

Bin Yuan Capital All China Strategy – Second Quarter 2016

China Market Review

During the second quarter of 2016, the global markets again experienced roller-coaster-like shifts. Volatility was creeping higher because of three big events during the period. Firstly, the potential interest rate hike of the US was concerning. The probability of a June hike, however, plunged to zero after the latest announcement on June 3 regarding non-farm payrolls, which dropped significantly to 38k in May from 123k in April. Secondly, On June 15, MSCI decided again to not include the China local A share index into their indices even though the market expectation of the inclusion was high. Lastly, the event which led to the chaotic situation of the global financial market was the Brexit.

As for China, the economy has shown a sign of stability compared to the previous quarter, though sustainability still remains to be seen. PMI data announced by the National Bureau of Statistics of China (NBS) kept above 50. However, it is important to note that there was a declining trend month by month. Loosening monetary policy was maintained as well. The May New Yuan Loans' figure, which was announced on June 15, was far higher than expectations. The figure was 985.5 billion yuan actual versus 750 billion yuan surveyed. As we indicated in our last quarter newsletter, some of the commodity inventory at the very low level and commodity price recovered greatly during this quarter. The supply side reform enacted earlier this year is and will continue to stay on track.

Among the A share listed companies who have announced their first half results, some of the sectors, namely the commodities and consumption/services industries which recently witnessed price hikes, have reported improvement in financial results. High growth is seen in the chain of electric vehicle industries as well.

We view the impact of Brexit on China to be limited. The business and economic relationship between Europe and Greater Britain should not be materially changed in the foreseeable future. The potential launch of the Shenzhen – Hong Kong connect in the second half should benefit both H and A shares. The openness of capital in two directions will help to re-direct liquidity to seek value stocks in each exchange.

China Outlook

The Chinese economy started to show signs of positive long term structural change

The key concerns regarding the Chinese economy remain the oversupply of the manufacturing sector and over-stretched banking balance sheets. While we agree with these issues, we believe that the market may have overlooked the importance of the service sector to the economy. The service sector contribution to the overall GDP has been largely increasing over the past 25 years. In the 1990s, the services sector only contributed 20% to the GDP, compared to in the 2000s during which it contributed to 40%. The service sector contribution reached a record high of 62% during the first quarter of 2016 (Chart 1). By contrast, the

manufacturing sector has been losing importance in the economy through the years; it contributed less than 38% early in 2016, dropping from 60% in 2008.

Chart 1: GDP contribution by industries

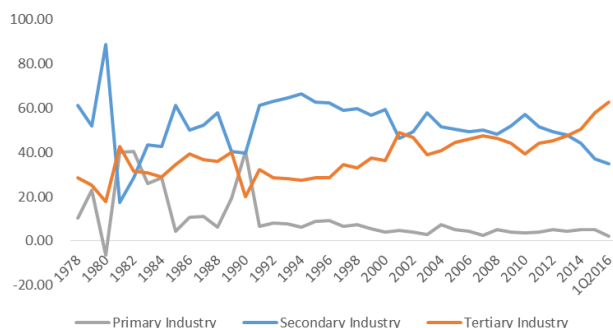
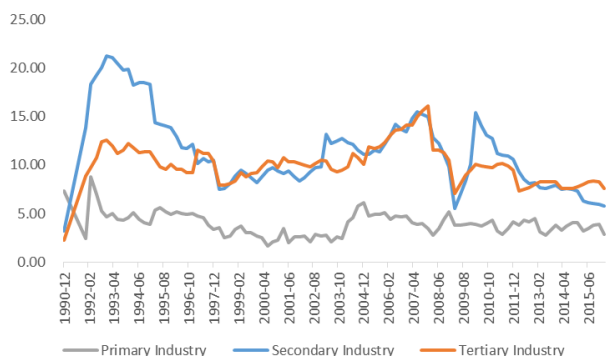


Chart 2: Real growth by industries



The service sector in the economy is becoming a growth driver and this trend should continue. Structurally, unlike the oversupply situation in the infrastructure plus manufacturing sectors, the service sector is in short supply. The underdeveloped service sector has provided strong growth since 2015, replacing the negative impact caused by a slowing manufacturing segment (Chart 2). The largest cities in China recorded continued strong growth in the service industry. The tertiary industry in Shanghai, for example, reported a real growth of 11% in 2015 while the real growth of the secondary and primary industry was negative during the same period. Due to the short supply, the nominal growth of the service industry is much faster than real growth because of the uptrend of prices. Chart 3 shows the diverging trend of service CPI and PPI since 2012. As a result, the profitability of the service sector is higher than that of the manufacturing industry in recent years. Using A share listed companies as a proxy and excluding financials, the return on equity ratio of tertiary industries was close 10% in 2015, compared to only 5.9% by secondary industries (Chart 4). The net margin tells the same story. The net margin of tertiary industries excluding financials was 183bp higher than that of the secondary industries (Chart 5).

The economic structural change in China towards a higher quality and growth service space is mostly ignored. We believe that this positive structural change will lead China into a second stage of robust and more sustainable growth (A research report on structural change is available upon request).

