurers in the coming years, given the long-term nominal GDP growth potential of 11% (8% real growth + 3% inflation) and further penetration/density improvement.

Figure 5: Life insurance density 2008



Source: Swiss Re

Figure 6: Life insurance penetration 2008



Source: Swiss Re

In the medium term, the roll out of the health care and pension reforms will become an additional premium growth driver. For instance, Shanghai will "soon" (we think it is likely by end-2009) launch a pilot program for tax-deferred individual pensions, as indicated by the Chairman of China Taiping Life in September and by Deputy Chief of CIRC (China Insurance Regulatory Committee) Shanghai in June. As per the pilot program, the new insurance scheme will be managed by eight selected insurers and they will sell it to enterprises as a supplement to the basic pension plan. This will be the first commercial pension scheme which provides tax incentives to policy holders. If successful, the scheme is likely to be extended across the country in the next two to three years.

The impact of health reforms is also positive. Some people argue that the more developed public health insurance system may crowd out commercial insurance products. In our view, these people underestimate the role of insurance companies in the reform. The CIRC circulated a bulletin in June 2009, encouraging insurers to sell/manage health insurance projects to/for local governments. As an example, in a pilot program in Luoyang, Henan

Province, the government uses China Life's branches and billing system to collect public health insurance premiums and pay reimbursements. China Life, acting as an agent, neither manages the funds nor sells their own products. However, it receives a management fee of RMB1.1 per participant from the local government each year. In another pilot program in Guangdong, the local governments allocate 15% of the public health insurance premiums to buy insurance policies from the commercial insurance companies. In this case, the government becomes the insurers' client. Shanghai has expressed an interest in copying the second model in its health insurance reform for university students. We expect many other local governments to follow suit going forward.

A major risk to the life insurers' bottom-line growth next year is the A-share market performance. However, the SHCOMP index is currently trading about 20x consensus 09 PE after the recent correction. This is over 30% lower than the long-term average and thus valuation-wise, the downside risk appears to be limited. In addition, the beta of insurance share prices (against the A share index) has declined to the recent 0.85, down from the previous 1.2, suggesting that insurance has become a relatively "low beta" sector.

China Life (2628.HK, Buy, HK$36.0)

Our insurance analyst Michael Chang is highly convinced that insurance companies will revise up their investment return assumptions in their embedded values at the FY09 results, with China Taiping and China Life the key beneficiaries. He believes that the market is misguided by Ping An's seemingly high "existing" embedded value (EV) sensitivity to investment return. He argues that the "new" business EV, which is responsible for over half of insurers' PE valuation, is much more sensitive for China Life and China Taiping (966.HK, Buy, HK$24.3), than for Ping An (2318.HK, Buy, HK$67) (see Michael's sensitivity table in Figure 7).

Figure 7: Sensitivities of the value-in-force and value of one year's new business to changes in the actuarial investment assumption for the China insurers

	Sensitivities to:			
	Value in-force		Value of one year's new business	
	+ 50 bps	-50 bps	+ 50 bps	-50 bps
China Life	16%	-16%	16%	-16%
Ping An	24%	-28%	6%	-6%
China Taiping	21%	-18%	39%	-39%

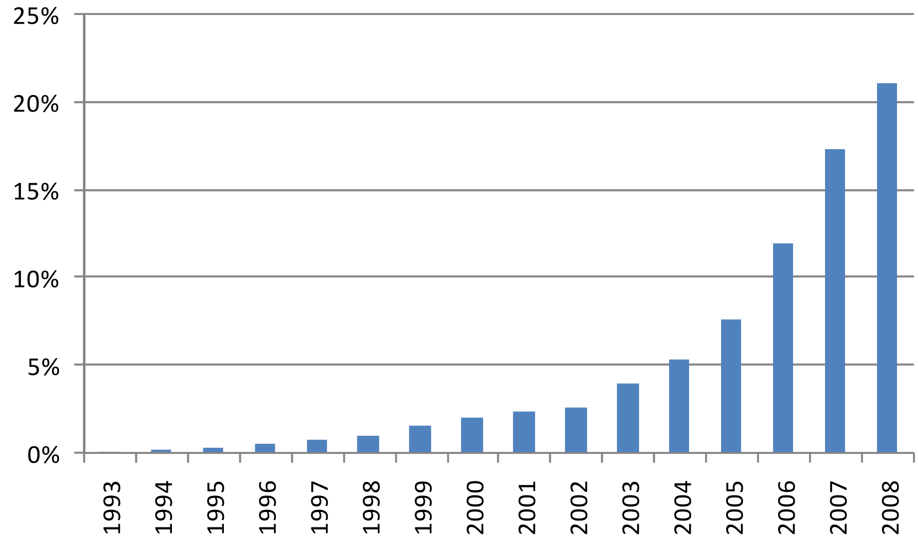
Source: Deutsche Bank, company data

Michael also likes China Life's defensive geographical positioning (less exposure to Tier 1 cities than peers) and capital strength (strongest-among-peers solvency margin ratio). The company valuation is also more attractive than peers - 23x FY10E PE vs. Ping An's 29x and China Taiping's 32x. China Life's recurrent 09-11E EPS CAGR is expected to reach 20%.

Baby diapers – Hengan International

The market for disposable baby diapers is saturated in developed regions. Nearly or more than 95% market penetration along with lower birth rates (1.0-1.5%) in developed nations has led to marginal growth in the western world. However, China's baby diaper market is still in its infancy. The industry's total revenue reached RMB12bn in 2008, and is continuing its growth at 20-25% per year.

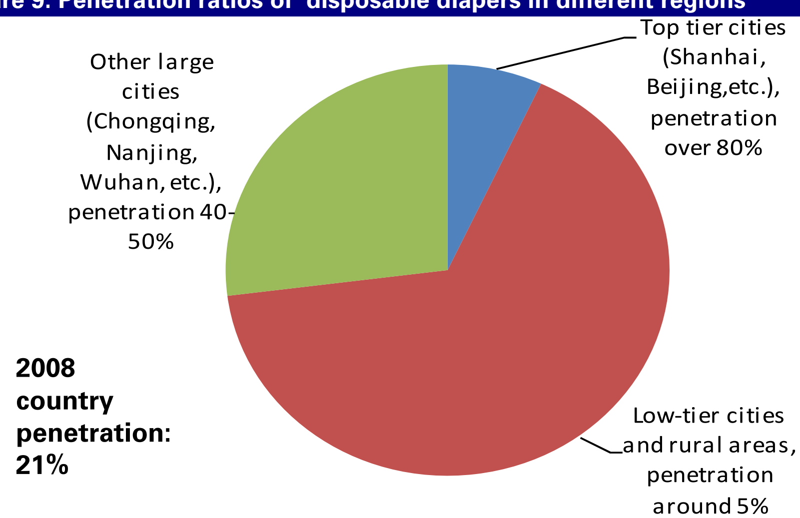
Figure 8: Penetrate rate of disposable baby diapers in China



Source: CNNHPIA(China Household Paper Industry Association)

Over the last few years, the exponential growth was mainly contributed by large cities, reflecting the rapid expansion of the population of middle class parents. This group of young consumers is very receptive to the benefits of disposable diapers compared with the traditional cloth diapers. Small cities and rural areas, though twice as large (in terms of population) compared with big cities, are still poorly penetrated due to relatively lower income levels (see Figure 9). We estimate that in lower tier cities and rural areas, which have a population of nearly 900m people, the penetration ratio of disposable baby diapers is only 5%.

Figure 9: Penetration ratios of disposable diapers in different regions



Source: CNNHPIA, Deutsche Bank estimate

If the big city experience provides any guide, the small city and rural market penetration rate will likely rise exponentially from the current 5% to about 20% within the next four years. Taking into account price inflation, this means that the small city and rural market will expand at an annual average of 45% per year for the next four years, and the industry's sales growth overall should maintain an annual average growth of close to 20% during the same period.

Smart suppliers produce a variety of products, broadly classified into the premium and economy segments, to cater to different demands. This variety of products enables a wide range of RMB50-500 diaper expenditure per month for parents in different income brackets. On the consumers' side, rural household incomes have doubled over the last five years and are currently at the same level as urban incomes in 2001. More importantly, the usage of disposable diapers is becoming increasingly common in rural homes thanks to the 220m rural migrant workers, who are working in cities and have seen the convenience enjoyed by urban families that used disposable diapers.

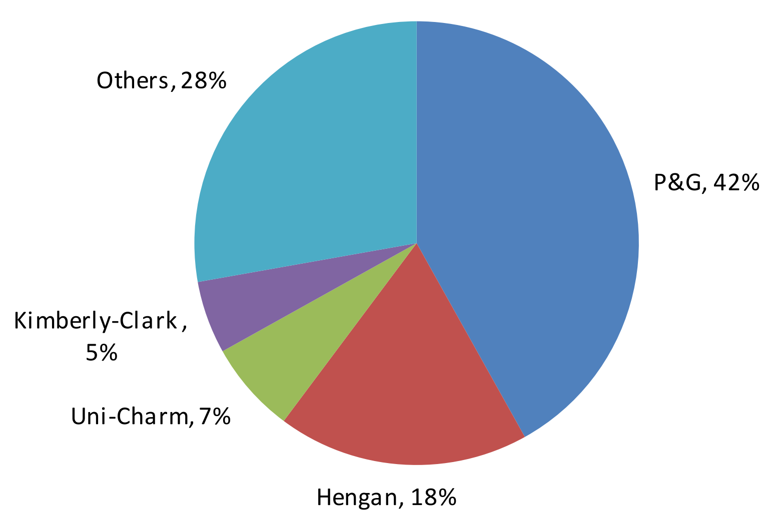
Apart from the low penetration, the upside potential for diaper consumption per baby is also significant. Average Chinese parents use 3.0 diapers per day, compared to 4.9 in Japan and 5.6 in western developed countries according to CNHPIA. The improvement of personal incomes will certainly help encourage more usage.

