Economy / Asia ex Japan
8 January 2014

Asia Strategy

The 10-second briefing

How to beat the market in 2014

- After mixed market performances in 2013, Daiwa and consensus forecasts call for an average 16% rise in MSCI indices in 2014
- But US stimulus withdrawal and accelerating economic growth in the G3 threaten to polarise performance
- Overweight China, Korea, and Malaysia; Underweight Hong Kong and most of ASEAN; Neutral on Taiwan and Singapore

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Note: closing share prices as at 3 January 2014

How to beat the market in 2014

Regional outlook

- ***We set out to write a slightly different "outlook" this year by asking each of our Country Heads to set MSCI country index targets, identify the sectors and stocks that will outperform and underperform, and highlight key "non-index" plays.***
- ***After the mixed stock-market performances of 2013, our index targets call for increases of 4% YoY (MSCI Taiwan) to 25% (MSCI Thailand). The simple average of our index targets for the region is 16% upside, which we see as reasonably bullish, helped by forecasts for a 21% rise in the MSCI China and 20% rise in the MSCI Korea.***
- ***Daiwa's forecasts for earnings growth in 2014 are similarly bullish: 12.2% YoY growth for the region, led by 22.4% YoY growth in Korea.***
- ***But against these expectations we must weigh a macro-economic view that is far more measured than in previous years. As Daiwa's regional economist, Kevin Lai, points out, 2012 and 2013 also started with high expectations but ended in disappointment.***
- ***Although Asia should get a lift from GDP growth in the G3 (forecast to improve from 1.0% YoY in 2013 to 1.8% YoY in 2014), it faces potential headwinds from US tapering, reverse decoupling, tighter credit conditions, and a further rise in the US dollar.***
- ***Much of our view on Asia rests on the assumption that Fed stimulus will be unwound progressively between now and the end of the year. Should this not be the case, many of our expectations and targets would be challenged.***

Market outlook

- ***Our cautious strategy favours North Asian markets which benefit the most from G3 growth and are relatively well protected from the negatives associated with capital outflows. We are Overweight on China and Korea.***
- ***The exception is Hong Kong (Underweight), as it is the first domino to fall when capital leaves Asia due to its open current account and liquid markets.***
- ***Our Underweight markets are Indonesia, India, Thailand and the Philippines, mainly due to the risks associated with capital flight. Malaysia is the only ASEAN market on which we are Overweight, as it is relatively protected by its current-account surplus.***
- ***We are Neutral on Taiwan and Singapore.***

Stock picks

- ***We have selected our regional top picks on a bottom-up basis in each market.***

■ **Daiwa's key regional stock calls for 2014**

	Top Buys	Top Sells	Alpha pick
China	Bank of China, CNOOC, Great Wall Motor	PICC Group, Guangzhou Auto	Anton Oil, CIMC Enric, Angang Steel
HK	BOC HK	Power Assets	Dah Sing Bank, Pacific Textiles, Techtronic
Korea	Samsung Heavy, Hyundai Motor, Hynix	Kumho Petrochem, E-Mart	GS Home Shopping
India	Axis Bank, Hindustan Zinc	Bharat Heavy, Reliance Communications	Punjab National Bank
Indonesia	Bank Central Asia, Telekom Indonesia, Gudang Garam	United Tractors, Holcim Indonesia, Ramayana	SRIL
Singapore	CapitaMalls Asia, Keppel Corp	CapitaLand, StarHub	Ezion, OUE, Suntec REIT
Taiwan	Mediatek, Hon Hai, Cathay Financial	Acer, HTC, TPK	TWi Pharma
Thailand	Airports of Thailand, CP All	TRUE	MC Group, Thaicom

Source: Daiwa

Regional market outlook

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How to outperform in 2014

We have set out to write a different type of outlook report from the usual sell-side research fare at this time of year. We have challenged our country research heads in this publication to answer the following specific questions that we believe are most pertinent to investors.

- What is your index target for the year and why, based on the MSCI country index?
- Among the major sectors in your market, which do you believe will outperform and underperform the most in 2014?
- What are your strongest index stock calls, both buys and sells?
- What are your strongest non-index buys for investors looking for high-conviction alpha-generating opportunities?
- What are the major risks to your view?

We feature 8 Asia ex-Japan markets in this report, 6 of which are covered by Daiwa analysts – China, Hong Kong, Korea, Taiwan, Singapore, and India. We also include contributions from our alliance partners in Thailand (Thanachart Securities) and Indonesia (Bahana Securities).

In addition, we highlight some Pan-Asia investment themes, which can be found immediately after this introductory section.

Individual country targets

For all 8 Asia ex-Japan regions, the country research heads expect their respective indices to close this year at a higher level than they were at the start of January. Their optimism ranges from a rise of 4% YoY for the MSCI Taiwan Index, from Daiwa's Mark Chang, to a high of 25% YoY for the MSCI Thailand Index, from Thanachart's Pimpaka Nichgaroon. Other than Taiwan, the only other index that is forecast to return less than 10% YoY is Singapore, as the following table shows.

MSCI Index	2014 target	Index (3-Jan-2014)	Expected change
China	75	62	21.0%
Hong Kong	13,678	12,087	13.2%
India	955	809	18.0%
Indonesia	5,650	4,899	15.3%
Korea	680	567	20.0%
Singapore	1,830	1,680	9.0%
Taiwan	310	299	3.8%
Thailand	540	433	24.8%

Sources: Bloomberg, Daiwa, Thanachart Securities, Bahana Securities

The simple average of these forecasts is 16%, which we see as a reasonably bullish outlook, although it fits the pattern of the past four years, with average high-teen-percentage positive returns for 2010 and 2012, and years of flat or a decline in performance for 2011 and 2013. In and of itself, this pattern is of course meaningless, unless one assumes that Asia's stock markets are in a multi-year period of being directionless, with an equal measure of up and down periods — but even that assumption would need to be proven. Nevertheless, Daiwa's bullishness for 2014 is not unique, as the following table shows:

MSCI Index	Our* Target change	Consensus Target change	Difference (pp)
India	18.0%	7.2%	10.8
China	21.0%	16.0%	5.0
Hong Kong	13.2%	8.5%	4.7
Indonesia	15.3%	14.4%	0.9
Singapore	9.0%	9.6%	-0.7
Taiwan	3.8%	4.6%	-0.8
Korea	20.0%	29.1%	-9.1
Thailand	24.8%	36.6%	-11.8

*Source: Bloomberg. *Daiwa, Thanachart Securities, and Bahana Securities.*
Note: The consensus index targets are based on the weighted aggregation of index-constituent consensus target prices

Economics view

This bottom-up bullishness needs to be reconciled with our more measured macroeconomic views. As Daiwa's Head of Economics Asia ex-Japan, Kevin Lai, rightly points out, 2012 and 2013 were years that started with high expectations but ended in disappointment. A year ago, the Thomson Reuters-consensus 2013 GDP forecast for Asia ex-Japan was 6.8% YoY. Throughout the past year we saw this forecast cut progressively, such that the region is now on track to achieve close to 6.1% YoY growth. This is below the 6.2% YoY for 2012 and the average of 7.7% YoY from 2009-11. The biggest GDP growth disappointments in 2013 were in China and India.

So what to make of 2014? Can Asia pin its outlook on a more inspiring demand picture from the G3? We forecast G3 GDP growth to improve from 1.0% YoY for 2013 to 1.8% YoY for 2014. If that is the case, then investors should be buying Korea, Taiwan, and China, as they should be the key beneficiaries of global demand, and underweighting the countries that do poorly in periods of US Dollar strength.

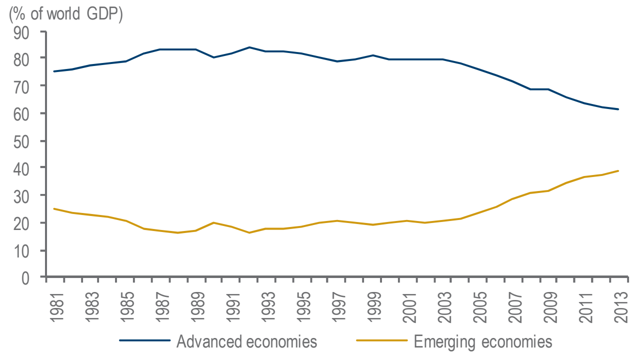
■ Global: GDP forecasts

	2013		2014	
(% YoY)	Daiwa	Consensus	Daiwa	Consensus
US	1.9	1.7	2.5	2.6
EU	(0.4)	(0.4)	1.1	1.0
Japan	1.8	1.9	1.6	1.6
G3	1.0	1.0	1.8	1.8

Source: Bloomberg, Daiwa forecasts

For Asia ex-Japan, however, the outlook is more complicated. The divergences in GDP growth over the past 4 years show that the Asia economies have struggled to keep up with the pace of growth in the G3 – the so-called "reverse decoupling". For 2014, investors will have to assess whether this demand improvement from the G3 can offset or even overcome the negative impact of the US Fed's tapering and other challenges faced by emerging economies, including many in Asia.

■ Emerging and advanced economies: % of world GDP



Source: IMF, Daiwa

To this we need to add headwinds to GDP growth, such as an end to the rapid credit and commodity booms that have come with QE 1-3. Many of Asia's emerging economies have been the beneficiaries of these cycles, but many have now found themselves in a financially fragile position. India and Indonesia are among them, and while China's credit position remains sound it has deteriorated over recent years. The rate at which international capital flows leave Asia due to tapering or a tightening of global funding conditions will be key as to whether or not Indonesia and India achieve their forecast 15-18% MSCI Index upside.

On the other hand, with relatively low levels of debt, the banking systems of Taiwan and Korea are far better placed to cope with an unwinding of the leveraged positions that were built up during the period of extremely loose US monetary policy, and the renewed money outflows, asset-price corrections, and even the tighter financial conditions that they are likely to produce. A larger impact is likely to be felt by those Asia economies with weaker fundamentals and greater credit exposure.

We must also consider the impact of continued US Dollar strength in 2014 against a range of asset classes, especially industrial and agricultural commodities. While this would help reduce the cost-inflation pressure on Asia's more industrialised and developed economies, Taiwan and Korea, it has negative current-account implications for the higher-growth but more import-reliant economies of Indonesia, India, and Thailand.

Market views

Somewhere between the extremely bullish bottom-up targets that our country heads, and the consensus, forecast and the much more cautious view that Daiwa economist Kevin Lai espouses lies where we think investors should be positioned. The following table shows our recommended MSCI country index weightings for 10 Asian regions, including the 8 covered in more detail in this report, plus the Philippines, where Daiwa has very recently rebuilt its research capabilities, and Malaysia (in December, Daiwa entered into a research co-branding arrangement with Affin Investment Bank, with the first co-branded product expected to be published in a few weeks).

■ Recommended MSCI country index weightings

	Neutral wtg.	Overweight	Neutral	Underweight	Recommended wtg.
China	25.8	+8%			27.9
Korea	20.8	+10%			22.9
Taiwan	14.5		0%		14.5
Hong Kong	12.8			-10%	11.5
India	7.6			-30%	5.3
Singapore	6.7		0%		6.7
Malaysia	4.8	+15%			5.5
Thailand	3.0			-15%	2.6
Indonesia	2.8			-25%	2.1
Philippines	1.2			-20%	0.9
	100.0				**100.0**

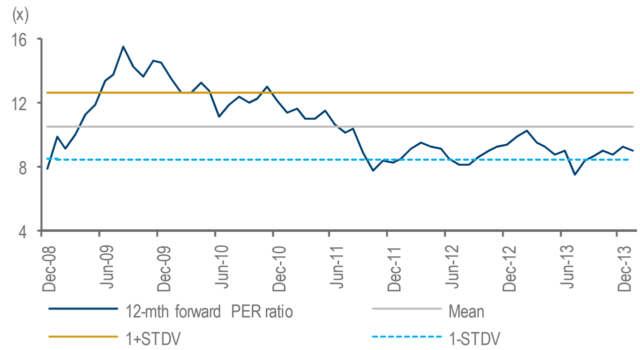
Source: Daiwa

To understand how we have reached these recommended weightings, it is useful to examine the questions of valuation, earnings, and the macroeconomic outlook on a market-by-market basis.

China (overweight)

- With the MSCI China Index trading at a PER of less than 10x (based on the consensus 2014 forecasts), and with earnings growth forecast of 9-10% YoY, the valuation is supportive of an overweight call.
- The big macro story is the next round of major economic reforms, which should gain momentum in 2014.
- In our view, there is less risk of capital flight, certainly relative to the rest of the region. When the liquidity tide goes out of Asia, China is the least affected.
- The country's exports should benefit from accelerating GDP growth in the G3.

■ **MSCI China Index – 12-month forward PER**

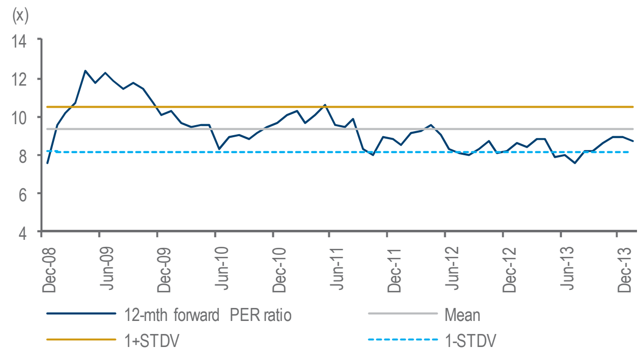


Source: Thomson Reuters

Korea (overweight)

- The country should be a beneficiary of accelerating GDP growth in the G3 and US Dollar strength as a result of a rise in exports and an improved current-account balance.
- The index is priced at single-digit valuations compared with high consensus EPS growth expectations of more than 20% YoY for 2014, although history suggests that this will be cut over the course of the year.

■ **MSCI Korea Index – 12-month forward PER**

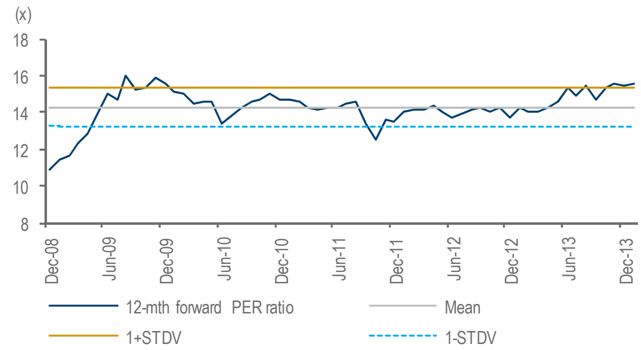


Source: Thomson Reuters

Malaysia (overweight)

- While the MSCI Malaysia Index's valuation is not cheap, trading at a 2014 PER of over 15x, based on the consensus forecasts, with EPS growth forecast of 8% YoY, the market's relative defensiveness should ensure outperformance as liquidity exits other ASEAN markets more quickly.
- This is very much a relative call, especially within the context of our cautious outlooks for Indonesia, Thailand and the Philippines.
- Besides Singapore, Malaysia stands out in ASEAN for its positive current account balance.

■ **MSCI Malaysia Index – 12-month forward PER**

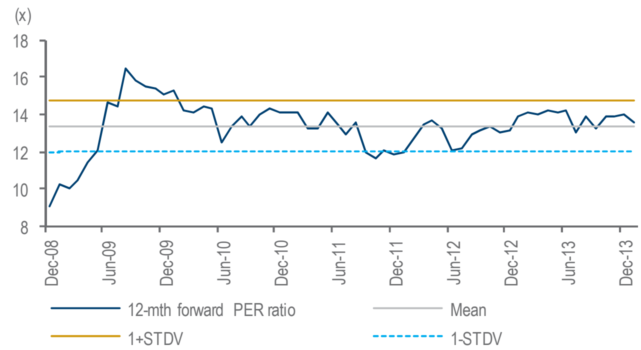


Source: Thomson Reuters

Singapore (neutral)

- As the conduit for Southeast Asia capital flows, Singapore remains vulnerable to regional liquidity outflows resulting from Fed tightening.
- While valuations are somewhat expensive, with the MSCI Singapore Index trading at a PER of 13-14x, the consensus forecasts suggest a recovery in EPS growth for 2014 to about 9% YoY from a decline of 3% for 2013.

■ **MSCI Singapore Index – 12-month forward PER**

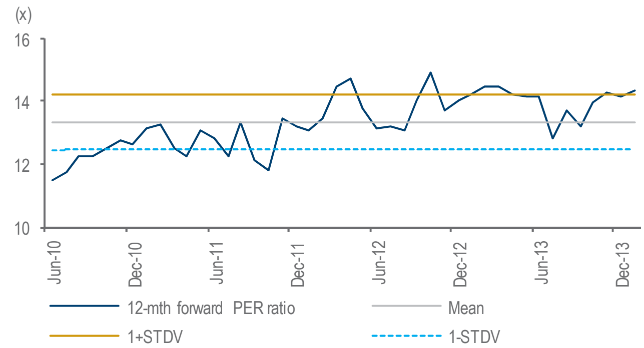


Source: Thomson Reuters

Taiwan (neutral)

- Market valuations of some 14x (based on consensus 2014 forecasts) are high relative to the past three years and the consensus forecast of a slowdown in EPS growth this year of 12-13% YoY (2013 forecast of 28% YoY).
- There is relatively benign macro risk, according to Daiwa economist Kevin Lai, with low levels of debt in the banking system.
- The economy should be a beneficiary of accelerating GDP growth in the G3 and a strong US Dollar, but large segments of the important tech industry are struggling to compete with either international or China peers.

■ **MSCI Taiwan Index – 12-month forward PER**

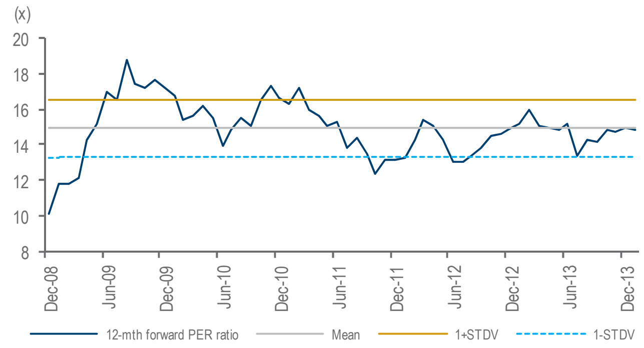


Source: Thomson Reuters

Hong Kong (underweight)

- As Kevin says, Hong Kong is the first domino to fall when capital leaves Asia, due to its open current account and liquid markets.
- While Daiwa property analyst Jonas Kan is relatively optimistic on the rate of decline in Hong Kong property prices, the fact remains that residential costs in the city are high, exposing them to capital flight.
- The MSCI Hong Kong Index, meanwhile is priced at a post-global financial crisis mean PER of 15x, despite a consensus forecast of sub-10% YoY EPS growth.

■ **MSCI Hong Kong Index – 12-month forward PER**

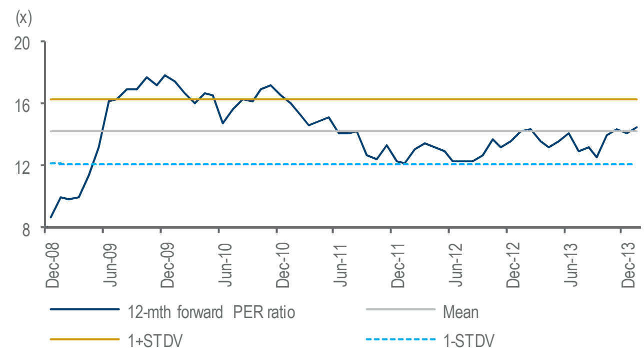


Source: Thomson Reuters

India (underweight)

- For 2014, the consensus forecasts 18% YoY EPS growth for the MSCI India Index, likely on the assumption that the balance of payments challenges are largely over, as the recent stability of the currency against the US Dollar attests.
- Meanwhile, the market is priced at a not overly attractive 2014 PER of 14x (based on the consensus forecasts), in line with the post-global financial crisis mean.
- Our aggressive 30% underweight call is premised on the view that the macroeconomic pain is not yet over. At the very least, import inflation should mean the RBI remains hawkish for most of 2014, and pressure domestically-focused corporate margins.
- At worst, the US Fed tapering could reignite capital flight, currency weakness, and another current-account crisis.

■ **MSCI India Index – 12-month forward PER**

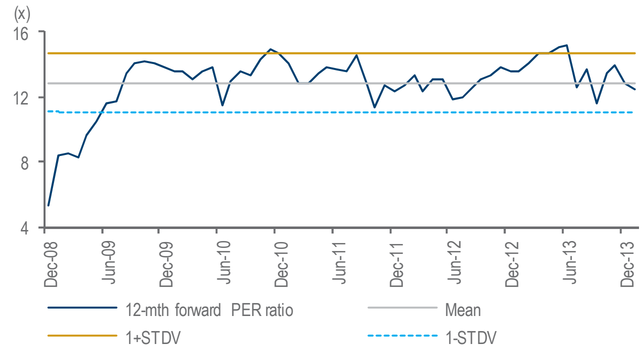


Source: Thomson Reuters

Indonesia (underweight)

- The Rupiah depreciated against the US Dollar by 22% in 2H13, with no clear respite in sight, which has negative implications for the fiscal and current-account balances, as well as domestic inflation.
- If Daiwa's economics view of the impact of Fed tapering on Asia liquidity proves correct, then Indonesia is the most negatively exposed after India.
- The one caveat is that the MSCI Indonesia Index's valuations are no longer stretched, trading at 12-13x on the consensus 2014 EPS-growth forecast of 14-15% YoY, although macroeconomic risks could erode this growth.

■ MSCI Indonesia Index – 12-month forward PER

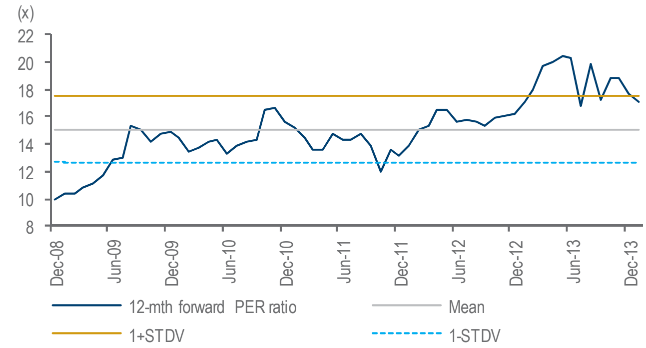


Source: Thomson Reuters

Philippines (underweight)

- A very expensive market in both absolute terms and relative to its own history (see the following chart), the MSCI Philippines Index is trading at 17x 2014 earnings while offering just 7-8% YoY EPS growth, based on the consensus forecasts.
- Like the other ASEAN member countries, the Philippines is exposed to capital-flight risk, despite having a current-account surplus, due to overseas remittances and strong business process outsourcing industry growth.

■ MSCI Philippines Index – 12-month forward PER

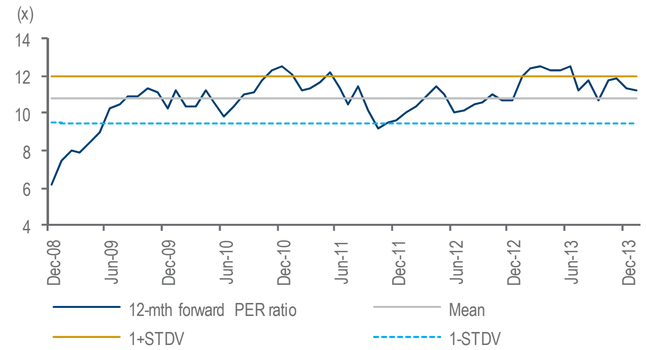


Source: Thomson Reuters

Thailand (underweight)

- The big risks for Thailand are macro-related, as the country is exposed to both Fed tapering-related outflows and domestic political instability.
- However, the MSCI Thailand Index's valuations are not high at a 2014 PER of 11x (based on the consensus forecasts), backed by a forecast of low, double-digit earnings growth.
- On balance, macroeconomic risks lead us to an underweight call for the first half of the year, after which we will re-assess our view.

■ MSCI Thailand Index – 12-month forward PER



Source: Thomson Reuters

What could go wrong?

Most of our view is premised on an assumed progressive tapering of the Fed stimulus. According to Daiwa's US economist, Michael Moran, the Fed could complete tapering by the end of this year. The complete withdrawal of US monetary stimulus would lead to abrupt capital flight from Asia, as Daiwa's Kevin Lai has argued for some time.

However, the risk is that the Fed continues with its current asset-purchase programme for longer than we or the market expect. This would challenge many of our views, notably the underweight calls on India and most of the ASEAN markets, which have been key beneficiaries of increased global liquidity over the past few years.

■ **Net profit growth forecasts**

MSCI	Daiwa, Bahana, Thanachart + Consensus			All Consensus		
market	2013E	2014E	2015E	2013E	2014E	2015E
China	13.4%	11.1%	10.1%	11.3%	9.3%	11.6%
Hong Kong	12.0%	10.4%	12.1%	10.4%	9.1%	10.5%
India	7.7%	15.1%	13.7%	8.7%	18.0%	15.0%
Indonesia	1.5%	12.3%	n.a.	1.7%	14.2%	12.3%
Korea	9.1%	28.3%	9.5%	8.8%	22.4%	10.0%
Malaysia	-1.8%	10.5%	9.0%	-0.8%	7.8%	9.7%
Philippines	5.1%	9.0%	13.4%	7.6%	7.5%	15.4%
Singapore	-5.8%	10.0%	10.8%	-3.4%	8.8%	10.5%
Taiwan	27.5%	10.0%	10.6%	27.8%	11.7%	10.6%
Thailand	13.9%	13.0%	11.7%	12.6%	13.2%	12.0%

Source: Bloomberg, Daiwa

Pan-Asia themes

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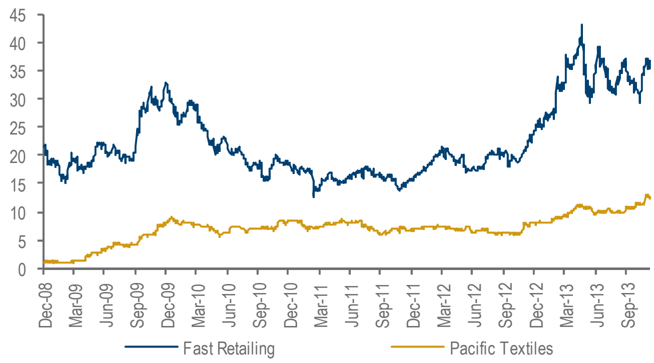
A cheaper way to invest in Japan's Fast Retailing

Fast Retailing (9983 JP, JPY43,400, Neutral) is Japan's biggest index constituent, with a weighting in the Nikkei 225 Index of just under 10%. Daiwa forecasts operating-profit growth for the company of about 15% YoY for FY14 and beyond, driven mainly by growth at its overseas Uniqlo operations, especially in Asia and the US, where new store openings should continue to bolster earnings. We estimate the Asia (ex-Japan) and US apparel markets are 3 and 4 times', respectively, the size of Japan's.

However, for the domestic Uniqlo operations, which contribute to the majority of Fast Retailing's profit, the mid-to-long-term earnings growth outlook is fairly subdued, in our view. On top of this, the stock looks expensive, trading at a Bloomberg consensus 44x FY14E PER and PBR of 7.4x, with a consensus FY14 ROE of 19%. Our Japanese analyst who covers the company, Tatsuhiko Ikeda, maintains a Neutral rating.

As such, we recommend investing in Uniqlo's growth overseas through a cheaper opportunity in Asia: Pacific Textiles Holdings (Pacific Textiles) in Hong Kong.

▪ Fast Retailing, Pacific Textiles: forward PER



Source: Bloomberg

Pacific Textiles (1382 HK, HKD11.76, Buy [1])
Pacific Textiles was one of the top performers in our small-cap universe in 2013, and we expect its share price to do well again in 2014. The company's earnings recovery that began in 2013 is poised to accelerate in 2014 and continue for a few more years, based on Daiwa's forecasts, supported by its establishment of production facilities in Vietnam which will boost its capacity and should help to lower unit costs. Well-positioned to benefit from the Trans-Pacific Partnership, Pacific Textiles is a key supplier to many leading apparel brands, including Uniqlo (which accounts for nearly 50% of its sales), Calvin Klein, Nike, Adidas and Victoria's Secret.

In addition, the Pacific Textiles stock offers a generous-looking dividend yield of nearly 7% based on our DPS for FY14E. Our analyst on the company, John Choi, recently raised his six-month target price to HKD14.20 (implying 21% upside potential from the current share price), based on a target 15x PER applied to his FY14 EPS forecast.

Tyres: expectations look too high but Japan the ultimate winner?

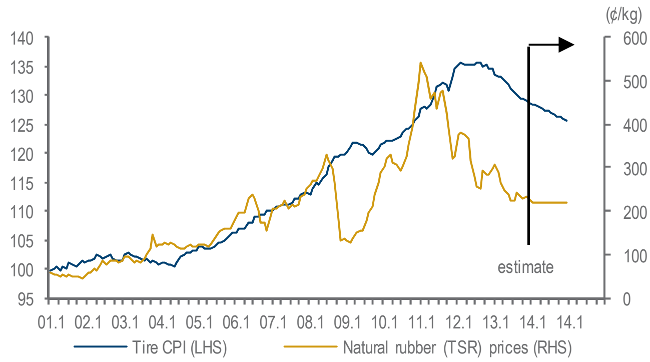
Daiwa expects competition among the Asia ex-Japan and Japanese tyre manufacturers to intensify in 2014 as they exit a "golden period" of low natural rubber prices and high tyre prices. Whilst both our Japanese and Korean analysts have long-term bullish views on their stocks, they are increasingly bearish on the fundamentals of the sector. At the same time, we believe the Japanese majors, particularly Bridgestone and Sumitomo Rubber, will take market share from the Asia ex-Japan manufacturers in 2014 given their cheaper selling prices on the back of a weaker Yen.

First indications of this came late in 2013, when we downgraded our recommendation on Hankook Tire to Outperform (2) (from Buy [1]) and cut our EPS forecasts and target price for the company. Daiwa maintains its Outperform (2) ratings on **Bridgestone (5108 JP, JPY3980)** and **Sumitomo Rubber (5110 JP, JPY1494).**

The Pan-Asia tyre sector has been in a good place, and some even say it has enjoyed a "super-cycle" for a number of years. The spread between the Tyre CPI and natural rubber prices in Asia (shown in the following chart) has been at 12-year highs, allowing for elevated profit margins at tyre makers.

Rubber prices have fallen as a result of new trees that were planted 7-9 years ago, and most of the synthetic rubber plants in Asia are now running at less than 70% capacity, leaving plenty of room for tyre makers to negotiate favourable raw-material prices. However, the rubber price is now close to production cost and thus we forecast the gap between the Tyre CPI and natural rubber prices (highlighted in the following chart) to close in 2014, leading us to be more fundamentally negative on the sector going forward.

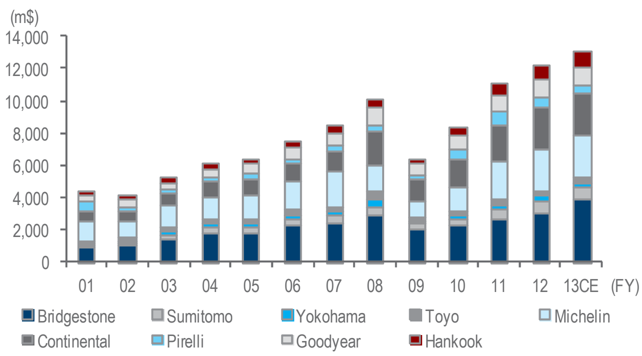
■ **Trend in Tyre CPI and natural rubber prices in Asia**



Source Daiwa Securities

The situation in terms of supply capacity and competition is also turning less favourable. New tyre capacity globally was limited post the Lehman crisis, but since 2009 there has been a surge in new factory capacity which is scheduled to come on-line in 2014-15. Tyre prices are already falling and we forecast them to decline further in 2014.

■ **Major tyre makers globally: capex trend**



Source: Companies, compiled by Daiwa

Hankook Tire (161390 KS, KRW59,000, Outperform [2])

In response to competitive market conditions, in recent months Hankook Tire has cut its capacity expansion plans for 2014; it will add just 2.2m units/year, versus its original guidance for 6m units/year. Taking this into account, Daiwa recently cut its 2014 revenue and operating profit forecasts for Hankook Tire by 4.8% and 11% respectively, assuming ASPs and utilisation rates in 2014 remain flat, and reduced its EPS forecasts by 10.5% for 2014 and 11.4% for 2015. Daiwa maintains an optimistic long-term view on the company's fundamentals. Should this view prove wrong, then we would expect to see further earnings-forecast cuts by the market consensus.

Doosan Heavy Industries and Construction: the meat in "the power sandwich"

Daiwa recently downgraded its rating on **Doosan Heavy Industries and Construction (DHI) (034020 KS, KRW34000)** to Underperform (4), on the basis that the company is being squeezed by both its China and Japan competitors. Daiwa currently has the only Underperform rating on the stock among the Bloomberg consensus estimates. If our view is right, then the stock has further to fall in the coming months.

Our analyst on the company, Mike Oh, recently visited DHI's competitors in China, namely Shanghai Electric and Dongfang Electric. His impression, given both companies are seeing a low inflow of domestic new orders, was that these two players plan to explore more opportunities overseas by expanding their presence in the emerging Asia market for 500-600MW thermal boilers over the next 5 years, an area in which DHI's expertise lies.

Meanwhile, neither DHI nor its China peers can export 1,000MW boilers as of yet, and thus the 1,000MW-boiler market will likely continue to be dominated by the Japan power-equipment makers, at least for the next 5 years. (For details, see our Japan report published on 24 October 2013, entitled *Capital Goods Sector Update Volume 18*).

Based on our market research, both the China and Korea power-equipment makers are seeing a weak order flow currently and as such we believe they will be challenged to achieve their 2014 new-order targets.

In our view, the main weakness of both DHI and the China power-equipment makers seems to be their lack of experience in making gas turbines for liquefied natural gas (LNG) and natural gas power plants. DHI still depends on Mitsubishi Heavy Industries' (MHI) (7011 JP, JPY651, Buy [1]) technology for core-parts manufacturing, and the situation seems to be the same for the China makers.

DHI's China peers are seeing low demand for domestic gas turbines due to currently high gas prices in the Mainland (which makes gas power plants unprofitable). DHI is unable to benefit fully from the rising demand for gas turbines in its domestic market, as more Korea independent power producers (IPP) now want high-end gas turbines (ie, from MHI or Siemens).

We recommend investors invest in the sector in 2014 through **Hitachi (6501 JP, JPY796, Outperform [2]).** With the benefits of a strategic refocus becoming evident in its reported numbers and macro conditions now much more favourable, we believe Hitachi is now due for a "second-stage restructuring" rally. Trading currently at a 17x PER based on consensus FY14 EPS forecast, the stock trades at a discount to the market but offers a stronger, more reliable and diverse earnings-growth profile, in our view. Thus, we reaffirm our Outperform (2) rating with a 6-month target price of JPY900 (13% upside potential from the current share price).

Smartphones: tier-1 players consolidating the market, China marches to its own drum

We have recently seen a raft of rating downgrades by Daiwa analysts for the smartphone makers in Asia as the dominant global players continue to take market share from the second-tier manufacturers. We ask what this means for Japan's largest smartphone maker, Sony, and whether or not what we are seeing in Asia is a precursor to a sell-off of Sony shares?

One of our Technology analysts, Kylie Huang, recently initiated coverage on **HTC (2498 TT, TWD138.5)** with a Sell (5) rating, citing: 1) increasing competition from Apple and Samsung Electronics, China brands such as Xiaomi, Lenovo and Coolpad, as well as other global OEMs, 2) a YoY decline that she expects in the growth rate of high-end smartphone demand in 2014, and 3) continuous pressure on ASPs.

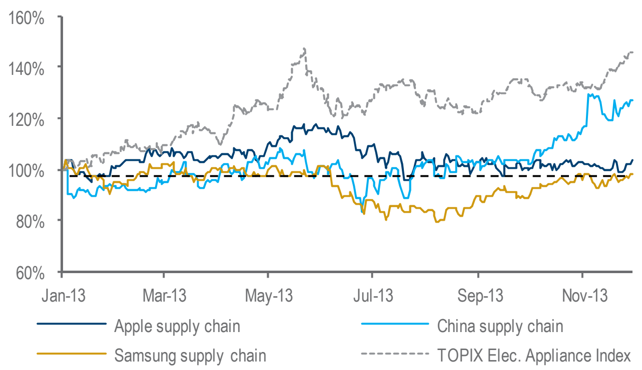
We have seen similar evidence with **LG Electronics (LGE) (066570 KS, KRW67,000, Hold [3])**, for which our analyst, Jae Lee, expects the handset division to post losses up to 1Q14 due to higher marketing costs as LGE's handsets struggle to compete with the Galaxy Note3 and iPhone5S in the premium smartphone segment. Like many of its peers, LGE plans to launch a cluster of mid-to-low range handsets to help drive earnings, but as with HTC we remain sceptical on its chances of success here.

On the other hand, **Lenovo (992 HK, HKD9.29, Buy [1])** seems to be an outlier. Its smartphone shipments were up by 78% YoY for 2Q14 and the company believes its shipments have reached critical mass in China so intends to focus more on profitability going forward. Lenovo ships mainly to emerging markets and was China's number-two manufacturer in terms of shipment volume in 2013. We expect business growth in markets outside China and the premium segment (including its sub-brand Vibe) to be the company's focus in the future.

For a guide on the outlook for PCs, we focus on **ASUSTeK Computer (ASUSTeK) (2357 TT, TWD270, Underperform [4])**, on which our analyst Steven Tseng recently downgraded his rating. His key reasons are not dissimilar to those identified above for the smartphone market, being: 1) pressure on ASPs with continued unit sales declines for PCs, and 2) similar ASP pressure for tablets – own-brand products are less attractive than the Nexus 7 from Google (where it will lose the contract as a distributor in Asia in 2014).

We conclude that the overriding theme in both the smartphone and PC industries is commoditisation, coupled with increasing competition, which should lead to falling ASPs and slowing shipment growth in 2014 and 2015. Key drivers of this should be: 1) smartphones – Apple's iPhone6 is expected to be a major overhaul compared with the iPhone5S and iPhone5C and also highly competitive; slowing demand for high-end smartphones versus more growth in the mid/lower segment; declining ASPs, and 2) PCs – a continuous decline in demand.

■ **China IT vs. Japan IT vs. Korea IT vs. Apple supply chain: shipment growth**



Source: Daiwa

So what does this mean for **Sony (6758 JP, JPY1,826, Buy [1])**? Our analyst, Junya Ayada, has a Buy (1) rating on the stock, his key reasoning being that Sony's game and mobile businesses should drive earnings growth for FY13-15, and that the company has streamlined operations in the TV and PC segments.

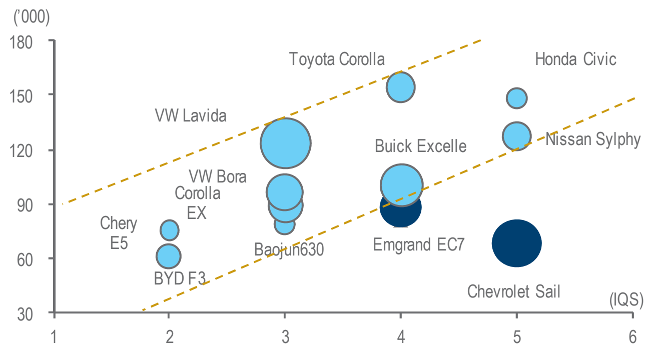
But, if what we are seeing in Asia materialises for Sony, there could be a risk to the Bloomberg consensus forecasts of earnings from smartphones. Based on the Bloomberg consensus forecasts, Sony is currently trading at a 69x PER for FY14E. Whilst the consensus sales growth forecast of 12% YoY for FY14 looks attractive, this is a company with a past-10-year average ROE of -0.3% and thus not much room to disappoint.

Auto parts: Denso should gain from a changing China auto-parts market

The "bellwether" of global auto-parts makers is **Denso (6902 JP, JPY5,550, Outperform [2])**. The stock trades at a 16x PER based on the consensus forecast of FY14 EPS, while Daiwa forecasts an 8.4% ROE for FY14, and believes the company should be a major beneficiary of a structural change under way in China's auto-parts market.

The China auto market has traditionally been polarised into high-quality, high-priced foreign vehicles on one side, and lower-quality, cheaper local vehicles on the other. However, the barrier between the two segments seems to be disappearing. Targeting China's growing middle class, local and foreign automakers are now going beyond their traditional boundaries and have started launching models to tap a new market segment – one for affordable vehicles with sound quality. These days, cars that are both of high quality and reasonably priced are selling well, with examples being General Motors' Chevrolet Sail and Geely Automobile's Emgrand EC7.

■ **Launches of high-quality, low-priced cars in China in 2013**



Source: sina auto, JD Power; compiled by Daiwa
Notes: 1) Prices are based on average for dealership price range according to sina auto (http://auto.sina.com.cn/).
2) IQS (Initial Quality Study) calculates scores based on the number of complaints about problems by new-car owners. In separate model studies, quality is rated 1-5 based on the number of circles awarded. The chart shows ratings for overall quality based on the number of circles (the greatest number of circles denotes the highest quality). The circle sizes represent production volumes in 1H13.

We expect auto-parts suppliers that are able to provide affordable parts of a satisfactory standard to be the biggest beneficiaries of this trend, as they should be able to capitalise on the economies of scale that come from supplying parts to both foreign and local automakers. Additionally, growth in this new market segment could lead to a shift in China's auto industry from sourcing parts from affiliated suppliers to a more horizontal structure, whereby auto-parts makers are relatively independent.

Against the backdrop of automakers whittling down the number of auto-parts suppliers they use to a few very large suppliers, we still think Denso is the lead contender among the Japan players to be the winner. Denso's success in winning orders for heating ventilation and air conditioning (HVAC) systems in recent years for China's micro-van market, which was hitherto dominated entirely by local players, is probably the result of its efforts to make affordable, quality parts bearing fruit.

Denso's first production base in China was a joint venture, Yantai Shougang Denso, which started operations in 1994. Denso has since expanded its operations in China, including the establishment of a wholly-owned subsidiary, Denso (China) Investment (DICH), in 2003. In 2012, Denso announced plans to expand and relocate its technical centre to Shanghai.

As regards Denso's strategy, its focus is on: 1) winning local parts orders for affordable cars in China and other emerging markets, and 2) receiving parts orders for the global platforms of automakers in advanced markets. Denso's initiative to halve manufacturing costs is an example of its efforts to win orders in emerging and advanced markets. By raising local procurement rates and localising development, Denso is making a company-wide effort to halve manufacturing costs on 23 products in emerging markets. When it launched these efforts in 2009, Denso established an in-house division known as the DPEM office (Denso Project Emerging Market). The highlight of its early days was supplying HVAC systems to Wuling Motors, which boasts the best-selling model in China with its Sunshine micro-van and is the biggest player in this market.

We have an Outperform (2) rating on Denso and a 6-month target price of JPY5,200.

Economic outlooks

Asia ex-Japan economy

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Five key macro themes

- The Fed's tapering and its impact on money flows, credit conditions and economic growth dynamics in Asia
- A continuous demand recovery in G3 economies, especially in Europe
- The US Dollar is entering a new phase of strength, which should benefit the more industrialised and developed economies in Asia
- Reverse decoupling – emerging and developing economies, led by the BRIC ones, continue to lag behind the developed world in this global recovery cycle
- Positive but incremental structural forces coming out of China's new round of market reforms

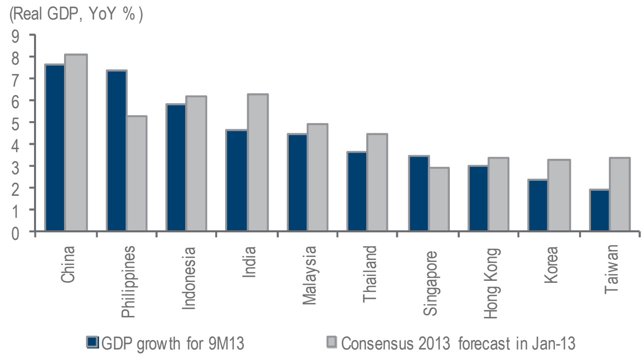
G3 recovery versus Fed's tapering

In the way that 2012 was, 2013 was a year filled with high expectations but eventual disappointments. A year ago, the FocusEconomics consensus 2013 GDP forecast for Asia ex-Japan was 6.8% YoY. Throughout the year, we have seen this forecast cut progressively. According to the FocusEconomics consensus, the region is now on track to achieve GDP growth of close to 6.1% YoY for 2013, down further from 6.2% YoY recorded for 2012 and its average growth of 7.7% YoY achieved between 2009 and 2011. The biggest growth disappointment has been with China and India. For China, the consensus began with a GDP growth forecast of 8.1% YoY for 2013 but has cut this progressively to 7.6% YoY currently. Likewise for India, the consensus forecast has been reduced progressively from 6.3% YoY to 4.7% YoY for FY14.

Other than growth disappointment, concerns over the Fed's tapering have been another major negative macro factor for the region. Over the first eight months of the year, forex reserves of Asia-9 (excluding Japan and China) were down by USD57bn or 2.7% compared with their level at end-December 2012, pointing to money outflows amid QE uncertainty and other factors.

The second half of 2013 witnessed a more stable macro environment, but this was due mainly to several 'relief factors'. First, China's economic slowdown turned out to be a little less sharp than feared. Second, perhaps most importantly, the Fed delayed its tapering plan when the market widely expected this to happen in September. Finally, the outcomes from China's Third Plenum held in November have once again boosted investor expectations for the country.

■ Asia ex-Japan's GDP growth has broadly disappointed consensus



Source: CEIC, FocusEconomics

We believe the underlying demand picture from G3 is likely to be more inspiring in 2014. On our assumptions, Daiwa forecasts GDP growth for G3 to improve from 1.0% YoY for 2013 to 1.8% YoY for 2014, as discussed elsewhere in this report.

For Asia ex-Japan, the implications of a recovery in G3 are more complicated, however. The divergences in Asia ex-Japan's economic growth performance compared to G3's over the past five years (since the Lehman's crisis) show that the Asian economies as well as many other emerging markets have struggled to keep up with the same growth pace in G3 – the so-called 'reverse decoupling'. For 2014, investors will have to assess whether a demand improvement from G3 can offset or even overcome the negative impact from the Fed's tapering and other challenges faced by emerging economies, including many in Asia.

■ Global GDP growth forecasts outside Asia ex-Japan

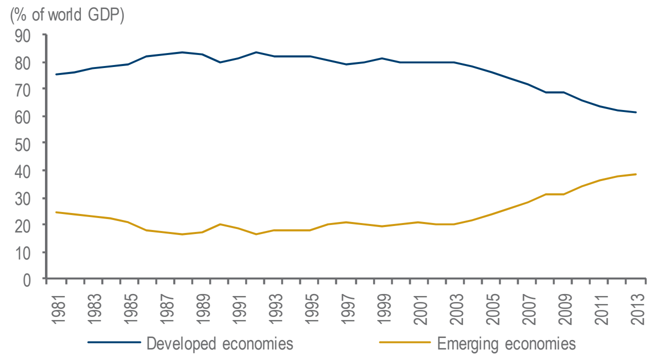
	2013E		2014E	
(% YoY)	Daiwa	Consensus	Daiwa	Consensus
US	1.9	1.7	2.5	2.6
Euro area	(0.4)	(0.4)	1.1	1.0
Japan	1.8	1.9	1.6	1.6
G3	1.0	1.0	1.8	1.8

Source: Bloomberg, Daiwa forecasts

Pressure on emerging world likely to catch up

Traditionally, world economic output has been dominated by developed economies. For the first half of the past decade, emerging economies only contributed to 21% of the world's GDP, or 39% if GDP is measured on a purchasing-power parity (PPP) basis. But, emerging economies grew more rapidly than developed economies in the second half. By the end of the decade, the same ratios went up to 34% and 48%, respectively. Emerging economies globally currently account for 38% of world output (not adjusted for PPP). In other words, the relative importance of the emerging world has risen so significantly that one can no longer just think about growth being delivered by developed economies and how it may benefit the emerging world. The latter is now large enough to be a force of its own.

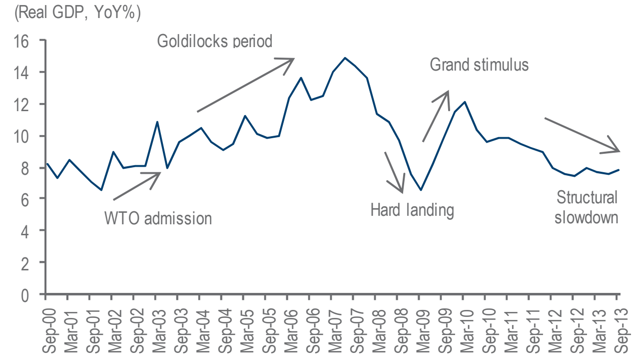
■ Emerging world has been gaining more significance



Source: CEIC, IMF, Daiwa

Nonetheless, emerging economy growth rates are now down some 3pp from 2010 levels, with Brazil, China, and India accounting for about two-thirds of the decline in the growth rates. Several reasons are behind this important macro trend. Much of these economies' catch-up potential has been exhausted. The rapid credit and commodity booms have come to an end, as the global liquidity cycle has peaked (unless the Fed comes back with QE4). Many of the emerging economies have been the beneficiaries of these cycles. Many have now found themselves in a financially fragile position; India and Indonesia are among them. China's credit position remains sound but has deteriorated over recent years.

■ China appears on track for a multi-year slowdown

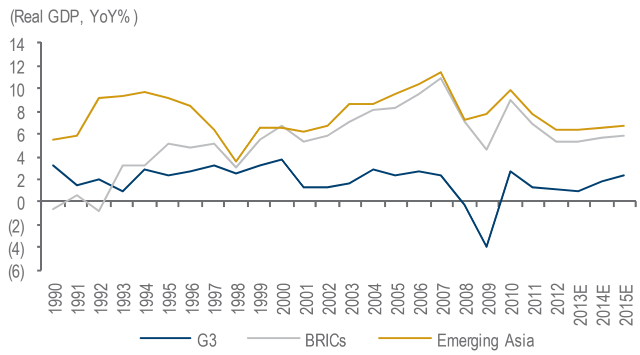


Source: CEIC, Daiwa

Following the Lehman's crisis, most of Asia's emerging economies enjoyed vigorous cyclical recoveries. Domestic expansionary economic policies helped buffer the demand shortfall from the developed economies. Excessive use of stimulus tools bolstered these cyclical recoveries. In China, aggressive money and credit expansion was used deliberately to inject stimulus in the face of stagnating external demand. Capital inflows, attracted by higher yields than in the developed economies, supported the expansion of credit as well as many other economic activities. Moreover, much of this credit has gone to riskier areas such as local-government debts and shadow-banking sectors.

The 2011-13 period was a major threshold for emerging economies in Asia. Policies began to be tightened. Growth started to decelerate. But inflation pressure has persisted. In several of these economies, core inflation has actually picked up continuously, consistent with observations of bottlenecks in labour markets, infrastructure, energy and real estate. India's infrastructure and regulatory bottlenecks are well documented, while China's labour markets have turned tighter because of rapid demographic changes. Stubbornly high inflation in Indonesia can also be explained by similar supply-side constraints.

