China / Hong Kong Industry Focus

China Brokerage Sector

Refer to important disclosures at the end of this report

DBS Group Research . Equity

25 May 2022

Time to bottom fish

HSI: 20,112

- **Key businesses remain healthy despite recent market turmoil.**
- **Improving capital utilisation and institutional client participation drive ROE enhancement, provided more lucrative businesses engage**
- **Sector remains under favourable policy environment with registration listing reform the key to watch in 2H22F**
- **Lower FY22/23F ADT and margin growth assumption due to recent market volatility. Lower brokers' FY22F earnings by -38% to -3% with CICC most resilient. BUY CICC and GF**

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Key businesses retain growth trajectory. The sluggishness of the China 1Q22 economy is evidently reflected in the China A-share market, with key indicators such as ADT, margin finance outstanding, and fund-raising volume seeing slowdown in 1Q22. However, they still maintain at positive y-o-y given current market liquidity remaining abundant and expect further simulating policies. Our sensitivity analysis suggests a 5% incremental y-o-y growth in both ADT and margin finance will lead to an average 4% and 0.3% increase in brokers' earnings and ROE. Hence, sector performance should recover once market stabilize.

Improving capital utilisation to drive ROE enhancement. We see that the strategy to focus more on institutional businesses coupled a with total of Rmb70bn in new capital, replenished during FY19-21, put brokers in a sweet spot to boost ROE, given that institutional businesses are more lucrative than traditional retail businesses. Reforms on mainboard registration-based listing are to be launched in FY22, and will be the key policy stimulus to expect.

Risk-reward attractive. China brokers' share prices have declined 23% YTD, as 1Q22 earnings was impacted by market volatility and weak investment income. Sector now is trading at 0.69x PB, or three-year trough level. With the favourable policy deregulation cycle remaining intact and a positive long-term outlook, we see attractive risk-reward at the current level. We lower our ADT and margin finance growth assumptions to +5% and 0%, and revise down FY22F earnings by -38% to -3%. Within the sector, we like CICC (3908HK, BUY) and GF (1776HK, BUY).

Recommendation & valuation

Stock	Ticker	Old TP (HKD)	New TP (HKD)	DBS ratings	% upside/ downside
CITIC - H	6030 HK	27.00	24.50	BUY	57%
CICC - H	3908 HK	29.00	25.00	BUY	78%
GF - H	1776 HK	20.00	16.00	BUY	64%
Haitong - H	6837 HK	8.00	7.50	BUY	36%
Huatai - H	6886 HK	15.15	15.00	BUY	48%
Guotai Junan - H	2611 HK	14.00	13.50	BUY	39%

Source: Thomson Reuters, DBS Bank (Hong Kong) Limited ("DBS HK")

Live more, Bank less

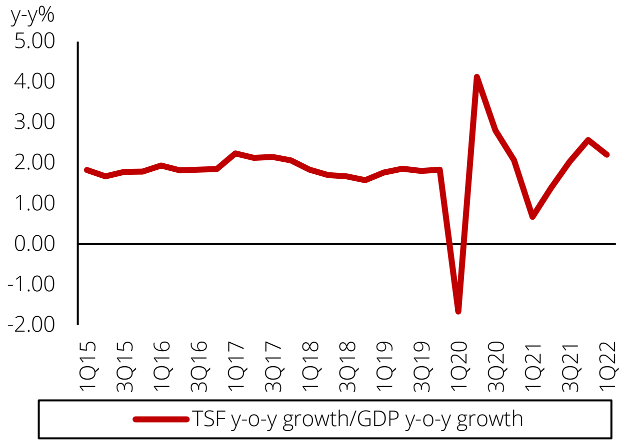
ed-BM/ sa-CS / DW

Business recap: Key business remain healthy despite recent market turmoil

Further RRR/LPR cut expected to ensure liquidity. China's 1Q22 economic performance remains resilient, with GDP +4.8% y-o-y to Rmb27tn, and total social financing outstanding +10.6% y-o-y to Rmb326tn. As such, total social financing (TSF) y-o-y growth/GDP y-o-y growth, which measures the extent of liquidity, reached 2.2x in 1Q22 (Fig 1). Therefore, we think that the current liquidity level remains solid to further support trading and financing activities.

