

PRC B1407-R

A Gift from the Chinese Government
Bloomberg | Reuters | POEMS
86606 HK | 86606.HK | 86606.HK
Industry: Government Bond



Phillip Securities (Hong Kong) Ltd
Phillip Securities Research

10 July 2012

Report type: IPO Report

Rating: **Subscribe**

IPO Price: RMB 100 | Target Price RMB 102

Bond Overview

Issuer: The Ministry of Finance of the People's Republic of China

Bonds offered: RMB 5,500,000,000 Fixed Rate Bonds due 2014

Subscription period: 9:00 a.m., 29 June 2012 to 2:00 p.m., 13 July 2012

Issue date: 19 July 2012

Subscription price: 100% of the principal amount

Coupon rate: 2.38%

Interest payment dates: Semi-annually in arrear on 19 January and 19 July of each year, beginning on 19 January 2013. If any of the dates on which the Ministry of Finance should pay interest is not a business day in Hong Kong or Beijing, the relevant interest payment date will be postponed to the next day which is a business day in both Hong Kong and Beijing unless the next business day would thereby fall into the next calendar month, in which event the relevant interest payment date will be brought forward to the immediately preceding business day.

Use of proceeds: The net proceeds from the sale of the Bonds, after deduction of underwriting commissions and other offering expenses, will be used by the Ministry of Finance for general governmental purposes.

Selling restrictions: May not be offered, sold, pledged or transferred to, or for the account or benefit of, U.S. persons or U.S./Canadian residents.

Research Analyst

Philip Mok

philipmok@phillip.com.hk
+852 2277 6609

Summary

There are a few similarities between PRC B1407-R and the iBond series. 1. Both of them are Hong Kong exchange traded government bonds. 2. Both of them are listing at face value. 3. Both intrinsic values are above the face values. For their differences, we expected a lower first day gain from PRC B1407-R comparing with the iBond series and the investment risks and costs incurred by the investment are higher for PRC B1407-R. For the valuation of PRC B1407-R, we estimate the discount rate by discounting the yield of the three-Year RMB Bonds (86601.HK). We also deploy a scenario with further interest rate cut. We estimate the fair value of PRC B1407-R to be 102% of the face value. (RMB 10,200) and conclude our report of PRC B1407-R with a "Subscribe" rating.

Preface

On 29th June 2012, HKEx announced that the Bonds issued by the Ministry of Finance of the People's Republic of China will be listed and traded in RMB on Hong Kong Stock Exchange and admitted into CCASS as Eligible Securities for clearing and settlement for the first time. Following the issuance of iBond (HKGB IBOND 1506; 4214.HK and HKGB IBOND 1407; 4208.HK), the public awareness on bonds investment has improved remarkably. iBonds have been regarded as a gift from the Hong Kong Government. In the follow paragraphs, we will compare PRC B1407-R with the iBonds and find out the whether PRC B1407-R is another gift from the Chinese Government.

Overview of Bonds Issuance

Other than PRC B1407-R, the Ministry of Finance of the People's Republic of China offered five different bonds through a competitive tender. The details and the results of the tender are as followed. Meanwhile, as the coupon rate of PRC B1407-R (Two-Year RMB Bonds due 2014) is higher than the coupon rate of Three-Year RMB Bonds due 2015 and the coupon rate of the Three-Year RMB Bonds was decided via a competitive tender, we believe that PRC B1407-R is offering to the investors in a discount.

