## Bin Yuan Capital  China Equity Strategy – First Quarter 2016

### China Market Review and Performance Attribution

China stock market kicked off the year of 2016 with dramatic volatilities. The benchmark CES300 index that combines 300 names listed in both H share and A share plummeted by 18.2% for the first two months, followed by an 11% recovery in March. There were liquidity issues that extended from last year, plus concern on the RMB. The capital came to the equity market with leverage early last year seeking for higher return were forced to exit. The deleveraging requirement by the market regulator caused negative feedback loop during the market correction. The newly set up mechanism of circuit breaker, which started in January and suspended later, accelerated the sell-off and caused margin calls that pushed the market down further.

The top contributors in the first quarter for Bin Yuan investments were new energy, consumption and railway stocks.  Industrial names lagged during the period.

New energy stocks including wind and solar performed strongly in March after heavy correction earlier as the results of lower oil price and temporarily poor curtailment in Xinjiang and Gansu provinces in China. We have added a distributed solar name during the quarter, which is a leader of PV tracking system. The product can improve generation efficiency by 20%, which attracts increasing operators to procure amid the pressure of cost hike. Tracking system is nearly 0% penetration in China compared with 20% in overseas markets. The company has strong market position and almost dominant in this area with technology patent.

### China Outlook

The most discussed topics for this quarter are the collapse of Chinese financial system, the valuation of the RMB and supply side reform. We believe most of the concerns are valid, however, some of the worries are overdone.

#### *Bad Debt concerns and financial resource allocation*

The risks of NPL problems in China are well-known and widely discussed by global investors. We issued a liquidity analysis report “Channel the Capital to the Real Economy” (available on request) to discuss the liquidity situation in China and its implication on stock market. Capital misallocation is a more severe problem than NPL. Due to the structural problem, the financial system is not efficiently allocating financial assets to most needed and value-added sectors to maintain a sustainable economic growth. From chart 1 below, we can see that although the money supply hiked sharply in 2015, the economy was immune to the loosening money supply. The liquidity was largely directed to the debt restructuring of those industries with redundant capacity, or to chase speculative higher return financial assets (Chart 2).

The "innovation" in the financial industry, which include but not limited to the lending activities in stock market, internet finance, Peer to Peer (P2P) financing and Wealth Management Product (WMP), was aimed to solve the capital misallocation issues and provide liquidity to the real economy. However without tight regulatory supervision and structural reform, the fund raised by above "innovation" went to short term duration assets with higher promised returns. We estimate that around 40% of cash was invested in high risk assets including secondary stock market. A big portion of the rest was used to bail out the earlier invested capital. Those are good examples of good government intention brought in unfavorable results due to economic structural problems.

Chart 1:

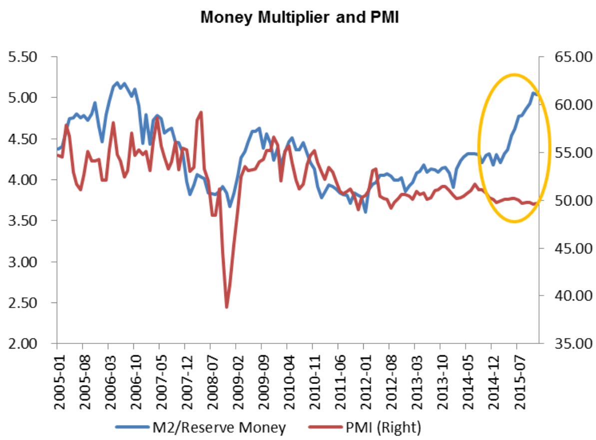
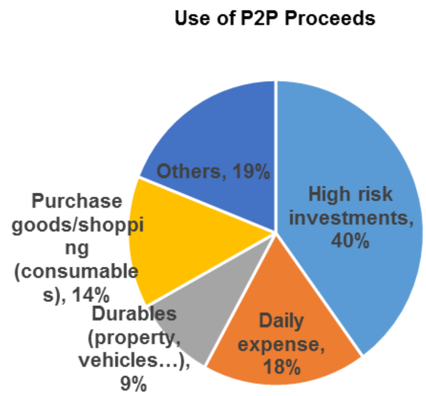



Chart 2:




A few large P2P companies have begun to collapse during the quarter as the result of duration mismatch and the Ponzi schemes came to an end. We view them positively. It indicates that the household will redirect their investments and the government regulators started to be cautious on financial innovations. We believe that in a country with less developed financial industry, innovation will bring more trouble than adding benefits. Thanks to the limited scale, in the short term, the default of higher yield financial products would have limited impact on the entire financial system, but could effectively reduce the expected rate of return. The liquidity should potentially shift back to the banking system and the real economy. It is also helpful for small and medium enterprises (SME) as funding costs would be cheaper in the future.