■ Reverse decoupling: BRICs/emerging Asia on track for multi-year slowdown



Source: CEIC, Daiwa, IMF forecasts

Money outflows and potential adverse financial consequences

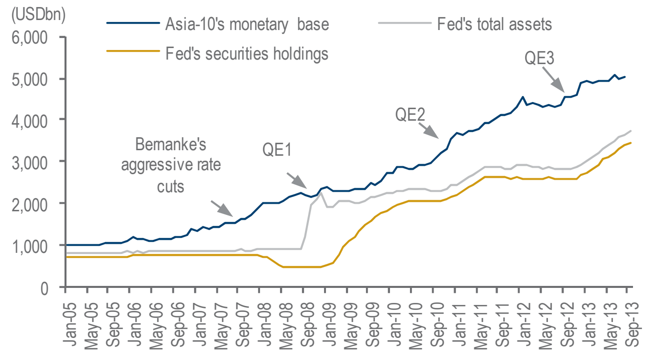
Since May 2013, the Fed's messages – albeit confusing at times – indicating that tapering of its asset-purchase plan could begin sooner rather than later, have had a significant impact on financial markets. Interest rates have increased and exchange rates have depreciated significantly in many parts of Asia. Financial conditions have tightened in many ways, with or without rises in policy interest rates. Asian bond yields remain above their levels prior to taper talk. This has raised our concerns about the outlook for Asia ex-Japan for 2014.

In our view, international capital flows into Asia over the past five years have been driven to a substantial degree by money taking the advantage of low interest rates of the US Dollar and chasing high-yielding (and riskier) assets in emerging markets. The leveraged positions that were built up during the period of extremely loose US monetary policy and high emerging market growth might well be unwounded more rapidly than many expect.

A further tightening of global funding conditions is possible and could trigger renewed money outflows, asset-price corrections, and even tighter financial conditions. A larger impact is likely to be felt by those Asian economies with weaker fundamentals and greater credit exposures (which we list in the next paragraph).

While demand channels should help over time as the G3 economies strengthen, the immediate effect in Asia could be a net negative for its GDP growth. Adverse feedback loops could form between further growth disappointments, weakening household and corporate balance sheets, and tighter external funding conditions — especially in economies with weaker fundamentals and relying heavily on external funding to support credit-driven growth. We continue to regard India, Indonesia, China and Hong Kong, as the most sensitive economies to these risks.

■ US aggressive monetary policy has led to massive money inflows and money expansion in Asia



Source: CEIC, Daiwa

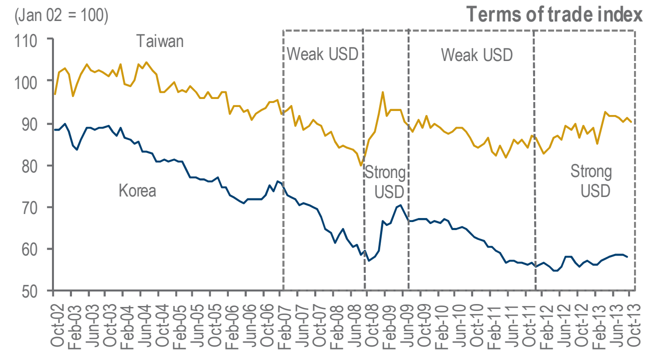
The impact of the Fed's tapering and eventual exit of its QE programme will depend on its magnitude and pace, and on how broadly the tightening affects domestic financial and credit conditions. Many money and credit links are indirect across the region and are not easily recognised by the investors. (See also our previous regional reports, *Heading toward the exit* and *Fed's exit, China's structural slowdown and a paradigm shift*.)

Resurrection of the US Dollar

The trend in the US Dollar will also be important to our outlook for Asia ex-Japan. The US Dollar has regained some strength in 2013 on the back of tapering expectations. In our view, the US Dollar has every reason to propel higher, as the Fed gets serious about tapering and an eventual exit of all its QE programmes. If the US Dollar continues to strengthen in 2014, which looks likely to us, against a range of asset classes – especially the industrial and agricultural commodities – it would help reduce the cost inflation pressure on Asia's more industrialised and developed economies. The persistent US Dollar weakness since 2006 has been a key negative for those economies' terms-of-trade trends. Over 2012 and 2013, as the US Dollar started to recover, industrialised countries like Korea and Taiwan have already started to see improvements to varying degrees in their terms of trade.

This trend would also provide a more benign backdrop for consumer prices. Under such a scenario, the prospects for a domestic-demand (consumption and investment) recovery would be brighter. It would also reinforce our views that countries like Korea and Taiwan are in the best position to stand up against potential money outflows from Asia.

■ Taiwan and Korea are the main beneficiaries of a strong USD



Source: CEIC, Daiwa

Less room for policy manoeuvre

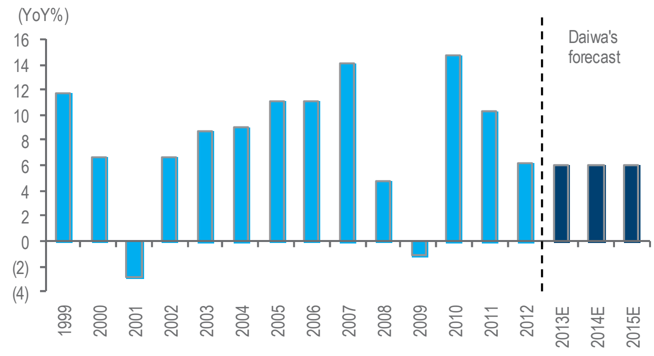
The current economic growth dynamics in the Asia ex-Japan region usually call for more policy support through either monetary or fiscal tools. However, active policy responses were absent in 2013. China only launched a 'mini package' of support measures, mostly symbolic, in the summer, and refrained from cutting interest rates or reserve ratios. To defend their currencies and stem money capital outflows, India and Indonesia had no better options but chose to tighten their monetary policies regardless of the negative impact on GDP growth.

In most Asian economies, even though the threat of money outflows may not be imminent, inflation pressures have remained high, reducing the room for monetary easing. Policymakers should generally allow fiscal policy to respond more actively. But room for expansionary fiscal policy has generally declined. Fiscal deficits remain appreciably above pre-Lehman's crisis levels. Debt dynamics are turning less favourable, given that real government bond yields are already significantly higher than they were a year ago. Against this backdrop, the case is now for many Asian policymakers to rebuild fiscal space rather than engage in another round of stimulus measures, in our view. The case looks particularly urgent for India and Malaysia, where public debt is already elevated.

Consensus is on the optimistic side

Overall, we continue to forecast GDP growth for Asia ex-Japan to ease marginally, to 6.0% YoY for 2014, from a projected 6.1% YoY for 2013. As such, like 2013, we see room for the FocusEconomics consensus (6.4% YoY for 2014E) to be disappointed again. Sporadic bouts of worries about growth occurred in 2013. We believe 1Q14 will be the most sensitive period to another potential round of worries about growth. We see China, India and Hong Kong as the most likely candidates to surprise the consensus on the downside.

■ Asia ex-Japan: real GDP growth



Source: CEIC, Daiwa forecasts

We would stress that our forecasts for the region are premised on the assumption of a more or less orderly market response to the Fed's tapering actions. If for any reasons there are extreme reactions from the market and/or disorderly consequences to the financial and credit conditions in each country, our forecasts would be subject to much greater downside risk. Barring any very negative global developments, we look for Asia ex-Japan's GDP growth to settle at 5.9% YoY for 2015.

■ Regional GDP growth forecasts

	2014E		2015E	
(% YoY)	Daiwa	Consensus	Daiwa	Consensus
Asia ex Japan	6.0	6.4	5.9	6.5
China	7.5	7.5	7.2	7.4
Hong Kong	2.0	3.5	1.8	3.8
Taiwan	2.7	3.4	3.3	3.9
Korea	3.4	3.5	3.0	3.7
India	4.8	5.4	5.2	6.2
Singapore	3.0	3.7	3.0	3.8
Indonesia	5.2	5.5	5.6	5.5
Malaysia	4.3	5.2	4.2	5.1
Philippines	5.8	6.4	5.5	6.2
Thailand	3.2	4.3	4.0	4.9

Source: FocusEconomics, Daiwa forecasts
Note: Fiscal year for India

■ Asia ex-Japan: real GDP growth

(% YoY)	2005	2006	2007	2008	2009	2010	2011	2012	*2013E*	*2014E*	*2015E*
Asia ex-Japan	9.2	10.2	11.1	7.3	6.5	9.3	7.3	6.2	*6.1*	*6.0*	*5.9*
China	11.3	12.7	14.2	9.6	9.2	10.4	9.2	7.8	*7.6*	*7.5*	*7.2*
Hong Kong	7.1	7.0	6.4	2.3	(2.6)	7.1	5.0	1.5	*2.6*	*2.0*	*1.8*
Taiwan	4.7	5.4	6.0	0.7	(1.8)	10.8	4.1	1.3	*2.0*	*2.7*	*3.3*
Korea	4.0	5.2	5.1	2.3	0.3	6.3	2.0	2.0	*2.7*	*3.4*	*3.0*
India	9.5	9.6	9.3	6.7	8.6	9.3	6.5	5.2	*4.8*	*4.8*	*5.2*
Singapore	7.4	8.8	8.9	1.7	(1.0)	14.8	4.9	1.3	*3.5*	*3.0*	*3.0*
Indonesia	5.7	5.5	6.3	6.0	4.6	6.2	6.5	6.2	*5.7*	*5.2*	*5.6*
Malaysia	5.3	5.8	6.5	4.8	(1.6)	7.2	5.1	5.6	*4.5*	*4.3*	*4.2*
Philippines	4.8	5.2	6.6	4.2	1.1	7.6	3.6	6.6	*6.5*	*5.8*	*5.5*
Thailand	4.6	5.1	5.0	2.5	(2.3)	7.8	0.1	6.4	*2.8*	*3.2*	*4.0*

Source: CEIC, Daiwa
Note: Fiscal year for India

■ Asia ex-Japan: CPI

(% YoY)	2005	2006	2007	2008	2009	2010	2011	2012	*2013E*	*2014E*	*2015E*
Asia ex-Japan	3.0	3.2	4.3	6.3	0.7	4.1	5.6	3.5	*3.4*	*3.4*	*2.8*
China	1.8	1.5	4.8	5.9	(0.7)	3.3	5.4	2.7	*2.7*	*3.2*	*2.5*
Hong Kong	0.9	2.0	2.0	4.3	0.5	2.4	5.3	4.1	*4.2*	*3.0*	*1.5*
Taiwan	2.3	0.6	1.8	3.5	(0.9)	1.0	1.4	1.9	*1.0*	*1.4*	*1.7*
Korea	2.8	2.2	2.5	4.7	2.8	2.9	2.2	2.2	*1.2*	*2.0*	*1.9*
India	4.4	6.6	4.7	8.1	3.9	9.6	9.0	7.4	*6.0*	*5.0*	*4.0*
Singapore	0.4	1.0	2.1	6.5	0.6	2.8	5.3	4.6	*2.5*	*2.2*	*2.0*
Indonesia	10.5	13.1	6.4	9.8	4.9	5.1	5.4	4.3	*8.9*	*5.6*	*5.7*
Malaysia	3.0	3.6	2.0	5.4	0.6	1.7	3.2	1.7	*2.1*	*2.7*	*3.0*
Philippines	7.6	6.2	2.8	9.3	3.2	3.8	4.7	3.1	*3.0*	*3.4*	*3.6*
Thailand	4.5	4.7	2.2	5.5	(0.8)	3.3	3.8	3.0	*2.1*	*2.0*	*2.5*

Source: CEIC, Daiwa
Note: Fiscal year for India

■ Asia ex-Japan: exports

(% YoY)	2005	2006	2007	2008	2009	2010	2011	2012	*2013E*	*2014E*	*2015E*
China	28.4	27.2	26.0	17.2	(16.0)	31.3	20.3	7.9	*8.0*	*9.5*	*8.0*
Hong Kong	11.6	9.5	8.7	5.3	(12.2)	22.5	9.9	2.9	*4.5*	*5.0*	*6.0*
Taiwan	8.8	12.9	10.1	3.6	(20.3)	34.8	12.3	(2.3)	*1.0*	*3.0*	*5.0*
Korea	12.0	14.4	14.1	13.6	(13.9)	28.3	19.0	(1.3)	*2.0*	*3.5*	*4.5*
India	23.0	22.7	29.0	13.7	(3.5)	40.5	21.8	(1.8)	*3.5*	*5.0*	*6.0*
Singapore	15.8	18.2	10.1	12.6	(20.2)	30.6	16.5	(0.2)	*1.0*	*2.0*	*4.0*
Indonesia	19.7	17.7	13.2	20.2	(15.0)	35.5	28.9	(6.6)	*(3.4)*	*1.1*	*2.8*
Malaysia	11.8	13.6	9.5	13.4	(21.2)	26.3	14.9	(0.3)	*(1.0)*	*3.0*	*5.0*
Philippines	4.0	14.9	6.4	(2.8)	(21.7)	34.0	(6.2)	7.6	*(2.0)*	*2.0*	*5.0*
Thailand	15.1	16.9	17.2	15.9	(14.3)	28.1	14.0	3.2	0.0	3.5	*6.0*

Source: CEIC, Daiwa
Note: Fiscal year for India

■ Asia ex-Japan: imports

(% YoY)	2005	2006	2007	2008	2009	2010	2011	2012	*2013E*	*2014E*	*2015E*
China	17.6	19.9	20.8	18.5	(11.2)	38.7	24.9	4.3	*7.1*	*8.4*	*9.5*
Hong Kong	10.5	11.7	9.8	5.7	(10.6)	24.7	11.7	3.9	*4.0*	*3.0*	*6.0*
Taiwan	8.2	11.0	8.2	9.7	(27.5)	44.1	12.0	(3.8)	*(0.5)*	*4.0*	*4.5*
Korea	16.4	18.4	15.3	22.0	(25.8)	31.6	23.3	(0.9)	*1.0*	*3.0*	*5.5*
India	32.3	25.6	34.9	21.2	(5.0)	28.2	32.3	0.4	*4.0*	*2.0*	*3.0*
Singapore	15.4	19.1	10.2	21.2	(23.1)	26.8	17.7	3.9	*(2.0)*	*2.0*	*3.0*
Indonesia	37.7	6.5	15.4	37.0	(24.9)	40.1	30.8	8.0	*(0.8)*	*(1.2)*	*1.8*
Malaysia	8.7	14.2	12.1	7.0	(20.9)	33.0	13.9	4.9	*4.5*	*4.0*	*6.0*
Philippines	7.7	9.2	7.2	2.2	(24.1)	27.5	10.1	2.0	*1.0*	*2.0*	*8.0*
Thailand	25.8	7.9	9.0	25.8	(25.4)	36.8	25.1	7.8	0.4	2.1	*5.5*

Source: CEIC, Daiwa
Note: Fiscal year for India

Asia ex-Japan: policy rates

(%, end of period)	2005	2006	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
China	5.58	6.12	7.47	5.31	5.31	5.81	6.56	6.00	6.00	6.00	6.00
Taiwan	2.25	2.75	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.88	2.25
Korea	3.75	4.50	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.75	3.00
India	6.50	7.75	7.75	5.00	5.00	6.75	8.50	7.50	8.00	7.00	6.50
Indonesia	12.75	9.75	8.00	9.25	6.50	6.50	6.00	5.75	7.50	8.50	8.25
Malaysia	3.00	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50	3.50
Philippines	7.50	7.50	5.25	5.50	4.00	4.00	4.50	3.50	3.50	3.75	4.00
Thailand	4.00	5.00	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	2.50

Source: CEIC, Daiwa
Note: Fiscal year for India

Asia ex-Japan: fiscal balances

(% of GDP)	2005	2006	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
China	(1.2)	(1.0)	0.2	(0.8)	(2.8)	(2.5)	(1.8)	(1.5)	(1.8)	(2.1)	(2.2)
Hong Kong	1.0	4.0	3.6	7.4	0.1	1.5	4.0	3.7	(1.0)	(0.9)	(1.2)
Taiwan	(0.6)	(0.3)	(0.4)	(0.9)	(4.5)	(3.3)	(2.2)	(2.0)	(2.0)	(1.8)	(1.6)
Korea	0.6	0.7	3.8	1.5	(1.7)	1.4	1.5	1.5	(0.6)	(0.5)	0.0
India	(4.0)	(3.3)	(2.5)	(6.0)	(6.4)	(4.8)	(5.8)	(4.9)	(4.8)	(4.5)	(4.3)
Singapore	(0.3)	0.5	3.1	1.4	(1.0)	0.2	1.3	2.0	1.2	1.3	1.0
Indonesia	(0.5)	(0.9)	(1.3)	(0.1)	(1.6)	(0.7)	(1.1)	(1.9)	(2.5)	(2.0)	(2.0)
Malaysia	(3.4)	(3.2)	(3.1)	(4.6)	(6.7)	(5.4)	(4.8)	(4.5)	(4.5)	(3.8)	(3.4)
Philippines	(2.6)	(1.0)	(0.2)	(0.9)	(3.7)	(3.5)	(2.0)	(2.3)	(2.5)	(3.0)	(2.3)
Thailand	(0.6)	1.1	(1.7)	(1.1)	(4.4)	(2.6)	(1.3)	(4.3)	(3.1)	(2.8)	(3.3)

Source: CEIC, Daiwa
Note: Fiscal year for India

Asia ex-Japan: current-account balances

(% of GDP)	2005	2006	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
China	5.9	8.6	10.1	9.3	4.9	4.0	1.9	2.3	2.3	2.2	2.1
Hong Kong	11.9	12.7	13.0	15.0	9.5	6.6	4.8	1.1	0.5	(0.5)	(0.8)
Taiwan	4.8	7.0	8.9	6.9	11.4	9.3	9.0	10.7	11.0	10.3	10.7
Korea	2.2	1.5	2.1	0.3	3.9	2.9	2.3	3.8	2.5	2.0	2.8
India	(1.3)	(1.1)	(1.4)	(2.4)	(2.9)	(2.9)	(4.5)	(4.9)	(4.5)	(4.0)	(3.5)
Singapore	21.4	24.8	26.1	15.1	17.7	26.8	24.6	18.6	17.5	16.5	16.0
Indonesia	0.1	3.0	2.4	0.0	2.0	0.7	0.2	(2.8)	(3.4)	(2.6)	(1.9)
Malaysia	14.4	16.1	15.4	17.1	15.5	11.1	11.0	6.4	2.7	2.3	3.5
Philippines	1.9	4.4	4.8	2.1	5.6	4.5	3.2	2.9	3.5	2.5	3.0
Thailand	(4.3)	1.1	6.4	0.6	8.3	4.1	3.4	0.8	(0.6)	0.1	0.1

Source: CEIC, Daiwa
Note: Fiscal year for India

Asia ex-Japan: exchange rates

(National currency per USD, end of period)	2005	2006	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
China	8.08	7.82	7.30	6.82	6.83	6.59	6.30	6.29	6.10	6.02	5.95
Hong Kong	7.75	7.77	7.80	7.75	7.76	7.77	7.77	7.75	7.75	7.80	7.80
Taiwan	33.3	32.5	32.4	33.1	32.3	30.5	30.3	29.0	29.8	30.5	31.0
Korea	1,012	930	936	1,260	1,165	1,135	1,152	1,071	1,055	1,030	1,000
India	44.3	43.8	40.1	51.1	45.5	44.9	50.4	54.4	61.9	63.0	63.0
Singapore	1.66	1.53	1.44	1.44	1.40	1.29	1.30	1.22	1.27	1.30	1.30
Indonesia	9,830	9,020	9,419	10,950	9,400	8,991	9,068	9,637	12,189	11,300	11,200
Malaysia	3.78	3.53	3.31	3.46	3.42	3.08	3.18	3.06	3.28	3.40	3.35
Philippines	53.1	49.1	41.4	47.5	46.4	43.9	43.9	41.1	44.4	45.0	44.0
Thailand	41.1	36.0	33.7	34.9	33.3	30.2	31.7	30.6	32.8	33.6	34.0

Source: CEIC, Daiwa
Note: Fiscal year for India

Japan economy

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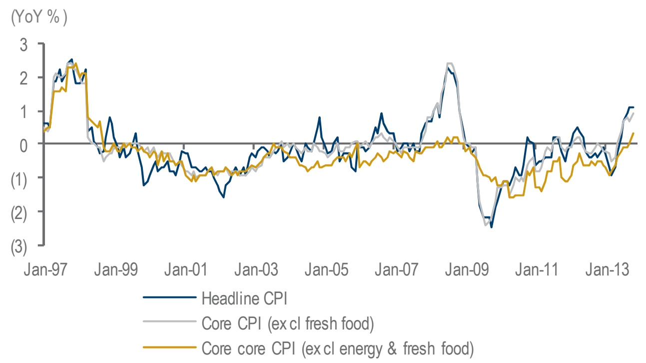
Recovery set to continue

The transformation in the fortunes of the Japanese economy over the past year or so, triggered by a more vigorous approach to economic policy in the guise of Abenomics, has been dramatic. The first half of 2013 saw the Japanese economy grow at the fastest rate in the G7, and while growth slowed in the third quarter, at 0.3% QoQ it remained above the economy's potential growth rate.

The resurgence in growth through 2013 has primarily been driven by stronger domestic demand, and in particular stronger private consumption growth. Fiscal policy has also been supportive, with the Abenomics-inspired supplementary budget in FY12 of roughly 2% of GDP providing significant support to growth. And, of course, the depreciation in the Yen associated with the massive monetary stimulus currently under way by the Bank of Japan (BoJ) has provided some support for exports, although the contribution to growth from net trade has been tempered by strengthening import growth.

With faster growth eating fairly rapidly into spare capacity and the weaker Yen providing a direct boost to prices via higher import costs, inflation has also picked up sharply over recent months. Headline CPI, at 1.5% YoY, stands at its highest rate for more than five years. But it is not just higher food and energy prices that are driving this improvement – even when they are stripped out, "core-core" inflation (ie, excluding food and energy prices) was running at 0.6% YoY in October, its highest rate since 1998.

▪ Consumer price inflation

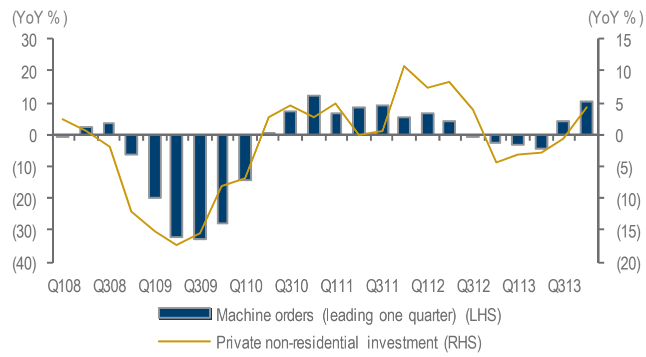


Source: MIC, Daiwa Capital Markets Europe Ltd

And the recovery looks set to be maintained over the near term at least. The manufacturing sector continues to strengthen, with the manufacturing PMI hitting a more-than-7-year high in Q4, boosted not only by rising external demand, but also by strengthening domestic demand. The construction sector, too, looks set to continue to support growth. Indeed, after construction sector output rose by more than 5% in 3Q, housing starts rose by 14% in November, suggesting continued solid growth in the sector in the final quarter of the year.

The outlook for exports is also promising – a recovering global economy and the lagged effects of the weakening Yen will provide a favourable tailwind for exporters. And the buoyant economic outlook should present firms with a greater incentive to dust down their investment plans. Surveys suggest that firms are increasingly looking to raise their investment spending, while machine orders data, a good leading indicator of corporate investment, suggest that investment spending continues to pick up.

▪ Private sector orders and investment



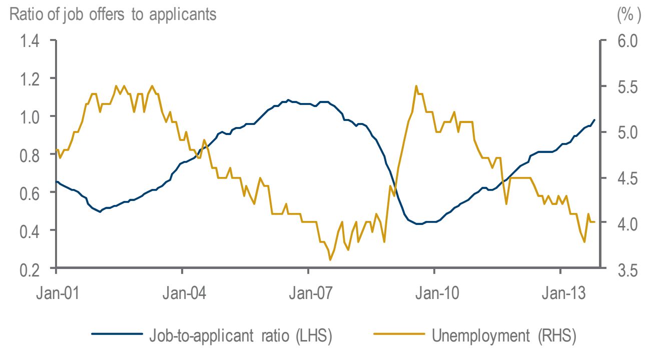
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd

It is private consumption growth, however, that we believe will provide the largest near-term support to the recovery. This in part reflects the improvement in household confidence, supported by the ongoing improvement in the labour market, where both the unemployment rate and employment are back to levels last seen before the global financial crisis hit. But it is the looming increase in the consumption tax in April 2014, and the associated bringing forward of purchases ahead of that, which will have the most impact in the near term.

Faster spending in the run-up to April will, of course, just mean that spending falls sharply subsequently, leaving the profile of GDP growth over coming quarters very choppy indeed. But, unlike in 1997, the last time the consumption tax was raised, we do not expect it to tip the economy back into recession. Then, the increase in the tax rate was accompanied by the Asian crisis and heightened strains in Japan's financial sector.

Neither looks likely this time around, while a planned supplementary budget of around 1% of GDP will soften the blow to the real economy. The economy therefore looks just about strong enough to withstand the rise in the consumption tax.

■ **Unemployment rate and job-to-applicant ratio**



Source: MIC, Bloomberg and Daiwa Capital Markets Europe Ltd

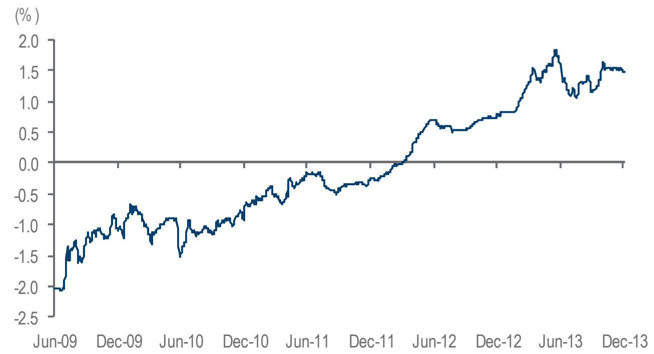
Overall, our colleagues at the Daiwa Institute of Research (DIR) look for GDP growth to have accelerated sharply in 3Q FY13, to close to 3.5% QoQ, annualised, and to above 4% in the final quarter. That would give growth for FY13 as a whole of 2.5% YoY. Thereafter, however, growth will contract sharply in 1Q FY14 as the payback for the consumption tax increase is felt, with growth expected to fall at an annualised 5.5% QoQ.

But it will recover thereafter, and we look for growth in excess of 2.5% QoQ, annualised, in each of the remaining three quarters of the year. Nevertheless, given the scale of the contraction expected in the first quarter, that would leave growth at 1.0% for FY14 as a whole, a rate still in excess of the economy's potential growth rate.

But even assuming the recovery survives the consumption tax increase, as we expect, an enduring end to deflation remains far from assured. While the rise in the consumption tax will push headline inflation temporarily higher, it will not of itself do much to boost underlying inflation. By the end of FY14, the date the BoJ set itself to meet its 2% inflation target, underlying inflation looks set to be only half that, based on current policy. So, the BoJ will need to do more to ensure that inflation expectations become anchored at 2% – while they have risen, they remain below the 2% level the BoJ is targeting, suggesting that investors remain unconvinced of the BoJ's ability (or willingness) to meet its target.

And, ultimately, what the Japanese economy needs to defeat deflation is rising wages. As the labour market has tightened, labour earnings, and in particular bonus payments, are beginning to move higher. But progress looks too slow. As such, if there is no evidence of a significant rise in basic wages when annual pay negotiations are held in the New Year, we expect the BoJ to take further action next spring, possibly via an increase in its purchases of ETFs, to underline its commitment to meet its inflation target.

■ **Market inflation expectations***



Source: Bloomberg and Daiwa Capital Markets Europe Ltd
**Break-even inflation rate derived from 5Y inflation-linked JGBs*

US economy

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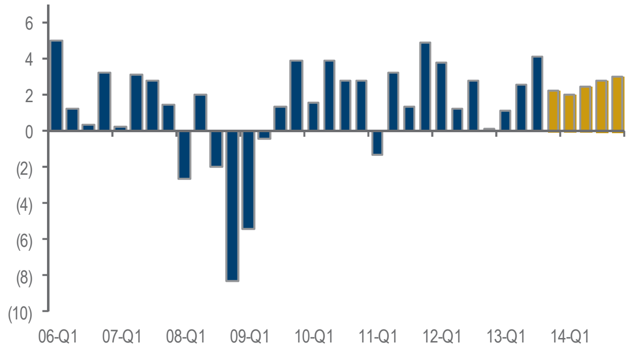
Economic growth set to increase during 2014

The US economy in the coming year is likely to gain a degree of momentum and grow at a faster pace than the estimated advance of 2.0% in 2013. However, we do not expect a breakout to a robust expansion. Growth is likely to remain near 2% at the start of the year and to build to a rate of approximately 3% by 4Q14. We expect the average advance for the year to total 2.5%.

■ **US: GDP growth***



Source: Bureau of Economic Analysis; Daiwa Capital Markets America
** The gold bars are forecasts (2013-Q4 to 2014-Q4).*

Shift in fiscal policy

The most notable shift in the new year involves fiscal policy. In 2013, spending cuts associated with sequestration and a series of tax increases led to notable fiscal tightening that constrained economic activity. Households have probably adjusted to the heavier tax burden adopted last year and no major changes in personal taxes are scheduled for the new year. Additional spending cuts from previous budget agreements were scheduled for 2014, but Congress eased the restraints with its budget compromise in December. Without new tax burdens and with lighter spending reductions, the federal government should be much less of a drag than it was in 2013.

■ **Federal budget as a share of GDP**

Source: U.S. Treasury Department for historical data; Congressional Budget Office for FY2014 forecast

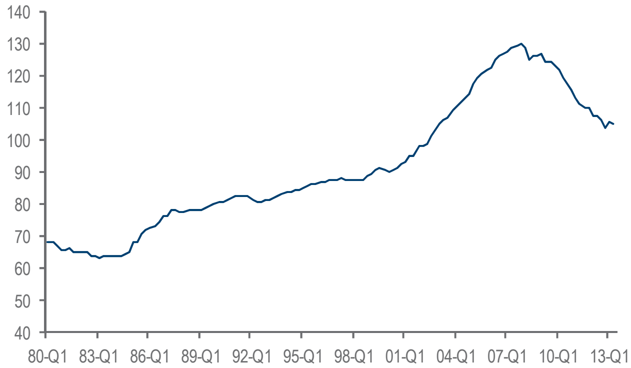
The influence of state and local governments on the economy is also likely to take a turn for the better in 2014. Budget difficulties in recent years have forced state and local governments to adopt tax increases and implement spending cuts, but they seem to be moving on to firmer financial ground. Tax collections have improved, and spending has picked up slightly. GDP statistics show that real outlays by state and local governments increased in both 2Q13 and 3Q13, ending an extended period of retrenchment (down in 13 of the prior 14 quarters). In addition, state and local governments have expanded payrolls in 8 of the past 10 months, ending a string of net reductions that began back in 2008.

Households likely to remain cautious

The shift in fiscal positions is certainly helpful, but the influence of households and businesses will be more important in shaping the contours of the economy, and here we expect a continuation of cautious behaviour. For individuals, we see the process of deleveraging as ongoing; for businesses, we expect that executives will limit their activity because of uncertainty.

Households have made good progress in repairing balance sheets. Rising prices of equities and real estate, along with new additions to savings, have pushed aggregate net worth to new highs, which would lead to large, positive wealth effects in most settings. However, we believe that individuals are still uncomfortable with their debt levels. Total household debt relative to personal income, despite reductions in the past five years, remains elevated at 105%, well above the average of 85% during the 1990s and far from the 65% achieved after debt restructuring in the early 1980s.

■ US household debt ratio*



Source: Federal Reserve Board, Financial Accounts of the United States
** Total household debt as a share of disposable personal income.*

We believe the financial crisis has led households to be highly sensitive to debt burdens and that individuals will not feel comfortable until debt ratios return to at least the average in the 1990s. Thus, we see a continuation of moderate growth in spending. The rate of growth is likely to improve during the course of 2014 as individuals build assets and reduce debt, but we see growth averaging 2.5% over the four quarters of the year, only moderately better than the 2.3% expected in 2013.

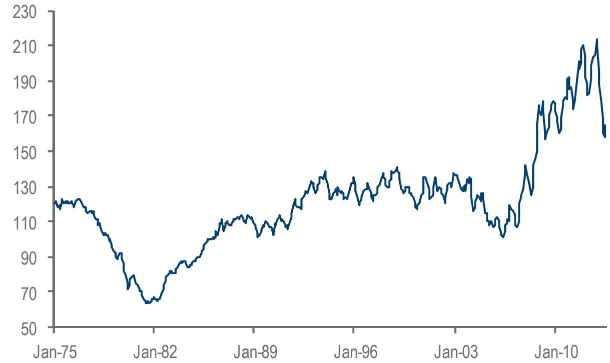
Sensitivity to debt burdens and cautious behaviour by individuals is evident in the usage of debt by households. Monthly figures on consumer credit show respectable growth overall (approximately 6% in the past year), but most of this advance reflects student loans issued through the federal government; other debt has increased only moderately (2.4%). The change in credit-card debt has been especially telling, as credit-card usage has shown essentially no change in the past two years after marked paydowns during the recession and early portion of the recovery. We view credit-card usage as an insightful gauge of attitudes toward debt and spending, and the tendency to keep cards in their wallets suggests that households are still working to repair balance sheets.

Housing unlikely to be the growth engine it has been in previous cycles

Individuals also will influence the economy through the housing market. Fundamentals remain favourable, with job growth steady and interest rates low, and thus, home construction is likely to remain a growth sector. However, housing is not likely to be the engine of growth that it has been in other cycles. The buying environment, while still favourable, has shifted a bit because of the increase in interest rates in the past few months, and rates are likely to increase a bit more in 2014.

Also, some individuals might not view housing in the same favourable light that they did in the past. Specifically, because of the drop in prices during the recession, some individuals are likely to view a house as an asset with downside risk rather than as an investment with marked upside potential. Finally, tight credit remains an issue for this sector, as many potential buyers will be closed out of the market by high loan standards.

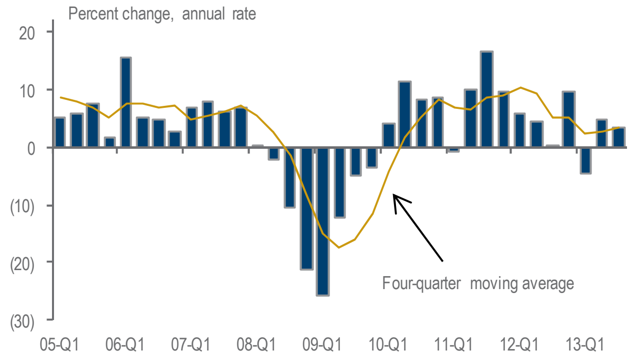
■ US: Housing Affordability Index*



Source: National Association of Realtors
**At a value of 100, an individual earning the median income can afford to buy a median-priced home at current interest rates, assuming a 20 percent downpayment.*

Business outlays for new equipment have been eased recently, with growth moving from a double-digit pace in the early portion of the expansion to only 3.5% in the past year. We look for growth to remain positive but underwhelming, as uncertainty limits the appetite of business executives for new projects. Washington is the biggest source of uncertainty, with lower spending by the government and tighter regulation possibly constraining the prospects in several industries. In addition, the implementation of Obamacare in 2014 is adding another layer of uncertainty, which has been deepened by the early problems associated with the introduction of the programme's website.

■ Non-residential investment



Source: Bureau of Economic Analysis

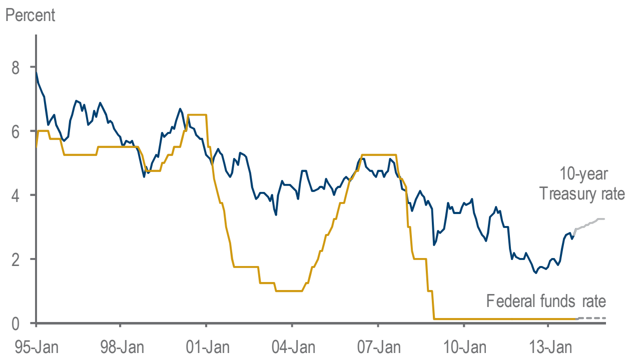
Fed likely to complete tapering process by year-end

Particular sectors of the US economy have unique factors that shape the outlook, but all areas will be influenced one way or another by monetary policy. Fed officials have emphasised that they intend to keep short-term interest rates low well into the future, and we believe that moderate economic growth and tame inflation will keep the Fed's target for the federal funds rate at its current level until 3Q15. However, the Fed began tapering its asset purchase programme in January and we look for it to complete the effort by the end of this year.

We believe that two considerations led officials to pull back from the programme. First, QE is probably providing less support to the economy than it has in the past. Asset purchases were instrumental in calming financial markets during the period of turmoil in 2008 and 2009. Over time, however, purchases have probably experienced diminishing returns in their effectiveness. Second, Fed officials have limited experience in operating with asset purchases, and they are concerned about unintended consequences, such as stirring excessive risk taking or fomenting an asset bubble.

Although the Federal Reserve is moving away from quantitative easing, it will most likely continue to provide accommodation through low short-term interest rates and forward guidance. We do not expect the Fed to raise short-term interest rates until the third quarter of 2015.

■ US: interest rates*



Source: Federal Reserve Board; Daiwa Capital Markets America
**Thin lines are forecasts.*

■ US: key indicators

(Percent change annual rate, unless otherwise noted)

	Item	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4
1	Gross Domestic Product	1.1	2.5	4.1	2.2	2.0	2.4	2.8	3.0
2	Personal Consumption Expenditures	2.3	1.8	2.0	3.0	2.2	2.4	2.5	2.7
3	Business Fixed Investment	-4.6	4.7	4.8	2.3	3.7	4.3	4.6	4.6
4	Residential Construction	12.5	14.2	10.3	7.0	10.0	12.0	12.0	10.0
5	Change in Business Inventories	0.9	0.4	1.7	-0.7	-0.3	-0.2	0.0	0.0
	(Contribution to growth)								
6	Government Spending	-4.2	-0.4	0.4	1.0	0.3	0.8	1.1	1.6
7	Net Exports	-0.3	-0.1	0.1	0.2	0.0	0.0	0.0	0.0
	(Contribution to growth)								
	End of Period Figures:								
	Inflation and Unemployment								
8	Core PCE Deflator	1.4	0.6	1.4	1.2	1.5	1.6	1.6	1.7
	(Annual Rate)								
9	Unemployment Rate	7.7	7.6	7.3	7.1	7.0	6.8	6.7	6.5
	Interest Rates and Exchange Rates								
10	Federal Funds Target	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
11	2-year Treasury	0.25	0.36	0.33	0.35	0.40	0.50	0.60	0.70
12	10-year Treasury	1.87	2.52	2.64	2.90	3.00	3.10	3.20	3.25
13	30-year Fixed-Rate Mortgages	3.57	4.46	4.32	4.50	4.65	4.85	5.00	5.10

Source: Daiwa Capital Markets America

Euro area economy

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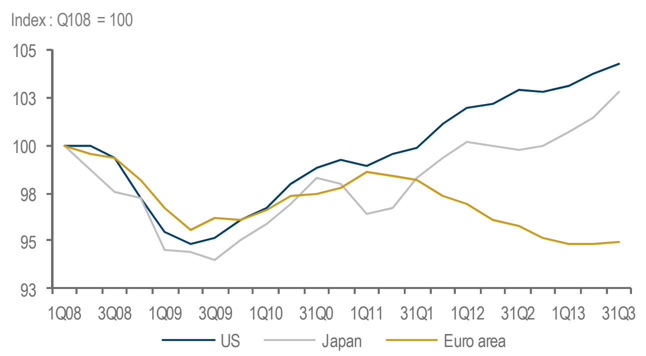
A long road back

The performance of the euro area's economy over recent years has been nothing short of woeful. Having been hit hard by the global financial crisis in 2008, the euro area's very own crisis – centred on the periphery but dragging most economies in the single currency down with it – saw the euro area heavily underperform its G3 peers since 2011. The area's economy shrank for six consecutive quarters up until the second quarter of this year, with domestic demand suffering particularly badly (as seen in the following chart).

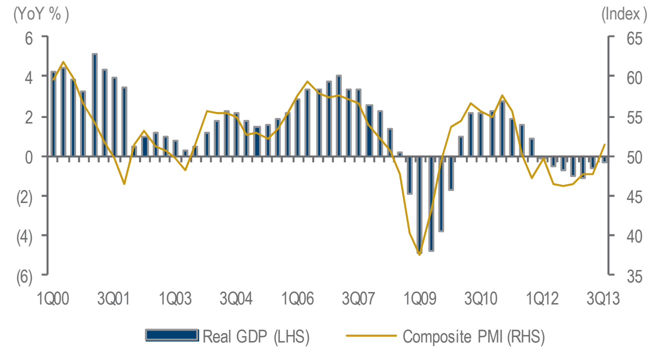
▪ **Domestic demand levels: euro area vs. the US and Japan**



Source: Datastream, Daiwa

Growth finally returned to the euro area in the second quarter of 2013, with GDP rising by 0.3% QoQ. Also, growth was maintained into the third quarter, albeit only just at 0.1% QoQ, boosted by inventory growth but dragged lower by net exports. The recovery looks set to continue in the near term at least. Sentiment data suggest that growth continued into the fourth quarter of the year, and should be maintained into 2014 as the repercussions from the crisis continue to fade and growth in the euro area's trading partners, including the UK, strengthens. Following a contraction of 0.4% YoY for 2013 on our forecast, we project GDP for the euro area as a whole to grow by 1.1% YoY for 2014 and 1.6% YoY for 2015.

▪ **Euro area: GDP growth and composite PMI**



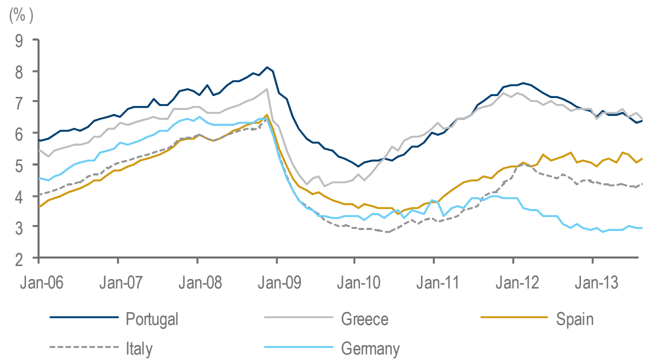
Source: Markit, Datastream, Daiwa

But, while growth in the core, and in Germany in particular, looks set to remain relatively robust, for the euro area as a whole the recovery will likely remain insipid into the medium term, with average growth dragged lower by the periphery. While the ECB's outright monetary transactions (OMT) programme ensures that the crisis will never again reach the heights seen in July 2012, the past few years have exposed the significant institutional shortcomings in euro area economic governance, while leaving a pernicious legacy in the peripheral economies in particular.

Having suffered disproportionately during the crisis, experiencing unprecedented falls in output and in some cases substantial increases in unemployment rates, the peripheral economies have a long road to travel before their full economic health is restored, in our view. Fiscal positions in the periphery were severely undermined by the crisis, leaving continued fiscal tightening in prospect and limited (or no) budgetary headroom to deal with any future economic shocks.

Meanwhile, the lesson for markets that not all euro area sovereign debt carries the same credit risk has resulted in significant financial fragmentation across the area. Not only does a wide dispersion in the borrowing costs of euro area governments remain; firms and households also face widely varying borrowing costs (as the next chart shows), with those in the periphery facing much higher interest rates, weighing further on already weak levels of investment and private consumption.

■ **Average interest rates on new loans to SMEs***



Source: ECB

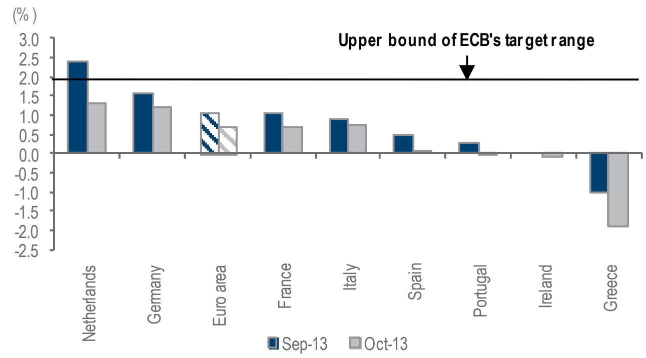
*Note: * Average interest rate on loans of up to EUR1m for between 1-5 years to non-financial corporations*

Finally, the peripheral economies still have much further to go to restore the price competitiveness they lost in the pre-crisis years. This likely means weak, or even negative, wage growth for these economies over the coming years as unit labour costs are forced lower. This should serve to limit private consumption growth. But it also raises the prospect of deflation, a risk that has risen markedly over recent months.

Indeed, much of the periphery is now either in deflation or flirting dangerously with it. Even in the core, inflation is now running well below the 2% upper limit of the ECB's target. Given this, the ECB Governing Council already cut its refinancing rate to a record low of 25bps in November, while maintaining the forward guidance it adopted in July that it expects its interest rates to remain at current or lower levels for an extended period.

Furthermore, ECB President Mario Draghi has emphasised that, against a backdrop of declining excess liquidity, all available instruments remain on the table to ensure that money market rates remain low. Having extended its policy of offering full allotment in its main refinancing operations through to mid-2015, the case for the ECB to conduct a long-term refinancing operation in the near term is not yet strong, in our view. Finally, while a further small cut in the ECB's refinancing rate – and eventually even the Fed's QE – might be on the table if deflationary pressures intensify, we expect the refinancing rate to be on hold for some time, with no prospect of any tightening in 2014 at least.

■ **Inflation across the euro area**



Source: Datastream, Daiwa

Note: Euro area HICP inflation

Market outlooks

China – Overweight

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End-2014 target for the MSCI China: 75 (+21% YoY)

Using a bottom-up weighted aggregation of analyst stock target prices to derive a MSCI China Index target, Daiwa's HK/China research team is implicitly looking for a 21% YoY increase in the index for 2014 to a level of 75, including consensus data for constituent stocks not covered by Daiwa. This compares with the 16% rise that is calculated based solely on consensus target prices. This 5pp difference is the fourth-largest among the 8 Asia ex-Japan MSCI regions covered in this report, when using this methodology.

When comparing performance expectations, Daiwa's HK/China team is more optimistic on the China market than many of its peers elsewhere in the region. The projected return ranks second in the region on Daiwa or our co-branding partners' target prices, versus third when using consensus data.

How to beat the index

One of the key forecasts in this report is the expected outperformance of China within the regional benchmark. This expectation has material implications for how we believe investors should position portfolios within the MSCI China. While we are lacking coverage at present of China telco stocks, the third-largest weighted sector in the index, the traditional defensiveness of telcos would probably merit being underweight the sector in 2014. Having made this caveat, we can now proceed to outline our strongest sector views:

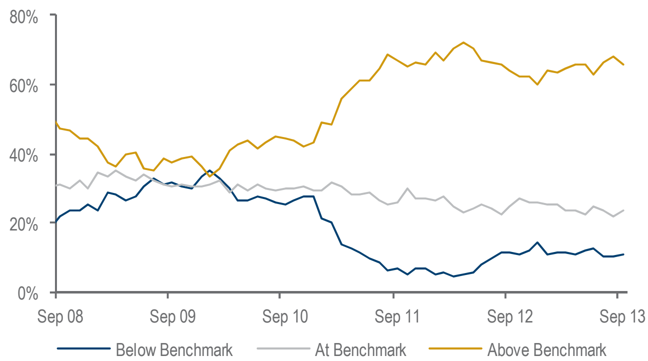
Banks – overweight BOC, underweight ABC
Daiwa's Grace Wu believes volume growth in China's banking sector will be constrained by deposit and capital considerations, which are an invisible cap on how much the banks can lend out. Hence, she expects the China banks to shift from a volume-driven business model to one that focuses more on margins, cost efficiency and profitability in 2014. Fee-income expansion meanwhile is a positive trend, as it is not capital-intensive.

Grace also sees the China banks continuing to optimise their loan mixes and exercise high loan pricing power to maximise their loan yields in 2014. She believes the banks have no incentive to compete aggressively on loan pricing when the supply of credit falls short of loan demand. On deposit funding, a nationwide deposit insurance scheme is expected to be introduced in 1H14, but Grace does not expect any increase in the deposit rate ceiling (which is currently capped at a 10% premium to the benchmark rate) in 2014. Hence, any funding cost pressures should be largely offset by an improvement in loan yields, thus enabling the sector to deliver stable NIMs.

At the stock level, Grace prefers **Bank of China** (3988 HK, HKD3.46, Buy [1]) among the big-4 banks, as its experience in international markets gives it an advantage in coping with financial deregulation. BOC has also had greater success in expanding fee income, while overseas earnings are accelerating from the increased use of Renminbi financing globally.

Among the smaller banks, Grace favours **China Merchants Bank** (3968 HK, HKD15.74, Buy [1]), while she would be underweight **Agricultural Bank of China** (ABC) (1288 HK, HKD3.67, Hold [3]) due to its higher exposure to rural banking where policy-driven lending is more prevalent.

■ China: new loan pricing breakdown



Source: CEIC, Daiwa
Note: With reference to the benchmark PBOC lending rates

Energy – overweight CNOOC, underweight Sinopec

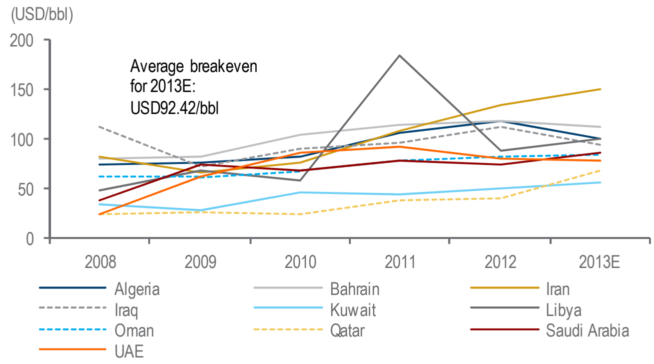
In the view of Daiwa's Regional Head of Oil & Gas, Adrian Loh, the key factors affecting the outlook for China's energy industry in 2014 are:

- **Oil prices:** similar to 2013, Adrian expects minimal price changes in 2014 (using Brent as a benchmark). OPEC spare capacity remains low by historical standards at 1.67mmbpd as at the end of 3Q13, and thus geopolitical events in the Middle East are more likely to exert upward pressure on oil prices. Balancing this factor, Fed tapering may have a negative effect on oil prices, assuming it proves to be a drag on the global economy.
- **Natural gas price reform:** given that the government has already started natural gas price reform by linking prices to those of competing fuels at the city gate in July 2013, Adrian expects another two rounds of price increases, one each in 2014 and 2015.
- **Exploration success in unconventional gas:** 2013 saw limited success in proving up China's shale gas resources as drilling activity was lower than Adrian expected. While recently reported flow rates from Sinopec's wells have been higher than the company's expectations, China's shale gas prospects remain uncertain due to highly faulted and tectonically active shale basins and the concentrated nature of China's oil and gas industry.
- **Appetite for acquisitions to continue:** On Adrian's estimates, the three Chinese oil majors (and their parent companies) spent USD14.6bn on international acquisitions in 2013, a 40% decline from USD24.6bn in 2012. China's appetite for international oil & gas acquisitions is more than likely to continue in 2014, and thus the oil majors' gearing will likely increase.