The recent geopolitical impacts arising from the Russia-Ukraine conflict and the resurgence of the COVID-19 pandemic in China since March pose significant challenges to the manufacturing sector and household consumption in 1Q22, given the strict lockdown measures. Considering the mounting uncertainties, the DBS Econ team still forecasts that China's GDP would reach 4.8% in FY22F. In addition, we also expect proactive and strong, supportive policies to be announced in the coming quarters. Our econ team is expecting a further 20bps and 100 bps decrease in the LPR and RRR over the remainder of the year since 1Q22 to help revive economic activities and ensure liquidity. All in all, we believe all these are favourable and positive for the continuous growth of the China capital market.

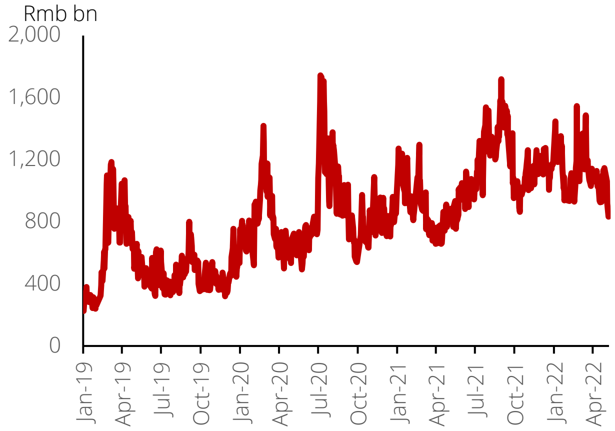
Fig 1. Current liquidity remains solid



Source: National Bureau of Statistics, DBS HK

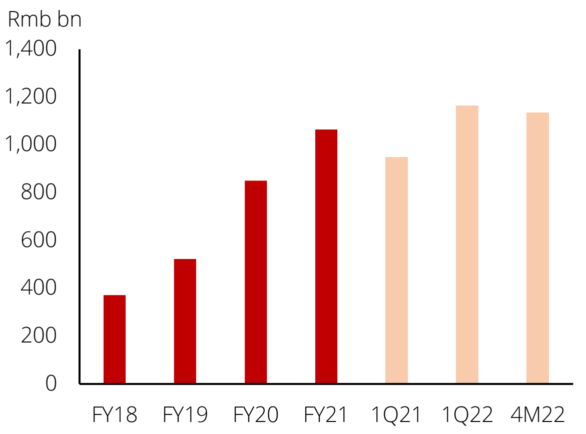
Brokerage business to still see steady growth. Average daily trading volume in 1Q22 was at Rmb1.2tn, representing a 9% growth from Rmb1.1tn in 4Q21. However, the sector still achieved its greatest 1Q performance over the last five years and experienced 23% y-o-y growth after the high base since the pandemic (Fig 2). The A-share SSE Index saw a 16% decrease YTD due to concerns over the possible economic slowdown from the resurgence of the pandemic and due to the impact from the Russia-Ukraine conflict. While the index decreased, structural opportunities and sector rotation show that market participation remains strong. While the pandemic and geopolitical conflict might hurt China's economy and financial markets in the short term, in the mid-long term a steady recovery can be expected, as a policy was recently announced to stabilise financial markets and a set of stimulating policies are expected as well. To factor in the short-term impact from the pandemic and geopolitical conflict, we lower our forecast of ADT growth from +15% y-o-y to +5% y-o-y in FY22F and remain positive about market participation recovering in 2H22F.

