

Jing Ulrich
Managing Director, Chairman,
Global Markets, China
+852 2800 8635
jing.l.ulrich@jpmorgan.com

Amir Hoosain
+852 2800 8641
amir.h.hoosain@jpmorgan.com

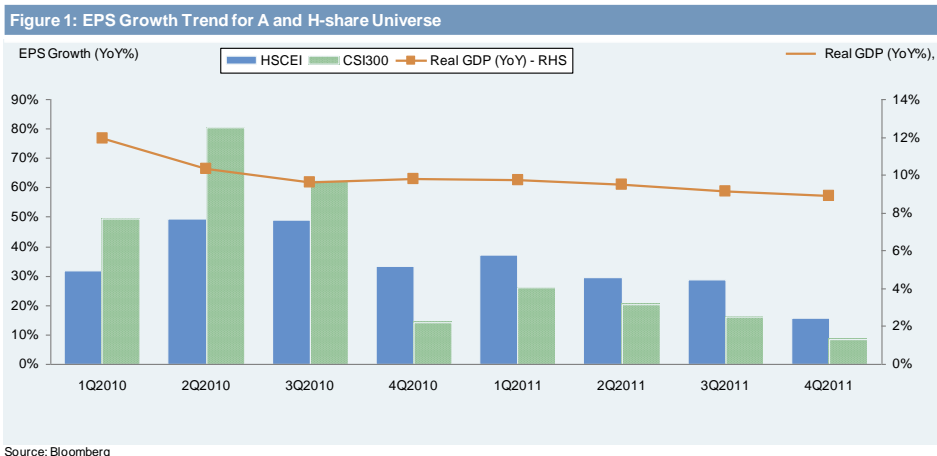
Ling Zou
+852 2800 8962
johnny.l.zou@jpmorgan.com

Sheila Wang
+852 2800 8985
sheila.s.wang@jpmorgan.com

Soft or Hard Landing for China's Corporate Earnings?

I. Executive Summary

The debate about whether China's macro-economy will have a soft or hard landing has continued for many years. However, concerns about a sharp slowdown have subsided somewhat following the recent improvement in PMI, cut in bank reserve ratios and pledges of government support for further tax reforms. China's strong balance sheet and policy flexibility suggest that the economy is in good position to withstand risks to growth arising from weak export demand and the domestic housing market correction. That said, the economy's resilience does not necessarily point to an optimistic outlook for corporate earnings. In 2011, EPS growth in the Chinese A and H-share universes decelerated steadily (see *Figure 1*) against a backdrop of credit tightening, as well as cost inflation and overcapacity in some midstream industries. This occurred even as a range of macro indicators such as urban fixed asset investment, industrial production and retail sales showed a degree of resilience. In this report, we examine the composition and outlook for corporate earnings, both for China's A and H-listed universe and for the industrial sector.



- **The outlook for corporate earnings in 2012 remains challenging** – pre-earnings guidance from 1,534 listed A-share companies (approximately two-thirds of the universe) points to a downtrend in sequential growth in 4Q2011, with only 44% reporting positive growth over the preceding quarter, as compared to 60% reporting sequential growth in 4Q2010. The earnings picture, however, is healthier than it was during the onset of the global financial crisis in 4Q2008, when more than two-thirds of listed A-share companies experienced a sequential decline in earnings.
- **Less heady growth in 2012 for last year's best performing sectors.** The three sectors expected to report the strongest profit growth in 2011 – building materials, banks and retail are generally expected to experience some degree of earnings deceleration in the year ahead. J.P. Morgan's analysts expect earnings growth of ~20% for banks in 2012 (compared to ~36% net profit growth for all commercial banks in 2011, according to the

CBRC), ~14-22% earnings growth for covered retail companies (with discretionary names at the lower-end of the spectrum, but offering more upside risk) as compared to 36% YoY earnings growth in 1H2011 and an expected average 20% YoY growth for China/HK retailers in 2H2011. The likely moderation in fixed asset investment growth over the next few years may dampen earnings growth for building material industries; however, a recovery in railway capex this year could benefit major construction contractors and equipment providers.