Within the energy sector, Adrian prefers the oil services companies given his view that oil prices will stay above USD100/bbl, sustaining upstream capex plans. In order of preference, he likes **Anton Oilfield** (3337 HK, HKD4.85, Buy [1]) and **China Oilfield Services** (2883 HK, HKD23.35, Buy [1]), as these are leveraged plays on onshore and offshore oil and gas exploration related capex.

Between the oil majors, he prefers **CNOOC** (883 HK, HKD13.82, Buy [1]) over **PetroChina** (857 HK, HKD8.2, Outperform [2]) and **Sinopec** (386 HK, HKD6.08, Hold [3]), given its faster production growth in 2013-15 and its lack of exposure to the highly regulated downstream industry.

■ Break-even oil prices for OPEC members



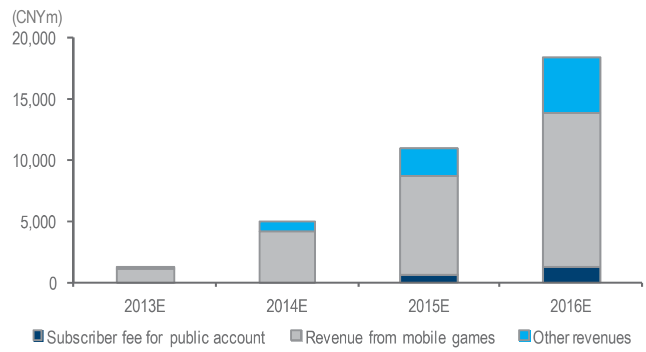
Source: IMF
Note: Excludes Yemen

Internet – overweight

Daiwa analyst John Choi is positive on the China Internet Sector, as he sees plenty of opportunities in mobile Internet due to rapidly growing penetration of smartphones in China. As mobile Internet service providers introduce new products dedicated to mobile (ie, games, search and video), John believes this will drive traffic growth, which would lead to faster revenue and earnings growth for companies in this area.

As **Tencent** (700 HK, HKD494, Buy [1]) lies at the centre of this trend, while also becoming a leading global mobile social platform and being the only Hong Kong-listed large-cap Chinese Internet stock providing it with scarcity value, the stock could continue outperforming in 2014. That said, Tencent has reached John's target price and, as such, now may not be the right time to add new money to this stock. The key risk would be slower-than-expected monetisation, which would result in disappointing earnings growth.

■ Tencent: Daiwa's revenue forecasts for WeChat



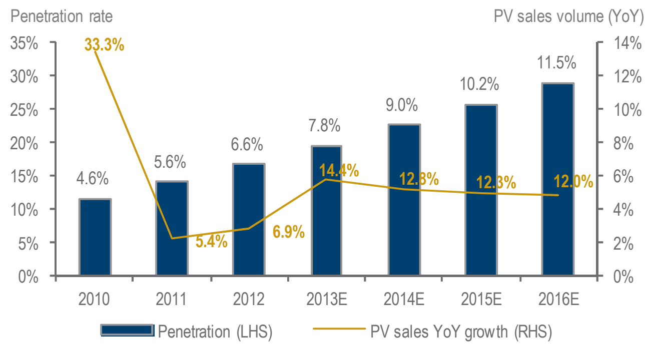
Source: Daiwa forecasts
Note: Other revenue in terms of commission fees for content publishing, e-commerce transaction payments, and etc.

Autos – overweight Great Wall Motor
The bar has been set high for China's automakers, following a strong 2013 when passenger vehicle (PV) sales increased an estimated 14% YoY to 17.7m units, due to strong demand from lower-tier cities and inland areas which offset slower growth in tier-1 cities.

Nevertheless, Daiwa's Jeff Chung sees PV sales volume growth reaching a still-high 12-13% per year for 2014-2016E, with PV per capita penetration climbing to a still low 11.5% in 2016. Globally, there has historically been a very high correlation between per capita GDP and automobile penetration, and despite structurally slower GDP growth broadly expected for the rest of the decade, Daiwa economists still see per capita GDP growth climbing to 12.5% YoY for 2014 and 10.4% YoY for 2015.

With PV growth expected to remain strong in China, we recommend remaining overweight the sector in 2014, despite the fact that the China automakers' outperformed the MSCI World Auto Index by 7-41% and the MSCI China by 6-41% over 2010-13. Jeff's top sector pick is **Great Wall Motor** (2333 HK, HKD43.2, Buy [1]), due to its strong SUV sales prospects, healthy new product pipeline, and strong FCF generation and balance sheet.

■ **China auto sales and penetration rate forecasts**



Source: CEIC, Daiwa forecasts

City Gas – non-index pick: CIMC Enric
According to the NDRC, China's natural gas supply is forecast to increase from 150bcm in 2012 to 260bcm in 2015, representing a CAGR of 20%. In 2014, new supply is expected to mainly come from imported LNG, imported piped gas (Central Asia and Myanmar) and unconventional gas (coal-bed methane and Keqi's coal-to-gas), which would account for 11%, 19% and 8% of total gas supply in 2014, respectively, based on Daiwa's Dennis Ip's estimates.

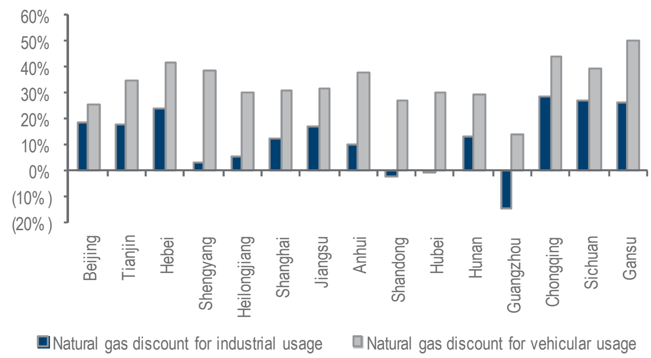
Gas supply is the key earnings driver for China's city-gas operators. However, picking stocks based solely on gas availability is too simple a strategy, according to Dennis. Certain areas of the country have not only surplus supply, but also high natural-gas per capita consumption, such as Sichuan, Chongqing, and Nanjing, which only saw low single-digit YoY gas-volume consumption growth in 1H13.

Regions that have low penetration rates, however, such as in the southwest, northeast, Fujian and Jiangxi, are much more likely to see significant natural-gas consumption growth as a result of new supplies from the Sino-Myanmar Pipeline and coal-to-gas/LNG projects. **Towngas China** (TCCL) (1083 HK, HKD9.35, Buy [1]), **China Gas** (CGHL) (384 HK, HKD11.5, Outperform [2]), and **China Resources Gas** (CRG) (1193 HK, HKD25.85, Hold [3]) have significant exposure to these regions.

Launched in June 2013, China's gas price reform targets to link the price of natural gas to that of competing fuels at the city gate. This reform will take place over two years. With effect from July 2013, the NDRC increased the gas price at the city gate for non-residential use by 15% to CNY1.95/m^3 (from CNY1.69/m^3). Under this schedule, Dennis projects a nationwide 42% hike for C&I customers from CNY1.95/m^3 currently to CNY2.77/m^3 by July 2015. In 2014E, he estimates the average city-gate price for non-residential gas would increase by 20% from to CNY2.36/m^3

Based on an analysis of 15 provinces, Dennis believes that city-gas operators should be able to maintain a material 15-35% discount in 2014 to competing industrial fuels (2013E: 20-40%). Therefore, he believes cost pass-through should remain effective in 2014E.

■ **Natural gas price discount to competing fuels (2014E)**



Source: Provincial DRCs, Daiwa

Steel – non-index pick: Angang
China's steel companies have in recent years been plagued by a sharp decline in selling prices, persistent over-supply, high raw-material costs and tight working capital. However, Daiwa's Joey Chen believes that 2013 marked the beginning of a steady industry-wide recovery.

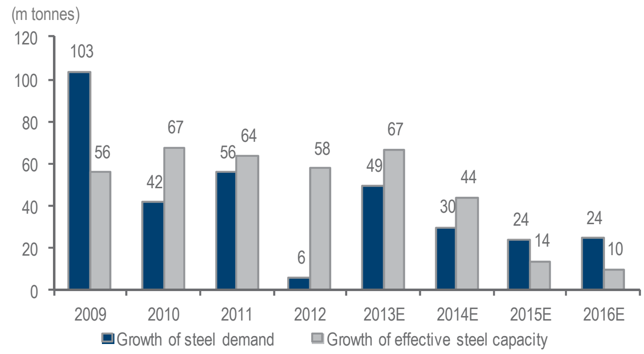
First, she argues that supply pressures are abating as the weak financial position of the industry is forcing traders out, while many small mills are shutting down due in part to an inability to finance mandated pollution-reduction capital investment.

Second, over-supplies of iron ore in the seaborne market could provide some margin relief if it leads as expected to lower raw-material costs. Daiwa forecasts iron-ore spot prices to decline 10% YoY to USD114/ tonne in 2014, which is significant as iron ore accounts for about 40% of steelmakers' cost of goods sold in China.

Third, the government appears more intent than ever to eliminate obsolete steel capacity to meet more stringent environmental targets. This factor could accelerate industry consolidation.

Joey in fact expects significant closures of redundant industry capacity in China over the next 2-3 years, lowering industry supply growth to 1-2%, while demand growth is projected to remain steady at 3-4%. A better demand-supply balance therefore should underpin steel prices.

■ China: growth in steel capacity and demand



Source: CUSteel, Daiwa forecasts

Key stock calls

Having established our strongest sectoral views in the section above, the following summarises our top stock picks in China for 2014:

Top buys

Bank of China (BOC) (3988 HK, HKD3.46, Buy [1]) : Earnings momentum in BOC's overseas business is accelerating, from increased use of the Renminbi globally and on the back of BOC's increasing traction as an international bank. BOC aims for positive jaws for the group, and we see more room for it to lower its cost-to-income ratio as overseas income improves. BOC's long operating history in overseas markets gives the company an unmatched advantage in its sector, in our view, and we believe it has the most talent and experience among the China banks to adapt to interest-rate deregulation. Priced at a multi-year low of about 0.8x one-year forward book value, BOC shares look inexpensive, especially relative to Grace's 1.2x book target price, which includes a 30% LGFV haircut.

CNOOC (883 HK, HKD13.82, Buy [1]): Adrian estimates that the market is only pricing in c.USD85/bbl oil into CNOOC's share price versus his Brent forecast of USD110/bbl average for 2014. In terms of production, Adrian expects CNOOC (including Nexen) to achieve 16% YoY growth in 2014 to 470mmboe and 15% YoY growth in 2015 to 540mmboe. Despite this strength, the stock is priced at a mere 6.7x 2014E EPS versus its past-5-year average of 10.6x. In addition, the company has had a great year on the exploration front, and Adrian expects it to report a reserves replacement ratio of >100% in January when it previews its strategy for the year. Adrian's 6-month target price of HKD19.70 is based on a blended NAV using a long-term USD95/bbl oil price and 11x PER.

Great Wall Motor (2333 HK, HKD43.2, Buy [1]): Jeff expects GWM's new SUV will sell well due to attractive price/quality ratios (ASP/m^3 and hp/cc), which allows them to capture first-mover advantage within the unique large-and-budget SUV segment with strong entry barriers. As a result, Jeff sees the company's net profit more than doubling over 2013-15 due to strong gross-margin expansion from an improved product mix, operating leverage and double-digit SSS growth. He also expects its new SUV models (the H7, H8, H9) to generate 10% of total sales for 2015, or 25% of the total gross profit, which would allow the group's multi-year momentum to continue with 49% EPS growth in 2014, followed by 55% YoY in 2015.

Top underweights

PICC Group (1339 HK, HKD3.64, Hold [3]): Daiwa's Jerry Yang expects EV growth for PICC's life insurance business of only 7% YoY for 2014, compared with most analysts' forecasts of 15-20%. This conservatism is due to the fact that more than 80% of PICC's life premium income is derived from low-margin policies which are likely to face greater competition from bank-affiliated insurers in 2014 given their bancassurance ties. Jerry also believes PICC Group's less productive agency force would make it difficult to capture the growth in higher-margin insurance products (PICC's agents account for only 17% of life premium income, compared to 66% for Ping An and 32% for CPIC). PICC trades at about 1x 2014E EV, which fully prices in its opportunities, according to Jerry.

Guangzhou Auto (2238 HK, HKD8.39, Sell [5]): Jeff argues that, at 10.6x 2014E earnings, the group's valuation is at best fair, considering the low 11% ROE. While EPS growth is still strong in 2014, the rate is slowing as the recovery matures, while the nearly 50% return since April has factored the recovery in. Meanwhile, the joint ventures' margin expansion is slowing, from a 1.3pp YoY improvement in 2013 to an expected 0.5pp lift in 2014, due to higher depreciation and amortisation costs. Moreover, negative FCF will persist in 2013-15, due to a large increase in financing costs as net debt/EBITDA rises 39pp YoY to 75% in 2014. Meanwhile, Jeff suspects that sizeable operating changes will be necessary due to too many new car platforms being ramped up in 2014.

Top alpha generators (non-index picks)

Anton Oil (3337 HK, HKD4.85, Buy [1]): Adrian likes Anton for its onshore oil services exposure, especially as a major shareholder and business partner is Schlumberger (SLB US, Not rated), a global leader in oil services and related technologies. Although the stock performed well in 2013, it actually lagged its oil services peers given perceptions that growth had slowed, which Adrian disagrees with. In his view, investors should not focus on the completed-jobs number but instead Anton's revenue-per-job, which is increasing. On this measure, Anton's growth prospects over the next 2-3 years remain bright given the PRC government's interest in developing its unconventional gas resources, especially for tight gas. Adrian's HKD7.20 target price for Anton implies a PEG ratio of 0.6x. On his estimates, Anton's 2014 PER of 14.1x is inexpensive and prices in the risk that shale gas development will disappoint.

CIMC Enric (3899 HK, HKD12.52, Buy [1]), a natural-gas equipment supplier, is Dennis's top pick in the China Gas Sector. China targets for 5% of all vehicles to be fuelled by clean energies by 2020. Assuming natural gas vehicles take a 50% share of this market, Dennis expects the number of natural gas vehicles on the road in China to rise six-fold to 6m by the end of the decade, and threefold to 3m by 2015. He believes CIMC Enric is a leveraged play on natural gas vehicles volume growth, given the company's heavy investment in refuelling and related infrastructure. In addition, some northern cities have started to convert coal-fired heating centres to gas-fired ones to reduce air pollution. Daiwa's market research suggests that the government has an ambitious fuel-conversion plan over the next five years, which would lead to higher peak gas consumption in the winter. This would lead city-gas operators to expedite LNG storage tank construction to ensure fuel supplies, which is another area of strength for CIMC Enric. The stock nearly doubled in 2013, but on a 15.3x PER with more than 20% EPS growth, 2014 could prove another very profitable year for CIMC Enric investors.

Angang Steel (347 HK, HKD5.6, Buy [1]): Angang is Joey's top sector pick. She sees earnings recovering rapidly in 2014 due to abating pressure on ASPs and expected lower raw-material costs. Angang's product mix is also superior to that of Maanshan Iron & Steel (323 HK, HKD2.08, Hold [3]), providing Angang with a better gross margin outlook, which Joey expects will reach 11% in 2014 versus Maanshan's 5%. Trading now at about 0.5x 2014E book, Angang shares look attractive relative to the average 0.9x PBR of the past three years.

What could go wrong?

Since we are bullish on the prospects of investing in Chinese equities in 2014, the risks to our view are negative ones. Of course, for a topic as large as this, the range of risks will be very broad, although the ones that would matter for the market as a whole would likely be macro-related ones. Below are four risks that we believe are most important and should be monitored regularly:

Government policy shift. Due to the still-large role of the state in setting the direction for a wide range of industries, not least of which is the banks, how policy evolves in 2014 will be critical. The recently concluded Third Plenary Session of the 18th CPC Central Committee set high expectations for coming deregulation. If this policy shift is side-tracked, be it due to a more forceful clampdown on corruption, credit tightening or some other reason, then the stock market's performance would likely suffer.

Credit crisis. If the Pandora's Box of unrecognised non-performing loans or unsupervised activity in the shadow banking sector is opened and a credit crisis takes hold in China, then clearly our positive call on the market and some of the banks would likely prove incorrect.

Geopolitical crisis. The over-lapping air defence identification zones in the East China Sea and the Obama Administration's policy to shift the US's foreign policy focus to East Asia could create a Cold War-like situation in the region. The most significant risk for China is the emergence of a US-led containment policy that, at the extreme, could become bellicose which would be negative for most risk assets in the region.

Aggressive Fed tapering. As Daiwa economist Kevin Lai has repeatedly argued, China has seen massive money inflows as a result of US quantitative easing, thanks in part to limited currency risk. Since August 2008, China's FX reserves have nearly doubled, while base money and total credit have grown at even faster rates. If the US Federal Reserve were to embark on a more-aggressive-than-expected tapering programme, then money flows into China could change direction, which would have a negative impact on China-related asset prices.

▪ Valuation comparison

Bloomberg code	Company name	Rating	Target price (HKD)	Share price (HKD) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x)		EV/EBITDA (x)		Dividend Yield (%)		PBR (x)		ROE (%)	
							13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E
Automobiles & components																
1114 HK	Brilliance China Automotive	Hold	12.89	12.16	7,879	17.3	14.1	11.1	n.a.	n.a.	0.7	-	3.6	2.7	29.4	28.3
951 HK	Chaowei Power	Buy	5.00	4.09	530	0.8	6.1	4.0	4.1	2.8	5.7	8.5	1.2	1.0	25.3	30.4
489 HK	Dongfeng Motor Group	Buy	13.99	11.96	13,290	21.4	7.4	6.6	3.0	2..5	2.1	5.6	1.3	1.1	18.8	18.4
175 HK	Geely Automobile	Buy	5.84	3.64	3,515	36.8	8.2	6.1	3.1	1.9	1.4	1.9	1.6	1.3	20.6	22.7
2333 HK	Great Wall Motor	Buy	69.59	43.20	16,949	47.1	12.0	8.1	8.3	5.5	2.5	3.8	3.7	2.8	34.8	39.9
2238 HK	Guangzhou Automobile Group	Sell	6.61	8.39	7,161	10.7	13.2	10.6	9.7	7.9	2.3	2.8	1.3	1.2	9.8	11.3
Banks																
1288 HK	Agricultural Bank of China	Hold	4.20	3.67	153,729	59.7	5.7	5.4	n.a.	n.a.	6.1	6.5	1.1	1.0	20.3	19.2
3988 HK	Bank of China	Buy	5.00	3.46	124,564	132.8	5.1	4.9	n.a.	n.a.	7.1	7.5	0.9	0.8	17.5	16.7
3328 HK	Bank of Communications	Hold	6.10	5.26	50,378	16.9	5.2	5.0	n.a.	n.a.	5.8	6.1	0.7	0.7	14.6	13.6
998 HK	China Citic Bank	Underperform	3.90	4.07	24,559	19.5	4.7	4.8	n.a.	n.a.	4.9	4.8	0.7	0.6	15.0	13.2
939 HK	China Construction Bank	Buy	8.25	5.68	183,143	191.0	5.2	4.9	n.a.	n.a.	6.7	7.1	1.0	0.9	21.1	19.8
3968 HK	China Merchants Bank	Buy	21.00	15.74	51,422	44.6	6.1	5.9	n.a.	n.a.	5.0	5.0	1.2	1.0	20.2	18.2
1988 HK	China Minsheng Banking Corp	Outperform	10.80	8.34	32,669	57.2	4.8	4.8	n.a.	n.a.	4.7	5.1	1.1	0.9	22.8	20.8
3618 HK	Chongqing Rural Commercial Bank	Hold	4.30	3.64	4,366	7.4	4.6	4.2	n.a.	n.a.	6.5	7.1	0.7	0.6	16.4	15.6
1398 HK	ICBC	Buy	7.45	5.06	228,155	159.6	5.5	5.0	n.a.	n.a.	6.5	7.1	1.1	1.0	21.3	20.3
Capital goods																
1800 HK	China Communications Construction	Hold	6.64	6.05	12,620	12.9	5.9	5.5	8.3	8.0	4.2	4.5	0.8	0.7	14.1	13.6
2039 HK	China International Marine Containers	Buy	20.00	18.44	3,402	3.3	21.3	15.7	7.9	6.4	1.6	1.6	1.8	1.6	8.7	10.6
2128 HK	China Lesso Group Holdings	Buy	7.90	5.32	2,089	3.4	8.5	7.3	5.7	4.6	2.9	2.9	1.8	1.5	22.9	22.5
1893 HK	China National Materials	Hold	1.65	1.61	742	0.9	10.9	9.0	6.3	6.1	2.3	2.8	0.4	0.4	3.6	4.2
1186 HK	China Railway Construction	Buy	11.81	7.35	11,695	10.4	6.7	6.1	5.9	5.6	2.3	2.5	0.9	0.8	13.9	13.5
390 HK	China Railway Group	Outperform	4.87	3.91	10,741	8.8	7.5	6.7	11.3	11.7	2.0	2.2	0.8	0.7	10.6	10.7
3311 HK	China State Construction International	Buy	16.15	13.70	6,868	6.3	19.5	15.0	19.4	15.3	1.5	2.0	3.5	3.0	18.9	21.3
3899 HK	CIMC Enric	Buy	16.60	12.52	3,039	6.9	18.1	15.3	12.0	9.9	1.0	1.2	3.8	3.1	23.2	22.8
1766 HK	CSR Corp	Buy	6.99	6.31	11,233	15.9	15.4	12.6	8.4	7.2	1.9	2.4	1.9	1.7	12.8	14.3
3339 HK	Lonking Holdings	Sell	1.31	1.55	856	2.9	9.9	9.3	9.3	8.9	-	3.2	0.7	0.7	7.6	7.7
1157 HK	Zoomlion Heavy Industry	Hold	6.68	7.06	7,016	8.7	8.3	7.6	7.4	6.7	4.0	4.5	1.0	0.9	12.0	11.9
Construction & real estate																
81 HK	China Overseas Grand Oceans Group	Buy	14.20	7.19	2,116	3.2	5.7	4.7	2.9	1.8	1.8	2.2	1.5	1.2	30.6	28.5
688 HK	China Overseas Land & Investment	Buy	27.50	21.45	22,608	48.3	9.6	8.4	6.2	5.1	2.2	2.6	1.7	1.5	19.2	18.9
1109 HK	China Resources Land	Buy	28.30	19.12	14,367	19.4	13.0	11.2	9.7	8.3	2.1	2.4	1.5	1.3	11.9	12.6
2007 HK	Country Garden	Buy	6.60	4.66	10,956	15.3	7.4	5.8	6.5	4.8	5.0	6.4	1.5	1.3	21.9	23.9
3333 HK	Evergrande Real Estate	Outperform	3.80	2.88	5,951	15.0	4.6	3.7	5.2	4.6	5.5	6.8	0.7	0.6	18.2	18.7
535 HK	Gemdale Properties and Investment	Buy	1.40	0.70	701	1.4	n.a.	10.0	n.a.	4.4	-	-	1.6	1.4	n.a.	14.9
2777 HK	Guangzhou R&F Properties	Buy	15.90	11.18	4,646	7.3	4.6	4.0	4.1	3.6	7.5	8.0	0.9	0.8	21.5	21.9
960 HK	Longfor Properties	Hold	13.65	10.70	7,491	5.7	7.3	6.5	5.6	5.5	3.0	3.5	1.3	1.1	19.3	18.8
563 HK	Shanghai Industrial Urban Development Group	Buy	2.50	1.89	1,173	2.4	10.0	4.9	20.5	6.0	2.0	4.1	0.7	0.6	7.2	13.4
272 HK	Shui On Land	Buy	3.05	2.33	2,404	2.6	13.3	9.0	11.4	7.5	2.5	2.4	0.4	0.4	2.9	4.4
405 HK	Yuexiu REIT	Hold	4.00	3.80	522	1.5	11.8	11.5	n.a.	n.a.	7.8	8.0	0.6	0.6	5.2	5.3
Consumer durables & apparel																
1234 HK	China Lilang	Underperform	3.70	4.77	739	0.7	8.7	8.4	5.6	5.2	7.4	7.7	1.8	1.6	20.9	20.3
2382 HK	Sunny Optical Technology	Buy	9.80	8.00	1,019	7.3	13.3	10.0	8.9	6.8	2.3	3.0	2.0	1.8	19.1	20.3
2678 HK	Texhong Textile	Buy	17.50	9.55	1,090	1.6	7.7	5.4	6.2	4.4	3.9	5.5	2.1	1.6	29.7	33.5
Diversified financials																
6881 HK	China Galaxy Securities	Hold	6.20	6.60	1,439	11.9	n.a.	n.a.	n.a.	n.a.	2.0	2.5	n.a.	n.a.	n.a.	n.a.
2628 HK	China Life Insurance	Outperform	28.90	23.05	84,023	107.7	15.5	12.4	n.a.	n.a.	1.3	1.6	2.0	1.7	n.a.	n.a.
2601 HK	China Pacific Insurance Group	Buy	39.00	29.00	33,893	36.0	18.1	15.5	n.a.	n.a.	1.7	1.9	1.8	1.6	n.a.	n.a.
6030 HK	CITIC Securities	Outperform	23.00	20.45	29,056	26.9	n.a.	n.a.	n.a.	n.a.	1.4	1.7	n.a.	n.a.	n.a.	n.a.
6837 HK	Haitong Securities	Buy	16.00	13.04	16,120	22.1	n.a.	n.a.	n.a.	n.a.	1.6	2.3	n.a.	n.a.	n.a.	n.a.
1339 HK	PICC Group	Hold	4.00	3.64	19,916	19.6	10.5	8.9	n.a.	n.a.	1.0	1.1	1.5	1.3	n.a.	n.a.
2328 HK	PICC Property and Casualty	Buy	13.40	10.72	20,672	28.4	9.0	8.4	n.a.	n.a.	2.8	3.0	1.9	1.6	n.a.	n.a.
2318 HK	Ping An Insurance	Buy	78.40	67.40	68,809	137.5	13.4	10.7	n.a.	n.a.	1.3	1.1	2.3	1.9	n.a.	n.a.
Electronics																
3336 HK	Ju Teng International	Buy	6.30	5.25	779	4.6	8.3	6.1	5.2	3.8	1.5	1.8	1.0	0.9	12.8	15.2
992 HK	Lenovo Group	Buy	10.70	9.29	12,482	34.2	15.3	12.7	7.9	6.5	1.6	2.0	4.1	3.1	28.3	27.7
981 HK	Semiconductor Manufacturing Int'l Corp	Hold	0.55	0.63	2,603	12.1	14.4	13.3	4.3	3.8	-	-	1.0	0.9	7.6	7.4

Source: Bloomberg, Daiwa forecasts

■ Valuation comparison (cont'd)

Bloomberg code	Company name	Rating	Target price (HKD)	Share price (HKD) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x) 13E/FY14E	PER (x) 14E/FY15E	EV/EBITDA (x) 13E/FY14E	EV/EBITDA (x) 14E/FY15E	Dividend Yield (%) 13E/FY14E	Dividend Yield (%) 14E/FY15E	PBR (x) 13E/FY14E	PBR (x) 14E/FY15E	ROE (%) 13E/FY14E	ROE (%) 14E/FY15E
Energy																
3337 HK	Anton Oilfield Services Group	Buy	7.20	4.85	1,323	11.8	19.5	14.1	7.2	5.5	1.7	2.3	3.6	3.0	19.7	23.2
2883 HK	China Oilfield Services	Buy	27.50	23.35	13,537	16.4	11.8	10.8	8.1	7.5	1.7	1.9	2.1	1.8	19.7	18.4
883 HK	CNOOC	Buy	19.70	13.82	79,616	101.2	7.7	6.7	3.4	2.8	4.3	3.7	1.4	1.2	18.9	19.0
857 HK	PetroChina	Outperform	10.00	8.20	193,552	89.5	9.2	9.0	4.6	4.4	4.9	5.0	1.0	1.0	11.6	11.1
386 HK	Sinopec Corp	Hold	5.70	6.08	91,309	81.1	8.6	7.7	4.5	4.2	4.3	4.1	1.0	0.9	11.7	11.8
Materials																
2300 HK	AMVIG Holdings	Buy	4.30	3.70	475	0.3	9.1	7.7	4.7	3.9	4.4	5.2	1.0	0.9	10.7	11.8
347 HK	Angang Steel	Buy	7.10	5.60	5,225	9.4	28.9	17.4	6.9	6.5	1.7	2.9	0.7	0.6	2.3	3.8
914 HK	Anhui Conch Cement	Hold	27.00	27.70	18,931	38.0	13.0	11.4	7.8	6.5	1.5	1.8	2.0	1.8	16.8	16.7
3323 HK	China National Building Material	Hold	8.00	7.94	5,529	37.8	6.3	5.9	7.9	7.5	2.4	2.5	1.0	0.8	16.3	15.1
1194 HK	China Precious Metal Resources	Outperform	1.25	1.16	651	2.1	16.5	12.6	7.6	6.4	n.a.	n.a.	0.9	0.8	5.3	6.6
1313 HK	China Resources Cement Holdings	Buy	6.60	5.10	4,288	7.8	11.0	8.5	7.8	6.4	2.3	2.9	1.4	1.3	13.4	15.5
691 HK	China Shanshui Cement Group	Hold	3.20	3.10	1,126	9.8	7.3	6.8	5.9	5.7	4.8	5.2	0.8	0.7	10.6	10.7
323 HK	Maanshan Iron & Steel	Hold	2.30	2.08	2,066	2.9	27.5	17.5	5.9	5.8	-	2.0	0.6	0.5	2.0	3.1
975 HK	Mongolian Mining	Sell	1.00	1.01	483	0.7	n.a.	n.a.	20.5	10.7	n.a.	n.a.	0.7	0.7	n.a.	n.a.
2233 HK	West China Cement	Hold	1.28	1.11	651	1.3	8.2	7.8	5.1	4.5	1.8	1.9	0.8	0.7	9.7	9.4
Retailing																
1728 HK	China ZhengTong Auto Services Holdings	Buy	6.71	4.91	1,399	3.3	9.1	6.7	4.7	3.4	-	-	1.1	0.9	13.0	15.4
1828 HK	Dah Chong Hong Holdings	Buy	7.55	5.70	1,342	5.1	9.2	7.3	5.2	4.3	4.1	5.1	1.1	1.0	12.9	14.8
Software																
700 HK	Tencent Holdings	Buy	500.00	494.00	118,076	214.7	42.3	32.8	27.9	21.0	0.3	0.4	13.5	10.0	36.8	35.9
Transportation																
753 HK	Air China	Buy	6.00	5.46	8,546	10.0	15.0	9.2	5.6	4.6	-	1.1	1.0	0.9	6.7	9.9
2357 HK	AviChina Industry & Technology	Buy	5.20	4.81	3,333	7.8	28.6	23.5	12.0	8.9	0.5	0.6	2.1	1.6	7.6	7.8
694 HK	Beijing Capital International Airport	Hold	5.20	5.88	3,284	4.2	14.8	13.3	8.3	7.8	2.0	2.3	1.2	1.1	8.5	8.9
1919 HK	China COSCO	Buy	5.40	3.61	4,756	5.8	n.a.	11.0	44.7	10.5	-	-	1.3	1.2	n.a.	11.4
670 HK	China Eastern Airlines	Buy	3.40	2.87	4,174	3.9	14.6	7.1	6.9	6.2	-	-	1.0	0.9	7.1	12.9
144 HK	China Merchants Holding International	Buy	31.00	27.65	8,882	16.1	17.7	14.7	15.1	14.7	2.4	2.7	1.4	1.3	8.3	9.4
2866 HK	China Shipping Container Lines	Buy	2.40	2.00	3,014	9.7	n.a.	14.4	23.7	7.7	-	-	0.7	0.7	n.a.	4.8
1055 HK	China Southern Airlines	Outperform	3.20	2.98	3,961	9.4	33.8	12.4	6.7	5.2	0.4	1.6	0.7	0.7	2.2	5.7
1199 HK	COSCO Pacific	Outperform	12.20	10.40	3,669	6.0	10.9	11.7	8.3	8.2	7.6	3.2	0.8	0.8	7.9	6.7
177 HK	Jiangsu Expressway	Outperform	9.50	9.42	6,120	4.6	12.9	11.7	8.1	7.4	5.1	4.9	1.9	1.8	15.1	16.1
548 HK	Shenzhen Expressway	Buy	4.00	3.50	984	1.4	7.4	6.6	5.6	4.8	5.4	6.1	0.6	0.6	8.2	8.8
598 HK	Sinotrans	Buy	3.30	3.15	726	4.4	13.3	10.9	3.2	2.7	1.2	1.2	0.9	0.9	7.4	8.4
1052 HK	Yuexiu Transport Infrastructure	Buy	5.00	4.13	891	0.6	9.9	7.8	8.2	6.8	7.6	8.5	0.6	0.6	6.5	7.9
576 HK	Zhejiang Expressway	Hold	6.80	7.42	4,156	3.0	14.0	13.6	7.8	6.9	5.4	5.5	1.6	1.5	11.4	11.4
Utilities																
579 HK	Beijing Jingneng Clean Energy	Buy	5.50	4.37	3,651	8.4	15.4	10.2	12.7	11.0	1.3	2.0	2.1	1.8	14.0	19.1
1193 HK	China Resources Gas	Hold	20.50	25.85	7,414	9.4	26.5	21.8	13.6	12.3	0.8	0.9	4.3	3.7	17.2	18.2
836 HK	China Resources Power	Buy	25.00	17.66	10,673	13.4	8.7	7.9	6.7	6.0	3.6	4.0	1.4	1.2	16.9	16.6
1083 HK	Towngas China	Buy	11.10	9.35	3,147	2.9	21.9	17.6	15.6	12.7	0.9	1.2	2.0	1.8	9.8	10.8

Source: Bloomberg, Daiwa forecasts

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Korea – Overweight

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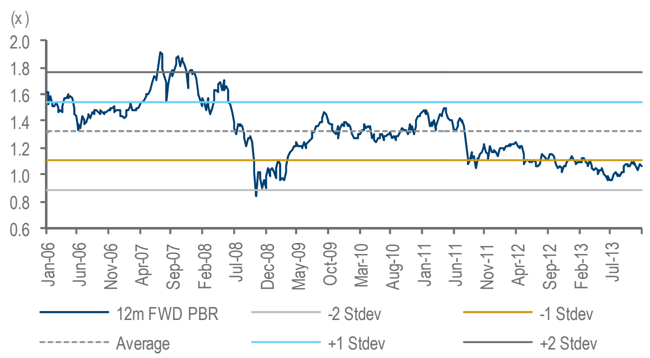
End-2014 target for MSCI Korea Index: 680 (+20%)

We expect the Korea stock market to offer a favourable risk-return profile to investors in 2014. We believe the potential downside to the market is limited compared with those in weaker emerging countries against the backdrop of QE tapering starting from 1Q14. This is because Korea should be able to differentiate itself by continuing to have a current account surplus and ample foreign reserves, which are far larger than the country's short-term external debt.

For 2014, we expect Korea to reap the full benefits of a global economic recovery, led by developed markets such as the US and the Eurozone, with continuous strong exports. In addition, domestic demand growth should improve gradually compared with 2013. Given this, the 12-month forward PBR of the stock market should expand this year.

■ MSCI Korea Index: 12-month forward PBR since 2006



Source: IBES, MSCI, Daiwa

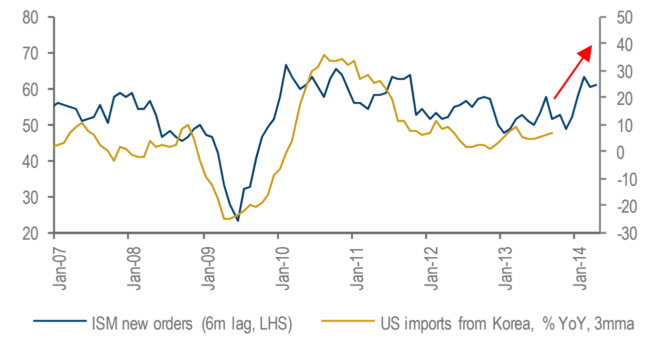
The IBES consensus forecasts MSCI Korea Index EPS growth for 2014 of 22.1%, which is the highest among the Asia ex-Japan MSCI constituent countries. However, we note that cuts to this year's consensus earnings forecasts are ongoing, and also that some of the high EPS growth for 2014 is due to the lowered EPS forecasts for 2013. Given this, we believe that the PBR expansion this year will still be below the average level of 1.32x since 2006.

Our target PBR for the MSCI Korea Index for 2014 is 1.25x, or 680 points, which translates into a forecast of 2,300 for the Kospi by the end of this year, assuming that the Kospi moves in tandem with the MSCI Korea Index. We set our target multiple at 1.25x, above the current 12-month forward PBR of 1.07x. We believe it is justified for the 2014 valuation to increase to at least the level just before the Eurozone crisis pulled down the market in March 2012, as we expect GDP growth in the Eurozone to resume from this year.

How to beat the index

In our view, the global macroeconomic backdrop this year will be favourable for Korea, because the country has an export-oriented economy poised to reap the benefits of a broad-based global economic recovery. We therefore believe that overweighting cyclical sectors, notably autos, memory chips and shipbuilding, will be one of the keys to beating the rise we expect in the stock market this year.

■ US ISM new orders index and US imports from Korea

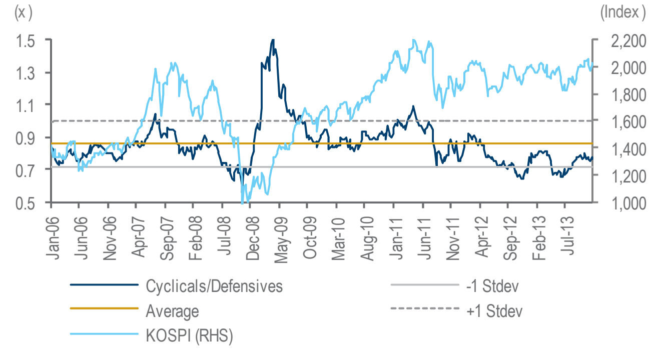


Source: CEIC, Daiwa

The US ISM new orders index, which is a component of US ISM manufacturing index, has picked up over the past 6 months. As Korea's exports to the US lag this index by 6 months, we believe exports to the US will pick up over the coming months as shown in the preceding chart.

We believe that a cyclical sector focus is a sensible strategy at this time, especially considering that cyclical sectors are trading at substantial discounts to defensive sectors. These discounts arose because doubts about a strong global economic outlook in the past made defensive sectors very attractive, and allowed them to command higher valuations at the expense of cyclical sectors, as shown in the following chart.

■ **Relative 12-month forward PER of cyclical and defensive sectors**



Source: IBES, MSCI, Daiwa

We recommend investors overweight the following sectors: 1) semiconductor and semiconductor services, and software and services under IT, 2) automobiles and components, 3) shipbuilding under industrial, 4) banks under financials, and 5) refinery under energy. (Note: we use the GICS sectors to make our sector-weighting definitions clear).

The sectors to underweight are: 1) food and staples retailing under consumer staples, 2) machinery under industrials, and 3) metals and mining, and chemicals, under materials.

We suggest a neutral weighing on: 1) telecommunication services, 2) utilities, 3) construction under industrials, 4) technology hardware and equipment under IT, and 5) food, beverage and tobacco, and household and personal products, under consumer staples.

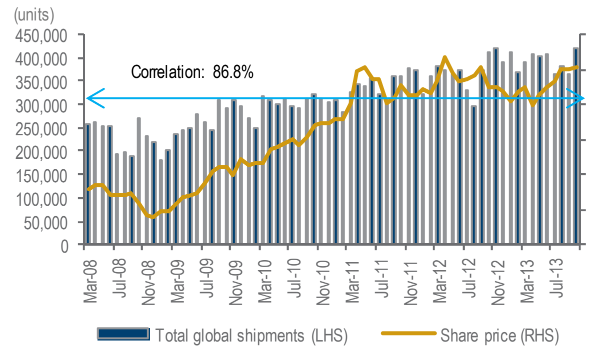
Autos (overweight) – new-model cycle should drive earnings

We forecast global auto industry demand to rise by 4.1% YoY to 84.6m vehicles for 2014, up from 4.4% YoY growth to 81.2m vehicles for 2013E. We remain positive on the industry outlook on the back of YoY rise in auto demand in China and the US, and also expect auto industry demand to recover in Europe as well as the BRIC economies this year.

We recommend overweighting the Korea Auto Sector as Hyundai Motor (HMC) (005380 KS, KRW224,500, Buy [1]) and Kia Motors (Kia) (000270 KS, KRW52,700, Outperform [2]) have competitive advantages in emerging markets and could benefit from the recovery of auto demand there. More importantly, the resumption of HMC's new-model cycle from 4Q13 onwards – with the launch of the redesigned Genesis on 26 November 2013, the likely launch of its volume-seller Sonata (a mid-sized sedan) in 1Q14, and the launch of other volume-sellers such as the Tucson (small-sized CUV) and Elantra (compact-sized sedan) – should drive the company's earnings growth over 2014 and 2015. Meanwhile, as shown in the following chart, we expect HMC's monthly global shipments (a key share-price driver) to stage a meaningful rebound throughout 2014, bolstered by the company's new-model cycle. While lagging that of HMC, Kia's new-model cycle is likely to resume from 2H14 with the launch of the Sorento (a mid-sized SUV).

Furthermore, we believe a possible announcement about HMC and Kia building plants or adding more production capacity in Latin America or the US before 1H14 could be a share-price catalyst.

■ **HMC: monthly global shipments vs. share price**



Source: FnGuide, Company

Shipbuilding (overweight) – poised for a cyclical upturn

For 2014, we forecast global shipbuilding orders to increase by 12% YoY to 48.2m CGT from 43m CGT for 2013E. This compares with an average global new shipbuilding order level of 46.8m CGT over the past 10 years, which we believe illustrates that the shipbuilding sector globally is heading for a cyclical upturn. Of all types of vessels, we expect orders for fuel-efficient and cost-competitive, large-sized containerships to increase YoY for 2014. We also remain optimistic on the order prospects for LNGCs, and offshore structures and vessels amid a tightened demand and supply balance and the rising capex cycle of the major global energy players.

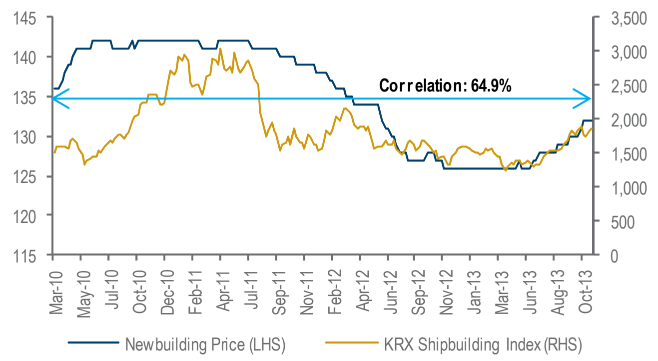
Meanwhile, despite a strong rebound in bulk-carrier orders YoY for 2013, we are pessimistic on the order outlook for bulk carriers as the Baltic Dry Index is still below the break-even level of 2,000 and we expect this to be the case throughout this year.

Our market research suggests that the Big-3 Korea shipyards – Hyundai Heavy Industries (HHI) (009540 KS, KRW253,500, Outperform [2]), Samsung Heavy

Industries (SHI) (010140 KS, KRW38,050, Buy [1]), and Daewoo Shipbuilding and Marine Engineering (042660 KS, KRW34,900, Outperform [2]) – have become more selective in terms of order intake, given that their berth capacity is full until 2016 (implying an order book equivalent to 2.3 years). We believe this will trigger the market dynamics to change to a seller's market.

Also, bolstered by strong orders in 2013, we expect a moderate rise in Clarksons's new shipbuilding price index (a key share-price driver for the Big-3 Korea shipyards) over the next 6 months.

▪ Clarksons: new shipbuilding price index vs. Korea shipyards share price index



Source: Clarksons

Internet/online games (overweight) – mobile momentum is accelerating

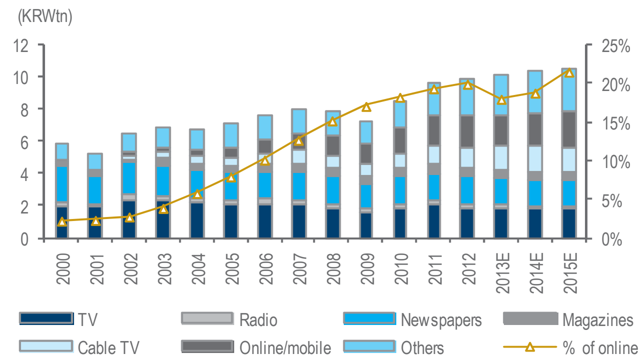
We believe Korea's Internet and Online Game Sector will see a shift in its revenue model into mobile ads, mobile commerce, and digitalised item transactions. Given the strong expansion in digital commerce, we expect robust demand for smart applications related to service infrastructure, such as payment gateways and network-security solutions.

Meanwhile, more regulation is likely to be introduced in Korea's online-game market, especially related to web board-game services. In addition, the regulator now requires search engines to differentiate clearly between the results of search queries and advertisements. This may decrease search-related advertising over the short term, but over the long term we expect a steady recovery in the click-through rate for the leading search-engine companies in Korea.

In the sector, we continue to favour Naver (035420 KS, KRW725,000, Buy [1]) as the company is in the process of building various proprietary revenue models, based on advertisements, games, and e-commerce, while expanding its service region and product offerings.

Compared with 2013, we expect the stock to trade at a higher PER this year, given the company's potential to become a global mobile social platform and generate more revenue from outside Japan through the development of different business streams, such as mobile ads and digital commerce. As the following chart on the Korea ad-market illustrates, mobile is one of the fastest-growing platforms for advertising currently.

▪ Korea: ad-dollar spending by formats



Source: Company, Daiwa forecasts

Banks (overweight) – beginning of a new cycle

Due in part to a likely rise in market interest rates this year, we expect the net-interest margin of the Korea banks to see a gradual improvement YoY over the next 12 months. In addition, given that the top managements of the leading bank-centric holding companies have voluntarily taken pay-cuts of up to 30%, we believe that stringent bank-wide cost-control measures will be implemented in 2014, which should be positive for the bottom line.

Amid the improving global and domestic economic growth we expect in 2014, the likelihood of large corporate failures – such as those seen in 2013 of STX Group, Ssangyong E&C, Kukdong E&C – is diminishing, which implies that one-off additional credit costs should decline. We also believe that improving economic growth, along with a mild but gradual improvement in the condition of the property market, will lead to an increase in loan growth.

Last but not least, industry consolidation as a result of the privatisation of Woori Finance Holdings's (053000 KS, KRW13,300, Buy [1]) affiliates, and ultimately of Woori Finance itself, could change the industry's competitive landscape for the better.

Electronics (neutral) – upbeat on memory-chip outlook

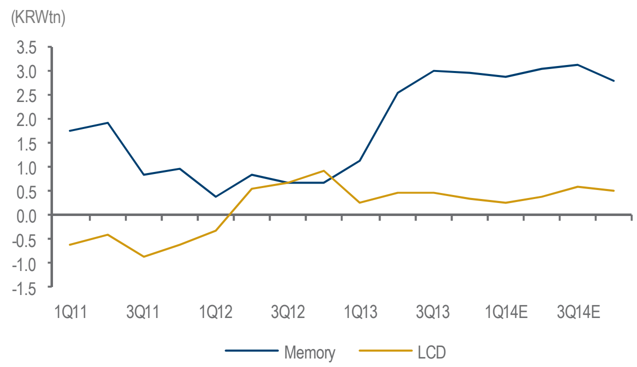
From smartphones to TVs, many makers of electronics products globally are facing slowing market demand and falling product prices. Keen to avoid ceding market share to their rivals, these companies are seeking ways to differentiate their products. This year, we expect the increased use of flexible displays by the Korea handset makers to change the look and feel of their flagship smartphones. In TVs, LCD-TV makers are likely to market ultra high-definition TVs aggressively, but we forecast shipments of about 5m units for 2014, representing only 2-3% of global LCD-TV demand for the year.

We remain positive on the outlook for memory-chip market in 2014 due to the limited increase in plans for production capacity and as process migration technology will become more complex. For DRAM, prices could be under pressure once production at SK Hynix's (Hynix) (000660 KS, KRW35,500, Buy [1]) Wuxi fab normalises in 1Q14. However, given that inventory levels for the industry are very low at present, any price decline would result in inventory build-ups by key industry participants, in our view.

Although we are positive on the outlook for Samsung Electronics's semiconductor division for 2014, overall earnings expansion for the company will depend mostly upon its smartphone business. For its forthcoming flagship smartphones, successful product differentiation could lead to an improvement in investor confidence, though the YoY comparison will likely be compromised by the high base of 2013.

Although the memory-chip companies' earnings continue to expand on healthy supply-and-demand dynamics, LCD-panel makers face low earnings from chronic overcapacity, due to slowing demand and a continuous ramp-up in new capacity. As a result, we believe that the LCD-panel makers' quarterly operating-profit margin will remain at low-to-mid-single-digit percentages for 2014.

■ LCD and memory-chip operating profit



Source: Companies, Daiwa forecasts

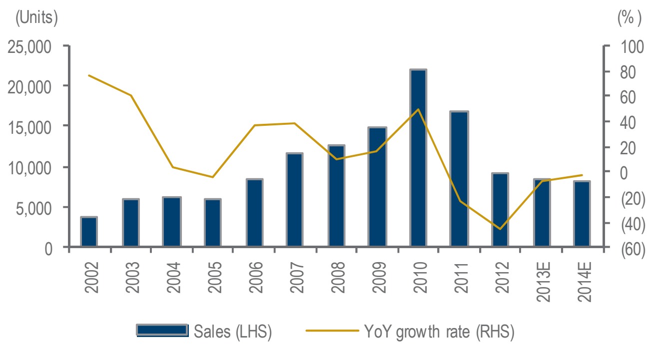
Note: Memory-chip operating profit for SEC and Hynix and LCD operating profit for Samsung Display and LGD

Machinery (underweight) – restructuring likely to continue

We expect restructuring to be the key theme for the Korea Machinery Sector in 2014, resulting from demand for both construction machinery and power equipment remaining weak.

In terms of China excavator demand, we expect this year's first half, which in most years would be the peak period, to be uninspiring. Hence, we forecast Doosan Infracore's (042670 KS, KRW12,400, Hold [3]) China excavator unit sales for the whole year to be flat YoY at 8,300 units. We are concerned about power-equipment demand as well. We forecast Doosan Heavy's (DHI) (034020 KS, KRW34,400, Underperform [4]) power-equipment demand to increase by only 3.3% YoY to KRW8.6tn. Domestic nuclear orders are being delayed and overseas opportunities are declining due to intensifying competition in emerging Asia.

