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FY06 HSI Constituents Results Review

- ◆ Total net profit for the 38 HSI constituents showed a sturdy 12.9% increase for 2006. However, profit growth for the “HSI portfolio” (i.e. including only the H-share portion for H-share counters and adjusting for the free-float adjustment factors (FAFs) as well as the current 20% weighting cap) was a tamer 4.8%.
- ◆ Among the sub-sectors of the index, the raw material price-sensitive stocks generally performed well in 2006 whereas major laggards were primarily the property developers and public services and infrastructure counters. The emerging earnings gap amid diminishing revaluation gains would become a big challenge for most of the property and conglomerate counters in the near term.
- ◆ For 2007, we anticipate a slight decline in EPS of 1.3% for the HSI because of the anticipated weak profit figures from the property-related counters. EPS growth would return to a solid 10.4% in 2008, driven by financial and commercial and industrial counters, since most of the mainland companies in these groups should benefit from a lower tax rate from that year onwards.
- ◆ With the HSI registering another record close of 20,897 yesterday (7 May), the benchmark index is now trading at 16.8x FY07F PER, versus a historical range of 10x to 14x forward PER. If the five H-shares were excluded, the HSI would still be trading at 16.6x FY07F PER, a relatively high figure historically. We continue to see the 21,100 mark (translating to 17x FY07F PER) as a major resistance for HSI on the upside.

All 38 of the Hang Seng Index (HSI) constituents, with the exception of **Yue Yuen Industrials (551 HK Not Rated)** whose financial year ends in September, have announced their 2006 earnings results. Total net profit for the 38 HSI constituents¹ showed a sturdy 12.9% increase for 2006. However, since most of the mainland-related stocks were the out-performers in terms of profit growth, profit growth for the “HSI portfolio” (i.e. including only the H-share portion for H-share counters and adjusting for the free-float adjustment factors (FAFs) as well as the current 20% weighting cap) was a tamer 4.8%.

For individual stocks, the overall performance was fairly diverged, with **China Life Insurance (CL) (2628 HK BUY)** and **CITIC Pacific (267 HK SELL)** recording profit increases of more than 100% while **New World Development (NWD) (17 HK Not Rated)** saw its 2006 net profit plunged 91.2%. Among the sub-sectors of the index, the raw material price-sensitive stocks generally performed well in 2006 whereas major laggards were primarily the property developers and public services and infrastructure counters. The following table is a summary of the profit performance of the 38 HSI constituents, in a descending order according to their y-o-y net profit gain.

¹ Yue Yuen's net profit figures are referring to FY06 and FY05 ended 30 September 2006 and 30 September 2005, respectively.

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Company name	Bloomberg code	2006 net profit (HK\$ m)	2005 net profit (HK\$ m)	y-o-y (%)
China Life Insurance	2628 HK	19,446	8,834	+120.1
CITIC Pacific	267 HK	8,272	3,989	+107.4
HK Exchanges & Clearing	388 HK	2,519	1,340	+88.0
Foxconn International	2038 HK	5,578	3,000	+85.9
Bank of China	3988 HK	41,736	24,607	+69.6
Hutchison Whampoa	13 HK	20,030	14,343	+39.7
Sino Land*	83 HK	6,470	4,780	+35.4
ICBC	1398 HK	48,005	35,651	+34.7
Sinopec	386 HK	52,535	39,353	+33.5
Cheung Kong	1 HK	18,075	13,995	+29.2
China Mobile	941 HK	64,339	50,836	+26.6
China Resources	291 HK	2,776	2,220	+25.0
Bank of East Asia	23 HK	3,435	2,749	+24.9
CNOOC	883 HK	30,137	24,206	+24.5
Cathay Pacific Airways	293 HK	4,088	3,298	+24.0
Esprit Holdings*	330 HK	4,264	3,465	+23.1
Li & Fung	494 HK	2,202	1,790	+23.0
Swire Pacific	19 HK	22,566	18,757	+20.3
Yue Yuen^	551 HK	2,747	2,317	+18.6
HK & China Gas	3 HK	5,863	5,281	+11.0
China Merchants Holdings	144 HK	2,540	2,364	+7.4
Hang Seng Bank	11 HK	12,346	11,563	+6.8
HSBC Holdings	5 HK	122,659	117,296	+4.6
BOC (HK)	2388 HK	14,007	13,602	+3.0
China Construction Bank	939 HK	45,139	44,715	+0.9
China Netcom	906 HK	12,629	13,184	-4.2
MTR Corp	66 HK	7,759	8,450	-8.2
COSCO Pacific	1199 HK	2,261	2,605	-13.2
CLP Holdings	2 HK	9,900	11,420	-13.3
Hong Kong Electric	6 HK	6,842	8,562	-20.1
PCCW	8 HK	1,252	1,595	-21.5
China Unicom	762 HK	3,636	4,681	-22.3
Wharf Holdings	4 HK	10,757	13,888	-22.5
Hang Lung Properties*	101 HK	5,073	6,825	-25.7
Sun Hung Kai Properties*	16 HK	17,255	26,345	-34.5
Cheung Kong Infrastructure	1038 HK	3,670	6,007	-38.9
Henderson Land Dev.*	12 HK	9,693	16,714	-42.0
New World Development	17 HK	330	3,752	-91.2
Total		652,830	578,379	+12.9
<i>HSI portfolio#</i>		<i>317,091</i>	<i>302,696</i>	<i>+4.8</i>

