



## 2007/08 Budget Preview: Exercise Tax Concession with Care

- FY2006/07 may end up with a budget surplus of HKD 30 billion, 5 times higher than the government's initial estimates of HKD5.6 billion. Nevertheless, any consideration of tax cuts need to be exercised with care so as not to narrow the tax net.

### Hong Kong Update. P. 5

- There have been big swings in market sentiment in recent weeks with a weakening HKD and firming Hibors. Nevertheless, Hibor is still close to the six-month average of 4.04%, which should indicate little signs of massive reverse in fund flows.
- While we project no change in Hong Kong prime rates in the first half of the year, the major risk lies in massive outflow of funds should the stock markets in both Hong Kong/mainland further inflate in the short term but then collapse later in the year

### China Update. P. 7

- We have three observations on the Chinese stock market. First, retail participation has risen rapidly. Second, stock trading volume and warrant trading activities are also on the rise. Third, financial stock valuations are overstretched. These are not healthy signs and warrant extra cautions.
- Separately, we look at a recent World Bank survey of 120 cities (and 12,400 firms) in China to see how investment climate and government efficiency vary across different regions.

### Economic Forecasts. P. 9

### Statistics. P. 10

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**Vincent Kwan**

Chief Economist  
vincentkwan@hangseng.com

**Kevin Lai**

Senior Economist  
kevinlai@hangseng.com

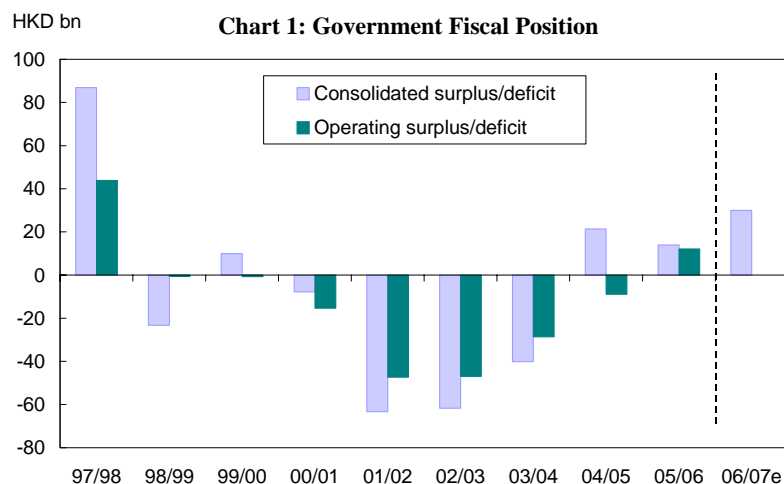
**Irina Fan**

Senior Economist  
irinafan@hangseng.com



## 2007/08 Budget Preview: Exercise Tax Concessions with Care

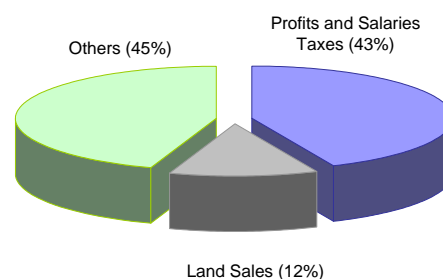
The recent economic performance, return of direct taxes, land sales, stamp duties and investment income from Exchange Fund have all come above official targets. For the first nine months of FY2006/07 (April-December 2006), the government posted a budget surplus of HKD5.9 billion. Given that the bulk of the profits and salaries taxes will be materialised in the last three months of the fiscal year, FY2006/07 may end up with a budget surplus exceeding HKD30 billion, 5 times of the government's initial estimate of HKD5.6 billion. With such a strong fiscal position, the government has hinted for tax concessions.



### Tax Concessions Should Not Affect Tax Net

The majority of government's revenue is derived from taxes and land sales. Profits and salaries taxes together accounted for over 43% of government revenue and land sales contributed another 12% (Chart 2) in last fiscal year. Government revenue, whether from taxes or land sales, is highly cyclical and dependent on the performance of the economy. Revenue from land sales, for instance, has been better than expected this year. The government has originally budgeted to receive HKD30.5 billion from land sales in FY2006/07. Nevertheless, land premiums in the first nine months (April-December 2006) have already exceeded HKD33 billion. Such revenue is volatile in nature. It swung between HKD5 to 45 billion over the last 10 years.

**Chart 2: Government Revenue FY2005/06**



Moreover, the tax base is very narrow. Currently, the top 100,000 taxpayers contribute 59.6% of the total salaries tax (Chart 3).

## Feature

About 60% of the profits tax is paid by the top 800 companies, or 1.2% of the 64,000 taxpaying corporations. The government decided to abort the Goods and Services Tax (GST) consultation in December 2006, which was designed to broaden the tax base. If the tax base could not be broadened, any consideration of tax cuts need to be exercised with care so that the tax net would not be affected.