■ China excavator demand (2010-14E)



Source: DI, Daiwa forecasts

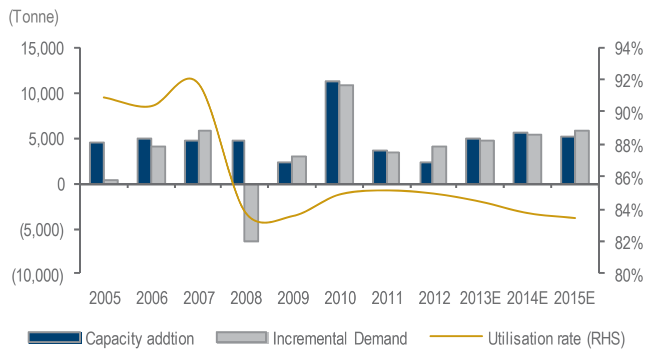
Petrochemical (underweight) – expectations of demand recovery appear to be priced in

The Korea Petrochemical Sector is highly leveraged to the cycles of the global economy and the industry's worldwide supply-demand balance. Hence, given our expectation that the world economy is improving and industrial capacity will remain tight, petrochemical margins and earnings this year should be buoyant. Nevertheless, the sector has outperformed the Kospi since September last year. We believe that the sharp rise in the share prices of the stocks in the sector fully reflect further upside in key petrochemical spreads and mid-cycle earnings for petrochemical companies. Unless there is a significant pick-up in downstream demand, we believe further share-price upside is limited.

Given the heavy purified terephthalic acid (PTA) volume addition scheduled in 2014, we expect PTA and polyester spreads to weaken from the current low levels. Similarly, with low plant utilisation rates and new capacity volume scheduled for synthetic rubber, we believe the price and product-margin recovery for synthetic rubber will be much slower than many in the market expect.

We are most bearish on Korea Kumho Petrochemical (011780 KS, KRW92,500, Underperform [4]), as we believe that the market's expectation on the SBK/BR-BD spread outlook is too optimistic, and we do not believe the pick-up in downstream demand will translate into an improved BR/SBR price this year.

■ **Ethylene capacity-demand balance & utilisation forecasts**



Source: CMAI, Daiwa forecasts

Key stock calls

Top buys

Samsung Heavy Industries (010140 KS, W38,050, Buy [1]). We have a DCF/PER-based six-month target price of KRW48,000. SHI easily achieved its 2013 order target of USD13bn and should see a YoY increase in 2014 orders, on the back of its strong competitive advantage in building LNGCs and offshore structures/vessels (which account for 86% of its current order book). We also like the company's strategy of focusing on profitable orders and the fact that it has a higher revenue contribution from high-margin drillships than its peers. Bolstered by the above, we expect SHI to have a stronger operating-profit margin than its peers this year.

Hyundai Motor (005380 KS, KRW224,500, Buy [1]). We expect the upward earnings-revision cycle for HMC to resume from 2014, given: 1) a new-model cycle that should run from 4Q13 to 2015, which would have a positive impact on the company's ASP and global sales volume (although only moderately, as it is facing production-capacity constraints globally with a global inventory level of less than 2 months compared with an ideal level of 3 months, and currently has a global capacity-utilisation rate of more than 100% from 2011-2013), 2) a possible announcement that HMC is building a new plant or adding production capacity in Mexico or Brazil or the US before 1H13, and 3) an appealing valuation, with the stock trading currently at a 2014 PER of 5.7x, based on our 2014 EPS forecast, which compares with a past-5-year average of 8.1x. We have a DCF/PER-based six-month target-price of KRW320,000.

SK Hynix (000660 KS, KRW35,500, Buy [1]). Despite a production loss at its DRAM fab in Wuxi, China, that is likely to weigh on 4Q13 earnings, further earnings expansion is likely this year on the back of the healthy supply and demand dynamics for memory chips. The company's share price rose strongly last year on the back of robust memory-chip prices and strong earnings momentum, while we remain positive on memory-chip earnings for 2014. We have a six-month target price of KRW40,000, based on the stock's mid-cycle PBR of 1.8x.

Top shorts/sells

Korea Kumho Petrochemical (011780 KS, KRW92,500, Underperform [4]). Despite the modest recovery in replacement tyre demand in recent months, we doubt that this will translate into an improved BR/SBR price in 2014, as the recovery in the price of synthetic rubber price is likely to be hampered by the low utilisation rates at existing plants and new supply scheduled in 2014. Meanwhile, we believe that the Bloomberg-consensus forecast for the company's 2014 earnings, which is about 20% higher than ours, is far too bullish.

E-Mart (139840 KS, KRW270,000, Hold [3]). E-Mart's share price has outperformed the market by 15% in the past three months, mainly on the back of expectations that the contraction in same-store sales will ease due to a more favourable base of comparison. However, we expect the share-price outperformance to be short-lived, as we believe that the hypermarket industry will go through a structural decline and E-Mart's new businesses are unlikely to make up the difference. The ageing demographic profile of the population of Korea and the rising number of single-person households are negative trends for large store formats, in our view. E-Mart has been putting a focus on expanding its Internet shopping mall and the wholesales store format, the Traders. However, these businesses have not been able to see much improvement in sales-growth as the company has been focused on business profitability. On the other hand, should the company focus on increasing sales, a rise in investment costs would be inevitable.

Top alpha generator (non-index pick)

GS Home Shopping (028150 KS, KRW307,800, Buy [1]). We expect the company to enjoy structural growth in 2014. Home-shopping companies have improved their merchandising mix on the back of strengthening high-margin apparel by launching private-label brands and exclusive third-party brands. This is positive for the company's EBIT margin, as private-label brands and exclusive brands generate an operating-profit margin that is 3-4pp higher than local brands.

Meanwhile, the company's exposure to mobile shopping should be value-accretive. Mobile shopping, which is expanding rapidly in Korea on the back of the rise in smartphone use and the convenience offered, is able to help the company expand its customer base to a wider age group, while GS Home Shopping's cable-TV channel division is more geared towards the older age segment. Strong sales growth in mobile shopping (we forecast it to account for more than 10% of total sales for 2014) is also improving the company's operating-profit margin, given that it has a margin of 3-4%.

What could go wrong?

Our bullish market view is based primarily on a strong economic recovery led by developed economies. If such a recovery did not materialise, then defensive sectors would be more attractive to investors than overweighting export-driven cyclical stocks.

If the US Fed's QE tapering significantly disrupts the global financial market, with a continuous decrease in the amount of asset purchases by the Fed throughout 2014, then a repeat of what happened last summer is possible, with money flowing out of emerging markets amid US Dollar strength and a rise in market interest rates. While Korea would be able to weather such a storm better than many other emerging economies, in our view, the end result would still be disappointment for investors, as regional outperformance amid absolute capital losses would be their only solace.

A more worrying response to tapering would be if interest rates were raised sharply and stayed high. If this happened, debt-ridden households might default, leading to a systemic credit contraction and possible bank solvency. Under such a scenario, demand in the property market could weaken and the consequent drop in property prices might present unprecedented challenges, not only to the financial system but also to Korea's economy over the long term.

Meanwhile, a further sharp and rapid depreciation in the Yen against the US Dollar as a result of Abenomics in Japan is another risk. This could result in investors preferring the Japan global exporters to their Korea counterparts in sectors such as autos.

While we expect a policy rate hike in 2H14, the Bank of Korea could cut its policy rate by 25bps to 2.25% in 2Q14 should a new governor be appointed and succumb to government pressure in the name of boosting the economy. In this case, loose credit in the system could lead to a bubble in asset prices. However, the upside potential might be short-lived, as an interest-rate policy that is out of sync with the expectations of the market could cause additional problems, notably inflation. In addition, the long-awaited net interest margin expansion of the banks would not materialise, which would be disappointing for investors in banks.

If North Korea, which is reportedly undergoing a purge of supporters of the second-in-command in the country, opts to divert people's attention from domestic political issues, this could lead to military tensions with South Korea. In such a case, and depending on the degree of provocation and South Korea's counter measures, there could be instability in the financial market.

■ Valuation comparison

Bloomberg code	Company name	Rating	Target price (KRW)	Share price (KRW) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x) 13E	PER (x) 14E	EV/EBITDA (x) 13E	EV/EBITDA (x) 14E	Dividend Yield (%) 13E	Dividend Yield (%) 14E	PBR (x) 13E	PBR (x) 14E	ROE (%) 13E	ROE (%) 14E
Automobiles & components																
161390 KS	Hankook Tire	Outperform	66,000	59,900	7,065	17.2	9.1	8.6	5.8	5.6	0.7	0.7	1.8	1.5	22.4	19.3
012330 KS	Hyundai Mobis	Hold	290,000	279,000	25,858	49.9	8.3	6.7	4.9	3.8	0.7	0.7	1.4	1.2	17.9	19.0
005380 KS	Hyundai Motor	Buy	320,000	224,500	47,084	108.3	6.6	5.7	4.8	4.0	0.8	0.8	0.9	0.8	19.2	19.2
011210 KS	Hyundai Wia Corp	Buy	220,000	176,000	4,312	20.3	10.0	7.0	5.6	4.2	0.4	0.5	2.0	1.6	22.1	25.9
000270 KS	Kia Motors	Outperform	72,000	52,700	20,340	71.5	5.4	5.0	3.6	3.0	1.2	1.2	1.1	1.0	21.7	21.0
060980 KS	Mando Corp	Buy	160,000	122,500	2,124	17.9	9.7	6.1	6.0	4.4	0.8	0.8	1.3	1.1	14.1	20.0
002350 KS	Nexen Tire	Hold	16,000	14,400	1,301	4.7	9.5	8.1	7.4	6.7	-	-	1.7	1.4	19.6	19.1
Banks																
138930 KS	BS Financial	Buy	18,800	16,250	2,992	7.3	8.1	6.8	n.a.	n.a.	2.5	2.9	0.9	0.8	11.4	12.2
139130 KS	DGB Financial Group	Outperform	18,400	16,400	2,093	3.4	7.9	7.0	n.a.	n.a.	2.5	2.9	0.8	0.7	10.6	10.9
086790 KS	Hana Financial Group	Buy	50,000	43,850	10,147	37.7	5.8	6.8	n.a.	n.a.	1.1	2.2	0.7	0.6	12.4	9.5
024110 KS	Industrial Bank of Korea	Underperform	11,500	12,100	6,290	19.5	6.7	7.1	n.a.	n.a.	3.4	3.2	0.5	0.5	9.4	8.3
053000 KS	Woori Finance Holdings	Buy	13,500	13,300	10,207	17.3	8.0	7.0	n.a.	n.a.	1.5	1.8	0.6	0.5	7.1	7.6
Capital goods																
000210 KS	Daelim Industrial	Buy	135,000	92,600	3,403	18.9	7.7	6.2	5.6	4.6	0.2	0.2	0.7	0.6	9.4	10.8
042660 KS	Daewoo Shipbuilding & Marine Engineering	Outperform	40,000	34,900	6,360	44.5	26.1	10.0	11.1	5.1	0.7	0.7	1.4	1.2	5.5	13.2
000150 KS	Doosan Corp	Outperform	156,000	133,500	3,337	5.7	16.3	14.7	10.6	10.4	3.0	3.4	0.3	0.3	4.8	3.7
034020 KS	Doosan Heavy Industries and Construction	Underperform	30,000	34,400	3,477	22.1	27.8	14.9	15.8	18.9	2.2	2.2	0.6	0.6	2.9	4.6
006360 KS	GS Engineering & Construction	Underperform	25,000	30,400	1,476	13.3	n.a.	14.7	n.a.	21.3	-	0.7	0.6	0.5	n.a.	3.8
012630 KS	Hyundai Development	Hold	22,000	23,000	1,651	6.9	56.7	13.4	29.7	14.7	0.9	0.9	0.7	0.7	1.3	5.3
000720 KS	Hyundai Engineering & Construction	Outperform	72,000	60,000	6,367	17.4	10.7	8.2	6.4	4.6	0.8	0.8	1.3	1.2	13.1	15.3
009540 KS	Hyundai Heavy Industries	Outperform	300,000	253,500	18,343	63.4	22.3	12.0	8.1	6.4	1.0	1.0	1.0	0.9	4.5	7.9
052690 KS	KEPCO Engineering & Construction	Hold	56,000	60,100	2,187	8.3	46.6	18.6	28.7	12.2	1.1	2.7	5.0	5.5	11.2	28.2
051600 KS	KEPCO Plant Service & Engineering	Outperform	59,000	54,400	2,331	6.5	19.3	15.9	11.5	9.8	2.9	3.7	4.1	3.6	22.5	24.2
000830 KS	Samsung C&T	Outperform	70,000	59,000	9,037	28.2	21.2	15.3	19.9	12.4	0.8	0.8	0.7	0.7	3.8	5.1
028050 KS	Samsung Engineering	Hold	74,000	68,100	2,594	30.2	n.a.	11.6	n.a.	13.4	4.4	4.4	3.0	2.7	n.a.	24.4
010140 KS	Samsung Heavy Industries	Buy	48,000	38,050	8,364	46.7	8.8	8.2	3.7	3.4	1.3	1.3	1.4	1.2	17.5	16.2
Consumer durables & apparel																
066570 KS	LG Electronics	Hold	70,000	67,000	10,439	43.4	27.1	12.3	6.0	5.1	0.3	0.4	0.8	0.8	3.2	6.6
Diversified financials																
000810 KS	Samsung Fire & Marine Insurance	Buy	278,000	252,000	11,367	20.8	13.3	11.6	n.a.	n.a.	2.1	2.4	1.2	1.1	n.a.	n.a.
Electronics																
054620 KS	Advanced Process Systems	Buy	13,000	9,610	209	7.1	14.7	8.7	8.4	4.4	-	-	2.1	1.6	19.6	26.2
077360 KS	Duksan Hi-Metal	Buy	27,000	18,200	509	3.7	15.5	11.6	12.1	8.6	-	-	2.5	2.0	17.3	19.2
020760 KS	Iljin Display	Buy	23,000	14,550	392	4.1	6.6	5.2	5.7	4.0	1.4	1.4	2.5	1.7	39.6	39.5
034220 KS	LG Display	Hold	26,000	24,750	8,432	43.7	15.0	12.2	2.0	2.0	0.8	1.2	0.8	0.8	5.6	6.6
011070 KS	LG Innotek	Hold	85,000	83,100	1,873	9.3	36.0	14.4	5.1	3.7	-	0.2	1.2	1.1	3.8	8.1
096640 KS	Melfas Inc	Hold	10,000	9,180	157	2.3	181.3	11.9	25.6	7.7	1.1	1.1	1.0	0.9	0.6	8.5
009150 KS	Samsung Electro-Mechanics	Hold	78,000	69,700	4,957	28.3	12.1	11.7	5.4	4.8	1.4	1.4	1.2	1.1	10.5	9.9
005930 KS	Samsung Electronics	Buy	1,700,000	1,309,000	183,581	281.8	6.1	5.6	2.9	2.4	0.8	0.8	1.3	1.1	23.9	21.0
006400 KS	Samsung SDI	Hold	175,000	157,500	6,832	48.1	16.1	12.9	16.6	11.7	1.0	1.0	0.9	0.9	5.9	7.0
056190 KS	SFA Engineering	Buy	65,000	39,900	682	5.9	10.3	7.6	5.6	3.6	3.0	3.5	1.8	1.5	18.2	21.4
000660 KS	SK Hynix	Buy	44,000	35,550	24,039	142.7	9.8	7.3	4.2	3.3	-	0.6	2.0	1.6	23.8	24.9
030530 KS	Wonik IPS	Buy	11,000	8,420	587	13.7	22.0	12.3	12.1	5.7	-	-	2.1	1.7	10.9	16.9
Energy																
078930 KS	GS Holdings	Outperform	68,000	56,400	4,989	15.4	9.1	7.4	10.3	7.8	2.4	2.4	0.8	0.7	8.7	9.7
010950 KS	S-Oil Corp	Outperform	89,000	72,500	7,771	15.4	14.3	11.1	9.8	6.8	4.3	4.5	1.5	1.4	10.4	12.7
096770 KS	SK Innovation	Buy	190,000	140,000	12,325	42.1	10.8	7.2	7.0	5.8	1.3	1.3	0.8	0.7	7.5	10.5
Food, beverage & tobacco																
007070 KS	GS Retail	Hold	29,000	26,600	1,950	3.5	16.9	13.9	7.2	6.3	1.7	1.9	1.3	1.2	7.8	8.8
000080 KS	Hite Jinro	Hold	23,000	21,750	1,462	4.2	16.6	20.7	10.3	9.8	5.7	3.7	1.1	1.1	6.6	5.3
033780 KS	KT&G Corp	Hold	78,000	73,600	9,621	16.0	15.0	12.2	7.8	7.1	4.3	4.6	1.9	1.8	12.0	14.0
001800 KS	Orion	Hold	1,040,000	931,000	5,288	12.6	29.8	22.1	17.4	15.0	0.4	0.5	4.9	4.1	15.5	17.8
Hotels, restaurants & leisure																
114090 KS	Grand Korea Leisure	Outperform	42,000	40,350	2,376	6.7	16.8	15.2	9.7	8.6	3.0	3.1	5.6	4.6	38.1	33.3
035250 KS	Kangwon Land	Outperform	35,000	30,850	6,284	13.1	19.1	15.0	10.6	8.5	3.2	3.6	2.4	2.2	14.0	16.4
034230 KS	Paradise	Outperform	30,000	26,700	2,312	6.2	20.7	18.0	14.1	11.9	1.1	1.1	2.3	2.1	15.7	14.1
Household & personal products																
051900 KS	LG Household & Health Care	Hold	560,000	544,000	8,089	16.3	24.7	21.7	14.8	13.2	0.7	0.8	5.7	4.7	25.6	23.8

Source: Bloomberg, Daiwa forecasts

■ Valuation comparison (cont'd)

Bloomberg code	Company name	Rating	Target price (KRW)	Share price (KRW) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x)		EV/EBITDA (x)		Dividend Yield (%)		PBR (x)		ROE (%)	
							13E	14E	13E	14E	13E	14E	13E	14E	13E	14E
Materials																
010520 KS	Hyundai Hysco	Hold	43,000	41,500	3,169	12.3	11.1	9.2	5.1	4.5	0.7	0.7	1.6	1.4	15.0	15.7
004020 KS	Hyundai Steel	Outperform	93,000	83,700	6,799	31.9	11.3	8.7	11.7	8.4	0.7	0.8	0.7	0.6	6.3	7.8
011780 KS	Korea Kumho Petrochemical	Underperform	89,000	92,500	2,683	20.5	32.3	11.2	12.9	9.1	-	-	1.5	1.3	5.8	15.6
051910 KS	LG Chem	Outperform	300,000	292,000	18,424	58.7	12.7	11.3	6.8	5.9	1.4	1.4	1.6	1.4	13.5	13.5
005490 KS	POSCO	Hold	320,000	322,000	26,730	55.3	12.5	9.1	6.9	6.3	2.5	2.5	0.7	0.6	5.3	7.0
036830 KS	Soulbrain	Outperform	57,000	42,200	665	5.0	8.6	6.8	4.9	3.5	0.9	0.9	1.7	1.4	21.5	22.1
Retailing																
035760 KS	CJ O Shopping	Outperform	440,000	426,100	2,517	5.7	16.8	13.9	8.4	7.0	0.4	0.4	3.5	2.7	23.3	21.9
028150 KS	GS Home Shopping	Buy	350,000	307,800	1,923	3.5	14.9	13.5	7.6	6.6	1.0	1.0	2.5	2.2	18.3	17.4
069960 KS	Hyundai Department Store	Buy	186,000	160,500	3,576	8.7	11.1	9.8	7.4	6.6	0.4	0.4	1.2	1.1	11.2	11.2
057050 KS	Hyundai Home Shopping Network	Outperform	215,000	189,500	2,165	5.5	11.9	12.8	10.5	8.1	0.6	0.6	2.0	1.7	18.0	14.4
071840 KS	Lotte Himart	Hold	92,000	89,600	2,014	5.0	15.3	13.1	11.4	9.7	0.3	0.3	1.3	1.2	9.0	9.6
023530 KS	Lotte Shopping	Hold	370,000	406,000	11,424	13.0	12.7	11.5	9.6	9.1	0.4	0.4	0.8	0.7	6.0	6.3
004170 KS	Shinsegae	Hold	235,000	257,500	2,414	8.5	14.6	13.1	10.2	9.5	0.2	0.2	1.1	1.0	7.5	7.7
Software																
035720 KS	Daum Communications	Outperform	105,000	85,000	1,097	3.0	12.8	10.4	5.5	4.1	1.3	1.3	2.0	1.8	16.8	18.1
035420 KS	Naver	Buy	760,000	725,000	22,753	122.6	62.4	33.5	31.2	22.1	0.1	0.1	13.4	10.6	25.6	35.3
036570 KS	NCsoft	Buy	285,000	244,500	5,102	36.6	29.3	15.5	17.4	10.3	0.2	0.3	4.6	3.6	16.8	25.8
Telecommunication services																
030200 KS	KT Corporation	Hold	35,000	30,900	7,682	44.4	13.3	7.6	3.5	3.3	6.5	6.5	0.7	0.6	4.9	8.4
032640 KS	LG Uplus	Outperform	13,700	10,900	4,531	20.0	14.4	8.6	4.7	3.8	2.3	2.8	1.2	1.1	8.4	12.9
033630 KS	SK Broadband	Hold	4,400	4,260	1,200	2.6	48.4	11.0	4.7	3.7	-	-	1.1	1.0	2.3	9.6
017670 KS	SK Telecom	Outperform	255,000	228,000	17,528	41.6	10.0	8.8	3.8	3.0	4.1	4.1	1.4	1.3	14.8	15.2
Transportation																
000120 KS	CJ Korea Express	Underperform	84,000	99,600	2,163	4.2	n.a.	26.7	27.7	13.4	-	0.2	0.8	0.8	n.a.	3.8
Utilities																
015760 KS	KEPCO	Outperform	38,000	34,550	21,118	59.7	n.a.	10.2	6.8	5.3	-	2.9	0.4	0.4	n.a.	4.3

Source: Bloomberg, Daiwa forecasts

Singapore – Neutral

Adrian Loh
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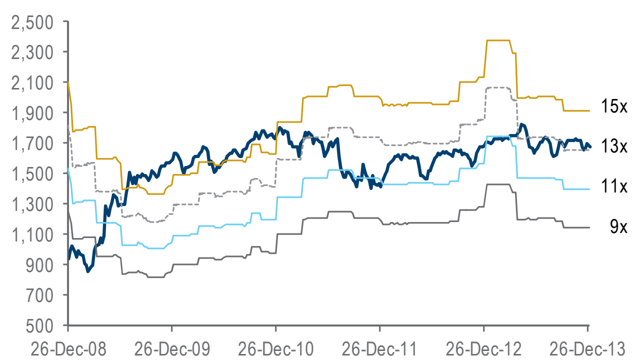
End-2014 target for MSCI Singapore: 1,830 (+9%)

We set our end-2014 target for the MSCI Singapore index at 1,830, based on Daiwa's target-price expectations for the stocks that we cover within this index. For the stocks that we do not cover, we have used the Bloomberg consensus target prices.

Our end-2014 target implies a 9% increase from the index level as at 19 December 2013 of 1,648, compared with the consensus expectation for a 10% increase.

■ 5-year PER band for MSCI Singapore

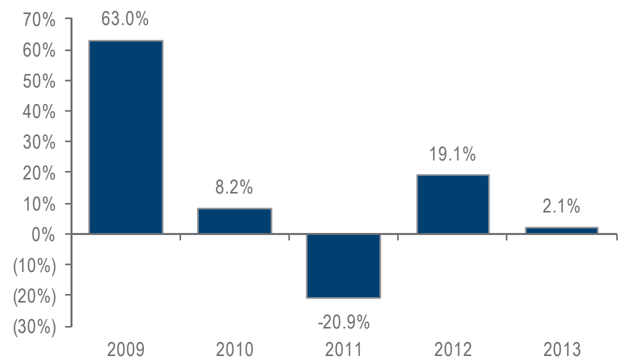


Source: Bloomberg

Currently, the MSCI Singapore index is trading at a 2014E PER of 13.7x (as at 3 January 2014), which seems fair relative to its past-5-year historical trading range, in our view. As a result, we have not assumed any meaningful PER expansion in 2014.

In terms of earnings growth in 2014, Daiwa forecasts an aggregate 9.4% YoY EPS growth in 2014 for the stocks that it covers within the index. The Bloomberg consensus view is more bullish, as it is forecasting an aggregate 12.6% YoY growth. However, we highlight that excluding two outlier stocks with 50%-plus forecast EPS growth in 2014 (ie, Noble Group and Golden Agri-Resources) brings the Bloomberg consensus aggregate down to 9.8%.

■ MSCI Singapore: annual index performance



Source: Bloomberg

How to beat the index

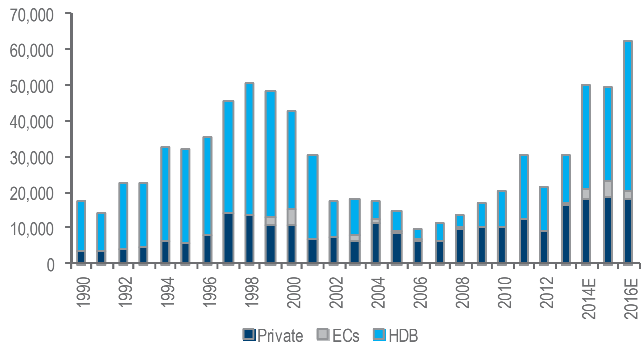
We recommend being overweight the Capital Goods and REITs sectors and underweight the Property Developers and Telecommunications sectors. Our key stock calls are companies that we believe are: 1) sector leaders in product differentiation and/or cost efficiency, or 2) positioned to capitalise on structural industry upcycles.

Property developers (underweight)

We remain underweight the property developers (even after their underperformance relative to the FSSTI in 2013), as residential prices are beginning to show signs of a correction after having appreciated by 62% (from the end of 2Q09 to the end of 3Q13), fuelled by the post-global financial crisis recovery and easy global monetary conditions. As the physical market now enters a critical stage, with a high degree of uncertainty in the outlook for both prices and sales volumes, Daiwa's David Lum believes the risk is still firmly on the downside (for home prices and volumes).

Daiwa foresees home prices facing pressure from two potential imbalances: 1) rising inventories (if sales volumes consistently fall below about 1,200 units per month) as developers must continue to launch new projects from sites they have clinched in recent government land sales tenders, and 2) a record number of deliveries of completed units in 2014-16, which could disrupt the rental market, raise the vacancy rate, and force rents and capital values down.

■ Singapore residential: unit deliveries (private, executive condos [ECs], and public housing)



Source: Singapore Urban Redevelopment Authority, Housing Development Board, Daiwa forecasts

Since these systemic risks have not diminished in 2013 (despite relatively resilient home sales), we maintain our base scenario of a multi-year correction in home prices (from end-2012 to end-2015) of 18-20%.

We acknowledge that the share prices of the Singapore developers look undemanding, with almost all trading well below their historical average discounts to NAV, so it appears that the market has discounted to some extent the weak fundamentals of the residential property market. However, it would be difficult for us to justify a neutral or overweight weighting on the sector, since the residential market data points in 1H14 could be much worse than the market expects (we reckon that the market still expects property prices to decline by less than 10% and home sales to remain above 14,000 units for 2014).

We also believe that some property-market participants (including developers) have an overly optimistic view on the speed and extent to which the government would "rescue" the property market in a downturn. We believe a slower-than-expected pace in rolling back certain cooling measures could also disappoint the market.

We maintain our preference for stocks with negligible or no Singapore residential exposure, including CapitaMalls Asia (CMA SP, SGD1.92, Buy [1]), Overseas Union Enterprise (OUE SP, SGD2.49, Buy [1]), and Global Logistic Property (GLP SP, SGD2.86, Outperform [2]).

REITs (overweight)

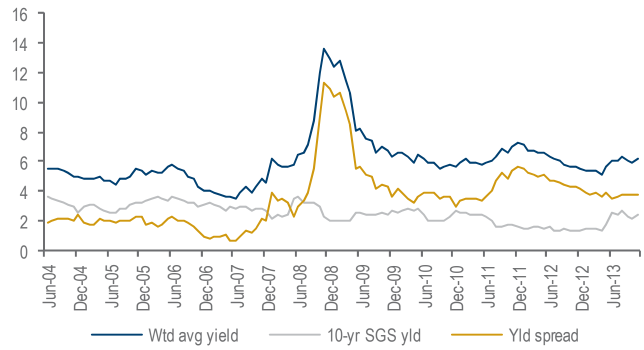
Daiwa's David Lum believes the S-REIT sector is attractively valued on an absolute basis, trading, on Daiwa's estimates, at a weighted-average 12-month forward dividend yield of 6.7% (as at 3 January 2014), a PBR of 1.0x, and 2014E distribution-per-unit (DPU) growth of 6%YoY.

Moreover, we see strong visibility in our DPU forecasts over the next 6 to 12 months and see little risk of DPU-growth disappointment. For the office, retail, and industrial-property sectors, rental growth for 3Q13 was either flat or slightly positive QoQ, and we expect the trend to continue for at least a few more quarters.

Office and retail are our top S-REIT subsectors. Office - sector rents bottomed out in 1Q13 and we expect a modest recovery in rents for the next several years. Meanwhile, office S-REITs trade at the largest discounts to NAV. With the worst of the domestic cyclical slowdown probably over, we expect the retail property sector's fundamentals to improve gradually. The valuations of retail S-REITs also look undemanding relative to their long-term (from the time of our coverage) price-to-Daiwa NAV ratios. Our top pick, and the only deep value play in the sector, in our opinion, is **Suntec REIT** (SUN SP, SGD1.54, Buy)

On the sector's yield spread (the 2013E dividend yield less the 10-year Singapore government securities [SGS] yield), we estimate that the current yield spread of 4.0% (as at 3 January 2014) is slightly higher than the sector's median (since June 2004) yield spread of 3.5%.

■ S-REITs: weighted-average yield, 10-year government bond yield, and yield spread (%)



Source: Singapore Monetary Authority of Singapore, Daiwa

Capital Goods and Oil Services (overweight)

We remain overweight the Capital Goods and Oil Services sector, as we believe the strong order win momentum seen in 2013 will carry into 2014 given Daiwa's expectation that relatively high oil prices (ie, >USD100/bbl) will persist. We do not believe that there is meaningful downside to oil prices below USD90 given the continued global oil supply constraints; we note that OPEC spare capacity continues to trend well below 2.5mmbpd despite the material increase in US shale oil production.

We believe that the key themes regarding the rig-building and oil services sector in 2014 will be:

- The sustainability of new rig-order flow and, more importantly, whether this new order flow will act as a share-price catalyst.
- Competitive threats from outside Singapore, especially China, given that China's yards have won market share for jack-up rigs in 2012 and 2013 due to their favourable financing packages. In our view, this competitive threat may explain the poor share-price performances of Sembcorp Marine in 2013 and, to a lesser extent, Keppel Corp.
- The profitability of international businesses, which is especially pertinent for the rig-builders which have started to build semi-subs and drillships for Petrobras. Given their Brazilian yard investments and the high level of local content required for these rigs, a key trend to watch in 2014 will be the extent to which Keppel and Sembcorp Marine maintain their operating margins.

Within the rig-building sector, we prefer **Keppel Corp** (KEP SP, SGD11.03, Buy [1]) over **Sembcorp Marine** (SMM SP, SGD4.41, Outperform [2]), as we believe that there is less Brazil-related project execution risk in the former on account of its longer operating history in the country. As revenue recognition of Keppel's semi-sub rigs accelerates over the next few quarters, we expect the company's operating-profit margins to hold up better compared with its rig-building peers.

We recommend that investors avoid **Cosco Singapore** (COS SP, SGD0.74, Sell [5]). The company is still ascending the learning curve and thus we expect its gross-profit margin to remain in the 7-9% range, compared with the 20-40% seen over 2003-08. While we prefer **Yangzijiang** (YZJSGD SP, SGD1.17, Hold [3]) over Cosco, we believe the stock will lack share-price catalysts over the next 6 months.

In the mid-cap oil services space, we prefer **Ezion** (EZI SP, SGD2.28, Buy [1]) over **Vard** (VARD SP, SGD0.83, Outperform [2]) and **Ezra** (EZRA SP, SGD1.31, Sell [5]) given the company's growth prospects as a leader in Southeast Asia's service-rig space. Although Ezion currently trades at the highest 2014E PER of 8.9x relative to Vard (7.9x) and Ezra (8.6x), we believe that this is justified given its market share growth opportunities and earnings visibility over 2014-15. Thus, we forecast that its PER should expand over the next 12 months as the company continues to add new charter contracts for its service rigs.

Telecoms (underweight)

Daiwa's Ramakrishna Maruvada rates the Singapore Telecoms Sector as Neutral owing to the companies' lacklustre revenue and earnings growth prospects, rich valuations, and low dividend yield spreads relative to the domestic 10-year bond yields. From a country strategy perspective, however, we believe the sector's growth prospects will lead it to underperform the index.

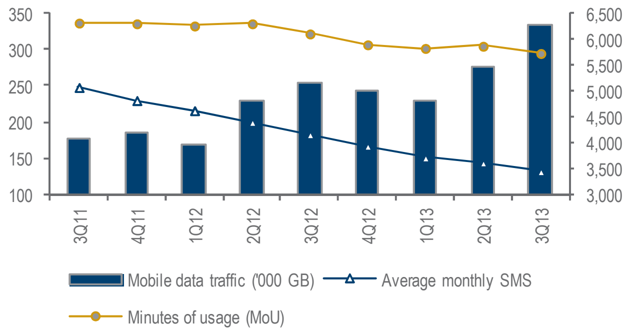
While we have Hold (3) ratings on Singapore Telecom SingTel (ST SP, SGD3.60, Hold) and M1 (M1 SP, SGD3.24, Hold), we prefer them to StarHub (StarHub; STH SP, SGD4.24, Underperform) in view of the widening disconnect between the latter's operational outlook and its share-price performance. Thus, we believe StarHub will de-rate in the coming months on rich valuations – its 2013E EV/EBITDA is more than 1SD above the stock's seven-year historical mean – and we think its dividend yield compression theme has fully played out.

In our view, the key themes for the sector in 2014 will include the following:

- We believe the dividend-yield spread (dividend yield vs. 10-year government bond yield) outlook is likely to be a key driver of share-price performance. The average dividend yield spread for the sector fell to 2.3pp in 2013 (versus 4.2pp at the beginning of 2013), partly driven by the increase in domestic bond yields over the course of the year (1.3% at the beginning of 2013 to 2.6% as of 3 January 2014. We believe there is little prospect of a further compression in dividend yields. On the flip side, a widening of sector dividend yields, which is likely to be contingent on the US Fed's tapering plan and the associated impact on Singapore's 10-year domestic bond yields, appears to be a more probable development, underpinning our relatively cautious stance on the sector.
- Operationally, the dominant sector theme continues to be the growth in usage of data services and a continuation of declines in traditional voice and SMS usage. However, despite our expectation for a further contraction in the volume of SMS and voice calls, operators have introduced effective bundling propositions in the market to mitigate the overall revenue impact arising from changes in subscriber consumption patterns.

Overall, we forecast 2.8% YoY industry revenue growth in 2014, versus a 4.7% revenue CAGR over 2009-12. We also forecast that the industry EBITDA margin will expand by 0.13pp in 2014. On our forecasts, net profit in the Singapore segment (ie, taking into account the Singapore-only portion of profits at SingTel) will grow by 3.1% YoY in 2014.

■ StarHub: postpaid subscriber usage trends (3Q11-13)



Source: Company

We believe there was little change in industry revenue market shares in 2013. For 2014, we forecast revenue market shares for SingTel, StarHub and M1 of 66.0%, 23.4% and 10.6%, respectively.

- **Post-paid**: we do not expect major shifts (less than 0.5pp) in subscriber market shares, given industry saturation, a stable pricing environment, and a lack of differentiation among products and service offerings among Singapore's major operators. In particular, we believe the trend of subscriber market-share gains for SingTel in the post-paid segment (+1.1 pp over 2009-13) are likely to come to a halt.
- **Broadband**: we expect M1's subscriber market share in 2014 to rise by 2.4pp YoY to 12%, at the expense of SingTel (-1.1pp YoY) and StarHub (-1.3pp YoY).
- **Pay TV:** we forecast a slight drop in SingTel's market share in 2014 (-0.7pp YoY to 41.1%), as we think the implementation of the English Premier League cross-carriage ruling in 2013 will arrest the trend of market-share gains experienced by the company.

We expect the competitive environment to be stable in the mobile and pay-TV segments, and to intensify in the broadband segment. In our view, the regulator is likely to focus its attention on service quality and provisioning standards, which suggests the regulatory environment for the whole sector is likely to be stable in 2014.

Key stock calls

Top buys

CapitaMalls Asia (CMA SP, SGD1.92, Buy [1]): In our opinion, CapitaMalls Asia offers quality exposure to necessity spending and Asia's middle class, segments that we believe present an attractive combination of resilience and growth. Investors' concerns of retail space oversupply in China have weighed on CapitaMalls Asia's share price, but the company looks to be navigating the challenging operating environment well, as evidenced by its above-market occupancy rate (97.2% as of end-3Q13) in China. Its new openings in 2013 all commenced operations with occupancy rates of above 90%.

The stock currently trades at a PBR of 1.1x, in line with its historical average six-month forward PBR. Our target price for the stock, set at a PBR of 1.3x, or +1SD above the historical average, is SGD2.39, implying a 1.8% discount to our end-2014E RNAV of SGD2.43. A rerating of the shares will, in our view, be driven by strong and increasingly visible core earnings growth (we forecast a 30.9% CAGR for 2013-15), as malls opened in recent years mature and progressively enter new leasing cycles.

Keppel Corp (KEP SP, SGD11.03, Buy [1]): We like the company's margin-focused strategy and its relatively low-risk Brazil rig-building business compared with its peers. We expect Keppel to register steady net profit and DPS growth over 2013-15, driven by consistent rig delivery, and its focus on keeping its operating-profit margin relatively steady (we forecast it to be 15-17% over the 2013-15 period). We note that jack-up pricing has reached the highs seen during the 2007-08 period, and as a result we believe the company will maintain a reasonably healthy operating-profit margin over the coming 2-3 years.

Top sells

CapitaLand (CAPL SP, SGD2.98, Sell [5]): CapitaLand's valuations are undemanding, trading at a price-to-Daiwa NAV of 0.77x vs. its long-term (since August 2004) mean of 0.98x, but investors must confront two issues. First, though the Singapore residential market makes up only about 10% of the group's NAV, we think there is always a risk that CapitaLand will make an expensive landbank acquisition in Singapore at the peak of the market. CapitaLand still considers Singapore to be a core market, and compared with its peers the company has been inactive during the post-global-financial-crisis recovery of the Singapore residential market. Second, a meaningful ROE recovery (surely an essential driver of a share-price rerating, in our view) is unlikely in 2014, as a bulk of the group's development projects will need more time to deliver their returns while the partial divestment of its stake in Australand (Not rated) might even lower the ROE in the short term. We peg our six-month target price of SGD2.65 (equivalent to a target P/NAV of 0.67x) to 1.5SD below CapitaLand's mean price-to-Daiwa NAV since our initiation.

StarHub (STH SP, SGD4.24, Underperform [4]): We believe the shares of StarHub could be derated in 2014 owing to their rich valuations (2014E EV/EBITDA multiple of 10.1x, almost 2SD above the stock's past-7-year average) and a widening disconnect between the company's operational outlook and its share-price performance over 2013. For example, even though the company's management softened its revenue outlook over the course of 2013 — 4Q12: 'single-digit YoY increase'; 2Q13: 'low-single-digit YoY increase'; 3Q13: 'YoY fall' — the share price rose by 17.8% in 2013.

Top alpha generator (non-index pick)

Ezion (EZI SP, SGD2.28, Buy [1]): We like Ezion's market leadership and first-mover advantage in the service-rig space, and we believe the company is well-placed to cater to the growing demand for service rigs in Southeast Asia. In our view, the market's adoption of this versatile type of rig for a wide range of offshore support activities will accelerate in the region and the Middle East over the next 2-3 years. Since 2012, the company has added some USD2.0bn worth of charter contracts for its 29-unit strong service-rig fleet, which we estimate will provide revenue visibility until at least 2020.

The stock is trading at a 2014E PER of 9.0x, almost a 20% discount to its average one-year-forward PER of 11.1x between 2010 and 2013. Although Singapore-listed oil services and offshore-related peers trade at an average one-year-forward PER of 8.0x, we view Ezion's valuation as undemanding in the context of the company's market share growth opportunities and earnings visibility. Our PER-based target price of SGD2.65 implies an upside potential of 16%, and Ezion remains our top pick in the small-/mid-cap offshore-related segment.

Overseas Union Enterprise (OUE SP, SGD2.49, Buy [1]): Judging by the stock's performance in 2013 (-0.9% vs. the Straits Times Index's +2.1% over the same period), Overseas Union Enterprise's (OUE) management seems to get little respect from the market. This is despite the company's: 1) intriguing acquisition of US Bank Tower in Los Angeles at below replacement cost, which we think could pay off significantly in several years' time, 2) successful spin-off of its prime (but with a short remaining leasehold tenure of 43 years) assets (Mandarin Orchard Singapore [hotel] and Mandarin Gallery [retail]) into OUE Hospitality Trust (Not rated) under difficult market conditions, and 3) decision to pay out a special interim dividend of SGD0.20 to shareholders promptly after the spin-off.

We set our six-month target price at SGD3.34, after applying a 10% discount on OUE's Singapore office assets to our overall NAV estimate of SGD3.66. We see an immediate positive catalyst for 2014 in the possible listing of OUE Commercial Trust, which we think would likely lead to another special dividend.

Suntec REIT (SUN SP, SGD1.54, Buy [1]): Suntec is the only S-REIT that we regard as deep value. It is trading at a 25% discount to its end-September book value of SGD2.053 vs. its office S-REIT peers, which trade at a discount of only about 10%. We believe this discount is unjustified. Despite reporting solid 3Q13 results and progressing smoothly with its refurbishment of Suntec City, the unit price declined when the market learned of Suntec REIT's proposed acquisition (announced on 15 November 2013) of 177-199 Pacific Highway, an office tower under development in North Sydney, Australia, for AUD413.19m. Although it appears low-risk (the property is already 100% committed with annual rental escalations) and highly yield-accretive (at a 6.32% coupon during the construction phase and an initial net-property income yield of 6.9% upon completion in early 2016 vs. an all-in financing cost of less than 3%, according to management), the market appears to be wary of an impending equity-funding exercise. However, we estimate that Suntec's gearing will rise from 38.6% (as at 30 September 2013) to 42.2% when the property is fully completed in early 2016 (assuming no revaluation gains on its existing properties), and believe the risk of equity fundraising over the next 12 months is negligible. Our DDM-derived six-month target price is SGD2.00.

What could go wrong?

The largest macro risk for a small, open economy like Singapore is probably liquidity flight. This is a relevant risk as Singapore has been one of the prime beneficiaries globally of the US Fed's quantitative easing. As the Fed has decided to begin to taper its securities purchases in 2014, there may well be property-led asset deflation as liquidity flows out of the city state. There could also be a spike in interest rates, which would likely hit high-dividend-yielding stocks with little or no profit growth.

Also, as the Singapore government positions itself for the 2016 election, investors will need to be on the right side of government policy, which we think is another potential overhang for the property developers.

Rig-builders/Oil services

The main downside risk to our ratings, target prices and forecasts for the rig-building and oil services sector in Singapore would be delays in project execution, which could cause a softening in the respective companies' operating margins. In addition, structurally lower oil prices could cause upstream oil and gas companies to lower their capex spending, and thus lead to a slowdown in new orders for various types of rigs, as well as offshore support vessels and tugs.

We assign a low probability to either of these risks occurring given that: 1) the Singapore-based rig-builders have a track record of delivering projects on time and on budget, and 2) the long-term oil price should remain structurally higher, at over USD90-95/bbl, and thus be supportive of continued spending on offshore oil and gas projects for reasons noted above. However, we highlight that oil-price weakness may rear its head for a short period as we expect Fed tapering to negatively impact oil prices, and this may present a buying opportunity should share prices be negatively impacted.

Property developers

The main risk to our Negative view on the property developers for 2014 is a scenario in which home prices and volumes remain stable and resilient while the risk of more cooling measures by the government subsides. However, we believe the government will only relent on the imposed cooling measures if there is a clear sign of weakness in the market, with at least several quarters of price declines.

A secondary risk to our view is if the market believes that share prices have already discounted the residential market's weakness (paving the way for a recovery in share prices). However, we would argue that the 1H14 data could easily be much worse than the consensus currently expects and those waiting for the government to scale back its cooling measures could be sorely disappointed in 2014.

The main risk to our Sell (5) rating on CapitaLand would be the announcement of a transformational corporate restructuring (including the divestment of some underperforming business units) that immediately raised the outlook for its ROE. We believe such a restructuring would have to be more profound than a partial divestment of Australand, and do not foresee such a move occurring.

Aside from weak market conditions, which could delay the listing of OUE Commercial Trust, the main risk to our Buy rating for OUE would be a perceived delay in the ambitious redevelopment activities in its existing properties, some of which represent pipeline properties for its listed trusts.

REITs

We believe the returns of the S-REITs over the next six months will be determined by the Fed's moves and the bond markets, which strongly influence the 10-year Singapore government securities (SGS) yield. A downside risk to our Positive view on the sector could come from a sudden and sharp increase in the 10-year SGS yield, which could narrow the S-REIT sector's yield spread to unattractive levels (by at least 100 bps).

For Suntec, the risk to our Buy (1) rating would be a dilutive equity fundraising exercise over the next six months (on the heels of its acquisition in Australia), as such a move could raise questions in the market over management's view that a gearing level of around 40% is still comfortable.

Telecoms

All three Singapore operators could raise dividend payouts in 2014 given the strength of their balance sheets (2013E net debt/EBITDA ratios are 0.9x for SingTel, 0.6x for StarHub, and 0.7x for M1).

We expect StarHub to raise its minimum DPS commitment to SGD0.21 (from SGD0.20 currently) from 2014, and have already factored this prospect into our forecasts. However, while we think the likelihood of a bumper special dividend is slim, it remains a possibility.

In the case of M1, we think the company could undertake capital-management initiatives as early as during its 4Q13 result announcement, by re-gearing its balance sheet. We have not factored this into our forecasts, as think the company may instead prefer to keep cash on hand to fund its spectrum payouts, due in 2017.

On the other hand for SingTel, given that the company was successful in its efforts to secure regulatory approval to postpone the divestment of its stake in Netlink Trust to April 2018 (from April 2014), we do not expect to see any special dividends from the company in 2014.

One area where operators could surprise positively in 2014 is handset subsidies, especially as the euphoria associated with iPhone/Samsung touch-screen devices seems to have calmed down. Churn rates in the mobile segment have fallen sharply in the past couple of years (M1: 1.6% for 2009, 1.1% for 2013E) and as such handset subsidies could surprise on the downside.

■ Valuation comparison

Bloomberg code	Company name	Rating	Target price (SGD/USD)	Share price (SGD/USD) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x)		EV/EBITDA (x)		Dividend Yield (%)		PBR (x)		ROE (%)	
							13E	14E	13E	14E	13E	14E	13E	14E	13E	14E
CAPITAL GOODS																
COS SP	Cosco Corp Singapore	Sell	0.55	0.74	1,308	1.0	36.7	22.4	9.5	8.1	1.2	1.9	1.3	1.2	3.5	5.5
KEP SP	Keppel Corp	Buy	13.20	11.03	15,525	25.7	12.7	11.7	9.1	8.3	3.6	3.9	1.9	1.8	16.0	15.9
SCI SP	Sembcorp Industries	Outperform	6.00	5.44	7,674	7.3	13.1	11.1	8.8	6.3	3.1	3.7	2.0	1.8	15.8	16.9
SMM SP	SembCorp Marine	Outperform	5.10	4.41	7,297	7.7	17.5	13.7	11.5	7.1	3.4	4.4	3.4	3.0	20.6	23.7
VARD SP	Vard Holdings	Outperform	0.92	0.83	768	2.1	12.0	8.0	9.6	5.5	2.1	3.7	1.4	1.2	12.0	16.4
YZJSGD SP	Yangzijiang Shipbuilding	Hold	1.22	1.17	3,539	8.5	7.1	8.7	4.5	5.5	4.2	4.0	1.2	1.1	18.2	13.4
CONSTRUCTION & REAL ESTATE																
AREIT SP	Ascendas Real Estate Investment Trust	Hold	2.23	2.18	4,133	11.7	13.1	11.8	n.a.	n.a.	6.6	7.4	1.1	1.1	8.5	9.3
ART SP	Ascott Residence Trust	Hold	1.25	1.21	1,449	1.6	12.0	15.3	n.a.	n.a.	7.8	6.5	0.9	0.9	8.4	5.9
CREIT SP	Cambridge Industrial Trust	Hold	0.71	0.69	676	1.3	7.8	10.9	n.a.	n.a.	7.3	7.8	1.0	1.0	13.2	9.0
CCT SP	CapitaCommercial Trust	Outperform	1.65	1.43	3,236	7.1	12.8	8.1	n.a.	n.a.	5.7	5.7	0.8	0.8	6.6	10.1
CAPL SP	CapitaLand	Sell	2.65	2.98	10,014	18.5	12.7	10.9	9.2	8.7	2.5	3.0	0.8	0.7	6.4	7.0
CT SP	CapitaMall Trust	Outperform	2.18	1.88	5,120	10.2	12.3	12.5	n.a.	n.a.	5.4	6.0	1.1	1.1	9.1	8.6
CMA SP	CapitaMalls Asia	Buy	2.39	1.92	5,884	6.0	30.0	22.7	15.3	14.9	1.8	1.8	1.1	1.0	3.7	4.6
CRCT SP	CapitaRetail China Trust	Outperform	1.48	1.32	827	0.7	6.7	8.4	n.a.	n.a.	6.8	8.1	0.9	0.8	14.2	10.0
CDREIT SP	CDL Hospitality Trusts	Outperform	1.80	1.63	1,252	1.1	11.2	8.7	n.a.	n.a.	6.8	7.2	1.0	0.9	8.9	11.1
FCT SP	Frasers Centrepoint Trust	Outperform	2.10	1.76	1,147	1.9	10.4	11.7	n.a.	n.a.	6.2	6.5	1.0	0.9	9.4	8.1
GLP SP	Global Logistic Properties	Outperform	3.32	2.86	10,745	21.2	18.6	17.3	33.6	30.2	1.5	1.5	1.2	1.2	6.7	6.8
KREIT SP	Keppel REIT	Hold	1.29	1.18	2,595	5.6	19.7	9.4	n.a.	n.a.	6.8	7.2	0.9	0.9	4.6	9.5
MLT SP	Mapletree Logistics Trust	Hold	1.09	1.04	2,010	2.7	13.2	13.9	n.a.	n.a.	7.2	7.4	1.1	1.1	8.5	7.9
SGREIT SP	Starhill Global REIT	Outperform	0.90	0.78	1,326	0.8	11.4	10.0	n.a.	n.a.	6.4	6.6	0.9	0.9	8.0	8.8
SUN SP	Suntec REIT	Buy	2.00	1.54	2,746	10.8	14.4	11.0	n.a.	n.a.	5.9	6.9	0.7	0.7	5.1	6.7
ENERGY																
EZI SP	Ezion Holdings	Buy	2.65	2.28	2,032	7.9	15.3	9.0	16.3	9.6	-	-	3.5	2.5	26.9	33.7
EZRA SP	Ezra Holdings	Sell	0.88	1.31	1,007	8.3	n.a.	11.4	12.7	9.9	-	-	0.9	0.9	n.a.	8.0
FOOD, BEVERAGE & TOBACCO																
SSG SP	Sheng Siong Group	Outperform	0.73	0.62	672	0.6	21.9	17.9	12.8	10.3	4.1	5.0	5.5	5.1	25.5	29.7
HOTELS, RESTAURANTS & LEISURE																
OUE SP	Overseas Union Enterprise	Buy	3.34	2.49	1,788	1.3	34.8	26.1	23.5	19.1	9.6	9.6	0.8	0.8	2.1	3.0
TELECOMMUNICATION SERVICES																
M1 SP	M1	Hold	3.11	3.24	2,334	2.1	17.1	16.0	9.8	9.3	5.0	5.3	7.9	7.2	47.9	46.9
ST SP	Singapore Telecom	Hold	3.67	3.60	45,392	48.0	15.9	14.6	12.8	13.1	4.7	5.1	2.3	2.2	14.8	15.5
STH SP	StarHub	Underperform	3.92	4.24	5,776	5.9	20.0	18.7	10.6	10.1	4.7	5.0	113.4	75.0	677.9	482.5
TRANSPORTATION																
HPHT SP	Hutchison Port Holdings Trust	Hold	0.77	0.68	5,879	16.1	24.3	21.0	12.9	12.6	7.5	7.6	0.7	0.7	2.8	3.3

Source: Bloomberg, Daiwa forecasts

Taiwan – Neutral

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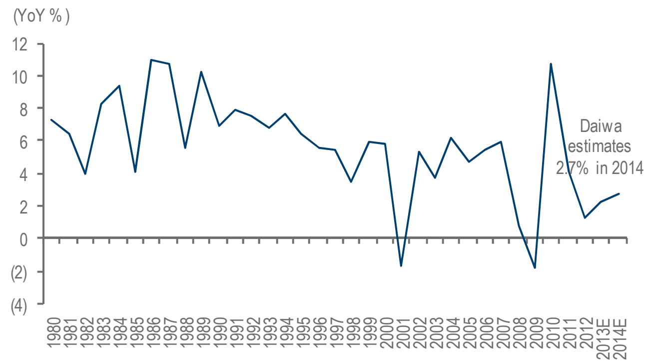
End-2014 target for MSCI Taiwan Index: 310 (+4%)

The Taiwan market was a relative outperformer in the region in 2013, with the Taiex up about 10.7% in US Dollar terms. For 2014, we hold a more neutral view and forecast a year-end 2014 Taiex target of 8,800 and a target of 310 for the MSCI Taiwan Index, based on an aggregation of our target prices and consensus target prices for the stocks we do not cover.