Fig.1 Tender results and Bonds information

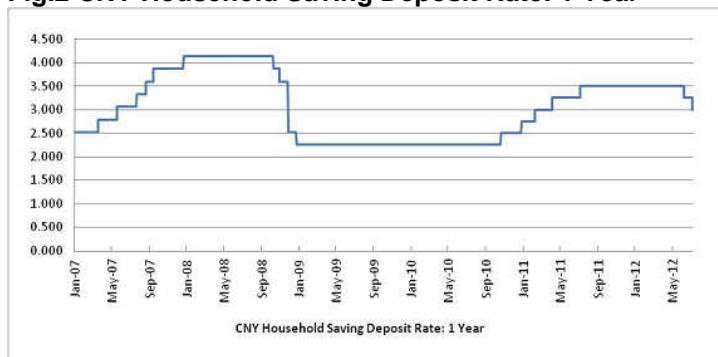
	Coupon Rate (%)
Two-Year RMB Bonds due 2014 (86606.HK)	2.38
Three-Year RMB Bonds due 2015 (86601.HK)	1.85
Five-Year RMB Bonds due 2017 (86602.HK)	2.56
Seven-Year RMB Bonds due 2019 (86603.HK)	2.65
Ten-Year RMB Bonds due 2022 (86604.HK)	3.1
Fifteen-Year RMB Bonds due 2027 (86605.HK)	3.48

Sources: HKEx

1-Year RMB fixed deposit rate

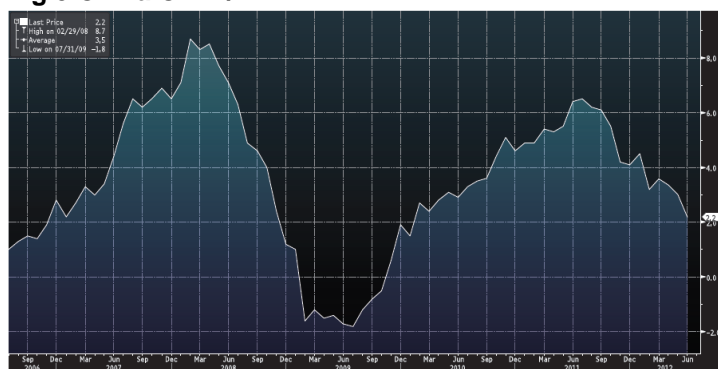
The hobbling world economies remain a major threat to growth of the Chinese economy. In order to maintain the GDP growth rate, the Chinese Government has trimmed 1-Year RMB fixed deposit rate twice in a month, with the latest cut of 25 basis points. The interest rate cut will fuel the price of the government bonds. The inflation in China has been curbed by a series of measures pursued by the Chinese Government, paving the way for further interest rate cut in future. In addition, the current 1-Year RMB fixed deposit rate is still above the recorded low during the financial crisis in 09/10, there is room for further interest rate cut. However, the current 1-Year RMB fixed deposit rate is standing at the 3% level. If the 1-Year RMB fixed deposit rate is used as the discount rate for bond valuation, the intrinsic value for PRC B1407-R will drop below its face value.

Fig.2 CNY Household Saving Deposit Rate: 1 Year



Sources: Bloomberg

Fig.3 China CPI Y/Y



Sources: Bloomberg

On the contrary, PRC B1407-R possesses a distinct competitive edge comparing with RMB fixed deposit. Although the current 1-Year RMB fixed deposit rate of 3% is higher than the coupon of PRC B1407-R, investor's fund will be locked up in the fixed deposit and interest penalty will be resulted upon early withdrawal. Meanwhile, listing on Hong Kong Stock Exchange provides great liquidity and the demand deposit nature to the bond. Additionally, investors can gain the accrued interest when the bond was sold. As a result, PRC B1407-R provides investors an option of high yield demand deposit. It also explained why the tender yield of the Three-Year RMB Bonds was far below the current 1-Year RMB fixed deposit rate.

Potential of RMB appreciation

Another advantage of the RMB bonds is the appreciation potential of RMB. The RMB appreciated substantially since 2007. But this trend has ended after years of appreciation of the RMB. As the current world economy is fragile without clear direction, we expect the RMB to oscillate around the current level in short run. As the rise of the Chinese power is inevitable, we expect the RMB will appreciate further in the long run.

