Bin Yuan Capital

To all investors:

A long term, sustainable, equity bull market must be underpinned by economic value creation from listed companies on the stock exchange.

The short history of the Chinese stock market has witnessed sharp volatility with very short up and down cycles. The fundamental reasons behind these market movements, in our view, are:1) the lack of importance placed on shareholder value, particularly minority shareholder value, within corporate cultures, 2) inefficient capital allocation and 3) the highly speculative nature of the broad investment community.

Without drastic improvements on these three fronts, investment in the China's stock market will continue to be perceived as a gamble, with an unattractive risk/reward profile for long-term fundamental investors.

Observations:

1. Return on Equity analysis

How much a firm can generate value for its shareholders is often measured by the profit it generated against the shareholders' equity. Chinese companies have a much lower return on equity (ROE) than their US counterparts due to a lack of emphasis placed on shareholder returns and minority value. The long term ROE for the domestic listed Chinese companies is approximately 10% and has fluctuated from 2005 to 2014 and decreased sharply since 2007 (see Chart 1). The ROE for US S&P composite companies averaged approximately 16% for the past 30 years.

In Chart 1, the dark blue line represents ROEs for total non financial A-share listed companies. The light blue line represents the ROEs of companies that in the Binyuan stock selection pool. Note that high ROEs are strongly correlated to stock price appreciation in the past 10 years. Thus, in the long-run, companies that can deliver higher ROEs will outperform overall market.

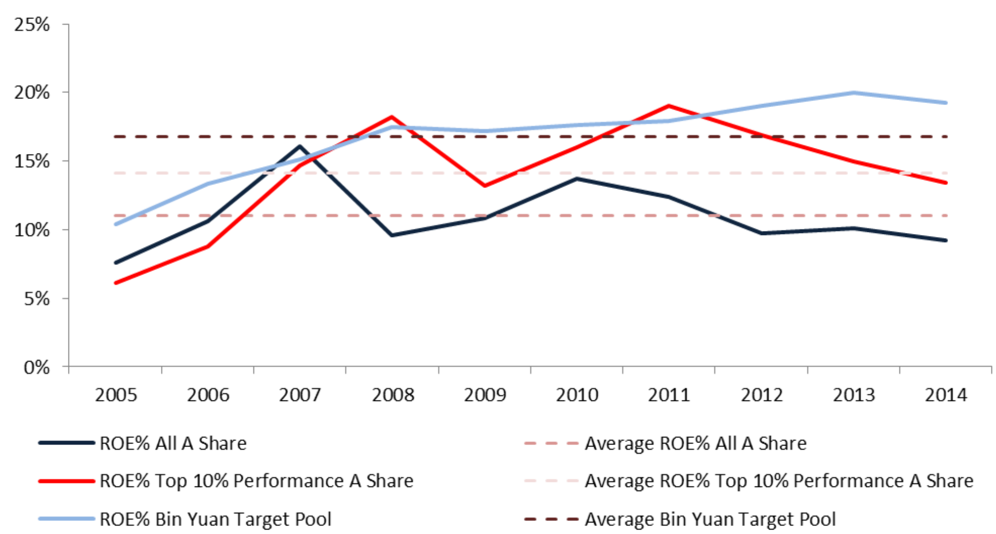

Chart 1: ROE (Non Financials)

Chart 2 to Chart 4 break down the components of the ROE calculation. The lower ROEs are mainly driven by lower and decreasing margin, decreasing asset turnover even with increasing leverage. These represent corporates that continue to operate or invest with decreased profitability and borrowed money. The balance sheet risk inevitably becomes higher and the appetite for equity fund raising increases.