Though we still expect a lacklustre economic performance for Taiwan in 2014 (GDP growth up just 2.7% YoY on our forecast), we believe the market will be supported by abundant liquidity. As Taiwan is heavily reliant on exports, a steady recovery of major economies including China, Europe and the US would also support the Taiwan market.

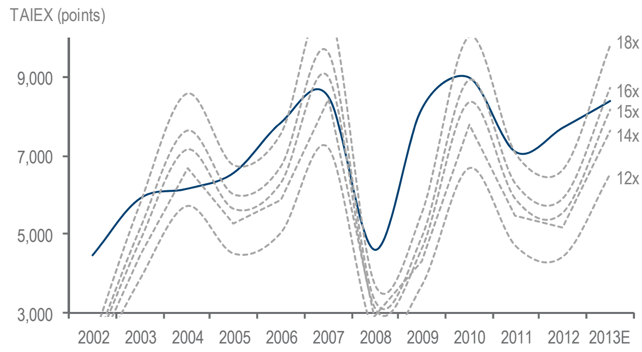
■ **Taiwan: GDP growth**



Source: National Statistics, R.O.C, Daiwa forecasts

Our index target equates to a 15.0x 1-year forward PER (based in turn on the Bloomberg consensus 2014 EPS forecasts), which is at the low end of the market's trading range of 13-34x since 2002.

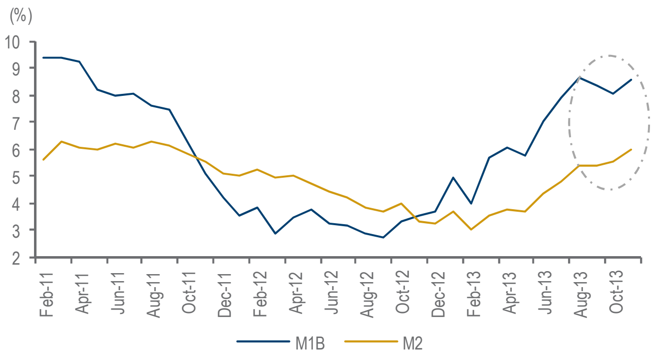
■ **Taiex: PER bands**



Source: Bloomberg
Note: 2013E is based on the Bloomberg-consensus forecast; data as at 3 Jan 2014

With the widening gap between the growth of M1B and M2 money supply in Taiwan, we see abundant liquidity for the market. Even with the political turmoil in September 2013 (with concern over the conflict between President Ma Yin Jiu and Premier Yuan leader Wang Jin Ping), the average daily transaction value was a healthy TWD76bn in 4Q13 (8% higher than TWD70bn in 4Q12), and the index was up nearly 9.4% from its late-August trough.

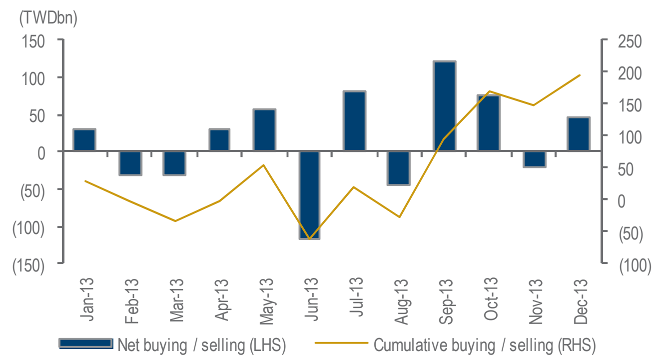
■**Taiex: growth in M1B and M2 money supply (YoY)**



Source: National Statistics, R.O.C
Note: data as at 31 December 2013

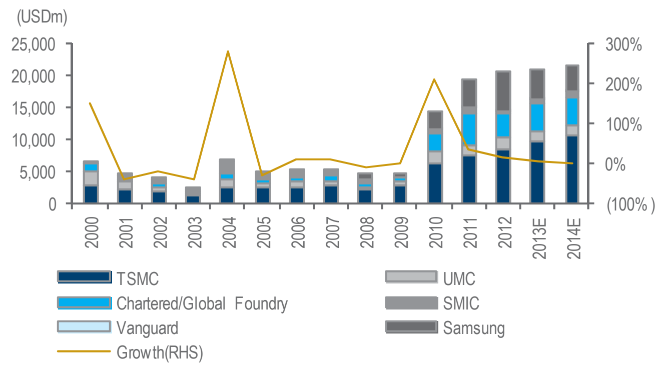
In 2013, foreigners were net buyers of Taiwan equities to the tune of TWD243bn, which was the sixth-highest amount in the past 10 years. Similar to Korea, Taiwan seems to have been a safe haven for money flows in 2013. Given that Taiwan received less inflow as a result of the Fed's QE in recent years, it could become an attractive place to park funds while weathering the Fed's expected tapering action. This should lead to upward valuation expansion in Taiwan in 2014, even though we are cautious outlook on the fundamentals.

■ **Taiex: QFIIs' net buying and selling**



Source: CMoney
Note: Data as at 31 December 2013

■ **Major foundry players: capex trend**



Source: Bloomberg, Companies, Daiwa forecasts
Note: TSMC – Taiwan Semiconductor Manufacturing, UMC – United Microelectronics, SMIC – Semiconductor Manufacturing International

How to beat the index

Given the modest upside we expect for the market in 2014, we advise investors to watch the mid-small caps, especially recently-listed niche plays.

In the tech space, as there are no killer applications or structural industry changes in the next 12 months, we suggest investors do not make the typical upstream or downstream weighting decisions, but instead focus on specific company stories. Our top picks include MediaTek, Hon Hai Precision Industry (Hon Hai), Catcher Technology (Catcher) and Compal Electronics (Compal).

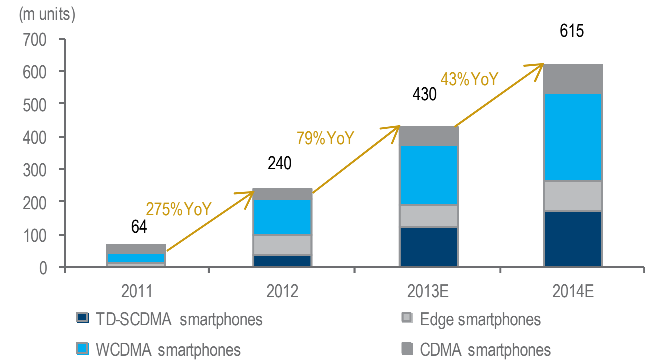
We also believe healthcare/biotech stocks will continue to draw investors' attention, with more new listings scheduled in the next 12 months.

Semiconductors (neutral)

Daiwa forecasts 2014 global semiconductor sales to grow by 7% YoY, which is a modest uptick on the 2013E rate. According to Daiwa's Eric Chen and Lynn Cheng, driving the expected growth will be smartphone and tablet PC ICs, broadband ICs and MEMS/sensors. Among the sub-segments, we expect the fabless and foundry companies to outperform the back-end players in terms of top- and bottom-line growth, with the following notable trends:

- **Foundry.** Eric believes the three areas that investors in the sector should focus on in 2014 are wafer-price competition on the 28nm process, technology migration to 16/14nm processes, and foundry services competition among Taiwan Semiconductor Manufacturing (TSMC) (2330 TT, TWD104.5, Hold [3]), Intel (INTC US, USD25.78, Underperform [4]), and Samsung Electronics (SEC) (005930 KS, KRW1,296,000, Buy [1]).
- **Backend:** Daiwa believes the performance of backend players will increasingly relate to orders from key mobile-IC players, such as Qualcomm (QCOM US, USD72.89, Hold [3]) and MediaTek. Price competition will also be a factor due in part to TSMC entering backend services.
- **Fabless:** Consolidation among IC players is likely to continue in 2014, following MediaTek's acquisition under way of MStar Semiconductor (due to be completed on 1 February), and given interest in China in a takeover of Spreadtrum (SPRD US, USD30.92, not rated) and RDA Microelectronics (RDA US, USD17.88, Not rated). The revenue growth outlook depends on the China smartphone-IC market, especially 64bit or Octa-core ICs, and emerging demand for 4K2K (UHD) TVs.

■ **China smartphone shipments**



Source: Industry data, Daiwa forecasts

PC hardware (underweight)

Daiwa forecasts global PC shipments to fall by 4% YoY in 2014, after declining by 10% YoY in 2013E. While the decline is moderating, a number of challenges remain for the overall PC supply chain, according to Daiwa's Steven Tseng. Having said that, Steven expects the PC-related players' increasing efforts to diversify into non-PC products, such as smart devices, to help offset the pressures we are seeing on the PC business. For 2014, Steven expects the growth drivers to come from three areas.

- **Smart devices –** While most PC-related companies have been moving towards this area at different paces, we expect the overall progress to accelerate in 2014. Apple's (AAPL, USD554.99, Hold [3]) sourcing diversification should be an important driver, while PC OEMs' increasing efforts in this area should also help the related suppliers to some extent.
- **2-in-1 devices –** Prices of 2-in-1 devices could come down significantly (eg, to below USD350) in the next few quarters, thanks to Intel's aggressive push on Bay Trail chips (ASP likely below USD10 after subsidies) and Microsoft's royalty discount on software. Android or Chrome-based models (ASP likely below USD200) should also be available going forward.
- **Enterprise demand –** Daiwa expects corporate PC demand to remain resilient, as the segment does not face direct pressure from smart devices. In addition, demand for cloud computing should continue to rise and help drive demand for related products, such as servers and storage.

Consumer (underweight)

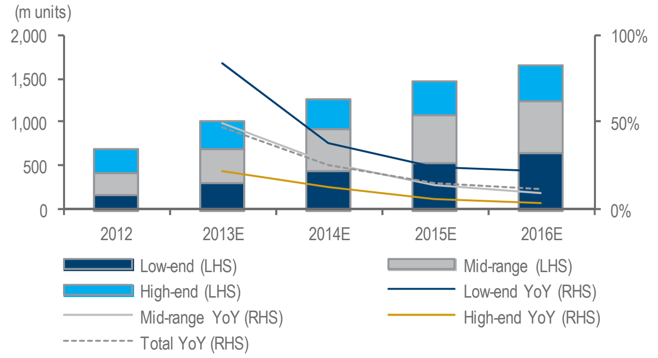
Given the lacklustre fundamental outlook for the domestic market, we are conservative on the performance of Taiwan consumer stocks.

Although some of the consumer stocks with significant exposure to Mainland China may get a boost from ongoing growth in that market, the domestic consumption story in Taiwan is unlikely to be exciting in the absence of a rise in disposable incomes. Hence, we recommend that investors underweight the Taiwan consumer space in 2014.

Smartphones (overweight)

Daiwa forecasts total smartphone shipments to reach 1.3bn units for 2014, implying 26% YoY growth. In terms of segments, we regard low-end and mid-range smartphones as the major growth drivers, forecasting respective shipment growth of 38% YoY and 27% YoY in 2014, while we look for high-end smartphone growth to decelerate to 12% YoY.

■ Global smartphone shipments by segment



Source: IDC, Daiwa forecasts

Note: We define low-end smartphones as those that cost less than USD200, mid-range as those costing USD200-500, and those costing more than USD500 as high-end

Geographically, we still see substantial room for smartphone shipment growth in emerging countries due to their relatively low smartphone adoption, and thus expect these countries to remain the key growth drivers in 2014. As for developed regions – such as North America and Western Europe – we expect smartphone shipments to still see 10-15% YoY growth in 2014 on the back of a further rise in smartphone penetration (from 75-85% in 2013E to 85-90% in 2014E).

■ Smartphone penetration by region

Smartphone penetration (%)	2012	2013E	2014E	2015E	2016E
Asia Pacific ex-Japan	32.4	51.6	62.2	68.9	75.6
Japan	82.0	87.7	90.9	92.8	94.7
Western Europe	69.2	78.3	86.3	92.9	96.6
North America	68.7	83.9	89.4	93.2	95.9
Latin America	28.8	47.7	60.5	70.3	80.8
Middle East & Africa	20.5	34.1	54.6	68.6	78.3
Eastern Europe	28.7	44.9	56.7	70.2	80.0
Total	**38.9**	**55.4**	**66.3**	**74.1**	**80.8**

Source: For 2012 - Gartner ("Forecast: Devices by Operating System and User Type, Worldwide, 2010-2017, 3Q13 Update", authors include Carolina Milanesi, Lillian Tay, Roberta Cozza, Ranjit Atwal,Tuong Huy Nguyen,Tracy Tsai, Annette Zimmermann, CK Lu, published on September 25, 2013); for 2013-2016 - Daiwa forecasts

Smartphones are moving into a volume-growth stage, where the premium brands (Apple and SEC) or the budget devices (high-performance, low-cost) providers (notably the China brands) should stand out. In 2014, we expect competition to intensify and believe those brands without economic scale or brand premium, such as HTC and Blackberry, could be squeezed further.

For Apple and SEC – Market research by Daiwa's Kylie Huang indicates Apple could release its next flagship model, the iPhone 6, with significant upgrades such as a larger display, in 3Q14, which we think would enable Apple to expand its market share further in the high-end segment. As for SEC, we believe it will remain very competitive in 2014 with a full range of smartphone products, and believe it might add more models to its high-end product portfolio (just the Galaxy S and Note series currently) so as to reaffirm its market leading position.

For Chinese brands – In addition to Lenovo (992 HK, HKD9.29, Buy [1]), ZTE (Not rated), Huawei, (Not listed) and Coolpad (Not rated), which we expect to continue their market-share gains by expanding their portfolios to the mid-to-high-end segment (CNY2500-3500) from their current focus on low-to-mid range products (retail prices of CNY800-CNY2500), rising brands such as Xiaomi (Not listed) and TCL (Not rated) are also likely to play a more important role in 2014.

In 2014, we expect to see more spec upgrades in the smartphone space including: 1) Display – moving from 3.5-4 inch to 4-4.5 inch, while high-end flagship models could arrive at 5-5.5 inch. Flexible displays are also likely to emerge in some niche models. 2) Resolution –more smartphones to carry HD/full HD resolution display. 3) Camera – pixel migration to continue (more 8-10MP or above cameras in 2014E) with further upgrades on aperture ratio, OIS function add-on, and software enhancement on picture quality. 4) Acoustics – more smartphones to carry speaker boxes (better sound). 5) CPU – more devices to carry 64 bit and quad-core/octa-core CPUs. 6) Memory – content per unit set to increase to support faster CPU and other hardware/software upgrades. 7) Other upgrades – NFC and fingerprint sensors could be adopted in more smartphones in 2014.

Despite the possible spec upgrades discussed above, smartphones are becoming difficult to differentiate, in our view. We believe smartphone OEMs need to have either very strong brand image or very good cost/budget phones with sound quality to win in the smartphone space.

Automation (overweight)

Daiwa's Christine Wang expects 2014 to be a better year than 2013 in terms of orders for the automation industry. In particular, demand in Europe should continue to improve.

Demand by region:

- *Greater China:* demand for automation should be better than that for machine tools. This is largely because several big names are considering implementing automation lines in their manufacturing plants.
- *Japan:* overall investment is improving; there are also more Japanese corporates willing to procure components from abroad due to cost concerns.
- *Europe and the US:* the supply chain expects demand in 2014 to be stronger than in 2013 for both Europe (especially Germany) and the US.

Demand by sector:

- *Machine tools:* order visibility is currently low. However, the supply chain expects some improvement in 2014.
- *Semiconductor equipment and automation-related equipment:* 2014 should be better than 2013.
- *Medical equipment:* demand should remain strong and stable.
- *Auto industry:* demand should remain strong, as in 2013.

We prefer the component makers over the machine-tool makers as investments in 2014, premised on the following key considerations:

- Machine-tool makers could face greater competition from Japanese makers after the inventory absorption of higher-priced Japanese machine tools comes to an end.
- Component makers have a broader customer base that would benefit from more demand from multi-industries. In addition, the channels' inventory absorption of components appears close to an end and this should trigger higher earnings growth for component makers compared to the machine-tool makers in 2014, in our view.

Healthcare (overweight)

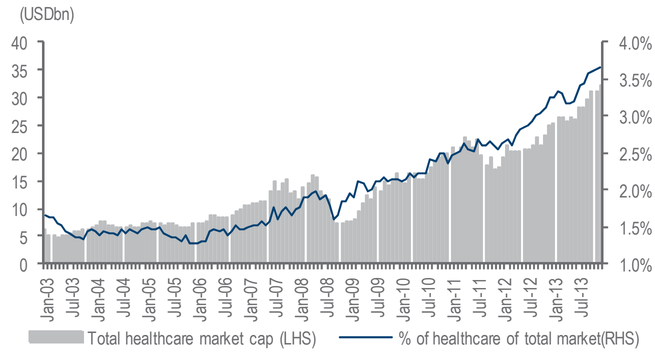
The healthcare sector currently accounts for 3.6% of MSCI Taiwan's market cap. Daiwa's Christine Wang expect the sector's weighting to double by the end of 2015, as more than 20 companies are waiting to list on Taiwan's OTC market or main board in the next 2 years.

The pharmaceutical industry supply chain in Taiwan is very deep, ranging from upstream companies such as manufacturers of active pharmaceutical ingredients (API) to downstream ones such as manufacturers of generics and new drugs. This gives the pharmaceutical companies several opportunities to integrate resources in a bid to achieve further success.

Specifically for the pharmaceutical segment, we expect some Taiwan players to reach important milestones in 2014, including signing up with foreign co-development partners, launching new drugs and generics in both domestic and foreign markets, and expanding their contract manufacturing businesses. Meanwhile, clinical trials, as well as new drug applications (NDA) and abbreviated new drug applications (ANDA) are ongoing, which should be the bases for the next set of drivers for the Taiwan healthcare industry.

In 2014, we recommend focusing on companies with experienced management teams, solid pipelines and strong execution capability/proven track records. These companies should carry lower risk, given that this industry has a high risk of drug development failure.

▪ **Market cap of Taiwan healthcare stocks vs. total market**

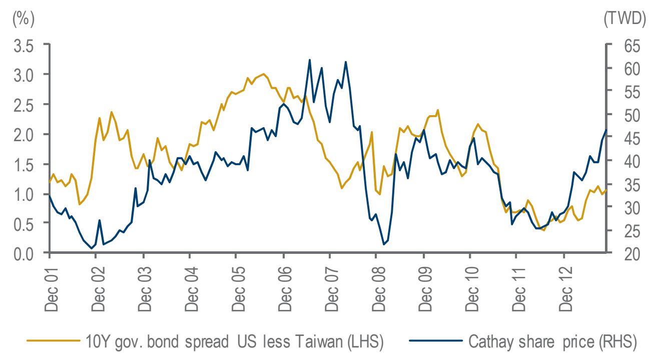


Source: TEJ

Financials (overweight)

Daiwa's Jerry Yang maintains a bullish stance on Taiwan financials in 2014 on the back of the following: 1) macro conditions remain favourable: QE tapering stands to benefit the Taiwan life insurers while China credit tightening should benefit the Taiwan banks, 2) more deregulation would act as a catalyst for share prices, including liberalising Renminbi funds across the strait for Taiwan financials and investment scope for Taiwan insurers, and 3) valuations remain undemanding in our view: the sector is trading currently at a 1.3x PBR for 2014E, in line with its past-10-year average. We see further share-price upside potential, supported by improving core business trends.

▪ **10-year yield spread (US less Taiwan) vs. Cathay share price**



Source: TEJ, Daiwa

Key stock calls

We have three top picks in Taiwan for this year: MediaTek, Hon Hai and Cathay Financial Holding (Cathay Financial). Our short ideas are Acer, HTC, and TPK. TWi Pharmaceutical (TWi) is our main non-index choice. The company was listed on the Taiwan main board in December last year. With a market cap now of more than USD1bn and increased liquidity following its listing, we believe there is a high likelihood that the stock will be included in the MSCI Taiwan Index in 2014.

Top buys

MediaTek (2454TT, TWD441, Buy [1]). MediaTek's share price outperformed those of its peers in 2013 by the company building on its leading market share in China by offering quad-core smartphone ICs. This year, we expect the company to maintain a strong 50% share of the China smartphone-IC market (up from our forecast of 48% for 2013) with its cost-efficient MT6582/6588 quad-core ICs, and to benefit from industry consolidation with its acquisition of MStar (due to complete on 1 February). Our six-month target price of TWD526 is based on our 2014 EPS forecast and a PER of 20x (above the stock's past-2-year average trading PER of 17.2x), reflecting our favourable earnings-growth outlook.

Hon Hai Precision Industry (2317 TT, TWD80.4, Buy [1]). Hon Hai remains our top pick in the Greater China iPhone supply chain, as we believe the company will be the major beneficiary of new i-devices. We expect Hon Hai to maintain its allocation share of 70-75% for iPhones and iPads this year. We also expect the upward trend in its operating-profit margin to continue in 2014, on improved operating leverage, better cost control and a more stable ASP. Our six-month target price of TWD91 is based on a PER of 11x applied to our 1-year-forward (ie, 4Q13-3Q14E) EPS.

Cathay Financial Holding (2882 TT, TWD49.1, Buy [1]). Cathay Financial should be the key beneficiary of the widening spread between the US and Taiwan treasury yields that we expect in 2014, and as a result we expect the stock's outperformance relative to the Taiex to continue. The regulatory environment remains favourable; Cathay Financial should be a beneficiary of the IFRS implementation of mark-to-market property books in corporate balance sheets in 2014 (details remain under discussion). Cathay currently has unrealised property gains of TWD189bn, equating to about 63% of our end-2014E book value for the company. According to the *Commercial Times*, Tsai Hong-tu, the chairman of Cathay Financial, increased his stake in the company in September 2013, which we view favourably. We believe the stock remains undervalued, trading at a PBR of 2.2x for 2014E. Our six-month target price of TWD58.30 is based on a 2014E PBR of 2.6x.

Top shorts/sells

Acer (2353 TT, TWD18.05, Underperform). We believe Acer is likely to lose more share in the PC market in 2014 due to weakening consumer demand. Furthermore, the ongoing management reshuffle and transition likely mean continuing uncertainty among investors about its core operation. Potential asset-impairment losses will also be a concern, in light of the sizeable intangible assets on the book. Our six-month target price of TWD14.70 is based on a 2014E PBR of 0.7x.

HTC (2498 TT, TWD138.5, Sell [5]). In the smartphone OEM space, we are pessimistic on the prospects for HTC given persistently weak demand we expect for high-end smartphones, rising competition from other international OEMs as well as China brands, and limited short-term benefits from the company's recent changes in its business strategy. While we would regard any potential co-operation between HTC and China Mobile as a long-term positive, we believe the company's current share price factors in too much hope, as our scenario analysis implies a 2014E EPS of just TWD0.30 even if the company were to ship 8m units from this deal in 2014 (we assume 4m units). Our six-month target price of TWD90 is based on a PBR of 1x applied to our 2014 BVPS forecast.

TPK (3673 TT, TWD181, Sell [5]). We believe TPK faces stiffer competition in all its business segments in 2014. Its touch-on-lens solution for smartphones does not look mature enough to offset the phasing out of orders for the iPhone 4S. Also, the company is losing tablet orders from Google, Amazon, and possibly from Apple due to its peers' improving yields and attractive pricing. We believe TPK's market share in touch notebooks dropped sharply in 2H13 on stiffer pricing competition. Our six-month target price of TWD150 is based on a PBR of 1x applied to our 2014 BVPS forecast.

Top alpha generator (non-index pick)

TWi Pharmaceutical (4180 TT, TWD325, Buy [1]). TWi focuses on developing and manufacturing high entry-barrier specialty generic drugs. The company's management has extensive experience in developing drugs in this field and dealing with patent-litigation issues in the US. We expect its revenue to increase more than three-fold YoY for 2014, and over four-fold YoY for 2015 on the back of launches of its own generic drugs. Given its much larger revenue base we expect in 2014 and 2015 compared to 2013, we forecast narrowing losses for 2014 and a net profit for 2015.

TWi's listing on the Taiwan main board in December 2013 has strengthened its balance sheet. In addition, the stock's liquidity has improved from 18% before it listed on the main board to 26% now, which in turn could attract more large funds to invest in the stock. Our six-month target price of TWD465 is based on a DCF methodology, assuming a WACC of 9.3% and a terminal growth rate of 1%.

What could go wrong?

2014 will also be a year of elections for Taiwan. A total of 11,000 public servants will be elected at the end of the year. These include mayors and councillors of special municipalities, heads and councillors of cities and counties, township chiefs, township representatives, village and borough chiefs.

■ Elected numbers of 7-in-1 elections

Mayors of special municipalities	6
Councillors of special municipalities	373
Heads of cities and counties	16
Councillors of cities and counties	532
Township chiefs	198
Township representatives	2,097
Village and borough chiefs	7,831
Total	**11,053**

Source: Market research

This will be a test of voter confidence in the ruling KMT, as President Ma has seen the party's popularity decline gradually since the start of his second term, to a record low at the end of 2013. His open policy with China has attracted criticism from the opposition parties.

We believe the ruling party will try to roll out more positive policies to boost the economy before the elections. However, if the KMT loses enough positions in the election in 2014, there is a risk this would trigger political instability, which would in turn lead to more challenges for the next presidential election due in early 2016.

■ Valuation comparison

Bloomberg code	Company name	Rating	Target price (TWD)	Share price (TWD) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x) 13E	PER (x) 14E	EV/EBITDA (x) 13E	EV/EBITDA (x) 14E	Dividend Yield (%) 13E	Dividend Yield (%) 14E	PBR (x) 13E	PBR (x) 14E	ROE (%) 13E	ROE (%) 14E
Banks																
2891 TT	CTBC Financial	Hold	18.2	20.5	8,514	17.1	15.0	13.3	n.a.	n.a.	1.6	1.9	1.4	1.5	10.5	12.0
2884 TT	E.Sun Financial	Buy	24.0	19.9	3,202	8.4	11.6	10.1	n.a.	n.a.	1.6	1.9	1.2	1.2	10.9	11.8
2892 TT	First Financial	Buy	22.0	18.5	5,028	4.3	11.5	10.5	n.a.	n.a.	2.2	2.2	1.0	1.0	9.4	9.6
2886 TT	Mega Financial	Buy	29.0	25.3	9,670	14.3	12.3	10.8	n.a.	n.a.	5.7	5.7	1.3	1.2	10.6	11.5
2887 TT	Taishin Financial	Hold	14.0	14.7	3,388	7.9	7.8	11.3	n.a.	n.a.	2.6	1.9	1.1	1.0	15.0	9.7
Capital goods																
2049 TT	Hiwin Technologies Corp	Outperform	300.0	258.0	2,160	17.7	31.8	19.5	20.0	13.2	1.1	1.0	5.7	4.7	19.2	26.4
Diversified financials																
2882 TT	Cathay Financial Holdings	Buy	58.3	49.1	19,713	31.0	17.0	15.6	n.a.	n.a.	1.9	1.9	2.4	2.2	14.1	14.9
5871 TT	Chailease Holding	Outperform	79.0	78.5	2,615	23.1	13.0	12.4	19.8	21.1	2.3	2.4	2.6	2.3	22.4	19.7
2881 TT	Fubon Financial Holding	Buy	49.2	43.6	13,877	19.6	11.8	11.3	n.a.	n.a.	2.3	2.3	1.3	1.2	11.4	11.3
Electronics																
2353 TT	Acer	Underperform	14.7	18.1	1,711	10.8	n.a.	n.a.	n.a.	n.a.	-	-	0.8	0.9	n.a.	n.a.
2311 TT	Advanced Semiconductor Engineering	Underperform	27.4	27.7	7,047	32.2	13.3	12.3	5.8	5.2	3.2	1.8	1.8	1.6	13.9	13.7
2357 TT	ASUSTeK Computer	Underperform	236.6	270.0	6,708	32.8	9.6	11.4	6.3	6.5	6.6	6.5	1.5	1.5	16.1	13.1
5264 TT	Casetek Holdings	Hold	160.0	159.0	1,807	12.8	8.8	8.5	4.6	4.2	0.6	4.6	2.3	2.0	31.2	25.1
2474 TT	Catcher Technology	Outperform	222.0	197.0	4,946	40.9	10.6	10.7	6.9	5.7	3.8	3.8	2.1	1.9	21.3	18.6
2360 TT	Chroma ATE	Outperform	75.0	61.9	780	1.7	18.1	15.0	19.1	13.5	4.4	5.3	3.0	2.8	16.5	19.4
2324 TT	Compal Electronics	Outperform	26.0	22.9	3,372	11.2	45.9	9.6	6.7	5.6	4.3	4.4	1.0	1.0	2.2	10.4
2354 TT	Foxconn Technology	Underperform	69.0	70.2	3,068	7.0	11.7	11.6	3.9	3.2	1.4	1.4	1.3	1.2	12.0	11.0
2317 TT	Hon Hai Precision Industry	Buy	91.0	80.4	35,305	77.5	10.4	9.4	5.3	4.2	2.4	2.7	1.4	1.3	14.5	14.3
2498 TT	HTC Corp	Sell	90.0	138.5	3,902	64.6	n.a.	n.a.	n.a.	n.a.	-	-	1.5	1.5	n.a.	n.a.
2454 TT	MediaTek	Buy	526.0	441.0	19,905	82.1	22.0	16.8	16.3	10.1	1.7	3.0	2.9	2.6	14.3	19.0
3034 TT	Novatek Microelectronics	Hold	120.0	125.5	2,553	13.5	14.8	12.9	10.3	9.1	3.7	5.1	3.0	2.8	20.7	22.3
4938 TT	Pegatron Corp	Outperform	43.8	38.3	2,966	12.1	10.0	9.3	3.7	3.2	4.2	5.9	0.9	0.8	9.1	9.3
2379 TT	Realtek Semiconductor	Hold	73.5	83.2	1,403	12.1	15.2	14.3	8.9	8.2	3.3	3.9	2.3	2.2	15.0	15.4
2325 TT	Siliconware Precision	Outperform	39.0	35.7	3,716	6.7	20.3	14.9	6.5	5.8	3.9	3.7	1.9	1.8	9.1	12.2
6121 TT	Simplo Technology	Outperform	153.0	134.5	1,387	6.9	13.1	12.0	8.1	6.8	3.2	3.0	2.1	1.9	17.2	16.9
2330 TT	Taiwan Semiconductor Manufacturing	Hold	107.0	104.5	91,148	100.2	14.9	14.0	7.4	6.5	2.4	2.4	3.2	2.8	23.3	21.7
3673 TT	TPK	Sell	150.0	181.0	1,980	64.6	7.3	13.5	5.2	6.4	4.1	2.2	1.3	1.2	17.5	9.2
3042 TT	TXC Corp	Hold	33.5	37.4	387	3.8	12.7	11.3	6.8	5.8	4.7	5.3	1.4	1.3	11.4	12.1
2303 TT	United Microelectronics	Hold	13.0	12.3	5,206	14.9	13.7	14.3	4.0	3.8	2.7	4.0	0.7	0.7	5.5	5.0
3231 TT	Wistron	Sell	20.0	24.9	1,980	9.2	9.7	9.8	6.4	5.7	6.1	5.2	1.2	1.1	10.9	11.8
Food, beverage & tobacco																
2912 TT	President Chain Store	Outperform	240.0	206.5	7,180	9.3	26.7	23.6	12.7	11.2	2.3	2.8	8.3	7.4	33.0	33.2
1216 TT	Uni-President Enterprises	Hold	57.0	54.0	9,310	17.1	20.7	20.2	9.7	8.5	3.1	3.2	2.6	2.1	14.2	11.6
Household & personal products																
4137 TT	Chlitina	Outperform	345.0	325.0	820	12.9	35.9	28.1	23.1	17.5	1.4	1.8	7.7	7.3	32.7	26.6
Materials																
1102 TT	Asia Cement	Hold	38.0	38.1	4,117	5.1	17.8	14.3	15.2	12.5	3.5	4.3	1.1	1.0	8.0	8.7
Pharmaceuticals & healthcare																
8406 TT	Ginko International	Hold	580.0	565.0	1,711	6.2	38.5	29.2	26.4	20.0	0.8	1.1	7.5	6.2	21.7	24.2
1789 TT	ScinoPharm Taiwan	Outperform	107.0	87.1	1,969	6.9	43.2	32.8	28.6	21.7	1.4	1.5	5.7	5.0	14.1	16.3
4105 TT	TTY Biopharm	Outperform	105.0	92.1	718	6.1	36.3	23.7	45.0	15.1	0.7	0.7	5.1	4.1	15.4	19.3
4180 TT	TWi Pharmaceuticals	Buy	465.0	325.0	1,224	9.0	n.a.	n.a.	n.a.	n.a.	-	-	9.2	9.7	n.a.	n.a.

Source: Bloomberg, Daiwa forecasts

Hong Kong – Underweight

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End-2014 target for MSCI Hong Kong: 13,678 (+13.2%)

We aggregated on a weighted basis the percentage changes needed for the MSCI Hong Kong constituents to reach Daiwa's analyst target prices, including consensus data for stocks not currently covered by Daiwa. This calculation produced a year-end 2014 index target of 13,678, implying a 13.2% YoY increase. This compares with the 8.5% rise that is calculated solely on consensus target prices. This 4.7pp difference is the fifth-largest among the 8 Asia ex-Japan regions covered in this report, when using this methodology, although Hong Kong ranks sixth in terms of expected performance in 2014.

While our bottom-up target prices suggest a much more optimistic outlook than consensus for the MSCI Hong Kong in 2014, the upside is almost solely premised on Daiwa's Regional Property Head, Jonas Kan's resiliently bullish view of Hong Kong property stocks. This contrasts with the much more cautious perspective of Daiwa economist Kevin Lai, who sees downside risk to Hong Kong's economic growth, consumption and asset prices. When the investment opportunities and risks are looked at from a regional perspective, Kevin's cautiousness appears to carry more weight, which is why we have recommended underweighting the MSCI Hong Kong.

On a relative value basis, underweighting Hong Kong in favour of China might be one of the most profitable macro trades in the region in 2014, if the widening performance gap between the two indices in recent years begins to close (see chart below). It may not be coincidental that the performance of the two indices began to diverge at a time when China was curbing stimulus while the US Fed continued its various securities purchase programmes. The onset of Fed tapering might well be the catalyst that reverses this trend.

■ Performance gap between MSCI China and Hong Kong to narrow in 2014?

Source: Bloomberg, Daiwa

How to beat the index

Due to recent staff changes, Daiwa research at present only covers some 40% of the MSCI Hong Kong, a situation that will be rectified over the course of 2014. In the meantime, our MSCI Hong Kong focus is mostly on property and banks.

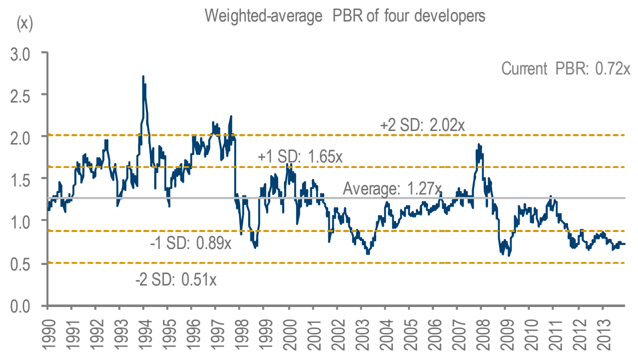
Property – and the bull case is …

We think there are two factors which may not have been recognised yet by the market but would become much clearer in the course of 2014: 1) the implications for the property market of Hong Kong's transformation from a medium-sized city in Asia into an integral part of China, and 2) Hong Kong property companies' transformation into major landlords and their growing earnings from China.

We think the first factor, among others, would result in Hong Kong property prices being more resilient than most people might have thought. In terms of PBR, the current valuation of property developers is now at over 1SD below the historical average since 1990 and at levels similar to past crises such as SARS, the Asia financial crisis, etc. Our forecast for Hong Kong residential property prices in 2014 (down 10-15%) is among the most optimistic in the market. Meanwhile, we also think the combination of the two aforementioned factors has resulted in the rental income stream and investment property assets of many property companies being priced at levels which are far cheaper than in the physical market.

We see SHK Properties as a good vehicle to play on this theme. Based on its current share price, the implied rental yield of SHK Properties's completed investment properties is some 14% which is inconceivable in the physical market given that its investment properties include prime commercial property assets in Hong Kong and Shanghai.

■ **Major property developers: PBR**

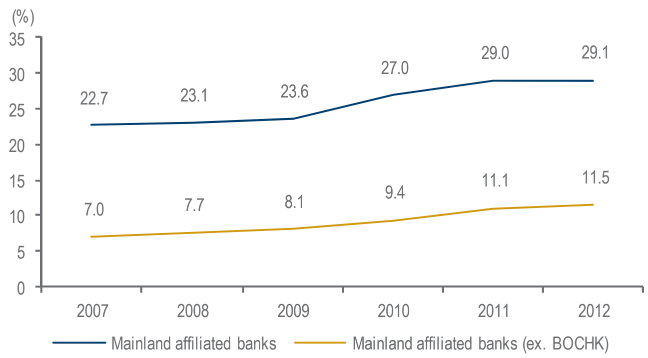


Source: Datastream, Daiwa

Banks – all about Renminbi opportunities

We expect loan growth in Hong Kong for 2014 to remain dominated by cross-border financing activities. Mainland-affiliated banks have steadily expanded their deposit market share in Hong Kong since 2007, and we believe this will be a continuing trend in 2014. Thus, having the capital and balance sheet strengths to capture the Renminbi-related growth opportunities will be an important focus for Hong Kong banks. Overall asset quality in Hong Kong is expected to remain robust in 2014, on the back of our view of a relatively stable property market. Our analysis based on the sector's past loan default experience shows that credit costs only rise significantly when nominal GDP growth in Hong Kong turns negative. Hence, we remain confident on the asset quality outlook for the sector.

■ **Hong Kong banks sector: deposit market share at major Mainland-affiliated banks**



Source: HKMA, KPMG Hong Kong Banking Survey

Note: Major mainland affiliated banks include Bank of China (HK), ICBC (Asia), CCB (Asia), ABC (HK branch), BoCom (HK branch), Wing Lung Bank and Citic Bank International' Bank of China (HK) includes BOCHK, Nanyang Commercial

Key stock calls

Top buy

BOCHK (2388 HK, HKD24.40, Buy [1]): We see more room for BOCHK to improve its NIM in 2014 relative to other Hong Kong banks. We expect higher yields on BOCHK's Mainland bond investments in 2014 due to tighter liquidity conditions which we expect for China in 2014, and that BOCHK can sustain its NIM improvement by lifting its loan-to-deposit ratio. With an estimated one-third market share in offshore Renminbi deposits in Hong Kong, BOCHK stands as the biggest beneficiary.

Top underperformer

Power Assets (6 HK, HKD60.80, Hold [3]): PAH and its parent, Cheung Kong Infrastructure (CKI) (1038 HK, HKD48.80, Buy [1]), which has a 38.89% stake in PAH, could face more competition in securing new overseas investments given the current low interest rate environment, leaving PAH sitting on a large HKD45-65bn pile of cash (on our estimates) after the planned spin-off of Hong Kong Electric (HEC). HEC is likely to replace PAH as the yield play (bond-like, stable electricity business). But, once the deal is done, we question what the future holds for PAH, as it would be left with a similar asset profile as its parent. This being the case, we would recommend that investors switch to CKI, as we see CKI as the more direct play on the group's overseas infrastructure investment strategy.

Top alpha generators

Dah Sing Banking Group (DSBG) (2356 HK, HKD13.80, Buy [1]): From an investment perspective, we expect investor sentiment towards the Hong Kong Banks Sector to continue to be dominated by M&A expectations in 2014. We believe DSBG could be the last family-owned bank standing, which raises its scarcity value. We are also impressed by the company's improving fundamentals. DSBG is actively promoting its transaction-based relationship management for its SME customers, which we believe should help increase the proportion of savings and current-account deposits at DSBG, thus lowering its funding costs.

Pacific Textiles (1382, HK11.76, Buy [1]): A top performer in 2013, we expect Pacific Textiles' share price to do well again in 2014. The earnings recovery that began last year is poised to accelerate in 2014, on Daiwa forecasts, and continue for a few more years. Supporting this view is the group's establishment of production facilities in Vietnam, which provides a material boost to capacity, helps lower unit costs, while also positions the group well to benefit from the Trans-Pacific Partnership. Pacific Textiles is a key supplier to many leading brands, including Uniqlo (nearly 50% of sales), Calvin Klein, Nike, Adidas and Victoria's Secret, while its shares offer a generous yield of nearly 7%.

Techtronic Industries (669 HK, HKD21.30, Buy [1]): Techtronic is expected to benefit from a strong, innovative product pipeline that will be launched in 2014, and which should produce higher gross margins. We also think that the company's floor-care and hand tools businesses will be increasingly profitable in coming years, as the group has promising new products in the pipeline.

What could go wrong?

As noted above, the PBR of the property sector is at levels previously only seen during crises. If there were a large correction in real-estate prices in Hong Kong, the negative impact on Hong Kong share prices could still be significant, notably for the banks due to heightened asset quality concerns, which is a risk that partly underlies our MSCI Hong Kong underweight call. Even for the property sector, analyst NAVs would have to be revised down, while company book values would be hit by negative revisions to the value of their investment property portfolios, if commercial property prices also fell sharply. However, if property prices do not fall, and worries of liquidity outflows abate or the Hong Kong government relaxes its real-estate policy, then Hong Kong property stocks could rise significantly in value, lifting the index with them.

The Hong Kong dollar peg to the US dollar makes Hong Kong banks highly efficient in raising US dollar liquidity. More than USD150bn has entered Hong Kong since QE1. Between December 2008 and March 2013, this USD150bn helped feed a USD314bn (HKD2,451bn) expansion in credit, with non-bank China corporates, including SOEs, alone accounting for USD258bn (HKD2,009bn) of this amount. But, of course, the ease with which US dollar liquidity can flow because of the peg works both ways, and our caution on the market stems primarily from concerns that liquidity outflows will be sizeable. If, however, the Fed tapers at a slower rate than expected, or reverses course and increases its US securities purchases, then liquidity could easily flow back into Hong Kong, lifting asset prices.

■ Valuation comparison

Bloomberg code	Company name	Rating	Target price (HKD)	Share price (HKD) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x)		EV/EBITDA (x)		Dividend Yield (%)		PBR (x)		ROE (%)	
							13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E	13E/FY14E	14E/FY15E
Banks																
23 HK	Bank of East Asia	Hold	33.00	32.20	9,394	7.6	11.9	11.5	n.a.	n.a.	3.4	3.5	1.2	1.1	10.2	9.8
2388 HK	BOC Hong Kong	Buy	32.00	24.40	33,271	28.7	11.6	10.3	n.a.	n.a.	5.4	6.1	1.6	1.5	14.3	15.2
2356 HK	Dah Sing Banking Group	Buy	17.40	13.80	2,227	3.4	9.8	9.2	n.a.	n.a.	3.5	3.8	1.1	1.0	11.2	11.0
440 HK	Dah Sing Financial	Buy	57.00	43.90	1,679	2.7	8.8	8.2	n.a.	n.a.	4.0	4.3	0.8	0.8	9.3	9.5
11 HK	Hang Seng Bank	Hold	128.00	123.80	30,525	16.0	9.1	14.4	n.a.	n.a.	4.4	4.5	2.3	2.2	27.2	15.7
302 HK	Wing Hang Bank	Buy	145.00	117.20	4,567	5.1	16.1	16.8	n.a.	n.a.	2.5	2.7	1.7	1.6	11.1	10.0
Construction & real estate																
2778 HK	Champion REIT	Outperform	3.80	3.42	2,515	1.6	18.8	21.2	n.a.	n.a.	5.7	5.4	0.4	0.4	2.3	2.0
1 HK	Cheung Kong	Buy	143.70	120.50	35,995	48.2	10.4	8.9	3.7	2.9	2.8	3.1	0.9	0.8	8.5	9.3
778 HK	Fortune REIT	Buy	8.20	6.09	1,378	1.1	19.4	16.8	n.a.	n.a.	6.0	6.8	0.7	0.8	3.6	4.4
101 HK	Hang Lung Properties	Buy	34.40	23.55	13,598	12.7	22.1	18.1	16.5	14.0	3.1	3.4	0.9	0.9	4.0	4.8
12 HK	Henderson Land	Buy	61.18	44.05	14,848	17.5	13.9	11.8	11.8	10.1	2.7	3.0	0.5	0.5	3.9	4.4
14 HK	Hysan Development	Buy	48.16	33.25	4,528	4.3	16.6	14.9	14.4	13.0	3.5	3.6	0.6	0.6	3.5	3.8
1200 HK	Midland	Hold	3.60	3.61	336	1.4	n.a.	17.2	n.a.	5.6	2.8	5.5	1.9	1.8	n.a.	10.8
808 HK	Prosperity REIT	Buy	3.00	2.25	407	0.6	18.9	16.9	n.a.	n.a.	6.8	7.8	0.6	0.6	2.9	3.3
1881 HK	Regal REIT	Outperform	2.90	2.20	924	0.3	15.4	13.8	n.a.	n.a.	7.0	7.8	0.4	0.4	2.9	3.2
16 HK	SHK Properties	Buy	136.50	96.40	33,207	50.7	10.8	9.6	8.4	7.3	3.8	4.1	0.6	0.6	5.8	6.4
83 HK	Sino Land	Buy	13.50	10.24	7,871	8.1	15.9	12.4	10.0	9.0	4.9	4.9	0.6	0.6	3.6	4.6
878 HK	Soundwill	Buy	28.40	14.52	515	0.2	6.8	2.9	7.8	3.1	1.5	1.7	0.3	0.3	4.2	9.0
435 HK	Sunlight REIT	Buy	4.00	2.98	624	0.4	19.2	16.3	n.a.	n.a.	5.9	6.7	0.5	0.5	2.7	3.2
823 HK	The Link REIT	Buy	48.00	37.10	11,019	19.5	22.2	19.6	n.a.	n.a.	4.5	5.0	1.0	1.0	4.7	5.3
4 HK	Wharf Holdings	Buy	78.00	58.20	22,736	30.9	14.1	12.6	12.4	11.0	3.0	3.2	0.7	0.7	5.0	5.4
Consumer durables & apparel																
1382 HK	Pacific Textiles Holdings	Buy	14.20	11.76	2,178	1.0	13.4	12.4	8.7	8.1	6.7	7.3	4.0	3.8	30.6	31.3
1836 HK	Stella International	Sell	16.10	19.10	1,957	1.1	16.8	15.4	9.8	8.8	4.2	4.5	2.1	2.0	12.6	13.2
669 HK	Techtronic Industries	Buy	23.50	21.30	5,025	8.7	20.4	16.8	11.7	10.1	1.3	1.9	2.9	2.5	14.9	16.0
321 HK	Texwinca	Hold	7.20	7.97	1,412	1.2	12.1	10.6	7.1	6.2	6.6	7.6	1.8	1.7	15.1	16.6
891 HK	Trinity	Sell	2.20	2.47	548	0.9	14.2	13.4	7.7	6.8	4.9	5.2	1.2	1.2	8.7	9.2
Diversified financials																
388 HK	Hong Kong Exchanges & Clearing	Buy	159.60	127.50	18,906	55.8	28.2	26.5	22.0	20.3	3.2	3.4	8.0	7.8	28.8	29.8
Electronics																
2018 HK	AAC Technologies	Underperform	31.00	38.90	6,161	29.3	14.4	15.1	15.1	13.2	2.8	2.7	4.7	4.0	37.2	28.7
303 HK	VTech	Hold	100.00	102.90	3,323	5.3	15.1	13.9	10.7	9.8	6.3	6.9	5.6	5.4	37.8	39.7
Transportation																
293 HK	Cathay Pacific Airways	Buy	17.30	16.08	8,158	6.9	27.9	16.0	5.3	4.3	1.3	1.9	1.1	1.0	3.9	6.5
66 HK	MTR Corporation	Outperform	33.40	28.70	21,146	7.1	20.3	14.1	13.3	13.0	2.9	3.3	1.1	1.1	5.5	7.7
316 HK	Orient Overseas International	Outperform	52.00	38.70	3,123	8.0	16.7	11.9	9.6	8.6	1.5	2.1	0.7	0.6	4.1	5.6
1308 HK	SITC International	Buy	4.00	3.59	1,198	0.8	10.9	7.4	8.3	6.1	4.1	5.8	1.5	1.3	14.9	19.4
152 HK	Shenzhen International	Buy	1.30	0.99	2,115	8.2	7.9	6.7	8.8	8.0	3.8	3.7	1.2	1.0	15.5	16.3
1052 HK	Yuexiu Transport Infrastructure	Buy	5.00	4.13	891	0.6	9.9	7.8	8.2	6.8	7.6	8.5	0.6	0.6	6.5	7.9
Utilities																
1038 HK	Cheung Kong Infrastructure	Buy	63.00	48.80	15,711	8.9	11.1	10.9	27.0	20.5	3.7	3.9	1.5	1.4	14.4	13.5
6 HK	Power Assets	Hold	63.00	60.80	16,735	25.0	12.3	12.1	11.4	10.3	4.9	5.0	1.9	1.8	16.1	15.4

Source: Bloomberg, Daiwa forecasts

India – Underweight

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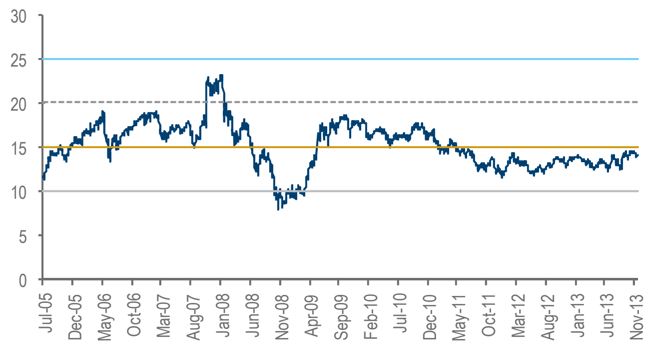
End-2014 target for MSCI India: 955 (+18.0%)

Regionally, Daiwa's view is cautious on India this year, as discussed at the beginning of this report. At the country level, however, our Head of India Research, Punit Srivastava, believes that the risk-reward balance of investing fresh capital in Indian equities is favourable right now. The following few paragraphs summarise his perspective:

We assign a target PER of 17x to the MSCI India Index, which is at a premium to the index's current 1-year rolling forward PER of 14.2x, as we think most of the stress that we have seen in the economy is now abating, and believe the macro environment will improve in 2014.