We witnessed another positive signal that the restructuring of the capital allocation is making progress. Although bank loans are still biased toward large enterprises, state-owned enterprises (SOE) in particular, the situation has been improved since 2009. The bank loans to SME have been increased from 2009 to 2014, although at a higher cost. The loans to large enterprises have dropped from 63% in 2009 to 49% in 2014 (see charts 3 and 4 below). The drivers behind the improvement are the interest rate liberalization, regulation change and the higher interest loans to SME.

Chart 3: Capital allocation 2009

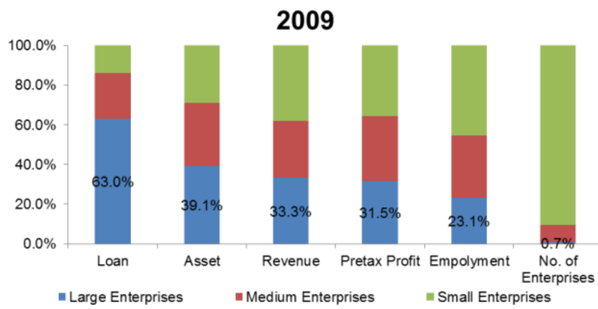
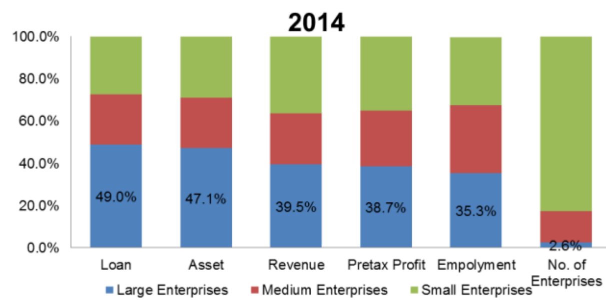