Hengan International (1044.HK, Buy, HK$49.0)

Hengan's Anerle is one of the top baby diaper brands in China (see Figure 10). The company's diaper sales increased by 30% over 2005-08, beating the industry's average of 26%. Our consumer analyst Mabel Wong believes that Hengan has been gaining market share from low-tier cities and rural regions with 9,000+ salespersons across China. She forecasts the Hengan's diaper sales will continue to grow strongly by 28% per annum in the next two years.

From a macro perspective, Hengan should reap greater-than-peer benefits from the diaper penetration surge in China's lower-tier and rural markets. Among the major competitors, Kimberley Clark (KMB.US, Hold, US$59.4) focuses on the high-end segment with 70% market share in premium diaper products. P&G (PG.US, Hold, US$57.2) has a wider range of products but its low-end diapers are still 30% more expensive than Hengan's.

Figure 10: Market share of top Chinese diaper manufacturers (by 2008 retail value)



Source: Euromonitor

Apart from the diaper business (21% of 09E total sales), Mabel believes Hengan's other product lines (sanitary napkins and tissue papers) will also grow by 20-22% per annum over 2009-11.

Hengan is currently trading at around 25x FY10E PE. Mabel forecasts its EPS growth to be 22% and 21% in FY10 and FY11 respective. We believe its 1.1x PEG is justified by the company's solid market leadership in a rapidly growing industry.

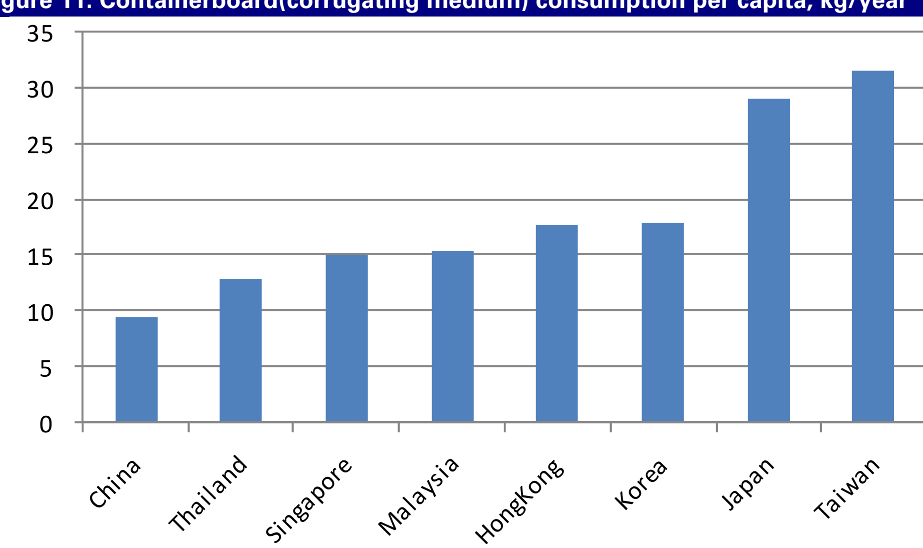
Packaging

In this section we look at the outlook for China's containerboard manufacturing industry. Containerboard includes linerboard, corrugating medium and high-quality coated board. They are used to make corrugated boxes for product packaging as well as shipping containers, e.g. household appliances, electronic products, and food & beverage products.

In the past ten years, the output of China's containerboard industry (measured by production in tons) expanded at a pace similar to real GDP growth, with an annual average rate at about 9%. Its revenue growth enjoyed an annual average rate of over 15% in the few years before the subprime crisis. In 2009, with ASP down 14.5%, the industrial revenue growth will likely be -6%. However, its pace of growth will likely accelerate in 2010 to 15.4%, given (1) rising ASP due to inflation, and (2) an increase in packaging-to-product ratios at the current level of per capita income. The containerboard price took a severe hit in late 2008 when China's exports collapsed. In the worst month of December 2008, both linerboard and corrugating medium prices dropped 21% m-o-m. However, since then, prices have been recovering the lost ground. We expect prices to return to 2007 levels by early 2010.

Currently, the packaging to F&B product ratio (i.e. the ratio between costs of packing to the final sale price of product) in China is below 10%, significantly lower than the government limit of 20%, and way below those in developed markets. This provides some significant upside for the growth of packaging products to outpace the growth of product sales. Another way to gauge the upside potential for the packaging industry is to look at per capita consumption in comparison with other countries at higher per capital income levels. The following chart shows that China's per capita consumption of corrugating medium is about 9.5kg per annum, vs 15kg in Malaysia, 19kg in Korea, and 32kg in Taiwan. Assuming China to reach the same level as Malaysia in the next ten years would mean that China's consumption growth would be 4ppts faster than per capita income growth (about 7%). This supports the 9% volume growth forecast in the coming years by RISI, a wood and paper industry consulting firm. We believe the rebound in export sectors, which are heavy users of packaging products, could provide further upside. Together with the paper ASP forecast of our sector analyst Karen Tang, we believe 2010's containerboard industry's revenue growth will likely accelerate to 15%, up from -6% in 2009.

Figure 11: Containerboard(corrugating medium) consumption per capita, kg/year



Source: RISI, IMF

Nine Dragons Paper (2689.HK, Buy, HK$10.8)

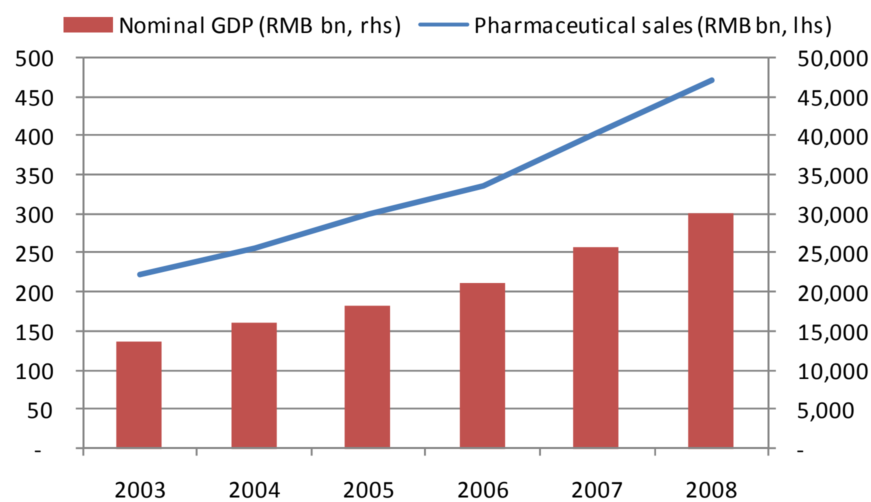
The top five containerboard manufacturers in China account for 56% of local production capacity, rendering the industry a relatively concentrated oligarchic structure. Entry barriers are high, as the paper industry is a heavy user of wood, water and energy, and the government imposes strict controls on their environmental impact. These characteristics make the leading companies in China's containerboard sector a safe and stable play on packaging demand growth.

Our favorite name in the sector is Nine Dragons Paper, the largest containerboard manufacturer in China with a 23% share in national production capacity. The company has reduced exposure to exports as 22% of its products were sold to the overseas market in 1HFY09, compared with 51% in FY05. According to our analyst Karen Tang, EPS of Nine Dragons will likely grow at 69% CAGR over FY09-11E on the back of a stronger demand outlook, margin recovery (with running-down of high-cost inventory) and capacity expansion. The company is trading around 25x FY10E PE.

Pharmaceutical distribution

For years China's pharmaceutical industry has been a good tracker of nominal GDP growth (see Figure 12). According to the China Association of Pharmaceutical Commerce, China's pharmaceutical sales have been growing at a sustainable rate of 16% per annum in the past six years. We believe it has the potential to accelerate to an average 20% per year in the coming years. This is due to the rising elasticity of demand at current income levels as well as more aggressive health care reforms that improve accessibility and affordability of health care. We believe the consolidators in the distribution market (via a series of acquisitions) may be able to grow at a pace of 25% per year.

Figure 12: China pharmaceutical sales vs. nominal GDP (RMB bn)

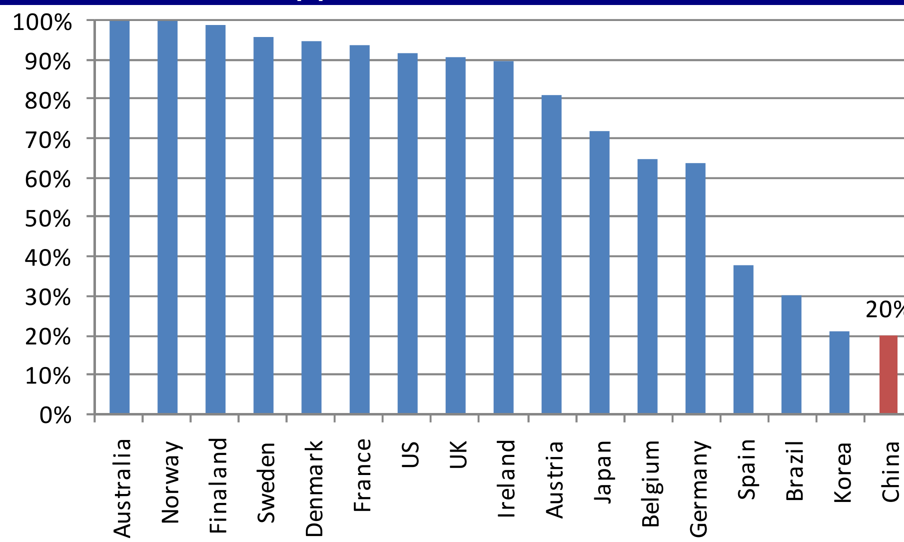


Source: China Association of Pharmaceutical Commerce, CEIC

The supply chain of pharmaceutical delivery could be divided into three segments: the upstream drug manufacturers; the downstream retailers which include hospital pharmacies, clinics and medicine stores; and in the middle, medicine distributors. To sell drugs to hospitals and clinics, manufacturers need distributors to physically send drugs efficiently from factories to 30,000 hospitals/clinics and 350,000+ drug stores. Manufacturers also rely on distributors to manage inventory, maintain cash flow, collect market information and in some cases, build up sales relationships with hospitals. Large distributors also provide value-added services, including electronic ordering systems, tailored packaging, payment collection, import/export agency, etc.

