Bin Yuan Capital – Second Quarter 2017

Market Review

The mainland Chinese stocks recovered in June after dropping for two consecutive months partly contributed by the optimistic sentiment after MSCI's decision to include A-shares into its indexes. In Q2 2017, the Shanghai Composite Index edged down by 0.93% while Hang Seng China Enterprise Index picked by 0.89%.

China's economy maintained stable in the second quarter of 2017. The official manufacturing Purchasing Managers' Index (PMI) rose steadily from 51.2 in April to 51.7 in June and the official non-manufacturing PMI was also up from 54.0 to 54.9 during the same period. The producer price index (PPI) dropped in the second quarter from 6.4% year on year (YoY) in April to 5.5% YoY in May but the readings did not drop further and maintained at 5.5% YoY in June. The consumer price index (CPI) kept its momentum by rising around 1.4% YoY in Q2 2017.

After China continuously upgraded and internationalized its financial market, the global equity indexes provider MSCI finally decided to include China A-shares in the MSCI Emerging Markets Index and the MSCI All Country World Index. The inclusion would promote both A-shares' and H-shares' attractions for international investors and would have a far-reaching effect on the flow of capital to China's equities. Due to the preference of the international investors, the inclusion was especially positive to those Chinese companies with global competitiveness and sustainable growth potentials, which were exactly the focus of our fund's investment targets.

Supported by the country's innovation-driven strategy, China ranked 22 on the 2016 Global Innovation Index released in June. This was the first time for a middle-income country to join the world's top 25 innovative economies. The breakthrough was also evidenced by the 1.01 million patents filed in 2016, according to the data of World Intellectual Property Organization. We expect innovations will continue to contribute to the competences of Chinese companies compared to their global peers.

Performance Attribution

During Q2 2017, our stock selection in Information Technology and Financials performed well while Industrials names lagged. At the stock level, a social media name was the top performer primarily due to the unprecedented hit of its mobile game. 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's traffic barrier is almost impossible to challenge currently and it will continue to extend its dominant leadership in the Chinese internet industry.

China Outlook and Portfolio Positioning

We discussed the issue of capital misallocation in our previous research report "Channel the Capital to the Real Economy February 2016" (Available upon request). Expansionary monetary policy without fundamental economic reform had resulted in liquidity being wasted on the less productive sectors. Tightened financial industry regulation and structural economic reform are needed to reverse this course. During the past two years, the government was determined to tighten the supervision to ensure the long-term stability and safety of financial system and regulators have taken actions to contain the speculative financial leverage, showing their willingness to direct the restructuring of the economy in the right direction.

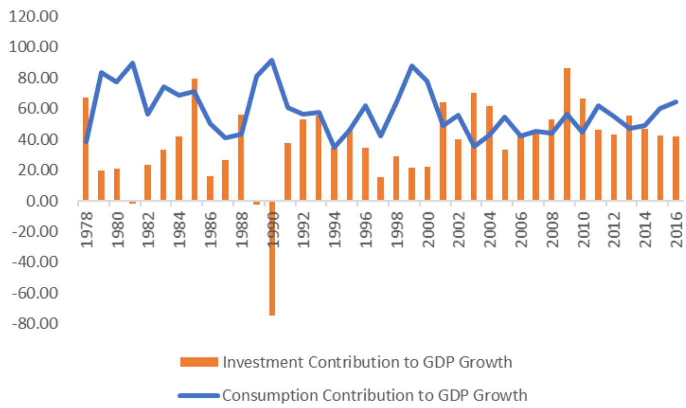
As a result, overall liquidity situation has been and will continue to move towards less expansionary inevitably. Street investors concern that whether the slower growth of liquidity will have a negative impact on economy growth of China.

We believe the volume impact of liquidity on GDP will become less important in China. Efficiency is the factor that matters. Firstly, China's economy structure has been transformed from manufacturing oriented to service oriented, the space which has lighter asset and requires less capital expenditure. Secondly, idle capital was circulated and wasted within financial system in the past. The deleveraging within financial system can help to remove the speculative liquidity loop and re-direct capital back to real economy to work. Thirdly, efficiency of capital use will be improved driven by the shift from bank loan financing to capital market financing.

<u>Less Contribution of Capital Formulation to GDP</u>

Consumption has been the most significant contributor to GDP in the economy nowadays, resulting from the structural trend from manufacturing oriented to service oriented growth.