### An Appropriate Level of Government Expenditure

While it is not easy to have full control over the revenue, the government should find better ways to control its expenditure. It is important to find an appropriate level of government expenditure relative to the economy. The Armeiy Curve shows the relationship of public spending and economic growth. Armeiy argued that an increase in the size of government would bring expansions in output when the government is small in size, as government spending on education, infrastructure and means of communications can contribute to increased productivity. However, further expansion after some point would contribute to economic stagnation, as heavier tax burden is needed to finance the expenses, which de-motivates private sector investment (Chart 4). The Hong Kong government does commit to “Big Market and Small government” principle, which is one of the key factors contributing to Hong Kong’s top world ranking in economic freedom.

Chart 3: Distribution of Salary Tax

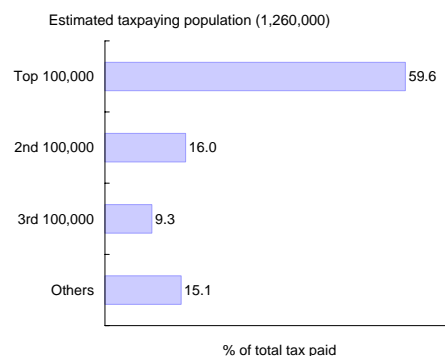
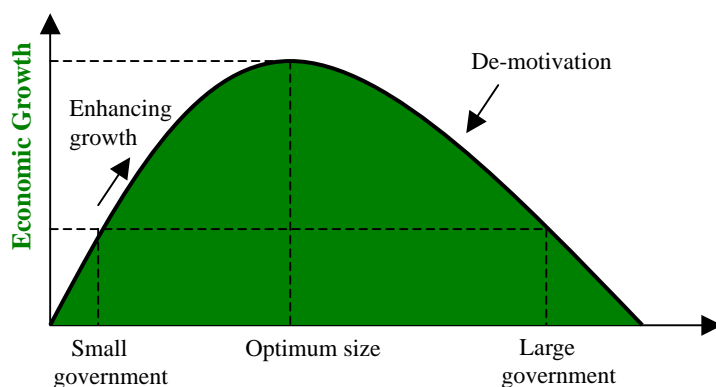


Chart 4: The Armeiy Curve



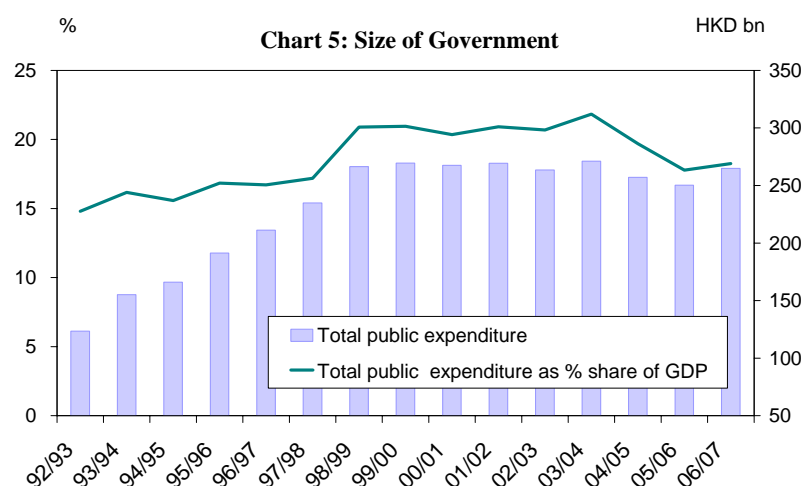
#### Government spending as % of GDP

It is not easy to come up with a simple rule, as different economies have different political environment and spending histories. A prudent principle is to keep expenditure growth below nominal GDP growth. The Hong Kong government was not able to do this during recessions. But they should aim to achieve this when

## Feature

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prosperity returns. Hong Kong's public expenditure as a % of GDP (a common measure of size of government) rose from less than 15% in FY1992/93 to over 18% in FY2006/07 (Chart 5). It should be noted that the government had adopted austerity measures over the past few years to cap operating expenditure at about HKD200 billion. It is unlikely that the government will be able to continue the austerity measures amidst such strong fiscal position and positive economic outlook. With inflation and private-sector salaries rising, the government is under pressure to re-visit the salary levels of civil servants. Moreover, in the years ahead, government's expenditure will grow given an aging Hong Kong population. Education, social welfare and health have been accounting for an increasingly large share of public expenditure, which is estimated to take about 56% of the government's recurrent expenditure in 2006/07.



