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Strategy Report

Oil prices crash's impact on economy and stocks

Crude oil prices plunged 30% since last Friday on a collapsed deal by OPEC+. We estimate that lower oil price would boost global GDP growth by 0.1/0.3/0.5pct in the best/base/worst scenarios for oil price. On China, lower oil price would help the economy by reducing costs, but demand shock from COVID-19 persists. As for Hong Kong stock market, while sectors would have different impacts from lower oil, we believe earnings estimates of the HSI would be cut further, and thereby we lower our targets for the HSI & HSCEI.

- **Oil prices plunged on failed OPEC+ deal.** OPEC+'s failure to reach an output curb deal and Saudi Aramco's price cut led to a crash in oil prices. Global oil demand is already very fragile due to the COVID-19 outbreak, and we believe oil price may drop further.

- **Global economy given modest boost.** Crash in oil prices is definitely a negative shock to oil-exporting countries, and generally negative to emerging markets, but would boost the global economy modestly by helping consumer spending and firms' operating costs. For global central banks, we believe they are now mainly focusing on COVID-19 risks while deflationary pressure gives them a fresh reason to cut to fight deflation.

- **China: amiable cost environment, but demand shock still prevails.** Low oil prices may prove amiable to China's real economy, by alleviating costs for midstream and downstream corporates and freeing up growth potential for consumption. The demand shock coming from COVID-19, may persist till end-Mar or Apr in China and even longer in other places in the world.

- **HSI at risks of more earnings cut.** Since the COVID-19 outbreak in China in January, HSI's 2020E EPS has been revised down by 3.4%. Having considered the impact of oil prices and COVID-19, our estimates of HSI's 2020 EPS is 4.6% lower than consensus in our base case. Keeping our target P/E, we cut our HSI target range in 2020 to 23,280 - 28,050.

- **Energy & Utilities: negative to neutral impact.** Oil & gas upstream players and oilfield services names will suffer from oil price tumble. Impact on renewables is very limited at current stage, as operators' project development decision is relatively independent from oil price. City gas distributors will have little impact too, given relatively stable demand and dollar-margin outlook.

- **Positive to airlines, auto & certain industrial stocks.** The crash of oil price, together with policy support, will help China's airlines alleviate operating costs in an environment of reduced fare prices and load factors due to COVID-19. Auto sector will benefit as lower oil prices will stimulate first-purchase demand and slightly reduce production costs. In addition, certain industrial and construction machinery stocks would enjoy lower production costs.

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Oil prices plunged on failed OPEC+ deal

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A collapsed deal led further risks for oversupply, with fragile demand

OPEC+ output curb deal collapsed on 6th Mar triggered first wave of oil price decline, while Saudi Aramco's price cut on export offer triggered second wave of oil price tumbled by more than 25% on 9th Mar. OPEC+'s Vienna meeting was discussing 1) extending existing 2.1mbpd output cut till end-2020, and 2) additional 1.5mbpd output cut for weakening global oil demand due to COVID-19 impact. Russia refused both of the requests, and Saudi Arabia made tough response with a price war and threatening increasing production from Apr 2020.

Suffering from the coronavirus outbreak, global oil demand is very fragile. According to IEA's demand outlook in its Feb OMR report, it cut global oil demand growth outlook by 30.7% from 1.19mbpd to 825kbpd in 2020, and pointing out that 1Q20 will be the first quarterly demand contraction in more than 10 years, with an output decline projection of 435kbpd. Based on IEA data, OPEC produced 28.86mbpd but market calls for only 27.2mbpd, implying a supply glut of 1.7mbpd.

In such situation, the deal burst sent negative signal to the market, and concern is now on Saudi Arabia's market share over price strategy for significant output growth from Apr 2020. Russia and other gulf countries such as Iraq and Kuwait and UAE whose operating low costs oil field may follow to boost output, which is likely to worsen short term supply-demand outlook.

Oil price may drop further

With reference to oil price tumble in 2015-16 driven by supply side actions, WTI had touched down to US$26.21 per barrel on 11 Feb, 2016, while discussion of production curb cuts in the following months save the situation and drove rebound in V-shape.

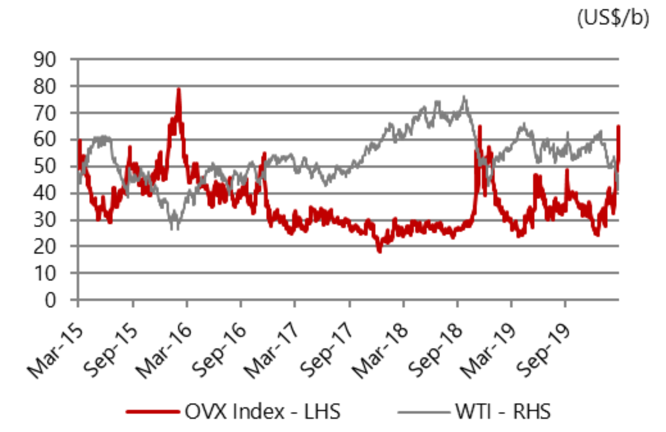
Situation may be different this time, as the collaboration between OPEC and Russia just burst, and we think Saudi Arabia may intend to drive oil price to low enough to fight against competitors such as Russia, Iran and US shale and tight oil producers.

Oil price outlook in scenarios

1) Base case: with no further aggressive move, oil price will likely to test US$20-25, then remain low at US$30 per barrel in the next 3 months;
2) Worst case: Saudi Arabia, gulf countries and Russia choose to increase output and seize market shares as much as they could. Oil price will crash to US$20 and remain at low levels for the rest of the year;
3) Best case: After initial flip, OPEC+ countries return to the table for another round of output curb discussion. Oil price would rebound back to US$40-50 per barrel.