Fig 2. ADT retains growth trajectory



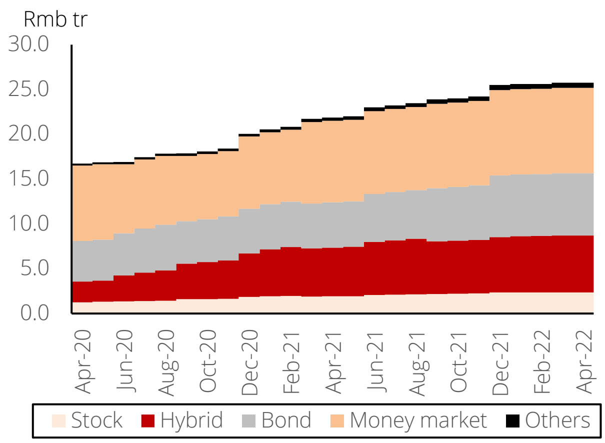
Source: Wind, DBS HK

Fig 3. ADT might experience short-term impacts



Source: Wind, DBS HK

Fig 4. Mutual fund AUM: Muted 1Q growth



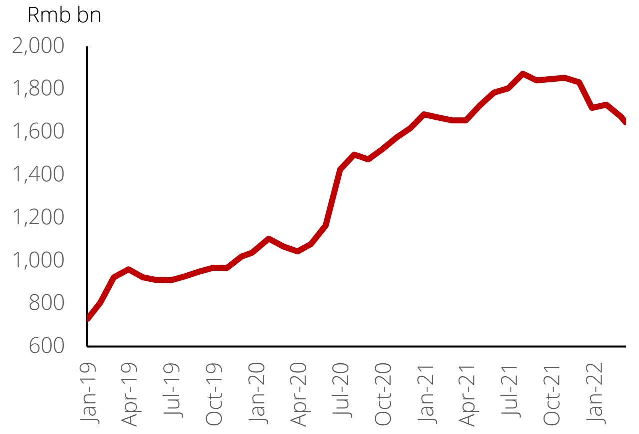
Source: Wind, DBS HK

Growth in mutual fund AUM remains healthy. Mutual fund AUM continues to grow, reaching Rmb25.8tn in 1Q22, representing a 19% y-o-y growth. While it has shown a slight sequential slowdown of +1% q-o-q, as retail investor sentiment was impacted by the volatile market during the same period, overall, we believe the mutual fund market remains healthy (Fig 4). As such, brokers may see a temporary decrease in commission fee due to the distribution of fund products in the near term. However, with strong policy stimuli in the capital market, the total AUM scale is still moderately growing, and as a result, brokers' management fee income from the mutual fund business should still steadily grow. In the longer term, we continue to see brokers with mutual fund holdings such as GF (1776HK, BUY) and CITIC (6030HK, BUY) standing out.

Margin finance business – increasing institutional participation to offset the slowdown in retail's margin long financing. The margin finance business reached its peak in 3Q21 at Rmb1.8tn and started to decline since then to Rmb1.7tn in 1Q22 due to relatively unfavourable stock performance (Fig 5). Considering that the China A-share market is a long-only market with the majority of margins outstanding from margin long financing, the temporary adjustment of the stock market will hurt market sentiment, and hence dampen the willingness of raising leveraged investments, especially among retail investors.

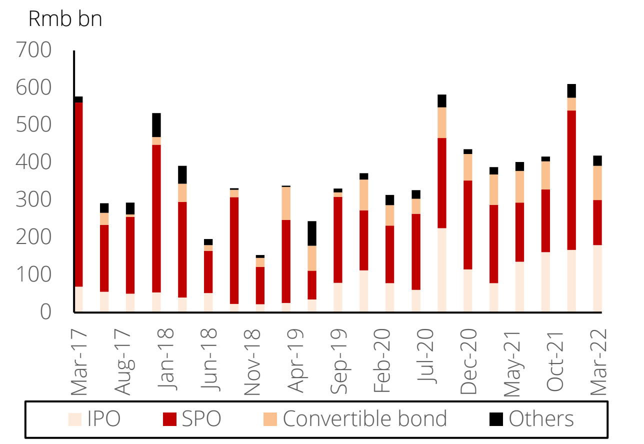
Given the expectation of more stimulating policies and several statements made recently by officials aiming to ensure the stability of the financial market, we expect the gradual recovery of the A-share market to help stabilise brokers' margin finance business. Nonetheless, due to the slowdown in 1Q22, we are revising down our margin finance outstanding forecast to remain at the Rmb1.8tn level (flat y-o-y growth), the same as of end-FY21, from our previous forecast of a 5% y-o-y growth to Rmb1.9tn.