China's medicine distribution market is much more fragmented than that in developed markets (see Figure 13). In China, there are more than 9,000 GSP-certified distributors covering 660 cities and extensive rural areas. As a legacy of the multi-tiered (country-province-city) distribution system started in the 1970s, the direct channel to some hospitals and drug stores is tightly controlled by local distributors. However, market consolidation has just started and the process is likely to be rapid due the Matthew Effect – the larger distributors should get more of the new businesses as manufacturers tend to use channels that can most effectively reach the largest number of clients.

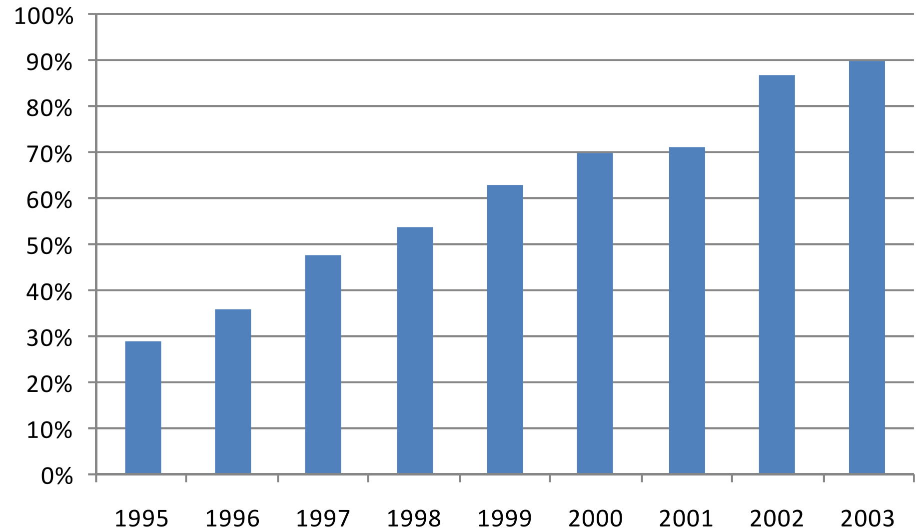
Figure 13: Market share of top pharmaceutical distributors



Source: European data from GIRP 2005, China data from China Association of Pharmaceutical Commerce 2008, other data from IMS Health 2002, data compiled and updated by Deutsch Bank

In the US, the market share of the top three distributors increased from 30% to 80% in only seven years (1995-2002) (see Figure 14). The top three wholesalers now have a virtual lock on the wholesale drug market with over 90% combined market share. During the busiest years for M&A, Cardinal Health (CAH.US, Hold, US$28), the most active acquirer of the trio, made an acquisition once every six weeks on average during 2000 and 2001. In total, it purchased at least 65 companies since1980 and the company's share price has risen considerably from US$1 in 1985 to over US$50 in 2001.

Figure 14: Market share of top three pharmaceutical distributors in the US



Source: IMS Health

Substantial consolidation also occurred in Japan. The market share of the top three distributors picked up from 20% to 70% in eight years between 1999 and 2006. The market would have be more concentrated if the planned merger between Mediceo and Alfresa (both among the top three and with a combined market share of 45-50%) was not called off by Japan's anti-trust regulators in early 2009.

From the perspective of drug manufacturers, the dominance of a few large distributors is helpful. When large pharmaceutical companies make the blockbuster launch of new drugs, they prefer to team up with a short list of large distributors so that the drugs can be delivered quickly and reliably across the country. Any delay in logistics could cause weaker product recognition and leave room for clone products to follow. Therefore, small wholesalers who try to deal directly with major drug makers often find themselves steered towards large distributors for products. That puts small players in the position of sub-distributors and eventually, their reliance on larger rivals for survival often forces them out of the market or to be acquired by market leaders.

In China there are a few unique factors to accelerate the pace of consolidation in the next 3-5 years.

1. Health reform – the government now requires each province to designate a short list of distributors to collectively handle drugs in the Basic Drug Catalog. These drugs will eventually account for over 80% of prescriptions in rural clinics and over 25% in large urban hospitals.
2. The expansion of global pharmaceutical manufacturers – China's drug imports surged over 40% per year in 2007 and 2008, much faster than the 1999-2006 CAGR of 19%. As a common practice in developed markets, foreign drug makers tend to cooperate with only a few large distributors in China.
3. High entry barriers – the State Food and Drug Administration (SFDA) is reported to be drafting a new version of the GSP certificate with stricter criteria on distributors' hardware, such as warehouse size and low-temperature storage facilities[2]. Many small distributors simply do not qualify.

[2] News link: http://finance.sina.com.cn/roll/20090717/21326496419.shtml

Fosun Pharma (600196.CH, NR)

Fosun Pharma is a medical conglomerate with a number of subsidiaries in medicine distribution, drug retailing, pharmaceutical and medical equipment manufacturing. The company is the second-largest shareholder of China's largest distributor. The medical commercials (incl. drug distribution and retailing) contributed 27% of the company's consolidated revenue in 1H 2009. The company's drug manufacturing division holds 11 exclusively-invested or controlled subsidiaries with expertise in hepatic, gynecological, diabetes and anti-parasitic medicines. It accounted for 59% of Fosun's 2009 1H revenue.

Medical equipment

The performance of China's medical equipment sector in 2010 should benefit from the delayed health care reform in China and in the US. In other words, both domestic and foreign demand will likely accelerate in 2010.

At the beginning of this year, the government promised RMB850bn healthcare expenditure in 2009-11. Like the RMB4tn stimulus package, the government did not clarify how much of the RMB850bn is new money – i.e., in additional to earlier planned budget. However, according to the Ministry of Finance, this RMB850 package implies at least 36%, and probably higher, government health expenditure growth per annum during the three years to 2011[3].

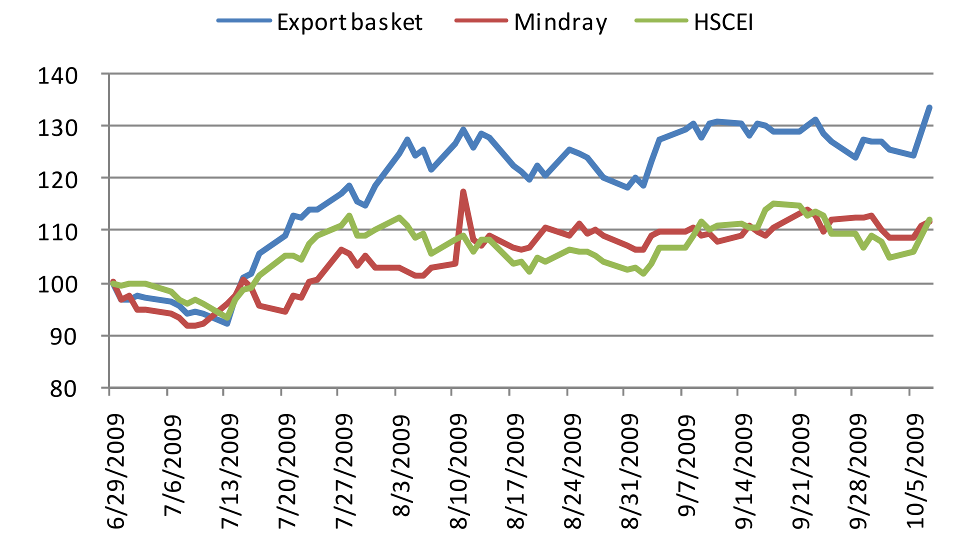
That said, we believe that healthcare spending under the RMB850 program is very likely to be back-loaded due to a delay in the reforms. By design, the planned heath reforms should at least include the following steps: 1) improving medical infrastructure, especially rural and urban community clinics; 2) expanding health insurance coverage; 3) cutting drug prices; 4) hospitals shifting revenue focus from drugs to services; 5) government compensating hospitals' losses in drug revenue via more subsidies. So far, progress in implementing the first two steps seems reasonably on target. However, step 3 triggered some local protectionism and was delayed. The Ministry of Health originally planned to publish the Basic Medicine Catalog by April 2009 and the price cap for the drugs in the catalog by September. Eventually the catalog was published on August 18 2009, four months later than MoH's expectation. The announcement of drug price caps was also postponed to October. Accordingly, steps 4 and 5 are also postponed. For medical equipment manufacturers, the direct benefits of the reform come from steps 1 (government procurement) and 4 (hospitals buying more equipment to increase service revenue). Therefore the acceleration in equipment orders will not appear till mid next year, when the Basic Drug Catalog system begins to affect over 15% of the drug market[4].

As for the medical equipment exporters, they tend to be a laggard beneficiary of the export recovery cycle (see discussion below). The first movers in the export sector include electronics, textile, ports and container shipping. Indeed the price performance of our "export basket" (published in our report dated 29 June, "Exports to outperform FAI in next 12 months") which comprises some of the largest companies in the sectors mentioned above, has outperformed HSCEI by 25%, while Mindray -- China's largest listed medical equipment exporter – has been trading in line with the index (see Figure 15).

[3] News link: http://finance.sina.com.cn/review/20090409/12276082730.shtml

[4] The MoH originally targeted for the execution of the Basic Drug Catalog in 30% community and rural medical institutions by end-2009 and nearly complete execution by end-2011. With the four-month delay of the issuance of the Catalog, the first target will be hard to achieve but around 50% execution rate by mid-2010 is still realistic. Given that community and rural hospitals/clinics account for 20-30% of the total drug market, we estimate around 15% of the drug sales will be affected by mid next year.