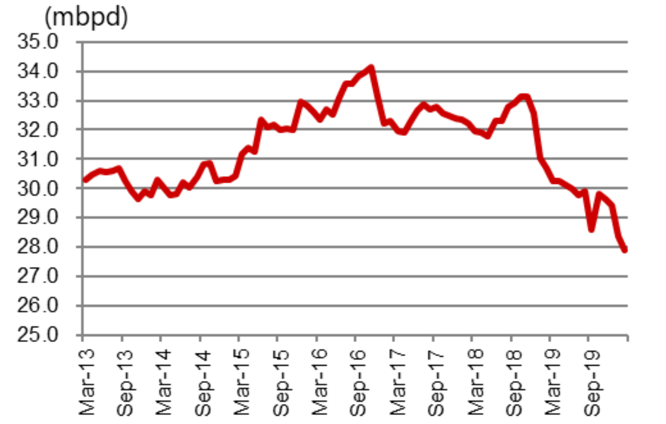
Charts

Figure 1: OVX Index shoot up to 65 during the tumble. The highest level in Feb 2016 was up to 80.



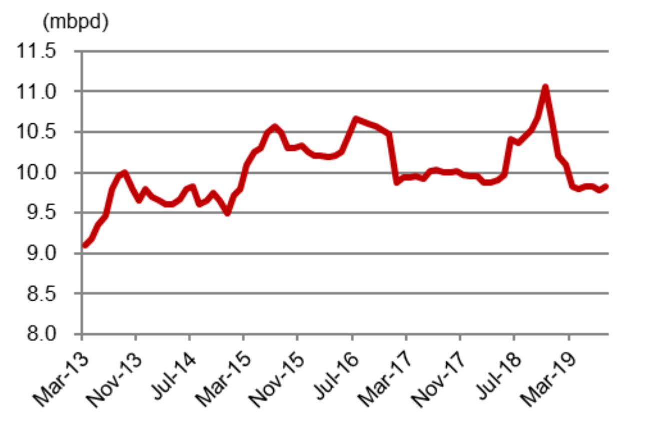
Source: Bloomberg, CMBIS

Figure 2: OPEC's output level was 27.9mbpd in Feb, with significant capability to drive an output growth



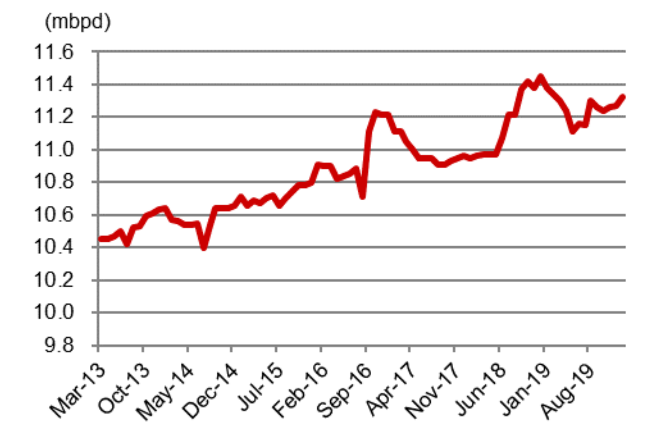
Source: Bloomberg, CMBIS

Figure 3: Saudi Arabia performed high compliance rate to the output curb. The County has plenty of spare capacity to drive a price war.



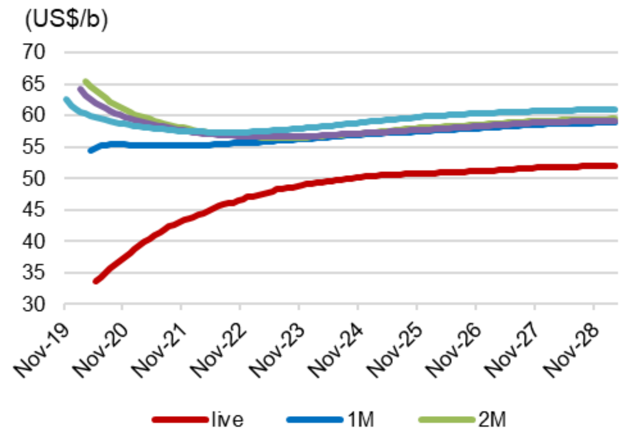
Source: Bloomberg, CMBIS

Figure 4: Russia's crude output was expanding during the past few months



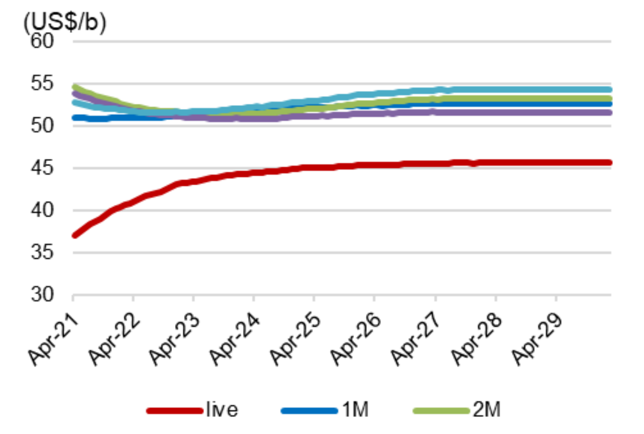
Source: Bloomberg, CMBIS

Figure 5: Brent crude's future curve



Source: Bloomberg, CMBIS

Figure 6: WTI's future curve



Source: Bloomberg, CMBIS

Impact on global economy

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Game theory and the Saudi-Russia breakup: US is a game changer

A non-zero sum game: Russia and Saudi Arabia, along with other oil-producing countries, are playing a non-zero sum game, in which two or more players either cooperate for a win/win scenario or the failure to cooperate for a lose/lose scenario.

Figure 7: Payoff matrix: either win/win or lose/lose in a non-zero sum game

		Saudi Arabia	
		Cut oil production	**Not cut oil production**
Russia	**Cut oil production**	Oil price rises/stabilizes; both countries earn profits **Win/Win**	Oil price fluctuates more and tends to increase; Saudi Arabia gains both more revenue and market share; Russia loses some market share **Win/Lose**
	Not cut oil production	Oil price fluctuates more and tends to increase; Russia gains both more revenue and market share; Saudi Arabia loses some market share **Lose/Win**	Oil prices tend to decline due to higher total production. Both Saudi Arabia and Russia earn less profits **Lose/Lose**

Source: CMBIS

Why in a lose/lose situation now? This time, Russia and Saudi Arabia failed to enter an agreement on oil production cuts. In other words, they are stepping into the lose/lose scenario, which is a risky gamble for both Saudi and Russia that could not pay off. Why have they fallen into the lose/lose situation instead of maintaining mutual benefits? Beside the long-standing reason that different stances on energy policy and terrorism make the collective actions difficult and fragile, the oil market has completely changed and there are a lot of new players and many different interests. Among them, US is an important game changer, which has become the world's largest oil producer since 2018 and is now threatening Saudi Arabia as the world's top oil exporter. In sum, the current price war is one of the profound implications for the changing geopolitics of energy. OPEC+ is more likely to stay in lose/lose situation than a win/win one with respect to US oil production.