Chart 4: Capital allocation 2014



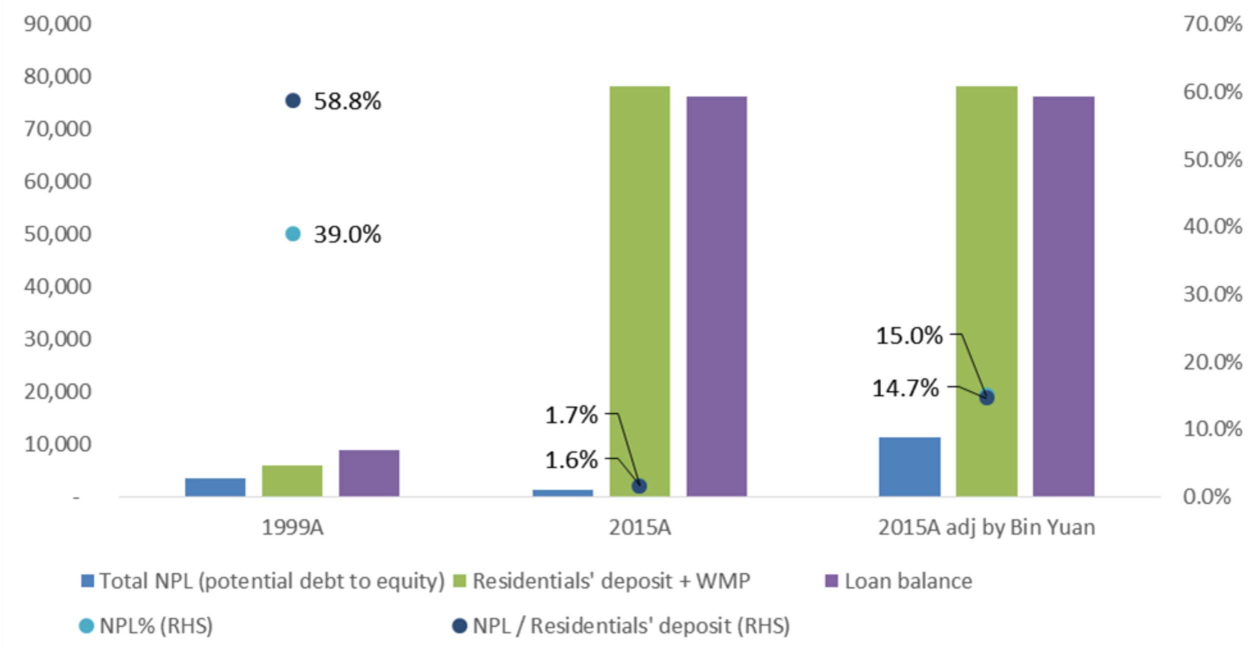

The newly added bank loans in January and February had recorded a new high of 3.2 trillion RMB, a 30% growth on the year on year basis (with January data soared by 70%). The key questions for future are whether the rising credit will be effectively channeled to the real economy. While we admitting the current debt situation of non-financial corporates is concerning, we are happy to see that the government is taking action to deal with the above discussed issues.

***Deleveraging plan***

The distribution of outstanding loans in China is not well balanced, but provides rooms for improvement. The leverage in corporate and local government is much higher than households and central government. This made the NPL less a problem than it looks from surface. The non-financial corporate debt as % of GDP is over 120%, however, the household debt is below 40% (Chart 6), which indicates that the households are able to increase their leverage. High Household savings and low asset securitization ratio provide capacity to absorb some of the NPLs from non-financial corporates. Government is having taken actions to implement that:

1. Asset securitization ratio is low in China, 56% of state-owned enterprise (SOE) equity has not been listed per our estimate. The potential SOE group listing could be a part of the deleveraging process.
2. Debt to equity swap backed by fiscal will help to reduce the accounting leverage. The first batch of 1 trillion plan has been announced.
3. Household balance sheet is very strong with deposit plus WMP totaled 78 trillion RMB. Compared with 1999, residential has an abundant cushion to absorb NPL. Even with the bearish assumption of 15% NPL ratio, NPL only accounts for 14.7% of household assets. (Chart 5) WMP has begun to take an active role to absorb problematic loan.

Chart 5: Compared with 1999, residential has stronger B/S to absorb NPL




We forecast the potential amount of 33 trillion RMB non-financial corporates debt could be digested over a period of time, in the form of asset securitization, debt to equity swap and leverage shift to household (Chart 7). The debt situation as a whole is not that despairing and we see a low possibility that a massive financial crisis will happen in China in the next few years.

Chart 6: Deleveraging plan estimation

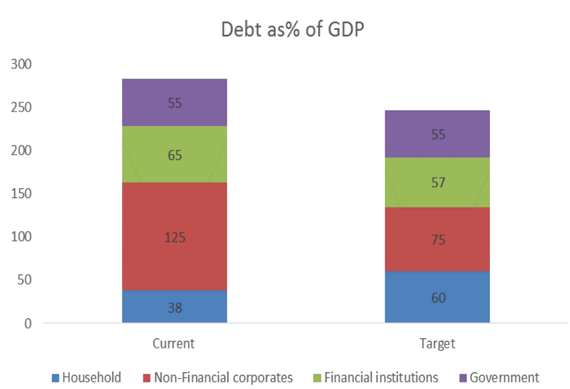
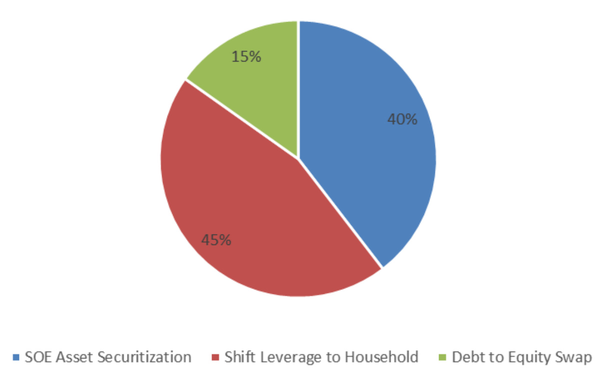



Chart 7: Non-financial corporates deleveraging plan



***Supply side reform***

The painful excess capacity adjustments and industry-wide consolidation have been ongoing for the past three years. We have seen signs of bottoming and believe the worst is over. The capacity utilization ratios were lowest in the past 5 years and the output growth in steel and coal sectors were negative since 2014 (Chart 8 & Chart 9), and inventory have been declining (Chart 10 & Chart 11). If we assume 6-7% annual demand growth and no further supply increase, the equilibrium will happen in 2017 or 2018 (Chart 12 & Chart 13), otherwise, current capacity needs to be cut.