■ MSCI India index: one-year rolling forward PER bands (x)



Source: MSCI

Between June 2009 and December 2010, the MSCI India Index traded in a range of 16-18x one-year forward earnings, before problems such as infrastructure woes, inflation and lower GDP growth led to a derating of India's stock market. We believe that as we start to see a recovery in the economy, the MSCI India Index will return to trade at around 17x, which would be in the middle of the range in which it was trading between June 2009 and December 2010, when the macro situation was better.
Based on our bottom-up calculation for the constituents of the MSCI India (using Daiwa's forecasts for stocks that we cover and Bloomberg-consensus forecasts for stocks that we do not), we forecast the FY15 EPS for the MSCI to increase by 17% YoY to INR56.2. Assuming a market PEG of 1x, this would give us a target PER of 17x, and an FY15 index target of 955, representing 18% upside potential from current levels.

How to beat the index

In our view, India has gone through the worst part of this economic cycle, driven by low GDP growth, high inflation, and weak government policies (ie, slow decision making, corruption scandals, etc), all of which culminated in a currency crisis in July-August 2013, triggered by news of the Fed's possible QE tapering sometime in 2013. Since then, we have seen some green shoots of recovery, even though a broad-based recovery may still not be firmly in place for another 6-12 months.

Short-term interest rates have fallen by almost 200bps, GDP growth has seen a pick-up, and the current-account deficit saw a marked improvement, falling to 1.2% of GDP for 2Q FY14, from 5% for 1Q FY14. However, high inflation and a high and rising fiscal deficit remain the main macro concerns for India.

We believe the India domestic sectors that have done poorly over the past couple of years (namely, financials, materials and autos) should see an improvement in fundamentals, and thus we are overweight these sectors for 2014. We are negative on the consumer and capital goods sectors, given the current demanding valuations of the consumer sector and the slow recovery we expect in the capital goods space.

Also, we are underweight telecoms, largely because of the significant regulatory risks that we see for the sector. As we expect the economic cycle to see a pick-up in 2014, going overweight on the domestic-driven sectors would be the best way to beat the index, in our opinion.

Financials sector (overweight)

We believe the financials sector would be one of the biggest beneficiaries of an improving domestic economy in 2014, arising from a revival in some of the country's key sectors, such as textiles, iron and steel, agriculture, etc.

Even in the infrastructure space, many companies that are highly leveraged should see a reduction in leverage from monetisation of some of their assets and an improvement in cash flows from their existing functional projects. Moreover, a revival in some projects that are being held up by regulatory hurdles should help boost credit demand within the banking sector.

Also, bond yields may ease as inflationary pressures decline during the year and the Rupee stabilises against the USD. Further, we expect banking system liquidity to be more stable in 2014 as credit grows in line with deposit growth. Over the past couple of years, credit had risen at a pace that was 3-4% higher than deposit growth, leading to a higher sector loan-to-deposit ratio (LDR) and structural liquidity deficit.

However, the banking sector's asset-quality challenges have still not subsided. Fresh NPLs within the sector as a whole have remained high, and over the past 6 months or so, the sector's restructured loans have risen, highlighting that corporates continue to face financial stress on the back of low demand and margin compression. Looking ahead, even though we expect net NPL additions in 2014 to subside driven by higher recoveries, fresh restructuring of loans will remain high, in our opinion.

Given the overall current scenario, we believe ICICI Bank (ICICIB IN, INR1,067, Buy [1]) and Axis Bank (AXSB IN, INR1,261, Buy [1]) will continue to rerate as both banks have managed their asset quality well and as their operating assets as a proportion of their total loans increase over the next year. Similarly, as liquidity pressure eases, we think YES Bank (YES IN, INR371, Buy [1]) will witness a further rerating.

Among the public sector banks (PSBs), we see the possibility of a rerating for Punjab National Bank (PNB IN, INR618, Buy [1]) and Bank of Baroda (BOB IN, INR650, Buy [1]), as there have been some signs of their asset quality improving in 2Q FY14, and we expect this to continue over the next 12 months, although at a very moderate pace.

■ **Private banks and PSBs: asset-quality performance (%)**

	1Q FY14			2Q FY14		
	Annualised delinquencies	Annualised restructuring	Total (Delinquencies +restructuring	Annualised delinquencies	Annualised restructuring	Total (Delinquencies +Restructuring
Private banks						
Axis Bank	1.4	1.2	**2.6**	1.2	2.1	**3.3**
ICICI Bank	1.6	1.2	**2.8**	1.6	1.5	**3.1**
ING Vysya	1.9	0.5	**2.4**	1.1	1.0	**2.1**
Yes Bank	0.3	-	**0.3**	1.4	-	**1.4**
PSBs						
SBI	5.8	2.5	**8.3**	3.5	3.6	**7.1**
PNB	4.8	3.7	**8.5**	4.1	3.7	**7.8**
BOB	3.0	2.9	**5.9**	2.7	2.2	**4.9**
BOI	3.0	1.1	**4.1**	2.3	1.3	**3.6**
UNBK	3.4	2.5	**5.9**	3.7	3.5	**7.2**
OBC	2.7	1.6	**4.3**	3.4	1.2	**4.6**
ALBK	6.2	1.2	**7.4**	4.3	3.3	**7.6**
SNDB	4.0	2.7	**6.7**	5.4	0.8	**6.2**

Source: Companies

Note: SBI=State Bank of India; PNB=Punjab National Bank; BOB=Bank of Baroda; BOI=Bank of India; UNBK=Union Bank of India; OBC= Oriental Bank of Commerce; ALBK= Allahabad Bank; SNDB= Syndicate Bank

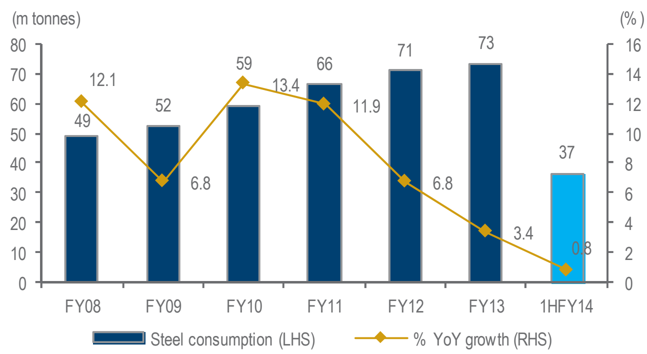
Note: Delinquencies stand for fresh NPLs and Restructuring refers to loans whose repayment terms have been rescheduled/ modified.

Materials sector (overweight)

For FY13, steel consumption rose by just 3.4% YoY, the lowest growth for the past 5 years. Further, for 1H FY14, steel demand increased by a mere 0.8% YoY, while for October 2013 and November 2013, we expect steel demand to have witnessed subdued growth on a year-on-year basis. Even though the World Steel Association forecasts steel demand growth of 5.6% YoY for 2014, driven by structural reforms, we expect steel demand to show a marginal improvement of about 4.0% YoY for 2014, as the government might be more focused on the upcoming election (until May 2014) than on implementing reforms.

Accordingly, Daiwa's Deepak Poddar remains cautiously optimistic on the sector. His cautious stance is driven by the possibility that the recovery in domestic steel demand will prove to be slower than we expected. But he remains optimistic on the encouraging trends being seen in India's steel exports and imports, better steel ASP (due to the depreciation of the Rupee against the US Dollar), an Daiwa's bearish outlook for coking-coal prices, which form a major portion of the cost structure for India steel players.

■ **India: steel consumption growth**



Source: Joint Plant Committee (JPC)

While we remain cautious on the growth of domestic demand for steel, the two key trends of increasing steel exports and declining steel imports are pushing up steel sales for India's steel players. India steel imports were down 25% YoY for 1H FY14, while many of the steel players in India, eg, JSW Steel (JSTL IN, INR994, Hold [3]) and Jindal Steel (JSP IN , INR255, Buy [1]), are looking for a significant improvement in their steel exports for FY14.

Meanwhile, Rupee depreciation against the US Dollar is also playing an important role, as it makes imports more expensive and exports more competitive, resulting in both higher steel exports from India and lower steel imports into India. Rupee depreciation in our view has also helped improve domestic steel prices.

Over the past three months, steel prices in India have appreciated by INR2,500-3,000/tonne (6-8%) and this is likely to benefit the steel players in 2H FY14.

We remain bearish on the outlook for coking-coal prices (which accounted for about 25-40% of the FY13 cost of production for the India ferrous players), as we forecast surpluses globally of about 11m tonnes for 2014 and about 18m tonnes for 2015. Daiwa's Jiro Iokibe forecasts the coking-coal contract price to decline by 6.8% YoY to USD145/tonne FOB for 2014, and to be flat YoY for 2015.

Overall, given what we see as improved spot steel prices and weak coking-coal prices, along with the higher steel exports and lower steel imports, we prefer the ferrous space, in which Tata Steel (TATA IN, INR420, Buy [1]) remains our preferred pick.
In the non-ferrous segment, we remain selective. Our outlook for LME aluminium prices for 2014 remains bearish, driven by weak fundamentals and a global surplus, while we are positive on zinc as a commodity, driven by the global deficit for this metal. Accordingly, Hindustan Zinc (HZ IN, INR132, Buy [1]) is our preferred pick in the non-ferrous space.

Auto sector (overweight)

Although high fuel prices and interest rates are dampening near term demand, Navin believes the demand recovery for automobiles on a low base could be back-ended in 2014. He remains positive on the long-term outlook for the sector based on positive structural factors including low penetration rates and increasing affordability levels. Daiwa forecasts sales volumes of two-wheelers/passenger vehicles (PVs)/commercial vehicles (CVs) to increase by 10%/14%/15% YoY, respectively, in 2014.

In the recent 2Q FY14 earnings results, most auto manufacturers reported better-than-expected operational performances. Besides benign commodity cost trends, the aggressive cost reduction programmes being undertaken by most OEMs have started to be reflected in their operating performances. An increase in commodity prices on the back of Rupee deprecation and higher discount levels could result in margin pressure in the near term. However, as demand recovers, we expect operating leverage benefits to mitigate inflationary trends in commodity prices.

The share-price trend for most companies under coverage has been relatively strong over the past 3 months. We believe that sector valuations are near +1SD levels of their past 5-year averages. We continue to advocate a bottom-up stock selection strategy.

We retain our preference for Tata Motors (TTMT IN, INR363, Buy [1]) given the catalysts we see for healthy volume growth and an operating performance improvement. We also like Maruti Suzuki (MSIL IN INR1,799, Buy [1]), as we expect the company to benefit most among its domestic peers from a demand recovery for PVs, which is likely to be led by higher growth in the compact car segment.

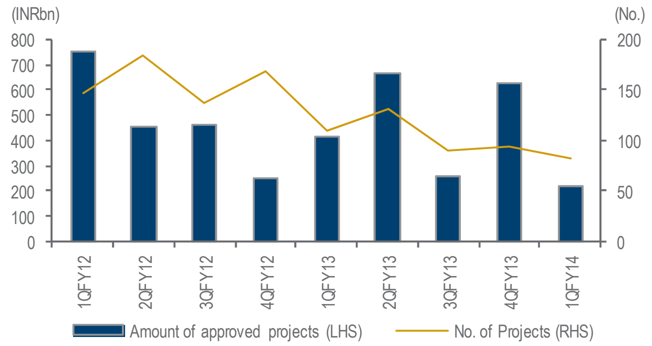
We maintain our cautious view on two-wheeler players including Hero Motocorp (HMCL IN, INR2,097, Hold [3]) and Bajaj Auto (BJAUT IN, INR1,899, Hold [3]), as we believe both players could see increased pressure on market share as Honda Motorcycle and Scooter (HMSI) continue to ramp up volumes in the executive motorcycle segment.

Capital goods sector (underweight)

In the long-cycle industrial-project segments of the capital goods sector, investment plans in India have remained subdued, with the planned cost of projects sanctioned during the quarter ended June 2013 at INR220bn, significantly lower than the quarterly average for the previous two years. While the cycle is likely to bottom this year, we believe the recovery will be slow and the sector is unlikely to outperform until clear signals emerge that the new order trend is accelerating.

Key sectors contributing to the fall have been power and metals. The issues that affected these sectors were delays in approvals by the government and earlier aggressive bidding by private developers, which have brought the infrastructure sector to a standstill with stressed balance sheets due to increased leverage.

■ RBI's estimate of amount of approved projects



Source: RBI

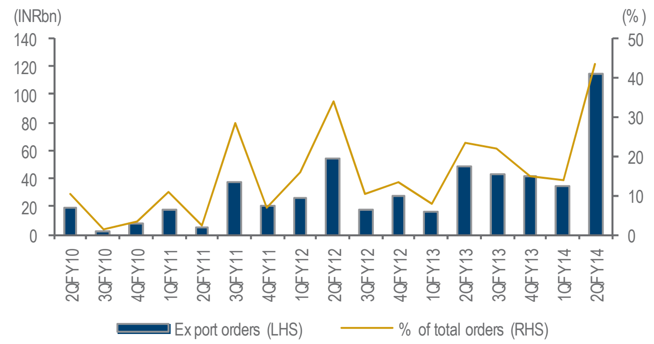
Strong policy measures by the government, for instance the establishment of the Cabinet Committee on Investments (CCI) to expedite the clearance of projects (the CCI had cleared about 209 projects up to mid-September 2013), as well as a project monitoring group set up by the Prime Minister's Office, have at least set deadlines for the intermediate steps to be taken to accelerate key mega infrastructure projects.

The impact of these initiatives will not immediately be seen, but concerted efforts could bring about a turnaround in investment demand later this year, according Daiwa's Saurabh Mehta. He expects the capex cycle to pick up over the next 12-18 months post the general elections, starting with spending by the public-sector companies, followed by the private sector.

Meanwhile, capital goods companies have been focusing on export orders in the Middle East and Africa, for instance the companies that did well in 2Q FY14 in terms of getting stronger order inflow include the likes of Larsen & Toubro (L&T) (LT IN, INR1,012, Buy [1]) and Siemens (SIEM IN, INR629, Sell [5]).

For L&T, order inflows rose by 27% YoY to INR265bn for 2Q FY14 (although domestic order-inflow declined by 6% YoY), as a result of strong orders from the infrastructure and hydrocarbon sectors in the Middle East. For Siemens, order-inflow growth of 22% YoY was also a positive surprise, with the company citing an increase in export orders. Also, the other industrial companies under our coverage indicated an increased focus on export orders to offset the slowdown in domestic orders.

■ L&T: increasing share of export orders in order inflows



Source: Company

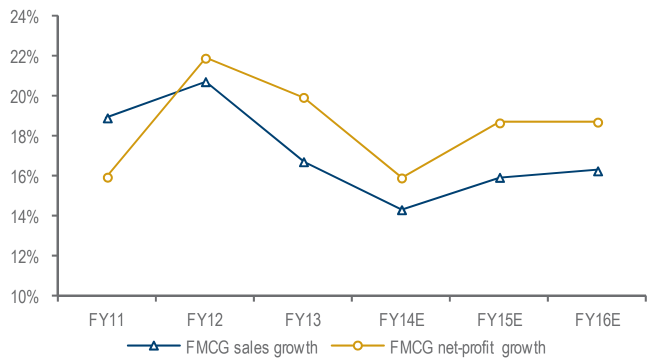
New segments, such as railways, defence, mining, and water, are likely to take precedence over power sector orders, implying that companies with diversified offerings will be better placed to win orders. Opportunities in the railways segment could come from the dedicated freight corridor and from metro-rail projects in tier-2 cities.

Consumer sector (underweight)

Daiwa's Mihir Shah expects sales-value growth in the India consumer sector to pick up in 2014 on the back of the good monsoon in 2013, the marginal revival in the economy, and increase in contribution from price-led growth.

The strong monsoon season in 2013 should not only propel sales growth in rural areas due to a better *kharif* (summer crop) season, but also due to an expected robust *rabi* (winter crop) season, the sowing of which has started on a strong note.

■ Consumer sector: sales and PAT growth



Source: Company, Daiwa forecasts

However, Mihir believes stock selection is vital, as even after the recent correction in consumer stocks, the sector is still trading above its mean historical valuations, making us underweight on the sector. He believes the sector could witness a 5-10% moderation in valuations in 2014, yet should continue to trade at high multiples until investors see a sustainable recovery in the economy. In most of our communications with investors, they believe the Indian economy is not yet out of the woods and may remain under pressure in 2014.

For investors who want exposure to the India consumer sector, our preferred picks are ITC (ITC IN, INR315, Outperform [2]) due to its strong pricing power, good visibility and comparatively reasonable valuations, and Dabur (DABUR IN, INR167, Outperform [2]), which could report higher volume growth on the back of increased rural distribution.

Telecoms sector (underweight)

The 2013 rally in the telecom sector has been largely driven by market expectations of a return of pricing power for telecom players. However, in the opinion of Daiwa's Ramakrishna Maruvada, the signs that could point to a sustained improvement in the pricing environment have yet to emerge. Despite realised rates showing an improvement on an average revenue per minute (ARPM) basis (due mainly to the reduction of promotional minutes), the lack of a meaningful boost to ARPU appears to run contrary to the thesis of a continual improvement in the pricing environment, in our view.

Moreover, as a result of the share-price rally, valuations have exceeded operational prospects, while issues surrounding 3G-refarming as well as the outcome of a consequent 700MHz spectrum auction will continue to pose an overhang over the performance of the sector in 2014. Rama has a Negative rating on the sector, and maintains his Hold (3) rating on Bharti (BHARTI IN, INR329), and Sell (5) ratings on Reliance Communications (RCOM) (RCOM IN, INR132) and Idea Cellular (IDEA IN, INR163).

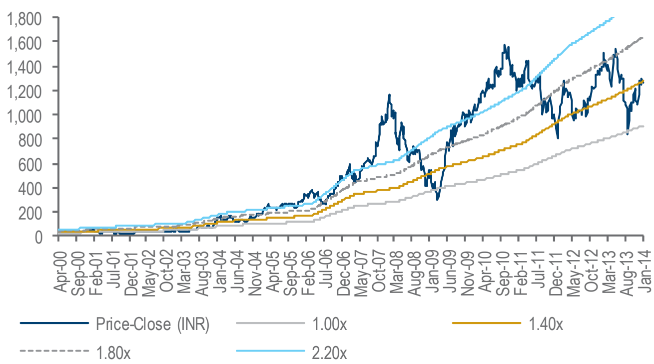
Key stock calls

Top buys

Axis Bank (AXSB IN, INR1,261, Buy [1]): We believe that Axis Bank is one of the best ways to play the theme of a recovery in the domestic economy. The bank's high exposure to the infrastructure segment (especially power) has been a key overhang on the stock's valuation. However, we are already seeing positive policy-related developments in the infrastructure segment, and Axis Bank should benefit as more infrastructure projects financed by the bank become operational in the coming 2 years.

Moreover, over the past 2-3 years, the bank has seen a rise in its proportion of retail loans, which now constitute around 30% of the loan book. The high proportion of retail loans should lend support to the overall asset quality of the bank. While most banks have seen high NPLs in the SME segment in the current credit cycle, Axis Bank's SME portfolio has performed very well for the past couple of years, due to strict underwriting standards and better borrower selection. We expect a similar performance in FY14. Even though restructuring of loans is likely to remain high in FY14, we expect rising operating profits to comfortably absorb any possible rise in provisions, and we forecast the bank to deliver a 20%-plus net profit CAGR and average ROE of around 19% for FY14-16, with provisioning coverage of around 80%.

■ Axis Bank: PBR bands

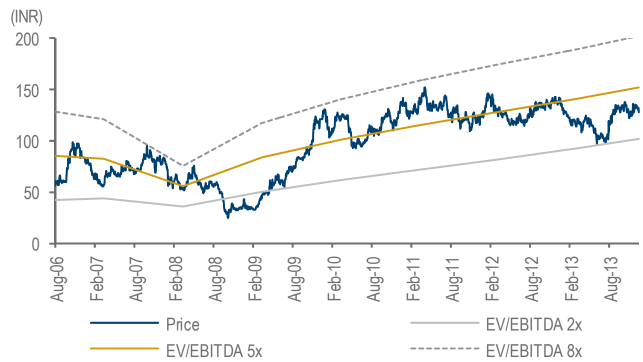


Source: Daiwa

Hindustan Zinc (HZ IN, INR132, Buy [1]): We have a Buy (1) rating on Hindustan Zinc, with a 6-month target price of INR159. It remains our preferred stock pick in the non-ferrous space. We believe the stock will see catalysts from both a fundamental and technical point of view. On the fundamental side, we expect a ramp-up in the company's refined zinc volume in the coming quarters and forecast a 10% CAGR in zinc volume over FY13-15, which should reduce its fixed costs per ton. Further, we expect its lead and silver sales volumes to see CAGRs of 14% and 15%, respectively, over the same period. In addition, we remain structurally positive on LME zinc prices due to the global demand/supply picture, which we expect to remain in deficit until 2016. Over the past 6 months, the LME zinc price has appreciated by 13%, which should help the company's EBITDA margin in the coming quarters. We maintain a positive outlook on zinc and a negative outlook on aluminium.

In the current macro-economic environment, we believe the company stands out for its circa-50% EBITDA margin, integrated operating model with zero debt, high dividend yield of 2.7%, and attractive valuation (EV/EBITDA of 3.6x on our FY15 forecasts). Further, on the technical side, the government of India's stake sale remains a potential trigger. Vedanta group, the parent company, has received approval to pay up to INR149/share to buy out the government's 29.5% stake in Hindustan Zinc, but it could technically bid up to INR172/share if it does not bid for BALCO at the same time or it assigns a much lower value to the BALCO stake.

■ Hindustan Zin: one-year forward EV/EBITA bands



Source: Daiwa

Top sells

Bharat Heavy Electricals (BHEL IN, INR166.1, Underperform [4]): The company has continued its weak run, with the order backlog down 16% YoY in 1H FY14, revenue down 15% YoY, EBITDA down 78% YoY, and PAT declining by 64% YoY. While there was some respite in execution, with a pick-up in a few slow-moving orders, funding constraints continued to affect a few other private customers, which put BHEL's balance sheet under stress.

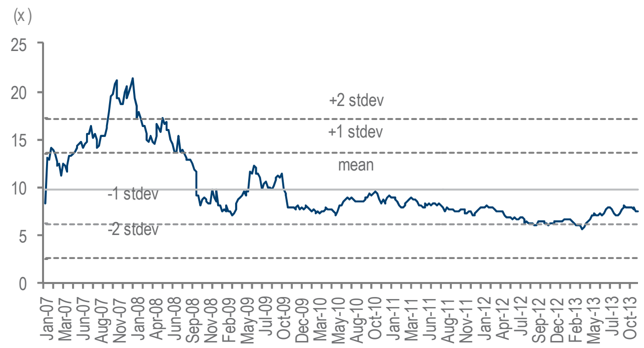
We have an Underperform (4) rating on the stock, as we believe the demand outlook remains weak, there is limited visibility on FY14-15 orders, and competition for the limited number of orders will remain fierce given that domestic capacity is to increase from 10GW in FY08 to 33GW in FY14E.

■ BHEL: one-year forward PER (x)

Source: Bloomberg, Daiwa estimates

Reliance Communication (RCOM IN, INR131.7, Sell [5]): We believe the YTD share-price rally that has been witnessed by RCOM has been driven more by positive sentiment led by news of tariff hikes and the INR12bn network-sharing agreement with Reliance Jio Infocomm (Not listed), rather than an improvement in the company's earnings outlook. Also, the company's profitability remains weighed down by a high debt burden (2Q FY14 net-debt/EBITDA was 5.4x).

■ RCOM: one-year forward EV/EBITDA(x)



Source: Bloomberg, Daiwa estimates

Top alpha generator (non-index pick)

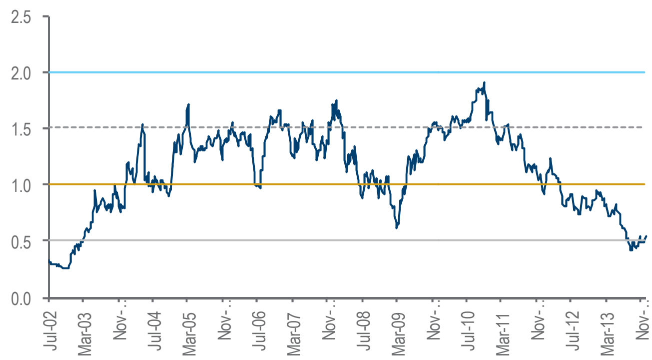
Punjab National Bank (PNB IN, INR618.35, Buy [1]): We believe the time has come to take a fresh look at PNB, the second-largest state owned bank in India. This bank used to have the highest PBR among PSBs but lost its premium completely in the past couple of years due to a substantial rise in NPLs. However, after seeing a lot of asset quality pain, net additions to NPLs should start to improve, in our view. Also, after a long time, management is expecting less pain on the asset quality front, lower fresh restructured loans, and a pick-up in loan growth over the next 6 months, which has substantially lagged system loan growth over the past year.

While it is still difficult to decide whether the worst is over or not, PNB performed better than expected in 2Q FY14 in terms of asset quality, as net additions to NPLs declined by 37% QoQ to INR15.1bn, from INR24.2bn in 1Q FY14. The restructured loans pipeline is quite thin for PNB and we should also see a meaningful decline in fresh restructured loans going ahead.

While the bank guides for a lower NIM for FY14, it has managed to maintain the NIM at around the 3.5% level for the past 7 quarters – something none of the other PSU banks has been able to achieve. While there could be slight pressure on the NIM due to a rising cost of funds, an expected improvement in asset quality could offset this pressure, and hence overall, the NIM could remain flat over the next 2-3 quarters.

The stock is trading currently at a 0.6x FY14E PBR and 4.7x FY14E PER, among the lowest of the top-3 PSU banks. We believe a fall in fresh NPLs, improved NPL recoveries and a fall in government bond yields would help the stock to be substantially rerated. We have a 6-month target price of INR850, based on a target PBR of 0.75x on our FY15E BVPS forecast, offering almost 37% upside potential from the current share price.

■ PNB: one-year forward PBR(x)



Source: Daiwa estimates, Bloomberg

What could go wrong?

One of the biggest catalysts that investors will be focusing on in FY14 will be the general elections scheduled for May 2014. A stable government is the most important cue that investors will be looking for, whether it comes from the ruling Congress or the BJP, the largest opposition party currently. With the BJP winning 3 out of the 5 states (Rajasthan, Madhya Pradesh and Chhattisgarh) with a clear majority in the recently concluded state elections in December 2013, and winning the maximum number of seats in Delhi (32 seats out of 70), investor sentiment has received a big boost prior to the national elections in May 2014. However, as Indian voters are quite unpredictable, a minority government in the centre could cause major concerns and lead to a sell-off.

High food inflation is still a concern in India and could remain very volatile given the structural changes happening in Indian demographics. While the good monsoon in 2013 would provide relief, if food prices remain high, then the chances of interest rates coming down would be quite slim, and would only add to the delays in the investment cycle.

Also, while the trade deficit and the current account deficit has seen an improvement, a pick-up in economic activity could lead to higher imports of capital goods and crude oil, which in turn could put additional pressure on the country's trade deficit. The volatility of the Rupee is seen as a key risk to investing in India, and unless investors are convinced of seeing a fundamental improvement on this front, a sustainable rerating could remain a pipe dream and India could remain a traders market, with only a few non-domestic sectors doing well.

■ Valuation comparison

Bloomberg code	Company name	Rating	Target price (INR)	Share price (INR) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x) FY14E	PER (x) FY15E	EV/EBITDA (x) FY14E	EV/EBITDA (x) FY15E	Dividend Yield (%) FY14E	Dividend Yield (%) FY15E	PBR (x) FY14E	PBR (x) FY15E	ROE (%) FY14E	ROE (%) FY15E
AUTOMOBILES & COMPONENTS																
AL IN	Ashok Leyland	Hold	16	19	808	3.1	n.a.	407.4	35.1	13.7	-	1.6	1.2	1.2	n.a.	0.3
BJAUT IN	Bajaj Auto	Hold	2,080	1,899	8,834	12.5	15.5	13.7	10.8	9.3	2.9	3.2	5.8	4.8	40.8	38.2
BHFC IN	Bharat Forge	Outperform	384	320	1,198	2.1	18.8	15.4	9.7	8.2	1.6	1.9	3.0	2.7	17.1	18.6
EXID IN	Exide Industries	Outperform	134	117	1,603	3.5	17.0	14.9	10.1	8.9	1.5	1.7	2.6	2.3	16.2	16.5
HMCL IN	Hero Motocorp	Hold	1,940	2,097	6,731	10.9	18.9	14.2	10.6	9.2	2.6	3.1	7.0	5.7	40.4	44.3
MM IN	Mahindra & Mahindra	Outperform	998	900	8,541	15.3	14.2	13.3	10.4	9.5	1.5	1.7	3.1	2.6	23.5	21.4
TTMT IN	Tata Motors	Buy	446	363	18,769	46.6	8.1	7.3	4.2	3.7	0.6	0.6	2.3	1.8	32.9	27.5
BANKS																
ALBK IN	Allahabad Bank	Buy	105	96	773	4.4	3.9	3.4	n.a.	n.a.	5.7	6.2	0.4	0.4	11.3	11.8
AXSB IN	Axis Bank	Buy	1,460	1,261	9,484	55.7	9.5	7.7	n.a.	n.a.	1.6	2.0	1.6	1.3	17.4	18.8
BOB IN	Bank of Baroda	Buy	666	650	4,415	21.5	6.1	5.4	n.a.	n.a.	3.1	3.8	0.8	0.7	13.8	14.1
HDFCB IN	HDFC Bank	Outperform	722	663	25,374	34.0	18.5	14.4	n.a.	n.a.	1.1	1.4	3.7	3.0	21.6	23.2
HDFC IN	Housing Development Finance	Outperform	889	790	19,748	32.9	22.0	18.8	n.a.	n.a.	1.8	2.1	4.4	3.9	21.0	22.0
ICICIBC IN	ICICI Bank	Buy	1,195	1,067	19,788	63.0	12.1	10.1	n.a.	n.a.	2.2	2.7	1.7	1.5	14.5	15.6
VYSB IN	ING Vysya Bank	Outperform	632	591	1,781	1.3	13.5	11.9	n.a.	n.a.	1.1	1.3	1.6	1.4	13.0	12.6
OBC IN	Oriental Bank of Commerce	Buy	234	217	1,018	7.5	5.2	4.5	n.a.	n.a.	5.1	5.8	0.5	0.4	9.7	10.2
PNB IN	Punjab National Bank	Buy	850	618	3,514	17.9	4.7	3.5	n.a.	n.a.	4.5	5.5	0.6	0.5	14.0	16.9
SBIN IN	State Bank of India	Buy	1,858	1,716	18,871	64.4	7.2	6.6	n.a.	n.a.	2.2	2.4	0.8	0.8	12.5	12.3
SNDB IN	Syndicate Bank	Buy	163	95	923	3.3	3.3	3.2	n.a.	n.a.	4.7	5.2	0.6	0.5	20.0	17.7
UNBK IN	Union Bank of India	Hold	138	128	1,232	11.1	4.4	3.5	n.a.	n.a.	5.6	6.7	0.5	0.4	10.7	12.3
YES IN	Yes Bank	Buy	532	371	2,136	50.9	8.5	6.3	n.a.	n.a.	2.0	2.6	1.9	1.5	24.2	26.7
CAPITAL GOODS																
ABB IN	ABB Ltd (India)	Sell	400	669	2,278	2.1	59.4	41.8	30.9	22.9	0.1	0.2	5.0	4.5	8.8	11.4
BHEL IN	Bharat Heavy Electricals	Underperform	115	166	6,536	15.2	9.7	11.6	5.0	4.9	3.0	3.0	1.2	1.2	13.2	10.2
CRG IN	Crompton Greaves	Hold	90	125	1,285	5.0	19.7	15.1	10.3	8.3	1.1	1.1	2.1	1.9	10.9	13.0
LT IN	Larsen & Toubro	Buy	1,050	1,012	15,057	40.9	19.4	17.1	13.6	12.0	1.3	1.5	2.9	2.6	15.6	15.8
SIEM IN	Siemens India	Sell	420	629	3,442	4.1	132.6	46.6	47.4	22.2	0.8	0.8	5.4	5.1	4.1	11.2
CONSUMER DURABLES & APPAREL																
TTAN IN	Titan Industries	Outperform	250	227	3,243	6.7	26.1	21.8	18.2	15.3	0.8	1.0	7.9	6.2	34.3	31.9
DIVERSIFIED FINANCIALS																
IDFC IN	Infrastructure Development Finance	Hold	138	106	2,571	18.4	7.6	6.4	n.a.	n.a.	2.8	3.3	1.0	0.9	14.6	15.3
POWF IN	Power Finance Corp	Buy	248	159	3,369	6.2	4.3	3.7	n.a.	n.a.	5.0	5.7	0.8	0.7	19.8	19.9
RECL IN	Rural Electrification	Buy	290	213	3,373	4.8	5.3	4.4	n.a.	n.a.	4.2	4.9	1.2	1.0	25.7	25.6
SHTF IN	Shriram Transport Finance	Buy	780	673	2,455	3.5	10.4	8.7	n.a.	n.a.	1.3	1.5	1.8	1.5	18.8	19.1
ENERGY																
BPCL IN	Bharat Petroleum	Buy	479	329	3,826	7.5	20.8	16.6	8.8	9.1	1.6	1.6	1.4	1.3	6.7	8.0
CAIR IN	Cairn India	Buy	352	320	9,811	11.6	4.8	4.3	3.3	2.5	4.1	4.7	1.1	0.9	24.0	22.7
COAL IN	Coal India	Buy	400	278	28,203	12.5	10.0	9.1	5.5	4.4	5.0	5.5	3.1	2.7	33.6	32.2
HPCL IN	Hindustan Petroleum	Buy	320	227	1,239	4.1	8.5	7.5	8.6	6.9	4.4	4.7	0.6	0.5	6.7	7.3
IOCL IN	Indian Oil	Buy	303	203	7,935	1.7	9.9	7.2	8.3	5.7	3.0	4.2	0.8	0.8	8.4	10.8
ONGC IN	Oil & Natural Gas Corp	Outperform	305	276	37,933	13.3	9.3	7.2	4.3	3.4	3.4	3.4	1.4	1.2	15.9	18.2
OINL IN	Oil India	Buy	600	470	4,543	2.6	7.8	7.4	4.6	4.0	4.2	4.5	1.3	1.2	17.8	16.8
PLNG IN	Petronet LNG	Outperform	145	122	1,465	2.4	11.9	12.1	7.3	6.1	1.5	1.5	1.8	1.6	16.1	14.1
RIL IN	Reliance Industries	Hold	945	865	44,901	40.1	12.4	11.0	7.5	6.7	1.0	1.2	1.4	1.3	11.9	12.1
FOOD, BEVERAGE & TOBACCO																
ITC IN	ITC	Outperform	392	315	40,265	34.8	27.9	23.2	18.6	15.3	2.0	2.3	9.5	8.3	36.2	38.0
NEST IN	Nestle India	Outperform	5,988	5,335	8,269	5.0	42.8	36.3	24.5	21.1	1.3	1.9	23.9	21.4	60.9	62.2
UNSP IN	United Spirits	Sell	463	2,699	5,461	40.7	215.2	105.6	34.7	29.0	0.1	0.1	7.0	6.7	3.5	6.5
HOUSEHOLD & PERSONAL PRODUCTS																
CLGT IN	Colgate-Palmolive India	Underperform	1,175	1,356	2,965	2.5	39.8	33.5	28.9	23.4	1.9	2.3	34.0	30.6	89.9	96.1
DABUR IN	Dabur India	Outperform	185	167	4,715	4.5	31.0	25.3	23.7	19.4	1.1	1.3	10.9	8.6	39.2	38.1
MRCO IN	Marico	Outperform	239	216	2,134	1.3	40.5	31.5	28.1	21.3	0.7	1.0	11.6	9.2	31.8	32.6
MATERIALS																
APNT IN	Asian Paints	Hold	525	489	7,547	9.6	33.7	28.0	21.6	17.8	1.3	1.8	11.6	9.9	37.5	38.1
BHUS IN	Bhushan Steel	Hold	463	476	1,734	0.7	9.9	6.7	10.8	7.6	0.1	0.1	1.1	1.0	12.4	15.6
HNDL IN	Hindalco Industries	Underperform	114	119	3,938	16.1	8.3	8.0	8.7	7.5	1.3	1.4	0.6	0.6	7.6	7.3
HZ IN	Hindustan Zinc	Buy	159	132	8,949	2.5	8.3	7.8	4.5	3.6	2.4	2.7	1.5	1.3	19.3	17.8
JSP IN	Jindal Steel & Power	Buy	343	255	3,839	11.1	7.1	6.6	8.5	7.5	0.6	0.7	1.0	0.9	14.8	13.9
JSTL IN	JSW Steel	Hold	819	994	3,862	12.9	19.1	15.6	6.7	6.5	1.0	1.0	1.4	1.3	7.4	8.8
SSLT IN	Sesa Sterlite	Outperform	201	199	9,465	24.8	5.3	4.6	4.7	4.1	1.5	1.8	0.7	0.6	23.0	14.9
TTCH IN	Tata Chemicals	Buy	372	266	1,089	1.6	8.5	7.3	5.2	4.4	3.6	3.6	1.0	0.9	12.0	12.9
TATA IN	Tata Steel	Buy	416	413	6,442	38.1	10.8	8.1	7.0	6.2	2.3	2.3	1.5	1.3	10.2	12.4
TELECOMMUNICATION SERVICES																
BHARTI IN	Bharti Airtel	Hold	350	329	21,132	24.2	38.9	19.0	6.8	5.7	0.3	0.3	2.2	2.0	6.0	11.0
IDEA IN	Idea Cellular	Sell	133	163	8,658	14.2	26.8	20.4	7.5	6.4	0.4	0.5	3.3	2.9	13.1	15.2
RCOM IN	Reliance Communications	Sell	80	132	4,370	16.5	31.3	24.7	7.9	7.1	0.4	0.4	0.8	0.8	2.5	3.1
UTILITIES																
ADANI IN	Adani Power	Hold	50	37	1,281	4.4	n.a.	15.7	39.7	8.8	-	-	1.8	1.6	n.a.	10.9
GAIL IN	GAIL India	Buy	410	340	6,930	4.8	9.8	10.2	6.9	6.9	3.0	2.9	1.6	1.4	17.1	14.8
GUJS IN	Gujarat State Petronet	Buy	80	59	530	0.5	8.3	9.2	4.1	3.8	1.7	1.7	1.0	0.9	12.8	10.5
IGL IN	Indraprastha Gas	Hold	369	268	604	1.2	11.9	11.3	6.6	5.9	1.9	2.1	3.0	2.5	28.1	24.4
NTPC IN	NTPC	Buy	178	132	17,497	11.5	10.2	9.6	9.4	8.1	4.4	3.6	1.4	1.2	13.9	13.5
RPWR IN	Reliance Power	Underperform	65	71	3,215	8.9	19.8	12.8	20.0	9.6	-	-	1.0	0.9	5.3	7.7

Source: Bloomberg, Daiwa forecasts

Indonesia – Underweight

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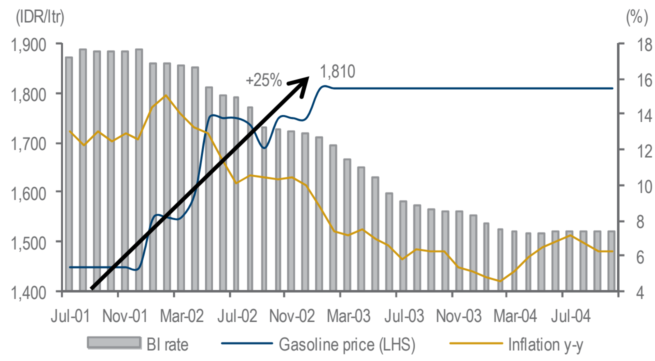
End-2014 target for MSCI Indonesia: 5,650 (+15.3%)

While Daiwa is cautious on the Indonesia market from a regional strategy perspective, Bahana's on-the-ground view is markedly more bullish:

Over the next 6-9 months, we expect overall market improvements on the back of:

- Improving IDR:USD exchange rate on the back of a better current-account deficit due to:
  - Fewer imports as the economy slows,
  - Higher exports as the economies around the globe recover,
  - Continued high foreign direct investment, as companies relocate from China, into Indonesia,
  - Potential funds inflows given the currently marked underweight positions of foreign fund managers if election euphoria occurs.
- Interest rates peaking with the possibility of lower inflation as medium-term government policy responses come into effect.
- The bottoming-out of corporate earnings.
- A clearer political roadmap; we would expect a PDI-P win to improve market sentiment. This would be accomplished through the appointments of strong technocrats as ministers. Additionally, PDI-P has had a strong track record (ie, Megawati Sukarnoputri was not averse to raising fuel prices when she was in power in 2001-04).

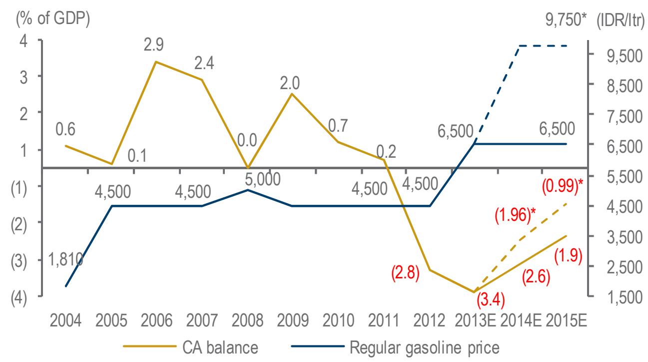
■ **Indonesia: fuel prices during Megawati's presidential term**



Source: Ministry of Home Affairs and various news sources

In our view, a further fuel price hike to the current market level of IDR9,750/litre could improve not only the 2015 current-account deficit from 1.9% to less than 1%, but also significantly boost market sentiment.

■ **Indonesia: impact of higher fuel price on current-account deficit**



*Source: CEIC, *CA deficit if subsidised fuel prices are raised by 50%*

Hence, our end-2014 target for the MSCI Indonesia is 5,650, supported by our 2014 forecast of 15% YoY for the index EPS growth, and election euphoria.

How to beat the index

Consumer staples sector (Overweight)

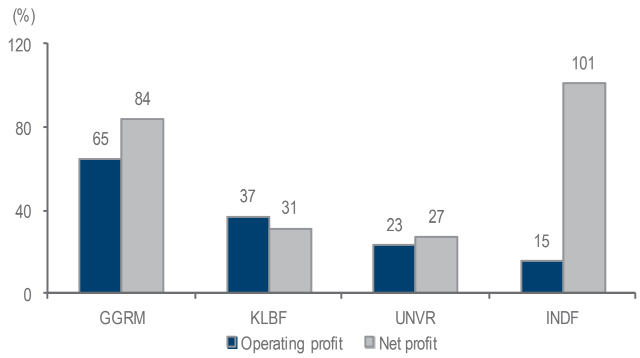
Indonesia's consumer market is likely to see continued long-term burgeoning growth, given the pace of accelerated urbanisation, rapid growth in modern trades (retail segment) and expanding FMCG sales. The country is the fourth-largest consumer market in Asia ex-Japan (behind China, India and Korea), with 2014E GDP/capita of USD4,000 and 253m people (only 12% are older than 55).

In the lead-up to the July 2014 elections, we expect the consumer-staple stocks that we cover to benefit from election spending, resulting in well-supported domestic consumption, despite Bank Indonesia's (BI) current tight monetary policy. Additionally, continued infrastructure development and FDI inflows should create an environment that fosters macro and micro growth.

At this stage, we think the consumer-staple companies will benefit in 2014 from lower raw-materials prices and prefer those with strong balance sheets so that they can deal with higher interest rates. The following chart also shows that consumer staple stocks managed to book extremely solid earnings growth during the financial crisis back in 2009, when GDP growth of Indonesia plunged to just 4.6%.

Hence, we like Unilever Indonesia (UNVR IJ, IDR26,500, Buy), Gudang Garam (GGRM IJ, IDR42,500, Buy), Kalbe Farma (KLBF IJ, IDR1,320, Buy) and Indofood Sukses Makmur (INDF IJ, IDR6,700, Buy).

■ Indonesia Consumer Staples Sector: (YoY growth, 2009 during the time of the global financial crisis)



Source: companies

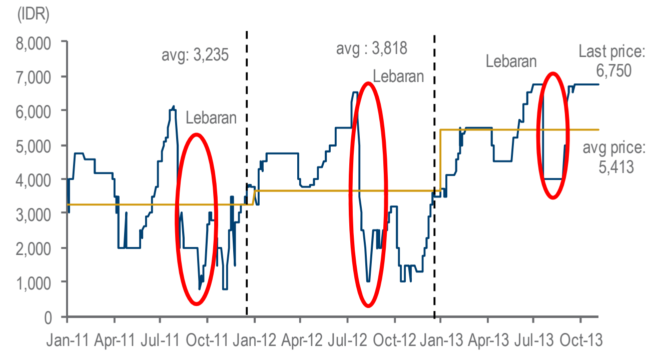
Poultry sector (Overweight)

Going into 2014, the negative impact of USD:IDR exchange rate volatility on the sector's earnings should be minimised, as every company that we cover applies pricing on a cost-plus basis, enabling higher prices to be passed onto respective customers. This is important as 75% of the poultry sector's total COGS comprises imported commodities, such as corn and soybean meal.

Regardless of the impact of seasonal factors (the fourth quarter of the year is usually the worst-performing), the prices of day-old chicks and chickens have stayed strong, paving the way for margin enhancement in 2014. Margins should be supported by higher poultry-feed selling prices, coupled with the stronger IDR.

Fundamentally, we still like the sector given Indonesia's low chicken consumption/capita compared with its neighbouring countries. This should allow for poultry plays to record continued market outperformance. We advise investors to Overweight the sector. In terms of individual stocks, we prefer Japfa Comfeed Indonesia (JPFA IJ, IDR1,270, Buy) and Malindo Feedmill (MAIN IJ, IDR3,250, Buy) due to their low valuations.

■ Indonesia Poultry Sector: price of day-old-chicks



Source: pinsar

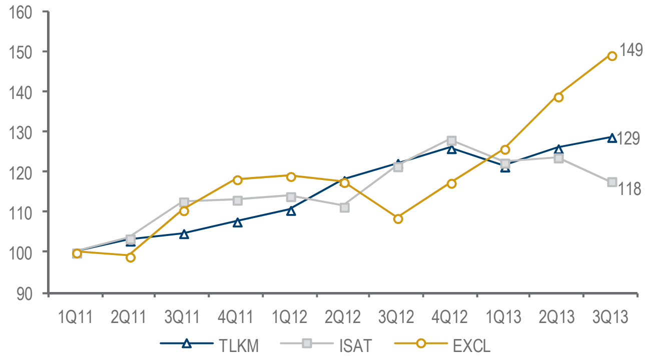
Telecommunications sector (Overweight)

Going into 2014, we are positive on the telco sector mainly due to: 1) the higher phone usage that we see relating to the elections to coordinate political rallies and campaigns (ie, including prepaid cards/phone vouchers distributed by political parties to potential grass-root voters), 2) our expectation that the industry consolidation will continue, and 3) the sector having a defensive business model amid the protracted global economic uncertainty. We also like telco derivatives, such as the phone voucher-distribution business.

Given the severe pricing competition that we saw over 2008-10, we expect the smaller telco players to experience continued negative earnings growth currently, resulting in further industry consolidation on the back of the EXCL-Axis M&A at the end of September 2013. Going forward, we expect to see further industry consolidation, leading to healthier pricing competition over the longer run.

We have an Overweight sector rating and Telekomunikasi Indonesia (TLKM IJ, IDR2,125, Buy) is our top pick in the telecoms operator space. In terms of telco derivatives, we also like Tiphone Mobile Indonesia (TELE IJ, IDR640, Buy) given its resilient business model and its efforts to increase margins by entering the middle-upper market segment within the mobile-phone distribution business.

■ Indonesia Telecos Sector: subscriber base (rebased)



Source: companies

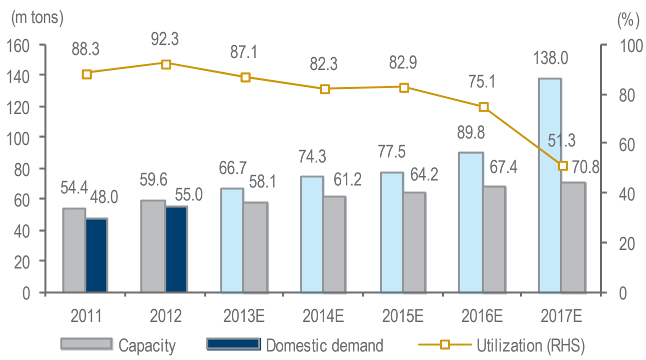
Cement sector (Underweight)

Given the likely softening in domestic cement consumption that we see in 2014, on the back of a slowdown in the property market and potential delays in infrastructure projects due to the government's efforts to cut the budget deficit, we forecast a 2013-15 sales volume growth of less than 6%, compared with 14.5% YoY for 2012 and 17.7% YoY for 2011.

We expect around 78m tonnes of new capacity from incumbents and new players to come on stream over 2013-17. Note that 59% of these cement projects have secured licences and/or started construction. This oversupply is likely to limit the flexibility of the producers to adjust prices in response to cost hikes, causing margin compression.

We have an Underweight rating on this sector, and prefer the big cement producers such as Semen Indonesia (SMGR IJ, IDR14,350, Hold) and Indocement Tunggal Prakarsa (INTP IJ, IDR20,000, Hold), which have better pricing power on the back of their stronger brand loyalty. The main risk to our call would include possible delays to new players entering the local market.

■ Indonesia Cement Sector: domestic volume and capacity



Source: Indonesia Cement Association, Bahana forecasts

Coal sector (Underweight)

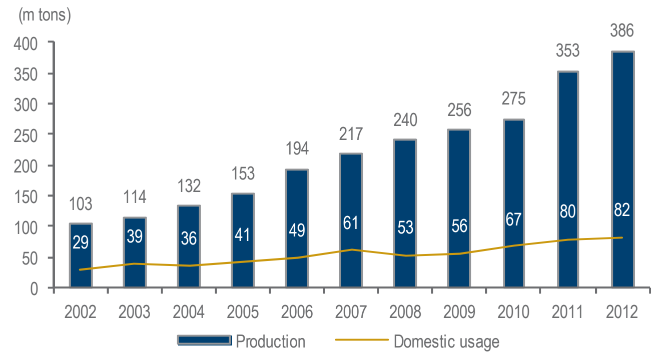
Although China's coal-production growth in 2014 is likely to slow, the absolute level should remain high by global standards. Similarly, we expect Indonesia to produce 400m tonnes of coal for 2013E and to continue to ramp up production in 2014E to 420m tonnes. With no production cuts, we believe oversupply will linger, depressing the coal price.