Fight for global domination: If defending market share and dominating price-setting become the priority concerns for oil-producing countries, they tend to increase oil production to prevent other participants from controlling the market. Therefore, cooperation among OPEC+ is never an easy task. Moreover, evolving role of US in global oil market has broken the potential standoff. Russia would rather moving away from a deal than giving up market share to the US. If OPEC+ gets paralyzed in the coming several years, collective actions by Russia and Saudi will become less likely and we are about to see a trilateral game in the global oil market, which will increase the uncertainties of both oil production and price.

Why now? COVID-19 explains the timing. Shrinking global demand due to the COVID-19 outbreak makes the issue vital and urgent, because OPEC+ is not only talking about additional US shale oil production; it has to cope with large amount of excess oil on the market.

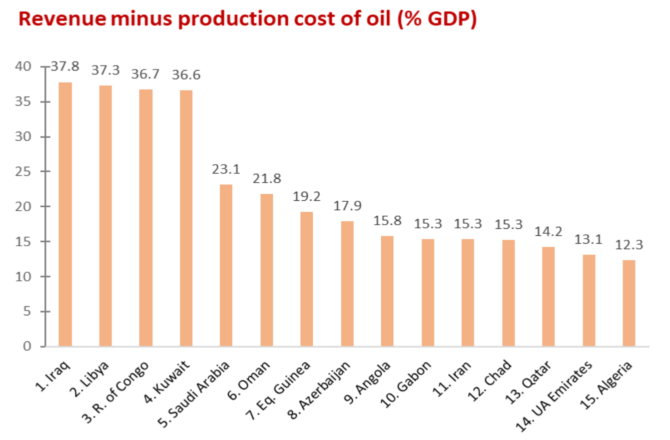
An expensive and risky gamble: Last time when the strategy was used in 2014, global oil prices slumped but US shale oil producers were far more resilient than expected and bounced back even stronger. Thus two years later OPEC returned to production cuts to restore prices. Will this time be different? If one day Russia or other parties feel that the pain is too great, they may come back to table. It is possible that we are entering a multiyear oil price war. High uncertainties persist and oil prices are in the uncharted waters.

Oil price and global economy

For oil-exporting countries: definitely a negative shock. The economies that are most reliant on oil (including Kuwait, Libya, Saudi Arabia, Iraq, Angola, Venezuela, Algeria, Brunei, Qatar, etc.) may face an immediate negative shock to GDP growth. For Saudi Arabia, oil directly accounts for more than 40% of GDP, nearly 70% of fiscal revenue and about 80% of exports. Russia will also be a big loser. Natural gas and oil contribute about 60% of Russia's GDP and oil taxation accounts for over half of its federal budget. The sharp drop of oi price will inevitably harm Russia's economic outlook, or cause a recession of Russian economy in 2020 in the worst case. For the US, shale oil producers will feel the pressure and some may go bankruptcy, but the overall impact will be much smaller given energy sector accounts for a smaller part of the whole economy.

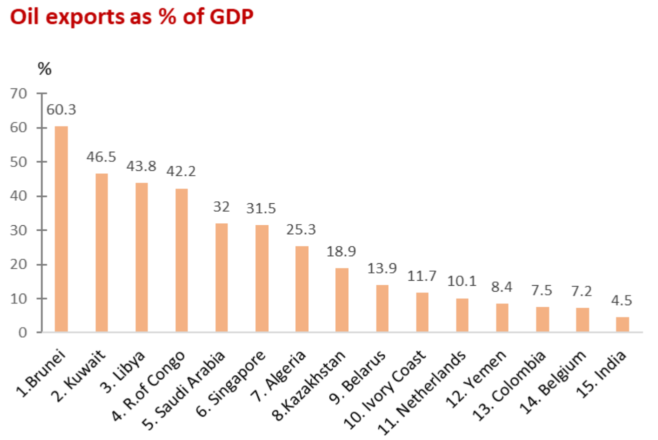
For emerging markets: negative impact. In addition to virus-triggered nervousness, tumbling oil and commodity prices is a fresh headwind for EMs, leading to outflow of capital, less trade and depreciation of currencies of EMs, especially for Mexico, South Africa, Venezuela and Iran etc. In the worst scenario, if one or more emerging markets fall into debt or currency crisis in this difficult time, it may trigger larger-scale panic.

Figure 8: Top 15 economies most dependent on oil: oil profit/GDP



Source: World Bank, CMBIS

Figure 9: Top 15 economies most dependent on oil: oil export/GDP



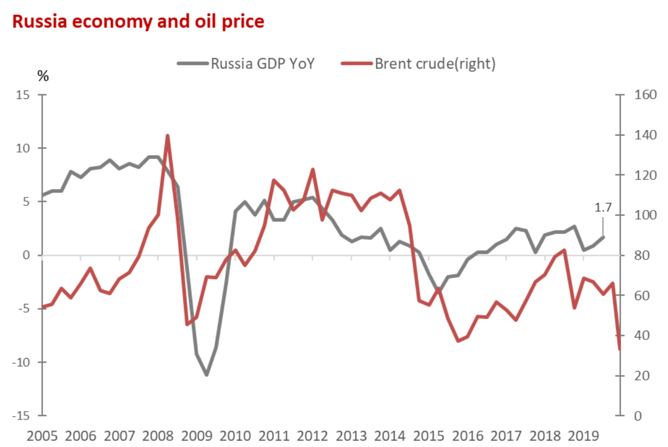
Source: Bloomberg, CMBIS

For global economy: modest growth boost. Macroeconomic effects of falling oil prices vary by country and over time, and it also depends on persistence of the decline. Generally speaking, lower prices for energy increase consumer spending and decrease firms' energy costs and may have significant positive effect on most economies around the globe. Importing countries such as China, Japan and US stand to gain. For example, US consumer sector, which accounts for some 70% of its economy, is likely to gain support from cheaper oil. The overall effect on the global economy should be positive since the economies of the oil-importing countries are significantly larger than the oil exporters. The impact of lower oil price alone is expected to add **0.1/0.3/0.5pct** to global GDP growth **in the best/base/worst scenarios respectively** in the next 12 months.