Figure 15: Price performance: HSCEI, Mindray and our "export basket"



Source: Bloomberg, Deutsch Bank
Note: The constituents of our "export basket" are representative companies in typical export sectors including Li&Fung(494.HK), Alibaba(1688.HK), BYD(1211.HK), China Merchant(144.HK), China Shipping Container(2866.HK), Foxconn(2038.HK), Yue Yuen(551.HK) and Lenovo(992.HK)

Such a price performance difference is supported by the economic fundamentals. China's medical equipment exports rely heavily on the US market (28% vs. 18% for overall exports). However, despite the green shots of the US GDP recovery which boosts demand for Chinese products, US health reform still has a long bumpy road ahead – President Obama outlined his plan only last month and the time for action is probably several months away. According to the survey of hospital administrators made in July by Leerink Swann, a US healthcare research company, 2009 US hospital capex will decline by 13% in 2009 and continue to slide over the next 12 months, though at a slower pace. Compared with our forecast that China exports will rebound to 15-20% by mid next year, the stabilizing but still weak US hospital budget depicts a slower-than-overall recovery of Chinese medical equipment exports. Timing wise, the market recovery in US orders may begin to pick up after sequential growth of electronics orders reaches its peak in early 2010.

In the longer term, growth will be underpinned by the upgrading of health care demand. China's RMB83bn medical equipment industry comprises less than one-eighth of the total health care market. In developed countries, the ratio is usually one-third to one-half, according to the consulting company Frost&Sullivan.

Mindray (MR.US, NR)

Mindray is the third-largest player in the global patient monitoring devices market. In 1H09 it generated 50% of revenue from foreign markets, while developed markets are responsible for 20-25% of its total sales. In the first half of 2009, the company experienced solid domestic growth (45% y-o-y vs. 43% in 2008). However, international sales slowed significantly to -13% in 2Q09 from 96% in 2008. The company president admitted that "the US hospital market remains difficult to predict, as capital spending remains constrained and healthcare reform has yet to be established".

That said, Mindray's patient monitoring devices hold 49% market share in China. The other product lines also enjoy a leading position with a 30-40% share in the domestic market. China's back-loaded health expenditure and the forthcoming stabilization/recovery of US hospital capex budgets will be the two key catalysts for earnings upside for the company in the next four to six quarters.

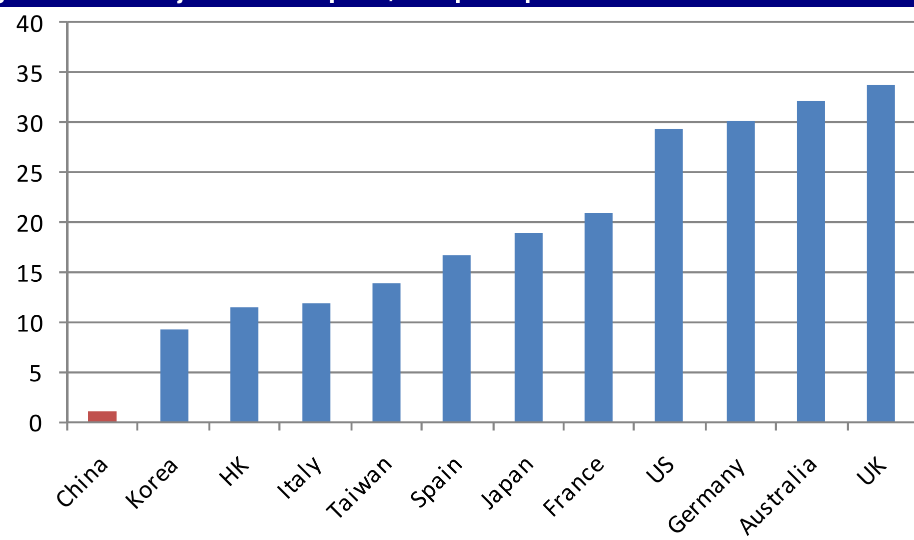
Consensus estimates (Bloomberg; Wind) forecast 2010 revenue growth to accelerate to 22% from this year's 14%. Consensus estimated 09-11 EPS CAGR is 31%, significantly higher than its 2010 PE of 20x.

Juices

China's fruit/vegetable juice market barely existed a decade ago, but has now become one of the largest soft drink segments. Annual sales reached RMB55bn in 2008 and the average growth rate has been 36% per annum over the last five years.

Yet the low penetration indicates that the high growth rate is likely to sustain for many years to come. According to a survey by the market research company CTR China, the annual per capita consumption of fruit juice drinks was less than 1kg in China in 2007. This is one-tenth of the world average level and 1/40 of the average level in developed countries (see Figure 16). This gap is even wider than other beverage products – China's per capital milk consumption is around one-quarter of the world average and beer consumption is already slightly higher than the world average. There seems to be a "health effect". Drinking for fun (beer) is easily popular; drinking for supplement calcium (milk) requires a higher income level and more awareness of health; drinking for vitamins (fruit) takes the pursuit for health further.

Figure 16: Annual juice consumption, litre per capita

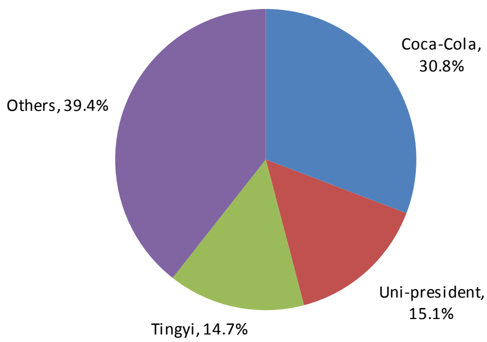


Source: China Juice Consumption Survey by CTR China (2007), Euromonitor, Deutsche Bank

Market competition, however, is intense with more than 1,000 juice producers. In the high-end 100% juice and nectars (25-99% juice) markets, Huiyuan remains the leader with over 40% market share, but it seems to have been losing ground to competitors such as Uni-president and COFCO over the last few quarters. The juice drink segment (up to 24% juice) is much larger in terms of volume consumption (75% of total juice products). In this sub-market, Coca-cola, Uni-president and Tingyi are the top three (Figure 17).

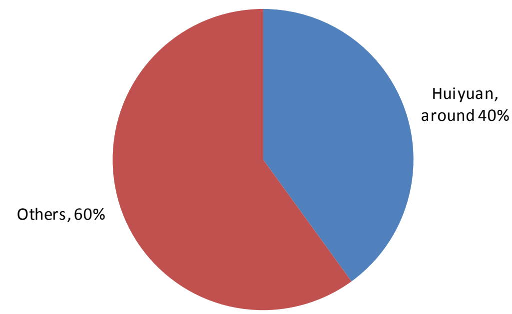
Although in March 2009 the Ministry of Commerce blocked Coca-Cola's acquisition of Huiyuan citing concerns on anti-monopoly grounds, we believe further market consolidation is very likely. The underlying M&A incentive is that in the F&B sector, an increase in market shares usually provides substantial synergy of bundled sales (e.g., juice bundled with diary or bottled water) and marketing/production costs. Such market dynamics should favor established market leaders due to greater M&A opportunities.

Figure 17: Juice drink (concentration<24%, ~80% of total juice market) sub-market



Source: AC Nielson June 2009,]

Figure 18: 100% juice and nectars (25-99% concentration, ~20% of total juice market) sub-market



Source: Jiouiam annual report 2008

A macro upside risk for the juice industry is rising inflation. Historically, when CPI inflation exceeds 4%, the government tends to impose price controls or to disallow normal pass-through of costs to selling prices for refined oil, power, and staple food and beverage products (e.g., grain, edible oils, sugar, noodles, and milk), but not on juice. This is because juice is not considered to be a basic necessity. Therefore, it is reasonable to assume that raw material inflation rises can be fully passed through to product selling prices for the juice sector to ensure stable margins. With rising ASP and stable margins, profits will therefore rise in line with inflation. For those juice producers that are vertically integrated (i.e., with upstream operations), the benefits from inflation will be even more visible.

Uni-president (220.HK, NR)

Uni-president is one of top three juice producers in China in terms of market share (see Figure 17 and Figure 18). Compared to Tinyi (332.HK, Hold, HK$17), it provides higher exposure to the juice market - juice products account for c.30% of Uni-president's total revenue vs. c.15% for Tingyi.

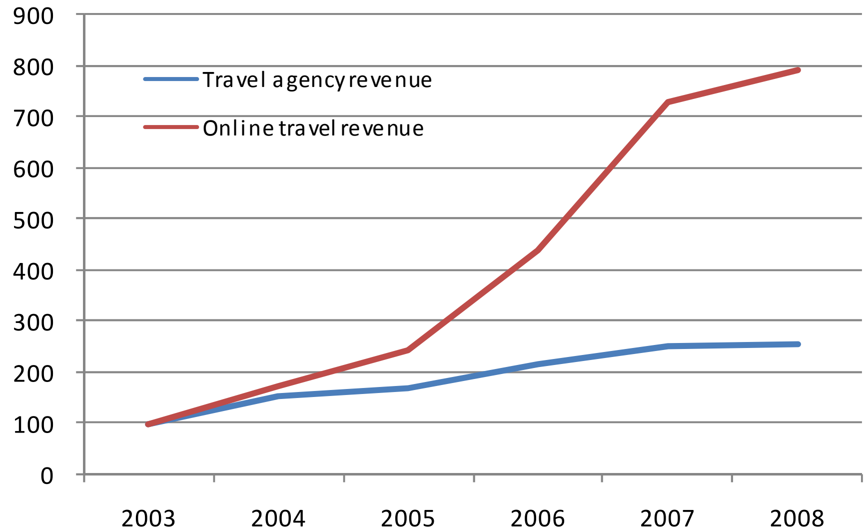
In December 2008, Uni-president raised its stake of Andre Juice (8259.HK, NR) from 5% to around 15% with RMB159m. Andre owns the largest juice concentrate production capacity in the world. The acquisition marked a strategic move for Uni-president to secure upstream supply and should help shelter it from inflation pressure next year.

The company is currently trading at 16.5x 2010E PE. The PEG ratio is 1.0x on consensus 2009-11E EPS CAGR of 16% (source: Bloomberg; Wind).