Fig.4 RMB/USD Spot



Sources: Bloomberg

Risk and Valuation of PRC B1407-R

Similar to typical sovereign bonds, risks of PRC B1407-R stem from three major areas. 1. The default risk of the Chinese Government – As China is currently the world second largest economy in terms of GDP, while the bond will mature in two years; the default risk of the Chinese Government is almost non-existence. 2. Interest rate risk - A hike in interest rate will have a negative impact on bond price. Again, as the bond will mature in two years, the sensitivity of bond price on interest rate is minimized. Furthermore, we expect the bond price will benefit from the interest rate cut resulting from the current global financial turmoil. 3. RMB exchange rate risk - RMB exchange rate risk is the major risk of the investment. The current momentum of RMB exchange rate was fragile, and investors should be ready for the potential loss from exchange rate movement. However, we remain optimistic for the long-term prospect of RMB.

For the valuation of PRC B1407-R, we estimate the discount rate by discounting the yield of the three-Year RMB Bonds (86601.HK). We also deploy a scenario with further interest rate cut. We estimate the fair value of PRC B1407-R to be 102% of the face value. (RMB 10,200)

Fig. 5 Valuation Forecast

Coupon Rate: 2.38%

Average Risk Free Rate (%)	Price (% of face value)
0.60%	103.53
0.85%	103.03
1.10%	102.53
1.35%	102.03
1.60%	101.53
1.85%	101.04
2.10%	100.55
2.35%	100.06
2.60%	99.57
2.85%	99.09
3.00%	98.81

Sources: PSHK Est.

iBond Series

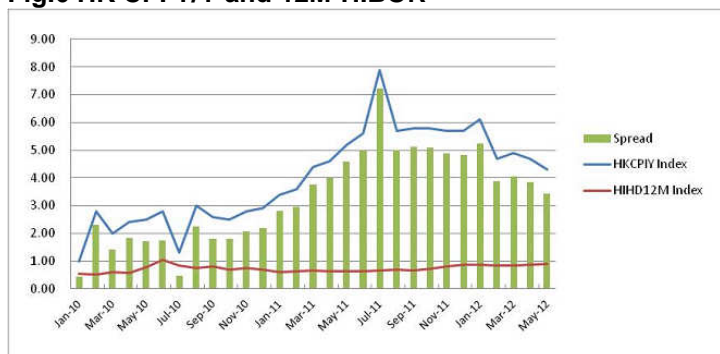
iBond is a Hong Kong dollar retail inflation-indexed bonds issued by the Hong Kong Government. iBond is the first exchange traded bond listing on Hong Kong Stock Exchange. The first round of iBond is named HKGB IBOND 140, issuing at 28th July 2011 with face value of HK\$10,000. The rate for each interest payment will be determined by the year-on-year inflation rate of Hong Kong on semiannual basis, which according to the Hong Kong Composite Consumer Price Index, with the lower limit of 1% return.

iBond Analysis

Valuation of iBond is based on the inflation expectation in Hong Kong and the corresponding discount rate. We compared the Hong Kong inflation rate with 1. One-year HIBOR 2. Yield of Hong Kong Exchange Fund Note. (Three and ten years).

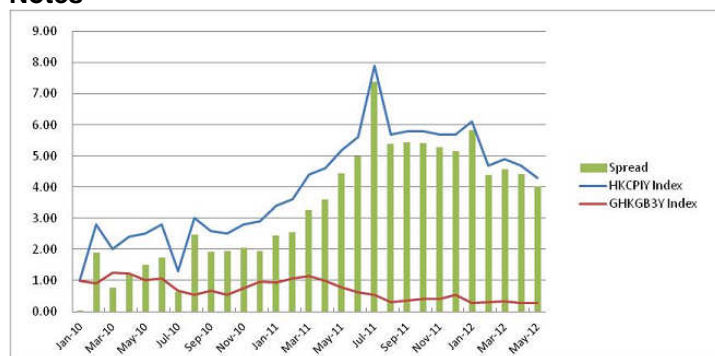
Since 2010, inflation in Hong Kong became problematic due the imported inflation caused by the quantitative easing of the global economies. Meanwhile, HIBOR remained at a low level reflecting the liquidity flooding in the Hong Kong bank system. While under the quantitative easing program implemented by the U.S. Government, the yield of the three-years and ten-year Hong Kong Exchange Fund Note was pressured into a relative low level. As a result, there was a positive yield spread between Hong Kong inflation rate and the corresponding discount rate, fueling the iBond price over its face value. (HK\$100)