Fig 5. Margin finance outstanding declined from peak



Source: Wind, DBS HK

Fig 6. IPO becomes the major source of fundraising



Source: Wind, DBS HK

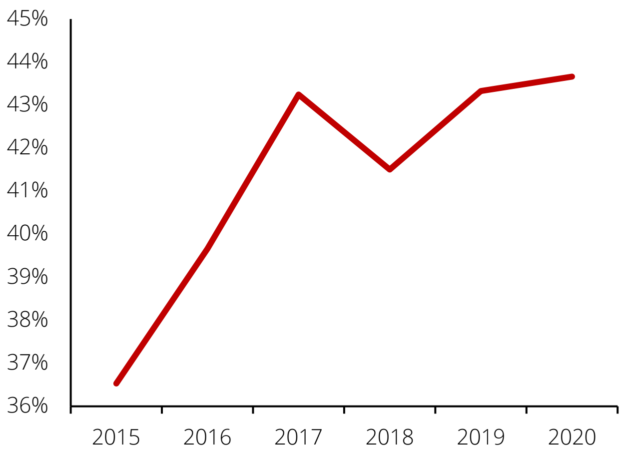
Full registration listing reform to boost investment banking business. Total fundraising volume retains its growth trajectory, with total volume up 8% y-o-y to Rmb420bn in 1Q22. The IPO, for the first time in the last five years, became the major contributor to the fundraising market, with a 130% y-o-y growth to Rmb180bn in 1Q22 (Fig 6). This is due to the previous adoption of the registration-based listing system to the STAR Board, ChiNext Board, and Beijing Stock Exchange, which encourages more SMEs to acquire direct financing from the capital market. With authorities focusing on speeding up additional adoptions to the mainboard, we expect the fundraising market to see another strong year, with total fundraising volume to reach Rmb2.2tn in FY22. Considering the market-driven mechanism of a registration-based listing system, brokers with more investment banking focus and previous exposure, such as CITIC (6030HK, BUY) and CICC (3908HK, BUY), are expected to become stronger, given their more professional sponsorships to provide more professional paperwork and more diversified distribution channels.

Effects from institutionalisation start emerging

Similar to other developed capital markets, the China brokerage sector is undergoing institutionalisation by providing diversified services to financial institutions and enterprises, to offset the impacts felt by retail investors due to declining brokerage fees. We have seen the gradual progress of institutionalisation in the China capital market, evidenced by 1) the gradual growth of institutions' market participation, 2) fast-growing OTC derivatives trading, and 3) larger mutual fund AUM size.

The China A-share market is gradually shifting from being dominated by retail investors to seeing more participation from institutional investors. This is evidenced by the proportion of shareholdings from institutional investors increasing from 37% in FY15 to 44% in FY20 (Fig 7). The changing mix towards institutional investors is a positive for brokers, given that brokers only charge a brokerage fee of less than 3bps from retail investors, while the rate charged from institutional investors is usually around 8bps.

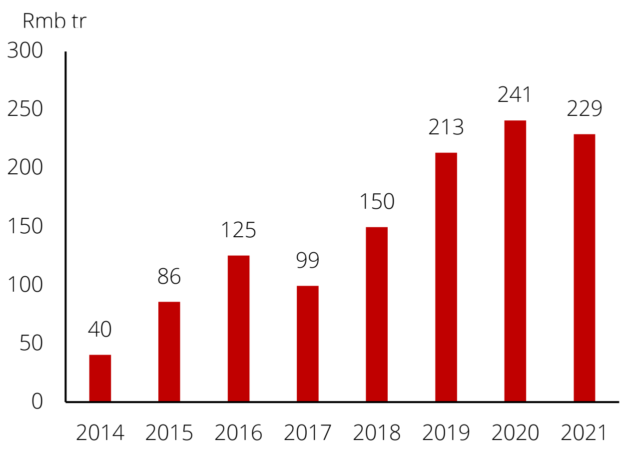
Fig 7. Shareholdings from institutional investors rise



Source: Wind, DBS HK

Given that the bond market is primarily composed of institutional investors, the bond trading market is also a proxy to seeing the effects of institutionalisation. Trading volume in the bond market soared from Rmb40tn in FY14 to Rmb229tn in FY21, representing a 28% CAGR (Fig 8).