Sectors

Raw-material price sensitive	71,414	53,224	+34.2
Red chips	126,591	104,085	+21.6
Financials	309,290	260,357	+18.8
Overall	652,830	578,379	+12.9
Conglomerates	53,683	50,740	+5.8
Public services and infrastructure	35,286	41,315	-14.6
Properties	56,566	68,659	-17.6

* Year end 30 June; 2006 = 1HFY07 + 2HFY06 and 2005 = 1HFY06 + 2HFY05

^ Year end 30 September;

HSI portfolio: Only H-share portion, adjusted for FAFs and 20% weighting cap

Sources: the companies and Core Pacific - Yamaichi

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Financials (+18.8%): Mainland financials powering through

Amid a robust local stock market last year, CL and **Hong Kong Exchanges and Clearing (388 HK Not Rated)** led the financial counters in profit growth by posting 114.4% (in RMB terms) and 88% y-o-y increases in net profit. Among the three mainland banks, **China Construction Bank (CCB) (939 HK SELL)** under-performed markedly with a 1.7% decline in net profit (in RMB terms) due to the expiration of tax exemption in relation to its restructuring in mid-05. Pre-tax profit growth differential was much narrower for the three mainland banks (**ICBC (1398 HK Not Rated)** had in fact reported the smallest pre-tax profit gain of 14.3%). Hong Kong large-cap banks were laggards as well, posting y-o-y profit growth ranging from 3% to 6.8%. Given the strong growth was mostly powered by mainland financial counters, profit growth for the group constructed according to the HSI portfolio criteria was a more down-to-earth 8%. All in all, mainland financials would remain the earnings growth driver for the group in the next few years.

Company name	Bloomberg code	Net profit (HK\$ m)			Comment
		2006	2005	y-o-y (%)	
China Life Insurance	2628 HK	19,446	8,834	+120.1	
HK Exchanges & Clearing	388 HK	2,519	1,340	+88.0	
Bank of China	3988 HK	41,736	24,607	+69.6	PBT: Rmb67.9bn (+26.3%)
ICBC	1398 HK	48,005	35,651	+34.7	PBT: Rmb72.1bn (+14.3%)
Bank of East Asia	23 HK	3,435	2,749	+24.9	Pre-provisioning op. profit: HK\$4.1bn (+38.3%)
Hang Seng Bank	11 HK	12,346	11,563	+6.8	Pre-provisioning op. profit: HK\$12.8bn (+9.9%)
HSBC Holdings	5 HK	122,659	117,296	+4.6	
BOC (HK)	2388 HK	14,007	13,602	+3.0	Pre-provisioning op. profit: HK\$14.8bn (+18.9%)
China Construction Bank	939 HK	45,139	44,715	+0.9	PBT: Rmb65.7bn (+18.7%)
Financials		309,290	260,357	+18.8	
<i>HSI portfolio#</i>		<i>118,860</i>	<i>110,075</i>	<i>+8.0</i>	