## Conclusion

Tax concessions are to be the main theme of the coming 2007/08 Budget. Nevertheless, given a narrow tax base, any tax concessions should not affect the tax net. It is thus not advisable for the government to increase tax allowances. One-off tax rebates and widening the marginal tax band are viable options. Moreover, the government should continue to consider tax reforms over the long term to broaden the tax base.

It is also important for the government to control the growth of public expenditure below the growth of nominal GDP, so as to keep public expenditure at a medium-target of below 20 % of GDP.

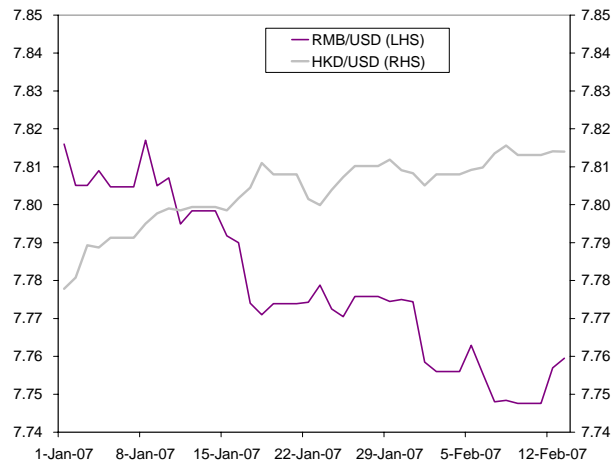
**Irina Fan**  
irinafan@hangseng.com

# Hong Kong Update

## ◆ Disparity of HKD & RMB Movement.

HKD/USD exchange rate began to weaken in recent weeks, while RMB/USD was undergoing accelerating appreciation. Traders who betted on a possible de-pegging of HKD/USD in 2006 would have been disappointed on 11 January 2007 when nothing occurred with parity achieved on that day. Subsequent unwinding of such positions would have contributed to traders switching into the USD for higher interest rates, which put downward pressure on the HKD spot exchange rate.

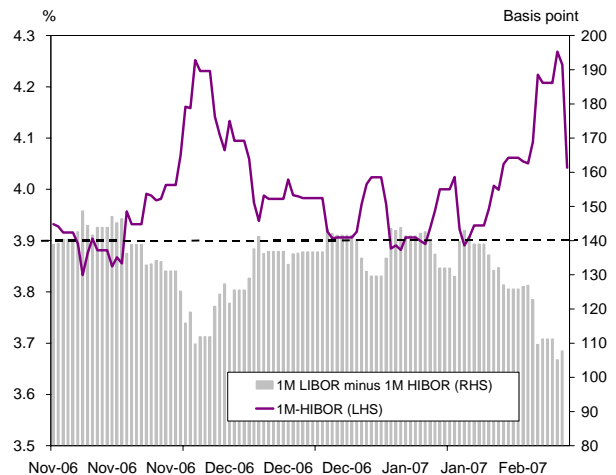
HKD/USD & RMB/USD Exchange Rate



## ◆ HIBOR Starts to Rise.

Interest rate arbitrage activities have pushed local interbank rates up to above 4% and driven HKD down to the weak side of the 7.75-7.85 trading band. The one-month Libor-Hibor spread has been narrowing rapidly from 140 basis points at the beginning of this year to 107 basis points in mid-Feb. Yet, Hibor is still close to the six-month average of 4.04%, which should not indicate massive reversing fund flows. However, a further firming of Hibors from present levels can then indicate outflow of funds.

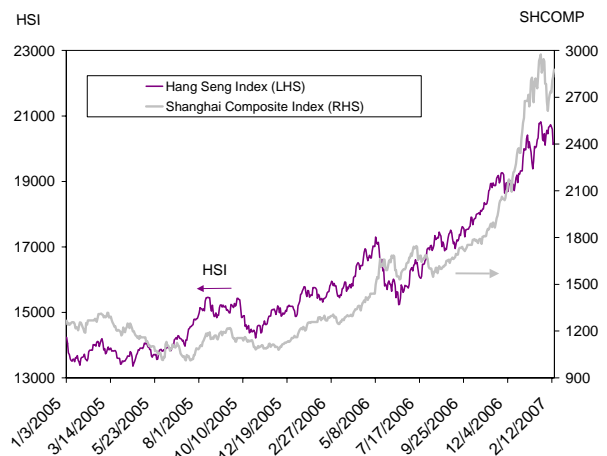
HIBOR Starts to Rise



## ◆ Risk of Massive Outflows.

While we project no change in Hong Kong prime rates in the first half of the year, the major risk lies in massive outflow of funds should the stock markets in both Hong Kong/mainland further inflate in the short term but then collapse later in the year. In such an event, Hong Kong interest rates would move up regardless of US rate moves. The recent stock market rallies prompted mainland authorities to impose policy tightening. One should watch out for drastic policy actions in mainland China.