However, remember that we are in an unusual time with global selloff. Oil market is hit by supply and demand shocks at the same time. Thus the demand-boosting effect by lower energy prices will be much smaller. Concerns on COVID-19 impacts and worse financial condition are not likely to be offset by the economic positives brought by lower oil prices. There will be higher risks if slump in oil price prolongs.

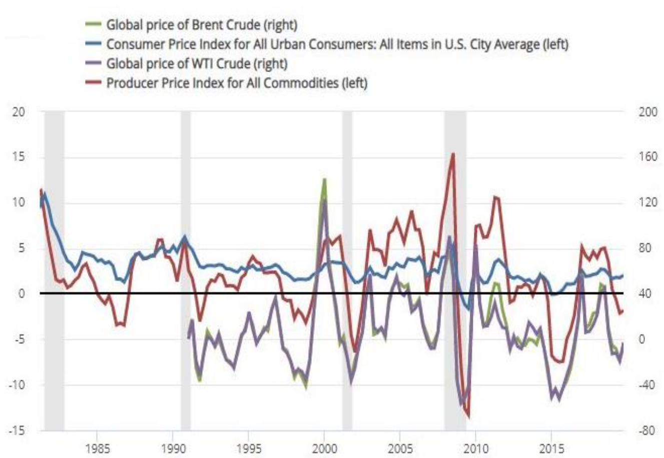
For global central banks: Falling oil price is deflationary, which means that central banks have to bring forward their tools to avoid deflation. For US, lower oil prices are associated with lower producer prices and vice versa. Relationship between US CPI and oil prices are also positive but much weaker. Now central banks in US, Europe and Japan remain profoundly concerned about the low level of inflation. Fed's preferred measure of inflation, core PCE price index, increase only 1.6% in Jan 20, well below its 2% target. We believe major central banks now are mainly focusing on COVID-19 risks while deflationary pressure gives them a fresh reason to cut to fight deflation. We expect US Fed to cut its target rate range by 75bp more in 1H20 to 0.25-0.5% from the current 1-1.25% after a surprise cut of 50bp on 3 Mar 2020.

Figure 10: Russian economy relies heavily on oil



Source: Bloomberg, CMBIS

Figure 11: Lower oil price may lower US inflation



Source: US Fed, CMBIS

Impact on China's economy

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Amiable cost environment, but demand shock still prevails

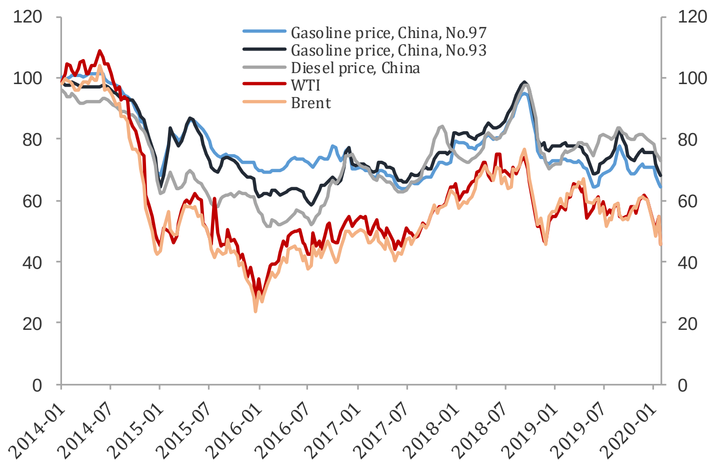
Paramount concern lies in demand shock

Weakness in oil price is a reflection of muted economic and demand growth across the globe. The demand shock coming from COVID-19, may persist till end-Mar or Apr in China and even longer in other places in the world. That said, we think any discussions or scenarios analysis should primarily consider the impact of COVID-19, rather than singling out oil price changes as an external shock.

Amiable in the sense of reducing cost

From the cost perspective, however, low oil prices may prove amiable to China's real economy, by 1) alleviating cost for midstream and downstream corporates. These firms, which take crude oil or oil-related products as major input materials or cost components, are struggling to deal with freefalling demand; 2) reducing oil-related consumption prices and freeing up growth potential for other consumption categories.

Figure 12: Domestic gasoline and diesel prices will follow

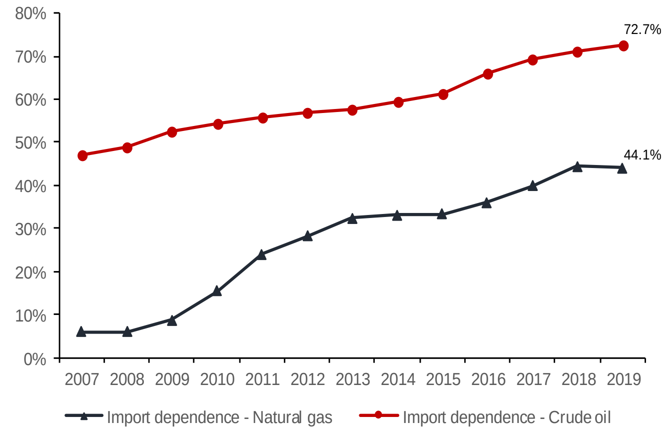


Source: Wind, CMBISNote: Price level at YE2013 is normalized to 100.

