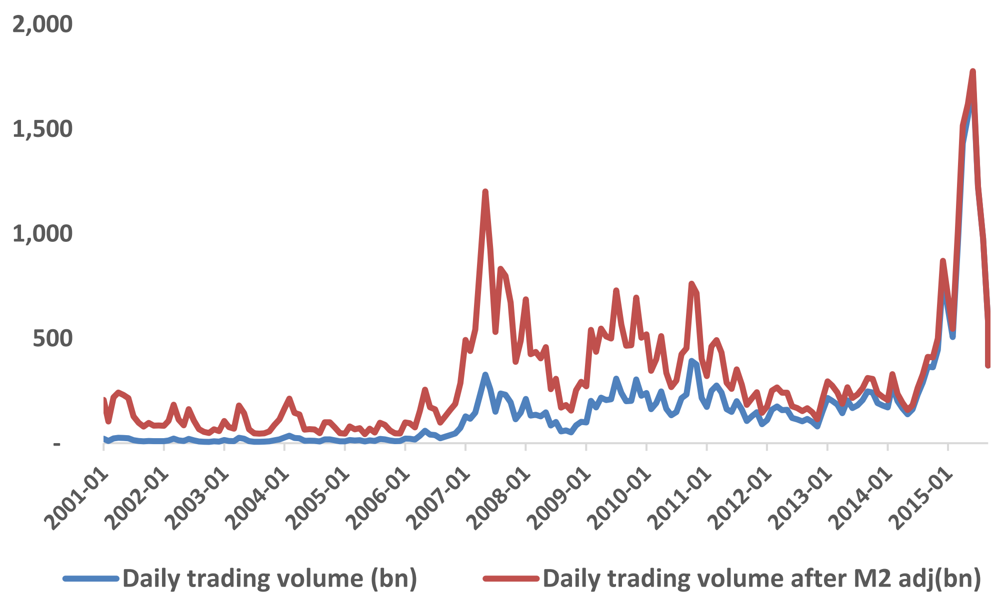
Bin Yuan Capital Greater China Strategy – Third Quarter 2015

China Market Review

The actions taken by the Chinese regulators since the end of the last quarter to clean the irrational margin borrowing by the market punters have extended into this quarter. New policies have been adopted in the quarter. All the margin lending accounts by the non-broker entities have to be closed and umbrella trust funds have to be cleaned up by the end of September. The total amount is estimated at RMB200 billion. It is close to 20% of the total leverage in the market. The daily trading volume has dried up and was getting back to the past three years average level (see chart 1).

Chart 1 Trading Volume



The index hit new low for the year and was back to the level in November 2014 which was the beginning of the short term bull run. Institutional investors have the consensus that the market will continue to go lower. Most of the mutual funds are now at their maximum cash level which is above 50%. The cash level for private funds is even higher. We believe, for the short term, the market is healthier today after this sharp correction. Some of the stocks valuation is trading at very attractive level.

The Hong Kong market has not escaped and had a very tough quarter. It was impacted not only by poor China A share market sentiment, but also by weak global equity markets. The

Hong Kong listed stocks are at their historical low valuation. Many stocks are very attractive as long term investment targets.

A chain store of fresh bread, cakes and beverages has delivered strong earnings growth and performed well during the quarter. With its strong brand name and management, the company has become one of the top tier players in mainland China and is penetrating into 2nd and 3rd tier cities. It's also expanding the business successfully in the US.

Another positive contributor is a major player in auto interior/exterior decoration industry. It targets mid to high end customers with 15%-20% market share in this segment. It has moved into car networking market as future growth engine.

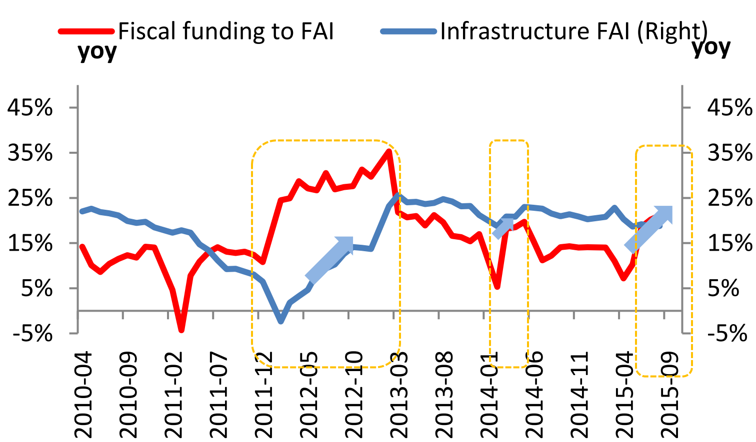
China Outlook

Chinese economy has been continuing going soft as we have expected. Increasing local economists and government officials have realized that the slowing economy is a reality. The overcapacity and weak demand will last longer than most have expected. This common understanding, on the positive side, is helping on most needed economic structure reform. We are expecting the changes and reforms will happen in the following areas:

1. Government bailout stimulus

Due to limited options, investment will continue to be driver to keep the economy growing. The difference going forward is that the capital resources will be directed to selected sectors. The investment in those must-do areas is expected to accelerate, as illustrated in chart 2 below.

Chart 2 Fiscal Funding to Infrastructure Investment



Although investment still remains weak, those FAI funded by fiscal source have picked up and will in turn drive the development of needed projects. We have witnessed the approval of initiatives in railway, grid distribution, environmental protection and new energy…etc. The cut of interest rate and RRR will help to release the liquidity from banking system to those selective investments.

The housing market is a very challenging area for the policy makers. Even the prices of the properties in the largest cities are still solid, the oversupply with affordability issues is severe in tier 2 and below cities. It is a common understanding that the overall property market has problem, but a sharp slowdown in the property development activities will significantly impact the economic balance. To reduce the impact of the oversupply, the policy makers have issued policies to stimulate demand. One of the policies is to lower the down payment ratio of first house purchaser from 30% to 25% in non-restrictive cities. This move could help to improve the affordability of some buyers in the tier 2 cities and may cause reverse people migration from larger cities to smaller ones. We are closely watching the trend of reverse migration as it may structurally impact the consumption spending patterns.

2. Pro-market reform

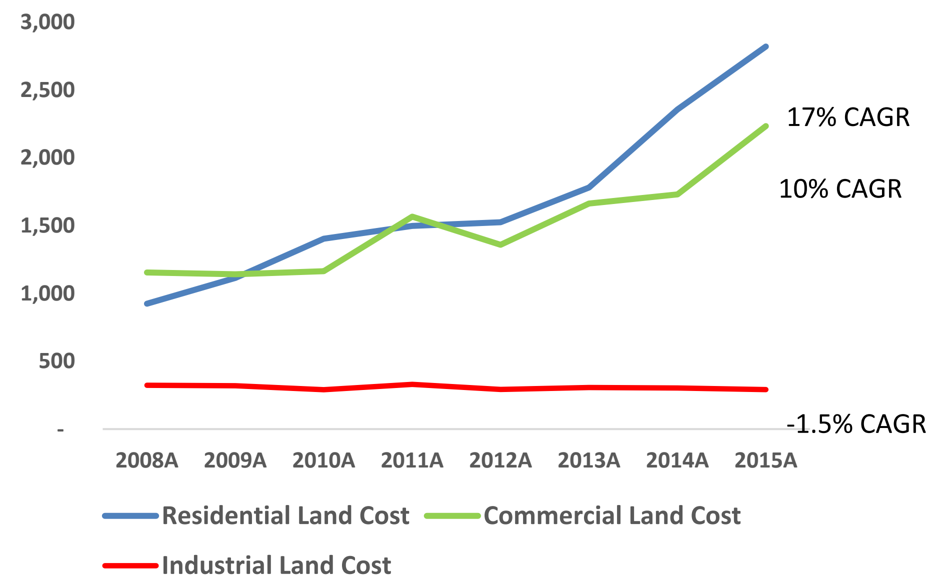
We still believe that this government leadership is pro-market reform. It is believed that reform is the prerequisite for quality growth in the long run, as it could effectively improve total factor productivity and thus enhance efficiency in the economy. The areas that need to be focused on for reform are currency, SOE, banking system and the opening of the capital account.

RMB liberalization

The devaluation of RMB, as we earlier believed, happened at the end of the third quarter. However, we still believe that RMB has more room to go weaker as it is still overvalued by 10-15%. A simple way to analyze this is that Chinese exporters have enjoyed various government subsidies; their productivity is not catching up with increased production cost. Most of the peer countries have relatively devalued their currency against RMB.