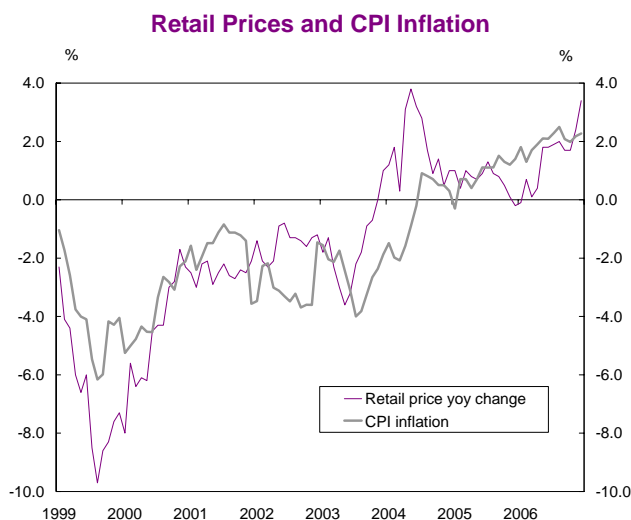
Stock Markets Corrections



# Hong Kong Update

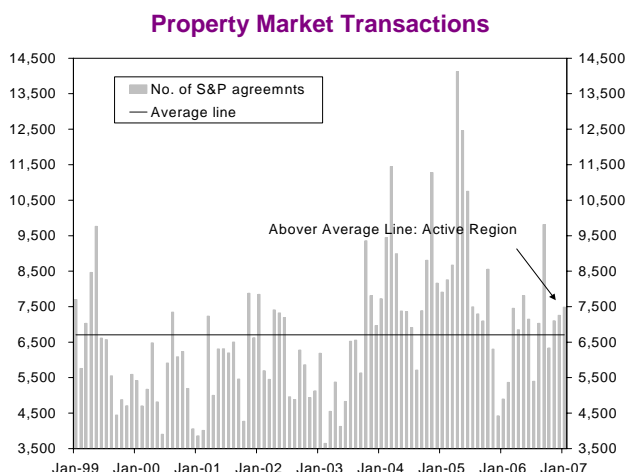
## ◆ Watch Out for Higher Inflation.

Although we currently only project a moderate increase in inflation to an average of 2.5% average for 2007, certain factors that might worsen the price trend need to be watched carefully. The RMB is moving up at an accelerating pace, which is a source of price rise for key staples. Retailers are also keen to transfer the rising rental and labour cost to consumers given the buoyant business and consumer sentiment. Retail and import prices, leading indicators of CPI inflation, have been rising gradually.



## ◆ Property Market Recovery.

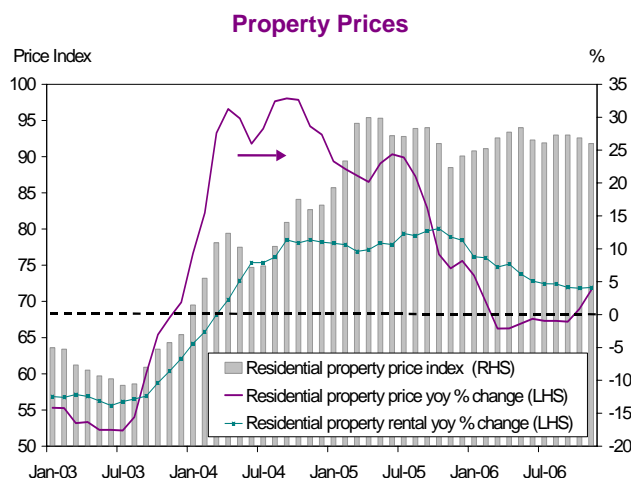
Property transactions showed signs of recovery. The monthly sales and purchase agreements (S&P) of residential units was 7,485 in January 2007, up 3.2% from 7,255 in December 2006. The value of S&P totalled HKD21.3billion, decline of 4.6% from HKD22.4billion in December 2006. After a significant drop of activities in the first half of 2006, residential market picked up since Q3 2006. Preliminary figures from property agencies showed market sentiment seemed getting more favourable in February.



Source: Land Registry

## ◆ Property Prices.

The average property prices remained stable. The overall price index was 92.8 in December 2006, slightly higher than 92.5 in November. Compared with the beginning of 2006, property prices rose by 2.2% with higher prices and activities registered in the Q4 2006. While strong income growth and low interest rates seem to be favourable to property prices, the risk is that sentiment can change rapidly should interest rates and stock market reversed course.



Source: Rating and Valuation Department

# China Update

## ◆ More retail participation in stock trading. What does it tell us?

When more retail investors participate in the stock market, it is usually not a good sign because they are less privileged to timely market information and more driven by market sentiments rather than economic fundamentals. We have seen this before. The bear stock market in China beginning in 2001 was preceded by sharp rises in retail investor participation. Similar pattern has emerged lately, with opening of new individual trading accounts exceeding 1.4 million in December 2006.