HSI portfolio: Only H-share portion, adjusted for FAFs and 20% weighting cap

Sources: the companies and Core Pacific - Yamaichi

Red chips (21.6%): Mostly robust

Given the HK\$2.2bn gain from the restructuring of **Dragonair** and **Cathay Pacific (293 HK Not Rated)**, **CITIC Pacific (267 HK SELL)** posted an impressive 107.4% y-o-y jump in net profit for 2006. Nevertheless, underlying profit (i.e. excluding the gains from restructuring and revaluation surplus from investment property) saw robust growth of 54.5% y-o-y. The two red-chips giants – **China Mobile (CMHK) (941 HK SELL)** and **CNOOC (883 HK BUY)** also reported strong profit growth of 26.6% and 24.5%, respectively. The other two telecom operators, **China Netcom (906 HK SELL)** and **China Unicom (CU) (762 HK SELL)**, on the contrary, experienced a 4.2% and 22.3% drop in profits in 2006. Nevertheless, CU's profit decline was mostly due to a Rmb2.4bn fair value loss from derivative component of its Convertible Bonds; excluding such a loss, FY06 net profit would have actually increased 24.3% y-o-y to Rmb6.2bn. Likewise, **Cosco Pacific (1199 HK HOLD)**'s 13.2% net profit decline was largely attributable to a US\$55m loss associated with put options on **China Marine Containers Company (CIMC) (000039 CH / 200039 CH)** issued by the company in the latter's non-tradable share reform. Driven by the vigorous mainland economy, these mainland-related counters should continue to enjoy healthy profit growth in the medium term, especially those with leading positions in their respective industries (such as CMHK and CNOOC).

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Company name	Bloomberg code	Net profit (HK\$ m)			Comment
		2006	2005	y-o-y (%)	
CITIC Pacific	267 HK	8,272	3,989	+107.4	Underlying profit: HK\$5bn (+54.5%)
China Mobile	941 HK	64,339	50,836	+26.6	EBITDA margin: 54.0% (2005: 54.9%)
China Resources	291 HK	2,776	2,220	+25.0	Underlying profit: HK\$1.8bn (+29.9%)
CNOOC	883 HK	30,137	24,206	+24.5	
China Merchants Holdings	144 HK	2,540	2,364	+7.4	Recurrent profit: HK\$2.6bn (+22.5%)
China Netcom	906 HK	12,629	13,184	-4.2	EBITDA margin: 52.4% (2005: 53.2%)
COSCO Pacific	1199 HK	2,261	2,605	-13.2	Underlying profit: US\$346m (+3.4%)
China Unicom	762 HK	3,636	4,681	-22.3	EBITDA margin*: 33.6% (2005: 32.7%)
Red chips		126,591	104,085	+21.6	

* Excluding fair value loss from derivative component of the company's Convertible Bonds

Sources: the companies and Core Pacific - Yamaichi

Raw-material price sensitive stocks (+34.2%): Stabilising margin

Despite the continuous rising raw material costs and the subsequent increasing cost pressure, raw material price-sensitive stocks in the HSI have demonstrated their ability to sustain or further improve their profit margins by passing the rising costs onto their customers while enhancing their operating efficiency. Together with robust top-line growth amid the booming global economy, all six raw material price-sensitive HSI stocks posted sturdy net profit growth and widening margins (except Yue Yuen), and we expect this favourable combination to be sustainable under a healthy global economic backdrop.

Company name	Bloomberg code	Net profit (HK\$ m)			Gross margin(%)	
		2006	2005	y-o-y (%)	2006	2005
Foxconn International	2038 HK	5,578	3,000	+85.9	9.4	9.1
Sinopec	386 HK	52,535	39,353	+33.5	7.4	7.1
Cathay Pacific Airways	293 HK	4,088	3,298	+24.0	8.6#	8.1#
Esprit Holdings*	330 HK	4,264	3,465	+23.1	20.7#	19.8#
Li & Fung	494 HK	2,202	1,790	+23.0	10.8	10.2
Yue Yuen^	551 HK	2,747	2,317	+18.6	23.0	23.0
Total		71,414	53,224	+34.2		
<i>Excluding Sinopec</i>		<i>18,879</i>	<i>13,870</i>	<i>+36.1</i>		