Chart 8: Steel output

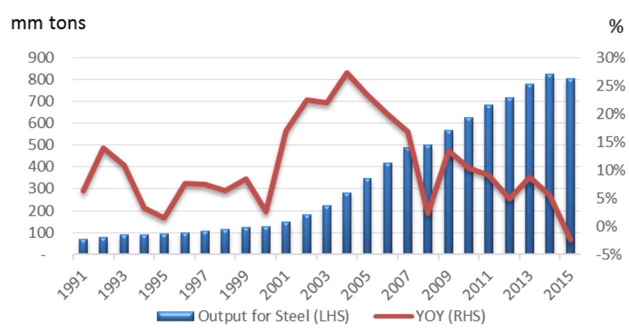



Chart 9: Coal output

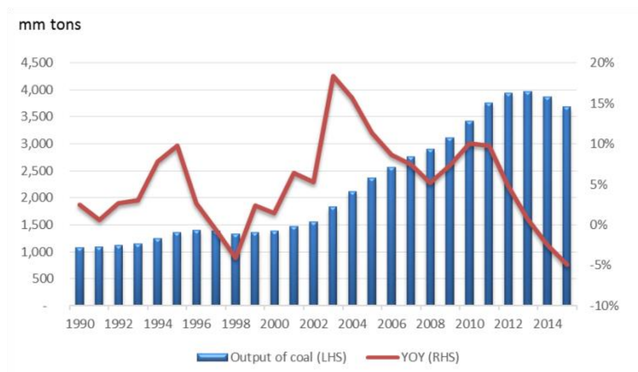



Chart 10: Steel inventory

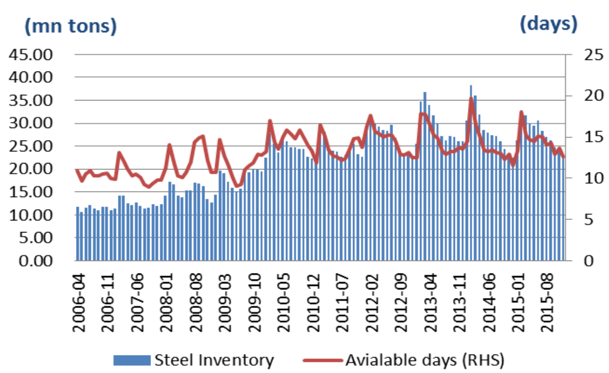



Chart 9: Coal inventory

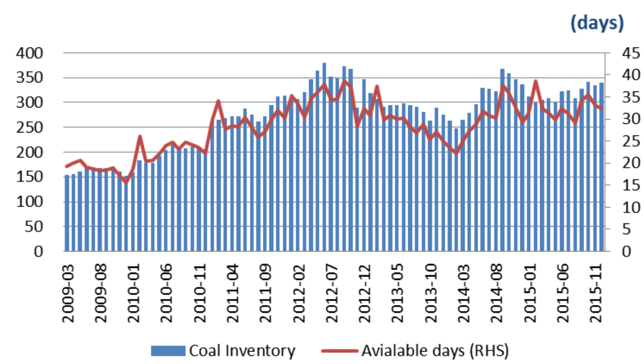


Chart 12: Steel equilibrium point

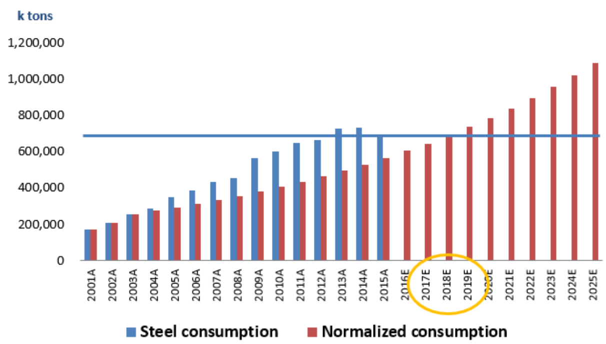
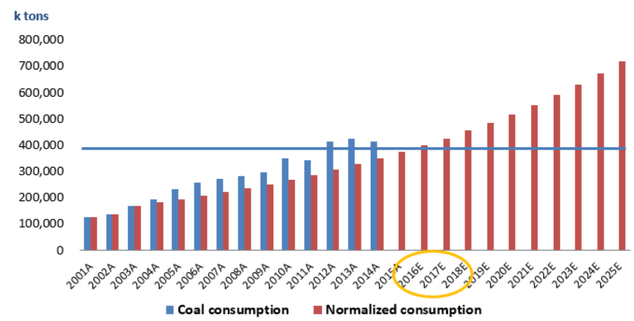



Chart 13: Coal equilibrium point




The effects of reducing capacity in fixed asset investment will bring positive benefits to the Chinese economy. It will be a painful process. An increasing proportion of service sector in the economy is still a long term project and thus lead us to be very selective in investing our money.