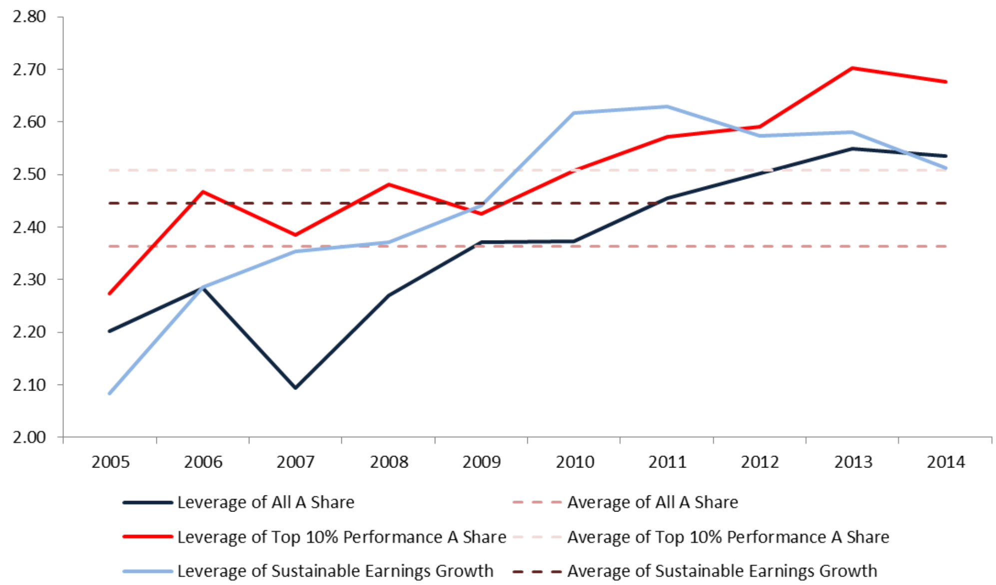

Chart 2: Leverage (Non-Financials)

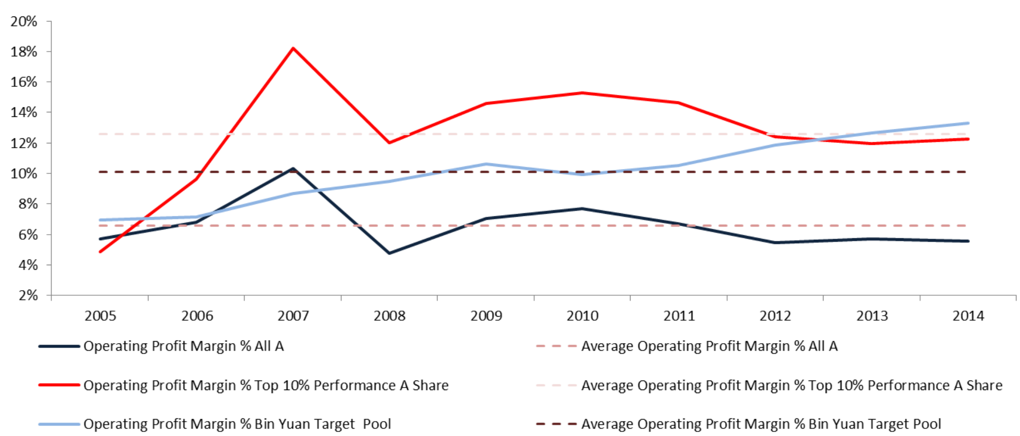

Chart 3: Operating Profit Margin (Non-Financials)