* Year end 30 June; 2006 = 1HFY07 + 2HFY06 and 2005 = 1HFY06 + 2HFY05

^ Year end 30 September

Operating margin

Sources: the companies and Core Pacific - Yamaichi

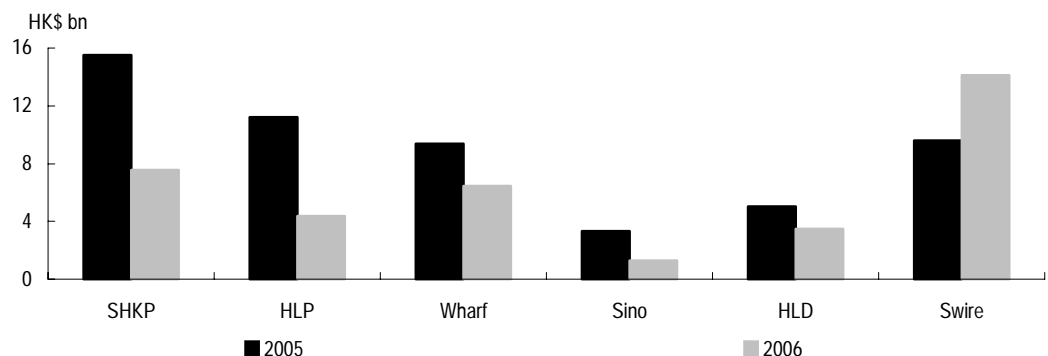
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Conglomerates (+5.8%) and properties (-17.6%): Dwindling revaluation surplus

Among the conglomerates and property counters, **Hutchison Whampoa (Hutch) (13 HK SELL)** recorded the biggest y-o-y net profit gain of 39.7% in 2006 on the back of the HK\$24.4bn gains from disposing a 20% stake in **Hutchison Ports Holdings** and **Hutchison Ports Investments**. **Sino Land (Sino) (83 HK SELL)**, **Cheung Kong (CK) (1 HK BUY)** and **Swire Pacific (19 HK HOLD)** also saw their net profits increased by 35.4%, 29.2% and 20.3% y-o-y in the same period, respectively.

The profit performance of other counters in the sector was less appealing. The 91.2% plunge in profit for NWD that had resulted from the HK\$2.1bn provision against payment from the owners of the fibre optic backbone network to **New World TMT** was obviously eye-catching. However, other property counters and conglomerates also recorded y-o-y declines in the range of 22.5% to 42%, because of substantial reduction in revaluation surpluses from their investment properties as well as unexciting performance in their underlying profit. In fact, Swire was the only company that had booked in more revaluation surplus for 2006, compared with 2005 (HK\$14.1bn versus HK\$9.6bn), filling up the gap from a HK\$2.3bn gain subsequent to the sale of a **Modern Terminal** stake in 2005, and thus erasing the modest 0.3% drop in underlying profit for 2006. Therefore, the emerging earnings gap amid diminishing revaluation gains would become a big challenge for most of the property and conglomerate counters in the near term.

Gains from investment property revaluation and disposals



Sources: the companies and Core Pacific - Yamaichi

Company name	Bloomberg code	Net profit (HK\$ m)			Underlying profit (i.e. excl. inv. prop. reval.) (HK\$ m)			Comment
		2006	2005	y-o-y (%)	2006	2005	y-o-y (%)	
Hutchison Whampoa	13 HK	20,030	14,343	+39.7	43,791	38,514	+13.7	Recurring EBIT
Swire Pacific	19 HK	22,566	18,757	+20.3	8,716	8,742	-0.3	
Wharf Holdings	4 HK	10,757	13,888	-22.5	4,285	4,499	-4.8	
New World Development	17 HK	330	3,752	-91.2	4,937	3,464	+42.5	Segment results
Conglomerates total		53,683	50,740	+5.8				
Cheung Kong	1 HK	18,075	13,995	+29.2	8,068	6,829	+18.1	Excl. HW
Sino Land*	83 HK	6,470	4,780	+35.4	5,176	1,465	+253.2	
Hang Lung Properties*	101 HK	5,073	6,825	-25.7	1,607	1,792	-10.3	
Sun Hung Kai Properties*	16 HK	17,255	26,345	-34.5	9,686	10,839	-10.6	Excl. in. prop. reval. & disposal
Henderson Land Dev.*	12 HK	9,693	16,714	-42.0	5,339	5,484	-2.6	
Properties total		56,566	68,659	-17.6				