We think the price of coal will be range-bound in 2014 – any further decline (to less than USD80/tonne) would lead to unattractive producer profitability, resulting in reduced production. Thus, we forecast an average coal-price benchmark of USD81/tonne for 2014.

In Indonesia, policy risks have clouded the coal miners' future as the government is set to increase royalties for Ijin Usaha Pertambangan (IUP) or mining licence holders in 2014 (to 9-13.5% from 3-7% currently, based on our estimates) to boost the revenue it receives from the coal-mining sector. Thus, we reiterate our Underweight call on the sector, particularly given the risk of China's current migration to renewable energies.

Although we have Reduce ratings for all the coal counters under our coverage, our top Sell is Bukit Asam (PTBA IJ, IDR10,000, Reduce) as the company is likely to suffer as it moves from CIF to FOB terms for its domestic sales, leading to an average local price decline of 32% YoY.

■ Indonesia Coal Sector: production and local consumption



Source: Indonesia Cement Association, Bahana

Key stock calls

Top buys

Bank Central Asia (BBCA IJ, IDR9,500, Buy). Amid tight monetary policy, BBCA, Indonesia's largest bank by market cap, is the safest bank for investors, in our view, given that its gross NPLs are equivalent to less than 1% of total loans. This, coupled with an ROAE of 23-25% for 2013-15E and an EPS CAGR of 16% for 2013-15E, should mean a continued premium valuation. Our 12-month target price of IDR11,500 is based on a 2014E PBR of 3.7x, while we forecast ROE of 23%.

As one of Indonesia's domestic transactional banks, BBCA continues to maintain its liquidity with an LDR of less than 80% and a CASA ratio of more than 75% of total deposits. This allows BBCA to benefit from a competitive cost of funding and the current high interest-rate environment.

BBCA's exposure to the top-tier debtors should ensure that loan quality remains strong in 2014 while low lending rates should provide flexibility for upward adjustments in response to increased funding costs, allowing for margin expansion in 2014-15E. The bank's sustainable long-term earnings growth should be backed by its ability to preserve a low level of NPLs and maintain a positive mix in its loan portfolios.

Telekomunikasi Indonesia (TLKM IJ, IDR2,125, Buy). TLKM's 50% share of the domestic cellular market through its 65%-owned Telkomsel (35% owned by Singtel) clearly shows the incumbent's dominance. Going forward, a greater focus on its core business could mean that TLKM's stranglehold on both the mobile and fixed-line segments is unlikely to diminish despite the intense competition.

TLKM divested its pay-TV business in July 2013, and will also divest its tower business in the future. In our view, the new management of TLKM is proactive, and should work to maintain TLKM's superior brand image and network coverage, which should translate into strong data growth ahead. Additionally, we expect the unlocking of value within its huge landbank to pave the way for higher-than-expected dividend yields in the future.

TLKM is trading at a compelling 2014E EV/EBITDA multiple of 4.8x, which is about a 25% discount to the average 6.3x EV/EBITDA multiple that we assign to its peers in the region. Our 12-month target price of IDR2,900 is based on this 2014 EV/EBITDA multiple of 6.3x (we believe the stock deserves to trade at least on par with its regional peers).

Gudang Garam (GGRM IJ, IDR42,500, Buy). With around a 22% market share, GGRM is retaining its status as Indonesia's second-largest *kretek* (clove) cigarette maker. As the demand is falling for hand-rolled cigarettes, we believe GGRM is well placed to benefit operationally as 86% of its products are machine-rolled, up from 82% in 2012.

Going into 2014, GGRM will continue to implement its restructuring measures through greater advertising and promotions and its continued focus on the mild (low tar – low nicotine) segment. GGRM is establishing a serious presence in Indonesia's light/mild cigarette segment through the success of Surya Pro (a top-5 brand in its category) and the introduction of GG Mild in April 2013. We expect solid 2014 EPS growth of 16% YoY despite a competitive market.

Trading at 2014E PER of 16.8x, which is a 2% discount to its regional peers, GGRM is the cheapest big-cap consumer play under our coverage, which we believe has fully priced in concerns relating to slower volume growth, higher clove prices and stricter government policies on smoking.

Top sells/shorts

United Tractors (UNTR IJ, IDR19,550, Reduce). UNTR should continue to see lacklustre earnings growth in 2014, as 82% of its businesses is exposed to the coal/mining sectors. However, we expect its 2014 heavy-equipment sales to recover slightly to 4,751 units, up 5% YoY, on an improved contribution from the construction and plantation segment, with sales for the mining segment remaining flat.

On the mining contracting front, Pama Persada, a wholly owned subsidiary, should book a lower stripping ratio of 7.5x (2013E: 8.2x), based on our forecast, in line with the coal companies' move to improve efficiencies. Mining-revenue contribution should decline from 60% for 2013E to 57% in 2014E, as most of the coal players plan to renegotiate down Pama's mining fees.

We expect to see minimal 2014 operating-profit contribution from the coal-mining business as the price of coal should remain flat at USD81/tonne, based on our estimates. Despite the lacklustre coal-price outlook that we see for 2014, we have a DCF-based 12-month target price of IDR15,000 (WACC: 13%), implying 23% downside potential.

Holcim Indonesia (SMCB IJ, IDR2,325, Reduce) is Indonesia's third-largest cement producer with 8.7m tpa in capacity currently and should complete the first phase of its full-line 1.7m tpa cement plant in Tuban, East Java, in 1Q14. This would provide much-needed volumes following capacity constraints in 2011-12. The second phase in Tuban would add a further 1.7m tpa, with completion due in 1H15.

However, SMCB's earnings should be heavily affected by increasing trademark and franchise fees (2012: 0.7% from sales; 2013E: 4.0%; 2014E onwards: 5.0%), coupled with a weakening IDR against the USD, higher clinker imports, and more costly transportation costs.

Despite the additional volumes, we believe SMCB will face challenges due to increasing competition in Java from existing and incoming players, as well as lower pricing power due to slower demand. Our 12-month IDR1,700 target price implies a 2014 PER of 11.8x, a 10% discount to the sector 2014E PER.

Ramayana Lestari Sentosa (RALS IJ, IDR1,120, Reduce). Amid IDR weakness and cost pressures, RALS, Indonesia's largest low-end department-store chain with 119 stores as at 10M13, is increasing the scale of its higher-margin consignment business as part of its turnaround strategy (9M13 gross margin: 26.2%; 9M12 gross margin: 25.7%).

However, an earnings drag is likely to come from weak SSS growth of just 1% for 10M13, hurt by worse-than-expected store performances around the country (excluding Java). Hence, store expansions have been mainly concentrated in the Java region.

RALS has never benefited from election spending in the past, and sales growth has been constrained by intense competition from the mini markets, cheap Chinese imports and hypermarkets selling basic clothing. The stock's YTD underperformance is likely to persist, and we see only single-digit percentage EPS growth for 2014-15E. Our 12-month target price of IDR850 is based on 2014E PER of 15x 2014.

Top alpha generator (non-index pick)

Sri Rejeki Isman (SRIL IJ, IDR235, Buy), widely known as Sritex, is Indonesia's largest integrated textile manufacturer (from spinning to finishing final garments). It is currently in an operating sweet spot, enjoying the benefit of demand displacement out of China as companies relocate to Southeast Asia due to more favourable labour conditions.

Hence, SRIL managed to obtain an order worth USD25m from Uniqlo in 2013. By 2015, orders from Uniqlo could reach USD100-150m (or up to 46% of SRIL's 2013 top line, based on our estimates). On the local front, SRIL should benefit from an increase of military uniform orders in 2014 and beyond.

In 2013-15, faster-than-expected earnings growth should materialise from SRIL's IDR723b (USD61m) recent purchase of Sinar Pantja Djaja (SPD), an affiliated spinning company. We value the SPD acquisition at 10x 2014 PER, and think it should enhance earnings. Our 12-month target price of IDR310 is based on the average of its regional peers', at 2014E PER of 12x.

What could go wrong?

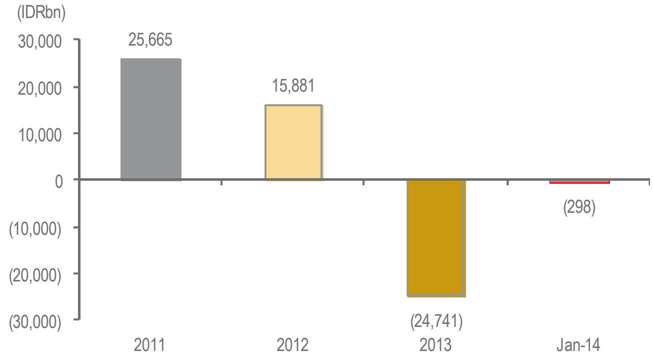
Currency, interest-rate and tapering risks

A weaker IDR:USD exchange rate is not good for the overall market as we estimate every 1% depreciation in the IDR:USD would erode the index EPS by 1.1%, while every 1% higher interest rates would lower market EPS growth by 0.7%.

■ IDR:USD exchange rate (Jul 2004 - Jan 2014)

Source: Bloomberg

■ Monthly foreign equity capital flow in JCI, 2011 – ytd



Source: Bloomberg, data as at 3 January 2014

With the Fed tapering ahead, fund flows back to the US would mean a stronger short-term USD. In this regard, the net foreign funds outflow in 2013 amounted to nearly IDR25tn (USD2bn), more than wiping out 2012's foreign net inflow of almost IDR16tn (USD1.7bn). This, coupled with the 3Q13 current account deficit at 3.8% of GDP, means that the local currency should remain under pressure in the short term.

This is very much in line with our finding from our recent overseas roadshow: most fund management companies are already underweight in Indonesia, some with zero positions. On a more positive note, severe underweight positions on Indonesia would suggest there is minimal downside risk for the market. Closer to home, large domestic institutional fund managers that we visited recently have cash on hand and are looking for re-entry points in the lead-up to the 2014 election period.

Political risks

In the lead-up to the 2014 elections, the political climate is likely to heat up. However, we expect cooler heads to maintain stable conditions on the ground.

Following Susilo Bambang Yudhoyono's final term, the political situation on the ground remains fluid, with no political party in a position of dominance.

There will be 12 nation-wide parties and 3 local parties competing in the legislative election. Interestingly, we note that almost 28% of eligible voters in 2009 did not cast their ballots.

■ **2013-14 elections: estimated schedules**

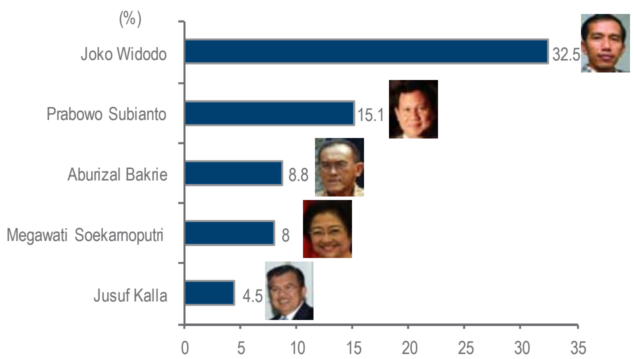
Event	Legislative	Presidential
Candidates registration	9-15 Apr 2013	May-14
Candidates announcement	4-Aug-13	May-14
List of voters' finalisation	21 Sep '13-5 Mar '14	Mar-14
Election campaigns	11 Jan-5 Apr 2014	Jun-Jul 2014
		Sep 2014*
The election	**9-Apr-14**	**9-Jul-14**
		Sep 2014*
Results announcement	7-9 May 2014	Aug-14
		Oct 2014*
Inaugural ceremony	Jul-Oct 2014	21-Oct-14

*Source: Bahana estimates; *second round if necessary*

The legislative election campaign will run from 11 January to 5 April 2014, with the election to be held on 9 April. Meanwhile, the presidential campaign will begin in June 2014, with the election on 9 July 2014.

We expect to see the PDI-P returned to power, with Joko Widodo (Jokowi) as arguably the most electable presidential candidate. Prabowo's party, Gerindra, is the wildcard for the 2014 general elections, in our view.

■ **Presidential candidates survey, by popularity**



Source: Kompas' research

The political dynamics in the 2014 general elections could depend on Gerindra. If the party's votes were to be well below its target of 20%, Prabowo could face difficulty in forming a coalition, allowing Megawati to run in the presidential election.

We also expect Aburizal Bakrie to run in the election, supported by Golkar's political strength at the provincial levels.

While interesting dark-horse candidates could emerge in this type of scenario, we note that during Megawati's term, Indonesia's economy did well.

If Gerindra's votes were to meet the party's 20% target, we would expect a more heated political race as Prabowo would likely be able to run as a presidential candidate without the need for a coalition.

Backed by a high level of public approval and popularity, Joko Widodo would be the only main contender against Prabowo in gaining presidential votes. In this scenario, we think Megawati would not run.

It will be interesting to see whether large parties like PDIP, Golkar and Demokrat form coalitions in order to win.

We are hopeful that the new president will be market-friendly and pro-democracy, bringing reforms which should bode well for both economic growth and the markets.

Market risks: valuation still not cheap

Despite the recent correction in the MSCI Indonesia index of around 20% from its recent peak, the market is now trading at 2014E PER of 16.0x, still higher than the regional average of 14.1x. However, if we exclude UNVR's high 2014E PER of 34x and its high market cap (fourth-largest amounting to USD16.9bn), the valuation would drop to 14.7x, closer to the 2014 regional average, which makes it more attractive to us.

We expect the 2014 market EPS to grow by 15.1% YoY, which is slightly higher than what we see for the regional average. However, we forecast a PEG of 1.1x, which is more reasonable than the regional average of 1.2x (based on Bloomberg). The PEG would drop to an attractive level of 0.9x, if we were to exclude UNVR from our calculations.

■ Valuation comparison

Bloomberg code	Company name	Rating	Target price (IDR)	Share price (IDR) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER		EV/EBITDA (x)		Dividend Yield (%)		PBR (x)		ROE (%)	
							13E	14E	13E	14E	13E	14E	13E	14E	13E	14E
Aviation																
GIAA IJ	Garuda Indonesia	Buy	750	485	921	0.2	72.6	11.9	7.4	4.5	-	-	0.9	0.9	1.1	7.0
CASS IJ	Cardig Aero Service	Buy	1,010	820	144	0.0	15.5	12.0	4.1	3.3	2.3	2.9	5.5	4.3	40.1	40.0
Automotive																
ASII IJ	Astra International	Hold	6,800	6,750	22,925	13.2	14.7	12.8	13.2	11.7	3.1	3.5	3.4	2.9	24.4	24.3
IMAS IJ	Indomobil Sukses International	Reduce	4,000	4,775	1,108	0.1	18.1	18.7	27.6	24.6	1.4	1.3	2.2	2.0	13.0	11.2
GJTL IJ	Gajah Tunggal	Reduce	1,500	1,690	494	0.5	n.a.	7.2	5.6	5.7	-	1.0	1.1	1.0	n.a.	14.8
Banks																
BBCA IJ	Bank Central Asia	Buy	11,500	9,500	19,650	9.0	16.6	14.7	na	na	1.4	1.5	3.7	3.1	24.6	23.0
BBRI IJ	Bank Rakyat Indonesia	Buy	9,000	7,250	15,004	20.1	8.7	7.8	na	na	2.3	2.6	2.3	1.8	28.6	25.9
BMRI IJ	Bank Mandiri	Buy	9,000	7,800	15,268	19.8	10.5	9.6	na	na	1.9	2.1	2.1	1.8	21.3	19.8
BBNI IJ	Bank Negara Indonesia	Buy	5,300	3,850	6,023	6.7	8.1	7.4	na	na	2.5	2.7	1.5	1.3	19.1	18.5
BDMN IJ	Bank Danamon	Reduce	3,000	3,750	3,015	1.3	9.0	8.7	na	na	2.8	2.8	1.1	1.0	13.4	12.6
BTPN IJ	Bank Tabungan Pensiunan Nasional	Hold	4,300	4,400	2,156	0.1	10.7	9.7	na	na	-	2.1	2.5	2.0	26.9	23.0
BBTN IJ	Bank Tabungan Negara	Hold	1,000	890	789	0.8	6.6	6.0	na	na	3.0	3.3	0.8	0.8	13.3	13.1
BJBR IJ	Bank Jabar Banten	Buy	1,000	880	716	0.6	5.9	5.3	na	na	8.3	8.8	1.3	1.1	22.8	22.2
BJTM IJ	Bank Jatim	Buy	420	385	482	0.1	6.2	5.7	na	na	10.6	11.4	1.0	0.9	16.2	16.5
BBKP IJ	Bank Bukopin	Hold	600	630	562	0.6	5.3	6.3	na	na	3.6	3.6	0.9	0.8	15.7	13.5
Cement																
SMGR IJ	Semen Gresik	Hold	13,600	14,350	7,141	8.9	15.7	14.6	10.4	10.1	2.6	2.6	4.2	3.6	28.9	26.5
INTP IJ	Indocement	Hold	18,400	20,000	6,177	4.3	14.7	13.7	9.0	8.5	2.4	2.5	3.2	2.8	23.8	21.9
SMCB IJ	Holcim Indonesia	Reduce	1,700	2,325	1,495	0.5	21.1	16.1	15.1	14.4	1.7	2.2	2.1	1.9	9.9	12.3
SMBR IJ	Semen Baturaja	Hold	350	340	281	0.2	10.0	9.5	3.9	6.3	1.8	2.1	1.3	1.2	17.0	13.1
Coal																
UNTR IJ	United Tractors	Reduce	15,000	19,550	6,118	4.4	14.9	13.6	6.5	6.2	2.7	2.9	2.3	2.1	15.9	15.9
ADRO IJ	Adaro Energy	Reduce	1,010	1,010	2,710	6.4	10.9	10.8	5.0	4.5	3.5	3.7	1.1	0.8	8.0	8.1
ITMG IJ	Indo Tambangraya Megah	Reduce	22,250	27,150	2,574	2.8	12.1	12.0	5.3	6.1	7.0	6.6	2.8	2.7	24.4	23.4
PTBA IJ	Tambang Batubara Bukit Asam	Reduce	10,000	10,000	1,933	2.5	13.3	12.2	9.9	8.5	4.9	4.9	2.7	2.4	20.2	20.7
BUMI IJ	Bumi resources	Reduce	250	305	532	3.1	n.a.	n.a.	6.8	6.0	-	-	n.a.	n.a.	na	nm
Cons. & toll roads																
JSMR IJ	Jasa Marga	Buy	6,450	4,625	2,638	3.3	22.6	18.7	13.5	11.6	1.8	2.1	3.4	3.0	15.5	16.9
WIKA IJ	Wijaya Karya	Buy	2,000	1,660	855	3.0	18.1	15.7	8.3	7.5	1.7	1.9	3.4	2.9	20.0	19.9
CMNP IJ	Citra Marga Nusapala	Buy	3,600	3,075	568	0.2	18.7	15.1	9.7	8.5	1.2	1.5	2.3	2.0	13.4	14.3
PTPP IJ	Pembangunan Perumahan	Buy	1,350	1,170	475	2.7	13.6	12.0	4.4	3.9	2.2	2.5	2.9	2.4	22.9	21.9
WSKT IJ	Waskita Karya	Hold	435	415	335	2.2	14.9	12.9	5.4	4.7	2.3	2.3	1.8	1.7	12.8	13.4
ADHI IJ	Adhi Karya	Buy	2,475	1,500	227	3.8	8.3	7.2	3.1	2.9	3.6	4.2	1.9	1.6	25.0	23.9
TOTL IJ	Total Bangun Persada	Buy	750	540	154	0.4	10.7	8.8	4.9	4.1	4.7	5.7	2.5	2.2	24.9	26.9
Consumer - discre.																
SCMA IJ	Surya Citra Media	Reduce	1,770	2,600	3,189	3.2	28.8	27.0	20.0	18.5	1.7	1.9	9.7	8.3	46.4	41.4
MNCN IJ	Media Nusantara Citra	Reduce	2,000	2,600	3,075	4.8	20.2	20.1	13.7	13.4	2.2	2.2	4.2	3.8	22.7	19.9
LPPF IJ	Matahari Department Store	Buy	14,700	11,100	2,717	1.9	27.5	21.2	16.6	13.3	-	1.9	n.a.	41.7	na	na
ACES IJ	ACE Hardware	Buy	760	640	921	1.3	26.0	21.2	18.2	14.8	1.5	1.9	5.5	4.7	23.6	24.1
HERO IJ	HERO Supermarket	Reduce	2,200	2,525	886	0.1	32.3	29.8	12.1	10.5	-	-	2.0	2.0	9.3	6.9
MAPI IJ	Mitra Adiperkasa	Buy	5,750	5,500	766	1.0	26.3	21.5	9.1	8.0	1.0	0.8	3.7	3.2	15.0	16.1
RALS IJ	Ramayana Lestari Sentosa	Reduce	850	1,120	667	0.5	20.9	19.4	11.1	10.7	2.6	2.8	2.5	2.3	12.2	12.4
SRIL IJ	Sri Rejeki isman	Buy	310	235	367	0.6	11.1	9.4	7.4	6.6	-	-	1.3	1.3	16.1	14.5
RANC IJ	Supra Boga Lestari	Hold	650	660	87	0.0	29.2	25.4	15.2	11.7	0.7	0.8	2.9	2.7	9.5	10.1
Consumer - staples																
UNVR IJ	Unilever Indonesia	Buy	31,500	26,500	16,963	5.4	37.3	33.5	27.4	24.3	2.5	2.8	43.9	38.7	126.3	122.8
GGRM IJ	Gudang Garam	Buy	45,000	42,500	6,860	6.2	19.6	16.8	11.5	9.9	1.9	2.2	2.8	2.5	15.0	15.8
KLBF IJ	Kalbe Farma	Buy	1,450	1,320	5,191	7.2	34.4	29.9	21.2	18.9	1.7	2.0	8.2	7.2	25.5	25.7
INDF IJ	Indofood Sukses Makmur	Buy	7,950	6,700	4,935	6.0	26.9	13.6	9.8	7.5	3.8	4.6	2.6	2.3	10.0	18.1
ICBP IJ	Indofood CBP Sukses Makmur	Buy	12,000	10,200	4,990	2.5	24.8	21.1	13.7	11.5	1.8	2.1	4.7	4.1	19.8	20.8
TSPC IJ	Tempo Scan Pacific	Buy	3,800	3,075	1,161	0.2	21.7	20.4	14.4	13.0	2.4	2.6	3.8	3.5	18.4	17.9
ROTI IJ	Nippon Indosari Corpindo	Reduce	840	1,020	433	0.4	34.6	27.2	20.2	15.8	0.6	0.7	6.6	5.5	20.6	22.0
Industrial estates																
KIJA IJ	Kawasan Industri Jababeka	Buy	235	194	327	0.9	41.3	6.4	6.4	5.8	0.7	4.7	0.9	0.8	2.3	13.7
BEST IJ	Bekasi Fajar Industrial Estate	Buy	600	430	347	0.7	5.6	5.7	4.7	4.8	3.6	3.5	1.6	1.3	35.2	26.9
SSIA IJ	Surya Semesta Internusa	Buy	960	580	229	1.2	3.9	3.0	2.0	1.8	3.1	4.0	1.3	0.9	37.5	35.3
LPCK IJ	Lippo Cikarang	Buy	6,000	5,100	298	1.0	6.1	5.4	4.7	3.9	-	-	2.0	1.4	38.2	30.6
Metals																
INCO IJ	Vale Indonesia	Reduce	2,050	2,375	1,980	1.6	37.1	39.9	8.5	8.5	2.0	1.9	1.3	1.2	3.4	2.9
TINS IJ	Timah	Reduce	1,000	1,530	646	1.1	40.5	47.4	12.1	10.8	1.2	1.1	1.7	1.7	4.2	3.6
Oil & gas																
PGAS IJ	Perusahaan Gas Negara	Hold	4,900	4,550	9,253	10.1	10.2	10.6	6.4	5.9	5.9	5.6	1.5	1.0	37.7	32.6
AKRA IJ	AKR Corporindo	Reduce	4,150	4,475	1,457	3.3	24.8	20.3	16.8	15.5	1.4	1.7	3.5	3.1	15.5	16.2
WINS IJ	Wintermar Offshore Marine	Buy	750	640	197	0.1	10.2	7.3	4.6	3.5	1.5	2.2	1.4	1.2	14.8	18.0

Source: Bloomberg, Bahana forecasts

■ Valuation comparison (cont'd)

Bloomberg code	Company name	Rating	Target price (IDR)	Share price (IDR) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER		EV/EBITDA (x)		Dividend Yield (%)		PBR (x)		ROE (%)	
							13E	14E	13E	14E	13E	14E	13E	14E	13E	14E
Plantations																
AALI IJ	Astra Agro Lestari	Buy	28,000	23,450	3,098	2.6	28.2	12.6	13.5	8.1	1.6	3.6	3.9	3.2	14.2	27.8
SIMP IJ	Salim Ivomas Pratama	Reduce	800	800	1,061	1.0	68.5	15.1	8.7	6.0	0.6	2.7	0.9	0.9	1.4	6.1
LSIP IJ	London Sumatra Indonesia	Hold	2,000	1,840	1,053	4.5	18.6	14.0	14.1	8.9	1.6	2.1	1.9	1.7	10.6	13.1
BWPT IJ	BW Plantation	Hold	1,300	1,310	477	2.6	37.6	17.7	19.6	12.2	0.4	0.8	2.7	2.3	8.0	14.1
ANJT IJ	Austindo Nusantara Jaya	Buy	1,600	1,490	417	0.1	18.2	11.5	9.4	7.1	2.8	4.3	1.3	1.2	6.3	9.2
SGRO IJ	Sampoerna Agro	Reduce	1,300	2,000	317	0.2	38.4	21.1	11.7	8.7	0.8	1.4	1.4	1.3	3.7	6.5
Poultry																
CPIN IJ	Charoen Pokphand Indonesia	Buy	4,500	3,400	4,677	2.4	21.4	16.1	13.6	11.1	1.4	1.4	5.6	4.4	28.8	30.7
JPFA IJ	Japfa Comfeed Indonesia	Buy	1,800	1,270	1,136	0.3	14.3	10.7	8.2	7.3	1.5	1.4	2.7	2.2	20.0	22.5
MAIN IJ	Malindo Feedmill	Buy	4,200	3,250	462	1.6	19.9	12.1	9.8	8.1	1.0	1.7	4.4	3.3	35.2	42.6
Property																
BSDE IJ	Bumi Serpong Damai	Hold	1,350	1,290	1,894	2.2	9.4	12.5	7.8	8.3	2.1	1.6	2.2	2.0	26.7	16.8
LPKR IJ	Lippo Karawaci	Buy	1,020	900	1,742	8.4	17.0	15.7	13.9	12.1	1.5	1.6	1.6	1.5	10.3	9.8
SMRA IJ	Summarecon Agung	Buy	975	820	992	2.3	11.0	11.0	7.6	7.6	3.2	3.2	2.7	2.3	26.8	22.7
CTRA IJ	Ciputra Development	Buy	870	790	1,005	2.4	12.7	10.1	6.2	4.6	2.4	3.0	1.9	1.7	15.8	17.4
ASRI IJ	Alam Sutera	Buy	640	445	734	4.6	6.6	4.5	5.6	4.5	3.8	5.5	1.6	1.2	26.1	30.0
APLN IJ	Agung Podomoro Land	Buy	300	215	370	0.5	6.0	3.1	4.9	3.6	3.4	6.4	0.8	0.6	13.9	22.7
CTRP IJ	Ciputra Property	Buy	720	600	310	1.0	8.2	7.5	7.3	7.0	3.7	4.0	0.9	0.8	11.5	11.6
Steel																
KRAS IJ	Krakatau Steel	Reduce	400	485	642	0.2	na	35.3	45.8	22.0	-	-	0.6	0.6	n.a.	1.7
Telcos																
TLKM IJ	Telekomunikasi Indonesia	Buy	2,900	2,125	17,970	20.1	15.3	14.0	5.2	4.8	3.3	3.6	3.6	3.2	25.1	23.9
EXCL IJ	XL Axiata	Buy	5,500	5,200	3,723	1.4	35.8	19.4	7.0	6.2	1.3	2.6	2.9	2.6	8.0	14.0
TOWR IJ	Sarana Menara Nusantara	Buy	2,950	2,700	2,311	0.0	140.7	21.2	14.5	12.1	-	-	7.8	5.8	5.6	31.1
ISAT IJ	Indosat	Buy	4,550	4,125	1,880	2.2	n.a.	67.8	4.0	3.5	-	0.7	1.4	1.3	n.a.	1.9
TELE IJ	Tiphone Mobile Indonesia	Buy	800	640	294	0.7	14.7	10.8	9.0	6.9	2.1	2.9	3.5	2.8	25.0	28.8
ERAA IJ	Erajaya Swasembada	Hold	1,000	1,040	253	2.0	8.4	8.2	7.4	6.2	4.7	4.9	1.1	1.0	13.4	12.7
Transportation																
TAXI IJ	Ekspress Transindo Utama	Buy	1,800	1,430	257	2.3	24.4	19.2	9.0	7.3	1.1	1.4	3.9	3.3	17.0	18.7
ASSA IJ	Adi Sarana Armada	Buy	330	255	73	0.1	10.2	8.8	4.4	4.1	-	-	1.1	0.9	10.9	11.4

Source: Bloomberg, Bahana forecasts

Thailand – Underweight

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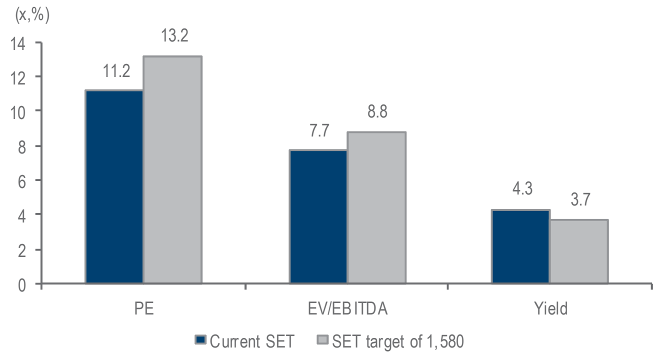
End-2014 target for MSCI Thailand: 540 (+24.8%)

Our end-2014 target for the SET index is 1,450, based on our bottom-up derived valuation for the stocks under our coverage (85% of the Thailand market's total market cap). We value the majority of our stocks using a DCF methodology, and apply SOTP, NAV and dividend discount model approaches to value the others.

The implied MSCI country target index for end-2014 from our bottom-up derived valuation is 540.

■ **SET: multiples and dividend yields – current and end-2014 targets**



Source: Thanachart forecasts

How to beat the index

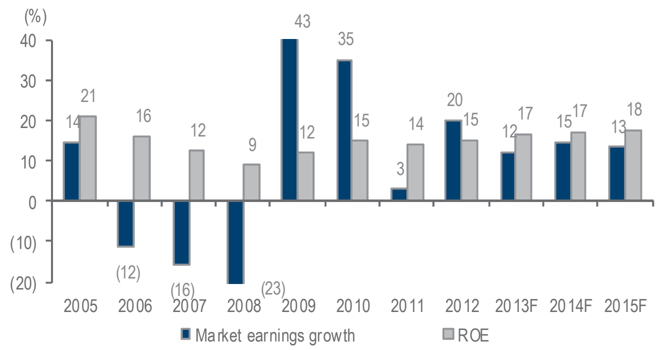
Thailand is currently in economic slowdown mode, with high short-term market risk from political turmoil. Although our year-end target is above the current SET level, we see downside risk to the SET in the near term and believe that investors should await a better entry point.

We forecast GDP growth of 2.8% YoY for 2013 and 3.2% YoY for 2014. We have factored in the current political uncertainty, but a military coup would be a downside risk to our GDP numbers.

Thailand does not have a real issue with its balance sheet, as its debt level still looks manageable with a 45% public-debt-to-GDP ratio and an average net gearing ratio of 60% for listed companies at present. We see the household-debt-to-GDP ratio having peaked, at 80%. The high ratio was driven by the government's one-off first-car/first-home policies implemented in 2012. In terms of liquidity risk as a result of the Fed's tapering now starting in January, we think Thailand will be in a far better position than many of its Asia peers, as it has excess liquidity of more than THB3tn (USD95bn), or 25% of its GDP. The Bank of Thailand could gradually release this into the system in the event of excessive capital outflows.

Despite the backdrop of a slowing economy, earnings growth for the listed companies should be in the double digits, on our forecasts. We forecast EPS growth for the SET of 14.5% YoY for 2014 and 13.2% YoY for 2015. We believe the SET's earnings quality is high, as reflected in elevated and rising ROEs.

■ **SET: earnings growth and ROE (YoY)**



Source: Thanachart forecasts

In our view, the best way to beat the SET is to be very selective in terms of stocks and underweight the heavy-weight sectors, such as energy and banks. The energy sector remains in a value trap due to a lack of both volume and pricing drivers, and the banks' ROEs have reached the peak of the current cycle, in our view.

We recommend overweight positions in telecoms, yield plays and earnings-turnaround stories.

Telecoms sector (Overweight): new earnings cycle

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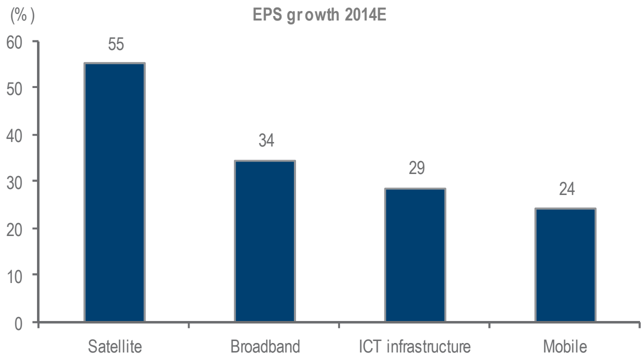
Most of the segments in the telecoms sector, ie, mobile, broadband, ICT infrastructure and satellite operators, are in both new capex and earnings-growth cycles.

▪ Telecoms sector: strong EPS growth in most segments for 2014E



Source: Thanachart forecasts

For the mobile operators, the key earnings driver for 2014 is likely to be a full-year operation of a new 3G platform. The 2G, or voice-service, platform reached saturation point some years ago, and the Thai cellular operators are now embarking on a new earnings cycle from data usage as a result of migrating to the 3G platform. Significant 3G investments started in 2013, and 2014 is the first full year of implementation. As the current data-user penetration rate is just above 20% in Thailand, the move to 3G is driving significant data-usage growth; we forecast this at 43% YoY for 2013 and 34% YoY for 2014.

Despite concerns in the market about the ongoing pricing promotions to boost data volumes, we do not expect to see margin contraction, given the significant cost savings in evidence from the shift to the 3G platform. We do not see these promotions as a price-war situation but rather as a tool to expand the data-usage base to critical mass in order to speed up migration from 2G and increase the data penetration rate under the 3G platform. While volume growth should help offset the impact of the price promotions, a lower 3G licence fee (5.25% of revenue versus 25-30% revenue-sharing under the 2G concessions) provides significant room to offer these promotions without hurting margins, in our view.

Additionally, we believe the broadband segment has strong and sustainable earnings-growth potential, given the current industry penetration rate of less than 25%.

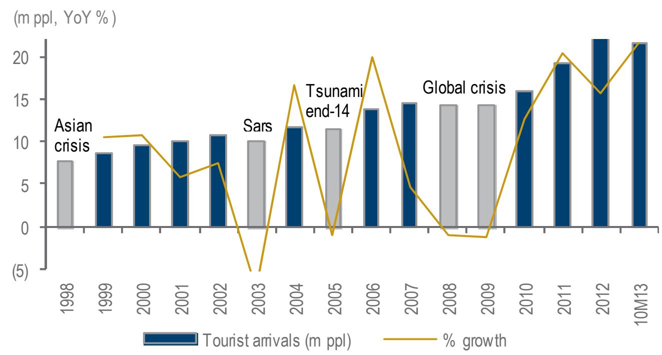
We also like the Thailand satellite operator, Thaicom (THCOM TB, THB36.75, Buy), for its earnings growth story from its new satellite launches by the end of 2013. Finally, we also like FICT infrastructure play Samart Corporation (SAMART TB, THB14.10, Buy), which we believe is in a new earnings-growth cycle.

Tourism sector (Overweight): booming

Tourism has been one of the country's most resilient industries. The number of tourists has been increasing consistently, and past natural disasters such as the Tsunami in 2004 and political turmoil have only been short-term hiccups. Growth in tourism has been driven by Thailand's relatively low cost of living and accommodation, good food, natural beauty and positive attitude towards foreigners, etc.

Thus, we believe the current political rallies that are currently having a negative effect on the tourism industry are just a short-term hiccup for only a few months.

▪ Tourism: growth trend in Thailand



Source: Department of Tourism

Of the three ways to invest in the tourism sector, we like the airports the most, followed by the hotels, but not the airlines. Our airports pick is Airports of Thailand (AOT) (AOT TB, THB145.00, Buy), while in the hotel sector our preferred pick is Central Plaza Hotel (CENTEL TB, THB25.25, Buy). We do not like the airlines due to the substantial capacity increases that have been occurring, especially from the low-cost airlines around the region, which has resulted in high competition.

The airports are the best way to invest in the tourism theme in our opinion, due to their high operating leverage, where income received from increases in passenger numbers and aircraft landing goes straight to the bottom line, after paying corporate tax.

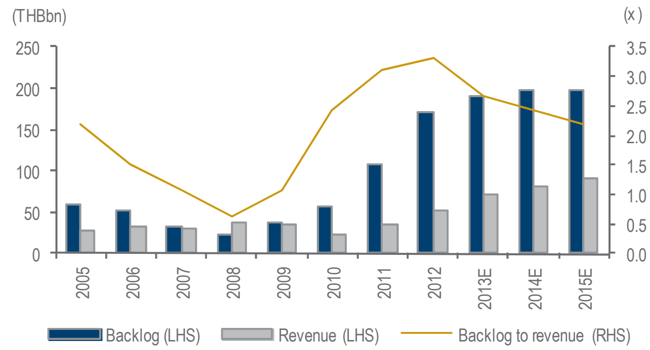
The hotel industry is also benefiting from a boom in tourism, but the new hotel supply has increased over the year and many new hotels are opening, which is diluting some of the benefit. That said, the average occupancy rate is still higher compared with the past few years. Tourist arrivals increased by 21.6% YoY in 10M13. According to the Bank of Thailand, the average occupancy rate was 64% for 10M13, versus 61% for 2012 and 57% for 2011.

Infrastructure sector (Overweight): be selective

Infrastructure stocks appear in the SET's construction and transportation constituent sectors. Given the government budget approved for 2014, we expect government spending on these sectors to see some growth in 2014, even allowing for the fact that the Thai prime minister dissolved the lower house of parliament a month ago and the present government is a caretaker one. We had earlier hoped for extra spending to be allocated given that the budget deficit-to-GDP ratio still does not look excessive, at 2.8%. However, the current political instability is likely to quash any hope of extra spending for 2014.

For the construction sector, rising government spending should be the key earnings driver for 2014, especially as the existing project backlog is at its highest ever, at well over 3x 2013E revenue based on our forecasts. Note that the sector is not only receiving work orders from the public sector but also from the private sector, including the booming power-plant construction sector. Our preferred sector stock is Sino-Thai Engineering (STEC TB, THB11.90, Buy), as it has net cash and the most transparent financial statements among its peers.

■ Construction sector: project backlog to revenue at new high



Sources: Companies, Thanachart forecasts

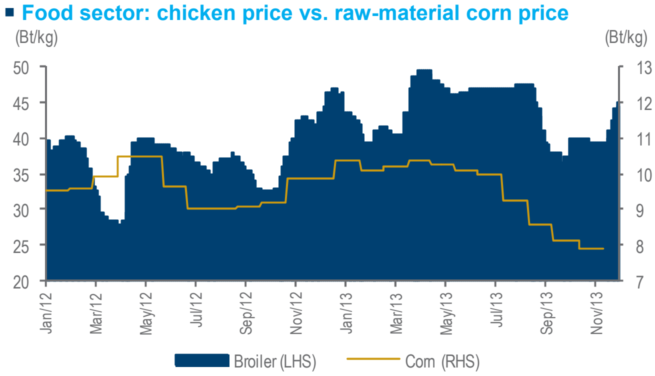
Food sector (Overweight): turnaround stories

Many of Thailand's food companies operate a mix of food and agriculture businesses, with the agriculture business the key weak spot. While chicken prices recovered to a profitable level in 2H13 from a loss-making level in 1H13, raw-material prices have declined in 2H13, so the sugar and rubber industries remain in a weak pricing cycle. Sales volumes for shrimps are low given a flare-up of the Early Mortality Syndrome (EMS), though these have started to improve since 3Q13.

The low base for the food industry in 2013 could present earnings turnaround stories in 2014. The most clear-cut earnings turnaround should be for chicken producers that are already seeing higher chicken prices, as well as lower raw-material costs. We believe GFPT Pcl (GFPT TB THB12.00, Buy) is the purest chicken investment in Thailand. As we started to see the turnaround in 2H13, we forecast EPS growth of 3,215% YoY for 2013 (albeit from a very low base) and 13% YoY for 2014. The stock trades currently at a PER of just 9.9x for 2014E based on our EPS.

Also, we expect the shrimp business to improve in 2014, though it is unlikely to return to normal production volumes. EMS is a chronic affliction that stands to limit the shrimp-production volume from returning to normal this year. However, we see two areas of likely improvement: 1) a gradual increase in the volume, which bottomed out in 2013 in our view, and 2) an increase in shrimp prices to offset the low volume. We expect the shrimp-production business to turn to a profit in 2014, versus losses in 2013. Thailand's two major shrimp producers are CP Food (CPF) (CPF TB, THB30.50, Buy) and Thai Union Frozen (TUF) (TUF TB, THB67.75, Buy). We believe both stocks offer earnings turnaround stories in 2014. We forecast an earnings turnaround at CPF on the back of improvements in its chicken and shrimp businesses and overseas operations, while TUF should benefit from improving tuna and shrimp businesses.

■ Food sector: chicken price vs. raw-material corn price



Source: Office of Agricultural of Economics, CPF

Retail sector (Neutral): not a bargain yet

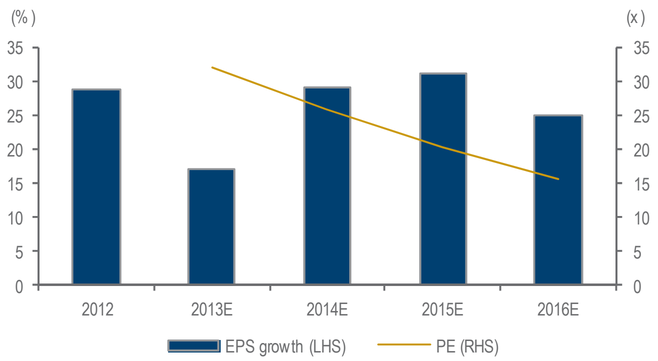
Thailand's retail sector is dealing with a slowdown in consumption. The rate of SSS growth fell from 9% YoY for 2012 to 5% YoY for 9M13, due to a consumption slowdown and aggressive expansion by stores over the past several years.

That said, despite the consumption slowdown, we still forecast strong earnings growth for the retail sector of 17% YoY for 2013, rising to 29% YoY for 2014. The key reason for the stronger growth in 2014E is the earnings-growth rebound we expect this year for CPALL (CPALL) (CPALL TB, THB40.00, Buy), after substantial interest expenses from its acquisition of Siam Makro (MAKRO TB, THB29.00, Hold) ate into its earnings growth in 2013. The sector's key earnings growth drivers for 2014 should be organic SSS growth of about 4-5% YoY, margin expansion from economies of scale and procurement power, and continued aggressive store expansion, which should allow market-share gains from traditional stores (such as mom & pop shops, building material shop houses, etc.).

Reflecting sound earnings growth, its defensive business nature and strong cash-flow generation, the sector currently trades at an 2014E PER of 25.5x, which we believe is not a bargain.

Still, we like CPALL for its earnings turnaround story, as most of the bad news flow surrounding the stock has become old news. The adverse news flow was due to the company's expensive takeover of MAKRO, which has turned CPALL from a net-cash company into one of the highest-geared constituents of the SET, with exposure to interest-rate and forex risk due to its unhedged USD-debt exposure. But as we believe the impact of this is has faded, we expect CPALL's earnings to turn around from 2014, with financial costs being brought down. Also, the policy rate was cut in December, and the company's USD unhedged debt portion is down to only 7%, reducing its forex risk exposure.

■ Retail sector: EPS growth and PER



Sources: Companies; Thanachart forecasts

Banking sector (Neutral): headwinds

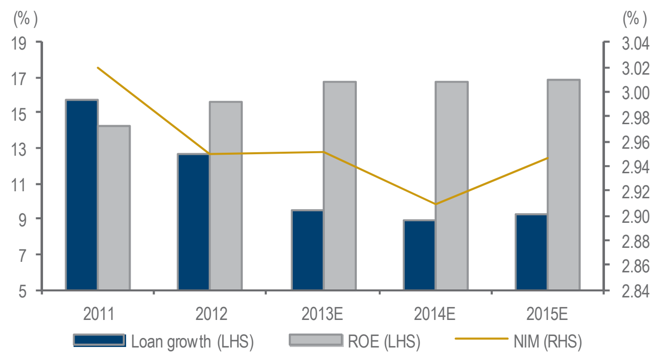
Thailand's banking sector's ROE cycle peaked in 2013 and the sector is now facing many headwinds, in our view. The major disintermediation trend seen since last year is still in place, with the following factors that are loosening the relationship between the country's economic growth and the banks' business performance.

First, the corporate bond market is becoming more liquid and popular, and this looks set to continue in 2014. Second, more companies are opting to raise money by selling assets to property and infrastructure funds (rather than taking out bank loans). Third, competition for deposits is intense, especially from the state-owned banks' so-called specialised financial institutions.

These factors represent the main risks to the banks' loan growth and margins, in our view. Given these factors, combined with continued high provisioning levels during the current economic slowdown, as well as the drop in the operating leverage effect given the sector's already-high average loan-to-deposit ratio (LDR), we believe the sector's ROE has peaked.

The December policy rate cut from 2.5% to 2.25% has also added to the pressure that Thailand banks now face.

■ Bank sector: loans, NIM and ROE



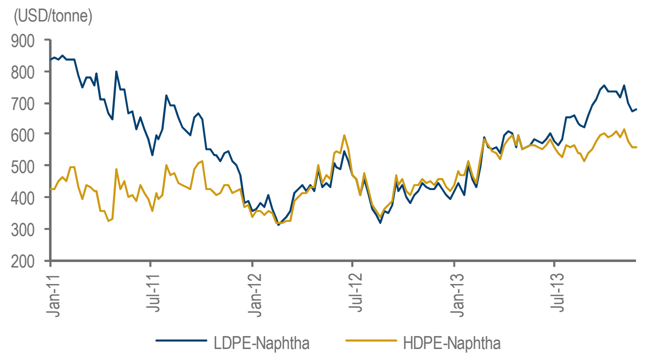
Sources: Companies, Thanachart forecasts

Energy sector (Underweight): a value trap

We think the value of the energy sector has been locked in for many years and expect this to continue into 2014. The reasons for this include a lack of clear pricing-growth and volume-growth drivers. The oil price has been range-bound for a few years, and there are no plans for major capacity expansion to drive production volume over the next 2 years.

The bright spot in this sector is the petrochemical industry, as petrochemical spreads have been recovering since early 2013. In this context, we like PTT Global Chemical (PTTGC) (PTTGC TB, THB74.75, Buy). Not only does PTTGC benefit from high petrochemical prices, it also offers a turnaround story, with plants that had been shut down (both planned and unplanned) resuming operations in 4Q13. Also, the disruptions to the gas supply that occurred in 3Q13 have subsided. As such, we expect PTTGC to report a strong operating turnaround for 4Q13, with the full sequential impact likely materialising in 1Q14.

■ Key petrochemical spreads



Source: Thomson Reuters

Key stock calls

Our key stock calls for Thailand comprise telecoms and tourism plays, as well as yield stocks and those that offer promising turnaround stories for 2014.

Top buys

Our top Buy calls are Airports of Thailand (AOT) and CPALL.

■ AOT and CPALL: target prices and valuation summary

	Current price (THB)	Target price (THB)	Norm EPS growth 2014F (%)	Norm EPS growth 2015F (%)	EV/EBITDA 2014F (x)	EV/EBITDA 2015F (x)	Yield 2014F (%)
AOT TB	145.00	245.00	25.3	15.9	10.2	9.5	2.4
CPALL TB	40.00	60.00	32.4	33.6	15.7	12.9	2.3

Sources: Thanachart forecasts

AOT. This stock is a tourism play, as well as an asset and operating-leverage play. Its key earnings drivers should be passenger/aircraft traffic growth and margin expansion from a rising utilisation rate (operating-leverage effect). Given depreciation accounts for about 35% of the company's cost of goods sold, it is also a cash-cow business. We forecast EPS growth of 25% YoY for FY14 (year-end September) and 16% YoY for FY15.

CPALL. This is our top pick among the turnaround stocks. After being hit by considerable adverse news flow following its expensive takeover of MAKRO, CPALL's fundamentals now look better for several reasons. First, the bad news flow relating to the takeover is old news. Second, weak earnings expectations due to the impact of financial fees and interest expenses on new debt incurred as part of the takeover are in line with what we expect for 2013, while we expect an earnings turnaround to start in 2014 due to lower financial costs. We forecast EPS growth of 32% YoY for 2014 and 34% YoY for 2015. Third, CPALL is a beneficiary of the recent policy rate cut due to its high gearing. Finally, its unhedged USD debt has come down from 35% to 7% of its total debt from its recent Baht bond refinancing, and we believe there is more to come. Irrespective of the bad news that has plagued the stock, CPALL owns the 2 best-performing businesses in the retail sector, in our opinion (its 7-eleven convenient-store chain and MAKRO cash-and-carry business).

Top shorts/sells

TRUE. Thailand's third-largest mobile operator, TRUE has been loss-making for many years and we expect it to remain so into 2015. Though we expect TRUE's infrastructure fund (IFF) launched in December 2013 to bring about a marked improvement on the company's balance sheet, we believe market expectations of the benefit of this fund are too high. To us, the IFF is just a way to avoid the need to raise more equity. We expect TRUE's interest expenses to fall with a lower debt level, but note that with the additional leasing fees TRUE has to pay for IFF onwards of 2014, the set-up of IFF is cash-flow dilutive for the company. As TRUE is still in the middle of a large capex cycle, we believe it will have to start new borrowing soon and thus expect its net gearing to gradually rise again. Leaving aside IFF, TRUE's operation is bleeding as strong revenue growth and lower regulatory fees are still unlikely to suffice to cover rising network costs and marketing expenses. We forecast a net loss of Bt3.2bn for 2014.

Top alpha generators (non-index picks)

MC Group (MC TB, THB11.50, Buy). MC is a jeans company set up in Thailand 38 years ago. Its own brand, Mc, is very popular, and the company is the market leader with 38% of the branded jeans market in the country. It focuses on the middle-income segment.

