Bin Yuan Capital China Greater China Strategy – Fourth Quarter 2016

Market Review

The Chinese stock markets had another challenging year in 2016 after an already bumpy 2015. The A-share market started by closing earlier twice when market plunge triggered the circuit breaker. The Shanghai Composite Index and Hang Seng China Enterprise Index dropped by 24.1% and 18.1% respectively in the first two months of 2016, and recovered some of the losses during the second half of the year.

The weakness of RMB and concern on the financial leverage in China are not helping the investment sentiment. RMB depreciated against USD by 6.8% in 2016, which was the largest fall in 10 years and caused capital outflow from China. Liquidity tightened and the bond yield sharply increased in Q4 2016. Although Brexit was not viewed as having much impact on China, the result of the US presidential election did add some volatility to the Chinese equity markets due to the concerns on China - US trade relationship, even the launching of the Shenzhen Hong Kong Stock Connect was not able to smooth the worries.

Despite the challenging equity markets, the fundamental economy has shown signs of stabilization. After the 3-year plus supply-side consolidation, the demand on some of the commodities and capital goods has increased since the beginning of the year. The coal price in China, for example, rose to its highest level in more than four years in October 2016. The producer price index kept increasing steadily in 2016 and grew by 5.5% year-on-year ("YoY") in December, representing the highest record since October 2011. Meanwhile, the official manufacturing Purchasing Managers' Index recorded 51.4 in December, the second highest reading in 2016 and had been above the 50-point threshold for five consecutive months.

The global emerging market funds have seen cash inflows since 2016, but not much allocated to China. The level of underweight on Chinese equities is at the historical high. Due to the nature of global managers, the proportion of the money they allocated to China mostly went to large cap index stocks. As a result, small- and mid-cap names have underperformed the index for the year.

China Outlook and Portfolio Positioning

Summary

As a result of the four trillion RMB stimulus package in 2008, which has led to a massive increase in capacity for steel, cement and aluminum, the economy suffered from the excess capacity while demand from infrastructure investment and export markets fell. The manufacturing and industrial sectors have struggled and consolidated since 2012 and there was a sign of bottoming out since the beginning of 2016. Unlike the volatile equity markets, the commodity and capital goods related sectors, which were at the lowest in inventory and production utilization ratio for a few years, have started to recover in sales volume and prices.

After the 6.8% depreciation of RMB in 2016, we believe People’s Bank of China (the central bank) is going to continue to test the economic and political fair value of the RMB. We believe the equilibrium of RMB against USD is between 7.2 to 7.5. The trade against RMB depreciation is expected to reduce in mid-2017. In addition, the depreciation of RMB from 6.1 to 7 is positive to China, as the currency value is more close to the competitiveness of the economy, and we should see positive impacts to the Chinese economy in the second half of 2017.

The economic concerns on President-elect Donald Trump’s toughness on China and bringing back manufacturing to the US should be reduced in the second half of 2017 as well. The reverse of the globalization is very difficult as the US is not competitive anymore in basic manufacturing and does not have the infrastructure of the production value chain (please refer to our research report “Next Stage Growth Oct 2016”). The result will be the opposite as China shall be benefited in the long term if the US new administration aggressively increases the domestic infrastructure spending.

Our attention will stay on the cause as we believed that the Chinese economy has been transforming from a manufacturing and investment story to a consumption upgrade story. There is clear evidence that the service sector is taking over the importance of the manufacturing sector which has made the economy more balanced (please refer to our research report “Next Stage Growth Oct 2016”). The high per capita savings to debt ratio, the ongoing urbanization process, and the positive household cash flow categorically underpin the Chinese consumption upgrade story. We have seen an ongoing consumer trading-up trend in various categories from food & beverage, personal care to household discretionary consumptions. In a reflationary environment, those products or services that are scarce in nature or that are able to trade up sales mix (through innovations and enhanced branding) can pass through inflated costs in 2017.

In regard to the manufacturing sector, we found that after recent years’ severe competition and consolidation, some Chinese firms had become domestic bellwethers and global leaders. The manufacturing value chain that has been built gave China advantages in production scale, skilled labor and efficient logistics systems that are not easy to be replaced. Those companies that are high value added with strong cash flows will continue to be our focus.

We will also pay attention to a series of economic reforms in 2017. Those reforms shall benefit the Chinese economy in the long run, which include structural changes of the capital allocation, income re-distribution, the State-owned enterprise reform and the fiscal reform.

Riding on China’s economic transition, we will continue to focus on four investment themes in the year of 2017.

Domestic Upgraded Consumption

In the consumption spending universe, we prefer companies that own scarce resources, platforms and contents or that can meet the demand of consumer trading-up.

➢ **Scarce resources, platforms and contents**

- ***Scarce attraction resources****:* Chinese people increase their budgets for tourism as they get wealthier. In the whole tourism value chain, those companies with scarce attraction resources and capabilities of replicating the operation model have the strongest bargaining power and are going to grow steadily.

- ***Scarce cemetery resources:*** The aging population and traditional minds in China drive the demand for cemetery land continuously. Companies with cemetery land and industry consolidation capabilities are going to be a perfect asset inflation play in future.