- **China's earnings universe is not representative of the broader economy.** Banks account for the largest share of earnings for the HK/China listed universe at 29.4% (roughly double the sector's share of market capitalization), while sectors associated with fixed investment and household consumption are generally underrepresented in the equity markets. The composition of China's listed company earnings will evolve over the long-term, especially as more consumer-related companies become listed and if interest rate reforms temper the earnings growth of China's banks.

II. Earnings Profile of China's Listed Universe

To fully appreciate the contrast in the outlook for China's economy and its listed corporate sector, one must consider the composition of earnings in the listed universe. Figure 2, which charts the trailing 12-month net income for all A and H-share stocks as well as Red Chips, clearly shows that banks account for the largest share of earnings at 29.4%. Although gross capital formation contributed 4.99 percentage points to last year's 9.2% growth in GDP, three sectors closely associated with fixed investment – basic resources, construction & materials and industrial goods & services – collectively accounted for only 22.2% of trailing net income. Sectors associated with the consumer economy are similarly underrepresented in the equity market, in terms of both earnings and market capitalization.

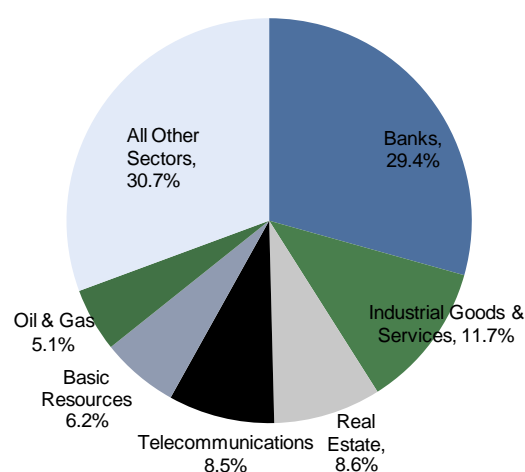
Banks account for >40% of index earnings

Figure 2a: Composition of A/H/Red Chip Share Universe

A+H Share Universe	% of Market Cap.	% of Net Income (Trailing 12M)
Banks	14.9%	29.4%
Industrial Goods & Services	14.4%	11.7%
Telecommunications	9.3%	8.5%
Basic Resources	7.9%	6.2%
Food & Beverage	6.5%	3.0%
Real Estate	6.0%	8.6%
Technology	4.6%	2.2%
Oil & Gas	4.4%	5.1%
Health Care	4.2%	2.4%
Chemicals	3.9%	2.7%
Construction & Materials	3.9%	4.3%
Personal & Household Goods	3.9%	3.0%
Retail	3.4%	2.3%
Automobiles & Parts	3.3%	3.6%
Utilities	2.9%	2.2%
Financial Services	2.9%	1.9%
Insurance	1.7%	1.2%
Travel & Leisure	1.2%	1.5%
Media	0.6%	0.4%

Source: Bloomberg

Figure 2b: Share of Net Income (Trailing 12M)



China's equity markets are not representative of the broader economy, and this is in part due to the prominence of large state-owned enterprises within the universe. This is truer still with respect to the banking sector, since nearly all major banks in the nation are now listed on one or both equity markets.

The dominance of banking is even more pronounced at the index-level, with banks accounting for 44.6% of HSCEI earnings and 43.9% of MSCI China earnings on a 12-month trailing basis. There are also disparities between market capitalization and earnings, with banks' share of earnings nearly double that of the sector's share of market capitalization. The sectoral composition of China's listed company earnings will evolve in the coming years, especially as more consumer-related companies become listed and if interest rate reforms temper the earnings growth of China's banks.

