

Equity Strategy
China

China Strategy

The future is farming

- ▶ **This year's No.1 Central Document focuses again on 'san nong' reforms for agriculture, rural areas and farmers**
- ▶ **Ensuring a sufficient food supply to maintain social and price stability remains a daunting challenge**
- ▶ **We screen for opportunities in agricultural machinery, fertilizer, food processor, rural consumption and financing**

3 February 2012
Steven Sun (孙瑜)*

Equity Strategist
 The Hongkong and Shanghai Banking Corporation Limited
 +852 2822 4298
stevensun@hsbc.com.hk

Roger Xie*

Equity Strategist
 The Hongkong and Shanghai Banking Corporation Limited
 +852 2822 4297
rogerpxie@hsbc.com.hk

Garry Evans*

Global Head of Equity Strategy
 The Hongkong and Shanghai Banking Corporation Limited
 +852 2996 6916
garryevans@hsbc.com.hk

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Issuer of report: The Hongkong and Shanghai Banking Corporation Limited

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The No.1 Central Policy Document for 2012 – released last Wednesday – extends the country's almost-decade long focus on farming and rural reform, stressing the importance of technological innovation to sustaining growth in agricultural output. In the past 4 years, the market has priced in such favourable agricultural policies 3 months ahead of the No.1 Central Policy Document's release, with relevant stocks tending to continue outperforming for a month after the event. The good news this year is that the usual sector rally has yet to take place.

Ensuring a sufficient supply of agricultural output is vital to social and price stability, especially amid the deepening impact of climate change, and increasing shortage of arable land and water at home. China now consumes nearly 50% of the pigs, 40% of the eggs and 30% of the rice that the world produces (chart 1). Food items make up one-third of China's CPI basket and have driven 95% of its movement in the past 10 years (chart 2).

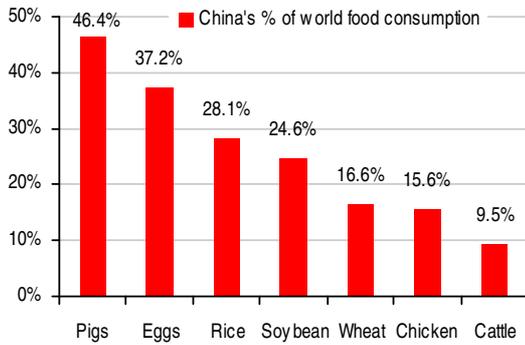
Reforms targeting the agricultural sector, rural areas and farmers – collectively known as *san nong* – became the top policy priority in 2004 (chart 3), the year after China's grain yield fell to a low of 430m tonnes (less than a kilogram per capita per day). *San nong* related central fiscal spending has since risen at 22% CAGR from RMB200bn in 2004 to RMB1trn in 2011, and may rise another 20-30% in 2012 to fund agricultural subsidies and investment, as the government attempts to stabilize grain production at 570m tonnes.

This is a challenge because China's arable land has shrunk 5% to under 122m hectares since 2000, due to urbanization and property development. Moreover, there are environmental restrictions on fertilizer usage, which has risen 40%+ to nearly half a ton per hectare (chart 5). Meanwhile, the number of large and medium tractors – the most common machinery used in rural areas – has more than quadrupled to around 4m units in the past decade (chart 6).

For these reasons, the 2012 policy urges development of frontier agricultural technologies, machinery and basic research, as well as construction of more irrigation, water conservation and logistics facilities in rural areas. Moreover, it encourages China's banks to increase lending to rural regions and supports commercial banks in extending their branches to townships (table 7).

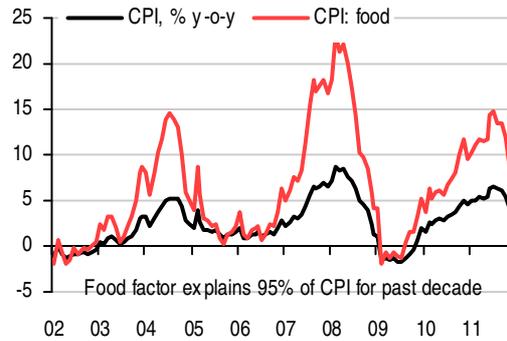
Achieving food independence a major challenge

Chart 1. China consumes nearly 50% of pigs, 40% of eggs and 30% of rice globally



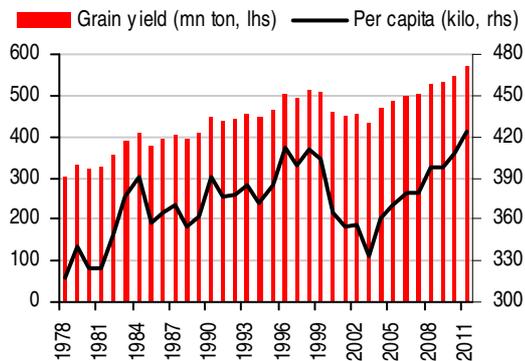
Source: IMF, UN

Chart 2. Food items are one-third of CPI basket and explain 95% of CPI movement for the past decade



