

Bin Yuan Capital All China Strategy – February 2017

Market Review and Performance Attribution

In February, Information Technology, Health Care, and Financials were the top three contributors while Consumer Discretionary, Industrials and Telecommunication Services lagged.

Chinese stocks extended their rally in February, with both the Shanghai Composite Index and Hang Seng China Enterprise Index closing at their highest level in the past 12 months, factoring in an improving economy. The Shanghai Composite Index increased by 2.61% in February and Hang Seng Index gained 1.63%.

Economic data came in slightly beating the market's expectation. The producer price index (PPI) maintained its growth momentum in previous months by rising 6.9% year on year (YoY) in January, supported by rising commodity prices and robust demand. Meanwhile, the consumer price index (CPI) increased by 2.5% YoY thanks to a pickup in consumption and travel activities during the Spring Festival season, but inflation may ease in February. Because of the Spring Festival impact, the official manufacturing Purchasing Managers' Index (PMI) eased to 51.3 in January from 51.4 in the previous month, still well above the neutral threshold of 50. Meanwhile, the official non-manufacturing PMI in January came in at 54.6, up from 54.5 in December 2016. Rail cargo volume grew 10.4% YoY in January to reach about 311 million tons, marking the sixth consecutive monthly rise.

The interbank lending rate in Shanghai rose above 4% in February but a stabilizing trend was seen after that. The People's Bank of China raised the overnight rate of the standing lending facility, a liquidity support tool. The move signaled a preliminary reverse of the monetary policy stance and a recovery of China's economy. This also relieved the market's expectation of RMB depreciation despite the continuous downward trend of foreign exchange reserves.

China Securities Regulatory Commission (CSRC) was taking effective actions to crack down on market manipulation and other illegal activities. Meanwhile, CSRC was also putting forward a series of market-oriented policies, including fewer restrictions on domestic stock index futures trading and the much anticipated registration-based IPO system. In addition, the government started to grant local pension managers more flexibility in investment scope, including the investment in the equity. According to our estimation, this will ultimately bring about RMB400 billion to the A-share market. All these measures mentioned above will contribute to a lasting and healthy capital market in China in the long term.

Local Observation and Portfolio Positioning

Channel and traffic brought great dividends to the consumption and service companies who have those edges in the past decade. While such dividends of traffic still exist today, though generating diminishing marginal returns, the quality of contents or products delivered play an increasingly important role to attract customers and retain user stickiness.

We focus on the companies who have the capability to continuously generate high-quality contents and the contents they possess help to expand the user base and enhance the user engagement.

Tencent (700.HK)

People normally attribute Tencent's success to its traffic driven instant message (IM) products like QQ and Wechat. However, it needs to be noticed that Tencent is also a giant of content. The virtual world is more appealing to Chinese people than to western people due to personality reason and Tencent is extremely good at providing virtual products and services to meet younger generation's demands. Tencent has built its leadership in entertaining areas based on its 800 million active users from Wechat and QQ. Its content layouts cover Gaming, Comic, Music, Drama, Movie and Fiction.

Tencent is the biggest game company in the world with RMB22 billion revenue, accounting for 55% of its revenue in the third quarter of 2016. Market share expansion in the past 10 years was rather steady and significant from just 2% in 2005 to 43% in 2016. What is more, Tencent's latest top mobile game, Glory of the King, now generates monthly cash income of around RMB2.7 billion and its peak daily active user (DAU) has once reached around 80 million during the Spring Festival, representing the highest level in mobile game's history in China. This phenomenal mobile game is certain to further increase Tencent's market share in game industry to over 50%.

In comic industry, Tencent Comic has over 90 million Monthly Active Users (MAU) with 22,600 comics and animations in which 29 comics have over 1 billion clicks and 12 animations have over 100 million views.

After merged with Chinese Music Corporation(CMC), Tencent music became the absolute leader with sum-up 395 million MAU and over 80% market share in the digital music industry.

As for drama, Tencent video is one of the top two online video platforms with 280 million MAU and Tencent built its own drama making company Penguin Picture in 2015 to provide exclusive drama to Tencent Video. In 2016 December, Tencent Video launched its self-made drama series Guichuideng and obtained over 3.78 billion views within 3 months which ranked first in online drama history. The representative of Tencent on online fiction is its controlling company China Reading Limited which was founded in January 2015 by merging Cloudary and Tencent Fiction. China Reading Limited is not only the biggest online fiction platform with 15 million Daily Active

Users (DAU) but also the biggest IP (Intellectual Property, referring to the copyrights in media) inventory in China. Many hit dramas, movies and games were made based on the IPs from China Reading Limited. A good example is Guichuideng mentioned above, it is initially a top rated fantasy fiction in Starting Point Net which is one of the platforms in China Reading Limited, and Penguin Picture adapted it to a successful drama series.

In the news media industry, its news distribution platform Tencent News has cumulated over 222 million active users and totally spent 118 billion minutes per month on it. Besides the traditional news feeds app, Tencent also tried to apply its technology of big data and Artificial Intelligence (AI) on its content distribution. Tencent launched a news feeds App TianTian Kuaibao in 2015 which provides news to the user based on big data and user painting. This app significantly improves the experience and efficiency of users obtaining information and now it has over 92 million MAU, which is the second popular interest-oriented news feeds platform only after Toutiao.

Tencent has already built its whole supply chain and ecosystem of IPs. The hit games can be adapted to dramas, fictions and comics, and such contents can also be used to develop games. This system is similar to Disney and almost fully covers the population between 15 to 35 years old in China. With such dominated position in online entertainment, Tencent will sustain the leading position in Chinese internet industry.

Phoenix Media (601928.SH)

While much of the attention brought to the internet companies, traditional media players with great IP resources are less noticed.

Phoenix Media is one of the top three education publishing companies in China. Its textbooks cover all the courses from primary school to high school and over 50 million students and teachers use its teaching material every year. With the long-term experience and expertise in textbooks system, Phoenix Media has accumulated a huge number of questions in the question bank. TAL education group(TAL.N) invested in one of the subsidiaries of Phoenix in 2015 to get access to the K12 education resources Phoenix owns.

In vocational education segment, Phoenix media has developed 460 3D courses covering 49 majors. It is the most comprehensive vocational education curriculum system in China. The system is opened to teachers and teachers could use the system to develop their own curriculum. Phoenix's target is to make an online vocational education platform, which will significantly lift the manipulative skill of vocational school students, who are lacking practice opportunities now.

Phoenix also has 9 well-known publishing house subsidiaries, and through them, the company holds a large number of high-quality IP resources. Phoenix media has adapted several IPs to movies and TV dramas and received many compliments.

Sincerely,

Bin Yuan Capital

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