Trade – likely to reduce import by 5%

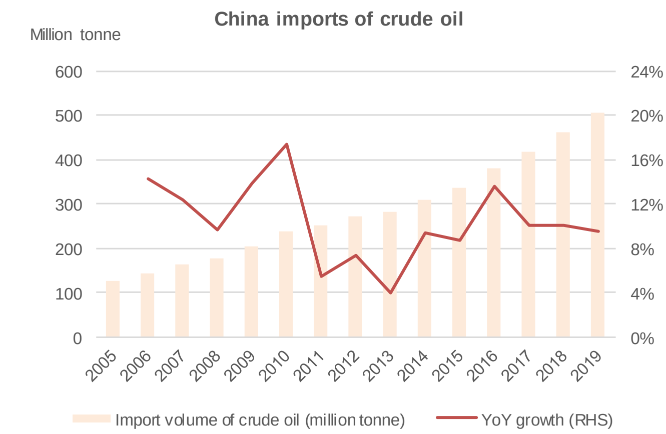
In 2019, China imported 505 million tons crude oil in 2019, totaling US$ 241.3bn. Assuming 10% import volume growth in 2020, in our base case oil price forecast, China is going to save close to the magnitude of US$100bn in crude oil import. On the other hand, import value could be dragged by 5% by low oil prices and it would be challenging to fulfill the energy import commitment in the China-US Phase One Deal.

Figure 13: China's import dependence of crude oil climbed to 72.7% in 2019



Source: Wind, CMBIS

Figure 14: China's crude oil imports have been growing at around 10% YoY

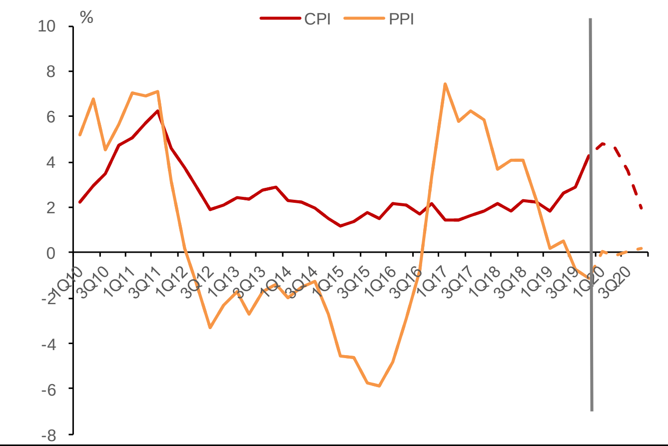


Source: China Customs, Wind, CMBIS

Alleviate inflation pressure

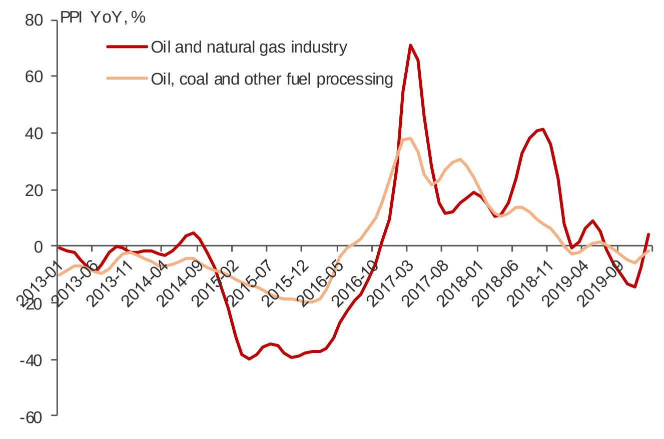
CPI growth is centered on pork this year and we perceive upward trend of pork prices may continue throughout 1H20. We estimate low oil prices may reduce CPI growth of the year by 0.2-0.3ppt (CMBIS forecast at 3.3%). PPI growth may also dip deeper in the negative territory. PPI of oil and natural gas exploring industry declined ~40% YoY during the previous oil price plunge.

Figure 15: Inflation trend estimate



Source: NBS, CMBIS estimates

Figure 16: During the previous oil price plunge, PPI of oil and natural gas industry declined ~40% YoY



Source: NBS, CMBIS estimates

RMB

Recent developments in the global economy (control of COVID-19, etc.) may exert upward pressures on RMB against other major currencies. From the mid to long run, however, we maintain our previous forecast that USDCNY is to float primarily in the range of 6.9-7.1, and YE20 estimate is 7.0.

Domestic policy boost

Domestic policy boost is stepping up in all aspects, from monetary, fiscal to industry policies. Provincial governments have recently rolled out key investment projects. Technology-oriented infrastructure and extensions of traditional infrastructure are becoming the new investment drivers. Again, execution is what we should really focus on.

Hong Kong Stock Market Outlook

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Stock markets around the globe dived on 9th Mar, triggered by the oil prices' slump.

Figure 17: Global stock markets sunk on 9th Mar

	9th Mar (%)	YTD (%)
HK - HSI	-4.2	-11.2
HK - HSCEI	-4.5	-10.6
China - SHCOMP	-3.0	-3.5
Japan - Nikkei	-5.1	-16.7
Australia - ASX 200	-7.3	-13.8
Taiwan - TWSE	-3.0	-8.5
Germany - DAX	-7.9	-19.8
France - CAC	-8.4	-21.2
UK - FTSE	-7.7	-20.9
US - Dow Jones	-7.8	-16.4
US - S&P 500	-7.6	-15.0
US - Nasdaq	-7.3	-11.4

Source: Bloomberg, CMBIS

Cut HSI target range to 23,280 – 28,050

Following the COVID-19 outbreak and oil prices' slump, we believe the Hang Seng Index and the Hang Seng China Enterprises Index will face more earnings cut, and we accordingly revise down our index targets, based on three scenarios.

In our base case, the HSI's target range for this year is cut to 23,280 – 28,050, from 25,100 – 30,200 put forth in Dec 2019. The HSCEI's target range is cut to 9,550 – 12,080, from 10,200-13,100 (see 2020 Strategy Report).

