

## Bin Yuan Capital – First Quarter 2017

### Market Review

The Chinese stocks consolidated in March after increasing for two consecutive months in January and February. During the first quarter, the Shanghai Composite Index was up by 3.83% and Hang Seng China Enterprise Index performed even better by gaining 9.35%.

China's economy kept expanding in the first quarter of 2017. The official manufacturing Purchasing Managers' Index (PMI) rose steadily from 51.3 in January to 51.8 in March and the official non-manufacturing PMI was also up from 54.6 to 55.1 during the same period. The producer price index (PPI) maintained its growth momentum in the first quarter by rising 7.4% year on year (YoY), primarily driven by the mining sector. The consumer price index (CPI) eased a little bit to 1.4% YoY in Q1 2017 from 2.0% in 2016.

From Q4 2016, three of the four first-tier cities, dozens of second-tier cities and third or fourth-tier cities neighboring first-tier cities unveiled tougher rules to restrict housing purchases, where home prices tended to rise again. These measures included higher down payment percentage, tightened financing, purchase limits, etc. Then in the first quarter of 2017, China's property market started to stabilize. According to National Bureau of Statistics, of 70 large and medium-sized cities surveyed, more than half of them in February witnessed a month-on-month price decline or a mild price uptick less than 0.5% for new residential housing. The control of the property price will contribute to a stable and healthy property market and benefit the economy in the long term.

After the successful launch of stock trading connects between Mainland China (Shanghai and Shenzhen) and Hong Kong in the past two years, the government now is considering to explore the opening of the bond market. The bond market trading link is going to be put forward later this year, which will allow overseas investors to buy and trade bonds in the Chinese mainland market and vice versa. This is another signal of the country's continuous opening of its securities market.

### Performance Attribution

During Q1 2017, our stock selection in Information Technology and Financials performed well while small-cap consumer discretionary names lagged. At the stock level, an H-share auto part name was the top performer primarily due to the positive earnings growth announcement. The company is the beneficiary of rising demand for plastics parts to replace steel parts amid the vehicle trend of going lighter weight.

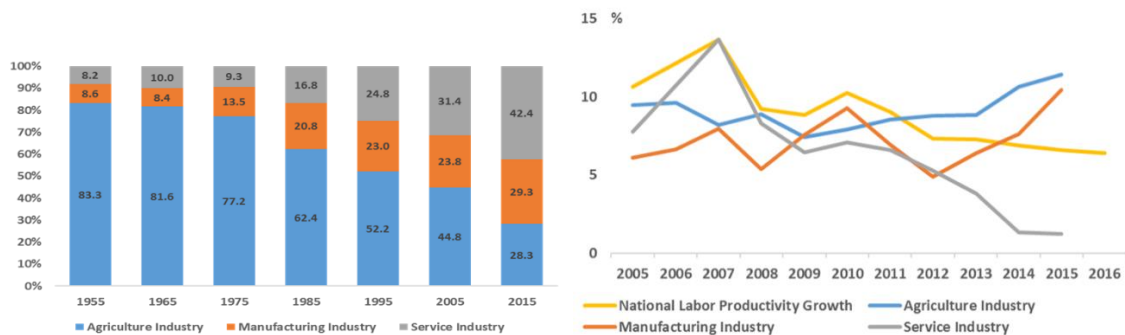
## China Outlook and Portfolio Positioning

### Summary

In our previous newsletter and research report “[Next Stage Growth Oct 2016](#)”, we discussed the structural changes from manufacturing to service in Chinese economy. Market-driven industry consolidation in the past five years helped to phase out the overcapacity in manufacturing space. As a result, a large quantity of employment has been shifted from excessive manufacturing to under-supplied service industries (Chart 1).

China is pursuing a high-quality growth which will be driven by productivity enhancement and efficiency improvement. We split the labor productivity growth into manufacturing and service for deeper analysis (Chart 2). The accelerated growth of manufacturing productivity echoes the situation that Chinese manufacturing companies are moving up the value chain, and the potential improvement of service productivity will contribute to the economy growth of China in the future.