On-line travel

China's tourism sector – measured by revenue -- has been growing at 17% CAGR since 2001. Overall travel agency revenue reached RMB 166.5bn in 2008. Within the travel sector, online travel services have been taking a growing market share from a zero start since 2000. However, the current market share of online travel services in China is around 2%, still heavily under-penetrated compared with 50% in the US. We note that in the US online travel's market share increased steadily from 5% in 2000 to 50% in 2008. If one assumes that the online travel service's market share in China will increase from the current 2% to 5% by 2012, the market size for online service providers should reach RMB15.6bn between 2008-2012, representing a CAGR of over 50% for the coming few years.

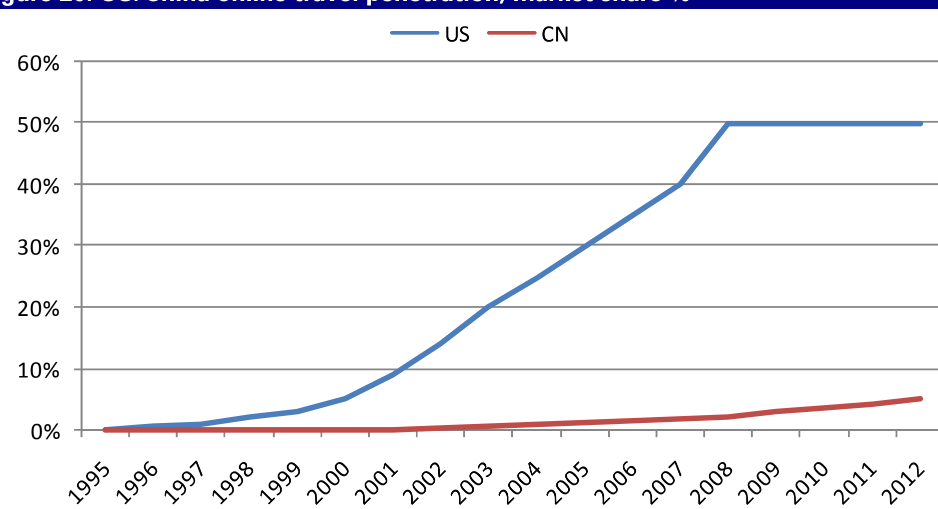
Figure 19: Travel agency vs. online travel revenue, 2003=100



Source: CEIC, iResearch

Several underpinning trends will support this growth story. First, the number of Internet users in China will continue to grow rapidly, at an annual average rate of 16% in the next 3 years according to CNNIC. Second, the majority of the travelers are tourists or businessmen who are receptive to and capable of using online services. Third, the convenience and cost-efficiency of online booking of air-tickets and hotels have been impressive, are becoming a major reason for attracting more customers.

Figure 20: US/China online travel penetration, market share %



Source: Deutsche Bank, iResearch, China National Travel Administration

Ctrip.com (CTRP.OQ, Buy, US$62.0)

Ctrip is the market leader in China's online travel service, holding a lion's share of 56% of the market in 2008. The closest rivals are Elong (with 14% of the market share) and Mangocity (6%). Over the past three years, in spite of fierce competition, C-trip has increased its market share from 51% to 57%, mainly gaining from the second and third players.

Ctrip has a solid grip on its existing market share with (1) economies of scale, (2) a loyal customer base, and (3) exemplary service quality. Ctrip has signed agreements with all 5-star hotels, 80%+ of 4-star hotels, and 75%+ airlines. About 80% of its transactions are from returning customers.

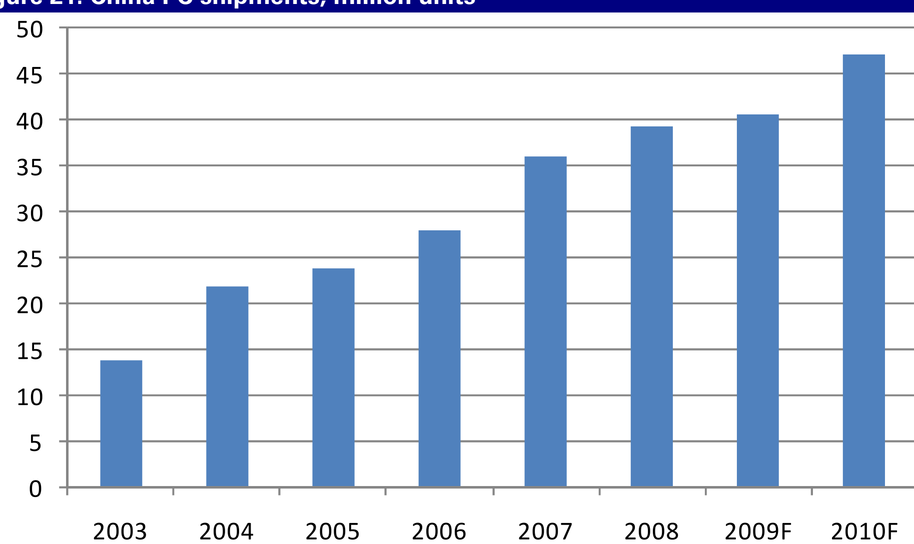
Ctrip is currently trading at 37.5x 2010E PE. Our analyst Alan Hellawell expects EPS to grow by 29% CAGR 09-11E, driven by volume growth and further market shares expansion.

PC distribution

According to a report by the Boston Consulting Group[5], 25% of the Chinese population now has computer access; but in rural areas the figure is only 6%. The report forecasts that by 2015 the country's PC access rate will surge to 56% and the rural rate will jump to 42%. Such a trend underpins the long-term growth potential of the PC distribution market and we believe it could translate into sustainable growth of 10-15% in the coming five years. However, 2010 will likely see a stronger growth recovery to over 15%.

The PC market was hit hard by the financial crisis due to consumers' concerns about job security and income outlook. According to the IT research company IDC, China's PC shipment growth would slump to 3% y-o-y in 2009 from 9.5% last year (see Figure 21). We believe this could be explained by the high consumption sensitivity of PC purchases to income and employment outlook amid the difficult economic environment. Our survey of 642 individuals in 2008 also showed that the negative wealth effect would drive 26% consumers to cut spending on electronics products. Looking into 2010, we believe the PC shipment growth will accelerate to 16%, partly on the recovery of consumer confidence. This is evidenced by a six-consecutive-month rally in the Consumer Confidence Index published by the National Statistics Bureau.

Figure 21: China PC shipments, million units



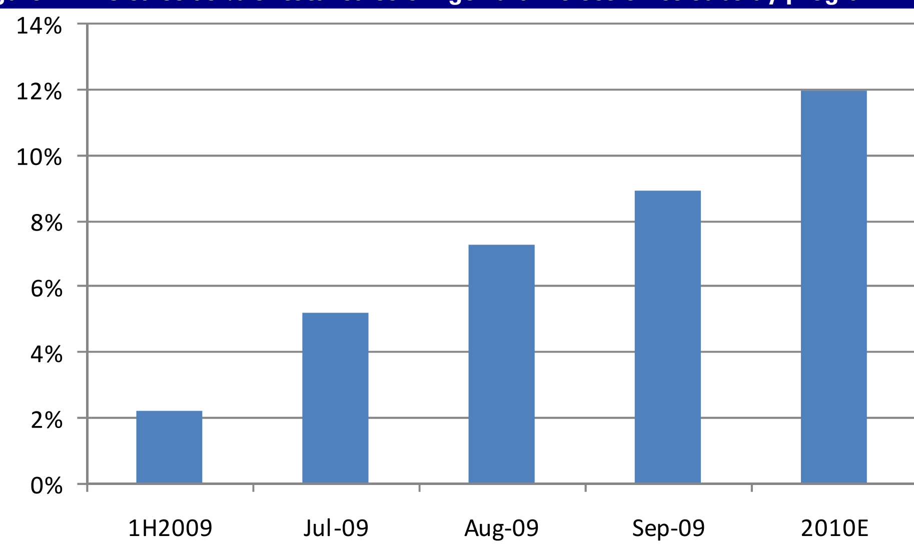
Source: IDC

[5] "China's Digital Generations", the Boston Consulting Group, 2008

We believe the leading PC distributors, rather than manufacturers, could deliver more steady growth in this recovering market. Even for top PC manufacturers, the short shelf-life and ever-changing consumer appetite make it difficult to defend their market shares consistently. The PC distributors, on the other hand, compete on network building and sales volume. The established leaders tend to enjoy the Matthew effect with a competitive edge on pricing (larger distributors can get better prices from manufacturers) and market understanding (distributors with broader networks can better predict the supply-demand dynamics in each region).

Last but not least, the government's "go-rural" subsidy program mainly benefitted traditional household appliances this year. The impact on PC sales will be more visible in 2010. Figure 22 shows that PCs accounted for only 2.3% of "go-rural" program sales but according to a CCTV survey, rural consumers want PCs (40.2% households) more than refrigerators (28.6%), color TVs (27.4%) and washing machines (21.9%). Coupled with the low rural PC penetration (4% in rural vs. 53% in urban areas[6]), we believe that PCs will likely account for 10-15% of the "go-rural" program sales next year.

Figure 22: PC sales as % of total sales of "go-rural" electronics subsidy program



Source: Ministry of Commerce, DB forecast.

Digital China (861.HK, NR)

Digital China has been the largest PC distributor since 1999 and one of the leading IT service provides. Its FY10 1Q (Apr-Jun 2009) gross margin mix is 44% PC distribution and supply chain services, 37% IT systems (network products, servers, etc) and 19% IT services. In the PC distribution market, it occupies a 25% share, the sum of the closest three competitors.

The company has delivered 22.3% revenue CAGR over the last six years. Consensus estimates (Bloomberg; Wind) forecast its revenue to decelerate to 14% y-o-y this year, but to pick up to 15% y-o-y in FY11 (fiscal year end in March 2011). The company is trading at 10x consensus FY11 PE, lower than its FY10-12 EPS CAGR of 16%.

[6] The penetration raet is defined as the amount of computers owned per 100 households. Note it is lower than the rural computer access rate of 6% mentioned at the beginning of this section. The access rate, as defined in the report of the Boston Consulting Group, includes those who do not own but have access to computers.