Two of the three indicators suggest HSI is close to trough…

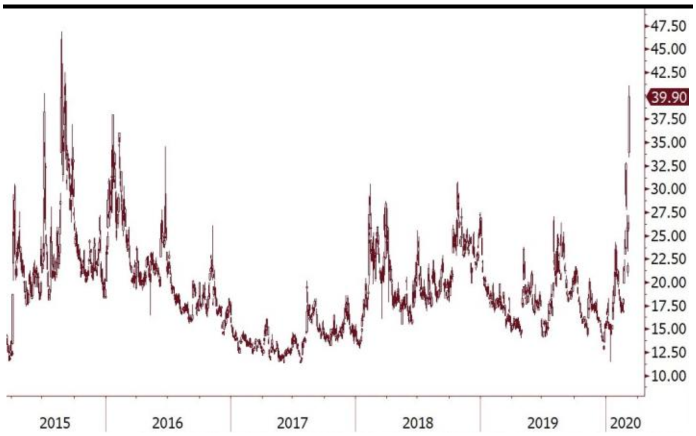
Fear Index & Chart

In our Monthly Strategy Report on 4th March 2020, we suggest to monitor three indicators to catch the HSI's bottom. After yesterday's 1,106-point drop in the HSI, two of the three indicators are suggesting that a major bottom is not far away.

Firstly, the **HSI Volatility Index (VHSI) jumped to as high as 41.12 yesterday**, the highest since Sep 2015, a sign that investors are already in panic, which often coincide with market troughs.

Secondly, **the HSI has reached the uptrend since 2018 at 25,200.** While having closed at slightly below the uptrend might be bearish, if the HSI swiftly rebound to above 25,200 in coming days, that would indicate the uptrend is an important support. Besides, the HSI has formed a bearish "head and shoulders", and today breached the neckline 26,000. In the worst case, this pattern's target is as low as 23,000, but in the best case should be around 24,500.

Figure 18: VHSI surged to panic level



Source: Bloomberg, CMBIS

Figure 19: HSI trying to find support at uptrend

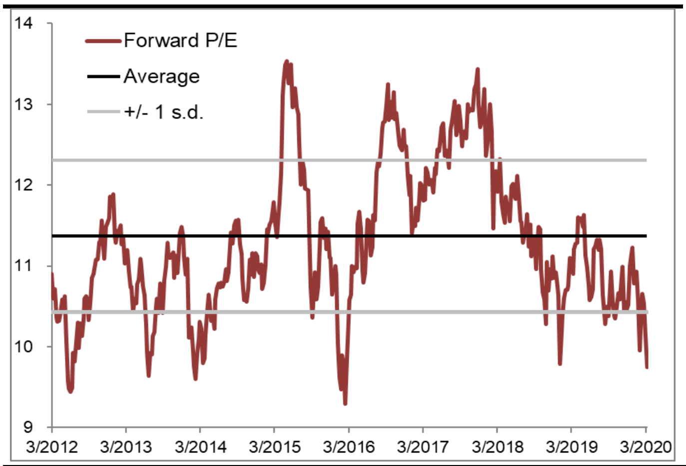
Source: Bloomberg, CMBIS

…the missing piece is valuation / earnings

Valuation close to trough…

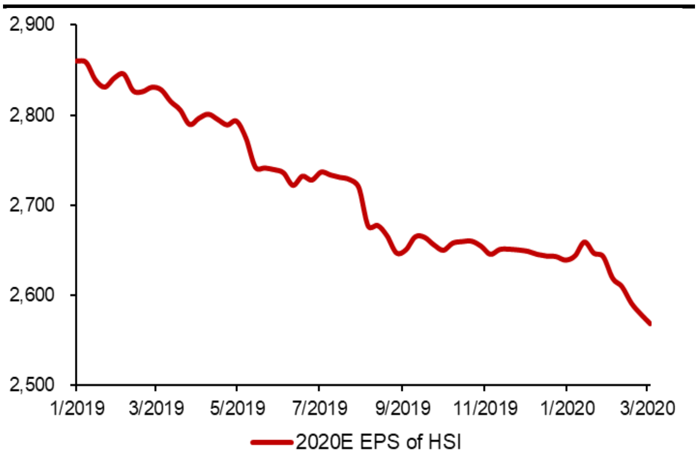
The HSI's 2020E P/E is at 9.8x, close to the range of troughs 9.3-9.6x in recent years. There should be limited downside in terms of P/E, but the variable is earnings forecast, which we believe are subject to further downside. Although lower oil prices would ease some costs for certain industrial stocks, they have little weight in HSI and thus contribute little to the HSI's earnings.

Figure 20: HSI's forward P/E approaching trough



Source: Bloomberg, CMBIS

Figure 21: EPS cut by 3.4% since virus outbreak



Source: Bloomberg, CMBIS

…but earnings have more downside

Since the COVID-19 outbreak in China in January, HSI's 2020E EPS has been revised down by 3.4%, according to Bloomberg consensus. Given the risks of pandemic (the WHO has yet to call the COVID-19 "pandemic") and oil prices' slump, HSI's EPS would probably be further revised downwards.

The last time oil prices slumped, the HSI's earnings forecast was significantly cut. During Jan 2015 - Feb 2016, HSI's 2016E EPS was slashed by 20%, mainly due to 70% drop in oil prices, 50% crash in China A-shares, and 7% depreciation in RMB. Sectors which suffered most from these negative factors were commodities, financials, property. Since these sectors make up of 60% of the HSI weighting, they dragged the HSI's EPS more severely.

Currently, the main negative factors are COVID-19, 50% drop in oil prices, and US-China tensions. Sectors which are hardly hit include commodities, consumption, transportation and exports. Energy alone made up of only 5% of the HSI, while the heavy-weight sectors, namely financials (48%), I.T. (11%) and property (10%) suffer less. Therefore, **we expect the HSI's EPS cut will be much milder than in 2015-2016**. The HSCEI's EPS cut will be more as energy's weight (8%) is higher than in the HSI.

Our assumption of earnings cuts in HSI and HSCEI in different scenarios, having considered both the impact of oil prices and COVID-19, are as follows.

Figure 22：EPS estimates & target range of HSI & HSCEI

		Best case	Base case	Worst case
HSI	CMBI est. 2020 EPS	2501.4	**2450.1**	2398.7
	vs. consensus on 6th Mar	-2.6%	**-4.6%**	-6.6%
	Target range (9.5x-11.4x P/E)	23,760 – 28,640	**23,280 – 28,050**	22,790 – 27,460
HSCEI	CMBI est. 2020 EPS	1258.8	**1224.8**	1190.8
	vs. consensus on 6th Mar	-3.8%	**-6.4%**	-9.0%
	Target range (7.8x-9.9x P/E)	9,820 – 12,410	**9,550 – 12,080**	9,290 – 11,740

Source: Bloomberg, CMBIS; as of 16:52 HKT on 9th Mar 2020

Investment strategy – Buy in three phases

We maintain our suggestion in March's Monthly Strategy Report to accumulate stocks in three phases:

1. **Phase 1 – Sectors with policy support from China.** Such as infrastructure, construction machinery, cement and 5G telco equipment. They are less impacted by the epidemic and oil prices' fluctuations, while benefit from fiscal stimuli.