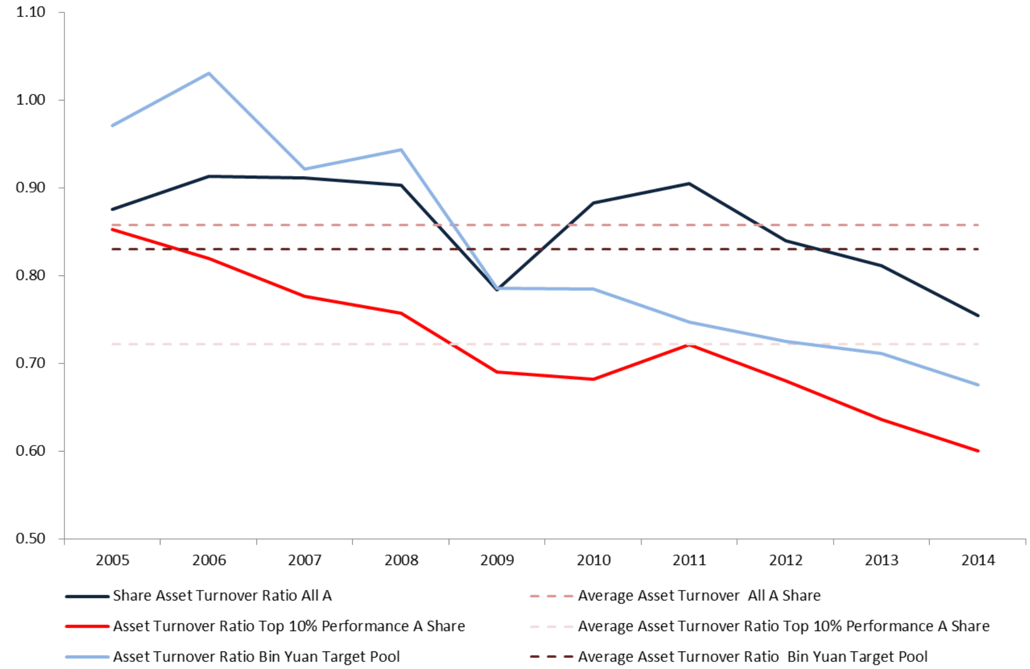

Chart 4: Total Asset Turnover Ratio (Non-Financials)

2. Cash flow against capital spending :

The Chinese economy is highly dependent on fixed asset investment. The dark blue line on Chart 5 shows that operating cash flow generation is lagging against cash spending which indicate that the liquidity at the corporate level is getting tight, and again creates demand for additional fund raising. The light blue line in Chart 5 is the capital spend relative to operating cash flow for those stocks in Binyuan stock selection pool. It shows the selected companies have improving cash flow positions.

Chart 5: Capex/Free Cash Flow (Non-Financials)

3. Return on invested capital:

To create economic value of a company, the return on shareholder equity or return on invested capital (ROIC) need to be higher than the investors opportunity cost or total cost of capital that the company holds. When return on capital is negative against the cost of capital, economic value is destroyed by the corporate.

Chinese listed companies have a relatively low return on invested capital (ROIC) at 8% on average for the past ten years (see Chart 6).