***Currency***

We continue to hold the view that the RMB is overvalued. A sharp decline of the RMB against the US dollar is very unlikely as it is very difficult to calculate the impact it may cause. What we will see is a gradual devalue process through the RMB match the value of a basket of the currencies. A lower value of RMB is positive for China.

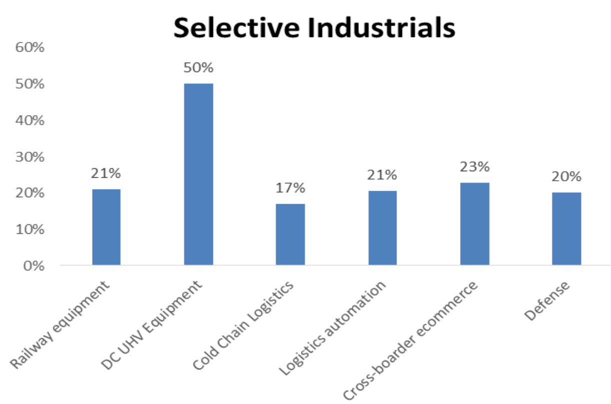
***Summary***

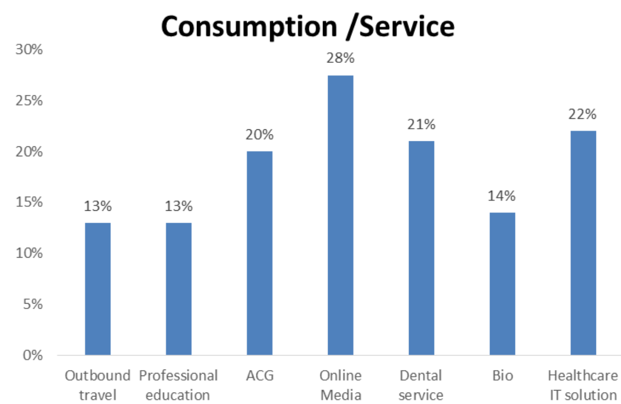
We have seen positive signs in terms of supply side reform and improving capital allocation. With healthy household deposits, the concern on massive financial crisis is overdone. However, with the emerging default of higher return products and bonds, we need to monitor the risk of bond rating downgrades which may negatively impact liquidity in the near term.

