Bin Yuan Capital China Greater China Strategy – November 2016

Market Review

Chinese stocks extended their rally in November, with both the Shanghai Composite Index and Heng Seng China Enterprise Index closing at their highest level in 10 months, driven by expectations of an improving economy. China's consumer price index grew by 2.1% year-on-year(YoY) in October, up from 1.9% in September and the producer price index grew by 1.2% YoY, expanding from last month's rise of 0.1%. The official manufacturing Purchasing Managers' Index(PMI) rose to 51.7 in November, recording its highest level since July 2014, up from previous month's 51.2. Meanwhile, the official non-manufacturing PMI in November came in at 54.7, up from 54.0 in October.

The upward trend of interbank lending rate in Shanghai and Hong Kong persisted in November. The tightening interbank liquidity in the past month has already affected the performance of fixed income market. We will closely monitor the trend of the lending rate and assess its impact on the liquidity of the stock market. Currently, the increasing expectations of improving earnings mitigated the impact of the cost of equity increase. We will continue to focus on fundamental analysis of our holdings to be assured that they would deliver their earnings as our forecasts.

In November, several insurance companies started to aggressively boost their holdings in A-share large-cap stocks. For example, Anbang Insurance Group bought 3 billion shares in China State Construction Engineering Corp(601668.SH), representing a market value of RMB27.1 billion(USD3.9 billion) in total by 24 November 2016. Similar cases are China Evergrande Group's investment in China Vanke(000002.SZ) and Foresea Life Insurance's investment in Gree Electric Appliances(000651.SZ), etc. These investments by insurance companies increased the market's preference for large-cap stocks, which we underweighted.

Local Observation and Portfolio Positioning

We added Zoomlion in our portfolio this month. The construction machinery sector has been in a massively oversupply situation since 2011. As a result, the industry sales decreased by 32% from 2011 to 2015. After past four years' consolidation and restructuring, there are signs that the sector started to bottom out in 2016. The supply has been significantly cut with capacities shrinking to 25% of the peak level and the demand also 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.

Company Profile and Distressed Value

Zoomlion is one of the leading players in China construction machinery market and suffered during the industry downward period. Its revenue in 2015 was only 45% of that in 2011. In the past three years, the company has gone through a series of restructuring and at the current price, the company is trading at a big discount to its adjusted book value. With the business starting to turn around, the downside of the share price will be limited.

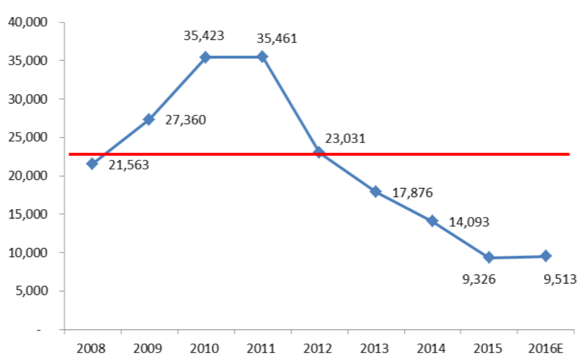
From the book value perspective, it is trading at 61 cents on a dollar. Since 2013, the company has been cleaning up its inventory and accounts receivable. It provided bad debt for 8.3% of the accounts receivable balance as at 30 June 2016. To be more conservative, we have made additional adjustments to take out all the accounts receivable aging over 2 years, even though above 80% of those customers are in good operation, and other potential high-risk accounts receivable, representing another 28.3% of the accounts receivable balance as at 30 June 2016 in total. After that, Zoomlion is still trading at 80 cents on a dollar.

Industry Outlooks

From the construction machinery industry perspective, both inventory and sales volume are at historically low level. Chart 1 is the example of auto crane sales, the segment of which is the largest contributor of Zoomlion's gross profit. The red line on the chart represents the normalized demand which only reflects the replacement needs of the auto cranes assuming a useful life of 10 years. The blue line represents the actual auto crane sales, which shows that the oversupplied units during 2009 to 2011 have already been absorbed due to the undersupply during 2013 to 2016E. This is a strong indication that demand and supply are much better balanced than before.

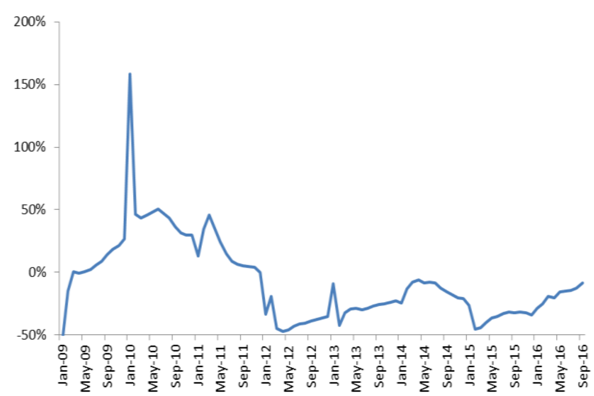
Demand for construction machinery has been recovering since the beginning of this year and the end-users' usage hours have also seen growth for the past 5 months. Chart 2 shows that the crane sales growth has gradually picked up.

Chart 1: Auto crane sales by unit & normalized demand unit



Source: Wind, Bin Yuan Capital

Chart 2: Crane sales YTD YoY growth



Source: Citi research, Bin Yuan Capital

To support the less developed areas to grow and leverage the private sector capital, the government has launched the Public-Private-Partnership(PPP). As of the end of Q3 2016, there were 10,471 projects on Ministry of Finance(MoF)'s PPP list and 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.

Business Improvements

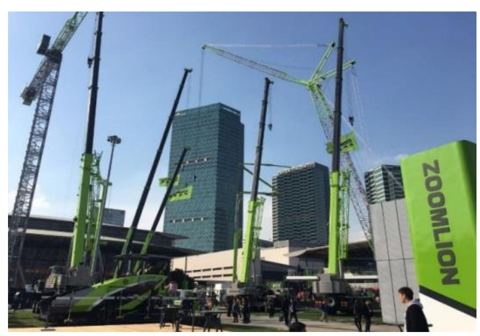
In addition to sales recovery, the company aggressively cut operating costs in 2016. It reduced construction machinery employees from around 27,000 to 7,000, which will help the company save three-fourths of the manufacturing labor costs in future. If we exclude the one-off impact of the layoff costs of RMB120 million and the provision of RMB800 million for cleaning up accounts receivable and inventory, the company will be better than breakeven in 2016. Thus, even if the sales do not increase further in 2017, the core business will turn profitable. The downside risk is relatively limited. We expect that the earnings will continue to improve in the next two years with non-cash restructuring costs reducing to the normal level.

Conclusion

We have followed Zoomlion for more than 10 years and we rated highly on the company's management team in terms of technology and product developments. The company has been investing in R&D to improve the quality of products even during the downturn cycle. The management team also owns equity interest in the company. With very attractive valuation and a high quality company with earnings recovery, we think it was now the right opportunity for us to add this stock into our portfolio.

Picture 1: Products in Zoomlion's factory

Picture 2: Zoomlion's products on Bauma Exhibition



Sincerely,

Bin Yuan Capital

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