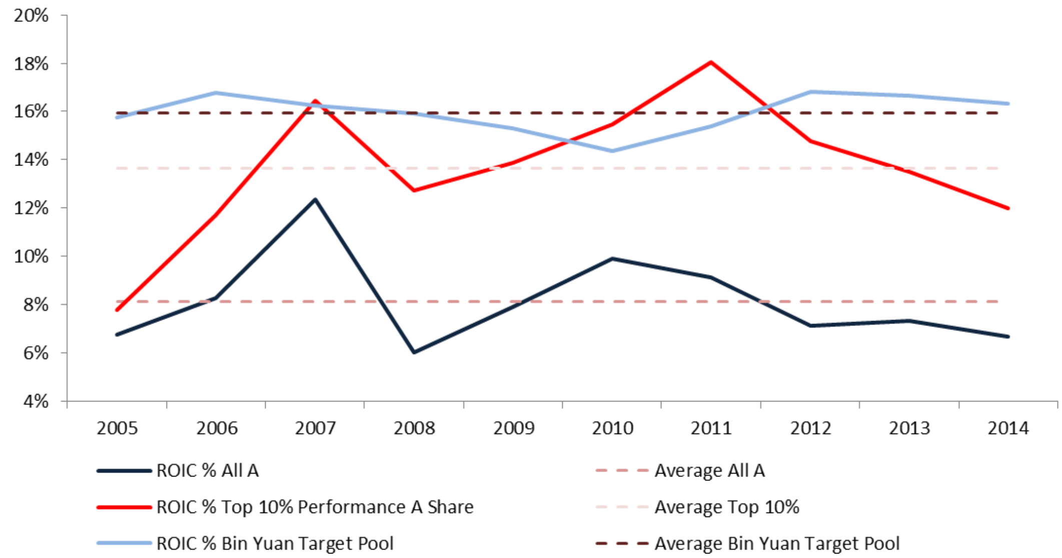

Chart 6: ROIC% (Non-Financials)

Chart 7 shows that non-financial companies have a lower ROE against the cost of capital. The companies are difficult to create value for equity investors. The financials have higher ROEs due to leverage and regulated profitability (see red line).

(note: we use estimated cost of capital here for easy calculation as cost of equity should be higher than cost of debt. The cost of capital we used are estimated cost of debt in the overall economy)

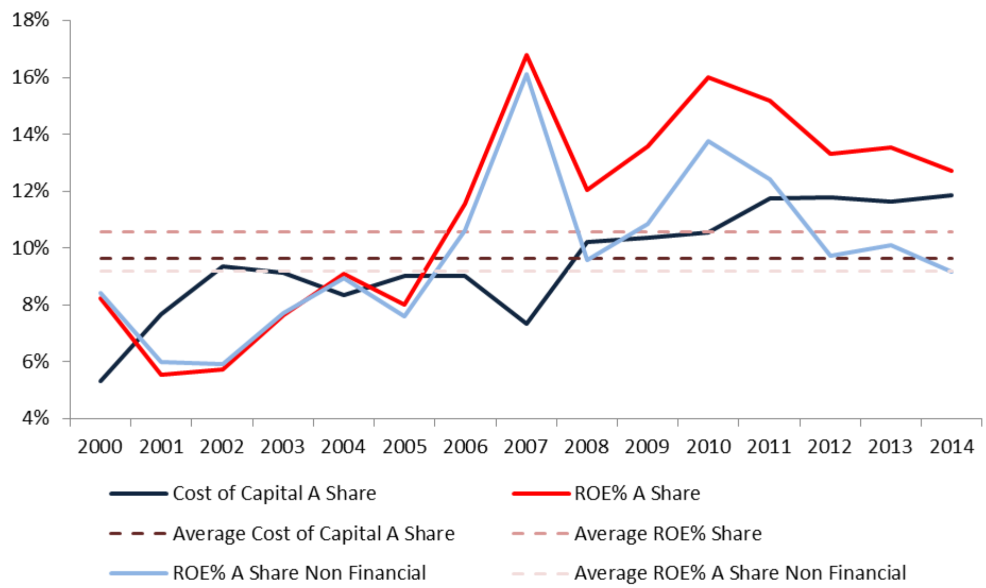

Chart 7: ROE vs. Cost of Capital

4. Market movement analysis:

We studied earnings and price contributions to stock price movements for the past 10 years. The bars in Chart 8 represents the price change for the last 10 years. The red portion shows the price changes contributed by net price increases or decreases. The blue portion represents the earnings contributions versus total price changes.

Compared to the US market in Chart 9, The China market has a shorter earnings contribution cycle and higher price movements. This echoes what we have experienced in that the China market has higher volatility and a less stable trend. The corresponding reasons, from an investment perspective, are 1) China has less investments choices for household savings, 2) irrational retail investment behavior by most of the market's participants, and 3) the dominance of short term result measurements in the market place have made institutional managers seeking for the same information and act coherently. As a result, the market moves quickly in the same direction with any good or bad information which cause short bubble and bust cycles.