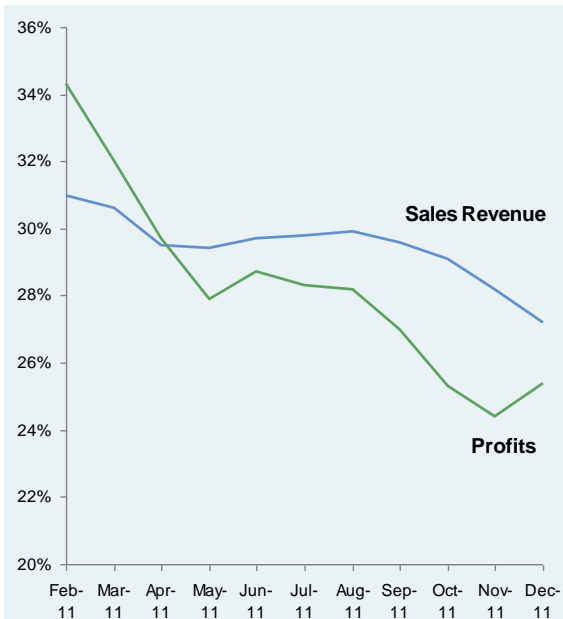
III. Decelerating Profit Growth for Industrial Enterprises

Deceleration in profit growth within the "real economy" is also evident in recent data from the National Bureau of Statistics, based on a business survey of 5,000 industrial enterprises with sales revenues in excess of RMB20 million per year. While the survey showed 2011 profits totaling RMB5,454 billion, or 25.4% higher than 2010 profits (see Figure 3), there was a gradual deceleration from 32% YoY growth in 1Q2011, to 28.7% in 1H2011 and 27% in 9M2011. The growth rate rebounded somewhat in December, but it should be noted that there was some upward bias in the monthly figure as a result of year-end profit remittances, investment income and the recently increased threshold on the windfall tax paid by oil & gas producers (profits for this sector jumped 44.8% YoY during the month).

- **Revenue growth decelerating.** Sales revenue growth for all surveyed enterprises slowed from 31.0% YoY in January 2011 to 27.2% in December, while account receivables picked up by 19.6% during the year, reflecting the tight cash flow situation in many industrial sectors.

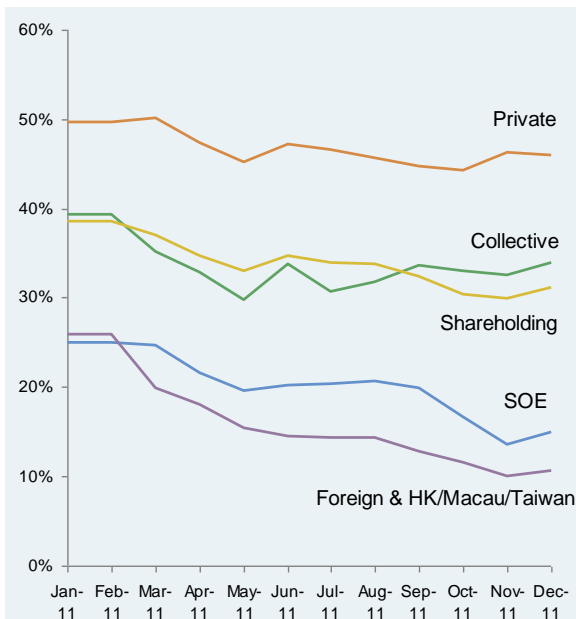
- **Private enterprises demonstrate the strongest profit growth.** As Figure 3 shows, private enterprises exhibited the highest rate of profit growth (46% YoY), followed by collectively-owned enterprises (34%). Profits for State-owned enterprises in the survey grew 15% YoY, while foreign and Hong Kong, Macau and Taiwan enterprises exhibited the weakest profit growth at 10.6%.