Chart 3:

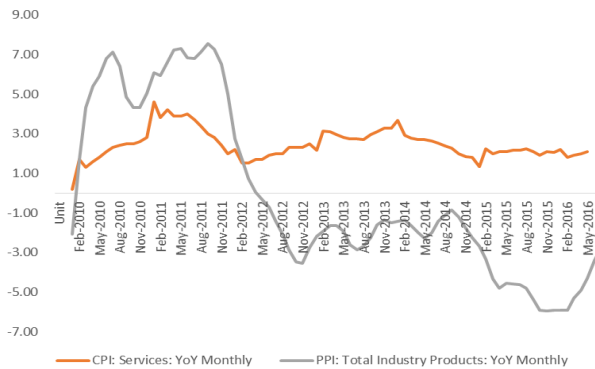


Chart 4: ROE comparison

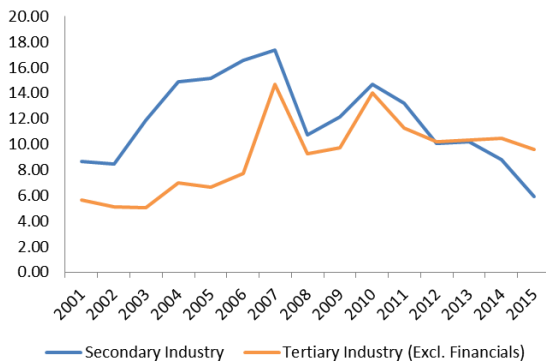
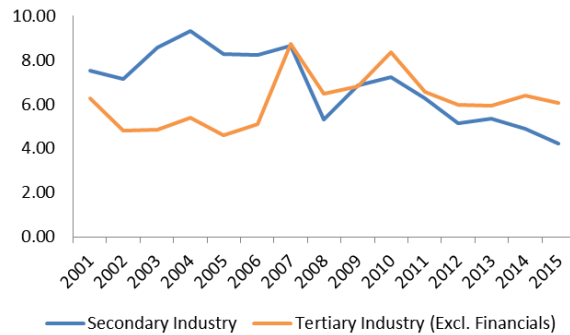


Chart 5: Net margin comparison

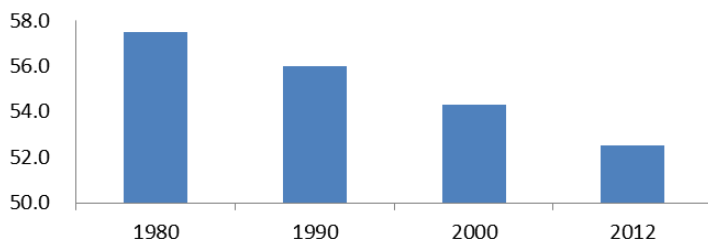


The structural improvement in the manufacturing sector

In addition to the oversupply of manufacturing capacity, the labor cost of China today is no longer cheap. The low end manufacturing jobs have been moving out of China. The manufacturing industry has struggled in the past three to four years. This situation has forced the industry to consolidate and move up the value chain. The manufacturing industry as a whole is investing in technology to improve its competitiveness. We believe that China has advantages to remain very competitive in the manufacturing industry.

When a country enters an industrialized economy, a global phenomenon where the labor cost as a percentage of GDP is reduced, occurs. As chart 6 shows, the percentage of labor cost to GDP has fallen from almost 58% in 1980s to approximately 52% in 2012. The main rationale behind the move includes both globalization and more advanced technology. In the globalization tide, the business shifted from high labor cost countries to low cost countries, which effectively reduced the proportion of labor cost to GDP. The improved advanced technology consisting of software and artificial intelligence that relieved the work load of labor, further lowered labor contributions to GDP activities.

Chart 6: Worldwide labor costs as % of GDP



China was the biggest beneficiary of globalization due to cheap labor costs in the past 20 years. During the last 20 plus years, China has gained two major invisible advantages that will help it move to the next stage of growth. The first is that the country has built up a very advanced infrastructure that makes the economy efficient. The second is that during those years, China has accumulated a large number of well-educated and skilled labor that has also improved overall productivity.

Summary

We believe China is entering into new stage of healthy growth associated with favorable structural changes. The cycle begins in a positive way. However, the volatilities may continue in the short term. Military uncertainties may rise across borders as well. Furthermore, with the emerging default of higher return products and bonds, we need to monitor the risk of bond rating downgrades that may negatively impact liquidity.

Portfolio positioning

Structurally, we like the service theme and trend in China. We realize that the companies with strong service capabilities will stand out amid competition. This applies not only to the players in the service sector, but also to the manufacturing enterprises who offer better services than their peers.

CYTS, who runs two waterside ancient towns in China (Wuzhen near Shanghai and Gubei near Beijing), differentiates itself by offering high-quality services. Since all service providers in the region are well trained employees of CYTS, they are not allowed, nor do they have the incentive to raise the price. Instead, their performance is valued solely by the entire region's performance and the service feedback from customers. These value added services helped Wuzhen continue attracting increasing passenger flow every year for the past decade. By focusing on service quality, we believe the Gubei project will copy the success model of Wuzhen and become the growth engine for the next few years.

Shandong Himile, a leading player with a 12% global market share in the tire mold industry, continues to increase its market share through its high quality products and service capabilities. Himile has joined into the design process for the clients and has built factories near clients to provide timely services. With the increasing trend of tire makers easing away from tire mold manufacturing, Himile will continue to grasp the up to 20% of the market share in the next five years, leveraging its long-time-accumulated skilled labor and proprietary self-made equipment. Thanks to its strong precision manufacturing capabilities, Himile has managed to become a qualified supplier for top multinational companies seeking turbine components and is expected to expand into other components as well.

We continuously seek companies that have the potential to develop “from good to great”. We believe a great company must possess a strong business culture of innovation and self-motivation, and this should not only exist in the speeches from senior management, but be carried out through all layers within the organization. The behavior of individuals reflects the value of the enterprise, and this can be observed through onsite visits and cross checking.

Shandong Himile, in the previous example, encourages learning and innovation all the way from the top management team to the lower level staff. Even a worker on a production line is incentivized to improve the process, either by reducing costs or enhancing efficiency. It is a very well-managed company with a strong balance sheet and high ROE of 20%+ due to higher efficiency.

Sincerely,



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