When a listed company price increases faster than corporate value creation, the cost of equity decreases for the company and increases for investors. With inflated stock prices, companies raise equity and spend the fund on businesses with lower returns. With the lower return on reinvestment of the cash generated from operations, financial resources have destroyed. Subsequently, the investment return to the shareholders decreases. This vicious cycle is unhealthy for the stock market.

Using US market as a reference in chart 9, US corporate has generated more stable earnings growth, the market has less price volatility and the index up trend is stable.

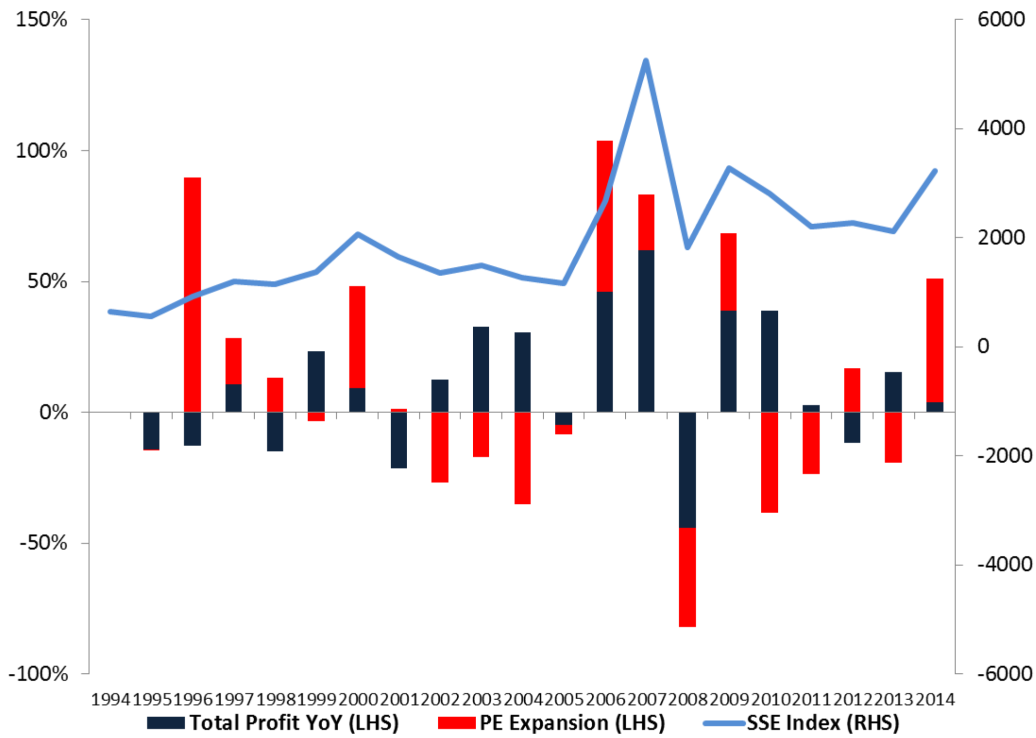

Chart 8: SSE Index, Total Profit Growth YoY and PE Expansion for All A Shares (Non Banks)