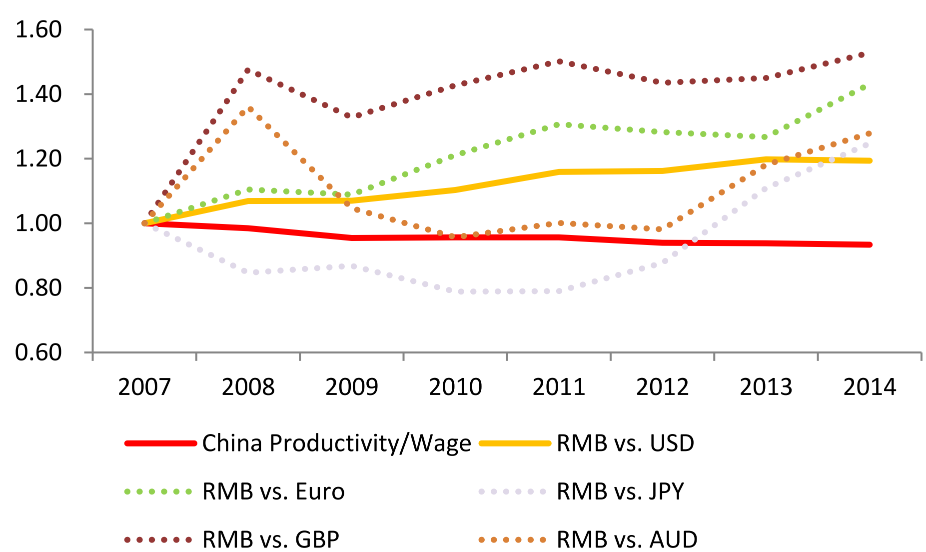
We understand that there is an argument that an expensive RMB can make Chinese exporters consolidate and be more efficient. However, the various subsidies to the exporters through VAT rebate and other support including cheap land have distorted the competitiveness comparison. The chart 3 below shows that the industrial land has significantly underperformed the residential and commercial land in the past 7 years. Based on our calculation, this subsidy is about 10% of the total manufacturing cost.

Chart 3 Land Cost Growth



The chart 4 below also elaborates the reverse trend of productivity efficiency (GDP generated per each $1 wage spent) and RMB value, and the productivity efficiency in China, unfortunately, did not catch up with currency appreciation.

Chart 4 Productivity analysis



Another sign of RMB over valuation is that the price of goods sold in China is almost 50% higher than that in US and Developed European countries. Chinese people have been massively purchasing goods and services in other countries. Depreciating RMB will help to encourage Chinese people to consume domestically to support service industry.

We think that the start of RMB depreciation could help to improve the competitiveness of Chinese exporters, especially for those ones moving toward upper end of the value chain to become potential global players.

SOE reform

SOE reform is a repeated topic in our previous newsletters and it will be an ongoing subject. In September, the State Counsel released guidelines for SOE Mixed Ownership Reform. With more detailed policies yet to be unveiled, we are selectively positive on the injection of quality assets in parent group and asset restructuring in the sectors that are able to become globally competitive players.

Financial system reform

Financial resources in China need to be efficiently channeled to real economy to support healthy growth. During the quarter, one SOE Tianwei group filed for bankruptcy and rigid payment has been broken in this case. As a result, mispricing in whole system could be effectively reduced and risk free rate is expected to be lower. In our prospective, it is a good sign and this tendency is beneficial to development of Chinese financial market.

We have also witnessed the initiatives by some banks to move from pure commercial bank model to financial holdings model. The synergy between commercial bank and investment bank could help to provide integrated solution of investment and loan, which will improve the efficiency of financial resource allocation.

Capital account opening up

The opening of capital account will still be a long term project and it will be a gradual process. We have already seen that the government is pushing for the RMB internationalization. The next important step for the equity market is the start of "Shenzhen-Hong Kong through Train". We hope this will happen in the next two quarters, and it will gradually narrow the valuation gaps between the exchanges.

3. <u>Supervision and regulation tightening</u>

It is good to see regulators to make increasing effort to improve regulation and risk control system. The government was cleaning up the leverage and the umbrella trusts. We have already seen that anti-corruption campaign has been spread to financial system. With that, the capital market could function better to allocate resources to good companies that create value over time.

Corporate Earnings Review and Portfolio Positioning

The low quality of corporate earnings growth is a concern to us. In this past two quarter's earnings announcement, we found that the growth was mainly boosted by investment income and merger and acquisitions (M&A), instead of operational organic growth. The downside risk of earnings growth in the coming quarters will spike as reinvestment returns are diminishing, especially for GEM board listed companies.