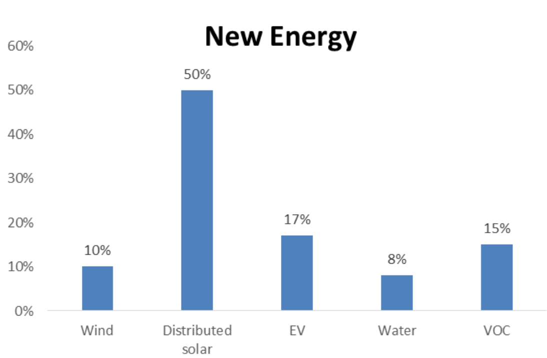
**Portfolio positioning**

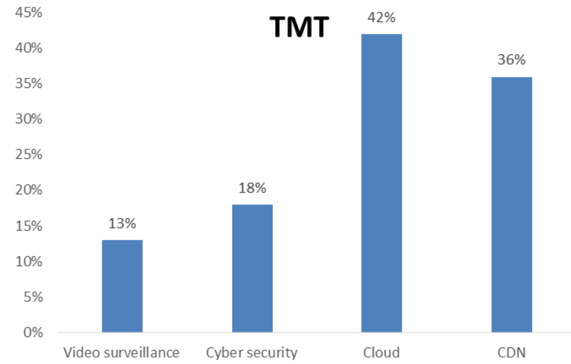
While bearing the macro risk in mind, our portfolio positioning is consistent with the structural trends we identified for mid to long term, no matter how fast the overall GDP grows. The opportunities we target to focus have huge potential of market size and robust growth rate in the 13th five-year plan.

| bn RMB market size | 2011-2015 Fvie Year Total | 2016-2020 Five Year Total |
|---|---|---|
| **Selective Industrials** | | |
| Railway equipment | 1,062 | 2,062 |
| DC UHV Equipment | 35 | 200 |
| Cold Chain Logistics | 201 | 443 |
| Logistics automation | 191 | 534 |
| Cross-boarder ecommerce | 16,000 | 48,000 |
| Defense | 3,698 | 7,919 |
| Helicopter | 40 | 113 |
| **Consumption/Service** | | |
| Outbound travel | 2,500 | 5,000 |
| Professional education | 1,346 | 2,699 |
| ACG | 445 | 1,076 |
| Online Media | 59 | 250 |
| Dental service | 45 | 110 |
| Bio | 300 | 650 |
| IT solution | 22 | 57 |
| **New Energy** | | |
| Wind | 816 | 960 |
| Distributed solar | 40 | 320 |
| EV | 68 | 405 |
| Water | 380 | 700 |
| VOC | 63 | 108 |
| **TMT** | | |
| Video surveillance | 129 | 267 |
| Cyber security | 96 | 228 |
| Cloud | 25 | 166 |
| CDN | 13 | 66 |

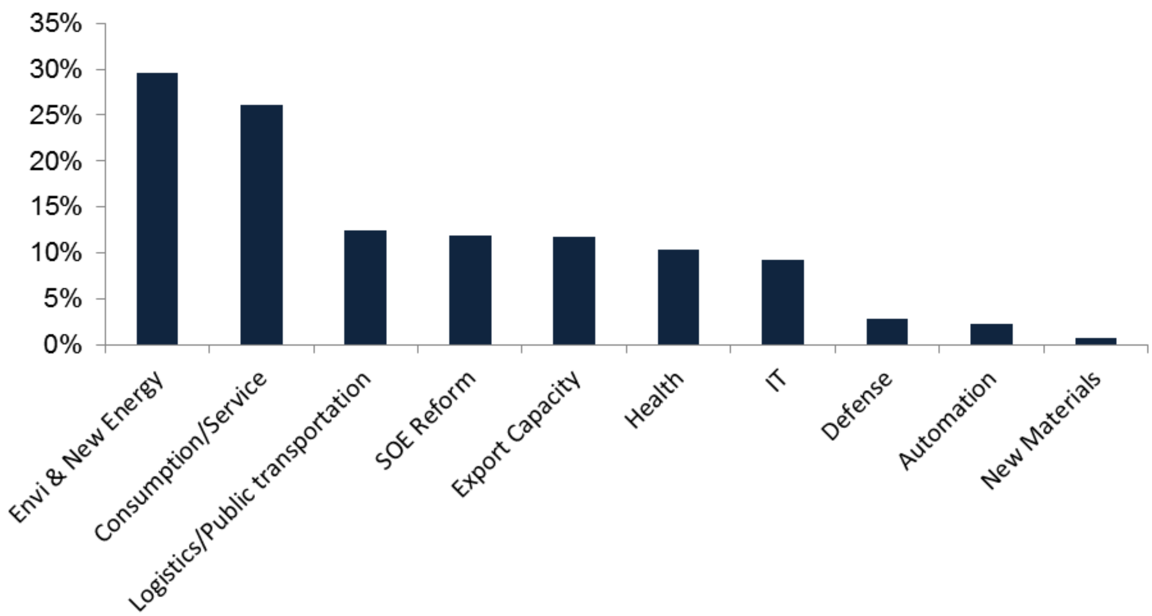





Our portfolio exposure by theme for Greater China strategy is as below:




Sincerely,

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