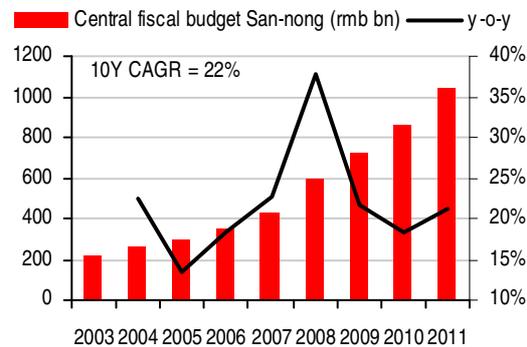
Source: CEIC

Chart 3. Decline in China's grain yield till 2003 prompted policy re-focus on the agriculture sector



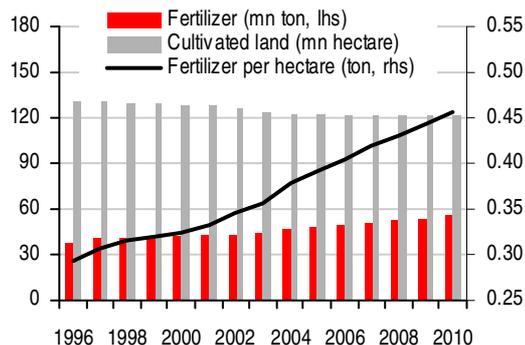
Source: CEIC

Chart 4. San nong-related central fiscal spending topped RMB1trn in 2011 and may rise 20-30% in 2012



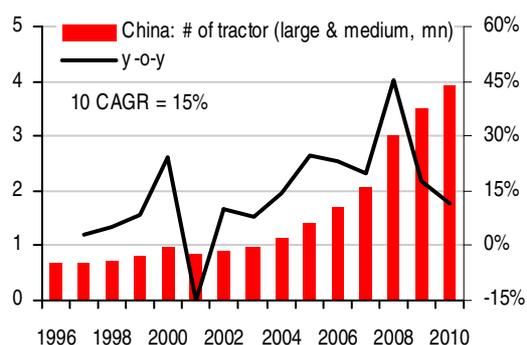
Source: CEIC

Chart 5. Arable land has declined by 5% in the past decade, but usage of fertilizer has risen over 40%



Source: CEIC

Chart 6. The number of large and medium tractors in rural areas has more than quadrupled in the past decade



Source: CEIC

Table 7. Summary of No. 1 Central Policy Documents for the past nine years

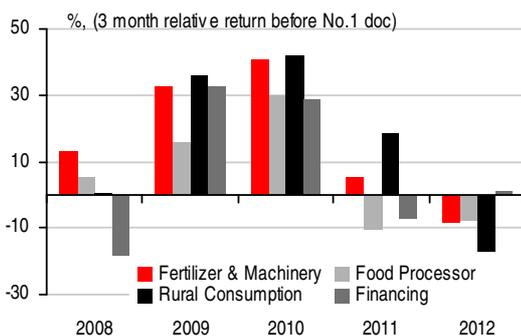
Date	No. 1 Policy Document Theme	Highlights
Feb 1, 2012	Technological innovation for sustainable output growth	Develop agricultural technologies, machineries and basic researches Constructions of irrigation, water-conservation and logistic facilities Increase lending to rural regions and support commercial banks to set up township outlets
Jan 29, 2011	Speed up the development of water resources	Water is essential to modern agriculture Investment in water should reach RMB4trn in next 10 years Complete flood control and drought mitigation system by 2020
Feb 1, 2010	Coordinate development between urban and rural areas	Coordinate to promote industrialization and urbanization Integrate urban and rural economic development
Feb 1, 2009	Achieve steady agricultural development	Take measures to avoid declining grain production Support modern agriculture and service system
Jan 30, 2008	Fortify the foundation of agriculture	Enhance rural infrastructure Strengthen the role of agricultural science and technology Improve the level of rural public service
Jan 29, 2007	Develop modern agriculture	Improve agricultural irrigation and mechanization Improving grain productivity
Feb 21, 2006	Construct a new socialist countryside	Change the method of grain growth Vigorously develop modern agriculture Increase rural incomes channels
Jan 30, 2005	Strengthen rural work and improve production capacity	Strengthen the agricultural infrastructure Accelerate agricultural science and technology Increase agricultural production capacity
Feb 8, 2004	Boost farmers' incomes	Support major grain producing areas to develop food industry Fully liberalize grain purchase and sales market Enhance rural investments and reform

Source: HSBC Equity Strategy Research, Chinese Government Website

We screen investment opportunities in four broader categories: 1) agricultural machinery and fertilizer, 2) food processor, 3) rural consumption, and 4) rural financing plays (table 10). There are 13 Hong Kong-listed stocks that meet our liquidity requirement, but the two real questions are: has the policy effect already been priced in and how long could a sector rally last?