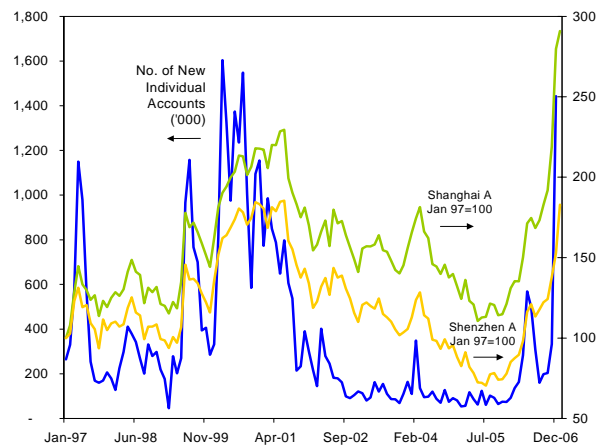
## ◆ Warrant trading activities is another sign of investors' exuberance.

The increase in individual accounts has been fully matched by a surge in trading volume. Daily volume in January jumped sharply to reach Rmb114 billion, higher than the volume in a typical week a year ago or nearly quadruple of that three months ago. The emergence of many stock derivative products is also challenging. Stock warrant trading volume can easily exceed Rmb250 billion on a typical month or 15% of the ordinary stock trading volume. The increase in warrant trading activities tends to bring more volatility to the market.

## ◆ Overstretched financial stock valuations.

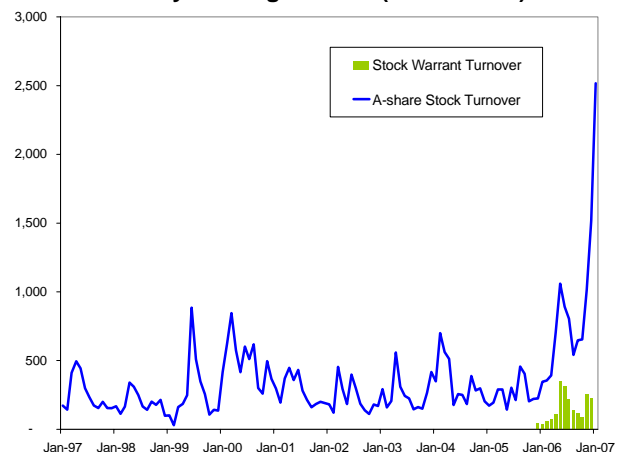
The bull runs in the past have been largely driven by expansions of price-earnings multiple. In the Shanghai A-share market, the overall PE ratio reached 38.4 times in January, not really overstretched compared to the 10-year average of 37.0. The ratio surge to 61.0 in March 2001 and was followed by a 4-year bear market. Nevertheless, the current cycle has been driven by a powerful run of financial stocks, which account for 42% of the total Shanghai-A market capitalization. Financial PE ratio spiked to 51.3 times in December (and most likely higher by now), which warrant extra cautions.

**Retail Investors Vs Stock Market Performance**



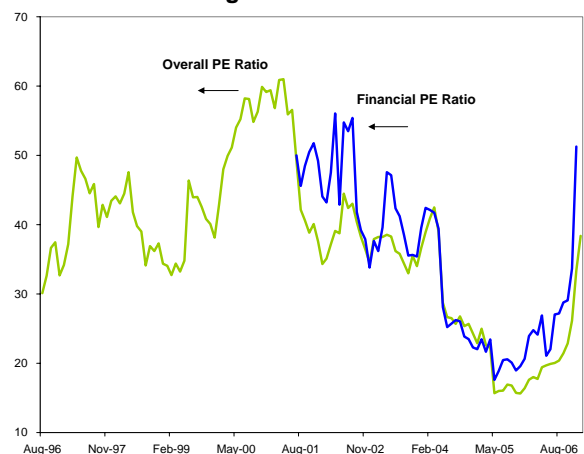
Source: CEIC

**Monthly Trading Volume (Rmb billion)**



Source: CEIC

**Shanghai A-share Market**



Source: CEIC

# China Update

## ◆ Customs efficiency is found to be higher in Southeast

With the help from the National Statistics Bureau, the World Bank has conducted a survey of governance and investment climate, using data from 12,400 firms in 120 Chinese cities. Business law/regulation is basically the same throughout China. But differences mainly reflect disparities of local government efficiency. Some findings are particularly interesting. First, looking at customs clearance - a vital business service provided by government - tends to be 33-50% faster in Southeast or Bohai cities than in the rest of China.

