Bin Yuan Capital All China Strategy – April 2017

Performance Snapshot and Market Update

The Chinese stocks continued to correct in April amid damped market sentiment after a series of tightened measures by regulators. The Shanghai Composite Index and Hang Seng China Enterprise Index dropped by 2.11% and 0.52% in April, respectively. However, with the contribution from some large-cap blue-chip stocks such as Tencent and BABA, MSCI ALL CHINA Index increased by 0.14%.

China's economy maintained a steady growth in April 2017. The producer price index (PPI) rose 6.4% year on year (YoY) in April, but eased from the 7.6% registered in March. China's PPI has stayed in a positive territory since last September. The consumer price index (CPI) picked up to 1.2% YoY from 0.9% YoY in March. The official manufacturing Purchasing Managers' Index (PMI) edged down to 51.2 in April from 51.8 in the previous month and the official non-manufacturing PMI in April also declined to 54.0 from 55.1 in March. Though the growth pace slowed amid higher base, the readings still stood above the threshold of 50 that demarcates expansion from contraction. Rail cargo volume grew 17.3% YoY in March to reach about 322 million tons, marking the eighth consecutive YoY monthly rise.

All the companies listed on the Shanghai and Shenzhen stock exchanges completed releasing their annual reports of 2016 and Q1 reports of 2017 by the end of April. The YoY revenue growth of A-share listed companies picked up from 14.2% in Q4 2016 to 21.0% in Q1 2017, while the YoY net profit growth maintained at an already high level of approximately 20%. This good result was primarily attributable to China's market driven supply-side consolidation and improvements in the economy.

On April 1st, China announced that it would establish Xiongan New Area in North China's Hebei Province, about 100 kilometers south of Beijing. The area will be of the same national significance as the Shenzhen Special Economic Zone in the south and the Shanghai Pudong New Area in the east, two milestones in China's reform and opening-up. Xiongan New Area is going to accommodate the "non-Capital functions" of Beijing, advance coordinated development of the Beijing-Tianjin-Hebei region. Investors also turned bullish on shares of companies involved in development, infrastructure, construction materials and transportation.

The government reiterated the importance of deleveraging and containing financial risks in April. The China Banking Regulatory Commission conducted on-site inspections of banks to screen out risks of corporate loans as part of efforts to deleverage the institutions. Also, the China Insurance Regulatory Commission called for a prudent investment plan to be established to strengthen asset and liability duration management and to avoid using return on investment as the only investment goal and performance indicator. Concern over the regulatory squeeze weighed on the stock market in the short term but deleveraging will contribute to a stable and healthy economy in the long term.

Performance Attribution

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

At the stock level, a TMT company continued to be the top performer still primarily due to the unprecedented hit of its popular mobile game, which might contribute over RMB6 billion net revenue in the first quarter. We expect the company will announce a very strong financial result in the first quarter. In addition to the mobile game segment, mobile payment is another highlighted business for the company which might contribute profit in the current year. We believe the company, whose traffic barrier is almost impossible to challenge currently, will continue to extend its dominant leadership in the Chinese internet industry.

A tire mode player underperformed in April. The main reason was that its Q1 result was below the consensus. The top line grew at around 20% while the growth of the bottom line was only 8.5% due to the decreasing gross margin. Though the company enjoyed a strong bargaining power for its high-end products, it still needed to keep prices at a competitive level for the mid-end products. Thus it did not pass through all the raw material price increase in Q1, which hurt its gross margin. However, we think this will be a short-term impact and our investment logic that the company will take global market share and further extend its product portfolio was unchanged. Thus we will keep it as one of our core holdings.

Local Observation and Portfolio Positioning

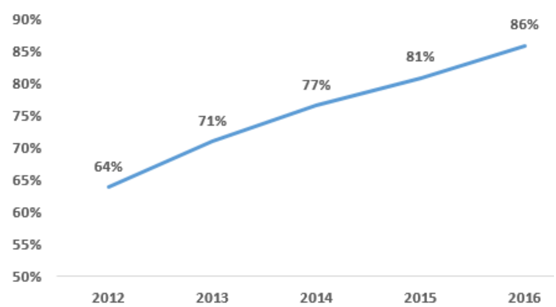
China manufacturing space is no longer linked to low-end products peddled at cheap prices. Instead, quality and technology are becoming the important characteristics of Chinese merchandises and goods. The domestic companies are now moving up the global supply chain to build their brands and spend lavishly on research and development (R&D). The domestic leaders have made inroads substituting imports and/or foreign brands.

The competitiveness of domestic leaders comes from two aspects. Firstly, with the accumulation of know-how and technology, Chinese players are very good at applying those technologies in an innovative and creative way to meet customers' demands, which made Chinese goods even more attractive in terms of function and application. Secondly, domestic leaders are normally well penetrated to lower tier cities to be able to capture the huge market. The scale they have achieved also grant them with abundant resources to continuously invest in more advanced technology and human resources. The positive feedback loop will contribute to the sustainable development of domestic winners. Notable recent examples include smartphones, home appliances and autos.