Figure 3a: Business Revenue and Profit Growth for Industrial Enterprises (YoY%)



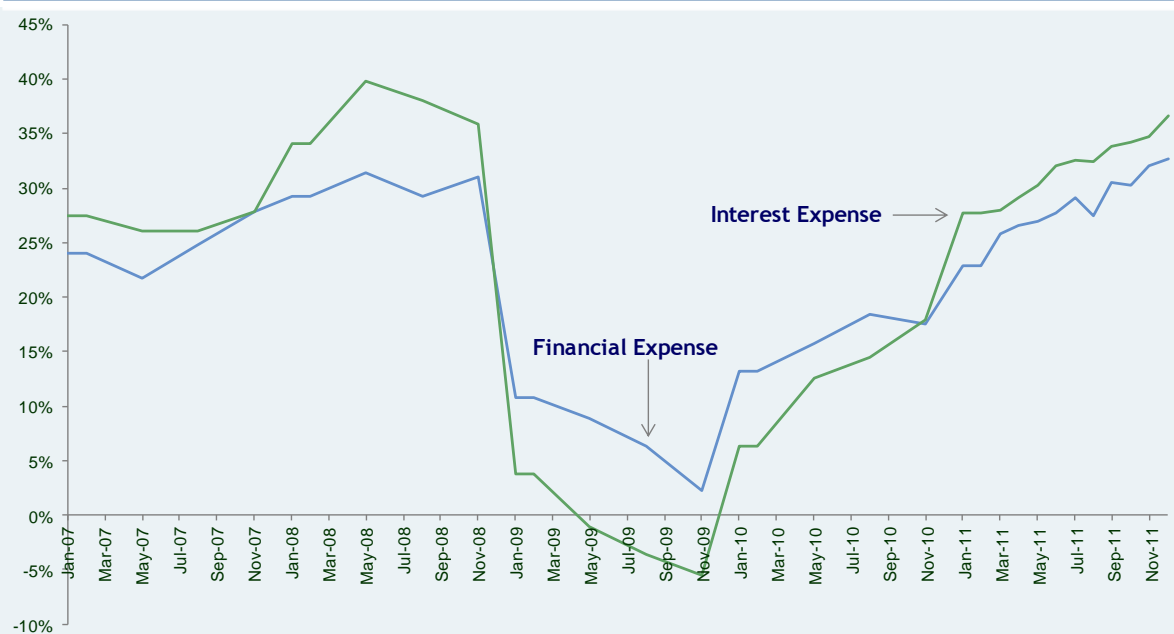
Source: CEIC

Figure 3b: Industrial Enterprise Profit Growth (YoY) by Entity Type



- **Financial expenses on the rise.** According to the NBS data, the growth in financial expenses has rebounded to the level seen during the 2008 financial crisis (see Figure 4), with interest expenses surging over the course of 2011 as a result of the government's monetary tightening (which raised financing costs while also reducing channels for financing).

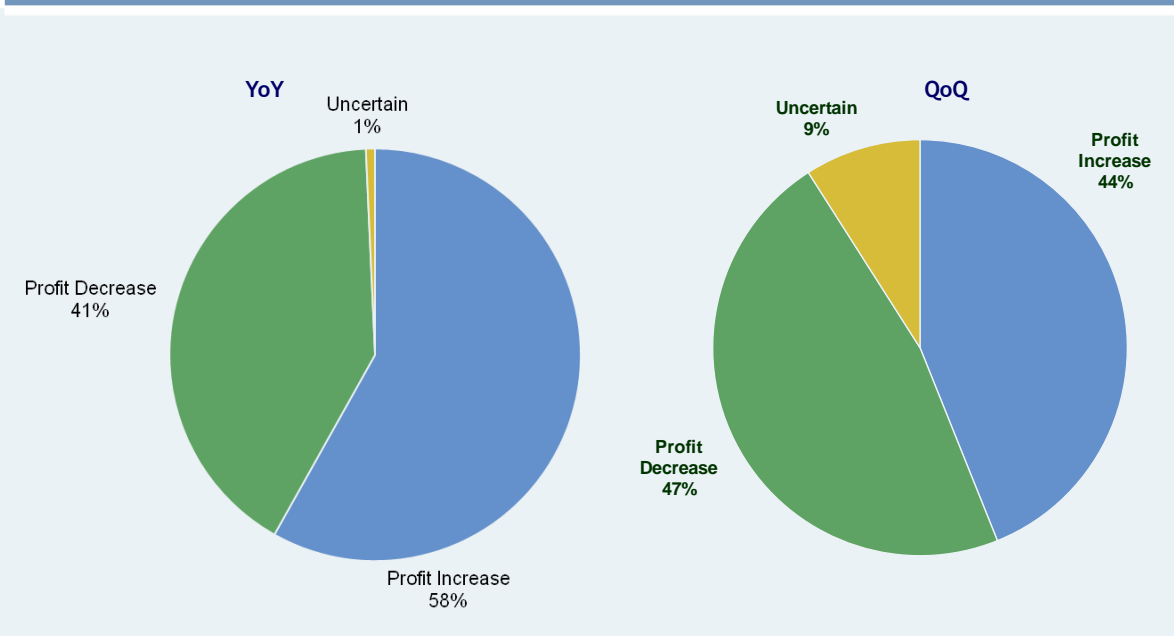
Figure 4: Financial Expenses Rose Sharply due to Monetary Tightening (%)