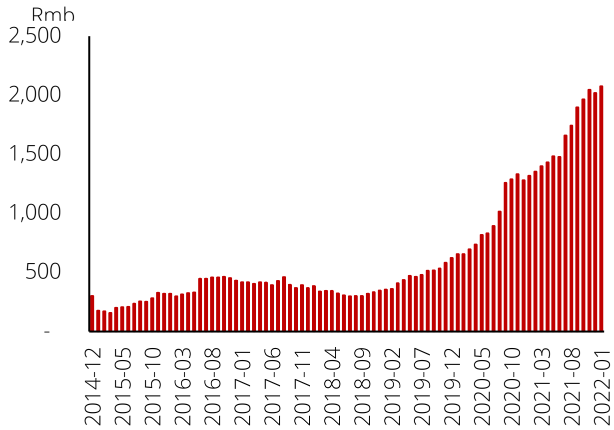
Fig 8. Bond market trading volume



Source: Wind, DBS HK

The fast-growing OTC derivatives market is also a plus for brokers. The derivatives trade is relatively new in the China capital market compared to developed markets but is growing strong since FY18, with the nominal principal size having jumped from Rmb347bn to Rmb2,017bn in FY21, representing a 80% CAGR over the last three years (Fig 9). The fast-growing OTC derivatives business allows brokers to build more in-depth business relationships with institutional clients by satisfying more of their sophisticated trading needs. At the same time, by designing the OTC derivatives products to clients, brokers could utilise their own capital to serve clients while at the same time generating higher ROE from such business.

Fig 9. OTC derivatives nominal principal size



Source: Wind, DBS HK

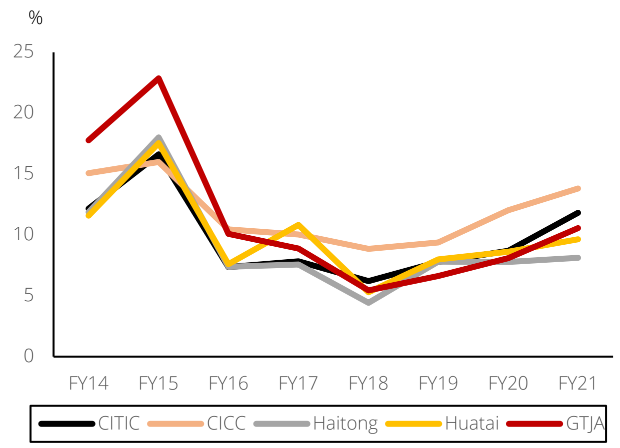
With more evidence that brokers are moving toward institutional investors by providing more targeted and more lucrative services, we believe China brokers are still under an ROE expansion cycle. However, China brokers' share prices, under DBS coverage, have fallen 23% year-to-date on average. If compared to China insurers and China banks under DBS coverage, which have, on average, fallen by 8% and up 3%, respectively, China brokers are considered the most underperformed within the China financial sector. We believe this is due to 1) brokers' business and share price being more sensitive to A-share market performance; with the A-share index declining by 16% year-to-date, this has more negatively impacted brokers compared to banks and insurers; and 2) brokers having outperformed in FY21, both from the perspective of the share price and earnings growth, hence the base is also higher.