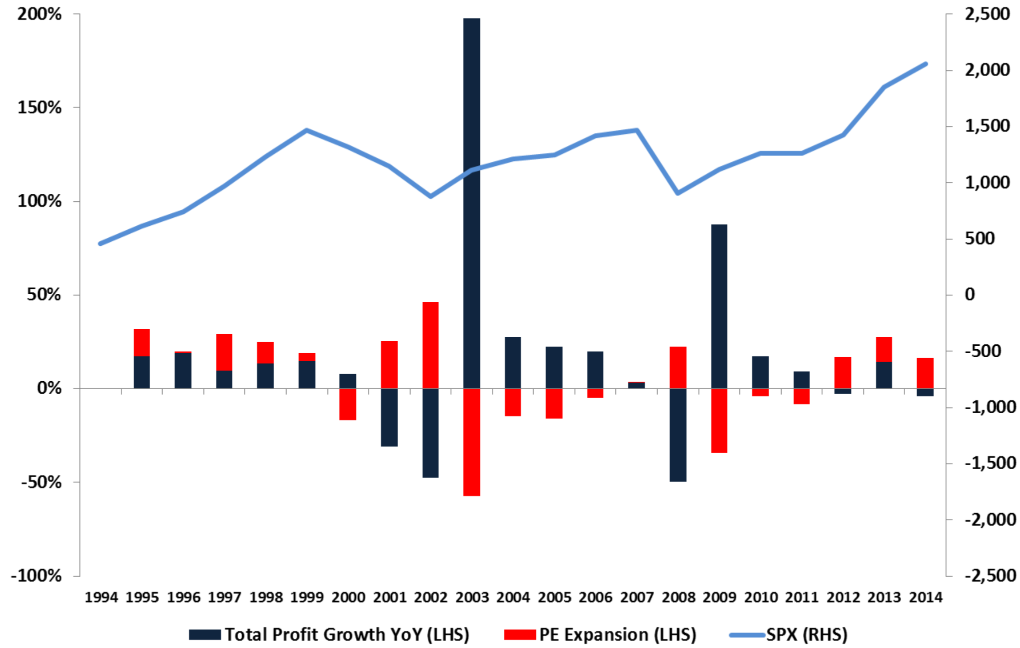

Chart 9: S&P500, Total Profit Growth YoY and PE Expansion 1995-2014 Non Financial

Chart 10 is the data from Binyuan stock selection pool. In the past 10 years, those names delivered stable earnings growth and better than the market returns with lower volatility.

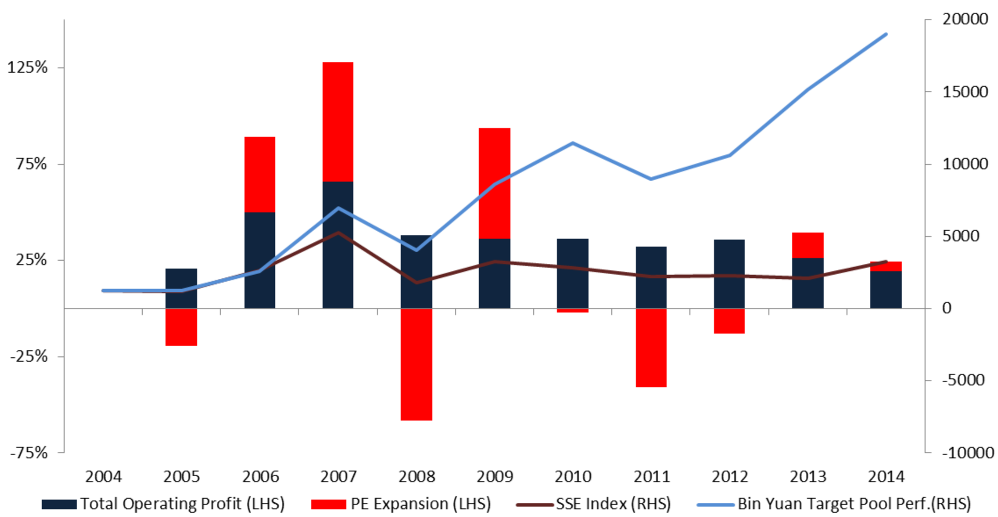

Chart 10: Share Price Performance, Total Profit Growth YoY and PE Expansion for Binyuan Target Pool 2005-2014

What we are expecting

We do not expect that overall corporate and investor behavior to change in the near-term.

Solution

Stock selection is still critical for long term investors, although it requires patience to transcend short term volatility. Otherwise, irrational decisions will occur and in turn adversely impact long-term performance. Over time, good companies will deliver superior returns.

Hedge systematic risk

If short term volatility is a major concern, index futures may be used to smooth out the systematic risks.

Sincerely,

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