Motorcycles

The motorcycle sector is looking homeward. Though China raised the motorcycle export rebate twice from 9% to 14%, the export y-o-y growth rate dropped dramatically from 41% y-o-y in August 08 to -45% y-o-y in August 2009. In contrast to the dim export outlook, the domestic market (which accounts for two-thirds of China's total motorcycle output) was more resilient due to better domestic demand and, to a lesser extent, the "go-rural" policy. Looking forward to next year, domestic rural demand especially in three-wheeled sector is likely to enjoy strong growth, the purchase tax and/or consumption tax cuts may become effective, export sales will also likely rebound strongly due to the economic recovery and the appreciation of currencies of many import countries in the EM world.

In China, 90% of mid- and low-emissions motorcycles are bought by rural residents. The China Auto Association Manufactures estimates that rural potential demand is around 200m motorcycles based on the penetration trajectory of bicycles. Given the 60m existing motorcycles in rural areas and a short average replacement period of 2-3 years, this market is not yet saturated. In the domestic market, a recent growth driver is three-wheel motorcycles, which are widely used as substitute for mini-trucks for transporting agricultural products and construction materials. These vehicles can carry up to 1,000kg goods but each costs only RMB7,000-8,000, one-third of the price of the cheapest mini-truck. In Jan-Aug 2009, three-wheel motorcycle volume sales recorded 8.2% y-o-y growth, not a bad number compared to 12% y-o-y decline of total motorcycle sales during the same period.

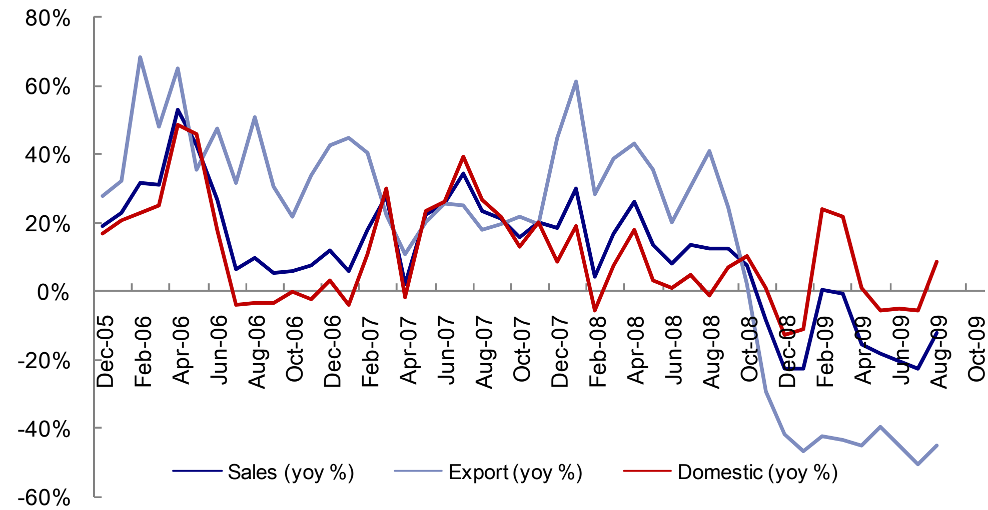
We expect 2010 to be a better year for the motorcycle sector due to further expansion of the three-wheel market, potential policy incentives, and export recovery.

In February this year, motorcycles were added to the support list of the government's "go-rural" policy. Under this scheme, rural buyers could receive a 13% price refund, subject to a subsidy ceiling of RMB650 from Feb-2009 to Jan-2013. Rural demand should show a 25% growth rate (according to Mr. ZUO Zongshen, president of the Zongshen Group). However, unlike autos and other consumer electronics under the government's incentive program, motorcycles have not recovered visibly due to the high licensing costs.

All "go-rural" motorcycles should be licensed before getting the price subsidy. Many rural buyers prefer not to apply for the subsidy because the 13% price refund cannot cover the higher 15-18% licence fees (including the 3% consumption tax and the 10% purchase tax, etc). That is, the high taxes have substantially weakened the attractiveness of the current incentive. With the upcoming tax reduction, more rural market potential will be released and should increase motorcycle sales more than other 'go-rural' consumer electronics.

The government is now considering a proposal to cancel the 3% consumption tax and cut or exempt the 10% purchase tax on motorcycles to further stimulate rural demand. Motorcycle buyers are sensitive to tax reductions. In April 2006, when motorcycle consumption tax was cut from 11% to 3%, it led to an acceleration of sales growth to 12.5% in that year, up from -1.4% in the previous year. If the proposed tax reduction goes ahead next year, we believe that motorcycle sales growth will likely accelerate to 15-20% y-o-y growth next year, up from this year's estimated decline of 10%-15%.

Figure 23: Breakdown of China's motorcycle growth rate (by volume, monthly)



Source: Deutsche Bank, China Association of Automobile Manufacturers

Another likely catalyst for acceleration in China motorcycle revenue growth is export recovery. Other than the global economic slowdown, another important factor that caused the decline in exports early this year was the massive currency depreciation of major import countries (by as much as 10-50% against the RMB from October 2008 to March 2009), such as those in Southeast Asia, Latin America, Eastern Europe and Africa, during the early stage of the financial crisis. With the steady appreciation of these currencies, Chinese motorcycles sales will likely rebound gradually by 2010.

Figure 24: EM currency depreciation in 2008 and potential rally in 2010

Country	Exch rate	2007	2008	2009F	2010F	Depreciation (2008/2007)	Appreciation (2010/2008)
China	CNY/USD	7.4	6.9	6.8	6.7	-7.0%	2.3%
India	INR/USD	39.5	48.6	47.0	45.0	23.2%	8.0%
Indonesia	IDR/USD	9356	11223	10000	9850	19.9%	13.9%
Malaysia	MYR/USD	3.3	3.5	3.7	3.5	6.3%	2.2%
Thailand	THB/USD	33.7	35.0	34.0	32.0	3.9%	9.5%
Philippine	PHP/USD	41.7	47.9	47.4	45.5	15.1%	5.4%
Brazil	BRL/USD	1.8	2.4	1.8	1.7	34.9%	38.8%
Mexico	MXN/USD	10.8	13.4	13.0	12.5	23.7%	7.4%
South Africa	ZAR/USD	6.8	10.0	7.8	8.0	45.5%	24.4%

Source: Deutsche Bank, Reuters, Bloomberg.
Note: All exchange rates are stated as end of period.

Zongshen Power (001696, NR)

As the largest domestic supplier of motorcycle engines in China, Zongshen stands to benefit the most from the policy incentive for domestic rural demand as well as export recovery. Focusing on China's rural market, the company developed the high-power 350cc and 500cc engines for the three wheeled motorcycles, which could sustain strong demand growth at 20% per annum in the coming years.

With Zongshen's nearly 40% export exposure (including both direct exports and engine sales to domestic motorcycle exporters), China's export recovery sets a favorable macro environment. Besides, currency appreciation in emerging markets (see figure 24), which are the main buyers of Chinese motorcycles, should provide further upside to the sector sales growth in 2010.

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Investment implications

A "sustainable growth" basket

We think in the coming months investors should gradually switch to sectors/companies that can enjoy sustainable growth in domestic consumer demand, as the cyclical FAI and export themes will likely be played out. Based on the previous sections detailing the sector trends and catalysts, we have constructed a basket of the nine representative companies in subsectors that we believe will enjoy sustainable and accelerating growth. The specific products/services they provide include **life insurance, diapers, packaging, PC distribution, drug distribution, medical equipment, on-line travel, juices, and motorcycles.**

Based on Deutsche Bank's estimates and consensus forecasts, this basket of nine companies will likely deliver an EPS CAGR of 28% for next two years, with a PEG at 0.77. As a comparison, the MSCI China consumer index is trading at a PEG of 1.15x, with EPS CAGR at 14% for the next two years.

Figure 25: Representative companies in sectors with "sustainable growth"

Company	Ticker	Sector	Rating	16-Oct Price local	M. cap (US$m)	PE 2010	EPS CAGR 09-11	PEG (10PE/EPS 09-11
China Life Insurance	2628.HK	Insurance	Buy	36.0	131,111	23.5	20%	1.16
Nine Dragons Paper	2689.HK	Paper	Buy	10.8	5,957	23.3	69%	0.34
Hengan Intl.	1044.HK	Household & Personal Products	Buy	49.0	7,859	24.7	21%	1.15
Ctrip.Com	CTRP.OQ	Consumer Services	Buy	62.0	4,215	37.5	31%	1.20
Digital China	861.HK	PC Distribution/Wholesales	NR	8.1	1,060	9.6	16%	0.59
Uni-President	220.HK	Food-Misc/Diversified	NR	4.4	2,034	16.2	16%	1.01
Shanghai Fosun Pharma	600196.CH	Medical-Drugs	NR	13.0	3,240	16.4	15%	1.09
Mindray Medical	MR.US	Medical equipment	NR	29.9	3,334	18.5	31%	0.61
Chongqing Zongshen	001696.CH	Engines/ motorcycle	NR	14.0	1,232	18.2	20%	0.89
Average					17,782	21.2	28%	0.77
MSCI China Consumer						15.8	14%	1.15

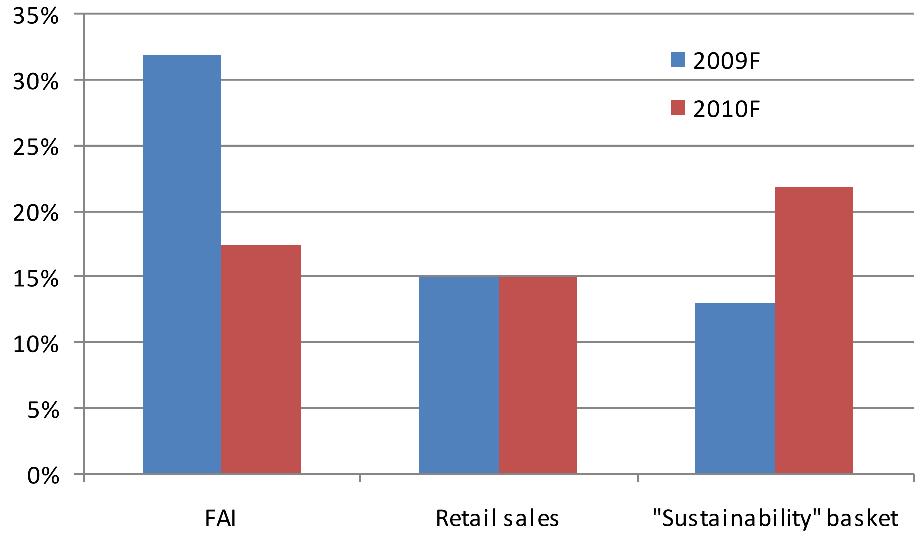
Source: Deutsche Bank, Bloomberg; Wind for non rated stocks
Note: 1. Average PE and EPS calculated as the simple average of the constituents; average PEG is calculated as average PE/average EPS CAGR; 2 For non-rated stocks, we use market consensus estimates for revenue growth calculation. Also, these stocks are not covered by Deutsche Bank's fundamental research and consequently we make no representation to the quality of the business, assets or management

Why this basket?