However, the current supressed valuation with continuous ROE expansion potential provides an attractive risk-reward at this level. We believe, 1) with rounds of capital replenishments executed during FY19-21, brokers' capital capability is better equipped to further develop capital-intensive businesses, including investment banking and FICC, which will drive ROE expansion; 2) the adoption of the registration-based listing system to the mainboard will be the strongest policy support over the next few years to drive IB and related businesses, which we believe would spark the brokerage sector; and 3) the structural opportunity offered from the wealth management business will generate more fee income, and is a revenue source that has low capital consumption.

ROE remains under an expansion cycle. Brokers' ROE had seen a significant drop after the bull market crash in FY15, with consistent down-trending market participation to hurt brokerage fee income and interest income. Things had changed in FY19 with policy deregulations in place to regain market participation, and brokers have achieved ROE growth over the last three years. While the last round of ROE hikes (FY14-15) was primarily driven by soaring brokerage fee income and interest income from margin financing, this round of ROE growth is from a varied set of lucrative sources, such as wealth management product distribution, investment banking, and derivative trading, which, combined, could provide more sustainable ROE growth going forward.

Given that the brokerage business is diversified and more capital intensive whilst lucrative, leading brokers performed several rounds of SPOs to enrich their capital level. While the market might be concerned that the SPOs might dilute ROE, which would in turn hurt share price performance, we believe that although the timing of SPOs might influence ROE performance, the more important factor in ROE performance is overall market participation. We listed the SPOs under our coverage since FY14 and found that a dilutive effect on ROE was seen when SPOs were executed in a bear market; but this has little impact on ROE if SPOs are executed in a bull market. (Figs 10 & 11).

Fig 10. Selected brokers' ROE history



Source: Company data, DBS HK

Fig 11. Leading brokers' fundraising history

Date	Fund raising size
CITIC	
Jun-2015	46,482
Mar-2020	13,460
Feb-2021	29,673
CICC	
Nov-2016	23,364
Sep-2017	3,451
Oct-2019	3,053
Haitong	
Dec-2014	39,679
Aug-2020	20,000
Huatai	
Aug-2018	14,208
GTJA	
Apr-2019	3,819

Source: Company Data, DBS HK

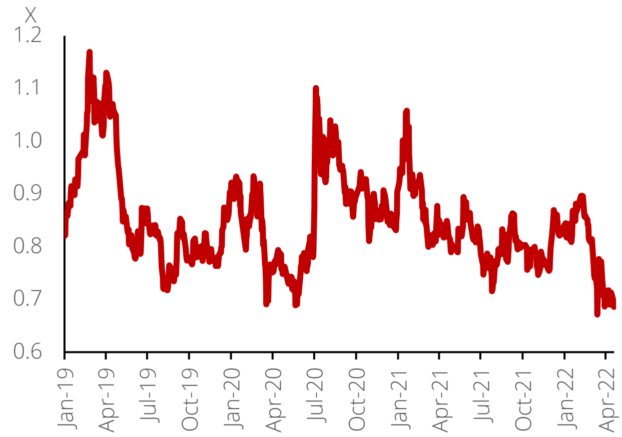
Brokers' business structure seems to be migrating to that of higher ROE businesses. Setting aside the impacts of SPOs on ROE performance, capital replenishments are beneficial to brokers' long-term development. Capital-intensive businesses such as investment banking and FICC are key institutional businesses, especially considering the deepening registration-based listing reform and the bullish commodity market that leads to more OTC trading demands. Such businesses are more lucrative compared to traditional brokerage businesses, and servicing institutional clients could generate more cross-business coordination, which would help enhance operational efficiency. With the full adoption of the registration-based listing system to mainboards expected in FY22, we believe leading brokers, such as CITIC (6030 HK) and CICC (3908 HK), with sufficient capital levels are ready to absorb additional projects, and as a result, expect to see an ROE hike going forward.