Chart 1: Proportion of Employment by Industries Chart 2: Growth of Labor Productivity



Source: NBS, Bin Yuan Capital

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The **productivity of manufacturing industry** recorded a robust growth, mainly driven by:

- ✓ Improved skilled labor force
- ✓ Economies of scale
- ✓ Integrated supply chain
- ✓ Automation and technology advancement.

The improving productivity enabled Chinese manufacturing leaders to gain competitiveness to grasp market share in both domestic and global market.

**Service productivity growth** dragged the overall productivity growth. With an increasing number of people flowing into the service sector to gradually fill the gap of under-supply, the service

sector enjoyed a vigorous development and it contributed 50% of GDP in 2016, compared to 39% in 2010.

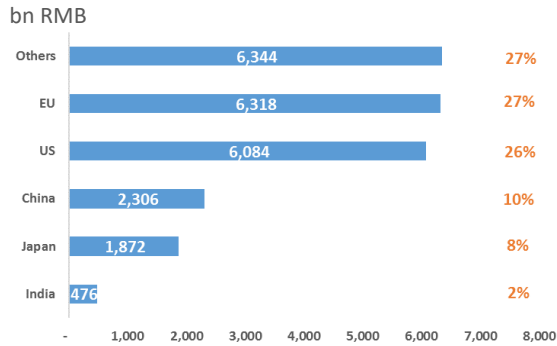
While the service productivity growth lagged in the past, we think there will be huge potential to improve in the future, which will be certainly driven by the development of:

- ✓ Life-long professional education
- ✓ Service automation
- ✓ Artificial intelligence and deep learning
- ✓ Digitalization and big data

Chinese companies are open minded to new technologies and they are very innovative in technology application. China's expenditure in Information Technology (IT) every year is the second largest in the world, only after US (Chart 3) and it has ranked itself in top tier group worldwide in the "New" area including deep learning (Chart 4), cloud, cyber security and big data. For example, Alicloud is the dominant player in Chinese public cloud industry, and ranked the 3rd worldwide in revenue scale. There are also a lot of Chinese technology companies with huge R&D investment in cyber security, like Qihoo and Tencent. In the latest Pwn2Own2017 hacker competition, the security team from Qihoo won the championship with a record score and three security teams from Tencent ranked in top 10. Chinese technology companies started to play an important role in the international cyber security industry.

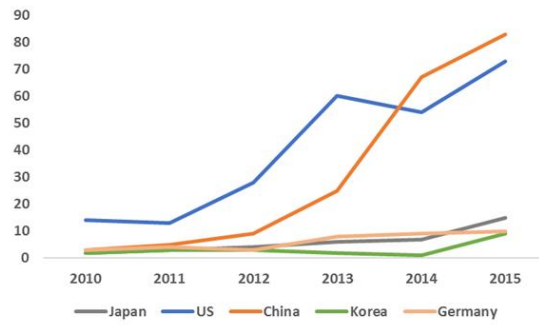
The high penetration of mobile phone fostered the dynamic development of mobile applications, and China is ahead of others on mobile payment, mobile e-commerce and mobile entertainment, which helped the accumulation of data and then data analysis capabilities. There is a high possibility for Chinese service companies who have early-bird advantages to export their operation experience and capabilities to other countries, following the path of those manufacturing leaders.

Chart 3: IT Expenditure in Various Countries



Source: Gartner, Bin Yuan Capital

Chart 4: Papers Cited in Deep Learning Field



Source: Bin Yuan Capital

Our investment focus will be on those areas that can help to drive the productivity growth, and we shall stick to the high-quality companies who can generate value and cash flow from their core competitiveness. On this front, we like Himile, Hongfa, Phoenix Media, Weibo, Hikivision, Tencent, Alibaba as a few examples.

For newsletters of previous periods, please refer to "[Bin Yuan Capital Newsletters](#)".

Sincerely,

**Bin Yuan Capital**

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