MC's weak SSS performance for 9M13 (down 1.3% YoY) was affected by the slowdown in domestic consumption and rising competition. However, its market-share gains through aggressive new store expansion and strong gross margin, supported by economies of scale and a rising sales mix in high-margin free-standing shops, are still core engines that should boost its EPS growth. In addition, its acquisition of Time Deco (imported branded watch and accessories shops) in October 2013 should support earnings. We forecast average EPS growth of 20% p.a. for 2014-15. Also, MC has a net-cash position and is a good dividend play, currently offering a yield of 6-7% for 2014-15E based on our dividend forecasts.

Thaicom PCL (THCOM TB, THB36.75, Buy). Thaicom is the only satellite-service provider in Thailand offering strong and clear earnings visibility for the next few years, in our view. We believe the stock offers the following key earnings drivers: 1) the launch of two conventional satellites – Thaicom 6 in December 2013 and Thaicom 7 due in 2Q14, 2) higher iPSTAR bandwidth sales, and 3) operating leverage. We forecast an EPS CAGR of 44% for 2014-15. Also, we believe THCOM's current trading EV/EBITDA multiple of 7.8x for FY14E, looks attractive compared with its earnings outlook and peers' current valuations.

What could go wrong?

The biggest risk we see to our SET target and MSCI target for Thailand is politics, which has reached the point where even the dissolution of the House in December has proved insufficient to end the current unrest in the country. When even the dissolution of the House does not resolve the unrest, the risk of political deadlock generally emerges, as does the probability of a military coup. Visibility is currently very low as to how this situation could end up.

As the current unrest is likely to have an impact on the domestic economy, we have factored this into our 2014 GDP numbers. However, a political vacuum or military coup would pose significant downside risk to our 2014 GDP forecast and SET index target.

Other risks to our numbers stem from the eventual cessation of the government's 'rice-pledging' scheme, whereby the government pays farmers a price of nearly 50% above the market price. Though in the long term we would view an end to this scheme as very positive news (as we do not think the scheme is a good one), the short-term impact of the scheme ending could be that the provincial growth story falls behind schedule. The government invests around THB270-300bn a year in the scheme, which is a lot. As such, we believe the government realises the scheme cannot continue for too many years. In fact, it has decided to cut the amount it invests for the current crop season into 2014. A further cut in the above investment would be a risk to our GDP numbers.

	Norm EPS Gr. (%)		Norm P/E (x)		EV/EBITDA or P/BV of Bank (x)		Yield (%)
	14F	15F	14F	15F	14F	15F	14F
SET	14.6	13.2	11.2	9.8	7.7	7.0	4.3
SECTORS							
Banks	10.8	13.7	8.1	7.1	1.2	1.1	4.0
Construction	18.2	25.3	15.2	12.1	9.2	7.2	3.1
Energy	8.1	4.9	8.1	7.7	4.9	4.7	4.9
Media	15.4	22.0	17.3	14.1	9.2	7.9	6.0
Food	74.8	29.6	16.0	12.3	12.3	10.4	3.2
Healthcare	11.9	12.8	25.7	22.8	17.1	15.3	2.1
Hotel	19.7	19.7	17.5	14.6	12.6	11.2	2.1
Industrial Estate	7.3	4.6	8.2	7.8	9.4	9.1	6.3
Materials	13.4	11.6	11.4	10.2	11.3	9.7	4.5
Property	14.0	13.4	8.1	7.1	10.0	8.5	6.5
Retail	24.6	26.1	23.4	18.5	14.3	11.8	2.4
Telecom	30.0	22.2	15.9	13.0	8.2	7.1	6.0
Transport	67.2	27.0	23.8	18.8	9.1	8.4	3.5
Utilities	16.3	20.9	12.0	9.9	10.6	9.1	4.8

Sources: Thanachart forecasts

Top picks	REC	Current price	Target price	Norm EPS Gr. (%)		Norm P/E (x)		EV/EBITDA (x)		Yield (%)
				14F	15F	14F	15F	14F	15F	14F
AOT	BUY	145.00	245.00	25.3	15.9	16.7	14.4	10.2	9.5	2.4
CPALL	BUY	40.00	60.00	32.4	33.6	24.6	18.4	15.7	12.9	2.3
MC	BUY	11.50	19.20	21.8	17.4	10.1	8.6	6.7	5.4	6.9
THCOM	BUY	36.75	48.00	54.8	33.8	19.6	14.6	7.8	6.4	2.3

Sources: Bloomberg, Thanachart forecasts

■ Valuation comparison

Bloomberg code	Company name	Rating	Target price (THB)	Share price (THB) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x) 13E	PER (x) 14E	EV/EBITDA (x) 13E	EV/EBITDA (x) 14E	Dividend Yield (%) 13E	Dividend Yield (%) 14E	PBR (x) 13E	PBR (x) 14E	ROE (%) 13E	ROE (%) 14E
Banks																
BAY TB	Bank of Ayudhya Pcl	Hold	38.0	29.8	5,632	12.9	10.9	9.1	n.a	n.a	3.2	3.8	1.4	1.3	13.9	15.0
BBL TB	Bangkok Bank Pcl	Buy	213.0	168.5	10,024	21.3	8.6	8.2	n.a	n.a	4.2	4.5	1.1	1.0	13.0	12.6
KBANK TB	Kasikornbank Pcl	Buy	207.0	151.0	11,262	44.9	8.7	7.8	n.a	n.a	2.3	2.6	1.6	1.4	20.5	19.5
KKP TB	Kiatnakin Bank Pcl	Buy	51.0	35.3	916	2.3	7.2	6.6	n.a	n.a	6.9	7.6	0.8	0.8	12.0	12.4
KTB TB	Krung Thai Bank Pcl	Buy	23.0	15.6	6,797	29.1	7.0	6.3	n.a	n.a	5.8	6.4	1.1	1.0	16.4	16.3
SCB TB	The Siam Commercial Bank Pcl	Hold	170.0	132.5	14,036	34.7	8.8	8.2	n.a	n.a	3.4	3.7	1.8	1.5	21.6	19.9
TISCO TB	Tisco Financial Group Pcl	Buy	45.0	37.3	929	2.3	6.6	5.7	n.a	n.a	6.0	7.1	1.4	1.1	22.4	22.0
TMB TB	TMB Bank Pcl	Buy	2.9	1.9	2,605	25.0	15.9	11.7	n.a	n.a	1.9	2.6	1.5	1.3	9.5	11.9
Construction																
CK TB	Ch. Karnchang Pcl	Buy	26.0	13.9	716	14.6	24.9	21.4	17.3	14.0	3.1	2.3	1.3	1.3	7.1	6.1
STEC TB	Sino-Thai Engineering & Construction Pcl	Buy	25.0	11.9	566	7.2	12.6	11.1	4.7	2.2	3.2	3.6	2.4	2.1	21.1	20.2
TTCL TB	Toyo-thai Corporation Pcl	Buy	65.0	30.3	453	0.9	19.9	16.4	13.2	9.0	2.4	3.1	6.1	3.1	33.1	26.6
Energy																
BANPU TB	Banpu Pcl	Buy	40.0	26.5	2,132	12.6	13.8	11.3	7.9	7.5	3.0	4.0	0.9	0.8	6.4	7.6
BCP TB	The Bangchak Petroleum Pcl	Buy	44.0	25.5	1,094	2.4	8.7	7.8	6.5	5.7	4.0	3.9	1.0	0.9	12.0	12.2
IRPC TB	IRPC Public Co Ltd	Sell	3.0	3.1	1,942	4.1	29.0	23.7	13.1	12.2	2.1	2.5	0.8	0.8	2.9	3.5
IVL TB	Indorama Ventures Pcl	Buy	28.0	19.5	2,926	19.1	24.0	12.8	10.2	8.3	1.8	2.7	1.5	1.4	6.4	11.2
PTT TB	PTT Pcl	Hold	332.0	268.0	23,856	34.6	6.9	6.7	4.9	4.6	4.9	5.2	1.1	1.0	17.2	16.0
PTTEP TB	PTT Exploration And Production Pcl	Buy	200.0	153.0	18,929	17.9	9.0	8.3	4.0	3.4	4.4	4.8	1.6	1.5	19.3	18.6
PTTGC TB	PTT Global Chemical Pcl	Buy	96.0	74.8	10,504	20.1	9.7	8.2	6.9	6.1	4.6	5.5	1.4	1.3	15.0	16.2
TOP TB	Thai Oil Pcl	Buy	77.0	50.3	3,195	7.1	7.9	8.9	7.3	7.6	5.2	5.1	1.1	1.0	14.6	12.1
Entertainment																
BEC TB	BEC World Pcl	Hold	56.5	44.5	2,774	4.0	16.1	14.3	9.5	8.4	6.0	6.8	10.3	9.7	65.8	69.8
GRAMMY TB	GMM Grammy Pcl	Sell	11.0	17.0	337	0.1	na	na	n.a	17.1	-	-	3.4	4.3	n.a.	n.a.
MAJOR TB	Major Cineplex Group Pcl	Buy	25.5	16.0	443	1.1	14.6	12.8	7.7	7.5	6.1	7.1	2.2	2.1	15.2	17.0
RS TB	RS Public Co Ltd	Buy	12.4	6.7	214	0.7	17.0	15.8	8.8	9.1	4.1	3.8	4.5	4.1	29.0	26.9
VGI TB	VGI Global Media Pcl	Buy	14.0	9.1	931	4.8	31.7	22.6	22.8	16.5	2.6	3.8	16.8	13.9	89.2	67.2
Food																
CPF TB	Charoen Pokphand Foods Pcl	Buy	36.0	30.5	7,360	14.2	50.4	18.7	39.2	14.2	1.5	2.7	2.3	2.1	4.5	11.6
GFPT TB	GFPT Pcl	Buy	15.0	12.0	469	1.5	11.2	9.9	9.5	8.0	2.7	3.0	2.2	1.9	22.0	20.9
KBS TB	Khonburi Sugar Pcl	Buy	13.5	9.2	157	0.2	8.8	6.6	5.3	4.2	4.5	6.1	1.6	1.4	19.4	22.8
KSL TB	Khon Kaen Sugar Industry Pcl	Buy	18.5	11.8	627	0.2	12.1	7.7	14.8	7.7	4.6	5.2	1.9	1.7	14.6	20.3
M TB	MK Restaurant Group Pcl	Buy	57.2	48.8	1,389	3.0	22.7	19.6	12.3	10.5	3.1	3.6	3.8	3.5	29.6	18.6
STA TB	Sri Trang Agro-Industry Pcl	Sell	11.8	12.0	479	0.7	10.0	9.3	10.5	11.0	4.0	4.3	0.8	0.7	7.9	8.1
TUF TB	Thai Union Frozen Products Pcl	Buy	77.0	67.8	2,441	5.6	26.1	15.8	16.4	12.1	1.9	3.2	2.0	1.9	7.9	12.5
TVO TB	Thai Vegetable Oil Pcl	Sell	15.7	18.8	474	0.3	16.3	14.7	12.6	10.6	5.5	6.1	2.3	2.3	14.1	15.6
Healthcare																
BCH TB	Bangkok Chain Hospital Pcl	Sell	5.7	5.7	443	0.6	22.6	19.6	12.9	11.4	2.6	3.1	3.7	3.4	16.6	18.0
BGH TB	Bangkok Dusit Medical Services Pcl	Buy	149.0	108.5	5,238	10.7	27.9	25.1	21.5	19.3	1.5	1.8	4.0	3.7	15.3	15.4
BH TB	Bumrungrad Hospital Pcl	Buy	106.0	85.0	1,934	1.5	25.7	22.8	16.6	14.7	2.2	2.4	6.5	5.7	26.9	26.8
CHG TB	Chularat Hospital Group	Buy	13.3	9.5	326	0.3	25.4	21.2	15.2	13.2	2.6	2.8	4.1	3.8	22.5	18.6
Hotel																
CENTEL TB	Central Plaza Hotel Pcl	Buy	43.0	25.3	1,062	2.5	21.7	17.0	12.2	10.9	1.7	2.2	3.3	2.9	15.8	18.0
ERW TB	The Erawan Group Pcl	Buy	6.1	3.1	240	1.6	36.0	31.4	11.2	10.6	4.8	1.2	1.6	1.5	4.9	4.9
MINT TB	Minor International Pcl	Hold	26.5	18.7	2,337	6.7	19.6	16.6	15.7	14.0	1.8	2.1	3.6	3.1	19.6	20.0
Industrial Estate																
AMATA TB	Amata Corporation Pcl	Buy	19.5	11.9	396	2.8	7.3	7.2	7.2	5.2	5.5	5.5	1.3	1.1	18.5	16.7
HEMRAJ TB	Hemaraj Land And Development Pcl	Buy	4.5	2.7	823	1.6	9.8	7.8	12.2	11.3	5.1	6.4	2.2	1.9	24.0	26.5
TICON TB	Ticon Industrial Connection Pcl	Buy	23.0	15.0	428	1.8	8.3	11.2	10.8	10.6	6.2	5.5	1.5	1.2	19.3	12.7
Materials																
DCC TB	Dynasty Ceramic Pcl	Buy	58.0	48.3	614	0.4	15.6	15.0	11.3	10.9	6.4	6.7	7.4	7.3	47.6	49.2
SCC TB	The Siam Cement Pcl	Buy	500.0	380.0	14,211	17.3	12.8	11.3	13.9	11.3	3.9	4.4	2.8	2.5	23.2	23.2
Property																
AP TB	AP (Thailand) Pcl	Buy	5.8	4.2	370	1.9	5.9	5.6	8.7	7.9	5.1	5.3	0.9	0.8	15.6	15.0
LH TB	Land And Houses Pcl	Buy	13.0	8.3	2,593	6.8	12.7	10.9	17.4	15.7	6.3	7.3	2.4	2.4	20.2	22.0
LPN TB	L.P.N. Development Pcl	Buy	23.5	15.1	694	2.7	8.7	7.9	6.9	6.5	5.8	6.3	2.3	2.0	28.3	26.7
QH TB	Quality Houses Pcl	Buy	4.2	2.4	681	6.1	7.8	6.5	16.4	14.1	6.4	7.6	1.3	1.2	17.6	19.1
SIRI TB	Sansiri Pcl	Hold	2.1	1.7	533	3.9	7.8	6.9	13.0	10.6	6.4	6.8	1.0	0.9	13.3	13.1
SPALI TB	Supalai Pcl	Buy	19.0	14.0	749	2.2	7.9	6.2	7.0	5.6	5.0	6.4	1.7	1.4	22.6	24.6
Retail																
BIGC TB	Big C Supercenter Pcl	Hold	200.0	172.0	4,422	1.5	22.5	19.2	12.3	10.4	1.3	1.6	3.9	3.4	18.5	19.0
BJC TB	Berli Jucker Pcl	Sell	38.0	45.3	2,247	5.4	31.0	28.1	17.0	15.3	1.9	2.1	4.9	4.6	16.3	16.8
CPALL TB	CP All Pcl	Buy	60.0	40.0	11,202	28.0	32.6	24.6	24.9	15.7	2.2	2.3	12.4	10.2	39.5	45.5
CPN TB	Central Pattana Pcl	Buy	53.0	37.0	5,175	8.3	28.6	23.5	19.9	15.8	1.0	1.7	5.7	3.9	21.3	19.5
GLOBAL TB	Siam Global House Pcl	Buy	21.5	14.3	1,165	1.9	39.9	29.4	23.2	17.1	0.7	1.0	3.5	3.2	9.4	11.5
HMPRO TB	Home Product Center Pcl	Buy	13.9	8.3	2,481	5.8	24.8	19.6	14.8	12.2	2.8	3.6	6.0	5.4	27.9	29.1
MAKRO TB	Siam Makro Pcl	Hold	32.0	29.0	4,338	0.8	31.4	24.8	20.9	16.7	2.9	3.6	12.0	11.0	39.9	46.3
MC TB	MC Group Pcl	Buy	19.2	11.5	287	1.0	12.3	10.1	8.2	6.7	6.5	6.9	2.3	2.2	31.3	22.1
OFM TB	Officemate Pcl	Hold	34.0	29.3	292	0.3	23.8	20.3	52.0	33.3	2.1	2.5	2.1	2.0	9.1	10.1
ROBINS TB	Robinson Department Store Pcl	Buy	62.0	44.0	1,523	1.4	24.1	19.3	12.8	10.2	1.9	2.3	4.2	3.7	18.7	20.4
SF TB	Siam Future Development Pcl	Buy	7.5	5.1	209	0.6	12.3	10.7	15.9	14.9	2.4	2.8	1.1	1.0	9.1	10.0

Source: Bloomberg, Thanachart forecasts

■ Valuation comparison (cont'd)

Bloomberg code	Company name	Rating	Target price (THB)	Share price (THB) 3-Jan-14	Market cap (USDm)	Avg 3m TO (USDm)	PER (x) 13E	PER (x) 14E	EV/EBITDA (x) 13E	EV/EBITDA (x) 14E	Dividend Yield (%) 13E	Dividend Yield (%) 14E	PBR (x) 13E	PBR (x) 14E	ROE (%) 13E	ROE (%) 14E
Telecom																
ADVANC TB	Advanced Info Service Pcl	Buy	303.0	196.0	18,160	48.8	16.0	14.7	9.5	8.7	5.6	6.8	12.4	11.5	80.6	81.3
DTAC TB	Total Access Communication Pcl	Buy	145.0	92.5	6,838	9.6	19.8	15.5	8.5	6.8	4.9	6.5	6.4	6.1	32.0	40.4
INTUCH TB	Shin Corporation Pcl	Buy	109.0	65.5	6,545	33.2	14.1	12.4	11.7	10.2	6.5	7.0	8.5	7.7	63.2	65.2
JAS TB	Jasmine International Pcl	Buy	9.6	6.0	1,335	54.8	13.6	10.2	7.9	6.2	4.1	5.9	4.1	3.4	33.1	37.0
SAMART TB	Samart Corporation Pcl	Buy	31.0	14.1	442	3.8	9.4	7.3	5.3	4.3	5.8	7.5	2.3	1.9	25.8	28.7
SIM TB	Samart i-mobile Pcl	Buy	5.2	3.1	423	0.7	15.7	11.4	12.3	9.3	4.1	5.7	4.2	3.6	29.6	33.9
SYMC TB	Symphony Communication Pcl	Hold	13.0	12.8	120	0.1	19.2	16.0	8.7	7.3	3.9	4.7	3.1	3.0	16.6	19.0
THCOM TB	Thaicom Pcl	Buy	48.0	36.8	1,256	5.0	30.3	19.6	11.3	7.8	1.4	2.3	2.7	2.5	9.1	13.3
Transport																
AAV TB	Asia Aviation Pcl	Hold	4.8	3.4	517	2.1	15.1	12.9	7.5	5.6	-	1.5	0.8	0.8	5.8	6.4
AOT TB	Airports of Thailand Pcl	Buy	245.0	145.0	6,455	30.1	21.0	16.7	10.6	10.2	2.6	2.4	2.3	2.1	11.7	13.0
BECL TB	Bangkok Expressway Pcl	Sell	31.5	31.5	756	1.6	12.3	10.3	7.3	7.4	5.2	5.3	1.0	0.9	8.4	9.0
BTS TB	BTS Group Holdings Pcl	Buy	10.0	8.0	2,858	21.2	55.8	35.7	19.6	18.3	4.7	6.4	1.9	1.5	3.6	4.8
NOK TB	Nok Airlines Pcl	Buy	30.0	17.1	333	0.9	7.8	6.8	4.2	5.1	5.8	7.3	2.1	1.8	41.5	28.5
Utilities																
DEMCO TB	Demco Pcl	Buy	12.7	6.6	143	1.2	8.9	7.4	11.8	9.5	4.7	6.1	1.5	1.3	20.7	18.6
EA TB	Energy Absolute Pcl	Buy	10.7	7.4	860	2.9	158.2	26.6	71.0	25.4	0.2	1.1	6.3	5.2	6.2	21.4
EGCO TB	Electricity Generating Pcl	Buy	196.0	122.0	2,002	2.6	9.5	9.2	15.6	14.6	4.9	5.1	0.9	0.9	9.7	9.6
GLOW TB	Glow Energy Pcl	Buy	78.0	66.3	3,020	1.7	13.1	12.1	8.9	8.0	4.3	5.1	2.4	2.2	19.2	18.8
GUNKUL TB	Gunkul Engineering Pcl	Buy	26.0	10.0	206	0.6	22.3	9.4	20.9	14.2	6.2	4.3	2.4	2.1	12.5	23.6
RATCH TB	Ratchaburi Electricity Generating Holding Pcl	Buy	63.0	46.5	2,101	1.1	10.8	10.4	9.1	10.0	5.1	5.3	1.2	1.1	11.4	11.3
SPCG TB	SPGC Pcl	Buy	32.0	17.4	448	1.2	29.4	8.3	16.6	8.3	1.3	4.8	4.2	2.9	18.4	41.7
TTW TB	Thai Tap Water Supply Pcl	Hold	9.7	9.7	1,200	0.8	15.5	13.4	12.2	11.2	4.8	5.6	3.5	3.2	22.8	24.7

Source: Bloomberg, Thanachart forecasts

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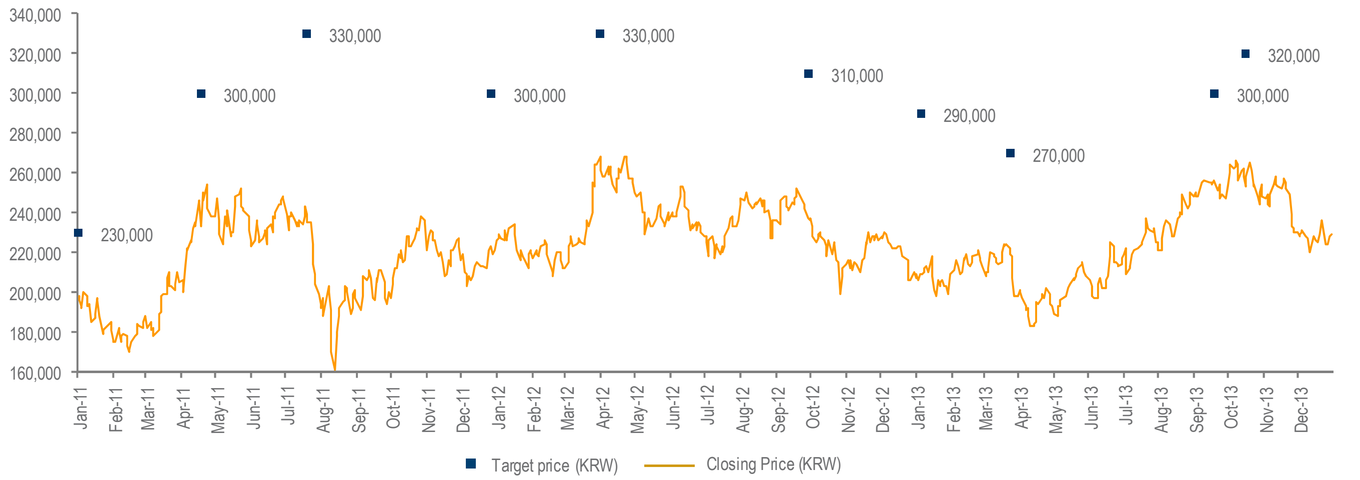
Share price and Daiwa recommendation trend

■ Hyundai Motor: share price and Daiwa recommendation trend

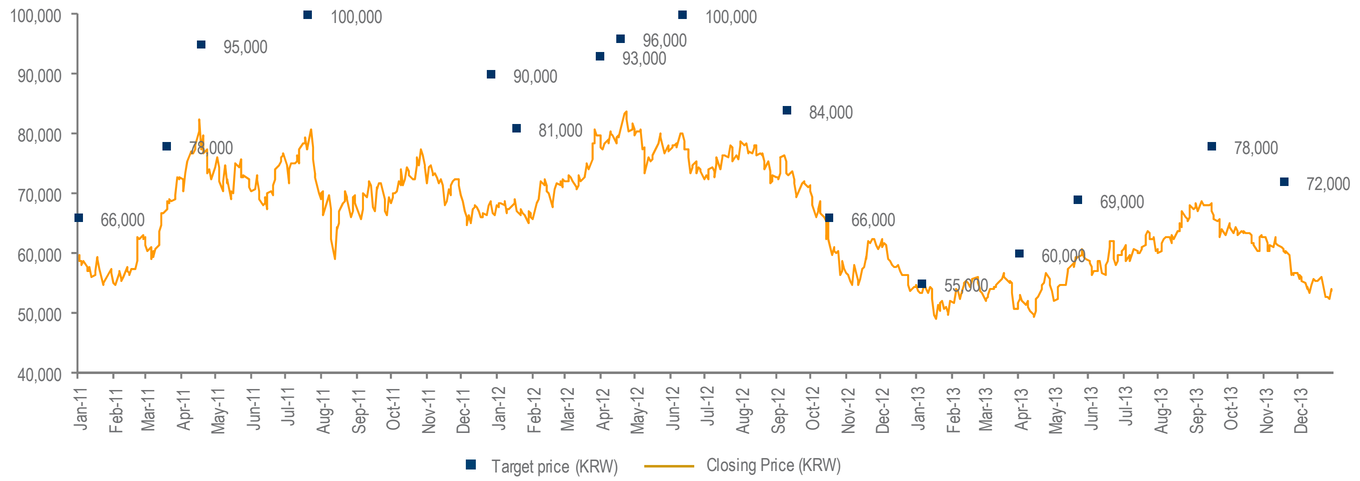
Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
28/07/11	330,000	Buy	08/10/12	310,000	Buy	27/09/13	300,000	Buy
05/01/12	300,000	Buy	14/01/13	290,000	Buy	24/10/13	320,000	Buy
09/04/12	330,000	Buy	02/04/13	270,000	Buy			



Source: Daiwa

■ Kia Motors: share price and Daiwa recommendation trend

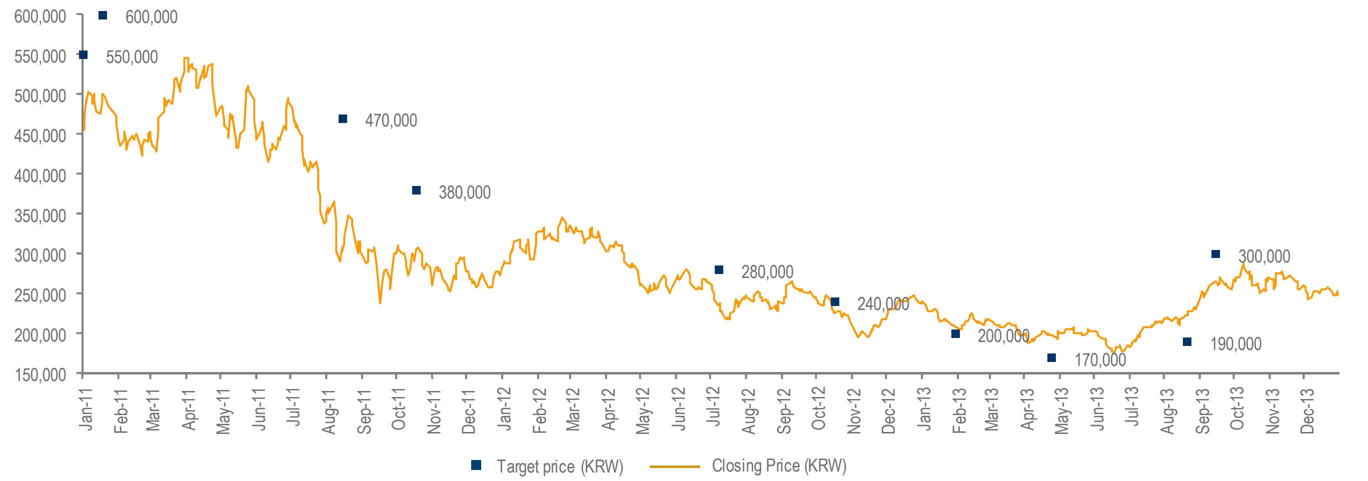
Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
27/04/11	95,000	Outperform	09/04/12	93,000	Buy	15/01/13	55,000	Hold
29/07/11	100,000	Outperform	27/04/12	96,000	Buy	10/04/13	60,000	Outperform
05/09/11	100,000	Buy	20/06/12	100,000	Buy	31/05/13	69,000	Outperform
05/01/12	90,000	Buy	19/09/12	84,000	Outperform	25/09/13	78,000	Outperform
27/01/12	81,000	Buy	26/10/12	66,000	Hold	27/11/13	72,000	Outperform



Source: Daiwa

■ Hyundai Heavy Industries: share price and Daiwa recommendation trend

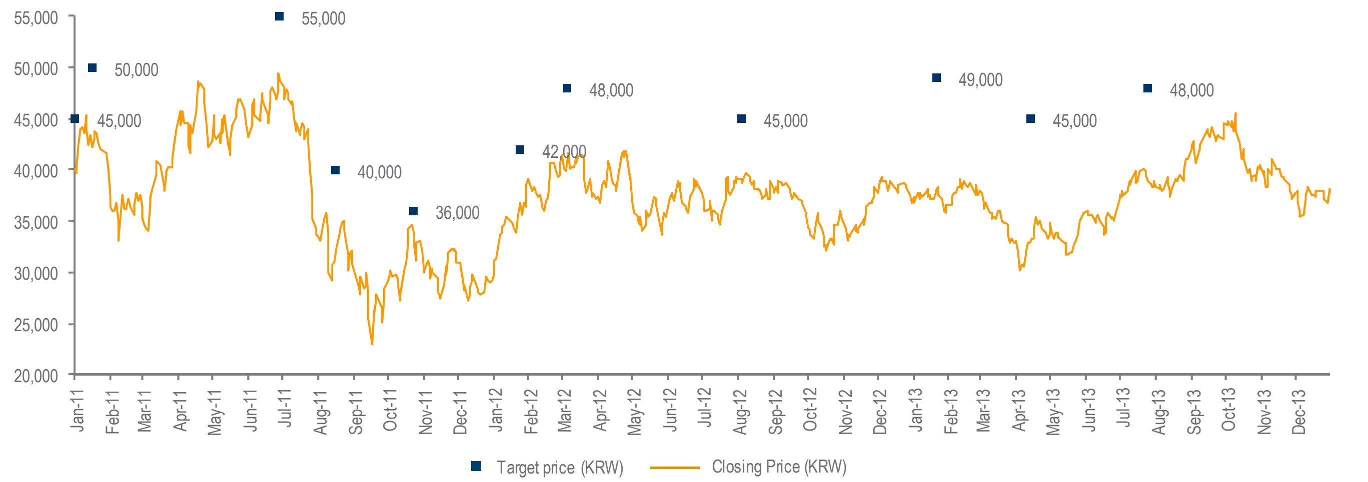
Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
24/08/11	470,000	Buy	26/10/12	240,000	Hold	29/08/13	190,000	Underperform
27/10/11	380,000	Buy	08/02/13	200,000	Hold	23/09/13	300,000	Outperform
17/07/12	280,000	Outperform	03/05/13	170,000	Underperform			



Source: Daiwa

■ Samsung Heavy Industries: share price and Daiwa recommendation trend

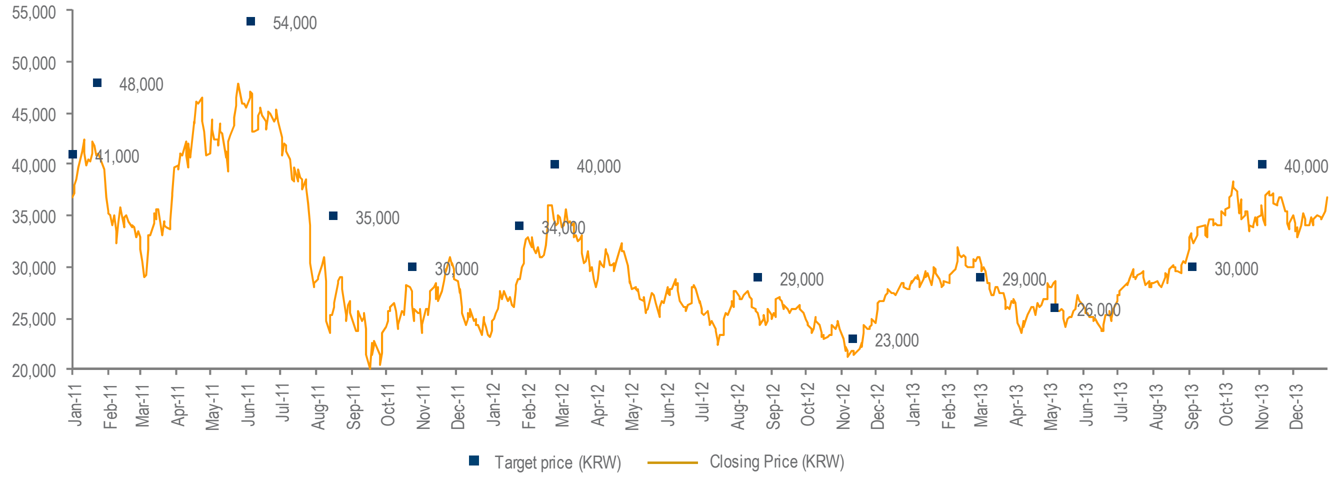
Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
07/07/11	55,000	Outperform	14/03/12	48,000	Outperform	22/04/13	45,000	Buy
25/08/11	40,000	Outperform	13/08/12	45,000	Outperform	02/08/13	48,000	Buy
01/11/11	36,000	Outperform	01/11/12	45,000	Buy			
02/02/12	42,000	Outperform	30/01/13	49,000	Buy			



Source: Daiwa

Daewoo Shipbuilding & Marine Engineering: share price and Daiwa recommendation trend

Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
14/06/11	54,000	Outperform	05/03/12	40,000	Outperform	11/03/13	29,000	Hold
25/08/11	35,000	Outperform	30/05/12	40,000	Buy	15/05/13	26,000	Hold
02/11/11	30,000	Outperform	29/08/12	29,000	Outperform	12/09/13	30,000	Hold
03/02/12	34,000	Outperform	20/11/12	23,000	Hold	12/11/13	40,000	Outperform



Source: Daiwa

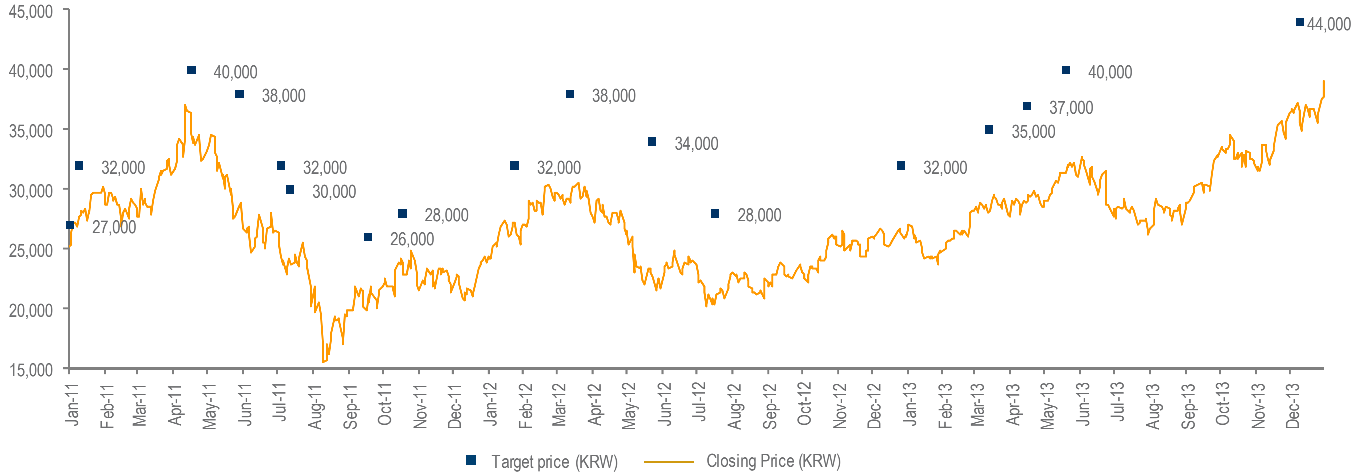
Woori Finance Holdings: share price and Daiwa recommendation trend

Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
21/10/11	11,900	Outperform	18/10/12	11,000	Hold	21/05/13	13,500	Outperform
16/02/12	13,600	Outperform	21/03/13	11,500	Hold	27/06/13	13,500	Buy

Source: Daiwa

■ SK Hynix: share price and Daiwa recommendation trend

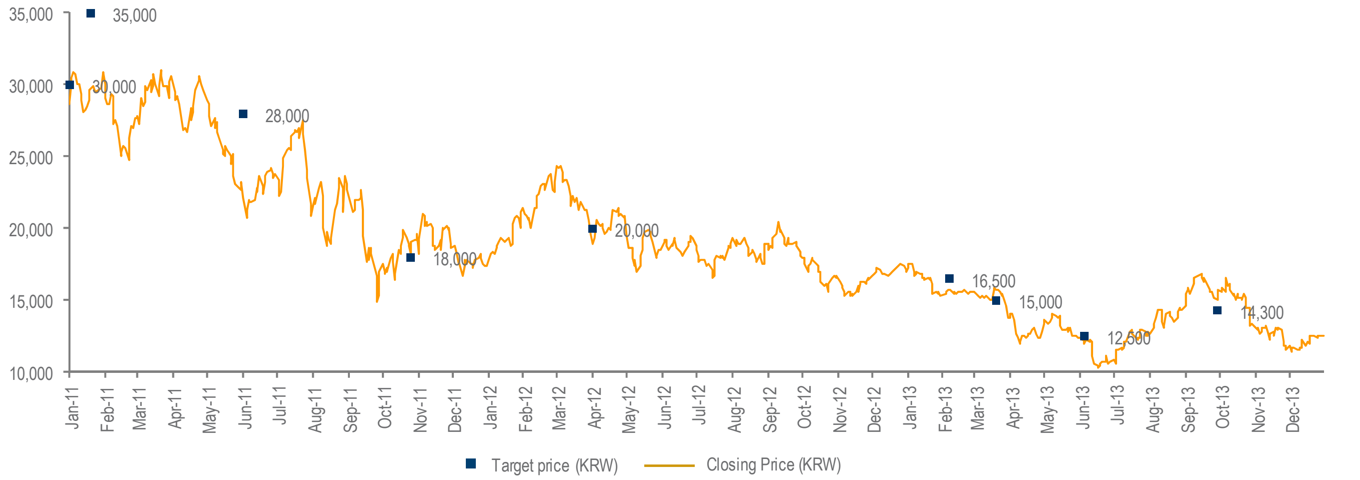
Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
26/04/11	40,000	Outperform	27/10/11	28,000	Outperform	04/01/13	32,000	Buy
07/06/11	38,000	Outperform	02/02/12	32,000	Outperform	22/03/13	35,000	Buy
13/07/11	32,000	Outperform	21/03/12	38,000	Buy	24/04/13	37,000	Buy
21/07/11	30,000	Outperform	01/06/12	34,000	Buy	28/05/13	40,000	Buy
27/09/11	26,000	Outperform	26/07/12	28,000	Buy	18/12/13	44,000	Buy



Source: Daiwa

■ Doosan Infracore: share price and Daiwa recommendation trend

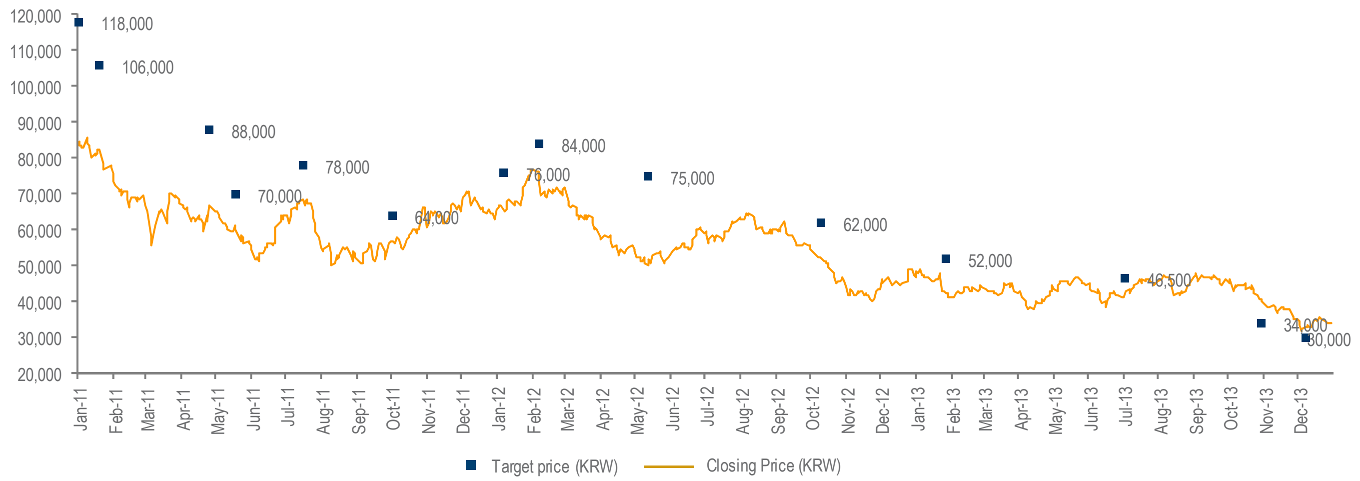
Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
10/06/11	28,000	Outperform	15/02/13	16,500	Hold	07/10/13	14,300	Hold
03/11/11	18,000	Hold	28/03/13	15,000	Hold			
10/04/12	20,000	Hold	13/06/13	12,500	Hold			



Source: Daiwa

■ **Doosan Heavy Industries and Construction: share price and Daiwa recommendation trend**

Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
04/05/11	88,000	Buy	16/02/12	84,000	Outperform	11/07/13	46,500	Hold
27/05/11	70,000	Outperform	20/04/12	84,000	Buy	07/11/13	34,000	Underperform
25/07/11	78,000	Outperform	21/05/12	75,000	Buy	16/12/13	30,000	Underperform
11/10/11	64,000	Outperform	19/10/12	62,000	Outperform			
16/01/12	76,000	Outperform	05/02/13	52,000	Outperform			



Source: Daiwa

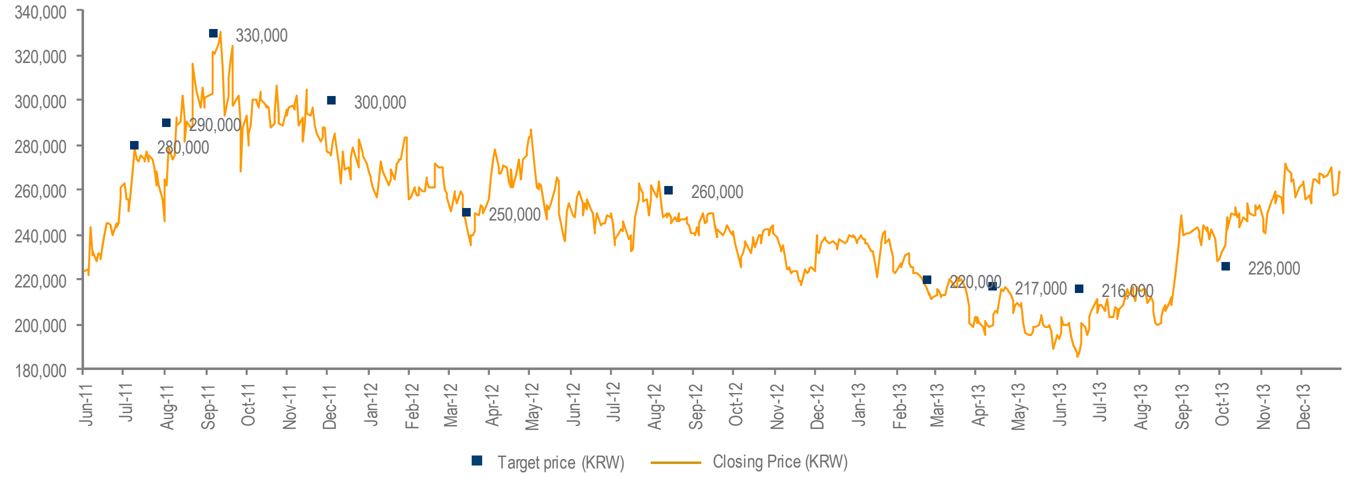
■ **Korea Kumho Petrochemical: share price and Daiwa recommendation trend**

Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
07/03/13	110,000	Hold	18/07/13	79,000	Hold	18/10/13	89,000	Underperform

Source: Daiwa

■ E-MART: share price and Daiwa recommendation trend

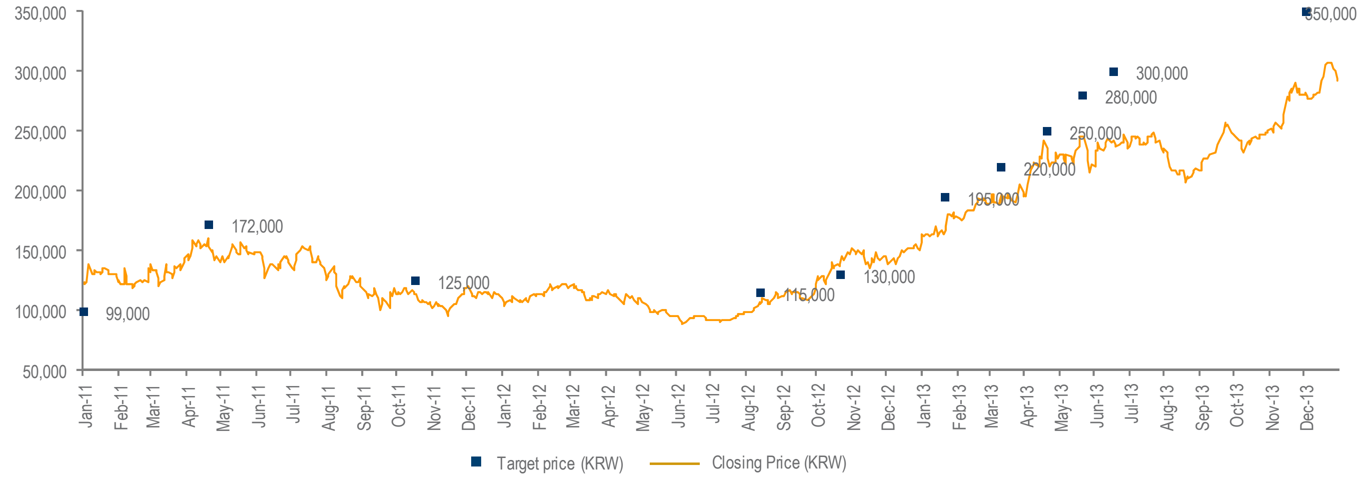
Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
18/07/11	280,000	Hold	23/03/12	250,000	Hold	26/06/13	216,000	Outperform
11/08/11	290,000	Hold	22/08/12	260,000	Hold	14/08/13	216,000	Hold
15/09/11	330,000	Hold	04/03/13	220,000	Hold	14/10/13	226,000	Hold
13/12/11	300,000	Hold	22/04/13	217,000	Hold			



Source: Daiwa

■ GS Home Shopping: share price and Daiwa recommendation trend

Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
26/10/11	125,000	Hold	30/01/13	195,000	Outperform	30/05/13	280,000	Outperform
22/08/12	115,000	Hold	20/03/13	220,000	Outperform	26/06/13	300,000	Buy
31/10/12	130,000	Hold	29/04/13	250,000	Outperform	11/12/13	350,000	Buy



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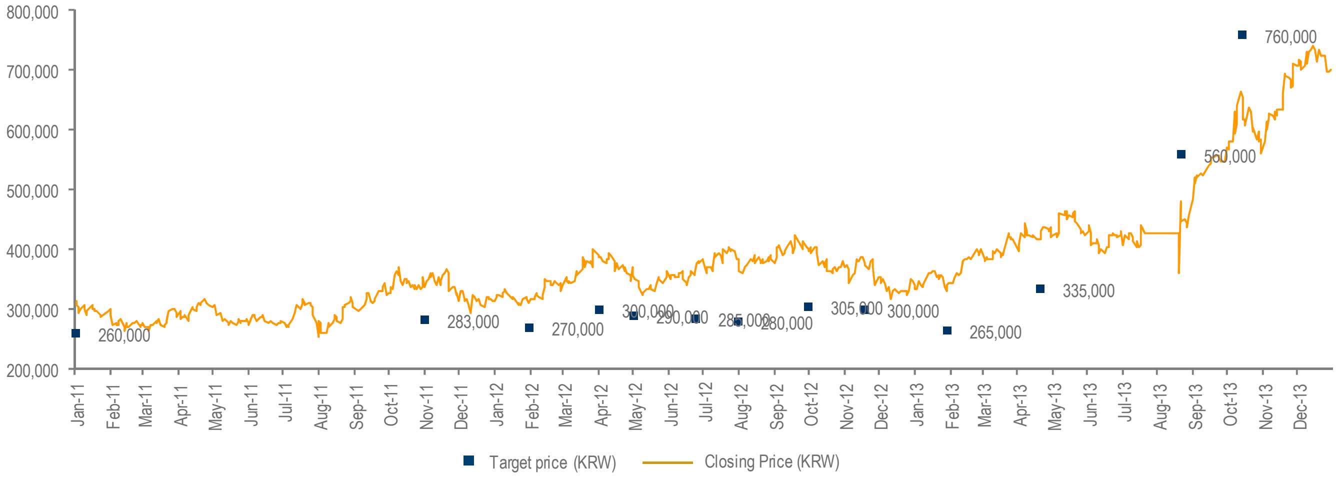
■ Naver: share price and Daiwa recommendation trend

Date	Target price	Rating	Date	Target price	Rating	Date	Target price	Rating
09/02/12	270,000	Buy	09/08/12	280,000	Outperform	29/04/13	335,000	Buy
10/04/12	300,000	Outperform	09/10/12	305,000	Outperform	28/08/13	0	
10/05/12	290,000	Outperform	27/11/12	300,000	Outperform	30/08/13	560,000	Buy
03/07/12	285,000	Outperform	07/02/13	265,000	Outperform	22/10/13	760,000	Buy



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"Buy": the price of the security is expected to increase by 10% or more.
"Hold": the price of the security is expected to range from an increase of less than 10% to a decline of less than 5%.
"Reduce": the price of the security is expected to decline by 5% or more.

Sector ratings are based on fundamentals for the sector as a whole. Hence, a sector may be rated "Overweight" even though its constituent stocks are all rated "Reduce"; and a sector may be rated "Underweight" even though its constituent stocks are all rated "Buy".
"Overweight": positive fundamentals for the sector.
"Neutral": neither positive nor negative fundamentals for the sector.
"Underweight": negative fundamentals for the sector.

Ownership of Securities
For "Ownership of Securities" information, please visit BlueMatrix disclosure Link at https://daiwa3.bluematrix.com/sellside/Disclosures.action .

Investment Banking Relationships
For "Investment Banking Relationship", please visit BlueMatrix disclosure Link at https://daiwa3.bluematrix.com/sellside/Disclosures.action .

Relevant Relationships (Bahana Securities)
Bahana Securities may from time to time have an individual employed by or associated with it serves as an officer of any of the companies under its research coverage.

Bahana Securities market making
Bahana Securities may from time to time make a market in securities covered by this research.

Additional information may be available upon request.

Japan - additional notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with us based on the information described in materials presented along with this document, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, we will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction.
- In some cases, we may also charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident of Japan.

- For derivative and margin transactions etc., we may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by us.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

*The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with us.

Corporate Name:	Daiwa Securities Co. Ltd.
	Financial instruments firm: chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships:	Japan Securities Dealers Association, Financial Futures Association of Japan
	Japan Securities Investment Advisers Association
	Type II Financial Instruments Firms Association