Smartphones

In the past several years, China smartphone manufacturers continued to invest in R&D and innovation. For instance, Huawei spent RMB76.4 billion in R&D in 2016 alone, representing 14.6% of its revenue. Some high-end product portfolios of Huawei, such as the MATE series, have already had better performances than Samsung's flagship handset. And they started to gain market share in the high-end segment from Apple and Samsung. Other local brands like OPPO and VIVO have also gained market share in the middle-end segment. Total local brands' market share in China increased remarkably from 64% in 2012 to 86% in 2016 (Chart 1).

Chart 1: Local Brand Mobile Phone's Market Share in China



Source: Wind, Bin Yuan Capital

Home appliances

Home appliance industry started to compete with imports back in the 1990s and local brands had already dominated the market by the end of 2009. However, their market share did not stop but continued to increase steadily from an already high level. The market share of local brand refrigerators increased from 76% in 2009 to 83% in 2016. And we can also see similar trends in air conditioner and washing machine segments.

At company level, take one of our holdings, Midea as an example, its market share in air conditioner increased from 14% in 2006 to 23% in 2016 and its market share in washing machine increased from 9% to 24% during the same period.

Market Share	CR3	CR5	Top 3 Names
Air Conditioner	72%	80%	Gree 39%, Midea 23%, Haier 10%
Refrigerator	57%	76%	Haier 30%, Hisense 15%, Siemens 12%
Washing machine	64%	76%	Haier 28%, Midea 24%. Siemens 12%

Source: Zhongyikang, 2016 data

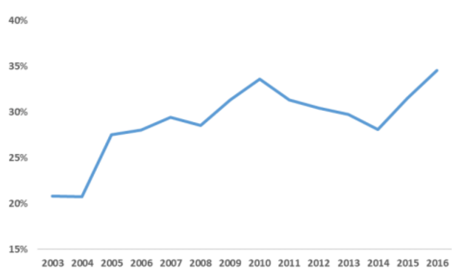
The rise of industry concentration ratio has enhanced the bargaining power of leaders and we have witnessed the continuous margin expansion of Midea and Gree.

Autos

We believe that Chinese autos will continue to follow the path of handsets and home appliances.

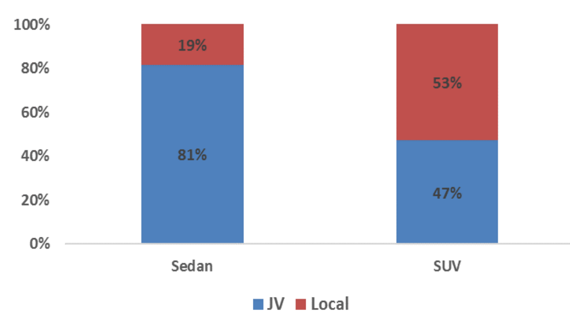
Progress have been made in the past. With decades of accumulation in R&D and manufacturing experience, local brands have narrowed the gap in quality and technology with its global peers now. Their market share reached 35% in 2016 up from 20% in 2003 (Chart 2). SUV segment is the focus of local brands at the current stage. Local brands, such as Great Wall, have put a lot of efforts and have gained more than half of the market share within the space. Afterwards, the local brands are going to catch up in Sedan segment, by leveraging their past SUV experience and facilities (Chart 3).

Chart 2: Local Auto Brands' Market Share



Source: Wind, NBS, Bin Yuan Capital

Chart 3: Market Share of Local and JV Brands



Source: Wind, Bin Yuan Capital

One important trend of auto industry that cannot be ignored is going smart and green. Electric Vehicles (EV) equipped with feature of artificial intelligence and internet application will ultimately transform the overall auto industry. We think Chinese auto players have the potential to leapfrog in the future due to:

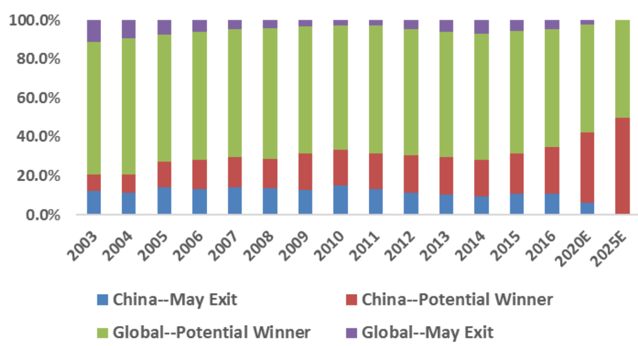
- China is an early bird and a top tier player in the whole supply chain of EV, from materials, battery to OEM.

- China has one of the best infrastructure and environment of information technology (IT). Internet giant in China including Tencent, Alibaba and Baidu are heavily investing in advanced technology including deep learning and big data, in which areas China has ranked in the top tier group in the world.

- Compared with global traditional brands, Chinese auto players have no big burden of sunk cost related to fuel vehicle. They are more open-minded to the new technology and new collaborative partners in IT space.

The local potential winners such as Shanghai Auto, Great Wall Motors, Geely, Guangzhou Auto and BYD, who enjoy strong market positions, will benefit from the consolidation and localization trend in the following years, which will be the key driver of their growth regardless of the overall auto sales (Chart 4).

Chart 4: Consolidation and Localization Trend



Source: Wind, Bin Yuan Capital

We believe that the trends we have described above are long-term trends, not cyclical ones. We expect them to persist in the coming years and to remain to be key aspects of our outlook for China.

Sincerely,

Bin Yuan Capital

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