Source:CEIC

IV. Pre-earnings trends for Mainland China-listed companies

Figure 5: 2011(E) Earnings Projections Based on Companies' Pre-earnings Announcements



Source: Wind, J.P. Morgan's Hands-on China Series

To gauge the profit outlook across different sectors, we examined 2011 pre-earnings announcements for a sample of 1,534 stocks listed in Shanghai/Shenzhen. Of this sample, 892 companies or 58.1% of the total expect to post an increase in annual earnings over 2010 (see Figure 5). However, of the companies for which fourth quarter financials were available, only 44.4% of firms posted sequential growth in 4Q2011, whereas in 4Q2010, 60% of firms experienced positive sequential growth. The

earnings picture, however, is still healthier than it was in 4Q2008, when more than two-thirds of listed firms had a QoQ drop in earnings.¹

The worst performing sectors (using the Bloomberg Industry Classification System) include iron & steel, transportation, forest products & papers and electrical components (see Figure 6). The autos, real estate and general manufacturing sectors showed very weak or negative sequential growth in the fourth quarter. Sectors with relatively strong earnings growth include banks, engineering & construction, building materials & household products, as well as retail.

Figure 6: A-share 2011(e) Earnings Growth by Sector



Source: Wind, J.P. Morgan's Hands-on China Series

• Iron & Steel

The iron and steel sector posted steep losses in 4Q2011, with full-year earnings declining by 110% on average for the 21 companies with pre-announcements; 13 companies within the sample project negative earnings growth. In the fourth quarter, steel prices, according to *Mysteel's* composite steel price index declined by 9.6% over the previous quarter, depressing sales margins to the lowest level since early-2009. Citing high raw material prices and a drop in 4Q11 steel prices, Angang (000898 CH/0347 HK), for instance, announced a FY 2011 preliminary loss of RMB2.05 billion (roughly the same as its level of profit in 2010) after previously reporting a 9M11 profit of RMB239 million. Maanshan Iron & Steel has issued a profit warning of a 50% YoY drop in its net profit in 2011.

In the last five years, the annual growth in iron prices has outpaced the growth in steel prices (CAGR: 17.7% vs 7.1%). As J.P. Morgan analyst Daniel Kang has noted, steel mills have difficulty passing on higher costs with utilization rates at the low-70% levels. Capacity reductions among Chinese steelmakers (>100 mtpa in 3Q-4Q 2011) have helped spur a moderation inventory levels for 10 consecutive weeks since mid-October. Even so, capacity issues and the slowdown in FAI will weigh

¹ As some A-share companies disclose preliminary earnings through an indicative range, we take the conservative approach of adopting the lowest-growth scenario for such cases.

on the sector's outlook in 2012. Daniel Kang projects a 5% YoY increase in steel consumption and incremental capacity growth of 2.5%. Steel producers could face an additional cost burden as miners attempt to pass on the impact of the recent hike in resource taxes on iron ore.