2. **Phase 2 – China consumer stocks less affected by epidemic.** When outbreak is contained in China, go for China consumer stocks which are less impacted by COVID-19 and less cyclical in nature and thus have higher earnings visibility, including property management, education, healthcare, dairy, gas, internet, as well as handset equipment names that benefit from work resumption.

3. **Phase 3 – Sectors mostly hit by epidemic.** When the global epidemic is eventually contained, bottom-fish sectors with positive outlook in the long run, such as sports apparel, export, transportation, retail, and franchised restaurant. These sectors experience significant fall in stock price during outbreak and leave huge room for upward revision in earnings and valuation after then.

Energy & Utilities sectors

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Energy: Negative to Oil and gas upstream, oil field services

Negative to oil and gas upstream, especially to 3 SOE oil majors. During oil price sharp declining period, SOE oil majors will face lower refined products selling prices (based on a 10days' observation window with reference oil price basket), while inventory costs stand high. Given impacts from COVID-19, it would take longer time for SOE oil majors to consume inventories.

In 2016, NDRC released pricing floor to protect oil majors, stating refined product's pricing adjustment won't follow oil price movement when price dive below US$40 per barrel. The policy aimed at protecting refiners, which sustain or boost refiner's profitability under extreme market condition. China economy is facing downturn risks, however, we infer State Council and NDRC may twist the protection to boost downstream consumption.

Oil field services names will also take hits from oil price tumble. Oil majors and IOCs will cut CAPEX if oil price stay low for long enough period, which hurts oil field services' business and cash flow.

Utilities: neutral to city gas distributors

Market may wonder whether natural gas will stay competitive when substitute energy (i.e. heavy fuel oil and diesel etc.) becomes cheaper, and that may trigger natural gas consumption revert back from burning natural gas as energy sources. After years of environmental measures enforcement, we believe it is unlikely to observe a massive revert to heavy fuel oil, while only few will consider burning some fuel oil as mix to improve overall costs structure.

In the gas costs and demand perspective, we think 1) declining oil price may provide room for upstream to offer discount as imported pipe gas and spot LNG may settle as lower prices with reference to oil price decline, and that will help improve gas sales costs and ASP structure; and 2) natural gas consumption in China has relatively high demand stickiness.

Given relatively stable demand outlook, and stable dollar margin outlook, we expect gas distributors to maintain stable dollar margin. We think oil price collapse will have limited impact to city gas distributors.

Renewables: neutral to wind and solar farm operators

We think renewables operators' project development decision is relatively independent and subject to very low impact from oil price. Some government funded projects (especially in the Middle East country such as Saudi Arabia, the Country launched aggressive renewable development plan to add 58.7GW capacity by 2025, and boost overall renewable investment to more than US$30bn) subject to some uncertainty due to significant change on budget balance. At current stage, we think oil price's impact will be limited to those government funded projects. Renewables developers and manufacturers have more focus on COVID-19's impact rather than oil price tumble. We think overall impact on renewables supply chain will be neutral.

Airlines sector

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We believe that the crash of oil price will help China Airlines alleviate operating costs under reduced fare prices and load factors. During the epidemic, demand for both domestic and international air travel plummeted. Although some international routes are suspended or reduced, affected by protective measures against the epidemic, but according to CAAC's February press conference, there still are 710 international routes operated by Chinese and foreign airlines to 46 countries. On March 5, the Ministry of Finance and the CAAC jointly issued a notice to reward international flights that were not suspended and resumed during the epidemic. We believe that the crash of oil price, together with policy support, will help China airlines alleviate operating costs under reduced fare prices and load factors.

Automobile sector

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Falling oil prices will stimulate first-purchase demand

The market generally believes that when the price of oil drops, the use costs of large-displacement cars and SUV models will fall significantly. Therefore, the demand for this category will be released to a certain extent. However, we believe that given the initial 'Popularization stage' of the passage vehicles has passed, the proportion of first-purchase demand groups has gradually decreased. The intuition is that some auto consumers who are more sensitive to changes in oil prices are expected to make the purchase as the decline in oil prices directly reduces the use cost. Therefore, we believe the low oil prices will release the potential first-purchase demand in China which will benefit the local brand.

Quantitatively, we assume that a drop by 1RMB/L in retail price will directly stimulate passenger vehicle sales by 3 - 4%. Based on this data, we estimate that under the baseline situation, the incremental passenger car demand will be 1.10 mn to 1.47 mn in 2020E.

Figure 23: Car Demand Scenario Analysis

	Worst case	Base case	Best case
Oil price	US$20	US$30	US$50
China retail price	RMB3.9	RMB4.5	RMB5.5
Incremental car sales(%) in 2020E	7.02-9.36	5.4-7.2	2.7-3.6
Incremental passage vehicle sales('000 Units) in 2020E	1,437-1,917	1,106-1,474	553-737

Source: CAAM, CMBIS estimates

Falling oil prices will slightly reduce production costs for auto companies

On the production side, there is little impact of rising raw material costs on auto production as the cost of materials only accounts for a small proportion of the total cost. The major raw materials derived from crude oil include rubber, plastics, glass and so on. Falling crude oil prices will drive down the prices of these raw materials. Even though the materials cost of accounts for about 50% of the total cost, the crude oil only affected the small portion of it. According to our estimation, if the decline in crude oil prices drives some of its raw materials down by 30%, the profits will only increase by about 3%.