The major problems for growth driven by investment income and M&A are inflated balance sheet and non-sustainable earnings growth. At first glance, the earnings growth of all A share listed companies in the first half have accelerated (we use A share listed companies as a proxy for Chinese names). However, the sustainability is very questionable. The chart 5 below lists the earnings growth by different boards. If we remove investment income (gain through investment in capital market) and take share dilution into consideration, the earnings growth was largely lowered.

Chart 5 Earnings Growth by Board

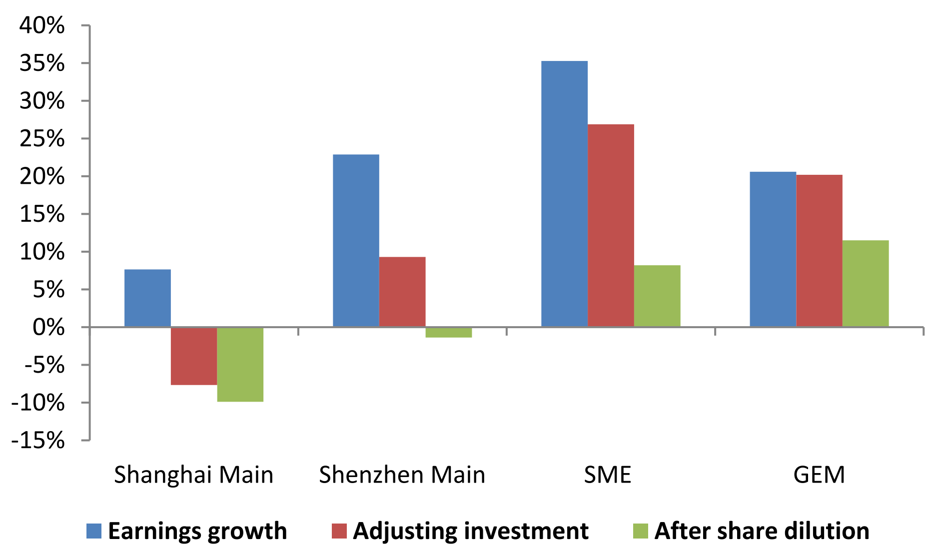
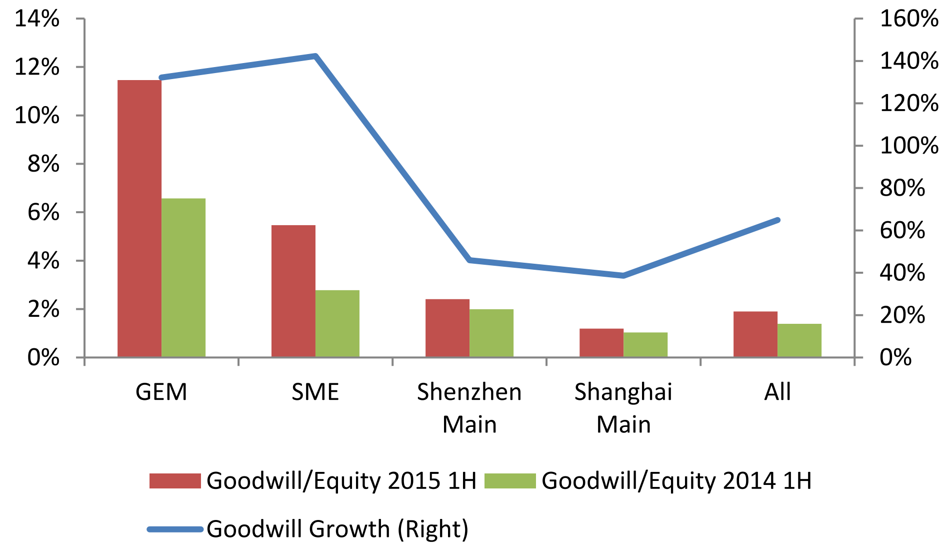


Chart 6 shows that the percentage of goodwill to equity has climbed up sharply recently. Especially for GEM board, the ratio has achieved 12%, which is significant. The goodwill balance grew by 65% as a whole in the first half of 2015. The write down of goodwill value will negatively impact earnings.

Chart 6 Goodwill/Equity Ratio



A good rule of thumb is that an M&A deal's possibility of success tend to be low mainly because:

- Integration is always more difficult than expected considering culture and interest conflicts.
- Some of M&A is not vertically expansion. 140+ of 317 deals announced in 2015 are cross industry. Transparency is very low.
- Due to the weak regulatory system and loose punishment in the past, large shareholders do not care the interest of minority shareholders, and some even cheat on the books. The valuation of target assets might be exaggerated for raising money.

Sincerely,

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