- ***Scarce social media platforms:*** With the highest traffic flow and usage time, social media platforms are going to benefit most from the growth of the online social media advertising market which is expected to reach RMB89 billion by 2020 versus RMB 24.4 billion in 2016. In 2017, the trend of advertising budget transferring from traditional media to digital media will sustain and the share of social media advertising in digital advertising will rise as people tend to spend more time on social media like Weibo and Wechat.

- ***Scarce contents:*** Chinese people tend to pay for high quality contents, which have been seen in the cases of mobile game, online video, music and other contents. People are becoming picky about the quality and prefer contents with good intellectual properties. Therefore, we believe sophisticated content providers will continue to gain market share with their superior developing abilities and abundant intellectual property inventories on hand.

  The names we will focus on for this theme in 2017 are China Youth Travel Services (600138.SH), Fortune (600965.SH), Weibo (WB.O) and Tencent (0700.HK).

➢ **Consumer trading-up**

- ***Furniture and small home appliances:*** Thanks to the trend of trading-up, furniture market and small home appliance market keep expanding and have been independent of the housing market which is cooling down. We believe the industries have started to consolidate and the leading players will continue to outperform in 2017.

- ***Baijiu (Chinese White Wine):*** China’s PPI and CPI kept increasing in recent months and we expect that the inflation will rise in 2017. Middle- and high-end Baijiu with pricing power benefit most during the inflation period as they can lift selling prices without incurring much more costs.

- ***Infant Milk Formula:*** Due to the competition from imported products and the inventory clearing out, Chinese infant milk formula ("IMF") companies suffered in the past two years. They rose to the challenge by upgrading their products in both quality and branding. With the negative impact phasing out and China's official abolishment of the one-child policy, we expect that Chinese IMF companies' performance will turn around in 2017.

  The names we will focus on for this theme in 2017 are Suofeiya (002572.SZ) Midea (000333.SZ), Yanghe (002304.SZ) and Biostime (1112.HK).

High-End Manufacturing

- ***Automation:*** Industrial robot adoption reduces costs and improves the yield and quality in the meantime. The industrial robot shipment in China increased quickly in the past few years and in 2015, China market accounted for 30% of the global shipments. Instead of sourcing automation equipments externally, some of the Chinese top manufacturers have moved one step further to design and make automation equipments in house with their accumulated know-how. Those self-made equipments are unique and more efficient than those purchased ones, which endows those companies with considerable cost and quality advantages to take global market shares.

- ***Electronics:*** Although electronics industry slowed down in 2016 due to an already high smartphone penetration rate, there is still enough room for component companies to grow through micro innovations. Companies lead in the following niche markets might outperform: AMOLED display, wireless charging, 2.5D glass cover, waterproof acoustic components, etc.

  The names we will focus on for this theme in 2017 are Himile (002595.SZ), Luxshare (002475.SZ) and Hongfa (600885.SH).

Environmental Awareness

Driven by tightening implementation of the environmental protection regulations, the favorable situation of supply side will sustain and the upcycle might last longer than expected. The survivors from the consolidation with competitive advantages will structurally improve their profitability.

- ***New energy equipments:*** The wind power sector has underperformed the index since the beginning of 2016 due to the market concern that the capacity addition would slow down after the rush installation in 2015. However, in spite of the installation decline in 2016, we noticed that the new tender amount of wind power in China, on the other hand, kept increasing at fast paces. A total of 25GW of new tenders were recorded in the first three quarters of 2016, representing a YoY increase of 67%. As a leading indicator, the new tenders are going to be followed by new orders for wind turbine manufacturers in 2017.

- ***Heavy-duty trucks:*** After struggling for two years, the heavy-duty truck industry started to pick up in 2016 and recorded an amazing YoY growth of 30%. The recovery was primarily attributable to two reasons related to supervision: 1) Removing heavily polluting vehicles. 2) Harsher measures on overloading trucks. We expect that the prosperous demand for heavy-duty trucks will continue in 2017.

The names we will focus on for this theme in 2017 are Goldwind (2208.HK/002202.SZ) and Weifu (200581.SZ/000581.SZ).

Pro-growth Reform Beneficiaries

A series of economic reforms will continue to channel the liquidity into the real economy. For instance, to support the less developed areas to grow and leverage the private sector capital, the government launched the Public-Private-Partnership ("PPP"). The total planned investment amount is expected to exceed RMB12.5 trillion for the next five years. Most of the PPP projects will be infrastructure related and thus, we believe the recovery of the demand for construction machinery is sustainable.

- ***Construction machinery:*** China construction machinery industry has experienced a drastic downward period since 2012. But there were signs that the sector started to bottom out in 2016. The supply was significantly cut with capacities shrinking to 25% of the peak level while the demand started to pick up. We noticed that the sales of excavators, a leading capital goods indicator, had jumped by 71.3% YoY in October 2016. We believe the recovery will continue in 2017.

The names we will focus on for this theme in 2017 is Zoomlion (000157.SH /1157.HK) and China State Construction (3311.HK).

Sincerely,

Bin Yuan Capital

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