Bin Yuan Capital All China Strategy – October 2016

Market Review and Performance Attribution

During the month, Energy, Consumer Staple and Consumer Discretionary were the top three contributors while Healthcare and Information Technology lagged driven by profit-taking after past outperformance.

Shanghai Stock Exchange Composite Index remains buoyant above 3000 points, driven by multiple signs that China economy is stabilizing. China CPI and PPI recorded year on year growth of 1.9% and 0.1% respectively. The latter being the first positive reading in the past five years. In addition, the progress of China supply-side reform is well proven by the coal mining industry. China Qinhuangdao Port Thermal Coal Price Index, a widely recognized coal price gauge in China, rebounded back to more than four years high in October amid tremendous effort in reducing spare capacity. The consolidation of other industries is expected to follow. As a leading indicator, China official Manufacturing PMI improved to 51.2, which indicates that manufacturing activity is expanding at the highest pace in two years.

The recovery of economy pave the way of further reform in resources allocation and efficiency improvement, which will build a solid base for more sustainable growth in the long term.

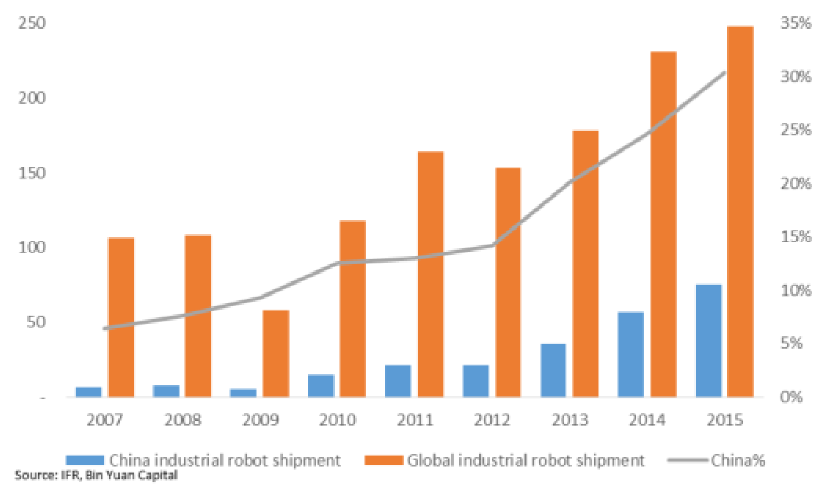
The Shenzhen-Hong Kong stock connect, which both exchanges are putting their effort to launch before year end, will help the investors from both side to seek value stocks. We expect a healthy stock market to come with the momentum of "stock connect" and a recovery theme in China.

Local Observation and Portfolio Positioning

In the previous newsletters, we discussed the trend of structural changes from manufacturing towards service in China. The manufacturing space itself has shown the positive trend that it has been consolidated and moved up the value chain. The manufacturing industry is investing in technology to improve its competitiveness.

Labor cost is not the only factor in manufacturing competitiveness. The government efficiency, maturity of the production supply chain, advanced logistics system, supply of the financial capital, size of the domestic market, and experienced/skilled labor are combined factors to consider economically. To move to high value added space, the importance of "know how" and technology is overwhelming. Automation and robots adoption has reduced cost and improved the yield and quality of delivery. As we can see below chart, the industrial robot shipment ratio in China increased fast in the past few years and China consumed 30% of the total global shipments in 2015.

Chart: China Industrial Robots Shipment



Source: IFR, Bin Yuan Capital

From our survey, this trend should stay as it works economically. Automation does significantly improve the efficiency of Chinese enterprises. We take medium-sized logistics center of SF express as an example. Two thirds of workers could be reduced and error ratio decreased from 1% to less than 0.1%. There are over 30% savings of total operating expenses for five years. A household appliance leader Midea in China has acquired Kuka, a robot player from German, to move upstream after enjoying efficiency and cost benefits of being its customer.

In addition to sourcing equipment externally, some of Chinese competitive players have moved one step further to produce device and equipment in house with rich manufacturing know how accumulated in the past. Those self-made equipment are unique and much more advanced and efficient than those standard ones. By doing this, those players enjoy massive cost advantage compared to the peers and continue to take global market share.

Self-developed equipment is one of Hongfa's (a relay leader in China) main advantage to keep competitiveness. For example, Hongfa self-developed winding machine costs less than 0.5 million RMB, while foreign equipment price is more than 2 million RMB with same efficiency and quality. It also sells its equipment to other players include domestic and foreign peers, like Schneider, Tyco and CHINT at a price third times of its internal cost. Besides, it keeps the most advanced equipment for self-use only.

Another example is Himile, who is the biggest tire mold maker in the world with almost all the top tier tire brands being its clients. When the global tier demand has slowed down to low single digit growth, Himile's revenue growth keeps high pace because it has enlarged the market share. One of the major reasons for Himile's success is its cost advantage. Based on their deep understanding of the industry, Himile created their own mold machines, which are cheaper and more efficient than the general machinery their peers buy on market. Himile does not sell these machines and makes it as their unique competitiveness. Home-made machinery helps Himile earn cost advantage of 10-15%.

Manufacturing and service sectors should supplement each other to foster a healthy development economy. China has entered into a good cycle with two sectors well positioned for the next growth stage. Consumption/service and global competitive manufacturing are two major themes we position in the portfolio.

Sincerely,

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