Fig.6 HK CPI Y/Y and 12M-HIBOR



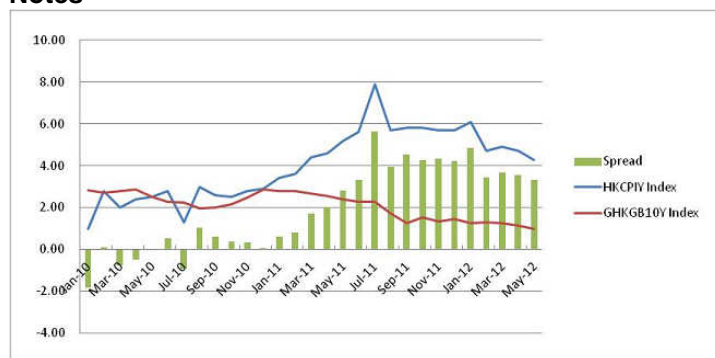
Sources: Bloomberg

Fig.7 HK CPI Y/Y and Yield of 3YHK Exchange Fund Notes



Sources: Bloomberg

Fig.8 HK CPI Y/Y and Yield of 10YHK Exchange Fund Notes



Sources: Bloomberg

iBond Valuation

Since 2010, inflation in Hong Kong became problematic due the imported inflation caused by the quantitative easing of the global economies. We expected the inflation will persist in short to medium term. Meanwhile, as the yield of Hong Kong Exchange Fund Note will continue to be pressured into a relative low level, we estimate that the iBond will trade above its face value with HK\$106.1.

Fig.9 iBond Valuation Forecast

Average Risk Free Rate	Average Inflation Rate									
	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%	
0.2%	102.39	103.89	105.38	106.88	108.37	109.87	111.36	112.85	114.35	
0.4%	101.79	103.28	104.77	106.26	107.75	109.24	110.72	112.21	113.70	
0.6%	101.19	102.67	104.16	105.64	107.13	108.61	110.09	111.58	113.06	
0.8%	100.59	102.07	103.55	105.03	106.51	107.99	109.47	110.95	112.43	
1.0%	100.00	101.47	102.95	104.42	105.90	107.37	108.84	110.32	111.79	
1.2%	99.41	100.88	102.35	103.82	105.29	106.76	108.23	109.70	111.16	
1.4%	98.83	100.29	101.76	103.22	104.68	106.15	107.61	109.08	110.54	
1.6%	98.25	99.71	101.17	102.63	104.08	105.54	107.00	108.46	109.92	
1.8%	97.67	99.13	100.58	102.04	103.49	104.94	106.40	107.85	109.30	

Sources: PSHK Est.

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PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within \pm 5% from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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Contact Information (Regional Member Companies)

SINGAPORE

Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

HONG KONG

Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites: www.phillip.com.hk

INDONESIA

PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

THAILAND

Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website www.phillip.co.th

UNITED KINGDOM

King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

AUSTRALIA

PhillipCapital Australia
Level 37, 530 Collins Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96298380
Fax (613) 96148309
Website: www.phillipcapital.com.au

MALAYSIA

Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

JAPAN

PhillipCapital Japan K.K.
Nagata-cho Bldg.,
8F, 2-4-3 Nagata-cho,
Chiyoda-ku, Tokyo 100-0014
Tel (81-3) 35953631
Fax (81-3) 35953630
Website: www.phillip.co.jp

CHINA

Phillip Financial Advisory (Shanghai) Co. Ltd
No 550 Yan An East Road,
Ocean Tower Unit 2318,
Postal code 200001
Tel (86-21) 51699200
Fax (86-21) 63512940
Website: www.phillip.com.cn

FRANCE

King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
Website: www.kingandshaxson.com

UNITED STATES

Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005