Chart 1: Contribution to GDP Growth



Source: NBS, Bin Yuan Capital

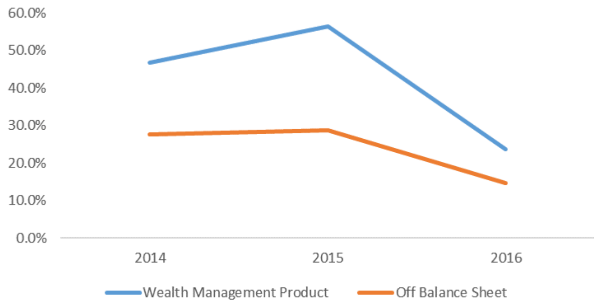
The business model of service sectors is normally asset-light, which requires less capital expenditure. Asset turnover of service space is higher than manufacturing and by nature the gearing level is lower. With service gaining shares in the economy structure, the demands for liquidity per single unit of GDP generated should be lower than the situation in the past.

Deleveraging within financial system

Some financial institutions gained capital return from the mismatched duration by funding long duration assets through short duration liabilities. The yield then might be exaggerated further by adding multiple layers of leveraging, which increased the vulnerability of capital and the risk of overall financial system. The normal way of chasing speculative return is to invest in wealth management products (WMP) and other forms of off-balance sheet items.

The regulators have taken a series of measures, including covering WMP within Macro Prudential Assessment (MPA), to ensure the stability and safety of financial system. As Chart 2 shows, the deleveraging effort has born fruit and overall growth of off-balance sheet items has come down. We think the tight supervision will continue by expanding interbank deposit into MPA, which will help to contain the growth of off-balance sheet items further. The loop of speculative liquidity will be removed and they are encouraged to flow to real economy, especially for high value added and high productive sectors.

Chart 2: Growth Rate of WMP and Off Balance Sheet Items



Source: PBOC, Bin Yuan Capital

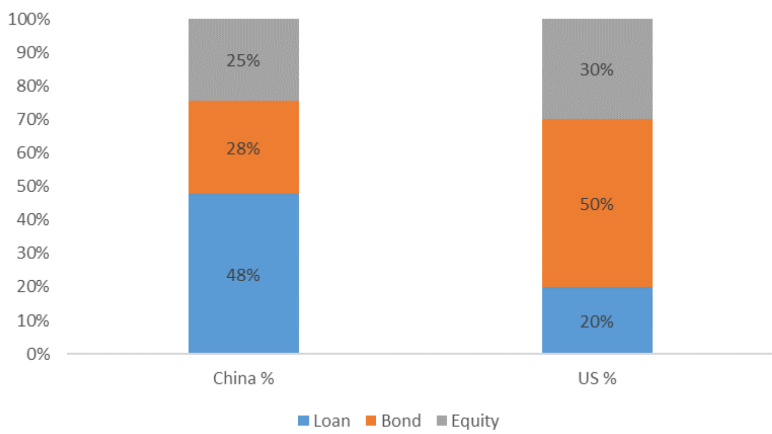
<u>Rising Efficiency of Capital Allocation</u>

Indirect financing is a financing method that relies on intermediary banks to allocate capital. Professional investors of bond and equity, who are purely market driven, are better allocators than banks.

Compared with the US, financing structure of China is skewed to indirect financing bank loans. Based on our analysis (Chart 3), bank loans account for nearly 50% of total financing demands and the ratio in the US only stands at 20% in 2016.

By enforcing the tighter supervision, regulators aimed to maintain the healthiness of financial system and foster the sustainable development of capital market. Financing needs of value added and productive Small and Medium Enterprises (SME) could be met in capital market and the issue of capital misallocation could be well addressed.

Chart 3: Financing Structure Comparison



Source: Wind, Bin Yuan Capital

Conclusion

To sum up, China growth story will continue with quality growth taking over the previous volume expansion. The efficiency of capital use is more important than the volume of liquidity. The market driven reform and tight supervision will facilitate the improvement of efficiency. Stock market, which is the right place to allocate capital, will play crucial role in financing and pave the way for the sustainable development of China economy. Those companies with high ROE and high value added business will attract capital as it could generate high returns to its shareholders, and those high-quality names will be our investment focus.

Sincerely,

Bin Yuan Capital

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