- **Transportation**

A-share pre-earnings announcements showed a broad-based sequential decline in the transportation sector's profits, beginning from 3Q11. A major overhang for the sector was the high-speed train accident in Wenzhou in July, which prompted a suspension of new railway project approvals and a steep decline in rail construction investments. J.P. Morgan's China infrastructure analyst Karen Li believes railway capex should rebound in 2012, with a recovery in new rail orders likely to materialize in late 1Q or early 2Q. This view has prompted a recent upgrade to OW for the country's two largest contractors – China Railway Group (CRG) and China Railway Construction (CRCC). Karen Li has also highlighted CSR and Hollysys Automation as two companies likely to benefit from the shift in capex mix towards trains and equipment as more track construction is completed.

Meanwhile, the toll-road sector was a significant underperformer in 2011 due to concerns arising from the Nationwide Toll Fee Review due in June 2012. Some provincial governments have already cut toll fees, reduced minimal charges and unified toll rates, with the nationwide review expected to conclude by mid-year. With the market having already reduced revenue growth expectations to a single-digit level in 2012E, Karen Li expects a sector re-rating this year as uncertainties are removed and operators achieve stable operating margins.

- **Autos**

While China's auto market is characterized by a low level of vehicle penetration and will continue to expand, a return to the breakneck pace of recent years is unlikely. In 2011, China's auto sales rose only 2.5% YoY to 18.5 million vehicles, the slowest pace of growth in more than a decade. Specifically, passenger vehicle sales rose 5% YoY to 14.5 million units, while commercial vehicle sales declined 6% YoY to 4 million units. The slowdown in sales could be attributed to the expiration of tax incentives and subsidies, as well as the introduction of restrictions on car purchases in Beijing. Meanwhile, domestic automakers have been experiencing margin pressure due to rising costs and price competition, especially in the low and mid-range segments where capacity expansion has been very aggressive. J.P. Morgan analyst Frank Li sees luxury automobiles as being the most resilient segment of the market due to the societal boom in luxury consumption and an ongoing trend of vehicle upgrades. He is especially positive on the outlook for Geely Automobiles due to such factors as potentially strong growth in Volvo sales in China, the near-term introduction of an SUV model and expected strong sales growth in the company's higher-margined Emgrand model. He also recommends Brilliance China and the large luxury dealership Baoxin Auto Group, which is well positioned to benefit from strong demand for sale and after-sale services in affluent coastal regions of China.

- **Real Estate**

Many property developers' financial positions deteriorated in 2011, given the decline in transaction volumes, funding problems and recent correction in real estate prices. Out of 56 companies for which pre-earnings information is available, 25 expect to post negative earnings growth in 2011. Inventories of unsold housing are edging higher in many cities, which suggests that the moderation in ASPs is set to continue and will be reflected in this year's earnings. Although real estate investment growth has decelerated in recent months and many cities saw sales plummet during the Chinese New Year period, policymakers show no near-term inclination to loosen home purchase restrictions that have served to cool the housing market. Under current market conditions, J.P. Morgan's property analyst

Lucia Kwong prefers Evergrande, Guangzhou R&F and Agile, considering that housing markets in Southern China are less over-supplied.

- **Retail**

Unsurprisingly, the retail sector was one of the brighter spots in the 2011 earnings landscape, with 38 companies projecting profit growth in 2011 compared to 9 that expected negative growth (for a sample average of 36.3% growth). Consumer spending has been underpinned by a steady rise in disposable incomes and an accelerated pace of urbanization, especially into lower-tier cities where retail demand has been robust. However, several factors could temper the sector's earnings growth this year, including i) erosion in consumer confidence due to external headwinds and subdued asset markets, ii) the decline in CPI and iii) elevated labor costs. J.P. Morgan's consumer research team expects growth rates to remain under pressure, especially in 1H2012 with gross margins weakening across the board for the full year as promotional activities increase. J.P. Morgan's Ebru Sener Kurumlu expects discretionary names to deliver 14% earnings growth on the back of 16% sales growth in 2012, while staples names could deliver 22% earnings growth on average, driven by 18% sales growth and higher margins. However, she sees greater earnings upside risk in the discretionary universe if the recovery cycle begins in the next several months. Top picks in the discretionary sector are Trinity, Golden Eagle, Belle and I.T. Ltd.