## ◆ Taxes/fees are lowest in SE and Bohai.

Taxes and fees relative to sales appear to be lowest in the Southeast and Bohai. Their lower VAT burden can be attributed to: greater reliance on component purchases; more VAT-advantaged high-tech firms; and higher export sales. Their corporate tax burdens appear to be higher, which is surprising given a stronger presence of foreign enterprises and lower income tax rates for these enterprises. Hence, the lower income tax burden among firms in North, Central, and Southwest China may reflect lower profits (and more unprofitable enterprises, including state-owned).

## ◆ Bureaucratic interaction is a “time-tax”

The amount of time enterprise must spend interacting with bureaucracies (tax bureau, public security, environmental protection, and labor and social security) varies widely. For the top 90th percentile, surveyed firms reportedly average 36 days/year or less of bureaucratic interaction. For the bottom 10th percentile, the average is 87 days or more. On a regional basis, the low “time tax” for Southeast cities is consistent with their pro-business reputation. The similarly low figure for Central cities is somewhat surprising. But the average for Northeast cities falls below that for Bohai cities, despite their legacy of greater government intervention in the economy.

**Average Days for Customs Clearance**

2005	Exports	Imports	Combined
Southeast	3.5	4.2	7.3
Bohai	4.4	5.0	8.6
Northeast	6.4	8.0	12.6
Central	6.8	8.5	13.8
Southwest	7.4	8.3	14.0
Northwest	9.0	7.8	16.8

Source: the World Bank

**Average Taxes and Fees Relative to Sales (%)**

2005	South East	Bohai	North East	Central	South West	North West
VAT	2.8	3.1	3.9	3.5	4.5	7.3
Income tax	0.8	0.8	0.6	0.6	0.7	8.6
Other taxes and fees	0.5	0.6	0.9	0.9	1.1	12.6
Total	4.1	4.5	5.4	5.0	6.3	13.8

Source: the World Bank

**Average Annual Bureaucratic Interaction (No. of Days)**

2005	South East	Bohai	North East	Central	South West	North West
State Owned	58	84	74	62	76	89
Foreign Invested	56	71	69	50	60	87
Small Domestic	30	45	34	31	43	45
All Firms	52	72	63	52	66	78

Source: the World Bank

## Economic Forecasts

GDP, Annual & Quarterly						(yoy % change)	
	Annual			2006		2007	
	2005	2006 (A)	2007 (F)	Q3 (A)	Q4	Q1(F)	
Hong Kong Real GDP	+7.3	+6.6	+5.6	+6.8	+6.1 (F)	+5.8	
China Real GDP	+10.4	+10.7	+9.8	+10.6	+10.4 (A)	+9.9	

Interest Rates, Year-end & Quarter-end						(Period-end figures)	
	Annual			2006		2007	
	2005	2006 (A)	2007 (F)	Q4 (A)	Q1 (F)	Q2 (F)	
Hong Kong Prime Rate	7.75	7.75	7.75	7.75	7.75	7.75	
Hong Kong HIBOR (1-mth)	4.10	3.91	4.00	3.91	4.00	4.00	
China Lending Rate (1-Yr)	5.58	6.12	6.66	6.12	6.39	6.39	
China Interbank T-Bill Rate (1-Yr)	1.61	2.12	2.62	2.12	2.29	2.29	

Hong Kong Statistics, Annual & Monthly						(yoy % change)	
	Annual			2006		2007	
	2005	2006 (A)	2007 (F)	Dec (A)	Jan (F)	Feb (F)	
Total Exports	+11.4	+9.3	+8.0	+13.7	+19.1	+0.2	
Re-exports	+11.6	+10.0	+9.1	+18.0	+22.0	+2.5	
Imports	+10.3	+10.3	+8.2	+14.5	+19.0	+0.9	
Visitor Arrivals	+7.1	+8.1	+6.0	+9.3	-1.2	+18.0	
Retail Sales Value	+6.8	+7.3	+5.9	+11.5	-6.5	+24.0	
Inflation (CPI)	+0.9	+2.0	+2.5	+2.3	+2.4	+2.3	
Unemployment (%)	5.6	4.8	4.3	4.4	4.4 (A)	4.4	
Total M3	+5.2	+15.7	+13.0	+15.7	+17.0	+15.0	

China Statistics, Annual & Monthly						(yoy % change)	
	Annual			2006		2007	
	2005	2006 (A)	2007 (F)	Dec (A)	Jan (A)	Feb (F)	
Merchandise Exports	+28.4	+27.2	+22.0	+24.8	+33.0	+26.5	
Merchandise Imports	+17.6	+20.0	+18.0	+13.5	+27.5	+20.3	
Retail Sales Value	+12.9	+13.7	+14.5	+14.6	+14.6 *	+14.5	
Foreign Direct Investment	+19.4	+4.5	+5.5	-21.1	+5.8 *	+4.8	
Industrial Value-added	+16.4	+16.6	+15.0	+14.7	+15.3 *	+15.2	
Fixed Asset Investment	+26.0	+24.0	+20.0	+19.6	+16.2 *	+16.3	
Inflation (CPI)	+1.8	+1.5	+1.4	+2.8	+2.2	+2.0	
M2	+17.6	+16.9	+15.0	+16.9	+15.9	+16.1	

Notes: Actual (A). Forecast (F). Estimate (E). \* Forecast.

