Bin Yuan Capital China Greater China Strategy – January 2017

Market Review

China A-share market started Year of 2017 with reduced volatility and volume amid Chinese New Year sentiment and the Shanghai Composite Index increased slightly by 1.79% in January. Hong Kong market made a decent start and Hang Seng Index gained 6.18%, closing at the highest point since October 2016.

The upward trend of the interbank lending rate in Shanghai persisted in January. In addition, People's Bank of China raised the Medium-term Lending Facility (MLF) rate by 10 basis points. It was considered as a signal that the central bank was confident in the country's economic fundamental and was working on the deleverage.

Economic data was mostly better than expected. The producer price index (PPI) rose 5.5% year on year (YoY) in December, which was the highest in more than five years, supported by rising commodity prices and robust demand. Meanwhile, the consumer price index (CPI) remained moderate by increasing 2.1% YoY in December. China's gross domestic product (GDP) grew 6.8% YoY in the fourth quarter, accelerating from 6.7% in the third quarter. Although the 6.7% GDP growth in 2016 was the slowest pace of growth in 26 years, it was well within the government's target range of 6.5% to 7%. And as a result of the ongoing rebalancing from a manufacturing-centered export-led growth model to service-focused domestic demand-driven growth, the industrial structure continued to be optimized. Retail sales grew 10.9% YoY in December 2016, which was the highest monthly growth reading in 2016. Online retail sales continued to outperform the offline retail sales by surging 26.2% in 2016. China's service sector accounted for 51.6% of GDP in 2016, up 1.4 percentage points YoY.

China's supply-side structural reform, which was proposed at the end of 2015 to resolve structural imbalances in the economy, had delivered initial results by the end of 2016. China met 2016's target of reducing 45 million tons of steel and 250 million tons of coal production capacity ahead of schedule. As a result, steel firms' profitability improved in 2016 compared to a huge loss in 2015. Besides steel and coal industries, the Chinese government will target other sectors with overcapacity issues in 2017. We will continue to monitor those sectors that will benefit from the reform.

Local Observation and Portfolio Positioning

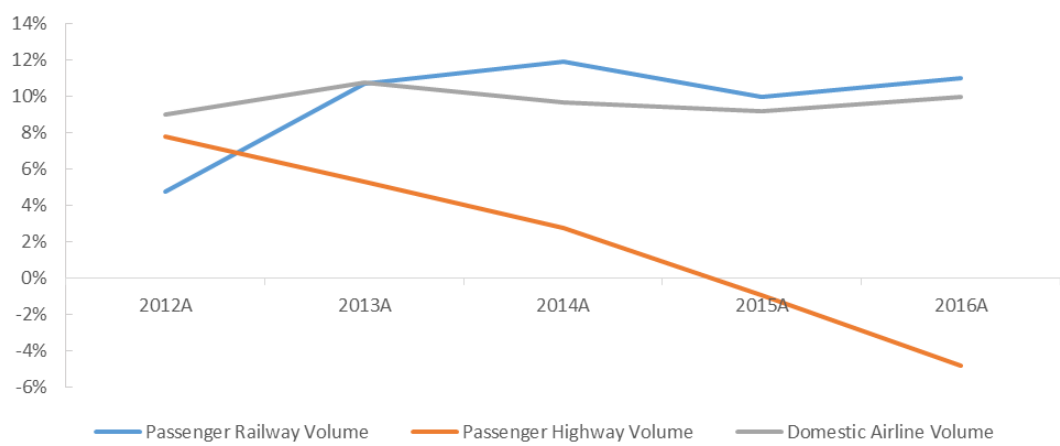
The Chinese government has been generously supporting the construction of high speed railway (HSR) lines since 2004 for several strategic reasons. Firstly, as a country with a large population, China does not have plenty of energy resources. Railways can provide efficient capacity with much less energy consumption per capita. Secondly, for defense purpose, if there is a war and the supply of oil is cut off, China can use railways (powered by coal fired electricity) to move people around. Thirdly, it is economical for people to travel by railway, which will serve to increase population's mobility and narrow the country's geographic and economic disparities. Lastly, in the transportation industry, it will take time for Chinese companies to catch up with global leading players in the segment of airplane and auto. By contrast, Chinese railway manufacturers have been domestically dominant and globally competitive to take market share worldwide. It will foster the development of the whole value chain, from material and component development to operating services.