* Year end 30 June; 2006 = 1HFY07 + 2HFY06 and 2005 = 1HFY06 + 2HFY05

Sources: the companies and Core Pacific - Yamaichi

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Public services and infrastructure (-14.6%): Dull underlying growth

The group showed rather weak earnings performance, with **HK & China Gas (3 HK HOLD)** being the only counter to post a gain in net profit on a y-o-y basis. **CLP Holdings (CLP) (2 HK SELL)**, **Hong Kong Electric (HKE) (6 HK SELL)** and **Cheung Kong Infrastructure (CKI) (1038 HK Not Rated)**, on the other hand, registered profit declines of 13.3%, 20.1% and 38.9%, respectively, due to the lack of disposal gains (for HKE and CKI) and tax concessions (CLP) in 2006. That said, most of the companies in this category were only able to generate modest single-digit underlying profit growth. In addition, **PCCW (8 HK Not Rated)**'s swelling losses in its mobile business after its acquisition of a stake in **Sunday Communications** (and eventually its mobile communications business) has resulted in the worst-in-class 21.5% and 20.8% drop in net and underlying profit, respectively. The earnings outlook of these companies is likely to remain dull in the near future.

Company name	Bloomberg code	Net profit (HK\$ m)			Underlying profit (i.e. excl. inv. prop. reval.) (HK\$ m)			Comment
		2006	2005	y-o-y (%)	2006	2005	y-o-y (%)	
HK & China Gas	3 HK	5,863	5,281	+11.0	3,224	3,062	+5.3	Gas business & property rentals
MTR Corp	66 HK	7,759	8,450	-8.2	5,246	5,110	+2.7	EBITDA ex. prop. dev. & reval.
CLP Holdings	2 HK	9,900	11,420	-13.3	7,290	7,047	+3.4	HK operations
Hong Kong Electric	6 HK	6,842	8,562	-20.1	6,173	5,508	+4.0	HK operations
PCCW	8 HK	1,252	1,595	-21.5	3,507	4,428	-20.8	EBIT ex PCPD (432 HK)
Cheung Kong Infrastructure	1038 HK	3,670	6,007	-38.9	3,956	3,872	+2.2	PBT ex. gain on disposal and impair. losses
Public services & infras.		35,286	41,315	-14.6				

Sources: the companies and Core Pacific - Yamaichi

Valuation on the high side

For 2007, we anticipate a slight decline in EPS of 1.3% for the HSI because of the anticipated weak profit figures from the property-related counters. EPS growth would return to a solid 10.4% in 2008, driven by financial and commercial and industrial counters, since most of the mainland companies in these groups should benefit from a lower tax rate from that year onwards.

HSI's sector EPS

	EPS Growth (%)				PER			
	2005	2006	2007F	2008F	2005	2006	2007F	2008F
Finance	11.8	7.3	3.9	17.6	18.2	16.9	16.3	13.9
Utilities	38.9	(10.7)	(1.2)	(0.7)	13.1	14.6	14.8	14.9
Properties	37.5	6.5	(12.3)	(1.6)	17.5	16.4	18.7	19.0
Comm & Ind	28.9	17.6	(3.0)	8.0	19.5	16.6	17.1	15.9
Hang Seng Index	23.0	10.2	(1.3)	10.4	18.3	16.6	16.8	15.2

Sources: Bloomberg and Core Pacific - Yamaichi estimates

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With the HSI registering another record close of 20,897 yesterday (7 May), the benchmark index is now trading at 16.8x FY07F PER, versus a historical range of 10x to 14x forward PER. While it is convenient to attribute that to the introduction of more mainland-related shares into the index, we found that the five H-shares that have been included into the HSI were not particularly strong in terms of driving the index.