Figure 24: Earning impacts

	As % of total revenue	As % of total revenue
Revenue	100%	100%
Cost of sales	-82%	-78%
Gross profit	18%	22%
Expenses	-6%	-6%
PROFIT BEFORE TAX	12%	16%
Income tax expense	-2%	-3%
PROFIT FOR THE YEAR	10%	13%

Source: Company data, CMBIS estimates

Therefore, we believe that the decline in crude oil prices will improve PV demand and drive down the production cost. We expect the improvement in demand-side will be more obvious than the supply-side. Taking into account the factors such as stock replenishment, policy support, and significant delayed demand, we believe that the auto industry will outperform the market starting from 2Q20E.

Industrials sector

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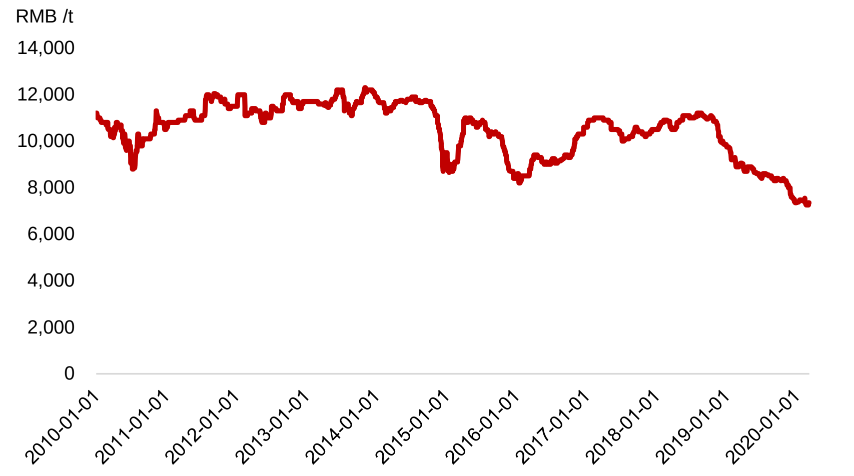
China Lesso (2128 HK, NR) – Positive

Petrochemical-based plastic resin, such as polyethylene, is the major raw materials for the production of China Lesso's non-PVC pipes. Prices of these plastic resins are positively correlated with the crude oil price. While China Lesso has long been adopting a cost-plus pricing model in order to reduce the fluctuation of the gross margin, a significant decline in crude oil price will still help China Lesso achieve margin expansion on lower production cost (raw material cost, mainly plastic resins, accounts for >80% of production cost). In 1H19, revenue from non-PVC pipes accounted for 1/3 of China Lesso's total revenue.

Figure 25: China high-density polyethylene (HDPE) price

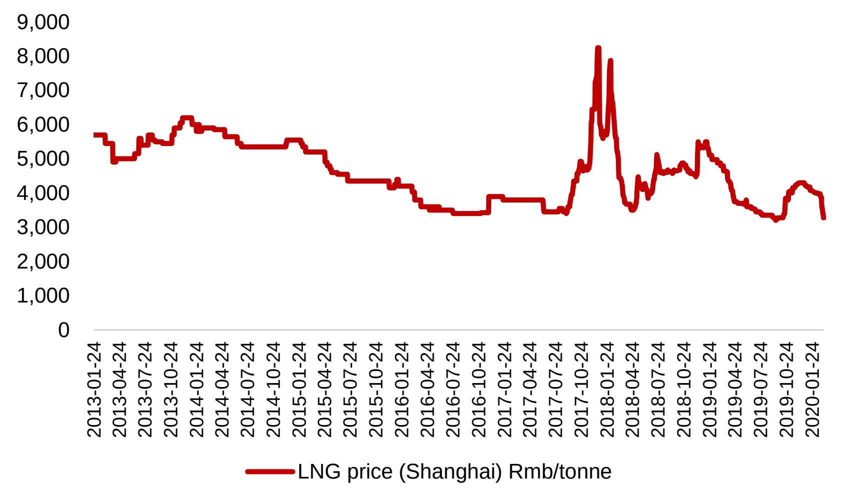


Source: Wind, CMBIS

Xingda International (1899 HK, BUY) – Positive

LNG accounts for ~2% of Xingda's production cost. While the percentage is not high, Xingda should likely enjoy the potential cost reduction without the need to pass through the cost to customers due to its improving pricing power. Based on our estimate, every 10% decline in LNG price will boost Xingda's earnings by ~3%.

Figure 26: Shanghai LNG price



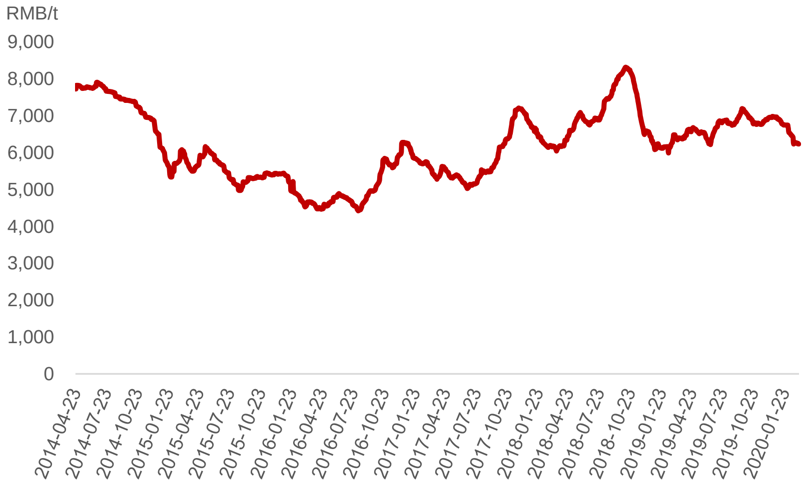
Source: Wind, CMBIS

Heavy-duty truck and construction machinery – Slightly positive

While the demand for truck and construction machinery is more driven by the downstream demand such as infrastructure and property construction activities, a significant decline in diesel price will reduce the operating expense of the truck/machine owners (assuming here that the decline in crude price will pass to the diesel price), and thereby driving the demand for the trucks and machinery.

Key ideas: **Weichai Power (2338 HK / 000338 CH, BUY)**, **Sinotruk (3808 HK, BUY), SANY Heavy (600031 CH, BUY), Zoomlion (1157 HK / 000157 CH, BUY)**

Figure 27: China diesel price



Source: Wind, CMBIS

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