<u>Market Share of Railways Increased in Passenger Transportation</u>

The first high speed railway (HSR) line (Beijing-Tianjin Intercity Railway) started to be built in the year of 2005. By 2015, China had had around 19,000 kilometers (km) of HSR (>250km/hour) and 45,000 kilometers of railways (>160km/hour) in operation. According to the 13th Five-Year Plan, China will build another 30,000 kilometers of HSR before 2020.

In the first eleven months of 2016, passenger traffic of railways enjoyed 11% year-on-year (YoY) growth, while the traffic of highways was down 4.8% compared with the same period of last year **(Chart 1)**. Railways are taking highways' market share.

Chart 1:



Source: Bin Yuan Capital, Wind

Fare and Time Comparisons by Travelling Methods

Taking the Beijing-Shanghai Route as an example, we conduct the fare and time comparisons by travelling methods as below (Chart 2):

Chart 2:

Vehicle	Length	Time consumption	Frequency	Price (RMB)	Expenditures per kilometer (RMB)
HSR	1,318km	5-6 hours Averagely 8 hours from door to door	Averagely 10 minutes	RMB553 for economy class RMB933 for business class RMB1,748 for first class	RMB0.42 for economy class RMB0.71 for business class RMB1.33 for first class
Train	1,318km	15 hours Averagely 17.5 hours from door to door	Overnight	RMB304.5 for hard sleeper RMB476.5 for soft berth	RMB0.23 for hard sleeper RMB0.36 for soft berth
Airline	1,088km	2.5 hours Averagely 7 hours from door to door	Averagely 15 minutes	RMB1,130 for economy class RMB3,100 for business class RMB4,710 for first class	RMB1.04 for economy class RMB2.85 for business class RMB4.33 for first class
Highway	1,262km	Averagely 10-12 hours from door to door	N/A	RMB555 road toll + RMB500 oil price RMB1,055 in total	RMB0.84

Source: Bin Yuan Capital

The price of HSR is 51% lower than that of airline, while the time consumption makes no much difference when taking flight delay and inner city transportation into account. Railways are punctual most of the time, and the railway station is usually located in downtown area while the airport was often built in suburbs. Thus, an increasing number of middle-class travelers prefer HSR to airline between Shanghai and Beijing. Those price-sensitive customers prefer ordinary trains to highways due to 71% lower prices.

We believe the passenger volume of railways will continue to outperform that of airline and highways, especially for short and medium distance journeys (less than 6 hours).

Profitability Potential of HSR in China is Greater Than Global Peers

There are only two traditional HSRs making profit in the world. One is Central Japan Railway (Tokyo-Osaka), and the other is TGV Southeast Line (Paris-Lyon). Both of them cover the most populous areas in their countries, a population of 63.5 million (mm) for Central Japan Railway and 18.2mm for TGV Southeast Line. A sufficient population base is very important for HSR's profitability.

In China, Beijing-Tianjin-Hebei area, Yangtze River Delta area, Central Delta area, Chengdu-Chongqing area and Pearl River Delta area are the five super-city clusters with a population of 104mm, 170mm, 110mm, 90mm and 70mm, respectively. By just connecting the first two super-city clusters, Beijing-Shanghai HSR started to make profit in the fourth year of its operation. Benefiting from the large population base, we expect a greater potential for profitability of HSR in China.

Stock Implications

Railway sector have always been one of our preferred sectors for the past ten years and ZhuZhou (3898.HK) remained to be our core holding in the past decade. The share price was tenfold in the past 10 years and it had contributed great value to shareholders. Although the cycle is less attractive compared with 5 years ago, we think Zhuzhou is still a high quality company driven by urban subway investment, maintenance, repair and replacement market development, market share expansion and non-railway applications. It is a well-managed company with good transparency to investors.

In future, we believe the Chinese government aims to have all the operating, controlling and signaling systems provided by Chinese local companies. We will continue to seek long term winners that start to substitute foreign players in certain areas.

As for operating services, Guangshen Railway (601333.SH) will be a long term beneficiary. Guangshen Railway (GSR) is the only listed passenger railway operator in China. The company benefits from its high operating leverage driven by potential increase of the passenger traffic. Meanwhile GSR is developing a light asset business model by leveraging its operation experience to help its parent company run the assets more efficiently, such as Guangzhou-Zhuhai HSR and Xiamen-Guangzhou HSR.

Lastly, the fast development of the HSR and subway lines both domestically and globally in the next few years will be certain to benefit railway construction companies as well.

Sincerely,

Bin Yuan Capital

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