# Economic & Financial Statistics: Hong Kong

	2005	2006	2006					
			Q3	Q4	Oct	Nov	Dec	Jan-Dec
<b>General Economy</b>								
GDP								
- At Current Prices, HKD Billion	1,382	n.a.	379	n.a.	—	—	—	—
- Real Growth, % YOY	+7.3	n.a.	+6.8	n.a.	—	—	—	—
- Nominal Growth, % YOY	+7.0	n.a.	+6.6	n.a.	—	—	—	—
Total Exports								
- HKD Billion	2,250	2,461	666	674	230	229	215	2,461
- Growth, % YOY	+11.4	+9.3	+8.4	+11.8	+7.9	+14.2	+13.7	+9.3
Imports								
- HKD Billion	2,329	2,600	692	707	233	238	235	2,600
- Growth, % YOY	+10.3	+11.5	+10.6	+14.0	+11.2	+16.3	+14.5	+11.5
Trade Balance								
- HKD Billion	-79.3	-138.8	-26.3	-32.8	-3.1	-8.9	-20.8	-138.8
Inflation								
- Composite CPI, %	+0.9	+2.0	+2.3	+2.1	+2.0	+2.2	+2.3	+2.0
Unemployment Rate								
- %	5.6	4.8	4.7	4.4	4.5	4.4	4.4	4.8
Retail Sales								
- HKD Billion	205	220	53	56	18	17	21	220
- Growth, % YOY	+6.8	+7.3	+7.7	+8.8	+7.0	+7.5	+11.5	+7.3
Tourist Arrivals								
- Number, ('000)	23,359	25,251	6,375	6,679	2,194	2,081	2,403	25,251
- Growth, % YOY	+7.1	+8.1	+6.7	+4.3	+2.3	+1.0	+9.3	+8.1
<b>Property Sector</b>								
Residential Property Price								
- Index	92.0	92.5	92.7	92.7	92.9	92.5	92.8	92.5
- Growth, % YOY	+18.8	+0.6	-0.9	+2.9	+1.2	+4.5	+3.0	+0.6
Office Rental								
- Index	96.4	117.2	119.1	121.7	119.0	122.0	124.1	117.2
- Growth, % YOY	+23.8	+21.6	+19.9	+15.5	+16.4	+13.8	+16.3	+21.6
<b>Monetary Sector (Period-End)</b>								
Total Deposits								
- HKD Billion	4,068	4,766	4,551	4,766	4,563	4,893	4,766	—
- Growth, % YOY	+5.2	+17.2	+15.9	+17.2	+15.3	+22.1	+17.2	—
HKD Deposits								
- HKD Billion	2,131	2,568	2,441	2,568	2,436	2,735	2,568	—
- Growth, % YOY	+5.6	+20.5	+17.4	+20.5	+17.6	+29.1	+20.5	—
USD Deposits								
- HKD Billion	1,337	1,606	1,506	1,606	1,503	1,562	1,606	—
- Growth, % YOY	+2.1	+20.1	+17.3	+20.1	+14.9	+20.1	+20.1	—
FCY Deposits								
- HKD Billion	600	592	603	592	624	596	592	—
- Growth, % YOY	+11.3	-1.2	+7.2	-1.2	+8.6	+1.7	-1.2	—
Total Loan								
- HKD Billion	2,312	2,468	2,498	2,468	2,451	2,676	2,468	—
- Growth, % YOY	+7.2	+6.7	+10.1	+6.7	+7.0	+15.8	+6.7	—
Loans Used in HK								
- HKD Billion	2,072	2,127	2,170	2,127	2,119	2,341	2,127	—
- Growth, % YOY	+7.8	+2.7	+6.8	+2.7	+3.2	+13.1	+2.7	—
Loans Used Outside HK								
- HKD Billion	219	318	301	318	307	310	318	—
- Growth, % YOY	+2.4	+45.9	+39.6	+45.9	+41.2	+41.5	+45.9	—
Residential Mortgages								
- HKD Billion	533	530	526	530	526	526	530	—
- Growth, % YOY	+1.0	-0.7	-2.3	-0.7	-2.0	-1.7	-0.7	—
Trade Finance								
- HKD Billion	142	152	160	152	159	156	152	—
- Growth, % YOY	+8.9	+7.4	+8.4	+7.4	+8.2	+8.7	+7.4	—