- **Banks**

According to the China Banking Regulatory Commission (CBRC), the profits of China's commercial banks expanded to RMB1.04 trillion in 2011, compared to net profit of RMB763.7 billion in 2010. The sector-wide NPL ratio stood at 1% at year-end, down 0.1% YoY, but up 0.1 percentage points since end-September. The capital adequacy ratio of Chinese banks rose to 12.7% at the end of 2011, from 12.2% a year earlier. Meanwhile, preliminary full-year results for a small sample of four A-share banks (China Minsheng Bank, Hua Xia Bank, Shenzhen Development Bank and Bank of Ningbo) showed 50.3% growth on average. Although one may question the long-term ability of Chinese banks to rely heavily on net interest margin income (against a backdrop of gradual interest rate liberalization), the NIM trend is expected to be largely stable in 2012. J.P. Morgan's China bank analyst Samuel Chen believes the sector could weather a modest pickup in NPL balances and limited deposit growth to deliver about 20% earnings growth this year, as China's economy achieves a soft-landing. While he sees a stronger long-term outlook for certain medium-sized banks (preferring Minsheng-H and BoComm-H), he argues that some bigger banks offer stronger earnings visibility and higher dividend yield in the near-term.

- **Building Materials**

Among the sample of companies for which preliminary earnings are available, the building materials sector was the strongest performer in 2011, primarily due to surging profits in the cement industry. China's largest cement producer Anhui Conch (600585 CH/914 HK) reported a 187% YoY increase in 3Q 2011 net profit, reflecting strong FAI growth during the first half of 2011. However, sales momentum softened towards year-end and the company has projected full-year earnings growth of just over 80%. Other materials sectors, such as glass, have also experienced slowing demand since 3Q 2011. J.P. Morgan analyst Nick Lai estimates 2012 cement demand growth at 3%, compared to 11% in 2011. For most companies, profit per ton in 2012 is expected to be 5-10% lower than in 2011. Although demand for cement from affordable housing construction should be higher in 2012, this represents less than 5% of total demand, whereas infrastructure accounts for more than 40%.

Disclaimer

J.P. Morgan is a marketing name for investment banking businesses of JPMorgan Chase & Co. and its subsidiaries worldwide. JPMorgan Chase & Co. or any of its affiliates (collectively, "J.P. Morgan") makes no representation or warranty regarding the accuracy or completeness of the information herein. J.P. Morgan is not an advisor to any person in respect of any referenced transaction.

This material is not the product of J.P. Morgan's research departments and along with any associated verbal presentation (together the "Presentation") is purely indicative and is based on current assumptions and market conditions. Although information contained herein has been obtained from sources which we believe to be reliable, none of J.P. Morgan, nor any person acting on their behalf, makes any representation or warranty, implied or express regarding the accuracy or completeness of the information contained herein. The Presentation is not intended as an offer or solicitation for the purchase or sale of any financial instrument, nor does it constitute a commitment by J.P. Morgan to enter into any transaction referred to in the Presentation. J.P. Morgan shall incur no responsibility or liability whatsoever to the client or to any other person in respect of the Presentation and in the event that J.P. Morgan enters into any transaction described in the Presentation then such transaction shall be governed exclusively by the relevant transaction documents.

The recipient must make an independent assessment of any legal, credit, tax, regulatory and accounting issues and determine with its own professional advisors any suitability or appropriateness implications of any transaction referenced herein in the context of its particular circumstances. J.P. Morgan assumes no responsibility or liability whatsoever to any person in respect of such matters. This material is directed exclusively at market professionals and institutional investors and is not for distribution in any jurisdiction where such distribution contravenes applicable laws of any relevant jurisdiction, nor could it be distributed to any other person or replicated in any form without the prior written consent of J.P. Morgan. Notwithstanding any prior written consent provided by J.P. Morgan for the further distribution or replication of these materials and as consideration therefore, the initial recipient of these materials acknowledges to J.P. Morgan that it shall hold J.P. Morgan harmless for the consequences of such further distribution or replication (as the case may be).

Copyright 2012 JPMorgan Chase & Co. All rights reserved. Additional information is available upon request.