We see the following benefits of gaining exposure to companies in this basket:

1) **Accelerating growth in 2010/11.** Chinese consumption, measured by retail sales growth, will likely maintain its growth at 15% next year, the same as this year. This provides a backdrop of the overall sustainability of the consumer sector. The representative companies in the nine subsectors in our basket, however, would deliver average revenue growth of 22% in 2010, far stronger than this year's 13%. Figure 26 illustrates this acceleration, in comparison with deceleration in FAI growth next year. We did not plot export growth in this chart, as it would show a substantial increase in 2010 but the problem is that we expect most of its y-o-y recovery to end in 2Q next year.

Figure 26: 2009 vs 2010 growth: FAI, retail, and revenue of "sustainability" basket



Source: Deutsche Bank
Note: see Figure 25 for the constituents o f the "sustainability" basket

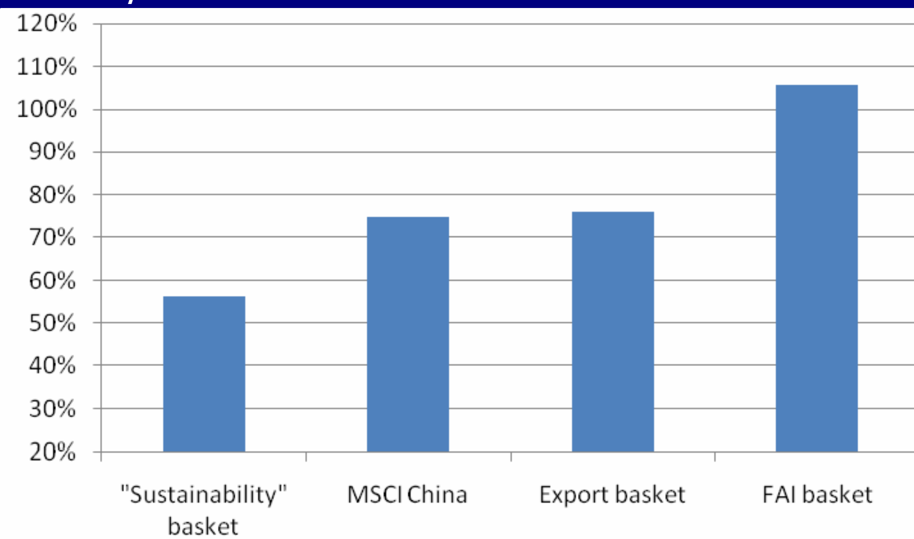
2) **Avoiding downside risk of "second dips" in FAI and export growth**. The companies in our basket derive most of their revenues and earnings from Chinese consumers, rather than government-led capex or exports. Thus, they are subject to minimum downside risks arising from decelerating FAI and the potential second dip in the US in the second half of next year.

3) **Potential new policy catalysts that are not yet fully priced in.** The government is considering introducing new measures to stimulate consumer spending, as the policy focus is shifting away from stimulating FAI. Proposals that have been made include new measures (e.g. tax incentives and coupons) for stimulating demand for motorcycles, travel, and entertainment activities. In addition, health care reform has been delayed and may show a more positive impact on the health care industry in 2010. Once these changes have materialized, they may provide new catalysts for selected companies in our basket.

4) **Liquidity support from sector rotations.** When investors become more aware of the downside risks posed to their cyclical exposures, sector rotations to the consumer and insurance spaces will tend to boost market valuations of the companies in our basket.

5) **Lower volatility.** Our "sustainability" basket has shown much lower volatility in its share price history than those of MSCI China Index, our export-related basket (see our June 29 report, "Exports to outperform FAI in next 12 months", and our FAI-related basket (also see the June 29 report). Figure 27 illustrates this point. Therefore, from a risk-reward perspective, our "sustainable" basket is even more attractive than it may appear on a simple EPS growth or PEG comparison. Simply speaking, we believe the "sustainability basket" offers not only upside on growth and more attractive PEG, but also lower risks (or better sustainability).

Figure 27: 3-year share price volatility: MSCI China, export basket, FAI basket, and "sustainability" basket



Source: Deutsche Bank

Note: 1. see Figure 25 for the consistent o f the "sustainability" basket; 2. the constituents of our "export basket" are representative companies in typical export sectors including Li&Fung(494.HK), Alibaba(1688.HK), BYD(1211.HK), China Merchant(144.HK), China Shipping Container(2866.HK), Foxconn(2038.HK), Yue Yuen(551.HK) and Lenovo(992.HK); 3. the constituents of our "export basket" are representative companies in metal, building material, truck and dry bulk sectors including Chalco(2600.HK), Angang(347.HK), Anhui Conch(914.HK), Jiangxi Copper(358.HK), Yanzhou Coal(1171.HK), China Zhongwang(1333.HK), China Shipping Development(1138.HK), Maanshan Steel(323.HK), CNBM(3323.HK), Weichai Power(2338.HK) and China Moly(3993.HK). These two baskets were published in our report dated June 29, 2009, 'Exports to outperform FAI in next twelve months'.

Buy "sustainability", Sell "deceleration"

In addition to buying the "sustainability" basket or selected names within the basket, another way to take advantage of our theme is to pair trade the "sustainability" basket against a "deceleration" basket also in the consumer space. Our "deceleration" basket includes names in telecom, beer, auto, and sportswear, which will likely see both top-line and bottom-line slowing in coming years. The "deceleration" basket is trading at a PEG of 2.4x (see Figure 28), far higher than our "sustainability" basket of 0.77.

Figure 28: Companies to see both top-line and bottom-line deceleration in 2010/11

Company	Ticker	Sector	Rating	16-Oct Price local	M. cap (US$m)	PE 2010	EPS CAGR 09-11	PEG (10PE/EPS 09-11
Li Ning Co Ltd	2331.HK	Sportwear	Sell	22.0	3,048	19.8	16%	1.21
China Unicom	0762.HK	Telco	Sell	10.9	33,735	31.1	-6%	NA
Dongfeng Motor	0489.HK	Auto	Hold	9.6	10,295	12.8	11%	1.14
Tsingtao Brewery C	0168.HK	Beverage	Hold	31.4	5,385	24.5	16%	1.55
Average					13,116	22.1	9%	2.36

Source: Deutsche Bank, Bloomberg

The specific reasons for their "deceleration" include high penetration ratios, fading policy stimulus, and the one-off nature of many factors that drive the current growth.

Sportswear – Li Ning (2331.HK, Sell, HK$22.0)

After the pre-Olympic frenzy of sportswear brands, the industry's sales growth of 30-40% per annum seen before 2008 is very unlikely to recur in the coming years. The channel check by our consumer analyst Rebecca Jiang suggests that most sportswear brands are now experiencing nearly zero or even negative SSS growth in the over-crowded tier-one cities. She expects industry growth to decelerate to mid-teens from this year due to market saturation.

Our top Sell in the sector is Li Ning. Rebecca expects the company to post slower top-line growth versus peers in the coming 12 months. The company is trading around 20x FY10E PE and the FY09-11 EPS CAGR is estimated at 16%.

Telecom – China Unicom (762.HK, Sell, HK$10.9)

China's mobile subscriber population had reached 710m by August 2009. The mobile penetration rate of 52.5% in China is already close to the world average level of 59%. All the telecom operators are now experiencing negative growth of new added subscribers. To make matters worse, our sector analyst William Bratton has calculated that China is experiencing the most rapid intensification in competition in the region, as reflected by a significant y-o-y increase in sales and marketing costs relative to revenues. ARPU has also been declining rapidly – by about 10% y-o-y in 1H this year -- as new subscribers are largely from the low income rural areas.

Among the three listed telecom operators we think China Unicom has the weakest outlook. Deutsche Bank analyst Alan Hellawell does not believe Unicom's iPhone launch will provide much help in the short term as ~90% of its 3G user base will not have an iPhone by end-2010. He forecast -6% FY09-10 EPS CAGR and the company is trading at 32x 10PE vs. 12x for China Mobile and 15x for China Telecom.

Auto – Dongfeng Motor (489.HK, Hold, HK$9.6)

China's auto sales surged 34% y-o-y in the first nine months this year from 6.6% in 2008. In the last two months (August and September), the y-o-y sales growth surged to about 80%. This record high growth since 2003 is beyond the expectations of both auto makers and sector analysts. However, we believe all factors driving this exceptional growth are one-off in nature, and their disappearance will likely lead to negative auto sales growth sometime around mid next year. For example, the purchase tax reduction from 10% to 5% on vehicles with 1.6-litre or smaller engines is only valid until the end of this year and part of this policy may be allowed to expire. Although the rural subsidy is a four-year scheme, its y-o-y impact will be much weaker next year when the program enters into its second year of implementation. Also, this year's y-o-y growth enjoys a very favorable base effect, but it will be reversed next year. Our auto analyst Vincent Ha forecasts that for the full year of 2010 auto sales growth will decelerate to 8-10%, down from this year's c.40%.