# Economic & Financial Statistics: China

	2005	2006	2006					2007
			Q3	Q4	Oct	Nov	Dec	Jan
<b>General Economy</b>								
GDP								
- RMB Billion	18,309	20,941	5,003	6,793	—	—	—	—
- Real Growth, % YOY	+10.4	+10.7	+10.6	+10.4	—	—	—	—
Fixed Asset Investment								
- RMB Billion	8,860*	9,347	2,551	3,159	819	924	1,416	n.a.
- Growth, % YOY	+25.7*	+24.5	+22.8	+19.9	+16.2	+23.8	+19.6	n.a.
Retail Sales								
- RMB Billion	6,718	7,641	1,864	2,132	700	682	750.	n.a.
- Growth, % YOY	+12.9	+13.7	+13.8	+12.5	+14.3	+14.1	+14.6	n.a.
Industrial Value-added								
- RMB Billion	6,643	7,746	2,254	2,324	760	794	770.	n.a.
- Real Growth, % YOY	+16.4	+16.6.	+16.2	+14.8	+14.7	+14.9	+14.7	n.a.
Electricity Production								
- kWh Billion	2,415	2,749	745	726	232	236	257	n.a.
- Growth, %, YOY	+13.3	+14.7	+16.6	+15.3	+15.6	+15.7	+14.5	n.a.
Inflation								
- CPI, %	+1.8	+1.5	+1.3	+2.0	+1.4	+1.9	+2.8	+2.2
- PPI, %	+4.9	+3.0	+3.5	+2.9	+2.9	+2.8	+3.0	+3.3
<b>External Sector</b>								
Exports								
- US\$ Billion	762.0	969.0	262.7	278.0	88.1	95.8	94.1	86.6
- Growth, %, YOY	+28.4	+27.2	+28.7	+29.0	+29.6	+32.8	+24.8	+33.0
Imports								
- US\$ Billion	660.1	792.0	214.0	210.3	64.3	72.9	73.1	70.7
- Growth, %, YOY	+17.6	+20.0	+22.1	+15.5	+14.7	+18.3	+13.5	+27.5
Trade Balance								
- US\$ Billion	+101.9	+177.5	+48.7	+67.7	+23.8	+22.9	+21.0	+15.9
FDI (Utilised)								
- US\$ Billion	72.4	69.5	14.2	26.9	6.0	5.7	15.2	5.2
- Growth, %, YOY	+19.4	+4.5	-3.6	-7.8	+15.9	+20.6	-21.1	+13.9
FDI (Contracted)								
- US\$ Billion	189.1	n.a.	44.3	n.a.	n.a.	34.7	n.a.	n.a.
- Growth, %, YOY	+23.2	n.a.	+0.4	n.a.	n.a.	+56.6	n.a.	n.a.
<b>Monetary Sector (Period-End)</b>								
Foreign Reserves								
- US\$ Billion	819	1,066	n.a.	1,066	1,010	1,039	1,066	n.a.
- Growth, %, YOY	+34.3	+30.2	n.a.	+30.2	+28.6	+30.8	+30.2	n.a.
Money Supply (Period-End)								
- M0, Growth, %, YOY	+11.9	+12.7	+15.3	+12.7	+13.6	+13.9	+12.7	-4.6
- M1, Growth, %, YOY	+11.8	+17.5	+15.7	+17.5	+16.3	+16.8	+17.5	+20.2
- M2, Growth, %, YOY	+17.6	+16.9	+16.8	+16.9	+17.1	+16.8	+16.9	+15.9
RMB Deposits Outstanding								
- RMB Billion	28,720	33,540	32,778	33,540	32,930	33,436	33,543	34,000
- Growth, %, YOY	+19.0	+16.8	+17.1	+16.8	+17.0	+17.1	+16.8	+16.8
RMB Loans Outstanding								
- RMB Billion	19,500	22,530	22,104	22,530	22,120	22,314	22,528	23,100
- Growth, %, YOY	+13.0	+15.1	+15.2	+15.1	+15.2	+14.8	+15.1	+16.0
RMB Lending Rates								
- 6 Month	5.22	5.58	5.58	5.58	5.58	5.58	5.58	5.58
- 1 Year	5.58	6.12	6.12	6.12	6.12	6.12	6.12	6.12
- 1-3 Years	5.76	6.30	6.30	6.30	6.30	6.30	6.30	6.30
- Over 5 Years	6.12	6.84	6.84	6.84	6.84	6.84	6.84	6.84
RMB Deposit Rates								
- Current Account	0.72	0.72	0.72	0.72	0.72	0.72	0.72	0.72
- 1 Year	2.25	2.52	2.52	2.52	2.52	2.52	2.52	2.52
- 5 Years	3.60	4.14	4.14	4.14	4.14	4.14	4.14	4.14

Notes: \* National Figures

^ Effective 29 Oct 2004

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