Full adoption of registration listing system a multi-year driver. The China brokerage sector is highly sensitive to policy sentiment due to its highly regulated nature. A deregulated policy environment would push the whole sector towards a growth trajectory, whereas a tightened policy environment would lead the sector to face a long adjustment period. The emphasis of channelling SMEs to perform more direct financing rather than relying on the banking system, has sparked the capital market in terms of fundraising and market participation. The brokerage sector, as a result, is to be the main beneficiary of this round of policy deregulation, with leading brokers' share prices entering a growth trajectory since FY19. We think that while sector share price performance in FY21 was volatile, it was on the back of strong earnings results. We believe this is primarily due to the rather quiet policy environment, given that each year since FY19, one of the major stock markets adopted the registration-based listing system (STAR in FY19 and ChiNext in FY20). The commencement of the Beijing Stock Exchange in FY21 offers less policy stimulus to the sector, as it has a relatively small trading volume. Nonetheless, brokers' business performance has benefited from the rounds of policy deregulations since FY19.

Considering the banking system has limited capacity to empower SMEs, given its stringent risk management, the encouragement of direct financing from the capital market is still the main stimulant for SME growth. This is evidenced by the central government's determination to implement the registration-based listing reform in all boards. This, we think, would be the key policy deregulation to drive the brokerage sector to re-engage.

Time to bottom fish. The China brokerage sector has experienced an average share price decrease of 23% YTD due to the sluggish economy influenced by the pandemic and geopolitical conflict between Russia and Ukraine. As such, market PB has dropped to its three-year trough level of 0.69x, which ranged between 0.67x to 1.17x. Considering the expectation of the recovery after the pandemic and the continuously easing policy environment with attractive risk-reward, we maintain our positive view on the sector and believe it is a great position for bottom fishing.

Fig 12. Market PB in historical trough level



Source: Wind, DBS HK

We calculated a sensitivity analysis on how the ADT movement and the margin finance outstanding growth to influence brokers ROE and EPS level. Considering ADT +5% y-o-y and margin finance outstanding +0% y-o-y as the base case, we found that a 5% incremental increase in both ADT and margin finance outstanding together would lead EPS and ROE to grow 4% and 0.3% on average respectively. (Fig 13 & 14)

Buy CICC and GF

We fine-tuned our FY22-23F forecasts of our brokerage sector coverage by factoring in the 1Q21 actual number and the new FY22F forecasts of ADT and margin finance outstanding growth, which were +5% and 0%, from +15% y-o-y and +10% y-o-y previously, respectively, and also factoring in the investment income downturn experienced in 1Q22. As such, our FY22F earnings forecasts were adjusted by -38% to -3%. We also slightly scaled down the PB multiple to better reflect the current market sentiment.

To pick the relatively premium shares from the low-valuation sector, we believe that leading brokers with a proven, strong investment banking capability could better benefit from the upcoming mainboard registration-based listing reform. Based on this reason, we like CICC (3908HK BUY). We also believe that brokers with large holdings in leading mutual fund companies will continue to bear fruit from the AUM size effect amid the slowly growing market. Hence, we also like GF (1776HK, BUY).

Fig 13. Sensitivity analysis on ROE

ADT growth to affect ROE							Margin outstanding growth to affect ROE						
	CITIC	CICC	GF	GTJA	Huatai	Haitong		CITIC	CICC	GF	GTJA	Huatai	Haitong
15%	0.4%	0.5%	0.4%	0.5%	0.2%	0.3%	15%	0.5%	0.3%	0.5%	0.5%	0.6%	0.3%
10%	0.2%	0.2%	0.2%	0.2%	0.1%	0.2%	10%	0.3%	0.2%	0.3%	0.3%	0.4%	0.2%
5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	5%	0.2%	0.1%	0.2%	0.2%	0.2%	0.1%
0	-0.2%	-0.2%	-0.2%	-0.2%	-0.1%	-0.2%	0	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
-5%	-0.4%	-0.5%	-0.4%	-0.5%	-0.2%	-0.3%	-5%	-0.2%	-0.1%	-0.2%	-0.2%	-0.2%	-0.1%
-10%	-0.7%	-0.7%	-0.6%	-0.7%	-0.4%	-0.5%	-10%	-0.3%	-0.2%	-0.3%	-0.3%	-0.4%	-0.2%