Intuitively, the five counters combined only make up for 13.9% of the index's weighting as of 7 May. Moreover, two of the five H-shares – **Bank of China (3988 HK SELL)** and ICBC – have under-performed the HSI by 7.8% and 11.6%, respectively, since their HSI inclusion. According to our calculation, the HSI would close at 20,856 yesterday if the five H-shares were not included into the index, just 0.2% lower than the actual closing. In fact, if the five H-shares were excluded, the HSI would still be trading at 16.6x FY07F PER, a relatively high figure historically. Hence, we continue to see the 21,100 mark (translating to 17x FY07F PER) as a major resistance for HSI on the upside.

Relative performance versus HSI since inclusion

Company name	Bloomberg code	Closing price(HK\$)		HSI at Inclusion date	Relative price performance vs HSI (%)
		07/05/07	Inclusion		
HSI inclusion: 08/09/06					
China Construction Bank	939 HK	4.95	3.42	17,145.76	+22.9
HSI inclusion: 01/12/06					
Bank of China	3988 HK	3.93	3.78	18,690.82	-7.8
Sinopec	386 HK	7.15	6.29	18,690.82	+1.9
HSI inclusion: 09/03/07					
China Life Insurance	2628 HK	25.45	21.50	19,134.88	+9.2
ICBC	1398 HK	4.32	4.40	19,134.88	-11.0

Sources: Bloomberg; HSI Services; Core Pacific – Yamaichi

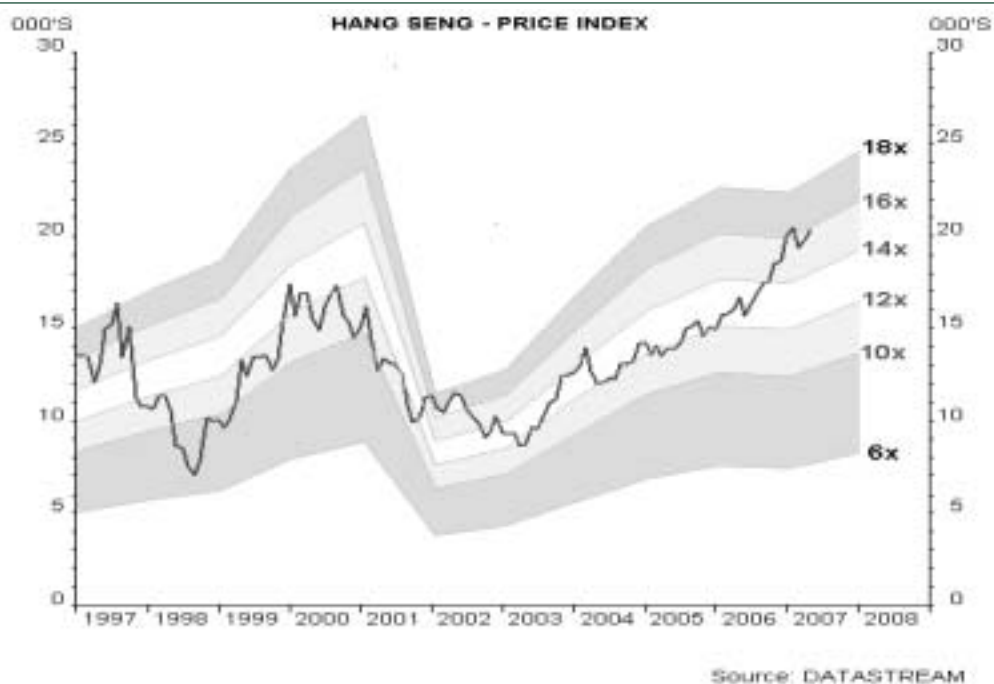
Valuation: H-shares versus HSI

Index / company name	Bloomberg code	Closing price (HK\$, 07/05/07)	FY07F PER (x)
China Construction Bank	939 HK	4.95	20.4
Bank of China	3988 HK	3.93	19.7
Sinopec	386 HK	7.15	8.8
China Life Insurance	2628 HK	25.45	28.3
ICBC	1398 HK	4.32	23.8
Hang Seng Index	HSI	20,897	16.8
<i>Excluding 5 H-shares</i>		<i>20,856</i>	<i>16.6</i>

Sources: Bloomberg; HSI Services; Core Pacific - Yamaichi

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HSI: Forward PER Band



Sources: Datastream and Core Pacific - Yamaichi

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