Dongfeng Motor is likely to show similar deceleration to the industry in 2010. In addition, the capacity of its Nissan JV is now fully utilized, and it will be difficult to ramp up production next year even if demand surprises on the upside. The company is trading at 12x FY10E PE.

Beer – Tsingtao Brewery (168.HK, Hold, HKI$31.4)

Chinese consumers drank 32.8 liters of beer per capita in 2008, 60% more than five years ago. This is already 10% above the world average and the growth rate will likely drop to 3-5% per annum in the next few years, according to the forecast by the China Alcoholic Drinks Industry Association. Even the market leaders will find it hard to achieve double-digit growth.

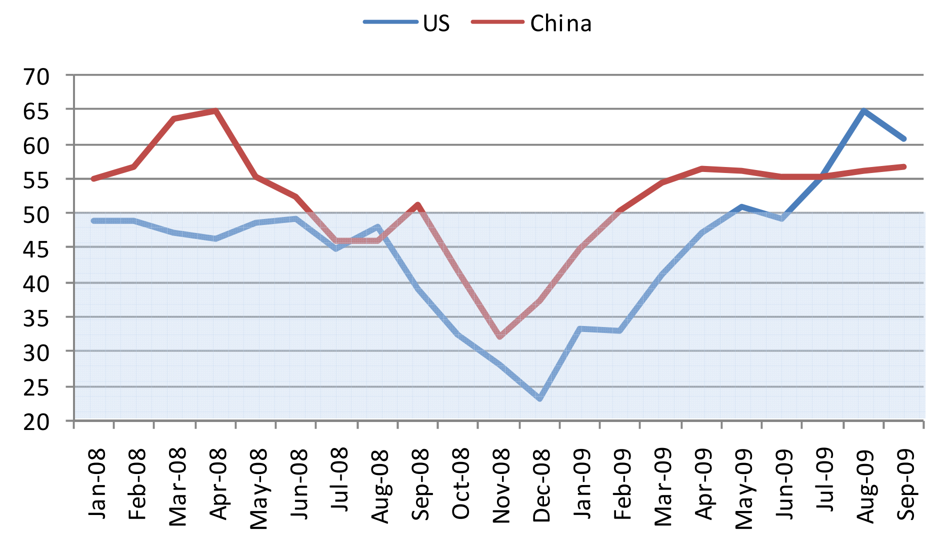
Tsingtao Brewery is China's second-largest beer brand with a 13% market share. The company has not started budgeting for next year's sales volume growth and capex plans, but our analyst Mabel Wong does not expect its 1H09 strong sales growth of 15% to sustain next year. Mabel believes that even with the brand franchise, the company's 24x FY10E PE is not justified by 09-11E EPS CAGR of 16%.

Update on overall market outlook and strategy

1) In a regional context, China has underperformed other Asian markets which have been more driven by the US recovery for the past few months, and we expect this underperformance to continue for a few more months. This is because China is now in its second phase of sequential (q-o-q) economic deceleration (started from 3Q) due to fading stimulus, while the US (and the rest of Asia which is highly leveraged on US growth) has started its exceptionally strong sequential recovery only from 3Q this year.

   The following chart illustrates this point by comparing the new orders index in China's PMI reports and the new orders index in the US manufacturing ISM reports. Two differences are interesting to note. First, the recovery of the Chinese new orders index, measured by its reading exceeding the breakeven level of 50, started as early as in February. That is, it is an eight-month-old story and should have been largely priced in. However, the US recovery measured by its new orders index breaking the 50 level, began only in July this year, i.e., a much more recent phenomenon. It therefore suggests that the market is less likely to have fully priced in the US-led recovery. Second, using the level of the new orders index as a measure of the strength of sequential recovery, the latest two US readings average 63, while that of China is around 56.5. It says that at this particular moment, the sequential recovery of the US economy (and therefore the key beneficiaries such as Korea and Taiwan) is in fact much stronger than that in China.

Figure 29: US vs China: new orders index



Source: Deutsche Bank, CEIC

1. **On China's market indices per se (H share and SHCOMP), we see upside in the next 3-5 months,** as in the initial stage of inflation corporates tend to be net beneficiaries due to rising ASPs and margins but without an immediate threat of policy tightening. We think this period should last until CPI inflation rises to about 2%, i.e., sometime in 1Q next year.

   However, we believe the macro environment from 2Q next year will become more challenging for the equity market. First, inflation is likely to rise to 3% y-o-y, prompting the central bank to begin raising rates. Second, in the later part of 2Q, when the market and government begin to realize that even y-o-y GDP growth is likely to show a second dip (could be as much as 2-3ppts), but inflation remains on the uptrend, stagflation concerns will kick in. Thirdly, under a stagflation situation, an asymmetric rate hike will be the most likely policy response from the PBOC, which may squeeze banks' NIMs. Fourth, if inflation rises to 4%, the likelihood of price controls will also rise. Finally, by 2Q next year, the market may begin to reflect on the potential of the US' second dip in economic growth.

2. Our sector strategy

   a) We stay overweight on export-related sectors, including exporters, container shipping, ports, trade financing providers, and other export service providers, in the next two to three months.

   b) We think insurance, consumer and technology sectors (see companies mentioned in our "sustainability" basket as examples) will offer more sustainable upside potential, and therefore should form a major part of investors' core portfolios for 2010. Buying these themes and stocks on dips should be the strategy for most of next nine months, in our opinion.

   c) We continue to dislike selected FAI-related names such as steel, given further downside to steel spot prices and overcapacity.

d) We think the property sector is unlikely to perform in the near term given the supply pressure from a long list of IPOs in the pipeline. A few months later, if share prices are over correcting, it may provide a short-term trading (buying) opportunity. However, from 2Q next year, we will begin to worry about renewed overcapacity (due to the recent surge in property FAI growth) and potential rate hikes.

e) On banks, we are positive in the coming few months due to rising NIMs and the absence of significant monetary policy tightening. However, from late 1Q to 3Q next year, it is likely to be a trading market for banks. We think the first rate hike is likely to be symmetric, under the perception of economic overheating, and thus should further boost banks' NIMs. However, after the release of second-quarter GDP, the fear of stagflation will probably lead to a policy compromise of an asymmetric rate hike. If it is sufficiently asymmetric, it will depress banks' NIMs.

f) For the oil refining and power sectors, the near-term outlook appears stable to positive given rising demand and stable margins. However, when CPI inflation rises to 3%, we will turn cautious as the market will begin to reflect the rising probability of price controls.

Figure 30: China macroeconomic forecasts

	2007	2008	2009F	2010F
National Income				
Nominal GDP (USD bn)	3406	4290	4617	5312
Population (mn)	1342	1353	1364	1374
GDP per capita (USD)	2538	3171	3385	3866
Real GDP (YoY%)[1]	13.0	9.0	8.7	9.0
Private consumption	11.0	9.3	7.5	7.5
Government consumption	11.5	9.3	8.0	8.0
Gross capital formation	13.1	10.6	13.5	8.5
Exports	17.7	11.4	-12.0	12.5
Imports	13.5	15.2	-12.5	10.0
Prices, Money and Banking				
CPI (YoY%)	4.8	5.9	-0.5	3.4
Broad money (M2)	17.5	17.8	28.3	15.5
Bank credit (YoY%)	16.5	18.8	31.0	17.0
Fiscal Accounts (% of GDP)				
Budget surplus	0.6	-0.4	-3.0	-3.0
Government revenue	19.8	20.5	19.0	19.1
Government expenditure	19.2	20.9	22.0	22.1
Primary surplus	1.3	0.3	-2.3	-2.3
External Accounts (USD bn)				
Merchandise exports	1218.6	1428.5	1199.9	1367.9
Merchandise imports	955.9	1133.1	906.5	1051.5
Trade balance	262.7	295.4	293.5	316.4
% of GDP	8.3	6.4	6.4	6.0
Current account balance	304.0	301.3	283.5	296.4
% of GDP	9.5	7.2	6.1	5.6
FDI (net)	151.5	163.0	70.0	90.0
FX reserves (USD bn)	1528.3	1946.0	2300.0	2650.0
FX rate (eop) CNY/USD	7.31	6.84	6.83	6.67
Debt Indicators (% of GDP)				
Government debt[2]	22.2	20.0	21.3	21.9
Domestic	21.2	19.1	20.5	21.2
External	1.0	0.9	0.8	0.7
Total external debt	14.7	13.9	14.8	14.2
in USD bn	373.6	440.0	500.0	550.0
Short-term (% of total)	59.0	65.0	60.0	50.0
General (YoY%)				
Fixed asset inv't (nominal)	24.8	25.5	32.0	17.5
Retail sales (nominal)	16.5	21.6	15.0	15.0
Industrial production (real)	18.0	12.9	11.5	11.5
Merch exports (USD nominal)	26.0	17.2	-16.0	14.0
Financial Markets	*Current*	*3M*	*6M*	*12M*
1-year deposit rate	2.25	2.25	2.52	3.06
CNY/USD	6.83	6.83	6.80	6.70

Source: CEIC, Deutsche Bank Global Markets Research, National Sources
Note: Growth rates of GDP components may not match overall GDP growth rates due to inconsistency between historical data calculated from expenditure and product method. (2) Including bank recapitalization and AMC bonds issued.

Appendix 1

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Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

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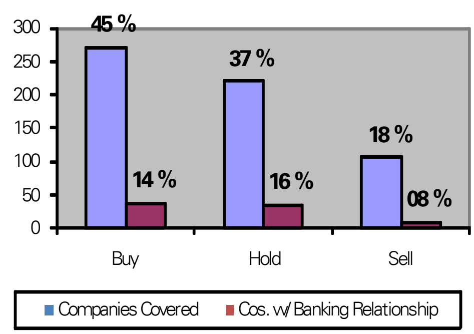

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