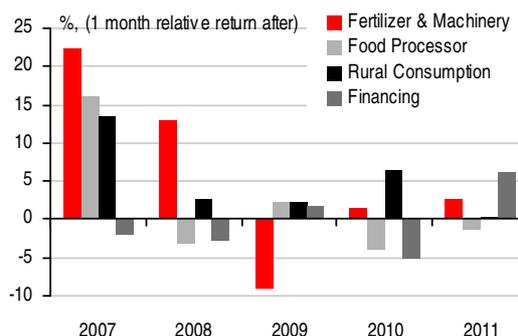
From 2008 to 2010, the equity market has started to price in favourable agriculture policy three months ahead of the policy announcement, as indicated by the outperformance of relevant stocks over the MSCI China index (chart 8). The good news this year is that such a sector rally has yet to take place; indeed, the relevant stocks have actually underperformed the MSCI China index by some 10ppts. Moreover, from 2007-11, the relevant stocks have tended to enjoy one month of outperformance after the policy release (chart 9).

Chart 8. The market has tended to price in favourable agricultural policies in the No.1 Central Policy Document 3 months ahead of its release, but not this year



Source: HSBC Equity Strategy Research, Bloomberg (relative to MSCI China)

Chart 9. The sector's outperformance tends to last a month after the No.1 policy document's release, judging by data from 2007-11



Source: HSBC Equity Strategy Research, Bloomberg (relative to MSCI China)

Table 10. Agriculture-related stocks in China/HK investable equities universe with daily trading volume over USD1m

Name	BBG Code	Sector	Price (HKD)	Perf 1M	Perf YTD	2012 PE	2011 PB	2011-2013 EPS Growth	2012 Div Yield	ROE	Market Cap (USDm)	3M ADT (USDm)
Fertilizer & Machinery												
CHINA BLUECHEM-H	3983 HK	Materials	6.30	7%	7%	10.9	1.9	11.5%	3.1%	16.3%	3,745	3.0
SINOFERT HOLDING	297 HK	Materials	2.22	2%	2%	10.4	0.9	15.6%	1.5%	8.8%	2,010	2.0
FIRST TRACTOR-H	38 HK	Industrials	8.69	20%	20%	10.7	1.2	24.7%	2.6%	13.8%	948	2.7
Food Processor												
CHINA MENGNIU DA	2319 HK	Staples	22.15	22%	22%	17.5	2.8	18.9%	1.3%	15.4%	5,048	27.9
CHINA AGRI-INDUS	606 HK	Staples	6.40	8%	8%	7.9	1.2	16.0%	3.3%	14.6%	3,333	3.5
CHINA YURUN FOOD	1068 HK	Staples	12.96	27%	27%	8.8	1.4	16.9%	3.1%	16.1%	3,046	13.1
CHINA FOODS LTD	506 HK	Staples	6.20	3%	3%	19.9	2.8	28.4%	1.8%	12.6%	2,233	1.0
Rural Consumption												
HAIER ELECTRONIC	1169 HK	Discretionary	8.35	20%	20%	8.9	4.1	25.8%	1.7%	37.4%	2,527	8.5
SKYWORTH DIGITAL	751 HK	Discretionary	3.36	24%	24%	5.8	1.1	8.9%	5.4%	17.1%	1,151	7.3
TCL COMM TECH HL	2618 HK	Info Tech	3.64	4%	4%	4.3	1.5	12.5%	7.1%	29.8%	523	1.8
Rural Financing												
AGRICULTURAL-H	1288 HK	Financials	3.90	17%	17%	6.8	1.6	16.5%	5.0%	22.0%	142,829	69.7
CHONGQING RURA-H	3618 HK	Financials	4.61	15%	15%	7.4	1.3	14.8%	3.5%	16.7%	5,528	7.9
PICC PROPERTY &	2328 HK	Financials	10.64	1%	1%	10.1	3.0	11.5%	1.5%	25.0%	16,814	34.2
HANG SENG CHINA ENT INDX	HSCEI		11,583	17%	17%	7.6	1.4	12.7%	4.0%	17.8%		
HANG SENG INDEX	HSI		20,739	13%	13%	9.4	1.3	12.9%	4.2%	16.9%		

Source: HSBC Equity Strategy Research, Bloomberg (price as 2 Feb 2012).

Disclosure appendix

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Issuer of report

The Hongkong and Shanghai Banking Corporation Limited

Level 19, 1 Queen's Road Central

Hong Kong SAR

Telephone: +852 2843 9111

Telex: 75100 CAPEL HX

Fax: +852 2596 0200

Website: www.research.hsbc.com

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