Source: DBS HK

Fig 14. Sensitivity analysis on EPS

ADT growth to affect EPS							Margin outstanding growth to affect EPS						
	CITIC	CICC	GF	GTJA	Huatai	Haitong		CITIC	CICC	GF	GTJA	Huatai	Haitong
15%	4.2%	4.0%	5.0%	5.3%	3.0%	5.8%	15%	4.7%	2.9%	6.8%	5.3%	7.1%	5.2%
10%	2.1%	2.0%	2.5%	2.7%	1.5%	2.9%	10%	3.2%	1.9%	4.5%	3.5%	4.8%	3.5%
5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	5%	1.6%	1.0%	2.3%	1.8%	2.4%	1.7%
0	-2.1%	-2.0%	-2.5%	-2.7%	-1.5%	-2.9%	0	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
-5%	-4.2%	-4.0%	-5.0%	-5.3%	-3.0%	-5.8%	-5%	-1.6%	-1.0%	-2.3%	-1.8%	-2.4%	-1.7%
-10%	-6.4%	-5.9%	-7.4%	-8.0%	-4.5%	-8.7%	-10%	-3.2%	-1.9%	-4.5%	-3.5%	-4.8%	-3.5%

Source: Company data, DBS HK

Fig 15. Operating matrix at a glance

Rmb mn	CITIC			CICC			GF			GTJA			Huatai			Haitong		
	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21
Brokerage commission	10,143	16,504	19,622	3,878	6,111	8,175	4,420	6,879	8,305	7,322	11,061	13,548	6,967	10,467	12,494	6,172	8,549	9,669
Investment banking	4,625	6,056	8,113	4,396	6,209	7,978	1,547	831	562	2,743	3,887	4,232	2,013	3,794	4,559	3,940	5,286	5,230
Asset management	6,073	8,436	12,211	2,002	2,796	3,265	3,911	6,598	9,946	1,665	1,546	1,794	3,904	4,092	5,093	2,395	3,403	3,691
Margin trade	7,718	9,307	11,788	1,461	2,038	1,343	3,575	4,852	6,352	6,831	7,956	9,214	4,986	6,397	9,410	3,757	4,405	5,326
Investment income	16,913	19,046	24,514	8,844	15,009	15,881	11,631	12,397	9,485	10,431	11,433	12,379	10,164	11,284	11,570	12,111	11,581	11,583
Commodity trading	5,516	6,081	12,388	n.a	n.a	n.a	1,898	1,758	2,058	4,744	5,396	8,685	936	1,207	3,416	6,755	5,082	5,866
Others	6,089	6,439	8,688	2,202	238	4,322	3,095	2,668	5,207	5,312	5,166	6,559	3,466	3,293	5,385	16,422	15,971	16,445
Total	57,080	71,869	97,324	22,783	32,402	40,964	30,077	35,983	41,915	39,050	46,445	56,411	32,437	40,534	51,926	51,552	54,277	57,810
	CITIC			CICC			GF			GTJA			Huatai			Haitong		
	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21	FY19	FY20	FY21
Brokerage commission	18%	23%	20%	17%	19%	20%	15%	19%	20%	19%	24%	24%	21%	26%	24%	12%	16%	17%
Investment banking	8%	8%	8%	19%	19%	19%	5%	2%	1%	7%	8%	8%	6%	9%	9%	8%	10%	9%
Asset management	11%	12%	13%	9%	9%	8%	13%	18%	24%	4%	3%	3%	12%	10%	10%	5%	6%	6%
Margin trade	14%	13%	12%	6%	6%	3%	12%	13%	15%	17%	17%	16%	15%	16%	18%	7%	8%	9%
Investment income	30%	27%	25%	39%	46%	39%	39%	34%	23%	27%	25%	22%	31%	28%	22%	23%	21%	20%
Commodity trading	10%	8%	13%	n.a	n.a	n.a	6%	5%	5%	12%	12%	15%	3%	3%	7%	13%	9%	10%
Others	11%	9%	9%	10%	1%	11%	10%	7%	12%	14%	11%	12%	11%	8%	10%	32%	29%	28%

Source: Company data, DBS HK

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:
STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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